Global edition 20
International GAAP® 2025

Generally Accepted Practice for
IFRS accounting and
IFRS sustainability disclosures

EY International Corporate Reporting Group

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International GAAP® 2025

Generally Accepted Practice for IFRS accounting and IFRS sustainability disclosures

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About this book

2025 Edition

The 2025 edition of *International GAAP®* has been revised to provide expanded guidance by:

- Adding a new chapter that discusses the requirements of IFRS 18 *Presentation and Disclosure in Financial Statements* that will replace IAS 1 *Presentation of Financial Statements* for periods beginning on or after 1 January 2027. This chapter also discusses the overarching concepts of IFRS 19 *Subsidiaries without Public Accountability: Disclosures*, which allows eligible entities to provide reduced disclosures when applying the recognition, measurement and presentation requirements in other IFRS accounting standards.
- Updating the two chapters on IFRS sustainability disclosure standards (namely, IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* and IFRS S2 *Climate-related Disclosures*) by adding real-life examples that illustrate practices that have developed in sustainability reporting, which could help entities considering disclosures required by IFRS sustainability disclosure standards.
- Discussing the new agenda decisions issued by the IFRS Interpretations Committee and the narrow scope amendments proposed by the IASB since the preparation of the 2024 edition.
- Addressing the amendments to IFRS accounting standards and the potential consequential changes to accounting requirements, as well as the many other initiatives that are currently being discussed by the IASB and the ISSB.
- Providing further insight on the many issues relating to the practical application of IFRS accounting standards and IFRS sustainability disclosure standards, based on the extensive experience of the book's authors in dealing with current issues.

The book is published in 53 chapters along with a Supplement on IBOR Reform.

Preface

The International Accounting Standards Board (IASB) which is responsible for the IFRS accounting standards reported in 2023 that 147 of the 168 jurisdictions they had researched require the use of IFRS accounting standards for all or most domestic publicly accountable entities (listed companies and financial institutions) in their capital markets, and a further 12 jurisdictions permit the use of IFRS accounting standards.[i]

In the past few years, the International Sustainability Standards Board (ISSB), which was established in 2021, has taken significant steps towards meeting the needs of global capital markets for a comprehensive global baseline of sustainability disclosure requirements. Sue Lloyd (Vice-Chair of the ISSB) noted in a recent speech that "…only one year after the issuance of our inaugural standards [IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* and IFRS S2 *Climate-related Disclosures*], over 25 jurisdictions are making progress towards the adoption or other use of the ISSB Standards. … we have counted the European Union as one jurisdiction rather than 27. And to give you a sense of the reach of the jurisdictions covered they represent more than 40 percent of global market capitalisation and more than 50 percent of global GHG emissions."[ii] This represents a considerable achievement by all concerned and represents tangible progress towards significantly greater consistency in sustainability reporting.

This edition of International GAAP now covers the ISSB sustainability disclosure standards in two separate chapters on the general requirements of IFRS S1 and climate-related disclosures of IFRS S2. In addition, the chapters on the IFRS accounting standards cover issues related to accounting for climate change and considerations regarding disclosures of climate-related and other uncertainties in the financial statements.

Under the governance of the IFRS Foundation, the IASB and ISSB work closely together to ensure connectivity and compatibility between IFRS accounting standards and ISSB sustainability disclosure standards. IFRS S1 requires information about the current and anticipated effects of sustainability-related risks and opportunities on an entity's financial position, financial performance and cash flows. This requirement represents a specific application of connected information between sustainability-related financial disclosures and the related financial statements of an entity. An entity is required to align data and assumptions to the extent possible by taking into consideration the requirements in IFRS accounting standards. Furthermore, the IASB explicitly considers connectivity in developing its accounting standards. Andreas Barckow (Chair of the IASB) noted recently that "The IASB is working closely with the ISSB to address the growing demand for connectivity. There has been a shift in perspective on the role of financial statements within the broader corporate reporting system. Although financial statements have traditionally been viewed as the central focus of corporate reporting, the rise of sustainability reporting and the formation of the ISSB have created new expectations for reporting that connects financial and sustainability-related information to meet investor needs."[iii]

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i Media release: *Who uses IFRS Accounting Standards?*, September 2023. Available on the IFRS Foundation website.

ii Speech: *Sue Lloyd delivers speech at World Standard-setters Conference 2024*, by Sue Lloyd, 23 September 2024. Available on the IFRS Foundation's website.

iii Speech: *Complexity in focus*, by Andreas Barckow, 26 June 2024. Available on the IFRS Foundation's website.

New IFRS accounting standards

In the past year, the IASB published several new IFRS accounting standards, amendments, and interpretations that have been included in this edition of International GAAP.

IFRS 18 *Presentation and Disclosure in Financial Statements*, issued in April 2024, is aimed at improving comparability and transparency of communication in financial statements and requires an entity to classify all income and expenses within its statement of profit or loss into one of five categories: operating; investing; financing; income taxes; and discontinued operations. It also requires disclosure of management-defined performance measures and includes new requirements for aggregation and disaggregation of financial information based on the identified 'roles' of the primary financial statements and the notes.

IFRS 19 *Subsidiaries without Public Accountability: Disclosures*, issued in May 2024, permits eligible entities to elect to apply IFRS 19's reduced disclosure requirements while still applying the recognition, measurement and presentation requirements in other IFRS accounting standards.

The IASB finalised its maintenance projects on the classification and measurement of financial instruments (amendments to IFRS 9 *Financial Instruments* and IFRS 7 *Financial Instruments: Disclosures*) and annual improvements volume 11.

The IFRS Interpretations Committee published agenda decisions on the merger between a parent and its subsidiary in separate financial statements, climate-related commitments, payments contingent on continued employment during handover periods, and disclosure of revenues and expenses for reportable segments. While limited in scope, the amendments and agenda decisions provide welcome clarifications that ensure consistent application of IFRS accounting standards.

Current work plan

The IASB is currently working on the projects in its work plan for the period from 2022 until 2026, which can be divided into four elements: standard-setting, research, application questions, and maintenance.

A new standard resulting from the project on rate-regulated activities, which affects a more limited group of preparers, is now expected to be published in the second half 2025. The remaining standard-setting projects – equity method, financial instruments with characteristics of equity, dynamic risk management, management commentary, and business combinations—disclosures, goodwill and impairment – could significantly change financial reporting for many companies in the future. The management commentary project is expected to result in a revised practice statement in the first half of 2025, the other projects currently on the IASB's active agenda are expected to be completed in 2026 or thereafter.

The IASB also has four projects on its active research agenda: amortised cost measurement; intangible assets; post-implementation review of IFRS 16 *Leases*; and statement of cash flows and related matters. The IASB decided not to proceed with its projects on business combinations under common control and the project on extractive activities.

The IASB's application questions and maintenance projects largely focus on narrow-scope projects that address certain aspects of existing IFRS accounting standards. However, the maintenance projects on climate-related and other uncertainties in the financial statements, power purchase agreements, and provisions–targeted improvements address a broader set of issues related to climate change and the energy transition. The IASB aims to address stakeholders' concerns about the inconsistent application of IFRS accounting standards to the reporting of climate-related risks in the financial statements and disclosure of insufficient information about climate-related risks. These concerns are being addressed by exploring the development of illustrative examples and narrow-scope standard-setting.

The IASB's current work plan is covered in detail in separate future developments sections in each of the chapter affected.

International GAAP® 2025

This edition of *International GAAP®* covers the many interpretations, practices and solutions that have now been developed based on our work with clients, and discussions with regulators, standard-setters and other professionals. We believe that *International GAAP®*, now in its twentieth edition, plays an important role in ensuring consistent application of IFRS accounting standards and IFRS sustainability disclosure standards and helping companies as they address emerging issues (e.g., accounting for and disclosure of the impact of climate change and related legislation). These issues are complex and give rise to many practical financial reporting and sustainability questions about a variety of recognition, measurement, presentation and disclosure requirements.

Contributors

Our team of authors and reviewers hails from all parts of the world and includes not only our global technical experts but also senior client-facing professionals. This gives us an in-depth knowledge of practice in many different countries and industry sectors, enabling us to go beyond mere recitation of the requirements of standards to explaining their application in many varied situations.

We are deeply indebted to many of our colleagues within the global organisation of EY for their selfless assistance and support in the publication of this book. It has been a truly international effort, with valuable contributions from EY people around the globe.

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Abbreviations

The following abbreviations are used in this book:

Professional and regulatory bodies:

AASB	Australian Accounting Standards Board
AcSB	Accounting Standards Board of Canada
AICPA	American Institute of Certified Public Accountants
AOSSG	Asian–Oceanian Standard–Setters Group
APB	Accounting Principles Board (of the AICPA, predecessor of the FASB)
ARC	Accounting Regulatory Committee of representatives of EU Member States
ASAF	Accounting Standards Advisory Forum
ASB	Accounting Standards Board in the UK
ASBJ	Accounting Standards Board of Japan
ASU	Accounting Standards Update
CASC	China Accounting Standards Committee
CDSB	Climate Disclosure Standards Board
CESR	Committee of European Securities Regulators, an independent committee whose members comprised senior representatives from EU securities regulators (replaced by ESMA)
CICA	Canadian Institute of Chartered Accountants
EC	European Commission
ECB	European Central Bank
ECOFIN	The Economic and Financial Affairs Council
EDTF	Enhanced Disclosure Task Force of the (FSB)
EFRAG	European Financial Reporting Advisory Group
EITF	Emerging Issues Task Force in the US
EPRA	European Public Real Estate Association
ESMA	European Securities and Markets Authority (see CESR)
EU	European Union
FAF	Financial Accounting Foundation
FASB	Financial Accounting Standards Board in the US
FCAG	Financial Crisis Advisory Group
FEE	Federation of European Accountants
FSB	Financial Stability Board (successor to the FSF)
FSF	Financial Stability Forum
G4+1	The (now disbanded) group of four plus 1, actually with six members, that comprised an informal 'think tank' of staff from the standard setters from Australia, Canada, New Zealand, UK, and USA, plus the IASC
G7	The Group of Seven Finance Ministers (successor to G8)

G8	The Group of Eight Finance Ministers
G20	The Group of Twenty Finance Ministers and Central Bank Governors
GPPC	Global Public Policy Committee of the six largest accounting networks
GRI	Global Reporting Initiative
HKICPA	Hong Kong Institute of Certified Public Accountants
IASB	International Accounting Standards Board, or the Board
IASC	International Accounting Standards Committee. The former Board of the IASC was the predecessor of the IASB
IASCF	International Accounting Standards Committee Foundation (predecessor of the IFRS Foundation)
ICAEW	Institute of Chartered Accountants in England and Wales
ICAI	Institute of Chartered Accountants of India
ICAS	Institute of Chartered Accountants of Scotland
IFAC	International Federation of Accountants
IFASS	International Forum of Accounting Standard Setters
IFRS IC	The IFRS Interpretations Committee (formerly the International Financial Reporting Interpretations Committee (IFRIC)) of the IASB
IGC	Implementation Guidance Committee on IAS 39 (now disbanded)
IOSCO	International Organisation of Securities Commissions
IPSASB	International Public Sector Accounting Standards Board
IPTF	International Practices Task Force (a task force of the SEC Regulations Committee)
ISDA	International Swaps and Derivatives Association
ISSB	International Sustainability Standards Board
ITG	IFRS Transition Resource Group for Impairment of Financial Instruments
IVSC	International Valuation Standards Council
KASB	Korea Accounting Standards Board
RICS	Royal Institution of Chartered Surveyors
SAC	Standards Advisory Council, predecessor of the IFRS Advisory Council which provides advice to the IASB on a wide range of issues
SASB	Sustainability Accounting Standards Board
SEC	Securities and Exchange Commission (the US securities regulator)
SIC	Standing Interpretations Committee of the IASC (replaced by IFRIC)
TCFD	Taskforce for Climate-related Disclosures
TEG	Technical Expert Group, an advisor to the European Commission
TIG	Transition Implementation Group
TPT	Transition Plan Taskforce
TRG	Joint Transition Resource Group for Revenue Recognition

Accounting and sustainability related terms:

ADS	American Depositary Shares
AFS	Available-for-sale investment
ARB	Accounting Research Bulletins (issued by the AICPA)
ARS	Accounting Research Studies (issued by the APB)
ASC	Accounting Standards Codification®. The single source of authoritative US GAAP recognised by the FASB, to be applied to non-governmental entities for interim and accounting periods ending after 15 September 2009
ASU	Accounting Standards Update
BCUCC	Business Combinations Under Common Control
CCIRS	Cross Currency Interest Rate Swap
CDO	Collateralised Debt Obligation
CLO	Collateralized Loan Obligation
CF	Conceptual Framework
CGU	Cash-generating Unit
CO_2	Carbon dioxide
CO_2e	Carbon dioxide equivalent
CU	Currency Unit
DD&A	Depreciation, Depletion and Amortisation
DPF	Discretionary Participation Feature
E&E	Exploration and Evaluation
EBIT	Earnings Before Interest and Taxes
EBITDA	Earnings Before Interest, Taxes, Depreciation and Amortisation
EIR	Effective Interest Rate
EPS	Earnings per Share
ESRS	European Sustainability Reporting Standards
FAS	Financial Accounting Standards (issued by the FASB). Superseded by Accounting Standards Codification® (ASC)
FC	Foreign currency
FICE	Financial Instruments with the Characteristics of Equity
FIFO	First-In, First-Out basis of valuation
FRS	Financial Reporting Standard (issued by the ASB)
FTA	First-time Adoption
FVLCD	Fair value less costs of disposal
FVLCS	Fair value less costs to sell (following the issue of IFRS 13, generally replaced by FVLCD)
FVPL	Fair value through profit and loss
FVOCI	Fair value through other comprehensive income
GAAP	Generally accepted accounting practice (as it applies under IFRS), or generally accepted accounting principles (as it applies to the US)
GHG	Greenhouse gas
GWP	Global warming potential
HTM	Held-to-maturity investment
IAS	International Accounting Standard (issued by the former board of the IASC)
IBOR	Interbank Offered Rate
IBNR	Incurred but not reported claims

IFRS	International Financial Reporting Standard
IFRS for SMEs	IFRS Accounting Standards for Small and Medium-sized Entities
IGC Q&A	Implementation guidance to the original version of IAS 39 (issued by the IGC)
IPO	Initial Public Offering
IPR&D	In-process Research and Development
IPSAS	International Public Sector Accounting Standard
IRR	Internal Rate of Return
IRS	Interest Rate Swap
JA	Joint Arrangement
JCA	Jointly Controlled Asset
JCE	Jointly Controlled Entity
JCO	Jointly Controlled Operation
JO	Joint Operation
JV	Joint Venture
LAT	Liability Adequacy Test
LC	Local Currency
LIBOR	London Inter Bank Offered Rate
LIFO	Last-In, First-Out basis of valuation
NBV	Net Book Value
NCI	Non-controlling Interest
NPV	Net Present Value
NRV	Net Realisable Value
OCI	Other Comprehensive Income
PP&E	Property, Plant and Equipment
R&D	Research and Development
SCA	Service Concession Arrangement
SE	Structured Entity
SFAC	Statement of Financial Accounting Concepts (issued by the FASB as part of its conceptual framework project)
SFAS	Statement of Financial Accounting Standards (issued by the FASB). Superseded by Accounting Standards Codification® (ASC)
SME	Small or medium-sized entity
SPAC	Special Purpose Acquisition Company
SPE	Special Purpose Entity
SPE-PRMS	Society of Petroleum Engineers – Petroleum Resources Management System
SPPI	Solely Payments of Principal and Interest
SV	Separate Vehicle
TLTRO	Targeted Longer-Term Refinancing Operation
TSR	Total Shareholder Return
VIU	Value In Use
WACC	Weighted Average Cost of Capital

References to IFRSs, IASs, Interpretations and supporting documentation:

AG	Application Guidance
AV	Alternative View
BCZ	Basis for Conclusions on IASs
BC	Basis for Conclusions
DI	Draft Interpretation
DO	Dissenting Opinion
DP	Discussion Paper
ED	Exposure Draft
IE	Illustrative Examples on IFRSs and IASs
IG	Implementation Guidance
IN	Introduction to IFRSs and IASs
PIR	Post-implementation Review

Authoritative literature

The content of this book takes into account all accounting standards and other relevant rules issued up to September 2024. Consequently, it covers the IASB's *Conceptual Framework for Financial Reporting* and authoritative literature listed below.

References in the main text of each chapter to the pronouncements below are generally to the versions of those pronouncements as approved and expected to be included in the Blue Book edition of the Bound Volume 2025 IFRS Accounting Standards – Consolidated without early application – Official pronouncements applicable on 1 January 2025, to be published by the IASB.

References to those pronouncements below which have an effective date after 1 January 2025 are to the versions of those pronouncements that are expected to be included in the Red Book edition of the Bound Volume 2024 IFRS Accounting Standards – Official pronouncements issued at 1 January 2025, to be published by the IASB.

US GAAP accounting standards are organised within a comprehensive FASB Accounting Standards Codification©, which is now the single source of authoritative US GAAP recognised by the FASB to be applied to non-governmental entities and has been applied in this publication.

† The standards and interpretations marked with a dagger have been withdrawn or superseded.

IASB Conceptual Framework	
	The Conceptual Framework for Financial Reporting
International Financial Reporting Standards (2024 Bound Volume)	
IFRS 1	First-time Adoption of International Financial Reporting Standards
IFRS 2	Share-based Payment
IFRS 3	Business Combinations
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations
IFRS 6	Exploration for and Evaluation of Mineral Resources
IFRS 7	Financial Instruments: Disclosures
IFRS 8	Operating Segments
IFRS 9	Financial Instruments
IFRS 10	Consolidated Financial Statements
IFRS 11	Joint Arrangements
IFRS 12	Disclosure of Interests in Other Entities
IFRS 13	Fair Value Measurement
IFRS 14	Regulatory Deferral Accounts
IFRS 15	Revenue from Contracts with Customers
IFRS 16	Leases
IFRS 17	Insurance Contracts
IFRS 18	Presentation and Disclosure in Financial Statements
IFRS 19	Subsidiaries without Public Accountability: Disclosures

International Accounting Standards (2023 Bound Volume)

IAS 1	Presentation of Financial Statements
IAS 2	Inventories
IAS 7	Statement of Cash Flows
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors
IAS 10	Events after the Reporting Period
IAS 12	Income Taxes
IAS 16	Property, Plant and Equipment
IAS 19	Employee Benefits
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance
IAS 21	The Effects of Changes in Foreign Exchange Rates
IAS 23	Borrowing Costs
IAS 24	Related Party Disclosures
IAS 26	Accounting and Reporting by Retirement Benefit Plans
IAS 27	Separate Financial Statements
IAS 28	Investments in Associates and Joint Ventures
IAS 29	Financial Reporting in Hyperinflationary Economies
IAS 32	Financial Instruments: Presentation
IAS 33	Earnings per Share
IAS 34	Interim Financial Reporting
IAS 36	Impairment of Assets
IAS 37	Provisions, Contingent Liabilities and Contingent Assets
IAS 38	Intangible Assets
IAS 39	Financial Instruments: Recognition and Measurement
IAS 40	Investment Property
IAS 41	Agriculture

IFRS Interpretations Committee Interpretations

IFRIC 1	Changes in Existing Decommissioning, Restoration and Similar Liabilities
IFRIC 2	Members' Shares in Co-operative Entities and Similar Instruments
IFRIC 5	Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
IFRIC 6	Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment
IFRIC 7	Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies
IFRIC 10	Interim Financial Reporting and Impairment
IFRIC 12	Service Concession Arrangements
IFRIC 14	IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction
IFRIC 16	Hedges of a Net Investment in a Foreign Operation
IFRIC 17	Distributions of Non-cash Assets to Owners
IFRIC 19	Extinguishing Financial Liabilities with Equity Instruments
IFRIC 20	Stripping Costs in the Production Phase of a Surface Mine
IFRIC 21	Levies
IFRIC 22	Foreign Currency Transactions and Advance Consideration
IFRIC 23	Uncertainty over Income Tax Treatments

Standing Interpretations Committee Interpretations

SIC-7	Introduction of the Euro
SIC-10	Government Assistance – No Specific Relation to Operating Activities
SIC-25	Income Taxes – Changes in the Tax Status of an Entity or its Shareholders
SIC-29	Service Concession Arrangements: Disclosures
SIC-32	Intangible Assets – Web Site Costs

IASB Exposure Drafts

ED/2021/1	Regulatory Assets and Regulatory Liabilities
ED/2021/6	Management Commentary
ED/2023/5	Financial Instruments with Characteristics of Equity
ED/2024/1	Business Combinations – Disclosures, Goodwill and Impairment
ED/2024/3	Contracts for Renewable Electricity
ED/2024/4	Translation to a Hyperinflationary Presentation Currency
ED/2024/5	Amendments to IFRS 19 *Subsidiaries without Public Accountability: Disclosures*
ED/2024/6	Climate-related and Other Uncertainties in the Financial Statements
ED/2024/7	Equity Method of Accounting

IASB Discussion Papers

DP/2014/1	Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging

Other IASB publications

IFRS for SMEs	International Financial Reporting Standard (IFRS) for Small and Medium-sized Entities (SMEs)
Practice Statement 1	Management Commentary
Practice Statement 2	Making Materiality Judgements

IFRS sustainability disclosure standards

IFRS S1	General Requirements for Disclosure of Sustainability-related Financial Information
IFRS S2	Climate-related Disclosures

Chapter 1 International GAAP

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Overview

This chapter discusses the structure and governance of the IFRS Foundation (Foundation) and the International Accounting Standards Board (IASB), the technical agenda of the IASB and the adoption of IFRS accounting standards around the world.

IFRS accounting standards have become widely adopted in capital markets worldwide in the past two decades and is now a globally recognised accounting framework. To support the development of a single set of high-quality, understandable, enforceable and globally accepted accounting standards and to promote and facilitate the adoption of the standards, a governance structure has been put in place for this global initiative involving a wide variety of stakeholders including preparers, users, standard-setters, auditors, academics, and regulators. IFRS accounting standard setting activities are subject to the due process to ensure transparency and accountability. However, convergence with other national accounting frameworks is no longer a significant driver of the agenda setting process.

The manner in which IFRS accounting standards are adopted varies across jurisdictions. Instead of the full adoption of IFRS accounting standards, some jurisdictions have converged, or have a plan to converge, their standards with IFRS accounting standards. To maximise the benefits from using a consistent set of accounting standards by companies throughout the world, IFRS accounting standards need to be applied, audited and enforced on a consistent basis in each jurisdiction.

More recently, the Trustees of the Foundation (Trustees) have established the International Sustainability Standards Board (ISSB) to set IFRS sustainability disclosure standards within the existing governance structure.

What you need to know

- IFRS accounting standards are required for all or most domestic publicly accountable entities (e.g., listed companies) in the capital markets of 147 jurisdictions.
- The development of IFRS accounting standards is supported by the standard-setting structure and governance.
- The remit of the Foundation has been expanded to include setting IFRS sustainability disclosure standards.

1 Why international financial reporting standards matter

With globalisation has come the increasing integration of world markets for goods, services and capital- with the result that companies that traditionally were reliant on their domestic capital markets for financing now have substantially increased access to debt and equity capital, both inside and outside their national borders.

Yet - perhaps not entirely surprisingly - the world of financial reporting was slow to respond reflecting, no doubt, a widespread nationalism in respect of countries' own standards.

Undoubtedly, one of the main advantages of a single set of global accounting standards is that it would enable the international capital markets to assess and compare inter-company performance in a much more meaningful, effective and efficient way. This should increase companies' access to global capital and ultimately reduce the cost thereof. Thus, the request for global standards came both from regulatory bodies and from preparers of financial statements. As early as 1989, the International Organisation of Securities Commissions (IOSCO), the world's primary forum for co-operation among securities regulators, prepared a paper noting that cross border security offerings would be facilitated by the development of internationally accepted standards. For preparers, greater comparability in financial reporting with their global peers had obvious attractions.

Notwithstanding these anticipated benefits, it has only been since 2000 that there has been a serious effort made toward such global standards. This came about largely as a result of the European Commission's announcement in June 2000 that it would present proposals to introduce the requirement that all listed European Union (EU) companies report in accordance with International Accounting Standards by 2005. This requirement not only changed the face of European financial reporting, but global reporting as well after many other countries followed Europe's lead. Indeed, the Foundation reports that 147 jurisdictions require IFRS accounting standards for all or most domestic publicly accountable entities (e.g., listed companies) in their capital markets.[1]

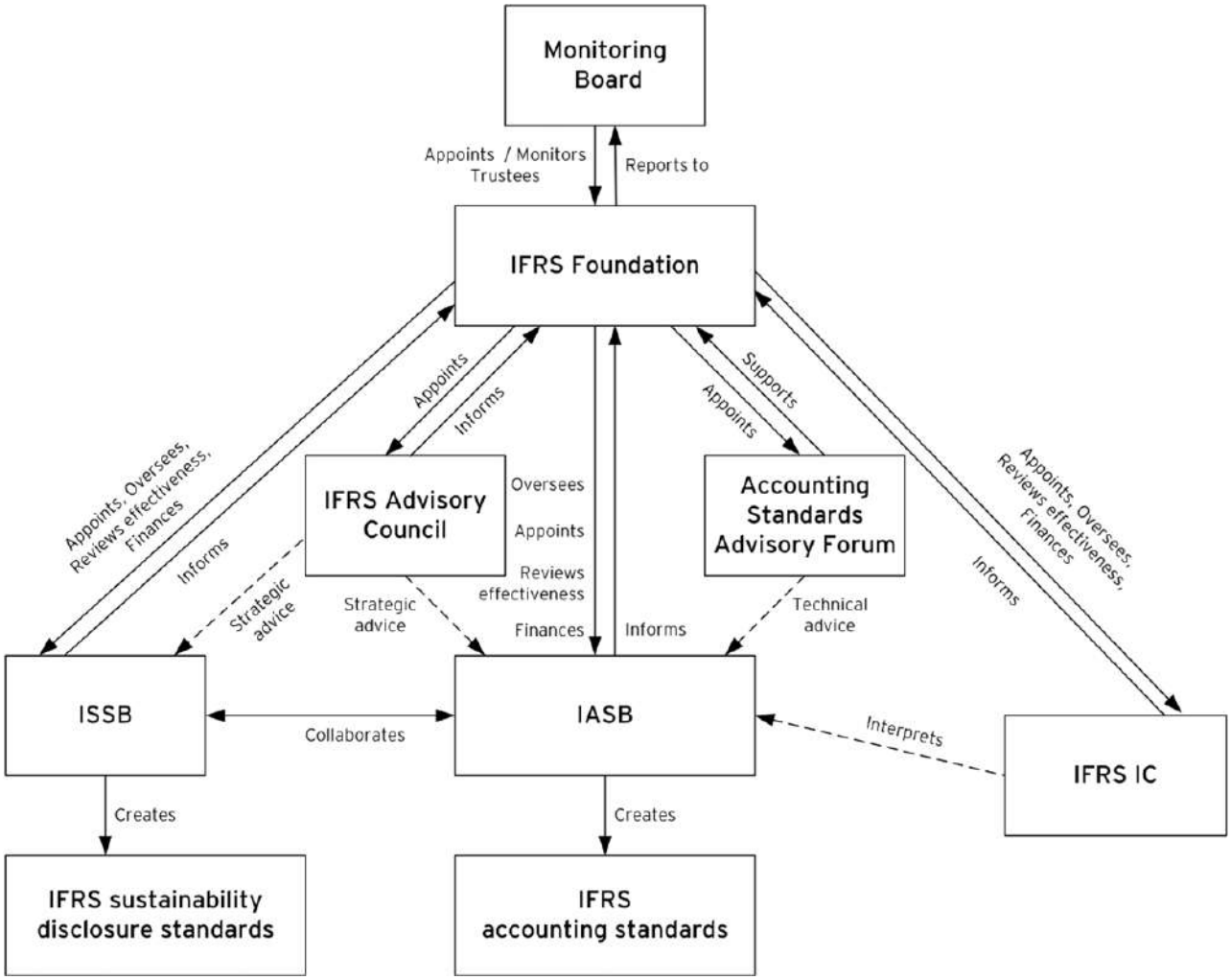
Thus, global financial reporting has ceased to be characterised by numerous disparate national systems to the point at which there are today essentially only two - IFRS accounting standards and US GAAP.

1 IFRS - Who uses IFRS Accounting Standards?, available on IFRS Foundation's website (accessed 19 July 2024).

2 The IFRS Foundation and the IASB

2.1 The standard-setting structure

The diagram below illustrates the structure within which IFRS accounting standards are set.



The various elements of the structure are discussed further below.

Unless indicated otherwise, references to IFRS accounting standards include the following:

- International Financial Reporting Standards - accounting standards developed by the IASB
- International Accounting Standards (IAS) - accounting standards developed by the International Accounting Standards Committee (IASC), the predecessor to the IASB
- Interpretations developed by the IFRS IC or its predecessor, the Standing Interpretations Committee (SIC)

  And

- International Financial Reporting Standards for Small and Medium-sized Entities (IFRS for SMEs) - a stand-alone accounting standard for general purpose financial statements of small and medium-sized entities (as defined)

Refer to section 2.10 below on further discussion on the recent establishment of the ISSB.

2.2 The IFRS Foundation

The governance of the Foundation primarily rests with the Trustees who, in turn, act under the terms of the IFRS Foundation *Constitution* (the Constitution).[2] Section 18 of the Constitution requires a review, every five years, of the structure and effectiveness of the Foundation. The last review was completed in September 2021 and, as a result, the Constitution was revised in the same year. The amendments were made to establish the ISSB under the Foundations' governance and to reflect the intended interconnectivity between the IASB and the ISSB.[3]

It is a requirement of the Constitution that, in order to ensure a broad international basis, there must be:[4]

- Six Trustees appointed from the Asia/Oceania region
- Six Trustees appointed from Europe
- Six Trustees appointed from the Americas
- One Trustee appointed from Africa

  And
- Three Trustees appointed from any area, subject to maintaining overall geographical balance

The appointment of Trustees to fill vacancies caused by routine retirement or other reasons is the responsibility of the remaining Trustees but subject to the approval of the Monitoring Board as discussed in section 2.3 below. The appointment of the Trustees is normally for a term of three years, renewable once.[5]

The Constitution requires that the Trustees comprise individuals that, as a group, provide a balance of professional backgrounds, and have an interest in promoting and maintaining transparency in corporate reporting globally. This includes individuals with global experience at a senior level in securities market regulators, firms representing investors, international audit networks, preparers, users, academics and officials serving the public interest. To achieve such a balance, Trustees are selected after consultation with the accounting and audit profession, the securities market and other public interest bodies, regulators, investors, preparers, users and academics. The Trustees are required to establish procedures for inviting suggestions for appointments from these relevant organisations and for allowing individuals to put forward their own names, including advertising vacant positions.[6]

The Constitution provides that "all Trustees shall be required to show a firm commitment to the Foundation and the IASB and the ISSB as a high quality global standard-setter, to be financially knowledgeable, and to have an ability to meet the time commitment. Each Trustee shall have an understanding of, and be sensitive to, the challenges associated with the adoption and application of high quality global accounting standards developed for use in the world's capital markets and by other users".[7]

The Trustees are responsible also for appointing the members of the IASB, ISSB, IFRS IC, IFRS Advisory Council (the Advisory Council)[8] and the Accounting Standards Advisory Forum (ASAF).[9] In addition, their duties include the following:[10]

- Appointing the Executive Director, in consultation with the IASB and ISSB Chairs, and establishing his or her contract of service and performance criteria.
- Reviewing annually the strategy of the Foundation, the IASB and the ISSB and its effectiveness, including consideration, but not determination, of the IASB's and ISSB's agenda.
- Assuming responsibility for establishing and maintaining appropriate financing arrangements.
- Approving annually the budget of the Foundation and determining the basis for funding.
- Reviewing broad strategic issues affecting corporate reporting standards, promoting the Foundation and its work and promoting the objective of rigorous application of IFRS accounting and sustainability disclosure standards, provided that the Trustees are excluded from involvement in technical matters relating to corporate reporting standards.

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2 IFRS Foundation *Constitution*, November 2021, Section 4.

3 *Summary of October 2021 meeting*, IFRS Foundation Trustees, available on the IFRS Foundation's website (accessed on 19 July 2024).

4 IFRS Foundation *Constitution*, November 2021, Section 7.

5 IFRS Foundation *Constitution*, November 2021, Section 9.

6 IFRS Foundation *Constitution*, November 2021, Section 8.

7 IFRS Foundation *Constitution*, November 2021, Section 7.

8 IFRS Foundation *Constitution*, November 2021, Sections 16(a) and (c).

9 Accounting Standards Advisory Forum: Terms of Reference/Charter.

10 IFRS Foundation *Constitution*, November 2021, Sections 14 and 16.

- Establishing or amending operating procedures for the Trustees.
- Establishing and amending operating procedures, consultative arrangements and due process for the IASB, the ISSB, IFRS IC and the Advisory Council and reviewing their compliance.
- Approving amendments to the Constitution after following a due process, including consultation with the Advisory Council and publication of an exposure draft for public comment and subject to the voting requirements given in the Constitution.
- Exercising all powers of the Foundation except for those expressly reserved to the IASB, the ISSB, the IFRS IC and the Advisory Council.
- Fostering and reviewing the development of educational programmes and materials that are consistent with the Foundation's objectives.

  And
- Publishing an annual report on the Foundation's activities, including audited financial statements and priorities for the coming year.

The majority of the Foundation's funding is from voluntary contributions, including ISSB seed funding, contributions from jurisdictions, philanthropic grants and contributions from companies. Most jurisdictions have established either a levy on companies or a system of publicly supported financing, although funding mechanisms differ. In addition, earned revenue comes from licensing intellectual property. Licensing agreements allow companies and other entities to use IFRS accounting and sustainability disclosure standards for translation, publication or commercial use.[11] In 2023, the major funders of the Foundation were Canada, Germany and the People's Republic of China.[12]

2.3 The Monitoring Board

The Monitoring Board provides a formal link between the Trustees and public authorities. This relationship seeks to replicate, on an international basis, the link between accounting standard-setters and those public authorities that have generally overseen accounting standard-setters.[13]

The Charter of the Monitoring Board notes that the Monitoring Board's mission is:[14]

- To cooperate, to promote the continued development of IFRS accounting and sustainability disclosure standards as a high-quality set of global standards.
- To monitor and reinforce the public interest oversight function of the Foundation, while preserving the independence of the IASB and the ISSB. In that regard:
  - To participate in the selection and approval of the Trustee appointments.
  - To advise the Trustees with respect to the fulfilment of their responsibilities, in particular with respect to regulatory, legal and policy developments that are pertinent to the Foundation's oversight of the IASB and ISSB and appropriate sources of Foundation funding.

    And
  - To discuss issues and share views relating to IFRS accounting and sustainability disclosure standards, as well as regulatory and market developments affecting the development and functioning of these standards.

11 *Who we are*, available on IFRS Foundation's website (accessed 19 July 2024).

12 IFRS Foundation Annual Report 2023, IFRS Foundation, 2024.

13 IFRS Foundation *Constitution*, November 2021, Section 19.

14 Charter of the IFRSF Monitoring Board, 2023.

The responsibilities of the Monitoring Board are to:[15]

- Participate in the process for appointing Trustees and approve the appointment of Trustees.
- Review and provide advice to the Trustees on the fulfilment of their responsibilities - there is an obligation on the Trustees to report annually to the Monitoring Board.

  And

- Meet with the Trustees or a sub-group thereof at least annually; the Monitoring Board has the authority to request meetings with the Trustees or separately with the chair of the Trustees and with the chair of the IASB and the ISSB to discuss any area of the work of the Trustees, the IASB or the ISSB.

At the time of writing, the Monitoring Board comprises representatives of:[16]

- The IOSCO Board
- The IOSCO Growth and Emerging Markets Committee
- The Financial Services Agency, Japan
- The European Commission
- The Securities and Exchange Commission, United States of America (US SEC)
- The Comissão de Valores Mobiliários, Brazil
- The Financial Services Commission, Republic of Korea
- The Ministry of Finance, People's Republic of China
- The Financial Conduct Authority (FCA) of the United Kingdom

  And

- The Basel Committee on Banking Supervision (observer)

The current chairman is the representative of the Financial Services Agency, Japan. Membership of the Monitoring Board is assessed based on the following criteria:[17]

- The member must be a capital market authority responsible for setting the form and content of financial reporting in its jurisdiction.
- The jurisdiction has made a clear commitment to moving towards application of IFRS accounting standards and promoting global acceptance of a single set of high-quality international accounting standards as the final goal.
- The IFRS accounting standards to be applied should be essentially aligned with IFRS accounting standards developed by the IASB.
- The jurisdiction is considering the use of the IFRS sustainability disclosure standards according to its own legal frameworks for adopting, applying or otherwise making use of international standards.
- The jurisdiction is committed to contributing to interoperability between its domestic standards and the IFRS sustainability disclosure standards.
- The jurisdiction can be regarded as a major market for capital-raising based on the size of market capitalisation, the number of listed companies and capital market activity.
- The jurisdiction makes financial contributions to setting IFRS accounting standards.
- The jurisdiction has a robust enforcement mechanism to ensure proper implementation of relevant accounting standards.

  And

- The relevant national or regional standard-setting body is committed to contributing actively to the development of IFRS accounting standards.

Historically the motivation for the use of IFRS accounting standards was to facilitate cross-border capital raising and, therefore, the membership of the Monitoring Board was focused on capital markets authorities that were committed to the development of high-quality global accounting standards. While this continues to be a criterion for membership, beginning from the 2016 review of its members, the Monitoring Board will evaluate the integration of IFRS accounting standards for domestic issuers in that member's jurisdiction.[18]

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15 IFRS Foundation *Constitution*, November 2021, Section 20.

16 Monitoring Board Members, available on IOSCO's website (accessed 19 July 2024).

17 Charter of the IFRSF Monitoring Board, 2023, Appendix A.

18 IFRS Foundation Monitoring Board Press Release, *Monitoring Board finalizes assessment approach for membership criteria and announces Chair selection*, 1 March 2013.

2.4 The International Accounting Standards Board (IASB)

Members of the IASB are appointed by the Trustees.[19] Currently, the IASB comprises 14 members. The main qualifications for membership of the IASB are professional competence and recent relevant professional experience.[20]

The Trustees are required to select IASB members so that the IASB, as a group, will comprise the best available combination of technical expertise and diversity of international business and market experience, including auditors, preparers, users, academics and market and/or financial regulators. No individual should be both, a Trustee and a member of the IASB at the same time.[21] Furthermore, the IASB, in consultation with the Trustees, is expected to establish and maintain liaison with national standard-setters and other official bodies concerned with standard-setting to assist in the development of IFRS accounting standards and to promote the convergence of national accounting standards and IFRS accounting standards.[22]

The IASB will normally be required to comprise:[23]

- Four members from Asia/Oceania
- Four members from Europe
- Four members from the Americas
- One member from Africa

  And
- One member appointed from any area, subject to maintaining overall geographical balance

The responsibilities of the IASB are listed in Section 37 of the Constitution. Its primary role is to have complete responsibility for all IASB technical matters including preparing and issuing IFRS accounting standards (other than interpretations) and exposure drafts, each of which is required to include any dissenting opinions; and final approval of and issuing interpretations developed by the IFRS IC.[24]

Approval by at least eight members of the IASB is required for the publication of an exposure draft and IFRS accounting standards (which includes final interpretations of the IFRS IC), if there are fewer than 14 members of the IASB. If there are 14 members, approval is required by at least nine members.[25] Other decisions of the IASB, including the publication of a discussion paper, require a simple majority of the members present at a meeting that is attended by at least 60% of the members.[26] The IASB has full discretion over its technical agenda and over project assignments on technical matters. It must, however, consult the Trustees on its agenda, and the Advisory Council on major projects, agenda decisions and work priorities. In addition, the IASB is required to carry out public consultation every five years in developing its technical agenda.[27] The IASB is also required to establish procedures in order to achieve the objective of developing IFRS accounting standards that are compatible, and avoid inconsistences and conflicts, with IFRS sustainability disclosure standards issued by the ISSB.[28]

The IASB meets monthly, but not in August. These meetings are open to the public and meeting materials are available on the IASB's website.

2.4.1 Agenda consultation

As discussed above, under the Constitution, the IASB is required to carry out a public consultation on its technical agenda every five years from the date of the most recent public agenda consultation. The objective of this agenda consultation is to gather views on:

- The strategic direction and balance of the IASB's activities
- The criteria for assessing the priority of financial reporting issues that could be added to the work plan

  And
- New financial reporting issues that could be given priority in the IASB's work plan

19 IFRS Foundation *Constitution*, November 2021, Section 25.

20 IFRS Foundation *Constitution*, November 2021, Section 26.

21 IFRS Foundation *Constitution*, November 2021, Section 26.

22 IFRS Foundation *Constitution*, November 2021, Section 28.

23 IFRS Foundation *Constitution*, November 2021, Section 27.

24 IFRS Foundation *Constitution*, November 2021, Section 37(a).

25 IFRS Foundation *Constitution*, November 2021, Section 36.

26 IFRS Foundation *Constitution*, November 2021, Section 36.

27 IFRS Foundation *Constitution*, November 2021, Section 37(d), (e) and (h).

28 IFRS Foundation *Constitution*, November 2021, Section 37(i),

The IASB began the latest agenda consultation in March 2021. In July 2022, it released the feedback statement on the consultation. The IASB has decided to leave the current level of focus on its main activities mostly unchanged and its priorities from 2022 to 2026 include the following:[29]

- Continuing to progress research and standard-setting projects on the IASB's current work plan
- Completing the required post-implementation review of IFRS 9 *Financial Instruments*, conducting the required post-implementation reviews of IFRS 15 *Revenue from Contracts with Customers* and IFRS 16 *Leases*, and to undertake possible priority follow-on projects where applicable
- Starting new projects to review the accounting requirements for intangible assets, the accounting requirements for the statement of cash flows and related matters; and responding to any time-sensitive issues that may arise after the agenda consultation
- Creating a reserve list of two projects on operating segments and pollutant pricing mechanisms that will be added to its work plan if additional capacity becomes available before its next five-yearly agenda consultation
- Working with the ISSB on relevant projects, such as, the IASB's current project on management commentary, its new research project on intangible assets and its reserve-list project on pollutant pricing mechanisms
- Starting a new, narrow-scope project to determine whether and, if so, what further actions might be needed to improve the accounting for climate-related risks in the financial statements, after the publication of the Foundation's educational material on the effects of climate-related matters on financial statements and application of the ISSB's future standard on climate-related disclosures. The IASB will coordinate any work on this topic with the ISSB

  And
- Completing, together with its consultation body the SME Implementation Group, the second comprehensive review of the IFRS for SMEs and publishing educational materials to help preparers understand and apply IFRS for SMEs.

2.5 The IFRS Interpretations Committee (the IFRS IC)

For IFRS accounting standards to be truly global standards, consistent application and interpretation is required. The IFRS IC assists the IASB in improving financial reporting through timely assessment, discussion and resolution of financial reporting issues identified within the IFRS accounting framework.[30]

The national accounting standard-setting bodies and regional bodies involved with accounting standard-setting are often consulted on issues referred to the IFRS IC.[31] The IFRS IC is expected to address issues:[32]

"(a) that have widespread effect and have, or are expected to have, a material effect on those affected;

(b) where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods;

(c) that can be resolved efficiently within the confines of existing IFRS standards and the *Conceptual Framework for Financial Reporting;* and

(d) the matter is sufficiently narrow in scope that the Board or the IFRS IC can address it in an efficient manner, but not so narrow that it is not cost-effective for the Board or the IFRS IC and stakeholders to undertake the due process required to change a standard."

The IASB may seek the assistance of the IFRS IC in developing narrow-scope amendments (which include annual improvements), drawing on the IFRS IC's experience of the application of IFRS accounting standards.[33]

If the IFRS IC does not plan to add an item to its work programme, it publishes a tentative agenda decision in the *IFRIC Update* and on the Foundation website and requests comments on the matter. The comment period for tentative agenda decisions is normally at least 60 days. After considering comments received, the IFRS IC will either confirm its decision and publish an agenda decision, revise its tentative agenda decision and re-expose for comment a revised tentative agenda decision, add the issue to its work programme or refer the matter to the IASB.[34]

29 *Third Agenda Consultation: Snapshot*, IASB, July 2022, available on the IFRS Foundation's website (accessed on 19 July 2024).

30 IFRS Foundation *Due Process Handbook*, August 2020, para. 1.3.

31 IFRS Foundation *Due Process Handbook*, August 2020, para. 5.15.

32 IFRS Foundation *Due Process Handbook*, August 2020, para. 5.16.

33 IFRS Foundation *Due Process Handbook*, August 2020, para. 5.18.

34 IFRS Foundation *Due Process Handbook*, August 2020, para. 8.2.

Before an agenda decision is published, the IASB is asked- at its first public meeting at which it is practicable to present the agenda decision - whether it objects to the agenda decision. Specifically, IASB members are asked whether they object to (a) the IFRS IC's decision that a standard-setting project should not be added to the work plan, and (b) the IFRS IC's conclusion that the agenda decision does not add or change requirements in IFRS accounting standards. If four or more IASB members object, the agenda decision is not published and the IASB decides how to proceed.[35]

The IFRS IC has 14 voting members. The chair, who is appointed by the Trustees, is a member of the IASB, the Director of Technical Activities or an appropriately qualified individual. The chair does not have the right to vote. The Trustees may appoint representatives of regulatory organisations, who have the right to attend and speak at meetings but not the right to vote.[36] Currently, the Basel Committee on Banking Supervision, European Commission and IOSCO have observer status. The quorum for a meeting is 10 members,[37] and approval of draft or final interpretations requires that not more than four voting members vote against the draft or final interpretation.[38]

The IFRS IC meets six times a year. All technical decisions are taken at sessions that are open to public observation. Although the IFRS IC develops interpretations because they are part of the respective IFRS accounting standards, they must be ratified by the IASB.[39]

2.5.1 Agenda decisions

An agenda decision explains why a standard-setting project has not been added to the work plan and, in many cases, includes explanatory material.[40] It cannot add or change requirements in IFRS accounting standards. Instead, explanatory material explains how the applicable principles and requirements in IFRS accounting standards apply to the transaction or fact pattern described in the agenda decision.[41] Explanatory material derives its authority from the standards themselves. Accordingly, an entity is required to apply the applicable IFRS accounting standard(s), reflecting the explanatory material in an agenda decision.[42]

In December 2018, the IASB discussed the timing of application of accounting policy changes that result from an agenda decision published by the IFRS IC and confirmed its view that it expects companies to be entitled to sufficient time to implement changes in accounting policy.

In March 2019, the IASB further explained its position on agenda decisions. Firstly, the Board acknowledged that agenda decisions often provide new information that should be seen as helpful and persuasive. It follows that a company does not make an error simply because its application of IFRS accounting standards was inconsistent with an agenda decision. Secondly, regarding how quickly companies are expected to implement an accounting policy change that results from an agenda decision, the IASB formally acknowledged that it may take time to implement such an accounting policy change. The IASB believes that this reflects its expectations of what is reasonable for preparers, assists companies in implementing any such change, and ultimately supports consistent application of IFRS accounting standards by facilitating accounting policy changes. What constitutes 'sufficient time' would depend on the particular facts and circumstances, taking into account the accounting policy change and the reporting entity and would require judgement. What the IASB had in mind was 'a matter of months rather than years'. However, it is not expected that sufficient time would include the time needed to undertake related steps, such as changing affected covenants in documents nor the time to wait to see whether any of the IASB's projects could remove the need to make an accounting policy change (to avoid two changes in accounting in a short period of time).[43] The IASB also made it clear that companies need to consider agenda decisions and implement any necessary accounting policy changes on a timely basis (i.e., as soon and as quickly as possible). If necessary, companies should be in a position to explain their implementation process and, if material, consideration should be given to whether disclosure related to the accounting policy change is required.[44] The Due Process Handbook (The Handbook) has also been amended in August 2020 to reflect this.[45]

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35 IFRS Foundation *Due Process Handbook*, August 2020, para. 8.7.

36 IFRS Foundation *Constitution*, November 2021, Section 49.

37 IFRS Foundation *Due Process Handbook*, August 2020, para. 3.18.

38 IFRS Foundation *Constitution*, November 2021, Section 42.

39 IFRS Foundation *Due Process Handbook*, August 2020, para. 7.23.

40 IFRS Foundation *Due Process Handbook*, August 2020, para. 8.3.

41 IFRS Foundation *Due Process Handbook*, August 2020, para. 8.4.

42 IFRS Foundation *Due Process Handbook*, August 2020, para. 8.5.

43 *Feature: Agenda decisions-time is of the essence*, available on IFRS Foundation's website (accessed 19 July 2024).

44 *Feature: Agenda decisions-time is of the essence*, available on IFRS Foundation's website (accessed 19 July 2024).

45 IFRS Foundation *Due Process Handbook*, August 2020, para. 8.6.

2.6 The Due Process Handbook

The Trustees' Due Process Oversight Committee (DPOC) is responsible for overseeing the due process procedures of the IASB and IFRS IC throughout all the development stages of a standard, the IFRS Taxonomy or an interpretation, including agenda-setting and post-implementation reviews (PIRs).[46] The Foundation published the revised Handbook in August 2020. The main changes are:[47]

- Clarifying the authority of agenda decisions published by the IFRS IC and their role in supporting consistent application of IFRS accounting standards and enhancing the related due process by formally involving the IASB in their finalisation

  And

- Reflecting recent developments in the IASB's effect analysis process - assessing the likely effects of a new or amended IFRS accounting standards - that emphasise the role of such analyses in standard-setting and make it clear that such analyses take place at all stages of standard-setting

In addition, the amendments enhance and streamline the consultation requirements for adding major projects to the IASB's work plan; update and enhance the minimum amount of review required for educational material produced by the Foundation; and clarify the DPOC's role in overseeing the IFRS Taxonomy due process.

The Handbook describes the due process requirements of the IASB and IFRS IC.[48] The requirements are built on the following principles:[49]

- Transparency - the IASB and the IFRS IC conduct their standard-setting process in a transparent manner
- Full and fair consultation - considering the perspectives of stakeholders globally

  And

- Accountability - the IASB analyses the potential effects of its proposals on affected parties and explains the rationale for why it made the decisions it reached in developing or amending a standard

In order to gain a wide range of views from interested parties throughout all stages of the development of IFRS accounting standards, the Trustees and the IASB have established consultative procedures with the objective of ensuring that, in exercising its independent decision-making, the IASB conducts its standard-setting process in a transparent manner.[50] The Handbook specifies some minimum steps that the IASB and the IFRS IC are required to follow before a standard or interpretation can be issued.[51] The following due process steps are mandatory:[52]

- Debating any proposals in one or more public meetings
- Exposing for public comment a draft of any proposed new standard, proposed amendment to a standard or proposed interpretation with minimum comment periods
- Considering in a timely manner those comment letters received on the proposals
- Considering whether the proposals should be exposed again
- Consulting the IFRS Advisory Council (see section 2.7 below) and the ASAF (see section 2.8 below) on the work plan, major projects, project proposals and work priorities

  And

- Ratification of an interpretation by the IASB in a public board meeting

The steps specified in the Constitution that are 'non-mandatory' include:[53]

- Publishing a discussion document (for example, a discussion paper) before an exposure draft is developed
- Establishing consultative groups or other types of specialist advisory groups
- Holding public hearings

  And

- Undertaking fieldwork

46 IFRS Foundation *Due Process Handbook*, August 2020, para 2.4.

47 *IFRS Foundation publishes revised Due Process Handbook*, available on IFRS Foundation's website (accessed 19 July 2024).

48 IFRS Foundation *Due Process Handbook*, August 2020, para. 1.5.

49 IFRS Foundation *Due Process Handbook*, August 2020, para. 3.1.

50 IFRS Foundation *Due Process Handbook*, August 2020, para. 1.2.

51 IFRS Foundation *Due Process Handbook*, August 2020, para. 3.43.

52 IFRS Foundation *Due Process Handbook*, August 2020, para. 3.44.

53 IFRS Foundation *Due Process Handbook*, August 2020, para. 3.45.

If the IASB decides not to undertake any of the non-mandatory steps, it is required to inform the DPOC of its decision and reason (known as the 'comply or explain' approach). Those explanations must be published in the decision summaries and in the Basis for Conclusions with the exposure draft or IFRS accounting standard in question.[54]

Although not mandatory, the IASB conducts public meetings and roundtables to ensure that it has appropriate input from its constituents.

The IASB normally allows a minimum period of 120 days for comment on an exposure draft. If the matter is narrow in scope and urgent, the IASB may consider a comment period of no less than 30 days, but it will only set a period of less than 120 days after consulting, and obtaining approval from, the DPOC.[55]

Under a 'fast track' comment process, if the matter is exceptionally urgent, and only after formally requesting and obtaining prior approval from 75% of the Trustees, "the IASB may reduce the period for public comment on an exposure draft to below 30 days but may not dispense with a comment period".[56]

2.7 The IFRS Advisory Council

The Advisory Council (whose members are appointed by the Trustees) provides a forum for geographically and functionally diverse organisations and individuals with an interest in international corporate reporting to:

- Provide input on the IASB's and ISSB's agenda, project timetable and project priorities

  And
- Give advice on projects, with emphasis on application and implementation issues, including matters that may warrant the attention of the IFRS IC[57]

A secondary objective of the Advisory Council is "to encourage broad participation in the development of IFRS as high-quality, globally-accepted standards".[58]

The Advisory Council comprises thirty or more members, having a diversity of geographical and professional backgrounds. The chair of the Council is appointed by the Trustees, and may not be a member of the IASB, the ISSB or a member of its staff.[59] The Advisory Council normally meets at least two times a year, and its meetings are open to the public. The matters on the agenda for the Advisory Council's meetings will include those strategic matters and other priorities identified through consultation with the chair of the Advisory Council and representatives of the Trustees, the IASB and the ISSB. In addition, the Trustees must consult the Advisory Council in advance of any proposed changes to the Constitution.[60]

Members are appointed for an initial term of three years and may be asked to remain for up to three additional years.[61]

2.8 Accounting Standards Advisory Forum

The ASAF, established in 2013, is an advisory group consisting of national accounting standard-setters and regional bodies, the purpose of which is to provide technical advice and feedback to the IASB.

The membership of the ASAF consists of 12 non-voting members (appointed by the Trustees), plus the chair, who is the IASB chair or vice-chair. The 12 individuals represent 12 national standard setters and regional bodies from around the globe. The appointment is not in their personal capacity.[62] To ensure a broad geographical representation, the members are from the following geographic regions:[63]

- One member from Africa
- Three members from the Americas (North and South)
- Three members from the Asia/Oceania region
- Three members from Europe (including non-EU)

  And
- Two members appointed from any area of the world at large, subject to maintaining overall geographic balance

54 IFRS Foundation *Due Process Handbook*, August 2020, para. 3.46.

55 IFRS Foundation *Due Process Handbook*, August 2020, para. 6.7.

56 IFRS Foundation *Due Process Handbook*, August 2020, para. 6.8.

57 IFRS Foundation *Constitution*, November 2021, Section 60.

58 IFRS Advisory Council, *Terms of reference and operating procedures*, July 2014.

59 IFRS Foundation *Constitution*, November 2021, Section 62.

60 IFRS Foundation *Constitution*, November 2021, Section 63.

61 IFRS Advisory Council, *Terms of reference and operating procedures*, July 2014.

62 Accounting Standards Advisory Forum, *Terms of Reference/Charter*, March 2022.

63 Accounting Standards Advisory Forum, *Terms of Reference/Charter*, March 2022.

The ASAF normally meets four times a year and, where appropriate, one of the meetings may be held by videoconference. Its meetings are open to the public.

The objective of the ASAF is "to provide an advisory forum where members can constructively contribute towards the achievement of the IASB's goal of developing globally accepted high-quality accounting standards." The ASAF was established to:[64]

- Support the Foundation in its objectives, and contribute towards the development, in the public interest, of a single set of high quality understandable, enforceable and globally accepted financial reporting standards to serve investors and other market participants in making informed resource allocations and other economic decisions.
- Formalise and streamline the IASB's collective engagement with the global community of national standard-setters and regional bodies in its standard setting process to ensure that a broad range of national and regional input on major technical issues related to the IASB's standard setting activities are discussed and considered.

  And
- Facilitate effective technical discussions on standard-setting issues, primarily on the IASB's work plan but which may include other issues that have major implications for the IASB's work, in sufficient depth, with representatives at a high level of professional capability and with a good knowledge of their jurisdictions/regions.

2.9 Other advisory bodies

In addition to the Advisory Council and the ASAF, discussed in sections 2.7 and 2.8 above, respectively, the IASB has a number of other formal advisory bodies that provide input on its work and resources to consult. Meetings with the advisory bodies are held in public and meeting materials are available on the IASB's website.

The IASB's other advisory bodies are as follows:[65]

- Integrated Reporting and Connectivity Council - provides guidance on how reporting required by the IASB and the ISSB could be integrated and how the IASB and the ISSB could consider applying principles and concepts from the Integrated Reporting Framework to their projects
- Capital Markets Advisory Committee - provides the IASB with regular input from the international community of users of financial statements
- Emerging Economies Group - enhances the participation of emerging economies in the development of IFRS accounting standards
- Global Preparers Forum - provides the IASB with input from companies preparing financial statements
- IFRS Taxonomy Consultative Group - advises the IASB and ISSB on their respective digital taxonomies and related activities.
- Islamic Finance Consultative Group - focuses on potential challenges in applying IFRS accounting standards to Shariah-compliant instruments and transactions
- SME Implementation Group - supports the international adoption of IFRS for SMEs and monitors its implementation
- Consultative Group for Rate Regulation - informs the project on rate regulation

  And
- Management Commentary Consultative Group - informs the project on management commentary

64 Accounting Standards Advisory Forum, *Terms of Reference/Charter*, March 2022.

65 *IFRS Foundation consultative bodies*, available on IFRS Foundation's website (accessed 19 July 2024).

2.10 The International Sustainability Standards Board

In recent years, there has been growing interest among stakeholders in wider corporate reporting, in particular, sustainability reporting. The Trustees of the Foundation set up a task force in October 2019 to undertake further research and analysis. In September 2020, it carried out public consultation to identify the demand from stakeholders in the area of sustainability reporting and understand what the Foundation could do in response to that demand.[66] As a result, the Trustees decided to take steps to formalise the creation of a sustainability board.[67] In November 2021, the Trustees amended the Constitution after public consultation to expand the Foundation's objectives to create the ISSB which will set IFRS sustainability disclosure standards within the Foundation's governance structure, set out the structure and function of the new board and align other parts of the Constitution with the creation of the new board.[68] The intention is for the ISSB to deliver a comprehensive global baseline of sustainability-related disclosure standards that provide investors and other capital market participants with information about companies' sustainability-related risks and opportunities to help them make informed decisions.[69]

There is a commitment by leading investor-focused sustainability disclosure organisations to consolidate into the ISSB. Since November 2021, the IFRS Foundation has consolidated Climate Disclosure Standards Board (an initiative of CDP) and the Value Reporting Foundation which houses the Integrated Reporting Framework and the SASB Standards. In addition, in March 2022, the Foundation signed a collaboration agreement with Global Reporting Initiative (GRI) such that their respective standard-setting boards, the ISSB and the Global Sustainability Standards Board, will seek to coordinate their work programmes and standard-setting activities.[70] In November 2023, GRI announced the establishment of the Sustainability Innovation Lab (SIL) in partnership with the Foundation. The SIL will enable companies to meet their evolving sustainability disclosure requirements, fostering professional development, training, practical solutions and innovative thinking.[71] In addition, since 2024, the Foundation has taken over the responsibilities over the monitoring of the progress on companies' climate-related disclosures from the Task Force on Climate-related Financial Disclosures (TCFD). The recommendations from the TCFD have been fully incorporated into IFRS sustainability disclosure standards (see next paragraph).[72]

The ISSB issued its inaugural standards, namely IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* (IFRS S1) and IFRS S2 *Climate-related Disclosures* (IFRS S2) in June 2023. IFRS S1 sets out the overall requirements for disclosing sustainability-related financial information about all its significant sustainability-related risks and opportunities, to provide the market with a complete set of sustainability-related financial disclosures. IFRS S2 sets out the specific requirements for the identification, measurement and disclosure of climate-related financial information. IFRS S1 and IFRS S2 are effective for annual reporting periods beginning on or after 1 January 2024. The ISSB has provided a number of transition reliefs when an entity first applies the standards. Mandatory application of IFRS sustainability disclosure standards depends on each jurisdiction's endorsement or regulatory processes. The application of IFRS sustainability disclosure standards is not linked to the application of IFRS accounting standards. Therefore, an entity applying IFRS accounting standards for financial reporting purposes is currently not required to also apply IFRS sustainability disclosure standards, and *vice versa*.

In December 2023, the ISSB published amendments to the SASB Standards to enable international application and help preparers apply the SASB Standards regardless of the jurisdiction in which they operate or the type of accounting framework they use. The SASB Standards are a source of guidance for applying IFRS sustainability disclosure standards.

66 *Consultation Paper on Sustainability Reporting*, IFRS Foundation, September 2020. Available on the IFRS Foundation's website (accessed on 10 July 2024).

67 IFRS Foundation Feedback Statement: *IFRS Foundation Trustees' Feedback Statement on the on the Consultation Paper on Sustainability Reporting*, April 2020. Available on the IFRS Foundation's website (accessed on 19 July 2024).

68 IFRS Foundation Feedback Statement: *IFRS Foundation Trustees' Feedback Statement on proposed amendments to the IFRS Foundation's Constitution*, November 2021. Available on the IFRS Foundation's website (accessed on 19 July 2024).

69 *International Sustainability Standards Board*, available on IFRS Foundation's website (accessed 19 July 2024).

70 *IFRS Foundation announces International Sustainability Standards Board, consolidation with CDSB and VRF, and publication of prototype disclosure requirements*, available on IFRS Foundation's website (accessed on 19 July 2024).

71 IFRS - GRI establishes Sustainability Innovation Lab in coordination with the IFRS Foundation, available on IFRS Foundation website, (accessed on 19 July 2024).

72 IFRS - ISSB and TCFD, available on IFRS Foundation website, (accessed on 19 July 2024).

The ISSB has a global and multi-location presence with offices in the Americas, EMEA (Europe, Middle East and Africa) and Asia. Currently, the ISSB comprises 14 members, including the Chair and Vice-Chair. A number of advisory groups have also been established to support the ISSB's standard setting activities.[73] For example, the Transition Implementation Group on IFRS S1 and IFRS S2 (TIG) held its first meeting in March 2024. The TIG discusses, in a public forum, implementation questions that arise when entities implement IFRS S1 and IFRS S2.[74]

In May 2023, the ISSB published the Request for Information *Consultation on Agenda Priorities* to seek feedback on its priorities for its next two-year work plan. Specifically, the ISSB requested constituents' views on the strategic direction and balance of ISSB activities, the criteria for assessing which sustainability-related matters to prioritise and add to the ISSB's work plan and the scope and structure of potential new research and standard-setting projects. The ISSB released the feedback statement on the agenda consultation in June 2024 and announced that it will commence projects to research disclosure about risks and opportunities associated with biodiversity, ecosystems and ecosystem services, and human capital. The research projects will focus on the common information needs of investors in assessing whether and how these risks and opportunities could reasonably be expected to affect an entity's prospects.[75]

How we see it

There will be a high level of connectivity between the IASB and ISSB. While each board is independent, their standard-setting activities will complement each other in order to develop, in the public interest, high quality, understandable, enforceable and globally accepted accounting and sustainability disclosure standards for general purpose financial reporting based on clearly articulated principles.

73 IFRS - IFRS Foundation consultative bodies, available on IFRS Foundation's website (accessed 19 July 2024).

74 IFRS - Transition Implementation Group on IFRS S1 and IFRS S2, available on IFRS Foundation website, (accessed on 19 July 2024).

75 IFRS - ISSB to commence research projects about risks and opportunities related to nature and human capital, available on IFRS Foundation website, (accessed on 19 July 2024).

3 The IASB's technical agenda and convergence with US GAAP

3.1 The IASB's current priorities and future agenda

The IASB's 2024 activities focused on:[76]

- Deciding the project direction on the *Financial Instruments with Characteristics of Equity* project
- Publishing an exposure draft for the equity method project. The project objective is to develop answers to application questions about the equity method, as set out in IAS 28 *Investments in Associates and Joint Ventures*, using the principles derived from IAS 28 where possible
- Reviewing feedback from the exposure draft on contracts for renewable electricity. This narrow-scope standard-setting project focuses on how to apply the own use exception on derivative accounting to physical power purchase agreements in which the underlying non-financial item cannot be stored economically and is required to either be consumed or sold within a short time as determined by the market structure in which the item is bought and sold
- Publishing the feedback statement on the Post-implementation Review of IFRS 15
- Reviewing feedback from the exposure draft on the *Business Combinations- Disclosure, Goodwill and Impairment* project. This exposure draft includes proposed changes to IFRS 3 *Business Combinations* and IAS 36 *Impairment of Assets* which in the IASB's view would result in entities providing better information at a reasonable cost about acquisitions
- Reviewing feedback on the exposure draft of *Addendum to the Exposure Draft Third edition of the IFRS for SMEs accounting standard*

  And
- Publishing an exposure draft on the targeted improvements to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* on provisions

At the time of writing, the IASB's work plan reflects that work on a number of these projects will continue into 2025 and beyond.

3.2 IFRS accounting standards/US GAAP convergence

'Convergence' is a term used to describe the coming together of national systems of financial reporting and IFRS accounting standards. Between 2002 and 2013, the IASB and Financial Accounting Standards Board (FASB) had various projects to both improve IFRS accounting standards and US GAAP, respectively, and to achieve their convergence. In addition, the US SEC took steps towards the acceptance of IFRS accounting standards in the US. In 2007, the US SEC began permitting foreign private issuers to file IFRS financial statements without reconciliation to US GAAP.

In 2008, the US SEC set out a proposed roadmap outlining the milestones and conditions that, if met, could lead to the use of IFRS accounting standards in the US by domestic registrants. In 2011, the US SEC staff issued a work plan to explore the incorporation of IFRS accounting standards into the US financial reporting system. However, its final report in 2012 raised significant concerns and noted there was '(R)elatively less support within the U.S. financial reporting community for the designation of the standards of the IASB as authoritative for use by U.S. issuers for domestic reporting purposes.'[77] Additionally, feedback to the IASB's the 2011 agenda consultation indicated the IASB should also consider whether convergence should continue to be a priority for the IASB.

While the IASB and FASB continue to collaborate on areas of mutual interest (e.g., via regular joint meetings), in 2013, the convergence process between the IASB and the FASB largely came to an end. In fact, The Handbook, which was revised in 2013, removed convergence from the list of factors that are influential in setting the agenda.

76 *IFRS Foundation work plan*, available on IFRS Foundation's website (accessed 19 July 2024).

77 2012 SEC IFRS Report, United States Securities Exchange Commission website, (accessed on 22 July 2024).

4 The adoption of IFRS accounting standards around the world

4.1 Worldwide adoption

Since 2001, there has been a tremendous increase in the adoption of IFRS accounting standards around the world. The precise way in which this has happened has varied among jurisdictions. This section sets out a brief description of how a number of key jurisdictions in each continent have approached the adoption. Some have adopted full IFRS accounting standards, i.e., IFRS accounting standards as issued by the IASB. Other jurisdictions have converged, or have a plan to converge, their standards with IFRS accounting standards.

An entity is required to apply IFRS 1 *First-time Adoption of International Financial Reporting Standards* when it first asserts compliance with IFRS accounting standards. The IASB has, therefore, established unambiguously the principle that full application of its standards and related interpretations is necessary for an entity to be able to assert that its financial statements comply with IFRS accounting standards (as issued by the IASB). Consequently, it is necessary for countries that align their national standards with IFRS accounting standards to require the application of IFRS 1 so that entities reporting under those standards can assert compliance with IFRS accounting standards. In addition, an entity that applies IFRS accounting standards as amended by a local authority cannot assert compliance with IFRS accounting standards.

The following table summarises the adoption of IFRS accounting standards (generally for consolidated financial statements) in selected jurisdictions with significant capital markets. For further details on selected locations, see sections 4.2 to 4.6 below. In addition, the Foundation is developing profiles of application of IFRS accounting standards. At the time of writing, profiles for 168 jurisdictions have been completed and are available on the IASB's website.

Jurisdiction	Required use of IFRS accounting standards	Permitted use of IFRS accounting standards
Australia	Required for all publicly accountable for-profit private sector entities that are required by legislation to prepare financial statements that comply with accounting standards, and any entities preparing general purpose financial statements that elect not to apply the Simplified Disclosure Standard (SDS). Non-publicly accountable for-profit private sector entities required by legislation to prepare financial statements that comply with accounting standards, or required by their constituting document or another document to prepare financial statements that comply with Australian Accounting Standards are required to apply IFRS recognition and measurement requirements, but can provide simplified disclosures under SDS.	
Brazil	Required for regulated public companies, with exemptions for banks and real estate companies; other companies must follow converged national standards.	
Canada	Required for publicly accountable entities.	Permitted for all other entities.
Mainland China	Substantially converged national standards.	
European Union	IFRS accounting standards as adopted by the European Union (EU) (EU IFRS - see section 4.2.1 below) are required for consolidated financial statements of all EU companies listed on an EU regulated market. Exemption for non-EU companies applying for listing on an EU regulated market that apply certain GAAPs determined by the European Commission to be equivalent to EU IFRS.	EU member states may permit or require the application of EU IFRS by unlisted companies and in separate financial statements.
France	See European Union.	EU IFRS permitted for the consolidated financial statements of non-listed entities.
Germany	See European Union.	EU IFRS permitted for the consolidated financial statements of non-listed entities.
Hong Kong	HKFRS (converged with IFRS accounting standards) is required for all Hong Kong incorporated companies (listed and non-listed).	Permitted for listed companies incorporated overseas.

Jurisdiction	Required use of IFRS accounting standards	Permitted use of IFRS accounting standards
India	IFRS accounting standards converged Indian Accounting Standards, with some mandatory and numerous optional departures from IFRS accounting standards, to apply in phases from financial years beginning on or after 1 April 2016.	Until the Indian Accounting Standards were introduced, listed companies with subsidiaries were permitted to apply IFRS accounting standards in consolidated financial statements. This option is no longer available.
Italy	EU IFRS is required in the separate financial statements of companies on the Italian regulated stock exchange and for all other non-listed PIEs (banks, asset management companies and other regulated financial institutions) except insurance companies.	EU IFRS permitted in the statutory separate and consolidated financial statements of all other non-listed entities and non-regulated enterprises (except SMEs).
Japan	Mandatory adoption has been put on hold for the time being.	Permitted for most companies that are listed or planning to be listed on a domestic stock exchange.
Korea	IFRS accounting standards as adopted by Korea without modification (K-IFRS) is required for all listed entities, unlisted financial institutions and state-owned entities.	K-IFRS permitted for non-listed entities.
Saudi Arabia	IFRS accounting standards (as adopted by the local regulators - mainly with some additional disclosure requirements) is required for banks, insurance companies and listed entities.	Non-listed entities have the option to adopt either full IFRS accounting standards or IFRS for SMEs. Self-regulated entities can choose, but are not required, to adopt IFRS accounting standards.
Singapore	Singapore incorporated entities listed on the Singapore Exchange are required to file financial statements prepared in accordance with converged national standards equivalent to IFRS accounting standards (Singapore Financial Reporting Standards (International) - SFRS(I)). Foreign entities that are listed on the Singapore Exchange are required to file financial statements prepared in accordance with SFRS(I), IFRS accounting standards or US GAAP.	Singapore incorporated entities are permitted to file IFRS financial statements with approval.
South Africa	Required for all listed companies. Non-listed companies generally use either IFRS accounting standards or IFRS for SMEs.	
Spain	See European Union.	EU IFRS permitted for non-listed groups for consolidated financial statements; no reversion to local GAAP once an entity has voluntarily applied EU IFRS.
Switzerland	Issuers of equity securities that are incorporated in Switzerland and listed under the International Reporting Standard on the SIX Swiss Exchange (SIX) must apply either IFRS or US GAAP. Other listed entities incorporated in Switzerland must apply IFRS, US GAAP or Swiss GAAP FER or the accounting rules of the Swiss Banking Act. Entities not incorporated in Switzerland must apply IFRS, US GAAP or a national GAAP deemed to be equivalent by the SIX.	IFRS accounting standards permitted in consolidated statutory financial statements of listed and non-listed entities.

Jurisdiction	Required use of IFRS accounting standards	Permitted use of IFRS accounting standards
Taiwan	Standards and interpretations endorsed by the local regulators apply for financial statements beginning on or after 1 January 2024. The effective dates for standards and interpretations for Taiwan IFRS are mostly aligned with global effective dates, except for IFRS 17 *Insurance Contracts*; however, early adoption is generally not permitted.	IFRS accounting standards permitted for foreign issuers, with reconciliation to 'Taiwan-IFRS'.
Thailand	Domestic companies in Thailand have to adopt Thai Accounting Standards. Thai Accounting Standards are substantially converged with IFRS accounting standards. Normally, the effective date of Thai Accounting Standards which are translated from IFRS accounting standards will be effective 1 year later than the effective date of the respective IFRS accounting standards.	IFRS accounting standards permitted for foreign companies.
United Arab Emirates	Companies incorporated in the United Arab Emirates, in general, are required, by law, to apply IFRS accounting standards. However, other frameworks such as the International Public Sector Accounting Standards (IPSAS) and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) financial accounting standards may be applied by government entities and Islamic institutions, respectively.	
United Kingdom	UK companies must apply UK-adopted international accounting standards rather than EU IFRS. This is discussed further in section 4.2.2 below.	UK-adopted IAS permitted for all companies, except in the charities sector; restrictions on reversion to local GAAP once an entity has applied UK-adopted international accounting standards.
United States	Substantial convergence of selected standards.	Permitted for foreign private issuers preparing financial statements in accordance with IFRS accounting standards as issued by the IASB. There is no endorsement process in the US.

4.2 Europe

4.2.1 EU

In July 2002, the European Parliament adopted Regulation No. 1606/2002 (the Regulation), which required publicly traded EU incorporated companies[78] to prepare, by 2005 at the latest, their consolidated financial statements under IFRS accounting standards 'adopted' (as discussed further below) for application within the EU. Although an EU regulation has direct effect on companies, without the need for national legislation, the Regulation provides an option for EU member states to permit or require the application of adopted IFRS accounting standards in the preparation of annual unconsolidated financial statements and to permit or require the application of adopted IFRS accounting standards by unlisted companies. This means that EU member states can require the uniform application of adopted IFRS accounting standards by important sectors, such as banking or insurance, regardless of whether companies are listed. An analysis of the implementation of the Regulation published in 2012 shows that nearly all EU member states use the option to permit the application of adopted IFRS accounting standards in the consolidated accounts of some or all types of unlisted companies. More than half of the EU member states also permit the application of adopted IFRS accounting standards in the annual financial statements of some or all types of unlisted companies.[79]

78 This means those with their securities admitted to trading on a regulated market within the meaning of Article 1(13) of Council Directive 93/22/EEC (on investment services in the securities field) or those offered to the public in view of their admission to such trading under Council Directive 80/390/EEC (coordinating the requirements for the drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing).

79 *Implementation of the IAS Regulation (1606/2002) in the EU and EEA*, European Commission, 7 February 2012.

The Regulation established the basic rules for the creation of an endorsement mechanism for the adoption of IFRS accounting standards, the timetable for implementation and a review clause to permit an assessment of the overall approach proposed. The European Commission took the view that an endorsement mechanism was needed to provide the necessary public oversight. The European Commission considered also that it was not appropriate, politically or legally, to delegate accounting standard-setting unconditionally and irrevocably to a private organisation over which the European Commission had no influence. In addition, the endorsement mechanism is responsible for examining whether the standards adopted by the IASB satisfy relevant EU public policy criteria.

The role of the endorsement mechanism is not to reformulate or replace IFRS accounting standards, but to oversee the adoption of new standards and interpretations, intervening only when they contain material deficiencies or have failed to cater for features specific to the EU economic or legal environments. The central task of this mechanism is to confirm that IFRS accounting standards provide a suitable basis for financial reporting by listed EU companies. The mechanism is based on a two-tier structure, combining a regulatory level with an expert level, to assist the European Commission in its endorsement role.

The recitals to the Regulation state that the endorsement mechanism should act expeditiously and also be a means to deliberate, reflect and exchange information on international accounting standards among the main parties concerned, in particular national accounting standard setters, supervisors in the fields of securities, banking and insurance, central banks including the European Central Bank (ECB), the accounting profession and users and preparers of accounts. The mechanism should be a means of fostering common understanding of adopted international accounting standards in the EU community.[80]

The European Commission is advised on IFRS accounting standards by EFRAG (European Financial Reporting Advisory Group). In addition to EFRAG, the European Commission seeks approval from its member states through the Accounting Regulatory Committee (ARC). EFRAG is a private sector body established by the European organisations prominent in European capital markets, e.g., Accountancy Europe and the European Banking Federation. In addition to advising the European Commission on endorsement of IFRS accounting standards, EFRAG is the mechanism by which Europe as a whole can participate in the global debate on accounting standards and it coordinates European responses to IASB proposals. EFRAG plays a proactive role issuing discussion papers, field-test reports and feedback statements on outreach events. The objective of the proactive work is to involve European stakeholders at an early stage in identifying necessary improvements to financial reporting to influence the IASB. EFRAG's activities also include assessments of whether the IASB's proposals and IFRS accounting requirements are conducive to the European public good. This includes the interaction with economic concerns, such as financial stability and growth.

EFRAG includes representatives of European stakeholder organisations and national standard setters respectively national organisation chapters and are led by its Presidents, who are nominated by the European Commission after having heard the European Parliament and the Council. EFRAG is responsible for all EFRAG positions and operates based on a consensus-based decision-making process with the objective of Europe speaking with one voice. The European Commission, the European supervisory authorities and the ECB participate in EFRAG in an observer capacity. EFRAG takes all its decisions after considering the advice of the EFRAG Technical Expert Groups and the results of EFRAG's due process, and after making all assessments deemed relevant from the political perspective.

The EU endorsement process for IFRS accounting standards is only completed when the standard, interpretation or amendment is published in the Official Journal of the European Union. The advice from EFRAG and the vote by the ARC are not sufficient to adopt a standard, an interpretation or an amendment.

80 Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002, European Commission, Recital 11.

4.2.1.A Endorsed IFRS accounting standards

To date, apart from the carve-out from IAS 39 *Financial Instruments: Recognition and Measurement*, the decision not to endorse IFRS 14 *Regulatory Deferral Accounts* and the pending endorsement of the amendments to IAS 12 *Income taxes: International Tax Reform - Pillar Two Model Rules*, all IFRS accounting standards which are currently effective have ultimately been endorsed.

IAS 39 as endorsed for use in the EU is currently different in one important respect from the version published by the IASB. Certain text has been carved out so that, essentially, the EU version allows the use of macro fair value hedge accounting in situations that the full version of IAS 39 does not. The European Commission has continued to emphasise the need for the IASB and representatives of European banks to find an appropriate technical solution to allow the removal of the carve-out as rapidly as possible. However, there have been only limited signs of progress on this issue and IFRS 9 does not remove the reasons for the carve-out (see Chapter 40 at section 5). Consequently, the carve-out continues to be available for entities that prepare their financial statements in accordance with IFRS accounting standards as endorsed for use in the EU and continue to apply the macro fair value hedge accounting requirements of IAS 39.

On 19 November 2021, the EC enacted through the Official Journal of the European Union the commission regulation on the adoption of IFRS 17.[81] The regulation endorses IFRS 17 with an exemption to provide an option not to apply the annual cohort requirement as defined in IFRS 17.22 for specific types of contracts. Article 2 of the regulation permits (i.e., it is an option) companies in the scope of the regulation to depart from IFRS 17.22. In the recitals to the regulation, the European Commission pointed out that the annual cohort requirement as a unit of account for groups of insurance and investment contracts does not always reflect the business model, nor the legal and contractual features of intergenerationally-mutualised and cash flow matched contracts that are common in some member states of the EU. Those contracts represent more than 70% of the total life insurance liabilities in the EU. According to the European Commission, the annual cohort requirement applied to such contracts does not always have a favourable cost-benefit balance so that companies should have the option to exempt intergenerationally-mutualised and cash flow matched contracts from the annual cohort requirement of IFRS 17. As investors should be able to understand if an entity has applied the exemption from the annual cohort requirement for groups of contracts, the regulation introduces specific disclosure requirements if an entity applies the exemption. The regulation also includes in its article 3 a review clause for the optional exemption in article 3, i.e., the European Commission should review it by 31 December 2027 and, where appropriate propose to amend or end the exemption.

In addition to the above-mentioned modifications to the content of IFRS accounting standards, there were previously standards and several IFRS IC interpretations that have had delayed application dates. The most notable is the effective date for IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements*, IFRS 12 *Disclosure of Interests in Other Entities*, IAS 27 *Separate Financial Statements* and IAS 28 for which the European Commission permitted a one-year deferral to the mandatory effective date set by the IASB.

4.2.1.B Evaluation of the Regulation

In 2014, the European Commission started an evaluation of the Regulation on the application of IFRS accounting standards to assess whether the Regulation achieved its objective in an efficient and effective manner, the criteria that all new IFRS accounting standards should meet to become EU law are appropriate, the process for adoption of standards works properly and the governance structure of the bodies developing the standards and advising the European Commission is appropriate. The evaluation mainly included a public consultation, an informal expert group, and a review of literature on the impact of the mandatory adoption of IFRS accounting standards in the EU and on the performance of IFRS accounting standards during the financial crisis. The results were included in a report issued in 2015. The key findings showed that IFRS accounting standards were successful in creating a common accounting language for capital markets and that there is still no well-defined alternative to IFRS accounting standards. However, the report also identified room for improvement in some areas.

81 Commission Regulation (EU) 2021/2036 of 19 November 2021 amending Regulation (EC) No 1126/2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council as regards International Financial Reporting Standard 17, 19 November 2021.

On 31 January 2018, the High-Level Expert Group (HLEG) on Sustainable Finance, established by the European Commission, published its final report setting out strategic recommendations for a financial system that supports sustainable investments.[82] In this report, the HLEG recommends the European Commission to change the Regulation to specify that international accounting standards should only be adopted if they are 'conducive to the European public good, including its sustainability and long-term investment objectives and to provide the power to the EU to adjust specific aspects of IFRS accounting standards adopted by the IASB before transposing them into EU law'.

Reference to the HLEG report was made when the European Commission launched in March 2018 a consultation document *Fitness Check on the EU Framework for Public Reporting by Companies* which generally sought stakeholder views on whether the EU framework for public reporting by companies is fit for purpose.[83]

Stakeholders from 23 Member States and 25 third countries submitted 338 responses on the public consultation. Most respondents commented that the EU framework for public reporting overall brings added value and is coherent, effective and relevant for achieving its main intended objectives of safeguarding stakeholders' interests, ensuring financial stability, developing the internal market, integrated EU capital markets and promoting sustainability. Most respondents supported the status quo about the EU IFRS accounting endorsement process and cautioned against 'EU carve-ins' that could lead to 'EU-IFRS accounting'.

4.2.2 United Kingdom

For financial years beginning on or after 1 January 2021, UK incorporated companies that do not apply UK GAAP will use UK-adopted international accounting standards (IAS) rather than EU IFRS. The UK Endorsement Board has the delegated authority to endorse new or amended standards. UK incorporated entities with securities admitted to trading on non-UK regulated markets may need to confirm they have followed the appropriate frameworks, such as EU-adopted IFRS or IFRS accounting standards as issued by the IASB, in addition to UK-adopted IAS.

4.3 Americas

4.3.1 US

See section 3.2 above for a discussion of the status of US adoption of IFRS accounting standards.

4.3.2 Canada

For publicly accountable enterprises, the Accounting Standards Board (AcSB) adopted IFRS accounting standards as Canadian GAAP for fiscal years beginning on or after 1 January 2011, with some deferrals for certain types of entities, which have now expired, and with the exception of pension plans and benefit plans that have characteristics similar to pension plans. Such plans follow the accounting standards for pension plans issued by the AcSB as of 1 January 2011, rather than IAS 26 *Accounting and Reporting by Retirement Benefit Plans*.

The definition of 'publicly accountable enterprises' is essentially the same as 'publicly accountable entity' in IFRS for SMEs. Canadian publicly accountable enterprises that are registered with the US SEC are permitted to apply US accounting standards rather than IFRS accounting standards. Securities regulators have indicated that they will consider permitting the use of US standards by Canadian rate-regulated entities that file with Canadian securities commissions even if they are not US SEC registered. A number of these entities have been granted permission to use US standards.

For non-publicly accountable enterprises and not-for-profit organisations, the AcSB has developed new bases of accounting that are derived from Canadian standards rather than IFRS accounting standards, although IFRS accounting standards are also available for use by those entities on a voluntary basis.

82 *Financing a Sustainable European Economy*, European Union High-Level Expert Group on Sustainable Finance, 31 January 2018.

83 *Consultation Document Fitness Check on the EU Framework for Public Reporting by EU Companies*, European Commission, 21 March 2018.

The adoption of IFRS accounting standards in Canada for publicly accountable enterprises means that the AcSB has effectively ceased to make final decisions on most matters affecting the technical content and timing of implementation of standards applied to publicly accountable enterprises in Canada. The AcSB's plans for incorporating new or amended IFRS accounting standards into Canadian standards include reviewing all IASB documents issued for comment. As part of this process, the AcSB seeks the input of Canadian stakeholders by issuing its own 'wraparound exposure draft' of the IASB proposals, together with a document highlighting the key elements of the IASB proposals that are particularly relevant to Canadian stakeholders. In addition, the AcSB may perform outreach activities such as public roundtables. Any changes to IFRS accounting standards must be approved by the AcSB before becoming part of Canadian GAAP.

While the AcSB retains the power to modify or add to the requirements of IFRS accounting standards, it intends to avoid changing IFRS accounting standards when adopting them as Canadian GAAP. Accordingly, the AcSB does not expect to eliminate any options within existing IFRS accounting standards. As issues relevant to Canadian users of financial information arise in the future, the AcSB will work to resolve them through the IFRS IC or the IASB. In the event that a resolution by the IFRS IC or IASB is not possible, the AcSB will stand ready to develop additional temporary guidance.

The AcSB has an IFRS Discussion Group to provide a public forum to discuss the application of IFRS accounting standards in Canada and to identify matters that should be forwarded to the IFRS IC for further consideration. The Group does not interpret IFRS accounting standards or seek consensus on its application in Canada. It meets in public up to four times per year and has generated several submissions for the IFRS IC's agenda.

4.3.3 Brazil

Local accounting standards in Brazil (CPCs) have been converged with IFRS accounting standards since 2010 and public companies regulated by the 'Comissão de Valores Mobiliários' (CVM) are also required to make a formal statement of compliance with IFRS accounting standards as issued by the IASB for their consolidated financial statements. The previous exception for homebuilding companies, which were temporarily permitted to continue to apply IAS 11 *Construction Contracts* rather than IAS 18 *Revenue* under IFRIC 15 *Agreements for the Construction of Real Estate*, was eliminated with the adoption of IFRS 15. However, local regulators have established specific accounting policies for homebuilding revenue recognition and the financial statements of entities in the industry do not refer to IFRS accounting standards as issued by the IASB as the basis of preparation.

Banks are regulated by the Brazilian Central Bank, which continues to require preparation of financial statements under its pre-existing rules. However, larger companies, as defined by law, including banks, are also required to prepare annual financial statements in accordance with IFRS accounting standards since 2010, which must be made publicly available. Insurance companies were required to adopt the local CPCs, and hence IFRS accounting standards, in 2011.

Non-public companies outside financial services are required to apply the CPCs. Smaller non-public companies are permitted to apply CPCs for SMEs which is an equivalent of IFRS for SMEs.

4.4 Asia

4.4.1 China

4.4.1.A Mainland China

The Ministry of Finance in China (the MOF) - through its Accounting Regulatory Department - is responsible for the promulgation of accounting standards, which are applicable to various business enterprises.

Representatives of the China Accounting Standards Committee (CASC), which falls under the Accounting Regulatory Department of the MOF, and the IASB met in Beijing in November 2005 to discuss a range of issues relating to the convergence of Chinese accounting standards with IFRS accounting standards. At the conclusion of the meeting, the two delegations released a joint statement (2005 Beijing Joint Statement) setting out key points of agreement, including the following:

- The CASC stated that convergence is one of the fundamental goals of its standard-setting programme, with the intention that an enterprise applying Chinese accounting standards should produce financial statements that are the same as those of an enterprise that applies IFRS accounting standards.

  And

- The delegation acknowledged that convergence with IFRS accounting standards will take time and how to converge with IFRS accounting standards is a matter for China to determine.

Since February 2006, the MOF issued a series of new and revised Accounting Standards for Business Enterprises (ASBE), which included the Basic Standard and 41 specific accounting standards. In April 2010, the MOF issued the *Road Map for Continual Convergence of the ASBE with IFRS* (the MOF Road Map), which requires the application of ASBE by all listed companies, some non-listed financial enterprises and central state-owned enterprises, and most large and medium-sized enterprises. The MOF Road Map also states that ASBE will continue to maintain convergence with IFRS accounting standards.

In November 2015, representatives of the Trustees of the Foundation and the MOF held a bilateral meeting in Beijing, China. During the meeting, both parties noted the success of 2005 Beijing Joint Statement, between CASC and IASB. It is the view of both parties that 2005 Beijing Joint Statement has achieved its objectives. In particular, the ASBE is now substantially converged with IFRS accounting standards and the use of those standards has significantly enhanced the quality and transparency of financial reporting in China. Recognising these developments, both parties updated the 2005 Beijing Joint Statement to reflect progress made in China and set out the following bases for future cooperation:

- Reaffirming the goal of full convergence
- Enhancing continued cooperation

  And
- Establishing a joint working group for further cooperation

To maintain continuous convergence with IFRS accounting standards, during the period from July 2023 to June 2024, the MOF released the interpretations on (1) *Classification of Liabilities as Current or Non-current,* which is consistent with *Classification of Liabilities as Current or Non-current (Amendments to IAS 1)* and *Non-current Liabilities with Covenants (Amendments to IAS 1)* issued by the IASB in January 2020 and October 2022; (2) Disclosure of Supplier Finance Arrangements, which is consistent with *Supplier Finance Arrangements (Amendments to IAS 7 and IFRS 7)* issued by the IASB in May 2023; and (3) Accounting treatment of Sale and leaseback transactions, which is consistent with *Lease Liability in a Sale and Leaseback (Amendments to IFRS 16)* issued by the IASB in September 2022.

4.4.1.B Hong Kong

The Hong Kong Institute of Certified Public Accountants (HKICPA) is the principal source of accounting principles in Hong Kong. These include a series of Hong Kong Financial Reporting Standards, accounting standards referred to as Hong Kong Accounting Standards (HKAS) and Interpretations issued by the HKICPA. The term 'Hong Kong Financial Reporting Standards' (HKFRS) is deemed to include all of the foregoing.

HKFRS was fully converged with IFRS accounting standards (subject to the exceptions discussed below) with effect from 1 January 2005. The HKICPA Council supports the integration of its standard-setting process with that of the IASB.

Although the HKICPA Council has a policy of maintaining convergence of HKFRS with IFRS accounting standards, the HKICPA Council may consider it appropriate to include additional disclosure requirements in an HKFRS or, in some exceptional cases, to deviate from an IFRS accounting standard. Each HKFRS contains information about the extent of compliance with the equivalent IFRS accounting standard. When the requirements of an HKFRS and an IFRS accounting standard differ, the HKFRS is required to be followed by entities reporting within the area of application of HKFRS. However, in practice, exceptions to IFRS accounting standards are few and relate to certain transitional provisions.

Certain smaller companies or groups meeting the necessary requirements and size criteria are permitted (but not required) to adopt the HKICPA's locally developed *Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard*.

4.4.2 Japan

Gradual convergence of Japanese GAAP towards IFRS accounting standards has been ongoing for a number of years. Currently, IFRS accounting standards may be adopted on a voluntary basis by listed companies or those applying for listing who are able to state that they meet certain governance conditions around IFRS accounting standards in their consolidated financial statements. Standalone financial statements must be prepared using Japanese GAAP.

IFRS accounting standards as issued by the IASB is the basis for voluntary adoption of the standards in Japan, as designated by the Financial Services Agency. Each IFRS accounting standard issued by the IASB is endorsed for the voluntary adoption through a formal process and all IFRS accounting standards issued by the IASB currently have been designated in a timely manner without any changes at the time of writing.

In addition, from 2015, a second endorsement mechanism led to the issuance of Japan's Modified International Standards (JMIS). JMIS differs from IFRS accounting standards in that it requires goodwill to be amortised and requires all items recorded in other comprehensive income to be recycled to profit or loss eventually. Currently, no companies apply JMIS.

The number of the companies adopting IFRS accounting standards in Japan voluntarily (including those who have announced their plan to adopt them in the future) increased to approximately 280 as of July 2024, mostly being larger companies. Whilst this is a small proportion of the of total number of listed companies in Japan, it represents a significant proportion of the market capitalisation of the Tokyo Stock Exchange, accounting for over 50% of the total market capitalisation at the time of writing.

4.4.3 India

Accounting standards in India are formulated by the Institute of Chartered Accountants of India (ICAI). The central government prescribes the standards of accounting or any addendum thereto, as recommended by the ICAI, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority (NFRA). The Ministry of Corporate Affairs (MCA) notifies the standards under the Companies Act by publishing them in the Gazette of India. Notified standards are authoritative under Indian law. Until the financial year ended 31 March 2016, all companies registered under the Companies Act were required to follow local GAAP known as Accounting Standards (ASs), which are based on old versions of IFRS accounting standards and contain many key differences from IFRS accounting standards.

In February 2015, the MCA notified the Companies (Indian Accounting Standards) Rules, 2015, laying down the roadmap for application of IFRS converged standards, known as Indian Accounting Standards (Ind AS), to Indian companies other than banking companies, insurance companies and non-banking finance companies (NBFCs). The Ind AS standards have also been notified.

In January 2016, the MCA issued the phasing-in dates of Ind AS applicability for NBFCs. The Reserve Bank of India had also originally issued the Ind AS applicability dates in phases for banks starting from 1 April 2018. However, pending necessary legislative amendments and considering the level of preparedness of many banks, implementation of Ind AS to the banks has been deferred till further notice.

The Insurance Regulatory and Development Authority of India (IRDAI) initially expected Ind AS to be applied to insurers from the same date as banks. However, due to the issuance of IFRS 17 by the IASB, it was decided that the effective date of implementation will be decided after the finalisation of IFRS 17 by the IASB. Now, as IFRS 17 has been issued by the IASB, IRDAI is working on implementation of Ind AS in the insurance sector including new standard on insurance contracts in India which is equivalent of IFRS 17. Considering the operational complexities and concerns involved in the implementation of Ind AS, an Expert Committee on Implementation of Ind AS/ IFRS in the insurance sector has also been created to address implementation issues of Ind AS/ IFRS in the insurance sector.

All companies applying Ind AS are required to present comparative information according to Ind AS for at least one year. Ind AS will apply to both standalone financial statements and consolidated financial statements of companies covered under the roadmap.

Companies not covered under the roadmap can either apply Ind AS voluntarily or continue applying existing standards, i.e., ASs. If Ind ASs are applied voluntarily, this option will be irrevocable. Voluntary adoption of Ind AS is permitted for all companies other than NBFCs. In 2009, the SEBI, the securities regulator in India, permitted listed companies with subsidiaries to submit their consolidated financial statements in accordance with IFRS accounting standards as issued by the IASB. Few companies in India have availed themselves of this option, which is no longer available for companies.

In January 2022, the SEBI amended SEBI (Mutual Funds) Regulations, 1996, which, *inter alia,* mandated that asset management companies (AMCs) prepare the financial statements and accounts of mutual fund schemes in accordance with Ind AS with effect from 1 April 2023. Accordingly, the first set of the financial statements under Ind AS for mutual fund schemes are for the annual period ended 31 March 2024.

4.5 Australia

Australia has a regime in which IFRS accounting standards are issued under its legal framework as Australian Accounting Standards (AAS). These are essentially word-for-word copies of IFRS accounting standards (IFRS equivalent). AAS also include some additional Australian specific paragraphs for not-for-profit and public sector entities.

In addition to the IFRS equivalent AAS, there are some additional Australian specific standards for entities such as superannuation entities, not-for-profit entities and public sector entities and some additional disclosures exist within certain standards.

Compliance by Australian for-profit private sector entities with AAS will result in compliance with IFRS accounting standards as issued by the IASB, unless they are not publicly accountable and elect to apply the Simplified Disclosure Standard (SDS). Explicit statements of compliance with IFRS accounting standards as issued by the IASB - when they are compliant- are required to be made by the preparers (in the notes to the financial statements and in the Directors' Declaration required by the Corporations Act), as well by the auditors in their reports. Not-for-profit and public sector entities cannot make an explicit statement of compliance with IFRS accounting standards, as they are required to also comply with other Australian specific accounting standards and Australian specific paragraphs when preparing their financial statements.

Australia has not adopted the IFRS for SMEs because of measurement differences and the removal of options as compared to IFRS accounting standards. SDS is available to for-profit private entities that are not publicly accountable (per definition in IFRS for SMEs) and required either: a) by legislation to prepare financial statements that comply with accounting standards, or b) by their constituting document or another document to prepare financial statements that comply with AAS (subject to certain grandfathering provisions). SDS is also available to for-profit public sector or not-for-profit entities that are reporting entities[84] and other for-profit entities that elect to apply the *Conceptual Framework for Financial Reporting* and the consequential amendments to other pronouncements set out in AASB 2019-1 *Amendments to Australian Accounting Standards - References to the Conceptual Framework*. SDS requires such entities to apply all recognition and measurement requirements of AAS, but provide simplified disclosures. The disclosures are closely based on those in the IFRS for SMEs, with an overlay of certain Australian specific disclosures. Financial statements prepared under SDS are general purpose financial statements, but cannot be held out as being in compliance with IFRS accounting standards as issued by the IASB.

The Australian standard-setter has not endorsed and incorporated IFRS *19 Subsidiaries without Public Accountability: Disclosures* into its local accounting framework. The AASB intends to conduct a research project before deciding whether to incorporate IFRS 19.

4.6 South Africa

For periods beginning on or after 1 January 2005, the South African securities exchange, JSE Limited (JSE), has required that all listed companies prepare financial statements under IFRS accounting standards.

Effective 1 May 2011, the South African Companies Act permits different accounting frameworks to apply to different categories of companies based on their 'public interest score'. Listed companies are required to use IFRS accounting standards, however, other companies (depending on their public interest score) may apply IFRS accounting standards, IFRS for SMEs, or in certain situations (introduced, in particular, for micro-entities) entity-specific accounting policies as determined by themselves.

In addition to the disclosure requirements of IFRS accounting standards and IFRS for SMEs, the South African Companies Act and the JSE impose certain additional disclosure requirements on reporting entities. Further, the previous South African standard setter - the Accounting Practices Board - has issued three Financial Reporting Guides. While these interpretations are specific to issues in the South African environment, IFRS reporters in South Africa make use of them as they are based on a framework equivalent to that used for IFRS accounting standards. These are updated for developments in IFRS accounting standards.

84 A reporting entity is one in respect of which it is reasonable to expect the existence of users who rely on the entity's general purpose financial statements for information that will be useful to them for making and evaluating decisions about the allocation of resources. A reporting entity can be a single entity or a group comprising a parent and all of its subsidiaries.

5 Consistency in application of IFRS accounting standards

The use of a consistent set of accounting standards by companies throughout the world has the potential to improve the comparability and transparency of financial information. The provision of higher quality information has been shown to reduce financial statement preparation costs and, it is believed, to enable capital markets participants to make better decisions. The global adoption of IFRS accounting standards is a necessary condition for global comparability, but, on its own, it is insufficient. Global comparability cannot be achieved without a rigorous and consistent application of the standards. However, consistent application of the standards cannot be achieved unless countries adopt IFRS accounting standards without modifying the standards issued by the IASB.

Studies into the impact of the use of IFRS accounting standards indicate reduced cost of capital and improvements in share prices and trading, resulting in part from increased disclosure and enhanced information comparability. However, the research concludes that these improvements occur in countries with strong legal enforcement.[85] The adoption of IFRS accounting standards alone is, therefore, unlikely to produce uniform financial reporting. The standards need to be applied, audited and enforced on a consistent basis in order to get the most out of comparability.[86]

Practitioners and regulators agree that enforcement of accounting standards is an integral part of achieving accounting quality under IFRS accounting standards. With this in mind, ESMA has agreed on common enforcement priorities and has made the consistent application of IFRS accounting standards one of its primary objectives. In December 2014, ESMA's guidelines on enforcement of financial information (the Guidelines) became effective. They replace earlier versions of the guidelines from ESMA and its predecessor, the Council of European Securities Regulators (CESR). The Guidelines apply to all EU national competent authorities and other bodies in the EU that undertake enforcement responsibilities. The Guidelines build on a common approach to the enforcement of financial information and reinforce coordination among European enforcers. In addition, the Guidelines codify European common enforcement priorities and include a requirement to discuss views on accounting matters prior to taking enforcement decisions.[87]

In addition to enforcement, ESMA contributes to the standard-setting process by engaging with the IASB and the IFRS IC by submitting comment letters and identifying areas of diversity in practice (including areas in which a lack of clarity in standards could lead to diversity in practice). In addition, the Foundation and ESMA have entered into a joint Statement of Protocols, which reaffirms the cooperation between the two entities as well as describes additional areas of cooperation including electronic reporting, the implementation of new standards and emerging financial reporting issues.[88]

The Foundation and IOSCO have entered into a joint Statement of Protocols to facilitate consistency in the application of IFRS accounting standards. This is in addition to the memorandum of understanding between the capital markets authorities that formed the Monitoring Board (see section 2.3 above) and the Foundation.[89]

The US SEC stresses the importance of enforcing IFRS accounting standards, not only through its filing review process of foreign private issuers, but also through its collaboration with foreign counterparts bilaterally and through IOSCO.[90]

85 *Does mandatory adoption of International Financial Reporting Standards in the European Union reduce the cost of equity capital?,* Li, S. (2010), The Accounting Review, 85(2), 607-636.

86 Speech by Hans Hoogervorst, *'The Search for Consistency in Financial Reporting'*, Ernst & Young/Cass Business School, 17 January 2013.

87 *ESMA Report on Enforcement and Regulatory Activities of Accounting Enforcers in 2014*, European Securities and Markets Authority, 31 March 2015.

88 IFRS Foundation and ESMA Press Release, *IFRS Foundation and ESMA sign joint Statement of Protocols*, 15 July 2014.

89 *Statement of Protocols for Cooperation on International Financial Reporting Standards*, IOSCO and IFRS Foundation, 16 September 2013.

90 Speech by Mary Jo White, *'Regulation in a Global Financial System'*, Investment Company Institute General Membership Meeting, 1 May 2013.

Although consistent application of IFRS accounting standards is not the primary responsibility of the IASB, it understandably takes a keen interest. The ASAF was established (see section 2.8 above) to coordinate interaction with national and regional standard-setting bodies to, among other things, identify where divergence occurs across borders.[91] The post-implementation reviews of all major standards and interpretations are intended to identify and rectify difficulties in consistency that are identified only after the standard is used. The IFRS IC plays a key role as well.

Much has been written about consistency in IFRS accounting standards, but a recurring message is that it requires a coordinated effort by standard-setters, preparers, regulators and auditors.

6 Summary

IFRS accounting standards are now, together with US GAAP, one of the two globally recognised financial reporting frameworks. Although the goal of a single set of high-quality global accounting standards has not been fulfilled, given the number of countries that have adopted or converged with IFRS accounting standards or have plans to in the future, it is safe to say that IFRS accounting standards have become 'International GAAP'.

91 *Report of the Trustees' Strategy Review 2011: IFRSs as the Global Standards: Setting a Strategy for the Foundation's Second Decade*, IFRS Foundation, February 2012.

Chapter 2 The IASB's Conceptual Framework

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Overview

This chapter discusses the *Conceptual Framework for Financial Reporting* (the *Framework*) as published by the IASB in 2018. Readers interested in predecessor versions should refer to earlier editions of *International GAAP*. The effective date for the revised *Framework* for preparers of financial statements was, broadly speaking, January 2020, although there are some exceptions to this.

Relevant chapters in this book will discuss, as appropriate, references to the *Framework* in the standards with which they deal.

What you need to know

- The purpose of the *Framework* is to assist the Board to develop IFRSs that are based on consistent concepts.
- The *Framework* describes the objective of, and the concepts for, general purpose financial reporting.
- The *Framework* is not a standard and nothing in it overrides any specific standard or any requirement of one; however, some accounting standards make reference to it.
- If an entity needs to develop an accounting policy in the absence of a specifically applicable IFRS it is required, *inter alia*, to consider the applicability of the definitions, recognition criteria and measurement concepts in the *Framework*.

1 Introduction

There have been numerous attempts over many decades to define the purpose and nature of accounting. Perhaps not surprisingly, most of the earlier studies were carried out by individual academics and academic committees in the US; for example, the writings in 1940 of Paton and Littleton[1] were intended to present a framework of accounting theory that would be regarded as a coherent and consistent foundation for the development of accounting standards, whilst the studies carried out over the years by various committees of the American Accounting Association have made a significant contribution to accounting theory.[2] In addition to the research carried out by individuals and academic committees, professional accounting bodies around the world have also, from time to time, issued statements that deal with various aspects of accounting theory. These can be seen as the first attempts at developing some form of conceptual framework.

With the globalisation of business and the increased access to the world's capital markets that goes with it, there are essentially only two truly global systems of financial reporting - IFRS and US GAAP.

In 2004, the IASB and FASB began a joint project to develop a single conceptual framework, the first phase of which was completed in September 2010. This version of the IASB's conceptual framework (the 2010 *Framework*) comprised two sections finalised in this first phase of the joint project with the FASB, together with other material carried forward from the conceptual framework issued by the former IASC in 1989 ('the 1989 *Framework*'), which was originally intended to be replaced in a second phase of the joint framework project. The 1989 *Framework*, although not jointly developed with the FASB, nevertheless drew heavily on the FASB's then current conceptual framework. No further joint work was undertaken by the two boards and in September 2012 the IASB decided to restart the project as an IASB-only project.

In July 2013 the IASB published a discussion paper[3] which was followed by an exposure draft of an updated framework in May 2015.[4]

In March 2018 the IASB published *Conceptual Framework for Financial Reporting* (the *Framework*).

This chapter discusses the *Framework* as published in 2018. Readers interested in predecessor versions should refer to earlier editions of *International GAAP*. The effective date for the revised *Framework* for preparers of financial statements is, broadly speaking, January 2020, although there are some exceptions to this. Furthermore, certain IFRS accounting standards make reference to earlier versions of the *Framework*. This is discussed in section 2 below.

1.1 What is a conceptual framework?

In general terms, a conceptual framework is a statement of generally accepted theoretical principles which form the frame of reference for a particular field of enquiry. In terms of financial reporting, these theoretical principles provide the basis for both the development of new reporting practices and the evaluation of existing ones. Since the financial reporting process is concerned with the provision of information that is useful in making business and economic decisions, a conceptual framework will form the theoretical basis for determining which events should be accounted for, how they should be measured and how they should be communicated. Therefore, although it is theoretical in nature, a conceptual framework for financial reporting has a highly practical end in view.

1 W. A. Paton and A. C. Littleton, *An Introduction to Corporate Accounting Standards*, Monograph No. 3, American Accounting Association, 1940.

2 See, for example: American Accounting Association, Executive Committee, *A Tentative Statement of Accounting Principles Affecting Corporate Reports*, Accounting Review, June 1936, pp.187-191; American Accounting Association, Executive Committee, *Accounting Principles Underlying Corporate Financial Statements*, Accounting Review, June 1941, pp.133-139; American Accounting Association, Committee to Prepare a Statement of Basic Accounting Theory, *A Statement of Basic Accounting Theory*, 1966; American Accounting Association, Committee on Concepts and Standards for External Financial Reports, *Statement on Accounting Theory and Theory Acceptance*, 1977. The 1977 report concluded that closure on the debate was not feasible, which is perhaps indicative of the complexity of the problem.

3 Discussion Paper DP/2013/1: *A Review of the Conceptual Framework for Financial Reporting*, IASB, July 2013.

4 Exposure Draft ED/2015/3: *Conceptual Framework for Financial Reporting*, IASB, May 2015.

1.2 Why is a conceptual framework necessary?

A conceptual framework for financial reporting should be a theory of accounting against which practical problems can be tested objectively, and the utility of which is decided by the adequacy of the practical solutions it provides. However, the various standard-setting bodies around the world initially often attempted to resolve practical accounting and reporting problems through the development of accounting standards, without such an accepted theoretical frame of reference. The end result was that standard-setters determined the form and content of external financial reports, without resolving such fundamental issues as:

- What are the objectives of these reports?
- Who are the users of these reports?
- What are the informational needs of these users?
- What types of report will best satisfy their needs?

Consequently, standards were often produced on a haphazard and 'fire-fighting' basis with the danger of mutual inconsistencies. By contrast, an agreed framework would, in principle, provide standard-setters with a basis for designing standards that facilitate more consistent external financial reports that meet the needs of the user.

The main role of a conceptual framework is to assist the standard-setter and this is the focus of the discussion in the remainder of this section.

Experience of the last thirty years also shows that, in the absence of an agreed comprehensive conceptual framework, the same theoretical issues were revisited on numerous occasions by different standard-setting bodies. This inevitably sometimes resulted in the development of standards that were internally inconsistent and inconsistent with each other, or which were founded on incompatible concepts. For example, inconsistencies and conflicts have existed between and within individual standards concerning the emphasis placed on substance versus form; neutrality versus prudence; and whether earnings should be determined through balance sheet measurements or by matching costs and revenue. Some standard-setters have permitted two or more methods of accounting for the same set of circumstances, whilst others permitted certain accounting practices to be followed on an arbitrary or unspecified basis. These inconsistencies and irrationalities perhaps reflect the fundamental difficulty of determining what is required in order to give a faithful representation of economic phenomena.

Standard setters have adopted different approaches to the realisation of their conceptual frameworks in specific accounting standards. This can be seen by comparing the standards issued by the FASB with those issued by the IASB. In the US the FASB, in spite of its pioneering work on a conceptual framework, has produced a large number of highly detailed accounting rules. The IASB, on the other hand has tended to produce less detailed standards, relying on preparers and auditors to consider the general principles on which they are based in applying them to specific situations. Clearly, the proliferation of accounting standards in the US stems from many factors, not least the legal and regulatory environment. However, a more satisfactory conceptual framework might reduce the need for such a large number of highly detailed standards, since the emphasis would be on general principles rather than specific rules. Indeed, this change of emphasis has been specifically considered by the US authorities following the financial reporting problems that led, in the US, to the Sarbanes-Oxley Act and the establishment of the Public Company Accounting Oversight Board. This is not to say that the IASB's more general 'principles-based' approach to standard setting is necessarily more satisfactory than the FASB's; rather, the legal and regulatory environment within which non-US businesses habitually work is quite different from that of the US.

The political and economic environment influences not only the approach taken to standard setting, but also the nature of the conceptual framework on which standards are based. Following the widespread incorporation of IFRS into the national GAAPs of many other countries, the IASB is faced with many stakeholders with a variety of needs and expectations. These different stakeholders often express differing views on proposals issued by the IASB and expect their views to be taken into account. Under these circumstances, an agreed conceptual framework is of great value, although the best defence against undue interference in the standard-setting process is the need of the capital markets for financial reporting that provides a sound basis for decision making, which in turn implies a system of financial reporting characterised by relevance, faithful representation, practicality and understandability. While it is probable that these characteristics are more likely to be achieved using a sound theoretical foundation, the converse also applies: namely that the framework must result in standards that account appropriately for actual business practice and economic reality. Otherwise how, for example, is an industry to be persuaded that a particular accounting treatment perceived as adversely affecting its economic interests is better than one which does not?

An agreed framework is therefore not the panacea for all accounting problems. Nor does it obviate the need for judgement to be exercised in the process of resolving accounting issues. What it can provide is a framework within which those judgements can be made. Indeed this is happening, as the principles expressed in the IASB's framework are frequently referred to in IFRSs and during the process of their development. Unfortunately, there is also evidence of the IASB issuing standards that contravene its own conceptual framework. For example, IAS 38 *Intangible Assets* requires the capitalisation of goodwill as an asset, despite the fact that goodwill does not meet the definition of an asset in the IASB's framework. Similarly, IAS 12 *Income Taxes* requires recognition of deferred tax assets and liabilities that arguably do not meet the definitions of asset and liability under the framework.

2 Development of the IASB's Conceptual Framework and effective date

The IASB published *Conceptual Framework for Financial Reporting 2010* in September 2010. This was effectively work-in-progress, comprising two chapters developed in the first phase of the then joint project of the IASB and FASB to develop an agreed framework (see section 1 above), together with material carried forward from the former IASC's 1989 *Framework* (which was adopted in 2001 by the then newly-constituted IASB).

Following the completion of the first phase in 2010, the joint project with the FASB stalled somewhat until, in 2012, the IASB indicated that it no longer saw convergence between IFRS and US GAAP in the area of the conceptual framework as a primary objective and, moreover, that active work on the conceptual framework would resume shortly. This resulted in the publication by the IASB in July 2013 of a discussion paper DP/2013/1 - *A Review of the Conceptual Framework for Financial Reporting*. The discussion paper noted this was no longer a joint project with the FASB, but the IASB's own project.[5] The IASB followed the discussion paper with an exposure draft of an updated framework in May 2015 (*Exposure Draft ED/2015/3: Conceptual Framework for Financial Reporting*).

In March 2018 the IASB published *Conceptual Framework for Financial Reporting* (the *Framework*). This fully revised document replaced the sections of the 2010 version previously carried-forward from the 1989 *Framework* and also made amendments to the sections produced in 2010.

This chapter discusses the *Framework* as published in 2018. Readers interested in predecessor versions should refer to earlier editions of *International GAAP*.

The *Framework* itself has no explicit effective date. However:

The Board and the IFRS Interpretations Committee (IFRS IC) commenced using the 2018 *Framework* immediately it was issued. If, when developing a draft Interpretation, the IFRS IC is faced with an inconsistency between a standard (including any standard developed on the basis of the 1989 *Framework* or the 2010 *Framework*) and the concepts in the 2018 *Framework*, it will refer the issue to the Board, as required by the IFRS Foundation Due Process Handbook. *[CF BC0.27]*.

Preparers of financial statements could be affected by the changes to the *Framework* if they need to use it to develop an accounting policy when no standard applies to a particular transaction or other event or when a standard allows a choice of accounting policy (see Chapter 3 at section 4.3). To achieve transition to the *Framework* for such entities, the Board issued *Amendments to References to the Conceptual Framework in IFRS Standards* in March 2018 (CF References). Where appropriate, that document updated references in standards to refer to the new *Framework* and updated related quotations. *[CF BC0.28]*. These changes became effective for periods beginning on or after 1 January 2020.[6]

Relevant chapters in this publication discuss, as appropriate, references to the *Framework* in the standards with which they deal. At a more general level, it should be noted that not all such references have been changed to refer to the new *Framework*; some continue to refer to previous versions as discussed below.

5 Discussion Paper DP/2013/1: *A Review of the Conceptual Framework for Financial Reporting*, IASB, July 2013, para. 1.5.

6 *Conceptual Framework*, References: Introduction and other sections.

The following continue to refer to the version of the framework in effect when they were developed:

- IFRIC 12 *Service Concession Arrangements* and IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* continue to refer to the 1989 *Framework*. *[IFRIC 12 references, IFRIC 12.BC20, IFRIC 19 references, IFRIC 19.BC16]*.
- IFRS 14 *Regulatory Deferral Accounts*, IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine* and IFRIC 22 *Foreign Currency Transactions and Advance Consideration* continue to refer to the 2010 *Framework*. *[IFRS 14.13, IFRS 14.BC10, IFRIC 20 references, IFRIC 20.BC7, IFRIC 22 references, IFRIC 22.BC17]*.

  And
- IFRS 3 *Business Combinations* continues to refer to the 2010 *Framework* until, at the latest, periods beginning on or after 1 January 2022.[7] For subsequent periods, references in IFRS 3 are to the new *Framework* (see Chapter 10 at section 1.1). *[IFRS 3.11, IFRS 14.13]*. There remains an exception to this requirement whereby IFRS 3 requires reference to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* rather than the *Framework* in certain circumstances. The Board added this exception to avoid an unintended consequence of updating the reference. Without the exception, an entity would have recognised some liabilities on the acquisition of a business that it would not recognise in other circumstances. Immediately after the acquisition, the entity would have had to derecognise such liabilities and recognise a gain that the Board did not consider to depict an economic gain. The Board expects this exception to remain in IFRS 3 for as long as the definition of a liability in IAS 37 differs from the definition in the latest version of the Conceptual *Framework*.

7 *Reference to the Conceptual Framework, Amendments to IFRS 3*, paragraph 64Q, IASB, May 2020.

3 Contents, purpose and scope of the IASB's Conceptual Framework

3.1 Contents of the Conceptual Framework

The *Framework* comprises an introductory section dealing with its status and purpose (discussed in section 3.2 below), followed by eight chapters and an appendix of defined terms. The appendix is an editorial device which extracts (or derives) definitions from the *Framework* itself. As these are dealt with in this chapter in the relevant sections the appendix is not reproduced.

The chapters are as follows:

- Chapter 1 - The objective of general purpose financial reporting (discussed in section 4 below)
- Chapter 2 - Qualitative characteristics of useful financial information (discussed in section 5 below)
- Chapter 3 - Financial statements and the reporting entity (discussed in section 6 below)
- Chapter 4 - The elements of financial statements (discussed in section 7 below)
- Chapter 5 - Recognition and derecognition (discussed in section 8 below)
- Chapter 6 - Measurement (discussed in section 9 below)
- Chapter 7 - Presentation and disclosure (discussed in section 10 below)

  And
- Chapter 8 - Concepts of capital and capital maintenance (discussed in section 11 below)

3.2 Status and purpose of the Conceptual Framework

The purpose of the *Framework* is to assist:

- The Board to develop IFRSs that are based on consistent concepts. However, the Board notes that to meet the objective of general purpose financial reporting, it may sometimes specify requirements that depart from aspects of the *Framework*. If it does so, it will explain the departure in the basis for conclusions on that standard. *[SP 1.3]*.
- Preparers of financial statements to develop consistent accounting policies when no standard applies to a particular transaction or other event, or when a standard allows a choice of accounting policy (see Chapter 3 at section 4.3).

  And
- All parties to understand and interpret IFRS.

The *Framework* describes the objective of, and the concepts for, general purpose financial reporting. *[SP 1.1]*. It is not a standard, and nothing in it overrides any specific standard or any requirement of one. *[SP 1.2]*.

The *Framewor*k may be revised from time to time in light of the IASB's experience of working with it. Revisions to it will not automatically lead to changes to the standards; any decision to amend a standard would require the Board to go through its normal due process. *[SP 1.4]*.

The Board states that its work serves the public interest by fostering trust, growth and long-term financial stability in the global economy and that the *Framework* contributes to the development of standards that bring transparency, accountability and efficiency to financial markets. The IASB describes its *Framework* as providing the foundation for standards that:

- Contribute to transparency by enhancing the international comparability and quality of financial information, enabling investors and other market participants to make informed economic decisions; strengthen accountability by reducing the information gap between the providers of capital and the people to whom they have entrusted their money. Standards based on the *Framework* provide information needed to hold management to account. As a source of globally comparable information, those standards are also of vital importance to regulators around the world; and contribute to economic efficiency by helping investors to identify opportunities and risks across the world, thus improving capital allocation. For businesses, the use of a single, trusted accounting language derived from standards based on the *Framework* lowers the cost of capital and reduces international reporting costs. *[SP 1.5]*.

4 Chapter 1: The objective of general purpose financial reporting

Chapter 1 of the *Framework* discusses the objective of general purpose financial reporting: *[CF 1.1]*

Extract from the Conceptual Framework

Introduction

1.1 The objective of general purpose financial reporting forms the foundation of the *Conceptual Framework*. Other aspects of the *Conceptual Framework*-the qualitative characteristics of, and the cost constraint on, useful financial information, a reporting entity concept, elements of financial statements, recognition and derecognition, measurement, presentation and disclosure - flow logically from the objective.

The Chapter is divided into three main sections dealing with:

- The objective, usefulness and limitations of general purpose financial reporting
- Information about a reporting entity's economic resources, claims, and changes in resources and claims

  And
- Information about an entity's use of such resources

The first of these is discussed in section 4.1 below; section 4.2 below deals with the other two items.

4.1 Objective, usefulness and limitations of general purpose financial reporting

4.1.1 Objective and usefulness

The *Framework* defines the objective of general purpose financial reporting as being: to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity. Those decisions involve decisions about: buying, selling or holding equity and debt instruments; providing or settling loans and other forms of credit; or exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources. *[CF 1.2]*.

Existing and potential investors, lenders and other creditors (collectively, 'users' or 'primary users') cannot generally require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need. Consequently, they are the primary users to whom general purpose financial reports are directed. *[CF 1.5]*. Moreover, financial reports are prepared for users with a reasonable knowledge of business and economic activities who can review and analyse the information diligently. *[CF 2.36]*.

Other parties, such as regulators and members of the public, may also find general purpose financial reports useful. However, those reports are not primarily directed to these other groups. *[CF 1.10]*. This draws out an interesting facet of the Board's objective for financial reporting being restricted to the information needs of those providing resources to a reporting entity. It excludes other common uses of financial information, notably the levying of corporation taxes and restrictions on distribution to members. These two very important areas of corporate activity will typically take as a starting point a measure of profit as reported in the entity's financial reports. Self-evidently, if these uses are not considered in the development of accounting requirements, there is a risk that financial statements will be less suitable for these purposes.

The decisions described in the objective depend on the returns that existing and potential investors, lenders and other creditors expect, for example, dividends, principal and interest payments or market price increases. Investors', lenders' and other creditors' expectations about returns depend on their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity and on their assessment of management's stewardship of the entity's economic resources. Existing and potential investors, lenders and other creditors need information to help them make those assessments. *[CF 1.3]*.

In doing so, users need information about: *[CF 1.4]*

- The economic resources of the entity, claims against the entity and changes in those resources and claims (see section 4.2 below)

  And

- How efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's economic resources (see section 4.2.3 below)

4.1.2 Limitations

The *Framework* acknowledges that general purpose financial reports do not, and cannot, provide all of the information needed by providers of capital. Users of financial reports need to consider other pertinent information, such as general economic and political conditions, and industry and company outlooks. Moreover, general purpose financial reports are not designed to show the value of a reporting entity, but to provide information to allow users to estimate it for themselves. *[CF 1.6, CF 1.7]*.

General purpose financial reports are focused on meeting the needs of the maximum number of primary users, who may have different, and possibly conflicting, needs for information. However, this does not preclude a reporting entity from including additional information that is most useful to a particular subset of primary users. *[CF 1.8]*. It should be noted, however, that IAS 1 *Presentation of Financial Statements* contains the requirement that the understandability of financial statements must not be reduced by obscuring material information with immaterial information. *[IAS 1.30A]*. Similar requirements have been carried over to IFRS 18 *Presentation and Disclosure in Financial Statements*, which replaces IAS 1 from 1 January 2027 at the latest. *[IFRS 18.41(e), IFRS 18.B3. IAS 8(2027).27E]*. IAS 1 and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* are discussed in Chapter 3; IFRS 18 is discussed in Chapter 4. Management of an entity need not rely on general purpose financial reports, since the relevant information can be obtained internally. *[CF 1.9]*.

The IASB notes that, to a large extent, financial reports are based on estimates, judgements and models rather than exact depictions. The *Framework* establishes the concepts that underlie those estimates, judgements and models. The concepts should be seen as a goal which the IASB and preparers should strive towards, but are unlikely to achieve in full, at least in the short term, because it takes time to understand, accept and implement new ways of analysing transactions and other events. Nevertheless, the IASB believes that setting such a goal is essential if financial reporting is to evolve so as to improve its usefulness. *[CF 1.11]*.

4.2 Information about the economic resources of an entity and the use made of them, claims against the entity, and changes in resources and claims

General purpose financial reports provide information about:

- The financial position of a reporting entity (the economic resources of, and claims against, the entity) - see section 4.2.1 below

  And

- The effects of transactions and other events that change the economic resources of, and claims against, the entity - see section 4.2.2 below

Both types of information provide useful input for decisions about providing resources to an entity. *[CF 1.12]*.

4.2.1 Economic resources and claims

Information about the nature and amounts of a reporting entity's economic resources and claims can help users to:

- Identify the entity's financial strengths and weaknesses
- Assess the entity's liquidity and solvency, its needs for additional financing and how successful it is likely to be in obtaining that financing

  And

- Assess management's stewardship of the entity's economic resources

Information about the priorities and payment requirements of existing claims helps users to predict how future cash flows will be distributed among lenders and creditors. *[CF 1.13]*.

Different types of economic resources affect a user's assessment of the entity's prospects for future cash flows in different ways. Some future cash flows result directly from existing economic resources, such as accounts receivable. Other cash flows result from the entity using several resources in combination to produce and market goods or services to customers. Although those cash flows cannot be identified with individual economic resources (or claims), users need to know the nature and amount of the resources available for use in an entity's operations. *[CF 1.14]*.

4.2.2 Changes in economic resources and claims

Changes in a reporting entity's economic resources and claims result from that entity's financial performance and from other events or transactions such as issuing debt or equity instruments. In order to assess properly the prospects for future cash flows of the entity and management's stewardship of resources, users need to know the extent to which the reporting entity has increased its available economic resources, and thus its capacity for generating net cash inflows through its operations rather than by obtaining additional resources directly from providers of capital. *[CF 1.15, CF 1.18, CF 1.21]*.

Information about a reporting entity's financial performance helps users to understand the return that the entity has produced on its economic resources. Information about the return can help users to assess management's stewardship of the entity's economic resources. Information about the variability and components of that return is also important, especially in assessing the uncertainty of future cash flows. Information about a reporting entity's past financial performance and how its management discharged its stewardship responsibilities is usually helpful in predicting the entity's future returns on its economic resources. *[CF 1.16]*.

Financial performance is reflected by changes in the entity's economic resources and claims other than by obtaining additional resources directly from providers of capital. *[CF 1.15, CF 1.18]*. This is sometimes described as a 'balance sheet approach' to recording financial performance, whereby financial performance for a period is essentially derived as part of the overall movement in the entity's financial position during that period. This is discussed more explicitly in the section of the *Framework* dealing with the elements of financial statements (see section 7 below).

Consistent with this 'balance sheet approach', financial performance is based on accrual accounting, which depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period. This provides a better basis for assessing the entity's past and future performance than information based solely on cash flows. *[CF 1.17]*.

Information about an entity's financial performance may also indicate the extent to which events such as changes in market prices or interest rates have changed the entity's economic resources and claims, thereby affecting the entity's ability to generate net cash inflows. *[CF 1.19]*. Nevertheless, information about an entity's cash flows during a period also helps users to assess the entity's ability to generate future net cash inflows, understand the entity's operations, evaluate its financing and investing activities, assess its liquidity or solvency, assess management stewardship and interpret other information about financial performance. *[CF 1.20]*.

4.2.3 Information about the use of economic resources (stewardship)

Management is responsible for the use of an entity's economic resources - for example, by protecting those resources from unfavourable effects of economic factors, such as price and technological changes, and ensuring that the entity complies with applicable laws, regulations and contractual provisions. *[CF 1.23]*.

Information about how efficiently and effectively the reporting entity's management has discharged its responsibilities to use the entity's economic resources helps users to assess management's stewardship of those resources. Such information is also useful for predicting how efficiently and effectively management will use the entity's economic resources in future periods. Hence, it can be useful for assessing the entity's prospects for future net cash inflows. *[CF 1.22]*.

5 Chapter 2: Qualitative characteristics of useful financial information

The *Framework* states that the types of information likely to be most useful to providers of capital are identified by various qualitative characteristics, *[CF 2.1]*, comprising:

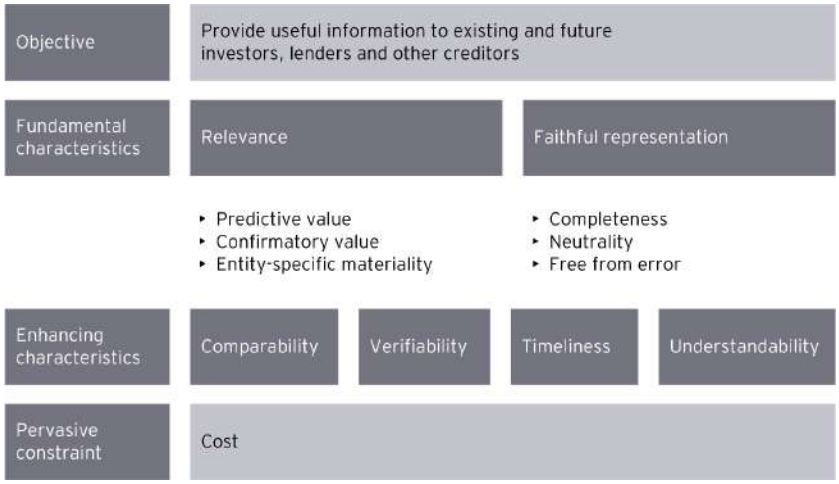
- Two 'fundamental qualitative characteristics' (see section 5.1 below):
  - Relevance
    And
  - Faithful representation *[CF 2.5]*

  Supplemented by:
- Four 'enhancing qualitative characteristics' (see section 5.2 below):
  - Comparability
  - Verifiability
  - Timeliness
    And
  - Understandability *[CF 2.23]*

Chapter 3 of the *Framework* also notes the role of cost as a 'pervasive constraint' on a reporting entity's ability to provide useful financial information. *[CF 2.39]*. This is discussed further in section 5.3 below.

The relationship between the objective, fundamental characteristics, enhancing characteristics and the pervasive cost constraint can be represented diagrammatically:

Figure 5-1: Components of the Conceptual Framework



Monetary amounts in financial reports will not always be observed directly and must instead be estimated; in such cases measurement uncertainty arises. The use of reasonable estimates is an essential part of the preparation of financial information and does not undermine the usefulness of the information if the estimates are clearly and accurately described and explained. Even a high level of measurement uncertainty does not necessarily prevent such an estimate from providing useful information. This is discussed further in section 5.1.3 below. *[CF 2.19]*.

Financial reports provide information about the reporting entity's economic resources, claims against the reporting entity and the effects of transactions and other events and conditions that change those resources and claims (collectively referred to in the *Framework* as 'the economic phenomena'). Some financial reports also include explanatory material about management's expectations and strategies for the reporting entity, and other types of forward-looking information. *[CF 2.2]*. The IASB's work on management reports is discussed in section 12 below.

The qualitative characteristics of useful financial information apply to all financial information, whether provided in financial statements or in other ways. All financial information is also subject to a pervasive cost constraint on the reporting entity's ability to provide useful financial information. However, the considerations in applying the qualitative characteristics and the cost constraint may be different for different types of information. For example, applying them to forward-looking information may be different from applying them to information about existing economic resources and claims and to changes in those resources and claims. *[CF 2.3]*.

5.1 Fundamental qualitative characteristics

In order to be useful, financial information must be relevant (see section 5.1.1 below) and faithfully represent what it purports to represent (see section 5.1.2 below). *[CF 2.4]*.

5.1.1 Relevance (including materiality)

Extract from the Conceptual Framework	
2.6	Relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or are already aware of it from other sources.
2.7	Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value or both.

[CF 2.6, CF 2.7].

Financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes. Financial information with predictive value need not itself be a prediction or forecast, but is employed by users in making their own predictions. Financial information has confirmatory value if it confirms or changes previous evaluations. *[CF 2.8, CF 2.9]*.

The predictive value and confirmatory value of financial information are interrelated. For example, information on revenue for the current year can be used both as the basis for predicting revenues in future years, and as a point of comparison with predictions made in prior years of revenue for the current year. The results of those comparisons can help a user to correct and improve the processes that were used to make those previous predictions. *[CF 2.10]*.

The *Framework* refers to materiality as "an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report". In other words, information is material (and therefore relevant) if omitting it, misstating it, or obscuring it could reasonably be expected to influence the decisions of users of financial information about a specific reporting entity. Because of the specificity of materiality to a particular reporting entity, the IASB cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation. *[CF 2.11]*.

5.1.2 Faithful representation

The *Framework* observes that financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the substance of the phenomena that it purports to represent. In many circumstances, the substance of an economic phenomenon and its legal form are the same. If they are not the same, providing information only about the legal form would not faithfully represent the economic phenomenon (see section 7.1.3 below). *[CF 2.12]*.

A perfectly faithful representation would be:

- Complete
- Neutral

  And

- Free from error

The IASB's objective is to maximise those qualities to the extent possible, while acknowledging that perfection is seldom, if ever, achievable. *[CF 2.13]*.

A complete depiction includes all information, including all necessary descriptions and explanations, necessary for a user to understand the phenomenon being depicted. For example, a complete depiction of a group of assets would include, at a minimum:

- A description of the nature of the assets
- A numerical depiction of the assets

  And

- A description of what the numerical depiction represents (for example, historical cost or fair value)

For some items, a complete depiction may also entail explanations of significant facts about the quality and nature of those items, factors and circumstances that might affect their quality and nature, and the process used to determine the numerical depiction. *[CF 2.14]*.

A neutral depiction is one without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users. That is not to imply that neutral information has no purpose or no influence on behaviour. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions. *[CF 2.15]*.

The *Framework* has a discussion of the word 'prudence', the exercise of which is considered by the Board to support neutrality. The IASB considers prudence to be the exercise of caution when making judgements under conditions of uncertainty. This is said to mean that:

- Assets and income are not overstated and liabilities and expenses are not understated

  But also that

- The exercise of prudence does not allow for the understatement of assets or income or the overstatement of liabilities or expenses

Such misstatements can lead to the overstatement or understatement of income or expenses in future periods. *[CF 2.16]*.

This is not, perhaps, a universally accepted view of the meaning of the word prudence - which to many may mean a more cautious approach to recognising gains and assets and a less cautious approach to recognising losses and liabilities.

The IASB addresses this by stating that the exercise of prudence does not imply a need for asymmetry, for example, a systematic need for more persuasive evidence to support the recognition of assets or income than the recognition of liabilities or expenses. Such asymmetry is not considered by the Board to be a qualitative characteristic of useful financial information. Nevertheless, particular standards may contain asymmetric requirements if this is a consequence of decisions intended to select the most relevant information that faithfully represents what it purports to represent. *[CF 2.17]*.

The *Framework* stresses that the term 'free from error' does not necessarily imply that information is accurate in all respects. Rather, information is 'free from error' if there are no errors or omissions either in the description of the economic phenomenon being depicted or in the selection or application of the process used to produce the reported information. For example, an estimate of an unobservable price or value cannot be determined to be accurate or inaccurate. However, a representation of that estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate. *[CF 2.18]*.

5.1.3 Applying the fundamental qualitative characteristics

In order to be useful, information must be both relevant and provide a faithful representation. In the IASB's words "neither a faithful representation of an irrelevant phenomenon nor an unfaithful representation of a relevant phenomenon helps users make good decisions". *[CF 2.20]*.

The most efficient and effective process for applying the fundamental qualitative characteristics would, subject to the effects of the enhancing qualitative characteristics (see section 5.2 below) and the cost constraint (see section 5.3 below), usually be as follows:

- Identify an economic phenomenon, information about which is capable of being useful to users of the reporting entity's financial information.
- Identify the type of information about that phenomenon that would be most relevant.

  And

- Determine whether that information is available and whether it can provide a faithful representation of the economic phenomenon.

If so, the process of satisfying the fundamental qualitative characteristics ends at that point. If not, the process is repeated with the next most relevant type of information. *[CF 2.21]*.

The *Framework* notes that, potentially, a trade-off between the fundamental qualitative characteristics may need to be made in order to meet the objective of financial reporting, which is to provide useful information about economic phenomena. This is illustrated by reference to estimation which, as noted in section 5 above, is an essential part of the preparation of financial information and does not undermine the usefulness of it. The example given is where the most relevant information about a phenomenon may be a highly uncertain estimate. In some cases, the level of measurement uncertainty involved in making that estimate may be so high that it may be questionable whether the estimate would provide a sufficiently faithful representation of that phenomenon. In some such cases, the most useful information may be the highly uncertain estimate, accompanied by a description of the estimate and an explanation of the uncertainties that affect it. In other such cases, if that information would not provide a sufficiently faithful representation of that phenomenon, the most useful information may include an estimate of another type that is slightly less relevant but is subject to lower measurement uncertainty. In limited circumstances, there may be no estimate that provides useful information. In those limited circumstances, it may be necessary to provide information that does not rely on an estimate. *[CF 2.22]*.

5.2 Enhancing qualitative characteristics

The usefulness of relevant and faithfully represented financial information is enhanced by the characteristics of comparability (see section 5.2.1 below), verifiability (see section 5.2.2 below), timeliness (see section 5.2.3 below) and understandability (see section 5.2.4 below). These enhancing characteristics may also help determine which of two ways should be used to depict a phenomenon if both are considered equally relevant and faithfully represented. *[CF 2.4, CF 2.23]*.

5.2.1 Comparability

The IASB notes that: *[CF 2.24]*

Extract from the Conceptual Framework	
2.24	Users' decisions involve choosing between alternatives, for example, selling or holding an investment, or investing in one reporting entity or another. Consequently, information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.

Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Unlike the other qualitative characteristics, comparability does not relate to a single item, since - by definition - a comparison requires at least two items. The IASB clarifies that, for information to be comparable, like things must look alike and different things must look different, adding that "comparability of financial information is not enhanced by making unlike things look alike any more than it is enhanced by making like things look different." *[CF 2.25, CF 2.26, CF 2.27]*. Although a single economic phenomenon can be faithfully represented in more than one way, permitting alternative accounting methods for the same economic phenomenon diminishes comparability. *[CF 2.29]*.

The *Framework* stresses that consistency (that is, the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities) helps to achieve comparability, but is not the same as comparability. The IASB adds that comparability is not the same as uniformity, but without any definition of 'uniformity' or clarification of how it differs from comparability. Some degree of comparability is likely to be attained simply by satisfying the fundamental qualitative characteristics. In other words, a faithful representation of a relevant economic phenomenon by one entity should naturally be comparable with a faithful representation of a similar relevant economic phenomenon by another entity. *[CF 2.26, CF 2.27, CF 2.28]*.

5.2.2 Verifiability

Verifiability helps assure users that information faithfully represents the economic phenomena that it purports to depict. Verifiability means that different knowledgeable and independent observers could reach a consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Quantified information need not be a single point estimate to be verifiable. A range of possible amounts and their related probabilities can also be verified. *[CF 2.30]*.

The IASB notes that verification can be direct or indirect. Direct verification means verifying an amount or other representation through direct observation. Indirect verification means checking the inputs to a model, formula or other technique and recalculating the outputs using the same methodology. Some explanations and forward-looking financial information may not be verifiable until a future period, if at all. To help users decide whether to use such information, it would normally be necessary to disclose the assumptions, other factors and circumstances underlying the information, together with the methods of compiling the information. *[CF 2.31, CF 2.32]*.

5.2.3 Timeliness

Timeliness means that information is available to decision-makers in time to be capable of influencing their decisions. Generally, the older the information is the less useful it is. However, some information may continue to be timely long after the end of a reporting period, for example because some users may need to identify and assess trends. *[CF 2.33]*.

5.2.4 Understandability

Information is made understandable by classifying, characterising and presenting it clearly and concisely. *[CF 2.34]*. The IASB concedes that some phenomena are so inherently complex and difficult to understand that financial reports might be easier to understand if information about those phenomena were excluded. However, reports prepared without that information would be incomplete and therefore possibly misleading. Moreover, financial reports are prepared for users with a reasonable knowledge of business and economic activities who can review and analyse the information diligently. Even such users, however, may need to seek specialist advice in order to understand information about complex economic phenomena. *[CF 2.35, CF 2.36]*.

5.2.5 Applying the enhancing qualitative characteristics

The *Framework* stresses that, while the enhancing qualitative characteristics should be maximised to the extent possible, they cannot, either individually or as a group, make information useful if that information is irrelevant or does not give a faithful representation. *[CF 2.37]*.

Applying the enhancing qualitative characteristics is an iterative process that does not follow a prescribed order. Sometimes, one enhancing qualitative characteristic may have to be diminished in order to maximise another. For example, applying a new standard prospectively (that is, with no restatement of prior periods) will reduce comparability in the short term. However, that may be a price worth paying for improved relevance or faithful representation in the longer term. Appropriate disclosures may partially compensate for the lack of comparability. *[CF 2.38]*.

5.3 The cost constraint

The IASB acknowledges that cost is a pervasive constraint on the information provided by financial reporting, and that the cost of producing information must be justified by the benefits that it provides. Interestingly, the IASB argues that, while there is clearly an explicit cost to the preparers of financial information, the cost is ultimately borne by users, since any cost incurred by the reporting entity reduces the returns earned by users. In addition, users incur costs not only in analysing and interpreting any information that is provided, but also in obtaining or estimating any information that is not provided. *[CF 2.39, CF 2.40, CF 2.42]*.

Relevant and faithfully representative financial information helps users to make decisions with more confidence, resulting in a more efficient functioning of capital markets and a lower cost of capital for the economy as a whole. An individual provider of capital also receives benefits by making more informed decisions. However, it is not possible for general purpose financial reports to provide all information relevant to every user. *[CF 2.41]*.

In assessing whether the benefits of reporting particular information are likely to justify the cost, the IASB seeks information from providers of financial information, users, auditors, academics and others about the expected nature and quantity of the benefits and costs of that standard. In most situations, assessments are based on a combination of quantitative and qualitative information, and will normally be considered in relation to financial reporting generally, and not in relation to individual reporting entities. However, an assessment of costs and benefits will not always justify the same reporting requirements for all entities. Differences may be appropriate because of different sizes of entities, different ways of raising capital (publicly or privately), different needs of users or other factors. *[CF 2.42, CF 2.43]*.

6 Chapter 3: Financial statements and the reporting entity

Chapter 3 of the *Framework* deals with two questions:

- What are financial statements? (Discussed in section 6.1 below.)

  And

- What is the 'reporting entity' which prepares financial statements? (Discussed in section 6.2 below.) *[CF 3.1, CF 3.10]*.

6.1 Financial statements

Financial statements provide information about economic resources of the reporting entity, claims against the entity, and changes in those resources and claims, that meet the definitions of the elements of financial statements (discussed in section 7 below). *[CF 3.1]*.

6.1.1 Objective and scope of financial statements

The objective of financial statements is to provide financial information about the reporting entity's assets, liabilities, equity, income and expenses that is useful to users of financial statements in assessing the prospects for future net cash inflows to the reporting entity and in assessing management's stewardship of the entity's economic resources (discussed in section 4 above). *[CF 1.1, CF 1.2, CF 3.2]*.

The *Framework* goes on to note: *[CF 3.3]*

Extract from the Conceptual Framework

3.3 That information is provided:

(a) in the statement of financial position, by recognising assets, liabilities and equity;

(b) in the statement(s) of financial performance,[9] by recognising income and expenses; and

(c) in other statements and notes, by presenting and disclosing information about:

(i) recognised assets, liabilities, equity, income and expenses (see paragraph 5.1), including information about their nature and about the risks arising from those recognised assets and liabilities;

(ii) assets and liabilities that have not been recognised (see paragraph 5.6), including information about their nature and about the risks arising from them;

(iii) cash flows;

(iv) contributions from holders of equity claims and distributions to them; and

(v) the methods, assumptions and judgements used in estimating the amounts presented or disclosed, and changes in those methods, assumptions and judgements.

9 The *Conceptual Framework* does not specify whether the statement(s) of financial performance comprise(s) a single statement or two statements.

The subject of presentation and disclosure is discussed in section 10 below; recognition and derecognition is discussed in section 8 below.

6.1.2 Reporting period and comparative information

Financial statements are prepared for a specified period of time (reporting period) and provide information about:

- Assets and liabilities (including unrecognised assets and liabilities) and equity that existed at the end of the reporting period, or during the reporting period

  And

- Income and expenses for the reporting period *[CF 3.4]*

To help users of financial statements to identify and assess changes and trends, financial statements also provide comparative information for at least one preceding reporting period. *[CF 3.5]*.

Information about possible future transactions and other possible future events (forward-looking information) is included in financial statements if it:

- Relates to the entity's assets or liabilities (including unrecognised assets or liabilities) or equity that existed at the end of the reporting period, or during the reporting period, or to income or expenses for the reporting period

  And

- Is useful to users of financial statements

For example, if an asset or liability is measured by estimating future cash flows, information about those estimated future cash flows may help users of financial statements to understand the reported measures. Financial statements do not typically provide other types of forward-looking information, for example, explanatory material about management's expectations and strategies for the reporting entity. *[CF 3.6]*.

Financial statements include information about transactions and other events that have occurred after the end of the reporting period if providing that information is necessary to meet the objective of financial statements (see section 4 above). *[CF 3.7]*.

6.1.3 Perspective adopted in financial statements

Financial statements provide information about transactions and other events viewed from the perspective of the reporting entity as a whole, not from the perspective of any particular group of the entity's existing or potential investors, lenders or other creditors. *[CF 3.8]*.

6.1.4 Going concern assumption

Financial statements are normally prepared on the assumption that the reporting entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to enter liquidation or to cease trading. If such an intention or need exists, the financial statements may have to be prepared on a different basis. If so, the financial statements describe the basis used. *[CF 3.9]*.

6.2 The reporting entity

A reporting entity is an entity that is required, or chooses, to prepare financial statements. A reporting entity can be a single entity or a portion of an entity or can comprise more than one entity. A reporting entity is not necessarily a legal entity. *[CF 3.10]*.

Sometimes one entity (parent) has control over another entity (subsidiary). If a reporting entity comprises both the parent and its subsidiaries, the reporting entity's financial statements are referred to as 'consolidated financial statements'. If a reporting entity is the parent alone, the reporting entity's financial statements are referred to as 'unconsolidated financial statements' (see section 6.2.1 below). *[CF 3.11]*.

If a reporting entity comprises two or more entities that are not all linked by a parent-subsidiary relationship, the reporting entity's financial statements are referred to as 'combined financial statements'. *[CF 3.12]*.

Determining the appropriate boundary of a reporting entity can be difficult if the reporting entity:

- Is not a legal entity

  And

- Does not comprise only legal entities linked by a parent-subsidiary relationship *[CF 3.13]*

In such cases, determining the boundary of the reporting entity is driven by the information needs of the primary users of the reporting entity's financial statements. Those users need relevant information that faithfully represents what it purports to represent. Faithful representation requires that:

- The boundary of the reporting entity does not contain an arbitrary or incomplete set of economic activities.
- Including that set of economic activities within the boundary of the reporting entity results in neutral information.

  And

- A description is provided of how the boundary of the reporting entity was determined and of what constitutes the reporting entity. *[CF 3.14]*.

Without being explicit, this discussion in the *Framework* seems to confirm that combined financial statements can be said to comply with IFRS (subject, of course, to the matters in the bullets above and to compliance generally with IFRS for the 'combined' reporting entity).

The Basis for Conclusions, however, suggests a certain hesitancy by the Board. It articulates that the IASB is of the opinion that combined financial statements "can provide useful information to users of financial statements in some circumstances" and for this reason the *Framework* "acknowledges the concept of combined financial statements."

This view is somewhat attenuated by the Board stating that the *Framework* "does not discuss when or how entities could prepare combined financial statements" and that "such discussion would be best developed if the Board decides in the future to develop a Standard on this topic". *[CF BC3.21]*.

The *Framework* remains silent on a similar matter regarding what is frequently called 'carve-out' accounting. This is where a reporting entity is determined to be part of a legal entity.

How we see it

In our view, considerations similar to those discussed in the *Framework* regarding combined financial statements should apply to financial statements prepared on a 'carve-out' basis.

6.2.1 Consolidated and unconsolidated financial statements

Consolidated financial statements provide information about the assets, liabilities, equity, income and expenses of both the parent and its subsidiaries as a single reporting entity. That information is useful for existing and potential investors, lenders and other creditors of the parent in their assessment of the prospects for future net cash inflows to the parent. This is because net cash inflows to the parent include distributions to the parent from its subsidiaries, and those distributions depend on net cash inflows to the subsidiaries. *[CF 3.15]*.

Consolidated financial statements are not designed to provide separate information about the assets, liabilities, equity, income and expenses of any particular subsidiary. A subsidiary's own financial statements are designed to provide that information. *[CF 3.16]*.

Unconsolidated financial statements are designed to provide information about the parent's assets, liabilities, equity, income and expenses, and not about those of its subsidiaries. That information can be useful to existing and potential investors, lenders and other creditors of the parent because:

- A claim against the parent typically does not give the holder of that claim a claim against subsidiaries

  And
- In some jurisdictions, the amounts that can be legally distributed to holders of equity claims against the parent depend on the distributable reserves of the parent

Another way to provide information about some or all assets, liabilities, equity, income and expenses of the parent alone is to present it in the notes to consolidated financial statements. *[CF 3.17]*.

Information provided in unconsolidated financial statements is typically not sufficient to meet the information needs of existing and potential investors, lenders and other creditors of the parent. Accordingly, when consolidated financial statements are required, unconsolidated financial statements cannot serve as a substitute for consolidated financial statements. Nevertheless, a parent may be required, or choose, to prepare unconsolidated financial statements in addition to consolidated financial statements. *[CF 3.18]*.

7 Chapter 4: The elements of financial statements

As discussed in section 4 above, it is the central tenet of the *Framework* that users of financial information require information concerning:

- The economic resources of and claims against an entity

  And

- Changes in those resources and claims

These are described in the *Framework* as being linked to the 'elements' of financial statements which are: assets, liabilities, equity, income and expense.

They are analysed as follows. *[CF 4.1, CF 4.2, CF 4.3, CF 4.4, CF 4.26, CF 4.63, CF 4.68, CF 4.69]*.

Economic resources are rights which have the potential to produce economic benefits.

Assets are present economic resources controlled by an entity as a result of past events (discussed in section 7.2 below):

Claims against an entity comprise:

- *Liabilities*, which are present obligations to transfer economic resources as a result of past events (discussed in section 7.3 below)
- *Equity* is the residual interest in the assets of an entity after deducting all its liabilities (discussed in section 7.4 below)

Changes in economic resources and claims comprise:

- *Income* and *expenses* (discussed in section 7.5 below)

  And

- *Other changes*

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

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

Other changes are:

- Exchanges of assets or liabilities that do not result in increases or decreases in equity

  And

- Contributions from and distributions to holders of equity claims

The recognition and derecognition of elements is discussed in section 8 below. Measurement of the elements is discussed in section 9 below and presentation in section 10 below.

It is apparent that the approach to the elements of financial statements reflects what is sometimes described as a 'balance sheet approach' to recording financial performance, whereby financial performance for a period is essentially derived as part of the overall movement in the entity's financial position during that period. What this means is that all non-owner changes in equity comprise 'performance' in its broadest sense. A difficulty for the Board in developing the *Framework* is that there is in financial reporting a well-established idea of profit (and hence, a profit and loss account) which contains only a subset of all such performance. The provisions of the *Framework* in this regard are discussed in section 10.2.3 below.

7.1 Matters concerning both assets and liabilities

The *Framework* discusses three concepts which will apply both to assets and liabilities and are relevant for accounting purposes. These are: unit of account, executory contracts and the substance of arrangements. These are discussed in turn below.

7.1.1 Unit of account

The unit of account is the right or the group of rights, the obligation or the group of obligations, or the group of rights and obligations, to which recognition criteria and measurement concepts are applied. *[CF 4.48]*.

A unit of account is selected for an asset or liability when considering how recognition criteria and measurement concepts will apply to that asset or liability and to the related income and expenses. In some circumstances, it may be appropriate to select one unit of account for recognition and a different unit of account for measurement. For example, contracts may sometimes be recognised individually but measured as part of a portfolio of contracts. For presentation and disclosure, assets, liabilities, income and expenses may need to be aggregated or separated into components. *[CF 4.49]*.

If an entity transfers part of an asset or part of a liability, the unit of account may change at that time, so that the transferred component and the retained component become separate units of account (derecognition is discussed in section 8.3 below). *[CF 4.50]*.

A unit of account is selected to provide useful information, which implies that:

- The information provided about the asset or liability and about any related income and expenses must be relevant. Treating a group of rights and obligations as a single unit of account may provide more relevant information than treating each right or obligation as a separate unit of account if, for example, those rights and obligations:
  - Cannot be or are unlikely to be the subject of separate transactions
  - Cannot or are unlikely to expire in different patterns
  - Have similar economic characteristics and risks and hence are likely to have similar implications for the prospects for future net cash inflows to the entity or net cash outflows from the entity

    Or
  - Are used together in the business activities conducted by an entity to produce cash flows and are measured by reference to estimates of their interdependent future cash flows
  - The information provided about the asset or liability and about any related income and expenses must faithfully represent the substance of the transaction or other event from which they have arisen. Therefore, it may be necessary to treat rights or obligations arising from different sources as a single unit of account, or to separate the rights or obligations arising from a single source. Equally, to provide a faithful representation of unrelated rights and obligations, it may be necessary to recognise and measure them separately. *[CF 4.51]*.

  Also relevant here is the discussion in the *Framework* of the substance of rights and obligations - see section 7.1.3 below.

Just as cost constrains other financial reporting decisions, it also constrains the selection of a unit of account. Hence, in selecting a unit of account, it is important to consider whether the benefits of the information provided to users of financial statements by selecting that unit of account are likely to justify the costs of providing and using that information. In general, the costs associated with recognising and measuring assets, liabilities, income and expenses increase as the size of the unit of account decreases. Hence, in general, rights or obligations arising from the same source are separated only if the resulting information is more useful and the benefits outweigh the costs. *[CF 4.52]*.

Sometimes, both rights and obligations arise from the same source. For example, some contracts establish both rights and obligations for each of the parties. If those rights and obligations are interdependent and cannot be separated, they constitute a single inseparable asset or liability and hence form a single unit of account. For example, this is the case with executory contracts (see section 7.1.2 below). Conversely, if rights are separable from obligations, it may sometimes be appropriate to group the rights separately from the obligations, resulting in the identification of one or more separate assets and liabilities. In other cases, it may be more appropriate to group separable rights and obligations in a single unit of account treating them as a single asset or a single liability. *[CF 4.53]*.

Treating a set of rights and obligations as a single unit of account differs from offsetting assets and liabilities (see section 10.2.1.A below). *[CF 4.54]*.

The Framework provides the following examples of units of account: *[CF 4.55]*

Extract from the Conceptual Framework

4.55 Possible units of account include:

(a) an individual right or individual obligation;

(b) all rights, all obligations, or all rights and all obligations, arising from a single source, for example, a contract;

(c) a subgroup of those rights and/or obligations-for example, a subgroup of rights over an item of property, plant and equipment for which the useful life and pattern of consumption differ from those of the other rights over that item;

(d) a group of rights and/or obligations arising from a portfolio of similar items;

(e) a group of rights and/or obligations arising from a portfolio of dissimilar items-for example, a portfolio of assets and liabilities to be disposed of in a single transaction; and

(f) a risk exposure within a portfolio of items-if a portfolio of items is subject to a common risk, some aspects of the accounting for that portfolio could focus on the aggregate exposure to that risk within the portfolio.

7.1.2 Executory contracts

An executory contract is a contract, or a portion of a contract, that is equally unperformed. That is, either: neither party has fulfilled any of its obligations, or both parties have partially fulfilled their obligations to an equal extent. *[CF 4.56]*.

An executory contract establishes a combined right and obligation to exchange economic resources. The right and obligation are interdependent and cannot be separated. Hence, the combined right and obligation constitute a single asset or liability. The entity has an asset if the terms of the exchange are currently favourable; it has a liability if the terms of the exchange are currently unfavourable. Whether such an asset or liability is included in the financial statements depends on both the recognition criteria (see section 8 below) and the measurement basis (see section 9 below) selected for the asset or liability, including, if applicable, any test for whether the contract is onerous. *[CF 4.57]*.

To the extent that either party fulfils its obligations under the contract, the contract is no longer executory. If the reporting entity performs first under the contract, that performance is the event that changes the reporting entity's right and obligation to exchange economic resources into a right to receive an economic resource. That right is an asset. If the other party performs first, that performance is the event that changes the reporting entity's right and obligation to exchange economic resources into an obligation to transfer an economic resource. That obligation is a liability. *[CF 4.58]*.

7.1.3 Substance of contractual rights and contractual obligations

The terms of a contract create rights and obligations for an entity that is a party to that contract. To represent those rights and obligations faithfully (discussed in section 5.1.2 above), financial statements report their substance. In some cases, the substance of the rights and obligations is clear from the legal form of the contract. In other cases, the terms of the contract or a group or series of contracts require analysis to identify the substance of the rights and obligations. *[CF 4.59]*.

All terms in a contract, whether explicit or implicit, are considered unless they have no substance. Implicit terms could include, for example, obligations imposed by statute, such as statutory warranty obligations imposed on entities that enter into contracts to sell goods to customers. *[CF 4.60]*.

Terms that have no substance are disregarded. A term has no substance if it has no discernible effect on the economics of the contract. Terms that have no substance could include, for example:

- Terms that bind neither party

  Or

- Rights, including options, that the holder will not have the practical ability to exercise in any circumstances *[CF 4.61]*

A group or series of contracts may achieve or be designed to achieve an overall commercial effect. To report the substance of such contracts, it may be necessary to treat rights and obligations arising from that group or series of contracts as a single unit of account. For example, if the rights or obligations in one contract merely nullify all the rights or obligations in another contract entered into at the same time with the same counterparty, the combined effect is that the two contracts create no rights or obligations. Conversely, if a single contract creates two or more sets of rights or obligations that could have been created through two or more separate contracts, an entity may need to account for each set as if it arose from separate contracts in order to represent faithfully the rights and obligations (see the discussion of unit of account in section 7.1.1 above). *[CF 4.62]*.

7.2 Definition of assets

As noted in section 7 above, the definition of an asset is an economic resource subject to three criteria: it is a right of the entity; it has the potential to produce economic benefits; and it is controlled by the entity. Each is discussed in turn in the following sections. *[CF 4.5]*.

7.2.1 Rights

It is observed that rights that have the potential to produce economic benefits take many forms, including:

- Rights that correspond to an obligation of another party (see section 7.3.1 below), for example, rights to:
  - Receive cash
  - Receive goods or services
  - Exchange economic resources with another party on favourable terms. Such rights include, for example, a forward contract to buy an economic resource on terms that are currently favourable or an option to buy an economic resource

    And
  - Benefit from an obligation of another party to transfer an economic resource if a specified uncertain future event occurs
- Rights that do not correspond to an obligation of another party, for example, rights:
  - Over physical objects, such as property, plant and equipment or inventories. Examples of such rights are a right to use a physical object or a right to benefit from the residual value of a leased object.

    And
  - To use intellectual property *[CF 4.6]*

Many rights are established by contract, legislation or similar means. For example, an entity might obtain rights from owning or leasing a physical object, from owning a debt instrument or an equity instrument, or from owning a registered patent. However, an entity might also obtain rights in other ways, for example:

- By acquiring or creating know-how that is not in the public domain (see discussion of control in section 7.2.3 below).

  Or
- Through an obligation of another party that arises because that other party has no practical ability to act in a manner inconsistent with its customary practices, published policies or specific statements - that is, a constructive obligation discussed in section 7.3.1 below. *[CF 4.7]*.

Some goods or services, for example, employee services, are received and immediately consumed. An entity's right to obtain the economic benefits produced by such goods or services exists momentarily until the entity consumes the goods or services. *[CF 4.8]*.

Not all of an entity's rights are assets of that entity; to be assets the rights must also satisfy the other two criteria noted above (the potential to produce economic benefits, discussed in section 7.2.2 below; and, control, discussed in section 7.2.3 below). For example, rights available to all parties without significant cost - for instance, rights of access to public goods, such as public rights of way over land, or know-how that is in the public domain - are typically not assets for the entities that hold them. *[CF 4.9]*.

An entity cannot have a right to obtain economic benefits from itself. Accordingly:

- Debt instruments or equity instruments issued by the entity and repurchased and held by it (for example, treasury shares) are not economic resources of that entity.

  And

- If a reporting entity comprises more than one legal entity, debt instruments or equity instruments issued by one of those legal entities and held by another of those legal entities are not economic resources of the reporting entity. *[CF 4.10]*.

In principle, each of an entity's rights is a separate asset. However, for accounting purposes, related rights are often treated as a single unit of account that is a single asset (unit of account is discussed in section 7.1.1 above). For example, legal ownership of a physical object may give rise to several rights, including:

- The right to use the object
- The right to sell rights over the object
- The right to pledge rights over the object

  And

- Other rights *[CF 4.11]*

In many cases, the set of rights arising from legal ownership of a physical object is accounted for as a single asset. Conceptually, the economic resource is the set of rights, not the physical object. Nevertheless, describing the set of rights as the physical object will often provide a faithful representation of those rights in the most concise and understandable way. *[CF 4.12]*.

In some cases, it is uncertain whether a right exists. For example, an entity and another party might dispute whether the entity has a right to receive an economic resource from that other party. Until that existence uncertainty is resolved, for example, by a court ruling, it is uncertain whether the entity has a right and, consequently, whether an asset exists (see section 8.2.1.A below). *[CF 4.13]*.

7.2.2 Potential to produce economic benefits

An economic resource is a right that has the potential to produce economic benefits. For that potential to exist, it does not need to be certain, or even likely, that the right will produce economic benefits. It is only necessary that the right already exists and that, in at least one circumstance, it would produce for the entity economic benefits beyond those available to all other parties. *[CF 4.14]*.

A right can meet the definition of an economic resource, and hence can be an asset, even if the probability that it will produce economic benefits is low. Nevertheless, that low probability might affect decisions about what information to provide about the asset and how to provide that information, including decisions about whether the asset is recognised (see section 8.2.1.B below) and how it is measured (see section 9 below). *[CF 4.15]*.

An economic resource could produce economic benefits for an entity by entitling or enabling it to do, for example, one or more of the following:

- Receive contractual cash flows or another economic resource
- Exchange economic resources with another party on favourable terms
- Produce cash inflows or avoid cash outflows by, for example:
  - Using the economic resource either individually or in combination with other economic resources to produce goods or provide services
  - Using the economic resource to enhance the value of other economic resources

    Or

  - Leasing the economic resource to another party
- Receive cash or other economic resources by selling the economic resource

  Or

- Extinguish liabilities by transferring the economic resource *[CF 4.16]*

Although an economic resource derives its value from its present potential to produce future economic benefits, the economic resource is the present right that contains that potential, not the future economic benefits that the right may produce. For example, a purchased option derives its value from its potential to produce economic benefits through exercise of the option at a future date. However, the economic resource is the present right, that is the right to exercise the option at a future date. The economic resource is not the future economic benefits that the holder will receive if the option is exercised. *[CF 4.17]*.

There is a close association between incurring expenditure and acquiring assets, but the two do not necessarily coincide. Hence, when an entity incurs expenditure, this may provide evidence that the entity has sought future economic benefits, but does not provide conclusive proof that the entity has obtained an asset. Similarly, the absence of related expenditure does not preclude an item from meeting the definition of an asset. Assets can include, for example, rights that a government has granted to the entity free of charge or that another party has donated to the entity. *[CF 4.18]*.

7.2.3 Control

Control links an economic resource to an entity. Assessing whether control exists helps to identify the economic resource for which the entity accounts. For example, an entity may control a proportionate share in a property without controlling the rights arising from ownership of the entire property. In such cases, the entity's asset is the share in the property, which it controls, not the rights arising from ownership of the entire property, which it does not control. *[CF 4.19]*.

An entity controls an economic resource if it has the present ability to direct the use of the economic resource and obtain the economic benefits that may flow from it. Control includes the present ability to prevent other parties from directing the use of the economic resource and from obtaining the economic benefits that may flow from it. It follows that, if one party controls an economic resource, no other party controls that resource. *[CF 4.20]*.

An entity has the present ability to direct the use of an economic resource if it has the right to deploy that economic resource in its activities, or to allow another party to deploy the economic resource in that other party's activities. *[CF 4.21]*.

Control of an economic resource usually arises from an ability to enforce legal rights. However, control can also arise if an entity has other means of ensuring that it, and no other party, has the present ability to direct the use of the economic resource and obtain the benefits that may flow from it. For example, an entity could control a right to use know-how that is not in the public domain if the entity has access to the know-how and the present ability to keep the know-how secret, even if that know-how is not protected by a registered patent. *[CF 4.22]*.

For an entity to control an economic resource, the future economic benefits from that resource must flow to the entity either directly or indirectly rather than to another party. This aspect of control does not imply that the entity can ensure that the resource will produce economic benefits in all circumstances. Instead, it means that if the resource produces economic benefits, the entity is the party that will obtain them either directly or indirectly. *[CF 4.23]*.

Having exposure to significant variations in the amount of the economic benefits produced by an economic resource may indicate that the entity controls the resource. However, it is only one factor to consider in the overall assessment of whether control exists. *[CF 4.24]*.

Sometimes one party (a principal) engages another party (an agent) to act on behalf of, and for the benefit of, the principal. For example, a principal may engage an agent to arrange sales of goods controlled by the principal. If an agent has custody of an economic resource controlled by the principal, that economic resource is not an asset of the agent. Furthermore, if the agent has an obligation to transfer to a third party an economic resource controlled by the principal, that obligation is not a liability of the agent, because the economic resource that would be transferred is the principal's economic resource, not the agent's. *[CF 4.25]*.

7.3 Definition of liabilities

As noted in section 7 above, the *Framework* defines a liability as: *[CF 4.2, CF 4.26]*

Extract from the Conceptual Framework	
4.26	A liability is a present obligation of the entity to transfer an economic resource as a result of past events.

For a liability to exist, three criteria must all be satisfied:

- The entity has an obligation
- The obligation is to transfer an economic resource

  And
- The obligation is a present obligation that exists as a result of past events *[CF 4.27]*

These criteria are discussed in turn below.

7.3.1 Obligation

The first criterion for a liability is that the entity has an obligation. An obligation is a duty or responsibility that an entity has no practical ability to avoid. An obligation is always owed to another party (or parties). The other party (or parties) could be a person or another entity, a group of people or other entities, or society at large. It is not necessary to know the identity of the party (or parties) to whom the obligation is owed. *[CF 4.28, CF 4.29]*.

If one party has an obligation to transfer an economic resource, it follows that another party (or parties) has a right to receive that economic resource. However, a requirement for one party to recognise a liability and measure it at a specified amount does not imply that the other party (or parties) must recognise an asset or measure it at the same amount. For example, particular standards may contain different recognition criteria or measurement requirements for the liability of one party and the corresponding asset of the other party (or parties) if those different criteria or requirements are a consequence of decisions intended to select the most relevant information that faithfully represents what it purports to represent. *[CF 4.30]*.

Many obligations are established by contract, legislation or similar means and are legally enforceable by the party (or parties) to whom they are owed. Obligations can also arise, however, from an entity's customary practices, published policies or specific statements if the entity has no practical ability to act in a manner inconsistent with those practices, policies or statements. The obligation that arises in such situations is sometimes referred to as a 'constructive obligation'. *[CF 4.31]*.

In some situations, an entity's duty or responsibility to transfer an economic resource is conditional on a particular future action that the entity itself may take. Such actions could include operating a particular business or operating in a particular market on a specified future date, or exercising particular options within a contract. In such situations, the entity has an obligation if it has no practical ability to avoid taking that action. *[CF 4.32]*.

A conclusion that it is appropriate to prepare an entity's financial statements on a going concern basis also implies a conclusion that the entity has no practical ability to avoid a transfer that could be avoided only by liquidating the entity or by ceasing to trade. *[CF 4.33]*.

The factors used to assess whether an entity has the practical ability to avoid transferring an economic resource may depend on the nature of the entity's duty or responsibility. For example, in some cases, an entity may have no practical ability to avoid a transfer if any action that it could take to avoid the transfer would have economic consequences significantly more adverse than the transfer itself. However, neither an intention to make a transfer, nor a high likelihood of a transfer, is sufficient reason for concluding that the entity has no practical ability to avoid a transfer. *[CF 4.34]*.

In some cases, it is uncertain whether an obligation exists. For example, if another party is seeking compensation for an entity's alleged act of wrongdoing, it might be uncertain whether the act occurred, whether the entity committed it or how the law applies. Until that existence uncertainty is resolved, for example, by a court ruling, it is uncertain whether the entity has an obligation to the party seeking compensation and, consequently, whether a liability exists (see section 8.2.1.A below). *[CF 4.35]*.

7.3.2 Transfer an economic resource

The second criterion for a liability is that the obligation is to transfer an economic resource. To satisfy this criterion, the obligation must have the potential to require the entity to transfer an economic resource to another party (or parties). For that potential to exist, it does not need to be certain, or even likely, that the entity will be required to transfer an economic resource; the transfer may, for example, be required only if a specified uncertain future event occurs. It is only necessary that the obligation already exists and that, in at least one circumstance, it would require the entity to transfer an economic resource. *[CF 4.36, CF 4.37]*.

An obligation can meet the definition of a liability even if the probability of a transfer of an economic resource is low. Nevertheless, that low probability might affect decisions about what information to provide about the liability and how to provide that information, including decisions about whether the liability is recognised (see section 8.2.1.B below) and how it is measured (discussed in section 9 below). *[CF 4.38]*.

Obligations to transfer an economic resource include, for example, obligations to:

- Pay cash
- Deliver goods or provide services
- Exchange economic resources with another party on unfavourable terms. Such obligations include, for example, a forward contract to sell an economic resource on terms that are currently unfavourable or an option that entitles another party to buy an economic resource from the entity.
- Transfer an economic resource if a specified uncertain future event occurs

  And
- Issue a financial instrument if that financial instrument will oblige the entity to transfer an economic resource *[CF 4.39]*

Instead of fulfilling an obligation to transfer an economic resource to the party that has a right to receive that resource, entities sometimes decide to, for example:

- Settle the obligation by negotiating a release from the obligation
- Transfer the obligation to a third party

  Or
- Replace that obligation to transfer an economic resource with another obligation by entering into a new transaction

  In these situations, an entity has the obligation to transfer an economic resource until it has settled, transferred or replaced that obligation. *[CF 4.40, CF 4.41]*.

7.3.3 Present obligation existing as a result of past events

The third criterion for a liability is that the obligation is a present obligation that exists as a result of past events. That is:

- The entity has already obtained economic benefits or taken an action

  And
- As a consequence, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer *[CF 4.42, CF 4.43]*

The economic benefits obtained could include, for example, goods or services. The action taken could include, for example, operating a particular business or operating in a particular market. If economic benefits are obtained, or an action is taken, over time, the resulting present obligation may accumulate over that time. *[CF 4.44]*.

If new legislation is enacted, a present obligation arises only when, as a consequence of obtaining economic benefits or taking an action to which that legislation applies, an entity will or may have to transfer an economic resource that it would not otherwise have had to transfer. The enactment of legislation is not in itself sufficient to give an entity a present obligation. Similarly, an entity's customary practice, published policy or specific statement of the type mentioned in section 7.3.1 above gives rise to a present obligation only when, as a consequence of obtaining economic benefits, or taking an action, to which that practice, policy or statement applies, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer. *[CF 4.45]*.

A present obligation can exist even if a transfer of economic resources cannot be enforced until some point in the future. For example, a contractual liability to pay cash may exist now even if the contract does not require a payment until a future date. Similarly, a contractual obligation for an entity to perform work at a future date may exist now even if the counterparty cannot require the entity to perform the work until that future date. *[CF 4.46]*.

An entity does not yet have a present obligation to transfer an economic resource if it has not yet obtained economic benefits, or taken an action, that would or could require the entity to transfer an economic resource that it would not otherwise have had to transfer. For example, if an entity has entered into a contract to pay an employee a salary in exchange for receiving the employee's services, the entity does not have a present obligation to pay the salary until it has received the employee's services. Before then the contract is executory; the entity has a combined right and obligation to exchange future salary for future employee services (executory contracts are discussed in section 7.1.2 above). *[CF 4.47]*.

7.4 Definition of equity

As noted in section 7 above, equity is the residual interest in the assets of the entity after deducting all its liabilities; accordingly, equity claims are claims on this residual interest. Put another way, equity claims are claims against the entity that do not meet the definition of a liability. Such claims may be established by contract, legislation or similar means, and include, to the extent that they do not meet the definition of a liability:

- Shares of various types, issued by the entity

  And

- Some obligations of the entity to issue another equity claim *[CF 4.63, CF 4.64]*

Different classes of equity claims, such as ordinary shares and preference shares, may confer on their holders different rights, for example, rights to receive some or all of the following from the entity:

- Dividends, if the entity decides to pay dividends to eligible holders
- The proceeds from satisfying the equity claims, either in full on liquidation, or in part at other times

  Or

- Other equity claims *[CF 4.65]*

Sometimes, legal, regulatory or other requirements affect particular components of equity, such as share capital or retained earnings. For example, some such requirements permit an entity to make distributions to holders of equity claims only if the entity has sufficient reserves that those requirements specify as being distributable. *[CF 4.66]*.

Business activities are often undertaken by entities such as sole proprietorships, partnerships, trusts or various types of government business undertakings. The legal and regulatory frameworks for such entities are often different from frameworks that apply to corporate entities. For example, there may be few, if any, restrictions on the distribution to holders of equity claims against such entities. Nevertheless, the *Framework* makes clear that the definition of equity applies to all reporting entities. *[CF 4.67]*.

7.5 Definition of income and expenses

Income and expenses are the elements of financial statements that relate to an entity's financial performance. Users of financial statements need information about both an entity's financial position and its financial performance. Hence, although income and expenses are defined in terms of changes in assets and liabilities, information about income and expenses is just as important as information about assets and liabilities. *[CF 4.71]*.

Those terms are defined as follows:

- Income is increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.
- Expenses are decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.

A consequence of these definitions is that:

- Contributions from holders of equity claims are not income

  And

- Distributions to holders of equity claims are not expenses *[CF 4.68, CF 4.69, CF 4.70]*

Different transactions and other events generate income and expenses with different characteristics. Providing information separately about income and expenses with different characteristics can help users of financial statements to understand the entity's financial performance (see section 10.2.3.A below). *[CF 4.72]*.

8 Chapter 5: Recognition and derecognition

Recognition is described in the *Framework* as the process of capturing for inclusion in the statement of financial position or the statement(s) of financial performance an item that meets the definition of one of the elements of financial statements (that is, an asset, a liability, equity, income or expenses).

8.1 The recognition process

Recognition involves depicting the item in one of those statements (either alone or in aggregation with other items) in words and by a monetary amount, and including that amount in one or more totals in that statement. The amount at which an asset, a liability or equity is recognised in the statement of financial position is referred to as its 'carrying amount'. *[CF 5.1]*.

The statement of financial position and statement(s) of financial performance depict an entity's recognised assets, liabilities, equity, income and expenses in structured summaries that are designed to make financial information comparable and understandable. An important feature of the structures of those summaries is that the amounts recognised in a statement are included in the totals and, if applicable, subtotals that link the items recognised in the statement. *[CF 5.2]*.

Recognition links the elements, the statement of financial position and the statement(s) of financial performance as follows:

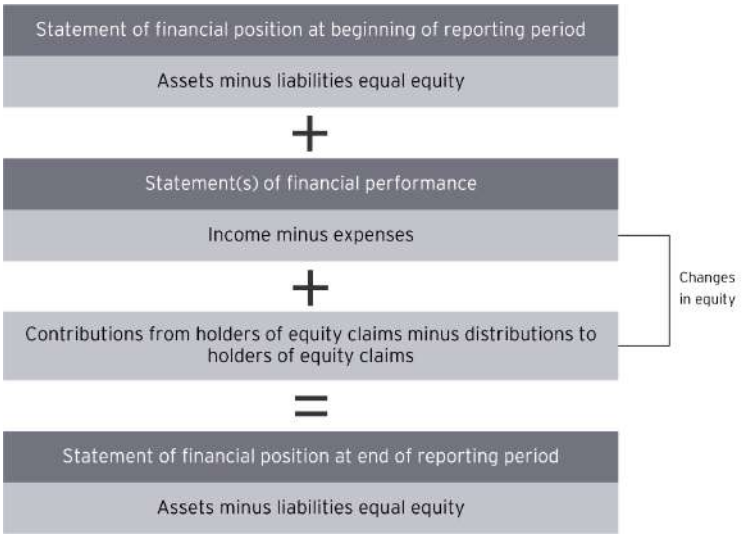
- In the statement of financial position at the beginning and end of the reporting period, total assets minus total liabilities equal total equity.

  And
- Recognised changes in equity during the reporting period comprise:
  - Income minus expenses recognised in the statement(s) of financial performance

    Plus
  - Contributions from holders of equity claims, minus distributions to holders of equity claims. *[CF 5.3]*.

This is illustrated diagrammatically in Figure 8-1 below.

Figure 8-1: How recognition links the elements of financial statements



The statements of financial position and performance are linked because the recognition of one item (or a change in its carrying amount) requires the recognition or derecognition of one or more other items (or changes in the carrying amount of one or more other items). This is the familiar concept of 'double-entry' and the *Framework* provides the following description:

- The recognition of income occurs at the same time as:
  - The initial recognition of an asset, or an increase in the carrying amount of an asset

    Or
  - The derecognition of a liability, or a decrease in the carrying amount of a liability
- The recognition of expenses occurs at the same time as:
  - The initial recognition of a liability, or an increase in the carrying amount of a liability

    Or
  - The derecognition of an asset, or a decrease in the carrying amount of an asset *[CF 5.4]*

The initial recognition of assets or liabilities arising from transactions or other events may result in the simultaneous recognition of both income and related expenses. For example, the sale of goods for cash results in the recognition of both income (from the recognition of one asset, being the cash) and an expense (from the derecognition of another asset, being the goods sold). The simultaneous recognition of income and related expenses is sometimes referred to as the matching of costs with income. Application of the concepts in the *Framework* leads to such matching when it arises from the recognition of changes in assets and liabilities. However, matching of costs with income is not an objective of the *Framework*. The *Framework* does not allow the recognition in the statement of financial position of items that do not meet the definition of an asset, a liability or equity. *[CF 5.5]*.

8.2 Recognition criteria

Extract from the Conceptual Framework	
5.6	Only items that meet the definition of an asset, a liability or equity are recognised in the statement of financial position. Similarly, only items that meet the definition of income or expenses are recognised in the statement(s) of financial performance. However, not all items that meet the definition of one of those elements are recognised.

[CF 5.6].

Not recognising an item that meets the definition of one of the elements makes the statement of financial position and the statement(s) of financial performance less complete and can exclude useful information from financial statements. On the other hand, in some circumstances, recognising some items that meet the definition of one of the elements would not provide useful information. An asset or liability is recognised only if recognition of that asset or liability and of any resulting income, expenses or changes in equity provides users of financial statements with information that is useful; that is, with:

- Relevant information about the asset or liability and about any resulting income, expenses or changes in equity (see section 8.2.1 below)

  And

- A faithful representation of the asset or liability and of any resulting income, expenses or changes in equity (see section 8.2.2 below) *[CF 5.7]*

Just as cost constrains other financial reporting decisions, it also constrains recognition decisions. There is a cost to recognising an asset or liability. Preparers of financial statements incur costs in obtaining a relevant measure of an asset or liability. Users of financial statements also incur costs in analysing and interpreting the information provided. An asset or liability is recognised if the benefits of the information provided to users of financial statements by recognition are likely to justify the costs of providing and using that information. In some cases, the costs of recognition may outweigh its benefits. *[CF 5.8]*.

It is not possible to define precisely when recognition of an asset or liability will provide useful information to users of financial statements, at a cost that does not outweigh its benefits. What is useful to users depends on the item and the facts and circumstances. Consequently, judgement is required when deciding whether to recognise an item, and thus recognition requirements may need to vary between and within standards. *[CF 5.9]*.

It is important when making decisions about recognition to consider the information that would be given if an asset or liability were not recognised. For example, if no asset is recognised when expenditure is incurred, an expense is recognised. Over time, recognising the expense may, in some cases, provide useful information, for example, information that enables users of financial statements to identify trends. *[CF 5.10]*.

Even if an item meeting the definition of an asset or liability is not recognised, an entity may need to provide information about that item in the notes. It is important to consider how to make such information sufficiently visible to compensate for the item's absence from the structured summary provided by the statement of financial position and, if applicable, the statement(s) of financial performance. *[CF 5.11]*.

8.2.1 Relevance

Information about assets, liabilities, equity, income and expenses is relevant to users of financial statements. However, recognition of a particular asset or liability and any resulting income, expenses or changes in equity may not always provide relevant information. That may be the case if, for example:

- It is uncertain whether an asset or liability exists (see section 8.2.1.A below)

  Or

- An asset or liability exists, but the probability of an inflow or outflow of economic benefits is low (see section 8.2.1.B below) *[CF 5.12]*

The presence of one or both of the factors described above does not lead automatically to a conclusion that the information provided by recognition lacks relevance. Moreover, factors other than these may also affect the conclusion. It may be a combination of factors and not any single factor that determines whether recognition provides relevant information. *[CF 5.13]*.

8.2.1.A Existence uncertainty

Sometimes it is uncertain whether an asset or liability exists. In some cases, that uncertainty, possibly combined with a low probability of inflows or outflows of economic benefits and an exceptionally wide range of possible outcomes, may mean that the recognition of an asset or liability, necessarily measured at a single amount, would not provide relevant information. Whether or not the asset or liability is recognised, explanatory information about the uncertainties associated with it may need to be provided in the financial statements. *[CF 5.14]*.

8.2.1.B Low probability of an inflow or outflow of economic benefits

An asset or liability can exist even if the probability of an inflow or outflow of economic benefits is low (see sections 7.2.2 and 7.3.2 above). *[CF 5.15]*.

If the probability of an inflow or outflow of economic benefits is low, the most relevant information about the asset or liability may be information about the magnitude of the possible inflows or outflows, their possible timing and the factors affecting the probability of their occurrence. The typical location for such information is in the notes. *[CF 5.16]*.

Even if the probability of an inflow or outflow of economic benefits is low, recognition of the asset or liability may provide relevant information beyond the information described above. Whether that is the case may depend on a variety of factors. For example:

- If an asset is acquired or a liability is incurred in an exchange transaction on market terms, its cost generally reflects the probability of an inflow or outflow of economic benefits. Thus, that cost may be relevant information, and is generally readily available. Furthermore, not recognising the asset or liability would result in the recognition of expenses or income at the time of the exchange, which might not be a faithful representation of the transaction (see section 8.2.2.B below).
- If an asset or liability arises from an event that is not an exchange transaction, recognition of the asset or liability typically results in recognition of income or expenses. If there is only a low probability that the asset or liability will result in an inflow or outflow of economic benefits, users of financial statements might not regard the recognition of the asset and income, or the liability and expenses, as providing relevant information. *[CF 5.17]*.

8.2.2 Faithful representation

Recognition of a particular asset or liability is appropriate if it provides not only relevant information, but also a faithful representation of that asset or liability and of any resulting income, expenses or changes in equity. Whether a faithful representation can be provided may be affected by the level of measurement uncertainty associated with the asset or liability or by other factors. *[CF 5.18]*.

8.2.2.A Measurement uncertainty

For an asset or liability to be recognised, it must be measured. In many cases, such measures must be estimated and are therefore subject to measurement uncertainty. As noted in section 5.1.2 above, the use of reasonable estimates is an essential part of the preparation of financial information and does not undermine the usefulness of the information if the estimates are clearly and accurately described and explained. Even a high level of measurement uncertainty does not necessarily prevent such an estimate from providing useful information. *[CF 5.19]*.

In some cases, the level of uncertainty involved in estimating a measure of an asset or liability may be so high that it may be questionable whether the estimate would provide a sufficiently faithful representation of that asset or liability and of any resulting income, expenses or changes in equity. The level of measurement uncertainty may be so high if, for example, the only way of estimating that measure of the asset or liability is by using cash-flow-based measurement techniques and, in addition, one or more of the following circumstances exists:

- The range of possible outcomes is exceptionally wide and the probability of each outcome is exceptionally difficult to estimate.
- The measure is exceptionally sensitive to small changes in estimates of the probability of different outcomes, for example if the probability of future cash inflows or outflows occurring is exceptionally low, but the magnitude of those cash inflows or outflows will be exceptionally high if they occur.

  Or

- Measuring the asset or liability requires exceptionally difficult or exceptionally subjective allocations of cash flows that do not relate solely to the asset or liability being measured. *[CF 5.20]*.

In some of these cases, the most useful information may be the measure that relies on the highly uncertain estimate, accompanied by a description of the estimate and an explanation of the uncertainties that affect it. This is especially likely to be the case if that measure is the most relevant measure of the asset or liability. In other cases, if that information would not provide a sufficiently faithful representation of the asset or liability and of any resulting income, expenses or changes in equity, the most useful information may be a different measure (accompanied by any necessary descriptions and explanations) that is slightly less relevant but is subject to lower measurement uncertainty. *[CF 5.21]*.

In limited circumstances, all relevant measures of an asset or liability that are available (or can be obtained) may be subject to such high measurement uncertainty that none would provide useful information about the asset or liability (and any resulting income, expenses or changes in equity), even if the measure were accompanied by a description of the estimates made in producing it and an explanation of the uncertainties that affect those estimates. In those limited circumstances, the asset or liability would not be recognised. *[CF 5.22]*.

Whether or not an asset or liability is recognised, a faithful representation of the asset or liability may need to include explanatory information about the uncertainties associated with the asset or liability's existence or measurement, or with its outcome, that is, the amount or timing of any inflow or outflow of economic benefits that will ultimately result from it (measurement uncertainty is discussed in section 9.3.2 below). *[CF 5.23]*.

8.2.2.B Other factors

Faithful representation of a recognised asset, liability, equity, income or expense involves not only recognition of that item, but also its measurement as well as presentation and disclosure of information about it (measurement is discussed in section 9 below; presentation and disclosure is discussed in section 10 below). *[CF 5.24]*.

Accordingly, when assessing whether the recognition can provide a faithful representation of an asset or liability, it is necessary to consider not merely its description and measurement in the statement of financial position, but also:

- The depiction of resulting income, expenses and changes in equity. For example, if an entity acquires an asset in exchange for consideration, not recognising the asset would result in recognising expenses and would reduce the entity's profit and equity. In some cases, for example, if the entity does not consume the asset immediately, that result could provide a misleading representation that the entity's financial position has deteriorated.
- Whether related assets and liabilities are recognised. If they are not recognised, recognition may create a recognition inconsistency (accounting mismatch). That may not provide an understandable or faithful representation of the overall effect of the transaction or other event giving rise to the asset or liability, even if explanatory information is provided in the notes.

  And

- Presentation and disclosure of information about the asset or liability, and resulting income, expenses or changes in equity. A complete depiction includes all information necessary for a user of financial statements to understand the economic phenomenon depicted, including all necessary descriptions and explanations. Hence, presentation and disclosure of related information can enable a recognised amount to form part of a faithful representation of an asset, a liability, equity, income or expenses. *[CF 5.25]*.

8.3 Derecognition

Extract from the Conceptual Framework

5.26 Derecognition is the removal of all or part of a recognised asset or liability from an entity's statement of financial position. Derecognition normally occurs when that item no longer meets the definition of an asset or of a liability:

(a) for an asset, derecognition normally occurs when the entity loses control of all or part of the recognised asset; and

(b) for a liability, derecognition normally occurs when the entity no longer has a present obligation for all or part of the recognised liability.

[CF 5.26].

Accounting requirements for derecognition aim to represent faithfully both:

- Any assets and liabilities retained after the transaction or other event that led to the derecognition (including any asset or liability acquired, incurred or created as part of the transaction or other event)

  And

- The change in the entity's assets and liabilities as a result of that transaction or other event *[CF 5.27]*

These aims are normally achieved by:

- Derecognising any assets or liabilities that have expired or have been consumed, collected, fulfilled or transferred, and recognising any resulting income and expenses (transferred component).
- Continuing to recognise the assets or liabilities retained (retained component), if any. That retained component becomes a unit of account separate from the transferred component. Accordingly, no income or expenses are recognised on the retained component as a result of the derecognition of the transferred component, unless the derecognition results in a change in the measurement requirements applicable to the retained component.

  And

- Applying one or more of the following procedures, if that is necessary to achieve one or both of those aims:
  - Presenting any retained component separately in the statement of financial position.
  - Presenting separately in the statement(s) of financial performance any income and expenses recognised as a result of the derecognition of the transferred component.

    Or

  - Providing explanatory information. *[CF 5.28]*.

In some cases, an entity might appear to transfer an asset or liability, but that asset or liability might nevertheless remain an asset or liability of the entity. For example, as discussed in section 7.2.3 above:

- If an entity has apparently transferred an asset but retains exposure to significant positive or negative variations in the amount of economic benefits that may be produced by the asset, this sometimes indicates that the entity might continue to control that asset.

  Or

- If an entity has transferred an asset to another party that holds the asset as an agent for the entity, the transferor still controls the asset. *[CF 5.29]*.

In these cases, derecognition of that asset or liability is not appropriate because it would not achieve a faithful representation of either the retained elements or the change in assets or liabilities. *[CF 5.27, CF 5.30]*.

When an entity no longer has a transferred component, derecognition of the transferred component faithfully represents that fact. However, in some of those cases, derecognition may not faithfully represent how much a transaction or other event changed the entity's assets or liabilities, even when supported by appropriate presentation and disclosure. In those cases, derecognition of the transferred component might imply that the entity's financial position has changed more significantly than it has. This might occur, for example:

- If an entity has transferred an asset and, at the same time, entered into another transaction that results in a present right or present obligation to reacquire the asset. Such present rights or present obligations may arise from, for example, a forward contract, a written put option, or a purchased call option.

  Or

- If an entity has retained exposure to significant positive or negative variations in the amount of economic benefits that may be produced by a transferred component that the entity no longer controls. *[CF 5.31]*.

If derecognition is not sufficient to achieve a faithful representation of the retained elements and the change in assets or liabilities (even when supported by appropriate presentation and disclosure) those two aims might sometimes be achieved by continuing to recognise the transferred component. This would have the following consequences:

- No income or expenses are recognised on either the retained component or the transferred component as a result of the transaction or other event.
- The proceeds received (or paid) upon transfer of the asset (or liability) are treated as a loan received (or given).

  And

- Separate presentation of the transferred component in the statement of financial position, or provision of explanatory information, is needed to depict the fact that the entity no longer has any rights or obligations arising from the transferred component. Similarly, it may be necessary to provide information about income or expenses arising from the transferred component after the transfer. *[CF 5.32]*.

One case in which questions about derecognition arise is when a contract is modified in a way that reduces or eliminates existing rights or obligations. In deciding how to account for contract modifications, it is necessary to consider which unit of account provides users of financial statements with the most useful information about the assets and liabilities retained after the modification, and about how the modification changed the entity's assets and liabilities:

- If a contract modification only eliminates existing rights or obligations, the discussion of derecognition above is considered in deciding whether to derecognise those rights or obligations.
- If a contract modification only adds new rights or obligations, it is necessary to decide whether to treat the added rights or obligations as a separate asset or liability, or as part of the same unit of account as the existing rights and obligations (see section 7.1.1 above).

  And

- If a contract modification both eliminates existing rights or obligations and adds new rights or obligations, it is necessary to consider both the separate and the combined effect of those modifications. In some such cases, the contract has been modified to such an extent that, in substance, the modification replaces the old asset or liability with a new asset or liability. In cases of such extensive modification, the entity may need to derecognise the original asset or liability, and recognise the new asset or liability. *[CF 5.33]*.

9 Chapter 6: Measurement

As discussed in section 8 above, elements recognised in financial statements are quantified in monetary terms. This requires the selection of a measurement basis, which is defined in the *Framework* as an identified feature (for example, historical cost, fair value or fulfilment value) of the item being measured. Applying a measurement basis to an asset or liability creates a measure for that asset or liability and for related income and expenses. *[CF 6.1]*.

The *Framework* does not provide detailed guidance on when a particular measurement basis would be suitable. Rather, it describes various measurement bases, the information they provide and the factors to consider in their selection (discussed further in section 9.1 below). *[CF BC6.1]*. This approach reflects the belief of the Board that in different circumstances:

- Different measurement bases may provide information relevant to users of financial statements

  And
- A particular measurement basis may be:
  - Easier to understand and implement than another
  - More verifiable, less prone to error or subject to a lower level of measurement uncertainty than another

    Or
  - Less costly to implement than another *[CF BC6.10]*

Consideration of the qualitative characteristics of useful financial information and of the cost constraint is likely to result in the selection of different measurement bases for different assets, liabilities, income and expenses. *[CF 6.2]*.

A standard may need to describe how to implement the measurement basis selected in that standard. That description could include:

- Specifying techniques that may or must be used to estimate a measure applying a particular measurement basis
- Specifying a simplified measurement approach that is likely to provide information similar to that provided by a preferred measurement basis

  Or
- Explaining how to modify a measurement basis, for example, by excluding from the fulfilment value of a liability the effect of the possibility that the entity may fail to fulfil that liability (own credit risk) *[CF 6.3]*

The contents of Chapter 6 of the *Framework* are discussed in this section as follows:

- Measurement bases (such as historical cost and current value) - discussed in section 9.1 below
- Information provided by different measurement bases - discussed in section 9.2 below
- Factors to consider in selecting measurement bases - discussed in section 9.3 below
- Measurement of equity - discussed in section 9.4 below
- Cash-flow-based measurement techniques - discussed in section 9.5 below

9.1 Measurement bases

9.1.1 Historical cost

Historical cost measures provide monetary information about assets, liabilities and related income and expenses, using information derived, at least in part, from the price of the transaction or other event that gave rise to them. Unlike current value, historical cost does not reflect changes in values, except to the extent that those changes relate to impairment of an asset or a liability becoming onerous. *[CF 6.4]*.

The historical cost of an asset when it is acquired or created is the value of the costs incurred in acquiring or creating the asset, comprising the consideration paid to acquire or create the asset plus transaction costs. The historical cost of a liability when it is incurred or taken on is the value of the consideration received to incur or take on the liability minus transaction costs. *[CF 6.5]*.

When an asset is acquired or created, or a liability is incurred or taken on, as a result of an event that is not a transaction on market terms, it may not be possible to identify a cost, or the cost may not provide relevant information about the asset or liability. In some such cases, a current value of the asset or liability is used as a deemed cost on initial recognition and that deemed cost is then used as a starting point for subsequent measurement at historical cost (see section 9.3.4 below). *[CF 6.6]*.

The historical cost of an asset is updated over time to depict, if applicable:

- The consumption of part or all of the economic resource that constitutes the asset (depreciation or amortisation)
- Payments received that extinguish part or all of the asset
- The effect of events that cause part or all of the historical cost of the asset to be no longer recoverable (impairment)

  And

- Accrual of interest to reflect any financing component of the asset *[CF 6.7]*

The historical cost of a liability is updated over time to depict, if applicable:

- Fulfilment of part or all of the liability, for example, by making payments that extinguish part or all of the liability or by satisfying an obligation to deliver goods.
- The effect of events that increase the value of the obligation to transfer the economic resources needed to fulfil the liability to such an extent that the liability becomes onerous. A liability is onerous if the historical cost is no longer sufficient to depict the obligation to fulfil the liability.

  And

- Accrual of interest to reflect any financing component of the liability. *[CF 6.8]*.

One way to apply a historical cost measurement basis to financial assets and financial liabilities is to measure them at amortised cost. The amortised cost of a financial asset or financial liability reflects estimates of future cash flows, discounted at a rate determined at initial recognition. For variable rate instruments, the discount rate is updated to reflect changes in the variable rate. The amortised cost of a financial asset or financial liability is updated over time to depict subsequent changes, such as the accrual of interest, the impairment of a financial asset and receipts or payments. *[CF 6.9]*.

9.1.2 Current value

Current value measures provide monetary information about assets, liabilities and related income and expenses, using information updated to reflect conditions at the measurement date. Because of the updating, current values of assets and liabilities reflect changes, since the previous measurement date, in estimates of cash flows and other factors reflected in those current values. Unlike historical cost, the current value of an asset or liability is not derived, even in part, from the price of the transaction or other event that gave rise to the asset or liability. *[CF 6.10]*.

Current value measurement bases include:

- Fair value (discussed in section 9.1.2.A below)
- Value in use for assets and fulfilment value for liabilities (discussed in section 9.1.2.B below)

  And

- Current cost (discussed in section 9.1.2.C below) *[CF 6.11]*

9.1.2.A Fair value

Extract from the Conceptual Framework	
6.12	Fair value is the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date.

[CF 6.12].

Fair value reflects the perspective of market participants; that is, participants in a market to which the entity has access. The asset or liability is measured using the same assumptions that market participants would use when pricing the asset or liability if those market participants act in their economic best interest. *[CF 6.13]*.

In some cases, fair value can be determined directly by observing prices in an active market. In other cases, it is determined indirectly using measurement techniques, for example, cash-flow-based measurement techniques (discussed in section 9.5 below), reflecting all the following factors:

(a) Estimates of future cash flows

(b) Possible variations in the estimated amount or timing of future cash flows for the asset or liability being measured, caused by the uncertainty inherent in the cash flows

(c) The time value of money

(d) The price for bearing the uncertainty inherent in the cash flows (a risk premium or risk discount). The price for bearing that uncertainty depends on the extent of that uncertainty. It also reflects the fact that investors would generally pay less for an asset (and generally require more for taking on a liability) that has uncertain cash flows than for an asset (or liability) whose cash flows are certain.

And

(e) Other factors, for example, liquidity, if market participants would take those factors into account in the circumstances *[CF 6.14]*

The factors mentioned in (b) and (d) above include the possibility that a counterparty may fail to fulfil its liability to the entity (credit risk), or that the entity may fail to fulfil its liability (own credit risk). *[CF 6.15]*.

Because fair value is not derived, even in part, from the price of the transaction or other event that gave rise to the asset or liability, fair value is not increased by the transaction costs incurred when acquiring the asset and is not decreased by the transaction costs incurred when the liability is incurred or taken on. In addition, fair value does not reflect the transaction costs that would be incurred on the ultimate disposal of the asset or on transferring or settling the liability. *[CF 6.16]*.

9.1.2.B Value in use and fulfilment value

Value in use is the present value of the cash flows, or other economic benefits, that an entity expects to derive from the use of an asset and from its ultimate disposal. Fulfilment value is the present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils a liability. Those amounts of cash or other economic resources include not only the amounts to be transferred to the liability counterparty, but also the amounts that the entity expects to be obliged to transfer to other parties to enable it to fulfil the liability. *[CF 6.17]*. Value in use and fulfilment value cannot be observed directly and are determined using cash-flow-based measurement techniques (see section 9.5 below). *[CF 6.20]*.

Because value in use and fulfilment value are based on future cash flows, they do not include transaction costs incurred on acquiring an asset or taking on a liability. However, value in use and fulfilment value include the present value of any transaction costs an entity expects to incur on the ultimate disposal of the asset or on fulfilling the liability. *[CF 6.18]*.

Value in use and fulfilment value reflect entity-specific assumptions rather than assumptions by market participants. Nonetheless, they do reflect the factors set out in (a)-(e) in section 9.1.2.A above. In practice, there may sometimes be little difference between the assumptions that market participants would use and those that an entity itself uses. *[CF 6.19, CF 6.20]*.

9.1.2.C Current cost

The current cost of an asset is the cost of an equivalent asset at the measurement date, comprising the consideration that would be paid at the measurement date plus the transaction costs that would be incurred at that date. The current cost of a liability is the consideration that would be received for an equivalent liability at the measurement date minus the transaction costs that would be incurred at that date. Current cost, like historical cost, is an entry value: it reflects prices in the market in which the entity would acquire the asset or would incur the liability. Hence, it is different from fair value, value in use and fulfilment value, which are exit values. However, unlike historical cost, current cost reflects conditions at the measurement date. *[CF 6.21]*.

In some cases, current cost cannot be determined directly by observing prices in an active market and must be determined indirectly by other means. For example, if prices are available only for new assets, the current cost of a used asset might need to be estimated by adjusting the current price of a new asset to reflect the current age and condition of the asset held by the entity. *[CF 6.22]*.

9.2 Information provided by different measurement bases

When selecting a measurement basis, it is important to consider the nature of the information that the measurement basis will produce in both the statement of financial position and the statement(s) of financial performance. The *Framework* summarises that information in a table which is reproduced in Figure 9-1 below. *[CF 6.23]*. This is followed by some further discussion in sections 9.2.1 and 9.2.2 below.

Figure 9-1: Summary of information provided by particular measurement bases

Assets

Statement of financial position				
	Historical cost	**Fair value (market-participant assumptions)**	**Value in use (entity-specific assumptions)[a]**	**Current cost**
Carrying amount	Historical cost (including transaction costs), to the extent unconsumed or uncollected, and recoverable. (Includes interest accrued on any financing component.)	Price that would be received to sell the asset (without deducting transaction costs on disposal).	Present value of future cash flows from the use of the asset and from its ultimate disposal (after deducting present value of transaction costs on disposal).	Current cost (including transaction costs), to the extent unconsumed or uncollected, and recoverable.
Initial recognition[b]	-	Difference between consideration paid and fair value of the asset acquired.[c] Transaction costs on acquiring the asset.	Difference between consideration paid and value in use of the asset acquired. Transaction costs on acquiring the asset.	-
Sale or consumption of the asset[d], [e]	Expenses equal to historical cost of the asset sold or consumed. Income received. (Could be presented gross or net.) Expenses for transaction costs on selling the asset.	Expenses equal to fair value of the asset sold or consumed. Income received. (Could be presented gross or net.) Expenses for transaction costs on selling the asset.	Expenses equal to value in use of the asset sold or consumed. Income received. (Could be presented gross or net.)	Expenses equal to current cost of the asset sold or consumed. Income received. (Could be presented gross or net.) Expenses for transaction costs on selling the asset.

Statement(s) of financial performance				
Event	**Historical cost**	**Fair value (market-participant assumptions)**	**Value in use (entity-specific assumptions)[a]**	**Current cost**
Interest income	Interest income, at historical rates, updated if the asset bears variable interest.	Reflected in income and expenses from changes in fair value. (Could be identified separately.)	Reflected in income and expenses from changes in value in use. (Could be identified separately.)	Interest income, at current rates.
Impairment	Expenses arising because historical cost is no longer recoverable.	Reflected in income and expenses from changes in fair value. (Could be identified separately.)	Reflected in income and expenses from changes in value in use. (Could be identified separately.)	Expenses arising because current cost is no longer recoverable.
Value changes	Not recognised, except to reflect an impairment. For financial assets, income and expenses from changes in estimated cash flows.	Reflected in income and expenses from changes in fair value.	Reflected in income and expenses from changes in value in use.	Income and expenses reflecting the effect of changes in prices (holding gains and holding losses).

(a) This column summarises the information provided if value in use is used as a measurement basis. However, as noted in section 9.3.3.B below, value in use may not be a practical measurement basis for regular remeasurements.

(b) Income or expenses may arise on the initial recognition of an asset not acquired on market terms.

(c) Income or expenses may arise if the market in which an asset is acquired is different from the market that is the source of the prices used when measuring the fair value of the asset.

(d) Consumption of the asset is typically reported through cost of sales, depreciation or amortisation.

(e) Income received is often equal to the consideration received but will depend on the measurement basis used for any related liability.

Liabilities

Statement of financial position				
	Historical cost	**Fair value (market-participant assumptions)**	**Fulfilment value (entity-specific assumptions)**	**Current cost**
Carrying amount	Consideration received (net of transaction costs) for taking on the unfulfilled part of the liability, increased by excess of estimated cash outflows over consideration received. (Includes interest accrued on any financing component.)	Price that would be paid to transfer the unfulfilled part of the liability (not including transaction costs that would be incurred on transfer).	Present value of future cash flows that will arise in fulfilling the unfulfilled part of the liability (including present value of transaction costs to be incurred in fulfilment or transfer).	Consideration (net of transaction costs) that would be currently received for taking on the unfulfilled part of the liability, increased by excess of estimated cash outflows over that consideration.
Initial recognition[(a)]	-	Difference between consideration received and the fair value of the liability.[(b)] Transaction costs on incurring or taking on the liability.	Difference between consideration received and the fulfilment value of the liability. Transaction costs on incurring or taking on the liability.	-
Fulfilment of the liability	Income equal to historical cost of the liability fulfilled (reflects historical consideration). Expenses for costs incurred in fulfilling the liability. (Could be presented net or gross.)	Income equal to fair value of the liability fulfilled. Expenses for costs incurred in fulfilling the liability. (Could be presented net or gross. If gross, historical consideration could be presented separately.)	Income equal to fulfilment value of the liability fulfilled. Expenses for costs incurred in fulfilling the liability. (Could be presented net or gross. If gross, historical consideration could be presented separately.)	Income equal to current cost of the liability fulfilled (reflects current consideration). Expenses for costs incurred in fulfilling the liability. (Could be presented net or gross. If gross, historical consideration could be presented separately.)

Statement(s) of financial performance				
Event	**Historical cost**	**Fair value (market-participant assumptions)**	**Fulfilment value (entity-specific assumptions)**	**Current cost**
Transfer of the liability	Income equal to historical cost of the liability transferred (reflects historical consideration). Expenses for costs paid (including transaction costs) to transfer the liability. (Could be presented net or gross.)	Income equal to fair value of the liability transferred. Expenses for costs paid (including transaction costs) to transfer the liability. (Could be presented net or gross.)	Income equal to fulfilment value of the liability transferred. Expenses for costs paid (including transaction costs) to transfer the liability. (Could be presented net or gross.)	Income equal to current cost of the liability transferred (reflects current consideration). Expenses for costs paid (including transaction costs) to transfer the liability. (Could be presented net or gross.)
Interest expenses	Interest expenses, at historical rates, updated if the liability bears variable interest.	Reflected in income and expenses from changes in fair value. (Could be identified separately.)	Reflected in income and expenses from changes in fulfilment value. (Could be identified separately.)	Interest expenses, at current rates.
Effect of events that cause a liability to become onerous	Expenses equal to the excess of the estimated cash outflows over the historical cost of the liability, or a subsequent change in that excess.	Reflected in income and expenses from changes in fair value. (Could be identified separately.)	Reflected in income and expenses from changes in fulfilment value. (Could be identified separately.)	Expenses equal to the excess of the estimated cash outflows over the current cost of the liability, or a subsequent change in that excess.
Value changes	Not recognised except to the extent that the liability is onerous. For financial liabilities, income and expenses from changes in estimated cash flows.	Reflected in income and expenses from changes in fair value.	Reflected in income and expenses from changes in fulfilment value.	Income and expenses reflecting the effect of changes in prices (holding gains and holding losses).

(a) Income or expenses may arise on the initial recognition of a liability incurred or taken on not on market terms.

(b) Income or expenses may arise if the market in which a liability is incurred or taken on is different from the market that is the source of the prices used when measuring the fair value of the liability.

9.2.1 Historical cost

Information provided by measuring an asset or liability at historical cost may be relevant to users of financial statements, because historical cost uses information derived, at least in part, from the price of the transaction or other event that gave rise to the asset or liability. *[CF 6.24]*.

Normally, if an entity acquired an asset in a recent transaction on market terms, the entity expects that the asset will provide sufficient economic benefits that the entity will at least recover the cost of the asset. Similarly, if a liability was incurred or taken on as a result of a recent transaction on market terms, the entity expects that the value of the obligation to transfer economic resources to fulfil the liability will normally be no more than the value of the consideration received minus transaction costs. Hence, measuring an asset or liability at historical cost in such cases provides relevant information about both the asset or liability and the price of the transaction that gave rise to that asset or liability. *[CF 6.25]*.

Because historical cost is reduced to reflect consumption of an asset and its impairment, the amount expected to be recovered from an asset measured at historical cost is at least as great as its carrying amount. Similarly, because the historical cost of a liability is increased when it becomes onerous, the value of the obligation to transfer the economic resources needed to fulfil the liability is no more than the carrying amount of the liability. *[CF 6.26]*.

If an asset other than a financial asset is measured at historical cost, consumption or sale of the asset, or of part of the asset, gives rise to an expense measured at the historical cost of the asset, or of part of the asset, consumed or sold. *[CF 6.27]*.

The expense arising from the sale of an asset is recognised at the same time as the consideration for that sale is recognised as income. The difference between the income and the expense is the margin resulting from the sale. Expenses arising from consumption of an asset can be compared to related income to provide information about margins. *[CF 6.28]*.

Similarly, if a liability other than a financial liability was incurred or taken on in exchange for consideration and is measured at historical cost, the fulfilment of all or part of the liability gives rise to income measured at the value of the consideration received for the part fulfilled. The difference between that income and the expenses incurred in fulfilling the liability is the margin resulting from the fulfilment. *[CF 6.29]*.

Information about the cost of assets sold or consumed, including goods and services consumed immediately (see section 7.2.1 above), and about the consideration received, may have predictive value. That information can be used as an input in predicting future margins from the future sale of goods (including goods not currently held by the entity) and services and hence to assess the entity's prospects for future net cash inflows. To assess an entity's prospects for future cash flows, users of financial statements often focus on the entity's prospects for generating future margins over many periods, not just on its prospects for generating margins from goods already held. Income and expenses measured at historical cost may also have confirmatory value because they may provide feedback to users of financial statements about their previous predictions of cash flows or of margins. Information about the cost of assets sold or consumed may also help in an assessment of how efficiently and effectively the entity's management has discharged its responsibilities to use the entity's economic resources. *[CF 6.30]*.

For similar reasons, information about interest earned on assets, and interest incurred on liabilities, measured at amortised cost may have predictive and confirmatory value. *[CF 6.31]*.

9.2.2 Current value

9.2.2.A Fair value

Information provided by measuring assets and liabilities at fair value may have predictive value because fair value reflects market participants' current expectations about the amount, timing and uncertainty of future cash flows. These expectations are priced in a manner that reflects the current risk preferences of market participants. That information may also have confirmatory value by providing feedback about previous expectations. *[CF 6.32]*.

Income and expenses reflecting market participants' current expectations may have some predictive value, because such income and expenses can be used as an input in predicting future income and expenses. Such income and expenses may also help in an assessment of how efficiently and effectively the entity's management has discharged its responsibilities to use the entity's economic resources. *[CF 6.33]*.

A change in the fair value of an asset or liability can result from various factors set out in (a)-(e) in section 9.1.2.A above. When those factors have different characteristics, identifying separately income and expenses that result from those factors can provide useful information to users of financial statements (see section 10.2.3 below). *[CF 6.34]*.

If an entity acquired an asset in one market and determines fair value using prices in a different market (the market in which the entity would sell the asset), any difference between the prices in those two markets is recognised as income when that fair value is first determined. *[CF 6.35]*.

Sale of an asset or transfer of a liability would normally be for consideration of an amount similar to its fair value, if the transaction were to occur in the market that was the source for the prices used when measuring that fair value. In those cases, if the asset or liability is measured at fair value, the net income or net expenses arising at the time of the sale or transfer would usually be small, unless the effect of transaction costs is significant. *[CF 6.36]*.

9.2.2.B Value in use and fulfilment value

Value in use provides information about the present value of the estimated cash flows from the use of an asset and from its ultimate disposal. This information may have predictive value because it can be used in assessing the prospects for future net cash inflows. *[CF 6.37]*.

Fulfilment value provides information about the present value of the estimated cash flows needed to fulfil a liability. Hence, fulfilment value may have predictive value, particularly if the liability will be fulfilled, rather than transferred or settled by negotiation. *[CF 6.38]*.

Updated estimates of value in use or fulfilment value, combined with information about estimates of the amount, timing and uncertainty of future cash flows, may also have confirmatory value because they provide feedback about previous estimates of value in use or fulfilment value. *[CF 6.39]*.

9.2.2.C Current cost

Information about assets and liabilities measured at current cost may be relevant because current cost reflects the cost at which an equivalent asset could be acquired or created at the measurement date or the consideration that would be received for incurring or taking on an equivalent liability. *[CF 6.40]*.

Like historical cost, current cost provides information about the cost of an asset consumed or about income from the fulfilment of liabilities. That information can be used to derive current margins and can be used as an input in predicting future margins. Unlike historical cost, current cost reflects prices prevailing at the time of consumption or fulfilment. When price changes are significant, margins based on current cost may be more useful for predicting future margins than margins based on historical cost. *[CF 6.41]*.

To report the current cost of consumption (or current income from fulfilment), it is necessary to split the change in the carrying amount in the reporting period into the current cost of consumption (or current income from fulfilment), and the effect of changes in prices. The effect of a change in prices is sometimes referred to as a 'holding gain' or a 'holding loss'. *[CF 6.42]*.

9.3 Factors to consider in selecting measurement bases

In selecting a measurement basis it is necessary to consider not just the nature of the information that it will produce (discussed in section 9.2 above), but also other factors (including the qualitative characteristics discussed in section 5 above). *[CF 6.43]*. These other factors set out in the *Framework* are discussed in this section and comprise:

- Relevance (see section 9.3.1 below)
- Faithful representation (see section 9.3.2 below)
- Enhancing characteristics and the cost constraint (see section 9.3.3 below)

  These discussions focus on the factors to be considered in selecting a measurement basis for recognised assets and recognised liabilities. Some of those discussions may also apply in selecting a measurement basis for information provided in the notes, for recognised or unrecognised items. *[CF 6.47]*.
- Factors specific to initial measurement (see section 9.3.4 below)

  And
- The use of more than one measurement basis (see section 9.3.5 below)

In most cases, no single factor will determine which measurement basis should be selected. The relative importance of each factor will depend on facts and circumstances. *[CF 6.44]*.

The information provided by a measurement basis must be useful to users of financial statements. To achieve this, the information must be relevant and it must faithfully represent what it purports to represent. In addition, the information provided should be, as far as possible, comparable, verifiable, timely and understandable. *[CF 2.4, CF 6.45]*.

As noted in section 5.1.3 above, the *Framework* states that the most efficient and effective process for applying the fundamental qualitative characteristics would usually be to identify the most relevant information about an economic phenomenon. If that information is not available or cannot be provided in a way that faithfully represents the economic phenomenon, the next most relevant type of information is considered. The role played in the selection of a measurement basis by the fundamental qualitative characteristics is discussed in sections 9.3.1 and 9.3.2 below. That played by the enhancing characteristics and the cost constraint is discussed in section 9.3.3 below. *[CF 6.46]*.

Additional factors to consider in selecting a measurement basis on initial recognition are discussed in section 9.3.4 below. If the initial measurement basis is inconsistent with the subsequent measurement basis, income and expenses might be recognised at the time of the first subsequent measurement solely because of the change in measurement basis. Recognising such income and expenses might appear to depict a transaction or other event when, in fact, no such transaction or event has occurred. Hence, the choice of measurement basis for an asset or liability, and for the related income and expenses, is determined by considering both initial measurement and subsequent measurement. *[CF 6.48, CF 6.77]*.

9.3.1 Relevance

The relevance of information provided by a measurement basis for an asset or liability and for the related income and expenses is affected by:

- The characteristics of the asset or liability (see section 9.3.1.A below)

  And
- How that asset or liability contributes to future cash flows (see section 9.3.1.B below) *[CF 6.49]*

9.3.1.A Characteristics of the asset or liability

The relevance of information provided by a measurement basis depends partly on the characteristics of the asset or liability, in particular, on the variability of cash flows and on whether the value of the asset or liability is sensitive to market factors or other risks. *[CF 6.50]*.

If the value of an asset or liability is sensitive to market factors or other risks, its historical cost might differ significantly from its current value. Consequently, historical cost may not provide relevant information if information about changes in value is important to users of financial statements. For example, amortised cost cannot provide relevant information about a financial asset or financial liability that is a derivative. *[CF 6.51]*.

Furthermore, if historical cost is used, changes in value are reported not when that value changes, but when an event such as disposal, impairment or fulfilment occurs. This could be incorrectly interpreted as implying that all the income and expenses recognised at the time of that event arose then, rather than over the periods during which the asset or liability was held. Moreover, because measurement at historical cost does not provide timely information about changes in value, income and expenses reported on that basis may lack predictive value and confirmatory value by not depicting the full effect of the entity's exposure to risk arising from holding the asset or liability during the reporting period. *[CF 6.52]*.

Changes in the fair value of an asset or liability reflect changes in expectations of market participants and changes in their risk preferences. Depending on the characteristics of the asset or liability being measured and on the nature of the entity's business activities, information reflecting those changes may not always provide predictive value or confirmatory value to users of financial statements. This may be the case when the entity's business activities do not involve selling the asset or transferring the liability, for example, if the entity holds assets solely for use or solely for collecting contractual cash flows or if the entity is to fulfil liabilities itself. *[CF 6.53]*.

9.3.1.B Contribution to future cash flows

As noted in section 4.2.1 above, some economic resources produce cash flows directly; in other cases, economic resources are used in combination to produce cash flows indirectly. How economic resources are used, and hence how assets and liabilities produce cash flows, depends in part on the nature of the business activities conducted by the entity. *[CF 6.54]*.

When a business activity of an entity involves the use of several economic resources that produce cash flows indirectly, by being used in combination to produce and market goods or services to customers, historical cost or current cost is likely to provide relevant information about that activity. For example, property, plant and equipment is typically used in combination with an entity's other economic resources. Similarly, inventory typically cannot be sold to a customer, except by making extensive use of the entity's other economic resources (for example, in production and marketing activities). The manner in which measuring such assets at historical cost or current cost can provide relevant information that can be used to derive margins achieved during the period is discussed in sections 9.2.1 and 9.2.2 above. *[CF 6.55]*.

For assets and liabilities that produce cash flows directly, such as assets that can be sold independently and without a significant economic penalty (for example, without significant business disruption), the measurement basis that provides the most relevant information is likely to be a current value that incorporates current estimates of the amount, timing and uncertainty of the future cash flows. *[CF 6.56]*.

When a business activity of an entity involves managing financial assets and financial liabilities with the objective of collecting contractual cash flows, amortised cost may provide relevant information that can be used to derive the margin between the interest earned on the assets and the interest incurred on the liabilities. However, in assessing whether amortised cost will provide useful information, it is also necessary to consider the characteristics of the financial asset or financial liability. Amortised cost is unlikely to provide relevant information about cash flows that depend on factors other than principal and interest. *[CF 6.57]*.

9.3.2 Faithful representation

When assets and liabilities are related in some way, using different measurement bases for those assets and liabilities can create a measurement inconsistency (accounting mismatch). If financial statements contain measurement inconsistencies, those financial statements may not faithfully represent some aspects of the entity's financial position and financial performance. Consequently, in some circumstances, using the same measurement basis for related assets and liabilities may provide users of financial statements with information that is more useful than the information that would result from using different measurement bases. This may be particularly likely when the cash flows from one asset or liability are directly linked to the cash flows from another asset or liability. *[CF 6.58]*.

As noted in section 5.1.2 above, although a perfectly faithful representation is free from error, this does not mean that measures must be perfectly accurate in all respects. *[CF 6.59]*.

When a measure cannot be determined directly by observing prices in an active market and must instead be estimated, measurement uncertainty arises. The level of measurement uncertainty associated with a particular measurement basis may affect whether information provided by that measurement basis provides a faithful representation of an entity's financial position and financial performance. A high level of measurement uncertainty does not necessarily prevent the use of a measurement basis that provides relevant information. However, in some cases the level of measurement uncertainty is so high that information provided by a measurement basis might not provide a sufficiently faithful representation (see section 5.1.3 above). In such cases, it is appropriate to consider selecting a different measurement basis that would also result in relevant information. *[CF 6.60]*.

Measurement uncertainty is different from both outcome uncertainty and existence uncertainty:

- Outcome uncertainty arises when there is uncertainty about the amount or timing of any inflow or outflow of economic benefits that will result from an asset or liability.
- Existence uncertainty arises when it is uncertain whether an asset or a liability exists (see section 8.2.1.A above). *[CF 6.61]*.

The presence of outcome uncertainty or existence uncertainty may sometimes contribute to measurement uncertainty. However, outcome uncertainty or existence uncertainty does not necessarily result in measurement uncertainty. For example, if the fair value of an asset can be determined directly by observing prices in an active market, no measurement uncertainty is associated with the measurement of that fair value, even if it is uncertain how much cash the asset will ultimately produce and hence there is outcome uncertainty. *[CF 6.62]*.

9.3.3 Enhancing characteristics and the cost constraint

The enhancing qualitative characteristics of comparability, understandability and verifiability, and the cost constraint, have implications for the selection of a measurement basis (discussed in section 5.2 above). The enhancing qualitative characteristic of timeliness has no specific implications for measurement. *[CF 6.63]*.

Just as cost constrains other financial reporting decisions, it also constrains the selection of a measurement basis. Hence, in selecting a measurement basis, it is important to consider whether the benefits of the information provided to users of financial statements by that measurement basis are likely to justify the costs of providing and using that information. *[CF 6.64]*.

Consistently using the same measurement bases for the same items, either from period to period within a reporting entity or in a single period across entities, can help make financial statements more comparable. *[CF 6.65]*.

A change in measurement basis can make financial statements less understandable. However, a change may be justified if other factors outweigh the reduction in understandability, for example, if the change results in more relevant information. If a change is made, users of financial statements may need explanatory information to enable them to understand the effect of that change. *[CF 6.66]*.

Understandability depends partly on how many different measurement bases are used and on whether they change over time. In general, if more measurement bases are used in a set of financial statements, the resulting information becomes more complex and, hence, less understandable and the totals or subtotals in the statement of financial position and the statement(s) of financial performance become less informative. However, it could be appropriate to use more measurement bases if that is necessary to provide useful information. *[CF 6.67]*.

Verifiability is enhanced by using measurement bases that result in measures that can be independently corroborated either directly, for example, by observing prices, or indirectly, for example, by checking inputs to a model. If a measure cannot be verified, users of financial statements may need explanatory information to enable them to understand how the measure was determined. In some such cases, it may be necessary to specify the use of a different measurement basis. *[CF 6.68]*.

9.3.3.A Historical cost

In many situations, it is simpler, and hence less costly, to measure historical cost than it is to measure a current value. In addition, historical cost is generally well understood and, in many cases, verifiable. *[CF 6.69]*.

However, estimating consumption and identifying and measuring impairment losses or onerous liabilities can be subjective. Hence, the historical cost of an asset or liability can sometimes be as difficult to measure or verify as a current value. *[CF 6.70]*.

Using a historical cost measurement basis, identical assets acquired, or liabilities incurred, at different times can be reported in the financial statements at different amounts. This can reduce comparability, both from period to period for a reporting entity and in a single period across entities. *[CF 6.71]*.

9.3.3.B Current value

Because fair value is determined from the perspective of market participants, not from an entity-specific perspective, and is independent of when the asset was acquired or the liability was incurred, identical assets or liabilities measured at fair value will, in principle, be measured at the same amount by entities that have access to the same markets. This can enhance comparability both from period to period for a reporting entity and in a single period across entities. In contrast, because value in use and fulfilment value reflect an entity-specific perspective, those measures could differ for identical assets or liabilities in different entities. Those differences may reduce comparability, particularly if the assets or liabilities contribute to cash flows in a similar manner. *[CF 6.72]*.

If the fair value of an asset or liability can be determined directly by observing prices in an active market, the process of fair value measurement is low-cost, simple and easy to understand; and the fair value can be verified through direct observation. *[CF 6.73]*.

Valuation techniques, sometimes including the use of cash-flow-based measurement techniques, may be needed to estimate fair value when it cannot be observed directly in an active market and are generally needed when determining value in use and fulfilment value. Depending on the techniques used:

- Estimating inputs to the valuation and applying the valuation technique may be costly and complex.

  And

- The inputs into the process may be subjective and it may be difficult to verify both the inputs and the validity of the process itself. Consequently, the measures of identical assets or liabilities may differ. That would reduce comparability. *[CF 6.74]*.

In many cases, value in use cannot be determined meaningfully for an individual asset used in combination with other assets. Instead, the value in use is determined for a group of assets and the result may then need to be allocated to individual assets. This process can be subjective and arbitrary. In addition, estimates of value in use for an asset may inadvertently reflect the effect of synergies with other assets in the group. Hence, determining the value in use of an asset used in combination with other assets can be a costly process and its complexity and subjectivity reduces verifiability. For these reasons, value in use may not be a practical measurement basis for regular remeasurements of such assets. However, it may be useful for occasional remeasurements of assets, for example, when it is used in an impairment test to determine whether historical cost is fully recoverable. *[CF 6.75]*.

Using a current cost measurement basis, identical assets acquired or liabilities incurred at different times are reported in the financial statements at the same amount. This can enhance comparability, both from period to period for a reporting entity and in a single period across entities. However, determining current cost can be complex, subjective and costly. For example, as noted in section 9.1.2.C above, it may be necessary to estimate the current cost of an asset by adjusting the current price of a new asset to reflect the current age and condition of the asset held by the entity. In addition, because of changes in technology and changes in business practices, many assets would not be replaced with identical assets. Thus, a further subjective adjustment to the current price of a new asset would be required in order to estimate the current cost of an asset equivalent to the existing asset. Also, splitting changes in current cost carrying amounts between the current cost of consumption and the effect of changes in prices (see section 9.2.2.C above) may be complex and require arbitrary assumptions. Because of these difficulties, current cost measures may lack verifiability and understandability. *[CF 6.76]*.

9.3.4 Factors specific to initial measurement

At initial recognition, the cost of an asset acquired, or of a liability incurred, as a result of an event that is a transaction on market terms is normally similar to its fair value at that date, unless transaction costs are significant. Nevertheless, even if those two amounts are similar, it is necessary to describe what measurement basis is used at initial recognition. If historical cost will be used subsequently, that measurement basis is also normally appropriate at initial recognition. Similarly, if a current value will be used subsequently, it is also normally appropriate at initial recognition. Using the same measurement basis for initial recognition and subsequent measurement avoids recognising income or expenses at the time of the first subsequent measurement solely because of a change in measurement basis (see section 9.3 above). *[CF 6.78]*.

When an entity acquires an asset, or incurs a liability, in exchange for transferring another asset or liability as a result of a transaction on market terms, the initial measure of the asset acquired, or the liability incurred, determines whether any income or expenses arise from the transaction. When an asset or liability is measured at cost, no income or expenses arise at initial recognition, unless income or expenses arise from the derecognition of the transferred asset or liability, or unless the asset is impaired or the liability is onerous. *[CF 6.79]*.

Assets may be acquired, or liabilities may be incurred, as a result of an event that is not a transaction on market terms. For example:

- The transaction price may be affected by relationships between the parties, or by financial distress or other duress of one of the parties.
- An asset may be granted to the entity free of charge by a government or donated to the entity by another party.
- A liability may be imposed by legislation or regulation.

  Or
- A liability to pay compensation or a penalty may arise from an act of wrongdoing. *[CF 6.80]*.

In such cases, measuring the asset acquired, or the liability incurred, at its historical cost may not provide a faithful representation of the entity's assets and liabilities and of any income or expenses arising from the transaction or other event. Hence, it may be appropriate to measure the asset acquired, or the liability incurred, at deemed cost, as noted in section 9.1.1 above. Any difference between that deemed cost and any consideration given or received would be recognised as income or expenses at initial recognition. *[CF 6.81]*.

When assets are acquired, or liabilities incurred, as a result of an event that is not a transaction on market terms, all relevant aspects of the transaction or other event need to be identified and considered. For example, it may be necessary to recognise other assets, other liabilities, contributions from holders of equity claims or distributions to holders of equity claims to represent faithfully the substance of the effect of the transaction or other event on the entity's financial position (see section 7.1.3 above) and any related effect on the entity's financial performance. *[CF 6.82]*.

9.3.5 More than one measurement basis

Sometimes, consideration of the factors described in section 9 above may lead to the conclusion that more than one measurement basis is needed for an asset or liability and for related income and expenses in order to provide relevant information that faithfully represents both the entity's financial position and its financial performance. *[CF 6.83]*.

In most cases, the most understandable way to provide that information is:

- To use a single measurement basis both for the asset or liability in the statement of financial position and for related income and expenses in the statement(s) of financial performance

  And

- To provide in the notes additional information applying a different measurement basis *[CF 6.84]*

However, in some cases, information is more relevant, or results in a more faithful representation of both the entity's financial position and its financial performance, through the use of:

- A current value measurement basis for the asset or liability in the statement of financial position

  And

- A different measurement basis for the related income and expenses in the statement of profit or loss - as distinct from the statement(s) of financial performance (see section 10.2.3 below)

In selecting those measurement bases, it is necessary to consider the factors discussed in sections 9.3-9.3.4 above. *[CF 6.85]*.

In such cases, the total income or total expenses arising in the period from the change in the current value of the asset or liability is separated and classified (see section 10.2.3 below) so that:

- The statement of profit or loss includes the income or expenses measured applying the measurement basis selected for that statement

  And

- Other comprehensive income includes all the remaining income or expenses. As a result, the accumulated other comprehensive income related to that asset or liability equals the difference between:

  - The carrying amount of the asset or liability in the statement of financial position

  And

  - The carrying amount that would have been determined applying the measurement basis selected for the statement of profit or loss *[CF 6.86]*

9.4 Measurement of equity

Extract from the Conceptual Framework	
6.87	The total carrying amount of equity (total equity) is not measured directly. It equals the total of the carrying amounts of all recognised assets less the total of the carrying amounts of all recognised liabilities.

[CF 6.87].

Because general purpose financial statements are not designed to show an entity's value, the total carrying amount of equity will not generally equal:

- The aggregate market value of equity claims on the entity
- The amount that could be raised by selling the entity as a whole on a going concern basis

  Or

- The amount that could be raised by selling all of the entity's assets and settling all of its liabilities *[CF 6.88]*

Although total equity is not measured directly, it may be appropriate to measure directly the carrying amount of some individual classes of equity and some components of equity (see section 7.4 above). Nevertheless, because total equity is measured as a residual, at least one class of equity cannot be measured directly. Similarly, at least one component of equity cannot be measured directly. *[CF 6.89]*.

Moreover, some initial recognition of equity will be a consequence of the initial recognition of an asset. Measurement on initial recognition is discussed in section 9.3.4 above.

The total carrying amount of an individual class of equity or component of equity is normally positive, but can be negative in some circumstances. Similarly, total equity is generally positive, but it can be negative, depending on which assets and liabilities are recognised and on how they are measured. *[CF 6.90]*.

9.5 Cash-flow-based measurement techniques

When a measure cannot be observed directly, one way to estimate the measure is by using cash-flow-based measurement techniques. Such techniques are not measurement bases. They are techniques used in applying a measurement basis. Hence, when using such a technique, it is necessary to identify which measurement basis is used and the extent to which the technique reflects the factors applicable to that measurement basis. For example, if the measurement basis is fair value, the applicable factors are those described in section 9.1.2.A above. *[CF 6.91]*.

Cash-flow-based measurement techniques can be used in applying a modified measurement basis, for example, fulfilment value modified to exclude the effect of the possibility that the entity may fail to fulfil a liability (own credit risk). Modifying measurement bases may sometimes result in information that is more relevant to the users of financial statements or that may be less costly to produce or to understand. However, modified measurement bases may also be more difficult for users of financial statements to understand. *[CF 6.92]*.

Outcome uncertainty (see section 9.3.2 above) arises from uncertainties about the amount or timing of future cash flows. Those uncertainties are important characteristics of assets and liabilities. When measuring an asset or liability by reference to estimates of uncertain future cash flows, one factor to consider is possible variations in the estimated amount or timing of those cash flows (see (b) in section 9.1.2.A above). Those variations are considered in selecting a single amount from within the range of possible cash flows. The amount selected is itself sometimes the amount of a possible outcome, but this is not always the case. The amount that provides the most relevant information is usually one from within the central part of the range (a central estimate). Different central estimates provide different information. For example:

- The expected value (the probability-weighted average, also known as the statistical mean) reflects the entire range of outcomes and gives more weight to the outcomes that are more likely. The expected value is not intended to predict the ultimate inflow or outflow of cash or other economic benefits arising from that asset or liability.
- The maximum amount that is more likely than not to occur (similar to the statistical median) indicates that the probability of a subsequent loss is no more than 50% and that the probability of a subsequent gain is no more than 50%.

  And
- The most likely outcome (the statistical mode) is the single most likely ultimate inflow or outflow arising from an asset or liability. *[CF 6.93]*.

A central estimate depends on estimates of future cash flows and possible variations in their amounts or timing. It does not capture the price for bearing the uncertainty that the ultimate outcome may differ from that central estimate (that is, the factor noted in (d) in section 9.1.2.A above). *[CF 6.94]*.

As no central estimate gives complete information about the range of possible outcomes, users may need information about the range of possible outcomes. *[CF 6.95]*.

10 Chapter 7: Presentation and disclosure

Financial statements are viewed in the *Framework* as a communication tool wherein an entity presents and discloses information about its assets, liabilities, equity, income and expenses. *[CF 7.1]*.

As discussed in section 8.1 above:

- Recognised assets, liabilities and equity are depicted in an entity's statement of financial position (discussed in sections 10.2.1 and 10.2.2 below).

  And

- Income and expenses are depicted in an entity's statement(s) of financial performance (discussed in section 10.2.3 below).

  These are structured summaries that are designed to make financial information comparable and understandable. An important feature of the structures of those summaries is that the amounts recognised in a statement are included in the totals and, if applicable, subtotals that link the items recognised in the statement. *[CF 5.2]*.

Typically, the statement of financial position and the statement(s) of financial performance provide summarised information and more detailed information is provided in the notes. *[CF 7.22]*.

Effective communication of information in financial statements makes that information more relevant and contributes to a faithful representation of an entity's assets, liabilities, equity, income and expenses. It also enhances the understandability and comparability of information in financial statements. Effective communication of information in financial statements requires:

- Focusing on presentation and disclosure objectives and principles rather than focusing on rules (discussed in section 10.1 below)
- Classifying information in a manner that groups similar items and separates dissimilar items (discussed in section 10.2 below)

  And

- Aggregating information in such a way that it is not obscured either by unnecessary detail or by excessive aggregation (discussed in section 10.3 below) *[CF 7.2]*

Just as cost constrains other financial reporting decisions, it also constrains decisions about presentation and disclosure. Hence, in making decisions about presentation and disclosure, it is important to consider whether the benefits provided to users of financial statements by presenting or disclosing particular information are likely to justify the costs of providing and using that information. *[CF 7.3]*.

10.1 Presentation and disclosure objectives and principles

Extract from the Conceptual Framework

7.4 To facilitate effective communication of information in financial statements, when developing presentation and disclosure requirements in Standards a balance is needed between:

(a) giving entities the flexibility to provide relevant information that faithfully represents the entity's assets, liabilities, equity, income and expenses; and

(b) requiring information that is comparable, both from period to period for a reporting entity and in a single reporting period across entities.

[CF 7.4].

Including presentation and disclosure objectives in standards supports effective communication in financial statements because such objectives help entities to identify useful information and to decide how to communicate that information in the most effective manner. *[CF 7.5]*.

Effective communication in financial statements is also supported by considering the following principles:

- Entity-specific information is more useful than standardised descriptions, sometimes referred to as 'boilerplate'.

  And

- Duplication of information in different parts of the financial statements is usually unnecessary and can make financial statements less understandable. *[CF 7.6]*.

10.2 Classification

Classification is the sorting of assets, liabilities, equity, income or expenses on the basis of shared characteristics for presentation and disclosure purposes. Such characteristics include, but are not limited to, the nature of the item, its role (or function) within the business activities conducted by the entity, and how it is measured. *[CF 7.7]*.

Classifying dissimilar assets, liabilities, equity, income or expenses together can obscure relevant information, reduce understandability and comparability and may not provide a faithful representation of what it purports to represent. *[CF 7.8]*.

10.2.1 Classification of assets and liabilities

Classification is applied to the unit of account selected for an asset or liability (see section 7.1.1 above). However, it may sometimes be appropriate to separate an asset or liability into components that have different characteristics and to classify those components separately. That would be appropriate when classifying those components separately would enhance the usefulness of the resulting financial information. For example, it could be appropriate to separate an asset or liability into current and non-current components and to classify those components separately. *[CF 7.9]*.

10.2.1.A Offsetting

Offsetting occurs when an entity recognises and measures both an asset and liability as separate units of account, but groups them into a single net amount in the statement of financial position. Offsetting classifies dissimilar items together and therefore is generally not appropriate. *[CF 7.10]*.

Offsetting assets and liabilities differs from treating a set of rights and obligations as a single unit of account (see section 7.1.1 above). *[CF 7.11]*.

10.2.2 Classification of equity

To provide useful information, it may be necessary to classify equity claims separately if those equity claims have different characteristics (equity is discussed in section 7.4 above). *[CF 7.12]*.

Similarly, to provide useful information, it may be necessary to classify components of equity separately if some of those components are subject to particular legal, regulatory or other requirements. For example, in some jurisdictions, an entity is permitted to make distributions to holders of equity claims only if the entity has sufficient reserves specified as distributable. Separate presentation or disclosure of those reserves may provide useful information. *[CF 7.13]*.

10.2.3 Classification of income and expenses

Classification is applied to:

- Income and expenses resulting from the unit of account selected for an asset or liability

  Or
- Components of such income and expenses if those components have different characteristics and are identified separately. For example, a change in the current value of an asset can include the effects of value changes and the accrual of interest (see Figure 9-1 at section 9.2 above). It would be appropriate to classify those components separately if doing so would enhance the usefulness of the resulting financial information. *[CF 7.14]*.

Recognised changes in equity during the reporting period comprise:

- Income minus expenses recognised in the statement(s) of financial performance

  And
- Contributions from, minus distributions to, holders of equity claims *[CF 5.3]*

A particularly important facet of classification is determining whether items of financial performance should be considered part of profit and loss or as other comprehensive income.

10.2.3.A Profit or loss and other comprehensive income

Income and expenses are classified and included either:

- In the statement of profit or loss

  Or
- Outside the statement of profit or loss, in other comprehensive income *[CF 7.15]*

The *Framework* does not explicitly define other comprehensive income. In 2024, the IASB published IFRS 18. That standard does contain a definition of other comprehensive income, being: 'Items of income and expense (including reclassification adjustments) that are recognised outside profit or loss as required or permitted by other IFRS Accounting Standards.' *[IFRS 18 Appendix A]*.

The statement of profit or loss is the primary source of information about an entity's financial performance for the reporting period. That statement contains a total for profit or loss that provides a highly summarised depiction of the entity's financial performance for the period. Many users of financial statements incorporate that total in their analysis either as a starting point for that analysis or as the main indicator of the entity's financial performance for the period. Nevertheless, understanding an entity's financial performance for the period requires an analysis of all recognised income and expenses, including income and expenses included in other comprehensive income, as well as an analysis of other information included in the financial statements. *[CF 7.16]*.

Because the statement of profit or loss is the primary source of information about an entity's financial performance for the period, all income and expenses are, in principle, included in that statement. Indeed, the Board observes that its intention in establishing this principle was to emphasise that the statement of profit or loss is the default location for income and expenses. *[CF 7.17, CF BC7.24]*.

However, in developing standards, the Board may decide in exceptional circumstances that income or expenses arising from a change in the current value of an asset or liability are to be included in other comprehensive income when doing so would result in the statement of profit or loss providing more relevant information, or providing a more faithful representation of the entity's financial performance for that period. *[CF 7.17]*.

Income and expenses that arise on a historical cost measurement basis (see Figure 9-1 at section 9.2 above) are included in the statement of profit or loss. That is also the case when income and expenses of that type are separately identified as a component of a change in the current value of an asset or liability. For example, if a financial asset is measured at current value and if interest income is identified separately from other changes in value, that interest income is included in the statement of profit or loss. *[CF 7.18]*. This use of more than one measurement basis is discussed in section 9.3.5 above.

In the view of the Board, if the statement of profit or loss is the primary source of information about financial performance for a period, the cumulative amounts included in that statement over time need to be as complete as possible. As a consequence, income and expenses can only be excluded permanently from the statement of profit or loss if there is a compelling reason to do so in any particular case. *[CF BC7.29]*. In principle, therefore, income and expenses included in other comprehensive income in one period are reclassified from other comprehensive income into the statement of profit or loss in a future period when doing so results in the statement of profit or loss providing more relevant information, or providing a more faithful representation of the entity's financial performance for that future period.

However, if, for example, there is no clear basis for identifying the period in which reclassification would have that result, or the amount that should be reclassified, the Board may, in developing standards, decide that income and expenses included in other comprehensive income are not to be subsequently reclassified. *[CF 7.19]*.

Whilst the *Framework* itself does not set out a list of items which are to be reported in other comprehensive income, IFRS 18 does so in its application guidance as follows.

'The components of other comprehensive income include:

(a) changes in revaluation surplus (see IAS 16 *Property, Plant and Equipment* and IAS 38);

(b) remeasurements of defined benefit plans (see IAS 19 *Employee Benefits*);

(c) gains and losses arising from translating the financial statements of a foreign operation (see IAS 21);

(d) gains and losses from investments in equity instruments designated at fair value through other comprehensive income in accordance with paragraph 5.7.5 of IFRS 9 *Financial Instruments*;

(e) gains and losses on financial assets measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of IFRS 9;

(f) the effective portion of gains and losses on hedging instruments in a cash flow hedge and the gains and losses on hedging instruments that hedge investments in equity instruments designated at fair value through other comprehensive income in accordance with paragraph 5.7.5 of IFRS 9 (see chapter 6 of IFRS 9);

(g) for particular liabilities designated as at fair value through profit or loss, the amount of the change in fair value that is attributable to changes in the liability's credit risk (see paragraph 5.7.7 of IFRS 9);

(h) changes in the value of the time value of options when separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the changes in the intrinsic value (see chapter 6 of IFRS 9);

(i) changes in the value of the forward elements of forward contracts when separating the forward element and spot element of a forward contract and designating as the hedging instrument only the changes in the spot element, and changes in the value of the foreign currency basis spread of a financial instrument when excluding it from the designation of that financial instrument as the hedging instrument (see chapter 6 of IFRS 9);

(j) insurance finance income and expenses from contracts issued within the scope of IFRS 17 *Insurance Contracts* excluded from profit or loss when total insurance finance income or expenses is disaggregated to include in profit or loss an amount determined by a systematic allocation applying paragraph 88(b) of IFRS 17, or by an amount that eliminates accounting mismatches with the finance income or expenses arising on the underlying items, applying paragraph 89(b) of IFRS 17; and

(k) finance income and expenses from reinsurance contracts held excluded from profit or loss when total reinsurance finance income or expenses is disaggregated to include in profit or loss an amount determined by a systematic allocation, applying paragraph 88(b) of IFRS 17.' *[IFRS 18.B87]*.

It is interesting to note that the Board chose to use the word 'include' when introducing this list of items, rather than (for example) the word 'comprise', which suggests that it should not, perhaps, be considered a complete list. A more likely explanation may be that it avoids the necessity of amending that paragraph should a future project introduce another item to be reported in other comprehensive income.

10.3 Aggregation

Aggregation is the adding together of assets, liabilities, equity, income or expenses that have shared characteristics and are included in the same classification. *[CF 7.20]*.

Aggregation makes information more useful by summarising a large volume of detail. However, aggregation conceals some of that detail. Hence, a balance needs to be found so that relevant information is not obscured either by a large amount of insignificant detail or by excessive aggregation. *[CF 7.21]*.

Different levels of aggregation may be needed in different parts of the financial statements. For example, typically, the statement of financial position and the statement(s) of financial performance provide summarised information and more detailed information is provided in the notes. *[CF 7.22]*.

11 Chapter 8: Concepts of capital and capital maintenance

The concept of capital maintenance is concerned with how an entity defines the capital that it seeks to maintain. It is a prerequisite for distinguishing between an entity's return *on* capital (that is, profit) and its return *of* capital. In general terms, an entity has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount over and above that required to maintain the capital at the beginning of the period is profit. *[CF 8.4, CF 8.6]*.

The *Framework* identifies two broad concepts of capital maintenance:

- Financial capital maintenance (see section 11.1 below)

  And

- Physical capital maintenance (see section 11.2 below)

The principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the entity. *[CF 8.6]*. The selection of the appropriate concept of capital by an entity should be based on the needs of the users of its financial statements. *[CF 8.2]*.

The concept of capital maintenance chosen by an entity will determine the accounting model used in the preparation of its financial statements. Most entities adopt a financial concept of capital. It is explained that different accounting models exhibit different degrees of relevance and reliability, and it is for management to seek a balance between relevance and reliability (see section 5 above for a discussion of the qualitative characteristics of useful financial information). *[CF 8.9]*. This use in Chapter 8 of the *Framework* of the term 'reliability' seems to be a drafting error - the term was used in the *1989 Framework* but was replaced in the *2010 Framework* with the term 'faithful representation'. As the text concerned has been carried forward unchanged from the *1989 Framework* to the current one, the failure to update this reference seems to us to be an oversight. The *Framework* notes that the IASB does not prescribe a particular model other than in exceptional circumstances, such as in a hyperinflationary economy (see Chapter 17). This intention will, however, be reviewed in the light of world developments. *[CF 8.1, CF 8.9]*.

The *Framework* notes that the revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity that meet the definition of income and expenses, but - under certain concepts of capital maintenance - are included in equity as capital maintenance adjustments or revaluation reserves. *[CF 8.10]*.

11.1 Financial capital maintenance

Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the entity. Under this concept a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. *[CF 8.1, CF 8.3(a)]*.

Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power. *[CF 8.3(a)]*. The financial capital maintenance concept does not require a particular measurement basis to be used. Rather, the basis selected depends upon the type of financial capital that the entity is seeking to maintain. *[CF 8.5]*.

Where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. This has the implication that increases in the prices of assets held over the period, conventionally referred to as holding gains, are conceptually profits. They may not be recognised as such, however, until the assets are disposed of in an exchange transaction. *[CF 8.7]*.

When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity. *[CF 8.7]*.

11.2 Physical capital maintenance

Under this concept a profit is earned only if the physical productive capacity (or operating capability) of the entity (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. *[CF 8.3(b)]*. The physical capital maintenance concept requires the current cost basis of measurement to be adopted. *[CF 8.5]*.

Because capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. Price changes affecting the assets and liabilities of the entity are changes in the measurement of the physical productive capacity of the entity, which are therefore treated as capital maintenance adjustments within equity and not as profit. *[CF 8.8]*.

12 Management commentary

Over a number of years, a number of individual countries have issued regulations or guidance requiring or encouraging the preparation of narrative 'management commentary' to accompany the financial statements.

12.1 The IASB's practice statement

In December 2010 the IASB published its first guidance on management commentary - *Management Commentary - A Framework for Presentation* - as a non-binding 'IFRS Practice Statement'. The introduction to the Practice Statement clarifies that it is neither an IFRS nor part of the *Framework*. However, it has been prepared on the basis that management commentary meets the definition of other financial reporting in the *Preface to International Financial Reporting Standards*, and is therefore within the scope of the *Framework*. Consequently, the Statement should be read 'in the context of' the *Framework*. *[MC.IN2, MC.IN4]*.

Management commentary is described as a narrative report that relates to financial statements that have been prepared in accordance with IFRSs. Management commentary provides users with historical explanations of the amounts presented in the financial statements, specifically the entity's financial position, financial performance and cash flows. It also provides commentary on an entity's prospects and other information not presented in the financial statements. Management commentary also serves as a basis for understanding management's objectives and its strategies for achieving those objectives. *[MC Appendix]*. For many entities, management commentary is already an important element of their communication with the capital markets, supplementing as well as complementing the financial statements. *[MC.IN3]*.

The Practice Statement is intended to set out a broad framework for the preparation of management commentaries, to be applied by management of individual reporting entities to their own specific circumstances. *[MC.IN5]*. The statement indicates that management commentary should be consistent with the following principles:

- To provide management's view of the entity's performance, position and progress

  And
- To supplement and complement information presented in the financial statements *[MC.12]*

Management commentary should include information that is forward-looking and has the qualitative characteristics referred to in the *Framework*. *[MC.13]*.

The IASB also envisages that any management commentary will include the following elements:

- The nature of the business
- Management's objectives and strategies for meeting those objectives
- The entity's most significant resources, risks and relationships
- The results of operations and prospects

  And
- The critical performance measures and indicators that management uses to evaluate the entity's performance against stated objectives *[MC.24]*

12.2 Possible future changes to the practice statement

At the time of writing, the Board is pursuing a project to update the practice statement; an exposure draft was published in May 2021 with comments requested by 23 November 2021.[8] The matter was discussed at the Board meeting in June 2024, where it was decided to finalise a revised statement 'by making targeted refinements' to the proposals set out in the exposure draft. At the time of writing, the IASB website states: 'In refining its proposals, the IASB will collaborate with the International Sustainability Standards Board (ISSB). With the project already at an advanced stage and the IASB's proposals broadly supported, the IASB expects to issue the revised Practice Statement in the first half of 2025.'[9]

8 Practice Statement Exposure Draft ED/2021/6 - *Management Commentary*, IASB, May 2021.

9 IASB website September 2024.

Appendix A - Defined terms

Extract from IFRS standards - Definitions		
aggregation	The adding together of assets, liabilities, equity, income or expenses that have shared characteristics and are included in the same classification.	CF.7.20
asset	A present economic resource controlled by the entity as a result of past events.	CF.4.3
carrying amount	The amount at which an asset, a liability or equity is recognised in the statement of financial position.	CF.5.1
classification	The sorting of assets, liabilities, equity, income or expenses on the basis of shared characteristics for presentation and disclosure purposes.	CF.7.7
combined financial statements	Financial statements of a reporting entity that comprises two or more entities that are not all linked by a parent-subsidiary relationship.	CF.3.12
consolidated financial statements	Financial statements of a reporting entity that comprises both the parent and its subsidiaries.	CF.3.11
control of an economic resource	The present ability to direct the use of the economic resource and obtain the economic benefits that may flow from it.	CF.4.20
derecognition	The removal of all or part of a recognised asset or liability from an entity's statement of financial position.	CF.5.26
economic resource	A right that has the potential to produce economic benefits.	CF.4.4
enhancing qualitative characteristic	A qualitative characteristic that makes useful information more useful. The enhancing qualitative characteristics are comparability, verifiability, timeliness and understandability.	CF.2.4, CF.2.23
equity	The residual interest in the assets of the entity after deducting all its liabilities.	CF.4.63
equity claim	A claim on the residual interest in the assets of the entity after deducting all its liabilities.	CF.4.64
executory contract	A contract, or a portion of a contract, that is equally unperformed-neither party has fulfilled any of its obligations, or both parties have partially fulfilled their obligations to an equal extent.	CF.4.56
existence uncertainty	Uncertainty about whether an asset or liability exists.	CF.4.13, CF.4.35
expenses	Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.	CF.4.69
fundamental qualitative characteristic	A qualitative characteristic that financial information must possess to be useful to the primary users of general purpose financial reports. The fundamental qualitative characteristics are relevance and faithful representation.	CF.2.4, CF.2.5
general purpose financial report	A report that provides financial information about the reporting entity's economic resources, claims against the entity and changes in those economic resources and claims that is useful to primary users in making decisions relating to providing resources to the entity.	CF.1.2, CF.1.12
general purpose financial statements	A particular form of general purpose financial reports that provide information about the reporting entity's assets, liabilities, equity, income and expenses.	CF.3.2

income	Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.	CF.4.68
liability	A present obligation of the entity to transfer an economic resource as a result of past events.	CF.4.26
material information	Information is material if omitting, misstating, or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial reports make on the basis of those reports, which provide financial information about a specific reporting entity.	CF.2.11
measure	The result of applying a measurement basis to an asset or liability and related income and expenses.	CF.6.1
measurement basis	An identified feature-for example, historical cost, fair value or fulfilment value-of an item being measured.	CF.6.1
measurement uncertainty	Uncertainty that arises when monetary amounts in financial reports cannot be observed directly and must instead be estimated.	CF.2.19
offsetting	Grouping an asset and liability that are recognised and measured as separate units of account into a single net amount in the statement of financial position.	CF.7.10

Chapter 3 Presentation of financial statements and accounting policies – IAS 1

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Overview

This chapter deals with the requirements of IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

These two standards contain the main requirements of IFRS accounting standards regarding the form, content and structure of financial statements and the accounting policies to be applied in their preparation.

IAS 1 requires the presentation of a statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows, along with notes. It sets out the requirements of each, with the exception of the statement of cash flows which is the subject of a separate standard (see Chapter 36). IAS 1 also deals with certain general matters such as the requirement for a 'fair presentation' and the requirement to present comparatives.

IAS 8 deals with accounting policies in a general and conceptual way; other individual standards set out specific accounting requirements for the areas with which they deal. IAS 8 also addresses the difference between accounting policies and accounting estimates, as well as explaining how errors should be corrected.

What you need to know

- IAS 1 deals with:
  - The components of financial statements
  - Fair presentation
  - Fundamental accounting concepts
  - Disclosure of accounting policies

    And
  - The structure and content of financial statements
- IAS 8 applies to selecting and applying accounting policies and accounting for changes in accounting policies, changes in accounting estimates and corrections of prior period errors.

1 Introduction

There is no single IFRS accounting standard dealing with the form, content and structure of financial statements and the accounting policies to be applied in their preparation. The subject of just what financial statements are, their purpose, contents and presentation is addressed principally by the following standards.

IAS 1 is the main standard dealing with the overall requirements for the presentation of financial statements, including their purpose, form, content and structure. IAS 8 deals with the requirements for the selection and application of accounting policies. It also deals with the accounting and disclosure requirements for changes in accounting policies, changes in estimates and corrections of errors. IAS 7 *Statement of Cash Flows* deals with the presentation of the statement of cash flows and related disclosures. IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* deals with the classification and presentation of non-current assets held for sale in the statement of financial position, and the presentation of the results of discontinued operations; it also sets out the measurement requirements for such items. This chapter deals with the requirements of IAS 1 and IAS 8. Chapter 36 discusses the requirements of IAS 7, Chapter 5 discusses the requirements of IFRS 5.

1.1 Objective and scope of IAS 1

IAS 1 deals with the components of financial statements, fair presentation, fundamental accounting concepts, disclosure of accounting policies, and the structure and content of financial statements.

IAS 1 applies to 'general purpose financial statements' (financial statements), that is those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to meet their particular information needs, and it should be applied to all such financial statements prepared in accordance with IFRS accounting standards. *[IAS 1.2, IAS 1.7]*. The meaning of 'users' of financial statements is expanded upon in IAS 1 as it is related to the concept of materiality; this is discussed in section 4.1.5 below. Although International Financial Reporting Standards is a self-explanatory phrase, both IAS 1 and IAS 8 define it as:

"Standards and Interpretations issued by the International Accounting Standards Board (IASB). They comprise:

"(a) International Financial Reporting Standards;

"(b) International Accounting Standards;

"(c) IFRIC Interpretations; and

"(d) SIC Interpretations.[1]" *[IAS 1.7, IAS 8.5]*

An important point is that implementation guidance for standards issued by the IASB does not form part of those standards, and therefore does not contain requirements for financial statements. *[IAS 8.9]*. Accordingly, the often voluminous implementation guidance accompanying standards is not, strictly speaking, part of 'IFRS'.

How we see it

Whilst the implementation guidance accompanying individual standards is not part of IFRS, we would generally expect entities to follow such guidance when it is relevant to their circumstances.

The standard applies equally to all entities including those that present consolidated financial statements, those that present separate financial statements and those that present individual financial statements (discussed in Chapter 9 at section 1.1). IAS 1 does not apply to the structure and content of condensed interim financial statements prepared in accordance with IAS 34 *Interim Financial Reporting* (discussed in Chapter 37 at section 3.2), although its general principles, as discussed in section 4.1 below, do apply to such interims. *[IAS 1.4]*.

The objective of the standard is to prescribe the basis for the presentation of general purpose financial statements, and by doing so, to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. The standard sets out overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content. The recognition, measurement and disclosure of specific transactions and other events are dealt with in other standards and in interpretations. *[IAS 1.1, IAS 1.3]*.

1 "Definition of IFRSs amended after the name changes introduced by the revised Constitution of the IFRS Foundation in 2010."

IAS 1 is primarily directed at profit-oriented entities (including public sector business entities), and this is reflected both in the terminology it uses and in its requirements. It acknowledges that entities with not-for-profit activities in the private sector, public sector or government may apply the standard and that such entities may need to amend the descriptions used for particular line items in the financial statements and for the financial statements themselves. *[IAS 1.5]*. Furthermore, IAS 1 is a general standard that does not address issues specific to particular industries. It does observe, though, that entities without equity (such as some mutual funds) or whose share capital is not equity (such as some co-operative entities) may need to adapt the presentation of members' or unit holders' interests. *[IAS 1.6]*.

1.2 Objective and scope of IAS 8

IAS 8 applies to selecting and applying accounting policies, and accounting for changes in accounting policies, changes in accounting estimates and corrections of prior period errors. *[IAS 8.3]*. Its objective is to prescribe the criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and corrections of errors. The intention is to enhance the relevance and reliability of an entity's financial statements and the comparability of those financial statements over time and with the financial statements of other entities. *[IAS 8.1]*.

Two particular issues which one might expect to be dealt with regarding the above are discussed in other standards and cross referred to by IAS 8:

- Disclosure requirements for accounting policies, except those for changes in accounting policies, are dealt with in IAS 1. *[IAS 8.2]*.

  And

- Accounting and disclosure requirements regarding the tax effects of corrections of prior period errors and of retrospective adjustments made to apply changes in accounting policies are dealt with in IAS 12 *Income Taxes* (discussed in Chapter 29 at section 10.2). *[IAS 8.4]*.

2 The purpose and composition of financial statements

What financial statements are and what they are for are important basic questions for any corpus of accounting literature and answering them is one of the main purposes of IAS 1.

2.1 The purpose of financial statements

IAS 1 describes financial statements as a structured representation of the financial position and financial performance of an entity. It states that the objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. A focus on assisting decision making by the users of financial statements is seeking (at least in part) a predictive quality. This is reflected by some requirements of accounting standards. For example: the disclosure of discontinued operations (discussed in Chapter 5 at section 3); the use of profit from continuing operations as the 'control number' in calculating diluted earnings per share (discussed in Chapter 33 at section 6.3.1); and also, the desire of some entities to present performance measures excluding what they see as unusual or infrequent items (discussed in section 3.2.6 below).

In addition to the focus on decision making, IAS 1 states that financial statements show the results of management's stewardship of the resources entrusted to it. *[IAS 1.9].* This is closely connected to decision making, as an analysis of management's current stewardship would provide predictive information about how management may perform that role in the future.

To meet this objective for financial statements, IAS 1 requires that they provide information about an entity's:

(a) Assets

(b) Liabilities

(c) Equity

(d) Income and expenses, including gains and losses

(e) Contributions by owners and distributions to owners in their capacity as owners (owners being defined as holders of instruments classified as equity) *[IAS 1.7]*

And

(f) Cash flows

The standard observes that this information, along with other information in the notes, assists users of financial statements in predicting the entity's future cash flows and, in particular, their timing and certainty. *[IAS 1.9]*.

2.2 Frequency of reporting and period covered

IAS 1 requires that a complete set of financial statements (including comparative information, see section 2.4 below) be presented 'at least annually'. Whilst this drafting is not precise, it does not seem to mean that financial statements must never be more than a year apart. This is because the standard mentions that the end of an entity's reporting period may change, and that the annual financial statements are therefore presented for a period longer or shorter than one year. When this is the case, IAS 1 requires disclosure of, in addition to the period covered by the financial statements:

(a) The reason for using a longer or shorter period

And

(b) The fact that amounts presented in the financial statements are not entirely comparable *[IAS 1.36]*

Normally financial statements are consistently prepared covering a one-year period. Some entities, particularly in the retail sector, traditionally present financial statements for a 52-week period. IAS 1 does not preclude this practice. *[IAS 1.37]*.

2.3 The components of a complete set of financial statements

A complete set of financial statements under IAS 1 comprises the following, each of which should be presented with equal prominence: *[IAS 1.10, IAS 1.10A, IAS 1.11]*

(a) A statement of financial position as at the end of the period

(b) A statement of profit or loss and other comprehensive income for the period to be presented either as:

  (i) One single statement of comprehensive income with a section for profit and loss followed immediately by a section for other comprehensive income

  Or

  (ii) A separate statement of profit or loss and statement of comprehensive income. In this case, the former must be presented immediately before the latter.

(c) A statement of changes in equity for the period

(d) A statement of cash flows for the period

(e) Notes, comprising material accounting policy information and other explanatory information

(f) Comparative information in respect of the preceding period

  And

(g) A statement of financial position as at the beginning of the preceding period when:

  (i) An accounting policy has been applied retrospectively

  Or

  (ii) A retrospective restatement has been made

  Or

  (iii) Items have been reclassified

The titles of the statements need not be those used in the standard (shown above).

The standard explains that notes contain information in addition to that presented in the statements above and provide narrative descriptions or disaggregation of items presented in those statements and information about items that do not qualify for recognition in those statements. *[IAS 1.7]*.

In addition to information about the reporting period, IAS 1 also requires information about the preceding period. Comparative information is discussed in section 2.4 below.

Financial statements are usually published as part of a larger annual report, with the accompanying discussions and analyses often being more voluminous than the financial statements themselves. IAS 1 acknowledges this but makes clear that such reports and statements (including financial reviews, environmental reports and value added statements) presented outside financial statements are outside the scope of IFRS accounting standards. *[IAS 1.14]*.

Although the standard acknowledges that this type of information is not within the scope of IFRS accounting standards, IAS 1 devotes two paragraphs to discussing what this information may comprise, observing that:

- A financial review by management may describe and explain the main features of the entity's financial performance and financial position and the principal uncertainties it faces and that it may include a review of:
  - The main factors and influences determining financial performance, including changes in the environment in which the entity operates, the entity's response to those changes and their effect, and the entity's policy for investment to maintain and enhance financial performance, including its dividend policy.
  - The entity's sources of funding and its targeted ratio of liabilities to equity (IAS 1 itself requires certain disclosures about capital. These are discussed in section 5.4 below).

    And
  - The entity's resources not recognised in the statement of financial position in accordance with IFRS accounting standards. *[IAS 1.13]*.
- Reports and statements such as environmental reports and value added statements may be presented, particularly in industries in which environmental factors are significant and when employees are regarded as an important user group. *[IAS 1.14]*.

The IASB has published a practice statement on management commentary. The practice statement is a broad, non-binding framework for the presentation of narrative reporting to accompany financial statements prepared in accordance with IFRS accounting standards.

Although management commentaries add helpful and relevant information beyond what is included in the financial statements, IFRS accounting standards require the financial statements to provide a fair presentation of the financial position, financial performance and cash flows of a reporting entity on a stand-alone basis.

The Board continues to consider wider aspects of corporate reporting and has added to its agenda a project to revise and update the practice statement (see section 6.1.1 below).

2.4 Comparative information

2.4.1 General requirements

IAS 1 requires, except when IFRS accounting standards permit or require otherwise, comparative information to be disclosed in respect of the previous period for all amounts reported in the current period's financial statements. *[IAS 1.38]*. If any information is voluntarily presented, there will by definition be no standard or interpretation providing a dispensation from comparatives. Accordingly, comparative information is necessary for any voluntarily presented current period disclosure.

The above requirement for two sets of statements and notes represents the minimum which is required in all circumstances. *[IAS 1.38A]*.

An entity may present comparative information in addition to the minimum comparative financial statements required by IFRS, as long as that information is prepared in accordance with IFRS accounting standards. This comparative information may consist of one or more primary statements, but need not comprise a complete set of financial statements. When this is the case, IAS 1 requires an entity to present related note information for those additional statements. *[IAS 1.38C]*.

For example, an entity may present a third statement of profit or loss and other comprehensive income (thereby presenting the current period, the preceding period and one additional comparative period). In such circumstances, IAS 1 does not require a third statement of financial position, a third statement of cash flows or a third statement of changes in equity (that is, an additional comparative financial statement). The entity is required to present, in the notes to the financial statements, the comparative information related to that additional statement of profit or loss and other comprehensive income. *[IAS 1.38D]*.

However, further comparative information is required by IAS 1 in certain circumstances. Whenever an entity:

(a) Applies an accounting policy retrospectively

Or

(b) Makes a retrospective restatement

Or

(c) Reclassifies items in its financial statements (see section 2.4.2 below)

An additional statement of financial position is required as at the beginning of the preceding period if the change has a material effect on that additional statement. *[IAS 1.40A]*. The standard describes this as an 'additional' statement because the minimum requirement is for one comparative statement of financial position. Should an entity already have a policy of presenting two comparative statements this requirement would not necessarily require a fourth statement. Only if the second comparative statement is not essentially the same as one drawn-up 'as at the beginning of the preceding period', would a financial position as at the beginning of the preceding period be required. As such restatements are considered, by the IASB, narrow, specific and limited, no notes are required for this additional statement of financial position. *[IAS 1.40C, IAS 1.BC32C]*.

Comparative information is also required for narrative and descriptive information when it is relevant to an understanding of the current period's financial statements. *[IAS 1.38]*. The standard gives an example of the current year relevance of the previous year's narratives; a legal dispute, the outcome of which was uncertain at the previous period and is yet to be resolved (the disclosure of contingent liabilities is discussed in Chapter 27 at section 7.2). It observes that users benefit from information that the uncertainty existed at the end of the previous period, and about the steps that have been taken during the period to resolve the uncertainty. *[IAS 1.38B]*.

Another example would be any narrative describing a separately disclosed material item (see section 3.2.6 below). IAS 1 requires the disclosure of the nature and amount of such items. *[IAS 1.97]*. Often a simple caption or line item label will be sufficient to convey the 'nature' of material items. Sometimes, though, a more extensive description in the notes may be needed to do this. In that case, the same information is likely to be relevant the following year.

2.4.2 Reclassification

It is important to note that 'reclassifies', as that word is used by IAS 1 in the context of comparative information, is not referring to a 'reclassification adjustment'. 'Reclassification adjustment' is a term defined by IAS 1 which describes the recognition of items in profit or loss which were previously recognised in other comprehensive income (often referred to as 'recycling'). IAS 1 applies this definition when setting out the required presentation and disclosure of such items (see section 3.2.4.B below).

As noted in section 1.1 above, one of the objectives of IAS 1 is to ensure the comparability of financial statements with previous periods. The standard notes that enhancing the inter-period comparability of information assists users in making economic decisions, especially by allowing the assessment of trends in financial information for predictive purposes. *[IAS 1.43]*. Requiring the presentation of comparatives allows such a comparison to be made within one set of financial statements. For a comparison to be meaningful, the amounts for prior periods need to be reclassified whenever the presentation or classification of items in the financial statements is amended. When this is the case, disclosure is required of the nature, amount and reasons for the reclassification (including as at the beginning of the preceding period). *[IAS 1.41]*.

The standard acknowledges, though, that in some circumstances it is impracticable to reclassify comparative information for a particular prior period to achieve comparability with the current period. For these purposes, reclassification is impracticable when it cannot be done after making every reasonable effort to do so. *[IAS 1.7]*. An example given by the standard is that data may not have been collected in the prior period(s) in a way that allows reclassification, and it may not be practicable to recreate the information. *[IAS 1.43]*. When it proves impracticable to reclassify comparative data, IAS 1 requires disclosure of the reason for this and also the nature of the adjustments that would have been made if the amounts had been reclassified. *[IAS 1.42]*.

As well as reclassification to reflect current period classifications as required by IAS 1, a change to comparatives as they were originally reported could be necessary:

(a) Following a change in accounting policy (discussed in section 4.4 below)

(b) To correct an error discovered in previous financial statements (discussed in section 4.6 below)

Or

(c) In relation to discontinued operations (discussed in Chapter 5 at section 3.2)

2.5 Identification of the financial statements and accompanying information

2.5.1 Identification of financial statements

It is commonly the case that financial statements will form only part of a larger annual report, regulatory filing or other document. As IFRS accounting standards only apply to financial statements, it is important that the financial statements are clearly identified so that users of the report can distinguish information that is prepared using IFRS accounting standards from other information that may be useful but is not the subject of those requirements. *[IAS 1.49, IAS 1.50]*.

This requirement will be particularly important in those instances in which standards allow for disclosure of information required by IFRS accounting standards outside the financial statements.

As well as requiring that the financial statements be clearly distinguished, IAS 1 also requires that each financial statement and the notes be identified clearly. Furthermore, the following is required to be displayed prominently, and repeated when that is necessary for the information presented to be understandable:

(a) The name of the reporting entity or other means of identification, and any change in that information from the end of the preceding period

(b) Whether the financial statements are of an individual entity or a group of entities

(c) The date of the end of the reporting period or the period covered by the set of financial statements or the notes (presumably whichever is appropriate to that component of the financial statements)

(d) The presentation currency, as defined in IAS 21 *The Effects of Changes in Foreign Exchange Rates* (discussed in Chapter 16 at section 3)

And

(e) The level of rounding used in presenting amounts in the financial statements *[IAS 1.51]*

These requirements are met by the use of appropriate headings for pages, statements, notes, and columns etc. The standard notes that judgement is required in determining the best way of presenting such information. For example, when the financial statements are presented electronically, separate pages are not always used and therefore headings for pages cannot be relied on for presentation of the above; instead those items may need to be presented in a different manner to ensure that the information included in the financial statements can be understood. *[IAS 1.52]*. IAS 1 considers that financial statements are often made more understandable by presenting information in thousands or millions of units of the presentation currency. It considers this acceptable as long as the level of rounding in presentation is disclosed and material information is not omitted. *[IAS 1.53]*.

2.5.2 Statement of compliance with IFRS

As well as identifying which particular part of any larger document constitutes the financial statements, IAS 1 also requires that financial statements complying with IFRS accounting standards make an explicit and unreserved statement of such compliance in the notes. *[IAS 1.16]*. As this statement itself is required for full compliance, its absence would render the whole financial statements non-compliant, even if there was otherwise full compliance. The standard goes on to say that "an entity shall not describe financial statements as complying with IFRSs unless they comply with all the requirements of IFRSs." *[IAS 1.16]*.

How we see it

The note containing the statement of compliance is also usually where entities provide any other compliance statement required by local regulation. For example, entities required to comply with IFRS accounting standards as adopted for use in the EU would typically state compliance with that requirement alongside the statement of compliance with IFRS accounting standards themselves (assuming, of course, that the financial statements were in full compliance with both).

3 The structure of financial statements

As noted in section 2.3 above, a complete set of financial statements under IAS 1 comprises the following, each of which should be presented with equal prominence: *[IAS 1.10, IAS 1.10A, IAS 1.11]*

(a) A statement of financial position as at the end of the period

(b) A statement of profit or loss and other comprehensive income for the period to be presented either as:

  (i) One single statement of comprehensive income with a section for profit and loss followed immediately by a section for other comprehensive income

  Or

  (ii) A separate statement of profit or loss and statement of comprehensive income. In this case, the former must be presented immediately before the latter.

(c) A statement of changes in equity for the period

(d) A statement of cash flows for the period

(e) Notes, comprising material accounting policy information and other explanatory information

(f) Comparative information in respect of the preceding period

  And

(g) A statement of financial position as at the beginning of the preceding period in certain circumstances (see section 2.4 above) *[IAS 1.10, IAS 1.10A]*

The standard adopts a generally permissive stance, by setting out minimum levels of required items to be shown in each statement (sometimes specifically on the face of the statement, and sometimes either on the face or in the notes) whilst allowing great flexibility of order and layout. The standard notes that sometimes it uses the term 'disclosure' in a broad sense, encompassing items 'presented in the financial statements'. It observes that other IFRS accounting standards also require disclosures and that, unless specified to the contrary, they may be made 'in the financial statements'. *[IAS 1.48]*. This begs the question: if not 'in the financial statements' then where else could they be made? We suspect this stems from, or is reflective of, an ambiguous use of similar words and phrases. In the introductory paragraphs to structure and content, 'financial statements' appears to be restricted to the 'primary' statements (statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows). This is because a complete set of financial statements also includes notes.

How we see it

For the purposes of specifying where a particular required disclosure must be made, we consider the term 'in the financial statements' is intended to mean anywhere within the 'complete set of financial statements' - in other words the primary statements or notes.

IAS 1 observes that cash flow information provides users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows. Requirements for the presentation of the statement of cash flows and related disclosures are set out in IAS 7. *[IAS 1.111]*. Statements of cash flows are discussed in Chapter 36; each of the other primary statements listed above is discussed in the following sections.

3.1 The statement of financial position

3.1.1 The distinction between current/non-current assets and liabilities

In most situations, IAS 1 requires statements of financial position to distinguish current assets and liabilities from non-current ones. *[IAS 1.60]*. There is an exception relating to presentation based on liquidity, discussed below, and the treatment of non-current assets held for sale is discussed in Chapter 5 at section 2.2.4. The standard uses the term 'non-current' to include tangible, intangible and financial assets of a long-term nature. It does not prohibit the use of alternative descriptions as long as the meaning is clear. *[IAS 1.67]*.

The standard explains the requirement to present current and non-current items separately by observing that when an entity supplies goods or services within a clearly identifiable operating cycle, separate classification of current and non-current assets and liabilities on the face of the statement of financial position will provide useful information by distinguishing the net assets that are continuously circulating as working capital from those used in long-term operations. Furthermore, the analysis will also highlight assets that are expected to be realised within the current operating cycle, and liabilities that are due for settlement within the same period. *[IAS 1.62]*. The distinction between current and non-current items therefore depends on the length of the entity's operating cycle. The standard states that the operating cycle of an entity is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. However, when the entity's normal operating cycle is not clearly identifiable, it is assumed to be twelve months. *[IAS 1.68, IAS 1.70]*. The standard does not provide any guidance on how to determine if an entity's operating cycle is 'clearly identifiable'. In some businesses, the time involved in producing goods or providing services varies significantly from one customer project to another. In such cases, it may be difficult to determine what the normal operating cycle is. In the end, management must consider all facts and circumstances and judgement to determine whether it is appropriate to consider that the operating cycle is clearly identifiable, or whether the twelve months default is to be used.

Once assets have been classified as non-current they should not normally be reclassified as current assets until they meet the criteria to be classified as held for sale in accordance with IFRS 5 (see Chapter 5 at section 2.1). However, an entity which routinely sells items of property plant and equipment previously held for rental should transfer such items to inventory when they cease to be rented and become held for sale. *[IAS 16.68A]*. Assets of a class that an entity would normally regard as non-current that are acquired exclusively with a view to resale also should not be classified as current unless they meet the criteria in IFRS 5. *[IFRS 5.3]*.

The basic requirement of the standard is that current and non-current assets, and current and non-current liabilities, should be presented as separate classifications on the face of the statement of financial position. *[IAS 1.60]*. The standard defines current assets and current liabilities (discussed in sections 3.1.3 and 3.1.4 below), with the non-current category being the residual. *[IAS 1.66, IAS 1.69]*. Illustration 3-2 in section 3.1.7 below provides an example of a statement of financial position presenting this classification.

An exception to this requirement is when a presentation based on liquidity provides information that is reliable and is more relevant. When that exception applies, all assets and liabilities are required to be presented broadly in order of liquidity. *[IAS 1.60]*. The reason given by the standard for this exception is that some entities (such as financial institutions) do not supply goods or services within a clearly identifiable operating cycle, and for these entities a presentation of assets and liabilities in increasing or decreasing order of liquidity provides information that is reliable and more relevant than a current/non-current presentation. *[IAS 1.63]*.

The standard also makes clear that an entity is permitted to present some of its assets and liabilities using a current/non-current classification and others in order of liquidity when this provides information that is reliable and more relevant. It goes on to observe that the need for a mixed basis of presentation might arise when an entity has diverse operations. *[IAS 1.64]*.

Whichever method of presentation is adopted, IAS 1 requires disclosure of the amount expected to be recovered or settled after more than twelve months for each asset and liability line item that combines amounts expected to be recovered or settled:

(a) No more than twelve months after the reporting period

And

(b) More than twelve months after the reporting period *[IAS 1.61]*

The standard explains this requirement by noting that information about expected dates of realisation of assets and liabilities is useful in assessing the liquidity and solvency of an entity. In this vein, IAS 1 asserts that IFRS 7 *Financial Instruments: Disclosures* requires disclosure of the maturity dates of financial assets (including trade and other receivables) and financial liabilities (including trade and other payables). This assertion in IAS 1 is not strictly correct, as IFRS 7 only requires a maturity analysis for financial liabilities (see Chapter 50 at section 5.4.2). Similarly, IAS 1 views information on the expected date of recovery and settlement of non-monetary assets and liabilities such as inventories and provisions as also useful, whether assets and liabilities are classified as current or as non-current. An example of this given by the standard is that an entity should disclose the amount of inventories that are expected to be recovered more than twelve months after the reporting period. *[IAS 1.65]*.

3.1.2 Non-current assets and disposal groups held for sale or distribution

The general requirement to classify items as current or non-current (or present them broadly in order of liquidity) is overlaid with further requirements by IFRS 5 regarding non-current assets and disposal groups held for sale or distribution (discussed in Chapter 5 at section 2.2.4). The aim of IFRS 5 is that entities should present and disclose information that enables users of the financial statements to evaluate the financial effects of disposals of non-current assets (or disposal groups). *[IFRS 5.30]*.

3.1.3 Current assets

IAS 1 requires an asset to be classified as current when it satisfies any of the following criteria, with all other assets classified as non-current. The criteria are: *[IAS 1.66]*

Extract from IAS 1

66 **An entity shall classify an asset as current when:**

(a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;

(b) it holds the asset primarily for the purpose of trading;

(c) it expects to realise the asset within twelve months after the reporting period; or

(d) the asset is cash or a cash equivalent (as defined in IAS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

An entity shall classify all other assets as non-current.

As an exception to this, deferred tax assets are never allowed to be classified as current. *[IAS 1.56]*.

Current assets include assets (such as inventories and trade receivables) that are sold, consumed or realised as part of the normal operating cycle even when they are not expected to be realised within twelve months after the reporting period. Current assets also include assets held primarily for the purpose of being traded, for example, some financial assets that meet the definition of held for trading in IFRS 9 *Financial Instruments* and the current portion of non-current financial assets. *[IAS 1.68]*.

3.1.4 Current liabilities

In January 2020 the IASB issued *Classification of Liabilities as Current or Non-current - Amendments to IAS 1*, amending aspects of the existing classification principle for classifying liabilities as current or non-current. Specifically, the Board made amendments to reconcile apparent contradictions between the former wording which referred to an 'unconditional right' in paragraph 69 and 'expects' and 'discretion' in paragraph 74. *[IAS 1.BC48A].* Concerns were raised about the impact of the amendments in certain scenarios and subsequently, further amendments were proposed, resulting in additional amendments issued in October 2022. *[IAS 1.BC48EA].* The amendments took effect for periods beginning on or after 1 January 2024. *[IAS 1.139U]*.

IAS 1 requires a liability to be classified as current when it satisfies any of the following criteria, with all other liabilities classified as non-current. The criteria for classifying a liability as current are:

(a) It is expected to be settled in the entity's normal operating cycle (discussed in section 3.1.1 above)

(b) It is held primarily for the purpose of trading

(c) It is due to be settled within twelve months after the end of the reporting period

Or

(d) The entity does not have the right at the end of the reporting period to defer settlement of the liability for at least twelve months after the reporting period. *[IAS 1.69]*.

Notwithstanding the foregoing, deferred tax liabilities are never allowed to be classified as current. *[IAS 1.56]*.

The standard clarifies that a right to defer settlement of a liability for at least twelve months must have substance and must exist at the end of the reporting period. *[IAS 1.72A].* Often, an entity's right to defer settlement of a loan liability for at least twelve months after the reporting period is subject to the entity complying with certain conditions in the loan arrangements. Those conditions are described as covenants. For the purposes of applying the classification criteria in paragraph 69(d), such covenants affect whether the right exists at the end of the reporting period, if the entity is required to comply with the covenant *on or before* the end of the reporting period. This is the case, even if compliance with the covenant is assessed after the reporting period. If, however, a covenant is only required to be complied with *after* the reporting period end, such a covenant is ignored for classification purposes. *[IAS 1.72B]*

The question arises as to whether the guidance in paragraph 72B can be extended to liabilities other than liabilities arising from loan arrangements; the standard provides no definition of loan arrangements.

How we see it

Despite the lack of a definition of loan agreements in the standard, we believe that loan arrangements are generally considered to have particular characteristics: they constitute a contract between a borrower and a lender and that contract identifies the parties and outlines the key terms - for example, the amount borrowed, the term, the interest rate and the repayment dates.

The guidance in paragraph 72B is only framed in terms of loan arrangements and therefore other liabilities not constituting loan arrangements would need to be assessed, according to their individual facts and circumstances, to see if there is a basis for concluding that there is a right to defer settlement for at least twelve months after the reporting period end. *[IAS 1.69(d)]*.

The standard further explains that liabilities would be non-current if an entity has the right, at the end of the reporting period, to roll over an obligation for at least twelve months after the period end under an existing loan facility, even if it would otherwise be due within a shorter period, i.e., if it were due to be settled within 12 months after the end of the reporting period. However, if no such right exists at the end of the reporting period, the entity does not consider the potential to refinance the obligation and consequently classifies the obligation as current. *[IAS 1.73]*.

How we see it

A rollover right may exist in conjunction with a future covenant, such that the latter is to be tested before the right to roll over may be exercised. In such a case, we believe the covenant must be assessed under paragraph 72B, separately from the rollover right assessed under paragraph 73. Thus, the loan is classified as non-current, unless there are other circumstances unrelated to the covenant that impact the classification assessment.

A liability will also be classified as current when an entity breaches a covenant of a long-term loan arrangement on or before the period end, with the effect that the liability becomes payable on demand. This is the case even if the lender agreed, after the period end and before the authorisation of the financial statements for issue, not to demand payment as a consequence of the breach (although the post period end agreement would be disclosed). The meaning of the term 'authorised for issue' is discussed in Chapter 34 at section 2.1.1. The standard explains that the liability should be classified as current because, at the period end, the entity does not have the right to defer its settlement for at least twelve months after that date. *[IAS 1.74, IAS 1.76]*. However, the liability would be classified as non-current if the lender agreed by the period end to provide a period of grace ending at least twelve months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment. *[IAS 1.75]*.

It is important to note that management intention does not play a role in the classification of liabilities. Thus a liability meeting the criteria in paragraph 69 for classification as non-current will still be classified as non-current even if management intends or expects the entity to settle the liability within twelve months after the reporting period, or even if the liability is settled between the end of the reporting period and the date the financial statements are authorised for issue. Despite ignoring management intention with regards to classification, it is not ignored for disclosure purposes. It may still be necessary to disclose information relating to the timing of the settlement in order for users of the financial statements to understand the impact of the liability on the entity's financial position. *[IAS 1.75A]*. The requirement to ignore management intent in respect of classification may represent a change in practice for some entities, as previous practice may have taken into account management's expectations and the discretion afforded to management.

For the avoidance of doubt, the standard clarifies situations in which certain events affecting liabilities classified as current are disclosed as non-adjusting post balance sheet events:

- Refinancing on a long-term basis
- Rectification of a breach of a long-term loan arrangement
- Granting by the lender of a period of grace to rectify a breach of a long-term loan arrangement

And one situation in which a liability classified as non-current is disclosed as a non-adjusting post balance sheet event:

- Settlement of a liability classified as non-current *[IAS 1.76]*

As discussed above, if an entity has loan arrangements with covenants and those covenants are only required to be complied with after the reporting period end, the resulting classification of the liabilities will be non-current. Whether or not the company can influence or control the circumstances surrounding compliance with the future covenants is not relevant for the assessment. For such liabilities, an entity is required to disclose in the notes information which enables users to understand the risk that the liabilities may become repayable within twelve months after the reporting period. Specifically, the entity must disclose information about the covenants, including:

- The nature of the covenants
- When the entity is required to comply with the covenants
- The carrying amount of the liabilities related to the covenants
- Facts and circumstances, if any, which indicate that the entity may have difficulty complying with the covenants. *[IAS 1.76ZA]*

With regard to the last bullet above, factors an entity may wish to consider are:

- Whether it has acted to avoid or mitigate a potential breach, either during or after the reporting period
- Whether it would have complied with a covenant, had that covenant been tested based on circumstances at the end of the reporting period. *[IAS 1.76ZA]*

The above disclosure requirements only apply to entities that present current and non-current liabilities as separate classifications in their statements of financial position. Nonetheless, entities presenting liabilities in order of liquidity may still disclose similar information about liabilities with covenants, when applying the requirements in IFRS 7 regarding exposure to liquidity risk. *[IAS 1.BC48ED].*

Respondents to the draft amendments raised concerns about the volume of detailed information which entities might need to disclose, which may obscure material information about covenants. The Board made four observations in response to these concerns:

- An entity would assess what information about the covenants is material and therefore would not disclose immaterial information
- An entity requiring guidance on materiality judgements could refer to the guidance on assessing materiality of information about covenants contained in IFRS Practice Statement 2 Making Materiality Judgements
- An entity would consider both the consequences and the likelihood of a breach when assessing if information is material
- If there is only a remote likelihood of a breach occurring, such information is immaterial, irrespective of the consequences of the breach. *[IAS 1.BC48EE]*

The standard also sets out the meaning of the 'settlement' of a liability. In the context of IAS 1, settlement refers to a transfer to the counterparty that results in the extinguishment of the liability. The transfer could be of cash, other economic resources or, in certain circumstances, the entity's own equity instruments. *[IAS 1.76A].* The amendments clarify the meaning of the term for two reasons. Firstly, the Board concluded that rolling over an existing liability does not constitute settlement, as there is no transfer of economic resources. Secondly, it noted that certain liabilities are settled by economic resources other than cash, of which an example would be a performance obligation under IFRS 15 *Revenue from Contracts with Customers*. The Board considered that it would be helpful to clarify the meaning of settlement, incorporating these two aspects. *[IAS 1.BC48F].*

Settlement by way of own equity instruments is an example of non-cash settlement that impacts the classification of a liability. A single situation is outlined in which the terms of a liability, relating to an option held by the counterparty to trigger settlement by way of own equity instruments, do not affect its classification: if the liability could be settled, at the option of the counterparty, by transfer of the entity's own equity instruments and if that option is separately classified as an equity instrument, in that case only, the option is ignored for classification purposes. *[IAS 1.76B].*

Were it not for this exception, any instrument with an option held by the counterparty to settle in own equity instruments would automatically have to be classified as current, as there would be no right to defer settlement for at least 12 months after the reporting period end. This exception existed in the standard prior to the amendments but in practice some applied it to all convertible instruments containing a conversion option, regardless of whether that option was classified as equity or as a liability. The standard now clarifies that the exception is limited to instruments where the option is classified as an equity instrument. Under the amended requirements, the transfer of equity instruments constitutes a settlement event for any obligation to transfer equity instruments classified as a liability.

The requirement may change practice for certain entities because, as noted above, it had been perceived by some to be applicable to all convertible instruments.

3.1.4.A Practical Illustrations of the requirements

Some common scenarios involving debt covenants are discussed in the following Illustration.

Illustration 3-1: Determining whether liabilities should be presented as current or non-current

Scenario 1

An entity has a long-term loan arrangement containing a debt covenant. The specific requirements in the debt covenant must be met as at 31 December every year. The loan is due in more than 12 months. The entity breaches the debt covenant at or before the period end. As a result, the loan becomes payable on demand.

Scenario 2

Same as scenario 1, but the loan arrangement stipulates that the entity has a grace period of 3 months after the year end to rectify the breach and during which the lender cannot demand immediate repayment.

Scenario 3

Same as scenario 1, but the lender agreed not to demand repayment as a consequence of the breach. This agreement from the lender is obtained:

(a) At or before the period end and is for a period of more than 12 months after the period end

(b) At or before the period end and is for a period of less than 12 months after the period end

(c) After the period end but before the financial statements are authorised for issue.

Scenario 4

An entity has a long-term loan arrangement containing a debt covenant. The loan is due in more than 12 months. At the period end, the debt covenants are met. However, circumstances change unexpectedly and the entity breaches the debt covenant after the period end but before the financial statements are authorised for issue.

As discussed in Chapter 50 at section 4.4.8, IFRS 7 requires the following disclosures for any loans payable recognised at the reporting date:

- Details of any defaults during the period of principal, interest, sinking fund, or redemption terms
- The carrying amount of the loans payable in default at the reporting date

  And
- Whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue

If, during the period, there were breaches of loan agreement terms other than those described above, the same information should be disclosed if those breaches permitted the lender to demand accelerated repayment (unless the breaches were remedied, or the terms of the loan were renegotiated, on or before the reporting date). *[IFRS 7.18]*. As noted in section 5.5 below, IAS 1 requires certain disclosures of refinancing and rectification of loan agreement breaches which happen after the end of the reporting period and before the accounts are authorised for issue. Other disclosures, such as those relating to non-adjusting events after the reporting period, may be relevant in particular scenarios.

The table below sets out whether debt is to be presented as current or non-current and whether the disclosures in IAS 1.76 are required. Note that additional disclosures are required for liabilities arising from loan arrangements classified as non-current, when the entity's right to defer settlement of those liabilities is subject to it complying with covenants within twelve months after the reporting period.

	Scenario 1	Scenario 2	Scenario 3(a)	Scenario 3(b)	Scenario 3(c)	Scenario 4
At the period end, does the entity have a right to defer the settlement of the liability for at least 12 months?	no	no	yes	no	no	yes
Classification of the liability	**current**	**current**	**non-current**	**current**	**current**	**non-current**
Are the above IFRS 7 disclosures required?	yes	yes	no	yes	yes	no
Are the disclosures in IAS 1.76 required?	no	no	no	no	yes	no
Are the disclosures in IAS 1.76ZA required?	yes	yes	yes	yes	yes	yes

3.1.5 Information required on the face of the statement of financial position

IAS 1 does not contain a prescriptive format or order for the statement of financial position. *[IAS 1.57]*. Rather, it contains two mechanisms which require certain information to be shown on the face of the statement. First, it contains a list of specific items for which this is required, on the basis that they are sufficiently different in nature or function to warrant separate presentation. *[IAS 1.54, IAS 1.57]*. Second, it stipulates that additional line items (including the disaggregation of those items specifically required), headings and subtotals should be presented on the face of the statement of financial position when such presentation is relevant to an understanding of the entity's financial position. *[IAS 1.55]*. The judgement as to whether additional items should be presented separately is based on an assessment of:

(a) The nature and liquidity of assets

(b) The function of assets within the entity

And

(c) The amounts, nature and timing of liabilities *[IAS 1.58]*

How we see it

Determining whether additional items need to be presented in reference to nature, liquidity and function of assets and amounts, nature and timing of liabilities is a highly judgemental decision for entities to make when preparing a statement of financial position and allows a wide variety of possible presentations.

IAS 1 indicates that the use of different measurement bases for different classes of assets suggests that their nature or function differs and, therefore, that they should be presented as separate line items. For example, different classes of property, plant and equipment can be carried at cost or revalued amounts in accordance with IAS 16 *Property, Plant and Equipment*. *[IAS 1.59]*.

The face of the statement of financial position should include line items that present the following amounts: *[IAS 1.54]*

(a) Property, plant and equipment

(b) Investment property

(c) Intangible assets

(d) Financial assets (excluding amounts shown under (f), (i) and (j))

(e) Groups of contracts within the scope of IFRS 17 *Insurance Contracts* that are assets arising from each of:

  (i) Insurance contracts

  And

  (ii) Reinsurance contracts

(f) Investments accounted for using the equity method

(g) Biological assets

(h) Inventories

(i) Trade and other receivables

(j) Cash and cash equivalents

(k) The total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with IFRS 5

(l) Trade and other payables

(m) Provisions

(n) Groups of contracts within the scope of IFRS 17 that are liabilities arising from each of:

  (i) Insurance contracts

  And

  (ii) Reinsurance contracts

(o) Financial liabilities (excluding amounts shown under (l) and (m))

(p) Liabilities and assets for current tax, as defined in IAS 12

(q) Deferred tax liabilities and deferred tax assets, as defined in IAS 12

(r) Liabilities included in disposal groups classified as held for sale in accordance with IFRS 5

(s) Non-controlling interests, presented within equity

And

(t) Issued capital and reserves attributable to owners of the parent

The standard notes that items above represent a list of items that are sufficiently different in nature or function to warrant separate presentation on the face of the statement of financial position. In addition:

(a) Line items should be included when the size, nature or function of an item or aggregation of similar items is such that separate presentation is relevant to an understanding of the entity's financial position.

And

(b) The descriptions used and the ordering of items or aggregation of similar items may be amended according to the nature of the entity and its transactions, to provide information that is relevant to an understanding of the entity's financial position. For example, a financial institution may amend the above descriptions to provide information that is relevant to the operations of a financial institution. *[IAS 1.57]*.

As noted above, when relevant to an understanding of financial position, additional line items and subtotals should be presented. Regarding subtotals, IAS 1 requires that they should:

(a) Be comprised of line items made up of amounts recognised and measured in accordance with IFRS

(b) Be presented and labelled in a manner that makes the line items that constitute the subtotal clear and understandable

(c) Be consistent from period to period (see section 4.1.4 below)

And

(d) Not be displayed with more prominence than the subtotals and totals required in IFRS accounting standards for the statement of financial position *[IAS 1.55A, IAS 1.BC38G]*

The distinction between trade and financial liabilities in certain supply chain financing arrangements is discussed in Chapter 48 at section 6.5.

3.1.6 Information required either on the face of the statement of financial position or in the notes

IAS 1 requires further sub-classifications of the line items shown on the face of the statement of financial position to be presented either on the face of the statement or in the notes. The requirements for these further sub-classifications are approached by the standard in a similar manner to those for line items on the face of the statement of financial position. There is a list of examples of items required (see below) and also a more general requirement that the sub-classifications should be made in a manner appropriate to the entity's operations. *[IAS 1.77]*. The standard notes that the detail provided in sub-classifications depends on the requirements of IFRS accounting standards (as numerous disclosures are required by other standards) and on the size, nature and function of the amounts involved. *[IAS 1.78]*.

Aside of the specific requirements, deciding what level of detailed disclosure is necessary is clearly a judgemental exercise. As is the case for items on the face of the statement of financial position, IAS 1 requires that the judgement as to whether additional items should be presented separately should be based on an assessment of:

(a) The nature and liquidity of assets

(b) The function of assets within the entity

And

(c) The amounts, nature and timing of liabilities *[IAS 1.58, IAS 1.78]*

The disclosures will also vary for each item, examples given by the standard are: *[IAS 1.78]*

Extract from IAS 1

78 The detail provided in subclassifications depends on the requirements of IFRSs and on the size, nature and function of the amounts involved. An entity also uses the factors set out in paragraph 58 to decide the basis of subclassification. The disclosures vary for each item, for example:

(a) items of property, plant and equipment are disaggregated into classes in accordance with IAS 16;

(b) receivables are disaggregated into amounts receivable from trade customers, receivables from related parties, prepayments and other amounts;

(c) inventories are disaggregated, in accordance with IAS 2 *Inventories*, into classifications such as merchandise, production supplies, materials, work in progress and finished goods;

(d) provisions are disaggregated into provisions for employee benefits and other items; and

(e) equity capital and reserves are disaggregated into various classes, such as paid-in capital, share premium and reserves.

IAS 1 specifically requires the following information regarding equity and share capital to be shown either on the face of the statement of financial position or in the notes:

(a) For each class of share capital:
  (i) The number of shares authorised
  (ii) The number of shares issued and fully paid, and issued but not fully paid
  (iii) Par value per share, or that the shares have no par value
  (iv) A reconciliation of the number of shares outstanding at the beginning and at the end of the period
  (v) The rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital
  (vi) Shares in the entity held by the entity or by its subsidiaries or associates
  And
  (vii) Shares reserved for issue under options and contracts for the sale of shares, including the terms and amounts
  And
(b) A description of the nature and purpose of each reserve within equity *[IAS 1.79]*

An entity without share capital (such as a partnership or trust) should disclose information equivalent to that required by (a) above, showing changes during the period in each category of equity interest, and the rights, preferences and restrictions attaching to each category of equity interest. *[IAS 1.80]*.

IAS 32 *Financial Instruments: Presentation* allows two specific classes of liabilities to be reported as equity. These are:

- Puttable financial instruments
  And
- Instruments that impose on the entity an obligation to deliver to another party a *pro rata* share of the net assets of the entity only on liquidation

Both terms are defined and discussed at length in IAS 32 (see Chapter 43 at section 4.6).

If an entity reclassifies one of these items between financial liabilities and equity, IAS 1 requires disclosure of:

- The amount reclassified into and out of each category (financial liabilities or equity)
  And
- The timing and reason for that reclassification *[IAS 1.80A]*

3.1.7 Illustrative statements of financial position

The implementation guidance accompanying IAS 1 provides an illustration of a statement of financial position presented to distinguish current and non-current items. It makes clear that other formats may be equally appropriate, as long as the distinction is clear. *[IAS 1.IG3]*. As discussed in Chapter 5 at section 2.2.4, IFRS 5 provides further guidance relating to the presentation of non-current assets and disposal groups held for sale. *[IAS 1.IG Part I]*.

Illustration 3-2: Illustrative statement of financial position

XYZ GROUP - STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X2

(in thousands of currency units)

	20X2	20X1
ASSETS		
Non-current assets		
Property, plant and equipment	350,700	360,020
Goodwill	80,800	91,200
Other intangible assets	227,470	227,470
Investments in associates	100,150	110,770
Investments in equity instruments	142,500	156,000
	901,620	945,460
Current assets		
Inventories	135,230	132,500
Trade receivables	91,600	110,800
Other current assets	25,650	12,540
Cash and cash equivalents	312,400	322,900
	564,880	578,740
Total assets	1,466,500	1,524,200
EQUITY AND LIABILITIES		
Equity attributable to owners of the parent		
Share capital	650,000	600,000
Retained earnings	243,500	161,700
Other components of equity	10,200	21,200
	903,700	782,900
Non-controlling interests	70,050	48,600
Total equity	973,750	831,500
Non-current liabilities		
Long-term borrowings	120,000	160,000
Deferred tax	28,800	26,040
Long-term provisions	28,850	52,240
Total non-current liabilities	177,650	238,280
Current liabilities		
Trade and other payables	115,100	187,620
Short-term borrowings	150,000	200,000
Current portion of long-term borrowings	10,000	20,000
Current tax payable	35,000	42,000
Short-term provisions	5,000	4,800
Total current liabilities	315,100	454,420
Total liabilities	492,750	692,700
Total equity and liabilities	1,466,500	1,524,200

3.2 The statement of comprehensive income and the statement of profit or loss

3.2.1 Profit and loss and comprehensive income

The IASB regards all changes in net assets (other than the introduction and return of capital) and not just more traditional realised profits, as 'performance' in its widest sense. Accordingly, IAS 1 requires a performance statement showing such changes and calls it a statement of comprehensive income.

Total comprehensive income is defined by IAS 1 as the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners. It comprises all components of 'profit or loss' and of 'other comprehensive income'. These two terms are defined as follows:

- Profit or loss is the total of income less expenses, excluding the components of other comprehensive income.

  And
- Other comprehensive income comprises items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other IFRS accounting standards. *[IAS 1.7]*.

What this means is that profit and loss is the default category - all comprehensive income is part of profit and loss unless a provision of IFRS accounting standards requires or permits it to be 'other' comprehensive income. *[IAS 1.88]*.

The use of a variety of terminology is recognised by IAS 1 which notes the following: "Although this Standard uses the terms 'other comprehensive income', 'profit or loss' and 'total comprehensive income', an entity may use other terms to describe the totals as long as the meaning is clear. For example, an entity may use the term 'net income' to describe profit or loss." *[IAS 1.8]*.

IAS 1 sets out the following items which are included in other comprehensive income: *[IAS 1.7]*

Extract from IAS 1

7 ...

The components of other comprehensive income include:

(a) changes in revaluation surplus (see IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*);

(b) remeasurements of defined benefit plans (see IAS 19 *Employee Benefits*);

(c) gains and losses arising from translating the financial statements of a foreign operation (see IAS 21 *The Effects of Changes in Foreign Exchange Rates*);

(d) gains and losses from investments in equity instruments designated at fair value through other comprehensive income in accordance with paragraph 5.7.5 of IFRS 9 *Financial Instruments*;

(da) gains and losses on financial assets measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of IFRS 9.

(e) the effective portion of gains and losses on hedging instruments in a cash flow hedge and the gains and losses on hedging instruments that hedge investments in equity instruments measured at fair value through other comprehensive income in accordance with paragraph 5.7.5 of IFRS 9 (see Chapter 6 of IFRS 9);

(f) for particular liabilities designated as at fair value through profit or loss, the amount of the change in fair value that is attributable to changes in the liability's credit risk (see paragraph 5.7.7 of IFRS 9);

(g) changes in the value of the time value of options when separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the changes in the intrinsic value (see Chapter 6 of IFRS 9);

(h) changes in the value of the forward elements of forward contracts when separating the forward element and spot element of a forward contract and designating as the hedging instrument only the changes in the spot element, and changes in the value of the foreign currency basis spread of a financial instrument when excluding it from the designation of that financial instrument as the hedging instrument (see Chapter 6 of IFRS 9);

(i) insurance finance income and expenses from contracts issued within the scope of IFRS 17 *Insurance Contracts* excluded from profit or loss when total insurance finance income or expenses is disaggregated to include in profit or loss an amount determined by a systematic allocation applying paragraph 88(b) of IFRS 17, or by an amount that eliminates accounting mismatches with the finance income or expenses arising on the underlying items, applying paragraph 89(b) of IFRS 17; and

(j) finance income and expenses from reinsurance contracts held excluded from profit or loss when total reinsurance finance income or expenses is disaggregated to include in profit or loss an amount determined by a systematic allocation applying paragraph 88(b) of IFRS 17.

...

IAS requires that all items of income and expense be presented either:

(a) In a single statement of profit or loss and other comprehensive income (with a separate section for each in the order stated)

Or

(b) In two separate statements:

(i) A statement of profit or loss

And

(ii) A statement of comprehensive income beginning with profit and loss and containing components of other comprehensive income *[IAS 1.10A]*

If the approach in (b) is followed, the statement of profit or loss must be displayed immediately before the statement of comprehensive income. *[IAS 1.10A]*. If the statement of profit or loss is presented separately, the profit or loss section should not be presented in the statement presenting comprehensive income. *[IAS 1.81A]*. In other words, the standard clarifies, perhaps unnecessarily, that there is no need to repeat the full information in the statement of profit or loss, when separate statements are presented.

In addition to this choice, IAS 1 permits different titles to be used for these statements. *[IAS 1.10]*.

Many entities continue to present a separate statement of profit or loss (often titled 'income statement'), and this section is structured in these terms. However, the requirements are the same whether total comprehensive income is presented in one or two statements.

IAS 1 adopts an essentially permissive approach to the format of the statement of profit or loss and statement of comprehensive income. It observes that, because the effects of an entity's various activities, transactions and other events differ in frequency, potential for gain or loss and predictability, disclosing the components of financial performance assists users in understanding the financial performance achieved and in making projections of future performance. *[IAS 1.86]*. In other words, some analysis of the make-up of net profit and other comprehensive income is needed, but a wide variety of presentations would all be acceptable.

IAS 1 requires certain specific items to appear on the face of the statement(s) and then supplements this with a more general requirement that:

- Additional line items be presented (including the disaggregation of those specifically required) on the face of the statement(s)

  And

- The descriptions used and the ordering of items be amended

When this is relevant to an understanding of the entity's financial performance. *[IAS 1.85, IAS 1.86]*.

The standard explains that additional line items should be included, and the descriptions used and the ordering of items amended when this is necessary to explain the elements of financial performance. Factors to be considered would include materiality and the nature and function of the items of income and expense. A financial institution, for example, may amend the descriptions to provide information relevant to the operations of a financial institution. *[IAS 1.86]*.

When additional subtotals are presented, line items should be given that reconcile those subtotals with the subtotals or totals required in IFRS accounting standards. *[IAS 1.85B]*.

When such additional subtotals are presented, they should:

(a) Be comprised of line items made up of amounts recognised and measured in accordance with IFRS accounting standards

(b) Be presented and labelled in a manner that makes the line items that constitute the subtotal clear and understandable

(c) Be consistent from period to period (see section 4.1.4 below)

And

(d) Not be displayed with more prominence than the subtotals and totals required in IFRS accounting standards for the statement(s) presenting profit or loss and other comprehensive income *[IAS 1.85A]*

3.2.2 Information required on the face of the statement of profit or loss

As is the case for the statement of financial position, IAS 1 sets out certain items which must appear on the face of the statement of profit or loss and other required disclosures which may be made either on the face or in the notes.

The face of the statement of profit or loss should include, in addition to items required by other IFRS accounting standards, line items that present the following amounts (although as noted above, the order and description of the items should be amended as necessary): *[IAS 1.82]*

(a) Revenue, presenting separately:
  (i) Interest revenue calculated using the effective interest method
    And
  (ii) Insurance revenue under IFRS 17

(b) Gains and losses from the derecognition of financial assets measured at amortised cost

(c) Insurance service expenses from contracts issued in accordance with of IFRS 17

(d) Income or expenses from reinsurance contracts held in accordance with of IFRS 17

(e) Finance costs

(f) Impairment losses (including reversals of impairment losses or impairment gains) determined under IFRS 9

(g) Insurance finance income or expenses from contracts issued in accordance with of IFRS 17

(h) Finance income or expenses from reinsurance contracts held in accordance with of IFRS 17

(i) Share of the profit or loss of associates and joint ventures accounted for using the equity method

(j) Any difference between fair value and the previous carrying amount at the date of reclassification when a financial asset is reclassified out of the amortised cost category to be measured at fair value through profit or loss

(k) Any accumulated gain or loss previously recognised in other comprehensive income that is reclassified to profit or loss when a financial asset is reclassified out of the fair value through other comprehensive income category so that it is measured at fair value through profit or loss

(l) Tax expense

(m) A single amount comprising the total of:
  (i) The post-tax profit or loss of discontinued operations
    And
  (ii) The post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation *[IFRS 5.33(a)(ii)]*

(n) Profit or loss *[IAS 1.81A]*
  And

(o) The following as allocations of profit or loss for the period:
  (i) Profit or loss attributable to non-controlling interests
    And
  (ii) Profit or loss attributable to owners of the parent *[IAS 1.81B]*

It should be noted that (with the exception of (m) above) this provision of the standard does not require a single line item for each of the above. Indeed, in some circumstances a single line item may not be possible.

As discussed in section 3.2.3 below, an analysis of expenses is required based either on their nature or their function. IAS 1 encourages, but does not require, this to be shown on the face of the statement of profit or loss. *[IAS 1.99, IAS 1.100]*. The specific items listed above essentially identify the results of transactions by their nature (that is to say, not by their function in the business). Accordingly, those entities categorising expenses by function and also following the 'encouragement' to display this on the face of the statement could be required to present one or more of the above in more than one place within the statement. This may be particularly relevant to entities choosing to differentiate between 'operating' items and other items in the statement of profit or loss (which is a quite common practice and one acknowledged by the IASB - discussed in section 3.2.2.A below) as some items in the list above may contain the results of transactions from operating and non-operating activities. By way of example, items (f) and (j) above could encompass both operating and non-operating items.

In practice judgement will be required when applying these provisions of the standard along with the more general requirements on: additional line items and subtotals, and the ordering and description of line items, discussed in section 3.2.1 above.

The implementation guidance accompanying the standard provides an illustrative example of a statement of profit or loss (see Illustration 3-4 in section 3.2.3.A below).

3.2.2.A Operating profit

The current IAS 1 has omitted the requirement in the 1997 version to disclose the results of operating activities as a line item on the face of the statement of profit or loss. The reason given for this in the Basis for Conclusions to the standard because 'Operating activities' are not defined in the standard, and the Board decided not to require disclosure of an undefined item. *[IAS 1.BC55]*.

The Basis for Conclusions for IAS 1 explains that: *[IAS 1.BC56]*

Extract from IAS 1

BC56 The Board recognises that an entity may elect to disclose the results of operating activities, or a similar line item, even though this term is not defined. In such cases, the Board notes that the entity should ensure that the amount disclosed is representative of activities that would normally be regarded as 'operating'. In the Board's view, it would be misleading and would impair the comparability of financial statements if items of an operating nature were excluded from the results of operating activities, even if that had been industry practice. For example, it would be inappropriate to exclude items clearly related to operations (such as inventory write-downs and restructuring and relocation expenses) because they occur irregularly or infrequently or are unusual in amount. Similarly, it would be inappropriate to exclude items on the grounds that they do not involve cash flows, such as depreciation and amortisation expenses.

IAS 1 requires the face of the statement of profit or loss to show the share of the profit or loss of associates and joint ventures accounted for using the equity method.

How we see it

For entities presenting a measure of operating profit, as noted in section 3.2.2 above, in our view it is acceptable for them to determine which investments accounted for using the equity method form part of its operating activities and include their results in that measure, with the results of non-operating investments excluded from it.

3.2.3 Classification of expenses recognised in profit or loss by nature or function

IAS 1 states that components of financial performance may differ in terms of frequency, potential for gain or loss and predictability, and requires that expenses should be sub-classified to highlight this. *[IAS 1.101]*. To achieve this, the standard requires the presentation of an analysis of expenses (but only those recognised in profit or loss) using a classification based on either their nature or their function within the entity, whichever provides information that is reliable and more relevant. *[IAS 1.99]*. It is because each method of presentation has merit for different types of entities, that the standard requires management to make this selection. *[IAS 1.105]*. As noted in section 3.2.2 above, IAS 1 encourages, but does not require the chosen analysis to be shown on the face of the statement of profit or loss. *[IAS 1.100]*. This means that entities are permitted to disclose the classification on the face on a mixed basis, as long as the required classification is provided in the notes. Indeed, the IASB itself produces an example of such a statement of profit or loss in an illustrative example to IAS 7. *[IAS 7.IE.A]*.

The standard also notes that the choice between the function of expense method and the nature of expense method will depend on historical and industry factors and the nature of the entity. Both methods provide an indication of those costs that might vary, directly or indirectly, with the level of sales or production of the entity. However, because information on the nature of expenses is useful in predicting future cash flows, additional disclosure is required when the function of expense classification is used (see section 3.2.3.B below). *[IAS 1.105]*.

3.2.3.A Analysis of expenses by nature

For some entities, this 'reliable and more relevant information' may be achieved by aggregating expenses for display in profit or loss according to their nature (for example, depreciation, purchases of materials, transport costs, employee benefits and advertising costs), and not reallocating them among various functions within the entity. IAS 1 observes that this method may be simple to apply because no allocations of expenses to functional classifications are necessary. The standard illustrates a classification using the nature of expense method as follows: *[IAS 1.102]*

Illustration 3-3: Example of classification of expenses by nature

Revenue		x
Other income		x
Changes in inventories of finished goods and work in progress	x	
Raw materials and consumables used	x	
Employee benefits expense	x	
Depreciation and amortisation expense	x	
Other expenses	x	
Total expenses		(x)
Profit before tax		x

The implementation guidance accompanying the standard provides a further example of a statement of profit or loss analysing expenses by nature. Whilst very similar to the above, it is expanded to show further captions as follows: *[IAS 1.IG Part I]*

Illustration 3-4: Illustrative statement of profit or loss with expenses classified by nature

XYZ Group - Statement of profit or loss for the year ended 31 December 20X2

(in thousands of currency units)

	20X2	20X1
Revenue	390,000	355,000
Other income	20,667	11,300
Changes in inventories of finished goods and work in progress	(115,100)	(107,900)
Work performed by the entity and capitalised	16,000	15,000
Raw material and consumables used	(96,000)	(92,000)
Employee benefits expense	(45,000)	(43,000)
Depreciation and amortisation expense	(19,000)	(17,000)
Impairment of property, plant and equipment	(4,000)	-
Other expenses	(6,000)	(5,500)
Finance costs	(15,000)	(18,000)
Share of profit of associates	35,100	30,100
Profit before tax	161,667	128,000
Income tax expense	(40,417)	(32,000)
Profit for the year from continuing operations	121,250	96,000
Loss for the year from discontinued operations	-	(30,500)
Profit for the year	121,250	65,500
Profit attributable to:		
Owners of the parent	97,000	52,400
Non-controlling interests	24,250	13,100
	121,250	65,500
Earnings per share (currency unit)		
Basic and diluted	0.46	0.30

A footnote to the illustrative examples explains that 'share of profits of associates' means share of the profit attributable to the owners of the associates and hence is after tax and non-controlling interests in the associates.

Illustration 3-4 above is an example of presenting comprehensive income in two statements. Illustration 3-6 in section 3.2.4.A below illustrates the presentation of comprehensive income in a single statement. An entity using the approach above would need to give a second statement presenting items of other comprehensive income - this would simply be the bottom portion of Illustration 3-6 in section 3.2.4.A below, starting with 'Profit for the year' and omitting earnings per share and the analysis of profit between owners and non-controlling interests. This is illustrated in Illustration 3-8 in section 3.2.4.C below.

3.2.3.B Analysis of expenses by function

For some entities, 'reliable and more relevant information' may be achieved by aggregating expenses for display purposes according to their function for example, as part of cost of sales, the costs of distribution or administrative activities. Under this method, IAS 1 requires as a minimum, disclosure of cost of sales separately from other expenses. The standard observes that this method can provide more relevant information to users than the classification of expenses by nature, but that allocating costs to functions may require arbitrary allocations and involve considerable judgement. An example of classification using the function of expense method given by the standard is set out below. *[IAS 1.103]*.

Illustration 3-5: Example of classification of expenses by function

Revenue	x
Cost of sales	(x)
Gross profit	x
Other income	x
Distribution costs	(x)
Administrative expenses	(x)
Other expenses	(x)
Profit before tax	x

Entities classifying expenses by function are required by IAS 1 to disclose additional information on the nature of expenses. The standard highlights that this requirement also applies to depreciation and amortisation expense and employee benefits expense, *[IAS 1.104]*, which seems redundant considering that the disclosure of these items (broken down into their components) is specifically required by IAS 16, IAS 19 and IAS 38 *Intangible Assets*.

The standard gives another illustration of expenses classified by function in the profit and loss section of the single statement of comprehensive income - see Illustration 3-6 in section 3.2.4.A below.

3.2.4 The statement of comprehensive income

3.2.4.A The face of the statement of comprehensive income

Whether presented as a separate statement or as a section of a combined statement (see section 3.2.1 above), the face of the statement of comprehensive income should set out the items below. The items in (b) and, separately, the items in (c) should be presented in two groups, one including items which may subsequently be reclassified into profit or loss and another including items which will not: *[IAS 1.7, IAS 1.81A, IAS 1.82A, IAS 1.91]*

(a) Profit or loss (if two statements are presented this will be a single line item)

(b) Each item of comprehensive income, classified by nature, which include:

  (i) Changes in revaluation surplus relating to property, plant and equipment and intangible assets

  (ii) Remeasurements on defined benefit plans in accordance with IAS 19

  (iii) Gains and losses arising from translating the financial statements of a foreign operation

  (iv) Gains and losses from investments in equity instruments designated at fair value through other comprehensive income

  (v) Gains and losses on financial assets measured at fair value through other comprehensive income

  (vi) The effective portion of gains and losses on hedging instruments in a cash flow hedge and the gains and losses on hedging instruments that hedge investments in equity instruments measured at fair value through other comprehensive income

  (vii) For particular liabilities designated as at fair value through profit and loss, fair value changes attributable to changes in the liability's credit risk

  (viii) Changes in the value of the time value of options when separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the changes in the intrinsic value

  (ix) Changes in the value of the forward elements of forward contracts when separating the forward element and spot element of a forward contract and designating as the hedging instrument only the changes in the spot element, and changes in the value of the foreign currency basis spread of a financial instrument when excluding it from the designation of that financial instrument as the hedging instrument. These, together with the changes in the time value of options in (viii) above, are commonly referred to as the 'costs of hedging' (see Chapter 49 at section 7.5).

  (x) Insurance finance income and expenses related to insurance or reinsurance contracts which is excluded from profit or loss in certain circumstances in accordance with IFRS 17

  (xi) The aggregate amount of tax relating to components of comprehensive income, unless the components are shown individually net of tax (see section 3.2.4.C below). Tax should be allocated between the two groups mentioned above

(c) Share of the items of other comprehensive income of associates and joint ventures accounted for using the equity method

(d) Reclassification adjustments, unless the components of comprehensive income are shown after any related reclassification adjustments (see section 3.2.4.B below) *[IAS 1.94]*

  And

(e) Total comprehensive income

In a separate statement of other comprehensive income IAS 1 also requires an analysis of total comprehensive income for the period between that attributable to:

(a) Non-controlling interests,

  And

(b) Owners of the parent *[IAS 1.81B]*

In a combined statement of total comprehensive income, the equivalent analysis of profit and loss would also be required as would earnings per share disclosures (discussed in Chapter 33 at section 7). When two separate statements are presented, these would appear on the statement of profit or loss. *[IAS 33.67A]*.

IAS 1 provides an illustration of both the 'one statement' and 'two statement' approach in its implementation guidance. An illustration of a single statement of comprehensive income is given in Illustration 3-6 below. *[IAS 1.IG Part I]*. An illustration of a separate statement of profit or loss is given in Illustration 3-4 in section 3.2.3.A above and an illustrative separate statement of other comprehensive income is given in Illustration 3-8 in section 3.2.4.C below.

Illustration 3-6: Presentation of comprehensive income in one statement and the classification of expenses by function

XYZ Group - Statement of profit or loss and other comprehensive income for the year ended 31 December 20X2

(in thousands of currency units)

	20X2	20X1
Revenue	390,000	355,000
Cost of sales	(245,000)	(230,000)
Gross profit	145,000	125,000
Other income	20,667	11,300
Distribution costs	(9,000)	(8,700)
Administrative expenses	(20,000)	(21,000)
Other expenses	(2,100)	(1,200)
Finance costs	(8,000)	(7,500)
Share of profit of associates[1]	35,100	30,100
Profit before tax	161,667	128,000
Income tax expense	(40,417)	(32,000)
Profit for the year from continuing operations	121,250	96,000
Loss for the year from discontinued operations	-	(30,500)
PROFIT FOR THE YEAR	121,250	65,500
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	933	3,367
Investments in equity instruments	(24,000)	26,667
Remeasurements of defined benefit pension plans	(667)	1,333
Share of other comprehensive income of associates[2]	400	(700)
Income tax relating to items that will not be reclassified[3]	5,834	(7,667)
	(17,500)	23,000
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations[4]	5,334	10,667
Cash flow hedges[4]	(667)	(4,000)
Income tax relating to items that may be reclassified[3]	(1,167)	(1,667)
	3,500	5,000
Other comprehensive income for the year, net of tax	(14,000)	28,000
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	107,250	93,500
Profit attributable to:		
Owners of the parent	97,000	52,400
Non-controlling interests	24,250	13,100
	121,250	65,500
Total comprehensive income attributable to:		
Owners of the parent	85,800	74,800
Non-controlling interests	21,450	18,700
	107,250	93,500
Earnings per share (in currency units):		
Basic and diluted	0.46	0.30

Alternatively, items of other comprehensive income could be presented in the statement of profit or loss and other comprehensive income net of tax.

	20X2	20X1
Other comprehensive income for the year, after tax:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	600	2,700
Investments in equity instruments	(18,000)	20,000
Remeasurements of defined benefit pension plans	(500)	1,000
Share of other comprehensive income of associates	400	(700)
	(17,500)	23,000
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations	4,000	8,000
Cash flow hedges	(500)	(3,000)
	3,500	5,000
Other comprehensive income for the year, net of tax(3)	(14,000)	28,000

(1) This means the share of associates' profit attributable to owners of the associates, i.e., it is after tax and non-controlling interests in the associates.
(2) This means the share of associates' other comprehensive income attributable to owners of the associates, i.e., it is after tax and non-controlling interests in the associates. In this example, the other comprehensive income of associates consists only of items that will not be subsequently reclassified to profit or loss. Entities whose associates' other comprehensive income includes items that may be subsequently reclassified to profit or loss are required to present that amount in a separate line.
(3) The income tax relating to each item of other comprehensive income is disclosed in the notes.
(4) This illustrates the aggregated presentation, with disclosure of the current year gain or loss and reclassification adjustment presented in the notes. Alternatively, a gross presentation can be used.

The illustrative examples in the standard all use the option, which is discussed in section 3.2.4.B below, to present components of other comprehensive income net of related reclassification adjustments. The disclosure of those reclassification adjustments in a note is reproduced in Illustration 3-7 below.

3.2.4.B Reclassification adjustments

'Reclassification adjustments' are items recognised in profit or loss which were previously recognised in other comprehensive income (commonly referred to as 'recycling') and IAS 1 requires their disclosure. *[IAS 1.7, IAS 1.92, IAS 1.93, IAS 1.95]*. Examples include adjustments arising in relation to the disposal of a foreign operation and hedged forecast transactions affecting profit or loss.

The standard allows a choice of how reclassification adjustments are presented. They may either be presented 'gross' on the face of the statement, or alternatively shown in the notes. In the latter case, components of comprehensive income on the face of the statement are shown net of any related reclassification adjustments. *[IAS 1.94]*.

IAS 1 illustrates this requirement as follows: *[IAS 1.IG Part I]*

Illustration 3-7: Note disclosure of components of other comprehensive income

XYZ GROUP

Disclosure of components of other comprehensive income(1)

Notes - Year ended 31 December 20X2

(in thousands of currency units)

		20X2		20X1
Other comprehensive income				
Exchange differences on translating foreign operations(2)		5,334		10,667
Investments in equity instruments		(24,000)		26,667
Cash flow hedges:				
Gains (losses) arising during the year	(4,667)		(4,000)	
Less:				
Reclassification adjustments for gains (losses) included in profit or loss	4,000		-	
		(667)		(4,000)
Gains on property revaluation		933		3,367
Remeasurements of defined benefit pension plans		(667)		1,333
Share of other comprehensive income of associates		400		(700)
Other comprehensive income		(18,667)		37,334
Income tax relating to components of other comprehensive income(3)		4,667		(9,334)
Other comprehensive income for the year		**(14,000)**		**28,000**

(1) When an entity chooses an aggregated presentation in the statement of comprehensive income, the amounts for reclassification adjustments and current year gain or loss are presented in the notes.
(2) There was no disposal of a foreign operation. Therefore, there is no reclassification adjustment for the years presented.
(3) The income tax relating to each component of other comprehensive income is disclosed in the notes.

Some IFRS accounting standards require that gains and losses recognised in other comprehensive income cannot be 'recycled' to profit and loss, and hence will not give rise to reclassification adjustments. IAS 1 gives the following examples:

(a) Revaluation surpluses for revalued property, plant and equipment, and intangible assets

(b) Remeasurements on defined benefit plans

And

(c) Amounts that are removed from the cash flow hedge reserve or a separate component of equity and included directly in the initial cost or other carrying amount of an asset or a liability in accordance with IFRS 9 in respect of a cash flow hedge or the accounting for the time value of an option (or the forward element of a forward contract or the foreign currency basis spread of a financial instrument). These amounts are directly transferred to assets or liabilities.

The standard observes that whilst items in (a) are not reclassified to profit or loss they may be transferred to retained earnings as the assets concerned are used or derecognised. *[IAS 1.96]*. This is illustrated in Illustration 3-9 below.

3.2.4.C Tax on items of other comprehensive income

IAS 1 requires disclosure of the amount of income tax relating to each item of other comprehensive income, including reclassification adjustments, either on the face of the statement or in the notes. *[IAS 1.90]*. This may be done by presenting the items of other comprehensive income either:

(a) Net of related tax effects

Or

(b) Before related tax effects with one amount shown for the aggregate amount of income tax relating to those items

If the alternative at (b) is selected, the tax should be allocated between the items that might be reclassified subsequently to profit and loss and those that will not. *[IAS 1.91]*.

The reference to reclassification adjustments here and in the definition of other comprehensive income (see section 3.2.1 above) seems to suggest that such adjustments are themselves 'components' of other comprehensive income. That would mean that the standard requires disclosure of tax related to reclassification adjustments. The implementation guidance, however, suggests this is not required because the note to Illustration 3-8 below, showing the presentation in (b) above, allocates tax only to items of comprehensive income themselves net of related reclassification adjustments.

IAS 1 provides an illustration of both approaches in its implementation guidance.

The statement of comprehensive income and related note analysing tax are illustrated in Illustration 3-8 below (the related separate statement of profit or loss is shown in Illustration 3-4 in section 3.2.3.A above). *[IAS 1.IG Part I]*.

Illustration 3-8: Statement of comprehensive income illustrating the presentation of comprehensive income in two statements with note disclosure of the tax effects relating to components of other comprehensive income

XYZ Group - Statement of profit or loss and other comprehensive income for the year ended 31 December 20X2

(in thousands of currency units)	20X2	20X1
Profit for the year	121,250	65,500
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	933	3,367
Remeasurements of defined benefit pension plans	(667)	1,333
Share of other comprehensive income of associates(1)	400	(700)
Income tax relating to items that will not be reclassified(2)	(166)	(1,000)
	500	3,000
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations	5,334	10,667
Investments in equity instruments	(24,000)	26,667
Cash flow hedges	(667)	(4,000)
Income tax relating to items that may be reclassified(2)	4,833	(8,334)
	(14,500)	25,000
Other comprehensive income for the year, net of tax	(14,000)	28,000
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	107,250	93,500
Total comprehensive income attributable to:		
Owners of the parent	85,800	74,800
Non-controlling interests	21,450	18,700
	107,250	93,500

Disclosure of tax effects relating to each component of other comprehensive income

Notes	20X2			20X1		
	Before-tax amount	Tax (expense) benefit	Net-of-tax amount	Before-tax amount	Tax (expense) benefit	Net-of-tax amount
Exchange differences on translating foreign operations	5,334	(1,334)	4,000	10,667	(2,667)	8,000
Investments in equity instruments	(24,000)	6,000	(18,000)	26,667	(6,667)	20,000
Cash flow hedges	(667)	167	(500)	(4,000)	1,000	(3,000)
Gains on property revaluation	933	(333)	600	3,367	(667)	2,700
Remeasurements of defined benefit pension plans	(667)	167	(500)	1,333	(333)	1,000
Share of other comprehensive income of associates	400	-	400	(700)	-	(700)
Other comprehensive income	(18,667)	4,667	(14,000)	37,334	(9,334)	28,000

(1) This means the share of associates' other comprehensive income attributable to owners of the associates, i.e., it is after tax and non-controlling interests in the associates. In this example, the other comprehensive income of associates consists only of items that will not be subsequently reclassified to profit or loss. Entities whose associates' other comprehensive income includes items that may be subsequently reclassified to profit or loss are required to present that amount in a separate line.

(2) The income tax relating to each item of other comprehensive income is disclosed in the notes.

3.2.5 Discontinued operations

As discussed in Chapter 5 at section 3.2, IFRS 5 requires the presentation of a single amount on the face of the statement of profit or loss relating to discontinued operations, with further analysis either on the face of the statement or in the notes.

3.2.6 Material and 'extraordinary' items

3.2.6.A Material items

IAS 1 requires that when items of income or expense (a term covering both profit and loss, and other comprehensive income) are material, their nature and amount should be disclosed separately. *[IAS 1.97]*. Materiality is discussed in section 4.1.5 below. The standard goes on to suggest: *[IAS 1.98]*

Extract from IAS 1

98 Circumstances that would give rise to the separate disclosure of items of income and expense include:

(a) write-downs of inventories to net realisable value or of property, plant and equipment to recoverable amount, as well as reversals of such write-downs;

(b) restructurings of the activities of an entity and reversals of any provisions for the costs of restructuring;

(c) disposals of items of property, plant and equipment;

(d) disposals of investments;

(e) discontinued operations;

(f) litigation settlements; and

(g) other reversals of provisions.

This information may be given on the face of the statement of profit or loss, on the face of the statement of comprehensive income or in the notes. In line with the permissive approach taken to the format of the performance statements discussed above, the level of prominence given to such items is left to the judgement of the entity concerned. However, regarding (e) above, IFRS 5 requires certain information to be presented on the face of the statement of profit or loss (see Chapter 5 at section 3.2).

3.2.6.B Ordinary activities and 'extraordinary' items

IAS 1 states that: *[IAS 1.87]*

Extract from IAS 1	
87	**An entity shall not present any items of income or expense as extraordinary items, in the statement(s) presenting profit or loss and other comprehensive income or in the notes.**

This derives from the fact that earlier versions of the standard required a distinction to be made between ordinary activities (and the results of them) and extraordinary items. *[IAS 1.87]*.

The Basis for Conclusions for IAS 1 explains that the removal of this distinction, and the prohibition on the presentation of extraordinary items, was made to avoid arbitrary segregation of an entity's performance. *[IAS 1.BC64]*.

3.3 The statement of changes in equity

IAS 1 requires the presentation of a statement of changes in equity showing: *[IAS 1.106]*

(a) Total comprehensive income for the period (comprising profit and loss and other comprehensive income - see section 3.2.1 above) showing separately the total amounts attributable to owner of the parent and to non-controlling interests

(b) For each component of equity, the effects of retrospective application or retrospective restatement recognised in accordance with IAS 8 (discussed in sections 4.4 and 4.6 below)

And

(c) For each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing changes resulting from:

(i) Profit or loss

(ii) Other comprehensive income

And

(iii) Transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control

The reconciliation in (c)(ii) above must show each item of other comprehensive income, although that detail may be shown in the notes. *[IAS 1.106A]*.

The amounts of dividends shown as distributions to owners and the amounts of dividends per share should be shown either on the face of the statement or in the notes. *[IAS 1.107]*.

It can be seen that (a) above is effectively a sub-total of all the items required by (c)(i) and (c)(ii).

For these purposes, 'components' of equity include each class of contributed equity, the accumulated balance of each class of other comprehensive income and retained earnings. *[IAS 1.108]*.

This analysis reflects the focus of the IASB on the statement of financial position - whereby any changes in net assets (aside of those arising from transactions with owners) are gains and losses, regarded as performance. In this vein, IAS 1 observes that changes in an entity's equity between two reporting dates reflect the increase or decrease in its net assets during the period. Except for changes resulting from transactions with owners acting in their capacity as owners (such as equity contributions, reacquisitions of the entity's own equity instruments and dividends) and transaction costs directly related to such transactions, the overall change in equity during a period represents the total amount of income and expenses, including gains and losses, generated by the entity's activities during that period. *[IAS 1.109]*. After taking account of total gains and losses and owner transactions in this way, any other changes in equity will result from the restatement of prior periods. Point (b) above reflects this.

IAS 8 requires retrospective adjustments to effect changes in accounting policies, to the extent practicable, except when the transitional provisions in another IFRS accounting standard require otherwise. IAS 8 also requires that restatements to correct errors are made retrospectively, to the extent practicable. These are discussed in section 4 below. IAS 1 observes that retrospective adjustments and retrospective restatements "are not changes in equity but they are adjustments to the opening balance of retained earnings, except when an IFRS accounting standard requires retrospective adjustment of another component of equity." Point (b) above therefore requires disclosure in the statement of changes in equity of the total adjustment to each component of equity resulting, separately, from changes in accounting policies and from corrections of errors. These adjustments should be disclosed for each prior period and the beginning of the period. *[IAS 1.110]*.

The illustrative statement from the implementation guidance accompanying IAS 1 is set out in Illustration 3-9 below and is a continuation of Illustration 3-8 in section 3.2.4.C above. *[IAS 1.IG Part I]*.

Illustration 3-9: Statement of changes in equity

XYZ Group – Statement of changes in equity for the year ended 31 December 20X2

(in thousands of currency units)

	Share capital	Retained earnings	Translation of foreign operations	Investments in equity instruments	Cash flow hedge	Re-valuation surplus	Total	Non-controlling interest	Total equity
Balance at 1 January 20X1	600,000	118,100	(4,000)	1,600	2,000	-	717,700	29,800	747,500
Changes in accounting policy	-	400	-	-	-	-	400	100	500
Restated balance	600,000	118,500	(4,000)	1,600	2,000	-	718,100	29,900	748,000
Changes in equity for 20X1									
Dividends	-	(10,000)	-	-	-	-	(10,000)	-	(10,000)
Total comprehensive income for the year[1]	-	53,200	6,400	16,000	(2,400)	1,600	74,800	18,700	93,500
Balance at 31 December 20X1	600,000	161,700	2,400	17,600	(400)	1,600	782,900	48,600	831,500
Changes in equity for 20X2	Share capital	Retained earnings	Translation of foreign operations	Investments in equity instruments	Cash flow hedge	Re-valuation surplus	Total	Non-controlling interest	Total equity
Issue of share capital	50,000	-	-	-	-	-	50,000	-	50,000
Dividends	-	(15,000)	-	-	-	-	(15,000)	-	(15,000)
Total comprehensive income for the year[2]	-	96,600	3,200	(14,400)	(400)	800	85,800	21,450	107,250
Transfer to retained earnings	-	200	-	-	-	(200)	-	-	-
Balance at 31 December 20X2	650,000	243,500	5,600	3,200	(800)	2,200	903,700	70,050	973,750

(1) The amount included in retained earnings for 20X1 of 53,200 represents profit attributable to owners of the parent of 52,400 plus remeasurements of defined benefit pension plans of 800 (1,333, less tax 333, less non-controlling interest 200).
The amount included in the translation, investments in equity instruments and cash flow hedge reserves represent other comprehensive income for each component, net of tax and non-controlling interest, e.g., other comprehensive income related to investments in equity instruments for 20X2 of 16,000 is 26,667, less tax 6,667, less non-controlling interest 4,000.
The amount included in the revaluation surplus of 1,600 represents the share of other comprehensive income of associates of (700) plus gains on property revaluation of 2,300 (3,367, less tax 667, less non-controlling interest 400). Other comprehensive income of associates relates solely to gains or losses on property revaluation.

(2) The amount included in retained earnings of 20X2 of 96,600 represents profit attributable to owners of the parent of 97,000 less remeasurements of defined benefit pension plans of 400 (667, less tax 167, less non-controlling interest 100).
The amount included in the translation, investments in equity instruments and cash flow hedge reserves represent other comprehensive income for each component, net of tax and non-controlling interest, e.g., other comprehensive income related to the translation of foreign operations for 20X2 of 3,200 is 5,334, less tax 1,334, less non-controlling interest 800.
The amount included in the revaluation surplus of 800 represents the share of other comprehensive income of associates of 400 plus gains on property revaluation of 400 (933, less tax 333, less non-controlling interest 200). Other comprehensive income of associates relates solely to gains or losses on property revaluation.

3.3.1 Transfers between components of equity

IFRS accounting standards give no definition of retained earnings and provides limited guidance on how to distinguish components of equity in the statement of changes in equity and on how to reflect legal transfers between components in that statement.

In some instances, a company takes steps to effect a transfer of contributed equity, such as share premium, to another component of equity, such as retained earnings/accumulated losses. Provided that it has taken all necessary steps permitted or required under the relevant legal framework, it is permissible to reflect in the statement of changes in equity a reduction of the share premium component and a corresponding increase/reduction of the retained earnings/accumulated losses component. It may also be acceptable to reflect the transfer in a separate component. In either case, explanatory disclosures clarifying the policy choice must be considered.

How we see it

In the absence of a definition of retained earnings in IFRS accounting standards and given that there is no prohibition on transfers between reserves and retained earnings in IFRS, unless this is prohibited by local law or regulations, we consider that such a transfer is permitted. However, we acknowledge that in certain jurisdictions, such a transfer may be considered inappropriate and we believe that entities must have regard to the regulatory perspective in all relevant jurisdictions in which they operate, when developing an accounting policy under IAS 8.

3.4 The notes to the financial statements

IAS 1 requires the presentation of notes to the financial statements that:

(a) Present information about the basis of preparation of the financial statements and the specific accounting policies used (see section 5.1 below)

(b) Disclose the information required by IFRS accounting standards that is not presented elsewhere in the financial statements

And

(c) Provide additional information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them *[IAS 1.112]*

The notes should, as far as practicable, be presented in a systematic manner, determined in consideration of its effect on the understandability and comparability of the financial statements. Each item on the face of the primary statements should be cross-referenced to any related information in the notes. *[IAS 1.113]*.

How we see it

There is, perhaps, a trade-off to be made between understandability and comparability, in that allowing entities to structure their notes to, for instance, reflect their business model or perceived importance may reduce the comparability between one entity and another.

The standard does not prescribe a specific order, but in the Basis for Conclusions the consistency dimension of comparability is highlighted, and it is clarified that the ordering of the notes generally is not expected to be changed frequently. *[IAS 1.BC76D]*.

Examples given in the standard of the systematic ordering or grouping of the notes are as follows:

(a) Giving prominence to the areas of its activities that the entity considers to be most relevant to an understanding of its financial performance and financial position, such as grouping together information about particular operating activities

(b) Grouping together information about items measured similarly such as assets measured at fair value

Or

(c) Following the order of the line items in the statement(s) of profit or loss and other comprehensive income and the statement of financial position, such as:

  (i) A statement of compliance with IFRS accounting standards (see section 2.5.2 above)

  (ii) Material accounting policy information (see section 5.1.1 below)

  (iii) Supporting information for items presented on the face of the primary statements, in the order in which each statement and each line item is presented

  And

  (iv) Other disclosures, including: contingent liabilities, unrecognised contractual commitments and non-financial disclosures such as financial risk management objectives and policies *[IAS 1.114]*

The standard also permits notes providing information about the basis of preparation of the financial statements and specific accounting policies being presented as a separate section of the financial statements. *[IAS 1.116]*.

4 Accounting policies

The selection and application of accounting policies is crucial for the preparation of financial statements. As a general premise, the whole purpose of accounting standards is to specify required accounting policies, presentation and disclosure. However, judgement will always remain; many standards may allow choices to accommodate different views, and no body of accounting literature could hope to prescribe precise treatments for all possible situations.

In the broadest sense, accounting policies are discussed by both IAS 1 and IAS 8. Whilst, as its title suggests, IAS 8 deals explicitly with accounting policies, IAS 1 deals with what one can describe as overarching or general principles.

4.1 General principles

IAS 1 deals with some general principles relating to accounting policies, with IAS 8 discussing the detail of selection and application of individual accounting policies and their disclosure.

The general principles discussed by IAS 1 can be described as follows:

- Fair presentation and compliance with accounting standards
- Going concern
- The accrual basis of accounting
- Consistency
- Materiality and aggregation
- Offsetting

  And
- Profit or loss for the period

These are discussed in sections 4.1.1 to 4.1.7 below.

4.1.1 Fair presentation

4.1.1.A Fair presentation and compliance with IFRS accounting standards

Consistent with its objective and statement of the purpose of financial statements, IAS 1 requires that financial statements present fairly the financial position, financial performance and cash flows of an entity. Fair presentation for these purposes requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the *Conceptual Framework* (discussed in Chapter 2).

The main premise of the standard is that application of IFRS accounting standards, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation. *[IAS 1.15]*.

It is worth noting that IAS 1 specifies that circumstances may require additional disclosures (that is, over and above those specified in IFRS accounting standards). *[IAS 1.15, IAS 1.31]*. There is no general concept that disclosures, where material, could be avoided on the grounds of them being seriously prejudicial to the reporting entity.

As noted in section 1.1 above, an important point is that implementation guidance for standards issued by the IASB does not form part of those standards (unless they are explicitly 'scoped-in'), and therefore does not contain requirements for financial statements. *[IAS 8.9]*. In contrast, any application guidance appended to a standard forms an integral part of that standard.

Accordingly, the often voluminous implementation guidance accompanying standards is not, strictly speaking, part of IFRS accounting standards. However, we would generally expect entities to follow such guidance. The presumption that application of IFRS accounting standards (with any necessary additional disclosure) results in a fair presentation is potentially rebuttable, as discussed in section 4.1.1.B below.

A fair presentation also requires an entity to:

(a) Select and apply accounting policies in accordance with IAS 8, which also sets out a hierarchy of authoritative guidance that should be considered in the absence of an IFRS accounting standard that specifically applies to an item (see section 4.3 below)

(b) Present information, including material accounting policy information, in a manner that provides relevant, reliable, comparable and understandable information

And

(c) Provide additional disclosures when compliance with the specific requirements in IFRS accounting standards is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance *[IAS 1.17]*

However, the standard makes clear that inappropriate accounting policies are not rectified either by disclosure of those accounting policies or by notes or explanatory material. *[IAS 1.18]*. As discussed in section 4.1.1.B below, it is possible that an extremely rare circumstance arises where departure from a provision of IFRS accounting standards is needed to achieve fair presentation. This is only allowed by IAS 1, if permitted by the relevant regulatory framework.

4.1.1.B The fair presentation override

The presumption that the application of IFRS accounting standards, with additional disclosure when necessary, results in financial statements that achieve a fair presentation is a rebuttable one, although the standard makes clear that in virtually all situations a fair presentation is achieved through compliance.

The standard observes that an item of information would conflict with the objective of financial statements when it does not represent faithfully the transactions, other events and conditions that it either purports to represent or could reasonably be expected to represent and, consequently, it would be likely to influence economic decisions made by users of financial statements. When assessing whether complying with a specific requirement in an IFRS accounting standard would be so misleading that it would conflict with the objective of financial statements, IAS 1 requires consideration of:

(a) Why the objective of financial statements is not achieved in the particular circumstances

And

(b) How the entity's circumstances differ from those of other entities that comply with the requirement. If other entities in similar circumstances comply with the requirement, there is a rebuttable presumption that the entity's compliance with the requirement would not be so misleading that it would conflict with the objective of financial statements. *[IAS 1.24]*.

In the extremely rare circumstances in which management concludes that compliance with a requirement in an IFRS accounting standard would be so misleading that it would conflict with the objective of financial statements, IAS 1 requires departure from that requirement. However, this is only permitted if the "relevant regulatory framework requires, or otherwise does not prohibit, such a departure", which is discussed further below. *[IAS 1.19]*.

When the relevant regulatory framework allows a departure, an entity should make it and also disclose:

(a) That management has concluded that the financial statements present fairly the entity's financial position, financial performance and cash flows

(b) That it has complied with applicable IFRS accounting standards, except that it has departed from a particular requirement to achieve a fair presentation

(c) The title of the IFRS accounting standard from which the entity has departed, the nature of the departure, including:

  (i) The treatment that the IFRS accounting standard would require

  (ii) The reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the *Conceptual Framework*

  And

  (iii) The treatment adopted

(d) For each period presented, the financial impact of the departure on each item in the financial statements that would have been reported in complying with the requirement

And

(e) When there has been a departure from a requirement of an IFRS accounting standard in a prior period, and that departure affects the amounts recognised in the financial statements for the current period, the disclosures set out in (c) and (d) above *[IAS 1.20, IAS 1.21]*

Regarding (e) above, the standard explains that the requirement could apply, for example, when an entity departed in a prior period from a requirement in an IFRS accounting standard for the measurement of assets or liabilities and that departure affects the measurement of changes in assets and liabilities recognised in the current period's financial statements. *[IAS 1.22]*.

When the relevant regulatory framework does not allow a departure from IFRS accounting standards, IAS 1 accepts that, notwithstanding the failure to achieve fair presentation, that it should not be made. Although intended to occur only in extremely rare circumstances, this is a very important provision of the standard as it allows a 'relevant regulatory framework' to override the requirement of IFRS accounting standards to achieve a fair presentation. In that light, it is perhaps surprising that there is no definition or discussion in the standard of what a relevant regulatory framework is.

When a departure otherwise required by IAS 1 is not allowed by the relevant regulatory framework, the standard requires that the perceived misleading aspects of compliance are reduced, to the maximum extent possible, by the disclosure of:

(a) The title of the IFRS accounting standard in question, the nature of the requirement, and the reason why management has concluded that complying with that requirement is so misleading in the circumstances that it conflicts with the objective of financial statements set out in the *Conceptual Framework*

And

(b) For each period presented, the adjustments to each item in the financial statements that management has concluded would be necessary to achieve a fair presentation *[IAS 1.23]*

How we see it

In our view, it will be extremely rare that a departure from a requirement is required to achieve a fair presentation and equally rare that in such a circumstance the departure is not permitted by the relevant regulatory framework. As such, the compromise outlined above, although limited in its effectiveness, is unlikely to be frequently used.

4.1.2 Going concern

4.1.2.A Assessment of going concern

When preparing financial statements, IAS 1 requires management to make an assessment of an entity's ability to continue as a going concern. This term is not defined, but its meaning is implicit in the requirement of the standard that financial statements should be prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. The standard requires that when management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, those uncertainties should be disclosed. Beyond requiring disclosure of the uncertainties, the standard does not specify more precisely what information should be disclosed. The IFRS IC recommended, in January 2013, that the IASB make a narrow-scope amendment to IAS 1 that would address when these disclosures should be made and what information should be disclosed. Although the IASB acknowledged that more prescriptive requirements would lead to useful information for investors and creditors, it also had the expectation that such requirements may result in 'boilerplate' disclosures that would obscure relevant disclosures about going concern and thus would contribute to disclosure overload. It also observed that this is a topic that is better handled through local regulation or audit guidance.[2]

In January 2021, the IFRS Foundation (as distinct from the Board) released a document, prepared for educational purposes, highlighting the requirements in IFRS accounting standards that are relevant to an entity's assessment of its ability to continue as a going concern and the respective disclosures.[3] The document does not change, remove, or add to, the requirements in IFRS accounting standards. Rather the intention is to remind preparers of the IFRS accounting standards requirements for going concern assessments and the disclosure of material uncertainties and significant judgements.

2 *IFRIC Update*, January 2013, available on the IFRS Foundation's website.

3 Going concern-a focus on disclosure, IASB, January 2021. Available on the IFRS Foundation's website.

How we see it

Although the educational document does not introduce any new requirements, it may help preparers to apply the existing requirements in IFRS accounting standards. More specifically, in light of the economic uncertainty caused by recent geopolitical developments, the educational document represents a helpful reminder about challenging assessments that management may need to make and key disclosures that may apply to many entities under the current circumstances.

In assessing whether the going concern assumption is appropriate, the standard requires that all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period should be taken into account. The degree of consideration required will depend on the facts in each case. When an entity has a history of profitable operations and ready access to financial resources, a conclusion that the going concern basis of accounting is appropriate may be reached without detailed analysis. In other cases, management may need to consider a wide range of factors relating to current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate. *[IAS 1.26]*.

4.1.2.B Basis other than going concern

IAS 1 requires that if an entity is not a going concern, the financial statements must be prepared on a basis other going concern, but does not specify what that alternate basis may be. *[IAS 1.25].* As a result of this lack of guidance in IFRS accounting standards as to what might constitute an alternate basis of accounting, informal practices have developed in different jurisdictions. A common method is to prepare accounts under a 'liquidation' or 'break-up' basis; however, as these are not defined terms in IFRS accounting standards, there is not necessarily a common understanding of what such a basis may entail.

The objective of a using a basis other than going concern is primarily to assist users of those financial statements to assess the amount of cash or other assets that might reasonably be available for distribution once liquidation is complete. Significant judgement will be required to determine appropriate accounting policies under a basis other than going concern, based on individual facts and circumstances. IFRS accounting standards are written from the perspective that an entity is a going concern. Thus, in the case of a non-going concern entity, the recognition and measurement requirements of IFRS accounting standards must be assessed to determine whether they provide relevant information that faithfully represents the non-going concern circumstances. If they do so, accounts prepared on that basis could be compliant with IFRS accounting standards; if they do not, an entity may apply accounting policies other than those applicable to entities that are going concerns and may apply the hierarchy in IAS 8 to consider the most recent pronouncements of other standard setters who use a similar conceptual framework, other accounting literature and accepted industry practices, subject to any applicable jurisdictional requirements. *[IAS 8.12]*. Financial statements prepared on the latter basis could also be compliant with IFRS accounting standards.

When financial statements are not prepared on a going concern basis, that fact should be disclosed, together with the basis on which the financial statements are prepared and the reason why the entity is not regarded as a going concern. *[IAS 1.25]*. Disclosures relevant to an understanding of non-going concern basis financial statements should be included; in particular, any recognition, measurement and presentation policies developed specifically for a non-going concern basis must be disclosed and the relevance of them must be explained. *[IAS 1.17(c)].*

In an agenda decision of June 2021, the IFRS IC confirmed that if an entity is no longer a going concern, but has not yet issued financial statements for previous periods in which it was a going concern, that entity cannot prepare its financial statements on a going concern basis, including for those prior periods that have not yet been authorised for issue.[4] A second question asked if an entity should restate comparative information to reflect the basis of accounting used in preparing the current period's financial statements, if it had previously issued financial statements for the comparative period on a going concern basis. The IFRS IC noted no diversity in the application of IFRS accounting standards in respect of this question and therefore considered that there was no evidence that this matter had widespread effect.

How we see it

A change from a going concern to a non-going concern basis is a change in circumstances in which the financial statements are prepared and thus, the new basis is applied prospectively.

4 *IFRIC Update*, June 2021, available on the IFRS Foundation's website.

4.1.3 The accrual basis of accounting

IAS 1 requires that financial statements be prepared, except for cash flow information, using the accrual basis of accounting. *[IAS 1.27]*. No definition of this is given by the standard, but an explanation is presented that: "When the accrual basis of accounting is used, items are recognised as assets, liabilities, equity, income and expenses (the elements of financial statements) when they satisfy the definitions and recognition criteria for those elements in the *Conceptual Framework*." *[IAS 1.28]*.

The *Conceptual Framework* explains the accruals basis as follows: *[CF 1.17]*

Extract from the Conceptual Framework for Financial Reporting

1.17 Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period. This is important because information about a reporting entity's economic resources and claims and changes in its economic resources and claims during a period provides a better basis for assessing the entity's past and future performance than information solely about cash receipts and payments during that period.

The requirements of the *Conceptual Framework* are discussed in more detail in Chapter 2.

4.1.4 Consistency

As noted in sections 1.1 and 1.2 above, one of the objectives of both IAS 1 and IAS 8 is to ensure the comparability of financial statements with those of previous periods. To this end, each standard addresses the principle of consistency.

IAS 1 requires that the 'presentation and classification' of items in the financial statements be retained from one period to the next unless:

(a) It is apparent, following a significant change in the nature of the entity's operations or a review of its financial statements, that another presentation or classification would be more appropriate having regard to the criteria for the selection and application of accounting policies in IAS 8 (see section 4.3 below)

Or

(b) An IFRS accounting standard requires a change in presentation *[IAS 1.45]*

The standard amplifies this by explaining that a significant acquisition or disposal, or a review of the presentation of the financial statements, might suggest that the financial statements need to be presented differently. An entity should change the presentation of its financial statements only if the changed presentation provides information that is reliable and is more relevant to users of the financial statements and the revised structure is likely to continue, so that comparability is not impaired. When making such changes in presentation, an entity will need to reclassify its comparative information as discussed in section 2.4 above. *[IAS 1.46]*.

IAS 8 addresses consistency of accounting policies and observes that users of financial statements need to be able to compare the financial statements of an entity over time to identify trends in its financial position, financial performance and cash flows. For this reason, the same accounting policies need to be applied within each period and from one period to the next unless a change in accounting policy meets certain criteria (changes in accounting policy are discussed in section 4.4 below). *[IAS 8.15]*. Accordingly, the standard requires that accounting policies be selected and applied consistently for similar transactions, other events and conditions, unless an IFRS accounting standard specifically requires or permits categorisation of items for which different policies may be appropriate. If an IFRS accounting standard requires or permits such categorisation, an appropriate accounting policy should be selected and applied consistently to each category. *[IAS 8.13]*.

4.1.5 Materiality and aggregation

Financial statements result from processing large numbers of transactions or other events that are aggregated into classes according to their nature or function. The final stage in the process of aggregation and classification is the presentation of condensed and classified data, which form line items in the financial statements, or in the notes. *[IAS 1.30]*. The extent of aggregation versus detailed analysis is clearly a matter of judgement, with either extreme eroding the usefulness of the information.

IAS 1 resolves this issue with the concept of materiality, by requiring:

- Each material class of similar items to be presented separately in the financial statements

  And

- Items of a dissimilar nature or function to be presented separately unless they are immaterial *[IAS 1.29]*

The standard also states when applying IAS 1 and other IFRS accounting standards an entity should decide, taking into consideration all relevant facts and circumstances, how it aggregates information in the financial statements, which include the notes. In particular, the understandability of financial statements should not be reduced by obscuring material information with immaterial information or by aggregating material items that have different natures or functions. *[IAS 1.30A]*.

Materiality is defined in IAS 1 and IAS 8 (by cross reference to IAS 1) as follows: *[IAS 1.7, IAS 8.5]*

"Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity."

The terms 'primary users' and 'users' are intended to be synonyms and are used interchangeably in IAS 1. *[IAS 1.BC13Q]*.

The standard goes on to observe that materiality depends on the nature or magnitude of information, or both. An entity assesses whether information, either individually or in combination with other information, is material in the context of its financial statements taken as a whole.

Information is considered to be obscured if it is communicated in a way that would have a similar effect for primary users of financial statements to omitting or misstating that information. The following are given as examples of circumstances that may result in material information being obscured: *[IAS 1.7]*

(a) Information regarding a material item, transaction or other event is disclosed in the financial statements but the language used is vague or unclear
(b) Information regarding a material item, transaction or other event is scattered throughout the financial statements
(c) Dissimilar items, transactions or other events are inappropriately aggregated
(d) Similar items, transactions or other events are inappropriately disaggregated

  And

(e) The understandability of the financial statements is reduced as a result of material information being hidden by immaterial information to the extent that a primary user is unable to determine what information is material

At a general level, applying the concept of materiality means that a specific disclosure required by an IFRS accounting standard to be given in the financial statements (including the notes) need not be provided if the information resulting from that disclosure is not material. This is the case even if the IFRS accounting standard contains a list of specific requirements or describes them as minimum requirements. On the other hand, the provision of additional disclosures should be considered when compliance with the specific requirements in IFRS accounting standards is insufficient to enable users of financial statements to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance. *[IAS 1.31]*.

IAS 1 goes on to observe that assessing whether information could reasonably be expected to influence economic decisions made by the primary users of a specific reporting entity's general purpose financial statements requires an entity to consider the characteristics of those users along with its own circumstances. For these purposes primary users of general purpose financial statements:

- Are existing and potential investors, lenders and other creditors that cannot require reporting entities to provide information directly to them and must rely on general purpose financial statements for much of the financial information they need

  And

- Have a reasonable knowledge of business and economic activities and review and analyse the information diligently

It is noted in the standard, though, that at times even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena. *[IAS 1.7]*.

Regarding the presentation of financial statements, IAS 1 requires that if a line item is not individually material, it should be aggregated with other items either on the face of those statements or in the notes. The standard also states that an item that is not sufficiently material to warrant separate presentation on the face of those statements may nevertheless be sufficiently material for it to be presented separately in the notes. *[IAS 1.30]*.

4.1.6 Offset

IAS 1 considers it important that assets and liabilities, and income and expenses, are reported separately. This is because offsetting in the statement of profit or loss or statement of comprehensive income or the statement of financial position, except when offsetting reflects the substance of the transaction or other event, detracts from the ability of users both to understand the transactions, other events and conditions that have occurred and to assess the entity's future cash flows. It clarifies, though, that measuring assets net of valuation allowances - for example, obsolescence allowances on inventories and doubtful debts allowances on receivables - is not offsetting. *[IAS 1.33]*.

Accordingly, IAS 1 requires that assets and liabilities, and income and expenses, should not be offset unless required or permitted by an IFRS accounting standard. *[IAS 1.32]*.

Just what constitutes offsetting, particularly given the rider noted above of 'reflecting the substance of the transaction', is not always obvious. IAS 1 expands on its meaning as follows. It notes that:

(a) IFRS 15 defines revenue from contracts with customers and requires it to be measured at the amount of consideration to which the entity expects to be entitled in exchange for transferring promised goods or services, taking into account the amount of any trade discounts and volume rebates allowed by the entity - in other words a notional 'gross' revenue and a discount should not be shown separately. Revenue from contracts with customers is discussed in Chapter 28.

(b) Entities can undertake, in the course of their ordinary activities, other transactions that do not generate revenue but are incidental to the main revenue-generating activities. The results of such transactions should be presented, when this presentation reflects the substance of the transaction or other event, by netting any income with related expenses arising on the same transaction. For example:

    (i) Gains and losses on the disposal of non-current assets, including investments and operating assets, should be reported by deducting from the proceeds on disposal the carrying amount of the asset and related selling expenses.

    And

    (ii) Expenditure related to a provision that is recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and reimbursed under a contractual arrangement with a third party (for example, a supplier's warranty agreement) may be netted against the related reimbursement. *[IAS 1.34]*.

    And

(c) Gains and losses arising from a group of similar transactions should be reported on a net basis, for example, foreign exchange gains and losses or gains and losses arising on financial instruments held for trading. However, such gains and losses should be reported separately if they are material. *[IAS 1.35]*.

4.1.7 Profit or loss for the period

The final provision of IAS 1 which we term a general principle is a very important one. It is that, unless an IFRS accounting standard requires or permits otherwise, all items of income and expense recognised in a period should be included in profit or loss. *[IAS 1.88]*. This is the case whether one combined statement of comprehensive income is presented or whether a separate statement of profit or loss is presented (discussed in section 3.2.1 above).

Income and expense are not defined by the standard, but they are defined by the *Conceptual Framework* as follows:

(a) Income is increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.

    And

(b) Expenses are decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims. *[CF 4.68, CF 4.49]*.

These definitions clearly suggest that the terms do not have what many would consider their natural meaning, as they encompass all gains and losses (for example, capital appreciation in a non-current asset like property). There is a somewhat awkward compromise with various gains and losses either required or permitted to bypass profit or loss and be reported instead in 'other comprehensive income'. Importantly, as discussed in section 3.2.1 above, profit and loss, and other comprehensive income may each be reported as a separate statement.

IAS 1 notes that some IFRS accounting standards specify circumstances when an entity recognises particular items outside profit or loss, including the effect of changes in accounting policies and error corrections (discussed in sections 4.4 and 4.6 below). *[IAS 1.89]*. Other IFRS accounting standards deal with items that may meet the *Conceptual Framework's* definitions of income or expense but are usually excluded from profit or loss. Examples given by IAS 1 are shown in section 3.2.4.A above.

4.1.8 Practice Statement 2 - Making Materiality Judgements

In September 2017 the IASB published Practice Statement 2 - *Making Materiality Judgements* (Statement 2). This is a non-mandatory statement and does not form part of IFRS accounting standards; its application is not, therefore, required to state compliance with IFRS accounting standards. *[PS 2.2]*.

Notwithstanding the above, preparers of financial statements may wish to consider the practice statement and an overview of it is given below.

Statement 2 addresses three main areas:

- The general characteristics of materiality
- A four-step process that may be applied in making materiality judgements when preparing financial statements (the 'materiality process')

  And
- Guidance on how to make materiality judgements in relation to the following:
  - Disclosure of information about accounting policies
  - Prior period information
  - Errors
  - Information about covenants

    And
  - Interim reporting

There is also a discussion of the interaction between the materiality and local laws and regulations. Local laws and regulations may specify additional requirements that can affect the information included in the financial statements. IFRS accounting standards permit the disclosure of such additional information in order to meet local legal or regulatory requirements, although not material from an IFRS accounting standard perspective, as long as it does not obscure information that is material (see section 4.1.5 above). *[PS 2.28, IAS 1.30A, IAS 1.BC13L, IAS 1.BC30F]*.

4.1.8.A General characteristics of materiality

The Practice Statement explores materiality by considering the following characteristics:

- *Definition of material*

  The objective of financial statements is to provide financial information about the reporting entity that is useful to primary users. An entity identifies the information necessary to meet the objective by making appropriate materiality judgements. The definition of material is discussed in section 4.1.5 above. *[PS 2.5, PS 2.6, PS 2.7]*.
- *Materiality judgements are pervasive*

  Materiality judgements are pervasive to the preparation of financial statements. Entities make materiality judgements in decisions about recognition and measurement as well as presentation and disclosure. Requirements in IFRS accounting standards only need to be applied if their effect is material to the complete set of financial statements. However, it is inappropriate to make, or leave uncorrected, immaterial departures from IFRS accounting standards to achieve a particular presentation. The Practice Statement reiterates that, as discussed in section 4.1.5 above, an entity does not need to provide a disclosure specified by IFRS accounting standards if the information resulting from that disclosure is not material, even if IFRS accounting standards contain a list of specific disclosure requirements or describes them as minimum requirements. *[PS 2.8, PS 2.9, PS 2.10]*.
- *Judgement*

  Materiality judgements require consideration of both the entity's circumstances (and how they have changed compared to prior periods) and how the information responds to the information needs of its primary users. *[PS 2.11, PS 2.12]*.

- *Primary users and their information needs*

  When making materiality judgements, an entity needs to take into account how information could reasonably be expected to influence the primary users of its financial statements and what decisions they make on the basis of the financial statements. Primary users are existing and potential investors, existing and potential lenders and existing and potential other creditors. They are expected to have a reasonable knowledge of business and economic activities and to review and analyse the information included in the financial statements diligently. Since financial statements cannot provide all the information that primary users need, entities aim to meet the common information needs of their primary users and not, therefore, needs that are unique to particular users or to niche groups. *[PS 2.13-23]*.

- *Impact of publicly-available information*

  Financial statements must be capable of standing alone. Therefore, entities make the materiality assessment regardless of whether information is publicly available from another source. *[PS 2.24, PS 2.25, PS 2.26]*.

4.1.8.B Making materiality judgements

The Practice Statement sets out a four-step process to help preparers making materiality judgements. This process describes how an entity may assess whether information is material for the purposes of recognition, measurement, presentation and disclosure.

The materiality process considers potential omissions and misstatements as well as unnecessary inclusion of immaterial information. In all cases, an entity focuses on how the information could reasonably be expected to influence the decisions of users of financial statements. *[PS 2.29-32]*.

The steps are as follows:

- *Step 1 - Identify*

  Identify information about transactions, other events and conditions that has the potential to be material considering the requirements of IFRS accounting standards and the entity's knowledge of its primary users' common information needs. *[PS 2.35-39]*.

- *Step 2 - Assess*

  Determine whether the information identified in Step 1 is material considering quantitative (size of the impact of the information against measures of the financial statements) and qualitative (characteristics of the information making it more likely to influence decisions of the primary users) factors in the context of the financial statements as a whole. *[PS 2.40-55]*.

- *Step 3 - Organise*

  Organise material information within the draft financial statements in a way that communicates the information clearly and concisely (for example, by emphasising material matters, tailoring information to the entity's own circumstances, highlighting relationships between different pieces of information). *[PS 2.56-59]*.

- *Step 4 - Review*

  Review the draft financial statements to determine whether all material information has been identified and consider the information provided from a wider perspective and in aggregate, on the basis of the complete set of financial statements. *[PS 2.60-65]*.

4.1.8.C Specific topics

The Practice Statement provides guidance on how to make materiality judgements in the following specific circumstances:

- *Prior period information*

  Entities are required to provide prior period information if it is relevant to understand the current period financial statements, regardless of whether it was included in the prior period financial statements (discussed in section 2.4 above). This might lead an entity to include prior period information that was not previously provided (if necessary to understand the current period financial statements) or to summarise prior period information, retaining only the information necessary to understand the current period financial statements. *[PS 2.66-71]*.

- *Errors*

  An entity assesses the materiality of an error (omissions or misstatements or both) on an individual and collective basis and corrects all material errors, as well as any immaterial financial reporting errors made intentionally to achieve a particular presentation of its financial statements (discussed in section 4.6 below). When assessing whether cumulative errors (that is, errors that have accumulated over several periods) have become material an entity considers whether its circumstances have changed or further accumulation of a current period error has occurred. Cumulative errors must be corrected if they have become material to the current-period financial statements. *[PS 2.72-80]*.

- *Loan covenants*

  When assessing whether information about a covenant in a loan agreement is material, an entity considers the impact of a potential covenant breach on the financial statements and the likelihood of the covenant breach occurring. *[PS 2.81, PS 2.82, PS 2.83]*.

- *Materiality judgements for interim reporting*

  An entity considers the same materiality factors for the interim report as in its annual assessment. However, it takes into consideration that the time period and the purpose of interim financial statements (that is, to provide an update on the latest complete set of annual financial statements) differ from those of the annual financial statements. Interim financial statements are discussed in Chapter 37. *[PS 2.84-88]*.

- *Information about accounting policies* In assessing whether accounting policy information is material to its financial statements, an entity considers whether users of the entity's financial statements would need that information to understand other material information in the financial statements. An entity makes this assessment in the same way it assesses other information: by considering qualitative and quantitative factors (step 2 in section 4.1.8.B above). *[PS 2.88A-88G]*.

4.2 The definition of, and distinction between, accounting policies and accounting estimates

IAS 8 defines accounting policies as: "the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements." *[IAS 8.5]*.

An accounting policy may require items in financial statements to be measured in a way that involves measurement uncertainty; that is, the accounting policy may require such items to be measured at monetary amounts that cannot be observed directly and must instead be estimated. In such a case, an entity is required to develop an accounting estimate to achieve the objective set out by the accounting policy. Developing accounting estimates involves the use of judgements or assumptions based on the latest available, reliable information. *[IAS 8.32]*.

The standard defines an accounting estimate as follows: *[IAS 8.5]*

Extract from IAS 8	
5	**The following terms are used in this Standard with the meanings specified:** **...** ***Accounting estimates*** **are monetary amounts in financial statements that are subject to measurement uncertainty.** **...**

IAS 8 clarifies that the term 'estimate' in IFRS accounting standards sometimes refers to an estimate that is not an accounting estimate as defined by IAS 8. For example, it sometimes refers to an input used in developing accounting estimates. *[IAS 8.32B]*. Two examples illustrating the application of the definition of accounting estimates are reproduced as Illustrations 4-1 and 4-2 in section 4.5 below.

IAS 8 uses the phrase 'measurement techniques and inputs' which it states are used to develop an accounting estimate. Measurement techniques include estimation techniques (for example, techniques used to measure a loss allowance for expected credit losses applying IFRS 9) and valuation techniques (for example, techniques used to measure the fair value of an asset or liability applying IFRS 13 *Fair Value Measurement*). *[IAS 8.32A]*.

The standard also notes that corrections of errors should be distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need changing as additional information becomes known. For example, the gain or loss recognised on the outcome of a contingency is not the correction of an error. *[IAS 8.48]*.

The distinction between an accounting policy and an accounting estimate is particularly important because a very different treatment is required when there are changes in accounting policies or accounting estimates (discussed in sections 4.4 and 4.5 below). When it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, IAS 8 requires the change to be treated as a change in an accounting estimate. *[IAS 8.35]*.

How we see it

The 2021 amendments introduce greater clarity as to the definition of accounting estimates, particularly in terms of the differentiation between accounting estimates and accounting policies. We believe they represent helpful guidance for entities in determining whether changes are to be treated as changes in estimates, changes in policies, or errors.

4.3 The selection and application of accounting policies

Entities complying with IFRS accounting standards (which is a defined term, discussed in section 1.1 above) do not have a free hand in selecting accounting policies; indeed the very purpose of a body of accounting literature is to confine such choices.

IFRS accounting standards set out accounting policies that the IASB has concluded result in financial statements containing relevant and reliable information about the transactions, other events and conditions to which they apply. *[IAS 8.8]*.

To this end, the starting point in IAS 8 is that when an IFRS accounting standard specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item should be determined by applying the IFRS accounting standard and considering any relevant implementation guidance issued by the IASB for the IFRS accounting standard. *[IAS 8.7]*. This draws out the distinction that IFRS accounting standards must be applied whereas implementation guidance (which, as discussed in section 1.1 above, does not form part of IFRS accounting standards) must be considered. As noted earlier, though, we would generally expect entities to follow such guidance.

Those policies need not be applied when the effect of applying them is immaterial. However, it is inappropriate to make, or leave uncorrected, immaterial departures from IFRS accounting standards to achieve a particular presentation of an entity's financial position, financial performance or cash flows (see section 4.6 below). *[IAS 8.8]*. The concept of materiality is discussed in section 4.1.5 above.

There will be circumstances where a particular event, transaction or other condition is not specifically addressed by IFRS accounting standards. When this is the case, IAS 8 sets out a hierarchy of guidance to be considered in the selection of an accounting policy.

The primary requirement of the standard is that management should use its judgement in developing and applying an accounting policy that results in information that is relevant and reliable. These concepts are further explained in the extract below: *[IAS 8.10]*.

Extract from IAS 8

10 In the absence of an IFRS that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is:

(a) relevant to the economic decision-making needs of users; and

(b) reliable, in that the financial statements:

(i) represent faithfully the financial position, financial performance and cash flows of the entity;

(ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;

(iii) are neutral, ie free from bias;

(iv) are prudent; and

(v) are complete in all material respects.

Prudence and neutrality are not defined or otherwise discussed by IAS 8. They are, however, discussed in the IASB's *Conceptual Framework* as follows (see Chapter 2 for a discussion of the *Conceptual Framework* and specifically Chapter 2 at section 5.1.2 for a discussion regarding faithful representation).

A neutral depiction is one without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users. That is not to imply that neutral information has no purpose or no influence on behaviour. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions. *[CF 2.15]*.

The *Conceptual Framework* has a discussion of the word 'prudence', the exercise of which is considered by the Board to support neutrality. The IASB considers prudence to be the exercise of caution when making judgements under conditions of uncertainty. This is said to mean that:

- Assets and income are not overstated and liabilities and expenses are not understated

  But also that

- The exercise of prudence does not allow for the understatement of assets or income or the overstatement of liabilities or expenses. Such misstatements can lead to the overstatement or understatement of income or expenses in future periods. *[CF 2.16]*.

The standard gives guidance regarding the primary requirement for exercising judgement in developing and applying an accounting policy. This guidance is divided into two categories - certain things which management is required to consider, and others which it 'may' consider, as follows.

In making its judgement, management *shall* refer to, and consider the applicability of, the following sources in descending order:

(a) The requirements and guidance in IFRS accounting standards dealing with similar and related issues

And

(b) The definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the *Conceptual Framework* *[IAS 8.11]*

In making this judgement, management *may* also consider:

- The most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards
- Other accounting literature

  And
- Accepted industry practices, to the extent that these do not conflict with the sources in (a) and (b) above *[IAS 8.12]*

How we see it

If an entity considers pronouncements of other standard-setting bodies in making its judgement in developing and applying an accounting policy, it must consider all the contents of the pronouncements that are relevant to the issue. In other words, it cannot adopt a selective or 'cherry-picking' approach.

In an agenda decision of March 2011, the IFRS IC noted the following: "The Committee observed that when management develops an accounting policy through analogy to an IFRS dealing with similar and related matters, it needs to use its judgement in applying all aspects of the IFRS that are applicable to the particular issue." The IFRS IC concluded that the issue of developing accounting policies by analogy requires no further clarification, so did not add the matter to its agenda.

4.4 Changes in accounting policies

4.4.1 Basic principles

As discussed in section 4.1.4 above, consistency of accounting policies and presentation is a basic principle in both IAS 1 and IAS 8. Accordingly, IAS 8 only permits a change in accounting policies if the change:

(a) Is required by an IFRS accounting standard

Or

(b) Results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows *[IAS 8.14]*

IAS 8 addresses changes of accounting policy arising from three sources:

(a) The initial application (including early application) of an IFRS accounting standard containing specific transitional provisions

(b) The initial application of an IFRS accounting standard which does not contain specific transitional provisions

And

(c) Voluntary changes in accounting policy

Policy changes under (a) should be accounted for in accordance with the specific transitional provisions of that IFRS accounting standard.

A change of accounting policy under (b) or (c) should be applied retrospectively, that is applied to transactions, other events and conditions as if it had always been applied. *[IAS 8.5, IAS 8.19, IAS 8.20]*. The standard explains that retrospective application requires adjustment of the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented, as if the new accounting policy had always been applied. *[IAS 8.22]*. The standard observes that the amount of the resulting adjustment relating to periods before those presented in the financial statements (which is made to the opening balance of each affected component of equity of the earliest prior period presented) will usually be made to retained earnings. However, it goes on to note that the adjustment may be made to another component of equity (for example, to comply with an IFRS accounting standard). IAS 8 also makes clear that any other information about prior periods, such as historical summaries of financial data, should be also adjusted. *[IAS 8.26]*.

In its March 2019 meeting, the IFRS IC acknowledged that circumstances exist where an entity might determine that it needs to change an accounting policy as a result of an agenda decision issued by the IFRS IC. Articles 8.5 and 8.6 of the *Due Process Handbook* were subsequently updated in August 2020; they acknowledge that explanatory material may provide additional insights that may change an entity's understanding of the principles and requirements of the standards. They explain that as explanatory material derives its authority from the standards themselves, an entity is required to reflect the explanatory material in an agenda decision, as it is thereby applying the standard itself. It follows from the above that as the authority for an agenda decision is derived from the standards themselves, any resulting change in accounting policy falls to be required by an IFRS accounting standard, rather than being a voluntary change. *[IAS 8.14]*.

The discussion also addressed the timing of such a change in accounting policy, stating the following: "The Board expects that an entity would be entitled to sufficient time to make that determination and implement any change (for example, an entity may need to obtain new information or adapt its systems to implement a change)."[5] The appropriate time period for implementation may vary from entity to entity. The *Due Process Handbook* explains this as follows: "Determining how much time is sufficient to make an accounting policy change is a matter of judgement that depends on an entity's particular facts and circumstances."[6]

Frequently it will be straightforward to apply a change in accounting policy retrospectively. However, the standard accepts that sometimes it may be impractical to do so. Accordingly, retrospective application of a change in accounting policy is not required to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the change. *[IAS 8.23]*. This is discussed further in section 4.7 below. As noted in section 4.3 above, in the absence of a specifically applicable IFRS accounting standard an entity may apply an accounting policy from the most recent pronouncements of another standard-setting body that use a similar conceptual framework. The standard makes clear that a change in accounting policy reflecting a change in such a pronouncement is a voluntary change in accounting policy which should be accounted for and disclosed as such. *[IAS 8.21]*. The standard also clarifies that a change in measurement basis is a change in an accounting policy, and not a change in an accounting estimate. However, when it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the standard requires it to be treated as a change in an accounting estimate, as discussed in section 4.5 below. *[IAS 8.35]*.

The standard explains that the following are not changes in accounting policy:

- The application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring

  And

- The application of a new accounting policy for transactions, other events or conditions that did not occur previously or were immaterial *[IAS 8.16]*

4.4.2 The revaluation exception

As an exception to the principle, the standard requires that a change to a policy of revaluing intangible assets or property plant and equipment, in accordance with IAS 38 and IAS 16 respectively, is not to be accounted for under IAS 8 as a change in accounting policy. Rather, such a change should be dealt with as a revaluation in accordance with the relevant standards (discussed in Chapters 18 at section 8.2 and Chapter 19 at section 6). *[IAS 8.17, IAS 8.18]*. What this means is that it is not permissible to restate prior periods for the carrying value and depreciation charge of the assets concerned.

4.5 Changes in accounting estimates

The making of estimates is a fundamental feature of financial reporting. An accounting policy may require items to be measured in a way that involves measurement uncertainty; in other words, it may require items to be measured at monetary amounts that cannot directly be observed and must instead be estimated. If this is the case, the entity must develop an accounting estimate which achieves the objective set out in the accounting policy. Developing estimates involves the use of judgements or assumptions based on the latest available, reliable information. *[IAS 8.32]*. IAS 8 notes that the use of reasonable estimates is an essential part of the preparation of financial statements and it does not undermine their reliability. *[IAS 8.33]*. Examples of estimates given by the standard are:

- Loss allowances for expected credit losses
- The net realisable value of inventory
- The fair value of assets or liabilities
- The depreciation expense for property, plant and machinery

  And

- Provisions for warranty obligations *[IAS 8.32]*

There are many other examples, some of the more subjective relating to share-based payments and post-retirement benefits.

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5 *IFRIC Update*, March 2019, available on the IFRS Foundation's website.

6 IFRS Foundation *Due Process Handbook*, August 2020, para. 8.6.

The standard observes that measurement techniques and inputs used to develop an accounting estimate encompass both estimation techniques (for example, techniques used to measure a loss allowance) and valuation techniques (for example, techniques used to measure the fair value of an asset or liability). *[IAS 8.32A]*. It also notes that the term 'estimate' is used elsewhere in IFRS accounting standards to refer to an input used in developing an accounting estimate, rather than referring to the accounting estimate itself. *[IAS 8.32B]*.

Accounting estimates may need to change if changes occur in the circumstances on which they are based or as a result of new information, new developments or more experience. The standard observes that, by its nature, a change in an accounting estimate does not relate to prior periods and is not the correction of an error. *[IAS 8.34]*. Furthermore, the effects on an accounting estimate of a change in an input or a change in a measurement technique are changes in accounting estimates unless they result from the correction of prior period errors. *[IAS 8.34A]*.

IAS 8 requires that changes in estimate be accounted for prospectively; defined as recognising the effect of the change in the accounting estimate in the current and future periods affected by the change. *[IAS 8.5, IAS 8.36]*. The standard goes on to explain that this will mean (as appropriate):

- Adjusting the carrying amount of an asset, liability or item of equity in the statement of financial position in the period of change

  And

- Recognising the change by including it in profit and loss in:
  - The period of change, if it affects that period only (for example, a change in a loss allowance for expected credit losses)

    Or

  - The period of change and future periods, if it affects both (for example, a change in estimated useful life of a depreciable asset or the expected pattern of consumption of the economic benefits embodied in it) *[IAS 8.36, IAS 8.37, IAS 8.38]*

The implementation guidance to IAS 8 presents two examples illustrating the application of the definition of accounting estimates; these are reproduced as Illustrations 4-1 and 4-2 below.

Illustration 4-1: Applying the definition of accounting estimates - Fair value of an investment property

Fact pattern

Entity A owns an investment property that it accounts for by applying the fair value model in IAS 40 *Investment Property*. Since it acquired the investment property, Entity A has been measuring the investment property's fair value using a valuation technique consistent with the income approach described in IFRS 13.

However, because of changes in market conditions since the previous reporting period, Entity A changes the valuation technique it uses to a valuation technique consistent with the market approach described in IFRS 13. Entity A has concluded that the resulting measurement is more representative of the investment property's fair value in the circumstances existing at the end of the current reporting period and, therefore, that IFRS 13 permits such a change. Entity A has also concluded that the change in the valuation technique is not a correction of a prior period error.

Applying the definition of accounting estimates

The fair value of the investment property is an accounting estimate because:

(a) The fair value of the investment property is a monetary amount in the financial statements that is subject to measurement uncertainty. Fair value reflects the price that would be received or paid in a hypothetical sale or purchase transaction between market participants- accordingly, it cannot be observed directly and must instead be estimated.

(b) The fair value of the investment property is an output of a measurement technique (a valuation technique) used in applying the accounting policy (fair value model).

(c) In developing its estimate of the fair value of the investment property, Entity A uses judgements and assumptions, for example, in:

- Selecting the measurement technique - selecting the valuation technique that is appropriate in the circumstances

  And

- Applying the measurement technique - developing the inputs that market participants would use in applying the valuation technique, such as information generated by market transactions involving comparable assets

In this fact pattern, the change in the valuation technique is a change in the measurement technique applied to estimate the fair value of the investment property. The effect of this change is a change in an accounting estimate because the accounting policy - to measure the investment property at fair value - has not changed.

Illustration 4-2: Applying the definition of accounting estimates - Fair value of a cash-settled share-based payment liability

Fact pattern

On 1 January 20X2, Entity A grants 100 share appreciation rights (SARs) to each of its employees, provided the employee remains in the entity's employment for the next three years. The SARs entitle the employees to a future cash payment based on the increase in the entity's share price over the three-year vesting period starting on 1 January 20X2.

Applying IFRS 2 *Share-based Payment*, Entity A accounts for the grant of the SARs as cash-settled share-based payment transactions - in doing so it recognises a liability for the SARs and measures that liability at its fair value (as defined by IFRS 2). Entity A applies the Black-Scholes-Merton formula (an option pricing model) to measure the fair value of the liability for the SARs at 1 January 20X2 and at the end of the reporting period.

At 31 December 20X3, because of changes in market conditions since the end of the previous reporting period, Entity A changes its estimate of the expected volatility of the share price - an input to the option pricing model - in estimating the fair value of the liability for the SARs at that date. Entity A has concluded that the change in that input is not a correction of a prior period error.

Applying the definition of accounting estimates

The fair value of the liability is an accounting estimate because:

(a) The fair value of the liability is a monetary amount in the financial statements that is subject to measurement uncertainty. That fair value is the amount for which the liability could be settled in a hypothetical transaction - accordingly, it cannot be observed directly and must instead be estimated.

(b) The fair value of the liability is an output of a measurement technique (option pricing model) used in applying the accounting policy (measuring a liability for a cash-settled share-based payment at fair value).

(c) To estimate the fair value of the liability, Entity A uses judgements and assumptions, for example, in:

- Selecting the measurement technique-selecting the option pricing model

  And

- Applying the measurement technique-developing the inputs that market participants would use in applying that option pricing model, such as the expected volatility of the share price and dividends expected on the shares

In this fact pattern, the change in the expected volatility of the share price is a change in an input used to measure the fair value of the liability for the SARs at 31 December 20X3. The effect of this change is a change in accounting estimate because the accounting policy-to measure the liability at fair value - has not changed.

4.6 Correction of errors

As with all things, financial reporting is not immune to error and sometimes financial statements can be published which, whether by accident or design, contain errors. IAS 8 defines prior period errors as omissions from, and misstatements in, an entity's financial statements for one or more prior periods (including the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud) arising from a failure to use, or misuse of, reliable information that:

(a) Was available when financial statements for those periods were authorised for issue

And

(b) Could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements *[IAS 8.5]*

Errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. IAS 8 states that financial statements do not comply with IFRS accounting standards if they contain errors that are:

(a) Material

Or

(b) Immaterial but are made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows *[IAS 8.41]*

The concept in (b) is a little curious. As discussed in section 4.1.5 above, an error is material if it could influence the economic decisions of users taken on the basis of the financial statements. It would be rare to find a scenario where an entity would deliberately seek to misstate its financial statements to achieve a particular presentation of its financial position, performance or cash flows but only in such a way that did not influence the decisions of users. IAS 8 notes that potential current period errors detected before the financial statements are authorised for issue should be corrected in those financial statements. This requirement is phrased so as to apply to all potential errors, not just material ones. *[IAS 8.41]*. The standard notes that corrections of errors are distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need revision as additional information becomes known. For example, the gain or loss recognised on the outcome of a contingency is not the correction of an error. *[IAS 8.48]*.

When it is discovered that material prior period errors have occurred, IAS 8 requires that they be corrected in the first set of financial statements prepared after their discovery. *[IAS 8.42]*. The correction should be excluded from profit or loss for the period in which the error is discovered. Rather, any information presented about prior periods (including any historical summaries of financial data) should be restated as far back as practicable. *[IAS 8.46]*. This should be done by:

(a) Restating the comparative amounts for the prior period(s) presented in which the error occurred

Or

(b) If the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented *[IAS 8.42]*

This process is described by the standard as retrospective restatement, which it also defines as correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred. *[IAS 8.5]*.

The implementation guidance accompanying the standard provides an example of the retrospective restatement of errors as follows: *[IAS 8.IG1]*

Illustration 4-3: Retrospective restatement of errors

During 20X2, Beta Co discovered that some products that had been sold during 20X1 were incorrectly included in inventory at 31 December 20X1 at CU6,500.

Beta's accounting records for 20X2 show sales of CU104,000, cost of goods sold of CU86,500 (including CU6,500 for the error in opening inventory), and income taxes of CU5,250.

In 20X1, Beta reported:

	CU
Sales	73,500
Cost of goods sold	(53,500)
Profit before income taxes	20,000
Income taxes	(6,000)
Profit	14,000

The 20X2 opening retained earnings was CU20,000 and closing retained earnings was CU34,000.

Beta's income tax rate was 30% for 20X2 and 20X1. It had no other income or expenses.

Beta had CU5,000 of share capital throughout, and no other components of equity except for retained earnings. Its shares are not publicly traded and it does not disclose earnings per share.

Beta Co

Extract from the statement of comprehensive income

	20X2	(restated) 20X1
	CU	CU
Sales	104,000	73,500
Cost of goods sold	(80,000)	(60,000)
Profit before income taxes	24,000	13,500
Income taxes	(7,200)	(4,050)
Profit	16,800	9,450

Beta Co

Statement of Changes in Equity

	Share capital	Retained earnings	Total
	CU	CU	CU
Balance at 31 December 20X0	5,000	20,000	25,000
Profit for the year ended 31 December 20X1 as restated	-	9,450	9,450
Balance at 31 December 20X1	5,000	29,450	34,450
Profit for the year ended 31 December 20X2	-	16,800	16,800
Balance at 31 December 20X2	5,000	46,250	51,250

Extracts from the Notes

1. Some products that had been sold in 20X1 were incorrectly included in inventory at 31 December 20X1 at CU6,500. The financial statements of 20X1 have been restated to correct this error. The effect of the restatement on those financial statements is summarised below. There is no effect in 20X2.

	Effect on 20X1
	CU
(Increase) in cost of goods sold	(6,500)
Decrease in income tax expense	1,950
(Decrease) in profit	(4,550)
(Decrease) in inventory	(6,500)
Decrease in income tax payable	1,950
(Decrease) in equity	(4,550)

As is the case for the retrospective application of a change in accounting policy, retrospective restatement for the correction of prior period material errors is not required to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the error. *[IAS 8.43]*. This is discussed further in section 4.7 below.

4.7 Impracticability of restatement

As noted in sections 4.4 and 4.6 above, IAS 8 does not require the restatement of prior periods following a change in accounting policy or the correction of material errors if such a restatement is impracticable.

The standard devotes a considerable amount of guidance to discussing what 'impracticable' means for these purposes.

The standard states that applying a requirement is impracticable when an entity cannot apply it after making every reasonable effort to do so. It goes on to note that, for a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:

(a) The effects of the retrospective application or retrospective restatement are not determinable

(b) The retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period

Or

(c) The retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:

(i) Provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed

And

(ii) Would have been available when the financial statements for that prior period were authorised for issue from other information *[IAS 8.5]*

An example of a scenario covered by (a) above given by the standard is that in some circumstances it may impracticable to adjust comparative information for one or more prior periods to achieve comparability with the current period because data may not have been collected in the prior period(s) in a way that allows either retrospective application of a new accounting policy (or its prospective application to prior periods) or retrospective restatement to correct a prior period error, and it may be impracticable to recreate the information. *[IAS 8.50]*.

IAS 8 observes that it is frequently necessary to make estimates in applying an accounting policy and that estimation is inherently subjective, and that estimates may be developed after the reporting period. Developing estimates is potentially more difficult when retrospectively applying an accounting policy or making a retrospective restatement to correct a prior period error, because of the longer period of time that might have passed since the affected transaction, other event or condition occurred.

However, the objective of estimates related to prior periods remains the same as for estimates made in the current period, namely, for the estimate to reflect the circumstances that existed when the transaction, other event or condition occurred. *[IAS 8.51]*. Hindsight should not be used when applying a new accounting policy to, or correcting amounts for, a prior period, either in making assumptions about what management's intentions would have been in a prior period or estimating the amounts recognised, measured or disclosed in a prior period. For example, if an entity corrects a prior period error in calculating its liability for employees' accumulated sick leave in accordance with IAS 19, it would disregard information about an unusually severe influenza season during the next period that became available after the financial statements for the prior period were authorised for issue. However, the fact that significant estimates are frequently required when amending comparative information presented for prior periods does not prevent reliable adjustment or correction of the comparative information. *[IAS 8.53]*.

Therefore, retrospectively applying a new accounting policy or correcting a prior period error requires distinguishing information that: (a) provides evidence of circumstances that existed on the date(s) as at which the transaction, other event or condition occurred; and (b) would have been available when the financial statements for that prior period were authorised for issue, from other information.

The standard states that for some types of estimates (for example, a fair value measurement that uses significant unobservable inputs), it is impracticable to distinguish these types of information. When retrospective application or retrospective restatement would require making a significant estimate for which it is impossible to distinguish these two types of information, it is impracticable to apply the new accounting policy or correct the prior period error retrospectively. *[IAS 8.52]*.

IAS 8 addresses the impracticability of restatement separately (although similarly) for changes in accounting policy and the correction of material errors.

4.7.1 Impracticability of restatement for a change in accounting policy

When retrospective application of a change in accounting policy is required, the change in policy should be applied retrospectively except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the change. *[IAS 8.23]*. When an entity applies a new accounting policy retrospectively, the standard requires it to be applied to comparative information for prior periods as far back as is practicable. Retrospective application to a prior period is not practicable for these purposes unless it is practicable to determine the cumulative effect on the amounts in both the opening and closing statement of financial position for that period. *[IAS 8.26]*.

When it is impracticable to determine the period-specific effects of changing an accounting policy on comparative information for one or more prior periods presented:

- The new accounting policy should be applied to the carrying amounts of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable.

  And

- A corresponding adjustment to the opening balance of each affected component of equity for that period should be made.

The standard notes that this may be the current period. *[IAS 8.24]*.

When it is impracticable to determine the cumulative effect, at the beginning of the current period, of applying a new accounting policy to all prior periods, the standard requires an adjustment to the comparative information to apply the new accounting policy prospectively from the earliest date practicable. *[IAS 8.25]*. Prospective application is defined by the standard as applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed. *[IAS 8.5]*. This means that the portion of the cumulative adjustment to assets, liabilities and equity arising before that date is disregarded. Changing an accounting policy is permitted by IAS 8 even if it is impracticable to apply the policy prospectively for any prior period. *[IAS 8.27]*.

4.7.2 Impracticability of restatement for a material error

IAS 8 requires that a prior period error should be corrected by retrospective restatement except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the error. *[IAS 8.43]*.

When it is impracticable to determine the period-specific effects of an error on comparative information for one or more prior periods presented, the opening balances of assets, liabilities and equity should be restated for the earliest period for which retrospective restatement is practicable (which the standard notes may be the current period). *[IAS 8.44]*.

When it is impracticable to determine the cumulative effect, at the beginning of the current period, of an error on all prior periods, the comparative information should be restated to correct the error prospectively from the earliest date practicable. *[IAS 8.45]*. The standard explains that this will mean disregarding the portion of the cumulative restatement of assets, liabilities and equity arising before that date. *[IAS 8.47]*.

5 Disclosure requirements

5.1 Disclosures relating to accounting policies

5.1.1 Disclosure of accounting policies

Material accounting policy information is information which, when considered together with other information included in an entity's financial statements, can reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements. *[IAS 1.117]*. Immaterial accounting policy information must not obscure material information, but there is no outright prohibition on the presentation of immaterial accounting policy information. *[IAS 1.117D]*. The related requirements of other standards are not affected by a conclusion that accounting policy information is immaterial. *[IAS 1.117E]*.

The standard presents a number of observations about materiality as it relates to accounting policy information which can be summarised as follows:

- Information is more useful if it focuses on how an entity has applied the requirements of IFRS accounting standards to its own circumstances (that is, it is entity-specific) rather that if it is standardised information, or information that only duplicates or summarises the requirements of IFRS accounting standards. *[IAS 1.117C]*.
- Information about immaterial matters is itself immaterial. Accounting policy information may nevertheless be material because of the nature of the related transactions, other events or conditions, even if the amounts are immaterial. *[IAS 1.117A]*.
- Not all accounting policy information relating to material transactions, other events or conditions is itself material. *[IAS 1.117A]*.
- Accounting policy information is expected to be material if users of an entity's financial statements would need it to understand other material information in the financial statements. The standard presents examples of when it is likely that such information should be disclosed; that is when the information relates to material transactions, other events or conditions and: *[IAS 1.117B]*
  - The entity changed its accounting policy during the period and this change resulted in a material change to the information in the financial statements.
  - The entity chose the accounting policy from one or more options permitted by IFRS accounting standards, for example if the entity chose to measure investment property at historical cost rather than fair value.
  - The accounting policy was developed in accordance with IAS 8 in the absence of an IFRS accounting standard that specifically applies (see section 4.3 above).
  - The accounting policy relates to an area for which an entity is required to make significant judgements or assumptions in applying an accounting policy, and the entity discloses those judgements or assumptions as required by IAS 1 (see section 5.1.1.A below).
  - The accounting required for them is complex and users of the entity's financial statements would otherwise not understand those material transactions, other events or conditions. For example, if an entity applies more than one IFRS accounting standard to a class of material transactions.

How we see it

The requirement to disclose 'material accounting policy information' in IAS 1 requires the application of judgement. The use of boilerplate disclosures for accounting policy information has been observed in practice. Entities can enhance the usefulness of their financial statements by making accounting policy information more entity-specific and reducing the disclosure of immaterial and standardised disclosures.

5.1.1.A Judgements made in applying accounting policies

The process of applying an entity's accounting policies requires various judgements, apart from those involving estimations, that can significantly affect the amounts recognised in the financial statements. For example, judgements are required in determining:

(a) When substantially all the significant risks and rewards of ownership of financial assets and, for lessors, assets subject to leases are transferred to other entities

(b) Whether, in substance, particular sales of goods are financing arrangements and therefore do not give rise to revenue

And

(c) Whether the contractual terms of a financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding *[IAS 1.123]*

IAS 1 requires disclosure, along with material accounting policy information or other notes, of the judgements (apart from those involving estimations, see section 5.2.1 below) management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements. *[IAS 1.122]*.

Some of these disclosures are required by other standards. For example:

- IFRS 12 *Disclosure of Interests in Other Entities*, requires disclosure of the judgements made in determining if control is present.
- IAS 40 requires disclosure of the criteria developed by the entity to distinguish investment property from owner-occupied property and from property held for sale in the ordinary course of business, when classification of the property is difficult. *[IAS 1.124]*.
- IFRS 15 requires disclosures of the judgements made in applying the standard that significantly affect the determination of the amount and timing of revenue from contracts with customers. *[IFRS 15.123]*.

5.1.2 Disclosure of changes in accounting policies

IAS 8 distinguishes between accounting policy changes made pursuant to the initial application of an IFRS and voluntary changes in accounting policy (discussed in section 4.4 above). It sets out different disclosure requirements for each, as set out in sections 5.1.2.A and 5.1.2.B below. Also, if an IFRS accounting standard is in issue but is not yet effective and has not been applied, certain disclosures of its likely impact are required. These are set out in section 5.1.2.C below.

5.1.2.A Accounting policy changes pursuant to the initial application of an IFRS accounting standard

When initial application of an IFRS accounting standard has an effect on the current period or any prior period, would have such an effect except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods, an entity should disclose:

(a) The title of the IFRS accounting standard

(b) When applicable, that the change in accounting policy is made in accordance with its transitional provisions

(c) The nature of the change in accounting policy

(d) When applicable, a description of the transitional provisions

(e) When applicable, the transitional provisions that might have an effect on future periods

(f) For the current period and each prior period presented, to the extent practicable, the amount of the adjustment:

  (i) For each financial statement line item affected

  And

  (ii) If IAS 33 *Earnings per Share* applies to the entity, for basic and diluted earnings per share

(g) The amount of the adjustment relating to periods before those presented, to the extent practicable

And

(h) If retrospective application required by IAS 8 is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied

Impracticability of restatement is discussed in section 4.7 above. Financial statements of subsequent periods need not repeat these disclosures. *[IAS 8.28]*.

5.1.2.B Voluntary changes in accounting policy

When a voluntary change in accounting policy has an effect on the current period or any prior period, would have an effect on that period except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods, an entity should disclose:

(a) The nature of the change in accounting policy

(b) The reasons why applying the new accounting policy provides reliable and more relevant information

(c) For the current period and each prior period presented, to the extent practicable, the amount of the adjustment:

  (i) For each financial statement line item affected

  And

  (ii) If IAS 33 applies to the entity, for basic and diluted earnings per share

(d) The amount of the adjustment relating to periods before those presented, to the extent practicable

And

(e) If retrospective application is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied

Impracticability of restatement is discussed in section 4.7 above. Financial statements of subsequent periods need not repeat these disclosures. *[IAS 8.29]*.

5.1.2.C Future impact of a new IFRS accounting standard

When an entity has not applied a new IFRS accounting standard that has been issued but is not yet effective, it should disclose:

(a) That fact

And

(b) Known or reasonably estimable information relevant to assessing the possible impact that application of the new IFRS accounting standard will have on the financial statements in the period of initial application *[IAS 8.30]*

In producing the above disclosure, the standard requires that an entity should consider disclosing:

(a) The title of the new IFRS accounting standard

(b) The nature of the impending change or changes in accounting policy

(c) The date by which application of the IFRS accounting standard is required

(d) The date as at which it plans to apply the IFRS accounting standard initially

And

(e) Either:

  (i) A discussion of the impact that initial application of the IFRS accounting standard is expected to have on the entity's financial statements

  Or

  (ii) If that impact is not known or reasonably estimable, a statement to that effect *[IAS 8.31]*

5.2 Disclosure of estimation uncertainty and changes in estimates

5.2.1 Sources of estimation uncertainty

Determining the carrying amounts of some assets and liabilities requires estimation of the effects of uncertain future events on those assets and liabilities at the end of the reporting period. Examples given by IAS 1 are that (in the absence of fair values in an active market for identical items used to measure them) the following assets and liabilities require future-oriented estimates to measure them:

- The recoverable amount of classes of property, plant and equipment
- The effect of technological obsolescence on inventories
- Provisions subject to the future outcome of litigation in progress

  And

- Long-term employee benefit liabilities such as pension obligations

These estimates involve assumptions about such items as the risk adjustment to cash flows or discount rates used, future changes in salaries and future changes in prices affecting other costs. *[IAS 1.126]*.

In light of this, IAS 1 requires disclosure of information about the assumptions concerning the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes must include details of:

(a) Their nature

And

(b) Their carrying amount as at the end of the reporting period *[IAS 1.125]*

IAS 1 goes on to observe that these assumptions and other sources of estimation uncertainty relate to the estimates that require management's most difficult, subjective or complex judgements. As the number of variables and assumptions affecting the possible future resolution of the uncertainties increases, those judgements become more subjective and complex, and the potential for a consequential material adjustment to the carrying amounts of assets and liabilities normally increases accordingly. *[IAS 1.127]*.

The disclosures are required to be presented in a manner that helps users of financial statements to understand the judgements management makes about the future and about other key sources of estimation uncertainty. The nature and extent of the information provided will vary according to the nature of the assumption and other circumstances. Examples given by the standard of the types of disclosures to be made are:

(a) The nature of the assumption or other estimation uncertainty

(b) The sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity

(c) The expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected

And

(d) An explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved *[IAS 1.129]*

The disclosure of some of these key assumptions is required by other standards. IAS 1 notes the following examples:

- IAS 37 requires disclosure, in specified circumstances, of major assumptions concerning future events affecting classes of provisions.

  And

- IFRS 13 requires disclosure of significant assumptions (including the valuation technique(s) and inputs) used when measuring the fair values of assets and liabilities (not just financial ones) that are carried at fair value. *[IAS 1.133]*.

Other examples would include:

- IAS 19 requires disclosure of actuarial assumptions.
- IFRS 2 requires disclosure, in certain circumstances, of: the option pricing model used, and the method used and the assumptions made to incorporate the effects of early exercise.

  And

- IAS 36 *Impairment of Assets* requires disclosure, in certain circumstances, of each key assumption on which management has based its cash flow projections.

These assumptions and other sources of estimation uncertainty are not required to be disclosed for assets and liabilities with a significant risk that their carrying amounts might change materially within the next financial year if, at the end of the reporting period, they are measured at fair value based on a quoted price in an active market for an identical asset or liability. *[IAS 1.128]*.

Also, it is not necessary to disclose budget information or forecasts in making the disclosures. *[IAS 1.130]*. Furthermore, the disclosures of particular judgements management made in the process of applying the entity's accounting policies (discussed in section 5.1.1.A above) do not relate to the disclosures of sources of estimation uncertainty. *[IAS 1.132]*.

When it is impracticable to disclose the extent of the possible effects of an assumption or another source of estimation uncertainty at the end of the reporting period, the entity should disclose that it is reasonably possible, based on existing knowledge, that outcomes within the next financial year that are different from assumptions could require a material adjustment to the carrying amount of the asset or liability affected. In all cases, the entity should disclose the nature and carrying amount of the specific asset or liability (or class of assets or liabilities) affected by the assumption. *[IAS 1.131]*.

These requirements of IAS 1 represent potentially highly onerous disclosures. The extensive judgements required in deciding the level of detail to be given has resulted in a wide variety of disclosure in practice. The Basis for Conclusions to the standard reveals that the Board was aware that the requirement could potentially require quite extensive disclosures and explains its attempt to limit this as follows: "IAS 1 limits the scope of the disclosures to items that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. The longer the future period to which the disclosures relate, the greater the range of items that would qualify for disclosure, and the less specific are the disclosures that could be made about particular assets or liabilities. A period longer than the next financial year might obscure the most relevant information with other disclosures." *[IAS 1.BC84]*. Careful judgement will be required to provide useful and compliant information without reducing the understandability of the financial statement by obscuring material information with immaterial information.

5.2.2 Changes in accounting estimates

IAS 8 requires disclosure of the nature and amount of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods, except for the disclosure of the effect on future periods when it is impracticable to estimate that effect. *[IAS 8.39]*. If the amount of the effect in future periods is not disclosed because estimating it is impracticable, that fact should be disclosed. *[IAS 8.40]*.

5.3 Disclosure of prior period errors

When correction has been made for a material prior period error, IAS 8 requires disclosure of the following:

(a) The nature of the prior period error

(b) For each prior period presented, to the extent practicable, the amount of the correction:

  (i) For each financial statement line item affected

  And

  (ii) If IAS 33 applies to the entity, for basic and diluted earnings per share

(c) The amount of the correction at the beginning of the earliest prior period presented

  And

(d) If retrospective restatement is impracticable for a particular prior period, the circumstances that led to the existence of that condition and a description of how and from when the error has been corrected

In relation to retrospective adjustments and restatements, IAS 1 explains that they are not changes in equity, but simply adjustments to the opening balance of retained earnings or to another component of equity, if that is required by a specific IFRS accounting standard. IAS 1 builds on the disclosure requirements of IAS 8 by requiring that the effects of retrospective application or retrospective restatement are included for each component of equity affected - in other words, adjustments from changes in accounting policies and those arising from the correction of errors should be disclosed separately. *[IAS 1.106(b), IAS 1.110]*.

Financial statements of subsequent periods need not repeat these disclosures. *[IAS 8.49]*. Illustration 4-1 in section 4.5 above illustrates these disclosure requirements.

5.4 Disclosures about capital

5.4.1 General capital disclosures

The IASB believes that the level of an entity's capital and how it manages it are important factors for users to consider in assessing the risk profile of an entity and its ability to withstand unexpected adverse events. Furthermore, the level of capital might also affect the entity's ability to pay dividends. *[IAS 1.BC86]*. For these reasons, IAS 1 requires disclosure of information that enables users of financial statements to evaluate an entity's objectives, policies and processes for managing capital. *[IAS 1.134]*.

To achieve this, IAS 1 requires disclosure of the following, which should be based on the information provided internally to the entity's key management personnel: *[IAS 1.135]*

(a) Qualitative information about its objectives, policies and processes for managing capital, including:
   (i) A description of what it manages as capital
   (ii) When an entity is subject to externally imposed capital requirements, the nature of those requirements and how those requirements are incorporated into the management of capital

   And
   (iii) How it is meeting its objectives for managing capital

(b) Summary quantitative data about what it manages as capital

   Some entities regard some financial liabilities (for example, some forms of subordinated debt) as part of capital. Other entities regard capital as excluding some components of equity (for example, components arising from cash flow hedges)

(c) Any changes in (a) and (b) from the previous period

(d) Whether during the period it complied with any externally imposed capital requirements to which it is subject

   And

(e) When the entity has not complied with such externally imposed capital requirements, the consequences of such non-compliance

IAS 1 observes that capital may be managed in a number of ways and be subject to a number of different capital requirements. For example, a conglomerate may include entities that undertake insurance activities and banking activities, and those entities may also operate in several jurisdictions. When an aggregate disclosure of capital requirements and how capital is managed would not provide useful information or distorts a financial statement user's understanding of an entity's capital resources, the standard requires disclosure of separate information for each capital requirement to which the entity is subject. *[IAS 1.136]*.

Illustrations 5-1 and 5-2 below are based on the illustrative examples of capital disclosures contained in the implementation guidance accompanying IAS 1. *[IAS 1.IG10, IAS 1.IG11]*.

Illustration 5-1: Illustrative capital disclosures: An entity that is not a regulated financial institution

The following example illustrates the application of the requirements discussed above for an entity that is not a financial institution and is not subject to an externally imposed capital requirement. In this example, the entity monitors capital using a debt-to-adjusted capital ratio. Other entities may use different methods to monitor capital. The example is also relatively simple. An entity should decide, in the light of its circumstances, how much detail to provide.

Facts

Group A manufactures and sells cars. It includes a finance subsidiary that provides finance to customers, primarily in the form of leases. Group A is not subject to any externally imposed capital requirements.

Example disclosure

The Group's objectives when managing capital are:

- To safeguard the entity's ability to continue as a going concern, so that it can continue to provide returns for shareholders and benefits for other stakeholders

  And
- To provide an adequate return to shareholders by pricing products and services commensurately with the level of risk

The Group sets the amount of capital in proportion to risk. The Group manages the capital structure and makes adjustments to it in the light of changes in economic conditions and the risk characteristics of the underlying assets. In order to maintain or adjust the capital structure, the Group may adjust the amount of dividends paid to shareholders, return capital to shareholders, issue new shares, or sell assets to reduce debt.

Consistently with others in the industry, the Group monitors capital on the basis of the debt-to-adjusted capital ratio. This ratio is calculated as net debt ÷ adjusted capital. Net debt is calculated as total debt (as shown in the statement of financial position) less cash and cash equivalents. Adjusted capital comprises all components of equity (i.e., share capital, share premium, non-controlling interests, retained earnings, and revaluation surplus) other than amounts accumulated in equity relating to cash flow hedges, and includes some forms of subordinated debt.

During 20X2, the Group's strategy, which was unchanged from 20X1, was to maintain the debt-to-adjusted capital ratio at the lower end of the range 6:1 to 7:1, in order to secure access to finance at a reasonable cost by maintaining a BB credit rating. The debt-to-adjusted capital ratios at 31 December 20X2 and at 31 December 20X1 were as follows:

	20X2	20X1
	CU million	CU million
Total debt	1,000	1,100
Less: cash and cash equivalents	(90)	(150)
Net debt	910	950
Total equity	110	105
Add: subordinated debt instruments	38	38
Less: amounts accumulated in equity relating to cash flow hedges	(10)	(5)
Adjusted capital	138	138
Debt-to-adjusted capital ratio	6.6	6.9

The decrease in the debt-to-adjusted capital ratio during 20X2 resulted primarily from the reduction in net debt that occurred on the sale of subsidiary Z. As a result of this reduction in net debt, improved profitability and lower levels of managed receivables, the dividend payment was increased to CU2.8 million for 20X2 (from CU2.5 million for 20X1).

Illustration 5-2: Illustrative capital disclosures: An entity that has not complied with externally imposed capital requirements

The following example illustrates the application of the requirement to disclose when an entity has not complied with externally imposed capital requirements during the period. Other disclosures would be provided to comply with the other requirements relating to capital.

Facts

Entity A provides financial services to its customers and is subject to capital requirements imposed by Regulator B. During the year ended 31 December 20X2, Entity A did not comply with the capital requirements imposed by Regulator B. In its financial statements for the year ended 31 December 20X2, Entity A provides the following disclosure relating to its non-compliance.

Example disclosure

Entity A filed its quarterly regulatory capital return for 30 September 20X2 on 20 October 20X2. At that date, Entity A's regulatory capital was below the capital requirement imposed by Regulator B by CU1 million. As a result, Entity A was required to submit a plan to the regulator indicating how it would increase its regulatory capital to the amount required. Entity A submitted a plan that entailed selling part of its unquoted equities portfolio with a carrying amount of CU11.5 million in the fourth quarter of 20X2. In the fourth quarter of 20X2, Entity A sold its fixed interest investment portfolio for CU12.6 million and met its regulatory capital requirement.

5.4.2 Puttable financial instruments classified as equity

IAS 32 allows certain liabilities called 'puttable financial instruments' to be classified as equity. 'Puttable financial instrument' is a term defined and discussed at length in IAS 32 (see Chapter 43 at section 4.6). The IASB observes that "Financial instruments classified as equity usually do not include any obligation for the entity to deliver a financial asset to another party. Therefore, the Board concluded that additional disclosures are needed in these circumstances." *[IAS 1.BC100B]*.

The required disclosure for puttable financial instruments classified as equity instruments is as follows:

(a) Summary quantitative data about the amount classified as equity

(b) Its objectives, policies and processes for managing its obligation to repurchase or redeem the instruments when required to do so by the instrument holders, including any changes from the previous period

(c) The expected cash outflow on redemption or repurchase of that class of financial instruments

And

(d) Information about how the expected cash outflow on redemption or repurchase was determined *[IAS 1.136A]*

5.5 Disclosures about non-current liabilities arising from loan arrangements with covenants

New disclosures have been added for accounting periods beginning on or after 1 January 2024; for accounting periods beginning before this date, there are no equivalent requirements. IAS 1 requires the disclosure of information about non-current liabilities arising from loan arrangements with covenants, that enables users of the financial statements to understand the risk that those liabilities could become repayable withing twelve months of the reporting period (see section 3.1.4 above). Specifically, an entity must disclose:

- Information about the covenants, including the nature of the covenants and when the entity is required to comply with them
- The carrying amount of the liabilities related to the covenants
- Facts and circumstances, if any, which indicate that the entity may have difficulty complying with the covenants. *[IAS 1.76ZA]*

When assessing which facts and circumstances may need to be disclosed, factors an entity may wish to consider are:

- Whether it has acted to avoid or mitigate a potential breach, either during or after the reporting period
- Whether it would have complied with a covenant, had that covenant been tested based on circumstances at the end of the reporting period.

5.6 Other disclosures

IAS 1 also requires disclosure:

(a) In the notes of: *[IAS 1.137]*

  (i) The amount of dividends proposed or declared before the financial statements were authorised for issue but not recognised as a distribution to owners during the period, and the related amount per share

  And

  (ii) The amount of any cumulative preference dividends not recognised

(b) In accordance with IAS 10 *Events after the Reporting Period,* the following non-adjusting events, if they occur between the end of the reporting period and the date the financial statements are authorised for issue (see Chapter 34 at section 2.1.1): *[IAS 1.76]*

  (i) Refinancing on a long-term basis of a liability classified as current

  (ii) Rectification of a breach of a long-term loan arrangement classified as current

  (iii) The granting by the lender of a period of grace to rectify a breach of a long-term loan arrangement classified as current

  And

  (iv) Settlement of a liability classified as non-current.

(c) The following, if not disclosed elsewhere in information published with the financial statements: *[IAS 1.138]*

  (i) The domicile and legal form of the entity, its country of incorporation and the address of its registered office (or principal place of business, if different from the registered office)

  (ii) A description of the nature of the entity's operations and its principal activities

  (iii) The name of the parent and the ultimate parent of the group

  And

  (iv) If it is a limited life entity, information regarding the length of its life

6 Future developments

The IASB is pursuing a number of matters which relate to the subjects discussed in this chapter.

The Board groups its projects into four categories: standard-setting, maintenance, research and application questions. We discuss below the current projects relevant to this chapter under these headings.[7]

6.1 Standard-setting projects

6.1.1 Management commentary

In November 2017, the Board added a project to its agenda to revise and update IFRS Practice Statement 1 - *Management Commentary* - issued in 2010 (see section 2.3 above). In undertaking the project, the Board will consider how broader financial reporting could complement and support financial statements prepared using IFRS accounting standards. To support the Board's work on updating the Practice Statement, the Board established the Management Commentary Consultative Group.

In May 2021, the Board published IFRS Practice Statement Exposure Draft ED/2021/6 *Management Commentary*. The Exposure Draft sets out the Board's proposals for a comprehensive new framework for preparing management commentary. The comment period closed in November 2021 and the Board discussed the feedback received in April 2022; the Board was not asked to make any decisions at this juncture.[8]

In December 2022, the International Sustainability Standards Board (ISSB) sought feedback regarding a potential joint project with the IASB on connectivity in reporting, with the intention of building on the existing work done on both the Management Commentary project and the Integrated Reporting Framework. In May 2023, an education session was held to consider the IFRS Foundation staff analysis of similarities and differences between the proposals in the in the exposure draft, published in May 2021 and the *Integrated Reporting Framework* revised in January 2021 and touched on the approach to further alignment. The IASB was not asked to make any decisions.

In June 2024, the IASB decided to finalise the project and intends to make targeted refinements to the proposals in the Exposure Draft issued in 2021. At the time of writing, the final revised Practice Statement is scheduled to be issued in H1 2025.[9]

6.1.2 IFRS 18 *Presentation and Disclosure in Financial Statements*

IFRS 18 *Presentation and Disclosure in Financial Statements* (IFRS 18), a new IFRS accounting standard, was published in April 2024. It addresses presentation and disclosure in financial statements and replaces IAS 1. While much of IAS 1 is carried forward to the new standard with only limited wording changes, IFRS 18 introduces several new requirements:

- Classification of all income and expense in the statement of profit or loss into five categories, three of which are new
- Presentation of two new mandatory subtotals
- Mandatory disclosures about a sub-set of alternative performance measures ('management-defined performance measures' or 'MPMs') in a single note to the financial statements
- Enhanced guidance on the aggregation, location and labelling of information in the primary financial statements and the notes
- Some requirements currently included within IAS 1 have been moved (mostly unchanged) to IAS 8 and, to a much lesser extent, to IFRS 7. IFRS 18, once effective, also makes narrow scope amendments to other IFRS accounting standards including:
  - IAS 7
  - IAS 33
  - IAS 34

7 *IFRS Foundation work plan*, IFRS Foundation website (accessed August 2024).

8 *IFRS Foundation work plan*, IFRS Foundation website (accessed August 2024).

9 *IFRS Foundation work plan*, IFRS Foundation website (accessed August 2024).

The new requirements are expected to impact how most, if not all, reporting entities communicate financial statement information, both in the primary financial statements and in the notes and are discussed in detail in Chapter 4 of this publication.

6.1.3 IFRS 19 *Subsidiaries without Public Accountability: Disclosures*

In May 2024, the IASB issued IFRS 19 *Subsidiaries without Public Accountability: Disclosures*, which allows eligible entities to elect to apply the reduced disclosure requirements of IFRS 19, while still applying the recognition, measurement and presentation requirements in other IFRS accounting standards. The application of the standard is optional for eligible entities and is effective for reporting periods beginning on or after 1 January 2027. See Chapter 4 at section 7 for further details on the requirements of IFRS 19.

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Overview

IFRS 18

This chapter discusses the new requirements of IFRS 18 *Presentation and Disclosure in Financial Statements*, an IFRS accounting standard, addressing presentation and disclosure in financial statements, applicable for periods beginning on or after 1 January 2027. IFRS 18, once effective, will replace IAS 1 *Presentation of Financial Statements*.

While much of IAS 1 will be carried forward to the new standard with only limited wording changes, IFRS 18 introduces several new requirements that are expected to impact the presentation and disclosure of most, if not all, entities. These new requirements include:

- Requirements to classify all income and expenses included in the statement of profit or loss into one of five categories (three being new) and to present two new mandatory subtotals (see section 3 below).
- Required disclosures about certain non-GAAP measures ('management-defined performance measures' or 'MPMs'), all in a single note to the financial statements (see section 4 below)
- Enhanced guidance on the aggregation of information across all the primary financial statements and the notes (see section 2 below).

To implement these requirements, it is expected that entities will need to make changes to their data collection processes, information systems and their financial statement close process. In some cases, the requirements are also expected to trigger revisiting of remuneration policies and debt covenants that are currently linked to IAS 1 profit or loss metrics, which will require negotiations with relevant stakeholders. *[IFRS 18.BC415]*. It is likely that identifying MPMs, and providing the required disclosure, will necessitate more collaboration between an entity's financial reporting, legal and investor relations teams (among others) than is currently the norm. These measures will now generally be subject to audit and increased regulatory scrutiny.

The focus of this chapter is on the new requirements. The requirements carried forward from IAS 1 substantially unchanged will only be addressed if necessary to explain the context of the new requirements.[1]

IFRS 18, once effective, will also make narrow-scope, but widely applicable, consequential amendments to other standards including:

- IAS 7 *Statement of Cash Flows* (see section 5.1 below), which will both:
  - Require the use of 'operating profit or loss' as the mandatory starting point for entities using the indirect method
  - Largely remove the current optionality for classifying cash flows from interests and dividends
- IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*[2] (see section 5.2 below), which will contain some requirements currently included within IAS 1
- IAS 33 *Earnings per Share* (see section 5.3 below), which will:
  - Restrict the types of additional earnings per share measures that entities can disclose
- IAS 34 *Interim Financial Statements* (see section 5.4 below), which will:
  - Require the same MPM-related disclosures in interim financial statements as required in annual financial statements

IFRS 18 and the consequential amendments to other IFRS accounting standards, which must be adopted at the same time, are effective for periods beginning on or after 1 January 2027 and apply fully retrospectively. The transitional provisions specifically require a reconciliation between the presentation of the statement of profit or loss under IAS 1 and IFRS 18 for certain comparative periods, and also set out requirements for the interim financial statements in the first year of adoption. Earlier application is permitted and will need to be disclosed (see section 6 below).

1 For guidance on IAS 1, see Chapter 3.

2 The consequential amendments, once effective, changes the title of IAS 8 to '*Basis of Preparation of Financial Statements*' to better reflect the amended content of IAS 8.

IFRS 19

Section 7 below summarises the overarching concept of IFRS 19 *Subsidiaries without Public Accountability: Disclosures*, which allows eligible entities to elect to provide reduced disclosures when they apply the recognition, measurement and presentation requirements in other IFRS accounting standards.
The application of the standard is optional for eligible entities. IFRS 19 is applicable for periods beginning on or after 1 January 2027.

What you need to know

IFRS 18

- IFRS 18 replaces IAS 1 and responds to investor demand for better information about an entity's financial performance.
- IFRS 18 sets out the general and specific requirements for the presentation of financial statements and for disclosures in the notes.
- The new requirements of the standard include:
  - Required totals, subtotals and new categories for all income and expenses included in the statement of profit or loss
  - Disclosure about management-defined performance measures
  - Enhanced guidance on the grouping (aggregation and disaggregation), description (labelling) and location of information
- Limited, but widely applicable, amendments have been made to other IFRS accounting standards, most notably IAS 7, IAS 33 and IAS 34.
- Some requirements previously included in IAS 1 have been moved to IAS 8, and that standard has been renamed.
- IFRS 18, and the consequential amendments to other standards, are effective for reporting periods beginning on or after 1 January 2027, with earlier application permitted.
- Retrospective application is required in both annual and interim financial statements along with specified reconciliations for certain comparative periods.

IFRS 19

- IFRS 19 enables eligible entities, that elect to apply the standard, to provide reduced disclosures compared to the requirements in other IFRS accounting standards.
- Eligible entities are subsidiaries without public accountability, whose parent prepares consolidated financial statements available for public use that comply with IFRS accounting standards.
- Entities that elect IFRS 19 are still required to apply the recognition, measurement and presentation requirements of other IFRS accounting standards.
- IFRS 19 is effective for reporting periods beginning on or after 1 January 2027, with earlier application permitted.

1 Introduction - IFRS 18

In April 2024, the IASB published a new IFRS accounting standard on presentation and disclosure in financial statements. IFRS 18 marks the culmination of the IASB's Primary Financial Statements project, running since 2014, whose objective was to improve communication in financial statements.

Once effective, the new standard replaces IAS 1 and some requirements currently included within IAS 1 are moved to IAS 8 (which was also renamed *Basis of Preparation of Financial Statements* - see section 5.2 below) and to a much lesser, extent IFRS 7 *Financial Instruments: Disclosures*. There are also narrow-scope consequential amendments made to other IFRS accounting standards including:

- IAS 7 (see section 5.1 below)
- IAS 33 (see section 5.3 below)
- IAS 34 (see section 5.4 below)

IFRS 18 and the consequential amendments to other IFRS accounting standards are effective for periods beginning on or after 1 January 2027, with earlier application permitted.

While IFRS 18 represents a major overhaul of the requirements relating to presentation and disclosure of information in financial statements, many of the existing requirements in IAS 1 are carried forward substantially unchanged. This is because the IASB has chosen to focus on targeted improvements designed to address the three key concerns expressed by users of financial statements (hereafter users), being:

1) Financial statements, particularly the statement of profit or loss, are not sufficiently comparable across reporting entities
2) The transparency and understandability of non-GAAP measures needs to be improved

   And
3) The level of disaggregation in financial statements does not always provide the information users need and material information can be obscured *[IFRS 18.BC2, IFRS 18.BC3]*

Key new requirements in IFRS 18 intended to address these concerns include:

- Mandatory subtotals and categories of income and expense in the statement of profit or loss, as well as new requirements for the disclosure of operating expenses (see section 3 below)
- Disclosures about management-defined performance measures in the financial statements (see section 4 below)
- Enhanced requirements for the aggregation and location of information presented in the primary financial statements and disclosed in the notes, as well as guidance on providing informative labels (see section 2 below)

While most of the principles in IAS 1 are carried over to IFRS 18 substantially unchanged, the language and the format of the standard have been updated. For example, in line with the general structure of more recent IFRS accounting standards, both the definitions and the application guidance have been moved out of the main body of the standard to appendices.

This chapter deals with the key new requirements in IFRS 18 and key consequential amendments in other IFRS accounting standards that could impact the financial statements for most reporting entities.

How we see it

The adoption of the new standard provides an opportunity for entities reporting under IFRS accounting standards to revisit their communication strategy in the financial statements in general and especially for financial performance. We expect that the new requirements will improve both comparability and transparency of financial statements prepared under IFRS accounting standards.

To implement IFRS 18, it is likely that entities will need to update their financial statement close process and make changes to their information systems. Management needs to plan ahead as the transition process could require considerable time.

It is likely that identifying management-defined performance measures, and providing the required disclosure, will necessitate significantly more collaboration between the entity's financial reporting, legal and investor relations teams, among others than is currently the norm in practice.

1.1 Objective and scope

The objective of IFRS 18 is the same as for its predecessor: to help ensure that general purpose financial statements (financial statements) provide users with relevant information that faithfully represents the reporting entity's assets, liabilities, equity, income and expenses. The standard must be applied by all entities which prepare financial statements in accordance with IFRS accounting standards. *[IFRS 18.1, IFRS 18.2]*.

IFRS 18 sets out general requirements for financial statements and general principles for aggregation and disaggregation (see section 2.2 below). It includes specific requirements for the presentation of information in the statement(s) of financial performance, the statement of financial position and the statement of changes in equity as well as for the disclosure of information in the notes to financial statements (see section 2.1 below). *[IFRS 18.3]*. IFRS 18 also includes requirements for the descriptions (or labels) of line items presented in the financial statements or items disclosed in the notes (see section 2.3 below). Furthermore, IFRS 18 introduces requirements to classify all income and expenses included in the statement of profit or loss into categories and to present certain mandatory subtotals (see section 3 below). IFRS 18 also requires disclosures about certain non-GAAP measures ('management-defined performance measures' or 'MPMs') to be included in a single note to the financial statements (see section 4 below).

The standard clarifies that "Other IFRS Accounting Standards set out the recognition, measurement, presentation and disclosure requirements for specific transactions and other events". *[IFRS 18.4]*.

The presentation and disclosure requirements for information in the statement of cash flows are still contained in IAS 7. However, the general requirements for financial statements, the principles of aggregation and disaggregation and some requirements relating to disclosures in the notes in IFRS 18 also apply to the statement of cash flows (see section 2 below). *[IFRS 18.3]*. Furthermore, as explained in section 5.1 below, a few narrow-scope amendments have been made to IAS 7.

The requirements in IFRS 18 apply to consolidated and separate financial statements, but not to the presentation and disclosure of information in condensed interim financial statements prepared in accordance with IAS 34 (discussed in section 5.4 below). However, the principles of aggregation and disaggregation (see section 2.2 below), as well as the requirements relating to MPMs, (see section 4 below and Chapter 37) do apply to such interim condensed financial statements. *[IFRS 18.5]*.

1.2 New terms, definitions, and labels

Some of the terms in IFRS 18 differs from that in IAS 1. For example, IFRS 18 refers to a 'statement of financial performance', whereas IAS 1 refers to a 'statement of profit or loss and other comprehensive income'. *[IFRS 18.10(a)]*.

The standard uses the term 'statement of profit or loss' to refer both to the profit or loss section of a single performance statement and to a separate statement of profit or loss. *[IFRS 18.13(a)]*. In a similar way, the standard uses the term 'statement presenting comprehensive income' to refer both to the other comprehensive income section in a single performance statement and a separate statement presenting comprehensive income. *[IFRS 18.13(b)]*.

IFRS 18 introduces the concept of 'primary financial statements', encompassing:

- The statement of financial performance
- The statement of financial position
- The statement of changes in equity

  And
- The statement of cash flows

A complete set of financial statements, therefore, comprises the primary financial statements and the notes. *[IFRS 18.10, IFRS 18.11]*.

A key change in the use of language in the standard is reflected in its title, which refers both to 'presentation' and 'disclosure'. The standard explains that "an entity presents information in the primary financial statements and discloses information in the notes". *[IFRS 18.15]*.

Following the establishment of the ISSB, the IASB has introduced a new term of reference for the body of standards, to distinguish them from IFRS sustainability disclosure standards, issued by its sister board. The standards are to be referred to as "IFRS Accounting Standards" rather than "International Financial Reporting Standards, IFRS, IFRSs or IFRS Standards". *[IFRS 18 Appendix A]*.

Extract from IFRS 18

Appendix A
Defined terms

IFRS Accounting Standards	Accounting standards issued by the International Accounting Standards Board. They comprise: (a) International Financial Reporting Standards; (b) International Accounting Standards; (c) IFRIC Interpretations; and (d) SIC Interpretations. IFRS Accounting Standards were previously known as International Financial Reporting Standards, IFRS, IFRSs and IFRS Standards.

Consequential amendments have been made to references to IFRS, IFRSs or IFRS Standards in some, but not all, other IFRS accounting standards. *[IFRS 18.BC425]*. IAS 8 requires an explicit and unreserved statement of compliance with IFRS accounting standards in the notes. *[IAS 8(2027).6B]*.

How we see it

The *IFRS Foundation Trade Mark Guidelines*[3] state that the set of accounting standards issued by the IASB must be referred to as 'IFRS Accounting Standards' and that 'IFRS' or 'IFRSs' cannot be used.

Once IFRS 18 is effective, entities are required to refer to the set of standards and interpretations issued by the IASB as IFRS Accounting Standards.

In the meantime, entities ought to consider referring to 'IFRS Accounting Standards' when making the compliance statement in accordance with IAS 1.16 in order to explicitly differentiate between the information disclosed under IFRS accounting standards and IFRS sustainability disclosure standards.

We acknowledge that local regulators could require otherwise, in which case, the local requirements must be complied with.

In either case, the reference to accounting framework must be the same in both the financial statements and the auditor's opinion.

1.3 The identification of financial statements

Like IAS 1, IFRS 18 requires an entity to "clearly identify the financial statements and distinguish them from other information in the same published document". *[IFRS 18.25]*. The related application guidance has been updated to allow for the differing requirements of financial statements provided electronically, now stating that if "an entity provides the financial statements electronically, an entity considers other ways to meet the requirements - for example, by appropriate digital tagging of information provided in the financial statements". *[IFRS 18.B10]*.

3 IFRS Foundation® Trade Mark Guidelines. Available on the IFRS Foundation's website.

2 Roles, aggregation and labelling - IFRS 18

The Board sets out the objective of financial statements, as follows: *[IFRS 18.9]*

Extract from IFRS 18

Objective of financial statements

9 The objective of financial statements is to provide financial information about a reporting entity's assets, liabilities, equity, income and expenses that is useful to users of financial statements in assessing the prospects for future net cash inflows to the entity and in assessing management's stewardship of the entity's economic resources.

To achieve the objective of financial statements, the primary financial statements and the notes have distinct and complementary roles in providing financial information to users. In order for such information to be useful, it needs to be appropriately aggregated and labelled, without obscuring material information.

IFRS 18 defines the roles of the financial statements and provides additional guidance (compared to that previously included in IAS 1) to assist entities in determining how best to present and label summarised information in the primary financial statements and disclose material detailed (or disaggregated) information in the notes. All three aspects are discussed in more detail in the sub-sections below.

IFRS 18 differentiates between 'presenting' information in the primary financial statements and 'disclosing' it in the notes and introduces a principle for determining the location of information based on identified 'roles' of the primary financial statements and the notes (see section 2.1 below). *[IFRS 18.15]*.

The Board stated that the materiality requirements apply equally to all requirements to present or disclose information. Information is either material (and, therefore, contributes to the objective of financial statements) or it is not material (and, therefore, is not required). As such, the materiality requirements set out whether information is required to be provided by an entity, not where in the financial statements to include that information. *[IFRS 18.BC53]*.

IFRS 18 requires an entity to aggregate and disaggregate information with reference to similar and dissimilar characteristics while keeping in mind the roles of the primary financial statements and the notes (see section 2.2 below).

To represent an item faithfully, IFRS 18 requires an entity to provide all the descriptions and explanations necessary for a user to understand the item. It also includes guidance on determining informative labels in order to provide useful information (see section 2.3 below). For example, the use of the term "other" is generally not considered to provide useful information. *[IFRS 18.43, IFRS 18.B25]*.

2.1 The roles of the primary financial statements and the notes

The Board observed that users pay more attention to information presented in the primary financial statements and use it more often compared to information disclosed in the notes. *[IFRS 18.BC45]*. Therefore, in order to meet the objective of financial statements, an entity 'presents' summarised information in the primary financial statements and 'discloses' more detailed information in the notes. That said, an entity is only required to present or disclose material information,[4] as IFRS accounting standards do not apply to immaterial items. *[IFRS 18.15]*.

4 Refer to IFRS 18.19 and IFRS 18.B1-B5.

The distinct and complementary roles of the primary financial statements and the notes are as follows: *[IFRS 18.16, IFRS 18.17]*

Extract from IFRS 18

16 The role of the primary financial statements is to provide structured summaries of a reporting entity's recognised assets, liabilities, equity, income, expenses and cash flows, that are useful to users of financial statements for:

(a) obtaining an understandable overview of the entity's recognised assets, liabilities, equity, income, expenses and cash flows;

(b) making comparisons between entities, and between reporting periods for the same entity; and

(c) identifying items or areas about which users of financial statements may wish to seek additional information in the notes.

17 The role of the notes is to provide material information necessary:

(a) to enable users of financial statements to understand the line items presented in the primary financial statements (see paragraph B6); and

(b) to supplement the primary financial statements with additional information to achieve the objective of financial statements (see paragraph B7).

Since the primary financial statements serve as a useful structured summary, they are more prominent than information disclosed in the notes. However, this does not mean the information disclosed in the notes is secondary to, or less important than, information presented in the primary financial statements. The notes have a different role from the primary financial statements both in digital[5] and paper-based reporting. Understanding those respective roles helps an entity determine where to provide particular information in the financial statements. *[IFRS 18.BC49]*.

This difference in roles between the primary financial statements and the notes means that there will also be a difference in the extent of the information required in the notes compared to that in the primary financial statements. Specifically: *[IFRS 18.18]*

(a) In order to serve as a structured summary, the primary financial statements will, by design, provide more aggregated information than that provided in the notes.

And

(b) In order to provide material information, the notes will need to contain more detailed and disaggregated information about the entity's assets, liabilities, equity, income, expenses and cash flows than information in the primary financial statements.

2.1.1 Information presented in the primary financial statements

An entity needs to assess what material information to present in its primary financial statements to meet their role of providing a useful structured summary. *[IFRS 18.21]*.

IFRS 18 distinguishes between: *[IFRS 18.41]*

- **An 'item'**

  An item is an asset, liability, equity instrument or reserve, income, expense or cash flow or any aggregation or disaggregation of such assets, liabilities, equity, income, expenses or cash flows

  And

- **A 'line item'**

  A line item is an item that is presented separately in the primary financial statements

All material information cannot be presented in (or on the face of) the primary financial statements as too many line items would clutter the primary financial statements, thereby making it difficult for users to obtain an understandable overview of the entity's assets, liabilities, equity, income, expenses and cash flows. This assessment will require an entity to consider its specific facts and circumstances to determine what information will provide an understandable overview to users, while avoiding clutter. *[IFRS 18.BC54]*.

5 Refer to IFRS 18.BC62-BC63.

All the aspects of the role of the primary financial statements, set out in IFRS 18.16 (see section 2.1 above), help an entity to determine whether or not to present an item as a line item in its primary financial statements to contribute to a useful structured summary. This can be shown by the following Illustration based on an example included in the Basis for Conclusion to IFRS 18: *[IFRS 18.BC55]*

Illustration 2-1: Determining whether or not to present an item based on the aspects of the role of the primary financial statements

Assume an entity undertakes a major restructuring during the reporting period and concludes that information about that restructuring is material.

In order to determine whether to present a line item for 'restructuring expenses' in the statement of profit or loss, the entity needs to consider whether such a line item contributes to a 'useful structured summary' by helping users to:

(a) Obtain an understandable overview of the entity's expenses for the period

Separate presentation of the restructuring expenses could help users understand an increase in total operating expenses for the current period.

(b) Make comparisons between entities or between reporting periods

Separately presenting the restructuring expenses, since they lack persistence, could make other line items more comparable to the amounts presented by this entity in prior periods as well as to amounts presented by other entities, thereby aiding trend analysis by users.

Or

(c) Identify items or areas about which users might wish to seek additional information in the notes

When the notes include additional information about restructuring expenses, presenting these expenses separately on the face of the primary financial statements (and including a cross-reference to the related note) could draw users' attention to that additional information.

Some IFRS accounting standards contain specific requirements for presentation in the primary financial statements. The Board noted that, in some cases, an entity will need to assess whether applying these requirements will result in a useful structured summary. However, the Board concluded that certain requirements will always be necessary for the primary financial statements to provide useful structured summaries. For example, the requirements to classify income and expenses into categories and present the totals and subtotals specified in IFRS 18 in the statement of profit or loss (see section 3 below). *[IFRS 18.BC56]*.

The standard, therefore, lists the specific requirements, as follows: *[IFRS 18.22]*

Extract from IFRS 18

22 To provide a useful structured summary in a primary financial statement, an entity shall comply with specific requirements that determine the structure of the statement. The specific requirements are:

(a) for the statement of profit or loss-the requirements in paragraphs 47, 69, 76 and 78;

(b) for the statement presenting comprehensive income-the requirements in paragraphs 86-88;

(c) for the statement of financial position-the requirements in paragraphs 96 and 104;

(d) for the statement of changes in equity-the requirements in paragraph 107; and

(e) for the statement of cash flows-the requirements in paragraph 10 of IAS 7.

Section 3 below addresses the new requirements IFRS 18, in (a) above, for the structure of the statement of profit or loss.

The requirements in (b)-(e) of the extract above have been brought over from IAS 1 mostly unchanged, aside from certain narrow-scope amendments, including:

- Replacing the term 'reliable and more relevant' with 'a useful structured summary' when referring to presentation of the statement of financial position based on the order of liquidity *[IFRS 18.96]*
- Including 'goodwill' in the list of line items to be presented in the statement of financial position (previously IAS 1.54) *[IFRS 18.103(d)]*

These changes are not further discussed in this chapter. For guidance on the requirements currently included in IAS 1, see Chapter 3.

2.1.1.A Minimum line items, additional line items and additional subtotals

Extract from IFRS 18

103 An entity shall present in the statement of financial position line items for:

(a) property, plant and equipment;
(b) investment property;
(c) intangible assets;
(d) goodwill;
(e) financial assets (excluding amounts shown under (g), (j) and (k));
(f) portfolios of contracts within the scope of IFRS 17 that are assets, disaggregated as required by paragraph 78 of IFRS 17;
(g) investments accounted for using the equity method;
(h) biological assets within the scope of IAS 41 *Agriculture*;
(i) inventories;
(j) trade and other receivables;
(k) cash and cash equivalents;
(l) the total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with IFRS 5;
(m) trade and other payables;
(n) provisions;
(o) financial liabilities (excluding amounts shown under (m) and (n));
(p) portfolios of contracts within the scope of IFRS 17 that are liabilities, disaggregated as required by paragraph 78 of IFRS 17;
(q) liabilities and assets for current tax, as defined in IAS 12;
(r) deferred tax liabilities and deferred tax assets, as defined in IAS 12; and
(s) liabilities included in disposal groups classified as held for sale in accordance with IFRS 5.

[IFRS 18.103]

Some IFRS accounting standards, including IFRS 18, require specific line items to be presented separately in the primary financial statements (e.g., IFRS 18.75 - see section 3.4 below - and IFRS 18.103 in the extract above). The Board concluded that an entity is not required to present such line items in one of the primary financial statements if those line items are not necessary for that statement to provide a useful structured summary. This is the case even if that IFRS accounting standard contains a list of specific line items or describes them as minimum requirements. *[IFRS 18.23, IFRS 18.B8, IFRS 18.BC57]*.

However, if an entity concludes it does not need to present a line item specifically required by IFRS accounting standards, it still needs to disclose that item in the notes, unless it is immaterial. For example, if an entity concludes that presenting 'impairment losses' determined under IFRS 9 *Financial Instruments* is not necessary to provide a useful structured summary of the entity's income and expenses, the entity is still required to disclose those losses in the notes, unless that information is immaterial. *[IFRS 18.BC58]*.

How we see it

The interaction between the minimum line item requirements, materiality and the useful structure summary concept involves some key nuances that might not always be easy to reflect in practice. Thus, determining whether to present or disclose information in, or to exclude information from, the financial statements will, in some cases, involve difficult judgements.

The standard also specifies that an entity presents additional subtotals and line items if they are necessary to provide a useful structured summary in the primary financial statements. *[IFRS 18.B9, IFRS 18.BC59]*. However, the standard restricts the type of additional line items or subtotals by including the following requirements: *[IFRS 18.24]*

Extract from IFRS 18

24 An entity shall present additional line items and subtotals if such presentations are necessary for a primary financial statement to provide a useful structured summary. When an entity presents additional line items or subtotals, those line items or subtotals shall (see paragraph B9):

(a) comprise amounts recognised and measured in accordance with IFRS Accounting Standards;

(b) be compatible with the statement structure created by the requirements listed in paragraph 22;

(c) be consistent from period to period, in accordance with paragraph 30; and

(d) be displayed no more prominently than the totals and subtotals required by IFRS Accounting Standards.

The requirement in IFRS 18.24(b) above limits the inclusion of additional subtotals in the primary financial statements to those that fit the specified structure of that particular primary financial statement, as set out in IFRS 18.22 (see section 2.1.1 above). For example, a subtotal representing 'gross profit net of income taxes' mixes the operating and income tax categories, and would, therefore, conflict with the requirement. The requirement in IFRS 18.24(c) above indicates that an entity's use of additional subtotals must be retained from one reporting period to the next unless a change in presentation is warranted.

These requirements for additional subtotals and line items are meant to supplement the requirements for fair presentation previously included in IAS 1, that have now been moved to IAS 8 (see section 5.2 below). *[IFRS 18.BC61]*.

2.1.2 Information disclosed in the notes

An entity is required to provide the information necessary for users to understand the line items presented on the face of the primary financial statements, and to include this information in the notes.
IFRS 18 provides the following examples of such information: *[IFRS 18.B6]*

(a) Disaggregation of the line items presented in the primary financial statements

(b) Descriptions of the characteristics of the line items presented in the primary financial statements

And

(c) Information about the methods, assumptions and judgements used in order to recognise, measure and present the items included in the primary financial statements

Similarly, an entity is required to supplement the primary financial statements by providing the additional information necessary to achieve the objective of financial statements. In other words: *[IFRS 18.B7]*

(a) The information specifically required by an IFRS accounting standard

For example:

(i) Information about an entity's unrecognised contingent assets and contingent liabilities required by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

And

(ii) Information about an entity's exposure to the various types of risks, such as credit risk, liquidity risk and market risk required by IFRS 7

And

(b) Additional information required for a user's understanding

Like IAS 1, IFRS 18 requires an entity to consider whether additional information needs to be provided when the specific requirements in IFRS accounting standards are insufficient to enable users to understand the effect of transactions and other events and conditions on the entity's financial position and financial performance. *[IFRS 18.20]*.

As explained in section 2.1.1.A above, IFRS 18 clarifies that an entity is not required to present a specific line item or make a disclosure required by an IFRS accounting standard if that information is not material. This is the case even if that IFRS accounting standard contains a list of specific requirements or describes them as minimum requirements. *[IFRS 18.19]*.

2.1.3 Cross references between the primary financial statements and the notes

IFRS 18, like IAS 1, requires an entity to cross-reference each item in the primary financial statements to any related information in the notes. An amount disclosed in a note is often included in one or more line items in the primary financial statements. In such cases, IFRS 18 requires an entity to disclose in that note the line item(s) in the primary financial statements in which the amounts are included. *[IFRS 18.114]*.

This signposting in both directions ensures that users understand how amounts disclosed in the notes relate to the line items presented in the primary financial statements. *[IFRS 18.BC324]*.

How we see it

We believe that the new requirement to cross refer from the notes to the primary financial statements, when amounts disclosed in the notes are included in one or more lines in the primary financial statements, will improve transparency for users and make it easier for them to understand how amounts disclosed in the notes link to those presented in the primary financial statements.

2.2 Aggregation and disaggregation

IFRS 18 requires an entity to aggregate and disaggregate information with reference to similar and dissimilar characteristics while keeping the roles of the primary financial statements and the notes in mind. The related application guidance sets out that items aggregated and presented as line items in the primary financial statements must have "at least one similar characteristic other than meeting the definition of assets, liabilities equity, income, expenses, or cash flows." *[IFRS 18.B21]*. However, since the role of the primary financial statements is to provide a useful structured summary, the line items in the primary financial statements will, by design, aggregate items that have sufficiently dissimilar characteristics, such that disaggregated information about the aggregated items is likely to be material and will, therefore, need to be disclosed in the notes (see section 2.3 below).

IFRS 18 defines aggregation, disaggregation and classification, as follows: *[IFRS 18 Appendix A]*

Extract from IFRS 18

Appendix A
Defined terms

aggregation	The adding together of assets, liabilities, equity, income, expenses or cash flows that share characteristics and are included in the same classification.
classification	The sorting of assets, liabilities, equity, income, expenses and cash flows based on shared characteristics.
disaggregation	The separation of an item into component parts that have characteristics that are not shared.

Aggregation and disaggregation of information requires an entity to avoid both:

- Omitting useful information by providing insufficient detail

  And

- Obscuring information by providing too much detail

To illustrate, on one hand, an entity's total assets, total liabilities, total equity, total income, total expenses and total cash flows obviously provides information about the entity's financial position, financial performance and cash flows, but this information is too aggregated to be useful on its own. On the other hand, disaggregated information about individual transactions or other events provides detailed information, but can be so detailed as to obscure material information. Therefore, an entity needs to apply judgement to determine how much detail is necessary to provide useful information. *[IFRS 18.BC73]*.

Financial statements are the result of processing large numbers of transactions and other events. These transactions and other events give rise to assets, liabilities, equity, income, expenses and cash flows. *[IFRS 18.B16]*. The effective reporting of these assets, liabilities, equity, income, expenses and cash flows (which resulted from large numbers of transactions and other events) necessarily requires aggregating some, or in fact most, of the individual amounts into items that are material to users before presenting and disclosing these amounts within the financial statements.

2.2.1 Principles of aggregation and disaggregation

Unless it overrides specific aggregation or disaggregation requirements in IFRS accounting standards, an entity is required to: *[IFRS 18.41]*

(a) Classify and aggregate assets, liabilities, equity, income, expenses or cash flows into items based on shared characteristics

(b) Disaggregate items based on dissimilar characteristics

(c) Aggregate or disaggregate items into line items that are presented in the primary financial statements so that they provide useful structured summaries

(d) Aggregate or disaggregate items in order to disclose material information in the notes

And

(e) Ensure that the aggregation and disaggregation of information in the financial statements do not obscure material information

Applying the principles above, an entity shall disaggregate items whenever the resulting information is material; and where the application of (c) above results in an entity not presenting material information in the primary financial statements, it shall disclose that material information in the notes. *[IFRS 18.42]*.

To assist entities in applying the principles of aggregation and disaggregation, the Board decided to provide application guidance on: *[IFRS 18.BC74]*

(a) The process involved in deciding whether to aggregate or disaggregate information (discussed below)

(b) The basis of aggregation and disaggregation (including the characteristics of assets, liabilities, equity, income and expenses to consider in assessing whether items have dissimilar characteristics) (see section 2.2.2 below)

And

(c) The description of items presented or disclosed (see section 2.3 below)

The Board replaced the requirements for aggregation and disaggregation in IAS 1, including a requirement for an entity to present separately each 'material class of similar items', with the principles of aggregation and disaggregation in IFRS 18. Entities are now required to aggregate and disaggregate items based both on their characteristics and the roles of the primary financial statements and the notes. That said, the Board expects that an entity would generally conclude that line items previously determined to be a 'material class of items' also contribute to the primary financial statements providing useful structured summaries. *[IFRS 18.BC75]*.

The Board developed the principles of aggregation and disaggregation from the descriptions of 'classification' and 'aggregation' in the Conceptual Framework. Those descriptions recognise shared characteristics as a condition for classifying and aggregating items. *[IFRS 18.BC72]*.

How we see it

While IFRS 18 includes more guidance on aggregation and disaggregation, including the guidance on the principles of aggregation and disaggregation above, it remains a difficult balance to strike.

Entity will need to apply judgement to determine how much detail is necessary to provide useful information, without obscuring material information.

To apply the requirements above, an entity is required to aggregate items based on their shared characteristics (i.e., aggregate items with similar characteristics) and disaggregate items based on characteristics that are not shared (i.e., disaggregate items with dissimilar characteristics). In order to do this, an entity must: *[IFRS 18.B17]*

(a) Identify the assets, liabilities, equity, income, expenses and cash flows that arise from individual transactions or other events

(b) Classify and aggregate assets, liabilities, equity, income, expenses and cash flows into 'items' based on their shared characteristics so that the 'line items' presented in the primary financial statements and the items disclosed in the notes have at least one similar characteristic

And

(c) Disaggregate items based on dissimilar characteristics:

  (i) In the primary financial statements, so that the primary financial statements provide useful structured summaries

  And

  (ii) In the notes, so that the notes disclose material information

The steps above can be applied in varying order when applying the principles of aggregation and disaggregation. *[IFRS 18.B18]*.

2.2.2 Basis of aggregation and disaggregation

The Board concluded it was not feasible to create a specific disaggregation threshold (such as a mandatory quantitative threshold) that could apply to all entities. Any threshold might conflict with the definition of material information and the requirement for entities to include a qualitative assessment in their materiality judgements. *[IFRS 18.BC76]*.

Therefore, the Board decided to require an entity to aggregate (and disaggregate) assets, liabilities, equity, income, expenses and cash flows from individual transactions and other events based on similar (and dissimilar) characteristics. IFRS 18 is explicit that this process will require an entity to use its judgement. *[IFRS 18.B19]*.

The standard states that the more similar the characteristics of assets, liabilities, equity, income, expenses and cash flows are, the more likely it is that aggregating them will fulfil the role of the primary financial statements (i.e., to provide useful structured summaries) or the notes (i.e., to provide material information). Conversely, the more dissimilar the characteristics of assets, liabilities, equity, income, expenses and cash flows are, the more likely it is that disaggregating the items will fulfil the roles of the primary financial statements or the notes. *[IFRS 18.B20]*.

The guidance does include a 'minimum threshold' in that items that are aggregated and presented as line items in the primary financial statements must share at least one characteristic other than meeting the definition of assets, liabilities, equity, income, expenses or cash flows. *[IFRS 18.B21]*.

Applying the principles of aggregation and disaggregation, an entity must disaggregate items with dissimilar characteristics when the disaggregated information is material. A single dissimilar characteristic could result in disaggregated information about an item being material. *[IFRS 18.B22]*.

This is shown in the following Illustration based on the example included in the application guidance in IFRS 18: *[IFRS 18.B23]*

Illustration 2-2: Determining line items and disaggregation in the notes

An entity presents financial assets that comprise equity investments and debt investments separately from non-financial assets in its statement of financial position. The financial assets have dissimilar characteristics because of their different measurement bases (i.e., some are measured at fair value through profit or loss and others at amortised cost).

Assume the entity determined that presenting separate line items for the financial assets based on those measurement bases provides a useful structured summary. This disaggregation results in:

- A line item for equity and debt investments measured at fair value through profit or loss

  And

- A line item for debt investments measured at amortised cost

However, because equity investments expose the entity to different risks compared to debt investments, these investments are dissimilar. The entity would therefore need to assess whether further disaggregation of the financial assets measured at fair value through profit or loss (i.e., into equity investments and debt investments) is needed for the statement of financial position to provide a useful structured summary.

If the entity concludes this further disaggregation is not necessary to fulfil the role of the primary financial statements, it then needs to consider if the disaggregated information is material, and if so, disclose that disaggregated information in the notes.

If the equity investments, in turn, have other dissimilar characteristics, the entity will need to further disaggregate those equity investments in the notes if the disaggregated information is material.

The application guidance in IFRS 18 provides some examples of the characteristics an entity considers in making the judgements discussed in section 2.2.1 above. *[IFRS 18.B19, IFRS 18.B78, IFRS 18.B110]*.

Examples given in relation to *both* transactions and balances:

- Nature
- Function (or role) within the activities of the entity
- Measurement basis
- Measurement uncertainty, outcome uncertainty or other risks associated with the item
- Size
- Geographical location or regulatory environment
- Tax effects (for example, if different tax rates apply to the items or if they have different tax bases)

Examples given in relation to income and expenses (i.e., those related to transactions):

- Persistence (for example, how frequent the item of income or expense occurs and whether it is recurring or non-recurring)
- Whether arising on initial recognition of an item or from subsequent change in an estimate relating to the item

Examples given in relation to assets, liabilities and items of equity (i.e., those related to balances):

- Duration and timing of recovery or settlement including:
  - Whether the item is classified as current or non-current
  - Whether the item's recovery or settlement forms part of the entity's operating cycle
- Liquidity
- Type (for example, type of good, service or customer)
- Restrictions on the use or transferability the item

IFRS 18 explains that the assessment of whether to present additional line items in the statement of financial position is based on the entity's judgement and its assessment of the nature or function of the assets or liabilities. The other examples of characteristics assist an entity in identifying the relevant nature or function of the assets and liabilities. By requiring the use of nature and function to disaggregate assets and liabilities on the face of the statement of financial position, IFRS 18 retains IAS 1's emphasis on presentation of line items based on the nature and function of assets and liabilities. This emphasis on nature and function in the statement of financial position also aligns with a similar emphasis in the statement of profit or loss. *[IFRS 18.B109, IFRS 18.BC315]*.

2.2.3 Examples of items that have sufficiently dissimilar characteristics

The application guidance in IFRS 18 also sets out examples of income, expenses, assets, liabilities and items of equity that might have sufficiently dissimilar characteristics that presentation in the statement of profit or loss or statement of financial position or disclosure in the notes will be necessary to provide material information. *[IFRS 18.42, IFRS 18.B79, IFRS 18.B111]*.

Extract from IFRS 18

B79 Income and expenses that might have sufficiently dissimilar characteristics that presentation in the statement of profit or loss is necessary to provide a useful structured summary or disclosure in the notes is necessary to provide material information include:

(a) write-downs of inventories, as well as reversals of such write-downs;
(b) impairment losses for property, plant and equipment, as well as reversals of such impairment losses;
(c) income and expenses from restructurings of an entity's activities and reversals of any provisions for restructuring;
(d) income and expenses from disposals of property, plant and equipment;
(e) income and expenses from disposals of investments;
(f) income and expenses from litigation settlements;
(g) reversals of provisions; and
(h) non-recurring income and expenses not included in (a)-(g).

B111 Assets, liabilities and items of equity that might have sufficiently dissimilar characteristics that presentation in the statement of financial position is necessary to provide a useful structured summary or disclosure in the notes is necessary to provide material information include:

(a) property, plant and equipment disaggregated into classes in accordance with IAS 16;
(b) receivables disaggregated into amounts receivable from trade customers, amounts receivable from related parties, prepayments and other amounts;
(c) inventories disaggregated, applying IAS 2, into items such as merchandise, production supplies, materials, work in progress and finished goods;
(d) trade payables disaggregated, applying IAS 7, to provide separately the amounts of those payables that are part of supplier finance arrangements;
(e) provisions disaggregated according to their nature, such as, provisions for employee benefits, decommissioning liabilities, or other items; and
(f) equity capital and reserves disaggregated into various classes, such as paid-in capital, share premium and reserves.

The application guidance is expected to help entities understand the principles of aggregation and disaggregation by illustrating them with the help of some common examples. However, the transactions and balance listed in the extract will not be applicable to all, and they are, therefore, presented as examples rather than an exhaustive list.

2.3 Description of items

IFRS 18 includes requirements for the description of line items presented in the financial statements or items disclosed in the notes. This is to ensure that the descriptions used by entities are complete. For example, some entities provide information about 'unusual' income or expense items without explaining why those items are considered to be 'unusual'. *[IFRS 18.BC77]*.

To achieve a faithful representation, an entity needs to provide all the descriptions and explanations that are necessary for a user to understand the item. In some cases, an entity might need to include the meaning of the terms used by the entity in the descriptions and explanations and disclose information about how it has aggregated or disaggregated assets, liabilities, equity, income, expenses and cash flows. For example, if an entity described some items of income or expense as 'unusual', it would explain its definition of which income and expenses are considered 'unusual'. *[IFRS 18.BC78]*.

Therefore, the Board decided to require an entity to label and describe the items presented in the primary financial statements or disclosed in the notes in a way that faithfully represents the characteristics of those items. *[IFRS 18.43]*.

Such items are often aggregations of individual items arising from transactions or other events. These aggregated items could be made up of individual items for which the information is material, individual items for which the information is immaterial, or a mix of both: *[IFRS 18.B24]*

(a) A material item is aggregated with other material items

Such an aggregation could be provided to summarise material information. However, the entity would then be required to disclose disaggregated information about each material item.

(b) A material item is aggregated with immaterial items

In this case, an entity would only need to provide disaggregated information about the material item if the immaterial information obscured the material information about that item.

(c) Immaterial items are aggregated with other immaterial items

An entity might provide such an aggregation of immaterial items in order to complete a list of items, or a subtotal. Since items are immaterial, no disaggregated information would be required, subject to the guidance on using the label 'other' discussed below.

2.3.1 Using the label 'other'

Currently, some entities present or disclose a large amount of 'other' income or expenses without explaining what those 'other' items include; this is a matter of concern for users. The Board noted that using the label 'other' for such an aggregation is usually unhelpful and, therefore, it developed the application guidance below to help entities determine a more informative label and provide more useful information. *[IFRS 18.BC79, IFRS 18.B25]*.

Extract from IFRS 18

B25 An entity shall label items presented or disclosed as 'other' only if it cannot find a more informative label. Examples of how an entity might find a more informative label are:

(a) if an item for which information is material is aggregated with items for which information is not material, finding a label that describes the item for which information is material; and

(b) if items for which information is not material are aggregated:

(i) aggregating items that share similar characteristics and describing them in a way that faithfully represents the similar characteristics; or

(ii) aggregating items with other items that do not share similar characteristics and describing them in a way that faithfully represents the dissimilar characteristics of the items.

If an entity cannot find a more informative label than 'other': *[IFRS 18.B26]*

(a) For any aggregation

The entity needs to use a label which describes the aggregated item as precisely as possible (for example, 'other operating expenses' or 'other finance expenses').

(b) For an aggregation comprising only immaterial items

An entity could aggregate immaterial items despite them having dissimilar characteristics, resulting in an aggregated item that is cumulatively large despite comprising individually immaterial items. Where that is the case, the entity needs to consider whether the aggregated amount is large enough that users might reasonably question whether it includes material items. If so, the information needed to resolve that question is itself material information. *[IFRS 18.BC80]*.

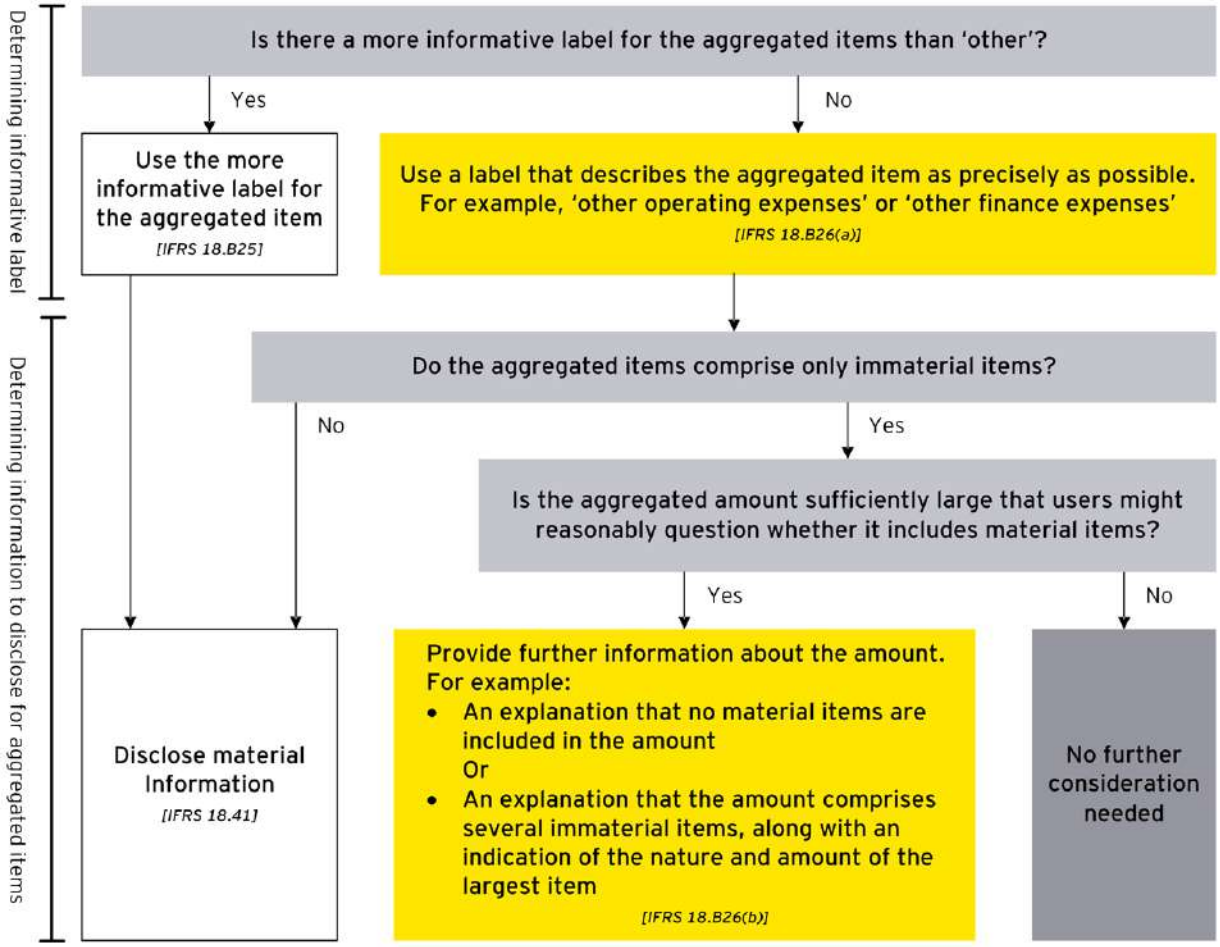
An entity in such a situation is required to disclose further information about the amount. Examples of such further information include:

(i) An explanation that no items for which information would be material are included in the aggregated amount.

(ii) An explanation that the aggregated amount comprises several items for which information would not be material, along with an indication of the nature and amount of the largest item.

The following diagram, based on Figure 7 in the Illustrative Examples to IFRS 18, sets out how an entity can navigate the requirements above: *[IFRS 18.IE Figure 7]*

Figure 2-1: Determining informative labels and information for aggregated items



3 Statement of financial performance - IFRS 18

IFRS 18 states that all items of income and expense in a reporting period must be included in the statement of profit or less unless an IFRS accounting standard permits otherwise. *[IFRS 18.46]*. Diversity in reporting had developed under IAS 1 and made it difficult for users to understand the information presented in the statement of profit and loss and compare information between entities. Operating profit, one of the most frequently used measures of performance, has until now not been defined in IFRS accounting standards, which has resulted in entities applying different definitions to the same subtotal. In an effort to eliminate this diversity, the IASB developed new requirements for the structure of the statement of profit and loss, specifically with the goal of increasing the comparability and understandability of the information presented in that primary statement. *[IFRS 18.BC81]*.

To achieve this goal, the standard has added three specified categories to the existing categories of income taxes and discontinued operations: *[IFRS 18.47, IFRS 18.BC82, IFRS 18.BC83]*

Extract from IFRS 18

47 **An entity shall classify income and expenses included in the statement of profit or loss in one of five categories (see paragraph B29):**

- **(a) the operating category (see paragraph 52);**
- **(b) the investing category (see paragraphs 53-58);**
- **(c) the financing category (see paragraphs 59-66);**
- **(d) the income taxes category (see paragraph 67); and**
- **(e) the discontinued operations category (see paragraph 68).**

To support the categories set out above, two additional subtotals are required, being: 1) 'operating profit or loss' and 2) 'profit or loss before financing and income tax'. The first subtotal is intended to give a relevant representation of an entity's operations, while the second is intended to allow users to analyse the performance of an entity before the effect of its financing decisions. These categories and subtotals ought to result in a more standardised statement of profit or loss. *[IFRS 18.69, IFRS 18.BC84]*.

The IASB has developed the requirements based on the needs of users. This means that while terminology might be the same across different primary statements (e.g., the statement of cash flows prepared under IAS 7), the purpose of those primary statements differs and, hence, there is no alignment between the categories. However, despite the lack of alignment, the Board concluded this should not affect presentation as there is no requirement to label the categories in the statement of profit or loss, nor is an entity required to present a subtotal for each category. *[IFRS 18.BC86, IFRS 18.BC87]*.

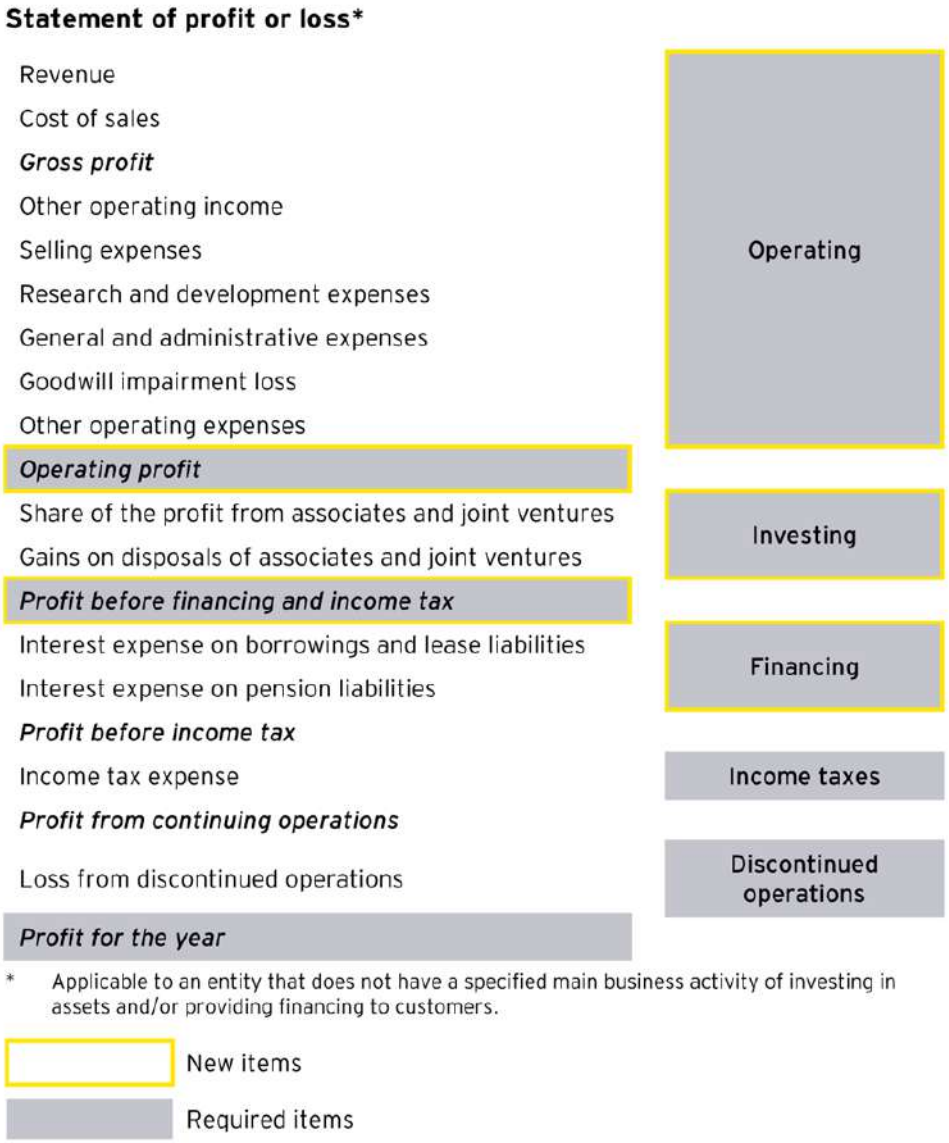
3.1 Overview of the new requirements

Sections 3.1.1 to 3.1.3 below provide a high-level summary of the new requirements and concepts relating to the classification and presentation of income and expenses in the statement of profit or loss. Each of these concepts is discussed in more detail in sections 3.2 to 3.4 below.

3.1.1 Categories and subtotals

An example, based on a presentation by the IASB Staff,[6] of a typical statement of profit or loss (for an entity *without* a specified main business activity) is shown below:

Figure 3-1: Example of presentation of the statement of profit of loss



As illustrated above, IFRS 18 requires all entities to classify their income and expenses included in profit or loss into one of five specified categories *[IFRS 18.47]*:

(a) Investing

The investing category will typically include income and expenses arising from:

- Assets that generate a return individually and largely independently of other resources held by an entity, for example:
  - Rental income from, and remeasurements of, investment property
  - Interest income and fair value changes on financial assets
  - Dividends and fair value changes on financial instrument investments
- Investments in associates, joint ventures and unconsolidated subsidiaries accounted for using the equity method
- Cash and cash equivalents

The requirements related to the investing category are discussed in more detail in section 3.2.1 below.

6 IASB Staff Paper AP1, Project: *Primary Financial Statements*, Topic: *Introduction to IFRS 18* Presentation and Disclosure in Financial Statements, Emerging Economies Group meeting, October 2023. Available on the IFRS Foundation's website.

(b) Financing

The financing category will typically include:

- All income and expenses from transactions that involve only the raising of financing (for example, income and expenses from bank loans)
- Interest expense and the effects of interest rate changes recognised while applying IFRS accounting standards to other liabilities (for example, interest expenses recognised on a lease liability under IFRS 16 *Leases* or the unwinding of discounting on a long-term provision under IAS 37)

Note that, for the type of liabilities mentioned in the second bullet above, only interest income and expense and the effects of interest rate changes are classified in the financing category; all other changes, such as fair value movements, are classified in the operating category.

The requirements for classifying income in the financing category are discussed in more detail in section 3.2.2 below.

(c) Operating

The operating category is a residual category and, therefore, it includes all items not required to be classified in one of the other categories. This was deliberately designed to ensure that all income and expenses arising from an entity's main business activities are included in the operating category.

The operating category will, therefore, typically include all income and expenses:

- Arising from an entity's main business activities
- Not classified in other categories, even if these income and expenses are volatile and unusual

The requirements applicable to this residual category are discussed in more detail in section 3.2.3 below.

(d) Income taxes

The income tax category includes tax expenses and tax income recognised in profit or loss applying IAS 12 *Income Taxes* and any related foreign exchange differences. This category is discussed in section 3.2.4 below.

(e) Discontinued operations

The discontinued operations category is made up of income and expenses from discontinued operations, applying IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. This category is discussed in section 3.2.5 below.

How we see it

All entities will need to carefully reconsider the structure of their statement of profit or loss, in light of the new categories and subtotals required by IFRS 18. Classifying income and expenses into the relevant profit or loss categories might require the use of judgement. Although many entities already present an operating profit or loss subtotal, the classification of income and expenses in this category might not be the same.

Entities also need to consider the broader impact of changing the structure of their statement of profit or loss if, for example, their current subtotals are inputs in determining management incentives, income tax or compliance with covenants.

The requirement to classify all income and expense into one of the five categories above can be difficult for items that might fit into more than one of these categories. Therefore, IFRS 18 provides guidance for classifying some specific types of income and expense.

The most common of these types is likely to be foreign exchange differences. The basic principle is that income and expenses from foreign exchange differences are classified in the same category as the income and expense that give rise to them, unless classifying them into those categories will cause undue cost and effort, in which case they must be classified in the operating category. The detailed requirements for classifying foreign exchange differences, as well the gain or loss on the net monetary position in a hyperinflationary economy, are discussed in section 3.2.7 below.

The standard also provides specific guidance for:

- Changes in classification and derecognition (see section 3.2.6 below)
- Hybrid contracts accounted for under IFRS 9 (see section 3.2.2.C below)

  And
- Gains and losses on derivatives and designated hedging instruments (see section 3.2.8 below)

3.1.2 Requirements for specific entities

The Board identified that if certain entities applied the general requirements outlined above, they would classify income and expenses from their main business activities in categories other than the operating category.

Therefore, the standard introduces the concept of a 'specified main business activity' being:

- Investing in particular types of assets (e.g., investment property companies)

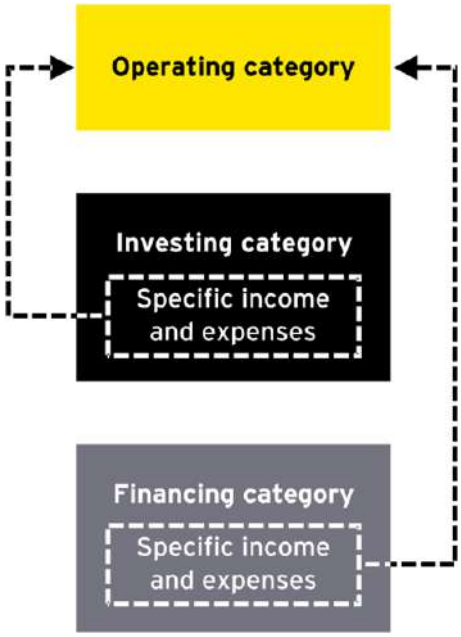
  And/or

- Providing financing to customers (e.g., banks and other lending institutions) *[IFRS 18.49]*

And as an exception to the general requirements, the standard requires entities with a 'specified main business' activity to classify *some* of their income and expenses in the operating category that would otherwise have been included in investing or financing.

This exception to the general requirements is depicted in the following diagram:

Figure 3-2: Classification of income and expenses by entities with a specified main business activity



It is important to stress that these specific requirements only apply to particular income and expenses related to these specified main business activities and, therefore, even these entities will be required to apply the general requirements (which are discussed in section 3.2 below) when classifying the rest of their income and expenses.

An entity could have several main business activities, but in order to determine the appropriate set of classification requirements to apply under IFRS 18, an entity is only required to assess whether it has one (or both) of the two 'specified main business activities' mentioned above. Whether an entity has one, or both, of the specified main business activities is a matter of fact, rather than merely an assertion and may require judgement, based on evidence.

How we see it

The use of 'main' is an important part of the concept of 'specified main business activity' and it is not intended to include minor or ancillary activities. IFRS 18 only provides two examples of evidence indicating an entity has a specified main business activity (see section 3.3.1 below), both of which indicate that it is a reasonably high hurdle to conclude that a particular business activity is a specified 'main' business activity.

IFRS 18 also includes certain exclusions to the financing category that applies to issuers of:

- Insurance contracts in the scope of IFRS 17 *Insurance Contracts*

  And/or

- Investment contracts with participation features in the scope of IFRS 9

Entities with a specified main business activity are discussed in more detail in section 3.3.1 below, the requirements for such entities are discussed in sections 3.3.2 to 3.3.4 below, and the guidance for entities that issue insurance contracts and investment contracts with participation features in the scope of IFRS 9 is discussed in section 3.3.5 and section 3.3.6 respectively below.

In addition, there are detailed requirements for hybrid contracts held by entities with a main business activity of providing financing to customers. These are discussed in section 3.3.3.B below.

3.1.3 Items to be presented in the statement of profit or loss

Like IAS 1, IFRS 18 specifies line items to be presented in the statement of profit or loss, though those line items are no longer described as 'minimum' line items. In addition, IFRS 18 provides guidance to determine when additional line items are required and situations in which the specified line items may not be required.

IFRS 18 also introduces new requirements relating to the presentation of expenses classified in the operating category. Expenses are still presented either by "function" or by "nature", but additional disclosure requirements have been added for entities choosing to present these items by function.

These new requirements are discussed in section 3.4 below.

3.2 General requirements for classification

This section discusses the general requirements for the classification of income and expenses included in the statement of profit or loss, applicable to all entities applying IFRS 18.

Entities with a specified main business activity (see section 3.3.1 below) should also refer to section 3.3 below for the specific requirements applicable to *some* of their income and expenses. There are also specific requirements for entities that issue 1) insurance contracts, and 2) investment contracts with participation features in the scope of IFRS 9, as discussed in sections 3.3.5 and 3.3.6 respectively below.

3.2.1 Investing

Many users analyse returns from an entity's investments separately from its operations. Thus, the introduction of an investing category enables those users to identify returns which are not part of the entity's main business activities. Investments in debt or equity instruments normally generate returns which are specific to that investment, i.e., an individual return, which is largely independent of the entity's other resources. *[IFRS 18.BC105]*.

There is no requirement to insert a heading for the 'investing category' and the standard permits an entity to present additional subtotals within that category, if this contributes to a useful structured summary. *[IFRS 18.BC120]*.

How we see it

We believe that the ability to present additional subtotals within the investing category will enable entities to communicate information which reflects the relevance of different investments to their business and thus contribute to providing a useful structured summary.

The investing category will include specified income and expenses from the following investments: *[IFRS 18.53, IFRS 18.BC103]*

Extract from IFRS 18

53 **Except as required by paragraphs 55-58 for an entity that has a specified main business activity, an entity shall classify in the investing category income and expenses specified in paragraph 54 from:**

- **(a) investments in associates, joint ventures and unconsolidated subsidiaries (see paragraphs B43-B44);**
- **(b) cash and cash equivalents; and**
- **(c) other assets if they generate a return individually and largely independently of the entity's other resources (see paragraphs B45-B49).**

The specified income and expenses arising from the investments listed above, which are required to be classified as investing, are as follows: *[IFRS 18.54, IFRS 18.BC106]*

- Income generated by those assets, e.g., interest revenue from debt investments, dividend income from equity instruments, rental income and remeasurements of investment properties.
- Income and expense that arise from the initial and subsequent measurement of the assets, e.g., impairment losses and reversals.
- Incremental expenses directly attributable to the acquisition and disposal of the assets, e.g., transaction costs and costs to sell the assets - see section 3.2.1.B below.

The standard provides examples of what is meant by assets which generate a return individually and largely independently of the entity's other resources and the types of income and expense which could arise: *[IFRS 18.B46, IFRS 18.B47]*

- Debt or equity instruments, generating interest income or dividends
- Investment properties, generating rental income, depreciation, impairment losses and reversals, fair value gains and losses and income and expenses from derecognition or classification and measurement as held for sale
- Receivables for rent generated by those investment properties

To further clarify, the standard provides examples of assets that are typically used in combination to produce or supply goods or services, and which, therefore, do *not* generate returns individually or largely independently of the entity's other resources. Such assets include but are not limited to: *[IFRS 18.B48]*

- Property, plant and equipment
- Assets such as receivables, which arise from the production or supply of goods and services and for which the income and expenses are classified in the operating category
- Loans to customers, when the entity provides financing to customers

Explanatory examples are given of the types of income and expenses that could arise from the above assets, and which would *not* be classified in the investing category: *[IFRS 18.B49]*

- Revenue for goods and services produced or supplied using a combination of assets
- Interest income
- Depreciation and amortisation
- Impairment losses and reversals thereof
- Income and expenses from the derecognition of the asset
- Income and expenses from an asset's classification and measurement as held for sale
- Income and expenses arising on a business combination that includes assets, which will give rise to income and expenses that will be classified in the operating category, such as:
  - Gain on a bargain purchase
  - Remeasurements of contingent consideration

Business combinations represent the underlying assets acquired and liabilities assumed and thus the returns from a business combination (for example, the gain on a bargain purchase) are not individual or largely independent of the entity's other resources. *[IFRS 18.BC144]*.

3.2.1.A Equity method investees

All entities, irrespective of whether they invest in assets as a main business activity or not, are required to classify their share of profit or loss and other income and expenses (e.g., an impairment loss) arising from an equity accounted investment in associates, joint ventures or unconsolidated subsidiaries in the investing category. *[IFRS 18.53(a), IFRS 18.55(a), IFRS18.BC110]*.

This requirement reflects the fact that, for both an entity that invests in assets and one that does not, the entity does not control the activities of its associates and joint ventures. Many users analyse equity method accounted income and expenses separately, therefore, classifying them in the operating category would disrupt analyses of both operating margin and the investments themselves. By classifying all such expenses in the investing category, a consistent starting point for analyses of the investments will be achieved, which better aligns with how users are known to approach those analyses, according to the Board. *[IFRS 18.BC111, IFRS 18.BC114, IFRS 18.BC115, IFRS 18.BC121]*.

The Board noted that this approach reflects the fact that returns of equity accounted investments are not closely related to an entity's main business activities and are instead generated individually and largely independently of its other resources. This is consistent with the principle for classification in the investing category and simplifies the structure of the statement of profit and loss. *[IFRS 18.BC119]*.

As the standard does not specify the location of the equity accounted investments line item within the investing category, it will be possible for entities to present this as the first line after operating profit subtotal and insert an additional subtotal for operating profit and income and expenses from equity accounted investments. Equally, an entity might decide to disaggregate its income and expenses from equity accounted investments into more than one line item within the investing category, based on investments with similar or dissimilar characteristics (see section 2.2.2 above). If an entity followed the latter route, it might present an additional subtotal. *[IFRS 18.BC120]*.

How we see it

The requirement to classify income and expenses from equity accounted investments in the investing category will represent a change for those entities who currently classify income and expenses from such investments above operating profit. However, such entities will be able to present an additional subtotal (within the investing category) for operating profit and income and expenses from investments from equity accounted investments if such a presentation contributes to providing a useful structure summary of the performance of the entity.

In their separate financial statements, some parent entities account for their investments in subsidiaries using the equity method, as permitted by IAS 27 *Separate Financial Statements*. As explained above, such entities are required to classify those equity accounted investments in the investing category.
This approach is consistent with the Board's approach for equity accounted investments relating to associates and joint ventures, and reflects the fact that users typically analyse such investments separately. *[IFRS 18.BC129]*.

Income and expenses from investments in associates, joint ventures and unconsolidated subsidiaries that are not accounted for using the equity method are also classified in the investing category.[7] *[IFRS 18.53(a)]*.

3.2.1.B Classification of incremental expenses

Incremental expenses related only to the acquisition and disposal of the investments (specified in IFRS 18.53 - see section 3.2.1 above) are required to be classified in the investing category. *[IFRS 18.54, IFRS 18.BC106]*. Without this requirement, costs such as directly attributable transaction costs, which are recognised as an expense immediately, would have been classified in the operating category. *[IFRS 18.BC107]*.

Such costs are typically easily identifiable external costs, therefore, the requirement is expected to lead to consistent classification and, as such, more useful information for users. Note that not *all* expenses or incremental expenses relating to such investments are required to be classified in the investing category. Therefore, the Board's chosen approach avoids the more complex allocations of costs across categories. *[IFRS 18.BC108, IFRS 18.BC109]*.

How we see it

Currently, there is mixed practice for the classification of incremental expenses related to the acquisition and disposal of investments. The requirement to classify such expenses in the investing category will lead to a change in practice for those entities that currently classify such expenses above the operating profit line.

3.2.1.C Cash and cash equivalents

To make the structure of the statement of profit and loss easier to understand, and because cash and cash equivalents are assets which generate returns individually and largely independently of an entity's other resources, income and expenses from cash and cash equivalents are classified in the investing category.[8] *[IFRS 18.53(b), IFRS 18.BC135]*.

7 There are specific requirements for entities with a main business activity of investing in assets, as discussed in section 3.3.2.A below.

8 There are specific requirements for entities with a main business activity of investing in certain financial assets, as discussed in section 3.3.4 below.

3.2.1.D Profit or loss before financing and income tax subtotal

'Profit or loss before financing and income tax' is introduced by IFRS 18 and comprises operating profit and loss and all income and expenses classified in the investing category. *[IFRS 18.71]*. Its role is to facilitate an analysis of an entity's performance, independently of how it is financed and to improve comparability between entities. *[IFRS 18.BC148]*.

Note that even if the 'profit or loss before financing and income tax' subtotal is the same as the 'operating profit' subtotal, both must still be presented; the main reason for this is to facilitate digital reporting. *[IFRS 18.BC152]*.

3.2.2 Financing

In order to determine what income and expenses to classify in the financing category, IFRS 18 requires an entity to differentiate between two types of liabilities: *[IFRS 18.59]*

Extract from IFRS 18	
59	**To determine what income and expenses to classify in the financing category, an entity shall distinguish between:** **(a) liabilities that arise from transactions that involve only the raising of finance (see paragraphs B50-B51); and** **(b) liabilities other than those described in (a) - that is, liabilities that arise from transactions that do not involve only the raising of finance (see paragraph B53).**

To distinguish between the two types, we have labelled them and will use these labels throughout the discussion:

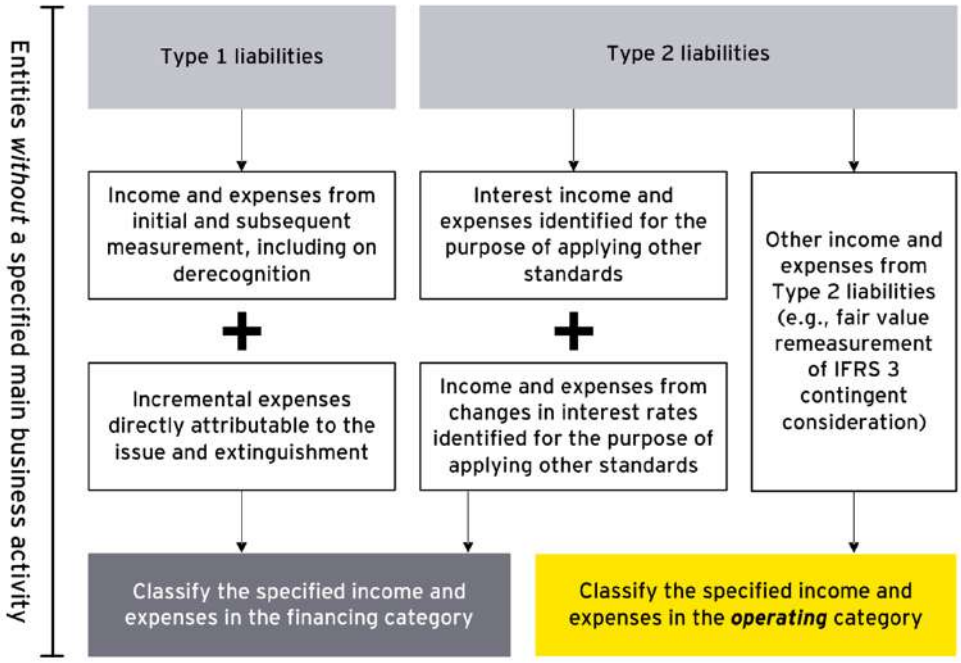
1) ***Type 1***: Liabilities that arise from transactions that involve only the raising of finance (see section 3.2.2.A below)

   And

2) ***Type 2***: Other liabilities (i.e., liabilities other than those in 1) above see section 3.2.2.B below)

The following diagram summarises the requirements for Type 1 and Type 2 liabilities: *[IFRS 18.60, IFRS 18.61]*

Figure 3-3: Classification of income and expense in the financing category



There are specific requirements relating to income and expenses from hybrid contracts, accounted for under IFRS 9, containing a host that is a liability, *[IFRS 18.62]*, and gains on losses on derivatives and designated hedging instruments, *[IFRS 18.63]*, which are dealt with in sections 3.2.2.C and 3.2.8 respectively below

3.2.2.A Type 1 liabilities

IFRS 18 describes liabilities that arise from transactions that involve only the raising of finance (i.e., Type 1 liabilities), as follows: *[IFRS 18.B50]*

Extract from IFRS 18

B50 Paragraph 59(a) requires an entity to identify liabilities that arise from transactions that involve only the raising of finance. In such transactions, an entity:

(a) receives finance in the form of cash, or an extinguishment of a financial liability, or receipt of the entity's own equity instruments; and

(b) at a later date, will return in exchange cash or its own equity instruments.

The standard also provides a non-exhaustive list of examples of Type 1 liabilities: *[IFRS 18.B51]*

- A debt instrument that will be settled in cash, such as debentures, loans, notes, corporate bonds and mortgages
- A liability under a supplier finance arrangement when the payable is derecognised
- A bond settled through delivery of the entity's own shares
- An obligation for an entity to purchase its own equity instruments

Income and expenses arising from the initial recognition and subsequent measurement, including derecognition, of Type 1 liabilities are required to be classified in the financing category. For example: *[IFRS 18.B52]*

- Interest expense on a debt instrument issued
- Remeasurements recognised on the extinguishment of a debt instrument
- Fair value gains and losses on a liability designated at fair value through profit or loss
- Dividends on issued shares classified as liabilities

Incremental expenses directly attributable to the issue and extinguishment of such liabilities, for example transaction costs, are also required to be classified in the financing category. *[IFRS 18.60, IFRS 18.BC161]*. This will provide consistency in classification; without this requirement, transaction costs on a financial liability at amortised cost would have been capitalised and subsequently amortised to the financing category, whereas transaction costs on liabilities at fair value through profit or loss would have been expensed immediately and classified in the operating category. *[IFRS 18.BC162]*. This approach is in line with the approach to classifying similar expenses from assets in the investing category and, as these costs are typically external, they are expected to be readily identifiable. *[IFRS 18.BC163]*.

3.2.2.B Type 2 liabilities

The classification requirements for Type 2 liabilities reflect the Board's broader approach to classification; some users consider certain types of income and expenses on other specified liabilities to be similar in nature to income and expenses from financing activities. *[IFRS 18.BC154, IFRS 18.BC155]*. The standard provides the following examples of Type 2 liabilities: *[IFRS 18.B53, IFRS 18.BC159]*

- Payables for goods and services with extended payment terms
- Contract liabilities
- Lease liabilities
- Defined benefit liabilities
- Decommissioning liabilities
- Provisions for litigation

For Type 2 liabilities, interest income and expenses, including any income and expenses arising from changes in interest rates will be classified within financing if they arise as a result of applying other IFRS accounting standards. *[IFRS 18.61]*. The latter part of this requirement is important, as not all IFRS accounting standards require an entity to disaggregate income and expenses arising from changes in the carrying amount into separate amounts for interest income and expenses and other types of income and expenses - IFRS 2 *Share-based Payments* is an example of such a standard. *[IFRS 18.BC167]*. An entity would therefore recognise in the financing category the interest expenses on Type 2 liabilities including: *[IFRS 18.B54, IFRS 18.BC164]*

- Payables recognised under IFRS 9
- Contract liabilities with a significant financing component, recognised under IFRS 15 *Revenue from Contracts with Customers*
- Lease liabilities recognised under IFRS 16
- Net interest expense (or income) on a net defined benefit liability (or asset) recognised under IAS 19 *Employee Benefits*
- Unwinding of a discount on a provision recognised under IAS 37

Taking a long-term provision as an example, an entity could recognise three types of changes to the provision: *[IFRS 18.BC165]*

1) Periodic unwinding of the discount
2) Effects of changes in the discount rate
3) Effects of changes in the best estimate of the expenditure required to settle the liability

Only the first two would be classified in the financing category, because they are financing in nature. *[IFRS 18.BC166]*.

How we see it

Under IAS 1, practice is somewhat mixed with respect to presentation of the different types of changes in provisions. Thus, the prescriptiveness of IFRS 18 will assist comparability between entities.

For the avoidance of doubt, the standard outlines income and expenses that are not *interest* income or expenses arising as a result of applying IFRS accounting standards and that will therefore be classified in the operating category, for example: *[IFRS 18.B55]*

- Expenses recognised for the consumption of purchased goods or services
- Current and past service costs from a defined benefit plan

  And
- Fair value remeasurements of a contingent consideration liability recognised applying IFRS 3 *Business Combinations*

3.2.2.C Hybrid contracts containing a host liability

Some contracts in the scope of IFRS 9 are hybrid contracts containing a liability and an embedded derivative, for example, a bank loan with a prepayment option. *[IFRS 18.BC169]*. Classification of income and expenses of a hybrid contract with a host liability will depend on whether the embedded derivative is separated from the host contract. *[IFRS 18.B56]*.

Host and embedded derivative are separated

If separated, income and expenses arising from the host liability will be classified in accordance with the requirements for classifying a similar liability that is not a host in a hybrid contract. In other words, an entity will follow the guidance outlined in section 3.2.2 above, i.e., assess whether it is a Type 1 or Type 2 liability and follow the appropriate guidance.[9] *[IFRS 18.B56(aXi), IFRS 18.BC171(a)]*.

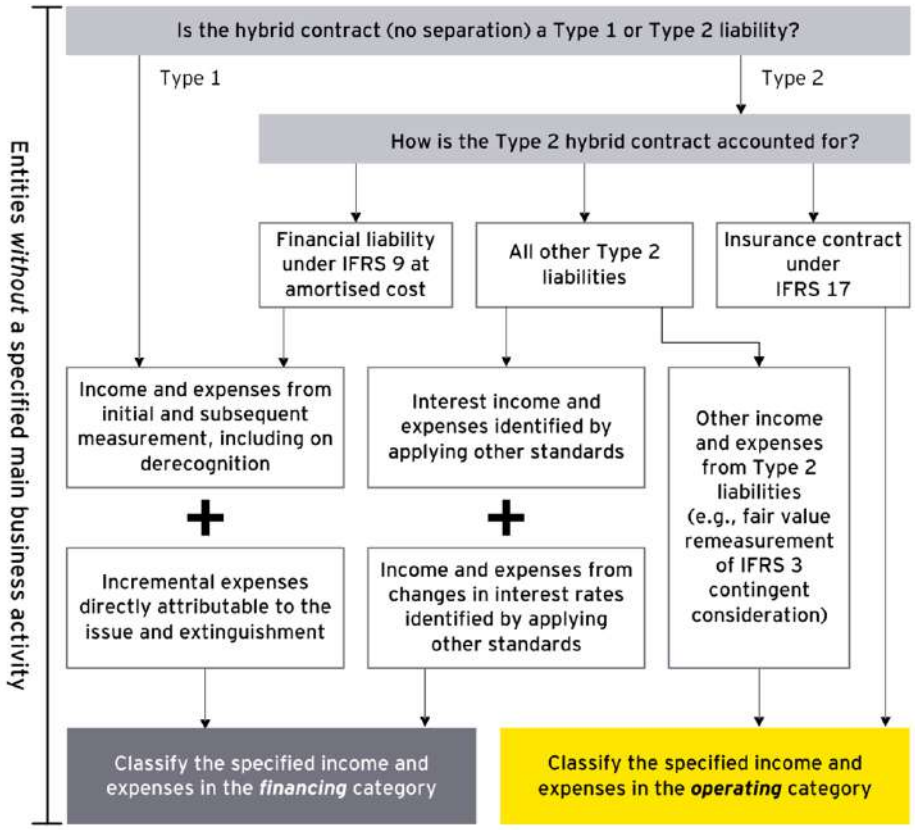
The separated embedded derivative is classified in accordance with the requirements for similar stand-alone derivatives, which are addressed in section 3.2.8 below. *[IFRS 18.B56(aXii), IFRS 18.BC171(b)]*.

9 There are specific requirements for entities with a main business activity of providing financing to customers, as discussed in section 3.3.3.B below.

Embedded derivative is *not* separated

The following diagram summarises the requirements for hybrid contracts where the embedded derivative is not separated: *[IFRS 18.B56]*

Figure 3-4: Classification for hybrid contracts (no separation)



For a hybrid contract (no separation) which is a Type 1 liability, the entity classifies all income and expenses resulting from the liability in the financing category. *[IFRS 18.B56(b), IFRS 18.BC173(a)]*.

For a hybrid contract (no separation) which is a Type 2 liability, the following applies: *[IFRS 18.B56(c)(i), IFRS 18.B56(c)(ii), IFRS 18.B56(c)(iii), IFRS 18.BC173, IFRS 18.BC174]*

- For a hybrid contract with a host liability accounted for under IFRS 9 and measured at amortised cost, all income and expenses arising from the hybrid contract will be classified in the financing category. *[IFRS 18.BC175, IFRS 18.BC176]*.
- For a hybrid insurance contract in the scope of IFRS 17, insurance finance income and expenses will be classified in the operating category. *[IFRS 18.BC179(b)]*.
- For all other hybrid contracts, interest income and expenses and income and expense from interest rate changes identified for the purposes of applying other IFRS accounting standards, will be classified in the financing category. If the income and expenses are not interest income and expenses, they will be classified as operating.

Note that the means of assessing whether the contract is hybrid is not relevant, so this guidance must be followed for all hybrid contracts in which the embedded derivative is not separated, irrespective of whether that contract met the requirements of IFRS 9.4.3.3. Hybrid contracts that arise from transactions combining financing with another activity may be designated at fair value through profit or loss as an entire contract under IFRS 9.4.3.5. Generally, income and expenses on these types of hybrid contracts are classified in the operating category because the interest expense is not separately recognised from changes in fair value for the purposes of applying other IFRS accounting standards. *[IFRS 18.B57, IFRS 18.BC178]*.

3.2.3 Operating

IFRS 18 sets out the operating category as the category that contains all items which are not classified in either the investing, financing, income taxes or discontinued categories. *[IFRS 18.52]*. In other words, it positions the operating category as a default, or residual category, which ensures that all items from an entity's main business activities will be classified in operating. However, as the residual category, the operating category is not confined to items from the entity's main business activities and will include other items that are not classified within the other four categories. This reflects the Board's view that all income and expenses included in profit and loss, which do not relate to another category, arise from an entity's operations. Thus, an entity's operations are not limited to its main business activities, but also include its supporting activities, which could give rise to income and expenses, though those activities do not generate revenue directly. *[IFRS 18.BC89]*.

This concept extends to volatile, unusual or non-recurring items, and thus such items are included in the operating category. There is acknowledgement that the inclusion of such items might not have predictive value, but the latter is not a characteristic which determines classification. An entity's operations may well be volatile and, therefore, volatile items of income and expense must be included in operating. Moreover, to achieve a faithful representation of the entity's operations for a given period, it is necessary to include such expenses. For example, impairment expenses as well as depreciation expenses relating to an item of equipment are classified in operating to give a complete picture of the results from the operations for the period. Omitting either of those expenses would not depict the operating decisions to buy and deploy the equipment, nor how those decisions had given rise to income and expenses. *[IFRS 18.BC89]*.

This approach was intended to work for different business models, while still providing a complete picture of the entity's operations. By applying the residual approach, the operating category will include all income and expenses from an entity's main business activities. The only exception is that any income or loss from investments accounted for using the equity method will be included in the investing category as discussed in section 3.2.1.A above. *[IFRS 18.B42]*.

How we see it

We believe that the use of the operating category as the 'default' category, thereby ensuring that all income and expenses from an entity's main business activities, whether volatile or not, are presented in the same category, will facilitate comparability between entities.

The standard clarifies that Income and expenses that are classified in the income taxes or discontinued operations categories are not subject to the requirements for classifying items in the operating, investing or financing categories. *[IFRS 18.B29]*.

3.2.3.A 'Operating profit or loss' subtotal

The standard specifies that an entity shall present a subtotal representing operating profit or loss, which comprises all income and expenses classified in the operating category. *[IFRS 18.69(a), IFRS 18.70]*. This has been introduced to provide useful information to users, to reduce diversity in reporting and to enhance comparability. *[IFRS 18.BC88]*.

Consistency is a key goal of the new requirement and there are other mechanisms which can be used to provide additional information about aspects of financial performance: presentation of additional line items or subtotals, further disaggregation and the presentation of management-defined performance measures (MPMs - see section 4 below). For example, the presentation of an MPM showing operating profit excluding expenses regarded as non-recurring or unusual could be disclosed. *[IFRS 18.BC93]*.

As noted in section 3.2.3 above, the operating category is a default category, therefore, 'operating profit' itself is not directly defined, as it would be near impossible to develop a direct definition that was appropriate for all entities and could be applied consistently. Moreover, applying a direct definition would inevitably require significant judgement and could result in inconsistent application, for example, an entity using a function of expense method might exclude from the operating category an operating expense that is not allocated to a function line item. By defining what is to be classified in the investing and financing categories, the Board believes that the application of judgement with respect to the operating category will be reduced and, therefore, more consistent application will be achieved. *[IFRS 18.BC89, IFRS 18.BC91]*.

The Board considered how this requirement would relate to entities with a specified main business activity of investing in assets or providing financing to customers (see section 3.3.1 below). Without the specific requirements relating to classification for entities with specified main business activities, those entities would be prevented from presenting key measures of performance in the operating category. As explained in section 3.3.1 below, this resulted in the requirement for such entities to classify some income and expenses in operating category instead of investing or financing. It is important to note that the reverse does not apply. An entity cannot exclude income and expenses from its operating category, based on whether those income and expenses arise from its main business activities. *[IFRS 18.BC90]*.

Currently, many entities already present an operating profit measure, but the content of operating profit measures can vary quite significantly across entities, and these are often not comparable from one entity to the next.

How we see it

Although many entities already present an operating profit or loss subtotal, it cannot be presumed that the classification of income and expenses to the operating category will not change. For example, many entities currently present 'share of the profit or loss of associates and joint ventures accounted for using the equity method' in the operating category, which is not permissible under IFRS 18.

3.2.4 Income taxes

An entity is required to classify in the income taxes category tax expense or tax income that are included in the statement of profit or loss applying IAS 12, and any related foreign exchange differences. *[IFRS 18.67]*. The Board clarified that the presentation of income and expenses related to income tax in that category complies with the presentation requirements of IAS 12. Although this category does not result in a required subtotal, generally entities present profit before income taxes as a subtotal when it is applicable. *[IFRS 18.BC83]*.

3.2.5 Discontinued operations

An entity is required to classify in the discontinued operations category income and expenses from discontinued operations as required by IFRS 5. *[IFRS 18.68]*. The Board clarified that the presentation of income and expenses related to discontinued operations in that category complies with the presentation requirements of IFRS 5. Although this category does not result in a required subtotal, generally entities present profit before discontinued operations as a subtotal when it is applicable. *[IFRS 18.BC83]*.

3.2.6 Changes in classification and derecognition

Some transactions result in a change to the category in which an entity classifies income and expenses. For example, a non-financial asset might be derecognised or classified as held for sale or might be reclassified from one category on the statement of financial position to another. *[IFRS 18.BC201]*.

The question arises as to whether such gains or losses arising from these transactions are classified according to the 'old' or 'new' classification of income and expenses. IFRS 18 specifically requires an entity to classify income and expenses arising in the same way as any other expenses arising from the asset or liability, i.e., in the 'old' way. *[IFRS 18.BC202]*.

For example, a gain or loss on disposal of an item of property, plant and equipment would be classified in the operating category, whereas a gain or loss on the disposal of an investment property[10] or an equity accounted investment would be classified in the investing section. *[IFRS 18.B60]*.

Looking at a different example, assume an entity with an equity accounted associate engages in a step acquisition to obtain a controlling shareholding. Before the execution of the step acquisition, the acquirer will have classified income and expenses from the associate in the investing category. Therefore, on remeasurement of the associate to fair value immediately before the step acquisition, the entity will classify any gain or loss on remeasurement in the investing category, i.e., the 'old' category. *[IFRS 18.BC200, IFRS 18.BC202]*.

10 There are specific requirements for entities with a main business activity of investing in assets, as discussed in section 3.3.2 below.

3.2.6.A Change in use of an asset

Sometimes an entity might reclassify an asset without derecognising it, for example, it might reclassify an item of property, plant and equipment to investment property. In such a case, the entity classifies any income or expenses arising from the accounting for the change in use of the asset in the same category as it classified them immediately before the transfer, so any gain or loss on remeasurement of the item of property, plant and equipment would be classified in the operating category. *[IFRS 18.B62, IFRS 18.BC203]*.

3.2.6.B Derecognition

Liabilities

When derecognising a liability, an entity is required to apply the same classification requirements to classify the income and expense on derecognition as it would when recognising a liability (as discussed in section 3.2.2 above). Therefore, the entity will first need to assess whether it is a Type 1 or Type 2 liability and follow the appropriate guidance.[11] For example, any gain or loss on the prepayment of a Type 1 liability will be classified in the financing category. In contrast, income and expenses from the derecognition of a Type 2 liability such as a payable (for goods received) as part of a supplier finance arrangement and the recognition of a new financial liability will be classified in the operating category. *[IFRS 18.B61]*.

Groups of assets (and liabilities)

A single transaction could result in derecognition, classification as held for sale, or a change in use of a whole group of assets (or a group of assets and liabilities). Income and expenses arising from these assets (or assets and liabilities) might have previously been classified in different categories immediately before the transaction. The standard introduces a 'tainting' concept, whereby the presence in a group of a single asset whose related income and expenses were classified in the operating category would require the income and expenses for the whole of that group to be classified in the operating category. *[IFRS 18.B63]*. Therefore, an entity classifies income and expense from such a transaction:

- In investing, if the group of assets previously generated income and expenses classified only as investing (any income tax assets in the group are disregarded for this purpose)
- In operating for all other groups of assets (or groups of assets and liabilities)

For example, gains or losses recognised on the disposal of a consolidated subsidiary, which has not been classified as a discontinued operation, will be recognised in: *[IFRS 18.B64, IFRS 18.BC204, IFRS 18.BC205, IFRS 18.BC206]*

- *Operating*

  If the subsidiary included assets that generated income and expenses that were previously categorised in the operating category

  But

- *Investing*

  If the subsidiary held only an investment property (and the group did *not* invest in assets as a main business activity as discussed in section 3.3.1 below). This is because the income and expenses arising from that investment property were previously included in the investing category.

Thus, if the subsidiary included both assets that generated operating category income and expenses and an asset that generated only investing category income and expenses, the total gain or loss on disposal would be presented in the operating category.

In any case, foreign exchange differences reclassified from equity as part of the disposal will form part of the gains or losses and, therefore, will also be included in the operating category or investing category respectively - see section 3.2.7 below.

The same principle applies to an impairment loss arising from the classification of a disposal group as held for sale. If the disposal group included assets which generated income classified in the operating category, the impairment loss will also be included in that category. *[IFRS 18.B64]*.

11 There are specific requirements for entities with a main business activity of providing financing to customers, as discussed in section 3.3.3.D below.

3.2.7 Foreign exchange differences and the gain or loss on the net monetary position

The basic principle for classifying foreign exchange differences is that they follow the category in which the related income and expenses have been classified, unless doing so would involve undue cost or effort. If the latter is the case, all such differences are classified in the operating category. *[IFRS 18.B65, IFRS 18.B68, IFRS 18.BC207, IFRS 18.BC208]*. For example, foreign exchange differences on a trade receivable denominated in a foreign currency will be classified in the operating category, whereas foreign exchange differences arising from a debt instrument liability (that will be settled in cash) denominated in a foreign currency will be classified in the financing category.[12] *[IFRS 18.B66]*.

In formulating this requirement, the Board considered that requiring the foreign exchange differences to be classified in the same category as the income or expense that gave rise to them contributes to a faithful representation of the business activities, as it provides a complete picture of the performance of an entity's main business activities. At the same time, the Board acknowledged that this could impose large implementation costs on preparers, as many systems are currently configured to capture all foreign exchange differences in aggregate as a single amount. *[IFRS 18.BC209, IFRS 18.BC210, IFRS 18.BC211]*. To address this, the Board introduced an exemption based on undue cost or effort for each item giving rise to foreign exchange differences. The exemption, requiring those differences to be classified in operating, is only applicable to the subset of differences that cannot be classified without undue cost or effort. *[IFRS 18.BC212]*.

The assessment of whether classifying foreign exchange differences involves undue cost and effort is performed for each item giving rise to foreign exchange differences and is specific to the facts and circumstances of each case. Nonetheless, if the same facts and circumstances relate to a number of items, the same assessment can be applied. *[IFRS 18.B68]*.

The Board acknowledged that the requirement to classify foreign exchange differences in the operating category under the undue cost and effort exemption is not a perfect solution, as it might cause other categories to be incomplete. However, it is consistent with the Board's view of the operating category as a default category and ensures that operating profit is complete, thus enhancing the usefulness of the operating profit subtotal as a measure of performance. *[IFRS 18.BC214, IFRS 18.BC215]*.

How we see it

The undue cost and effort exemption, resulting in the classification of particular foreign exchange differences in the operating category, is a pragmatic solution which could involve significant judgement.

In some cases, income and expenses from a Type 2 liability might be classified in two different categories, as the transactions involve financing and another activity, for example, purchased services denominated in a foreign currency with extended credit terms, could give rise to an operating expense for the purchase of the services and a financing expense for the interest on the payable. In this instance, judgement is required to determine to which of the two amounts the foreign exchange difference relates. The foreign exchange gain or loss will then be allocated in its entirety to the relevant category. Note that disaggregation of the foreign exchange difference arising on a Type 2 liability into more than one category is prohibited. Therefore, the judgement is made about the difference as a whole. It is made on a case-by-case basis and there is no requirement to classify in the same category differences on all Type 2 liabilities, but differences arising on liabilities of a similar nature must be classified in the same category. *[IFRS 18.B67, IFRS 18.BC217, IFRS 18.BC218, IFRS 18.BC219]*.

3.2.7.A Gains or losses on the net monetary position in a hyperinflationary economy

In a hyperinflationary economy, an entity might recognise a gain or a loss on the net monetary position, representing the excess of monetary assets over monetary liabilities and vice versa. IAS 29 *Financial Reporting in Hyperinflationary Economies* suggests that the gain or loss on the net monetary position might be presented with other related items such as interest income and expense and foreign exchange gains or losses. If the entity does not present the gain or loss on the net monetary position with the associated income and expense, it is required to classify the gain or loss in the operating category as it will not, in its totality, meet the requirements to be classified in the investing or financing categories. This is consistent with the use of the operating category as a default category. *[IFRS 18.B69, IFRS 18.BC220, IFRS 18.BC221]*.

12 There are specific requirements for entities with a main business activity of providing financing to customers, as discussed in section 3.3.3.E below.

3.2.8 Gains and losses on derivatives and designated hedging instruments

Specific requirements are set out for the classification of gains and losses on financial instruments designated as hedging instruments. The same requirements apply to gains and losses on a derivative that is not designated as a hedging instrument, but is used to manage identified risks. The basic principle is that all gains and losses must be classified in the same category as the income and expenses (or assets or liabilities) affected by the risk the financial instrument is used to manage. However, in the event this would lead to the grossing up of gains and losses, all gains and losses on the hedging instrument or derivative must be classified in the operating category. *[IFRS 18.B70, IFRS 18.B72, IFRS 18.BC223]*. Thus, the gains and losses are classified as follows: *[IFRS 18.BC224]*

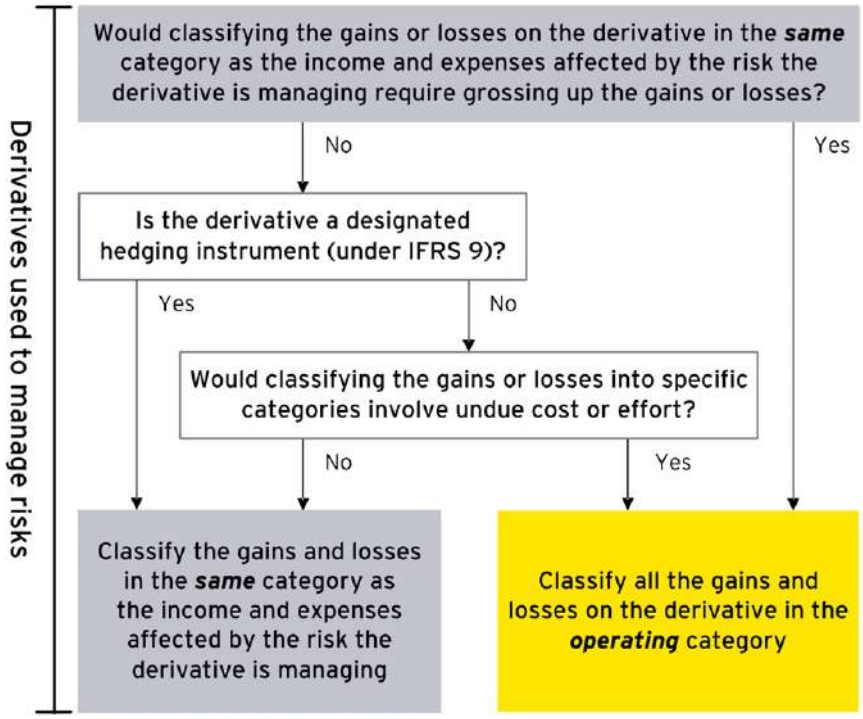
- ***Financial instruments designated as hedging instruments:***

  To the extent the derivative is recognised in the statement of profit or loss, the gains and losses are classified in the same category as the income and expenses exposed to the risks that the derivative is covering, unless this would require grossing up of those gains and losses. If the latter is the case, an entity will classify all gains and losses on the derivative in the operating category.
- ***Derivatives not designated as hedging instruments, but used to manage exposure to identified risks:***

  The gains and losses are classified in the same category as the income and expenses affected by the risks that the derivative is managing, unless this would require either undue cost or effort, or the grossing up of the gains and losses. If one of the latter two is applicable, an entity will classify all gains and losses on the derivative in the operating category.

The following diagram, based on Figure 5 in the Illustrative Examples to IFRS 18, summarises these requirements and the classification for each type is further discussed in section 3.2.8.A and section 3.2.8.B below. *[IFRS 18.IE Figure 5]*.

Figure 3-5: Classification of gains and losses on derivatives used to manage risks



Any gains or losses arising on an undesignated component of a designated hedging instrument, will be classified in the same category as those arising on the designated component. Similarly, the ineffective portion of a gain or loss must be classified in the same category as the effective portion. *[IFRS 18.B71]*.

The classification of derivatives that are not used to manage identified risk and discussed further in section 3.2.8.D below.

The requirements for derivatives only specify the appropriate category for gains and losses arising on them; they do not override the requirements in other IFRS accounting standards, nor do they specify the line item. As a result, entities will need to consider the aggregation and disaggregation guidance set out in section 2 above. *[IFRS 18.B76]*.

3.2.8.A Gains and losses on designated hedging instruments

Entities with designated hedging instruments will have identified the link between the derivative and the risk being hedged in order to comply with the eligibility criteria in IFRS 9 and for the purposes of creating the hedge documentation. Therefore, providing users with information about the risk management strategy via classifying the gains and losses on both the derivative and the income and expenses arising from the hedged risk in the same category is expected to provide useful information. *[IFRS 18.BC225]*.

However, if the hedged items are classified in more than one category, with offsetting risk positions, the entity would need to gross up the gains and losses on the hedging instrument to classify them in the relevant categories. Nevertheless, this presentation is not permitted by IFRS 9, as all gains and losses from a single hedging instrument must be presented in a separate line item, to avoid an artificial gross up. Consequently, IFRS 18 requires such gains or losses to be classified in the operating category to avoid a gross up. *[IFRS 18.BC226]*.

The type of situation in which grossing up might occur is when an entity uses a derivative for a dual purpose, for example, to hedge net foreign currency risk on revenue (classified in operating) and interest expenses (classified in financing). Presenting the gain or loss on the derivative in each category would require a larger gain or loss to be presented in each category than actually arose on the derivative in order to arrive at the net position. Thus, this is prohibited and the whole gain or loss is presented in the operating category. *[IFRS 18.B74, IFRS 18.B75]*.

3.2.8.B Gains and losses on other derivatives used to manage exposure to identified risks

As many entities use derivatives to manage risk without designating them as hedging instruments under the IFRS 9 hedge accounting rules, it is expected that those entities will be monitoring whether the derivatives actually mitigate the identified risk. As a result, the entity is expected to have the information necessary to determine the link between the derivative and the risk it manages, therefore, classifying the gains and losses in the same way as for designated hedging instruments will provide useful information. However, the Board acknowledges that, in some cases, identifying gains or losses affected by the risk managed could involve undue cost or effort. In such cases, the gains and losses must be classified in the operating category. *[IFRS 18.BC227, IFRS 18.BC228]*.

The prohibition on grossing up gains and losses equally applies to derivatives that are not designated as hedging instruments, but are used to manage identified risks. Therefore, if grossing up were needed to allocate gains and losses into the applicable categories this would not be permitted and the net gains and losses are required to be classified in the operating category. *[IFRS 18.BC230]*.

How we see it

Many entities already present the gains and losses on designated hedging instruments and on those instruments used to manage risk in the manner required by IFRS 18. However, the new prescriptive requirements will require entities who are not currently presenting this information in line with IFRS 18 to change current practice.

3.2.8.C Income and expenses on non-derivative financial instruments used to manage risk, but not designated as hedging instruments

An entity may use a *non-derivative* financial instrument to manage exposure to identified risks, without designating it as a hedging instrument. The IASB considered introducing a similar approach for such instruments to that required for derivative instruments, as described in section 3.2.8.B above, but decided against it as it might be too costly for entities to apply. This is because non-derivative financial instruments are typically held for more than just one purpose. For example, a debt instrument denominated in a foreign currency might be held to provide financing as well as to manage foreign currency risk exposure.

Given the IASB decided against providing specific requirements, an entity classifies the income and expenses on such non-derivative financial instruments in the operating, investing or financing categories, applying the general classification requirements of IFRS 18. *[IFRS 18.BC229]*.

3.2.8.D Income and expenses arising on derivatives not used to manage exposure to identified risks

The classification of derivatives that are *not* used to manage identified risk depends on whether they relate to transactions that involve only the raising of financing. Therefore, if a derivative is not used to manage identified risks, and is: *[IFRS 18.B73, IFRS 18.BC232, IFRS 18.BC233, IFRS 18.BC234, IFRS 18.BC235]*

- ***Related to a transaction that involves only the raising of finance***

  Any gains or losses are classified in the financing category[13]
- ***Not related to transactions involving only the raising of finance***

  Any gains or losses are classified in the operating category

3.3 Requirements for specific entities

The Board identified that if certain entities applied the general requirements, they would classify income and expenses from their main business activities in categories other than the operating category. Therefore, as an exception to the general requirements, the standard requires entities with a 'specified main business' activity (see section 3.3.1 below) to classify *some* of their income and expenses in the operating category that would otherwise have been included in investing or financing.

The standard also includes certain exclusions to the financing category that apply to issuers of:

- Insurance contracts in the scope of IFRS 17 (see section 3.3.5 below)

  And/or
- Investment contracts with participation features in the scope of IFRS 9 (see section 3.3.6 below)

It is important to note that these specific requirements only apply to the income and expenses set out in section 3.3.2 to section 3.3.6 below while the rest of an entity's income and expenses are still subject to the general requirements. Therefore, these specific entities will be required to consider both the general requirements (discussed in section 3.2 above) and the relevant specific requirements discussed further in this section.

3.3.1 Entities with specified main business activities

A new concept in IFRS 18 is that of a 'specified main business activity'. When classifying its income and expenses, an entity will be required to assess whether it has a specified main business activity of two types, either:

- Investing in particular types of assets (referred to as 'investing in assets' hereafter)

  Or
- Providing finance to customers

The identification of main business activities is limited to these two types. Therefore, it is not necessary to identify *all* the main business activities the entity engages in; it is only necessary to assess whether it engages in these two types, as there are particular classification requirements for entities with either of those specified main business activities. *[IFRS 18.49]*.

The standard requires certain items of income and expenses arising from an entity's specified main business activity to be classified in the operating category and thus reflect the nature of these operations. Without the concept of a main business activity, such entities would have been required to classify items of income and expenses arising from their day-to-day operations in the investing and financing categories. *[IFRS 18.50]*. This is significant as investment returns are an important indicator of performance for entities whose main business activity is investing in assets. Similarly, for entities who provide financing to customers, the difference between interest revenue and the related interest expense is an important indicator of operating performance. *[IFRS 18.BC94]*.

It is important to note that an entity's operations include, but are not limited to, its main business activities and that an entity could have just one, or more than one main business activity; for example, an entity might manufacture a product and also provide financing to customers to buy that product. Both of these activities might be determined to be main business activities. *[IFRS 18.B30, IFRS 18.BC95]*.

13 There are specific requirements for entities with a main business activity of providing financing to customers, as discussed in section 3.3.3.C below.

IFRS 18 provides examples of the types of entities that might fall into these categories: *[IFRS 18.B31, IFRS 18.B32]*

Extract from IFRS 18

B31 Examples of entities that might invest in assets as a main business activity include:

(a) investment entities as defined by IFRS 10 *Consolidated Financial Statements*;

(b) investment property companies; and

(c) insurers.

B32 Examples of entities that might provide financing to customers as a main business activity include:

(a) banks and other lending institutions;

(b) entities that provide financing to customers to enable those customers to buy the entity's products; and

(c) lessors that provide financing to customers in finance leases.

IFRS 18 is clear that whether an entity invests in assets or provides financing to customers as a main business activity is a matter of fact and not merely an assertion; the entity will use judgement to make its assessment and the latter must be evidence-based. The standard points out that a key determinant of whether an entity has a main business activity of investing in assets or providing financing to customers is whether it uses a subtotal such as gross profit as an important indicator of performance and whether that subtotal would include items that would be classified in investing or financing, were the main business activities not identified as investing in assets, or providing financing to customers. *[IFRS 18.B33, IFRS 18.B34, IFRS 18.BC96]*.

For example, a bank might use net interest income as an important indicator of performance. That subtotal typically includes interest earned from interest-bearing assets such as loans to customers and interest expenses from interest-bearing liabilities such as deposits. Were the bank unable to identify a main business activity of providing financing to customers, it would be required to present the interest expenses in the financing section. This classification would not provide a useful structured summary of the bank's operations.

The standard provides the following examples of the type of evidence which indicates that an entity considers such a subtotal (e.g., gross profit) as an important indicator of performance: *[IFRS 18.B35]*

- The use of the subtotal in external explanations of operating performance, such as investor presentations

  Or

- The use of the subtotal in internal assessment or monitoring

As mentioned above, the subtotal of net interest income is generally monitored or communicated as a measure of operating performance by entities who provide financing to customers as a main business activity. *[IFRS 18.BC96]*.

If an entity applies IFRS 8 *Operating Segments,* it is also relevant to consider its segment information for evidence of whether its main business activities are investing in assets or providing financing to customers:

- If a reportable segment is comprised of a single business activity of investing in assets or providing financing to customers, this indicates that the performance of the reportable segment is an important indicator of the entity's performance. Consequently, the business activity of that reportable segment is a main business activity of the entity. *[IFRS 18.B36, IFRS 18.BC97]*.
- If the performance of a single operating segment is an important indicator of the entity's performance and if the segment comprises a single business activity, this indicates that the activity could be a main business activity. *[IFRS 18.B36]*. For example, when a reportable segment comprises several operating segments and one of the operating segments contains a single main business activity, the entity might determine that business activity included in that reportable segment, relating to the single operating segment, is a main business activity. *[IFRS 18.BC97]*.

IFRS 18 requires an entity to make the assessment of main business activities for the reporting entity as a whole. Thus, it is possible for a reporting entity that is a consolidated group and a reporting entity that is a subsidiary within that group, to have differing conclusions about its main business activities. *[IFRS 18.B37]*. As a result, the classification of income and expenses for the subsidiary could differ from that of the group. This ensures that each reporting entity (consolidated, separate, or individual) appropriately reports its main business activities, notwithstanding that consolidation adjustments might be required as a result, thus incurring additional cost. *[IFRS 18.BC98]*.

The same applies to a parent entity, which may be a holding company, while one of its subsidiaries provides financing to customers; thus, the main business activity for the consolidated financial statements and the parent's separate financial statements could differ. *[IFRS 18.BC99]*.

The assessment of whether an entity invests as a main business activity in other assets that generate a largely independent return must be performed by assessing either an individual asset or a group of assets with shared characteristics (see section 2.2.2 above). When this principle is applied to groups of financial assets, those groups must be consistent with the classes of financial instruments used for disclosure by class under IFRS 7. *[IFRS 18.B40]*.

The assessment mentioned above is carried out at a point in time, based on facts at that time. This means that if, at a later date, there is a different outcome to the assessment, it will be based on new facts at that moment in time. As a result, any change is treated as a prospective adjustment from the date of the reassessment and there is no need to reclassify comparative amounts. However, to provide useful information to a user, disclosure of the amount and classification of items of income and expense immediately before and after the date of change in the current period is required, as well as information about the amount and classification in the prior period. *[IFRS 18.B41]*.

How we see it

Determining whether an entity has a specified main business activity of investing in assets or providing finance is a matter of fact, based on the evidence available, which will require an element of judgement, particularly when it is determined that the entity has more than one business activity.

The requirements of the standard and accompanying guidance suggest that the threshold for identifying a specified main business activity is higher than some might intuitively think. For instance, a manufacturer might identify a significant financing component in its customer contracts (applying IFRS 15) and thus, recognise a material amount as interest revenue. However, unless:

- That entity uses a subtotal, similar to gross profit, to monitor the performance of the financing activity or explain this performance externally

  Or

- The financing activity makes up a reportable segment under IFRS 8

It will not be considered to represent a 'main' business activity in many cases.

3.3.1.A Main business activities disclosures

Entities with a specified main business activity must make certain disclosures to enable users to understand the assessment of their main business activity, as follows: *[IFRS 18.51]*

Extract from IFRS 18

51 If an entity:

(a) invests in assets as a main business activity, it shall disclose that fact.

(b) provides financing to customers as a main business activity, it shall disclose that fact.

(c) identifies a different outcome from its assessment of whether it invests in assets or provides financing to customers as a main business activity (see paragraph B41), it shall disclose:

(i) the fact the outcome of the assessment has changed and the date of the change.

(ii) the amount and classification of items of income and expense before and after the date of the change in the outcome of the assessment in the current period and the amount and classification in the prior period for the items for which the classification has changed because of the changed outcome of the assessment, unless it is impracticable to do so. If an entity does not disclose the information because it is impracticable to do so, the entity shall disclose that fact.

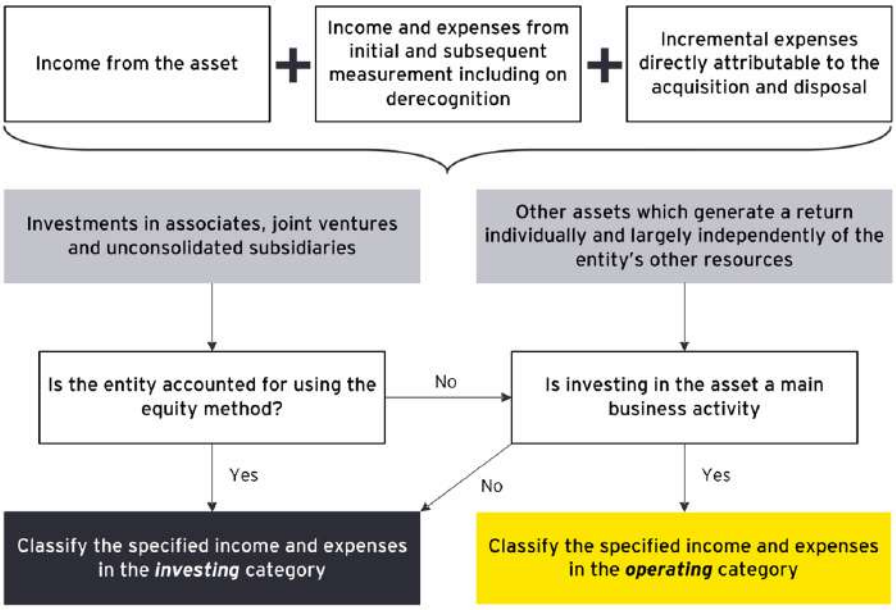
The requirement for entities to disclose whether they invest in assets or provide financing to customers as a main business activity helps users to understand the structure of an entity's statement of financial performance, especially in digital financial reports. To be clear, this disclosure is separate from the requirements to disclose a description of the nature of the entity's operations and its principal activities in IFRS 18.116(b). *[IFRS 18.BC100]*.

As the assessment of an entity's main business activities is a matter of fact, it follows that facts may change, and an assessment performed at the point of the change could lead to a different conclusion. When this is the case, as noted above, an entity will classify and present income and expenses from the change in assessment prospectively and amounts before the change are not reclassified. As this will inevitably cause some disruption to trend analysis, the requirement to disclose the change and information about the effects of the change relating to both the current and prior periods, has been introduced to alleviate the disruption, unless it is impracticable to make the disclosure. *[IFRS 18.BC101, IFRS 18.BC102]*.

3.3.2 Investing in assets

The classification requirements for entities with a specified main business activity of investing in assets are shown in the diagram below, adapted from Figure 3.1 in the Illustrative Examples to IFRS 18. *[IFRS 18.IE Figure 3.1]*.

Figure 3-6: Classification by entities that invest as a main business activity



Some entities, such as investment property companies, have a main business activity of investing in assets. For such entities, classifying rental income and remeasurements of investment property in the investing category would result in the operating profit subtotal excluding these items and would not faithfully represent the results of their operations. *[IFRS 18.BC145]*. The investments held by investment property companies typically generate a return individually and largely independently of the entity's other resources. The standard, therefore, specifies that entities that have a main business activity of investing in assets classify certain items of income and expense (which they would otherwise classify in the investing category) in the operating category, as follows: *[IFRS 18.BC104]*

- Income and expenses from investments in associates, joint ventures and unconsolidated subsidiaries accounted for at fair value through profit or loss or at cost *[IFRS 18.55(b)]*
- Income and expenses from other assets that generate a return individually and largely independently of the entity's other resources, for example, investment properties *[IFRS 18.58]*

  And
- Income and expenses from cash and cash equivalents, for certain entities (see section 3.3.4 below) *[IFRS 18.56(a)]*

The type of income and expenses the standard envisages include rental income, interest, dividends, depreciation, impairment losses and their reversal, fair value gains and losses and income and expenses from the derecognition of the asset or from its classification and remeasurements as held for sale. *[IFRS 18.B47]*.

3.3.2.A Investments in other entities not accounted for applying the equity method

Entities which are assessed as having a specified main business activity of investing in associates, joint ventures and unconsolidated subsidiaries which are not equity accounted, are required to classify specified income and expenses in the operating category, as follows: *[IFRS 18.54, IFRS 18.55(b), IFRS 18.BC106]*

- Income generated by the assets, e.g., interest revenue from debt investments, dividend income from equity instruments
- Income and expense that arise from the initial and subsequent measurement of the assets, e.g., impairment losses and reversals
- Incremental expenses directly attributable to the acquisition and disposal of the assets, e.g., transaction costs and costs to sell the assets - see section 3.2.1.B above

Income and expenses from equity accounted investees are required to be classified in the investing category, therefore, there is no need for an entity to assess whether they constitute a main business activity. *[IFRS 18.55(a), IFRS 18.B38]*. See section 3.2.1.A above for more detail.

For investments in associates and joint ventures which are *not* equity accounted (i.e., those investments accounted for at fair value through profit or loss in accordance with IFRS 9 or accounted for at cost in separate financial statements), the entity must perform the assessment of whether they constitute a main business activity, either by individual asset or by groups of assets with shared characteristics. If the entity prepares separate financial statements and chooses to use groups of assets to perform the assessment, it must group those assets according to the measurement basis it has chosen for accounting for the investments, that is, investments carried at cost or at fair value through profit or loss in accordance with IFRS 9 will be grouped separately. *[IFRS 18.B38, IFRS 18.B43]*.

While not initially obvious, these requirements apply equally to investments in unconsolidated subsidiaries which could comprise: *[IFRS 18.B44]*

1) Those subsidiaries accounted for in separate financial statements using the equity method
2) Investments in subsidiaries held by an investment entity and measured at fair value through profit or loss

   Or
3) Investments in subsidiaries that are accounted for at cost in separate financial statements

3.3.2.B Assets which generate a return individually and largely independently of the entity's other resources

If an entity invests as a main business activity in assets that generate a return (either positive or negative) individually and largely independently of the entity's other resources, it is required to classify the following in the operating category: *[IFRS 18.53(c), IFRS 18.54, IFRS 18.58, IFRS 18.B45]*

Extract from IFRS 18

54 The income and expenses from the assets identified in paragraph 53 that an entity shall classify in the investing category comprise the amounts included in the statement of profit or loss for (see paragraph B47):

(a) the income generated by the assets;

(b) the income and expenses that arise from the initial and subsequent measurement of the assets, including on derecognition of the assets; and

(c) the incremental expenses directly attributable to the acquisition and disposal of the assets-for example, transaction costs and costs to sell the assets.

For example, real estate companies will need to present rental income in the operating category. Assets such as debt and equity instruments can also generate individual and largely independent returns. If the entity invests in such assets as a main business activity, it is required to classify the income and expenses from those assets in the operating category. *[IFRS 18.58]*.

To clarify the concept of individual and largely independent returns, the standard gives examples of certain assets that do not generate individual and largely independent returns. For example, plant and equipment used in a production process usually generates returns in conjunction with other resources. Similarly, a receivable arising from the supply of goods and services generates returns individually but has arisen from the use of other resources or assets. Some assets, such as a disposal group held for sale, might generate returns largely independently of an entity's other resources, but not individually. Income and expenses arising from these examples do not meet the criteria of generating both individual and largely independent returns. *[IFRS 18.BC142]*.

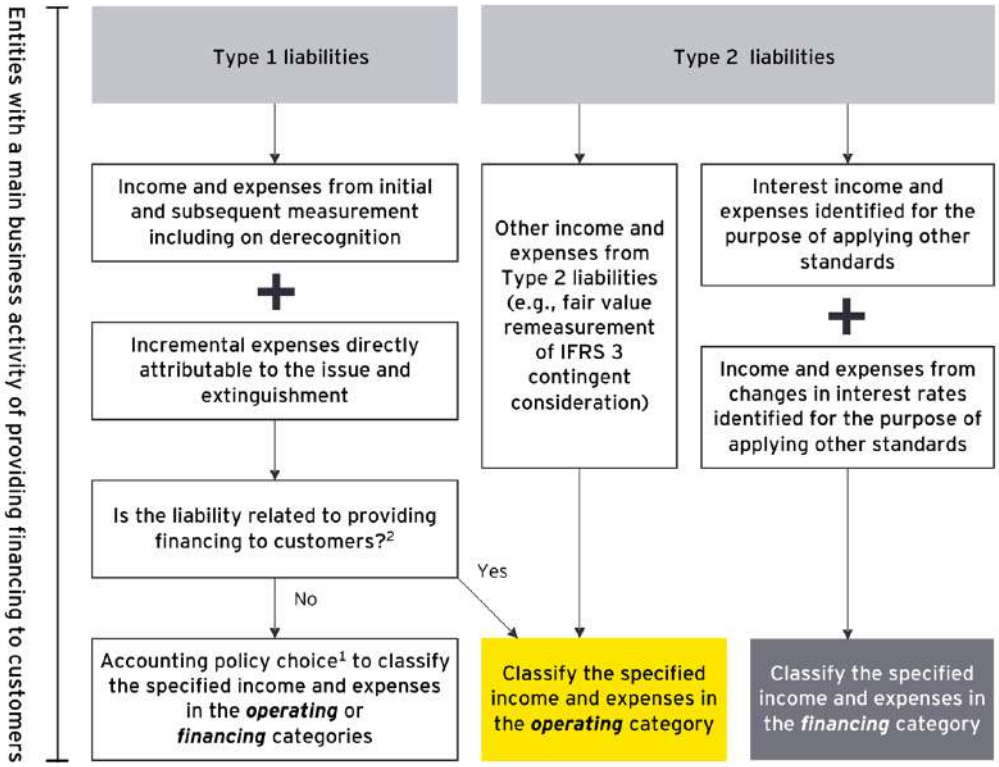
The requirement to classify income and expenses in the operating category is only relevant for assets in which the entity invests as a main business activity. It might have other investments such as financial assets that do not constitute a main business activity, therefore, income and expenses from those investments will be classified in the investing category. *[IFRS 18.BC146]*.

If an entity has a specified main business activity of investing in financial assets that generate a return individually and largely independently of the entity's other resources, it is required to classify the income and expenses from cash and cash equivalents in the operating category (see section 3.3.4 below). *[IFRS 18.56(a)]*.

3.3.3 Providing financing to customers

The following diagram, based on Figure 3.2 in the Illustrative Examples to IFRS 18, summarises the requirements for Type 1 and Type 2 liabilities (see section 3.2.2 above) held by entities with a specified main business activity of providing financing to customers: *[IFRS 18.IE Figure 3.2]*

Figure 3-7: Classification of income and expense related to liabilities of an entity with a specified main business activity of providing financing to customers



1 The choice of accounting policy must be consistent (where applicable) with that made for the classification of income and expenses from cash and cash equivalents (see section 3.3.4 below).

2 If the entity is unable distinguish between its Type 1 liabilities that are related to providing financing to customers and those that are not, it applies the accounting policy and classifies income and expenses from all such liabilities in the operating category.

There are specific requirements for classification of income and expenses for entities which provide financing to customers as a main business activity. Such entities will need to determine which of their Type 1 liabilities (see section 3.2.2.A above) relate to providing financing to customers, since income and expenses arising from Type 1 liabilities that relate to providing financing to customers will be classified in the operating category. *[IFRS 18.65(a)(i)]*. This is because the difference between the interest revenue from that main business activity and the interest expense incurred to finance that activity is an important measure of the entity's operating performance. *[IFRS 18.BC180]*.

For income and expenses from Type 1 liabilities that do not relate to providing financing to customers, entities have an accounting policy choice to classify the income and expenses either in the operating or in the financing category. The choice made must be consistent with the choice made for classifying income and expenses from cash and cash equivalents, addressed in section 3.3.4 below. *[IFRS 18.65(a)(ii)]*. This accounting policy choice arises because it might not be possible for certain entities, for example, those with a central treasury function, to easily distinguish between income and expenses that relate to the provision of finance to customers. *[IFRS 18.BC181, IFRS 18.BC182, IFRS 18.BC183]*.

If an entity cannot distinguish between its Type 1 liabilities that relate to providing financing to customers and those that do not, it is required to classify income and expenses from all such liabilities in the operating category, by effectively applying the accounting policy choice described above. *[IFRS 18.66, IFRS 18.BC184]*.

An entity with a main business activity of providing financing to customers treats Type 2 liabilities (see section 3.2.2.B above) in the same way as an entity without such a main business activity. Therefore, if interest income and expenses are identified for the purposes of applying other IFRS accounting standards or arise from changes in interest rates for the purposes of applying other IFRS accounting standards, entities are required to classify them in the financing category. *[IFRS 18.65(bX(i), IFRS 18.BC187]*. If the income and expenses are not interest income and expenses, they are classified as operating. *[IFRS 18.65(bX(ii)]*.

This could change existing practice for some banks, as those institutions might currently classify interest expenses on leases or defined benefit liabilities in net interest income, but the requirements will ensure consistent presentation for all entities. *[IFRS 18.BC188]*.

How we see it

The policy choices available to entities whose main business activity is providing financing to customers provide a practical option for preparers who are unable to distinguish easily between income and expenses that relate to the provision of finance to customers.

However, the availability of a policy choice is likely to create diversity in practice, which will result in a lack of comparability between entities with similar activities.

The following Illustration is a simple example of the application of the requirements. It shows the appropriate classification of income and expenses arising from a range of liabilities for an entity with a main business activity of providing financing to customers.

Illustration 3-1: Example of classification for an entity with a main business activity of providing financing to customers

Entity A, an automotive retailer, provides financing to customers to enable them to buy Entity A's products, as a main business activity. This is evidenced by the fact that Entity A discloses the gross profit on this activity in its analyst presentations to reflect the performance of the entity as a whole. Entity A borrows from the bank to finance the loans it provides and on-lends to its customers on deferred terms.

Entity A also has the following liabilities:

- Lease liabilities (relating to its showrooms)
- A provision for litigation (which it expects to settle in three years and for which the discounting under IAS 37 is material)
- A separate bank borrowing (to fund a business acquisition it made in the prior year)
- A liability for contingent consideration (as a result of the same business acquisition, payable in two years)

Bank borrowings relate to providing financing to customers

The bank borrowings related to the provision of financing to customers would be classified as a Type 1 liability (since Entity A receives finance in the form of cash and will return cash in exchange at a later date). As Entity A has a main business activity of providing financing to customers, the interest payable on those loans would be classified in the operating category.

Lease liabilities

The lease liabilities are Type 2 liabilities (since Entity A receives a right of use asset, rather than finance in the form of cash or the extinguishment of a liability from these transactions) and it will record interest expense on its lease liabilities as a result of applying IFRS 16. This expense will be classified in the financing category.

Provision for litigation

The litigation provision is a Type 2 liability (since Entity A does not receive finance from this transaction). Entity A has discounted the provision in accordance with IAS 37, therefore, the unwinding of the discount will be classified in the financing category.

Contingent consideration

The contingent consideration liability is a Type 2 liability (since Entity A receives assets and liabilities, not finance from the transaction). The remeasurement of the fair value of the liability is neither 'interest income or expense', nor does it result from a change in interest rates. Therefore, IFRS 18.61 (i.e., the requirement to classify interest income and expenses and/or income and expenses from interest rate changes) is not relevant. This remeasurement will be classified in the operating category.

Bank borrowing for business acquisition

The loan for the business acquisition is a Type 1 liability (since Entity A receives finance in the form of cash and will return cash at a later date in exchange), unrelated to the provision of financing to customers. Therefore, the entity has an accounting policy choice and can classify the income and expenses either in the operating or in the financing category.

3.3.3.A 'Profit or loss before financing and income tax' subtotal

As noted in section 3.2.1.D above, 'profit or loss before financing and income tax' is the second subtotal introduced by IFRS 18 and comprises operating profit and loss and all income and expenses classified in the investing category. *[IFRS 18.71]*. Its role is to facilitate an analysis of an entity's performance, independently of how it is financed and to improve comparability between entities. *[IFRS 18.BC148, IFRS 18.BC149]*.

An entity which provides financing to customers as a main business activity is prohibited from presenting this subtotal if, as an accounting policy choice, it classifies in the operating category all income and expenses from Type 1 liabilities (see section 3.3.3 above) that do not relate to the provision of financing to customers. In other words, this subtotal is not permitted when all income and expenses from liabilities arising from only the raising of finance have been presented in the operating category.

Nonetheless, in these cases, consideration must be given to whether an additional subtotal after the investing category and before the financing category is required to provide a useful structured summary of an entity's income and expenses. If an entity were to present an additional subtotal, it must label the subtotal with a name that accurately describes it, for example, the label 'profit before financing' would be misleading in the case described above, as there could be financing income and expenses included in operating profit, and is consequently prohibited. *[IFRS 18.73, IFRS 18.74, IFRS 18.BC189, IFRS 18.BC190]*.

How we see it

The standard requires precision in the labelling of subtotals and totals, but does not restrict the number of subtotals which can be presented, provided that they contribute to a useful structured summary. Entities need to carefully consider their choice of label for any additional subtotal presented, in order to faithfully represent the items included in that subtotal.

3.3.3.B Hybrid contracts containing a host liability

There are specific requirements for hybrid contracts held by entities with a main business activity of providing financing to customers and classification depends on whether the embedded derivative is separated from the host contract. *[IFRS 18.B56]*.

Embedded derivative is *not* separated

For a hybrid contract (no separation) that is a Type 1 liability and relates to providing financing to customers, an entity with a main business activity of providing financing to customers classifies all such income and expenses in the operating category. *[IFRS 18.B56(b), IFRS 18.BC173]*. If the Type 1 liability does not relate to providing financing to customers, the entity has an accounting policy choice to classify the income and expenses in the operating or in the financing category. *[IFRS 18.B56(b), IFRS 18.65(a)(ii)]*.

Consistent with the treatment by an entity *without* a main business activity of providing financing to customers, for a hybrid contract (no separation) which is a Type 2 liability, the following applies: *[IFRS 18.B56(c)(i), IFRS 18.B56(c)(ii), IFRS 18.B56(c)(iii), IFRS 18.BC173, IFRS 18.BC174]*

- For a hybrid contract (no separation), within the scope of IFRS 9 and measured at amortised cost, the income and expenses arising from initial recognition and subsequent measurement of the liability will be classified in the financing category, as income and expenses from Type 2 liabilities are not eligible to be classified in the operating category.
  [IFRS 18.B59, IFRS 18.BC177].
- For a hybrid insurance contract in the scope of IFRS 17, insurance finance income and expenses will be classified in the operating category.
- For all other hybrid contracts, interest income and expenses and income and expense from interest rate changes identified for the purposes of applying other IFRS accounting standards, will be classified in the financing category. If the income and expenses are not interest income and expenses, they will be classified as operating.

Embedded derivative is separated

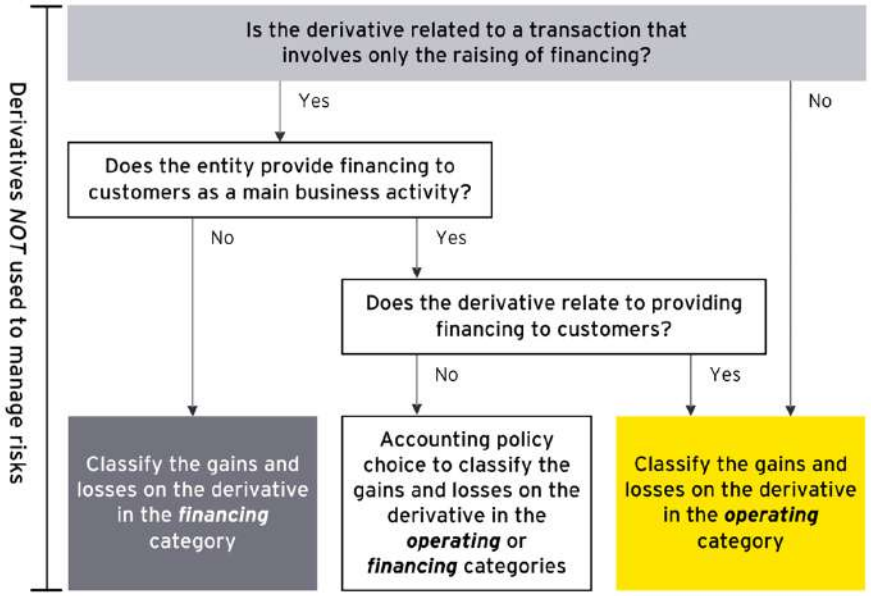
If the embedded derivative is separated, income and expenses arising from the host liability will be classified in accordance with the requirements for classifying a similar liability that is not a host in a hybrid contract. An entity with a main business activity of providing financing to customers will, therefore, need to assess whether the separated host liability is a Type 1 or Type 2 liability and follow the guidance in section 3.3.3 above. *[IFRS 18.B56(a)(i), IFRS 18.BC171]*.

The separated embedded derivative is classified in accordance with the requirements for similar stand-alone derivatives, addressed in section 3.2.8 above, unless the derivative is not used to manage identified risk, in which case the guidance in the next section applies. *[IFRS 18.B56(a)(ii), IFRS 18.BC171]*.

3.3.3.C Income and expenses on derivatives *not* used to manage exposure to identified risks

The following diagram, based on Figure 5 in the Illustrative Examples to IFRS 18, summarises the requirements for classifying derivatives *not* used to manage exposure to identified risks. *[IFRS 18.IE Figure 5]*.

Figure 3-8: Classification of gains and losses on derivatives *NOT* used to manage risks



The classification of derivatives that are not used to manage identified risk depends on whether: *[IFRS 18.B73]*

- They relate to transactions that involve only the raising of financing
- Whether the entity has a main business activity of providing financing to customers

  And
- Whether the derivative itself relates to providing financing to customers

If an entity provides financing to customers as a main business activity, income and expenses from derivatives which are *not* used to manage exposure to identified risks are classified, as follows:

- ***Operating category***
  - If the derivative is *not* related to a transaction that involves only the raising of finance *[IFRS 18.B73(b)]*

    Or
  - If the derivative *is* related to a transaction that involves only the raising of finance and the derivative itself relates to providing finance to customers *[IFRS 18.B59, IFRS 18.B73(a)]*
- ***Operating or financing category***

  (i.e., the accounting policy choice discussed in section 3.3.3 above)
  - If the derivative *is* related to a transaction that involves only the raising of finance but the derivative itself does *not* relate to providing financing to customers *[IFRS 18.B59, IFRS 18.B73(a)]*

3.3.3.D Derecognition

When derecognising a liability, an entity must apply the same classification requirements to classify income and expense from derecognition as it would when recognising a liability. Therefore, an entity with a main business activity of providing financing to customers will need to determine if it is a Type 1 or Type 2 liability and apply the guidance discussed in section 3.3.3 above. For example, such an entity will classify any gain or loss on the prepayment of a Type 1 loan, related to providing financing to customers, in the operating category. However, income and expenses from the derecognition of a Type 1 loan *not* related to providing financing to customers will be classified according to the accounting policy choice the entity has made, and thus may be classified in either the operating or the financing category. *[IFRS 18.B61]*.

3.3.3.E Foreign exchange differences

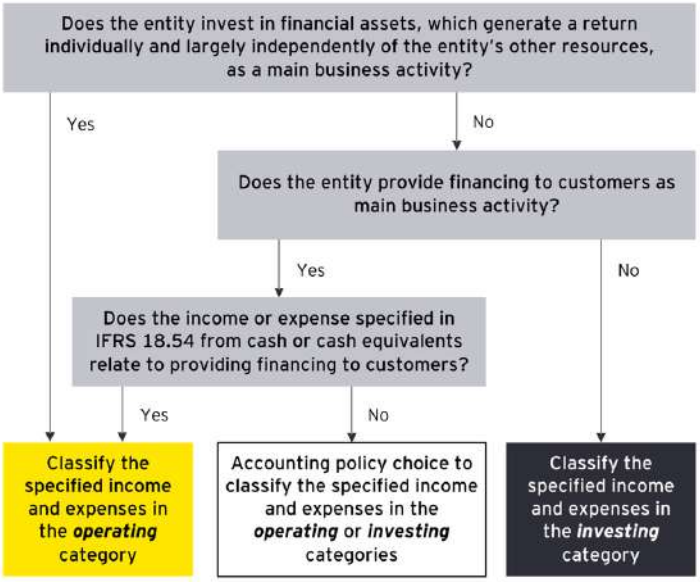
The basic principle for classifying foreign exchange differences (i.e., that they follow the category in which the related income and expenses have been classified) equally applies to entities that provide financing to customers as a main business activity, including the undue cost or effort exemption. If the latter is the case, all such differences are classified in the operating category. *[IFRS 18.B65, IFRS 18.B68, IFRS 18.BC207, IFRS 18.BC208]*. For example, foreign exchange differences arising from a Type 1 debt instrument liability, which is denominated in a foreign currency and is related to providing financing to customers, will also be classified in the operating category. *[IFRS 18.B66]*.

3.3.4 Income and expenses from cash and cash equivalents

Most entities do not need to assess whether they invest in cash and cash equivalents as a main business activity, as the standard requires income and expenses from cash and cash equivalents to be classified in the investing category. *[IFRS 18.53, IFRS 18.B39]*.

However, for entities with specified main business activities of investing in financial assets or providing finance to customers, the requirements are different. The diagram below, based on Figure 3.3 in the Illustrative Examples to IFRS 18, sets out the various permutations. *[IFRS 18.IE Figure 3.3]*.

Figure 3-9: Classification of income and expenses from cash and cash equivalents



If an entity invests as a main business activity in financial assets which generate a return individually and largely independently of the entity's other resources, such as debt instruments, it is required to classify the income and expenses from cash and cash equivalents in the operating category. This would include financial institutions such as banks. *[IFRS 18.56(a), IFRS 18.BC138]*.

If an entity provides financing to customers as a main business activity and the cash and cash equivalents relate to the provision of finance (for example, cash held for regulatory purposes), it classifies income and expenses from the cash and cash equivalents in the operating category. *[IFRS 18.56(b)(i)]*.

If an entity provides financing to customers as a main business activity and the cash and cash equivalents do *not* relate to the provision of finance, the entity has an accounting policy choice to classify the income and expenses arising from cash and cash equivalents in the operating or investing categories. This choice must be consistent with the similar accounting policy choice that exists for income and expenses arising from liabilities that do not relate to financing to customers, addressed in section 3.3.3 above. The outcome of this is that all income and expenses relating to the provision of financing to customers as a main business activity will always be classified in the operating category, whereas income and expenses on the portion that does not relate to the provision of financing could be classified in the investing category. *[IFRS 18.56(b)(ii), IFRS 18.65(a)(ii), IFRS 18.BC139, IFRS 18.BC140, IFRS 18.BC141]*.

If a reporting entity cannot distinguish between income and expenses from cash and cash equivalents related to providing finance to customers and from that unrelated, it is required (effectively applying the accounting policy choice above) to classify income and expenses from all its cash and cash equivalents in the operating category. *[IFRS 18.57, IFRS 18.BC141]*.

3.3.5 Entities that issue insurance contracts

While issuing insurance contracts is not a specified main business activity, IFRS 18 provides specific guidance for insurers about equity method investees and the classification of income and expenses that result from insurance contracts. These are discussed in more detail in the following sub-sections.

How we see it

Insurance entities typically also invest in assets as part of their operations and some provide financing to customers. Therefore, insurers should assess whether they have a specified main business activity as discussed in section 3.3.1 above.

3.3.5.A Equity method investees

The Board concluded that the reasons for excluding equity accounted investments from the operating category, discussed in section 3.2.1.A above, also applied to entities with specified main business activities. *[IFRS 18.BC121]*. Nonetheless, insurers raised specific concerns about the classification in the investing category of income and expenses from equity accounted investments that are linked to insurance contracts or are held for prudential purposes, as they would be considered part of 'net financial result', which is an important indicator of an insurer's operating performance. *[IFRS 18.BC123]*.

The Board highlighted that, while a presentation 'mismatch' might arise, depending on the entity's choice to account for such investments using the equity method or at fair value through profit or loss, the issue does not appear to be pervasive. *[IFRS 18.BC124, IFRS 18.BC125]*. Insurers facing the 'mismatch' could present a line item for income and expenses from equity accounted investments immediately below operating profit and disaggregate the line item for income and expenses to highlight those investments considered part of their net financial result. They could also present an additional subtotal or disclose an MPM. These options are expected to enable a user of the financial statements to analyse appropriately the impact of equity accounted investments on the net financial result. *[IFRS 18.BC127]*.

Furthermore, the Board introduced transitional requirements which permit an eligible entity to change its election under paragraph 18 of IAS 28 *Investments in Associates and Joint Ventures* for measuring an investment in an associate or joint venture from the equity method to fair value through profit or loss when it first applies IFRS 18. IAS 28 sets out what is meant by 'eligible entities':[14] *[IFRS 18.BC128, IFRS 18.BC423, IAS 28.18]*

Extract from IAS 28

18 When an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure that investment at fair value through profit or loss in accordance with IFRS 9. An example of an investment-linked insurance fund is a fund held by an entity as the underlying items for a group of insurance contracts with direct participation features. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. An entity shall make this election separately for each associate or joint venture, at initial recognition of the associate or joint venture. (See IFRS 17 *Insurance Contracts* for terms used in this paragraph that are defined in that Standard.)

3.3.5.B Insurance contracts

Certain exclusions apply to the financing category; insurance finance income and expenses included in the statement of profit or loss applying IFRS 17 must be classified in the operating category. Such income and expenses arise from issued insurance contracts, reinsurance contracts held and investment contracts with participation features in the scope of IFRS 17. This exclusion also applies to investment contracts with participation features in the scope of IFRS 9 (see section 3.3.6 below). *[IFRS 18.64(b), IFRS 18.BC196]*.

Host insurance contract and embedded derivative are separated

This exclusion also applies to the host in a hybrid contract, where the host liability and embedded derivative in an issued insurance contract are accounted for separately. Thus, income and expenses from the host liability will be classified in the operating category, as it relates to an insurer's main business activity. *[IFRS 18.B56, IFRS 18.BC179]*. Income and expenses from the separated embedded derivative are accounted for in the same way as a similar stand-alone derivative, see section 3.2.8 above.

14 For further guidance on eligible entities, see Chapter 12, section 3.3

Embedded derivative is *not* separated

If the host liability and the embedded derivative in an insurance contract are not separated, they are classified in the same way as for a single insurance contract and the income and expenses from the whole hybrid contract are classified in the operating category. *[IFRS 18.B56(c)(ii), IFRS 18.BC179]*.

3.3.6 Entities that issue investment contracts with participation features

The exclusion from the financing category also applies to income and expenses from issued investment contracts with participation features recognised applying IFRS 9. This will apply to any investment contract with participation features issued by an insurer, which does not meet the definition in IFRS 17 of an insurance contract with discretionary participation features, as well as any investment contract with participation features issued by an investment entity. *[IFRS 18.64(a), IFRS 18.B58]*.

Without the exclusion, applying the requirements of IFRS 18 would result in income and expenses arising from the assets in such contracts being classified in the operating category (assuming that the entity invested in the assets as a main business activity), whereas income and expenses from the liability would be classified in the financing category. However, the difference between the returns on the assets and the expense from the investment contract liability is typically an important indicator of an entity's operating performance. Therefore, such an entity is required to classify the income and expenses from the liabilities arising from the investment contracts with participation features in the operating category. *[IFRS 18.BC192, IFRS 18.BC193, IFRS 18.BC194]*.

Note that this requirement applies to all entities that have issued investment contracts with participation features, and not only to those that do this as a main business activity. In practice, most such entities are expected to assess investing in assets as a main activity. *[IFRS 18.BC195]*.

3.4 Items to be presented in the statement of profit or loss

The standard specifies the line items to be presented separately in the statement of profit or loss, as follows: *[IFRS 18.75, IFRS 18.76]*

Extract from IFRS 18

75 An entity shall present in the statement of profit or loss line items for (see paragraph B77):

(a) amounts required by this Standard, namely:
  (i) revenue, presenting separately the line items described in (b)(i) and (c)(i);
  (ii) operating expenses, presenting separately line items as required by paragraphs 78 and 82(a);
  (iii) share of the profit or loss of associates and joint ventures accounted for using the equity method;
  (iv) income tax expense or income; and
  (v) a single amount for the total of discontinued operations (see IFRS 5);

(b) amounts required by IFRS 9, namely:
  (i) interest revenue calculated using the effective interest method;
  (ii) impairment losses (including reversals of impairment losses or impairment gains) determined in accordance with Section 5.5 of IFRS 9;
  (iii) gains and losses arising from the derecognition of financial assets measured at amortised cost;
  (iv) any gain or loss arising from the difference between the fair value of a financial asset and its previous amortised cost at the date of reclassification from amortised cost measurement to measurement at fair value through profit or loss; and
  (v) any cumulative gain or loss previously recognised in other comprehensive income that is reclassified to profit or loss at the date of reclassification of a financial asset from measurement at fair value through other comprehensive income to measurement at fair value through profit or loss; and

(c) amounts required by IFRS 17, namely:
  (i) insurance revenue;
  (ii) insurance service expenses from contracts issued within the scope of IFRS 17;
  (iii) income or expenses from reinsurance contracts held;
  (iv) insurance finance income or expenses from contracts issued within the scope of IFRS 17; and
  (v) finance income or expenses from reinsurance contracts held.

76 An entity shall present in the statement of profit or loss (outside all the categories described in paragraph 47) an allocation of profit or loss for the reporting period attributable to:

(a) non-controlling interests; and
(b) *owners* of the parent.

An entity is required to present the line items listed in IFRS 18.75 above, unless the line item is not necessary for the statement of profit or loss to fulfil its role of providing a useful structured summary. *[IFRS 18.BC238]*. If a line item is omitted on the grounds that it is unnecessary for providing a useful structured summary, it is disclosed in the notes, if it provides material information. *[IFRS 18.BC237]*. See section 2.1 above for further discussion on the interaction between required line items and the useful structured summary in the primary financial statements as a whole.

IFRS 18 requires three totals and subtotals to be presented in the statement of profit and loss, which are intended to contribute to the presentation of a useful structure summary: *[IFRS 18.69]*

(a) Operating profit or loss, i.e., comprising all income and expenses classified in the operating category (see section 3.2.3.A above)
(b) Profit or loss before financing and income taxes, i.e., comprising operating profit and loss and all income and expenses classified in the investing category (see section 3.2.1.D and section 3.3.3.A above)
(c) Profit or loss, i.e., comprising the total of income less expenses included in the statement of profit or loss and, thus, includes all income and expenses classified in all categories in the statement of profit or loss *[IFRS 18.72]*

Following the introduction of the categories within the statement of profit or loss, an entity might need to present a required line item in more than one category. For example, impairment losses could arise on receivables for goods and services, as well as on financial assets. Such impairments recognised by an entity without a specified main business activity would be classified in the operating and investing categories, respectively. *[IFRS 18.B77]*. This requirement is intended to lead to enhanced comparability and understandability, compared with the alternative of requiring each line item to be presented in a single category. The standard requires any line item presented in more than one category to be described in a way that faithfully represents the characteristics of that item (which could be, for instance, 'expected credit losses on trade receivables balances' and 'expected credit losses on other financial assets' in the example above). *[IFRS 18.BC239]*.

An entity uses judgement to determine whether to present additional line items in the statement of profit or loss to fulfil the role of providing a useful structured summary, or to disclose items in the notes. *[IFRS 18.77]*. An entity's judgement is based on an assessment of whether the characteristics of the items in question are similar or dissimilar. IFRS 18 provides guidance on how to apply that judgement and sets out the types of characteristics to consider, as follows: *[IFRS 18.B78]*

Extract from IFRS 18

B78 ...

Such characteristics include:

(a) nature (see paragraph 80);

(b) function (role) within the entity's business activities (see paragraph 81);

(c) persistence (including the frequency of the item of income or expense or whether it is recurring or non-recurring);

(d) measurement basis;

(e) measurement uncertainty or outcome uncertainty (or other risks associated with an item);

(f) size;

(g) geographical location or regulatory environment;

(h) tax effects (for example, if different tax rates apply to items of income or expense); and

(i) whether the income or expenses arise on initial recognition of a transaction or event or from a subsequent change in estimate relating to the transaction or event.

The standard helpfully provides a list of income and expenses which may have dissimilar characteristics to the extent that either presentation in the statement of profit or loss is necessary to provide a useful structured summary or disclosure in the notes is necessary to provide material information, as follows: *[IFRS 18.B79]*

- Write-downs and reversals thereof relating to inventories
- Impairment losses and reversals thereof relating to property, plant and equipment
- Income and expenses from restructurings of an entity's activities and reversals of any provisions for restructuring
- Income and expenses from disposals of property, plant and equipment
- Income and expenses from disposals of investments
- Income and expenses from litigation settlements
- Reversals of provisions
- Non-recurring income and expenses not included in the items above

The principles of aggregation and disaggregation is discussed further in section 2.2.1 above.

3.4.1 Presentation of line items in the financing category

The line items to be presented in the statement of profit or loss have been brought forward from those required under IAS 1, with just two changes: the line item 'finance costs' has been removed; and 'operating expenses' has been included. *[IFRS 18.BC236]*. Although 'finance costs' has been removed as a line item, an entity will apply the requirements discussed in section 3.2.2 above and will, therefore, consider the following when determining the relevant line items in the financing category: *[IFRS 18.BC242]*

Extract from IFRS 18

BC242 The IASB also decided not to add any line items for expenses classified in the financing category to paragraph 75 of IFRS 18. However, an entity is required to present items classified in the financing category considering the role of the primary financial statements, which replaces the requirement in IAS 1 to present a line item for 'finance costs'. In applying the requirements in IFRS 18, an entity classifies in the financing category:

(a) income and expenses that arise from the initial and subsequent measurement of liabilities that arise from transactions that involve only the raising of finance;

(b) incremental expenses directly attributable to the issue and extinguishment of liabilities that arise from transactions that involve only the raising of finance; and

(c) interest expenses and income and expenses arising from changes in interest rates of liabilities that do not arise from a transaction that involves only the raising of finance, but only if the entity identifies such income and expenses for the purpose of applying other requirements in IFRS Accounting Standards.

An entity applies judgement to determine whether and how there is a distinction between amounts classified in the financing category (see section 3.2.2 above). This will determine whether the presentation provides a useful structured summary. If an entity decides that the presentation of a single line item is appropriate, it is required to disclose in the notes disaggregated information about those expenses, if the resulting information is material. *[IFRS 18.BC243]*.

3.4.2 Presentation and disclosure of expenses classified in the operating category

The principle of providing a useful structured summary informs the requirements for the classification and presentation of line items in the operating category of the statement of profit or loss. *[IFRS 18.BC246]*. An entity must use one, or both of the following characteristics: *[IFRS 18.78]*

- The nature of expenses - see section 3.4.2.A below
- The function of expenses within the entity - see section 3.4.2.B below

Classifying and presenting expenses based on nature and/or function improves the usefulness of information. Analysing individual components is made possible by a nature presentation, whereas a function presentation enables the calculation of certain performance metrics. However, for some entities a mixture of both could provide the most useful structured summary, see section 3.4.2.D below. *[IFRS 18.BC247]*.

Expenses are classified and presented consistently from one reporting period to another, unless the conditions in IFRS 18.30 set out below apply: *[IFRS 18.30, IFRS 18.B83]*.

Extract from IFRS 18*

Consistency of presentation, disclosure and classification

30 An entity shall retain the presentation, disclosure and classification of items in the financial statements from one reporting period to the next unless:

(a) it is apparent, following a significant change in the nature of the entity's operations or a review of its financial statements, that another presentation, disclosure or classification would be more appropriate having regard to the criteria for selecting and applying accounting policies in IAS 8 *Basis of Preparation of Financial Statements* (see paragraph B12); or

(b) an IFRS Accounting Standard requires a change in presentation, disclosure or classification.

* The consequential amendments, once effective, change the title of IAS 8 to '*Basis of Preparation of Financial Statements*' to better reflect the amended content of IAS 8.

For example, a goodwill impairment presented as a nature line item in one period must be presented as such in subsequent periods, unless the requirements above apply. An expense of nil in a subsequent period does not constitute a change in classification and presentation. *[IFRS 18.B83]*.

3.4.2.A Presentation of expenses by nature

As noted above, an entity can choose to present its operating expenses according to their nature (hereafter, "nature expenses"). Expenses presented by nature provide information about operating expenses related to the nature of the economic resources consumed to execute the entity's activities. Such expenses do not refer to the activities in relation to which those resources were consumed. Examples of nature expenses include: *[IFRS 18.80]*

- Raw material expense
- Employee benefit expense
- Depreciation and amortisation

The amounts of nature expenses presented or disclosed in a period need not be the amounts recognised as an expense in that period, as certain amounts might have been capitalised as part of the carrying amount of an asset and will, therefore, be recognised as an expense in a future period. A common example of this is the presentation of a line item relating to the changes in inventories of finished goods and work in progress. If an entity presents amounts that are not the same as the amounts recognised as an expense in the period, an additional line item is presented for the change in the carrying amount of the affected assets. *[IFRS 18.B84, IFRS 18.BC269, IFRS 18.BC270]*.

3.4.2.B Presentation of expenses by function

Entities can allocate and aggregate operating expenses according to the activity to which the consumed resource relates: this is classification by function. An example is cost of sales, which typically combines expenses relating to an entity's production or revenue-generating activities, such as raw material expense, employee benefit expense, depreciation and amortisation. 'Function' is not further defined in IFRS accounting standards, but it is a longstanding concept and considered to be widely understood. *[IFRS 18.BC253]*.

Adopting a function presentation results in the allocation of expenses relating to economic resources of the same nature across several function line items; for example, employee benefits might be allocated to cost of sales and research and development, whereas a single function line item might contain allocations of expenses relating to economic resources of several differing natures. *[IFRS 18.81, IFRS 18.BC254]*.

Building on the previous requirements in IAS 1, if an entity presents at least one or more line items of operating expense by function and those functions include a cost of sales function, it is required to: *[IFRS 18.82, IFRS 18.BC255]*

- Present a separate line item for cost of sales, which needs to include the total of inventory expense, described in paragraph 38 of IAS 2 *Inventories*
- Disclose a qualitative description of the nature of expenses included in each function line item

The Board concluded that the inclusion of the inventory expense, as described in IAS 2, ought to help reduce diversity in the costs included in cost of sales as, in practice, some entities have previously excluded certain components of inventory expense.[15] The Board believes this will improve comparability between entities presenting the cost of sales line item. The qualitative description of the nature of expenses included in each line item is expected to enhance the understandability of the composition of each line item. *[IFRS 18.BC257, IFRS 18.BC258]*

How we see it

The scope of cost of sales will remain, as under current practice, judgemental under IFRS 18, and entities will still need to consider facts and circumstances when classifying, for instance, shipping and handling costs.

15 For further information on including specific items in cost of sales see Chapter 28 at section 10.3, Question 10-8.

Function line items inherently aggregate nature expense items that could respond differently to changes in the economic environment. To enable users to better forecast future operating expenses, there are additional disclosure requirements for entities which present one or more function line items in the operating category of the statement of profit or loss. Such entities must disclose the following in a single note: *[IFRS 18.83, IFRS 18.BC259, IFRS 18.BC260]*

Extract from IFRS 18

83 An entity that presents one or more line items comprising expenses classified by function in the operating category of the statement of profit or loss shall also disclose in a single note:

(a) the total for each of:

(i) depreciation, comprising the amounts required to be disclosed by paragraph 73(e)(vii) of IAS 16 *Property, Plant and Equipment*, paragraph 79(d)(iv) of IAS 40 *Investment Property* and paragraph 53(a) of IFRS 16 *Leases*;

(ii) amortisation, comprising the amount required to be disclosed by paragraph 118(e)(vi) of IAS 38 *Intangible Assets*;

(iii) employee benefits, comprising the amount for employee benefits recognised by an entity applying IAS 19 *Employee Benefits* and the amount for services received from employees recognised by an entity applying IFRS 2 *Share-based Payment*;

(iv) impairment losses and reversals of impairment losses, comprising the amounts required to be disclosed by paragraphs 126(a) and 126(b) of IAS 36 *Impairment of Assets*; and

(v) write-downs and reversals of write-downs of inventories, comprising the amounts required to be disclosed by paragraphs 36(e) and 36(f) of IAS 2; and

(b) for each total listed in (a)(i)-(v):

(i) the amount related to each line item in the operating category (see paragraph B84); and

(ii) a list of any line items outside the operating category that also include amounts relating to the total.

Note that the requirement is limited to the five nature expenses listed in the extract above. This is intended to be a cost-effective solution to providing disaggregated information about operating expenses, which will provide useful information. *[IFRS 18.BC265]*. The disclosure is to be contained in a single note as users typically analyse information about operating expenses together. *[IFRS 18.BC268]*.

This requirement may appear to conflict with the requirement to disaggregate items to provide material information in IFRS 18.41 (see section 2.2.1 above). This means that there could be other nature items included within function line items, not listed above, which, when disaggregated, are individually material. The standard gives an exemption from disclosing those other items; there is no threshold for applying this exemption and so the exemption applies to all circumstances. Without the exemption, an entity would have been required to disclose further information about all its material nature expenses contained within its function line items and this would not have been cost effective. *[IFRS 18.BC272, IFRS 18.BC273, IFRS 18.BC274, IFRS 18.BC275]*.

IFRS 18 also provides an exemption for nature expenses that an IFRS accounting standard specifically requires to be disclosed in a note. For such expenses, disaggregated information about the amounts of the expenses included in each function line item presented in the operating category of the statement of profit or loss is limited to the five nature items listed in the extract above. *[IFRS 18.84, IFRS 18.BC259]*. Notwithstanding the exemption afforded above, entities are not exempted from applying the specific disclosure requirements relating to those expenses contained in other IFRS accounting standards. *[IFRS 18.85]*.

The amounts of nature expenses disclosed in a period need not be the amounts recognised as an expense in that period, as certain amounts might have been capitalised as part of the carrying amount of an asset and will, therefore, be recognised as an expense in a future period - see section 3.4.2.A above for the requirements relating to such amounts.

When an entity makes the required disclosures relating to the five nature items described in the extract above and discloses amounts that are not the amounts recognised as an expense in the period, it gives a qualitative explanation of that fact, identifying the assets involved. *[IFRS 18.B84, IFRS 18.BC271]*.

How we see it

In practice, the five items requirement could require entities to add functionality to their systems. Although IAS 1.104 and current practice require the disclosure of the nature of depreciation/amortisation and employee benefits expenses, the IFRS 18 requirement adds specifically identified expenses. Importantly, it adds the requirement to identify the function line in which the nature expenses are included.

3.4.2.C Assessing which presentation provides the most useful structured summary

Any individual line item can only contain expenses aggregated on the basis of that characteristic. That is, a single line item can only contain expenses aggregated according to function or nature, but a mixed presentation within the operating category as a whole is permitted. *[IFRS 18.79]*.

To make the determination of which presentation provides the most useful structured summary, an entity is required to consider the following:

- Which line items provide the most useful information about the main components or drivers of the entity's profitability
- Which line items most closely represent the way the business is managed and the entity's internal reporting
- Standard industry practice to enhance comparability
- Whether the allocation of particular expenses to functions would be arbitrary to the extent that the line items would not provide a faithful representation of the functions

If the allocation of particular expenses is arbitrary, to the extent that a faithful presentation of functions is lost, the entity is required to classify the expenses by nature. *[IFRS 18.B80]*.

These considerations can result in different presentations, depending on the industry in which the entity operates. For example, looking at drivers of profitability for a retail entity, the function of cost of sales might be a main driver, as there is a direct link between these costs and revenue. This is in contrast to a services industry, where information about the nature of certain expenses, such as employee benefits, might be more relevant as those expenses drive profitability. *[IFRS 18.B80]*.

Similarly, considering the way management reports internally could result in different presentation. Thus, a manufacturing entity that is managed by function is likely to have its internal reporting presented by function, whereas an entity with a single predominant function, such as providing finance to customers, might use nature of expense reporting for internal purposes. In both cases, this could influence the entity's assessment of the most useful structured summary of its expenses. *[IFRS 18.B80]*.

As previously stated, an entity is required to consider the level of aggregation that will provide the most useful structure summary. It might decide that certain activities such as human resources, information technology, legal services and accounting have a shared characteristic of being resources consumed in administrative activities. Thus, an entity might determine that a line item labelled 'administrative expenses' provides relevant information. The same entity might also incur expenses for resources consumed in selling activities and determine that these expenses have one dissimilar characteristic to the expenses aggregated in administrative expenses as they all relate to selling activities. For this reason, the entity might present a separate line item for 'selling expenses' in order to achieve the goal of presenting a useful structured summary. *[IFRS 18.B85]*.

3.4.2.D Mixed presentation

An outcome of considering the factors in the sub-section above is that an entity might conclude that a mixed presentation, i.e., classifying some expenses by function and others by nature, provides the most useful structured summary. This might be the case for entities with two different types of main business activity or for particular expenses, whose allocation to a function would be arbitrary. *[IFRS 18.B81]*.

In the outreach stage of developing IFRS 18, mixed feedback was received about the concept of permitting a mixed presentation, with some users asserting that a mixed presentation can affect comparability, whereas others asserted that it facilitates the presentation of useful information, particularly when an entity has two types of main business activities. It also avoids arbitrary allocations of certain types of expenses, such as goodwill impairment, and allows for the separate presentation of certain expenses which might have characteristics that could aid understanding of the financial performance, for example, an impairment expense. The Board decided that a mixed presentation could, in some circumstances, provide the most useful structured summary and added application guidance, described below, to address the concerns of the first group of users. *[IFRS 18.BC250, IFRS 18.BC251]*.

If an entity adopts a mixed presentation, as described above, it labels the line items in a manner that allows users to clearly identify which expenses are included in each line item. For example, if some employee benefits are included in cost of sales and others in a nature line item, the nature line item must clearly identify that not all employee benefits are contained within, for example, 'employee benefits other than those included in cost of sales'. *[IFRS 18.B82]*.

3.4.3 Presentation of profit or loss attributable to non-controlling interests

The standard requires 'profit or loss attributable to non-controlling interests' and 'profit or loss attributable to owners of the parent' to be presented in the statement of financial performance; they are presented as allocations of profit or loss, rather than as items of income or expense. *[IFRS 18.76, IFRS 18.BCZ244]*.

4 Management-defined performance measures - IFRS 18

4.1 Overview of the new requirements

IFRS 18 introduces the concept of a management-defined performance measure (or MPM) and defines it (see section 4.2 below) as a subtotal of income and expenses that an entity uses in public communications outside financial statements to communicate management's view of an aspect of the financial performance of the entity as a whole to users. *[IFRS 18.117, IFRS 18 Appendix A]* IFRS 18 explicitly notes that subtotals required by an IFRS accounting standard, including IFRS 18 itself, are not MPMs. IFRS 18.118 also lists some other subtotals that are not MPMs, e.g., "gross profit or loss (revenue minus cost of sales) and similar subtotals" (see section 4.2.4 below). *[IFRS 18.BC328]*.

Many entities currently use alternative performance measures in their financial communications. However, the Board intentionally limited the definition of MPMs to subtotals of income and expenses. Therefore, a measure (such as 'adjusted profit or loss') which adjusts a total or subtotal specified in IFRS accounting standards is an MPM while other measures (such as free cash flow or customer retention rate) which are not totals or subtotals of income and expenses are not MPMs. *[IFRS 18.BC331]*.

To improve the transparency around these measures, IFRS 18 requires an entity to disclose information about all of its MPMs in a single note to the financial statements. *[IFRS 18.BC369]*. The standard also lists several disclosures to be made (see section 4.3 below) including *[IFRS 18.123]*:

- How the measure is calculated
- How it provides useful information

  And
- A reconciliation to the most comparable subtotal specified by IFRS 18 or another IFRS accounting standard

While developing the new requirements, users of financial statements indicated that information about MPMs can be useful because it provides insight into how management views the entity's financial performance, the persistence of the entity's financial performance and how the business is managed. However, concerns were raised about the quality of the information about these measures that is generally communicated outside the financial statements. *[IFRS 18.BC325]*. The Board agreed that MPMs can provide useful entity-specific information and that including these measures in the financial statements will make them subject to the same disclosure requirements, regardless of an entity's jurisdiction. *[IFRS 18.BC326]*.

How we see it

We believe that the required disclosures around MPMs will improve transparency for users and since MPMs are required to be included in the financial statements, they will generally also be subject to audit.

It is likely that the required disclosures will elevate the prominence of MPMs and result in increased scrutiny from regulators.

4.2 Definition and scope

IFRS 18 includes the following definition of an MPM: *[IFRS 18.117, IFRS 18 Appendix A]*

Extract from IFRS 18

Appendix A

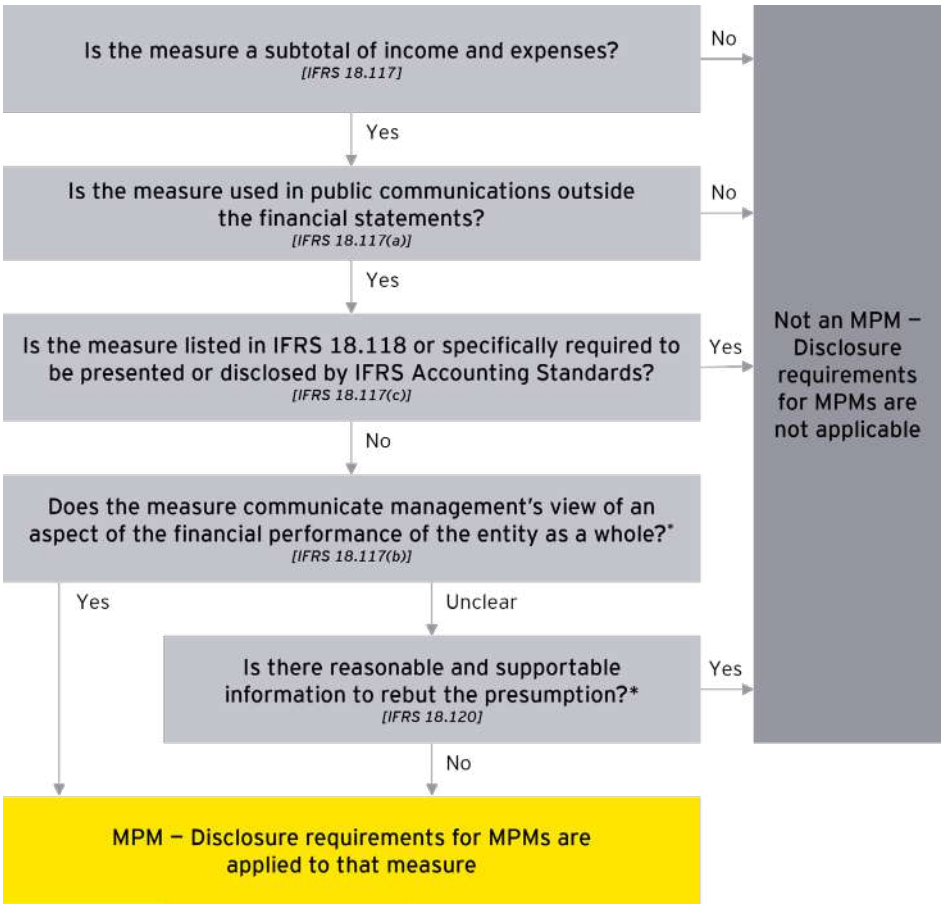
Defined terms

management-defined performance measure	A subtotal of income and expenses that: (a) an entity uses in public communications outside financial statements; (b) an entity uses to communicate to users of financial statements management's view of an aspect of the financial performance of the entity as a whole; and (c) is not listed in paragraph 118 of IFRS 18, or specifically required to be presented or disclosed by IFRS Accounting Standards.

Each of the concepts in this definition is discussed further in the sub-sections below.

The following figure, based on Figure 6 in the *Illustrative Examples* to IFRS 18, provides an overview of how an entity identifies an MPM: *[IFRS 18.IE Figure 6]*

Figure 4-1: Identifying MPMs

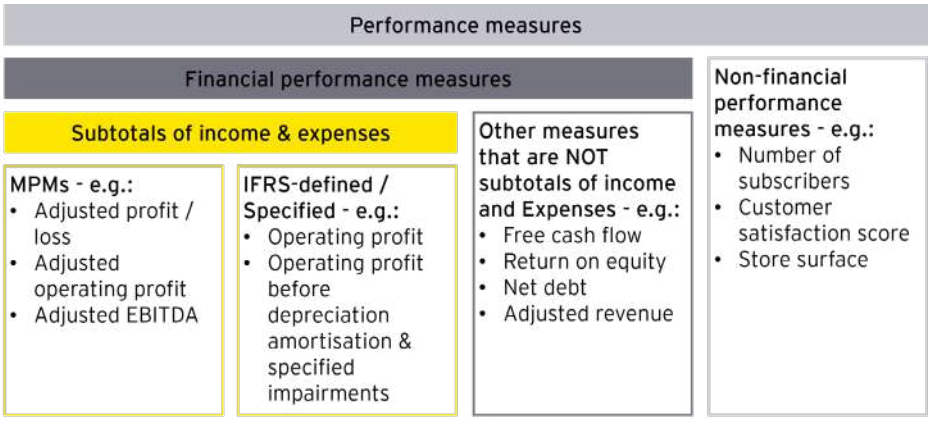


* There is a rebuttable presumption that a subtotal of income and expenses used in public communications communicates management's view (see section 4.2.3.C below).

4.2.1 Subtotals of income and expenses

IFRS 18 intentionally limits the definition of MPMs to subtotals of income and expenses. *[IFRS 18.BC331]*. This intentionally narrow definition results in MPMs being a subset of other performance measures (e.g., alternative performance measures), as illustrated in the following diagram based on a presentation by the IASB Staff:[16]

Figure 4-2: MPMs versus other performance measures



16 IASB Staff Paper AP1, Project: *Primary Financial Statements*, Topic: *Introduction to IFRS 18* Presentation and Disclosure in Financial Statements, Emerging Economies Group Meeting, October 2023. Available on the IFRS Foundation's website.

Since the definition of an MPM requires it to be a subtotal of income and expenses, the following measures would not be MPMs since they are not subtotals of income and expenses: *[IFRS 18.B116]*

(a) **Subtotals of only income or only expenses,** for example, a stand-alone measure of adjusted revenue

(b) **Measures of assets, liabilities, equity or combinations of these elements,** for example, net current operating assets

(c) **Financial ratios,** for example, return on assets. However, the numerator or denominator of a financial ratio could be an MPM (see below)

(d) **Measures of liquidity or cash flows,** for example, free cash flow

Or

(e) **Non-financial performance measures,** for example, customer satisfaction score

A subtotal of income and expenses that meets the definition of an MPM does not need to be presented in the statement of profit or loss in order for it to be an MPM. *[IFRS 18.B118]*. For instance, an entity might present an adjusted operating profit measure outside the financial statements without the same subtotal also being included in the statement of profit or loss. In such a case, this subtotal could be an MPM subject to the disclosure requirements, provided it meets the other elements of the MPM definition.

A financial ratio cannot be an MPM since it is not a subtotal of income and expenses. However, the numerator or denominator of a financial ratio could be an MPM if it represents a subtotal of income and expense that would meet the definition of an MPM had it not been part of a ratio. For example, while adjusted earnings per share is not a subtotal of income and expense, the numerator 'adjusted earnings' could be an MPM. The disclosure requirements for MPMs would apply to such a numerator or denominator. *[IFRS 18.B117]*.

An entity might decide to replicate its statement of profit or loss in a public communication (for example, in a presentation to users). The Board indicates that where the replicated statement of profit or loss includes an additional subtotal not listed in IFRS 18.118 or not specifically required by IFRS accounting standards (see section 4.2.4 below), that subtotal would meet the definition of an MPM unless the entity rebuts the presumption (see section 4.2.3.C below). *[IFRS 18.BC354]*.

An entity might have no MPMs, just one, or multiple. For example, an entity that only uses totals and subtotals required by IFRS accounting standards to publicly communicate its financial performance to users, does not have any MPMs. *[IFRS 18.B113]*.

How we see it

Many entities currently use alternative performance measures in their communications with capital markets outside the financial statements. Since MPMs, as defined in IFRS 18, are a subset of alternative performance measures, entities will still need to carefully consider whether it is appropriate to include alternative performance measures that are not also MPMs within the financial statements themselves.

Furthermore, considering the new disclosure requirements, many entities could take the opportunity to revisit the purpose and relevance of the alternative performance measures, including MPMs, used in their current communications with external users and capital markets.

4.2.2 Meaning of 'public communications'

A subtotal only meets the definition of an MPM if it is used by an entity in public communications outside the financial statements. Public communications include: *[IFRS 18.B119]*

- Management commentary
- Press releases
- Investor presentations

However, for the purpose of defining MPMs, public communication excludes:

- Oral communications
- Written transcripts of oral communications
- Social media posts

The Board decided to exclude these categories of communication in response to concerns raised by some stakeholders during the development of the standard that these types of communications were the most challenging to monitor. The Board expects that removing these categories from the scope of 'public communications' will reduce the costs of applying the requirements by eliminating the need to search these forms of communications. *[IFRS 18.BC336]*.

The Board considered providing specific requirements for private entities since they are less likely to have public communications. However, the Board concluded that the requirements are intended to provide transparency and discipline over measures communicated to users outside the financial statements, regardless of whether the entity is public or private. Therefore, the MPM requirements apply to all entities applying IFRS accounting standards and, if a private entity communicates subtotals that meet the definition of MPMs, that entity would be subject to the MPM requirements. It follows that, if an entity does not communicate measures of financial performance outside its financial statements, the MPM requirements would not apply, and no additional disclosures would be required. *[IFRS 18.BC342]*.

The Board observed, in response to some stakeholder questions during the development of the standard, that the requirements for MPMs relate to performance for the same period as is covered by the financial statements. *[IFRS 18.BC337]*. To make this clear, the Board decided to specify in IFRS 18 that MPMs relate to the same reporting period as the financial statements. Specifically: *[IFRS 18.B120]*

(a) A subtotal that relates to the interim financial statements, but not to the annual financial statements, is only an MPM in the interim financial statements

And

(b) A subtotal that relates to the annual financial statements, but not to interim financial statements, is only an MPM in the annual financial statements

How we see it

While MPM disclosure is also required in interim financial statements (see section 5.4 below), the subtotals that are considered MPMs could differ between the interim and annual financial statements.

While it is common for entities to issue public communications, such as press releases, before or at the date the financial statements are authorised for issue, some public communications (e.g., investor presentations) might not be made available until after the financial statements are authorised for issue. The Board decided to require an entity that routinely issues public communications containing performance measures after the financial statements are authorised for issue to consider what measures it included in the previous period's public communications when identifying MPMs for the current period. *[IFRS 18.B121, IFRS 18.BC339]*.

However, an entity is not required to include a measure identified in the prior period as an MPM where evidence indicates it will no longer be included in the public communications to be issued for the current reporting period. When a measure was previously disclosed as an MPM but is not identified as an MPM for the current reporting period, the disclosure requirements for a change to, or cessation of, an MPM in IFRS 18.124 apply (see section 4.3.5 below). *[IFRS 18.B122, IFRS 18.BC340]*.

4.2.3 Management's view

The Board decided to include the concept "management's view of an aspect of the entity's financial performance" in the definition of an MPM since making information about management's view of an entity's performance available to users was the reason for the Board developing the MPM requirements in the first place. Therefore, '*management-defined* performance measures' are limited to those measures that communicate management's view of an aspect of the financial performance of the entity as a whole. *[IFRS 18.BC343, IFRS 18.117, IFRS 18.B114]*.

4.2.3.A Management's view versus management's performance

The focus of MPMs is on communicating an aspect of an entity's performance rather than communicating management's performance. As a result, a subtotal only used to measure management's performance (for example, a measure used internally for the purpose of management remuneration, but not used externally to communicate management's view of an aspect of an entity's performance) would not meet the definition of an MPM. *[IFRS 18.BC344]*. However, in some cases, a measure used externally to communicate management's view of an aspect of the entity's performance might be used for the purpose of assessing management's performance, and thus the two could overlap.

4.2.3.B Entity as a whole

To meet the definition of an MPM, the measure must communicate management's view of an aspect of the financial performance of the entity *as a whole* to users. For example, a subtotal of income and expenses related to a reportable segment (disclosed in accordance with IFRS 8) that does not provide information about an aspect of the financial performance of the entity as a whole, does not meet the definition of an MPM. *[IFRS 18.B114]*.

However, in some cases, a subtotal of income and expenses related to a reportable segment could provide information about an aspect of the financial performance of the entity as a whole and, therefore, meet the definition of an MPM. An indicator of this is where a reportable segment contains a single main business activity of an entity and a subtotal of income and expenses relating to that segment is presented in the statement of profit or loss. *[IFRS 18.B115]*.

How we see it

Since the definition of an MPM refers to the entity as a whole, the focus is at an entity-level (for individual or stand-alone financial statements) or group-level (for consolidated financial statements) rather than just a part of the entity or group. Therefore, a measure used by a listed subsidiary in its public communications that meets the definition of an MPM at the subsidiary level, would not necessarily meet the definition of an MPM at the consolidated group level.

4.2.3.C Rebuttable presumption

The standard contains a *rebuttable presumption* that a subtotal of income and expenses used in public communications outside the entity's financial statements communicates to users management's view of an aspect of the financial performance of the entity as a whole. *[IFRS 18.119]*.

An entity can only rebut this presumption (i.e., assert that a subtotal does not communicate management's view of an aspect of the financial performance of the entity as a whole) if it is able to demonstrate, using reasonable and supportable information that: *[IFRS 18.120, IFRS 18.B124]*

(1) The subtotal does not communicate management's view of an aspect of the financial performance of the entity as a whole

And

(2) There is a reason for using the subtotal in the entity's public communications other than communicating management's view of an aspect of the financial performance of the entity as a whole

The Board felt it is reasonable to expect that an entity includes a subtotal of income and expenses in public communications for the purposes of communicating management's view of an aspect of the entity's financial performance to users. Where this condition is not true, reasonable and supportable information is required to rebut the presumption. *[IFRS 18.BC349]*.

The rebuttable presumption applies to the subtotal as a whole and not to individual items of income and expense that make up that subtotal. Therefore, an entity cannot rebut the presumption based on information indicating that an individual item (or items) of income or expense within the subtotal does not represent management's view. *[IFRS 18.B130]*.

Instead of specifying types of measures for which it would be appropriate to rebut the presumption, the Board provided examples of reasonable and supportable information that could support rebutting the presumption that the subtotal communicates management's view of an aspect of the financial performance of an entity as a whole: *[IFRS 18.B125, IFRS 18.BC351]*

(i) The subtotal is communicated without prominence

(ii) The subtotal is not used internally to assess or monitor the entity's financial performance

Each of these examples is discussed in more detail further below.

IFRS 18 also includes examples of 'reasonable and supportable information' that indicate the entity has a reason, other than to communicate management's view, for using a subtotal in its public communications: *[IFRS 18.B129]*

(a) The subtotal is required to be included in a public communication by law or regulation

(b) The subtotal communicates performance related to financial statements prepared under another accounting framework (i.e., other than IFRS accounting standards)

(c) The subtotal is used in a public communication on the request of an external party

(d) The subtotal is used to communicate information other than financial performance

In practice, entities often include a measure in their public communications as a result of a regulatory requirement or on the request of investors (examples (a) & (c) above). However, in some cases, these measures also communicate management's view despite originally being included for regulatory reasons or at the request of investors and, in these instances, the assumption could not be rebutted. *[IFRS 18.BC351]*.

The other two examples are likely to be less common in practice since a subtotal of income and expenses would typically be used as a financial measure (example (d) above) and it is likely that measures calculated under another accounting framework (example (b) above) will be provided due to a regulatory requirement or on the request of investors.

(i) The subtotal is communicated without prominence

Whether a subtotal is communicated without prominence is a matter of fact based on the particular circumstances and will require the use of judgement. The application guidance in IFRS 18 includes some factors to consider in making this judgement: *[IFRS 18.B126]*

Extract from IFRS 18

B126 Whether an entity communicates a subtotal without prominence is a matter of judgement based on a number of factors, for example:

(a) the extent of references to the subtotal-few references indicate a lack of prominence, numerous references indicate prominence; and

(b) the content of commentary or analysis about or relying on the subtotal, for example:

(i) a description of the subtotal as information that does not communicate management's view and that is provided only in response to frequent requests from some users of financial statements indicates a lack of prominence;

(ii) use of the subtotal to support management analysis and commentary on the entity's financial performance and to provide explanations of the reasons for changes in the subtotal from period to period indicates prominence; and

(iii) a comparison of the subtotal to competitors' subtotals or industry benchmarks indicates prominence.

(ii) The subtotal is not used internally

Management's use of a subtotal to assess or monitor an aspect of the entity's financial performance as a whole would be an indicator that the subtotal communicates management's view of an aspect of the financial performance of the entity as a whole. However, since the definition of an MPM requires it to be used in public communications outside the financial statements, when management only uses a subtotal internally without including it its public communications, that subtotal does not meet the definition of an MPM. *[IFRS 18.B127]*.

An entity might also adjust a subtotal included in its public communications for its internal assessment or monitoring of the entity's financial performance by management. In such cases, judgement will be required to assess whether the subtotal included in the entity's public communications externally is sufficiently similar to the subtotal used internally. The more similar the subtotals are, the more likely it is that the subtotal used in the entity's public communications communicates management's view of an aspect of the financial performance of the entity as a whole to users. *[IFRS 18.B128]*.

4.2.3.D Changes to public communications

An entity could change whether it uses a subtotal to communicate to users management's view of an aspect of the financial performance of the entity as a whole, causing the subtotal to become, or cease to be, an MPM. For example, an entity required by regulation to report a particular subtotal that initially did not communicate management's view of an aspect of the financial performance of the entity as a whole, could over time start using the measure internally to assess and monitor the entity's financial performance or expand the commentary and explanations in its public communications beyond the regulatory requirements, resulting in the measure meeting the definition of an MPM.

Judgement will be required to identify whether a measure not identified as an MPM in the prior period has become one, or whether a measure previously identified as an MPM has ceased to be one. *[IFRS 18.B131]*.

Such a change to a measure becoming, or ceasing to be, an MPM will trigger required disclosures (see section 4.3.5 below).

4.2.4 Subtotals that are not MPMs

Some subtotals are not required or defined by IFRS accounting standards, but are commonly used by entities in their financial statements and are well understood by users (for example, a gross profit subtotal). The Board is of the view that "providing the management-defined performance measures disclosures for such measures would not provide useful information because their purpose and relationship to totals or subtotals defined by IFRS accounting standards are well understood or would usually be apparent from their presentation in the statement(s) of financial performance." Therefore, the standard includes a list of such subtotals, in IFRS 18.118, and specifically excludes these subtotals from the definition of an MPM: *[IFRS 18.118, IFRS 18.BC362]*

(a) Gross profit or loss (revenue minus cost of sales) and similar subtotals

(b) Operating profit or loss before depreciation, amortisation and impairments within the scope of IAS 36 *Impairment of Assets*

(c) Operating profit or loss and income and expenses from all investments accounted for using the equity method

(d) For an entity that applies the accounting policy choice to present income and expense from liabilities that do not relate to the provision of financing to customers in the operating category (see section 3.3.3 above), a subtotal comprising operating profit or loss and all income and expenses classified in the investing category

(e) Profit or loss before income taxes

(f) Profit or loss from continuing operations

The Board also decided to exclude subtotals specifically required by an IFRS accounting standard from the definition of an MPM. *[IFRS 18.117]*. Since these subtotals are required by IFRS accounting standards, they are by definition not 'management-defined'. Such subtotals include those required by IFRS 18 (see section 3.4 above): *[IFRS 18.69]*

- Operating profit or loss
- Profit or loss before financing and income taxes
- Profit or loss

As noted above, subtotals similar to gross profit are not MPMs. A subtotal is similar to gross profit when it represents the difference between a type of revenue and the directly related expenses incurred in generating that revenue. The standard provides the following, non-exhaustive, list as examples of such subtotals: *[IFRS 18.B123]*

Extract from IFRS 18

Subtotals similar to gross profit

B123 In accordance with paragraph 118(a), subtotals similar to gross profit are not management-defined performance measures. A subtotal is similar to gross profit when it depicts the difference between a type of revenue and directly related expenses incurred in generating that revenue. Examples include:

(a) net interest income;

(b) net fee and commission income;

(c) insurance service result;

(d) net financial result (investment income minus insurance finance income and expenses); and

(e) net rental income.

During the deliberations, the Board considered defining 'earnings before interest, tax, depreciation and amortisation' (EBITDA), but ultimately decided against it. The Board noted that while EBITDA is one of the most commonly used alternative performance measures, it is not used in some industries (such as banking and insurance) and there is no consensus in practice on what EBITDA represents, other than serving as a starting point for various analyses. *[IFRS 18.BC363]*.

The Board acknowledged that an EBITDA measure could meet the definition of an MPM and concluded that a measure calculated as 'operating profit before depreciation, amortisation and impairments within the scope of IAS 36' would provide similar information to many of the EBITDA measures currently used in practice. However, the Board decided against describing this subtotal as 'EBITDA' since this would imply that 'operating profit or loss' is the same as what 'earnings before interest and tax' is currently understood to represent, which might not always be the case. For example, under IFRS 18 the 'operating profit' excludes income and expenses classified in the investing category and, therefore, might exclude income that some currently consider to be 'earnings'. *[IFRS 18.BC365]*. However, the label 'EBITDA' could be an accurate description of the corresponding measure if, for example, all of an entity's earnings are included in operating profit since it has no income and expenses that are required to be included in the investing category. In such cases, the standard would not prevent an entity from labelling the subtotal 'operating profit before depreciation, amortisation and specified impairments within the scope of IAS 36' as 'EBITDA'. *[IFRS 18.BC366]*.

In the Board's view, if an entity presented a subtotal for 'operating profit before depreciation, amortisation and impairments within the scope of IAS 36', the costs of the additional information required by the MPM disclosures would exceed its benefits since the measure is already well defined. Therefore, the Board decided to exclude this subtotal from the definition of an MPM. *[IFRS 18.BC364]*.

4.3 Disclosure of MPMs

4.3.1 Objective

The standard includes the following objective for the MPM disclosures: *[IFRS 18.121]*

Extract from IFRS 18

121 The objective of the disclosures for management-defined performance measures is for an entity to provide information to help a user of financial statements understand:

(a) the aspect of financial performance that, in management's view, is communicated by a management-defined performance measure; and

(b) how the management-defined performance measure compares with the measures defined by IFRS Accounting Standards.

The Board concluded that transparency about MPMs is enhanced by clearly stating the purpose and limitations of an MPM. Since an MPM reflects management's judgement about what is useful to users, sufficient information about that judgement is required for users to understand the information provided by the MPM and how it faithfully represents an aspect of the entity's financial performance. *[IFRS 18.BC377]*.

4.3.2 Information to be disclosed

IFRS 18 requires an entity to disclose information about all its MPMs in a single note to the financial statements and requires that this note includes a statement that MPMs provide management's view and are not comparable to MPMs of other entities.

The standard requires that each MPM is labelled and described in a clear and understandable manner and specifically requires the entity to make the following disclosures for each MPM: *[IFRS 18.123]*

(a) A description of the aspect of the entity's financial performance that, in management's view, is communicated by the MPM including an explanation why management believes that the MPM provides useful information about the entity's financial performance

(b) How the MPM is calculated

(c) A reconciliation to the most directly comparable total or subtotal specifically required by IFRS accounting standards or one of the subtotals listed in IFRS 18.118 (i.e., those which are not required, or defined, by IFRS accounting standards but which are commonly used by entities and well understood by users) (see section 4.2.4 above)

(d) The income tax effect and the effect on non-controlling interests for each reconciling item disclosed in the reconciliation required by (c) above

(e) A description of how the entity determined the income tax effect required by (d) above

Comparative numbers are also required for all MPM disclosures. *[IFRS 18.31]*

Any changes in MPMs need to be explained and comparative information must be restated to reflect these changes, unless it is impracticable to do so (see section 4.3.5 below).

Each of these requirements is discussed in more detail below.

Management's statement on the use of MPMs

An entity is required to include, in its MPM note, a statement that MPMs provide management's view of an aspect of the financial performance of the entity as a whole and are not necessarily comparable with measures provided by other entities that have a similar label or description. *[IFRS 18.122]*.

While the Board agreed MPMs can provide useful information, these measures are, by definition, entity-specific and, therefore, not necessarily comparable across entities, *[IFRS 18.BC326]*, and transparency about MPMs is enhanced by an entity clearly stating the purpose and limitations of an MPM. *[IFRS 18.BC377]*.

Labelling MPMs

An entity is required to label and describe each MPM in a clear and understandable manner that does not mislead users. *[IFRS 18.123]*. To meet this requirement, an entity will need to disclose information that enables users to understand which items of income or expense are included in, and which are excluded from, the particular subtotal.

The standard expands on this requirement by requiring an entity to label and describe each MPM in a way that faithfully represents its characteristics in accordance with the aggregation and disaggregation guidance in IFRS 18 (see section 2.2 above) by: *[IFRS 18.B135]*

(a) Labelling the measure in a way that represents the characteristics of that particular subtotal (for example, using the label 'operating profit before non-recurring expenses' only for a subtotal that does in fact exclude all expenses identified as non-recurring by the entity)

(b) Explaining the meaning of the terms used in the description that are necessary to understand the aspect of financial performance being communicated (for example, explaining how the entity defines 'non- recurring expenses' in its specific circumstances)

If the calculation of the MPM differs from the accounting policies the entity uses for the items in its statement(s) of financial performance, it is required to state that fact and disclose the calculations it used for the MPM. Additionally, where the calculation of the MPM also differs from accounting policies permitted or required by IFRS accounting standards, the entity must state that fact and where necessary explain the meaning of the terms used in calculating the MPM (see (b) above). *[IFRS 18.B134]*.

4.3.3 Reconciliation

IFRS 18 requires an entity to provide a reconciliation of each MPM to the most directly comparable total or subtotal specifically required by an IFRS accounting standard or a subtotal listed in IFRS 18.118 (see section 4.2.4 above). *[IFRS 18.123(c)]*. For example, an entity that discloses in the notes an MPM of 'adjusted operating profit or loss' will be required to reconcile that measure to the operating profit or loss total required to be presented under IFRS 18. *[IFRS 18.B136]*.

The Board decided to require such a reconciliation since it provides important information helping users to: *[IFRS 18.BC378]*

- Understand how an MPM relates to the totals or subtotals required by IFRS accounting standards
- Understand how the MPM compares with similar measures provided by other entities
- Judge whether to make their own adjustments to the measure

An entity applies the normal principles of aggregation and disaggregation to the reconciling items in order to decide the level of detail required. *[IFRS 18.B136]*.

For each reconciling item, an entity is required to disclose: *[IFRS 18.B137]*

(a) The line item presented in the statement(s) of financial performance that include the amount(s) making up the reconciling item

(b) A description of how the item:

  (i) Is calculated

  And

  (ii) Contributes to the MPM providing useful information (see below)

The Board decided to require the disclosure under (a) above since the fieldwork conducted while developing the standard indicated that the information provided by the reconciliation could vary depending on both the form of the reconciliation and the amount of detail included. The Board decided that linking the reconciling items with the related line items presented in the statement(s) of financial performance would help users understand the relationship between an MPM and the most directly comparable total or subtotal specifically required by an IFRS accounting standard or one of the subtotals listed in IFRS 18.118. *[IFRS 18.BC380]*.

The disclosure under (b) above is required, for each reconciling item, if it is necessary in order to explain (see section 4.3.2 above):

(1) What aspect of the entity's financial performance is being communicated by the MPM and why management believes the MPM provides useful information about the entity's financial performance

And/or

(2) How the MPM is calculated

This could be the case if there is more than one reconciling item and each item is calculated on a different basis or contributes to providing useful information in a different way. For example, an entity could exclude several items of expense from an MPM, some because they are considered outside management's control and others because they are considered non-recurring. In order to explain how the MPM provides useful information in such a case, the disclosure would need to distinguish which items contribute to which type of adjustment. *[IFRS 18.B138]*.

Conversely, a single explanation could be applicable to more than one item, or even all the reconciling items collectively. For example, an entity might calculate an MPM by excluding several items of income or expense based on an entity-specific application of 'non-recurring'. In such a case, the requirements in (b) above could be satisfied by a single explanation that applies to all reconciling items including the entity's definition of 'non-recurring' (i.e., what items it considers to be non-recuring and why). *[IFRS 18.B139]*.

The standard allows an entity to reconcile an MPM to a total or subtotal listed in IFRS 18.118; this is the case even if the entity does not present that total or subtotal in its statement(s) of financial performance.

In such cases, in addition to the reconciliation of the MPM to the total or subtotal listed in IFRS 18.118, the entity: *[IFRS 18.B140]*

(1) Is required to provide a reconciliation from that total or subtotal (listed in IFRS 18.118) to the most directly comparable total or subtotal actually presented by the entity in its statement(s) of financial performance

But

(2) Is not required to disclose the income tax effect and the effect on non-controlling interest for any of the reconciling items between the total or subtotal listed in IFRS 18.118 and the total or subtotal actually presented by the entity in its statement(s) of financial performance

The Board did not stipulate a specific format (for example, a table with reconciling items presented in columns) for the reconciliation since, in the Board's view, the most appropriate format for the reconciliation will depend on the MPM. *[IFRS 18.BC382]*.

4.3.3.A Income tax effect and the effect on non-controlling interests

An entity is required to disclose the income tax effect and the effect on non-controlling interests for each item disclosed in the reconciliation between an MPM and the most directly comparable total or subtotal specifically required by an IFRS accounting standard or one of the subtotals listed in IFRS 18.118. *[IFRS 18.B141]*. The Board decided to require this disclosure for each reconciling item because it gives users the necessary information to calculate their own adjusted earnings per share measure based on only the adjustments they want to consider in their analyses. *[IFRS 18.BC385]*.

Simplified approach

During the development of the standard, some preparers raised concerns that disclosing the tax effect for each reconciling item could be complex and costly if it had to be calculated in accordance with IAS 12. However, users indicated that high-level information about the tax effects of each reconciling item would meet their needs. Therefore, the Board decided to allow a simplified approach for calculating the income tax effect of the reconciling items in order to alleviate the costs to preparers. *[IFRS 18.BC386]*.

Under this simplified approach, an entity determines the income tax effect of each reconciling item by calculating the income tax effects for the underlying transaction(s) at the statutory tax rate(s) applicable to the particular transaction(s) in the relevant tax jurisdiction(s). *[IFRS 18.B141]*.

Alternative approaches

Alternatively, the standard also allows an entity to calculate the tax effects for the underlying transaction(s): *[IFRS 18.B141]*

- Based on a reasonable *pro rata* allocation of the entity's current and deferred tax in the relevant tax jurisdiction(s)

  Or

- Using another method, provided it achieves a more appropriate allocation in the circumstances

The Board decided to allow the use of alternative approaches for calculating the tax effects since limiting the methods would restrict an entity's judgement in providing the best possible information in the circumstances, which could reduce the usefulness of the information provided. This approach is similar to the approach set out in IAS 12.63 for determining the income tax effect on items of other comprehensive income.[17] *[IFRS 18.BC387]*.

IFRS 18.123(e) requires an entity to disclose a description of how it determined the income tax effect, discussed above, for the reconciling items it discloses. *[IFRS 18.123(e)]*. If an entity uses more than one method to calculate the income tax effects of its reconciling items, the entity is required to disclose how it determined the tax effects for each reconciling item. *[IFRS 18.B142]*.

4.3.3.B Example of a reconciliation

The Illustration below is based on the example included in the Illustrative Examples to IFRS 18 and shows XYZ Group's disclosures for its MPM. *[IFRS 18.IE8]*. In the interest of brevity, the comparative table has not been provided in the Illustration below, but comparative numbers are required for all MPM disclosures. *[IFRS 18.31]*.

For the purpose of this Illustration, assume that XYZ Group has:

(a) Disclosed a statement saying adjusted operating profit provide management's view of XYZ Group's operating profit and profit and is not necessarily comparable with measures sharing similar labels or descriptions provided by other entities (see section 4.3.2 above)

(b) Labelled and described its MPM in a clear and understandable manner by explaining that it has adjusted operating profit and profit for non-recurring items of income or expense that it does not expect to arise for several future annual reporting periods (see section 4.3.2 above)

(c) Included a description of the aspect of financial performance the MPM communicates. The entity explained that, in management's view, adjusted operating profit provide useful information about XYZ Group's financial performance because it provides information that is helpful in understanding trends in underlying profitability (see section 4.3.2 above)

(d) Explained how it calculated adjusted operating profit by explaining the specific adjusting items and it has cross-referred its adjusting items to related notes in its financial statements and provided a detailed explanation of restructuring expenses in its note on MPMs (see section 4.3.3 above)

(e) Provided a reconciliation between operating profit and adjusted operating profit - that is, a reconciliation to the most directly comparable subtotal presented in XYZ Group's statement of profit or loss (see section 4.3.3 above)

(f) Included for each of its adjusting items the income tax effect, the effect on non-controlling interests and the amount(s) related to each line item in XYZ Group's statement of profit or loss (see section 4.3.3.A above).

(g) Included a description of how it determined the income tax effects (see section 4.3.3.A above)

Illustration 4-1: MPMs note

XYZ Group's management-defined performance measures

XYZ Group uses the management-defined performance measure adjusted operating profit in its public communications. This measure is not specified by IFRS accounting standards. Therefore, it might not be comparable to apparently similar measures used by other entities.

To provide management's view of XYZ Group's financial performance, operating profit has been adjusted for items of income or expense that XYZ Group does not expect to arise for several future annual reporting periods. XYZ Group's management believes adjusting operating profit for such items provides information that is helpful in understanding trends in XYZ Group's underlying profitability.

XYZ Group generally adjusts for these items of income or expense:

- Impairment losses (or reversals thereof) of property, plant and equipment (including right-of-use assets) and intangible assets (for information related to impairments, refer to Note X Property, plant and equipment, Note Y Intangible assets and Note Z Research and development expenses)
- Restructuring expenses (for information related to restructuring expenses, refer to Note U Employee benefits and Note V General and administrative expenses)
- Non-recurring litigation expenses (for information related to litigation expenses, refer to Note W Provisions and Note V General and administrative expenses)
- Gains or losses on disposal of property, plant and equipment and of intangible assets (for information related to disposal of property, plant and equipment and intangible assets, refer to Note X Property, plant and equipment, Note Y Intangible assets and Note T Other operating income)
- Gains or losses on disposal of subsidiaries, associates and joint ventures

17 See Chapter 29.

XYZ Group assesses non-recurrence of litigation expenses on a case-by-case basis. XYZ Group generally categorises litigation expenses arising from intellectual property disputes, regulatory violations and employee claims as 'non-recurring'. This classification is based on XYZ Group's proactive approach of having in place measures designed to prevent such events from occurring.

Management-defined performance measures 20X2

(in thousands of CU)		Income tax expense:	Profit attributable to NCI
Operating profit (IFRS-specified)	**57,000**		
Gains on disposal of property, plant and equipment (included in 'Other operating income')	(1,800)	297	-
Impairment losses:	6,100	-	305
▸ Included in 'Research and development expenses'	1,600		
▸ Included in 'Goodwill impairment loss'	4,500		
Restructuring expense (included in 'General and administrative expenses')	3,800	(589)	161
Adjusted operating profit (MPM)	**65,100**		

Impairment losses	Impairment losses incurred in 20X2 did not yield any tax benefits because they were not eligible for tax deductions in Country A and Country B.
Restructuring expenses	The restructuring expenses in 20X2 are related to XYZ Group's restructuring programme 'Apollo 20X2'. These expenses include redundancy expenses, employee retraining expenses and relocation expenses, all related to the closure of several factories in Country C. The tax effect of these restructuring expenses is calculated based on the statutory tax rate applicable in Country C at the end of 20X2, which was 15.5%.
Gains on disposal of property, plant and equipment	The tax effect of gains on disposal of property, plant and equipment is calculated based on the statutory tax rate applicable in Country D at the end of 20X2, which was 16.5%.

4.3.4 All required MPM disclosures in a single note

The standard requires that an entity includes all the required information about MPMs in a single note to the financial statements. *[IFRS 18.122]*. The Board decided this will improve the transparency of those measures by: *[IFRS 18.BC369]*

(a) Providing MPMs in the same place as the calculations, explanations and reconciliations necessary to understand those MPMs

And

(b) Helping users easily locate all the information about MPMs

The Board decided not to specify that an entity can comply with the requirements by cross-reference since, if an entity uses cross-referencing, the information would be fragmented between several locations, possibly reducing transparency by making it more difficult to locate the information and understand the financial statements as a whole. The Board decided that an explicit prohibition against cross-referencing is not required as common practice under IFRS accounting standards is only to cross-refer if an IFRS accounting standard specifically allows it. *[IFRS 18.BC370, IFRS 18.BC371]*. This raises the question of whether an entity, in an effort to avoid duplication, is allowed to combine MPM disclosures with other information in the same note. This is addressed in IFRS 18.B132:

Extract from IFRS 18

B132 Paragraph 122 requires an entity to include in a single note all information about management-defined performance measures required by paragraphs 121-125. If an entity also discloses other information in that note, the information in the note shall be labelled in a way that clearly distinguishes the information required by paragraphs 121-125 from the other information.

The standard does not prohibit an entity from including additional information in the note on MPMs, in fact IFRS accounting standards require disclosure of additional information when compliance with the specific requirements in IFRS accounting standards is insufficient to enable users to understand the effect of transactions and other events and conditions on the entity's financial position and financial performance. However, the Board concluded that it was important to separately identify the required information about MPMs from other information included in the financial statements so that it is clear which measures are subject to the MPM requirements. *[IFRS 18.BC373]*.

Therefore, if an entity also discloses other information in the same note, the MPM information needs to be labelled in such a way that it can be clearly distinguished from the other information. *[IFRS 18.B132]*. For example, where the reportable segment information of an entity applying IFRS 8, includes an MPM, the entity could disclose the required MPM information in the same note as the other reportable segment information, provided the entity either: *[IFRS 18.B133]*

(a) Includes the required information about MPMs for all its MPMs in that note and labels the information in a way that clearly distinguishes the MPM information required by IFRS 18 from the other information required by IFRS 8

Or

(b) Provides a separate MPM note that includes the required information for all of the entity's MPMs, thereby duplicating the MPM information already included in the reportable segment note

4.3.5 Changes to MPMs

When an entity changes how it calculates an MPM, starts using a new MPM, stops using a previously disclosed MPM, or changes how it determines the income tax effects of any items disclosed in the reconciliation required for each MPM, it must disclose: *[IFRS 18.124]*

(a) An explanation enabling users to understand the change, addition or cessation and its related effects

(b) The reasons for the change, addition or cessation

And

(c) Restated comparative information reflecting the change, addition or cessation unless it is impracticable to restate comparatives

These disclosures are based on the information required by IAS 8 if an entity changes its accounting policies since the Board concluded that similar information would be useful to users if an entity makes changes to its MPMs. However, the Board stated that the choice of an MPM, including how the measure is calculated or how the entity calculates the income tax effects of reconciling items, is not an accounting policy choice as defined in IAS 8 and the disclosure requirements in IAS 8, therefore, do not apply. *[IFRS 18.BC388]*. The standard clarifies that while an entity's selection of an MPM is not an accounting policy choice, an entity is still required to apply the requirements in IAS 8.50-53 when assessing whether it is impracticable to restate comparative information. *[IFRS 18.124]*.

If an entity is not able to disclose the restated comparative information required by IFRS 18.124(c) because it is impracticable to do so, the entity must disclose that fact. *[IFRS 18.125]*.

4.4 Presentation of MPMs

The Board initially considered prohibiting an entity from presenting MPMs on the face of the statement(s) of financial performance, since some stakeholders were concerned that MPMs could be misleading and might otherwise be given undue prominence, but it ultimately decided against doing so. IFRS 18 requires an entity to present line items and subtotals (including line items and subtotals not specifically required by an IFRS accounting standard) in the statement(s) of financial performance if they are necessary to provide a 'useful structured summary' of the entity's income and expenses. Therefore, prohibiting an entity from presenting MPMs in the statement(s) of financial performance could prevent it from complying with this requirement. *[IFRS 18.BC374]*.

The Board noted that an entity presenting an MPM in the statement(s) of financial performance, will need to comply with the requirements set out in IFRS 18.24 for additional subtotals presented in the statement(s) of financial performance (see section 2.1.1.A above). An entity that presents an MPM in the statement(s) of financial performance would also need to disclose all the information required for MPMs in a single note, even if this results in duplication. *[IFRS 18.BC375]*.

How we see it

It is observed practice in some jurisdictions to present alternative performance measures alongside the IFRS accounting standard numbers on the face of the statement of financial performance using columns.

Since IFRS 18 does not prohibit presenting MPMs in the statement of financial performance, an entity currently using this 'column' approach needs to consider whether this provides a 'useful structured summary' of the entity's income and expenses. Such an entity must also consider whether this approach could comply with:

- The requirements in IFRS 18.24 for additional line items and subtotals (see section 2.1.1.A above)

  And
- The requirement in IFRS 18.25 to clearly identify the financial statements and distinguish them from other information in the same published document (see section 1.3 above).

5 Consequential amendments to other standards - IFRS 18

IFRS 18 introduced consequential amendments to other IFRS accounting standards. Most of the amendments are of an editorial nature, such as amending references from IAS 1 to IFRS 18. Other more significant consequential amendments are discussed in the sub-sections below.

An entity is required to apply these consequential amendments when it applies IFRS 18. For more information on transition, refer to section 6 below.

5.1 IAS 7 *Statement of Cash Flows*

The amended IAS 7, once effective, will require all entities to use the 'operating profit' subtotal as the starting point for determining cash flows from operating activities under the indirect method. *[IAS 7(2027).18(b)]*. The Board decided to require all entities to use the same starting point for the indirect method to reduce existing diversity in practice. The Board expects that the use of the operating profit subtotal as a consistent starting point will make the statement of cash flows more consistent and help investors analyse and compare companies' operating cash flows. The change in the starting point will also simplify the presentation of cash flows from operating activities as it will eliminate some reconciling items that are used at present. *[IAS 7(2027).BC47]*.

How we see it

Since the current guidance in IAS 7 (before the IFRS 18 amendments) requires the use of 'profit or loss' as the starting point without defining what 'profit or loss' refers to, it is common practice for entities to use 'profit (or loss) before tax' or 'profit (or loss) after tax' as a starting point for the reconciliation under the indirect method. Therefore, we expect the amendments to IAS 7 to impact most, if not all, entities.

The amendments will also remove the optionality around the classification of cash flows from dividends and interest in the statement of cash flows. That removal aims to increase comparability between entities and provide more meaningful information as, currently, the different classifications of these cash flows do not necessarily convey information about the role of interest and dividends in an entity's business activities. *[IAS 7(2027).BC48]*.

The standard requires that cash flows from dividends paid must be included in financing cash flows because dividends paid are a cost of obtaining financing. *[IAS 7(2027).33A, IAS 7(2027).BC49]*.

Entities without a specified main business activity

Entities that do not have a specified main business activity of investing in assets or providing finance to customers will be required to classify interest paid as financing activities, and interest and dividends received as cash flows from investing activities. *[IAS 7(2027).34A]*.

Entities with a specified main business activity

For entities that have a specified main business activity of investing in assets or providing finance to customers, the classification of cash flows from dividends received, interest paid and interest received will follow the classification of the related income and expenses in the statement of profit or loss. This means that entities will determine how to classify dividends received, interest received, and interest paid in the statement of cash flows by referring to how the related dividend income, interest income and interest expenses are classified in the statement of profit or loss applying IFRS 18. *[IAS 7(2027).34B]*.

The IASB decided to adopt a 'single category' approach to classifying dividends received, interest paid, and interest received. Therefore, the amended IAS 7 will require an entity to classify the total of each of these cash flows in a single category (i.e., either as operating, investing or financing activities). *[IAS 7(2027).34B, IAS 7(2027).BC50]*. This means that an entity with a main business activity of investing in assets will, for example, classify the total of all the cash flows from interest paid in financing activities in its statement of cash flows, if that entity classifies all of its interest expense in the financing category in its statement of profit or loss. The same requirements equally apply to the total of all interest received and the total of all dividends received respectively.

This single category approach applies even if the associated income and expenses are classified into more than one category in the statement of profit or loss when applying IFRS 18. *[IAS 7(2027).BC55]*. If that is the case, IAS 7 provides the following accounting policy choice: *[IAS 7(2027).34D]*

Extract from IAS 7 (as amended by IFRS 18)	
34D	In applying IFRS 18, an entity may be required to classify each of dividend income, interest income and interest expenses in more than one category of the statement of profit or loss. In such a case, in applying paragraph 34B the entity shall make an accounting policy choice to classify the related cash flows in one of the associated activities in the statement of cash flows. For example, if an entity classifies interest expenses in the operating category and the financing category of the statement of profit or loss, the entity would classify all its interest paid in accordance with its accounting policy as either cash flows from operating activities or cash flows from financing activities.

The application of these requirements and the accounting policy choice will result in the total of: (a) dividends received, (b) interest paid and (c) interest received, each respectively being classified into a single category within the statement of cash flows.

The total of each type of cash flow (i.e., (a)-(c) above) must be assessed separately and the three types would not necessarily be classified into the same category. For example, an entity that classifies all interest paid into financing activities in its statement of cash flows (in alignment with its profit or loss classification) might classify the total of all dividends received within investing activities in its statement of cash flow (applying the requirements or the accounting policy choice discussed above). *[IAS 7(2027).34C]*.

The table below, based on Table 4 in the IASB's *Effects Analysis* of IFRS 18,[18] presents the comparison of the IAS 7 requirements before and after the amendments:

Cash flow item	Classification before amendments to IAS 7	Classification after amendments to IAS 7	
		Companies without specified main business activities	**Companies with specified main business activities**
Interest received	Operating or investing	Investing	A single category for the total of each type of cash flow* - operating, investing or financing
Interest paid	Operating or financing	Financing	
Dividends received	Operating or investing	Investing	
Dividends paid	Operating or financing	Financing	Financing

* As noted above, classification of these types of cash flows for entities with a specified main business will be impacted by how the related income and expenses are classified in the statement of profit or loss.

The new requirements are illustrated below, based on the Illustrative Example A that accompanies the amended IAS 7. *[IAS 7(2027).IE A]*.

Since this chapter focuses on the new requirements introduced by IFRS 18, only the consolidated statement of financial performance and the statement of cash flow using the indirect method are presented.

The example illustrates current period reporting, however, comparative information for the preceding period is required to be presented in accordance with IFRS 18.

Illustration 5-1: A Statement of cash flows for an entity without a specified main business activity

Consolidated statement of financial performance for the period ended 20X2[(a)]	
Sales	30,650
Cost of sales	(26,450)
Gross profit	4,200
Selling expenses	(600)
General and administrative expenses	(310)
Operating profit	3,290
Share of equity accounted investments	50
Investment income	450
Foreign exchange loss	(40)
Profit before financing and income taxes	3,750
Interest expenses	(400)
Profit before income taxes	3,350
Income tax expense	(300)
Profit/total comprehensive income	**3,050**

(a) The entity did not recognise any components of other comprehensive income in the period ended 20X2

18 Effect Analysis: IFRS 18 Presentation and Disclosure in Financial Statements, April 2024. Available on the IFRS Foundation's website.

Consolidated statement of cash flows		
Cash flows from operating activities		**20X2**
Operating profit	3,290	
Adjustments for:		
Depreciation	350	
Amortisation	100	
Operating profit before depreciation and amortisation	3,740	
Increase in trade receivables	(500)	
Decrease in inventories	1,050	
Decrease in trade payables	(1,740)	
Cash from operating activities before income taxes	2,550	
Income taxes paid	(900)	
Net cash from operating activities		1,650
Cash flows from investing activities		
Acquisition of Subsidiary X, net of cash acquired	(550)	
Purchase of property, plant and equipment	(350)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividends received	200	
Net cash used in investing activities		(480)
Cash flows from financing activities		
Proceeds from issue of share capital	250	
Proceeds from long-term borrowings	250	
Payment of lease liabilities	(90)	
Interest paid	(270)	
Dividends paid	(1,200)	
Net cash used in financing activities		(1,060)
Net increase in cash and cash equivalents		110
Cash and cash equivalents at beginning of period		120
Cash and cash equivalents at end of period		**230**

The operating, investing and financing categories in IFRS 18 have different meanings to those in IAS 7. While developing IFRS 18, the IASB prioritised the objectives of each primary financial statement and did not seek alignment between the operating, investing and financing categories in the statement of profit or loss and the statement of cash flows (see section 3 above). *[IFRS 18.BC86]*

5.2 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*

The amendments, once effective, will change the scope and title of IAS 8 due to certain sections previously included within IAS 1 being moved to IAS 8.

The objective of the amended standard is to enhance the relevance and reliability of an entity's financial statements, and the comparability of those financial statements over time and with financial statements of other entities, by prescribing the basis of preparation of financial statements. *[IAS 8(2027).1]*.

While developing IFRS 18, the Board concluded that some requirements setting out general features of financial statements and some disclosure requirements fit better with the content of IAS 8. Therefore, the Board decided to move those requirements from IAS 1 to IAS 8. The requirements that the Board decided to move are: *[IAS 8(2027).BC3A]*

(a) The concepts of fair presentation and compliance with IFRS accounting standards

(b) Whether an entity is a going concern

(c) The accrual basis of accounting

(d) Disclosure of an entity's selection and application of accounting policies

These relocated requirements are in addition to the guidance currently included in IAS 8 on accounting policies, changes in estimates and errors.[19]

The Board changed the title of the amended IAS 8 to *Basis of Preparation of Financial Statements* to better reflect the updated content of IAS 8.

How we see it

Although the consequential amendments to IAS 8 might seem significant in terms of volume, since these requirements are carried over from IAS 1 mostly unchanged, we do not expect any significant impact on current practice.

Given the IASB's intention in relocating the guidance to IAS 8 was to improve the organisation of the IFRS accounting standards and to provide users with all the relevant topical content in one standard, we expect the experience of preparers navigating between the different standards and requirements to improve.

19 For the relevant guidance on the requirements currently included in IAS 8, see Chapter 3.

5.3 IAS 33 *Earnings per share*

IAS 33 requires entities to report basic and diluted earnings per share. The amended IAS 33, once effective, will permit entities to disclose additional amounts per share, if the numerator used in the calculation meets specified criteria. The IASB concluded that it was necessary to specify the numerator (or numerators) an entity can use when disclosing additional amounts per share to ensure that users of financial statements receive the same information about additional amounts per share as they receive for MPMs. *[IAS 33(2027).BC16, IAS 33(2027).BC17]*.

Therefore, an entity can only use additional numerators that are amounts attributable to ordinary equity holders of the parent entity of: *[IAS 33(2027).73B]*

- A total or subtotal identified in IFRS 18 (in paragraphs 69, 86 and 118 of IFRS 18 - see section 4.2.4 above)
  Or
- A management-defined performance measure (or MPM) as defined by IFRS 18 (see section 4.2 above)

In line with current requirements in IAS 33 (before the amendments), the amended standard specifies that the additional basic and diluted amounts per share must be disclosed with equal prominence and must be calculated using the weighted-average number of ordinary shares determined in accordance with IAS 33. *[IAS 33(2027).73C(a), IAS 33(2027).73C(b)]*.

The amended standard explicitly states that the additional amount per share cannot be presented in the primary financial statement and can only be disclosed in the notes. *[IAS 33(2027).73C(c)]*. The 'note only' disclosure requirement results from the fact that additional 'amounts per share' calculations require additional information and reconciliations between these additional amounts and the measures presented in the primary financial statements, in order to be understood by users. *[IAS 33(2027).BC18]*.

If an entity uses an MPM as a numerator in an earnings per share calculation, it must follow the disclosure guidance required for MPMs, in IFRS 18.121-125 (see section 4.3 above), for that numerator. *[IAS 33(2027).73C(d)]*.

Sometimes an entity is required by local law or regulation to disclose amounts per share in addition to basic and diluted earnings per share as required by IAS 33 (for example, adjusted earnings per share). Under the restrictions on allowable numerators in the amended standard, the entity would be permitted to disclose that amount per share in its financial statements, if it concludes that the numerator required by local law or regulation meets the definition of an MPM in IFRS 18. *[IAS 33(2027).BC17]*.

How we see it

Although both the current and amended IAS 33 allow entities to disclose additional amounts per share, the amended IAS 33 introduces restrictions on the nature of allowable numerators to be used in the calculation of such an additional amount per share and requires additional disclosures.

5.4 IAS 34 *Interim Financial Reporting*

IFRS 18, once effective, will amend the disclosure requirements for interim financial reporting. Under the amended standard, an entity will be required to make disclosures about its MPMs, as defined in IFRS 18 (see section 4.2 above), in the notes to the condensed interim financial statements. *[IAS 34(2027).16A(m)]*. The scope of these disclosures in the condensed interim financial statements is the same as that required in an entity's complete set of financial statements. As a result, an entity will be required to provide the same range of information on MPMs in its interim financial reporting no matter what the form and content of the interim financial statements might be.

The requirement in the amended IAS 34 to provide information on MPMs in the interim reporting is intended to provide users with transparent information about these measures and allow them to analyse all aspects of an entity's performance on a timely basis. *[IAS 34(2027).BC10A]*.

Consistent with the objective of condensed interim financial reports, an entity does not need to repeat previously reported information about MPMs, for example, information about why an entity's management considers that an MPM communicates aspects of the entity's performance. *[IAS 34(2027).BC10B]*.

It is worth noting that, because MPMs relate to performance for the same reporting period as the financial statements, a subtotal that relates to the annual financial statements, but not to interim financial statements, is only an MPM in the annual financial statements (see section 4.2.2 above).

How we see it

Generally, the disclosure requirements in IAS 34 are less prescriptive for condensed interim financial statements compared to complete financial statements. The fact that the Board decided that the same level of prescriptiveness is required for disclosure about MPMs in condensed interim financial statements highlights the Board's assessment that more detailed information about MPMs is also decision-useful in combination with otherwise condensed financial information.

6 Transition - IFRS 18

IFRS 18 supersedes IAS 1 and is effective for reporting periods beginning on or after 1 January 2027. Earlier application is permitted and must be disclosed in the notes. *[IFRS 18.C1]*. An entity is required to apply the consequential amendments to other IFRS accounting standards when it applies IFRS 18.

The standard applies retrospectively. However, an entity is not required to present the quantitative information specified in IAS 8.28(f) (i.e., the adjustment for each financial statement line item affected and the related effect on basic and diluted EPS, for the current period and each prior period presented). *[IFRS 18.C2]*.

In its annual financial statements, an entity must disclose, for the comparative period immediately preceding the period in which IFRS 18 is first applied, a reconciliation between each item in the statement of profit or loss between: *[IFRS 18.C3]*

- The restated amounts presented in accordance with IFRS 18

  And
- The amounts previously presented applying IAS 1

An entity is permitted, but not required, to provide the reconciliation for: *[IFRS 18.C6]*

- The reporting period in which IFRS 18 is first applied

  And/or
- Earlier comparative periods

At the date of initial application of IFRS 18, an entity that is eligible[20] to apply paragraph 18 of IAS 28 (see section 3.3.5.A above) is permitted to change its election for measuring an investment in an associate or joint venture from the equity method to fair value through profit or loss in accordance with IFRS 9. If an entity makes such a change, it applies the change retrospectively, applying IAS 8. An entity that applies the election is required to account for the applicable investments in the same way in its separate financial statements, as required by IAS 27.11. *[IFRS 18.C7]*.

How we see it

While there might appear to be ample time before the effective date of IFRS 18, entities are strongly encouraged to begin analysing the new requirements. Many entities will need to identify and collect information, which in some cases, could necessitate changes to their internal information systems and their financial statement close process.

Management needs to plan ahead as the transition process could require considerable time and involve the combination of resources from financial reporting, legal and investor relations, among others.

In addition, there could be impacts on remuneration agreements and covenants. Entities are advised to monitor practice as it develops, with a focus on the specific developments in their particular industry.

Some entities might consider a 'phased transition'. That is, IFRS 18, although a new standard, carries over most of the requirements of IAS 1, and many of the new requirements, such as the additional guidance on aggregation and disaggregation, comply to a great extent with the requirements of IAS 1. Similarly, the new requirements regarding MPM disclosures generally do not conflict with the disclosure requirements of IAS 1. Furthermore, some of the required changes in presentation when adopting IFRS 18, could, in some cases, be justifiable under the guidance in IAS 1 and IAS 8 regarding changes in presentation policies. Whether a phased or a 'all at once' transition to IFRS 18 is appropriate will have to be determined by an entity's specific facts and circumstances.

20 For further guidance on eligible entities, see Chapter 12 at section 3.3.

6.1 Interim reporting

If an entity prepares condensed interim financial statements in accordance with IAS 34, in the first year of applying IFRS 18, it presents each heading it expects to use and the subtotals required in IFRS 18 in its condensed interim financial statements. This is despite the requirement in IAS 34.10 to retain in the interim financial statements the headings and subtotals included in the most recent annual financial statements. That requirement is effectively ignored in each set of condensed interim financial statements until an entity has issued its first set of annual financial statements prepared in accordance with IFRS 18. *[IFRS 18.C4]*.

As part of the information required by IAS 34.16A(a) (i.e., where accounting policies have changed since the last annual period, a description of the nature and effect of these changes), an entity that applies IAS 34 to prepare interim financial statements in the first year of applying IFRS 18, discloses a reconciliation for each line item presented in the statement of profit or loss for the comparative periods immediately preceding the current periods between: *[IFRS 18.C5]*

(a) The restated amounts applying IFRS 18 to the comparative period and the cumulative comparative period

And

(b) The amounts previously presented applying IAS 1 to the comparative period and cumulative comparative period

An entity can voluntarily provide additional reconciliations between the IAS 1 and IFRS 18 presentation for: *[IFRS 18.C6]*

- The current interim period (and the cumulative current interim period)

  And/or

- An earlier interim period in addition to those immediately preceding the current period as required above

These requirements are shown in the Illustration below:

Illustration 6-1: Entity publishing quarterly interim financial reports

Entity A's financial year ends 31 December 2027 (i.e., calendar year) and it prepares quarterly interim financial statements. Entity A adopts IFRS 18 from 1 January 2027.

Entity A will present the following periods in its statement of profit or loss in its second quarterly interim statements report as of 30 June 2027:

		Statement of profit of loss applying IFRS 18	
		Comparatives*	**Current period**
Year to date	6 months ending:	30 June 2026	30 June 2027
Q2	3 months ending:	30 June 2026	30 June 2027

* Retrospectively restated

In addition, it will disclose a reconciliation between each line items as presented in the comparative (and cumulative comparative) statement of profit and loss applying IFRS 18 and the amounts previously presented for those comparatives applying IAS 1, for the following periods:

		Comparatives
Year to date	6 months ending	30 June 2026
Q2	3 months ending	30 June 2026

7 IFRS 19 *Subsidiaries without Public Accountability: Disclosures*

7.1 Overview

In May 2024, the IASB issued IFRS 19, which allows eligible entities to elect to apply the reduced disclosure requirements of IFRS 19, while still applying the recognition, measurement and presentation requirements in other IFRS accounting standards. The application of the standard is optional for eligible entities and an entity applying IFRS 19 is required to disclose that fact as part of its general IFRS accounting standards compliance statement.

The standard will become effective for reporting periods beginning on or after 1 January 2027, with early application permitted. In the first year of applying IFRS 19, an entity is required to disclose comparative information for the current year amounts disclosed as required by IFRS 19 (rather than the amounts disclosed in the prior year as required under other IFRS accounting standards), unless IFRS 19 or another IFRS accounting standard permits or requires otherwise.

The following subsections contain a summary of the context, purpose and contents of the standard.

7.2 The need for a reduced disclosure framework

The standard was developed in response to the Board's *Request for Views: 2015 Agenda Consultation*. Respondents had suggested that the Board consider permitting a subset of subsidiaries to apply IFRS accounting standards with reduced disclosure requirements. Respondents noted that although the *IFRS for SMEs* accounting standard has fewer disclosure requirements, its recognition and measurement requirements differ from those in IFRS accounting standards. This means that a subsidiary which applies the *IFRS for SMEs* accounting standard must maintain additional accounting records, in order to meet the group reporting requirements of its parent.

Eligible subsidiaries are subsidiaries of a parent that prepares consolidated financial statements available for public use, which comply with IFRS accounting standards. The Board noted that some disclosures in other IFRS accounting standards are more relevant to investment decisions in public capital markets than to transactions, other events and conditions encountered by typical eligible subsidiaries; these subsidiaries would therefore benefit from a reduced disclosure framework.

The Board undertook the project to reduce the cost of preparing financial statements under IFRS accounting standards for subsidiaries that are not publicly accountable and to extend the application of IFRS accounting standards within groups, while maintaining the usefulness of the information provided. The Board believes that the usefulness of the financial statements is maintained because the disclosures would be tailored to the needs of users of the subsidiaries' financial statements by removing certain disclosures that are more relevant for publicly accountable entities.

7.3 Key features of the standard

7.3.1 The objective of the standard

The objective of the standard is to allow eligible entities to apply the reduced disclosure requirements set out in IFRS 19, while still applying the recognition, measurement and presentation requirements in other IFRS accounting standards. Unless otherwise specified, eligible entities that elect to apply IFRS 19 will not need to apply the disclosure requirements in other IFRS accounting standards. *[IFRS 19.2, IFRS 19.3]*.

7.3.2 Eligible entities

An entity may elect to apply IFRS 19 if at the end of the reporting period:

- It is a subsidiary as defined in IFRS 10 *Consolidated Financial Statements*
- It does not have public accountability

  And
- It has a parent (either ultimate or intermediate) that prepares consolidated financial statements, available for public use, which comply with IFRS accounting standards

An eligible entity (including an intermediate parent) can apply IFRS 19 in its consolidated, separate or individual financial statements. IFRS 19 is applicable for both annual and interim reporting. *[IFRS 19.7]*.

7.3.2.A Public accountability

IFRS 19 uses the same language as the *IFRS for SMEs* accounting standard to define 'public accountability'. An entity is publicly accountable if:

- "its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market"

  Or

- it "holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses"

Entities that fall within the 'holding assets in a fiduciary capacity' criterion must do so for the purposes of their primary business (for example, this is often the case for banks, insurance companies and mutual funds). Entities that hold assets in a fiduciary capacity for reasons that are incidental to their primary business are not publicly accountable (for example, this might be the case for travel or real estate agents and utility companies that receive payments in advance of delivery of the goods or services). *[IFRS 19.11, IFRS 19.12]*.

7.3.3 Voluntary application

An entity that meets the requirements to apply IFRS 19 as described above may apply the standard on a voluntary basis. An entity may revoke its election to apply IFRS 19 at any time, in which case, it would be required to prepare financial statements that provide the disclosures set out in other IFRS accounting standards. IFRS 19 permits an entity to elect to apply the standard more than once, enabling entities that have revoked their election to reapply it in a later period. *[IFRS 19.13]*.

7.3.4 Statement of compliance

IFRS 19 requires an entity to disclose the fact that it is applying the standard as part of its general compliance statement, by making an explicit and unreserved statement of compliance with IFRS accounting standards and the disclosure requirements in IFRS 19. *[IFRS 19.20]*. The reference to IFRS 19 in the compliance statement must be made in both annual and interim financial statements.

How we see it

Based on IFRS 19.20 and IFRS 19.BC63, an example of such a compliance statement could be as follows: 'These [consolidated/ separate/ individual] financial statements have been prepared in accordance with IFRS Accounting Standards including IFRS 19 *Subsidiaries without Public Accountability: Disclosures*.'

7.3.5 Principles used to develop the disclosure requirements

Despite its name, the *IFRS for SMEs* accounting standard can be used by a company of any size, provided it does not have public accountability. Therefore, as a starting point, the Board applied the broad principles it had used for developing the disclosure requirements of that standard. However, there are recognition and measurement differences for certain topics between the *IFRS for SMEs* accounting standard and other IFRS accounting standards. For topics where the recognition and measurement requirements are the same, the disclosure requirements in the *IFRS for SMEs* accounting standard have been used, with the wording aligned to that used in other IFRS accounting standards. For topics where the recognition and measurement requirements differ, the disclosure requirements in IFRS 19 have been developed directly from the IFRS accounting standards addressing those topics. *[IFRS 19.BC41, IFRS 19.BC44]*.

The Board identified six broad principles which would provide information about topics important to users and to their understanding of the financial statements. Users are typically interested in information about *[IFRS 19.BC33]*:

- Short-term cash flows, obligations, and commitments or contingencies (whether or not they are recognised as liabilities)
- Liquidity and solvency
- Measurement uncertainties
- An entity's accounting policy choices
- Disaggregation of amounts presented in the financial statements
- Disclosures relevant to transactions and other events and conditions encountered by typical eligible entities

7.3.6 Disclosure requirements and references to other IFRS accounting standards

The disclosure requirements in IFRS 19 are organised into subheadings by IFRS accounting standard. Some disclosure requirements in IFRS accounting standards (e.g., those embedded in paragraphs that include recognition, measurement or presentation requirements) remain applicable and these are specified under the subheading for each IFRS accounting standard. For example, the subsection related to IFRS 5 includes a paragraph labelled "Disclosure requirements in IFRS 5 that remain applicable", with specific references paragraphs in IFRS 5 that are still applicable. *[IFRS 19.4(a)]*.

IFRS 19 disclosures exclude IFRS 8, IFRS 17 and IAS 33. Therefore, if an entity that applies IFRS 19 is required to apply IFRS 17 or elects to apply IFRS 8 and/or IAS 33, that entity would be required to apply all the relevant disclosure requirements in those standards. *[IFRS 19.4(b)]*.

Similarly, a new or amended IFRS accounting standard may include transitional disclosure requirements (i.e., those disclosures required in the first year of application of a new or amended IFRS accounting standard). Any relief from such transitional disclosure requirements will be set out in the new or amended IFRS accounting standard. *[IFRS 19.4(c)]*.

How we see it

Within the various subsections, IFRS 19 identifies specific disclosure requirements in other IFRS accounting standards that remain applicable. Therefore, entities will need to refer to other IFRS accounting standards and follow the specified disclosure requirements. As such, IFRS 19 is not a 'stand-alone' accounting standard.

7.3.7 Overarching principle of materiality

Eligible entities that elect to apply IFRS 19 do not need to provide a disclosure specified by IFRS 19, if the information resulting from that disclosure is not material. Furthermore, entities need to consider whether to provide additional disclosures when compliance with the specific requirements in IFRS 19 is insufficient to enable users to understand the effect of transactions and other events and conditions on the entity's financial position and financial performance. *[IFRS 19.5]*.

7.4 Effective date and transition

IFRS 19 is effective for reporting periods beginning on or after 1 January 2027 and earlier application is permitted. If an eligible entity chooses to apply the standard earlier, it is required to disclose that fact. *[IFRS 19.A1]*.

An entity is required, during the first period (annual and interim) in which it applies the standard, to disclose comparative information for current year amounts as required by IFRS 19 (rather than the amounts disclosed in the prior year as required under other IFRS accounting standards), unless IFRS 19 or another IFRS accounting standard permits or requires otherwise. If relevant, an entity will include comparative information for narrative and descriptive information. Similarly, an entity that revokes its election to apply IFRS 19 will need to provide comparatives for all amounts disclosed under the requirements in other IFRS accounting standards. *[IFRS 19.14, IFRS 19.15]*.

If an entity that applied IFRS accounting standards, but not IFRS 19, in the immediately preceding period, elects to apply IFRS 19 in the current period, the requirements in IFRS 1 *First-time Adoption of International Financial Reporting Standards* and the requirements for changes in accounting policies in IAS 8 will not be applicable. Similarly, if an entity revokes its election (or is no longer eligible) to apply IFRS 19 but continues to apply IFRS accounting standards, the requirements of IFRS 1 and the requirements of IAS 8 for changes in accounting policies would not be applicable. *[IFRS 19.18, IFRS 19.19]*.

As an entity could adopt IFRS 19 voluntarily before it is required to adopt IFRS 18, there is provision for the required disclosures in such a situation. Such an entity must provide the disclosures required by Appendix B, based on disclosures in IAS 1, rather than the disclosures in the section related to IFRS 18 in the main body of the standard. *[IFRS 19.B1]*.

7.4.1 Proposed 'catch-up' amendments

In developing the disclosure requirements in IFRS 19, the IASB considered the disclosure requirements in other IFRS accounting standards as at 28 February 2021. IFRS 19 does not currently contain reduced versions of any disclosure requirements that were amended or added to IFRS accounting standards after that date. Consequently, in July 2024, the IASB published an Exposure Draft setting out whether and how to reduce the disclosure requirements of these post-28 February 2021 amendments and additions for the purpose of updating IFRS 19. Comments are to be received by November 2024, with a proposed effective date for the amendments of 1 January 2027, to align with the effective date of IFRS 19.

How we see it

Early application of IFRS 19 is permitted and the standard does not impact recognition and measurement. Since the standard will reduce the disclosure requirements for eligible entities, we anticipate that eligible preparers may consider early adopting the standard, if endorsed in the relevant jurisdiction.

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Appendix B - Defined terms

Extract from IFRS 18

Appendix A
Defined terms

This appendix is an integral part of the IFRS Accounting Standard.

aggregation	The adding together of assets, liabilities, equity, income, expenses or cash flows that share characteristics and are included in the same classification.
classification	The sorting of assets, liabilities, equity, income, expenses and cash flows based on shared characteristics.
disaggregation	The separation of an item into component parts that have characteristics that are not shared.
IFRS Accounting Standards	Accounting standards issued by the International Accounting Standards Board. They comprise: (a) International Financial Reporting Standards; (b) International Accounting Standards; (c) IFRIC Interpretations; and (d) SIC Interpretations. IFRS Accounting Standards were previously known as International Financial Reporting Standards, IFRS, IFRSs and IFRS Standards.
management-defined performance measure	A subtotal of income and expenses that: (a) an entity uses in public communications outside financial statements; (b) an entity uses to communicate to users of financial statements management's view of an aspect of the financial performance of the entity as a whole; and (c) is not listed in paragraph 118 of IFRS 18, or specifically required to be presented or disclosed by IFRS Accounting Standards.
operating profit or loss	The total of all income and expenses classified in the operating category.
profit or loss before financing and income taxes	The total of operating profit or loss and all income and expenses classified in the investing category.
useful structured summary	A structured summary provided in a primary financial statement of a reporting entity's recognised assets, liabilities, equity, income, expenses and cash flows that is useful for: (a) obtaining an understandable overview of the entity's recognised assets, liabilities, equity, income, expenses and cash flows; (b) making comparisons between entities, and between reporting periods for the same entity; and (c) identifying items or areas about which users of financial statements may wish to seek additional information in the notes.

Chapter 5 Non-current assets held for sale and discontinued operations

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Overview

This chapter deals with the requirements of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

As its title suggests, the standard deals with two distinct but overlapping broad areas.

The first relates to the measurement and presentation of non-current assets when these will be principally recovered by disposal rather than by continuing use. The requirements deal with, *inter alia*:

- Classification as held for sale (and changes to a plan to sell)
- The ceasing of depreciation and amortisation
- The writing down of an asset and group of assets and liabilities to be disposed of to the lower of their carrying amount and fair value less costs to sell

  And
- The separate presentation of such assets and liabilities in the statement of financial position

The second matter relates to the concept of a discontinued operation. Requirements in this regard cover the identification of and presentation in profit and loss of the results of discontinued operations, the representation of comparative information to reflect the status of the operation at the end of the current period and cash flow information relating to the operation.

The standard sets out disclosure requirements in relation to the above.

What you need to know

- IFRS 5 sets out the criteria for classification of an asset and group of assets and liabilities as held for sale and the definition of discontinued operations, as well as corresponding measurement, presentation and disclosure requirements.
- The standard by design requires often significant judgements, based on the specific facts and circumstances applicable to an entity.
- Various matters relating to the standard have been raised over the years and discussed by the IFRS IC which deferred them to the IASB, such as the allocation of impairments in a disposal group or the treatment of intragroup transactions between continuing and discontinued operations. To date the IASB has not performed a post-implementation review of IFRS 5 nor otherwise addressed these matters.
- Entities need to carefully consider disclosing information needed to evaluate the financial effects of discontinued operations and disposals of non-current assets (or disposal groups), including the basis for and the effects of significant judgements and accounting policy choices made based on the entity's specific facts and circumstances.

1 Objective and scope of IFRS 5

The objective of IFRS 5 is to specify the accounting for assets held for sale, and the presentation and disclosure of discontinued operations. In particular, the standard requires that non-current assets (and, in a 'disposal group', related liabilities and current assets, discussed in section 2.1.1 below) meeting its criteria to be classified as held for sale be:

(a) Measured at the lower of carrying amount and fair value less costs to sell, with depreciation (or amortisation) on them ceasing

And

(b) Presented separately on the face of the statement of financial position with the results of discontinued operations presented separately in the statement of comprehensive income *[IFRS 5.1]*

The classification and presentation requirements apply to all recognised non-current assets and disposal groups, while there are certain exceptions to the measurement provisions of the standard. *[IFRS 5.2, IFRS 5.5]*. These issues are discussed further in section 2.2 below.

The classification, presentation and measurement requirements of IFRS 5 applicable to assets (or disposal groups) classified as held for sale also apply to those classified as held for distribution to owners acting in their capacity as owners. *[IFRS 5.5A]*. This is discussed in section 2.1.2 below.

2 Non-current assets (and disposal groups) held for sale or held for distribution to owners

2.1 Classification of non-current assets (and disposal groups) held for sale or held for distribution to owners

IFRS 5 frequently refers to current assets and non-current assets. It provides a definition of each term as follows: *[IFRS 5 Appendix A]*

Extract from IFRS 5

Appendix A
Defined terms

current asset	An entity shall classify an asset as current when: (a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle; (b) it holds the asset primarily for the purpose of trading; (c) it expects to realise the asset within twelve months after the reporting period; or (d) the asset is cash or a cash equivalent (as defined in IAS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.
non-current asset	An asset that does not meet the definition of a **current asset**.
disposal group	A group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. The group includes goodwill acquired in a business combination if the group is a **cash-generating unit** to which goodwill has been allocated in accordance with the requirements of paragraphs 80-87 of IAS 36 *Impairment of Assets* (as revised in 2004) or if it is an operation within such a cash-generating unit.

The first two definitions are the same as those in IAS 1 *Presentation of Financial Statements* (discussed in Chapter 3 at section 3.1.1).

2.1.1 The concept of a disposal group

As its title suggests, IFRS 5 addresses the accounting treatment of non-current assets held for sale, that is assets whose carrying amount will be recovered principally through sale rather than continuing use in the business. *[IFRS 5.6]*. However, the standard also applies to certain liabilities and current assets where they form part of a 'disposal group'.

The standard observes that sometimes an entity will dispose of a group of assets, possibly with some directly associated liabilities, together in a single transaction. *[IFRS 5.4]*. A common example would be the disposal of a subsidiary. For these circumstances, IFRS 5 introduces the concept of a disposal group, which it defines as a group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. The group includes goodwill acquired in a business combination if the group is a cash-generating unit to which goodwill has been allocated in accordance with the requirements of IAS 36 *Impairment of Assets* (discussed in Chapter 21) or if it is an operation within such a cash-generating unit. *[IFRS 5 Appendix A]*.

The use of the phrase 'together in a single transaction' indicates that the only liabilities that can be included in the group are those assumed by the purchaser. Accordingly, any borrowings of the entity which are to be repaid out of the sales proceeds would be excluded from the disposal group.

The standard goes on to explain that a disposal group:

- May be a group of cash-generating units, a single cash-generating unit, or part of a cash-generating unit. Once the cash flows from an asset or group of assets are expected to arise principally from sale rather than continuing use, they become less dependent on cash flows arising from other assets, and a disposal group that was part of a cash-generating unit becomes a separate cash-generating unit.

  And

- May include any assets and any liabilities of the entity, including current assets, current liabilities and assets outside the scope of the measurement requirements of IFRS 5 (see section 2.2 below). *[IFRS 5.4]*.

Discontinued operations are discussed in section 3 below. As noted there, it seems highly unlikely that the definition of a discontinued operation would ever be met by a single non-current asset. Accordingly, a discontinued operation will normally include one or more disposal groups, while a disposal group oftentimes will not meet the definition of a discontinued operation. Also, while discontinued operations involve clearly distinguishable cash flows and a major line of business or major geographical area, none of those characteristics need to be present in disposal groups.

2.1.1.A Deferred tax assets and liabilities in a disposal group held for sale

There may be various deferred tax assets and liabilities recorded in association with items included within a disposal group, such as deferred taxes on temporary differences between the tax base and the carrying amount of individual assets and liabilities included in a disposal group, or deferred tax assets on unused tax losses. It follows from the definition of a disposal group that an entity only classifies as held for sale those assets and liabilities that will be transferred to the buyer. *[IFRS 5 Appendix A]*. The standard does not include any further guidance on whether or when deferred tax assets and liabilities shall be included within a disposal group held for sale.

How we see it

In our view, it would be consistent with the definition of a disposal group to include deferred tax assets and liabilities within a disposal group if they will be assumed (taken over) by the buyer. However, where the disposal is expected to trigger a reversal of temporary differences related to assets and liabilities retained in the disposal group, any related deferred tax assets and liabilities would be retained (and ultimately settled) by the seller and must therefore be excluded from the disposal group.

Whilst any assessment will have to reflect the specific facts and circumstances of the expected disposal transaction and the tax regulations in the specific jurisdictions involved, deferred taxes will often be assumed by the buyer if the disposal group is a separate legal entity and the disposal will be carried out by way of a 'share deal' (i.e., the sale of shares in the entity). In such a case, in many jurisdictions the tax bases of the individual assets and liabilities (sometimes referred to as the 'tax history') will be retained in the legal entity being sold and thereby will be transferred to the buyer. These deferred tax assets and liabilities shall therefore be included in the disposal group. *[IFRS 5 Appendix A, IAS 12.51A]*. Care must also be taken to ensure that any 'outside' temporary differences related to the entity being sold (i.e., deferred taxes related to a temporary difference between the carrying amount of the seller's investment in the legal entity and the tax base of its investment) are not included in the disposal group, as this represents a liability or asset of the seller. 'Outside' temporary differences are discussed in Chapter 29 at section 7.6.

If a group of individual assets and liabilities are being sold (i.e., the disposal will be carried out by way of an 'asset deal'), the sale is likely to be treated by the tax authorities as a recovery of the related assets (or settlement of the related liabilities) and give rise to a reversal of previous temporary differences for the seller. A new tax base of those assets and liabilities for the buyer will usually be based on the purchase price. The seller will settle (realise) the deferred taxes on a disposal and will therefore not include these deferred tax balances in the disposal group. *[IFRS 5 Appendix A, IAS 12.51A]*.

The form of the anticipated disposal ('share deal' or 'asset deal') will often be considered a significant element of the plan to sell. As discussed in section 2.1.2.B below, for the sale to be highly probable, significant changes to the plan shall be unlikely. *[IFRS 5.8]*. Therefore, if an entity finds it difficult to establish whether an anticipated sale will be carried out by way of a share deal or an asset deal, it may indicate that the held for sale criteria have not been met. Subject to specific facts and circumstances, the form of the disposal may be relevant for determining which assets and liabilities are to be classified as held for sale, as highlighted in the Illustration 2-1 below.

Illustration 2-1: Deferred tax liability on remeasurement of an investment property held for sale

Entity A, which operates in the real estate industry, is committed to a plan to sell a shopping mall that is held by its fully-owned subsidiary. The only assets of the subsidiary are the investment property itself, trade receivables and cash. The subsidiary has no liabilities, except for a deferred tax liability reflecting the difference between the carrying amount of the investment property and its tax base (which equals to the costs directly attributable to the construction of the shopping mall).

Depending on whether the disposal is planned in the form of a share or asset deal, the scope of the disposal group will be impacted, as illustrated by Scenario 1 and Scenario 2 below.

1. Management of Entity A intends to dispose of the investment property by way of a share deal. The disposal group meets all the criteria to be classified as held for sale (see section 2.1.2 below). In the jurisdiction in which Entity A operates, no taxes are levied on sale of shares.

   The deferred tax liability will be transferred to the buyer, along with all the other assets of the subsidiary. Therefore, the entity includes the deferred tax liability of the subsidiary in the disposal group held for sale.

2. Management of Entity A intends to dispose of the investment property by way of an asset deal. On the disposal, the subsidiary will derecognise the investment property and realise the deferred tax liability associated with the investment property. The deferred tax liability is therefore excluded from the disposal group.

The two scenarios above significantly impact the scope of the disposal group (assuming that the deferred tax liability of the subsidiary is material), and therefore an intention to realise the disposal through a share or an asset deal needs to be carefully considered before concluding whether held for sale classification is appropriate. A mere intention will often not be sufficient to conclude that a change in the form of the disposal is unlikely.

Any income tax effect of the disposal is accounted for under IAS 12 *Income Taxes* and is not included in costs to sell when measuring the disposal group held for sale, as discussed in section 2.2.2.A below.

An intention to dispose of a group of assets or a subsidiary undertaking can affect the measurement of deferred tax assets and liabilities before the proposed transaction gives rise to a reclassification of those related assets and liabilities into a disposal group under IFRS 5. For example, the measurement of deferred tax assets and liabilities may have to be reassessed because the manner of recovery is expected to be through sale rather than continuing use. *[IAS 12.51]*. This is discussed in Chapter 29 at section 7.5.8 (in the context of the recognition of deferred tax assets) and in section 8.4.11 (in the context of expected manner of recovery of an asset or settlement of liability).

Any income tax gain or loss on disposal of a disposal group which represents a discontinued operation is presented within discontinuing operations (see section 3.2 below).

2.1.2 Classification as held for sale or as held for distribution to owners

IFRS 5 requires a non-current asset (or disposal group) to be classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. *[IFRS 5.6]*. For these purposes, sale transactions include exchanges of non-current assets for other non-current assets when the exchange has commercial substance in accordance with IAS 16 *Property, Plant and Equipment* (discussed in Chapter 19 at section 4.4). *[IFRS 5.10]*. For assets classified according to a liquidity presentation (see Chapter 3 at section 3.1.1), non-current assets are taken to be assets that include amounts expected to be recovered more than twelve months after the reporting date. *[IFRS 5.2]*.

Determining whether (and when) an asset stops being recovered principally through continuing use and becomes recoverable principally through sale is the critical distinction, and much of the standard is devoted to explaining how to make the determination.

For an asset (or disposal group) to be classified as held for sale:

(a) It must be available for immediate sale in its present condition, subject only to terms that are usual and customary for sales of such assets (or disposal groups)

(b) Its sale must be highly probable *[IFRS 5.7]*

And

(c) the disposal must be expected to qualify for recognition as a completed sale within one year from the date of classification [*IFRS 5.8]*.

These criteria are discussed further below.

If an asset (or disposal group) has been classified as held for sale, but these criteria cease to be met, an entity must cease to classify the asset (or disposal group) as held for sale. *[IFRS 5.26]*. Changes in disposal plans are discussed in section 2.2.5 below.

The reclassification from held for use to held for sale results from changes in relevant facts and circumstances. Often, a specific event will trigger held for sale classification, such as a formalised management decision or the receipt of a binding purchase offer, in which case the classification as held for sale must reflect the timing of the triggering event (assuming all of the criteria listed above are met, as also discussed further in sections 2.1.2.A, 2.1.2.B and 2.1.2.C below). It follows that the criteria for classification as held for sale are assessed throughout the reporting period. When these criteria are met at a specific point in time during the reporting period, a non-current asset (or disposal group) is reclassified from held for use and IFRS 5 measurement requirements (as discussed in section 2.2 below) apply from that date onwards, including that a non-current asset (or a disposal group) is remeasured to fair value less costs to sell and non-current assets cease to be depreciated or amortized. See also section 2.1.2.B for discussion on how external evidence (such as letters of intent, a binding offer or a firm purchase commitments) may impact the assessment of the highly probable criterion.

Illustration 2-2: Timing of reclassification to held for sale

The management of an international multi-industry group considers disposal of its German subsidiary. The subsidiary is available for immediate sale in its present condition. No regulatory approval is required. Financial year-end is 31 December and the Group issues half-year interim financial statements.

The following summarises the relevant chain of events in 20X1:

1 February 20X1	Management began to investigate whether disposal of the German subsidiary represented a realistic alternative, including feasibility studies and financial analyses.
30 April 20X1	The disposal plan was formally approved by the shareholders and management began active marketing of the subsidiary. Given the scale of the German subsidiary, the complexity of the potential transaction and the economic outlook at the time, management assessed that the sale was unlikely (and therefore not highly probable) to be closed before the end of June 20X2.
30 June 20X1	Management reviewed the above assumptions for the purposes of half-year reporting. No significant changes in facts and circumstances were identified.
July - September 20X1	A few non-binding offers were received and discussions were held with potential buyers. None of these events led management to assess that the disposal was highly probable within the next 12 months.
1 October 20X1	A binding purchase offer was received. The management considered all the facts and circumstances and assessed that completion of the sale within the next 12 months became highly probable.

In this fact pattern, the German subsidiary was classified as held for sale as at 1 October 20X1 being the first date at which all criteria were met, including the one year criterion.

Slightly different criteria apply when an entity acquires a non-current asset (or disposal group) exclusively with a view to its subsequent disposal. In that case it must only classify the non-current asset (or disposal group) as held for sale at the acquisition date if:

- The 'one-year rule' is met subject to its one exception (this is part of being 'highly probable', discussed in section 2.1.2.B below)

  And

- It is highly probable that any other criteria in (a) and (b) above that are not met at that date will be met within a short period following the acquisition (usually within three months) *[IFRS 5.11]*

The standard also makes it clear that the criteria above must be met at the reporting date for a non-current asset (or disposal group) to be classified as held for sale in those financial statements. However, if those criteria are met after the reporting date but before the authorisation of the financial statements for issue, the standard requires certain additional disclosures (discussed in section 5 below). *[IFRS 5.12]*.

The classification, presentation and measurement requirements of IFRS 5 applicable to non-current assets (or disposal groups) classified as held for sale also apply to those classified as held for distribution to owners acting in their capacity as owners. *[IFRS 5.5A]*. This applies when an entity is committed to distribute the non-current asset (or disposal group) to its owners. For this to be the case, the assets must be available for immediate distribution in their present condition and the distribution must be highly probable.

2.1.2.A Meaning of available for immediate sale

To qualify for classification as held for sale, a non-current asset (or disposal group) must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups). This is taken to mean that an entity currently has the intention and ability to transfer the asset (or disposal group) to a buyer in its present condition. The standard illustrates this concept with the following examples. *[IFRS 5.IG Example 1, IFRS 5.IG Example 2, IFRS 5.IG Example 3]*.

Illustration 2-3: Meaning of 'available for immediate sale'

1 Disposal of a headquarters building

An entity is committed to a plan to sell its headquarters building and has initiated actions to locate a buyer.

(a) The entity intends to transfer the building to a buyer after it vacates the building. The time necessary to vacate the building is usual and customary for sales of such assets. The criterion of being available for immediate sale would therefore be met at the plan commitment date.

(b) The entity will continue to use the building until construction of a new headquarters building is completed. The entity does not intend to transfer the existing building to a buyer until after construction of the new building is completed (and it vacates the existing building). The delay in the timing of the transfer of the existing building imposed by the entity (seller) demonstrates that the building is not available for immediate sale. The criterion would not be met until construction of the new building is completed, even if a firm purchase commitment for the future transfer of the existing building is obtained earlier.

2 Sale of a manufacturing facility

An entity is committed to a plan to sell a manufacturing facility and has initiated actions to locate a buyer. At the plan commitment date, there is a backlog of uncompleted customer orders.

(a) The entity intends to sell the manufacturing facility with its operations. Any uncompleted customer orders at the sale date will be transferred to the buyer. The transfer of uncompleted customer orders at the sale date will not affect the timing of the transfer of the facility. The criterion of being available for immediate sale would therefore be met at the plan commitment date.

(b) The entity intends to sell the manufacturing facility, but without its operations. The entity does not intend to transfer the facility to a buyer until after it ceases all operations of the facility and eliminates the backlog of uncompleted customer orders. The delay in the timing of the transfer of the facility imposed by the entity (seller) demonstrates that the facility is not available for immediate sale. The criterion would not be met until the operations of the facility cease, even if a firm purchase commitment for the future transfer of the facility were obtained earlier.

3 Land and buildings acquired through foreclosure

An entity acquires through foreclosure a property comprising land and buildings that it intends to sell.

(a) The entity does not intend to transfer the property to a buyer until after it completes renovations to increase the property's sales value. The delay in the timing of the transfer of the property imposed by the entity (seller) demonstrates that the property is not available for immediate sale. The criterion of being available for immediate sale would therefore not be met until the renovations are completed.

(b) After the renovations are completed and the property is classified as held for sale but before a firm purchase commitment is obtained, the entity becomes aware of environmental damage requiring remediation. The entity still intends to sell the property. However, the entity does not have the ability to transfer the property to a buyer until after the remediation is completed. The delay in the timing of the transfer of the property imposed by others *before* a firm purchase commitment is obtained demonstrates that the property is not available for immediate sale (different requirements could apply if this happened *after* a firm commitment is obtained, as illustrated in scenario (b) of Illustration 2-5 in section 2.1.2.B below). The criterion that the asset be available for immediate sale would not continue to be met. The property would be reclassified as held and used in accordance with the requirements discussed in section 2.2.5 below.

There may be circumstances other than those illustrated above where a non-current asset (or disposal group) is not available for immediate sale. A common example is when the expected transaction requires legal reorganizations before it can be executed (e.g., a carve out of activities in the disposal plan from continuing activities). Whether a non-current asset (or disposal group) is available for immediate sale will generally be obvious. However, this assessment will sometimes require a careful consideration of all facts and circumstances and involve some degree of judgement. When significant judgement is involved and this has a material impact on the financial statements, appropriate disclosures should be provided in the notes. *[IAS 1.122]*.

2.1.2.B Meaning of highly probable

Many observers may consider the meaning of 'highly probable' to be reasonably self-evident, albeit highly judgemental. However, IFRS 5 provides extensive discussion of the topic. As a first step, the term is defined by the standard as meaning "significantly more likely than probable". This is supplemented by a second definition - 'probable' is defined as "more likely than not". *[IFRS 5 Appendix A]*. Substituting the latter into the former leads to a definition of highly probable as meaning 'significantly more likely than more likely than not'.

The standard goes on to elaborate as follows:

For the sale to be highly probable:

- The appropriate level of management must be committed to a plan to sell the asset (or disposal group).
- An active programme to locate a buyer and complete the plan must have been initiated.
- The asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value.
- The sale must be expected to qualify for recognition as a completed sale within one year from the date of classification (although in certain circumstances this period may be extended as discussed below).

  And
- Actions required to complete the plan must indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn. *[IFRS 5.8]*.

In September 2013, the IFRS IC published an agenda decision in which it observed that the first three items above must have occurred to allow classification as held for sale.[1] The other criteria would be assessed based on expectations of the future with their probability of occurrence included in the assessment of whether a sale is highly probable.

The assessment can be highly judgemental and requires analysis of all relevant facts and circumstances, including the assessment of probability of obtaining shareholders' approval, if relevant. *[IFRS 5.8]*

Illustration 2-4: Shareholders' approval

The board has approved a plan to sell a manufacturing facility and has initiated actions to identify a buyer before the end of the reporting period. In accordance with the articles of association, formal approval by a majority of shareholders is required to finalise the sale. The next shareholders meeting is scheduled after the end of the reporting period.

The following two scenarios illustrate how shareholder approvals may impact the assessment of whether the highly probable criterion is met under different circumstances:

(a) The shareholding is widely dispersed and the rationale for the sale is assumed to potentially be controversial. In this scenario, the board would generally not have sufficient evidence to conclude that it is reasonable to expect that a majority of shareholders will vote for the sale. Therefore, the entity concludes that the highly probable criterion is not met.

(b) Before the end of the reporting period, the management had discussions with the majority shareholder who clearly suggested that it would vote in favour of the disposal. In such a scenario, there may be a basis to conclude that the highly probable criterion is met, albeit that depends on facts and circumstances. In particular, if the management is provided with a written consent from the majority shareholder before the end of the reporting period, that would normally be considered sufficient to conclude that the highly probable criterion is met (absent any other circumstances which would indicate otherwise).

1 *IFRIC update*, September 2013, available on the IFRS Foundation's website.

An entity needs to consider all relevant facts and circumstances (including for example communication by the entity outside the financial statements) and apply judgement when assessing whether and when a sale becomes highly probable. The standard does not require specific evidence for the highly probable criterion to be met but the hurdle is generally high and a mere intention to sell an asset would not trigger a classification as held for sale. Therefore, the lack of external evidence such as letters of intent, a binding offer or a firm purchase commitment often indicates that the criterion is not met. Conversely, even if a firm purchase commitment is obtained before the end of the reporting period, the entity can still conclude in some cases that the criterion is not met if other facts and circumstances cast doubt on whether the sale will be finalised - for instance, if a required regulatory approval is highly uncertain.

As noted above, the classification, presentation and measurement requirements of IFRS 5 applicable to non-current assets (or disposal groups) classified as held for sale also apply to those classified as held for distribution to owners acting in their capacity as owners (see section 2.1.2 above). *[IFRS 5.5A]*.

For the distribution to be highly probable, actions to complete the distribution must have been initiated and must be expected to be completed within one year from the date of classification. Actions required to complete the distribution must indicate that it is unlikely that significant changes to the distribution will be made or that the distribution will not be completed. Whilst judgement will be needed in individual circumstances, relevant actions to consider could include: the steps taken by management to prepare for the distribution, board decisions illustrating the commitment to the planned distribution, and steps taken to organise the meeting of shareholders, if their approval is required. The probability of shareholders' approval, if this is required, must be considered as part of the assessment of whether the distribution is highly probable. *[IFRS 5.12A]*.

The basic rule above that for qualification as held for sale the sale must be expected to qualify for recognition as a completed sale within one year from the date of classification (the 'one year rule') is applied quite strictly by the standard. *[IFRS 5.IG Example 4]*.

Extract from IFRS 5 - Guidance on implementing

Completion of sale expected within one year (paragraph 8)

Example 4

To qualify for classification as held for sale, the sale of a non-current asset (or disposal group) must be highly probable (paragraph 7), and transfer of the asset (or disposal group) must be expected to qualify for recognition as a completed sale within one year (paragraph 8). That criterion would not be met if, for example:

(a) an entity that is a commercial leasing and finance company is holding for sale or lease equipment that has recently ceased to be leased and the ultimate form of a future transaction (sale or lease) has not yet been determined.

(b) an entity is committed to a plan to 'sell' a property that is in use as part of a sale and leaseback transaction, but the transfer does not qualify to be accounted for as a sale in accordance with paragraph 99 of IFRS 16 *Leases* and, instead, will be accounted for in accordance with paragraph 103 of IFRS 16.

In (a), the entity does not yet know whether the asset will be leased out in an operating lease rather than sold or leased out under a finance lease and hence may not presume that it will be sold within a year.

In (b), whilst in legal form the asset has been sold, it will not be recognised as sold in the financial statements. Sale and leaseback transactions are discussed in Chapter 24 at section 8.

As indicated above, the standard contains an exception to the one-year rule. It states that events or circumstances may extend the period to complete the sale beyond one year. Such an extension would not preclude an asset (or disposal group) from being classified as held for sale if the delay is caused by events or circumstances beyond the entity's control and there is sufficient evidence that the entity remains committed to its plan to sell the asset (or disposal group). This will be the case in the following situations: *[IFRS 5.9, IFRS 5.B1]*

(a) At the date an entity commits itself to a plan to sell a non-current asset (or disposal group) it reasonably expects that others (not a buyer) will impose conditions on the transfer of the asset (or disposal group) that will extend the period required to complete the sale, and:

  (i) Actions necessary to respond to those conditions cannot be initiated until after a firm purchase commitment is obtained.

  And

  (ii) A firm purchase commitment is highly probable within one year.

(b) An entity obtains a firm purchase commitment and, as a result, a buyer or others unexpectedly impose conditions on the transfer of a non-current asset (or disposal group) previously classified as held for sale that will extend the period required to complete the sale, and:

(i) Timely actions necessary to respond to the conditions have been taken.

And

(ii) A favourable resolution of the delaying factors is expected.

(c) During the initial one-year period, circumstances arise that were previously considered unlikely and, as a result, a non-current asset (or disposal group) previously classified as held for sale is not sold by the end of that period, and:

(i) During the initial one-year period the entity took action necessary to respond to the change in circumstances.

(ii) The non-current asset (or disposal group) is being actively marketed at a price that is reasonable, given the change in circumstances.

And

(iii) The non-current asset (or disposal group) remains available for immediate sale and the sale is highly probable. *[IFRS 5 Appendix B]*.

The standard provides no quantification in relation to the possible length of any extension to the period required to complete a disposal, which means judgement will be required considering individual circumstances. However, as a general observation, the longer the expected extension becomes, as a result of conditions imposed by others, the less likely it is that the sale meets the highly probable threshold.

Firm purchase commitment is a defined term in IFRS 5, meaning an agreement with an unrelated party, binding on both parties and usually legally enforceable, that:

(1) Specifies all significant terms, including the price and timing of the transactions

And

(2) Includes a disincentive for non-performance that is sufficiently large to make performance highly probable *[IFRS 5 Appendix A]*

The word 'binding' in this definition seems to envisage an agreement still being subject to contingencies. The standard provides an example where a 'firm purchase commitment' exists but is subject to regulatory approval (see scenario (a) in Illustration 2-5 below).

The standard illustrates each of these exceptions to the one-year rule with the following examples. *[IFRS 5.IG Example 5, IFRS 5.IG Example 6, IFRS 5.IG Example 7]*.

Illustration 2-5: Exceptions to the 'one year rule'

Scenario illustrating (a) above

An entity in the power generating industry is committed to a plan to sell a disposal group that represents a significant portion of its regulated operations. The sale requires regulatory approval, which could extend the period required to complete the sale beyond one year. Actions necessary to obtain that approval cannot be initiated until after a buyer is known and a firm purchase commitment is obtained. However, a firm purchase commitment is highly probable within one year. In that situation, the conditions for an exception to the one-year requirement would be met.

Scenario illustrating (b) above

An entity is committed to a plan to sell a manufacturing facility in its present condition and classifies the facility as held for sale at that date. After a firm purchase commitment is obtained, the buyer's inspection of the property identifies environmental damage not previously known to exist. The entity is required by the buyer to make good the damage, which will extend the period required to complete the sale beyond one year. However, the entity has initiated actions to make good the damage, and satisfactory rectification of the damage is highly probable. In that situation, the conditions for an exception to the one-year requirement would be met.

Scenario illustrating (c) above

An entity is committed to a plan to sell a non-current asset and classifies the asset as held for sale at that date.

(a) During the initial one-year period, the market conditions that existed at the date the asset was classified initially as held for sale deteriorate and, as a result, the asset is not sold by the end of that period. During that period, the entity actively solicited but did not receive any reasonable offers to purchase the asset and, in response, reduced the price. The asset continues to be actively marketed at a price that is reasonable given the change in market conditions, and the criteria regarding availability for immediate sale which is highly probable are therefore met. In that situation, the conditions for an exception to the one-year requirement would be met. At the end of the initial one-year period, the asset would continue to be classified as held for sale.

(b) During the following one-year period, market conditions deteriorate further, and the asset is not sold by the end of that period. The entity believes that the market conditions will improve and has not further reduced the price of the asset. The asset continues to be held for sale, but at a price in excess of its current fair value. In that situation, the absence of a price reduction demonstrates that the asset is not available for immediate sale. In addition, to meet the condition that a sale be highly probable also requires an asset to be marketed at a price that is reasonable in relation to its current fair value. Therefore, the conditions for an exception to the one-year requirement would not be met. The asset would be reclassified as held and used in accordance with the requirements discussed in section 2.2.5 below.

2.1.2.C Form of disposal

For an asset (or a disposal group) to be classified as held for sale, it must be expected that its disposal will qualify for recognition as a completed sale within one year from the date of classification. Such disposal may take the form of a sale or a finance lease. *[IAS 16.69]*.

Conversely, IFRS 5 stipulates that a non-current asset (or disposal group) that is to be abandoned must not be classified as held for sale. This includes non-current assets (or disposal groups) that are to be used to the end of their economic life and non-current assets (or disposal groups) that are to be closed rather than sold. The standard explains that this is because its carrying amount will be recovered principally through continuing use. *[IFRS 5.13]*.

2.1.3 Partial disposals of operations

2.1.3.A Loss of control of a subsidiary

The standard provides that when an entity is committed to a sale plan involving loss of control of a subsidiary it must classify all the assets and liabilities of that subsidiary as held for sale when the relevant criteria are met (see section 2.1 above). This is regardless of whether it will retain a non-controlling interest in the former subsidiary after the sale, such as for instance an interest in an associate or a joint venture. *[IFRS 5.8A]*.

If the retained interest represents a joint operation, it could be argued that, since the entity retains a direct interest in the underlying assets and obligations for the liabilities after the disposal, the transaction is in substance a sale of parts of the underlying assets and liabilities. On that basis, only the disposed of portions of the assets and liabilities would be classified as held for sale. The counter argument is that the requirement in IFRS 5 does not scope out situations in which the retained interest represents a joint operation. Furthermore, the loss of control of a subsidiary is a significant economic event in that it changes the relationship between the entity and the investee fundamentally, and therefore it would be appropriate to classify all assets and liabilities of the subsidiary as held for sale. Some further argue that classification as held for sale will depend on whether the operation of the joint operation represents a business as defined by IFRS 3 *Business Combinations*. *[IFRS 3 Appendix A]*. If it does, it could be argued that applying IFRS 5 better reflects the substance of the transaction, namely that control over a business is lost (i.e., that effectively all assets and liabilities of the subsidiary are being disposed of). On that analysis, classification of all assets and liabilities of the subsidiary as held for sale is appropriate.

How we see it

Pending any changes to the standard, we believe that entities have an accounting policy choice as to whether to reclassify all assets and liabilities of the subsidiary or only the portion thereof that will not be retained when control is lost in a subsidiary and the retained interest represents a joint operation, to be applied consistently and disclosed.

If the subsidiary in question meets the definition of a discontinued operation, the standard's presentation and disclosure requirements for discontinued operations apply (see section 3.2 below). *[IFRS 5.36A]*.

IFRS 5 does not explicitly extend these requirements to loss of control of a subsidiary in other ways. Given the alignment of the rules on sales with distributions to owners, it seems clear that partial distributions triggering loss of control would result in held for distribution classification.

However, control may be lost in other ways than an actual sale or distribution of shares. Such 'deemed disposals' are discussed in section 2.1.4 below.

2.1.3.B Partial disposal of an associate or joint venture

In accordance with IAS 28 *Investments in Associates and Joint Ventures*, IFRS 5 will apply to an investment, or a portion of an investment, in an associate or a joint venture that meets the criteria to be classified as held for sale (see section 2.1.2 above). Any retained portion of such an investment that has not been so classified must be accounted for using the equity method until disposal of the portion that is classified as held for sale takes place. After the disposal takes place, any retained interest must be accounted for in accordance with IFRS 9 *Financial Instruments* unless the retained interest continues to be an associate or a joint venture, in which case the equity method must be used.

If such an investment ceases to be classified as held for sale, it must be accounted for using the equity method retrospectively from the date of its original classification as held for sale. Financial statements for the periods since classification as held for sale must be amended accordingly. *[IAS 28.20, IAS 28.21]*.

2.1.4 Deemed disposals

Control may be lost in other ways than an actual sale or distribution of shares. Examples would include:

- Loss of control due to dilution (i.e., a subsidiary issuing shares to third parties)
- Loss of control due to contractual rights and obligations, for instance:
  - Control established by a contract coming to an end
  - Potential voting rights held by the group expiring unexercised
  - Potential voting rights held by a non-controlling shareholder becoming exercisable

The standard does not address deemed disposals. However, the Basis for Conclusions sheds some light on the views of the Board. In particular, the following: *[IFRS 5.BC24B, IFRS 5.BC24C]*

Extract from IFRS 5

BC24B The Board noted that paragraph 6 states that 'An entity shall classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.' The Board also noted that IAS 27 Consolidated and Separate Financial Statements (as amended in January 2008) defines control and requires a parent to consolidate a subsidiary until control is lost.[7] At the date control is lost, all the subsidiary's assets and liabilities are derecognised and any investment retained in the former subsidiary is recognised. Loss of control is a significant economic event that changes the nature of an investment. The parent-subsidiary relationship ceases to exist and an investor-investee relationship begins that differs significantly from the former parent-subsidiary relationship. Therefore, the new investor-investee relationship is recognised and measured initially at the date when control is lost.

BC24C The Board concluded that, under the sale plan described above, the controlling interest in the subsidiary is, in substance, exchanged for a non-controlling interest. Therefore, in the Board's view, being committed to a plan involving loss of control of a subsidiary should trigger classification as held for sale. The Board also noted that this conclusion is consistent with IAS 27.

7 ...

This, and the fact that the standard applies to assets held for distribution to owners, may suggest that the explicit rules for partial *sales* of assets resulting in loss of control must also apply to loss of control from other causes. However, the standard is not explicit, and the IFRS IC concluded in January 2016[2] that this issue must be considered for a broad-scope project on IFRS 5 (future developments of IFRS 5 are discussed in section 6 below).

How we see it

Pending any changes to the standard, we believe entities have an accounting policy choice, as to whether IFRS 5 is applied to all losses of control or only to those resulting from an actual sale or distribution, to be applied consistently to similar events and conditions and disclosed.

2.2 Measurement of non-current assets (and disposal groups) held for sale or held for distribution to owners

2.2.1 Scope of the measurement requirements

IFRS 5's classification, presentation and disclosure requirements apply to all recognised non-current assets (which is defined in the same way as in IAS 1, discussed in section 2.1 above) and disposal groups. However, the measurement provisions of the standard do not apply to the following assets (which remain covered by the standards listed) either as individual assets or as part of a disposal group: *[IFRS 5.2, IFRS 5.5]*

(a) Deferred tax assets (dealt with in IAS 12)

(b) Assets arising from employee benefits (dealt with in IAS 19 *Employee Benefits*)

(c) Financial assets within the scope of IFRS 9

(d) Non-current assets that are accounted for in accordance with the fair value model in IAS 40 *Investment Property*

(e) Non-current assets that are measured at fair value less costs to sell in accordance with IAS 41 *Agriculture*

And

(f) Groups of contracts within the scope of IFRS 17 *Insurance Contracts*.

2 *IFRIC Update*, January 2016, available on the IFRS Foundation's website.

2.2.2 Measurement of non-current assets and disposal groups held for sale or held for distribution to owners

2.2.2.A Measurement on initial classification as held for sale

IFRS 5 requires that immediately before the initial classification of an asset (or disposal group) as held for sale, the carrying amount of the asset (or all the assets and liabilities in the group) must be measured in accordance with applicable IFRS accounting standards. *[IFRS 5.18].* The same approach is applicable in case of non-current assets (or disposal group) held for distribution to owners. In other words, an entity must apply its usual accounting policies up until the criteria for classification under IFRS 5 are met.

Thereafter, a non-current asset (or disposal group) classified as held for sale or for distribution to owners must be measured at the lower of its carrying amount and fair value less costs to sell (distribute). *[IFRS 5.15, IFRS 5.15A]*. IFRS 13 *Fair Value Measurement* defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date" (see Chapter 15). *[IFRS 13.9]*.

Costs to sell are defined as "the incremental costs directly attributable to the disposal of an asset (or disposal group), excluding finance costs and income tax expense." *[IFRS 5 Appendix A]*. The same definition applies for costs to distribute. *[IFRS 5.15A]*. The examples of such costs include broker commissions, legal and title fees necessary to execute the sale, transaction taxes, advisors, levies by regulatory agencies and similar costs. Although the guidance applies equally to both external and internal costs, the internal costs are not often incremental.

The costs of holding the assets (i.e., insurance, security services, utility expenses and similar) that are to be incurred between the date of classifying a non-current asset (or disposal group) as held for sale and the date of the disposal are not costs to sell. Those costs are not incremental costs directly attributable to the sale of an asset (or disposal group) as they would be incurred irrespective of the expected disposal.

Some costs may be incurred concurrently with the disposal of a non-current asset (or disposal group), but they may not necessarily be the 'cost to sell'. For example, the sale of a subsidiary may require an entity to pay redundancy costs to employees, however, those costs are not 'costs to sell' as they are not essential to the sale itself.

The costs to sell should be expensed when they are incurred unless they meet the definition of an asset under other IFRS accounting standards (for example in case of prepayment for future services).

When the sale is expected to occur beyond one year, the costs to sell must be measured at their present value. Any increase in the present value of the costs to sell that arises from the passage of time must be presented in profit or loss as a financing cost. *[IFRS 5.17]*.

For disposal groups, the standard adopts a portfolio approach. It requires that if a non-current asset within the scope of its measurement requirements is part of a disposal group, the measurement requirements must apply to the group as a whole, so that the group is measured at the lower of its carrying amount and fair value less costs to sell. *[IFRS 5.4]*. It will still be necessary to apportion any write down to the underlying assets of the disposal group, but it is not clear whether any element could or should be apportioned to items outside the scope of the standard's measurement provisions. This is discussed further in section 2.2.3 below.

The fair value less costs to sell of the disposal group will take into account fair value of assets and liabilities not recorded on the balance sheet (for instance fair value of unrecognised intangible assets or contingent liabilities) if that is consistent with the assumptions market participants would use when pricing the disposal group. *[IFRS 13.11, IFRS 13.22]*.

If a newly acquired asset (or disposal group) meets the criteria to be classified as held for sale (which, as discussed in section 2.1.2 above, are subtly different for assets acquired exclusively with a view to subsequent disposal), applying the above requirements will result in the asset (or disposal group) being measured on initial recognition at the lower of its carrying amount had it not been so classified (for example, cost) and fair value less costs to sell. This means that if the asset (or disposal group) is acquired as part of a business combination, it will be measured at fair value less costs to sell. *[IFRS 5.16]*.

The implementation guidance accompanying the standard provides the following example of a subsidiary acquired with a view to sale. *[IFRS 5.IG Example 13]*.

Illustration 2-6: Measuring and presenting subsidiaries acquired with a view to sale and classified as held for sale

Entity A acquires Entity H, which is a holding company with two subsidiaries, S1 and S2. S2 is acquired exclusively with a view to sale and meets the criteria to be classified as held for sale. Accordingly, S2 is also a discontinued operation (see section 3.1 below).

The fair value less costs to sell of S2 is CU135. A accounts for S2 as follows:

- Initially, A measures the identifiable liabilities of S2 at fair value, say at CU40.
- Initially, A measures the acquired assets as the fair value less costs to sell of S2 (CU135) plus the fair value of the identifiable liabilities (CU40), i.e., at CU175.
- At the reporting date, A remeasures the disposal group at the lower of its cost and fair value less costs to sell, say at CU130. The liabilities are remeasured in accordance with applicable IFRS accounting standards, say at CU35. The total assets are measured at CU130 + CU35, i.e., at CU165.
- At the reporting date, A presents the assets and liabilities separately from other assets and liabilities in its consolidated financial statements as shown in Illustration 2-8 in section 2.2.4 below.

  And

- In the statement of comprehensive income, A presents the total of the post-tax profit or loss of S2 and the post-tax gain or loss recognised on the subsequent remeasurement of S2, which equals the remeasurement of the disposal group from CU135 to CU130.

Further analysis of the assets and liabilities or of the change in value of the disposal group is not required.

The final sentence in the above example says no further analysis of the assets and liabilities is required. This must refer to there being no such disclosure requirement for financial statements.

How we see it

In our view, a detailed purchase price analysis and tracking of the acquired entity may still be needed, notwithstanding a partial relaxation of what is required to be disclosed by IFRS 5. This may be needed to be able to determine the split between gross assets and liabilities and how movements in the carrying amounts are reflected in profit or loss, or other comprehensive income.

2.2.2.B Subsequent remeasurement

While a non-current asset is classified as held for sale or while it is part of a disposal group classified as held for sale, it must not be depreciated or amortised. Interest and other expenses attributable to the liabilities of a disposal group classified as held for sale must continue to be recognised. *[IFRS 5.25]*.

On subsequent remeasurement of a disposal group, the standard requires that the carrying amounts of any assets and liabilities that are not within the scope of its measurement requirements, be remeasured in accordance with applicable IFRS accounting standards before the fair value less costs to sell of the disposal group is remeasured. *[IFRS 5.19]*.

It is noteworthy that there may be amounts corresponding to items included within a disposal group, which are recorded in the equity reserves (including those recognised in other comprehensive income and accumulated as equity reserves), such as exchange differences on translation of foreign operations. These balances are reclassified upon sale of the disposal group and they are not anticipated for IFRS 5 measurement purposes. There might therefore be additional gains or losses that need to be recognised upon disposal, resulting from reclassification from other comprehensive income. *[IFRS 5.BC37, IFRS 5.BC38]*. See also Chapter 49 at section 7.2.4 for discussion on whether cash flow hedges within a subsidiary need to be discontinued (and therefore corresponding balances accumulated as equity reserves need to be reclassified to profit or loss) in the consolidated financial statements when the subsidiary is anticipated to be disposed of.

Any cumulative income or expense recognised directly in other comprehensive income relating to a non-current asset (or disposal group) classified as held for sale must be presented separately, as discussed in section 2.2.4 below. *[IFRS 5.38]*. This will allow users to identify amounts that will be recognised upon disposal only.

2.2.3 Impairments and reversals of impairment

The requirement to measure a non-current asset or disposal group held for sale at the lower of carrying amount and fair value less costs to sell may give rise to a write down in value (impairment loss) and possibly its subsequent reversal. As noted above, the first step is to account for any items outside the scope of the standard's measurement rules in the normal way. After that, any excess of carrying value over fair value less costs to sell must be recognised as an impairment. *[IFRS 5.20]*.

Any subsequent increase in fair value less costs to sell of an asset up to the cumulative impairment loss previously recognised either in accordance with IFRS 5 or in accordance with IAS 36 must be recognised as a gain. *[IFRS 5.21]*. In the case of a disposal group, any subsequent increase in fair value less costs to sell must be recognised:

(a) To the extent that it has not been recognised under another standard in relation to those assets outside the scope of IFRS 5's measurement requirements

But

(b) Not in excess of the cumulative amount of losses previously recognised under IFRS 5 or before that under IAS 36 in respect of the non-current assets in the group which are within the scope of the measurement rules of IFRS 5 *[IFRS 5.22]*

Any impairment loss (or any subsequent gain) recognised for a disposal group must be allocated to the non-current assets in the group that are within the scope of the measurement requirements of IFRS 5. The order of allocation must be:

- First, to reduce the carrying amount of any goodwill in the group

  And

- Then, to the other non-current assets of the group *pro rata* on the basis of the carrying amount of each asset in the group *[IFRS 5.23]*

This is illustrated by the standard with the following example: *[IFRS 5.IG Example 10]*

Illustration 2-7: Allocation of impairment loss to the components of a disposal group

An entity plans to dispose of a group of its assets (as an asset sale). The assets form a disposal group, and are measured as follows:

	Carrying amount at the end of the reporting period before classification as held for sale	Carrying amount as remeasured immediately before classification as held for sale
	CU	CU
Goodwill	1,500	1,500
Property, plant and equipment (carried at revalued amounts)	4,600	4,000
Property, plant and equipment (carried at cost)	5,700	5,700
Inventory	2,400	2,200
Investments in equity instruments	1,800	1,500
Total	**16,000**	**14,900**

The entity recognises the loss of CU1,100 (CU16,000 - CU14,900) immediately before classifying the disposal group as held for sale. The entity measures the fair value less costs to sell of the disposal group as CU13,000. Because an entity measures a disposal group classified as held for sale at the lower of its carrying amount and fair value less costs to sell, the entity recognises an impairment loss of CU1,900 (CU14,900 - CU13,000) when the group is initially classified as held for sale. The impairment loss is allocated to non-current assets to which the measurement requirements of IFRS 5 are applicable. Therefore, no impairment loss is allocated to inventory and investments in equity instruments. The loss is allocated to the other assets in the order of allocation described above.

The allocation can be illustrated as follows:

First, the impairment loss reduces any amount of goodwill. Then, the residual loss is allocated to other assets *pro rata* based on the carrying amounts of those assets.

	Carrying amount as remeasured immediately before classification as held for sale	Allocated impairment loss	Carrying amount after allocation of impairment loss
	CU	CU	CU
Goodwill	1,500	(1,500)	-
Property, plant and equipment (carried at revalued amounts)	4,000	(165)	3,835
Property, plant and equipment (carried at cost)	5,700	(235)	5,465
Inventory	2,200	-	2,200
Investments in equity instruments	1,500	-	1,500
Total	**14,900**	**(1,900)**	**13,000**

As noted in section 2.2.2.A above, an entity is required to remeasure the assets as normal under the relevant standards immediately before classifying them as held for sale. This would mean the difference of CU1,100 reflects routine accounting entries (such as depreciation and revaluation) from the start of the period to the date of classification as held to sale. Also worthy of note is that the example does not say where the entity recognises the loss of CU1,100. Given that the disposal group contains investments in equity instruments, some of this amount might be recorded in other comprehensive income rather than in profit or loss. Similarly, movements in property, plant and equipment held at revalued amounts may be recorded directly in other comprehensive income.

One thing which the example above fails to illustrate is that the measurement requirements of the standard are incomplete. It is quite possible that the required impairment exceeds the carrying value of the non-current assets within the scope of the standard's measurement rules. IFRS 5 is silent on what to do in such circumstances.

This issue was brought to the attention of the IFRS IC which referred it to the IASB. The IASB intended to address the issue through a future amendment to IFRS 5. The Board decided tentatively to consider amending IFRS 5 as a matter of priority and to work with the FASB to ensure IFRS 5 remains aligned with US GAAP.[3] However, at its December 2009 meeting, the IASB "decided not to add a project to its agenda to address the impairment measurement and reversal issues at this time."[4] Possible future developments are discussed in section 6 below.

How we see it

Possible approaches to the above would be:

(a) To apply the impairment to current assets

(b) To apply the impairment to non-current assets outside the scope of the standard's measurement rules

(c) To recognise a separate liability

Or

(d) Restrict the impairment to the carrying value of the non-current assets within the scope of the standard's measurement requirements.

Pending any changes to the Standard, we believe entities have an accounting policy choice, as to which one of the above approaches is applied, to be applied consistently to similar events and conditions and disclosed.

3 *IASB Update*, July 2009, available on the IFRS Foundation's website.

4 *IASB Update*, December 2009, available on the IFRS Foundation's website.

The standard contains a reminder that requirements relating to derecognition are set out in IAS 16 for property, plant and equipment (discussed in Chapter 19 at section 7), and IAS 38 *Intangible Assets* for intangible assets (discussed in Chapter 18 at section 9.5) and notes that a gain or loss not previously recognised by the date of the sale of a non-current asset (or disposal group) must be recognised at the date of derecognition. *[IFRS 5.24]*. This may happen, for example, if the fair value less costs to sell of an asset classified as held for sale at the end of the previous period falls during the current period.

The standard is not clear on whether the reversal of impairment losses as a result of any subsequent increase in fair value less costs to sell also applies to impairment losses allocated to goodwill.

The issue was discussed by the IFRS IC in 2010, which noted "a potential conflict between the guidance in paragraph 22 and paragraph 23 of IFRS 5 relating to the recognition and allocation of the reversal of an impairment loss for a disposal group when it relates to goodwill."[5]

The IFRS IC discussion on the same issue in 2016 concluded that a broad-scope project on IFRS 5 might be warranted.[6] However, since then no further actions have been taken by the IASB.

How we see it

In our view, the following approaches to the reversal of goodwill impairment losses recognised under IFRS 5 are acceptable.

One approach prohibits the reversal of impairment allocated to goodwill. This approach considers the requirements of IAS 36. IFRS 5 requires an entity to recognise any gain on reversal of an impairment to be made in the order of allocation set out in IAS 36. As paragraph 124 of IAS 36 prohibits the reversal of an impairment of goodwill, any reversal of impairments allocated to goodwill is not acceptable.

Another, alternative, approach permits reversals of goodwill impairment losses recognised under IFRS 5. This approach considers the requirement in IFRS 5 to apply its measurement requirements to a disposal group as a whole. As the disposal group under IFRS 5 is a single unit of account for measurement purposes, reversal of impairments made for the disposal group as a whole, including impairment losses allocated to goodwill, is acceptable.

Whichever approach is applied, it should be applied consistently.

2.2.4 Presentation in the statement of financial position of non-current assets and disposal groups held for sale

The general requirement, discussed in Chapter 3 at section 3.1.1, to classify items in the statement of financial position as current or non-current (or present them broadly in order of liquidity) is overlaid with further requirements by IFRS 5 regarding non-current assets held for sale and disposal groups. IFRS 5's aim is that entities must present and disclose information that enables users of the financial statements to evaluate the financial effects of disposals of non-current assets (or disposal groups). *[IFRS 5.30]*. In pursuit of this aim, IFRS 5 requires:

- Non-current assets classified as held for sale and the assets of a disposal group classified as held for sale to be presented separately from other assets in the statement of financial position

  And

- The liabilities of a disposal group classified as held for sale to be presented separately from other liabilities in the statement of financial position

These assets and liabilities must not be offset and presented as a single amount. In addition:

(a) Major classes of assets and liabilities classified as held for sale must generally be separately disclosed either on the face of the statement of financial position or in the notes. However, this is not necessary for a disposal group if it is a newly acquired subsidiary that met the criteria to be classified as held for sale on acquisition.

And

(b) Any cumulative income or expense recognised directly in other comprehensive income relating to a non-current asset (or disposal group) classified as held for sale must be presented separately. *[IFRS 5.38, IFRS 5.39]*.

5 *IFRIC Update*, May 2010, available on the IFRS Foundation's website.

6 *IFRIC Update*, January 2016, available on the IFRS Foundation's website.

Although the IASB in IFRS 5.IG Example 12 (see Illustration 2-8 below) suggests presenting non-current assets and liabilities held for sale separately from current assets and current liabilities, respectively, an alternative approach applied by some in practice is to present non-current assets and liabilities held for sale on separate lines, but within current assets and current liabilities, respectively. However, not presenting non-current assets and liabilities held for sale in the statement of financial position, but adding disclosures to that effect in the notes, would not be in compliance with the requirement in IFRS 5.38.

The requirement in (b) was included in response to comments made to the IASB during the development of the standard. *[IFRS 5.BC58]*.

Extract from IFRS 5

BC58 Respondents to ED 4 noted that the separate presentation within equity of amounts relating to assets and disposal groups classified as held for sale (such as, for example, unrealised gains and losses on available-for-sale assets[14] and foreign currency translation adjustments) would also provide useful information. The Board agreed and has added such a requirement to the IFRS.

14 IFRS 9 Financial Instruments eliminated the category of available-for-sale financial assets. This paragraph refers to matters relevant when IFRS 5 was issued.

As noted in section 3.2 below, the standard requires an analysis of the income for the period attributable to owners between continuing and discontinued operations.

IFRS 5 is silent as to whether the information specified in (b) above must be on the face of the statement of financial position or in a note. However, the implementation guidance to IFRS 5 shows a caption called 'Amounts recognised in other comprehensive income and accumulated in equity in relation to non-current assets held for sale' and illustrates the requirements as follows: *[IFRS 5.IG Example 12]*

Illustration 2-8: Presenting non-current assets or disposal groups classified as held for sale

At the end of 20X2, an entity decides to dispose of part of its assets (and directly associated liabilities). The disposal, which meets the criteria to be classified as held for sale, takes the form of two disposal groups, as follows:

	Carrying amount after classification as held for sale	
	Disposal group I	Disposal group II
	CU	CU
Property, plant and equipment	4,900	1,700
Investments in equity instruments	*1,400	-
Liabilities	(2,400)	(900)
Net carrying amount of disposal group	**3,900**	**800**

* An amount of CU400 relating to these assets has been recognised in other comprehensive income and accumulated in equity.

The presentation in the entity's statement of financial position of the disposal groups classified as held for sale can be shown as follows:

	20X2	20X1
	CU	CU
ASSETS		
Non-current assets	X	X
AAA	X	X
BBB	X	X
CCC	X	X
	X	**X**
Current assets		
DDD	X	X
EEE	X	X
	X	**X**
Non-current assets classified as held for sale	8,000	-
	X	**X**
Total assets	**X**	**X**

EQUITY AND LIABILITIES		
Equity attributable to equity holders of the parent		
FFF	X	X
GGG	X	X
Amounts recognised in other comprehensive income and accumulated in equity relating to non-current assets held for sale	400	-
	X	**X**
Non-controlling (or minority) interests	X	X
Total equity	**X**	**X**
Non-current liabilities		
HHH	X	X
III	X	X
JJJ	X	X
	X	**X**
Current liabilities		
KKK	X	X
LLL	X	X
MMM	X	X
	X	**X**
Liabilities directly associated with non-current assets classified as held for sale	3,300	-
	X	**X**
Total liabilities	**X**	**X**
Total equity and liabilities	**X**	**X**

The presentation requirements for assets (or disposal groups) classified as held for sale at the end of the reporting period do not apply retrospectively. The comparative statements of financial position for any previous periods are therefore not re-presented.

Once assets have been classified as non-current, they must not be reclassified as current assets until they meet the criteria to be classified as held for sale in accordance with IFRS 5. So, for example, a mere intention to sell an asset would not trigger reclassification until all the criteria discussed in section 2.1.2 above have been met.

Assets of a class that an entity would normally regard as non-current that are acquired exclusively with a view to resale also must not be classified as current unless they meet the slightly relaxed criteria to be classified as held for sale (see section 2.1.2 above). *[IFRS 5.3]*.

The treatment of comparatives when the classification as held for sale commences or ceases is discussed in section 4 below.

2.2.5 Changes to a plan of sale or to a plan of distribution

2.2.5.A Assets (or disposal groups) to be retained by the entity

An asset (or disposal group) must cease to be classified as held for sale (or distribution) if and when the criteria discussed in section 2.1.2 above are no longer met. *[IFRS 5.26]*.

If an individual asset or liability is removed from a disposal group classified as held for sale or classified as held for distribution, the remaining assets and liabilities of the disposal group must only continue to be measured as a group if the group still meets the criteria to be held for sale (or for distribution) under IFRS 5. Otherwise, the remaining non-current assets of the group that individually meet the criteria must be measured individually at the lower of their carrying amounts and fair values less costs to sell at that date. Any non-current assets that do not meet the criteria must cease to be classified as held for sale or held for distribution. *[IFRS 5.29]*.

A non-current asset (or disposal group) that ceases to be classified as held for sale or for distribution (or ceases to be included in a disposal group which is so classified) must be measured at the lower of:

(a) Its carrying amount before the asset (or disposal group) was classified as held for sale or for distribution, adjusted for any depreciation, amortisation or revaluations that would have been recognised had the asset (or disposal group) not been so classified

And

(b) Its recoverable amount at the date of the subsequent decision not to sell or distribute *[IFRS 5.27]*

Regarding (b) above, the standard notes that if the non-current asset is part of a cash-generating unit, its recoverable amount is the carrying amount that would have been recognised after the allocation of any impairment loss arising on that cash-generating unit in accordance with IAS 36. *[IFRS 5.27]*.

Recoverable amount is defined as the higher of:

- An asset's fair value less costs to sell

  And

- Its value in use.

Value in use is defined as "the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life." *[IFRS 5 Appendix A]*.

How we see it

If a disposal group that ceases to be classified as held for sale (or distribution) contains goodwill that has been previously impaired under IFRS 5, and its value upon reclassification to held for use based on the above requirement exceeds the carrying amount of the group under IFRS 5, we believe the considerations in section 2.2.3 above on the reversal of impairment losses recognised under IFRS 5 also apply.

Any required adjustment to the carrying amount of a non-current asset that ceases to be classified as held for sale or for distribution must be included:

(a) In profit or loss from continuing operations in the period in which the criteria are no longer met (unless the asset had been revalued in accordance with IAS 16 or IAS 38 before classification as held for sale, in which case the adjustment must be treated as a revaluation increase or decrease)

And

(b) In the same caption of the statement of comprehensive income used to present any gain or loss recognised in relation to remeasuring non-current assets (or disposal groups) held for sale or distribution but not meeting the definition of a discontinued operation *[IFRS 5.28, IFRS 5.37]*

Financial statements for the periods since classification as held for sale must be amended accordingly if the disposal group or non-current asset that ceases to be classified as held for sale is a subsidiary, joint operation, joint venture, associate, or a portion of an interest in a joint venture or an associate. The adjustment must be presented in the same caption in the statement of comprehensive income described at (b) above.

The treatment of comparative information on the cessation of held-for-sale classification is discussed in section 4.2 below.

2.2.5.B Change in method of disposal

An entity may change the manner in which an asset (or disposal group) will be disposed of from being held for sale to being held for distribution to owners (or *vice versa*). Such a change raises the question as to whether the previous accounting treatment under IFRS 5 must be 'unwound' and started afresh based on the new disposal method, or whether a seamless transition from one to the other must be treated as a continuation of one overall disposal plan.

When the manner of disposal changes directly from one method to the other, the change in classification is considered to be a continuation of the original plan of disposal. In such cases:

(a) The guidance discussed in section 2.2.5.A above does not apply. Rather, the classification, presentation and measurement requirements that are applicable to the new method of disposal must be applied (see sections 2.1 and 2.2 above); that is, without first treating the asset (or disposal group) as ceasing to be held for sale by reversing the preceding accounting treatment.

(b) Any reduction or increase in the fair value less costs to sell/costs to distribute of the non-current asset (or disposal group) must be recognised as discussed in section 2.2.3 above.

And

(c) The date of classification as held for sale or for distribution does not change; nor does such a change preclude an extension of the 'one year rule' (both as discussed in section 2.1.2 above if the relevant conditions are met). *[IFRS 5.26A]*.

3 Discontinued operations

As discussed in section 3.2 below, IFRS 5 requires the presentation of a single amount on the face of the or statement of comprehensive income relating to discontinued operations, with further analysis either on the face of the statement or in the notes.

3.1 Definition of a discontinued operation

IFRS 5 defines a discontinued operation as: *[IFRS 5.32, IFRS 5 Appendix A]*

Extract from IFRS 5

Appendix A
Defined terms

discontinued operation	A **component of an entity** that either has been disposed of or is classified as held for sale and: (a) represents a separate major line of business or geographical area of operations, (b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or (c) is a subsidiary acquired exclusively with a view to resale.

Classification as held for sale is discussed in section 2.1 above. For the purposes of the above definition, a 'component of an entity' is also defined by the standard as comprising "operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. In other words, a component of an entity will have been a cash-generating unit or a group of cash-generating units while being held for use." *[IFRS 5.31, IFRS 5 Appendix A]*. IFRS 5 defines cash generating unit in the same way as IAS 36, that is as "the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets." *[IFRS 5 Appendix A]*. Cash generating units are discussed in Chapter 21 at section 3.

How we see it

In our view, it seems unlikely that this definition of a component would ever be met by a single non-current asset (for example, a single building or single equity-accounted investment). Accordingly, a discontinued operation will also be one or more 'disposal groups' which is a group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction (discussed in section 2.1.1 above).

Furthermore, even if a single equity-accounted investment was considered to meet the definition of a component, only in rare circumstances would it represent a separate major line of business or geographical area of operations. *[IFRS 5.32(a)]*.

Considering that the definition of discontinued operations also requires that it represents a "separate *major* line of business or geographical area of operations" (emphasis added), a question may arise whether the adjective 'major' refers also to the latter component of the definition, i.e., whether also a geographical operation needs to be 'major' for the definition of discontinued operations to be met.

How we see it

We believe that the term 'major' in the definition of the discontinued operation refers to both 'line of business' and 'geographical area of operations', i.e., a discontinued operations needs to represent either a major line of business or a major geographical area of operations.

That is consistent with the intention of the Board that the size of the unit that could be classified as discontinued is not too small and therefore the information provided by separately presenting discontinued operations is useful. *[IFRS 5.BC69]*.

Consequently, a component which neither represents a major line of business nor a major geographical area of operations would not meet the definition of a discontinued operation and cannot be presented as such.

The meaning of 'separate major line of business or geographical area' was raised with the IFRS IC. It concluded, in January 2016, that it must be considered for a broad-scope project on IFRS 5 (possible future developments of IFRS 5 are discussed in section 6 below).[7]

Pending more guidance, determining whether a line of business or geographical area is major may involve judgement and require appropriate disclosures in accordance with IAS 1 (specifically IAS 1.122).

The concept of 'single co-ordinated plan' is not defined in the standard but suggests that the component representing a major line of business or a major geographical area need not be sold in one transaction in order to be presented as a discontinued operation. For instance, it may be that the entity is expecting to sell the component piecemeal to two or more buyers, and that the piecemeal transactions are expected to occur at different times. In such a case, the different parts of the component may not qualify for held for sale classification at the same time, for instance because one or more parts are not expected to be sold within one year. The requirements for presenting discontinued operations would, however, still be applicable for the part (or parts) expected to be sold within one year in the current period, because the corresponding piecemeal disposal is a part of a single co-ordinated plan to sell a major line of business or geographical area of operations. The other part (or parts) would be presented under the discontinued operations guidance in the future periods when they meet the held for sale classification requirements. In these cases, the different parts of a component may not need to represent major lines of business or major geographical areas by themselves.

As discussed in section 2.1.2.C above, IFRS 5 stipulates that a non-current asset (or disposal group) that is to be abandoned must not be classified as held for sale. This includes non-current assets (or disposal groups) that are to be used to the end of their economic life and non-current assets (or disposal groups) that are to be closed rather than sold. However, if the disposal group to be abandoned meets the criteria above, the standard requires it to be treated as a discontinued operation 'at the date on which it ceases to be used'. *[IFRS 5.13]*. In other words, the treatment as discontinued only starts in the period when abandonment actually occurs (see Illustration 3-1 and Illustration 3-2 below).

A non-current asset that has been temporarily taken out of use must not be accounted for as if it had been abandoned. *[IFRS 5.14]*. Accordingly, it would not be presented as a discontinued operation. An example given by the standard is of a manufacturing plant that ceases to be used because demand for its product has declined but which is maintained in workable condition and is expected to be brought back into use if demand picks up. The plant is not regarded as abandoned. *[IFRS 5.IG Example 8]*. However, in these circumstances an impairment test and review of useful life will need to be performed in accordance with IAS 36 (discussed in Chapter 21) and, as appropriate, IAS 16 or IAS 38 (discussed in Chapter 19 and Chapter 18, respectively).

The standard provides an example of a discontinued operation arising from abandonment upon which the following Illustration is based. *[IFRS 5.IG Example 9]*.

Illustration 3-1: Discontinued operation arising from abandonment

In October 20X1 an entity decides to abandon all of its cotton mills, which constitute a major line of business. All work stops at the cotton mills during the year ended 31 December 20X2. In the financial statements for the year ended 31 December 20X1, results and cash flows of the cotton mills are treated as continuing operations. In the financial statements for the year ended 31 December 20X2, the results and cash flows of the cotton mills are treated as discontinued operations and the entity makes the disclosures required (see section 3.2 below).

If an entity is gradually extinguishing its operations, it generally will not present them as discontinued operations before all revenue-generating operations are ceased, as illustrated below:

Illustration 3-2: Operations ceasing gradually

An entity operating in construction industry has decided to cease its activities in the USA. The US component is a separate major geographical area. All current contracts will be completed, but no new contracts will be entered into. Employees from the selling and marketing departments have been made redundant and their employment is terminated.

In this case, the disposal group has not ceased to be used and thus cannot be presented as a discontinued operation. *[IFRS 5.13]*.

7 *IFRIC Update*, January 2016, available on the IFRS Foundation's website.

On the other hand, although all revenue-generating activities have ceased, some administrative tasks may still need to be continued, as illustrated below:

Illustration 3-3: Administrative activities ongoing

An entity operating in construction industry has decided to cease its activities in the USA. The US component is a separate major geographical area. All contracts with customers have been fulfilled, the inventory has been sold out, but some administrative activities are still ongoing, e.g.:

- Debtors are still being collected
- Outstanding rent is to be paid
- A few employees are still employed to execute the outstanding administrative activities.

In this case, the disposal group has ceased to be used and thus represents a discontinued operation in spite of certain administrative tasks still being outstanding. *[IFRS 5.13]*

How we see it

Although the standard does not further explain the meaning of the words 'cease to be used' when applied to an activity, we believe that they typically refer to the cessation of revenue-generating activities. This is because an activity will normally use assets (or groups of assets) to generate revenues and ceasing to use such assets will therefore result in cessation of any revenue derived from using them.

3.2 Presentation of discontinued operations

IFRS 5 requires the presentation of a single amount on the face of the statement of comprehensive income comprising the total of:

(a) The post-tax profit or loss of discontinued operations

And

(b) The post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation *[IFRS 5.33(a)]*

This single amount must be further analysed (either on the face of the statement or in the notes) into:

(a) The revenue, expenses and pre-tax profit or loss of discontinued operations

(b) The gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation

And

(c) Separately for each of (a) and (b) the related income tax expense as required by IAS 12 (see Chapter 29 at section 14.7)

The above analysis is not required for disposal groups that are newly acquired subsidiaries that meet the criteria to be classified as held for sale on acquisition (see section 2.2.2 above). *[IFRS 5.33(b)]*.

If the required analysis is presented on the face of the statement of comprehensive income it must be presented in a section identified as relating to discontinued operations, i.e., separately from continuing operations. *[IFRS 5.33A]*. The standard also makes clear that any gain or loss on the remeasurement of a non-current asset (or disposal group) classified as held for sale that does not meet the definition of a discontinued operation must not be included within these amounts for discontinued operations, but be included in profit or loss from continuing operations. *[IFRS 5.37]*.

Only those expenses that will no longer be incurred by the entity after the sale of the operations can be attributed to discontinued operations. Typically, most group overheads do not cease with the disposal and will therefore be allocated entirely to continuing operations.

Presentation of discontinued operations can be affected by how an entity presents elimination of certain intercompany transactions between continuing and discontinued operations. This is discussed in section 3.3 below.

IFRS 5 requires disclosure of the amount of income from continuing operations and discontinued operations attributable to owners of the parent. This may be given either in the notes or on the face of the statement of comprehensive income. *[IFRS 5.33(d)]*.

IFRS 5 requires that all the above disclosures be re-presented for prior periods presented in the financial statements so that the disclosures relate to all operations that have been discontinued by the reporting date for the latest period presented. *[IFRS 5.34]*. Accordingly, adjustments to the comparative information as originally reported will be necessary for those disposal groups categorised as discontinued operations. Comparative information relating to discontinued operations is discussed further in section 4 below.

The implementation guidance accompanying IFRS 5 provides an example illustration of the presentation of discontinued operations which has been replicated in the Illustration below. *[IFRS 5.IG Example 11]*. (Note that the illustrative example assumes that the entity did not recognise any components of other comprehensive income in the periods presented.)

Illustration 3-4: Presenting discontinued operations

XYZ GROUP - STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X2

(illustrating the classification of expenses by function)

(in thousands of currency units)

	20X2	20X1
Continuing operations		
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the period from continuing operations	X	X
Discontinued operations		
Profit for the period from discontinued operations*	X	X
Profit for the period	X	X
Attributable to:		
Owners of the parent		
Profit for the period from continuing operations	X	X
Profit for the period from discontinued operations	X	X
Profit for the period attributable to owners of the parent	X	X
Non-controlling interest		
Profit for the period from continuing operation	X	X
Profit for the period from discontinued operations	X	X
Profit for the period attributable to non-controlling interests	X	X
	X	X

* The required analysis would be given in the notes.

The above reflects the requirement to disclose the amount of income from continuing operations and discontinued operations attributable to owners of the parent. It is noteworthy that the standard's illustrative example goes beyond what is strictly required by also giving an equivalent analysis for income attributable to non-controlling interests.

Adjustments in the current period to amounts previously presented in discontinued operations that are directly related to the disposal of a discontinued operation in a prior period must be classified separately in discontinued operations. The nature and amount of the adjustments must be disclosed. Examples given by the standard of circumstances in which these adjustments may arise include the following:

(a) The resolution of uncertainties that arise from the terms of the disposal transaction, such as the resolution of purchase price adjustments and indemnification issues with the purchaser.

(b) The resolution of uncertainties that arise from and are directly related to the operations of the component before its disposal, such as environmental and product warranty obligations retained by the seller.

And

(c) The settlement of employee benefit plan obligations, provided that the settlement is directly related to the disposal transaction. *[IFRS 5.35]*.

As a discontinued operation will also include one or more disposal group(s), the requirements regarding presentation of disposal groups in the statement of financial position (discussed in section 2.2.4 above) also apply to discontinued operations.

3.2.1 Cash flows attributable to discontinued operations

In addition, IFRS 5 requires disclosure of the net cash flows attributable to the operating, investing and financing activities of discontinued operations. The standard allows that these disclosures may be presented either in the notes or on the face of the financial statements. IFRS 5 does not amend the requirements of IAS 7 *Statement of Cash Flows* to present cash flows classified by activity, however, the disclosures can be provided in different ways; this is discussed in Chapter 36 at section 12.1. These disclosures are not required for disposal groups that are newly acquired subsidiaries that meet the criteria to be classified as held for sale on acquisition (see section 2.2.2 above). *[IFRS 5.33(c)]*.

The Standard does not clarify whether proceeds from the disposal of discontinued operations are attributable to discontinued or continuing operations. These cash flows can be considered attributable to discontinued operations because they will not continue after the sale - same as a gain or loss on disposal is attributable to the discontinued operations in the statement of comprehensive income. *[IFRS 5.33(a)(ii)]*. An alternative view is that because the cash flows from disposals are not generated by the discontinued operations, rather they are retained by the continuing operations which are disposing of the discontinued operations, they are attributable to the continuing operations.

How we see it

We believe entities have an accounting policy choice, as to whether attribute proceeds from disposal to discontinued operations or continuing operations. The selected accounting policy needs to be applied consistently and disclosed.

If material, it may be appropriate to present the proceeds from disposal of discontinued operations as a separate line item on the face of the statement of cash flows. See also Chapter 36 at section 5.1 for discussion on presentation and disclosure of material cash flows.

3.3 Trading between continuing and discontinued operations

Notwithstanding the one-line presentation discussed above, discontinued operations remain consolidated in group financial statements. That means any transactions between discontinued and continuing operations are eliminated as usual in the consolidation. As a consequence, the amounts ascribed to the continuing and discontinued operations will be income and expense only from transactions with counterparties external to the group. However, the presentation of the eliminations is not addressed by the standard. If all intragroup transactions between continuing and discontinued operations are eliminated without any adjustments, the results presented on the face of the statement of comprehensive income will not represent the activities of the operations as individual entities. Some might consider the results for the continuing and discontinued operations on this basis to be of little use to readers of accounts. An argument could be made that allocating external transactions to or from the discontinued operation would yield more meaningful information.

The IFRS IC discussed this matter and published its agenda decision in January 2016.[8]

8 *IFRIC Update*, January 2016, available on the IFRS Foundation's website.

In that decision the IFRS IC includes the following: "The Interpretations Committee noted that neither IFRS 5 nor IAS 1 includes requirements regarding the presentation of discontinued operations that override the consolidation requirements in IFRS 10 *Consolidated Financial Statements*. The Interpretations Committee also noted that paragraph B86(c) of IFRS 10 requires elimination of, among other things, income and expenses relating to intragroup transactions, and not merely intragroup profit. Consequently, the Interpretations Committee observed that not eliminating intragroup transactions would be inconsistent with the elimination requirements of IFRS 10."

The IFRS IC went on to observe: "The Interpretations Committee also noted that paragraph 30 of IFRS 5 requires an entity to present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations and disposal activity. In the light of this objective, the Interpretations Committee observed that, depending on the particular facts and circumstances, an entity may have to provide additional disclosures in order to enable users to evaluate the financial effects of discontinued operations."

How we see it

In our view, it will clearly be a matter of judgement whether additional information is needed when transactions between continuing and discontinued operations are significant and, if it is, what the form and content of that information must be.

There are generally two alternative ways of eliminating transactions between continuing and discontinued operations: either to eliminate all transactions without any adjustments or to eliminate intragroup transactions, but make adjustments to reflect how transactions between continuing or discontinued operations will be reflected in continuing operations going forward. The latter alternative can be considered as providing more relevant outcome in certain circumstances. This can be illustrated with the following example, which is based on illustrative examples provided in the IFRS IC staff paper accompanying the discussions of the IFRS IC[9]:

Illustration 3-5: Elimination of transactions between continuing and discontinued operations

Group X consists of two entities: A and B. Entity A is a producer of components which are input to entity B's production process. Entity A was sold by the group in December 20X2. All revenues of Entity A consist of intercompany sales to Entity B. The consolidated financial statements for the year ended 31 December 20X2 present Entity A' business as discontinued operations. Entity B will continue to purchase components from entity A. The standalone results of operations of Entity A, Entity B and the consolidated group for the year 20X2 are as follows:

	Entity A (discontinued operations)		Entity B (continuing operations)		Eliminations		Group
	CU		CU		CU		CU
	{1}		*{2}*		*{3}*		*{1}+{2}+{3}*
Revenue	800	*{A1}*	3,200	*{B1}*	(800)	*{-A1}*	3,200
Cost of sales	500	*{A2}*	2,800	*{B2}*	(800)	*{-A1}*	2,500
Profit/(Loss)	**300**		**400**		**-**		**700**

The following alternatives can be considered when it comes to eliminating the transactions between continuing and discontinued operations (and, consequently, determining the split of net profit/loss between the profit/loss from continuing and discontinued operations):

- Alternative 1: Eliminate all intragroup transactions without any adjustments.
- Alternative 2: Eliminate intragroup transactions but make adjustments to reflect how transactions between continuing or discontinued operations will be reflected in continuing operations going forward.

As already discussed above, no elimination of intragroup transactions is not acceptable, as IFRS 10 requires elimination of intragroup transactions in the consolidated financial statements.

9 IASB Staff paper 3B, Project: *IFRS 5 Non-current Assets Held for Sale and Discontinued Operations* Paper topic: *Presentation of intragroup transactions between continuing and discontinued operations*, IFRS IC Meeting, May 2015. Available on the IFRS Foundation's website.

The outcome of these approaches for the consolidated statement of profit or loss of Group X for the year ended 31 December 20X2 would be as follows:

Consolidated statement of profit or loss for the year 20X2

	Alternative 1 eliminate without any adjustments		**Alternative 2** eliminate with adjustments		**No eliminations of intragroup transactions** *(not acceptable)*	
	CU		**CU**		**CU**	
Revenue	3,200		3,200		3,200	
Cost of sales	2,000	*{B2}-{A1}*	2,800	*{B2}*	2,800	*{B2}*
Profit from continuing operations	1,200		400		400	
Revenue	-		-		800	*{A1}*
Cost of sales	500	*{A2}*	(300)	*{A2}-{A1}*	500	*{A2}*
Profit/(Loss) from discontinued operations	(500)		300		300	
Profit for the year	**700**		**700**		**700**	

Under Alternative 1, consolidated profit from continuing operations shows only results of transaction with entities outside the group. Under Alternative 2, intragroup transactions are eliminated against Entity A so that the profit from continuing operations shows an expected impact of future purchases from Entity A.

How we see it

Pending any changes to the standard, we believe entities have an accounting policy choice (to be applied consistently and disclosed), as to whether eliminate the intragroup balances with or without adjustments to reflect the potential impact of these transactions in continuing operations going forward. Additional disclosures may be needed if that is useful to the users of the financial statements.

4 Comparative information

As discussed in Chapter 3 at section 2.4, IAS 1 requires the presentation of comparative information. IFRS 5 contains particular requirements for non-current assets held for sale (and disposal groups) and discontinued operations.

Entities will need to consider whether any (and, if so, what) changes are necessary to comparative information as previously reported whenever:

- Non-current assets or disposal groups first become classified as such
  And
- That classification ceases

4.1 Treatment of comparative information on initial classification as held for sale

4.1.1 The statement of comprehensive income

For non-current assets and disposal groups not qualifying as discontinued operations there are no special requirements relating to presentation in the statement of comprehensive income, accordingly no restatement of comparative amounts would be relevant.

When a component of an entity becomes classified as a discontinued operation, separate presentation of the total of its results for the period and any gain or loss on remeasurement is required on the face of the statement (see section 3.2 above). IFRS 5 requires that these disclosures be re-presented for prior periods presented in the financial statements so that the disclosures relate to all operations that have been discontinued by the reporting date for the latest period presented. *[IFRS 5.34]*. Accordingly, adjustments to the comparative information as originally reported will be necessary for those disposal groups categorised as discontinued operations.

4.1.2 The statement of financial position

IFRS 5 states that an entity shall not reclassify or re-present amounts presented for non-current assets or for the assets and liabilities of disposal groups classified as held for sale in the statements of financial position for prior periods to reflect the classification in the statement of financial position for the latest period presented. *[IFRS 5.40]*. The standard has no separate requirements relating to the statement of financial position for a disposal group also qualifying as a discontinued operation and accordingly comparatives are not adjusted.

4.2 Treatment of comparative information on the cessation of classification as held for sale

As discussed in section 2.2.5 above, when a non-current asset ceases to be classified as held for sale the measurement basis for it reverts to what it would have been if it had not been so classified at all (or recoverable amount if lower). Typically, this would require a 'catch-up' depreciation charge as depreciation would not have been accounted for while it was held for sale. The standard explicitly requires this to be a current year charge. *[IFRS 5.28]*. This indicates that for non-current assets and disposal groups ceasing to be so classified the measurement of items in comparative information (statement of comprehensive income and statement of financial position) must not be revisited. This requirement applies equally to discontinued operations. However, there are additional considerations relevant for subsidiaries, joint arrangements and associates ceasing to be classified as held for sale.

IFRS 5 explains that "Financial statements for the periods since classification as held for sale or as held for distribution to owners shall be amended accordingly if the disposal group or non-current asset that ceases to be classified as held for sale or as held for distribution to owners is a subsidiary, joint operation, joint venture, associate, or a portion of an interest in a joint venture or an associate. The entity shall present that adjustment in the same caption in the statement of comprehensive income" within continuing operations used to record any gains and losses on non-current assets (or disposal groups) held for sale. *[IFRS 5.28, IFRS 5.37]*. IAS 28 clarifies that, as regards associates and joint ventures, the amendment of financial statements 'for the periods since classification as held for sale' means retrospectively from the date of its original classification as held for sale. *[IAS 28.21]*. This clarification is not repeated in IFRS 10 or IFRS 11 *Joint Arrangements*. However, we believe the clarification also applies to assets or disposal groups within the scope of those standards and that this is the most common approach seen in practice. As a result, when a disposal group or non-current asset that was classified as held for sale represented an entire subsidiary, joint operation, joint venture or associate or was a portion of an interest in a joint venture or associate, and subsequently no longer qualifies as held for sale, financial statements must be amended retrospectively as though the disposal group or non-current asset never qualified as held for sale.

How we see it

For subsidiaries, joint arrangements and associates ceasing to be classified as held for sale, the financial statements must be amended retrospectively for the purpose of measurement. The standard is not explicit on whether the retrospective application requirement is also applicable for presentation purposes. In our view, it is necessary to align presentation and measurement, and thus comparatives are restated as if the investee never qualified as held for sale.

This area has been considered by the IFRS IC. The IFRS IC decided not to add it to its agenda, noting at the time that IFRS 5 was a possible subject for a research project by the IASB which would examine a number of areas (possible future developments of IFRS 5 are discussed in section 6 below). In its agenda decision the IFRS IC observed the following: "paragraph 28 requires the effects of a remeasurement (upon ceasing to be classified as held for sale) of a non-current asset to be recognised in profit or loss in the current period. Paragraph 28 also requires financial statements for the periods since classification as held for sale or as held for distribution to owners to be 'amended accordingly' if the disposal group or non-current asset that ceases to be classified as held for sale or as held for distribution to owners is a subsidiary, joint operation, joint venture, associate, or a portion of an interest in a joint venture or an associate. The issue relates to a situation in which a disposal group that consists of both a subsidiary and other non-current assets ceases to be classified as held for sale. In such a situation, should an entity recognise the remeasurement adjustments relating to the subsidiary and the other non-current assets in different accounting periods, and should any amendment apply to presentation as well as to measurement?"[10]

Regarding the treatment of discontinued operations in the statement of comprehensive income, the standard states that if an entity ceases to classify a component as held for sale, the results of operations of the component previously presented in discontinued operations must be reclassified and included in income from continuing operations for all periods presented. The amounts for prior periods must be described as having been re-presented. *[IFRS 5.36]*.

As discussed in section 4.1.2 above, the amounts presented for non-current assets or for the assets and liabilities of disposal groups classified as held for sale in the comparative statement of financial position must not be reclassified or re-presented.

10 *IFRIC Update*, January 2016, available on the IFRS Foundation's website.

5 Disclosure requirements

5.1 Requirements of IFRS 5

The standard includes the following general disclosure objective:

Extract from IFRS 5	
30	An entity shall present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations and disposals of non-current assets (or disposal groups).

[IFRS 5.30]

As discussed in sections 2.2.4 and 3.2 above, IFRS 5 sets out detailed requirements for the prominent presentation of amounts relating to non-current assets held for sale, disposal groups and discontinued operations. In particular, and as discussed in section 3.2 above, the single amount reflecting the income from discontinued operations must be analysed into its components, either on the face of the statement of comprehensive income or in the notes.

IFRS 5 also requires disclosure of the net cash flows attributable to the operating, investing and financing activities of discontinued operations (discussed in section 3.2.1 above and in Chapter 36 at section 12.1).

In addition, disclosure is required in the notes in the period in which a non-current asset (or disposal group) has been either classified as held for sale or sold:

(a) A description of the non-current asset (or disposal group)

(b) A description of the facts and circumstances of the sale, or leading to the expected disposal, and the expected manner and timing of that disposal

(c) The gain or loss recognised as a result of measuring the non-current asset (or disposal group) at fair value less costs to sell (discussed in section 2.2 above) and, if not separately presented on the face of the statement of comprehensive income, the caption in the statement that includes that gain or loss

And

(d) If applicable, the segment in which the non-current asset (or disposal group) is presented in accordance with IFRS 8 *Operating Segments* (discussed in Chapter 32 at section 3.1) *[IFRS 5.41]*

Siemens Aktiengesellschaft provided the following disclosures with respect to discontinued operations in its 2021 consolidated financial statements (apart from cash flows from discontinued operations which were disclosed on the face of the statement of cash flows):

Practical example 5-1: Siemens Aktiengesellschaft (2021) Germany

Siemens Report 2021 [extract]

Consolidated Financial Statements [extract]

6. Notes to Consolidated Financial Statements [extract]

Note 3 Acquisitions, dispositions and discontinued operations [extract]

Sale of Flender GmbH

In October 2020, Siemens signed an agreement to sell 100% of its shares in Flender GmbH including Siemens' Wind Energy Generation business (Flender) to The Carlyle Group, U.S. Both businesses were previously reported under Portfolio Companies. In the first quarter of fiscal 2021, the businesses of Flender (the disposal group) met the criteria for classification as held for disposal as well as for discontinued operation, and, accordingly, Siemens ceased depreciation and amortization of assets within the disposal group. Upon closing of the transaction in March 2021, Siemens no longer controls Flender. The consideration was €1.875 billion. Derecognized net assets amounted to €954 million. The results of Flender are reported as discontinued operations in the Consolidated Statements of Income and Cash Flows for all periods presented:

(in millions of €)	FY 2021	FY 2020
Revenue	928	1,885
Expenses	(818)	(1,710)
Disposal gain net of disposal costs	885	(5)
Income (loss) from discontinued operations before income taxes	995	170
Income taxes on ordinary activities	(8)	(36)
Other income taxes	(40)	–
Income (loss) from discontinued operations, net of income taxes	946	134
thereof attributable to Siemens AG shareholders	*946*	*134*

The carrying amounts of the major classes of assets and liabilities derecognized were as follows:

(in millions of €)	Mar 10, 2021
Cash and cash equivalents	95
Trade and other receivables	510
Other current financial assets	143
Inventories	540
Goodwill	123
Property, plant and equipment	359
Miscellaneous current and non-current assets	92
Assets classified as held for disposal	1,862
Trade payables	355
Other current financial liabilities	193
Miscellaneous current liabilities	244
Miscellaneous non-current liabilities	116
Liabilities associated with assets classified as held for disposal	907

If a non-current asset (or disposal group) meets the criteria to be classified as held for sale after the reporting date but before the financial statements are authorised for issue, the information specified in (a), (b) and (d) above must also be disclosed in the notes. *[IFRS 5.12]*.

Further, should:

- A non-current asset (or disposal group) ceases to be classified as held for sale

  Or
- An individual asset or liability be removed from a disposal group

Then IFRS 5 requires disclosure of, in the period of the decision to change the plan to sell the non-current asset (or disposal group), a description of the facts and circumstances leading to the decision and the effect of the decision on the results of operations for the period and any prior periods presented. *[IFRS 5.42]*. ENGIE SA provided the following information in its 2021 financial statements:

Practical example 5-2: ENGIE SA (2021) France

2021 MANAGEMENT REPORT AND ANNUAL CONSOLIDATED FINANCIAL STATEMENTS [extract]

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]

5.2 Assets held for sale [extract]

The assets related to renewable energy in India recorded as "Assets classified as held for sale" at December 31, 2020 were sold in 2021. However, the Group's stake in EV Charged BV (EV Box), for which the planned disposal of the majority of the shares was announced in December 2020, is no longer classified under IFRS 5 following the parties' decision to put to an end the planned transaction.

...

5.2 Disclosures required by standards other than IFRS 5

IFRS 5 explains that disclosures in other IFRS accounting standards do not apply to non-current assets (or disposal groups) classified as held for sale or discontinued operations unless those IFRS accounting standards require:

- Specific disclosures in respect of non-current assets (or disposal groups) classified as held for sale or discontinued operations

  Or
- Disclosures about the measurement of assets and liabilities within a disposal group that are not within the scope of the measurement requirement of IFRS 5 and such disclosures are not already provided in the other notes to the financial statements. *[IFRS 5.5B]*.

The requirement in the second bullet above reflects the fact that such assets continue to be measured in accordance with the specific IFRS accounting standard dealing with them. In practice, much of the requirement will be satisfied by the disclosure of accounting policies. The requirement for other disclosures will depend on the standard concerned. An example would be actuarial assumptions used to measure a pension plan as the surplus or deficit is not within the measurement scope of IFRS 5.

IFRS 12 *Disclosure of Interests in Other Entities* clarifies that all the disclosures of that standard apply to interests that are classified as held-for-sale, with the exception only of those disclosures (summarised financial information) identified by IFRS 12 as not being required. *[IFRS 12.5A, IFRS 2.B17]*.

The standard goes on to say that additional disclosures about non-current assets (or disposal groups) classified as held for sale or discontinued operations may be necessary to comply with the general requirements of IAS 1, in particular paragraphs 15 and 125 of that standard. *[IFRS 5.5B]*. Those provisions deal with fair presentation and estimation uncertainty and are discussed in Chapter 3 at sections 4.1.1 and 5.2.1.

Entities need also to carefully consider disclosing information regarding significant judgements and accounting policy choices made when applying the standard, as required by paragraphs 117 to 122 of IAS 1, such as:

- Whether IFRS 5 is applied when control is lost in a subsidiary and the retained interest represents a joint operation (see section 2.1.3.A above).
- Whether IFRS 5 is applied to all losses of control or only to those resulting from an actual sale or distribution (see section 2.1.4 above).
- How the entity accounts for impairment if it exceeds the carrying value of the non-current assets within the scope of the standard's measurement rules (see section 2.2.3 above).
- Whether the intragroup balances are eliminated with or without adjustments to reflect the potential impact of these transactions in continuing operations going forward (see section 3.3 above).

5.3 Disclosures required by IFRS 19 *Subsidiaries without Public Accountability*: Disclosures

IFRS 19 *Subsidiaries without Public Accountability: Disclosures* was issued by the IASB in May 2024 to simplify the preparation of financial statements by eligible subsidiaries. Eligible subsidiaries that elect to apply IFRS 19 are allowed to provide reduced disclosures while still applying the recognition, measurement and presentation requirements in other IFRS accounting standards. IFRS 19 is effective for annual reporting periods beginning on or after 1 January 2027, with earlier application permitted (subject to jurisdictional endorsement). See Chapter 4 at section 7 for further details on the requirements of IFRS 19.

6 Possible future developments

The IASB has, over recent years, discussed a number of issues related to IFRS 5, as set out below.[11]

(a) The scope of held-for-sale classification; discussed in section 2.1.3.A above

(b) Accounting for disposal groups consisting mainly of financial instruments

(c) The 'excess impairment' issue; discussed in section 2.2.3 above

(d) The reversal of goodwill impairments in a disposal group

(e) The allocation of impairments within a disposal group; discussed in section 2.2.3 above

(f) The definition of discontinued operation and disclosures; discussed in section 3.1 above

(g) The presentation of other comprehensive income of disposal groups

(h) The application of the term 'major line of business'; discussed in section 3.1 above

(i) The treatment of intragroup transactions between continuing and discontinued operations; discussed in section 3.3 above

(j) The application of the presentation requirements in the standard to a disposal group consisting of a subsidiary and other non-current assets in the case of a change to a plan of sale; discussed in section 4.2 above

And

(k) The applicability of the disclosure requirements in IFRS 12 to a subsidiary classified as held-for-sale

Item (i) above was referred to the IFRS IC for consideration. It published an agenda decision in January 2016, which is discussed in section 3.3 above. As regards item (k) above, the Board has amended IFRS 12 (see section 5.2 above).

With regard to the rest of the items, the IASB included a reference to them in its request for views in its 2015 Agenda Consultation. In November 2016, the Board published *IASB Work Plan 2017-2021: Feedback Statement on the 2015 Agenda Consultation*. This document notes: "The Board agreed that the best way to start a review of these issues would be through a post-implementation review of IFRS 5. The Board intends to carry out that review after the forthcoming post-implementation reviews of IFRS 13 and of IFRS accounting standards 10-12."[12]

The Board completed the post-implementation review of IFRS 13 in December 2018[13], and the post-implementation review of IFRS 10, IFRS 11 and IFRS 12 in June 2022.[14]

In March 2021, the Board published a request for information with regard to the third agenda consultation.[15] This document acknowledged the history of questions arising in relation to IFRS 5 and specifically asked respondents for views on whether they were 'still a priority'.[16] In the feedback statement to the third agenda consultation, the Board explained that mixed feedback was received from the respondents on the priority of the project on discontinued operations and disposal groups, and this project was not added to the IASB's work plan for 2022 to 2026.[17]

Time will tell whether the Board will conduct a review of IFRS 5 and, if it does, which, if any, of the matters discussed above will be addressed.

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11 IASB Staff paper 12C, Project: *IFRS 5 Non-current Assets Held for Sale and Discontinued Operations* Paper topic: *Next steps for a series of IFRS 5-related issues*, IASB Meeting, July 2015. Available on the IFRS Foundation's website.

12 *IASB® Work Plan 2017-2021*: *Feedback Statement on the 2015 Agenda Consultation*, November 2016, page 19. Available on the IFRS Foundation's website.

13 *IFRS® Project Report and Feedback Statement*: *Post-implementation Review of IFRS 13* Fair Value Measurement, IASB, December 2018. Available on the IFRS Foundation's website.

14 *Project Report and Feedback Statement*: *Post-implementation Review: IFRS 10* Consolidated Financial Statements, *IFRS 11* Joint Arrangements *and IFRS 12* Disclosure of Interests in Other Entities, IASB, June 2022. Available on the IFRS Foundation's website.

15 *Request for Information*: *Third Agenda Consultation*, IASB, March 2021. Available on the IFRS Foundation's website.

16 *Request for Information*: *Third Agenda Consultation*, IASB, March 2021, paragraphs 26 and B17 - B19. Available on the IFRS Foundation's website.

17 Feedback Statement: *Third Agenda Consultation*, IASB, July 2022, p. 23, 25-26. Available on the IFRS Foundation's website.

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Appendix B - Defined terms

Extract from IFRS 5

Appendix A
Defined terms

This appendix is an integral part of the IFRS.

cash-generating unit	The smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.
component of an entity	Operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.
costs to sell	The incremental costs directly attributable to the disposal of an asset (or **disposal group**), excluding finance costs and income tax expense.
current asset	An entity shall classify an asset as current when: (a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle; (b) it holds the asset primarily for the purpose of trading; (c) it expects to realise the asset within twelve months after the reporting period; or (d) the asset is cash or a cash equivalent (as defined in IAS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.
discontinued operation	A **component of an entity** that either has been disposed of or is classified as held for sale and: (a) represents a separate major line of business or geographical area of operations, (b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or (c) is a subsidiary acquired exclusively with a view to resale.
disposal group	A group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. The group includes goodwill acquired in a business combination if the group is a **cash-generating unit** to which goodwill has been allocated in accordance with the requirements of paragraphs 80-87 of IAS 36 *Impairment of Assets* (as revised in 2004) or if it is an operation within such a cash-generating unit.
fair value	*Fair value* is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13.)
firm purchase commitment	An agreement with an unrelated party, binding on both parties and usually legally enforceable, that (a) specifies all significant terms, including the price and timing of the transactions, and (b) includes a disincentive for non-performance that is sufficiently large to make performance **highly probable**.
highly probable	Significantly more likely than **probable**.
non-current asset	An asset that does not meet the definition of a **current asset**.
probable	More likely than not.
recoverable amount	The higher of an asset's **fair value** less **costs of disposal** and its **value in use**.
value in use	The present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

Chapter 6 First-time adoption

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Overview

IFRS 1 *First-time Adoption of International Financial Reporting Standards* ensures that an entity's first IFRS financial statements, and its interim financial reports for part of the period covered by those financial statements, contain high quality information that is transparent for users and comparable over all periods presented; provides a suitable starting point for accounting in accordance with IFRS accounting standards; and can be generated at a cost that does not exceed the benefits. *[IFRS 1.1]*.

This chapter addresses the accounting for the transition to IFRS accounting standards in an entity's first IFRS financial statements, including the scope of the first IFRS financial statements in section 2 below, exceptions to the retrospective application of other IFRS accounting standards in section 4 below and exemptions from other IFRS accounting standards in section 5 below. The chapter also discusses the requirements for presentation and disclosure in the first IFRS financial statements in section 6 below, some practical issues arising from the requirements of IFRS 1 in section 7 below, and some regulatory issues in section 8 below. This chapter generally discusses the requirements of IFRS 1 for accounting periods beginning on or after 1 January 2025 unless otherwise stated and reflects the amendments to the revised version of IFRS 1 referred to in section 1.1 below.

This chapter does not deal with the first-time adoption of the earlier versions of IFRS 1. A detailed discussion of the first-time adoption using the earlier versions of the standard can be found in Chapter 5 of *International GAAP 2024* and prior editions.

What you need to know

- A first-time adopter is an entity that presents its first IFRS financial statements, which are the first annual financial statements in which the entity adopts IFRS accounting standards by an explicit and unreserved statement of compliance with IFRS accounting standards.
- IFRS 1 applies to the first IFRS financial statements and to each interim financial report, if any, presented in accordance with IAS 34 Interim Financial Reporting for part of the period covered by the first IFRS financial statements. An entity that reapplies IFRS accounting standards, but whose most recent annual financial statements did not contain an explicit and unreserved statement of compliance, is permitted to choose to apply IFRS 1 or to retrospectively apply IFRS accounting standards as if it had never stopped applying IFRS accounting standards.
- A first-time adopter must use the same accounting policies in its opening IFRS statement of financial position (as at the date of transition to IFRS accounting standards, being the beginning of the earliest comparative period presented) and throughout all periods presented in its first IFRS financial statements. These accounting policies must comply with IFRS accounting standards effective at the end of the first IFRS reporting period, except for certain mandatory exceptions and voluntary exemptions. The transitional provisions in IFRS accounting standards available to existing IFRS reporters do not apply.
- When an entity makes estimates in accordance with IFRS accounting standards, these must be consistent with estimates made under previous GAAP for the same date (after adjusting for the effects of any differences in accounting policies), unless there is objective evidence that the previous GAAP estimates were in error.
- IFRS 1 requires a first-time adopter to present its opening IFRS statement of financial position and to explain the transition to IFRS accounting standards, including reconciliations of equity at the date of transition and the end of the comparative period and of total comprehensive income of the comparative period with previous GAAP. An explanation of material adjustments to the cash flow statement is also needed. The first IFRS financial statements must also comply with the presentation and disclosure requirements of other IFRS accounting standards. There are certain disclosures, including reconciliations to previous GAAP, required in interim financial reports to which IFRS 1 applies.

1 Introduction

1.1 Objectives of first-time adoption

In principle, a first-time adopter prepares financial statements as if it had always applied IFRS accounting standards. Although entities routinely have to apply new accounting standards by way of prior year adjustment, adopting IFRS accounting standards, a new basis of accounting, is a challenging undertaking and poses a distinct set of problems. One cannot underestimate the magnitude of the effort involved in adopting a large number of new accounting standards. The requirements of individual standards will often differ significantly from those under an entity's previous GAAP and adoption of IFRS accounting standards could require information to be collected that was not needed under the previous GAAP.

IFRS 1 has a rather limited objective: to ensure that an entity's first IFRS financial statements, and its interim financial reports for part of the period covered by those first IFRS financial statements, contain high quality financial information that: *[IFRS 1.1]*

(a) Is transparent for users and comparable over all periods presented

(b) Provides a suitable starting point for accounting in accordance with IFRS accounting standards

And

(c) Can be generated at a cost that does not exceed the benefits

It is important for users to be mindful of this objective as it provides the principal rationale underlying many of the decisions reflected in the standard, in particular the various exceptions that require, and exemptions that allow, a first-time adopter to deviate from the general rule (i.e., a retrospective application).

Although IFRS 1 owes its existence to the 2005 adoption of IFRS accounting standards by EU companies whose securities were traded on an EU regulated market,[1] one of the IASB's aims was "to find solutions that would be appropriate for any entity, in any part of the world, regardless of whether adoption occurs in 2005 or at a different time". *[IFRS 1.BC3]*. IFRS 1 had to be written in a way that completely ignores a first-time adopter's previous GAAP. This means that first-time adoption exemptions are made available to all first-time adopters, including those whose previous GAAP was very close to IFRS accounting standards. A first-time adopter that so desires will be able to make considerable adjustments to its opening IFRS statement of financial position, using the available exemptions in IFRS 1, even if the differences between its previous GAAP and IFRS accounting standards were only minor. The requirement to use the same IFRS accounting standards for all periods presented in the first IFRS financial statements could also give rise to considerable adjustments from previous GAAP.

Another issue is the potential for lack of comparability between different first-time adopters, and between first-time adopters and entities already applying IFRS accounting standards. *[IFRS 1.BC9]*. The IASB ultimately decided that it was "more important to achieve comparability over time within a first-time adopter's first IFRS financial statements and between different entities adopting IFRSs for the first time at a given date; achieving comparability between first-time adopters and entities that already apply IFRSs is a secondary objective." *[IFRS 1.BC10]*.

A revised IFRS 1 was issued in November 2008, which retains the substance of the previous version of the standard but within a changed structure. *[IFRS 1.BC3B]*. The standard has been further amended as a result of the IASB's annual improvements process, consequential amendments resulting from issuance of new standards, as well as to provide limited exceptions and exemptions that address specific matters. This approach always carried the risk that its complexity might eventually overwhelm its practical application. All these amendments are incorporated into the applicable sections of this chapter.

1.2 Convergence with US GAAP

Differences between the IFRS accounting standards and US GAAP guidance on this topic are not addressed in this chapter as the standards are not converged. Therefore, differences between IFRS accounting standards and US GAAP may exist which are not discussed in this publication.

1 Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, Article 4.

1.3 Future developments

Consideration will be given at the time of deliberations to how new standards or amendments could impact a first-time adopter of IFRS accounting standards and any consequential amendments to IFRS 1 will be included in the new standards or amendments. Entities contemplating conversion to IFRS accounting standards are recommended to monitor the IASB's agenda in order to anticipate the potential impact of future standards or amendments on their conversions.

1.4 Defined terms

IFRS 1 defines the following terms in connection with the transition to IFRS accounting standards. *[IFRS 1 Appendix A]*. Regardless of the following defined terms, we refer to 'IFRS accounting standards' instead of 'International Financial Reporting Standards' or 'IFRSs' in this chapter. We also refer to the 'date of transition to IFRS accounting standards' or the 'date of transition' instead of the 'date of transition to IFRSs'. The term 'IFRS financial statements' is, however, used to mean annual financial statements prepared in accordance with IFRS accounting standards.

Extract from IFRS 1

Appendix A
Defined terms

date of transition to IFRSs	The beginning of the earliest period for which an entity presents full comparative information under IFRSs in its **first IFRS financial statements**.
first IFRS financial statements	The first annual financial statements in which an entity adopts **International Financial Reporting Standards (IFRSs)**, by an explicit and unreserved statement of compliance with IFRSs.
first IFRS reporting period	The latest reporting period covered by an entity's **first IFRS financial statements**.
first-time adopter	An entity that presents its **first IFRS financial statements**.
International Financial Reporting Standards (IFRSs)	Standards and Interpretations issued by the International Accounting Standards Board (IASB). They comprise: (a) International Financial Reporting Standards; (b) International Accounting Standards; (c) IFRIC Interpretations; and (d) SIC Interpretations.[1]
opening IFRS statement of financial position	An entity's statement of financial position at the **date of transition to IFRSs.**
previous GAAP	The basis of accounting that a **first-time adopter** used immediately before adopting IFRSs.

1 Definition of IFRSs amended after the name changes introduced by the revised Constitution of the IFRS Foundation in 2010.

2 Who is a first-time adopter?

2.1 The first IFRS financial statements in scope of IFRS 1

An entity's first IFRS financial statements are the first annual financial statements in which the entity adopts IFRS accounting standards, by making in those financial statements an explicit and unreserved statement of compliance with IFRS accounting standards. IFRS 1 provides a description of the circumstances in which an entity is a first-time adopter and therefore is within the standard's scope (see the extract from IFRS 1 below). *[IFRS 1.3, IFRS 1 Appendix A]*.

Extract from IFRS 1

3 An entity's first IFRS financial statements are the first annual financial statements in which the entity adopts IFRSs, by an explicit and unreserved statement in those financial statements of compliance with IFRSs. Financial statements in accordance with IFRSs are an entity's first IFRS financial statements if, for example, the entity:

(a) presented its most recent previous financial statements:

(i) in accordance with national requirements that are not consistent with IFRSs in all respects;

(ii) in conformity with IFRSs in all respects, except that the financial statements did not contain an explicit and unreserved statement that they complied with IFRSs;

(iii) containing an explicit statement of compliance with some, but not all, IFRSs;

(iv) in accordance with national requirements inconsistent with IFRSs, using some individual IFRSs to account for items for which national requirements did not exist; or

(v) in accordance with national requirements, with a reconciliation of some amounts to the amounts determined in accordance with IFRSs;

(b) prepared financial statements in accordance with IFRSs for internal use only, without making them available to the entity's owners or any other external users;

(c) prepared a reporting package in accordance with IFRSs for consolidation purposes without preparing a complete set of financial statements as defined in IAS 1 *Presentation of Financial Statements* (as revised in 2007); or

(d) did not present financial statements for previous periods.

An entity whose most recent previous financial statements contained an explicit and unreserved statement of compliance with IFRS accounting standards can never be considered a first-time adopter. This is the case even in the following circumstances: *[IFRS 1.4]*

- The entity presented financial statements containing an explicit and unreserved statement of compliance with IFRS accounting standards despite the fact that the auditors issued a qualified audit report on those IFRS financial statements. By contrast, an entity that makes a statement of compliance that excludes any IFRS accounting standards will still be a first-time adopter (see Illustration 2-1 below).
- The entity presented financial statements stating compliance with both national GAAP and IFRS accounting standards.

  Or
- The entity stops presenting a separate set of financial statements under national requirements, which was previously presented in addition to its IFRS financial statements (see Illustration 2-2 below).

The IASB could have introduced special rules that would have required an entity that significantly departed from IFRS accounting standards to apply IFRS 1. However, the IASB considered that such rules would lead to "complexity and uncertainty". *[IFRS 1.BC5]*. In addition, this would have given entities applying 'IFRS-lite' (entities not applying IFRS accounting standards rigorously in all respects e.g., applying IFRS accounting standards except for certain standards and interpretations) an option to sidestep the requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to disclose departures from IFRS accounting standards as errors. *[IFRS 1.BC6]*.

Illustrations 2-1 to 2-3 below demonstrate certain scenarios in connection with determining whether an entity is a first-time adopter.

Illustration 2-1: Scope of application of IFRS 1 - statement of compliance

Entity A applied IFRS accounting standards in its previous financial statements, but stated that it "applied IFRS accounting standards except for IFRS 2 *Share-based Payment*."

Entity A is a first-time adopter because its previous financial statements did not contain an unreserved statement of compliance with IFRS accounting standards. It is irrelevant whether the auditors' report was qualified or not. *[IFRS 1.3(a)(iii)]*

Entity B applied IFRS accounting standards in its previous financial statements and stated that "the financial statements are prepared in conformity with IFRS accounting standards." Despite that statement, Entity B had not applied IFRS 2.

Entity B is not a first-time adopter because its financial statements contained an unreserved statement of compliance with IFRS accounting standards. Even if the auditors had qualified their report, the entity would still not be a first-time adopter. *[IFRS 1.4(c)]*.

It is clear that the scope of IFRS 1 is very much rules-based, which as Illustration 2-1 above demonstrates, can lead to different answers in similar situations and sometimes to counter-intuitive answers.

Illustration 2-2: Scope of application of IFRS 1 - entity applying national GAAP and IFRS accounting standards

Entity C prepares two sets of financial statements, one set of financial statements based on its national GAAP and the other set based on IFRS accounting standards. The IFRS financial statements contained an explicit and unreserved statement of compliance with IFRS accounting standards and were made available externally. From 20X3 onwards, Entity C stops presenting financial statements based on its national GAAP.

Entity C is not a first-time adopter because it already published financial statements that contained an explicit and unreserved statement of compliance with IFRS accounting standards. *[IFRS 1.4(a)]*.

Illustration 2-3: Scope of application of IFRS 1 - first IFRS financial statements outside the annual financial statements

Entity D prepared financial statements under its previous GAAP for the year ended 31 December 20X2. In connection with its initial public offering, Entity D published an offering document that includes IFRS financial statements that contain an explicit and unreserved statement of compliance with IFRS accounting standards. The date of transition to IFRS accounting standards for the purposes of those financial statements, which cover the most recent three financial years, was 1 January 20X0.

Entity D's annual financial statements (as required by the legal or regulatory framework of its jurisdiction) are prepared under IFRS accounting standards for the first time for the year ended 31 December 20X3.

The IFRS financial statements included in Entity D's offering document were its first IFRS financial statements, containing an explicit and unreserved statement of compliance with IFRS accounting standards. Therefore, Entity D does not apply IFRS 1 in its first annual financial statements prepared under IFRS accounting standards as it is not a first-time adopter. *[IFRS 1.3]*. Although not required by IFRS accounting standards, Entity D could, if it wished to do so, repeat information about its transition to IFRS accounting standards in its annual financial statements for the year ended 31 December 20X3.

If, however, Entity D had included financial statements in its offering document that did not contain an explicit and unreserved statement of compliance with IFRS accounting standards then the annual financial statements for 20X3 would need to be prepared in accordance with IFRS 1. If those financial statements only included comparative information for the year ended 31 December 20X2 then Entity D's date of transition would be 1 January 20X2.

An entity will be a first-time adopter if it has previously prepared financial statements in accordance with IFRS accounting standards but only for internal purposes, for example, where the entity had:

- Prepared financial statements in accordance with IFRS accounting standards for internal use only, without making them available to the entity's owners or any other external users *[IFRS 1.3(b)]*

  Or

- Prepared a reporting package in accordance with IFRS accounting standards for consolidation purposes without preparing a complete set of financial statements as defined in IAS 1 *[IFRS 1.3(c)]*

How we see it

Where previous financial statements containing an explicit and unreserved statement of compliance with IFRS accounting standards have been authorised for issue, but are subject to restrictions for specific use or that limited the distribution to certain users, these restrictions will need to be evaluated to determine whether or not those previous financial statements were general purpose financial statements (see section 2.1.1 below).

If the previous financial statements were general purpose financial statements made available to the entity's owners or any other external users, the entity is not a first-time adopter. In our view, the availability of financial statements, as described in IFRS 1.3(b), does not require active distribution of the financial statements. If the financial statements could be requested by owners or other external users (and there is a known mechanism by which such requests could be made), the financial statements would be available.

An entity that is a subsidiary of its parent that reports in accordance with IFRS accounting standards and has previously prepared only a reporting package in accordance with IFRS accounting standards for consolidation purposes is a first-time adopter. However, it could use the amounts reported for it in the group's financial statements when it adopts IFRS accounting standards for its own financial statements on the basis explained in section 5.8.1 below.

Finally, IFRS 1 applies also to a first-time adopter that did not present financial statements for previous periods. *[IFRS 1.3(d)]*. For example, when an entity transfers its operations into a new company prior to an issue to the public, the new company would be a first-time adopter if the entity never applied IFRS accounting standards in the past.

An entity that is already applying IFRS accounting standards in preparing its financial statements must not apply IFRS 1 to changes in its accounting policies. Instead, such an entity applies: *[IFRS 1.5]*

- The requirements on changes in accounting policies in IAS 8

  And

- Specific transitional requirements in other IFRS accounting standards

2.1.1 What are general purpose financial statements?

IFRS accounting standards are intended to be applied in the preparation of general purpose financial statements, i.e., those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs. Many existing and potential investors, lenders and other creditors ('the primary users') cannot require reporting entities to provide information directly to them and must rely on general purpose financial statements for much of the financial information they need. *[IAS 1.2, IAS 1.7, CF 1.5]*. The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to the primary users in making decisions relating to providing resources to the entity. *[CF 1.2]*. Management of an entity need not rely on general purpose financial reports, since the relevant information can be obtained internally (see Chapter 2 at sections 4.1.1 and 4.1.2 and Chapter 3 at section 1.1). *[CF 1.9]*.

How we see it

Judgement is required in making the determination of whether or not the previous financial statements were general purpose financial statements in accordance with IFRS accounting standards, based on the specific facts and circumstances. Factors to consider include: the purpose and intended use for which the financial statements have been prepared (including the nature of any restrictions over their use); the extent to which the financial statements have been made available to owners or other external users; whether or not the recipients are permitted to make the financial statements available to other users; and whether the financial statements have been authorised for issue by the relevant body.

A restriction of the distribution (or over the use) of the financial statements authorised for issue does not necessarily mean the financial statements are not general purpose financial statements, as explained below.

For example, if a set of financial statements that includes an explicit and unreserved statement of compliance with IFRS accounting standards was made available to an external party (such as a bank for the purposes of a lending decision) and the information has not specifically been tailored for the bank's needs, the financial statements would generally be regarded as general purpose financial statements. However, where a set of financial statements that includes an explicit and unreserved statement of compliance with IFRS accounting standards was made available only to an entity's board members, CEO or CFO (who are also the entity's shareholders) but not to other owners, there could be a question over whether these are general purpose financial statements. Accordingly, it would be necessary to understand the full facts and circumstances in making this determination, taking into account the above factors.

2.2 When is IFRS 1 applied?

An entity that presents its first IFRS financial statements is a first-time adopter, *[IFRS 1 Appendix A]*, and, accordingly, must apply IFRS 1 in preparing those financial statements. *[IFRS 1.2(a)]*. It must also apply the standard in each interim financial report that it presents in accordance with IAS 34 for part of the period covered by its first IFRS financial statements. *[IFRS 1.2(b)]*. Therefore, a first-time adopter does not apply IFRS 1 to a 'trading statement', an 'earnings press release' or other financial report issued at its interim reporting date that is not described as complying with IAS 34 or IFRS accounting standards. In Practical example 2-1 below, Sony Group Corporation described its adoption of IFRS accounting standards in its interim or quarterly financial statements.

Practical example 2-1: Sony Group Corporation (For the three months ended June 30, 2021) — **Japan**

Quarterly Securities Report [extract]

Notes to Condensed Consolidated Financial Statements (Unaudited) [extract]

2. Basis of preparation [extract]

Compliance with International Financial Reporting Standards

The condensed consolidated financial statements of Sony have been prepared in accordance with International Accounting Standards ("IAS") 34 "Interim Financial Reporting", as issued by the International Accounting Standards Board ("IASB").

Sony adopted International Financial Reporting Standards ("IFRS") for the first time this fiscal year (commencing on April 1, 2021 and ending on March 31, 2022), and so the annual consolidated financial statements for this fiscal year are the first ones prepared in conformity with IFRS. The date of Sony's transition to IFRS is April 1, 2020. Sony adopted IFRS 1 "First-Time Adoption of International Financial Reporting Standards" ("IFRS 1") for the transition to IFRS.

The effect of the transition to IFRS on Sony's financial position, results of operations and cash flows is presented in Note 11.

2.2.1 Repeat application of IFRS 1

In some cases, an entity's most recent annual financial statements did not contain an explicit and unreserved statement of compliance with IFRS accounting standards, but the entity applied IFRS accounting standards in a previous reporting period (giving an explicit and unreserved statement of compliance with IFRS accounting standards).

IFRS 1 does not prohibit an entity from applying IFRS 1 more than once. In May 2012, IFRS 1 was amended to clarify that an entity that stopped applying IFRS accounting standards in the past and chooses, or is required, to resume preparing IFRS financial statements has the option to apply IFRS 1 again. *[IFRS 1.4A]*. The Board decided, based on cost-benefit grounds, that "the entity should be allowed, rather than required, to apply IFRS 1" when it reapplies IFRS accounting standards. *[IFRS 1.BC6C]*. If the entity chooses not to reapply IFRS 1, it must retrospectively restate its financial statements in accordance with IAS 8 as if it had never stopped applying IFRS accounting standards.

Whichever option is selected the entity is required to disclose the reasons why it stopped applying IFRS accounting standards and why it resumed applying IFRS accounting standards. *[IFRS 1.23A]*. When the entity does not elect to reapply IFRS 1, it must also disclose the reasons for choosing the retrospective restatement method, in addition to giving the disclosures required by IAS 8. *[IFRS 1.4B, IFRS 1.23B]*.

The IASB explained this issue with an example of an entity that had applied IFRS 1 in connection with a foreign listing, subsequently delisted from the foreign exchange and no longer presented IFRS financial statements, but is now adopting IFRS accounting standards again together with other entities in its local jurisdiction - see Illustration 2-4 below. *[IFRS 1.BC6A]*.

Illustration 2-4: Repeated application of IFRS 1 when an entity does not apply IFRS accounting standards for one year

Entity A prepared IFRS financial statements for 20X0 and 20X1 that contained an explicit and unreserved statement of compliance with IFRS accounting standards. However, in 20X2 Entity A did not make an explicit and unreserved statement of compliance with IFRS accounting standards.

If Entity A resumes presenting financial statements in accordance with IFRS accounting standards, it could choose to apply IFRS accounting standards as a first-time adopter or it could elect to restate its financial statements retrospectively as if it had never stopped producing IFRS financial statements.

If it elects to apply IFRS accounting standards as a first-time adopter for the purposes of its 20X3 financial statements, there is no requirement under IFRS 1 for Entity A to base its first IFRS financial statements in 20X3 on the IFRS information that it produced before 20X3. Therefore, Entity A is able to apply the IFRS 1 exemptions without regard to the elections it made in its first IFRS financial statements in 20X0. In fact, in this case, Entity A is unable to apply certain IFRS 1 exemptions by reference to the date of transition to IFRS accounting standards that it used in its 20X0 financial statements (see section 3.5 below).

2.3 Determining the previous GAAP

Some entities prepare two complete sets of financial statements, e.g., one set of financial statements based on national GAAP and another set for distribution to foreign investors based on US GAAP. Applying the definition of 'previous GAAP', i.e., "The basis of accounting that a **first-time adopter** used immediately before adopting IFRSs", *[IFRS 1 Appendix A]*, to a dual reporting entity is not straightforward, as the examples below illustrate:

(a) *A dual reporting entity adopts IFRS accounting standards and at the same time stops presenting financial statements under its national GAAP and US GAAP:*

Both national GAAP and US GAAP meet the definition of 'previous GAAP'. However, the entity can only present one set of IFRS financial statements. Therefore, the entity must choose a 'previous GAAP'.

How we see it

While, at least in theory, this appears to be a free choice there are a number of limiting constraints to take into account in determining previous GAAP:

(i) National legislation and regulatory requirements could restrict an entity's options and require either national GAAP or US GAAP to be designated as the previous GAAP.

(ii) Comparability with other entities in the same jurisdiction could be increased if all entities in that jurisdiction use the same GAAP as their previous GAAP.

(iii) One set of financial statements could be considered to be the 'main' set of financial statements, for example:

- If the national GAAP financial statements received very limited circulation then they are clearly not the entity's 'main' financial statements. Conversely, if the US GAAP financial statements are only prepared for a specific purpose (e.g., to obtain a bank loan) then they might not be the entity's 'main' financial statements.
- The relative dominance of shareholder groups might provide an indication as to which set of financial statements is considered to be the 'main' set of financial statements.

An entity applies judgement when the constraints above do not all identify the same GAAP as the previous GAAP.

IFRS 1 only requires disclosure of reconciliations between an entity's previous GAAP and IFRS accounting standards. However, it will be advisable for an entity to provide disclosures, on a voluntary basis, that contain sufficient information to enable users to understand the material reconciling items between the IFRS financial statements and the financial statements that were prepared under its financial reporting framework which is not selected as the previous GAAP. Some national regulators (e.g., the US Securities and Exchange Commission), in fact, expect such disclosures (see section 8.1.2 below).[2]

2 International Practices Task Force - November 25, 2008 - Highlights, Center for Audit Quality Washington Office, 25 November 2008.

(b) *A dual reporting entity adopts IFRS accounting standards and at the same time continues to present financial statements under its national GAAP but stops presenting financial statements under US GAAP:*

How we see it

While one might expect US GAAP to be treated as the previous GAAP, both national GAAP and US GAAP meet the definition of 'previous GAAP'. An entity therefore considers the criteria (i) to (iii) under (a) above in determining its previous GAAP.

If an entity treated its national GAAP as its previous GAAP, then it could still present an explanation of the differences between US GAAP and IFRS accounting standards to aid former users of the US GAAP financial statements, if it wishes or if a regulator requires it.

As illustrated in Practical example 2-2 below, when Infosys Technologies Limited adopted IFRS accounting standards it treated Indian GAAP as its previous GAAP even though it continued to report under Indian GAAP for statutory purposes. However, Infosys provided additional reconciliations between US GAAP and its previous GAAP.

(c) *A dual reporting entity adopts IFRS accounting standards and at the same time stops presenting financial statements under US GAAP. Several years later it stops presenting financial statements under its national GAAP:*

The entity is not a first-time adopter when it ceases to present financial statements under its national GAAP, even if the entity treated US GAAP (rather than its national GAAP) as its previous GAAP when it adopted IFRS accounting standards. *[IFRS 1.4(a)]*. However, the entity could still present an explanation of the differences between its national GAAP and IFRS accounting standards to aid former users of its national GAAP financial statements, if it wishes or if a regulator requires it.

Practical example 2-2: Infosys Technologies Limited (2009) India

FORM 20-F [extract]

Notes to the Consolidated Financial Statements [extract]

2 Notes to the consolidated financial statements [extract]

2.1 Transition to IFRS reporting

The financial statements of Infosys Technologies Limited and its subsidiaries have been prepared in accordance with IFRS. Infosys Technologies Limited and its subsidiaries adopted all IFRS standards and the adoption was carried out in accordance to IFRS 1, using April 1, 2007 as the transition date. The transition was carried out from Indian GAAP, which was considered as the Previous GAAP. The effect of adopting IFRS has been summarized in the reconciliations provided.

The transition to IFRS reporting has resulted in changes in the reported financial statements, notes thereto and accounting principles compared to what had been presented previously.

Until the adoption of IFRS, the financial statements included in the Annual Reports on Form 20-F and Quarterly Reports on Form 6-K were prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) under the historical cost convention on the accrual basis. However, for the purposes of the transition, such transition was carried out from Indian GAAP, which has been considered as the Previous GAAP. The reconciliation statements provided in Note 2.2 describe the differences between IFRS and Indian GAAP. In addition, reconciliations from U.S. GAAP to Indian GAAP have been provided in Note 2.3 for the periods presented.

The Group's financial statements for the year ending March 31, 2009 are the first annual financial statements to comply with IFRS.

...

2.3 The following voluntary reconciliations provide a quantification of reconciliation items between U.S. GAAP and Previous GAAP :

- equity as at April 1, 2007 (Note 2.3.1)
- equity as at March 31, 2008 (Note 2.3.2)
- equity as at March 31, 2009 (Note 2.3.3)
- net income for the year ended March 31, 2008 (Note 2.3.4)
- net income for the year ended March 31, 2009 (Note 2.3.5)

...

2.3.1 Transition to IFRS accounting standards from a similar GAAP

One consequence of the ongoing harmonisation of accounting standards around the world is that many national GAAPs are now virtually identical to IFRS accounting standards. However, differences between these national GAAPs and IFRS accounting standards often exist regarding the scope, transitional provisions, effective dates and actual wording of standards. In addition, some national GAAPs contain accounting alternatives not permitted by IFRS accounting standards.

When an entity reporting under such a national GAAP (e.g., Singapore GAAP) adopts IFRS accounting standards there will often not be major changes required in its accounting policies to comply with IFRS accounting standards. A similar situation could arise where an entity reporting under the IFRS for SMEs adopts full IFRS accounting standards, for example, due to an IPO. However, under IFRS 1, it is not relevant whether or not a previous GAAP was very similar to IFRS accounting standards. Therefore, regardless of the absence of significant differences in accounting policies, that entity would be a first-time adopter when it includes an explicit and unreserved statement of compliance with IFRS accounting standards for the first time. So, even if the entity's accounting policies were already fully aligned with IFRS accounting standards:

(a) It would be permitted to apply the IFRS 1 exemptions and required to apply the IFRS 1 exceptions.

(b) It would need to restate items for which the applicable first-time adoption exceptions differ from the transitional rules applicable to ongoing reporters (e.g., classification and measurement of financial assets).

(c) It would not be permitted to apply different versions of IFRS accounting standards that were effective at earlier dates.

(d) It would need to explain the transition to IFRS accounting standards.

How we see it

Notwithstanding the above, we believe an entity that:

- Reported under a national GAAP that is virtually identical with IFRS accounting standards in all respects
- Applied the national GAAP equivalent of IFRS 1 when the entity adopted that national GAAP
- Made an explicit and unreserved statement of compliance with that national GAAP in its most recent financial statements

  And

- Could have made an explicit and unreserved statement of compliance with IFRS accounting standards in those financial statements, if required

Does not have to reapply IFRS 1 the first time that it makes an explicit and unreserved statement of compliance with IFRS accounting standards.

For example, if an entity that meets the requirements described above decides to make an explicit and unreserved statement of compliance with IFRS accounting standards for the first time, either voluntarily or required to do so by a regulatory requirement related to an IPO, the entity would not be required to reapply IFRS 1.

3 Opening IFRS statement of financial position

At the date of transition to IFRS accounting standards, an entity is required to prepare and present an opening IFRS statement of financial position that is the starting point for its accounting under IFRS accounting standards. *[IFRS 1.6]*. The date of transition to IFRS accounting standards is the beginning of the earliest period for which an entity presents full comparative information under IFRS accounting standards in its first IFRS financial statements. *[IFRS 1 Appendix A]*. Therefore, the date of transition for an entity reporting under IFRS accounting standards for the first time for the year ended on 31 December 20X3 and presenting one year of comparative figures is 1 January 20X2. It is recommended that entities consider the filing requirements for interim financial reports that a regulator in their jurisdiction could impose. For example, a regulator could require the opening IFRS statement of financial position to be presented in the first IFRS interim financial report even though this is not an IFRS 1 presentation requirement (see section 6.6 below).

3.1 First-time adoption timeline

An entity's first annual IFRS financial statements must include at least three statements of financial position (i.e., balance sheets), two statements of profit or loss and other comprehensive income, two separate statements of profit or loss (if presented), two statements of cash flows and two statements of changes in equity and related notes, including comparative information for all statements presented. *[IFRS 1.21]*. The beginning of the earliest comparative period for which the entity presents full comparative information under IFRS accounting standards will be treated as its date of transition to IFRS accounting standards. Figure 3-1 below shows how for an entity with a December year-end the above terms are related:

Figure 3-1: First-time adoption timeline

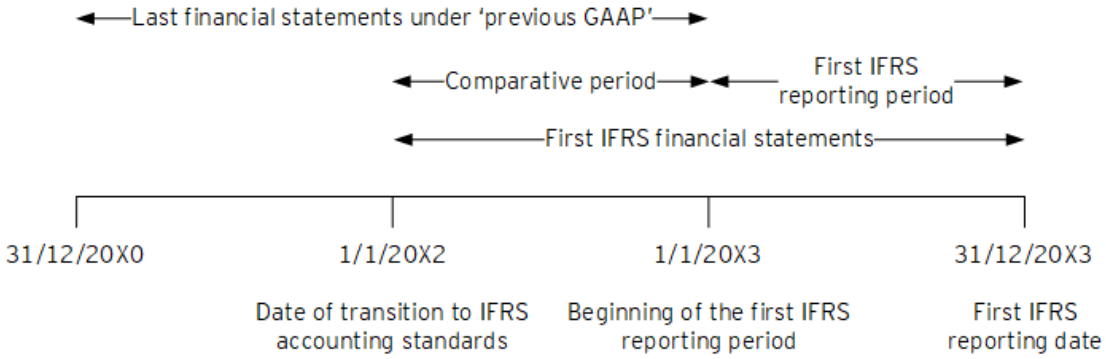


Figure 3-1 above also illustrates that there is a period of overlap, for the financial year 20X2, which is reported first under the entity's previous GAAP and then as a comparative period under IFRS accounting standards. Illustration 3-1 below demonstrates how an entity determines its date of transition to IFRS accounting standards.

Illustration 3-1: Determining the date of transition to IFRS accounting standards

Entity A's year-end is 31 December, and it presents financial statements that include one comparative period. Entity A is required (e.g., by national legislation) to produce IFRS financial statements for the first annual accounting period starting on or after 1 January 20X3.

Entity A's first IFRS financial statements are for the period ending on 31 December 20X3. Its date of transition to IFRS accounting standards is 1 January 20X2, which is the beginning of the single comparative period included in its first IFRS financial statements.

Entity B's year-end is 31 July, and it presents financial statements that include two comparative periods. Entity B is required to produce IFRS financial statements for the first annual accounting period starting on or after 1 January 20X3.

Entity B's first IFRS financial statements are for the period ending on 31 July 20X4. Its date of transition to IFRS accounting standards is 1 August 20X1, which is the beginning of the earliest period for which full comparative information is included in its first IFRS financial statements.

Entity C's most recent financial statements, under its previous GAAP, are for the period from 1 July 20X1 to 31 December 20X2. Entity C presents its first IFRS financial statements (that include one comparative period) for the period ending 31 December 20X3.

Entity C's date of transition to IFRS accounting standards is 1 July 20X1, which is the beginning of the comparative period included in its first IFRS financial statements.

How we see it

While IFRS accounting standards require presentation of at least one comparative period, the comparative period is not required to be equal in length to the current period. Thus, the entity's date of transition will be the beginning of the earliest comparative period, irrespective of the length of that period.

However, an entity must disclose the reason why the comparative period is not equal in length and the fact that the amounts presented in the financial statements are not entirely comparable. *[IAS 1.36]*.

Similarly, it is generally not considered to be a problem if the current or comparative period in an entity's first IFRS financial statements only covers a 52-week period, because IAS 1 does not preclude the practice of presenting financial statements for 52-week financial periods. *[IAS 1.37]*.

3.2 Opening IFRS statement of financial position and accounting policies

Extract from IFRS 1

7	**An entity shall use the same accounting policies in its opening IFRS statement of financial position and throughout all periods presented in its first IFRS financial statements. Those accounting policies shall comply with each IFRS effective at the end of its *first IFRS reporting period*, except as specified in paragraphs 13-19 and Appendices B-E.**
8	An entity shall not apply different versions of IFRSs that were effective at earlier dates. An entity may apply a new IFRS that is not yet mandatory if that IFRS permits early application. ...
9	The transitional provisions in other IFRSs apply to changes in accounting policies made by an entity that already uses IFRSs; they do not apply to a *first-time adopter's* transition to IFRSs, except as specified in Appendices B-E.

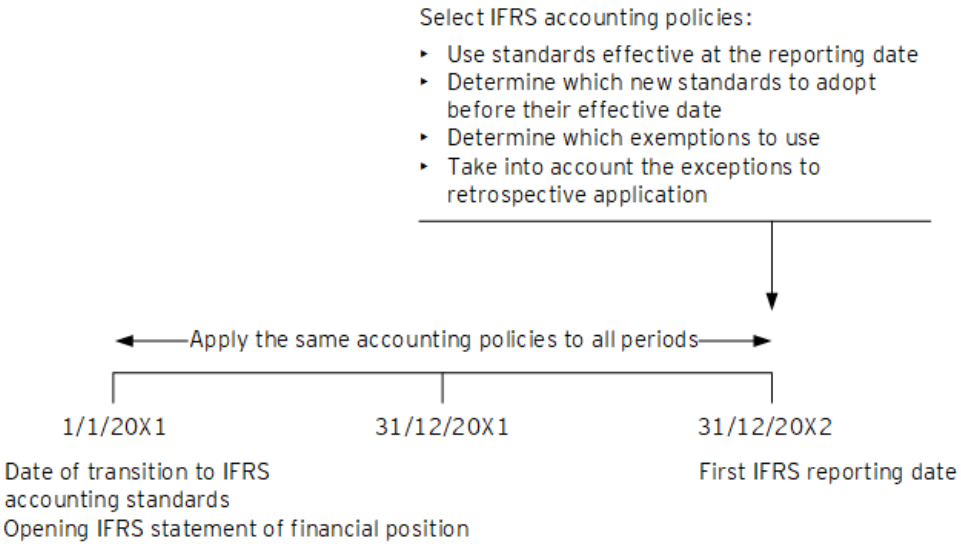
The fundamental principle of IFRS 1 is to require full retrospective application of IFRS accounting standards effective at the end of an entity's first IFRS reporting period, but with limited exceptions and exemptions for the opening IFRS statement of financial position. IFRS 1 requires a first-time adopter to use the same accounting policies in its opening IFRS statement of financial position and for all periods presented in its first IFRS financial statements. However, this is not always straightforward, since to achieve this, the entity complies with each IFRS accounting standard effective at the end of its first IFRS reporting period fully retrospectively, after taking into account a number of allowed exemptions from certain IFRS accounting standards and mandatory exceptions to retrospective application of other IFRS accounting standards in accordance with IFRS 1, as provided in IFRS 1.13-18[3] and Appendices B-E of IFRS 1 (see section 3.5 below). *[IFRS 1.7, IFRS 1.9, IFRS 1.13, IFRS 1.18]*.

The requirement to apply the same accounting policies to all periods also prohibits a first-time adopter from applying previous versions of standards that were effective at earlier dates. *[IFRS 1.8]*. As well as enhancing comparability, the IASB believes that this gives users comparative information that is based on IFRS accounting standards that are superior to superseded versions of those standards and avoids unnecessary costs. *[IFRS 1.BC11]*.

For similar reasons, IFRS 1 also permits an entity to choose to apply either the current standard or a new standard that is not yet mandatory if that standard allows early application. *[IFRS 1.8]*. Whichever standard is selected it would need to be applied consistently throughout the periods presented in its first IFRS financial statements on a retrospective basis, unless IFRS 1 provides an exemption or an exception that permits or requires otherwise. *[IFRS 1.BC11A]*. Figure 3-2 below summarises these requirements in IFRS 1.

3 IFRS 1.7 refers to paragraphs 13-19 as in the extract above, but paragraph 19 has been deleted.

Figure 3-2: Timeline for the first IFRS financial statements



Depending on the end of its first IFRS reporting period, there could be a choice over which version of a particular standard to apply.

Illustration 3-2: Prohibition from applying superseded standards

Entity A's first IFRS reporting period ends on 31 December 2025 and its date of transition to IFRS accounting standards is 1 January 2024 as it presents financial statements including one comparative period. How does Entity A apply *Lack of Exchangeability* (Amendments to IAS 21 *The Effects of Changes in Foreign Exchange Rates*), which are effective for annual periods beginning on or after 1 January 2025, in its first IFRS financial statements?

IFRS 1 requires Entity A to apply the amendments to IAS 21 because they are effective at the end of its first IFRS reporting period. IFRS 1 prohibits an entity from applying a superseded version of IAS 21 to transactions that occurred before 1 January 2025 while applying the amended standard in the periods beginning on or after 1 January 2025. Entity A must apply the above-mentioned amendments to IAS 21 fully retrospectively for all periods presented. *[IFRS 1.7, IFRS 1.8]*.

IFRS 1 sets out requirements for the recognition, derecognition, classification and measurement of assets and liabilities in an entity's opening statement of financial position as follows: *[IFRS 1.10]*

Extract from IFRS 1

10 Except as described in paragraphs 13-19 and Appendices B-E, an entity shall, in its opening IFRS statement of financial position:

(a) recognise all assets and liabilities whose recognition is required by IFRSs;

(b) not recognise items as assets or liabilities if IFRSs do not permit such recognition;

(c) reclassify items that it recognised in accordance with previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity in accordance with IFRSs; and

(d) apply IFRSs in measuring all recognised assets and liabilities.

Any change in accounting policies on adoption of IFRS accounting standards could cause changes in the amounts recorded under previous GAAP in respect of events and transactions that occurred before the date of transition to IFRS accounting standards. The effects of these changes are recognised at the date of transition to IFRS accounting standards in retained earnings or, if appropriate, in another category of equity. *[IFRS 1.11]*. For example, an entity that applies the revaluation model under IAS 16 *Property, Plant and Equipment* (see Chapter 19 at section 6) in its first IFRS financial statements would recognise the difference between cost (or deemed cost) and the revalued amount of property, plant and equipment in a revaluation reserve as a separate component of equity. *[IFRS 1.IG10]*. By contrast, an entity that had applied a revaluation model under its previous GAAP, but decided to apply the cost model under IAS 16, would reallocate the revaluation reserve to retained earnings or a separate component of equity not described as a revaluation reserve (see section 7.4.3 below).

A first-time adopter is under no obligation to ensure that its IFRS accounting policies are similar to or as close as possible to its previous GAAP accounting policies. Therefore, for example, a first-time adopter could adopt the IAS 16 revaluation model despite the fact that it applied a cost model under its previous GAAP or *vice versa*. However, a first-time adopter would need to take into account the guidance in IAS 8 to ensure that its choice of accounting policy results in information that is relevant and reliable. *[IAS 8.8, IAS 8.10, IAS 8.11, IAS 8.12]*.

The requirement to prepare an opening IFRS statement of financial position and 'reset the clock' at that date poses a number of challenges for first-time adopters. Even a first-time adopter that already applies a standard that is directly based on IFRS accounting standards might need to or decide to restate items in its opening IFRS statement of financial position (see section 2.3.1 above). For example, an entity applying a property, plant and equipment standard under previous GAAP that is based on IAS 16 could decide to use a deemed cost exemption for certain of its assets as allowed by IFRS 1.

3.3 Fair value and deemed cost

Some exemptions in IFRS 1 refer to 'fair value' and 'deemed cost', which the standard defines as follows: *[IFRS 1 Appendix A]*

- *Deemed cost:*

  An amount used as a surrogate for cost or depreciated cost at a given date. Subsequent depreciation or amortisation assumes that the entity had initially recognised the asset or liability at the given date and that its cost was equal to the deemed cost.

- *Fair value:*

  The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (see Chapter 15 and IFRS 13 *Fair Value Measurement*).

The fair values determined by a first-time adopter reflect the conditions that existed at the date for which they were determined, i.e., the first-time adopter does not apply hindsight in measuring the fair value at an earlier date.

3.4 Transitional provisions in other standards

The transitional provisions in other standards only apply to entities that already report under IFRS accounting standards. Therefore, a first-time adopter is not able to apply those transitional provisions (unless specified by the requirements in IFRS 1.14-17 and Appendices B-E of IFRS 1). *[IFRS 1.9, IFRS 1.12, IFRS 1.13, IFRS 1.18]*. The exceptions and the exemptions to this general rule are covered in the later parts of this chapter that deal with the exceptions to the retrospective application of other IFRS accounting standards (see section 4 below) and the exemptions from other IFRS accounting standards (see section 5 below).

It is important to note that the transition rules for first-time adopters and entities that already report under IFRS accounting standards could differ significantly.

The IASB considers "case by case when it issues a new IFRS whether a first-time adopter should apply that IFRS retrospectively or prospectively. The Board expects that retrospective application will be appropriate in most cases, given its primary objective of comparability over time within a first-time adopter's first IFRS financial statements. However, if the Board concludes in a particular case that prospective application by a first-time adopter is justified, it will amend the IFRS on first-time adoption of IFRSs." *[IFRS 1.BC14]*.

IAS 8 allows exceptions from retrospective application for entities that cannot apply a requirement after making every reasonable effort to do so. There is no such relief in IFRS 1. The IFRS Interpretations Committee (IFRS IC) agreed "that there were potential issues, especially with respect to 'old' items, such as property, plant and equipment. However, those issues could usually be resolved by using one of the transition options available in IFRS 1." (See section 3.5 below).[4] For example, an entity could elect to use fair value as deemed cost at the date of transition to IFRS accounting standards if an entity is unable to apply IAS 36 *Impairment of Assets* on a fully retrospective basis (see section 7.12 below). Therefore no 'impracticability relief' was added to the standard for first-time adopters. The transition options usually involve using certain surrogate values as deemed cost and are discussed in section 5.4 below.

4 *IFRIC Update*, October 2004, available on the IFRS Foundation's website.

3.5 Departures from full retrospective application

Extract from IFRS 1

12 This IFRS establishes two categories of exceptions to the principle that an entity's opening IFRS statement of financial position shall comply with each IFRS:

(a) paragraphs 14-17 and Appendix B prohibit retrospective application of some aspects of other IFRSs.

(b) Appendices C-E grant exemptions from some requirements of other IFRSs.

IFRS 1 provides for mandatory exceptions and optional exemptions as follows. *[IFRS 1.12]*.

Mandatory exceptions: IFRS 1 prohibits retrospective application of IFRS accounting standards in some areas, particularly where this would require judgements by management about past conditions after the outcome of a particular transaction is already known. The mandatory exceptions in the standard cover the following situations: *[IFRS 1.12(a), IFRS 1.13, IFRS 1.14, IFRS 1.B1]*

(a) Estimates (see section 4.2 below)
(b) Derecognition of financial assets and financial liabilities (see section 4.3 below)
(c) Hedge accounting (see sections 4.4 to 4.7 below)
(d) Non-controlling interests (see section 4.8 below)
(e) Classification and measurement of financial instruments (see section 4.9 below)
(f) Impairment of financial assets (see section 4.10 below)
(g) Embedded derivatives (see section 4.11 below)
(h) Government loans (see section 4.12 below)
(i) Insurance contracts (see section 4.13 below)
(j) Deferred tax related to leases and decommissioning, restoration and similar liabilities (see section 4.14 below)

The reasoning behind most of the exceptions is that retrospective application of IFRS accounting standards in these situations could easily result in an unacceptable use of hindsight. *[IFRS 1.BC12(b)]*. This could lead to arbitrary or biased restatements, which would be neither relevant nor reliable.

Optional exemptions: In addition to the mandatory exceptions, IFRS 1 grants limited optional exemptions from the general requirement of full retrospective application of the standards in force at the end of an entity's first IFRS reporting period, considering the fact that the cost of complying with them would be likely to exceed the benefits to users of financial statements. *[IFRS 1.BC12(a)]*. The standard provides exemptions in relation to: *[IFRS 1.12(b), IFRS 1.18, IFRS 1 Appendix C, IFRS 1.D1]*

(a) Business combinations and acquisitions of associates and joint arrangements (see section 5.2 below)
(b) Share-based payment transactions (see section 5.3 below)
(c) Deemed cost (see section 5.4 below)
(d) Leases (see section 5.5 below)
(e) Cumulative translation differences (see section 5.6 below)
(f) Investments in subsidiaries, joint ventures and associates (see section 5.7 below)
(g) Assets and liabilities of subsidiaries, associates and joint ventures (see section 5.8 below)
(h) Compound financial instruments (see section 5.9 below)
(i) Designation of previously recognised financial instruments (see section 5.10 below)
(j) Fair value measurement of financial assets or financial liabilities at initial recognition (see section 5.11 below)
(k) Decommissioning liabilities included in the cost of property, plant and equipment (see section 5.12 below)
(l) Financial assets or intangible assets accounted for in accordance with IFRIC 12 *Service Concession Arrangements* (see section 5.13 below)
(m) Borrowing costs (see section 5.14 below)
(n) Extinguishing financial liabilities with equity instruments (see section 5.15 below)
(o) Severe hyperinflation (see section 5.16 below)
(p) Joint arrangements (see section 5.17 below)
(q) Stripping costs in the production phase of a surface mine (see section 5.18 below)

(r) Designation of contracts to buy or sell a non-financial item (see section 5.19 below)

(s) Revenue from contracts with customers (see section 5.20 below)

(t) Foreign currency transactions and advance consideration (see section 5.21 below)

(u) Regulatory deferral accounts (see section 5.22 below). This exemption is dealt with in IFRS 14 *Regulatory Deferral Accounts*, rather than IFRS 1. *[IFRS 14.5]*.

In addition to the above, IFRS 1 grants certain exemptions that are intended to have short-term applications. These are included in Appendix E to the standard. *[IFRS 1 Appendix E]*. At the time of writing, there are no short-term exemptions that apply where an entity's first IFRS reporting period begins on or after 1 January 2025 (and therefore the requirements of Appendix E are not discussed in this chapter). First-time adopters should monitor developments for any new short-term exemptions that could be issued after the publication of this edition.

It is specifically prohibited under IFRS 1 to apply exemptions by analogy to other items. *[IFRS 1.18]*.

How we see it

Application of the transition exemptions is entirely optional except for IFRS 1.D16 and D17 (see section 5.8 below), i.e., a first-time adopter can pick and choose the exemptions that it wants to apply. Importantly, the IASB did not establish a hierarchy of exemptions. Therefore, we believe when an item is covered by more than one exemption, a first-time adopter has a free choice in determining the order in which it applies the exemptions.

Illustration 3-3 below provides an example.

Illustration 3-3: Order of application of exemptions

Entity A acquired a building in a business combination. If Entity A were to apply the business combinations exemption described in section 5.2 below, it would, at the date of transition to IFRS accounting standards, recognise the building at the acquisition date value net of subsequent depreciation and impairment of CU120. However, if it were to use the fair value as the deemed cost of the building it would have to recognise it at CU150. Which value does Entity A use?

Entity A can choose whether it wants to recognise the building at CU120 or CU150 in its opening IFRS statement of financial position. The fact that Entity A uses the business combinations exemption does not prohibit it from also applying the 'fair value as deemed cost' exemption in relation to the same assets. Also, Entity A is not required to apply the 'fair value as deemed cost' exemption to all assets or to all similar assets as entities can choose to which assets they want to apply this exemption (see section 5.4 below).

4 Exceptions to the retrospective application of other IFRS accounting standards

4.1 Introduction

IFRS 1 provides a number of mandatory exceptions that specifically prohibit retrospective application of some aspects of other IFRS accounting standards as listed in section 3.5 above. Each of the exceptions is explained in detail below.

4.2 Estimates

Extract from IFRS 1	
14	**An entity's estimates in accordance with IFRSs at the date of transition to IFRSs shall be consistent with estimates made for the same date in accordance with previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error.**

The above requirement, *[IFRS 1.14]*, has the effect that an entity must not apply hindsight and make 'better' estimates when it prepares its first IFRS financial statements. This also means that an entity is not allowed to consider subsequent events that provide evidence of conditions that existed at that date, but that came to light after the date its previous GAAP financial statements were finalised. If an estimate made under previous GAAP requires adjustment because of new information after the relevant date, an entity treats this information in the same way as a non-adjusting event after the reporting period under IAS 10 *Events after the Reporting Period*. *[IFRS 1.BC84]*. Effectively, the IASB wishes to prevent entities from using hindsight to 'clean up' their balance sheets as part of the preparation of the opening IFRS statement of financial position. In addition, the exception also ensures that a first-time adopter need not conduct a search for, and change the accounting for, events that might have otherwise qualified as adjusting events.

IFRS 1 provides the following guidance on estimates:

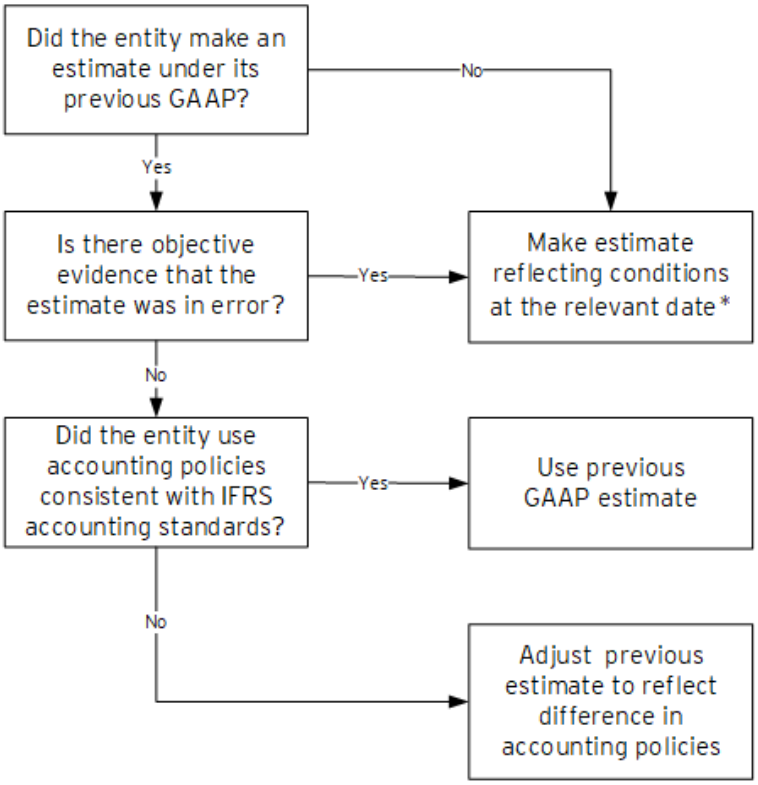
- When previous GAAP required estimates of similar items for the date of transition to IFRS accounting standards, an entity can be in one of the following two positions: *[IFRS 1.IG3]*
  - Its previous GAAP accounting policy was consistent with IFRS accounting standards, in which case the estimates under IFRS accounting standards need to be consistent with those made for that date under previous GAAP, unless there is objective evidence that those estimates were in error under IAS 8. *[IAS 8.5]*.
  - Its previous GAAP accounting policy was not consistent with IFRS accounting standards, in which case it adjusts the estimates only for the difference in accounting policies (unless there is objective evidence that those estimates were in error under IAS 8). *[IAS 8.5]*.

  In both situations, it accounts for the revisions to those estimates in the period in which it makes the revisions in the same way as a non-adjusting event after the reporting period under IAS 10. *[IFRS 1.15, IFRS 1.IG3, IAS 10.10]*.
- When an entity needs to make estimates under IFRS accounting standards at the date of transition to IFRS accounting standards that were not required under its previous GAAP, those estimates must reflect conditions that existed at that date. This is consistent with the distinction in IAS 10 between adjusting events and non-adjusting events after the reporting period. In particular, estimates of market prices, interest rates or foreign exchange rates reflect market conditions at that date. *[IFRS 1.16, IFRS 1.IG3]*. Entities that are preparing for transition to IFRS accounting standards need to consider gathering the data required for the estimate at the date of transition to IFRS accounting standards to make the transition easier and to ensure that hindsight is not incorporated into the estimate.

The requirements above apply both to estimates made in respect of the date of transition to IFRS accounting standards and to those in respect of any comparative period presented, in which case the references to 'the date of transition to IFRS accounting standards' above are replaced by references to 'the end of that comparative period'. *[IFRS 1.17]*.

Figure 4-1 below shows the decision-making process that an entity needs to apply in dealing with estimates at the date of transition to IFRS accounting standards and during any of the comparative periods included in its first IFRS financial statements.

Figure 4-1: The treatment of estimates in the first IFRS financial statements



* The relevant date is the date to which the estimate relates

The general prohibition in IFRS 1 on the use of hindsight in making estimates about past transactions does not override the requirements in other IFRS accounting standards that base classifications or measurements on circumstances existing at a particular date, e.g., the distinction between finance leases and operating leases for a lessor. *[IFRS 1.IG4]*.

IFRS 1 requires an entity that is unable to determine whether a particular portion of an adjustment is a transition adjustment or a change in estimate, to treat that portion as a change in accounting estimate under IAS 8.32-38, with appropriate disclosures as required by IAS 8.39-40. *[IFRS 1.IG58B, IAS 8.36, IAS 8.37, IAS 8.39, IAS 8.40]*. The distinction between changes in accounting policies and changes in accounting estimates is discussed in detail in Chapter 3 at section 4.2.

If a first-time adopter concludes that estimates under previous GAAP were made in error, it distinguishes the correction of those errors from changes in accounting policies in its reconciliations from previous GAAP to IFRS accounting standards (see section 6.3.1 below). *[IFRS 1.26]*.

Illustration 4-1 below demonstrates how an entity deals with estimates on the date of transition to IFRS accounting standards and in comparative periods included in its first IFRS financial statements.

Illustration 4-1: Application of IFRS 1 to estimates

Entity A's first IFRS financial statements have a reporting date of 31 December 20X3 and include comparative information for one year. In its previous GAAP financial statements for 31 December 20X2, Entity A accounted for its pension plan on a cash basis. However, under IAS 19 Employee Benefits the plan is classified as a defined benefit plan and actuarial estimates are required.

Entity A will need to make estimates under IFRS accounting standards at the relevant date that reflect conditions that existed at the relevant date. This means, for example, that Entity A's:

- Discount rates at 1 January 20X2 (date of transition to IFRS accounting standards) and 31 December 20X2 for the pension plan reflect market conditions at those dates
- Actuarial assumptions at 1 January 20X2 and 31 December 20X2 about future employee turnover rates do not reflect conditions that arose after those dates, such as a significant increase in estimated employee turnover rates as a result of a redundancy plan in 20X3 *[IFRS 1.IG Example 1]*

Entity B accounted for inventories at the lower of cost and net realisable value under its previous GAAP. Entity B's accounting policy is consistent with the requirements of IAS 2 Inventories. Under previous GAAP, the goods were accounted for at a price of CU1.25/kg. Due to changes in market circumstances, Entity B ultimately could only sell the goods in the following period for CU0.90/kg.

Assuming that Entity B's estimate of the net realisable value was not in error, it will account for the goods at CU1.25/kg upon transition to IFRS accounting standards and will make no adjustments because the estimate was not in error and its accounting policy was consistent with IFRS accounting standards. The effect of selling the goods for CU0.90/kg will be reflected in the period in which they were sold.

Entity C's first IFRS financial statements have a reporting date of 31 December 20X3 and include comparative information for one year. In its previous GAAP financial statements for 31 December 20X1, Entity C accounted for a provision of CU150,000 in connection with a court case. Entity C's accounting policy was consistent with the requirements of IAS 37 Provisions, Contingent Liabilities and Contingent Assets, except for the fact that Entity C did not discount the provision for the time value of money. The discounted value of the provision at 31 December 20X1 would have been CU135,000. The case was settled for CU190,000 during 20X2.

In its opening IFRS statement of financial position at 1 January 20X2, Entity C will measure the provision at CU135,000. IFRS 1 does not permit an entity to adjust the estimate itself, unless it was in error, but does require an adjustment to reflect the difference in accounting policies. The unwinding of the discount and the adjustment due to the under-provision will be included in the comparative statement of profit or loss and other comprehensive income for 20X2.

Entity D's first IFRS financial statements have a reporting date of 31 December 20X3 and include comparative information for one year. In its previous GAAP financial statements for 31 December 20X2, Entity D did not recognise a provision for a court case arising from events that occurred in September 20X2. When the court case was concluded on 30 June 20X3, Entity D was required to pay CU1,000,000 and paid this on 10 July 20X3.

In preparing its comparative statement of financial position at 31 December 20X2, the treatment of the court case at that date depends on the reason why Entity D did not recognise a provision under its previous GAAP at that date.

Scenario 1 - Previous GAAP was consistent with IAS 37. At the date of preparing its 20X2 financial statements, Entity D concluded that the recognition criteria were not met. In this case, Entity D's assumptions under IFRS accounting standards are required to be consistent with its assumptions under previous GAAP. Therefore, Entity D does not recognise a provision at 31 December 20X2 and the effect of settling the court case is reflected in the 20X3 statement of profit or loss and other comprehensive income.

Scenario 2 - Previous GAAP was not consistent with IAS 37. Therefore, Entity D develops estimates under IAS 37, which requires that an entity determines whether a present obligation exists at the end of the reporting period by taking account of all available evidence, including any additional evidence provided by events after the end of the reporting period. Similarly, under IAS 10, the resolution of a court case after the end of the reporting period is an adjusting event if it confirms that the entity had a present obligation at that date. In this instance, the resolution of the court case confirms that Entity D had a liability in September 20X2 (when the events occurred that gave rise to the court case). Therefore, Entity D recognises a provision at 31 December 20X2. Entity D measures that provision by discounting the CU1,000,000 paid on 10 July 20X3 to its present value, using a discount rate that complies with IAS 37 and reflects market conditions at 31 December 20X2. *[IFRS 1.IG Example 1]*.

Some of the potential consequences of applying IAS 37 resulting in changes in the way an entity accounts for provisions are addressed in section 7.13 below.

4.3 Derecognition of financial assets and financial liabilities

Extract from IFRS 1

Derecognition of financial assets and financial liabilities

B2 Except as permitted by paragraph B3, a first-time adopter shall apply the derecognition requirements in IFRS 9 prospectively for transactions occurring on or after the date of transition to IFRSs. For example, if a first-time adopter derecognised non-derivative financial assets or non-derivative financial liabilities in accordance with its previous GAAP as a result of a transaction that occurred before the date of transition to IFRSs, it shall not recognise those assets and liabilities in accordance with IFRSs (unless they qualify for recognition as a result of a later transaction or event).

B3 Despite paragraph B2, an entity may apply the derecognition requirements in IFRS 9 retrospectively from a date of the entity's choosing, provided that the information needed to apply IFRS 9 to financial assets and financial liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.

IFRS 1's requirements on derecognition of financial assets and financial liabilities, *[IFRS 1.B2, IFRS 1.B3]*, will effectively prevent most first-time adopters from restating transactions that occurred before the date of transition to IFRS accounting standards.

A first-time adopter that derecognised non-derivative financial assets and financial liabilities before the date of transition to IFRS accounting standards and chose not to apply the derecognition requirements in IFRS 9 *Financial Instruments* retrospectively from an earlier date does not recognise these items under IFRS accounting standards even if they meet the IFRS 9 recognition criteria. *[IFRS 1.IG53]*. An entity does not recognise financial assets and financial liabilities in its opening statement of financial position that do not qualify for recognition in accordance with IFRS 9, or have already qualified for derecognition in accordance with IFRS 9. *[IFRS 1.IG54]*.

Some arrangements for the transfers of assets, particularly securitisations, could last for some time, with the result that transfers could be made both before and after (or on) the date of transition to IFRS accounting standards under the same arrangement. IFRS 1 clarifies that transfers made under such arrangements fall within the first-time adoption exception only if they occurred before the date of transition to IFRS accounting standards (assuming the entity does not choose to apply IFRS 1.B3). *[IFRS 1.B3]*. Transfers on or after the date of transition to IFRS accounting standards are subject to the full requirements of IFRS 9. *[IFRS 1.IG53]*.

However, an entity could have derecognised, under its previous GAAP, non-derivative financial assets and financial liabilities when they were transferred to a structured entity as part of a securitisation programme, which is considered to be a controlled entity under IFRS 10 *Consolidated Financial Statements*.

How we see it

IFRS 1 contains no specific exceptions and exemptions to retrospective application of IFRS 10 except for those for non-controlling interests (see section 4.8 below). Accordingly, its consolidation requirements are applied fully retrospectively by first-time adopters.

Therefore, in this case, those assets and liabilities will be re-recognised on transition to IFRS accounting standards by way of the application of IFRS 10 rather than through application of IFRS 9. Of course, if the structured entity itself then subsequently achieved derecognition of those assets and liabilities under the entity's previous GAAP (other than by transfer to another structured entity or member of the entity's group), then the items remain derecognised on transition.

4.4 Hedge accounting: general

Extract from IFRS 1

Hedge accounting

B4 As required by IFRS 9, at the date of transition to IFRSs an entity shall:
(a) measure all derivatives at fair value; and
(b) eliminate all deferred losses and gains arising on derivatives that were reported in accordance with previous GAAP as if they were assets or liabilities.

B5 An entity shall not reflect in its opening IFRS statement of financial position a hedging relationship of a type that does not qualify for hedge accounting in accordance with IFRS 9 (for example, many hedging relationships where the hedging instrument is a stand-alone written option or a net written option; or where the hedged item is a net position in a cash flow hedge for another risk than foreign currency risk). However, if an entity designated a net position as a hedged item in accordance with previous GAAP, it may designate as a hedged item in accordance with IFRSs an individual item within that net position, or a net position if that meets the requirements in paragraph 6.6.1 of IFRS 9, provided that it does so no later than the date of transition to IFRSs.

B6 If, before the date of transition to IFRSs, an entity had designated a transaction as a hedge but the hedge does not meet the conditions for hedge accounting in IFRS 9, the entity shall apply paragraphs 6.5.6 and 6.5.7 of IFRS 9 to discontinue hedge accounting. Transactions entered into before the date of transition to IFRSs shall not be retrospectively designated as hedges.

In sections 4.4 to 4.7 below, we discuss the hedge accounting treatment for first-time adopters under IFRS 9. *[IFRS 1.B4, IFRS 1.B5, IFRS 1.B6]*.

First-time adoption issues relating to hedge accounting in the opening IFRS statement of financial position are discussed in section 4.5 below and subsequent measurement issues are discussed in section 4.6 below. Hedge accounting is dealt with comprehensively in Chapter 49.

Summary:

On transition:

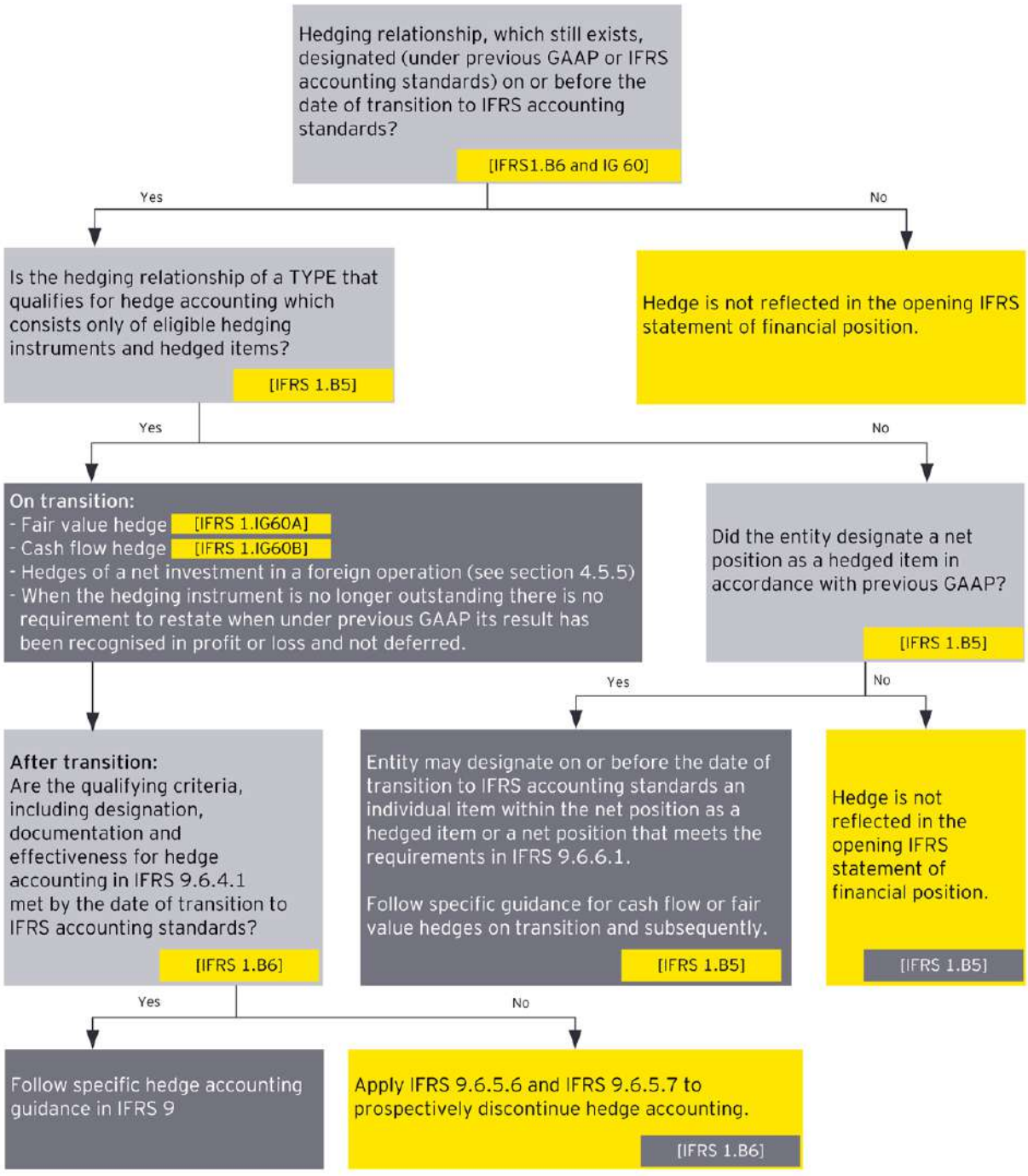
- A first-time adopter separately accounts for all derivatives as assets or liabilities measured at fair value (regardless of the previous accounting treatment). *[IFRS 1.B4(a)]*. However, deferred losses and gains arising on derivatives that were reported in accordance with previous GAAP as if they were assets and liabilities are eliminated. *[IFRS 1.B4(b)]*. See section 4.5.1 below.
- A first-time adopter can only reflect a hedging relationship that still exists in its opening IFRS statement of financial position if it was designated as such on or before the date of transition to IFRS accounting standards (i.e., hedges cannot be designated retrospectively). *[IFRS 1.B5, IFRS 1.B6, IFRS 1.IG60]*. In our view, such designation could be made under previous GAAP or in anticipation of adoption of IFRS accounting standards. See section 4.5.2 below.
- A first-time adopter can only reflect a hedging relationship of a type that qualifies for hedge accounting in accordance with IFRS 9, which consists only of eligible hedging instruments and eligible hedged items as per IFRS 9.6.4.1(a). Previous GAAP hedge documentation and effectiveness assessments that were not fully compliant with the criteria in IFRS 9.6.4.1(b)-(c) do not preclude the hedging relationship from qualifying for hedge accounting under IFRS 9 (see section 4.4.1 below). *[IFRS 1.B5, IFRS 9.6.4.1]*. However, unless updated so that the qualifying criteria for hedge accounting are fully met on or before the date of transition to IFRS accounting standards, the entity will need to follow the hedge discontinuation requirements in IFRS 9.6.5.6-6.5.7 immediately after transition. *[IFRS 1.B6, IFRS 9.6.5.6, IFRS 9.6.5.7, IFRS 1.IG60]*.
- If the hedging relationship is of a type that qualifies for hedge accounting under IFRS 9, the entity must reflect the hedge accounting under previous GAAP in the opening IFRS statement of financial position by applying the implementation guidance in IFRS 1 on fair value or cash flow hedges, as at the date of transition. *[IFRS 1.IG60A, IFRS 1.IG60B]*. See sections 4.5.3 to 4.5.6 below.
- If the hedging relationship is not of a type that qualifies for hedge accounting under IFRS 9, an entity is required to remove that relationship from its opening IFRS statement of financial position (except for the exception relating to certain net positions designated as a hedged item under previous GAAP - see section 4.5.2 below). *[IFRS 1.B5, IFRS 9.6.4.1(a)]*. Any adjustments to the carrying amounts of hedged items or deferrals of hedging gains or losses are, therefore, eliminated. See sections 4.5.1 and 4.5.2 below.
- When the hedging instrument is no longer outstanding at the date of transition to IFRS accounting standards and, under previous GAAP, the entity had already recognised its result in profit or loss without amortisation, no restatement is required. See Figure 4-2 below.

Subsequent accounting:

- Immediately after transition (i.e., after the date of the opening IFRS statement of financial position), the entity follows the normal hedge accounting provisions of IFRS 9 prospectively. If the hedge reflected in the opening statement of financial position does not fully comply with the qualifying criteria for hedge accounting in IFRS 9 (including hedge documentation and hedge effectiveness) the entity applies IFRS 9.6.5.6-6.5.7 to discontinue hedge accounting prospectively. *[IFRS 1.IG60, IFRS 1.B6, IFRS 9.6.4.1, IFRS 9.6.5.6, IFRS 9.6.5.7]*. See section 4.6 below.

Figure 4-2 below sets out a decision chart for the treatment of hedge accounting in the opening IFRS statement of financial position and subsequent periods. Hedge accounting in the opening IFRS statement of financial position is discussed in section 4.5 below and hedge accounting after transition to IFRS accounting standards is dealt with in section 4.6 below.

Figure 4-2: Treatment of hedge accounting in the first IFRS financial statements



4.4.1 Paragraphs B5 and B6 of IFRS 1 when applying IFRS 9

IFRS 1.B5 and IFRS 1.B6 refer to a 'hedging relationship of a type that does not qualify for hedge accounting' and the 'conditions for hedge accounting in IFRS 9' when specifying the recognition (or otherwise) of hedging relationships in the opening IFRS statement of financial position and subsequent accounting, respectively. *[IFRS 1.B5, IFRS 1.B6]*. However, IFRS 9 does not set out 'hedging relationship types' or 'conditions for hedge accounting'. Instead, it sets out qualifying criteria which consist of (a) eligibility, (b) formal designation and documentation, and (c) hedge effectiveness. *[IFRS 9.6.4.1]*. When IFRS 9 was issued, the wording in IFRS 1.B5 and IFRS 1.B6 was not updated for IFRS 9, and IFRS 1 was unclear as to whether the same two-step approach above (i.e., 'type' test and 'condition' test) continues to apply.

How we see it

The IASB did not intend to change the requirements of IFRS 1 for recognising a hedging relationship in the opening IFRS statement of financial position or the subsequent accounting upon issuance of IFRS 9. Therefore, we believe that the reference to a 'hedging relationship of a type that does not qualify for hedge accounting' in IFRS 1.B5 relates only to the qualifying criterion in IFRS 9.6.4.1(a) (i.e., eligible hedging instruments and hedged items) and the 'conditions for hedge accounting' in IFRS 1.B6 relate to the qualifying criteria in IFRS 9.6.4.1(b)-(c). The discussions in sections 4.4 above to 4.7 below are based on this view.

The Annual improvements to IFRS accounting standards issued in July 2024 clarified the above position. The amendments added a cross-reference to IFRS 9.6.4.1(a) from IFRS 1.B5 to clarify that the phrase 'hedging relationship of a type that does not qualify for hedge accounting' in paragraph B5 of IFRS 1 relates only to the 'eligibility' of a hedging relationship (i.e., there are eligible hedging instruments and eligible hedged items). Also, the phrase 'conditions for hedge accounting' in IFRS 1.B6 was replaced with 'qualifying criteria for hedge accounting in IFRS 9.6.4.1(b)-(c)'. The amendments to IFRS 1 must be applied for annual reporting periods beginning on or after 1 January 2026 and early application is permitted. *[IFRS 1(2026).B5, IFRS 1(2026).B6, IFRS 9.6.4.1]*

4.4.2 Applicability of IAS 39 hedge requirements

A transition requirement of IFRS 9 for hedge accounting permits an entity already applying IFRS accounting standards to choose as its accounting policy to continue to apply the hedge accounting requirements of IAS 39 *Financial Instruments: Recognition and Measurement* to all of its hedging relationships instead of the requirements in Chapter 6 of IFRS 9. *[IFRS 9.7.2.21]*. First-time adopters do not have this choice because IFRS 1 prohibits first-time adopters from applying the transition provisions in other IFRS accounting standards, except as specified in Appendices B-E. *[IFRS 1.9]*. Further, IFRS 1.B4-B6 contain mandatory exceptions for hedge accounting which do not refer to the transition requirements of IFRS 9, and the basis for conclusion attached to IFRS 9 under the heading "Transition related to the hedge accounting requirements" states "The IASB decided not to change the requirements of IFRS 1 for hedge accounting. The IASB noted that a first-time adopter would need to look at the entire population of possible hedging relationships and assess which ones would meet the qualifying criteria of the new hedge accounting model." *[IFRS 9.BC7.52]*.

How we see it

Accordingly, a first-time adopter applies IFRS 9's requirements on hedge accounting. This is in contrast to an entity already applying IFRS accounting standards, who would be permitted to continue to apply IAS 39 hedge accounting. Nevertheless, in our view, first-time adopters are permitted to apply IAS 39 hedge accounting to a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only to such a hedge) (see Chapter 49 at section 10.2). This is because this is permitted by Chapter 6 of IFRS 9, rather than being a transitional provision included in Chapter 7 of IFRS 9.

4.5 Hedge accounting in the opening IFRS statement of financial position

4.5.1 Measurement of derivatives and elimination of deferred gains and losses

Under its previous GAAP, an entity's accounting policies might have included a number of accounting treatments for derivatives that formed part of a hedging relationship. For example, accounting policies might have included those where the derivative was:

- Not explicitly recognised as an asset or liability (e.g., in the case of a forward contract used to hedge an expected but uncontracted future transaction)
- Recognised as an asset or liability but at an amount different from its fair value (e.g., a purchased option recognised at its original cost, perhaps less amortisation; or an interest rate swap accounted for by accruing the periodic interest payments and receipts)
- Subsumed within the accounting for another asset or liability (e.g., a foreign currency denominated monetary item and a matching forward contract or swap accounted for as a 'synthetic' functional currency denominated monetary item)

Whatever the previous accounting treatment, a first-time adopter must account for derivatives in the opening IFRS statement of financial position as assets or liabilities measured at fair value in accordance with IFRS 9 (for the treatment of embedded derivatives, see section 4.11 below). *[IFRS 1.B4(a)]*.

All derivatives are measured at fair value through profit or loss, other than those that are financial guarantee contracts, a commitment to provide a loan at a below-market interest rate, a loan commitment that is subject to the impairment requirements of IFRS 9, or those that are designated and effective as hedging instruments. Accordingly, the difference between the previous carrying amount of these derivatives (which may have been zero) and their fair value is recognised as an adjustment of the balance of retained earnings at the date of transition to IFRS accounting standards. *[IFRS 1.IG58A]*. If an entity is unable to determine whether a particular portion of an adjustment is a transition adjustment (i.e., a change in accounting policy) or a change in estimate, it must treat that portion as a change in accounting estimate, with the appropriate disclosures in accordance with IAS 8. *[IFRS 1.IG58B, IAS 8.36, IAS 8.37, IAS 8.39, IAS 8.40]*. The distinction between changes in accounting policies and changes in accounting estimates is discussed in detail in Chapter 3 at section 4.2.

Hedge accounting policies under an entity's previous GAAP might also have included one or both of the following accounting treatments:

- Derivatives were measured at fair value but, to the extent they were regarded as hedging future transactions, the gain (or loss) arising was reported as a liability (or asset) such as deferred (or accrued) income.
- Realised gains or losses arising on the termination of a previously unrecognised derivative used in a hedging relationship (such as an interest rate swap hedging a borrowing) were included in the statement of financial position as deferred or accrued income and amortised over the remaining term of the hedged exposure.

In all cases, an entity is required to eliminate deferred gains and losses arising on derivatives that were reported in accordance with previous GAAP as if they were assets or liabilities. *[IFRS 1.B4(b)]*. In contrast to adjustments made to restate derivatives at fair value, IFRS 1's implementation guidance does not specify in general terms how to deal with adjustments to eliminate deferred gains or losses, i.e., whether they are taken to retained earnings or a separate component of equity.

How we see it

We believe that the requirement to eliminate deferred gains and losses does not extend to those that have been included in the carrying amount of other assets or liabilities that will continue to be recognised under IFRS accounting standards. For example, under an entity's previous GAAP, the carrying amount of non-financial assets such as inventories or property, plant and equipment might have included the equivalent of a basis adjustment (i.e., hedging gains or losses were considered an integral part of the asset's cost). Of course, entities also need to consider any other provisions of IFRS 1 that apply to those hedged items, e.g., whether any of the exemptions such as those for business combinations (see section 5.2 below) or deemed cost (see section 5.4 below) will be used.

4.5.2 Hedging relationships reflected in the opening IFRS statement of financial position

IFRS 1 states that a first-time adopter must not reflect a hedging relationship in its opening IFRS statement of financial position if that hedging relationship is of a type that does not qualify for hedge accounting under IFRS 9 (see section 4.4.1 above). *[IFRS 9.6.4.1(a)]*. As examples of this, IFRS 1 cites many hedging relationships where the hedging instrument is a stand-alone written option or a net written option; or where the hedged item is a net position in a cash flow hedge for another risk than foreign currency risk. *[IFRS 1.B5]*. Previous GAAP hedge documentation and effectiveness that were not fully compliant with the criteria in IFRS 9.6.4.1(b)-(c) do not mean that the hedging relationship is of a type that does not qualify for hedge accounting under IFRS 9. *[IFRS 9.6.4.1(b), IFRS 9.6.4.1(c)]*. (See section 4.6 below for requirements for post-transition date hedge accounting).

However, if an entity designated a net position as a hedged item under its previous GAAP, it could designate as a hedged item under IFRS accounting standards an individual item within that net position, or a net position that meets the requirements in IFRS 9.6.6.1, provided that it does so no later than the date of transition to IFRS accounting standards. *[IFRS 1.B5, IFRS 9.6.6.1]*. In other words, such designation would allow the hedging relationship to be reflected in the opening IFRS statement of financial position.

On the other hand, a hedging relationship designated under an entity's previous GAAP is reflected in its opening IFRS statement of financial position if that hedging relationship consists of eligible hedging instruments and eligible hedged items in IFRS 9.6.4.1(a), regardless of whether or not the hedge designation, documentation and effectiveness criteria for hedge accounting under IFRS 9.6.4.1(b)-(c) are met on the date of transition. *[IFRS 1.B5, IFRS 9.6.4.1]*.

4.5.2.A Prohibition on retrospective designation

A first-time adopter is not permitted to designate hedges retrospectively in relation to transactions entered into before the date of transition to IFRS accounting standards. *[IFRS 1.B6]*. Instead, it must apply the requirements prospectively.

In the Basis for Conclusions, it is explained that:

> "... it is unlikely that most entities would have adopted IAS 39's criteria for (a) documenting hedges at their inception and (b) testing the hedges for effectiveness, even if they intended to continue the same hedging strategies after adopting IAS 39. Furthermore, retrospective designation of hedges (or retrospective reversal of their designation) could lead to selective designation of some hedges to report a particular result." *[IFRS 1.BC75]*.

While this paragraph refers to IAS 39's criteria, the IASB has since reinforced the above basis for conclusion when it issued IFRS 9, which says the following in its Basis for Conclusions:

> "To the extent that an entity wants to apply hedge accounting, those hedging relationships should be documented on or before the transition date. This is consistent with the transition requirements for existing users of IFRS and the existing transition requirements of IFRS 1 ...". *[IFRS 9.BC7.52]*.

4.5.2.B Designation in anticipation of adoption of IFRS accounting standards

If a first-time adopter, in anticipation of the adoption of IFRS accounting standards, decides to designate a transaction as a hedge under IFRS 9 and completes the required documentation sometime before the date of transition to IFRS accounting standards, some have questioned whether upon adoption of IFRS accounting standards, hedge accounting is applied prior to the date of transition.

How we see it

In our view, as long as the hedge is properly designated and documented in accordance with IFRS 9.6.4.1 prior to the date of transition, the first-time adopter applies hedge accounting from the date that it met the requirements. As explained in section 4.5.2.A above, a first-time adopter cannot designate a transaction retrospectively as a hedge under IFRS accounting standards.

4.5.3 Reflecting cash flow hedges in the opening IFRS statement of financial position

A first-time adopter could have deferred gains and losses on a cash flow hedge of a forecast transaction under its previous GAAP. If, at the date of transition to IFRS accounting standards, the hedged forecast transaction is not highly probable, but is expected to occur, the entire deferred gain or loss is recognised in the cash flow hedge reserve within equity. *[IFRS 1.IG60B]*. This is consistent with the treatment required for deferred gains or losses on cash flow hedges applicable after the transition to IFRS accounting standards (see Chapter 49 at section 7.2.1 and section 8.3.2). *[IFRS 9.6.5.11(d), IFRS 9.6.5.12(a)]*.

How we see it

The standard is not explicit as to how an entity deals with such a hedge if, at the date of transition to IFRS accounting standards, the forecast transaction is highly probable. However, it would make no sense if the hedge of a transaction that is no longer highly probable but is still expected to occur were required to be reflected in the cash flow hedge reserve within equity in the opening IFRS statement of financial position as described above, but the hedge of the highly probable forecast transaction were not. Therefore, a cash flow hedge is reflected in the opening IFRS statement of financial position in the way set out above if the hedged item is a forecast transaction that is highly probable (see Illustration 4-2 below).

It also follows that a cash flow hedge of the variability in cash flows attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) is reflected in the opening IFRS statement of financial position. To do otherwise would allow an entity to choose not to designate (in accordance with IFRS 9) certain cash flow hedges, say those that are in a loss position, until one day after its date of transition, thereby allowing associated hedging losses to bypass profit or loss completely. However, this would effectively result in the retrospective de-designation of hedges to achieve a desired result, thereby breaching the general principle of IFRS 1 (i.e., a first-time adopter cannot designate a hedging relationship retrospectively).

If, at the date of transition to IFRS accounting standards, the forecast transaction was not expected to occur, consistent with the requirements of IFRS 9.6.5.6-6.5.7 and IFRS 9.6.5.12(b), a first-time adopter reclassifies any related deferred gains and losses that are not expected to be recovered into retained earnings. *[IFRS 1.IG60B, IFRS 9.6.5.6, IFRS 9.6.5.7, IFRS 9.6.5.12(b)]*.

Illustration 4-2: Unrecognised gains and losses on existing cash flow hedge

Entity A has the euro (€) as its functional currency. In September 20X1, it entered into a forward currency contract to sell US dollars (US$) for euros in twelve months to hedge US$ denominated sales that it forecasts are highly probable to occur in September 20X2. Entity A prepares its first IFRS financial statements and its date of transition to IFRS accounting standards is 1 January 20X2. The historical cost of the forward contract is €nil and at the date of transition to IFRS accounting standards it had a positive fair value of €100.

Case 1: Gains and losses deferred

Under Entity A's previous GAAP, until the sales occurred the forward contract was recognised in the statement of financial position at its fair value and the resulting gain or loss was deferred in the statement of financial position as a liability or an asset. When the sale occurred, any deferred gain or loss was recognised in profit or loss as an adjustment to the revenue recognised on the hedged sale.

This relationship must be reflected in Entity A's opening IFRS statement of financial position whether or not the hedge designation, documentation and effectiveness criteria for hedge accounting under IFRS 9.6.4.1(b)-(c) are met on the date of transition to IFRS accounting standards: the deferred gain is reclassified to the cash flow hedge reserve within equity and there is no adjustment to the carrying amount of the forward contract. *[IFRS 1.IG60B]*.

Case 2: Gains and losses unrecognised

Under Entity A's previous GAAP, the contract was not recognised in the statement of financial position. When the sale occurred, any unrecognised gain or loss was recognised in profit or loss as an offset to the revenue recognised on the hedged sale.

How we see it

Although Case 2 is more problematic, we consider that it is accounted for in the same way as Case 1. The difference between the previous carrying amount of a derivative and its fair value would be recognised in the cash flow hedge reserve within equity.

Many existing hedging relationships that were acceptable under previous GAAP do not meet the full hedge accounting requirements of IFRS 9.6.4.1 although the hedging relationships are of a type that qualify for hedge accounting under IFRS 9.6.4.1(a) and are therefore reflected in the opening IFRS statement of financial position. Also, in many such cases hedge ineffectiveness has not previously been assessed or separately recognised in profit or loss. For cash flow hedges, ineffectiveness is not recognised in opening retained earnings but is deferred, as part of the cash flow hedge reserve within equity. As noted above, the entire unrecognised portion of the fair value of the hedging instrument is recognised in the cash flow hedge reserve in equity in the opening IFRS statement of financial position. There is no reference to the effective portion. *[IFRS 1.IG60B]*.

4.5.4 Reflecting fair value hedges in the opening IFRS statement of financial position

If a first-time adopter has, under its previous GAAP, deferred or not recognised gains and losses on a fair value hedge of a hedged item that is not measured at fair value, the entity adjusts the carrying amount of the hedged item at the date of transition to IFRS accounting standards. The adjustment, which is essentially the effective part of the hedge that was not recognised in the carrying amount of the hedged item under the previous GAAP, is calculated as the lower of: *[IFRS 1.IG60A]*

(a) That portion of the cumulative change in the fair value of the hedged item that was not recognised under previous GAAP

And

(b) That portion of the cumulative change in the fair value of the hedging instrument which, under previous GAAP, was either (i) not recognised or (ii) deferred in the statement of financial position as an asset or liability

Therefore, an entity could be required to recognise some ineffectiveness in retained earnings in the opening statement of financial position for fair value hedges, if the cumulative change in the fair value of the hedged item is lower than the unrecognised cumulative change in fair value of the hedging instrument. However, if the hedged item fair value adjustment on the date of transition to IFRS accounting standards is restricted by the change in fair value of the hedging instrument (i.e., where the cumulative change in the fair value of the hedged item is higher than the cumulative change in fair value of the hedging instrument), any ineffectiveness is not recognised on the date of transition.

4.5.5 Reflecting foreign currency net investment hedges in the opening IFRS statement of financial position

IFRS 1 does not provide explicit guidance on reflecting foreign currency net investment hedges in the opening IFRS statement of financial position.

How we see it

Since IFRS 9 requires that ongoing IFRS reporting entities account for foreign currency net investment hedges similarly to cash flow hedges, it follows that the first-time adoption provisions regarding cash flow hedges (see section 4.5.3 above) also apply to hedges of foreign currency net investments.

Specifically, the entire deferred or unrecognised gain or loss on the hedging instrument is recognised in the currency translation adjustment on transition. This will result in some previously deferred or unrecognised gains or losses on hedging instruments not being recognised in profit or loss until the foreign operation is disposed of.

IFRS 1 allows a first-time adopter to apply the exemption to reset the cumulative translation difference for all foreign operations to zero (see section 5.6 below); however, the standard does not explicitly state that this exemption extends to the gain or loss on the hedging instruments for net investment hedges.

How we see it

We believe that the requirement to reset the cumulative translation differences also applies to related gains and losses on hedging instruments (see section 5.6.1 below). Therefore, a first-time adopter that applies the exemption to reset cumulative translation differences to zero recognises those pre-transition gains and losses on the hedging instruments in the opening balance of retained earnings to avoid a disparity between the treatment of the gains and losses on the hedged item and the hedging instrument. Those pre-transition gains and losses on the hedging instruments that were recognised in retained earnings will not be reclassified to profit or loss upon disposal of a foreign operation.

4.5.6 'Costs of hedging' (where excluded from the hedging relationship under previous GAAP)

The time value of options, forward points of forward contracts and foreign currency basis spreads (collectively referred to as 'costs of hedging') might not have been accounted for in the manner permitted by IFRS 9. For instance, they might have been amortised under previous GAAP, regardless of whether there was a transaction-related or a time-period related hedged item. Also, the amount deferred under previous GAAP might not represent the 'aligned' value of 'costs of hedging' if the critical terms of the hedging instrument are not fully aligned with those of the hedged item (see Chapter 49 at section 7.5.1.A).

By separately accruing the option time value or forward points, for example, under previous GAAP and only locking in the intrinsic or spot value of the hedged item, an entity has made a clear intention that only the intrinsic or spot value forms part of the hedge. Therefore, the special cash flow hedging rules in IFRS 1.IG60B (see section 4.5.3 above) apply purely to the full unrecognised intrinsic or spot value. *[IFRS 1.IG60B]*. Similarly, if the 'costs of hedging' had been excluded from a fair value hedging relationship, they would not form part of the adjustment to the hedging instrument taken to retained earnings required by IFRS 1.IG60A (see section 4.5.4 above). *[IFRS 1.IG60A]*.

How we see it

IFRS 1 does not provide specific guidance on how to account for 'costs of hedging' excluded from a hedging relationship on transition to IFRS accounting standards. In our view, the same approach as applied to cash flow hedges (i.e., IFRS 1.IG60B) is also applied to the 'costs of hedging'.

Accordingly, any previously unrecognised amount of the fair value of the option time value, forward points or foreign currency basis spread would be recognised in a separate component of equity recognised at the date of transition. Therefore, the 'costs of hedging' excluded from the hedging relationship under previous GAAP are neither recognised in the cash flow hedge reserve nor in retained earnings. The same accounting applies to 'costs of hedging' excluded from cash flow and fair value hedging relationships.

In many cases, the amount of 'costs of hedging' that was amortised or deferred under previous GAAP and is recognised as a separate component of equity on transition includes accumulated differences due to the different accounting treatments under previous GAAP compared to IFRS 9 (rather than, say, representing only the aligned time value of the option, forward element or foreign currency basis spread). Any such accumulated differences are included in the amount deferred under previous GAAP and recognised in equity.

If the 'costs of hedging' were not excluded from the hedging relationship under previous GAAP, the above accounting does not apply but instead they give rise to ineffectiveness. The treatment of ineffectiveness for cash flow hedges, fair value hedges and foreign currency net investment hedges in the opening IFRS statement of financial position is explained in sections 4.5.3 to 4.5.5 above.

4.6 Hedge accounting: subsequent treatment

IFRS 1's implementation guidance explains that hedge accounting can be applied prospectively only from the date the hedging relationship is fully designated and documented. In other words, after the date of transition to IFRS accounting standards, hedge accounting under IFRS 9 can be applied only if the qualifying criteria in IFRS 9.6.4.1 are met. *[IFRS 9.6.4.1, IFRS 9.6.5.1]*. Therefore, if the hedging instrument is still held at the date of transition to IFRS accounting standards, the designation and documentation of the hedging relationship must be completed (and the effectiveness requirements met) on or before that date if the hedging relationship is to qualify for hedge accounting from that date. *[IFRS 1.IG60]*. For further discussion on measuring ineffectiveness, see Chapter 49 at section 7.4.

4.6.1 Discontinuation of a hedging relationship

Before the date of transition to IFRS accounting standards an entity might have designated as a hedge a transaction under previous GAAP that is of a type that qualifies for hedge accounting under IFRS 9, which consists only of eligible hedging instruments and eligible hedged items in IFRS 9.6.4.1(a), but does not meet other qualifying criteria in IFRS 9 (i.e., IFRS 9.6.4.1 (b)-(c)) at the date of transition to IFRS accounting standards. *[IFRS 9.6.4.1]*. In this case, the entity follows the general requirements in IFRS 9.6.5.6-6.5.7 for discontinuing hedge accounting subsequent to the date of transition to IFRS accounting standards - these are dealt with in Chapter 49 at section 8.3. *[IFRS 1.B6, IFRS 9.6.5.6, IFRS 9.6.5.7]*.

For cash flow hedges, any net cumulative gain or loss that was reclassified to the cash flow hedge reserve on the date of transition to IFRS accounting standards (see section 4.5.3 above) remains there until: *[IFRS 1.IG60B]*

(a) The forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability

(b) The forecast transaction affects profit or loss

Or

(c) Subsequently, circumstances change and the forecast transaction is no longer expected to occur, in which case any related net cumulative gain or loss that had been reclassified to the cash flow hedge reserve on the date of transition to IFRS accounting standards is reclassified to profit or loss

The requirements above do little more than reiterate the general requirements of IFRS 9, i.e., that hedge accounting can only be applied prospectively if the qualifying criteria are met, and entities are expected to experience few interpretative problems in dealing with this aspect of the hedge accounting requirements.

4.6.2 Ineffectiveness of cash flow and foreign currency net investment hedges in continuing hedging relationships

Hedge accounting in accordance with IFRS 9 is applied prospectively from the date the hedge accounting is fully designated and documented. *[IFRS 1.IG60]*. Accounting for ongoing cash flow hedges and foreign currency net investment hedges is discussed in more detail in Chapter 49 at sections 7.2 and 7.3.

As noted in sections 4.5.3 and 4.5.5 above, ineffectiveness relating to cash flow and foreign currency net investment hedges reflected in the opening statement of financial position is not recognised in the opening retained earnings but is deferred, as part of the cash flow hedge reserve (or cumulative translation reserve) within equity. The entity does not recognise any past ineffectiveness deferred in equity on transition in profit or loss as ineffectiveness in subsequent periods. Rather, the entity measures ineffectiveness in subsequent periods by reference to cumulative changes in the fair value of the hedging instrument and hedged item subsequent to the date of transition (if that is the date from which the hedging relationship qualifies under IFRS 9). In order to capture the appropriate cumulative change in fair value of the hedged item, where a hypothetical derivative is used to measure ineffectiveness, the ineffectiveness recognised in profit or loss on the continuing hedging relationship is determined by reference to the hypothetical derivative where terms were set at inception of the hedging relationship, rather than on the date of transition to IFRS accounting standards. This means that the fair value movements arising on the hedged item which are used in calculating the ongoing adjustments required to the cash flow hedge reserve derive from the hypothetical derivative whose terms were set at the inception of the hedging relationship (designated under previous GAAP).

Any ineffectiveness deferred in equity on transition (as part of, say, the cash flow hedge reserve) will remain in equity until (a) the forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability (when the amount deferred in equity is included directly in the initial cost or other carrying amount of the asset or liability), (b) the forecast transaction affects profit or loss, or (c) subsequently circumstances change and the forecast transaction is no longer expected to occur, in which case the amount is reclassified from equity to profit or loss.

How we see it

This deferral of ineffectiveness on transition implies a discrepancy between the profit or loss impact of the hedged item and the amounts reclassified from cash flow hedge reserves under IFRS 9.6.5.11(d) and IFRS 9.6.5.12. Therefore, when the hedged item affects several periods (e.g., a hedge of variable interest on a debt instrument), it is necessary to recognise this mismatch appropriately over the hedging period. For a net investment hedge, the amounts accumulated in the cumulative translation reserve are only reclassified to profit or loss on disposal or, in certain circumstances, partial disposal of the foreign operation in accordance with IAS 21 (see Chapter 16 at section 6.6 and Chapter 49 at section 7.3).

In certain cases, no deferral of ineffectiveness will occur, (e.g., where on transition the change in fair value of the hedged item exceeds the change in fair value of the hedging instrument). In those circumstances, subsequent changes in fair value of the hedging instrument that are effective are deferred in the cash flow hedge reserve or for a foreign currency net investment hedge, the cumulative translation reserve.

4.6.3 Ineffectiveness of fair value hedges in continuing hedging relationships

Hedge accounting in accordance with IFRS 9 is applied prospectively from the date the hedge accounting is fully designated and documented. *[IFRS 1.IG60]*. Accounting for ongoing fair value hedges is discussed in more detail in Chapter 49 at section 7.1.

As noted in section 4.5.4 above, if the cumulative change in the fair value of the hedged item is lower than the unrecognised cumulative change in fair value of the hedging instrument, ineffectiveness relating to fair value hedges is recognised in retained earnings on transition. However, if the hedged item's fair value adjustment on transition is restricted by the change in fair value of the hedging instrument (i.e., where the cumulative change in the fair value of the hedged item is higher than the cumulative change in fair value of the hedging instrument), any ineffectiveness is not recognised on transition.

How we see it

The ineffectiveness on a fair value hedge not recognised on transition is not subsequently recognised in profit or loss through the next revaluation of the hedged item. Illustration 4-3 below demonstrates how an entity treats the ineffectiveness not recognised on transition subsequently.

Illustration 4-3: Ineffectiveness of fair value hedge on transition

At the date of transition to IFRS accounting standards, the cumulative change in the fair value of the hedged item is CU100,000 whereas the cumulative change in fair value of the hedging instrument is CU80,000 (and therefore, the fair value adjustment to the hedged item is restricted to the change in fair value of the hedging instrument, i.e., CU80,000). Following the date from when the hedging relationship is designated under IFRS 9, subsequent changes in the fair value of the hedged item attributable to the hedged risk and changes in the fair value of the hedging instrument would be recognised in profit or loss (without reference to the adjustment made to the hedged item on transition. See also Case 1 in Illustration 4-5 in section 4.7 below for an example of adjustments required on transition for fair value hedges). *[IFRS 9.6.5.8]*.

As time passes, the mechanics of fair value hedge accounting would normally result in an automatic unwinding of 100% of the cumulative fair value changes attributable to the hedged risk so that the carrying amount of the hedged item would, at any point in time, reflect fair value adjustments attributable to the hedged risk that are consistent with the remaining term of the hedging relationship. However, because at the date of transition, some of the cumulative changes in the fair value of the hedged item were not recognised, total fair value changes unwound, at any point in time, would outpace the cumulative adjustments applied to the hedged item up to that point. In this example, the hedged item carrying amount at maturity would differ from its nominal amount by CU20,000 since the original adjustment on transition was CU80,000 but the subsequent cumulative net change in fair value that would be recognised in profit or loss would be CU100,000. In order to deal with this difference, the CU20,000 would need to be amortised over the term of the hedge in profit or loss. For interest-bearing hedged items, this would typically be achieved using the effective interest rate method. *[IFRS 9.6.5.10]*.

4.6.4 'Costs of hedging' (where excluded from the hedging relationship under previous GAAP)

As explained in section 4.5.6 above, 'costs of hedging' that were amortised or deferred under previous GAAP, are recognised as a separate component of equity rather than retained earnings on transition, including any accumulated difference in the amount deferred under previous GAAP and the amount in accordance with IFRS accounting standards.

IFRS 1 does not provide specific guidance on how to account for 'costs of hedging', including the difference arising on transition in subsequent periods.

How we see it

In our view, the same approach as that described earlier for cash flow hedges (see section 4.6.2 above) is applied to the 'costs of hedging'. In cases where there is a transaction-related hedged item, any amount of 'costs of hedging' on transition deferred in equity will be: (a) included directly in the initial cost or other carrying amount of a non-financial asset or a non-financial liability on its initial recognition, or (b) reclassified to profit or loss as a reclassification adjustment in the same period or periods during which the hedged expected future cash flows affect profit or loss, depending on whether the hedged item results in a non-financial item or not. If there is a time-period related hedged item, the difference will be amortised on a systematic and rational basis over the remaining hedging periods.

If the first-time adopter excludes 'costs of hedging' from the designation of the hedging relationship prospectively under IFRS 9, and the entity is required (in the case of time value of options) or chooses (in the case of the forward element of forward contracts and foreign currency basis spreads) to apply the 'costs of hedging' guidance in IFRS 9, the 'costs of hedging' will subsequently be accounted for in accordance with IFRS 9.6.5.15 and IFRS 9.6.5.16 and IFRS 9.B6.5.29-B6.5.39. *[IFRS 9.6.5.15, IFRS 9.6.5.16, IFRS 9.B6.5.29-B6.5.39]*. If the first-time adopter chooses not to apply the 'costs of hedging' guidance to the forward element of forward contracts or foreign currency basis spread, movements in the fair value of the forward element or foreign currency basis spread are recognised in profit or loss.

If the first-time adopter does not exclude the 'costs of hedging' from the designation of the hedging relationship prospectively under IFRS 9, normal hedge accounting is applied but this designation will give rise to ineffectiveness to be accounted for in profit or loss. Any amounts deferred in equity for 'costs of hedging' at the date of transition (see section 4.5.6 above) will be accounted for as described in the 'How we see it' above.

See Chapter 49 at section 7.5 for further discussion of accounting for 'cost of hedging' under IFRS 9.

4.7 Hedge accounting: Illustrations

Illustrations 4-4 and 4-5 below demonstrate the guidance considered in sections 4.5 to 4.6 above.

Illustration 4-4: Pre-transition cash flow hedges

Case 1: All hedge accounting qualifying criteria met from date of transition and thereafter

In 20X0, Entity A borrowed CU10m from a bank. The terms of the loan provide that a floating rate coupon (based on a specified index) plus 2% is payable quarterly in arrears and the principal is repayable after 10 years. In 20X3, Entity A decided to 'fix' its coupon payments for the remainder of the term of the loan by entering into a seven-year pay-fixed, receive-floating interest rate swap. The swap has a notional amount of CU10m and the floating leg resets quarterly based on the same floating rate index as the loan.

In Entity A's final financial statements prepared under its previous GAAP, the swap was clearly identified as a hedging instrument in a hedge of the loan and was accounted for as such. The fair value of the swap was not recognised in Entity A's statement of financial position and the periodic interest settlements were accrued and recognised as an adjustment to the loan interest expense. On 1 January 20X7, Entity A's date of transition to IFRS accounting standards, the loan and the swap were still in place and the swap had a positive fair value of CU1m and a CUnil carrying amount. In addition, Entity A met all the qualifying criteria in IFRS 9 to permit the use of hedge accounting for this arrangement throughout 20X7 and 20X8.

In its opening IFRS statement of financial position Entity A would:

- Recognise the interest rate swap as an asset at its fair value of CU1m
- Credit CU1m to a separate component of equity, to be reclassified to profit or loss as the hedged transactions (future interest payments on the loan) affect profit or loss

In addition, hedge accounting would be applied throughout 20X7 and 20X8.

Case 2: Hedge terminated prior to date of transition

The facts are as in Case 1 except that in April 20X6 Entity A decided to terminate the hedge and the interest rate swap was settled for its then positive fair value of CU1.5m. Under its previous GAAP, Entity A's stated accounting policy in respect of terminated hedges was to defer any realised gain or loss on terminated hedging instruments where the hedged exposure remained. These gains or losses would be recognised in profit or loss at the same time as gains or losses on the hedged exposure. At the end of December 20X6, Entity A's statement of financial position included a liability (unamortised gain) of CU1.4m.

In its opening IFRS statement of financial position Entity A would:

- Remove the deferred gain of CU1.4m from the statement of financial position
- Credit CU1.4m to a separate component of equity, to be reclassified to profit or loss as the hedged transactions (future interest payments on the loan) affect profit or loss

How we see it

IFRS 1 does not explicitly address hedges terminated prior to the date of transition to IFRS accounting standards. In our view, because the terminated hedge relates to a transaction that has an ongoing risk exposure, the provisions of IFRS 9 on hedge discontinuance are applied to this relationship.

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Illustration 4-5: Existing fair value hedges

Case 1: All hedge accounting qualifying criteria met from date of transition and thereafter

On 15 November 20X1, Entity B entered into a forward contract to sell 50,000 barrels of crude oil to hedge all changes in the fair value of certain inventory. Entity B prepares its first IFRS financial statements and its date of transition to IFRS accounting standards is 1 January 20X2. The historical cost of the forward contract is CUnil and at the date of transition to IFRS accounting standards the forward had a negative fair value of CU50.

In Entity B's final financial statements prepared under its previous GAAP, the forward contract was clearly identified as a hedging instrument in a hedge of the inventory and was accounted for as such. The contract was recognised in the statement of financial position as a liability at its fair value and the resulting loss was deferred in the statement of financial position as an asset. In the period between 15 November 20X1 and 1 January 20X2, the fair value of the inventory increased by CU47. In addition, Entity B met all the qualifying criteria in IFRS 9 to permit the use of hedge accounting for this arrangement throughout 20X2 until the forward expired.

In its opening IFRS statement of financial position Entity B would:

- Continue to recognise the forward contract as a liability at its fair value of CU50
- Derecognise the CU50 deferred loss asset on the forward contract
- Recognise the crude oil inventory at its historical cost plus CU47 (the lower of the change in fair value of the crude oil inventory, CU47, and that of the forward contract, CU50)
- Record the net adjustment of CU3 in retained earnings

In addition, hedge accounting would be applied throughout 20X2 until the forward contract expired.

Case 2: All hedge accounting qualifying criteria met from date of transition and thereafter

In 20X0 Entity C borrowed CU10m from a bank. The terms of the loan provide that a coupon of 8% is payable quarterly in arrears and the principal is repayable after 10 years. In 20X3, Entity C decided to alter its coupon payments for the remainder of the term of the loan by entering into a seven-year pay-floating, receive-fixed interest rate swap. The swap has a notional amount of CU10m and the floating leg resets quarterly based on a specified index.

In Entity C's final financial statements prepared under its previous GAAP, the swap was clearly identified as a hedging instrument in a hedge of the loan and accounted for as such. The fair value of the swap was not recognised in Entity C's statement of financial position and the periodic interest settlements on the swap were accrued and recognised as an adjustment to the loan interest expense.

On 1 January 20X7, Entity C's date of transition to IFRS accounting standards, the loan and the swap were still in place and the swap had a negative fair value of CU1m and a CUnil carrying amount. The cumulative change in the fair value of the loan attributable to changes in the floating interest rate was CU1.1m, although this change was not recognised in Entity C's statement of financial position because the loan was accounted for at amortised cost. In addition, Entity C met all the qualifying criteria in IFRS 9 to permit the use of hedge accounting for this arrangement throughout 20X7 and 20X8.

In its opening IFRS statement of financial position Entity C would:

- Recognise the interest rate swap as a liability at its fair value of CU1m
- Reduce the carrying amount of the loan by CU1m (the lower of the change in its fair value attributable to the hedged risk, CU1.1m, and that of the interest rate swap, CU1m) to CU9m

In addition, hedge accounting would be applied throughout 20X7 and 20X8.

Case 3: Hedge terminated prior to date of transition

The facts are as in Case 2 above except that, in April 20X6, Entity C decided to terminate the fair value hedge and the interest rate swap was settled for its then negative fair value of CU1.5m. Under its previous GAAP, Entity C's stated accounting policy in respect of terminated hedges was to defer any gain or loss on the hedging instrument as a liability or an asset where the hedged exposure remained and this gain or loss was recognised in profit or loss at the same time as the hedged exposure. At the end of December 20X6 the unamortised loss recognised as an asset in Entity C's statement of financial position was CU1.4m. The cumulative change through April 20X6 in the fair value of the loan attributable to changes in the floating interest rate that had not been recognised was CU1.6m.

In its opening IFRS statement of financial position, Entity C would:

- Remove the deferred loss asset of CU1.4m from the statement of financial position
- Reduce the carrying amount of the loan by CU1.4m (the lower of the change in its fair value attributable to the hedged risk, CU1.6m, and the change in value of the interest rate swap that was deferred in the statement of financial position, CU1.4m)

The CU1.4m adjustment to the loan would be amortised to profit or loss over its remaining term.

Case 4: Documentation completed after the date of transition

The facts are as in Case 2 above except that, at the date of transition, Entity C had not prepared documentation that would allow it to apply hedge accounting under IFRS 9. Hedge documentation was subsequently prepared as a result of which the hedge qualified for hedge accounting with effect from the beginning of July 20X7 and through 20X8.

As in Case 2, in its opening IFRS statement of financial position Entity C would:

- Recognise the interest rate swap as a liability at its fair value of CU1m
- Reduce the carrying amount of the loan by CU1m (the lower of the change in its fair value attributable to the hedged risk, CU1.1m, and that of the interest rate swap, CU1m), because the loan was clearly identified as a hedged item

For the period from January 20X7 to June 20X7, hedge accounting would not be available. Accordingly, the interest rate swap would be remeasured to its fair value and any gain or loss would be recognised in profit or loss with no offset from remeasuring the loan. The CU1m adjustment to the loan would be amortised to profit or loss over its remaining term (the amortisation could begin as soon as an adjustment exists and must begin no later than when the hedged item ceases to be adjusted for hedging gains and losses). With effect from July 20X7 hedge accounting would be applied prospectively.

4.8 Non-controlling interests

A first-time adopter must apply IFRS 10 retrospectively, except for the following requirements that apply prospectively from its date of transition to IFRS accounting standards: *[IFRS 1.B7]*

(a) The requirement that total comprehensive income is attributed to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance *[IFRS 10.B94]*

(b) The requirements on accounting for changes in the parent's ownership interest in a subsidiary that do not result in a loss of control *[IFRS 10.23, IFRS 10.B96]*

(c) The requirements on accounting for a loss of control over a subsidiary, and the related requirements in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* to classify all assets and liabilities of that subsidiary as held for sale *[IFRS 10.B97, IFRS 10.B98, IFRS 10.B99, IFRS 5.8A]*

However, if a first-time adopter restates any business combination that occurred prior to its date of transition to comply with IFRS 3 *Business Combinations* it must also apply IFRS 10, including the above requirements, from that date onwards (see section 5.2.2 below). *[IFRS 1.C1]*.

4.9 Classification and measurement of financial instruments

4.9.1 Classification of financial assets

IFRS 9 requires a financial asset to be measured at amortised cost if it meets two tests that deal with the nature of the business model that holds the financial asset and the contractual cash flow characteristics of the financial asset. *[IFRS 9.4.1.2]*. Also, the standard requires a financial asset to be measured at fair value through other comprehensive income if certain conditions are met. *[IFRS 9.4.1.2A]*. These conditions for classification of financial assets are described in detail in Chapter 44 at sections 1 and 1.1.

IFRS 1.B8 requires a first-time adopter to assess whether a financial asset meets the conditions on the basis of the facts and circumstances that exist at the date of transition to IFRS accounting standards. *[IFRS 1.B8]*. The resulting classifications are applied retrospectively. *[IFRS 1.IG56]*.

4.9.1.A Assessment of a modified time value of money element

If it is impracticable to assess a modified time value of money element under IFRS 9.B4.1.9B-B4.1.9D on the basis of the facts and circumstances that exist at the date of transition to IFRS accounting standards, the first-time adopter is required to assess the contractual cash flow characteristics of that financial asset on the basis of the facts and circumstances that existed at that date of transition without taking into account the requirements related to the modification of the time value of money element in IFRS 9.B4.1.9B-B4.1.9D.

In this case, the entity also applies IFRS 7.42R and discloses the carrying amount at the reporting date of the financial assets - whose contractual cash flow characteristics have been assessed based on the facts and circumstances that existed at the date of transition without taking into account the requirements related to the modification of the time value of money element in IFRS 9.B4.1.9B-B4.1.9D - until those financial assets are derecognised (see section 6.4.2 below). *[IFRS 1.B8A, IFRS 7.42R, IFRS 9.B4.1.9B, IFRS 9.B4.1.9C, IFRS 9.B4.1.9D]*.

4.9.1.B Assessment of whether the fair value of a prepayment feature is insignificant

Similarly, if it is impracticable to assess whether the fair value of a prepayment feature is insignificant under IFRS 9.B4.1.12(c) on the basis of the facts and circumstances that exist at the date of transition to IFRS accounting standards, IFRS 1.B8B requires an entity to assess the contractual cash flow characteristics of that financial asset on the basis of the facts and circumstances that existed at the date of transition without taking into account the exception for prepayment features in IFRS 9.B4.1.12 (see Chapter 44 at section 5.4.4.B).

In this case, the entity also applies IFRS 7.42S and discloses the carrying amount at the reporting date of the financial assets - whose contractual cash flow characteristics have been assessed based on the facts and circumstances that existed at the date of transition without taking into account the exception for prepayment features in IFRS 9.B4.1.12 - until those financial assets are derecognised (see section 6.4.2 below). *[IFRS 1.B8B, IFRS 7.42S, IFRS 9.B4.1.12]*.

4.9.2 Measurement of financial instruments measured at amortised cost

For those financial assets and financial liabilities measured at amortised cost in the opening IFRS statement of financial position, an entity determines the gross carrying amount of the financial assets and the amortised cost of the financial liabilities on the basis of circumstances existing when the assets and liabilities first satisfied the recognition criteria in IFRS 9. However, if the entity acquired those financial assets and financial liabilities in a past business combination to which the entity elects not to apply IFRS 3 retrospectively, their carrying amount in accordance with previous GAAP immediately following the business combination is their deemed cost in accordance with IFRS accounting standards at that date. *[IFRS 1.C4(e), IFRS 1.IG57]*.

IFRS 1.B8C states that if it is impracticable (as defined in IAS 8) for an entity to apply retrospectively the effective interest method in IFRS 9, the fair value of the financial asset or the financial liability at the date of transition to IFRS accounting standards will be the new gross carrying amount of that financial asset or the new amortised cost of that financial liability at the date of transition. *[IFRS 1.B8C, IAS 8.5]*.

4.9.3 Transition adjustments

An entity treats an adjustment to the carrying amount of a financial asset or financial liability as a transition adjustment to be recognised in the opening balance of retained earnings (or another component of equity, as appropriate) at the date of transition to IFRS accounting standards only to the extent that it results from adopting IFRS 9. *[IFRS 1.IG58A]*. If an entity is unable to determine whether a particular portion of the adjustment is a transition adjustment or a change in estimate, it treats that portion as a change in accounting estimate in accordance with IAS 8, with appropriate disclosures, *[IFRS 1.IG58B]*, (see section 4.2 above).

If an investment had been measured at fair value under previous GAAP with revaluation gains recognised outside profit or loss but the investment is classified as at fair value through profit or loss under IFRS 9, the pre-IFRS 9 revaluation gain that had been recognised outside profit or loss is reclassified into retained earnings on initial application of IFRS 9. If, on initial application of IFRS 9, the investment is measured at fair value through other comprehensive income in accordance with IFRS 9.4.1.2A or is designated at fair value through other comprehensive income in accordance with IFRS 9.5.7.5, then the pre-IFRS 9 revaluation gain is recognised in a separate component of equity. Subsequently, the entity recognises gains and losses on these financial assets in accordance with IFRS 9. *[IFRS 1.IG59, IFRS 9.4.1.2A, IFRS 9.5.7.5]*.

4.10 Impairment of financial assets

IFRS 1.B8D requires a first-time adopter to apply the impairment requirements in Section 5.5 of IFRS 9 retrospectively subject to IFRS 1.B8E-B8G. *[IFRS 1.B8D, IFRS 1.B8E, IFRS 1.B8F, IFRS 1.B8G]*.

At the date of transition to IFRS accounting standards, IFRS 1.B8E requires a first-time adopter to use reasonable and supportable information that is available without undue cost or effort (see Chapter 47 at section 5.9) to determine the credit risk at the date that the financial instruments were initially recognised (or, for loan commitments and financial guarantee contracts, the date that the entity became a party to the irrevocable commitment in accordance with IFRS 9.5.5.6) and compare that to the credit risk at the date of transition. IFRS 1.B8E references IFRS 9.B7.2.2-B7.2.3 which set out similar transitional rules on adoption of IFRS 9 for existing IFRS reporters. *[IFRS 1.B8E, IFRS 9.5.5.6, IFRS 9.B7.2.2, IFRS 9.B7.2.3]*.

In order to determine the loss allowance on financial instruments initially recognised (or loan commitments or financial guarantee contracts to which the entity became a party to the contract) prior to the date of transition to IFRS accounting standards, both on the transition and until the derecognition of those items, an entity is required to consider information that is relevant in determining or approximating the credit risk at initial recognition. In order to determine or approximate the initial credit risk, an entity could consider internal and external information, including portfolio information, in accordance with IFRS 9.B5.5.1-B5.5.6 (see Chapter 47 at section 6). *[IFRS 9.B5.5.1-B5.5.6, IFRS 9.B7.2.3]*.

A first-time adopter is allowed to apply the following guidance to determine whether there has been a significant increase in credit risk since initial recognition: *[IFRS 1.B8F]*

(a) The requirements (on financial instruments determined to have low credit risk) in IFRS 9.5.5.10 and IFRS 9.B5.5.22-B5.5.24 (see Chapter 47 at section 6.4.1) *[IFRS 9.5.5.10, IFRS 9.B5.5.22, IFRS 9.B5.5.23, IFRS 9.B5.5.24]*

(b) The rebuttable presumption in IFRS 9.5.5.11 (that there has been a significant increase in credit risk since initial recognition) for contractual payments that are more than 30 days past due if an entity will apply the impairment requirements by identifying significant increases in credit risk since initial recognition for those financial instruments on the basis of past due information (see Chapter 47 at section 6.2.2) *[IFRS 9.5.5.11]*

A first-time adopter would not be required to determine whether there has been a significant increase in credit risk if that would require undue cost or effort. In such a case, IFRS 1.B8G requires a first-time adopter to recognise a loss allowance at an amount equal to lifetime expected credit losses at each reporting date until that financial instrument is derecognised (unless that financial asset is low credit risk at a reporting date, in which case, IFRS 1.B8F(a) applies and, consequently, the entity is allowed to assume that the credit risk has not increased significantly since initial recognition (see Chapter 47 at section 6.4.1)). *[IFRS 1.B8F(a), IFRS 1.B8G, IFRS 9.5.5.10, IFRS 9.B5.5.22-B5.5.24]*.

4.11 Embedded derivatives

When IFRS 9 requires an entity to separate an embedded derivative from a host contract, *[IFRS 9.4.3.3]*, the initial carrying amounts of the components at the date the instrument first satisfied the recognition criteria in IFRS 9 must reflect circumstances that existed at that date. If the initial carrying amounts of the embedded derivative and host contract cannot be determined reliably, the entire combined contract is designated at fair value through profit or loss. *[IFRS 1.IG55, IFRS 9.4.3.6]*.

IFRS 1.B9 requires a first-time adopter to assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative based on conditions that existed at the later of the date it first became a party to the contract and the date a reassessment is required by IFRS 9.B4.3.11. *[IFRS 1.B9, IFRS 9.B4.3.11]*. It should be noted that IFRS 9 does not permit embedded derivatives to be separated from host contracts that are financial assets (see Chapter 42 at section 3).

4.12 Government loans

It is common practice in certain countries for the government to grant loans to entities at below-market interest rates, for example, in order to promote economic development. A first-time adopter might not have recognised and measured such loans in its previous GAAP financial statements on a basis that complies with IFRS accounting standards. IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* requires such loans to be recognised initially at fair value with the effect of the below-market interest rate separately accounted for as a government grant (see Chapter 25 at section 3.4). *[IAS 20.10A]*.

The IASB has provided transition relief to first-time adopters in the form of an exception that requires the first-time adopter to classify government loans received as a financial liability or an equity instrument in accordance with IAS 32 *Financial Instruments: Presentation* and to apply the requirements in IFRS 9 and IAS 20 prospectively to government loans existing at the date of transition to IFRS accounting standards (except as permitted by IFRS 1.B11, which is discussed below). Therefore, a first-time adopter does not recognise the corresponding benefit of the government loan at a below-market rate of interest as a government grant. A first-time adopter that did not, under its previous GAAP, recognise and measure a government loan at a below-market rate of interest on a basis consistent with IFRS accounting standards requirements will instead use its previous GAAP carrying amount of the loan at the date of transition to IFRS accounting standards as the carrying amount of the loan in the opening IFRS statement of financial position and apply IFRS 9 to the measurement of such loans after the date of transition to IFRS accounting standards. *[IFRS 1.B10]*.

Alternatively, IFRS 1.B11 allows an entity to apply the requirements in IFRS 9 and IAS 20 retrospectively to any government loan originated before the date of transition to IFRS accounting standards, provided the information needed to do so had been obtained when it initially accounted for the loan under previous GAAP. *[IFRS 1.B11]*.

The requirements and guidance set out in IFRS 1.B10-B11 (which are discussed above) do not preclude an entity from using the exemptions in IFRS 1.D19-D19C to designate previously recognised financial instruments at fair value through profit or loss (see section 5.10 below). *[IFRS 1.B12, IFRS 1.D19, IFRS 1.D19A, IFRS 1.D19B, IFRS 1.D19C]*.

Illustration 4-6 below demonstrates the accounting for a government loan with a below-market interest rate that is not restated from its previous GAAP amount. *[IFRS 1.IG Example 12, IFRS 1.IG66]*.

Illustration 4-6: Government loan with below-market interest rate

A government provides loans at a below-market rate of interest to fund the purchase of manufacturing equipment.

Entity A's date of transition to IFRS accounting standards is 1 January 20X2.

In 20X0, Entity A received a loan of CU100,000 at a below-market rate of interest from the government. Under its previous GAAP, Entity A accounted for the loan as equity and the carrying amount was CU100,000 at the date of transition. The amount repayable at 1 January 20X5 will be CU103,030.

No other payment is required under the terms of the loan and there are no future performance conditions attached to it. The information needed to measure the fair value of the loan was not obtained at the time it was initially accounted for.

The loan meets the definition of a financial liability in accordance with IAS 32. Entity A therefore reclassifies it from equity to liability. It also uses the previous GAAP carrying amount of the loan at the date of transition as the carrying amount of the loan in the opening IFRS statement of financial position. It calculates the effective interest rate starting at 1 January 20X2 as 1% based on the carrying amount of the loan at the date of transition and the amount repayable at maturity. The opening balance of CU100,000 will accrete to CU103,030 at 31 December 20X4 and interest of CU1,000, CU1,010 and CU1,020 will be charged to interest expense in each of the three years ended 31 December 20X2, 20X3 and 20X4.

4.13 Insurance contracts

An entity must apply the transition provisions in IFRS 17.C1-C24 and IFRS 17.C28 to contracts within the scope of IFRS 17 *Insurance Contracts* (see Chapter 51 at section 17). The references in those paragraphs in IFRS 17 to 'the transition date' must be read as 'the date of transition to IFRS accounting standards'. *[IFRS 1.B13]*.

This is because the Board saw no reason to give different transition approaches to first-time adopters of IFRS accounting standards from other entities. This means that the Board has amended IFRS 1 to require use of the modified retrospective approach or the fair value approach in IFRS 17 when retrospective application of IFRS 17 is impracticable, as defined by IAS 8. However, the Board decided not to give any additional relief on the restatement of comparative amounts from that already in IFRS 1. *[IFRS 17.BC407]*.

4.14 Deferred tax related to leases and decommissioning, restoration and similar liabilities

IAS 12 *Income Taxes* provides an exception (known as the 'initial recognition exception') from recognising the deferred tax on temporary differences arising on initial recognition of an asset or liability in a transaction that (a) is not a business combination; (b) at the time of the transaction, affects neither accounting profit nor taxable profit (or tax loss); and (c) at the time of the transaction does not give rise to equal taxable and deductible temporary differences (see Chapter 29 at section 7.3). *[IAS 12.15, IAS 12.24]*.

For example, at the commencement date of a lease, a lessee typically recognises a lease liability and the corresponding amount as part of the cost of a right-of-use asset. Depending on the applicable tax law, equal taxable and deductible temporary differences could arise on initial recognition of the asset and liability in such a transaction. If so, the initial recognition exception does not apply and any resulting deferred tax liability and asset is recognised. *[IAS 12.22A]*. It is important to note that IAS 12.15(b)(iii) and IAS 12.24(c) refer to 'equal taxable and deductible temporary differences', rather than 'equal deferred tax assets and liabilities'. For example, the deferred tax assets and liabilities recognised could differ due to the application of different tax rates or because the deferred tax assets are not recoverable. *[IAS 12.BC86, IAS 12.BC88]*.

Retrospective application would require entities to retrospectively assess whether each lease and decommissioning obligation gave rise to equal taxable and deductible temporary differences on initial recognition, which might have occurred many years before. Instead, first-time adopters are required to recognise deferred tax for all temporary differences associated with leases and decommissioning obligations existing at the date of transition to IFRS accounting standards. *[IAS 12.BC95]*.

Therefore, notwithstanding the initial recognition exception in IAS 12.15 and IAS 12.24, at the date of transition to IFRS accounting standards, a first-time adopter must recognise a deferred tax asset (to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised) and a deferred tax liability for all deductible and taxable temporary differences associated with: *[IFRS 1.B14]*.

(a) Right-of-use assets and lease liabilities

(b) Decommissioning, restoration and similar liabilities and the corresponding amounts recognised as part of the cost of the related asset

However, the initial recognition exception still applies fully retrospectively to transactions other than leases and decommissioning obligations.

5 Optional exemptions from the requirements of certain IFRS accounting standards

5.1 Introduction

As noted in section 3.5 above, IFRS 1 grants limited optional exemptions from the general requirement of full retrospective application of the standards effective at the end of an entity's first IFRS reporting period. *[IFRS 1.7, IFRS 1.12(b)]*. Each of these exemptions, which are set out in Appendices C and D of IFRS 1, is explained in detail below.

5.2 Business combinations and acquisitions of associates and joint arrangements

The business combinations exemption in IFRS 1 is probably the single most important exemption in the standard, as it permits a first-time adopter not to restate business combinations that occurred prior to its date of transition to IFRS accounting standards. The detailed guidance on the application of the business combinations exemption is contained in Appendix C to IFRS 1 and is organised in the sections as follows: *[IFRS 1 Appendix C]*

(a) Scope of the business combinations exemption in IFRS 1 - and application of the exemption to acquisitions of associates and joint arrangements (see section 5.2.1 below)

(b) Option to restate business combinations retrospectively (see section 5.2.2 below)

(c) Classification of business combinations (see section 5.2.3 below)

(d) Assets and liabilities to be recognised in the opening IFRS statement of financial position (see section 5.2.4 below)

(e) Restatement of goodwill (see section 5.2.5 below)

(f) Currency adjustments to goodwill (see section 5.2.6 below)

(g) Previously unconsolidated subsidiaries (see section 5.2.7 below)

(h) Previously consolidated entities that are not subsidiaries (see section 5.2.8 below)

(i) Measurement of deferred taxes and non-controlling interests (see section 5.2.9 below)

(j) Transition accounting for contingent consideration (see section 5.2.10 below)

How we see it

In our view, the business combinations exemption applies only to business combinations that occurred before the date of transition to IFRS accounting standards and only to business combinations as defined under IFRS 3 (see section 5.2.1 below). Therefore, it does not apply to a transaction that, for example, IFRS accounting standards treat as an acquisition of an asset (see section 5.2.1.A below).

5.2.1 Scope of the business combinations exemption in IFRS 1

As noted above, the business combinations exemption applies only to business combinations as defined under IFRS 3. Therefore, a first-time adopter needs to consider whether past transactions would qualify as business combinations under IFRS 3 which defines a business combination as:

"A transaction or other event in which an **acquirer** obtains control of one or more **businesses**. Transactions sometimes referred to as 'true mergers' or 'mergers of equals' are also **business combinations** as that term is used in this IFRS." *[IFRS 3 Appendix A]*.

The definition of a business is "An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities." *[IFRS 3 Appendix A]*. In addition, IFRS 3.3 states that "**If the assets acquired are not a business, the reporting entity shall account for the transaction or other event as an asset acquisition.**" (See section 5.2.1.A below). *[IFRS 3.3]*. Distinguishing a business combination from an asset acquisition is described in detail in Chapter 10 at section 3.

In October 2012, the IASB issued *Investment Entities: Amendments to IFRS 10, IFRS 12 and IAS 27* (see section 5.8.5 below). Amongst other changes, the amendment also stated that Appendix C of IFRS 1, which deals with the business combinations exemption, is applied only to business combinations within the scope of IFRS 3. *[IFRS 1 Appendix C, IFRS 3.2A]*.

How we see it

In our view, the purpose of this change was to preclude the application of Appendix C to the acquisition by an investment entity, as defined in IFRS 10, of an investment in subsidiary that is required to be measured at fair value through profit or loss.

Therefore, we believe that the exemption is still available to transactions that meet the definition of a business combination under IFRS 3, even if the business combination is outside the scope of IFRS 3 (such as a combination of entities or businesses under common control).

However, the business combinations exemption does not apply to transactions which are not 'business combinations' as defined in IFRS 3 (even if the transactions were accounted for as business combinations under previous GAAP). Examples of transactions that are not business combinations would include asset acquisitions (see section 5.2.1.A below) or continuations (such as where a new holding company is inserted above an existing group). A first-time adopter which had such transactions under previous GAAP retrospectively applies IFRS accounting standards applicable to those transactions. If transactions which are not business combinations as defined in IFRS 3 are combinations of entities under common control, there is no specific guidance under IFRS accounting standards on accounting for them. We discuss this issue in Chapter 11 at sections 1.2, 1.3, 2 and 4.

5.2.1.A Asset acquisitions

Because IFRS 3 provides such a specific definition of a business combination (as described in Chapter 10 at section 3), it is possible that under some national GAAPs, transactions that are not business combinations under IFRS 3, e.g., asset acquisitions, could have been accounted for as if they were business combinations. If so, a first-time adopter will need to restate such transactions, as discussed in Illustration 5-1 below.

Illustration 5-1: Acquisition of assets

Entity A acquired a company that held a single asset at the time of acquisition. That company had no employees and the asset itself was not in use at the date of acquisition. Entity A accounted for the transaction under its previous GAAP using the purchase method, which resulted in goodwill. Can Entity A apply the business combinations exemption to the acquisition of this asset?

If Entity A concludes that the asset is not a business as defined in IFRS 3, it will not be able to apply the business combinations exemption. Instead, Entity A accounts for such transaction as an asset acquisition (see Chapter 10 at section 2.2.2). Entity A could consider applying other applicable optional exemptions under IFRS 1.

How we see it

If, in Illustration 5-1 above, the entity had accounted for the transaction as an asset acquisition rather than a business combination under previous GAAP, it would need to determine whether the transaction meets the definition of a business combination in IFRS 3 in order to qualify for use of the exemption.

5.2.1.B Associates and joint arrangements

Extract from IFRS 1

C5 The exemption for past business combinations also applies to past acquisitions of investments in associates, interests in joint ventures and interests in joint operations in which the activity of the joint operation constitutes a business, as defined in IFRS 3. Furthermore, the date selected for paragraph C1 applies equally for all such acquisitions.

IFRS 1 extends the exemption for past business combinations to past acquisitions of investments in associates, interests in joint ventures and interests in joint operations (in which the activity of the joint operation constitutes a business, as defined in IFRS 3). The date selected for the first restatement of business combinations will also be applied to the restatement of these other acquisitions. *[IFRS 1.C5]*.

5.2.2 Option to restate business combinations retrospectively

Extract from IFRS 1

C1 A first-time adopter may elect not to apply IFRS 3 retrospectively to past business combinations (business combinations that occurred before the date of transition to IFRSs). However, if a first-time adopter restates any business combination to comply with IFRS 3, it shall restate all later business combinations and shall also apply IFRS 10 from that same date. For example, if a first-time adopter elects to restate a business combination that occurred on 30 June 20X6, it shall restate all business combinations that occurred between 30 June 20X6 and the date of transition to IFRSs, and it shall also apply IFRS 10 from 30 June 20X6.

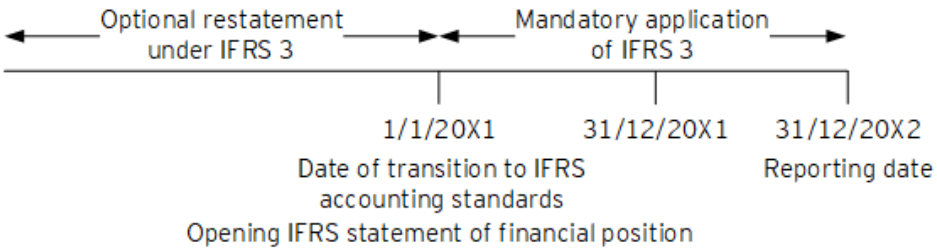
A first-time adopter must account for business combinations occurring after its date of transition to IFRS accounting standards under IFRS 3, i.e., any business combinations during the comparative periods presented need to be restated in accordance with IFRS 3. An entity accounts for a business combination under common control based on its accounting policy as determined under IFRS accounting standards (see Chapter 11 at section 3). This is because such transactions are outside the scope of IFRS 3. *[IFRS 3.2(c)]*.

A first-time adopter is allowed to elect not to apply IFRS 3 retrospectively to business combinations occurring before the date of transition to IFRS accounting standards. However, if a first-time adopter does restate a business combination occurring prior to its date of transition to IFRS accounting standards to comply with IFRS 3 it must also restate any subsequent business combinations under IFRS 3 and apply IFRS 10 from that date onwards. *[IFRS 1.C1]*. In other words, as shown on the timeline at Figure 5-1 below, a first-time adopter is allowed to choose any date in the past from which it wants to account for all business combinations under IFRS 3 and would not restate business combinations that occurred prior to such date. It must be noted that a first-time adopter availing itself of this option is required to apply the version of IFRS 3 effective at the end of its first IFRS reporting period to any retrospectively restated business combinations. *[IFRS 1.7]*.

Appendix C to IFRS 1 sets out the accounting consequences for business combinations not restated in accordance with IFRS 3 (see sections 5.2.3 to 5.2.10 below). *[IFRS 1.C2, IFRS 1.C3, IFRS 1.C4]*. However, the exemptions set out in IFRS 1.C2-C3 from applying IAS 21 to goodwill and fair value adjustments are also available for business combinations that are restated in accordance with IFRS 3. *[IFRS 1.C2, IFRS 1.C3]*. The various options for applying IAS 21 to goodwill and fair value adjustments are explained further in section 5.2.6 below.

If any pre-transition business combinations are restated, the first-time adopter must also apply IFRS 10's requirements on: the attribution of total comprehensive income to the owners of the parent and to the non-controlling interests; accounting for changes in the parent's ownership interest in a subsidiary without loss of control; and accounting for a loss of control of a subsidiary (and the related IFRS 5 requirements on classification of the disposal group as 'held for sale') from the date of the earliest business combination that is restated (see section 4.8 above). *[IFRS 1.B7, IFRS 1.C1]*.

Figure 5-1: Application of the optional business combination exemption



Even if a first-time adopter elects not to restate certain business combinations, it might still need to restate the carrying amounts of the acquired assets and assumed liabilities, as described in section 5.2.4 below.

How we see it

Although there is no restriction that prevents retrospective application by a first-time adopter of IFRS 3 to all past business combinations, in our view, a first-time adopter does not restate business combinations under IFRS 3 that occurred before the date of transition to IFRS accounting standards when this would require use of hindsight.

Practical example 5-1 below and Practical example 6-1 in section 6.3 below are examples of disclosures made by entities that opted not to restate business combinations that occurred before their date of transition to IFRS accounting standards, while Practical example 5-2 below illustrates disclosures by an entity that chose to restate certain business combinations that occurred prior to its date of transition to IFRS accounting standards.

Practical example 5-1: Husky Energy Inc. (2011) **Canada**

Consolidated Financial Statements [extract]

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]

Note 26 First-Time Adoption of International Financial Reporting Standards [extract]

Key First-Time Adoption Exemptions Applied

IFRS 1, "First-Time Adoption of International Financial Reporting Standards," allows first-time adopters certain exemptions from retrospective application of certain IFRSs.

The Company applied the following exemptions:

- IFRS 3, "Business Combinations," was not applied to acquisitions of subsidiaries or interests in joint ventures that occurred before January 1, 2010.

...

Notes to the Reconciliations of Equity and Comprehensive Income from Canadian GAAP to IFRS [extract]

i) IFRS 3 Adjustments – Business Combinations

Given that the Company elected to apply the IFRS 1 exemption which permits no adjustments to amounts recorded for acquisitions that occurred prior to January 1, 2010, no retrospective adjustments were required. The Company acquired the remaining interest in the Lloydminster Upgrader from the Government of Alberta in 1995 and is required to make payments to Natural Resources Canada and Alberta Department of Energy from 1995 to 2014 based on average differentials between heavy crude oil feedstock and the price of synthetic crude oil sales. Under IFRS, the Company is required to recognize this contingent consideration at its fair value as part of the acquisition and record a corresponding liability. Under Canadian GAAP, any contingent consideration was not required to be recognized unless amounts were resolved and payable on the date of acquisition. On transition to IFRS, Husky recognized a liability of $85 million, based on the fair value of remaining upside interest payments, with an adjustment to opening retained earnings. For the year ended December 31, 2010, the Company recognized pre-tax accretion of $9 million in finance expenses under IFRS. Changes in forecast differentials used to determine the fair value of the remaining upside interest payments resulted in the recognition of a pre-tax gain of $41 million for the year ended December 31, 2010.

The total impact of this change decreased (increased) retained earnings as follows:

Consolidated Statement of Comprehensive Income ($ millions)	2010
Increase in finance expenses	9
Decrease in other – net	(41)
Adjustment before income taxes	(32)

Consolidated Balance Sheets ($ millions)	January 1, 2010	December 31, 2010
Increase in other long-term liabilities	85	53
Decrease in retained earnings	85	53

Practical example 5-2: The Toronto-Dominion Bank (2011) Canada

2011 CONSOLIDATED FINANCIAL STATEMENTS AND NOTES [extract]

Notes to Consolidated Financial Statements [extract]

NOTE 34 TRANSITION TO IFRS [extract]

DESCRIPTION OF SIGNIFICANT MEASUREMENT AND PRESENTATION DIFFERENCES BETWEEN CANADIAN GAAP AND IFRS [extract]

(d) Business Combinations: Elective Exemption

As permitted under IFRS transition rules, the Bank has applied IFRS 3, *Business Combinations* (IFRS 3) to all business combinations occurring on or after January 1, 2007. Certain differences exist between IFRS and Canadian GAAP in the determination of the purchase price allocation. The most significant differences are described below.

Under Canadian GAAP, an investment in a subsidiary which is acquired through two or more purchases is commonly referred to as a "step acquisition". Each transaction is accounted for as a step-by-step purchase, and is recognized at the fair value of the net assets acquired at each step. Under IFRS, the accounting for step acquisitions differs depending on whether a change in control occurs. If change in control occurs, the acquirer remeasures any previously held equity investment at its acquisition-date fair value and recognizes any resulting gain or loss in the Consolidated Statement of Income. Any transactions subsequent to obtaining control are recognized as equity transactions.

Under Canadian GAAP, shares issued as consideration are measured at the market price over a reasonable time period before and after the date the terms of the business combination are agreed upon and announced. Under IFRS, shares issued as consideration are measured at their market price on the closing date of the acquisition.

Under Canadian GAAP, an acquirer's restructuring costs to exit an activity or to involuntarily terminate or relocate employees are recognized as a liability in the purchase price allocation. Under IFRS, these costs are generally expensed as incurred and not included in the purchase price allocation.

Under Canadian GAAP, costs directly related to the acquisition (i.e., finder fees, advisory, legal, etc.) are included in the purchase price allocation, while under IFRS these costs are expensed as incurred and not included in the purchase price allocation.

Under Canadian GAAP, contingent consideration is recorded when the amount can be reasonably estimated at the date of acquisition and the outcome is determinable beyond reasonable doubt, while under IFRS contingent consideration is recognized immediately in the purchase price equation at fair value and marked to market as events and circumstances change in the Consolidated Statement of Income.

The impact of the differences between Canadian GAAP and IFRS to the Bank's IFRS opening Consolidated Balance Sheet is disclosed in the table below.

Business Combinations: Elective Exemption

(millions of Canadian dollars)		*As at* Nov. 1, 2010
Increase/(decrease) in assets:		
Available-for-sale securities	$	(1)
Goodwill		(2,147)
Loans – residential mortgages		22
Loans – consumer instalment and other personal		–
Loans – business and government		–
Intangibles		(289)
Land, buildings and equipment and other depreciable assets		2
Deferred tax assets		(12)
Other assets		104
(Increase)/decrease in liabilities:		
Deferred tax liabilities		102
Other liabilities		37
Subordinated notes and debentures		2
Increase/(decrease) in equity	$	(2,180)

The total impact of business combination elections to the Bank's IFRS opening equity was a decrease of $2,180 million, comprised of a decrease to common shares of $926 million, a decrease to contributed surplus of $85 million and a decrease to retained earnings of $1,169 million.

5.2.3 Classification of business combinations

IFRS 3 mandates a business combination to be accounted for either as an acquisition or reverse acquisition. *[IFRS 3.4, IFRS 3.5(a), IFRS 3.6, IFRS 3.B19]*. An entity's previous GAAP could be based on a different definition of, for example, a business combination, an acquisition, a uniting of interests (or merger) or a reverse acquisition.

An important benefit of the exemption not to apply IFRS 3 retrospectively to pre-transition business combinations is that a first-time adopter keeps the same classification (as in its previous GAAP financial statements) for business combinations not restated under IFRS 3, *[IFRS 1.C4(a)]*. For example, a business combination that was accounted for as a merger (or uniting of interests) using the pooling of interests method under an entity's previous GAAP is not reclassified and accounted for under the acquisition method. Similarly, a business combination that was accounted for as an acquisition by the legal acquirer under the entity's previous GAAP continues to be classified as such even if it would be accounted for as a reverse acquisition by the acquiree under IFRS 3.

However, an entity could still elect to restate pre-transition business combinations retrospectively in accordance with IFRS 3, if it so wishes without using hindsight (see section 5.2.2 above). *[IFRS 1.C1]*.

5.2.3.A Business combinations under common control

As discussed in section 5.2.1 above, we believe that Appendix C of IFRS 1 applies to a business combination under common control, provided it meets the definition of a business combination under IFRS 3, even though it is outside of the scope of IFRS 3. *[IFRS 1 Appendix C, IFRS 3.B1]*. Therefore, a first-time adopter could use the exemption to not restate a business combination under common control occurring before the date of transition to IFRS accounting standards retrospectively. If a first-time adopter does not apply the exemption, it accounts for a business combination under common control based on its IFRS accounting policy, as discussed in Chapter 11 at section 3.

Illustration 5-2: Business combination under common control

Entity B, which is a first-time adopter under IFRS accounting standards, acquired Entity C in a business combination under common control that it accounted for as a pooling of interests under its previous GAAP prior to the date of transition to IFRS accounting standards. Entity B has the option to elect to use the business combinations exemption.

Case 1: Entity B uses the business combinations exemption

Entity B is required to apply the same classification as in its previous GAAP financial statements in accordance with IFRS 1.C4(a). *[IFRS 1.C4(a)]*. Entity B must also follow all of the other provisions of IFRS 1.C4. *[IFRS 1.C4]*.

Case 2: Entity B does not use the business combinations exemption

Entity B accounts for the business combination applying the accounting policy it has chosen for such business combinations under IFRS accounting standards. If Entity B applies the acquisition method to business combinations involving entities under common control (where the transaction has substance - see Chapter 11 at section 3.1), the business combination would be retrospectively restated in accordance with IFRS 3. Conversely, if the Entity B's accounting policy for such business combinations is to use the pooling of interests method, the business combination would be retrospectively restated if there were differences between the accounting treatment under previous GAAP compared to the accounting policy adopted under IFRS accounting standards in applying the pooling of interests method.

5.2.4 Assets and liabilities to be recognised in the opening IFRS statement of financial position

Extract from IFRS 1

C4 If a first-time adopter does not apply IFRS 3 retrospectively to a past business combination, this has the following consequences for that business combination:

(a) …

(b) The first-time adopter shall recognise all its assets and liabilities at the date of transition to IFRSs that were acquired or assumed in a past business combination, other than:

(i) some financial assets and financial liabilities derecognised in accordance with previous GAAP (see paragraph B2); and

(ii) assets, including goodwill, and liabilities that were not recognised in the acquirer's consolidated statement of financial position in accordance with previous GAAP and also would not qualify for recognition in accordance with IFRSs in the separate statement of financial position of the acquiree (see (f)-(i) below).

The first-time adopter shall recognise any resulting change by adjusting retained earnings (or, if appropriate, another category of equity), unless the change results from the recognition of an intangible asset that was previously subsumed within goodwill (see (g)(i) below).

(c) …

In its opening IFRS statement of financial position, a first-time adopter is required to recognise all assets acquired and liabilities assumed in a past business combination, with the exception of: *[IFRS 1.C4(b)]*

- Certain financial assets and liabilities that were derecognised in accordance with previous GAAP and that fall under the derecognition exception (see section 4.3 above) *[IFRS 1.B2]*
- Assets (including goodwill) and liabilities that were not recognised in the acquirer's consolidated statement of financial position under its previous GAAP and that also would not qualify for recognition under IFRS accounting standards in the separate statement of financial position of the acquiree (see section 5.2.4.B and Illustration 5-4 below) *[IFRS 1.C4(f), IFRS 1.C4(g), IFRS 1.C4(h), IFRS 1.C4(i)]*

The entity must exclude items it recognised under its previous GAAP that do not qualify for recognition as an asset or liability under IFRS accounting standards (see section 5.2.4.A and Illustration 5-3 below).

5.2.4.A Assets and liabilities to be excluded

Extract from IFRS 1

C4 If a first-time adopter does not apply IFRS 3 retrospectively to a past business combination, this has the following consequences for that business combination:

(a) ...

(c) The first-time adopter shall exclude from its opening IFRS statement of financial position any item recognised in accordance with previous GAAP that does not qualify for recognition as an asset or liability under IFRSs. The first-time adopter shall account for the resulting change as follows:

(i) the first-time adopter may have classified a past business combination as an acquisition and recognised as an intangible asset an item that does not qualify for recognition as an asset in accordance with IAS 38 *Intangible Assets*. It shall reclassify that item (and, if any, the related deferred tax and non-controlling interests) as part of goodwill (unless it deducted goodwill directly from equity in accordance with previous GAAP, see (g)(i) and (i) below).

(ii) the first-time adopter shall recognise all other resulting changes in retained earnings.[2]

(d) ...

2 Such changes include reclassifications from or to intangible assets if goodwill was not recognised in accordance with previous GAAP as an asset. This arises if, in accordance with previous GAAP, the entity (a) deducted goodwill directly from equity or (b) did not treat the business combination as an acquisition.

If the first-time adopter recognised under its previous GAAP items that do not qualify for recognition under IFRS accounting standards, these must be excluded from the opening IFRS statement of financial position.

An intangible asset, acquired as part of a business combination, that does not qualify for recognition as an asset under IAS 38 is required to be derecognised along with the related deferred tax and non-controlling interests (if any), with an offsetting change to goodwill, unless the entity previously deducted goodwill directly from equity under its previous GAAP (see section 5.2.5 below).

All other changes resulting from derecognition of such assets and liabilities are accounted for as adjustments of retained earnings or another category of equity, if appropriate. *[IFRS 1.C4(c)]*. For example:

- Any restructuring provisions recognised under previous GAAP and which remain at the date of transition to IFRS accounting standards will need to be assessed against the IFRS recognition criteria. If the criteria are not met, then the provisions must be reversed against retained earnings.
- If an entity has deferred transaction costs (for which the services were received) relating to a business combination that has not been finalised under previous GAAP at the date of transition to IFRS accounting standards, these deferred transaction costs would need to be recognised in retained earnings as they do not qualify for deferral under IFRS accounting standards.
- Assets and liabilities of a structured entity required to be consolidated under previous GAAP but that does not qualify for consolidation under IFRS 10 would be deconsolidated.

Illustration 5-3 below, which is based on one within the implementation guidance in IFRS 1, illustrates the exclusion of a restructuring provision that did not comply with IFRS accounting standards from the opening statement of financial position. *[IFRS 1.IG Example 3]*.

Illustration 5-3: Restructuring provision

Background

Entity D's first IFRS financial statements are for a period that ends on 31 December 20X3 and include comparative information for 20X2 only. It chooses not to restate previous business combinations under IFRS 3. On 1 July 20X1, Entity D acquired 100% of Entity E. Under its previous GAAP, Entity D recognised an (undiscounted) restructuring provision of CU100 that would not have qualified as an identifiable liability under IFRS 3. The recognition of this restructuring provision increased goodwill by CU100. At 1 January 20X2 (date of transition to IFRS accounting standards), Entity D:

(a) Had paid restructuring costs of CU60

(b) Estimated that it would pay further costs of CU40 in 20X2 and that the effects of discounting were immaterial. At 1 January 20X2, those further costs did not qualify for recognition as a provision under IAS 37.

This Illustration ignores any income tax effects of the adjustments.

Application of requirements

In its opening IFRS statement of financial position, Entity D:

(a) Does not recognise a restructuring provision in respect of the outstanding CU40 provision under previous GAAP. The adjustment is recognised in retained earnings. *[IFRS 1.C4(c)]*.

(b) Does not adjust the amount assigned to goodwill. However, Entity D tests the goodwill for impairment under IAS 36 and recognises any resulting impairment loss as an adjustment to retained earnings. *[IFRS 1.C4(g)]*.

5.2.4.B Recognition of assets and liabilities

Extract from IFRS 1

C4 If a first-time adopter does not apply IFRS 3 retrospectively to a past business combination, this has the following consequences for that business combination:

(a) ...

(f) If an asset acquired, or liability assumed, in a past business combination was not recognised in accordance with previous GAAP, it does not have a deemed cost of zero in the opening IFRS statement of financial position. Instead, the acquirer shall recognise and measure it in its consolidated statement of financial position on the basis that IFRSs would require in the statement of financial position of the acquiree. ...

(g) ...

For example, if the acquirer had not recognised an assumed provision under its previous GAAP that still exists at the date of transition to IFRS accounting standards, the acquirer recognises that provision at that date unless IAS 37 would prohibit its recognition in the financial statements of the acquiree. *[IFRS 1.C4(f), IAS 37.27]*.

The change resulting from the recognition of such assets and liabilities is accounted for as an adjustment of retained earnings or another category of equity, if appropriate. However, if the change results from the recognition of an intangible asset that was previously subsumed within goodwill, it is accounted for as an adjustment of that goodwill (and of the related deferred tax and non-controlling interests, if any) (see section 5.2.5 below). *[IFRS 1.C4(b), IFRS 1.C4(g)(i), IFRS 1.C4(k)]*.

How we see it

Intangible assets acquired as part of a business combination that were not recognised under a first-time adopter's previous GAAP will rarely be recognised in the opening IFRS statement of financial position because either: (1) they cannot be capitalised in the acquiree's own statement of financial position under IAS 38; or (2) capitalisation would require the use of hindsight which is not permitted under IAS 38 (see section 7.14 below).

Illustration 5-4 below discusses some examples in which certain assets were not recognised under previous GAAP.

Illustration 5-4: Items not recognised under previous GAAP

Entity F acquired Entity G but did not recognise Entity G's right-of-use assets and internally generated customer lists under its previous GAAP.

Upon first-time adoption of IFRS accounting standards, Entity F recognises the right-of-use assets in its opening IFRS statement of financial position using the amounts that Entity G would recognise in its separate statement of financial position. The resulting adjustment to the net assets at the date of transition is reflected in retained earnings; goodwill is not restated to reflect the net assets that would have been recognised at the date of acquisition (see section 5.2.5 below). However, Entity F does not recognise the customer lists in its opening IFRS statement of financial position, because Entity G is not permitted to capitalise internally generated customer lists under IAS 38. Any value that might have been attributable to the customer lists would remain subsumed in goodwill in Entity F's opening IFRS statement of financial position. *[IFRS 1.C4(b)(ii), IFRS 1.C4(f)]*.

Entity H acquired Entity I but did not recognise Entity I's brand name as a separate intangible asset under its previous GAAP.

Upon first-time adoption of IFRS accounting standards, Entity H will not recognise Entity I's brand name in its opening IFRS statement of financial position because Entity I would not have been permitted under IAS 38 to recognise it as an asset in its own separate statement of financial position. Again, any value that might have been attributable to the brand name would remain subsumed in goodwill in Entity H's opening IFRS statement of financial position. *[IFRS 1.C4(b)(ii), IFRS 1.C4(f)]*.

Illustration 5-5 below, which is based on one within the implementation guidance in IFRS 1, illustrates the capitalisation of leases that would be required under IFRS 16 *Leases*, but were not capitalised under the previous GAAP. *[IFRS 1.IG Example 7]*.

Illustration 5-5: Lease in which the acquiree was a lessee not capitalised in accordance with previous GAAP

Entity J's date of transition to IFRS accounting standards is 1 January 20X2. Entity J acquired Entity K on 15 January 20X0 and did not capitalise leases in which Entity K was a lessee. If Entity K prepared financial statements in accordance with IFRS accounting standards, it would recognise lease liabilities of CU300,000 and right-of-use assets of CU250,000 at 1 January 20X2. This Illustration ignores any income tax effects of the adjustments.

Entity J has elected not to apply the transition reliefs in IFRS 1.D9 and IFRS 1.D9B to D9E. *[IFRS 1.D9, IFRS 1.D9B, IFRS 1.D9C, IFRS 1.D9D, IFRS 1.D9E]*. In its consolidated opening IFRS statement of financial position, Entity J recognises lease liabilities of CU300,000 and right-of-use assets of CU250,000, and charges CU50,000 to retained earnings. *[IFRS 1.C4(b)(ii), IFRS 1.C4(f)]*.

5.2.4.C Previous GAAP carrying amount as deemed cost

Extract from IFRS 1

C4 If a first-time adopter does not apply IFRS 3 retrospectively to a past business combination, this has the following consequences for that business combination:

(a) ...

(e) Immediately after the business combination, the carrying amount in accordance with previous GAAP of assets acquired and liabilities assumed in that business combination shall be their deemed cost in accordance with IFRSs at that date. If IFRSs require a cost-based measurement of those assets and liabilities at a later date, that deemed cost shall be the basis for cost-based depreciation or amortisation from the date of the business combination.

(f) ...

IFRS 1 does not specifically define 'immediately after the business combination', but it is commonly understood that this takes account of the final determination of the purchase price allocation and final completion of purchase accounting. In other words, a first-time adopter would not use the provisionally determined fair values of assets acquired and liabilities assumed in applying the business combinations exemption, as explained in Illustration 5-6 below. *[IFRS 1.C4(e)]*.

Illustration 5-6: Provisionally determined fair values

Entity L acquired Entity M in August 20X1 and made a provisional assessment of Entity M's identifiable net assets in its 31 December 20X1 consolidated financial statements under its previous GAAP. In its 31 December 20X2 consolidated financial statements - its last financial statements under previous GAAP - Entity L completed the initial accounting for the business combination and adjusted the provisional values of the identifiable net assets and the corresponding goodwill. Upon first-time adoption of IFRS accounting standards, Entity L elects not to restate past business combinations in accordance with IFRS 3.

In preparing its opening IFRS statement of financial position as of 1 January 20X2, Entity L uses the adjusted carrying amounts of the identifiable net assets as determined in its 20X2 financial statements as the deemed cost at the date of the business combination rather than the provisional carrying amounts of the identifiable net assets and goodwill shown in the 20X1 financial statements.

IFRS 1 is silent as to whether the relevant carrying amounts of the identifiable net assets and goodwill are those that appeared in the financial statements drawn up immediately before the date of transition to IFRS accounting standards or any restated balance appearing in a later set of previous GAAP accounts.

How we see it

Since the adjustments that were made to provisional fair values of the identifiable net assets and goodwill under previous GAAP effectively resulted in a restatement of the balances at the date of transition to IFRS accounting standards in a manner that is consistent with the approach permitted by IFRS accounting standards, it is, in our view, appropriate to reflect those adjustments in the opening IFRS statement of financial position. Moreover, this remains the case even if such adjustments to goodwill and the identifiable net assets at the acquisition date would have been made prospectively under previous GAAP rather than restating prior periods as would be required under IFRS 3.

Since the adjustments are effectively made as at the date of transition to IFRS accounting standards, it is also appropriate to use the window period permitted by previous GAAP provided that this does not extend into the first IFRS reporting period. This is because any restatements in that period can only be made in accordance with IFRS 3. In effect, the phrase 'immediately after the business combination' in IFRS 1.C4(e) is interpreted as including a window period allowed by the previous GAAP that ends at the earlier of the end of the window period and the beginning of the first IFRS reporting period.

Although the use of cost-based measurements under previous GAAP might be considered inconsistent with the requirements of IFRS accounting standards for assets and liabilities that were not acquired in a business combination, the IASB did not identify any situations in a business combination in which it would not be acceptable to bring forward cost-based measurements made under previous GAAP. *[IFRS 1.BC36]*. For example, assume an entity that adopts IFRS accounting standards with a date of transition to IFRS accounting standards of 1 January 20X2 and, as required, applies IFRS 3 to business combinations occurring on or after 1 January 20X2. Under the entity's previous GAAP, it acquired a business in 20X0 and the purchase accounting resulted in negative goodwill. At that time, the negative goodwill was eliminated by reducing the amounts assigned to long-lived assets (PP&E and intangible assets) on a *pro rata* basis. In this situation, the negative goodwill adjustment to PP&E and intangible assets is 'grandfathered' and is not adjusted in the opening IFRS statement of financial position. The negative goodwill adjustment to PP&E and intangible assets was part of the original purchase accounting and is not a subsequent measurement difference between completing the purchase price allocation and 1 January 20X2 and therefore the adjustment forms part of the deemed cost of PP&E and intangible assets.

By contrast, if under previous GAAP, the entity had recognised amortisation of intangible assets from the date of acquisition in a way that was not in compliance with IAS 38, it is not 'grandfathered' under the business combination exemption. The amortisation therefore is amended to the amount that complies with IFRS accounting standards on transition, as explained in Illustration 5-7 below (note that the adjusted carrying amount is also required to be tested for impairment if there are impairment indicators pursuant to the requirements of IAS 36 at the date of transition; see section 7.12 below). *[IFRS 1.C4(c), IFRS 1.BC37]*.

Illustration 5-7: Items measured on a cost basis

Entity N applies the business combination exemption under IFRS 1. In a business combination Entity N acquired property, plant and equipment, inventory and accounts receivable. Under its previous GAAP, Entity N initially measured these assets at cost (i.e., their fair values at the date originally acquired).

Upon adoption of IFRS accounting standards, Entity N determines that its accounting policy for these assets under its previous GAAP complied with the requirements of IFRS accounting standards. Therefore, property, plant and equipment, inventory and accounts receivable are not adjusted but recognised in the opening IFRS statement of financial position at their carrying amounts under the previous GAAP.

In addition to the above, Entity N recognised a brand name as an intangible asset acquired in the business combination under its previous GAAP. Entity N initially measured the intangible asset at its cost of CU100 and amortised it over a period of 10 years (being the maximum period of amortisation under previous GAAP). The intangible asset had a carrying amount of CU80 at the date of transition to IFRS accounting standards under its previous GAAP. The intangible asset is not amortised in accordance with IAS 38, as it was concluded that it has an indefinite useful life. There are no indicators of impairment and the intangible asset's recoverable amount exceeds CU100.

Entity N recognises the intangible asset at its original cost under its previous GAAP of CU100 in the opening IFRS statement of financial position (reflecting the fact that under IAS 38, the intangible asset would not have been amortised since it had an indefinite life). The subsequent measurement not in accordance with IFRS accounting standards is not reflected.

5.2.4.D In-process research and development

IFRS 1 makes it clear that in-process research and development (IPR&D) that was included within goodwill under an entity's previous GAAP is not recognised separately upon transition to IFRS accounting standards unless it qualifies for recognition under IAS 38 in the statement of financial position of the acquiree. *[IFRS 1.C4(h)(i)]*. However, IFRS 1 is silent on the treatment of IPR&D that was identified separately by an entity under the business combinations accounting standard of its previous GAAP, but which was immediately written off to profit or loss.

There are two possible scenarios as follows:

(a) If previous GAAP required IPR&D to be written off as an integral part of the business combination accounting under that GAAP then the carrying amount of IPR&D 'immediately after the business combination' would be zero.

(b) If that write-off was not an integral part of the business combination accounting (e.g., the previous GAAP merely required accelerated amortisation) then the carrying amount 'immediately after the business combination' would be the amount allocated to IPR&D by the business combinations standard under previous GAAP.

How we see it

While we understand that there could be different views, it is our view that IFRS 1 does not allow reinstatement of the amount of IPR&D previously written off, where previous GAAP required IPR&D to be written off as an integral part of the business combination accounting (scenario (a) above).

On the other hand, where the write-off of IPR&D under previous GAAP was not an integral part of the business combination (scenario (b) above), we believe that reinstatement of the amount of IPR&D that was written off is appropriate.

The above distinction could be largely irrelevant if the business combination took place several years before the transition to IFRS accounting standards because, in practice, the IPR&D could have been amortised fully or impaired before the date of transition.

5.2.4.E Subsequent measurement under IFRS accounting standards not based on cost

IFRS accounting standards require subsequent measurement of some assets and liabilities on a basis other than original cost, such as fair value for certain financial instruments or on specific measurement bases for share-based payments (IFRS 2) and employee benefits (IAS 19). Even if a first-time adopter does not apply IFRS 3 retrospectively to a business combination, such assets and liabilities must be measured on that other basis in its opening IFRS statement of financial position. Any change in the carrying amount of those assets and liabilities is accounted for as an adjustment of retained earnings, or other appropriate category of equity, rather than as an adjustment of goodwill. *[IFRS 1.C4(d)]*. Illustration 5-8 below discusses the treatment of assets measured at fair value under IFRS accounting standards.

Illustration 5-8: Items not measured at original cost

Entity O acquired in a business combination a trading portfolio of equity securities and a number of investment properties. Under its previous GAAP, Entity O initially measured these assets at historical cost (i.e., at their fair values at the date of original acquisition).

Upon adoption of IFRS accounting standards, Entity O measures the trading portfolio of equity securities and the investment properties at fair value in its opening IFRS statement of financial position. The resulting adjustment to these assets at the date of transition is reflected in retained earnings.

5.2.4.F Illustration of recognition and measurement requirements

Illustration 5-9 below, which is based on one within the implementation guidance in IFRS 1, demonstrates many of the requirements discussed above. *[IFRS 1.IG Example 2]*.

Illustration 5-9: Business combination example

Background

Entity P's first IFRS financial statements are for a reporting period that ends on 31 December 20X3 and include comparative information for 20X2 only. On 1 July 20X0, Entity P acquired 100% of Entity Q. Under its previous GAAP, Entity P:

(a) Classified the business combination as an acquisition by Entity P

(b) Measured the assets acquired and liabilities assumed at the following amounts under previous GAAP at 1 January 20X2 (date of transition to IFRS accounting standards)

  (i) Identifiable assets less liabilities for which IFRS accounting standards require cost-based measurement at a date after the business combination: CU200 (with a tax base of CU150 and an applicable tax rate of 30%)

  (ii) Pension liability (for which the present value of the defined benefit obligation measured under IAS 19 is CU130 and the fair value of plan assets is CU100): CUnil (because Entity P used a pay-as-you-go cash method of accounting for pensions under its previous GAAP). The tax base of the pension liability is also CUnil

  (iii) Goodwill: CU180

(c) Did not, at the date of acquisition, recognise deferred tax arising from temporary differences associated with the identifiable assets acquired and liabilities assumed

Application of requirements

In its opening (consolidated) IFRS statement of financial position, Entity P decides to apply the business combination exemption and as a result:

(i) Classifies the business combination as an acquisition by Entity P even if the business combination would have qualified under IFRS 3 as a reverse acquisition by Entity Q. *[IFRS 1.C4(a)]*.

(ii) Does not adjust the accumulated amortisation of goodwill. Entity P tests the goodwill for impairment under IAS 36 and recognises any resulting impairment loss, based on conditions that existed at the date of transition to IFRS accounting standards. If no impairment exists, the carrying amount of the goodwill remains at CU180. *[IFRS 1.C4(g)]*.

(iii) For those net identifiable assets acquired for which IFRS accounting standards require cost-based measurement at a date after the business combination, treats their carrying amount under previous GAAP immediately after the business combination as their deemed cost at that date. *[IFRS 1.C4(e)]*.

(iv) Does not restate the accumulated depreciation and amortisation of the net identifiable assets in (iii) above, unless the depreciation methods and rates under previous GAAP result in amounts that differ materially from those required under IFRS accounting standards (for example, if they were adopted solely for tax purposes and do not reflect a reasonable estimate of the asset's useful life under IFRS accounting standards). If no such restatement is made, the carrying amount of those assets in the opening IFRS statement of financial position equals their carrying amount under previous GAAP at the date of transition to IFRS accounting standards (CU200). *[IFRS 1.IG7]*.

(v) If there is any indication that identifiable assets are impaired, tests those assets for impairment, under IAS 36, based on conditions that existed at the date of transition to IFRS accounting standards (see section 7.12 below).

(vi) Recognises the pension liability, and measures it, at the present value of the defined benefit obligation (CU130) less the fair value of the plan assets (CU100), giving a carrying amount of CU30, with a corresponding debit of CU30 to retained earnings. *[IFRS 1.C4(d)]*.

(vii) Recognises a net deferred tax liability of CU6 (CU20 at 30%) arising from:

  (a) The taxable temporary difference of CU50 (CU200 less CU150) associated with the identifiable assets acquired and non-pension liabilities assumed

  Less

  (b) The deductible temporary difference of CU30 (CU30 less CUnil) associated with the pension liability

  Entity P recognises the resulting increase in the deferred tax liability as a deduction from retained earnings. *[IFRS 1.C4(b), IFRS 1.C4(k)]*. If a taxable temporary difference arises from the initial recognition of the goodwill, Entity P does not recognise the resulting deferred tax liability. *[IAS 12.15(a)]*.

5.2.5 Restatement of goodwill

Under the business combinations exemption, a first-time adopter takes the carrying amount of goodwill under its previous GAAP at the date of transition to IFRS accounting standards as a starting point and only adjusts it as follows: *[IFRS 1.C4(g)]*

(a) Goodwill is increased by the carrying amount of any intangible asset acquired in a business combination under its previous GAAP (less any related deferred tax and non-controlling interests) that does not meet the recognition criteria under IFRS accounting standards. The first-time adopter accounts for the change in classification prospectively and does not, for example, reverse the cumulative amortisation on the item that it recognised as an intangible asset under its previous GAAP (see section 5.2.4.A above). *[IFRS 1.C4(c)(i), IFRS 1.C4(k)]*.

(b) Goodwill is decreased if a first-time adopter is required to recognise an intangible asset under IFRS accounting standards that was subsumed in goodwill under its previous GAAP. It adjusts deferred tax and non-controlling interests accordingly (see section 5.2.4.B above). *[IFRS 1.C4(b)(ii), IFRS 1.C4(f), IFRS 1.C4(k)]*.

(c) Goodwill must be tested for impairment at the date of transition to IFRS accounting standards in accordance with IAS 36 regardless of whether there is any indication that the goodwill could be impaired (see Chapter 21 at section 2); any resulting impairment loss is recognised in retained earnings unless IAS 36 requires it to be recognised in a revaluation surplus (see Chapter 21 at section 11). The impairment test must be based on conditions at the date of transition to IFRS accounting standards.

Application of the above guidance can sometimes be more complicated than expected as is shown in Illustration 5-10 below.

Illustration 5-10: Recognition and derecognition of acquired intangible assets

Before its date of transition to IFRS accounting standards, Entity R acquired an online retailer, Entity S. Under its previous GAAP, Entity R recognised an intangible asset of CU1,200 related to 'deferred marketing costs', which does not meet the recognition criteria under IFRS accounting standards. Entity R also acquired customer relationships with a fair value of CU900 that do meet the recognition criteria under IFRS 3, but which it did not recognise as an intangible asset under its previous GAAP.

Upon adoption of IFRS accounting standards, Entity R is required to derecognise the 'deferred marketing costs' intangible asset and increase the carrying amount of goodwill for a corresponding amount. It also adjusts deferred tax and non-controlling interests accordingly (with a corresponding adjustment to goodwill). *[IFRS 1.C4(c)(i), IFRS 1.C4(g)(i), IFRS 1.C4(k)]*. Nevertheless, the customer relationship intangible asset that is subsumed in goodwill cannot be recognised as its carrying amount in the statement of financial position of the acquiree, Entity S, would have been nil under IFRS accounting standards and therefore remains subsumed within goodwill. *[IFRS 1.C4(b)(ii), IFRS 1.C4(g)(i), IFRS 1.C4(f)]*.

In economic terms it might be contended that the 'deferred marketing costs' intangible asset in the Illustration above comprises the value that would have been attributable under IFRS accounting standards to the acquired customer relationships. However, unless Entity R concluded that not recognising the customer relationship intangible asset was an error under its previous GAAP, it would not be able to recognise the customer relationship intangible asset upon adoption of IFRS accounting standards.

Under IFRS 1, assets acquired and liabilities assumed in a business combination prior to the date of transition to IFRS accounting standards are not necessarily valued on a basis that is consistent with IFRS accounting standards. This can lead to 'double counting' in the carrying amount of assets and goodwill as is shown in Illustration 5-11 below.

Illustration 5-11: Impairment testing of goodwill on first-time adoption

Entity T acquired a business before its date of transition to IFRS accounting standards. The cost of acquisition was CU530 and Entity T allocated the purchase price as follows:

	CU
Properties, at carry-over cost	450
Liabilities, at amortised cost	(180)
Goodwill	260
Purchase price	**530**

The goodwill under Entity T's previous GAAP relates entirely to the properties that had a fair value at the date of acquisition that was significantly in excess of their value on a carry-over cost basis. In Entity T's opening IFRS statement of financial position the same assets, liabilities and goodwill are valued as follows:

	CU
Properties, at fair value	750
Liabilities, at amortised cost	(180)
Provisional IFRS goodwill (before impairment test)	260
Total carrying amount	**830**

Entity T used the option to measure the properties at fair value at its date of transition in its opening IFRS statement of financial position. *[IFRS 1.D5]*. However, IFRS 1 does not permit goodwill to be adjusted to reflect the extent to which the increase in fair value relates to other assets recognised at the time of the acquisition. The total carrying amount of the acquired net assets including goodwill of CU830 might now exceed the recoverable amount. When Entity T tests the 'provisional IFRS goodwill' for impairment on first-time adoption of IFRS accounting standards, the recoverable amount of the business is determined to be CU620. Accordingly, it will have to recognise an impairment of goodwill of CU210 and disclose this impairment under IFRS 1. *[IFRS 1.C4(g)(ii), IFRS 1.24(c)]*.

In some cases, the write-off will completely eliminate the goodwill and thereby any 'double counting'. However, in this particular case, the remaining goodwill of CU50 in truth represents goodwill that was internally generated between the date of acquisition and the date of transition to IFRS accounting standards.

The IASB accepted that IFRS 1 does not prevent the implicit recognition of internally generated goodwill that arose after the date of the business combination. It concluded that attempts to exclude such internally generated goodwill would be costly and lead to arbitrary results. *[IFRS 1.BC39]*.

The business combinations exemption also applies to associates, interests in joint ventures and interests in joint operations (in which the activity of the joint operation constitutes a business, as defined in IFRS 3) (see section 5.2.1.B above). *[IFRS 1.C5]*.

However, IAS 28 *Investments in Associates and Joint Ventures* states the goodwill that forms part of the carrying amount of the net investment in an associate or interest in a joint venture is not tested for impairment separately by applying the requirements for impairment testing goodwill in IAS 36. Instead, the entire carrying amount of the investment is tested for impairment in accordance with IAS 36 as a single asset. *[IAS 28.42]*.

How we see it

In our view, investments in associates and joint arrangements are tested for impairment as at the date of transition to IFRS accounting standards if they include an element of goodwill. However, the goodwill embedded in the amount of an investment in an associate or an interest in a joint venture will not be subject to a separate impairment test. Rather the entire carrying amount of the investment is tested for impairment following the requirements of IAS 36.

In some cases, there might have been an impairment of an investment in an associate or joint venture accounted using the equity method under previous GAAP.

How we see it

In testing the investment in an associate or joint venture for impairment as at the date of transition to IFRS accounting standards, in our view, an investor does not reverse a previous GAAP impairment that was recognised separately on the notional goodwill element embedded in the investment. However, if the previous GAAP impairment had been recognised as a reduction of the entire investment (without attribution to any particular embedded goodwill element), the first-time adopter is able to reverse such impairment if it is assessed to no longer be necessary.

This is discussed in the two scenarios set out in Illustration 5-12 below:

Illustration 5-12: Previous GAAP impairment of goodwill embedded in equity method investment in associate or joint venture

Scenario 1 - Impairment was recognised on the notional goodwill element embedded in the investment under previous GAAP

On 1 January 20X0, Entity U acquired an investment in Entity V, which it accounts for using the equity method (the investment would qualify as an associate under IFRS accounting standards). The cost of investment was CU1,500 compared to V's identifiable net assets of CU500; therefore, notional goodwill of CU1,000 was included in the carrying value of the investment at that time. The previous GAAP required the entity to:

- Amortise the notional goodwill of the associate on a straight-line basis over 10 years.
- Test the investment accounted using the equity method for impairment at the investment level.
- Allocate and recognise the impairment loss (if any) against notional goodwill.
- Not reverse goodwill impairments (including those on notional goodwill). Consequently, goodwill impairments recognised under previous GAAP affected future amortisation of goodwill.

Therefore, under its previous GAAP, Entity U tested its investment in Entity V for impairment and recognised an impairment loss of CU400 in the year ended 31 December 20X1 after amortisation of CU200 was recognised. This reduced the notional goodwill to CU400, which Entity U amortises over the remaining 8 years (CU50 annually). By its date of transition to IFRS accounting standards, 1 January 20X4, the notional goodwill had been amortised by a further 2 years × CU50 (CU100), reducing the notional goodwill to CU300. Net assets are unchanged since acquisition, leaving the investment with a carrying value of CU800.

Entity U applies the exemption from retrospective restatement for past acquisitions of investments in associates. *[IFRS 1.C5]*. Therefore, at 1 January 20X4, its date of transition, Entity U also tests the investment for impairment in accordance with IAS 36. At 1 January 20X4, the value of the investment in Entity V has recovered, and is CU1,500 based on its current listed share price. Under this scenario, the previous impairment to notional goodwill is not reversed, since the use of the business combination exemption as it applies to associates means that the goodwill determined under the previous GAAP acquisition accounting together with the subsequent accounting up to the date of transition is effectively grandfathered in a similar way to a subsidiary's goodwill under the business combinations exemption. *[IFRS 1.C4(g), IFRS 1.C4(h)]*. Therefore, the carrying value of the notional goodwill as determined under previous GAAP becomes the embedded notional goodwill at transition unless specifically required to be adjusted.

Scenario 2 - Impairment was recognised at the investment level under previous GAAP

The same as Scenario 1, except that Entity U's previous GAAP impairment test was performed at the investment level, using a test similar to that required under IAS 36. Because of applying this approach, when Entity U recognised an impairment loss of CU400 in the year ended 31 December 20X1, the carrying amount of the investment was CU900. Similar to Scenario 1, at 1 January 20X4, the value of the investment in Entity V has recovered and is CU1,500 based on its current listed share price.

Under this scenario, the previous impairment of notional goodwill, which is embedded in the full amount of the investment, is reversed. However, the impairment can only be reversed up to the pre-impairment investment carrying amount (using the equity method) that results from the application of the business combination exemption.

5.2.5.A Prohibition of other adjustments to goodwill

IFRS 1 prohibits restatement of goodwill for most other adjustments reflected in the opening IFRS statement of financial position. Therefore, a first-time adopter electing not to apply IFRS 3 retrospectively is not permitted to make any adjustments to goodwill other than those described in section 5.2.5 above. *[IFRS 1.C4(h)]*. For example, a first-time adopter cannot restate the carrying amount of goodwill:

(i) To exclude in-process research and development acquired in that business combination (unless the related intangible asset would qualify for recognition under IAS 38 in the statement of financial position of the acquiree)

(ii) To adjust previous amortisation of goodwill

(iii) To reverse adjustments to goodwill that IFRS 3 would not permit, but were made under previous GAAP because of adjustments to assets and liabilities between the date of the business combination and the date of transition to IFRS accounting standards

Differences between the goodwill amount in the opening IFRS statement of financial position and that in the financial statements under previous GAAP can arise, for example, because:

(a) Goodwill needs to be restated as a result of a retrospective application of IAS 21 (see section 5.2.6 below)

(b) Goodwill in relation to previously unconsolidated subsidiaries will have to be recognised (see section 5.2.7 below)

(c) Goodwill in relation to transactions that do not qualify as business combinations under IFRS accounting standards must be derecognised (see section 5.2.1 above)

And

(d) 'Negative goodwill' that had been included within goodwill under previous GAAP is derecognised under IFRS accounting standards (see section 5.2.5.B below)

Illustration 5-13 below demonstrates the adjustments required to goodwill, where applicable, for certain items.

Illustration 5-13: Adjusting goodwill

Entity W acquired Entity X but under its previous GAAP it did not recognise the following items:

- Entity X's customer lists which had a fair value of CU1,100 at the date of the acquisition and CU1,500 at the date of transition to IFRS accounting standards.
- Deferred tax liabilities related to the fair value adjustment of Entity X's property, plant and equipment, which amounted to CU9,500 at the date of the acquisition and CU7,800 at the date of transition to IFRS accounting standards.

What adjustment does Entity W make to goodwill to account for the customer lists and deferred tax liabilities at its date of transition to IFRS accounting standards, if the business combination exemption is taken?

As explained in section 5.2.4.B above, Entity W cannot recognise the customer lists (internally generated intangible assets of acquiree) when it uses the business combinations exemption. Accordingly, Entity W does not adjust goodwill for the customer lists. *[IFRS 1.C4(b)(ii), IFRS 1.C4(f)]*.

Entity W must recognise, under IAS 12, the deferred tax liability at its date of transition to IFRS accounting standards because there is no exemption from recognising deferred taxes under IFRS 1. However, Entity W is not permitted to adjust goodwill for the deferred tax liability that would have been recognised at the date of acquisition. Instead, Entity W recognises the deferred tax liability of CU7,800 with a corresponding charge to retained earnings or other category of equity, if appropriate. *[IFRS 1.C4(b), IFRS 1.C4(h), IFRS 1.C4(k)]*.

5.2.5.B Derecognition of negative goodwill

IFRS 1 does not specifically address accounting for negative goodwill recognised under a previous GAAP.

How we see it

We believe negative goodwill is derecognised by a first-time adopter because it is not permitted to recognise items as assets or liabilities if IFRS accounting standards do not permit such recognition.

Negative goodwill clearly does not meet the definition of a liability under the IASB's *Conceptual Framework, [CF 4.26]*, and its recognition is not permitted under IFRS 3. While not directly applicable to a first-time adopter, the transitional provisions of IFRS 3 specifically required that any negative goodwill is derecognised upon adoption of IFRS 3. *[IFRS 3.B69(e)]*.

5.2.5.C Goodwill previously deducted from equity

If a first-time adopter deducted goodwill from equity under its previous GAAP then it does not recognise that goodwill in its opening IFRS statement of financial position. Also, it does not reclassify that goodwill to profit or loss if it disposes of the subsidiary or if the investment in the subsidiary becomes impaired. *[IFRS 1.C4(i)(i)]*. Effectively, under IFRS accounting standards such goodwill ceases to exist, as is shown in Illustration 5-14 below, which is based on the implementation guidance in IFRS 1. *[IFRS 1.IG Example 5]*.

Illustration 5-14: Goodwill deducted from equity and treatment of related intangible assets

Entity Y acquired a subsidiary before the date of transition to IFRS accounting standards. Under its previous GAAP, Entity Y:

(a) Recognised goodwill as an immediate deduction from equity

(b) Recognised an intangible asset of the subsidiary that does not qualify for recognition as an asset under IAS 38

(c) Did not recognise an intangible asset of the subsidiary that would qualify under IAS 38 for recognition as an asset in the financial statements of the subsidiary. The subsidiary held the asset at the date of its acquisition by Entity Y and at the date of transition to IFRS accounting standards.

In its opening IFRS statement of financial position, Entity Y:

(a) Does not recognise the goodwill, as it did not recognise the goodwill as an asset under previous GAAP *[IFRS 1.C4(i)]*

(b) Does not recognise the intangible asset that does not qualify for recognition as an asset under IAS 38. Because Entity Y deducted goodwill from equity under its previous GAAP, the elimination of this intangible asset (and, if applicable, any related adjustments to deferred tax and non-controlling interests) reduces retained earnings (see section 5.2.4.A above) *[IFRS 1.C4(c)(ii), IFRS 1.C4(k)]*

And

(c) Recognises the intangible asset that qualifies under IAS 38 for recognition as an asset in the financial statements of the subsidiary, even though the amount assigned to it under previous GAAP in Entity Y's consolidated financial statements was nil (see section 5.2.4.B above). *[IFRS 1.C4(b)(ii), IFRS 1.C4(f)]*. The recognition criteria in IAS 38 include the availability of a reliable measurement of cost, *[IAS 38.21, IFRS 1.IG45-48]*, and Entity Y measures the asset at cost less accumulated depreciation and less any accumulated impairment losses identified under IAS 36 (see section 7.12 below). Because Entity Y deducted goodwill from equity under its previous GAAP, the recognition of this intangible asset (and, if applicable, any related adjustments to deferred tax and non-controlling interests) increases retained earnings. *[IFRS 1.C4(c)(ii), IFRS 1.C4(k)]*. However, if this intangible asset had been subsumed in goodwill recognised as an asset under previous GAAP, Entity Y would have decreased the carrying amount of that goodwill accordingly (and, if applicable, adjusted deferred tax and non-controlling interests) (see section 5.2.5 above). *[IFRS 1.C4(b), IFRS 1.C4(f), IFRS 1.C4(g)(i), IFRS 1.C4(k)]*.

The prohibition on reinstating goodwill that was deducted from equity could have a significant impact on first-time adopters that hedge their foreign net investments, as demonstrated in Illustration 5-15 below.

Illustration 5-15: Goodwill related to foreign net investments

Entity Z, which uses the euro (€) as its functional currency, acquired a subsidiary in the United States whose functional currency is the US dollar ($). The goodwill on the acquisition of $2,100 was deducted from equity. Under its previous GAAP, Entity Z hedged the currency exposure on the goodwill because it would be required to recognise the goodwill as an expense upon disposal of the subsidiary.

IFRS 1 does not permit reinstatement of goodwill deducted from equity nor does it permit transfer of such goodwill to profit or loss upon disposal of the investment in the subsidiary. *[IFRS 1.C4(i)(i)]*. Under IFRS accounting standards, goodwill deducted from equity ceases to exist and Entity Z can no longer hedge the currency exposure on that goodwill. Therefore, exchange gains and losses relating to the hedge will no longer be classified in currency translation difference but will be recognised in profit and loss after adoption of IFRS accounting standards.

If a first-time adopter deducted goodwill from equity under its previous GAAP, adjustments resulting from the subsequent resolution of a contingency affecting the purchase consideration, at or before the date of transition to IFRS accounting standards, are required to be recognised in retained earnings. *[IFRS 1.C4(i)(ii)]*. Effectively, the adjustment is being accounted for in the same way as the original goodwill that arose on the acquisition, rather than having to be accounted for in accordance with IFRS 3. This requirement could affect, for example, the way a first-time adopter accounts for provisional amounts relating to business combinations prior to its date of transition to IFRS accounting standards, as shown in Illustration 5-16 below.

Illustration 5-16: Adjustments made during measurement period to provisional amounts

Entity A acquired Entity B on 30 September 20X1. Entity A sought an independent valuation for an item of property, plant and equipment acquired in the combination. However, the valuation was not completed by the date of transition to IFRS accounting standards (1 January 20X2). Under Entity A's previous GAAP, any goodwill was written off against equity as incurred. Five months after the acquisition date (and after the date of transition), Entity A received the independent valuation.

In preparing its opening IFRS statement of financial position, Entity A uses the adjusted carrying amounts of the identifiable net assets (see section 5.2.4.C above) with the corresponding adjustment being recognised in retained earnings.

5.2.6 Currency adjustments to goodwill

A first-time adopter need not apply IAS 21 retrospectively to fair value adjustments and goodwill arising in business combinations that occurred before the date of transition to IFRS accounting standards. *[IFRS 1.C2, IFRS 1.IG21A]*. This exemption is different from the 'cumulative translation differences' exemption, which is discussed in section 5.6 below.

IAS 21 requires any goodwill arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation to be treated as assets and liabilities of the foreign operation. Thus, they are expressed in the functional currency of the foreign operation and are translated at the closing rate in accordance with the requirements discussed in Chapter 16 at section 6.5. *[IAS 21.47]*. For a first-time adopter it might be impracticable, especially after a corporate restructuring, to determine retrospectively the currency denomination of the goodwill and fair value adjustments required by IAS 21.

If IAS 21 is not applied retrospectively, a first-time adopter instead treats such fair value adjustments and goodwill as assets and liabilities of the entity rather than as assets and liabilities of the acquiree. As a result, those goodwill and fair value adjustments are either already expressed in the entity's functional currency or are non-monetary foreign currency items that are reported using the exchange rate applied in accordance with previous GAAP. *[IFRS 1.C2]*.

However, a first-time adopter is allowed to choose to apply IAS 21 retrospectively to fair value adjustments and goodwill arising in either: *[IFRS 1.C1, IFRS 1.C3]*

(a) All business combinations that occurred before the date of transition to IFRS accounting standards

Or

(b) All business combinations that the entity elects to restate to comply with IFRS 3

In practice, the exemption might be of limited use for a number of reasons:

First, the exemption permits 'goodwill and fair value adjustments' to be treated as assets and liabilities of the entity rather than as assets and liabilities of the acquiree, but does not clarify whether or not the exemption, if taken, must be applied to both goodwill and fair value adjustments.

How we see it

We believe that implicit in the exemption is the requirement to treat both the goodwill and the fair value adjustments consistently, as the exemption requires to treat them as assets and liabilities of the entity if the entity does not apply IAS 21 retrospectively to those fair value adjustments and goodwill.

However, the IASB apparently did not consider that many first-time adopters, under their previous GAAPs, will have treated fair value adjustments as assets or liabilities of the acquiree (so expressed in the foreign operation's functional currency), while at the same time treating goodwill as an asset of the acquirer (so expressed in the entity's functional currency). As noted above, we believe that the exemption requires the same treatment for both the goodwill and the fair value adjustments. In such cases, this means that the first-time adopter needs to use one of the following approaches:

(i) Goodwill and fair value adjustments treated as assets of the acquired foreign operation (i.e., in the foreign operation's functional currency)

The goodwill (which was previously expressed as an asset of the first-time adopter) is treated as an asset of the foreign operation from the date of acquisition. Therefore, the goodwill and fair value adjustments are measured, both initially and subsequently, in the foreign operation's functional currency, and are reported in the opening IFRS statement of financial position using the exchange rate at the date of transition to IFRS accounting standards.

(ii) Goodwill and fair value adjustments treated as separate assets of the first-time adopter

The fair value adjustments (which were previously expressed in the functional currency of the foreign operation acquired) are treated as separate assets (and liabilities) of the first-time adopter from the date of acquisition. Therefore, the goodwill and fair value adjustments are measured, both initially and subsequently, in the first-time adopter's functional currency, and are consistently expressed in that currency. If the presentation currency of the first-time adopter differs from its functional currency the recomputed functional currency amounts are then translated to the presentation currency of the first-time adopter.

As the exemption under IFRS 1 did not foresee this particular situation, those first-time adopters will need to restate either their goodwill or fair value adjustments. In many cases, restatement of goodwill is less onerous than restatement of fair value adjustments.

Secondly, the paragraphs in IFRS 1 that introduce the exemption were drafted at a later date than the rest of the Appendix of which they form part. Instead of referring to 'first-time adopter' these paragraphs refer to 'entity'.

How we see it

In our view, it is clear from the context that 'entity' is read as 'first-time adopter'. This means that the exemption only permits goodwill and fair value adjustments to be treated as assets and liabilities of the first-time adopter (i.e., the ultimate parent in the reporting group).

In practice, many groups have treated goodwill and fair value adjustments as assets and liabilities of an intermediate parent in the reporting group. Where the intermediate parent has a functional currency that is different from that of the ultimate parent who is the first-time adopter or the acquiree, it will be necessary to restate goodwill and fair value adjustments.

The decision to treat goodwill and fair value adjustments as either items denominated in the parent's or the acquiree's functional currency will also affect the extent to which the net investment in those foreign subsidiaries can be hedged (see also section 4.5.5 above).

5.2.7 Previously unconsolidated subsidiaries

A first-time adopter which did not consolidate a subsidiary acquired in a past business combination under previous GAAP, when applying the business combinations exemption, measures the carrying amounts of the subsidiary's assets and liabilities in its consolidated financial statements at the date of transition to IFRS accounting standards at either: *[IFRS 1.IG27(a)]*

(a) If the subsidiary has adopted IFRS accounting standards - the same carrying amounts as in the IFRS financial statements of the subsidiary, after adjusting for consolidation procedures and for the effects of the business combination in which it acquired the subsidiary. *[IFRS 1.D17]*.

Or

(b) If the subsidiary has not adopted IFRS accounting standards - the carrying amounts that IFRS accounting standards would require in the subsidiary's statement of financial position. *[IFRS 1.C4(j)]*.

The deemed cost of goodwill is the difference at the date of transition between: *[IFRS 1.C4(j)]*

(i) The parent's interest in those adjusted carrying amounts

And

(ii) The cost in the parent's separate financial statements of its investment in the subsidiary

How we see it

The cost of an investment in a subsidiary in the parent's separate financial statements will depend on which option the parent has taken to measure the cost under IFRS 1 (see section 5.7.2 below).

A parent can elect to measure its investment in a subsidiary at one of the following amounts as the cost in its separate opening IFRS statement of financial position: *[IFRS 1.D15]*

(a) Cost determined in accordance with IAS 27 *Separate Financial Statements*

Or

(b) Deemed cost, which is its:

(i) Fair value at the entity's date of transition to IFRS accounting standards in its separate financial statements

Or

(ii) Previous GAAP carrying amount at that date

A first-time adopter using the business combinations exemption not to apply IFRS 3 retrospectively is precluded from calculating what the goodwill would have been at the date of the original acquisition. The deemed cost of goodwill is capitalised in the opening IFRS statement of financial position. Illustration 5-17 below, which is based on one within the implementation guidance in IFRS 1, demonstrates this requirement. *[IFRS 1.IG Example 6]*.

Illustration 5-17: Subsidiary not consolidated under previous GAAP

Background

Entity C's date of transition to IFRS accounting standards is 1 January 20X2. Under its previous GAAP, Entity C did not consolidate its 75% interest in Entity D, which it acquired in a business combination on 15 July 20X0. On 1 January 20X2:

(a) The cost of Entity C's investment in Entity D is CU180

(b) Under IFRS accounting standards, Entity D would measure its assets at CU500 and its liabilities (including deferred tax under IAS 12) at CU300. On this basis, Entity D's net assets are CU200 under IFRS accounting standards.

Application of requirements

Entity C consolidates Entity D. The consolidated statement of financial position at 1 January 20X2 includes:

(a) Entity D's assets at CU500 and liabilities at CU300

(b) Non-controlling interests of CU50 (25% of [CU500 - CU300])

(c) Goodwill of CU30 (cost of CU180 less 75% of [CU500 - CU300]). *[IFRS 1.C4(j)]*. Entity C tests the goodwill for impairment under IAS 36 (see section 7.12 below) and recognises any resulting impairment loss, based on conditions that existed at the date of transition to IFRS accounting standards. *[IFRS 1.C4(gX(ii)]*.

If the cost of the subsidiary (as measured under IFRS 1, see section 5.7.2 below) is lower than the proportionate share of net asset value at the date of transition to IFRS accounting standards, the difference is taken to retained earnings, or other category of equity, if appropriate.

Slightly different rules apply to all other subsidiaries (i.e., those not acquired in a business combination but created) that an entity did not consolidate under its previous GAAP, the main difference being that goodwill is not recognised in relation to those subsidiaries. *[IFRS 1.IG27(c)]*.

How we see it

Note that this exemption requires the use of the cost of the investment in the separate financial statements of the parent prepared using IAS 27. Therefore, if a first-time adopter, in its separate financial statements, does not opt to measure its cost of investment in a subsidiary at deemed cost (i.e., its fair value or previous GAAP carrying amount at the date of transition), it is required to calculate the deemed cost of the goodwill by comparing the cost of the investment (as determined in accordance with IAS 27) to its share of the carrying amount of the net assets determined on a different date.

In the case of a highly profitable subsidiary this could give rise to the following anomaly, as shown in Illustration 5-18 below:

Illustration 5-18: Calculation of deemed cost of goodwill

Entity E acquired Entity F before the date of transition to IFRS accounting standards for CU500. The net assets of Entity F would have been CU220 under IFRS accounting standards at the date of acquisition. Entity F makes on average an annual net profit of CU60, which it does not distribute to Entity E.

At the date of transition to IFRS accounting standards, the cost of Entity E's investment in Entity F is still CU500. However, the net assets of Entity F have increased to CU460. Therefore, under IFRS 1, the deemed cost of goodwill is CU40. *[IFRS 1.C4(j)]*.

The deemed cost of goodwill is much lower than the goodwill that was paid at the date of acquisition because Entity F did not distribute its profits. In fact, if Entity F had distributed a dividend to its parent just before its date of transition to IFRS accounting standards, the deemed cost of goodwill would have been significantly higher.

5.2.8 Previously consolidated entities that are not subsidiaries

A first-time adopter might have consolidated an investment under its previous GAAP that does not meet the definition of a subsidiary under IFRS accounting standards. In this case the entity first determines the appropriate classification of the investment under IFRS accounting standards and then applies the first-time adoption rules in IFRS 1. Generally, such a previously consolidated investment is accounted for as either:

- *An associate, a joint venture or a joint operation:*

  First-time adopters applying the business combinations exemption must also apply that exemption to past acquisitions of investments in associates, interests in joint ventures or interests in joint operations in which the activity of the joint operation constitutes a business, as defined in IFRS 3. *[IFRS 1.C5]*. If the business combinations exemption is not applicable or the entity did not acquire (i.e., the entity created) the investment in the associate or joint venture, IAS 28 is applied retrospectively unless the entity applies the joint arrangements exemption. *[IFRS 1.D31]*. (See section 5.17 below).
- *An investment under IFRS 9* (see section 5.10 below).

  Or
- *An executory contract or service concession arrangement:*

  There are no first-time adoption exemptions that apply; therefore, IFRS accounting standards are applied retrospectively. However, a practical relief is provided for a service concession arrangement if retrospective application is impracticable (see section 5.13 below). *[IFRS 1.D22]*.

5.2.9 Measurement of deferred taxes and non-controlling interests

Deferred tax is calculated based on the difference between the carrying amounts of assets and liabilities and their respective tax bases. Therefore, deferred taxes are recalculated after all assets acquired and liabilities assumed have been adjusted under IFRS 1. *[IFRS 1.C4(k)]*.

IFRS 10 defines non-controlling interest as the "Equity in a **subsidiary** not attributable, directly or indirectly, to a **parent**." *[IFRS 10 Appendix A]*. This definition is discussed in Chapter 8 at section 5.1. Non-controlling interests are calculated after all assets acquired, liabilities assumed and deferred taxes have been adjusted under IFRS 1. *[IFRS 1.C4(k)]*.

Any resulting changes in the carrying amount of deferred taxes and non-controlling interests are recognised by adjusting retained earnings (or, if appropriate, another category of equity), unless they relate to adjustments to intangible assets that are adjusted against goodwill. See Illustration 5-19 below. *[IFRS 1.IG Example 4]*.

In terms of the treatment of deferred tax in relation to recognised intangible assets, there is a difference depending on whether the first-time adopter previously recognised acquired intangible assets in accordance with its previous GAAP or whether it had subsumed the intangible asset into goodwill (in both cases, a deferred tax liability was not recognised under its previous GAAP but is required to be recognised under IFRS accounting standards). In the first case, the first-time adopter must recognise a deferred tax liability and adjust non-controlling interests and opening reserves accordingly. *[IFRS 1.C4(b), IFRS 1.C4(k), IAS 12.15(b)]*. By contrast, in the second case it would have to decrease the carrying amount of goodwill, recognise the intangible assets and a deferred tax liability and adjust non-controlling interests as necessary, as discussed in section 5.2.5 above. *[IFRS 1.C4(b), IFRS 1.C4(f), IFRS 1.C4(g)(i), IFRS 1.C4(k), IAS12.15(b)]*. The IASB discussed this issue in October 2005, but decided not to propose an amendment to address this inconsistency, i.e., the difference in the treatment of deferred tax depending on whether acquired intangible assets were recognised separately or subsumed within goodwill under previous GAAP.[5]

5 *IASB Update*, October 2005, available on the IFRS Foundation's website.

Illustration 5-19 below illustrates how to account for restatement of intangible assets, deferred tax and non-controlling interests where previous GAAP requires deferred tax to be recognised. *[IFRS 1.IG Example 4]*.

Illustration 5-19: Restatement of intangible assets, deferred tax and non-controlling interests

Entity G's first IFRS financial statements are for a period that ends on 31 December 20X3 and include comparative information for 20X2 only. On 1 July 20X0, Entity G acquired 75% of subsidiary H. Under its previous GAAP, Entity G assigned an initial carrying amount of CU200 to intangible assets that would not have qualified for recognition under IAS 38. The tax base of the intangible assets was CUnil, giving rise to a deferred tax liability (at 30%) of CU60. Entity G measured non-controlling interests as their share of the fair value of the identifiable net assets acquired. Goodwill arising on the acquisition was capitalised as an asset in Entity G's consolidated financial statements.

On 1 January 20X2 (the date of transition to IFRS accounting standards), the carrying amount of the intangible assets under previous GAAP was CU160, and the carrying amount of the related deferred tax liability was CU48 (30% of CU160).

Under IFRS 1, Entity G derecognises intangible assets that do not qualify for recognition as separate assets under IAS 38, together with the related deferred tax liability of CU48 and non-controlling interests, with a corresponding increase in goodwill (see section 5.2.5 above). The related non-controlling interests amount to CU28 (25% of CU112 (CU160-CU48)). Entity G makes the following adjustment in its opening IFRS statement of financial position: *[IFRS 1.C4(g)(i)]*

Dr	Goodwill		CU84	
Dr	Deferred tax liability		CU48	
Dr	Non-controlling interests		CU28	
	Cr	Intangible assets		CU160

Entity G tests the goodwill for impairment under IAS 36 and recognises any resulting impairment loss, based on conditions that existed at the date of transition to IFRS accounting standards. *[IFRS 1.C4(g)(ii)]*.

5.2.10 Transition accounting for contingent consideration

IFRS 1 is silent on accounting for contingent consideration that relates to transactions that are within the scope of the business combinations exemption.

How we see it

The business combination exemption does not extend to contingent consideration that arose from a transaction that occurred before the date of transition to IFRS accounting standards, even if the acquisition itself is not restated due to the use of the exemption. Therefore, such contingent consideration, other than that classified as equity under IAS 32, is recognised at its fair value at the date of transition to IFRS accounting standards, regardless of the accounting under previous GAAP.

If the contingent consideration was not recognised at fair value at the date of transition to IFRS accounting standards under previous GAAP, the resulting adjustment is recognised in retained earnings or other category of equity, if appropriate. Subsequent adjustments will be recognised following the provisions of IFRS 3. *[IFRS 3.40, IFRS 3.58]*.

5.3 Share-based payment transactions

IFRS 2 applies to accounting for the acquisition of goods or services in equity-settled share-based payment transactions, cash-settled share-based payment transactions and transactions in which the entity or the counterparty has the option to choose between settlement in cash or equity. There is no exemption from recognising share-based payment transactions that have not yet vested at the date of transition to IFRS accounting standards. The exemptions in IFRS 1 clarify that a first-time adopter is not required to apply IFRS 2 fully retrospectively to equity-settled share-based payment transactions that have already vested at the date of transition to IFRS accounting standards.

IFRS 1 contains the following exemptions and requirements regarding share-based payment transactions:

(a) Only if a first-time adopter has disclosed publicly the fair value of its equity instruments, determined at the measurement date, as defined in IFRS 2, then it is encouraged to apply IFRS 2 to: *[IFRS 1.D2]*

  (i) Equity instruments that were granted on or before 7 November 2002 (i.e., the date the IASB issued ED 2 *Share-based Payment*)

  (ii) Equity instruments that were granted after 7 November 2002 but vested before the date of transition to IFRS accounting standards.

  Many first-time adopters that did not use fair value-based share-based payment accounting under previous GAAP will not have published the fair value of equity instruments granted and are, therefore, not allowed to apply IFRS 2 retrospectively to those share-based payment transactions.

(b) For all grants of equity instruments to which IFRS 2 has not been applied, a first-time adopter must still make the disclosures relating to the nature and extent of share-based payments required by IFRS 2.44-45. *[IFRS 1.D2, IFRS 2.44, IFRS 2.45]*.

(c) If a first-time adopter modifies the terms or conditions of a grant of equity instruments to which IFRS 2 has not been applied, the entity is not required to apply the requirements of IFRS 2.26-29 if the modification occurred before the date of transition to IFRS accounting standards. *[IFRS 1.D2, IFRS 2.26, IFRS 2.27, IFRS 2.28, IFRS 2.28A, IFRS 2.29]*.

(d) A first-time adopter is encouraged, but not required, to apply IFRS 2 to liabilities arising from share-based payment transactions that were settled before the date of transition to IFRS accounting standards. *[IFRS 1.D3]*.

There are a number of interpretation issues concerning these exemptions and requirements:

- *Meaning of 'disclosed publicly' under (a) above*

  IFRS 1 only permits retrospective application of IFRS 2 if the entity has 'disclosed publicly' the fair value of the equity instruments concerned, but IFRS accounting standards do not define what is meant by 'disclosed publicly'.

  ### How we see it

  While IFRS 1 does not specifically require public disclosure of the fair value of an entity's share-based payment transactions in its previous financial statements, it is clear that IFRS 1 requires fair value to have been published contemporaneously. In addition, the requirements in IFRS 1 to disclose publicly the fair value of share-based payment transactions can be met even if the fair value is only disclosed in aggregate rather than for individual awards.

- *First-time adopters encouraged to apply IFRS 2 under (a) and (d) above*

  The 'date of transition to IFRS accounting standards' to which those exemptions refer is the first day of the earliest comparative period presented in a first-time adopter's first IFRS financial statements.

  ### How we see it

  This effectively means that an entity could accelerate the vesting of an award that was otherwise due to vest after the date of transition to IFRS accounting standards in order to avoid applying IFRS 2 to that award.

- *Whether a consistent selection of the exemptions under (a) and (d) above is required*

  ### How we see it

  A first-time adopter can choose which of the exemptions under (a) and (d) it wants to apply, i.e., there is no specific requirement to select the exemptions in a consistent manner.

- *Meaning of 'encouraged' under (a) and (d) above*

  Under IFRS 1, a first-time adopter is encouraged, but not required, to apply IFRS 2 to certain categories of share-based payment transactions (see (a) and (d) above). IFRS 1 does not specifically prohibit a literal reading of 'encouraged', which could, for example, allow a first-time adopter to decide to apply IFRS 2 only to some share-based payment transactions granted before 7 November 2002.

How we see it

We believe that it would generally be acceptable for a first-time adopter to apply IFRS 2 only to share-based payment transactions:

(1) After an earlier date chosen by the entity (e.g., 1 January 2001), while not applying it to earlier transactions

(2) For which fair values were disclosed publicly

- *Treatment of modifications, cancellations and settlements under (c) above*

  There is a slight ambiguity concerning the interpretation of the exemption under (c) above, because IFRS 1.D2 refers only to the modification of awards. This could allow a literal argument that IFRS 1 does not prescribe any specific treatment when an entity cancels or settles, as opposed to modifying, an award to which IFRS 2 has not been applied. However, IFRS 1.D2 also requires an entity to apply IFRS 2.26-29 to 'modified' awards. These paragraphs deal not only with modification but also with cancellation and settlement (see Chapter 30 at section 7); indeed IFRS 2.28-29 are not relevant to modifications at all.

How we see it

Given the reference to IFRS 2.26-29 in IFRS 1.D2, it is clear that the IASB intended IFRS 2 to be applied not only to modifications, but also to any cancellation or settlement of an award to which IFRS 2 has not been applied, unless the modification, cancellation or settlement occurs before the date of transition to IFRS accounting standards.

- *Transactions where the counterparty has a choice of settlement method*

  These are not specifically addressed in the first-time adoption rules.

How we see it

It therefore appears that, where such transactions give rise to recognition of both an equity component and a liability component, the equity component is subject to the transitional rules for equity-settled transactions and the liability component to those for cash-settled transactions. This could well mean that the liability component of such a transaction is recognised in the financial statements, whilst the equity component is not.

- *Application of IFRS 2 to cash-settled transactions settled before the date of transition to IFRS accounting standards under (d) above*

How we see it

It is not entirely clear what lies behind the exemption under (d) above, since a first-time adopter would never be required to report a share-based payment transaction (or indeed any transaction) settled before the date of transition.

In Practical example 5-3 below, Manulife Financial Corporation (Manulife) made use of the exemption not to apply IFRS 2 to share-based payment transactions that were fully vested at the date of transition to IFRS accounting standards. The Practical example also illustrates that the share-based payment exemption does not apply for awards that were granted after 7 November 2002 and that were still vesting at the date of transition to IFRS accounting standards.

Practical example 5-3: Manulife Financial Corporation (2011) Canada

2011 Annual Report [extract]

Notes to Consolidated Financial Statements [extract]

Note 25 First-time Adoption of IFRS

As outlined in note 1, the Company has adopted IFRS as a replacement of previous Canadian GAAP effective January 1, 2011. References to Canadian GAAP throughout this note relate to Canadian GAAP prior to the adoption of IFRS. The Company's opening Consolidated Statement of Financial Position was prepared at January 1, 2010, the Company's date of transition to IFRS (the "Transition Date") in accordance with the requirements of IFRS 1 "First-Time Adoption of International Financial Reporting Standards". This note explains the principal adjustments made by the Company in preparing the opening IFRS Consolidated Statement of Financial Position as at January 1, 2010 compared to the Consolidated Balance Sheet as at December 31, 2009 under Canadian GAAP and the required adjustments between IFRS and previous Canadian GAAP to total equity and total comprehensive income for the 2010 comparative year.

IFRS has been applied retrospectively, except for certain optional and mandatory exemptions from full retrospective application provided for under IFRS 1, as detailed below.

(a) First-time adoption elections [extract]

Optional exemptions [extract]

Share-based payment transactions – The Company elected to apply IFRS 2 "Share-based Payments" to all equity instruments granted after November 7, 2002 that had not vested by the Transition Date. The Company applied IFRS 2 for all liabilities arising from share-based payment transactions that existed at the Transition Date.

5.3.1 Use of previously published fair values

There is no explicit requirement in IFRS 1 or IFRS 2 that any voluntary retrospective application of IFRS 2 must be based on the fair value previously published. This might appear to allow a first-time adopter the flexibility of using a different valuation for IFRS 2 purposes than that previously used for disclosure purposes.

How we see it

The requirements of IFRS 1 in relation to estimates under previous GAAP (see section 4.2 above) mean that the assumptions used, when retrospectively applying IFRS 2, must be consistent with those used in the originally disclosed valuation. In our view, the entity will also need to consider the implications of the assertion, in effect, that there is more than one fair value for the same transaction.

5.3.2 Restatement of costs recognised under previous GAAP

A first-time adopter could elect to take advantage of the transition exemption in IFRS 1 which allows it not to apply IFRS 2 to equity-settled share-based payment transactions that were vested before the date of transition to IFRS accounting standards, despite having recognised a cost for those transactions in accordance with its previous GAAP. Neither IFRS 1 nor IFRS 2 clearly indicates the appropriate treatment of the costs of share-based payment transactions that were recognised under the previous GAAP.

How we see it

There are mixed views on this issue in different jurisdictions, some of which are being driven by local regulatory expectations. In practice, either of the following approaches is considered acceptable, provided that the treatment chosen is disclosed in the financial statements if the previously recognised costs are material:

- *Not to change expense previously recognised under previous GAAP for equity instruments subject to transitional relief under IFRS 1.*

  This approach is consistent with the approach for cash-settled share-based payment transactions that are settled prior to the date of transition to IFRS accounting standards, since the entity must reflect the reduction in cash that was actually paid (and therefore the reduction in retained earnings) in the first IFRS financial statements.

  Or

- *To derecognise share-based payment expense under previous GAAP for equity instruments subject to transitional relief under IFRS 1.*

  In other words, reverse cumulative amounts recognised in the retained earnings and equity accounts of the opening IFRS statement of financial position.

5.4 Deemed cost

IFRS 1 requires full retrospective application of IFRS accounting standards effective at the end of a first-time adopter's first IFRS reporting period. *[IFRS 1.7]*. Therefore, in the absence of the deemed cost exemption, the requirements of, for example, IAS 16, IAS 38, IAS 40 *Investment Property* and IFRS 6 *Exploration for and Evaluation of Mineral Resources* would have to be applied as if the first-time adopter had always applied these standards. This could be quite onerous because:

- These items are long-lived which means that accounting records from the time of acquisition might not be available anymore. In the case of formerly state-owned businesses, the required accounting records possibly never even existed
- The entity might have revalued the items in the past as a matter of accounting policy or because this was required under national law

  Or
- Even if the items were carried at depreciated cost, the accounting policy for recognition and depreciation might not have been compliant with IFRS accounting standards

Given the significance of items like property, plant and equipment in the statement of financial position of most first-time adopters and the sheer number of transactions affecting property, plant and equipment, restatement is not only difficult but would often also involve huge cost and effort. Therefore, the IASB decided to introduce the notion of a 'deemed cost' that is not the 'true' cost basis of an asset (as required by IFRS accounting standards), but a surrogate that is deemed to be a suitable starting point.

There are seven separate deemed cost exemptions in IFRS 1:

(a) Fair value or revaluation as deemed cost (see section 5.4.1 below)

(b) Event-driven fair value measurement as deemed cost (see section 5.4.2 below)

(c) Deemed cost for oil and gas assets (see section 5.4.3 below)

(d) Deemed cost for assets used (or previously used) in operations subject to rate regulation (see section 5.4.4 below)

(e) Deemed cost for assets acquired, liabilities assumed and goodwill in a business combination not restated under IFRS accounting standards (see section 5.2 above)

(f) Deemed cost for a right-of-use asset for a lessee based on certain exemptions in IFRS 1 (see section 5.5 below)

(g) Deemed cost in determining the cost of an investment in a subsidiary, joint venture or associate in separate financial statements (see section 5.7.2 below)

5.4.1 Fair value or revaluation as deemed cost

To deal with the problem of restatement of long-lived assets upon first-time adoption of IFRS accounting standards, IFRS 1 permits a first-time adopter - for the categories of assets listed below - to measure an item in its opening IFRS statement of financial position using an amount that is based on its deemed cost (see section 5.4.1.A below): *[IFRS 1.D5, IFRS 1.D6, IFRS 1.D7]*

- Property, plant and equipment, including bearer plants (see section 7.4 below) *[IFRS 1.D5, IFRS 1.D6]*
- Investment property, if an entity elects to use the cost model in IAS 40. *[IFRS 1.D7(a)]*. The fact that the exemption can only be applied to investment property accounted for under the cost model will not pose any problems in practice as the fair value model under IAS 40 requires an entity to measure its investment property at fair value at its date of transition to IFRS accounting standards.
- Right-of-use assets under IFRS 16 *[IFRS 1.D7(aa)]*
- Intangible assets (see section 7.14 below) that meet: *[IFRS 1.D7(b)]*
  - The recognition criteria in IAS 38 (including reliable measurement of original cost)

    And
  - The criteria in IAS 38 for revaluation (including the existence of an active market)

A first-time adopter cannot use this deemed cost approach by analogy for any other assets or for liabilities. *[IFRS 1.D7]*.

The use of fair value or revaluation as deemed cost for intangible assets will be very limited in practice because of the definition of an 'active market' in IFRS 13. An active market is defined as: "A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis." *[IFRS 13 Appendix A]*. It is therefore unlikely that a first-time adopter will be able to apply this exemption to any intangible assets (see Chapter 18 at section 8.2).

It is important to note that this exemption does not take classes or categories of assets as its unit of measure, but refers to "an item of property, plant and equipment", and similarly for investment property, right-of-use assets under IFRS 16 and intangible assets. *[IFRS 1.D5, IFRS 1.D6, IFRS 1.D7]*.

How we see it

A first-time adopter is allowed to apply the deemed cost exemption to only some of its assets. For example, it could apply the exemption only to:

- A selection of properties
- Part of a factory

  Or
- Some of the right-of-use asset leased under a single lease agreement

This is because IFRS 1.IG12 states that "IAS 16 does not prescribe the unit of measure for recognition of an asset, i.e., what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances" (see Chapter 19 at section 3.1).

The IASB argued that it is not necessary to restrict application of the exemption to classes of assets to prevent arbitrarily selective revaluations, because IAS 36 "requires an impairment test if there is any indication that an asset is impaired. Thus, if an entity uses fair value as deemed cost for assets whose fair value is above cost, it cannot ignore indications that the recoverable amount of other assets may have fallen below their carrying amount. Therefore, the IFRS does not restrict the use of fair value as deemed cost to entire classes of asset." *[IFRS 1.BC45]*.

How we see it

In our view, it is doubtful that the quality of financial information would benefit from a revaluation of a haphazard selection of items of property, plant and equipment as deemed cost. Therefore, a first-time adopter needs to exercise judgement in selecting the items to which it believes it is appropriate to apply the exemption.

Practical examples 5-4 and 5-5 below refer to the use of the 'fair value or revaluation as deemed cost' exemption.

Practical example 5-4: Suncor Energy Inc. (2011) **Canada**

2011 ANNUAL REPORT [extract]

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]

6. FIRST-TIME ADOPTION OF IFRS [extract]

Explanation of Significant Adjustments [extract]

(9) *Fair Value as Deemed Cost*

The company has applied the IFRS 1 election to record certain assets of property, plant and equipment at fair value on the Transition Date. The exemption has been applied to refinery assets located in Eastern Canada and certain natural gas assets in Western Canada. When estimating fair value, market information for similar assets was used, and where market information was not available, management relied on internally generated cash flow models using discount rates specific to the asset and long-term forecasts of commodity prices and refining margins. The aggregate of these fair values was $1.370 billion, resulting in a reduction of the carrying amount of property, plant and equipment as at January 1, 2010. Under Previous GAAP, impairment losses were recorded in the third quarter of 2010 for certain of these natural gas properties. There were no impairment losses recognized during 2010 under IFRS, as these properties were adjusted to fair value at the Transition Date. The impacts on the financial statements were as follows:

($ millions)	As at and for the year ended Dec 31, 2010	As at Jan 1, 2010
Property, plant and equipment, net	(527)	(906)
Retained earnings	(527)	(906)
Depreciation, depletion, amortization and impairment	(379)	—

Practical example 5-5: Nexen Inc. (2011) **Canada**

2011 ANNUAL REPORT [extract]
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS [extract]
26. TRANSITION TO IFRS [extract]

Elected Exemptions from Full Retrospective Application

In preparing these Consolidated Financial Statements in accordance with IFRS 1 First-time Adoption of International Financial Reporting Standards (IFRS 1), we applied the following optional exemptions from full retrospective application of IFRS.

...

(II) FAIR VALUE OR REVALUATION AS DEEMED COST

We elected to measure certain producing oil and gas properties at fair value as at the transition date and use that amount as its deemed cost in the opening IFRS balance sheet.

5.4.1.A Determining deemed cost

IFRS 1 sets out the following options for deemed cost of an item of property, plant and equipment. *[IFRS 1.D5, IFRS 1.D6]*. As noted in section 5.4.1 above, the same options are available for certain other assets. *[IFRS 1.D7]*.

Extract from IFRS 1

D5 An entity may elect to measure an item of property, plant and equipment at the date of transition to IFRSs at its fair value and use that fair value as its deemed cost at that date.

D6 A first-time adopter may elect to use a previous GAAP revaluation of an item of property, plant and equipment at, or before, the date of transition to IFRSs as deemed cost at the date of the revaluation, if the revaluation was, at the date of the revaluation, broadly comparable to:

(a) fair value; or

(b) cost or depreciated cost in accordance with IFRSs, adjusted to reflect, for example, changes in a general or specific price index.

The 'previous GAAP revaluations' referred to in IFRS 1.D6 need only be "broadly comparable to fair value or reflect an index applied to a cost that is broadly comparable to cost determined in accordance with IFRSs". *[IFRS 1.BC47, IFRS 1.D6]*. It appears that in the interest of practicality the IASB is allowing a good deal of flexibility in this matter. The IASB explains in the Basis for Conclusions that "It may not always be clear whether a previous revaluation was intended as a measure of fair value or differs materially from fair value. The flexibility in this area permits a cost-effective solution for the unique problem of transition to IFRSs. It allows a first-time adopter to establish a deemed cost using a measurement that is already available and is a reasonable starting point for a cost-based measurement." *[IFRS 1.BC47]*.

How we see it

IFRS 1 describes the deemed cost in IFRS 1.D6 as a 'previous GAAP revaluation'. Therefore, in our view, a revaluation can be used as the basis for deemed cost only if it was recognised in the first-time adopter's previous GAAP financial statements. In some circumstances, as discussed below, a previous GAAP impairment (or its reversal) could represent a 'previous GAAP revaluation'.

A previous GAAP impairment (or reversal of an impairment) that resulted in the recognition of the related assets at fair value in the previous GAAP financial statements is allowed to be recognised as a previous GAAP revaluation for the purposes of applying this exemption only if it is broadly comparable to the fair value under IFRS 13 or cost (or depreciated cost) in accordance with IFRS accounting standards, adjusted to reflect, for example, changes in a general or specific price index and not another measure such as fair value less costs of disposal.

Moreover, when the previous GAAP impairment was determined for a group of impaired assets (e.g., a cash generating unit as defined in IAS 36, see Chapter 21 at section 3), the recognised value of an individual asset needs to be broadly comparable to the specific asset's fair value under IFRS 13 or cost (or depreciated cost) in accordance with IFRS accounting standards, adjusted to reflect, for example, changes in a general or specific price index and not another measure such as fair value less costs of disposal or an allocation thereof for the purposes of this exemption. *[IFRS 1.D6]*.

If revaluations under previous GAAP did not satisfy the criteria in IFRS 1.D6 (as discussed above) or IFRS 1.D8 (see section 5.4.2 below), a first-time adopter measures the revalued assets within the scope of IAS 16 in its opening IFRS statement of financial position on one of the following bases: *[IFRS 1.D5, IFRS 1.D6, IFRS 1.D8, IFRS 1.IG11]*

(a) Cost (or deemed cost) less any accumulated depreciation and any accumulated impairment losses under the cost model in IAS 16

(b) Deemed cost, being the fair value at the date of transition to IFRS accounting standards

Or

(c) Revalued amount, if the entity adopts the revaluation model in IAS 16 as its accounting policy under IFRS accounting standards for all items of property, plant and equipment in the same class

The elections in IFRS 1.D6 or IFRS 1.D8 are also available for use for investment property (measured under the cost model), right-of-use assets, and intangible assets meeting certain criteria (see section 5.4.1 above). *[IFRS 1.D7]*. If the elections in IFRS 1.D6 or IFRS 1.D8 are not permitted for such assets, a first-time adopter measures the asset in its opening IFRS statement of financial position on one of the bases above, i.e., applying the cost model, deemed cost or a revalued amount in accordance with relevant IFRS accounting standards. *[IFRS 1.D5, IFRS 1.D6, IFRS 1.D7, IFRS 1.D8]*. A right-of-use asset recognised by a lessee under IFRS 16 could also be measured at a carrying amount based on certain exemptions in IFRS 1 (see section 5.5 below).

A first-time adopter that uses fair value as deemed cost is required to disclose the resulting IFRS 1 adjustment separately (see section 6.5.1 below). *[IFRS 1.30]*.

5.4.1.B Deemed cost determined before the date of transition to IFRS accounting standards

If the deemed cost of an asset was determined before the date of transition to IFRS accounting standards, then an IFRS accounting policy needs to be applied to that deemed cost in the intervening period to determine what the carrying amount of the asset is in the opening IFRS statement of financial position. This means that a first-time adopter that uses previous GAAP revaluation as the deemed cost of an item of property, plant and equipment will need to start depreciating the item from the date when the entity established the previous GAAP revaluation and not from its date of transition. *[IFRS 1.IG9]*. Illustration 5-20 below demonstrates the application of this requirement.

Illustration 5-20: Deemed cost of property, plant and equipment

Entity A used to revalue items of property, plant and equipment to fair value under its previous GAAP, but changed its accounting policy on 1 January 20X0 when it adopted a different accounting policy. Under that accounting policy, Entity A did not depreciate the asset and only recognised the maintenance costs as an expense. Entity A's date of transition to IFRS accounting standards is 1 January 20X2.

In its balance sheet under previous GAAP the carrying amount of the asset is CU80,000 at the date of transition, which is equal to the last revaluation. Entity A can use the last revalued amount as the deemed cost of the asset on 1 January 20X0. *[IFRS 1.D6]*. However, Entity A will need to apply IAS 16 to the period after 1 January 20X0 because the accounting policy under its previous GAAP is not permitted under IFRS accounting standards. Assuming that the economic life of the asset is 40 years from 20X0 and that the residual value is nil, Entity A would account for the asset at CU76,000 in its opening IFRS statement of financial position, which represents the deemed cost minus 2 years of depreciation. *[IFRS 1.IG9]*.

5.4.2 Event-driven fair value measurement as deemed cost

A first-time adopter is allowed to use fair value measurements that arose from an event such as a privatisation or initial public offering as deemed cost for IFRS accounting standards at the date of that measurement. *[IFRS 1.D8]*.

Extract from IFRS 1

D8 A first-time adopter may have established a deemed cost in accordance with previous GAAP for some or all of its assets and liabilities by measuring them at their fair value at one particular date because of an event such as a privatisation or initial public offering.

(a) If the measurement date is *at or before* the date of transition to IFRSs, the entity may use such event-driven fair value measurements as deemed cost for IFRSs at the date of that measurement.

(b) If the measurement date is *after* the date of transition to IFRSs, but during the period covered by the first IFRS financial statements, the event-driven fair value measurements may be used as deemed cost when the event occurs. An entity shall recognise the resulting adjustments directly in retained earnings (or if appropriate, another category of equity) at the measurement date. At the date of transition to IFRSs, the entity shall either establish the deemed cost by applying the criteria in paragraphs D5-D7 or measure assets and liabilities in accordance with the other requirements in this IFRS.

IFRS 1 describes these revaluations as 'deemed cost in accordance with previous GAAP'. Therefore, to the extent that they related to an event that occurred prior to its date of transition to IFRS accounting standards, they can be used as the basis for deemed cost only if they were recognised in the first-time adopter's previous GAAP financial statements. As discussed in section 5.4.2.C below, a first-time adopter is also allowed to use event-driven fair values resulting from such events that occurred subsequent to the first-time adopter's date of transition to IFRS accounting standards, but during the period covered by the first IFRS financial statements.

How we see it

The 'fair value or revaluation as deemed cost' exemption discussed in section 5.4.1 above only applies to items of property, plant and equipment, investment property, right-of-use assets and certain intangible assets. The event-driven deemed cost exemption, however, is broader in scope because it specifies that when a first-time adopter established a deemed cost in accordance with previous GAAP *for some or all of its assets and liabilities* by measuring them at their fair value at one particular date because of an event such as a privatisation or initial public offering, the entity is allowed to use such event-driven fair value measurements as deemed cost for IFRS accounting standards at the date of that measurement. Certain limitations in the scope of the exemption are described below.

Although a first-time adopter could use an event-driven fair value measurement as deemed cost for any asset or liability, it does not have to use them for all assets and liabilities that were revalued as a result of the event.

There are two important limitations in the scope of this exemption:

- While it applies, in principle, to all assets and liabilities of an entity, it does not override the recognition criteria in IFRS accounting standards (see section 3.2 above). *[IFRS 1.10]*. Consequently, a first-time adopter derecognises goodwill, assets (e.g., certain intangible assets such as brand names and research) and liabilities that do not qualify for recognition under IFRS accounting standards in the statement of financial position of the entity. *[IFRS 1.IG50]*.
- It cannot be used if the event-driven revaluation did not result in a re-measurement to full fair value (i.e., it cannot be used in the case of a partial step-up towards fair value).

If revaluations under previous GAAP did not satisfy the criteria in IFRS 1.D6 (see section 5.4.1.A above) or IFRS 1.D8 (see above), the accounting options available for those previously revalued assets that are property, plant and equipment, right-of-use assets, intangible assets and investment property accounted using cost model are the same as those explained in section 5.4.1.A above.

5.4.2.A 'Push down' accounting

Under some previous GAAPs, an entity might have prepared its financial statements using 'push down' accounting, that is, the carrying amount of its assets and liabilities is based on their fair value at the date it became a subsidiary of its parent. If such a subsidiary subsequently adopts IFRS accounting standards, it will often require a very significant effort to determine the carrying amount of those assets and liabilities on a historical cost basis at the date of transition.

The event-driven deemed cost exemption (see section 5.4.2 above) applies to events 'such as a privatisation or initial public offering.' *[IFRS 1.D8]*. This list of events is clearly not meant to be exhaustive, but rather describes events that result in re-measurement of some or all assets and liabilities at their fair value.

How we see it

An acquisition that results in an entity becoming a subsidiary is a 'change of control event' similar to a privatisation or an initial public offering. In our view, the application of 'push down' accounting results in event-driven fair value measurements that could be used as deemed cost for IFRS accounting standards at the date of that measurement.

The exemption can only be used, however, if 'push down' accounting resulted in the recognition of the related assets and liabilities at their fair value. For example, previous GAAP might not have required remeasurement to full fair value in the case of a partial acquisition or a step-acquisition, or if there was a bargain purchase that was allocated, for example, to reduce the fair values of long-lived assets.

How we see it

In these cases, the entity would not qualify for the event-driven deemed cost exemption, since the event did not result in the measurement of its assets and liabilities at their fair value.

5.4.2.B 'Fresh start' accounting

Some previous GAAPs require an entity that emerges from bankruptcy or undertakes a legal reorganisation to apply 'fresh start' accounting, which involves recognition of assets and liabilities at their fair value at that date.

How we see it

In our view, the application of 'fresh start' accounting results in an event-driven fair value measurement (see section 5.4.2 above) that could be used as deemed cost for IFRS accounting standards at the date of that measurement. The use of the exemption is limited to instances that resulted in the recognition of the related assets and liabilities at their full fair value (i.e., it cannot be used in the case of a partial step-up towards fair value).

5.4.2.C Exemption for event-driven revaluations after the date of transition

The event-driven revaluation exemption allows a first-time adopter to recognise in its first IFRS financial statements fair values arising from events whose measurement date is after the date of transition to IFRS accounting standards but during the periods covered by the first IFRS financial statements. The event-driven fair value measurements are recognised as deemed cost at the date that the event occurs. An entity recognises the resulting adjustments directly in retained earnings (or if appropriate, another category of equity) at the measurement date. *[IFRS 1.D8(b)]*.

The Board explicitly considered whether to allow a first-time adopter that uses a revaluation subsequent to the date of transition to 'work back' to the deemed cost on the date of transition to IFRS accounting standards by adjusting the revaluation amounts to exclude any depreciation, amortisation or impairment between the date of transition to IFRS accounting standards and the date of that measurement. The Board rejected this approach "because making such adjustments would require hindsight and the computed carrying amounts on the date of transition to IFRSs would be neither the historical costs of the revalued assets nor their fair values on that date". *[IFRS 1.BC46B]*. Accordingly, at the date of transition to IFRS accounting standards, the entity either establishes the deemed cost by applying the criteria in IFRS 1.D5-D7 (see section 5.4.1 above) or measures assets and liabilities under the other requirements in IFRS 1. *[IFRS 1.D8(b)]*.

5.4.3 Deemed cost for oil and gas assets

It is common practice in some countries to account for exploration and development costs for oil and gas properties in development or production phases in cost centres that include all properties in a large geographical area, e.g., under the 'full cost accounting' method. However, this method of accounting generally uses a unit of account that is much larger than that which is acceptable under IFRS accounting standards. Applying IFRS accounting standards fully retrospectively would pose significant problems for first-time adopters because it would also require amortisation at the unit of account level (determined in accordance with IFRS accounting standards) to be calculated (on a unit of production basis) for each year, using a reserves base that has changed over time because of changes in factors such as geological understanding and prices for oil and gas. In many cases, particularly for older assets, this information may not be available. Even when such information is available, the effort and cost to determine the opening balances at the date of transition would usually be very high. *[IFRS 1.BC47A]*.

For these entities, use of the fair value as deemed cost exemption (see section 5.4.1 above) was not considered to be suitable because: *[IFRS 1.BC47B]*

> "Determining the fair value of oil and gas assets is a complex process that begins with the difficult task of estimating the volume of reserves and resources. When the fair value amounts must be audited, determining significant inputs to the estimates generally requires the use of qualified external experts. For entities with many oil and gas assets, the use of this fair value as deemed cost alternative would not meet the Board's stated intention of avoiding excessive cost …".

The IASB therefore decided to grant an exemption for a first-time adopter that accounted under its previous GAAP for "exploration and development costs for oil and gas properties in the development or production phases … in cost centres that include all properties in a large geographical area". *[IFRS 1.D8A]*. Under the exemption, a first-time adopter could elect to measure oil and gas assets at the date of transition to IFRS accounting standards on the following basis: *[IFRS 1.D8A]*

(a) Exploration and evaluation assets at the amount determined under the entity's previous GAAP.

(b) Assets in the development or production phases at the amount determined for the cost centre under the entity's previous GAAP. This amount must be allocated to the cost centre's underlying assets *pro rata* using reserve volumes or reserve values as of that date.

For this purpose, 'oil and gas assets' comprise only those assets used in the exploration, evaluation, development or production of oil and gas. *[IFRS 1.D8A]*.

A first-time adopter that uses the exemption under (b) above discloses that fact and the basis on which carrying amounts determined under previous GAAP were allocated (see section 6.5.3 below). *[IFRS 1.31A]*.

To avoid the use of deemed costs resulting in an oil and gas asset being measured at more than its recoverable amount, the Board also decided that oil and gas assets that were valued using this exemption must be tested for impairment at the date of transition to IFRS accounting standards as follows: *[IFRS 1.D8A, IFRS 1.BC47D]*

- Exploration and evaluation assets must be tested for impairment under IFRS 6
- Assets in the development and production phases must be tested for impairment under IAS 36

The deemed cost amounts are reduced to take account of any impairment charge. *[IFRS 1.D8A]*.

Finally, a first-time adopter that applies the deemed cost exemption for oil and gas assets in the development or production phases in (b) above must also apply IFRS 1.D21A to the related decommissioning and restoration obligation (see section 5.12.2 below). This is required instead of applying IFRS 1.D21 (see section 5.12.1 below) or IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*. *[IFRS 1.D21A]*.

Practical example 5-6 below presents disclosure of the use of the 'deemed cost for oil and gas assets' exemption.

Practical example 5-6: Zargon Oil & Gas Ltd. (2011) **Canada**

2011 ANNUAL FINANCIAL REPORT [extract]
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]
27. RECONCILIATION OF TRANSITION FROM CANADIAN GAAP TO IFRS [extract]
Explanatory notes [extract]

(b) The Company elected under IFRS 1 to deem the Canadian GAAP carrying value of its oil and gas assets accounted for under the full cost method as at January 1, 2010 as their deemed cost under IFRS as at that date. As such, the Canadian GAAP full cost pool was reallocated upon transition to IFRS and the 2010 comparatives were restated to reflect the new IFRS accounting policies as follows:

i. In accordance with IAS 16, IAS 38 and IFRS 6 on January 1, 2010 the Company reallocated costs of $24.37 million relating to unproved properties from property, plant and equipment to exploration and evaluation assets.

ii. Under Canadian GAAP, all costs incurred prior to having obtained licence rights and lease expiries were included within property, plant and equipment. Under IFRS, such expenditures are expensed as incurred. There was no impact on adoption of IFRS due to the full cost as deemed cost exemption. However, the comparative 2010 balances were restated at December 31, 2010 resulting in a reduction in property, plant and equipment and retained earnings of $2.81 million, and an increase in exploration and evaluation expenses for the year of the same amounts.

iii. The remaining full cost pool was allocated to the developed and producing assets pro rata using reserve values.

iv. Under IFRS, impairment tests must be performed at a more lower reporting level than was required under Canadian GAAP. The Canadian GAAP "ceiling test" incorporated a 2-step approach for testing impairment, while IFRS uses a 1-step approach. Under Canadian GAAP, a discounted cash flow analysis was not required if the undiscounted cash flows from proved reserves exceeded the carrying amount (step 1). If the carrying amount exceeded the undiscounted future cash flows, then a prescribed discounted cash flow test was performed (step 2). Under IFRS, impairment testing is based on discounted cash flows and is calculated at the CGU level. Impairment tests are required to be performed at the transition date, and as at January 1, 2010 no impairment was identified. At December 31, 2010 an impairment test was performed and four of the Company's CGUs were found to have impairment.

(c) Upon transition to IFRS, the Company adopted a policy of depleting oil and natural gas interests on a "units of production" basis over proved plus probable reserves on a field by field basis. The depletion policy under Canadian GAAP was units of production over proved reserves on a country by country basis. The December 31, 2010 effect was increases in property, plant and equipment and retained earnings and a decrease to depletion expense of $17.21 million.

(d) Under IFRS, impairment losses previously recorded are reversed if there has been an improvement in the estimates used to determine recoverable amount, except for goodwill. The reversal of impairment losses was not permitted under Canadian GAAP. This had no impact on adoption to IFRS at January 1, 2010 due to the full cost as deemed cost exemption. There were no impairment loss reversals from the transition date to December 31, 2010.

...

(j) As stated in Note (b), the Company has elected to utilize the full cost as deemed cost exemption, thereby requiring that the Company measure its asset retirement obligation as at the date of transition in accordance with IAS 37 and recognize the difference between Canadian GAAP and IFRS in retained earnings. As such, the Company has re-measured the provision as at January 1, 2010 under IAS 37 and estimated the amount to be recognized in retained earnings by discounting the liability to the date at which the liability first arose. This further resulted in a decrease in retained earnings and increase in the asset retirement obligation of $45.15 million at January 1, 2010. This resulted in an increase in the asset retirement obligation and property, plant and equipment of $53.42 million for the year ended December 31, 2010 primarily due to a change in the discount rate applied from a credit-adjusted rate required by Canadian GAAP, to a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the obligation as well as restatement of the entire obligation using the current period discount rate rather than only applying the current period discount rate to upward revisions in the future costs estimates as was required under Canadian GAAP.

5.4.4 Deemed cost for assets used (or previously used) in operations subject to rate regulation

Entities that hold items of property, plant and equipment, right-of-use assets under IFRS 16, or intangible assets that are used, or were previously used, in operations subject to rate regulation might have capitalised, as part of the carrying amounts, amounts that do not qualify for capitalisation in accordance with IFRS accounting standards. The Basis for Conclusions to IFRS 1 notes that "For example, when setting rates regulators often permit entities to capitalise, ..., an allowance for the cost of financing the asset's acquisition, construction or production. This allowance typically includes an imputed cost of equity. IFRSs do not permit an entity to capitalise an imputed cost of equity." *[IFRS 1.BC47F]*.

The IASB decided to permit a first-time adopter with operations subject to rate regulation to elect to use the previous GAAP carrying amount of such an item at the date of transition to IFRS accounting standards as deemed cost. *[IFRS 1.D8B]*. In the Board's view, this exemption is consistent with other exemptions in IFRS 1 in that it "avoids excessive costs while meeting the objectives of the IFRS". *[IFRS 1.BC47I]*.

Operations are subject to rate regulation if they are governed by a framework for establishing the prices that can be charged to customers for goods or services and that framework is subject to oversight and/or approval by a rate regulator (as defined in IFRS 14). *[IFRS 1.D8B, IFRS 14 Appendix A]*.

Extract from IFRS 1

D8B	Some entities hold items of property, plant and equipment, right-of-use assets or intangible assets that are used, or were previously used, in operations subject to rate regulation. The carrying amount of such items might include amounts that were determined under previous GAAP but do not qualify for capitalisation in accordance with IFRSs. If this is the case, a first-time adopter may elect to use the previous GAAP carrying amount of such an item at the date of transition to IFRSs as deemed cost. If an entity applies this exemption to an item, it need not apply it to all items. At the date of transition to IFRSs, an entity shall test for impairment in accordance with IAS 36 each item for which this exemption is used. For the purposes of this paragraph, operations are subject to rate regulation if they are governed by a framework for establishing the prices that can be charged to customers for goods or services and that framework is subject to oversight and/or approval by a rate regulator (as defined in IFRS 14 *Regulatory Deferral Accounts*).

Without this exemption, a first-time adopter with operations subject to rate regulation would have had either to restate those items retrospectively to remove the non-qualifying amounts, or to use fair value as deemed cost (see section 5.4.1 above). Both alternatives, the Board reasoned, pose significant practical challenges, the cost of which can outweigh the benefits. *[IFRS 1.BC47G]*. Typically, once amounts are included in the total cost of an item of property, plant and equipment, they are no longer tracked separately. Therefore, their removal would require historical information that, given the typical age of some of the assets involved, is probably no longer available and would be difficult to estimate. For many of these assets, it might be impractical to use the exemption to use a deemed cost equal to transition-date fair value (IFRS 1.D5) as such information may not be readily available. *[IFRS 1.BC47H]*.

A first-time adopter that applies this exemption to an item need not apply it to all items. At the date of transition to IFRS accounting standards, the first-time adopter must test for impairment in accordance with IAS 36 each item for which it used the exemption. *[IFRS 1.D8B]*.

If a first-time adopter uses the exemption for assets used in operations subject to rate regulation, it must disclose that fact and the basis on which carrying amounts were determined under previous GAAP (see section 6.5.4 below). *[IFRS 1.31B]*.

Practical example 5-7 below illustrates disclosure of the use of the deemed cost exemption for property, plant and equipment and intangible assets used in operations subject to rate regulation although IFRS 14 is not applied.

Practical example 5-7: Enersource Corporation (2012) **Canada**

Consolidated Financial Statements [extract]
Notes to Consolidated Financial Statements [extract]
5. First Time Adoption of IFRS: [extract]

(a) Previous Canadian GAAP carrying amount as deemed costs for PP&E and intangible assets.

Entities with operations subject to rate regulations may hold items of PP&E or intangible assets where the carrying amount of such items might include amounts that were determined under previous Canadian GAAP but do not qualify for capitalization in accordance with IFRS. If this is the case, a first-time adopter may elect to use the previous Canadian GAAP carrying amount of such an item at the date of transition to IFRS as deemed cost. An entity shall apply this exemption for annual periods beginning on or after 1 January 2011, but earlier application is permitted.

Entities are subject to rate regulation if they provide goods or services to customers at prices (i.e. rates) established by an authorized body empowered to establish rates that bind the customers and that are designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a specified return.

Under this exemption the deemed cost at the date of transition becomes the new IFRS cost basis. The accumulated amortization recognized under previous Canadian GAAP prior to the transition date has been included as part of the deemed cost so that the net book values will not be affected.

At the date of transition to IFRS, an entity shall also test for impairment, each item for which this exemption is used.

This exemption does not only apply to individual entities with rate regulated activities but also to the consolidated financial statements of their parent companies.

Based on the definition above, the Corporation qualifies for this IFRS 1 exemption as Enersource Hydro is subject to rate regulations and accordingly the Corporation elected to use the deemed cost election for opening balance sheet values for its PP&E and intangible assets.

At the date of transition, the Corporation's gross book value, accumulated depreciation and net book value for PP&E was $872,359, $422,992 and $449,367 respectively. The gross book value, accumulated amortization and net book value for intangible assets was $18,389, $2,806 and $15,583 respectively.

The Corporation reviewed the additional requirements against the information provided in IAS 36 Impairment of Assets and determined that no impairments would be recorded.

While the current exemption in IFRS 1.D8B provides a one-time relief to determine the transition-date balances of the eligible property, plant and equipment, right-of-use assets and intangible assets, IFRS 14 is wider in scope (see section 5.22 below).

5.4.5 Summary

At its date of transition to IFRS accounting standards, a first-time adopter is allowed under IFRS 1 to measure the following assets and liabilities using a deemed cost:

(a) An item of property, plant and equipment, an investment property, a right-of-use asset and an intangible asset meeting certain criteria:
   (i) At fair value at the date of transition (see section 5.4.1 above) *[IFRS 1.D5, IFRS 1.D7]*
   (ii) Using a previous GAAP revaluation amount (at or before the date of transition) that is broadly comparable to (see section 5.4.1 above): *[IFRS 1.D6]*
      - Fair value at the date of revaluation

        Or
      - Cost or depreciated cost under IFRS accounting standards adjusted to reflect, for example, changes in a general or specific price index as a deemed cost as at the date of the revaluation

(b) Some or all of its assets and liabilities, based on a previous GAAP measure of deemed cost at one particular date that arose from an event-driven fair value, for example, at the date of an initial public offering or privatisation (see section 5.4.2 above) *[IFRS 1.D8]*

(c) Certain oil and gas assets at a deemed cost at the date of transition based on the previous GAAP carrying amount and tested for impairment as at the date of transition (see section 5.4.3 above) *[IFRS 1.D8A]*

(d) Certain assets used or previously used in operations subject to rate regulation, at a deemed cost at the date of transition based on the previous GAAP carrying amount and tested for impairment as at the date of transition (see section 5.4.4 above) *[IFRS 1.D8B]*

(e) Assets acquired, liabilities assumed and goodwill in a business combination not restated under IFRS 3 (see section 5.2 above):
   (i) Using a deemed cost, as at the date of the business combination, equal to the carrying amount under previous GAAP immediately after that business combination *[IFRS 1.C4(e)]*
   (ii) If the item was not recognised under previous GAAP, using the carrying amount at the date of transition on the basis that IFRS accounting standards would require in the separate statement of financial position of the acquiree *[IFRS 1.C4(b)(ii), IFRS 1.C4(f)]*
   (iii) Goodwill for an unconsolidated subsidiary under previous GAAP which was acquired in a past business combination at the difference at the date of transition between the parent's interest in those adjusted carrying amounts and the cost in the parent's separate financial statements of its investment in the subsidiary *[IFRS 1.C4(j)]*

(f) A right-of-use asset for a lessee, at a carrying amount based on certain exemptions in IFRS 1 (see section 5.5 below) *[IFRS 1.D9, IFRS 1.D9B, IFRS 1.D9C, IFRS 1.D9D, IFRS 1.D9E]*

(g) An investment in a subsidiary, joint venture or associate in separate financial statements (see section 5.7.2 below) *[IFRS 1.D15(b)]*

The fact that IFRS 1 offers so many different bases for measurement does not disturb the IASB as it reasons that "cost is generally equivalent to fair value at the date of acquisition. Therefore, the use of fair value as the deemed cost of an asset means that an entity will report the same cost data as if it had acquired an asset with the same remaining service potential at the date of transition to IFRSs. If there is any lack of comparability, it arises from the aggregation of costs incurred at different dates, rather than from the targeted use of fair value as deemed cost for some assets. The Board regarded this approach as justified to solve the unique problem of introducing IFRSs in a cost-effective way without damaging transparency." *[IFRS 1.BC43]*. Although this is valid, it still means that an individual first-time adopter can greatly influence its future reported performance by carefully making decisions on whether to apply these exemptions for the valuation of its assets. Users of the financial statements of a first-time adopter are encouraged therefore to be mindful that historical trends under the previous GAAP might no longer be present in an entity's IFRS financial statements.

Where IFRS accounting standards require subsequent measurement of an asset or liability on a basis that is not based on original cost, for example, fair value, the asset or liability must be measured on that basis as at the date of transition to IFRS accounting standards. *[IFRS 1.7]*. This does not mean that a deemed cost could not be used. For example, where a class of property, plant and equipment is measured using the revaluation model, its carrying amount reflects the revalued amount under IAS 16 but the revaluation surplus is based on the difference between the revalued amount and the deemed cost (or historical cost) as at the date of transition to IFRS accounting standards (see section 7.4.3 below).

5.5 Leases

IFRS 1 (paragraphs D9-D9E) provide first-time adopters with some exemptions from full retrospective application of IFRS 16. *[IFRS 1.D9, IFRS 1.D9B, IFRS 1.D9C, IFRS 1.D9D, IFRS 1.D9E]*.

Firstly, a first-time adopter is allowed to assess whether a contract existing at the date of transition to IFRS accounting standards contains a lease by applying IFRS 16.9-11 to these contracts on the basis of facts and circumstances existing at that date. *[IFRS 1.D9, IFRS 16.9, IFRS 16.10, IFRS 16.11]*. Illustration 5-21 below demonstrates how a first-time adopter determines whether a contractual arrangement contains a lease.

Illustration 5-21: Determining whether an arrangement contains a lease

Entity A's first IFRS financial statements are for a period that ends on 31 December 20X3 and include comparative information for 20X2 only. Its date of transition to IFRS accounting standards is 1 January 20X2.

On 1 January 20X0, Entity A entered into a take-or-pay arrangement to supply gas. On 1 January 20X1, there was a change in the contractual terms of the arrangement.

On 1 January 20X2, Entity A could determine whether the arrangement contains a lease under IFRS 16 on the basis of facts and circumstances existing on that date. Alternatively, Entity A could apply the criteria in IFRS 16 on the basis of facts and circumstances existing on 1 January 20X0 but will need to reassess the arrangement on 1 January 20X1 in respect of the changes made on that date. *[IFRS 16.11]*.

IFRS 1 allows a first-time adopter that is a lessee to apply the following approach to all of its leases (subject to the practical expedients described in IFRS 1.D9D, which are discussed further below). *[IFRS 1.D9B, IFRS 1.D9C, IFRS 1.D9D]*.

Extract from IFRS 1

D9B When a first-time adopter that is a lessee recognises lease liabilities and right-of-use assets, it may apply the following approach to all of its leases (subject to the practical expedients described in paragraph D9D):

(a) measure a lease liability at the date of transition to IFRSs. A lessee following this approach shall measure that lease liability at the present value of the remaining lease payments (see paragraph D9E), discounted using the lessee's incremental borrowing rate (see paragraph D9E) at the date of transition to IFRSs.

(b) measure a right-of-use asset at the date of transition to IFRSs. The lessee shall choose, on a lease-by-lease basis, to measure that right-of-use asset at either:

(i) its carrying amount as if IFRS 16 had been applied since the commencement date of the lease (see paragraph D9E), but discounted using the lessee's incremental borrowing rate at the date of transition to IFRSs; or

(ii) an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the statement of financial position immediately before the date of transition to IFRSs.

(c) apply IAS 36 to right-of-use assets at the date of transition to IFRSs.

D9C Notwithstanding the requirements in paragraph D9B, a first-time adopter that is a lessee shall measure the right-of-use asset at fair value at the date of transition to IFRSs for leases that meet the definition of investment property in IAS 40 and are measured using the fair value model in IAS 40 from the date of transition to IFRSs.

Additionally, a first-time adopter that is a lessee is allowed to use one or more of the following practical expedients at the date of transition to IFRS accounting standards (applied on a lease-by-lease basis): *[IFRS 1.D9D]*

(a) Apply a single discount rate to a portfolio of leases with reasonably similar characteristics (e.g., a similar remaining lease term for a similar class of underlying asset in a similar economic environment).

(b) Elect not to apply IFRS 1.D9B to leases for which the lease term ends within 12 months of the date of transition. Instead, the entity must account for (including giving disclosure of information about) these leases as if they were short-term leases accounted for under IFRS 16.6. *[IFRS 1.D9B, IFRS 16.6]*.

(c) Elect not to apply IFRS 1.D9B to leases for which the underlying asset is of low value (as described in IFRS 16.B3-B8). Instead, the entity must account for (including giving disclosure of information about) these leases under IFRS 16.6. (see Chapter 24 at section 5.1.2). *[IFRS 1.D9B, IFRS 16.6, IFRS 16.B3-B8]*.

(d) Exclude initial direct costs from the measurement of the right-of-use asset at the date of transition to IFRS accounting standards.

(e) Use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease.

Lease payments, lessee, lessee's incremental borrowing rate, commencement date of the lease, initial direct costs and lease term are defined in IFRS 16 and are used in IFRS 1 with the same meaning (see Chapter 24 at section 4 and Appendix C). *[IFRS 1.D9E, IFRS 16 Appendix A]*.

5.6 Cumulative translation differences

IAS 21 requires that an entity recognise some translation differences in other comprehensive income and accumulate these in a separate component of equity. On disposal of a foreign operation, the cumulative amount of the exchange differences deferred in the separate component of equity relating to that foreign operation (which includes, for example, the cumulative translation difference for that foreign operation, the exchange differences arising on certain translations to a different presentation currency and any gains and losses on related hedges) must be reclassified to profit or loss when the gain or loss on disposal is recognised. This also applies to exchange differences arising on monetary items that form part of a reporting entity's net investment in a foreign operation in its consolidated financial statements. *[IAS 21.32, IAS 21.39, IAS 21.48, IFRS 1.D12]*.

Full retrospective application of IAS 21 would require a first-time adopter to restate all financial statements of its foreign operations to IFRS accounting standards from their date of inception or later acquisition onwards, and then determine the cumulative translation differences arising in relation to each of these foreign operations. A first-time adopter need not comply with these requirements for cumulative translation differences that existed at the date of transition to IFRS accounting standards. If it uses this exemption: *[IFRS 1.D13]*

(a) The cumulative translation differences for all foreign operations are deemed to be zero at the date of transition to IFRS accounting standards

(b) The gain or loss on a subsequent disposal of any foreign operation must exclude translation differences that arose before the date of transition to IFRS accounting standards but must include later translation differences

How we see it

If a first-time adopter chooses to use this exemption, it must apply it to all foreign operations at its date of transition to IFRS accounting standards, which include any foreign operations that became first-time adopters before their parent notwithstanding that IFRS 1.D17 is applied (see section 5.8.2 below). Any existing separate component of the first-time adopter's equity relating to such translation differences would be transferred to retained earnings at the date of transition.

A subsidiary, an associate or a joint venture which becomes a first-time adopter later than its parent (or investor or venturer) is also allowed to use this exemption even if IFRS 1.D16(a) is applied (see section 5.8.1 below) but has a further option in IFRS 1.D13A as described in section 5.8.1.A below.

An entity is allowed to present its financial statements in a presentation currency that differs from its functional currency. IFRS 1 is silent on whether the cumulative translation differences exemption is applied to all translation differences or possibly separately to differences between the parent's functional currency and the presentation currency.

How we see it

In our view, IAS 21 does not distinguish between the translation differences arising on translation of subsidiaries into the functional currency of the parent and those arising on the translation from the parent's functional currency to the presentation currency, therefore, the exemption is applied consistently to both types of translation differences.

Since there is no requirement to justify the use of the exemption on grounds of impracticality or undue cost or effort, *[IFRS 1.BC55]*, an entity that already has a separate component of equity and the necessary information to determine how much of it relates to each foreign operation in accordance with IAS 21 (or can do so without much effort) is still able to use the exemption. Accordingly, an entity that has cumulative exchange losses in respect of foreign operations could consider it advantageous to use the exemption if it wishes to avoid having to recognise these losses in profit or loss if the foreign operation is sold at some time in the future.

Practical example 5-8 below illustrates disclosure of the use of this exemption.

Practical example 5-8: Sony Group Corporation (2022) Japan

Form 20-F [extract]

Notes to Consolidated Financial Statements [extract]

34. First-time adoption [extract]

(1) Exemption under IFRS 1 [extract]

Exchange differences on translating foreign operations

First-time adopters may choose to deem the cumulative exchange differences on translating foreign operations as zero at the date of transition to IFRS. Sony has chosen to apply this exemption and deemed all cumulative exchange differences on translating foreign operations as zero at the date of transition to IFRS.

(4) Notes to reconciliation [extract]

Recognition and measurement differences

A. Exchange differences on translating foreign operations

Under IFRS 1, first-time adopters may choose to deem the cumulative exchange differences on translating foreign operations as zero at the date of transition to IFRS. Sony has chosen to apply this exemption and transferred all cumulative exchange differences on translating foreign operations into retained earnings at the date of transition to IFRS.

The impact of this change is as follows:

	Yen in millions	
	April 1, 2020	March 31, 2021
(Consolidated Statements of Financial Position)		
Accumulated other comprehensive income	(509,872)	(510,091)
Adjustment to retained earnings	(509,872)	(510,091)

...

5.6.1 Gains and losses arising on related hedges

IFRS 1 is not entirely clear whether this exemption extends to similar gains and losses arising on related hedges. Paragraph D13, which contains the exemption, explains that a first-time adopter need not comply with 'these requirements.' *[IFRS 1.D13]*. The requirements referred to are those summarised in IFRS 1.D12 which explain that IAS 21 requires an entity: *[IFRS 1.D12]*

(a) To recognise some translation differences in other comprehensive income and accumulate these in a separate component of equity

And

(b) On disposal of a foreign operation, to reclassify the cumulative translation difference for that foreign operation (including, if applicable, gains and losses on related hedges) from equity to profit or loss as part of the gain or loss on disposal

The problem arises because IFRS 1.D12 does not refer to the recognition of hedging gains or losses in other comprehensive income and accumulation in a separate component of equity (only the subsequent reclassification thereof). Accordingly, a very literal reading of the standard might suggest that an entity is required to identify historical gains and losses on such hedges. However, even if this position is accepted, the basis on which this might be done is not at all clear.

How we see it

We believe it is entirely appropriate for this exemption to be applied to net investment hedges as well as the underlying gains and losses. It is clear that the reasons cited by the IASB for including this exemption, apply as much to related hedges as they do to the underlying exchange differences.

5.7 Investments in subsidiaries, joint ventures and associates

5.7.1 Consolidated financial statements: subsidiaries and structured entities

A first-time adopter must consolidate all subsidiaries (as defined in IFRS 10) unless IFRS 10 requires otherwise. *[IFRS 1.IG26]*. First-time adoption of IFRS accounting standards could therefore result in the consolidation for the first time of a subsidiary not consolidated under previous GAAP, either because the subsidiary was not regarded as such before, or because the parent did not prepare consolidated financial statements. If a first-time adopter did not consolidate a subsidiary under its previous GAAP, it must recognise the assets and liabilities of that subsidiary in its consolidated financial statements at the date of transition to IFRS accounting standards at either: *[IFRS 1.IG27(a)]*

(a) If the subsidiary has adopted IFRS accounting standards, the same carrying amounts as in the IFRS financial statements of the subsidiary, after adjusting for consolidation procedures and for the effects of the business combination in which it acquired the subsidiary *[IFRS 1.D17]*

Or

(b) If the subsidiary has not adopted IFRS accounting standards, the carrying amounts that IFRS accounting standards would require in the subsidiary's statement of financial position *[IFRS 1.C4(j)]*

If the newly-consolidated subsidiary was acquired in a business combination before the date of the parent's transition to IFRS accounting standards, goodwill is the difference between the parent's interest in the carrying amount determined under either (a) or (b) above and the cost in the parent's separate financial statements of its investment in the subsidiary. This is no more than a pragmatic 'plug' that facilitates the consolidation process but does not represent the true goodwill that might have been recorded if IFRS accounting standards had been applied to the original business combination (see section 5.2.7 above). *[IFRS 1.C4(j), IFRS 1.IG27(b)]*.

How we see it

If the first-time adopter accounted for the investment as an associate under its previous GAAP, it cannot use the notional goodwill previously calculated under the equity method as the basis for goodwill under IFRS accounting standards.

If the parent did not acquire the subsidiary, but established it, it does not recognise goodwill. *[IFRS 1.IG27(c)]*. Any difference between the cost of investment in the subsidiary in the parent's separate financial statements and the parent's interest in the identifiable net assets as determined in (a) or (b) above would be treated as an adjustment to retained earnings, representing the accumulated profits or losses attributable to the parent that would have been recognised as if the subsidiary had always been consolidated.

The adjustment of the carrying amounts of assets and liabilities of a first-time adopter's subsidiaries might affect non-controlling interests and deferred tax, as discussed in section 5.2.9 above. *[IFRS 1.C4(k), IFRS 1.IG28]*.

5.7.2 Separate financial statements: Cost of an investment in a subsidiary, joint venture or associate

When an entity prepares separate financial statements, IAS 27 requires a first-time adopter to account for its investments in subsidiaries, joint ventures and associates either: *[IFRS 1.D14]*

- At cost
- In accordance with IFRS 9

  Or
- Using the equity method as described in IAS 28 (see Chapter 9 at section 2)

However, if a first-time adopter measures such an investment at cost then it can elect to measure that investment at one of the following amounts in its separate opening IFRS statement of financial position: *[IFRS 1.D15]*

(a) Cost determined in accordance with IAS 27

Or

(b) Deemed cost, which is its:

  (i) Fair value at the entity's date of transition to IFRS accounting standards in its separate financial statements

  Or

  (ii) Previous GAAP carrying amount at that date

A first-time adopter is permitted to choose to use either of these bases to measure its investment in each subsidiary, joint venture or associate where it elects to use a deemed cost. *[IFRS 1.D15]*.

A first-time adopter that applies the exemption discloses certain additional information in its financial statements (see section 6.5.2 below). *[IFRS 1.31]*.

For a first-time adopter that chooses to account for such an investment using the equity method procedures in accordance with IAS 28: *[IFRS 1.D15A]*

(a) The first-time adopter applies the exemption for past business combinations in IFRS 1 (Appendix C) to the acquisition of the investment (see section 5.2 above) *[IFRS 1 Appendix C]*

(b) If the entity becomes a first-time adopter for its separate financial statements earlier than for its consolidated financial statements and:

  (i) Later than its parent, the entity would apply IFRS 1.D16 in its separate financial statements (see section 5.8.1 below). *[IFRS 1.D16]*.

  (ii) Later than its subsidiary, the entity would apply IFRS 1.D17 in its separate financial statements (see section 5.8.2 below). *[IFRS 1.D17]*.

5.8 Assets and liabilities of subsidiaries, associates and joint ventures

Within groups, some subsidiaries, associates and joint ventures could have a different date of transition to IFRS accounting standards than the parent, investor or venturer, for example, because national legislation required the use of IFRS accounting standards after, or prohibited the use of IFRS accounting standards at, the date of transition of the parent, investor or venturer. As this could have resulted in permanent differences between the carrying amounts reported under IFRS accounting standards in a subsidiary's own financial statements and those it reports to its parent, the IASB introduced a special exemption regarding the assets and liabilities of subsidiaries, associates and joint ventures.

IFRS 1 contains detailed guidance on the approach to be adopted when a parent adopts IFRS accounting standards before its subsidiary (see section 5.8.1 below) and when a subsidiary adopts IFRS accounting standards before its parent (see section 5.8.2 below).

These provisions also apply when IFRS accounting standards are adopted at different dates by an investor in an associate and the associate, or by a venturer in a joint venture and the joint venture. *[IFRS 1.D16, IFRS 1.D17]*. In the discussion that follows 'parent' includes an investor in an associate or a venturer in a joint venture, and 'subsidiary' includes an associate or a joint venture. References to consolidation adjustments include similar adjustments made when applying equity accounting. IFRS 1 also addresses the requirements for a parent that adopts IFRS accounting standards at different dates for the purposes of its consolidated and its separate financial statements (see section 5.8.4 below).

5.8.1 Subsidiary becomes a first-time adopter later than its parent

Extract from IFRS 1

D16 If a subsidiary becomes a first-time adopter later than its parent, the subsidiary shall, in its financial statements, measure its assets and liabilities at either:

(a) the carrying amounts that would be included in the parent's consolidated financial statements, based on the parent's date of transition to IFRSs, if no adjustments were made for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary (this election is not available to a subsidiary of an investment entity, as defined in IFRS 10, that is required to be measured at fair value through profit or loss); or

(b) the carrying amounts required by the rest of this IFRS, based on the subsidiary's date of transition to IFRSs. These carrying amounts could differ from those described in (a):

  (i) when the exemptions in this IFRS result in measurements that depend on the date of transition to IFRSs.

  (ii) when the accounting policies used in the subsidiary's financial statements differ from those in the consolidated financial statements. For example, the subsidiary may use as its accounting policy the cost model in IAS 16 *Property, Plant and Equipment*, whereas the group may use the revaluation model.

A similar election is available to an associate or joint venture that becomes a first-time adopter later than an entity that has significant influence or joint control over it.

A subsidiary that becomes a first-time adopter later than its parent therefore has the option to measure its assets and liabilities at the carrying amounts included in the parent's consolidated financial statements if no adjustments were made for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary. *[IFRS 1.D16(a)]*. The Board provided this exemption so that a subsidiary would not have to keep two parallel sets of accounting records based on different dates of transition to IFRS accounting standards. *[IFRS 1.BC55A]*. If a subsidiary does not take advantage of the exemption, it applies IFRS 1, based on its own date of transition to IFRS accounting standards. *[IFRS 1.D16(b)]*. A subsidiary applying IFRS 1.D16(b) would prepare its own IFRS financial statements, completely ignoring the IFRS 1 elections that its parent used when it adopted IFRS accounting standards for its consolidated financial statements.

How we see it

IFRS 1 does not elaborate on exactly what constitutes 'consolidation procedures', for the purposes of IFRS 1.D16(a) but, in our view, it would encompass adjustments required in order to harmonise a subsidiary's accounting policies with those of the group, as well as purely 'mechanical' consolidation adjustments such as the elimination of intragroup balances, profits and losses.

Illustration 5-22 below, which is based on the implementation guidance in IFRS 1, demonstrates how an entity applies these requirements. *[IFRS 1.IG Example 8]*.

Illustration 5-22: Parent adopts IFRS accounting standards before subsidiary

Entity A presents its (consolidated) first IFRS financial statements in 20X0. Its foreign subsidiary B, wholly owned by Entity A since formation, prepares information under IFRS accounting standards for internal consolidation purposes from that date, but Subsidiary B will not present its first IFRS financial statements until 20X3.

If Subsidiary B applies IFRS 1.D16(a), the carrying amounts of its assets and liabilities are the same in both its opening IFRS statement of financial position at 1 January 20X2 and Entity A's consolidated statement of financial position (except for adjustments for consolidation procedures) and are based on Entity A's date of transition to IFRS accounting standards.

Alternatively, Subsidiary B is allowed to apply IFRS 1.D16(b) and measure all its assets or liabilities based on its own date of transition to IFRS accounting standards (1 January 20X2). However, the fact that Subsidiary B becomes a first-time adopter in 20X3 does not change the carrying amounts of its assets and liabilities in Entity A's consolidated financial statements.

Under IFRS 1.D16(a), the numbers in a subsidiary's IFRS financial statements will be as close to those used by its parent as possible. However, differences other than those arising from business combinations will still exist in many cases, for example:

- A subsidiary might have hedged an exposure by entering into a transaction with a fellow subsidiary. Such a transaction could qualify for hedge accounting in the subsidiary's own financial statements but not in the group's consolidated financial statements.
- A pension plan might have to be classified as a defined contribution plan from the subsidiary's point of view, but is accounted for as a defined benefit plan in the group's consolidated financial statements.

The IASB seems content with the fact that the exemption will ease some practical problems, *[IFRS 1.BC62]*, though it will rarely succeed in achieving more than a moderate reduction of the number of reconciling differences between a subsidiary's own reporting and the numbers used by its parent.

How we see it

Importantly, the choice of IFRS 1.D16(a) prevents the subsidiary from electing to apply any of the other voluntary exemptions offered by IFRS 1, since the parent had already made the choices for the group at its date of transition. Therefore, use of IFRS 1.D16(a) might not be appropriate for a subsidiary that prefers to use a different exemption (e.g., fair value as deemed cost) for property, plant and equipment due, for example, to a tax reporting advantage. However, in our view, application of IFRS 1.D16(a) would allow the subsidiary to adopt a new IFRS accounting standard that becomes effective during any of the periods presented in the same manner it was adopted by the parent.

Illustration 5-23 below explains the interaction between IFRS 1.D16(a) and the business combination exemptions in Appendix C of IFRS 1 applied by its parent.

Illustration 5-23: Interaction between IFRS 1.D16(a) and the business combination exemptions applied by its parent

Entity D has been a subsidiary of Entity C since 20X0. Entity E was acquired by Entity D in 20X2 and Entity D accounted for the acquisition under its previous GAAP. Entity C transitioned from previous GAAP to IFRS accounting standards with a date of transition of 1 January 20X3 and decided to apply the business combination exemption in Appendix C of IFRS 1 to this acquisition. Entity D adopted IFRS accounting standards from its date of transition of 1 January 20X6 and chose to apply IFRS 1.D16(a).

Can Entity D apply IFRS 3 retrospectively to the acquisition of Entity E in its first IFRS financial statements?

How we see it

In our view, Entity D cannot apply IFRS 3 to the acquisition of Entity E because, applying IFRS 1.D16(a), a subsidiary which becomes a first-time adopter later than its parent measures its assets and liabilities at the carrying amounts that would be included in the parent's consolidated financial statements, based on the parent's date of transition to IFRS accounting standards. Therefore, Entity D cannot apply IFRS 3 retrospectively, meeting the primary objective of using the IFRS 1.D16(a) election in keeping one set of books.

A subsidiary might become a first-time adopter later than its parent, because it previously prepared a reporting package under IFRS accounting standards for consolidation purposes but did not present a full set of financial statements under IFRS accounting standards. In such circumstances, IFRS 1.D16 still applies. The above election of IFRS 1.D16(a) could be relevant not only when a subsidiary's reporting package complies fully with the recognition and measurement requirements of IFRS accounting standards, but also when it is adjusted centrally for matters such as review of events after the reporting period and central allocation of pension costs. Adjustments made centrally to an unpublished reporting package are not considered to be corrections of errors for the purposes of the disclosure requirements in IFRS 1. *[IFRS 1.26]*. However, a subsidiary is not permitted to ignore misstatements that are immaterial to the consolidated financial statements of the group but material to its own financial statements. *[IFRS 1.IG31]*.

How we see it

If a subsidiary was acquired after the parent's date of transition to IFRS accounting standards then it cannot apply IFRS 1.D16(a) because there are no carrying amounts included in the parent's consolidated financial statements, based on the parent's date of transition. Therefore, the subsidiary is unable to use the values recognised in the parent's consolidated financial statements when it was acquired, since push-down of the group's purchase accounting values is not allowed in the subsidiary's financial statements. However, if the subsidiary had recognised those amounts in its previous GAAP financial statements, it could use the same amounts as deemed costs under IFRS accounting standards pursuant to the 'event-driven' deemed cost exemption (see section 5.4.2 above).

Implementation difficulties in applying IFRS 1.D16(a) might arise if the parent and its subsidiary have different financial years, as explained below.

How we see it

Application of IFRS 1.D16(a) is more difficult when a parent and its subsidiary have different financial years. In that case, IFRS 1 would seem to require the carrying amounts of the subsidiary's assets and liabilities under IFRS accounting standards to be based on the parent's date of transition to IFRS accounting standards, which might not even coincide with an interim reporting date of the subsidiary; the same applies to any joint venture or associate.

The exemption is also available to associates and joint ventures. This means that in many cases an associate or joint venture that wants to apply IFRS 1.D16(a) will need to choose which shareholder it considers its 'parent' for IFRS 1 purposes if more than one investor/joint venturer have already applied IFRS accounting standards. The associate or joint venture will determine the carrying amount of its assets and liabilities under IFRS accounting standards by reference to that 'parent's' date of transition to IFRS accounting standards.

A subsidiary that adopts IFRS accounting standards after its investment entity parent is not permitted to use IFRS 1.D16(a) (see section 5.8.5.A below).

5.8.1.A Cumulative translation differences

IFRS 1.D13A permits a subsidiary that applies IFRS 1.D16(a) to measure cumulative translation differences for all foreign operations at the carrying amount that would be included in its parent's consolidated financial statements, based on the parent's date of transition to IFRS accounting standards (if no adjustments were made for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary). A similar election is available to an associate or joint venture that uses the exemption in IFRS 1.D16(a). *[IFRS 1.D13A, IFRS 1.D16(a)]*. The subsidiary still has the option to apply IAS 21 retrospectively or apply IFRS 1.D13 and deem the cumulative translation differences for all foreign operations to be zero at its own date of transition to IFRS accounting standards (see section 5.6 above). *[IFRS 1.D12, IFRS 1.D13, IFRS 1.D13A, IFRS 1.BC55C]*.

5.8.2 Parent becomes a first-time adopter later than its subsidiary

Paragraph D17 of IFRS 1 addresses the situation where a parent becomes a first-time adopter later than its subsidiary. *[IFRS 1.D17]*.

Extract from IFRS 1

D17 However, if an entity becomes a first-time adopter later than its subsidiary (or associate or joint venture) the entity shall, in its consolidated financial statements, measure the assets and liabilities of the subsidiary (or associate or joint venture) at the same carrying amounts as in the financial statements of the subsidiary (or associate or joint venture), after adjusting for consolidation and equity accounting adjustments and for the effects of the business combination in which the entity acquired the subsidiary. Notwithstanding this requirement, a non-investment entity parent shall not apply the exception to consolidation that is used by any investment entity subsidiaries. Similarly, if a parent becomes a first-time adopter for its separate financial statements earlier or later than for its consolidated financial statements, it shall measure its assets and liabilities at the same amounts in both financial statements, except for consolidation adjustments.

Unlike other first-time adoption exemptions, this exemption does not offer a choice between different accounting alternatives. *[IFRS 1.D17]*. In fact, while a subsidiary that adopts IFRS accounting standards later than its parent can choose to prepare its first IFRS financial statements by reference to its own date of transition to IFRS accounting standards or that of its parent, the parent itself must use the measurements of the assets and liabilities already used in the subsidiary's IFRS financial statements, adjusted as appropriate for consolidation procedures and the effects of the business combination in which it acquired the subsidiary. *[IFRS 1.BC63]*. However, this exemption does not preclude the parent from adjusting the subsidiary's assets and liabilities for a different accounting policy, e.g., cost model or revaluation model for accounting for property, plant and equipment.

The case where a non-investment entity parent adopts IFRS accounting standards after its investment entity subsidiary is discussed in section 5.8.5.B below.

Illustration 5-24 below, which is based on the implementation guidance in IFRS 1, demonstrates how an entity applies these requirements. *[IFRS 1.IG Example 9]*.

Illustration 5-24: Subsidiary adopts IFRS accounting standards before parent

Entity F presents its (consolidated) first IFRS financial statements in 20X3. Its foreign subsidiary G, wholly owned by Entity F since formation, presented its first IFRS financial statements in 20X0. Until 20X3, Subsidiary G prepared information for internal consolidation purposes under Entity F's previous GAAP.

The carrying amounts of Subsidiary G's assets and liabilities at 1 January 20X2 (date of transition to IFRS accounting standards for Entity F) are the same in both Entity F's (consolidated) opening IFRS statement of financial position and Subsidiary G's own financial statements (except for adjustments for consolidation procedures) and are based on Subsidiary G's date of transition to IFRS accounting standards. The fact that Entity F becomes a first-time adopter in 20X3 does not change those carrying amounts. *[IFRS 1.D17]*.

How we see it

When a subsidiary adopts IFRS accounting standards before its parent, this will limit the parent's ability to choose first-time adoption exemptions in IFRS 1 freely as related to that subsidiary, as shown in Illustration 5-25 below.

However, this does not mean that the parent's ability to choose first-time adoption exemptions will always be limited. For example, a parent could still deem a subsidiary's cumulative translation differences to be zero because IFRS 1 specifically states that under the option "the cumulative translation differences for *all* foreign operations are deemed to be zero at the date of transition to IFRSs" (emphasis added). For a discussion of the various options in respect of cumulative translation differences, see sections 5.6 and 5.8.1.A above.

Illustration 5-25: Limited ability to choose first-time adoption exemptions

Entity H will adopt IFRS accounting standards for the first time in 20X6 and its date of transition to IFRS accounting standards is 1 January 20X5. Subsidiary I adopted IFRS accounting standards in 20X1 and its date of transition to IFRS accounting standards was 1 January 20X0:

(a) Subsidiary I and Entity H both account for their property, plant and equipment at historical cost under IAS 16

Upon first-time adoption, Entity H is only allowed to adjust carrying amounts of Subsidiary I's assets and liabilities for the effects of consolidation and the business combination in which Subsidiary I was acquired. Entity H can therefore not apply the exemption to use fair value as deemed cost for Subsidiary I's property, plant and equipment as at its own date of transition to IFRS accounting standards (1 January 20X5).

(b) Subsidiary I accounts for its property, plant and equipment at revalued amounts under IAS 16, while Entity H accounts for its property, plant and equipment at historical cost under IAS 16

In this case, Entity H would not be allowed to apply the exemption to use fair value as deemed cost of Subsidiary I's property, plant and equipment because IFRS 1.D17 would only permit adjustments for the effects of consolidation and the business combination in which Subsidiary I was acquired. Although a consolidation adjustment would be necessary, this would only be to adjust Subsidiary I's revalued amounts to figures based on historical cost.

(c) Subsidiary I deemed the cumulative translation difference for all its foreign subsidiaries to be zero at its date of transition to IFRS accounting standards (i.e., 1 January 20X0)

When Entity H adopts IFRS accounting standards it can deem Subsidiary I's cumulative translation differences to be zero at its date of transition (1 January 20X5). This is because those cumulative translation differences result from translation of Subsidiary I's financial statements into Entity H's presentation currency.

5.8.3 Implementation guidance on accounting for assets and liabilities of subsidiaries, associates and joint ventures

The requirements of IFRS 1 for a parent and subsidiary with different dates of transition to IFRS accounting standards do not override the following requirements of IFRS 1: *[IFRS 1.IG30]*

- The parent's election to use the business combinations exemption in Appendix C discussed in section 5.2 above, which applies to assets and liabilities of a subsidiary acquired in a business combination that occurred before the parent's date of transition to IFRS accounting standards. However, the rules in IFRS 1.D17, *[IFRS 1.D17]*, summarised in section 5.8.2 above (parent adopting IFRS accounting standards after subsidiary) apply to assets acquired and liabilities assumed by the subsidiary after the business combination and still held and owned by it at the parent's date of transition to IFRS accounting standards.
- To apply the requirements in IFRS 1 in measuring items in the financial statements for which the provisions in IFRS 1.D16 and D17 are not relevant. *[IFRS 1.D16, IFRS 1.D17]*. For example, the use of the exemption in IFRS 1.D16(a) to measure assets and liabilities at the carrying amounts in the parent's consolidated financial statements does not affect the use of the exemption in IFRS 1.D13 to deem the cumulative translation differences for all foreign operations are zero at its date of transition, discussed in section 5.6 above, since this is neither an asset nor a liability. However, the subsidiary also has an option to measure the cumulative translation differences at the carrying amount that would be included in its parent's consolidated financial statements, based on the parent's date of transition to IFRS accounting standards (if no adjustments were made for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary). See section 5.8.1.A above. *[IFRS 1.D12, IFRS 1.D13, IFRS 1.D13A]*.
- A first-time adopter must give all the disclosures required by IFRS 1 as of its own date of transition to IFRS accounting standards - see section 6 below.

Section 6.8 below discusses the disclosures required where IFRS 19 *Subsidiaries without Public Accountability: Disclosures* is applied.[6]

5.8.4 Adoption of IFRS accounting standards on different dates in separate and consolidated financial statements

Sometimes, an entity becomes a first-time adopter for its separate financial statements earlier or later than for its consolidated financial statements. Such a situation could arise, for example, when a parent avails itself of the exemption under IFRS 10.4 from preparing consolidated financial statements and prepares its separate financial statements under IFRS accounting standards (see Chapter 7 at section 2.2). *[IFRS 10.4]*. Subsequently, if the parent ceases to be entitled to the exemption or chooses not to use it, the parent would be required to apply IFRS 1 in its first IFRS consolidated financial statements.

Another example might be that, under local law, an entity is required to prepare its consolidated financial statements under IFRS accounting standards, but is required (or permitted) to prepare its separate financial statements under local GAAP. Subsequently, the parent chooses, or is required, to prepare its separate financial statements under IFRS accounting standards.

If a parent becomes a first-time adopter for its separate financial statements earlier or later than for its consolidated financial statements, it must measure its assets and liabilities at the same amounts in both financial statements, except for consolidation adjustments. *[IFRS 1.D17]*.

How we see it

The requirement is merely that the 'same' amounts be used in the first-time adopter's separate and consolidated financial statements under IFRS accounting standards, without being explicit as to which set of financial statements is used as the benchmark. However, we believe that it is clear from the context that the IASB intends that the measurement basis used in whichever set of financial statements first comply with IFRS accounting standards must also be used when IFRS accounting standards are subsequently adopted in the other set.

5.8.5 Application to investment entities under IFRS 10

IFRS 10 requires a parent that is an 'investment entity' as defined in the standard (see Chapter 7 at section 10) to account for most of its subsidiaries at fair value through profit or loss in its consolidated financial statements rather than through consolidation. *[IFRS 10.31, IFRS 10 Appendix A]*. This exception from normal consolidation procedures does not apply to:

- A parent entity that owns a subsidiary which is an investment entity but the parent itself is not an investment entity *[IFRS 10.33]*
- A parent that is an investment entity in accounting for a subsidiary that is not itself an investment entity and whose main purpose and activities are providing services that relate to the investment entity's investment activities *[IFRS 10.32]*

In IFRS 1, there are provisions relating to a parent adopting IFRS accounting standards earlier or later than its subsidiary. Below, we deal with situations where:

- A subsidiary that is required to be measured at fair value through profit or loss adopts IFRS accounting standards after its parent which is an investment entity (see section 5.8.5.A below)
- A parent that is not an investment entity adopts IFRS accounting standards after a subsidiary which is an investment entity (see section 5.8.5.B below)

6 IFRS 19 *Subsidiaries without Public Accountability: Disclosures* was issued by the IASB in May 2024 to simplify the preparation of financial statements by eligible subsidiaries. Eligible subsidiaries that elect to apply IFRS 19 are allowed to provide reduced disclosures while still applying the recognition, measurement and presentation requirements in other IFRS accounting standards. IFRS 19 is effective for annual reporting periods beginning on or after 1 January 2027, with earlier application permitted (subject to jurisdictional endorsement). See Chapter 4 at section 7 for further details on the requirements of IFRS 19.

5.8.5.A Subsidiary adopts IFRS accounting standards after investment entity parent

In this case, the subsidiary that is required to be measured at fair value through profit or loss must measure its assets and liabilities under the general provisions of IFRS 1, based on its own date of transition to IFRS accounting standards (i.e., IFRS 1.D16(b) - see section 5.8.1 above), *[IFRS 1.D16(b)]*, rather than (as would generally be permitted under IFRS 1.D16(a) - see section 5.8.1 above) by reference to the carrying amounts of its assets and liabilities in the IFRS consolidated financial statements of its parent, which are based on the fair value of the investment in the subsidiary. *[IFRS 1.D16(a)]*, This effectively prevents the accounting anomaly of the subsidiary measuring its net assets at the fair value of its own equity on transition to IFRS accounting standards.

5.8.5.B Non-investment entity parent adopts IFRS accounting standards after investment entity subsidiary

In this case, the parent is required to consolidate its subsidiaries and is not able to use the exception to consolidation in IFRS 10 (used by its investment entity subsidiaries). *[IFRS 1.D17]*.

If the provisions in section 5.8.2 above were to be applied, the effect would be that the parent would bring any investments in subsidiaries accounted for at fair value through profit or loss by the subsidiary into the parent's IFRS consolidated statement of financial position at their fair value. This would be contrary to the intention of the investment entities concept that such an accounting treatment is applied only by a parent that is itself an investment entity and IFRS 1.D17 specifically prohibits this.

5.9 Compound financial instruments

IAS 32 requires compound financial instruments (e.g., many convertible bonds) to be split at inception into separate equity and liability components on the basis of facts and circumstances existing when the instrument was issued. *[IAS 32.15, IAS 32.28]*. If the liability component is no longer outstanding at the date of transition to IFRS accounting standards, a full retrospective application of IAS 32 would involve identifying two components, one representing the original equity component and the other (retained earnings) representing the cumulative interest accreted on the liability component, both of which are accounted for in equity (see Chapter 43 at section 6). A first-time adopter does not need to make this possibly complex allocation if the liability component is no longer outstanding at the date of transition to IFRS accounting standards. *[IFRS 1.D18]*. For example, in the case of a convertible bond that has been converted into equity, it is not necessary to make this split.

However, if the liability component of the compound instrument is still outstanding at the date of transition to IFRS accounting standards then a split is required to be made (see Chapter 43 at section 6). *[IFRS 1.IG35, IFRS 1.IG36]*.

5.10 Designation of previously recognised financial instruments

The following discusses the application of the exemptions in IFRS 1.D19-D19C regarding designation of previously recognised financial instruments to certain financial assets and financial liabilities.

5.10.1 Designation of financial asset as measured at fair value through profit or loss

IFRS 9 permits a financial asset to be designated as measured at fair value through profit or loss if the entity meets the criteria in IFRS 9.4.1.5 at the date the entity becomes a party to the financial instrument (see Chapter 44 at section 6). *[IFRS 9.4.1.5]*.

IFRS 1.D19A allows a first-time adopter to designate a financial asset as measured at fair value through profit or loss in accordance with IFRS 9.4.1.5 on the basis of the facts and circumstances that exist at the date of transition to IFRS accounting standards. *[IFRS 1.D19A]*. If this exemption is used, IFRS 1 requires certain additional disclosures (see section 6.4.1 below). *[IFRS 1.29]*.

IFRS 7 *Financial Instruments: Disclosures* also requires an entity which designates a financial asset at fair value through profit or loss to disclose the cumulative change in the fair value of the financial asset attributable to changes in the credit risk of the financial asset. *[IFRS 7.9(c)]*. However, IFRS 1 and IFRS 7 do not describe how a first-time adopter calculates the cumulative change for this disclosure, i.e., which date the cumulative change is calculated from, that of initial recognition or initial designation. See section 5.10.2 below for further discussion.

5.10.2 Designation of financial liability at fair value through profit or loss

IFRS 9 permits a financial liability to be designated as a financial liability at fair value through profit or loss if the entity meets the criteria in IFRS 9.4.2.2 at the date the entity becomes a party to the financial instrument (see Chapter 44 at section 6). *[IFRS 9.4.2.2]*.

IFRS 1.D19 allows a first-time adopter to designate, at the date of transition to IFRS accounting standards, a financial liability as measured at fair value through profit or loss provided the liability meets the criteria in IFRS 9.4.2.2 at that date. *[IFRS 1.D19]*. If this exemption is used, IFRS 1 requires certain additional disclosures (see section 6.4.1 below). *[IFRS 1.29A]*.

IFRS 7 also requires an entity which designates a financial liability at fair value through profit or loss to disclose the cumulative change in the fair value attributable to changes in the credit risk of the financial liability. *[IFRS 7.10(a), IFRS 7.10A(a)]*. However, IFRS 1 and IFRS 7 do not describe how a first-time adopter calculates the cumulative change for this disclosure, i.e., which date the cumulative change is calculated from, that of initial recognition or initial designation. As noted in section 5.10.1 above, there is a similar disclosure required for financial assets designated at fair value through profit or loss. *[IFRS 7.9(c)]*.

How we see it

We believe that the cumulative change in fair value of a financial liability or financial asset designated at fair value through profit or loss is calculated from the date of initial recognition of the financial instrument. For a financial asset, the date of origination by the entity or purchase from another entity is the initial recognition date. For a financial liability, the initial recognition date is the issuance date. The intention of the required disclosures in IFRS 7 for the cumulative change in credit risk for those financial liabilities and financial assets designated at fair value through profit or loss, is to assist users of financial statements to understand the portion of the change in fair value attributable to changes in credit risk. Since the carrying amount of the instrument reflects the entire fair value movement since initial recognition, the corresponding disclosure is intended to reflect the cumulative movement in credit risk since initial recognition.

Where a financial liability is designated at fair value through profit or loss, the first-time adopter is also required to determine whether the accounting required by IFRS 9.5.7.7 would create or enlarge an accounting mismatch in profit or loss on the basis of the facts and circumstances that exist at the date of transition to IFRS accounting standards (see section 5.10.4 below). *[IFRS 1.D19C, IFRS 9.5.7.7, IFRS 9.5.7.8]*.

5.10.3 Designation of investment in an equity instrument

At initial recognition, an entity might make an irrevocable election to designate an investment in an equity instrument (that is neither held for trading nor contingent consideration recognised by an acquirer in a business combination to which IFRS 3 applies) as at fair value through other comprehensive income in accordance with IFRS 9 (see Chapter 44 at section 7). *[IFRS 9.5.7.5]*.

IFRS 1.D19B allows a first-time adopter to designate an investment in such an equity instrument as at fair value through other comprehensive income in accordance with IFRS 9.5.7.5 on the basis of the facts and circumstances that exist at the date of transition to IFRS accounting standards. *[IFRS 1.D19B]*.

5.10.4 Determination of an accounting mismatch for presenting a gain or loss on financial liability

IFRS 9 requires a gain or loss on a financial liability that is designated as at fair value through profit or loss to be presented as follows (unless this presentation creates or enlarges an accounting mismatch in profit or loss): *[IFRS 9.5.7.7, IFRS 9.5.7.8]*

- The amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability must be presented in other comprehensive income.
- The remaining amount of change in the fair value of the liability must be presented in profit or loss.

IFRS 1.D19C requires a first-time adopter to determine whether the treatment in IFRS 9.5.7.7 would create or enlarge an accounting mismatch in profit or loss on the basis of the facts and circumstances that exist at the date of transition to IFRS accounting standards (see Chapter 44 at section 2 and Chapter 46 at section 2.4). *[IFRS 1.D19C]*.

5.11 Fair value measurement of financial assets or financial liabilities at initial recognition

First-time adopters are granted similar transition relief in respect of the 'day 1' gain or loss recognition requirements of IFRS 9 as is available to existing IFRS reporters in response to concerns raised by constituents that retrospective application of the requirements would be difficult and expensive to implement, and might require subjective assumptions about what was observable and what was not. *[IFRS 1.BC83A]*.

Consequently, first-time adopters may apply the requirements of IFRS 9.B5.1.2A(b) about a deferral of the 'day 1' gain/loss prospectively to transactions entered into on or after the date of transition to IFRS accounting standards (see Chapter 45 at section 3.3). *[IFRS 1.D20, IFRS 9.B5.1.2A(b)]*.

5.12 Decommissioning liabilities included in the cost of property, plant and equipment

5.12.1 IFRIC 1 exemption

Under IAS 16, the cost of an item of property, plant and equipment includes "the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period." *[IAS 16.16(c)]*. Therefore, a first-time adopter needs to ensure that property, plant and equipment cost includes an item representing the decommissioning provision as determined under IAS 37. IAS 37 requires the liability, both initially and subsequently, to be measured at the amount required to settle the present obligation at the end of the reporting period, reflecting a current market-based discount rate. *[IAS 37.45, IAS 37.47, IFRS 1.IG201]*.

An entity applies IAS 16 in determining the amount to be included in the cost of the asset, before recognising depreciation and impairment losses which cause differences between the carrying amount of the decommissioning liability and the amount related to decommissioning costs to be included in the carrying amount of the asset. *[IFRS 1.IG13]*.

An entity accounts for changes in decommissioning provisions in accordance with IFRIC 1 which requires that, subject to specified conditions, changes in an existing decommissioning, restoration or similar liability are added to or deducted from the cost of the related asset. The resulting depreciable amount of the asset is depreciated over its useful life, and the periodic unwinding of the discount on the liability is recognised in profit or loss as it occurs. *[IFRS 1.IG202]*. However, IFRS 1.D21 provides an exemption for changes in such liabilities that occurred before the date of transition to IFRS accounting standards and prescribes an alternative treatment if the exemption is used. *[IFRS 1.D21, IFRS 1.IG203, IFRIC 1]*.

In such cases, a first-time adopter must: *[IFRS 1.D21]*

(a) Measure the decommissioning liability as at the date of transition to IFRS accounting standards in accordance with IAS 37

(b) To the extent that the liability is within the scope of IFRIC 1, estimate the amount that would have been included in the cost of the related asset when the liability first arose, by discounting the liability to that date using its best estimate of the historical risk-adjusted discount rate(s) that would have applied for that liability over the intervening period

(c) Calculate the accumulated depreciation on that amount, as at the date of transition to IFRS accounting standards, on the basis of the current estimate of the useful life of the asset, using the entity's IFRS depreciation policy

Illustration 5-26 below demonstrates the determination of the amount of decommissioning liability and the property, plant and equipment related to that decommissioning liability, when using this exemption.

Illustration 5-26: Decommissioning component in property, plant and equipment

Entity A's date of transition to IFRS accounting standards is 1 January 20X5 and the end of its first IFRS reporting period is 31 December 20X6. Entity A built a factory that was completed and ready for use on 1 January 20X0. Under its previous GAAP, Entity A accrued a decommissioning provision over the expected life of the factory. The facts can be summarised as follows:

Cost of the factory	CU1,400
Residual value	CU200
Economic life	20 years
Original estimate of decommissioning cost in year 20	CU175
Revised estimate on 1 January 20X2 of decommissioning cost in year 20	CU300
Discount rate applicable to decommissioning liability (the discount rate is assumed to be constant)	5.65%
Discounted value of original decommissioning liability on 1 January 20X0	CU58
Discounted value on 1 January 20X0 of revised decommissioning liability	CU100
Discounted value on 1 January 20X5 of revised decommissioning liability	CU131

If Entity A applies the exemption from full retrospective application, what are the carrying amounts of the factory and the decommissioning liability in Entity A's opening IFRS statement of financial position?

The tables below show how Entity A accounts for the decommissioning liability and the factory under its previous GAAP, under IFRS 1 using the exemption and under IFRS 1 applying IFRIC 1 retrospectively.

	Decommissioning liability		
	Previous GAAP	*IFRS 1 Exemption*	*Retrospective application of IFRIC 1*
	CU	**CU**	**CU**
1 January 20X0		**100**	**58**
Decommissioning costs CU175 ÷ 20 years × 2 =	17.5		
Decommissioning costs CU100 × (1.0565^2 - 1) =		12	
Decommissioning costs CU58 × (1.0565^2 - 1) =			7
1 January 20X2	**17.5**	**112**	**65**
Revised estimate of decommissioning provision	12.5		47
1 January 20X2	**30**	**112**	**112**
Decommissioning costs CU300 ÷ 20 years × 3 =	45		
Decommissioning costs CU112 × (1.0565^3 - 1) =		19	
Decommissioning costs CU112 × (1.0565^3 - 1) =			19
1 January 20X5	**75**	**131**	**131**
Decommissioning costs CU300 ÷ 20 years × 2 =	30		
Decommissioning costs CU131 × (1.0565^2 - 1) =		16	
Decommissioning costs CU131 × (1.0565^2 - 1) =			16
31 December 20X6	**105**	**147**	**147**

In calculating the decommissioning provision, it makes no difference whether Entity A goes back in time and tracks the history of the decommissioning provision or whether it just calculates the decommissioning provision at its date of transition to IFRS accounting standards. This is not the case for the calculation of the related asset, as can be seen below.

	Factory		
	Previous GAAP	*IFRS 1 Exemption*	*Retrospective application of IFRIC 1*
	CU	CU	CU
1 January 20X0	**1,400**	**1,500**	**1,458**
Depreciation (CU1,400 - CU200) ÷ 20 years × 2 =	(120)		
Depreciation (CU1,500 - CU200) ÷ 20 years × 2 =		(130)	
Depreciation (CU1,458 - CU200) ÷ 20 years × 2 =			(126)
1 January 20X2			**1,332**
Revised estimate of decommissioning provision			47
1 January 20X2			**1,379**
Depreciation (CU1,400 - CU200) ÷ 20 years × 3 =	(180)		
Depreciation (CU1,500 - CU200) ÷ 20 years × 3 =		(195)	
Depreciation (CU1,379 - CU200) ÷ 18 years × 3 =			(197)
1 January 20X5	**1,100**	**1,175**	**1,182**
Depreciation (CU1,400 - CU200) ÷ 20 years × 2 =	(120)		
Depreciation (CU1,500 - CU200) ÷ 20 years × 2 =		(130)	
Depreciation (CU1,379 - CU200) ÷ 18 years × 2 =			(131)
31 December 20X6	**980**	**1,045**	**1,051**

As can be seen above, a full retrospective application of IFRIC 1 would require an entity to go back in time and account for each revision of the decommissioning provision in accordance with IFRIC 1. In the case of a long-lived asset there could be a significant number of revisions that a first-time adopter would need to account for. It can be noted that despite the significant revision of the decommissioning costs, the impact on the carrying amount of the factory in many cases might not be significant.

At its date of transition to IFRS accounting standards (1 January 20X5), Entity A makes the following adjustments:

- The decommissioning liability is increased by CU56 (i.e., CU131 - CU75) to reflect the difference in accounting policy, irrespective of whether Entity A applies the exemption or not.
- If Entity A applies the exemption, this increases the carrying amount of the factory by CU75.
- If Entity A applies IFRIC 1 retrospectively, this increases the carrying amount of the factory by CU82.

It is important to note that in both cases the decommissioning component of the factory's carrying amount will be significantly lower than the decommissioning liability itself.

From the above example, it is clear that the exemption reduces the amount of effort required to restate items of property, plant and equipment with a decommissioning component. In many cases the difference between the two methods will be insignificant, except where an entity had to make major adjustments to the estimate of the decommissioning costs near the end of the life of the related assets.

It is important for a first-time adopter that elects the deemed cost approaches discussed in section 5.4 above and elects to use the IFRIC 1 exemption to recognise its decommissioning obligation to be aware of the interaction between these exemptions that could lead to a potential overstatement of the underlying asset.

How we see it

In determining the deemed cost of the asset equal to fair value, the first-time adopter would need to make sure that the fair value of the asset has taken the decommissioning into account to avoid the potential overstatement of the value of the asset that might result from the application of the IFRIC 1 exemption.

5.12.2 IFRIC 1 exemption for oil and gas assets at deemed cost

A first-time adopter that applies the deemed cost exemption for oil and gas assets in the development or production phases accounted for in cost centres that include all properties in a large geographical area under previous GAAP (see section 5.4.3 above) must not apply the IFRIC 1 exemption (see section 5.12.1 above) or IFRIC 1 itself, but instead is required to: *[IFRS 1.D8A(b), IFRS 1.D21A]*

(a) Measure decommissioning, restoration, and similar liabilities as at the date of transition to IFRS accounting standards in accordance with IAS 37

(b) Recognise directly in retained earnings any difference between that amount and the carrying amount of those liabilities at the date of transition determined under previous GAAP

The IASB introduced this requirement because it believed that the existing IFRIC 1 exemption would require detailed calculations that would not be practicable for entities that apply the deemed cost exemption for oil and gas assets. *[IFRS 1.BC63CA]*.

5.13 Financial assets or intangible assets accounted for in accordance with IFRIC 12

Service concession arrangements are contracts between the public and private sector to attract private sector participation in the development, financing, operation and maintenance of public infrastructure (e.g., roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and telecommunication networks). *[IFRIC 12.1, IFRIC 12.2]*.

IFRS 1 allows a first-time adopter to apply the transitional provision in IFRIC 12. *[IFRS 1.D22]*. IFRIC 12 requires retrospective application unless it is, for any particular service concession arrangement, impracticable for the operator to apply IFRIC 12 retrospectively at the start of the earliest period presented, in which case it must: *[IFRIC 12.29, IFRIC 12.30]*

(a) Recognise financial assets and intangible assets that existed at the start of the earliest period presented, which will be the date of transition to IFRS accounting standards for a first-time adopter

(b) Use the previous carrying amounts of those financial and intangible assets (however previously classified) as their carrying amounts as at that date

(c) Test financial and intangible assets recognised at that date for impairment, unless this is not practicable, in which case the amounts must be tested for impairment at the start of the current period, which will be the beginning of the first IFRS reporting period for a first-time adopter

This exemption was used by many Brazilian companies with service concession arrangements and a disclosure of the use of the exemption is given in Practical example 5-9 below from the financial statements of Centrais Elétricas Brasileiras S.A. - Eletrobras:

Practical example 5-9:	**Centrais Elétricas Brasileiras S.A. - Eletrobras (2010)**	**Brazil**

FORM 20-F [extract]

Explanatory Notes to the Consolidated Financial Statements [extract]

6 Transition to IFRS [extract]

6.1 Basis of transition to IFRS [extract]

6.1.2 Exemptions of full retrospective application adopted by the Company [extract]

(d) Exemption for initial treatment of IFRIC 12

The Company has chosen to apply the exemption provided for in IFRS 1 related to the infrastructure of assets classified as concession assets on the transition date and made the corresponding reclassifications based on the residual book value on January 1, 2009, due to the concession contracts of the Company being substantially old without any possibility to perform a retrospective adjustment.

5.14 Borrowing costs

5.14.1 Borrowing cost exemption

For many first-time adopters, full retrospective application of IAS 23 *Borrowing Costs* would be problematic as the adjustment would be required in respect of any asset held that had, at any point in the past, satisfied the criteria for capitalisation of borrowing costs. To avoid this problem, IFRS 1 allows a modified form of the transitional provisions set out in IAS 23, which means that the first-time adopter can elect to apply the requirements of IAS 23 from the date of transition to IFRS accounting standards or from an earlier date as permitted by IAS 23.28. *[IFRS 1.D23, IAS 23.28]*.

Extract from IFRS 1

D23 A first-time adopter can elect to apply the requirements of IAS 23 from the date of transition or from an earlier date as permitted by paragraph 28 of IAS 23. From the date on which an entity that applies this exemption begins to apply IAS 23, the entity:

(a) shall not restate the borrowing cost component that was capitalised under previous GAAP and that was included in the carrying amount of assets at that date; and

(b) shall account for borrowing costs incurred on or after that date in accordance with IAS 23, including those borrowing costs incurred on or after that date on qualifying assets already under construction.

IAS 23 applies to borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset, as defined in IAS 23. *[IAS 23.1, IAS 23.5]*. If a first-time adopter established a deemed cost for an asset (see section 5.4 above) then it cannot capitalise borrowing costs incurred before the measurement date of the deemed cost (see section 5.14.2 below). *[IFRS 1.IG23]*. IAS 23 requires disclosure of interest capitalised during the period. Neither IAS 23 nor IFRS 1 requires disclosure of the cumulative amount capitalised. *[IFRS 1.IG24, IAS 23.26]*.

5.14.2 Interaction with other exemptions

There are limitations imposed on capitalised amounts under IAS 23. IAS 23 states that when the carrying amount of a qualifying asset exceeds its recoverable amount or net realisable value, the carrying amount is written down or written off in accordance with the requirement of other standards. *[IAS 23.16]*.

How we see it

Once an entity uses the 'fair value as deemed cost exemption' described in section 5.4 above and has recognised an asset at fair value, in our view, the entity does not increase that value to capitalise interest incurred before the fair value measurement date. Interest incurred subsequent to the date of transition could be capitalised on a qualifying asset, subject to the requirements of IAS 23 (see Chapter 22).

5.15 Extinguishing financial liabilities with equity instruments

IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* deals with accounting for transactions whereby a debtor and creditor might renegotiate the terms of a financial liability with the result that the debtor extinguishes the liability fully or partially by issuing equity instruments to the creditor (see Chapter 43 at section 7). *[IFRIC 19.2]*. However, an entity does not apply IFRIC 19 to transactions in situations where: *[IFRIC 19.3]*

(a) The creditor is also a direct or indirect shareholder and is acting in its capacity as a direct or indirect existing shareholder

(b) The creditor and the entity are controlled by the same party or parties before and after the transaction and the substance of the transaction includes an equity distribution by, or contribution to, the entity

Or

(c) Extinguishing the financial liability by issuing equity shares is in accordance with the original terms of the financial liability

The transitional provisions of IFRIC 19 require retrospective application only from the beginning of the earliest comparative period presented. *[IFRIC 19.13]*. The IFRS IC concluded that application to earlier periods would result only in a reclassification of amounts within equity. *[IFRIC 19.BC33]*.

The Board provided similar transition relief to first-time adopters, effectively requiring application of IFRIC 19 from the date of transition to IFRS accounting standards. *[IFRS 1.D25]*.

5.16 Severe hyperinflation

Extract from IFRS 1	
D26	If an entity has a functional currency that was, or is, the currency of a hyperinflationary economy, it shall determine whether it was subject to severe hyperinflation before the date of transition to IFRSs. This applies to entities that are adopting IFRSs for the first time, as well as entities that have previously applied IFRSs.

If an entity has a functional currency that was, or is, the currency of a hyperinflationary economy, it must determine whether it was subject to severe hyperinflation before the date of transition to IFRS accounting standards. *[IFRS 1.D26]*. A currency of a hyperinflationary economy is subject to severe hyperinflation if it has both of the following characteristics: *[IFRS 1.D27]*

(a) A reliable general price index is not available to all entities with transactions and balances in the currency

(b) The currency is not exchangeable into a relatively stable foreign currency. Exchangeability is assessed in accordance with IAS 21.

The functional currency of an entity ceases to be subject to severe hyperinflation on the 'functional currency normalisation date', when the functional currency no longer has either, or both, of these characteristics, or when there is a change in the entity's functional currency to a currency that is not subject to severe hyperinflation. *[IFRS 1.D28]*.

If the date of transition to IFRS accounting standards is on, or after, the functional currency normalisation date, the first-time adopter is allowed to elect to measure all assets and liabilities held before the functional currency normalisation date at fair value on the date of transition to IFRS accounting standards and use that fair value as the deemed cost in the opening IFRS statement of financial position. *[IFRS 1.D29]*.

Preparation of information in accordance with IFRS accounting standards for periods before the functional currency normalisation date might not be possible. Therefore, entities are allowed to prepare financial statements for a comparative period of less than 12 months if the functional currency normalisation date falls within a 12-month comparative period, provided that a complete set of financial statements is prepared, as required by IAS 1.10, for that shorter period. *[IFRS 1.D30, IAS 1.10]*. The Board suggested that entities consider disclosure of non-IFRS comparative information and historical summaries if they would provide useful information to users of financial statements (see section 6.2 below). *[IFRS 1.22]*. The Board further noted that an entity should clearly explain the transition to IFRS accounting standards in accordance with IFRS 1's disclosure requirements in IFRS 1.23-28. *[IFRS 1.BC63J, IFRS 1.23-28]*.

If an entity elects to measure assets and liabilities at fair value and to use that fair value as the deemed cost in its opening IFRS statement of financial position because of severe hyperinflation, the entity must disclose an explanation of how, and why, the entity had, and then ceased to have, a functional currency that is subject to severe hyperinflation (see section 6.5.5 below). *[IFRS 1.D26, IFRS 1.D27, IFRS 1.D28, IFRS 1.D29, IFRS 1.D30, IFRS 1.31C]*.

In August 2023, the IASB issued *Lack of Exchangeability: Amendments to IAS 21* ('the IAS 21 amendments') which set out the approach an entity must apply when assessing whether a currency can be exchanged into another currency, and the exchange rate to use when this is not the case. The amendments also changed IFRS 1.D27(b) and IFRS 1.31C and the new requirements are reflected above. The IAS 21 amendments (including the consequential amendments to IFRS 1) must be applied for annual reporting periods beginning on or after 1 January 2025 with earlier application permitted.

See Chapter 17 regarding accounting during periods of hyperinflation and Chapter 16 at section 7 for assessment of exchangeability.

5.17 Joint arrangements

A first-time adopter is allowed to apply the transitional provisions in Appendix C of IFRS 11 *Joint Arrangements* with the following exceptions: *[IFRS 1.D31, IFRS 11 Appendix C]*

(a) A first-time adopter must apply these transitional provisions at the date of transition to IFRS accounting standards.

(b) When changing from proportionate consolidation to the equity method, a first-time adopter must test the investment for impairment in accordance with IAS 36 as at the date of transition to IFRS accounting standards, regardless of whether there is any indication that it might be impaired. Any resulting impairment must be recognised as an adjustment to retained earnings at the date of transition to IFRS accounting standards.

5.18 Stripping costs in the production phase of a surface mine

In surface mining operations, entities might need to remove mine waste materials ('overburden') to gain access to mineral ore deposits. This waste removal activity is known as 'stripping'. *[IFRIC 20.1]*. A mining entity might continue to remove overburden and to incur stripping costs during the production phase of the mine. *[IFRIC 20.3]*. IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine* considers when and how to account separately for the benefits arising from a surface mine stripping activity, as well as how to measure these benefits both on initial recognition and subsequently (see Chapter 39 at section 15.5). *[IFRIC 20.5]*.

First-time adopters are allowed to apply the transitional provisions set out in IFRIC 20, *[IFRIC 20 Appendix A]*, except that the effective date is deemed to be the beginning of the first IFRS reporting period. *[IFRS 1.D32]*.

5.19 Designation of contracts to buy or sell a non-financial item

IFRS 9 allows some contracts to buy or sell a non-financial item to be designated at inception as measured at fair value through profit or loss (see Chapter 41 at section 3.3.6). *[IFRS 9.2.5]*. Despite this requirement, IFRS 1.D33 allows an entity to designate, at the date of transition to IFRS accounting standards, contracts that already exist on that date as measured at fair value through profit or loss but only if they meet the requirements of IFRS 9.2.5 at that date and the entity designates all similar contracts at fair value through profit or loss. *[IFRS 1.D33]*.

5.20 Revenue from contracts with customers

IFRS 1 includes the following exemptions in relation to IFRS 15 *Revenue from Contracts with Customers*. The requirements of IFRS 15 are discussed in Chapter 28.

Extract from IFRS 1

	Revenue
D34	A first-time adopter may apply the transition provisions in paragraph C5 of IFRS 15. In those paragraphs references to the 'date of initial application' shall be interpreted as the beginning of the first IFRS reporting period. If a first-time adopter decides to apply those transition provisions, it shall also apply paragraph C6 of IFRS 15.
D35	A first-time adopter is not required to restate contracts that were completed before the earliest period presented. A completed contract is a contract for which the entity has transferred all of the goods or services identified in accordance with previous GAAP.

Under the full retrospective method, entities had to apply IFRS 15 as if it had been applied since the inception of all its contracts with customers that are presented in the financial statements. However, to ease the potential burden of applying it on a fully retrospective basis, the IASB provided the optional practical expedients included in IFRS 15.C5 to a first-time adopter. A first-time adopter is permitted to use one or more of the following practical expedients when applying IFRS 15 retrospectively and not to restate contracts that were completed before the earliest period presented (i.e., the date of transition to IFRS accounting standards) (see section 5.20.1 below). *[IFRS 1.D34, IFRS 1.D35]*.

Here are the practical expedients in IFRS 15.C5 as applied to a first-time adopter: *[IFRS 15.C5, IFRS 1.D34]*

(a) For completed contracts, an entity need not restate contracts that:
   (i) Begin and end within the same annual comparative reporting period
   Or
   (ii) Are completed contracts at the date of transition to IFRS accounting standards. *[IFRS 1.D35]*.

(b) For completed contracts that have variable consideration, an entity is allowed to use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.

(c) For contracts that were modified before the date of transition to IFRS accounting standards, an entity need not retrospectively restate the contract for those contract modifications in accordance with IFRS 15.20-21 (see Chapter 28 at section 3.4). Instead, an entity must reflect the aggregate effect of all of the modifications that occur before the date of transition to IFRS accounting standards when: *[IFRS 15.20, IFRS 15.21]*
   (i) Identifying the satisfied and unsatisfied performance obligations
   (ii) Determining the transaction price
   And
   (iii) Allocating the transaction price to the satisfied and unsatisfied performance obligations.

(d) For all reporting periods presented before the beginning of the first IFRS reporting period, an entity need not disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when the entity expects to recognise that amount as revenue (see IFRS 15.120). *[IFRS 15.120]*.

For the purposes of IFRS 15, IFRS 1.D35 defines a 'completed contract' as "a contract for which the entity has transferred all of the goods or services identified in accordance with previous GAAP." *[IFRS 1.D35]*.

A first-time adopter is allowed to elect to apply one, some, or all of these expedients. However, if an entity elects to use any of them, it must apply that expedient consistently to all contracts within all reporting periods presented. In addition, an entity is required to disclose the following information: *[IFRS 15.C6, IFRS 1.D34]*

(a) The expedients that have been used

(b) To the extent reasonably possible, a qualitative assessment of the estimated effect of applying each of those expedients

How we see it

Although IFRS 1 provides the practical expedients, adoption of IFRS 15 by a first-time adopter could be challenging. For example, a first-time adopter might find the determination of completed contracts challenging if its previous GAAP was not clear about when the goods or services had been transferred (see sections 5.20.1 and 5.20.2 below for discussion on the definition of a completed contract). Other application issues are discussed further later in this section.

While the practical expedients provide some relief, first-time adopters will still need to use judgement and make estimates. For example, first-time adopters will need to use judgement in estimating stand-alone selling prices if there has been a wide range of selling prices and when allocating the transaction price to satisfied and unsatisfied performance obligations if there have been several performance obligations or contract modifications over an extended period. Furthermore, if a first-time adopter applies the practical expedient for contract modifications, it will still have to apply IFRS 15's contract modification requirements (see Chapter 28 at section 3.4) to modifications made after the date of transition to IFRS accounting standards.

Illustration 5-27 below demonstrates the practical expedient for contract modifications.

Illustration 5-27: Transition practical expedient for contract modifications

Entity A entered into a contract with a customer to sell equipment for CU1 million and provide services for five years for CU20,000 annually.

The equipment was delivered on 1 January 20X0 and the service contract commenced at that time. The equipment and the service contract are separate performance obligations.

In 20X2, the contract was modified to extend it by five years and to provide an additional piece of equipment for CU1 million. The additional equipment will be delivered during 20X5 and is a separate performance obligation.

Entity A adopts IFRS accounting standards on 1 January 20X5 and, as part of adopting IFRS 15, it applies the practical expedient on contract modifications in accordance with IFRS 15.C5(c). *[IFRS 1.D34, IFRS 1.D35, IFRS 15.C5(c)]*.

The total transaction price for the modified contract is CU2,200,000 (CU1 million (equipment) + CU1 million (equipment) + (10 years × CU20,000 (service))), which is allocated to the two products and the service contract based on the relative stand-alone selling price of each performance obligation. See Chapter 28 at section 6 for discussion on allocating the transaction price to performance obligations.

The transaction price allocated to the second piece of equipment and the remaining unperformed services would be recognised when or as they are transferred to the customer.

When adopting IFRS 15 as part of its transition to IFRS accounting standards, a first-time adopter needs to analyse each of its contracts to determine the appropriate timing and pattern of recognition, considering the specific criteria and requirements of the standard. In some instances, this could result in a change in the timing and/or pattern of revenue recognition compared to its previous GAAP. An example of such a change in the timing of revenue recognition would be a contract manufacturer that produces goods designed to a customer's unique specifications where the goods do not have an alternative use. If the manufacturer also has an enforceable right to payment for performance completed to date, the third criterion in IFRS 15 to recognise revenue over time would be met, *[IFRS 15.35(c)]*, (see Chapter 28 at section 7.1 for further discussion), even though the manufacturer might have recognised revenue at a point in time under its previous GAAP (e.g., based on the number of units produced or units delivered).

Other application issues that could make adopting IFRS 15 as part of transitioning to IFRS accounting standards difficult and/or time-consuming, include the following:

- A first-time adopter will have to perform an allocation of the transaction price because of changes to the identified deliverables, the transaction price or both. If its previous GAAP required a method that is similar to the requirements in IFRS 15, this step might be straightforward. Regardless, a first-time adopter is required to determine the stand-alone selling price of each performance obligation as at inception of the contract. Depending on the age of the contract, this information might not be readily available and the prices could differ significantly from current stand-alone selling prices. While the practical expedients in IFRS 15.C5 are clear about when it is acceptable to use hindsight in respect of variable consideration to determine the transaction price (see Chapter 28 at section 5.2 for a discussion on variable consideration), the practical expedients are silent on whether the use of hindsight is acceptable for other aspects of the model (e.g., for the purpose of allocating the transaction price) or whether it is acceptable to use current pricing information if that were the only information available.
- Estimating variable consideration for all contracts for prior periods is likely to require significant judgement. The standard is clear that hindsight cannot be used for contracts that are not completed. As a result, entities must make this estimate based only on information that was available at contract inception. Contemporaneous documentation clarifying what information was available to management, and when it was available, is likely to be needed to support these estimates. In addition to estimating variable consideration using the expected value or a most likely amount method, a first-time adopter has to make conclusions about whether such variable consideration is subject to the constraint (see Chapter 28 at section 5.2.3 for further discussion).

Finally, a first-time adopter needs to consider a number of other issues as it prepares to adopt IFRS 15 as part of its adoption of IFRS accounting standards. For example, a first-time adopter with significant deferred revenue balances under its previous GAAP could experience what some refer to as 'lost revenue' if those amounts were deferred at the date of transition to IFRS accounting standards and, ultimately, are reflected in the restated prior periods or as part of the cumulative adjustment upon transition, but are never reported as revenue in a current period within the financial statements.

5.20.1 Definition of a completed contract

For the purposes of IFRS 1, a 'completed contract' is a contract for which the entity has transferred all of the goods or services identified in accordance with previous GAAP. *[IFRS 1.D35]*.

Depending on the practical expedients a first-time adopter chooses to apply, it need not apply IFRS 15 to contracts if it has completed performance before the earliest period presented, i.e., the date of transition to IFRS accounting standards, even if it has not yet received the consideration and that consideration is still subject to variability.

The IASB noted in the Basis for Conclusions that 'transferred all of the goods or services' is not meant to imply that an entity would apply the 'transfer of control' notion in IFRS 15 to goods or services that have been identified in accordance with previous GAAP. Rather it is performance in accordance with previous GAAP. *[IFRS 15.BC441]*. For example, if the previous GAAP has similar requirements to legacy revenue requirements in IFRS accounting standards (i.e., IAS 11 *Construction Contracts*, IAS 18 *Revenue* and related Interpretations), in many situations the term 'transferred' would mean 'delivered' within the context of contracts for the sale of goods and 'performed' within the context of contracts for rendering services and construction contracts. In some situations, the entity would use judgement when determining whether it has transferred goods or services to the customer. *[IFRS 15.BC445D]*.

As discussed in section 5.20 above, determining which contracts were completed before the date of transition to IFRS accounting standards might require significant judgement, particularly if a first-time adopter's previous GAAP did not provide detailed requirements that indicated when goods had been delivered or services performed.

5.20.2 Implementation questions on definition of a completed contract

5.20.2.A Elements in a contract to be considered

When determining whether a contract meets the definition of a completed contract, a first-time adopter must consider all of the elements (or components) in a contract that give rise to revenue in its previous GAAP. It does not consider the elements of a contract that do not result in recognition of revenue when assessing whether a contract is completed.

For example, under its previous GAAP, an entity might have accounted for a financing component (i.e., separating the interest income or expense from the revenue). Doing so effectively splits the contract into a revenue component and a financing component.

How we see it

In our view, the financing component generally would not be considered in determining whether the goods or services have transferred to the customer (i.e., it would generally not affect the assessment of whether the contract meets the definition of a completed contract). In addition, income elements that are not within the scope of IFRS 15 need not be considered even if they were covered by revenue requirements in previous GAAP.

None of the following, for example, would be considered when determining whether a contract meets the definition of a completed contract because they are within the scope of IFRS 9, not IFRS 15:

- Dividends (see Chapter 46 at section 2) *[IFRS 9.5.7.1A, IFRS 9.5.7.6]*
- Fees integral to the issuance of a financial instrument (see Chapter 46 at section 3.1) *[IFRS 9.B5.4.1, IFRS 9.B5.4.2, IFRS 9.B5.4.3]*

  Or
- Interest income that is accounted for in accordance with the effective interest method (see Chapter 46 at section 3) *[IFRS 9 Appendix A, IFRS 9.5.4.1, IFRS 9.B5.4.1-B5.4.7]*

5.20.2.B Identification of a contract under previous GAAP

When determining whether a contract is completed, a first-time adopter considers the requirements of its previous GAAP and not IFRS 15.

How we see it

In order to determine whether a contract is completed, a first-time adopter needs to determine the boundaries of a contract, including the term of the contract, whether it was combined with other contracts, whether it was modified, etc. That is, a first-time adopter must identify what is the contract in order to assess if it meets the definition of a completed contract as discussed further below.

IFRS 15 provides detailed requirements to assist entities in identifying a contract, including determining the contract duration. Considering the requirements of IFRS 15 could lead to different outcomes from previous GAAP (e.g., an entity might conclude a contract is of a shorter duration than the stated contractual term in certain circumstances under IFRS 15. See Chapter 28 at section 3.2 for further discussion).

While a first-time adopter's previous GAAP might not have provided detailed requirements for identifying the contract, its accounting policies and past practice might be informative in identifying the contract, including determining: (a) what the first-time adopter considered the contract to be (e.g., master supply agreement or individual purchase orders); and (b) the contract duration (i.e., the stated contractual term or a shorter period). Consider the examples in Illustration 5-28 below.

Illustration 5-28: Definition of completed contract: contract duration

Scenario 1

On 30 June 20X1, Entity B entered into a contract with a customer to provide services for 24 months. The customer was required to pay a fixed monthly fee of CU150, which remained constant during the contract term of 24 months, regardless of the time needed to provide the services or the actual usage from the customer each day. The customer could cancel the contract at any time without penalty by giving Entity B one month's notice. Entity B had not received any cancellation notice up to 1 January 20X2 and, based on past experience, Entity B did not expect customers to cancel within the first year. For this contract, Entity B had concluded that the contract duration under its previous GAAP was the stated contractual term of 24 months.

Entity B's accounting policy for these types of contracts under its previous GAAP stated that revenue from providing monthly services to customers was recognised over the service period, on a monthly basis. While not explicitly stated in its accounting policy, Entity B had typically treated the stated contractual term as the duration of the contract (unless the customer cancelled or the contract was modified), and considered this to be the period over which the contractual rights and obligations were enforceable.

Assume that Entity B adopts IFRS accounting standards for the first time for the year ended 31 December 20X3. Entity B uses the practical expedient in IFRS 15.C5(a)(ii) not to restate contracts that are completed contracts at the date of transition to IFRS accounting standards (i.e., 1 January 20X2; Entity B presents one comparative period only) (see section 5.20 above). *[IFRS 1.D34, IFRS 1.D35, IFRS 15.C5(a)(ii)]*.

Under IFRS 15, Entity B is likely to conclude that the contract is a month-to-month contract. However, when determining whether the contract is completed, Entity B only considers the requirements of its previous GAAP. Entity B might have noted that its previous accounting policy did not focus on the identification of contract duration and, therefore, perhaps the contract is neither a 24-month contract nor a month-to-month contract. Entity B had accounted for this type of service contract based on monthly invoicing and, arguably, that accounting treatment is similar to the accounting treatment of a month-to-month contract. However, while not explicitly stated, Entity B had generally viewed the stated contractual term as the period over which the rights and obligations are enforceable.

Furthermore, Entity B cannot cancel the contract with the customer and is obliged to render services for the entire contract period of 24 months, unless a termination notice is provided by the customer which would limit Entity B's obligation to provide services for the next 30 days from the notification date. Since no cancellation notice had been submitted by the customer at least one month before 1 January 20X2, approximately 18 months of services still had to be provided as at the date of transition to IFRS accounting standards (i.e., 1 January 20X2). Therefore, Entity B concludes that the contract does not meet the definition of a completed contract and would need to be transitioned to IFRS 15.

Scenario 2

Assume the same facts as Scenario 1, with the exception that the customer submitted an early termination notice on 30 November 20X1.

Similar to Scenario 1, the contract duration under previous GAAP would have been the stated contractual term of 24 months. However, in this scenario, the customer has submitted the termination notice on 30 November 20X1. Therefore, Entity B concludes that the term of the contract ceased on 31 December 20X1.

Entity B cannot cancel the contract with the customer and is obliged to render services for the entire contract period of 24 months, unless a termination notice is provided by the customer which limits Entity B's obligation to provide service to the next 30 days from the notification date. Since Entity B had provided all services prior to 31 December 20X1, Entity B concludes that the contract is a completed contract. Entity B continues to apply its previous accounting policy to any remaining consideration still to be recognised.

Scenario 3

Assume the same facts as Scenario 1, with the exception that the customer was required to pay a non-refundable upfront fee of CU50 at commencement of the contract (in addition to the monthly fixed fee). The customer can cancel the contract at any time without penalty, with a month's notice period. The customer cancelled the contract on 30 November 20X1.

In its financial statements, Entity B's accounting policy for these types of contracts under its previous GAAP stated that revenues from non-refundable upfront fees were deferred over the average customer retention period. The customer retention period was estimated to be two years, and the deferred revenue was recognised as revenue on a straight-line basis over the next 24 months.

Similar to Scenario 2, the contract duration under its previous GAAP would have been the stated contractual term of 24 months. However, the customer had submitted the termination notice on 30 November 20X1 and, therefore, Entity B concludes that the term of the contract ceases on 31 December 20X1.

Entity B's previous accounting policy for the non-refundable upfront fee referred to recognition of deferred income over the average customer retention period, not the contractual term. The definition of a completed contract is not dependent on all revenue being recognised, but rather on all goods and services being transferred to the customer. Furthermore, the period over which revenue is recognised does not affect the contract duration. As such, recognition of this upfront fee is not relevant in determining whether the contract is a completed contract. All previously contracted services had been provided to the customer up to the date of cancellation. Therefore, the contract is a completed contract.

Entity B continues applying its previous accounting policy to any remaining consideration still to be recognised. However, given that the customer has terminated the contract early, Entity B needs to reassess, in line with the requirements of its previous GAAP, the period over which this remaining revenue arising from the non-refundable upfront fee would be recognised.

5.20.2.C Some or all of revenue has not been recognised under previous GAAP

If some or all of revenue has not been recognised under a first-time adopter's previous GAAP, this could possibly prevent the contract from being completed.

How we see it

The definition of a completed contract is not dependent on a first-time adopter having recognised all related revenue. However, the requirements in its previous GAAP with respect to the timing of recognition might provide an indication of whether the goods or services have been transferred.

For example, previous GAAP might, like IAS 18, have required an entity to have transferred to the buyer the significant risks and rewards of ownership of the goods as the most crucial of criteria which needed to be satisfied in order to recognise revenue from the sale of goods. In the following four examples of situations which were listed in IAS 18.16, an entity might have retained the significant risks and rewards of ownership and, consequently, revenue might not have been recognised:

- When the entity retained an obligation for unsatisfactory performance not covered by normal warranty provisions
- When the receipt of the revenue from a particular sale was contingent on the derivation of revenue by the buyer from its sale of the goods
- When the goods were shipped subject to installation and the installation was a significant part of the contract which had not yet been completed by the entity
- When the buyer had the right to rescind the purchase for a reason specified in the sales contract and the entity was uncertain about the probability of return

Understanding the reasons for the accounting treatment under previous GAAP might, therefore, assist a first-time adopter in determining whether the goods or services have been transferred and the completed contract definition has been met. However, judgement might be needed in respect of some goods or services. Assume, for example, that a first-time adopter sells products, but cannot recognise revenue immediately. The delayed recognition of revenue might be because of factors related to the timing of transfer, such as a bill-and-hold arrangement, or because the goods or services have been transferred, but not all of the criteria for recognition have been met.

5.20.2.D Accounting for completed contracts excluded from transition

Depending on the practical expedients a first-time adopter applies, it might exclude contracts that meet the definition of a completed contract from the population of contracts to be transitioned to IFRS 15 (i.e., it would not need to restate those contracts) (see Illustration 5-28 in section 5.20.2.B above).

IFRS 15 clarifies that if a first-time adopter chooses not to apply IFRS 15 to completed contracts, it would continue to account for the completed contracts in accordance with its accounting policies based on its previous GAAP. *[IFRS 1.D34, IFRS 1.D35, IFRS 15.BC445E, IFRS 15.BC509]*.

Therefore, if a first-time adopter applies IFRS 1.D35 (or the practical expedient in IFRS 15.C5(a)(ii)) not to restate contracts that are completed contracts before the earliest period presented (i.e., the date of transition to IFRS accounting standards), the first-time adopter also would not record an asset for incremental costs to obtain contracts under IFRS 15 (see Chapter 28 at section 9.3.1) that meet the definition of a completed contract as at the date of transition to IFRS accounting standards if it did not recognise the costs as assets under its previous GAAP. Furthermore, any assets or liabilities related to completed contracts that are on the balance sheet prior to the date of transition to IFRS accounting standards would continue to be accounted for under its previous accounting policy after the adoption of IFRS accounting standards. *[IFRS 1.D34, IFRS 1.D35, IFRS 15.C5(a)(ii)]*.

5.21 Foreign currency transactions and advance consideration

IFRIC 22 *Foreign Currency Transactions and Advance Consideration* applies (with certain exceptions) to a foreign currency transaction (or part of it) when an entity recognises a non-monetary asset or non-monetary liability arising from the payment or receipt of advance consideration before the entity recognises the related asset, expense or income (or part of it). *[IFRIC 22.4]*. IFRIC 22 addresses how to determine 'the date of the transaction' for the purpose of determining the exchange rate to use on initial recognition of the related asset, expense or income (or part of it) on the derecognition of a non-monetary asset or non-monetary liability arising from the payment or receipt of advance consideration in a foreign currency. *[IFRIC 22.7]*.

IFRIC 22 explains that the date of the transaction for this purpose is the date on which an entity initially recognises the non-monetary asset or non-monetary liability arising from the payment or receipt of advance consideration. If there are multiple payments or receipts in advance, a date of transaction is determined for each payment or receipt of advance consideration (see Chapter 16 at section 5.1.2). *[IFRIC 22.8, IFRIC 22.9]*.

A first-time adopter need not apply IFRIC 22 to assets, expense and income in the scope of the Interpretation that were initially recognised before the date of transition to IFRS accounting standards. *[IFRS 1.D36]*.

5.22 Regulatory deferral accounts

IFRS 14 specifies the financial reporting requirements for regulatory deferral account balances that arise when an entity provides goods or services to customers at a price or rate that is subject to rate regulation (see definitions in section 5.22.1 below). *[IFRS 14.1]*.

The standard gives a first-time adopter that is a rate-regulated entity the option to continue with the recognition of rate-regulated assets and liabilities under previous GAAP on transition to IFRS accounting standards, subject to certain limited changes to previous GAAP accounting policies for regulatory deferral account balances (mainly impacting presentation) and certain disclosures (see section 5.22.6 and section 5.22.7 below). *[IFRS 14.2, IFRS 14.3]*.

IFRS 14 provides entities with some exceptions to and exemptions from compliance with other IFRS accounting standards and the conceptual framework on first-time adoption and subsequent reporting periods, until the comprehensive project on rate regulation is completed (see section 5.22.9 below). First-time adopters, whose previous GAAP prohibited the recognition of rate-regulated assets and liabilities, will not be allowed to apply IFRS 14 on transition to IFRS accounting standards. *[IFRS 14.5]*. We discuss the requirements of IFRS 14 in detail below.

5.22.1 Defined terms in IFRS 14

IFRS 14 defines the following terms in connection with regulatory deferral accounts. *[IFRS 14 Appendix A]*.

Extract from IFRS 14

Appendix A
Defined terms

rate-regulated activities	An entity's activities that are subject to **rate regulation**.
rate regulation	A framework for establishing the prices that can be charged to customers for goods or services and that framework is subject to oversight and/or approval by a **rate regulator**.
rate regulator	An authorised body that is empowered by statute or regulation to establish the rate or a range of rates that bind an entity. The **rate regulator** may be a third-party body or a related party of the entity, including the entity's own governing board, if that body is required by statute or regulation to set rates both in the interest of the customers and to ensure the overall financial viability of the entity.
regulatory deferral account balance	The balance of any expense (or income) account that would not be recognised as an asset or a liability in accordance with other Standards, but that qualifies for deferral because it is included, or is expected to be included, by the **rate regulator** in establishing the rate(s) that can be charged to customers.

5.22.2 Scope

Extract from IFRS 14

5 An entity is permitted to apply the requirements of this Standard in its *first IFRS financial statements* if and only if it:

(a) conducts *rate-regulated activities*; and

(b) recognised amounts that qualify as regulatory deferral account balances in its financial statements in accordance with its previous GAAP.

6 An entity shall apply the requirements of this Standard in its financial statements for subsequent periods if and only if, in its first IFRS financial statements, it recognised regulatory deferral account balances by electing to apply the requirements of this Standard.

...

8 An entity that is within the scope of, and that elects to apply, this Standard shall apply all of its requirements to all regulatory deferral account balances that arise from all of the entity's rate-regulated activities.

An entity is permitted to apply IFRS 14 in its first IFRS financial statements, if and only if the entity conducts rate-regulated activities and recognised amounts that qualify as regulatory deferral account balances in its financial statements under its previous GAAP. *[IFRS 14.5]*. IFRS 14 applies only to the rate-regulated activities that are subject to statutory or regulatory restrictions through the actions of a rate regulator. *[IFRS 14.B1]*. IFRS 14 "does not allow entities to recognise regulatory deferral account balances if those entities have a dominant position in a market and decide to self-regulate to avoid the potential government intervention that might occur if it were perceived to be abusing its dominant position. Instead, it requires there to be a formal rate regulator involved to ensure that the rate-regulatory mechanism in place is supported by statute or regulation and that the regulatory mechanism binds the entity." *[IFRS 14.BC22]*. Therefore, an entity cannot apply IFRS 14 to activities that are self-regulated, i.e., activities that are not subject to a pricing framework that is overseen and/or approved by a rate regulator. This does not prevent the entity from being eligible to apply IFRS 14 when: *[IFRS 14.B2, IFRS 14.BC23]*

(a) The entity's own governing body or a related party establishes rates both in the interest of the customers and to ensure the overall financial viability of the entity within a specified pricing framework

And

(b) The framework is subject to oversight and/or approval by an authorised body that is empowered by statute or regulation

An entity that is within the scope of, and that elects to apply, IFRS 14 must apply all of its requirements to all regulatory deferral account balances that arise from all of the entity's rate-regulated activities. *[IFRS 14.8]*.

An entity that elected to apply IFRS 14 in its first IFRS financial statements and recognised regulatory deferral account balances must apply IFRS 14 also in its financial statements for subsequent periods. An entity must not apply IFRS 14 in subsequent periods if it did not apply the standard when first adopting IFRS accounting standards. *[IFRS 14.6]*.

5.22.3 Continuation of previous GAAP accounting policies (temporary exemption from IAS 8.11)

In some cases, other IFRS accounting standards explicitly prohibit an entity from recognising, in the statement of financial position, regulatory deferral account balances that might be recognised, either separately or included within other line items such as property, plant and equipment, in accordance with previous GAAP accounting policies. *[IFRS 14.B4].*

However, an entity that elects to apply IFRS 14 in its first IFRS financial statements applies the exemption from IAS 8.11 (see Chapter 3 at section 4.3) to its accounting policies for the recognition, measurement, impairment and derecognition of regulatory deferral account balances. *[IFRS 14.10, IFRS 14.B4, IAS 8.11]*. The IASB decided that an entity must continue to follow those previous GAAP accounting policies, provided that they satisfy the requirements of IAS 8.10 and IAS 8.12 (see Chapter 3 at section 4.3). *[IFRS 14.9, IFRS 14.11, IFRS 14.B4, IAS 8.10, IAS 8.12]*.

IFRS 14 introduces certain constraints over changes in accounting policies (see section 5.22.5 below) and presentation requirements for regulatory deferral account balances (see section 5.22.6 below). *[IFRS 14.11]*.

This approach should help to ensure that those policies are generally accepted in the local jurisdiction, either because the local GAAP allows the use of another standard-setter's pronouncement or because of accepted industry practice. *[IFRS 14.BC32]*.

Extract from IFRS 14	
11	**On initial application of this Standard, an entity shall continue to apply its previous GAAP accounting policies for the recognition, measurement, impairment and derecognition of regulatory deferral account balances, except for any changes permitted by paragraphs 13-15. However, the presentation of such amounts shall comply with the presentation requirements of this Standard, which may require changes to the entity's previous GAAP presentation policies (see paragraphs 18-19).**

Such previous GAAP accounting policies might include, for example, the following practices: *[IFRS 14.B4]*

- Recognising a regulatory deferral account debit balance when the entity has the right, as a result of the actual or expected actions of the rate regulator, to increase rates in future periods in order to recover its allowable costs (i.e., the costs for which the regulated rate(s) is intended to provide recovery)
- Recognising, as a regulatory deferral account debit or credit balance, an amount that is equivalent to any loss or gain on the disposal or retirement of both items of property, plant and equipment and of intangible assets, which is expected to be recovered or reversed through future rates
- Recognising a regulatory deferral account credit balance when the entity is required, as a result of the actual or expected actions of the rate regulator, to decrease rates in future periods in order to reverse over-recoveries of allowable costs (i.e., amounts in excess of the recoverable amount specified by the rate regulator)
- Measuring regulatory deferral account balances on an undiscounted basis or on a discounted basis that uses an interest or discount rate specified by the rate regulator

The accounting policy for the regulatory deferral account balances, as explained above, must, of course, be consistent from period to period unless there is an appropriate change in accounting policies (see section 5.22.5 below). *[IFRS 14.12, IFRS 14.13, IFRS 14.14, IFRS 14.15]*.

5.22.4 Recognition of regulatory deferral account balances

Extract from IFRS 14	
regulatory deferral account balance	The balance of any expense (or income) account that would not be recognised as an asset or a liability in accordance with other Standards, but that qualifies for deferral because it is included, or is expected to be included, by the **rate regulator** in establishing the rate(s) that can be charged to customers.

The regulatory deferral account balances to be recognised are restricted to the incremental amounts that qualify for deferral (because they are included, or expected to be included, by the rate regulator in establishing the rate(s) that can be charged to customers) from what are permitted or required to be recognised as assets and liabilities under other IFRS accounting standards. *[IFRS 14.7, IFRS 14.B3, IFRS 14 Appendix A, IFRS 14.BC27]*.

Therefore, the measurement of these balances effectively entails a two-step process:

(a) An entity would first determine the carrying amounts of its assets and liabilities under IFRS accounting standards, excluding IFRS 14.

(b) These amounts would then be compared with the assets and liabilities determined under the entity's previous GAAP (i.e., its rate-regulated balances).

The differences would represent the regulatory deferral account debit or credit balances to be recognised by the entity under IFRS 14.

Some items of expense (income) might be outside the regulated rate(s) because, for example, the amounts are not expected to be accepted by the rate regulator or because they are not within the scope of the rate regulation. Consequently, such an item is recognised as income when earned or expense as incurred, unless another IFRS accounting standard permits or requires it to be included in the carrying amount of an asset or liability. *[IFRS 14.B3]*.

The following are examples of the types of costs that rate regulators might allow in rate-setting decisions and that an entity might, therefore, recognise in regulatory deferral account balances: *[IFRS 14.B5]*

- Volume or purchase price variances
- Costs of approved 'green energy' initiatives (in excess of amounts that are capitalised as part of the cost of property, plant and equipment in accordance with IAS 16)
- Non-directly-attributable overhead costs that are treated as capital costs for rate regulation purposes (but are not permitted, in accordance with IAS 16, to be included in the cost of an item of property, plant and equipment)
- Project cancellation costs
- Storm damage costs
- Deemed interest (including amounts allowed for funds that are used during construction that provide the entity with a return on the owner's equity capital as well as borrowings)

5.22.5 Changes in accounting policies

Extract from IFRS 14

13 **An entity shall not change its accounting policies in order to start to recognise regulatory deferral account balances. An entity may only change its accounting policies for the recognition, measurement, impairment and derecognition of regulatory deferral account balances if the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable[1], or more reliable and no less relevant to those needs. An entity shall judge relevance and reliability using the criteria in paragraph 10 of IAS 8.**

1 In 2010, the IASB replaced the IASC's *Framework for the Preparation and Presentation of Financial Statements* adopted by the IASB in 2001 (*Framework*) with the *Conceptual Framework for Financial Reporting (Conceptual Framework)*. The term "faithful representation", which was used in the *Conceptual Framework* issued in 2010 and is also used in the revised version of the *Conceptual Framework* issued in 2018, encompasses the main characteristics that the *Framework* called "reliability". The requirement in paragraph 13 of this Standard is based on the requirements of IAS 8, which retains the term "reliable".

IFRS 14 does not exempt entities from applying IAS 8.10 and IAS 8.12 when developing their accounting policies. *[IFRS 14.9, IAS 8.10, IAS 8.12]*. Moreover, IFRS 14 does not exempt entities from applying IAS 8.10 or IAS 8.14-15 (see Chapter 3 at sections 4.3 and 4.4) to changes in accounting policy. Consequently, an entity needs to demonstrate that the change brings its financial statements closer to meeting the IAS 8.10 criteria but need not achieve full compliance with those criteria for the recognition, measurement, impairment and derecognition of regulatory deferral account balances. *[IFRS 14.13, IFRS 14.14, IAS 8.10, IAS 8.14, IAS 8.15]*. These requirements apply both to changes in accounting policies made on initial application of IFRS 14 and to changes made in subsequent reporting periods. *[IFRS 14.15]*.

The application guidance in IFRS 14 clarifies that regulatory deferral account balances usually represent timing differences between the recognition of items of income or expenses for regulatory purposes and the recognition of those items for financial reporting purposes. When an entity changes an accounting policy on the first-time adoption of IFRS accounting standards or on the initial application of a new or revised IFRS accounting standard, new or revised timing differences may arise that create new or revised regulatory deferral account balances. The prohibition in IFRS 14.13 that prevents an entity from changing its accounting policy in order to start to recognise regulatory deferral account balances does not prohibit the recognition of the new or revised regulatory deferral account balances that are created because of other changes in accounting policies required by IFRS accounting standards. This is because the recognition of regulatory deferral account balances for such timing differences would be consistent with the existing recognition policy and would not represent the introduction of a new accounting policy. Similarly, IFRS 14.13 does not prohibit the recognition of regulatory deferral account balances arising from timing differences that did not exist immediately prior to the date of transition to IFRS accounting standards but are consistent with the entity's accounting policies established in accordance with IFRS 14.11 (see section 5.22.3 above), for example, storm damage costs. *[IFRS 14.11, IFRS 14.13, IFRS 14.B6]*.

5.22.6 Presentation

IFRS 14 requires an entity to present (1) the total of all regulatory deferral account debit balances and (2) the total of all regulatory deferral account credit balances as separate line items in the statement of financial position. The totals of regulatory deferral account balances must not be classified as current or non-current. The separate line items for (1) and (2) above presented in the statement of financial position must instead be distinguished from other items that are presented under other IFRS accounting standards by the use of sub-totals, which are drawn before the regulatory deferral account balances are presented. *[IFRS 14.20, IFRS 14.21, IFRS 14.IE1]*.

Similarly, IFRS 14 requires an entity to present the net movement in all regulatory deferral account balances as separate line items in the statement(s) of profit or loss and other comprehensive income. The net movement in all regulatory deferral account balances for the reporting period that relate to items recognised in other comprehensive income must be presented in the other comprehensive income section of the statement of profit or loss and other comprehensive income, giving separate lines for the net movement related to items that, in accordance with other IFRS accounting standards, (a) will not or (b) will be reclassified subsequently to profit or loss when specific conditions are met. *[IFRS 14.22, IFRS 14.IE1]*. The remaining net movement in all regulatory deferral balances (excluding movements not reflected in profit or loss, such as amounts acquired) is presented as a separate line item in the profit or loss section of the statement of profit or loss and other comprehensive income (or in the separate statement of profit or loss). This is distinguished from the income and expenses that are presented in accordance with other IFRS accounting standards by the use of a sub-total drawn before that line item. *[IFRS 14.23, IFRS 14.IE1]*.

See Illustration 5-29 in section 5.22.6.D below for an example of the presentation of regulatory deferral balances.

5.22.6.A Presentation of deferred tax balances

In relation to a deferred tax asset or deferred tax liability that is recognised as a result of recognising regulatory deferral account balances (see section 5.22.8.B below), the entity must not include that deferred tax amount within the total deferred tax asset (liability) balances. Instead, an entity is required to present the deferred tax asset or liability either: *[IFRS 14.24, IFRS 14.B11]*

(a) With the line items that are presented for the regulatory deferral account debit balances and credit balances

Or

(b) As a separate line item alongside the related regulatory deferral account debit balances and credit balances

Similarly, when an entity recognises the movement in a deferred tax asset (liability) that arises as a result of recognising regulatory deferral account balances, the entity must not include the movement in that deferred tax amount within the tax expense (income) line item that is presented in the statement(s) of profit or loss and other comprehensive income under IAS 12. Instead, the entity must present the movement either: *[IFRS 14.24, IFRS 14.B12]*

(a) With the line items that are presented in the statement(s) of profit or loss and other comprehensive income for the movements in regulatory deferral account balances

Or

(b) As a separate line item alongside the related line items that are presented in the statement(s) of profit or loss and other comprehensive income for the movements in regulatory deferral account balances

5.22.6.B Presentation of earnings per share amounts

IFRS 14 requires additional earnings per share amounts to be presented. When an entity presents earnings per share in accordance with IAS 33 *Earnings per Share* (see Chapter 33), the entity must present additional basic and diluted earnings per share calculated using the earnings amounts required by IAS 33 but excluding the movements in regulatory deferral account balances. This additional measure is required for each earnings per share amount presented. Furthermore, this earnings per share amount required by IFRS 14.26 has to be presented with equal prominence to the earnings per share required by IAS 33 for all periods presented. *[IFRS 14.26, IFRS 14.B14]*.

5.22.6.C Presentation of discontinued operations and disposal groups

When an entity applying IFRS 14 presents a discontinued operation, the movement in regulatory deferral account balances that arose from the rate-regulated activities of the discontinued operation must be excluded from the line items for discontinued operations required by IFRS 5.33 (see Chapter 5 at section 3.2). *[IFRS 5.33]*. Instead, the movement must be presented either: *[IFRS 14.25, IFRS 14.B20, IFRS 14.IE Example 2]*

(a) Within the line item that is presented for movements in the regulatory deferral account balances related to profit or loss

Or

(b) As a separate line item alongside the related line item that is presented for movements in the regulatory deferral account balances related to profit or loss

Similarly, notwithstanding the requirements of IFRS 5.38 (see Chapter 5 at section 2.2.4), when an entity presents a disposal group in the statement of financial position, the total of the regulatory deferral account debit balances and credit balances that are part of the disposal group are presented either: *[IFRS 14.25, IFRS 14.B21, IFRS 14.IE Example 2]*

(a) Within the line items that are presented for the regulatory deferral account debit balances and credit balances

Or

(b) As separate line items alongside the other regulatory deferral account debit balances and credit balances

If an entity chooses to include the regulatory deferral account balances and movements in those balances that are related to the disposal group or discontinued operation within the related regulated deferral account line items, it might be necessary to disclose them separately as part of the analysis of the regulatory deferral account line items described by IFRS 14.33 (see section 5.22.7.B below). *[IFRS 14.33, IFRS 14.B22, IFRS 14.IE Example 2]*.

5.22.6.D Illustrative presentation of financial statements

Illustration 5-29 below, which sets out Illustrative Example 1 which accompanied IFRS 14, *[IFRS 14.IE Example 1]*, illustrates how the requirements in sections 5.22.6 to 5.22.6.C above might be met, but is not intended to illustrate all aspects of IFRS 14 or IFRS accounting standards more generally. *[IFRS 14.IE1]*. Note that in this case, the deferred tax amounts are included within the separate line items for regulatory deferral account balances (see section 5.22.6.A above).

Illustration 5-29: Illustrative presentation of financial statements for regulatory deferral account balances

XYZ GROUP - STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X7		
	20X7	**20X6**
	CU	**CU**
ASSETS		
Non-current assets		
Property, plant and equipment	350,700	360,020
Goodwill	80,800	91,200
Other intangible assets	227,470	227,470
Investments in associates	100,150	110,770
Investments in equity instruments	129,790	146,460
	888,910	**935,920**
Current assets		
Inventories	135,230	132,500
Trade receivables	91,600	110,800
Other current assets	25,650	12,540
Cash and cash equivalents	212,160	220,570
	464,640	**476,410**
Total assets	**1,353,550**	**1,412,330**
Regulatory deferral account debit balances and related deferred tax asset	112,950	111,870
Total assets and regulatory deferral account debit balances	**1,466,500**	**1,524,200**

Note: The aggregated total that is presented for regulatory deferral account debit balances and the related deferred tax asset includes the sum of the regulatory deferral account debit balances of CU100,240 (20X6 - CU102,330) plus the deferred tax asset that is related to the recognition of regulatory deferral account balances of CU12,710 (20X6 - CU9,540). This aggregated presentation is permitted by IFRS 14.24 and IFRS 14.B11. *[IFRS 14.24, IFRS 14.B11]*.

XYZ GROUP - STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X7 (Continued)		
	20X7	**20X6**
	CU	**CU**
EQUITY AND LIABILITIES		
Equity attributable to owners of the parent		
Share capital	650,000	600,000
Retained earnings	243,500	164,500
Other components of equity	10,200	21,200
	903,700	785,700
Non-controlling interests	70,050	45,800
Total equity	**973,750**	**831,500**
Non-current liabilities		
Long-term borrowings	120,000	160,000
Deferred tax	28,800	26,040
Long-term provisions	28,850	52,240
	177,650	238,280
Current liabilities		
Trade and other payables	87,140	111,150
Short-term borrowings	80,000	200,000
Current portion of long-term borrowings	10,000	20,000
Current tax payable	35,000	42,000
Short-term provisions	5,000	4,800
	217,140	377,950
Total liabilities	**394,790**	**616,230**
Total equity and liabilities	**1,368,540**	**1,447,730**
Regulatory deferral account credit balances	97,960	76,470
Total equity, liabilities and regulatory deferral account credit balances	**1,466,500**	**1,524,200**

Note: Regulatory deferral account balances are not described as assets or liabilities for the purposes of IFRS 14. The sub-totals described as 'Total assets' and 'Total liabilities' are comparable to those that would be presented if the regulatory deferral account balances were not recognised. The difference between these two sub-totals represents the net balance of all regulatory deferral account balances recognised and any related deferred tax asset (liability) that arises as a result of recognising regulatory deferral account balances, which would otherwise be recognised within retained earnings or other components of equity.

XYZ Group - Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7[7]

(illustrating the presentation of profit or loss and other comprehensive income in one statement and the classification of expenses within profit or loss by function)

	20X7	20X6
	CU	CU
Revenue	390,000	358,784
Cost of sales	(237,062)	(230,000)
Gross profit	152,938	128,784
Other income	44,247	16,220
Distribution costs	(9,000)	(13,700)
Administrative expenses	(20,000)	(31,500)
Other expenses	(2,100)	(1,200)
Finance costs	(8,000)	(7,500)
Share of profit of associates	35,100	15,100
Profit before tax	**193,185**	**106,204**
Income tax expense	(43,587)	(44,320)
Profit for the year before net movements in regulatory deferral account balances	**149,598**	**61,884**
Net movement in regulatory deferral account balances related to profit or loss and the related deferred tax movement	(27,550)	3,193
Profit for the year and net movements in regulatory deferral account balances	**122,048**	**65,077**
Other comprehensive income: Items that will not be reclassified to profit or loss		
Remeasurements of defined benefit pension plans	(7,938)	(3,784)
Net movement in regulatory deferral account balances related to other comprehensive income	7,140	4,207
Other comprehensive income for the year, net of income tax	**(798)**	**423**
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	**121,250**	**65,500**
Profit and net movements in regulatory deferral account balances attributable to		
Owners of the parent	97,798	51,977
Non-controlling interests	24,250	13,100
	122,048	**65,077**
Total comprehensive income attributable to:		
Owners of the parent	97,000	52,400
Non-controlling interests	24,250	13,100
	121,250	**65,500**
Earnings per share (in CU):		
Basic and diluted	0.61	0.35
Basic and diluted including net movement in regulatory deferral account balances	0.46	0.30

7 The Illustration of statement of profit or loss and other comprehensive income is based on requirements of IAS 1.

Notes:

(1) To simplify the example, it is assumed that all regulatory deferral account balances relate to activities that are carried out in wholly-owned subsidiaries and thus no amounts are attributable to non-controlling interests.

(2) The aggregated total that is presented for the net movement in regulatory deferral account balances related to profit or loss and the related deferred tax movement includes the net movement in regulatory deferral account balances of CU30,720 (20X6 - CU9,127) and the movement in the related deferred tax asset that is related to the recognition of regulatory deferral account balances, which is CU3,170 (20X6 - CU12,320). This aggregated presentation is permitted by IFRS 14.24 and IFRS 14.B12. *[IFRS 14.24, IFRS 14.B12]*.

The Illustrative Examples to IFRS 14 also illustrate a situation where the entity has a rate-regulated subsidiary presented as a disposal group and discontinued operation. In that example (which is not included in this chapter), the entity has instead chosen to present the regulatory deferral account balances included in the disposal group and the related deferred tax asset balance (and movement therein) as separate line items (see sections 5.22.6.A and 5.22.6.C above). *[IFRS 14.IE Example 2]*.

5.22.7 Disclosures

IFRS 14 requires an entity to disclose information that enables users to assess: *[IFRS 14.27]*

(a) The nature of, and the risks associated with, the rate regulation that establishes the price(s) that the entity can charge customers for the goods or services it provides

(b) The effects of that rate regulation on the entity's financial position, financial performance and cash flows

Any of the disclosure requirements set out in sections 5.22.7.A and 5.22.7.B below can be omitted if not considered relevant to meet the disclosure objective above. Where those disclosures are insufficient to meet the disclosure objective, an entity provides additional information necessary to meet the disclosure objective. *[IFRS 14.28]*.

To meet the disclosure objective, an entity must consider all of the following: *[IFRS 14.29]*

(a) The level of detail that is necessary to satisfy the disclosure requirements

(b) How much emphasis to place on each of the various requirements

(c) How much aggregation or disaggregation to undertake

And

(d) Whether users of financial statements need additional information to evaluate the quantitative information disclosed

5.22.7.A Explanation of activities subject to rate regulation

In order to help users of the financial statements assess the nature of, and the risks associated with, an entity's rate-regulated activities, an entity is required to disclose the following for each type of rate-regulated activity: *[IFRS 14.30]*

(a) A brief description of the nature and extent of the rate-regulated activity and the nature of the regulatory rate-setting process

(b) The identity of the rate regulator(s). If the rate regulator is a related party (as defined in IAS 24 *Related Party Disclosures* (see Chapter 35 at section 3)), the entity must disclose that fact, together with an explanation of how it is related

(c) How the future recovery of each class (i.e., each type of cost or income) of regulatory deferral account debit balance or reversal of each class of regulatory deferral account credit balance is affected by risks and uncertainty, for example:

  (i) Demand risk (e.g., changes in consumer attitudes, the availability of alternative sources of supply or the level of competition)

  (ii) Regulatory risk (e.g., the submission or approval of a rate-setting application or the entity's assessment of the expected future regulatory actions)

  And

  (iii) Other risks (e.g., currency or other market risks)

These disclosures must be given in the notes to the financial statements or incorporated by cross-reference from the financial statements to some other statement (such as a management commentary or a risk report) that is available to users of the financial statements on the same terms as the financial statements and at the same time. *[IFRS 14.31]*.

5.22.7.B Explanation of recognised amounts

IFRS 14 also requires entities to explain the basis on which regulatory deferral account balances are recognised and derecognised, and how they are measured initially and subsequently, including how regulatory deferral account balances are assessed for recoverability and how impairment losses are allocated. *[IFRS 14.32]*.

Furthermore, for each type of rate-regulated activity, an entity is required to disclose the following information for each class of regulatory deferral account balance: *[IFRS 14.33]*

(a) A reconciliation of the carrying amount at the beginning and the end of the period, in a table unless another format is more appropriate. The entity must apply judgement in deciding the level of detail necessary (see section 5.22.7 above, *[IFRS 14.28, IFRS 14.29]*) but the following components would usually be relevant:
   (i) The amounts that have been recognised in the current period in the statement of financial position as regulatory deferral account balances
   (ii) The amounts that have been recognised in the statement(s) of profit or loss and other comprehensive income relating to balances that have been recovered (sometimes described as amortised) or reversed in the current period
   (iii) Other amounts, separately identified, that affected the regulatory deferral account balances, such as impairments, items acquired or assumed in a business combination, items disposed of, or the effects of changes in foreign exchange rates or discount rates

(b) The rate of return or discount rate (including a zero rate or a range of rates, when applicable) used to reflect the time value of money that is applicable to each class of regulatory deferral account balance

(c) The remaining periods over which the entity expects to recover (or amortise) the carrying amount of each class of regulatory deferral account debit balance or to reverse each class of regulatory deferral account credit balance

When rate regulation affects the amount and timing of an entity's income tax expense (income), the entity must disclose the impact of the rate regulation on the amounts of current and deferred tax recognised. In addition, the entity must separately disclose any regulatory deferral account balance that relates to taxation and the related movement in that balance. *[IFRS 14.34]*.

In addition, when an entity provides disclosures in accordance with IFRS 12 *Disclosure of Interests in Other Entities* for an interest in a subsidiary, associate or joint venture (see Chapter 14) that has rate-regulated activities and for which regulatory deferral account balances are recognised in accordance with IFRS 14, the following disclosures are required: *[IFRS 14.35]*

- For each of the entity's subsidiaries with non-controlling interests that are material to the reporting entity, the net movement in regulatory deferral account balances that is included within the profit or loss allocated to non-controlling interests *[IFRS 12.12(e), IFRS 14.B25]*
- The total regulatory deferral account debit balance, the total regulatory credit balance and the net movements in those balances (split between amounts recognised in profit or loss and amounts recognised in other comprehensive income) for each entity for which IFRS 12 disclosures are required *[IFRS 12.12, IFRS 12.21, IFRS 12.B10, IFRS 12.B12, IFRS 12.B13, IFRS 12.B16, IFRS 14.B26, IFRS 14.B27]*
- In addition to the IFRS 12 disclosures concerning a gain or loss on losing control of a subsidiary during the reporting period, the portion of that gain or loss that is attributable to derecognising regulatory deferral account balances in the former subsidiary at the date when control is lost *[IFRS 12.19, IFRS 14.B28]*

When an entity concludes that a regulatory deferral account balance is no longer fully recoverable or reversible, it must disclose that fact, the reason why it is not recoverable or reversible and the amount by which the regulatory deferral account balance has been reduced. *[IFRS 14.36]*.

The Illustrative Examples to IFRS 14 include an example of the reconciliation of movements in regulatory deferral account balances by class, as required at (a) above (not shown in this chapter), for the regulatory deferral account balances illustrated in Illustration 5-29 in section 5.22.6.D above. *[IFRS 14.IE2]*.

5.22.8 Interaction with other IFRS accounting standards

Any specific exceptions, exemptions or additional requirements related to the interaction of IFRS 14 with other IFRS accounting standards are contained within IFRS 14. Otherwise, other IFRS accounting standards must apply to regulatory deferral account balances in the same way as they apply to assets, liabilities, income and expenses that are recognised in accordance with other IFRS accounting standards. *[IFRS 14.16]*. In some situations, another IFRS accounting standard might need to be applied to a regulatory deferral account balance that has been measured in accordance with an entity's accounting policies established under IFRS 14.11-12 (see section 5.22.3 above), *[IFRS 14.11, IFRS 14.12]*, in order to reflect that balance appropriately in the financial statements. For example, the entity might have rate-regulated activities in a foreign country for which the transactions and regulatory deferral account balances are denominated in a currency that is not the functional currency of the reporting entity. The regulatory deferral account balances and the movements in those balances are translated by applying IAS 21 (see Chapter 16 at section 5). *[IFRS 14.17, IAS 21.21, IAS 21.23]*.

The following sections outline how some other IFRS accounting standards interact with the requirements of IFRS 14. In particular, the following sections clarify specific exceptions to, and exemptions from, other IFRS accounting standards and additional presentation and disclosure requirements that are expected to be applicable. *[IFRS 14.16, IFRS 14.B7]*.

5.22.8.A Application of IAS 10

An entity might need to use estimates and assumptions in the recognition and measurement of its regulatory deferral account balances. For events that occur between the end of the reporting period and the date when the financial statements are authorised for issue, an entity has to apply IAS 10 to identify whether those estimates and assumptions need to be adjusted to reflect those events. *[IFRS 14.B8, IAS 10.8, IAS 10.10]*.

5.22.8.B Application of IAS 12

Entities are required to apply the requirements of IAS 12 to rate-regulated activities, to identify the amount of income tax to be recognised. *[IFRS 14.B9]*. In some rate-regulatory schemes, rate regulators permit or require an entity to increase its future rates in order to recover some or all of the entity's income tax expense. In such circumstances, this might result in the entity recognising a regulatory deferral account balance in the statement of financial position related to income tax, in accordance with its accounting policies established in accordance with IFRS 14.11-12 (see section 5.22.3 above). *[IFRS 14.11, IFRS 14.12]*. The recognition of this regulatory deferral account balance that relates to income tax might itself create an additional temporary difference for which a further deferred tax amount would be recognised. *[IFRS 14.B10]*.

5.22.8.C Application of IAS 36

As a rate-regulated entity is allowed to continue applying previous GAAP accounting policies (see section 5.22.3 above), the requirements under IAS 36 do not apply to the separate regulatory deferral account balances recognised. *[IFRS 14.11, IFRS 14.12, IFRS 14.B15]*. However, IAS 36 could require an entity to perform an impairment test on a CGU that includes regulatory deferral account balances. An impairment test would be required if: *[IFRS 14.B16]*

- The CGU contains goodwill

  Or

- One or more of the impairment indicators described in IAS 36 have been identified relating to the CGU

In such situations, the requirements under IAS 36.74-79, for identifying the recoverable amount and the carrying amount of a CGU (see Chapter 21 at sections 4 and 5) must be applied to decide whether any of the regulatory deferral account balances recognised are included in the carrying amount of the CGU for the purpose of the impairment test. *[IAS 36.75]*. The remaining requirements of IAS 36 must then be applied to any impairment loss that is recognised as a result of this test (see Chapter 21). *[IFRS 14.B16]*.

5.22.8.D Application of IFRS 3

If an entity acquires a business, IFRS 14.B18 provides an exception to the core principle of IFRS 3 (i.e., to recognise the assets acquired and liabilities assumed at their acquisition-date fair values) for the recognition and measurement of an acquiree's regulatory deferral account balances at the date of acquisition. In other words, the acquiree's regulatory deferral account balances are recognised in the consolidated financial statements of the acquirer in accordance with the acquirer's policies established in accordance with IFRS 14.11-12 for the recognition and measurement of regulatory deferral account balances, irrespective of whether the acquiree recognises those balances in its own financial statements. *[IFRS 14.11, IFRS 14.12, IFRS 14.B17, IFRS 14.B18]*.

5.22.8.E Application of IFRS 5

Since a rate-regulated entity is allowed to continue applying previous GAAP accounting policies (see section 5.22.3 above), *[IFRS 14.11, IFRS 14.12]*, the measurement requirements of IFRS 5 do not apply to the regulatory deferral account balances recognised. *[IFRS 14.B19]*. The presentation of discontinued operations and disposal groups for an entity applying IFRS 14 is discussed in section 5.22.6.C above.

5.22.8.F Application of IFRS 10 and IAS 28

If a parent entity recognises regulatory deferral account balances in its consolidated financial statements under IFRS 14, the same accounting policies must be applied to the regulatory deferral account balances arising in all of its subsidiaries. This requirement applies irrespective of whether the subsidiaries recognise those balances in their own financial statements. *[IFRS 14.8, IFRS 14.B23, IFRS 10.19]*.

Similarly, accounting policies for the recognition, measurement, impairment and derecognition of regulatory deferral account balances of an associate or joint venture will have to conform to those of the investing entity in applying the equity method. *[IFRS 14.8, IFRS 14.B24, IAS 28.35, IAS 28.36]*.

5.22.9 Future developments

In January 2021, the IASB issued an Exposure Draft (ED) *Regulatory Assets and Regulatory Liabilities*. The ED sets out proposals for the recognition, measurement, presentation and disclosure of regulatory assets, regulatory liabilities, regulatory income and regulatory expense. If adopted, these proposals would replace IFRS 14.

During 2022 through 2024, the IASB continued its redeliberations on the proposals in the ED.[8] At the time of writing, it is expected that an IFRS accounting standard will be issued in 2025.

The IASB proposed the following key requirements in the ED:

- Regulatory assets and regulatory liabilities exist due to a regulatory agreement (to which the entity is a party) that determines the regulated rate in such a way that some, or all, of the total allowed compensation for goods or services supplied in one period is charged to customers in a different period.[9]
- An entity recognises its regulatory assets and regulatory liabilities existing at the end of the reporting period and its regulatory income and expense arising during the reporting period. If it is uncertain whether a regulatory asset or regulatory liability exists, an entity will recognise that regulatory asset or regulatory liability if it is 'more likely than not' that it exists.[10]
- An entity measures regulatory assets and regulatory liabilities at historical cost using estimates of future cash flows by applying a cash-flow-based measurement technique. For subsequent measurement, updated estimates of future cash flows are used. In predicting uncertainty, an entity can use either the 'most likely amount' or 'expected value' methods.[11]

8 IFRS Foundation work plan: Rate-regulated Activities. Available on the IFRS Foundation's website (accessed on 26 September 2024).

9 Exposure Draft ED/2021/1: *Regulatory Assets and Regulatory Liabilities*, IASB, January 2021, paragraph 6. Available on the IFRS Foundation's website.

10 Exposure Draft ED/2021/1: *Regulatory Assets and Regulatory Liabilities*, IASB, January 2021, paragraphs 25 and 28. Available on the IFRS Foundation's website.

11 Exposure Draft ED/2021/1: *Regulatory Assets and Regulatory Liabilities*, IASB, January 2021, paragraphs 29 and 39. Available on the IFRS Foundation's website.

- All regulatory income or regulatory expense must be presented as a separate line item immediately below revenue.[12]
- Where the Appendix C business combination exemption is applied, a first-time adopter accounts for goodwill-related regulatory balances that are not regulatory assets (as defined) in the same way as intangible assets not qualifying for recognition under IFRS accounting standards (see section 5.2.4.A above).[13]
- The existing transition relief (see section 5.4.4 above) that allows a first-time adopter to elect to use the carrying amounts determined under previous GAAP as at the date of transition to IFRS accounting standards as the deemed cost of items of property, plant and equipment, right-of-use assets or intangible assets that are used or previously used in operations subject to a regulatory agreement that is capable of creating regulatory assets or regulatory liabilities in scope of the proposed standard is retained.[14]

12 Exposure Draft ED/2021/1: *Regulatory Assets and Regulatory Liabilities*, IASB, January 2021, paragraph 67. Available on the IFRS Foundation's website.

13 Exposure Draft ED/2021/1: *Regulatory Assets and Regulatory Liabilities*, IASB, January 2021, Amendments to IFRS 1, paragraphs C4(c)(i), C4(g)(i). Available on the IFRS Foundation's website.

14 Exposure Draft ED/2021/1: *Regulatory Assets and Regulatory Liabilities*, IASB, January 2021, Amendments to IFRS 1, paragraph D8B. Available on the IFRS Foundation's website.

6 Presentation and disclosure

An entity's first IFRS financial statements include at least three statements of financial position, two statements of profit or loss and other comprehensive income, two separate statements of profit or loss (if presented), two statements of cash flows and two statements of changes in equity and related notes, including comparative information for all statements presented. *[IFRS 1.21]*.

A first-time adopter is required to present notes supporting its opening IFRS statement of financial position. This was clarified as a part of the *Annual Improvements to IFRSs 2009-2011 Cycle* issued in May 2012. The Board "noted that a first-time adopter should not be exempted from presenting three statements of financial position and related notes because it might not have presented this information previously on a basis consistent with IFRSs". *[IFRS 1.BC89B]*.

IFRS 1 does not exempt a first-time adopter from any of the presentation and disclosure requirements in other IFRS accounting standards, *[IFRS 1.20]*, with the exception of certain presentation requirements and disclosures regarding recognised regulatory deferral account balances under IFRS 14 (see section 5.22 above).

IFRS 18 *Presentation and Disclosure in financial Statements,* which was issued in April 2024, will replace IAS 1. An entity is required to apply the Standard for annual reporting periods beginning on or after 1 January 2027 and earlier application is permitted. An entity that is a first-time adopter is able to apply IAS 1 rather than IFRS 18 in its first IFRS financial statements until the effective date of IFRS 18. It is important to note that the presentation and disclosure requirements are quite different in both standards. (See further discussion in Chapter 4).

The disclosure requirements for subsidiaries without public accountability applying IFRS 19 are addressed in section 6.8 below.

6.1 Comparative information

IAS 1 requires, except where an IFRS accounting standard or interpretation permits or requires otherwise, comparative information in respect of the previous period for all amounts reported in the current period's financial statements and comparative information for narrative and descriptive information when it is relevant to an understanding of the current period's financial statements. *[IAS 1.38]*.

6.2 Non-IFRS comparative information and historical summaries

Normally, IFRS accounting standards require comparative information that is prepared on the same basis as information relating to the current reporting period. However, if an entity presents historical summaries of selected data for periods before the first period for which it presents full comparative information under IFRS accounting standards, e.g., information prepared under its previous GAAP, IFRS 1 does not require such summaries to comply with the recognition and measurement requirements of IFRS accounting standards. Furthermore, some entities present comparative information under previous GAAP in addition to the comparative information required by IAS 1. *[IFRS 1.22]*.

If an entity presents, in the IFRS financial statements, historical summaries or comparative information under its previous GAAP, it must: *[IFRS 1.22]*

(a) Label the previous GAAP information prominently as not being prepared in accordance with IFRS accounting standards

(b) Disclose the nature of the main adjustments that would make it comply with IFRS accounting standards. Those adjustments need not be quantified

How we see it

As an entity is only allowed to apply IFRS 1 in its first IFRS financial statements, a literal reading of IFRS 1 would seem to suggest that the above guidance is not available to an entity that prepares its second IFRS financial statements. In practice, this need not cause a significant problem because this type of information is generally presented outside the financial statements, where it is not covered by the requirements of IFRS accounting standards.

Although IFRS 1 does not specifically require disclosure of the information in (a) and (b) above when the historical summaries or comparative information are presented outside the financial statements, these explanations would clearly be of benefit to users.

6.3 Explanation of transition to IFRS accounting standards

A first-time adopter is required to explain how the transition from its previous GAAP to IFRS accounting standards affected its reported financial position, financial performance and cash flows. *[IFRS 1.23]*. The IASB decided "that such disclosures are essential, in the first (annual) IFRS financial statements as well as in interim financial reports (if any), because they help users understand the effect and implications of the transition to IFRSs and how they need to change their analytical models to make the best use of information presented using IFRSs." *[IFRS 1.BC91]*.

As discussed in sections 3.5 and 5 above, IFRS 1 offers a wide range of exemptions that a first-time adopter could elect to apply. However, perhaps surprisingly, the standard does not explicitly require an entity to disclose which exemptions it has applied and how it applied them. In the case of, for example, the exemption relating to cumulative translation differences, it will be rather obvious whether or not an entity has chosen to apply the exemption. In other cases, users will have to rely on a first-time adopter disclosing those transition accounting policies that are relevant to an understanding of the financial statements. IFRS 1 does not provide exemptions from the presentation and disclosure requirements in other IFRS accounting standards. *[IFRS 1.20]*. First-time adopters need to consider which disclosure information could help primary users understand the first financial statements, for example, applying IAS 1.31, which requires an entity to disclose additional information when it considers compliance with the specific requirements in IFRS accounting standards is insufficient. *[IAS 1.31]*. In practice, most first-time adopters voluntarily disclose which IFRS 1 exemptions they elected to apply and which exceptions apply to them, as is illustrated by Practical example 6-1 below.

Practical example 6-1: Toyota Motor Corporation (2021) Japan

FORM 20-F [extract]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS [extract]

36. First-time adoption [extract]

(1) Transition to reporting in accordance with IFRS

TMC has prepared its consolidated financial statements in accordance with IFRS from the first quarter ended June 30, 2020.

Up to the fiscal year ended March 31, 2020, Toyota prepared its consolidated financial statements in accordance with U.S. GAAP. The Transition Date was April 1, 2019.

IFRS 1 stipulates that, in principle, the retrospective application of IFRS is required. However, it provides some voluntary and mandatory exemptions from full retrospective applications. TMC elected such exemptions with respect to the following items.

(i) Business combination

IFRS 3 "Business Combinations", was not applied retrospectively to business combinations that occurred before the Transition Date.

(ii) Foreign currency translation adjustments of foreign operations

The cumulative foreign currency translation adjustments were reclassified from other comprehensive income to retained earnings as of the Transition Date.

(iii) Designation of equity financial assets

Equity financial assets recognized before the Transition Date were designated as financial assets measured at fair value through other comprehensive income based on the facts and circumstances that existed as of the Transition Date.

(iv) Deemed cost

IFRS 1 permits a first-time adopter to elect to use fair value at the Transition Date as deemed cost for items of property, plant and equipment. For some property, plant and equipment, the fair value at the Transition Date is used as deemed cost.

(v) Recognition of right of use assets and lease liabilities

When a first-time adopter that is a lessee recognizes right of use assets and lease liabilities, it is permitted to measure right of use assets and lease liabilities at the Transition Date under IFRS 1. Toyota measured all lease liabilities at the Transition Date, using the present value of the remaining lease payments discounted by the lessee's incremental borrowing rate at the Transition Date. Toyota measured right of use assets at the Transition Date, making them equal to the lease liabilities.

For leases for which the lease term ends within 12 months of the Transition Date, lease payments associated with those leases were recognized as profit or loss on a straight-line basis over the lease term.

If a first-time adopter did not present financial statements for previous periods, this fact must be disclosed. *[IFRS 1.28]*. The standard acknowledges that there are cases in which disclosure of how the transition to IFRS accounting standards affected the entity's reported financial position, financial performance and cash flows cannot be presented, because relevant comparative information under the entity's previous GAAP does not exist. In practice, this could apply to entities that did not prepare consolidated financial statements under their previous GAAPs or for a newly established entity.

How we see it

However, if a new entity is established by transferring a pre-existing business from a non-IFRS adopter to it and the new entity is determined to be a continuation of the pre-existing business, the entity would be expected to disclose the explanation of its transition to IFRS accounting standards.

6.3.1 Disclosure of reconciliations

A first-time adopter is required to present:

(a) Reconciliations of its equity reported under previous GAAP to its equity under IFRS accounting standards at: *[IFRS 1.24(a)]*

  (i) The date of transition to IFRS accounting standards

  (ii) The end of the latest period presented in the entity's most recent annual financial statements under previous GAAP

(b) A reconciliation to its total comprehensive income under IFRS accounting standards for the latest period in the entity's most recent annual financial statements. The starting point for that reconciliation is required to be total comprehensive income under previous GAAP for the same period or, if an entity did not report such a total, profit or loss under previous GAAP. *[IFRS 1.24(b)]*.

(c) An explanation of the material adjustments to the statement of cash flows, if it presented one under its previous GAAP. *[IFRS 1.25]*.

The reconciliations in (a) and (b) above must be sufficiently detailed to enable users to understand the material adjustments to the statement of financial position, statement of profit or loss (if presented) and statement of profit or loss and other comprehensive income. *[IFRS 1.25]*.

If a first-time adopter becomes aware of errors made under previous GAAP, it must distinguish the correction of errors from changes in accounting policies in those reconciliations. *[IFRS 1.26]*. This means that the adoption of IFRS accounting standards must not be used to mask the error.

While the standard does not prescribe a layout for these reconciliations, the implementation guidance contains an example of a line-by-line reconciliation of the statement of financial position, statement of profit or loss and other comprehensive income. *[IFRS 1.IG Example 11]*. This presentation could be particularly appropriate when a first-time adopter needs to make transition adjustments that affect a significant number of line items in the primary financial statements. If the adjustments are less pervasive, a straightforward reconciliation of equity, total comprehensive income and/or profit or loss could provide an equally effective explanation of how the adoption of IFRS accounting standards affects the reported financial position, financial performance and cash flows.

Illustration 6-1 below demonstrates how these requirements apply to an entity whose first IFRS financial statements are for the period ending on 31 December 20X3 and whose date of transition to IFRS accounting standards is 1 January 20X2.

Illustration 6-1: Reconciliations to be presented in first IFRS financial statements

Entity A's date of transition to IFRS accounting standards is 1 January 20X2 and the end of its first IFRS reporting period is 31 December 20X3. Entity A is required to present the following primary financial statements and reconciliations in its first IFRS financial statements.

	1 January 20X2	31 December 20X2	31 December 20X3
Statement of financial position	●	●	●
Reconciliation of equity	●	●	‡
For the period ending			
Statement of profit or loss and other comprehensive income*		●	●
Statement of cash flows		●	●
Statement of changes in equity		●	●
Reconciliation of total comprehensive income†		●	‡
Explanation of material adjustments to the statement of cash flows		●	‡

* Alternatively, the entity presents two statements: a statement of profit or loss and a statement of comprehensive income.

† If an entity did not previously report total comprehensive income, then a reconciliation from profit or loss under previous GAAP to total comprehensive income under IFRS accounting standards is presented.

‡ A first-time adopter that ceases to publish financial statements under previous GAAP is not required to present reconciliations of equity and total comprehensive income at the end of the first IFRS reporting period. However, a first-time adopter that continues to publish previous GAAP financial statements might need to reconcile the equity and total comprehensive income and explain material cash flow adjustments as at the end of, and for, the first IFRS financial reporting period. See section 6.3.1.A below for further discussion.

First-time adopters do not apply the requirements of IAS 8 relating to the changes in accounting policies in their first IFRS financial statements. This is because that standard does not apply to the changes in accounting policies an entity makes when it adopts IFRS accounting standards or changes in those policies until after it presents its first IFRS financial statements (see section 7.2 below). *[IFRS 1.27]*.

A first-time adopter must explain changes in accounting policies or in its use of exemptions during the period between its first IFRS interim financial report and its first IFRS annual financial statements (see section 6.6 below) and update the reconciliations of equity and total comprehensive income discussed above. *[IFRS 1.27A]*. This requirement is necessary in order to explain the transition to IFRS accounting standards, *[IFRS 1.23]*, since the first-time adopter is exempt from the requirements of IAS 8 concerning reporting of such changes. *[IFRS 1.BC97]*.

6.3.1.A Reconciliation by a first-time adopter that continues to publish previous GAAP financial statements

A first-time adopter that continues to publish financial statements under previous GAAP after adopting IFRS accounting standards must consider carefully the starting point of the reconciliations required by IFRS 1 in the first IFRS financial statements because the requirements to produce reconciliations do not consider this situation. IFRS 1.24 results in different applications depending on the timing of issuance of the previous GAAP financial statements in relation to the first-time adopter's first IFRS reporting period.

How we see it

We believe a first-time adopter, that continues to publish previous GAAP financial statements and has already issued those financial statements for the first IFRS reporting period prior to the issuance of the first IFRS financial statements, has a choice of presenting reconciliations of equity and total comprehensive income:

(a) Respectively as at the end of, and for, the first IFRS reporting period

(b) Respectively as at the end of, and for, both the first IFRS reporting period, and the comparative period

Or

(c) Respectively as at the end of, and for, the comparative period

In each case above, the reconciliation of equity as at the date of transition to IFRS accounting standards must be disclosed.

However, if the first IFRS financial statements were issued prior to the previous GAAP financial statements for the period, then IFRS 1 can only mean the previous GAAP financial statements for the immediately preceding year.

6.3.2 Line-by-line reconciliations and detailed explanations

Practical example 6-2 below provides an example of an entity that not only provides summary reconciliations of equity and profit or loss, but also line-by-line reconciliations, as suggested by the implementation guidance in IFRS 1, and detailed explanations of the reconciling items. *[IFRS 1.IG63, IFRS 1.IG Example 11]*.

Practical example 6-2: Yamaha Corporation (2020) Japan

Annual Report 2020 [extract]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS [extract]

37 First-time Adoption

The Group presents its consolidated financial statements in accordance with IFRS from the fiscal year ended March 31, 2020. The Group previously applied Japanese GAAP, and the most recent consolidated financial statements the Group prepared in accordance with Japanese GAAP were for the fiscal year ended March 31, 2019. The date of transition to IFRS was April 1, 2018.

(1) IFRS 1 exemptions

Companies adopting IFRS for the first time are, in principle, required to apply IFRS retrospectively to previous-year financial statements. However, IFRS 1 "First-time Adoption of International Financial Reporting Standards" (IFRS 1) allows certain exemptions in the preparation of financial statements applying IFRS retrospectively.

The Group has applied the following exemptions in the transition from Japanese GAAP to IFRS.

A) Business combinations

The Group has not retrospectively applied IFRS 3 "Business Combinations" for business combinations that occurred before the date of transition to IFRS.

B) Exchange differences on translation of foreign operations

The Group has transferred cumulative exchange differences on translation of all foreign operations as of the date of transition to IFRS from other components of equity to retained earnings.

C) Deemed cost

The Group has reported the fair value of a portion of property, plant and equipment as of the date of transition to IFRS as deemed cost in accordance with IFRS.

D) Recognizing previously designated financial instruments

The Group has designated holdings of equity instruments measured at fair value through other comprehensive income based on certain conditions on the date of transition to IFRS.

E) Leases

The Group has assessed whether contracts contain leases based on events and conditions existing at the date of transition to IFRS.

Lease liabilities other than assets that were categorized to finance leases prior to the date of transition to IFRS have been measured on the date of transition to IFRS and an equivalent amount has been recorded as right-of-use assets. Decisions whether to exempt recognition of underlying assets with low value or short-term leases were made based on conditions on the date of transition to IFRS.

(2) IFRS 1 mandatory exceptions

IFRS 1 prohibits retroactive application of IFRS to "estimates," "derecognition of financial assets and liabilities," "hedge accounting," "non-controlling interests" and "classification and measurement of financial assets." The Group applies IFRS to such items occurring after the date of transition to IFRS.

(3) Reconciliation from Japanese GAAP to IFRS

The changes in the Group's financial position, operating results and cash flows due to the transition from Japanese GAAP to IFRS are as follows:

The "Reclassification" column presents items that do not affect retained earnings and comprehensive income, and the "Difference in recognition and measurement" column presents items that affect retained earnings or comprehensive income.

A) Reconciliation of equity as of the date of transition to IFRS (April 1, 2018)

	Millions of yen					
JGAAP line item	JGAAP	Reclassification	Difference in recognition and measurement	IFRS	IFRS line item	Notes
Assets					Assets	
Current assets					Current assets	
Cash and deposits	¥122,731	¥ (5,327)	¥ –	¥117,403	Cash and cash equivalents	c
Notes and accounts receivable—trade	56,499	9,474	10	65,984	Trade and other receivables	e
	–	5,537	22	5,559	Other financial assets	c
Merchandise and finished goods	65,064	29,061	936	95,062	Inventories	g
Work in process	13,339	(13,339)	–	–		
Raw materials and supplies	15,721	(15,721)	–	–		
Other	17,352	(11,064)	399	6,687	Other current assets	e
Allowance for doubtful accounts	(1,216)	1,216	–	–		
Total current assets	289,493	(164)	1,368	290,697	Total current assets	
Non-current assets					Non-current assets	
Property, plant and equipment	115,817	(240)	(28,443)	87,133	Property, plant and equipment	h, i
	–	5,718	25,392	31,110	Right-of-use assets	f, j
Intangible assets	6,167	(5,478)	–	689	Intangible assets	f
Investment securities	130,341	4,001	4,370	138,713	Financial assets	k
Long-term loans receivable	93	(93)	–	–		
Net defined benefit assets	276	(276)	–	–		
Deferred tax assets	4,699	–	3,270	7,969	Deferred tax assets	m
Lease and guarantee deposits	4,087	(4,087)	–	–		
Other	1,452	615	154	2,221	Other non-current assets	l
Allowance for doubtful accounts	(120)	120	–	–		
Total non-current assets	262,816	278	4,742	267,837	Total non-current assets	
Total assets	¥552,309	¥ 114	¥ 6,110	¥558,535	Total assets	

	Millions of yen					
JGAAP line item	JGAAP	Reclassification	Difference in recognition and measurement	IFRS	IFRS line item	Notes
Liabilities					Liabilities	
Current liabilities					Current liabilities	
Notes and accounts payable—trade	¥ 19,946	¥ 44,370	¥ 778	¥ 65,094	Trade and other payables	e, n
Short-term loans payable	11,131	41	–	11,173	Interest-bearing debt	
Current portion of long-term loans payable	41	(41)	–	–		
	–	54	5,481	5,535	Lease liabilities	j
Accounts payable—other and accrued expenses	45,527	(45,527)	–	–		e
	–	9,754	–	9,754	Other financial liabilities	d
Income taxes payable	16,325	–	–	16,325	Income tax payables	
	–	1,955	(97)	1,858	Provisions	
Provision for product warranties	1,774	(1,774)	–	–		
Provision for sales returns	97	(97)	–	–		
Provision for loss on construction contracts	4	(4)	–	–		
Other	7,069	1,088	3,905	12,063	Other current liabilities	o
Total current liabilities	101,919	9,818	10,067	121,805	Total current liabilities	
Non-current liabilities					Non-current liabilities	
	–	190	19,895	20,086	Lease liabilities	j
	–	4,553	–	4,553	Financial liabilities	
Long-term accounts payable	5,406	(5,406)	–	–		
Net defined benefit liabilities	21,098	–	2,567	23,666	Retirement benefit liabilities	l
	–	442	–	442	Provisions	
Deferred tax liabilities	15,402	–	3,190	18,592	Deferred tax liabilities	m
Deferred tax liabilities for land revaluation	9,587	(9,587)	–	–		
Long-term deposits received	9,090	(9,090)	–	–		
Other	1,457	9,195	(9,587)	1,065	Other non-current liabilities	d, m
Total non-current liabilities	62,043	(9,703)	16,065	68,406	Total non-current liabilities	
Total liabilities	163,963	114	26,133	190,211	Total liabilities	
Net assets					Equity	
Capital stock	28,534	–	–	28,534	Capital stock	
Capital surplus	40,165	–	(186)	39,978	Capital surplus	q
Retained earnings	294,904	–	(31,276)	263,627	Retained earnings	
Treasury stock	(48,556)	–	–	(48,556)	Treasury shares	
Valuation difference on available-for-sale securities	79,729	(79,729)	–	–		
Deferred gains or losses on hedges	109	(109)	–	–		
Revaluation reserve for land	16,095	(16,095)	–	–		
Foreign currency translation adjustment	(23,862)	23,862	–	–		
Remeasurements of defined benefit plans	(600)	600	–	–		
	–	71,470	11,432	82,903	Other components of equity	h, k, l, r
Non-controlling interests	1,826	–	8	1,834	Non-controlling interests	
Total net assets	388,345	–	(20,022)	368,323	Total equity	
Total liabilities and net assets	¥552,309	¥ 114	¥ 6,110	¥558,535	Total liabilities and equity	

B) Reconciliation to equity as of March 31, 2019

	Millions of yen					
JGAAP line item	JGAAP	Reclassification	Difference in recognition and measurement	IFRS	IFRS line item	Notes
Assets					Assets	
Current assets					Current assets	
Cash and deposits	¥106,061	¥(10,246)	¥ –	¥ 95,815	Cash and cash equivalents	c
Notes and accounts receivable—trade	55,527	9,835	(16)	65,346	Trade and other receivables	e
	–	10,423	85	10,508	Other financial assets	c
Merchandise and finished goods	67,983	32,351	668	101,003	Inventories	g
Work in process	13,771	(13,771)	–	–		
Raw materials and supplies	18,580	(18,580)	–	–		
Other	20,770	(11,245)	619	10,144	Other current assets	e
Allowance for doubtful accounts	(1,085)	1,085	–	–		
Total current assets	281,608	(146)	1,357	282,819	Total current assets	
Non-current assets					Non-current assets	
Property, plant and equipment	121,934	(225)	(30,382)	91,326	Property, plant and equipment	h, i
	–	6,068	23,510	29,579	Right-of-use assets	f, j
	–	136	24	161	Goodwill	
Intangible assets	7,301	(5,979)	–	1,321	Intangible assets	f
Investment securities	93,354	3,726	4,012	101,093	Financial assets	k
Long-term loans receivable	96	(96)	–	–		
Net defined benefit assets	394	(394)	–	–		
Deferred tax assets	4,708	–	2,528	7,237	Deferred tax assets	m
Lease and guarantee deposits	3,970	(3,970)	–	–		
Other	1,541	844	1	2,387	Other non-current assets	l
Allowance for doubtful accounts	(147)	147	–	–		
Total non-current assets	233,153	256	(304)	233,105	Total non-current assets	
Total assets	¥514,762	¥ 109	¥ 1,052	¥515,924	Total assets	

	Millions of yen					
JGAAP line item	JGAAP	Reclassification	Difference in recognition and measurement	IFRS	IFRS line item	Notes
Liabilities					Liabilities	
Current liabilities					Current liabilities	
Notes and accounts payable—trade	¥ 17,548	¥41,347	¥ 630	¥ 59,525	Trade and other payables	e, n
Short-term loans payable	8,936	–	–	8,936	Interest-bearing debt	
	–	69	5,661	5,730	Lease liabilities	j
Accounts payable—other and accrued expenses	42,481	(42,481)	–	–		e
	–	9,650	–	9,650	Other financial liabilities	d
Income taxes payable	2,474	–	–	2,474	Income tax payables	
	–	2,009	(111)	1,898	Provisions	
Provision for product warranties	1,840	(1,840)	–	–		
Provision for sales returns	111	(111)	–	–		
Provision for construction loss	8	(8)	–	–		
Other	7,094	1,071	4,061	12,228	Other current liabilities	o
Total current liabilities	80,495	9,705	10,242	100,443	Total current liabilities	
Non-current liabilities					Non-current liabilities	
	–	149	18,108	18,258	Lease liabilities	j
	–	3,014	–	3,014	Financial liabilities	
Long-term accounts payable	3,902	(3,902)	–	–		
Net defined benefit liabilities	22,460	–	1,808	24,268	Retirement benefit liabilities	l
	–	455	–	455	Provisions	
Deferred tax liabilities	5,152	–	3,497	8,650	Deferred tax liabilities	m
Deferred tax liabilities for land revaluation	9,544	(9,544)	–	–		
Long-term deposits received	8,997	(8,997)	–	–		
Other	1,437	9,227	(8,840)	1,824	Other non-current liabilities	d, m, p
Total non-current liabilities	51,494	(9,596)	14,575	56,473	Total non-current liabilities	
Total liabilities	131,990	109	24,817	156,917	Total liabilities	
Net assets					Equity	
Capital stock	28,534	–	–	28,534	Capital stock	
Capital surplus	21,565	–	2	21,568	Capital surplus	q
Retained earnings	325,141	–	(31,594)	293,547	Retained earnings	
Treasury stock	(42,533)	–	–	(42,533)	Treasury shares	
Valuation difference on available-for-sale securities	54,796	(54,796)	–	–		
Deferred gains or losses on hedges	85	(85)	–	–		
Revaluation reserve for land	20,379	(20,379)	–	–		
Foreign currency translation adjustments	(24,691)	24,691	–	–		
Remeasurements of defined benefit plans	(1,582)	1,582	–	–		
	–	48,987	7,832	56,820	Other components of equity	h, k, l, r
Non-controlling interests	1,076	–	(5)	1,070	Non-controlling interests	
Total net assets	382,771	–	(23,764)	359,007	Total equity	
Total liabilities and net assets	¥514,762	¥ 109	¥ 1,052	¥515,924	Total liabilities and equity	

C) Reconciliation to profit or loss for the fiscal year ended March 31, 2019

	Millions of yen					
JGAAP line item	JGAAP	Reclassification	Difference in recognition and measurement	IFRS	IFRS line item	Notes
Net sales	¥ 437,416	¥(3,240)	¥ 197	¥ 434,373	Revenue	a
Cost of sales	(255,291)	9	(86)	(255,367)	Cost of sales	a, g, j, l, n, o
Gross profit	182,124	(3,230)	111	179,005	Gross profit	
Selling, general and administrative expenses	(126,094)	–	(164)	(126,259)	Selling, general and administrative expenses	j, l, n, o
	–	–	–	52,745	Core operating profit	
	–	5,110	(3,551)	1,558	Other income	b, h, k, p
	–	(1,510)	21	(1,488)	Other expenses	b
Operating income	56,030	369	(3,583)	52,815	Operating profit	
Non-operating income	6,742	(6,742)	–	–		a, b
Non-operating expenses	(4,349)	4,349	–	–		a, b
Extraordinary income	3,042	(3,042)	–	–		b
Extraordinary loss	(980)	980	–	–		b
	–	4,652	–	4,652	Finance income	b
	–	(579)	(429)	(1,008)	Finance expenses	b
	–	12	–	12	Share of profit of associates accounted for using the equity method	b
Income before income taxes	60,485	–	(4,013)	56,471	Profit before income taxes	
Income taxes	(16,667)	–	581	(16,085)	Income taxes	m
Net income for the period	¥ 43,817	¥ –	¥(3,431)	¥ 40,386	Profit for the period	

D) Reconciliation to comprehensive income for the fiscal year ended March 31, 2019

	Millions of yen					
JGAAP line item	JGAAP	Reclassification	Difference in recognition and measurement	IFRS	IFRS line item	Notes
Net income for the period	¥ 43,817	¥–	¥(3,431)	¥ 40,386	Profit for the period	
Other comprehensive income					Other comprehensive income	
					Items that will not be reclassified to profit or loss	
Remeasurements of defined benefit plans	(982)	–	538	(444)	Remeasurements of defined benefit plans	l
Valuation difference on available-for-sale securities	(24,917)	–	329	(24,588)	Financial assets measured at fair value through other comprehensive income	k
Share of other comprehensive income of affiliates accounted for using equity method	(14)	–	–	(14)	Share of other comprehensive income of associates accounted for using the equity method	
Revaluation reserve for land	1,315	–	(1,315)	–		h
					Items that may be subsequently reclassified to profit or loss	
Foreign currency translation adjustments	(863)	–	(52)	(916)	Exchange differences on translation of foreign operations	
Deferred gains or losses on hedges	(24)	–	11	(12)	Cash flow hedges	
Total other comprehensive income	(25,487)	–	(489)	(25,976)	Total other comprehensive income	
Comprehensive income	¥ 18,330	¥–	¥(3,921)	¥ 14,409	Comprehensive income for the period	

E) Notes to adjustments

(i) Reclassification

a Items such as sales and purchase discounts presented as non-operating income and non-operating expenses under Japanese GAAP are deducted from revenue and cost of sales, respectively, under IFRS.

b Items (excluding sales and purchase discounts) presented as non-operating income, non-operating expenses, extraordinary income, and extraordinary loss under Japanese GAAP are presented as finance income and finance expenses for financial-related items and as other income, other expenses, or share of profit of associates accounted for using the equity method for other items under IFRS.

c Time deposits with deposit periods longer than three months presented as "cash and deposits" under Japanese GAAP are presented as "other financial assets" under current assets under IFRS.

d Long-term deposits presented as "other" under non-current liabilities under Japanese GAAP are presented as "other financial liabilities" in current liabilities under IFRS.

e Other accounts receivable presented as "other" under current assets under Japanese GAAP are included in "trade and other receivables" under IFRS. Also, "accounts payable—other and accrued expenses" under Japanese GAAP are presented as "trade and other payables" under IFRS.

f Land use rights included in "intangible assets" under Japanese GAAP are included in "right-of-use assets" assets under IFRS.

(ii) Differences in recognition and measurement

The Group made the following adjustments related to tax effect accounting and allocations to non-controlling interests.

g Inventory valuation and unrealized gains or losses on consolidated internal transactions
The calculation method of unrealized gains or losses on inventories has been changed with the revaluation of inventories based on manufacturing costs under IFRS.

h Valuation of property, plant and equipment
The cost model was used for valuation of property, plant and equipment on the date of transition to IFRS. As a result, the land revaluation under Japanese GAAP was reversed and it was valued at acquisition cost. Also, the Group applied the exemption provision for the first-time adoption of IFRS regarding certain property, plant and equipment and has valued the landholdings at deemed cost.
The book value of property, plant and equipment valued at deemed cost is ¥528 million under Japanese GAAP and their fair value is ¥2,558 million on the date of transition to IFRS.

i Application of impairment accounting
Impairment losses were recorded on some items of property, plant and equipment as a result of evaluating the recoverability of non-current assets in accordance with IFRS on the date of transition to IFRS.

j Lease transactions
Under Japanese GAAP, lease payments other than those associated with finance lease transactions are recorded as expenses at the time of occurrence. Under IFRS, the present value is measured based on the future lease payments at the commencement date of the lease transaction and accounted for as a right-of-use assets and lease liabilities. For a right-of-use asset, depreciation is applied to the leased item using the straight-line method over the projected lease period, and the lease liability is then adjusted for interest and recognized as a liability.

k Measurement of financial instruments
Unlisted shares valued at acquisition cost under Japanese GAAP are valued at fair value through other comprehensive income under IFRS. Also, gain or loss on sales or impairment losses on equity instruments were recognized in net income under Japanese GAAP are classified as financial assets measured at fair value through other comprehensive income under IFRS and therefore gain or loss on sales or impairment losses are not recognized in profit or loss. When financial instruments are sold and are no longer recognized or when the fair value has declined substantially, the amount recognized in other comprehensive income is immediately reclassified to retained earnings.

l Retirement benefit liabilities
There are differences in actuarial assumptions such as discount rates between Japanese GAAP and IFRS. Under Japanese GAAP, actuarial differences and past service costs are accounted for through other comprehensive income at the time of occurrence and accounted as an expense over a fixed number of years within the average remaining service period of employees at the time of occurrence. Under IFRS, actuarial differences are recognized as other comprehensive income at the time of occurrence and immediately reclassified to retained earnings; past service costs are recognized in profit or loss at the time of occurrence. Under IFRS, for interest cost, the amount calculated by multiplying net defined benefit assets or liabilities by a discount rate is recognized in profit or loss.

m Accounting for deferred tax assets
Under Japanese GAAP, the judgment of recoverability of deferred tax assets takes into account future temporary differences; under IFRS, the method of judgment of recoverability does not take into account future temporary differences. In addition, regarding the accounting for deferred tax assets associated with unrealized gains from internal transactions within the consolidated group, under Japanese GAAP, recoverability is judged based on taxable income of the selling company and the amount is recorded based on the effective tax rate of the selling company. Under IFRS, recoverability is determined based on taxable income in the future at the purchasing company and recorded using the effective tax rate at the purchasing company. This both increases and decreases the amounts of deferred tax assets and liabilities, but it also reduces the amount of assets and liabilities that be offset and ultimately leads to higher amounts recognized as deferred tax assets and liabilities.

n Accounting for levies
Under Japanese GAAP, tax levies were accounted for as liabilities when they were levied; under IFRS, tax levies are accounted for as liabilities at the time of assessment and determination.

o Unutilized paid leave
Unutilized paid leave that is not recognized under Japanese GAAP is recognized as a liability under IFRS.

p Government grants
Under Japanese GAAP, a grant related to an asset is collectively recognized as revenue when it was determined that it would be received; under IFRS, it is treated as deferred revenue and is regularly recognized as revenue over the period in which the corresponding cost for which the grant was provided is recognized as an expense.

q Restricted stock compensation
Under Japanese GAAP, restricted stock compensation is recognized as an increase in equity at the time the stock is granted; under IFRS, an increase in equity is recognized corresponding to the provision of services for which the stock is granted.

r Exchange differences on translation of foreign operations
The Group has adopted the exemption provision for the first-time adoption of IFRS, and cumulative exchange differences of foreign operations as of the date of transition to IFRS are reclassified from other components of equity to retained earnings.

F) Adjustment to retained earnings

	Millions of yen	
	Date of transition to IFRS (April 1, 2018)	As of March 31, 2019
g Inventory valuation and unrealized gains or losses on consolidated internal transactions	¥ 936	¥ 668
h Valuation of property, plant and equipment	(2,217)	–
i Application of impairment accounting	(615)	(528)
l Retirement benefit liabilities	(3,027)	(3,389)
m Accounting for deferred tax assets*	1,390	229
n Accounting for levies	(772)	(872)
o Unutilized paid leave	(3,187)	(3,240)
p Government grants	–	(704)
r Exchange differences on translation of foreign operations	(23,862)	(23,862)
Other	79	105
Total	¥(31,276)	¥(31,594)

* "m Accounting for deferred tax assets" includes accounting for tax effects related to other categories.

G) Reconciliation to cash flows for the fiscal year ended March 31, 2019
Under Japanese GAAP, other than for finance leases, lease payments are classified as cash flows from operating activities; on the other hand, they are classified as cash flows from financing activities under IFRS since they are deemed as repayments of lease liabilities. As a result, net cash provided by operating activities increased by ¥5,577 million and net cash used in financing activities increased by the same amount.

6.3.3 Recognition and reversal of impairments

If a first-time adopter recognised or reversed any impairment losses on transition to IFRS accounting standards it must disclose the information that IAS 36 would have required if the entity had recognised those impairment losses or reversals in the period beginning with the date of transition to IFRS accounting standards (see Chapter 21 at section 13). *[IFRS 1.24(c)]*. This provides transparency about impairment losses recognised on transition that might otherwise receive less attention than impairment losses recognised in earlier or later periods. *[IFRS 1.BC94]*.

6.3.4 Inclusion of IFRS 1 reconciliations by cross reference

The reconciliation disclosures required by IFRS 1 are generally quite lengthy. While IFRS 1 allows an entity's first interim report under IAS 34 to give certain of these disclosures by way of cross-reference to another published document, *[IFRS 1.32(b), IFRS 1.33]*, there is no corresponding exemption for disclosure in the entity's first annual IFRS financial statements. Therefore, a first-time adopter must include all disclosures required by IFRS 1 within its first annual IFRS financial statements in the same way it would need to include other lengthy disclosures such as those on business combinations, financial instruments and employee benefits. Any additional voluntary information regarding the conversion to IFRS accounting standards that was previously published but that is not specifically required by IFRS 1 need not be repeated in the first IFRS financial statements.

6.4 Disclosure of financial instruments

6.4.1 Designation of financial instruments

If, on transition, a first-time adopter designates a previously recognised financial asset or financial liability as a 'financial asset or financial liability at fair value through profit or loss' (see sections 5.10.1 and 5.10.2 above), it must disclose: *[IFRS 1.29, IFRS 1.29A, IFRS 1.D19, IFRS 1.D19A]*

(a) The fair value of financial assets and the fair value of financial liabilities so designated at the date of designation
(b) Their classification and carrying amounts in the previous GAAP financial statements

6.4.2 Classification of financial instruments

An entity must disclose the carrying amount at the reporting date of the financial assets - whose contractual cash flow characteristics have been assessed based on the facts and circumstances that existed at the date of transition to IFRS accounting standards without taking into account the requirements related to the modification of the time value of money element in IFRS 9.B4.1.9B-B4.1.9D - until those financial assets are derecognised. *[IFRS 1.B8A, IFRS 7.42R, IFRS 9.B4.1.9B, IFRS 9.B4.1.9C, IFRS 9.B4.1.9D]*. See section 4.9.1.A above.

An entity must also disclose the carrying amount at the reporting date of the financial assets - whose contractual cash flow characteristics have been assessed based on the facts and circumstances that existed at the date of transition to IFRS accounting standards without taking into account the exception for prepayment features in IFRS 9.B4.1.12 - until those financial assets are derecognised. *[IFRS 1.B8B, IFRS 7.42S, IFRS 9.B4.1.12]*. See section 4.9.1.B above.

6.5 Disclosures regarding deemed cost

6.5.1 Use of fair value as deemed cost

If a first-time adopter uses fair value as deemed cost for any item of property, plant and equipment, investment property, right-of-use asset or an intangible asset in its opening IFRS statement of financial position (see section 5.4.1 above), it must disclose for each line item in the opening IFRS statement of financial position: *[IFRS 1.30, IFRS 1.D5, IFRS 1.D7]*

(a) The aggregate of those fair values
(b) The aggregate adjustment to the carrying amounts reported under previous GAAP

This disclosure is illustrated in Practical example 5-4 in section 5.4.1 above.

6.5.2 Use of deemed cost for investments in subsidiaries, joint ventures and associates in separate financial statements

If a first-time adopter uses deemed cost in its opening IFRS statement of financial position for an investment in a subsidiary, joint venture or associate in its separate financial statements (see section 5.7.2 above), the entity's first IFRS separate financial statements must disclose: *[IFRS 1.31, IFRS 1.D15]*

(a) The aggregate deemed cost of those investments for which deemed cost is their previous GAAP carrying amount
(b) The aggregate deemed cost of those investments for which deemed cost is fair value
(c) The aggregate adjustment to the carrying amounts reported under previous GAAP

6.5.3 Use of deemed cost for oil and gas assets

If a first-time adopter uses the deemed cost exemption in IFRS 1.D8A(b) for oil and gas assets in the development or production phases (see section 5.4.3 above), it must disclose that fact and the basis on which carrying amounts determined under previous GAAP were allocated. *[IFRS 1.31A, IFRS 1.D8A(b)]*.

6.5.4 Use of deemed cost for assets used (or previously used) in operations subject to rate regulation

If a first-time adopter uses the exemption for assets used (or previously used) in operations subject to rate regulation (see section 5.4.4 above), it must disclose that fact and the basis on which carrying amounts were determined under previous GAAP. *[IFRS 1.31B, IFRS 1.D8B]*.

6.5.5 Use of deemed cost after severe hyperinflation

If a first-time adopter uses the exemption to elect fair value as the deemed cost in its opening IFRS statement of financial position for assets and liabilities because of severe hyperinflation (see section 5.16 above), it must disclose an explanation of how, and why, the first-time adopter had, and then ceased to have, a functional currency that is subject to severe hyperinflation. *[IFRS 1.31C, IFRS 1.D26, IFRS 1.D27, IFRS 1.D28, IFRS 1.D29, IFRS 1.D30]*.

6.6 Interim financial reports

6.6.1 Reconciliations in the interim financial reports

If a first-time adopter presents an interim financial report under IAS 34 for part of the period covered by its first IFRS financial statements:

(a) Each such interim financial report must, if the entity presented an interim financial report for the comparable interim period of the immediately preceding financial year, include: *[IFRS 1.32(a)]*

  (i) A reconciliation of its equity under previous GAAP at the end of that comparable interim period to its equity under IFRS accounting standards at that date

  (ii) A reconciliation to its total comprehensive income under IFRS accounting standards for that comparable interim period (current and year to date). The starting point for that reconciliation is total comprehensive income under previous GAAP for that period or, if an entity did not report such a total, profit or loss under previous GAAP

(b) In addition, the entity's first interim financial report under IAS 34 for part of the period covered by its first IFRS financial statements must include the reconciliations (supplemented by the further details) described in section 6.3.1 above, *[IFRS 1.24(a), IFRS 1.24(b), IFRS 1.25, IFRS 1.26]*, or a cross-reference to another published document that includes these reconciliations. *[IFRS 1.32(b)]*.

For an entity presenting annual financial statements under IFRS accounting standards, it is not compulsory to prepare interim financial reports under IAS 34. Therefore, the above requirements only apply to first-time adopters that prepare interim reports under IAS 34 on a voluntary basis or that are required to do so by a regulator or other party. *[IFRS 1.IG37]*.

Illustrations 6-2 and 6-3 below show which reconciliations must be included in half-year reports and quarterly reports, respectively.

Illustration 6-2: Reconciliations to be presented in IFRS half-year reports

As in Illustration 6-1 in section 6.3.1 above, Entity A's date of transition to IFRS accounting standards is 1 January 20X2, the end of its first IFRS reporting period is 31 December 20X3 and it publishes a half-year report as at 30 June 20X3 under IAS 34. Which primary financial statements and reconciliations must Entity A present in its first IFRS half-year report?

	1 January 20X2	30 June 20X2	31 December 20X2	30 June 20X3
Statement of financial position			●	●
Reconciliation of equity	●‡	●	●‡	
For the period ending				
Statement of profit or loss and other comprehensive income*		●		●
Statement of cash flows		●		●
Statement of changes in equity		●		●
Reconciliation of total comprehensive income†		●	●‡	
Explanation of material adjustments to the statement of cash flows			●‡	

* Alternatively, the entity presents two statements: a statement of profit or loss and a statement of comprehensive income. *[IAS 1.10A]*.

† If an entity did not previously report total comprehensive income then a reconciliation from profit or loss under previous GAAP to total comprehensive income under IFRS accounting standards is presented. *[IFRS 1.24(b), IFRS 1.32(a)(ii), IFRS 1.32(b)]*.

‡ These additional reconciliations are required under IFRS 1.24(a)-(b) and IFRS 1.25. These must be included in the first interim financial report for part of the period covered by the entity's first IFRS financial statements (or by way of a cross reference to another published document including these reconciliations). The reconciliations must distinguish corrections of errors from changes in accounting policies (see section 6.3.1 above). *[IFRS 1.24(a), IFRS 1.24(b), IFRS 1.25, IFRS 1.26, IFRS 1.32(b)]*.

The IAS 34 requirements regarding the disclosure of primary financial statements in interim reports are discussed in Chapter 37 at section 5.

As can be seen from the tables in Illustration 6-2 above, the additional reconciliations and explanations required under (b) above would be presented out of context without the statement of financial position, statement of profit or loss (if presented), statement of profit or loss and other comprehensive income and statement of cash flows to which they relate.

How we see it

In order to provide context, we believe a first-time adopter either (1) includes the primary financial statements to which these reconciliations relate or (2) refers to another published document that includes these primary financial statements.

Illustration 6-3 below, which is based on an Illustrative Example in IFRS 1, *[IFRS 1.IG Example 10]*, shows the various reconciliations to be included in the financial statements of a first-time adopter:

Illustration 6-3: Reconciliations to be presented in IFRS quarterly reports

Entity B's date of transition to IFRS accounting standards is 1 January 20X2, the end of its first IFRS reporting period is 31 December 20X3 and it publishes quarterly reports under IAS 34. Which reconciliations must Entity B present in its 20X3 interim IFRS reports and in its first IFRS financial statements?

	Reconciliation of equity	Reconciliation of total comprehensive income or profit or loss†	Explanation of material adjustments to statement of cash flows
First quarter			
1 January 20X2	o		
31 December 20X2	o	o	o
31 March 20X2			
▸ 3 months ending	●	●	
Second quarter			
30 June 20X2			
▸ 3 months ending		●	
▸ 6 months ending	●	●	
Third quarter			
30 September 20X2			
▸ 3 months ending		●	
▸ 9 months ending	●	●	
First IFRS financial statements			
1 January 20X2	●		
31 December 20X2	●	●	●

o These reconciliations are only required to be presented in an entity's *first* interim financial report under IAS 34 and could be included by way of a cross-reference to another published document in which these reconciliations are presented. The reconciliations must distinguish corrections of errors from changes in accounting policies. *[IFRS 1.24(a), IFRS 1.24(b), IFRS 1.25, IFRS 1.26, IFRS 1.32(b)]*.

† If an entity did not previously report total comprehensive income, a reconciliation from profit or loss under previous GAAP to total comprehensive income under IFRS accounting standards must be presented. *[IFRS 1.24(b), IFRS 1.32(a)(ii), IFRS 1.32(b)]*.

If a first-time adopter issues an interim financial report in accordance with IAS 34 for part of the period covered by its first IFRS financial statements and changes its accounting policies or its use of exemptions contained in IFRS 1, the first-time adopter is required to explain the changes in each such interim financial report in accordance with IFRS 1.23, i.e., the disclosure objective to explain the transition (see section 6.3 above), and update the reconciliations at (a) and (b) above. *[IFRS 1.23, IFRS 1.32(c)]*.

If a first-time adopter issues an interim financial report in accordance with IAS 34 for part of the period covered by its first IFRS financial statements and will be applying IFRS 18 in its first IFRS financial statements, the entity must present each heading it expects to use in applying IFRS 18 and the subtotals required by IFRS 18.69-74 (see Chapter 4 at section 3) in those interim financial statements. After the entity has issued its first IFRS financial statements, an entity applies the usual requirements in IAS 34.10 for headings and subtotals in condensed financial statements (see Chapter 37 at section 3.2) after it has issued its first IFRS financial statements prepared in accordance with IFRS 18. *[IFRS 1(2027).32(za)]*.

6.6.2 Disclosures in the interim financial report

Interim financial reports under IAS 34 contain considerably less detail than annual financial statements because they assume that users of the interim financial report also have access to the most recent annual financial statements. However, they would be expected to provide disclosure relating to material events or transactions to allow users to understand the current interim period. Therefore, a first-time adopter needs to consider what disclosures required by IFRS accounting standards are material to an understanding of the current interim period. If the most recent annual financial statements under previous GAAP did not disclose information material to an understanding of the current interim period, the interim financial report must disclose that information (or include a cross reference to another published document that contains that information). *[IFRS 1.33, IAS 34.15, IAS 34.15A]*.

How we see it

A full set of IFRS accounting policy disclosures and related significant judgements and estimates needs to be included in the first IFRS interim financial report as well as information on the IFRS 1 exemptions employed (or that report needs to contain a cross reference to another published document that includes this information (see Chapter 37 at section 4.2.3)). In addition, consideration needs to be given to both new disclosures not previously required under previous GAAP, and disclosures made under previous GAAP but for which the amounts contained therein have changed significantly due to changes in accounting policies resulting from the adoption of IFRS accounting standards.

It is also important to note that such disclosures apply to balances in both the opening and comparative year-end statement of financial position, each of which could be included in the first IFRS interim financial report (see section 6.6.1 above). First-time adopters are expected to include significantly more information in their first IFRS interim financial report than would normally be included in an interim financial report (alternatively, the report could cross refer to another published document that includes such information). *[IFRS 1.33]*.

Examples of additional annual disclosures under IFRS accounting standards to be included in the entity's first IAS 34 compliant interim financial report could include disclosures relating to retirement benefits, income taxes, goodwill and provisions, amongst other items that significantly differ from previous GAAP and those disclosures required under IFRS accounting standards that are more substantial than previous GAAP (see Chapter 37 at section 11.1).

6.7 Disclosure of IFRS information before adoption of IFRS accounting standards

As the adoption of IFRS accounting standards might have a significant impact on their financial statements, many entities will want to provide information on its expected impact in advance of their first IFRS financial statements. There are certain difficulties that arise as a result of the application of IFRS 1 when an entity decides to quantify the impact of the adoption of IFRS accounting standards. In particular, IFRS 1 requires an entity to draw up an opening IFRS statement of financial position at its date of transition to IFRS accounting standards based on the standards that are effective at the end of its first IFRS reporting period. Therefore, it is not possible to prepare IFRS financial information - and assess the full impact of IFRS accounting standards - until an entity knows its date of transition to IFRS accounting standards and exactly which standards will be effective at the end of its first IFRS reporting period.

How we see it

If an entity wanted to quantify the impact of the adoption of IFRS accounting standards before its date of transition to IFRS accounting standards, it would not be able to do this in accordance with IFRS 1. While an entity would be able to select a date and apply by analogy the requirements of IFRS 1 to its previous GAAP financial information as of that date, it would not be able to claim that such additional information complied with IFRS accounting standards. Presentation of such additional information is to be avoided if there is a concern that the information, despite being clearly marked as not IFRS compliant, would be misleading or misunderstood.

If an entity wants to quantify the impact of the adoption of IFRS accounting standards in advance of the release of its first IFRS financial statements but after its date of transition to IFRS accounting standards, there could still be some uncertainty regarding the standards that apply. If so, an entity discloses the nature of the uncertainty and considers describing the information as 'preliminary' IFRS information.

Practical example 6-3 below is an example of an entity presenting information about the effect of adopting IFRS accounting standards in advance of its first IFRS financial statements. The Practical example complies with the versions of IFRS 1 and IAS 19 that were effective in 2011.

Practical example 6-3: Canadian Imperial Bank of Commerce (CIBC) (2011) Canada

2011 Annual Report [extract]

Notes to the consolidated financial statements [extract]

Note 32 | Transition to International Financial Reporting Standards

Publicly accountable enterprises are required to adopt IFRS for annual periods beginning on or after January 1, 2011. As a result, our audited consolidated financial statements for the year ending October 31, 2012 will be the first annual financial statements that comply with IFRS, including the application of IFRS 1 "First-time Adoption of International Financial Reporting Standards". IFRS 1 requires an entity to adopt IFRS in its first annual financial statements prepared under IFRS by making an explicit and unreserved statement of compliance with IFRS in those financial statements. We will make this statement of compliance when we issue our 2012 annual consolidated financial statements.

IFRS 1 also requires that comparative financial information be provided. As a result, the first day at which we applied IFRS was as at November 1, 2010 (the Transition Date), and our consolidated opening IFRS balance sheet was prepared as at this date. The opening IFRS balance sheet represents our starting point for financial reporting under IFRS.

In accordance with IFRS 1, we have retrospectively applied our IFRS accounting policies in the preparation of our opening IFRS balance sheet as at November 1, 2010. These IFRS accounting policies are those that we expect to apply in our first annual IFRS financial statements for the year ending October 31, 2012, although IFRS 1 provides certain optional exemptions and mandatory exceptions from retrospective application of IFRS, as described in Section A, Exemptions and exceptions from retrospective application of IFRS.

The following information is provided to allow users of the financial statements to obtain a better understanding of the effect of the adoption of IFRS on our consolidated financial statements. The information below includes our opening IFRS balance sheet as at November 1, 2010, based on the IFRS optional exemptions and accounting policies that we expect to apply in our first annual IFRS financial statements. A description of the differences in accounting policies under IFRS and Canadian GAAP that resulted in transition adjustments as at November 1, 2010 is provided in Section B, Differences in accounting policies.

...

Notes to the opening IFRS consolidated balance sheet

A. Exemptions and exceptions from retrospective application of IFRS

Set forth below are the applicable IFRS 1 optional exemptions and mandatory exceptions from retrospective application of IFRS accounting policies that have been applied in the preparation of the opening IFRS balance sheet.

...

IFRS optional exemptions [extract]

3. *Cumulative foreign currency translation differences* – Retrospective application of IAS 21 "The Effects of Changes in Foreign Exchange Rates" would require us to determine cumulative foreign currency translation gains and losses from the date that a subsidiary or equity-accounted investee was formed or acquired. However, IFRS 1 permits entities to elect to recognize the cumulative foreign currency translation adjustments account included in AOCI for foreign operations with a different functional currency from that of the parent, including accumulated gains or losses on hedges of net investments in such foreign operations, in retained earnings as at the Transition Date. We elected to apply this 'fresh-start' election, which resulted in an after-tax decrease in retained earnings of $575 million as at the Transition Date, with an offsetting increase in AOCI.

...

IFRS mandatory exceptions

IFRS 1 prohibits the retrospective application of some requirements of IFRS. Set forth below are the applicable mandatory exceptions under IFRS 1 that have been applied in the preparation of the opening IFRS balance sheet.

...

7. *Estimates* – Our estimates in accordance with IFRS as at the Transition Date are consistent with estimates made at that date in accordance with Canadian GAAP, with adjustments made only to reflect any differences in accounting policies. Additional estimates made under IFRS, that were not required under Canadian GAAP, were based on the information and conditions that existed as at the Transition Date. Hindsight was not used to create or revise estimates.

...

B. Differences in accounting policies

In addition to the exemptions and exceptions discussed above, the following narratives explain the significant differences between the Canadian GAAP accounting policies and the IFRS policies applied in preparing the opening IFRS balance sheet, and the impact thereof.

...

5. Share-based payments

Period of recognition of expense

Canadian GAAP – The estimated grant-date fair value of share-based payments are recognized in their entirety in the year preceding the grant date if the award is for performance during that year.

IFRS – Under IFRS 2 "Share-based Payment", for awards for which the service commencement date precedes the grant date (e.g., the award includes a performance year preceding the grant date), the grant date fair value is recognized over the period from the service commencement date (i.e., the beginning of the performance year preceding the grant date) to the vesting date. For such awards, the share-based payment expense is recognized over a longer period under IFRS. Retention awards are recognized over the vesting period, consistent with the treatment under Canadian GAAP.

Forfeitures

Canadian GAAP – Forfeitures of awards due to the failure to satisfy service or non-market vesting conditions are recognized as incurred.

IFRS – The impact of such forfeitures is estimated initially at the grant date of the award (or at the service commencement date if earlier), and the forfeiture estimate is adjusted if subsequent information indicates that actual forfeitures are likely to differ from the initial estimate. As a result, the carrying amount of the liability for cash-settled awards is lower under IFRS as it reflects an estimate of forfeitures at the reporting date.

As a result of the differences noted above, the net impact was a pre-tax decrease of $150 million in liabilities, with an offsetting after-tax increase of $103 million and $2 million in retained earnings and AOCI, respectively, and an after-tax increase in contributed surplus of $2 million as at the Transition Date.

...

C. Other presentation reclassifications

1. Non-controlling interests

Under Canadian GAAP, minority interests in subsidiaries are classified outside of shareholders' equity. Under IFRS, minority interests are referred to as non-controlling interests, and non-controlling interests are classified as equity, and are presented separately within total equity.

2. Precious metals

Under Canadian GAAP, we included precious metals in the balance sheet under Cash and non-interest-bearing deposits with banks, whereas under IFRS, we have included precious metals in Other assets. As a result, $373 million of precious metals were reclassified from Cash and non-interest-bearing deposits with banks to Other assets as at the Transition Date.

...

D. Reconciliation of equity from Canadian GAAP to IFRS as at the Transition Date

$ millions, as at November 1, 2010	Retained earnings	AOCI	Other equity	Total shareholders' equity	Non-controlling interest	Total equity	Note
As reported under Canadian GAAP	$ 6,095	$ (361)	$ 10,056	$ 15,790	$ –	$ 15,790	
Employee benefits	(1,080)	–	–	(1,080)	–	(1,080)	A.1, B.1
Securitized mortgages	(131)	(34)	–	(165)	–	(165)	A.8, B.2
Consolidation	(128)	(8)	–	(136)	–	(136)	A.8, B.3
Measurement of private AFS equity investments	–	201	–	201	–	201	B.4
Foreign exchange gains and losses on AFS debt instruments	5	(5)	–	–	–	–	B.4
Impairment of AFS equity investments	(50)	46	–	(4)	–	(4)	B.4
Reclassification of financial instruments	(85)	–	–	(85)	–	(85)	A.5, B.4
Share-based payments	103	2	2	107	–	107	B.5
Joint venture accounting	6	–	–	6	–	6	B.6
Foreign currency translation adjustments	(575)	575	–	–	–	–	A.3
Finance leases and leveraged leases	3	–	–	3	–	3	B.7, B.8
Customer loyalty points	(6)	–	–	(6)	–	(6)	B.9
Presentation of non-controlling interest as equity	–	–	–	–	168	168	C.1
	$ (1,938)	$ 777	$ 2	$ (1,159)	$ 168	$ (991)	
As reported under IFRS	$ 4,157	$ 416	$ 10,058	$ 14,631	$ 168	$ 14,799	

6.8 Disclosure requirements for subsidiaries without public accountability (IFRS 19)

In May 2024, the IASB issued IFRS 19 which is applicable for annual reporting periods beginning on or after 1 January 2027. Earlier application is permitted.

An entity can elect to apply IFRS 19 for its consolidated, separate and individual statements if, and only if, at the end of the reporting period: *[IFRS 19.7]*

(a) It is a subsidiary

(b) It does not have public accountability

And

(c) It has an ultimate or intermediate parent that produces consolidated financial statements available for public use that comply with IFRS accounting standards.

An entity that elects to apply IFRS 19 in one reporting period may later revoke that election and an entity may elect to apply IFRS 19 more than once. *[IFRS 19.13]*.

An entity whose financial statements comply with IFRS accounting standards and the requirements in IFRS 19 must make an explicit and unreserved statement of such compliance in the notes, specifically stating that IFRS 19 has been applied as part of that statement. *[IFRS 19.20]*. (see Chapter 4 at section 7)

6.8.1 Interaction with IFRS 1

IFRS 19 provides no exemption or exception for recognition, measurement and presentation requirements in IFRS accounting standards. Therefore, the requirements of IFRS 1 (except those relating to disclosures) apply in full in the first IFRS financial statements or when IFRS 1 is reapplied (see section 2.2.1 above). *[IFRS 19.2, IFRS 19.17, IFRS 1.4A]*.

It is important to note that electing or revoking an election to apply IFRS 19 does not, on its own, result in an entity meeting IFRS 1's definition of a first-time adopter of IFRS accounting standards. *[IFRS 19.18].* If an entity provided, in the immediately preceding period, a statement of compliance with both IFRS accounting standards and IFRS 19, it does not apply IFRS 1 for the current reporting period even if the entity revokes the election to apply IFRS 19 for the current reporting period. *[IFRS 19.19]*. Conversely, an entity that gave a complete and unreserved statement of compliance with IFRS accounting standards but did not apply IFRS 19 in the immediately preceding period, does not apply IFRS 1 for the current reporting period if it elects to apply IFRS 19 in the current reporting period. *[IFRS 19.18]*.

See section 6.8.2 below in relation to the disclosures relating to transition to IFRS accounting standards.

IFRS 19 is an optional standard and therefore an eligible subsidiary (see section 6.8 above) choosing not to apply IFRS 19 must instead apply IFRS 1's disclosure requirements when it prepares its first IFRS financial statements (see section 6 above).

6.8.2 Disclosure requirements in IFRS 19 relating to the transition to IFRS accounting standards

An eligible subsidiary who chooses to apply IFRS 19 when it prepares its first IFRS financial statements is required to apply the disclosure requirements in IFRS 19 rather than those in other IFRS accounting standards, although some disclosure requirements in other IFRS accounting standards remain applicable, which are specified in IFRS 19 (see further details in Chapter 4 at section 7). *[IFRS 19.2, IFRS 19.4].*

An entity that applies IFRS 19 when it prepares its first IFRS financial statements must apply the disclosure requirements in IFRS 19.21-30 instead of the disclosure requirements in IFRS 1.23-33. *[IFRS 19.17].* A first-time adopter applying IFRS 19 is required to make disclosures explaining the transition to IFRS accounting standards in its first IFRS financial statements. *[IFRS 19.21]*. These specifically cover requirements for:

- Disclosures when an entity reapplies IFRS accounting standards *[IFRS 19.22, IFRS 19.23]*
- Reconciliations *[IFRS 19.24, IFRS 19.25, IFRS 19.26, IFRS 19.27]*
- Interim financial reports *[IFRS 19.28, IFRS 19.29]*

These disclosures are similar to the corresponding requirements set out in IFRS 1 (see sections 2.2.1, 6.3, 6.3.1 and 6.6.1 above). There are some simplifications compared to the corresponding disclosures required under IFRS 1 by a first-time adopter. For example, even if the entity recognised or reversed impairment losses for the first time in preparing its opening IFRS statement of financial position, it is not required to give the disclosures that IAS 36 would have required (see section 6.3.3 above). *[IFRS 1.24(c)]*.

IFRS 19.30 further requires an entity who applies IFRS 19 to disclose specific information required by IFRS 2 when it applies IFRS 1.D2 (i.e., the same requirements as set out in IFRS 1.D2). *[IFRS 19.30]*. (see section 5.3 above and Chapter 30 at section 13).

7 Accounting policies and practical application issues

The exceptions and exemptions of IFRS 1 are explained in sections 4 and 5 above, respectively. This section provides an overview of the detailed application guidance in IFRS 1 (to the extent that it is not covered in sections 4 and 5 above) and some of the practical application issues that are not directly related to any of the exceptions or exemptions. These issues are discussed by IFRS accounting standard as follows:

- IAS 7 *Statement of Cash Flows* (see section 7.1 below)
- IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (see section 7.2 below)
- IAS 12 *Income Taxes* (see section 7.3 below)
- IAS 16 *Property, Plant and Equipment* and IAS 40 *Investment Property* (cost model) (see section 7.4 below)
- IFRS 16 *Leases* (see section 7.5 below)
- IFRS 15 *Revenue from Contracts with Customers* (see section 7.6 below)
- IAS 19 *Employee Benefits* (see section 7.7 below)
- IAS 21 *The Effects of Changes in Foreign Exchange Rates* (see section 7.8 below)
- IAS 28 *Investments in Associates and Joint Ventures* (see section 7.9 below)
- IAS 29 *Financial Reporting in Hyperinflationary Economies* (see section 7.10 below)
- IFRS 11 *Joint Arrangements* (see section 7.11 below)
- IAS 36 *Impairment of Assets* (see section 7.12 below)
- IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (see section 7.13 below)
- IAS 38 *Intangible Assets* (see section 7.14 below)

7.1 IAS 7 *Statement of Cash Flows*

A statement of cash flows prepared under IAS 7 could differ in the following ways from the one prepared under an entity's previous GAAP:

- The definition of 'cash and cash equivalents' under IAS 7 could well differ from the one used under previous GAAP. *[IAS 7.6, IAS 7.7, IAS 7.8]*. In particular, IAS 7 includes within cash and cash equivalents those bank overdrafts repayable on demand which form an integral part of an entity's cash management (see Chapter 36 at section 3). *[IAS 7.8]*.
- The layout and definition of the categories of cash flows (i.e., operating, investing and financing) is often different from previous GAAP. *[IAS 7.10]*. In addition, IAS 7 contains specific requirements about the classification of interest, dividends and taxes (see Chapter 36 at section 4). *[IAS 7.31, IAS 7.35]*.
- Differences in accounting policies between IFRS accounting standards and previous GAAP often have a consequential impact on the statement of cash flows.

IFRS 1 requires disclosure of an explanation of the material adjustments to the statement of cash flows, if a first-time adopter presented one under its previous GAAP (see section 6.3.1 above). *[IFRS 1.25]*. Practical example 7-1 below illustrates how the IFRS statement of cash flows differed from that presented under previous GAAP.

Practical example 7-1: Sony Group Corporation (2022) **Japan**

Form 20-F [extract]

Notes to Consolidated Financial Statements [extract]

34. First-time adoption [extract]

(5) Reconciliation of consolidated statements of cash flows

The main items causing the differences in the consolidated statements of cash flows are as follows:

	Yen in millions		
	Fiscal year ended March 31, 2021		
	Cash flows from operating activities	Cash flows from investing activities	Cash flows from financing activities
Consolidated statements of cash flows under U.S. GAAP	1,350,150	(1,781,516)	666,967
1. Principal payments for operating lease liabilities*1	72,098	—	(72,098)
2. Additions and disposals of content assets*2	(34,751)	34,751	—
3. Changes in assets and liabilities in the Financial Services segment*3			
(1) Investments and advances in the Financial Services segment	(1,181,744)	1,181,744	—
(2) Deposits from customers in the banking business	332,987	—	(332,987)
(3) Borrowings in the life insurance business and the banking business	463,783	—	(463,783)
(4) Future insurance policy benefits and other and policyholders' account in the life insurance business	134,299	—	(134,299)
4. Other	3,395	1,111	(2,333)
Total	(209,933)	1,217,606	(1,005,500)
Consolidated statements of cash flows under IFRS	1,140,217	(563,910)	(338,533)

*1 Principal payments for operating lease liabilities

Under U.S. GAAP, lessees classify leases as either operating leases or finance leases, and the principal payments for the operating lease liabilities are classified as cash flows from operating activities in the consolidated statements of cash flows. Under IFRS, the distinction between operating leases and finance leases no longer exists for lessees, and all of the principal payments for lease liabilities are classified as cash flows from financing activities in the consolidated statements of cash flows.

*2 Additions and disposals of content assets

Under U.S. GAAP, Sony classified the cash flows from the additions and disposals of film costs as cash flows from operating activities, and classified the cash flows from the additions and disposals of music catalogs, artist contracts, music distribution rights and other content assets as cash flows from investing activities in the consolidated statements of cash flows based on the nature of such transactions as additions and disposals of intangible assets. Under IFRS, Sony defines these intangible assets as content assets, and classifies the cash flows from the additions and disposals of content assets as cash flows from operating activities in the consolidated statements of cash flows except for additions and disposals of content assets from business combinations or business divestitures, because the additions and disposals of content assets are derived from the principal revenue-producing activities of Sony.

*3 Changes in assets and liabilities in the Financial Services segment

Under U.S. GAAP, Sony classified cash flows from changes in investments and advances in the Financial Services segment and repurchase agreements in the Financial Services segment, deposits from customers in the banking business and policyholders' account in the life insurance business according to the nature of these transactions in the consolidated statements of cash flows. Under IFRS, Sony classifies cash flows from these transactions as cash flows from operating activities in the consolidated statements of cash flows as these transactions are viewed as integral to the principal revenue-producing activities of Sony.

7.2 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*

Normally when an entity that is already using IFRS accounting standards changes an accounting policy, it applies IAS 8 to such a change. IFRS 1 requires that a first-time adopter applies the same accounting policies in its opening IFRS statement of financial position and throughout all periods presented in its first IFRS financial statements. *[IFRS 1.7]*. Therefore, the change in accounting policies must be treated as a change in the entity's opening IFRS statement of financial position and the policy must be applied consistently in all periods presented in its first IFRS financial statements.

7.2.1 Changes in IFRS accounting policies during the first IFRS reporting period

A first-time adopter might find that it needs to change IFRS accounting policies after it has issued an IFRS interim report but before issuing its first IFRS financial statements. Such a change in accounting policies could relate either to the ongoing IFRS accounting policies or to the selection of IFRS 1 exemptions.

IAS 8 does not apply to the changes in accounting policies an entity makes when it adopts IFRS accounting standards or to changes in those policies until after it presents its first IFRS financial statements. *[IFRS 1.27]*. Therefore, "if during the period covered by its first IFRS financial statements an entity changes its accounting policies or its use of the exemptions contained in this IFRS", it must explain the changes between its first IFRS interim financial report and its first IFRS financial statements in accordance with IFRS 1.23, i.e., the disclosure objective to explain the transition (see section 6.3 above) and update the reconciliations required by IFRS 1.24(a) and (b) (see section 6.3.1 above). *[IFRS 1.23, IFRS 1.24(a), IFRS 1.24(b), IFRS 1.27A]*. A similar requirement applies to the disclosures in a first-time adopter's interim financial reports (see section 6.6 above). *[IFRS 1.23, IFRS 1.32(c)]*.

The distinction between changes in accounting policies and changes in accounting estimates is discussed in detail in Chapter 3 at section 4.2.

7.2.2 Changes in estimates and correction of errors

An entity that adopts IFRS accounting standards needs to assess carefully the impact of information that has become available since it prepared its most recent previous GAAP financial statements because the new information might:

- Be a new estimate that must be accounted for prospectively (see section 4.2 above) *[IFRS 1.14, IFRS 1.15, IFRS 1.16, IFRS 1.17]*

  Or

- Expose an error in the previous GAAP financial statements due to mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud. *[IAS 8.5]*. In the reconciliation from previous GAAP to IFRS accounting standards such errors must be disclosed separately from the effect of changes in accounting policies (see section 6.3.1 above). *[IFRS 1.26]*.

7.3 IAS 12 *Income Taxes*

There are no particular provisions in IFRS 1 with regard to the first-time adoption of IAS 12, except for IFRS 1.B14 modifying the initial recognition exception of deferred tax assets and liabilities (see section 4.14 above). *[IFRS 1.B14]*.

However, the implementation guidance notes that IAS 12 requires entities to provide for deferred tax on temporary differences measured by reference to enacted or substantively enacted legislation by the end of the reporting period. Therefore, entities need to account for the effect of changes in tax rates and tax laws when those changes are enacted or substantively enacted. *[IFRS 1.IG5, IFRS 1.IG6]*.

The full retrospective application of IAS 12 (as modified by IFRS 1.B14) poses several problems that might not be immediately obvious. First, IAS 12 does not require an entity to account for all temporary differences. For example, an entity is not permitted under IAS 12 to recognise deferred tax on:

- Taxable temporary differences arising on the initial recognition of goodwill *[IAS 12.15]*
- Taxable and deductible temporary differences arising on the initial recognition of an asset or liability in a transaction that is not a business combination and that, at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss) and, at the time of the transaction, does not give rise to equal taxable and deductible temporary differences *[IAS 12.15, IAS 12.24]*

However, IFRS 1.B14 requires a first-time adopter, at the date of transition to IFRS accounting standards, to recognise a deferred tax asset (to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised) and a deferred tax liability for all deductible and taxable temporary differences associated with (1) right-of-use assets and lease liabilities; and (2) decommissioning, restoration and similar liabilities and the corresponding amounts recognised as part of the cost of the related asset (see section 4.14 above). *[IFRS 1.B14]*.

In addition, a change in deferred tax must be accounted for in other comprehensive income or equity, instead of profit or loss, when the tax relates to an item that was originally accounted for in other comprehensive income or equity. *[IAS 12.61A]*.

Therefore, full retrospective application of IAS 12 requires a first-time adopter to establish the history of the items that give rise to temporary differences because, depending on the type of transaction, deferred tax might or might not be recognised, or changes in the deferred tax might need to be accounted for in other comprehensive income or equity.

The main issue for many first-time adopters of IFRS accounting standards will be that their previous GAAPs either required no provision for deferred tax, or required provision under a timing difference approach. They also need to be aware that many of the other adjustments made to the statement of financial position at the date of transition to IFRS accounting standards will also have a deferred tax effect that must be accounted for - see, for example, the potential deferred tax consequences of recognising or derecognising intangible assets where an entity uses the business combinations exemption, described in sections 5.2.4.A, 5.2.4.B, 5.2.5 and 5.2.9 above. Entities that reported under US GAAP must also bear in mind that IAS 12, though derived from FASB's Accounting Standard Codification 740 *Income Taxes*, is different in a number of important respects.

7.3.1 Previous revaluation of plant, property and equipment treated as deemed cost on transition

In some cases, IFRS 1 allows an entity, on transition to IFRS accounting standards, to treat the carrying amount of plant, property or equipment revalued under its previous GAAP as its deemed cost as of the date of revaluation for the purposes of IFRS accounting standards (see section 5.4.1 above). *[IFRS 1.D6]*.

Where an asset is carried at deemed cost on the date of transition to IFRS accounting standards but the tax base of the asset remains at original cost, or an amount based on original cost, the previous GAAP revaluation will give rise to a temporary difference which is typically a taxable temporary difference associated with the asset. IAS 12 requires deferred tax to be recognised on the date of transition to IFRS accounting standards on any such temporary difference (see Chapter 29 at section 10.10).

If, after the date of transition to IFRS accounting standards, the deferred tax is required to be remeasured, e.g., because of a change in tax rate, or a re-basing of the asset for tax purposes, the entity elects the cost model of IAS 16 and the asset concerned was revalued outside profit or loss under previous GAAP, the question arises as to whether the resulting deferred tax income or expense is recognised in, or outside, profit or loss.

How we see it

In our view, either approach, i.e., recognising the deferred tax income or expense in profit or loss or in other comprehensive income, is acceptable, so long as it is applied consistently. See Chapter 29 at section 10.10.

7.3.2 Share-based payment transactions subject to transitional provisions of IFRS 1

While IFRS 1 provides exemptions from applying IFRS 2 to share-based payment transactions that were fully vested prior to the date of transition to IFRS accounting standards, there are no corresponding exemptions from the provisions of IAS 12 relating to the tax effects of share-based payment transactions. Therefore, the provisions of IAS 12 relating to the tax effects of share-based payments apply to all share-based payment transactions, whether they are accounted for in accordance with IFRS 2 or not. *[IAS 12.68A, IAS 12.68B, IAS 12.68C]*. IAS 12 effectively considers the cumulative expense associated with share-based payment transactions as an asset that has been fully expensed in the financial statements in advance of being recognised for tax purposes, thus giving rise to a deductible temporary difference (see Chapter 29 at section 10.8).

How we see it

This means that on transition to IFRS accounting standards, and subject to the restrictions on recognition of deferred tax assets, (see Chapter 29 at section 7.5), a deferred tax asset is established for all share-based payment awards outstanding at that date, including those not accounted for under the IFRS 1 transition provisions.

Where such an asset is remeasured or recognised after transition to IFRS accounting standards, the general rule regarding the 'capping' of the amount of any tax relief recognised in profit or loss to the amount charged to the profit or loss applies (see Chapter 29 at section 10.8.1). Therefore, if there was no profit or loss charge for share-based payment transactions under the previous GAAP, all tax effects of share-based payment transactions not accounted for under IFRS 2 are dealt with within equity.

7.3.3 Retrospective restatements or applications

The adjustments arising from different accounting policies under previous GAAP and IFRS accounting standards must be recognised directly in retained earnings (or, if appropriate, another category of equity) at the date of transition to IFRS accounting standards. *[IFRS 1.11]*.

Because IAS 12 requires tax relating to an item that has been recognised outside profit or loss to be treated in the same way, any tax effect of a retrospective restatement or retrospective application on the opening comparative statement of financial position is dealt with as an adjustment to equity also. *[IAS 12.61A]*. This could be taken by some to mean that any subsequent remeasurement of tax originally recognised in equity as part of an adjustment at the date of transition to IFRS accounting standards must be accounted for in equity also.

How we see it

IAS 8 defines retrospective application as the application of "a new accounting policy to transactions, other events and conditions as if that policy had always been applied", and the treatment required by IFRS 1 is based on the fact that an entity is restating amounts that arise from events and transactions before the date of transition to IFRS accounting standards.

Accordingly, in our view, if the item that gave rise to the deferred tax would have been recognised in profit or loss in the normal course of events had the new accounting policies (or IFRS accounting standards) always been applied, the effect of subsequent re-measurement is also recognised in profit or loss.

An example is given in Illustration 7-1 below.

Illustration 7-1: Remeasurement of deferred tax asset recognised as at the date of transition to IFRS accounting standards

Entity A's date of transition to IFRS accounting standards was 1 January 20X2. After applying IAS 37, its opening IFRS statement of financial position shows an additional liability for environmental remediation costs of CU5 million as an adjustment to retained earnings, together with an associated deferred tax asset at 40% of CU2 million.

The environmental liability does not change substantially over the next accounting period, but during the year ended 31 December 20X3 the tax rate falls to 30%. This requires the deferred tax asset to be remeasured to CU1.5 million giving rise to tax expense of CU500,000. Is this expense recognised in profit or loss for the period or in retained earnings?

In the fact pattern, if IFRS accounting standards had always been applied, all the charge for environmental costs (and all the related deferred tax) would have been reflected in profit or loss in previous income statements. Therefore, the effect of the change in the tax rate is recognised in profit or loss.

Where the retrospective restatement giving rise to a deferred tax asset or liability directly in equity represented the cumulative total of amounts that would have been recognised ordinarily in other comprehensive income or directly in equity in previous periods if the new accounting policy had always been applied (e.g., deferred tax relating to the revaluation of property, plant, or equipment), any subsequent re-measurement of the deferred tax is also accounted for in the same manner, i.e., in other comprehensive income or directly in equity. Remeasurement of deferred tax relating to an asset that is measured at deemed cost on transition to IFRS accounting standards but where the tax base of the asset remains at original cost, or is an amount based on original cost is discussed in section 7.3.1 above.

Retrospective restatements or applications are discussed in detail in Chapter 29 at section 10.2.

7.3.4 Defined benefit pension plans

IAS 19 requires an entity, in accounting for a post-employment defined benefit plan, to recognise actuarial gains and losses relating to the plan in other comprehensive income. At the same time, service cost and net interest on the net defined benefit liability (asset) is recognised in profit or loss.

In many jurisdictions, tax relief for post-employment benefits is given on the basis of cash contributions paid to the plan fund (or benefits paid when a plan is unfunded).

This significant difference between the ways in which defined benefit plans are treated for tax and financial reporting purposes can make the allocation of tax between profit or loss and other comprehensive income somewhat arbitrary.

How we see it

The issue is of particular importance when a first-time adopter has large funding shortfalls on its defined benefit schemes and at the same time can only recognise part of its deferred tax assets. In such a situation the method of allocation of tax could well affect the after-tax profit in a given year. In our view, this is an instance of the exceptional circumstances envisaged by IAS 12 when a strict allocation of tax between profit or loss and other comprehensive income is not possible. Accordingly, any reasonable method of allocation could be used, provided that it is applied on a consistent basis. See Chapter 29 at section 10.7 for further discussion, including approaches to allocation.

7.4 IAS 16 *Property, Plant and Equipment* and IAS 40 *Investment Property* (cost model)

The implementation guidance discussed in this section applies to property, plant and equipment as well as investment properties that are accounted for under the cost model in IAS 40. *[IFRS 1.IG62]*.

IFRS 1 requires an entity to use estimates made under its previous GAAP (after adjustment for different accounting policies), unless there is objective evidence those estimates are in error, *[IFRS 1.14]*, but also recognises that an entity might need to make estimates in accordance with IFRS accounting standards at the date of transition to IFRS accounting standards that were not required at that date under previous GAAP. *[IFRS 1.16]* (see section 4.2 above). Errors made under previous GAAP are corrected retrospectively and separately disclosed in the reconciliations from previous GAAP to IFRS accounting standards (see section 6.3.1 above). *[IFRS 1.26]*. These general requirements are relevant where estimates or accounting policies differ under previous GAAP and IFRS accounting standards, as discussed further below.

7.4.1 Depreciation method and rate

If a first-time adopter's depreciation methods and rates under its previous GAAP are acceptable under IFRS accounting standards, then it accounts for any change in estimated useful life or depreciation pattern prospectively from when it makes that change in estimate (see section 4.2 above). *[IFRS 1.14, IFRS 1.15, IAS 16.51, IAS 16.61]*. However, if the depreciation methods and rates are not acceptable under IFRS accounting standards and the difference has a material impact on the financial statements, a first-time adopter adjusts the accumulated depreciation in its opening IFRS statement of financial position retrospectively. *[IFRS 1.IG7]*. Further differences could arise from the requirement in IAS 16 to review the residual value and the useful life of an asset at least at each financial year end, *[IAS 16.51]*, which might not be required under a first-time adopter's previous GAAP (see section 7.4.2 below).

How we see it

If a restatement of the depreciation methods and rates would be too onerous, a first-time adopter could opt instead to use fair value as the deemed cost at the date of transition to IFRS accounting standards (see section 5.4.1 above). However, application of the deemed cost exemption is not always the only approach available. In practice, many first-time adopters have found that, other than buildings, there are generally few items of property, plant and equipment that still have a material carrying amount after more than 30 or 40 years of use. Therefore, the carrying value that results from a fully retrospective application of IAS 16 might not differ much from the carrying amount under an entity's previous GAAP.

7.4.2 Estimates of useful life and residual value

IAS 16 requires the entity to re-assess the remaining useful life and residual value at least each financial year-end and, if expectations differ from previous estimates, the change is accounted for as a change in an accounting estimate in accordance with IAS 8. *[IAS 16.51]*.

Consider the following situations:

- An entity uses fair value as deemed cost for an item of property, plant and equipment still in use that it had depreciated to zero under its previous GAAP (i.e., the asset has already reached the end of its originally assessed economic life).
- An entity does not use fair value as deemed cost, but there were indicators in the past that the useful life or residual value had changed but those changes were not required to be recognised under previous GAAP.

How we see it

In the former case, we believe that the asset's deemed cost is required to be depreciated over its re-assessed economic life and taking into account its re-assessed residual value.

The same applies to the latter case, i.e., the IFRS carrying amount as of the date of transition to IFRS accounting standards needs to be determined by taking into account the re-assessed useful life and the re-assessed residual value. Often, this is difficult, as most entities would not have re-assessed the useful lives contemporaneously with the issuance of the previous GAAP financial statements. Accordingly, the fair value as deemed cost exemption might be the most logical choice.

However, if there were indicators in the past that the useful life or residual value had changed but the entity did not recognise such changes under the previous GAAP despite its previous GAAP requiring an entity to adjust for changes in useful life or residual value, then, this is an 'error', that the entity corrects through retrospective restatement, and distinguishes from the effects of changes in policies in the reconciliations required to explain the transition (see section 6.3.1 above). *[IFRS 1.26]*.

7.4.3 Revaluation model

A first-time adopter that chooses to account for some or all classes of property, plant and equipment under the revaluation model needs to present the cumulative revaluation surplus as a separate component of equity. IFRS 1 requires that "The revaluation surplus at the date of transition to IFRSs is based on a comparison of the carrying amount of the asset at that date with its cost or deemed cost." *[IFRS 1.IG10]*.

How we see it

A first-time adopter that uses fair value as the deemed cost for those classes of property, plant and equipment would be required to reset the cumulative revaluation surplus to zero. Therefore, any previous GAAP revaluation surplus related to assets valued at deemed cost cannot be used to offset a subsequent impairment or revaluation loss under IFRS accounting standards.

Illustration 7-2 below demonstrates the treatment of the revaluation reserve at the date of transition to IFRS accounting standards based on different deemed cost exemptions applied under IFRS 1.

Illustration 7-2: Determination of revaluation reserve under IAS 16 as at the date of transition to IFRS accounting standards

Entity A, with a date of transition to IFRS accounting standards of 1 January 20X2, has freehold land classified as property, plant and equipment. The land was measured under previous GAAP using a revaluation model that is comparable to that required by IAS 16. The previous GAAP carrying amount is CU185,000, being the revaluation last determined in April 20X1. The cost of the land under IFRS accounting standards as at 1 January 20X2 is CU90,000. The fair value of the land on 1 January 20X2 is CU200,000. The entity elects to apply the revaluation model under IAS 16 to the asset class that includes the land.

The revaluation reserve at the date of transition would depend on the exemption applied by the entity:

- If Entity A chooses to use the transition date fair value as deemed cost, the IFRS revaluation reserve is zero (CU200,000 - CU200,000).
- If Entity A chooses to use the previous GAAP revaluation as deemed cost, the IFRS revaluation reserve is CU15,000 (CU200,000 - CU185,000).
- If Entity A does not use the deemed cost exemption under IFRS 1, the IFRS revaluation reserve is CU110,000 (CU200,000 - CU90,000).

7.4.4 Parts approach

IAS 16 requires a 'parts approach' to the recognition of property, plant and equipment. Thus, a large item such as an aircraft is recognised as a series of 'parts' that could have different useful lives. An engine of an aircraft could be a part. IAS 16 does not prescribe the physical unit of measure (the 'part') for recognition i.e., what constitutes an item of property, plant and equipment. Instead, the standard relies on judgement in applying the recognition criteria to an entity's specific circumstances. *[IAS 16.9, IFRS 1.IG12]*. However, the standard does require an entity to:

- Apply a restrictive definition of maintenance costs or costs of day-to-day servicing which it describes as "primarily the costs of labour and consumables, and may include the cost of small parts. The purpose of these expenditures is often described as for the 'repairs and maintenance' of the item of property, plant and equipment" *[IAS 16.12]*
- Derecognise the carrying amount of the parts that are replaced *[IAS 16.13]*
- Depreciate separately each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item *[IAS 16.43]*

Based on this, it is reasonable to surmise that parts can be relatively small units. Therefore, it is possible that even if a first-time adopter's depreciation methods and rates are acceptable under IFRS accounting standards, it might have to restate property, plant and equipment because its unit of measure under previous GAAP was based on physical units significantly larger than parts as described in IAS 16. Accounting for parts is described in detail in Chapter 19 at section 3.2.

How we see it

In practice, however, there is seldom a need to account for every single part of an asset separately. Very often there is no significant difference in the reported amounts once all significant parts have been identified. Furthermore, as explained in Chapter 19 at section 3.2, an entity might not actually need to identify the parts of an asset until it incurs the replacement expenditure.

7.5 IFRS 16 *Leases*

Other than the exemption in IFRS 1.D9 (concerning the assessment of whether a contract existing at the date of transition to IFRS accounting standards contains a lease - see section 5.5 above), there are no exemptions regarding lease accounting available to a first-time adopter that is a lessor.

Therefore, at the date of transition to IFRS accounting standards, a lessor classifies a lease as operating or financing on the basis of circumstances existing at the inception of the lease. Lease classification is reassessed only if there is a lease modification. *[IFRS 16.66]*. Changes in estimates (for example, changes in estimates of the economic life or the residual value of the underlying asset) or changes in circumstances (for example, default by the lessee) do not give rise to a new classification of a lease. *[IFRS 1.IG14]*. See Chapter 24 at section 5.5 for further discussion about modifying lease terms under IFRS 16.

7.5.1 Straight-lining of lease payments including incentives by the lessor

A first-time adopter that elects either fair value or fair value as deemed cost under IFRS 1.D7 for investment property leased out under an operating lease, might have paid lease incentives to a lessee. *[IFRS 1.D7]*.

IFRS 16 requires a lessor to recognise lease payments from operating leases, less any incentives provided by the lessor to the lessee, as income on either a straight-line basis or another systematic basis. *[IFRS 16.81]*. As there is no relief in IFRS 1 from full retrospective application of IFRS 16 by lessors, the lessor as first-time adopter would recognise an asset as a result of the recognition of the lease incentive on a straight-line basis or other basis.

However, the fair value of the investment property might include the effect of the lease incentive, as a market participant would take this into consideration when measuring fair value. Recognition of both assets by the spreading of lease incentives and investment property at fair value would therefore lead to 'double counting'. IAS 40 requires an entity which chooses the fair value model not to double-count assets or liabilities that are recognised as separate assets or liabilities, such as prepaid or accrued operating lease income. *[IAS 40.50(c)]*.

How we see it

In our view, the entity would elect either of the following approaches in order to avoid double counting the effect on the straight-lining of lease payments on the fair value or fair value as deemed cost of investment property:

(a) Assets or liabilities recognised as a result of straight-lining lease payments are not separately presented and are considered a component of investment property.

Or

(b) The fair value (or fair value as deemed cost) of the investment property is adjusted for the assets or liabilities presented separately.

When the entity uses approach (a) above, the component parts of investment property are adjusted to ensure the subsequent pattern of depreciation on the investment property is appropriate.

See Chapter 20 at section 4.9.1 for detailed guidance (including an Illustration) on the situation where an entity subsequently accounts for the investment property using the fair value model in IAS 40.

7.6 IFRS 15 *Revenue from Contracts with Customers*

The exemptions in IFRS 1.D34-D35 allow a first-time adopter not to restate contracts that were completed before the earliest period presented (i.e., the date of transition to IFRS accounting standards) or completed contracts that begin and end within the same annual reporting period (see section 5.20 above). *[IFRS 1.D34, IFRS 1.D35, IFRS 15.C5(a)]*.

However, where IFRS 15 is applied to a contract, a first-time adopter that has received amounts that do not yet qualify for recognition as revenue under IFRS 15 (e.g., the proceeds of a sale that does not qualify for revenue recognition) must recognise those amounts as a liability in its opening IFRS statement of financial position and adjust the liability for any significant financing component as required by IFRS 15. *[IFRS 1.IG17]*. It is therefore possible that revenue that was already recognised under a first-time adopter's previous GAAP will need to be deferred in its opening IFRS statement of financial position and recognised again (this time under IFRS accounting standards) as revenue at a later date.

Conversely, it is possible that revenue deferred under a first-time adopter's previous GAAP cannot be recognised as a contract liability in the opening IFRS statement of financial position. A first-time adopter would not be able to report such revenue deferred under its previous GAAP as revenue under IFRS accounting standards at a later date. See Chapter 28 for matters relating to revenue recognition under IFRS 15.

Some further application issues in relation to IFRS 15 on the transition to IFRS accounting standards are discussed in section 5.20 above.

7.7 IAS 19 *Employee Benefits*

7.7.1 Sensitivity analysis for each significant actuarial assumption

IAS 19 requires the disclosures set out below about sensitivity of defined benefit obligations. Therefore, for an entity's first IFRS financial statements careful preparation is needed to compile the information required to present the sensitivity disclosure for the current and comparative periods. IAS 19 requires an entity to disclose: *[IAS 19.145]*

(a) A sensitivity analysis for each significant actuarial assumption as of the end of the reporting period, showing how the defined benefit obligation would have been affected by changes in the relevant actuarial assumption that were reasonably possible at that date

(b) The methods and assumptions used in preparing the sensitivity analyses required by (a) and the limitations of those methods

(c) Changes from the previous period in the methods and assumptions used in preparing the sensitivity analyses, and the reasons for such changes

7.7.2 Full actuarial valuations

An entity's first IFRS financial statements reflect its defined benefit liabilities or assets on at least three different dates, i.e., the end of the first IFRS reporting period, the end of the comparative period and the date of transition to IFRS accounting standards (four different dates if it presents two comparative periods). If an entity obtains a full actuarial valuation at one or two of these dates, it is allowed to roll forward (or roll back) to another date but only as long as the roll forward (or roll back) reflects material transactions and other material events (including changes in market prices and interest rates) between those dates. *[IFRS 1.IG21, IAS 19.59]*.

7.7.3 Actuarial assumptions

A first-time adopter's actuarial assumptions at its date of transition to IFRS accounting standards must be consistent with the ones it used for the same date under its previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those assumptions were in error (see section 4.2 above). The impact of any later revisions to those assumptions is an actuarial gain or loss of the period in which the entity makes the revisions. *[IFRS 1.IG19]*.

If a first-time adopter needs to make actuarial assumptions at the date of transition to IFRS accounting standards that were not necessary for compliance with its previous GAAP, those actuarial assumptions must not reflect conditions that arose after the date of transition. In particular, discount rates and the fair value of plan assets at the date of transition need to reflect the market conditions at that date. Similarly, the entity's actuarial assumptions at the date of transition about future employee turnover rates must not reflect a significant increase in estimated employee turnover rates as a result of a curtailment of the pension plan that occurred after the date of transition. *[IFRS 1.16, IFRS 1.IG20]*.

How we see it

If there is a material difference arising from a change in assumptions at the date of transition to IFRS accounting standards, consideration needs to be given to whether there was an error under previous GAAP. Errors must be disclosed separately from other transition adjustments (see section 6.3.1 above).

7.7.4 Unrecognised past service costs

IAS 19 requires immediate recognition of all past service costs as an expense. *[IAS 19.103]*. Accordingly, a first-time adopter that has unrecognised past service costs under previous GAAP must recognise such amounts in retained earnings at the date of transition, regardless of whether the participants are fully vested in the benefit.

7.8 IAS 21 *The Effects of Changes in Foreign Exchange Rates*

7.8.1 Functional currency

A first-time adopter needs to confirm whether all entities included within the financial statements have appropriately determined their functional currency. IAS 21 defines an entity's functional currency as "the currency of the primary economic environment in which the entity operates", *[IAS 21.8]*, and contains detailed guidance on determining the functional currency. *[IAS 21.9-14]*. See Chapter 16 at section 4.

If the functional currency of an entity is not readily identifiable, IAS 21 requires consideration of whether the activities of the foreign operation are carried out as an extension of the reporting entity, rather than being carried out with a significant degree of autonomy. *[IAS 21.11]*. This requirement often leads to the conclusion under IFRS accounting standards that intermediate holding companies, treasury subsidiaries and foreign sales offices have the same functional currency as their parent (see Chapter 16 at section 4.2).

Many national GAAPs do not specifically define the concept of functional currency, or they might contain guidance on identifying the functional currency that differs from that in IAS 21. Consequently, a first-time adopter that measured transactions in a currency that was not its functional currency under IFRS accounting standards would need to restate its financial statements because IFRS 1 does not contain an exemption that would allow it to use a currency other than the functional currency under IFRS accounting standards in determining the cost of assets and liabilities in its opening IFRS statement of financial position.

How we see it

While there is an exemption that allows a first-time adopter to reset the cumulative exchange differences in equity to zero (see section 5.6 above), a first-time adopter recognises and measures its assets or liabilities in its functional currency retrospectively in accordance with IAS 21 (see Chapter 16 at section 5).

The IFRS IC considered whether a specific exemption should be granted to first-time adopters to permit entities to translate all assets and liabilities at the transition-date exchange rate rather than applying the functional currency approach in IAS 21 but declined to offer first-time adopters any exemptions on transition on the basis that the position under IFRS 1 and IAS 21 was clear.[15]

How we see it

The principal difficulty relates to non-monetary items that are measured on the basis of historical cost, particularly property, plant and equipment, since these will need to be re-measured in terms of the IAS 21 functional currency at the rates of exchange applicable at the date of acquisition of the assets concerned, and recalculating cumulative depreciation charges accordingly. It could be that, to overcome this difficulty, an entity considers using the option in IFRS 1 whereby the fair value of such assets at the date of transition is treated as being their deemed cost (see section 5.4.1 above).

7.9 IAS 28 *Investments in Associates and Joint Ventures*

There are a number of first-time adoption exemptions that have an impact on the accounting for investments in associates and joint ventures:

- The business combinations exemption, which also applies to past acquisitions of investments in associates and interests in joint ventures (see section 5.2.1.B above)
- An exemption in respect of determining the cost of an investment in an associate and a joint venture within any separate financial statements that an entity could prepare (see section 5.7.2 above)
- Separate rules that deal with situations in which an investor or a joint venturer adopts IFRS accounting standards before or after an associate or a joint venture does so (see section 5.8 above)

Otherwise, there are no specific first-time adoption provisions for IAS 28, which means that a first-time adopter of IFRS accounting standards is effectively required to apply IAS 28 as if it had always done so.

How we see it

For some first-time adopters, this could mean application of the equity method for the first time. For other first-time adopters, however, the issue is likely to be that they are already applying the equity method under their previous GAAPs and will now need to identify the potentially significant differences between the methodologies of the equity method under their previous GAAPs and under IAS 28.

In particular, there could be GAAP differences related to:

- The criteria used to determine which investments are associates or joint ventures
- The elimination of transactions between investors or joint venturers and associates or joint ventures
- The treatment of loss-making associates or joint ventures
- The permitted interval between the reporting dates of an investor or a joint venturer and an associate or joint venture with non-coterminous year-ends
- The treatment of investments in entities formerly classified as associates or joint ventures
- The requirement for uniform accounting policies between the investor or joint venturer and the associate or joint venture

In September 2024, the IASB issued an Exposure Draft addressing application questions relating to the equity method.[16] See the discussion of the IASB project - Equity Method in Chapter 12 at section 13.

15 *IFRIC Update*, October 2004, available on the IFRS Foundation's website.

16 Exposure Draft IASB/ED/2024/9 *Equity Method of Accounting - IAS 28 Investments in Associates and Joint Ventures*, IASB, September 2024. Available on the IFRS Foundation's website.

7.9.1 Impairment test at date of transition to IFRS accounting standards

A first-time adopter is required by IFRS 1 to perform an impairment test in accordance with IAS 36 for any goodwill recognised at the date of transition to IFRS accounting standards, regardless of whether there is any indication of impairment, unless a first-time adopter applies IFRS 3 retrospectively to the related past business combinations. *[IFRS 1.C4(g)(ii)]*.

IFRS 1 specifically notes that its provisions with regard to past business combinations apply also to past acquisitions of investments in associates, interests in joint ventures and interests in joint operations (in which the activity of the joint operation constitutes a business, as defined in IFRS 3). *[IFRS 1.C5]*. Therefore, an impairment test for investments in associates or joint ventures whose carrying value includes an element of goodwill must be undertaken as at the date of transition to IFRS accounting standards. This impairment test will, however, need to be carried out on the basis required by IAS 28 as described in Chapter 12 at section 10. See also section 5.2.5 and Illustration 5-12 above.

7.10 IAS 29 *Financial Reporting in Hyperinflationary Economies*

The IASB decided not to exempt first-time adopters from retrospective application of IAS 29 "because hyperinflation can make unadjusted financial statements meaningless or misleading." *[IFRS 1.BC67]*.

Therefore, in preparing its opening IFRS statement of financial position a first-time adopter applies IAS 29 to any periods during which the economy of the functional currency or presentation currency was hyperinflationary. *[IFRS 1.IG32]*. However, to make the restatement process less onerous, a first-time adopter might want to consider using fair value as deemed cost for property, plant and equipment (see section 5.4.1 above). *[IFRS 1.D5, IFRS 1.IG33]*. This exemption is also available to other long-lived assets such as investment properties, right-of-use assets and certain intangible assets. *[IFRS 1.D7]*. If a first-time adopter applies an exemption to use fair value or a revaluation as deemed cost available in IFRS 1.D5-D8, it applies IAS 29 to periods after the date for which the revalued amount or fair value was determined. *[IFRS 1.IG34, IFRS 1.D5, IFRS 1.D6, IFRS 1.D7, IFRS 1.D8]*.

The Exposure Draft, *Translation to a Hyperinflationary Presentation Currency - Proposed amendments to IAS 21*, which was published by the IASB in July 2024, addresses the use of a hyperinflationary presentation currency by an entity with a non-hyperinflationary functional currency and it does not propose transition relief for a first-time adopter (see Chapter 17 at section 12).

7.11 IFRS 11 *Joint Arrangements*

The 'business combinations' exemption described in section 5.2 above is also applicable to past acquisitions of interests in joint ventures and interests in joint operations in which the activity of the joint operation constitutes a business, as defined by IFRS 3 (see section 5.2.1.B above). *[IFRS 1.C5]*. Therefore, an impairment test for investments in joint ventures whose carrying value includes an element of goodwill must be undertaken as at the date of transition to IFRS accounting standards (see section 5.2.5 above). *[IFRS 1.C4(g)(ii)]*. This impairment test will, however, need to be carried out on the basis required by IAS 28 as described in Chapter 12 at section 10. See also section 5.2.5 and Illustration 5-12 above.

In addition, the first-time adoption exemptions that are available for investments in associates can be applied to investments in joint ventures (see section 7.9 above).

With respect to interests in joint operations, the requirements of IFRS 11 could well result in the 're-recognition' of assets that were transferred to others and therefore not recognised under previous GAAP. A joint operator is required to recognise its assets and liabilities, including its share of those assets that are jointly held and liabilities that are jointly incurred, based on the requirements of IFRS accounting standards applicable to such assets or liabilities. *[IFRS 11.20, IFRS 11.21, IFRS 11.21A, IFRS 11.22, IFRS 11.23]*.

7.12 IAS 36 *Impairment of Assets*

As far as goodwill is concerned, first-time adopters that make use of the business combinations exemption are required by IFRS 1 to subject all goodwill carried in the statement of financial position at the date of transition to IFRS accounting standards to an impairment test, regardless of whether there are any indicators of impairment (see section 5.2.5 above). *[IFRS 1.C4(g)(ii)]*.

While IFRS 1 does not specifically call for an impairment test of other assets, a first-time adopter needs to be mindful that there are no exemptions in IFRS 1 from full retrospective application of IAS 36. IFRS 1's implementation guidance reminds a first-time adopter to: *[IFRS 1.IG39]*

(a) Determine whether any impairment loss exists at the date of transition to IFRS accounting standards.

(b) Measure any impairment loss that exists at that date, and reverse any impairment loss that no longer exists at that date. An entity's first IFRS financial statements include the disclosures that IAS 36 would have required if the entity had recognised those impairment losses or reversals in the period beginning with the date of transition to IFRS accounting standards. *[IFRS 1.24(c)]*. See section 6.3.3 above.

As impairment losses for non-financial long-lived assets other than goodwill can be reversed under IAS 36, in many instances, there will be no practical difference between applying IAS 36 fully retrospectively and applying it at the date of transition to IFRS accounting standards. Performing the test under IAS 36 at the date of transition to IFRS accounting standards results in re-measuring any previous GAAP impairment to comply with the approach in IAS 36 and recognition of any additional impairment or reversing any previous GAAP impairment that is no longer necessary.

The estimates used to determine whether a first-time adopter recognises an impairment provision at the date of transition to IFRS accounting standards are required to be consistent with estimates made for the same date under previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error. *[IFRS 1.IG40, IFRS 1.14]*. If a first-time adopter needs to make estimates and assumptions that were not necessary under its previous GAAP, they must not reflect conditions that arose after the date of transition to IFRS accounting standards. *[IFRS 1.IG41, IFRS 1.16]*. See section 4.2 above.

If a first-time adopter's opening IFRS statement of financial position reflects impairment losses, it recognises any later reversal of those impairment losses in profit or loss unless IAS 36 requires that reversal to be treated as a revaluation. This applies to both impairment losses recognised under previous GAAP and additional impairment losses recognised on transition to IFRS accounting standards. *[IFRS 1.IG43, IAS 36.119]*.

In March 2024, the IASB published an Exposure Draft, *Business Combinations-Disclosures, Goodwill and Impairment - Proposed amendments to IFRS 3 and IAS 36*.[17] See the details in Chapter 10 at section 1.2.1.

How we see it

A first-time adopter needs to be particularly alert for indicators of impairment where use is made of any of the deemed cost exemptions.

In arguing that it is not necessary to restrict application of the deemed cost exemption to classes of assets to prevent selective revaluations, the IASB effectively relies on IAS 36 to avoid overvaluations:

> "... IAS 36 *Impairment of Assets* requires an impairment test if there is any indication that an asset is impaired. Thus, if an entity uses fair value as deemed cost for assets whose fair value is above cost, it cannot ignore indications that the recoverable amount of other assets may have fallen below their carrying amount. Therefore, the IFRS does not restrict the use of fair value as deemed cost to entire classes of asset." *[IFRS 1.BC45]*.

How we see it

Where a first-time adopter uses any of the deemed cost exemptions at the date of transition to IFRS accounting standards (see section 5.4 above), any previous impairment reflected in the deemed cost is effectively subsumed into the new cost and could not subsequently be separated (and hence could never be reversed).

While the example below refers to impairment of exploration and evaluation assets, the same considerations apply where a deemed cost is used for other assets, such as property, plant and equipment.

17 Exposure Draft IASB/ED/2024/3 *Business Combinations-Disclosures, Goodwill and Impairment Proposed amendments to IFRS 3 and IAS 36*, IASB, March 2024. Available on the IFRS Foundation's website.

For example, if a first-time adopter applies the deemed cost exemption in IFRS 1.D8A, *[IFRS 1.D8A]*, to exploration and evaluation assets which were previously partly impaired (see section 5.4.3 above), the first-time adopter recognises the previously impaired exploration and evaluation assets (which nevertheless still have a net book value) in the opening statement of financial position on a 'net basis' (i.e., with accumulated depreciation of 'zero'). In this case, the previous impairment effectively becomes part of the new cost and hence could never be reversed.

How we see it

However, if a first-time adopter does not elect to use any deemed cost exemptions to the exploration and evaluation assets, it must identify exploration and evaluation assets that were previously expensed, impaired, or written off (whichever terminology was used under previous GAAP) but that are recognised under IFRS accounting standards. The entity recognises both the gross cost and impairment provision in the opening statement of financial position. Exploration and evaluation assets that have previously been derecognised on the basis that no future economic benefits were expected cannot be re-recognised.

7.13 IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

The main issue for a first-time adopter in applying IAS 37 is that IFRS 1 prohibits retrospective application of some aspects of IFRS accounting standards relating to estimates. *[IFRS 1.14]*. This is discussed in detail in section 4.2 above. Briefly, the restrictions are intended to prevent an entity from applying hindsight and making 'better' estimates as at the date of transition to IFRS accounting standards. Unless there is objective evidence that those estimates were in error, recognition and measurement are to be consistent with estimates made under previous GAAP, after adjustments to reflect any difference in accounting policies. The entity has to report the impact of any later revisions to those estimates as an event of the period in which it makes the revisions. *[IFRS 1.IG40]*. An entity cannot use hindsight in determining the provisions to be included under IAS 37 at the end of the comparative period within its first IFRS financial statements as these requirements also apply at that date. *[IFRS 1.14, IFRS 1.15, IFRS 1.16, IFRS 1.17]*.

At the date of transition to IFRS accounting standards, an entity might also need to make estimates that were not necessary under its previous GAAP. Such estimates and assumptions must not reflect conditions that arose after the date of transition to IFRS accounting standards. *[IFRS 1.IG41]*.

If application of IAS 37 changes the way an entity accounts for provisions it needs to consider whether there are any consequential changes, for example:

- Derecognition of a provision for general business risks could mean that assets in the related cash-generating unit are impaired.
- Remeasurement of a decommissioning provision could indicate that the decommissioning component of the corresponding asset needs to be reconsidered (see Chapter 27 at section 6.3).

The above list is not exhaustive and a first-time adopter needs to carefully consider whether changes in other provisions have a consequential impact.

7.14 IAS 38 *Intangible Assets*

An entity's opening IFRS statement of financial position: *[IFRS 1.IG44]*

(a) Excludes all intangible assets and other intangible items that do not meet the criteria for recognition under IAS 38 at the date of transition to IFRS accounting standards

And

(b) Includes all intangible assets that meet the recognition criteria in IAS 38 at that date, except for intangible assets acquired in a business combination that were not recognised in the acquirer's consolidated statement of financial position under previous GAAP and also would not qualify for recognition under IAS 38 in the acquiree's separate statement of financial position (see section 5.2.4.B above) *[IFRS 1.C4(b)(ii), IFRS 1.C4(f)]*

IAS 38 imposes a number of criteria that restrict capitalisation of internally generated intangible assets. An entity is prohibited from using hindsight to conclude retrospectively that the recognition criteria are met, thereby capitalising an amount previously recognised as an expense. *[IAS 38.71]*. A first-time adopter must be particularly careful that, in applying IAS 38 retrospectively as at the date of transition to IFRS accounting standards, it does not capitalise costs incurred before the standard's recognition criteria were met. Therefore, a first-time adopter is not permitted to capitalise the costs of internally generated intangible assets incurred before the date when it: *[IFRS 1.IG46]*

(a) Concludes, based on an assessment made and documented at the date of that conclusion, that it is probable that future economic benefits from the asset will flow to the entity

And

(b) Has a reliable system for accumulating the costs of internally generated intangible assets when, or shortly after, they are incurred

In other words, it is not permitted under IFRS 1 to reconstruct retrospectively the costs of intangible assets.

If an internally generated intangible asset qualifies for recognition at the date of transition to IFRS accounting standards, it is recognised in the entity's opening IFRS statement of financial position even if the related expenditure had been expensed under previous GAAP. If the asset does not qualify for recognition under IAS 38 until a later date, its cost is the sum of the expenditure incurred from that later date. *[IFRS 1.IG47]*.

How we see it

A first-time adopter that did not capitalise internally generated intangible assets is unlikely to have the type of documentation and systems required by IAS 38 and will therefore not be able to capitalise these items in its opening IFRS statement of financial position. Going forward, a first-time adopter will need to implement internal systems and procedures that enable it to determine whether or not any future internally generated intangible assets are capitalised (for example, in the case of development costs).

Capitalisation of separately acquired intangible assets will generally be easier because there is usually contemporaneous documentation prepared to support the investment decisions and its cost can usually be measured reliably. *[IFRS 1.IG48, IAS 38.26]*. However, if an entity that used the business combinations exemption did not recognise an intangible asset acquired in a business combination under its previous GAAP, it would only be able to do so upon first-time adoption if the intangible asset were to qualify for recognition under IAS 38 in the acquiree's statement of financial position, with a consequential impact on goodwill (see section 5.2.4.B above). *[IFRS 1.C4(b)(ii), IFRS 1.C4(f), IFRS 1.C4(g)(i), IFRS 1.IG49]*.

If a first-time adopter's amortisation methods and rates under previous GAAP are acceptable under IFRS accounting standards, the entity does not restate the accumulated amortisation in its opening IFRS statement of financial position. Instead, the entity accounts for any change in estimated useful life or amortisation pattern prospectively from the period when it makes that change in estimate. *[IFRS 1.14, IAS 38.104]*. If an entity's amortisation methods and rates under previous GAAP differ from those acceptable in accordance with IFRS accounting standards and those differences have a material effect on the financial statements, the entity would adjust the accumulated amortisation in its opening IFRS statement of financial position. *[IFRS 1.14, IFRS 1.IG51]*.

When an entity uses the exemption in IFRS 1.D8B for assets used (or previously used) in operations subject to rate regulation (see section 5.4.4 above), it uses the carrying amount of the intangible asset at the date of transition to IFRS accounting standards as deemed cost as if it had acquired an intangible asset with the same remaining service potential for that amount at the date of transition to IFRS accounting standards. Subsequent amortisation is based on that deemed cost and starts from the date of transition to IFRS accounting standards. *[IFRS 1.IG51]*.

The useful life and amortisation method of an intangible asset must be reviewed at least each financial year end (see Chapter 18 at section 9.2.3), which is often something that is not required under a first-time adopter's previous GAAP. *[IAS 38.104]*.

8 Regulatory issues

8.1 First-time adoption by foreign private issuers that are US SEC registrants

8.1.1 US SEC guidance

A foreign private issuer that is registered with the US Securities and Exchange Commission (US SEC) is allowed to use IFRS accounting standards as issued by the IASB (referred to herein as 'IFRS accounting standards') in its filings. A foreign private issuer is normally required to present two comparative periods for its statement of profit or loss and other comprehensive income (or statement of profit or loss, if presented), statement of cash flows, and statement of changes in equity. Converting two comparative periods to IFRS accounting standards was considered to be a significant burden to companies. Therefore, in April 2005, the US SEC published amendments to Form 20-F that provided for a limited period a two-year accommodation for foreign private issuers that were first-time adopters of IFRS accounting standards.[18] In March 2008, the US SEC extended indefinitely the two-year accommodation to all foreign private issuers that are first-time adopters of IFRS accounting standards as issued by the IASB.[19]

The amendment states that "An issuer that changes the body of accounting principles used in preparing its financial statements presented pursuant to Item 8.A.2 ("Item 8.A.2") to International Financial Reporting Standards ("IFRS") issued by the International Accounting Standards Board ("IASB") may omit the earliest of three years of audited financial statements required by Item 8.A.2 if the issuer satisfies the conditions set forth in this Instruction G. For purposes of this instruction, the term "financial year" refers to the first financial year beginning on or after January 1 of the same calendar year." The accommodation only applies to an issuer that (a) adopts IFRS accounting standards for the first time by an explicit and unreserved statement of compliance with IFRS accounting standards and (b) the issuer's most recent audited financial statements are prepared in accordance with IFRS accounting standards.

First-time adopters that rely on the accommodation are allowed, but not required, to include any financial statements, discussions or other financial information based on their previous GAAPs. If first-time adopters do include such information, they must prominently disclose cautionary language to avoid inappropriate comparison with information presented under IFRS accounting standards. The US SEC did not mandate a specific location for any previous GAAP information but did prohibit presentation of previous GAAP information in a side-by-side columnar format with IFRS financial information.

Where a narrative discussion of its financial condition is provided, the accommodation requires management to focus on the financial statements prepared under IFRS accounting standards for the past two financial years.

IFRS 1 requires a first-time adopter to present reconciliations from its previous GAAP to IFRS accounting standards in the notes to its financial statements and allows certain exemptions from full retrospective application of IFRS accounting standards in deriving the relevant data. Under the US SEC's accommodation,[20] any issuer relying on any of the elective exemptions or mandatory exceptions from IFRS accounting standards that are contained within IFRS 1 will have to disclose additional information which includes:

- To the extent the primary financial statements reflect the use of exemptions permitted or exceptions required by IFRS 1:
  - Detailed information for each exemption or exception used, including:
    - An indication of the items or class of items to which the exemption or exception was applied
    - A description of what accounting principle was used and how it was applied

    And
  - Where material, qualitative disclosure of the impact on financial condition, changes in financial condition and results of operations that the treatment specified by IFRS accounting standards would have had absent the election to rely on the exemption

18 Release No. 33-8567, First-Time Application of International Financial Reporting Standards, Securities and Exchange Commission (SEC), 12 April 2005.

19 Release No. 33-8879, Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP, Securities and Exchange Commission, 21 December 2007.

20 Form 20-F, United States Securities and Exchange Commission, instruction 4 to item 5 and instruction 3 to item 8.

8.1.2 IPTF guidance

In November 2008, the Center for Audit Quality SEC Regulations Committee's International Practices Task Force ('IPTF') provided guidance as to the reconciliation requirements for an US SEC foreign private issuer the first time it presents financial statements according to IFRS accounting standards in its Form 20-F, when that issuer previously used US GAAP for its primary financial statements filed with the US SEC.[21] Among others, the IPTF guidance addresses the concern that the reconciliations called for by IFRS 1, which are prepared using the issuer's local GAAP rather than US GAAP, would not have sufficient information to help US investors to bridge from the prior US GAAP financial statements filed with the US SEC to IFRS accounting standards. Accordingly, the IPTF guidance requires additional detailed reconciliations in these circumstances from US GAAP to IFRS accounting standards either in a one-step or a two-step format (see below).

The reconciliation requirements for each of the scenarios are described below:

- *US SEC foreign private issuers that currently report under their local GAAP and provide a reconciliation from their local GAAP to US GAAP* - In the year of adoption of IFRS accounting standards, these entities are allowed to file two years rather than three years of profit or loss statements, shareholders' equity and cash flows prepared in accordance with IFRS accounting standards. As part of the IFRS transition, these entities will provide the disclosures and reconciliations required under IFRS 1 including:
  - An equity reconciliation as at the date of the transition and as at the comparative year-end
  - A comprehensive income (or statement of profit or loss, if presented) reconciliation for the comparative year
  - An explanation of material adjustments to the statement of cash flows for the comparative year

  If the IFRS 1 disclosures and reconciliations are prepared using the local GAAP as the issuer's previous GAAP rather than US GAAP, no additional US GAAP to IFRS accounting standards or US GAAP to local GAAP reconciliations will be required.
- *US SEC foreign private issuers that currently report under US GAAP only* - Some US SEC foreign private issuers currently use US GAAP as their primary GAAP in both their home jurisdiction and the United States without reconciliation. These registrants would also be eligible to file two years rather than three years of statements of profit or loss and other comprehensive income, shareholders' equity and cash flows in their first set of IFRS financial statements. In the year of adoption of IFRS accounting standards, these entities will be required to provide the IFRS 1 disclosures and reconciliations described above. Such disclosures will be prepared using US GAAP as the issuer's previous GAAP.
- *US SEC foreign private issuers that currently report under local GAAP for local reporting and under US GAAP in their US SEC Form 20-F filings (assuming these issuers adopt IFRS accounting standards in the current period for both local and US SEC reporting purposes)* - These registrants would also be eligible to file two years rather than three years of statements of profit or loss and other comprehensive income, shareholders' equity and cash flows in their first set of IFRS financial statements. Under IFRS 1, such entities might conclude their local GAAPs are their previous GAAPs and their IFRS 1 disclosures and reconciliations would be prepared on that basis. As no reconciliation from the local GAAP to US GAAP was previously provided, the US SEC will require additional disclosure in the Form 20-F to enable investors to understand material reconciling items between US GAAP and IFRS accounting standards in the year of adoption. Two possible forms of disclosure are acceptable:
  - *One-Step Format* - Registrants can provide an analysis of the differences between US GAAP and IFRS accounting standards in a tabular format (consistent with Item 17 of Form 20-F) for the same time period and dates that the IFRS 1 reconciliations are required. The registrant must provide this disclosure for equity as at the beginning and end of the most recent comparative period to the year of adoption and of comprehensive income (or profit or loss) for the most recent comparative year. A description of the differences between US GAAP and IFRS accounting standards for the statement of cash flows is not necessary because registrants are not required to reconcile IAS 7 statements of cash flows to those prepared under US GAAP.
  - *Two-Step Format* - Registrants can choose to disclose a two-step reconciliation which would include a quantitative analysis of the differences between US GAAP and their local GAAP (consistent with Item 17 of Form 20-F) and between their local GAAP to IFRS accounting standards (IFRS 1 disclosures and reconciliations). The registrant must provide these reconciliations for equity as of the beginning and end of the most recent comparative period to the year of adoption of IFRS accounting standards and for comprehensive income (or profit or loss) for the most recent comparative year. Registrants will also be required to provide an explanation of the material differences between the statement of cash flows under US GAAP and the statement of cash flows under their local GAAP for the most recent comparative period to the year of adoption of IFRS accounting standards.

21 Highlights, 25 November 2008 IPTF meeting.

- *US SEC foreign private issuers that currently report under IFRS accounting standards for local reporting and under US GAAP in their US SEC Form 20-F filings (assuming these issuers adopted IFRS accounting standards for local reporting in a period that preceded the earliest period for which audited financial statements are required in their US SEC filing)* - These registrants would not be eligible to file two years of statements of profit or loss and other comprehensive income, shareholders' equity and cash flows the first time they file IFRS financial statements with the US SEC, since they are not first-time adopters of IFRS accounting standards. Rather, they are required to present a complete set of IFRS financial statements for all periods required by the Form 20-F. In addition, these issuers will be required to present a reconciliation that enables US investors to bridge their previous US GAAP to IFRS accounting standards. Such a reconciliation will be similar to the One-Step Format described above, except that the periods presented will be for equity as of the most recent comparative period presented and for comprehensive income (or profit or loss) for the two most recent comparative periods. However, if the issuers are required to present a statement of financial position as of the end of the third preceding year, the reconciliation will also be required of the equity as of the end of that period.

8.2 Disclosure of IFRS information in financial statements for periods prior to an entity's first IFRS reporting period

8.2.1 Guidance in IFRS accounting standards

Although IFRS 1 provides detailed rules on disclosures to be made in an entity's first IFRS financial statements and in interim reports covering part of its first IFRS reporting period, it does not provide any guidance on presenting a reconciliation to IFRS accounting standards in financial reports before the start of the first IFRS reporting period. An entity wishing to disclose information on the impact of IFRS accounting standards in its last financial statements under its previous GAAP cannot claim that such information is prepared and presented in accordance with IFRS accounting standards because it does not disclose all information required in full IFRS financial statements and it does not disclose comparative information.

8.2.2 Disclosure of expected changes in accounting policies

In certain countries, publicly listed companies are required by regulation to disclose the potential impact that recently issued accounting standards will have on their financial statements when such standards are adopted in the future. The Canadian Securities Administrators (the CSA) in their Management's Discussion & Analysis (MD&A form)[22] require this disclosure for changes in accounting policies that registrants expect to make in the future. In connection with Canada's transition to IFRS accounting standards in 2011, the CSA issued a Staff Notice[23] clarifying that "Changes in an issuer's accounting policies that an issuer expects to make on changeover to IFRS are changes due to new accounting standards and therefore fall within the scope of section 1.13(a) of the MD&A form." Among other matters, the CSA Staff Notice requires certain disclosures of companies that have developed an IFRS changeover plan, in interim and annual MD&A forms starting three years before the first IFRS financial statement date, including the following:

- Accounting policies, including choices among policies permitted under IFRS accounting standards, and implementation decisions such as whether certain changes will be applied on a retrospective or a prospective basis
- Impact on information technology and data systems
- Changes to internal control over financial reporting
- Impact on disclosure controls and procedures, including investor relations and external communications plan
- Enhancements to financial reporting expertise, including training requirements
- Changes in business activities, such as foreign currency and hedging activities, as well as matters that may be influenced by GAAP measures such as debt covenants, capital requirements and compensation arrangements

22 Canadian Securities Administrators Form 51-102F1, Management's Discussion and Analysis (as amended 30 June 2015).

23 Canadian Securities Administrators Staff Notice 52-320 - Disclosure of Expected Changes in Accounting Policies Relating to Changeover to International Financial Reporting Standards, May 9, 2008.

The CSA Staff Notice also specified requirements for updates for periods up to the year of changeover, including discussion of the impact of transition for issuers that are well advanced in their plans.

An entity that is planning to adopt IFRS accounting standards must take note of the regulatory requirements in its jurisdiction or the exchange where it is listed to determine the form of communication that is required in advance of publishing its first IFRS financial statements.

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Appendix B - Defined terms

Extract from IFRS standards - Definitions	
date of transition to IFRSs	The beginning of the earliest period for which an entity presents full comparative information under IFRSs in its **first IFRS financial statements**. *[IFRS 1 Appendix A]*.
deemed cost	An amount used as a surrogate for cost or depreciated cost at a given date. Subsequent depreciation or amortisation assumes that the entity had initially recognised the asset or liability at the given date and that its cost was equal to the deemed cost. *[IFRS 1 Appendix A]*.
fair value	*Fair value* is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13.) *[IFRS 1 Appendix A]*.
first IFRS financial statements	The first annual financial statements in which an entity adopts **International Financial Reporting Standards (IFRSs)**, by an explicit and unreserved statement of compliance with IFRSs. *[IFRS 1 Appendix A]*.
first IFRS reporting period	The latest reporting period covered by an entity's **first IFRS financial statements**. *[IFRS 1 Appendix A]*.
first-time adopter	An entity that presents its **first IFRS financial statements**. *[IFRS 1 Appendix A]*.
International Financial Reporting Standards (IFRSs)	Standards and Interpretations issued by the International Accounting Standards Board (IASB). They comprise: (a) International Financial Reporting Standards; (b) International Accounting Standards; (c) IFRIC Interpretations; and (d) SIC Interpretations.[1] *[IFRS 1 Appendix A]*.
opening IFRS statement of financial position	An entity's statement of financial position at the **date of transition to IFRSs**. *[IFRS 1 Appendix A]*.
previous GAAP	The basis of accounting that a **first-time adopter** used immediately before adopting IFRSs. *[IFRS 1 Appendix A]*.
rate-regulated activities	An entity's activities that are subject to **rate regulation**. *[IFRS 14 Appendix A]*.
rate regulation	A framework for establishing the prices that can be charged to customers for goods or services and that framework is subject to oversight and/or approval by a **rate regulator**. *[IFRS 14 Appendix A]*.
rate regulator	An authorised body that is empowered by statute or regulation to establish the rate or a range of rates that bind an entity. The **rate regulator** may be a third-party body or a related party of the entity, including the entity's own governing board, if that body is required by statute or regulation to set rates both in the interest of the customers and to ensure the overall financial viability of the entity. *[IFRS 14 Appendix A]*.
regulatory deferral account balance	The balance of any expense (or income) account that would not be recognised as an asset or a liability in accordance with other Standards, but that qualifies for deferral because it is included, or is expected to be included, by the **rate regulator** in establishing the rate(s) that can be charged to customers. *[IFRS 14 Appendix A]*.

1 Definition of IFRSs amended after the name changes introduced by the revised Constitution of the IFRS Foundation in 2010.

We use 'IFRS accounting standards' instead of 'IFRSs' in this chapter. 'Date of transition to IFRS accounting standards' or 'date of transition' is used instead of 'date of transition to IFRSs' defined above as well.

Chapter 7 Consolidated financial statements

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Overview

This chapter discusses the requirements of IFRS 10 *Consolidated Financial Statements*, principally relating to which entities are controlled by a parent and therefore consolidated into the financial statements prepared by that parent (except for certain subsidiaries of investment entities). This chapter also deals with the definition of an investment entity (and the assessment thereof) and the accounting by a parent of an investment entity.

The requirements of IFRS 10 relating to consolidation procedures, non-controlling interests and accounting for loss of control are dealt with in Chapter 8 section 5 and section 3.

IFRS 10 provides the principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities. It establishes a single control model that applies to all entities, including structured entities. IFRS 10 also defines an investment entity and deals with the accounting requirements for particular subsidiaries of an investment entity.

When management concludes that an entity does not have control of an investee, the requirements of IFRS 11 *Joint Arrangements* and IAS 28 *Investments in Associates and Joint Ventures* must be considered to determine whether it has joint control or significant influence, respectively, over the investee. The requirements of IFRS 11 and IAS 28 are dealt with in Chapter 13 and Chapter 12, respectively.

What you need to know

- The single control model established within IFRS 10 revolves around:
  - Power over an investee
  - Exposure, or rights, to variable returns from involvement with an investee
  - Linkage between power over an investee and variable returns from involvement with an investee
- IFRS 10 provides an exemption for an intermediate parent from preparing consolidated financial statements when it meets certain conditions. When an entity uses this exemption, it may prepare separate financial statements as its only financial statements, which are dealt with in Chapter 9 at section 1 and section 3.1.
- Combined or carve-out financial statements are sometimes prepared in accordance with IFRS accounting standards for a 'reporting entity' that does not comprise a group under IFRS 10.
- When decision-making rights have been delegated or are being held for the benefit of others, it is necessary to assess whether the decision-maker is a principal or an agent to determine whether it has control.
- IFRS 10 requires an investor to consider whether there are other parties who are acting on behalf of the investor by virtue of their relationship with it, i.e., *de facto* agents for the investor, whereby the investor has the ability to direct those other parties to act on the investor's behalf.
- An investor has to consider whether it treats a portion of an investee as a deemed separate entity (i.e., a silo) and, if so, whether it controls that silo.
- IFRS 10 defines an investment entity and requires a parent that is an investment entity to measure its investments in particular subsidiaries at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments*, with limited exceptions.

1 Introduction

FASB differences

ASC 810 *Consolidation* contains the main guidance for consolidation of financial statements, including variable interest entities (VIEs), under US GAAP. IFRS 10 contains the IFRS guidance.

Under both US GAAP and IFRS accounting standards, the underlying determination of whether entities are consolidated by a reporting entity is based on control although differences exist in the consideration and definition of control.

Key differences relevant to this chapter are highlighted in this section, but this is not an exhaustive list of possible differences (further detail can be found in the *US GAAP/IFRS accounting differences identifier tool*[1]):

- US GAAP provides for two consolidation models (VIE model and voting model). The VIE model evaluates control based on determining which party has power and benefits. The voting model evaluates control based on existing voting interests (or kick-out rights for limited partnerships and similar entities). All entities are first evaluated as potential VIEs. If an entity is not a VIE, it is evaluated for control pursuant to the voting model. In contrast, IFRS accounting standards provide a single control model for all entities, including structured entities (the definition of a structured entity under IFRS 12 *Disclosure of Interests in Other Entities* is similar to the definition of a VIE in US GAAP).
- In US GAAP, potential voting rights are generally not considered, while they are considered in IFRS accounting standards.
- The notion of '*de facto* control' is only considered under IFRS accounting standards and may result in the consolidation of certain entities that are not consolidated under US GAAP.
- Under US GAAP, consolidated financial statements are required with certain industry-specific exceptions. Under IFRS accounting standards, there is a limited exemption from preparing consolidated financial statements for a parent company that is itself a wholly owned subsidiary, or is a partially owned subsidiary, if certain criteria are met.
- The assessment for determining whether an entity is an investment company under US GAAP is similar to the assessment for determining an investment entity under IFRS accounting standards, except, under IFRS accounting standards, an investment entity must measure and evaluate the performance of substantially all of its investments on a fair value basis and must have an exit strategy for investments without stated maturity dates. Also, under IFRS accounting standards, an investment entity may provide substantive investing-related services to third parties. Therefore, while the assessments are similar, these differences could result in different conclusions regarding whether an entity meets the definition of an investment entity under IFRS accounting standards.
- Under US GAAP, a parent of an investment company is required to retain the investment company subsidiary's fair value accounting in the parent's consolidated financial statements. However, under IFRS accounting standards, a parent of an investment entity consolidates all entities that it controls, including those controlled through an investment entity subsidiary, unless the parent itself is an investment entity.

1.1 Background

An entity may conduct its business not only directly, but also through strategic investments in other entities. IFRS accounting standards broadly distinguish between three types of such strategic investments:

- Entities controlled by the reporting entity (subsidiaries)
- Entities or activities jointly controlled by the reporting entity and one or more third parties (joint arrangements)
- Entities that, while not controlled or jointly controlled by the reporting entity, are subject to significant influence by it (associates)

The first type of investment is accounted for in accordance with IFRS 10.

1 US GAAP/IFRS accounting differences identifier tool - December 2024 | EY - US, EY Global, December 2024, available on ey.com.

The *Conceptual Framework for Financial Reporting* (the *Framework*) defines a reporting entity as: *[CF 3.10, CF Appendix]*

Extract from the Conceptual Framework for Financial Reporting	
3.10	A reporting entity is an entity that is required, or chooses, to prepare financial statements. A reporting entity can be a single entity or a portion of an entity or can comprise more than one entity. A reporting entity is not necessarily a legal entity.

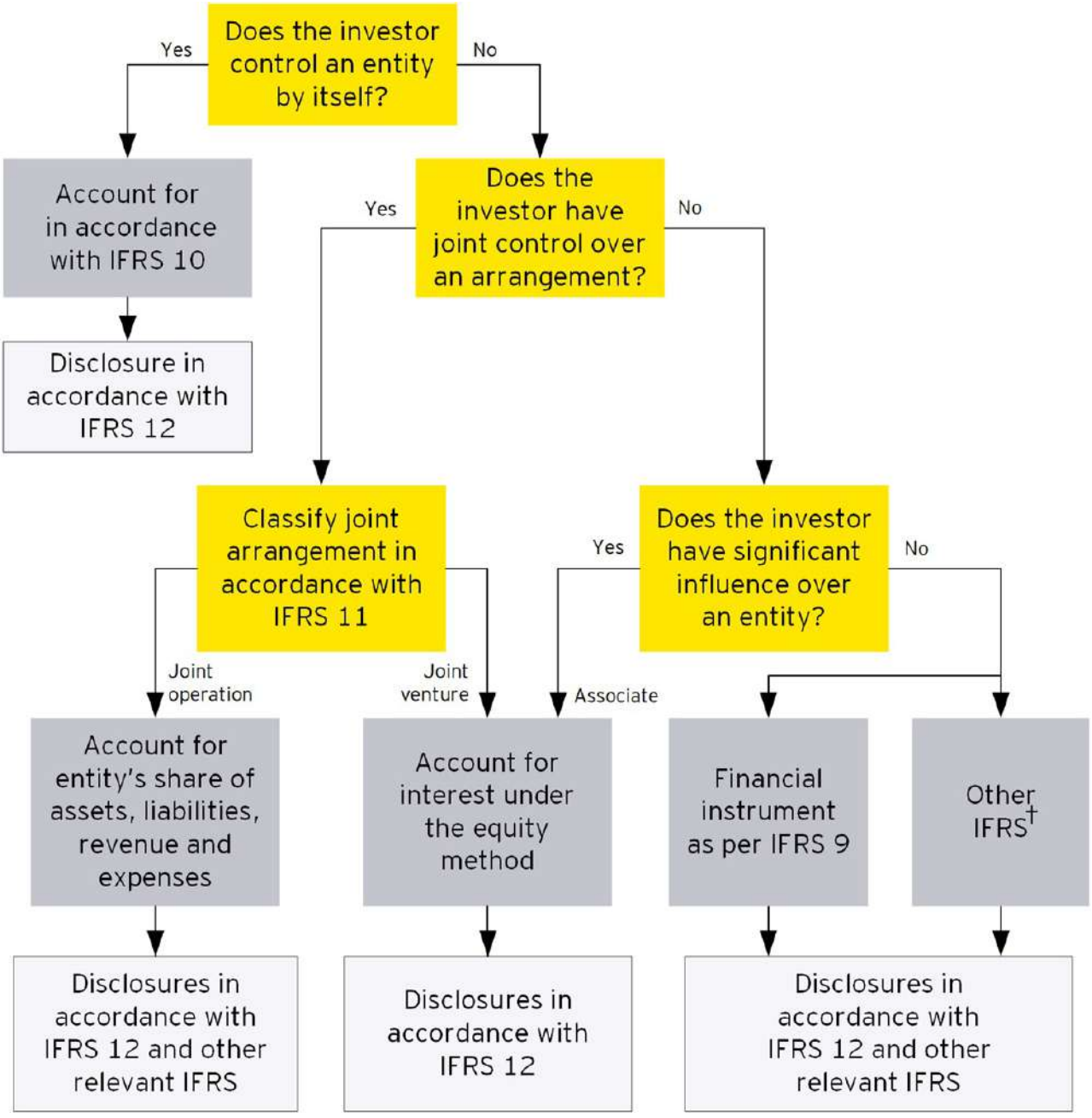
The requirements of the *Framework* are dealt with more fully in Chapter 2.

IFRS 10 establishes a single control model that applies to all entities, including 'structured entities' ('special purpose entities' and 'variable interest entities' under the previous IFRS accounting standards and US GAAP, respectively). In addition, IFRS 10 deals with accounting for subsidiaries by investment entities.

This chapter discusses the requirements of IFRS 10, principally relating to which entities are controlled by a parent and therefore consolidated into the financial statements prepared by that parent (except for certain subsidiaries of investment entities). The requirements of IFRS 10 dealing with consolidation procedures and non-controlling interests are summarised briefly in section 1.3 below and dealt with more fully in Chapter 8.

When management concludes that an entity does not have control of an investee, the requirements of IFRS 11 and IAS 28 must be considered to determine whether it has joint control or significant influence, respectively, over the investee. The requirements of IFRS 11 and IAS 28 are dealt with in Chapter 13 and Chapter 12, respectively. The diagram below summarises the identification and accounting for each type of investment, as well as the interaction between IFRS 10, IFRS 11, IFRS 12 and IAS 28.

Figure 1-1: Interaction between IFRS 10, IFRS 11, IFRS 12 and IAS 28



† This is the case, for example, if an entity has control over (or simply rights to) assets and obligations for liabilities, but *not* control of an entity. In this case, the entity accounts for these assets and obligations in accordance with the relevant IFRS.

1.2 Development of IFRS 10

IFRS 10 was issued in May 2011, together with an amended version of IAS 27 with a new title of *Separate Financial Statements* and IFRS 12. At the same time IFRS 11 and amended IAS 28 were issued.

1.2.1 Post-Implementation Review of IFRS 10

In June 2022, the IASB concluded its PIR of IFRS 10, IFRS 11 and IFRS 12 with the publication of the Project Report and Feedback Statement.[2] Feedback from stakeholders and research undertaken as part of the PIR showed that the requirements set out in the standards are working as intended, are meeting their objectives and that application of the requirements has not given rise to unexpected costs.

2 Project Report and Feedback Statement: *Post-implementation Review: IFRS 10* Consolidated Financial Statements, *IFRS 11* Joint Arrangements, *IFRS 12* Disclosure of Interests in Other Entities, IASB, June 2022. Available on the IFRS Foundation's website.

The feedback received did raise several matters, including matters that were raised to the IFRS IC in the past and not addressed. However, the IASB has determined that none of these matters are a high or medium priority and that no further action is required as a result of the PIR. If stakeholders require further guidance, they are encouraged to submit questions to the IFRS IC, provided these questions meet the submission criteria.

The PIR assessed the following topics as low priority:

- Subsidiaries that are investment entities
- Transactions that change the relationship between an investor and an investee
- Transactions that involve corporate wrappers
- Collaborative arrangements outside the scope of IFRS 11
- Additional disclosures about interests in other entities

The second and third of these topics are relevant to Chapter 8 and are discussed further in section 7 below.

The Board concluded that these topics could be explored if identified as priorities in the next agenda consultation (i.e., the Fourth Agenda Consultation, expected to start in 2026).

1.3 Consolidation procedures

When an investor determines that it controls an investee, the investor (the parent) consolidates the investee (the subsidiary). The requirements of IFRS 10 relating to consolidation procedures, non-controlling interests and accounting for loss of control are dealt with in Chapter 8 at section 5 and section 3.

A parent consolidates a subsidiary from the date on which the parent first obtains control and continues consolidating that subsidiary until the date on which control is lost. IFRS 3 *Business Combinations* defines the date of acquisition, that is, the date on which control is first obtained. *[IFRS 3.8, IFRS 3 Appendix A]*. The term 'date of acquisition' is used even if a parent gains control without acquiring an interest, or taking any action, as discussed in section 9.3 below. IFRS 10 deals with consolidation thereafter (see Chapter 8).

When a parent gains control of a group of assets or an entity that is not a business, such transactions are excluded from the scope of IFRS 3. *[IFRS 3.2(b)]*. This is often the case when a parent gains control of a structured entity. Business combinations under common control are also excluded from the scope of IFRS 3 *[IFRS 3.2(c)]* which means that if a parent gains control of a subsidiary (as defined in IFRS 10) that was previously controlled by an entity under common control, IFRS 3 also does not apply (see Chapter 11 at section 2).

A parent consolidates all subsidiaries and recognises non-controlling interests for any interests held by investors outside of the group.

How we see it

The definition of consolidated financial statements in Appendix A of IFRS 10 does not indicate an exemption from consolidation of immaterial subsidiaries. In our view, in a parent's consolidated financial statements, the accounting policies must state that all subsidiaries are consolidated and cannot refer to materiality. However, materiality can be invoked in applying the accounting policy, and whether the consolidated financial statements comply with IFRS accounting standards if certain immaterial subsidiaries are not consolidated.

1.4 Disclosure requirements

IFRS 10 does not contain any disclosure requirements regarding an entity's interests in subsidiaries included in the consolidated financial statements or its interests in structured entities (whether consolidated or unconsolidated). Such disclosure requirements are contained within IFRS 12.

IFRS 12 contains all disclosure requirements related to an entity's interests in subsidiaries, joint arrangements, associates and structured entities. IFRS 12 requires disclosure of the judgements that were made in determining whether it controls another entity. Even if management concludes that it does not control an entity, the information used to make that judgement will be transparent to users of the financial statements. The required disclosures also assist users of the financial statements in making their own assessment of the financial impact were management to reach a different conclusion regarding consolidation - by providing information about certain unconsolidated entities. The requirements of IFRS 12 are dealt with in Chapter 14 at section 3 to section 7.

2 Objective and scope of IFRS 10

2.1 Objective

The objective of IFRS 10 is as follows: *[IFRS 10.1, IFRS 10.2]*

Extract from IFRS 10	
1	The objective of this IFRS is to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities.
2	To meet the objective in paragraph 1, this IFRS: (a) requires an entity (the *parent*) that controls one or more other entities (*subsidiaries*) to present consolidated financial statements; (b) defines the principle of *control*, and establishes control as the basis for consolidation; (c) sets out how to apply the principle of control to identify whether an investor controls an investee and therefore must consolidate the investee; (d) sets out the accounting requirements for the preparation of consolidated financial statements; and (e) defines an investment entity and sets out an exception to consolidating particular subsidiaries of an investment entity.

This chapter deals with (a), (b), (c) and (e). The accounting requirements mentioned in (d) are dealt with in Chapter 8 at section 2.

IFRS 10 also states that it does not deal with the accounting requirements for business combinations and their effect on consolidation, including goodwill arising on a business combination; these are covered by IFRS 3 (see Chapter 10 at sections 3 to 6). *[IFRS 10.3]*.

2.2 Scope

IFRS 10 requires that a parent (unless exempt or an investment entity as discussed below) presents consolidated financial statements. This means that the financial statements of the group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are included, must be presented as those of a single economic entity. A group consists of a parent and its subsidiaries (i.e., entities that the parent controls). *[IFRS 10.4, IFRS 10 Appendix A]*.

Under IFRS 10, an entity must assess whether it controls the other entities in which it has an interest (the investees) - see section 3 below. This applies to all types of investees including corporations, partnerships, limited liability corporations, trusts, and other types of entities. However, there is a scope exemption for post-employment benefit plans or other long-term employee plans to which IAS 19 *Employee Benefits* applies (see section 2.2.2 below). In addition, an investment entity generally does not consolidate its subsidiaries (see section 2.2.3 below).

IFRS 10 also provides an exemption from preparing consolidated financial statements for entities that are not an ultimate parent, if they meet certain criteria (see section 2.2.1 below).

2.2.1 Exemption from preparing consolidated financial statements by an intermediate parent

A parent that prepares financial statements in accordance with IFRS is exempt from presenting (i.e., need not present) consolidated financial statements if it meets all of the following conditions:

(a) It is a wholly owned subsidiary, or is a partially owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements.

(b) Its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets).

(c) It did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market. And

(d) Its ultimate or any intermediate parent produces financial statements that are available for public use and comply with IFRSs, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with IFRS 10. *[IFRS 10.4(a)]*.

Where an entity uses this exemption, it may, but is not required to, prepare separate financial statements (see Chapter 9 at section 1.1) as its only financial statements. *[IAS 27.8]*. However, if separate financial statements are prepared, they must comply with IAS 27. *[IAS 27.2]*.

The conditions for exemption from preparing consolidated financial statements raise the following interpretation issues.

2.2.1.A Condition (a) - consent of non-controlling shareholders

It is not clear whether a parent is required to obtain explicit consent that the owners of a reporting entity do not object to the use of the exemption.

IFRS 10 requires that, where the parent is itself a partly owned subsidiary, any non-controlling shareholders must be informed of the parent's intention not to prepare consolidated financial statements. Since IFRS 10 does not expressly require obtaining explicit consent, the non-controlling shareholders may not have to give explicit consent, i.e., the absence of dissent is sufficient. However, parents that are partly owned subsidiaries and wish to use the exemption from preparing consolidated financial statements are advised to obtain explicit written consent from non-controlling shareholders in advance. This is because IFRS 10 sets no time limit on when the non-controlling shareholders can register any objection. Thus, it is possible for the non-controlling shareholders to object to a parent's proposed use of the exemption just before the separate financial statements are printed and even after they have been issued.

IFRS 10 also requires all non-controlling owners 'including those not otherwise entitled to vote' to be informed of the parent's intention not to prepare consolidated financial statements. *[IFRS 10.4(a)]*. Thus, for example, the holders of any voting or non-voting preference shares must be notified of, and consent (or not object) to, the entity's intention to use the exemption.

How we see it

In our view, the requirement to inform the non-controlling shareholders where the parent 'is a partially-owned subsidiary of another entity' is ambiguous, as shown by Illustration 2-1 and Illustration 2-2 below. Therefore, judgement is required depending on specific facts and circumstances.

Illustration 2-1: Consent for not preparing consolidated financial statements (1)

A parent (P) wishing to use the exemption is owned 60% by Entity A and 40% by entity B. Entity A and entity B are both wholly owned by entity C. In this case, P is not obliged to inform its non-controlling shareholder B of its intention not to prepare consolidated financial statements since, although it is a partly owned subsidiary of A, it is a wholly owned subsidiary of C (and therefore satisfies condition (a) without regard to its immediate owners).

Illustration 2-2: Consent for not preparing consolidated financial statements (2)

The facts are the same as in Illustration 2-1 above, except that A and B are both owned by an individual (Mr. X). P is not a wholly owned subsidiary of any other entity, and therefore the rules applicable to partly owned subsidiaries apply. Thus, P is required to inform B of any intention not to prepare consolidated financial statements.

2.2.1.B Condition (b) - securities not traded in a public market

It is not clear exactly what constitutes a 'public market'. It is clear that, where quoted prices are available for any of the parent's securities on a generally recognised share exchange, the parent is required to prepare consolidated financial statements, and cannot use the exemption. However, when there are no quoted prices, but the parent's shares are occasionally traded, for example, on a matched bargain basis through an exchange (as opposed to by private treaty between individual buyers and sellers), it is not clear whether this meets the definition of a 'public market' for this condition.

How we see it

In our view, any security that is traded in circumstances where it is necessary to have filed financial statements with a securities commission or regulator is regarded as 'traded in a public market' for condition (b). It is clear that the IASB regarded conditions (b) and (c) in section 2.2.1 above as linked; in other words, that an entity falls within (c) before falling within (b). Condition (c) refers to the filing of financial statements with a securities commission or regulator as a precursor to public listing of securities, and this forms the basis for our view.

The meaning of 'public market' is discussed in more detail in Chapter 32 at section 2.2.1.

2.2.1.C Condition (c) - not filing financial statements for listing securities

It is not clear whether the 'financial statements' referred to are only those prepared under IFRS accounting standards, or include those prepared under local GAAP.

How we see it

In our view, the test is whether the entity currently has, or shortly will have, an ongoing obligation to file financial statements with a regulator in connection with the public trading of any of its securities - whether under IFRS accounting standards or local GAAP. This conclusion is based on our view that the phrase 'financial statements' means any financial statements filed in connection with the public trading of securities.

The IASB's view is that the information needs of users of financial statements of entities whose debt or equity instruments are traded in a public market are best served when investments in subsidiaries, associates, and jointly controlled entities are accounted for in accordance with IFRS 10, IAS 28, and IFRS 11 respectively. The Board therefore decided that the exemption from preparing such consolidated financial statements is not available to such entities or to entities in the process of issuing instruments in a public market. *[IFRS 10.BCZ18]*.

2.2.1.D Condition (d) - parent's IFRS financial statements are publicly available and include subsidiaries that are consolidated or measured at fair value through profit or loss in accordance with IFRS 10

The first part of this condition means that the exemption can be used either where a parent of the reporting entity prepares consolidated financial statements under IFRS accounting standards that are publicly available through a regulatory filing requirement, or where those financial statements are available on request. An entity that uses the exemption from preparing consolidated financial statements must disclose the source for obtaining the financial statements of the relevant parent of the reporting entity (see Chapter 9 at section 3.1). *[IAS 27.16(a)]*. For example, this information can be provided by disclosing:

- Contact details of a person or an e-mail address from which a hard copy of the document can be obtained

  Or

- A website address where the financial statements can be found and downloaded

However, it is not clear whether this condition requires the IFRS consolidated financial statements of the reporting entity's parent to have been issued and made publicly available prior to the issuance of the reporting entity's separate financial statements for the same reporting period. Given IFRS 10 does not specifically address this question, reporting entities ought to consider the relevant facts and circumstances, including local law or regulations.

This condition requires that the parent's financial statements comply with IFRS accounting standards. There are a number of jurisdictions that have a national GAAP which is virtually identical to IFRS accounting standards. However, differences between these national GAAPs and IFRS accounting standards often exist regarding the scope, transitional provisions, effective dates and actual wording of standards. In addition, some national GAAPs contain accounting alternatives not permitted by IFRS accounting standards. The question arises as to whether a reporting entity, that is a parent entity preparing IFRS financial statements, can claim exemption for the requirement to prepare consolidated accounts on the grounds that it has an ultimate or intermediate parent that produces consolidated financial statements under a national GAAP which is similar to IFRS accounting standards (e.g., European Union (EU) adopted IFRS accounting standards).

How we see it

In our view, if the ultimate or intermediate parent:

- Reports under a national GAAP that is identical to IFRS accounting standards in all respects
- Applied the national GAAP equivalent of IFRS 1 *First-time Adoption of International Financial Reporting Standards* when it adopted that national GAAP
- Makes an explicit and unreserved statement of compliance with that national GAAP in its most recent consolidated financial statements

  And

- Could have made an explicit and unreserved statement of compliance with IFRS accounting standards in those consolidated financial statements, if required

Then the exemption from preparing consolidated financial statements is permitted for the reporting entity.

The second part of condition (d) above confirms that the exemption from preparing consolidated financial statements set out in (a) to (d) above is available to an intermediate parent entity that is a subsidiary of an investment entity. The exemption is available even though the investment entity parent may not prepare consolidated financial statements or consolidate the intermediate parent entity subsidiary. *[IFRS 10.BC28A, IFRS 10.BC28B]*. In making its decision, the IASB observed that, when an investment entity measures its interest in a subsidiary at fair value, the disclosures required by IFRS 12 are supplemented by those required by IFRS 7 *Financial Instruments: Disclosures* and IFRS 13 *Fair Value Measurement*. Accordingly, the IASB decided that this combination of information was sufficient to support the decision to retain an exemption from presenting consolidated financial statements for a subsidiary of an investment entity that is itself a parent entity. The IASB further noted that requiring an intermediate parent that is a subsidiary of an investment entity to prepare consolidated financial statements could result in significant additional costs, without commensurate benefit and this is contrary to its intention in requiring investment entities to measure investments at fair value, which was to provide more relevant information at a reduced cost. *[IFRS 10.BC28D]*.

However, local law or regulations may conflict with this exemption if it is required that an entity has to be included within the consolidated financial statements of a parent by full consolidation in order to obtain the exemption.

2.2.2 Employee benefit plans and employee share trusts

IFRS 10 exempts post-employment benefit plans or other long-term employee benefit plans to which IAS 19 applies. *[IFRS 10.4A]*. However, it is not clear whether this means that an employee benefit plan that controls an investee is not required to consolidate that investee in its financial statements, or whether an investor that controls an employee benefit plan need not consolidate the plan itself.

How we see it

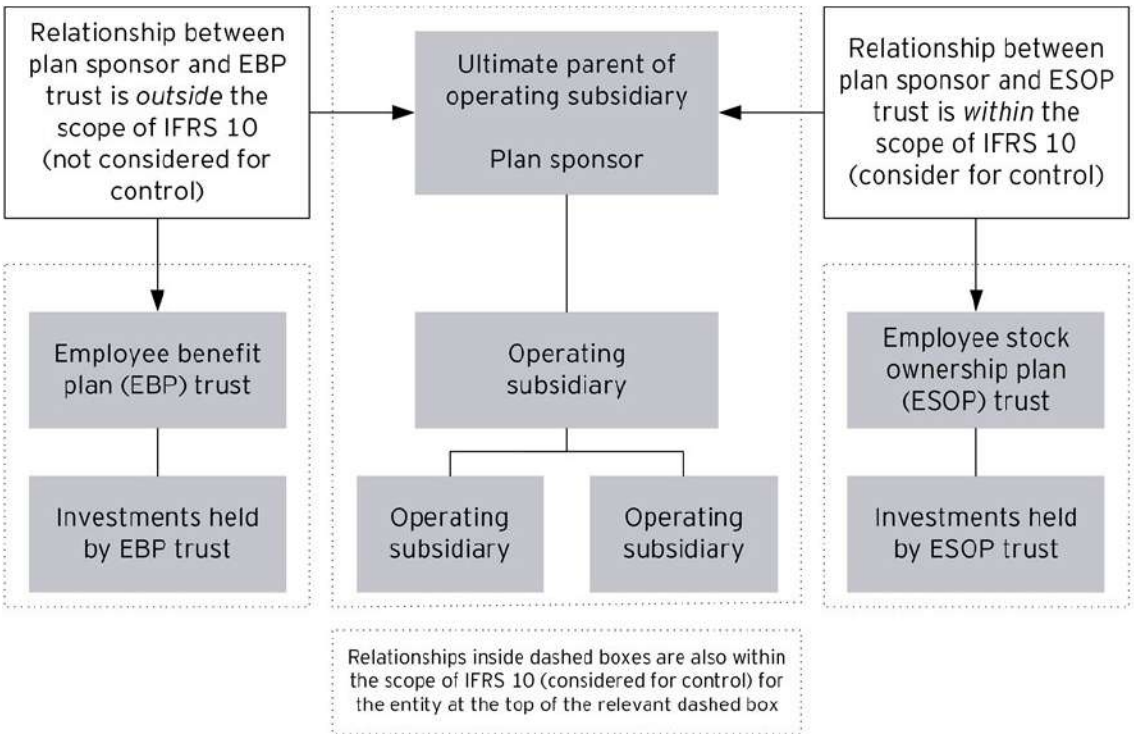
In our view, the latter of the two meanings above was intended: a sponsor of an employee benefit plan need not evaluate whether it controls that employee benefit plan, and, therefore, need not consolidate it.

However, the employee benefit plan applies IFRS 10 if it is preparing financial statements under IAS 26 *Accounting and Reporting by Retirement Benefit Plans*. These employee benefit plans are referred to as 'Employee benefit plan (EBP) trust' in Figure 2-1 below.

In contrast, employee benefit trusts (or similar entities) established for employee share option plans, employee share purchase plans and other share-based payment programmes are not excluded from the scope of IFRS 10. This is because these are outside the scope of IAS 19. These trusts are referred to as 'Employee stock ownership plan (ESOP) trust' in Figure 2-1 below. The sponsoring entity of these trusts needs to evaluate whether it controls (and therefore consolidates) the trusts. If the trust is treated as an extension of the employer or sponsoring entity (see Chapter 30 at section 12.3), its assets and liabilities will already be included in the financial statements of the employer entity that are used for preparing the consolidated financial statements of the group. If the trust is not accounted for as an extension of the employer or sponsoring entity, the parent will need to assess whether the trust, as a separate vehicle, needs to be consolidated according to the control criteria of IFRS 10.

The diagram below illustrates what is in scope and out of scope of IFRS 10.

Figure 2-1: Understanding scope in employee benefit plans and employee stock ownership plans



2.2.3 Investment entity exception

As an exception to the consolidation rule, a parent that is an investment entity does not present consolidated financial statements if it is required to measure all of its subsidiaries at fair value through profit or loss. *[IFRS 10.4B]*. This is discussed in section 10.3 below.

2.2.4 Entity no longer a parent at the end of the reporting period

It is not clear whether IFRS 10 requires an entity to prepare consolidated financial statements only if it is a parent at the end of the reporting period or also if it was a parent at any time during the reporting period.

How we see it

In our view, consolidated financial statements must be prepared by an entity that was a parent during the reporting period, even if that entity is no longer a parent at the end of the reporting period (e.g., because it disposed of all its subsidiaries).

IFRS 10 requires a parent to consolidate a subsidiary until the date on which the parent ceases to control the subsidiary, and such consolidated financial statements are to include the income and expenses of the subsidiary up to the date on which the parent ceases to control the subsidiary. *[IFRS 10.20, IFRS 10.B88]*. IFRS 10 also requires the gain or loss from loss of control of a subsidiary to be calculated based on the difference between the proceeds and the carrying amounts of the assets and liabilities of the subsidiary at the date when control is lost. The carrying amount as of the date of disposal reflects the income and expense of the subsidiary. The gain or loss recognised on disposal in the consolidated financial statements is therefore generally different from the gain or loss in the separate financial statements of the parent. *[IFRS 10.B98]*.

This means that if a parent does not prepare consolidated financial statements pursuant to a concession in local law (see section 2.2.5 below), the parent may not present separate financial statements in compliance with IFRS accounting standards.

How we see it

Likewise, we believe that an entity that had an associate, or an interest in a joint venture, during the reporting period but no longer does so at end of the reporting period, must apply IAS 28 and/or IFRS 11 to those investments in its financial statements for the reporting period, if not otherwise exempt from doing so.

2.2.5 Interaction of IFRS 10 and EU law

For entities incorporated in the EU, there may, in some cases, be a subtle interaction between the requirements to prepare consolidated financial statements in accordance with IFRS accounting standards as issued by IASB and IFRS accounting standards as adopted by the EU. The determination of whether or not consolidated financial statements are required is made under the relevant national legislation based on the EU Accounting Directive, and not IFRS 10.[3] In the majority of cases, this is a technicality with little practical effect. In some cases, however, there will be differences because IAS 27 states that an entity may present separate financial statements as its sole financial statements only if it is exempt from preparing consolidated financial statements in accordance with IFRS 10.4(a). *[IAS 27.8]*.

In contrast, in November 2006, the European Commission stated that in its opinion "…a parent company always has to prepare annual accounts as defined by the 4th Directive. Where, under the 7th Company Law Directive, a parent company is exempted from preparing consolidated accounts, but chooses or is required to prepare its annual accounts in accordance with IFRS as adopted by the EU, those provisions in IAS 27 setting out the requirement to prepare consolidated accounts do not apply. Such annual accounts [i.e., the separate financial statements] are described as having been prepared in accordance with IFRS as adopted by the EU"[4] (the 4th and 7th Directives have now been replaced by a single EU Accounting Directive 2013/34/EU[5]). While this statement was under the previous IAS 27, the same arguments apply under IFRS 10.

Applying the above discussions, when an entity is not explicitly required to prepare consolidated financial statements under national legislation based on the EU Accounting Directive, even though IFRS 10 obliges it to do so, it will not meet the criterion for exemption under IFRS 10.4(a). Consequently, when that entity presents separate financial statements, such financial statements must be described as having been prepared in accordance with 'IFRS accounting standards as adopted by the EU' rather than 'IFRS accounting standards as issued by the IASB'. An example of this situation is an entity that has an investment in an entity that is not a 'subsidiary undertaking' under the EU Accounting Directive 2013/34/EU, but is a subsidiary under IFRS 10.

2.2.6 Combined and carve-out financial statements

Combined or carve-out financial statements are sometimes prepared under IFRS accounting standards for a 'reporting entity' that does not comprise a group under IFRS 10.

How we see it

Although some GAAPs draw a distinction between combined and carve-out financial statements, in our view, the determination of whether these financial statements are permitted to be prepared in accordance with IFRS accounting standards is the same. Accordingly, where the term 'combined financial statements' is used below, our views apply equally to 'carve-out financial statements'.

The *Conceptual Framework* defines combined financial statements as "Financial statements of a reporting entity that comprises two or more entities that are not all linked by a parent-subsidiary relationship." *[CF Appendix]*. However, the *Framework* does not discuss when or how entities could prepare combined financial statements. The IASB concluded that such discussion would be best developed if the IASB decides in the future to develop a Standard on this topic. *[CF 3.12, CF BC3.21]*.

Examples of when combined or carve-out financial statements might be requested include the following:

- Two or more legal entities under common control of the same individual or group of individuals (e.g., 'horizontal' groups)

  Or

- A group of business units that are intended to become a group in the future (e.g., following an initial public offering or demerger), which may or may not be separate legal entities

3 Regulation (EC) No. 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, preamble para. (3).

4 Agenda paper for the meeting of the Accounting Regulatory Committee on 24th November 2006 (document ARC/19/2006), Subject: *Relationship between the IAS Regulation and the 4th and 7th Company Law Directives - Meaning of 'Annual Accounts'*, European Commission: Internal Market and Services DG: Free movement of capital, company law and corporate governance: Accounting/RC MX D(2006), 7 November 2006, para. 5.1.

5 Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC, preamble para. (1).

In 2009, the IFRS IC received a request for guidance on whether a reporting entity may, in accordance with IFRS accounting standards, present financial statements that include a selection of entities that are under common control, rather than being restricted to a parent/subsidiary relationship as defined by IFRS accounting standards. The IFRS IC noted that the ability to include entities within a set of IFRS financial statements depends on the interpretation of 'reporting entity' in the context of common control. The IFRS IC decided not to add these issues on to its agenda.[6]

How we see it

In our view, there are limited circumstances in which such combined financial statements can give a true and fair view in accordance with IFRS accounting standards and be presented as 'general purpose' financial statements. As a minimum, there must be both of the following:

- Common control for the full or a portion of the reporting period (see section 2.2.6.A below)
- A clear purpose for which the combined financial statements will be used by clearly identified intended users (see section 2.2.6.B below)

In addition, the preparer must be able to coherently describe the various legal entities, segments, reportable segments, branches, divisions, geographical jurisdictions, or other 'units' that will be included in the combined financial statements. Careful consideration is required when concluding that it is appropriate to exclude any 'units' from the combined financial statements (such as unprofitable operations) that are similar to the 'units' that are being included in the combined financial statements. Such exclusion must be appropriate when considered in the context of the purpose of the financial statements, the intended users, and the terms and conditions of any relevant agreements (e.g., acquisitions, spin-offs). Other practical considerations related to the preparation of combined financial statements are noted in section 2.2.6.C below.

How we see it

Although IFRS accounting standards are unclear on this issue, we believe that the fact that *IFRS for Small and Medium-sized Entities* specifically permits the preparation of combined financial statements, and the fact that the *Conceptual Framework* refers to combined financial statements, together provide a basis for preparing combined financial statements in appropriate circumstances.

2.2.6.A Common control

Determining whether common control exists can be difficult, and requires judgement based on the facts and circumstances (see Chapter 11 at section 2.1.1).

How we see it

In our view, general purpose combined financial statements can only be prepared if the entities are under common control for the full or a portion of the reporting period. Furthermore, the financial results of each combined entity can only be included in the general purpose combined financial statements for the period in which that entity was under common control.

Events that occur after the end of a reporting period that result in common control are non-adjusting events (see Chapter 34 at section 2.1.3).

2.2.6.B Purpose and users of combined financial statements

A reporting entity is an entity that is required, or chooses, to prepare financial statements. *[CF 3.10, CF Appendix]*. Therefore, it is a matter of judgement of whether it is appropriate to prepare general purpose combined financial statements, depending upon the facts and circumstances related to both the purpose and the users of the financial statements, considerations that are interrelated.

6 *IFRIC Update*, January 2010, pp.2-3, available on the IFRS Foundation's website.

For example, the facts and circumstances usually indicate that it is appropriate to prepare general purpose combined financial statements when required by regulators on behalf of investors. This is because the regulators purport to represent the needs of a wide range of users (investors) for a general purpose, for which the investors cannot otherwise command the financial information. Situations where regulators typically require combined financial statements include:

- Carve-out transactions
- Spin-off transactions
- Financing transactions that require approval by a broad group of investors
- Transactions in which the combined entity will become the predecessor financial statements of a new entity

  Or
- Transactions in which the combined entity will be a material acquisition (for the acquirer)

In addition, there may be circumstances when several third parties (e.g., banks or acquirers in a private bidding process) all request financial statements that combine the same entities - that is, the same combined financial statements. In such cases, the combined financial statements might be 'general purpose', because they are used by a wide range of users.

2.2.6.C Preparation of combined financial statements

Combined financial statements must include all normal consolidation entries (such as elimination of group transactions, unrealised profit elimination, etc.).

How we see it

In our view, the combined financial statements ought to disclose:

- The fact that the financial statements are combined financial statements
- The reason why combined financial statements are prepared
- The basis for determining which 'units' are included in the combined financial statements
- The basis of preparation of the combined financial statements

  And
- The related party disclosures required by IAS 24 *Related Party Disclosures*

Determining the appropriate boundary of a reporting entity can be difficult, as discussed in the 2018 *Conceptual Framework*. *[CF 3.13, CF 3.14]*.

Extract from the Conceptual Framework for Financial Reporting

3.13 Determining the appropriate boundary of a reporting entity can be difficult if the reporting entity:

(a) is not a legal entity; and

(b) does not comprise only legal entities linked by a parent-subsidiary relationship.

3.14 In such cases, determining the boundary of the reporting entity is driven by the information needs of the primary users of the reporting entity's financial statements. Those users need relevant information that faithfully represents what it purports to represent. Faithful representation requires that:

(a) the boundary of the reporting entity does not contain an arbitrary or incomplete set of economic activities;

(b) including that set of economic activities within the boundary of the reporting entity results in neutral information; and

(c) a description is provided of how the boundary of the reporting entity was determined and of what constitutes the reporting entity.

In addition, management should consider who has the appropriate knowledge and authority to authorise the general purpose combined financial statements for issue (see Chapter 34 at section 2.4).

While regulators may require combined or carve-out financial statements, IFRS accounting standards does not describe how to prepare such information. Accordingly, practical issues frequently arise when preparing financial statements on a combined or carve-out basis, including the items below:

- *Management judgement and hindsight*

  Absent clear legal boundaries, determining whether certain items are part of a combined reporting entity often requires significant management judgement and possibly the use of hindsight.
- *Comparative periods*

  There is a risk that comparative information is prepared on a basis that reflects the impact of events before they actually occur (e.g., disposals of assets). Once it is determined what 'units' are being included in the combined financial statements, the comparative information presented is the comparative information for such units.
- *Allocation of overhead costs*

  Combined reporting entities that are part of a larger group often benefit from certain overheads (e.g., legal or administrative).
- *Transfers of assets*

  The group that owns the combined reporting entity may have been reorganised, resulting in the transfer of assets between 'units'. This raises questions about recognising gains or losses on disposals and the appropriate cost basis of assets acquired.
- *Financing costs*

  It is often not clear how to allocate a group's liabilities and equity to the individual 'units' that it owns. The individual 'units' may differ considerably in nature, e.g., a group may own both low-risk established 'units' and a high-risk new venture. Therefore, it is not clear how to allocate interest expenses and other aspects of an entity's funding structure (e.g., embedded derivatives and compound financial instruments).
- *Taxation and employee benefits*

  Legal and other requirements often create practical issues when determining the amount of the tax or employee benefit liabilities that are recognised in combined or carve-out financial statements.
- *Designation*

  Accounting under IFRS accounting standards sometimes relies on management's stated intent and other designations (e.g., financial instrument and hedge designations, intent regarding assets held for sale and designation of groups of cash-generating units). It is often not clear how to reflect management's intent and designations in combined or carve-out financial statements.

There is a risk that an inappropriate allocation could result in a set of financial statements that does not offer a 'true and fair view' of the reporting entity. Preparation of financial information on a combined or carve-out basis generally requires a substantial number of adjustments and allocations to be made, and draws heavily on pronouncements of other standard-setting bodies that are referred to by the hierarchy of authoritative guidance in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Absent clarification by the IASB or the IFRS IC, diversity in practice will continue to exist. Therefore, the basis of preparation ought to disclose:

- Which accounting standards have been applied

  And
- The significant accounting judgements that were made, including the adjustments and allocations

2.2.6.D When combined financial statements are not general purpose

How we see it

In our view, it is generally not appropriate to present 'general purpose' combined financial statements when requested by parties that can obtain the desired combined financial information through other means. In such cases, the combined financial statements are often deemed 'special purpose'.

Examples of such parties include:

- Lenders (e.g., banks) for the purpose of approving a loan or ensuring covenant compliance
- Governments and their agencies other than investor regulators (e.g., tax authorities)
- A single potential acquirer
- A board of directors or management

When a group of family members prepares combined financial statements, judgement is required to assess the facts and circumstances, as to whether such combined financial statements are 'general purpose' or 'special purpose', depending on the purpose for which the family intends to use the combined financial statements.

Where it is not appropriate to present combined financial statements as 'general purpose', either because they are requested by a party that has the ability to otherwise command the information, or because there are deviations from IFRS accounting standards as issued by the IASB due to the specific nature and purpose of the combined or carved-out financial statements, alternative options might include preparing:

- Financial statements of each of the entities that would have been included in the combined financial information

  Or

- Special purpose financial statements

2.2.6.E The reporting entity in combined financial statements and in consolidated financial statements

In certain circumstances, entities prepare general purpose combined financial statements in compliance with IFRS accounting standards followed by consolidated financial statements in accordance with IFRS accounting standards. Sometimes, group entities may be excluded from a parent's combined financial statements despite the fact that they are controlled by the parent, and would otherwise be consolidated by the parent under IFRS 10. For example, a subsidiary that will not form part of a sub-group to be listed may be excluded from the combined financial statements.

How we see it

In our view, the subsequent consolidated financial statements must be prepared according to IFRS 10 and therefore must include all subsidiaries controlled by a parent.

This is because IFRS 10 defines consolidated financial statements as those including assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries. *[IFRS 10 Appendix A]*. A subsidiary is derecognised at the date that control is lost. *[IFRS 10.20, IFRS 10.25]*. IFRS 10 does not provide any exceptions to these requirements. Illustration 2-3 below shows the differences in the scope of consolidation that can arise where an entity prepares both combined and consolidated financial statements.

Illustration 2-3: Preparation of consolidated financial statements after combined financial statements

In 20X3, intermediate parent (P), which has three subsidiaries (S1, S2 and S3), is preparing for an IPO. P has historically not prepared consolidated financial statements as it has applied the exemption in IFRS 10.4(a). One of the subsidiaries, S3, is to be transferred to the ultimate parent prior to the listing and will not form part of the sub-group to be listed. In the prospectus, combined financial statements are presented including P, S1 and S2 for the annual periods ending 31 December 20X1 and 20X2. The combined financial statements are deemed to be general purpose financial statements in compliance with IFRS, as the combined entities have been under common control for the entire reporting period, and the combined financial statements are required by the regulator on behalf of investors, representing a wide range of users. The transfer of S3 to the ultimate parent occurred in August 20X3 and P group was listed in October 20X3.

When preparing the 20X3 consolidated financial statements, should (now listed) P:

(a) Present consolidated financial statements for 20X3 (P+S1+S2+S3), showing comparatives for 20X2 and consolidating S3 until August 20X3?

  Or

(b) Present consolidated financial statements for 20X3 excluding S3 (P1+S1+S2), showing comparative information for 20X2 for only P1+S1+S2, as per the combined financial statements?

The consolidated financial statements must be prepared according to IFRS 10 and therefore the 20X3 consolidated financial statements of P must include S3 in the 20X2 comparatives and until control ceased in August 20X2 (option (a) above).

3 Control

An investor, regardless of the nature of its involvement with an entity (the investee), determines whether it is a parent by assessing whether it controls the investee. *[IFRS 10.5, IFRS 10.6, IFRS 10.7]*.

Extract from IFRS 10

6 An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

7 Thus, an investor controls an investee if and only if the investor has all the following:

(a) power over the investee (see paragraphs 10-14);

(b) exposure, or rights, to variable returns from its involvement with the investee (see paragraphs 15 and 16); and

(c) the ability to use its power over the investee to affect the amount of the investor's returns (see paragraphs 17 and 18).

Although not a defined term, IFRS 10 uses the term 'investor' to refer to a reporting entity that potentially controls one or more other entities, and 'investee' to refer to an entity that is, or may potentially be, the subsidiary of a reporting entity. Ownership of a debt or equity interest may be a key factor in determining whether an investor has control. However, it is also possible for a party to be an investor and potentially control an investee, without having an equity or debt interest in that investee.

An investor has to consider all facts and circumstances when assessing whether it controls an investee. *[IFRS 10.8]*.

Only one party, if any, can control an investee. *[IFRS 10.BC69]*. However, IFRS 10 notes that two or more investors collectively can control an investee. To control an investee collectively, investors must act together to direct the relevant activities (see section 4.1 below). In such cases, because no investor can direct the activities without the co-operation of the others, no investor individually controls the investee. Each investor would account for its interest in the investee in accordance with the relevant IFRS accounting standards, such as IFRS 11, IAS 28 or IFRS 9. *[IFRS 10.9]*.

3.1 Assessing control

Detailed application guidance is provided by IFRS 10 with respect to the assessment of whether an investor has control over an investee. To determine whether it controls an investee, an investor assesses whether it has all three elements of control described in section 3 above. *[IFRS 10.B2]*.

Each of the three control criteria are explored in more detail in sections 4, 5 and 6 below, respectively.

IFRS 10 notes that consideration of the following factors may assist in making that determination:

(a) The purpose and design of the investee (see section 3.2 below)

(b) What the relevant activities are and how decisions about those activities are made (see section 4.1 below)

(c) Whether the rights of the investor give it the current ability to direct the relevant activities (see sections 4.2 to 4.6 below)

(d) Whether the investor is exposed, or has rights, to variable returns from its involvement with the investee (see section 5 below)

And

(e) Whether the investor has the ability to use its power over the investee to affect the amount of the investor's returns (see section 6 below) *[IFRS 10.B3]*

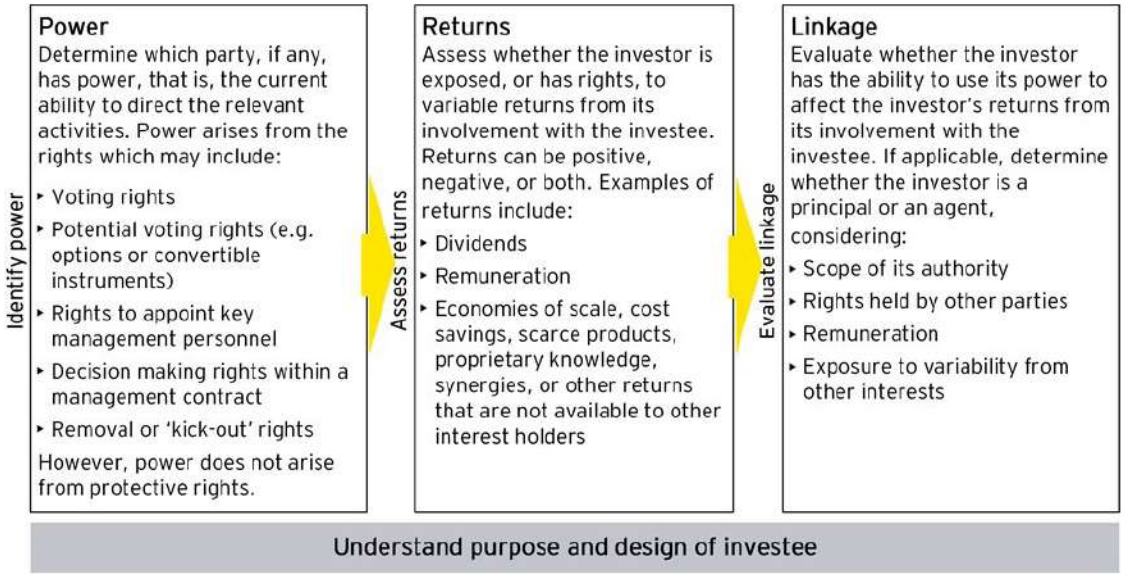
In addition, when assessing control of an investee, an investor considers the nature of its relationship with other parties (see section 7 below). *[IFRS 10.B4]*.

In many cases, when decision-making is controlled by voting rights that also give the holder exposure to variable returns, it is clear that whichever investor holds a majority of those voting rights controls the investee. *[IFRS 10.B6]*. However, in other cases (such as when there are potential voting rights, or an investor holds less than a majority of the voting rights), it may not be so clear. In those instances, further analysis is needed, and the criteria need to be evaluated based on all facts and circumstances (considering the factors listed above), to determine which investor, if any, controls an investee. *[IFRS 10.8]*. The diagram below illustrates this assessment.

The control principle outlined above applies to all investees, including structured entities. A structured entity is defined in IFRS 12 as an entity that is designed so that voting or similar rights are not the dominant factor in determining who controls the entity, such as when the voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. *[IFRS 12 Appendix A]*.

There are no bright lines to determine whether an investor has an exposure, or has rights, to variable returns from its involvement with a structured entity, or whether it has the ability to affect the returns of the structured entity through its power over the structured entity. Rather, as with all investees, all facts and circumstances are considered when assessing whether the investor has control over an investee that is a structured entity. That is, the process outlined in the diagram below is used for structured entities, although the relevant facts and circumstances may differ from when voting rights are a more important factor in determining control. This is discussed further in section 4.4.1 below.

Figure 3-1: Assessing control



When management concludes that an entity does *not* have control, the requirements of IFRS 11 and IAS 28 must be considered to determine whether it has joint control or significant influence, respectively, over the investee, as shown in the diagram in section 1.1 above.

3.2 Purpose and design of an investee

When assessing control of an investee, an investor considers the purpose and design of the investee in order to identify the relevant activities, how decisions about the relevant activities are made, who has the current ability to direct those activities and who receives returns from those activities. *[IFRS 10.B5]*. Understanding the purpose and design of an investee is therefore critical when identifying who has control.

When an investee's purpose and design are considered, it may be clear that an investee is controlled by means of equity instruments that give the holder proportionate voting rights, such as ordinary shares in the investee. In this case, in the absence of any additional arrangements that alter decision-making, the assessment of control focuses on which party, if any, is able to exercise voting rights (see section 4.3 below) sufficient to determine the investee's operating and financing policies. In the most straightforward case, the investor that holds a majority of those voting rights, in the absence of any other factors, controls the investee. *[IFRS 10.B6]*.

To determine whether an investor controls an investee in more complex cases, it may be necessary to consider some or all of the other factors listed in section 3.1 above. *[IFRS 10.B7]*.

IFRS 10 notes that an investee may be designed so that voting rights are not the dominant factor in deciding who controls the investee, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements (this is the same wording that IFRS 12 uses in defining a structured entity - see section 3.1 above). In such cases, an investor's consideration of the purpose and design of the investee shall also include consideration of the risks to which the investee was designed to be exposed, the risks it was designed to pass on to the parties involved with the investee and whether the investor is exposed to some or all of those risks. Consideration of the risks includes not only the downside risk, but also the potential for upside. *[IFRS 10.B8]*.

Understanding the purpose and design of the investee helps to determine:

- To what risks was the investee designed to be exposed, and what are the risks it was designed to pass on to the parties with which it is involved?
- What are the relevant activities?
- How are decisions about the relevant activities made?
- Who has the ability to direct the relevant activities?
- Which parties have exposure to variable returns from the investee?
- How do the relevant activities affect returns?
- Do the parties that have power and have exposure to variable returns have the ability to use that power to affect returns?

In short, understanding the purpose and design of the investee helps to understand the goal of each investor; that is, why they are involved with the investee, and what that involvement is.

4 Power over an investee

The first criterion to have control relates to power. An investor has power when it has existing rights that give it the current ability to direct the relevant activities. *[IFRS 10.10, IFRS 10.B9]*. Therefore, when assessing whether an investor has power, there are two critical concepts:

- Relevant activities
- Existing rights

These concepts are discussed in sections 4.1 and 4.2 below, respectively. Power may be achieved through voting rights (see section 4.3 below) or through rights arising from contractual arrangements (see section 4.4 below). We also discuss other evidence of power (see section 4.5 below) and determine whether sponsoring (designing) a structured entity gives power (see section 4.6 below).

An investor can have power over an investee even if other entities have existing rights that give them the current ability to participate in the direction of the relevant activities. This may occur when another entity has significant influence, *[IFRS 10.14]*, i.e., the power to participate in the financial and operating policy decisions of the investee but does not have control or joint control over those policies. *[IAS 28.3]*.

4.1 Relevant activities

In many cases, it is clear that control of an investee is held through voting rights. However, when it is not clear that control of an investee is held through voting rights, a crucial step in assessing control is identifying the relevant activities of the investee and the way decisions about such activities are made. *[IFRS 10.B10]*. Relevant activities are the activities of the investee that significantly affect the investee's returns. *[IFRS 10.10]*.

For many investees, a range of activities significantly affect their returns. Examples of relevant activities, and decisions about them, include, but are not limited to:

- Determining or changing operating and financing policies (which might include the items below)
- Selling and purchasing goods and/or services
- Managing financial assets during their life (and/or upon default)
- Selecting, acquiring or disposing of assets
- Researching and developing new products or processes
- Determining a funding structure or obtaining funding
- Establishing operating and capital decisions of the investee, including budgets
- Appointing, remunerating or terminating the employment of an investee's service providers or key management personnel *[IFRS 10.B6, IFRS 10.B11, IFRS 10.B12]*

4.1.1 More than one relevant activity

In many cases, more than one activity will significantly affect an investee's returns.

Under IFRS 10, if two or more unrelated investors each have existing rights that give them the unilateral ability to direct different relevant activities, the investor that has the current ability to direct the activities that most significantly affect the returns of the investee has power over the investee. *[IFRS 10.13]*.

In some situations, activities that occur both before and after a particular set of circumstances or events may be relevant activities. When two or more investors have the current ability to direct relevant activities and those activities occur at different times, the investors shall determine which investor is able to direct the activities that most significantly affect those returns consistently with the treatment of concurrent decision-making rights. The investors reconsider this assessment over time if relevant facts or circumstances change. *[IFRS 10.B13]*.

Therefore, when there is more than one activity that significantly affects an investee's returns, and these activities are directed by different investors, it is important to determine which activities most significantly affect the investee's returns. This is shown in Illustration 4-1 below, which is from IFRS 10. *[IFRS 10.B13 Example 1]*.

Illustration 4-1: Identifying relevant activities in life sciences arrangements

Two investors form an investee to develop and market a medical product. One investor is responsible for developing and obtaining regulatory approval of the medical product - that responsibility includes having the unilateral ability to make all decisions relating to the development of the product and to obtaining regulatory approval. Once the regulator has approved the product, the other investor will manufacture and market it - this investor has the unilateral ability to make all decisions about the manufacture and marketing of the product. If all the activities - developing and obtaining regulatory approval as well as manufacturing and marketing of the medical product - are relevant activities, each investor needs to determine whether it is able to direct the activities that most significantly affect the investee's returns. Accordingly, each investor needs to consider whether developing and obtaining regulatory approval or the manufacturing and marketing of the medical product is the activity that most significantly affects the investee's returns and whether it is able to direct that activity. In determining which investor has power, the investors would consider:

(a) The purpose and design of the investee

(b) The factors that determine the profit margin, revenue and value of the investee as well as the value of the medical product

(c) The effect on the investee's returns resulting from each investor's decision-making authority with respect to the factors in (b)

And

(d) The investors' exposure to variability of returns

In this particular example, the investors would also consider:

(e) The uncertainty of, and effort required in, obtaining regulatory approval (considering the investor's record of successfully developing and obtaining regulatory approval of medical products)

And

(f) Which investor controls the medical product once the development phase is successful

In this Illustration, IFRS 10 does not conclude which of the activities is the most relevant activity (i.e., the activity that most significantly affects the investee's returns). If it were concluded that the most relevant activity is:

- Developing and obtaining regulatory approval of the medical product - then the investor that has the power to direct that activity would have power from the date of entering into the arrangement.

  Or

- Manufacturing and marketing the medical product - then the investor that has the power to direct that activity would have power from the date of entering into the arrangement.

To determine whether either investor controls the arrangement, the investors would also need to assess whether they have exposure to variable returns from their involvement with the investee (see section 5 below) and the ability to use their power over the investee to affect the amount of the investor's returns (see section 6 below). *[IFRS 10.7, IFRS 10.B2]*. The investors are required to reconsider this assessment over time if relevant facts or circumstances change. *[IFRS 10.8]*.

Illustration 4-1 above shows a situation when two different activities that significantly affect an investee's returns are directed by different investors. Thus, it is important to identify the activity that *most* significantly affects returns, as part of assessing which investor, if any, has power. This differs from joint control, defined as the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control. *[IFRS 11 Appendix A]*. Joint control is discussed in more detail in Chapter 13 at section 4.

A second example, also provided by IFRS 10, is reproduced in Illustration 4-2 below. *[IFRS 10.B13 Example 2]*.

Illustration 4-2: Identifying relevant activities in an investment vehicle

An investment vehicle (the investee) is created and financed with a debt instrument held by an investor (the debt investor) and equity instruments held by a number of other investors. The equity tranche is designed to absorb the first losses and to receive any residual return from the investee. One of the equity investors who holds 30% of the equity is also the asset manager. The investee uses its proceeds to purchase a portfolio of financial assets, exposing the investee to the credit risk associated with the possible default of principal and interest payments of the assets. The transaction is marketed to the debt investor as an investment with minimal exposure to the credit risk associated with the possible default of the assets in the portfolio because of the nature of these assets and because the equity tranche is designed to absorb the first losses of the investee.

The returns of the investee are significantly affected by the management of the investee's asset portfolio, which includes decisions about the selection, acquisition and disposal of the assets within portfolio guidelines and the management upon default of any portfolio assets. All those activities are managed by the asset manager until defaults reach a specified proportion of the portfolio value (i.e., when the value of the portfolio is such that the equity tranche of the investee has been consumed).

From that time, a third-party trustee manages the assets according to the instructions of the debt investor. Managing the investee's asset portfolio is the relevant activity of the investee. The asset manager has the ability to direct the relevant activities until defaulted assets reach the specified proportion of the portfolio value; the debt investor has the ability to direct the relevant activities when the value of defaulted assets surpasses that specified proportion of the portfolio value. The asset manager and the debt investor each need to determine whether they are able to direct the activities that *most* significantly affect the investee's returns, including considering the purpose and design of the investee as well as each party's exposure to variability of returns.

Illustration 4-3 below shows a structured entity in which there is more than one activity that affects the investee's returns.

Illustration 4-3: Identifying relevant activities in a structured entity

A structured entity buys dollar-denominated assets, issues euro-denominated notes, and hedges the cash flow differences through currency and interest rate swaps. The activities that affect the structured entity's returns include:

- Sourcing the assets from the market
- Determining the types of assets that are purchased
- Deciding how the structure is hedged
- Managing the assets in the event of default

If each of these activities is managed by different investors (e.g., one investor manages the assets in the event of default, but a different investor determines the types of assets that are purchased), it is necessary to determine which activity most significantly affects the structured entity's returns.

When there are multiple activities that significantly affect an investee's returns, but those activities are all directed by the same investor(s) (which is frequently the case when those activities are directed by voting rights), it is not necessary to determine which activity most significantly affects the investee's returns because the power assessment would be the same in each case.

4.1.2 No relevant activities

How we see it

We believe that structured entities for which there is no substantive decision-making are rare. That is, we believe virtually all structured entities have some level of decision-making and few, if any, are on 'autopilot'. Even if a structured entity operates on 'autopilot', there may be decisions outside the predetermined parameters that may need to be taken if an expected return fails to materialise which could significantly affect the returns of the entity and therefore be relevant activities.

In practice, many entities that may initially have few if any relevant activities can be terminated by at least one of the parties involved in the structure. In this case, the choice of whether to terminate may often be viewed as the relevant activity. IFRS 10 would most likely result in such entities being consolidated by an investor that has the power to dissolve the entity, if this power would affect its variable returns. See section 4.6 below for additional guidance on evaluating relevant activities for structured entities and section 6.3.2 below for additional guidance on liquidation and redemption rights.

However, if a structured entity truly has no decision-making, then no investor controls that structured entity. This is because no investor has power over the structured entity, that is, no investor has the current ability to direct the activities that significantly affect the structured entity's returns if there are no relevant activities after inception significantly affecting those returns. As discussed above, we believe that such situations where there is no substantive decision-making are rare.

4.1.3 Single asset, single lessee vehicles

Some structured entities are single asset, single lease vehicles created to lease a single asset to a single lessee. Between November 2014 and May 2015, the IFRS IC discussed requests for clarification about the interaction of IFRS 10 and IAS 17 *Leases* - in two situations which involved the establishment of a structured entity to lease a single asset to a single lessee.

In the first situation, the lease between the structured entity and the lessee was an operating lease and the question was whether the lessee consolidates the structured entity. In the second situation, the lease between the structured entity and the lessee was a finance lease, and the question was whether the junior lender of the structured entity consolidates the structured entity. In both situations, the consolidation decision is based on an assessment of whether the entity controls the structured entity. The IFRS IC was asked whether the lessee's use of the leased asset was a relevant activity of the structured entity when assessing power over the structured entity.

The IFRS IC was of the view that the lessee's right to use the asset for a period of time does not, in isolation, typically give the lessee decision-making rights over the relevant activities of the structured entity and hence is not typically be a relevant activity of the structured entity. This is because on entering into a lease, regardless of whether it is a finance lease or an operating lease, the structured entity (lessor) has two rights - a right to receive lease payments and a right to the residual value of the leased asset at the end of the lease. Consequently, the activities that affect the structured entity's returns relate to managing the returns derived from those rights; for example, managing the credit risk associated with the lease payments or managing the leased asset at the end of the lease term (for example, managing its sale or re-leasing). How the decision-making relating to those activities significantly affects the structured entity's returns depends on the particular facts and circumstances.

The IFRS IC noted that its conclusion does not mean that a lessee can never control the lessor. For example, a parent that controls another entity for other reasons can lease an asset from that entity. Further, in assessing control, an entity considers all of the rights that it has in relation to the investee to determine whether it has power over that investee. This includes rights in contractual arrangements other than the lease contract, such as contractual arrangements for loans made to the lessor, as well as rights included within the lease contract, including those that go beyond simply providing the lessee with the right to use the asset.

We believe the discussions above also apply to leases as defined in IFRS 16 *Leases*.

4.1.4 Management of assets in the event of default

The management of defaults on assets held by a structured entity will frequently be a relevant activity for that entity (see Illustration 4-2 in section 4.1.1 above). However, in practice, if the assets held by the structured entity are bonds, the activities of a decision-maker that is contracted to manage any defaults may be limited to voting at creditors' meetings, as an independent administrator is appointed to manage the bond default on behalf of all bond holders. Whether the decision-maker has power (i.e., the current ability to direct the management of defaults) or not will probably depend on the size of the structured entity's holding in the individual bonds that have defaulted. The greater the holding, the more likely the decision-maker may be able to control decision-making in a creditors' meeting.

4.2 Existing rights

Once the relevant activities are identified, the next step is to determine which investor, if any, has the current ability to direct those activities (i.e., who has the power). Sometimes, assessing power is straightforward, such as when power over an investee is obtained directly and solely from the voting rights that stem from holding voting interests (e.g., shares), and can be assessed by considering the voting rights from those shareholdings. In other cases, the assessment is more complex and requires many factors to be considered (e.g., instances when power is embedded in one or more contractual arrangements). *[IFRS 10.11]*.

The Application Guidance to IFRS 10 discusses the following, in relation to rights that give an investor power over an investee. *[IFRS 10.B14, IFRS 10.B15, IFRS 10.B16]*.

Extract from IFRS 10	
B14	Power arises from rights. To have power over an investee, an investor must have existing rights that give the investor the current ability to direct the relevant activities. The rights that may give an investor power can differ between investees.
B15	Examples of rights that, either individually or in combination, can give an investor power include but are not limited to: (a) rights in the form of voting rights (or potential voting rights) of an investee (see paragraphs B34-B50); (b) rights to appoint, reassign or remove members of an investee's key management personnel who have the ability to direct the relevant activities; (c) rights to appoint or remove another entity that directs the relevant activities; (d) rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor; and (e) other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities.
B16	Generally, when an investee has a range of operating and financing activities that significantly affect the investee's returns and when substantive decision-making with respect to these activities is required continuously, it will be voting or similar rights that give an investor power, either individually or in combination with other arrangements.

4.2.1 Evaluating whether rights are substantive

For a right to convey power, it must provide the current ability to direct the relevant activities. An investor, in assessing whether it has power, considers only substantive rights relating to the investee (held by the investor and others). IFRS 10 notes that "For a right to be substantive, the holder must have the practical ability to exercise that right". *[IFRS 10.B22]*. An investor that holds only protective rights (see section 4.2.2 below) does not have power over an investee, and consequently does not control the investee. *[IFRS 10.14]*. Whether rights are substantive depends on facts and circumstances. The table below (although not exhaustive) describes the factors that are considered. *[IFRS 10.B23]*.

Figure 4-1: Factors to consider in assessing whether a right is substantive

Factors	Examples
▸ Are there barriers (economic, operational or otherwise) that would prevent (or deter) the holder(s) from exercising their right(s)?	▸ Financial penalties ▸ High exercise or conversion price ▸ Narrow exercise periods ▸ Absence of a mechanism to exercise ▸ Lack of information to exercise ▸ Lack of other parties willing or able to take over or provide specialist services ▸ Legal or regulatory barriers (e.g., where a foreign investor is prohibited from exercising its rights)
▸ Do the holders have the practical ability to exercise their rights, when exercise requires agreement by more than one investor?	▸ The more parties necessary to come together to exercise this right, the less likely that the right is substantive ▸ A mechanism is in place that provides those parties with the practical ability to exercise their rights collectively if they choose to do so ▸ An independent board of directors may serve as a mechanism for numerous investors to act collectively in exercising their rights
▸ Would the investor that holds the rights benefit from their exercise or conversion?	▸ A potential voting right is in-the-money ▸ An investor would obtain benefits from synergies between the investor and the investee

Furthermore, to be substantive, rights need to be exercisable when decisions about the direction of the relevant activities need to be made. IFRS 10 notes "Usually, to be substantive, the rights need to be currently exercisable. However, sometimes rights can be substantive, even though the rights are not currently exercisable". *[IFRS 10.B24]*. This is shown by IFRS 10, *[IFRS 10.B24 Example 3-3D]*, as reflected in Illustration 4-4 below.

Illustration 4-4: Rights exercisable when decisions need to be made

An investee has annual shareholder meetings at which decisions to direct the relevant activities are made. The next scheduled shareholders' meeting is in eight months. However, shareholders that individually or collectively hold at least 5% of the voting rights can call a special meeting to change the existing policies over the relevant activities, but a requirement to give notice to the other shareholders means that such a meeting cannot be held for at least 30 days. Policies over the relevant activities can be changed only at special or scheduled shareholders' meetings. This includes the approval of material sales of assets as well as the making or disposing of significant investments.

The above fact pattern applies to each scenario described below. Each scenario is considered in isolation.

Scenario A

An investor holds a majority of the voting rights in the investee. The investor's voting rights are substantive because the investor is able to make decisions about the direction of the relevant activities when they need to be made. The fact that it takes 30 days before the investor can exercise its voting rights does not stop the investor from having the current ability to direct the relevant activities from the moment the investor acquires the shareholding.

Scenario B

An investor is party to a forward contract to acquire the majority of shares in the investee. The forward contract's settlement date is in 25 days. The existing shareholders are unable to change the existing policies over the relevant activities because a special meeting cannot be held for at least 30 days, at which point the forward contract will have been settled. Thus, the investor has rights that are essentially equivalent to the majority shareholder in scenario A above (i.e., the investor holding the forward contract can make decisions about the direction of the relevant activities when they need to be made). The investor's forward contract is a substantive right that gives the investor the current ability to direct the relevant activities even before the forward contract is settled.

Scenario C

An investor holds a substantive option to acquire the majority of shares in the investee that is exercisable in 25 days and is deeply in the money. The same conclusion would be reached as in scenario B.

Scenario D

An investor is party to a forward contract to acquire the majority of shares in the investee, with no other related rights over the investee. The forward contract's settlement date is in six months. In contrast to the scenarios A to C above, the investor does not have the current ability to direct the relevant activities. The existing shareholders have the current ability to direct the relevant activities because they can change the existing policies over the relevant activities before the forward contract is settled.

This Illustration shows that an investor with the current ability to direct the relevant activities has power even if its rights to direct have yet to be exercised. IFRS 10 states: "Evidence that the investor has been directing relevant activities can help determine whether the investor has power, but such evidence is not, in itself, conclusive in determining whether the investor has power over an investee". *[IFRS 10.12]*.

It should be noted that an investor in assessing whether it has power needs to consider substantive rights held by other parties. Substantive rights exercisable by other parties can prevent an investor from controlling the investee to which those rights relate. Such substantive rights do not require the holders to have the ability to initiate decisions. As long as the rights are not merely protective (see section 4.2.2 below), substantive rights held by other parties may prevent the investor from controlling the investee even if the rights give the holders only the current ability to approve or block decisions that relate to the relevant activities. *[IFRS 10.B25]*.

It is important to remember that the purpose and design of an investee is critical when assessing whether a right is substantive. For example, the following should be considered when evaluating whether an investor's rights are substantive:

- Why were the rights granted?
- What compensation was given (or received) for the right? Does that compensation reflect fair value?
- Did other investors also receive this right? If not, why?

These questions should be considered both when a right is first granted, but also if an existing right is modified.

To be substantive and convey power, a right must give the investor the 'current ability' to direct the investee's relevant activities. However, 'current ability' does not always mean 'able to be exercised this instant'. The concept of 'current ability' is discussed more in the context of potential voting rights in section 4.3.4 below.

4.2.2 Evaluating whether rights are protective

In evaluating whether rights give an investor power over an investee, the investor has to assess whether its rights, and rights held by others, are protective rights. *[IFRS 10.B26]*.

Under IFRS 10, protective rights are defined as: *[IFRS 10 Appendix A]*

Extract from IFRS 10

Appendix A
Defined terms

protective rights	Rights designed to protect the interest of the party holding those rights without giving that party power over the entity to which those rights relate.

Since power is an essential element of control, protective rights do not provide the investor control over the investee. *[IFRS 10.14]*. In addition, holding protective rights cannot prevent another investor from having power over an investee. *[IFRS 10.B27]*.

Protective rights are typically held to prohibit fundamental changes in the activities of an investee that the holder does not agree with and usually only apply in exceptional circumstances (i.e., upon a contingent event). However, the fact that the right to make decisions is contingent upon an event occurring does not mean that the right is always a protective right. *[IFRS 10.B26]*.

Examples of protective rights include (but are not limited to) the right to:

- Restrict an investee from undertaking activities that could significantly change the credit risk of the investee to the detriment of the investor
- Approve an investee's capital expenditures (greater than the amount spent in the ordinary course of business)
- Approve an investee's issuance of equity or debt instruments
- Seize assets if an investee fails to meet specified loan repayment conditions *[IFRS 10.B28]*
- Veto transactions between the investee and a related party

In some cases, a right might be deemed protective, such as the ability to sell assets of the investee if an investee defaults on a loan, because default is considered an exceptional circumstance. However, in the event that the investee defaults on a loan (or, say, breaches a covenant), the investor holding that right will need to reassess whether that right has become a substantive right that gives the holder power (rather than merely a protective right), based on the change in facts and circumstances. This issue has been raised with the IFRS IC which, in September 2013, concluded that reassessment of control is required when facts and circumstances change in such a way that rights, previously determined to be protective, change (for example upon the breach of a covenant in a borrowing arrangement that causes the borrower to be in default). In making its conclusion, the IFRS IC observed that:

- Paragraph 8 of IFRS 10 requires an investor to reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control.
- A breach of a covenant that results in rights becoming exercisable constitutes such a change.
- IFRS 10 does not include an exemption for any rights from this need for reassessment.
- The IASB's redeliberation of this topic during the development of IFRS 10 concluded that rights initially determined to be protective are included in a reassessment of control whenever facts and circumstances indicate that there are changes to one or more of the three elements of control.[7]

7 *IFRIC Update*, September 2013, p.3, available on the IFRS Foundation's website.

4.2.2.A Veto rights

Whether veto rights held by an investor are merely a protective right or a right that may convey power to the veto holder will depend on the nature of the veto rights. If the veto rights relate to changes to operating and financing policies that significantly affect the investee's returns, the veto right may not merely be a protective right.

Other veto rights that are common, and are typically protective (because they rarely significantly affect the investee's returns) include veto rights over changes to:

- Amendments to articles of incorporation
- Location of investee headquarters
- Name of investee
- Auditors
- Accounting principles for separate reporting of investee operations

4.2.2.B Franchises

Many have questioned how to consider franchise rights, and whether they give power (to the franchisor), or whether they are merely protective rights. IFRS 10 notes that a franchise agreement for which the investee is the franchisee often gives the franchisor rights that are designed to protect the franchise brand. Franchise agreements typically give franchisors some decision-making rights with respect to the operations of the franchisee. *[IFRS 10.B29]*.

The standard goes on to say that, generally, franchisors' rights do not restrict the ability of parties other than the franchisor to make decisions that have a significant effect on the franchisee's returns. Nor do the rights of the franchisor in franchise agreements necessarily give the franchisor the current ability to direct the activities that significantly affect the franchisee's returns. *[IFRS 10.B30]*.

It is necessary to distinguish between having the current ability to make decisions that significantly affect the franchisee's returns and having the ability to make decisions that protect the franchise brand. The franchisor does not have power over the franchisee if other parties have existing rights that give them the current ability to direct the relevant activities of the franchisee. *[IFRS 10.B31]*.

By entering into the franchise agreement, the franchisee has made a unilateral decision to operate its business in accordance with the terms of the franchise agreement, but for its own account. *[IFRS 10.B32]*.

Control over such fundamental decisions as the legal form of the franchisee and its funding structure often are not made by the franchisor and may significantly affect the returns of the franchisee. The lower the level of financial support provided by the franchisor and the lower the franchisor's exposure to variability of returns from the franchisee the more likely it is that the franchisor has only protective rights. *[IFRS 10.B33]*.

When analysing whether a franchisor has power over a franchisee, it is necessary to consider the purpose and design of the franchisee. The assessment of whether a franchisor has power hinges on the determination of the relevant activities, and which investor (the franchisor or owner of the franchisee) has the current ability to direct that activity through its rights. The rights held by the franchisor must be evaluated to determine if they are substantive, (i.e., the franchisor has the practical ability to exercise its rights when decisions of the relevant activities need to be made so that it has the current ability to direct the relevant activities), or whether they are merely protective rights. A determination will need to be made in each case, based on the specific facts and circumstances. This is shown in Illustration 4-5 below.

Illustration 4-5: Rights held by franchisor

A franchisor has certain rights that are designed to protect its brand when it is being licensed by a franchisee. Activities that significantly affect the franchisee's returns include:

- Determining or changing its operating policies
- Setting its prices for selling goods
- Selecting suppliers
- Purchasing goods and services
- Selecting, acquiring or disposing of equipment
- Appointing, remunerating or terminating the employment of key management personnel
- Financing the franchise

If certain of the activities above are directed by one investor (e.g., the owners of the franchisee), and other activities are directed by another investor (e.g., the franchisor), then the investors will need to determine which activity most significantly affects the franchisee's returns, as discussed in section 4.1.1 above.

4.2.2.C Budget approval rights

Approval rights over budgets are fairly common in shareholders' agreements and form part of the assessment as to the level of power held by investors. If the budget approval rights held by a shareholder (or other investor) are viewed as substantive, that might indicate that the entity having those rights has power over an investee.

However, the purpose and design of arrangements is key to the analysis of who has power. Therefore, the right to approve budgets is not automatically considered substantive but is based on a careful consideration of the facts and circumstances. Factors to consider in assessing whether budget approval rights are substantive or protective include (but are not limited to):

- The level of detail of the budget that is required to be approved
- Whether the budget covers the relevant activities of the entity
- Whether previous budgets have been challenged and if so, the practical method of resolution
- Whether there are any consequences of budgets not being approved (e.g., may the operator/directors be removed?)
- Whether the entity operates in a specialised business for which only the operator/directors have the specialised knowledge required to draw up the budget
- Who appoints the operator and/or key management personnel of the investee
- The nature of the counterparty with budget approval rights and their practical involvement in the business

4.2.2.D Independent directors

In some jurisdictions, there are requirements that an entity appoints directors who are 'independent'. The phrase 'independent director' has a variety of meanings in different jurisdictions but generally means a director who is independent of a specific shareholder. In some situations, a majority of directors of an entity may be 'independent'.

The fact that a majority of directors of an entity are 'independent' does not mean that no shareholder controls an entity. IFRS 10 requires that all facts and circumstances be considered and in the context of an entity with independent directors it is necessary to determine the role that those directors have in decisions about the relevant activities of the entity. The power to appoint and remove independent directors is considered as part of this assessment.

Similarly, an entity may have more than one governing body and it is not assumed that because one body (which may consist of a majority of independent directors) has oversight of another this means that the supervisory body is the one that makes decisions about the relevant activities of the entity.

4.2.3 Incentives to obtain power

There are many incentives to obtain rights that convey power; generally, the more exposure to variable returns (whether positive or negative), the greater that incentive. IFRS 10 notes this in two contexts:

- The greater an investor's exposure, or rights, to variability of returns from its involvement with an investee, the greater the incentive for the investor to obtain rights sufficient to give it power. Therefore, having a large exposure to variability of returns is an indicator that the investor may have power. However, the extent of the investor's exposure is not determinative regarding whether an investor has power over the investee. *[IFRS 10.B20]*.
- An investor may have an explicit or implicit commitment to ensure that an investee continues to operate as designed. Such a commitment may increase the investor's exposure to variability of returns and thus increase the incentive for the investor to obtain rights sufficient to provide it with power. Therefore, a commitment to ensure that an investee operates as designed may be an indicator that the investor has power, but does not, by itself, give an investor power, nor does it prevent another party from having power. *[IFRS 10.B54]*.

Thus, even though there may be an incentive to obtain rights that convey power when there is an exposure to variable returns, that incentive, by itself, does not represent power. Rather, the investor must analyse whether it actually does have power through existing rights, which might be in the form of voting rights, or rights through a contractual agreement, as discussed in sections 4.3 and 4.4 below, respectively.

4.3 Voting rights

Power stems from existing rights. Often an investor has the current ability, through voting or similar rights, to direct the relevant activities. *[IFRS 10.B34]*.

In many cases, assessing power can be straightforward. This is often the case when, after understanding the purpose and design of the investee, it is determined that power over an investee is obtained directly and solely from the proportionate voting rights that stem from holding equity instruments, such as ordinary shares in the investee. In this case, in the absence of evidence to the contrary, the assessment of control focuses on which party, if any, is able to exercise voting rights sufficient to determine the investee's operating and financing policies. In the most straightforward case, the investor that holds a majority of those voting rights, in the absence of any other factors, controls the investee. *[IFRS 10.B6]*.

Nevertheless, when taking into account other factors relating to voting rights, an investor can have power even if it holds less than a majority of the voting rights of an investee, for example, through:

(a) A contractual arrangement between the investor and other vote holders (see section 4.3.5 below)

(b) Rights arising from other contractual arrangements (see section 4.3.6 below)

(c) The investor's voting rights being sufficient (see section 4.3.3 below)

(d) Potential voting rights (see section 4.3.4 below)

Or

(e) A combination of (a)-(d) *[IFRS 10.B38]*

If the relevant activities of an investee are directed through voting rights, an investor needs to consider the requirements of IFRS 10 in relation to such matters as discussed in sections 4.3.1 to 4.3.6 below. *[IFRS 10.B34]*.

See section 4.4 below for a discussion of cases when voting rights are *not* the right that gives power over an investee.

4.3.1 Power with a majority of the voting rights

In many cases, the legal environment or corporate structure dictate that the relevant activities are directed by the agreement of shareholders who hold more than half of the voting rights of the investee. Alternatively, a governing body, e.g., a board of directors, might make decisions regarding the investee and that board might be appointed by whoever has the majority of the voting rights to direct an investee's relevant activities. In both cases, when one investor has more than half the voting rights, it has power, assuming that no other facts and circumstances are relevant. *[IFRS 10.B35]*.

However, there may be other facts and circumstances that are relevant, as discussed in section 4.3.2 below. In addition, any potential voting rights need to be considered (see section 4.3.4 below).

4.3.2 A majority of voting rights without power

In some cases, voting rights do *not* provide the holder the power to direct the relevant activities. This might be the case, when:

- Relevant activities are directed by another party with existing rights under a contract, and that party is not an agent of the investor (see section 4.4 below) *[IFRS 10.B36]*
- Voting rights are not substantive (see section 4.2.1 above). For example, if the relevant activities are directed by government, judiciary, administrator, receiver, liquidator, or regulator (see section 4.3.2.A below) *[IFRS 10.B37]*
- Voting rights have been delegated to a decision-maker, which then holds the voting rights as an agent (see section 6 below)

  Or
- Voting rights are held as a *de facto* agent of another investor (see section 7 below)

4.3.2.A Evaluating voting rights during bankruptcy

Many jurisdictions have laws that offer protection from creditors when an entity is in financial difficulty. For example, an investee in such a position might be placed in the hands of liquidators, receivers or court-appointed managers under a reorganisation plan. Evaluating whether an investor holding the majority of voting rights still has power over an investee in such situations requires the exercise of judgement based on the facts and circumstances. It also requires an assessment as to whether the holder of the voting rights continues to have the current ability to direct the activities that most significantly affect the investee's returns.

In this evaluation, it is determined whether the shareholders (who hold voting rights) can still direct the operating and financial policies of the investee (assuming that this is the relevant activity), once the investee enters into bankruptcy proceedings. Alternatively, the bankruptcy court (or trustee, or administrator) may direct operating and financial policies. Consideration is given to the following:

- Who appoints management during the bankruptcy period?
- Who directs management (e.g., the shareholders, or a trustee for the creditors)?
- Does management have to seek approval from parties besides the shareholders (e.g., for significant and/or unusual transactions)?
- Who negotiates the plan of reorganisation?

Even if it appears that the shareholders retain power once the investee enters bankruptcy (i.e., they retain the current ability to direct the relevant activities), this does not mean that a majority shareholder automatically controls the investee. This is because the shareholder may not have any exposure to variable returns (see section 5 below), or the ability to affect its returns through its power (see section 6 below), which are the other two criteria for having control. Depending on the facts and circumstances, a shareholder might lose power (or control) when the investee files for bankruptcy protection, or when the investee exits from bankruptcy. Determining the appropriate method of accounting for the interest in the investee upon loss of power (or control) requires careful consideration of the nature of the rights and interests, such as whether the shareholder has significant influence over the investee, in which case it applies the equity method under IAS 28 see Chapter 12. Alternatively, if the investor does not have significant influence, it likely accounts for its investment in the investee as a financial instrument under IFRS 9.

When an investee files for bankruptcy, parties holding other rights with respect to that investee might also have to consider whether the control assessment has changed. For example, a right that was previously deemed protective (such as the right to appoint an administrator in the event of a bankruptcy - a right that is frequently held by creditors), may be considered to be a right that now gives power. Alternatively, the trustee itself might have power, through its ability to direct the activities of the investee in bankruptcy.

4.3.3 Power without a majority of voting rights (*de facto* control)

An investor might have control over an investee even when it has less than a majority of the voting rights of that investee if its rights are sufficient to give it power, because such rights give the investor the practical ability to direct the relevant activities unilaterally (a concept known as '*de facto* control'). *[IFRS 10.B41]*.

When assessing whether an investor's voting rights are sufficient to give it power, an investor considers all facts and circumstances, including:

(a) The size of the investor's holding of voting rights relative to the size and dispersion of holdings of the other vote holders, noting that:
   (i) The more voting rights an investor holds, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities.
   (ii) The more voting rights an investor holds relative to other vote holders, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities.

   And

   (iii) The more parties that need to act together to outvote the investor, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities.

(b) Potential voting rights held by the investor, other vote holders or other parties

(c) Rights arising from other contractual arrangements

   And

(d) Any additional facts and circumstances that indicate the investor has, or does not have, the current ability to direct the relevant activities at the time that decisions need to be made, including voting patterns at previous shareholders' meetings *[IFRS 10.B42]*

In addition, IFRS 10 states that if it is not clear that the investor has power, having considered the factors above, then the investor does not control the investee. *[IFRS 10.B46]*.

Whether an investor includes voting rights held by related parties not controlled by the investor (e.g., shareholdings held by its parent, sister companies, associates or shareholdings held by key management personnel or other individuals who are related parties) depends on the specific facts and circumstances (i.e., whether the related parties are *de facto* agents of the investor). See section 7 below.

Potential voting rights and rights arising from other contractual arrangements are discussed in sections 4.3.4 to 4.3.6 below. *De facto* control is discussed in more detail below.

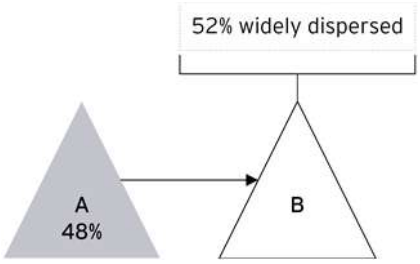
IFRS 10 includes several examples illustrating the assessment of power when an investor has less than a majority of voting rights. Some of these are summarised in Illustration 4-6 to Illustration 4-9 below. Our variation on the examples provided in IFRS 10 is introduced in Illustration 4-10 below. In each of the Illustrations below, it is assumed that, after understanding the purpose and design of the investee:

- Voting rights give an investor the ability to direct activities that most significantly affect the investee's returns (i.e., voting rights give power).
- None of the shareholders has arrangements to consult any of the other shareholders or make collective decisions.
- Decisions require the approval of a majority of votes cast at the shareholders' meeting.
- No other facts or circumstances are relevant.

When the direction of relevant activities is determined by majority vote and an investor holds significantly more voting rights than any other party, and the other shareholdings are widely dispersed, it may be clear, after considering the factors listed in (a)-(c) above alone, that the investor has power over the investee. *[IFRS 10.B43]*. This is shown in Illustration 4-6 below (although factors (b) and (c) are not applicable).

Illustration 4-6: Less than a majority of voting rights (1)

A holds 48% of the voting rights of B; the remaining 52% of B is widely held by thousands of shareholders (none of whom individually holds more than 1% of the voting rights, and none of the shareholders has any arrangements to consult any of the others or make collective decisions).

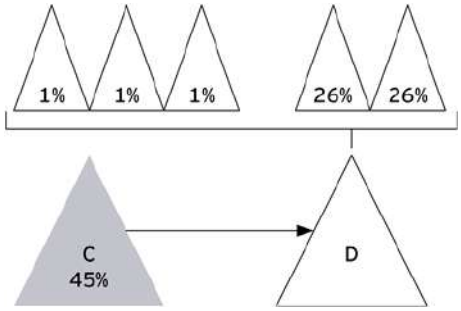


A has power over B, because A has a dominant voting interest (based on the absolute size of its holding, and relative to other shareholders), and a large number of shareholders have to agree to outvote A. *[IFRS 10.B43 Example 4]*.

In other situations, it may be clear after considering the factors listed in (a)-(c) above alone that an investor does not have power. *[IFRS 10.B44]*. This is shown in Illustration 4-7 below (although factors (b) and (c) are not applicable).

Illustration 4-7: Less than a majority of voting rights (2)

C holds 45% of the voting rights in D. Two other investors each hold 26% of the voting rights (total 52%), with the remaining 3% held by three other shareholders, each holding 1%. There are no other arrangements that affect decision-making.



C does *not* have power over D, because the two remaining significant shareholders (i.e., a relatively small number) could easily cooperate to outvote C. The size of C's holding, and size of that holding relative to other shareholders, does *not* give it power. *[IFRS 10.B44 Example 6]*.

However, the factors listed in (a)-(c) above alone may not be conclusive. If an investor, having considered those factors, is unclear whether it has power, it considers additional facts and circumstances, such as whether other shareholders are passive in nature as demonstrated by voting patterns at previous shareholders' meetings. *[IFRS 10.B45]*.

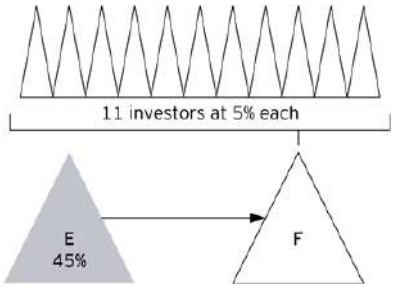
When evaluating past voting patterns, significant judgement will be required to determine how far back to review. Judgement will also be required to determine whether past voting patterns may have been influenced by conditions that existed at a point in time, such as how well the entity was operating during the periods reviewed. For example, if an entity was profitable and operating smoothly, other shareholders may have been less motivated to exercise their voting rights. The fewer voting rights the investor holds, and the fewer parties that need to act together to outvote the investor, the more reliance placed on the additional facts and circumstances to assess whether the investor's rights are sufficient to give it power. *[IFRS 10.B45]*.

Consideration of additional facts and circumstances, referred to in IFRS 10.B45, includes the assessment of the factors that provide evidence of the practical ability to direct the relevant activities of the investee (IFRS 10.B18), and the indicators that the investor may have power as a result of any special relationship with the investee (IFRS 10.B19) or due to the extent of its exposure to variability of returns (IFRS 10.B20), which are discussed in section 4.5 below. When the facts and circumstances in IFRS 10.B18 to B20 are considered together with the investor's rights, greater weight is given to the evidence of power in IFRS 10.B18 than to the indicators of power in IFRS 10.B19 and B20. *[IFRS 10.B45]*.

Illustration 4-8 below shows a situation where the factors in (a)-(c) above alone are not conclusive, and therefore facts and circumstances need to be considered.

Illustration 4-8: Less than a majority of voting rights (3)

E holds 45% of the voting rights in F. The rest of F is dispersed among 11 investors, who each hold 5%. None of the shareholders has contractual arrangements to consult any of the others or make collective decisions.



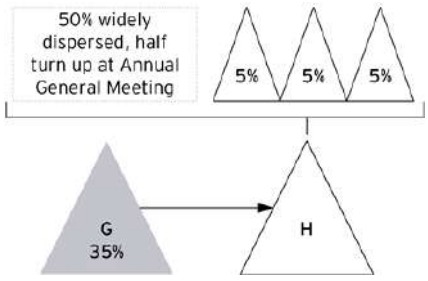
The size of E's holding and the dispersion of the other shareholders are *not* conclusive in determining whether E has power over F. Other relevant facts and circumstances (such as those discussed in section 4.5 below) are considered to determine whether E has power over F. *[IFRS 10.B45 Example 7]*.

Comparing Illustration 4-7 and Illustration 4-8 above shows that judgement will need to be applied in determining whether an investor has power. The IASB considers that it may be easy for two other shareholders to act together to outvote an investor (as in Illustration 4-7 above), but that it may be more difficult for 11 other shareholders to act together to outvote an investor (as in Illustration 4-8 above).

Illustration 4-9 below shows a situation where additional facts and circumstances need to be considered. For example, this may include whether other shareholders are passive in nature as demonstrated by voting patterns at previous shareholders' meetings.

Illustration 4-9: Less than a majority of voting rights (4)

G holds 35% of the voting rights in H. Three other shareholders each hold 5% of the voting rights of H. The remaining 50% of the voting rights are held by numerous other shareholders, none individually holding more than 1% of the voting rights. None of the shareholders has arrangements to consult any of the others or make collective decisions. At recent shareholders' meetings, 75% of the voting rights have been represented (including G).

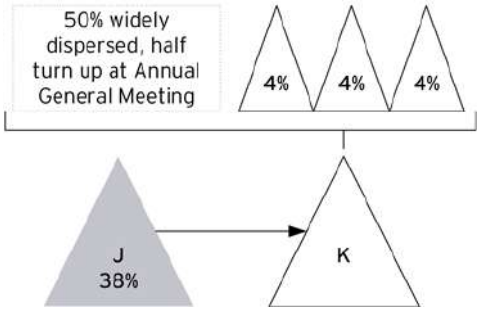


G does not have power over H because the size of G's holding relative to other shareholders, when considering their active participation at recent shareholders' meetings, does not give G the current ability to direct the activities of H. This is the case regardless of whether there is evidence that G directed H in the past, or whether other shareholders voted in the same way as G. *[IFRS 10.B45 Example 8]*.

In Illustration 4-9 above, G cannot have power because it does not have, at a minimum, more than half the votes of shareholders that have turned up at recent meetings. That is, since 75% have turned up at recent meetings, G needs a minimum of 37.5% to have power. A variation of the above scenario is shown in Illustration 4-10 below.

Illustration 4-10: Less than a majority of voting rights (5)

J holds 38% of the voting rights of K. Three other shareholders each hold 4% of the voting rights of K. Numerous other shareholders hold the remaining 50% of the voting rights, although none individually holds more than 1%. At recent shareholders' meetings, 75% of the voting rights have been represented, including J. None of the shareholders has arrangements to consult any of the others or make collective decisions.



There are diverse views regarding the conclusion on this fact pattern, and judgement will need to be applied in practice. Some believe that J has power, because it has more than half the voting rights of those who have turned up at recent shareholder meetings. (J has more than half the voting rights, because J holds 38%, which is more than 37.5%, or half of 75%). Others believe that it is inconclusive whether J has power, because, while J has more than half the voting rights of those who have turned up at recent shareholder meetings, this is just barely the case. Contrast this fact pattern with Illustration 4-6 above, where IFRS 10 concludes that, after all relevant facts and circumstances have been considered, holding 48% in combination with remaining ownership that is widely dispersed results in an entity (A) having power.

Applying the concept of *de facto* control in the absence of 'bright lines' will require significant judgement of the facts and circumstances. For example:

- How large does an investor's interest need to be relative to others?
- How widely dispersed are the other investors? Could three shareholders easily act together?
- Are past voting patterns expected to be indicative of future voting patterns? How much history is needed to make an assessment?
- Are there other relevant agreements between shareholders?

Generally, the lower the percentage held by one investor (the dominant shareholder, in Illustration 4-6 to Illustration 4-10 above), the less likely that investor has *de facto* control.

Although perhaps rare, an investor could find itself in control of an investee simply because of circumstances that exist at a point in time, rather than because of deliberate action (see section 9.3 below). In addition, while it may be easy to use hindsight to determine whether an investor had (or has) control, it might be difficult to apply this principle on a real-time basis. Information will need to be gathered and analysed (e.g., how widely dispersed are the other shareholders), so that management can reach a timely conclusion. It will also be necessary to monitor the changes in the profile of the other shareholders as this could mean that the investor has gained or lost power over the investee (see section 9.3 below).

The following Practical example shows the disclosure of the significant judgements used in determining the existence of *de facto* control.

Practical example 4-1: ENGIE SA (2021) **France**

2021 MANAGEMENT REPORT AND ANNUAL CONSOLIDATED FINANCIAL STATEMENTS [extract]
03 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]
NOTE 3 MAIN SUBSIDIARIES AT DECEMBER 31, 2021 [extract]
3.2 Significant judgements exercised when assessing control [extract]

Entities in which the Group does not have the majority of the voting rights

In the entities in which the Group does not have a majority of the voting rights, judgment is exercised with regard to the following items, in order to assess whether there is a situation of *de facto* control:

- dispersion of the shareholding structure: number of voting rights held by the Group relative to the number of rights held respectively by the other vote holders and their dispersion;
- voting patterns at shareholders' meetings: the percentages of voting rights exercised by the Group at shareholders' meetings in recent years;
- governance arrangements: representation in the governing body with strategic and operational decision-making power over the relevant activities;
- rules for appointing key management personnel;
- contractual relationships and material transactions.

The main fully consolidated entities in which the Group does not have the majority of the voting rights at December 31, 2021 are Compagnie Nationale du Rhône (49.98%).

Compagnie Nationale du Rhône ("CNR" – France excluding Infrastructures): 49.98%

The Group holds 49.98% of the share capital of CNR, with CDC holding 33.2%, and the balance of 16.82% being dispersed among around 200 local authorities. In view of the current provisions of the French "Murcef" law, under which a majority of CNR's share capital must remain under public ownership, the Group is unable to hold more than 50% of the share capital. However, the Group considers that it exercises *de facto* control as it holds the majority of the voting rights exercised at shareholders' meetings due to the widely dispersed shareholding structure and the absence of evidence of the minority shareholders acting in concert.

4.3.4 Potential voting rights

When assessing whether it has power over an investee, an investor also considers the potential voting rights that it holds, as well as potential voting rights held by others. Common examples of potential voting rights include options, forward contracts, and conversion features of a convertible instrument. Those potential voting rights are considered only if the rights are substantive (see section 4.2.1 above). *[IFRS 10.B47]*. In the remainder of this section, reference is made to 'options', but the concepts apply to all potential voting rights.

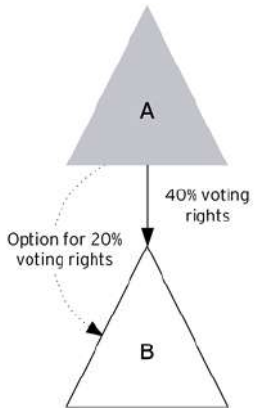
When considering potential voting rights, an investor considers the purpose and design of the entity, including the rights associated with the instrument, as well as those arising from any other involvement the investor has with the investee. This includes an assessment of the various terms and conditions of the instrument as well as the investor's apparent expectations, motives and reasons for agreeing to those terms and conditions. *[IFRS 10.B48]*.

If the investor also has voting or other decision-making rights relating to the investee's activities, the investor assesses whether those rights, in combination with potential voting rights, give the investor power. *[IFRS 10.B49]*.

Substantive potential voting rights alone, or in combination with other rights, may provide an investor the current ability to direct the relevant activities. *[IFRS 10.B50]*. For example, if an investor has less than a majority of voting rights, but holds a substantive option that, if exercised, gives the investor a majority of voting rights, that investor likely has power. *[IFRS 10.B42, IFRS 10.B50]*. Illustration 4-11 below shows when holding an option would likely give an investor power.

Illustration 4-11: Potential voting rights (1)

A holds 40% of the voting rights of B, and holds a currently exercisable in-the-money option to acquire a further 20% of the voting rights of B.



Assuming that voting rights give power over B, the option is substantive, and no other facts and circumstances are relevant to this assessment, A would likely have power over B, because A can currently exercise its right to obtain a majority of B's voting shares at any time.

The opposite is also true. If an investor holds a majority of the voting rights, but those voting rights are subject to a substantive option held by another investor, the majority shareholder would likely not have power.

Another example provided by IFRS 10 of a situation where substantive potential voting rights, in combination with other rights, can give an investor the current ability to direct the relevant activities is reflected in Illustration 4-12 below.

Illustration 4-12: Potential voting rights (2)

Investor A and two other investors each hold a third of the voting rights of an investee. The investee's business activity is closely related to investor A. In addition to its equity instruments, investor A also holds debt instruments that are convertible into ordinary shares of the investee at any time for a fixed price that is out of the money (but not deeply out of the money). If the debt were converted, investor A would hold 60% of the voting rights of the investee. Investor A would benefit from realising synergies if the debt instruments were converted into ordinary shares. Investor A has power over the investee because it holds voting rights of the investee together with substantive potential voting rights that give it the current ability to direct the relevant activities. *[IFRS 10.B50 Example 10]*.

IFRS 10 is silent on whether the intention of the holder (i.e., whether the holder intends to exercise the option or not) is considered in the assessment of potential voting rights. However, IFRS 10 is clear that power arises from rights in themselves, and the ability those rights give the investor to direct the relevant activities. *[IFRS 10.B14]*. Therefore, an option is only considered in the assessment of power if it is substantive (i.e., the holder has the practical ability to exercise the option when decisions about the direction of relevant activities need to be made). *[IFRS 10.B22, IFRS 10.B24, IFRS 10.B47]*. As discussed in section 4.2.1 above, whether an option is substantive depends on facts and circumstances. Common factors to consider when evaluating whether an option is substantive include:

- Exercise price or conversion price, relative to market terms
- Ability to obtain financing

  And
- Timing and length of exercise period

These factors are each discussed in more detail below, and their implications are indicated in the table below. The evaluation of whether an option is substantive considers all the factors discussed in section 4.2.1 above, rather than limited to only one of the factors.

Figure 4-2: Evaluating whether potential voting rights are substantive

Evaluation	Non-substantive	Depends on facts and circumstances	Substantive
Exercise price	Deeply-out-of-the-money	Out-of-the-money or at market (fair value)	In-the-money
Financial ability to exercise	Holder has no financial ability	Holder would have to raise financing	Holder has cash or financing readily available
Exercise period	Not exercisable	Exercisable before decisions need to be made	Currently exercisable

4.3.4.A Exercise price or conversion price

IFRS 10 is clear that the exercise price (or conversion price) can and must be considered, in evaluating whether an option can give power, because it might represent a barrier to exercise. *[IFRS 10.B23(a)(ii)]*. Factors to consider are:

- ***Deeply-out-of-the-money***

  Generally, these are considered non-substantive.
- ***Out-of-the-money (but not deeply)***

  Judgement will be needed to assess whether the cost of paying more than fair value is worth the potential benefits of exercise, including the exposures to variable returns that are associated with exercising that option (see section 5 below for examples of exposures to variable returns).
- ***At market (fair value)***

  Consideration must be given as to whether the option conveys rights that differ from those that are available to third parties in an open market.
- ***In-the-money***

  Generally, in-the-money options are considered substantive.

IFRS 10 does not define 'deeply-out-of-the-money' or provide a list of indicators for management to consider when exercising judgement in determining whether an option is deeply-out-of-the-money (as opposed to merely out-of-the-money). A call option with a strike price significantly above the value of the underlying interest is normally considered to be deeply-out-of-the-money.

When evaluating the exercise price, consideration is given as to whether the nature of the exercise price (e.g., deeply-out, out, or in-the-money) is expected to remain so for the entire exercise period, or whether the nature of the exercise price may change in the future. That is, the evaluation is not solely based on the nature of the option at inception or as at the end of the reporting period. This is because to convey power, an option must give an investor the current ability to direct the relevant activities when the decisions need to be made. Thus, for example, if an option was deeply-out-of-the-money at the reporting date, but the exercise price was subject to decrease such that the option was expected to become in-the-money before the relevant activities of the investee need to be directed, then the option may be substantive (or *vice versa*). This evaluation will require the exercise of judgement based on all relevant facts and circumstances. As noted above, the evaluation is not solely based on the nature of the option as at the end of the reporting period, i.e., whether a potential voting right is substantive is not based solely on a comparison of the strike or conversion price of the instrument and the then current market price of its underlying share. Although the strike or conversion price is one factor to consider, determining whether potential voting rights are substantive requires a holistic approach, considering a variety of factors. This includes assessing the purpose and design of the instrument, considering whether the investor can benefit for other reasons such as by realising synergies between the investor and the investee, and determining whether there are any barriers (financial or otherwise) that prevent the holder of potential voting rights from exercising or converting those rights. Accordingly, a change in market conditions (i.e., the market price of the underlying shares) alone does not typically result in a change in the consolidation conclusion. *[IFRS 10.BC124]*.

Illustration 4-13 below reflects an example from IFRS 10 of an option that is currently exercisable but is deeply-out-of-the-money and is expected to remain so for the whole of the exercise period. *[IFRS 10.B50 Example 9]*.

Illustration 4-13: Potential voting rights (3)

Investor A holds 70% of the voting rights of an investee. Investor B has 30% of the voting rights of the investee as well as an option to acquire half of investor A's voting rights. The option is exercisable for the next two years at a fixed price that is deeply out of the money (and is expected to remain so for that two-year period). Investor A has been exercising its votes and is actively directing the relevant activities of the investee. In such a case, investor A is likely to meet the power criterion because it appears to have the current ability to direct the relevant activities. Although investor B has currently exercisable options to purchase additional voting rights (that, if exercised, would give it a majority of the voting rights in the investee), the terms and conditions associated with those options are such that the options are not considered substantive.

4.3.4.B Financial ability

The financial ability of an investor to pay the exercise price must be considered when evaluating whether an option is substantive, because this could be an 'economic barrier' as contemplated by IFRS 10. *[IFRS 10.B23(a)]*. For example, if there is evidence that an investor cannot obtain financing to exercise an in-the-money option, this might indicate that the option is not substantive. However, financial ability is generally considered to be linked to the exercise price, because an investor is usually able to obtain financing for an in-the-money option. As such, instances in which an investor is unable to obtain financing for in-the-money options are expected to be uncommon.

In contrast, it is probably more common that the holder has the financial ability to exercise an option that is out-of-the-money (but not deeply so) and considers exercising that option to benefit from synergies. This might be the case when the investee has strategic importance to the option holder.

4.3.4.C Exercise period

To have power over an investee, an investor must have existing rights that give the investor the current ability to direct an investee's relevant activities. *[IFRS 10.10]*. This implies that an option needs to be currently exercisable to give power. However, under IFRS 10, an option can give an investor the current ability to direct an investee's relevant activities even when it is not currently exercisable. Although 'current' often means 'as of today' or 'this instant' in practice, the IASB's use of the term in IFRS 10 broadly refers to the ability to make decisions about an investee's relevant activities when they need to be made. *[IFRS 10.B24]*. This is shown in Illustration 4-14 below.

Illustration 4-14: Potential voting rights (4)

An investee holds annual shareholder meetings, at which decisions to direct the relevant activities are made. An investor holds an option to acquire the majority of shares in the investee, which is not currently exercisable. However, the option is exercisable before the next scheduled shareholder meeting, and before the next special shareholder meeting could be held (based on the investee's governance policies).

When considering solely the exercise period, the investor's option is a substantive right that gives the investor power (since it gives the holder a majority of shares). This is because the investor *does have* the current ability to direct the investee's relevant activities when decisions need to be made, i.e., at the next scheduled shareholder meeting or next special shareholder meeting.

However, when concluding whether an investor has power over the investee in real fact patterns, all relevant facts and circumstances are considered, to evaluate whether the option is substantive, not solely the exercise period.

In contrast, if the next shareholders' meeting occurs (or could be held) before the option is exercisable, that option is not a right that gives the holder the current ability to direct the investee's activities (and therefore does not give the holder power). This is consistent with the conclusion for Scenario D in Illustration 4-4 in section 4.2.1 above.

IFRS 10 does not contain separate requirements for different types of potential voting rights; that is, employee options are subject to the same requirements as those that are held by a third party. However, it is unlikely that an option held by an employee gives that employee power (or control) over an investee in practice, usually because the employee options represent a small percentage of the outstanding shares, even if exercised. However, in a very small, privately owned entity it is possible for an employee (such as a member of management) to have power, if an option gives the employee the current ability to direct the relevant activities, or if the employee has other interests in the investee.

It is noted that the IASB considered, but did not change, similar requirements in IAS 28 related to how options are considered when evaluating whether an investor has significant influence. That is, IAS 28 does not incorporate the IFRS 10 concept of evaluating whether an option is substantive (see Chapter 12 at section 2.3). Accordingly, an option might give power under IFRS 10, but the same option might not result in significant influence under IAS 28.

Simply holding a currently exercisable option that, if exercised, gives the investor more than half of the voting rights in an investee is not sufficient to demonstrate control of the investee. All facts and circumstances must be considered to assess whether an investor has power over an investee, including whether an option is substantive (including, but not limited to consideration of the exercise period). This may require considerable judgement to be exercised.

4.3.5 Contractual arrangement with other vote holders

A contractual arrangement between an investor and other vote holders can give the investor the right to exercise voting rights sufficient to give the investor power, even if the investor does not have voting rights sufficient to give it power without the contractual arrangement. However, a contractual arrangement might ensure that the investor can direct enough other vote holders on how to vote to enable the investor to make decisions about the relevant activities. *[IFRS 10.B39]*.

It is noted that the contractual arrangement has to ensure that investor can direct the other party to vote as required. When the arrangement is merely that the parties agree to vote the same way, that only represents joint control; defined as the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control. *[IFRS 11 Appendix A]*. Joint control is discussed in more detail in Chapter 13 at section 4.

In some jurisdictions, investors holding a certain number of issued shares of a public company may be able to obtain proxy votes from other shareholders by public request or other means for voting at shareholder meetings. The question as to whether the investor has the ability to obtain a majority of votes (and hence power over an investee) through control of proxy votes will depend on the specific facts and circumstances of the process such as, for example, the investor's freedom to use the proxy vote and whether any statements of voting intent must be provided by the investor as a condition of obtaining the proxy vote. A situation where, for example, proxies must be requested each year makes it more difficult to demonstrate that the investor had power as a result of its ability to obtain proxy votes.

4.3.6 Additional rights from other contractual arrangements

Other decision-making rights, in combination with voting rights, can give an investor the current ability to direct the relevant activities. For example, the rights specified in a contractual arrangement in combination with voting rights may be sufficient to give an investor the current ability to direct the manufacturing processes of an investee or to direct other operating or financing activities of an investee that significantly affect the investee's returns. However, in the absence of any other rights, economic dependence of an investee on the investor (e.g., relations of a supplier with its main customer) does not lead to the investor having power over the investee. *[IFRS 10.B40]*.

Illustration 4-15 below reflects an example from IFRS 10 of a situation where an investor with less than a majority of the voting rights is considered to have power of the investee, taking into account rights under a contractual arrangement. *[IFRS 10.B43 Example 5]*.

Illustration 4-15: Less than a majority of voting rights combined with additional rights under a contractual arrangement

Investor A holds 40% of the voting rights of an investee and twelve other investors each hold 5% of the voting rights of the investee. The shareholder agreement grants investor A the right to appoint, remove and set the remuneration of management responsible for directing the relevant activities. To change the agreement, a two-thirds majority vote of the shareholders is required. In this case, investor A concludes that the absolute size of the investor's holding and the relative size of the other shareholdings alone are not conclusive in determining whether the investor has rights sufficient to give it power. However, investor A determines that its contractual right to appoint, remove and set the remuneration of management is sufficient to conclude that it has power over the investee. The fact that investor A might not have exercised this right or the likelihood of investor A exercising its right to select, appoint or remove management shall not be considered when assessing whether investor A has power.

4.4 Contractual arrangements

Power stems from existing rights. Sometimes, the relevant activities are not directed through voting rights, but rather, are directed by other means, such as through one or more contractual arrangements. *[IFRS 10.11]*. For example, an investor might have the contractual ability to direct manufacturing processes, operating activities, or determine financing of an investee through a contract or other arrangement.

Similarly, when voting rights cannot have a significant effect on an investee's returns, such as when voting rights relate to administrative tasks only and contractual arrangements determine the direction of the relevant activities, the investor needs to assess those contractual arrangements in order to determine whether it has rights sufficient to give it power over the investee. To determine whether an investor has rights sufficient to give it power, the investor considers the purpose and design of the investee (see IFRS 10.B5 to B8 discussed in section 3.2 above) and the requirements in IFRS 10.B51 to B54 (discussed below) together with IFRS 10.B18 to B20 (see section 4.5 below). *[IFRS 10.B17]*.

When these contractual arrangements involve activities that are closely related to the investee, then these activities are, in substance, an integral part of the investee's overall activities, even though they may occur outside the legal boundaries of the investee. Therefore, explicit or implicit decision-making rights embedded in contractual arrangements that are closely related to the investee need to be considered as relevant activities when determining power over the investee. *[IFRS 10.B52]*.

When identifying which investor, if any, has power over an investee, it is important to review the contractual arrangements that the investor and the investee entered into. This analysis includes the original formation documents and governance documents of the investee, as well as the marketing materials provided to investors and other contractual arrangements entered into by the investee.

It is common that the relevant activities of a structured entity are directed by contractual arrangement. This is discussed further in section 4.4.1 below.

4.4.1 Structured entities

IFRS 12 defines a structured entity as: *[IFRS 12 Appendix A]*

Extract from IFRS 12

Appendix A
Defined terms

structured entity	An entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. Paragraphs B22-B24 provide further information about structured entities.

Therefore, an entity that is controlled by voting rights is not a structured entity. Accordingly, although it might be thought that an entity that receives funding from third parties following a restructuring is a structured entity, this is not the case, if that entity continues to be controlled by voting rights after the restructuring. *[IFRS 12.B24]*.

A structured entity often has some or all of the following features:

- Restricted activities
- A narrow and well-defined objective, such as:
  - Holding a tax-efficient lease
  - Carrying out research and development activities
  - Funding an entity

    Or
  - Providing investment opportunities for investors by passing on risks and rewards associated with assets to investors
- Insufficient equity to finance its activities without subordinated financial support
- Financing in the form of multiple contractually linked instruments to investors that create concentrations of credit or other risks (tranches) *[IFRS 12.B22]*

Examples of structured entities include:

- Securitisation vehicles
- Asset-backed financings
- Some investment funds *[IFRS 12.B23]*

Management needs to evaluate whether it controls a structured entity using the same approach as for 'traditional entities' (those that are controlled through voting rights). That is, management evaluates whether an investor has power over the relevant activities, exposure to variable returns and the ability to affect those returns through its power over the structured entity, as shown in the diagram in section 3.1 above. Frequently, as discussed above, the relevant activities of a structured entity are directed by contractual arrangement.

For some investees, relevant activities occur only when particular circumstances arise or events occur. The investee may be designed so that the direction of its activities and returns are predetermined unless and until those particular circumstances arise or events occur. In this case, only the decisions about the investee's activities when those circumstances or events occur can significantly affect its returns and thus be relevant activities. The circumstances or events need not have occurred for an investor with the ability to make those decisions to have power. The fact that the right to make decisions is contingent on circumstances arising or an event occurring does not, in itself, make those rights protective. *[IFRS 10.B53]*.

This is shown in Illustration 4-16 below, which is summarised from an example included in IFRS 10. *[IFRS 10.B53 Example 11]*.

Illustration 4-16: Power through contractual arrangements

An investee's only business activity, as specified in its founding documents, is to purchase receivables and service them on a day-to-day basis for its investor. The servicing includes collecting the principal and interest payments as they fall due and passing them on to the investor. For any receivable in default, the investee is required to automatically put the receivable in default to the investor, as contractually agreed in the put agreement between the investor and the investee.

The relevant activity is managing the receivables in default because it is the only activity that can significantly affect the investee's returns. Managing the receivables before default is not a relevant activity because it does not require substantive decisions to be made that could significantly affect the investee's returns - the activities before default are predetermined and amount only to collecting cash flows as they fall due and passing them on to investors.

The purpose and design of the investee gives the investor decision-making authority over the relevant activity. The terms of the put agreement are integral to the overall transaction and the establishment of the investee. Therefore, the put agreement, together with the founding documents of the investee, gives the investor power over the investee. This is the case, even though:

- The investor takes ownership of the receivables only in the event of default.

  And

- The investor's exposures to variable returns are *not* technically derived from the investee (because the receivables in default are no longer owned by the investee and are managed outside the legal boundaries of the investee).

To conclude whether the investor has control, it also needs to assess whether the other two criteria are met, i.e., it has exposure to variable returns from its involvement with the investee (see section 5 below) and the ability to use its power over the investee to affect the amount of its returns (see section 6 below). *[IFRS 10.7, IFRS 10.B2]*.

IFRS 10 also includes a much simpler example where the only assets of an investee are receivables and when the purpose and design of the investee are considered, it is determined that the only relevant activity is managing the receivables upon default. In this situation, the party that has the ability to manage the defaulting receivables has power over the investee, irrespective of whether any of the borrowers have defaulted. *[IFRS 10.B53 Example 12]*.

An investor may have an explicit or implicit commitment to ensure that an investee continues to operate as designed. Such a commitment may increase the investor's exposure to variability of returns and thus increase the incentive for the investor to obtain rights sufficient to give it power. Therefore, a commitment to ensure that an investee operates as designed may be an indicator that the investor has power, but does not, by itself, give an investor power, nor does it prevent another party from having power. *[IFRS 10.B54]*.

Notwithstanding the fact that the same approach is used to evaluate control for structured entities and traditional entities, it is still important to identify which entities are structured entities. This is because certain disclosure requirements of IFRS 12 apply only to structured entities, as discussed in Chapter 14.

4.5 Other evidence of power

In some circumstances, it may be difficult to determine whether an investor's rights give it power over an investee. In such cases, the investor considers other evidence that it has the current ability to direct an investee's relevant activities unilaterally. Consideration is given, but is not limited, to the following factors, which, when considered together with its rights, the indicators of a special relationship with the investee and the extent of the investor's exposure to variability of returns (see below), may provide evidence that the investor's rights are sufficient to give it power over the investee:

- The investor can, without having the contractual right to do so, appoint, approve or nominate the investee's key management personnel (or board of directors) who have the ability to direct the relevant activities
- The investor can, without having the contractual right to do so, direct the investee to enter into, or veto any changes to, significant transactions for the benefit of the investor
- The investor can dominate either the nominations process for electing members of the investee's governing body, or obtaining proxies from other holders of voting rights
- The investee's key management personnel are related parties of the investor (for example, the chief executive officer of the investee and the chief executive officer of the investor are the same person)

  Or
- The majority of the members of the investee's governing body are related parties of the investor *[IFRS 10.B18]*

When the above factors and the indicators set out below are considered together with an investor's rights, IFRS 10 requires that greater weight is given to the evidence of power described above. *[IFRS 10.B21]*. Sometimes, there will be indications that an investor has a special relationship with the investee, which suggests that the investor has more than a passive interest in the investee. The existence of any individual indicator, or a particular combination of indicators, does not necessarily mean that the power criterion is met. However, having more than a passive interest in an investee may indicate that the investor has other rights that give it power over the investee or provide evidence of existing power over the investee. For example, IFRS 10 states that this might be the case when the investee:

- Is directed by key management personnel who are current or previous employees of the investor
- Has significant:
  - Obligations that are guaranteed by the investor

    Or
  - Activities that either involve or are conducted on behalf of the investor
- Depends on the investor for:
  - Funds for a significant portion of its operations
  - Licences, trademarks, services, technology, supplies or raw materials that are critical to the investee's operations

    Or
  - Key management personnel, such as when the investor's personnel have specialised knowledge of the investee's operations

  Or
- The investor's exposure, or rights, to returns from its involvement with the investee is disproportionately greater than its voting or other similar rights. For example, there may be a situation in which an investor is entitled, or exposed, to more than half of the returns of the investee but holds less than half of the voting rights of the investee. *[IFRS 10.B19]*.

As noted in section 4.2.3 above, the greater an investor's exposure, or rights, to variability of returns from its involvement with an investee, the greater is the incentive for the investor to obtain rights sufficient to give it power. IFRS 10 adds the following: "Therefore, having a large exposure to variability of returns is an indicator that the investor may have power. However, the extent of the investor's exposure does not, in itself, determine whether an investor has power over the investee." *[IFRS 10.B20]*.

4.6 Determining whether sponsoring (designing) a structured entity gives power

IFRS 10 discusses whether sponsoring (that is, designing) a structured entity gives an investor power over the structured entity.

In assessing the purpose and design of an investee, an investor considers the involvement and decisions made at the investee's inception as part of its design and evaluates whether the transaction terms and features of the involvement provide the investor with rights that are sufficient to give it power. Being involved in the design of an investee alone is not sufficient to give an investor control. However, involvement in the design may indicate that the investor had the opportunity to obtain rights that are sufficient to give it power over the investee. *[IFRS 10.B51]*.

An investor's involvement in the design of an investee does not mean that the investor necessarily has control, even if that involvement was significant. Rather, an investor has control of an investee when all three criteria of control are met (see section 3.1 above), considering the purpose and design of the investee. Thus, an investor's involvement in the design of an investee is part of the context when concluding if it controls the investee, but is not determinative. There appear to be relatively few structured entities that have no substantive decision-making. *[IFRS 10.13]*.

That is, virtually all structured entities have some level of decision-making and few, if any, are on 'autopilot' (see section 4.1.2 above). In such cases, if that decision-making can significantly affect the returns of the structured entity, the investor with the rights to make those decisions has power. This is because IFRS 10 clarifies that an investor has power when it has existing rights that give it the current ability to direct the relevant activities, even if those relevant activities only occur when particular circumstances arise or specific events occur (see section 4.1.1 above).

However, a structured entity with limited decision-making requires additional scrutiny to determine which investor, if any, has power (and possibly control) over the structured entity, particularly for the investors that have a potentially significant explicit or implicit exposure to variable returns. Careful consideration is required regarding the purpose and design of the structured entity.

In addition, the evaluation of power may require an analysis of the decisions made at inception of the structured entity, including a review of the structured entity's governing documents, because the decisions made at formation may affect which investor, if any, has power.

For a structured entity with a limited range of activities, such as certain securitisation entities, power is assessed based on which activities, if any, significantly affect the structured entity's returns, and if so, which investor, if any, has existing rights that give it the current ability to direct those activities. The following considerations may also be relevant when determining which investor, if any, has power (and possibly control):

- An investor's ability to direct the activities of a structured entity only when specific circumstances arise or events occur may constitute power if that ability relates to the activities that most significantly affect the structured entity's returns (see section 4.1.1 above).
- An investor does not have to actively exercise its power to have power over a structured entity (see section 4.2.1 above).

  Or

- An investor is more incentivised to obtain power over a structured entity the greater its obligation to absorb losses or its right to receive benefits from the structured entity (see section 4.2.3 above).

5 Exposure to variable returns

The second criterion for assessing whether an investor has control of an investee is determining whether the investor has an exposure, or has rights, to variable returns from its involvement with the investee. *[IFRS 10.B55, IFRS 10.15, IFRS 10.16]*.

Extract from IFRS 10

Returns

15 An investor is exposed, or has rights, to variable returns from its involvement with the investee when the investor's returns from its involvement have the potential to vary as a result of the investee's performance. The investor's returns can be only positive, only negative or both positive and negative.

16 Although only one investor can control an investee, more than one party can share in the returns of an investee. For example, holders of non-controlling interests can share in the profits or distributions of an investee.

Variable returns are returns that are not fixed and have the potential to vary as a result of the performance of an investee. As discussed in section 5.2 below, returns that appear fixed can be variable. *[IFRS 10.B56]*.

Examples of exposures to variable returns include:

- Dividends, fixed interest on debt securities that expose the investor to the credit risk of the issuer (see section 5.2 below), variable interest on debt securities, other distributions of economic benefits and changes in the value of an investment in an investee
- Remuneration for servicing an investee's assets or liabilities, fees and exposure to loss from providing credit or liquidity support, residual interests in the investee's assets and liabilities on liquidation of that investee, tax benefits and access to future liquidity that an investor has from its involvement with the investee
- Economies of scale, cost savings, scarce products, proprietary knowledge, synergies, or other exposures to variable returns that are not available to other investors (see section 5.4 below) *[IFRS 10.B57]*

Simply having an exposure to variable returns from its involvement with an investee does not mean that the investor has control. To control the investee, the investor also needs to have power over the investee, and the ability to use its power over the investee to affect the amount of the investor's returns. *[IFRS 10.7, IFRS 10.B2]*. For example, it is common for a lender to have an exposure to variable returns from a borrower through interest payments that it receives from the borrower, that are subject to credit risk. However, the lender does not control the borrower if it does not have the ability to affect those interest payments (which is frequently the case).

It is emphasised that with respect to this criterion, the focus is on the existence of an exposure to variable returns, not the amount of the exposure to variable returns.

5.1 Exposure to variable returns can be an indicator of power

Exposure to variable returns can be an indicator of power by the investor. This is because the greater an investor's exposure to the variability of returns from its involvement with an investee, the greater the incentive for the investor to obtain rights that give the investor power. However, the magnitude of the exposure to variable returns is not determinative of whether the investor holds power. *[IFRS 10.B20]*.

When an investor's exposure, or rights, to variable returns from its involvement with the investee are disproportionately greater than its voting or other similar rights, this might be an indicator that the investor has power over the investee when considered with other rights. *[IFRS 10.B19, IFRS 10.B20]*.

5.2 Returns that appear fixed can be variable

An investor assesses whether exposures to returns from an investee are variable, based on the substance of the arrangement (regardless of the legal form of the returns). Even a return that appears fixed may actually be variable.

IFRS 10 gives the example of an investor that holds a bond with fixed interest payments. The fixed interest payments are considered an exposure to variable returns, because they are subject to default risk and they expose the investor to the credit risk of the issuer of the bond. How variable those returns are depends on the credit risk of the bond. *[IFRS 10.B56]*. The same logic extends to the investor's ability to recover the principal of the bond.

Similarly, IFRS 10 also explains that fixed performance fees earned for managing an investee's assets are considered an exposure to variable returns, because they expose the investor to the performance risk of the investee. That is, the amount of variability depends on the investee's ability to generate sufficient income to pay the fee. *[IFRS 10.B56]*. Performance fees that vary based on the value of an investee's assets are also an exposure to variable returns using the same reasoning.

In contrast, a non-refundable fee received up-front (wherein the investor does not have exposure to credit risk or performance risk) is likely to be considered a fixed return.

5.3 Evaluating whether derivatives provide an exposure to variable returns

Investors need to evaluate whether being party to a derivative gives them an exposure to a variable return.

As indicated in section 3.2 above, an investee may be designed so that voting rights are not the dominant factor in deciding who controls the investee, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. In such cases, an investor's consideration of the purpose and design of the investee also includes consideration of the risks to which the investee was designed to be exposed, the risks that it was designed to pass on to the parties involved with the investee and whether the investor is exposed to some or all of these risks. Consideration of the risks includes not only the downside risk, but also the potential for upside. *[IFRS 10.B8]*.

When evaluating whether being party to a derivative is an exposure to a variable return, it is helpful to follow these steps:

- Analyse the nature of the risks in the investee - for example, assess whether the purpose and the design of the investee exposes the investor to the following risks:
  - Credit risk
  - Interest rate risk (including prepayment risk)
  - Foreign currency exchange risk
  - Commodity price risk
  - Equity price risk
  - Operational risk
- Determine the purpose(s) for which the investee was created - for example, obtain an understanding of the following:
  - Activities of the investee
  - Terms of the contracts the investee has entered into
  - Nature of the investee's interests issued
  - How the investee's interests were negotiated with, or marketed to, potential investors
  - Which investors participated significantly in the design or redesign of the entity

  And
- Determine the variability that the investee is designed to create and pass along to its interest holders - considering the nature of the risks of the investee and the purposes for which the investee was created

Some might argue that any derivative creates an exposure to variable returns, even if that exposure is only a positive exposure. However, we do not believe that this was the IASB's intention, given the following comments made by the IASB in both the Basis for Conclusions accompanying IFRS 10 and the Application Guidance of IFRS 12. *[IFRS 10.BC66, IFRS 12.B9]*.

Extract from IFRS 10

BC66 Some instruments are designed to transfer risk from a reporting entity to another entity. During its deliberations, the Board concluded that such instruments create variability of returns for the other entity but do not typically expose the reporting entity to variability of returns from the performance of the other entity. For example, assume an entity (entity A) is established to provide investment opportunities for investors who wish to have exposure to entity Z's credit risk (entity Z is unrelated to any other party involved in the arrangement). Entity A obtains funding by issuing to those investors notes that are linked to entity Z's credit risk (credit-linked notes) and uses the proceeds to invest in a portfolio of risk-free financial assets. Entity A obtains exposure to entity Z's credit risk by entering into a credit default swap (CDS) with a swap counterparty. The CDS passes entity Z's credit risk to entity A, in return for a fee paid by the swap counterparty. The investors in entity A receive a higher return that reflects both entity A's return from its asset portfolio and the CDS fee. The swap counterparty does not have involvement with entity A that exposes it to variability of returns from the performance of entity A because the CDS transfers variability to entity A, rather than absorbing variability of returns of entity A.

This principle is applied in the following Illustration.

Illustration 5-1: Derivatives that create risk for an investee

A structured entity (Entity A) enters into a CDS whereby a bank passes the credit risk of a reference asset to the structured entity and, hence, to the investors of that structured entity. In this Illustration, if the bank has the power to amend the referenced credit risk in the CDS, it has power over a relevant activity. However, as the bank, through the CDS, creates rather than absorbs risk, the bank is not exposed to a variable return. Consequently, the bank is not able to use its power to affect its variable returns and so does not control the structured entity.

How we see it

In our view, a derivative that introduces risk to an investee (e.g., a structured entity) is not normally considered an exposure to variable returns under IFRS 10. Only a derivative that exposes a counterparty to risks that the investee was designed to create and pass on is considered an exposure to variable returns under IFRS 10. We believe this view is consistent with the IASB's intentions.

5.3.1 Plain vanilla foreign exchange swaps and interest rate swaps

It is important to consider the purpose and design of the entity when evaluating whether a plain vanilla foreign exchange or interest rate swap is considered a creator or absorber of variable returns.

How we see it

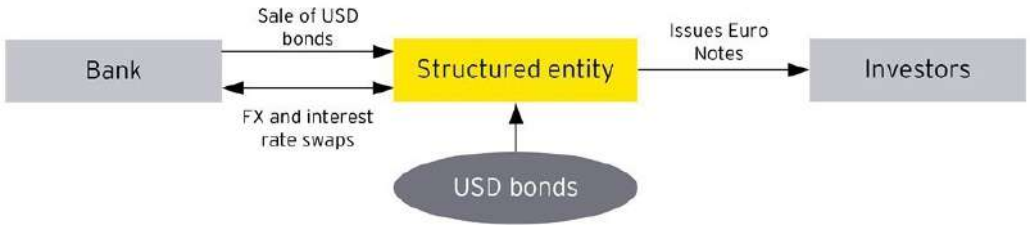
It is our view that an exposure to variable returns generally absorbs the variability created by the investee's assets, liabilities or other contracts, and the risks the investee was designed to pass along to its investors. Therefore, if a derivative is entered into to reduce the variability of a structured entity's cash flows (such as might arise from movements in foreign currency or interest rates), it is not intended to absorb the cash flows of the entity. Instead, the derivative is entered into to align the cash flows of the assets of the structured entity with those of the investors and so reduce the risks to which the investors in the structured entity are exposed. Accordingly, the counterparty does not have an exposure to a variable return.

Meanwhile, a counterparty to a foreign exchange or interest rate swap typically has a senior claim on any cash flows due under the swap relative to any noteholders. Consequently, it is unlikely to be exposed to the credit risk of the assets held by the structured entity, or else that risk will be deemed to be insignificant (i.e., losses on the assets would need to be so large that there are insufficient funds in the structured entity to settle the derivatives).

However, if payments on a swap were subordinate to the rights of noteholders, or contractually referenced to the performance of the underlying assets in the structured entity, the counterparty is exposed to the risk associated with the performance of the underlying assets (i.e., the risk that the structured entity may be unable to fulfil its obligations under the swap). In that case, if the swap counterparty had power over the structured entity because it has the ability to manage its assets, it is likely that it is deemed to have the ability to affect its variable returns and so controls the structured entity.

The above principles are shown in Illustration 5-2 below.

Illustration 5-2: Structured entity that enters into foreign currency and interest rate swaps



A bank designs a structured entity to meet the requirements of European investors, who wish to be exposed to US corporate bonds without the foreign exchange risk. The structured entity buys dollar-denominated debt securities through the bank, issues euro-denominated notes and hedges the cash flow differences through a series of swaps entered into with the bank. Subsequently, the structured entity collects and pays the resultant cash flows. The bonds will be held by the structured entity until maturity and cannot be substituted. The bank manages the assets, including in the event of their default and earns a fixed fee for its services. The right to receive the fee ranks more senior than the notes.

Most of the activities of the structured entity are predetermined. It is possible that the relevant activity is the management of the assets in the event of default as discussed in section 4.1.4 above. If this is the case, power is held by the bank, since it has the existing rights that give it the current ability to direct this activity. In evaluating the bank's exposure to variable returns from its involvement with the structured entity:

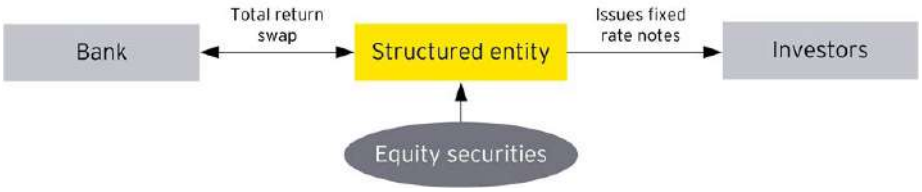
- The foreign currency and interest rate risks were not risks that the structured entity was designed to be exposed to or to pass on to the bank.
- The bank's exposure to movements in foreign exchange and interest rate risks is not affected by its power over the relevant activity.
- The fixed fee that the bank earns is not considered a variable return as its payment is unlikely to be affected by the credit risk of the bonds.
- The bank's exposure to potential credit risk on its derivatives is considered insignificant, as that risk only arises if losses on the bonds were so large that there were insufficient funds in the structured entity to settle the derivatives.

In conclusion, even if the bank has power by virtue of managing the defaults (i.e., the relevant activity), the bank has no exposure to variable returns, and thus does not control the structured entity and so does not consolidate it.

5.3.2 Total return swaps

The principles discussed in section 5.3.1 above are also relevant where a structured entity enters into a total return swap, since the swap creates an equal, but opposite risk to each party, as shown in Illustration 5-3 below.

Illustration 5-3: Structured entity that enters into a total return swap



A structured entity acquires a portfolio of equity securities from the market, issues fixed rate notes to investors and hedges the mismatch in cash flows between the equity securities and the notes through entering into a total return swap with a bank. The choice of equity securities that make up the portfolio is pre-agreed by the bank and the note investors. However, the bank also has substitution rights over the equity securities held by the structured entity within certain parameters. The terms of this swap are that the structured entity pays the bank any increase in value of the securities and any dividends received from them, while the bank pays the structured entity any decline in the value of the securities and interest at a fixed rate.

The structured entity was designed to give equity risk to the bank while the noteholders earn a fixed rate of interest. The bank's substitution rights over the equity securities is likely the relevant activity, because it may significantly affect the structured entity's returns. Therefore, the bank has power. The bank also has an exposure to variable returns since it absorbs the equity risk. Since it has the ability to use its power to affect its returns from the total return swap, all three criteria for control are met and the bank consolidates the structured entity.

5.4 Exposures to variable returns not directly received from an investee

When identifying an exposure to variable returns, an investor must include all variable returns resulting from its investment including not only those directly received from the investee but also returns generated as a result of the investment that are not available to other interest holders. *[IFRS 10.B57]*.

Generally, the focus is on the variable returns that are generated by the investee. However, depending on the purpose and design of the arrangements and the investee, when the investor receives variable returns that are not generated by the investee, but stem from involvement with the investee, these variable returns are also considered.

Examples of such variable returns include using assets in combination with the assets of the investee, such as combining operating functions to achieve economies of scale, cost savings, sourcing scarce products, gaining access to proprietary knowledge or limiting some operations or assets, to enhance the value of the investor's other assets. *[IFRS 10.B57(c)]*.

5.5 Exposure to variable returns in bankruptcy filings

As discussed in section 4.3.2.A above, evaluating whether an investor has control when its investee files for bankruptcy requires the exercise of judgement based on the facts and circumstances. Part of the assessment includes an evaluation of whether the investor has an exposure to variable returns from the investee once the investee files for bankruptcy. For example, based on the requirements for the particular type of bankruptcy in the relevant jurisdiction:

- Is the investee restricted from paying dividends to the investors upon filing for bankruptcy?
- Are the investors exposed to a variable return through their interests in the investee, notwithstanding the bankruptcy (e.g., do shares in the investee retain any value)?
- Do the investors have a loan receivable, or other financial interest in the investee, that is expected to provide a return (or is the loan worthless)?
- Do the investors have access to other synergies from the investee?

For an investor to have control, it must also have power (as discussed in section 4.3.2.A above) and the ability to use its power over the investee to affect the amount of the investor's returns (see section 6 below).

5.6 Interaction of IFRS 10 with the derecognition requirements in IFRS 9

In evaluating whether an entity has an exposure to the variable returns of a structured entity, it is also necessary to consider the interaction with the derecognition requirements set out in IFRS 9 (see Chapter 48). Specifically, it is relevant to consider the impact of whether or not the transfer criteria have been satisfied by the transferor or whether a transferor has exposure to variable returns arising from its involvement with a structured entity. The following Illustration will help show this issue.

Illustration 5-4: Structured entity that enters into a total return swap with the transferor

Assume the same facts as in Illustration 5-3 in section 5.3.2 above, except that the bank originally sold the equity securities to the structured entity (rather than the structured entity acquired the equity securities from the market).

As the bank has, through the total return swap, retained substantially all of the risks and rewards of ownership of the securities, it does not derecognise them. Consequently, the structured entity does not recognise the securities but, instead recognises a loan to the bank, collateralised by the securities. As the bank has not derecognised the securities, it has no variable return from its involvement with the structured entity. Hence, it does not have control of the structured entity and does not consolidate it. The investors have no power over the structured entity, so none of the investors consolidate it either.

5.7 Reputational risk

The term 'reputational risk' often refers to the risk that failure of an entity could damage the reputation of an investor or sponsor. To protect its reputation, the investor or sponsor might be compelled to provide support to the failing entity, even though it has no legal or contractual obligation to do so. During the financial crisis, some financial institutions stepped in and provided financing for securitisation vehicles that they sponsored, and in some cases took control of these vehicles. The IASB concluded that reputational risk is not an indicator of power in its own right, but may increase an investor's incentive to secure rights that give the investor power over an investee. Accordingly, reputational risk alone is not regarded as a source of variable returns and so does not require a bank to consolidate a structured entity that it sponsors. *[IFRS 10.BC37, IFRS 10.BC38, IFRS 10.BC39]*.

6 Link between power and returns: principal-agency situations

The third criterion for having control is that the investor must have the ability to use its power over the investee to affect the amount of the investor's returns. *[IFRS 10.7(c)]*. An investor controls an investee if the investor not only has power over the investee and exposure or rights to variable returns from its involvement with the investee, but also has the ability to use its power to affect the investor's returns from its involvement with the investee. *[IFRS 10.17]*.

Thus, an investor with decision-making rights determines whether it is a principal or an agent. An investor that is an agent in accordance with IFRS 10.B58 to B72 does not control an investee when it exercises decision-making rights delegated to it. *[IFRS 10.18]*. This is discussed further in section 6.1 below.

In January 2015, the IFRS IC noted that a fund manager that concludes that it is an agent in accordance with IFRS 10 then assesses whether it has significant influence in accordance with the guidance in IAS 28.[8] See Chapter 12 at section 2.

The link between power over an investee and exposure to variable returns from involvement with the investee is essential to having control. An investor that has power over an investee, but cannot benefit from that power, does not control that investee. An investor that has an exposure to a variable return from an investee, but cannot use its power to direct the activities that most significantly affect the investee's returns, does not control that investee. This is shown in Illustration 6-1 below.

Illustration 6-1: Link between power and returns is essential for control

A structured entity is created and financed by debt instruments held by a senior lender and a subordinated lender and a minimal equity investment from the sponsor. The subordinated lender transferred receivables to the structured entity. Managing the receivables in default is the only activity of the structured entity that causes its returns to vary, and this power has been given to the subordinated lender by contract. The subordinated loan is designed to absorb the first losses and to receive any residual return from the structured entity. The senior lender has exposure to variable returns due to the credit risk of the structured entity.

When analysing which investor, if any, has control the first step is to identify the relevant activities. In this Illustration, managing the receivables in default is the only activity of the structured entity that causes its returns to vary. Therefore, it is the relevant activity. The next step is to determine which investor, if any, has the current ability to direct that relevant activity. In this Illustration, the subordinated lender has the power that it was granted by contract. The subordinated lender is exposed to variable returns from its involvement with the structured entity through its subordinated debt. The subordinated lender has the ability to affect those returns through its power to manage the receivables in default. Since all three elements of control are present, the subordinated lender has control over the structured entity. This evaluation is made in the context of understanding the structured entity's purpose and design.

While the senior lender's exposure to variable returns is affected by the structured entity's activities, the senior lender has no power to direct those activities. Thus, the senior lender does *not* control the structured entity, because it is missing two of the elements of control.

6.1 Delegated power: principals and agents

When decision-making rights have been delegated or are being held for the benefit of others, it is necessary to assess whether the decision-maker is a principal or an agent to determine whether it has control. This is because if that decision-maker has been delegated rights that give the decision-maker power, it must assess whether those rights give the decision-maker power for its own benefit, or merely power for the benefit of others. An agent is a party primarily engaged to act on behalf of another party or parties (the principal(s)), and therefore does not control the investee when it exercises its decision-making powers. *[IFRS 10.B58]*. As an agent does not control the investee, it does not consolidate the investee. *[IFRS 10.18]*.

While principal-agency situations often occur in the asset management and banking industries, they are not limited to those industries. Entities in the construction, real estate and extractive industries also frequently delegate powers when carrying out their business. This is especially common when an investee is set up and one of the investors (often the lead investor) is delegated powers by the other investors to carry out activities for the investee. Assessing whether the lead investor is making decisions as a principal, or simply carrying out the decisions made by all the investors (i.e., acting as an agent) will be critical to the assessment.

8 *IFRIC Update*, January 2015, p.10, available on the IFRS Foundation's website.

An investor may delegate decision-making authority to an agent on some specific issues or on all relevant activities, but, ultimately, the investor as principal retains the power. This is because the investor treats the decision-making rights delegated to its agent as held by the investor directly. *[IFRS 10.B59]*. Accordingly, a decision-maker that is not an agent is a principal. However, it is noted that:

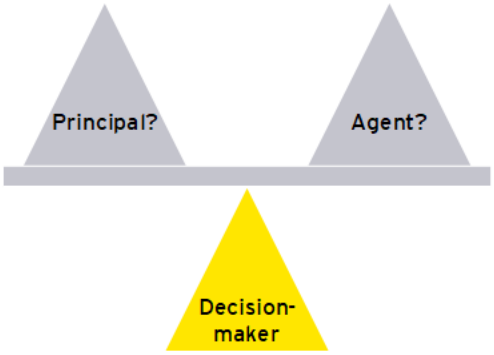
- A decision-maker is not an agent simply because others benefit from the decisions that it makes. *[IFRS 10.B58]*.
- An obligation to act in the best interest of those who have delegated the power does not prevent the decision-maker from being a principal.

The terms and conditions of the arrangement are considered to assess whether an entity is an agent or a principal. The determination of whether a decision-maker is an agent or a principal is made based on the following:

- Scope of decision-making authority
- Rights held by other parties (e.g., existence of removal rights)
- Remuneration of the decision-maker

  And
- Exposure to variability of returns through other interests *[IFRS 10.B60]*

Each of these factors is discussed in more detail below. When reaching a conclusion, each of the factors is weighted according to the facts and circumstances of each case, *[IFRS 10.B60]*, which will require judgement. The only situation that is conclusive by itself is when removal rights are held by a single investor and the decision-maker can be removed without cause. *[IFRS 10.B61]*. This is discussed in more detail in section 6.3 below. Accordingly, although each of the factors are discussed in isolation below, a conclusion must be based on all of the factors considered together. Of the four factors that need to be considered when assessing whether the decision-maker is acting as principal or agent, generally it will be the rights held by third parties to remove the decision-maker (see section 6.3 below) and the exposure to variability of returns (see section 6.5 below) that will require careful consideration.



6.2 Scope of decision-making

To assess whether a decision-maker is a principal or an agent, the scope of its authority is evaluated by considering both:

- The activities that the decision-maker is permitted to direct (e.g., by agreement or by law)
- The discretion that the decision-maker has when making decisions about those activities *[IFRS 10.B62]*

It is implicit in the definition of control that, for a decision-maker to control the entity over which it has been delegated decision-making authority, the decision-maker must have power. This means that it must have been delegated the rights that give the current ability to direct the relevant activities (the activities that most significantly affect that investee's returns). If a decision-maker has been delegated rights that do not relate to the relevant activities, it does not have control over the investee.

For this reason, it is imperative to understand the purpose and design of the investee, the risks to which it was designed to be exposed and the risk it was designed to pass on to the other parties involved. Understanding the purpose and design of the investee often helps in assessing which rights were delegated, why they were delegated, and which rights have been retained by other parties, and why those rights were retained.

6.2.1 Involvement in design

IFRS 10 requires that a decision-maker considers the purpose and design of the investee, the risks to which the investee was designed to be exposed, the risks it was designed to pass on to the parties involved and the level of involvement the decision-maker had in the design of an investee. For example, if a decision-maker is significantly involved in the design of the investee (including in determining the scope of decision-making authority), that involvement may indicate that the decision-maker had the opportunity and incentive to obtain rights that result in the decision-maker having the ability to direct the relevant activities. *[IFRS 10.B63]*.

However, a decision-maker's involvement in the design of an investee does not mean that decision-maker necessarily is a principal, even if that involvement was significant.

A decision-maker is a principal if it is not primarily engaged to act on behalf of and for the benefit of others. This determination is made in the context of considering the purpose and design of the investee, and the other factors listed in section 6.1 above. While not determinative, a decision-maker's involvement in the design of an investee is part of the context when concluding if it is a principal or agent.

How we see it

In our view, similar to the considerations for structured entities discussed in section 4.6 above, when a decision-maker sponsors an investee and establishes certain decisions in the governing documents of the investee, there must be increased scrutiny as to whether that decision-maker is a principal or an agent with respect to the investee, particularly if the other factors are indicative of the decision-maker being a principal. However, when there are many parties involved in the design of an investee, the decisions established in the governing documents might be less relevant.

6.2.2 Assessing whether the scope of powers is narrow or broad

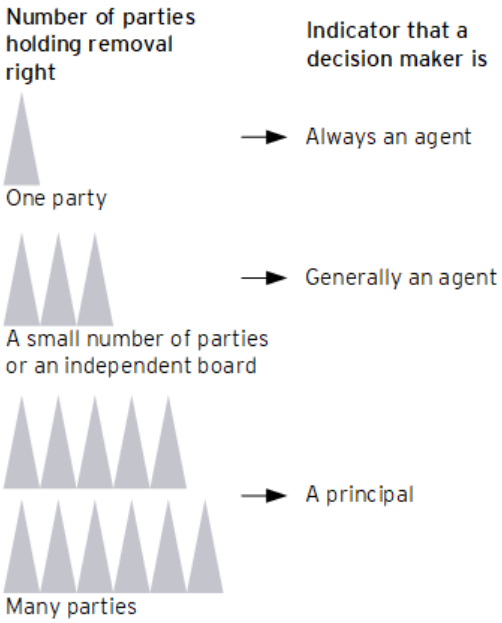
When evaluating whether a decision-maker is a principal or an agent, in considering the scope of its decision-making authority, it appears that a relevant factor is whether the scope of powers that have been delegated (and the discretion allotted) is narrow or broad. In an example in IFRS 10 where a decision-maker (fund manager) establishes, markets and manages a publicly traded, regulated fund according to narrowly defined parameters set out in the investment mandate, it is stated that this is a factor that indicates that the fund manager is an agent. *[IFRS 10.B72 Example 13]*. In another example, where the decision-maker (fund manager) has wide decision-making authority, it is implied that the extensive decision-making authority of the fund manager is an indicator that it is a principal. *[IFRS 10.B72 Example 14-14A]*. This suggests that where the scope of powers is broad, this is an indicator that the decision-maker is a principal. However, to conclude whether a decision-maker is an agent or a principal, the scope of power needs to be evaluated with the other three factors in totality.

6.3 Rights held by other parties

The decision-maker may be subject to rights held by other parties that may affect the decision-maker's ability to direct the relevant activities of the investee, such as rights of those parties to remove the decision-maker. Rights to remove are often referred to as 'kick-out' rights. Substantive removal rights may indicate that the decision-maker is an agent. *[IFRS 10.B64]*. Liquidation rights and redemption rights held by other parties, which may in substance be similar to removal rights, are discussed in section 6.3.2 below.

Other substantive rights held by other parties that restrict a decision-maker's discretion are considered similarly to removal rights when evaluating whether the decision-maker is an agent. For example, a decision-maker that is required to obtain approval from a small number of other parties for its actions is generally an agent. *[IFRS 10.B66]*.

Figure 6-1: Evaluating rights to remove without cause



As shown in the diagram above, when a single investor holds substantive rights to remove the decision-maker without cause, that fact in isolation is sufficient to conclude that the decision-maker is an agent. *[IFRS 10.B65]*. That is, the decision-maker does not consolidate the entity.

However, if multiple investors hold such rights (i.e., no individual investor can remove the decision-maker without cause without the others), these rights do not, in isolation, determine whether a decision-maker is an agent or a principal. That is, all other facts and circumstances need to be considered. The more parties that must act together to remove a decision-maker and the greater the magnitude of, and variability associated with, the decision-maker's other economic interests, the less weighting that is placed on the removal right. *[IFRS 10.B65]*. This is reflected in an example provided by IFRS 10 where there is a large number of widely dispersed unrelated third-party investors. Although the decision-maker (the asset manager) can be removed, without cause, by a simple majority decision of the other investors, this is given little weighting in evaluating whether the decision-maker is a principal or agent. *[IFRS 10.B72 Example 15]*.

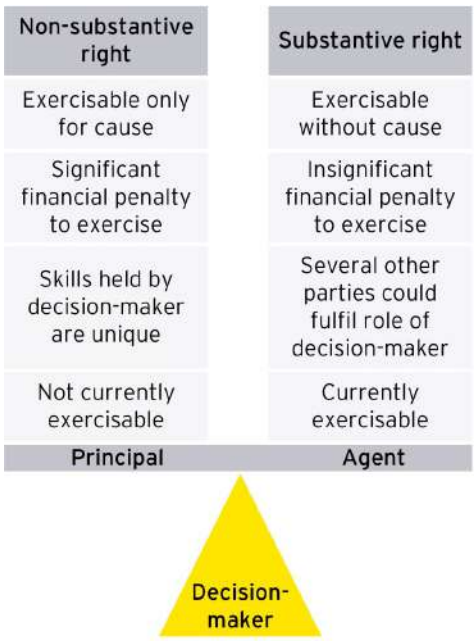
If an independent board of directors (or governing body), which is appointed by the other investors, holds a right to remove without cause, that is an indicator that the decision-maker is an agent. *[IFRS 10.B23(b), IFRS 10.B67]*. This is the position taken in an example in IFRS 10 (see Illustration 6-8 in section 6.6 below) where a fund has a board of directors, all of whose members are independent of the decision-maker (the fund manager) and are appointed by the other investors. The board of directors appoints the fund manager annually. The example explains that the board of directors provides a mechanism to ensure that the investors can remove the fund manager if they decide to do so.

6.3.1 Evaluating whether a removal right is substantive

When evaluating removal rights, it is important to determine whether they are substantive, as discussed in section 4.2.1 above. If the removal right is substantive, this may be an indicator that the decision-maker is an agent. *[IFRS 10.B64]*. On the other hand, if the removal right is not substantive, this may be an indicator that the decision-maker is a principal, but this indicator is given less weight. The determination of whether the decision-maker is a principal needs to be based on the three other factors, i.e., scope of decision-making authority, remuneration and exposure to variability of returns through other interests.

Some of the criteria that might be more relevant when evaluating whether a removal right is substantive are shown in the diagram below. However, all of the factors noted in section 4.2.1 above and IFRS 10 must be considered in this evaluation.

Figure 6-2: Evaluating whether removal rights are substantive



Evaluating whether a removal right is substantive will depend on facts and circumstances. *[IFRS 10.B23]*.

6.3.1.A Available replacements

When evaluating whether a removal right is substantive, consideration is given as to whether suitable replacements exist. This is because if there are no (or few) suitable replacements for the decision-maker, this is an operational barrier that would likely prevent the parties holding the removal right from exercising that removal right. *[IFRS 10.B23(a)(vi)]*.

In the asset management industry, suitable replacements are generally available. However, in other industries (e.g., construction, real estate, extractive), it is more common for the decision-maker to possess unique traits. For example, the decision-maker may have experience with a particular geographic location, local government, or proprietary intellectual property or tools. That might make it more difficult to assess whether there are other parties that could replace the decision-maker if the parties wanted to remove the decision-maker. However, regardless of the industry, an assessment of whether there are available replacements depends upon the specific facts and circumstances and will require judgement.

6.3.1.B Exercise period

A removal right may not be exercisable until a date in the future. In such cases, judgement must be exercised to determine whether (or when) that right becomes substantive. Similarly, when a removal right can only be exercised during a narrow period (e.g., for one day on the last day of the reporting period), judgement is necessary to determine whether the right is substantive.

When a removal right is exercised, there is typically a period (e.g., six months) until the decision-maker transitions decision-making back to the principal (or to another decision-maker) in an orderly manner. In such cases, judgement will be required to assess whether the principal has the current ability to direct the relevant activities when decisions need to be made, and therefore whether the removal right is substantive.

How we see it

In our view, even if there is a transition period between when the decision-maker is removed and when the principal (or another decision-maker) becomes responsible for making decisions, the removal right may still be substantive.

6.3.2 Liquidation rights and redemption rights

In some cases, rights held by other parties (such as some liquidation rights and some redemption rights) may have the same effect on the decision-maker's authority as removal rights. When a liquidation right or a redemption right is in substance the same as a removal right, its consideration in the evaluation of whether a decision-maker is a principal or an agent is the same.

For example, if a limited partnership is required to be liquidated upon the withdrawal of one limited partner, that is considered a removal right if it is substantive (as discussed in sections 4.2.1 and 6.3.1 above). However, such rights must be analysed carefully, based on the facts and circumstances.

6.4 Remuneration

The third factor to evaluate when assessing whether a decision-maker is a principal or an agent is remuneration.

The greater the magnitude of, and variability associated with, the decision-maker's remuneration relative to the returns expected from the activities of the investee, the more likely the decision-maker is a principal. *[IFRS 10.B68]*. Therefore, when determining if a decision-maker is a principal or an agent, the magnitude and variability of exposure to returns through remuneration are always considered. This applies even if the remuneration is at market rates. However, as discussed in section 6.4.1 below, IFRS 10 does not include any examples of remuneration arrangements where it is clear the remuneration is of such significance that it, in isolation, indicates that the decision maker is a principal.

Extract from IFRS 10

B69 In determining whether it is a principal or an agent the decision maker shall also consider whether the following conditions exist:

(a) The remuneration of the decision maker is commensurate with the services provided.

(b) The remuneration agreement includes only terms, conditions or amounts that are customarily present in arrangements for similar services and level of skills negotiated on an arm's length basis.

IFRS 10 states that a decision-maker cannot be an agent unless the conditions set out in (a) and (b) above are present. However, meeting those conditions in isolation is not sufficient to conclude that a decision-maker is an agent. *[IFRS 10.B69, IFRS 10.B70]*.

6.4.1 Evaluating remuneration in the asset management industry

When evaluating whether a decision-maker is a principal or an agent, an entity is required to evaluate the magnitude and the variability of the remuneration relative to the expected returns from the investee. In examples related to the asset management industry, IFRS 10 describes three common remuneration structures:

- 1% of net assets under management *[IFRS 10.B72 Example 13]*
- 1% of assets under management and performance-related fees of 10% of profits if the investee's profits exceed a specified level *[IFRS 10.B72 Example 15]*
- 1% of assets under management and 20% of all the fund's profits if a specified profit level is achieved *[IFRS 10.B72 Example 14]*

In each case, the examples assume that the remuneration is commensurate with the services provided. In addition, the remuneration aligns the interests of the decision-maker with those of other investors. However, IFRS 10 concludes for each of these cases that the level of remuneration does not create an exposure to variable returns that is of such significance that, in isolation, it indicates that the fund manager is a principal. IFRS 10 does not include any examples of remuneration arrangements where the remuneration is of such significance that, in isolation, it does indicate that the fund manager is a principal. Additionally, IFRS 10 does not provide any examples of remuneration arrangements that are not market-based although this always needs to be assessed.

How we see it

In our experience, in most asset management scenarios involving retail investors, management will be able to conclude that the remuneration is commensurate with services provided and only includes market terms. This is because otherwise, retail investors would take their business elsewhere.

As discussed in section 6.4 above, a decision-maker cannot be an agent unless conditions (a) and (b) are met. However, meeting both criteria is not conclusive. The decision-maker must evaluate whether the magnitude and exposure to variable returns received through the remuneration, together with other factors, indicates that it is an agent or a principal.

6.4.2 Evaluating remuneration in other industries

IFRS 10 does not include any examples of principal-agency evaluations in the construction, real estate and extractive industries.

How we see it

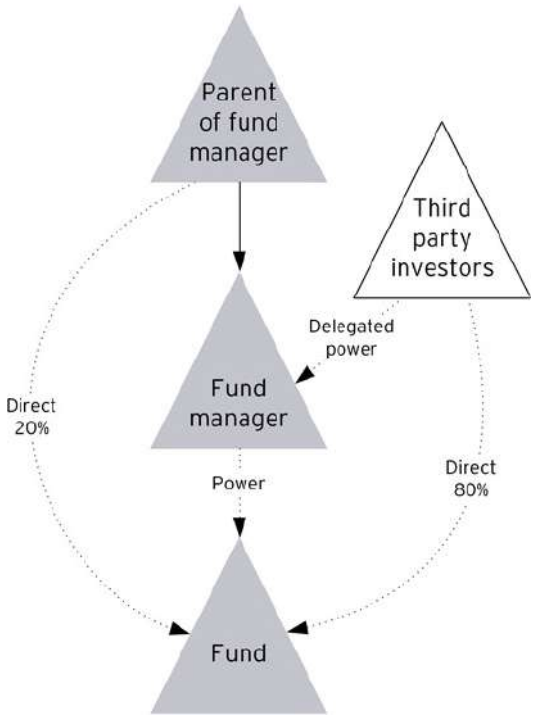
In our view, in these industries, it is more common for the decision-maker to possess unique traits (see section 6.3.1.A above). That might make it more difficult to assess whether the remuneration is commensurate with the skills provided and includes only market terms.

6.5 Exposure to variability of returns from other interests

When an investor has exposure to variable returns from its involvement with an investee (e.g., an investment in that investee, or provides a guarantee), and has been delegated decision-making authority by other parties, the investor considers that exposure to variable returns when assessing whether it has control over that investee. *[IFRS 10.B59, IFRS 10.B71]*. This is shown in Illustration 6-2 below as well as in the examples provided by IFRS 10 reproduced in section 6.6 below.

Illustration 6-2: Illustration of exposure to variability of returns through other interests

A parent of a fund manager has a 20% direct interest in a fund. The other 80% of the fund is held by third-party investors, who have delegated their rights with respect to the fund to the fund manager. When evaluating whether the parent controls the fund, it assesses whether the fund manager (which the parent controls) can use the power that has been delegated to it by the third parties holding the 80% interest, to benefit the parent, since the parent has a 20% direct interest in the fund and could benefit from that power.



As discussed in section 5 above, being an 'investor' and having an 'interest' in an investee is not limited to holding equity or debt instruments. A variety of exposures to variable returns can represent an 'interest' and any potential controlling party is referred to as an 'investor.'

IFRS 10 states that if a decision-maker has interests in an investee, just by virtue of holding those other interests, the decision-maker may be a principal. *[IFRS 10.B71]*. In the Basis for Conclusions accompanying IFRS 10, the IASB notes that a decision-maker might use its decision-making authority primarily to affect its exposure to variable returns from that interest. That is, the decision-maker has power for its own benefit. *[IFRS 10.BC132]*. The IASB also notes in its Basis for Conclusions that it is inappropriate to conclude that every decision-maker that is obliged, by law or contract (i.e., having any fiduciary responsibility) to act in the best interests of other parties is always an agent. This is because it assumes that a decision-maker that is legally or contractually obliged to act in the best interests of other parties will always do so, even if that decision-maker receives the vast majority of the returns that are influenced by its decision-making. *[IFRS 10.BC130]*.

Accordingly, IFRS 10 requires an entity to evaluate the magnitude and variability of its other interests when determining if it is a principal or an agent, notwithstanding its fiduciary responsibility.

In evaluating its exposure to variability of returns from other interests in the investee a decision-maker considers the following:

(a) The greater the magnitude of, and variability associated with, its economic interests, considering its remuneration and other interests in aggregate, the more likely the decision-maker is a principal.

(b) Whether its exposure to variability of returns is different from that of the other investors and, if so, whether this might influence its actions. For example, this might be the case when a decision-maker holds subordinated interests in, or provides other forms of credit enhancement to, an investee.

The decision-maker evaluates its exposure relative to the total variability of returns of the investee. This evaluation is made primarily on the basis of returns expected from the activities of the investee but does not ignore the decision maker's maximum exposure to variability of returns of the investee through other interests that the decision-maker holds. *[IFRS 10.B72]*.

As indicated at (a) above, in evaluating its exposure to variability of returns from other interests, the investor considers its remuneration and other interests in aggregate. So, even if the initial assessment about remuneration is that the decision-maker is an agent (see section 6.4 above), the remuneration needs to be considered in the assessment of exposure to variability of returns.

Since the magnitude and variability of exposure to returns are considered together with the other factors, there is no bright line as to what level of other direct interests, on their own, causes a decision-maker to be a principal or an agent. That is, the scope of authority, removal rights, and remuneration also need to be considered. The examples in IFRS 10 (see section 6.6 below) also do not specify the magnitude and variability of the remuneration.

6.5.1 Evaluating returns received via an indirect investment in another entity

In Illustration 6-2 above, the exposure of the investor (the parent of the fund manager) to variable returns was through a direct investment in the fund. However, what if the exposure to variable returns arises from an investor's indirect involvement with an investee, e.g., via a joint venture or an associate?

When assessing whether an investor has control of an investee, the investor determines whether it is exposed, or has rights, to variable returns from its involvement with the investee. IFRS 10 discusses 'returns' as a broad term, and the examples in IFRS 10.B57 (see section 5 above) suggest the exposure to variable returns encompasses both direct and indirect involvement with the investee.

The Basis for Conclusions accompanying IFRS 10 further clarifies that the IASB intended the term 'returns' as a broad term, stating that "The Board confirmed its intention to have a broad definition of 'returns' that would include synergistic returns as well as more direct returns, for example, dividends or changes in the value of an investment. In practice, an investor can benefit from controlling an investee in a variety of ways. The Board concluded that to narrow the definition of returns would artificially restrict those ways of benefiting." *[IFRS 10.BC63]*.

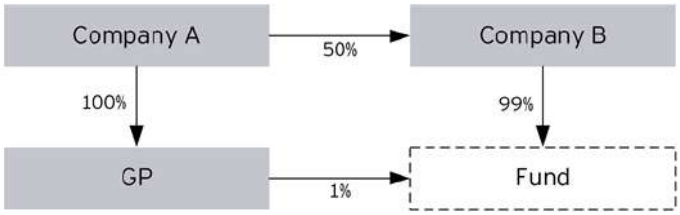
How we see it

Given the clarification above, in our view, when an investor evaluates the exposure to variable returns from its involvement with another entity, the returns received indirectly via another entity that is not under the control of that investor, are included in that assessment. This is regardless of the structure of the indirect involvement - that is, whether it is held through a joint venture, an associate, or neither influence nor joint control exists such that it is just an investment.

In the case of an indirect interest, there are essentially two different ways of assessing the returns - the dividend flow and/or the change in fair value of the intermediate investment. While the dividend flow is not in the control of the investor, it still receives the returns via the change in value of its intermediate investment, and therefore these returns cannot be ignored.

Illustration 6-3: Illustration of exposure to variability of returns through indirect interests

Company A has a wholly owned subsidiary, GP, which is the General Partner and fund manager of a Fund. A has a 50% interest in the shares of Company B and, as a result of the contractual arrangement with the other investors in B, has joint control of B. GP has a 1% interest in the Fund, with the remaining 99% of the Fund owned by B.



It has been assessed and concluded that GP, in its capacity as the fund manager, has power over the Fund. Therefore, by extension, A has power over the Fund. At the same time, GP also concluded that it is acting on behalf and for the benefit of another party or parties, i.e., as an agent for the investors, and therefore does not control the Fund.

B also evaluated its involvement with the Fund and determined it has no power over the Fund, and therefore does not control it.

A has joint control of B. It does not have control over B and therefore does not control how the returns from the Fund are ultimately distributed to the investors in B.

While A does not control how the returns from the Fund are ultimately distributed, its indirect entitlement to the returns of the Fund is considered with its direct investment through the GP when evaluating whether there is sufficient exposure to variable returns, when combined with power, to conclude that control exists.

6.6 Application examples in IFRS 10

IFRS 10 provides a number of application examples in relation to the determination of whether a decision-maker is a principal or an agent. These are reflected in Illustration 6-4 to Illustration 6-10 below.

As with all of the examples included in the Application Guidance, the examples portray hypothetical situations. Although some aspects of the examples may be present in actual fact patterns, all relevant facts and circumstances of a particular fact pattern need to be evaluated when applying IFRS 10. *[IFRS 10.B1]*. When reaching a conclusion on a particular fact pattern, each of the factors discussed above is weighted according to the facts and circumstances of each case, which will require judgement. *[IFRS 10.B60]*.

Illustration 6-4: Determining whether a decision-maker is a principal or agent (1)

A decision-maker (fund manager) establishes, markets and manages a publicly traded, regulated fund according to narrowly defined parameters set out in the investment mandate as required by its local laws and regulations. The fund was marketed to investors as an investment in a diversified portfolio of equity securities of publicly traded entities. Within the defined parameters, the fund manager has discretion about the assets in which to invest. The fund manager has made a 10% *pro rata* investment in the fund and receives a market-based fee for its services equal to 1% of the net asset value of the fund. The fees are commensurate with the services provided. The fund manager does not have any obligation to fund losses beyond its 10% investment. The fund is not required to establish, and has not established, an independent board of directors. The investors do not hold any substantive rights that affect the decision-making authority of the fund manager, but can redeem their interests within particular limits set by the fund.

Analysis

Although operating within the parameters set out in the investment mandate and in accordance with the regulatory requirements, the fund manager has decision-making rights that give it the current ability to direct the relevant activities of the fund - the investors do not hold substantive rights that could affect the fund manager's decision-making authority. The fund manager receives a market-based fee for its services that is commensurate with the services provided and has also made a *pro rata* investment in the fund. The remuneration and its investment expose the fund manager to variability of returns from the activities of the fund without creating exposure that is of such significance that it indicates that the fund manager is a principal.

In this example, consideration of the fund manager's exposure to variability of returns from the fund together with its decision-making authority within restricted parameters indicates that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund. *[IFRS 10.B72 Example 13]*.

Illustration 6-5: Determining whether a decision-maker is a principal or agent (2)

A decision-maker establishes, markets and manages a fund that provides investment opportunities to a number of investors. The decision-maker (fund manager) must make decisions in the best interests of all investors and in accordance with the fund's governing agreements. Nonetheless, the fund manager has wide decision-making discretion and there are no other rights held by others that affect this discretion. The fund manager receives a market-based fee for its services equal to 1% of assets under management and 20% of all the fund's profits if a specified profit level is achieved. The fees are commensurate with the services provided. The fund manager does not hold a direct interest in the fund.

Analysis

Although it must make decisions in the best interests of all investors, the fund manager has extensive decision-making authority to direct the relevant activities of the fund. The fund manager is paid fixed and performance-related fees that are commensurate with the services provided. In addition, the remuneration aligns the interests of the fund manager with those of the other investors to increase the value of the fund, without creating exposure to variability of returns from the activities of the fund that is of such significance that the remuneration, when considered in isolation, indicates that the fund manager is a principal. Therefore, the fund manager is an agent. *[IFRS 10.B72 Example 14]*.

See Illustration 6-6 to Illustration 6-8 below for an evaluation of other factors based on the same fact pattern and initial analysis.

Illustration 6-6: Determining whether a decision-maker is a principal or agent (3)

Assume the fact pattern and initial analysis in Illustration 6-5 above.

However, in this example, the fund manager also has a 2% investment in the fund that aligns its interests with those of the other investors. The fund manager does not have any obligation to fund losses beyond its 2% investment. The investors can remove the fund manager by a simple majority vote, but only for breach of contract.

Analysis

The fund manager's 2% investment increases its exposure to variability of returns from the activities of the fund without creating exposure that is of such significance that it indicates that the fund manager is a principal. The other investors' rights to remove the fund manager are considered to be protective rights because they are exercisable only for breach of contract. In this example, although the fund manager has extensive decision-making authority and is exposed to variability of returns from its interest and remuneration, the fund manager's exposure indicates that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund. *[IFRS 10.B72 Example 14A]*.

Illustration 6-7: Determining whether a decision-maker is a principal or agent (4)

Assume the fact pattern and initial analysis in Illustration 6-5 above.

However, in this example, the fund manager has a more substantial *pro rata* investment in the fund (than the 2% in Illustration 6-6 above), but does not have any obligation to fund losses beyond that investment. The investors can remove the fund manager by a simple majority vote, but only for breach of contract.

Analysis

In this scenario, the other investors' rights to remove the fund manager are considered to be protective rights because they are exercisable only for breach of contract. Although the fund manager is paid fixed and performance-related fees that are commensurate with the services provided, the combination of the fund manager's investment together with its remuneration could create exposure to variability of returns from the activities of the fund that is of such significance that it indicates that the fund manager is a principal. The greater the magnitude of, and variability associated with, the fund manager's economic interests (considering its remuneration and other interests in aggregate), the more emphasis the fund manager places on those economic interests in the analysis, and the more likely the fund manager is a principal.

For example, having considered its remuneration and the other factors, the fund manager might consider a 20% investment to be sufficient to conclude that it controls the fund. However, in different circumstances (i.e., if the remuneration or other factors are different), control may arise when the level of investment is different. *[IFRS 10.B72 Example 14B]*.

Illustration 6-8: Determining whether a decision-maker is a principal or agent (5)

Assume the fact pattern and initial analysis in Illustration 6-5 above.

However, in this example, the fund manager has a 20% *pro rata* investment in the fund, but does not have any obligation to fund losses beyond its 20% investment. The fund has a board of directors, all of whose members are independent of the fund manager and are appointed by the other investors. The board appoints the fund manager annually. If the board decided not to renew the fund manager's contract, the services performed by the fund manager could be performed by other managers in the industry.

Analysis

Although the fund manager is paid fixed and performance-related fees that are commensurate with the services provided, the combination of the fund manager's 20% investment together with its remuneration creates exposure to variability of returns from the activities of the fund that is of such significance that it indicates that the fund manager is a principal. However, the investors have substantive rights to remove the fund manager - the board of directors provides a mechanism to ensure that the investors can remove the fund manager if they decide to do so.

In this scenario, the fund manager places greater emphasis on the substantive removal rights in the analysis. Thus, although the fund manager has extensive decision-making authority and is exposed to variability of returns of the fund from its remuneration and investment, the substantive rights held by the other investors indicate that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund. *[IFRS 10.B72 Example 14C]*.

Illustration 6-9: Determining whether a decision-maker is a principal or agent (6)

An investee is created to purchase a portfolio of fixed rate asset-backed securities, funded by fixed rate debt instruments and equity instruments. The equity instruments are designed to provide first loss protection to the debt investors and receive any residual returns of the investee. The transaction was marketed to potential debt investors as an investment in a portfolio of asset-backed securities with exposure to the credit risk associated with the possible default of the issuers of the asset-backed securities in the portfolio and to the interest rate risk associated with the management of the portfolio. On formation, the equity instruments represent 10% of the value of the assets purchased. A decision-maker (the asset manager) manages the active asset portfolio by making investment decisions within the parameters set out in the investee's prospectus. For those services, the asset manager receives a market-based fixed fee (i.e., 1% of assets under management) and performance-related fees (i.e., 10% of profits) if the investee's profits exceed a specified level. The fees are commensurate with the services provided. The asset manager holds 35% of the equity in the investee.

The remaining 65% of the equity, and all the debt instruments, are held by a large number of widely dispersed unrelated third-party investors. The asset manager can be removed, without cause, by a simple majority decision of the other investors.

Analysis

The asset manager is paid fixed and performance-related fees that are commensurate with the services provided. The remuneration aligns the interests of the fund manager with those of the other investors to increase the value of the fund. The asset manager has exposure to variability of returns from the activities of the fund because it holds 35% of the equity and from its remuneration.

Although operating within the parameters set out in the investee's prospectus, the asset manager has the current ability to make investment decisions that significantly affect the investee's returns - the removal rights held by the other investors receive little weighting in the analysis because those rights are held by a large number of widely dispersed investors. In this example, the asset manager places greater emphasis on its exposure to variability of returns of the fund from its equity interest, which is subordinate to the debt instruments. Holding 35% of the equity creates subordinated exposure to losses and rights to returns of the investee, which are of such significance that it indicates that the asset manager is a principal. Thus, the asset manager concludes that it controls the investee. *[IFRS 10.B72 Example 15]*.

The conclusions in Illustration 6-4 to Illustration 6-9 above in respect of whether the fund manager is a principal (and therefore has control) or an agent (and therefore does not have control) can be summarised as follows:

Remuneration	Equity holding	Removal rights	Control?
1% of NAV	10%	None	No
1% of NAV plus 20% profits above a certain level	None	None	No
1% of NAV plus 20% profits above a certain level	2%	Only for breach of contract	No
1% of NAV plus 20% profits above a certain level	20% (illustrative)	Only for breach of contract	Yes
1% of NAV plus 20% profits above a certain level	20%	Yes - annually by board appointed by other investors	No
1% of NAV plus 10% profits above a certain level	35% of equity (0% of debt)	Yes - by simple majority of other widely diverse investors	Yes

Illustration 6-10 below shows a slightly different type of structure where there is an entitlement to a residual return rather than a *pro rata* return.

Illustration 6-10: Determining whether a decision-maker is a principal or agent (7)

A decision-maker (the sponsor) sponsors a multi-seller conduit, which issues short-term debt instruments to unrelated third-party investors. The transaction was marketed to potential investors as an investment in a portfolio of highly rated medium-term assets with minimal exposure to the credit risk associated with the possible default by the issuers of the assets in the portfolio. Various transferors sell high-quality medium-term asset portfolios to the conduit. Each transferor services the portfolio of assets that it sells to the conduit and manages receivables on default for a market-based servicing fee. Each transferor also provides first loss protection against credit losses from its asset portfolio through over-collateralisation of the assets transferred to the conduit. The sponsor establishes the terms of the conduit and manages the operations of the conduit for a market-based fee. The fee is commensurate with the services provided. The sponsor approves the sellers permitted to sell to the conduit, approves the assets to be purchased by the conduit and makes decisions about the funding of the conduit. The sponsor must act in the best interests of all investors.

The sponsor is entitled to any residual return of the conduit and also provides credit enhancement and liquidity facilities to the conduit. The credit enhancement provided by the sponsor absorbs losses of up to 5% of all of the conduit's assets, after losses are absorbed by the transferors. The liquidity facilities are not advanced against defaulted assets. The investors do not hold substantive rights that could affect the decision-making authority of the sponsor.

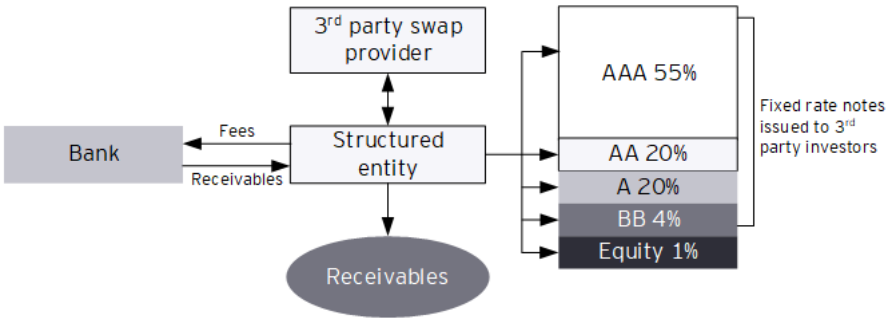
Analysis

Even though the sponsor is paid a market-based fee for its services that is commensurate with the services provided, the sponsor has exposure to variability of returns from the activities of the conduit because of its rights to any residual returns of the conduit and the provision of credit enhancement and liquidity facilities (i.e., the conduit is exposed to liquidity risk by using short-term debt instruments to fund medium-term assets). Even though each of the transferors has decision-making rights that affect the value of the assets of the conduit, the sponsor has extensive decision-making authority that gives it the current ability to direct the activities that most significantly affect the conduit's returns (i.e., the sponsor established the terms of the conduit, has the right to make decisions about the assets (approving the assets purchased and the transferors of those assets) and the funding of the conduit (for which new investment must be found on a regular basis)). The right to residual returns of the conduit and the provision of credit enhancement and liquidity facilities expose the sponsor to variability of returns from the activities of the conduit that is different from that of the other investors. Accordingly, that exposure indicates that the sponsor is a principal and thus the sponsor concludes that it controls the conduit. The sponsor's obligation to act in the best interest of all investors does not prevent the sponsor from being a principal. *[IFRS 10.B72 Example 16]*.

6.7 Other illustrative examples

Illustration 6-11 below shows the application of the guidance relating to the determination of a principal or an agent for a bank that establishes a structured entity to facilitate a securitisation.

Illustration 6-11: Determining whether a bank is a principal or agent in relation to a securitisation



A bank establishes a structured entity to facilitate a securitisation. It transfers floating rate receivables to the structured entity. The structured entity issues fixed rate notes in tranches to investors (rated AAA, AA, A and BB) and an equity tranche to the bank. The AAA tranche is the most senior and the equity tranche is the most junior in the event that there is insufficient cash to meet the payments under the terms of the notes.

The bank services the receivables on behalf of the structured entity including the management of defaults (if any), and has substitution rights over the receivables within certain parameters (for example, asset quality).

The bank receives a fee for managing the receivables, that is 1% of the notional amount of the receivables and is commensurate with the level of work performed and only includes market terms. The investors are not able to remove the bank from performing this function, other than in exceptional circumstances, such as negligence by the bank.

A third party provides an interest rate swap to convert the cash flows of the receivables into the cash flows required to be paid to meet the terms of the notes.

As the bank retains only the equity tranche, it concludes that it is no longer exposed to substantially all the risks and rewards of ownership and can derecognise the receivables on transfer to the structured entity and recognises just the equity tranche as its continuing involvement in the receivables.

Analysis

The purpose and design of the structured entity was to:

(a) Enable the bank to generate external funding through the securitisation structure

(b) Provide investors with an attractive investment opportunity

The activities of the structured entity that significantly affect its returns are:

- Selection and transfer of assets at inception
- Determining which assets are held by the structured entity (i.e., asset substitution)
- Management of defaults on the receivables

The bank has decision-making rights over all of these relevant activities in its capacity as sponsor and service provider, so it has power over the structured entity.

The bank has exposure to variable returns through its holding of the equity tranche of the notes, in addition to the 1% management fee.

However, the question arises as to whether the bank is using its power as principal or as agent. To make that determination, the four factors (scope of decision-making authority, rights held by other investors, remuneration and exposure to variability of returns through other interests) need to be evaluated. Although the bank was involved in the design of the structured entity, the scope of the bank's decision-making authority is considered to be narrow as substitution rights have to be within certain parameters. However, the rights of the investors to remove the bank is not considered to be substantive, as it can only be removed by the investors in exceptional circumstances. In respect of remuneration, the bank earns a modest fee for services rendered that is commensurate with the services provided. Taking account of all the factors, the variability of returns of the equity tranche is likely to be significant relative to the total returns of the entity, such that the bank is considered to exercise its power as principal rather than as agent. As a result, it is likely that the bank would be considered to use its power to affect its returns.

In conclusion, the bank has control and therefore consolidates the structured entity.

7 Related parties and *de facto* agents

IFRS 10 also requires an investor to consider whether there are other parties who are acting on behalf of the investor by virtue of their relationship with it. That is, IFRS 10 requires consideration of whether the other parties are acting as *de facto* agents for the investor. The determination of whether other parties are acting as *de facto* agents requires judgement, considering not only the nature of the relationship but also how those parties interact with each other and the investor. *[IFRS 10.B73]*.

Such relationships need not be contractual. A party is a *de facto* agent when the investor has, or those that direct the activities of the investor have, the ability to direct that party to act on the investor's behalf. In these circumstances, the investor considers its *de facto* agent's decision-making rights and its indirect exposure, or rights, to variable returns through the *de facto* agent together with its own when assessing control of an investee. *[IFRS 10.B74]*. Paragraph B74 has been amended to clarify that the relationship described in B74 is just one example of various relationships that might exist between the investor and other parties acting as *de facto* agents of the investor. The amendment is intended to remove the inconsistency with the requirement in paragraph B73 for an entity to use judgement to determine whether other parties are acting as *de facto* agents. The amendment was finalized in July 2024. *[IFRS 10.B74]*.

IFRS 10 lists several examples of parties that might be *de facto* agents for an investor:

(a) The investor's related parties

(b) A party that received its interest in the investee as a contribution or loan from the investor

(c) A party that has agreed not to sell, transfer or encumber its interests in the investee without the investor's prior approval (except for situations in which the investor and the other party have the right of prior approval and the rights are based on mutually agreed terms by willing independent parties)

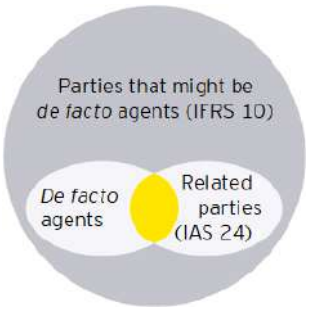
(d) A party that cannot finance its operations without subordinated financial support from the investor

(e) An investee for which the majority of the members of its governing body or for which its key management personnel are the same as those of the investor

(f) A party that has a close business relationship with the investor, such as the relationship between a professional service provider and one of its significant clients *[IFRS 10.B75]*

However, just because a party falls within the examples above, that does not mean that it is necessarily a *de facto* agent for the investor, as shown in the diagram below. It simply means that management must carefully evaluate whether that party is a *de facto* agent for the investor. Parties that are actually *de facto* agents are only a sub-set of the list above. Therefore, management must determine whether the other party is acting on behalf of the investor because of its relationship to the investor. IFRS 10 does not provide much explanation on how this evaluation is to be made; IFRS 10 only states that the evaluation considers the nature of the relationship and how the parties interact with each other. *[IFRS 10.B73]*.

Figure 7-1: Identifying parties that might be *de facto* agents



How we see it

Given the breadth of the parties that might be a *de facto* agent in IFRS 10, there are likely to be numerous parties that need to be evaluated to determine if they are actually *de facto* agents, which requires careful evaluation of the facts and circumstances, including the purpose and design of the investee.

If a party is determined to be a *de facto* agent, then its rights and exposures to variable returns are considered together with those of the investor when evaluating whether an investor has control of an investee. *[IFRS 10.B74]*. Just because one party is a *de facto* agent of the other party, that does not mean that the *de facto* agent is controlled by the investor. Consolidation procedures in situations when a *de facto* agent exists are discussed in section 7.2 below.

7.1 Customer-supplier relationships

Normally, a typical supplier-customer relationship is not expected to result in one party being a *de facto* agent of the other. This is because, in a typical supplier-customer relationship, one party cannot direct the other party to act on its behalf. Instead, the activities of each are directed by their respective shareholders (and board of directors and management).

However, a party with a 'close business relationship' is an example of a *de facto* agent. *[IFRS 10.B75(f)]*. Accordingly, where a close business relationship exists between a customer and a supplier, consideration needs to be given to whether the supplier is a *de facto* agent of the customer. For example, this might be the case if:

- An entity has only one significant customer
- The customer and supplier have common management or common shareholders
- The customer has the ability to direct product design, sales, etc.

  Or
- The supplier is a service provider (e.g., investment banker, attorney) that assists in structuring a transaction

7.2 Non-controlling interests when there is a *de facto* agent

When consolidating a subsidiary, a parent only reflects its exposures to variable returns (including those held by its subsidiaries), in its consolidated financial statements. Any rights or exposures to variable returns held by a *de facto* agent that is not in the group are generally shown as non-controlling interests. This is shown in Illustration 7-1 below.

Illustration 7-1: Control evaluation and consolidation with a *de facto* agent

A has a 40% interest in Z, whose relevant activities are directed by voting shares that entitle the holder to a *pro rata* share of returns of Z. Based on the facts and circumstances, A concludes that, by itself, its 40% interest does not give A control over Z.

B holds a 15% interest in Z.

A evaluates the facts and circumstances and concludes that B is a *de facto* agent of A. This might be concluded if, for example, A and B are members of the same group - that is, when A and B have the same ultimate parent, but B is not part of A's group in its sub-level consolidated financial statements. Based on the combined interest, A concludes that it controls Z, because it can direct B how to vote by virtue of being a *de facto* agent. Accordingly, A consolidates Z in its consolidated financial statements and reflects a non-controlling interest in Z of 60% (that is, all interests not held by A).

Careful evaluation of arrangements between the parties is needed to ensure that there are no other rights and exposures that are required to be accounted for in the consolidated financial statements.

8 Control of specified assets

IFRS 10 requires that an investor has to consider whether it treats a portion of an investee as a deemed separate entity and, if so, whether it controls the deemed separate entity (a 'silo'). *[IFRS 10.B76]*.

It therefore clarifies that an investor can have control over specified assets of an investee (i.e., whether a 'silo' exists within a host entity). IFRS 10 gives a very strict rule as to when a portion of an entity is deemed to be a silo, and therefore, evaluated separately for consolidation from the remainder of the host entity: *[IFRS 10.B77]*

Extract from IFRS 10

B77 An investor shall treat a portion of an investee as a deemed separate entity if and only if the following condition is satisfied:

> Specified assets of the investee (and related credit enhancements, if any) are the only source of payment for specified liabilities of, or specified other interests in, the investee. Parties other than those with the specified liability do not have rights or obligations related to the specified assets or to residual cash flows from those assets. In substance, none of the returns from the specified assets can be used by the remaining investee and none of the liabilities of the deemed separate entity are payable from the assets of the remaining investee. Thus, in substance, all the assets, liabilities and equity of that deemed separate entity are ring-fenced from the overall investee. Such a deemed separate entity is often called a 'silo'.

The description of a silo above includes the phrase 'in substance', but it is unclear how this is interpreted. Some proponents take the view that this allows a portion of an investee to be regarded as ring-fenced if the possibility of using the assets of the silo to meet liabilities of the rest of the investee (or *vice versa*) was remote.

How we see it

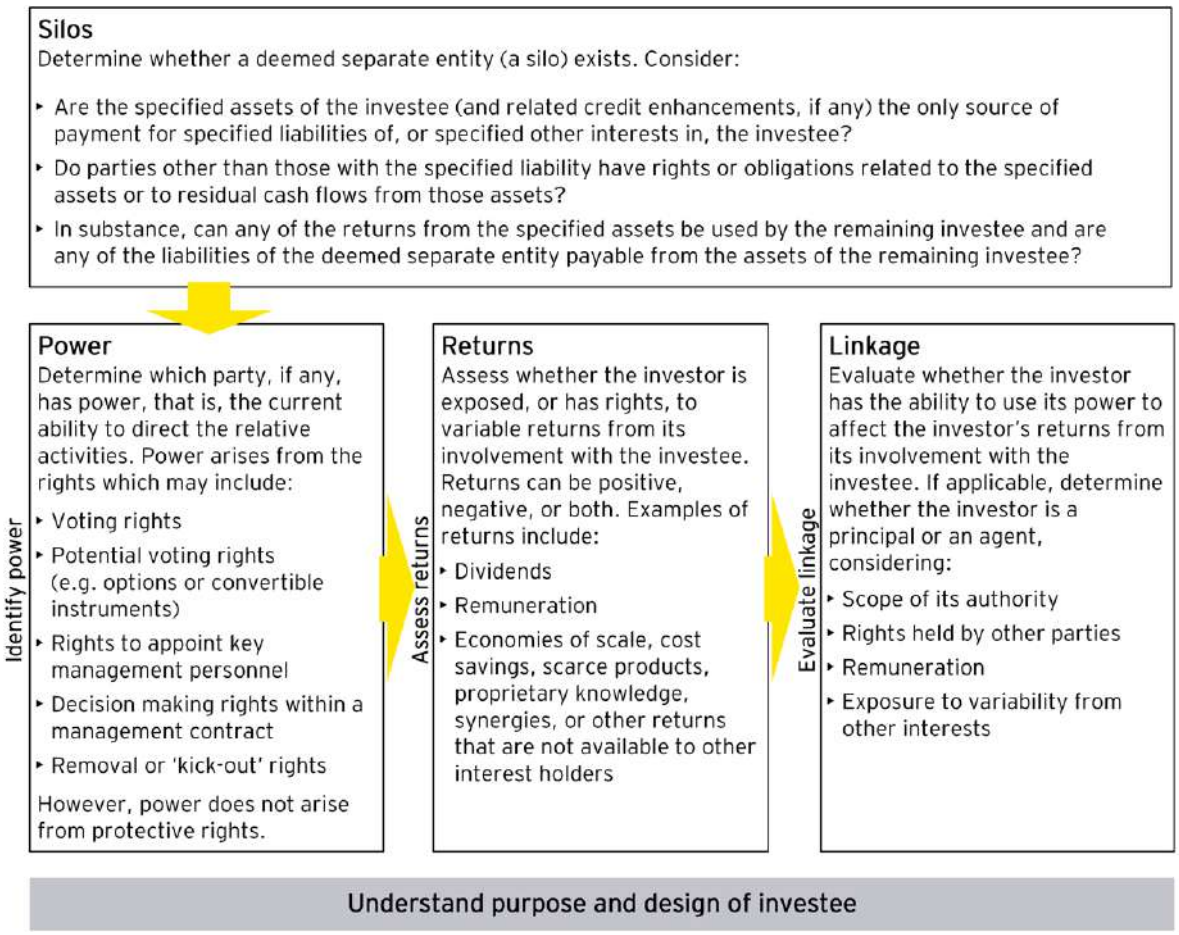
In our view, this means that the silo has to be 'legally ring-fenced', and if there is any possibility that the assets could be used to meet liabilities of the rest of the investee, it is not a silo. The phrase 'in substance' is used in the standard to ensure that any terms in the contract that might override a ring fence needs to have substance, not that a silo can be established through 'in substance' ring fencing.

In many cases, where a silo exists, it will be because a trust or similar legal structure exists to ring-fence the assets and liabilities from the host and other silos within the host entity.

Under IFRS 10, it is clear that an investor needs to identify and consolidate any silos that it controls. Accordingly, it is crucial to identify silos (as discussed in section 8.1 below).

Identifying whether a silo exists, and whether an investor controls a silo, can be complex. However, the same process outlined in the diagram for assessing control included in section 3.1 above can be used for silos, with the initial step of identifying a silo, as shown in the diagram below. Understanding the purpose and design of an investee is critical when identifying whether a silo exists, and if so which investor, if any, has control of that silo.

Figure 8-1: Identifying and assessing control of a silo



8.1 Identifying a silo

When identifying a silo, it is important to meet the condition that IFRS 10 requires to be satisfied for there to be a silo (see section 8 above). Silos occur most often in the following industries:

- Insurance (see section 8.1.1 below)
- Investment funds (see section 8.1.2 below)

8.1.1 Identifying silos in the insurance industry

For insurers, silos may arise in a structure such as a multi-cell reinsurance vehicle, which is an entity comprised of a number of 'cells' where the assets and liabilities are legally ring-fenced.

Insurers evaluate whether investments made on behalf of insurance contract holders (policyholders) are considered silos under IFRS 10. The evaluation will depend on the facts and circumstances of the particular case, and may vary by jurisdiction and by policy, given the differences in regulatory environments and types of policies offered by insurance entities.

When determining whether investments held on behalf of policyholders are ring-fenced (i.e., whether a silo exists) relevant facts and circumstances, including local laws and contractual arrangements with the contract holder, must be assessed.

Where a silo exists and the investments in the silo are held by the insurance company on behalf of policyholders and all returns from the silo are passed to the policyholders, the following needs to be considered:

- Does the insurance company have a contractual obligation to hold investments in the silo?
- Are the investments legally ring-fenced such that they may not be used to satisfy other liabilities of the insurance company in the event of liquidation?
- Do the policyholders select the investments?
- Will other funds beyond the value of the specified assets in the silo be necessary to fulfil the obligation to the policyholders?
- Is there an exact matching of the policy to the assets held?

All of the relevant facts and circumstances need to be considered to determine if a silo exists. As discussed in section 8.2 below, if a silo exists, control is evaluated for each silo. However, if a silo does not exist, this simply means that the control evaluation is made at the entity level.

8.1.2 Identifying silos in the investment funds industry

Silos may exist in the investment fund industry. Certain investment vehicles are set up as 'umbrella funds' with a number of sub-funds, each with its own investment goals and strategies e.g., a sub-fund may specialise in the shares of small companies, or in a particular country, or a particular industry. An assessment will need to be made as to whether a sub-fund is considered a silo under IFRS 10. The evaluation will depend on the facts and circumstances of the particular case as to whether the sub-funds are legally ring-fenced from each other and the investment vehicle itself, and may vary by jurisdiction, given the differences in regulatory environments and types of such investment vehicles.

8.2 Evaluating control of a silo

If a silo exists, the next step is to identify the relevant activities (the activities that most significantly affect the silo's returns). Only the relevant activities of that silo are considered, even if other activities affect the returns from other portions of the host.

The next step is then to identify which investor has the ability to direct the relevant activities, (i.e., who has the power over the silo). Only rights that affect the relevant activities of the silo are considered. Rights that affect the relevant activities for other portions of the host entity are not considered.

To conclude whether an investor has control over the silo, the investor also evaluates whether the investor has exposure to variable returns from that silo, and whether the investor can use its power over the silo to affect the amount of the investor's returns. Only exposure to variable returns from that silo are considered; exposures to variable returns from other portions of the host are excluded. *[IFRS 10.B78]*.

8.3 Consolidation of a silo

If an investor concludes that it controls a silo, it consolidates only the silo. That investor does not consolidate the remaining portions of the host entity. *[IFRS 10.B79]*.

Similarly, if an investor concludes that it controls a host entity, but not a silo within that entity, it only consolidates the host entity, but excludes the silo.

9 Continuous assessment

IFRS 10 clarifies that an investor is required to reassess whether it controls an investee if the facts and circumstances indicate that there are changes to one of the three elements of control, *[IFRS 10.8, IFRS 10.B80]*, which are repeated below. For example, the following are likely to be triggers:

- Power over the investee:
  - An investor increases or decreases its holdings in the investee - see Illustration 9-1 below
  - A potential voting right is granted, expires, or changes from being substantive to non-substantive (or *vice versa*) - see Illustration 9-2 in section 9.1 below
  - A change in how power over an investee can be exercised. For example, changes to decision making rights, which mean that the relevant activities of the investee are no longer governed through voting rights, but instead, are directed by contract (or *vice versa*) *[IFRS 10.B81]*
  - Bankruptcy filings - see Illustration 9-5 in section 9.2 below
  - Troubled debt restructurings - see Illustration 9-6 in section 9.2 below
  - Changes in voting patterns
  - Action taken by others without the investor being involved in the event - see Illustration 9-7 in section 9.3 below *[IFRS 10.B82]*
- Exposures, or rights, to variable returns from involvement with the investee - in many cases, these changes occur concurrent with a change in power, such as when acquiring an interest or selling an interest in an investee:
  - An investor can lose control of an investee if it ceases to be entitled to receive returns or to be exposed to obligations because, for example, a contract to receive performance related fees is terminated. *[IFRS 10.B83]*.
- Ability of the investor to use its power over the investee to affect the amount of the investor's returns:
  - When the investor is a decision-maker (i.e., a principal or agent), changes in the overall relationship between the investor and other parties can mean that the investor no longer acts as agent, even though it has previously acted as agent or *vice versa*. *[IFRS 10.B84]*.

Therefore, it is possible that a previously unconsolidated investee needs to be consolidated (or *vice versa*) as facts and circumstances change. However, absent a change in facts and circumstances, control assessments are not expected to change.

Illustration 9-1: Providing seed money for a fund

A fund manager provides all of the seed money for a new fund upon inception. Until such times as other investors invest in that fund, the fund manager likely controls that fund. This is because the fund manager has the power to direct the relevant activities of that fund, exposure to variable returns from its involvement with the fund, and the ability to use its power over the fund to affect the amount of its returns.

As third parties invest in the fund and dilute (or acquire) the fund manager's interest, this would likely result in a reassessment of whether the fund manager has control. As the third parties invest, they are likely to obtain rights to direct the relevant activities (that is, the third parties will gain power). In many cases, analysing the facts and circumstances may indicate that the fund manager is acting as an agent of those third parties (as discussed in section 6 above). Accordingly, the fund manager deconsolidates the fund upon its determination that it no longer had control.

9.1 Changes in market conditions

IFRS 10 discusses when a change in market conditions triggers a reassessment of control.

An investor's initial assessment of control or its status as a principal or an agent does not change simply because of a change in market conditions (e.g., a change in the investee's returns driven by market conditions), unless the change in market conditions changes one or more of the three elements of control listed in IFRS 10.7 (see section 9 above) or changes the overall relationship between a principal and an agent (see section 6 above). *[IFRS 10.B85]*.

In response to concerns, the IASB decided to add this guidance to address the reassessment of control when there are changes in market conditions. The IASB observed that a change in market conditions alone would not generally affect the consolidation conclusion, or the status as a principal or an agent, for two reasons. The first is that power arises from substantive rights, and assessing whether those rights are substantive includes the consideration of many factors, not only those that are affected by a change in market conditions. The second is that an investor is not required to have a particular specified level of exposure to variable returns in order to control an investee. If that were the case, fluctuations in an investor's expected returns might result in changes in the consolidation conclusion. *[IFRS 10.BC152]*.

Accordingly, only a market condition that causes a change in one of the three criteria triggers a reassessment (see Illustration 9-7 below). Evaluating whether a change in a market condition triggers a reassessment of control is considered in the context of the investee's purpose and design.

As discussed in section 5 above, with respect to the second criterion, the focus is on the existence of an exposure to variable returns, not the amount of the variable returns. While a change in market conditions often affects the amount of the exposure to variable returns, it typically does not affect whether the exposure exists.

However, when power has been delegated to a decision-maker, a change in market conditions could change whether the magnitude and variability of exposures to variable returns from remuneration and/or other interests are such that they indicate that the decision-maker is a principal (as discussed in sections 6.4 and 6.5 above, respectively). That is, a change in market conditions could change the evaluation of whether a decision-maker has the ability to use its power over the investee to affect the amount of the decision-maker's returns (the linkage between power and returns). Accordingly, a change in market conditions may trigger a reassessment of control in principal-agency evaluations.

As discussed in section 4.3.4.A above, when evaluating the exercise price of an option in the context of whether potential voting rights give control, the evaluation is not solely based on the nature of the option as at the end of the reporting period. During the development of IFRS 10, some constituents raised concerns as to whether frequent changes in the control assessment solely because of market conditions mean that an investor consolidates and deconsolidates an investee if potential voting rights moved in and out of the money. In response, the IASB noted that determining whether a potential voting right is substantive is not based solely on a comparison of the strike or conversion price of the instrument and the then current market price of its underlying share. Although the strike or conversion price is one factor to consider, determining whether potential voting rights are substantive requires a holistic approach, considering a variety of factors. This includes assessing the purpose and design of the instrument, considering whether the investor can benefit for other reasons such as by realising synergies between the investor and the investee, and determining whether there are any barriers (financial or otherwise) that prevent the holder of potential voting rights from exercising or converting those rights. Accordingly, a change in market conditions (i.e., the market price of the underlying shares) alone does not typically result in a change in the consolidation conclusion. *[IFRS 10.BC124]*.

Illustration 9-2: Value of option changes from 'in-the-money' to 'out-of-the-money'

A holds 40% of the voting rights of B, and holds a currently exercisable in-the-money option to acquire a further 20% of the voting rights of B. Assuming that voting rights give power over B, the option is substantive and no other facts and circumstances are relevant, A likely has power over B, because A could currently exercise its right to obtain a majority of B's voting shares.

Consider a situation in which the in-the-money option changed to being slightly (but not deeply) out-of-the-money, due to a change in market conditions (and this change was not previously expected to occur, as discussed in section 4.3.4 above). This would probably not trigger reassessment, because the option is likely to remain substantive, and therefore there is no change in how power over B is evaluated.

Consider a second situation in which the option changed to being deeply-out-of-the-money due to a change in market conditions (and this change was not previously expected to occur and it was now expected to remain deeply-out-of-the-money for the remainder of the option period, as discussed in section 4.3.4 above). This would likely trigger reassessment, since the option would no longer be substantive, and the fact that the option was previously a substantive right was a critical factor in assessing whether A had power over B.

Illustration 9-3: Structured entity reassessments

There are two investors in a structured entity; one holds the debt, and the other holds the equity. In the initial assessment, the investors concluded that the equity holder had control because it had the power to direct the relevant activities, exposure to variable returns through its equity interests, and the ability to use its power over the structured entity to affect the equity holder's returns. Due to a change in market conditions, the value of the equity diminishes. This fact, by itself, would probably not trigger reassessment, because the equity holder continues to have exposure to variable returns (i.e., it continues to be exposed to further decreases in equity, and has potential upside if market conditions improve). Accordingly, the conclusion that the equity holder had control of the structured entity would probably not change.

However, if, concurrently with the deterioration of the equity, there are other changes in facts and circumstances (e.g., the equity holder loses its ability to direct the relevant activities), this might trigger a reassessment. In this case, the trigger is actually the other change in facts and circumstances, not the decrease in equity itself. In this case, whether the debt holder has control depends on whether it has rights that give it the current ability to direct the relevant activities, and the ability to affect its exposure to variable returns.

Illustration 9-4: Investee loses money due to change in market conditions

C holds 100% of the voting rights of D, which is a profitable entity. In its initial assessment, C concludes that it controls D.

Due to a change in the market conditions, D begins to lose money and is no longer profitable (e.g., due to a decrease in demand for its products). This would probably *not* trigger reassessment, because the change in market conditions would likely not change the identification of the relevant activities, how those activities are directed, the investors' exposure to variable returns, or the linkage between power and returns.

However, at some point, D might become so unprofitable as to consider restructuring its debt or filing for bankruptcy. This situation is discussed in section 9.2 below.

9.2 Bankruptcy filings and troubled debt restructurings

Filing for bankruptcy or restructuring a debt will usually trigger reassessment as to which investor, if any, controls the investee (see section 4.3.2 above). While control is reassessed at such triggering points, it does not necessarily mean the conclusion as to which entity consolidates will change. Illustration 9-5 and Illustration 9-6 below show situations when the control conclusion might change, and possibly result in a bank consolidating an entity that it had previously concluded it did not control.

Illustration 9-5: Bankruptcy filing

A made a loan to B. Because of A's position as a senior creditor, if B defaults on the loan, A has the right to direct B to sell certain assets to repay the loan to A. In its initial assessment of control, A concluded that this right was a protective right, because it concluded that defaulting on the loan would be an exceptional circumstance. Consequently, this right did not give A power over B, and therefore, A did not control B. A concluded that the voting rights, which are held by the equity investors, give the equity investors power over B.

B later defaults on the loan and files for bankruptcy, giving A the right to direct B to sell certain assets to repay the loan to A. Upon B filing for bankruptcy, A would need to evaluate whether having this right, which was previously protective, gives A power.

Before concluding which investors, if any, control B once it files for bankruptcy, consideration would also be given to what rights the equity investors have, if any, to direct the relevant activities of B, and also to whether A and the equity investors have exposure to variable returns from B.

Illustration 9-6: Troubled debt restructuring

Consider the same facts as Illustration 9-5 above, except that A and B agree to restructure the loan, rather than B filing for bankruptcy. During the restructuring, A determines which assets will be sold to repay the loan, with management and the equity investors agreeing to this plan. In addition, management agreed to an incentive scheme under which payments are based on asset sale and loan repayment targets.

Upon restructuring the loan, A would need to evaluate whether determining which assets are sold to repay the loan gives A power. This might be the case if voting rights do not give power over B, because management is required to comply with the asset sale plan mandated by A.

Before concluding which investors, if any, control B, consideration is also given to what rights the equity investors have, if any, to direct the relevant activities of B, and also to whether A and the equity investors have exposure to variable returns from B.

In some jurisdictions, it is possible that a trustee or court administrator may have power (and possibly control) over an investee that files for bankruptcy. In such situations, consideration needs to be given not only to whether the trustee has power, but also whether it has an exposure to variable returns from the investee, and if so, whether it has the ability to use that power to affect its exposure to variable returns. In many cases, a trustee or court administrator might have power, but this power is held as an agent (see section 6 above). However, a determination will need to be made as to whether the trustee or court administrator is an agent for a specific lender, or for the creditors as a group. This will depend on individual facts and circumstances for the jurisdiction.

The following facts and circumstances are examples of those that are considered in assessing whether the parent still controls the investee, and which may indicate a loss of control:

- Management's decisions regarding the daily financial and operating policies are directed for the benefit of the creditors, or management is restricted from making any significant financial decisions without the approval of the bankruptcy court, trustee or administrator.
- The pre-bankruptcy shareholders' voting interests are expected to be diluted (thereby resulting in the parent ultimately losing control) upon exiting from bankruptcy.
- While the existing management may remain in place during the bankruptcy proceedings, management must now seek approval from the relevant bankruptcy court, trustee or committee of creditors to make any significant decisions.
- The parent is frequently not among the largest creditors, and therefore excluded from the committee.
- The parent's retained ownership interest is likely to be significantly diluted or even deemed worthless upon commencement of the filing.

The items above are not individually determinative; that is, all facts and circumstances must be carefully considered.

In the situations in Illustration 9-5 and Illustration 9-6 above, it might be determined that the lender obtained control over the investee. In this case, judgement will also be needed to determine the date at which the lender obtained control over the investee. Is it the date that the investee filed for bankruptcy or restructured the debt? Or, did the lender obtain control over the investee before the actual filing, or restructuring, when it became evident that the investee would likely have to file for bankruptcy or restructure the debt?

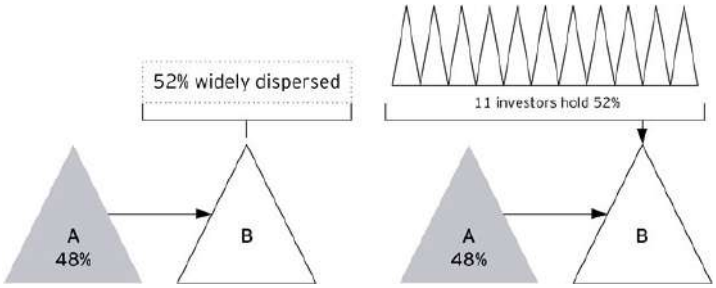
9.3 Control reassessment as a result of action by others

An investor may gain or lose power over an investee as a result of action by others (i.e., without direct involvement in the change in circumstances). For example, an investor can gain power over an investee because decision-making rights held by another party or parties that previously prevented the investor from controlling an investee have elapsed. *[IFRS 10.B82]*.

Alternatively, actions of others, such as a government, could cause an investor to lose the ability to make key operational decisions and therefore direct the relevant activities of the investee. However, IFRS 10 does not include any consolidation exception when the functional currency of an investee is subject to a long-term lack of exchangeability. As explained in the Basis for Conclusions, the Board decided to remove from the previous version the exclusion of a subsidiary from consolidation when there are severe long-term restrictions that impair a subsidiary's ability to transfer funds to the parent. It did so because such circumstances may not preclude control. The Board decided that a parent, when assessing its ability to control a subsidiary, considers restrictions on the transfer of funds from the subsidiary to the parent. In themselves, such restrictions do not preclude control. *[IFRS 10.BCZ21]*.

Another example is when other investors acquire rights from other parties. In such cases, it might be more difficult to determine whether an event has happened that causes an investor to reassess control, because the information might not be publicly available. Consider the situation in Illustration 9-7 below.

Illustration 9-7: Control reassessment without being involved



A holds 48% of the voting rights of B, with the remaining 52% being widely dispersed. In its initial assessment, A concludes that the absolute size of its holding, relative to the other shareholdings, gives it power over B.

Over time, some of the shareholders begin to consolidate their interests, such that eventually, the 52% is held by a much smaller group of shareholders. Depending on the regulatory environment, and rights held by A regarding the right to receive information when shareholders acquire other interests in B, it is possible, although perhaps unlikely, that A would not be aware of this occurrence. Nonetheless, it seems that IFRS 10 would require A to re-evaluate whether it has control over B, because the other shareholders are no longer widely dispersed, and thus A may not have the current ability to direct the relevant activities of B.

While the situation in Illustration 9-7 above might be uncommon, management considers what systems and processes are needed to monitor external events for changes that could trigger reassessment. Without knowledge of such events, and a process for gathering this information, it may be difficult to determine the date when the other voters became sufficiently concentrated to conclude that the investor no longer has control. The same might apply where an investor has determined that it does not have control due to there being a relatively small number of other shareholders, but the other voters become sufficiently dispersed or disorganised such that the investor now has control. Depending on the facts and circumstances, there could be a lag in the period between when the facts and circumstances actually change, and when management is able to conclude that the investor has control.

10 Investment entities

IFRS 10 has an exception for investment entities which entails investment entities to account for their investments at fair value instead of consolidating them. This exception is intended to address what many in the asset management and private equity industries, and users of their financial statements, believe is a significant issue with the consolidation requirements in IFRS 10.

10.1 Definition of an investment entity

IFRS 10 requires that a parent must determine whether it is an investment entity. *[IFRS 10.27]*.

Extract from IFRS 10

27 A parent shall determine whether it is an investment entity. An investment entity is an entity that:

(a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;

(b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and

(c) measures and evaluates the performance of substantially all of its investments on a fair value basis.

Paragraphs B85A-B85M provide related application guidance.

An entity considers all facts and circumstances when assessing whether it is an investment entity, including its purpose and design. An entity that possesses all of the three elements (a) to (c) above is an investment entity. *[IFRS 10.B85A]*.

In addition, when considering the investment entity definition, an entity considers whether it has the following typical characteristics:

- It has more than one investment
- It has more than one investor
- It has investors that are not related parties of the entity

  And
- It has ownership interests in the form of equity or similar interests *[IFRS 10.28]*

The absence of any of these typical characteristics does not necessarily disqualify an entity from being classified as an investment entity. However, it indicates that additional judgement is required in determining whether the entity is an investment entity and therefore, where any of these characteristics are absent, disclosure is required by IFRS 12 of the reasons for the entity concluding that it is nonetheless, an investment entity. *[IFRS 10.28, IFRS 10.B85N, IFRS 12.9A]*.

In November 2016, the IFRS IC discussed a number of questions regarding the investment entity requirements in IFRS 10, including whether an entity qualifies as an investment entity if it does not have one or more of the typical characteristics of an investment entity listed in IFRS 10.28. In its March 2017 agenda decision not to add this question to its standard-setting agenda, the Committee concluded that an entity that possesses all three elements of the definition of an investment entity in IFRS 10.27 is an investment entity, even if that entity does not have one or more of the typical characteristics of an investment entity listed in IFRS 10.28.[9]

If facts and circumstances indicate that there are changes to one or more of the three elements (a) to (c) above, that make up the definition of an investment entity, or changes to the typical characteristics of an investment entity, a parent reassesses whether it is an investment entity. *[IFRS 10.29]*.

A parent that either ceases to be an investment entity or becomes an investment entity accounts for the change in its status prospectively from the date at which the change in status occurred. *[IFRS 10.30]*.

9 *IFRIC Update*, March 2017, pp.7-8, available on the IFRS Foundation's website.

10.2 Determining whether an entity is an investment entity

The first part of the definition of an investment entity in IFRS 10.27 is the requirement that an investment entity provide investors with investment management services. IFRS 10 does not specify how the investment entity must provide these services. In March 2017 (see section 10.1 above), the IFRS IC noted that IFRS 10 does not preclude an investment entity from outsourcing the performance of these services to a third party and therefore concluded that an investment entity responsible for providing investment management services to its investors can engage another party to perform some or all of the services on its behalf.[10]

Application guidance is provided in respect of the definition (b) in section 10.1 above, as follows:

- Business purpose (see section 10.2.1 below)
- Exit strategies (see section 10.2.2 below)
- Earnings from investments (see section 10.2.3 below)

Application guidance is provided in respect of definition (c) in section 10.1 above, as follows:

- Fair value measurement (see section 10.2.4 below)

Application guidance is provided in respect of the four typical characteristics described in section 10.1 above, as follows:

- More than one investment (see section 10.2.5 below)
- More than one investor (see section 10.2.6 below)
- Unrelated investors (see section 10.2.7 below)
- Ownership interests (see section 10.2.8 below)

10.2.1 Business purpose

The definition of an investment entity requires that the purpose of the entity is to invest solely for capital appreciation, investment income (such as dividends, interest or rental income), or both. *[IFRS 10.B85B]*.

Documents that include a discussion of an entity's investment objectives, such as offering memoranda, publications distributed by the entity and other corporate or partnership documents, typically provide evidence of an entity's business purpose. Further evidence may include the manner in which an entity presents itself to other parties (such as potential investors or potential investees). *[IFRS 10.B85B]*.

However, an entity that presents itself as an investor whose objective is to jointly develop, produce or market products with its investees, has a business purpose that is inconsistent with the business purpose of an investment entity. This is because the entity will earn returns from the development, production and marketing activity as well as from its investments. *[IFRS 10.B85B]*.

10.2.1.A Entities that provide investment-related services

An investment entity may provide investment-related services (e.g., investment advisory services, investment management, investment support and administrative services), either directly or through a subsidiary, to third parties as well as its investors and not lose its investment entity status. This applies even if those activities are substantial to the entity, subject to the entity continuing to meet the definition of an investment entity. *[IFRS 10.B85C]*. In March 2017, the IFRS IC confirmed that an investment entity may provide investment-related services to third parties, either directly or through a subsidiary, as long as those services are ancillary to its core investment activities and thus do not change the business purpose of the investment entity (see section 10.1 above).[11]

Extract from IFRS 10

B85D An investment entity may also participate in the following investment-related activities, either directly or through a subsidiary, if these activities are undertaken to maximise the investment return (capital appreciation or investment income) from its investees and do not represent a separate substantial business activity or a separate substantial source of income to the investment entity:

(a) providing management services and strategic advice to an investee; and

(b) providing financial support to an investee, such as a loan, capital commitment or guarantee.

10 *IFRIC Update*, March 2017, pp.7-8, available on the IFRS Foundation's website.

11 *IFRIC Update*, March 2017, pp.7-8, available on the IFRS Foundation's website.

The rationale for these provisions is that investment-related services to third parties are simply an extension of the investment entity's investing activities and do not prohibit an entity from qualifying as an investment entity. *[IFRS 10.B85D, IFRS 10.BC239]*.

An investment entity must consolidate a subsidiary that is itself not an investment entity and whose main purpose and activities are providing services that relate to the investment entity's investment activities. *[IFRS 10.32]*. If the subsidiary that provides the investment-related services or activities is itself an investment entity, the investment entity parent must measure that subsidiary at fair value through profit or loss. *[IFRS 10.B85E]*.

This means that only those entities that are not investment entities that provide investment related services are consolidated. See section 10.3 below for further discussion of the accounting consequences resulting from this requirement.

The requirement to consolidate particular subsidiaries of an investment entity is intended to be a limited exception, capturing only operating subsidiaries that support the investment entity's investing activities as an extension of the operations of the investment entity parent. *[IFRS 10.BC240E]*. When an entity assesses whether it qualifies as an investment entity, it considers whether providing services to third parties is ancillary to its core investing services. However, the definition of an investment entity requires that the purpose of the entity is to invest solely for capital appreciation, investment income or both (see section 10.1 above). Consequently, an entity whose main purpose is to provide investment-related services in exchange for consideration from third parties has a business purpose that is different from the business purpose of an investment entity. This is because the entity's main activity is earning fee income in exchange for its services in contrast to an investment entity whose fee income will be derived from its core activities, which are designed for earning capital appreciation, investment income or both. *[IFRS 10.BC240F]*.

If the subsidiary is not an investment entity, the investment entity parent must assess whether the main activities undertaken by the subsidiary support the core investment activities of the parent. If so, the subsidiary's activities are considered to be an extension of the parent's core investing activities and the subsidiary must be consolidated. These support services provided to the parent and other members of the group could include administration, treasury, payroll and accounting services. *[IFRS 10.BC240H]*.

In November 2016, the IFRS IC received a question as to whether a subsidiary provides services that relate to its parent investment entity's investment activities by holding an investment portfolio as beneficial owner. In its agenda decision in March 2017, the Committee concluded that an investment entity does not consider the holding of investments by a subsidiary as beneficial owner (and recognised in the subsidiary's financial statements) to be a service that relates to the parent investment entity's investment activities (see section 10.1 above), and observed that it had previously discussed a similar question in March 2014 (see section 10.2.1.B below).[12]

The requirement that an investment entity measures at fair value through profit or loss all of its subsidiaries that are themselves investment entities is consistent with the decision not to distinguish between investment entity subsidiaries established for different reasons. *[IFRS 10.BC240B]*. See section 10.2.1.B below.

10.2.1.B Entities that are intermediate holding companies established for tax optimisation purposes

Some investment entities establish wholly owned intermediate subsidiaries in some jurisdictions which own all or part of the portfolio of investments in the group structure. The sole purpose of the intermediate subsidiaries is to minimise the tax paid in the 'parent' investment entity. There is no activity within the subsidiaries and the tax advantage arises from returns being channelled through the jurisdiction of the intermediate subsidiary. In March 2014, the IFRS IC discussed a request to clarify whether the 'tax optimisation' described above is considered investment-related services or activities. The IFRS IC noted that the IASB believes that fair value measurement of all of an investment entity's subsidiaries provide the most useful information, except for subsidiaries providing investment-related services or activities and that the IASB had decided against requiring an investment entity to consolidate investment entity subsidiaries that are formed for tax purposes. The IFRS IC further noted that one of the characteristics of the 'tax optimisation' subsidiaries described is 'that there is no activity within the subsidiary'. Accordingly, the IFRS IC concluded that the parent does not consolidate such subsidiaries and accounts for such intermediate subsidiaries at fair value because they do not provide investment-related services or activities and therefore do not meet the requirements for consolidation.[13]

12 *IFRIC Update*, March 2017, pp.7-8, available on the IFRS Foundation's website.

13 *IFRIC Update*, March 2014, p.4, available on the IFRS Foundation's website.

10.2.2 Exit strategies

IFRS 10 notes "One feature that differentiates an investment entity from other entities is that an investment entity does not plan to hold its investments indefinitely; it holds them for a limited period". *[IFRS 10.B85F]*.

For investments that have the potential to be held indefinitely (typically equity investments and non-financial asset investments), the investment entity must have a documented exit strategy. This documented exit strategy must state how the entity plans to realise capital appreciation from substantially all of these potentially indefinite life investments. An investment entity must also have an exit strategy for any debt instruments that have the potential to be held indefinitely (e.g., perpetual debt instruments). *[IFRS 10.B85F]*.

The investment entity need not document specific exit strategies for each individual investment but must identify different potential strategies for different types or portfolios of investments, including a substantive time frame for exiting the investments. Exit mechanisms that are only put in place for default events, such as breach of contract or non-performance, are not considered exit strategies. *[IFRS 10.B85F]*.

Exit strategies can vary by type of investment. Examples of such strategies for investments in equity securities include an initial public offering, selling the investment in a public market, a private placement, a trade sale of a business, distributions (to investors) of ownership interests in investees and sales of assets (including the sale of an investee's assets followed by a liquidation of an investee). For real estate investments, an example of an exit strategy includes the sale of the real estate through specialised property dealers or the open market. *[IFRS 10.B85G]*.

An investment entity may have an investment in another investment entity that is formed in connection with the entity for legal, regulatory, tax or similar business reasons. In this case, the investment entity investor need not have an exit strategy for that investment, provided that the investment entity investee has appropriate exit strategies for its investments. *[IFRS 10.B85H]*. This is intended to prevent an entity that conducts most of its investing activities through a subsidiary that is a holding company from failing to qualify as an investment entity. *[IFRS 10.BC248]*.

10.2.3 Earnings from investments

An investment entity must commit to its investors that its business purpose is to invest funds solely for returns from capital appreciation, investment income or both.

An entity does not meet this condition when it, or another member of the group containing the entity (i.e., the group that is controlled by the entity's ultimate parent) obtains, or has the objective of obtaining, other benefits from the entity's investments that are not available to other parties that are not related to the investee. 'Other benefits' means benefits in addition to capital appreciation or investment return and such benefits include:

- The acquisition, use, exchange or exploitation of the processes, assets or technology of an investee including the entity or another group member having disproportionate, or exclusive, rights to acquire assets, technology, products or services of any investee; for example, by holding an option to purchase an asset from an investee if the asset's development is deemed successful
- Joint arrangements or other agreements between the entity or another group member and an investee to develop, produce, market or provide products or services
- Financial guarantees or assets provided by an investee to serve as collateral for borrowing arrangements of the entity or another group member (however, an investment entity would still be able to use an investment in an investee as collateral for any of its borrowings)
- An option held by a related party of the entity to purchase from that entity or another group member, an ownership interest in an investee of the entity
- Except as described below, transactions between the entity or another group member and an investee that:
  - Are on terms that are unavailable to entities that are not related parties of either the entity, another group member or the investee
  - Are not at fair value

    Or
  - Represent a substantial portion of the investee's or the entity's business activity, including business activities of other group entities *[IFRS 10.B85I]*

These requirements in respect of 'other benefits' are anti-avoidance provisions. As explained in the Basis for Conclusions, the Board was concerned that an entity that meets the definition of an investment entity could be inserted into a larger corporate group in order to achieve a particular accounting outcome. This concern is illustrated by an example of a parent entity using an 'internal' investment entity subsidiary to invest in subsidiaries that may be making losses (e.g., research and development activities on behalf of the overall group) and therefore record its investments at fair value, rather than reflecting the underlying activities of the investee. Because of these concerns, the Board included the requirement that the investment entity, or other members of the group containing the entity, should not obtain benefits from its investees that are unavailable to other parties that are not related to the investee. *[IFRS 10.BC242]*.

It is also clarified that an entity should demonstrate that fair value is the primary measurement attribute used to evaluate the performance of its investments, both internally and externally. *[IFRS 10.BC252]*.

An entity is not disqualified from being classified as an investment entity because it has investees in the same industry, market or geographical area that trade with each other. This applies where the investment entity has a strategy to invest in more than one investee in that industry, market or geographical area in order to benefit from synergies that increase the capital appreciation and investment income from those investees. *[IFRS 10.B85J]*. The Board decided that trading transactions or synergies that arise between the investments of an investment entity should not be prohibited because their existence does not necessarily mean that the investment entity is receiving any returns beyond solely capital appreciation, investment return, or both. *[IFRS 10.BC243]*.

10.2.4 Fair value measurement

In order to qualify as an investment entity, a reporting entity must measure and evaluate the performance of substantially all of its investments on a fair value basis. This is because using fair value results in more relevant information than, for example, consolidation for subsidiaries or the use of the equity method for interests in associates or joint ventures. In order to demonstrate fair value measurement, an investment entity must:

(a) Provide investors with fair value information and measure substantially all of its investments at fair value in its financial statements whenever fair value is permitted in accordance with IFRS accounting standards

And

(b) Report fair value information to the entity's key management personnel who use fair value as the primary measurement attribute to evaluate the performance of substantially all of its investments and to make investment decisions *[IFRS 10.B85K]*

In order to meet the requirements in (a) above, an investment entity:

- Elects to account for any investment property using the fair value model in IAS 40 *Investment Property*
- Elects the exemption from applying the equity method in IAS 28 for its investments in associates and joint ventures

  And

- Measures its financial assets at fair value using the requirements in IFRS 9 *[IFRS 10.B85L]*

As described in the Basis for Conclusions, investments measured at fair value in the statement of financial position with fair value changes recognised in other comprehensive income rather than through profit or loss still satisfy the fair value measurement condition of the definition of an investment entity. *[IFRS 10.BC251]*. However, an investment entity does not account for more than an insignificant amount of financial assets at amortised cost under IFRS 9, nor fail to elect the fair value measurement options in IAS 28 or IAS 40. *[IFRS 10.BC250]*.

Fair value measurement applies only to an investment entity's investments. There is no requirement to measure non-investment assets such as property, plant and equipment or liabilities such as financial liabilities at fair value. *[IFRS 10.B85M]*.

10.2.5 Holding more than one investment

Extract from IFRS 10	
B85O	An investment entity typically holds several investments to diversify its risk and maximise its returns. An entity may hold a portfolio of investments directly or indirectly, for example by holding a single investment in another investment entity that itself holds several investments.

[IFRS 10.B85O].

Holding a single investment does not necessarily prevent an entity from meeting the definition of an investment entity. Examples where an investment entity may hold only a single investment are when the entity:

- Is in its start-up period and has not yet identified suitable investments and, therefore, has not yet executed its investment plan to acquire several investments
- Has not yet made other investments to replace those it has disposed of
- Is established to pool investors' funds to invest in a single investment when that investment is unobtainable by individual investors (e.g., when the required minimum investment is too high for an individual investor)
- Is in the process of liquidation *[IFRS 10.B85P]*

As holding only one investment is not a typical characteristic of an investment entity, this requires disclosure as a significant judgement (see section 10.1 above).

10.2.6 Having more than one investor

An investment entity typically has several investors who pool their funds to gain access to investment management services and investment opportunities they might not have had access to individually. In the Board's opinion, having more than one investor makes it less likely that the entity, or other members of the group containing the entity, would obtain benefits other than capital appreciation or investment income (see section 10.2.3 above). *[IFRS 10.B85Q]*.

Although the Board considers that an investment entity typically has more than one investor, there is no conceptual reason why an investment fund with a single investor should be disqualified from being an investment entity. Therefore, the presence of more than one investor is a typical characteristic of an investment entity rather than as part of the definition of an investment entity. *[IFRS 10.BC260]*.

An investment entity may be formed by, or for, a single investor that represents or supports the interests of a wider group of investors such as a pension fund, a government investment fund or a family trust. *[IFRS 10.B85R]*.

The Board acknowledges that there may be times when the entity temporarily has a single investor. For example, an investment entity may have a single investor when it:

- Is within its initial offering period and the entity is actively identifying suitable investors
- Has not yet identified suitable investors to replace ownership interests that have been redeemed

  Or
- Is in the process of liquidation *[IFRS 10.B85S]*

These examples are not stated to be exhaustive and there could be other reasons why an investment entity might have only one investor. Having only one investor is not a typical characteristic of an investment entity. The fact that an entity is considered to be an investment entity despite having only one investor is a significant judgement requiring disclosure (see section 10.1 above).

10.2.7 Unrelated investors

An investment entity typically has several investors that are not related parties of the entity or other members of the group containing the entity. The existence of unrelated investors makes it less likely that the entity, or other members of the group containing the entity, would obtain benefits other than capital appreciation or investment income (see section 10.2.3 above). *[IFRS 10.B85T]*.

As the definition of a related party includes an entity which has significant influence over a reporting entity, when read literally this means that, typically, an entity that is significantly influenced by one or more parties by, for example, having investors with a greater than 20% ownership interest (see Chapter 11 at section 2), cannot be an investment entity.

However, an entity may still qualify as an investment entity even though its investors are related to the entity. To support this, an example is illustrated in which an investment entity sets up a separate 'parallel' fund for a group of its employees (such as key management personnel) or other related party investors, which mirrors the investment of the entity's main investment fund. It is stated that this 'parallel' fund may qualify as an investment entity even though all of its investors are related parties. *[IFRS 10.B85U]*. In this example, the key determinant in concluding that the parallel fund is an investment entity is that it is being managed for capital appreciation or investment income.

Although IFRS 10 provides only one example of a fund which qualifies as an investment entity with investors that are related parties, it is explained in the Basis for Conclusions that respondents to the Investment Entities ED provided "…examples of entities with related investors that they believed should qualify as investment entities." *[IFRS 10.BC261]*.

10.2.8 Ownership interests

An investment entity is typically, but is not required to be, a separate legal entity. Ownership interests in an investment entity will usually be in the form of equity or similar interests (e.g., partnership interests), to which proportionate shares of the net assets of the investment entity are attributed. However, having different classes of investors, some of which have rights only to a specific investment or groups of investments or which have different proportionate shares of the net assets, does not preclude an entity from being an investment entity. *[IFRS 10.B85V]*.

It is rationalised in the Basis for Conclusions that holding a proportionate share of the net assets of an investment entity explains in part why fair value is more relevant to investors of an investment entity because the value of each ownership interest is linked directly to the fair value of the entity's investments. *[IFRS 10.BC263]*. However, whether there is this form of ownership interest in an entity is not a deciding factor and would inappropriately exclude certain structures from investment entity status. One example illustrated by the Basis for Conclusions of entities that do not have units of ownership interest in the form of equity or similar interests is a pension fund or sovereign wealth fund with a single direct investor which may have beneficiaries that are entitled to the net assets of the investment fund, but do not have ownership units. Another example is funds with different share classes or funds in which investors have discretion to invest in individual assets. *[IFRS 10.BC264, IFRS 10.BC266]*. In both of these examples, the investors are entitled to a proportionate share of at least part of the assets of the fund although not the entire fund.

An entity that has significant ownership interests in the form of debt that does not meet the definition of equity may still qualify as an investment entity, provided that the debt holders are exposed to variable returns from changes in the fair value of the entity's net assets. *[IFRS 10.B85W]*.

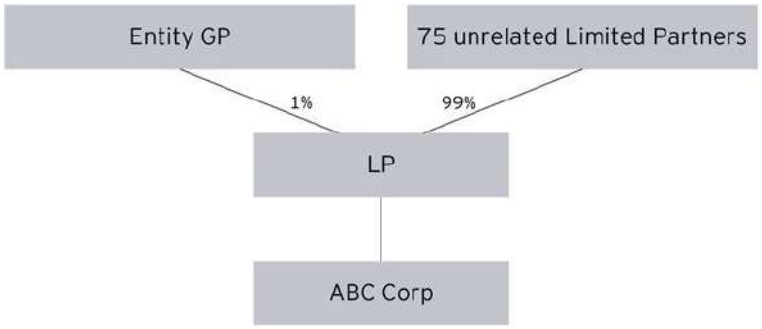
10.2.9 Investment entity illustrative examples

The following Illustrations show the application of the investment entity criteria and are based on illustrative examples contained in IFRS 10.

Illustration 10-1: A limited partnership that is an investment entity

An entity, Limited Partnership (LP), is formed in 20X3 with a 10-year life. The offering memorandum states that LP's purpose is to invest in entities with rapid growth potential, with the objective of realising capital appreciation over their life. Entity GP (the general partner of LP) provides 1% of the capital to LP and has responsibility for identifying suitable investments for the partnership. Approximately 75 limited partners, who are unrelated to Entity GP, provide 99% of the capital to the partnership. LP begins its investment activities in 20X3 but no investments are identified until 20X4 when LP acquires a controlling interest in ABC Corp.

The group structure at 31 December 20X4 is illustrated as follows:



In 20X4, LP acquires equity interests in five additional operating companies. Other than acquiring those equity interests, LP conducts no other activities. LP measures and evaluates its investments on a fair value basis and this information is provided to Entity GP and the external investors.

LP plans to dispose of its interests in each of its investees during the 10-year stated life of the partnership. Such disposals include the outright sale for cash, the distribution of marketable equity securities to investors following the successful public offering of the investees' securities and the disposal of investments to the public or other unrelated entities.

In this example, LP meets the definition of an investment entity from formation in 20X3 to 31 December 20X4 because:

- LP has obtained funds from limited partners and is providing them with investment management services.
- LP's only activity is acquiring equity interests in operating companies with the purpose of realising capital appreciation over the life of the investments. LP has identified and documented exit strategies for its investments, all of which are equity investments.
- LP measures and evaluates its investments on a fair value basis and reports this financial information to its investors.

In addition, LP displays the following typical characteristics of an investment entity:

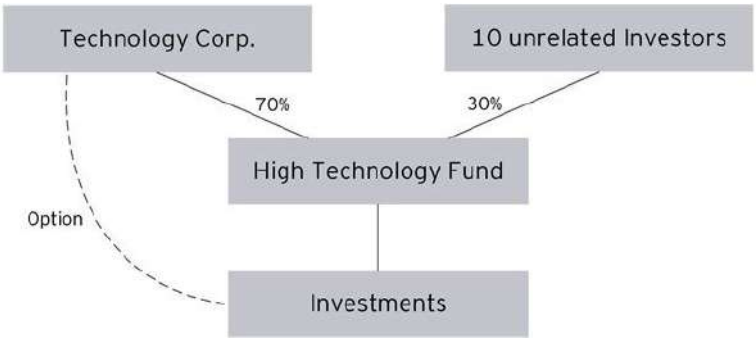
- LP is funded by many investors.
- Its limited partners are unrelated to LP.
- Ownership in LP is represented by units of partnership interests acquired through a capital contribution.

LP does not hold more than one investment throughout the period. However, this is because it was still in its start-up period and had not identified suitable investment opportunities. *[IFRS 10.IE1-IE6]*.

Illustration 10-2: Start-up high technology fund that is not an investment entity

An entity, High Technology Fund, is formed by Technology Corp. to invest in start-up technology companies for capital appreciation. Technology Corp. holds a 70% interest in High Technology Fund and controls it; the other 30% ownership interest is held by 10 unrelated investors. Technology Corp. holds options to acquire investments held by High Technology Fund, at their fair value, which would be exercised if the technology developed by the investees would benefit the operations of Technology Corp.

The group structure is illustrated below:



High Technology Fund has no plans for exiting the investments. High Technology Fund is managed by an investment advisor that acts as agent for the investors in High Technology Fund.

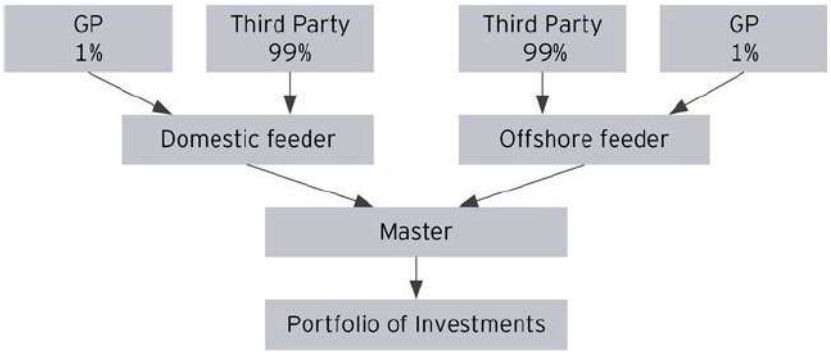
In this Illustration, although High Technology Fund's business purpose is investing for capital appreciation and it provides investment management services to its investors, High Technology Fund is not an investment entity because:

- Technology Corp., the parent of High Technology Fund, holds options to acquire investments in investees held by High Technology Fund if assets developed by the investees would benefit the operations of Technology Corp. This provides a benefit in addition to capital appreciation and investment income.
- The investment plans of High Technology Fund do not include exit strategies for its investments, which are equity instruments. The options held by Technology Corp. are not controlled by High Technology Fund and do not constitute an exit strategy. *[IFRS 10.IE7, IFRS 10.IE8]*.

Illustration 10-3: Master and feeder funds that are investment entities

An entity, Master Fund, is formed in 20X4 with a 10-year life. The equity of Master Fund is held by two related feeder funds. The feeder funds are established in connection with each other to meet legal, regulatory, tax or similar requirements. The feeder funds are capitalised with a 1% investment from the general partner and 99% from equity investors that are unrelated to the general partner (with no party holding a controlling financial interest).

The group structure is illustrated below:



The purpose of Master Fund is to hold a portfolio of investments in order to generate capital appreciation and investment income (such as dividends, interest or rental income). The investment objective communicated to investors is that the sole purpose of the master-feeder structure is to provide investment opportunities for investors in separate market niches to invest in a large pool of assets. Master Fund has identified and documented exit strategies for the equity and non-financial investments that it holds. Master Fund also holds a portfolio of short and medium-term debt instruments, some of which will be held until maturity and some of which will be traded but Master Fund has not specifically identified which investments will be held and which will be traded. Master Fund measures and evaluates substantially all of its investments, including its debt investments, on a fair value basis. In addition, investors receive periodic financial information, on a fair value basis, from the feeder funds. Ownership in both Master Fund and the feeder funds is represented through units of equity.

In this example, Master Fund and the two feeder funds all meet the definition of an investment entity because:

- Both Master Fund and the two feeder funds have obtained funds for the purpose of providing investors with investment management services.
- The business purpose of the master-feeder structure, which was communicated directly to investors of the feeder funds, is investing solely for capital appreciation and investment income and Master Fund has identified and documented potential exit strategies for its equity and non-equity financial instruments.
- Although the feeder funds do not have an exit strategy for their interests in Master Fund, the feeder funds can nevertheless be considered to have an exit strategy for their investments because Master Fund was formed in connection with the feeder funds and holds investments on behalf of the feeder funds.
- The investments held by Master Fund are measured and evaluated on a fair value basis and information about the investments made by Master Fund is provided to investors on a fair value basis through the feeder funds.

Master Fund and the feeder funds were formed in connection with each other for legal, regulatory, tax or similar requirements. When considered together, they display the following typical characteristics of an investment entity:

- The feeder fund indirectly holds more than one investment because Master Fund holds a portfolio of investments.
- Although Master Fund is wholly capitalised by feeder funds, the feeder funds are funded by many investors who are unrelated to the feeder funds (and to the general partner).
- Ownership in the feeder funds is represented by units of equity interests through a capital contribution.

[IFRS 10.IE12, IFRS 10.IE13, IFRS 10.IE14, IFRS 10.IE15].

10.2.10 Multi-layered fund structures

Illustration 10-3 above shows a multi-layered fund structure. The reason and purpose of these is usually to accomplish one or more of the following:

- Regulatory reasons to invest in certain jurisdictions
- Risk mitigation reasons, that is, to ring fence particular investees

  Or

- Investment-return enhancement, where the after-tax returns on an investment can be enhanced by using vehicles in certain jurisdictions

When an investment entity has a subsidiary that is an intermediate parent that is formed in connection with the parent investment entity for legal, regulatory, tax or similar business reasons, the investment entity investor need not have an exit strategy for that subsidiary. This is on condition that the intermediate investment entity parent has appropriate exit strategies for its investments. *[IFRS 10.B85H]*. In addition, an entity must consider all facts and circumstances in assessing whether it is an investment entity, including its purpose and design. *[IFRS 10.B85A]*. Illustrative Example 4 of IFRS 10, represented by Illustration 10-3 above, indicates that funds formed in connection with each other for legal, regulatory, tax or similar requirements can be considered together to determine whether they display the characteristics of an investment entity. In Illustration 10-3 above, both Domestic Feeder and Offshore Feeder are considered to be investment entities.

10.3 Accounting by an investment entity

In its consolidated financial statements, an investment entity:

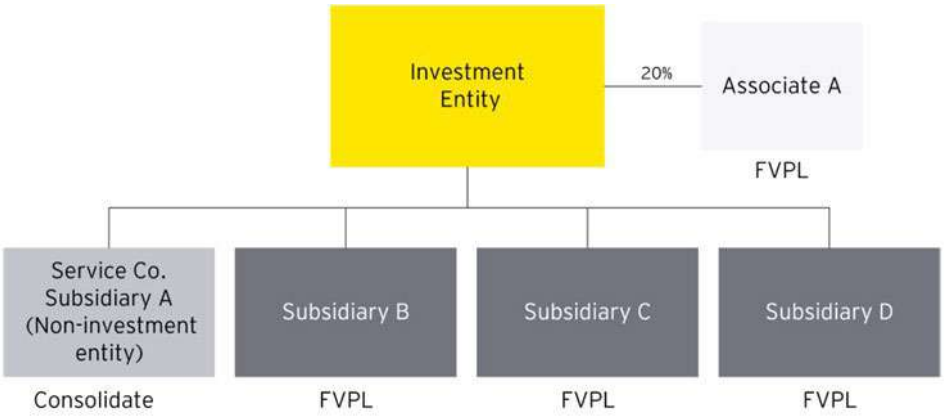
- Consolidates any subsidiary that is not an investment entity and whose main purpose and activities are providing services that relate to the investment entity's investment activities and apply the requirements of IFRS 3 to the acquisition of any such subsidiary (see section 10.2.1.A above) *[IFRS 10.32]*

  And

- Measures all other investments in a subsidiary at fair value through profit or loss in accordance with IFRS 9 *[IFRS 10.31]*

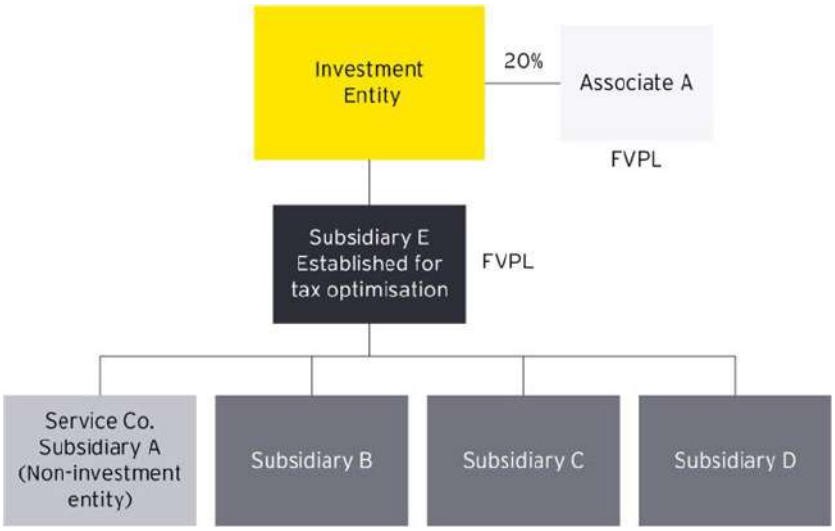
In addition, as discussed in section 10.2.4 above, the investment entity must elect to account for its own investments in investment property, associates, joint ventures and financial assets at fair value. However, where applicable, some of these investments could be measured at fair value through other comprehensive income. Other assets (e.g., property, plant and equipment) and financial liabilities need not be measured at fair value unless this is required by the relevant IFRS accounting standard.

The following diagram illustrates the accounting in the consolidated financial statements of an investment entity in a simple group structure:



The accounting is less intuitive for investment entities with intermediate holding company subsidiaries. If the intermediate holding company does not meet the conditions for consolidation, then the intermediate holding company, including its investments in subsidiaries, is measured at fair value through profit or loss. The underlying subsidiaries are not measured separately.

The diagram below illustrates the accounting for an investment entity parent using the same group structure as above but with an intermediate parent established for tax optimisation purposes inserted between the investment entity parent and the subsidiaries. As discussed in section 10.2.1.B above, the IFRS IC has clarified that intermediate holding companies established for tax optimisation purposes are measured by a parent investment entity at fair value through profit or loss. Therefore, in this situation, the underlying subsidiaries are not separately measured at fair value through profit or loss (or consolidated in the case of the non-investment entity service company). Instead, the intermediate holding entity, including its investments in subsidiaries, is measured at fair value through profit or loss. Parent investment entities with this type of group structure may wish to provide further information in their financial reports to help explain their performance.



If Subsidiary A (the non-investment entity service company) was owned directly by the investment entity parent, rather than by Subsidiary E, it would be consolidated.

When an investment entity has no subsidiaries that are consolidated (i.e., all subsidiaries are measured at fair value through profit or loss as illustrated above), it presents separate financial statements as its only financial statements. *[IAS 27.8A]*.

When an investment entity parent prepares consolidated financial statements, any subsidiary measured at fair value through profit or loss in those consolidated financial statements must also be accounted for in the same way in its separate financial statements (i.e., at fair value through profit or loss). *[IAS 27.11A]*. When an investment entity parent has subsidiaries that are consolidated in its consolidated financial statements, the parent has a separate accounting policy choice to account for those subsidiaries either at cost, in accordance with IFRS 9 or using the equity method in its separate financial statements (see Chapter 9 at section 2).

Fair value will be as determined by IFRS 13. Under IFRS 13, net asset value cannot be presumed to equal fair value as the asset being measured is the equity investment in an investment entity, not the underlying assets and liabilities of the investment entity itself. Instead, the characteristics of the investment being measured need to be considered when determining its fair value. The use of net asset value in determining fair value is discussed in Chapter 15 at section 2.5.1.A.

10.3.1 Accounting for a change in investment entity status

A parent that either ceases to be an investment entity or becomes an investment entity accounts for its change in status prospectively from the date at which the change in status occurred. *[IFRS 10.30]*.

10.3.1.A Becoming an investment entity

In summary, when an entity becomes an investment entity, the change in status is treated as a loss of control of the investment entity subsidiaries. Therefore, when an entity becomes an investment entity, it ceases to consolidate its subsidiaries from the date of the change in status, except for any non-investment entity subsidiary whose main purpose and activities are providing services that relate to the investment entity's investment activities, and apply the loss of control provisions of IFRS 10. *[IFRS 10.B101]*.

This means that the parent:

- Derecognises the assets and liabilities of those subsidiaries from the consolidated statement of financial position
- Recognises any investment retained in those subsidiaries at fair value through profit or loss in accordance with IFRS 9

  And

- Recognises a gain or loss associated with the loss of control attributed to the subsidiaries *[IFRS 10.25]*

Similarly, in the separate financial statements of the parent, when an entity becomes an investment entity, it accounts for an investment in a subsidiary at fair value through profit or loss in accordance with IFRS 9. The difference, if any, between the previous carrying amount of the subsidiary and its fair value at the date of the change in status of the investor is recognised as a gain or loss in profit or loss. If the parent has previously recorded its investment in accordance with IFRS 9 at fair value through other comprehensive income (OCI), the cumulative amount of any gain or loss recognised previously in OCI in respect of that subsidiary is treated as if the entity had disposed of it at the date of change in status. *[IAS 27.11B(b)]*. This gain or loss in OCI is not recycled to profit or loss.

IFRS 10 is silent in respect of any accounting changes required when an entity becomes an investment entity in respect of its own investment property, associates, joint ventures and financial assets. However, it is a condition of being an investment entity that a reporting entity must measure and evaluate the performance of substantially all of its investments on a fair value basis. This implies that those assets have been measured already on a fair value basis in order for the entity to meet the requirements of an investment entity.

10.3.1.B Ceasing to be an investment entity

In summary, when an entity ceases to be an investment entity, the event is treated similarly to a business combination. Therefore, when an entity ceases to be an investment entity, it applies IFRS 3 to any subsidiary that was previously measured at fair value through profit or loss. This means that all of the individual assets and liabilities of the subsidiary are recognised at fair value (unless IFRS 3 requires otherwise) and the difference between the previous fair value and the value of the individual assets and liabilities is goodwill. The date of change of status is the deemed acquisition date. The fair value of the subsidiary at the deemed acquisition date represents the transferred deemed consideration when measuring any goodwill or gain from a bargain purchase that arises from the deemed acquisition. All subsidiaries are consolidated in accordance with IFRS 10 from the date of change in status. *[IFRS 10.B100]*.

In the separate financial statements of the parent, when the parent ceases to be an investment entity, it accounts for an investment in a subsidiary either at cost, in accordance with IFRS 9, or using the equity method as described in IAS 28. The date of the change in status is the deemed acquisition date. The fair value of the subsidiary at the deemed acquisition date when accounting for the investment, under any of the permitted methods, represents the transferred deemed consideration. *[IAS 27.11B(a)]*.

10.4 Accounting by a parent of an investment entity

A parent of an investment entity that is not itself an investment entity cannot use the investment entity exception. It must therefore consolidate all entities that it controls including those controlled through an investment entity subsidiary. *[IFRS 10.33]*.

According to the Board, non-investment entities do not have the unique business models of investment entities; they have other substantial activities besides investing or do not manage substantially all of their investments on a fair value basis. Consequently, in the Board's view, the argument for a fair value measurement is weakened at non-investment entity level. *[IFRS 10.BC276, IFRS 10.BC277, IFRS 10.BC278]*.

The Board also noted the following in arriving at its conclusion:

- Concern that a non-investment entity could achieve different accounting outcomes by holding subsidiaries directly or indirectly through an investment entity *[IFRS 10.BC280]*
- Practical difficulties when a non-investment entity parent and an investment entity invest in the same investment or when an investment entity subsidiary holds a subsidiary that invests in the equity of a non-investment entity parent *[IFRS 10.BC281]*
- Although US GAAP permits 'rolled up' accounting in certain circumstances, this is linked to industry-specific guidance that is not generally contained in IFRS accounting standards *[IFRS 10.BC282]*
- Inconsistency with the roll-up of fair value accounting option permitted by IAS 28. However, the Board thought it was important to retain the fair value accounting that is currently allowed for venture capital organisations, mutual funds, unit trusts and similar entities and that the differences between using equity accounting and fair value accounting was considered to be smaller than between consolidation and fair value measurement for investments in subsidiaries. *[IFRS 10.BC283]*.

Ultimately, due to concerns about potential abuses, the Board considered that the investment entity exception is not retained by a non-investment entity parent in its consolidated financial statements.

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Appendix B - Defined terms

Extract from IFRS standards - Definitions	
acquisition date	The date on which the **acquirer** obtains control of the **acquiree**. *[IFRS 3 Appendix A]*.
combined financial statements	Financial statements of a reporting entity that comprises two or more entities that are not all linked by a parent-subsidiary relationship. *[CF 3.12, CF Appendix Defined terms]*.
consolidated financial statements	The financial statements of a **group** in which the assets, liabilities, equity, income, expenses and cash flows of the **parent** and its **subsidiaries** are presented as those of a single economic entity. *[IFRS 10 Appendix A]*.
control of an investee	An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. *[IFRS 10 Appendix A]*.
group	A **parent** and its **subsidiaries**. *[IFRS 10 Appendix A]*.
investment entity	An entity that: (a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services; (b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and (c) measures and evaluates the performance of substantially all of its investments on a fair value basis. *[IFRS 10 Appendix A]*.
joint control	The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control. *[IFRS 11 Appendix A]*.
parent	An entity that **controls** one or more entities. *[IFRS 10 Appendix A]*.
protective rights	Rights designed to protect the interest of the party holding those rights without giving that party power over the entity to which those rights relate. *[IFRS 10 Appendix A]*.
reporting entity	A reporting entity is an entity that is required, or chooses, to prepare financial statements. *[CF 3.10, CF Appendix Defined terms]*.
separate financial statements	***Separate financial statements*** **are those presented by an entity in which the entity could elect, subject to the requirements in this Standard, to account for its investments in subsidiaries, joint ventures and associates either at cost, in accordance with IFRS 9 *Financial Instruments*, or using the equity method as described in IAS 28 *Investments in Associates and Joint Ventures*.** *[IAS 27.4]*.
significant influence	***Significant influence*** **is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.** *[IAS 28.3]*.
structured entity	An entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. Paragraphs B22-B24 provide further information about structured entities. *[IFRS 12 Appendix A]*.
subsidiary	An entity that is controlled by another entity. *[IFRS 10 Appendix A]*.

Chapter 8 Consolidation procedures and non-controlling interests

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Overview

IFRS 10 *Consolidated Financial Statements* sets out the principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities.

Chapter 7 discusses the requirements of IFRS 10 relating to the concepts underlying control of an entity (a subsidiary) by its parent, the requirement to prepare consolidated financial statements and what subsidiaries are to be consolidated within a set of consolidated financial statements. It also covers the definition of an investment entity and the exception from consolidating particular subsidiaries of an investment entity. The development, objective, and scope of IFRS 10 are dealt with in Chapter 7 at sections 1.2 and 2.

This chapter deals with the accounting requirements of IFRS 10 relating to the preparation of consolidated financial statements. In particular, it covers topics such as: consolidation procedures, when to commence or cease consolidation, how to account for the acquisition of a subsidiary that is not a business (business combinations are addressed in Chapter 10), how to account for a loss of control (including deemed disposals and distributions in kind), how to account for changes in ownership interest without a loss of control, and how to account for non-controlling interests (NCI). The chapter also covers the accounting for put and call options over NCI ('NCI puts and calls'). Finally, the chapter includes a section on future developments being considered by the IASB or the IFRS IC.

What you need to know

- Consolidated financial statements represent the financial statements of a group (i.e., the parent and its subsidiaries) in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.
- Investment entities do not consolidate particular subsidiaries, instead including them at fair value through profit or loss. IFRS 10 provides specific guidance on the definition of and accounting for investment entities.
- If the subsidiary is not wholly-owned, the profit or loss and each component of other comprehensive income (OCI) of the subsidiary, and the equity of the subsidiary, are attributed to the parent's interest and to NCI. This allocation is usually done on the basis of existing ownership interests. IFRS 3 *Business Combinations* addresses the initial measurement of NCI arising from a business combination. However, IFRS accounting standards do not address the initial measurement of NCI arising from an acquisition that is not a business and different approaches have developed.
- A parent consolidates a subsidiary from the date on which the parent first obtains control, and ceases consolidating that subsidiary on the date on which the parent loses control.
- On a loss of control of a subsidiary, the group deconsolidates the assets and liabilities and any NCI relating to a former subsidiary. Any retained interest in the former subsidiary is measured at fair value. A gain or loss is recognised in profit or loss equal to the fair values of the consideration received and retained interest less the carrying amounts of the assets and liabilities and any NCI in the subsidiary that is deconsolidated. Certain elements of OCI relating to the former subsidiary are required to be reclassified to profit or loss on a loss of control.
- Where a subsidiary is sold (or contributed) to an associate or joint venture accounted using the equity method, conflicts between IFRS 10 (which requires a full gain or loss to be recognised in profit or loss on loss of control of the subsidiary) and IAS 28 *Investments in Associates and Joint Ventures* (which requires a partial gain or loss only to be recognised in a 'downstream transaction') have led to diversity in accounting approaches. The IASB and IFRS IC have also discussed other situations involving the loss of control of a subsidiary where it was unclear whether the requirements of IFRS 10 and/or other IFRS accounting standards applied.
- Increases or decreases in the ownership interest in a subsidiary that do not involve a loss of control are accounted for in equity. There is no change to the assets (including goodwill) and liabilities recognised in the consolidated financial statements but there may be reallocations in equity between the parent's interest and NCI in the subsidiary.
- IFRS 10 does not directly address the accounting for NCI puts and calls. IAS 32 *Financial Instruments: Presentation* requires that a financial liability is recognised for the present value of the redemption price for an NCI put. There is diversity of accounting approaches in accounting for NCI puts and this issue has been addressed in the IASB's *Financial Instruments with the Characteristics of Equity* Project. An Exposure Draft *Financial Instruments with the Characteristics of Equity* was published in November 2023.

1 Introduction

This chapter deals with the accounting requirements of IFRS 10 relating to the presentation and preparation of consolidated financial statements. IFRS 10's requirements on consolidation procedures are dealt with in section 2 below; accounting for changes in control in section 3 below; accounting for changes in ownership interest without loss of control in section 4 below; the recognition, measurement and presentation of NCI in section 5 below; and accounting for NCI puts and calls (or combinations of such options) in section 6 below. The final section covers future developments in section 7 below.

FASB differences

Differences between the IFRS and US GAAP guidance on this topic are not addressed in this chapter as the standards are not converged. Therefore, differences between IFRS and US GAAP may exist that are not addressed in this publication.

2 Consolidation procedures

2.1 Basic principles

Extract from IFRS 10

Appendix A
Defined terms

consolidated financial statements	The financial statements of a **group** in which the assets, liabilities, equity, income, expenses and cash flows of the **parent** and its **subsidiaries** are presented as those of a single economic entity.

[IFRS 10 Appendix A].

The above approach to preparing consolidated financial statements is referred to as 'the entity concept'. As noted in Chapter 7 at section 10, an investment entity generally measures its investments in subsidiaries at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments*, with limited exceptions. *[IFRS 10.31, IFRS 10.32, IFRS 10.33]*.

IFRS 10 requires a parent to prepare consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances (see section 2.6 below). *[IFRS 10.19, IFRS 10.21, IFRS 10.B87]*. Consolidation of an investee begins from the date the investor obtains control of the investee and ceases when the investor loses control of the investee. *[IFRS 10.20, IFRS 10.21, IFRS 10.B88]*.

In order to present financial information about the group as that of a single economic entity, the entity must: *[IFRS 10.21, IFRS 10.B86]*

(a) Combine like items of assets, liabilities, equity, income, expenses, and cash flows of the parent with those of its subsidiaries

(b) Offset (eliminate) the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary (IFRS 3 explains how to account for any related goodwill - see Chapter 10 at section 13) *[IFRS 3.B63(a)]*

(c) Eliminate in full intragroup assets and liabilities, equity, income, expenses, and cash flows relating to transactions between entities of the group (profits or losses resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets, are eliminated in full). Intragroup losses may indicate an impairment that requires recognition in the consolidated financial statements. IAS 12 *Income Taxes* applies to temporary differences that arise from the elimination of profits and losses resulting from intragroup transactions. See section 2.4 below.

Income and expenses of a subsidiary are based on the carrying amounts of the assets and liabilities recognised in the consolidated financial statements at the acquisition date. Many items will have a fair value on acquisition that will affect subsequent recognition of income and expense. IFRS 10 gives the example of depreciation expense, which will be based on the fair values of the related depreciable assets recognised in the consolidated financial statements at the acquisition date. *[IFRS 10.21, IFRS 10.B88]*.

Point (b) above refers to the elimination of the parent's investment and the parent's portion of equity. The equity in a subsidiary not attributable, directly or indirectly, to the parent, represents an NCI. *[IFRS 10 Appendix A]*. The profit or loss and each component of OCI of a subsidiary are attributed to the owners of the parent and to the NCI. *[IFRS 10.24, IFRS 10.B94]*. NCI in subsidiaries (in aggregate) are presented within equity, separately from the equity of the owners of the parent. *[IFRS 10.22]*. Changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are accounted for as equity transactions. *[IFRS 10.23]*. Accounting for NCI is discussed in more detail in sections 2.2, 4 and 5 below.

2.2 Proportion of subsidiary's profit or loss, OCI and equity allocated to parent and NCI

The basic consolidation procedures described above effectively mean that 100% of the assets, liabilities, income, expenses, and cash flows of a subsidiary are consolidated with those of the parent, irrespective of the parent's ownership interest in the subsidiary. However, the profit or loss and each component of OCI of the subsidiary, and the equity of the subsidiary, are attributed to the parent and the NCI (if the subsidiary is not wholly-owned).

As discussed in Chapter 7 at section 4.3.4, when assessing control, an investor considers any potential voting rights that it holds as well as those held by others. Common examples of potential voting rights include options, forward contracts, and conversion features of a convertible instrument.

If there are potential voting rights, or other derivatives containing potential voting rights, IFRS 10 contains the following guidance on the proportion of profit or loss, OCI and changes in equity allocated to the parent and NCI (see section 5.7 below) in preparing consolidated financial statements: *[IFRS 10.21, IFRS 10.B89, IFRS 10.B90, IFRS 10.B91]*

Extract from IFRS 10

Potential voting rights

B89 When potential voting rights, or other derivatives containing potential voting rights, exist, the proportion of profit or loss and changes in equity allocated to the parent and non-controlling interests in preparing consolidated financial statements is determined solely on the basis of existing ownership interests and does not reflect the possible exercise or conversion of potential voting rights and other derivatives, unless paragraph B90 applies.

B90 In some circumstances an entity has, in substance, an existing ownership interest as a result of a transaction that currently gives the entity access to the returns associated with an ownership interest. In such circumstances, the proportion allocated to the parent and non-controlling interests in preparing consolidated financial statements is determined by taking into account the eventual exercise of those potential voting rights and other derivatives that currently give the entity access to the returns.

B91 IFRS 9 does not apply to interests in subsidiaries that are consolidated. When instruments containing potential voting rights in substance currently give access to the returns associated with an ownership interest in a subsidiary, the instruments are not subject to the requirements of IFRS 9. In all other cases, instruments containing potential voting rights in a subsidiary are accounted for in accordance with IFRS 9.

Generally, the proportion of NCI is determined solely on the basis of existing ownership interests. It does not reflect the possible exercise or conversion of potential voting rights and other derivatives. *[IFRS 10.21, IFRS 10.24, IFRS 10.B89, IFRS 10.B94]*.

Usually, there is no difference between the existing ownership interests and the present legal ownership interests in the underlying shares. However, allocating the proportions of profit or loss, OCI, and changes in equity based on present legal ownership interests is not always appropriate. For example, there may be situations where the terms and conditions of the potential voting rights mean that the existing ownership interest does not correspond to the legal ownership of the shares. IFRS 10 recognises that, in some circumstances, an entity has, in substance, an existing ownership interest as a result of a transaction that currently gives it access to the returns associated with an ownership interest. In such circumstances, the proportion allocated to the parent and NCI is determined by taking into account the eventual exercise of those potential voting rights and other derivatives that currently give the entity access to the returns. *[IFRS 10.21, IFRS 10.B90]*.

Where this is the case, such instruments are not within the scope of IFRS 9 (since IFRS 9 does not apply to subsidiaries that are consolidated). *[IFRS 9.2.1(a)]*. This scope exclusion prevents double counting of the changes in the fair value of such a derivative under IFRS 9, and of the effective interest created by the derivative in the underlying investment. In all other cases, instruments containing potential voting rights in a subsidiary are accounted for in accordance with IFRS 9. *[IFRS 10.21, IFRS 10.B91]*.

Illustration 2-1 below shows this principle.

Illustration 2-1: Proportion of subsidiary's profit or loss, OCI and equity allocated to parent and NCI where potential voting rights exist

Entities A and B hold 40% and 60%, respectively, of the equity of Entity C. A also holds a currently exercisable option over one third of B's holding (of shares in C) which, if exercised, would give A a 60% interest in C. The terms of the option are such that it leads to the conclusion that C is controlled by and therefore is a subsidiary of A, but do not give A present access to the returns of the underlying shares. Therefore, in preparing its consolidated financial statements, A attributes 60% of profit or loss, OCI and changes in equity of C to the NCI.

How we see it

Whether potential voting rights and other derivatives, in substance, already provide existing ownership interests in a subsidiary that currently give an entity access to the returns associated with that ownership interest will be a matter of judgement.

Issues raised by NCI puts and calls, including whether or not such options give an entity present access to returns associated with an ownership interest (generally in connection with a business combination) are discussed further in section 6 below. That guidance may also be helpful in assessing whether potential rights and other derivatives, in substance, give present access to returns associated with an ownership interest in other contexts.

This chapter uses the term 'present ownership interest' to include existing legal ownership interests together with potential voting rights and other derivatives that, in substance, already provide existing ownership interests in a subsidiary because they currently provide the entity access to the returns associated with an ownership interest (as described in IFRS 10.B90). *[IFRS 10.21, IFRS 10.B90]*.

2.2.1 Attribution when NCI change in an accounting period

NCI may change during the accounting period. For example, a parent may purchase shares in a subsidiary held by NCI.

By acquiring some (or all) of the NCI, the parent will be allocated a greater proportion of the profits or losses of the subsidiary in periods after the additional interest is acquired. *[IFRS 10.BCZ175]*. Therefore, the profit or loss and OCI of the subsidiary for the part of the reporting period prior to the transaction are attributed to the owners of the parent and the NCI based on their ownership interests prior to the transaction. Following the transaction, the profit or loss and OCI of the subsidiary are attributed to the owners of the parent and the NCI based on their new ownership interests after the transaction.

2.3 Consolidating foreign operations

IFRS 10 does not specifically address how to consolidate subsidiaries that are foreign operations. As explained in IAS 21 *The Effects of Changes in Foreign Exchange Rates*, an entity is permitted to present its financial statements in any currency (or currencies). If the presentation currency differs from the entity's functional currency, it needs to translate its results and financial position into the presentation currency. Therefore, when a group contains individual entities with different functional currencies, the results and financial position of each entity are translated into the presentation currency of the consolidated financial statements. *[IAS 21.38]*. The requirements of IAS 21 in respect of this translation process are explained in Chapter 16 at section 6.

A reporting entity comprising a group with intermediate holding companies is permitted to adopt either the 'direct method' or the 'step-by-step method' of consolidation. IFRIC 16 *Hedges of a Net Investment in a Foreign Operation* refers to these methods as follows:

- *Direct method* - The financial statements of the foreign operation are translated directly into the functional currency of the ultimate parent.
- *Step-by-step method* - The financial statements of the foreign operation are first translated into the functional currency of any intermediate parent(s) and then translated into the functional currency of the ultimate parent (or the presentation currency, if different).

An entity has an accounting policy choice of which method to use, which it must apply consistently for all foreign operations. *[IFRIC 16.17]*.

Both methods will result in the same amounts in the presentation currency for the statement of financial position. However, this does not necessarily hold true for income and expense items particularly if an indirectly held foreign operation is disposed of (as the different methods impact the amount of cumulative retranslation reserve subsequently reclassified to profit or loss). *[IFRIC 16.BC36]*. Differences will also arise between the two methods if an average rate is used, although these are likely to be insignificant. See Chapter 16 at sections 6.1.1, 6.1.4 and 6.6.3 for further discussion and a comparison of the effect of the two approaches on accounting for a disposal of an indirectly held foreign operation.

IFRIC 16 also provides guidance on what does and does not constitute a valid hedge of a net investment in a foreign operation, and on how an entity determines the amounts to be reclassified from equity to profit or loss for both the hedging instrument and the hedged item, where the foreign operation is disposed of. It notes that in a disposal of a subsidiary by an intermediate parent, the use of the 'step-by-step method' of consolidation may result in the reclassification to profit or loss of a different amount from that used to determine hedge effectiveness. An entity can eliminate this difference by determining the amount relating to that foreign operation that would have arisen if the entity had used the 'direct method' of consolidation. However, IAS 21 does not require an entity to make this adjustment. Instead, it is an accounting policy choice that should be followed consistently for all net investments. *[IFRIC 16.17]*.

IFRIC 16 is discussed in more detail in Chapter 16 at sections 6.1.4 and 6.6.3 and Chapter 49 at section 5.3.

2.4 Intragroup eliminations

IFRS 10 requires intragroup assets and liabilities, equity, income, expenses, and cash flows relating to transactions between entities of the group to be eliminated. Profits or losses resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets, are eliminated in full as shown in Illustration 2-2 in section 2.4.1 below. *[IFRS 10.21, IFRS 10.B86(c)]*.

Even though losses on intragroup transactions are eliminated in full, they may still indicate an impairment that requires recognition in the consolidated financial statements. *[IFRS 10.21, IFRS 10.B86(c)]*. For example, if a parent sells a property to a subsidiary at fair value and this is lower than the carrying amount of the asset, the transfer may indicate that the property (or the cash-generating unit to which that property belongs) is impaired in the consolidated financial statements. This will not always be the case as the value-in-use of the asset (or cash-generating unit) may be sufficient to support the higher carrying value. Transfers between companies under common control involving non-monetary assets are discussed in Chapter 9 at section 4.4.1; impairment is discussed in Chapter 21.

Intragroup transactions may give rise to a current and/or deferred tax expense or benefit in the consolidated financial statements. IAS 12 applies to temporary differences that arise from the elimination of profits and losses resulting from intragroup transactions. *[IFRS 10.21, IFRS 10.B86(c)]*. These issues are discussed in Chapter 29 at sections 7.2.5 and 8.7. The application of IAS 12 to intragroup dividends and unpaid intragroup interest, royalties or management charges is discussed in Chapter 29 at sections 7.6.4, 7.6.5 and 8.5.

Where an intragroup balance is denominated in a currency that differs to the functional currency of a transacting group entity, exchange differences will arise. See Chapter 16 at section 6.3 for discussion of the accounting for exchange differences on intragroup balances in consolidated financial statements.

2.4.1 Intragroup eliminations - allocation between parent and NCI

IFRS 10 does not specify how the elimination of profits and losses are to be allocated between the parent and NCI.

Illustration 2-2 shows how intragroup transactions are eliminated in both upstream and downstream transactions between a parent and subsidiary.

Illustration 2-2: Eliminating intragroup transactions

Entity A holds a 75% interest in its subsidiary, Entity B. A sold inventory costing CU100,000 to B for CU200,000, giving rise to a profit in A of CU100,000. B still held the inventory at the end of the reporting period. Tax effects are ignored in this example.

Under IFRS 10, as well as the intragroup sale between A and B, the unrealised profit is eliminated from the group's point of view in consolidation as follows:

			CU'000	CU'000
Dr	Revenue in A		200	
	Cr	Cost of sales in A		100
	Cr	Inventory in B		100

The profit from the sale of inventory of CU100,000 is reversed against group profit or loss. As the parent made the sale, no amount of the eliminated profit is attributed to the NCI.

If the fact pattern was reversed, such that B sold inventory to A, and A still held the inventory at the end of the reporting period, the CU100,000 of profit would still be reversed in the consolidated financial statements. However, in this instance, as the subsidiary made the sale, CU25,000 of the eliminated profit (i.e., the NCI's 25% share of the CU100,000 profit) would be allocated to the NCI. Therefore, the reduction in profit would be attributed to the owners of the parent and NCI, in their proportionate interests, 75% and 25%.

If the inventory held by B had been sold to a third party for CU300,000 before the end of the reporting period (resulting in a profit in A of CU100,000 for the sale to B at CU200,000 and a profit in B of CU100,000 for the sale to a third party at CU300,000), no intragroup elimination of profit is required. The group has sold an asset with a cost of CU100,000 for CU300,000 creating a profit to the group of CU200,000. In this case, the intragroup elimination is limited to the sale between A and B as follows:

			CU'000	CU'000
Dr	Revenue in A		200	
	Cr	Cost of sales in B		200

2.5 Non-coterminous accounting periods

The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements shall have the same reporting date. If the end of the reporting period of the parent is different from that of a subsidiary, the subsidiary must prepare, for consolidation purposes, additional financial information as of the same date as the financial statements of the parent, unless it is impracticable to do so. *[IFRS 10.21, IFRS 10.B92]*. 'Impracticable' presumably means when the entity cannot apply the requirement after making every reasonable effort to do so. *[IAS 1.7]*.

If it is impracticable for the subsidiary to prepare such additional financial information, then the parent consolidates the financial information of the subsidiary using the most recent financial statements of the subsidiary. These must be adjusted for the effects of significant transactions or events that occur between the date of those financial statements and the date of the consolidated financial statements. *[IFRS 10.21, IFRS 10.B93]*.

How we see it

IFRS 10 does not give examples of 'significant transactions or events' that must be adjusted. However, there will commonly be items that will need to be eliminated as part of the consolidation process such as distributions from the subsidiary to the parent, cash transfers or settlement of intragroup balances. Care is needed to ensure such transactions are properly eliminated in order to avoid double counting effects, e.g., where assets transferred intragroup might otherwise be reported by both the subsidiary and parent. Significant transactions could also include significant acquisitions or disposals, impairments or developments on contingencies or provisions in the intervening period between the dates of the subsidiary and parent financial statements.

The difference between the date of the subsidiary's financial statements and that of the consolidated financial statements must not be more than three months. The length of the reporting periods and any difference between the dates of the financial statements must be the same from period to period. *[IFRS 10.21, IFRS 10.B93]*. It is not necessary, as in some national GAAPs, for the subsidiary's reporting period to end before that of its parent.

How we see it

The requirements relating to coterminous accounting periods seem to imply that, where a subsidiary that was previously consolidated using non-coterminous financial statements is now consolidated using coterminous financial statements (i.e., the subsidiary changed the end of its reporting period), comparative information is restated so that financial information of the subsidiary is included in the consolidated financial statements for an equivalent period in each period presented. However, other approaches not involving restatement of comparatives might sometimes be acceptable (as discussed below).

Other approaches not involving restatement of comparatives might be acceptable, particularly where the comparative information had already reflected the effects of significant transactions or events during the period between the date of the subsidiary's financial statements and the date of the consolidated financial statements. Where comparatives are not restated, additional disclosures might be needed about the treatment adopted and the impact on the current period of including information for the subsidiary for a period different from that of the parent.

IAS 21 addresses what exchange rate is used in translating the assets and liabilities of a foreign operation that is consolidated on the basis of financial statements made up to a different date to the reporting date used for the reporting entity's financial statements. *[IAS 21.46]*. This issue is discussed further in Chapter 16 at section 6.4.

2.6 Consistent accounting policies

IFRS 10 requires the use of consistent accounting policies by the group in consolidated financial statements. Accordingly, if a member of the group uses accounting policies that differ from those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to that group member's financial statements in preparing the consolidated financial statements to ensure conformity with the group's accounting policies. *[IFRS 10.21, IFRS 10.B87]*.

3 Changes in control

3.1 Commencement and cessation of consolidation

A parent consolidates a subsidiary from the date on which the parent first obtains control, and ceases consolidating that subsidiary on the date on which the parent loses control. *[IFRS 10.20, IFRS 10.21, IFRS 10.B88]*. IFRS 3 defines the acquisition date, which is the date on which the acquirer obtains control of the acquiree, *[IFRS 3.8, IFRS 3 Appendix A]*, (see Chapter 10 at section 4.2).

The requirement to continue consolidating (albeit in a modified form) also applies to a subsidiary held for sale accounted for under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* (see Chapter 5).

3.1.1 Acquisition of a subsidiary that is not a business

The same basic requirement to consolidate a subsidiary (see section 3.1 above) also applies when a parent acquires a controlling interest in an entity that is not a business, as defined in IFRS 3 (see Chapter 10 at section 3.2). *[IFRS 3.3, IFRS 3 Appendix A, IFRS 3.B7-B12D]*. As required by IFRS 10, the parent consolidates all investees that it controls, not just those that are businesses, and recognises any NCI in the subsidiary (see section 5 below). IFRS 3 states that when an entity acquires an asset or group of assets that is not a business, the acquirer allocates the cost of the group between the individual identifiable assets acquired and liabilities assumed based on their relative fair values at the date of purchase. Such a transaction or event does not give rise to goodwill. *[IFRS 3.2(b)]*. The cost of the group of assets is the sum of all consideration given, any NCI recognised, and transaction costs incurred, if any. The allocation of the transaction price (or cost) to the identifiable assets acquired and liabilities assumed is discussed further in Chapter 10 at section 2.2.2.

However, neither IFRS 10 nor IFRS 3 address how NCI in the entity is initially measured, where the entity is not a business.

How we see it

In our view, if the NCI has a present ownership interest and is entitled to a proportionate share of net assets upon liquidation, the acquirer of a subsidiary that is not a business has a choice to recognise the NCI on initial measurement in one of the following ways:

(a) Its proportionate share of the fair values of the entity's identifiable net assets

(b) Its fair value (measured in accordance with IFRS 13 *Fair Value Measurement*)

(c) Its proportionate share of the consolidated book values of the net assets, including transaction costs. The basis for including transaction costs is that these are included in the consolidated book values of the subsidiary's net assets

Or

(d) Its proportionate share of the consolidated book values of the net assets, excluding transaction costs. The basis for excluding transaction costs is that these are borne by the parent and are not part of the net assets attributable to the NCI

In all other cases, NCI is recognised at fair value (measured in accordance with IFRS 13), unless another measurement basis is required in accordance with IFRS accounting standards (e.g., any share-based payment transaction classified as equity is measured in accordance with IFRS 2 *Share-based Payment* - referred to as a 'market-based measure' - see section 5.2 below.

As discussed in section 2.2 above, IFRS 10 recognises that, in some circumstances, an entity has, in substance, an existing ownership interest as a result of a transaction that currently gives it access to the returns associated with an ownership interest. Consequently, there may be situations where no NCI is recognised in relation to, say, a derivative over a subsidiary's shares where the parent has, in substance, an existing ownership interest over those shares.

Approaches (a) and (b) above are consistent with the choices on the initial recognition of NCI required by IFRS 3. *[IFRS 3.19]*. However, it could be argued that an asset acquisition is an economically dissimilar transaction to a business combination, and therefore the guidance in IFRS 3 is not a 'similar and related issue' under the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for selection and application of accounting policies.[1] *[IAS 8.11(a)]*. Under this view, Approaches (c) and (d) above, which are based on the proportionate share of the consolidated book values of the entity's net assets, could also be supported.

1 The consequential amendments resulting from IFRS 18 *Presentation and Disclosure in Financial Statements*, once effective, changes the title of IAS 8 to '*Basis of Preparation of Financial Statements*' to better reflect the amended content of IAS 8. See Chapter 4 for further details on the requirements of IFRS 18.

Illustration 3-1 below is an example of an acquisition of a subsidiary that is not a business (where there is no pre-existing interest). The determination of NCI where the entity acquired was an associate or joint venture accounted under the equity method is explained in Illustration 3-2 in section 3.1.2.B below.

Illustration 3-1:[2] Acquisition of a subsidiary that is not a business

Entity A pays CU160,000 to acquire an 80% controlling interest in the equity shares of Entity B, which holds a single building (measured using the cost model under IAS 16 *Property, Plant and Equipment*) that is not a business. The fair value of the building is CU200,000.

An unrelated third party holds the remaining 20% interest in the equity shares. The fair value of the NCI is CU40,000. In this case, the fair value of the NCI (as an equity interest) is the same as the NCI's proportionate share of the fair values of the identifiable net assets of B. Transaction costs are CU4,000. Tax effects, if any, are ignored in this example. As noted in section 3.1.1 above, there are four approaches to determining NCI which are illustrated below.

Approach (a) - measure NCI based on the proportionate share of the fair values of B's identifiable net assets

A initially records the following accounting entry:

			CU'000	CU'000
Dr	Building		204	
	Cr	NCI (20% × CU200,000)		40
	Cr	Cash		164

Approach (b) - measure NCI at its fair value

A initially records the following accounting entry:

			CU'000	CU'000
Dr	Building		204	
	Cr	NCI (at fair value)		40
	Cr	Cash		164

Approach (c) - measure NCI based on the proportionate share of the consolidated book values of B's net assets, including transaction costs

A initially records the following accounting entry:

			CU'000	CU'000
Dr	Building		205	
	Cr	NCI (at 20% ÷ 80% × CU164,000)		41
	Cr	Cash		164

The calculation effectively grosses up the consideration paid by the parent (together with transaction costs) and determines the NCI's proportionate share. This approach has the effect that the NCI is recorded at its proportionate share (20%) of the consolidated book values of the net assets, including transaction costs.

Approach (d) - measure NCI based on the proportionate share of the consolidated book values of B's net assets, excluding transaction costs

A initially records the following accounting entry:

			CU'000	CU'000
Dr	Building		204	
	Cr	NCI (at 20% ÷ 80% × CU160,000)		40
	Cr	Cash		164

2 Illustrations which involve NCI assume that the NCI has a present ownership interest equal to the proportionate equity interest held, except where otherwise noted.

3.1.2 Step acquisition of an associate or joint venture (equity accounted) that is not a business and becomes a subsidiary

An entity that has an interest in an associate or joint venture that does not constitute a business may obtain control and so become a parent of a subsidiary that does not constitute a business. Current IFRS accounting standards do not address the accounting treatment for an acquisition in stages from associate or joint venture to a subsidiary that is considered as an asset acquisition rather than a business combination. This raises questions as to how to measure the previously held interest and the NCI on acquisition.

3.1.2.A Measuring the previously held interest

As discussed in section 3.1.1 above, the cost of the group of assets is the sum of all the consideration given (including transaction costs incurred, if any) and any NCI recognised. It is therefore necessary to determine the 'cost' of the previously held interest, being part of the consideration given for the group of assets acquired. *[IFRS 3.2(b)]*. In January 2019, the IFRS IC issued an agenda decision regarding a different, but relevant, example of the step acquisition of an investment in a subsidiary accounted for at cost in the separate financial statements of the parent. The IFRS IC concluded that a reasonable reading of the requirements in IFRS accounting standards could result in the application of either one of two approaches to determine 'cost': the 'fair value as deemed cost approach' or the 'accumulated cost approach'.[3] See Chapter 9 at section 2.1.1.C.

How we see it

Given the IFRS IC agenda decision relating to a step acquisition of a subsidiary in separate financial statements, in our view, the following approaches are both acceptable methods of measuring the previously held interest in the associate or joint venture:

- Approach 1 *Fair value as deemed cost*
- Approach 2 *Equity-accounted carrying amount as accumulated cost*

Consistent with that agenda decision, any adjustment to remeasure the previously held interest to its fair value meets the definition of income or expense in the *Conceptual Framework for Financial Reporting* and is, therefore, recognised in profit or loss.

Approach 1 *Fair value as deemed cost*

Where a 'fair value as deemed cost approach' is applied, the fair value of the previously held interest at the date that control is obtained is deemed to be the cost for the purposes of accounting for the acquisition of the subsidiary. Under this approach, the transaction is viewed as if the entity is exchanging its initial interest (plus consideration for the additional interest) for a controlling interest in the investee ('exchange view'). As noted above, any adjustment to remeasure the previously held interest to its fair value is recognised in profit or loss.

Approach 2 *Equity-accounted carrying amount as accumulated cost*

Following an 'accumulated cost approach', the carrying amount of the associate or joint venture could be considered the relevant cost in accounting for the acquisition of the subsidiary. Although there is a change in status, it is not appropriate to remeasure the existing ownership interest as the subsidiary is not a business. Accordingly, no gain or loss is recorded on the acquisition of the subsidiary, assuming that the carrying amount of the new subsidiary is recoverable.

In certain circumstances, it might be acceptable to take a third approach and consider the cost of the previously held interest to be the accumulated historical cost consideration for the investment in the associate or joint venture. Given the agenda decision of the IFRS IC mentioned above, any difference arising between the previous carrying amount and the accumulated historical costs will be recognised in profit or loss. However, caution needs to be taken with using this approach as it does not always provide relevant information. If the accumulated historical cost consideration was lower than the equity-accounted carrying amount of the previous associate or joint venture, there would be a loss recognised, even though there is no economic loss arising from the transaction. Where the accumulated historical cost consideration exceeds the equity-accounted carrying amount of the previous associate or joint venture, care is needed when using this approach to ensure that the subsidiary is not carried at above its recoverable amount.

3 *IFRIC Update,* January 2019, available on the IFRS Foundation's website.

How we see it

In our view, the entity accounts for all amounts previously recognised in OCI in relation to the investment on the same basis as would have been required if the investee had directly disposed of the related assets or liabilities. That is, certain amounts previously recognised in OCI (such as cumulative translation differences relating to a foreign operation) must be recycled to profit or loss upon disposal. See Chapter 12 at section 9.2.

3.1.2.B Measuring the NCI

Illustration 3-2 shows the computation of the NCI and the cost of an asset in the consolidated financial statements where a subsidiary (that does not meet the definition of a business, but only holds an asset) is acquired following the purchase of an additional interest in an equity-accounted joint venture.

Illustration 3-2: Acquisition of a subsidiary that is not a business where previously held interest is an equity-accounted joint venture

Entity A acquires a 50% interest in Entity C upon formation of a joint venture with Entity B in 20X6. Each venturer contributed CU5 million which was used by C to purchase a building accounted using the cost model in IAS 16. All entities have the same functional currency, currency unit (CU).

In 20Y1, cumulative earnings of the joint venture were CU1.5 million and cumulative dividends declared were CU0.5 million. Immediately prior to the following transaction, A has an equity accounted joint venture with a carrying amount of CU5.5 million (CU5m initial investment + 50% × (CU1.5m - CU0.5m)).

A and B entered into an arrangement whereby A acquired 30% of the shares of C in exchange for CU4.5 million cash paid to B. Transaction costs incurred by A were CU0.2 million. Following the transaction, A has an 80% controlling interest in the equity shares of C, which holds a single building that is not a business. Assuming that there are no control premiums or other investment premiums or discounts, the fair value of the NCI is CU3 million. The fair value of 100% of C at the acquisition date is CU15 million. Tax effects, if any, are ignored in this example.

For an asset acquisition, the cost of the group of assets is the sum of all the consideration given (i.e., the cash paid of CU4.5 million plus the 'cost' of the previously held interest in C) and any NCI recognised, together with transaction costs.

How should A measure the previously held interest in C?

As noted in section 3.1.2.A above, there are two main approaches to determine the 'cost' of the previously held interest - Approach 1 and Approach 2.

Under Approach 1, A records the previously held interest in C at its fair value of CU7.5 million (50% × CU15m). Accordingly, on acquisition, A records a gain of CU2 million on remeasurement of the previously held interest.

Under Approach 2, A measures its previously held interest in C at its previous equity accounted value of CU5.5 million. No gain or loss is recognised on the transaction.

How should A measure the NCI in the step acquisition?

As noted in section 3.1.1 above, there are four approaches:

- Approach (a) *Measure NCI based on the proportionate share of the fair values of C's identifiable net assets*
- Approach (b) *Measure NCI at its fair value*
- Approach (c) *Measure NCI based on the proportionate share of the consolidated book values of C's net assets (including transaction costs)*
- Approach (d) *Measure NCI based on the proportionate share of the consolidated book values of C's net assets (excluding transaction costs)*

A records the following amounts for NCI:

	Previously held interest - deemed cost	
	Approach 1 (fair value)	Approach 2 (equity-accounted value)
	CU m	CU m
Fair value of building (i)	15.0	15.0
Deemed cost of previous interest (ii)	7.5	5.5
Consideration paid for second tranche (iii)	4.5	4.5
Transaction costs (iv)	0.2	0.2
Fair value of NCI (v)	3.0	3.0
NCI - Approach (a): 20% of fair value of building (i)	3.0	3.0
NCI - Approach (b): fair value (v)	3.0	3.0
NCI - Approach (c): 20/80 of [(ii) + (iii) + (iv)]	3.1	2.6
NCI - Approach (d): 20/80 of [(ii) + (iii)]	3.0	2.5

The cost of the building consolidated is as follows:

	Previously held interest - deemed cost	
	Approach 1 (fair value)	Approach 2 (equity-accounted value)
	CU m	CU m
NCI - Approach (a)	15.2	13.2
NCI - Approach (b)	15.2	13.2
NCI - Approach (c)	15.3	12.8
NCI - Approach (d)	15.2	12.7

The cost of the building comprises the sum of:

- The deemed cost of the previously held interest (i.e., CU7.5 million under Approach 1 and CU5.5 million under Approach 2)
- The consideration paid for the second tranche of CU4.5 million
- Transaction costs of CU0.2 million

And

- NCI recognised as in the earlier table above

3.2 Accounting for a loss of control

IFRS 10 clarifies that an investor is required to reassess whether it controls an investee if the facts and circumstances indicate that there are changes to one or more of the three elements of control. *[IFRS 10.8, IFRS 10.B80]*. The elements of control are: power over the investee; exposure, or rights, to variable returns from the investor's involvement with the investee; and the investor's ability to use its power over the investee to affect the amount of the investor's returns. *[IFRS 10.7]*. See Chapter 7 at section 9 for further discussion, including examples of situations where a change in control may arise.

A parent may lose control of a subsidiary because of a transaction that changes its absolute or relative ownership level. For example, a parent may lose control of a subsidiary if:

- It sells some or all of the ownership interests
- It contributes or distributes some or all of the ownership interests
- A subsidiary issues new ownership interests to third parties (therefore a dilution in the parent's interests occurs)

Alternatively, a parent may lose control without a change in absolute or relative ownership levels. For example, a parent may lose control on expiry of a contractual agreement that previously allowed the parent to control the subsidiary, *[IFRS 10.BCZ180]*, or on entry into a contractual arrangement which gives joint control with another party (or parties). A parent may also lose control if the subsidiary becomes subject to the control of a government, court, administrator, receiver, liquidator, or regulator. This evaluation may require the exercise of judgement, based on the facts and circumstances, including the laws in the relevant jurisdiction (see Chapter 7 at sections 4.3.2.A and 9.2).

Extract from IFRS 10

25 If a parent loses control of a subsidiary, the parent:

(a) derecognises the assets and liabilities of the former subsidiary from the consolidated statement of financial position.

(b) recognises any investment retained in the former subsidiary at its fair value when control is lost and subsequently accounts for it and for any amounts owed by or to the former subsidiary in accordance with relevant IFRSs. That fair value shall be regarded as the fair value on initial recognition of a financial asset in accordance with IFRS 9 or, when appropriate, the cost on initial recognition of an investment in an associate or joint venture.

(c) recognises the gain or loss associated with the loss of control attributable to the former controlling interest.

[IFRS 10.25]

If a parent loses control of a subsidiary, IFRS 10 further specifies that the parent is required to: *[IFRS 10.25, IFRS 10.26, IFRS 10.B98]*

- Derecognise the assets (including any goodwill) and liabilities of the former subsidiary at their carrying amounts at the date when control is lost
- Derecognise the carrying amount of any NCI in the former subsidiary at the date when control is lost. This includes any components of OCI attributable to them
- Recognise the fair value of the consideration received, if any, from the transaction, event or circumstances that resulted in the loss of control
- Recognise a distribution if the transaction, event, or circumstances that resulted in the loss of control involves a distribution of shares in the subsidiary to owners in their capacity as owners (see section 3.7 below)
- Recognise any investment retained in the former subsidiary at its fair value at the date when control is lost (see section 3.3 below)
- Reclassify to profit or loss, or transfer directly to retained earnings if required by other IFRS accounting standards, the amounts recognised in OCI in relation to the subsidiary

  If a parent loses control of a subsidiary, the parent accounts for all amounts previously recognised in OCI in relation to that subsidiary on the same basis as would be required if the parent had directly disposed of the related assets or liabilities. This is discussed in section 3.5 below.
- Recognise any resulting difference as a gain or loss in profit or loss attributable to the parent

Any amounts owed to or by the former subsidiary (which cease to be eliminated on consolidation) are accounted for in accordance with the relevant IFRS accounting standards. Such balances are often financial assets or financial liabilities, which are initially recognised at fair value in accordance with IFRS 9 at the date of loss of control. *[IFRS 9.5.1.1]*. See Chapter 45 at section 3.

Sometimes, the parent may receive contingent consideration on the sale of a subsidiary. In most cases, the parent will have a contractual right to receive cash or another financial asset from the purchaser and, therefore, such balances are often financial assets within the scope of IFRS 9, and consequently initially measured at fair value. *[IFRS 9.5.1.1]*. See also Chapter 41 at section 2.7.1.B.

IFRS 5's requirements apply to a non-current asset (or disposal group) that is classified as held for sale. See Chapter 5 at section 2. The presentation requirements when the subsidiary of which the parent loses control meets the definition of a discontinued operation are discussed in Chapter 5 at section 3.

A proposed transaction that would, if implemented, lead to loss of control of a subsidiary could be an indicator of impairment under IAS 36 *Impairment of Assets*, or, if the subsidiary is held for sale, under IFRS 5. *[IFRS 10.BCZ186]*.

Chapter 21 at section 8.5 addresses the allocation of goodwill when an operation is disposed of which forms part of a cash-generating unit to which goodwill has been allocated.

IFRS 12 *Disclosure of Interests in Other Entities* requires disclosure of the gain or loss (if any) arising on loss of control of a subsidiary during the reporting period and the line item in which the gain or loss is recognised (if not presented separately). The portion of the gain or loss attributable to measuring any investment retained in the former subsidiary at its fair value (in accordance with IFRS 13) at the date when control is lost must also be disclosed. *[IFRS 12.10(b)(iv), IFRS 12.19]*. See Chapter 14 at section 4.5.2. Similar disclosures are required where IFRS 19 *Subsidiaries without Public Accountability: Disclosures* is applied by eligible subsidiaries (see Chapter 4 at section 7 for further details on the requirements of IFRS 19).[4] *[IFRS 19.81].*

How we see it

Applying IFRS 10's requirements on loss of control of a subsidiary could pose some difficulties, where these interact with the requirements of certain other IFRS accounting standards, such as IFRS 15 *Revenue from Contracts with Customers* (sale of a single-asset entity containing real estate), IFRS 16 *Leases* (sale of a single-asset entity and leaseback of its building) and IAS 28 (sale or contribution of an asset to an associate or joint venture). In our view, this is partly caused by the fact that IFRS 10 refers only to loss of control of a subsidiary, without drawing a distinction between whether the subsidiary is a business or not, or whether the loss of control happens as part of the entity's ordinary activities or not. The interaction of the above standards with IFRS 10 has been the subject of discussions by the IFRS IC and by the IASB, as described further below.

During 2019 and 2020, the IFRS IC and the IASB discussed whether IFRS 10 or IFRS 15 applies when an entity loses control of a single asset entity containing real estate as part of its ordinary activities.[5] This is discussed further in section 3.2.1 below. Moreover, during 2020 and 2021, the IFRS IC discussed the interaction of IFRS 10 and IFRS 16 in relation to a transaction where the entity's equity interest in a wholly-owned subsidiary that held only a building was sold, resulting in loss of control of the former subsidiary, and the building was leased back. This is discussed further in section 3.2.2 below.

The conflict between the requirements of IFRS 10 and those of IAS 28 arises because IAS 28 restricts any gain arising on the sale of an asset to an associate or joint venture (or on the contribution of a non-monetary asset in exchange for an equity interest in an associate or a joint venture) to that attributable to the unrelated investors' interests in the associate or joint venture, whereas IFRS 10 does not. *[IAS 28.28, IAS 28.30, IFRS 10.25]*. In order to resolve the conflict, in September 2014, the IASB had issued *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (Amendments to IFRS 10 and IAS 28) but subsequently deferred the effective date of application of the amendments. This issue is discussed further in sections 3.3.2 and 7.1 below.

The following parts of this section address further issues relating to accounting for the loss of control of a subsidiary including: where an interest is retained in the former subsidiary (see section 3.3 below), loss of control in multiple arrangements (see section 3.4 below), the treatment of OCI on loss of control (see section 3.5 below), deemed disposals (see section 3.6 below), and demergers and distributions (see section 3.7 below).

3.2.1 IFRS IC and IASB discussions about the sale of a single asset entity containing real estate

In June 2019, the IFRS IC discussed a request about the accounting for a transaction in which an entity, as part of its ordinary activities, enters into a contract with a customer to sell real estate by selling its equity interest in a subsidiary.[6] The entity established the subsidiary some time before it enters into the contract with the customer; the subsidiary has one asset (real estate inventory) and a related tax asset or liability. The entity has applied IFRS 10 in consolidating the subsidiary before it loses control of the subsidiary as a result of the transaction with the customer. The IFRS IC discussed this issue but did not issue an agenda decision on this matter. Instead, the issue was referred to the IASB.

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4 IFRS 19 *Subsidiaries without Public Accountability: Disclosures* was issued by the IASB in May 2024 to simplify the preparation of financial statements by eligible subsidiaries. Eligible subsidiaries that elect to apply IFRS 19 are allowed to provide reduced disclosures while still applying the recognition, measurement and presentation requirements in other IFRS accounting standards. IFRS 19 is effective for annual reporting periods beginning on or after 1 January 2027, with earlier application permitted (subject to jurisdictional endorsement). See Chapter 4 at section 7 for further details on the requirements of IFRS 19.

5 *IFRIC Update*, June 2019, *IASB Update*, October 2019, *IASB Update*, June 2020, available on the IFRS Foundation's website.

6 *IFRIC Update*, June 2019, available on the IFRS Foundation's website.

In October 2019, the IASB directed its Staff to research the feasibility of narrow-scope standard setting.[7] In June 2020, the IASB discussed a possible narrow-scope amendment that would have required an entity to apply IFRS 15, instead of IFRS 10, to sales of subsidiaries where all of the following apply:

- The entity contracts with a customer for goods or services that are the output of its ordinary activities in exchange for consideration
- The subsidiary contains only inventory and any related income tax asset or liability
- The entity retains no interest in the inventory transferred to the customer

The Board decided against proposing this amendment.[8]

During the discussions held by both the IFRS IC and the IASB, a number of members of the IFRS IC and the Board considered that, absent an amendment, IFRS 10 (rather than IFRS 15) would apply to the transaction considered. During the June 2020 discussion, some Board members thought there was merit in a narrow-scope amendment. However, concerns were raised about potential unintended consequences of proposing a narrow-scope amendment without a more comprehensive discussion. Any narrow-scope amendment would affect the scope of both IFRS 10 and IFRS 15 and, as such, Board members wanted to learn more from stakeholders about the need for, and the consequences of such a project.[9] However, these considerations were not noted in the relevant *IFRIC Update* and *IASB Update* that were issued as summaries of the meetings. This matter was further considered as part of Phase 2 of the post-implementation review (PIR) of IFRS 10 (see section 7.5 below).[10] In June 2022, the Board assessed this matter as a low priority and concluded this topic could be explored if identified as a priority in the next agenda consultation (i.e., the Fourth Agenda Consultation, expected to start in 2026).[11] Indeed, the Board decided not to include a question on this matter as part of the PIR of IFRS 15.[12] In July 2024, the Board confirmed this matter would be considered in the next Agenda Consultation rather than as part of the PIR of IFRS 15.[13]

This issue is discussed further in Question 2-11 of Chapter 28 at section 2.5.

How we see it

Even though the deliberation process on this question has been completed, there might continue to be some diversity in practice. However, in the meantime, entities might need to consider the discussions on this matter as they determine the appropriate standard to apply to transactions with customers involving the loss of control of a single asset entity.

3.2.2 IFRS IC discussions about a transaction where the entire equity interest in a subsidiary holding only a single building is sold and the building is leased back

In September 2020, a related issue was considered by the IFRS IC concerning the accounting for a sale and leaseback transaction.[14] In the fact pattern, the parent sells all its equity interest in a wholly-owned subsidiary, losing control at the date of transfer. The subsidiary was established some time ago and holds only a single asset - a building (which does not constitute a business under IFRS 3) - and has no liabilities. The sales price (equal to the fair value of the building) exceeds the carrying amount of the transferred building, resulting in a gain. As part of the transaction, the entity enters into a contract to lease the building back, paying market rates for the lease rentals. The transfer of the building would meet the requirements to be accounted for as a 'sale' under IFRS 15.

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7 *IASB Update*, October 2019, available on the IFRS Foundation's website.

8 *IASB Update*, June 2020; and IASB Staff Paper 12A, Project: *Maintenance and Consistent Application*, Paper topic: *Sale of a Subsidiary to a Customer*, IASB Meeting, June 2020. Available on the IFRS Foundation's website.

9 Project summary: *Sale of a Subsidiary to a Customer*, IFRS Foundation's website (accessed 26 September 2024).

10 Request for Information: *Post-implementation Review: IFRS 10* Consolidated Financial Statements, *IFRS 11* Joint Arrangements and *IFRS 12* Disclosure of Interests in Other Entities, IASB, December 2020. Available on the IFRS Foundation's website.

11 Project Report and Feedback Statement: *Post-implementation Review: IFRS 10* Consolidated Financial Statements, *IFRS 11* Joint Arrangements, *IFRS 12* Disclosure of Interests in Other Entities, IASB, June 2022. Available on the IFRS Foundation's website.

12 Request for Information: *Post-implementation review of IFRS 15* Revenue from Contracts with Customers, June 2023, Spotlight 9.4, available on the IFRS Foundation's website.

13 *IASB Update*, July 2024, available on the IFRS Foundation's website.

14 *IFRIC Update*, September 2020, available on the IFRS Foundation's website.

The question posed to the IFRS IC was whether the IFRS 16 sale and leaseback guidance applies, *[IFRS 16.100(a)]*, (and therefore the entity recognises only the amount of the gain that relates to the rights transferred to the third party - see Chapter 24 at section 8) or whether the transaction is accounted for as a loss of control of a subsidiary in accordance with IFRS 10. *[IFRS 10.25, IFRS 10.26, IFRS 10.B98, IFRS 10.B99]*. Under IFRS 10, a gain on loss of control would be recognised and then the parent would account for the lease entered into with the third party.

The IFRS IC noted that, in the transaction described in the request, the entity loses control of the subsidiary. Accordingly, the loss of control requirements in IFRS 10 apply to the transaction. In addition, the entity transfers the building to the third party (through the sale of its equity interest in the subsidiary) and leases the building back. The transaction is therefore a sale and leaseback transaction as described in IFRS 16.98, to which the sale and leaseback requirements in IFRS 16 apply. *[IFRS 16.98]*.

The IFRS IC therefore tentatively concluded that, in the transaction described in the request, the entity is required to apply IFRS 10.25 and IFRS 10.B97-B99 to account for the loss of control of the subsidiary. In particular, IFRS 10.B98 requires the entity to derecognise the building held by the subsidiary and recognise the fair value of the consideration received. *[IFRS 10.25, IFRS 10.26, IFRS 10.B97, IFRS 10.B98, IFRS 10.B99]*.

Since the transfer of the building satisfies the requirements in IFRS 15 to be accounted for as a sale of the building (the IFRS IC observed that this does not mean that the transaction is within the scope of IFRS 15), *[IFRS 16.99]*, the entity must also apply IFRS 16.100(a). Therefore, the entity (a) measures the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the building that relates to the right of use it retains; and (b) recognises only the amount of any gain that relates to the rights transferred to the third party. The entity also recognises a liability at the date of the transaction, the initial measurement of which is a consequence of how the right-of-use asset is measured and the gain on the sale and leaseback transaction determined. Consequently, the gain recognised by the entity on the transaction reflects the requirements in IFRS 16.100(a). *[IFRS 16.100(a)]*.

The IFRS IC received a number of comment letters on the tentative agenda decision that raised concerns about the accounting requirements.[15] Therefore, in February 2021, the IFRS IC decided to refer the matter to the IASB for further consideration of narrow-scope standard-setting. At the time of writing, the Board has not yet discussed this issue.[16]

As noted in section 3.2.1 above, transactions involving corporate wrappers were further considered as part of Phase 2 of the PIR of IFRS 10 (see section 7.5 below).[17] In June 2022, the Board assessed transactions involving corporate wrappers as a low priority and concluded this topic could be explored if identified as a priority in the next agenda consultation (i.e., the Fourth Agenda Consultation expected to start in 2026).[18]

How we see it

In the absence of further guidance, we believe entities should consider the views of local regulators before establishing an initial accounting policy for transactions involving the transfer of a controlling interest in an entity that holds an underlying asset that will be leased back to the transferor. Entities also need to carefully consider the disclosure of these transactions to ensure that users of the financial statements can assess the impact. The disclosure requirements for sale and leaseback transactions are discussed in Chapter 24 at section 8.4.

3.3 Accounting for a loss of control where an interest is retained in the former subsidiary

IFRS 10 requires that when a parent loses control of a subsidiary, it must recognise any investment retained in the former subsidiary at its fair value at the date when control is lost. Any gain or loss on the transaction will be recorded in profit or loss. The fair value of any investment that it retains at the date control is lost will be accounted for, as applicable, as: *[IFRS 10.25(b)]*

- The fair value on initial recognition of a financial asset (see Chapter 45 at section 3)

  Or
- The cost on initial recognition of an investment in an associate or joint venture (see Chapter 12 at section 6.2.2)

15 IASB Staff Paper 2: Project: *Sale and Leaseback of an Asset in a Single-Asset Entity (IFRS 10 and IFRS 16)*, Paper topic: *Comment letters on tentative agenda decision*, IFRS IC meeting, February 2021. Available on the IFRS Foundation's website.

16 *IFRIC Update*, February 2021; and *IASB pipeline projects*, IFRS Foundation's website (accessed 26 September 2024).

17 Request for Information: *Post-implementation Review: IFRS 10* Consolidated Financial Statements, *IFRS 11* Joint Arrangements and *IFRS 12* Disclosure of Interests in Other Entities, IASB, December 2020. Available on the IFRS Foundation's website.

18 Project Report and Feedback Statement: *Post-implementation Review: IFRS 10* Consolidated Financial Statements, *IFRS 11* Joint Arrangements, *IFRS 12* Disclosure of Interests in Other Entities, IASB, June 2022. Available on the IFRS Foundation's website.

As noted in section 3.2 above, any amounts owed to or by the former subsidiary (which cease to be eliminated on consolidation subsequent to the loss of control of the former subsidiary) are accounted for in accordance with the relevant IFRS accounting standards. Such balances are often financial assets or financial liabilities, which are initially recognised at fair value in accordance with IFRS 9 at the date of loss of control. *[IFRS 9.5.1.1]*. IAS 28 also clarifies that an entity applies IFRS 9 to other financial instruments in an associate or joint venture to which the equity method is not applied. These include long-term interests that, in substance, form part of the entity's net investment in an associate or joint venture although the standard explains the interaction of its requirements on recognition of losses under the equity method and impairment, where there are such long-term interests. *[IAS 28.14A, IAS 28.38, IAS 28.40-43]*. See Chapter 12 at section 10.3 and Chapter 45 at section 3.

The IASB's view is that the loss of control of a subsidiary is a significant economic event that marks the end of the previous parent-subsidiary relationship and the start of a new investor-investee relationship, which is recognised and measured initially at the date when control is lost. IFRS 10 is based on the premise that an investor-investee relationship differs significantly from a parent-subsidiary relationship. Therefore, the IASB decided that "any investment the parent has in the former subsidiary after control is lost should be measured at fair value at the date that control is lost and that any resulting gain or loss should be recognised in profit or loss." *[IFRS 10.BCZ182]*.

The following discussion addresses the accounting for the loss of control in certain situations:

- The interest retained in the former subsidiary is a financial asset (see section 3.3.1 below)
- The interest retained in the former subsidiary is an associate or joint venture that is accounted for using the equity method (see section 3.3.2 below)
- The interest retained in the former subsidiary is a joint operation (see section 3.3.3 below)

3.3.1 Interest retained in the former subsidiary - financial asset

Illustration 3-3 below demonstrates the above requirement where the interest retained in the former subsidiary is a financial asset.

Illustration 3-3: Disposal of a subsidiary with a retained interest that is a financial asset

A parent sells an 85% interest in a wholly-owned subsidiary as follows:

- After the sale the parent elects to account for the interest at fair value through other comprehensive income (FVOCI) under IFRS 9
- The subsidiary did not recognise any amounts in OCI
- Net assets of the subsidiary before the disposal are CU500 million
- Cash proceeds from the sale of the 85% interest are CU750 million
- The fair value of the 15% interest retained by the parent is CU130 million

The parent accounts for the disposal of an 85% interest as follows:

			CU m	CU m
Dr	Financial asset		130	
Dr	Cash		750	
	Cr	Net assets of the subsidiary derecognised (summarised)		500
	Cr	Gain on loss of control of subsidiary		380

The gain recognised on the loss of control of the subsidiary is calculated as follows:

	CU m	CU m
Gain on interest disposed of		
Cash proceeds on disposal of 85% interest	750	
Carrying amount of 85% interest (85% × CU500m)	(425)	
		325
Gain on interest retained		
Carrying amount of 15% investment carried at FVOCI	130	
Carrying amount of 15% interest (15% × CU500m)	(75)	
		55
Gain recognised on loss of control of subsidiary		380

Although IFRS 10 requires that any investment retained in the former subsidiary is to be recognised at its fair value at the date when control is lost, no guidance is given in the standard as to how such fair value is to be determined. However, IFRS 13 provides detailed guidance on how fair value is determined for financial reporting purposes. IFRS 13 is discussed in detail in Chapter 15.

3.3.2 Interest retained in the former subsidiary - associate or joint venture

It can be seen that the requirements in IFRS 10 discussed above result in a gain or loss arising on loss of control as if the parent had sold *all* of its interest in the subsidiary, not just that relating to the percentage interest that has been sold. IFRS 10's requirements also apply where a parent loses control over a subsidiary that has become an associate or a joint venture. However, there is a conflict between these requirements and those of IAS 28 for transactions where a parent sells or contributes an interest in a subsidiary to an associate or a joint venture (accounted for using the equity method) and the sale or contribution results in a loss of control in the subsidiary by the parent. This is because IAS 28 restricts any gain arising on the sale of an asset to an associate or a joint venture, or on the contribution of a non-monetary asset in exchange for an equity interest in an associate or a joint venture, to that attributable to unrelated investors' interests in the associate or joint venture. *[IAS 28.28, IAS 28.30]*.

In order to resolve the conflict, in September 2014, the IASB had issued *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (Amendments to IFRS 10 and IAS 28) (the September 2014 amendments). These amendments, where applied, would require the gain or loss resulting from the loss of control of a subsidiary that does *not* contain a business (as defined in IFRS 3, *[IFRS 3.3, IFRS 3 Appendix A, IFRS 3.B7-B12D]* - see Chapter 10 at section 3.2) - as a result of a sale or contribution of a subsidiary to an associate or a joint venture accounted for using the equity method - to be recognised only to the extent of the unrelated investors' interests in the associate or joint venture. The same requirement applies to the remeasurement gain or loss relating to the parent's retained interest in the former subsidiary if, following the transaction, the former subsidiary is now an associate or a joint venture that is accounted for using the equity method. *[IFRS 10.25, IFRS 10.26, IFRS 10.B99A]*. See Illustration 3-4 in section 3.3.2.B below. However, a full gain or loss would be recognised on the loss of control of a subsidiary that constitutes a business, including cases in which the investor retains joint control of, or significant influence over, the investee. *[IFRS 10.25, IFRS 10.26, IFRS 10.B98, IFRS 10.B99]*.

IFRS 10, prior to the revisions resulting from the September 2014 amendments, does not draw a distinction in accounting for the loss of control of a subsidiary that is a business and one that is not.

The September 2014 amendments were to be applied prospectively to transactions occurring in annual periods beginning on or after 1 January 2016, with earlier application permitted. However, in December 2015, the IASB issued a further amendment, *Effective Date of Amendments to IFRS 10 and IAS 28*. This amendment deferred the effective date of the September 2014 amendment indefinitely. *[IFRS 10.C1C, IAS 28.45C]*. Nevertheless, the IASB has continued to allow early application of the September 2014 amendments as it did not wish to prohibit the application of better financial reporting. *[IFRS 10.BC190N, IFRS 10.BC190O, IAS 28.BC37I, IAS 28.BC37J]*.

The IASB commenced its research project on the equity method in 2020 and issued an Exposure Draft addressing application questions relating to the equity method in September 2024[19] (see section 7.1 below). The Exposure Draft proposes that an investor, in applying IAS 28, would recognise the full gain or loss on all transactions with its associate and improvements for the disclosure requirements when an investor recognises the full gain or loss on transactions with its associate, consistent with the tentative decisions made during the research project.[20] This is a different position to the September 2014 amendments.

The accounting treatment where the September 2014 amendments are not applied is explained in section 3.3.2.A below, whereas section 3.3.2.B below addresses the accounting treatment where the September 2014 amendments are applied. In these sections, IFRS 10's approach is also referred to as 'full gain recognition' whereas IAS 28's approach is also referred to as 'partial gain recognition'.

Sections 3.3.2.C to 3.3.2.G below explain additional issues relevant to loss of control transactions where the retained interest in the former subsidiary is an associate or joint venture accounted for using the equity method, whether or not the September 2014 amendments are applied (except where stated).

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19 Exposure Draft IASB/ED/2024/7 *Equity Method of Accounting - IAS 28 Investments in Associates and Joint Ventures*, IASB, September 2024, paras. 53 to 54. Available on the IFRS Foundation's website.

20 *IASB Update*, March 2023, available on the IFRS Foundation's website.

3.3.2.A Conflict between IFRS 10 and IAS 28 (September 2014 amendments not applied)

Examples of situations that result in the loss of control of a subsidiary, where the interest retained in the former subsidiary is an associate or joint venture accounted for using the equity method, include:

- Scenario 1 - a 'downstream' sale or contribution of the investment in the subsidiary (which is a business) to an existing associate or joint venture
- Scenario 2 - a 'downstream' sale or contribution of the investment in the subsidiary (which is not a business) to an existing associate or joint venture
- Scenario 3 - a direct sale or dilution of the investment in the subsidiary (which is a business) for cash in a transaction involving a third party with a retained interest in an associate or joint venture
- Scenario 4 - a direct sale or dilution of the investment in the subsidiary (which is not a business) for cash in a transaction involving a third party with a retained interest in an associate or joint venture

While the discussion below refers to these scenarios for simplicity, the same principles apply where the consideration received is not cash, for example, receipt of non-cash assets such as an interest in a subsidiary, or the assumption of liabilities.

The scenarios above consider existing associates or joint ventures. Transactions involving the formation of a joint venture, with contributions (which could include an investment in a subsidiary) from the venturers, are discussed further in Chapter 12 at section 7.5.3. *[IAS 28.28, IAS 28.29, IAS 28.30, IAS 28.31]*. While that chapter discusses the formation of a joint venture, similar accounting would be expected on the establishment of an associate with contributions from the investors. See also Chapter 12 at sections 6.2.2, 6.2.2.A and 6.2.2.B.

In determining the accounting under the scenarios listed above prior to applying the September 2014 amendments, it is important first to determine whether the transactions fall within scope of IFRS 10's requirements on loss of control of a subsidiary (see section 3.2 above) or IAS 28's requirements on 'downstream transactions' with an associate or joint venture accounted using the equity method.

Extract from IAS 28

28	Gains and losses resulting from 'upstream' and 'downstream' transactions between an entity (including its consolidated subsidiaries) and its associate or joint venture are recognised in the entity's financial statements only to the extent of unrelated investors' interests in the associate or joint venture. 'Upstream' transactions are, for example, sales of assets from an associate or a joint venture to the investor. 'Downstream' transactions are, for example, sales or contributions of assets from the investor to its associate or its joint venture. The investor's share in the associate's or joint venture's gains or losses resulting from these transactions is eliminated.
29	When downstream transactions provide evidence of a reduction in the net realisable value of the assets to be sold or contributed, or of an impairment loss of those assets, those losses shall be recognised in full by the investor. …

These requirements in IAS 28 only apply to 'downstream' transactions with an associate or joint venture accounted for using the equity method and not to all transactions where the retained interest in the former subsidiary is an associate or joint venture accounted for using the equity method.

As noted in section 3.3.2 above, IFRS 10.25, prior to the revisions resulting from the September 2014 amendments, does not draw a distinction in accounting for the loss of control of a subsidiary that is a business and one that is not. The September 2014 amendments (and indeed other pronouncements, such as *Accounting for Acquisitions of Interests in Joint Operations* (Amendments to IFRS 11) issued May 2014), however, do set out different accounting treatments depending on whether an entity is a business or not.

How we see it

In our view, an entity is not precluded from applying IFRS 10.25, i.e., full gain recognition (see section 3.2 above), in accounting for the loss of control of a subsidiary that is not a business. We believe that entities *not* applying the September 2014 amendments are entitled to make an accounting policy determination as to whether IFRS 10.25 applies to *all* transactions involving a loss of control of a subsidiary ('wide view') or *only* to such transactions where the subsidiary is a business ('narrow view').

Where a transaction falls in scope of both IFRS 10.25 and IAS 28.28, we believe that there is a choice of which accounting standards takes precedence, to be applied consistently. Where a transaction falls outside the scope of both standards, an appropriate accounting policy must be determined, with regard to the requirements of IAS 8.

Therefore, in our view, the following accounting policy determinations are needed:

(a) Do the requirements of IFRS 10.25 apply to:
- A loss of control of a subsidiary that is a business ('narrow view')

  Or
- A loss of control of a subsidiary (whether a business or not) ('wide view')?

(b) Where there is a conflict between the requirements of IFRS 10.25 ('IFRS 10 approach') and IAS 28.28 ('IAS 28 approach'), which accounting standard takes precedence?

(c) Where the transaction falls within the scope of neither IFRS 10.25 nor IAS 28.28, what accounting policy is applied?

Scenarios 1 and 3 fall within the scope of IFRS 10.25, whether a 'wide view' or 'narrow view' is taken for accounting policy determination (a) above. However, Scenarios 2 and 4 will only fall within the scope of IFRS 10 if a 'wide view' is taken. Only Scenarios 1 and 2 fall within the scope of IAS 28.28. This is because this requirement in IAS 28 only applies to 'downstream' transactions with an associate or joint venture accounted for using the equity method and not to all transactions where the retained interest in the former subsidiary is an associate or joint venture accounted for using the equity method.

Both the IFRS IC and IASB have discussed the accounting for certain transactions, where there was a question over the interaction of IFRS 10 with IFRS 15 (see section 3.2.1 above) and with IFRS 16 (see section 3.2.2 above). These discussions may have an impact on the accounting policy determinations outlined above.

How we see it

Until such time as the IASB issues further pronouncements, there is likely to continue to be diversity of practice.

However, in the meantime, considering the discussions on the interplay of IFRS 10 with other standards such as IFRS 15 and IFRS 16 above, entities may need to be mindful when applying a 'narrow view' of the scope of IFRS 10.25 as mentioned above.

Figure 3-1 below summarises how the above policy determinations apply to the four scenarios where the September 2014 amendments are not applied.

Figure 3-1: Loss of control transactions where the retained interest in the former subsidiary is an associate or joint venture accounted for using the equity method

	Subsidiary meets the definition of a business	Subsidiary does not meet the definition of a business
Sale or contribution of investment in former subsidiary in downstream transaction with existing associate or joint venture	**Scenario 1** ▸ Both IFRS 10.25 (as the subsidiary is a business) and IAS 28.28 (as this is a 'downstream' transaction) apply to this scenario, so a conflict arises. ▸ An entity would need to develop an accounting policy to resolve the conflict, which would result in either applying full gain recognition (IFRS 10 approach) or partial gain recognition (IAS 28 approach).	**Scenario 2** ▸ IAS 28.28 (as this is a 'downstream' transaction) applies to this scenario. Therefore, partial gain recognition applies. ▸ However, if a 'wide view' is taken on the scope of IFRS 10.25, a conflict arises. An entity would then need to develop an accounting policy to resolve the conflict, which would result in either applying full gain recognition (IFRS 10 approach) or partial gain recognition (IAS 28 approach).
Sale or dilution of investment in former subsidiary for cash in transaction with third party	**Scenario 3** ▸ IAS 28.28 does not apply (as this is not a 'downstream' transaction). ▸ IFRS 10.25 applies (as the subsidiary is a business). ▸ Therefore, an entity applies full gain recognition (IFRS 10 approach) to the transaction.	**Scenario 4** ▸ IAS 28.28 does not apply (as this is not a 'downstream transaction'). ▸ IFRS 10.25 only applies if a 'wide view' is taken. ▸ Therefore, if a 'wide view' over the scope of IFRS 10.25 applies, an entity applies full gain recognition (IFRS 10 approach) to the transaction. ▸ If a 'narrow view' over the scope of IFRS 10.25 applies, an entity must develop and apply an appropriate accounting policy that provides relevant and reliable information in accordance with IAS 8.

How we see it

Where it is determined that a loss of control transaction falls within the scope of neither IFRS 10.25 nor IAS 28.28 (which might be the case for Scenario 4 if a 'narrow view' of the scope of IFRS 10.25 is taken), management will need to use judgement in developing and applying an appropriate accounting policy that results in relevant and reliable information, which must be consistently applied.

Some transactions that fall within Scenarios 1 and 3, and in Scenarios 2 and 4 might be similar in substance, which could be a relevant consideration when developing an appropriate accounting policy. Nevertheless, different accounting outcomes could arise depending on the accounting policy determinations made by the entity. In our view, accounting policies must be applied consistently to like transactions. This does not preclude a different choice of which standard takes precedence in Scenario 1 to the choice made for transactions in Scenario 2.

An entity only needs to make a determination as to whether a 'wide view' or 'narrow view' of the scope of IFRS 10.25 applies, if it enters into a transaction that falls within Scenarios 2 or 4 (because Scenarios 1 and 3 always fall within that paragraph's scope). However, once that determination has been required to be made, the 'wide view' or 'narrow view' must be applied consistently.

However, a different accounting policy could be adopted for transactions that are businesses and transactions that are not businesses (even where a 'wide view' of the scope of IFRS 10.25 is taken). For example, an entity taking the 'wide view' might consider it appropriate that IFRS 10 takes precedence in Scenario 1 (where the subsidiary is a business) but IAS 28 takes precedence in Scenario 2 (where the subsidiary is not a business). This is because transactions involving the loss of control of a subsidiary that is a business have a different nature to those involving a subsidiary that is not a business and an entity might conclude that partial gain recognition is more appropriate for the loss of control of a subsidiary that is not a business.

Note that if the September 2014 amendments (discussed in sections 3.3.2.B and 7.1 below) were applied, full gain recognition would be required in Scenario 1, whereas partial gain recognition would be required in Scenario 2.

3.3.2.B Conflict between IFRS 10 and IAS 28 (September 2014 amendments applied)

As noted in section 3.3.2 above, in September 2014, the IASB had issued *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (Amendments to IFRS 10 and IAS 28). Although the mandatory application of the September 2014 amendments was subsequently deferred, the amendments remain available for early application. However, these amendments have not been endorsed for use in all jurisdictions.

In the Basis for Conclusions, the IASB clarified that the amendments do not apply where a transaction with a third party leads to a loss of control (even if the retained interest in the former subsidiary becomes an associate or joint venture that is accounted for using the equity method), nor where the investor elects to measure its investments in associates or joint ventures at fair value in accordance with IFRS 9. *[IFRS 10.BC190I]*.

How we see it

The September 2014 amendments regarding the sale or contribution of assets between an investor and its associate or joint venture impact the accounting for situations where there was a conflict between IAS 28 and IFRS 10 (i.e., for Scenarios 1 and 2 discussed above), as discussed in section 3.3.2.A above. The amendments do not specifically address the accounting for situations where such a conflict does not directly exist (i.e., Scenarios 3 and 4 discussed above), and the analysis included in section 3.3.2.A above remains relevant to such situations.

The September 2014 amendments added the guidance explained in the following paragraph in relation to the accounting for the loss of control of a subsidiary that *does not* contain a business. *[IFRS 10.25, IFRS 10.26, IFRS 10.B99A]*. Consequently, on the loss of control of a subsidiary that constitutes a business, including cases in which the investor retains joint control of, or significant influence over, the investee, the guidance below is not to be applied. In such cases, the full gain or loss determined under the requirements of IFRS 10.B98 and B99 (see section 3.2 above) is to be recognised. *[IFRS 10.25, IFRS 10.26, IFRS 10.B98, IFRS 10.B99]*. Corresponding amendments were made to IAS 28 to clarify that partial gain recognition would apply if the sale or contribution to the associate or joint venture involved assets that do not constitute a business. *[IAS 28.28, IAS 28.30, IAS 28.31A, IAS 28.31B]*. See Chapter 12 at section 6.2.2.

Extract from IFRS 10 (as amended by September 2014 amendments)

B99A If a parent loses control of a subsidiary that does not contain a business, as defined in IFRS 3, as a result of a transaction involving an associate or a joint venture that is accounted for using the equity method, the parent determines the gain or loss in accordance with paragraphs B98-B99. The gain or loss resulting from the transaction (including the amounts previously recognised in other comprehensive income that would be reclassified to profit or loss in accordance with paragraph B99) is recognised in the parent's profit or loss only to the extent of the unrelated investors' interests in that associate or joint venture. The remaining part of the gain is eliminated against the carrying amount of the investment in that associate or joint venture. In addition, if the parent retains an investment in the former subsidiary and the former subsidiary is now an associate or a joint venture that is accounted for using the equity method, the parent recognises the part of the gain or loss resulting from the remeasurement at fair value of the investment retained in that former subsidiary in its profit or loss only to the extent of the unrelated investors' interests in the new associate or joint venture. The remaining part of that gain is eliminated against the carrying amount of the investment retained in the former subsidiary. If the parent retains an investment in the former subsidiary that is now accounted for in accordance with IFRS 9, the part of the gain or loss resulting from the remeasurement at fair value of the investment retained in the former subsidiary is recognised in full in the parent's profit or loss.

An example, based on one provided by IFRS 10 illustrating the application of this guidance, is reflected in Illustration 3-4 below.[21]

Illustration 3-4: Loss of control of a subsidiary that does not contain a business as a result of a transaction involving an associate

A parent has a 100% interest in a subsidiary that does not contain a business. The parent sells 70% of its interest in the subsidiary to an associate in which it has a 20% interest. As a consequence of this transaction, the parent loses control of the subsidiary. The carrying amount of the net assets of the subsidiary is CU100 and the carrying amount of the interest sold is CU70 (CU100 × 70%). The fair value of the consideration received is CU210, which is also the fair value of the interest sold. The investment retained in the former subsidiary is an associate accounted for using the equity method and its fair value is CU90. The gain determined in accordance with IFRS 10.B98-B99 is CU200 and after the elimination required by IFRS 10.B99A amounts to CU146. *[IFRS 10.B98, IFRS 10.B99, IFRS 10.B99A]*. This gain comprises two parts:

(a) A gain of CU140 resulting from the sale of the 70% interest in the subsidiary to the associate. This gain is the difference between the fair value of the consideration received (CU210) and the carrying amount of the interest sold (CU70). In accordance with IFRS 10.B99A, the parent recognises in its profit or loss the amount of the gain attributable to the unrelated investors' interests in the existing associate. *[IFRS 10.B99A]*. This is 80% of this gain, which is CU112 (CU140 × 80%). The remaining 20% of the gain (CU28 = CU140 × 20%), is eliminated against the carrying amount of the investment in the existing associate.

(b) A gain of CU60 resulting from the remeasurement at fair value of the investment directly retained in the former subsidiary. This gain is the difference between the fair value of the investment retained in the former subsidiary (CU90) and 30% of the carrying amount of the net assets of the subsidiary (CU30=CU100 × 30%). In accordance with IFRS 10.B99A, the parent recognises in its profit or loss the amount of the gain attributable to the unrelated investors' interests in the new associate. This is 56% (70% × 80%) of the gain, which is CU34 (CU60 × 56%). *[IFRS 10.B99A]*. The remaining 44% of the gain (CU26 = CU60 × 44%) is eliminated against the carrying amount of the investment retained in the former subsidiary.

This example would therefore give rise to the following journal, assuming cash consideration of CU210:

			CU	CU
Dr	Cash		210	
Dr	Investment in new associate (former subsidiary) (see (1) below)		64	
	Cr	Gain on disposal (see (2) below)		146
	Cr	Net assets of former subsidiary (previously consolidated)		100
	Cr	Investment in existing associate		28

(1) This represents the fair value of the investment in the former subsidiary (now an associate) of CU90 less the eliminated gain of CU26 (see (b) above).

(2) This represents the gain of CU200 less the eliminated gains of CU28 (eliminated against the investment in the associate - see (a) above) and CU26 (eliminated against the investment in the new associate/former subsidiary - see (1) above).

3.3.2.C Reclassification of items of OCI where the interest retained in the former subsidiary is an associate or joint venture accounted using the equity method

As discussed in section 3.2 above, on loss of control of a subsidiary, an entity must reclassify to profit or loss, or transfer directly to retained earnings if required by other IFRS accounting standards, the amounts recognised in OCI in relation to the subsidiary (see section 3.5 below). Where the retained interest in the former subsidiary is an associate or joint venture accounted using the equity method, the question arises as to whether amounts recognised in OCI that are required to be reclassified to profit or loss are reclassified in full or in part.

How we see it

In our view, where an IFRS 10 approach is applied, OCI reclassified is recognised in full on loss of control of the subsidiary, consistent with the full gain approach. While IAS 28 does not explicitly address this issue, we believe that where an IAS 28 approach is applied, partial gain reclassification of OCI applies such that only the proportion attributable to unrelated investors' interests in the associate or joint venture is reclassified. This treatment is consistent with the September 2014 amendments (see section 3.3.2.B above) but is also applicable where the September 2014 amendments are not applied.

21 *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (Amendments to IFRS 10 and IAS 28), IASB, September 2014, IFRS 10, paras. 25, 26, B99A, Example 17.

3.3.2.D Application of partial gain recognition where the gain exceeds the carrying amount of the investment in the associate or joint venture accounted using the equity method

Occasionally, upon sale or contribution of a subsidiary to an associate or joint venture (that is accounted for using the equity method), the investor's share of the gain exceeds the carrying value of the investment in the associate or joint venture. Where an IAS 28 approach (partial gain recognition) is applied, the question arises as to what extent is any profit in excess of the carrying value of the investment eliminated. This is addressed in Chapter 12 at section 7.1.1.

3.3.2.E Examples of accounting for sales or contributions to an existing associate (where the September 2014 amendments are not applied)

Scenario 1 is demonstrated in Illustration 3-5 below, showing both an IFRS 10 and an IAS 28 approach (a choice between these approaches is permitted where the September 2014 amendments are not applied). As noted in section 3.3.2.B above, an IFRS 10 approach is required for Scenario 1 where the September 2014 amendments are applied. Scenario 3 (where the IFRS 10 approach is required) is demonstrated in Illustration 3-9 in section 3.6 below (for a deemed disposal) and in Illustration 6-1 in Chapter 12 at section 6.2.2.A (a direct sale to a third party). The scenarios referred to in this paragraph are those set out in section 3.3.2.A above.

Illustration 3-5: Sale of a subsidiary to an existing associate

Parent P owns a 60% interest in its subsidiary S (which is a business). The carrying value of S's net identifiable assets in the consolidated financial statements of P is CU120 million. P measured the NCI using the proportionate share of net assets; therefore, the NCI is CU48 million (40% of CU120 million). In addition, goodwill of CU15 million was recognised upon the original acquisition of S and has not subsequently been impaired. The goodwill is allocated to S for the purposes of impairment testing.

Subsequently, P sells its interest in S to its associate A, in which it has a 40% interest, for CU96 million cash, being the fair value of its 60% interest in S. Therefore, P has a 40% interest in the enlarged associate A (which now holds the 60% interest in S).

If the September 2014 amendments to IFRS 10 and IAS 28 have *not* been early adopted, either a full gain is recognised (IFRS 10 approach), or the gain is restricted to that attributable to the other investors in A (IAS 28 approach). See section 3.3.2.A above. If the September 2014 amendments have been early adopted, the full gain is recognised as S is a business. See section 3.3.2.B above.

IFRS 10 approach

This results in a gain of CU9 million on disposal, recognised as follows:

			CU m	CU m
Dr	Cash		96.0	
Dr	NCI		48.0	
	Cr	Gain on disposal		9.0
	Cr	Net assets of S (previously consolidated)		120.0
	Cr	Goodwill (previously shown separately)		15.0

IAS 28 approach

Where the September 2014 amendments are *not* early adopted and the gain recognised is restricted to the 60% attributable to the other investors in A, a gain of CU5.4 million on disposal is recognised (with the remaining CU3.6 million adjusted against the carrying amount of the investment in A), as follows:

			CU m	CU m
Dr	Cash		96.0	
Dr	NCI		48.0	
	Cr	Gain on disposal		5.4
	Cr	Investment in A		3.6
	Cr	Net assets of S (previously consolidated)		120.0
	Cr	Goodwill (previously shown separately)		15.0

3.3.2.F Determination of the fair value of the retained interest in a former subsidiary which is an associate or joint venture

As indicated in section 3.3.1 above, no guidance is given in IFRS 10 as to how the fair value of the retained interest in the former subsidiary should be determined. However, IFRS 13 provides detailed guidance on how fair value is to be determined for financial reporting purposes. IFRS 13 is discussed in detail in Chapter 15.

One particular issue that has been discussed by the IASB, which might be relevant in determining the fair value of a retained interest that is an associate or a joint venture, is the unit of account for investments in subsidiaries, joint ventures and associates. In September 2014, the IASB issued an Exposure Draft that proposed among other matters, the following clarifications to the requirements for measuring fair value, in accordance with IFRS 13, for investments in subsidiaries, joint ventures and associates:

- The unit of account for investments in subsidiaries, joint ventures and associates would be the investment as whole
- When a quoted price in an active market is available for the individual financial instruments that comprise the entire investment, the fair value measurement would be the product of the quoted price of the financial instrument (P) multiplied by the quantity (Q) of instruments held (i.e., P × Q)[22]

During 2015, the IASB continued its deliberations on these proposals and decided that further research should be undertaken with respect to the fair value measurement of investments in subsidiaries, associates and joint ventures that are quoted in an active market.[23] This topic was considered further in the PIR of IFRS 13. The IASB concluded that IFRS 13 is working as intended and that the project was complete with no further work required. Although the Project Report and Feedback Statement noted that many stakeholders expressed a view that the IASB should clarify how IFRS 13 deals with the issue of prioritising the unit of account or Level 1 inputs, the IASB decided that it would conduct no other follow up activities in this area (because the costs of further work would exceed its benefits).[24]

These issues are discussed further in Chapter 15 at sections 1.3 and 4.1.1.

3.3.2.G Presentation of comparative information for a former subsidiary that becomes an investee accounted for using the equity method

Where a parent loses control of a subsidiary, so that the former subsidiary becomes an associate or a joint venture accounted for using the equity method, the effect is that the former parent/investor's interest in the investee is reported:

- Using the equity method from the date on which control is lost in the current reporting period
- Using full consolidation for any earlier part of the current reporting period, and of any earlier reporting period, during which the investee was controlled

It is not acceptable for an entity to restate financial information for reporting periods prior to the loss of control using the equity method to provide comparability with the new presentation. Consolidation continues until control is lost, *[IFRS 10.21, IFRS 10.B88]*, and equity accounting starts only from the date on which an entity becomes an associate or joint venture, *[IAS 28.32]*, (see Chapter 12 at section 6.1).

3.3.3 Interest retained in the former subsidiary - joint operation

In some transactions, it is possible that an entity would lose control of a subsidiary but retain an interest in a joint operation to be accounted for under IFRS 11 *Joint Arrangements*. For example, a parent might contribute an existing business to a newly created joint operation and obtain joint control of the combined operation. Alternatively, it could be achieved by a parent with a 100% subsidiary selling a 50% interest to another party, with the transaction resulting in the formation of a joint operation, with each party having a 50% share of the assets and liabilities of the joint operation.

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22 Exposure Draft ED/2014/4, *Measuring Quoted Investments in Subsidiaries, Joint Ventures and Associates at Fair Value* (Proposed amendments to IFRS 10, IFRS 12, IAS 27, IAS 28 and IAS 36 and Illustrative Examples for IFRS 13), IASB, September 2014.

23 *IASB Update*, July 2015, available on the IFRS Foundation's website.

24 *IASB Update*, March 2018; and IFRS Project Report and Feedback Statement: Post-implementation Review of IFRS 13 *Fair value Measurement*, IASB, December 2018. Available on the IFRS Foundation's website.

As set out in section 3.2 above, in accounting for a loss of control of a subsidiary, a parent is required, among other matters, to:

- Derecognise the assets and liabilities of the subsidiary
- Recognise any investment retained in the former subsidiary at fair value at the date when control is lost
- Recognise any resulting gain or loss in profit or loss

However, it is unclear how these requirements are to be applied when the retained interest is in the assets and liabilities of a joint operation. One view is that the retained interest is remeasured at fair value. Another view is that the retained interest is not derecognised or remeasured at fair value, but continues to be recognised and measured at its carrying amount.

In July 2016, the IFRS IC discussed whether an entity should remeasure its retained interest in the assets and liabilities of a joint operation when the entity loses control of a business, or an asset or group of assets that is not a business. In the transaction discussed, the entity either retains joint control of a joint operation or is a party to a joint operation (with rights to assets and obligations for liabilities) after the transaction.

The IFRS IC noted that IFRS 11.B34-B35 specify that an entity recognises gains or losses on the sale or contribution of assets to a joint operation only to the extent of the other parties' interests in the joint operation. *[IFRS 11.22, IFRS 11.B34, IFRS 11.B35]*. The requirements in these paragraphs could be viewed as conflicting with the requirements in IFRS 10, which specify that an entity remeasures any retained interest when it loses control of a subsidiary.

The IFRS IC observed that the IASB had issued amendments to IFRS 10 and IAS 28 in September 2014 to address the accounting for the sale or contribution of assets to an associate or a joint venture. Those amendments (which are discussed in section 3.3.2.B above and section 7.1 below) address a similar conflict that exists between the requirements in IFRS 10 and IAS 28. The IASB decided to defer the effective date of the amendments to IFRS 10 and IAS 28 and further consider a number of related issues at a later date.

Because of the similarity between the transaction discussed by the IFRS IC and a sale or contribution of assets to an associate or a joint venture (see section 3.3.2 above), the IFRS IC concluded that the accounting for the two types of transactions should be considered concurrently by the IASB. Consequently, the IFRS IC decided not to add this issue to its agenda but, instead, to recommend that the IASB consider the issue at the same time that it further considers the accounting for the sale or contribution of assets to an associate or a joint venture.[25] The interaction of IFRS 10 and IAS 28 has subsequently been considered as part of the IASB's equity method project (see section 7.1 below).

How we see it

Where an entity loses control of a former subsidiary, and retains an interest in a joint operation, there is a conflict between the requirements of IFRS 10 and IFRS 11 which means it is unclear whether remeasurement of the retained interest to its fair value is required or allowed. Until the IASB issues further guidance, we believe that, where a parent loses control over a subsidiary but retains an interest in a joint operation that is a business, entities have an accounting policy choice as to whether to remeasure the retained interest at fair value or not.

3.4 Loss of control in multiple arrangements

IFRS 10 only allows a parent to recognise a gain or loss on disposal of a subsidiary when the parent loses control over it. This requirement could present opportunities to structure the disposal in a series of disposals, thereby potentially reducing the loss recognised. Illustration 3-6 below, provides an example, based on one included in the Basis for Conclusions to IFRS 10. *[IFRS 10.BCZ185]*.

25 *IFRIC Update*, July 2016, available on the IFRS Foundation's website.

Illustration 3-6: Step-disposal of a subsidiary (1)

A parent controls 70% of a subsidiary. The parent intends to sell all of its 70% controlling interest in the subsidiary. The parent could structure the disposal in two different ways:

- The parent could initially sell 19% of its ownership interest without loss of control and then, soon afterwards, sell the remaining 51% and lose control

  Or

- The parent could sell its entire 70% interest in one transaction

In the first case, any difference between the amount by which the NCI are adjusted and the fair value of the consideration received upon sale of the 19% interest would be recognised directly in equity (as it is a transaction with owners in their capacity as owners) while the gain or loss from the sale of the remaining 51% interest would be recognised in profit or loss (once control is lost). In the second case, however, a gain or loss on the sale of the whole 70% interest would be recognised in profit or loss.

However, if an entity wanted to conceal losses on a disposal of a subsidiary, the opportunities are limited given the requirements of IAS 36 and IFRS 5, which usually require recognition of an impairment loss even before the completion of any sale, *[IFRS 10.BCZ186]*, (although they do not require reclassification of losses recognised in OCI).

In addition, IFRS 10 has the following guidance: *[IFRS 10.26, IFRS 10.B97]*

Extract from IFRS 10

B97 A parent might lose control of a subsidiary in two or more arrangements (transactions). However, sometimes circumstances indicate that the multiple arrangements should be accounted for as a single transaction. In determining whether to account for the arrangements as a single transaction, a parent shall consider all the terms and conditions of the arrangements and their economic effects. One or more of the following indicate that the parent should account for the multiple arrangements as a single transaction:

(a) They are entered into at the same time or in contemplation of each other.

(b) They form a single transaction designed to achieve an overall commercial effect.

(c) The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.

(d) One arrangement considered on its own is not economically justified, but it is economically justified when considered together with other arrangements. An example is when a disposal of shares is priced below market and is compensated for by a subsequent disposal priced above market.

These indicators clarify that arrangements that are part of a package are accounted for as a single transaction.

How we see it

Judgement is needed in determining whether the circumstances really do support multiple arrangements being accounted as a single transaction since there is a risk that an entity might end up accounting for a transaction that is truly separate as part of the transaction in which the loss of control occurred.

IFRS 10 is silent on how an entity accounts for multiple arrangements that are part of a single transaction. Depending on the facts and circumstances, the parent accounts for these transactions as either an advance payment or as an immediate disposal.

Advance payment - If the parent does not lose control over the subsidiary and access to the benefits associated with ownership until later steps in the transaction, then it accounts for the first step of the transaction as an advance receipt of consideration and continues to consolidate the subsidiary until the later date. In many cases, the assets and liabilities of the consolidated subsidiary could qualify as a disposal group held for sale under IFRS 5 (see Chapter 5 at section 2.1).

Immediate disposal - If the parent loses control and access to benefits associated on the first step of the transaction, then it ceases to consolidate the former subsidiary immediately, recognises a gain or loss on disposal, and accounts for the consideration due in the second step as deferred consideration receivable. Illustration 3-7 below shows a fact pattern where the entity would need to evaluate how to account for transactions that are linked.

Illustration 3-7: Step-disposal of a subsidiary (2)

A parent initially controls 70% of a subsidiary that has net assets of CU1,000,000 and a foreign currency translation loss that was recognised in OCI and is accumulated within equity of CU100,000. Of this amount, CU30,000 was allocated to NCI, and is included within the NCI of CU300,000. No goodwill was recognised in respect of this subsidiary and the subsidiary is not part of a CGU to which goodwill is allocated.

In November 20X0, the parent sells 19% of its ownership interest for CU200,000. In February 20X1, the parent sells the remaining 51% for CU550,000 in an arrangement that is considered part of a single overall transaction. It is assumed that there are no gains or losses in the intervening period. The effects of discounting for the deferral of consideration are assessed as immaterial.

The net assets of the subsidiary are not impaired under IAS 36, which is confirmed by the fact that the total sales price exceeds the parent's share in the net assets by CU50,000 (CU750,000 - CU700,000). The total loss on disposal can be calculated as follows:

			CU'000	CU'000
Dr	Proceeds from the sale (CU200,000 + CU550,000)		750	
Dr	NCI derecognised		300	
Dr	Loss on disposal of the subsidiary attributable to the parent		20	
	Cr	Net assets of the subsidiary derecognised		1,000
	Cr	Reclassification of parent's share of the loss in OCI		70

If the parent is considered not to have lost control over the investment in the subsidiary until February 20X1 then it accounts for the CU200,000 received in the first step of the transaction as an advance receipt of consideration. The parent continues to consolidate the subsidiary until the later date, at which point the loss on disposal of CU20,000 would be recognised.

If the parent is considered to have lost control over the investment in the subsidiary on the first step of the transaction, then it ceases to consolidate the former subsidiary immediately, recognises a loss on disposal of CU20,000, and accounts for the consideration of CU550,000 due in the second step as deferred consideration receivable.

3.5 Treatment of OCI on loss of control of a subsidiary

If a parent loses control of a subsidiary, all amounts previously recognised in OCI are accounted for on the same basis as would be required if the parent had directly disposed of the related assets or liabilities. If a gain or loss previously recognised in OCI would be reclassified to profit or loss on the disposal of the related assets or liabilities, the parent reclassifies the gain or loss from equity to profit or loss (as a reclassification adjustment) when it loses control of the subsidiary. *[IFRS 10.26, IFRS 10.B98(c), IFRS 10.B99]*. Therefore:

(a) If a revaluation surplus previously recognised in OCI would be transferred directly to retained earnings on the disposal of the asset, the parent transfers the revaluation surplus directly to retained earnings when it loses control of the subsidiary. *[IFRS 10.26, IFRS 10.B99]*.

(b) Remeasurement gains or losses on a defined benefit plan recognised in OCI would not be reclassified to profit or loss when the parent loses control of the subsidiary, but may be transferred within equity. *[IAS 19.122]*.

(c) On disposal of a subsidiary that includes a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation (that is recognised in OCI and accumulated in the separate component of equity) is reclassified from equity to profit or loss, except for the amounts that have been attributed to the NCI. Those amounts are derecognised, and not reclassified to profit or loss. *[IAS 21.48, IAS 21.48A, IAS 21.48B]*. This would appear to mean that it is only the parent's share of the cumulative exchange differences that is reclassified; those attributable to the NCI are not reclassified as they have already been included within the carrying amount of the NCI that is derecognised as part of calculating the gain or loss attributable to the parent.

(d) Changes in fair value of debt instruments measured at fair value through OCI and accumulated in equity would be reclassified from equity to profit or loss. *[IFRS 9.4.1.2A, IFRS 9.5.7.10]*.

(e) The effective portion of gains and losses on hedging instruments in a cash flow or net investment hedge previously recognised in OCI and accumulated in equity would be reclassified from equity to profit or loss. *[IFRS 9.6.5.12, IFRS 9.6.5.14]*.

(f) The 'cost of hedging' adjustments previously recognised in OCI and accumulated in equity would be reclassified from equity to profit or loss. *[IFRS 9.6.5.15, IFRS 9.6.5.16]*.

How we see it

There are two different interpretations of how to treat OCI accumulated in equity (other than exchange differences related to the net investment in foreign operations) that would be reclassified to profit or loss on the disposal of the related assets or liabilities, both of which are acceptable:

- Approach 1 *Reclassification of OCI related to parent interest only*
- Approach 2 *Reclassification of OCI related to parent and the NCI*

These approaches for the treatment of OCI accumulated in equity (other than exchange differences related to the net investment in foreign operations) are described below.

Approach 1 *Reclassification of OCI related to parent interest only*

IFRS 10 requires derecognition of the NCI (including any components of OCI attributable to them) at the date when control is lost, which implies derecognition of the NCI without any need for reclassification. *[IFRS 10.26, IFRS 10.B98(a)]*. In addition, IFRS 10 requires recognition of a gain or loss in profit or loss to be attributable to the parent, *[IFRS 10.26, IFRS 10.B98(d)]*, which again implies that there is no reclassification of OCI in respect of the NCI. Approach 1 is more consistent with the treatment of exchange differences relating to the net investment in foreign operations, as described at (c) above.

Approach 2 *Reclassification of OCI related to parent and the NCI*

IFRS 10 specifically requires that "if a gain or loss previously recognised in other comprehensive income would be reclassified to profit or loss on the disposal of the related assets or liabilities, the parent shall reclassify the gain or loss from equity to profit or loss (as a reclassification adjustment) when it loses control of the subsidiary." *[IFRS 10.26, IFRS 10.B98(c), IFRS 10.B99]*. That would clearly require reclassification of the entire balance of OCI accumulated within equity. However, where this is done, the portion of the reclassification adjustment attributable to the NCI is included as part of the profit or loss attributable to the NCI, not as part of the profit or loss attributable to the parent.

Illustration 3-8 below shows the application of the above requirements.

Illustration 3-8: Reclassification of OCI on loss of control of a subsidiary

A parent sells a 70% interest in a 90%-owned subsidiary to a third party for a cash consideration of CU28 million. The fair value of the 20% interest retained by the parent is CU8 million.

At the date of disposal, the net assets of the subsidiary were CU30 million. Included within those net assets, the subsidiary had recognised, in its own financial statements, the following:

- Property, plant and equipment of CU5 million that has resulted in a revaluation reserve of CU2 million
- Derivative financial assets of CU3.2 million (designated in a cash flow hedge) that have resulted in a cash flow hedge reserve of CU3 million
- A net defined benefit liability of CU3 million that has resulted in a reserve relating to net remeasurement losses of CU1.5 million on the defined benefit plan
- Net assets of a foreign operation of CU10 million that has resulted in a cumulative translation reserve in respect of net translation gains on the foreign operation of CU4 million

In the parent's consolidated financial statements, the parent has recognised 90% of these reserves in equivalent equity reserve balances, with the 10% attributable to the NCI included as part of the carrying amount of the NCI.

The impact of the subsidiary on the statement of financial position included in the parent's consolidated financial statements immediately prior to the disposal is as follows:

	CU m	CU m
Net assets of the subsidiary	30.00	
Equity attributable to parent		
▸ PP&E revaluation reserve		1.80
▸ Cash flow hedge reserve		2.70
▸ Net remeasurement loss reserve on defined benefit plan		(1.35)
▸ Cumulative translation reserve		3.60
▸ Other equity/retained earnings		20.25
Total equity attributable to parent		27.0
NCI		3.00

If the parent follows Approach 1 for the cash flow hedge reserve and makes a reserve transfer for the net remeasurement loss reserve on the defined benefit plan and the PP&E revaluation reserve, the impact of the disposal on the parent's consolidated financial statements is as follows:

	CU m	CU m
	DR	CR
Cash proceeds from the disposal	28.00	
Retained 20% investment at fair value	8.00	
Derecognition of net assets of the subsidiary		30.00
Derecognition of NCI	3.00	
Reserves reclassified to profit or loss		
▸ Cash flow hedge reserve (a)	2.70	
▸ Cumulative translation reserve (b)	3.60	
Reserves transferred to retained earnings:		
▸ PP&E revaluation reserve (c)	1.80	
▸ Net remeasurement loss reserve on defined benefit plan (d)		1.35
Retained earnings resulting from above transfers		0.45
Gain on disposal (attributable to parent)		15.30

The parent:

(a) Reclassifies its CU2.7 million cash flow hedge reserve to profit or loss for the period. This is reflected in the gain on disposal. The remaining 10% (i.e., CU0.3 million) is included as part of the carrying amount of the NCI that is derecognised as part of the gain or loss recognised on disposal of the subsidiary but is not reclassified to profit or loss nor is it transferred within equity.

(b) Reclassifies its cumulative translation reserve of CU3.6 million (90% × CU4 million) relating to the parent's interest to profit or loss. Again, this is reflected in the gain on disposal. The CU0.4 million (10% × CU4 million) relating to the NCI is included as part of the carrying amount of the NCI that is derecognised in calculating the gain or loss recognised on disposal of the subsidiary but is not reclassified to profit or loss nor is it transferred within equity.

(c) Transfers its revaluation reserve of CU1.8 million relating to its 90% share of the revaluation surplus on property, plant and equipment within equity to retained earnings. It is not reclassified to profit or loss. The remaining 10% attributable to the NCI is included as part of the carrying amount of the NCI that is derecognised in calculating the gain or loss recognised on disposal of the subsidiary but is not reclassified to profit or loss nor is it transferred within equity.

(d) Transfers its reserve of CU1.35 million relating to its 90% share of the net remeasurement losses on the defined benefit plan within equity to retained earnings. It is not reclassified to profit or loss. The remaining 10% attributable to the NCI is included as part of the carrying amount of the NCI that is derecognised in calculating the gain or loss recognised on disposal of the subsidiary but is not reclassified to profit or loss nor is it transferred within equity. This results in the same position as if the parent had not recognised a separate reserve for the net remeasurement losses on the defined benefit liability but had included them within retained earnings.

If, instead, the parent follows Approach 2 for the cash flow hedge reserve, the impact of the disposal on the parent's consolidated financial statements is as follows:

	CU m	CU m
	DR	CR
Cash proceeds from the disposal	28.00	
Retained 20% investment at fair value	8.00	
Derecognition of net assets of the subsidiary		30.00
Derecognition of NCI	3.00	
Reserves reclassified to profit or loss:		
▸ Cash flow hedge reserve (a)	2.70	
▸ Cumulative translation reserve (b)	3.60	
NCI (reclassification of cash flow hedge reserve) (a)	0.30	
Reserves transferred to retained earnings:		
▸ PP&E revaluation reserve (c)	1.80	
▸ Net remeasurement loss reserve on defined benefit plan (d)		1.35
Retained earnings resulting from above transfers		0.45
Gain on reclassification of cash flow hedge reserve (attributable to NCI) (a)		0.30
Gain on disposal (attributable to parent)		15.30

The parent:

(a) Reclassifies the entire CU3 million surplus on the cash flow hedge reserve to profit or loss for the period. The 90% of the balance (i.e., CU2.7 million) attributable to the parent is included within the gain on disposal that is attributable to the parent, while the remaining 10% (i.e., CU0.3 million) attributable to the NCI is reclassified to profit or loss and is included within the profit or loss attributable to the NCI.

(b) Reclassifies its cumulative translation reserve of CU3.6 million (90% × CU4 million) relating to the parent's interest to profit or loss. Again, this is reflected in the gain on disposal. The CU0.4 million (10% × CU4 million) relating to the NCI is included as part of the carrying amount of the NCI that is derecognised in calculating the gain or loss recognised on disposal of the subsidiary but is not reclassified to profit or loss nor is it transferred within equity.

(c) Transfers its revaluation reserve of CU1.8 million relating to its 90% share of the revaluation surplus on property, plant and equipment within equity to retained earnings. It is not reclassified to profit or loss. The remaining 10% attributable to the NCI is included as part of the carrying amount of the NCI that is derecognised in calculating the gain or loss recognised on disposal of the subsidiary but is not reclassified to profit or loss nor is it transferred within equity.

(d) Transfers its reserve of CU1.35 million relating to its 90% share of the net remeasurement losses on the defined benefit plan within equity to retained earnings. It is not reclassified to profit or loss. The remaining 10% attributable to the NCI is included as part of the carrying amount of the NCI that is derecognised in calculating the gain or loss recognised on disposal of the subsidiary but is not reclassified to profit or loss nor is it transferred within equity. This results in the same position as if the parent had not recognised a separate reserve for the net remeasurement losses on the defined benefit liability but had included them within retained earnings.

3.6 Deemed disposal

A subsidiary may cease to be a subsidiary, or a group may reduce its interest in a subsidiary, other than by actual disposal. This is commonly referred to as a 'deemed disposal'. Deemed disposals may arise for many reasons, including:

- A group does not take up its full allocation in a rights issue by a subsidiary in the group
- A subsidiary declares scrip dividends that are not taken up by its parent, so that the parent's proportional interest is diminished
- Another party exercises its options or warrants issued by a subsidiary
- A subsidiary issues shares to third parties
- A contractual agreement by which a group obtained control over a subsidiary is terminated or changed

A deemed disposal that results in the loss of control of a subsidiary is accounted for as a regular disposal. This accounting is shown in Illustration 3-9 below.

Illustration 3-9: Deemed disposal through share issue by subsidiary

A parent entity P owns 600,000 of the 1,000,000 shares issued by its subsidiary S, giving it a 60% interest. The carrying value of S's net identifiable assets in the consolidated financial statements of P is CU120 million. P measured the NCI using the proportionate share of net assets; therefore, the NCI is CU48 million (40% x CU120 million). In addition, goodwill of CU15 million was recognised upon the original acquisition of S and has not subsequently been impaired. The goodwill is allocated to S for the purposes of impairment testing.

Subsequently, S issues 500,000 shares to a new investor for CU80 million. As a result, P's 600,000 shares now represent 40% of the 1,500,000 shares issued by S in total and S becomes an associate of P.

IFRS 10 requires the remaining interest in the former subsidiary to be recognised at fair value. P considers that, based on the requirements of IFRS 13, the fair value of its 600,000 shares in S is CU96 million.

This results in a gain of CU9 million on disposal, recognised as follows:

			CU m	CU m
Dr	Interest in S		96	
Dr	NCI		48	
	Cr	Gain on disposal		9
	Cr	Net assets of S (previously consolidated)		120
	Cr	Goodwill (previously shown separately)		15

As indicated in section 3.3.2.F above, the IASB has discussed issues relating to the unit of account for investments in subsidiaries, joint ventures and associates, and their fair value measurement under IFRS 13.

3.7 Demergers and distributions of non-cash assets to owners

Groups may dispose of subsidiaries by way of a demerger. This situation typically involves the transfer of the subsidiaries to be disposed of, either directly to shareholders, by way of a dividend in kind or to a newly formed entity in exchange for the issue of shares by that entity to the shareholders of the disposing entity.

IFRS 10 requires recognition of a distribution of shares of the subsidiary to owners in their capacity as owners but does not describe how to account for such transactions. *[IFRS 10.26, IFRS 10.B98(b)]*. Instead, IFRIC 17 *Distributions of Non-cash Assets to Owners* addresses distributions of subsidiary shares to shareholders. *[IFRIC 17.9]*. The application of IFRIC 17 in the context of demergers is discussed below. The application of IFRIC 17 to assets in general is discussed in Chapter 9 at section 2.4.2.

3.7.1 Scope of IFRIC 17

The scope of IFRIC 17 is explained in the following extract. *[IFRIC 17.3]*.

Extract from IFRIC 17

3 This Interpretation applies to the following types of non-reciprocal distributions of assets by an entity to its owners acting in their capacity as owners:

(a) distributions of non-cash assets (eg items of property, plant and equipment, businesses as defined in IFRS 3, ownership interests in another entity or disposal groups as defined in IFRS 5); and

(b) distributions that give owners a choice of receiving either non-cash assets or a cash alternative.

See Chapter 10 at section 3.2 for further guidance on the definition of a business in IFRS 3, and Chapter 5 at section 2.1 for further guidance on disposal groups as defined in IFRS 5.

The scope of IFRIC 17 is limited in several respects:

- It only applies to distributions in which all owners of the same class of equity instruments are treated equally. *[IFRIC 17.4]*.
- It does not apply to "a distribution of a non-cash asset that is ultimately controlled by the same party or parties before and after the distribution", *[IFRIC 17.5]*, which means that IFRIC 17 does not apply when:
  - A group of individual shareholders receiving the distribution, as a result of contractual arrangements, collectively have the power to govern financial and operating policies of the entity making the distribution so as to obtain benefits from its activities, *[IFRIC 17.6]*,
  - An entity distributes some of its ownership interests in a subsidiary but retains control of the subsidiary. The entity making a distribution that results in the entity recognising NCI in its subsidiary accounts for the distribution in accordance with IFRS 10. *[IFRIC 17.7]*. In this situation, the requirements of IFRS 10 discussed in section 4 below would be applied.

  This exclusion applies to the separate, individual, and consolidated financial statements of an entity that makes the distribution. *[IFRIC 17.5]*.
- It only addresses the accounting by an entity that makes a non-cash asset distribution. It does not address the accounting by shareholders who receive the distribution. *[IFRIC 17.8]*.

The rest of this section describes the requirements of IFRIC 17. However, as noted above, certain transactions fall out of scope of the Interpretation. Chapter 9 at section 4.4.1.D includes guidance on the accounting by a subsidiary making a distribution of a non-cash asset to its parent.

3.7.2 Recognition and measurement in IFRIC 17

An entity making a non-cash distribution to its owners recognises a liability to pay a dividend when the dividend is appropriately authorised and is no longer at the discretion of the entity. This is the date: *[IFRIC 17.10]*

- When declaration of the dividend (e.g., by management or the board of directors) is approved by the relevant authority (e.g., shareholders) if the jurisdiction requires such approval

  Or

- When the dividend is declared (e.g., by management or the board of directors) if the jurisdiction does not require further approval

An entity measures the liability at the fair value of the assets to be distributed. *[IFRIC 17.11]*. If the owners have a choice between receiving a non-cash asset or cash, the entity estimates the dividend payable by considering both the fair value of each alternative and the associated probability of owners selecting each alternative. *[IFRIC 17.12]*. IFRIC 17 does not specify any method of assessing probability nor its effect on measurement. In a demerger involving the distribution of shares in a subsidiary, the fair value will be determined based on the guidance in IFRS 13. As indicated in section 3.3.2.F above, the IASB has discussed issues relating to the unit of account for investments in subsidiaries, joint ventures and associates, and their fair value measurement under IFRS 13.

IFRS 5's requirements apply also to a non-current asset (or disposal group) that is classified as held for distribution to owners acting in their capacity as owners (held for distribution to owners). *[IFRS 5.5A, IFRS 5.12A]*. This means that a non-current asset (or disposal group) classified as held for distribution within scope of IFRS 5 will be carried at the lower of its carrying amount and fair value less costs to distribute (i.e., incremental costs directly attributable to the distribution, excluding finance costs and income tax expense). *[IFRS 5.15A]*. Assets not subject to the measurement provisions of IFRS 5 are measured in accordance with the relevant standard. *[IFRS 5.2, IFRS 5.5]*. See further discussion in Chapter 5 at section 2.2.

At the end of each reporting period and at the date of settlement, the carrying amount of the dividend payable is adjusted to reflect any changes in the fair value of the assets being distributed and changes are recognised in equity as adjustments to the amount of the distribution. *[IFRIC 17.11, IFRIC 17.13]*.

When the dividend payable is settled, any difference between the carrying amount of the assets distributed and the carrying amount of the dividend payable is recognised as a separate line item in profit or loss. *[IFRIC 17.14, IFRIC 17.15]*. IFRIC 17 does not express any preference for particular line items or captions in the income statement.

The non-cash assets that are to be distributed are measured in accordance with other applicable IFRS accounting standards up to the time of settlement as IFRIC 17 does not override the recognition and measurement requirements of other IFRS accounting standards. While the IFRS IC recognised concerns about the potential 'accounting mismatch' in equity resulting from measuring the dividend payable and the related assets on a different basis, *[IFRIC 17.BC55]*, it concluded that:

> "... there was no support in IFRSs for requiring a remeasurement of the assets because of a decision to distribute them. The IFRIC noted that the mismatch concerned arises only with respect to assets that are not carried at fair value already. The IFRIC also noted that the accounting mismatch is the inevitable consequence of IFRSs using different measurement attributes at different times with different triggers for the remeasurement of different assets and liabilities." *[IFRIC 17.BC56]*.

3.7.3 Presentation and disclosure

An entity is required to disclose the following information in respect of distributions of non-cash assets within the scope of IFRIC 17:

- The carrying amount of the dividend payable at the beginning and end of the reporting period *[IFRIC 17.16]*
- The increase or decrease in the carrying amount recognised in the reporting period as result of a change in the fair value of the assets to be distributed *[IFRIC 17.16]*
- If an entity declares a dividend to distribute a non-cash asset after the end of a reporting period but before the financial statements are authorised for issue: *[IFRIC 17.17]*
  - The nature of the asset to be distributed
  - The carrying amount of the asset to be distributed as of the end of the reporting period
  - The fair value of the asset to be distributed as of the end of the reporting period, if it is different from its carrying amount
  - Information about the method(s) used to determine that fair value required by IFRS 13.93(b), (d), (g) and (i) and IFRS 13.99 (see Chapter 15 at sections 19.1 and 19.3) *[IFRS 13.93, IFRS 13.99]*

Chapter 5 at section 3 discusses the presentation requirements of IFRS 5 where the demerger meets the definition of a discontinued operation. Chapter 5 at section 2.2.4 discusses the presentation of non-current assets and disposal groups held for sale. The same requirements apply to non-current assets and disposal groups held for distribution. *[IFRS 5.5A]*.

Less extensive disclosures are needed where IFRS 19 is applied (see Chapter 4 at section 7).[26] *[IFRS 19.38-40, IFRS19.95-97]*.

26 IFRS 19 *Subsidiaries without Public Accountability: Disclosures* was issued by the IASB in May 2024 to simplify the preparation of financial statements by eligible subsidiaries. Eligible subsidiaries that elect to apply IFRS 19 are allowed to provide reduced disclosures while still applying the recognition, measurement and presentation requirements in other IFRS accounting standards. IFRS 19 is effective for annual reporting periods beginning on or after 1 January 2027, with earlier application permitted (subject to jurisdictional endorsement). See Chapter 4 at section 7 for further details on the requirements of IFRS 19.

4 Changes in ownership interest without a loss of control

Extract from IFRS 10

23 Changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are equity transactions (ie transactions with owners in their capacity as owners).

A parent's ownership interest can change without a loss of control, e.g., when a parent buys shares from or sells shares to NCI, a subsidiary redeems shares held by NCI (and changes the NCI's proportionate interest), or when a subsidiary issues new shares to NCI (and changes the NCI's proportionate interest).

Extract from IFRS 10

Changes in the proportion held by non-controlling interests

B96 When the proportion of the equity held by non-controlling interests changes, an entity shall adjust the carrying amounts of the controlling and non-controlling interests to reflect the changes in their relative interests in the subsidiary. The entity shall recognise directly in equity any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received, and attribute it to the owners of the parent.

This means that no changes to a subsidiary's assets (including goodwill) and liabilities are recognised in a transaction in which a parent increases or decreases its ownership interest in a subsidiary but retains control. *[IFRS 10.BCZ173]*. Increases or decreases in the ownership interest in a subsidiary do not result in the recognition of a gain or loss but adjust the carrying amounts of the controlling interest and NCI in equity. *[IFRS 10.23, IFRS 10.24, IFRS 10.B96]*.

IFRS 12 requires an entity to disclose information on the consequences of such changes in ownership interest, through the presentation of a schedule showing the effects on the equity attributable to the owners of the parent (i.e., parent equity) of any changes in its ownership interest in a subsidiary that do not result in a loss of control. *[IFRS 12.10(b)(iii), IFRS 12.18]*. See Chapter 14 at section 4.5.1.

4.1 Reattribution of OCI

If there has been a partial disposal of a subsidiary without a loss of control and the disposal includes a foreign operation, the proportionate share of the cumulative amount of exchange differences recognised in OCI is reattributed to the NCI in that foreign operation (see Chapter 16 at section 6.6.2.B). *[IAS 21.48C]*. In other words, these exchange differences are not reclassified to profit or loss. The accounting is shown in Illustration 4-1 below.

If the entity subsequently disposes of the remainder of its interest in the subsidiary, the exchange differences previously attributed to the NCI (including prior reattributions on changes of ownership without loss of control) are derecognised (i.e., along with the rest of the NCI balance) but are not separately reclassified to profit or loss (see Chapter 16 at section 6.6.1). *[IAS 21.48B]*. In other words, on loss of control, only the exchange differences attributable to the controlling interest immediately before loss of control are reclassified to profit or loss. *[IAS 21.48]*. The accounting is shown in Illustration 4-3 below and Illustration 6-10 in Chapter 16 at section 6.6.1.A.

Although not explicitly addressed in IFRS 10 or IAS 21, the IASB has clarified that IFRS accounting standards require the reattribution of other amounts recognised in OCI. The May 2009 *IASB Update* noted that in the Board's view "there is no need to clarify the following points, because the relevant requirements are clear:

"• ...

"• When a change in ownership in a subsidiary occurs but does not result in the loss of control, the parent must reattribute other comprehensive income between the owners of the parent and the non-controlling interest."[27]

27 *IASB Update*, May 2009, available on the IFRS Foundation's website.

Illustration 4-1 below shows the accounting for reattribution of OCI.

Illustration 4-1: Reattribution of OCI upon a decrease in ownership interest that does not result in a loss of control

A parent has a wholly-owned subsidiary that has net assets of CU4,000,000, and total OCI accumulated within equity of CU1,000,000 related to exchange gains on a foreign operation. No goodwill has been recognised in respect of this subsidiary.

The parent sells a 10% interest in the subsidiary for CU500,000 and does not lose control. The carrying amount of the NCI is CU400,000 which includes CU100,000 (i.e., 10%) of the total OCI of CU1,000,000 related to exchange differences on a foreign operation reattributed to the NCI (as shown below).

The parent accounts for the transaction through equity as follows:

			CU'000	CU'000
Dr	Cash		500	
Dr	Parent's share of OCI (CU1,000,000 × 10%)		100	
	Cr	Other components of parent equity		200
	Cr	NCI's share of OCI (CU1,000,000 × 10%)		100
	Cr	NCI (excluding share of OCI) ((CU4,000,000 × 10%) - (CU1,000,000 × 10%))		300

The effect of the above journals is an increase in the carrying amount of NCI of CU400,000, a reduction in the parent's cumulative translation reserve from CU1,000,000 to CU900,000, and an increase in other components of parent equity of CU200,000. As IFRS accounting standards do not specify where the adjustment to parent equity is recognised, this would be permitted in retained earnings or another component of parent equity that will not be reclassified on loss of control.

Illustration 4-2 below shows the reattribution approach upon an increase in ownership interest.

Illustration 4-2: Reattribution of OCI upon an increase in ownership interest that does not result in a loss of control

A parent holds an 80% interest in a subsidiary that has net assets of CU4,000,000. No goodwill has been recognised in respect of this subsidiary. The carrying amount of the 20% NCI is CU800,000 which includes CU200,000 that represents the NCI's share of total OCI of CU1,000,000 related to exchange gains on a foreign operation.

The parent acquires an additional 10% interest in the subsidiary for CU500,000, which increases its total interest to 90%. The carrying amount of the NCI is now CU400,000 which includes CU100,000 (i.e., 10%) of the total OCI of CU1,000,000 related to exchange differences on a foreign operation, after reattributing CU100,000 to the parent (as shown below).

The parent accounts for the transaction through equity as follows:

			CU'000	CU'000
Dr	NCI's share of OCI (CU1,000,000 × 10%)		100	
Dr	NCI (excluding share of OCI) ((CU800,000 × 10% ÷ 20%) - (CU1,000,000 × 10%))		300	
Dr	Other components of parent's equity		200	
	Cr	Parent's share of OCI (CU1,000,000 × 10%)		100
	Cr	Cash		500

The effect of the above journals is a reduction in the carrying amount of NCI of CU400,000, an increase in the parent's cumulative translation reserve from CU800,000 to CU900,000, and a decrease in other components of parent equity of CU200,000. As IFRS accounting standards do not specify where the adjustment to parent equity is recognised, this would be permitted in retained earnings or another component of parent equity that will not be reclassified on loss of control.

Illustration 4-3 below shows the reclassification of reattributed exchange differences upon subsequent loss of control. This demonstrates that the reattribution of the exchange differences arising on the change in the parent's ownership of the subsidiary (as shown in Illustration 4-1 and Illustration 4-2 above) affects the gain recognised on loss of control of the subsidiary.

Illustration 4-3: Reclassification of reattributed exchange differences upon subsequent loss of control

Assume the same facts as in Illustration 4-1 or Illustration 4-2 above. Following those transactions, the parent now holds a 90% interest in a subsidiary that has net assets of CU4,000,000. No goodwill has been recognised in respect of this subsidiary. The carrying amount of the 10% NCI is CU400,000 which includes CU100,000 of the total OCI of CU1,000,000 related to exchange gains on a foreign operation, as reattributed to the NCI. The parent subsequently sells its 90% interest for CU4,700,000. For the purposes of illustration, there have been no subsequent changes in net assets nor OCI up to the date of sale.

The parent accounts for the transaction as follows:

			CU'000	CU'000
Dr	Cash proceeds from sale		4,700	
Dr	NCI derecognised		400	
Dr	Parent's share of OCI reclassified (CU1,000,000 × 90%)		900	
	Cr	Net assets of subsidiary derecognised		4,000
	Cr	Gain recognised on disposal of subsidiary attributable to parent		2,000

4.2 Goodwill attributable to NCI

It is not clear under IFRS 10 what happens to the NCI's share of goodwill, when accounting for transactions with NCI.

How we see it

We believe that when there are changes in their relative ownership interests, the parent is required to reallocate a proportion of the goodwill between the controlling interest and NCI. However, the amount of goodwill, if any, to be allocated may depend on whether NCI was recognised at fair value or not on initial acquisition, and on whether there is an increase or decrease in ownership of the NCI without a loss on control. If an appropriate amount of goodwill is not reallocated, the loss recognised upon loss of control (see section 3.2 above), or goodwill impairment would not reflect the ownership interest in the subsidiary applicable to that NCI (see Chapter 21 at section 9).

The issues arising include:

- Calculation of the 'gross up' of the carrying amount of goodwill (for the purposes of the impairment test) because the NCI is measured at its proportionate share of net identifiable assets and hence its share of goodwill is not recognised
- The allocation of impairment losses between the parent and NCI
- Reallocation of goodwill between NCI and the controlling interest after a change in a parent's ownership interest in a subsidiary that does not result in loss of control

Under IFRS 3, the proportion of goodwill that is attributable to NCI is not necessarily equal to the ownership percentage. The most common situation where this occurs is when the parent recognised the NCI at its proportionate share of the acquiree's identifiable net assets and therefore does not recognise any goodwill for the NCI (see Chapter 10 at sections 5.1 and 8.2). This situation might also occur because goodwill has been recognised for both the parent's interest and the NCI, but the parent's goodwill reflects a control premium that was paid upon acquisition (see Chapter 10 at section 8.1).

Illustration 4-4 below shows one approach to reallocating goodwill where there is a change in ownership of the subsidiary with no loss of control (for a situation where the NCI is recognised initially at its fair value).

Illustration 4-4: Reallocation of goodwill to NCI

A parent pays CU920 million to acquire an 80% interest in a subsidiary that owns net assets with a fair value of CU1,000 million. NCI is recognised initially at its fair value of CU220 million at the acquisition date.

	Share of net assets	Share of goodwill	Total
	CU m	CU m	CU m
Parent	800	120	920
NCI	200	20	220
	1,000	140	1,140

Decrease in ownership percentage

A year after the acquisition, the parent sells a 20% interest in the subsidiary to a third party for CU265 million. There has been no change in the net assets of the subsidiary since acquisition.

The parent's interest decreases to 60% and its share of net assets decreases to CU600 million. Correspondingly, the share of net assets attributable to the NCI increases from CU200 million to CU400 million. The parent company sold a 20% interest in its subsidiary. Therefore, one approach for reallocating goodwill is to allocate CU30 million (20% ÷ 80% × CU120 million) of the parent's goodwill to the NCI. After the transaction, the parent's share of goodwill is CU90 million (CU120 million - CU30 million).

In its consolidated financial statements, the parent accounts for this transaction as follows:

			CU m	CU m
Dr	Cash		265	
	Cr	NCI ((CU400m - CU200m) + CU30m)		230
	Cr	Equity of the parent		35

Increase in ownership percentage

Taking the initial fact pattern as a starting point, the parent acquires an additional 10% interest in the subsidiary for CU115 million. There has been no change in the net assets of the subsidiary since acquisition.

The parent's interest increases to 90% and its share of net assets increases to CU900 million. Correspondingly, the share of net assets attributable to NCI is reduced from CU200 million to CU100 million. The parent acquired half of the NCI. Using the proportionate allocation approach discussed above, the parent allocates CU10 million (10% ÷ 20% × CU20 million) of the NCI's goodwill to the parent.

In its consolidated financial statements, the parent accounts for this transaction as follows:

			CU m	CU m
Dr	NCI ((CU200m - CU100m) + CU10m)		110	
Dr	Equity of the parent		5	
	Cr	Cash		115

In Illustration 4-4 above, the NCI was recognised and measured at its fair value at the acquisition date. If the NCI had been measured based on its proportionate share of net assets, the proportionate allocation approach described in the Illustration would have resulted in the same accounting for the transaction where the parent's ownership interest had decreased. However, where the parent increased its ownership interest, as the carrying amount of the NCI did not include any amount for goodwill, the adjustment to the NCI would only have been CU100 million resulting in a debit to the parent's equity of CU15 million.

How we see it

Reallocation of the goodwill between parent and NCI on a proportionate basis is one method that may result in relevant and reliable information. However, other approaches may also be appropriate depending on the circumstances (see Chapter 21 at section 9.3).

We consider that an entity is not precluded from attributing goodwill on a basis other than ownership percentages if to do so is reasonable, e.g., because the NCI is measured on a proportionate share (rather than fair value) and because of the existence of a control premium. In such circumstances, an allocation approach which takes into account the acquirer's control premium will result in a goodwill balance that most closely resembles the balance that would have been recorded had the NCI been recorded at fair value. An entity may also be able to allocate impairment losses on a basis that recognises the disproportionate sharing of the controlling interest and the NCI in the goodwill book value. This is discussed further in Chapter 21 at section 9 which addresses how an entity tests goodwill for impairment where there is NCI.

4.3 Non-cash acquisition of NCI

One issue considered by the IFRS IC is the accounting for the purchase of NCI by the controlling shareholder when the consideration includes non-cash items, such as an item of property, plant and equipment. More specifically, the submitter asked the IFRS IC to clarify whether the difference between the fair value of the consideration given and the carrying amount of such consideration should be recognised in equity or in profit or loss. The submitter asserted that, according to the requirements of the then IAS 27 *Consolidated and Separate Financial Statements* (now reflected in IFRS 10), the difference described should be recognised in equity, whereas applying IFRIC 17 by analogy, the difference should be recognised in profit or loss (see section 3.7 above).

The IFRS IC noted that the requirements of the then IAS 27 (now reflected in IFRS 10), deal solely with the difference between the carrying amount of the NCI and the fair value of the consideration given; this difference is required to be recognised in equity. These requirements do not deal with the difference between the fair value of the consideration given and the carrying amount of such consideration. *[IFRS 10.24, IFRS 10.B96]*. The difference between the fair value of the assets transferred and their carrying amount arises from the derecognition of those assets. Since IFRS accounting standards generally require an entity to recognise, in profit or loss, any gain or loss arising from the derecognition of an asset,[28] this difference has to be recognised in profit or loss.

4.4 Transaction costs

Although IFRS 10 is clear that changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are equity transactions (i.e., transactions with owners in their capacity as owners), *[IFRS 10.23]*, it does not specifically address how to account for related transaction costs. Only incremental costs directly attributable to the equity transaction that otherwise would have been avoided qualify as transaction costs. *[IAS 32.37]*.

How we see it

In our view, any incremental directly attributable transaction costs incurred to acquire an outstanding NCI in a subsidiary, or to sell an NCI in a subsidiary without loss of control, are deducted from equity. This is regardless of whether the consideration is in cash or shares.

This is consistent with both guidance elsewhere in IFRS accounting standards regarding the treatment of such costs, *[IAS 32.35, IAS 32.37, IAS 1.109]*, and the view expressed by the IFRS IC.[29] Although where shares are given as consideration there is no change in total consolidated equity, there are in fact two transactions - an issue of new equity and a repurchase of existing equity. The entity accounts for the transaction costs on the two elements in the same manner as if they had occurred separately. The tax effects of transaction costs of equity instruments are discussed in Chapter 29 at section 10.3.5.

IFRS accounting standards do not specify where to allocate the costs in equity - in particular, whether to the parent (who incurred the costs) or to the NCI (whose equity was issued/repurchased).

28 *IFRIC Update*, January 2013, available on the IFRS Foundation's website.

29 *IFRIC Update*, May 2009, available on the IFRS Foundation's website.

How we see it

As IFRS accounting standards have no guidance, the parent determines where in equity to allocate the transaction costs incurred to acquire or sell an outstanding NCI, based on the facts and circumstances surrounding the change in ownership, and any legal requirements of the jurisdiction.

Regardless of the account in equity to which the charge is allocated, we believe that the amount is not reclassified to profit or loss in future periods. Consequently, if the costs are allocated to NCI, this amount must be separately tracked. If a subsidiary is later sold in a separate transaction (i.e., loss of control), the transaction costs previously recognised directly in equity to acquire or sell NCI are not reclassified from equity to profit and loss, because they do not represent components of OCI.

The need to track any costs allocated to NCI (if material) is explained in the following Illustration.

Illustration 4-5: Treatment of transaction costs arising on a previous NCI purchase/sale on subsequent loss of control of a subsidiary

Parent P owned 80% of the shares in Subsidiary S since its establishment (so there is no goodwill). P subsequently purchased 10% of the minority investor's shares for CU150,000, incurring transaction costs of CU10,000. At the time of the transaction, the net assets of S included in the consolidation were CU1m. Two years later, the net assets of S had increased to CU2m and P sold its 90% ownership interest in S for CU3m. There were no amounts in OCI required to be reclassified on the loss of control of S.

If the transaction costs were originally debited to parent equity, the gain on disposal would be CU1.2m (i.e., CU3m proceeds less CU2m net assets of S included in the consolidation plus CU0.2m derecognition of NCI).

If the transaction costs were originally debited to NCI, the gain on disposal (if no re-allocation of the transaction costs was made at the date of disposal), would be CU1.19m (i.e., CU3m proceeds less CU2m net assets of S included in the consolidation plus CU0.19m derecognition of NCI). This is a lower gain and is the same amount that would be calculated if the transaction costs had been debited to parent equity and recycled to profit or loss on the disposal. Since the transaction costs are not a component of OCI, this would be inappropriate and, consequently, a transfer would be needed at the date of disposal to reallocate the transaction costs from NCI to parent equity before determining the gain or loss from the loss of control.

The same situation would arise if the transaction costs debited to NCI had arisen on an earlier sale of NCI without loss of control.

4.5 Contingent consideration on purchase of NCI

IFRS 10 does not provide guidance on accounting for remeasurement of contingent consideration relating to the purchase of NCI. The question arises as to whether the remeasurement is accounted for in profit or loss, or in equity (on the grounds that it is related to the purchase of the NCI - see section 4 above). This discussion assumes that the purchase of NCI is separate from the business combination. It is not uncommon for a written put and/or a purchased call option over NCI to be put in place at the time of a business combination. The accounting for such transactions (including forward contracts to sell NCI) is discussed in section 6 below.

IFRS 3 addresses the accounting for remeasurement of contingent consideration recognised by the acquirer in a business combination. Contingent consideration is initially recognised at its fair value. Contingent consideration classified as equity is not remeasured and its subsequent settlement is accounted for within equity. Other contingent consideration (not classified as equity) is measured at fair value at each reporting date and changes in its fair value are recognised in profit or loss. This is the case whether or not the contingent consideration is within the scope of IFRS 9. *[IFRS 3.39, IFRS 3.40, IFRS 3.58, IFRS 9.4.2.1(e)]*. See Chapter 10 at section 7.1.2.

The purchase of NCI is not a business combination and, consequently, IFRS 3's requirements do not apply. In practice, most contingent consideration meets the definition of a financial liability and would fall within the scope of IFRS 9.

How we see it

In our view, a distinction needs to be drawn between the initial recognition of the financial liability for contingent consideration arising on the purchase of NCI (which is a transaction with NCI to be reflected as an equity transaction) and its subsequent measurement (which is not a transaction with NCI).

On initial recognition, contingent consideration is recognised at its fair value, *[IFRS 3.40]*, the NCI purchased is derecognised (and any balancing adjustment is reflected in parent equity). Subsequent movements in contingent consideration classified as a financial liability are recognised in accordance with IFRS 9 (in profit or loss, as explained below) rather than regarded as relating to a transaction with NCI (and recognised in equity). If the contingent consideration is classified as an equity instrument, it will not be remeasured. *[IFRS 3.58]*.

Depending on the terms and conditions, the contingent consideration is classified as a financial liability at amortised cost, or at fair value through profit or loss in accordance with IFRS 9. *[IFRS 9.4.2.1, IFRS 9.4.2.2]*. In both cases, subsequent remeasurements for any changes in estimated contractual cash flows or fair value, or on final settlement of the financial liability are recognised in profit or loss (except for any fair value movements attributable to own credit risk required to be recognised in OCI, where the financial liability is designated at fair value through profit or loss). See Chapter 44 at sections 2, 3 and 6, and Chapter 46 at sections 2.2, 2.4 and 3.

5 NCI

5.1 The definition of NCI

Extract from IFRS 10

Appendix A
Defined terms

non-controlling interest	Equity in a **subsidiary** not attributable, directly or indirectly, to a **parent**.

[IFRS 10 Appendix A].

The principle underlying accounting for NCI is that all residual economic interest holders of any part of the consolidated entity have an equity interest in that consolidated entity.

Consequently, NCI relates to consolidated subsidiaries, and not to those investments in subsidiaries accounted for at fair value through profit or loss in accordance with IFRS 9 by an investment entity (see Chapter 7 at section 10.3). *[IFRS 10.31, IFRS 10.32, IFRS 10.33]*. This principle applies regardless of the decision-making ability of that interest holder and where in the group that interest is held. Therefore, any equity instruments issued by a subsidiary that are not owned by the parent (apart from those that are required to be classified by IAS 32 as financial liabilities in the consolidated financial statements, as discussed in section 5.6 below) are NCI, including, for example:

- Ordinary shares
- Equity components of convertible debt and other compound financial instruments
- Preference shares that are classified as equity (including both those with, and without, an entitlement to a *pro rata* share of net assets on liquidation)
- Warrants that are classified as equity
- Options over own shares that are classified as equity
- Awards under equity-settled share-based payment transactions

Options and warrants classified as equity are NCI, regardless of whether they are vested and regardless of the exercise price (e.g., whether they are 'in-the-money' or not).

IAS 32 defines an equity instrument as "any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities". *[IAS 32.11]*. This is consistent with the definition of 'equity' in the IASB's *Conceptual Framework for Financial Reporting* published in 2018. *[CF 4.63, CF 4.64]*. Hence, the reference to 'equity' in the definition of NCI refers to those 'equity instruments' of a subsidiary that are not attributable, directly or indirectly, to its parent. This also means that financial instruments that are not classified within equity in accordance with IAS 32 (e.g., total return swaps) are not included within the definition of NCI.

If a parent has an indirect ownership interest in the subsidiary, this is taken into account in computing the NCI. For example, if a parent has a 60% direct interest in Subsidiary A (which in turn owns 80% of Subsidiary B), there will be a 52% (i.e., 100% - (60% × 80%)) NCI in Subsidiary B's equity. Where Subsidiary A acquired Subsidiary B in a business combination, there will also be a 40% NCI in the goodwill arising in the consolidated financial statements. This situation is shown in Illustration 5-3 in section 5.2.1 below (note though that, in this specific Illustration, the NCI in the goodwill arising on acquisition of the Target is not simply 40% of the goodwill amount, as the Target has also issued warrants).

5.2 Initial measurement of NCI

5.2.1 Initial measurement of NCI in a business combination

IFRS 3 requires any NCI in an acquiree to be recognised, *[IFRS 3.10]*, but there are differing measurement requirements depending on the type of equity instrument.

There is a choice of two measurement methods for those components of NCI that are both present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of a liquidation (referred to here as 'qualifying NCI'). They can be measured at either:

- Option 1 *Acquisition-date fair value* (consistent with the measurement principle for other components of the business combination)

  Or

- Option 2 *The present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets*

The choice of method is to be made for each business combination on a transaction-by-transaction basis, rather than being a policy choice. This choice of measurement is discussed in Chapter 10 at section 8.

However, this choice is not available for all other components of NCI, which are required to be measured at their acquisition-date fair values, unless another measurement basis is required by IFRS accounting standards. *[IFRS 3.19]*.

Of the items listed in section 5.1 above, entities are only given a choice of either proportionate share in the recognised amounts of the acquiree's identifiable net assets or acquisition-date fair value, for ordinary shares or preference shares classified as equity that are entitled to a *pro rata* share of net assets on liquidation.

Another measurement basis (referred to as a 'market-based measure') is required by IFRS 3 for share-based payment transactions classified as equity in accordance with IFRS 2 - these are measured in accordance with the method in IFRS 2. *[IFRS 3.30, IFRS 3.B62A, IFRS 3.B62B]*. The accounting for replaced and not replaced share-based payment transactions in a business combination is discussed in Chapter 10 at sections 7.2, 8.4 and 11.2.2 and in Chapter 30 at sections 11.2 and 11.3.

The other items listed in section 5.1 above, e.g., the equity component of convertible debt or other compound financial instruments, preference shares classified as equity without an entitlement to a *pro rata* share of net assets upon liquidation, warrants and options over own shares, must be measured at acquisition-date fair value.

The initial recognition of NCI in a business combination is discussed in more detail in Chapter 10 at section 8. That chapter also addresses many of the topics discussed in this chapter as well as an indirect acquisition of NCI where the acquiree in a business combination is the owner of an NCI in an acquirer's existing subsidiary (see Chapter 10 at section 11.5).

How we see it

While IFRS 3 permits the measurement of 'qualifying NCI' (as described above) at either acquisition-date fair value (Option 1) or at the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets (Option 2), the standard is not clear on how Option 2 is to be applied where there are other elements of NCI arising in the business combination that are reported at fair value.

Sometimes, a non-wholly-owned subsidiary of the group acquires a subsidiary with NCI in a business combination. In this case, we believe that the goodwill arising will be the same as if the parent company itself acquired the subsidiary but that some of the goodwill is attributable to the NCI in the acquiring subsidiary. This is because the respective NCI have an ownership interest in the party making the acquisition that gives rise to the goodwill (and identifiable net assets of the subsidiary).

These scenarios are explained further in Illustrations 5-1 to 5-3 below.

Illustration 5-1 below is an example showing the measurement of NCI in a business combination.

Illustration 5-1: Initial measurement of NCI in a business combination (1)

Parent acquires 80% of the ordinary shares of Target for CU950,000 in cash. The total fair value of the equity instruments issued by Target is CU1,165,000 and the fair value of its identifiable net assets is CU850,000. The fair value of the 20% of the ordinary shares owned by non-controlling shareholders is CU190,000. In addition, the subsidiary has also written gross settled call options over its own shares with a fair value of CU25,000, which are considered equity instruments under IAS 32.

Option 1 - NCI at fair value

The impact of the business combination and the measurement of NCI are as follows:

		CU'000	CU'000
Dr	Fair value of identifiable net assets	850	
Dr	Goodwill (CU950,000 + CU215,000 - CU850,000)	315	
Cr	Cash		950
Cr	NCI (CU190,000 + CU25,000)		215

The NCI are measured at the fair value of all equity instruments issued by Target that are not owned by the parent (i.e., ordinary shares and gross settled call options).

Option 2 - Qualifying NCI are measured at proportionate share of identifiable net assets

The impact of the business combination and the measurement of NCI are as follows:

		CU'000	CU'000
Dr	Fair value of identifiable net assets	850	
Dr	Goodwill (CU950,000 - (80% × CU850,000) + CU25,000)	295	
Cr	Cash		950
Cr	NCI (20% × CU850,000 + CU25,000)		195

The NCI that are present ownership interests and entitle their holders to a proportionate share of the Target's net assets in the event of liquidation (i.e., the ordinary shares) are measured at the NCI's proportionate share of the identifiable net assets of Target. The NCI that are *not* present ownership interests or *do not* entitle their holders to a proportionate share of the Target's net assets in the event of liquidation (i.e., the gross settled call options) are measured at their fair value.

Reconciliation of goodwill

Goodwill as determined under the two methods can be reconciled as follows:

	CU'000
Option 2: Goodwill (CU950,000 - (80% × CU850,000) + CU25,000)	295
Goodwill related to the NCI in ordinary shares (CU190,000 - 20% × CU850,000)	20
Option 1: Goodwill (CU1,165,000 - CU850,000)	315

This makes clear that Option 2 effectively ignores the goodwill related to ordinary shares that are held by the NCI.

In Illustration 5-1 above, under Option 2, the computation of the NCI represented by the ordinary shares was based solely on the fair value of the identifiable net assets, i.e., no deduction was made in respect of the other component of NCI. IFRS 3 does not state whether this is the case. An alternative view would be that such other components of NCI are deducted from the value of the net identifiable net assets acquired based on their acquisition-date fair value (or market-based measure) or based on their liquidation rights, as demonstrated in Illustration 5-2 below. See also Chapter 10 at section 8.3.

Illustration 5-2: Initial measurement of NCI in a business combination (2)

Option 3 - Qualifying NCI are measured at proportionate share of identifiable net assets net of other components of NCI

The impact of the business combination and the measurement of NCI are as follows:

			CU'000	CU'000
Dr	Fair value of identifiable net assets		850	
Dr	Goodwill (CU950,000 - 80% × (CU850,000 - CU25,000))		290	
	Cr	Cash		950
	Cr	NCI ((20% × (CU850,000 - CU25,000)) + CU25,000)		190

The difference between goodwill of CU295,000 (Option 2 in Illustration 5-1 above) and CU290,000 is 20% of CU25,000, i.e., the amount attributable to the NCI in the call options.

In Illustration 5-1 above, Option 2 resulted in no goodwill being attributable to NCI. However, if the Target had been acquired, not by Parent, but by a 60% owned subsidiary of Parent, we believe that the goodwill recognised remains the same, but that some of the goodwill is attributable to the NCI in the acquiring subsidiary as demonstrated in Illustration 5-3 below. In such circumstances, particular care would be needed in determining the 'gross up' of the carrying amount of goodwill (for the purposes of the impairment test), in the allocation of any goodwill impairment to Parent and the NCI, and in any reallocation of goodwill between Parent and the NCI in a transaction with no loss of control. These issues are further discussed in section 4.2 above.

Illustration 5-3: Initial measurement of NCI in a business combination by a partly owned subsidiary

Assume the same facts as in Illustration 5-1 above, except that a 60% Subsidiary of Parent acquires 80% of the ordinary shares of Target for CU950,000 in cash.

Under Option 1, the impact of the business combination and the measurement of NCI in Parent's consolidated financial statements are as follows:

			CU'000	CU'000
Dr	Fair value of identifiable net assets		850	
Dr	Goodwill (CU950,000 + CU215,000 - CU850,000)		315	
	Cr	Cash		950
	Cr	NCI in Target (CU190,000 + CU25,000)		215
	Cr	NCI in 60% Subsidiary		-

Although the overall impact on the NCI in the 60% Subsidiary is nil, this is represented by:

			CU'000	CU'000
Dr	NCI share of cash consideration (40% × CU950,000)		380	
	Cr	NCI share of fair value of identifiable net assets (40% × 80% × CU850,000)		272
	Cr	NCI share of goodwill (40% × (CU315,000 - CU25,000 - CU20,000))		108

The NCI share of goodwill excludes the CU25,000 represented by the warrants and the Target NCI's interest in the goodwill of CU20,000, recognised by the 60% subsidiary. This is because these amounts are reflected directly in the NCI in Target.

Under Option 2, the impact of the business combination and the measurement of NCI in Parent's consolidated financial statements are as follows:

		CU'000	CU'000
Dr	Fair value of identifiable net assets	850	
Dr	Goodwill (CU950,000 - (80% × CU850,000) + CU25,000)	295	
Cr	Cash		950
Cr	NCI in Target (20% × CU850,000 + CU25,000)		195
Cr	NCI in 60% Subsidiary		-

Although the overall impact on the NCI in the 60% Subsidiary is nil, this is represented by:

		CU'000	CU'000
Dr	NCI share of cash consideration (40% × CU950,000)	380	
Cr	NCI share of fair value of identifiable net assets (40% × 80% × CU850,000)		272
Cr	NCI share of goodwill (40% × (CU295,000 - CU25,000))		108

5.2.2 Initial measurement of NCI in a subsidiary that is not a business combination

The initial measurement of NCI in a subsidiary that is not a business combination is discussed in sections 3.1.1 and 3.1.2 above.

5.3 Measurement of NCI where an associate holds an interest in a subsidiary of the group

Neither IFRS 10 nor IAS 28 explains how to account for NCI when the group owns an associate which has a holding in a subsidiary of the group. NCI is defined as the equity in a subsidiary not attributable, directly or indirectly to a parent. *[IFRS 10 Appendix A]*. It is unclear whether this is to be computed based on the ownership interests held by the group (i.e., by the parent and any consolidated subsidiary), or whether it also must take into account the indirect ownership of the subsidiary held by the associate.

The reciprocal interests can also give rise to a measure of double counting of profits and net assets between the investor and its associate.

How we see it

Where an associate holds an interest in a subsidiary, we believe that there are two possible approaches to determine the amount of NCI in the subsidiary:

- The NCI are determined after considering the associate's ownership of the subsidiary ('look through approach')

  Or

- The NCI are determined based on the holdings of the group in the subsidiary ('black box approach')

An entity must apply the chosen approach consistently.

In applying the 'look through approach', the parent must not recognise the share of the subsidiary's results recognised by the associate applying the equity method, in order to avoid double counting. The 'black box approach' will often lead to reporting higher consolidated net assets and results than when using the 'look through approach' as this adjustment is not made, although the amounts attributed to the owners of the parent are expected to be the same under both approaches. The two approaches are shown in Illustration 5-4 below.

Illustration 5-4: Measurement of NCI where an associate accounted using the equity method holds an interest in a subsidiary

Parent P owns directly 60% of subsidiary S. P also directly owns 40% of associate A that in turn holds a 30% interest in S. S has earned profits of CU1,000,000 in the period and has net assets of CU3,000,000 (which are consolidated in both P's consolidated financial statements and equity accounted by A) at the reporting date. A has net assets of CU1,100,000 (excluding its share of the net assets of S). There are no transactions between A and S (which was not acquired in a business combination).

Approach 1 ('look through approach')

This approach involves determining the ownership attributable to the NCI *after* considering A's ownership of S. This approach views the equity method as primarily a method of consolidation (albeit on a single line), as further discussed in Chapter 12 at section 5.1.

Therefore, under the 'look through' approach, P's total ownership interest in S is 72% (and the NCI's interest is 28%). P's effective ownership interest of 72% in S represents 60% held directly and an additional effective interest of 12% (40% × 30%) via A.

Therefore, P consolidates the profits of S of CU1,000,000, with:

Profits of S attributable to the owners of P	CU720,000 (CU1,000,000 × 72%)
Profits of S attributable to NCI	CU280,000 (CU1,000,000 × 28%)

However, when equity accounting for A, P does not recognise its share of S's results recognised by A of CU120,000 (CU1,000,000 × (40% × 30%)). This is to avoid double counting as S's results have already been consolidated and P's effective ownership of 12% of S that is indirectly held via A has been attributed to the owners of the parent.

The assets and liabilities of S are consolidated, with:

Net assets of S attributable to the owners of P	CU2,160,000 (72% × CU3,000,000)
Net assets of S attributable to NCI	CU840,000 (28% × CU3,000,000)
Investment in A	CU440,000 (Note 1)
Overall impact on P's consolidated net assets (including equity accounting)	CU3,440,000
▸ Of which, attributable to the owners of P	CU2,600,000 (CU3,440,000 - CU840,000)

Note 1 - when equity accounting for A, P does not recognise its share of S's net assets recognised by A of CU360,000 (CU3,000,000 × (40% × 30%)) to avoid double counting as the net assets of S owned by A have already been included in the amounts attributable to the owners of P. Therefore, the investment in A is reported at P's 40% share of A's net assets (excluding A's share of S), i.e., 40% × CU1,100,000.

Approach 2 ('black box approach')

Under this approach (the 'black box approach'), when determining NCI, P considers the ownership interests in S not held by the group (i.e., by P and its subsidiaries). This approach views the equity method as primarily a method of valuing an investment, as further discussed in Chapter 12 at section 5.1.

Accordingly, P's ownership interest is 60% and the NCI's ownership interest is 40%.

Therefore, P consolidates the profits of S of CU1,000,000, with:

Profits of S attributable to the owners of P	CU600,000 (60% × CU1,000,000)
Profits of S attributable to NCI	CU400,000 (40% × CU1,000,000)

The assets and liabilities of S are consolidated, with:

Net assets of S attributable to the owners of P	CU1,800,000 (60% × CU3,000,000)
Net assets of S attributable to NCI	CU1,200,000 (40% × CU3,000,000)
Investment in A	CU800,000 (Note 2)
Overall impact on P's consolidated net assets (including equity accounting)	CU3,800,000
▸ Of which, attributable to the owners of P	CU2,600,000 (CU3,800,000 - CU1,200,000)

Note 2 - when equity accounting for A, P does not eliminate its share of S's results of CU120,000 and net assets of CU360,000. Therefore, the investment in A is reported at P's 40% share of A's net assets (including the associate's share of S), i.e., 40% × (CU1,100,000 + (30% × CU3,000,000)).

The results and net assets in respect of S (including the effect of equity accounting for A's holding in S) that are attributed to the owners of P are the same as in Approach 1. However, the total consolidated results and net assets exceed those reported in Approach 1 by CU120,000 and CU360,000 respectively (being P's effective ownership interest of 12% in S's profits and net assets that are equity accounted in Approach 2). While this approach has the merit that the attribution of S's profits and net assets to NCI reflects the 40% ownership interests in S not held by the group, a downside is the double counting of 12% of S's profits and net assets that are equity accounted by A.

5.4 Measurement of NCI where a subsidiary owns shares in parent

Shares of a parent held by a subsidiary are reflected as treasury shares rather than outstanding shares in the statement of changes in equity. The same applies for the purposes of computing earnings per share (see Chapter 33 at sections 3.2 and 4.1). This is shown in the following Illustration.

Illustration 5-5: Presentation of shares in a parent held by a subsidiary in the parent's consolidated financial statements

Entity P owns 100% of subsidiary S. At the start of the period, S purchased 1 million shares in the parent for CU2m. In its individual financial statements, S records the investment at fair value through OCI which is recorded at CU3m at the end of the period.

In preparing P's consolidated financial statements, the following journals are required:

		CU m	CU m
Dr	Treasury shares (parent equity)	2	
Dr	Parent's share of OCI	1	
	Cr Investment in parent shares		3

In computing earnings per share, the 1 million treasury shares are excluded from the number of shares included in the denominator.

Where there is NCI (with a present ownership interest) in a subsidiary, the NCI has an interest in the net income of the parent by virtue of the shares of the parent that the subsidiary owns. Consequently, the subsidiary's ownership share in the profit (or loss) and OCI of the parent would be included in determining the amounts attributable to the NCI in the subsidiary. Care, however, needs to be taken to avoid any double counting when determining the NCI.

5.5 Presentation and disclosure of NCI in primary financial statements

IFRS 10 requires NCI to be presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent. *[IFRS 10.22]*. This amount is the aggregate of all NCI if there is NCI in more than one subsidiary.

The entity's profit or loss and each component of OCI are attributed to the owners of the parent and to the NCI. Attribution of total comprehensive income to the NCI continues even if it results in a deficit balance. *[IFRS 10.24, IFRS 10.B94]*. See section 2.2 above and section 5.7 below for further discussion. Deficit balances are considered further in section 5.7.1 below.

The presentation of NCI in the primary financial statements is addressed in Chapter 3 at section 3.1.5 (statement of financial position), *[IAS 1.54]*, section 3.2.2 (statement of profit or loss), *[IAS 1.81B]*, section 3.2.4 (statement of comprehensive income), *[IAS 1.81B]*, and section 3.3 (statement of changes in equity). *[IAS 1.106]*.

There are similar requirements under IFRS 18 *Presentation and Disclosure in Financial Statements*.[30] The allocation of profit or loss attributable to owners of the parent and NCI is presented in the statement of profit or loss outside the five specified categories of income and expense *[IFRS 18.76, IFRS 18.104, IFRS 18.107]*. See Chapter 4 at sections 3.4 and 3.4.3.

IFRS 12 includes further disclosures in respect of subsidiaries that have NCI that are material to the reporting entity. *[IFRS 12.10(a)(ii), IFRS 12.12]*. See Chapter 14 at section 4.2.

30 IFRS 18 *Presentation and Disclosure in Financial Statements*, which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted) was issued by the IASB in April 2024. See Chapter 4 for further details on the new concepts and requirements of IFRS 18.

5.6 Non-controlling interests classified as financial liabilities

In spite of the general requirement in IFRS 10 to treat non-controlling interests as equity, a non-controlling interest is classified by IAS 32 as a financial liability and payments to the non-controlling interest as interest expense if the group as a whole has an obligation to deliver cash or another financial asset in respect of the instrument, or to settle it in a manner that results in its classification as a financial liability. *[IAS 32.AG29]*. See Chapter 43 at section 4.8.1.

The subsidiary may have issued certain puttable instruments and instruments that impose an obligation on the entity to deliver to another party a *pro rata* share of the net assets of the entity only on liquidation. While such instruments impose a contractual obligation on the entity, they may meet the conditions to be classified as equity instruments under paragraphs 16A-16D of IAS 32 in the separate or individual financial statements of the subsidiary. *[IAS 32.16A, IAS 32.16B, IAS 32.16C, IAS 32.16D]*. See Chapter 43 at section 4.6. This exception does not extend to the classification of non-controlling interests in the consolidated financial statements of the group, where such instruments are classified as liabilities. *[IAS 32.AG29A].* This position was confirmed by the IFRS IC in November 2013.[31]

In some cases, the effect of options over what are by law non-controlling interests may be such that no NCI is recognised in the financial statements, particularly when such options are issued as part of a business combination (see section 6 below).

How we see it

In our view, where NCI is classified as equity in consolidated financial statements, it is subject to all the requirements of IAS 32 relating to own equity. For example, put or call options over NCI accounted for as equity should be accounted for in consolidated financial statements as contracts over own equity instruments under IAS 32 (see Chapter 43 at section 11). These requirements do not apply where the non-controlling interests are classified as financial liabilities, or the effect of options means that there is no NCI recognised in the financial statements.

5.7 Subsequent measurement of NCI

Extract from IFRS 10

Non-controlling interests

B94 An entity shall attribute the profit or loss and each component of other comprehensive income to the owners of the parent and to the non-controlling interests. The entity shall also attribute total comprehensive income to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance.

B95 If a subsidiary has outstanding cumulative preference shares that are classified as equity and are held by non-controlling interests, the entity shall compute its share of profit or loss after adjusting for the dividends on such shares, whether or not such dividends have been declared.

A proportion of profit or loss, OCI and changes in equity is only attributed to those instruments included within NCI if they give rise to an existing ownership interest. NCI that are potential voting rights and other derivatives that require exercise or conversion (such as options, warrants, or share-based payment transactions) generally do not receive an allocation of profit or loss, OCI and changes in equity. *[IFRS 10.21, IFRS 10.24, IFRS 10.B89, IFRS 10.B94]*. However, as discussed in section 2.2 above, allocating the proportions of profit or loss, OCI and changes in equity based on present legal ownership interests is not always appropriate. An entity also considers the eventual exercise of potential rights and other derivatives if, in substance, they provide an existing ownership interest that currently gives it access to the returns associated with that ownership interest. In that case, the proportion allocated to the parent and NCI takes into account the eventual exercise of those potential voting rights and other derivatives. *[IFRS 10.21, IFRS 10.B90]*. As noted in section 2.2 above, this chapter uses the term 'present ownership interest' to include existing legal ownership interests, together with potential voting rights and other derivatives that, in substance, already provide existing ownership interests in a subsidiary.

31 *IFRIC Update*, November 2013, available on the IFRS Foundation's website.

If a subsidiary has outstanding cumulative preference shares classified as equity that are held by NCI, the parent is required to compute its share of profits or losses after adjusting for the dividends on these shares, whether or not such dividends have been declared. *[IFRS 10.24, IFRS 10.B95]*. This effectively means that the NCI represented by the cumulative preference shares are being allocated a portion of the profit or loss equivalent to the dividends. This accounting treatment is shown in Illustration 5-6 below.

Illustration 5-6: Attribution to NCI where subsidiary has outstanding cumulative preference shares classified as equity

Entity X's ordinary shares are owned by its founders, Entity A (which has a controlling 70% ownership interest) and Entity B (which has 30% ownership interest). X also issued CU400,000 preference shares to Entity C which entitle holders to receive a 5% cumulative preferred dividend. However, as the payment of the fixed rate dividend is at the issuer's discretion and there is no maturity date or holder redemption right, the preference shares are classified as equity. On liquidation, the preference shares are entitled to repayment at par and cumulative unpaid dividends (whether or not declared). X is not a limited life entity.

The profits (losses) of X are CU60,000 (in Year 1), CU(10,000) (in Year 2) and CU30,000 (in Year 3).

Because C is entitled to a 5% cumulative dividend on CU400,000 shares, i.e., CU20,000 per year, the profit of X attributable to the NCI in A's consolidated financial statements is as follows:

	Year 1	Year 2	Year 3
	CU'000	CU'000	CU'000
Profit (loss) of X	60	(10)	30
Less amounts attributable to the NCI in preference shares held by C (1)	20	20	20
Profit (loss) attributable to ordinary shareholders	40	(30)	10
Owners of parent (70%)	28	(21)	7
NCI (30%) (2)	12	(9)	3
Total NCI ((1)+(2)) (in ordinary shares and preference shares)	**32**	**11**	**23**

Although X incurred a net loss in Year 2, the NCI attributable to the preference shares would be attributed income associated with its stated dividend for that year. The NCI presented in the statement of profit and loss and other comprehensive income and in the statement of changes in equity will be the sum of the NCI for the ordinary and preference shares, i.e., CU32,000, CU11,000 and CU23,000 in Years 1 to 3 respectively.

In some cases, an entity may have a complex equity structure with several classes of equity shares or other contractual arrangements specifying different entitlements to net profits, equity or liquidation preferences. In such cases, the parent needs to assess carefully the rights attaching to each class of equity share or the effect of the contractual arrangements in determining whether and, if so, how these impact the appropriate attribution of profit or loss. The assessment will be very dependent on the particular facts and circumstances.

Illustration 5-7 below presents an example of a situation where the arrangements specify different contractual entitlements to net profits and final distribution of net assets to the proportionate ownership interests of the equity shares.

Illustration 5-7: Allocation of NCI where contractual entitlements to net profits and net assets differ from the proportionate ownership interests

Entity X and Entity Y set up Subsidiary Z, to undertake a real estate development for subsequent sale. The share capital of Z is owned 70% by X (which has been determined to control Z) and 30% by Y (which is the NCI) with X investing CU7 million and Y investing CU3 million.

Under the shareholder's agreement between X and Y:

- No dividends will be distributed until the exit date, i.e., on disposal of the developed property, which is expected to occur in 3 years.
- There is a contractual waterfall for the final distribution of Z's net assets which will vary depending on the final profit achieved:
  - The first CU1 million of profit is allocated only to Y.
  - The next CU0.5 million of profit is allocated 50:50 to X and Y.
  - Any profit in excess of CU1.5 million is allocated 70:30 to X and Y.
  - Losses will be allocated 70:30 to X and Y, in accordance with their proportionate shareholdings.

The asymmetric allocation of profits reflected the fact that Y, a passive investor, demanded a higher return for its funding, given the riskiness of the venture. The allocations are consistent with the entitlements of X and Y on liquidation of Z.

At the end of the reporting period, the profit is CU0.9 million. However, the final cumulative profit in Year 3, based on the approved business plan, is forecast to be CU4 million.

How should the NCI be determined for reporting periods prior to the exit date?

How we see it

IFRS 10 does not specifically address how to attribute profits to the NCI where the entitlements under the contractual arrangement differ to the proportionate ownership interests. Judgement is, therefore, required, based on the particular facts and circumstances. In our view, an appropriate method in this case could be determination of the NCI in line with its entitlement, based on the cumulative profit achieved at each reporting date, applying the contractual waterfall rules. Where material, it is important that the basis of allocation and the judgements involved are disclosed.

The initial balance of the NCI is CU3 million. However, the profit from Z will not be allocated to the parent until there is a cumulative profit exceeding CU1 million. Accordingly, the NCI at the end of the reporting period is CU3.9 million (i.e., CU3m+CU0.9m). This is consistent with the fact that X, the parent, would not receive distribution of profit from Z if it was liquidated at the end of the reporting period.

This conclusion could be analogised to IFRS 10.B95 which explains that if a subsidiary has outstanding cumulative preference shares that are classified as equity and are held by NCI, the entity computes its share of profit or loss after adjusting for the dividends on such shares, whether or not such profits have been declared. *[IFRS 10.24, IFRS 10.B95].*

Where a gain or loss is recognised by a non-wholly-owned subsidiary in an upstream transaction with its parent, the gain or loss is eliminated on consolidation. Therefore, the profit or loss allocated to NCI excludes the NCI's share of that eliminated gain or loss (see section 2.4.1 above).

Where a subsidiary has granted options over its own shares under an equity-settled share-based payment transaction, the share-based payment expense recognised in profit or loss will be attributable to the parent and any other NCI that has a present ownership in the subsidiary. None of the expense is attributed to the NCI represented by the options under the share-based payment transaction. The corresponding entry taken to equity by the subsidiary in respect of the options under the share-based payment transaction will be recognised as NCI in the consolidated financial statements, as shown in Illustration 5-8 below.

Illustration 5-8: Share-based payment over a subsidiary's shares

On 1.1.20X0, Entity X, a wholly-owned subsidiary with 900 shares in issue, grants share options over 200 shares to its employees with a grant-date fair value of CU300 which vest at the end of 2 years' service. The aggregate exercise price (if all options were exercised) is CU50.

At the end of 20X1, 50% of the employees exercise their options over 100 shares. Therefore, the parent P's ownership interest in X falls to 90%. Prior to the exercise of the awards, the net assets of X are CU975.

At the end of 20X2, the remaining share options lapse unexercised.

In P's consolidated financial statements, the following entries are reflected:

			CU	CU
	20X0			
Dr	Share-based payment expense (P&L)		150	
	Cr	NCI in share options		150
	20X1			
Dr	Share-based payment expense (P&L)		150	
	Cr	NCI in share options		150

Note that, as X is a wholly-owned subsidiary, the share-based payment expense is allocated to P as the holders of the share option awards do not have a present ownership in X's shares. If the shares in X were instead partly owned (e.g., owned 80% by the parent), the share-based payment expense would be allocated to the parent (80%) and the NCI (20%) in accordance with their present ownership.

However, the grant of the share option awards gives rise to an NCI in X's equity, so NCI is increased by the full amount of the credit entry in the statement of changes in equity and equals CU300 at the end of 20X1 (immediately prior to the exercise of the share option awards).

At the end of 20X1, 50% of the awards are exercised and X issues 100 shares to employees for CU25 cash. The employees now own 10% of X's shares and X has net assets of CU1,000. The exercise of the awards is reflected as follows:

			CU	CU
Dr	Cash		25	
Dr	NCI in share options exercised (50% x CU300)		150	
	Cr	NCI in shares (10% x CU(975 + 25)) ('ordinary NCI')		100
	Cr	Parent equity		75

In 20X2, X makes profits of CU200 which are allocated between owners of the parent (90%) and ordinary NCI (10%). The remaining share options lapse unexercised and therefore the remaining NCI of 150 in the share options is derecognised against parent equity (e.g., retained earnings). Consequently, there only remains ordinary NCI in X's shares.

The ordinary NCI will be allocated a 10% share of X's profit or loss and OCI. Closing NCI represents 10% of X's net assets of CU1,200.

These accounting entries would be reflected in the Statement of Changes in Equity as follows:

	Parent equity	NCI	Total equity
	CU	CU	CU
At 1.1.20X0			
Profit for year	(150)		(150)
Share-based payment of subsidiary		150	150
At 31.12.20X0	**(150)**	**150**	**-**
Profit for year	(150)		(150)
Share-based payment of subsidiary		150	150
Exercise of share options in subsidiary	75	(50)	25
At 31.12.20X1	**(225)**	**250**	**25**
Profit for the year	180	20	200
Lapse of share awards	150	(150)	-
At 31.12.20X2	**105**	**120**	**225**

Ordinary share dividends paid to NCI proportionate to the NCI's shareholding are changes in equity allocated to the NCI. Accordingly, an ordinary share dividend paid to NCI reduces cash (or other net assets) and the carrying amount of NCI in the consolidated financial statements.

When the proportion of equity held by the NCI changes (and the parent retains control of the subsidiary), the carrying amount originally recognised in NCI is adjusted to reflect the change in the relative interests in the subsidiary. *[IFRS 10.24, IFRS 10.B96]*. This situation might arise, for example, if a potential voting right like a share option is exercised into ordinary shares of the subsidiary carrying a proportionate right to dividends. Accordingly, the carrying amount of the NCI, if any, relating to the potential voting right now exercised is derecognised but, in its place, NCI representing the proportionate interest in the underlying shares now held is recognised. The difference between the consideration received by the parent on exercise of the option, and the adjustment to the carrying amount of NCI is recognised in parent equity.

How we see it

In our view, the requirements in IFRS 10 mean that if potential voting rights lapse unexercised, the amount originally recognised in NCI, if any, is reversed to parent equity, so that the carrying amounts of the controlling and NCI reflect the relative interests in the subsidiary. Otherwise, amounts previously recognised related to lapsed potential voting rights would remain recognised as part of the NCI until the next remeasurement of NCI occurs, which may be an unrelated transaction, or which may never occur.

5.7.1 Loss-making subsidiaries

Total comprehensive income is attributed "to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance." *[IFRS 10.24, IFRS 10.B94]*. This approach is consistent with the fact that the controlling interest and the NCI participate proportionately in the risks and rewards of an investment in the subsidiary. The IASB observed that "although it is true that non-controlling interests have no further obligation to contribute assets to the entity, neither does the parent." *[IFRS 10.BCZ165]*.

Guarantees or other support arrangements by the parent often protect the NCI from losses of the subsidiary in excess of their equity. The IASB believes that the parent ought to account for such arrangements separately, and that the accounting for these arrangements should not affect how an entity should attribute comprehensive income to the parent and the NCI. *[IFRS 10.BCZ162]*.

6 Call and put options over NCI

Some business combinations involve options over some or all of the outstanding shares. For example, the acquirer might have a call option, i.e., a right to acquire the outstanding shares at a future date for a particular price. Alternatively, the acquirer might have granted a put option to the other shareholders whereby they have the right to sell their shares to the acquirer at a future date for a particular price. In some cases, there may be a combination of such call and put options, the terms of which may be equivalent or may be different.

How we see it

IFRS 3 gives no guidance as to how to account for a combination of call and put options over NCI in a business combination. Therefore, when determining the appropriate accounting in the consolidated financial statements in such situations, IFRS 10, IAS 32, and IFRS 9 need to be considered. The accounting for call and put options depends on whether or not the acquirer has obtained present access to returns associated with the ownership interest in the shares of the acquiree subject to the call and/or put option.

Potential voting rights that represent a present ownership interest are discussed in general in sections 2.2 and 5.7 above but specific considerations for call and/or put options are discussed in sections 6.1 and 6.2.2 below.

While the discussion below deals with options, similar considerations to those discussed in sections 6.1 and 6.2 below apply where the acquirer entered into a forward purchase contract for the shares held by the other shareholders (see section 6.3 below).

Although the discussion in sections 6.1 to 6.3 below focuses on call and put options entered into at the same time as control of the subsidiary is gained, an entity may enter into the options with non-controlling shareholders after gaining control. This situation is discussed in section 6.4 below, although the appropriate accounting in the consolidated financial statements will still be based on the discussions in sections 6.1 to 6.3 below.

How we see it

Sometimes, the operation of put and/or call options over NCI are subject to employment conditions. Typically, such put and/or call options over NCI arise as part of a business combination. The guidance in sections 6.1 to 6.5 below is intended to apply to put and/or call options over NCI held in the holder's capacity as a shareholder.

Accounting for put and/or call options over NCI subject to employment conditions (holders of such instruments are referred to below as 'employee-shareholders') involves a careful analysis of how the requirements of the relevant IFRS accounting standards apply to the specific transaction. Such arrangements could, in whole or in part, constitute an employee benefit (accounted under IAS 19 *Employee Benefits* - see Chapter 31 at sections 12 and 13) or share-based payment arrangement (accounted under IFRS 2 - see Chapter 30).

Judgement is often required in determining whether and to what extent there is a remuneration element to be accounted for and whether the company or the NCI have a present ownership interest in the shares that are legally owned by the NCI.

Examples of situations which might indicate a remuneration element include where:

- There is a discount on the NCI put exercise price if the employee-shareholder leaves before completing a specified period of service
- The entity can exercise a call at a lower exercise price than the exercise price on the NCI put if the employee-shareholder leaves

In certain arrangements, an employee-shareholder is entitled to a minimum amount even if no service was provided and it might be appropriate to account for part of the arrangement in line with the guidance for NCI puts and calls (in sections 6.1 to 6.4 below), and part as an employee benefit or share-based payment arrangement. See Chapter 30 at sections 2.2 and 2.2.4, and Chapter 31 at section 2.2 for a discussion of when cash-settled awards may fall within the scope of IAS 19 or IFRS 2.

Even if the NCI put held by employee-shareholders has an exercise price equal to fair value of the shares at the date of exercise, this does not necessarily mean that the NCI has a present ownership interest in the shares legally owned at the date of the business combination. For example, it might be the case that the NCI are able to benefit from dividends and/or fair value gains accreting to the shares only after completion of a period of service. In such cases, it might be considered that the shares have not economically vested in the NCI at the date of the business combination. This assessment will be very dependent on the particular facts and circumstances.

6.1 Call options only

Call options are considered when determining whether the entity has obtained control, as discussed in Chapter 7 at section 4.3.4. Where it is determined that an entity has control over another entity, the proportions of profit or loss, OCI and changes in equity allocated to the parent and NCI are based on present ownership interests, and generally do not reflect the possible exercise or conversion of potential voting rights under call options. *[IFRS 10.21, IFRS 10.24, IFRS 10.B89, IFRS 10.B94]*. The eventual exercise of potential voting rights under the call option is reflected in the proportion of profit or loss, OCI and changes in equity only if in substance the entity already has access to the returns associated with that ownership interest. *[IFRS 10.21, IFRS 10.24, IFRS 10.B90, IFRS 10.B94]*. This assessment depends on the terms of the call option, and judgement is required.

6.1.1 Options giving the acquirer present access to returns associated with that ownership interest

A call option is likely to give the acquirer present access to returns associated with the ownership interest in the shares subject to the call in limited circumstances, for example:

- When the option price is fixed with an exercise price sufficiently low in relation to the fair value of the underlying shares (that substantially all expected variations in the fair value of the underlying shares will be realised by the acquirer) and either (i) it is agreed between the parties that no dividends will be paid to the other shareholders (or the acquiring entity can control that no dividends will be paid prior to the exercise of the option) or (ii) the dividend payments lead to an adjustment of the option exercise price

  Or

- When the terms are set such that the other shareholders effectively receive only a lender's return

This is because any accretion in the fair value of the underlying ownership interest under the option (for example, due to improved financial performance of the acquiree subsequent to the granting of the call option) is likely to be realised by the acquirer.

How we see it

If a call option gives the acquiring entity present access to returns over all of the shares held by non-controlling shareholders (see discussion above), then there will be no NCI presented in equity. The acquirer accounts for the business combination as though it acquired a 100% interest. The acquirer also recognises a financial liability for the present value of the exercise price to be paid to the non-controlling shareholders under the call option.

Changes in the carrying amount of the financial liability are recognised in profit or loss, in accordance with IFRS 9. If the call option expires unexercised, then the entity has effectively disposed of a partial interest in its subsidiary in return for the amount recognised as the 'liability' at the date of expiry. Where the entity continues to control the subsidiary, it accounts for the transaction as a change in ownership interest without a loss of control, as discussed in section 4 above. Where the lapse of the call option leads to a loss of control, this is accounted for as discussed in sections 3.2 to 3.5 above.

6.1.2 Options not giving the acquirer present access to returns associated with that ownership interest

A call option is not expected to give the acquirer present access to the returns associated with the ownership interest in the shares subject to the call where, for example, the option's terms contain one or more of the following features:

- The option exercise price has not yet been determined or will be the fair value (or an amount that approximates fair value) of the underlying shares at the date of exercise
- The option exercise price is not sufficiently low in relation to the fair value of the underlying shares (that substantially all expected variations in the fair value of the underlying shares will be realised by the acquirer)
- The option exercise price is based on expected future results or net assets of the subsidiary at the date of exercise
- It has been agreed between the parties that, prior to the exercise of the option, all retained profits are to be freely distributed to the existing shareholders according to their current shareholdings (and there is no adjustment to the option exercise price for dividends paid)

If a call option does not give the acquirer present access to the returns associated with the ownership interest in the shares subject to the call, IFRS 10 requires that the instruments containing the potential voting rights be accounted for in accordance with IFRS 9. *[IFRS 10.21, IFRS 10.B91]*. Derivatives on an interest in a subsidiary are accounted for as financial instruments unless the derivative meets the definition of an equity instrument of the entity in IAS 32. *[IFRS 9.2.1(a)]*.

How we see it

The accounting for the call option over NCI by the parent in its consolidated financial statements depends on whether the call option meets the definition of a financial asset or an equity instrument.

Where settlement is not exclusively by an exchange of a fixed number of shares for a fixed amount of cash (or another financial asset), the purchased call option does not meet the definition of an equity instrument in IAS 32 and is treated as a derivative financial asset. *[IAS 32.11(d), IAS 32.26, IAS 32.27, IFRS 9 Appendix A]*. Therefore, the classification will be a financial asset, unless both the fixed-for-fixed criterion is met and the option is gross-settled in the subsidiary's equity instruments. The classification of purchased call options is discussed further in Chapter 43 at sections 5, 5.2.8, 11 and 11.2.1.

Financial asset - A purchased call option is initially recognised as a financial asset at its fair value, with any subsequent changes in its fair value recognised in profit or loss. If the call option is exercised, the fair value of the option at that date is included as part of the consideration paid for the acquisition of the NCI (see section 4 above). If it lapses unexercised, any carrying amount is expensed in profit or loss.

Equity instrument - A purchased call option is accounted for in a similar way to a call option over an entity's own equity shares, as discussed in Chapter 43 at section 11.2.1. This is because it is an option over the NCI in the consolidated financial statements, and IFRS 10 regards the NCI as 'equity' in those financial statements. Because such a call option over the NCI's shares will be gross settled, the initial fair value of the option is recognised as a debit to equity (and is not subsequently remeasured). If the call option is exercised, this initial fair value is included as part of the consideration paid for the acquisition of the NCI (see section 4 above). If a call option lapses unexercised, there is no entry required within equity.

The above discussion addresses the initial debit entry on recognising the call option at fair value (as a financial asset, or within equity). However, the related initial credit entry will depend on the transactions giving rise to the call option. For example, the entity may have paid consideration for the option in a separate transaction or as part of a larger transaction (such as where a business combination involves an outright purchase of shares as well as the acquisition of a call option over the remaining shares). In the latter case, part of the consideration paid in the larger transaction needs to be allocated to the acquisition of the call option.

6.2 Put options only

Under current IFRS accounting standards, it is not clear how to account for put options that are granted to holders of NCI ('NCI puts') at the date of acquiring control of a subsidiary (or, indeed, after gaining control). There is a lack of explicit guidance in IFRS accounting standards and potential contradictions between the requirements of IFRS 10 (in respect of accounting for NCI and changes in ownership without loss of control - see sections 4 and 5 above) and IAS 32 (see section 6.2.1 below).

How we see it

The accounting for put options over NCI has been the subject of much debate over the years. It is clear that, under current IFRS accounting standards, the NCI put itself gives rise to a liability representing the present value of the exercise price (see section 6.2.1 below for a discussion of the measurement of this liability). However, there are a number of decisions that must be made in order to account for the arrangements, including:

- Whether or not the terms of the NCI put mean that it gives the parent a present ownership interest in the underlying securities (see section 6.2.2 below)
- Where the parent does not have a present ownership interest, whether or not an NCI continues to be recognised, i.e., does the parent recognise both the NCI and the financial liability for the NCI put (see section 6.2.3 below)

In the latter case, there are a number of additional decisions that must be made, in particular the basis on which the NCI is recognised.

Although the IFRS IC unequivocally confirmed as early as 2006 that an NCI put with an exercise price to be settled in cash is itself a financial liability,[32] the nature of the financial liability remains controversial and has been discussed by the IFRS IC and the IASB on a number of occasions.

The previous deliberations have been in the context of an NCI put that is required to be settled in cash. The IFRS IC has also considered a request in 2016 regarding how an entity accounts for an NCI put in its consolidated financial statements where the NCI put has a strike price that will be settled by delivery of a variable number of the parent's own equity instruments. Specifically, the IFRS IC was asked to consider whether, in its consolidated financial statements, the parent recognises:

(a) A financial liability representing the present value of the option's strike price - in other words, a gross liability

Or

(b) A derivative financial liability presented on a net basis measured at fair value.

The IFRS IC was also asked whether the parent applies the same accounting in its consolidated financial statements for NCI puts for which the parent has the choice to settle the exercise price either in cash or by way of delivery of a variable number of its own equity instruments to the same value.

However, on the basis of its previous discussions and the IASB's Financial Instruments with Characteristics of Equity (FICE) project (see section 7.3 below), the IFRS IC decided in November 2016 not to add this issue to its agenda.[33]

How we see it

Given that the IFRS IC did not conclude on this matter, in our view, both approaches to accounting for an NCI put - for which the parent must or has the choice to settle the exercise price by way of delivery of a variable number of its own equity shares - are acceptable. Therefore, the parent is permitted to measure the financial liability at the present value of the option's strike price or as a derivative financial liability measured at its fair value.

In June 2018, the IASB issued a DP, *Financial instruments with Characteristics of Equity*[34] which further considered the accounting for NCI puts and in November 2023 issued an Exposure Draft *Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1*.[35] At the time of writing, the IASB is considering stakeholder feedback on the proposals, and is expected to issue final amendments during 2026.[36] The Exposure Draft is discussed further in section 7.3 below.

Like the previous deliberations of the IFRS IC and the IASB, the discussion that follows relates to NCI puts that are required to be settled in cash.

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32 *IFRIC Update*, November 2006, available on the IFRS Foundation's website.

33 *IFRIC Update*, November 2016, available on the IFRS Foundation's website.

34 Discussion Paper DP/2018/1, *Financial Instruments with Characteristics of Equity*, IASB, June 2018. Available on the IFRS Foundation's website.

35 Exposure Draft (IASB/ED/2023/5) *Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1*, IASB, November 2023. Available on the IFRS Foundation's website.

36 IFRS Foundation work plan and IFRS - Financial Instruments with Characteristics of Equity project page (accessed 26 September 2024), available on the IFRS Foundation's website.

6.2.1 The financial liability for the NCI put

Extract from IAS 32

23 With the exception of the circumstances described in paragraphs 16A and 16B or paragraphs 16C and 16D, a contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount (for example, for the present value of the forward repurchase price, option exercise price or other redemption amount). This is the case even if the contract itself is an equity instrument. One example is an entity's obligation under a forward contract to purchase its own equity instruments for cash. The financial liability is recognised initially at the present value of the redemption amount, and is reclassified from equity. Subsequently, the financial liability is measured in accordance with IFRS 9. If the contract expires without delivery, the carrying amount of the financial liability is reclassified to equity. An entity's contractual obligation to purchase its own equity instruments gives rise to a financial liability for the present value of the redemption amount even if the obligation to purchase is conditional on the counterparty exercising a right to redeem (eg a written put option that gives the counterparty the right to sell an entity's own equity instruments to the entity for a fixed price).

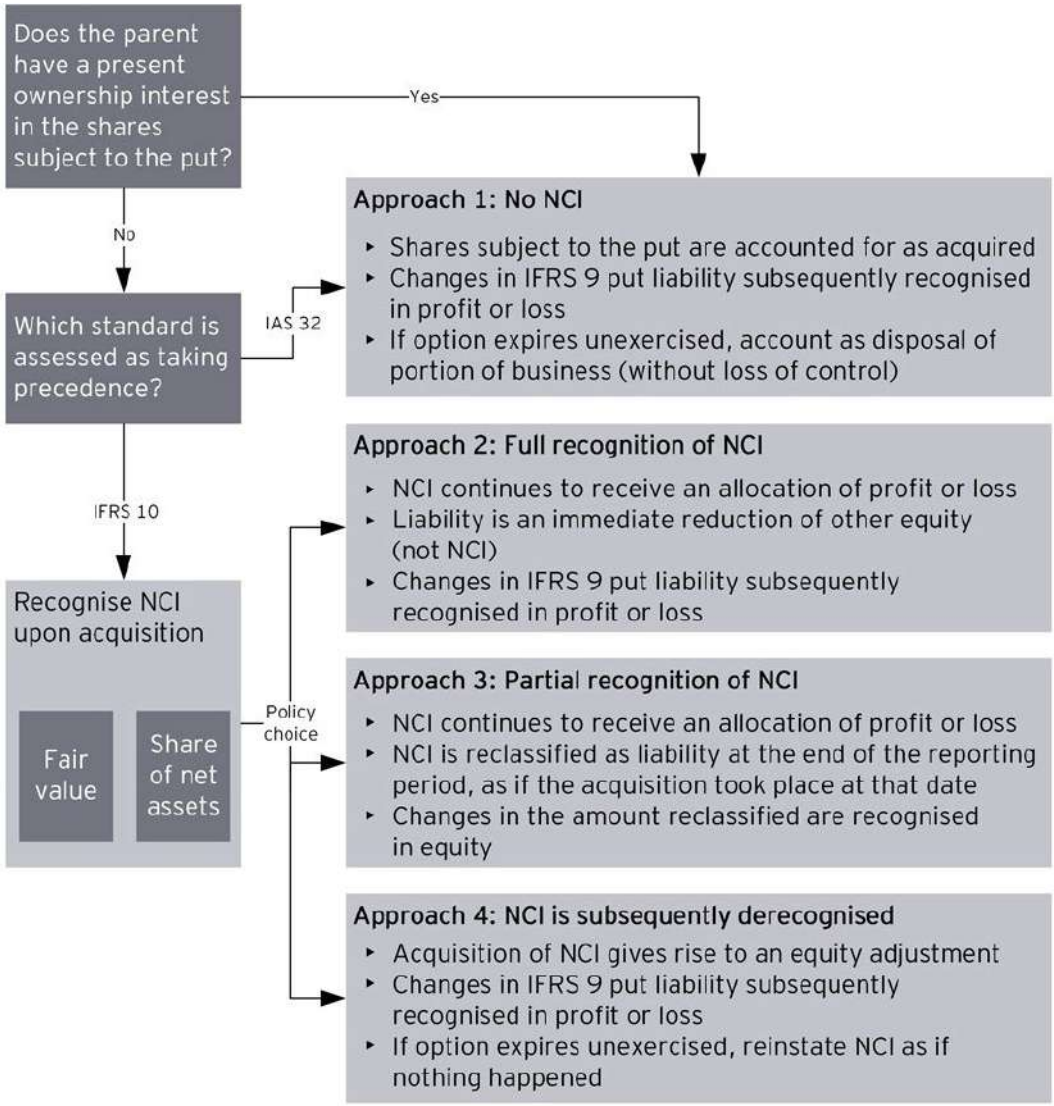
As indicated in section 5.1 above, IFRS 10 regards the NCI as 'equity' in the consolidated financial statements. Therefore, in applying IAS 32.23, any contractual obligation to purchase NCI - such as an NCI put - gives rise to a financial liability measured at the present value of the redemption amount which is subsequently measured in accordance with IFRS 9 (see Chapter 43 at section 5.3 and section 11.3.2). *[IAS 32.23]*.

IAS 32 offers no guidance as to how the financial liability is measured if the number of shares to be purchased and/or the date of purchase are not known.

How we see it

In our view, in measuring the NCI put liability it would be consistent with the requirement of IFRS 13 that liabilities with a demand feature such as a demand bank deposit have to be measured at not less than the amount payable on demand, to adopt a 'worst case' approach (see Chapter 15 at section 10.5). In other words, it should be assumed that the purchase will take place on the earliest possible date for the maximum number of shares. This is also consistent with IAS 32's emphasis, in the general discussion of the differences between liabilities and equity instruments, on a liability arising except to the extent that an entity has an 'unconditional' right to avoid delivering cash or other financial assets. See also Chapter 43 at section 5.3.

Figure 6-1: Decision tree for accounting for NCI puts



The diagram above (and explanations about the different approaches given in sections 6.2.3.A to 6.2.3.D below) indicate that, under Approaches 1, 2 and 4, changes in the IFRS 9 financial liability subsequent to initial recognition are recognised in profit or loss. This would be the case regardless of whether the financial liability is subsequently remeasured at amortised cost or at fair value through profit or loss under IFRS 9. However, if the financial liability is designated at fair value under IFRS 9, the fair value changes attributable to changes in own credit risk are normally recognised in OCI (see Chapter 46 at section 2.4).

How we see it

Under all approaches, a financial liability representing the present value of the exercise price is recognised for an NCI put settled in cash. The accounting for the remaining aspects of the NCI put depends in part upon an assessment of the terms of the transaction and, in some areas, involves a choice of accounting policy which, once selected, must be applied consistently.

Figure 6-1 above summarises the analysis that we believe needs to be performed, the questions to be addressed and the approaches to be applied.

6.2.2 The NCI put provides a present ownership interest

How we see it

In our view, in the same way as for call options, an entity has to consider whether the terms of the transaction give it present access to the returns associated with the ownership interest in the shares subject to the NCI put.

Factors to consider in determining whether the NCI put might provide a present ownership interest to the acquirer include:

- *Pricing* - to the extent that the price is fixed or determinable, rather than being at fair value (or an amount that approximates fair value) of the underlying share - so that substantially all the variations in fair value of the underlying share accrete to the acquirer. However, in situations where there is only an NCI put, the level of the exercise price needs to be sufficiently high compared to the fair value of the underlying shares to exceed likely fair value variations in order to provide a present ownership interest. If the exercise price is low compared to fair value of the underlying shares, it is unlikely that the NCI will exercise the put. Even if the exercise price exceeds fair value of the underlying shares at the outset, reasonably possible upward fair value movements might mean that the NCI put does not provide a present ownership interest to the acquirer.
- *Voting rights and decision-making* - to the extent that the voting rights or decision-making connected to the shares concerned are restricted.
- *Dividend rights* - to the extent that the dividend rights attached to the shares concerned are restricted. It is likely that the NCI retains a present ownership interest where it has been agreed between the parties that, prior to the exercise of the option, all retained profits are to be freely distributed to the existing shareholders according to their current shareholdings (and there is no adjustment to the option exercise price for dividends paid). However, in many cases, dividend rights do not affect the assessment as the parent (through its control) can generally prevent distributions to the NCI prior to exercise or the exercise price of the NCI put is adjusted downwards for payment of any dividends to the NCI.
- *Issue of call options* - a combination of NCI puts and calls, with the same period of exercise and same or similar pricing indicates that the arrangement is in the nature of a forward contract. This feature means that the instrument is highly likely to be exercised by one of the counterparties in situations where the exercise price is not at fair value (or an amount that approximates fair value) of the underlying shares. See section 6.3 below.

The parent will generally have obtained a present ownership interest if there is an NCI put and call with matching terms and a fixed exercise price (or a fixed price forward contract to purchase the entity's shares held by the NCI). Where the pricing of the NCI put and call is at fair value (or an amount that approximates fair value), the present ownership will generally remain with the NCI. Other situations, including where the exercise price is based on a formula, are likely to require further analysis, based on the factors outlined above.

If it is concluded that the acquirer has a present ownership interest in the shares concerned, it is accounted for as an acquisition of those underlying shares, and no NCI is recognised. The accounting is described in section 6.2.3.A below.

6.2.3 The NCI put does not provide a present ownership interest

How we see it

When the terms of the transaction do not provide the parent with a present ownership interest of the shares subject to an NCI put, there are four approaches that can be taken. Key policy decisions that management must make in order to conclude an accounting approach, are:

- Due to the potential contradictions between IAS 32 and IFRS 10, which standard takes precedence?
- If an NCI is recognised on initial acquisition, whether or not it continues to be recognised?

If the entity chooses to base its accounting policy on IAS 32, i.e., IAS 32 takes precedence, then it will only recognise a financial liability for the NCI put and not recognise an NCI. The approach is described in section 6.2.3.A below.

If the accounting policy choice is that IFRS 10 takes precedence, the entity will initially recognise both the NCI and the financial liability under the NCI put.

It initially measures any 'qualifying NCI' (i.e., those components of NCI that are both present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of a liquidation), either at fair value or at the proportionate share of net assets, with this choice available for each transaction (as discussed in section 5.2.1 above). *[IFRS 3.19]*. There is then a further accounting policy choice as to whether the NCI that was initially recognised continues to be recognised (as described in sections 6.2.3.B to 6.2.3.D below).

6.2.3.A NCI is not recognised - financial liability recognised (Approach 1)

Approach 1 must be used when the entity has a present ownership interest in the shares concerned (see section 6.2.2 above).

Approach 1 could be used when the entity does not have a present ownership interest but concludes that IAS 32 takes precedence over IFRS 10. By recognising a liability for the put option over the shares held by the NCI, no NCI is recognised. The business combination is accounted for on the basis that the underlying shares subject to the NCI put have been acquired. Thus, if the acquirer has granted a put option over all of the remaining shares, the business combination is accounted for as if the acquirer has obtained a 100% interest in the acquiree. No NCI is recognised when the acquirer completes the purchase price allocation and determines the amount of goodwill to recognise. The consideration transferred for the business combination includes the present value of the amount payable upon exercise of the NCI put to the non-controlling shareholders.

Approach 1 is based on the requirements and guidance within IAS 32.

IAS 32 requires the NCI put to be recognised as a liability, as discussed in section 6.2.1 above. *[IAS 32.23]*. IAS 32 explains that when a subsidiary issues a financial instrument and a parent or other entity in the group agrees additional terms directly with the holders of the instrument (e.g., a guarantee), it could be the case that the group does not have discretion over distributions or redemption. Even though the subsidiary appropriately classifies the instrument without regard to these additional terms in its financial statements, their effect is taken into account in the consolidated financial statements. To the extent that there is such an obligation or settlement provision, the instrument (or the component of it that is subject to the obligation) is classified as a financial liability in the consolidated financial statements. *[IAS 32.AG29]*. The implication is that the underlying financial instruments (i.e., the shares in the subsidiary) are represented by the financial liability. Accordingly, since the shares held by those non-controlling shareholders are not treated as equity interests in the consolidated financial statements, there is no NCI to be accounted for under IFRS 10. This means that the profit or loss (and changes in OCI) with respect to the subsidiary are allocated to the owners of the parent and not to the NCI, as there is none.

Under this approach, any dividends paid to the other shareholders are recognised as an expense in the consolidated financial statements, except where they represent a repayment of the liability (e.g., where the exercise price is adjusted by the dividends paid).

The NCI put is accounted for as a financial liability under IFRS 9. *[IAS 32.23, IFRS 9.4.2.1, IFRS 9.4.2.2]*. Changes in the carrying amount of the financial liability are recognised in profit or loss.

If the NCI put is exercised, the financial liability is extinguished by the payment of the exercise price.

If the NCI put is not exercised, then the entity has effectively disposed of a partial interest in its subsidiary, without loss of control, in return for the amount recognised as the financial liability at the date of expiry. The entity accounts for the transaction as discussed in section 4 above. The consideration received is the amount of the financial liability extinguished and any difference between this and the carrying amount of the NCI (as of the date that the NCI put expires) is recognised within equity attributable to the owners of the parent (i.e., parent equity).

6.2.3.B Full recognition of NCI (Approach 2)

Approach 2 is one of the alternatives that could be used when the entity does not have a present ownership interest in the shares concerned and concludes that IFRS 10 takes precedence. The acquirer initially recognises the NCI, either at fair value or at the proportionate share of the acquiree's net assets. *[IFRS 3.19]*.

Approach 2 takes the view that the NCI continues to be recognised within equity until the NCI put is exercised. The carrying amount of the NCI changes due to allocations of profit or loss, allocations of changes in OCI and dividends made for the reporting period (see section 5.7 above).

The financial liability for the NCI put is recognised at the present value of the amount payable upon exercise of the NCI put and is subsequently accounted for under IFRS 9 like any other written put option on equity instruments. On initial recognition, the corresponding debit is made to another component of parent equity, not to the NCI.

All subsequent changes in the carrying amount of the financial liability that result from the remeasurement of the present value of the amount payable upon exercise of the NCI put are recognised in the profit or loss attributable to the owners of the parent, and not the NCI's share of the profit or loss of the subsidiary.

If the NCI put is exercised, the entity accounts for an increase in its ownership interest as an equity transaction (see section 4 above). Consequently, the financial liability, as remeasured immediately before the transaction, is extinguished by payment of the exercise price and the NCI purchased is derecognised against parent equity.

If the NCI put expires unexercised, the financial liability is reclassified to the same component of parent equity that was previously reduced (on initial recognition).

6.2.3.C Partial recognition of NCI (Approach 3)

Approach 3 is one of the alternatives that could be used when the entity does not have a present ownership interest in the shares concerned but initially applies IFRS 10 and recognises the NCI, either at fair value or at the proportionate share of the acquiree's net assets. *[IFRS 3.19]*.

Under Approach 3, while the NCI put remains unexercised, the accounting at the end of each reporting period is as follows:

(a) The entity determines the amount that would have been recognised for the NCI, including an update to reflect allocations of profit or loss, allocations of changes in OCI and dividends declared for the reporting period, as required by IFRS 10 (see section 5.7 above).

(b) The entity derecognises the NCI as if it was acquired at that date.

(c) The entity recognises a financial liability at the present value of the amount payable on exercise of the NCI put in accordance with IFRS 9. There is no separate accounting for the unwinding of the discount due to the passage of time.

(d) The entity accounts for the difference between (b) and (c) as an equity transaction.

If the NCI put is exercised, the same treatment is applied up to the date of exercise. The amount recognised as the financial liability at that date is extinguished by the payment of the exercise price.

If the NCI put expires unexercised, the position is unwound so that the NCI is recognised at the amount it would have been, as if the put option had never been granted (i.e., measured initially at the date of the business combination, and remeasured for subsequent allocations of profit or loss, OCI and changes in equity attributable to the NCI). The financial liability is derecognised, with a corresponding credit to the same component of parent equity that was previously reduced.

6.2.3.D NCI is subsequently derecognised (Approach 4)

Approach 4 could be used when the entity does not have a present ownership interest in the shares concerned and concludes that IFRS 10 takes precedence. When the NCI put is granted in a business combination, the acquirer initially recognises the NCI, either at fair value or at the proportionate share of the acquiree's net assets. *[IFRS 3.19]*.

When the parent recognises the financial liability for the NCI put, it derecognises the NCI. There are two ways of viewing this, but the accounting effect is the same:

- This transaction is an immediate acquisition of the NCI. The NCI is treated as having been acquired when the NCI put is granted, as in Approach 1. However, in accordance with IFRS 10, any difference between the liability recognised (at the present value of the amount payable upon exercise of the NCI put) and the amount of NCI derecognised is recognised directly in equity. (Under Approach 1, the difference is reflected in the measurement of goodwill.)
- This transaction is viewed as a reclassification of an equity instrument to a financial liability. In accordance with IAS 32, when the financial liability is recognised, the present value of the amount payable upon exercise of the NCI put is reclassified from equity with the effect that the NCI is derecognised. Any difference between the carrying value of NCI and the liability is adjusted against another component of parent equity.

The financial liability for the NCI put is subsequently accounted for under IFRS 9, with all changes in the carrying amount recognised in profit or loss.

Dividends paid to the other shareholders are recognised as an expense of the group, unless they represent a repayment of the liability (e.g., where the exercise price is adjusted by the dividends paid). This means that the profit or loss (and changes in OCI) with respect to the subsidiary are allocated to the parent and not to the NCI, as there is none.

If the NCI put is exercised, the carrying amount of the financial liability at that date is extinguished by the payment of the exercise price.

If the NCI put expires unexercised, the liability is derecognised with the NCI being reinstated as if nothing happened. Any difference between the liability and NCI is recognised against another component of equity, generally the same component reduced when the liability was initially recognised.

6.2.4 Assessing whether to account for multiple transactions as a single arrangement

As discussed in section 3.4 above, IFRS 10 provides guidance on when to account for two or more arrangements as a single transaction when a parent loses control of a subsidiary. *[IFRS 10.26, IFRS 10.B97]*. However, neither IFRS 10 nor IFRS 3 specifically addresses the accounting for a sequence of transactions that begins with an acquirer gaining control over another entity, followed by acquiring additional ownership interests shortly thereafter. This frequently happens where public offers are made to a group of shareholders and there is a regulatory requirement for an acquirer to make an offer to the non-controlling shareholders of the acquiree.

The IFRS IC considered this issue and tentatively agreed that the initial acquisition of the controlling stake and the subsequent mandatory tender offer should be treated as a single transaction. However, there was no consensus among the IFRS IC members on whether a liability should be recognised for the mandatory tender offer at the date that the acquirer obtains control of the acquiree. A small majority expressed the view that a liability should be recognised in a manner that is consistent with IAS 32. Other IFRS IC members expressed the view that a mandatory tender offer to purchase NCI is not within the scope of IAS 32 or IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and that a liability should therefore not be recognised.[37] The issue was escalated to the IASB[38] and the accounting for mandatory tender offers has subsequently been considered as part of the FICE project. See sections 7.3 and 7.4 below.

How we see it

In our view, when determining the appropriate accounting, a simple distinction between a statutory obligation and a contractual obligation is not always clear and the effects of a mandatory tender offer may, in any event, be economically similar to a contractual NCI put.

Statutory requirements (such as a mandatory tender offer or a statutory process that has the same effect) may have the effect of modifying the contractual terms of the equity instruments, thereby giving rise to a contractual obligation to purchase the equity instruments. The rules and regulations regarding tender offers differ by jurisdiction and careful analysis of the facts and circumstances is needed.

In any event, even if it is established there is no contractual obligation, the effects of a mandatory tender offer are economically similar to a contractual NCI put and, in the absence of specific requirements in IFRS accounting standards, it might be appropriate to account in the same way. We believe that this is an area where the IASB needs to provide further clarification.

How we see it

In the absence of any specific requirements in IFRS accounting standards for transactions such as mandatory tender offers arising in connection with a business combination, we believe that entities generally have an accounting policy choice to:

(a) Account for the transaction as a single linked transaction in which control is gained (a single business combination), where the indicators of a linked transaction are met

Or

(b) Account for the transaction as a discrete transaction (a business combination followed by an acquisition of NCI)

However, policy (a) can only be applied where the acquisition of NCI is assessed as linked to the same transaction as that by which control is gained (as explained in section 6.2.4.A below). Entities would need to apply the policy consistently (for example, if policy (a) is applied, it needs to be applied for all transactions where the criteria for linked transactions are met). Entities applying policy (a) should refer to section 6.2.4.B below for accounting for linked transactions.

Where an entity adopts policy (b) to account for the transaction as a discrete transaction, a further determination needs to be made as to whether (and at what point), based on the facts and circumstances, the mandatory tender offer gives rise to a contractual obligation.

37 *IFRIC Update*, March 2013, available on the IFRS Foundation's website.

38 *IASB Update*, May 2013, available on the IFRS Foundation's website.

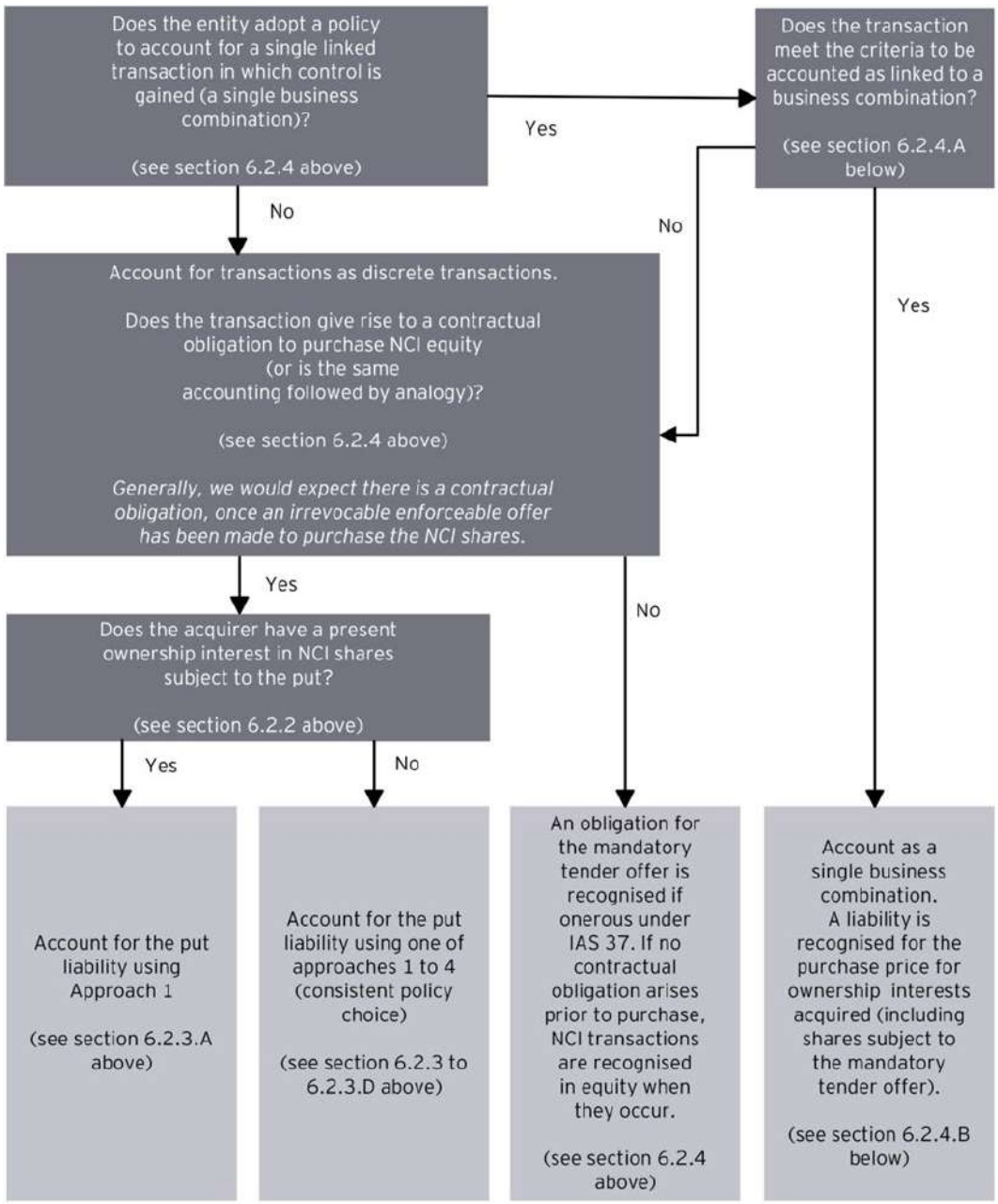
The accounting under policy (b) is as follows:

- Where a mandatory tender offer is considered to give rise to a contractual obligation to purchase the equity shares (or the transaction is accounted by analogy in the same way as a contractual put), an obligation for the NCI put is recognised in accordance with the guidance on Approaches 1 to 4 described in sections 6.2 to 6.2.3.D above (and consistent with the guidance in section 6.4 below). While the exact point at which a contractual obligation arises in the mandatory tender process will depend on the specific facts and circumstances in the relevant jurisdiction, we would generally expect that an irrevocable and enforceable offer made by the acquirer to purchase the NCI will constitute a contractual obligation.
- If no contractual obligation arises in advance of the purchase (and the transaction is not accounted by analogy in the same way as a contractual put), the purchase of the NCI is accounted for as a separate equity transaction when it occurs (see section 4 above). An obligation is recognised for the statutory obligation for the mandatory tender offer, if onerous, in accordance with IAS 37.

This is summarised in the following decision tree at Figure 6-2 below.

Figure 6-2: Accounting for a mandatory tender offer

This shows a simplified decision chart for accounting for a mandatory tender offer following the acquisition of a controlling stake in an investee. It is important that this is read in conjunction with the text in section 6.2.4 above as well as the sections cross referenced from the boxes in the chart.



6.2.4.A Identifying a linked transaction

The acquisition of the NCI is a linked transaction when it arises from the same transaction as that by which control was gained. This will generally be the case where it arises as part of the same offer, including where legal or regulatory requirements lead to the offer being extended through the creation of a shareholder put, or acquirer compulsory acquisition rights.

How we see it

In many cases where NCI is acquired in connection with a transaction in which control is gained, it will be clear where there is a single offer. Where it is not clear, the existence of all of the following factors indicate a linked transaction:

- The option over the remaining interest and subsequent acquisition is not negotiated separately by the non-controlling shareholders
- The offer period is short
- The price per share offered for subsequent increases in shareholding is fixed and consistent with the price paid for the controlling interest

These factors are generally all present in the case of public offers to the entire group of shareholders. This is not necessarily the case for private offers where, for example, some of the options may be for extended terms.

If a put option is granted over the NCI and the terms of the put option are such that the present ownership interest attached to the underlying shares is gained at the same time as gaining control, this will satisfy the factor that 'the offer period is short'. Even if the put nominally extends over a long period, the effect is that ownership has already passed to the acquirer. See section 6.2.2 above for the factors to be considered in assessing whether or not the acquirer gains present ownership interest over the underlying shares. Where the other factors listed in the 'How we see it' box above are also met, this is a linked transaction.

6.2.4.B Accounting for the linked transaction (where a policy to account as a single business combination is followed)

A linked transaction is accounted for as if all ownership interests were acquired at the acquisition date as part of the transaction to gain control.

The consideration transferred is the sum of the amount paid for the controlling interest and NCI (that is acquired as part of the linked transaction) and the percentage acquired is the sum of the respective shareholdings. If, at the date of gaining control the NCI has not actually been acquired, a financial liability is recognised at the present value of the amount payable upon exercise of the option to acquire the NCI.

If, at the date the NCI is actually acquired, the percentage acquired differs to that originally accounted for as being acquired, the purchase accounting is adjusted to reflect the actual percentage acquired. A 'true up' exercise is performed to adjust the total consideration paid and therefore the amount of goodwill recognised. It is not accounted for as a partial disposal of NCI (changes in ownership interest without loss of control are addressed in section 4 above). The NCI is measured as of the date of acquisition, not as of the date that the offer expires.

When the transaction is linked because the arrangement provides a present ownership interest in the NCI, the entity will not recognise the NCI. Accounting for the transaction is as described in Approach 1 in section 6.2.3.A above.

Illustration 6-1 below shows the accounting for a linked transaction.

Illustration 6-1: Put option and gaining control accounted for as a single transaction

Entity A acquires a 60% controlling interest in listed Entity B. As A has obtained a controlling interest in B, the regulator requires A to offer to purchase the remaining shares of B from all other shareholders of B, paying the same price per share as in the transaction in which A obtained control of B ('mandatory tender offer'). A makes the mandatory tender offer immediately and the offer period lasts for 30 days.

At the end of 30 days, other shareholders of B owning 30% accept the mandatory tender offer for their shares. The offer to acquire the remaining 10% of shares held in B expires unexercised.

When considering whether the mandatory tender offer is linked to the acquisition of 60% of B's shares, in which A gained control, it is relevant that:

- The price per share is fixed and at the same price as paid by A to acquire 60% of B's shares
- The shareholders of B who own the 40% did not negotiate to receive the offer
- The offer benefits the shareholders of B (by providing the same opportunity to sell their shares that the shareholder(s) who sold the 60% received)
- Although the offer was initiated by A, it stemmed from a regulatory requirement triggered by the acquisition of B (it was not at A's discretion to make the offer)
- The offer period is relatively short

A concludes that the mandatory tender offer is linked to the transaction when control was gained and is therefore part of the business combination. Therefore, A records the following journal entries:

a) Acquisition of 60% and entering into the mandatory tender offer over the remaining 40% of B's shares (granting the offer):

Dr Net assets
(summarised, 100% of fair value of net assets of B, as required by IFRS 3)

Dr Goodwill (as if A acquired 100% of B)

Cr Cash transferred (on acquisition date)

Cr Financial liability
(present value of offer price to be paid at the expiry date of the option relating to the 40% of B's shares subject to the mandatory tender offer)

b) Accounting for the liability in accordance with IFRS 9 (unwinding of the discount during the 30-day period):

Dr Finance expense

Cr Financial liability

c) Actual acquisition of 30% offered at the end of the 30-day period is accounted for as a reduction of the financial liability:

Dr Financial liability

Cr Cash

d) Reclassification of the financial liability to equity for the 10% outstanding at the end of the offer period.

A adjusts the initial purchase price allocation related to Entity B to recognise any NCI, with an offset to goodwill:

Dr Financial liability (offer price of 10% of shares)

Cr NCI
(either (1) fair value of the NCI in B or (2) the 10% shareholders' proportionate share of B's identifiable net assets), measured as of the acquisition date (the date that control was gained, and not the date that the offer expires)

Dr/Cr Goodwill (difference, if applicable).

If the adjustment to goodwill resulted in 'negative goodwill', any excess after eliminating the original positive goodwill would be recognised in profit or loss.

6.3 Combination of call and put options

In some business combinations, there might be a combination of call and put options, the terms of which may be equivalent or may be different.

How we see it

The appropriate accounting for a combination of call and put options over NCI is determined based on the discussions in sections 6.1 and 6.2 above. However, where there is a call and put option with matching terms, particularly at a fixed price, the combination of the options is more likely to mean that they give the acquirer a present ownership interest. Where the exercise price is at fair value (or an amount that approximates fair value), however, the returns of ownership arising from fair value movements will accrete to the NCI and consequently, this situation is unlikely to give the acquirer a present ownership interest.

In cases where the combination of call and put options gives the acquirer a present ownership interest, where the options are over all of the shares not held by the parent, the acquirer has effectively acquired a 100% interest in the subsidiary at the date of the business combination. The entity is likely to be economically in a similar position as if it had acquired a 100% interest in the subsidiary with either deferred consideration (where the exercise price is fixed) or contingent consideration (where the settlement amount is not fixed, but is dependent upon a future event). See Chapter 10 at sections 7 and 7.1.

As noted in section 6 above, similar considerations would apply where the acquirer entered into a forward purchase contract for the shares held by the other shareholders.

6.4 Call and put options entered into in relation to existing NCI - additional accounting considerations

The discussion in sections 6.1 to 6.3 above focused on call and put options entered into at the same time as control is gained of the subsidiary. However, an entity may enter into the options with non-controlling shareholders after gaining control.

How we see it

The appropriate accounting policy for call and put options entered into in relation to existing NCI will be based on the discussions in sections 6.1 to 6.3 above.

Where the entity already has a controlling interest and as a result of the options now has a present ownership interest in the remaining shares concerned, or concludes that IAS 32 takes precedence, the NCI is no longer recognised within equity. The transaction is accounted for as an acquisition of the NCI, i.e., it is accounted for as an equity transaction, (see section 4 above), because such acquisitions are not business combinations under IFRS 3.

6.5 Call and put options in separate financial statements

Purchased call options (and written put options) over shares in an acquired subsidiary are derivatives in the separate financial statements. *[IFRS 9.2.1(a)].* Note that this treatment differs from that in the consolidated financial statements which is addressed generally in section 6 above.

A purchased call option over shares in an acquired subsidiary is initially recognised as a financial asset at its fair value, with any subsequent changes in the fair value of the option recognised in profit or loss. Similarly, a written put option over shares in an acquired subsidiary is initially recognised as a financial liability at its fair value, with any subsequent changes in the fair value of the option recognised in profit or loss.

The initial credit entry for the call option (and the initial debit entry for the put option) will depend on the transactions giving rise to the options. For example, the entity may have paid (or received) consideration for the call (or put option) in a separate transaction or as part of a larger transaction.

Where a purchased call option (or written put) option lapses, the financial asset (or financial liability) is derecognised, with a debit (or credit) to profit or loss. Where a purchased call option (or written put option) is exercised, the financial asset (or financial liability) is derecognised with an adjustment to the cost of investment of purchasing the shares subject to the option.

The fair value of the purchased call option (or written put option) is not expected to be significant if the option is exercisable at the fair value (or at an amount that approximates fair value) of the underlying shares at the date of exercise. Where there is both a purchased call and a written put option, particularly where the options have the same fixed redemption price, it is likely that the fair values of the purchased call option and written put option will differ.

7 Future developments

The IASB has been engaged in a number of implementation projects that might change the accounting for transactions where there is a loss of control of a subsidiary, the accounting for NCI or the accounting for NCI puts and calls. In many cases, the accounting for the transactions is at the intersection of IFRS 10 and a different IFRS accounting standard. These issues are discussed in sections 7.1 to 7.5 below.

In addition, during 2019 and 2020, the IFRS IC and the IASB held discussions about the accounting for a transaction in which an entity, as part of its ordinary activities, enters into a contract with a customer to sell real estate by selling its equity interest in a subsidiary.[39] Having considered feedback from the PIR of IFRS 10, IFRS 11 and IFRS 12 (see section 7.5 below), the Board intends no further action on this topic.[40] The IASB decided not to include a question in the PIR of IFRS 15.[41] However, some stakeholder feedback to the PIR of IFRS 15 raised the issue of sales of corporate wrappers again.[42] In response to the feedback, the Board reconfirmed in April 2024 that it will consider the priority of matters relating to applying IFRS 15 with IFRS 10 and IFRS 11 in the next agenda consultation (i.e., the Fourth Agenda Consultation, expected to start in 2026) instead of as part of the PIR of IFRS 15.[43] This issue is discussed further in section 3.2.1 above.

Similarly, in 2020 and 2021, the IFRS IC discussed the interaction of IFRS 10 and IFRS 16 in relation to a transaction where the entity's equity interest in a wholly-owned subsidiary that held only a building was sold, resulting in loss of control, and the building was leased back. The IFRS IC recommended, following review of feedback on a previous tentative agenda decision, that the IASB undertake narrow-scope standard-setting to address this and similar transactions. The IASB is expected to discuss this recommendation at a future meeting.[44] However, transactions involving corporate wrappers were identified as low priority in the PIR of IFRS 10, IFRS 11 and IFRS 12 (see section 7.5 below).[45] This issue is discussed further in section 3.2.2 above.

7.1 Sale or contribution of assets between an investor and its associate or joint venture (amendments to IFRS 10 and IAS 28)

One issue that the IASB has been trying to resolve was a conflict between the IFRS 10 requirements relating to loss of control over a subsidiary and those of IAS 28 for transactions where a parent sells or contributes an interest in a subsidiary to an associate or a joint venture. In order to resolve the conflict, in September 2014, the IASB had issued *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (Amendments to IFRS 10 and IAS 28).

These amendments, where applied, would require the gain or loss resulting from the loss of control of a subsidiary that does not contain a business (as defined in IFRS 3) - as a result of a sale or contribution of a subsidiary to an associate or a joint venture (that is accounted for using the equity method) - to be recognised in profit or loss only to the extent of the unrelated investors' interests in the associate or joint venture. The same requirement applies to the remeasurement gain or loss relating to the former subsidiary if, following the transaction, a parent retains an investment in a former subsidiary and the former subsidiary is now an associate or a joint venture that is accounted for using the equity method. However, a full gain or loss would be recognised on the loss of control of a subsidiary that constitutes a business, including cases in which the investor retains joint control of, or significant influence over, the investee. *[IFRS 10.25, IFRS 10.26, IFRS 10.B98, IFRS 10.B99, IFRS 10.B99A]*.

39 *IFRIC Update*, June 2019, *IASB Update*, October 2019, *IASB Update*, June 2020, available on the IFRS Foundation's website.

40 Project summary: *Sale of a Subsidiary to a Customer*, IFRS Foundation's website (accessed 26 September 2024).

41 Request for Information: *Post-implementation review of IFRS 15* Revenue from Contracts with Customers, June 2023, Spotlight 9.4, available on the IFRS Foundation's website.

42 IFRS Staff Paper 6C, Project: Post-implementation Review of IFRS 15, Paper topic: Applying IFRS 15 with IFRS 10 and IFRS 11, IASB Meeting, April 2024, available on the IFRS Foundation's website.

43 *IASB Update*, April 2024, available on the IFRS Foundation's website.

44 *IFRIC Update*, February 2021; and *IASB pipeline projects*, IFRS Foundation's website (accessed 26 September 2024).

45 Project Report and Feedback Statement: *Post-implementation Review: IFRS 10* Consolidated Financial Statements, *IFRS 11* Joint Arrangements, *IFRS 12* Disclosure of Interests in Other Entities, IASB, June 2022. Available on the IFRS Foundation's website.

In the Basis for Conclusions, the IASB clarifies that the amendments do not apply where a transaction with a third party leads to a loss of control (even if the retained interest in the former subsidiary becomes an associate or joint venture that is accounted for using the equity method), nor where the investor elects to measure its investments in associates or joint ventures at fair value in accordance with IFRS 9. *[IFRS 10.BC190I]*.

These amendments were to be applied prospectively to transactions occurring in annual periods beginning on or after 1 January 2016, with earlier application permitted. However, in December 2015, the IASB issued a further amendment, *Effective Date of Amendments to IFRS 10 and IAS 28*. This amendment deferred the effective date of the September 2014 amendments indefinitely.

Nevertheless, the IASB has continued to allow early application of the September 2014 amendments, which must be disclosed, as the Board did not wish to prohibit the application of better financial reporting. *[IFRS 10.C1C, IFRS 10.BC190N, IFRS 10.BC190O, IAS 28.45C, IAS 28.BC37I, IAS 28.BC37J]*.

The September 2014 amendments are discussed in sections 3.3.2 and 3.3.2.B above.

This issue has been reconsidered as part of the IASB's equity method project which aims to develop answers to application questions about the equity method, as set out in IAS 28, using the principles derived from that standard where possible.[46] In September 2024, the IASB issued an Exposure Draft addressing application questions relating to the equity method. The Exposure Draft proposes that an investor, in applying IAS 28, would recognise the full gain or loss on all transactions with its associate together with improvements to the disclosure requirements when an investor recognises the full gain or loss on transactions with its associate.[47] This is a different position to the September 2014 amendments.

Please refer to the IASB's website for the latest information on these issues.[48] See also Chapter 12 at section 13.

7.2 Sale or contribution of assets to a joint operation (where the entity has joint control or is a party to the joint operation)

In July 2016, the IFRS IC discussed whether an entity should remeasure its retained interest in the assets and liabilities of a joint operation when the entity loses control of a business, or an asset or group of assets that is not a business. In the transaction discussed, the entity either retains joint control of a joint operation or is a party to a joint operation (with rights to assets and obligations for liabilities) after the transaction.

Because of the similarity between the transaction being discussed by the IFRS IC and a sale or contribution of assets to an associate or joint venture (see section 7.1 above), the IFRS IC decided not to add the issue to its agenda, but instead to recommend that the IASB consider the issue at the same time that it further considers the accounting for the sale or contribution of assets to an associate or a joint venture. The IFRS IC observed that the PIR of IFRS 10 and IFRS 11 would provide the IASB with an opportunity to consider loss of control transactions and a sale or contribution of assets to an associate or joint venture.[49] That matter was considered as part of Phase 2 of the PIR of IFRS 10, IFRS 11 and IFRS 12 (see section 7.1 above and section 7.5 below). In June 2022, the Board assessed transactions that change the relationship between an investor and an investee as a low priority and concluded this topic could be explored if identified as a priority in the next agenda consultation (i.e., the Fourth Agenda Consultation, expected to start in 2026).[50]

The IFRS IC agenda decision, and the accounting for such transactions are discussed further in section 3.3.3 above.

46 IASB Update, April 2023, available on the IFRS Foundation's website.

47 Exposure Draft IASB/ED/2024/7 *Equity Method of Accounting - IAS 28 Investments in Associates and Joint Ventures*, IASB, September 2024, paras. 53-54. Available on the IFRS Foundation's website.

48 Equity method, project page, available on the IFRS Foundation's website (accessed 26 September 2024).

49 IFRIC Update, July 2016, available on the IFRS Foundation's website.

50 Project Report and Feedback Statement: *Post-implementation Review: IFRS 10* Consolidated Financial Statements, *IFRS 11* Joint Arrangements, *IFRS 12* Disclosure of Interests in Other Entities, IASB, June 2022. Available on the IFRS Foundation's website.

7.3 Accounting for NCI puts - Financial Instruments with Characteristics of Equity ('FICE') project

Both the IFRS IC and the IASB have been debating the accounting for NCI puts over a number of years. Many of these issues have now been considered by the FICE project.

In June 2018, the IASB issued Discussion Paper (DP/2018/1) *Financial instruments with Characteristics of Equity*.[51] However, after considering feedback, the IASB decided not to continue with the proposed classification approach but instead to clarify the classification requirements in IAS 32, including their underlying principles, to address known application issues and to limit changes in classification outcomes to situations where such a change would provide more useful information.[52]

In December 2020, the IASB added the FICE project to its standard-setting programme and subsequently, in November 2023, issued Exposure Draft (IASB/ED/2023/5) *Financial instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1*.[53]

The proposals relevant to contracts which include an obligation for an entity to purchase its own equity instruments (such as a forward contract to purchase an entity's own shares or an NCI put) include:

- An entity that does not yet have access to the rights and returns associated with ownership of the equity instruments to which the obligation relates, continues to recognise those instruments as equity instruments and removes from a component of parent equity other than issued share capital an amount equal to the initial amount of the financial liability
- On initial recognition and subsequent remeasurement, the financial liability is measured at the present value of the redemption amount (the existing requirement to subsequently remeasure the financial liability in accordance with IFRS 9 is removed)
- On initial and subsequent measurement, an entity disregards the probability and estimated timing of the counterparty's exercise of its redemption right and discounts the redemption amount to its present value assuming that the redemption will occur at the earliest possible redemption date
- An entity recognises gains or losses on remeasurement of the financial liability in profit or loss
- On expiry of the contract, the carrying amount of the financial liability is derecognised and that amount is included in the same component of equity from which it was removed on initial recognition of the financial liability (Note, the cumulative amount in retained earnings arising from remeasurement of the financial liability could be reclassified to another component of equity but is not reversed in profit or loss)

  And

- An entity also applies the requirements relating to obligations to purchase its own equity instruments to contracts that will be settled by delivering a variable number of another class of the entity's own equity instruments to the value of the contractual obligation[54]

Therefore, written put options and forward purchase contracts on an entity's own equity instruments continue to be presented gross (i.e., using the present value of the redemption price) rather than net (i.e., as a derivative) if an entity's contractual obligation is to be gross physically settled. If an entity's obligation is to be net settled (in cash or shares) or could be net settled at the election of either party, derivative accounting would apply.[55] This is considered to help users in assessing the entity's liquidity risk exposure as, for example, the gross cash flow settling the obligation in cash reduces the entity's assets unlike other derivatives where the entity receives assets not own shares.[56]

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51 Discussion Paper DP/2018/1, *Financial Instruments with Characteristics of Equity*, IASB, June 2018. Available on the IFRS Foundation's website.

52 Exposure Draft - Snapshot Financial Instruments with Characteristics of Equity, IASB, November 2023. Available on the IFRS Foundation's website.

53 Exposure Draft (IASB/ED/2023/5) *Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1*, IASB, November 2023. Available on the IFRS Foundation's website.

54 Exposure Draft (IASB/ED/2023/5) *Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32*, IASB, November 2023, paras. 23, AG27B and AG27C. Available on the IFRS Foundation's website.

55 Exposure Draft (IASB/ED/2023/5) *Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32*, IASB, November 2023, para. AG27D. Available on the IFRS Foundation's website.

56 Exposure Draft (IASB/ED/2023/5) *Basis for Conclusions on Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1*, IASB, November 2023, paras. BC66-BC70. Available on the IFRS Foundation's website.

To enable users of financial statements to understand the accounting for financial instruments, extensive disclosures are also proposed including:

- The amount removed from equity (and the component of equity from which removed) and included in financial liabilities on initial recognition of the obligation as a financial liability
- The amount of any remeasurement gain or loss recognised in profit or loss during the reporting period
- The amount of any gain or loss recognised on settlement of the obligation during the reporting period
- The amount removed from financial liabilities and included in equity if the obligation has expired unexercised in the reporting period

  And
- Any transfers within equity of amounts related to the obligation during the reporting period (and the components of equity that the amounts were transferred to and from)[57]

A summary of respondents' feedback[58] was discussed in May 2024 and will be considered further during the IASB's redeliberation of the ED's proposals.[59] At the time of writing, the IASB expects to issue final amendments during 2026. Please refer to the IASB's website for the latest information on these issues.[60]

See Chapter 43 at sections 12 and 12.8 for further discussion of the FICE project.

7.4 Mandatory purchase of non-controlling interests

As discussed more fully in section 6.2.4 above, neither IFRS 10 nor IFRS 3 specifically addresses the accounting for a sequence of transactions that begins with an acquirer gaining control over another entity, followed by it acquiring additional ownership interests shortly thereafter. This frequently happens where public offers are made to a group of shareholders and there is a regulatory requirement for an acquirer to make an offer to the non-controlling shareholders of the acquiree. This issue had been considered by the IFRS IC and was escalated to the IASB.

This issue was subsequently considered within the Discussion Paper (DP/2018/1) *Financial instruments with Characteristics of Equity*. In the IASB's preliminary view, an entity would apply the IASB's preferred approach to the contractual terms of a financial instrument consistently with IAS 32 and IFRS 9. This would result in, for example, the obligations that arise in mandatory tender offers, which have similar consequences to those that arise from written put options, not being considered for the purpose of classification because they are beyond the scope of IAS 32. The DP stated that the IASB will consider whether it should take any action to address the accounting for mandatory tender offers, including potential disclosure requirements, following its analysis of responses to the DP.[61]

In October 2019, the Staff recommended that the topic of mandatory tender offers was excluded from the scope of the FICE project as "In the staff's view, amending IAS 32 in a way that it scopes in this type of obligation would require a fundamental rewrite of IAS 32. Therefore, the staff would expect this issue to be outside the scope of this project".[62]

The IASB discussed the effects of applicable laws on contractual terms of financial instruments on classification of financial instruments in September 2021, December 2021 and February 2023.

57 Exposure Draft (IASB/ED/2023/5) *Financial Instruments with Characteristics of Equity - Proposed amendments to IFRS 7*, IASB, November 2023, para. 30J. Available on the IFRS Foundation's website.

58 IASB Agenda Paper 5: Project: *Financial Instruments with Characteristics of Equity (FICE)*, Paper topic: *Feedback Summary*, IASB meeting, May 2024. Available on the IFRS Foundation's website.

59 *IASB Update*, May 2024, available on the IFRS Foundation's website.

60 IFRS Foundation work plan and *Financial Instruments with the Characteristics of Equity, project page* (accessed 26 September 2024) available on the IFRS Foundation's website.

61 Discussion Paper DP/2018/1, *Financial Instruments with Characteristics of Equity*, IASB, June 2018, paras. 8.27-8.36. Available on the IFRS Foundation's website.

62 IASB Staff Paper 5: Project: *Financial Instruments with Characteristics of Equity (FICE)*, Paper topic: *Clarifying amendments to IAS 32 Project plan*, IASB meeting, October 2019, para. 48. Available on the IFRS Foundation's website.

In November 2023, the IASB issued Exposure Draft (IASB/ED/2023/5) *Financial instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1*. The ED proposes that in classifying a financial instrument (or its component parts) as a financial liability or an equity instrument, an entity:[63]

- Considers only contractual rights and obligations that are enforceable by laws or regulations and are in addition to those created by relevant laws or regulations (such as statutory or regulatory requirements applicable to the instrument)

  And

- Disregards any rights or obligations created by applicable laws or regulations that would arise regardless of whether the right or obligation is included in the contractual arrangement

In the Basis for Conclusions to the ED, the Board explains that: "These contractual rights and obligations are subject to negotiation and agreement between the parties to the contract and, therefore, can be modified by mutual agreement. In contrast, a right or obligation solely created by laws or regulations applies to all similar instruments and cannot be negotiated or modified by the parties to the contract. A change in relevant laws or regulations would affect all instruments subject to those laws or regulations without any action required from the parties to the contract."[64]

A contractual right or obligation that is not solely created by laws or regulations but is in addition to a right or obligation established by relevant laws or regulations is considered in its entirety in classifying the financial liability or its component parts (rather than being disaggregated into contractual and non-contractual parts).[65]

In certain circumstances, a company might recognise and measure the rights and obligations that it disregarded when classifying a financial instrument as a financial liability or an equity instrument, applying other IFRS accounting standards.[66] For example, IAS 37 might apply.

How we see it

While the ED and its Basis for Conclusions do not explicitly discuss mandatory tender offers, the proposed requirements on the effects of laws or regulations have potential to impact the determination of whether and, if so, at what point a mandatory tender offer gives rise to a contractual obligation to purchase equity, and hence a financial liability is recognised under IFRS accounting standards. The assessment is likely to depend on the precise contractual terms of the offer made and the legal or regulatory requirements that govern the offer. Until the ED is finalised and effective, we believe there is likely to remain diversity over this assessment and it is not precluded to account by analogy in the same way as if the transaction gave rise to a contractual NCI put. See section 6.2.4 above.

See section 7.3 above, Chapter 10 at section 8.5 and Chapter 43 at section 12 for further discussion of the FICE project.

7.5 PIR of IFRS 10, IFRS 11 and IFRS 12

In June 2022, the IASB concluded its PIR of IFRS 10, IFRS 11 and IFRS 12 with the publication of the Project Report and Feedback Statement.[67] Feedback from stakeholders and research undertaken as part of the PIR showed that the requirements set out in the standards are working as intended, are meeting their objectives and that application of the requirements has not given rise to unexpected costs.

63 Exposure Draft (IASB/ED/2023/5) *Financial Instruments with Characteristics of Equity - Proposed amendment to IAS 32*, IASB, November 2023, para. 15A. Available on the IFRS Foundation's website.

64 Exposure Draft (IASB/ED/2023/5) *Basis for Conclusions on Financial Instruments with Characteristics of Equity*, IASB, November 2023, para. BC20 and Exposure Draft (IASB/ED/2023/5) *Financial Instruments with Characteristics of Equity - Proposed amendment to IAS 32*, IASB, November 2023, para. AG24A. Available on the IFRS Foundation's website.

65 Exposure Draft (IASB/ED/2023/5) *Financial Instruments with Characteristics of Equity - Proposed amendment to IAS 32*, IASB, November 2023, para. AG24B. Available on the IFRS Foundation's website

66 Exposure Draft - Snapshot IFRS Accounting Standards *Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1*, p4. Available on the IFRS Foundation's website.

67 Project Report and Feedback Statement: *Post-implementation Review: IFRS 10* Consolidated Financial Statements, *IFRS 11* Joint Arrangements, *IFRS 12* Disclosure of Interests in Other Entities, IASB, June 2022. Available on the IFRS Foundation's website.

The feedback received did raise several matters, including matters that were raised to the IFRS IC in the past and not addressed. However, the IASB has determined that none of these matters are a high or medium priority and that no further action is required as a result of the PIR. If stakeholders require further guidance, they are encouraged to submit questions to the IFRS IC, provided these questions meet the submission criteria.

The PIR assessed the following topics as low priority:

- Subsidiaries that are investment entities
- Transactions that change the relationship between an investor and an investee
- Transactions that involve 'corporate wrappers'
- Collaborative arrangements outside the scope of IFRS 11

  And
- Additional disclosures about interests in other entities

The second and third of these topics are relevant to this chapter and are discussed further in sections 3.2 to 3.2.2, sections 3.3.2 to 3.3.2.B, section 3.3.3, sections 7, 7.1 and 7.2 above.

The Board concluded that these topics could be explored if identified as priorities in the next agenda consultation (i.e., the Fourth Agenda Consultation, expected to start in 2026).

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Appendix B - Defined terms

Extract from IFRS 10

Appendix A
Defined terms

consolidated financial statements	The financial statements of a **group** in which the assets, liabilities, equity, income, expenses and cash flows of the **parent** and its **subsidiaries** are presented as those of a single economic entity.
group	A **parent** and its **subsidiaries**.
non-controlling interest	Equity in a **subsidiary** not attributable, directly or indirectly, to a **parent**.
parent	An entity that **controls** one or more entities.
subsidiary	An entity that is controlled by another entity.

In addition, the following terms are used throughout this chapter:

- 'NCI' to refer to non-controlling interest(s)
- 'NCI put' to refer to a written put option over non-controlling interest(s)
- 'NCI puts and calls' to refer to written put options and purchased call options over non-controlling interest(s)
- 'Present ownership interest' to include existing legal ownership interests together with potential voting rights and other derivatives that, in substance, already provide existing ownership interests in a subsidiary

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Overview

IAS 27 *Separate Financial Statements* prescribes the accounting and disclosure requirements for investments in subsidiaries, joint ventures and associates when an entity prepares separate financial statements. Although IAS 27 does not mandate which entities produce separate financial statements it applies when an entity prepares separate financial statements that comply with IFRS accounting standards.

This chapter deals not only with aspects of the preparation of separate financial statements but also with some of the consequences of common control or group transactions in individual or separate financial statements, and in a set of consolidated financial statements prepared for a sub-group as far as transactions with the ultimate parent or with other entities under common control, other than with respect to business combination under common control (see Chapter 11).

What you need to know

- Separate financial statements are those presented by an entity in which the entity could elect, subject to the requirements in IAS 27, to account for its investments in subsidiaries, joint ventures and associates either at cost, in accordance with IFRS 9 *Financial Instruments*, or using the equity method as described in IAS 28 *Investments in Associates and Joint Ventures*.
- The financial statements of an entity that does not have a subsidiary, associate or joint venture are not 'separate financial statements'.
- When an entity has no subsidiaries, but has investments in joint ventures or associates, there could be differences between separate financial statements and individual financial statements.
- Guidance in IFRS accounting standards for the consequences of common control or group transactions in individual or separate financial statements is limited and incomplete. Whilst such intra-group transactions do not affect the consolidated financial statements of the parent, as they are eliminated during consolidation, they can have a significant impact on the separate or individual financial statements of the parent and/or subsidiaries and/or a set of consolidated financial statements prepared for a sub-group.

1 Separate and individual financial statements

Separate financial statements are defined as follows: *[IAS 27.4]*.

Extract from IAS 27

4 **The following terms are used in this Standard with the meanings specified:**

Consolidated financial statements are the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

Separate financial statements are those presented by an entity in which the entity could elect, subject to the requirements in this Standard, to account for its investments in subsidiaries, joint ventures and associates either at cost, in accordance with IFRS 9 *Financial Instruments*, or using the equity method as described in IAS 28 *Investments in Associates and Joint Ventures*.

Generally, the IASB takes the view that the needs of users of financial statements are fully met by requiring entities to consolidate subsidiaries and equity account for associates and joint ventures. However, it is recognised that entities with subsidiaries, associates or joint ventures may wish, or may be required by local law, to present financial statements in which their investments are accounted for on another basis, e.g., as equity investments or under the equity method. *[IAS 27.2]*.

The IASB has collected information about the use of IFRS accounting standards around the world that also provides details on whether different jurisdictions have elected to require or permit entities to present financial statements in accordance with IAS 27.[1]

Accordingly, IFRS accounting standards do not require the preparation of separate financial statements. However, when an investor with subsidiaries, associates or joint ventures does prepare separate financial statements purporting to comply with IFRS accounting standards, they must be prepared in accordance with IAS 27. *[IAS 27.3]*.

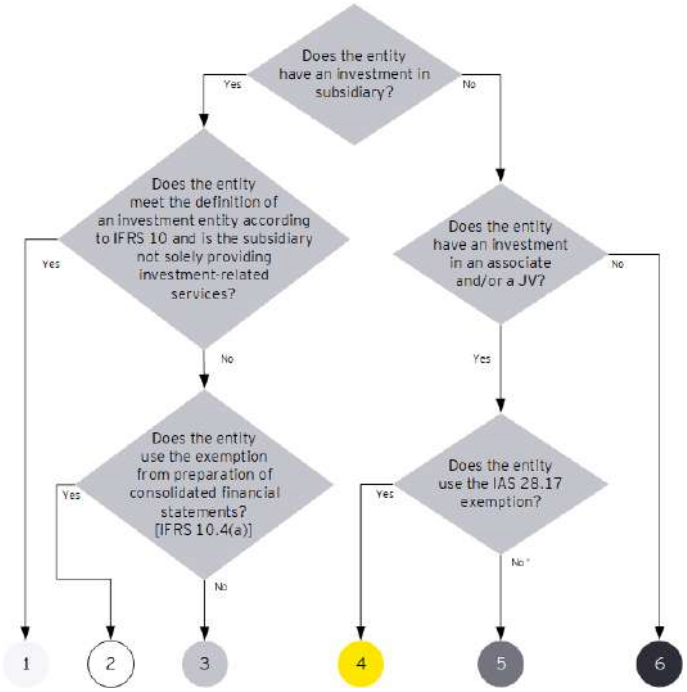
It follows from the definition of separate financial statements above, that the financial statements of an entity that does not have a subsidiary, associate or joint venture are not 'separate financial statements'. *[IAS 27.7]*.

This chapter also addresses matters that are not exclusive to separate financial statements but relate to any stand-alone financial statements prepared by any entity within a group. We have called these 'individual financial statements', although they may also be referred to (amongst other names) as 'stand-alone', 'solus' or 'single-entity' financial statements. The term 'individual financial statements' for the purpose of this chapter is a term that covers (i) financial statements of entities that do not have investments in associates, joint ventures and subsidiaries, and (ii) financial statements of entities that have only investments in associates and/or joint ventures. When an entity has no investments in associates, joint ventures and subsidiaries in both the current and comparative period, effectively there is no difference between individual and separate financial statements of such an entity.

Figure 1-1 below summarises the interactions between consolidated, individual and separate financial statements. This is further discussed in section 1.1 below.

1 *Who uses IFRS Accounting Standards?*, IFRS Foundation's website (accessed 30 September 2023).

Figure 1-1: Interactions between consolidated, individual and separate financial statements



Notes:

1 The entity prepares separate financial statements as its only financial statements. *[IAS 27.8A]*. In this situation IFRS 10 *Consolidated Financial Statements* would require that investments in subsidiaries, associates and/or joint ventures are accounted for in accordance with IFRS 9. Hence, the cost or equity method would not be available as an accounting policy choice to account for investments in subsidiaries, associates and/or joint ventures in the separate financial statements.

2 If the entity is either not an investment entity, or it is an investment entity and has a subsidiary or subsidiaries that provide(s) investment-related services, the entity prepares consolidated financial statements. If the entity makes use of the exemption from preparing consolidated financial statements, the entity may prepare separate financial statements as its only IFRS financial statements. (See section 1.1 below).

3 If the entity is not an investment entity, or it is an investment entity and has a subsidiary or subsidiaries that provide(s) investment-related services, and the entity has not made use of the exemption from preparing consolidated financial statements, the entity prepares consolidated financial statements. In addition, the entity may prepare separate financial statements.

4 If the entity has an investment in an associate and/or a joint venture and the entity has made use of the exemption from applying the equity method to those investments, the entity may prepare separate financial statements as its only financial statements, in which investments in the associate/joint venture are accounted for at cost or in accordance with IFRS 9.

5 The entity prepares individual financial statements and applies the equity method to its investment in an associate and/or a joint venture. Separate financial statements may be prepared in addition wherein the company may elect a different accounting policy to account for its investment in an associate or a joint venture, such as at cost or in accordance with IFRS 9.

6 When an entity has no investments in subsidiaries, associates or joint ventures, the entity's individual financial statements are identical to the separate financial statements. In certain jurisdictions these individual financial statements may be referred to as separate financial statements due to local Companies Act, or similar, naming conventions. However, as they do not have an investment in either a subsidiary, associate or joint venture, they do not meet the definition of separate financial statements in IAS 27. *[IAS 27.7]*.

* The entity may, in certain circumstances (e.g., when the investment is held by, or indirectly through, an entity that is a venture capital organisation or mutual fund), elect to measure an investment in an associate or a joint venture at fair value through profit or loss in accordance with IFRS 9. *[IAS 28.18]*. If the entity elects this policy for all such investments in joint ventures and associates, the financial statements may be referred to as separate financial statements. If the election is not made for one or more investments the financial statements are individual financial statements.

Transactions often take place between a parent entity and its subsidiaries or between subsidiaries within a group that may or may not be carried out at fair value. The objective of IAS 27 is only to prescribe the accounting and disclosure requirements for investments in subsidiaries, joint ventures and associates when an entity prepares separate financial statements. Therefore, there may be uncertainty and ambiguity about how these common control or group transactions should be accounted for. IAS 24 *Related Party Disclosures* requires only that these transactions are disclosed and provides no accounting requirements.

Whilst such transactions do not influence the consolidated financial statements of the ultimate parent (as they are eliminated during consolidation), they can have a significant impact on the individual or separate financial statements of the entities concerned or on the consolidated financial statements prepared for a sub-group.

These issues are discussed in section 4 below.

Differences between the IFRS accounting standards and US GAAP guidance on this topic are not addressed in this chapter as the standards are not converged. Therefore, differences between IFRS accounting standards and US GAAP may exist that are not discussed in this chapter.

1.1 Consolidated financial statements and separate financial statements

A parent is an entity that controls one or more entities. A parent entity, unless exempt, should present consolidated financial statements in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity. *[IFRS 10.4, IFRS 10 Appendix A]*.

Extract from IFRS 10

4 An entity that is a parent shall present consolidated financial statements. This IFRS applies to all entities, except as follows:

(a) a parent need not present consolidated financial statements if it meets all the following conditions:

(i) it is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;

(ii) its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);

(iii) it did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and

(iv) its ultimate or any intermediate parent produces financial statements that are available for public use and comply with IFRSs, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with this IFRS.

This exemption is discussed further in Chapter 7 at section 2.2.1. It should be noted that if the entity chooses to prepare consolidated financial statements even if it is exempted from doing so it must comply with all IFRS accounting standards requirements related to consolidated financial statements.

An entity that avails itself of the above exemption may prepare separate financial statements as its only financial statements. *[IAS 27.8]*. For example, most intermediate holding companies take advantage of this exemption. If such an entity prepares unconsolidated financial statements that are in accordance with IFRS accounting standards, they must comply with the provisions of IAS 27 for such statements and they will then be separate financial statements as defined. The requirements for separate financial statements are dealt with in section 2 below. Certain issues related to timing of issuance of such separate financial statements are also discussed in section 1.1.3. below.

IFRS 10 includes an exception to the consolidation principle for a parent that meets the definition of an investment entity. An investment entity measures its investments in subsidiaries, other than those solely providing services that relate to its investment activities, at fair value through profit or loss in accordance with IFRS 9 instead of consolidating those subsidiaries. The investment entity exception is discussed in Chapter 7 at section 10. Investment entities measure their investments in those subsidiaries in the same way in their separate financial statements as required in the consolidated financial statements. *[IAS 27.11A]*. As a result, IAS 27 clarifies that an investment entity that is required, throughout the current period and all comparative periods presented, to apply the exception to consolidation for all its subsidiaries in accordance with IFRS 10.31 presents separate financial statements as its only financial statements. *[IAS 27.8A, IFRS 10.31]*. An investment entity that prepares separate financial statements as its only financial statements, discloses that fact and presents the disclosures relating to investment entities required by IFRS 12 *Disclosure of Interests in Other Entities* about its interests in subsidiaries. *[IAS 27.16A]*. The exemption from preparing consolidated financial statements, in criterion (iv) above, is available to a parent entity that is a subsidiary of an investment entity, even when the investment entity does not prepare consolidated financial statements but measures its subsidiaries at fair value through profit or loss. *[IFRS 10.BC28A, IFRS 10.BC28B]*.

The requirements to prepare consolidated and separate financial statements are very often subject to local jurisdictional rules regardless of whether these financial statements are prepared in accordance with local GAAP or IFRS accounting standards. However, IFRS 10 provides specific IFRS requirements which need to be considered when financial statements are prepared on the basis of IFRS accounting standards as issued by the IASB. *[IFRS 10.20]*.

How we see it

If a parent does not prepare IFRS consolidated financial statements due to a concession in local law, the parent could not present separate financial statements in compliance with IFRS accounting standards. This is also further discussed in Chapter 7 at section 2.2.5. See section 1.2 below regarding the interrelationship between IFRS accounting standards and local European law in respect of consolidated and separate financial statements.

IFRS 10 requires a parent to consolidate a subsidiary until the date on which the parent ceases to control the subsidiary. *[IFRS 10.20]*.

How we see it

In our view, consolidated financial statements must be prepared by an entity that was a parent during the reporting period, even if that entity is no longer a parent at the end of the reporting period (e.g., because it disposed of all its subsidiaries).

Entities should consider applicable local regulation requirements governing the preparation of IFRS Financial Statements.

1.1.1 Separate financial statements and interests in associates and joint ventures

IAS 28 must be applied by 'all entities that are investors with joint control of, or significant influence over, an investee'. *[IAS 28.2]*. IAS 28 requires that an investment in an associate or a joint venture be accounted for in the entity's separate financial statements in accordance with IAS 27.10. *[IAS 28.44, IAS 27.10]*.

An entity that is an investor may present separate financial statements as its only financial statements if it is a parent that is exempt from preparing consolidated financial statements by the scope exemption in IFRS 10.4(a) (see above). *[IFRS 10.4(a)]*. If it does not have subsidiaries it may still present separate financial statements as its only financial statements if the same criteria as in (i)-(iv) above apply (they are replicated in IAS 28.17) and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the entity not applying the equity method to its investees. *[IAS 28.17]*.

A parent cannot prepare financial statements in purported compliance with IFRS accounting standards in which subsidiaries are consolidated but associates and joint ventures are not accounted for under IAS 28 but on some other basis (e.g., at cost). Financial statements prepared on such a basis would be neither consolidated financial statements (because of the failure to apply IAS 28) nor separate financial statements (because of the failure to account for subsidiaries on the basis of the direct equity interest).

The conditions for exemption in IAS 28.17 mentioned above are the same as those in IFRS 10. This means that (as illustrated in Figure 1-1 in section 1 above):

- An entity that has subsidiaries and is exempt under IFRS 10 from preparing consolidated accounts is automatically exempt in respect of its associates or joint ventures as well, i.e., it does not account for them under IAS 28.
- An entity that has associates or joint ventures, but no subsidiaries, and does not meet all the exemption criteria in section 1.1 above, is required to apply equity accounting to its associates in its own (non-consolidated) financial statements. Such non-consolidated financial statements include the investment in the associate or joint venture on the basis of the reported results and net assets of the investment. Unless the entity opts to account for all associates or joint ventures using the equity method in its separate financial statements (see section 2.3 below) such non-consolidated financial statements are *not* 'separate financial statements' as defined in IAS 27 (see definition above) and therefore do not have to meet the additional measurement and disclosure requirements required by IAS 27 for separate financial statements that are described in section 3 below to comply with IFRS accounting standards. If such an entity also presents separate financial statements, the Board expects that the entity is likely to account for its investments in associates or joint ventures either at cost or in accordance with IFRS 9. *[IAS 27.BC10D]*.

Although IAS 27 also allows for a policy to use the equity method to account for investments in associates and joint ventures in the separate financial statements, this could be different to some national GAAPs, under which investors that have no subsidiaries (and therefore, do not prepare consolidated financial statements) but have associates or joint ventures, are not permitted to account for their share of the profits and net assets of associates or joint ventures in their statutory financial statements.

How we see it

We believe an entity that has held investments in associates and/or joint ventures during the reporting period is required to prepare individual financial statements at the end of period in which any such investments were sold or otherwise disposed of. This is the case even if they are the only investments of the investor and these investments were sold during the period.

Entities should consider applicable local regulation requirements governing the preparation of IFRS Financial Statements.

1.1.2 Separate financial statements and interests in joint operations

IFRS 11 *Joint Arrangements* differentiates between joint operations and joint ventures. In the separate financial statements, joint ventures are accounted for at cost, in accordance with IFRS 9, or using the equity method as required by IAS 27.10. A joint operator applies paragraphs 20 to 22 of IFRS 11 to account for a joint operation. *[IFRS 11.26]*. This means that regardless of the type of financial statements prepared, the joint operator in a joint operation recognises in relation to the joint operation its:

- Assets, including its share of any assets held jointly
- Liabilities, including its share of any liabilities incurred jointly
- Revenue from the sale of its share of the output arising from the joint operation
- Share of the revenue from the sale of the output by the joint operation

  And
- Expenses, including its share of any expenses incurred jointly *[IFRS 11.20]*

Similarly, in its individual financial statements, a party that participates in, but does not have joint control of, a joint operation, accounts for its interest as outlined above provided it has rights to the assets and obligations for the liabilities, relating to the joint operation (see Chapter 12 at section 6.4). *[IFRS 11.23]*.

In March 2015, the IFRS IC published a number of agenda decisions relating to IFRS 11. The following two are relevant to separate financial statements:[2]

Frequently asked questions

Question 1-1: How does a joint operator, in its separate financial statements, account for its share of the assets and liabilities of a joint operation when it is structured through a separate vehicle?

The IFRS IC noted that IFRS 11 requires the joint operator to account for its rights and obligations in relation to the joint operation. It also noted that those rights and obligations, in respect of that interest, are the same regardless of whether separate or consolidated financial statements are prepared, by referring to IFRS 11.26. *[IFRS 11.26]*. Consequently, the same accounting is required in the consolidated financial statements and in the separate financial statements of the joint operator.

The IFRS IC also noted that IFRS 11 requires the joint operator to account for its rights and obligations, which are its share of the assets held by the entity and its share of the liabilities incurred by it. Accordingly, the IFRS IC observed that the joint operator would not additionally (in its separate or consolidated financial statements) account for its shareholding in the separate vehicle, whether at cost or fair value.

2 *IFRIC Update*, March 2015, p.11. Available on the IFRS Foundation's website.

Frequently asked questions

Question 1-2: How does a joint operation that is a separate vehicle account for its share of assets and liabilities in its separate financial statements?

This issue has arisen because the recognition by joint operators in both consolidated and separate financial statements of their share of assets and liabilities held by the joint operation leads to the question of whether those same assets and liabilities should also be recognised in the financial statements of the joint operation itself. The IFRS IC decided not to add the issue to its agenda, because sufficient guidance exists:[3]

(a) IFRS 11 applies only to the accounting by the joint operators and not to the accounting by a separate vehicle that is a joint operation.

(b) The financial statements of the separate vehicle would therefore be prepared in accordance with applicable Standards.

And

(c) Company law often requires a legal entity/separate vehicle to prepare financial statements. Consequently, the reporting entity for the financial statements would include the assets, liabilities, revenues and expenses of that legal entity/separate vehicle. However, when identifying the assets and liabilities of the separate vehicle, it is necessary to understand the joint operators' rights and obligations relating to those assets and liabilities and how those rights and obligations affect those assets and liabilities.

1.1.3 Issuing separate financial statements without consolidated financial statements or financial statements in which investments in associates or joint ventures are equity accounted

IAS 27 does not directly address the issuance requirements for separate financial statements. In some jurisdictions, an entity that prepares consolidated financial statements is prohibited from issuing its separate financial statements without also publishing its consolidated financial statements.

How we see it

In our view, an entity that prepares consolidated financial statements can issue its separate financial statements compliant with IAS 27 without also issuing its consolidated financial statements, provided that certain criteria are met as discussed below.

The same conditions should be applied by an entity having no subsidiaries that prepares financial statements in which investments in associates or joint ventures are equity accounted for but issues its separate financial statements (in which the investments in associates and joint ventures are not equity accounted) without also issuing its financial statements in which investments in associates or joint ventures are equity accounted.

Separate financial statements of a parent entity can also be considered compliant with IAS 27 when the exemption to present consolidated financial statements criteria in IFRS 10.4(a) are met. *[IFRS 10.4(a)]*.

An entity would have to meet the following criteria to issue separate financial statements without also issuing consolidated financial statements:

(a) The separate financial statements identify the consolidated financial statements prepared under IFRS 10 to which they relate. *[IAS 27.17]*. In other words, they must draw attention to the fact that the entity also prepares consolidated financial statements and disclose the address where the consolidated financial statements are available, for example, by providing contact details of a person or an e-mail address from which a hard copy of the document can be obtained or a website address where the consolidated financial statements can be found and downloaded.

And

(b) The consolidated financial statements have been prepared and approved no later than the date on which the separate financial statements have been approved. Thus, it is not possible to issue the separate financial statements before the consolidated financial statements have been finalised.

3 *IFRIC Update*, March 2015, p.11. Available on the IFRS Foundation's website.

IAS 27 requires a parent to identify the consolidated financial statements prepared by the parent where the parent is not exempt from preparing consolidated financial statements. *[IAS 27.17]*. Therefore, if the parent, or ultimate or intermediate parent, has not issued consolidated financial statements prepared in accordance with IFRS accounting standards at the date the separate financial statements are issued, this requirement cannot be met and therefore the separate financial statements cannot be considered to be in compliance with IAS 27. This will also be the case if the consolidated financial statements are prepared, but are not in accordance with IFRS accounting standards (e.g., prepared in accordance with local GAAP).

Frequently asked questions

Question 1-3: Can separate financial statements be issued before the respective consolidated financial statements?

The matter of whether separate financial statements can be issued before the respective consolidated financial statements was explicitly considered by the IFRS IC in March 2006. The IFRS IC concluded that separate financial statements issued before consolidated financial statements could not comply with IFRS accounting standards as issued by the IASB, because "separate financial statements should identify the financial statements prepared in accordance with paragraph 9 of IAS 27 to which they relate (the consolidated financial statements), unless one of the exemptions provided by paragraph 10 is applicable".[4] *[IAS 27.9, IAS 27.10]*. Although IAS 27 has changed since the IFRS IC considered that issue, the current version of IAS 27 still requires separate financial statements to identify financial statements prepared in accordance with IFRS 10, IFRS 11 or IAS 28. *[IAS 27.17]*. It therefore implies that consolidated financial statements should be available before or at the same date as separate financial statements. However, the situation may be different if local requirements set specific rules relating to the timing of publication of financial statements. This is for example, the case for an entity that is incorporated in the European Union (EU), as described in section 1.2 below.

Whilst the conclusion reached by the IFRS IC is applicable to a parent that prepares consolidated financial statements, there are mixed views about whether it is applicable by analogy to an entity that is exempted from consolidation in accordance with IFRS 10.4(a), or from applying the equity method in accordance with IAS 28.17 and hence, whether these entities may present separate financial statements as their only financial statements (e.g., intermediate holding companies). *[IFRS 10.4(a), IAS 28.17]*. Some argue that such intermediate holding companies that use the exemption cannot issue their separate financial statements before the IFRS consolidated financial statements of the parent are issued and available for use as they are required to disclose where such consolidated financial statements are obtainable. *[IAS 27.16]*. Others believe that the parent's consolidated financial statements must be periodically produced and be available for public use. Due to the lack of clear guidance, the determination of an acceptable approach may need to consider specific facts and circumstances such as local regulatory requirements and the timing between the issuance of the intermediate parent's separate financial statements and its parent's consolidated financial statements.

1.2 Entities incorporated in the EU and consolidated and separate financial statements

The EU Regulation on International Accounting Standards requires IFRS accounting standards to be applied by certain entities in their consolidated financial statements. As a result of the EU endorsement mechanism, IFRS accounting standards as adopted by the EU may differ in some respects from the body of Standards and Interpretations issued by the IASB (see Chapter 1 at section 4.2.1). In some circumstances a difference between IFRS accounting standards and IFRS accounting standards as adopted by the European Union may affect separate financial statements.

4 *IFRIC Update*, March 2006, p.7. Available on the IFRS Foundation's website.

The IFRS IC concluded that separate financial statements issued before consolidated financial statements cannot comply with IFRS accounting standards as issued by the IASB (see Question 1-3 in section 1.1.3 above). However, in January 2007 the European Commission stated that "the Commission Services are of the opinion that, if a company chooses or is required to prepare its annual accounts in accordance with IFRS accounting standards as adopted by the EU, it can prepare and file them independently from the preparation and filing of its consolidated accounts - and thus in advance, where the national law transposing the Directives requires or permits separate publication".[5] In other words, under 'IFRS accounting standards as adopted by the EU' it may be possible to issue separate financial statements before the consolidated financial statements are issued. The details about differences between scope of consolidation under IFRS 10 and European Union national legislation are described in Chapter 7 at section 2.2.5.

5 Agenda paper for the meeting of the Accounting Regulatory Committee on 2nd February 2007 (document ARC/08/2007), Subject: Relationship between the IAS Regulation and the 4th and 7th Company Law Directives - Can a company preparing both individual and consolidated accounts in accordance with adopted IFRS issue the individual accounts before the consolidated accounts?, European Commission: Internal Market and Services DG: Free movement of capital, company law and corporate governance: Accounting/PB D(2006), 15 January 2007, para. 3.1.

2 Requirements of separate financial statements

In separate financial statements, investments in subsidiaries, associates and joint ventures are accounted for either:

- At cost (see section 2.1 below)
- In accordance with IFRS 9 (see section 2.2 below)

  Or
- Using the equity method as described in IAS 28 (see section 2.3 below)

The above applies to all situations except when such investments are classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. When this is the case, investments in subsidiaries, associates and joint ventures that are accounted for at cost, or using the equity method in the separate financial statements, are measured in accordance with IFRS 5, *[IAS 27.10]*, i.e., at the lower of carrying amount and fair value less costs to sell (see Chapter 5). Investments that are accounted for in accordance with IFRS 9 in the separate financial statements and which are classified as held for sale continue to be measured in accordance with IFRS 9 (see Chapter 5 at section 2.2.1).

Each 'category' of investment must be accounted for consistently. *[IAS 27.10]*.

'Category' is not defined in IFRS accounting standards but is used in a number of Standards. For example, IFRS 7 *Financial Instruments: Disclosures* uses 'category' to refer to groupings of financial assets and financial liabilities that are measured in different ways - for example, financial assets measured at fair value through profit or loss is one category of financial asset and financial assets measured at amortised cost is another category of financial asset. While acknowledging this in the Basis for Conclusions of the Annual Improvements 2014 - 2016 Cycle issued in 2016, the IASB clarified that paragraph 10 of IAS 27 should not be read to mean that, in all circumstances, all investments in associates are one 'category' of investment, and that all investments in joint ventures are one 'category' of investment. Accordingly, determining multiple categories for each class of investments is not precluded under IFRS accounting standards in all circumstances.

Furthermore, while the Annual Improvements 2014-2016 cycle and the related Basis for Conclusions refer to investments in associates and joint ventures, rather than investments in subsidiaries, the same logic could be extended to investments in subsidiaries, given that the accounting treatment of all these investments in the separate financial statements of the parent entity is defined in the same paragraph 10 of IAS 27.

When an entity applies the concept of category more granularly, the determination of categories should be based on clear and objective criteria that results in information that is relevant and reliable. An entity could consider, for instance, the guidance in IFRS 7 above or its business model as in the case of investment entities (as discussed below). However, we believe that in identifying categories more granularly an entity shall not consider in isolation only a few criteria such as an investments geography or type of products sold. Judgement is exercised to define criteria to identify categories more granularly.

In applying a consistent policy to each category of investment, we believe IAS 27 would consider the categorisation of investments in subsidiaries, separate to associates and joint ventures; therefore, categorisation and the measurement of similar categories does not need to be consistent between classes of investments.

How we see it

While 'category' is not defined, we believe that investments in subsidiaries, associates, and joint ventures can be further divided into more granular categories, only if a category can be defined clearly and objectively and results in information that is relevant and reliable.

Judgement is exercised to define criteria to identify categories more granularly and should be consistently applied.

When an investment in an associate or joint venture is accounted for in accordance with IFRS 9 in the consolidated financial statements, it must also be accounted for in the same way in the separate financial statements. *[IAS 27.11]*. The circumstances in which IFRS 9 is applied to account for investments in associates and joint ventures in consolidated financial statements are discussed in Chapter 12 at section 5 and Chapter 13 at section 2.2, respectively.

A parent that meets the definition of an investment entity is required to measure its investments in particular subsidiaries at fair value through profit or loss in accordance with IFRS 9 in its consolidated financial statements, *[IFRS 10.31]*, and is required to account for them in the same way in the separate financial statements. *[IAS 27.11A]*. When an investment entity parent has shares in subsidiaries that only provide investment related services (and therefore are not subject to mandatory fair value measurement), that parent effectively has shares in two categories of subsidiaries. It therefore, has an accounting policy choice to account for those subsidiaries that only provide investment related services at cost, in accordance with IFRS 9, or using the equity method in its separate financial statements.

When an entity becomes an investment entity, the difference between the previous carrying value of the investment in a subsidiary and its fair value at the date of change in status of the parent is recognised as a gain or loss in profit or loss. When a parent ceases to be an investment entity, it should follow IAS 27.10 and account for the investment in a subsidiary either at cost (the then fair value of the subsidiary at the date of the change in the status becomes the deemed cost), continue to account for the investment in accordance with IFRS 9, or apply the equity method. *[IAS 27.10, IAS 27.11B]*.

IAS 27 contains specific requirements related to the treatment of dividends from investments in subsidiaries, joint ventures or associates. Such dividends are recognised in profit or loss unless the entity elects to use equity method, in which case the dividend is recognised as a reduction of the carrying amount of the investment. *[IAS 27.12]*. IAS 36 *Impairment of Assets* includes specific triggers for impairment reviews on receipt of such dividends. These are discussed in section 2.4.1 below.

2.1 Cost method

There is no general definition or description of 'cost' in IAS 27. How the term applies in practice is described in section 2.1.1 below.

IAS 27 addresses the cost of investment in a new holding company that becomes the parent of an existing parent in a one-for-one share exchange. This is discussed further in sections 2.1.1.E and 2.1.1.F below.

IAS 27 also indicates that when an entity ceases to be an investment entity and its accounting policy is to account for investments in subsidiaries, associates or joint ventures at cost, the fair value as at the date of the change in status shall be used as the deemed cost. *[IAS 27.11B]*.

IFRS 1 *First-time Adoption of International Financial Reporting Standards* allows use of a 'deemed cost' as a transitional exemption for those applying IFRS accounting standards for the first time in separate financial statements (see section 2.1.2 below).

2.1.1 Cost of investment

IAS 27 does not define what is meant by 'cost' except in the specific circumstances of certain types of group reorganisations, described below, and when an entity ceases to be an investment entity and accounts for investments in subsidiaries at cost as indicated above.

'Consideration given' is likewise not defined.

As discussed further in Chapter 3 at section 4.3, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that, in the absence of specific requirements in IFRS accounting standards, management should first refer to the requirements and guidance in IFRS accounting standards that deal with similar and related issues.

The glossary to IFRS accounting standards defines cost as "the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction".

How we see it

When considering what is meant by 'cost' in IAS 27 we believe that in applying IAS 8 the key sources of guidance in IFRS accounting standards are:

- 'Consideration transferred' in the context of a business combination, as referred to in paragraph 37 of IFRS 3 *Business Combinations*
- 'Cost' as applied in relation to acquisitions of property, plant and equipment in accordance with IAS 16 *Property, Plant and Equipment*, intangible assets in accordance with IAS 38 *Intangible Assets* and investment property in accordance with IAS 40 *Investment Property*

  And
- 'Cost' in the context of determination of the cost of an investment in an associate as discussed in the agenda decision issued by the IFRS IC in July 2009

Applying the requirements of IFRS 3, the 'consideration transferred' in a business combination comprises the sum of the acquisition-date fair values of assets transferred by the acquirer, liabilities incurred by the acquirer to the former owners of the acquiree, and equity interests issued by the acquirer. *[IFRS 3.37]*. This includes any liability (or asset) for contingent consideration, which is measured and recognised at fair value at the acquisition date. Subsequent changes in the measurement of the changes in the liability (or asset) are recognised in profit or loss (see Chapter 10 at section 7.1).

'Cost' as applied in relation to acquisitions of property, plant and equipment is the amount of cash or cash equivalents paid, or the fair value of the other consideration given, to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRS accounting standards, e.g., IFRS 2 *Share-based Payment*. *[IAS 16.6]*.

The IFRS IC and IASB have discussed the topic *Variable payments for the separate acquisition of PPE and intangible assets* for a few years, attempting to clarify how the initial recognition of the variable payments, such as contingent consideration, and subsequent changes in the value of those payments should be recognised. The scope of the past deliberations did not specifically include the cost of an investment in a subsidiary, associate, or joint venture. However, as they considered general principles about the recognition of variable payments, we believe they can also be considered relevant in determining the cost of such investments.

There was diversity of views about whether the liability for contingent consideration relating to the separate acquisition of property, plant and equipment and intangible assets falls within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* or within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* (this is still relevant after IFRS 9 adoption as well). This diversity of views affects the initial recognition and subsequent accounting for changes in the value of the contingent consideration. The issue was discussed by the IFRS IC in the past however it was considered too broad to be addressed and was referred to the IASB.[6]

A critical step in analysing the accounting for variable or contingent consideration in a transaction to acquire an investment in the scope of IAS 27 is to fully understand the contractual arrangements, understanding the nature of the contingent or variable payments. This includes developing a full understanding of whether those contingent payments are linked to the initial value of the asset, or to its future performance, whether the contingency or variability is within or outside of the purchaser's control and whether the variable payment is a payment for some other goods or services from the seller. In some cases, the contract may establish an obligation for the contingent payment at the outset, whilst in others it might be determined that the arrangement is an executory contract, and the liability to make the contingent payments is only recognised later once either party fulfils its obligations under the contract.

The two key issues with regards to the accounting for variable consideration in an asset purchase are 1) whether and when to recognise a liability for that variable consideration, and 2) whether subsequent changes to the estimate of variable or contingent consideration should be accounted for as part of the cost of the acquired asset (see Chapter 19 at section 4.1.9).

Looking at the first question of when a liability to make variable or contingent payments would be recognised, if the arrangement is not considered to be an executory contract, one consideration is whether those payments are dependent on the entity's future activity, or not. IAS 32.25 stipulates that where the contingency is outside the control of both the issuer and the holder, a contingent obligation to deliver cash meets the definition of a financial liability (see Chapter 43 at section 4.3). Therefore, if the obligation to make the variable payment does not depend on the acquiring entity's future activity, it would seem appropriate to recognise a financial liability in respect of the contingent amounts. *[IAS 32.25]*. However, it is acknowledged that whilst this view was tentatively agreed during the course of the IFRS IC discussions on the topic, ultimately, this was not clarified or confirmed as part of the final agenda decision. Furthermore, the final agenda decision notes that there are questions about the accounting for variable payments subsequent to the purchase of the asset, and in making that statement the IFRS IC did not distinguish between the different types of variable payments.

6 *IFRIC Update*, March 2016, p.5. Available on the IFRS Foundation's website.

How we see it

In light of the discussions held by the IFRS IC and the absence of clear guidance in the final agenda decision, entities will need to develop and apply an accounting policy in respect of whether and when the obligation to make contingent payments is recognised as a liability. In doing so, entities will need to apply the hierarchy in IAS 8. The policy selected should result in information that is relevant and reliable in the particular circumstances and must be consistently applied to similar transactions. Different payments may have different types of variability. Therefore, it might be appropriate for an entity to have different policies for dissimilar transactions.

If information about the selected accounting policy is expected to be material to users of the financial statements, that accounting policy information should be disclosed.

As described above, there is no explicit guidance on the treatment of variable or contingent consideration in the acquisition of an asset and there is diversity in practice for these types of arrangements. Therefore, examples of some accounting policies an entity may want to consider regarding initial recognition of the asset include the following:

- The cost of the asset on initial recognition includes the fair value of all variable or contingent consideration at the date of acquisition. A corresponding liability is recognised for the same amount.
- The cost of the asset on initial recognition excludes any variable or contingent payments. Accordingly, no liability is recognised for those contingent or variable amounts.

The second question that needs to be addressed is how the entity accounts for subsequent payments and changes to the estimate of variable or contingent consideration. Depending on the facts and circumstances of the arrangement an entity may determine that:

1) Variability arises from exchange rates, time value of money, or embedded derivatives - Changes in the carrying amount of a recognised liability that arise from exchange rates are accounted for in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates* and IFRIC 22 *Foreign Currency Transactions and Advance Consideration*, while the time value of money and embedded derivatives are accounted for in accordance with IFRS 9;
2) Variability is directly linked to the quality or quantity of the asset(s) received - In these cases the initial recognition of the asset and liability were based on an accounting estimate that is subsequently updated in accordance with IAS 8.37; or
3) The variability in the arrangement does not fall under (1) or (2) above and an accounting policy needs to be developed to address it.

In the latter case, an entity will need to apply the requirements of IAS 8 to develop an accounting policy that it should apply consistently to all similar transactions. The accounting policy developed will need to address whether the change in the estimate of variable or contingent consideration should be capitalised as part of the cost of the asset or expensed. This determination is usually based on the reason for the contingent payment and entities should consider the substance of the arrangement in determining the appropriate treatment.

How we see it

Until this matter is resolved by the IASB, where the accounting for the variability or contingency is not prescribed in another standard, an entity should adopt and apply a consistent accounting policy in relation to whether subsequent payments or changes to the measurement of a recognised liability to make contingent or variable payments are included as part of the cost of the investment or expensed as incurred, in accordance with the hierarchy in IAS 8.

An entity should exercise judgement in developing and consistently applying an accounting policy that results in information that is relevant and reliable in the particular circumstances.

If information about the selected accounting policy is expected to be material to users of the financial statements, that accounting policy information should be disclosed.

Similar challenges to the above arise when the seller in a business combination contractually agrees to indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability (see Chapter 10 at section 5.6.4). Such indemnification agreements often relate to uncertain tax positions or litigations. Whilst there is guidance about how to deal with the resulting indemnification assets in the consolidated financial statements of the acquirer, there is no comparable guidance about the accounting of such indemnification agreements in the separate financial statements of the acquirer.

How we see it

We believe that as these indemnification assets have some similarities to contingent consideration, an entity can apply the guidance explained in the box above by analogy in developing its accounting policy for indemnification agreements.

Contingent consideration is discussed in relation to intangible assets, property, plant and equipment and investment property in Chapter 18 at section 4.5, Chapter 19 at section 4.1.9 and Chapter 20 at section 4.10 respectively.

Frequently asked questions

Question 2-1: How are transactions costs relating to the acquisition of an investment in a subsidiary, associate or joint venture treated in the separate financial statements?

In July 2009, the IFRS IC discussed the determination of the initial carrying amount of an equity method investment, which under IAS 28 is at cost, and noted that IFRS accounting standards consistently require assets not measured at fair value through profit or loss to be measured on initial recognition at cost. Generally stated, 'cost' includes the purchase price and other costs directly attributable to the acquisition or issuance of the asset such as professional fees for legal services, transfer taxes and other transaction costs.[7]

How we see it

Given that IAS 27 does not separately define 'cost', we believe it is appropriate to apply a general meaning of 'cost' in determining the cost of investments in subsidiaries, associates or joint ventures in separate financial statements based on the IFRS IC discussion in July 2009. Consequently, we believe that the cost of investment in a subsidiary in the separate financial statements includes any transaction costs incurred even though such costs are expensed in the consolidated financial statements.

2.1.1.A Investments acquired for own shares or other equity instruments

This section relates to the acquisition of an investment in exchange for own shares and other equity instruments. Guidance on the acquisition of an investment in exchange for an owned investment is dealt in section 4.4.1.B below. Transfers of assets in group restructuring arrangements may fall in the scope of IFRS 2 (see Chapter 30 at section 2.2.3.B); further guidance is also included in section 4.4.1 below in this Chapter.

In some jurisdictions, local law may permit investments acquired for an issue of shares to be recorded at a notional value (for example, the nominal value of the shares issued). In our view, this is not an appropriate measure of 'cost' under IFRS accounting standards.

How we see it

In our view, an investment in a subsidiary, associate or joint venture acquired in exchange for an issue of shares or other equity instruments is recorded at the fair value of the consideration given (being the fair value of equity instruments issued) or the assets received, if that could be more reliably measured, together with directly attributable transaction costs.

A transaction in which an investment in a subsidiary, associate or joint venture is acquired in exchange for an issue of shares or other equity instruments is not specifically addressed under IFRS accounting standards, since it falls outside the scope of both IFRS 9 and IFRS 2 (see Chapter 30 at section 2.2.3.F).

2.1.1.B Investments acquired in common control transactions

An investment in a subsidiary, associate or joint venture could also be acquired in a common control transaction. Section 4.4.1 below discusses transactions between entities under common control involving non-monetary assets, while section 4.4 below discusses the concept of substance that can be relevant when analysing similar transactions.

7 *IFRIC Update*, July 2009, p.3. Available on the IFRS Foundation's website.

How we see it

When an investment in a subsidiary, associate or joint venture is acquired in a common control transaction, in our view, the cost is generally measured at the fair value of the consideration given (be it cash, other assets or additional shares) plus, where applicable, any costs directly attributable to the acquisition. However, when the purchase consideration does not correspond to the fair value of the investment acquired, in our view, the acquirer has an accounting policy choice to account for the investment at the fair value of consideration given or can impute an equity contribution or dividend distribution and in effect account for the investment at its fair value.

Illustration 2-1 below illustrates the determination of the cost of an investment in a subsidiary in separate financial statements as described above.

Illustration 2-1: Cost of a subsidiary in separate financial statements when the pooling of interest method is applied in consolidated financial statements

Parent has a 100% direct interest in Sub 1 and Sub 2. As part of a group reorganisation, the parent transfers its direct interest in Sub 2 to Sub 1 in exchange for consideration of:

Scenario 1 - CU200 (equal to the fair value of Sub 2).

Scenario 2 - CU150.

The carrying amount of the investment in Sub 2 in the separate financial statements of Parent is CU50. The carrying amount of Sub 2's net assets in the separate financial statements of Sub 2 is CU110.

Sub 1 accounts for the acquisition of Sub 2 using the pooling of interest method in its consolidated financial statements.

In Scenario 1, the cost of an investment in a subsidiary that is acquired as part of a group reorganisation is the fair value of the consideration given (be it cash, other assets, or additional shares), plus, where applicable, any costs directly attributable to the acquisition. Therefore, the cost to Sub 1 is CU200. The cost is not the carrying amount of the investment in Sub 2 in the separate financial statements of Parent (i.e., CU50), nor the carrying amount of Sub 2's net assets in the separate financial statements of Sub 2 (i.e., CU110).

In Scenario 2, the conclusion in Scenario 1 applies even if the fair value of the consideration given is less than the fair value of the acquiree. Therefore, the cost of investment is CU150. However, the acquirer may choose to recognise an equity element (equity contribution). In this case, the cost of investment is CU200 with CU50 recognised as an equity contribution.

Frequently asked questions

Question 2-2: How does a new intermediate parent established within a group determine the cost of its investments in subsidiaries when it accounts for those investments at cost in accordance with IAS 27.10(a)?

In July and September 2011, the IFRS IC discussed group reorganisations in separate financial statements in response to a request asking for clarification on how entities that are established as new intermediate parents within a group determine the cost of their investments in subsidiaries when they account for those investments at cost in accordance with IAS 27.10(a). In the agenda decision issued, the IFRS IC noted that the normal basis for determining the cost of an investment in a subsidiary under IAS 27.10(a) has to be applied to reorganisations that result in the new intermediate parent having more than one direct subsidiary.[8] *[IAS 27.10(a)]*.

Some have read this to mean that 'the normal basis for determining the cost of investment' in a common control transaction is not restricted to using the fair value of the consideration given, but that another basis for determining cost may be appropriate.

How we see it

One situation when we believe that it would be acceptable not to use the fair value of the consideration given is for a common control transaction in which an investment in a subsidiary constituting a business is acquired in a share-for-share exchange. In that circumstance, we believe that it is also acceptable to measure the cost based on the carrying amount of the investment in the subsidiary in the transferor entity's separate financial statements immediately prior to the transaction, rather than at the fair value of the shares given as consideration. This approach is conceptually based on the pooling of interest approach that is allowed for business combinations under common control (see Chapter 11 at section 3).

8 *IFRIC Update*, September 2011, p.3. Available on the IFRS Foundation's website.

Common control transactions are discussed further in section 4 below. There are specific measurement requirements applicable to certain arrangements involving the formation of a new parent or intermediate parent, which are described in sections 2.1.1.E and 2.1.1.F below.

2.1.1.C Cost of investment in subsidiary, associate or joint venture acquired in stages

It may be that an investment in a subsidiary, associate or joint venture is acquired in stages and that, up to the date on which control, significant influence or joint control is first achieved, the initial investment was accounted for at fair value under IFRS 9. This raises the question of what the carrying amount should be in the separate financial statements when the cost method is applied.

Frequently asked questions

Question 2-3: How does an entity account for an acquired additional interest in the investee (that is not an associate, joint venture, or subsidiary of the entity) which results in the entity obtaining control of the investee i.e., the investee becomes a subsidiary of the entity?

In January 2019, the IFRS IC discussed the following fact pattern: the entity holds an initial investment in another entity (investee) that is an investment in an equity instrument as defined in paragraph 11 of IAS 32 *Financial Instruments: Presentation*; the investee is not an associate, joint venture or subsidiary of the entity and, accordingly, the entity applies IFRS 9 in accounting for its initial investment (initial interest). Subsequently the entity acquires an additional interest in the investee (additional interest), which results in the entity obtaining control of the investee, i.e., the investee becomes a subsidiary of the entity.

The IFRS IC observed that IAS 27 does not define 'cost', nor does it specify how an entity determines the cost of an investment acquired in stages and concluded that a reasonable reading of the requirements in IFRS accounting standards could result in the application of either one of the following two approaches:

- Approach 1 *Fair value as deemed cost approach*

  Under this approach, the transaction is viewed as if the entity is exchanging its initial interest (plus consideration paid for the additional interest) for a controlling interest in the investee (exchange view). As a result, the cost of investment will be determined as the fair value of the initial interest at the date of obtaining control of the subsidiary, plus any consideration paid for the additional interest.
- Approach 2 *Accumulated cost approach*

  Under this approach, the transaction is viewed as if the entity is purchasing the additional interest while retaining the initial interest (non-exchange view). As a result, the cost of investment will be determined as the consideration paid for the initial interest (original consideration), plus any consideration paid for the additional interest.

In the exchange view the step acquisition transaction is considered a significant economic event - this is because an entity obtains control. The parallel can be drawn, for example, to a business combination achieved in stages, *[IFRS 3.BC384],* or an entity that ceases to be an investment entity. *[IFRS 10.BC271]*. In these situations, the fair value of the existing investment is deemed to be the consideration paid at the date of the transaction or event.

Alternatively, the accumulated cost approach considers both the initial acquisition of an interest that is neither an interest in a subsidiary, an associate or a joint venture, and the acquisition of the controlling stake to be separate transactions.

The application of either one of the two approaches is an accounting policy choice and hence it should be applied consistently to all step acquisition transactions. The selected approach is disclosed in accordance with requirements of paragraphs 117-124 of IAS 1 *Presentation of Financial Statements*. *[IAS 1.117-124]*.

Although both approaches are acceptable, the IFRS IC decided to report to the Board that, in their view, the fair value as deemed cost approach would provide more useful information to users of financial statements than the accumulated cost approach.[9]

The IFRS IC also considered how an entity should account for any difference between the fair value of the initial interest at the date of obtaining control and its original consideration when applying the accumulated cost approach. The IFRS IC concluded that the difference meets the definitions of income or expense in the *Conceptual Framework for Financial Reporting*. Accordingly, the IFRS IC concluded that, the entity recognises this difference in profit or loss, regardless of whether, before obtaining control, the investment had been measured at fair value through profit and loss or fair value through other comprehensive income, in accordance with IAS 1.88. *[IAS 1.88]*.

9 *IFRIC Update*, January 2019, p.8. Available on the IFRS Foundation's website.

The two approaches are further explained in the following Illustration 2-2:

Illustration 2-2: Cost of a subsidiary acquired in stages

Entity A has a 10% interest in Entity B, which it acquired in January 20X2 for CU300. This investment is a financial asset measured at fair value in accordance with IFRS 9, in both the consolidated and separate financial statements of Entity A for the six months ended 30 June 20X2. On 1 July 20X2, Entity A acquires a further 45% interest in Entity B for CU2,160 (its then fair value), giving Entity A control over Entity B. The original 10% interest has a fair value of CU480 at that date. In addition, transaction costs were incurred amounting to CU50.

Approach 1 - Fair value as deemed cost approach

The cost of investment after both transactions is the sum of the fair value of the initial interest at the date of obtaining control of the subsidiary plus any consideration paid for the additional interest plus transaction costs - CU2,690 (CU480 + CU2,160 + CU50).

Approach 2 - Accumulated cost approach

The cost of investment after both transactions is the sum of the consideration given for each tranche plus transaction costs - CU2,510 (CU300 + CU2,160 + CU50). The reversal of increase in the fair value of CU180 (CU480 - CU300) relating to the initial 10% interest is recognised in profit or loss, regardless of whether the entity accounted for the initial interest at fair value through other comprehensive income or at fair value through profit or loss.

If changes to the carrying amount of the investment had resulted from an impairment charge, this charge may not necessarily be reversed. This is because the investment must still be considered for impairment in the separate financial statements of the investor.

How we see it

Although the January 2019 agenda decision discussed above does not deal with IAS 28, we believe that based on this agenda decision, the fair value as deemed cost approach and the accumulated cost approach could also be applied by analogy to step acquisition transactions in which an existing investment accounted for under IFRS 9 subsequently becomes an associate or a joint venture, to which the equity method is applied.

2.1.1.D Investment in a subsidiary accounted for at cost: partial disposal

An entity that accounts for its investments in subsidiaries at cost in accordance with IAS 27.10 may dispose of parts of its investment in a subsidiary so that following the disposal the entity either maintains control or has joint control or significant influence over the investee. This raises the question of how the carrying amount of the retained interest should be determined in the separate financial statements.

How we see it

When the cost method is applied to all investments in subsidiaries, associates, and joint ventures we believe that no remeasurement of cost should occur on reclassification between types of investments. As a result, the change in the carrying amount of the investment should be proportionate to the part disposed of.

IAS 27 does not define cost (see section 2.1 above) and consequently there is no specific guidance on how to calculate the cost of investments in subsidiaries for derecognition purposes. IFRS 9 also contains no specific guidance for the purpose of derecognition of financial assets. Under IAS 39, which was also silent on this topic, entities chose between three cost allocation methods for available-for-sale securities: the average cost method, the first-in-first-out (FIFO) method, or the specific identification method. Specific identification can be applied if the entity is able to identify the specific items sold and their costs. For example, a specific security may be identified as sold by linking the date, amount and cost of securities bought with the sale transaction, provided that there is no other evidence suggesting that the actual security sold was not the one identified under this method.

How we see it

We believe that, in the absence of specific guidance, entities can elect to apply a FIFO approach, a specific identification method, or the average cost method constituting acceptable accounting policy choices to be applied consistently (see Chapter 47 at section 6.6).

If, following the disposal, the entity has neither control, joint control nor significant influence over the investee, a question arises as to how the carrying amount of the retained interest should be determined in the separate financial statements.

Frequently asked questions

Question 2-4: How is a transaction accounted for when an entity disposes of part of its investment in a subsidiary, that was previously accounted for at cost in accordance with IAS 27.10, and following the disposal the entity has neither control, joint control nor significant influence over the investee?

In January 2019, the IFRS IC concluded that IAS 27.9 requires an entity to apply all applicable IFRS accounting standard in preparing its separate financial statements, except when accounting for investments in subsidiaries, associates and joint ventures to which IAS 27.10 applies.[10] *[IAS 27.9, IAS 27.10]*. After the partial disposal transaction, the investee is not a subsidiary, associate, or joint venture of the entity. Accordingly, the entity applies IFRS 9 for the first time in accounting for its retained interest in the investee. The IFRS IC observed that the presentation election in IFRS 9.4.1.4 applies at initial recognition of an investment in an equity instrument, which permits the holder of particular investments in equity instruments to present subsequent changes in fair value in other comprehensive income. *[IFRS 9.4.1.4]*. Therefore, an investment in an equity instrument within the scope of IFRS 9 is eligible for the election if it is neither held for trading (as defined in Appendix A of IFRS 9) nor contingent consideration recognised by an acquirer in a business combination to which IFRS 3 applies.

Assuming the retained interest is not held for trading in the fact pattern discussed by the IFRS IC:

(a) The retained interest is eligible for the presentation election in IFRS 9.4.1.4

And

(b) The entity would make this presentation election when it first applies IFRS 9 to the retained interest (i.e., at the date of losing control of the investee)[11]

Any difference between the cost of the retained interest and its fair value on the date the entity loses control of the investee meets the definitions of income or expense in the *Conceptual Framework for Financial Reporting*. Accordingly, the IFRS IC concluded that, applying IAS 1.88, the entity recognises this difference in profit or loss. *[IAS 1.88]*. This is the case regardless of whether the entity presents subsequent changes in fair value of the retained interest in profit or loss or other comprehensive income. The IFRS IC also noted that its conclusion is consistent with the requirements in IAS 28.22(b) and IAS 27.11B, which deal with similar and related issues. *[IAS 28.22(b), IAS 27.11B]*.

The application of the IFRS IC's conclusion is explained in the following Illustration 2-3:

Illustration 2-3: Partial disposal of a subsidiary accounted for at cost when an investor retains an interest that is neither a subsidiary, associate nor joint venture

Entity A has a 60% interest in Entity B, which it acquired for CU2,700 in 20X0. This investment is measured at cost of CU2,700 in the separate financial statements of Entity A at 30 June 20X3. On 1 July 20X3, Entity A sells a 50% interest in Entity B for CU3,000 (its then fair value) and retains a 10% interest in Entity B. The fair value of the 10% interest is CU600 at that date. As the retained interest is not held for trading, the entity elects to account for the retained interest at fair value through other comprehensive income. The total gain from the partial disposal to be recognised in profit or loss amounts to CU900 (CU3,000 + CU600 - CU2,700).

10 *IFRIC Update*, January 2019, p.4. Available on the IFRS Foundation's website.

11 *IFRIC Update*, January 2019, p.4. Available on the IFRS Foundation's website.

2.1.1.E Formation of a new parent

IAS 27 has the following specific guidance when a new parent is formed above an existing parent: *[IAS 27.13]*

Extract from IAS 27

13 When a parent reorganises the structure of its group by establishing a new entity as its parent in a manner that satisfies the following criteria:

(a) the new parent obtains control of the original parent by issuing equity instruments in exchange for existing equity instruments of the original parent;

(b) the assets and liabilities of the new group and the original group are the same immediately before and after the reorganisation; and

(c) the owners of the original parent before the reorganisation have the same absolute and relative interests in the net assets of the original group and the new group immediately before and after the reorganisation,

and the new parent accounts for its investment in the original parent in accordance with paragraph 10(a) in its separate financial statements, the new parent shall measure cost at the carrying amount of its share of the equity items shown in the separate financial statements of the original parent at the date of the reorganisation.

The same guidance is also applicable if the entity that puts a new parent between it and the shareholders is not itself a parent, i.e., it has no subsidiaries. In such cases, references in the three conditions to 'original parent' and 'original group' are to the 'original entity'. *[IAS 27.14]*.

The types of reorganisation to which these requirements apply involves an existing entity and its shareholders agreeing to create a new parent between them without changing either the composition of the group or their own absolute and relative interests. This is not a general rule that applies to all common control transactions. Transfers of subsidiaries from the ownership of one entity to another within a group are not within the scope. The IASB deliberately excluded extending the amendment to other types of reorganisations or to common control transactions more generally because of its plans, now superseded as described below, to address this in its project on common control transactions. *[IAS 27.BC27]*.

The formation of a new parent - calculating the cost and measuring equity is further discussed in section 2.1.1.F below.

The IASB in December 2012 identified business combinations under common control as a priority research project. In June 2014, the Board tentatively decided that the research project should consider business combinations under common control and group restructurings.[12] The Discussion Paper *Business Combinations under Common Control* was issued for public comment in November 2020.[13] The Discussion Paper does not address how a receiving company should report in its separate financial statements an investment in a subsidiary received in a business combination under common control as this topic is addressed by IAS 27.[14] However, if the combination involves the transfer of an unincorporated business, the possible reporting requirements developed in this project would also apply in separate financial statements prepared by the receiving company. In April 2024, the IASB published a project summary that explained the reasons behind its decision in November 2023 not to develop requirements for reporting business combinations under common control; namely, the IASB acknowledged that information needed by investors varied among jurisdictions, making it difficult to develop requirements that would meet the information needs of users globally. Furthermore, the IASB acknowledged that diversity in reporting on business combinations under common control would continue and observed that investors said that they can work with this diversity.

This implies that entities - in the absence of authoritative guidance issued by the IASB - will continue to account for such common control transactions in accordance with their accounting policies (see section 4.4 below and Chapter 11 at section 3).

12 *IASB Update*, June 2014, p.9. Available on the IFRS Foundation's website.

13 Discussion Paper DP/2020/2: *Business Combinations under Common Control*, IASB, November 2020. Available on the IFRS Foundation's website.

14 Discussion Paper DP/2020/2: *Business Combinations under Common Control*, IASB, November 2020, 1.23, p.19. Available on the IFRS Foundation's website.

As well as the establishment of a new ultimate parent of a group, arrangements that could meet the criteria in IAS 27.13, *[IAS 27.13]*, mentioned above include the following:

(a) Reorganisations in which the new parent does not acquire all classes of the equity instruments issued by the original parent.

For example, the original parent may have preference shares that are classified as equity in addition to ordinary shares; the new parent does not have to acquire the preference shares for the transaction to be within scope. *[IAS 27.BC24(a)]*.

(b) A new parent obtains control of the original parent without acquiring all the ordinary shares of the original parent. *[IAS 27.BC24(a)]*. However, the absolute and relative holdings must be the same immediately before and after the transaction. *[IAS 27.13(c)]*.

The requirements will apply, for example, if a controlling group of shareholders insert a new entity between themselves and the original parent that holds all their original shares, and the new parent is formed in a manner that does not change the relative ownership interests of the owners of the group and does not change the equity, assets, and liabilities of the group as before.

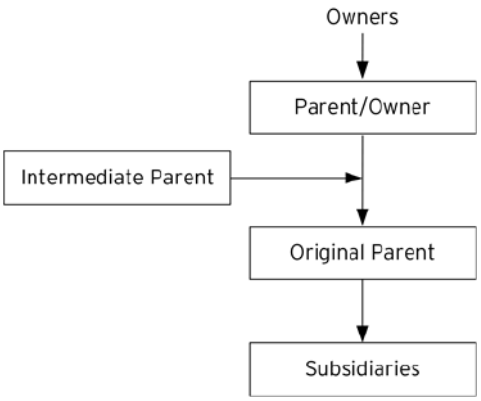
This is further explained in the following Illustration 2-4:

Illustration 2-4: Formation of new parent that does not acquire all the original parent's ordinary shares

Shareholders A and B each hold 50% of the equity instruments of Original Parent. A and B transfer their shares to New Parent in a share-for-share exchange so that both now hold 50% of the shares in New Parent. The absolute and relative interests of A and B and those of the other shareholders in Original Parent are unchanged, so the arrangement is a reorganisation to which the cost method for reorganisations applies.

(c) The establishment of an intermediate parent within a group. *[IAS 27.BC24(b)]*.

The principle is exactly the same as inserting a new parent company over the top of a group. 'Original Parent' will be an intermediate company within a group, owned by another group company. If the transaction is within scope, the intermediate parent will acquire Original Parent from its parent (the Owner) in a share for share swap. The group structure before and after the transaction can be summarised as follows:



If the composition of the underlying group changes, perhaps because the intermediate parent acquires only part of that group or because it acquires another subsidiary as part of the reorganisation, then the arrangement will not be within scope as the assets and liabilities of the group immediately after the reorganisation would not be 'the same' as those immediately before the reorganisation. *[IAS 27.13(b)]*. However, there may be arrangements when, to establish an intermediate parent, shares must be issued for an amount of cash, the value of which is typically driven by various legal aspects. Consequently, the assets and liabilities of the new group differ from the assets and liabilities of the original group (or subgroup) by the amount of cash received on the initial issue of shares by the intermediate parent. In those cases, the issuance of shares of the intermediate parent in exchange for cash was merely done to allow the entity to be incorporated under the local jurisdiction.

How we see it

We believe that the arrangements described above, in which shares have to be issued for an amount of cash, are within the scope of the exception, provided that the amount of cash is truly '*de minimis*'; that is, not sufficient to form a substantive part of the group reorganisation transaction such that the assets and liabilities of the group immediately before and after the reorganisation may still be considered 'the same'.

Frequently asked questions

Question 2-5: How is the cost of an investment in a subsidiary determined if the new intermediate parent has more than one direct subsidiary?

The formation of a new parent was also considered by the IFRS IC in 2011. The IFRS IC noted "that the normal basis for determining the cost of an investment in a subsidiary under … paragraph 10(a) of IAS 27 … has to be applied to reorganisations that result in the new intermediate parent having more than one direct subsidiary. … Paragraphs 13 and 14 of IAS 27 … apply only when the assets and liabilities of the new group and the original group (or original entity) are the same before and after the reorganisation". The IFRS IC observed that reorganisations that result in the new intermediate parent having more than one direct subsidiary do not meet the conditions in IAS 27 and therefore the exemptions for group reorganisations in IAS 27 do not apply. They also cannot be applied by analogy because this guidance is an exception to the normal basis for determining the cost of investment in a subsidiary.[15] *[IAS 27.10(a), IAS 27.13, IAS 27.14]*.

For example, if, in the group structure presented above, the Intermediate Parent had been inserted between the Original Parent and its subsidiaries, paragraphs 13 and 14 of IAS 27 would not apply as there are several subsidiaries acquired by the Intermediate Parent. In this case, there has been no 'parent' that has been established by the Intermediate Parent as its new parent. *[IAS 27.13, IAS 27.14]*.

2.1.1.F Formation of a new parent: calculating the cost and measuring equity

IAS 27 states that the new parent measures cost at the carrying amount of its share of the 'equity items' shown in the separate financial statements of the original parent at the date of the reorganisation. *[IAS 27.13]*. It does not define 'equity items' but the term appears to mean the total equity in the original parent, i.e., its issued capital and reserves attributable to owners. This will be the equity as recorded in the IFRS separate financial statements, so it will exclude shares that are classified as liabilities and include, for example, the equity component of a convertible loan instrument.

It is important to stress that the new parent does not record its investment at the consideration given (the shares that it has issued) nor at the assets received (the fair value of the investments it has acquired or the book cost of those investments). Instead, it must look to the total of the equity in the original parent, which is the acquired entity. Even then, it does not record the investment at the amount of original parent's investments but at the amount of its equity; that is to say, its net assets.

The requirements do not apply to the measurement of any other assets or liabilities in the separate financial statements of either the original parent or the new parent, or in the consolidated financial statements. *[IAS 27.BC25]*.

It is possible for the original parent to have negative equity because its liabilities exceed its assets. IAS 27 does not discuss this, but we consider that in these circumstances the investment should be recorded at zero. There is no basis for recording an investment as if it were a liability.

The above applies only when the new parent issues equity instruments but it does not address the measurement of the equity of the new parent. IFRS accounting standards has no general requirements for accounting for the issue of own equity instruments. Rather, consistent with the position taken by the *Conceptual Framework* that equity is a residual rather than an item 'in its own right', the amount of an equity instrument is normally measured by reference to the item (expense or asset) in consideration for which the equity is issued, as determined in accordance with IFRS accounting standards applicable to that other item. The new parent will record the increase in equity at the carrying amount of the investments it has acquired (i.e., at cost), regardless of the amount and face value of the equity instruments issued.

The amount at which the new parent's issued share capital is recorded will depend on the relevant law in the jurisdiction applicable to the new parent. The shares may be recorded at fair value, which is the fair value of the investments acquired, or at an amount calculated on some other basis. Local law may allow a company to record its issued share capital at a nominal amount, e.g., the nominal (face) value of the shares. In some jurisdictions, intermediate holding companies that acquire an asset from a parent (the 'transferor') for shares at a premium are required by law to record the share capital issued (its nominal value and share premium) at the carrying value in the transferor's books of the asset transferred; if the nominal value exceeds this book amount, the shares are recorded at their total nominal value.

15 *IFRIC Update*, September 2011, p.3. Available on the IFRS Foundation's website.

Once the share capital has been recorded, there will usually need to be an adjustment to equity so that in total the equity is equal to the carrying amount (i.e., cost) of the investments acquired. This adjustment may increase or decrease the acquirer's equity (compared to share capital value) as it depends on the carrying amounts of the investment in the owner, original parent's equity and the number and value of the shares issued as consideration, as shown in the following Illustration 2-5: *[IAS 27.13]*

Illustration 2-5: Formation of a new parent, statutory share capital and adjustments to equity

Intermediate Parent A acquires the investments in Original Parent from Parent; the structure after the arrangement is as presented above in section 2.1.1.E. Parent carries its investment in Original Parent at CU200, but it has a fair value of CU750. Original Parent's equity in its separate financial statements is CU650. Intermediate Parent A issues shares with a nominal value of CU100 to Parent.

In accordance with IAS 27.13, Intermediate Parent records its investment in Original Parent at CU650. Depending on local law, it may record its share capital (including share premium, where appropriate) at:

(i) CU750, being the fair value of the consideration received for the shares. It records a negative adjustment of CU100 elsewhere in equity.

(ii) CU100, being the nominal value of the shares issued. It records a credit adjustment of CU550 elsewhere in equity.

Or

(iii) CU200, being the carrying value of the investment in Parent. It records a credit adjustment of CU450 elsewhere in equity.

2.1.1.G Reverse acquisitions in the separate financial statements

For the purposes of consolidated financial statements, IFRS 3 takes the view that the acquirer is usually the entity that issues its equity interests to acquire the other entity, but recognises that in some business combinations, known as 'reverse acquisitions', the issuing entity is the acquiree (see Chapter 10 at section 14).

Under IFRS 3, a reverse acquisition occurs when the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes based on the guidance in IFRS 3 (see Chapter 10 at section 4.1). Perhaps more accurately, the legal acquiree must be identified as the acquirer for accounting purposes. Similar circumstances may arise when the legal acquirer obtains control over an unincorporated business (see Chapter 10 at section 14.9).

Existing IFRS accounting standards do not contain any guidance on accounting for reverse acquisitions in the separate financial statements, where the reverse acquisition is accounted for in the consolidated financial statements. The application guidance in IFRS 3 only deals with reverse acquisition accounting in the consolidated financial statements (see Chapter 10 at section 14.3); the consequences on the accounting in the separate financial statements, if any, of the legal parent/accounting acquiree are not addressed. However, the previous version of IFRS 3 indicated that reverse acquisition accounting applies only in the consolidated financial statements, and that in the legal parent's separate financial statements, the investment in the legal subsidiary is accounted for in accordance with the requirements in IAS 27. *[IFRS 3(2007).B8]*.

How we see it

In our view, applying the current IFRS 3 and IAS 27 standards, reverse acquisition accounting only applies in the consolidated financial statements.

This is explained in the following Illustration 2-6:

Illustration 2-6: Reverse acquisition - legal parent's statement of financial position in separate financial statements

Entity A, the entity issuing equity instruments and therefore the legal parent, is acquired in a reverse acquisition by Entity B, the legal subsidiary, on 30 September 20X3. The accounting for any income tax effects is ignored.

Statements of financial position of Entity A and Entity B immediately before the business combination are:

	Entity A	Entity B
	CU	CU
Current assets	500	700
Non-current assets	1,300	3,000
Total assets	1,800	3,700
Current liabilities	300	600
Non-current liabilities	400	1,100
Total liabilities	700	1,700
Owner's equity		
Issued equity		
100 ordinary shares	300	
60 ordinary shares		600
Retained earnings	800	1,400
Total shareholders' equity	1,100	2,000

Other information

(a) On 30 September 20X3, Entity A issues 2.5 shares in exchange for each ordinary share of Entity B. All of Entity B's shareholders exchange their shares in Entity B. Therefore, Entity A issues 150 ordinary shares in exchange for all 60 ordinary shares of Entity B.

(b) The fair value of each ordinary share of Entity B at 30 September 20X3 is CU40. The quoted market price of Entity A's ordinary shares at that date is CU16.

(c) The fair values of Entity A's identifiable assets and liabilities at 30 September 20X3 are the same as their carrying amounts, except that the fair value of Entity A's non-current assets at 30 September 20X3 is CU1,500.

Using the facts above, the statement of financial position of Entity A, the legal parent, in its separate financial statements immediately following the business combination will be as follows:

	Entity A
	CU
Current assets	500
Non-current assets	1,300
Investment in subsidiary (Entity B)	2,400
Total assets	4,200
Current liabilities	300
Non-current liabilities	400
Total liabilities	700
Owner's equity	
Issued equity	
250 ordinary shares	2,700
Retained earnings	800
	3,500

The investment in the subsidiary is included at its cost of CU2,400, being the fair value of the shares issued by Entity A (150 × CU16). It can be seen that the issued equity is different from that in the consolidated financial statements and its non-current assets remain at their carrying amounts before the business combination (see Illustration 14-4 in Chapter 10 at section 14.1).

2.1.2 Deemed cost on transition to IFRS accounting standards

IFRS 1 allows a first-time adopter an exemption with regard to its investments in subsidiaries, joint ventures, and associates in its separate financial statements. *[IFRS 1.D15]*. If the first-time adopter elects to apply the cost method, it can either measure the investment in its separate opening IFRS statement of financial position at cost determined in accordance with IAS 27 or at deemed cost. Deemed cost is either:

(i) Fair value (determined in accordance with IFRS 13 *Fair Value Measurement*) at the entity's date of transition to IFRS accounting standards in its separate financial statements

Or

(ii) Previous GAAP carrying amount as at the entity's date of transition to IFRS accounting standards in its separate financial statements

As with the other asset measurement exemptions, the first-time adopter may choose either (i) or (ii) above to measure each individual investment in subsidiaries, joint ventures, or associates that it elects to measure using a deemed cost. *[IFRS 1.D15]*.

2.2 IFRS 9 method

Under IFRS 9, the equity investments in subsidiaries, joint ventures or associates would likely be classified as financial assets measured at fair value through profit or loss or, as financial assets measured at fair value through other comprehensive income (OCI), if an entity elects at initial recognition to present subsequent changes in their fair value in OCI. In the former case, subsequent changes in the fair value of the investments will be recognised in profit or loss. In the latter case, subsequent changes in the fair value of the investments will be recognised in OCI and will never be reclassified to profit or loss. The classification requirements of IFRS 9 are discussed in Chapter 44, and the measurement principles of IFRS 9 on initial and subsequent measurement are discussed in detail in Chapters 45 and 46.

One issue that has been discussed by the IASB that is relevant in determining the fair value of investments in subsidiaries, joint ventures and associates is the unit of account for such investments (see further details in Chapter 15 at section 4.1.1). The Board, for the time being, have decided not to finalise discussions on unit of account for such investments.[16]

2.3 Equity method

IAS 27 allows entities to use the equity method as described in IAS 28 to account for investments in subsidiaries, joint ventures, and associates in their separate financial statements. *[IAS 27.4]*. When the equity method is used, dividends from those investments are recognised as a reduction from the carrying value of the investment. *[IAS 27.12]*. The application of the equity method under IAS 28 is discussed in Chapter 12 at section 7. Some jurisdictions require the use of the equity method to account for investments in subsidiaries, associates, and joint ventures in the separate financial statements.

In the Basis for Conclusions to IAS 27, the IASB indicates that in general, the application of the equity method to investments in subsidiaries, joint ventures, and associates in the separate financial statements of an entity is expected to result in the same net assets and profit or loss attributable to the owners as in the entity's consolidated financial statements. However, there may be situations when this may not be the case, including: *[IAS 27.BC10G]*

- Impairment testing requirements in IAS 28.

  For an investment in a subsidiary accounted for in the separate financial statements using the equity method, goodwill that forms part of the carrying amount of the investment in the subsidiary is not tested for impairment separately. Instead, the entire carrying amount of the investment in the subsidiary is tested for impairment in accordance with IAS 36 as a single asset. However, in the consolidated financial statements of the entity, because goodwill is recognised separately, it is tested for impairment by applying the requirements in IAS 36 for testing goodwill for impairment.
- Subsidiary that has a net liability position.

  IAS 28 requires an investor to discontinue recognising its share of further losses when its cumulative share of losses of the investee equals or exceeds its interest in the investee, unless the investor has incurred legal or constructive obligations or made payments on behalf of the investee, in which case a liability is recognised, whereas there is no such requirement in relation to the consolidated financial statements.

16 IFRS Project report and Feedback Statement: *Post-implementation Review of IFRS 13* Fair Value Measurement, IASB, December 2018. Available on the IFRS Foundation's website.

- Capitalisation of borrowing costs incurred by a parent in relation to the assets of a subsidiary.

  IAS 23 *Borrowing Costs* notes that, in some circumstances, it may be appropriate to include all borrowings of the parent and its subsidiaries when computing a weighted average of the borrowing costs. When a parent borrows funds and its subsidiary uses them for the purpose of obtaining a qualifying asset, in the consolidated financial statements of the parent the borrowing costs incurred by the parent are considered to be directly attributable to the acquisition of the subsidiary's qualifying asset. However, this would not be appropriate in the separate financial statements of the parent when the parent's investment in the subsidiary is a financial asset which is not a qualifying asset.

In the above situations, there will not be alignment of the net assets and profit or loss of an investment in a subsidiary between the consolidated and separate financial statements.

2.3.1 First-time adoption of IFRS accounting standards

IFRS 1 allows a first-time adopter that accounts for an investment in a subsidiary, joint venture or associate using the equity method in the separate financial statements (see Chapter 6 at section 5.7.2) to apply the exemption for past business combinations to the acquisition of the investment. *[IFRS 1.D15A]*. The exemption for past business combinations is discussed in Chapter 6 at section 5.2. The first-time adopter can also apply certain exemptions to the assets and liabilities of subsidiaries, associates, and joint ventures when it becomes a first-time adopter for its separate financial statements earlier than its consolidated financial statements and later than its parent or subsidiary. *[IFRS 1.D15A]*. These exemptions are discussed in Chapter 6 at section 5.8.

2.4 Dividends and other distributions

IAS 27 contains a general principle for dividends received from subsidiaries, joint ventures, or associates. This is supplemented by specific indicators of impairment in IAS 36 that apply when a parent entity receives the dividend. The general principle and the specific impairment indicators are discussed in section 2.4.1 below.

IFRIC 17 *Distributions of Non-cash Assets to Owners* considers in particular the treatment by the entity making the distribution. Details about the requirements of that Interpretation are discussed in section 2.4.2 below.

2.4.1 Dividends from subsidiaries, joint ventures, or associates

The following guidance is included in IAS 27 in relation to recognition of dividends from subsidiaries, joint ventures, or associates: *[IAS 27.12]*

Extract from IAS 27	
12	**Dividends from a subsidiary, a joint venture or an associate are recognised in the separate financial statements of an entity when the entity's right to receive the dividend is established. The dividend is recognised in profit or loss unless the entity elects to use the equity method, in which case the dividend is recognised as a reduction from the carrying amount of the investment.**

Dividends are recognised only when they are declared (i.e., the dividends are appropriately authorised and no longer at the discretion of the entity). IFRIC 17 expands on this point: the relevant authority may be the shareholders, if the jurisdiction requires such approval, or management or the board of directors, if the jurisdiction does not require further approval. *[IFRIC 17.10]*. If the declaration is made after the reporting period but before the financial statements are authorised for issue, the dividends are not recognised as a liability at the end of the reporting period because no obligation exists at that time. Such dividends are disclosed in the notes in accordance with IAS 1. *[IAS 1.137, IAS 10.13]*. A parent cannot record income, or a reduction of the equity accounted investment and recognise an asset until the dividend is a liability of its subsidiary, joint venture or associate, the paying company.

Once dividends are recognised in income, the investor must determine whether or not the investment has been impaired as a result. IAS 36 requires the entity to assess at each reporting date whether there are any 'indications of impairment'. Only if indications of impairment are present will the impairment test itself have to be carried out. *[IAS 36.8, IAS 36.9]*.

The list of indicators in IAS 36 includes the recognition of a dividend from a subsidiary, joint venture, or associate when there is evidence that:

(i) The dividend exceeds the total comprehensive income of the subsidiary, joint venture, or associate in the period the dividend is declared

Or

(ii) The carrying amount of the investment in the separate financial statements exceeds the carrying amounts in the consolidated financial statements of the investee's net assets, including associated goodwill *[IAS 36.12(h)]*

2.4.1.A The dividend exceeds the total comprehensive income

There are circumstances in which recognition of a dividend will trigger the first indicator, even if the dividend is payable entirely from the profit for the period.

First, the indicator states that the test is by reference to the total comprehensive income in the period in which the declaration is made. Dividends are usually declared after the end of the period to which they relate; an entity whose accounting period ends on 31 December 20X2 will not normally declare a dividend in respect of its earnings in that period until its financial statements have been drawn up, i.e., some months into the next period ended 31 December 20X3. We assume that it is expected that the impairment review itself will take place at the end of the period, in line with the general requirements of IAS 36 referred to above, in which case the dividends received in the period will be compared to the income of the subsidiary for that period. This means that there may be a mismatch, for example, dividends declared on the basis of 20X2 profits will be compared to total comprehensive income in 20X3.

Second, the test is by reference to total comprehensive income, not profit or loss for the period. Total comprehensive income reflects the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners. Total comprehensive income takes into account the components of 'other comprehensive income' that are not reflected in profit or loss that include:

(a) Changes in revaluation surpluses of property, plant and equipment or intangible assets (see Chapters 19 and 18, respectively)

(b) Remeasurements of defined benefit plans (see Chapter 31)

(c) Gains and losses arising from translating the financial statements of a foreign operation (see Chapter 16)

(d) Fair value changes from financial instruments measured at fair value through other comprehensive income (see Chapter 46)

And

(e) The effective portion of gains and losses on hedging instruments in a cash flow hedge (see Chapter 49) *[IAS 1.7]*

This means that all losses on remeasurement that are allowed by IFRS accounting standards to bypass profit or loss and can be taken directly to other components of equity are taken into account in determining whether a dividend is an indicator of impairment. If a subsidiary, joint venture, or associate pays a dividend from its profit for the year that exceeds its total comprehensive income because there have been actuarial losses on the pension scheme or a loss on remeasuring its hedging derivatives, then receipt of that dividend is an indicator of impairment to the parent.

The opposite should also be true: a dividend that exceeds profit for the period but does not exceed total comprehensive income (if, for example, the entity has a revaluation surplus on its property) is not an indicator of impairment. However, IAS 36 makes clear that its list of indicators is not exhaustive and if there are other indicators of impairment then the entity must carry out an impairment test in accordance with IAS 36. *[IAS 36.13]*.

It must be stressed that this test is solely to see whether a dividend triggers an impairment review. It has no effect on the amount of dividend that the subsidiary, joint venture, or associate may pay, which is governed by local law.

2.4.1.B The carrying amount exceeds the consolidated net assets

An impairment is indicated if, after paying the dividend, the carrying amount of the investment in the separate financial statements exceeds the carrying amount of the investee's net assets, including associated goodwill, in the consolidated financial statements.

It will often be clear when dividends are paid out of profits for the period by subsidiaries, joint ventures, or associates, whether the consolidated net assets of the investee in question have declined below the carrying amount of the investment. However, this could require the preparation of consolidated financial statements by an intermediate parent which would otherwise be exempt from the preparation of consolidated financial statements.

Similar issues to those described above may arise, when, for example, the subsidiary, joint venture, or associate may have made losses or taken some sort of remeasurement to other comprehensive income in the period in which the dividend is paid. However, it is the net assets in the consolidated financial statements that are relevant, not those in the subsidiary's, joint venture's or associate's own financial statements, which may be different if the parent acquired the subsidiary.

Testing assets for impairment is described in Chapter 20. There are particular problems to consider in assessing the investments in subsidiaries, joint ventures, and associates for impairment. These are discussed in Chapter 21 at section 12.4.

2.4.1.C Returns of capital

Returns of capital are not usually considered to be dividends and hence they are not directly addressed by IAS 27. They are an example of a 'distribution', the broader term applied when an entity gives away its assets to its members.

How we see it

Returns of capital are not always accounted for as a reduction of the carrying value of the investment in the separate financial statements. It is a matter of judgement and depends on the facts and circumstances. Returns of capital frequently cannot be easily distinguished from dividends.

For example, depending on local law, entities may be able to:

- Make repayments that directly reduce their share capital

  Or

- Create reserves by transferring amounts from share capital into retained earnings and, at the same time or later, pay dividends from that reserve

Returns of capital can be accounted for in the same way as dividends, i.e., by applying the impairment testing process described above. However, the effect on an entity that makes an investment (whether on initial acquisition of a subsidiary or on a subsequent injection of capital) and immediately receives it back (whether as a dividend or return of capital) generally will be that of a return of capital that reduces the carrying value of the parent's investment. In these circumstances there will be an impairment that is equal to the dividend that has been received (provided that the consideration paid as investment was at fair value). If there is a delay between the investment and the dividend or return of capital, then the impairment (if any) will be a matter of judgement based on the criteria discussed above. Judgement should be applied in determining whether a distribution from an investee is dividend income (i.e., a return on capital) or a return of capital that 'clearly represents a recovery of part of the cost of the investment'. *[IFRS 9.B5.7.1]*.

2.4.2 Distributions of non-cash assets to owners (IFRIC 17)

Entities sometimes make distributions of assets other than cash, e.g., items of property, plant and equipment, businesses as defined in IFRS 3, ownership interests in another entity or disposal groups as defined in IFRS 5. *[IFRIC 17.1, IFRIC 17.2]*. IFRIC 17 has the effect that gains or losses relating to some non-cash distributions to shareholders will be accounted for in profit or loss. *[IFRIC 17.1]*. The Interpretation addresses only the accounting by the entity that makes a non-cash asset distribution, not the accounting by recipients.

2.4.2.A Scope

IFRIC 17 is relevant for the following transactions: *[IFRIC 17.3, IFRIC 17.4, IFRIC 17.5]*

Extract from IFRIC 17

3 This Interpretation applies to the following types of non-reciprocal distributions of assets by an entity to its owners acting in their capacity as owners:

(a) distributions of non-cash assets (e.g. items of property, plant and equipment, businesses as defined in IFRS 3, ownership interests in another entity or disposal groups as defined in IFRS 5); and

(b) distributions that give owners a choice of receiving either non-cash assets or a cash alternative.

4 This Interpretation applies only to distributions in which all owners of the same class of equity instruments are treated equally.

5 This Interpretation does not apply to a distribution of a non-cash asset that is ultimately controlled by the same party or parties before and after the distribution. This exclusion applies to the separate, individual and consolidated financial statements of an entity that makes the distribution.

The IFRS IC did not want the Interpretation to apply to exchange transactions with shareholders, which can include an element of distribution, e.g., a sale to one of the shareholders of an asset having a fair value that is higher than the sales price. *[IFRIC 17.BC5]*. Therefore, it applies only to non-reciprocal distributions in which all owners of the same class of equity instruments are treated equally. *[IFRIC 17.4]*.

The Interpretation will not apply to distributions made by subsidiaries but only to distributions made by parent entities or individual entities that are not themselves parents. In order to avoid ambiguity regarding 'common control' and to ensure that demergers achieved by way of distribution are dealt with, the Interpretation emphasises that 'common control' is used in the same sense as in IFRS 3. A distribution to a group of individual shareholders will only be out of scope if those shareholders, as a result of contractual arrangements, have ultimate collective power over the entity making the distribution as a result of contractual arrangements. *[IFRIC 17.6]*.

Although the Interpretation does not apply to distributions if the assets are ultimately controlled by the same party or parties before and after the distribution, whether in the separate, individual, or consolidated financial statements of an entity that makes the distribution, it may be applied by analogy for common control distributions as further discussed in section 4.4.1.D below.

If the non-cash asset distributed is an interest in a subsidiary over which the entity retains control, this is accounted for by recognising a non-controlling interest in the subsidiary in equity in the consolidated financial statements of the entity, as required by IFRS 10.23 (see Chapter 8 at section 4). *[IFRS 10.23, IFRIC 17.7]*.

2.4.2.B Recognition, measurement, and presentation

A dividend is not a liability until the entity is obliged to pay it to the shareholders. *[IFRIC 17.10]*. The obligation arises when payment is no longer at the discretion of the entity, which will depend on the requirements of local law. In some jurisdictions, the UK or Italy for example, shareholder approval is required before there is a liability to pay. In other jurisdictions, declaration by management or the board of directors may suffice.

The liability is measured at the fair value of the assets to be distributed. *[IFRIC 17.11]*. If an entity gives its owners a choice of receiving either a non-cash asset or a cash alternative, the entity estimates the dividend payable by considering both the fair value of each alternative and the associated probability of owners selecting each alternative. *[IFRIC 17.12]*. IFRIC 17 does not specify any method of assessing probability nor its effect on measurement.

IFRS 5's requirements apply also to a non-current asset (or disposal group) that is classified as held for distribution to owners acting in their capacity as owners (held for distribution to owners). *[IFRS 5.5A, IFRS 5.12A, IFRS 5.15A]*. This means that assets or asset groups within scope of IFRS 5 will be carried at the lower of carrying amount and fair value less costs to distribute. *[IFRS 5.15A]*. Assets not subject to the measurement provisions of IFRS 5 are measured in accordance with the relevant standard. In practice, most non-cash distributions of assets out of scope of the measurement provisions of IFRS 5 will be of assets held at fair value in accordance with the relevant standard, e.g., financial instruments that under IFRS 9 should be measured at fair value through profit or loss or other comprehensive income, and investment property carried at fair value. *[IFRS 5.5]*. Accordingly, there should be little difference, if any, between their carrying value and the amount of the distribution.

The liability is adjusted as at the end of any reporting period at which it remains outstanding and at the date of settlement with any adjustment being taken to equity. *[IFRIC 17.13]*. When the liability is settled, the difference, if any, between its carrying amount and the carrying amount of the assets distributed is accounted for as a separate line item in profit or loss. *[IFRIC 17.14, IFRIC 17.15]*. IFRIC 17 does not express any preference for particular line items or captions in the statement of profit or loss.

It is rare for entities to distribute physical assets such as property, plant, and equipment to shareholders, although these distributions are common within groups and hence out of scope of IFRIC 17. In practice, the Interpretation will have most effect on demergers by way of distribution, as explained in the following Illustration 2-7:

Illustration 2-7: Non-cash asset distributed to shareholders

Conglomerate Plc has two divisions, electronics, and music, each of which is in a separate subsidiary. On 18 December 20X3 the shareholders approve a non-cash dividend in the form of the electronics division, which means that the dividend is a liability when the annual financial statements are prepared as at 31 December 20X3. The distribution is to be made on 17 January 20X4.

In Conglomerate Plc's separate financial statements at 18 December and 31 December 20X3, the investment in Electronics Ltd, which holds the electronics division, is carried at CU100 million; the division has consolidated net assets of CU210 million. The fair value of the electronics division at 18 December and 31 December 20X3 is CU375 million, so is the amount at which the liability to pay the dividend is recorded in Conglomerate Plc's separate financial statements and in its consolidated financial statements, as follows:

Conglomerate Plc

Separate financial statements					*Consolidated financial statements*				
			CU	**CU**				**CU**	**CU**
Dr	Equity		375		Dr	Equity		375	
	Cr	Liability		375		Cr	Liability		375

In Conglomerate PLC's separate financial statements, its investment in Electronics Ltd of CU100 million is classified as held for distribution to owners. In the consolidated financial statements, the net assets of CU210 million are so classified.

If the value of Electronics Ltd had declined between the date of declaration of the dividend and the period end, say to CU360 million (more likely if there had been a longer period between declaration and the period end) then the decline would be reflected in equity and the liability recorded at CU360 million. Exactly the same entry would be made if the value were CU375 million at the period end and CU360 million on the date of settlement (Dr liability CU15 million, Cr equity CU15 million).

The dividend is paid on 17 January 20X4 at which point the fair value of the division is CU360 million. There was no change in the carrying value of the investment in the separate financial statements and of the net assets in the consolidated financial statements between 31 December and distribution date. The difference between the assets distributed and the liability is recognised as a gain in profit or loss.

Conglomerate Plc

Separate financial statements					*Consolidated financial statements*				
			CU	**CU**				**CU**	**CU**
Dr	Liability		360		Dr	Liability		360	
	Cr	Profit or loss		260		Cr	Profit or loss		150
	Cr	Asset held for sale		100		Cr	Disposal group		210

IFRIC 17 requires the following disclosures: *[IFRIC 17.16, IFRIC 17.17]*

Extract from IFRIC 17

16 An entity shall disclose the following information, if applicable:

(a) the carrying amount of the dividend payable at the beginning and end of the period; and

(b) the increase or decrease in the carrying amount recognised in the period in accordance with paragraph 13 as result of a change in the fair value of the assets to be distributed.

17 If, after the end of a reporting period but before the financial statements are authorised for issue, an entity declares a dividend to distribute a non-cash asset, it shall disclose:

(a) the nature of the asset to be distributed;

(b) the carrying amount of the asset to be distributed as of the end of the reporting period; and

(c) the fair value of the asset to be distributed as of the end of the reporting period, if it is different from its carrying amount, and the information about the method(s) used to measure that fair value required by paragraphs 93(b), (d), (g) and (i) and 99 of IFRS 13.

IFRS 13 related disclosures are further discussed in Chapter 15 at section 20.3.

3 Disclosure

An entity applies all applicable IFRS accounting standards when providing disclosures in the separate financial statements. *[IAS 27.15]*. In addition, there are a number of specific disclosure requirements in IAS 27 which are discussed below.

3.1 Separate financial statements prepared by parent electing not to prepare consolidated financial statements

When separate financial statements are prepared for a parent that, in accordance with the exemption discussed in section 1.1 above, elects not to prepare consolidated financial statements, those separate financial statements are to disclose: *[IAS 27.16]*

(a) The fact that the financial statements are separate financial statements; that the exemption from consolidation has been used; and the name and the principal place of business (and country of incorporation, if different) of the entity whose consolidated financial statements that comply with IFRS accounting standards have been produced for public use and the address where those consolidated financial statements are obtainable

(b) A list of significant investments in subsidiaries, joint ventures, and associates, including:

  (i) The name of those investees

  (ii) The principal place of business (and country of incorporation, if different) of those investees

  And

  (iii) Its proportion of the ownership interest and, if different, proportion of voting rights held in those investees

  And

(c) A description of the method used to account for the investments listed under (b)

In addition to disclosures required by IAS 27, an entity also must disclose in its separate financial statements qualitative and quantitative information about its interests in unconsolidated structured entities as required by IFRS 12. IFRS 12 does not generally apply to an entity's separate financial statements to which IAS 27 applies but if the entity has interests in unconsolidated structured entities and prepares separate financial statements as its only financial statements, it must apply the requirements in paragraphs 24 to 31 of IFRS 12 when preparing those separate financial statements (see Chapter 14 at section 6). *[IFRS 12.6(b), IFRS 12.24-31]*.

The unconsolidated structured entity disclosures in IFRS 12 are given only in separate financial statements when the parent has taken advantage of the exemption from preparing consolidated financial statements. When the parent has not taken advantage of the exemption, and also prepares separate financial statements, it gives the disclosures in section 3.3 below in respect of those separate financial statements. *[IAS 27.17]*.

3.2 Separate financial statements prepared by an investment entity

When an investment entity that is a parent (other than a parent electing not to prepare consolidated financial statements) prepares separate financial statements as its only financial statements, it discloses that fact. The investment entity also presents disclosures relating to investment entities required by IFRS 12 (see Chapter 14 at section 4.6). *[IAS 27.16A]*.

3.3 Separate financial statements prepared by an entity other than a parent electing not to prepare consolidated financial statements

IAS 27 requires the disclosures below to be given by:

- A parent preparing separate financial statements in addition to consolidated financial statements (i.e., whether or not it is required to prepare consolidated financial statements - the disclosures in section 3.1 above apply only when the parent has actually taken advantage of the exemption, not merely when it is eligible to do so).

  And

- An entity (not being a parent) that is an investor in an associate or in a joint venture in respect of any separate financial statements that it prepares, i.e., whether:

  (i) As its only financial statements (if permitted by IAS 28)

  Or

  (ii) In addition to financial statements in which the results and net assets of associates or joint ventures are included

When an entity is both a parent and an investor in either an associate or a joint venture, it should follow the disclosure requirements governing parents - in other words, it complies with the disclosures in section 3.1 above if electing not to prepare consolidated financial statements and otherwise with the disclosures below.

Separate financial statements prepared by an entity other than a parent electing not to prepare consolidated financial statements must disclose: *[IAS 27.17]*

(a) The fact that the statements are separate financial statements and the reasons why those statements are prepared if not required by law

(b) A list of significant investments in subsidiaries, joint ventures, and associates, including for each such investment its:

  (i) Name

  (ii) Principal place of business (and country of incorporation, if different)

  And

  (iii) Proportion of ownership interest and, if different, proportion of voting power held

  And

(c) A description of the method used to account for the investments listed under (b)

The separate financial statements must also identify the financial statements prepared in accordance with the requirements of IFRS 10 (requirement to prepare consolidated financial statements), IFRS 11 or IAS 28 to which they relate. *[IAS 27.17]*. In other words, they must draw attention to the fact that the entity also prepares consolidated financial statements or, as the case may be, financial statements in which the associates or joint ventures are accounted for using the equity method.

The implication of this disclosure requirement is that an entity which publishes both separate and consolidated financial statements under IFRS accounting standards cannot issue the separate financial statements before the consolidated financial statements have been prepared and approved, since there would not be, at the date of issue of the separate financial statements, any consolidated financial statements 'to which they relate'. This is discussed in section 1.1.3 above.

How we see it

In our view, if the parent has issued consolidated financial statements prepared not in accordance with IFRS accounting standards but with its local GAAP, the parent cannot make reference to the financial statements prepared in accordance with IFRS 10, IFRS 11 or IAS 28, therefore the separate financial statements cannot be considered in compliance with IAS 27.

3.3.1 Entities with no subsidiaries but exempt from applying IAS 28

Entities which have no subsidiaries, but which have investments in associates or joint ventures are permitted by IAS 28 to prepare separate financial statements as their only financial statements if they satisfy the conditions described in section 1.1.1 above; namely, if the entity has an investment in an associate and/or a joint venture and the entity has made use of the exemption from applying the equity method to those investments, the entity may prepare separate financial statements as its only financial statements, in which investments in the associate/joint venture are accounted for at cost or in accordance with IFRS 9.

IAS 27 requires such entities to make the disclosures in (a) to (c) above in section 3.3. In addition, the entity identifies the financial statements prepared in accordance with IAS 28. *[IAS 27.17]*.

4 Common control or group transactions in individual or separate financial statements

4.1 Introduction

Transactions often take place between a parent entity and its subsidiaries or between subsidiaries within a group that may or may not be carried out at fair value.

Whilst such transactions do not affect the consolidated financial statements of the parent as they are eliminated in the course of consolidation, they can have a significant impact on the separate financial statements of the parent, the individual financial statements of an entity that is not a parent, and/or a set of consolidated financial statements prepared for a sub-group. IAS 24 requires only that these transactions are disclosed and provides no accounting requirements.

The IASB generally considers that the needs of users of financial statements are fully met by requiring entities to consolidate subsidiaries and to equity account for associates and joint ventures. Accounting issues within individual or separate financial statements are not a priority and are usually only addressed in IFRS accounting standards when a standard affects consolidated and individual or separate statements in different ways, e.g., accounting for pensions or employee benefits.

How we see it

As there is limited guidance under IFRS accounting standards, we consider that it is helpful to set out some general principles in accounting for these transactions that enhance the consistency of application of IFRS accounting standards whether for the separate financial statements of a parent, the individual financial statements of an entity that is not a parent or the consolidated financial statements of a sub-group.

The considerations provided in this section in certain circumstances also apply to sub-group consolidated financial statements in relation to common control transactions with entities controlled by the ultimate parent or ultimate controlling party or parties, but that are outside the sub-group.

We have considered how to apply these principles to certain common types of arrangement between entities under common control, which are described in more detail in section 4.4 below:

- Sales, exchanges, and contributions of non-monetary assets including sales and exchanges of investments not within the scope of IFRS 9, i.e., investments in subsidiaries, associates, or joint ventures (see section 4.4.1 below)
- Transfers of businesses, including contributions and distribution of businesses (see sections 4.4.2 and 4.4.3 below)
- Incurring costs and settling liabilities without recharge (see section 4.4.4 below)
- Loans that bear interest at non-market rates or are interest free (see section 4.4.5.A below)

  And
- Financial guarantee contracts given by a parent over a subsidiary's borrowings in the financial statements of a subsidiary (see section 4.4.5.B below)

Other arrangements that are subject to specific requirements in particular standards are dealt with in the relevant chapters. These include:

- Financial guarantee contracts over a subsidiary's borrowings in the accounts of the parent (see Chapter 45 at section 3.3.3)
- Put and call options in separate financial statements (see Chapter 8 at section 6.5)
- Product warranties in separate financial statements (see Chapter 51 at section 2.3.1.A)
- Share-based payment plans of a parent (see Chapter 30 at section 12)

  And
- Employee benefits (see Chapter 31 at section 3.3.2)

How we see it

In determining how to account for transactions between entities under common control, we believe that the following two aspects need to be considered:

(a) Is the transaction at fair value? Is the price in the transaction the one that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants?

(b) Is it a contractual arrangement and, if so, is the entity whose financial statements are being considered a party to the contract?

It is necessary to consider whether the transaction is of a type that market participants could or would enter into. It is also important to remember that an arm's length transaction includes the repayment terms that would be expected of independent parties, and this may not be the case in intra-group transactions. The analysis of the design and purpose of the transaction and whether the transaction lacks commercial substance may also be helpful in assessing the features above.

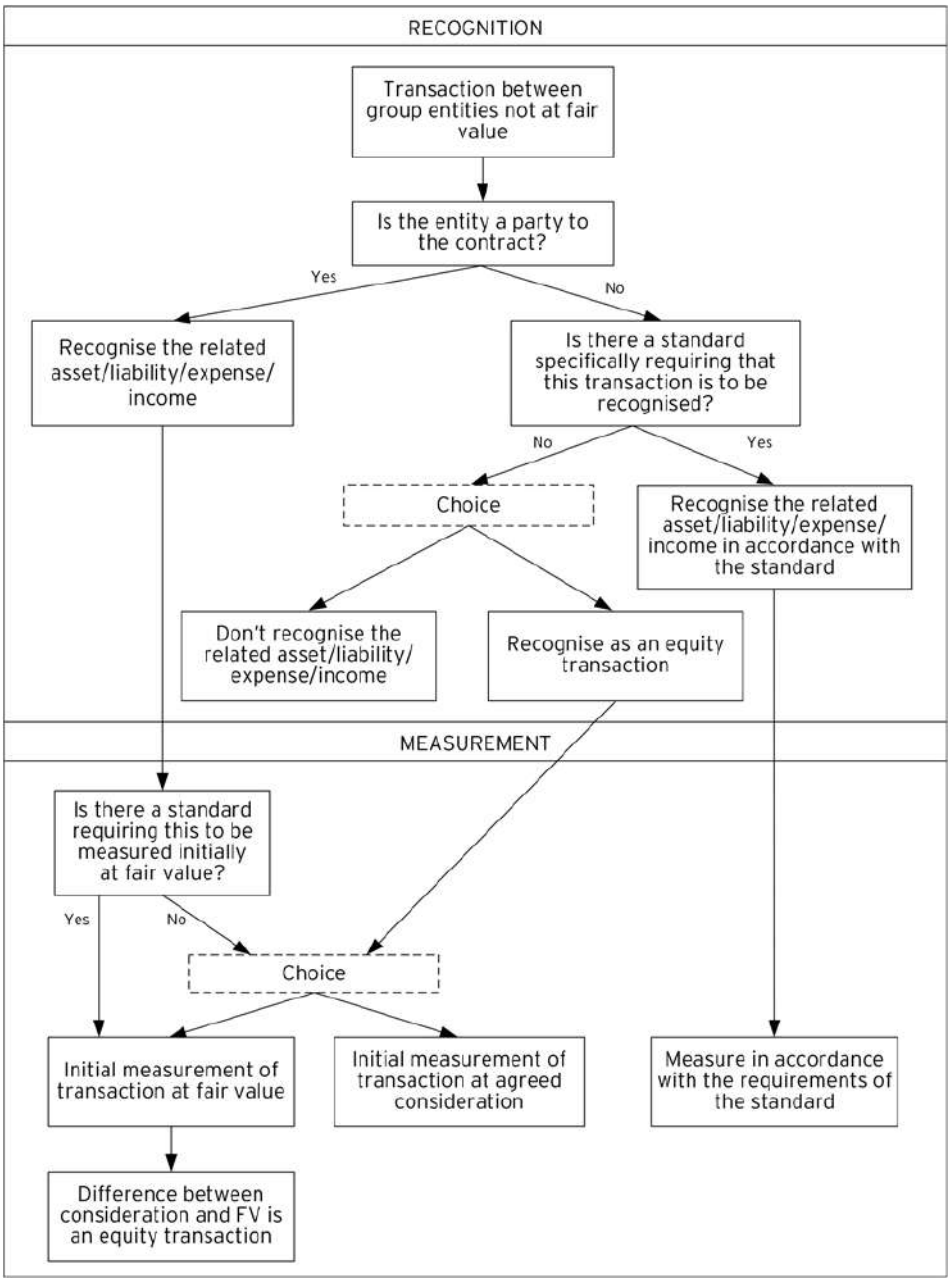
How we see it

If the transaction is at fair value and the entity is a party to the contract, we believe that it should be accounted for in accordance with the terms of the contract and general requirements of IFRS accounting standards related to this type of transaction.

The principles for accounting for transactions between group entities that are not transacted at fair value are presented in the following figure. Detailed comments on the principles are provided further in sections 4.2 and 4.3 below.

Group entities represent entities under common control of the same parent or the same controlling party or parties. The following figure therefore does not apply to transactions of group entities with joint ventures or associates of any of the group entities.

Figure 4-1: The principles for accounting for transactions between group entities that are transacted not at fair value



How we see it

If there is more than one acceptable way of accounting for specific transactions and therefore a choice of accounting policies, we believe the entity applies its chosen policy consistently to similar arrangements and discloses it if it is material. However, not all group entities need adopt the same accounting policy in their individual, separate or sub-group consolidated financial statements. Nor is there a requirement for symmetrical accounting by the entities involved in the transaction.

4.2 Recognition

If an entity is a party to a contract under which it receives a right and incurs an obligation, then on the assumption that there is substance to the transaction, it will be recognised in the financial statements of the entity.

The concept of substance, sometimes also referred to as commercial substance, is currently used for exchange of assets in the scope of other standards. In IAS 16, it refers to transactions that modify the configuration (risk, timing, and amount) of the cash flows before and after the transaction for the entity involved. *[IAS 16.24]*.

An entity may receive a right without incurring an obligation or *vice versa* without being a party to a contract. There are many different types of arrangement that contain this feature, either in whole or in part:

- Some arrangements are not contractual at all, such as capital contributions and distributions, that are in substance gifts made to the receiving entities without consideration.
- Some standards require transactions to which the entity is not a party to be reflected in their financial statements, e.g., IFRS 2 requires an entity to account for a transaction in which it receives goods or services when another entity in the same group has the obligation to settle the share-based payment transaction. The accounting treatment is representing that the subsidiary has received a capital contribution from the parent, which the subsidiary has then spent on employee remuneration or *vice versa*. (see Chapter 30 at section 12).
- Some are contractual arrangements for the other party, e.g., a parent enters into a contract to engage an auditor for the subsidiary and pays the audit fees without any recharge.

How we see it

If an entity has a relationship to a transaction but is not a party to a contractual relationship, its rights and obligations are not modified, and there is no IFRS accounting standard requiring recognition then, in our view, the entity could choose not to recognise the transaction at all. As further described below, if it chooses to recognise the transaction, then recognition will depend on whether the entity is a parent or a subsidiary and on the specific nature of the transaction.

In some circumstances, i.e., when the transaction has substance, a parent could treat a debit as either an addition to its investment in its subsidiary or as an expense and a credit as a gain to profit or loss. It is not generally possible for the parent to recognise gains in equity as these are usually transactions with subsidiaries, not shareholders. A subsidiary treats the transaction as a credit or debit to income (income or expense) or a debit to asset or credit to liability and an equal and opposite debit or credit to equity (distribution of or contribution to equity).

One example when a subsidiary is required by an IFRS accounting standard to record an expense when it is not a party to a contractual arrangement is a share-based payment. If the employees of a subsidiary are granted options by the parent company over its shares in exchange for services to the subsidiary, the subsidiary must record a cost for that award within its own financial statements, even though it may not legally be a party to it. The parent must also record the share-based payment as an addition to the investment in the subsidiary (see Chapter 30 at section 12.2.4).

Although the entity not party to the contract could have a choice to either record the transaction or not, the other entity within the group that could have entered into the contract on behalf of the entity is required to recognise the transaction. When a group entity is incurring expenses on behalf of another entity, this group entity could be able to capitalise the expenses as part of the cost of the investment (e.g., a parent is incurring expenses of the subsidiary without recharging them), treat them as a distribution (e.g., a sister company is incurring expenses of the entity without recharging them) or to expense them.

The principles apply equally to transactions between a parent and its subsidiaries and those between subsidiaries in a group. If the transaction is between two subsidiaries, and both entities are either required or choose to recognise an equity element in the transaction, one subsidiary recognises a capital contribution from the parent, while the other subsidiary recognises a distribution to the parent. The parent could choose whether or not to recognise the equity transfer in its stand-alone financial statements.

The above treatment could be impacted by the regulations in the jurisdiction that the entity operates in and, therefore, it is useful to understand local practice.

4.3 Measurement

If a standard requires the transaction to be recognised initially at fair value, it must be measured at fair value regardless of the actual consideration. A difference between the fair value and the actual consideration may mean that other goods or services are being provided, e.g., the transaction includes a management fee. This will be accounted for separately on one of the bases described below. If there is still a difference having taken account of all goods or services, it is accounted for as an equity transaction, i.e., as either a contribution to or distribution of equity.

How we see it

In all other cases when there is a difference between the fair value and the actual consideration after having taken account of all goods or services being provided, we believe there is a choice available to the entity to:

(a) Recognise the transaction at fair value, irrespective of the actual consideration; any difference between fair value and agreed consideration will be a contribution to or a distribution of equity for a subsidiary, or an increase in the investment held or a distribution received by the parent

Or

(b) Recognise the transaction at the actual consideration stated in any agreement related to the transaction

The predecessor values accounting (accounting based on the carrying amounts of the transferor) cannot be applied except for specific circumstances described below.

Except for accounting for the acquisition of businesses when the pooling of interest method is considered (see section 4.4.2 below), the transfer of businesses between a parent and its subsidiary (see section 4.4.3 below), and the acquisition of an investment in a subsidiary constituting a business that is acquired in a share-for-share exchange (see section 2.1.1.B above), there is no other basis for the measurement of the transactions between entities under common control other than those stated in (a) and (b) above.

4.3.1 Fair value in intra-group transactions

The requirements for fair value measurement included in IFRS 13 should be applied to common control transactions. However, fair value can be difficult to establish in intra-group transactions.

If there is more than one element to the transaction, this means in principle identifying all the goods and services being provided and accounting for each element at fair value. This is not necessarily straightforward: a bundle of goods and services in an arm's length arrangement will usually be priced at a discount to the price of each of the elements acquired separately and this is reflected in the fair value attributed to the transaction. It can be much harder to allocate fair values in intra-group arrangements when the transaction may not have a commercial equivalent.

As we have already noted, the transaction may be based on the fair value of an asset, but the payment terms are not comparable to those in a transaction between independent parties. The purchase price often remains outstanding on an intercompany account, whereas commercial arrangements always include agreed payment terms. Interest-free loans are common between group companies; these loans may have no formal settlement terms and, while this makes them technically repayable on demand, they too may remain outstanding for prolonged periods.

As a result, there can be a certain amount of estimation when applying fair values to group arrangements.

Some IFRS accounting standards are based on the assumption that one entity may not have the information available to the other party in a transaction, for example:

- A lessee may not know the interest rate implicit in the lease, in which case IFRS 16 *Leases* requires the lessee to substitute it with the lessee's incremental borrowing rate (see Chapter 24 at section 4.6).

  And

- In exchanges of assets, IAS 16 and IAS 38 note that one party may not have information about the fair value of the asset it is receiving, the fair value of the asset it is giving up or it may be able to determine one of these values more easily than the other (see Chapter 19 at section 4.4 and section 4.4.1.B below).

In an intra-group transaction, it will be difficult to assume that one group entity knows the fair value of the transaction, but the other does not. The approximations allowed by these standards will probably not apply.

However, if a subsidiary is not wholly-owned, such transactions are undertaken generally at arm's length as non-controlling shareholders are impacted. Therefore, in a situation when such a transaction is not at arm's length, the reasons for and implications of the transaction must be assessed and carefully analysed.

4.4 Application of the principles in practice

The following sections deal with some common transactions that occur between entities under common control. While the scenarios depict transactions between a parent and its subsidiaries they apply similarly to transactions between subsidiaries. Most of the examples in these sections deal with transactions having a non-arm's length element. As for any other transactions undertaken at fair value (at arm's length), respective IFRS accounting standards that are applicable must be taken into account.

Deferred tax has been ignored for the purposes of the examples.

4.4.1 Transactions involving non-monetary assets

The sections below describe a number of examples of transactions between a parent and subsidiary. The principles described also apply when the asset acquired, for a consideration different to fair value, is inventory (IAS 2 *Inventories* - Chapter 23), property, plant, and equipment ('PP&E') (IAS 16 - Chapter 19), an intangible asset (IAS 38 - Chapter 18) or investment property (IAS 40 - Chapter 20). These standards all require assets to be initially recognised at cost.

These principles generally also apply to the acquisition of an investment in a subsidiary, an associate or joint venture when the purchase consideration does not reflect the fair value of the investment, and such investments are accounted for initially at cost in the separate financial statements as discussed in section 2.1 above. Investments acquired in common control transactions are discussed in section 2.1.1.B above.

4.4.1.A Sale of PP&E from the parent to the subsidiary for an amount of cash not representative of the fair value of the asset

The parent and subsidiary are both parties to the transaction and both must recognise it. As the asset is recognised by the acquiring entity at cost, and not necessarily at fair value, a choice exists as to how the cost is determined.

In some jurisdictions, some entities are legally required to conduct such transactions at fair value and in others they may conduct them at the agreed upon amount (actual consideration).

The above choice that exists when accounting for acquisition of the asset for an amount of cash not representative of the fair value of the asset is explained in the following Illustration 4-1:

Illustration 4-1: Sale of PP&E at an undervalue

A parent entity sells PP&E that has a carrying amount of 50 and a fair value of 100 to its subsidiary for cash of 80.

Method (a)					Method (b)				
Recognise the transaction at fair value, regardless of the values in any agreement, with any difference between that amount and fair value recognised as an equity transaction. (Note 1)					Recognise the transaction at the consideration agreed between the parties, being the amount of cash paid.				
Subsidiary									
			CU	**CU**				**CU**	**CU**
Dr	PP&E		100		Dr	PP&E		80	
	Cr	Cash		80		Cr	Cash		80
	Cr	Equity		20					
Parent									
			CU	**CU**				**CU**	**CU**
Dr	Cash		80		Dr	Cash		80	
Dr	Investment		20			Cr	PP&E		50
	Cr	PP&E		50		Cr	Gain (profit or loss)		30
	Cr	Gain (profit or loss)		50					

Note 1 This may only be applied when fair value can be measured reliably.

However, what if the asset is sold for more than fair value? What are the implications if, in the above example, the PP&E sold for 80 has a carrying value of 80 but its fair value is 75? There are a number of explanations that may affect the way in which the transaction is accounted for:

- The excess reflects additional services or goods included in the transaction, e.g., future maintenance that will be accounted for separately.
- The excess reflects the fact that the asset's value in use ('VIU') is at least 80. There are instances when PP&E is carried at an amount in excess of fair value because its VIU, or the VIU of the cash-generating unit of which it is a part, is unaffected by falls in fair value. Plant and machinery often have a low resale value; vehicles lose much of their fair value soon after purchase; and falls in property values may not affect the VIU of the head office of a profitable entity (see Chapter 21). Where an entity has an accounting policy to recognise such transactions at consideration paid, there is no reason why the subsidiary cannot record the asset it has acquired for the cash it has paid, which means that it effectively inherits the transferor's carrying value. An impairment test potentially would not reveal any requirement to write down the asset, assuming of course that other factors do not reduce the asset's VIU (e.g., the fact that the asset will after the sale be part of a different cash generating unit).
- The excess over fair value is a distribution by the subsidiary to the parent that will be accounted for in equity. This treatment is a legal requirement in some jurisdictions, which means that the overpayment must meet the legal requirements for dividends, principally that there be sufficient distributable profits to meet the cost.
- The asset is impaired before transfer, i.e., both its fair value and VIU are lower than its carrying amount in which case it must be written down by the transferor before the exchange takes place when Method (b) is applied. If it is still sold for more than its fair value, the excess will be accounted for as a distribution received (by the parent) and a distribution made by the subsidiary (as above).

4.4.1.B The parent exchanges PP&E for a non-monetary asset of the subsidiary

The parent and subsidiary are both parties to the transaction and both must recognise it. The exchange of an asset for another non-monetary asset is accounted for by recognising the received asset at fair value, unless the transaction lacks commercial substance (as defined by IAS 16) or the fair value of neither of the exchanged assets can be measured reliably. *[IAS 16.24]*. The requirements of IAS 16 are explained in Chapter 19 at section 4.4; the treatment required by IAS 38 and IAS 40 is the same.

The mere fact that an exchange transaction takes place between entities under common control does not of itself indicate that the transaction lacks commercial substance. In an exchange transaction between unrelated parties the fair values of the assets are usually the same, but this does not necessarily need to be the case in transactions between entities under common control.

If the fair value of both assets can be measured reliably there may be a difference between the two. IAS 16 requires that, if an entity is able to determine reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure the cost of the asset received unless the fair value of the asset received is more clearly evident. *[IAS 16.26]*. Therefore, IAS 16 actually requires an entity to base its accounting for the exchange on the asset whose fair value is most clearly evident. *[IAS 16.26]*. If fair values are different, it is possible that the group entities have entered into a transaction that includes a component of a non-reciprocal transaction. This means that the entity has the policy choice described in section 4.3 above, which in this case means that there are three alternative treatments; it can recognise the transaction as follows:

- Method (a) - an exchange of assets at fair value of the asset received with an equity transaction. Any difference between the fair value of the asset received and the fair value of the asset given up is an equity transaction, while the difference between the carrying value of the asset given up and its fair value is recognised in profit or loss.
- Method (b) - an exchange of assets at fair value of the asset received without recognising an equity element. The asset received is recognised at its fair value and any resulting difference to the carrying value of the asset given up is recognised in profit or loss.

  Or
- Method (c) - apply a 'cost' method based on IAS 16 (the fair value of the asset given up is used to measure the cost of the asset received) under which each entity records the asset at the fair value of the asset it has given up. This could result in one of the parties recording the asset it has received at an amount in excess of its fair value, which may be an indicator of impairment of the asset. It would be consistent with the principles outlined in section 4.3 above to treat the write down as an equity transaction, i.e., an addition to the carrying value of the subsidiary by the parent and a distribution by the subsidiary.

Illustration 4-2: Exchange of assets with dissimilar values

A parent entity transfers an item of PP&E to its subsidiary in exchange for an item of PP&E of the subsidiary, with the following values:

Subsidiary		Parent	
	CU		CU
Carrying Value	20	Carrying Value	50
Fair Value	80	Fair Value	100

The fair value of both assets can be measured reliably.

The accounting for the transaction by the parent and the subsidiary under each of the methods is as follows:

Method (a)

Subsidiary					Parent				
			CU	CU				CU	CU
Dr	PP&E		100		Dr	PP&E		80	
	Cr	PP&E		20	Dr	Investment		20	
	Cr	Gain (profit or loss)		60		Cr	PP&E		50
	Cr	Equity		20		Cr	Gain (profit or loss)		50

Method (b)

Subsidiary					*Parent*				
			CU	CU				CU	CU
Dr	PP&E		100		Dr	PP&E		80	
	Cr	PP&E		20		Cr	PP&E		50
	Cr	Gain (profit or loss)		80		Cr	Gain (profit or loss)		30

Method (c)							
Subsidiary					*Parent*		
			CU	CU			CU	CU
Dr	PP&E		80		Dr	PP&E (100 - 20)	80	
	Cr	PP&E		20	Dr	Investment	20	
	Cr	Gain (profit or loss)		60		Cr PP&E		50
						Cr Gain (profit or loss)		50

If the fair value of only one of the exchanged assets can be measured reliably, IAS 16 allows both parties to recognise the asset they have received at the fair value of the asset that can be measured reliably. *[IAS 16.26]*. Underlying this requirement is a presumption that the fair value of both assets is the same, but one cannot assume this about common control transactions.

If the fair value of neither of the exchanged assets can be measured reliably, or the transaction does not have commercial substance, both the parent and subsidiary recognise the received asset at the carrying amount of the asset they have given up.

4.4.1.C Acquisition and sale of assets for shares

These transactions include the transfer of inventory, property plant and equipment, intangible assets, investment property and investments in subsidiaries, associates, and joint ventures by one entity in return for shares of the other entity. These transactions are usually between a parent and subsidiary and the subsidiary is the transferee that issues shares to the parent in exchange for the assets received. In some cases, local regulations require that the fair value of the assets transferred is not lower than the nominal amount of shares issued.

(a) Accounting treatment by the subsidiary

Transactions that include the transfer of inventory, property plant and equipment, intangible assets, and investment property are within the scope of IFRS 2, as goods have been received in exchange for shares. The assets are recognised at their fair value, unless the fair value cannot be estimated reliably, and an increase in equity of the same amount is recognised. If the fair value of the assets cannot be estimated reliably, the fair value of the shares is used instead. *[IFRS 2.10]*.

Transactions in which an investment in a subsidiary, associate or joint venture is acquired in exchange for shares are not specifically addressed under IFRS accounting standards, since they fall outside the scope of both IFRS 9 and IFRS 2. Similar transactions that do not occur under common control are discussed in section 2.1.1.A above.

How we see it

We believe that it is appropriate, by analogy with IFRS accounting standards on related areas (such as IFRS 2, IFRS 3, or the guidance in IAS 16 on exchange of assets), to account for transactions in which an investment in a subsidiary, associate or joint venture is acquired in exchange for shares, at the fair value of (i) the consideration given (being fair value of equity instruments issued) or (ii) the assets received, if that is more easily measured, together with directly attributable transaction costs. In selecting the accounting policy choice an entity considers applicable local regulation requirements.

As discussed in section 2.1.1.B above, when the purchase consideration does not correspond to the fair value of the investment acquired, in our view, the acquirer has an accounting policy choice to account for the investment at fair value of the consideration given or may impute an equity contribution or dividend distribution and in effect account for the investment at its fair value.

Alternatively, if the investment in a subsidiary constitutes a business and is acquired in a share-for-share exchange, it is also acceptable to measure the cost, as explained in section 2.1.1.B above, based on the carrying amount of the investment in the subsidiary in the transferor entity's separate financial statements, rather than at the fair value of the shares given as consideration. This approach is conceptually based on the pooling of interest approach that is allowed for business combinations under common control (see Chapter 11 at section 3).

(b) Accounting treatment by the parent

The parent has disposed of an asset in exchange for an increased investment in a subsidiary. Based on what has been said in section 2.1.1 above, the cost of investment should be recorded at the fair value of the consideration given i.e., the fair value of the asset sold. Such a transaction has also the nature of an exchange of assets and, by analogy to IAS 16.24, the investment should be measured at fair value unless the exchange transaction lacks commercial substance or the fair value of neither the investment received, nor the asset given up is reliably measurable. If the investment cannot be measured at fair value, it is measured at the carrying value of the asset given up. *[IAS 16.24]*.

It may be that the asset's fair value is lower than its carrying value, but it is not impaired, because its VIU is sufficient to support its carrying value (see section 4.4.1.A above and Chapter 21 at section 12). In these circumstances, the parent is not prevented from treating the difference between the fair value of the asset disposed and the carrying value as an addition to the investment in the subsidiary solely because the fair value is lower. In substance, the entity is exchanging an asset with an investment as if the transaction has no commercial substance. If the asset is impaired, then this is recognised before reclassification, unless the reorganisation affects, and increases, the VIU. Significant judgement is exercised to understand how, and if, the reorganisation affects the future cash flows on which the VIU calculation is based.

If the fair value is higher than the carrying value and the investment is accounted for at fair value as discussed above, the transferring entity recognises a gain. In certain circumstances, it may not be appropriate to account for the transaction at fair value due to lack of commercial substance. For example, exchanging the asset for an investment in the shares of a subsidiary that holds nothing, but the asset given as consideration may not give rise to a gain on transfer.

4.4.1.D Contribution and distribution of assets

These transactions include transfers of inventory, property, plant and equipment, intangible assets, investment property and investments in subsidiaries, associates, and joint ventures from one entity to another for no consideration. These arrangements are not contractual but are equity transactions: either specie capital contributions (an asset is gifted by a parent to a subsidiary) or non-cash distributions (an asset is given by a subsidiary to its parent). IFRIC 17 explicitly excludes intra-group non-cash distributions from its scope (see section 2.4.2 above). *[IFRIC 17.5]*.

The relevant standards (IAS 2, IAS 16, IAS 38, and IAS 40) refer to assets being recognised at cost. Similarly, investments in subsidiaries, associates and joint ventures may be recognised at cost under IAS 27 as discussed in section 2.1 above.

How we see it

We believe that following the principles described in section 4.3 above, (and having considered applicable local regulations) the entity receiving the asset has a choice: to recognise it at zero, or at fair value. It is in practice more common for an entity that has received an asset in what is purely an equity transaction to recognise it at fair value. An entity must consistently apply its chosen accounting policy.

The entity that gives away the asset must reflect the transaction. A parent that makes a specie capital contribution to its subsidiary will recognise an increased investment in that subsidiary (in principle at fair value, recognising a gain or loss based on the difference from the carrying amount of the asset) provided the increase does not result in the impairment of the investment, or an expense (based on the carrying amount of the asset given away). A subsidiary that makes a distribution in specie to its parent can account for the transaction by derecognising the distributed asset at its carrying value against retained earnings.

However, the subsidiary could also account for the distribution at fair value, if the fair value can be established reliably. This would potentially result in recognising a gain in profit or loss for the difference between the fair value of the asset and its carrying value. There would also be a charge to equity for the distribution, recognised and measured at the fair value of the asset. Although such in specie distribution from the subsidiary to its parent is not in scope of IFRIC 17, the provisions of IFRIC 17 can be applied by analogy.

4.4.1.E Transfers between subsidiaries

As noted in section 4.2 above, similar principles apply when the arrangement is between two subsidiaries rather than a subsidiary and parent. To illustrate this, assume that the transaction in Illustration 4-1 in section 4.4.1.A above takes place between two subsidiaries rather than parent and subsidiary.

Illustration 4-3: Transactions between subsidiaries

The facts are as in Illustration 4-1 above except that Subsidiary A sells PP&E that has a carrying amount of CU50 and a fair value of CU100 to its fellow-subsidiary B for cash of CU80. As before, it is assumed that fair value can be measured reliably.

Method (a)	Method (b)
Recognise the transaction at fair value, regardless of the values in any agreement, with any difference between that amount and fair value recognised as an equity transaction.	Recognise the transaction at the consideration agreed between the parties, being the amount of cash paid.

Subsidiary A

			CU	CU
Dr	Cash		80	
Dr	Equity (Note 1)		20	
	Cr	PP&E		50
	Cr	Gain (profit or loss)		50

			CU	CU
Dr	Cash		80	
	Cr	PP&E		50
	Cr	Gain (profit or loss)		30

Subsidiary B

			CU	CU
Dr	PP&E		100	
	Cr	Cash		80
	Cr	Equity (Note 1)		20

			CU	CU
Dr	PP&E		80	
	Cr	Cash		80

Note 1 From subsidiary A's perspective there is an equity element to the transaction representing the difference between the fair value of the asset and the contractual consideration. This reflects the amount by which the transaction has reduced A's fair value and has been shown as a distribution by A to its parent. From subsidiary B's perspective, the equity element is a capital contribution from the parent.

Parent (Note 2)

			CU	CU
Dr	Investment in B		20	
	Cr	Investment in A		20

No entries made

Note 2 Parent can choose to reallocate the equity element of the transaction between its two subsidiaries so as to reflect the changes in value.

In some circumstances, the transfer of an asset from one subsidiary to another may affect the value of the transferor's assets to such an extent as to be an indicator of impairment in respect of the parent's investment in its shares. This could happen if the parent acquired the subsidiary for an amount that includes goodwill and the assets generating part or all of that goodwill have been transferred to another subsidiary. As a result, the carrying value of the shares in the parent may exceed the fair value or VIU of the remaining assets. This is discussed further in Chapter 21 at section 12.3.

4.4.2 Acquiring and selling businesses - transfers between subsidiaries

One group entity may sell, and another may purchase, the net assets of a business rather than the shares in the entity. The acquisition may be for cash or shares and both entities must record the transaction in their individual or separate financial statements. There can also be transfers for no consideration. As this chapter only addresses transactions between entities under common control, any arrangement described in this section from the perspective of the transferee will be as common control transactions out of scope of IFRS 3. The common control exemption is discussed in Chapter 10 at section 2.

If the arrangement is a business combination for the acquiring entity it will also not be within scope of IFRS 2. *[IFRS 2.5]*.

The transferor must recognise the transfer of a business under common control. If the consideration received does not represent fair value of the business transferred or there is the transfer without any consideration, the principles described in section 4.4.2.C below are applied to decide whether any equity element is recognised.

4.4.2.A Has a business been acquired?

IFRS 3 defines a business as "an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities". *[IFRS 3 Appendix A]*. See Chapter 9 at section 3.2 for descriptions of the features of a business.

4.4.2.B If a business has been acquired, how should it be accounted for?

How we see it

As described in Chapter 11 at section 3, we believe that, given that the IASB decided in November 2023 not to develop requirements for reporting business combinations under common control, entities should apply either:

(a) The pooling of interest method

Or

(b) The acquisition method (as in IFRS 3)

In our view, when the acquisition method of accounting is selected to reflect, in the separate financial statements, the acquisition of the business under common control, the transaction must have substance from the perspective of the reporting entity. This is because the method results in a reassessment of the value of the net assets of one or more of the entities involved and/or the recognition of goodwill. Chapter 11 discusses the factors that will give substance to a transaction and although this is written primarily in the context of the acquisition of an entity by another entity, it applies equally to the acquisition of a business by an entity or a legal merger of two subsidiaries.

4.4.2.C Purchase and sale of a business for equity or cash not representative of the fair value of the business

How we see it

In our view, the principles of accounting in the separate financial statements, if a business has been acquired or sold under common control when the consideration in equity or cash is not representative of the fair value of the business, are no different to those described in section 4.4.1.A above. The entity may:

- Recognise the transaction at fair value, regardless of the values in any agreement, with any difference between that amount and fair value recognised as an equity transaction.

  Or

- Recognise the transaction at the consideration agreed between the parties, being the amount of cash paid or fair value of shares issued.

From the perspective of the acquirer of the business, the above choice matters only when the acquisition method is applied in accounting for the business acquired. Depending on which approach is applied, goodwill on the acquisition may be different (or there can even be a gain on bargain purchase recognised). This is discussed further in Chapter 11 at section 3.2. When the pooling of interest method is applied, the difference between the consideration paid and carrying value of net assets received is always recognised in equity no matter whether the consideration agreed between the parties represents the fair value of the business. If no consideration is payable for the transfer of the business, this could affect the assessment as to whether the transaction has substance to enable the acquisition method to be applied.

From the perspective of the seller of the business, the choice will impact any gain or loss recognised on the disposal. Recognising the transaction on the basis of the consideration agreed will result in a gain or loss based on the difference between the consideration received and the carrying value of the business disposed. Recognising the transaction at fair value including an equity element imputed will result in the gain or loss being the difference between the fair value of the business and its carrying value. If no consideration is received for the transfer of the business, the transaction may be considered to be more in the nature of a distribution in specie, the accounting for which is discussed in section 4.4.1.D above.

4.4.2.D If the net assets are not a business, how should the transactions be accounted for?

Even though one entity acquires the net assets of another, this is not necessarily a business combination. IFRS 3 rules out of scope acquisitions of assets or net assets that are not businesses, noting that:

> "This IFRS does not apply to … the acquisition of an asset or a group of assets that does not constitute a *business*. In such cases the acquirer shall identify and recognise the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, *intangible assets* in IAS 38 *Intangible Assets*) and liabilities assumed. The cost of the group shall be allocated to the individual identifiable assets and liabilities on the basis of their relative *fair values* at the date of purchase. Such a transaction or event does not give rise to goodwill." *[IFRS 3.2(b)]*.

How we see it

In our view, if the net assets, rather than a business, have been acquired or sold under common control and the consideration in equity or cash is not representative of the fair value of the net assets the principles for accounting in the separate financial statements are no different to those described in sections 4.4.1.A, 4.4.1.C and 4.4.1.D above. The entity may:

- Recognise the transaction at fair value, regardless of the values in any agreement, with any difference between that amount and fair value recognised as an equity transaction, provided that the fair value can be reliably measured.

  Or

- Recognise the transaction at the consideration agreed between the parties, being the amount of cash paid or fair value of shares issued.

4.4.3 Transfers of businesses between parent and subsidiary

As an acquisition of a business by a subsidiary from its parent in exchange for cash, other assets or equity instruments may meet the definition of a business combination, the guidance provided in section 4.4.2 above is applicable. Therefore, this section mainly deals with the transfer of a business from a subsidiary to its parent.

A feature that all transfers of businesses to parent entities have in common, whatever the legal form that they take, is that it is difficult to categorise them as business combinations. There is no acquirer whose actions result in it obtaining control of an acquired business; the parent already controlled the business that has been transferred to it.

A transfer without any consideration is comparable to a distribution by a subsidiary to its parent. The transfer can be a dividend but there are other legal arrangements that have a similar effect including reorganisations sanctioned by a court process or transfers after liquidation of the transferor entity. Some jurisdictions allow a legal merger between a parent and subsidiary to form a single entity. The general issues related to distributions of business are addressed in section 4.4.3.A below, while the special concerns raised by legal mergers are addressed in section 4.4.3.B below.

4.4.3.A Distributions of businesses without consideration - subsidiary transferring business to the parent

When a subsidiary transfers a business to the parent, from the parent perspective, two views exist. One view is that the transfer is a distribution and the model on which to base the accounting is that of receiving a dividend (distribution approach). This approach is permitted when the subsidiary is measured at cost or at fair value applying IFRS 9. Another view is that the parent has exchanged the investment in shares for the underlying assets and this is essentially a change from an equity interest to a direct investment in the net assets and results (exchange of investment for net assets approach). Neither analogy is perfect, although both have their supporters.

How we see it

We believe that in all circumstances, the following two major features will impact the accounting by the parent for the business transferred by the subsidiary:

- Whether the transfer is accounted for at fair value or at 'book value'

  And

- Whether the subsidiary transfers the entirety of its business or only part of it

The transaction could be accounted for at fair value using similar principles to IFRS 3, since a business is being received. Fair value can be used in both circumstances when the parent has set up or acquired the subsidiary.

Book value in turn may depend on whether the subsidiary has been acquired by the parent, in which case the relevant book values would be those reflected in the consolidated financial statements of the parent, rather than those in the subsidiary's financial statements.

The two perspectives are accounted for by the parent as follows:

(i) Distribution approach - the parent effectively has received a distribution that it accounts for in its statement of profit or loss at the fair value of the business received. It reflects the assets acquired and liabilities assumed at their fair value, including goodwill, which will be measured as at the date of the transfer. The existing investment is written off to the statement of profit or loss when the subsidiary transfers the entirety of its business, or tested for impairment when only part of its business is transferred.

(ii) Exchange of investment for net assets approach - the parent has exchanged its investment or part of its investment for the underlying assets and liabilities of the subsidiary and accounts for them at book values. The parent recognises the assets and liabilities transferred in its financial statements. The carrying values that are reported in the consolidated financial statements become the cost of these assets and liabilities for the parent. When the transfer represents the entirety of the subsidiary's business and underlying net assets, the parent's investment in the subsidiary is written off as the transaction results, in substance, in the redemption of shares in the subsidiary in exchange for the underlying assets and liabilities. When only part of the subsidiary's business is transferred, the parent tests for impairment the carrying amount of the investment in the subsidiary. This accounting gives rise to a 'catch-up' adjustment; being the difference between the carrying amounts of the net assets of the subsidiary (including, where appropriate, any goodwill) recognised directly by the parent and the reduction (if any) in the cost of the investment in the subsidiary.

How we see it

In our view, the distribution approach can be applied in all circumstances and is the only appropriate method when the parent carries its investment in shares at fair value applying IFRS 9.

The two linked questions when using the exchange of investment for net assets approach are the treatment of any 'catch-up adjustment' and whether or not to reflect goodwill (or an 'excess' - negative goodwill) relating to the acquisition of the subsidiary in the parent's financial statements. The recognition of goodwill will depend primarily on whether the subsidiary has historically been acquired by the parent (the only circumstances in which this approach allows goodwill in the parent's financial statements after the transfer).

These alternative treatments are summarised in the following table:

Subsidiary set up or acquired	Basis of accounting	Goodwill recognised	Effect on statement of profit or loss
Subsidiary set up by parent	Fair value.	Goodwill or negative goodwill at date of transfer.	Dividend recognised at fair value of the business. Investment written off or tested for impairment. (Note 4)
	Book value from consolidated accounts.	No goodwill or negative goodwill. (Note 1)	Catch up adjustment recognised fully in equity or as income, except that the element relating to a transaction recorded directly in equity may be recognised in equity. (Note 2) Investment written off or tested for impairment.
Subsidiary acquired by parent	Fair value.	Goodwill or negative goodwill at date of transfer.	Dividend recognised at fair value of the business. Investment written off or tested for impairment. (Note 4)
	Book value from consolidated accounts. (Note 3)	Goodwill as at date of original acquisition. (Note 3)	Catch up adjustment recognised fully in equity or as income, except that the element relating to a transaction recorded directly in equity may be recognised in equity. (Note 2) Investment written off or tested for impairment.

Notes

(1) If the parent established the subsidiary itself and its investment reflects only share capital it has injected, an excess of the carrying value over the net assets received will not be recognised as goodwill. This generally arises because of losses incurred by the transferred subsidiary.

If the subsidiary's net assets exceed the carrying value of the investment, then this will be due to profits or other comprehensive income retained in equity.

(2) The catch-up adjustment is not an equity transaction so all of it can be recognised in income. However, to the extent that it has arisen from a transaction that had occurred directly in equity, such as a revaluation, an entity can make a policy choice to recognise this element in equity. In this case the remaining amount is recognised in income. The entity can also take a view that although the transfer of business is a current period transaction, the differences relate to a prior period and hence should be recognised in equity.

(3) Because this was originally an acquisition, the values in the consolidated financial statements (and not the subsidiary's underlying records) become 'cost' for the parent. The assets and liabilities will reflect fair value adjustments made at the time of the business combination. Goodwill or negative goodwill will be the amount as at the date of the original acquisition.

(4) When the investment in the subsidiary is measured at fair value, the parent recognises the fair value of the received net assets and a reduction in the fair value of the investment in the subsidiary in accordance with IFRS 9.

In the separate financial statements, regardless of which approach or variety of approaches are used, comparative information should not be restated to include the net assets distributed by the subsidiary. The financial position and results of operations distributed by the subsidiary are reflected in the separate financial statements only from the date on which the distribution occurred.

How we see it

If the business of the acquired subsidiary is transferred to the parent company as a distribution shortly after acquisition of that subsidiary, we believe that the accounting shall follow IAS 27 in relation to the dividend payment by the subsidiary. It can be accounted for effectively as a return of capital. The parent eliminates its investment in the subsidiary or part of its investment (based on the relative fair value of the business transferred compared to the value of the subsidiary), recognising instead the assets and liabilities of the business acquired at their fair value including the goodwill that has arisen on the business combination. The effect is to reflect the substance of the arrangement which is that the parent acquired a business. Comparative information is not restated in this case.

4.4.3.B Legal merger of parent and subsidiary

A legal merger can occur for numerous reasons, including facilitating a listing or structuring to transfer the borrowings obtained to acquire an entity to be repaid by the entity itself or to achieve tax benefits. Legal mergers are also referred to as 'hive up' or 'hive down' transactions. Legal mergers always affect the individual or separate financial statements of the entities involved. As legal mergers are not specifically discussed in IFRS accounting standards, different views and approaches are encountered in practice.

In many jurisdictions it is possible to affect a 'legal merger' of a parent and its subsidiary whereby the two separate entities become a single entity without any issue of shares or other consideration. This is usually the case when there is a legal merger of a parent with its 100% owned subsidiary. Depending on the jurisdiction, different scenarios may take place.

It is not uncommon for a new entity to be formed as a vehicle used in the acquisition of an entity from a third party in a separate transaction. Subsequently both entities legally merge.

How we see it

Judgement is required to make an assessment as to whether a legal merger occurs 'close to' the date of acquisition, including considering the substance of the transaction and the reasons for doing the merger. If, for example, a new entity is formed concurrently with (or near the date of) the acquisition of a subsidiary, and there is a legal merger of the new entity and the subsidiary, these transactions may, in certain circumstances, be viewed as a single transaction in which a subsidiary is acquired. Facts and circumstances that would, on balance, lead to application of the single transaction perspective are further discussed in Chapter 10 at section 4.1.1.

Even though the substance of the legal merger may be the same, whether the survivor is the parent or subsidiary affects the accounting. The below discussion assumes that both the parent and subsidiary contain businesses. Examples of when these transactions involve entities that do not contain a business are discussed with reference to SPAC transactions. See Chapter 10 at section 2.2.2.A.

In January 2024, the IFRS IC published an agenda decision about how a parent entity that prepares separate financial statements applying IAS 27 accounts for a merger with its subsidiary in its separate financial statements.[17] The IFRS IC noted that in the fact pattern discussed, there is little evidence of diversity in practice as parent entities generally do not apply the requirements in IFRS 3 that apply to the accounting for a business combination and therefore, the IFRS IC did not propose to add a standard-setting project to the work plan.

(a) The parent is the surviving entity

The parent's consolidated financial statements

The legal merger of the parent and its subsidiary on its own does not affect the consolidated financial statements of the group. When non-controlling interests (NCI) are acquired in conjunction with the legal merger transaction, the transaction with the NCI holders is accounted for as a separate equity transaction (i.e., transactions with owners in their capacity as owners). *[IFRS 10.23]*.

How we see it

Even if there is no consolidated group after the legal merger, in our view, according to IFRS 10 consolidated financial statements are still required (including comparative financial statements) in the reporting period in which the legal merger occurs. In such a case, individual financial statements are the continuation of the consolidated group - in subsequent reporting periods, the amounts are carried forward from the consolidated financial statements (and shown as the comparatives in the individual financial statements).

In the reporting period in which the legal merger occurs the parent is also permitted, but not required, to present separate financial statements under IFRS accounting standards.

Separate financial statements

How we see it

When the parent is the surviving entity following the legal merger, then in the parent's separate financial statements we believe two approaches are available if the investment in the subsidiary was previously measured at cost:

- The legal merger is in substance the distribution of the business from subsidiary to the parent.

  Or

- The legal merger is in substance the redemption of shares in the subsidiary, in exchange for the underlying assets of the subsidiary.

17 *IFRIC Update*, November 2023, Addendum to IFRIC Update-Committee's agenda decisions. Available on the IFRS Foundation's website.

An entity chooses its policy and applies it consistently. Under both approaches, any amounts that were previously recognised in the parent's separate financial statements continue to be recognised at the same amount, except for the investment in the subsidiary that is merged into the parent.

The approaches to consider are as follows:

(i) The legal merger is in substance the distribution of the business from subsidiary to the parent (distribution approach).

One way to apply the distribution approach, consistently with distributions of businesses without consideration, is to recognise the assets acquired and the liabilities assumed at their fair value, including goodwill (see section 4.4.3.A above). Another way, which is based on the principles that are used for a business combination that occurs in stages, implies that the investment in the subsidiary is first remeasured to fair value as at the date of the legal merger, with any resulting gain or loss recognised in profit or loss. The investment in the subsidiary is then derecognised and the acquired assets (including investments in subsidiaries, associates, or joint ventures held by the merged subsidiary) and assumed liabilities are recognised at fair value. Any difference gives rise to goodwill or income (bargain purchase, which is recognised in profit or loss).

(ii) The legal merger is in substance the redemption of shares in the subsidiary, in exchange for the underlying assets of the subsidiary.

Consistently with the exchange of investment for net assets approach (see section 4.4.3.A above), giving up the shares for the underlying assets is essentially a change in perspective of the parent of its investment, from a 'direct equity interest' to 'the reported results and net assets'. Hence, the values recognised in the consolidated financial statements become the cost of these assets for the parent. The acquired assets (including investments in subsidiaries, associates, or joint ventures held by the merged subsidiary) and assumed liabilities are recognised at the carrying amounts in the consolidated financial statements as at the date of the legal merger. This includes any associated goodwill, intangible assets, or other adjustments arising from measurement at fair value upon acquisition that were recognised when the subsidiary was originally acquired, less the subsequent related amortisation, depreciation and impairment losses, as applicable. As the parent recognises assets and liabilities of the merged subsidiary, these may also include investments in subsidiaries that are eliminated in preparing the parent's consolidated financial statements. In applying the redemption of shares method, the parent needs to determine the carrying amount of these subsidiaries to be able to recognise values consistent with those in its consolidated financial statements.

How we see it

We believe that, when applying the exchange of investment for net assets approach, the difference between:

(1) The amounts assigned to the assets and liabilities in the parent's separate financial statements after the legal merger

And

(2) The carrying amount of the investment in the merged subsidiary before the legal merger, is recognised in one of the following (accounting policy choice):

- Profit or loss
- Directly in equity

  Or
- Allocated to the appropriate component in the separate financial statements in the current period (e.g., current period profit or loss, current period other comprehensive income, or directly to equity) of the parent based on the component in which they were recognised in the financial statements of the merged subsidiary

If the investment in the subsidiary was measured at fair value in the separate financial statements of the parent, then only the distribution approach is applicable, because there is a direct swap of the investment with the underlying business. The parent would already have reflected the results of transactions that the subsidiary entered into since making its investment - depending on the designation either in other comprehensive income or in profit or loss. Because the underlying investment in the subsidiary is derecognised, this may trigger the reclassification within equity of any amounts previously recognised in other comprehensive income.

In the separate financial statements, regardless of which approach or variety of approaches is used, comparative information should not be restated to include the merged subsidiary. The financial position and results of operations of the merged subsidiary are reflected in the separate financial statements only from the date on which the merger occurred.

(b) The subsidiary is the surviving entity

How we see it

If the subsidiary is the surviving entity following the legal merger then in the subsidiary's separate financial statements, we believe two approaches are available if the investment in the subsidiary was previously measured at cost:

- The economic approach

  Or

- The legal approach

Some argue that the legal form of a merger is more important in the context of the individual or separate financial statements of the subsidiary as these have a different purpose, being the financial statements of a legal entity. Others contend that as the legal mergers are not regulated in IFRS accounting standards the accounting policy selected should reflect the economic substance of transactions, and not merely the legal form. This results in two possible approaches, the economic approach, and the legal approach. The economic approach is on balance the approach that usually provides the more faithful representation of the transaction. The legal approach may however be appropriate when facts and circumstances indicate that the needs of the users of the general-purpose financial statements after the legal merger are best served by using the financial statements of the surviving subsidiary as the predecessor financial statements. This need must outweigh the needs of users who previously relied upon the general-purpose financial statements of the parent (as such information may no longer be available, for example, when, following the merger, there is no group). Consideration is given as to whether either set of users can otherwise obtain the information needed using, for example, special-purpose financial statements.

(i) The economic approach

The legal merger between the parent and subsidiary is considered to have no substance. The amounts recognised after the legal merger are the amounts that were previously recognised in the consolidated financial statements, including goodwill and intangible assets recognised upon acquisition of that subsidiary. The consolidated financial statements after the legal merger also reflect any amounts in the consolidated financial statements (pre-merger) related to subsidiaries, associates, and joint ventures held by the surviving subsidiary. If the surviving subsidiary prepares separate financial statements after the legal merger, the subsidiary recognises the amounts that were previously recognised in the consolidated financial statements of the parent, as a contribution from the parent in equity. When the subsidiary holds investments in other subsidiaries, their cost should be adjusted in order to obtain amounts consistent with those recognised in the consolidated financial statements.

(ii) The legal approach

The financial statements after the legal merger reflect the legal form of the transaction from the perspective of the subsidiary. There are two methods (as described below) with respect to recognising the identifiable assets acquired of the parent or liabilities assumed from the parent; regardless of which is used, amounts recognised previously in the consolidated financial statements with respect to the parent's acquisition of the surviving subsidiary (e.g., goodwill, intangible assets, fair value purchase price adjustments) are not recognised by the subsidiary. The surviving subsidiary does not recognise any change in the basis of subsidiaries, associates, and joint ventures that it held before the legal merger unless its ownership following the merger increased.

Fair value method

If a merged parent meets the definition of a business, the transaction is accounted for as an acquisition, with the consideration being a 'contribution' from the parent recognised in equity at fair value. Principles in IFRS 3 apply then by analogy.

The subsidiary recognises:

(1) The fair value of the parent as a business as a contribution to equity

(2) The identifiable assets acquired, and liabilities assumed from the parent at fair value

And

(3) The difference between (2) and (1) as goodwill or gain on a bargain purchase.

Book value method

Under this method the subsidiary accounts for the transaction as a contribution from the parent at book values. The subsidiary recognises the identifiable assets acquired or liabilities assumed from the parent at the historical carrying amounts and the difference between that amount and the value of any shares issued to affect the transaction, is recognised in equity. The historical carrying amounts may be the carrying amounts previously recognised in the parent's separate financial statements, the amounts in the ultimate parent's consolidated financial statements, or in a sub-level consolidation (prior to the merger).

Whatever variation of the legal approach is applied, the subsidiary may not recognise amounts that were previously recognised in the consolidated financial statements that related to the operations of the subsidiary, because there is no basis in IFRS accounting standards for the subsidiary to recognise fair value adjustments to its internally generated assets or goodwill that were recognised by its parent when it was first acquired. Therefore, the carrying amount of the assets (including investments in subsidiaries, associates, and joint ventures) and liabilities held by the subsidiary are the same both before and after a legal merger (there is no revaluation to fair value). There is also no push-down accounting of any goodwill or fair value adjustments recognised in the consolidated financial statements related to the assets and liabilities of the subsidiary that were recognised when the parent acquired the subsidiary.

How we see it

In the separate financial statements, regardless of which approaches, or variety of approaches are used to account for the merger, comparative information should not be restated to include the merged parent. The financial position and results of operations of the merged parent are reflected in the separate financial statements only from the date on which the merger occurred.

4.4.4 Incurring expenses and settling liabilities without recharges

How we see it

Entities may incur costs that provide a benefit to fellow group entities, for example, audit, management, or advertising fees, and do not recharge the costs. If such costs are not recharged to the beneficiary, then the beneficiary is not party to the transaction and does not directly incur an obligation to settle a liability. We believe that the beneficiary may elect to recognise the cost, in which case it will charge profit or loss and credit equity with equivalent amounts. Alternatively, it may elect to do nothing provided the transaction is not within scope of IFRS 2. If the cost is incurred by a parent and the beneficiary is its subsidiary the parent could also elect to increase the investment in the subsidiary rather than to recognise the cost as an expense.

There is no policy choice if the expense relates to a share-based payment, in which case IFRS 2 mandates that expenses incurred for a subsidiary be added to the carrying amount of the investment in the parent and be recognised by the subsidiary (see Chapter 30 at section 12).

Many groups recharge expenses indirectly, by making management charges, and in these circumstances, it would be inappropriate to recognise the transaction in any entity other than the one that makes the payment.

A parent or other group entity may settle a liability on behalf of a subsidiary. If this is not recharged, the liability will have been extinguished in the entity's accounts. This raises the question of whether the gain should be taken to profit or loss or to equity. IFRS 15 *Revenue from Contracts with Customers* defines income as increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity, other than those relating to contributions from equity participants. *[IFRS 15 Appendix A]*. Except in unusual circumstances, the forgiveness of debt will be a contribution from owners and therefore ought to be taken to equity.

It will usually be appropriate for a parent to add the payment to the investment in the subsidiary as a capital contribution unless a parent concludes that it is more appropriate to expense such forgiveness of debt. If a parent increases the investment in the subsidiary, it may trigger an impairment test. If one subsidiary settles a liability of its fellow subsidiary, both entities can choose to recognise an equity element in the transaction; one subsidiary recognises a capital contribution from the parent, while the other subsidiary recognises a distribution to the parent.

4.4.5 Financial instruments within the scope of IFRS 9

IFRS 9 (except for certain trade receivables) requires the initial recognition of financial assets and financial liabilities to be at fair value, *[IFRS 9.5.1.1]*, so management has no policy choice. Financial instruments arising from group transactions are initially recognised at their fair value, with any difference between the fair value and the terms of the agreement recognised as an equity transaction. The measurement of financial instruments that are received in a transferred business are addressed in sections 4.4.3.A and 4.4.3.B above.

4.4.5.A Interest-free or non-market interest rate loans

Parents may lend money to subsidiaries on an interest-free or low-interest basis and *vice versa*. A feature of some intra-group payables is that they have no specified repayment terms and are therefore, repayable on demand. The fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. This means that an intra-group loan payable on demand has a fair value that is the same as the cash consideration given.

Loans are recognised at fair value on initial recognition based on the market rate of interest for similar loans at the date of issue (see Chapter 45 at section 3.3.1). *[IFRS 9.B5.1.1]*. The party making the loan has a receivable recorded at fair value and must, on initial recognition, account for the difference between the fair value and the loan amount. Also, the party receiving such a loan accounts for a liability at fair value on initial recognition and must deal with the difference between the fair value of such liability and the loan amount.

If the party making the non-market loan is a parent, it adds this to the carrying value of its investment. The subsidiary will initially record a capital contribution in equity. Subsequently, the parent will recognise interest income and the subsidiary interest expense using the effective interest method so that the loan is stated at the amount receivable/repayable at the redemption date. When the loan is repaid, the overall effect in parent's financial statements is of a capital contribution made to the subsidiary as it has increased its investment and recognised income to the same extent (assuming, of course, no impairment). By contrast, the subsidiary has initially recognised a gain in equity that has been reversed as interest has been charged.

If the subsidiary makes the non-market loan to its parent, the difference between the loan amount and its fair value is treated as a distribution by the subsidiary to the parent, while the parent reflects a gain. Again, interest is recognised so that the loan is stated at the amount receivable and payable at the redemption date. For the subsidiary's financial statements, this has the effect of reversing the initial gain or loss taken to equity. Note that the effects in the parent's financial statements are not symmetrical to those when it makes a loan at below market rates. The parent does not need to deduct the benefit it has received from the subsidiary from the carrying value of its investment, but would recognise income from a distribution.

The following Illustration shows the accounting for a variety of intra-group loan arrangements.

Illustration 4-4: Interest-free and below market rate loans within groups

Entity S is a wholly-owned subsidiary of Entity P. In each of the following scenarios one of the entities provides an interest free or below market rate loan to the other entity.

1) P provides an interest free loan in the amount of CU100,000 to S. The loan is repayable on demand.

On initial recognition the receivable is measured at its fair value, which in this case is equal to the cash consideration given. The loan is classified as a current liability in the financial statements of the subsidiary. The classification in the financial statements of the parent depends upon management intention. If the parent had no intention of demanding repayment in the near term, the parent would classify the receivable as non-current in accordance with IAS 1.66.

If S makes an interest-free loan to parent, the accounting is the mirror image of that for the parent.

2) P provides an interest free loan in the amount of CU100,000 to S. The loan is repayable when funds are available.

Generally, a loan that is repayable when funds are available will be classified as a liability. The classification of such a loan, or a part of it, as current or non-current and the measurement at origination date will depend on the subsidiary's right to defer settlement at reporting date. The guidance in IAS 1 on classification of liabilities as current or non-current has changed due to the amendments to that Standard effective for annual periods beginning on or after 1 January 2024 (see Chapter 3 at section 3.1.4); these amendments clarify that management intention does not play a role in the classification of liabilities. If no funds are available to repay the loan of the subsidiary at the reporting date and there is no realistic prospect of funds becoming available for at least twelve months after the reporting date, then at that date the subsidiary has a substantive right to defer. This analysis should be revised at each reporting date. Note that there are differing considerations for classification and measurement, with expectation being disregarded for the former. If the loan is expected to be repaid in three years, measurement of the loan would be the same as in scenario 3.

If S makes an interest-free loan to parent, the accounting is the mirror image of that for the parent.

3) P provides an interest free loan in the amount of CU100,000 to S. The loan is repayable in full after 3 years. The fair value of the loan (based on current market rates of 10%) is CU75,131.

At origination, the difference between the loan amount and its fair value (present value using current market rates for similar instruments) is treated as an equity contribution to the subsidiary, which represents a further investment by the parent in the subsidiary.

Journal entries at origination:

	Parent	**CU**	**CU**
Dr	Loan receivable from subsidiary	75,131	
Dr	Investment in subsidiary	24,869	
	Cr Cash		100,000
	Subsidiary	**CU**	**CU**
Dr	Cash	100,000	
	Cr Loan payable to parent		75,131
	Cr Equity - capital contribution		24,869

Journal entries during the periods to repayment:

	Parent	**CU**	**CU**
Dr	Loan receivable from subsidiary (Note 1)	7,513	
	Cr Profit or loss - notional interest		7,513
	Subsidiary	**CU**	**CU**
Dr	Profit or loss - notional interest	7,513	
	Cr Loan payable to parent		7,513

Note 1 Amounts represent Year 1 assuming no payments before maturity. Years 2 and 3 amounts would be CU8,264 and CU9,092 respectively i.e., accreted at 10%. At the end of year 3, the recorded balance of the loan will be CU100,000.

If S makes an interest-free loan to the parent, the accounting is the mirror image of that of the parent.

4) S provides a below market rate loan in the amount of CU100,000 to P. The loan bears interest at 4% and is repayable in full after 3 years (i.e., CU112,000 at the end of year 3). The fair value of the loan (based on current market rates of 10%) is CU84,147.

At origination, the difference between the loan amount and its fair value is treated as a distribution from the subsidiary to the parent. If parent provides a below market rate loan of CU100,000 to S, the accounting is the mirror image of that of the subsidiary; however, the difference between the loan amount and its fair value is treated as an equity contribution to the subsidiary, which represents a further investment by the parent in the subsidiary.

Journal entries at origination:

	Parent		**CU**	**CU**
Dr	Cash		100,000	
	Cr	Loan payable to subsidiary		84,147
	Cr	Profit or loss - distribution from subsidiary		15,853
	Subsidiary		**CU**	**CU**
Dr	Loan receivable from parent		84,147	
Dr	Retained earnings - distribution		15,853	
	Cr	Cash		100,000

Journal entries during the periods to repayment:

	Parent		**CU**	**CU**
Dr	Profit or loss - notional interest		8,415	
	Cr	Loan payable to subsidiary		8,415
	Subsidiary		**CU**	**CU**
Dr	Loan receivable from parent (Note 1)		8,415	
	Cr	Profit or loss - notional interest		8,415

Note 1 Amounts represent Year 1 assuming no payments before maturity. Years 2 and 3 amounts would be CU9,256 and CU10,182, respectively i.e., accreted at 10% such that at the end of year 3 the recorded balance of the loan will be CU112,000 being the principal of the loan (CU100,000) plus the interest payable in cash (CU12,000).

4.4.5.B Financial guarantee contracts: parent guarantee issued on behalf of subsidiary

Financial guarantees given by an entity that are within the scope of IFRS 9 must be recognised initially at fair value as there is no exemption from the measurement requirements of IFRS 9 for guarantees issued between parents and their subsidiaries, between entities under common control nor by a parent or subsidiary on behalf of a subsidiary or a parent (See Chapter 41 at section 2.4.4). *[IFRS 9.5.1.1]*.

If a parent or other group entity gives a guarantee on behalf of an entity, this must be recognised in its separate or individual financial statements. Whether or not the guarantee is provided at stand-alone arm's length terms or on off-market terms (for example for no charge) will need to be considered. When the guarantee is provided on off-market terms, it is normally appropriate for a parent that gives a guarantee to treat the off-market terms component as a debit that arises on recognising the guarantee as an additional investment in its subsidiary. This is described in Chapter 45 at section 3.3.3.

The situation is different for the subsidiary (or borrower) whose obligations are guaranteed under the contract.

Appendix A of IFRS 13 defines a unit of account for purposes of fair value measurement as "the level at which an asset or a liability is aggregated or disaggregated in an IFRS for recognition purposes". Guarantees that are part of the contractual terms of a financial instrument are described in Chapter 47 at section 5.8.1.A.

Therefore, in situations where the guarantee would be transferred along with the subsidiary's liability, the fair value of that liability to the subsidiary both at inception and for purposes of subsequent measurement includes the guarantee; this implies that there will be no separate recognition of the financial guarantee unless it is provided to the lender separate and apart from the original borrowing, such that it does not form part of the overall terms of the loan (i.e., would not transfer with the loan if it were assigned by the lender to a third party).

Facts and circumstances must be carefully analysed before concluding that guarantees will be reflected separately in the financial statements of the entities that benefit from the guarantees. Financial guarantee contracts are generally described in Chapter 41 at section 2.4.

Illustration 4-5: Financial guarantee contracts

A group consists of two entities, H plc (the parent) and S Ltd (H's wholly-owned subsidiary). Entity H has a stronger credit rating than S Ltd. S Ltd is looking to borrow CU100, repayable in five years. A bank has indicated it will charge interest of 7.5% per annum. However, the bank has offered to lend to S Ltd at a rate of 7.0% per annum if H plc provides a guarantee of S Ltd's debt to the bank and this is accepted by S Ltd. No charge was made by H plc to S Ltd in respect of the guarantee. The fair value of the guarantee is calculated at CU2, which is the difference between the present value of the contractual payments discounted at 7.0% and 7.5%. If the bank were to assign the loan to S Ltd to a third party, the assignee would become party to both the contractual terms of the borrowing with S Ltd as well as the guarantee from H plc.

H plc will record the guarantee at its fair value of CU2.

S Ltd will record its loan at fair value including the value of the guarantee provided by the parent. It will simply record the liability at CU100 but will not recognise separately the guarantee provided by the parent.

If the guarantee was separate, S Ltd would record the liability at its fair value without the guarantee of CU98 with the difference of CU2 recorded as a capital contribution.

4.5 Disclosures

When there have been significant transactions between entities under common control that are not on arm's length terms, it will be necessary for the entity to disclose its accounting policy for recognising and measuring such transactions.

IAS 24 applies whether or not a price has been charged, so gifts of assets or services and asset swaps are within scope. Details and terms of the transactions must be disclosed (see Chapter 34 at section 4.1).

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Appendix C - Defined terms

Extract from IAS 27

4 The following terms are used in this Standard with the meanings specified:

Consolidated financial statements are the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

Separate financial statements are those presented by an entity in which the entity could elect, subject to the requirements in this Standard, to account for its investments in subsidiaries, joint ventures and associates either at cost, in accordance with IFRS 9 *Financial Instruments*, or using the equity method as described in IAS 28 *Investments in Associates and Joint Ventures*.

Chapter 10 Business combinations

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Overview

This chapter discusses principles and requirements that an acquirer applies in accounting for a business combination under IFRS 3 *Business Combinations*. These principles and requirements determine how the acquirer:

- Recognises and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree
- Recognises and measures the goodwill acquired in the business combination or a gain from a bargain purchase
- Determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination

The guidance discussed in this chapter covers business combinations primarily effected by unrelated parties and accounted for under the acquisition method. Business combinations involving entities under common control are discussed in Chapter 11. Accounting for business combinations resulting from the formation of a joint arrangement in the financial statements of the joint arrangement itself is discussed in Chapter 12 at section 7.5.3.

This chapter also provides some guidance on accounting for the acquisition of assets or group of assets that do not constitute a business even if they are housed in a separate legal entity (see section 2.2.2 below).

What you need to know

- IFRS 3 requires an entity to determine whether a transaction or event is a business combination (see section 3.1 and 3.2.6 below).
- To assess whether a transaction is the acquisition of a business, an entity may apply first a quantitative concentration test. The entity is not required to apply the test but may elect to do so separately for each transaction or other event (see section 3.2.3 below).
- If the concentration test is met, the set of activities and assets is not a business and no further assessment is required. Otherwise, or if the entity elects not to apply the test, the entity performs the qualitative analysis of whether an acquired set of assets and activities includes at a minimum, an input and a substantive process (see section 3.2.4 below) that together significantly contribute to the ability to create outputs.
- A business combination is accounted for by applying the acquisition method that involves identifying an acquirer (see section 4.1 below), determining the acquisition date (see section 4.2 below), recognising and measuring the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree (see section 5 below) and recognising and measuring goodwill or a gain from a bargain purchase (see section 6 below).
- If the assets acquired and liabilities assumed do not constitute a business, the transaction is accounted for as an acquisition of a group of assets, i.e., the cost of the group is allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase and goodwill is not recognised (see section 2.2.2 below).

1 Introduction

A business combination is defined by the IASB ('the Board') as a "transaction or other event in which an **acquirer** obtains control of one or more **businesses**". *[IFRS 3 Appendix A]*.

Over the years, business combinations have been defined in different ways. Whatever definition has been applied, it includes circumstances in which an entity obtains control of an integrated set of activities and assets that constitute a business.

In accounting terms there have traditionally been two distinctly different forms of reporting the effects of a business combination; the purchase method of accounting (typically known as the acquisition method) and the pooling of interests method (or merger accounting).

The two methods of accounting look at business combinations through quite different eyes. An acquisition was seen as the absorption of the target by the acquirer; there is continuity only of the acquiring entity, in the sense that only the post-acquisition results of the target are reported as earnings of the acquiring entity and the comparative figures remain those of the acquiring entity. In contrast, a pooling of interests or merger is seen as the pooling together of two formerly distinct shareholder groups; in order to present continuity of both entities there is retrospective restatement to show the enlarged entity as if the two entities had always been together, by combining the results of both entities pre- and post-combination and also by restatement of the comparatives. The acquisition method has become the established method of accounting for business combinations under IFRS Accounting standards. Nevertheless, the pooling of interests method is still sometimes used for business combinations involving entities under common control when the transactions have been scoped out of the relevant standard dealing with business combinations (see Chapter 11).

The other main issues facing preparers have been in relation to the application of the acquisition method of accounting for a business combination. Broadly speaking, the acquiring entity has to determine the fair values of the identifiable assets and liabilities of the target. When the acquisition-date fair value of the assets acquired and liabilities assumed in the business combination (subject to certain limited recognition and measurement exceptions) are less than the overall consideration given, the difference is accounted for as goodwill. Goodwill is an asset that is not amortised, but is subject to an impairment test by applying the guidance in IAS 36 *Impairment of Assets*. When the consideration given is less than the fair value of the identifiable net assets acquired, known as a 'bargain purchase', the issue is whether and when such a credit is taken to the income statement.

FASB differences

Differences between IFRS accounting standards and US GAAP guidance on this topic are not addressed in this chapter. Therefore, differences between IFRS accounting standards and US GAAP may exist which are not discussed in this publication.

1.1 IFRS 3 (as revised in 2008) and subsequent amendments

This chapter discusses IFRS 3 as revised in 2008 and amended subsequently and its associated Basis for Conclusions and Illustrative Examples.

The specific requirements of IAS 38 *Intangible Assets* relating to intangible assets acquired as part of a business combination accounted for under IFRS 3 are dealt with as part of the discussion of IFRS 3 in this chapter; the other requirements of IAS 38 are covered in Chapter 18. Impairment of goodwill is addressed in Chapter 21 at section 8.

In May 2011, the IASB issued a series of IFRS accounting standards that deal broadly with consolidated financial statements. IFRS 10 *Consolidated Financial Statements* is a single standard addressing consolidation. The requirements of IFRS 10 are discussed in Chapter 7 and Chapter 8 which address, respectively, its consolidation requirements and consolidation procedures. Some consequential amendments were made to IFRS 3, principally to reflect that the guidance on 'control' within IFRS 10 is used to identify the acquirer in a business combination.

IFRS 13 *Fair Value Measurement* changed the definition of 'fair value' to an explicit exit value, but it did not change when fair value is required or permitted under IFRS accounting standards. Its impact on IFRS 3 is considered in section 5.3 below and Chapter 15 contains a full discussion. Unless otherwise indicated, references to fair value in this chapter are to fair value as defined by IFRS 13.

In October 2012, the IASB amended IFRS 10 to provide an exception to the consolidation requirement for entities that meet the definition of an investment entity. As a result of this amendment, the scope of IFRS 3 was also amended (see section 2.2 below). The investment entities exception is discussed in Chapter 7 at section 10.

In December 2013, the IASB issued two cycles of Annual Improvements - *Cycles 2010-2012* and *2011-2013* - that had the following impact on IFRS 3:

- Contingent consideration in a business combination that is not classified as equity is subsequently measured at fair value through profit or loss whether or not it falls within the scope of IFRS 9 *Financial Instruments* (see sections 7.1.2 and 7.1.3 below).
- The formation of joint arrangements, both joint operations and joint ventures, is outside the scope of IFRS 3. The amendment has also clarified that the scope exception applies only to the accounting in the financial statements of the joint arrangement itself (see section 2.2.1 below).
- A clarification that the guidance on ancillary services in IAS 40 *Investment Property*, *[IAS 40.11, IAS 40.12, IAS 40.13, IAS 40.14]*, is intended to distinguish an investment property from an owner-occupied property, not whether a transaction is a business combination or an asset acquisition (see section 3.2.6 below).

As a result of the issue of IFRS 15 *Revenue from Contracts with Customers* in May 2014, a consequential amendment was made to IFRS 3 for the requirements for the subsequent measurement of a contingent liability recognised in a business combination (see section 5.6.1.B below).

Some consequential amendments have been made to IFRS 3 as a result of the issue of IFRS 9. These relate principally to the requirements for:

- Classifying or designating identifiable assets acquired and liabilities assumed (see section 5.4 below)
- Business combinations achieved in stages (see section 9 below)
- Contingent consideration classified as an asset or liability (see section 7.1 below)

In January 2016, the IASB issued IFRS 16 *Leases*, which requires lessees to recognise assets and liabilities for most leases under a single accounting model. A number of consequential amendments have been made to IFRS 3 in respect of leases accounted for under IFRS 16. These relate to the requirements for:

- Classifying or designating identifiable assets acquired and liabilities assumed (see section 5.4 below)
- Recognising and measuring particular assets acquired and liabilities assumed (see section 5.5.1 below)
- Exceptions to the recognition and/or measurement principles (see section 5.6.8 below)

In May 2017, the IASB issued IFRS 17 *Insurance Contracts* (which was further amended in June 2020). IFRS 17 replaces IFRS 4 *Insurance Contracts* and is effective for reporting periods beginning on or after 1 January 2023, with early application permitted. IFRS 17 introduced a new exception to measurement principles in IFRS 3 (see section 5.6.9 below).

In December 2017, the IASB issued amendments to IFRS 3 and IFRS 11 *Joint Arrangements* as part of the *Annual Improvements to IFRS Standards 2015-2017 Cycle*. The amendments clarified how a party to a joint operation accounts for a transaction in which it obtains control of a joint operation that constitutes a business (see section 9.1 below).

In October 2018, as a result of the *Post Implementation Review of IFRS 3* (PIR of IFRS 3), the IASB issued narrow-scope amendments to IFRS 3 to address the challenges in applying the definition of a business. In particular, the amendments clarified the minimum requirements for a business (under the amended definition, a business can exist without including all of the inputs and processes needed to create outputs), removed the assessment of whether market participants are capable of replacing any missing elements, narrowed the definitions of a business and outputs by excluding from the definition of outputs returns in the form of lower costs, introduced an optional fair value concentration test and added guidance to help entities assess whether an acquired process is substantive. New illustrative examples were also added to explain the application of the amended requirements (see section 3.2 below).

In May 2020, the IASB issued amendments to IFRS 3 to replace a reference to a previous version of the IASB's Conceptual Framework with a reference to the current version issued in March 2018 (2018 Conceptual Framework) without significantly changing its requirements. The amendments added an exception to the recognition principle of IFRS 3 to avoid the issue of potential 'day 2' gains or losses arising for liabilities and contingent liabilities that would be within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* or IFRIC 21 *Levies*, if incurred separately. The exception requires entities to apply the criteria in IAS 37 or IFRIC 21, respectively, instead of the Conceptual Framework, to determine whether a present obligation exists at the acquisition date. In the IASB's view, the obligations recognised as liabilities applying the amended IFRS 3 are the same as those recognised under IFRS 3 before the amendment. The amendments also added a new paragraph to IFRS 3 to clarify that contingent assets do not qualify for recognition at the acquisition date. This addition has only reconfirmed the IASB's original conclusion that criteria for a recognition of an acquired asset at the acquisition date might not be met if it is uncertain whether an asset exists.

1.2 Future developments

1.2.1 Business combinations - Disclosures, Goodwill and Impairment project

In March 2024, the IASB issued an Exposure Draft *Business Combinations-Disclosures, Goodwill and Impairment* (proposed amendments to IFRS 3 and IAS 36) (the ED).[1] The IASB is proposing amendments to IFRS 3 and IAS 36.

The proposed amendments to IFRS 3 add new disclosure requirements that would result in an entity disclosing:

- For a strategic business combination, information about the performance of business combinations, specifically, information about the entity's acquisition-date key objectives and targets and the extent to which those key objectives and targets are met in subsequent periods; and
- Quantitative information about synergies expected to arise as a result of a business combination.

To address stakeholders concerns that some of that information is commercially sensitive and that disclosing that information could expose an entity to litigation risk, the Board has:

- Included a proposed exemption from disclosing some of this information in specific circumstances
- Proposed that an entity be required to disclose information about the performance of business combinations for only one subset of business combinations - strategic business combinations.

A strategic business combination would be one for which failure to meet any one of an entity's acquisition-date key objectives would put the entity at serious risk of failing to achieve its overall business strategy. The IASB is proposing that entities identify a strategic business combination using a set of thresholds in IFRS 3 - a business combination that met any one of these thresholds would be considered a strategic business combination.

The IASB has also proposed some other minor amendments to the disclosure requirements in IFRS 3.

The proposed changes to IFRS 3, if confirmed, would affect any entity that enters into a business combination after the beginning of the first annual reporting period in which the proposals become effective.

For the proposed amendments to IAS 36, as part of this project, see Chapter 21 at section 14.

1.2.2 Financial Instruments with Characteristics of Equity ('FICE') project

The IFRS IC and the IASB have been debating the accounting for NCI puts over a number of years. Many of these issues have now been considered by the FICE project.

In November 2023, the IASB issued Exposure Draft (IASB/ED/2023/5) *Financial instruments with Characteristics of Equity* - Proposed amendments to IAS 32, IFRS 7 and IAS 1.

See Chapter 43 at section 12.1, Chapter 8 at section 7.3 and section 8.5 below for further discussion of the FICE project.

1 Exposure Draft, ED/2024/1 *Business Combinations-Disclosures, Goodwill and Impairment*, IASB, March 2024. Available on the IFRS Foundation's website.

2 Scope of IFRS 3

Extract from IFRS 3

Scope

2 This IFRS applies to a transaction or other event that meets the definition of a business combination. This IFRS does not apply to:

(a) the accounting for the formation of a joint arrangement in the financial statements of the joint arrangement itself.

(b) the acquisition of an asset or a group of assets that does not constitute a business. In such cases the acquirer shall identify and recognise the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, *intangible assets* in IAS 38 *Intangible Assets*) and liabilities assumed. The cost of the group shall be allocated to the individual identifiable assets and liabilities on the basis of their relative *fair values* at the date of purchase. Such a transaction or event does not give rise to goodwill.

(c) a combination of entities or businesses under common control (paragraphs B1-B4 provide related application guidance).

2A The requirements of this Standard do not apply to the acquisition by an investment entity, as defined in IFRS 10 *Consolidated Financial Statements*, of an investment in a subsidiary that is required to be measured at fair value through profit or loss.

Entities are required to apply the provisions of IFRS 3 to transactions or other events that meet the definition of a business combination (see section 3.1 below). *[IFRS 3.2, IFRS 3.2A]*.

2.1 Mutual entities

The acquisition method of accounting applies to combinations involving only mutual entities (e.g., mutual insurance companies, credit unions and cooperatives) and combinations in which separate entities are brought together by contract alone (e.g., dual listed corporations and stapled entity structures). *[IFRS 3.BC58]*. The IASB considers that the attributes of mutual entities are not sufficiently different from those of investor-owned entities to justify a different method of accounting for business combinations between two mutual entities. It also considers that such combinations are economically similar to business combinations involving two investor-owned entities and similar reporting is required. *[IFRS 3.BC71, IFRS 3.BC72]*. Similarly, the IASB has concluded that the acquisition method "can and should" be applied for combinations achieved by contract alone. *[IFRS 3.BC79]*. Additional guidance is given in IFRS 3 for applying the acquisition method to such business combinations (see sections 7.4 and 7.5 below).

2.2 Arrangements out of scope of IFRS 3

The standard does not apply to:

(a) The accounting for the formation of a joint arrangement in the financial statements of the joint arrangement itself (see Chapter 12 at sections 7.5.4 and 2.2.1 below for details)

(b) The acquisition of an asset or a group of assets that does not constitute a business (see section 2.2.2 below for details)

(c) A combination of entities or businesses under common control (see Chapter 11)

Or

(d) The acquisition by an investment entity, as defined in IFRS 10 (see Chapter 7 at section 10.1), of an investment in subsidiary that is required to be measured at fair value through profit or loss *[IFRS 3.2, IFRS 3.2A]*

2.2.1 Formation of a joint arrangement

The scope exception in IFRS 3 for the formation of a joint arrangement relates only to the accounting in the financial statements of the joint arrangement, i.e., the joint venture or joint operation (see Chapter 12 at section 7.5.4 for details), and not to the accounting for the joint venturer's or joint operator's interest in the joint arrangement. *[IFRS 3.BC61B, IFRS 3.BC61C, IFRS 3.BC61D]*.

By contrast, a particular type of arrangement in which the owners of multiple businesses agree to combine their businesses into a new entity (sometimes referred to as a roll-up transaction) does not include a contractual agreement requiring unanimous consent to decisions about the relevant activities. Majority consent on such decisions is not sufficient to create a joint arrangement. Therefore, such arrangements are accounted for by the acquisition method. *[IFRS 3.BC60]*.

2.2.2 Acquisition of an asset or a group of assets that does not constitute a business

Although the acquisition of an asset or a group of assets is not within the scope of IFRS 3, in such cases the acquirer has to identify and recognise the individual identifiable assets acquired (including intangible assets) and liabilities assumed. The cost of the group is allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase. These transactions or events do not give rise to goodwill. *[IFRS 3.2]*. Thus, using existing book values or values in the acquisition agreement will not always be appropriate.

The cost of the group of assets is the sum of all consideration given and any non-controlling interest recognised. If the non-controlling interest has a present ownership interest and is entitled to a proportionate share of net assets upon liquidation, the acquirer has a choice to recognise the non-controlling interest at its proportionate share of net assets or its proportionate share of the consolidated book values of the net assets including or excluding transaction costs or its fair value. In all other cases, the non-controlling interest is recognised at fair value, unless another measurement basis is required in accordance with IFRS accounting standards. An example could be the acquisition of an incorporated entity that holds a single property, where this is assessed not to be a business (see Chapter 8 at section 3.1.1).

It may be difficult to determine whether or not an acquired asset or a group of assets constitutes a business (see section 3.2 below), yet this decision can have a considerable impact on an entity's reported results and the presentation of its financial statements. Accounting for a business combination under IFRS 3 differs from accounting for an asset(s) acquisition in a number of important respects:

- Goodwill or a gain on bargain purchase only arise on business combinations.
- Assets acquired and liabilities assumed are generally accounted for at fair value in a business combination, while they are generally assigned a carrying amount based on their relative fair values in an asset acquisition.
- Directly attributable acquisition-related costs are expensed if they relate to a business combination, but are generally capitalised as part of the cost of the asset in an asset acquisition.
- While deferred tax assets and liabilities must be recognised if the transaction is a business combination, they are not recognised under IAS 12 *Income Taxes* if it is an asset acquisition (see Chapter 29 at section 12.5).
- Where the consideration is in the form of shares, IFRS 2 *Share-based Payment* does not apply in a business combination, but will apply in an acquisition of assets within the scope of IFRS 2.
- Another difference may arise where the transaction involves contingent consideration. While IFRS 3 provides guidance on the accounting for contingent consideration in the acquisition of a business (see section 7.1 below), IAS 16 *Property, Plant and Equipment* and IAS 38 provide no clear guidance on accounting for contingent consideration in an asset(s) acquisition (see Chapter 18 at section 4.5 and Chapter 19 at section 4.1.9).
- Disclosures are much more onerous for business combinations than for asset acquisitions.

The accounting differences above will not only affect the accounting as at the acquisition date, but will also have an impact on future depreciation, possible impairment and other costs.

Frequently asked questions

Question 2-1: How does an entity account for the acquisition of a group of assets that does not constitute a business?

In November 2017, the IFRS IC issued an agenda decision that clarified how an entity accounts for the acquisition of a group of assets that does not constitute a business. More specifically, the submitter of the request asked for clarity on how to allocate the transaction price to the identifiable assets acquired and liabilities assumed when:

(a) The sum of the individual fair values of the identifiable assets and liabilities is different from the transaction price.

And

(b) The group includes identifiable assets and liabilities initially measured both at cost and at an amount other than cost.

The IFRS IC concluded that a reasonable reading of the requirements in IFRS 3.2(b) on the acquisition of a group of assets that does not constitute a business results in one of the following two approaches:

(a) Under the first approach, an entity accounts for the acquisition of the group as follows:

  (i) It identifies the individual identifiable assets acquired and liabilities assumed that it recognises at the date of the acquisition.

  (ii) It determines the individual transaction price for each identifiable asset and liability by allocating the cost of the group based on the relative fair values of those assets and liabilities at the date of the acquisition.

  And then

  (iii) It applies the initial measurement requirements in applicable IFRS accounting standards to each identifiable asset acquired and liability assumed. The entity accounts for any difference between the amount at which the asset or liability is initially measured and its individual transaction price applying the relevant requirements.

(b) Under the second approach, for any identifiable asset or liability initially measured at an amount other than cost, an entity initially measures that asset or liability at the amount specified in the applicable standard. The entity deducts from the transaction price of the group the amounts allocated to the assets and liabilities initially measured at an amount other than cost, and then allocates the residual transaction price to the remaining identifiable assets and liabilities based on their relative fair values at the date of the acquisition.

The IFRS IC also concluded that an entity is required to apply its reading of the requirements consistently to all such acquisitions and an entity would also disclose the selected approach applying paragraphs 117-124 of IAS 1 *Presentation of Financial Statements* if that disclosure would assist users of financial statements in understanding how those transactions are reflected in reported financial performance and financial position.[2]

2.2.2.A Special Purpose acquisition companies (SPACs) transactions

Acquisition by a SPAC offers private companies a way to go public without having to conduct a traditional initial public offering (IPO). A SPAC is an entity that raises capital from investors in an IPO for the sole business purpose of the future business acquisition of a target which typically has not been identified at the time of the SPAC's IPO.

The SPAC typically has a limited period of time to complete an acquisition (e.g., 18 to 24 months). If no successful acquisition has occurred by the end of that period, the SPAC is liquidated, unless public shareholders accept an extension. If the SPAC is liquidated, the IPO proceeds received from public shareholders are returned and the sponsors' contribution is lost.

Once a SPAC identifies a target, it solicits shareholder approval to consummate its acquisition of the target. Public shareholders usually have the right to redeem their shares if they do not wish to invest in the proposed target. Therefore, after an acquisition has been approved, some (e.g., dissenting shareholders) or all public shareholders may require a refund of their investment.

2 *IFRIC Update*, November 2017, available on the IFRS Foundation's website.

The sellers of the target may receive cash or equity in the SPAC (or other successor entity) or a combination of the two. In most cases, the sellers of the target will retain some ownership in the combined entity. After the acquisition, the combined entity is a publicly traded entity, and is usually governed by a board of directors that includes the SPAC sponsors, or their representatives, in addition to directors chosen by the sellers. The sponsors may retain the management of the target to manage the combined entity, or the sponsors may actively participate in managing the combined entity.

The determination of the accounting acquirer in SPAC transactions is particularly important, as it will impact the accounting and financial statement presentation, which can differ significantly depending on which party is determined to be the accounting acquirer. The determination of the accounting acquirer in SPAC transactions is further discussed in section 4.1.3 below.

If a SPAC is determined to be the accounting acquirer, the transaction in which control over the target is acquired, is accounted for as a business combination in accordance with IFRS 3 (i.e., applying the acquisition method).

If the target is determined to be the accounting acquirer, and the SPAC (i.e., the accounting acquiree) does not constitute a business under IFRS 3, the transaction cannot be accounted for as a business combination or 'reverse acquisition' of a SPAC by the target. IFRS 3 has no clear guidance on how to account for such transactions. Instead, we believe the transaction is accounted for as the continuation of the pre-acquisition financial statements of the target.

In October 2022, the Board ratified the IFRS IC's agenda decision on the accounting for warrants when the target is both the accounting and legal acquirer. For the accounting discussion and the conclusion reached, please refer to Chapter 30 at section 2.2.4.L.

As a SPAC life cycle involves the IPO of the SPAC and the additional complexity of a subsequent acquisition of the target, there are potentially many other financial reporting issues, including those related to the accounting for financial instruments and share-based payment transactions before and after the acquisition. Please refer to *Applying IFRS: Accounting for SPACs, January 2023*[3] for further discussion.

2.2.3 Business combinations under common control

IFRS accounting standards do not specify how to account for business combinations involving companies controlled by the same party.

The IASB undertook a research project to consider whether to develop reporting requirements for a receiving entity reporting a business combination under common control (BCUCC) and published a Discussion Paper (DP) in 2020.[4] The DP summarised the IASB's preliminary views on how a receiving entity should report a BCUCC, including potential measurement methods to apply and also explored potential disclosure requirements. However, in November 2023, the IASB considered the project's direction and decided to discontinue further work developing guidance for BCUCCs.

The application guidance in Appendix B to IFRS 3 gives some guidance on accounting for business combinations involving entities or businesses under common control that are excluded from the requirements of the standard. *[IFRS 3.B1, IFRS 3.B2, IFRS 3.B3, IFRS 3.B4]*. These arrangements are discussed further in Chapter 11.

3 *Applying IFRS:* Accounting for SPACs, Updated January 2023, EY Global,

4 Discussion Paper DP/2020/2, *Business Combinations under Common Control*, IASB, November 2020. Available on the IFRS Foundation's website.

3 Identifying a business combination

Extract from IFRS 3

Identifying a business combination

3 **An entity shall determine whether a transaction or other event is a business combination by applying the definition in this IFRS, which requires that the assets acquired and liabilities assumed constitute a business. If the assets acquired are not a business, the reporting entity shall account for the transaction or other event as an asset acquisition. Paragraphs B5-B12D provide guidance on identifying a business combination and the definition of a business.**

IFRS 3 requires an entity to determine whether a transaction or event is a *business combination;* the definition requires that the assets acquired and liabilities assumed constitute a *business*. If the assets acquired and liabilities assumed do not constitute a business, the transaction is accounted for as an asset acquisition (see section 2.2.2 above). *[IFRS 3.3]*.

3.1 Definition of a business combination

IFRS 3 defines a business combination as a "transaction or other event in which an **acquirer** obtains control of one or more **businesses**". *[IFRS 3 Appendix A]*.

IFRS 3 notes that an acquirer might obtain control of an acquiree (i.e., the business or businesses over which the acquirer obtains control) in a variety of ways, for example:

(a) Transferring cash, cash equivalents or other assets (including net assets that constitute a business)

(b) Incurring liabilities

(c) Issuing equity interests

(d) Providing more than one type of consideration

Or

(e) Without transferring consideration - including by contract alone (see section 7.4 below) *[IFRS 3.B5]*

A business combination may be structured in a variety of ways for legal, taxation or other reasons, which include but are not limited to:

(a) One or more businesses become subsidiaries of an acquirer or the net assets of one or more businesses are legally merged into the acquirer.

(b) One combining entity transfers its net assets, or its owners transfer their equity interests, to another combining entity or its owners.

(c) All of the combining entities transfer their net assets, or the owners of those entities transfer their equity interests, to a newly formed entity (sometimes referred to as a roll-up or put-together transaction).

Or

(d) A group of former owners of one of the combining entities obtains control of the combined entity. *[IFRS 3.B6]*.

3.2 Definition of a business

IFRS 3 defines a business as "An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities". *[IFRS 3 Appendix A]*.

3.2.1 Inputs, processes and outputs

The application guidance to IFRS 3 describes the components of a business as inputs and processes applied to those inputs that have the ability to contribute to the creation of outputs. The three elements are described as follows:

- *Input*

  Any economic resource that creates outputs or has the ability to contribute to the creation of outputs when one or more processes are applied to it. Examples include non-current assets (including intangible assets or rights to use non-current assets), intellectual property, the ability to obtain access to necessary materials or rights and employees.

- *Process*

  Any system, standard, protocol, convention or rule is a process if, when applied to an input or inputs, it either creates or has the ability to contribute to the creation of outputs. Examples include strategic management processes, operational processes and resource management processes. These processes typically are documented, but the intellectual capacity of an organised workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. Accounting, billing, payroll and other administrative systems typically are not processes used to create outputs so their presence or exclusion generally will not affect whether an acquired set of activities and assets is considered a business.

- *Output*

  The result of inputs and processes applied to those inputs that provide goods or services to customers, generate investment income (such as dividends or interest) or generate other income from ordinary activities. *[IFRS 3.B7]*.

Although businesses usually have outputs, outputs need not be present at the acquisition date for an integrated set of activities and assets to be identified as a business. *[IFRS 3.B8]*. The nature of the elements of a business varies by industry and by the structure of an entity's operations (activities), including the entity's stage of development. Established businesses often have many different types of inputs, processes and outputs, whereas new businesses often have few inputs and processes and sometimes only a single output (product). Nearly all businesses also have liabilities, but a business need not have liabilities. Furthermore, an acquired set of activities and assets that is not a business as defined, might have liabilities. *[IFRS 3.B9]*.

3.2.2 Assessment of whether acquired set of activities and assets constitutes a business

To assess whether a transaction is the acquisition of a business, an entity may apply first a quantitative concentration test (also known as a screening test). The entity is not required to apply the test but may elect to do so separately for each transaction or other event.

If the concentration test is met, the set of activities and assets is determined not to be a business and no further assessment is required. Otherwise, or if the entity elects not to apply the test, the entity performs the qualitative analysis of whether an acquired set of assets and activities includes at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. *[IFRS 3.B7A]*.

The concentration test is further discussed in section 3.2.3 below and assessment of whether an acquired process is substantive is considered in section 3.2.4 below.

3.2.3 Concentration test

IFRS 3 sets out an optional concentration test designed to simplify the evaluation of whether an acquired set of activities and assets is not a business. An acquired set of activities and assets is not a business if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. IFRS 3 notes that for the purposes of the concentration test:

(a) Gross assets acquired exclude cash and cash equivalents, deferred tax assets, and goodwill resulting from the effects of deferred tax liabilities.

(b) The fair value of the gross assets acquired includes any consideration transferred (plus the fair value of any non-controlling interest and the fair value of any previously held interest) in excess of the fair value of net identifiable assets acquired. The fair value of the gross assets acquired may normally be determined as the total obtained by adding the fair value of the consideration transferred (plus the fair value of any non-controlling interest and the fair value of any previously held interest) to the fair value of the liabilities assumed (other than deferred tax liabilities), and then excluding the items identified in subparagraph (a) above. However, if the fair value of the gross assets acquired is more than that total, a more precise calculation may sometimes be needed.

(c) A single identifiable asset includes any asset or group of assets that would be recognised and measured as a single identifiable asset in a business combination.

(d) If a tangible asset is attached to, and cannot be physically removed and used separately from, another tangible asset (or from an underlying asset subject to a lease, as defined in IFRS 16), without incurring significant cost, or significant diminution in utility or fair value to either asset (for example, land and buildings), those assets are considered a single identifiable asset.

(e) When assessing whether assets are similar, an entity considers the nature of each single identifiable asset and the risks associated with managing and creating outputs from the assets (that is, the risk characteristics).

(f) The following are not considered similar assets:

(i) A tangible asset and an intangible asset

(ii) Tangible assets in different classes (for example, inventory, manufacturing equipment and automobiles) unless they are considered a single identifiable asset in accordance with the criterion in subparagraph (d) above

(iii) Identifiable intangible assets in different classes (for example, brand names, licences and intangible assets under development)

(iv) A financial asset and a non-financial asset

(v) Financial assets in different classes (for example, accounts receivable and investments in equity instruments)

And

(vi) Identifiable assets that are within the same class of asset but have significantly different risk characteristics. *[IFRS 3.B7B]*.

In addition, IFRS 3 clarifies that the requirements above do not modify the guidance on similar assets in IAS 38; nor the meaning of the term 'class' in IAS 16, IAS 38 and IFRS 7 *Financial Instruments: Disclosures*. *[IFRS 3.B7C]*.

Illustration 3-1 and Illustration 3-2 below illustrate application of the guidance on the concentration test to the specific scenarios.

Illustration 3-1: Acquisition of wind farm - concentration test (1)

Greentech A acquires all outstanding shares of Greentech B, which owns 25 windmills of similar types and specifications that each have an in-place lease. The fair value of the consideration paid is equal to the aggregate fair value of the 25 windmills acquired. Each windmill includes the land leased from the local authority and a wind turbine. All windmills are in the same wind farm and are leased out to the small local olive oil producers under the mid-term contracts. The local oil producers are from the same area and are similar in all other respects. No employees, other assets, processes or other activities are transferred.

Greentech A elects to apply the optional concentration test and concludes that:

(a) Each windmill is considered a single identifiable asset for the following reasons:

(i) The wind turbine is attached to and cannot be physically removed and used separately from the leased land plot on which it is located without incurring significant cost.

And

(ii) The windmill and the in-place lease are considered a single identifiable asset because they would be recognised and measured as a single identifiable asset in a business combination (see IFRS 3.B42).

(b) The group of 25 windmills is a group of similar identifiable assets because the assets (all windmills) are similar in nature and the risks associated with managing and creating outputs are not significantly different. This is because the types and specifications of windmills and customers are not significantly different.

And

(c) Consequently, substantially all of the fair value of the gross assets acquired is concentrated in a group of similar identifiable assets.

Greentech A concludes that the optional concentration test is met and, therefore, the set of activities and assets is not a business and no further assessment is required.

Illustration 3-2: Acquisition of wind and solar farms - concentration test (2)

Assume that in the Illustration 3-1 above, in addition to the wind farm, Greentech B also owns a solar farm located in a foreign country and the aggregate fair value associated with the solar farm is similar to the aggregate fair value associated with the 25 windmills acquired. The fair value of the consideration paid is approximately equal to the aggregate fair value of the wind and solar farms acquired. As in Illustration 3-1 above, no employees, other assets, other processes or other activities are transferred.

Greentech A elects to apply the optional concentration test and concludes that the 25 windmills and the solar farm are not a group of similar identifiable assets because the windmills and the solar farm differ significantly in the risks associated with operating the assets and obtaining and managing customers. In particular, the technology employed in wind and solar energy operations are significantly different and the risks associated with the two classes of customers are also dissimilar because customers operate in different economic environments. In addition, the fair value of the windmills is similar to the aggregate fair value of the solar farm. Consequently, substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or a group of similar identifiable assets.

Greentech A concludes that the optional concentration test is not met and, therefore, further assessment is required.

The Illustrative Examples to IFRS 3 on application of definition of a business contain further illustrations of the application of the concentration test, including the approach to the determination of the fair value of the gross assets acquired. *[IFRS 3.IE73-IE123]*.

3.2.4 Assessing whether an acquired process is substantive

The existence of a process (or processes) is what distinguishes a business from a set of activities and assets that is not a business. Consequently, the Board decided that to be considered a business, an acquired set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. *[IFRS 3.B8]*.

IFRS 3 also clarifies that an acquired contract is an input and not a substantive process. Nevertheless, an acquired contract, for example, a contract for outsourced property management or outsourced asset management, may give access to an organised workforce. An entity assesses whether an organised workforce accessed through such a contract performs a substantive process that the entity controls, and thus has acquired. Factors considered in making that assessment include the duration of the contract and its renewal terms. *[IFRS 3.B12D(a)]*.

In addition, the Basis for Conclusions on IFRS 3 clarifies that presence of more than an insignificant amount of goodwill is not a relevant indicator that the acquired process is substantive. *[IFRS 3.B12D(a)]*.

IFRS 3 includes guidance to help entities assess whether an acquired process is substantive. That guidance seeks more persuasive evidence when there are no outputs because the existence of outputs already provides some evidence that the acquired set of activities and assets is a business. *[IFRS 3.BC21M]*. However, if an acquired set of activities and assets has outputs, continuation of revenue does not on its own indicate that both an input and a substantive process have been acquired. *[IFRS 3.B8A]*.

If a set of activities and assets does not have outputs at the acquisition date, an acquired process (or group of processes) is considered substantive only if:

(a) It is critical to the ability to develop or convert an acquired input or inputs into outputs.

And

(b) The inputs acquired include both an organised workforce that has the necessary skills, knowledge, or experience to perform that process (or group of processes) and other inputs that the organised workforce could develop or convert into outputs. Those other inputs could include:

  (i) Intellectual property that could be used to develop a good or service (e.g., technology)

  (ii) Other economic resources that could be developed to create outputs (e.g., in-process research and development projects)

  Or

  (iii) Rights to obtain access to necessary materials or rights that enable the creation of future outputs (e.g., real estate and mineral interests) *[IFRS 3.B12B]*

If a set of activities and assets has outputs at the acquisition date, an acquired process (or group of processes) is considered substantive if, when applied to an acquired input or inputs, it:

(a) Is critical to the ability to continue producing outputs, and the inputs acquired include an organised workforce with the necessary skills, knowledge, or experience to perform that process (or group of processes)

Or

(b) Significantly contributes to the ability to continue producing outputs and:

(i) Is considered unique or scarce

Or

(ii) Cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs *[IFRS 3.B12C]*

Difficulties in replacing an acquired organised workforce may indicate that the acquired organised workforce performs a process that is critical to the ability to create outputs. *[IFRS 3.B12D(b)]*.

IFRS 3 also clarifies that a process (or group of processes) is not critical if, for example, it is ancillary or minor within the context of all the processes required to create outputs. *[IFRS 3.B12D(c)]*.

3.2.5 'Capable of' from the viewpoint of a market participant

IFRS 3 clarifies that an acquired set of activities and assets does not need to include all of the inputs or processes necessary to operate that set of activities and assets as a business, i.e., it does not need to be self-sustaining. *[IFRS 3.B8]*. The definition of a business in IFRS 3 requires that inputs, and processes applied to those inputs, have the 'ability to contribute to the creation of outputs' rather than the 'ability to create outputs'. *[IFRS 3.BC21F]*. Determining whether a set of activities and assets is a business is based on whether the integrated set is capable of being conducted and managed as a business by a market participant. Therefore, it is not a relevant consideration whether a vendor operated a transferred set as a business or whether a buyer intends to operate it as a business. *[IFRS 3.B11]*. The acquired set is a business, even if an acquirer stops all the operations of the acquiree and disposes of assets acquired as a scrap, if any other market participant would be able to operate the acquired set as a business. Under IFRS 3, a market participant would be able to operate an acquired set as a business, if it includes at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. However, if an acquirer obtains control of an input or set of inputs without any processes, the acquired input(s) would not be considered a business, even if a market participant had all the processes necessary to operate the input(s) as a business. It is not a relevant consideration whether market participants would be capable of replacing any missing inputs or processes, for example by integrating the acquired activities and assets. *[IFRS 3.BC21H, IFRS 3.BC21I]*.

3.2.6 Identifying business combinations

Significant judgement is required in determining whether an acquired set of activities and assets constitute a business. The following are examples from extractive industries and real estate that illustrate the issues.

Illustration 3-3: Extractive industries - definition of a business (1)

E&P Co A (an oil and gas exploration and production company) acquires a mineral interest from E&P Co B, on which it intends to perform exploration activities to determine if reserves exist. The mineral interest is an unproven property and there have been no exploration activities performed on the property. E&P Co A elects not to apply the optional concentration test.

Inputs - mineral interest

Processes - none

Output - none

Conclusion

In this scenario, we do not believe E&P Co A acquired a business. While E&P Co A acquired an input (mineral interest), it did not acquire any processes. Whether or not a market participant has the necessary processes in place to operate the input as a business is not relevant to the determination of whether the acquired set is a business because no processes, whether substantive or not, were acquired from E&P Co B.

E&P Co A elected not to apply the optional concentration test. However, we do not believe the conclusion would be different, if it had elected to do so. The transferred set includes only a mineral interest that would be recognised and measured as a single identifiable intangible asset in a business combination; consequently, there are no other assets or processes to which a significant portion of the fair value of the gross assets acquired would be assigned. Therefore, the fair value of the gross assets acquired is concentrated in a single identifiable asset.

Illustration 3-4: Extractive industries - definition of a business (2)

E&P Co A acquires a property similar to that in Illustration 3-3 above, except that oil and gas production activities are in place and the acquired set also includes a SCADA system. The target's employees are not part of the transferred set. E&P Co A will take over the operations by using its own employees.

Inputs - oil and gas reserves and SCADA system

Processes - operational processes associated with oil and gas production embodied in the SCADA system

Output - revenues from oil and gas production

Conclusion

In this scenario, we believe that E&P Co A has acquired a business. The acquired set includes both inputs and processes and has outputs. Although the employees are not being transferred to the acquirer, for a set that has outputs, transfer of the organised workforce is not necessary to conclude that it constitutes a business. An acquired process is substantive if, when applied to an acquired input or inputs, it significantly contributes to the ability to continue producing outputs and cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs. We believe that the SCADA systems that consist of physical equipment, including pumps, meters and other assets used to facilitate gathering, processing, storing, and transporting of oil and gas serve as a substantive process because they significantly contribute to the ability to continue producing outputs and cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs.

E&P Co A elected not to apply the optional concentration test. However, we do not believe that conclusion would be different if it had elected to do so. This is because, while the acquired set includes only oil and gas reserves and the SCADA system, they generally would not be considered either as a single identifiable asset or group of similar identifiable assets, and we expect that a significant portion of the fair value of the consideration would be assigned to both the value of the transferred oil and gas reserves and the value of assets comprising the SCADA system, which would normally include the operational processes associated with oil and gas production embodied in the SCADA system.

In the real estate industry, IAS 40 notes that when ancillary services (i.e., processes) are provided and they are insignificant to the overall arrangement, this will not prevent the classification of the asset as investment property. *[IAS 40.11]*. (See Chapter 20 at section 2.8). The guidance on ancillary services, *[IAS 40.11, IAS 40.12, IAS 40.13, IAS 40.14]*, is intended to distinguish an investment property from an owner-occupied property, not whether a transaction is a business combination or an asset acquisition. Entities acquiring investment properties must assess whether the property is a business applying the requirements of IFRS 3. *[IAS 40.14A]*. See also Chapter 20 at section 3.3.

Therefore, evaluating whether it is a real estate business where certain processes are transferred involves assessing those processes in the light of the guidance in IFRS 3.

Illustration 3-5: Real estate - definition of a business (1)

Company A acquires land and a vacant building from Company B. No processes, other assets or employees (for example, leases and other contracts, maintenance or security personnel, or a leasing office) are acquired in the transaction. Company A elects not to apply the optional concentration test.

Inputs - land and vacant building constructed on that land

Processes - none

Output - none

Conclusion

In this scenario, we do not believe Company A has acquired a business. While Company A acquired inputs (land and a vacant building), it did not acquire any processes. Whether or not a market participant has the necessary processes in place to operate the inputs as a business is irrelevant to the determination of whether the acquired set is a business, because no processes, whether substantive or not, were acquired from Company B.

Company A elected not to apply the optional concentration test. However, we do not believe the conclusion would be different if it elected to do so. The transferred set includes only land and a vacant building, and the vacant building is attached to and cannot be physically removed and used separately from the land without significant diminution in its utility and fair value. Thus, the land and the building are considered a single identifiable asset for the purposes of the concentration test. In addition, there are no other assets or processes to which a significant portion of the fair value of the gross assets acquired would be assigned. Therefore, the fair value of the gross assets acquired is concentrated in a single identifiable asset acquired.

However, irrespective of the determination whether a business is acquired or not, the classification of the acquired property as an investment property would depend on whether the property meets the definition of investment property in IAS 40. For example, if Company A intends to lease out the property without the provision of significant ancillary services, it would classify the property as an investment property. Alternatively, if Company A intends to operate the property as an owner-managed hotel, it would classify the property as property, plant and equipment. Refer to Chapter 20 at sections 2.8 and 3.3 for further discussion.

Illustration 3-6: Real estate - definition of a business (2)

Company A acquires an operating hotel, the hotel's employees, the franchise agreement, inventory, a reservations system and all 'back office' operations. Company A elects not to apply the optional concentration test.

Inputs - non-current assets, franchise agreement, inventory, a reservations system and employees

Processes - undocumented operational and resource management processes associated with operating the hotel

Output - revenues from operating the hotel

Conclusion

In this scenario, we believe Company A has acquired a business. The acquired set has outputs and includes both inputs and processes. In addition, the organised workforce has necessary skills, knowledge, or experience to perform processes (i.e., operational and resource management processes associated with operating the acquired hotel) that are substantive because they are critical to the ability to continue producing outputs when applied to the acquired inputs (i.e., non-current assets and franchise agreement).

Company A elected not to apply the optional concentration test. However, we do not believe that, generally, the conclusion would be different, if it had elected to do so. The acquired set includes non-current assets, inventory, a reservations system and a franchise agreement that are not considered similar assets for the purposes of the concentration test and might have significant individual fair values. In addition, when an operating hotel is acquired in its entirety, it may be the case that a not insignificant portion of the fair value of consideration paid is attributed to the intellectual capacity of the organised workforce acquired, provided skills, knowledge and experience they have, are valued by market participants.

However, as indicated in Illustration 3-5 above, the classification of the acquired property as an investment property would depend on whether the property meets the definition of investment property in IAS 40. For example, if Company A intends to close the hotel and lease out the property to the third party without the provision of significant ancillary services, it would classify the property as an investment property. Alternatively, if Company A intends to continue operating the acquired hotel it would classify the property as property, plant and equipment. Refer to Chapter 20 at sections 2.8 and 3.3 for further discussion.

The Illustrative Examples to IFRS 3 provide further illustrations of the application of principles of IFRS 3 to specific scenarios.

3.2.7 Development stage entities

Development stage entities may qualify as businesses, and their acquisitions accounted for as business combinations because outputs are not required at the acquisition date. The IASB concluded that if the set has no outputs, to qualify as a business the set must include not only a process that is critical to the ability to develop or convert the acquired input or inputs into outputs, but also both an organised workforce that has the necessary skills, knowledge or experience to perform that process, and other inputs that the acquired organised workforce could develop or convert into outputs. *[IFRS 3.B12B]*. The IASB observed that many entities in the development stage will meet this criterion because technology, intellectual property, or other assets are being developed into a good or service. *[IFRS 3.BC21Q]*.

The application of this guidance may be particularly relevant to transactions in the life sciences industry. This is illustrated in the following Illustrations.

Illustration 3-7: Life sciences - definition of a business (1)

Biotech A acquires all of the outstanding shares in Biotech B, which is a development stage company with a licence for a product candidate. Due to a loss of funding, Biotech B has no employees and no other assets. Neither clinical trials nor development are currently being performed. When additional funding is obtained, Biotech A plans to commence phase I clinical trials for the product candidate. Biotech A elects not to apply the optional concentration test.

Input - licence for a product candidate

Processes - none

Outputs - none

Conclusion

In this scenario, Biotech A has not acquired a business. While Biotech B has an input (licence), it lacks processes to apply to the licence in order to create outputs. Furthermore, Biotech B has no employees or any other inputs.

Biotech A elected not to apply the optional concentration test. However, we do not believe the conclusion would be different if it elected to do so. The transferred set includes only a licence for a product candidate that is a single identifiable asset because it would be recognised and measured as a single identifiable intangible asset in a business combination. There are no other assets or processes to which a significant portion of the fair value of the gross assets acquired would be assigned. Therefore, the fair value of the gross assets acquired is concentrated in a single identifiable asset acquired.

Illustration 3-8: Life sciences - definition of a business (2)

Biotech C acquires all of the outstanding shares in Biotech D, a development stage company that has a licence for a product candidate. Phase III clinical trials are currently being performed by Biotech D employees (one of whom founded Biotech D and discovered the product candidate). Biotech D's administrative and accounting functions are performed by a contract employee. Biotech C elects not to apply the optional concentration test.

Inputs - licence for a product candidate and employees

Processes - operational and management processes associated with the performance and supervision of the clinical trials

Output - none

Conclusion

In this scenario, Biotech C has acquired a business because it has acquired not only a process that is critical to the ability to develop acquired inputs into outputs, but also both an organised workforce that has the necessary skills, knowledge or experience to perform that process and other inputs that the acquired organised workforce could develop into output. Biotech D undertakes a Phase III clinical trials process that is critical to develop the acquired input into output (i.e., a commercially developed product that will be sold or licensed) and has both sufficiently qualified and experienced employees, including a scientist who discovered the product candidate and obtained a licence for the product candidate.

Biotech C elected not to apply the optional concentration test. However, we do not believe the conclusion would be different if it had elected to do so. This is because, while the acquired set includes only a single identifiable asset, a licence for a product candidate, we expect that a significant portion of the fair value of the consideration would have been assigned to the value of the intellectual capacity of the employees transferred in the acquisition, provided skills, knowledge and experience they have, are valued by market participants.

4 Acquisition method of accounting

Extract from IFRS 3

4 **An entity shall account for each business combination by applying the acquisition method.**

5 Applying the acquisition method requires:

(a) identifying the acquirer;

(b) determining the *acquisition date*;

(c) recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree; and

(d) recognising and measuring goodwill or a gain from a bargain purchase.

IFRS 3 requires a business combination to be accounted for by applying the acquisition method. *[IFRS 3.4]*. Applying the acquisition method involves the following steps:

(a) Identifying an acquirer (see section 4.1 below)

(b) Determining the acquisition date (see section 4.2 below)

(c) Recognising and measuring the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree (see section 5 below)

(d) Recognising and measuring goodwill or a gain from a bargain purchase (see section 6 below) *[IFRS 3.5]*

4.1 Identifying the acquirer

The first step in applying the acquisition method is identifying the acquirer. IFRS 3 requires one of the combining entities to be identified as the acquirer. *[IFRS 3.6]*. For this purpose, the guidance in IFRS 10 is used, i.e., the acquirer is the entity that obtains control of the acquiree. *[IFRS 3.7, IFRS 3.B13]*. An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. *[IFRS 10.6]*. This is discussed further in Chapter 7 at section 3.

If IFRS 10 does not clearly indicate which of the combining entities is the acquirer, additional guidance in IFRS 3 includes other factors to take into account. *[IFRS 3.7, IFRS 3.B13]*.

The other factors require significant judgement, particularly when the business combination may be a 'reverse acquisition' or when the combination occurred by contract alone.

In a business combination effected primarily by transferring cash or other assets, or by incurring liabilities, the acquirer is usually the entity that transfers the cash or other assets or incurs the liabilities. *[IFRS 3.B14]*.

In a business combination effected primarily by exchanging equity interests, the acquirer is usually the entity that issues its equity interests, but in some business combinations, so-called 'reverse acquisitions', the issuing entity is the acquiree. Application guidance on the accounting for reverse acquisitions is provided in Appendix B to IFRS 3 (see section 14 below). In identifying the acquirer, IFRS 3 requires that other facts and circumstances are also considered, including:

- The relative voting rights in the combined entity after the business combination. The acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity, after taking account of any unusual or special voting arrangements and options, warrants or convertible securities.
- The existence of a large minority voting interest in the combined entity if no other owner or organised group of owners has a significant voting interest. The acquirer is usually the combining entity whose single owner or organised group of owners holds the largest minority voting interest in the combined entity.
- The composition of the governing body of the combined entity. The acquirer is usually the combining entity whose owners have the ability to elect, appoint or remove a majority of the members of the governing body of the combined entity.
- The composition of the senior management of the combined entity. The acquirer is usually the combining entity whose (former) management dominates the management of the combined entity.
- The terms of the exchange of equity interests. The acquirer is usually the combining entity that pays a premium over the pre-combination fair value of the equity interests of the other combining entity or entities. *[IFRS 3.B15]*.

The acquirer is usually the combining entity whose relative size is significantly greater than that of the other combining entity or entities, measured by, for example, assets, revenues or profit. *[IFRS 3.B16]*.

If the business combination involves more than two entities, determining the acquirer includes considering, among other things, which of the combining entities initiated the combination, as well as the relative size of the combining entities. *[IFRS 3.B17]*.

Frequently asked questions

Question 4-1: Must an acquirer always be a legal entity?

The acquirer is not necessarily a legal entity. In September 2011, the IFRS IC concluded that an acquirer that is a reporting entity but not a legal entity, can be the acquirer in a reverse acquisition[5] (see section 14.9 below).

The conclusion above would also apply to acquisitions where the legal and accounting acquirer are the same. Therefore, for example, a combined rather than consolidated group might be identified as the acquirer, provided that the combined financial statements are compliant with IFRS accounting standards (see Chapter 7 at section 2.2.6).

4.1.1 New entity formed to effect a business combination

A new entity formed to effect a business combination is not necessarily the acquirer. This will depend among others on whether it has issued equity interests or paid cash. If it has issued equity interests, one of the combining entities is identified as the acquirer by applying the guidance described above. *[IFRS 3.B18]*.

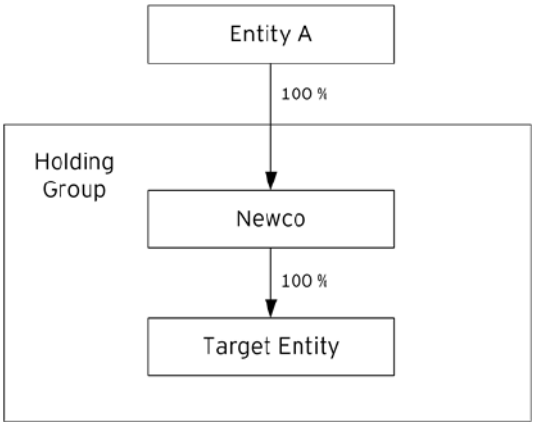
If a new entity transfers cash or other assets, or incurs liabilities as consideration, it may be the acquirer. IFRS 3 does not specify in what circumstances this may be the case but it is clear that 'control' is the fundamental concept when identifying an acquirer. Generally, a new entity that was formed to effect a business combination other than through the issue of shares will be identified as an acquirer if this new entity is an extension of the party (or parties) that ultimately gains control of the combining entities. The determination of whether such a new entity is an extension of the selling party (or parties) or the party (or parties) that ultimately gains control over the combining entities, requires a thorough analysis of all the facts and circumstances. This analysis requires an assessment of the purpose and design of the transaction. Sometimes, even if the transaction results in a change of control, the underlying substance of the transaction may be for a purpose other than a party or parties to gain control of an entity. In such a situation, even if a new entity transfers cash or other assets and/or incurs liabilities as consideration, it may be appropriate to conclude that this new entity is not an extension of the party (or parties) ultimately gaining control and, therefore cannot be identified as an acquirer (see Illustration 4-3 below). However, when the purpose and design of the transaction indicate that its underlying substance is to gain control over the business by the new ultimate controlling party (or parties), then this new entity is an extension of such party (or parties) and, therefore, would likely be identified as an acquirer. An example of the latter is a situation where the newly formed entity ('Newco') is used by a group of investors or another entity to acquire a controlling interest in a target entity in an arm's length transaction.

5 *IFRIC Update*, September 2011, available on the IFRS Foundation's website.

Illustration 4-1: Business combination effected by a Newco for cash consideration (1)

Entity A intends to acquire the voting shares (and therefore obtain control) of Target Entity. Entity A incorporates Newco and uses this entity to effect the business combination. Entity A provides a loan at commercial interest rates to Newco. The loan funds are used by Newco to acquire 100% of the voting shares of Target Entity in an arm's length transaction.

The group structure post-transaction is as follows:



Under its local regulations, Newco is required to prepare consolidated financial statements for the Holding Group (the reporting entity) that are compliant with IFRS accounting standards. In most situations like this, Newco would be exempt from preparing consolidated financial statements - see Chapter 7 at section 2.2.1.

The acquirer is the entity that obtains control of the acquiree. Whenever a new entity is formed to effect a business combination other than through the issue of shares, it is appropriate to consider whether Newco is an extension of one of the transacting parties. If it is an extension of the transacting party (or parties) that ultimately gain control of the other combining entities, Newco is the acquirer.

In this situation, Entity A has obtained control of Target Entity in an arm's length transaction, using Newco to effect the acquisition. The transaction has resulted in a change in control of Target Entity and Newco is in effect an extension of Entity A, acting at its direction to obtain control on behalf of Entity A. Accordingly, Newco would be identified as the acquirer at the Holding Group level.

It is not appropriate to conclude that Target Entity must be the acquirer and argue that Newco does not have any substance to it, as this ignores the fact that there is a third party involved and that this party is, in substance, the ultimate controlling party in the transaction.

If, rather than Entity A establishing Newco, a group of investors had established it as the acquiring vehicle through which they obtained control of Target Entity then, we believe, Newco would also be regarded as the acquirer since it is an extension of the group of investors.

Another specific situation in which a Newco might be identified as the acquirer is illustrated in Illustration 4-2 below, where a parent uses a Newco to facilitate a public flotation of shares in a group of subsidiary companies. Although a Newco incorporated by the existing parent of the subsidiaries concerned would not generally be identified as the acquirer, in this particular situation the critical distinguishing factor is that the acquisition of the subsidiaries was conditional on an IPO of Newco. This means that there has been a substantial change in the ownership of the subsidiaries by virtue of the IPO and indicates that the purpose and design of the transaction is to achieve a change in control over the transferred business. Refer to Chapter 11 at section 4 for further discussion.

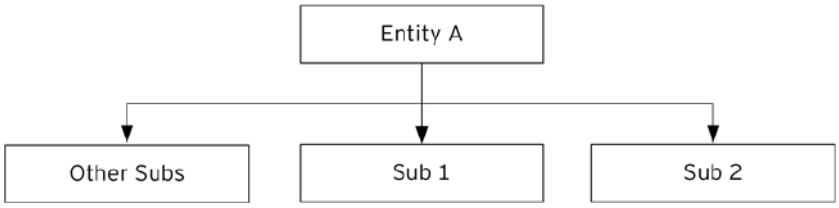
The IFRS IC discussed similar fact patterns[6] but has subsequently observed that accounting for arrangements involving the creation of a Newco is too broad to be addressed through an interpretation or an annual improvement. The IFRS IC concluded that it would be better considered within the context of a broader project on accounting for common control transactions.[7] However, the IASB has subsequently decided not to explore developing guidance for business combinations under common control. See chapter 11 at section 6.1 for further information.

6 *IFRIC Update*, July 2011, available on the IFRS Foundation's website.

7 *IFRIC Update*, September 2011, available on the IFRS Foundation's website.

Illustration 4-2: Business combination effected by a Newco for cash consideration: spin-off transaction (2)

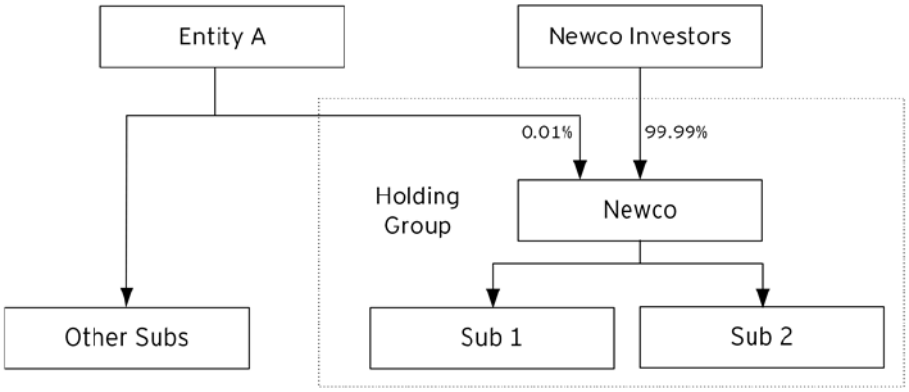
Entity A proposes to spin off two of its existing businesses (currently housed in two separate entities, Sub 1 and Sub 2) as part of an IPO. The existing group structure is as follows:



To facilitate the spin off, Entity A incorporates a new company (Newco) with nominal equity and appoints independent directors to the Board of Newco.

Newco signs an agreement to acquire Sub 1 and Sub 2 from Entity A, conditional on the IPO proceeding. Newco issues a prospectus offering to issue shares for cash to provide Newco with funds to acquire Sub 1 and Sub 2. The IPO proceeds and Newco acquires Sub 1 and Sub 2 for cash. Entity A's nominal equity leaves virtually 100% ownership in Newco with the new investors.

Following the IPO, the respective group structures of Entity A and Newco appear as follows:



In this case, we believe it would likely be appropriate to identify Newco as the acquirer. The Newco investors have obtained control and virtually 100% ownership of Sub 1 and Sub 2 in an arm's length transaction, using Newco to effect the acquisition. The transaction has resulted in a change in control of Sub 1 and Sub 2 (i.e., Entity A losing control and Newco investors, via Newco, obtaining control). Newco could in effect be considered as an extension of the Newco investors since:

- The acquisition of Sub 1 and Sub 2 was conditional on the IPO proceeding so that the IPO is an integral part of the transaction as a whole, evidencing that Newco is an extension of new investors to acquire control of Sub 1 and Sub 2.

  And

- There is a substantial change in the ownership of Sub 1 and Sub 2 by virtue of the IPO (i.e., Entity A only retains a negligible ownership interest in Newco).

Accordingly, Newco might be identified as the acquirer at the Holding Group level.

How we see it

Whether a Newco formed to facilitate an IPO is capable of being identified as an acquirer depends on the facts and circumstances and ultimately requires judgement. If, for example, Entity A incorporates Newco and arranges for it to acquire Sub 1 and Sub 2 prior to the IPO proceeding, Newco could be viewed as an extension of Entity A or possibly an extension of Sub 1 or Sub 2. This is because the IPO and the reorganisation are not always seen as being part of one integral transaction, and therefore the transaction would be a combination of entities under common control (see Chapter 11 at section 4). In that situation, Newco would not be the acquirer.

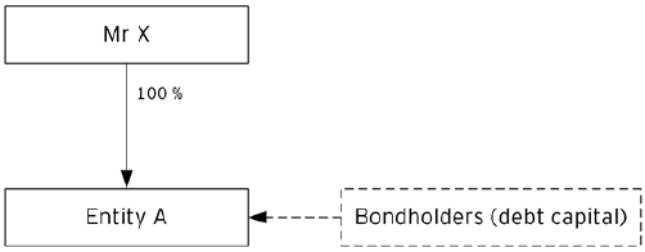
In Illustration 4-2 above, virtually 100% of the interest is sold, which is clear evidence of both a change in control and a significant change in ownership. However, if, for example, the existing ownership was 51% and this was diluted to 46% due to the IPO, although there has been a loss of control by Entity A, we do not believe that there has been a significant change in ownership to justify the Newco being identified as the acquirer.

Illustration 4-3 below illustrates a situation where, despite the fact that the transaction results in a change of control, the purpose and design indicate that the substance of the transaction was to achieve something other than gaining control. Assessing the purpose and design of a transaction requires careful consideration of all facts and circumstances.

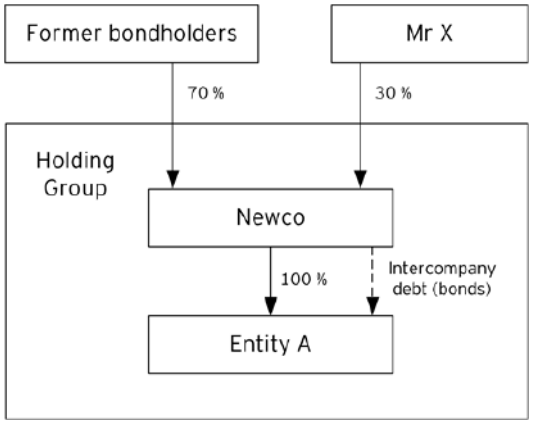
Illustration 4-3: Newco formed to facilitate a debt-to-equity swap transaction

Entity A was wholly owned by a single shareholder Mr X and had issued bonds, ownership of which is widely dispersed. Five years before the maturity of the bonds, Entity A initiated and negotiated with bondholders to swap their bonds for an equity interest in Entity A, in order to facilitate Entity A's future market expansion strategy. Mainly due to tax reasons, the transaction was structured as follows: Mr X formed Newco with *de minimis* share capital, appointed to its Board of Directors the same individuals that comprise the Board of Directors of Entity A, and contributed his interest in Entity A for nil consideration. The bondholders then swapped their bonds for new shares issued by Newco. As result of the transaction, Mr X owns 30% of Entity A's shares indirectly through Newco, and the former bondholders hold 70%. Neither Mr X, nor any individual former bondholder, nor any organised sub-group of former bondholders, controls Newco. No changes were made or are expected to be made to the Board of Directors of Entity A or Newco, on which the former bondholders are not represented. While under the local legislation, Newco is required to present its IFRS financial statements to the regulator, the shareholders of Newco (i.e., Mr X and former bondholders) will continue to use Entity A's financial statements to evaluate its performance and financial position. The shareholding and debt structures before after the transaction are as follows:

Before transaction:



After transaction:



In this transaction, Mr X loses control over Entity A and the former bondholders as a group obtain the majority of shares in Newco and indirectly therefore in Entity A. In order to assess whether the purpose and design of the transaction is to obtain ultimate control over Entity A by the former bondholders as a group, and hence whether it is appropriate to consider Newco as an extension of the former bondholders, the following facts and circumstances are identified:

- The debt-to-equity swap was initiated by Entity A to facilitate its future market expansion strategy.
- The Newco was formed mainly for tax reasons.
- There was no concerted effort by the bondholders to form Newco to acquire control over Entity A.
- There was no new cash involved in this transaction.
- There is no existing or planned Board representation of the former bondholders at Newco or Entity A level. This suggests that the intention of the bondholders was not to change control over Entity A through Newco.
- Financial statements of Entity A will continue to be used to provide the shareholders of Newco (Mr X and former bondholders) with information about the financial performance and financial position of Entity A.
- Neither Mr X, nor any individual bondholder, or any organised sub-group of bondholders, controls Newco after the transaction.

When assessing all these facts and circumstances, the purpose and design of this transaction appears to reflect a facilitation of a debt-to-equity swap rather than an intended change in control over Entity A, even though the change of control happened as well. Therefore, in this specific example, it is appropriate to consider Newco as an extension of Entity A rather than as extension of the former bondholders and, therefore, not to identify Newco as the acquirer.

4.1.2 Stapling arrangements

In 2014, the IFRS IC considered whether an acquirer identified for the purpose of IFRS 3 is a parent for the purpose of IFRS 10 in circumstances in which a business combination is achieved by contract alone, such as a stapling arrangement, with no combining entity obtaining control of the other combining entities. When considering this issue, the IFRS IC thought that the guidance outlined in IFRS 3.B15(a), i.e., that the acquirer is usually the combining entity whose owners as a group receive the largest portion of the voting rights in the combined entity, would be relevant to identifying which of the combining entities is the acquirer in the stapling transaction considered.[8]

4.1.3 Determining the accounting acquirer in SPAC transactions

Although a SPAC legally acquires a target, the accounting for the transaction depends on which entity is considered the acquirer for accounting purposes (i.e., the accounting acquirer). IFRS 3 and IFRS 10 requirements are applied to determine whether the SPAC or its target (or one of its targets) is identified as an accounting acquirer.

Generally, a new entity that has been formed to effect a business combination other than through the issue of shares, will be identified as an acquirer if it is an extension of the party (or parties) that ultimately gains control of the combining entities. This determination requires a thorough analysis of all the facts and circumstances, including an assessment of the purpose and design of the transaction. When the purpose and design of the transaction indicate that its underlying substance is to gain control over the business by the new ultimate controlling party (or parties), then this new entity is an extension of such a party (or parties) and, therefore, would likely be identified as the acquirer. An example could be a situation when the Newco is used by a group of investors or another entity to acquire a controlling interest in a target entity in an arm's length transaction.

As noted in section 4.1 above, in a business combination effected primarily by transferring cash or other assets, or by incurring liabilities, the acquirer is usually the entity that transfers the cash or other assets or incurs the liabilities. In a business combination effected primarily by exchanging equity interests, the acquirer is usually the entity that issues its equity interests, except for a situation where the issuing entity is the accounting acquiree. For example, a private operating entity may arrange the acquisition of all its existing shares by a public entity in exchange for additional shares issued by the public entity. While the public entity might first appear to be the accounting acquirer by issuing additional shares to acquire the controlling interest in a private entity, it is necessary to consider other facts and circumstances in order to determine the accounting acquirer in a business combination effected by exchanging equity interests under IFRS 3. This may result in a conclusion that the private entity is the accounting acquirer and the public entity is the accounting acquiree. Therefore, when a SPAC acquires a business for cash-only consideration, the SPAC is usually the accounting acquirer. However, if the consideration is equity or a mix of cash and equity, determining the accounting acquirer requires considering the guidance in IFRS 3.B14 to B18. Application of this guidance including facts and circumstances that an entity needs to consider while identifying the accounting acquirer is discussed in detail in section 4.1 above.

Since SPAC acquisitions often involve redemptions by selling shareholders that may affect the relative voting rights, as well as complex equity structures (e.g., voting shares, non-voting shares, warrants, convertible instruments), these transactions require a careful analysis of the combined entity's post-combination voting structure. If consideration paid for the target includes shares in the SPAC, the former owners of the target may hold the largest portion of voting rights in the combined entity, which would indicate that the target is the accounting acquirer.

The determination of the accounting acquirer in a SPAC acquisition requires careful analysis and significant judgement. Some of the factors an entity is required to consider as stated above and in section 4.1 may suggest that the SPAC is the accounting acquirer, while others may suggest that the target is the accounting acquirer.

8 *IFRIC Update*, May 2014, available on the IFRS Foundation's website.

4.2 Determining the acquisition date

The next step in applying the acquisition method is determining the acquisition date, which is 'the date on which the acquirer obtains control of the acquiree'. *[IFRS 3.8, IFRS 3 Appendix A]*. This is generally the 'closing date', i.e., the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree. *[IFRS 3.9]*. However, although the standard refers to the 'closing date', this does not necessarily mean that the transaction has to be closed or finalised at law before the acquirer obtains control over the acquiree.

The acquirer might obtain control on a date that is either earlier or later than the closing date. If a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date, the acquisition date might precede the closing date. *[IFRS 3.9]*. This does not mean that the acquisition date can be artificially backdated or otherwise altered, for example, by the inclusion of terms in the agreement indicating that the acquisition is effective as at an earlier date, with the acquirer being entitled to profits arising after that date, even if the purchase price is based on the net asset position of the acquiree at that date.

The Basis for Conclusions accepts that, for convenience, an entity might wish to designate an acquisition date at the beginning or end of a month, the date on which it closes its books, rather than the actual acquisition date during the month. Unless events between the 'convenience' date and the actual acquisition date result in material changes in the amounts recognised, that entity's practice would comply with the requirements of IFRS 3. *[IFRS 3.BC110]*.

The date control is obtained will be dependent on a number of factors, including whether the acquisition arises from a public offer or a private deal, is subject to approval by other parties, or is effected by the issue of shares.

However, in all cases, whether control has been obtained by a certain date is a matter of fact, and all pertinent facts and circumstances surrounding a business combination need to be considered in assessing when the acquirer has obtained control. To evaluate whether control has been obtained, the acquirer applies the guidance in IFRS 10 (see Chapter 7 at section 3).

For an acquisition by way of a public offer, the date of acquisition could be:

- When the offer has become unconditional because sufficient irrevocable acceptances have been received

  Or

- The date that the offer closes

Since the nature of public offers can be different depending on the jurisdiction they are in, it is always necessary to consider the impact of the nature and terms of the offer and any other relevant laws or regulations in determining the date of acquisition.

In a private deal, the date would generally be when an unconditional offer has been accepted by the vendors, the acquirer obtains substantive voting rights in the investee and all other criteria of control in IFRS 10 are met.

Thus, when an offer is conditional on the approval of the acquiring entity's shareholders, until that approval has been received, it is unlikely that control will have been obtained. When the offer is conditional upon receiving some form of regulatory approval, then it will depend on the nature of that approval. If it is a substantive hurdle, such as obtaining the approval of a competition authority, it is unlikely that control is obtained prior to that approval. However, when the approval is merely a formality, or 'rubber-stamping' exercise, then this would not preclude control having been obtained at an earlier date, provided that at that earlier date, the acquirer effectively obtains power to direct the relevant activities of the acquiree.

When the acquisition is effected by the issue of shares, the date of control will generally be when the exchange of shares takes place.

Application of the IFRS 10 criteria for control may also result in the determination of the acquisition date as the date when acquirer obtains substantive voting rights via options held over the acquiree's shares (see Chapter 7 at section 4.3.4).

5 Recognition and measurement of identifiable assets acquired, liabilities assumed and non-controlling interests

Extract from IFRS 3

10 **As of the acquisition date, the acquirer shall recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree. Recognition of identifiable assets acquired and liabilities assumed is subject to the conditions specified in paragraphs 11 and 12.**

11 To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in the *Conceptual Framework for Financial Reporting* at the acquisition date. For example, costs the acquirer expects but is not obliged to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree's employees are not liabilities at the acquisition date. Therefore, the acquirer does not recognise those costs as part of applying the acquisition method. Instead, the acquirer recognises those costs in its post-combination financial statements in accordance with other IFRSs.

12 In addition, to qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must be part of what the acquirer and the acquiree (or its former *owners*) exchanged in the business combination transaction rather than the result of separate transactions. The acquirer shall apply the guidance in paragraphs 51-53 to determine which assets acquired or liabilities assumed are part of the exchange for the acquiree and which, if any, are the result of separate transactions to be accounted for in accordance with their nature and the applicable IFRSs.

18 **The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values.**

21 This IFRS provides limited exceptions to its recognition and measurement principles. Paragraphs 22-31 specify both the particular items for which exceptions are provided and the nature of those exceptions. The acquirer shall account for those items by applying the requirements in paragraphs 22-31, which will result in some items being:

(a) recognised either by applying recognition conditions in addition to those in paragraphs 11 and 12 or by applying the requirements of other IFRSs, with results that differ from applying the recognition principle and conditions.

(b) measured at an amount other than their acquisition-date fair values.

[IFRS 3.10, IFRS 3.11, IFRS 3.12, IFRS 3.18, IFRS 3.21].

The next step in applying the acquisition method involves recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree.

5.1 General principles

The identifiable assets acquired and liabilities assumed of the acquiree are recognised as at the acquisition date and measured at fair value as at that date, with certain limited exceptions. *[IFRS 3.10, IFRS 3.14, IFRS 3.18, IFRS 3.20]*.

Any non-controlling interest in the acquiree is recognised at the acquisition date. Non-controlling interests that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation can be measured on one of two bases:

- At fair value at that date

  Or

- At the non-controlling interest's proportionate share of the acquiree's net identifiable assets *[IFRS 3.19]*

All other components of non-controlling interests are measured at their acquisition-date fair values, unless another measurement basis is required by other IFRS accounting standards. *[IFRS 3.10, IFRS 3.19]*. See section 8 below.

5.2 Recognising identifiable assets acquired and liabilities assumed

To qualify for recognition, an item acquired or assumed must be:

(a) An asset or liability at the acquisition date

And

(b) Part of the business acquired (the acquiree) rather than the result of a separate transaction *[IFRS 3.BC112]*

The first condition requires the identifiable assets acquired and liabilities assumed to meet the definitions of assets and liabilities in the *Conceptual Framework for Financial Reporting* (*Conceptual Framework*), issued in 2018. *[IFRS 3.11]*.

Applying the definitions in the *Conceptual Framework* means that costs that the acquirer expects but is not obliged to incur in the future cannot be provided for. For example, the entity's plans to reorganise the acquiree's activities (e.g., plans to exit from an activity, or terminate the employment of or relocate employees) are not liabilities at the acquisition date. These costs will be recognised by the acquirer in its post-combination financial statements in accordance with other IFRS accounting standards. *[IFRS 3.11]*. Liabilities for restructuring or exit activities can only be recognised if they meet the definition of a liability at the acquisition date. *[IFRS 3.BC132]*. Although the standard no longer contains explicit requirements relating to restructuring plans, the Basis for Conclusions clearly indicates that the requirements for recognising liabilities associated with restructuring or exit activities remain the same. *[IFRS 3.BC137]*. This is discussed further in section 11.4 below.

The first condition for recognition makes no reference to probability of the inflow or outflow of economic benefits. Thus, identifiable assets and liabilities are recognised regardless of the degree of probability that there will be inflows or outflows of economic benefits. *[IFRS 3.BC126]*. The first condition for recognition makes no reference to reliability of measurement either.

The second condition requires the identifiable assets acquired and liabilities assumed must be part of the exchange for the acquiree, rather than the result of separate transactions. *[IFRS 3.12]*. Explicit guidance is given in the standard for making such an assessment as discussed in section 11 below. An acquirer may recognise some assets and liabilities that had not previously been recognised in the acquiree's financial statements, e.g., intangible assets, such as internally-generated brand names, patents or customer relationships. *[IFRS 3.13]*.

Guidance on recognising intangible assets and lessor's operating leases, as well as items for which IFRS 3 provides limited exceptions to the recognition principles and conditions are discussed in sections 5.5 and 5.6 below.

5.3 Acquisition-date fair values of identifiable assets acquired and liabilities assumed

The general principle is that the identifiable assets acquired and liabilities assumed are measured at their acquisition-date fair values. In this chapter, reference to fair value means fair value as measured by IFRS 13.

IFRS 13 provides guidance on how to measure fair value, but it does not change when fair value is required or permitted under IFRS accounting standards. IFRS 13 is discussed in detail in Chapter 15. IFRS 3 allows some assets and liabilities to be measured at other than fair value on initial recognition, as described in section 5.6 below.

IFRS 13 defines 'fair value' as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date" under current market conditions. It is explicitly an exit price. *[IFRS 13.9]*.

When IFRS 3 requires an identifiable asset acquired or liability assumed to be measured at its fair value at the acquisition date, although an entity applies the IFRS 13 measurement requirements, it does not need to disclose information about those acquisition-date fair value measurements under IFRS 13. However, the IFRS 13 disclosure requirements would apply to any fair value measurement after initial recognition, for example the fair value measurement of contingent consideration classified as a financial liability (see Chapter 15 at section 19). *[IFRS 13.91]*.

IFRS 3 specifies which assets and liabilities are not measured at fair value, including income taxes and employee benefits. *[IFRS 3.20]*. These are discussed in section 5.6 below.

5.4 Classifying or designating identifiable assets acquired and liabilities assumed

The acquirer must classify or designate the identifiable assets and liabilities assumed on the basis of its own contractual terms, economic conditions, operating and accounting policies and other relevant conditions as at the acquisition date. *[IFRS 3.15]*.

Examples of classifications or designations made by the acquirer on the basis of conditions at the acquisition date include but are not limited to:

(a) Classifying financial assets and liabilities as measured at fair value through profit or loss or at amortised cost, or as a financial asset measured at fair value through other comprehensive income, in accordance with IFRS 9

(b) Designating a derivative instrument as a hedging instrument in accordance with IFRS 9

And

(c) Assessing whether an embedded derivative is separated from the host contract in accordance with IFRS 9 (which is a matter of 'classification' as IFRS 3 uses that term) *[IFRS 3.16]*

The requirements for the classification of financial assets and liabilities under IFRS 9 are discussed in Chapter 44. Although IFRS 9 prohibits reclassifications of financial liabilities and allows reclassifications of financial assets when, and only when, an entity changes its business model for managing financial assets as described in Chapter 44 at section 8, these do not apply in the circumstances of a business combination. The acquirer has to make its own classification at the acquisition date. If it has not had to consider the classification of such assets or liabilities before, it could choose to adopt the classification applied by the acquiree or adopt a different classification if appropriate. However, if it already has an accounting policy for like transactions, the classification must be consistent with that existing policy.

As discussed in Chapter 49 at section 6, there are a number of conditions that need to be met for hedge relationships to qualify for hedge accounting, in particular formal designation and documentation, and an ongoing assessment of the designated hedge. If an acquiree has derivative or other financial instruments that have been used as hedging instruments in a hedge relationship, IFRS 3 requires the acquirer to make its own designation about the hedging relationship that satisfy the conditions for hedge accounting, based on the conditions as they exist at the acquisition date. If the hedging relationship is being accounted for as a cash flow hedge by the acquiree, the acquirer does not inherit the acquiree's existing cash flow hedge reserve, as this clearly represents cumulative pre-acquisition gains and losses. This has implications for the assessment of hedge effectiveness and the measurement of ineffectiveness because, so far as the acquirer is concerned, it has started a new hedge relationship with a hedging instrument that is likely to have a non-zero fair value. This may mean that although the acquiree can continue to account for the relationship as a cash flow hedge, the acquirer is unable to account for it as a cash flow hedge in its financial statements.

In the situations discussed above, the effect of applying the principle in IFRS 3 only affects the post-business combination accounting for the financial instruments concerned. The financial instruments that are recognised as at the acquisition date, and their measurement at their fair value at that date, do not change.

However, the requirement for the acquirer to assess whether an embedded derivative is separated from the host contract based on acquisition date conditions could result in additional assets or liabilities being recognised (and measured at their acquisition-date fair values) that differ from those recognised by the acquiree. Embedded derivatives are discussed in Chapter 42.

5.4.1 Exception to the classifying or designating principle

The standard provides an exception to the principle in IFRS 3.15 regarding classification under IFRS 16 of leases in which the acquiree is the lessor. That is, contracts within the scope of the exception are classified on the basis of the contractual terms and other factors at the inception of the contract or at the date of modification. This could be the acquisition date if the terms of the contract have been modified in a manner that would change its classification. *[IFRS 3.17]*.

Thus, if an acquiree is a lessor under a lease contract that has been classified appropriately as an operating lease under IFRS 16, the acquirer would continue to account for the lease as an operating lease in the absence of any modification to the terms of the contract. Only if, prior to, or as at, the acquisition date, the terms of the lease were modified in such a way that it would be reclassified as a finance lease under IFRS 16 (see Chapter 24 at section 6.5), would the acquirer derecognise the underlying asset and recognise instead a financial asset (net investment in a lease).

IFRS 3 as updated by IFRS 17, which is effective for annual periods beginning on or after 1 January 2023, removes the second classification exception[9] and requires that an acquirer will measure a group of acquired insurance contracts and any assets for insurance acquisition cash flows as defined in IFRS 17, as a liability or asset in accordance with the provisions of IFRS 17.39 and IFRS 17.B93-B95F, at the acquisition date.

9 IFRS 17 *Insurance Contracts*, Appendix D Amendments to other IFRS Standards, IFRS 3 *Business Combinations*, May 2017.

5.5 Recognising and measuring particular assets acquired and liabilities assumed

IFRS 3 gives some application guidance on recognising and measuring particular assets acquired and liabilities assumed in a business combination, as discussed below.

5.5.1 Operating leases in which the acquiree is the lessor

If the acquiree is a lessor in an operating lease, i.e., it has an item of property, plant and equipment that is leased to another party, there is no requirement for the acquirer to recognise intangible assets or liabilities if the terms of the lease are favourable or unfavourable relative to market terms and prices. Instead, off-market terms are reflected in the acquisition-date fair value of the asset (such as a building or a patent) subject to the lease. *[IFRS 3.B42]*. The IASB sought to avoid any inconsistency with the fair value model in IAS 40, which requires the fair value of investment property to take into account rental income from current leases. *[IFRS 3.BC146]*.

The requirement to reflect the off-market terms in the fair value of the asset subject to an operating lease in which the acquiree is the lessor applies to any type of asset, to the extent market participants would take them into consideration when pricing the asset, and is not restricted to investment properties accounted for under the fair value model in IAS 40. Based on the requirements of IAS 16 and IAS 38, an entity would be required to adjust the depreciation or amortisation method of the leased asset so as to reflect the timing of the cash flows attributable to the underlying leases. *[IFRS 3.BC148]*.

5.5.2 Intangible assets

Identifiable intangible assets may have to be recognised by an acquirer although they have not previously been recognised by the acquiree. *[IFRS 3.B31]*. IFRS 3 and IAS 38 give guidance on the recognition of intangible assets acquired in a business combination.

IFRS 3 and IAS 38 both define an 'intangible asset' as "An **identifiable** non-monetary asset without physical substance". *[IFRS 3 Appendix A, IAS 38.8]*. The definition requires an intangible asset to be 'identifiable' to distinguish it from goodwill. *[IAS 38.11]*. Both standards regard an asset as identifiable if it:

- Is separable, i.e., capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so (the 'separability' criterion)

  Or

- Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations (the 'contractual-legal' criterion) *[IFRS 3 Appendix A, IAS 38.12]*

IFRS 3 provides the following application guidance.

Separability

An intangible asset is separable even if the acquirer has no intention of selling, licensing or otherwise exchanging it. An acquired intangible asset is separable if there is evidence of exchange transactions for that type of asset or an asset of a similar type, even if those transactions are infrequent and regardless of whether the acquirer is involved in them. For example, customer and subscriber lists are frequently licensed and thus separable. Even if an acquiree believes its customer lists have characteristics that distinguish them from others, this would not generally prevent the acquired customer list from being considered separable. However, if confidentiality terms or other agreements prohibit an entity from selling, leasing or otherwise exchanging information about its customers, then the customer list would not be separable. *[IFRS 3.B33]*.

An intangible asset may be separable from goodwill in combination with a related contract, identifiable asset or liability. Two examples are given by IFRS 3:

- Market participants exchange deposit liabilities and related depositor relationship intangible assets in observable exchange transactions. Therefore, the acquirer recognises the depositor relationship intangible asset separately from goodwill.

  And

- An acquiree owns a registered trademark and documented but unpatented technical expertise used to manufacture the trademarked product. When it sells the trademark, the owner must also transfer everything else necessary for the new owner to produce a product or service indistinguishable from that produced by the former owner. Because the unpatented technical expertise must be separated from the acquiree or combined entity and sold if the related trademark is sold, it meets the separability criterion. *[IFRS 3.B34]*.

Contractual-legal

An intangible asset that meets the contractual-legal criterion is identifiable, and hence accounted for separately from goodwill, even if the asset is not transferable or separable from the acquiree or from other rights and obligations. For example:

- An acquiree owns and operates a nuclear power plant. The licence to operate the power plant is a separate intangible asset, even if the acquirer cannot sell or transfer it separately from the power plant itself. IFRS 3 goes on to say that an acquirer may recognise the operating licence and the power plant as a single asset for financial reporting purposes if their useful lives are similar.
- An acquiree owns a technology patent that it has licensed to others for their exclusive use outside the domestic market, for which it has received a specified percentage of future foreign revenue. Both the technology patent and the related licence agreement meet the contractual-legal criterion for separate recognition even if it would not be practical to sell or exchange them separately from one another. *[IFRS 3.B32]*.

Accordingly, under IFRS 3, intangible assets are recognised separately from goodwill if they are identifiable, i.e., they either are separable or arise from contractual or other legal rights. *[IFRS 3.B31]*. They must be assigned an acquisition-date fair value.

5.5.2.A Examples of identifiable intangible assets

We have considered above a number of different types of identifiable intangible assets that are recognised separately from goodwill, such as customer and subscriber lists, depositor relationships, registered trademarks, unpatented technical expertise, licences and technology patents.

IAS 38 also explicitly requires an acquirer to recognise as a separate intangible asset in-process research and development of the acquiree, in accordance with IFRS 3, if the project meets the definition of an intangible asset. *[IAS 38.34]*. IFRS 3 itself only refers to this in its Basis for Conclusions. *[IFRS 3.BC149-BC156]*. This is discussed in section 5.5.2.D below.

IFRS 3's Illustrative Examples list items acquired in a business combination that are identifiable intangible assets, noting that the examples are not intended to be all-inclusive. *[IFRS 3.IE16-IE44]*. The assets listed are designated as being 'contractual', or 'non-contractual', in which case they do not arise from contractual or other legal rights but are separable. It emphasises that assets do not have to be separable to meet the contractual-legal criterion.

The table below summarises the items included in the Illustrative Examples. See the Illustrative Examples for further explanations.

Intangible assets arising from contractual or other legal rights (regardless of being separable)	Other intangible assets that are separable
Marketing-related	
▸ Trademarks, trade names, service marks, collective marks and certification marks ▸ Trade dress (unique colour, shape or package design) ▸ Newspaper mastheads ▸ Internet domain names ▸ Non-competition agreements	
Customer-related	
▸ Order or production backlog ▸ Customer contracts and the related customer relationships	▸ Customer lists ▸ Non-contractual customer relationships
Artistic-related	
▸ Plays, operas and ballets ▸ Books, magazines, newspapers and other literary works ▸ Musical works such as compositions, song lyrics and advertising jingles ▸ Pictures and photographs ▸ Video and audio-visual material, including motion pictures or films, music videos and television programmes	

Intangible assets arising from contractual or other legal rights (regardless of being separable)	Other intangible assets that are separable
Contract-based	
▸ Licensing, royalty and standstill agreements ▸ Advertising, construction, management, service or supply contracts ▸ Construction permits ▸ Franchise agreements ▸ Operating and broadcast rights ▸ Servicing contracts such as mortgage servicing contracts ▸ Employment contracts ▸ Use rights such as drilling, water, air, mineral, timber-cutting and route authorities	
Technology-based	
▸ Patented technology ▸ Computer software and mask works ▸ Trade secrets, such as secret formulas, processes or recipes	▸ Unpatented technology ▸ Databases, including title plants

Some items have been designated as being 'contractual' due to legal protection, for example, trademarks and trade secrets. The guidance explains that even without that legal protection, they would still normally meet the separability criterion.

Customer relationships established through contracts are deemed identifiable as they meet the contractual-legal criterion. However, there need not be a current contract or any outstanding orders at the date of acquisition for customer relationships to meet the identifiability criteria. Customer relationships can also be recognised as intangible assets if they arise outside a contract but in this case, they must be separable to be recognised. This is discussed further in section 5.5.2.B below.

IFRS 3's Illustrative Examples clarify that for contracts with terms that are favourable or unfavourable relative to the market terms, the acquirer recognises either a liability assumed or an asset acquired in a business combination. For example, if the terms of a customer contract are unfavourable in comparison to market terms, the acquirer recognises a corresponding liability. *[IFRS 3.IE34]*. Conversely, for supply contracts acquired in a business combination that are beneficial from the perspective of the acquiree because the pricing of those contracts is favourable in comparison to market terms, the acquirer recognises a contract-based intangible asset. However, this guidance is not applicable to lease contracts within the scope of IFRS 16. For such contracts, off-market terms are either reflected in the acquisition-date fair value of the asset (such as a building or a patent) subject to the lease if the acquiree is the lessor (see section 5.5.1 above) or captured in the acquisition-date carrying amount of the right-of-use asset if the acquiree is the lessee (see section 5.6.8 below).

5.5.2.B Customer relationship intangible assets

Further guidance on customer relationships acquired in a business combination is provided in IFRS 3's Illustrative Examples, which form the basis of the example below. These demonstrate how an entity interprets the contractual-legal and separability criteria in the context of acquired customer relationships. *[IFRS 3.IE30]*.

Illustration 5-1: Customer relationship intangible assets

(i) Supply agreement

Acquirer Company (AC) acquires Target Company (TC) in a business combination. TC has a five-year agreement to supply goods to Customer. Both TC and AC believe that Customer will renew the agreement at the end of the current contract. The agreement is not separable.

The agreement, whether cancellable or not, meets the contractual-legal criterion. Because TC establishes its relationship with Customer through a contract, both the agreement itself and also TC's customer relationship with Customer meet the contractual-legal criterion.

(ii) Sporting goods and electronics

AC acquires TC in a business combination. TC manufactures goods in two distinct lines of business: sporting goods and electronics. Customer purchases both sporting goods and electronics from TC. TC has a contract with Customer to be its exclusive provider of sporting goods but has no contract for the supply of electronics to Customer. Both TC and AC believe that only one overall customer relationship exists between TC and Customer.

The contract to be Customer's exclusive supplier of sporting goods, whether cancellable or not, meets the contractual-legal criterion. In addition, as TC establishes its relationship with Customer through a contract, the customer relationship with Customer meets the contractual-legal criterion. Because TC has only one customer relationship with Customer, the fair value of that relationship incorporates assumptions about TC's relationship with Customer related to both sporting goods and electronics. However, if AC determines that it has two separate customer relationships with Customer, for sporting goods and for electronics, AC would need to assess whether the customer relationship for electronics is separable before it could be recognised as an intangible asset.

(iii) Order backlog and recurring customers

AC acquires TC in a business combination. TC does business with its customers solely through purchase and sales orders. At the acquisition date, TC has a backlog of customer purchase orders from 60% of its customers, all of whom are recurring customers. The other 40% of TC's customers are also recurring customers. However, as at the acquisition date, TC has no open purchase orders or other contracts with those customers.

Regardless of whether they are cancellable or not, the purchase orders from 60% of TC's customers meet the contractual-legal criterion. Additionally, because TC has established its relationship with 60% of its customers through contracts, not only the purchase orders but also TC's customer relationships meet the contractual-legal criterion. Because TC has a practice of establishing contracts with the remaining 40% of its customers, its relationship with those customers also arises through contractual rights and therefore meets the contractual-legal criterion even though TC does not have contracts with those customers at the acquisition date.

(iv) Motor insurance contracts

AC acquires TC, an insurer, in a business combination. TC has a portfolio of one-year motor insurance contracts that are cancellable by policyholders.

Because TC establishes its relationships with policyholders through insurance contracts, the customer relationship with policyholders meets the contractual-legal criterion.

Sometimes the acquirer may be a customer of the acquiree immediately before the business combination. While a separate customer relationship intangible asset would generally be recognised by the acquirer for the existing relationships between the acquiree and its third-party customers, no separate intangible asset will be recognised for the pre-existing relationship, either contractual or not, between the acquiree and the acquirer. Instead, this relationship will be implicitly considered in the determination of a gain or loss on effective settlement of the pre-existing relationship as illustrated in Illustration 11-2 in section 11.1 below. This is different from any reacquired rights, for which the acquirer would recognise a separate asset (see section 5.5.3 below).

One of the most difficult areas of interpretation is whether an arrangement is contractual or not. Contractual customer relationships are always recognised separately from goodwill, but non-contractual customer relationships are recognised only if they are separable. Consequently, determining whether a relationship is contractual is critical to identifying and measuring customer relationship intangible assets and different conclusions could result in substantially different accounting outcomes.

Paragraph IE28 in the Illustrative Examples explains that a customer relationship is deemed to exist if the entity has information about the customer and regular contact with it and the customer can make direct contact with the entity. A customer relationship "may also arise through means other than contracts, such as through regular contact by sales or service representatives". However, the argument is taken a stage further. Regardless of whether any contracts are in place at the acquisition date, "customer relationships meet the contractual-legal criterion for recognition if an entity has a practice of establishing contracts with its customers". *[IFRS 3.IE28]*. An example of what is meant by this is given in Illustration 5-1 above. In the third illustration, 'Order backlog and recurring customers', it states "Because TC has a practice of establishing contracts with the remaining 40% of its customers, its relationship with those customers also arises through contractual rights and therefore meets the contractual-legal criterion even though TC does not have contracts with those customers at the acquisition date".

In 2008 the IFRS IC considered the circumstances in which non-contractual customer relationships arise. The staff's survey of IFRS IC members indicated that there were diverse practices regarding which customer relationships have a contractual basis and which do not. In addition, valuation experts seemed to be taking different views.[10]

The IFRS IC noted that the IFRS Glossary of Terms defined the term 'contract'. Whilst the manner in which a relationship is established is relevant to confirming the existence of a customer relationship, it is not the primary basis for determining whether an intangible asset is recognised by the acquirer. What might be more relevant is whether the entity has a practice of establishing contracts with its customers or whether relationships arise through other means, such as through regular contact by sales and service representatives (i.e., the matters identified in IFRS 3.IE28). The existence of contractual relationships and information about a customer's prior purchases would be important inputs in valuing a customer relationship intangible asset, but it does not determine whether it is recognised.[11] Therefore, a customer base (e.g., customers of a fast food franchise or movie theatres) is an example of a non-contractual customer relationship that would not be recognised in a business combination.

The IFRS IC referred the issue to the IASB but to date no further guidance has been developed. Therefore, divergent treatments will remain in practice, depending on how entities interpret 'contractual' and 'non-contractual' customer-related intangible assets in a particular business combination.

5.5.2.C Combining an intangible asset with a related contract, identifiable asset or liability

IAS 38 states that an intangible asset acquired in a business combination might be separable, but only together with a related contract, identifiable asset, or liability. In such cases, the acquirer recognises the intangible assets separately from goodwill, but together with the related item. *[IAS 38.36]*.

Similarly, the acquirer may recognise a group of complementary intangible assets as a single asset provided the individual assets have similar useful lives. For example, "the terms 'brand' and 'brand name' are often used as synonyms for trademarks and other marks. However, the former are general marketing terms that are typically used to refer to a group of complementary assets such as a trademark (or service mark) and its related trade name, formulas, recipes and technological expertise." *[IAS 38.37]*.

It is not clear whether an intangible asset that is only separable in combination with a tangible asset, is recognised together as a single asset for financial reporting purposes in all circumstances. IFRS 3 gives an example of a licence to operate a nuclear power plant, and says that the fair value of the operating licence and the fair value of the power plant may be recognised as a single asset for financial reporting purposes, if the useful lives of those assets are similar (see section 5.5.2 above), yet the requirements in IAS 38 only refer to similar useful lives in the context of a group of complementary intangible assets.

In practice entities account for intangible assets separately from the related tangible asset if the useful lives are different. The Rank Group Plc considers that its casino and gaming licences have indefinite useful lives and accounts for them separately from the buildings with which they are acquired, as disclosed in its accounting policy.

Practical example 5-1: The Rank Group Plc (2021) **United Kingdom**

Annual Report 2021 [extract]

Notes to the financial statements [extract]

1 General information and accounting policies [extract]

Summary of significant accounting policies [extract]

1.13 Intangible assets [extract]

(b) Casino and other gaming licences and concessions

The Group capitalises acquired casino and other gaming licences and concessions. Management believes that casino and other gaming licences have indefinite lives as there is no foreseeable limit to the period over which the licences are expected to generate net cash inflows and each licence holds a value outside the property in which it resides. Each licence is reviewed annually for impairment.

Guidance on determining useful lives of intangible assets is discussed in Chapter 18 at section 9.1.

10 *IFRIC Update*, September 2008, available on the IFRS Foundation's website.

11 *IFRIC Update*, March 2009, available on the IFRS Foundation's website.

5.5.2.D In-process research or development project expenditure

IFRS 3 itself only refers to in-process research and development in its Basis for Conclusions, where it is made clear that the acquirer recognises all tangible and intangible research and development assets acquired in a business combination. *[IFRS 3.BC149-BC156]*.

IAS 38's general recognition conditions require it to be probable that expected future economic benefits will flow to the entity and that the costs can be measured reliably before an intangible asset can be recognised. *[IAS 38.21]*.

IAS 38 states that "an acquiree's in-process research and development project meets the definition of an intangible asset when it meets the definition of an asset, and is identifiable, i.e., is separable or arises from contractual or other legal rights." *[IAS 38.34]*.

In-process research and development projects, whether or not recognised by the acquiree, are protected by legal rights and are clearly separable as on occasion they are bought and sold by entities without there being a business acquisition. Both of the standard's general recognition criteria, probability of benefits and reliable measurement, are always considered to be satisfied for in-process research and development projects acquired in a business combination. The fair value of an intangible asset reflects expectations about the probability of these benefits, despite uncertainty about the timing or the amount of the inflow. There will be sufficient information to measure the fair value of the asset reliably if it is separable or arises from contractual or other legal rights. If there is a range of possible outcomes with different probabilities, this uncertainty is taken into account in the measurement of the asset's fair value. *[IAS 38.33, IAS 38.34, IAS 38.35]*.

Therefore, recognising in-process research and development as an asset on acquisition applies different criteria to those that are required for internal projects. The research costs of internal projects may under no circumstances be capitalised. *[IAS 38.54]*. Before capitalising development expenditure, entities must meet a series of exacting requirements. They must demonstrate the technical feasibility of the intangible assets, their intention and ability to complete the assets and use them or sell them and must be able to measure reliably the attributable expenditure. *[IAS 38.57]*. The probable future economic benefits must be assessed using the principles in IAS 36 which means that they have to be calculated as the net present value of the cash flows generated by the asset or, if it can only generate cash flows in conjunction with other assets, of the cash-generating unit of which it is a part. *[IAS 38.60]*. This process is described further in Chapter 18 at section 6.2.

What this means is that entities will be required to recognise on acquisition some research and development expenditure that they would not have been able to recognise if it had been an internal project. The IASB is aware of this inconsistency, but concluded that this did not provide a basis for subsuming in-process research and development within goodwill. *[IAS 38.BC82]*.

Although the amount attributed to the project is accounted for as an asset, IAS 38 goes on to require that any subsequent expenditure incurred after the acquisition of the project is accounted for in accordance with IAS 38.54 to 62. *[IAS 38.42]*. These requirements are discussed in Chapter 18 at section 6.3.

In summary, this means that the subsequent expenditure is:

- Recognised as an expense when incurred if it is research expenditure
- Recognised as an expense when incurred if it is development expenditure that does not satisfy the criteria for recognition as an intangible asset in IAS 38.57
- Added to the carrying amount of the acquired in-process research or development project if it is development expenditure that satisfies the recognition criteria in IAS 38.57 *[IAS 38.43]*

The inference is that the in-process research and development expenditure recognised as an asset on acquisition that never progresses to the stage of satisfying the recognition criteria for an internal project will ultimately be impaired, although it may be that this impairment will not arise until the entity is satisfied that the project will not continue. However, since it is an intangible asset not yet available for use, such an evaluation cannot be significantly delayed as it will need to be tested for impairment annually by comparing its carrying amount with its recoverable amount, as discussed in Chapter 21 at section 10. *[IAS 36.10]*.

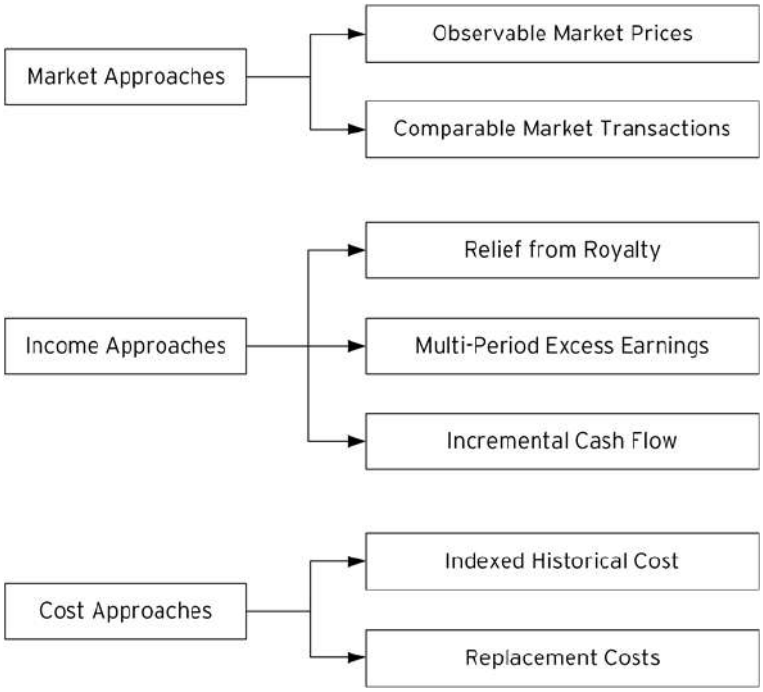
5.5.2.E Emissions schemes

Refer to Chapter 18 at section 11.2.6 for the accounting when an entity that is acquired in a business combination participates in emissions scheme.

5.5.2.F Determining the fair values of intangible assets

IAS 38 states that the fair value of an intangible asset will reflect market participants' expectations at the acquisition date about the probability that the expected future economic benefits embodied in the asset will flow to the entity. *[IAS 38.33]*. Like IFRS 3, IAS 38 incorporates IFRS 13's definition of fair value (see section 5.3 above and Chapter 15). *[IAS 38.8]*.

There are three broad approaches to valuing intangible assets that correspond to the valuation approaches referred to in IFRS 13. *[IFRS 13.62]*. These are the market, income and cost approaches (further discussed in Chapter 15 at section 13). The diagram below shows these valuation approaches, together with some of the primary methods used to measure the fair value of intangible assets that fall under each approach, shown in the boxes on the right.



IFRS 13 does not limit the types of valuation techniques an entity can use to measure fair value. Instead the standard indicates that entities are required to use valuation techniques that are appropriate in the circumstances and for which sufficient data is available, which may result in the use of multiple valuation techniques. Regardless of the technique(s) used, a fair value measurement maximises the use of relevant observable inputs and minimises the use of the unobservable inputs. *[IFRS 13.61]*. The resulting fair value measurement must also reflect an exit price, i.e., the price to sell an asset. *[IFRS 13.2]*.

In practice, the ability to use a market-based approach is very limited as intangible assets are generally unique and are not typically traded. For example, there are generally no observable transactions for unique rights such as brands, newspaper mastheads, music and film publishing rights, patents or trademarks noted in IAS 38.78, i.e., a number of the intangible assets that IFRS 3 and IAS 38 require an acquirer to recognise in a business combination (see Chapter 18 at section 5.2).

The premise of the cost approach is that an investor would pay no more for an intangible asset than the cost to recreate it. The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (i.e., current replacement cost). It is based on what a market participant buyer would pay to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. Obsolescence includes physical deterioration, technological (functional) and economic obsolescence so it is not the same as depreciation under IAS 16. *[IFRS 13.B8, IFRS 13.B9]*. This approach is most often used for unique intangible assets constructed by the entity, e.g., internally-developed software.

Income-based approaches are much more commonly used. These involve identifying the expected cash flows or economic benefits to be derived from the ownership of the particular intangible asset, and calculating the fair value of an intangible asset at the present value of those cash flows. These are discussed further below.

For each asset, there may be several methodologies that can be applied. The methods used will depend on the circumstances, as the assets could result in additional revenue, cost savings, or replacement time. A discounted cash flow method may be used, for example, in determining the value of cost-savings that will be achieved as a result of having a supply contract with advantageous terms in relation to current market rates.

Two income-based methods that are commonly used to value intangible assets are:

- The Multi-Period Excess Earnings Method ('MEEM')

  And

- The Relief from Royalty method

The MEEM is a residual cash flow methodology that is often used in valuing the primary intangible asset acquired. The key issue in using this method is how to isolate the income/cash flow that is related to the intangible asset being valued.

As its name suggests, the value of an intangible asset determined under the MEEM is estimated through the sum of the discounted future excess earnings attributable to the intangible asset. The excess earnings is the difference between the after-tax operating cash flow attributable to the intangible asset and the required cost of invested capital on all other assets used in order to generate those cash flows. These contributory assets include property, plant and equipment, other identifiable intangible assets and net working capital. The allowance made for the cost of such capital is based on the value of such assets and a required rate of return reflecting the risks of the particular assets. As noted in section 5.5.4.A below, although it cannot be recognised as a separate identifiable asset, an assembled workforce may have to be valued for the purpose of calculating a 'contributory asset charge' in determining the fair value of an intangible asset under the MEEM.

The Relief from Royalty method is often used to calculate the value of a trademark or trade name. This approach is based on the concept that if an entity owns a trademark, it does not have to pay for the use of it and therefore is relieved from paying a royalty. The amount of that theoretical payment is used as a surrogate for income attributable to the trademark. The valuation is arrived at by computing the present value of the after-tax royalty savings, calculated by applying an appropriate royalty rate to the projected revenue, using an appropriate discount rate. The legal protection expenses relating to the trademark and an allowance for tax at the appropriate rate are deducted. The Relief from Royalty method was applied by Carlsberg A/S in its 2022 financial statements.

Practical example 5-2: CARLSBERG A/S (2022) **Denmark**

CARLSBERG GROUP ANNUAL REPORT 2022 [extract]
CONSOLIDATED FINANCIAL STATEMENTS [extract]
Notes [extract]
SECTION 5 DISCONTINUED OPERATIONS, ACQUISITIONS, DISPOSALS AND ASSOCIATES [extract]
SECTION 5.3 ACQUISITIONS AND DISPOSALS [extract]
ACCOUNTING ESTIMATES AND JUDGEMENTS [extract]
Brands [extract]

> Brands are measured using the relief from royalty method, under which the expected future cash flows are based on key assumptions about expected useful life, royalty rate, growth rate and the theoretical tax effect. A post-tax discount rate is used that reflects the risk-free interest rate with the addition of a risk premium associated with the particular brand. The model and assumptions applied are consistent with those used in impairment testing, and are described in further detail in section 2.2.3.

It may be that the value of an intangible asset will reflect not only the present value of the future post-tax cash flows as indicated above, but also the value of any tax benefits (sometimes called 'tax amortisation benefits') that might generally be available to the owner if the asset had been bought separately, i.e., not as part of a business combination. Whether such tax benefits are included will depend on the nature of the intangible asset and the relevant tax jurisdiction. If tax amortisation benefits are included, an asset that has been purchased as part of a business combination could not actually be tax-deductible by the entity, either wholly or in part. This therefore raises a potential impairment issue that is discussed in Chapter 21 at section 8.3.1.

In the Practical example below, Allied Electronics Corporation Limited discloses in its annual financial statements the use of the Relief from Royalty method for valuation of trade names and the MEEM to value customer relationships acquired in business combinations.

Practical example 5-3:	Allied Electronics Corporation Limited (2021)	South Africa

ANNUAL FINANCIAL STATEMENTS [extract]
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]
31 CRITICAL JUDGEMENTS AND ESTIMATES MADE BY MANAGEMENT [extract]
31.1 CRITICAL ESTIMATES MADE BY MANAGEMENT [extract]

Purchase price allocation of acquisitions

The following valuation techniques were used in measuring the fair value of material assets acquired in business combinations:

- Relief-from-royalty method (trade names)
- Multi-period excess earnings method (customer relationships)

Because fair value is an exit price, the acquirer's intention in relation to intangible assets, e.g., where the acquirer does not intend to use an intangible asset of the acquiree, is not taken into account in attributing fair value. This is explicitly addressed in IFRS 3 and IFRS 13 and discussed in section 5.5.6 below and in Chapter 15 at section 9.1.

5.5.3 Reacquired rights

A reacquired right, that is, a right previously granted to the acquiree to use one or more of the acquirer's recognised or unrecognised assets, must be recognised separately from goodwill. Reacquired rights include a right to use the acquirer's trade name under a franchise agreement or a right to use the acquirer's technology under a technology licensing agreement. *[IFRS 3.B35]*.

A reacquired right is not treated as the settlement of a pre-existing relationship. Reacquisition of, for example, a franchise right does not terminate the right. The difference is that the acquirer, rather than the acquiree by itself, now controls the franchise right. The IASB also rejected subsuming reacquired rights into goodwill, noting that they meet both contractual-legal and separability criteria and therefore qualify as identifiable intangible assets. *[IFRS 3.BC182, IFRS 3.BC183, IFRS 3.BC184]*.

Guidance on the valuation of such reacquired rights, and their subsequent accounting, is discussed in section 5.6.5 below.

Although the reacquired right itself is not treated as a termination of a pre-existing relationship, contract terms that are favourable or unfavourable relative to current market transactions are accounted for as the settlement of a pre-existing relationship. The acquirer has to recognise a settlement gain or loss. *[IFRS 3.B36]*. Guidance on the measurement of any settlement gain or loss is discussed in section 11.1 below.

5.5.4 Assembled workforce and other items that are not identifiable

The acquirer subsumes into goodwill the value of any acquired intangible asset that is not identifiable as at the acquisition date.

5.5.4.A Assembled workforce

A particular example of an intangible asset subsumed into goodwill is an assembled workforce. IFRS 3 regards this as being an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date without having to hire and train a workforce. *[IFRS 3.B37]*.

Although individual employees might have employment contracts with the employer, the collection of employees, as a whole, does not have such a contract. In addition, an assembled workforce is not separable; it cannot be sold, transferred, licensed, rented or otherwise exchanged without causing disruption to the acquirer's business. Therefore, it is not an identifiable intangible asset recognised separately from goodwill. *[IFRS 3.BC178]*.

Nor does the assembled workforce represent the intellectual capital of the skilled workforce, which is the (often specialised) knowledge and experience that employees of an acquiree bring to their jobs. *[IFRS 3.B37]*. Prohibiting an acquirer from recognising an assembled workforce as an intangible asset does not apply to intellectual property and the value of intellectual capital may well be reflected in the fair value of other intangible assets. For example, a process or methodology such as a software program would be documented and generally would be the property of the entity; the employer usually 'owns' the intellectual capital of an employee. The ability of the entity to continue to operate is unlikely to be affected significantly by changing programmers, even replacing the particular programmer who created the program. The intellectual property is part of the fair value of that program and is an identifiable intangible asset if it is separable from the entity. *[IFRS 3.BC180]*.

5.5.4.B Items not qualifying as assets

The acquirer subsumes into goodwill any value attributed to items that do not qualify as assets at the acquisition date.

Potential contracts with new customers

Potential contracts that the acquiree is negotiating with prospective new customers at the acquisition date might be valuable to the acquirer. The acquirer does not recognise them separately from goodwill because those potential contracts are not themselves assets at the acquisition date. Nor does the acquirer subsequently reclassify the value of those contracts from goodwill for events that occur after the acquisition date. The acquirer is required, of course, to assess the facts and circumstances surrounding events occurring shortly after the acquisition to determine whether there was a separately recognisable intangible asset at the acquisition date. *[IFRS 3.B38]*.

Contingent assets

IFRS 3 includes an explicit statement clarifying that contingent assets do not qualify for recognition at the acquisition date. *[IFRS 3.23A]*. IFRS 3 states that an acquired identifiable asset qualifies for recognition as at the acquisition date only if it meets the definition of an asset in the *Conceptual Framework*. *[IFRS 3.11]*. The *Conceptual Framework* specifies criteria for recognising assets and liabilities and says that these criteria might not be met if it is uncertain whether an asset exists. *[CF 5.14]*. In the Basis for Conclusions, the IASB noted that in case of contingent assets it is uncertain whether an asset exists at the acquisition date, and it is expected that some future event will confirm whether the entity has an asset. Therefore, the IASB concluded that an asset must only be recognised if the entity has an unconditional right at the acquisition date. However, an asset would not be recognised, even if it is virtually certain that it will become unconditional or non-contingent after that date. *[IFRS 3.BC276]*. Accounting for contingent assets under IAS 37 is discussed in Chapter 27 at section 3.2.2.

Future contract renewals

In measuring the fair value of an intangible asset, the acquirer considers assumptions that market participants would use when pricing the intangible asset, such as expectations of future contract renewals. It is not necessary for the renewals themselves to meet the identifiability criteria. *[IFRS 3.B40]*. Any value attributable to the expected future renewal of the contract is reflected in the value of, for example, the customer relationship, rather than being subsumed within goodwill.

However, any potential contract renewals that market participants would consider in determining the fair value of reacquired rights would be subsumed within goodwill. Refer to the discussion in section 5.6.5 below.

5.5.5 Assets with uncertain cash flows (valuation allowances)

Under IFRS 3, the acquirer must not recognise a separate provision or valuation allowance for assets that are initially recognised at fair value. Because receivables, including loans, are recognised and measured at fair value at the acquisition date, any uncertainty about collections and future cash flows is included in the fair value measure (see Chapter 45 at section 3.3.4). *[IFRS 3.B41]*. Therefore, although an acquiree may have assets, typically financial assets such as receivables and loans, against which it has recognised a provision or valuation allowance for expected credit losses or uncollectible amounts, an acquirer cannot 'carry over' any such valuation allowances nor create its own allowances in respect of those financial assets.

Subsequent measurement of financial instruments under IFRS 9 is dealt with in Chapter 46. Chapter 47 at section 7.4 deals specifically with the interaction between the initial measurement of debt instruments acquired in a business combination and the impairment model of IFRS 9.

5.5.6 Assets that the acquirer does not intend to use or intends to use in a way that is different from other market participants

An acquirer may intend not to use an acquired asset, for example, a brand name or research and development intangible asset or it may intend to use the asset in a way that is different from the way in which other market participants would use it. IFRS 3 requires the acquirer to recognise all such identifiable assets and measure them at their fair value determined in accordance with their highest and best use by market participants (see Chapter 15 at section 9.1). This requirement is applicable both on initial recognition and when measuring fair value less costs of disposal for subsequent impairment testing. *[IFRS 3.B43]*. This means that no immediate impairment loss is reflected if the acquirer does not intend to use the intangible asset to generate its own cash flows, but market participants would.

However, if the entity is not intending to use the intangible asset to generate cash flows, it is unlikely that it could be regarded as having an indefinite life for the purposes of IAS 38, and therefore is amortised over its expected useful life.

Illustration 5-2: Acquirer's intention not to use an intangible asset

Entity A acquires a competitor, Entity B. One of the identifiable intangible assets of Entity B is the trade name of one of Entity B's branded products. As Entity A has a similar product, it does not intend to use that trade name post-acquisition. Entity A will discontinue sales of Entity B's product, thereby eliminating competition and enhancing the value of its own branded product. The cash flows relating to the acquired trade name are therefore expected to be nil. Can Entity A attribute a fair value of nil to that trade name?

The fair value of the asset is determined in accordance with its use by market participants. Entity A's future intentions about the asset are reflected in determining the fair value, if that is what other market participants would do.

- There are other market participants that would continue to sell the product.
- Entity A could probably have sold the trade name after acquisition but has chosen not to do so.
- Even if all other market participants would, like Entity A, not sell the product in order to enhance the value of their own products, the trade name is still likely to have some value.

Accordingly, a fair value is attributed to that trade name.

As Entity A is not intending to use the trade name to generate cash flows but to use it defensively by preventing others from using it, the trade name is amortised over the period it is expected to contribute directly or indirectly to the entity's future cash flows.

5.5.7 Investments in equity-accounted entities

An acquiree may hold an investment in an associate, accounted for under the equity method (see Chapter 12 at section 5). There are no recognition or measurement differences between an investment that is an associate or a trade investment because the acquirer has not acquired the underlying assets and liabilities of the associate. Accordingly, the fair value of the associate is determined on the basis of the value of the investment, rather than the underlying fair values of the identifiable assets and liabilities of the associate. The impact of having listed prices for investments in associates when measuring fair value is discussed further in Chapter 15 at section 4.1.1. Any goodwill relating to the associate is subsumed within the carrying amount for the associate rather than within the goodwill arising on the overall business combination. Nevertheless, although this fair value is effectively the 'cost' of an investment in an associate to which equity accounting is applied, the underlying fair values of the various identifiable assets and liabilities also need to be determined to apply equity accounting (see Chapter 12 at section 6).

This also applies if an acquiree holds an investment in a joint venture that is accounted for under the equity method according to IFRS 11 (see Chapter 13 at section 7).

5.5.8 Assets and liabilities related to contracts with customers

As part of a business combination, an acquirer may assume liabilities or acquire assets recognised by the acquiree in accordance with IFRS 15, for example, contract assets, receivables or contract liabilities.

Under IFRS 15, if a customer pays consideration, or an entity has a right to an amount of consideration that is unconditional (i.e., a receivable), before the entity transfers a good or service to the customer, the entity presents a contract liability. *[IFRS 15.106]*. An acquirer recognises a contract liability (e.g., deferred revenue) related to a contract with a customer that it has assumed if the acquiree has received consideration (or the amount is due) from the customer. To determine whether to recognise a contract liability, however, an acquirer may also need to consider the definition of a performance obligation in IFRS 15. That is, at the acquisition date, the acquirer would identify the remaining promised goods and services in a contract with a customer and evaluate whether the goods and services it must transfer to a customer in the future are an assumed performance obligation for which the acquired entity has received consideration (or the amount is due). This is important because the consideration received (or the amount due) may relate to a satisfied or partially satisfied performance obligation for which no (or not all) revenue was recognised pre-combination (e.g., due to variable consideration being constrained). Since it was not party to the acquiree's performance pre-combination, an acquirer may need to consider how that affects its financial statements. For example, whether any consideration received that relates to the acquiree's pre-combination performance is presented as revenue or other income.

Chapter 28 at section 4 provides additional guidance on identifying performance obligations in a contract with a customer. If a contract liability for an assumed performance obligation is recognised, the acquirer derecognises the contract liability and recognises revenue as it provides those goods or services after the acquisition date.

In accordance with the requirements in IFRS 3, at the date of acquisition, an assumed contract liability is measured at its fair value, which reflects the acquiree's obligation to transfer some (if advance covers only a portion of consideration for the remaining promised goods and services) or all (if advance covers full consideration for the remaining promised goods and services) of the remaining promised goods and services in a contract with a customer, as at the acquisition date.

The fair value is measured in accordance with the requirements in IFRS 13 and may require significant judgement. One method that might be used in practice to measure fair value of the contract liability is a cost build-up approach. That approach is based on a market participant's estimate of the costs that will be incurred to fulfil the obligation plus a 'normal' profit margin for the level of effort or assumption of risk by the acquirer after the acquisition date. The normal profit margin also is from the perspective of a market participant and will not include any profit related to selling or other efforts completed prior to the acquisition date.

Illustration 5-3: Contract liability of an acquiree

Target is an electronics company that sells contracts to service all types of electronic equipment for an annual fee of CU120,000 paid in advance. Acquirer purchases Target in a business combination. At the acquisition date, Target has one service contract outstanding with 6 months remaining and for which a contract liability of CU60,000 was recorded in Target's pre-acquisition financial statements.

To fulfil the contract over its remaining 6-month term, Acquirer estimates that a market participant would incur costs of CU45,000, and expect a profit margin for that fulfilment effort of 20% (i.e., CU9,000), and thus would expect to receive CU54,000 for the fulfilment of the remaining performance obligation.

Accordingly, Acquirer will recognise a contract liability of CU54,000 in respect of the acquired customer contract.

The acquirer does not recognise a contract liability or a contract asset for the contract with customer that is an executory contract (see Chapter 27 at section 2.2.1.A) at the acquisition date and where no consideration is received from the customer and no amount is due. However, for executory contracts with customers with terms that are favourable or unfavourable relative to the market terms, the acquirer recognises either a liability assumed or an asset acquired in a business combination (see section 5.5.2.A above).

In addition to the contract liability, an acquirer may also assume refund liabilities of the acquiree. Under IFRS 15, an entity recognises a refund liability if the entity receives consideration from a customer and expects to refund some or all of that consideration to the customer, including refund liabilities relating to a sale with a right of return. *[IFRS 15.55]*. A refund liability, therefore, is different from a contract liability and might be recognised even if at the acquisition date no contract liability is recognised. Under IFRS 3, refund liabilities are also measured at their fair value at the acquisition date with fair value determined in accordance with the requirements of IFRS 13. The requirements in IFRS 13 for measuring the fair value of liabilities are discussed in more detail in Chapter 15 at section 10.

If an entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due, the entity presents a contract as a contract asset, excluding amounts presented as receivable. *[IFRS 15.107]*. Contract assets represent entity's rights to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (e.g., the entity's future performance). *[IFRS 15 Appendix A]*. A receivable is an unconditional right to receive consideration from the customer (see also Chapter 28 at section 10.1.1). *[IFRS 15.105]*.

The value of acquired contracts with customers may be recognised in multiple assets and liabilities (e.g., receivables, contract assets, right of return assets, intangible assets, contract liabilities, refund liabilities).

Under IFRS 3 at the date of acquisition, all acquired assets related to the contract with customers are measured at their fair value at that date determined under IFRS 13. The IFRS 13 requirements for measuring the fair value of assets are discussed in more detail in Chapter 15 at section 4.

When measuring the fair value of acquired contracts with customers, an acquirer must verify that all of the components of value have been considered (i.e., an acquirer is required to verify that none of the components of value have been omitted or double counted). An acquirer also must verify that all of the components are appropriately reflected in the fair value measurement. After the date of acquisition, an acquirer applies IFRS 15 to account for any of the acquiree's assets, liabilities, income and expenses that fall within that standard's scope. *[IFRS 3.54]*. Because IFRS 15 does not measure revenue (or any assets or liabilities within its scope) on a fair value basis, so-called 'day 2' measurement differences may arise post-combination. Neither IFRS 3 nor IFRS 15 specify how to account for such differences and, therefore, the acquirer may need to develop an accounting policy in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

5.6 Exceptions to the recognition and/or measurement principles

There are a number of exceptions to the principles in IFRS 3 that all assets acquired and liabilities assumed are recognised and measured at fair value. For the particular items discussed below, this will result in some items being:

- Recognised either by applying additional recognition conditions or by applying the requirements of other IFRS accounting standards, with results that differ from applying the recognition principle and conditions

  And/Or

- Measured at an amount other than their acquisition-date fair values *[IFRS 3.21]*

5.6.1 Liabilities and contingent liabilities that would be in the scope of IAS 37 or IFRIC 21 if they were incurred separately

IFRS 3 includes an exception to the recognition principle that applies to liabilities and contingent liabilities assumed in a business combination that would be within the scope of IAS 37 or IFRIC 21 if they were incurred separately, rather than assumed in a business combination. *[IFRS 3.21A]*.

The *Conceptual Framework* defines a liability as "a present obligation of the entity to transfer an economic resource as a result of past events". *[CF 4.26]*. However, the exception requires an acquirer to apply specific guidance in IAS 37 (instead of the definitions in the *Conceptual Framework*) to determine whether, at the acquisition date, a present obligation exists as a result of past events. For levies that would be within the scope of IFRIC 21, the exception requires an acquirer to apply IFRIC 21 to determine whether the obligating event that gives rise to a liability to pay the levy had occurred by the acquisition date. *[IFRS 3.21B]*.

The board decided to add this exemption to the recognition principle of IFRS 3 to avoid the issue of potential 'day 2' gains or losses arising for liabilities and contingent liabilities that would be within the scope of IAS 37 or IFRIC 21, if incurred separately. Those 'day 2' gains or losses could have been incurred if an acquirer first recognised those liabilities or contingent liabilities at the time of the business combination according to the definition of the *Conceptual Framework* and then measured them according to the principles of IAS 37 or IFRIC 21 and derecognised them immediately afterwards. *[IFRS 3.BC264C, IFRS 3.BC264D]*. The exception refers to IFRIC 21 as well as IAS 37 because, although IFRIC 21 is an interpretation of IAS 37, it also applies to levies whose timing and amount are certain and so are outside the scope of IAS 37. *[IFRS 3.BC264D]*.

Following this guidance in IFRS 3, the acquirer recognises, as at the acquisition date, a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably. That is, contrary to paragraphs 14(b), 23, 27, 29 and 30 of IAS 37, the acquirer recognises a contingent liability assumed in a business combination at the acquisition date even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation (see section 5.2 above)

5.6.1.A Initial recognition and measurement

Under IAS 37, contingent liabilities are not recognised as liabilities; instead, they are disclosed in financial statements. However, under IFRS 3 contrary to the requirements of IAS 37, the acquirer recognises a contingent liability as a liability in the statement of financial position at its fair value if there is a present obligation arising from a past event that can be reliably measured, even if it is not probable that an outflow of resources will be required to settle the obligation. *[IFRS 3.23]*. If a contingent liability only represents a possible obligation arising from a past event, whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity, no liability is recognised under IFRS 3. *[IFRS 3.BC275]*. No liability is recognised if the acquisition-date fair value of a contingent liability cannot be measured reliably.

5.6.1.B Subsequent measurement and accounting

IFRS 3 requires that after initial recognition and until the liability is settled, cancelled or expires, the acquirer measures a contingent liability that is recognised in a business combination at the higher of:

(a) The amount that would be recognised in accordance with IAS 37

And

(b) The amount initially recognised less, if appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15

This requirement does not apply to contracts accounted for in accordance with IFRS 9. *[IFRS 3.56]*

The implications of part (a) of the requirement are clear. If the acquiree has to recognise a provision in respect of the former contingent liability, and the best estimate of this liability is higher than the original fair value attributed by the acquirer, then the greater liability will now be recognised by the acquirer with the difference taken to the income statement. It would now be a provision measured and recognised in accordance with IAS 37. What is less clear is part (b) of the requirement.

How we see it

The reference to "the cumulative amount of income recognised in accordance with the principles of IFRS 15" in IFRS 3.56 might relate to the recognition of income in respect of those contingent liabilities of the acquiree that have been recognised at fair value at date of acquisition. The requirement would appear to mean that, unless the recognition of income in accordance with the principles of IFRS 15 is appropriate, the amount of the liability cannot be reduced below its originally attributed fair value until the liability is settled, cancelled or expires.

Despite the fact that the requirement for subsequent measurement discussed above was originally introduced for consistency with IAS 39 *Financial Instruments: Recognition and Measurement*, which was replaced by IFRS 9, *[IFRS 3.BC245]*, IFRS 3 makes it clear that this requirement does not apply to contracts accounted for in accordance with IFRS 9. *[IFRS 3.56]*. This would appear to mean that contracts that are excluded from the scope of IFRS 9, but are accounted for by applying IAS 37, will fall within the requirements of IFRS 3 outlined above.

5.6.2 Income taxes

In developing IFRIC 23 *Uncertainty over Income Tax Treatments*, the IFRS IC considered whether the Interpretation should address the accounting for tax assets and liabilities acquired or assumed in a business combination when there is uncertainty over income tax treatments. It noted that IFRS 3 applies to all assets acquired and liabilities assumed in a business combination and concluded that on this basis the Interpretation should not explicitly address tax assets and liabilities acquired or assumed in a business combination. *[IFRIC 23.BC23]*.

Nonetheless, IFRS 3 requires an entity to account for deferred tax assets and liabilities that arise as part of a business combination (see also Chapter 29 at section 6.2.1.E and section 6.2.2.E) by applying IAS 12. *[IFRS 3.24]*. Accordingly, the Interpretation applies to such assets and liabilities when there is uncertainty over income tax treatments that affect deferred tax. *[IFRIC 23.BC24]*.

How we see it

Unlike the specific guidance for deferred tax assets and liabilities, IFRS 3 suggests that current tax is measured at fair value, which differs from the subsequent measurement required by IFRIC 23. Entities must consider whether the application of IFRS 3 fair value requirements to current tax assets and liabilities (which may result in possible 'day 2' gains and losses) takes precedence over the requirements of IFRIC 23 for the measurement of current tax assets and liabilities. We believe either approach is acceptable, provided that it is applied consistently (see also Chapter 29 at section 9.1.1).

As mentioned above, IFRS 3 requires the acquirer to recognise and measure, in accordance with IAS 12, a deferred tax asset or liability, arising from the assets acquired and liabilities assumed in a business combination. *[IFRS 3.24]*. The acquirer is also required to account for the potential tax effects of temporary differences and carry-forwards of an acquiree that exist at the acquisition date or arise as a result of the acquisition in accordance with IAS 12. *[IFRS 3.25]*.

IAS 12 requires that:

- Acquired deferred tax benefits recognised within the measurement period (see section 12 below) reduce the goodwill related to that acquisition if they result from new information obtained about facts and circumstances existing at the acquisition date. If the carrying amount of goodwill is zero, any remaining deferred tax benefits are recognised in profit or loss.

  And

- All other acquired tax benefits realised are recognised in profit or loss, unless IAS 12 requires recognition outside profit or loss. *[IAS 12.68]*.

It will therefore be necessary to assess carefully the reasons for changes in the assessment of deferred tax made during the measurement period to determine whether it relates to facts and circumstances at the acquisition date or if it is a change in facts and circumstances since acquisition date. As an anti-abuse clause, if the deferred tax benefits acquired in a business combination are not recognised at the acquisition date but are recognised after the acquisition date with a corresponding gain in profit or loss, IAS 12.81(k) requires a description of the event or change in circumstances that caused the deferred tax benefits to be recognised.

IAS 12 also requires that tax benefits arising from the excess of tax-deductible goodwill over goodwill for financial reporting purposes is accounted for at the acquisition date as a deferred tax asset in the same way as other temporary differences. *[IAS 12.32A]*.

The requirements of IAS 12 relating to the deferred tax consequences of business combinations are discussed further in Chapter 29 at section 12.

5.6.3 Employee benefits

IFRS 3 requires the acquirer to recognise and measure a liability (or asset, if any) related to the acquiree's employee benefit arrangements in accordance with IAS 19 *Employee Benefits* (see Chapter 31), rather than at their acquisition-date fair values. *[IFRS 3.26, IFRS 3.BC296-BC300]*.

5.6.4 Indemnification assets

The seller in a business combination may contractually indemnify the acquirer for the outcome of the contingency or uncertainty related to all or part of a specific asset or liability. These usually relate to uncertainties as to the outcome of pre-acquisition contingencies, e.g., uncertain tax positions, environmental liabilities, or legal matters. The amount of the indemnity may be capped or the seller may guarantee that the acquirer's liability will not exceed a specified amount.

IFRS 3 considers that the acquirer has obtained an indemnification asset. *[IFRS 3.27]*.

From the acquirer's perspective, the indemnification is an acquired asset recognised at its acquisition-date fair value. However, IFRS 3 makes an exception to the general principles in order to avoid recognition or measurement anomalies for indemnifications related to items for which liabilities are either not recognised or are not required to be measured at fair value (e.g., uncertain tax positions related to recognised deferred tax assets and liabilities). *[IFRS 3.BC302, IFRS 3.BC303]*. Accordingly, under IFRS 3 the acquirer measures an indemnification asset on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts, if necessary.

- If the indemnification relates to an asset or a liability that is measured at fair value, the acquirer will recognise the indemnification asset at its fair value. The effects of uncertainty about future cash flows (i.e., the collectability of the asset) are included in the fair value measure and a separate valuation allowance is not necessary (see section 5.5.5 above). *[IFRS 3.27]*.
- The indemnification may relate to an asset or liability that is not measured at fair value. A common example is an indemnification pertaining to a deferred tax liability that is measured in accordance with IAS 12, rather than at its fair value (see section 5.6.2 above). If the indemnified item is recognised as a liability but is measured on a basis other than fair value, the indemnification asset is recognised and measured using consistent assumptions, subject to management's assessment of collectability and any contractual limitations on the indemnified amount. *[IFRS 3.27, IFRS 3.28]*.
- If the indemnified item is not recognised as a liability at the date of acquisition, the indemnification asset is not recognised. An indemnification could relate to a contingent liability that is not recognised at the acquisition date because its fair value is not reliably measurable, *[IFRS 3.28]*, or it is only a possible obligation at that date (see section 5.6.1 above).

Thereafter, the indemnification asset continues to be measured using the same assumptions as the indemnified liability or asset. *[IFRS 3.57]*. Thus, where the change in the value of the related indemnified liability or asset is recognised in profit or loss, this will be offset by any corresponding change in the value recognised for the indemnification asset. The acquirer derecognises the indemnification asset only when it collects the asset, sells it or otherwise loses the right to it. *[IFRS 3.57]*.

5.6.4.A Acquirer's obligation to transfer proceeds from realisation of acquired contingent asset ('Reverse indemnification liabilities')

A business combination sometimes includes an agreement under which the acquirer is required to transfer to the seller all or part of the proceeds the acquirer subsequently receives from the realisation of a contingent asset of the acquiree that existed at acquisition date.

The acquirer is required to analyse whether it is acting as an agent for the seller in relation to that particular contingent asset. If so, the obligation, and the realisation of the contingent asset, must be accounted for separately from the business combination.

However, if the acquirer is not acting as an agent for the seller, the question arises as to how the acquirer is required to account for such an obligation. IFRS 3 does not provide specific guidance in that respect.

IFRS 3 defines a contingent consideration as "an obligation of the **acquirer** to transfer additional assets … to the former owners of an **acquiree** as part of the exchange for control of the acquiree if specified future events occur or conditions are met". *[IFRS 3 Appendix A]*. Future realisation of the contingent asset therefore could be treated as a specified future event giving rise to the contingency. Under this 'contingent consideration liability' approach, at the acquisition date, an acquirer recognises a contingent consideration liability measured at its fair value at that date (see section 7.1 below).

However, since IFRS 3 prohibits the recognition of a contingent asset acquired in a business combination, there seems to be an accounting anomaly when the 'contingent consideration liability' approach is applied, as such application of IFRS 3 would lead to recognition of an obligation that economically does not exist at the acquisition date, because the respective future outflow of economic resources will only occur when the referenced contingent asset is realised, and a corresponding inflow of economic resources occurs. As result, the amount of goodwill would be initially overstated with subsequent recognition of the gain in a post-combination profit or loss, not containing any economic substance, since it was agreed by the seller and the acquirer in advance that all economic benefits or losses associated with the realization of the particular contingent asset would be transferred to the seller. Such 'artificial' gain would be recognised subsequently irrespective of whether or not the related contingent asset is subsequently recognised, or it expires.

The alternative approach that allows elimination of such a recognition and measurement anomaly, assumes that the agreement effectively indemnifies the acquirer from transfer of economic resources if a particular contingent asset acquired in a business combination does not realise subsequently (hereinafter - 'reverse indemnification liability' approach). The 'reverse indemnification liability' approach is based on application by analogy of the indemnification asset guidance in IFRS 3, which was introduced by the IASB to avoid a similar anomaly when it revised IFRS 3 in 2008. In the Basis for Conclusions to IFRS 3, the IASB clarifies that under the indemnification asset guidance, the acquirer does not apply the recognition principle in determining whether or when to recognise an indemnification asset. Instead, the acquirer recognises the asset when it recognises the related liability. *[IFRS 3.BC303]*. Accordingly, under the 'reverse indemnification liability' approach, no liability is recognised until the related asset is recognised, that is, when its realisation is virtually certain.

How we see it

We believe that accounting for such obligation by using the 'reverse indemnification liability' approach would better reflect the substance of the agreement. The application of the 'reverse indemnification liability' approach is illustrated in Illustration 5-4 below.

Illustration 5-4: Reverse indemnification liability

Entity A acquires Entity B from Seller C for a cash consideration. The net assets of Entity B include a contingent asset related to a court case, which, per IFRS 3, is not recognised by the acquirer as part of the net assets acquired. Entity A and Seller C agreed that, in the event the contingent asset is subsequently realised, the related cash received is transferred to Seller C. Assume that Entity A is not identified in this case as an agent that collects and transfers the contingent asset on behalf of Seller C.

Based on the fact that there is a direct link between the obligation of the entity to transfer certain amount of consideration to Seller C and realisation of the particular contingent asset not recognised at the acquisition date, Entity A treats that obligation as 'reverse indemnification liability'. Accordingly, no liability is recognised at the acquisition date. Entity A will recognise the liability in the post-combination periods, only if the related contingent asset is realised.

5.6.5 Reacquired rights

Reacquired rights (see section 5.5.3 above) are valued on the basis of the remaining contractual term of the related contract, regardless of whether market participants would consider potential contractual renewals when measuring their fair value. *[IFRS 3.29]*.

If the terms of the contract giving rise to the reacquired right are favourable or unfavourable relative to current market transactions for the same or similar items, this is accounted for as the settlement of a pre-existing relationship and the acquirer has to recognise a settlement gain or loss. *[IFRS 3.B36]*. Guidance on the measurement of any settlement gain or loss is discussed in section 11.1 below. An example of accounting for the settlement gain or loss on the acquisition of reacquired rights is illustrated in Illustration 11-5 in section 11.1 below.

After acquisition, the intangible asset is amortised over the remaining contractual period of the contract, without including any renewal periods. *[IFRS 3.55, IFRS 3.BC308]*. As the reacquired right is no longer a contract with a third party it might be thought that the acquirer could assume indefinite renewals of its contractual term, effectively making the reacquired right an intangible asset with an indefinite life. However, the IASB considers that a right reacquired from an acquiree has, in substance, a finite life. *[IFRS 3.BC308]*.

If the acquirer subsequently sells a reacquired right to a third party, the carrying amount of the intangible asset is included in determining the gain or loss on the sale. *[IFRS 3.55, IFRS 3.BC310]*.

5.6.6 Assets held for sale

Non-current assets or disposal groups classified as held for sale at the acquisition date in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* are measured at fair value less costs to sell (see Chapter 5 at section 2.2). *[IFRS 3.31]*. This avoids the need to recognise a loss for the selling costs immediately after a business combination (a so-called 'day 2' loss).

5.6.7 Share-based payment transactions

Liabilities or equity instruments related to the acquiree's share-based payments are measured in accordance with IFRS 2 (referred to as the 'market-based measure'), rather than at fair value, as are replacement schemes where the acquirer replaces the acquiree's share-based payments with its own. *[IFRS 3.30, IFRS 13.6]*. The measurement rules of IFRS 2 are not based on the fair value of the award at a particular date; measuring share-based payment awards at their acquisition-date fair values would cause difficulties with the subsequent accounting in accordance with IFRS 2. *[IFRS 3.BC311]*.

Additional guidance given in IFRS 3 for accounting for the replacement of share-based payment awards (i.e., vested or unvested share-based payment transactions) in a business combination is discussed in sections 7.2 and 11.2 below and in Chapter 30 at section 11. Any equity-settled share-based payment transactions of the acquiree that the acquirer does not exchange for its own share-based payment transactions will result in a non-controlling interest in the acquiree being recognised, as discussed in section 8.4 below.

5.6.8 Leases in which the acquiree is the lessee

IFRS 3 requires the acquirer to measure the acquired lease liability as if the lease contract were a new lease at the acquisition date. That is, the acquirer applies IFRS 16's initial measurement provisions to the initial measurement of the lease liability, using the present value of the remaining lease payments at the acquisition date. The acquirer follows the requirements for determining the lease term, lease payments and discount rate as discussed in Chapter 24 at section 4.

IFRS 3 also requires the acquirer to measure the right-of-use asset at an amount equal to the recognised liability, adjusted to reflect the favourable or unfavourable terms of the lease, relative to market terms. Because the off-market nature of the lease is captured in the right-of-use asset, the acquirer does not separately recognise an intangible asset or liability for favourable or unfavourable lease terms relative to market terms.

It might appear unclear as to how this guidance is applied to fully or partially prepaid leases acquired in a business combination. Assume, for example, that at the date of acquisition, the lessee had a fully prepaid lease. From the acquiree's perspective, the lease technically might be at market (i.e., prepayment reflects the market price for a prepaid lease), so theoretically, under IFRS 3 no assets or liabilities related to that lease will be recognised by the acquirer at the acquisition date. Nevertheless, the prepaid right to use obtained by the acquirer has a value. The question is whether such right is presented as a separate intangible asset or as an adjustment to the carrying value of the right-of-use asset.

How we see it

We believe that from the perspective of a market participant, an acquired fully or partially prepaid lease in a business combination is not 'at market' since the acquirer obtains the right to use the underlying asset without assuming an obligation to pay the market price for that right. Therefore, the fair value of such right is considered in determining any off-market adjustment to the right-of-use asset at the acquisition date.

Illustration 5-5: Fully prepaid leases acquired in a business combination

Entity A acquires a 100% interest in Entity B for cash. At the acquisition date, Entity B recognised in its statement of financial position a right-of-use asset equal to the unamortised prepayment for the fully prepaid lease for the remaining five years of the lease term; an amount of CU120.

If Entity B were to enter the new prepaid lease for the remaining five years at the date of acquisition it would have to pay CU110 in advance for the whole period of the lease. The difference between the market price of the new prepaid lease of CU110 and the assumed contractual obligation for future lease payments of nil represents the favourable terms of the lease from the perspective of the acquirer.

Consequently, at the date of acquisition, Entity A recognises a right-of-use asset of CU110 and does not recognise any lease liability.

Under IFRS 3, the acquirer is not required to recognise right-of-use assets and lease liabilities for leases with lease terms which end within 12 months of the acquisition date and leases for low-value assets acquired in a business combination. As indicated in the Basis for Conclusions for IFRS 16, the IASB considered whether to require an acquirer to recognise assets and liabilities relating to off-market terms for short-term leases and leases of low-value assets. However, the IASB observed that the effect of off-market terms would rarely be material for short-term leases and leases of low-value assets and so decided not to require this. *[IFRS 16.BC298]*.

5.6.9 Insurance contracts within the scope of IFRS 17

IFRS 17 introduces a new exception to measurement principles in IFRS 3. Under IFRS 3, as amended by IFRS 17, the acquirer in a business combination measures a group of contracts within the scope of IFRS 17 as a liability or asset in accordance with IFRS 17.39 and IFRS 17.B93 to B95, at the acquisition date.[12] For further discussion see Chapter 51 at section 14.

12 IFRS 17 *Insurance Contracts*, Appendix D Amendments to other IFRS Standards, IFRS 3 *Business Combinations*, May 2017.

6 Recognising and measuring goodwill or a gain from a bargain purchase

Extract from IFRS 3

32 The acquirer shall recognise goodwill as of the acquisition date measured as the excess of (a) over (b) below:

(a) the aggregate of:

(i) the consideration transferred measured in accordance with this IFRS, which generally requires acquisition-date fair value (see paragraph 37);

(ii) the amount of any non-controlling interest in the acquiree measured in accordance with this IFRS; and

(iii) in a business combination achieved in stages (see paragraphs 41 and 42), the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

(b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this IFRS.

33 In a business combination in which the acquirer and the acquiree (or its former owners) exchange only equity interests, the acquisition-date fair value of the acquiree's equity interests may be more reliably measurable than the acquisition-date fair value of the acquirer's equity interests. If so, the acquirer shall determine the amount of goodwill by using the acquisition-date fair value of the acquiree's equity interests instead of the acquisition-date fair value of the equity interests transferred. To determine the amount of goodwill in a business combination in which no consideration is transferred, the acquirer shall use the acquisition-date fair value of the acquirer's interest in the acquiree in place of the acquisition-date fair value of the consideration transferred (paragraph 32(a)(i)). Paragraphs B46-B49 provide related application guidance.

[IFRS 3.32, IFRS 3.33].

The final step in applying the acquisition method is recognising and measuring goodwill or a gain from a bargain purchase.

IFRS 3 defines 'goodwill' in terms of its nature, rather than in terms of its measurement. It is defined as "An asset representing the future economic benefits arising from other assets acquired in a **business combination** that are not individually identified and separately recognised." *[IFRS 3 Appendix A]*.

However, having concluded that the direct measurement of goodwill is not possible, the standard requires that goodwill is measured as a residual. *[IFRS 3.BC328]*.

Goodwill at the acquisition date is computed as the excess of (a) over (b) below:

(a) The aggregate of:
  (i) The consideration transferred (generally measured at acquisition-date fair value)
  (ii) The amount of any non-controlling interest in the acquiree
  And
  (iii) The acquisition-date fair value of the acquirer's previously held equity interest in the acquiree

(b) The net of the acquisition-date fair values (or other amounts recognised in accordance with the requirements of the standard) of the identifiable assets acquired and the liabilities assumed *[IFRS 3.32]*

Having concluded that goodwill is measured as a residual, the IASB, in deliberating IFRS 3, considered the following two components to comprise 'core goodwill':

- The fair value of the going concern element of the acquiree's existing business. This represents the ability of the established business to earn a higher rate of return on an assembled collection of net assets than would be expected if those net assets had to be acquired separately. The value stems from the synergies of the net assets of the business, as well as from other benefits, such as factors related to market imperfections, including the ability to earn monopoly profits and barriers to market entry (by potential competitors, whether through legal restrictions or costs of entry).
- The fair value of the expected synergies and other benefits from combining the acquirer's and acquiree's net assets and businesses. These are unique to each combination, and different combinations would produce different synergies and, hence, different values. *[IFRS 3.BC313, IFRS 3.BC316]*.

However, in practice the amount of goodwill recognised in a business combination will probably not be limited to 'core goodwill'. Items that do not qualify for separate recognition (see section 5.5.4 above) and items that are not measured at fair value, e.g., deferred tax assets and liabilities, will also affect the amount of goodwill recognised (see section 5.6.2 above).

Even though goodwill is measured as a residual, after identifying and measuring all the items in (a) and (b), the acquirer should have an understanding of the factors that make up the goodwill recognised. IFRS 3 requires the disclosure of qualitative description of those factors (see section 16.1.1 below).

Where (b) exceeds (a), IFRS 3 regards this as giving rise to a gain on a bargain purchase. *[IFRS 3.34]*. Bargain purchase transactions are discussed further in section 10 below.

The measurement of (b) has been discussed in section 5 above. The items included within (a) are discussed in sections 7, 8 and 9 below.

6.1 Subsequent accounting for goodwill

The main issue relating to the goodwill acquired in a business combination is how it is subsequently accounted for. The requirements of IFRS 3 in this respect are straightforward; the acquirer measures goodwill acquired in a business combination at the amount recognised at the acquisition date less any accumulated impairment losses. *[IFRS 3.B63]*.

Goodwill is not amortised. Instead, the acquirer tests it for impairment annually, or more frequently if events or changes in circumstances indicate that it might be impaired, in accordance with IAS 36. The requirements of IAS 36 relating specifically to the impairment of goodwill are dealt with in Chapter 21 at section 8, including specific considerations related to testing for impairment of goodwill acquired during the current reporting period, if at the end of that reporting period, the initial accounting for a business combination is incomplete (see Chapter 21 at section 8.1.5).

In March 2024, the IASB issued an Exposure Draft *Business Combinations-Disclosures, Goodwill and Impairment* (proposed amendments to IFRS 3 and IAS 36). As part of the project, the IASB considered reintroducing amortisation of goodwill. On balance, considering extensive evidence collected, the IASB concluded it had no compelling case to justify reintroducing amortisation of goodwill and so decided to retain the impairment only model for the subsequent accounting for goodwill.

7 Consideration transferred

Extract from IFRS 3

37 The consideration transferred in a business combination shall be measured at fair value, which shall be calculated as the sum of the acquisition-date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree and the equity interests issued by the acquirer. (However, any portion of the acquirer's share-based payment awards exchanged for awards held by the acquiree's employees that is included in consideration transferred in the business combination shall be measured in accordance with paragraph 30 rather than at fair value.) Examples of potential forms of consideration include cash, other assets, a business or a subsidiary of the acquirer, *contingent consideration*, ordinary or preference equity instruments, options, warrants and member interests of *mutual entities*.

Contingent consideration

39 The consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement (see paragraph 37). The acquirer shall recognise the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree.

40 The acquirer shall classify an obligation to pay contingent consideration that meets the definition of a financial instrument as a financial liability or as equity on the basis of the definitions of an equity instrument and a financial liability in paragraph 11 of IAS 32 *Financial Instruments: Presentation*. The acquirer shall classify as an asset a right to the return of previously transferred consideration if specified conditions are met. Paragraph 58 provides guidance on the subsequent accounting for contingent consideration.

[IFRS 3.37, IFRS 3.39, IFRS 3.40].

The consideration transferred in a business combination comprises the sum of the acquisition-date fair values of assets transferred by the acquirer, liabilities incurred by the acquirer to the former owners of the acquiree and equity interests issued by the acquirer. The consideration may take many forms, including cash, other assets, a business or subsidiary of the acquirer, and securities of the acquirer (e.g., ordinary shares, preferred shares, options, warrants, and debt instruments). The consideration transferred also includes the fair value of any contingent consideration and may also include some or all of any acquirer's share-based payment awards exchanged for awards held by the acquiree's employees measured in accordance with IFRS 2 rather than at fair value. These are discussed further in sections 7.1 and 7.2 below. *[IFRS 3.37]*.

The consideration transferred could include assets or liabilities whose carrying amounts differ from their fair values. These are remeasured to fair value at the acquisition date and any resulting gains or losses are recognised in profit or loss. If the transferred assets or liabilities remain within the combined entity after the acquisition date because they were transferred to the acquiree rather than to its former owners, the acquirer retains control of them. They are retained at their existing carrying amounts and no gain or loss is recognised. *[IFRS 3.38]*.

When the assets given as consideration or the liabilities incurred by the acquirer are financial assets or financial liabilities as defined by IAS 32 (see Chapter 43), the guidance in IFRS 13 on determining the fair values of such financial instruments is followed (see Chapter 15).

These assets and liabilities might be denominated in a foreign currency, in which case the entity may have hedged the foreign exchange risk. IFRS 9 (or IAS 39, if an entity when it first applied IFRS 9 chose as its accounting policy to continue to apply the hedge requirements in IAS 39 instead of the hedge requirements in IFRS 9) allows an entity to apply hedge accounting when hedging the movements in foreign currency exchange rates for a firm commitment to acquire a business in a business combination. *[IFRS 9.B6.3.1, IAS 39.AG98]*.

Frequently asked questions

Question 7-1: Would gains or losses arising from hedging the movements in foreign currency exchange rates, under IAS 39 (or IFRS 9), for a firm commitment to acquire a business result in an adjustment to the amount that is recognised for goodwill?

In January 2011, the IFRS IC considered the treatment of gains or losses arising from hedging this risk under IAS 39 and in particular whether they would result in an adjustment to the amount that is recognised for goodwill. When a basis adjustment is made to a hedged item, it is done after other applicable IFRS accounting standards have been applied. Accordingly, the IFRS IC noted that "such a basis adjustment is made to goodwill (or the gain from a bargain purchase) after the application of the guidance in IFRS 3".[13] That conclusion applies under IFRS 9 as well.

When equity interests are issued by the acquirer as consideration, the guidance in IFRS 13 on determining the fair value of an entity's own equity is followed (see Chapter 15 at section 10). *[IFRS 13.34]*. IFRS 3 clarifies that they are measured at their fair values at the acquisition date, rather than at an earlier agreement date (or on the basis of the market price of the securities for a short period before or after that date). *[IFRS 3.BC337-BC342]*.

Although a valid conceptual argument could be made for the use of the agreement date, it was observed that the parties to a business combination are likely to take into account expected changes between the agreement date and the acquisition date in the fair value of the acquirer and the market price of the acquirer's securities issued as consideration. While an acquirer and a target entity both consider the fair value of the target on the agreement date in negotiating the amount of consideration to be paid, the distorting effects are mitigated if acquirers and targets generally consider their best estimates of the fair values on the acquisition dates. In addition, measuring the equity securities on the acquisition date avoids the complexities of dealing with situations in which the number of shares or other consideration transferred can change between the agreement date and the acquisition date. *[IFRS 3.BC342]*.

Measuring the fair value of an entity's own equity issued on or close to the agreement date would not result in a consistent measure of the consideration transferred. The fair values of all other forms of consideration transferred are measured at the acquisition date as are the fair values of the assets acquired and liabilities assumed. *[IFRS 3.BC338-BC342]*.

The acquisition-date fair value of the acquiree's equity interests may be more reliably measurable than that of the acquirer's equity interests. In that case, IFRS 3 requires goodwill to be calculated using the fair value of the acquiree's equity interests rather than the fair value of the equity interests transferred. *[IFRS 3.33]*.

IFRS 3 gives additional guidance if no consideration is transferred by the acquirer. This is discussed in section 7.4 below.

7.1 Contingent consideration

Contingent consideration generally arises where the acquirer agrees to transfer additional consideration to the former owners of the acquired business after the acquisition date if certain specified events occur or conditions are met in the future, although it can also result in the return of previously transferred consideration. *[IFRS 3 Appendix A]*.

When entering into a business combination, the parties to the arrangement don't always agree on the exact value of the business, particularly if there are uncertainties as to the success or worth of particular assets or the outcome of uncertain events. They therefore often agree to an interim value for the purposes of completing the deal, with additional future payments to be made by the acquirer. That is, they share the economic risks relating to the uncertainties about the future of the business. These future payments may be in cash or shares or other assets and may be contingent upon the achievement of specified events, and/or may be linked to future financial performance over a specified period of time. Examples of such additional payments contingent on future events include:

- Earnings above an agreed target over an agreed period
- Components of earnings (e.g., revenue) above an agreed target over an agreed period
- Approval of a patent/licence
- Successful completion of specified contract negotiations
- Cash flows arising from specified assets over an agreed period
- Remaining an employee of the entity for an agreed period of time

An arrangement can have a combination of any of the above factors.

13 *IFRIC Update*, January 2011, available on the IFRS Foundation's website.

How we see it

A business combination may include an agreement under which the acquirer is required to transfer to the seller all or part of the proceeds the acquirer eventually receives from the realisation of a contingent asset that existed at acquisition date. We believe that accounting for such an obligation as part of the contingent consideration does not necessarily reflect the substance of the agreement; rather it would be better depicted by applying 'reverse indemnification liability' accounting. (See section 5.6.4.A above).

While additional payments contingent on future events may be negotiated as part of gaining control of another entity, the accounting may not necessarily always reflect this, particularly if these payments are made to those who remain as employees of the business after it is acquired. In the latter case, depending on the exact terms of the arrangement, the payment made may be accounted for as remuneration for services provided subsequent to the acquisition, rather than as part of the consideration paid for the business. These payments are also often referred to as 'earn-outs'. The guidance in IFRS 3 for determining whether the arrangements involving employees are accounted for as contingent consideration or remuneration is discussed further in section 11.2 below.

The IASB clarified in June 2009 that pre-existing contingent consideration from a prior business combination of an acquiree does not meet the definition of contingent consideration in the acquirer's business combination. It is one of the identifiable liabilities assumed in the subsequent acquisition.[14]

Usually, it makes no difference whether the pre-existing contingent consideration is treated as contingent consideration or as an identifiable liability, as they are both financial liabilities to be accounted for under IFRS 9. As discussed further below, they are initially recognised and measured at fair value at the date of acquisition, with any subsequent remeasurements recognised in profit or loss in accordance with IFRS 9.

7.1.1 Initial recognition and measurement

Contingent consideration is recognised at its fair value as part of the consideration transferred in exchange for the acquiree. *[IFRS 3.39]*.

IFRS 13 has specific requirements with respect to measuring fair value for liabilities. An entity has to determine the price it would need to pay to transfer the liability to a market participant at the measurement date. An entity must assume that the market participant would fulfil the obligation (i.e., it would not be settled or extinguished). *[IFRS 13.34(a)]*. The specific requirements are discussed in detail in Chapter 15 at section 10. In light of these requirements, it is likely that the fair value of contingent consideration will need to be measured "from the perspective of a market participant that holds the identical item as an asset at the measurement date". *[IFRS 13.37]*. That is, the entity measures the fair value of the liability by reference to the fair value of the corresponding asset held by the counterparty.

The initial measurement of the fair value of contingent consideration is based on an assessment of the facts and circumstances that exist at the acquisition date. Although the fair value of some contingent payments may be difficult to measure, it is argued that "to delay recognition of, or otherwise ignore, assets or liabilities that are difficult to measure would cause financial reporting to be incomplete and thus diminish its usefulness in making economic decisions". *[IFRS 3.BC347]*. Information used in negotiations between buyer and seller will often be helpful in estimating the fair value of the contingent consideration. *[IFRS 3.BC348]*.

An estimate of zero for the fair value of contingent consideration would not be reliable. *[IFRS 3.BC349]*. Equally, it would be inappropriate to assume an estimate of 100% for the acquisition-date fair value of the obligation to make the payments under the contingent consideration arrangement.

The fair value of contingent consideration will be measured in accordance with IFRS 13 which does not limit the valuation techniques an entity can use.

14 IASB Staff Paper 13C, Project: *Annual Improvements Process*, Topic: *Contingent consideration of an Acquiree ("pre-existing contingent consideration")*, IASB Meeting, June 2009, page 3. Available on the IFRS Foundation's website.

In most instances, contingent consideration will be valued using an income approach, typically using either a probability-weighted discounted cash flow method (otherwise referred to as a scenario-based method or SBM) or an option pricing method (OPM) to capture the uncertainty in the future payments. These methodologies are discussed in detail in the Appraisal Foundation's *Valuations in Financial Reporting Valuation Advisory 4: Valuation of Contingent Consideration* (Contingent Consideration Advisory)[15] that was issued in February 2019. The Contingent Consideration Advisory provides best practices on the methodology to use based on the nature of the contingent pay-out and the application of each methodology. Although the Contingent Consideration Advisory is not authoritative GAAP, there is little other specific guidance on how to determine the fair value of contingent consideration. We understand that the valuation techniques described in the Contingent Consideration Advisory are generally recognised by the valuation community as acceptable methods for measuring the fair value of contingent consideration.

The application of the probability-weighted discounted cash flow method is shown in the following Illustration.

Illustration 7-1: Contingent consideration - applying the probability-weighted discounted cash flow method to determine fair value

Entity G acquires Entity H and as part of the arrangement, Entity G agrees to pay an additional amount of consideration to the seller in the future, as follows:

- If the 12-months' earnings in two years' time (also referred to as the trailing 12 months) are CU1 million or less - nothing will be paid.
- If the trailing 12 months' earnings in two years' time are between CU1 million and CU2 million - 2 × 12-months' earnings will be paid.
- If the trailing 12 months' earnings in two years' time are greater than CU2 million - 3 × 12-months' earnings will be paid.

At the date of acquisition, the possible twelve-month earnings of Entity H in two years' time are determined to be, as follows:

- CU0.8 million - 40%
- CU1.5 million - 40%
- CU2.5 million - 20%

The probability-weighted pay-out is:

(40% ×CU0) + (40% × CU1.5 million × 2) + (20% × CU2.5 million × 3) = CU2.7 million

This CU2.7 million is then discounted at the date of acquisition to determine its fair value.

Since the liability must be measured at fair value, selecting the discount rate to be applied also requires significant judgement to assess the underlying risks associated with the outcomes and the risks of payment. The entity's own credit risk will need to be taken into account when measuring fair value, which could include adjusting the discount rate. In addition, IFRS 13 indicates that in those situations where the identical item is held by another party as an asset, the fair value of the liability is determined from the perspective of a market participant that holds this asset. This guidance applies even if the corresponding asset is not traded or recognised for financial reporting purposes. As such, when determining the fair value of a contingent consideration liability, entities consider market participants' assumptions related to the item when held as an asset. The IASB and the FASB indicated that "in an efficient market, the price of a liability held by another party as an asset must equal the price for the corresponding asset. If those prices differed, the market participant transferee (i.e., the party taking on the obligation) would be able to earn a profit by financing the purchase of the asset with the proceeds received by taking on the liability. In such cases, the price for the liability and the price for the asset would adjust until the arbitrage opportunity was eliminated." *[IFRS 13.BC89]*.

IFRS 3 also recognises that, in some situations, the agreement may give the acquirer the right to the return of previously transferred consideration if specified future events occur or conditions are met. Such a right falls within the definition of 'contingent consideration' and is accounted for as such by recognising an asset at its acquisition-date fair value. *[IFRS 3.39, IFRS 3.40, IFRS 3 Appendix A]*.

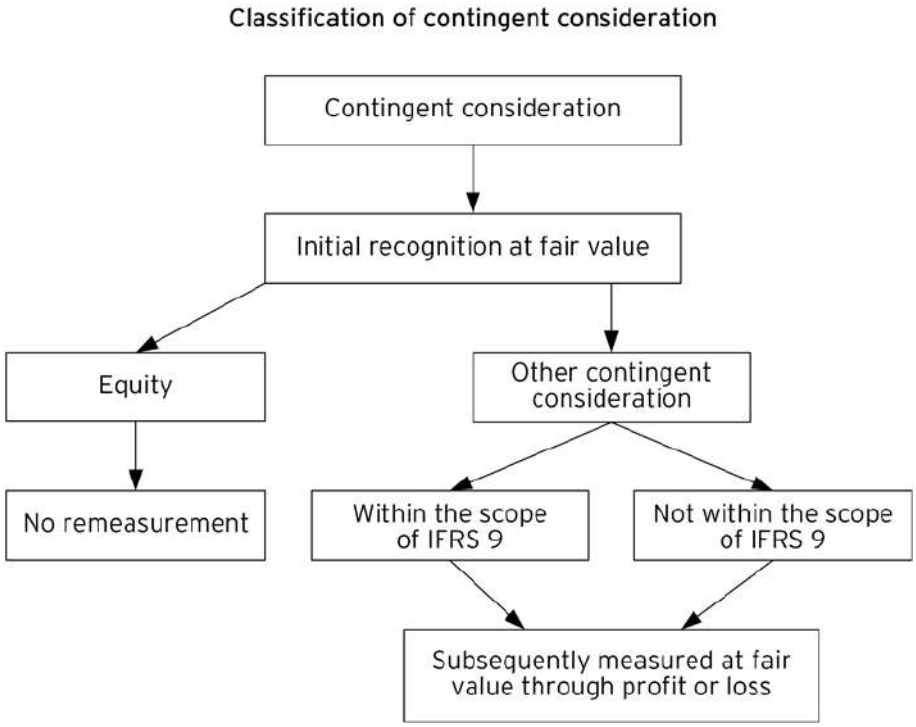
15 *Valuations in Financial Reporting Valuation Advisory 4: Valuation of Contingent Consideration*, The Appraisal Foundation, February 2019, available on The Appraisal Foundation's website, www.appraisalfoundation.org (accessed 30 September 2023).

7.1.2 Classification of a contingent consideration obligation

Most contingent consideration obligations are financial instruments, and many are derivative instruments. Some arrangements oblige the acquirer to deliver equity securities if specified future events occur, rather than, say, making additional cash payments.

The classification of a contingent consideration obligation that meets the definition of a financial instrument as either a financial liability or equity is based on the definitions in IAS 32 (see Chapter 43). *[IFRS 3.40]*.

These requirements, and the impact of subsequent measurement and accounting (which is discussed further in section 7.1.3 below), are summarised in the diagram below.



Contingent consideration will often meet the definition of a financial liability. This includes those arrangements where the acquirer is obliged to deliver equity securities because IAS 32 defines a financial liability to include "a contract that will or may be settled in the entity's own equity instruments" and is:

- "A non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments"

  Or

- "A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments" *[IAS 32.11]*

Most contingent consideration arrangements that are settled by delivering equity shares will involve a variable number of shares, e.g., an arrangement obliges the acquirer to issue between zero and 1 million additional equity shares on a sliding scale based on the acquiree's post-combination earnings. This arrangement will be classified as a financial liability. Only in situations where the arrangement involves issuing, say, zero or 1 million shares depending on a specified event or target being achieved would the arrangement be classified as equity.

How we see it

When the arrangement involves a number of different discrete targets that are independent of one another, which if met will result in additional equity shares being issued as further consideration, we believe that the classification of the obligation to provide such financial instruments in respect of each target is assessed separately in determining whether equity classification is appropriate.

However, if the targets are interdependent, the classification of the obligation to provide such additional equity shares is based on the overall arrangement, and as a variable number of shares is likely to be delivered, the arrangement would be classified as a financial liability.

Illustration 7-2: Share-settled contingent consideration - financial liability or equity?

Entity P acquires a 100% interest in Entity S on 1 January 20X1. As part of the consideration arrangements, additional consideration will be payable based on Entity S meeting certain profit targets over the 3 years ended 31 December 20X3, as follows:

Profit target	Additional consideration
Year ended 31 December 20X1 - CU1m+	100,000 shares
Year ended 31 December 20X2 - CU1.25m+	150,000 shares
Year ended 31 December 20X3 - CU1.5m+	200,000 shares

Each target is non-cumulative. If the target for a particular year is met, the additional consideration will be payable, irrespective of whether the targets for the other years are met or not. If a target for a particular year is not met, no shares will be issued in respect of that year.

In this scenario, as each of the targets are independent of one another, this arrangement can be regarded as being three distinct contingent consideration arrangements that are assessed separately. As either zero or the requisite number of shares will be issued if each target is met, the obligation in respect of each arrangement is classified as equity.

If the targets were dependent on each other, for example, if they were based on an average for the 3-year period, a specified percentage increase on the previous year's profits, or the later targets were forfeited if the earlier targets were not met, the classification would be assessed on the overall arrangement. As this would mean that a variable number of shares may be delivered, the obligation under such an arrangement would be classified as a financial liability.

For those contingent consideration arrangements where the agreement gives the acquirer the right to the return of previously transferred consideration if specified future events occur or conditions are met, IFRS 3 requires that such a right is classified as an asset. *[IFRS 3.40]*.

7.1.3 Subsequent measurement and accounting

The IASB has concluded that subsequent changes in the fair value of a contingent consideration obligation generally do not affect the fair value of the consideration transferred for the acquiree. Subsequent changes in value relate to post-combination events and changes in circumstances of the combined entity and do not affect the measurement of the consideration transferred or goodwill. *[IFRS 3.BC357]*.

Accordingly, IFRS 3 requires that changes in the fair value of contingent consideration resulting from events after the acquisition date such as meeting an earnings target, reaching a specified share price, or meeting a milestone on a research and development project are accounted for as follows:

- Contingent consideration classified as equity is not subsequently remeasured (consistent with the accounting for equity instruments generally), and its subsequent settlement is accounted for within equity.
- Other contingent consideration that either is within the scope of IFRS 9 or within the scope of other standards (e.g., a consideration payable that is a non-financial liability) is remeasured at fair value at each reporting date and changes in fair value are recognised in profit or loss. *[IFRS 3.58]*.

The IASB also decided that any gain or loss resulting from changes in the fair value of a contingent consideration arrangement classified as a liability, that are recognised in profit or loss will include changes in own credit risk. *[IFRS 3.BC360I]*.

If the changes are the result of additional information about the facts and circumstances that existed at the acquisition date, they are measurement period adjustments and are accounted for as discussed in section 12 below. *[IFRS 3.58]*.

Classification of fair value remeasurements of a contingent consideration liability under the requirements of IFRS 18 *Presentation and Disclosure in Financial Statements* is discussed in Chapter 4 at section 3.2.2.B.

7.2 Replacement share-based payment awards

Acquirers often exchange share-based payment awards (i.e., replacement awards) for awards held by employees of the acquiree. These exchanges frequently occur because the acquirer wants to avoid the effect of having non-controlling interests in the acquiree, the acquirer's shares are often more liquid than the shares of the acquired business after the acquisition, and/or to motivate former employees of the acquiree toward the overall performance of the combined, post-acquisition business.

If the acquirer replaces any acquiree awards, the consideration transferred will include some or all of any replacement share-based payment awards. However, arrangements that remunerate employees or former owners for future services are excluded from consideration transferred (see section 11.2 below).

Replacement awards are modifications of share-based payment awards in accordance with IFRS 2. *[IFRS 3.B56-B62]*. Discussion of this guidance, including illustrative examples is dealt with in Chapter 30 at section 11.2.

The acquirer is required to include some or all replacement awards (i.e., vested or unvested share-based payment transactions) as part of the consideration transferred, irrespective of whether it is obliged to replace acquiree's awards or does so voluntarily. There is only one situation in which none of the market-based measure of the awards is included in the consideration transferred: if acquiree awards would expire as a consequence of the business combination and the acquirer replaces those when it was not obliged to do so. In that case, all of the market-based measure of the awards is recognised as remuneration cost in the post-combination financial statements. *[IFRS 3.B56]*.

Any equity-settled share-based payment transactions of the acquiree that the acquirer does not exchange for its own share-based payment transactions will result in non-controlling interest in the acquiree being recognised and measured at their market-based measure as discussed in section 8.4 below. *[IFRS 3.B62A, IFRS 3.B62B]*.

7.3 Acquisition-related costs

IFRS 3 requires acquisition-related costs to be accounted for as expenses in the periods in which the costs are incurred and the related services are received with the exception of the costs of registering and issuing debt and equity securities that are recognised in accordance with IAS 32 and IFRS 9, i.e., as a reduction of the proceeds of the debt or equity securities issued. *[IFRS 3.53]*. In addition, IFRS 3 requires that a transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs is not included in applying the acquisition method (see section 11.3 below). This is in order to mitigate concerns about potential abuse, e.g., a buyer might ask a seller to make payments to third parties on its behalf, but the consideration paid for the business is sufficient to reimburse the seller for making such payments. *[IFRS 3.51, IFRS 3.52, IFRS 3.53, IFRS 3.BC370]*.

An acquirer's costs incurred in connection with a business combination include:

- Direct costs of the transaction, such as costs for the services of lawyers, investment bankers, accountants, and other third parties and issuance costs of debt or equity instruments used to effect the business combination
- Indirect costs of the transaction, such as recurring internal costs, e.g., the cost of maintaining an acquisition department

Acquisition-related costs, whether for services performed by external parties or internal staff of the acquirer, are not part of the fair value exchange between the buyer and seller for the acquired business. Accordingly, they are not part of the consideration transferred for the acquiree. Rather, they are separate transactions in which the buyer makes payments in exchange for the services received, to be accounted for separately. It might be necessary to recognise expenses and a liability for such costs before the deal is closed, if recognition criteria for a liability is met at the earlier date, even if fees are payable only upon successful completion of the business combination.

7.4 Business combinations achieved without the transfer of consideration

An acquirer sometimes obtains control of an acquiree without transferring consideration. The standard emphasises that the acquisition method applies to a business combination achieved without the transfer of consideration. *[IFRS 3.43]*. IFRS 3 indicates that such circumstances include:

(a) The acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control.

(b) Minority veto rights lapse that previously kept the acquirer from controlling an acquiree in which the acquirer held the majority voting rights.

(c) The acquirer and the acquiree agree to combine their businesses by contract alone. In that case, the acquirer transfers no consideration in exchange for control of an acquiree and holds no equity interests in the acquiree, either on the acquisition date or previously. Examples of business combinations achieved by contract alone include bringing two businesses together in a stapling arrangement or forming a dual listed corporation. *[IFRS 3.43]*.

In computing the amount of goodwill in a business combination, IFRS 3 normally requires the acquirer to aggregate:

- The consideration transferred
- The amount of any non-controlling interest in the acquiree

  And
- The acquisition-date fair value of the acquirer's previously held equity interest in the acquiree *[IFRS 3.32]*

However, when the consideration transferred is nil, IFRS 3 requires the entity to use the acquisition-date fair value of the acquirer's interest in the acquiree instead. *[IFRS 3.33, IFRS 3.B46]*.

How we see it

In the first two circumstances described in (a) and (b) above, the acquirer has a previously held equity interest in the acquiree. To also include the acquisition-date fair value of the previously-held interest would result in double-counting of the value of the acquirer's interest in the acquiree. The acquisition-date fair value of the acquirer's interest in the acquiree must only be included once in the computation of goodwill. These two circumstances would also be examples of business combinations achieved in stages (see section 9 below).

The fair value of the acquirer's interest in the acquiree is measured in accordance with IFRS 13.

7.4.1 Business combinations by contract alone

In a business combination achieved by contract alone ((c) above), IFRS 3 requires that the acquirer attributes to the owners of the acquiree the amount of the acquiree's net assets recognised under the standard (see section 2.1 above). In other words, the equity interests in the acquiree held by parties other than the acquirer are a non-controlling interest in the acquirer's consolidated financial statements, even if it results in all of the equity interests in the acquiree being attributed to the non-controlling interest. *[IFRS 3.44]*.

This might suggest that no goodwill is recognised in a business combination achieved by contract alone as the second item in part (a) will be equal to part (b) of the goodwill computation set out in section 6 above.

How we see it

We believe that the requirement to attribute the equity interests in the acquiree to the non-controlling interest discussed above is emphasising the presentation within equity in the consolidated financial statements. Thus, when the option of measuring non-controlling interests in an acquiree at its acquisition-date fair value is chosen, goodwill is recognised. If the option of measuring the non-controlling interest at its proportionate share of the value of net identifiable assets acquired is chosen, no goodwill is recognised (except to the extent any is recognised as a result of there being other equity instruments that are required to be measured at their acquisition-date fair value or other measurement basis required by IFRS accounting standards).

The options available for the measurement of the non-controlling interests at the date of acquisition are discussed in section 8 below.

7.5 Combinations involving mutual entities

Combinations involving mutual entities are within the scope of IFRS 3. A mutual entity is defined by IFRS 3 as "An entity, other than an investor-owned entity, that provides dividends, lower costs or other economic benefits directly to its **owners**, members or participants. For example, a mutual insurance company, a credit union and a co-operative entity are all mutual entities." *[IFRS 3 Appendix A]*.

The standard notes that the fair value of the equity or member interests in the acquiree (or the fair value of the acquiree) may be more reliably measurable than the fair value of the member interests transferred by the acquirer. In that situation, the acquirer determines the amount of goodwill by using the acquisition-date fair value of the acquiree's equity interests as the equivalent to the consideration transferred in the goodwill computation set out in section 7.4 above, instead of the acquirer's equity interests transferred as consideration. *[IFRS 3.B47]*.

IFRS 3 clarifies that the acquirer in a combination of mutual entities recognises the acquiree's net assets as a direct addition to capital or equity, not as an addition to retained earnings, which is consistent with the way other types of entity apply the acquisition method. *[IFRS 3.B47]*.

IFRS 3 recognises that mutual entities, although similar in many ways to other businesses, have distinct characteristics that arise primarily because their members are both customers and owners. Members of mutual entities generally expect to receive benefits for their membership, often in the form of reduced fees charged for goods and services or patronage dividends. Patronage dividends are distributions paid to members (or investors) in mutual entities and the portion allocated to each member is often based on the amount of business the member did with the mutual entity during the year. *[IFRS 3.B48]*. The fair value of a mutual entity includes the assumptions that market participants would make about future member benefits. If, for example, a present value technique is used to measure the fair value of the mutual entity, the cash flow inputs will be based on the expected cash flows of the mutual entity, which are likely to reflect reductions for member benefits, such as reduced fees charged for goods and services. *[IFRS 3.B49]*.

8 Recognising and measuring non-controlling interests

Extract from IFRS 3

19 For each business combination, the acquirer shall measure at the acquisition date components of non-controlling interests in the acquiree that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation at either:

(a) fair value; or

(b) the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets.

All other components of non-controlling interests shall be measured at their acquisition-date fair values, unless another measurement basis is required by IFRSs.

IFRS 3 requires any non-controlling interest in an acquiree to be recognised, *[IFRS 3.10]*, but provides a choice of two measurement methods. This choice only applies to those components of non-controlling interests that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of a liquidation ('qualifying non-controlling interests').

These measurement methods are:

- Option 1, to measure such components of non-controlling interests at acquisition-date fair value (consistent with the measurement principle for other components of the business combination)
- Option 2, to measure such components of non-controlling interests at their proportionate share of the value of net identifiable assets acquired (described in section 5.1 above)

This choice is not available for all other components of non-controlling interests. These are measured at their fair values, unless another measurement basis is required by IFRS accounting standards. *[IFRS 3.19]*.

IFRS 3 defines non-controlling interest as "The equity in a subsidiary not attributable, directly or indirectly, to a parent". *[IFRS 3 Appendix A]*. This is the same as that in IFRS 10. As discussed in Chapter 8 at section 5.1, this definition includes not only equity shares in the subsidiary held by other parties, but also other elements of 'equity' in the subsidiary. These could relate to, say, other equity instruments such as options or warrants, the equity element of convertible debt instruments, and the 'equity' related to share-based payment awards held by parties other than the parent.

The application to particular instruments is set out in the table below.

Instruments issued by the acquiree	Measurement required by IFRS 3
Ordinary shares	Proportionate share of net assets OR fair value
Preference shares entitled to a *pro rata* share of net assets upon liquidation	Proportionate share of net assets OR fair value
Preference shares *not* entitled to a *pro rata* share of net assets upon liquidation	Fair value
Equity component of convertible debt and other compound financial instruments◊	Fair value
Share warrants◊	Fair value
Options over own shares◊	Fair value
Options under share-based payment transactions◊	IFRS 2 'market-based measure'

◊ In practice, because these instruments are generally not entitled to a share of net assets as at the acquisition date, their proportionate share of net assets is nil.

An illustration of the consequences of applying these requirements is given in section 8.4 below.

The choice of method is made for each business combination on a transaction-by-transaction basis, rather than being a policy choice. Each option, combined with the accounting in IFRS 10 for changes in ownership interest of a subsidiary (see Chapter 8 at section 4), could have a significant effect on the amount recognised for goodwill.

8.1 Measuring qualifying non-controlling interests at acquisition-date fair value

An acquirer will sometimes be able to measure the fair value of a non-controlling interest on the basis of a quoted price in an active market for the equity shares it does not hold. If a quoted price in an active market is unavailable, the acquirer will need to measure the fair value of the non-controlling interest by using other valuation techniques. *[IFRS 3.B44]*.

The fair value of the acquirer's interest in the acquiree and the non-controlling interest on a per-share basis might differ. This generally would happen because the consideration transferred by the acquirer includes a control premium, or conversely, a discount for lack of control (also referred to as a non-controlling interest discount) is included in the per-share value of the non-controlling interest, if market participants would take into account such a premium or discount when pricing the non-controlling interest. *[IFRS 3.B45]*. In this case, it would not seem appropriate to extrapolate the fair value of an acquirer's interest (i.e., the amount that the acquirer paid per share) to determine the fair value of the non-controlling interests. If the acquiree's shares are quoted on an active market, IFRS 13 requires the fair value of the non-controlling interest to be determined using the quoted price of the shares at the acquisition date ('PxQ'). *[IFRS 13.80]*.

8.2 Measuring qualifying non-controlling interests at the proportionate share in the recognised amount of the acquiree's identifiable net assets

Under this option, the non-controlling interest is measured at the proportionate share of the value of the identifiable assets acquired and liabilities assumed of the acquiree (see section 5.1 above). The result is that the amount recognised for goodwill is only the acquirer's share. However, if any part of the outstanding non-controlling interest is subsequently acquired, no additional goodwill is recorded as under IFRS 10 this is an equity transaction (see Chapter 8 at section 4.2).

8.3 Implications of method chosen for measuring non-controlling interests

The following Illustration shows the impact of the two measurement options on measuring those components of qualifying non-controlling interests.

Illustration 8-1: Initial measurement of non-controlling interests in a business combination (1)

Entity B has 40% of its shares publicly traded on an exchange. Entity A purchases the 60% non-publicly traded shares in one transaction, paying CU630. Based on the trading price of the shares of Entity B at the date of gaining control, a value of CU400 is assigned to the 40% non-controlling interest, indicating that Entity A has paid a control premium of CU30. The fair value of Entity B's identifiable net assets is CU700. For the purposes of this Illustration, Entity B has no other instruments that would be regarded as non-controlling interests.

Option 1 - Non-controlling interest at fair value

Entity A accounts for the acquisition as follows:

Dr	Fair value of identifiable net assets acquired		CU700	
Dr	Goodwill		CU330	
	Cr	Cash		CU630
	Cr	Non-controlling interest in Entity B		CU400

Option 2 - Certain non-controlling interests are measured at proportionate share of identifiable net assets

Entity A accounts for the acquisition as follows:

Dr	Fair value of identifiable net assets acquired		CU700	
Dr	Goodwill		CU210	
	Cr	Cash		CU630
	Cr	Non-controlling interest in Entity B (CU700 × 40%)		CU280

The IASB noted that there are likely to be three main differences arising from measuring the non-controlling interest at its proportionate share of the acquiree's net identifiable assets, rather than at fair value. First, the amounts recognised in a business combination for the non-controlling interest and goodwill are likely to be lower (as illustrated in the above example).

Second, if a cash generating unit to which the goodwill has been allocated is subsequently impaired, any resulting impairment of goodwill recognised through income is likely to be lower than it would have been if the non-controlling interest had been measured at fair value. *[IFRS 3.BC217]*. Chapter 21 at section 9 discusses testing goodwill for impairment in entities with non-controlling interests. This guidance includes considerations when an entity applies an allocation methodology that recognises the disproportionate sharing of the controlling and non-controlling interests in the goodwill book value, i.e., taking into account the acquirer's control premium, if any.

The third difference arises if the acquirer subsequently purchases some or all of the shares held by the non-controlling shareholders. Under IFRS 10, such a transaction is accounted for as an equity transaction (see Chapter 8 at section 4). By acquiring the non-controlling interest, usually at fair value (unless there are some special circumstances surrounding the acquisition), the equity of the group is reduced by the non-controlling interest's share of any unrecognised changes in fair value of the net assets of the business, including goodwill. Measuring the non-controlling interest initially as a proportionate share of the acquiree's net identifiable assets, rather than at fair value, means that the reduction in the reported equity attributable to the acquirer is likely to be larger. *[IFRS 3.BC218]*. If in Illustration 8-1 above, Entity A were subsequently to acquire all of the non-controlling interest for, say, CU500, then assuming that there had been no changes in the carrying amounts for the net identifiable assets and the goodwill, the equity attributable to the parent, Entity A, would be reduced by CU220 (CU500 - CU280) if Option 2 (proportionate share of fair value of identifiable net assets) had been adopted. If Option 1 (full fair value) had been adopted, the reduction would only be CU100 (CU500 - CU400).

In Illustration 8-1 above, the acquiree had no other instruments that would be regarded as non-controlling interests. This will not always be the case. Non-controlling interests may include components of non-controlling interests that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of a liquidation ('qualifying non-controlling interests') that might be measured at the date of acquisition either at their proportionate share of the value of net identifiable assets acquired or at their acquisition-date fair values and other components that must be measured at their acquisition-date fair value. IFRS 3 does not explicitly state how to measure 'qualifying non-controlling interests' in such cases.

How we see it

We believe that two alternative approaches to the determination of the 'qualifying non-controlling interests' when other non-controlling interests exist, are acceptable:

- The computation of the 'qualifying non-controlling interests' is based solely on the fair value of the identifiable net assets, i.e., no deduction is made in respect of the other component of non-controlling interest.

  Or

- In the computation of the 'qualifying non-controlling interests' the other components of non-controlling interests are deducted from the value of the identifiable net assets based on their acquisition-date fair value (or market-based measure) or based on their liquidation rights.

The impact of the measurement of such non-controlling interests on goodwill is discussed in Illustration 8-2 below.

Illustration 8-2: Initial measurement of non-controlling interests in a business combination (2)

Parent acquires 80% of the ordinary shares of Target, a private entity, for CU950 in cash. The total fair value of the equity instruments issued by Target is CU1,165 and the fair value of its identifiable net assets is CU850. The fair value of the 20% of the ordinary shares owned by non-controlling shareholders is CU190. In addition, the subsidiary has also written gross settled call options over its own shares with a fair value of CU25, which are considered equity instruments under IAS 32.

Option 1 - Non-controlling interest at fair value

The impact of the business combination, and the measurement of non-controlling interests, is as follows:

Dr	Fair value of identifiable net assets acquired		CU850	
Dr	Goodwill ((CU950 + CU215) - CU850)		CU315	
	Cr	Cash		CU950
	Cr	Non-controlling interest in Target (CU190 + CU25)		CU215

Under this method, goodwill represents the difference between the fair value of Target and the fair value of its identifiable net assets. The non-controlling interests are measured as the fair value of all equity instruments issued by Target that are not owned by Parent (i.e., ordinary shares and gross settled call options).

Option 2 - Certain non-controlling interests are measured at proportionate share of identifiable net assets

The impact of the business combination, and the measurement of non-controlling interests, is as follows:

Dr	Fair value of identifiable net assets acquired		CU850	
Dr	Goodwill ((CU950 + CU195) - CU850)		CU295	
	Cr	Cash		CU950
	Cr	Non-controlling interest in Target (20% × CU850 + CU25)		CU195

Under this method, goodwill represents the difference between the total of the consideration transferred and the amount of the non-controlling interests, less the fair value of the identifiable assets acquired and liabilities assumed. The non-controlling interests that are present ownership interests and entitle their holders to a proportionate share of the Target's net assets in the event of liquidation (i.e., the ordinary shares) are measured at the non-controlling interest's proportionate share of the identifiable net assets of Target. The non-controlling interests that are not present ownership interests or do not entitle their holders to a proportionate share of the Target's net assets in the event of liquidation (i.e., the gross settled call options) are measured at their fair value.

Reconciliation of goodwill

Goodwill as determined under the two methods can be reconciled as follows:

	CU
Option 2: Goodwill (CU950 - 80% × CU850 + CU25)	295
Goodwill related to the non-controlling interest in ordinary shares (CU190 - 20% × CU850)	20
Option 1: Goodwill ((CU950 + CU215) - CU850)	315

This makes clear that Option 2 effectively ignores the goodwill related to ordinary shares that are held by non-controlling shareholders.

In Illustration 8-2 above, under Option 2, the computation of the non-controlling interests represented by the ordinary shares was based solely on the fair value of the identifiable net assets, i.e., no deduction was made in respect of the other component of non-controlling interest. As noted above an alternative view would be that other components of non-controlling interests are deducted from the value of the identifiable net assets based on their acquisition-date fair value (or market-based measure) or based on their liquidation rights (see Chapter 8 at section 5.2.1). This alternative view is illustrated in Illustration 5-2 of Chapter 8 at section 5.2.1.

8.4 Measuring share-based payment and other components of non-controlling interests

The above options for measuring the initial carrying values of non-controlling interests only apply to present ownership interests that entitle their holders to a proportionate share of the entity's net assets in the event of a liquidation. All other components of non-controlling interests must be measured at their fair values, unless another measurement basis is required by IFRS accounting standards. *[IFRS 3.19]*. For example, a preference share that entitles the holders only to a preferred return of capital and accrued and unpaid dividends (or any other restricted right) in the event of a liquidation does not qualify for the measurement choice in IFRS 3.19 because it does not entitle its holder to a proportionate share of the entity's net assets in the event of liquidation.

The exception to fair values relates to outstanding share-based payment transactions that are not replaced by the acquirer:

- If vested, they are measured at their market-based measure.
- If unvested, they are measured at their market-based measure as if the acquisition date were the grant date. *[IFRS 3.B62A]*.

The market-based measure of unvested share-based payment transactions is allocated to the non-controlling interest on the basis of the ratio of the portion of the vesting period completed to the greater of the total vesting period or the original vesting period of the share-based payment transaction. The balance is allocated to post-combination service. *[IFRS 3.B62B]*.

The above requirements for equity-settled share-based payment transactions of the acquiree are discussed further in Chapter 30 at section 11.

Illustration 8-3: Measurement of non-controlling interest represented by preference shares and employee share options

Preference shares

TC has issued 100 preference shares, which are classified as equity. The preference shares have a nominal value of CU1 each. The preference shares give their holders a priority right to a preferential dividend over the payment of any dividend to the holders of ordinary shares. On liquidation of TC, the holders of the preference shares are entitled to receive, out of the assets available for distribution, the amount of CU1 per share before any payment is made to the holders of ordinary shares. However, they do not have any further rights on liquidation.

AC acquires all ordinary shares of TC. The acquisition-date fair value of the preference shares is CU120.

The non-controlling interests that relate to TC's preference shares do not entitle their holders to a proportionate share of the entity's net assets in the event of liquidation. They are measured at a fair value of CU120.

If the preference shares have an equal right and ranking to the ordinary shares in the event of liquidation, they have a present ownership interest and could then be measured at their fair value or at their proportionate share of the identifiable net assets recognised by the acquiree. If the fair value of the preference shares is CU160 and the proportionate share of TC's identifiable net assets attributable to the preference shares is CU140, the acquirer can elect to measure the preference shares at either of these amounts.

Employee share options

TC has issued share options to its employees. The share options are classified as equity and are vested at the acquisition date. The share options do not expire on the acquisition date and AC does not replace them. They do not represent a present ownership interest and do not entitle their holders to a proportionate share of TC's net assets in the event of liquidation. The market-based measure of the share options in accordance with IFRS 2 at the acquisition date is CU200. The acquirer measures the non-controlling interests that are related to the share options at their market-based measure of CU200.

8.5 Call and put options over non-controlling interests

In some business combinations when less than 100% of the equity shares are acquired, it may be that the transaction also involves options over some or all of the outstanding shares held by the non-controlling shareholders. The acquirer may have a call option, i.e., a right to acquire the outstanding shares at a future date for cash at a particular price. Alternatively, it may have granted a put option to the other shareholders whereby they have the right to sell their shares to the acquirer at a future date for cash at a particular price. In some cases, there may be a combination of call and put options, the terms of which may be equivalent or may be different.

Those kinds of transactions raise many questions regarding the appropriate accounting treatment such as the appropriate classification of the call and put options and whether the transactions are accounted for as a single arrangement. IFRS 3 gives no guidance as to how such options impact the accounting for a business combination. Those issues are discussed in Chapter 8 at section 6.

Similarly, IFRS 3 does not explicitly address the accounting for a sequence of transactions that begin with an acquirer gaining control over another entity, followed by acquiring additional ownership interests shortly thereafter. This frequently happens where public offers are made to a group of shareholders and there is a regulatory requirement for an acquirer to make an offer to the non-controlling shareholders of the acquiree. This issue is also discussed in Chapter 8 at section 6.

The IFRS IC and the IASB have debated the accounting for NCI puts for a number of years. Many of these issues have now been considered as part of the Financial Instruments with Characteristics of Equity (FICE) project. An Exposure Draft *Financial Instruments with Characteristics of Equity*[16] was published in November 2023. See section 1.2.2 above and chapter 43 at sections 1.2 and 12.1 for further information on the FICE project.

16 Exposure Draft (IASB/ED/2023/5) *Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1*, IASB, November 2023. Available on the IFRS Foundation's website.

9 Business combinations achieved in stages ('step acquisitions')

Extract from IFRS 3	
42	In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss or other comprehensive income, as appropriate. In prior reporting periods, the acquirer may have recognised changes in the value of its equity interest in the acquiree in other comprehensive income. If so, the amount that was recognised in other comprehensive income shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest.
42A	When a party to a joint arrangement (as defined in IFRS 11 *Joint Arrangements*) obtains control of a business that is a joint operation (as defined in IFRS 11), and had rights to the assets and obligations for the liabilities relating to that joint operation immediately before the acquisition date, the transaction is a business combination achieved in stages. The acquirer shall therefore apply the requirements for a business combination achieved in stages, including remeasuring its previously held interest in the joint operation in the manner described in paragraph 42. In doing so, the acquirer shall remeasure its entire previously held interest in the joint operation.

[IFRS 3.42, IFRS 3.42A].

The third item in part (a) of the goodwill computation set out in section 6 above is the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

An acquirer sometimes obtains control of an acquiree in which it held an equity interest immediately before the acquisition date. For example, on 31 January 20X2, Entity A holds a 35% non-controlling equity interest in Entity B. On that date, Entity A purchases an additional 40% interest in Entity B, which gives it control of Entity B. IFRS 3 refers to such a transaction as a business combination achieved in stages, sometimes also referred to as a 'step acquisition'. *[IFRS 3.41]*.

If the acquirer holds a non-controlling equity investment in the acquiree immediately before obtaining control, the acquirer remeasures that previously held equity investment at its acquisition-date fair value and recognises any resulting gain or loss in profit or loss or other comprehensive income, as appropriate. *[IFRS 3.42]*.

In effect, the acquirer exchanges its status as an owner of an investment asset in an entity for a controlling financial interest in all of the underlying assets and liabilities of that entity (acquiree) and the right to direct how the acquiree and its management use those assets in its operations. *[IFRS 3.BC384]*.

In addition, any changes in the value of the acquirer's equity interest in the acquiree recognised in other comprehensive income (e.g., the investment was designated as measured at fair value through other comprehensive income without recycling to profit or loss upon derecognition) is recognised on the same basis that would be required if the acquirer had directly disposed of the previously held equity investment. *[IFRS 3.42]*.

The acquirer's non-controlling equity investment in the acquiree, after remeasurement to its acquisition-date fair value, is then included as the third item of part (a) of the goodwill computation set out in section 6 above.

Under IFRS 9 investments in equity instruments that are not held for trading would likely be classified as either:

- Financial assets designated as measured at fair value through profit or loss

  Or

- Financial assets measured at fair value through other comprehensive income (FVOCI) if an entity made an irrevocable election at initial recognition to present subsequent changes in their fair value in other comprehensive income

In the former case no transfer would be necessary as gains or losses from changes in the fair value would be already included in profit or loss in the previous periods. In the latter case, as demonstrated in Illustration 9-1 below, gains or losses from changes in the fair value accumulated in other comprehensive income would never be reclassified to profit or loss but may be transferred to retained earnings on 'deemed disposal' of the investment if an entity initially recognised these changes in a separate component of equity rather than directly within retained earnings.

Illustration 9-1: Business combination achieved in stages - original investment treated as FVOCI without recycling

Investor acquires a 20% ownership interest in Investee (a service company) on 1 January 20X1 for CU3,500,000 in cash, which is the fair value of the investment at that date. Investor has concluded that despite its 20% holding, it does not have significant influence over Investee. At that date, the fair value of Investee's identifiable assets is CU10,000,000, and the carrying amount of those assets is CU8,000,000. Investee has no liabilities or contingent liabilities at that date. The following shows Investee's statement of financial position as at 1 January 20X1 together with the fair values of the identifiable assets:

Investee's statement of financial position as at 1 January 20X1	Carrying amounts	Fair values
	CU'000	CU'000
Cash and receivables	2,000	2,000
Land	6,000	8,000
	8,000	10,000
Issued equity: 1,000,000 ordinary shares	5,000	
Retained earnings	3,000	
	8,000	

During the year ended 31 December 20X1, Investee reports a profit of CU6,000,000 but does not pay any dividends. In addition, the fair value of Investee's land increases by CU3,000,000 to CU11,000,000. However, the amount recognised by Investee in respect of the land remains unchanged at CU6,000,000. The following shows Investee's statement of financial position as at 31 December 20X1 together with the fair values of the identifiable assets:

Investee's statement of financial position as at 31 December 20X1	Carrying amounts	Fair values
	CU'000	CU'000
Cash and receivables	8,000	8,000
Land	6,000	11,000
	14,000	19,000
Issued equity: 1,000,000 ordinary shares	5,000	
Retained earnings	9,000	
	14,000	

On 1 January 20X2, Investor acquires a further 60% ownership interest in Investee for CU22,000,000 cash, thereby obtaining control. Before obtaining control, Investor does not have significant influence over Investee, and accounts for its initial 20% investment at FVOCI. Investee's ordinary shares have a quoted market price at 31 December 20X1 of CU30 per share.

Throughout the period 1 January 20X1 to 1 January 20X2, Investor's issued equity was CU30,000,000. Investor's only asset apart from its investment in Investee is cash.

Accounting for the initial investment before obtaining control

Investor's initial 20% investment in Investee is measured at its fair value at the acquisition date of CU3,500,000. However, Investee's 1,000,000 ordinary shares have a quoted market price at 31 December 20X1 of CU30 per share. Therefore, the carrying amount of Investor's initial 20% investment is remeasured in Investor's financial statements at CU6,000,000 on 31 December 20X1, with the CU2,500,000 increase recognised as a component of other comprehensive income. Therefore, Investor's statement of financial position before the acquisition of the additional 60% ownership interest is as follows:

Investor's statement of financial position as at 31 December 20X1	CU'000
Cash	26,500
Investment in Investee	6,000
	32,500
Issued equity	30,000
Gain on remeasurement of the equity investment designated as FVOCI (without recycling)	2,500
	32,500

Accounting for the business combination

Assuming Investor adopts option 2 for measuring the non-controlling interest in Investee, i.e., at the proportionate share of the value of the net identifiable assets acquired, it recognises the following amount for goodwill in its consolidated financial statements:

	CU'000
Consideration transferred for 60% interest acquired on 1 January 20X2	22,000
Non-controlling interest - proportionate share of fair values of identifiable net assets at that date (20% × CU19,000,000)	3,800
Acquisition-date fair value of initial 20% interest	6,000
	31,800
Acquisition-date fair values of identifiable net assets acquired	19,000
Goodwill	12,800

The existing gain on the equity investment designated as FVOCI (without recycling) of CU2,500,000, according to the Investor's accounting policy, is transferred from the separate component of accumulated Other Comprehensive Income (OCI) to retained earnings at the date of obtaining control on 1 January 20X2. If under the Investor's accounting policy gains or losses upon remeasurement were included directly in retained earnings rather than accumulated in a separate component of accumulated OCI, no transfer would be required.

The following shows Investor's consolidation worksheet immediately after the acquisition of the additional 60% ownership interest in Investee, together with consolidation adjustments and associated explanations:

	Investor	Investee	Consolidation adjustments		Consolidated	
			Dr	Cr		
	CU'000	CU'000	CU'000	CU'000	CU'000	
Cash and receivables	4,500	8,000			12,500	
Investment in Investee	28,000	-		28,000	-	
Land		6,000	5,000		11,000	(a)
Goodwill			12,800		12,800	(b)
	32,500	**14,000**			**36,300**	
Issued equity	30,000	5,000	5,000		30,000	(c)
Gain on remeasurement of the equity investment designated as FVOCI (without recycling)	2,500		2,500		-	(d)
Retained earnings		9,000	9,000	2,500	2,500	(d)
Non-controlling interest				3,800	3,800	(a)
	32,500	**14,000**			**36,300**	

Notes

The above consolidation adjustments result in:

(a) Investee's identifiable net assets being stated at their full fair values at the date Investor obtains control of Investee, i.e., CU19,000,000, including land of CU11,000,000. The 20% non-controlling interest in Investee is also stated at the non-controlling interest's 20% share of the fair values of Investee's identifiable net assets, i.e., CU3,800,000 (20% × CU19,000,000).

(b) Goodwill being recognised from the acquisition date based on the computation set out in section 6 above, i.e., CU12,800,000.

(c) Issued equity of CU30,000,000 comprising the issued equity of Investor of CU30,000,000.

(d) A retained earnings balance of CU2,500,000 being the amount transferred from accumulated other comprehensive income relating to the previously held investment in Investee on the step acquisition.

If the investor in the above Illustration had accounted for its original investment of 20% as an associate using the equity method under IAS 28 *Investments in Associates and Joint Ventures*, then the accounting would have been as follows:

Illustration 9-2: Business combination achieved in stages - original investment treated as an associate under IAS 28

This example uses the same facts as in Illustration 9-1 above, except that Investor has significant influence over Investee following its initial 20% investment.

Accounting for the initial investment before obtaining control

Investor's initial 20% investment in Investee is included in Investor's consolidated financial statements under the equity method. Accordingly, it is initially recognised at its cost of CU3,500,000 and adjusted thereafter for its share of the profits of Investee after the date of acquisition of CU1,200,000 (being 20% × CU6,000,000). Investor's policy for property, plant and equipment is to use the cost model under IAS 16; therefore, in applying the equity method, it does not include its share of the increased value of the land held by Investee. IAS 28 requires that, on the acquisition of an associate, any difference between the cost of the acquisition and its share of the fair value of the associate's identifiable assets and liabilities is accounted for as goodwill, but is included within the carrying amount of the investment in the associate. Accordingly, Investor has included goodwill of CU1,500,000 arising on its original investment of 20%, being CU3,500,000 less CU2,000,000 (20% × CU10,000,000). Therefore, Investor's consolidated statement of financial position as at 31 December 20X1, before the acquisition of the additional 60% ownership interest, is as follows:

Investor's consolidated statement of financial position as at 31 December 20X1	**CU'000**
Cash	26,500
Investment in associate	4,700
	31,200
Issued equity	30,000
Retained earnings	1,200
	31,200

In its separate financial statements, Investor includes its investment in the associate at the cost of CU3,500,000.

Accounting for the business combination

Although Investor has previously equity-accounted for its 20% interest in Investee (and calculated goodwill on that acquisition), the computation of goodwill in its consolidated financial statements as a result of obtaining control over Investee is the same as that in Illustration 9-1 above:

	CU'000
Consideration transferred for 60% interest acquired on 1 January 20X2	22,000
Non-controlling interest - share of fair values of identifiable net assets at that date (20% × CU19,000,000)	3,800
Acquisition-date fair value of initial 20% interest	6,000
	31,800
Acquisition-date fair values of identifiable net assets acquired	19,000
Goodwill	12,800

Investor recognises a gain of CU1,300,000 in profit or loss as a result of remeasuring its existing interest from its equity-accounted amount of CU4,700,000 at the date of obtaining control to its acquisition-date fair value of CU6,000,000.

The following shows Investor's consolidation worksheet immediately after the acquisition of the additional 60% ownership interest in Investee, together with consolidation adjustments and associated explanations:

	Investor	Investee	Consolidation adjustments		Consolidated	
			Dr	Cr		
	CU'000	CU'000	CU'000	CU'000	CU'000	
Cash and receivables	4,500	8,000			12,500	
Investment in Investee	26,700	-		26,700	-	
Land		6,000	5,000		11,000	(a)
Goodwill			12,800		12,800	(b)
	31,200	**14,000**			**36,300**	
Issued equity	30,000	5,000	5,000		30,000	(c)
Retained earnings	1,200	9,000	9,000		1,200	(d)
Profit for 20X2				1,300	1,300	(e)
Non-controlling interest				3,800	3,800	(a)
	31,200	**14,000**			**36,300**	

Notes

The above consolidation adjustments result in:

(a) Investee's identifiable net assets being stated at their full fair values at the date Investor obtains control of Investee, i.e., CU19,000,000, including land of CU11,000,000. The 20% non-controlling interest in Investee is also stated at the non-controlling interest's 20% share of the fair values of Investee's identifiable net assets, i.e., CU3,800,000 (20% × CU19,000,000).

(b) Goodwill being recognised from the acquisition date based on the computation set out in section 6 above, i.e., CU12,800,000.

(c) Issued equity of CU30,000,000 comprising the issued equity of Investor of CU30,000,000.

(d) A retained earnings balance of CU1,200,000 being Investor's equity-accounted share of Investee while it was an associate.

(e) Profit of CU1,300,000 being the amount of gain on remeasurement of the previously existing interest in Investee at its acquisition-date fair value (CU6,000,000 - CU4,700,000). As a result, total retained earnings in the statement of financial position are CU2,500,000.

Although the Illustrations above explain the requirements of IFRS 3 when the previously held investment has been accounted for as an equity investment designated as FVOCI (without recycling) or as an associate, the requirements in IFRS 3 for step acquisitions apply to all previously held non-controlling equity investments in the acquiree, including those that were accounted for as joint ventures or joint operations under IFRS 11. Accounting for step-acquisitions of former joint operations that are businesses is discussed in section 9.1 below. IAS 28's requirements also apply to joint ventures. *[IAS 28.2]*.

As a result of obtaining control over a former associate or joint venture, the acquirer accounts for the business combination by applying the other requirements under IFRS 3 as it would in any other business combination. Thus, it needs to recognise the net of the acquisition-date fair values (or other amounts recognised in accordance with the requirements of the standard) of the identifiable assets acquired and the liabilities assumed relating to the former associate or joint venture (see section 5 above), i.e., perform a new purchase price allocation. This will include reassessing the classification and designation of assets and liabilities, including the classification of financial instruments, embedded derivatives and hedge accounting, based on the circumstances that exist at the acquisition date (see section 5.4 above).

Obtaining control over a former associate or joint venture means that the investor 'loses' significant influence or 'joint control' over it. Therefore, any amounts recognised in other comprehensive income relating to the associate or joint venture is recognised by the investor on the same basis that would be required if the associate or joint venture had directly disposed of the related assets or liabilities. For associates and joint ventures, this is discussed further in Chapter 12 at section 9.1.

In Illustration 9-2 above, a gain was recognised as a result of the step-acquisition of the former associate. However, a loss may have to be recognised as a result of the step-acquisition.

Illustration 9-3: Business combination achieved in stages - loss arising on step-acquisition

An investor has an equity-accounted interest in a listed associate comprising 1,000 shares with a carrying value of CU1,000. The quoted price of the associate's shares is CU0.90 per share, i.e., CU900 in total. As there is an impairment indicator, the investment is tested for impairment in accordance with IAS 36. However, as the investor determines that the investment's value in use exceeds CU1,000, no impairment loss is recognised.

In the following period, the investor acquires all of the other outstanding shares in the associate. Up to the date of obtaining control, the investor has recognised a further share of profits of the associate, such that the equity-accounted interest in the associate is now CU1,050. At the date of obtaining control, the fair value of the shares has increased to CU0.93. The existing shares are remeasured to fair value at that date and a loss of CU120 (CU1,050 less CU930) is recognised in profit or loss.

9.1 Accounting for previously held interests in a joint operation

A party to a joint operation (i.e., either a joint operator or a party that does not share joint control) may obtain control of a joint operation that is a business (as defined in IFRS 3). The IASB views a transaction where control is gained as a significant change in the nature of, and the economic circumstances surrounding, the interest in the joint operation. Therefore, when a party to a joint operation obtains control of a joint operation that is a business, it must remeasure to fair value the entire interest it previously held in that joint operation. In other words, such a transaction must be accounted for as a business combination achieved in stages. *[IFRS 3.42A]*.

Chapter 13 at section 8.3.2 discusses how a party that participates in (but does not have joint control over) a joint operation, accounts for obtaining joint control over that joint operation that is a business (as defined in IFRS 3).

10 Bargain purchase transactions

Extract from IFRS 3

Bargain purchases

34 Occasionally, an acquirer will make a bargain purchase, which is a business combination in which the amount in paragraph 32(b) exceeds the aggregate of the amounts specified in paragraph 32(a). If that excess remains after applying the requirements in paragraph 36, the acquirer shall recognise the resulting gain in profit or loss on the acquisition date. The gain shall be attributed to the acquirer.

35 A bargain purchase might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion. However, the recognition or measurement exceptions for particular items discussed in paragraphs 22-31 may also result in recognising a gain (or change the amount of a recognised gain) on a bargain purchase.

36 Before recognising a gain on a bargain purchase, the acquirer shall reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and shall recognise any additional assets or liabilities that are identified in that review. The acquirer shall then review the procedures used to measure the amounts this IFRS requires to be recognised at the acquisition date for all of the following:

(a) the identifiable assets acquired and liabilities assumed;

(b) the non-controlling interest in the acquiree, if any;

(c) for a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree; and

(d) the consideration transferred.

The objective of the review is to ensure that the measurements appropriately reflect consideration of all available information as of the acquisition date.

IFRS 3 regards a bargain purchase as being a business combination in which:

- The net of the acquisition-date fair values (or other amounts recognised in accordance with the requirements of the standard) of the identifiable assets acquired and the liabilities assumed, exceeds
- The aggregate of:
  - The consideration transferred (generally measured at acquisition-date fair value)
  - The amount of any non-controlling interest in the acquiree

    And
  - The acquisition-date fair value of the acquirer's previously held equity interest in the acquiree *[IFRS 3.34]*

The IASB considers bargain purchases anomalous transactions - business entities and their owners generally do not knowingly and willingly sell assets or businesses at prices below their fair values. *[IFRS 3.BC371]*. Nevertheless, occasionally, an acquirer will make a bargain purchase, for example, in a forced sale in which the seller is acting under compulsion. *[IFRS 3.35]*. These may occur in a forced liquidation or distress sale (e.g., after the death of a founder or key manager) in which owners need to sell a business quickly. The IASB observed that an economic gain is inherent in a bargain purchase and concluded that, in concept, the acquirer recognises that gain at the acquisition date. However, there may not be clear evidence that a bargain purchase has taken place, and because of this there remained the potential for inappropriate gain recognition resulting from measurement bias or undetected measurement errors. *[IFRS 3.BC372, IFRS 3.BC373, IFRS 3.BC374, IFRS 3.BC375]*.

Therefore, before recognising a gain on a bargain purchase, the acquirer is required to reassess all components of the computation to ensure that the measurements are based on all available information as at the acquisition date. This means ensuring that it has correctly identified all of the assets acquired and all of the liabilities assumed and does not have to recognise any additional assets or liabilities. Having done so, the acquirer must review the procedures used to measure all of the following:

- The identifiable assets acquired and liabilities assumed
- The non-controlling interest in the acquiree, if any
- For a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree
- The consideration transferred *[IFRS 3.36]*

If an excess remains, the acquirer recognises a gain in profit or loss on the acquisition date. All of the gain is attributed to the acquirer. *[IFRS 3.34]*.

The computation means that a gain on a bargain purchase and goodwill cannot both be recognised for the same business combination. *[IFRS 3.BC376, IFRS 3.BC377]*.

IFRS 3 acknowledges that the requirements to measure particular assets acquired or liabilities assumed in accordance with other IFRS accounting standards, rather than their fair value, may result in recognising a gain (or change the amount of a recognised gain) on acquisition. *[IFRS 3.35, IFRS 3.BC379]*.

The computation of a gain on a bargain purchase is shown in the following Illustration, which is based on one included within the Illustrative Examples accompanying IFRS 3. *[IFRS 3.IE45-IE49]*.

Illustration 10-1: Gain on a bargain purchase (1)

Entity A acquires 80% of the equity interests of Entity B, a private entity, in exchange for cash of CU150m. Because the former owners of Entity B needed to dispose of their investments in Entity B by a pre-determined date, they did not have sufficient time to market Entity B to multiple potential buyers. The management of Entity A initially measures the separately recognisable identifiable assets acquired and the liabilities assumed as at the acquisition date in accordance with the requirements of IFRS 3. The identifiable assets are measured at CU250m and the liabilities assumed are measured at CU50m. Entity A engages an independent consultant, who determines that the fair value of the 20% non-controlling interest in Entity B is CU42m.

Entity B's identifiable net assets of CU200m (being CU250m - CU50m) exceed the fair value of the consideration transferred plus the fair value of the non-controlling interest in Entity B. Therefore, Entity A reviews the procedures it used to identify and measure the assets acquired and liabilities assumed and to measure the fair value of both the non-controlling interest in Entity B and the consideration transferred. After that review, Entity A decides that the procedures and resulting measures were appropriate. Entity A measures the gain on its purchase of the 80% interest as follows:

	CU million	CU million
Fair value of the identifiable net assets acquired (CU250m - CU50m)		200
Less:		
Fair value of the consideration transferred for Entity A's 80% interest	150	
Fair value of non-controlling interest in Entity B	42	
		(192)
Gain on bargain purchase of 80% interest in Entity B		**8**

Entity A records its acquisition of Entity B in its consolidated financial statements as follows:

			CU million	CU million
Dr	Identifiable assets acquired		250	
	Cr	Cash		150
	Cr	Liabilities assumed		50
	Cr	Gain on bargain purchase		8
	Cr	Equity - non-controlling interest in Entity B		42

If Entity A chooses to measure the non-controlling interest in Entity B on the basis of its proportionate interest in the identifiable net assets of the acquiree, the gain on the purchase of the 80% interest is as follows:

	CU million	CU million
Fair value of the identifiable net assets acquired (CU250m - CU50m)		200
Less:		
Fair value of the consideration transferred for Entity A's 80% interest	150	
Non-controlling interest in Entity B (20% × CU200m)	40	
		(190)
Gain on bargain purchase of 80% interest in Entity B		**10**

On that basis, Entity A records its acquisition of Entity B in its consolidated financial statements as follows:

			CU million	CU million
Dr	Identifiable net assets acquired		250	
	Cr	Cash		150
	Cr	Liabilities assumed		50
	Cr	Gain on bargain purchase		10
	Cr	Equity - non-controlling interest in Entity B		40

It can be seen from the above example that the amount of the gain recognised is affected by the way in which the non-controlling interest is measured. Indeed, it might be that if the non-controlling interest is measured at its acquisition-date fair value, goodwill is recognised rather than a gain as shown below.

Illustration 10-2: Gain on a bargain purchase (2)

This example uses the same facts as in Illustration 10-1 above, except that the independent consultant determines that the fair value of the 20% non-controlling interest in Entity B is CU52m.

In this situation, the fair value of the consideration transferred plus the fair value of the non-controlling interest in Entity B exceeds the recognised amount of the identifiable net assets acquired, giving rise to goodwill on the acquisition as follows:

	CU million
Fair value of the consideration transferred for Entity A's 80% interest	150
Fair value of non-controlling interest in Entity B	52
	202
Less: Fair value of the identifiable net assets acquired (CU250m - CU50m)	(200)
Goodwill on acquisition of 80% interest in Entity B	2

Therefore, although Entity A in the above example might have made a 'bargain purchase', the requirements of IFRS 3 lead to no gain being recognised.

11 Assessing what is part of the exchange for the acquiree

Extract from IFRS 3

Determining what is part of the business combination transaction

51 **The acquirer and the acquiree may have a pre-existing relationship or other arrangement before negotiations for the business combination began, or they may enter into an arrangement during the negotiations that is separate from the business combination. In either situation, the acquirer shall identify any amounts that are not part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination, ie amounts that are not part of the exchange for the acquiree. The acquirer shall recognise as part of applying the acquisition method only the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree. Separate transactions shall be accounted for in accordance with the relevant IFRSs.**

52 A transaction entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer or the combined entity, rather than primarily for the benefit of the acquiree (or its former owners) before the combination, is likely to be a separate transaction. The following are examples of separate transactions that are not to be included in applying the acquisition method:

(a) a transaction that in effect settles pre-existing relationships between the acquirer and acquiree;

(b) a transaction that remunerates employees or former owners of the acquiree for future services; and

(c) a transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs.

Paragraphs B50-B62 provide related application guidance.

Acquisition-related costs

53 Acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognised in accordance with IAS 32 and IFRS 9.

[IFRS 3.51, IFRS 3.52, IFRS 3.53].

To be included in the accounting for the business combination, the identifiable assets acquired and liabilities assumed must be part of the exchange for the acquiree, rather than as a result of separate transactions. *[IFRS 3.12]*.

IFRS 3 recognises that the acquirer and the acquiree may have a pre-existing relationship or other arrangement before the negotiations for the business combination, or they may enter into an arrangement during the negotiations that is separate from the business combination. In either situation, the acquirer is required to identify any amounts that are separate from the business combination and thus are not part of the exchange for the acquiree. *[IFRS 3.51]*. This requires the acquirer to evaluate the substance of transactions between the parties.

There are three types of transactions that IFRS 3 regards as separate transactions that are not considered part of the exchange for the acquiree:

- A transaction that effectively settles pre-existing relationships between the acquirer and acquiree, e.g., a lawsuit, supply contract, franchising or licensing arrangement (see section 11.1 below)
- A transaction that remunerates employees or former owners of the acquiree for future services (see section 11.2 below)
- A transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs (see section 11.3 below) *[IFRS 3.52]*

The acquirer is required to consider the following factors to determine whether a transaction is part of the exchange for the acquiree or whether it is separate. The standard stresses that these factors are neither mutually exclusive nor individually conclusive. *[IFRS 3.B50]*.

- *The reasons for the transaction*

  Understanding the reasons why the parties to the combination, the acquirer and the acquiree and their owners, directors and managers - and their agents - entered into a particular transaction or arrangement may provide insight into whether it is part of the consideration transferred and the assets acquired or liabilities assumed. If a transaction is arranged primarily for the benefit of the acquirer or the combined entity rather than for the benefit of the acquiree or its former owners before the combination, that portion of the transaction price paid (and any related assets or liabilities) is less likely to be part of the exchange for the acquiree. The acquirer would account for that portion separately from the business combination.
- *Who initiated the transaction*

  A transaction or other event that is initiated by the acquirer may be entered into for the purpose of providing future economic benefits to the acquirer or combined entity with little or no benefit received by the acquiree or its former owners before the combination. A transaction or arrangement initiated by the acquiree or its former owners is less likely to be for the benefit of the acquirer or the combined entity and more likely to be part of the business combination transaction.
- *The timing of the transaction*

  A transaction between the acquirer and the acquiree during the negotiations of the terms of a business combination may have been entered into in contemplation of the business combination to provide future economic benefits to the acquirer or the combined entity. If so, the acquiree or its former owners before the business combination are likely to receive little or no benefit from the transaction except for benefits they receive as part of the combined entity.

One particular area that may be negotiated between acquirer and acquiree could be a restructuring plan relating to the activities of the acquiree. This is discussed in section 11.4 below.

11.1 Effective settlement of pre-existing relationships

The acquirer and acquiree may have a relationship that existed before they contemplated the business combination, referred to as a 'pre-existing relationship'. This may be contractual, e.g., vendor and customer or licensor and licensee, or non-contractual, e.g., plaintiff and defendant. *[IFRS 3.B51]*.

The purpose of this guidance is to ensure that a transaction that in effect settles a pre-existing relationship between the acquirer and the acquiree is excluded from the accounting for the business combination. If a potential acquiree has an asset, for example, a receivable for an unresolved claim against the potential acquirer, the acquiree's owners could agree to settle that claim as part of an agreement to sell the acquiree to the acquirer. If the acquirer makes a lump sum payment to the seller-owner for the business, part of that payment is to settle the claim. In effect, the acquiree relinquished its claim against the acquirer by transferring its receivable as a dividend to the acquiree's owner. Thus, at the acquisition date the acquiree has no receivable to be acquired as part of the combination, and the acquirer accounts separately for its settlement payment. *[IFRS 3.BC122]*.

The acquirer recognises a gain or a loss on effective settlement of a pre-existing relationship, measured on the following bases:

- For a pre-existing non-contractual relationship, such as a lawsuit, the gain or loss is measured at its fair value
- For a pre-existing contractual relationship, such as a supply contract, the gain or loss is measured as the lesser of:

  (a) The amount by which the contract is favourable or unfavourable from the perspective of the acquirer when compared with terms for current market transactions for the same or similar terms (A contract that is unfavourable in terms of current market terms is not necessarily an onerous contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.)

  And

  (b) The amount of any settlement provisions in the contract available to the counterparty to whom the contract is unfavourable

  If (b) is less than (a), the difference is included as part of the business combination accounting.

The amount of gain or loss will depend in part on whether the acquirer had previously recognised a related asset or liability, and the reported gain or loss therefore may differ from the amount calculated by applying the above requirements. *[IFRS 3.B52]*.

If there is an 'at market' component to the settlement (i.e., part of the payment reflects the price any market participant would pay to settle the relationship), this is accounted for as part of goodwill and not as a separate intangible asset.[17]

The requirements for non-contractual relationships are shown in the following Illustration.

Illustration 11-1: Settlement of pre-existing non-contractual relationship

On 1 January 20X7, Entity A acquires a 100% interest in Entity B for CU250m in cash.

At the beginning of 20X5, a dispute arose over the interpretation of a contract for the development and implementation by Entity A of an e-business platform for Entity C, which at the end of 20X4 was merged with Entity B. The contract, signed in 20X0 and for which work was completed in December 20X3, provided for payment of part of the contract price by allocating to Entity A 5% of the profit from the platform for five years from the system's installation, i.e., from January 20X4 to January 20X9. At the end of 20X4 the merged Entity ceased to use the platform developed by Entity A, as Entity B had its own platform. Entity A, however, believes that 5% of certain profits is payable by Entity B for the period January 20X5 to January 20X9 regardless of the system used by Entity B. Several legal hearings took place in 20X5 and 20X6. However, at the date of acquisition the dispute is still unresolved. Entity B recognised a provision amounting to CU12m reflecting the best estimate of the expenditure required to settle the present obligation at 1 January 20X7. No assets are recognised by Entity A with respect to the dispute prior to the date of acquisition.

The acquisition by Entity A of Entity B includes the effective settlement of the dispute between Entity A and Entity B which is accounted for as a separate transaction from the business combination. On 1 January 20X7, Entity A recognises a gain on effective settlement of the dispute at its fair value, which is not necessarily equal to the amount of the provision reported by Entity B. The amount of consideration transferred for the acquisition of Entity B is increased accordingly. Assuming the fair value of the dispute at 1 January 20X7 is CU15m, Entity A will recognise a gain on effective settlement of CU15m, and the consideration transferred for the purposes of determining goodwill will be CU265m (CU250m + CU15m).

The requirements for contractual relationships relating to a supply contract are shown in the following Illustration . *[IFRS 3.IE54, IFRS 3.IE55, IFRS 3.IE56, IFRS 3.IE57]*.

Illustration 11-2: Settlement of pre-existing contractual relationship - Supply contract

Entity A purchases electronic components from Entity B under a five-year supply contract at fixed rates. Currently, the fixed rates are higher than the rates at which Entity A could purchase similar electronic components from another supplier. The supply contract allows Entity A to terminate the contract before the end of the initial five-year term, but only by paying a CU6m penalty. With three years remaining under the supply contract, Entity A pays CU50m to acquire Entity B, which is the fair value of Entity B based on what other market participants would be willing to pay.

Included in the total fair value of Entity B is CU8m related to the fair value of the supply contract with Entity A. The CU8m represents a CU3m component that is 'at market' because the pricing is comparable to pricing for current market transactions for the same or similar items (selling effort, customer relationships and so on) and a CU5 million component for pricing that is unfavourable to Entity A because it exceeds the price of current market transactions for similar items. Entity B has no other identifiable assets or liabilities related to the supply contract, and Entity A has not recognised any assets or liabilities related to the supply contract before the business combination.

In this example, Entity A calculates a loss of CU5m (the lesser of the CU6m stated settlement amount and the amount by which the contract is unfavourable to the acquirer) separately from the business combination. The CU3m 'at-market' component of the contract is part of goodwill. This means that in the business combination, the acquirer does not recognise any pre-existing relationship between the acquiree and the acquirer as a separate intangible asset acquired.

Whether Entity A had previously recognised an amount in its financial statements related to a pre-existing relationship will affect the amount recognised as a gain or loss for the effective settlement of the relationship. Suppose that Entity A had recognised a CU6m liability for the supply contract before the business combination. In that situation, Entity A recognises a CU1m settlement gain on the contract in profit or loss at the acquisition date (the CU5m measured loss on the contract less the CU6m loss previously recognised). In other words, Entity A has in effect settled a recognised liability of CU6m for CU5m, resulting in a gain of CU1m. *[IFRS 3.IE57]*.

17 *IFRIC Update*, November 2010, available on the IFRS Foundation's website.

A lease contract entered into between the parties to a business combination before the transaction, also represents a pre-existing contractual relationship between the acquirer and the acquiree that is treated as effectively settled at the acquisition date.

Illustration 11-3: Settlement of pre-existing contractual relationship - Lease contract (acquirer as a lessor in an operating lease)

Entity A leases a building to Entity B under a five-year lease. Currently, market lease rates for similar leases are less than the contractual lease rate, resulting in a lease that is favourable to Entity A. The fair value of the off-market lease provisions is CU2m. The lease contract permits Entity B to terminate the lease for a payment of CU3m. Entity A as a lessor classifies the lease as an operating lease. With three years remaining under the lease contract, Entity A pays CU25m to acquire Entity B.

In this example, Entity A recognises a CU2m gain on settlement of the lease (the lesser of the CU2m amount by which the lease is favourable to Entity A and the CU3m stated settlement provision amount available to Entity B) and the consideration transferred in the business combination is CU27m.

Another example of settlement of a pre-existing contractual relationship, which is recognised separately from the business combination, is when the acquirer has a loan payable to or receivable from the acquiree.

Illustration 11-4: Settlement of pre-existing contractual relationship - Loan agreement

Entity A acquires a 100% interest in Entity B for CU500m in cash.

Before the acquisition, Entity B granted a fixed interest rate loan to Entity A. At the date of acquisition, Entity A has recognised a financial liability in respect of the loan amounting to CU50m. The fair value of that financial liability is CU45m. The fair value of the identifiable net assets and liabilities of Entity B as at the date of acquisition is CU460m, including CU45m in respect of the fixed rate loan to Entity A.

The amount of consideration transferred for the acquisition of Entity B is decreased by the fair value of the financial liability and the financial liability is then derecognised. As such, the consideration transferred for the purposes of determining goodwill is CU455m (CU500m - CU45m). The amount by which the loan agreement is favourable to the acquirer is recognised as a gain in the consolidated profit or loss. The net identifiable assets and liabilities of Entity B exclude the receivable due from Entity A.

Entity A accounts for the acquisition of Entity B and settlement of the financial liability as follows:

			CU million	CU million
Dr	Net identifiable assets and liabilities acquired (CU460m - CU45m)		415	
Dr	Loan due to Entity B		50	
Dr	Goodwill (CU455m - CU415m)		40	
	Cr	Gain on derecognition of loan due to Entity B (CU50m - CU45m)		5
	Cr	Cash - consideration for business combination (CU500m - CU45m)		455
	Cr	Cash - effective settlement of loan due to Entity B		45

A pre-existing relationship may be a contract that the acquirer recognises as a reacquired right. As indicated in section 5.6.5 above, if the contract includes terms that are favourable or unfavourable when compared with pricing for current market transactions for the same or similar items, the acquirer recognises, separately from the business combination, a gain or loss for the effective settlement of the contract, measured in accordance with the requirements described above. *[IFRS 3.B53]*.

Illustration 11-5: Settlement of pre-existing contractual relationship - Reacquired technology licensing agreement

Entity A acquires a 100% interest in Entity B for CU350m in cash.

Before the acquisition, Entity A sold Entity B an exclusive right to use Entity A's technology in a specified territory. Entity B also pays a revenue-based royalty on a monthly basis. The terms of the technology licensing agreement state that if Entity A terminates the arrangement without cause, Entity A is required to pay a penalty of CU30m. Neither Entity A nor Entity B has recognised any assets or liabilities related to the licence agreement.

The fair value of the licence agreement is CU120m, which includes CU20m for the future royalties which are below current market rates. Therefore, the licence agreement is unfavourable to Entity A and favourable to Entity B. The fair value of the identifiable net assets and liabilities of Entity B at the date of the business combination is CU320m, including the fair value of the licence agreement of CU120m.

The reacquired licence right is recognised at CU100m, being the licence's fair value at current market rates (CU120m - CU20m). Entity A recognises a loss on settlement of the agreement at the lower of:

- CU20m, which is the amount by which the royalty is unfavourable to Entity A compared to market terms.
- CU30m, which is the amount that Entity A would have to pay to terminate the right at the date of acquisition.

A loss is therefore recognised of CU20m. The amount of consideration transferred for the acquisition of Entity B is decreased accordingly to CU330m (CU350m - CU20m).

Entity A accounts for the acquisition of Entity B and the reacquired technology licensing agreement as follows:

			CU million	CU million
Dr	Net identifiable assets and liabilities acquired (CU320m - CU20m)		300	
Dr	Goodwill (CU330m - CU300m)		30	
Dr	Loss on settlement of technology licensing agreement		20	
	Cr	Cash - consideration for business combination (CU350m - CU20m)		330
	Cr	Cash - effective settlement of technology licensing agreement		20

11.2 Remuneration for future services of employees or former owners of the acquiree

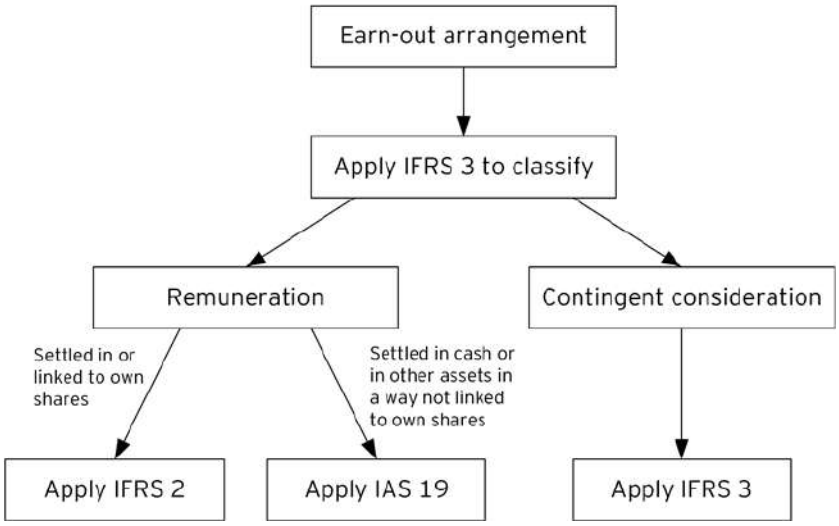
A transaction that remunerates employees or former owners of the acquiree for future services is excluded from the business combination accounting and accounted for separately. *[IFRS 3.52]*.

11.2.1 Arrangements for contingent payments to employee selling shareholders

Whether arrangements for contingent payments to employee selling shareholders are contingent consideration to be included in the measure of the consideration transferred (see section 7.1 above) or are separate transactions to be accounted for as remuneration, will depend on the nature of the arrangements.

Such payments are also often referred to as 'earn-outs'. The approach to accounting for earn-out arrangements is summarised in the diagram below:

Approach to accounting for earn-outs



Understanding the reasons why the acquisition agreement includes a provision for contingent payments, who initiated the arrangement and when the parties entered into the arrangement may be helpful in assessing the nature of the arrangement. *[IFRS 3.B54]*. If it is not clear whether the arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or is a transaction separate from the business combination, there are a number of indicators in IFRS 3. *[IFRS 3.B55]*. These are summarised in the table below:

Indicators to consider when classifying payments as remuneration or contingent consideration

Lead to conclusion as remuneration	Indicators to consider when assessing terms of additional payments to selling shareholders that remain employees	Lead to conclusion as contingent consideration
Payments forfeited on termination	Continuing employment	Payments are not affected by termination
Coincides with or exceeds payment period	Duration of required employment	Shorter than the payment period
Not reasonable compared to other key employees of the group	Level of other elements of remuneration	Reasonable compared to the other key employees of the group
Other non-employee selling shareholders receive lower additional payments (on a per share basis)	Incremental payments to other non-employee selling shareholders	Other non-employee selling shareholders receive similar additional payments (on a per share basis)
Selling shareholders remaining as employees owned substantially all shares (in substance profit-sharing)	Number of shares owned when all selling shareholders receive same level of additional consideration (on a per share basis)	Selling shareholders remaining as employees owned only a small portion of shares
Formula for additional payment consistent with other profit-sharing arrangements rather than the valuation approach	Linkage of payments to valuation of business	Initial consideration at lower end of range of business valuation, and formula for additional payment linked to the valuation approach
Formula is based on performance, such as percentage of earnings	Formula for additional payments	Formula is based on a valuation formula, such as multiple of earnings, indicating it is connected to a business valuation

Although these points are generally indicators, continuing employment is an exception. It is categorically stated that "a contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is remuneration for post-combination services". *[IFRS 3.B55(a)]*. In January 2013, the IFRS IC clarified that this conclusion assumes that the service condition is substantive.[18] That conclusion was reaffirmed by the IFRS IC in April 2024.[19] With this exception, no other single indicator is likely to be conclusive as to the accounting treatment.

The guidance in IFRS 3 expands the points in the table above, but also notes that:

- The relevant terms of continuing employment may be included in an employment agreement, acquisition agreement or some other document. *[IFRS 3.B55(a)]*.
- Other pre-acquisition ownership interests may be relevant, e.g., those held by parties related to selling shareholders such as family members, who continue as key employees. *[IFRS 3.B55(e)]*.

When some or all of the arrangement is accounted for as contingent consideration, the requirements in IFRS 3 discussed in section 7.1 above are applied. If some or all of the arrangement is post-combination remuneration, it is accounted for under IFRS 2 if it represents a share-based payment transaction (see Chapter 30) or otherwise under IAS 19 (see Chapter 31).

The requirements for contingent payments to employees are shown in the following Illustration. *[IFRS 3.IE58, IFRS 3.IE59, IFRS 3.IE60]*.

Illustration 11-6: Contingent payments to employees

Entity B appointed a candidate as its new CEO under a ten-year contract. The contract requires Entity B to pay the candidate CU5m if Entity B is acquired before the contract expires. Entity A acquires Entity B eight years later. The CEO was still employed at the acquisition date and will receive the additional payment under the existing contract.

In this example, Entity B entered into the employment agreement before the negotiations of the combination began, and the purpose of the agreement was to obtain the services of the CEO. Thus, there is no evidence that the agreement was arranged primarily to benefit Entity A or the combined entity. Therefore, the liability to pay CU5m is accounted for as part of the acquisition of Entity B.

In other circumstances, Entity B might enter into a similar agreement with the CEO at the suggestion of Entity A during the negotiations for the business combination. If so, the primary purpose of the agreement might be to provide severance pay to the CEO, and the agreement may primarily benefit Entity A or the combined entity rather than Entity B or its former owners. In that situation, Entity A accounts for the liability to pay the CEO in its post-combination financial statements separately from the acquisition of Entity B.

Not all arrangements relate to judgements about whether an arrangement is remuneration or contingent consideration and other agreements and relationships with selling shareholders may have to be considered. The terms of other arrangements and the income tax treatment of contingent payments may indicate that contingent payments are attributable to something other than consideration for the acquiree. These can include agreements not to compete, executory contracts, consulting contracts and property lease agreements. For example, the acquirer might enter into a property lease arrangement with a significant selling shareholder. If the lease payments specified in the lease contract are significantly below market, some or all of the contingent payments to the lessor (the selling shareholder) required by a separate arrangement for contingent payments might be, in substance, payments for the use of the leased property that the acquirer is required to recognise separately in its post-combination financial statements. In contrast, if the lease contract specifies lease payments that are consistent with market terms for the leased property, the arrangement for contingent payments to the selling shareholder may be contingent consideration in the business combination.

11.2.2 Share-based payment awards exchanged for awards held by the acquiree's employees

The acquirer may exchange share-based payment awards (i.e., replacement awards) for awards held by employees of the acquiree.

If the acquirer replaces any acquiree awards, the consideration transferred will include some or all of any replacement awards. Any amount not included in the consideration transferred is treated as a post-combination remuneration expense.

18 *IFRIC Update*, January 2013, available on the IFRS Foundation's website.

19 Agenda Decision, April 2024, available on the IFRS Foundation's website.

IFRS 3 includes application guidance dealing with replacement awards. *[IFRS 3.B56-B62]*. Replacement awards are modifications of share-based payment awards in accordance with IFRS 2. Discussion of this guidance, including illustrative examples that reflect the substance of the Illustrative Examples that accompany IFRS 3, *[IFRS 3.IE61-IE71]*, is dealt with in Chapter 30 at section 11.2.

11.3 Reimbursement for paying the acquirer's acquisition-related costs

The third example of a separate transaction is included to mitigate concerns about potential abuse. IFRS 3 requires the acquirer to expense its acquisition-related costs - they are not included as part of the consideration transferred for the acquiree. This means that they are not reflected in the computation of goodwill. As a result, acquirers might modify transactions to avoid recognising those costs as expenses. They might disguise reimbursements, e.g., a buyer might ask a seller to make payments to third parties on its behalf; the seller might agree to make those payments if the total amount to be paid to it is sufficient to reimburse it for payments made on the buyer's behalf. *[IFRS 3.BC370]*.

The same would apply if the acquirer asks the acquiree to pay some or all of the acquisition-related costs on its behalf and the acquiree has paid those costs before the acquisition date, so that at the acquisition date the acquiree does not record a liability for them. *[IFRS 3.BC120]*. This transaction has been entered into on behalf of the acquirer, or primarily for the benefit of the acquirer.

11.4 Restructuring plans

One particular area that could be negotiated between the acquirer and the acquiree or its former owners is a restructuring plan relating to the acquiree's activities.

How we see it

In our view, a restructuring plan that is implemented by or at the request of the acquirer is not a liability of the acquiree as at the date of acquisition and cannot be part of the accounting for the business combination under the acquisition method, regardless of whether the combination is contingent on the plan being implemented.

IFRS 3 states that costs the acquirer expects but is not obliged to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree's employees are not liabilities at the acquisition date. Therefore, the acquirer does not recognise those costs as part of applying the acquisition method. *[IFRS 3.11]*. Furthermore, as discussed in section 5.2 above, an acquirer recognises liabilities for restructuring or exit activities acquired in a business combination only if they meet the definition of a liability at the acquisition date. *[IFRS 3.BC132]*.

A restructuring plan that is decided upon or put in place between the date the negotiations for the business combination started and the date the business combination is completed is only likely to be accounted for as a pre-combination transaction of the acquiree if there is no evidence that the acquirer initiated the restructuring and the plan makes commercial sense, even if the business combination does not proceed.

If a plan initiated by the acquirer is implemented without an explicit link to the business combination, this may indicate that control has already passed to the acquirer at this earlier date.

This is discussed further in the following Illustration:

Illustration 11-7: Recognition or otherwise of a restructuring liability as part of a business combination

The acquirer and the acquiree (or the owners of the acquiree) enter into an arrangement before the acquisition that requires the acquiree to restructure its workforce or activities. They intend to develop the main features of a plan that involves terminating or reducing the acquiree's activities and to announce the plan's main features to those affected by it so as to raise a valid expectation that the plan will be implemented. The combination is contingent on the plan being implemented.

Does such a restructuring plan that the acquiree puts in place simultaneously with the business combination, and which will become effective upon the change in control, but which was implemented by or at the request of the acquirer qualify for inclusion as part of the liabilities assumed in accounting for the business combination?

Paragraph B50 of the Application Guidance to IFRS 3 gives some guidance on determining what is part of the business combination and requires the acquirer to consider the following factors:

- *The reason:*

  A restructuring plan implemented at the request of the acquirer is presumably arranged primarily for the benefit of the acquirer or the combined entity because of the possible redundancy expected to arise from the combination of activities of the acquirer with activities of the acquiree, e.g., capacity redundancy leading to closure of the acquiree's facilities.

- *Who initiated:*

  If such a plan is the result of a request by the acquirer, it means that the acquirer is expecting future economic benefits from the restructuring.

- *The timing:*

  The restructuring plan is usually discussed during the negotiations; therefore, it is contemplated from the perspective of the future combined entity.

Accordingly, a restructuring plan that is implemented as a result of an arrangement between the acquirer and the acquiree is not a liability of the acquiree at the date of acquisition and cannot be part of the accounting for the business combination under the acquisition method.

Does the answer differ if the combination is not contingent on the plan being implemented?

The answer applies regardless of whether the combination is contingent on the plan being implemented. A plan initiated by the acquirer will most likely not make commercial sense from the acquiree's perspective absent the business combination. For example, retrenchments of staff might only be necessary if the entities are combined. In that case, IFRS 3.B50 indicates that this is an arrangement to be accounted for separately, rather than as part of the business combination exchange. This arrangement may also indicate that control of the acquiree has already passed to the acquirer, otherwise it would be difficult to understand why the acquiree would enter into an arrangement that makes little or no commercial sense.

11.5 Acquisition of non-controlling interest in connection with a business combination

In some situations, a business combination will result in the indirect acquisition of a non-controlling interest i.e., the acquiree is the owner of a non-controlling interest in an acquirer's existing subsidiary.

How we see it

In such situations, we believe that the transaction consists of the following two elements that require separate accounting:

- The acquisition of a business under IFRS 3

  And

- The acquisition of a non-controlling interest under IFRS 10

We believe that the fair value of the consideration transferred is allocated to each element on a relative fair value basis.

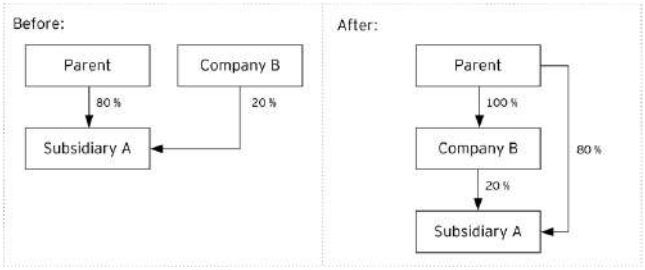
Because the acquirer retains control of its existing subsidiary, the indirect acquisition of the non-controlling interest is accounted for as an equity transaction. That is, any difference between the fair value of the allocated consideration transferred and the carrying amount of the non-controlling interest is recognised as an adjustment to equity in the acquirer's consolidated financial statements.

Illustration 11-8 below demonstrates this concept. Transactions with a non-controlling interest holder are further discussed in Chapter 8 at section 4.

Illustration 11-8: Indirect acquisition of non-controlling interest in connection with a business combination

Parent owns an 80% controlling interest in Subsidiary A. Company B holds the remaining 20% non-controlling interest in Subsidiary A. Parent pays CU600 million in cash to acquire all of the shares of Company B and therefore gains control over Company B, while still retaining control of Subsidiary A.

The following diagram depicts the corporate structure before and after the transaction:



Relevant fair value and book value information (in CU millions) is as follows:

	CU million
Fair value of non-controlling interest in Subsidiary A	120
Carrying amount of non-controlling interest in Parent's financial statements	80
Fair value of Company B (inclusive of goodwill but excluding the fair value of Company B's investment in Subsidiary A)	480
Fair value of Company B's identifiable net assets acquired (excluding goodwill and its investment in Subsidiary A)	460

In calculating the allocation on a relative fair value basis of the fair value of the consideration transferred for the acquisition of a business under IFRS 3 and the acquisition of a non-controlling interest under IFRS 10, the Parent allocates CU480m (calculated as (CU480m ÷ CU600m) × CU600m) to the acquisition of Company B and 120m (calculated as (CU120m ÷ CU600m) × CU600m) to the acquisition of the non-controlling interest in Subsidiary A.

Accounting for the business combination

Under IFRS 3, Parent calculates goodwill relating to the acquisition of Company B as follows (amounts in CU millions):

	CU million
Consideration transferred	480
Less: Fair value of Company B's net identifiable assets acquired (excluding goodwill)	(460)
Goodwill	**20**

Accounting for the acquisition of non-controlling interest

Under IFRS 10, the increase in Parent's ownership interest in Subsidiary A from 80% to 100% is accounted for as an equity transaction. As a result, the carrying amounts of the controlling and non-controlling interests are adjusted to reflect the changes in their relative interests in Subsidiary A. Any difference between the fair value of the consideration transferred and the carrying amount of the non-controlling interest is recognised directly in equity and attributed to Parent. Parent calculates the adjustment to recognise in equity the difference between the fair value and carrying amount of the non-controlling interest as follows (amounts in CU millions):

	CU million
Consideration transferred for acquisition of non-controlling interest	120
Less: Carrying value of non-controlling interest	(80)
Adjustment to controlling interest (Parent's) retained earnings	40

Consolidation Entry

Parent records the following journal entry to account for the transaction (in CU millions):

		CU million	CU million
Dr	Net assets acquired	460	
Dr	Goodwill	20	
Dr	Non-controlling interest	80	
Dr	Retained earnings of Parent	40	
	Cr Cash		600

12 Measurement period

Extract from IFRS 3

45 **If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the acquirer shall report in its financial statements provisional amounts for the items for which the accounting is incomplete. During the measurement period, the acquirer shall retrospectively adjust the provisional amounts recognised at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognised as of that date. During the measurement period, the acquirer shall also recognise additional assets or liabilities if new information is obtained about facts and circumstances that existed as of the acquisition date and, if known, would have resulted in the recognition of those assets and liabilities as of that date. The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. However, the measurement period shall not exceed one year from the acquisition date.**

IFRS 3 contains a 'measurement period' which provides the acquirer with a reasonable period of time to obtain the information necessary to identify and measure all of the various components of the business combination as at the acquisition date in accordance with the standard, i.e.:

- The identifiable assets acquired, liabilities assumed and any non-controlling interest in the acquiree
- The consideration transferred for the acquiree (or the other amount used in measuring goodwill)
- In a business combination achieved in stages, the equity interest in the acquiree previously held by the acquirer
- The resulting goodwill or gain on a bargain purchase *[IFRS 3.46]*

For most business combinations, the main area where information will need to be obtained is in relation to the acquiree, i.e., the identifiable assets acquired and the liabilities assumed, particularly as these may include items that the acquiree had not previously recognised as assets and liabilities in its financial statements and, in most cases, need to be measured at their acquisition-date fair values (see section 5 above). Information may also need to be obtained in determining the fair value of any contingent consideration arrangements (see section 7.1 above).

The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as at the acquisition date or learns that it cannot obtain more information. The measurement period cannot exceed one year from the acquisition date. *[IFRS 3.45]*. The Basis for Conclusions notes that in placing this constraint it was "concluded that allowing a measurement period longer than one year would not be especially helpful; obtaining reliable information about circumstances and conditions that existed more than a year ago is likely to become more difficult as time passes. Of course, the outcome of some contingencies and similar matters may not be known within a year. But the objective of the measurement period is to provide time to obtain the information necessary to measure the fair value of the item as at the acquisition date. Determining the ultimate settlement amount of a contingency or other item is not necessary. Uncertainties about the timing and amount of future cash flows are part of the measure of the fair value of an asset or liability." *[IFRS 3.BC392]*.

Under IFRS 3, if the initial accounting is incomplete at the end of the reporting period in which the combination occurs, the acquirer will include provisional amounts. *[IFRS 3.45]*. IFRS 3 specifies particular disclosures about those items (see section 16.2 below). *[IFRS 3.BC393]*. In addition, in such circumstances, impairment testing at the end of the reporting period, of goodwill acquired during that reporting period requires specific considerations, which are discussed in Chapter 21 at section 8.1.5.

How we see it

Although IFRS 3.45 refers to the initial accounting being 'incomplete by the end of the reporting period' and the acquirer reporting 'provisional amounts for the items for which the accounting is incomplete', it is clear from the Illustrative Examples accompanying IFRS 3 that this means that the initial accounting is incomplete at the date at which the financial statements for that period are authorised for issue (see Illustration 12-1 in section 12.1 below). Thus, any items that are finalised up to that date must be reflected in the initial accounting.

12.1 Adjustments made during measurement period to provisional amounts

During the measurement period, the acquirer retrospectively adjusts the provisional amounts recognised at the acquisition date to reflect new information obtained about facts and circumstances at the acquisition date that, if known, would have affected the measurement of the amounts recognised.

Similarly, the acquirer recognises additional assets or liabilities if new information is obtained about facts and circumstances at the acquisition date and, if known, would have resulted in the recognition of those assets and liabilities as at that date. *[IFRS 3.45]*.

IFRS 3 requires the acquirer to consider all pertinent factors to distinguish information that retrospectively adjusts the provisional amounts from information arising from events that occurred after the acquisition date. Factors to be considered include the date when additional information is obtained and whether the acquirer can identify a reason for a change to provisional amounts. Clearly, information obtained shortly after the acquisition date is more likely to reflect circumstances that existed at the acquisition date than information obtained several months later. If the acquirer sells an asset to a third party shortly after the acquisition date for an amount that is significantly different to its provisional fair value, this is likely to indicate an 'error' in the provisional amount unless there is an intervening event that changes its fair value. *[IFRS 3.47]*.

Adjustments to provisional amounts that are made during the measurement period are recognised as if the accounting for the business combination had been completed at the acquisition date. This may be in a prior period, so the acquirer revises its comparative information as needed. This may mean making changes to depreciation, amortisation or other income effects. *[IFRS 3.49]*. These requirements are shown in the following Illustration, which is based on one included within the Illustrative Examples accompanying IFRS 3. *[IFRS 3.IE50, IFRS 3.IE51, IFRS 3.IE52, IFRS 3.IE53]*. The deferred tax implications are ignored.

Illustration 12-1: Adjustments made during measurement period to provisional amounts

Entity A acquired Entity B on 30 September 20X1. Entity A sought an independent valuation for an item of property, plant and equipment acquired in the combination. However, the valuation was not complete by the time Entity A authorised its financial statements for issue for the year ended 31 December 20X1. In its 20X1 annual financial statements, Entity A recognised a provisional fair value for the asset of CU30,000. At the acquisition date, the item of property, plant and equipment had a remaining useful life of five years.

Five months after the acquisition date (and after the date on which the financial statements were issued), Entity A received the independent valuation, which estimated the asset's acquisition-date fair value at CU40,000.

In its financial statements for the year ended 31 December 20X2, Entity A retrospectively adjusts the 20X1 prior year information as follows:

(a) The carrying amount of property, plant and equipment as at 31 December 20X1 is increased by CU9,500. That adjustment is measured as the fair value adjustment at the acquisition date of CU10,000 less the additional depreciation that would have been recognised if the asset's fair value at the acquisition date had been recognised from that date (CU500 for three months' depreciation).

(b) The carrying amount of goodwill as at 31 December 20X1 is decreased by CU10,000.

(c) Depreciation expense for 20X1 is increased by CU500.

Entity A disclosed in its 20X1 financial statements that the initial accounting for the business combination had not been completed because the independent valuation for the item of property, plant and equipment had not yet been received.

In its 20X2 financial statements, Entity A will disclose the amounts and explanations of the adjustments to the provisional values recognised during the current reporting period. Therefore, Entity A will disclose that the 20X1 comparative information is adjusted retrospectively to increase the fair value of the item of property, plant and equipment at the acquisition date by CU10,000, resulting in an increase to property, plant and equipment of CU9,500, offset by a decrease in goodwill of CU10,000 and an increase in depreciation expense of CU500.

The example below illustrates that adjustments during the measurement period are also made when information is received about the existence of an asset as at the acquisition date:

Illustration 12-2: Identification of an asset during measurement period

Entity C acquired Entity D on 30 November 20X1. Entity C engaged an independent appraiser to assist with the identification and determination of fair values to be assigned to the acquiree's assets and liabilities. However, the appraisal was not finalised by the time Entity C authorised its financial statements for issue for the year ended 31 December 20X1, and therefore the amounts recognised in its 20X1 annual financial statements were on a provisional basis.

Six months after the acquisition date, Entity C received the independent appraiser's final report, in which it was identified by the independent appraiser that the acquiree had an intangible asset with a fair value at the date of acquisition of CU20,000. As this had not been identified at the time when Entity C was preparing its 20X1 annual financial statements, no value had been included for that asset.

In its financial statements for the year ended 31 December 20X2, Entity C retrospectively adjusts the prior year information to reflect the recognition of this intangible asset.

Although a change in the provisional amount recognised for an identifiable asset will usually mean a corresponding decrease or increase in goodwill, new information obtained could affect another identifiable asset or liability. For example, if the acquirer assumed a liability to pay damages relating to an accident in one of the acquiree's facilities, part or all of which was covered by the acquiree's liability insurance policy, new information during the measurement period about the fair value of the liability would affect goodwill. This adjustment to goodwill would be offset, in whole or in part, by a corresponding adjustment resulting from a change to the provisional amount recognised for the claim receivable from the insurer. *[IFRS 3.48]*. Similarly, if there is a non-controlling interest in the acquiree, and this is measured based on the proportionate share of the identifiable net assets of the acquiree (see section 8.2 above), any adjustments to those assets that had initially been determined on a provisional basis will be offset by the proportionate share attributable to the non-controlling interest.

12.2 Adjustments made after the end of the measurement period

After the end of the measurement period, the acquirer can only revise the accounting for a business combination to correct an error in accordance with IAS 8. *[IFRS 3.50]*. This would probably be the case only if the original accounting was based on a misinterpretation of the facts which were available at the time; it would not apply simply because new information had come to light which changed the acquiring management's view of the value of the item in question.

Adjustments after the end of the measurement period are not made for the effect of changes in estimates. In accordance with IAS 8, the effect of a change in estimate is recognised in current and future periods (see Chapter 3 at section 4.5).

13 Subsequent measurement and accounting

Extract from IFRS 3

54 **In general, an acquirer shall subsequently measure and account for assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination in accordance with other applicable IFRSs for those items, depending on their nature. However, this IFRS provides guidance on subsequently measuring and accounting for the following assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination:**

(a) reacquired rights;

(b) contingent liabilities recognised as of the acquisition date;

(c) indemnification assets; and

(d) contingent consideration.

Paragraph B63 provides related application guidance.

Assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination are usually accounted for in accordance with the applicable IFRS accounting standards. However, there is specific guidance on subsequent measurement of, and accounting for, the following:

- Reacquired rights (see section 5.6.5 above)
- Contingent liabilities recognised as at the acquisition date (see section 5.6.1.B above)
- Indemnification assets (see section 5.6.4 above)
- Contingent consideration (see section 7.1.3 above) *[IFRS 3.54]*

Other IFRS accounting standards provide guidance on subsequent measurement and accounting: *[IFRS 3.B63]*

- IAS 38 prescribes the accounting for identifiable intangible assets acquired in a business combination (see Chapter 18), although accounting for some intangible assets is not prescribed by IAS 38 but by other IFRS accounting standards (see Chapter 18 at section 2). *[IFRS 3.B39]*. Goodwill is measured at the amount recognised at the acquisition date less any accumulated impairment losses, measured in accordance with IAS 36 (see Chapter 21 at section 8).
- IFRS 17 provides guidance on the initial and subsequent measurement of a group of contracts within the scope of IFRS 17 acquired in a business combination (see Chapter 51).
- IAS 12 prescribes the subsequent accounting for deferred tax assets (including unrecognised deferred tax assets) and liabilities acquired in a business combination (see Chapter 29).
- IFRS 2 provides guidance on subsequent measurement and accounting for the portion of replacement share-based payment awards issued by an acquirer that are attributable to employees' future services (see Chapter 30 at section 11).
- IFRS 10 provides guidance on accounting for changes in a parent's ownership interest in a subsidiary after control is obtained (see Chapter 8).

14 Reverse acquisitions

Extract from IFRS 3

B19 A reverse acquisition occurs when the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes on the basis of the guidance in paragraphs B13-B18. The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition. For example, reverse acquisitions sometimes occur when a private operating entity wants to become a public entity but does not want to register its equity shares. To accomplish that, the private entity will arrange for a public entity to acquire its equity interests in exchange for the equity interests of the public entity. In this example, the public entity is the **legal acquirer** because it issued its equity interests, and the private entity is the **legal acquiree** because its equity interests were acquired. However, application of the guidance in paragraphs B13-B18 results in identifying:

(a) the public entity as the **acquiree** for accounting purposes (the accounting acquiree); and

(b) the private entity as the **acquirer** for accounting purposes (the accounting acquirer).

The accounting acquiree must meet the definition of a business for the transaction to be accounted for as a reverse acquisition, and all of the recognition and measurement principles in this IFRS, including the requirement to recognise goodwill, apply.

The standard takes the view that the acquirer is usually the entity that issues its equity interests, but recognises that in some business combinations, so-called 'reverse acquisitions', the issuing entity is the acquiree.

Under IFRS 3, a reverse acquisition occurs when the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes based on the guidance in the standard as discussed in section 4.1 above. Perhaps more accurately, the legal acquiree must be identified as the acquirer for accounting purposes.

Reverse acquisitions sometimes occur when a private operating entity wants to become a public entity but does not want to register its equity shares. The private entity will arrange for a public entity to acquire its equity interests in exchange for the equity interests of the public entity. Although the public entity is the legal acquirer because it issued its equity interests, and the private entity is the legal acquiree because its equity interests were acquired, application of the guidance results in identifying: *[IFRS 3.B19]*

- The public entity as the acquiree for accounting purposes (the accounting acquiree)

  And

- The private entity as the acquirer for accounting purposes (the accounting acquirer)

If the transaction is accounted for as a reverse acquisition, all of the recognition and measurement principles in IFRS 3, including the requirement to recognise goodwill, apply. The standard also notes that the legal acquirer must meet the definition of a business (see section 3.2 above) for the transaction to be accounted for as a reverse acquisition, *[IFRS 3.B19]*, but does not say how to account for the transaction when the accounting acquiree is not a business. It clearly cannot be accounted for as an acquisition of the legal acquiree by the legal acquirer under the standard either, if the legal acquirer has not been identified as the accounting acquirer based on the guidance in the standard. This is discussed further in section 14.8 below.

14.1 Measuring the consideration transferred

The first item included in the computation of goodwill in a reverse acquisition is the consideration transferred by the accounting acquirer, i.e., the legal acquiree/subsidiary. In a reverse acquisition, the accounting acquirer usually issues no consideration for the acquiree; equity shares are issued to the owners of the accounting acquirer by the accounting acquiree. The fair value of the consideration transferred by the accounting acquirer is based on the number of equity interests the legal subsidiary would have had to issue to give the owners of the legal parent the same percentage equity interest in the combined entity that results from the reverse acquisition. The fair value of the number of equity interests calculated in that way is used as the fair value of consideration transferred. *[IFRS 3.B20]*.

These requirements are shown in the following Illustration, which is based on one included within the Illustrative Examples accompanying IFRS 3. *[IFRS 3.IE1-IE5]*.

Illustration 14-1: Reverse acquisition - calculating the fair value of the consideration transferred

Entity A, the entity issuing equity instruments and therefore the legal parent, is acquired in a reverse acquisition by Entity B, the legal subsidiary, on 30 September 20X2. The accounting for any income tax effects is ignored.

Statements of financial position of Entity A and Entity B immediately before the business combination are:

	Entity A	Entity B
	CU	CU
Current assets	500	700
Non-current assets	1,300	3,000
Total assets	**1,800**	**3,700**
Current liabilities	300	600
Non-current liabilities	400	1,100
Total liabilities	**700**	**1,700**
Owner's equity		
Issued equity		
100 ordinary shares	300	-
60 ordinary shares	-	600
Retained earnings	800	1,400
Total shareholders' equity	**1,100**	**2,000**

Other information

(a) On 30 September 20X2, Entity A issues 2.5 shares in exchange for each ordinary share of Entity B. All of Entity B's shareholders exchange their shares in Entity B. Therefore, Entity A issues 150 ordinary shares in exchange for all 60 ordinary shares of Entity B.

(b) The fair value of each ordinary share of Entity B at 30 September 20X2 is CU40. The quoted market price of Entity A's ordinary shares at that date is CU16.

(c) The fair values of Entity A's identifiable assets and liabilities at 30 September 20X2 are the same as their carrying amounts, except that the fair value of Entity A's non-current assets at 30 September 20X2 is CU1,500.

Calculating the fair value of the consideration transferred

As a result of Entity A (legal parent/accounting acquiree) issuing 150 ordinary shares, Entity B's shareholders own 60% of the issued shares of the combined entity (i.e., 150 of 250 issued shares). The remaining 40% are owned by Entity A's shareholders. If the business combination had taken the form of Entity B issuing additional ordinary shares to Entity A's shareholders in exchange for their ordinary shares in Entity A, Entity B would have had to issue 40 shares for the ratio of ownership interest in the combined entity to be the same. Entity B's shareholders would then own 60 out of the 100 issued shares of Entity B - 60% of the combined entity.

As a result, the fair value of the consideration effectively transferred by Entity B and the group's interest in Entity A is CU1,600 (i.e., 40 shares each with a fair value of CU40).

The fair value of the consideration effectively transferred is calculated based on the most reliable measure. In this example, the quoted market price of Entity A's shares provides a more reliable basis for measuring the consideration effectively transferred than the estimated fair value of the shares in Entity B, and the consideration is measured using the market price of Entity A's shares - 100 shares with a fair value per share of CU16, i.e., CU1,600.

The final paragraph in the above example is based on the requirements of IFRS 3.33, i.e., "In a business combination in which the acquirer and the acquiree (or its former owners) exchange only equity interests, the acquisition-date fair value of the acquiree's equity interests may be more reliably measurable than the acquisition-date fair value of the acquirer's equity interests. If so, the acquirer determines the amount of goodwill by using the acquisition-date fair value of the acquiree's equity interests instead of the acquisition-date fair value of the equity interests transferred." *[IFRS 3.33]*. In the above example, this did not result in a difference as the value of the consideration measured under both approaches was the same. However, the example above indicates that there is a quoted market price for Entity A's shares which is a more reliable basis than the fair value of Entity B's shares. Therefore, if the quoted market price of Entity A's shares had been, say, CU14 per share, the fair value of the consideration effectively transferred would have been measured at CU1,400.

14.2 Measuring goodwill

As there is no non-controlling interest in the accounting acquiree, and assuming that the accounting acquirer had no previously held equity interest in the accounting acquiree, goodwill is measured as the excess of (a) over (b) below:

(a) The consideration effectively transferred (generally measured at acquisition-date fair value) by the accounting acquirer, i.e., the legal subsidiary.

(b) The net of the acquisition-date fair values (or other amounts recognised in accordance with the requirements of the standard) of the identifiable assets acquired and the liabilities assumed of the accounting acquiree, i.e., the legal parent.

Illustration 14-2: Reverse acquisition - measuring goodwill (1)

Using the facts in Illustration 14-1 in section 14.1 above, this results in goodwill of CU300, measured as follows:

	CU	CU
Consideration effectively transferred by Entity B		1,600
Net recognised values of Entity A's identifiable assets and liabilities:		
Current assets	500	
Non-current assets	1,500	
Current liabilities	(300)	
Non-current liabilities	(400)	
		1,300
Goodwill		300

Illustration 14-3: Reverse acquisition - measuring goodwill (2)

If Illustration 14-2 above had been based on the same facts as Illustration 14-1 in section 14.1 above, except that the quoted market price of Entity A's shares had been CU14 per share, the fair value of the consideration effectively transferred is CU1,400, resulting in goodwill of CU100.

14.3 Preparation and presentation of consolidated financial statements

Although the accounting for the reverse acquisition reflects the legal subsidiary as being the accounting acquirer, the consolidated financial statements are issued in the name of the legal parent/accounting acquiree. In some cases, a reverse acquisition may be immediately followed by a legal merger between the legal parent and subsidiary. This is considered further in Chapter 9 at section 4.4.3.B. Consequently, the financial statements have to be described in the notes as a continuation of the financial statements of the legal subsidiary/accounting acquirer, with one adjustment, which is to adjust retrospectively the accounting acquirer's legal capital to reflect the legal capital of the accounting acquiree. Comparative information presented in those consolidated financial statements is therefore that of the legal subsidiary/accounting acquirer, not that originally presented in the previous financial statements of the legal parent/accounting acquiree as adjusted to reflect the legal capital of the legal parent/accounting acquiree. *[IFRS 3.B21]*.

The consolidated financial statements reflect:

(a) The assets and liabilities of the legal subsidiary/accounting acquirer recognised and measured at their pre-combination carrying amounts, i.e., not at their acquisition-date fair values.

(b) The assets and liabilities of the legal parent/accounting acquiree recognised and measured in accordance with IFRS 3, i.e., generally at their acquisition-date fair values.

(c) The retained earnings and other equity balances of the legal subsidiary/accounting acquirer before the business combination, i.e., not those of the legal parent/accounting acquiree.

(d) The amount recognised as issued equity instruments in the consolidated financial statements determined by adding the issued equity of the legal subsidiary/accounting acquirer outstanding immediately before the business combination to the fair value of the legal parent/accounting acquiree. However, the equity structure (i.e., the number and type of equity instruments issued) reflects the equity structure of the legal parent/accounting acquiree, including the equity instruments issued by the legal parent to effect the combination. Accordingly, the equity structure of the legal subsidiary/accounting acquirer is restated using the exchange ratio established in the acquisition agreement to reflect the number of shares of the legal parent/accounting acquiree issued in the reverse acquisition.

(e) The non-controlling interest's proportionate share of the legal subsidiary's/accounting acquirer's pre-combination carrying amounts of retained earnings and other equity interests (as discussed in section 14.4 below). *[IFRS 3.B22]*.

(f) The income statement for the current period reflects that of the legal subsidiary/accounting acquirer for the full period together with the post-acquisition results of the legal parent/accounting acquiree based on the attributed fair values.

How we see it

It is unclear why the application guidance in (d) above refers to using 'the fair value of the legal parent/accounting acquiree', when, as discussed previously in section 14.1 above, the guidance for determining 'the fair value of the consideration effectively transferred' uses a different method of arriving at the value of the consideration given. The amount recognised as issued equity must reflect whichever value has been determined for the consideration effectively transferred.

Continuing with Illustration 14-1 in section 14.1 above, the consolidated statement of financial position immediately after the business combination will be as follows:

Illustration 14-4: Reverse acquisition - consolidated statement of financial position immediately after the business combination

Using the facts in Illustration 14-1 in section 14.1 above, the consolidated statement of financial position immediately after the date of the business combination is as follows (the intermediate columns for Entity B (legal subsidiary/accounting acquirer) and Entity A (legal parent/accounting acquiree) are included to show the workings):

	Entity B	Entity A	Consolidated
	Book values	Fair values	
	CU	CU	CU
Current assets	700	500	1,200
Non-current assets	3,000	1,500	4,500
Goodwill	-	300	300
Total assets	**3,700**	**2,300**	**6,000**
Current liabilities	600	300	900
Non-current liabilities	1,100	400	1,500
Total liabilities	**1,700**	**700**	**2,400**
Owner's equity			
Issued equity			
250 ordinary shares	600	1,600	2,200
Retained earnings	1,400	-	1,400
Total shareholders' equity	**2,000**	**1,600**	**3,600**

The amount recognised as issued equity interests in the consolidated financial statements (CU2,200) is determined by adding the issued equity of the legal subsidiary/accounting acquirer immediately before the business combination (CU600) and the fair value of the consideration effectively transferred (CU1,600). However, the equity structure appearing in the consolidated financial statements (i.e., the number and type of equity interests issued) must reflect the equity structure of the legal parent/accounting acquiree, including the equity interests issued by the legal parent/accounting acquiree to effect the combination. As noted above, we believe that the amount recognised as issued equity must reflect whichever value has been determined for the consideration effectively transferred.

The application guidance in IFRS 3 only deals with reverse acquisition accounting in the consolidated financial statements; no mention is made as to the accounting in the separate financial statements of the legal parent/accounting acquiree. However, the previous version of IFRS 3 indicated that reverse acquisition accounting applies only in the consolidated financial statements, and that in the legal parent's separate financial statements, the investment in the legal subsidiary is accounted for in accordance with certain superseded requirements in IAS 27. (See Chapter 9 at section 2.1.1.G for further discussion). *[IFRS 3(2007).B8]*.

14.4 Non-controlling interest

In a reverse acquisition, some of the owners of the legal subsidiary/accounting acquirer might not exchange their equity instruments for equity instruments of the legal parent/accounting acquiree. Those owners are required to be treated as a non-controlling interest in the consolidated financial statements after the reverse acquisition. This is because the owners of the legal subsidiary that do not exchange their equity instruments for equity instruments of the legal parent have an interest only in the results and net assets of the legal subsidiary, and not in the results and net assets of the combined entity. Conversely, even though the legal parent is the acquiree for accounting purposes, the owners of the legal parent have an interest in the results and net assets of the combined entity. *[IFRS 3.B23]*.

As indicated in section 14.3 above, the assets and liabilities of the legal subsidiary/accounting acquirer are recognised and measured in the consolidated financial statements at their pre-combination carrying amounts. Therefore, in a reverse acquisition the non-controlling interest reflects the non-controlling shareholders' proportionate interest in the pre-combination carrying amounts of the legal subsidiary's net assets even if the non-controlling interests in other acquisitions are measured at fair value at the acquisition date. *[IFRS 3.B24]*.

These requirements are shown in the following Illustration, which is based on one included within the Illustrative Examples accompanying IFRS 3. *[IFRS 3.IE11-IE15]*.

Illustration 14-5: Reverse acquisition - non-controlling interest

This example uses the same facts as in Illustration 14-1 above, except that only 56 of Entity B's 60 ordinary shares are exchanged. Because Entity A issues 2.5 shares in exchange for each ordinary share of Entity B, Entity A issues only 140 (rather than 150) shares. As a result, Entity B's shareholders own 58.3% of the issued shares of the combined entity (i.e., 140 shares out of 240 issued shares).

As in Illustration 14-1 above, the fair value of the consideration transferred for Entity A, the accounting acquiree, is calculated by assuming that the combination had been effected by Entity B issuing additional ordinary shares to the shareholders of Entity A in exchange for their ordinary shares in Entity A. That is because Entity B is the accounting acquirer, and IFRS 3 requires the acquirer to measure the consideration exchanged for the accounting acquiree (see section 14.1 above).

In calculating the number of shares that Entity B would have had to issue, the non-controlling interest is excluded from the calculation. The majority shareholders own 56 shares of Entity B. For that to represent a 58.3% ownership interest, Entity B would have had to issue an additional 40 shares. The majority shareholders would then own 56 out of the 96 issued shares of Entity B and therefore 58.3% of the combined entity.

As a result, the fair value of the consideration transferred for Entity A, the accounting acquiree, is CU1,600 (i.e., 40 shares, each with a fair value of CU40). That is the same amount as when all 60 of Entity B's shareholders tender all 60 of its ordinary shares for exchange (see Illustration 14-1 above). The recognised amount of the group's interest in Entity A, the accounting acquiree, does not change if some of Entity B's shareholders do not participate in the exchange.

The non-controlling interest is represented by the 4 shares of the total 60 shares of Entity B that are not exchanged for shares of Entity A. Therefore, the non-controlling interest is 6.7%. The non-controlling interest reflects the proportionate interest of the non-controlling shareholders in the pre-combination carrying amounts of the net assets of Entity B, the legal subsidiary. Therefore, the consolidated statement of financial position is adjusted to show a non-controlling interest of 6.7% of the pre-combination carrying amounts of Entity B's net assets (i.e., CU134 or 6.7% of CU2,000).

The consolidated statement of financial position as at 30 September 20X2 (the date of the business combination) reflecting the non-controlling interest is as follows (the intermediate columns for Entity B (legal subsidiary/accounting acquirer), non-controlling interest and Entity A (legal parent/accounting acquiree) are included to show the workings):

	Entity B Book values	Non-controlling interest	Entity A Fair values	Consolidated
	CU	CU	CU	CU
Current assets	700	-	500	1,200
Non-current assets	3,000	-	1,500	4,500
Goodwill	-	-	300	300
Total assets	**3,700**	**-**	**2,300**	**6,000**
Current liabilities	600	-	300	900
Non-current liabilities	1,100	-	400	1,500
	1,700	**-**	**700**	**2,400**
Owner's equity				
Issued equity				
240 ordinary shares	600	(40)	1,600	2,160
Retained earnings	1,400	(94)	-	1,306
Non-controlling interest	-	134	-	134
	2,000	**-**	**1,600**	**3,600**

The non-controlling interest of CU134 has two components. The first component is the reclassification of the non-controlling interest's share of the accounting acquirer's retained earnings immediately before the acquisition (CU1,400 × 6.7% or CU93.80). The second component represents the reclassification of the non-controlling interest's share of the accounting acquirer's issued equity (CU600 × 6.7% or CU40.20).

14.5 Earnings per share

The equity structure, i.e., the number and type of equity instruments issued, in the consolidated financial statements following a reverse acquisition reflects the equity structure of the legal parent/accounting acquiree, including the equity instruments issued by the legal parent to effect the business combination. *[IFRS 3.B25]*.

When the legal parent is required by IAS 33 *Earnings per Share* to disclose earnings per share information (see Chapter 33 at section 2.2), then for the purpose of calculating the weighted average number of ordinary shares outstanding (the denominator of the earnings per share calculation) during the period in which the reverse acquisition occurs:

- The number of ordinary shares outstanding from the beginning of that period to the acquisition date is computed on the basis of the weighted average number of ordinary shares of the legal subsidiary/accounting acquirer outstanding during the period multiplied by the exchange ratio established in the acquisition agreement.

  And

- The number of ordinary shares outstanding from the acquisition date to the end of that period is the actual number of ordinary shares of the legal parent/accounting acquiree outstanding during that period. *[IFRS 3.B26]*.

The basic earnings per share disclosed for each comparative period before the acquisition date is calculated by dividing:

- The profit or loss of the legal subsidiary/accounting acquirer attributable to ordinary shareholders in each of those periods

  By

- The legal subsidiary/accounting acquirer's historical weighted average number of ordinary shares outstanding multiplied by the exchange ratio established in the acquisition agreement *[IFRS 3.B27]*

These requirements are shown in the following Illustration, which is based on one included within the Illustrative Examples accompanying IFRS 3. *[IFRS 3.IE9, IFRS 3.IE10]*.

Illustration 14-6: Reverse acquisition - earnings per share

This example uses the same facts as in Illustration 14-1 in section 14.1 above. Assume that Entity B's earnings for the annual period ended 31 December 20X1 were CU600, and that the consolidated earnings for the annual period ending 31 December 20X2 were CU800. Assume also that there was no change in the number of ordinary shares issued by Entity B (legal subsidiary/accounting acquirer) during the annual period ended 31 December 20X1 and during the period from 1 January 20X2 to the date of the reverse acquisition (30 September 20X2), nor by Entity A (legal parent, accounting acquiree) after that date.

Earnings per share for the annual period ended 31 December 20X2 is calculated as follows:

Number of shares deemed to be outstanding for the period from 1 January 20X2 to the acquisition date (i.e., the number of ordinary shares issued by Entity A (legal parent, accounting acquiree) in the reverse acquisition, or more accurately, the weighted average number of ordinary shares of Entity B (legal subsidiary/accounting acquirer) outstanding during the period multiplied by the exchange ratio established in the acquisition agreement (i.e., 60 × 2.5)	150
Number of shares of Entity A (legal parent/accounting acquiree) outstanding from the acquisition date to 31 December 20X2	250
Weighted average number of shares outstanding (150 × 9/12) + (250 × 3/12)	175
Earnings per share (CU800 ÷ 175)	CU4.57

The restated earnings per share for the annual period ending 31 December 20X1 is CU4.00 - being CU600 ÷ 150, i.e., the earnings of Entity B (legal subsidiary, accounting acquirer) for that period divided by the number of ordinary shares Entity A issued in the reverse acquisition (or more accurately, by the weighted average number of ordinary shares of Entity B (legal subsidiary/accounting acquirer) outstanding during the period multiplied by the exchange ratio established in the acquisition agreement, i.e., 60 × 2.5). Any earnings per share information for that period previously disclosed by either Entity A or Entity B is irrelevant.

14.6 Cash consideration

In some circumstances the combination may be effected whereby some of the consideration given by the legal acquirer (Entity A) to acquire the shares in the legal acquiree (Entity B) is cash.

Normally, the entity transferring cash consideration would be considered the acquirer. *[IFRS 3.B14]*. This is because, if a substantial part of the consideration is cash, the legal acquiree's shareholders will receive insufficient shares to dominate the voting of the legal acquirer and thus will not be able to dictate the selection of the board and management of the legal acquirer. However, despite the form of the consideration, the key determinant in identifying an acquirer is whether it has control over the other entity (see section 4.1 above).

Therefore, if there is evidence demonstrating that the legal acquiree, Entity B, has obtained control over Entity A by being exposed, or having rights, to variable returns from its involvement with Entity A and having the ability to affect those returns through its power over Entity A, Entity B is then the acquirer and the combination is accounted for as a reverse acquisition.

In that case, how is any cash paid accounted for?

One approach might be to treat the payment as a pre-acquisition transaction with a resulting reduction in the consideration and in net assets acquired (with no net impact on goodwill). However, we do not believe this is appropriate. Any consideration, whether cash or shares, transferred by Entity A cannot form part of the consideration transferred by the acquirer as Entity A is the accounting acquiree. As discussed in section 14.3 above, although the consolidated financial statements following a reverse acquisition are issued under the name of the legal parent (Entity A), they are described in the notes as a continuation of the financial statements of the legal subsidiary (Entity B).

How we see it

Since the consolidated financial statements are a continuation of Entity B's financial statements, in our view the cash consideration paid from Entity A (the accounting acquiree) to the shareholders of Entity B (the accounting acquirer) is accounted for as a distribution from the consolidated group to the shareholders of the accounting parent as at the combination date.

When a cash payment is made to effect the combination, the requirements of IFRS 3 need to be applied with care as shown in the following Illustration.

Illustration 14-7: Reverse acquisition effected with cash consideration

Entity A has 100,000 ordinary shares in issue, with a market price of CU2.00 per share, giving a market capitalisation of CU200,000. It acquires all of the shares in Entity B for a consideration of CU500,000 satisfied by the issue of 200,000 shares (with a value of CU400,000) and a cash payment of CU100,000 to Entity B's shareholders. Entity B has 200,000 shares in issue, with an estimated fair value of CU2.50 per share. After the combination Entity B's shareholders control the voting of Entity A and, as a result, have been able to appoint Entity B's directors and key executives to replace their Entity A counterparts. Accordingly, Entity B is considered to have obtained control over Entity A. Therefore, Entity B is identified as the accounting acquirer. The combination must be accounted for as a reverse acquisition, i.e., an acquisition of Entity A (legal parent/accounting acquiree) by Entity B (legal subsidiary/accounting acquirer).

How is the consideration transferred by the accounting acquirer (Entity B) for its interest in the accounting acquiree (Entity A) determined?

Applying the requirements of IFRS 3.B20 (discussed in section 14.1 above) to the transaction might erroneously lead to the following conclusion. Entity A has had to issue 200,000 shares to Entity B's shareholders, resulting in Entity B's shareholders having 66.67% (200,000 ÷ 300,000) of the equity and Entity A's shareholders 33.33% (100,000 ÷ 300,000). If Entity B's share price is used to determine the fair value of the consideration transferred, then under IFRS 3.B20, Entity B would have had to issue 100,000 shares to Entity A's shareholders to result in the same % shareholdings (200,000 ÷ 300,000 = 66.67%). This would apparently give a value of the consideration transferred of 100,000 @ CU2.50 = CU250,000. This does not seem correct, for the reasons discussed below.

If there had been no cash consideration at all, Entity A would have issued 250,000 shares to Entity B's shareholders, resulting in Entity B's shareholders having 71.43% (250,000 ÷ 350,000) of the equity and Entity A's shareholders 28.57% (100,000 ÷ 350,000). If Entity B's share price is used to determine the value of the consideration transferred, then under IFRS 3.B20, Entity B would have had to issue 80,000 shares to Entity A's shareholders to result in the same % shareholdings (200,000 ÷ 280,000 = 71.43%). This would give a value for the consideration transferred of 80,000 @ CU2.50 = CU200,000. If it was thought that the fair value of Entity A's shares was more reliably measurable, IFRS 3.33 would require the consideration to be measured using the market price of Entity A's shares. As Entity B has effectively acquired 100% of Entity A, the value of the consideration transferred would be CU200,000 (the same as under the revised IFRS 3.B20 calculation above).

In our view, the proper analysis of the IFRS 3.B20 calculation in this case is that of the 100,000 shares that Entity B is deemed to have issued, only 80,000 of them are to acquire Entity A's shares, resulting in consideration transferred of CU200,000. The extra 20,000 shares are to compensate Entity A's shareholders for the fact that Entity B's shareholders have received a cash distribution of CU100,000, and is effectively a stock distribution to Entity A's shareholders of CU50,000 (20,000 @ CU2.50), being their share (33.33%) of a total distribution of CU150,000. However, since the equity structure (i.e., the number and type of shares) appearing in the consolidated financial statements reflects that of the legal parent, Entity A, this 'stock distribution' will not actually be apparent. The only distribution that will be shown as a movement in equity is the CU100,000 cash paid to Entity B's shareholders.

14.7 Share-based payments

In a reverse acquisition, the legal acquirer (Entity A) may have an existing share-based payment plan at the date of acquisition. How does the entity account for awards held by the employees of the accounting acquiree?

How we see it

We believe that when, at the date of reverse acquisition, the accounting acquiree has an existing share-based payment plan held by its employees, the accounting acquirer A allocates the acquisition-date fair value of awards made by the accounting acquiree to the portion attributable to the vesting period prior to the reverse acquisition, and to the portion that vests after the reverse acquisition. The former is recognised as part of the consideration transferred by the accounting acquirer for the business combination, and the latter is treated as post-combination expense.

Under IFRS 3, accounting for a reverse acquisition takes place from the perspective of the accounting acquirer, not the legal acquirer. Therefore, the accounting for the share-based payment plan of Entity A is based on what would have happened if Entity B rather than Entity A had issued such equity instruments. As indicated in section 14.1 above, in a reverse acquisition, the acquisition-date fair value of the consideration transferred by the accounting acquirer for its interest in the accounting acquiree is based on the number of equity interests the legal subsidiary would have had to issue to give the owners of the legal parent the same percentage equity interest in the combined entity that results from the reverse acquisition. The fair value of the number of equity interests calculated in that way can be used as the fair value of consideration transferred in exchange for the acquiree. Therefore, although the legal form of awards made by the accounting acquiree (Entity A) does not change, from an accounting perspective, it is as if these awards have been exchanged for a share-based payment award of the accounting acquirer (Entity B).

As a result, absent any legal modification to the share-based payment awards in Entity A, the acquisition-date fair value of the legal parent/accounting acquiree's (Entity A's) share-based payments awards are included as part of the consideration transferred by the accounting acquirer (Entity B), based on the same principles as those described in IFRS 3.B56 to B62 (see section 7.2 above and Chapter 30 at section 11.2). *[IFRS 3.B56-B62]*. That is, the portion of the fair value attributed to the vesting period prior to the reverse acquisition is recognised as part of the consideration paid for the business combination and the portion that vests after the reverse acquisition is treated as post-combination expense.

14.8 Acquisitions involving a non-trading shell company

The requirements for reverse acquisitions in IFRS 3, and the guidance provided by the standard, discussed above are based on the premise that the legal parent/accounting acquiree has a business which has been acquired by the legal subsidiary/accounting acquirer. In some situations, this may not be the case, for example when a private entity arranges to have itself 'acquired' by a non-trading public entity as a means of obtaining a stock exchange listing or when a target is determined to be an accounting acquirer in a transaction with a SPAC that does not constitute a business (see our publication *Applying IFRS: Accounting for SPACs)*.

As indicated in section 14 above, the standard notes that the legal parent/accounting acquiree must meet the definition of a business (see section 3.2 above) for the transaction to be accounted for as a reverse acquisition, *[IFRS 3.B19]*, but does not say how to account for the transaction when the accounting acquiree is not a business.

In 2013, the IFRS IC[20] has clarified that in a reverse acquisition involving an entity that does not constitute a business (i.e., an asset acquisition or the provision of a service), IFRS 2 rather than IFRS 3 is likely to apply.

The issue that was considered by the IFRS IC involved the former shareholders of a non-listed operating entity becoming the majority shareholders of the combined entity by exchanging their shares for new shares of a listed non-operating entity. The IFRS IC concluded that it is appropriate to apply the IFRS 3 guidance for reverse acquisitions by analogy, and the accounting acquirer is deemed to have issued shares to obtain control of the acquiree. The transaction is not a business combination, but a share-based payment transaction which is accounted for in accordance with IFRS 2 (i.e., an asset acquisition or provision of service). The IFRS IC concluded that any difference in the fair value of the shares deemed to have been issued by the accounting acquirer and the fair value of the accounting acquiree's identifiable net assets represents a service received by the accounting acquirer for obtaining a stock exchange listing.

How we see it

In our view, when an accounting acquiree is not a business, a transaction is accounted for in the consolidated financial statements of the legal parent as a continuation of the financial statements of the private entity (the legal subsidiary), together with a deemed issue of shares by the private entity (the legal subsidiary) and a re-capitalisation of the equity of the private entity (the legal subsidiary).

Under IFRS 2, for equity-settled share-based payments, an entity measures the goods or services received, and the corresponding increase in equity, directly at the fair value of the goods or services received. If the entity cannot estimate reliably the fair value of the goods and services received, the entity measures the amounts, indirectly, by reference to the fair value of the equity instruments issued. *[IFRS 2.10]*. For transactions with non-employees, IFRS 2 presumes that the fair value of the goods and services received is more readily determinable. *[IFRS 2.13]*. This would suggest that the increase in equity is based on the cash and the fair value of the listing status. As it is unlikely that a fair value of the listing status can be reliably estimated, the increase in equity will be measured by reference to the fair value of the shares that are deemed to have been issued.

20 *IFRIC Update*, March 2013, available on the IFRS Foundation's website.

Even if a fair value could be attributed to the listing status, if the total identifiable consideration received is less than the fair value of the equity given as consideration, the transaction is measured based on the fair value of the shares that are deemed to be issued. *[IFRS 2.13A]*. This issue was considered by the IFRS IC between September 2012 and March 2013 and the IFRS IC conclusions in the final agenda decision published in March 2013 accord with the analysis given above.

Frequently asked questions

Question 14-1: Is it appropriate to apply the IFRS 3 guidance for reverse acquisitions by analogy to a transaction in which the former shareholders of a non-listed operating entity become the majority shareholders of the combined entity, by exchanging their shares for new shares of a listed non-trading company?

In March 2013, the IFRS IC concluded that for a transaction in which the former shareholders of a non-listed operating entity become the majority shareholders of the combined entity by exchanging their shares for new shares of a listed non-trading company, it is appropriate to apply the IFRS 3 guidance for reverse acquisitions by analogy. This results in the non-listed operating entity being identified as the accounting acquirer, and the listed non-trading entity being identified as the accounting acquiree. The accounting acquirer is deemed to have issued shares to obtain control of the acquiree. If the listed non-trading entity is not a business, the transaction is not a business combination, but a share-based payment transaction which is accounted for in accordance with IFRS 2. Any difference in the fair value of the shares deemed to have been issued by the accounting acquirer and the fair value of the accounting acquiree's identifiable net assets represents a service received by the accounting acquirer. The IFRS IC concluded that regardless of the level of monetary or non-monetary assets owned by the non-listed operating entity the entire difference is considered to be payment for the service of obtaining a stock exchange listing for its shares and no amount is considered a cost of raising capital.[21]

The application of these conclusions is shown in the Illustration below.

Illustration 14-8: Acquisition of a non-trading shell company

Entity A is a non-trading public company with 10,000 ordinary shares in issue. On 1 January 20X2, Entity A issues 190,000 ordinary shares in exchange for all of the ordinary share capital of Entity B, a private trading company, with 9,500 ordinary shares in issue.

At the date of the transaction, Entity A has CU85,000 of cash and the quoted market price of Entity A's ordinary shares is CU12.

The fair value of Entity B has been determined by an independent professional valuer as being CU2,185,000, giving a value per share of CU230.

Following the transaction, apart from one non-executive director, all of the directors of Entity A resign and four new directors from Entity B are appointed to the Board of Entity A.

As a result of Entity A issuing 190,000 ordinary shares, Entity B's shareholders own 95% of the issued share capital of the combined entity (i.e., 190,000 of the 200,000 issued shares), with the remaining 5% held by Entity A's existing shareholders.

How is this transaction accounted for in the consolidated financial statements of Entity A?

As the shareholders of Entity A only retain a 5% interest in the combined entity after the transaction, and the Board is dominated by appointees from Entity B, this cannot be accounted for as an acquisition of Entity B by Entity A. Also, as Entity A is a non-trading cash shell company, and therefore not comprising a business (see section 3.2 above), it cannot be accounted for as a reverse acquisition of Entity A by Entity B.

The consolidated financial statements reflect the substance of the transaction which is that Entity B is the continuing entity. Entity B is deemed to have issued shares in exchange for the CU85,000 cash held by Entity A together with the listing status of Entity A.

However, the listing status does not qualify for recognition as an intangible asset, and therefore is expensed in profit or loss. As the existing shareholders of Entity A have a 5% interest in the combined entity, Entity B would have had to issue 500 shares for the ratio of ownership interest in the combined entity to be the same. Based on the fair value of an Entity B share of CU230, the accounting for the transaction is:

Dr	Cash received		CU85,000	
Dr	Listing expense (income statement)		CU30,000	
	Cr	Issued equity* (500 × CU230)		CU115,000

21 *IFRIC Update*, March 2013, available on the IFRS Foundation's website.

As Entity B is a private entity, it may be that a more reliable basis for determining the fair value of the deemed shares issued would have been to use the quoted market price of Entity A's shares at the date of the transaction. On this basis, the issued equity would have been CU120,000 (10,000 × CU12), giving rise to a listing expense of CU35,000.

In summary, the accounting for this transaction is similar in many respects to that which would have been the case if the transaction had been accounted for as a reverse acquisition; the main difference being that no goodwill arises on the transaction, and that any amount that would have been so recognised is accounted for as a listing expense. Indeed, if the transaction had been accounted for as a reverse acquisition, the overall effect may have been the same if an impairment loss on the 'goodwill' had been recognised.

* Refer to Chapter 30 at section 2.2.4.L on the accounting considerations for financial instruments, including cash, acquired in the acquisition applying IAS 32.

14.8.1 Special purpose acquisition companies (SPAC)

For the discussion on the accounting when a target that is a legal acquiree is determined to be an accounting acquirer in a transaction with a SPAC that does not constitute a business, please refer to section 14.8 above. For further discussion please see our publication *Applying IFRS: Accounting for SPACs*.

14.9 Reverse acquisitions and acquirers that are not legal entities

Sometimes reverse acquisitions involve a combination of a non-trading listed entity with a business that is not housed in a separate legal entity before the transaction. For instance, a larger legal entity may wish to carve-out an internal division or branch through an IPO. In September 2011, the IFRS IC considered whether a business that is not a legal entity could be the acquirer in a reverse acquisition. It noted that the issue is not widespread but nevertheless provided some guidance in its agenda decision.

Frequently asked questions

Question 14-2: Could a business that is not a legal entity be identified as an acquirer in a reverse acquisition?

The IFRS IC concluded that an acquirer that is a reporting entity, but not a legal entity, can be considered the acquirer in a reverse acquisition. The IFRS IC observed that IFRS accounting standards and the 1989 *Conceptual Framework* do not require a 'reporting entity' to be a legal entity. Therefore, as long as the business that is not a legal entity obtains control of the acquiree and, in accordance with Appendix A of IFRS 3, the acquiree is "the business or businesses that the **acquirer** obtains control of in a **business combination**" then "…the entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition." *[IFRS 3.7, IFRS 3 Appendix A, IFRS 3.B19]*.[22]

The 2018 *Conceptual Framework* (effective for annual periods beginning on or after 1 January 2020) does not alter the analysis above, as it states explicitly that a reporting entity is not necessarily a legal entity. *[CF 3.10]*.

22 *IFRIC Update*, September 2011, available on the IFRS Foundation's website.

15 Push down accounting

The term 'push down accounting' relates to the practice adopted in some jurisdictions of incorporating, or 'pushing down', the fair value adjustments which have been made by the acquirer into the financial statements of the acquiree, including the goodwill arising on the acquisition. It is argued that the acquisition, being an independently bargained transaction, provides better evidence of the values of the assets and liabilities of the acquiree than those previously contained within its financial statements, and therefore represents an improved basis of accounting. There are, however, contrary views, which hold that the transaction in question was one to which the reporting entity was not a party, and there is no reason why an adjustment is made to the entity's own accounting records.

Push down accounting may be useful as it removes the need to make consolidation adjustments in each subsequent year, based on parallel accounting records. However, eligibility of applying 'push down accounting' in financial statements prepared in accordance with IFRS accounting standards is questionable.

How we see it

In our view, if the acquiree is preparing its financial statements in accordance with IFRS accounting standards, it cannot apply push down accounting and reflect the fair value adjustments made by the acquirer and the goodwill that arose on its acquisition.

All of the requirements of IFRS accounting standards must be applied when an entity prepares its financial statements. IFRS accounting standards require assets and liabilities to be recognised initially at cost or fair value, depending on the nature of the assets and liabilities. The acquisition of an entity by another party is not a transaction undertaken by that entity itself; hence it cannot be a transaction to determine cost.

Application of push down accounting would result in the recognition and measurement of assets and liabilities that are prohibited by some standards (such as internally generated intangibles and goodwill) and the recognition and measurement of assets and liabilities at amounts that are not permitted under IFRS accounting standards. While some IFRS accounting standards include an option or requirement to revalue particular assets, this is undertaken as part of a process of determining accounting policies rather than as one-off revaluations. For example:

- IAS 2 *Inventories* requires that inventories are measured at the lower of cost and net realisable value (see Chapter 23 at section 3).
- IAS 16 requires that items of property, plant and equipment are initially measured at cost. Subsequently, property, plant and equipment can be measured at cost or at revalued amount. However, revaluations must be applied consistently and must be performed on a regular basis. Therefore, a one-off revaluation is not permitted (see Chapter 19 at section 6).
- IAS 38 requires that intangible assets are initially measured at cost. Subsequently, they can be revalued only in rare circumstances where there is an active market. In addition, IAS 38 specifically prohibits the recognition of internally generated goodwill. Therefore, a one-off revaluation is not permitted (see Chapter 18 at section 8.2).

16 Disclosures

Extract from IFRS 3

Disclosures

59 **The acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs either:**

(a) during the current reporting period; or

(b) after the end of the reporting period but before the financial statements are authorised for issue.

60 To meet the objective in paragraph 59, the acquirer shall disclose the information specified in paragraphs B64-B66.

61 **The acquirer shall disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognised in the current reporting period that relate to business combinations that occurred in the period or previous reporting periods.**

62 To meet the objective in paragraph 61, the acquirer shall disclose the information specified in paragraph B67.

63 If the specific disclosures required by this and other IFRSs do not meet the objectives set out in paragraphs 59 and 61, the acquirer shall disclose whatever additional information is necessary to meet those objectives.

[IFRS 3.59, IFRS 3.60, IFRS 3.61, IFRS 3.62, IFRS 3.63].

The disclosure requirements of IFRS 3 are set out below. Note that, although IFRS 13 provides guidance on how to measure fair value, IFRS 13 disclosures are not required for items that are recognised at fair value only at initial recognition. *[IFRS 13.91(a)]*. For example, the information about the fair value measurement of a non-controlling interest in an acquiree if measured at fair value at the acquisition date is disclosed in accordance with the requirements of IFRS 3. *[IFRS 3.B64(o)(i)]*.

16.1 Nature and financial effect of business combinations

The first disclosure objective is that the acquirer discloses information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs either:

- During the current reporting period

  Or

- After the end of the reporting period but before the financial statements are authorised for issue *[IFRS 3.59]*

Information that is required to be disclosed by the acquirer to meet the above objective is specified in the application guidance of the standard. *[IFRS 3.60]*.

16.1.1 Business combinations during the current reporting period

To meet the above objective, the acquirer is required to disclose the following information for each business combination that occurs during the reporting period: *[IFRS 3.B64]*

(a) The name and a description of the acquiree.

(b) The acquisition date.

(c) The percentage of voting equity interests acquired.

(d) The primary reasons for the business combination and a description of how the acquirer obtained control of the acquiree.

(e) A qualitative description of the factors that make up the goodwill recognised, such as expected synergies from combining operations of the acquiree and the acquirer, intangible assets that do not qualify for separate recognition or other factors.

(f) The acquisition-date fair value of the total consideration transferred and the acquisition-date fair value of each major class of consideration, such as:

  (i) Cash

  (ii) Other tangible or intangible assets, including a business or subsidiary of the acquirer

  (iii) Liabilities incurred, for example, a liability for contingent consideration

  (iv) Equity interests of the acquirer, including the number of instruments or interests issued or issuable and the method of measuring the fair value of those instruments or interests

(g) For contingent consideration arrangements and indemnification assets:
  (i) The amount recognised as of the acquisition date
  (ii) A description of the arrangement and the basis for determining the amount of the payment
  (iii) An estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer discloses that fact.

(h) For acquired receivables:
  (i) The fair value of the receivables
  (ii) The gross contractual amounts receivable
  (iii) The best estimate at the acquisition date of the contractual cash flows not expected to be collected

  The disclosures are to be provided by major class of receivable, such as loans, direct finance leases and any other class of receivables.

(i) The amounts recognised as of the acquisition date for each major class of assets acquired and liabilities assumed.

(j) For each contingent liability recognised in accordance with IFRS 3.23 of the standard (see section 5.6.1 above), the information required in IAS 37.85 (see Chapter 27 at section 7.1). If a contingent liability is not recognised because its fair value cannot be measured reliably, the acquirer discloses:
  (i) The information required by IAS 37.86 (see Chapter 27 at section 7.2)
  (ii) The reasons why the liability cannot be measured reliably

(k) The total amount of goodwill that is expected to be deductible for tax purposes.

(l) For transactions that are recognised separately from the acquisition of assets and assumption of liabilities in the business combination in accordance with IFRS 3.51 (see section 11 above):
  (i) A description of each transaction
  (ii) How the acquirer accounted for each transaction
  (iii) The amounts recognised for each transaction and the line item in the financial statements in which each amount is recognised
  (iv) If the transaction is the effective settlement of a pre-existing relationship, the method used to determine the settlement amount

(m) The disclosure of separately recognised transactions required by (l) above includes the amount of acquisition-related costs and, separately, the amount of those costs recognised as an expense and the line item or items in the statement of comprehensive income in which those expenses are recognised. The amount of any issue costs not recognised as an expense and how they were recognised are also to be disclosed.

(n) In a bargain purchase (see section 10 above):
  (i) The amount of any gain recognised and the line item in the statement of comprehensive income in which the gain is recognised
  (ii) A description of the reasons why the transaction resulted in a gain

(o) For each business combination in which the acquirer holds less than 100% of the equity interests in the acquiree at the acquisition date (i.e., there is a non-controlling interest - see section 8 above):
  (i) The amount of the non-controlling interest in the acquiree recognised at the acquisition date and the measurement basis for that amount
  (ii) For each non-controlling interest in an acquiree measured at fair value, the valuation techniques and significant inputs used to measure that value

(p) In a business combination achieved in stages (see section 9 above):
  (i) The acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the acquisition date
  (ii) The amount of any gain or loss recognised as a result of remeasuring to fair value the equity interest in the acquiree held by the acquirer before the business combination and the line item in the statement of comprehensive income in which that gain or loss is recognised

(q) The following information:
  (i) The amounts of revenue and profit or loss of the acquiree since the acquisition date included in the consolidated statement of comprehensive income for the reporting period
  (ii) The revenue and profit or loss of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period

  If disclosure of any of the information required by this subparagraph is impracticable, the acquirer discloses that fact and explain why the disclosure is impracticable. IFRS 3 uses the term 'impracticable' with the same meaning as in IAS 8 (see Chapter 3 at section 4.7).

Although it is not explicitly stated in IFRS 3.B64, it is evident that the above information is required for each material business combination. This is due to the fact that the standard states that for individually immaterial business combinations occurring during the reporting period that are material collectively, the acquirer has to disclose, in aggregate, the information required by items (e) to (q) above. *[IFRS 3.B65]*.

16.1.2 Business combinations effected after the end of the reporting period

If the acquisition date of a business combination is after the end of the reporting period but before the financial statements are authorised for issue, the acquirer is required to disclose the information set out in section 16.1.1 above for that business combination, unless the initial accounting for the business combination is incomplete at the time the financial statements are authorised for issue. In that situation, the acquirer describes which disclosures could not be made and the reasons why they cannot be made. *[IFRS 3.B66]*.

16.2 Financial effects of adjustments recognised in the current reporting period

The second objective is that the acquirer discloses information that enables users of its financial statements to evaluate the financial effects of adjustments recognised in the current reporting period that relate to business combinations that occurred in the period or previous reporting periods. *[IFRS 3.61]*.

Information that is required to be disclosed by the acquirer to meet the above objective is specified in the application guidance of the standard. *[IFRS 3.62]*.

To meet the above objective, the acquirer is required to disclose the following information for each material business combination or in the aggregate for individually immaterial business combinations that are material collectively: *[IFRS 3.B67]*

(a) If the initial accounting for a business combination is incomplete (see section 12 above) for particular assets, liabilities, non-controlling interests or items of consideration and the amounts recognised in the financial statements for the business combination thus have been determined only provisionally:
   (i) The reasons why the initial accounting for the business combination is incomplete
   (ii) The assets, liabilities, equity interests or items of consideration for which the initial accounting is incomplete
   (iii) The nature and amount of any measurement period adjustments recognised during the reporting period in accordance with IFRS 3.49 (see section 12.1 above)

(b) For each reporting period after the acquisition date until the entity collects, sells or otherwise loses the right to a contingent consideration asset, or until the entity settles a contingent consideration liability or the liability is cancelled or expires (see section 7.1 above):
   (i) Any changes in the recognised amounts, including any differences arising upon settlement
   (ii) Any changes in the range of outcomes (undiscounted) and the reasons for those changes
   (iii) The valuation techniques and key model inputs used to measure contingent consideration

(c) For contingent liabilities recognised in a business combination, the acquirer discloses the information required by IAS 37.84 and IAS 37.85 for each class of provision (see Chapter 27 at section 7).

(d) A reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period showing separately:
   (i) The gross amount and accumulated impairment losses at the beginning of the reporting period
   (ii) Additional goodwill recognised during the reporting period, except goodwill included in a disposal group that, on acquisition, meets the criteria for classified as held for sale in accordance with IFRS 5 (see Chapter 5 at section 2.1)
   (iii) Adjustments resulting from the subsequent recognition of deferred tax assets during the reporting period in accordance with IFRS 3.67 (there is in fact no such adjustment to disclose as any adjustment is recognised in profit or loss (see section 5.6.2 above))
   (iv) Goodwill included in a disposal group classified as held for sale in accordance with IFRS 5 and goodwill derecognised during the reporting period without having previously been included in a disposal group classified as held for sale
   (v) Impairment losses recognised during the reporting period in accordance with IAS 36. (IAS 36 requires disclosure of information about the recoverable amount and impairment of goodwill in addition to this requirement (see Chapter 21 at section 13.3))

(vi) Net exchange rate differences arising during the reporting period in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates* (see Chapter 16 at section 6.5)

(vii) Any other changes in the carrying amount during the reporting period

(viii) The gross amount and accumulated impairment losses at the end of the reporting period

(e) The amount and an explanation of any gain or loss recognised in the current reporting period that both:

(i) Relates to the identifiable assets acquired or liabilities assumed in a business combination that was effected in the current or previous reporting period

And

(ii) Is of such a size, nature or incidence that disclosure is relevant to understanding the combined entity's financial statements

16.3 Other necessary information

IFRS 3 includes a catch-all disclosure requirement, that if in any situation the information required to be disclosed set out above, or by other IFRS accounting standards, does not satisfy the objectives of IFRS 3, the acquirer discloses whatever additional information is necessary to meet those objectives. *[IFRS 3.63]*.

In addition, IAS 7 *Statement of Cash Flows* requires disclosures in respect of obtaining control of subsidiaries and other businesses (see Chapter 36 at section 9.3). *[IAS 7.39, IAS 7.40, IAS 7.41, IAS 7.42]*.

16.4 Disclosures in the interim financial statements

The disclosures under IFRS 3 are explicitly required in the interim financial statements for business combinations occurring during the interim period, even if those interim financial statements are condensed (see Chapter 37). *[IAS 34.16A(i)]*.

16.5 Illustrative disclosures

An illustration of some of the disclosure requirements of IFRS 3 is given in the Illustrative Examples accompanying the standard. The example, which is reproduced below, assumes that the acquirer, AC, is a listed entity and that the acquiree, TC, is an unlisted entity. The illustration presents the disclosures in a tabular format that refers to the specific disclosure requirements illustrated. (The references to IFRS 3.B64 correspond to the equivalent item in section 16.1.1 above and those to IFRS 3.B67 correspond to the equivalent item in section 16.2 above.) A footnote might present many of the disclosures illustrated in a simple narrative format. *[IFRS 3.IE72]*.

Extract from IFRS 3

Disclosure requirements

Illustrating the consequences of applying the disclosure requirements in paragraphs 59-63 and B64-B67 of IFRS 3.

IE72 The following example illustrates some of the disclosure requirements of IFRS 3; it is not based on an actual transaction. The example assumes that AC is a listed entity and that TC is an unlisted entity. The illustration presents the disclosures in a tabular format that refers to the specific disclosure requirements illustrated. An actual footnote might present many of the disclosures illustrated in a simple narrative format.

Footnote X: Acquisitions

Paragraph reference	
B64(a)-(d)	On 30 June 20X0 AC acquired 15 per cent of the outstanding ordinary shares of TC. On 30 June 20X2 AC acquired 60 per cent of the outstanding ordinary shares of TC and obtained control of TC. TC is a provider of data networking products and services in Canada and Mexico. As a result of the acquisition, AC is expected to be the leading provider of data networking products and services in those markets. It also expects to reduce costs through economies of scale.
B64(e)	The goodwill of CU2,500 arising from the acquisition consists largely of the synergies and economies of scale expected from combining the operations of AC and TC.

B64(k) None of the goodwill recognised is expected to be deductible for income tax purposes. The following table summarises the consideration paid for TC and the amounts of the assets acquired and liabilities assumed recognised at the acquisition date, as well as the fair value at the acquisition date of the non-controlling interest in TC.

At 30 June 20X2

	Consideration	**CU**
B64(f)(i)	Cash	5,000
B64(f)(iv)	Equity instruments (100,000 ordinary shares of AC)	4,000
B64(f)(iii); B64(g)(i)	Contingent consideration arrangement	1,000
B64(f)	**Total consideration transferred**	10,000
B64(p)(i)	**Fair value of AC's equity interest in TC held before the business combination**	2,000
		12,000
B64(m)	**Acquisition-related costs** (included in selling, general and administrative expenses in AC's statement of comprehensive income for the year ended 31 December 20X2)	1,250
B64(i)	**Recognised amounts of identifiable assets acquired and liabilities assumed**	
	Financial assets	3,500
	Inventory	1,000
	Property, plant and equipment	10,000
	Identifiable intangible assets	3,300
	Financial liabilities	(4,000)
	Contingent liability	(1,000)
	Total identifiable net assets	12,800
B64(o)(i)	Non-controlling interest in TC	(3,300)
	Goodwill	2,500
		12,000

B64(f)(iv) The fair value of the 100,000 ordinary shares issued as part of the consideration paid for TC (CU4,000) was measured using the closing market price of AC's ordinary shares on the acquisition date.

B64(f)(iii) B64(g) B67(b) The contingent consideration arrangement requires AC to pay the former owners of TC 5 per cent of the revenues of XC, an unconsolidated equity investment owned by TC, in excess of CU7,500 for 20X3, up to a maximum amount of CU2,500 (undiscounted).

The potential undiscounted amount of all future payments that AC could be required to make under the contingent consideration arrangement is between CU0 and CU2,500.

The fair value of the contingent consideration arrangement of CU1,000 was estimated by applying the income approach. The fair value measurement is based on significant inputs that are not observable in the market, which IFRS 13 *Fair Value Measurement* refers to as Level 3 inputs. Key assumptions include a discount rate range of 20-25 per cent and assumed probability-adjusted revenues in XC of CU10,000-20,000.

As of 31 December 20X2, neither the amount recognised for the contingent consideration arrangement, nor the range of outcomes or the assumptions used to develop the estimates had changed.

B64(h) The fair value of the financial assets acquired includes receivables under finance leases of data networking equipment with a fair value of CU2,375. The gross amount due under the contracts is CU3,100, of which CU450 is expected to be uncollectible.

B67(a) The fair value of the acquired identifiable intangible assets of CU3,300 is provisional pending receipt of the final valuations for those assets.

B64(j) B67(c) IAS 37.84, 85	A contingent liability of CU1,000 has been recognised for expected warranty claims on products sold by TC during the last three years. We expect that the majority of this expenditure will be incurred in 20X3 and that all will be incurred by the end of 20X4. The potential undiscounted amount of all future payments that AC could be required to make under the warranty arrangements is estimated to be between CU500 and CU1,500. As of 31 December 20X2, there has been no change since 30 June 20X2 in the amount recognised for the liability or any change in the range of outcomes or assumptions used to develop the estimates.
B64(o)	The fair value of the non-controlling interest in TC, an unlisted company, was estimated by applying a market approach and an income approach. The fair value measurements are based on significant inputs that are not observable in the market and thus represent a fair value measurement categorised within Level 3 of the fair value hierarchy as described in IFRS 13. Key assumptions include the following: (a) a discount rate range of 20-25 per cent; (b) a terminal value based on a range of terminal EBITDA multiples between 3 and 5 times (or, if appropriate, based on long term sustainable growth rates ranging from 3 to 6 per cent); (c) financial multiples of companies deemed to be similar to TC; and (d) adjustments because of the lack of control or lack of marketability that market participants would consider when measuring the fair value of the non-controlling interest in TC.
B64(p)(ii)	AC recognised a gain of CU500 as a result of measuring at fair value its 15 per cent equity interest in TC held before the business combination. The gain is included in other income in AC's statement of comprehensive income for the year ending 31 December 20X2.
B64(q)(i)	The revenue included in the consolidated statement of comprehensive income since 30 June 20X2 contributed by TC was CU4,090. TC also contributed profit of CU1,710 over the same period.
B64(q)(ii)	Had TC been consolidated from 1 January 20X2 the consolidated statement of comprehensive income would have included revenue of CU27,670 and profit of CU12,870.

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Appendix C - Defined terms

Extract from IFRS 3

Appendix A
Defined terms

Acquiree	The business or businesses that the **acquirer** obtains control of in a **business combination**.
Acquirer	The entity that obtains control of the **acquiree**.
acquisition date	The date on which the **acquirer** obtains control of the **acquiree**.
business	An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities.
business combination	A transaction or other event in which an **acquirer** obtains control of one or more **businesses**. Transactions sometimes referred to as 'true mergers' or 'mergers of equals' are also **business combinations** as that term is used in this IFRS.
contingent consideration	Usually, an obligation of the **acquirer** to transfer additional assets or **equity interests** to the former owners of an **acquiree** as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, *contingent consideration* also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.
equity interests	For the purposes of this IFRS, *equity interests* is used broadly to mean ownership interests of investor-owned entities and owner, member or participant interests of **mutual entities**.
fair value	*Fair value* is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13.)
goodwill	An asset representing the future economic benefits arising from other assets acquired in a **business combination** that are not individually identified and separately recognised.
identifiable	An asset is *identifiable* if it either: (a) is separable, ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or (b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.
intangible asset	An **identifiable** non-monetary asset without physical substance.
mutual entity	An entity, other than an investor-owned entity, that provides dividends, lower costs or other economic benefits directly to its **owners**, members or participants. For example, a mutual insurance company, a credit union and a co-operative entity are all mutual entities.
non-controlling interest	The equity in a subsidiary not attributable, directly or indirectly, to a parent.
owners	For the purposes of this IFRS, *owners* is used broadly to include holders of **equity interests** of investor-owned entities and owners or members of, or participants in, **mutual entities**.

Chapter 11 Business combinations under common control

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Overview

The accounting requirements for business combinations are set out in IFRS 3 *Business Combinations* and are covered in Chapter 10. However, IFRS 3 excludes business combinations under common control (BCUCC) from its scope. IFRS accounting standards do not specify how a receiving entity accounts for such transactions and for some other types of group reorganisations, including certain transactions involving a newly formed entity (Newco). Due to the lack of specifically applicable requirements, entities need to develop their own accounting policy in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*[1], which has resulted in diversity in practice. The IASB undertook a research project to consider how to fill this 'gap' in IFRS accounting standards and published a Discussion Paper (DP) for public consultation in November 2020.[2] The DP summarised the IASB's preliminary views on how a receiving entity should report a BCUCC, including potential measurement methods to apply, and also explored potential disclosure requirements. However, in November 2023, the IASB considered the project's direction and decided to discontinue further work developing guidance for BCUCCs.[3] It is, therefore, expected that diversity in practice will continue.

This chapter addresses common control transactions that involve the transfer of control over one or more businesses (whether incorporated or not) and focuses on the perspective of the receiving entity. It discusses when the scope exclusion for business combinations under common control applies and the appropriate accounting treatment in the absence of specific requirements.

This chapter also provides accounting considerations for transactions under common control (or common ownership) involving a Newco, which, depending on the facts and circumstances, might not meet the description of a business combination. One of the key questions in this respect is whether a Newco can be identified as the acquirer under IFRS 3 (see section 4 below), which is also discussed in Chapter 10.

Finally, this chapter addresses the accounting by a receiving entity for the acquisition of an investment in an associate or joint venture accounted for using the equity method from an entity under common control. The equity method of accounting is discussed in Chapter 12.

More details on the scope of this chapter can be found in section 1.3 below.

What you need to know

- IFRS accounting standards do not specify how to account for business combinations under common control and certain other types of group reorganisations.
- In our view, a receiving entity accounting for a business combination under common control has an accounting policy choice to apply either the pooling of interests or acquisition method, provided there is substance to the transaction.
- Applying the pooling of interests method to a business combination under common control requires a series of further accounting policy choices.
- Accounting for transactions under common control (or common ownership) involving a Newco requires careful consideration of all facts and circumstances.
- In our view, a receiving entity accounting for the acquisition of an investment in an associate or joint venture accounted for using the equity method from an entity under common control could elect to apply the scope exclusion in IFRS 3 for business combinations under common control by analogy.

1 The consequential amendments resulting from IFRS 18 *Presentation and Disclosure in Financial Statements*, once effective, changes the title of IAS 8 to '*Basis of Preparation of Financial Statements*' to better reflect the amended content of IAS 8. See Chapter 4 for further details on the requirements of IFRS 18.

2 Discussion Paper, DP 2020/2, *Business Combinations under Common Control*, IASB, November 2020. Available on the IFRS Foundation's website.

3 Business combinations under common control project page, available on the IFRS Foundation's website (accessed 24 September 2024).

1 Introduction

1.1 Common control transactions

Transactions between entities under common control (or common control transactions) occur frequently in business. For example, many entities conduct their business activities through subsidiaries and there are often transactions between the entities comprising the group. It is also common for entities under common control, which are not a group for financial reporting purposes, to transact with each other.

Examples of common control transactions include the sale of goods, property and other assets, the provision of services (including those of employees), leasing, transfers under licence agreements, financing transactions and the provision of guarantees.

It cannot always be assumed that common control transactions are undertaken on an arm's length basis or that equal values have been exchanged. Standard-setters internationally have developed standards that require disclosures about related party transactions (which include common control transactions), rather than requiring the transactions to be recognised at an arm's length price. The IASB also adopted this approach in IAS 24 *Related Party Disclosures*, which is a disclosure standard and does not establish recognition or measurement requirements. Entities would need to account for such transactions in accordance with the requirements of any IFRS accounting standard specifically applicable to that transaction. *[IAS 8.7]*.

In January 2018, the IFRS IC confirmed that IFRS accounting standards do not provide a general exception or exemption from applying the requirements in a particular IFRS accounting standard to common control transactions. In its agenda decision, the IFRS IC observed that "unless a Standard specifically excludes common control transactions from its scope, an entity applies the applicable requirements in the Standard to common control transactions".[4]

Nonetheless, IFRS accounting standards do not provide a complete framework and some common control transactions might not be covered by any IFRS accounting standard. Specific requirements might also be absent when common control transactions are excluded from the scope of an IFRS accounting standard that would otherwise apply. There is often more than one acceptable way of accounting for common control transactions, and this gives rise to an accounting policy choice. General guidance on accounting for transactions between a parent and its subsidiaries, or between subsidiaries within a group, is included in Chapter 9 at section 4.

One specific area where there is a scope exclusion for common control transactions is IFRS 3 (discussed in Chapter 10). That standard addresses business combinations but excludes "a combination of entities or businesses under common control" from its scope. *[IFRS 3.2]*. The IASB noted that current IFRS accounting standards do not specify how to account for business combinations under common control and carried out a research project with proposals to address this gap, in order to improve the comparability and transparency of accounting for such transactions. In November 2020, the IASB published a Discussion Paper (DP)[5] setting out its preliminary views. However, following the IASB's consideration of the feedback, the project was discontinued in November 2023.[6] See section 6 for further discussion.

This chapter deals with the implications of the scope exclusion in IFRS 3 for business combinations under common control and the current absence of guidance in IFRS accounting standards for certain types of group reorganisations. It also discusses the choice of accounting treatments that could be adopted for such transactions.

This chapter does not discuss any potential differences between IFRS and US GAAP, which might exist because US GAAP does have specific guidance on this topic.

1.2 Group reorganisations

Group reorganisations involve restructuring the relationships between entities or businesses within a group (or under common control) and can take many forms. They might be undertaken for various reasons, for example to reorganise activities with an aim to achieve synergies, to simplify a group structure, or to obtain tax efficiency (e.g., by creating a tax grouping in a particular jurisdiction). In some cases, a group reorganisation takes place to split an existing group into two or more separate groups or to create a single new reporting group, possibly as a prelude to a subsequent sale or initial public offering (IPO).

4 *IFRIC Update*, January 2018, *Committee's agenda decisions*: *Contributing property, plant and equipment to an associate (IAS 28 Investments in Associates and Joint Ventures)-Agenda Paper 2*. Available on the IFRS Foundation's website.

5 Discussion Paper, DP 2020/2, *Business Combinations under Common Control*, IASB, November 2020. Available on the IFRS Foundation's website.

6 Business combinations under common control project page, available on the IFRS Foundation's website.

Group reorganisations involve transferring entities or businesses between existing or newly formed entities under common control. From the perspective of the controlling party, the transfer does not affect the entities or businesses that party holds. Such changes often have no impact on the consolidated financial statements of an existing group (except for any potential tax consequences), provided the ownership interests of non-controlling interest holders (NCI) are not affected. This is because the effects of transactions within an existing group are generally eliminated in full (see Chapter 8 at section 2.4). Alternatively, some reorganisations involve transferring entities or businesses outside the existing group (e.g., demergers).

Transfers of entities or businesses between existing or newly formed entities under common control might be in exchange for cash, loan consideration or shares. Other transfers might be without any consideration, such as a distribution by a subsidiary to its parent or a contribution by a parent to its subsidiary. There can also be legal arrangements that have a similar effect, including reorganisations sanctioned by a court process or transfers after liquidation of the transferor (i.e., the transferring entity). In addition, some jurisdictions allow a legal merger between a parent and its subsidiary to form a single entity.

From the perspective of the transferee in the reorganisation (i.e., the receiving entity), there could be a business combination that needs to be accounted for. Such a business combination would be excluded from the scope of IFRS 3 if it satisfies the description of a business combination under common control. However, the transaction would not represent a business combination as defined in IFRS 3, where the assets acquired and liabilities assumed do not constitute a business (i.e., an asset acquisition), or where neither of the combining entities can be identified as the acquirer (e.g., in some situations where a newly formed entity is involved - see section 4.1 below). The accounting by the receiving entity in a group reorganisation is often not covered in existing IFRS accounting standards.

The transferor in the reorganisation will need to account for its part of the transaction in its own financial statements. The relevant requirements for transferors are discussed in other chapters, as set out in section 1.3 below.

1.3 Scope of this chapter

This chapter deals with common control transactions that involve the transfer of control over one or more businesses (as defined in IFRS 3) and focuses on the perspective of the receiving entity. That receiving entity might or might not be identified as the acquirer if IFRS 3 were applied to the transaction (see Chapter 10 at section 4.1). If the entity or net assets being transferred do not meet the definition of a business (see Chapter 10 at section 3.2), the transaction represents an asset acquisition. The accounting for acquisitions of (net) assets under common control is discussed in Chapter 9 at section 4.4.2.D.

This chapter addresses:

- The scope exclusion in IFRS 3 for business combinations under common control (see section 2 below)
- The accounting for business combinations (involving entities or businesses) under common control excluded from the scope of IFRS 3 (see section 3 below)
- The accounting for transactions under common control (or sometimes common ownership) involving a newly formed entity (see section 4 below)
- The accounting for transfers of investments in associates or joint ventures from entities under common control (see section 5 below)

  And
- The discontinuance of, and feedback received on the IASB's project on business combinations under common control (see section 6 below)

Although the discussion in sections 3 and 4 below (particularly the examples contained therein) generally refers to 'consolidated financial statements' and transfers of 'entities', the accounting might be equally applicable to the separate or individual financial statements of an entity that receives the net assets of a business (rather than the shares in the entity holding that business) in a common control transaction. In contrast, if the receiving entity obtains control over a business housed in a separate legal entity, it would recognise an investment in a subsidiary in accordance with IAS 27 *Separate Financial Statements* in its separate financial statements (and individual financial statements are not applicable). This is consistent with business combinations that are in the scope of IFRS 3. That IFRS accounting standard specifies only to which transactions it applies, but not to which financial statements it applies (e.g., consolidated, separate, individual).

This chapter, however, does not specifically deal with the accounting by the receiving entity for common control transactions in separate or individual financial statements, which is covered in Chapter 9 at section 4. Chapter 9 at section 4.4.3.A discusses distributions of businesses from a subsidiary to a parent and Chapter 9 at section 4.4.3.B discusses the accounting for legal mergers between a parent and its subsidiary.

An acquisition of a business by a subsidiary from its parent or a fellow subsidiary might meet the definition of a business combination under common control and, accordingly, be dealt with in this chapter. There is further discussion of the accounting for business combinations under common control in separate and individual financial statements in Chapter 9 at sections 4.4.2 and 4.4.3.

Although no control is obtained by the receiving entity, this chapter does address the transfer of an investment in an associate or joint venture from an entity under common control (see section 5 below). The issue is whether the scope exclusion in IFRS 3 for business combinations under common control can be applied by analogy to this scenario.

The transferor that loses control over an entity or business in a common control transaction will also need to account for the transaction in its own financial statements. In doing so, it will need to consider the requirements of other relevant IFRS accounting standards, in particular, the requirements of IFRS 10 *Consolidated Financial Statements* relating to disposals of, or loss of control over, subsidiaries (see Chapter 8 at section 3.2) and the requirements of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* relating to disposal groups held for sale and discontinued operations (see Chapter 5). The discussion in Chapter 8 at section 3.7 and in Chapter 9 at section 2.4.2 relating to demergers (e.g., the spin-off of a subsidiary or business) might also be relevant, as well as the discussion in Chapter 21 at sections 12.3 and 12.4 on impairment considerations relating to investments in subsidiaries.

Finally, any transaction between entities under common control is a related party transaction under IAS 24, the requirements of which are dealt with in Chapter 35.

1.3.1 First-time adoption considerations

The requirements of IFRS 1 *First-time Adoption of International Financial Reporting Standards* are applied when the reporting entity is a first-time adopter (see Chapter 6 at section 2). It could be the case that, in connection with a common control transaction or a proposed transaction (such as an IPO), the reporting entity prepares individual and/or consolidated financial statements with an unreserved statement of compliance with IFRS accounting standards for the first time. This chapter does not discuss the general requirements of IFRS 1 that are relevant for all first-time adopters. These are addressed in Chapter 6.

How we see it

Care should be taken in identifying whether and how IFRS 1 is applied by entities involved in transactions under common control. In many cases, there might be no accounting impact. However, in other cases there might be an accounting impact to reflect.

For example, where a newly incorporated company (Newco) acquires another entity that is an existing IFRS reporter in a transaction under common control, Newco will be regarded as a continuation of that entity (see Illustration 4-1 at section 4.2.1 below). There would be no change to the recognised assets and liabilities of the acquired entity in Newco's financial statements (if required to be prepared) as that entity had already adopted IFRS accounting standards and Newco is a continuation of that entity. Nevertheless, if that entity had not already adopted IFRS accounting standards, Newco would apply IFRS 1 in its first IFRS financial statements (since it is a continuation of an entity that is a first-time adopter). See Chapter 6 at sections 2.1 and 6.3.

Application of IFRS 1 could also be relevant where an entity acquires another entity in a business combination under common control and prepares IFRS consolidated financial statements for the first time. In such cases, particular care is needed with the application of IFRS 1.D16 and IFRS 1.D17 (discussed in Chapter 6 at section 5.8) where the entity is part of a group reporting under IFRS accounting standards.

2 The IFRS 3 scope exclusion

Extract from IFRS 3

2 This IFRS applies to a transaction or other event that meets the definition of a business combination. This IFRS does not apply to:

(a) the accounting for the formation of a joint arrangement in the financial statements of the joint arrangement itself.

(b) the acquisition of an asset or a group of assets that does not constitute a *business*. In such cases the acquirer shall identify and recognise the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, *intangible assets* in IAS 38 *Intangible Assets*) and liabilities assumed. The cost of the group shall be allocated to the individual identifiable assets and liabilities on the basis of their relative *fair values* at the date of purchase. Such a transaction or event does not give rise to goodwill.

(c) a combination of entities or businesses under common control (paragraphs B1-B4 provide related application guidance).

[IFRS 3.2].

IFRS 3 establishes principles and requirements for how the acquirer accounts for a business combination, which is defined as: "A transaction or other event in which an **acquirer** obtains control of one or more **businesses**." *[IFRS 3.1, IFRS 3 Appendix A]*. Identifying a business combination, including the definition of a business, is discussed generally in Chapter 10 at section 3.

However, IFRS 3 excludes from its scope "a combination of entities or businesses under common control …". *[IFRS 3.2(c)]*. Appendix B of IFRS 3 provides further guidance to determine when a business combination is regarded as a business combination under common control. This application guidance is discussed in section 2.1 below.

If the transaction is not a business combination in the first place, because the assets acquired and liabilities assumed do not constitute a business as defined in IFRS 3, it is accounted for as an asset acquisition. *[IFRS 3.2(b), IFRS 3.3]*. The accounting for acquisitions of (net) assets under common control is discussed in Chapter 9 at section 4.4.2.D. In addition, a transaction might not be a business combination as defined in IFRS 3 because, applying that IFRS accounting standard, no acquirer can be identified. This is considered in more detail in section 4.1 below.

2.1 Business combinations under common control

Extract from IFRS 3

B1 This IFRS does not apply to a business combination of entities or businesses under common control. A business combination involving entities or businesses under common control is a business combination in which all of the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

B4 The extent of non-controlling interests in each of the combining entities before and after the business combination is not relevant to determining whether the combination involves entities under common control. Similarly, the fact that one of the combining entities is a subsidiary that has been excluded from the consolidated financial statements is not relevant to determining whether a combination involves entities under common control.

[IFRS 3.B1, IFRS 3.B4].

For the purpose of the scope exclusion, IFRS 3 describes a business combination under common control as "a business combination in which all of the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory". *[IFRS 3.B1]*. This will include transactions such as transfers of subsidiaries or businesses between entities within a group, provided the transaction meets the definition of a business combination in IFRS 3 (see section 2 above).

The extent of NCI in each of the combining entities before and after the business combination is not relevant to determining whether common control exists. *[IFRS 3.B4]*. This is because a partially-owned subsidiary is nevertheless under the control of the parent entity. Therefore, transactions involving partially-owned subsidiaries are also outside the scope of IFRS 3. Similarly, the fact that one of the combining entities is a subsidiary that has been excluded from the consolidated financial statements of the group in accordance with IFRS 10 is not relevant to determining whether common control exists. *[IFRS 3.B4]*. This is because the parent entity controls the subsidiary regardless of that fact.

2.1.1 Common control by an individual or group of individuals

Extract from IFRS 3	
B2	A group of individuals shall be regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities. Therefore, a business combination is outside the scope of this IFRS when the same group of individuals has, as a result of contractual arrangements, ultimate collective power to govern the financial and operating policies of each of the combining entities so as to obtain benefits from their activities, and that ultimate collective power is not transitory.
B3	An entity may be controlled by an individual or by a group of individuals acting together under a contractual arrangement, and that individual or group of individuals may not be subject to the financial reporting requirements of IFRSs. Therefore, it is not necessary for combining entities to be included as part of the same consolidated financial statements for a business combination to be regarded as one involving entities under common control.

[IFRS 3.B2, IFRS 3.B3].

The scope exclusion is not restricted to transactions between entities within a group. An entity can be controlled by an individual or a group of individuals acting together under a contractual arrangement. That individual or group of individuals might not be subject to the financial reporting requirements of IFRS accounting standards. It is not necessary for combining entities to be included as part of the same consolidated financial statements for a business combination to be regarded as one involving entities under common control. *[IFRS 3.B3]*. Thus, if a transaction involves entities controlled by the same individual, even if it results in a new reporting group, the acquisition method would not always be applied.

A group of individuals controls an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities. Therefore, a business combination is outside the scope of IFRS 3 if the same group of individuals has ultimate collective power to control each of the combining entities and that ultimate collective power is not transitory. *[IFRS 3.B2]*.

The mere existence of common ownership is not sufficient. For the scope exclusion to apply to a group of individuals, there has to be a 'contractual arrangement' between them such that they have control over the entities involved in the transaction. IFRS 3 does not indicate what form such an arrangement must take. However, in describing a 'joint arrangement', IFRS 11 *Joint Arrangements* explains that "Contractual arrangements can be evidenced in several ways" and that "An enforceable contractual arrangement is often, but not always, in writing, usually in the form of a contract or documented discussions between the parties." *[IFRS 11.B2]*. This also implies that it is possible for a contractual arrangement to be in non-written form. If it is not written, great care needs to be taken with all of the facts and circumstances to determine whether it is appropriate to exclude a business combination from the scope of IFRS 3.

How we see it

Although not explicitly stated in IFRS 3, we believe that a contractual arrangement between a group of individuals does not necessarily need to be in written form. However, for an unwritten arrangement to exist, there must be clear evidence of that arrangement and this will depend on the facts and circumstances of each case.

One particular situation where there might be such an unwritten arrangement, is where the individuals involved are members of the same family. In such situations, whether common control exists between family members very much depends on the specific facts and circumstances and requires judgement.

A starting point could be the definition in IAS 24 of 'close members of the family of a person' as "those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity and include:

(a) that person's children and spouse or domestic partner;

(b) children of that person's spouse or domestic partner; and

(c) dependants of that person or that person's spouse or domestic partner." *[IAS 24.9]*.

How we see it

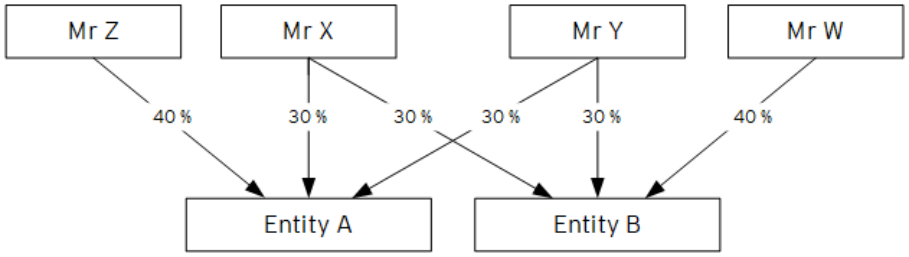
Whether common control exists between family members depends on the specific facts and circumstances, as often there will not be a written agreement between family members. In our view, the influence that normally arises within relationships between 'close members of the family' (as defined in IAS 24) means that it is possible that an unwritten arrangement exists. If family members are not 'close members of the family', we believe that there is a presumption that common control does not exist and clear evidence that those non-close family members act collectively, rather than independently, must exist to overcome this presumption.

If the individuals concerned are 'close members of the family' as defined in IAS 24 (and further discussed in Chapter 35 at section 3.1.1), then it is possible that they will act collectively, and the scope exclusion in IFRS 3 might apply. This could be the case where one family member effectively controls the voting of a dependent family member (e.g., scenario (a) in Illustration 2-1 below). It is also possible that a highly influential parent is able to ensure that adult family members act collectively (e.g., scenario (b) in Illustration 2-1 below). In this case, there would need to be clear evidence that the family influence has resulted in a pattern of collective family decisions. However, common control is unlikely to exist where the family members are adult siblings (e.g., scenario (c) in Illustration 2-1 below), as such individuals are more likely to act independently.

In all such situations involving family members, whenever there is sufficient evidence that the family members (irrespective of the family relationship) have acted independently, then the scope exclusion in IFRS 3 for business combinations under common control does not apply.

Illustration 2-1: Common control involving individuals

Entity A has three shareholders, Mr X, Mr Y and Mr Z. Mr X and Mr Y are family members who each hold a 30% interest in Entity A. Mr X and Mr Y also each hold a 30% interest in Entity B. There is no written contractual arrangement between Mr X and Mr Y requiring them to act collectively as shareholders in Entity A and Entity B. Both Entity A and Entity B are businesses as defined in IFRS 3.



If Entity A acquires 100% of Entity B, is this a business combination under common control and therefore outside the scope of IFRS 3 when the nature of the family relationship is:

(a) Mr X is the father and Mr Y is his young dependent son?

(b) Mr X is a patriarchal father and - because of his highly influential standing - his adult son Mr Y has traditionally followed his father's decisions?

(c) Mr X and Mr Y are adult siblings?

Whether common control exists between family members very much depends on the specific facts and circumstances. If so, the business combination would be outside the scope of IFRS 3.

Scenario (a)

The business combination might be outside the scope of IFRS 3. The father, Mr X, might effectively control the voting of his dependent son, Mr Y, by acting on his behalf and thus vote the entire 60% combined holding collectively. However, if there is evidence that Mr X and Mr Y are acting independently (e.g., by voting differently at shareholder or board meetings), the scope exclusion would not apply since these close family members have not been acting collectively to control the entities.

Scenario (b)

The business combination might be outside the scope of IFRS 3. A highly influential parent might be able to ensure that adult family members act collectively. However, there would need to be clear evidence that the family influence has resulted in a pattern of collective family decisions. If there is any evidence that Mr X and Mr Y are acting independently (e.g., by voting differently at shareholder or board meetings), the scope exclusion would not apply since the parent and adult family member have not been acting collectively to control the entities.

Scenario (c)

Common control is unlikely to exist, and therefore the business combination would be in scope of IFRS 3. In this scenario where Mr X and Mr Y are adult siblings (and not considered close family members otherwise), it is less likely that an unwritten arrangement will exist. Where family members are not 'close', they are less likely to have influence over each other and more likely to act independently. Accordingly, in our view, there is a presumption that common control does not exist between non-close family members. Sufficient evidence that they act collectively, rather than independently, would be needed to overcome this presumption.

If in Illustration 2-1 above, Mr X and Mr Y had been unrelated, then, in the absence of a written agreement, consideration would need to be given to all facts and circumstances to determine whether it is appropriate to exclude the transaction from the scope of IFRS 3. As discussed above, in our view, there would need to be very strong evidence of them acting together to control both entities in a collective manner, in order to demonstrate that an unwritten contractual arrangement really exists, and that such control is not transitory.

Prior to the acquisition of Entity B by Entity A in Illustration 2-1 above, another question is whether financial statements can be prepared under IFRS accounting standards for a 'reporting entity' that does not comprise a group under IFRS 10 (i.e., combined financial statements comprised of such 'sister' companies). This issue is discussed in Chapter 7 at section 2.2.6.

2.1.2 Transitory control

IFRS 3 requires that common control is 'not transitory' as a condition for the scope exclusion to apply. *[IFRS 3.B1, IFRS 3.B2]*. In contrast, if common control is only transitory, the business combination is still within the scope of IFRS 3. The 'not transitory' condition was included when IFRS 3 was first issued in 2004 to deal with concerns that business combinations between parties acting at arm's length could be structured through the use of 'grooming' transactions so that, for a brief period immediately before and after the combination, the combining entities or businesses are under common control. In this way, it might have been possible for combinations that would otherwise be accounted for in accordance with IFRS 3 using the purchase method (now called 'acquisition method') to be accounted for using some other method. *[IFRS 3(2007).BC28]*. Questions have been raised, however, on the meaning of 'transitory control'.

The IFRS IC was asked in 2006 whether a reorganisation involving the formation of a Newco to facilitate the sale of part of an organisation is a business combination within the scope of IFRS 3. Some suggested that, because control of Newco is transitory (i.e., it is subsequently sold), a combination involving that Newco would be within the scope of IFRS 3. The IFRS IC however, observed that IFRS 3.22 (now IFRS 3.B18) states that when an entity is formed to issue equity instruments to effect a business combination, one of the combining entities that existed before the combination must be identified as the acquirer. To be consistent, the IFRS IC noted that the question of whether the entities or businesses are under common control applies to the combining entities that existed before the combination (i.e., excluding the newly formed entity that did not exist before). Accordingly, the IFRS IC decided not to add this topic to its agenda.[7] Although the issue was considered in the context of the original IFRS 3, the comments remain valid as the relevant requirements in the current version of the standard are substantially unchanged. *[IFRS 3.B18]*.

Therefore, whether or not a Newco is set up within an existing group to facilitate the disposal of businesses is irrelevant as to whether or not common control is transitory. Another question is whether the fact that the reorganisation results in the parent of the existing group losing control over those businesses, means that common control is transitory.

How we see it

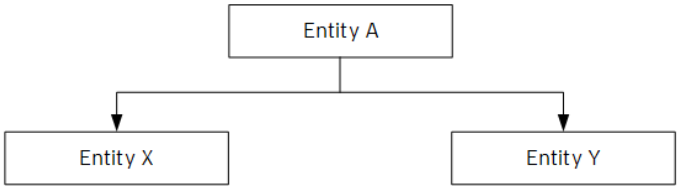
In our view, common control is not considered to be 'transitory' just because a reorganisation is undertaken to facilitate the disposal of businesses (e.g., by sale or IPO). Whether common control is transitory or not is assessed by looking at the duration of control over each of the combining businesses in the period before and after the reorganisation. It is not limited to an assessment of the duration of control only after the reorganisation.

7 *IFRIC Update*, March 2006, *IFRIC Agenda Decisions: 'Transitory' Common Control*. Available on the IFRS Foundation's website.

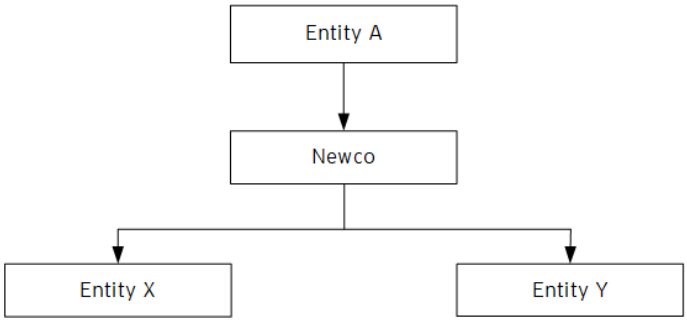
Accordingly, the requirement that common control is not transitory is intended as an anti-avoidance mechanism to prevent business combinations between parties acting at arm's length from being structured through the use of 'grooming' transactions so that, for a brief period immediately before and after the combination, the combining entities or businesses are under common control. Consequently, whether or not common control is transitory is assessed by looking at the duration of control in the period both before and after the reorganisation. Therefore, an intention to sell the businesses or go to an IPO shortly after the reorganisation does not, by itself, preclude the scope exclusion in IFRS 3 from applying. This is also consistent with the ordinary meaning of 'transitory' being something which is fleeting, brief or temporary. However, section 4.1 below discusses certain limited situations in which a Newco that is used to facilitate an external sale or IPO might be considered an acquirer.

Illustration 2-2: The meaning of 'transitory' common control

Entity A currently has two businesses (as defined in IFRS 3) operated through wholly-owned subsidiaries Entity X and Entity Y. The group structure (ignoring other entities within the group) is as follows:



Entity A proposes to combine the two businesses (currently housed in two separate entities, Entity X and Entity Y) into one entity and then spin off the combined entity as part of an IPO. Both businesses have been owned by Entity A for several years. The reorganisation will be structured such that Entity A will first establish a new entity (Newco) and transfer its interests in Entity X and Entity Y to Newco, resulting in the following group structure:



Newco will then be subject to an IPO, with the result that Entity A will lose control.

If Newco were to prepare consolidated financial statements, would the reorganisation undertaken to facilitate the disposal of Entity X and Entity Y be in the scope of IFRS 3? Or would the scope exclusion for business combinations under common control apply?

The question of whether the entities or businesses are under common control applies to the combining entities that existed before the combination, excluding the newly formed entity, i.e., Entity X and Entity Y. These are clearly entities that have been under the common control of Entity A and remain so after the transfer.

If Newco prepares consolidated financial statements without there being an intended IPO, the scope exclusion would apply. However, as the purpose of the transaction was to facilitate the disposal of the businesses by way of an IPO, such that Entity A loses control over Entity X and Entity Y, does this mean that common control is transitory?

In our view, the answer is 'no'. Common control is not considered to be transitory and therefore the reorganisation is excluded from the scope of IFRS 3. This is consistent with the ordinary meaning of transitory. The common control of Entity X and Entity Y was not fleeting in the fact pattern as both entities had been controlled by Entity A for several years. In contrast, if Entity Y had only recently come into the group, this might well indicate that control is transitory.

Although Illustration 2-2 above involves a newly formed entity, the same considerations apply regardless of how the reorganisation has been structured prior to the IPO. For example, Entity X might have acquired Entity Y or the net assets and trade of Entity Y, with Entity X then being subject to an IPO. In such a situation, Entity X would apply the scope exclusion for business combinations under common control.

3 Accounting for business combinations involving entities or businesses under common control

IFRS 3 prescribes a single method of accounting for all business combinations that are within its scope, i.e., the acquisition method. No other methods are described and the standard does not address the appropriate accounting for business combinations under common control excluded from its scope. The 'pooling of interests' method and 'fresh start' method are only referred to in the Basis for Conclusions as possible methods of accounting but were not deemed appropriate for all business combinations. *[IFRS 3.BC23]*.

The discussion in sections 3.1 to 3.3.6 below considers how entities account for business combinations under common control outside the scope of IFRS 3 (described in section 2 above). If the assets acquired and liabilities assumed do not constitute a business, the transaction is accounted for as an asset acquisition. The accounting for acquisitions of (net) assets under common control is discussed in Chapter 9 at section 4.4.2.D. Transactions under common control involving a Newco, which might or might not be a business combination as defined in IFRS 3, are considered separately in section 4 below.

Legal mergers between a parent and its subsidiary are discussed in Chapter 9 at section 4.4.3.B.

3.1 Pooling of interests method or acquisition method

Extract from IAS 8

10 In the absence of an IFRS that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is:

(a) relevant to the economic decision-making needs of users; and

(b) reliable, in that the financial statements:

(i) represent faithfully the financial position, financial performance and cash flows of the entity;

(ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;

(iii) are neutral, ie free from bias;

(iv) are prudent; and

(v) are complete in all material respects.

11 In making the judgement described in paragraph 10, management shall refer to, and consider the applicability of, the following sources in descending order:

(a) the requirements in IFRSs dealing with similar and related issues; and

(b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the *Conceptual Framework for Financial Reporting* (*Conceptual Framework*).[2]

12 In making the judgement described in paragraph 10, management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices, to the extent that these do not conflict with the sources in paragraph 11.

2 Paragraph 54G explains how this requirement is amended for regulatory account balances.

[IAS 8.10, IAS 8.11, IAS 8.12].

IFRS 3 scopes out business combinations under common control and is not prescriptive otherwise as to the method of accounting for such transactions. Entities must therefore develop an accounting policy that results in relevant and reliable information by applying the hierarchy in IAS 8.10-12 (discussed in Chapter 3 at section 4.3). *[IAS 8.10, IAS 8.11, IAS 8.12]*.

Applying that hierarchy, entities could refer to IFRS 3 as an IFRS accounting standard that deals with a similar and related issue and apply the acquisition method by analogy. Entities could also consider the most recent pronouncements of other standard-setting bodies having a similar framework to IFRS accounting standards, other accounting literature and accepted industry practices, to the extent that these do not conflict with any IFRS accounting standard or the *Conceptual Framework for Financial Reporting*. Several standard-setting bodies have issued guidance and some allow or require a pooling of interests-type method (also referred to as 'predecessor accounting', 'merger accounting' or 'carry over accounting' in some jurisdictions) to account for business combinations under common control.

How we see it

We believe that a receiving entity accounting for a business combination under common control must apply either:

(a) The acquisition method set out in IFRS 3 (see section 3.2 below)

Or

(b) The pooling of interests method (see section 3.3 below)

However, in our view, this accounting policy choice is only available if the transaction has substance for the combining parties. If there is no substance to the transaction, the pooling of interests method is the only method that can be applied to that transaction. If there is substance to the transaction, whichever accounting policy is adopted must be applied consistently to similar categories of transactions as required by IAS 8. An entity needs to exercise judgement in developing and consistently applying an accounting policy that results in information that is relevant and reliable in the particular circumstances.

We do not consider that the 'fresh start' method, whereby all assets and liabilities of all combining businesses are restated to fair value, is an appropriate method of accounting for business combinations under common control.

We believe that the accounting policy choice above is only available if the transaction has substance, because the acquisition method results in measuring the net identifiable assets of one or more of the businesses involved at their acquisition-date fair values (with some limited exceptions - see Chapter 10 at section 5) and/or the recognition of goodwill (or gain on a bargain purchase). IFRS accounting standards contain limited circumstances when net assets are restated to fair value and prohibit the recognition of internally generated goodwill. A common control transaction must not be used to circumvent these limitations. Careful consideration is required of all facts and circumstances, before it is concluded that a transaction has substance.

If substance exists, we believe that a receiving entity is allowed to determine a policy for how categories of BCUCC transactions will be accounted, provided the policy results in relevant and reliable information. For example, some entities might conclude that two BCUCC both have substance but that use of the acquisition method provides more relevant information to the users of the financial statements where the BCUCC is made on terms equivalent to those prevailing in arm's length transactions and the receiving company is a publicly traded subsidiary with non-controlling interests. By contrast, some entities might determine that the use of pooling for BCUCC involving wholly-owned subsidiaries provides more relevant and reliable information in the circumstances (even if the transaction is determined to have substance).

How we see it

Evaluating whether a business combination under common control has substance will involve consideration of multiple factors, including (but not necessarily limited to):

- The purpose of the transaction
- The involvement of outside parties in the transaction, such as NCI or other third parties
- Whether or not the transaction is conducted at fair value
- The existing activities of the entities involved in the transaction

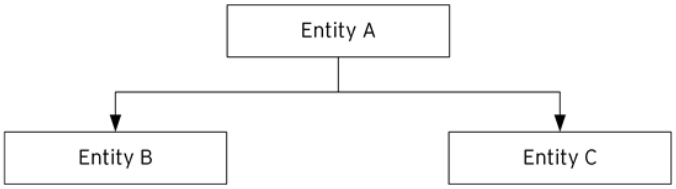
And

- Whether or not it is bringing entities together into a reporting entity that did not exist before

The concept of 'reporting entity' is clarified in the *Conceptual Framework for Financial Reporting*. A reporting entity is described as "an entity that is required, or chooses, to prepare financial statements." This can be a single entity or a portion of an entity or comprise more than one entity. A reporting entity is not necessarily a legal entity. *[CF 3.10]*. Further discussion is included in Chapter 2 at section 6.2 and Chapter 7 at section 2.2.6.

Illustration 3-1: Accounting for business combinations under common control - use of acquisition method? (1)

Entity A currently has two businesses (as defined in IFRS 3) operated through wholly-owned subsidiaries Entity B and Entity C. The group structure (ignoring other entities within the group) is as follows:



Entity A proposes to combine the two complementary businesses (currently housed in two separate entities, Entity B and Entity C) into one entity, in anticipation of spinning off the combined entity by way of an IPO. Both businesses have been owned by Entity A for several years. The reorganisation will be structured such that Entity C will acquire the shares of Entity B from Entity A for cash at their fair value of CU1,000. The carrying amount of the net assets of Entity B is CU200 (both in the individual financial statements of Entity B and in the consolidated financial statements of Entity A). The net of the acquisition-date fair values of the identifiable assets acquired and liabilities assumed of Entity B (measured in accordance with IFRS 3) is CU600.

How would this transaction (to facilitate a subsequent spin-off) be accounted for in the consolidated financial statements of both Entity C and Entity A?

As far as Entity C is concerned, there is a business combination that needs to be accounted for. That business combination is however excluded from the scope of IFRS 3, as it is under common control and that control is not transitory. In this fact pattern, there is substance to the transaction. There is a business purpose to the transaction; it has been conducted at fair value; both Entity B and Entity C have existing activities; and they have been brought together into a reporting entity that did not exist before (assuming no general purpose combined financial statements were prepared before - see Chapter 7 at section 2.2.6). Accordingly, Entity C can apply either the acquisition method as set out in IFRS 3 or the pooling of interests method in its consolidated financial statements. The selected accounting policy must be applied consistently to similar transactions.

If Entity C selects the acquisition method, it will need to identify whether Entity C or Entity B is the acquirer (see section 3.2 below). Assuming that Entity C is identified as the acquirer, in summary, this will mean that the net identifiable assets of Entity B will be initially reflected at their acquisition-date fair values (CU600), together with goodwill of CU400 (CU1,000 less CU600), in the consolidated statement of financial position. Only the post-acquisition results of Entity B will be reflected in the consolidated statement of comprehensive income.

As far as Entity A is concerned (i.e., from the perspective of the controlling party), there has been no change in the reporting entity - all that has happened is that Entity B, rather than being directly held and controlled by Entity A, is now indirectly held and controlled through Entity C (i.e., no change in control). Accordingly, there is no business combination and the effects resulting from the intragroup transaction are eliminated in full. Thus, the carrying amounts for Entity B's net assets included in the consolidated financial statements of Entity A do not change. There are also no NCI affected. The transaction therefore has no impact on the consolidated financial statements of Entity A (except for any potential tax consequences).

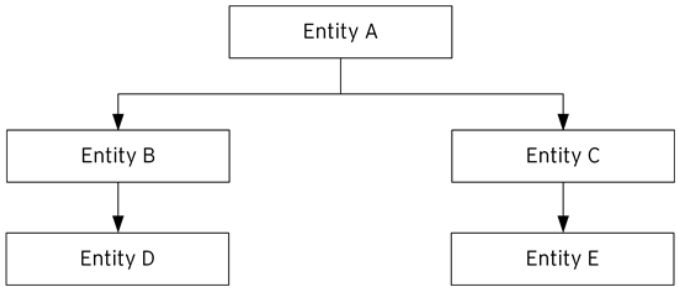
In Illustration 3-1 above, Entity C had to account for its business combination with Entity B, as it was preparing consolidated financial statements. In some situations, Entity C would not need to account for the business combination at all, as it might be exempt as an intermediate parent company from preparing consolidated financial statements (see Chapter 7 at section 2.2.1). If in Illustration 3-1 above, Entity C had acquired the business of Entity B, rather than the shares, then the same accounting policy choice would have to be made for the business combination in Entity C's financial statements, even if they are not consolidated financial statements.

However, in other types of reorganisations, careful consideration of the factors above might indicate that there is no substance to the transaction. This is shown in Illustration 3-2 below.

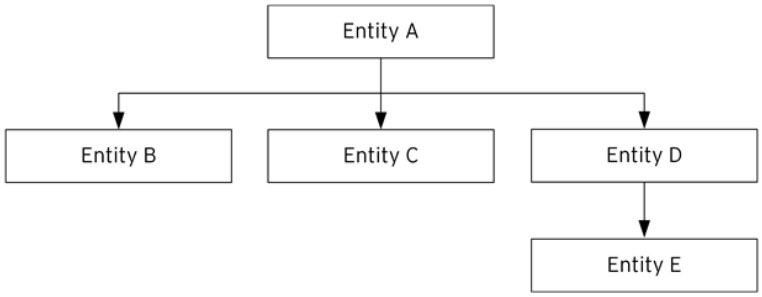
Illustration 3-2: Accounting for business combinations under common control - use of acquisition method? (2)

Entity A engages in different business activities in two geographical areas through four wholly-owned subsidiaries (all owned for several years). Each subsidiary individually meets the definition of a business in IFRS 3. Traditionally, the legal structure followed the geographical areas of operations. To align with its management structure, which is organised by business segment, Entity A proposes to reorganise its legal structure. This two-step process involves (i) Entity B distributing its shares in Entity D to Entity A, and (ii) Entity D acquiring the shares in Entity E. The transaction price for (ii) reflects the carrying amount of Entity E's net assets as included in the consolidated financial statements of Entity A. The group structure before and after this reorganisation is as follows:

Before



After



How would this transaction (to align the group's legal and management structure) be accounted for in the consolidated financial statements of both Entity A and Entity D?

As far as Entity A is concerned, neither its own acquisition of the shares in Entity D (by way of distribution from Entity B) nor the transfer of shares in Entity E from Entity C to Entity D represents a business combination. As described in Illustration 3-1 above, from the perspective of the controlling party, there is no change of control. Because there is also no NCI affected, the reorganisation has no impact on the consolidated financial statements of Entity A (except for any potential tax consequences).

In contrast, in the consolidated financial statements of Entity D, there is a business combination that needs to be accounted for. That business combination is however excluded from the scope of IFRS 3, as it is under common control and that control is not transitory. In this fact pattern, the transaction is bringing entities together into a reporting entity that did not exist before (assuming no general purpose combined financial statements were prepared before; see Chapter 7 at section 2.2.6) and both Entity D and Entity E have existing activities. Nevertheless, there is no substance to the transaction. There is no clear business purpose to the transaction; the restructuring is purely internal, with no external parties being involved; and the transaction is not conducted at fair value. Consequently, Entity D cannot apply the acquisition method in its consolidated financial statements. This reorganisation will be accounted for using the pooling of interests method.

In Illustration 3-2 above, Entity D had to account for its business combination with Entity E, as it was preparing consolidated financial statements. In some situations, Entity D would not need to account for the business combination at all, as it might be exempt as an intermediate parent company from preparing consolidated financial statements (see Chapter 7 at section 2.2.1). If in Illustration 3-2 above, Entity D had acquired the business of Entity E, rather than the shares, then the business combination would similarly have to be accounted for using the pooling of interests method in Entity D's financial statements, even if they are not consolidated financial statements.

3.2 Application of the acquisition method under IFRS 3

The application of the acquisition method is set out in IFRS 3 and discussed generally in Chapter 10. This method involves the following steps:

- Identifying the acquirer (see Chapter 10 at section 4.1)
- Determining the acquisition date (see Chapter 10 at section 4.2)
- Recognising and measuring the identifiable assets acquired, the liabilities assumed, and any NCI in the acquiree (see Chapter 10 at section 5)

  And
- Recognising and measuring goodwill or a gain on a bargain purchase (see Chapter 10 at section 6) *[IFRS 3.5]*

It could be that in some cases the identification of the acquirer means that the business combination under common control needs to be accounted for as a reverse acquisition (see Chapter 10 at section 14). Careful consideration is required where the transaction involves a Newco, as it is often a high hurdle for a Newco to be identified as the acquirer under IFRS 3 (see section 4.1 below).

Goodwill at the acquisition date is computed as the excess of (a) over (b) below:

(a) The aggregate of:
  (i) The consideration transferred (generally measured at acquisition-date fair value)
  (ii) The amount of any NCI in the acquiree

  And
  (iii) The acquisition-date fair value of the acquirer's previously held equity interest in the acquiree

(b) The net of the acquisition-date fair values (or other amounts measured in accordance with IFRS 3) of the identifiable assets acquired and the liabilities assumed *[IFRS 3.32]*

Where (b) exceeds (a) above, IFRS 3 regards this as giving rise to a gain on a bargain purchase. *[IFRS 3.34]*.

The requirements of IFRS 3 in relation to the acquisition method have clearly been developed for dealing with business combinations between parties transacting on an arm's length basis. The consideration transferred in a business combination at arm's length will generally be measured at the acquisition-date fair values of the assets transferred, liabilities incurred and/or equity interests issued by the acquirer (see Chapter 10 at section 7). The fair value of that consideration normally reflects the value of the acquired business. For business combinations under common control, however, this might not be the case. The transaction might not be at arm's length and the fair value of the consideration transferred might not reflect the value of the acquired business.

Where a higher value is given up than received, economically, the difference represents a distribution from the receiving entity's equity. Conversely, where a higher value is received than given up, the difference represents a contribution to the receiving entity's equity. Nevertheless, IFRS accounting standards neither require nor prohibit the recognition by the acquirer of a non-arm's length element in a business combination under common control.

How we see it

If a business combination under common control is not at arm's length, this might suggest that there is no substance to the transaction, in which case application of the acquisition method would not be appropriate (see section 3.1 above). If, however, the acquisition method is appropriate, in our view, the receiving entity can either:

(a) Recognise the transaction at the consideration transferred as agreed between the parties (measured at the acquisition-date fair value in accordance with IFRS 3)

  Or

(b) Recognise the transaction at the fair value of the acquired business (with the difference between the fair value of the consideration transferred and the fair value of the acquired business as a contribution to or distribution from equity)

Whichever accounting policy is adopted, it must be applied consistently.

This accounting policy choice is considered in Illustration 3-3 below. As the example does not include any NCI in the acquiree, nor any previously held interest in the acquiree by the acquirer, the computation of goodwill or a gain on a bargain purchase only involves the comparison between the consideration transferred and the net of the acquisition-date fair values of the identifiable assets acquired and liabilities assumed.

Illustration 3-3: Acquisition method - cash consideration less than the fair value of acquired business

Assume the same facts as in Illustration 3-1 above, except that Entity C, rather than acquiring Entity B from Entity A for cash at its fair value of CU1,000, only pays cash of CU700. Assuming there is still substance to the transaction, how would this be reflected by Entity C (if identified as the acquirer) when applying the acquisition method for its acquisition of Entity B?

As discussed above, in our view, there are two acceptable ways of accounting for the transaction:

(a) The transaction is recognised at the consideration transferred as agreed between Entity A and Entity C, being the acquisition-date fair value of the cash given as consideration, i.e., CU700. Accordingly, goodwill of only CU100 (CU700 less CU600) is recognised.

(b) The transaction is recognised at the fair value of the acquired business (CU1,000), with a deemed capital contribution from Entity A for the excess over the acquisition-date fair value of the cash given as consideration, i.e., CU300 (CU1,000 less CU700), reflected in Entity C's equity. Accordingly, goodwill of CU400 (CU1,000 less CU600) is recognised.

Whichever method is adopted, it must be applied on a consistent basis.

If Entity C only paid cash of CU500, assuming there is still substance to the transaction, then the impact under (a) and (b) above would be as follows:

(a) Since the consideration transferred is only CU500, no goodwill is recognised. However, a gain on a bargain purchase of CU100 (being the excess of the acquisition-date fair value of the net identifiable assets of Entity B of CU600 over the consideration transferred of CU500) is recognised immediately in profit or loss.

(b) As before, goodwill of CU400 is recognised, but a capital contribution of CU500 (CU1,000 less CU500) would be reflected in equity.

In Illustration 3-1 and Illustration 3-3 above, the consideration transferred by Entity C was in cash. However, what if Entity C issued shares to Entity A to effect this business combination under common control?

If an acquirer issues equity interests to effect a business combination, IFRS 3 requires the consideration transferred to be measured at the acquisition-date fair value of these equity interests issued. *[IFRS 3.37]*. As discussed in Chapter 10 at section 7, in a business combination in which the acquirer and the acquiree (or its former owners) exchange only equity interests, the acquisition-date fair value of the acquiree's equity interests might be more reliably measurable than that of the acquirer's equity interests. In that case, IFRS 3 requires goodwill to be calculated using the fair value of the acquiree's equity interests rather than the fair value of the equity interests transferred. *[IFRS 3.33]*.

IFRS 3 does not include detailed guidance on measuring the fair value of equity interests issued as consideration. In such circumstances, IFRS 13 *Fair Value Measurement* is relevant because it applies when another IFRS accounting standard requires or permits fair value measurements. *[IFRS 13.5]*. Fair value is defined as follows: *[IFRS 13.9]*

Extract from IFRS 13

9 This IFRS defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

IFRS 13 requires that entities maximise the use of relevant observable inputs and minimise the use of unobservable inputs to meet the objective of a fair value measurement. *[IFRS 13.36]*. If either the acquirer's or acquiree's shares are quoted, this would indicate which fair value is more reliably measurable. However, in arrangements between entities under common control, a quoted price for either the acquirer's or the acquiree's shares might not always be available. IFRS 13 is discussed in detail in Chapter 15.

In Illustration 3-3 above, if Entity C issued shares to Entity A to acquire Entity B, and there is no quoted price for either Entity B's or Entity C's shares, then the fair value of the consideration transferred would need to be based on whichever shares are considered to be more reliably measurable. If this were Entity C's shares and their fair value was only CU700, then Entity C would similarly have an accounting policy choice between (a) and (b) above. This choice exists regardless of whether Entity C transfers cash or equity interests as consideration. However, if Entity B's shares are considered to be more reliably measurable, both approaches would result in a similar outcome. This is because the consideration transferred by Entity C would then be based on the fair value of Entity B, i.e., CU1,000. Thus, goodwill of CU400 would be recognised, with the CU1,000 consideration transferred reflected in equity.

3.3 Application of the pooling of interests method

We believe that if an entity does not adopt an accounting policy of using the acquisition method under IFRS 3, or if the transaction has no substance, the pooling of interests method must be applied when accounting for business combinations under common control (see section 3.1 above).

3.3.1 General requirements

IFRS 3 makes no reference to the pooling of interests method, except in the context of rejecting it as a method of accounting for business combinations generally. Various local standard-setters have issued guidance, and some allow or require a pooling of interests-type method (sometimes known as 'predecessor accounting', 'merger accounting' or 'carry over accounting') to account for business combinations under common control. The pooling of interests method is generally considered to involve the following:[8]

- The assets and liabilities of the combining parties are reflected at their carrying amounts.

  No adjustments are made to reflect fair values, or recognise any new assets or liabilities, at the date of the combination that would otherwise be done under the acquisition method. The only adjustments made are to align accounting policies.
- No 'new' goodwill is recognised as a result of the combination.

  The only goodwill that is recognised is any existing goodwill relating to either of the combining parties. Any difference between the consideration transferred and the acquired net assets is reflected within equity.
- The income statement reflects the results of the combining parties.

Different practices exist as to where in equity any difference between the consideration transferred and acquired net assets is presented (e.g., in retained earnings or a separate merger reserve). IFRS accounting standards generally do not prescribe presentation within equity. Also, this is often influenced by legal or regulatory requirements in an entity's jurisdiction.

Apart from the second bullet point above, the application of the pooling of interests method, in the context of accounting for business combinations under common control under IFRS accounting standards, does raise particular issues as discussed in sections 3.3.2 to 3.3.6 below.

3.3.2 Carrying amounts of assets and liabilities

In general, no adjustments would be expected to be required to conform accounting policies of the entities involved in a business combination under common control. This is because in preparing the consolidated financial statements of the ultimate parent under IFRS accounting standards, uniform accounting policies would have been adopted by all members of the group. *[IFRS 10.19, IFRS 10.B87]*. However, it might be necessary to make adjustments where the combining entities or businesses used different accounting policies when preparing their own financial statements or were not part of the same group before.

The main issue relating to the use of predecessor carrying amounts, when the receiving entity applies the pooling of interests method for business combinations under common control, is whether the carrying amounts of the assets acquired and liabilities assumed are based on:

(a) The carrying amounts recognised by the controlling party (e.g., those reported in the consolidated financial statements of the parent)

  Or

(b) The carrying amounts recognised by the transferred business (e.g., those reported in the financial statements of the acquiree)

A difference between (a) and (b) above might result from fair value adjustments and/or goodwill that have/has arisen on the past acquisition of the transferred business by that controlling party.

The carrying amounts of the receiving entity's assets and liabilities remain the same as those in its existing financial statements prior to the business combination under common control.

8 For example, see FASB ASC 805-50, *Business Combinations - Related Issues*; and the Financial Reporting Council's FRS 102 Section 19, *Business Combinations and Goodwill*, paras. 29-32 (which refers to merger accounting).

How we see it

In our view, when applying the pooling of interests method for business combinations under common control, the receiving entity generally would use the carrying amounts as recognised by the controlling party for the transferred business (i.e., those in (a) above).

Usually, the carrying amounts as recognised in the ultimate parent's IFRS consolidated financial statements are used. However, there could be cases where the facts and circumstances mean that the carrying amounts as recognised in the IFRS consolidated financial statements of an intermediate parent provide relevant information.

In certain circumstances, it might be acceptable to use the carrying amounts as recognised by the transferred business (i.e., those in (b) above). Factors to consider include:

- The timing of the transaction
- Whether the transaction is in preparation for an external sale
- The identity and nature of the users of the financial statements
- Whether an accounting policy was already set for similar and related transactions
- Difficulties in identifying consolidated book values for the transferred business under IFRS accounting standards

An entity needs to exercise judgement in determining the basis for the carrying amounts of the transferred business that results in information that is relevant and reliable in the particular circumstances.

We believe that the receiving entity generally would use the carrying amounts in (a) above because those carrying amounts might be more recent (and therefore relevant) and reflect the perspective of that party that effectively directs the transaction. Generally, the consolidated book values under IFRS accounting standards of the ultimate parent are used. However, there can be cases where the consolidated book values under IFRS accounting standards of another parent in the group provide relevant information to the users of the financial statements. For example, it might be that the ultimate parent does not prepare IFRS consolidated financial statements including the transferred business whereas an intermediate parent does so. Even where both the ultimate parent and an intermediate parent prepare IFRS consolidated financial statements including the transferred business and the receiving entity, the carrying amounts in the lower-level consolidation might provide more relevant information, having regard to the factors listed below. For example, significant non-controlling interests or creditors in the intermediate parent's subgroup might rely primarily on the IFRS consolidated financial statements of the intermediate parent.

When evaluating if the carrying amounts in (b) above can be used, the following factors need to be considered:

- The timing of the business combination under common control in comparison to when the transferred business was previously acquired by the controlling party, if applicable. Generally, the carrying amounts in (a) above are deemed more relevant as they were reassessed more recently. However, the longer the period since the previous acquisition by the controlling party, the less relevant this factor might be. Where an intragroup transfer follows shortly after a third-party acquisition, use of the carrying amounts in (a) is appropriate because these represent the book values to the controlling party's group using the acquisition method. Use of the carrying amounts in (b) would give a different answer purely due to the structuring rather than reflecting the substance of the transaction.
- Whether the transaction is a 'grooming' transaction in preparation for a spin-off, sale or similar external transaction. Generally, the carrying amounts in (a) above will be more relevant in such a situation (for the reasons explained above). However, it could be argued that in a grooming transaction leading to an external trade sale (with different owners), the new owners are indifferent as to whether the carrying amounts in (a) or (b) are used, particularly if the transferred business had been acquired by its previous owners some considerable time before.
- The identity and nature of the users of the financial statements. If a broad group of users of the financial statements of the receiving entity after the transaction are parties that previously relied upon the financial statements of, or including, the transferred business before the transaction (e.g., if there are significant NCI and/or creditors), using the amounts in (b) above might provide more relevant information.
- Whether an accounting policy was already set within the group for similar and related common control transactions (e.g., whether the accounting policy for this transaction is consistent with the accounting policy applied to legal mergers between a parent and a subsidiary - see Chapter 9 at section 4.4.3.B).

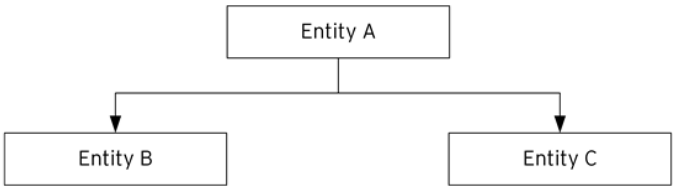
- Difficulties in identifying reliable book values under IFRS accounting standards for the transferred business. It will be more difficult and costly to use the carrying amounts in (a) if the controlling party has not previously prepared IFRS consolidated financial statements. In addition, it might be that allocations of goodwill and intangible assets which are reported in the IFRS consolidated financial statements need to be made when determining the consolidated book values relating to the transferred business. In such circumstances, it might be more straightforward to determine the carrying amounts in accordance with IFRS accounting standards for the transferred business particularly if these already exist.

Determining the appropriate basis of the IFRS carrying amounts of the transferred business requires judgement to ensure the information presented is relevant and reliable in the particular circumstances. It will generally be appropriate to disclose the basis used in the material accounting policy information and, where relevant, to disclose key judgements made. *[IAS 1.117, IAS 1.122]*.

The rationale for using the carrying amounts as recognised by the controlling party is explained further in Illustration 3-4 below.

Illustration 3-4: Pooling of interests method - carrying amounts of assets acquired and liabilities assumed

Entity A currently has two businesses (as defined in IFRS 3) operated through wholly-owned subsidiaries Entity B and Entity C. The group structure (ignoring other entities within the group) is as follows:



Both entities have been owned by Entity A for a number of years.

On 1 October 20X2, Entity A restructures the group by transferring its investment in Entity C to Entity B, such that Entity C becomes a subsidiary of Entity B. The accounting policy adopted for business combinations under common control excluded from IFRS 3 is to apply the pooling of interests method.

In Entity B's consolidated financial statements for the year ending 31 December 20X2, which carrying amounts would be reflected in respect of the assets and liabilities of Entity C?

Entity B generally would use the carrying amounts reported in Entity A's consolidated financial statements, rather than the carrying amounts reported in Entity C's own financial statements.

Accordingly, they will be based on their fair values as at the date Entity C became part of the Entity A group and adjusted for subsequently in accordance with the applicable IFRS accounting standards. Any goodwill relating to Entity C that was recognised in Entity A's consolidated financial statements, will also be recognised in Entity B's consolidated financial statements. Any difference between the equity of Entity C and those carrying amounts are adjusted against equity. The carrying amounts of the net assets of Entity B will remain as before.

The rationale for applying this approach is that the transaction is essentially a transfer of the assets and liabilities of Entity C from the consolidated financial statements of Entity A to the financial statements of Entity B. From a group perspective of Entity B's shareholder, nothing has changed except the location of those assets and liabilities. Entity B has effectively taken on the group's ownership. Therefore, the carrying amounts used in the consolidated financial statements are the appropriate and most relevant values to apply to the assets and liabilities of Entity C, as they represent the carrying amounts to the Entity A group.

The transferring entity might prepare IFRS financial statements which consolidate the transferred business up to the date of loss of control. The transferred business might qualify as a disposal group held for sale in the transferring entity's consolidated financial statements prior to the date of loss of control as a consequence of the expected sale to another entity in the same common control group. In accordance with IFRS 5, the transferring entity would cease depreciation of non-current assets and the disposal group would be measured at the lower of cost and fair value less costs of disposal. A similar situation could arise in the transferring entity's individual IFRS financial statements if the transferred business is an unincorporated business.

However, in the ultimate parent's case, its consolidated financial statements would not reflect IFRS 5 adjustments since it has not lost control of the transferred business.

When the receiving entity accounts for the transferred business under the pooling method using the transferring entity's book values, the question arises as to whether the carrying amounts recorded by the receiving entity in its IFRS financial statements need to reflect IFRS 5 adjustments made in relation to the transferred business.

How we see it

In our view, the carrying amounts for the transferred business used by the receiving entity need to exclude the IFRS 5 adjustments that are reflected in the transferring entity's IFRS financial statements. This is because the transferred business remains under common control, so there is no disposal to the wider group.

The same approach applies where the receiving entity uses the carrying amounts for the transferred business that are reflected in the IFRS consolidated financial statements of an intermediate parent that consolidates the transferring but not the receiving entity.

When applying the pooling of interests method to business combinations under common control, the receiving entity would apply the approach outlined above regardless of the legal form of the transaction. Therefore, if in Illustration 3-4 above, Entity B had acquired the business of Entity C, rather than the shares, or the entities had been merged into one legal entity whereby Entity B was the continuing entity, then the same treatment would apply in Entity B's financial statements, even if they are not consolidated financial statements.

3.3.3 Restatement of financial information for periods prior to the date of the combination

Another issue is whether the receiving entity would restate financial information for periods prior to the date of the business combination when applying the pooling of interests method. That is, from which date would the transaction be accounted for and how would comparative information for the prior period(s) be presented?

The pooling of interests method is generally considered to involve the combining parties being presented as if they had always been combined. To this effect, the receiving entity accounts for the transaction from the beginning of the period in which the combination occurs (irrespective of its actual date) and restates comparatives to include all combining parties. However, in applying the IAS 8 hierarchy (see section 3.1 above), an entity would need to consider whether the pooling of interests method is consistent with IFRS 10 specifically. That standard indicates that an entity only includes the income and expenses of a subsidiary in the consolidated financial statements from the date the entity gains control. *[IFRS 10.20, IFRS 10.B88]*.

Extract from IFRS 10

Measurement

B88 An entity includes the income and expenses of a subsidiary in the consolidated financial statements from the date it gains control until the date when the entity ceases to control the subsidiary. Income and expenses of the subsidiary are based on the amounts of the assets and liabilities recognised in the consolidated financial statements at the acquisition date. For example, depreciation expense recognised in the consolidated statement of comprehensive income after the acquisition date is based on the fair values of the related depreciable assets recognised in the consolidated financial statements at the acquisition date.

The IFRS IC discussed the presentation of comparatives when applying the pooling of interests method to business combinations under common control, prior to the issuance of IFRS 10, under the regime of IAS 27 *Consolidated and Separate Financial Statements* (now superseded). However, as resolving the issue would require interpreting the interaction of multiple IFRS accounting standards and the IASB had added a project on business combinations under common control to its research agenda, the IFRS IC decided not to add the issue to its agenda.[9] There was no substantial change in IFRS 10 from superseded IAS 27 regarding the measurement of income and expenses of a subsidiary in the consolidated financial statements.[10]

9 *IFRIC Update*, January 2010, *Agenda decisions: IAS 27 Consolidated and Separate Financial Statements - Presentation of comparatives when applying the 'pooling of interests' method*. Available on the IFRS Foundation's website.

10 Paragraph B88 of IFRS 10 essentially retains the wording of the superseded IAS 27.26, which was as follows: "The income and expenses of a subsidiary are included in the consolidated financial statements from the acquisition date as defined in IFRS 3. Income and expenses of the subsidiary shall be based on the values of the assets and liabilities recognised in the parent's consolidated financial statements at the acquisition date…".

One view is that the concept of pooling does not conflict with the requirements of IFRS 10, on the basis that the combined entity is considered a continuation from the perspective of the controlling party. In business combinations under common control, ultimately, there has been no change in control, because the controlling party already had control over the combined resources - it has merely changed the location of its resources. Accordingly, the receiving entity restates the periods prior to the combination to reflect that there has been no change in ultimate control. IFRS 10.B88 restricts when the pooling of interests method is applied (i.e., not until the combining parties have actually come under direct control), not how it is applied.

Another view is that the requirements of IFRS 10 are inconsistent with the concept of pooling, on the basis that the combined entity did not exist before, from the perspective of the combining parties. Therefore, the consolidated financial statements of the receiving entity cannot include financial information of a subsidiary prior to the date it obtains control, in accordance with IFRS 10.B88. The fact that the business combination is outside of the scope of IFRS 3 is irrelevant when considering the requirements of IFRS 10. Accordingly, the pooling of interests method does not involve restatement of periods prior to the combination and affects only the values assigned to the assets and liabilities of the transferred business when the receiving entity obtains control (see section 3.3.2 above).

How we see it

In our view, when applying the pooling of interests method for business combinations under common control, the receiving entity has an accounting policy choice between:

- View 1 - Restatement of periods prior to the business combination under common control, to the extent that the combining parties were under common control of the same controlling party (retrospective approach)
- View 2 - No restatement of periods prior to the business combination under common control (prospective approach)

An entity must consistently apply its chosen accounting policy.

Under View 1 above, the financial information in the consolidated financial statements is restated for periods prior to the business combination under common control, to reflect the combination as if it had occurred from the beginning of the earliest period presented, regardless of the actual date of the combination. However, financial information for periods prior to the business combination is restated only for the period that the combining parties were under common control of the same controlling party (or parties).

Under View 2 above, the financial information in the consolidated financial statements is not restated for periods prior to the business combination under common control. The receiving entity accounts for the combination prospectively from the date on which it occurred.

These views are illustrated in Illustration 3-5 and Illustration 3-6 below.

Illustration 3-5: Pooling of interests method - restatement of financial information for periods prior to the date of the combination (1)

Assume the same facts as in Illustration 3-4 above.

Entity B obtains control over Entity C on 1 October 20X2.

In preparing its consolidated financial statements for the year ending 31 December 20X2 (including comparatives for one year), from which date would Entity B include financial information for Entity C when applying the pooling of interests method?

Entity B has a choice of two views for its accounting policy, which must be applied consistently:

View 1 - Restatement of periods prior to the business combination under common control, to the extent that the combining parties were under common control of the same controlling party

Entity B and Entity C have been owned by Entity A for a number of years (i.e., common control already existed at the start of the first comparative period presented). Entity B therefore restates the financial information in its consolidated financial statements for 20X2 (both the current year pre-combination results and the 20X1 comparatives) to include financial information for Entity C as from 1 January 20X1.

View 2 - No restatement of periods prior to the business combination under common control

Entity B does not restate the financial information in its consolidated financial statements for 20X2 (neither the current year pre-combination results nor the 20X1 comparatives). No financial information is included for Entity C prior to 1 October 20X2.

In Illustration 3-5 above, Entity C had been part of the Entity A group for a number of years. What if this had not been the case? Entity B still has a choice of two views, to restate or not to restate. If it chooses restatement, then financial information in the consolidated financial statements for periods prior to the combination is restated only for the period that the entities were under common control of the same controlling party (or parties). If the controlling party has not always controlled these combined resources, then application of the pooling of interests method reflects that fact. That is, an entity cannot restate the comparative financial information for a period that common control by the same controlling party (or parties) did not exist.

Illustration 3-6: Pooling of interests method - restatement of financial information for periods prior to the date of the combination (2)

Assume the same facts as in Illustration 3-4 above, except that in this situation Entity A had acquired Entity C on 1 July 20X1. That is, (non-transitory) common control exists at the time of Entity B's acquisition of Entity C, but Entity B and Entity C were not under common control during the entire comparative period.

In preparing its consolidated financial statements for the year ending 31 December 20X2 (including comparatives for one year), from which date would Entity B include financial information for Entity C when applying the pooling of interests method?

View 1 - Restatement of periods prior to the business combination under common control, to the extent that the combining parties were under common control of the same controlling party

If Entity B applies View 1 as its accounting policy, it restates the financial information in its consolidated financial statements for 20X2 (both the current year pre-combination results and the 20X1 comparatives). However, Entity B includes financial information for Entity C only as from 1 July 20X1 (i.e., when both entities were first under common control of Entity A).

View 2 - No restatement of periods prior to the business combination under common control

If Entity B applies View 2 as its accounting policy, the change in fact pattern has no impact as Entity B does not restate the financial information in its consolidated financial statements for 20X2 (neither the current year pre-combination results nor the 20X1 comparatives). No financial information is included for Entity C prior to 1 October 20X2.

3.3.4 Equity reserves and history of assets and liabilities carried over

The concept of pooling generally is based on the premise of a continuation of the combining parties. Consistently, the pre-combination equity composition and history associated with the assets and liabilities would be carried forward upon the combination occurring and might affect the post-combination accounting. For instance, certain equity reserves might be transferred within equity or reclassified to profit or loss when specific conditions are met. Examples of equity reserves that are reclassified to profit or loss on the occurrence of specific circumstances (including a loss of control of a subsidiary) include fair value reserves of financial assets (other than investments in equity instruments) at FVOCI, hedging reserves, and foreign currency translation reserves. Carrying forward the history also means that if a hedging relationship was previously established in an entity that is transferred to another entity in a business combination under common control, that hedging relationship continues to be reflected in the consolidated financial statements of the receiving entity provided all the conditions of hedging are still met post-transfer. Similarly, previous impairment losses recognised for assets might possibly reverse post-combination.

If the receiving entity in a business combination under common control adopts View 1 in section 3.3.3 above, pooling is applied in full and the history of the combining parties (since they were under common control of the same controlling party or parties) is continued as described above.

If the receiving entity adopts View 2 in section 3.3.3 above, it would need to decide whether or not to retain the pre-combination equity reserves and history of assets and liabilities of the transferred business.

How we see it

In our view, when applying the pooling of interests method for business combinations under common control and electing not to restate periods prior to the transaction, the receiving entity has a further accounting policy choice between:

- View 2a - No restatement of periods prior to the business combination under common control, but retention of equity reserves and history
- View 2b - No restatement of periods prior to the business combination under common control, with reset of equity balances and history

An entity must consistently apply its chosen accounting policy.

View 2a above considers the absence of restatement as only a presentation issue, but to all intents and purposes the concept of pooling is applied in full. While the financial information for periods prior to the business combination is not restated, the transferred business continues within the combined entity as if pooling had been applied since the combining parties were under common control of the same controlling party (or parties). The pre-combination equity reserves and history of assets and liabilities of the transferred business are carried over as at the date of transaction and are reflected in the post-combination financial statements of the receiving entity.

View 2b above considers the absence of restatement as more than only a presentation issue. Rather, the business combination is viewed as an initial recognition event at that date, using the measurement principle of pooling. While the financial information for periods prior to the business combination is not restated, the transaction gives rise to an initial recognition of the assets and liabilities of the transferred business at their predecessor carrying amounts. This means that they essentially have a new deemed cost and their history is not retained (so, for example, if the deemed cost reflects a prior impairment, that impairment would not be capable of reversal subsequent to the business combination, as the transaction reset the initial cost). Equally, the equity reserves of the transferred business are not carried over but adjusted to another component of equity (e.g., retained earnings). The post-combination financial statements of the receiving entity do not reflect any pre-combination history of the transferred business. Since any cash flow hedge reserves are not retained, this view often has consequences for hedge effectiveness going forward. This is further discussed in Chapter 49 at section 7.4.3.

Overall, View 2a and View 2b above result in the same net asset position at the date of the combination. This is because under both views the assets and liabilities of the transferred business are carried over at their predecessor carrying amounts. However, they will have a different effect on the composition of equity at the date of the combination and the treatment of certain transactions post-combination. This is demonstrated in Illustration 3-7 below.

Illustration 3-7: Pooling of interests method - no restatement of financial information for periods prior to the date of the combination - impact of carrying over equity reserves and history

Assume the same facts as in Illustration 3-4 above, with Entity B adopting *View 2 - No restatement of periods prior to the business combination under common control*.

Entity B then has an accounting policy choice as to whether or not to retain the pre-combination equity reserves and history of assets and liabilities of Entity C.

How does this choice affect the accounting for the post-combination disposal of a foreign operation described below, in Entity B's consolidated financial statements for the year ending 31 December 20X2?

On 1 October 20X2, the date of the combination occurring, Entity C had a foreign currency translation reserve of CU100 (credit) relating to a foreign operation - for example, an equity-accounted associate. On 31 October 20X2, Entity C sold the associate carried at CU500 for CU700. Assume that the foreign exchange rate had remained unchanged during October 20X2.

View 2a - No restatement of periods prior to the business combination under common control, but retention of equity reserves and history

Entity B recognises the foreign currency translation reserve of CU100 at the date of the combination. When the associate (i.e., the underlying foreign operation) is subsequently sold, that CU100 is reclassified from equity to profit or loss for the year. Therefore, a net gain on disposal of CU300 is recognised in the statement of profit or loss (CU700 less CU500 plus CU100), with a CU100 debit entry to OCI.

View 2b - No restatement of periods prior to the business combination under common control, with reset of equity reserves and history

Entity B does not recognise the foreign currency translation reserve at the date of the combination. When the associate is subsequently sold, a net gain on disposal of CU200 is recognised (CU700 less CU500) and no additional amount is reclassified from equity to the profit or loss for the year.

3.3.5 Accounting for transaction costs in a business combination under common control

Transaction costs such as advisory, legal and other professional fees can arise in a pooling transaction. There is no guidance in IFRS accounting standards specifically addressing this issue.

How we see it

In our view, transaction costs that do not qualify as issue costs of a debt or equity instrument are recognised in profit or loss as an expense. This is consistent with how an entity would account for transaction costs incurred in connection with a business combination under IFRS 3 (since they do not form part of the exchange transaction).

3.3.6 Acquisition of NCI as part of a business combination under common control

As discussed in section 2.1 above, the extent of NCI in each of the combining entities before and after the business combination is not relevant to determining whether the combination involves entities under common control for the purposes of the scope exclusion in IFRS 3. *[IFRS 3.B4]*. Accordingly, the accounting for business combinations under common control is not restricted to combinations involving wholly-owned entities.

It could be that in a business combination under common control involving a partially-owned subsidiary, any NCI in that subsidiary is acquired at the same time as the common control transaction.

Where the receiving entity applies the pooling of interests method, the question arises as to at what date the acquisition of the NCI would be reflected in its consolidated financial statements. This is particularly pertinent where the receiving entity restates financial information for periods prior to the date of the combination under View 1 as set out in section 3.3.3 above.

How we see it

When NCI in the transferred business is acquired simultaneously with a business combination under common control that is accounted for using the pooling of interests method, in our view, there are two separate transactions to be accounted for:

- The reorganisation of entities under common control
- The acquisition of the NCI

Regardless of whether or not the receiving entity elects to restate periods prior to the business combination under common control (see section 3.3.3 above), the acquisition of the NCI is accounted for at the date of acquisition.

The basic principle of accounting for business combinations under common control using the pooling of interests method is that the structure of ownership is discretionary and any reorganisation thereof is without economic substance from the perspective of the controlling party. The receiving entity might reflect that perspective and present the combining parties as if they had always been combined, regardless of the actual date of the combination (see section 3.3.3 above). However, it is inconsistent with the principles of pooling to reflect ownership of a portion or all of a business prior to the date the controlling party (either directly or indirectly) obtained that ownership interest.

The acquisition of the NCI is a transaction with economic substance from the perspective of the controlling party. IFRS 10 states that the change in ownership interest resulting from such a transaction is accounted for as an equity transaction at that date. *[IFRS 10.23, IFRS 10.24, IFRS 10.B96]*. Also, IFRS accounting standards do not include a principle that transactions with a third party (such as the acquisition of NCI) can be accounted for as of a date earlier than when the transaction is actually consummated.

Accordingly, the receiving entity accounts for the acquisition of NCI at the actual date of acquisition. It is not appropriate to reflect the acquisition of NCI as if it occurred as of any prior date (as can be done for the controlling interest transferred), even if the acquisition occurs simultaneously with a common control transaction. This is consistent with requirements in IFRS accounting standards to present separately income attributable to the owners of the parent (see Chapter 3 at sections 3.2.2 and 3.2.4.A) and to calculate earnings per share based on profit or loss attributable to ordinary shareholders of the parent (see Chapter 33 at sections 3 and 6.2).

The discussion above is illustrated in Illustration 3-8 below.

Illustration 3-8: Pooling of interests method - acquisition of NCI as part of a business combination under common control

Parent A controls Entity B and Entity C. Both subsidiaries are businesses as defined in IFRS 3. From the group's perspective, there is a 40% NCI in Entity C that is held by an unrelated party, Entity Z. Entity B obtains control of Entity C by issuing additional shares on the same date to:

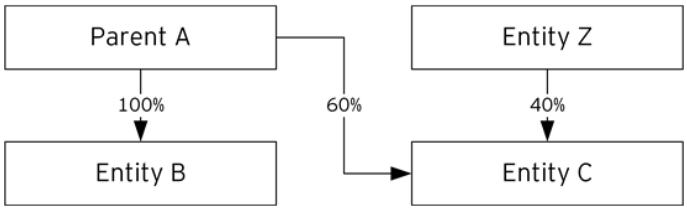
- Acquire Parent A's 60% interest in Entity C

  And

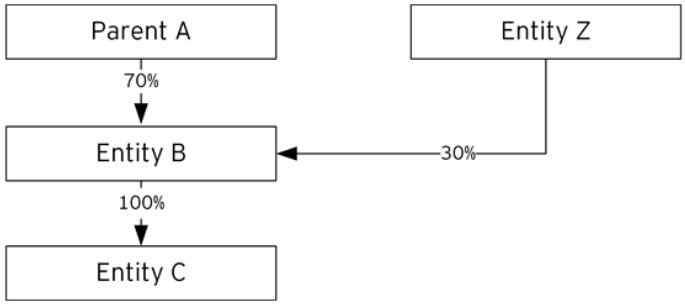
- Acquire Entity Z's 40% interest in Entity C

The group structure before and after these transactions is as follows:

Before



After



How would Entity B account for the acquisition of Entity Z's 40% interest in Entity C when applying the pooling of interests method in its consolidated financial statements?

Entity B must account for the acquisition of Entity Z's 40% interest in Entity C at the actual date of the transaction, regardless of whether financial information for periods prior to the business combination under common control is restated (see section 3.3.3 above). Thus, if Entity B restates its consolidated financial statements to reflect comparative information for Entity C for the period before the combination, it will include the 40% NCI in Entity C within equity until the actual date of the transaction. The change in ownership interest resulting from the acquisition of Entity Z's 40% interest will be accounted for as an equity transaction at that date.

4 Accounting for transactions under common control (or ownership) involving a Newco

4.1 Introduction

Extract from IFRS 3

B18 A new entity formed to effect a business combination is not necessarily the acquirer. If a new entity is formed to issue equity interests to effect a business combination, one of the combining entities that existed before the business combination shall be identified as the acquirer by applying the guidance in paragraphs B13-B17. In contrast, a new entity that transfers cash or other assets or incurs liabilities as consideration may be the acquirer.

B19 A reverse acquisition occurs when the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes on the basis of the guidance in paragraphs B13-B18. The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition. For example, reverse acquisitions sometimes occur when a private operating entity wants to become a public entity but does not want to register its equity shares. To accomplish that, the private entity will arrange for a public entity to acquire its equity interests in exchange for the equity interests of the public entity. In this example, the public entity is the **legal acquirer** because it issued its equity interests, and the private entity is the **legal acquiree** because its equity interests were acquired. However, application of the guidance in paragraphs B13-B18 results in identifying:

(a) the public entity as the **acquiree** for accounting purposes (the accounting acquiree); and

(b) the private entity as the **acquirer** for accounting purposes (the accounting acquirer).

The accounting acquiree must meet the definition of a business for the transaction to be accounted for as a reverse acquisition, and all of the recognition and measurement principles in this IFRS, including the requirement to recognise goodwill, apply.

[IFRS 3.B18, IFRS 3.B19].

The receiving entity in a common control transaction involving the transfer of control over one or more businesses is not always an existing entity but could also be a newly formed entity (or Newco). This raises particular questions since IFRS 3 indicates that a new entity formed to effect a business combination is not necessarily the acquirer. If a new entity issues equity interests to effect a business combination, one of the combining entities that existed before the transaction shall be identified as the acquirer. In contrast, a new entity that transfers cash or other assets or incurs liabilities as consideration could be the acquirer. *[IFRS 3.B18]*.

Whether a Newco can be identified as the acquirer could be relevant to determine if a transaction is a business combination and thus within the scope of IFRS 3 (unless otherwise excluded). The standard defines a business combination as "a transaction or other event in which an **acquirer** obtains control of one or more **businesses.**" *[IFRS 3 Appendix A]*. This requires one of the combining entities to be identified as the acquirer. IFRS 3 also states that "The accounting acquiree must meet the definition of a business for the transaction to be accounted for as a reverse acquisition". *[IFRS 3.B19]*. Since a Newco does not have its own operations, it would not be a business as defined. Accordingly, if a Newco combines with only one business, neither party might be capable of being identified as the acquirer under IFRS 3 and the transaction would not be a business combination.

Whether a Newco can be identified as the acquirer is also relevant in case the acquisition method is applied. When, for example, a Newco combines with two businesses and is identified as the acquirer, acquisition-date fair values would be attributed to the assets acquired and liabilities assumed of both existing businesses, and any goodwill or gain on a bargain purchase relating to those businesses would be recognised. In contrast, if Newco itself is not the acquirer under IFRS 3, one of the existing businesses must be identified as the acquirer and the acquisition method of accounting would be applied only to the other business.

IFRS 3 does not specify in which circumstances a Newco that effects a business combination other than through the issue of shares can be the acquirer, but it is clear that 'control' is the fundamental concept when identifying an acquirer. This is discussed further in Chapter 10 at section 4.1.1.

How we see it

The analysis of whether a Newco that effects a business combination other than through the issue of shares can be the acquirer requires careful consideration of all facts and circumstances. In our view, this ultimately depends on whether a Newco can be considered as an extension of the party (or parties) that ultimately gain control over the combining entities.

In common control transactions, however, there is typically no change of ultimate control over the transferred business or businesses. In that situation, we believe that a Newco would not be identified as the acquirer under IFRS 3.

That conclusion might be different when a reorganisation involving a Newco is used to facilitate an external sale or IPO. That is, if the transfer under common control is an integral part of another transaction that ultimately results in a change of control over the transferred business or businesses, the facts and circumstances might be such that a Newco could be regarded as the acquirer under IFRS 3. This situation is shown in Illustration 4-2 in Chapter 10 at section 4.1.1, where the transfer of two businesses from a parent to a newly incorporated entity for cash (i.e., under common control) is contingent on the completion of an IPO of that Newco. In this scenario, the parent loses ultimate control over the two businesses and Newco could in effect be considered as an extension of its new shareholders after the IPO. However, if the change of control is only planned, but not an integral part of the transaction, Newco would be viewed as an extension of the parent (or possibly the transferred businesses) and would not be the acquirer.

How we see it

In our view, if a reorganisation involving a Newco is conditional on the completion of another transaction that ultimately results in a change of control over the transferred business or businesses (e.g., by sale or IPO), it would be possible to identify Newco as the acquirer under IFRS 3. However, if the change of control is only planned, but not an integral part of the transaction, Newco would not be identified as the acquirer under IFRS 3.

While the IFRS IC discussed a few similar fact patterns in 2011, it ultimately observed that the accounting for arrangements involving the creation of a newly formed entity and for common control transactions is too broad to be addressed through an interpretation or an annual improvement. The IFRS IC concluded that these matters would be better considered in the context of a broader project on accounting for common control transactions.[11] As previously noted in section 1.1 above, the IASB undertook a research project on business combinations under common control but decided to discontinue the project in November 2023. The feedback statement issued by the IASB in April 2024 following the discontinuance of the project is further discussed in section 6 below.

The discussion in sections 4.2, 4.3 and 4.4 below addresses different scenarios involving a Newco. While this chapter mainly deals with transactions under common control, Illustration 4-1, Illustration 4-2 and Illustration 4-4 below also discuss the accounting treatment where the same group of shareholders owns the combining entities before and after the transaction, but without a single shareholder, or sub-group of the shareholders by virtue of a contractual arrangement (see section 2.1.1 above), having control. All of the Illustrations in sections 4.2, 4.3 and 4.4 below assume that all entities are owned 100% by the party or parties at the top of the particular structure.

Sometimes, BCUCCs and other transactions under common control (as discussed in section 4 of this chapter) involve use of an existing shell company for convenience, rather than establishing a Newco to effect a transaction.

How we see it

In our view, where a BCUCC or other transaction under common control is effected through use of an existing shell company for convenience, similar considerations to those discussed in section 4 of this chapter in connection to the use of Newcos apply.

11 *IFRIC Update*, September 2011, *IFRS Interpretations Committee agenda decisions: IFRS 3* Business Combinations-*business combinations involving newly formed entities: factors affecting the identification of the acquirer;* and *IFRS 3* Business Combinations-*business combinations involving newly formed entities: business combinations under common control*. Available on the IFRS Foundation's website.

4.2 Setting up a new top holding company

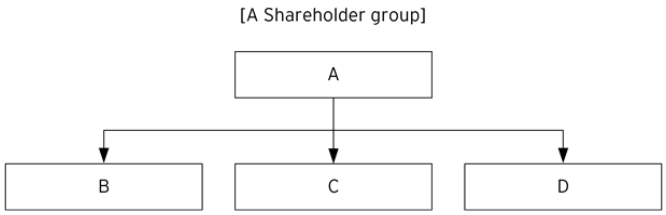
In Illustration 4-1 and Illustration 4-2 (see section 4.2.1 below), a new holding company has been inserted between shareholders and either an existing group or a series of entities with common ownership (but not necessarily common control). Newco issues shares to effect the transaction and is not identified as the acquirer in either case. However, the accounting consequences might differ depending on whether or not the transaction represents a business combination according to IFRS 3. Transactions such as this might also be effected for consideration other than shares or a combination of shares and other consideration. Arrangements in which Newco transfers cash or other assets or incurs liabilities are discussed in section 4.2.2 below.

4.2.1 Setting up a new top holding company: transactions effected through issuing equity interests

Illustration 4-1: Newco inserted at the top of an existing group

A Newco is incorporated and inserted at the top of an existing group, which is a business as defined in IFRS 3. Newco issues shares to the existing shareholders of Entity A in exchange for the shares already held in that entity. There are no changes to the shareholder group. The group structure before and after this transaction is as follows:

Before



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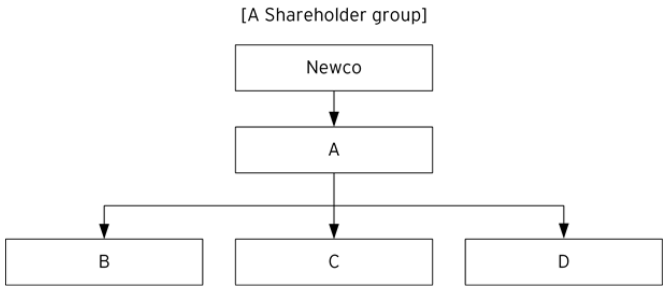


How would this reorganisation be accounted for in Newco's consolidated financial statements?

In many situations, this type of transaction will not be 'under common control' since there will be no contractual arrangement between the shareholders (see section 2.1.1 above). However, whether there is common ownership or common control by one individual, or a sub-group of the shareholders, over the combining parties is irrelevant in this specific scenario.

How we see it

The transaction in this specific fact pattern is not a business combination. In our view, Newco cannot elect to apply the acquisition method. Rather, its consolidated financial statements are a continuation of the existing group.

The transaction does not meet the definition of a business combination under IFRS 3, because neither Newco nor Entity A can be identified as the acquirer. Newco cannot be identified as the acquirer as it issues shares to effect the combination. Entity A cannot be identified as the acquirer (in a reverse acquisition) as Newco is not a business as defined. On that basis, the transaction is outside the scope of IFRS 3.

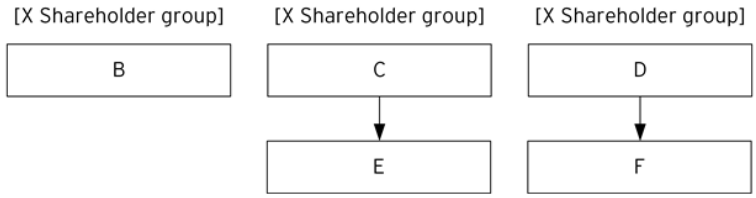
Applying the IAS 8 hierarchy, Newco cannot elect to apply the acquisition method as set out in IFRS 3 since the transaction does not result in any change of economic substance (e.g., in terms of any real alteration to the composition or ownership of the group). Accordingly, Newco's consolidated financial statements reflect that the arrangement is in substance a continuation of Entity A's group (combined with a capital reorganisation to reflect Newco's capital structure) and will reflect pre-combination carrying amounts for Entity A's group. The financial information presented for periods prior to the transaction is that of Entity A's group. Any difference in share capital is reflected as an adjustment to equity.

In Illustration 4-1 above, the transaction does not represent a business combination as none of the combining parties can be identified as the acquirer according to IFRS 3. This is because Newco issues equity interests to obtain control of only one business. In Illustration 4-2 below, whilst Newco still issues shares to effect the transaction, the combination involves more than one business.

Illustration 4-2: Newco inserted at the top of entities owned by the same shareholders thereby creating a new reporting group

A Newco is incorporated and inserted at the top of a number of entities owned by the same shareholders. Newco issues shares to the existing shareholders of Entities B, C and D in exchange for the shares already held in those entities. Entities B, C and D are businesses as defined in IFRS 3. The group structure before and after this transaction is as follows:

Before



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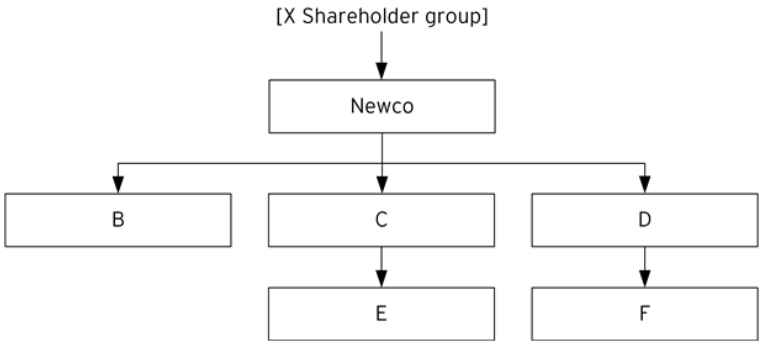


How would this reorganisation be accounted for in Newco's consolidated financial statements?

How we see it

The transaction in this fact pattern is a business combination that falls within the scope of IFRS 3 if common control does not exist (or is transitory). If common control does exist (and is not transitory), the transaction is outside the scope of IFRS 3 and Newco can elect to apply the pooling of interests method or acquisition method (provided the transaction has substance) in our view. Applying the acquisition method, Newco cannot be identified as the acquirer in this fact pattern.

Unlike the situation in Illustration 4-1 above, this transaction meets the definition of a business combination under IFRS 3. Entity B and sub-groups C and D (each a business as defined) have been brought together to form a new reporting entity under a new parent entity (Newco). Accordingly, the transaction is within the scope of IFRS 3 unless otherwise excluded. In this context it is relevant whether Entities B, C and D are under common control (that is not 'transitory' - see section 2.1.2 above) or just under common ownership.

If the transaction satisfies the description of a business combination under common control, it is outside the scope of IFRS 3. In practice, this type of transaction might be under common control since the number of shareholders will generally be relatively few. Accordingly, there might well be one individual, or a sub-group of the shareholders with a contractual arrangement (see section 2.1.1 above), who controls Entities B, C and D. The scope exclusion applies as long as that common control is not transitory. In that case, subject to certain conditions (see section 3.1 above), there is an accounting policy choice between the pooling of interests method and acquisition method.

If Entities B, C and D are not under common control (or if common control is transitory), then the business combination is within the scope of IFRS 3 and the acquisition method must be applied.

Pooling of interests method

If the pooling of interests method is used, the assets and liabilities of all combining parties will be reflected at their predecessor carrying amounts. The application of this method is discussed in section 3.3 above.

Acquisition method

If the acquisition method set out in IFRS 3 is used, Newco cannot be the acquirer as it issues shares to effect the combination (and there is no change in control arising). Accordingly, one of the pre-existing entities (i.e., Entity B, Entity C or Entity D) will need to be identified as the acquirer (see Chapter 10 at section 4.1). If, for example, Entity B is identified as the acquirer, the consolidated financial statements of Newco are effectively a continuation of Entity B (combined with a capital reorganisation to reflect Newco's capital structure), and will reflect pre-combination carrying amounts for Entity B and acquisition-date fair values of the assets acquired and liabilities assumed, together with any resulting goodwill, for sub-groups C and D. The financial information presented in those financial statements for periods prior to the acquisition date is that of Entity B. Newco cannot be accounted for as acquiree in a reverse acquisition, because it is not a business as defined. The application of the acquisition method is discussed generally in Chapter 10 and for business combinations under common control specifically in section 3.2 above.

4.2.2 Setting up a new top holding company: transactions involving consideration other than equity interests

In Illustration 4-1 and Illustration 4-2 above, a Newco has been inserted between shareholders and either an existing group or a series of entities with common ownership (but not necessarily common control). In neither case could Newco itself be identified as the acquirer under IFRS 3, since it issued equity interests to effect the combination.

How we see it

In the fact patterns described in section 4.2.1 above, we believe that even if Newco transferred cash or other assets, or incurred liabilities, as consideration, it generally cannot be identified as the acquirer under IFRS 3. In that situation, the way in which those transactions are accounted for would not change. The treatment of cash (or other consideration) paid is set out below.

Only in limited circumstances would it be possible to identify Newco as the acquirer under IFRS 3, as discussed in section 4.1 above. This might happen, for example, if the transaction was contingent on completion of an IPO that resulted in a change of control over Newco. In that case, the application of the acquisition method would result in fair values being attributed to the assets acquired and liabilities assumed of the existing businesses, and the recognition of goodwill or a gain on a bargain purchase relating to those businesses.

Unless the acquisition method is applied, any cash (or other form of consideration) paid to the shareholders is effectively a distribution and would be accounted for as such in equity. If the acquisition method can be applied, any cash paid to the shareholders in their capacity as owners of the identified acquirer is accounted for as a distribution. Any cash paid to the shareholders as owners of the acquiree(s) forms part of the consideration transferred for the entity or entities acquired. Determining whether cash is paid to shareholders in their capacity as owners of the identified acquirer or as owners of the acquiree(s) might require judgement.

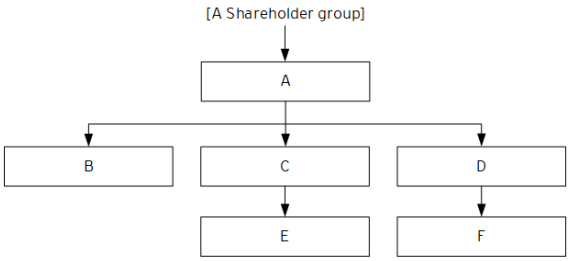
4.3 Inserting a new intermediate parent within an existing group

In Illustration 4-3 below, a new intermediate holding company has been inserted within an existing group, so as to form a new sub-group.

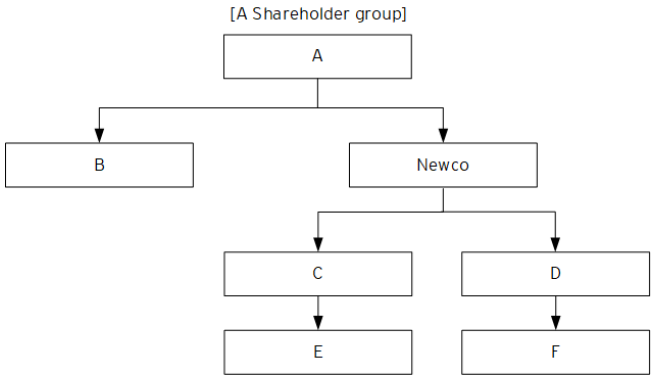
Illustration 4-3: Newco inserted as a new intermediate parent within an existing group

A Newco is incorporated and inserted above a number of entities within an existing group so as to form a new sub-group. Newco issues shares to Parent A in return for the shares in Entities C and D, both businesses as defined in IFRS 3. The group structure before and after this transaction is as follows:

Before



After



In most situations, Newco will be exempt from preparing consolidated financial statements (see Chapter 7 at section 2.2.1).

However, if Newco does prepare consolidated financial statements, how would this reorganisation be accounted for in its consolidated financial statements?

How we see it

The transaction in this fact pattern will generally satisfy the description of a business combination under common control that is scoped out of IFRS 3. In our view, Newco can elect to apply the pooling of interests method or acquisition method (provided the transaction has substance). Applying the acquisition method, Newco cannot be identified as the acquirer in this fact pattern.

This reorganisation is a business combination (Entities C and D are businesses as defined) and all combining parties are under common control of Parent A. Accordingly, the transaction is excluded from the scope of IFRS 3 as long as that common control is not 'transitory', and in making that assessment Newco is excluded (see section 2.1.2 above). Assuming that the scope exclusion applies, subject to certain restrictions (see section 3.1 above), there is an accounting policy choice between the pooling of interests method and acquisition method (assuming the transaction has substance). If common control is transitory, then the business combination is within the scope of IFRS 3, and the acquisition method must be applied.

Pooling of interests method

If the pooling of interests method is used, the assets and liabilities of all combining parties will be reflected at their predecessor carrying amounts. The application of this method is discussed in section 3.3 above.

Acquisition method

If the acquisition method as set out in IFRS 3 is used, Newco cannot be identified as the acquirer as it issues shares to effect the combination (and there is no change in control arising). Accordingly, one of the pre-existing entities (Entity C or Entity D) will need to be identified as the acquirer (see Chapter 10 at section 4.1). If, for example, Entity C is identified as the acquirer, the consolidated financial statements of Newco are effectively a continuation of Entity C, and will reflect pre-combination carrying amounts for sub-group C and acquisition-date fair values of the assets acquired and liabilities assumed, together with any resulting goodwill, for sub-group D. The financial information presented in those financial statements for periods prior to the acquisition date is that of Entity C. Newco cannot be accounted for as acquiree in a reverse acquisition, because it is not a business as defined. The application of the acquisition method is discussed generally in Chapter 10 and for business combinations under common control specifically in section 3.2 above.

How we see it

In Illustration 4-3 above, the reorganisation was effected by Newco issuing shares. We believe that even if Newco transferred cash or other assets, or incurred liabilities, as consideration, then in most situations this will not affect the analysis above and the further consequences would be the same as those described in section 4.2.2 above.

Only in limited circumstances would it be possible to identify Newco as the acquirer under IFRS 3, as discussed in section 4.1 above. This accounting might be appropriate when, for example, the transaction was contingent on completion of an IPO that resulted in a change of control over Newco. In that case, the application of the acquisition method would result in fair values being attributed to the assets acquired and liabilities assumed of both sub-groups C and D, and the recognition of goodwill or a gain on a bargain purchase relating to those businesses.

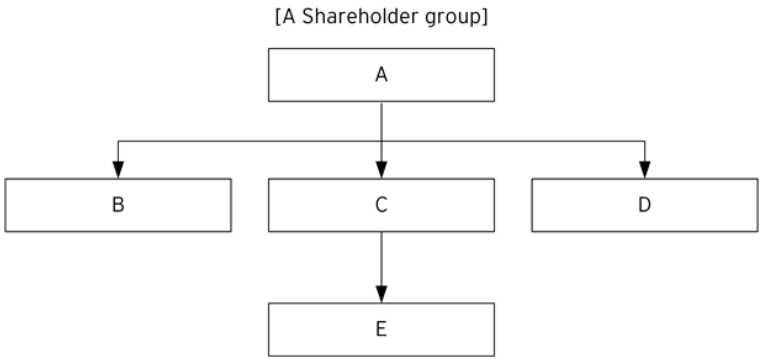
4.4 Transferring businesses outside an existing group using a Newco

Illustration 4-4 below illustrates a scenario where a business is transferred outside an existing group to a Newco owned by the same shareholders.

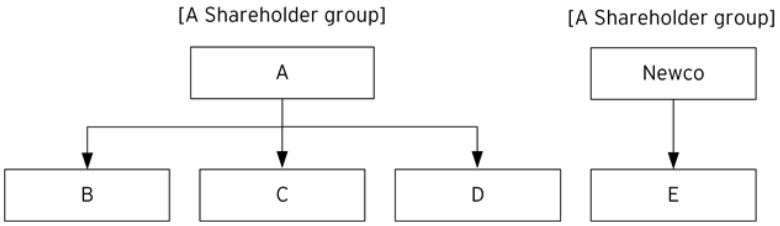
Illustration 4-4: Newco created to take over a business of an existing group (spin-off)

Entity C, a subsidiary of Parent A, transfers the shares held in its subsidiary, Entity E, to a newly formed entity, Newco. In return, Newco issues shares to the existing shareholders of Parent A. Entity E is a business as defined in IFRS 3. The group structure before and after this transaction is as follows:

Before



After



How would this reorganisation be accounted for in Newco's consolidated financial statements?

In many situations, this type of transaction will not be 'under common control' since there will be no contractual arrangement between the shareholders (see section 2.1.1 above). However, whether there is common ownership or common control by one individual, or a sub-group of the shareholders, over the combining parties is irrelevant in this specific scenario.

How we see it

The transaction in this specific fact pattern is not a business combination. In our view, Newco cannot elect to apply the acquisition method. Rather, its consolidated financial statements are a continuation of the transferred business.

The transaction does not meet the definition of a business combination under IFRS 3, because neither Newco nor Entity E can be identified as the acquirer. Newco cannot be identified as the acquirer as it issues shares to effect the combination. Entity E cannot be identified as the acquirer (in a reverse acquisition) as Newco is not a business as defined. On that basis, the transaction is outside the scope of IFRS 3.

Applying the IAS 8 hierarchy, Newco cannot elect to apply the acquisition method as set out in IFRS 3 since the transaction does not result in any change of economic substance for Newco and Entity E (e.g., in terms of any real alteration to the composition or ownership of Entity E). Accordingly, the consolidated financial statements of Newco reflect that the arrangement is in substance a continuation of Entity E and will reflect the pre-combination book values of Entity E (combined with a capital reorganisation to reflect Newco's capital structure). The financial information presented for periods prior to the transaction is that of Entity E. Any difference in share capital is reflected as an adjustment to equity.

Apart from any necessary change in share capital, the accounting treatment set out in Illustration 4-4 above is the same as would have been applied if the business was transferred by distributing the shares in Entity E directly to Parent A's shareholders, without the use of a Newco. In that case, there would be no question that there had been a business combination at all. Entity E would not reflect any changes in its financial statements. The only impact for Entity E would be that, rather than only having one shareholder (Entity C), it now has a number of shareholders.

How we see it

In Illustration 4-4 above, the reorganisation was effected by Newco issuing shares. We believe that even if Newco transferred cash or other assets, or incurred liabilities, as consideration, then in most situations this will not affect the analysis above. The only difference is that any consideration transferred to the shareholders is effectively a distribution and would be accounted for as such (see section 4.2.2 above).

Only in limited circumstances would it be possible to identify Newco as the acquirer under IFRS 3, as discussed in section 4.1 above. This accounting might be appropriate when, for example, the transaction was contingent on completion of an IPO that resulted in a change of control over Newco. In that case, the application of the acquisition method would result in fair values being attributed to the assets acquired and liabilities assumed of Entity E, and the recognition of goodwill or a gain on a bargain purchase relating to that business.

For Entity A, this transaction is a spin-off (or demerger) of Entity E, and therefore the discussion in Chapter 8 at section 3.7 and in Chapter 9 at section 2.4.2 would be relevant.

5 Accounting for transfers of investments in associates or joint ventures from entities under common control

Extract from IAS 28

26 Many of the procedures that are appropriate for the application of the equity method are similar to the consolidation procedures described in IFRS 10. Furthermore, the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate or a joint venture.

32 An investment is accounted for using the equity method from the date on which it becomes an associate or a joint venture. On acquisition of the investment, any difference between the cost of the investment and the entity's share of the net fair value of the investee's identifiable assets and liabilities is accounted for as follows:

(a) Goodwill relating to an associate or a joint venture is included in the carrying amount of the investment. Amortisation of that goodwill is not permitted.

(b) Any excess of the entity's share of the net fair value of the investee's identifiable assets and liabilities over the cost of the investment is included as income in the determination of the entity's share of the associate or joint venture's profit or loss in the period in which the investment is acquired.

Appropriate adjustments to the entity's share of the associate's or joint venture's profit or loss after acquisition are made in order to account, for example, for depreciation of the depreciable assets based on their fair values at the acquisition date. Similarly, appropriate adjustments to the entity's share of the associate's or joint venture's profit or loss after acquisition are made for impairment losses such as for goodwill or property, plant and equipment.

[IAS 28.26, IAS 28.32].

Although this chapter principally addresses common control transactions in which the receiving entity obtains control over a business, a reorganisation might also involve the transfer of investments in associates or joint ventures between entities under common control (e.g., within an existing group). Investments in associates and joint ventures are generally accounted for using the equity method as set out in IAS 28 *Investments in Associates and Joint Ventures* (see Chapter 12). IAS 28 states that "the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate or a joint venture". *[IAS 28.26]*. Consequently, the question arises whether the scope exclusion for business combinations under common control in IFRS 3 can be extended to the acquisition of an investment in an associate or joint venture from an entity under common control (i.e., where significant influence or joint control is obtained, rather than control).

This question is relevant when the investment in an associate or joint venture is acquired in a separate common control transaction, rather than as part of a larger business combination under common control. That is, if an investment in an associate or joint venture is being transferred as part of a business combination under common control (i.e., where the investment is one of the identifiable assets of the acquired business), the entire transaction is excluded from the scope of IFRS 3, and the receiving entity would need to develop an accounting policy as discussed in section 3.1 above.

In October 2012, the IFRS IC was asked whether it is appropriate to apply the scope exclusion for business combinations under common control in IFRS 3 by analogy to the acquisition of an interest in an associate or joint venture from an entity under common control. On the one hand, it was noted that IAS 28.32 has guidance on such acquisitions and does not distinguish between acquisitions under common control and acquisitions not under common control. IAS 8.10 requires management to use its judgement in developing and applying an accounting policy only in the absence of an IFRS accounting standard that specifically applies to a transaction. On the other hand, it was noted that IAS 28.26 refers to adopting "the concepts underlying the procedures used in accounting for the acquisition of a subsidiary" and that IFRS 3.2(c) excludes business combinations under common control from its scope. The IFRS IC observed "that some might read these paragraphs as contradicting the guidance in paragraph 32 of IAS 28, and so potentially leading to a lack of clarity". Ultimately, the IFRS IC noted that accounting for the acquisition of an interest in an associate or joint venture under common control would be better considered within the context of broader projects on accounting for business combinations under common control and the equity method. Consequently, it decided in May 2013 not to take the issue onto its agenda.[12]

12 *IFRIC Update*, May 2013, *Interpretations Committee agenda decisions: IAS 28* Investments in Associates and Joint Ventures *and IFRS 3* Business Combinations-*Associates and common control*. Available on the IFRS Foundation's website.

In June 2017, the IFRS IC reconsidered this topic and tentatively decided that the requirements in IFRS accounting standards provide an adequate basis to account for the acquisition of an interest in an associate or joint venture from an entity under common control. The IFRS IC observed that IAS 28 does not include a scope exception for acquisitions under common control and, accordingly, applies to the transaction. IAS 28.26 should not be used as a basis to apply the scope exclusion for business combinations under common control in IFRS 3.2(c) by analogy. The IFRS IC also observed that in accounting for the acquisition of the interest, an entity would assess whether the transaction includes a transaction with owners in their capacity as owners - if so, the entity determines the cost of the investment taking into account that transaction with owners.[13] However, the tentative agenda decision was eventually not finalised, as that might have been premature pending developments in the IASB's research project on business combinations under common control (see section 6 below).[14] The IASB decided to discontinue the business combinations under common control project in November 2023 and the IASB's tentative decisions on its equity method project did not address the accounting for the acquisition of an interest in an associate or a joint venture from an entity under common control.[15] In September 2024, the IASB issued an exposure draft[16] addressing application issues relating to the equity method of accounting.

How we see it

Based on the discussions of the IFRS IC described above, we believe there are two possible approaches to account for the acquisition of an investment in an associate or joint venture from an entity under common control, when applying the equity method. As IAS 28 is currently not clear, in our view, the receiving entity has an accounting policy choice between:

- Approach 1 - Apply the requirements in IAS 28.32
- Approach 2 - Apply by analogy the scope exclusion for business combinations under common control in IFRS 3 and use the predecessor carrying amount

An entity must consistently apply the chosen accounting policy.

Under Approach 1 above, the 'normal' requirements in IAS 28 are applied as there is no scope exclusion for the acquisition of an interest in an associate or joint venture from an entity under common control. The receiving entity/investor compares the cost of the investment against its share of the net fair value of the investee's assets and liabilities on the date of acquisition, to identify any goodwill or gain on a bargain purchase. Goodwill is included in the carrying amount of the investment. Any gain on a bargain purchase is recognised in profit or loss. *[IAS 28.32]*. If the common control transaction is not at arm's length, we believe that the receiving entity has an accounting policy choice to impute an equity contribution or distribution when it determines the cost of the investment.

How we see it

If Approach 1 above is applied and the common control transaction is not at arm's length, we believe that the receiving entity has an accounting policy choice whether or not to impute an equity contribution or distribution when it determines the cost of the investment in an associate or joint venture. Whichever accounting policy is adopted, it must be applied consistently.

Under Approach 2 above, the scope exclusion for business combinations under common control in IFRS 3 is applied by analogy to the acquisition of an interest in an associate or joint venture from an entity under common control. This is on the basis that IAS 28 indicates that the concepts applied to accounting for acquisitions of investments in associates or joint ventures are similar to those applied to acquisitions of subsidiaries. As such, the receiving entity/investor could recognise the investment in the associate or joint venture at its predecessor equity-accounted carrying amount on the date of acquisition. Any difference between this amount and the consideration given is accounted for as an equity contribution or distribution.

The two approaches are illustrated in Illustration 5-1 below.

---

13 *IFRIC Update*, June 2017, *Committee's tentative agenda decisions: IAS 28* Investments in Associates and Joint Ventures- *Acquisition of an associate or joint venture from an entity under common control (Agenda Paper 8)*. Available on the IFRS Foundation's website.

14 IASB Staff Paper 23A, Project: *Business Combinations under Common Control,* Paper topic: *Review of related projects*, IASB Meeting, December 2017, paras. 30-32. Available on the IFRS Foundation's website.

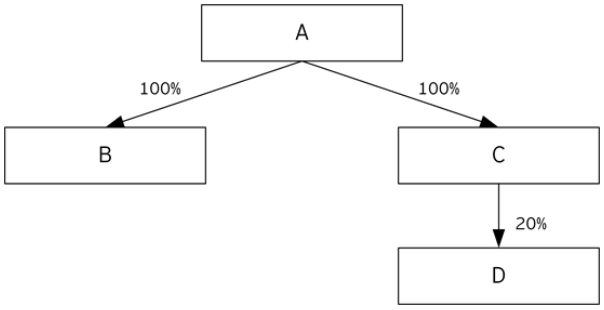
15 Staff summary of the IASB's tentative decisions (June 2024), Equity method project page, IFRS - Equity Method (accessed 24 September 2024).

16 Exposure Draft IASB/ED/2024/7 Equity Method of Accounting – IAS 28 Investments in Associates and Joint Ventures, IASB, September 2024. Available on the IFRS Foundation's website.

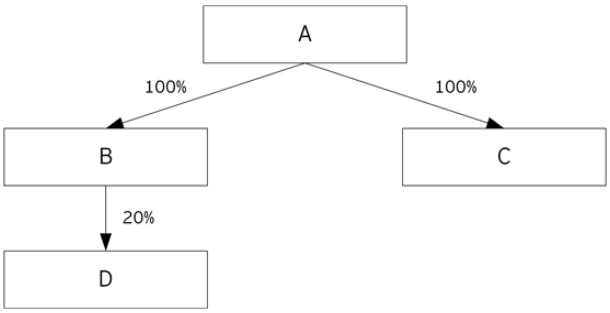
Illustration 5-1: Transfer of an associate within an existing group

Entity B and Entity C are under common control of Entity A. Entity C holds an investment in Associate D, which it sells to Entity B for cash. The transaction can be illustrated as follows:

Before



After



In Entity C's financial statements, the equity-accounted carrying amount of its 20% interest in Associate D is CU100. The net fair value of the identifiable assets and liabilities of Associate D is CU800 (based on 100%). Entity B gives consideration of CU190 to Entity C for the 20% interest in Associate D, which is the fair value of the 20% interest.

The consolidated financial statements of Entity A will not be impacted (except for any potential tax consequences), because from the group's perspective there has been no change.

How would Entity B account for this transaction in its own financial statements when applying the equity method to investments in associates?

As discussed above, in our view, there are two approaches that Entity B can apply in accounting for this common control transaction. Whichever approach is adopted, it must be applied consistently.

Approach 1 - Apply the requirements in IAS 28*.32*

Under this approach, IAS 28 applies as it does to any other acquisition of an investment in an associate (see Chapter 12). Accordingly, the receiving entity calculates its share of the net fair value of the investee's identifiable assets and liabilities applying IAS 28.32.

Entity B recognises an investment in an associate with a cost of CU190 (fair value of consideration given). This amount comprises Entity B's share of the net fair value of Associate D's identifiable assets and liabilities of CU160 (20% × CU800) and goodwill of CU30 (CU190 less CU160).

Approach 2 - Apply by analogy the scope exclusion for business combinations under common control in IFRS 3 *and use the predecessor carrying amount*

Under this approach, the scope exclusion in IFRS 3.2(c) is applied by analogy to the acquisition of an interest in an associate from an entity under common control. This is because IAS 28.26 indicates that the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate. Similarly, the receiving entity could elect to account for such transactions on a carry-over basis as its accounting policy.

Entity B recognises an investment in an associate based on the equity-accounted carrying amount in Entity C's financial statements as at the acquisition date, which is CU100. Entity B does not reassess the fair values of Associate D's identifiable assets and liabilities. Rather, Entity B continues to recognise any adjustments that Entity C recognised in accordance with IAS 28.32 due to differences in fair values at the date Entity C acquired its interest in Associate D.

Entity B recognises the excess of the consideration paid (CU190) over the carrying amount (CU100) of CU90 as a distribution from equity.

Although Illustration 5-1 above discusses the acquisition of an investment in an associate from an entity under common control, the same accounting policy choice would also apply to transfers of joint ventures between entities under common control.

6 Recent developments

6.1 Business Combinations under Common Control ('BCUCC') research project

In November 2020, the IASB published a Discussion Paper (DP) named *Business Combinations under Common Control* for public consultation.[17] The DP set out the IASB's preliminary views on possible reporting requirements for the receiving entity, with the objective to reduce diversity in practice and improve the transparency of reporting business combinations under common control (and certain other group reorganisations).

The IASB's preliminary view in the DP was that its proposals should cover reporting by the receiving entity for all transfers of a business under common control, even if the transfer is:

- Preceded by an acquisition from an external party or followed by a sale of one or more of the combining businesses to an external party

  Or

- Conditional on a sale of the combining businesses to an external party, such as in an IPO

The project, therefore, addressed both business combinations under common control that are explicitly scoped out of IFRS 3, and other transactions that involve the transfer of a business under common control but which do not meet the definition of a business combination in IFRS 3. For simplicity, the DP used the term 'business combinations under common control' (BCUCC) to refer to all transactions within the scope of the project.

The scope of the project, however, did not address transfers of investments in associates and joint ventures, transfers of entities with no business or transfers of assets that are not a business.[18]

The DP summarised the IASB's preliminary views on how a receiving entity should report a BCUCC and explored which measurement method to apply, how the acquisition method and a 'book-value method' should apply and disclosure requirements.

The IASB considered stakeholder feedback on the DP throughout 2022 and 2023. However, in November 2023, the IASB reconsidered the project direction. The Board decided not to develop requirements for reporting BCUCCs nor to explore disclosure-only requirements and, consequently, decided to discontinue the project.[19]

In April 2024, the IASB published the Project Summary.[20] This explains that:

- The IASB acknowledged that, without requirements for reporting BCUCCs, diversity could persist in how receiving entities report BCUCCs
- Feedback received had suggested that:
  (a) Users of financial statements are not significantly affected by diversity in how receiving entities report BCUCCs
  (b) Users' information needs vary among jurisdictions making it difficult to develop requirements that would meet needs globally
  (c) Stakeholders' views were split as to whether the IASB should develop requirements for reporting BCUCCs and, if so, what those requirements should be

  And
- Overall, the IASB's research findings suggested that any improvements to financial reporting that might result from developing requirements for reporting BCUCCs are likely to be outweighed by the costs of developing and implementing such changes

17 Discussion Paper DP/2020/2, *Business Combinations under Common Control*, IASB, November 2020. Available on the IFRS Foundation's website.

18 Discussion Paper DP/2020/2, *Business Combinations under Common Control*, IASB, November 2020, Appendix B. Available on the IFRS Foundation's website.

19 *IASB Update*, November 2023, *Research and standard-setting: Business Combinations under Common Control (Agenda Paper 23)*. Available on the IFRS Foundation's website.

20 Project Summary *Business Combinations under Common Control*, IASB, April 2024. Available on the IFRS Foundation's website (accessed 24 September 2024).

Please refer to the IASB's website for further information on the project, including more detailed stakeholder feedback, the DP and the Project Summary.[21]

How we see it

To ensure that users of financial statements understand the impact of a BCUCC, we encourage entities to consider the reporting requirements in IFRS accounting standards to ensure the faithful representation of the effects of a BCUCC, including clear disclosure of material accounting policies.

21 Business combinations under common control project page, available on the IFRS Foundation's website (accessed 24 September 2024).

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Appendix B - Defined terms

Extract from IFRS accounting standards - Definitions	
acquiree	The business or businesses that the **acquirer** obtains control of in a **business combination**. *[IFRS 3 Appendix A]*.
acquirer	The entity that obtains control of the **acquiree**. *[IFRS 3 Appendix A]*.
acquisition date	The date on which the **acquirer** obtains control of the **acquiree**. *[IFRS 3 Appendix A]*.
business	An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities. *[IFRS 3 Appendix A]*.
business combination	A transaction or other event in which an **acquirer** obtains control of one or more **businesses**. Transactions sometimes referred to as 'true mergers' or 'mergers of equals' are also **business combinations** as that term is used in this IFRS. *[IFRS 3 Appendix A]*.
close members of the family of a person	***Close members of the family of a person*** **are those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity and include:** **(a) that person's children and spouse or domestic partner;** **(b) children of that person's spouse or domestic partner; and** **(c) dependants of that person or that person's spouse or domestic partner.** *[IAS 24.9]*.
fair value	*Fair value* is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13.) *[IFRS 3 Appendix A]*.

In addition, references in this chapter to a 'receiving entity' mean the transferee in the reorganisation. In the context of section 6 above, this term has the definition set out in the DP.[22]

22 Discussion Paper, DP 2020/2, *Business Combinations under Common Control*, IASB, November 2020. Available on the IFRS Foundation's website.

Chapter 12 Investments in associates and joint ventures

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Overview

This chapter addresses the requirements of IAS 28 *Investments in Associates and Joint Ventures*. IAS 28 requires that investments in entities over which an investor has significant influence are classified as associates and are generally accounted for using the equity method of accounting. Joint arrangements that are classified as joint ventures are also generally accounted for using the equity method as described in IAS 28. The classification of joint arrangements as either joint ventures or joint operations is required by IFRS 11 *Joint Arrangements* and is discussed in Chapter 13 at section 5. The term joint venture is often used colloquially with different meanings, but references to 'joint venture' in this chapter have the meaning as defined in IAS 28.

The equity method of accounting involves a modified form of consolidation of the results and assets of investees in the investor's financial statements. The essence of the equity method of accounting is that, rather than full scale consolidation on a line-by-line basis, it requires incorporation of the investor's share (adjusted for basis differences, like fair value adjustments arising on initial acquisition of the interest in the associate or joint venture) of the investee's:

- Net assets, in one line in the investor's consolidated statement of financial position
- Profit or loss, in one line in the investor's consolidated statement of profit or loss
- Other comprehensive income (OCI), in one line in the investor's consolidated statement of other comprehensive income

Since its issuance, IAS 28 has been subject to several amendments. The equity method of accounting is the subject of a standard-setting project of the International Accounting Standards Board (IASB), as discussed in section 13 below.

What you need to know

- An investor has significant influence over an associate when it has the power to participate in the financial and operating policy decisions of the investee but does not have control or joint control of those policies.
- In the investor's consolidated financial statements, associates and joint ventures are accounted for using the equity method, unless one of the exemptions in IAS 28 applies.
- Under the equity method, an associate or joint venture is first recognised at its cost, including any directly attributable expenditures.
- The carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the associate or joint venture after the date of acquisition, adjusted for basis differences.
- Generally, equity method losses are recognised until the investor's interest in the associate or joint venture is reduced to zero.
- The equity method is discontinued when the investment ceases to be an associate or joint venture.
- In the investor's separate financial statements, there is an accounting policy choice for the measurement of associates and joint ventures between cost, in accordance with IFRS 9 *Financial Instruments* or using the equity method.

1 Introduction

1.1 Objective of IAS 28

The objective of the standard is to prescribe the accounting for investments in associates and to set out the requirements for the application of the equity method when accounting for investments in associates and joint ventures. *[IAS 28.1]*.

IAS 27 *Separate Financial Statements* allows an entity, in its separate financial statements, to account for its investments in subsidiaries, joint ventures and associates using the equity method of accounting as described in IAS 28. *[IAS 27.10]*. This is discussed further in Chapter 9 at section 2.3.

1.2 Scope of IAS 28

The standard is applied by all entities that are investors with joint control of a joint venture, or significant influence over an associate. *[IAS 28.2]*. Although there are no exemptions from the standard itself, there are exemptions from applying the equity method by certain types of entities as discussed in section 3 below.

1.3 Definitions

The following terms are used in IAS 28 with the meanings specified: *[IAS 28.3]*

Extract from IAS 28	
3	**The following terms are used in this Standard with the meanings specified:** **An *associate* is an entity over which the investor has significant influence.** ***Consolidated financial statements* are the financial statements of a group in which assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.** **The *equity method* is a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income.** **A *joint arrangement* is an arrangement of which two or more parties have joint control.** ***Joint control* is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.** **A *joint venture* is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.** **A *joint venturer* is a party to a joint venture that has joint control of that joint venture.** ***Significant influence* is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.**

IAS 28 also notes that the following terms are defined in IAS 27.4 and in Appendix A of IFRS 10 *Consolidated Financial Statements* and are used in IAS 28, with the meanings specified in the IFRS accounting standard in which they are defined:

- Control of an investee
- Group
- Parent
- Separate financial statements

  And
- Subsidiary *[IAS 28.4]*

1.4 Key differences between IAS 28 and ASC 323

IAS 28 is not converged with its US GAAP equivalent, ASC 323 *Investments - Equity Method and Joint Ventures*. However, they are similar, as summarised below, and therefore key differences are highlighted in this section. This is not an exhaustive list of differences. Further detail can be found in the US GAAP/IFRS accounting differences identifier tool.[1]

- An equity investment that gives an investor significant influence over an investee is considered an equity method investment under both US GAAP and IFRS accounting standards.
- An investor is generally presumed to have significant influence when it holds 20% or more of the voting interest in an investee.
- The equity method of accounting for such investments generally is consistent under US GAAP and IFRS accounting standards.

FASB differences

The key differences between the IFRS accounting standards and US GAAP guidance on this topic are as follows:

- When determining significant influence under IAS 28, potential voting rights are considered if currently exercisable. Under US GAAP, potential voting rights are generally not considered.
- Under IAS 28, the equity method is applied when an investor has significant influence, regardless of the legal form of the investee. Under US GAAP, the equity method is also applied when an investor holds more than 3-5% of a limited partnership or similar entity, unless the limited partner has virtually no influence over the investee, or the investor meets the criteria to apply proportional amortisation and elects that approach.
- Investments in associates held by venture capital organisations, mutual funds, unit trusts and similar entities are exempt from using the equity method under IAS 28 and the investor can elect to measure its investments in these associates at fair value. Under US GAAP (via ASC 825-10 *Financial Instruments*), all entities have the option to account for equity method investments at fair value. Therefore, the scope of entities that can apply a fair value measurement model is different.
- Uniform accounting policies between the investor and investee are required when applying IAS 28. Conforming accounting policies between investor and investee is generally not permitted under US GAAP.

1 *US GAAP/IFRS accounting differences identifier tool*, EY, December 2024, available on ey.com.

2 Significant influence

An investor has significant influence over an associate when it has the power to participate in the financial and operating policy decisions of the investee but does not have control or joint control of those policies. *[IAS 28.3]*.

Under IAS 28, a holding of 20% or more of the voting power of the investee (held directly or indirectly, through subsidiaries, see section 2.3 below) is presumed to give rise to significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, a holding of less than 20% of the voting power is presumed not to give rise to significant influence, unless it can be clearly demonstrated that there is in fact significant influence. The existence of a substantial or majority interest of another investor in the investee does not necessarily preclude the investor from having significant influence. *[IAS 28.5]*.

How we see it

In our view, an entity considers both ordinary shares and other categories of shares in determining its voting rights, because IAS 28 focuses on 'voting power'.

Extract from IAS 28

6 The existence of significant influence by an entity is usually evidenced in one or more of the following ways:

(a) representation on the board of directors or equivalent governing body of the investee;

(b) participation in policy-making processes, including participation in decisions about dividends or other distributions;

(c) material transactions between the entity and its investee;

(d) interchange of managerial personnel; or

(e) provision of essential technical information.

[IAS 28.6].

Significant influence might also exist over another entity through potential voting rights (see section 2.4 below). *[IAS 28.7]*.

An entity loses significant influence over an associate when it loses the power to participate in the financial and operating policy decisions of that associate. The loss of significant influence can occur with or without a change in absolute or relative ownership levels. It could result from a contractual arrangement. It could also occur, for example, when an associate becomes subject to the control of a government, court, administrator or regulator. *[IAS 28.9]*. An entity reassesses whether it has the ability to exercise significant influence when facts and circumstances change. The accounting for loss of significant influence over an associate is discussed in section 9 below.

2.1 Lack of significant influence

Indicators that the presumption of significant influence has been overcome include the following[2]:

- The investor has tried and failed to obtain representation on the investee's board of directors.
- The investee, other shareholders or regulatory authorities are opposing the investor's attempts to exercise significant influence.
- The investor and investee sign an agreement under which the investor surrenders significant rights as a shareholder, such as a standstill agreement.
- The investor is unable to obtain timely or adequate financial information required to apply the equity method.

  Or

- A group of shareholders that holds the majority ownership of the investee operates without regard to the views of the investor.

2 Similar considerations to those included in US GAAP, ASC 323-10-15-6.

How we see it

Determining whether the presumption of significant influence has been overcome requires considerable judgement. In our experience, many regulators take a keen interest in these decisions.

IFRS 12 *Disclosure of Interests in Other Entities* requires that an entity must disclose significant judgements and assumptions made in determining that it does not have significant influence even though it holds 20% or more of the voting rights of another entity. *[IFRS 12.9(d)]*. This is discussed further in Chapter 14 at section 3.

2.2 Holdings of less than 20% of the voting power

Although there is a presumption that an investor that holds less than 20% of the voting power in an investee does not have significant influence, *[IAS 28.5]*, careful judgement is needed to assess whether significant influence exists if one of the indicators in IAS 28.6(a) to (e) are present (see section 2 above).

For example, an investor might still be able to exercise significant influence in the following circumstances:

- The investor's voting power is much larger than that of any other shareholder of the investee.
- The corporate governance arrangements could be such that the investor is able to appoint members to the board, supervisory board or significant committees of the investee. The investor will need to apply judgement to the facts and circumstances to determine whether representation on the respective boards or committees is enough to provide significant influence.

  Or
- The investor has the power to veto significant financial and operating decisions.

How we see it

Determining whether the indicators above result in an investor having significant influence despite a holding of less than 20% of the voting power requires considerable judgement.

IFRS 12 requires that an entity must disclose significant judgements and assumptions made in determining that it does have significant influence when it holds less than 20% of the voting rights of another entity. *[IFRS 12.9(e)]*. This is discussed further in Chapter 14 at section 3.

Practical example 2-1 below shows Aveng Limited's disclosure of significant influence when it has voting rights of less than 20%.

Practical example 2-1: Aveng Limited (2021) — South Africa

Audited consolidated annual financial statements 2021 [extract]

Notes to the consolidated financial statements [extract]

3. SIGNIFICANT ACCOUNTING JUDGEMENTS AND ESTIMATES [extract]

3.1 Judgements and estimation assumptions [extract]

3.1.3 Equity-accounted investments [extract]

Equity-accounted entities are entities in which the Group holds less than 20% of the voting power, but the Group has determined that it has significant influence in entities where it holds less than 20% of the voting power. The Group's significant influence is due to the Group having a representation on the board of directors in each of these entities and the Group's participation in decisions over the relevant activities of the entities.

...

2.3 Assessing significant influence when an investor has both a direct holding and an indirect holding through an associate or joint venture

Extract from IAS 28

5	If an entity holds, directly or indirectly (eg through subsidiaries), 20 per cent or more of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the entity holds, directly or indirectly (eg through subsidiaries), less than 20 per cent of the voting power of the investee, it is presumed that the entity does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an entity from having significant influence.

[IAS 28.5].

The reference to investments held 'directly or indirectly (e.g., through subsidiaries)' is not explicitly clear whether investments held through an associate are considered when making the assessment of significant influence over an entity. Further, IAS 28.27 is clear that when assessing an investor's share of an associate or joint venture for the purposes of applying equity accounting, holdings of the group's other associates or joint ventures are ignored for this purpose.

This raises a question of how to account for a direct interest in a subsidiary of an associate or joint venture (that does not on its own give the investor significant influence or control). Considered alone, the direct interest would be a financial asset accounted for under IFRS 9, but considered in the context of the investment in the associate or joint venture would be accounted for under IAS 28.

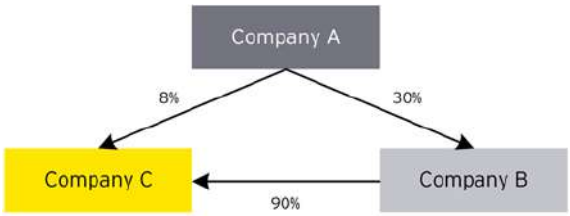
How we see it

As with any assessment of whether an investor has significant influence over another entity, the determination in this case requires judgement. Accounting for the direct interest depends on facts and circumstances. If the investor can demonstrate significant influence over the subsidiary of its associate or joint venture ("the investee"), the direct interest is accounted for under IAS 28. If not, it is a financial asset.

If the investor concludes that it has significant influence over the investee, applying IAS 28.27, its share of the investee is limited to the direct interest since holdings of associates and joint ventures are ignored in determining the investor's share in an associate or joint venture. The indirect interest in the investee is accounted for via equity accounting for the associate or joint venture.

Illustration 2-1: Investor holding a direct and indirect interest in an investee

Company A owns 30% of Company B and has significant influence over it. B has a 90% subsidiary, Company C, in which A also has a direct 8% interest. A's direct and indirect equity interests provide it with certain rights over C and there are no other relevant agreements providing rights over C. A has subsidiaries and prepares consolidated financial statements. How should A account for its 8% direct interest in C in its consolidated financial statements?



A considers the facts and circumstances of its relationship with C, including the factors in IAS 28.6 (see section 2 above) for the determination of significant influence. If the facts and circumstances indicate that A has significant influence over C, A equity accounts for its 8% interest in C and a further 27% indirect interest is equity accounted through its interest in B. If the facts and circumstances indicate that A does not have significant influence over C, the direct interest is accounted for as a financial asset under IFRS 9 and the 27% interest is accounted for under IAS 28 via A's equity accounting for B.

2.4 Potential voting rights

Extract from IAS 28

7 An entity may own share warrants, share call options, debt or equity instruments that are convertible into ordinary shares, or other similar instruments that have the potential, if exercised or converted, to give the entity additional voting power or to reduce another party's voting power over the financial and operating policies of another entity (ie potential voting rights). The existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by other entities, are considered when assessing whether an entity has significant influence. Potential voting rights are not currently exercisable or convertible when, for example, they cannot be exercised or converted until a future date or until the occurrence of a future event.

[IAS 28.7].

In assessing whether potential voting rights contribute to significant influence, an entity must examine facts and circumstances that affect potential voting rights, including their terms of exercise and any other contractual arrangements, whether considered individually or in combination. However, an entity does not include in the assessment the intention of management and the financial ability to exercise or convert those potential voting rights. *[IAS 28.8]*.

IAS 28 does not include guidance on potential voting rights comparable to that included in IFRS 10 (see Chapter 7 at section 4.3.4). In the amendments introduced to IAS 28 when IFRS 10, IFRS 11 and IFRS 12 were issued, the IASB did not reconsider the definition of significant influence and concluded that it would not be appropriate to address one element of the definition in isolation. Any such consideration would be done as part of a wider review of accounting for associates. *[IAS 28.BC16]*. Therefore, potential voting rights that are currently exercisable are included in the assessment of significant influence even if they are not 'substantive' in terms of IFRS 10. An example is a currently exercisable call option that is out of the money.

2.5 Fund managers

At its November 2016 meeting, the IFRS IC discussed a request to clarify whether, and how, a fund manager assesses if it has significant influence over a fund that it manages and in which it has a direct investment but does not control.

The IFRS IC observed that a fund manager assesses whether it has control, joint control or significant influence over a fund that it manages by applying the relevant IFRS accounting standard, which in the case of significant influence, is IAS 28. Unlike IFRS 10, IAS 28 does not contemplate whether and how decision-making authority held in the capacity of an agent affects the assessment of significant influence. The IFRS IC decided not to add the issue to its agenda.[3] However, IFRS 12.7(b) requires an entity to disclose information about significant judgements and assumptions it has made in determining that it has significant influence over another entity. *[IFRS 12.7(b)]*.

2.6 Severe long-term restrictions impairing ability to transfer funds to the investor

When assessing its ability to exercise significant influence over an entity, an investor considers the effect of severe long-term restrictions on the transfer of funds from the associate to the investor or other restrictions in exercising significant influence. However, such restrictions do not, in isolation, preclude the exercise of significant influence. *[IAS 28.BCZ18]*.

In some jurisdictions, an entity can seek protection from creditors to reorganise its business (e.g., under Chapter 11 of the Bankruptcy Code in the United States). In such situations, an investor (that is not under bankruptcy protection itself) with an interest in such an associate will need to evaluate the facts and circumstances to assess whether it is still able to exercise significant influence over the financial and operating policies of the investee.

3 *IFRIC Update*, November 2016, available on the IFRS Foundation's website.

3 Exemptions from applying the equity method

Under IAS 28, an entity with joint control of, or significant influence over, an investee accounts for its investment in an associate or a joint venture using the equity method, except when that investment qualifies for exemption in accordance with IAS 28.17 to 19. *[IAS 28.16]*. These exemptions are discussed in sections 3.1 to 3.4 below.

3.1 Parents exempt from preparing consolidated financial statements

An entity need not apply the equity method to its investment in an associate or a joint venture if the entity is a parent that is exempt from preparing consolidated financial statements by the scope exception in IFRS 10.4(a) (see Chapter 7 at section 2.2.1), which exempts subsidiaries from preparing consolidated financial statements if certain criteria are met. *[IAS 28.17]*.

3.2 Subsidiaries meeting certain criteria

Extract from IAS 28

17 An entity need not apply the equity method to its investment in an associate or a joint venture if the entity is a parent that is exempt from preparing consolidated financial statements by the scope exception in paragraph 4(a) of IFRS 10 or if all the following apply:

(a) The entity is a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the entity not applying the equity method.

(b) The entity's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets).

(c) The entity did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation, for the purpose of issuing any class of instruments in a public market.

(d) The ultimate or any intermediate parent of the entity produces financial statements available for public use that comply with IFRSs, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with IFRS 10.

[IAS 28.17].

An entity is exempt from applying the equity method to its investment in an associate or a joint venture if certain criteria are met. *[IAS 28.17]*. This exemption applies only when the investor in an associate or a joint venture is not also a parent. If it is a parent, it must look to the similar exemption from preparation of consolidated financial statements in IFRS 10, which also contains the conditions (a) to (d) above for a parent to be exempt from preparing consolidated financial statements under IFRS 10. *[IFRS 10.4(a)]*.

This exemption is available only to entities that are themselves either wholly-owned subsidiaries or partially-owned subsidiaries whose non-controlling shareholders do not object to the presentation of financial statements that do not include associates or joint ventures using the equity method. Subsidiaries are not exempt if none of their parent companies prepares consolidated financial statements in accordance with IFRS accounting standards. A typical example is that of an entity that is a subsidiary of a US group that prepares consolidated financial statements in accordance with US GAAP only. In addition, any entity that has publicly traded debt or equity, or is in the process of obtaining a listing for such instruments, will not satisfy the criteria for exemption.

The effect of the above requirements is that a reporting entity that has associates or joint ventures, but no subsidiaries, and does not meet all the criteria in (a)-(d) above, is required to apply equity accounting for its associates or joint ventures in its own (non-consolidated) financial statements (not to be confused with its 'separate financial statements' - see section 11 below).

Many jurisdictions apply a national GAAP that is based on IFRS but requires some form of endorsement process. The question then arises as to whether the exemption in (d) above can be applied when the ultimate or intermediate parent entity produces financial statements available for public use that comply with a national GAAP that is based on IFRS accounting standards.

How we see it

In our view, the exemption in (d), which relies on a parent of the entity producing financial statements available for public use that comply with IFRS accounting standards, can be applied when those financial statements use a national GAAP that is based on IFRS accounting standards if certain criteria are met. These are discussed in Chapter 7 at section 2.2.1.D.

3.3 Investments in associates or joint ventures held by venture capital organisations and similar organisations

Extract from IAS 28

18 When an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure that investment at fair value through profit or loss in accordance with IFRS 9. An example of an investment-linked insurance fund is a fund held by an entity as the underlying items for a group of insurance contracts with direct participation features. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. An entity shall make this election separately for each associate or joint venture, at initial recognition of the associate or joint venture. (See IFRS 17 *Insurance Contracts* for terms used in this paragraph that are defined in that Standard.)

[IAS 28.18].

This exemption is related to the fact that fair value measurement provides more useful information for users of the financial statements than application of the equity method. In the Basis for Conclusions to IAS 28, the IASB clarified that this is an exemption from the requirement to measure interests in joint ventures and associates using the equity method, rather than an exception to the scope of IAS 28 for the accounting for joint ventures and associates held by these entities. *[IAS 28.BC12, IAS 28.BC13]*.

This exemption raises the question of exactly which entities comprise "venture capital organisations, or a mutual fund, unit trust and similar entities including investment-linked insurance funds", since they are not defined in IAS 28. The determination of which entities are eligible for this exemption is discussed in sections 3.3.1 and 3.3.2 below.

IFRS 17 *Insurance Contracts* explains that an investment-linked insurance fund could be, for example, a fund held by an entity as the underlying items for a group of insurance contracts with direct participation features. *[IAS 28.18]*. For the purposes of the fair value election, insurance contracts include investment contracts with discretionary participation features.

3.3.1 Investment entities exception

IFRS 10 requires entities that meet the definition of an investment entity to measure investments in subsidiaries at fair value through profit or loss in accordance with IFRS 9. The investment entities exception is discussed further in Chapter 7 at section 10.

The application of the investment entity exception is not an accounting policy choice. If an entity meets the definition of an investment entity, it is required to measure its subsidiaries at fair value through profit or loss. To meet this definition, an investment entity must, as well as meeting other criteria, elect the exemption from applying the equity method in IAS 28 for its investments in associates and joint ventures. *[IFRS 10.B85L(b)]*.

As discussed further in section 8.2.1 below, if an entity that is not itself an investment entity has an interest in an associate or joint venture that is an investment entity, the investor can retain the fair value measurement applied by that investment entity associate or joint venture to the investment entity associate's or joint venture's interests in subsidiaries. *[IAS 28.36A]*.

3.3.2 Application of IFRS 9 to exempt investments in associates or joint ventures

The reason that IAS 28 allows venture capital organisations, mutual funds, unit trusts and similar entities to measure investments in associates and joint ventures at fair value is because these entities often manage their investments based on fair values and so the application of IFRS 9 produces more relevant information. Furthermore, the financial statements would be less useful if changes in the level of ownership in an investment resulted in frequent changes in the method of accounting for the investment. When investments are measured at fair value, the fair value is determined in accordance with IFRS 13 *Fair Value Measurement* (see Chapter 15).

3.3.2.A Entities with a mixture of activities

The exemption clearly applies to venture capital organisations and other similar financial institutions whose main activities consist of managing an investment portfolio comprising investments unrelated to the investor's business. Although, the exemption is not intended to apply to other entities that hold investments in several associates, there are cases in which entities have significant venture capital activities as well as significant other activities. It is clear from IAS 28.18 that the exemption applies to investments that are indirectly held through a venture capital or similar organisation (as well as to those held by the organisations themselves). Therefore, when an entity has a mixture of activities, if it can demonstrate that it runs a venture capital activity rather than merely undertaking, on an *ad hoc* basis, transactions that a venture capital activity would undertake, the exemption applies. *[IAS 28.18]*.

Illustration 3-1: Entity owning a discrete venture capital organisation

Parent P operates a construction business and owns a venture capital organisation (Subsidiary V) that invests in the telecommunications industry. Even though P itself is not a venture capital organisation, V would be able to apply the exemption and account for its investments at fair value under IFRS 9. In the consolidated financial statements of P, the investments held by V could also be accounted for at fair value under IFRS 9, with changes in fair value recognised in profit or loss in the period of change.

Illustration 3-2: Entity with a venture capital organisation segment

Bank A has several separate activities. One segment's business is that of a venture capital organisation. A's share of investees held by the venture capital organisation segment provides it with significant influence, but not control.

Even though A is itself not a venture capital organisation, it would be able to apply the exemption and account for its investments at fair value under IFRS 9, with changes in fair value recognised in profit or loss in the period of change.

3.3.2.B Establishment of a venture capital organisation or similar financial institution

IAS 28.18 says that the election to account for an associate or joint venture held by a venture capital or similar organisation is made 'at initial recognition of the associate or joint venture'. As described at 3.3.2.A above, an entity might conduct a mixture of activities, of which a venture capital or similar organisation is one part. An entity might therefore introduce such an operation and transfer to it existing holdings in associates or joint ventures accounted for using the equity method. This raises a question as to whether the exemption is available on initial transfer of investments to a newly formed venture capital or similar organisation or whether IAS 28.18 is interpreted such that the exemption is available only on initial recognition of the associate or joint venture itself.

Arguments for the exemption to be available to relevant investments on transfer to a newly formed venture capital or similar organisation include:

- IAS 28 does not provide guidance for when a venture capital or similar organisation is established as part of an internal restructuring.
- The election of accounting policy provided by IAS 28.18 becomes available only when a venture capital or similar organisation exists. Prior to this, the entity has made no accounting policy election and so is permitted to do so on initial transfer to the venture capital or similar organisation.
- The exemption in IAS 28 is provided because fair value measurement provides more useful information for users of the financial statements than application of the equity method. *[IAS 28.BC12]*.
- If the exemption were not available, associates and joint ventures held by the group on establishment of the venture capital or similar organisation, and transferred to it, would continue to be equity accounted while the exemption would be available for subsequent investments by the venture capital or similar organisation. This might result in mixed measurement models not accurately reflecting the manner in which investments are managed by the venture capital or similar organisation.

How we see it

In our view, this scenario is not considered in IAS 28. Therefore, it is acceptable to apply the exemption in IAS 28.18 once, on initial transfer of an existing investment in associate or joint venture to a newly established venture capital or similar organisation. It is also acceptable to interpret IAS 28.18 as not permitting such application of the exemption.

For the venture capital or similar organisation to have substance, the group must demonstrate that it runs a venture capital activity rather than merely undertaking, on an ad hoc basis, transactions that a venture capital activity would undertake. In the context of a newly established VCO organisation, this might be supported by evidence that the objective of holding the transferred investments in associates or joint ventures is for capital gain. This might be demonstrated by updates and changes to the entity's:

- Group structure
- Policies, procedures and business plans
- Management structures and remuneration arrangements

3.4 Partial use of fair value measurement of associates

Extract from IAS 28

19 When an entity has an investment in an associate, a portion of which is held indirectly through a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure that portion of the investment in the associate at fair value through profit or loss in accordance with IFRS 9 regardless of whether the venture capital organisation, or the mutual fund, unit trust and similar entities including investment-linked insurance funds, has significant influence over that portion of the investment. If the entity makes that election, the entity shall apply the equity method to any remaining portion of its investment in an associate that is not held through a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds.

[IAS 28.19].

In the Basis for Conclusions to IAS 28, the IASB discussed whether the partial use of fair value is allowed only in the case of venture capital organisations (or mutual funds, unit trusts and similar entities including investment-linked insurance funds) that have designated their portion of the investment in the associate at fair value through profit or loss in their own financial statements. The IASB noted that several situations might arise in which those entities do not measure their portion of the investment in the associate at fair value through profit or loss. In those situations, however, from the group's perspective, the appropriate determination of the business purpose would lead to the measurement of this portion of the investment in the associate at fair value through profit or loss in the consolidated financial statements. Consequently, the IASB decided that an entity can measure a portion of an investment in an associate held by a venture capital organisation (or a mutual fund, unit trust and similar entities including investment-linked insurance funds) at fair value through profit or loss regardless of whether this portion of the investment is measured at fair value through profit or loss in those entities' financial statements. *[IAS 28.BC22]*.

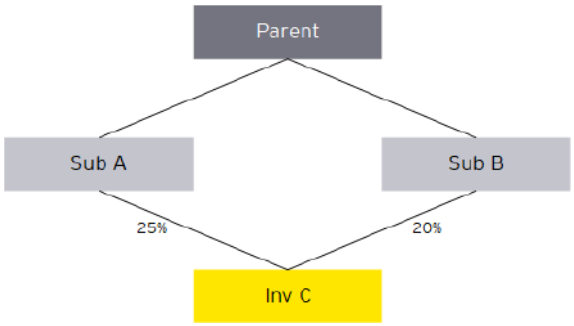
Illustration 3-3 below (which is based on four scenarios considered by the IFRS IC at its meeting in May 2009[4]) illustrates this partial use exemption.

4 IASB Staff Paper 3, Project: *IAS 28* Investments in Associates, Paper topic: *Venture capital consolidations and partial use of fair value through profit or loss*, IFRIC Meeting, May 2009. Available on the IFRS Foundation's website.

Illustration 3-3: Venture capital consolidations and partial use of fair value through profit or loss

A parent entity has two wholly-owned subsidiaries (A and B), each of which has an ownership interest in the same associate, Entity C. A is a venture capital business that holds its interest via an investment-linked fund. B is a holding company. Neither of the investments held by A and B is held for trading.

Scenario 1: both investments in the associate result in significant influence on a stand-alone basis

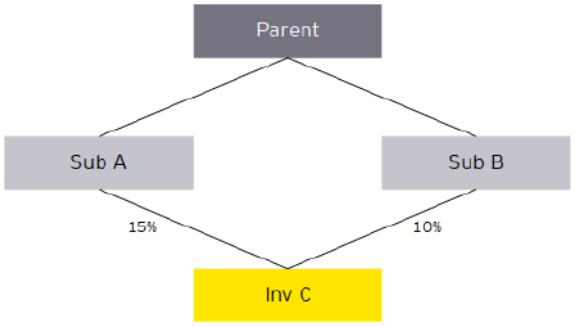


A accounts for its 25% share in the associate at fair value through profit or loss in accordance with IFRS 9 (see Chapter 46 at section 2.4).

B accounts for its 20% share in the associate using the equity method in accordance with IAS 28 (see section 5 below).

The parent entity must equity account for its 20% interest held by B. Under the partial use of fair value exemption, the parent entity can elect to measure the 25% interest held by A at fair value through profit or loss.

Scenario 2: neither of the investments in the associate results in significant influence on a stand-alone basis but do provide the parent with significant influence on a combined basis.

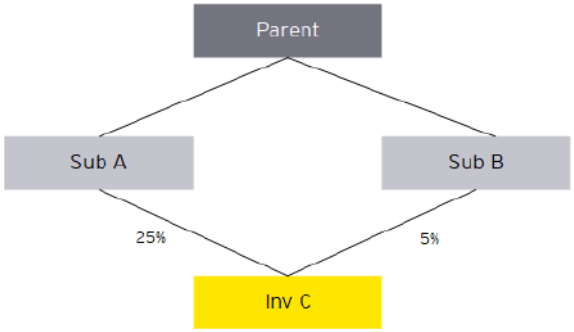


A accounts for its 15% share in the associate at fair value through profit or loss in accordance with IFRS 9 (see Chapter 46 at section 2.4).

B designated its 10% share in the associate as at fair value through OCI in accordance with IFRS 9 (see Chapter 46 at section 2.5).

The parent entity must equity account for its 10% interest held by B, even though B would not have significant influence on a stand-alone basis. Under the partial use of fair value exemption, the parent entity can elect to measure the 15% interest held by A at fair value through profit or loss.

Scenario 3: one of the investments in the associate results in significant influence on a stand-alone basis and the other investment in the associate does not result in significant influence on a stand-alone basis

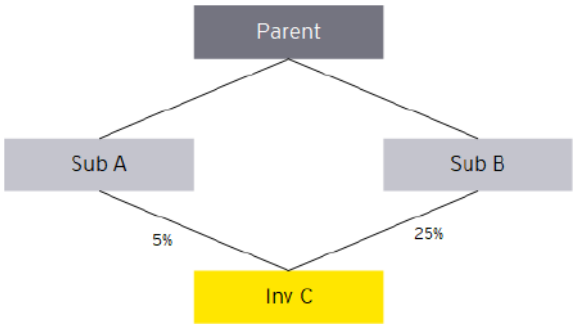


A accounts for its 25% share in the associate at fair value through profit or loss in accordance with IFRS 9 (see Chapter 46 at section 2.4).

B designated its 5% share in the associate as at fair value through OCI in accordance with IFRS 9 (see Chapter 46 at section 2.5).

The parent entity must equity account for its 5% interest held by B, even though B would not have significant influence on a stand-alone basis. Under the partial use of fair value exemption, the parent entity can elect to measure the 25% interest held by A at fair value through profit or loss.

Scenario 4: same as scenario 3, but with the ownership interests switched between the subsidiaries



A accounts for its 5% share in the associate at fair value through profit or loss in accordance with IFRS 9 (see Chapter 46 at section 2.4).

B accounts for its 25% share in the associate using the equity method in accordance with IAS 28 (see section 5 below).

The parent entity must equity account for its 25% interest held by B. Under the partial use of fair value exemption, the parent entity can elect to measure the 5% interest held by A at fair value through profit or loss.

4 Classification as held for sale (IFRS 5)

IAS 28 requires that an entity applies IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* to an investment, or a portion of an investment, in an associate or a joint venture that meets the criteria to be classified as held for sale. *[IAS 28.20]*. The detailed requirements for classification as held for sale are discussed in Chapter 5 at section 2.1.2. In this situation, the investor discontinues the use of the equity method from the date that the investment (or the portion of it) is classified as held for sale. Instead, the associate or joint venture is measured at the lower of its carrying amount and fair value less cost to sell. *[IFRS 5.15]*. The measurement requirements of IFRS 5 are discussed in Chapter 5 at section 2.2.

How we see it

In our view, once an investment (or a portion thereof) is classified as held for sale, dividends (or the related portion thereof) are recognised in profit or loss, because the investment (or portion thereof) is no longer being accounted for under the equity method. However, receiving dividends usually reduces the fair value of the investment, which could result in an offsetting loss recognised in the IFRS 5 measurement.

Any retained portion of an investment in an associate or a joint venture that has not been classified as held for sale is accounted for using the equity method until disposal of the portion that is classified as held for sale takes place. After the disposal takes place, an entity accounts for any retained interest in the associate or joint venture in accordance with IFRS 9 unless the retained interest continues to be an associate or a joint venture, in which case the entity uses the equity method. *[IAS 28.20]*.

As explained in the Basis for Conclusions to IAS 28, the IASB concluded that if a portion of an interest in an associate or joint venture fulfilled the criteria for classification as held for sale, it is only that portion that is accounted for under IFRS 5. An entity uses the equity method for the retained interest until the portion classified as held for sale is finally sold. This is because, even if the entity has the intention of selling a portion of an interest in an associate or joint venture, until it does so, it still has significant influence over, or joint control of, that investee. *[IAS 28.BC26, IAS 28.BC27]*.

When an investment, or a portion of an investment, in an associate or a joint venture previously classified as held for sale no longer meets the criteria to be so classified, it is accounted for using the equity method retrospectively, from the date of its classification as held for sale. Financial statements for the periods since classification as held for sale are amended accordingly. *[IAS 28.21]*.

5 Overview of the equity method

IAS 28 defines the equity method as "a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income." *[IAS 28.3]*.

Extract from IAS 28

10 Under the equity method, on initial recognition the investment in an associate or a joint venture is recognised at cost, and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition. The investor's share of the investee's profit or loss is recognised in the investor's profit or loss. Distributions received from an investee reduce the carrying amount of the investment. Adjustments to the carrying amount may also be necessary for changes in the investor's proportionate interest in the investee arising from changes in the investee's other comprehensive income. Such changes include those arising from the revaluation of property, plant and equipment and from foreign exchange translation differences. The investor's share of those changes is recognised in the investor's other comprehensive income (see IAS 1 *Presentation of Financial Statements*).

32 An investment is accounted for using the equity method from the date on which it becomes an associate or a joint venture. On acquisition of the investment, any difference between the cost of the investment and the entity's share of the net fair value of the investee's identifiable assets and liabilities is accounted for as follows:

(a) Goodwill relating to an associate or a joint venture is included in the carrying amount of the investment. Amortisation of that goodwill is not permitted.

(b) Any excess of the entity's share of the net fair value of the investee's identifiable assets and liabilities over the cost of the investment is included as income in the determination of the entity's share of the associate or joint venture's profit or loss in the period in which the investment is acquired.

Appropriate adjustments to the entity's share of the associate's or joint venture's profit or loss after acquisition are made in order to account, for example, for depreciation of the depreciable assets based on their fair values at the acquisition date. Similarly, appropriate adjustments to the entity's share of the associate's or joint venture's profit or loss after acquisition are made for impairment losses such as for goodwill or property, plant and equipment.

[IAS 28.10, IAS 28.32].

IAS 28 explains that equity accounting is necessary because recognising income simply based on distributions received might not be an adequate measure of the income earned by an investor on an investment in an associate or a joint venture, since distributions received might bear little relation to the performance of the associate or joint venture. Through its significant influence over the associate, or joint control of the joint venture, the investor has an interest in the associate's or joint venture's performance and, as a result, the return on its investment. The investor accounts for this interest by extending the scope of its financial statements to include its share of profits or losses of such an investee. As a result, application of the equity method provides more informative reporting of the net assets and profit or loss of the investor. *[IAS 28.11]*.

The investor's profit or loss and other comprehensive income are also adjusted for differences between the carrying amount of assets and liabilities in the associate's or joint venture's books and that in the investor's books, for example resulting from fair value adjustments on acquisition of the associate or joint venture. These are sometimes referred to as basis differences. *[IAS 28.32]*. Basis differences are important, because when an investor records its equity method earnings, the entity reflects not only its portion of earnings of the associate or joint venture, but also any effects of the basis differences related to identified assets or assumed liabilities, for example, by recognising additional depreciation on a property that had a fair value greater than its carrying amount in the associate's or joint venture's books at the date of acquisition.

Illustration 5-1: Application of the equity method

On the first day of its financial year, Entity A acquires a 35% interest in Entity B, over which it can exercise significant influence. A paid CU475,000 for its interest in B. The book value of B's net identifiable assets at acquisition date was CU900,000, and the fair value CU1.1m. The difference of CU200,000 relates to an item of property, plant and equipment (PP&E) with a remaining useful life of 10 years. During the year, B made a profit of CU80,000 and paid a dividend of CU120,000. B also owned an investment in securities classified as at fair value through OCI that increased in value by CU20,000 during the year. For the purposes of the example, any deferred tax implications have been ignored.

A accounts for its investment in B under the equity method as follows:

	CU	CU
Acquisition date of investment in B		
Share in book value of B's net identifiable assets: 35% of CU900,000	315,000	
Share in fair valuation of B's net identifiable assets: 35% of (CU1.1m - CU900,000)*	70,000	
Goodwill on investment in B: CU475,000 - CU315,000 - CU70,000*	90,000	
Cost of investment		475,000
Profit during the year		
Share in the profit reported by B: 35% of CU80,000	28,000	
Adjustment to reflect effect of fair valuation* 35% of ((CU1.1m - CU900,000) ÷ 10 years)	(7,000)	
Share of profit in B recognised in income by A (equity method income)		21,000
Revaluation of asset at fair value through OCI		
Share in revaluation recognised in OCI by A: 35% of CU20,000		7,000
Dividend received by A during the year		
35% of CU120,000 (debit cash, credit investment)		(42,000)
End of the financial year		
Share in book value of B's net assets: CU315,000 + 35% (CU80,000 - CU120,000 + CU20,000)	308,000	
Share in fair valuation of B's net identifiable assets: CU70,000 - CU7,000*	63,000	
Goodwill on investment in B*	90,000	
Closing balance of A's investment in B		461,000

* These line items are often referred to as 'basis differences' and are combined with the ones immediately above.

5.1 Comparison between equity accounting and consolidation

For some time, there has been a debate about whether the equity method of accounting is primarily a method of consolidation or a method of valuing an investment, as IAS 28 does not provide specific guidance either way.

An investor that controls a subsidiary has control over the assets and liabilities of that subsidiary. While an investor that has significant influence over an associate or joint control of a joint venture controls its holding in the shares of the associate or joint venture, it does not control the assets and liabilities of that associate or joint venture. Therefore, the investor does not account for the assets and the liabilities of the associate or joint venture, but accounts only for its investment in the associate or joint venture as a whole.

Extract from IAS 28

26 Many of the procedures that are appropriate for the application of the equity method are similar to the consolidation procedures described in IFRS 10. Furthermore, the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate or a joint venture.

[IAS 28.26].

However, although the equity method generally adopts consolidation principles (see Chapter 8), it also has features of a valuation methodology. For example, the IASB noted that IAS 28.20 (now IAS 28.26) explains "only the methodology used to account for investments in associates. This should not be taken to imply that the principles for business combinations and consolidations can be applied by analogy to accounting for investments in associates and joint ventures." *[IFRS 9.BCZ2.42]*.

The similarities between equity accounting and consolidation include:

- Appropriate adjustments to the entity's share of the associate's or joint venture's profits or losses after acquisition are made to account, for example, for depreciation of the depreciable assets based on their fair values at the acquisition date.
- Goodwill relating to an associate or a joint venture is recognised in the carrying amount of the investment.
- Goodwill is not amortised.
- Any excess of the investor's share of the net fair value of the associate's identifiable assets and liabilities over the cost of the investment is included as income in the determination of the entity's share of the associate's or joint venture's profit or loss in the period in which the investment is acquired (that is, any excess is recognised as a bargain purchase gain).
- Unrealised profits on 'upstream' and 'downstream' transactions are eliminated, although, unlike consolidation, only until realised in transactions with third parties (see section 7.1 below).
- Uniform accounting policies are applied for like transactions.

However, there are also several differences between equity accounting and consolidation, including:

- The investor ceases to recognise its share of losses of an associate or joint venture once the investment has been reduced to zero.
- The treatment of loans and borrowings (including preference shares classified as debt by the investee) between the reporting entity and its associates or joint ventures (see section 7.3 below).
- The investor cannot capitalise its own borrowing costs in respect of an associate's or joint venture's assets under construction (an equity accounted investment is not a qualifying asset under IAS 23 *Borrowing Costs* regardless of the associate's or joint venture's activities or assets). *[IAS 23.BC22]*.
- The investor considers whether there is any additional impairment loss with respect to its net investment.

As there is no clear principle underlying the application of the equity method, different views on how to account for certain transactions for which the standard has no clear guidance might be taken, depending on which principle (i.e., consolidation or valuation of an investment) is deemed to take precedence. We address these issues in the following sections.

6 Initial accounting for an associate or joint venture

6.1 Date of commencement of equity accounting

An investor begins equity accounting for an associate or a joint venture from the date on which it obtains significant influence over the associate or joint control over the joint venture (and is not otherwise exempt from equity accounting for it). *[IAS 28.32]*. In most situations, this is when the investor acquires the investment in the associate or joint venture. Determining whether an entity has significant influence is discussed in section 2 above.

6.2 Initial carrying amount of an associate or joint venture

Under the equity method, an investment is initially recognised at cost. *[IAS 28.3, IAS 28.10]*. However, 'cost' for this purpose is not defined.

Frequently asked questions

Question 6-1: Is directly attributable expenditure included in the initial carrying amount of an investment under the equity method?

In July 2009, the IFRS IC discussed the lack of a definition of cost in IAS 28. The IFRS IC issued an agenda decision[5] clarifying that the cost of an investment in an associate at initial recognition comprises its purchase price and any directly attributable expenditures necessary to obtain it. Therefore, any acquisition-related costs are not expensed (as is the case in a business combination under IFRS 3 *Business Combinations*) but are included as part of the cost of the associate.

The glossary to IFRS accounting standards defines cost as being the "amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction …".

'Consideration given' is likewise not defined, but guidance exists in IFRS accounting standards:

- 'Consideration transferred' in the context of a business combination, as referred to in IFRS 3.37. *[IFRS 3.37]*.
- 'Cost' as applied in relation to acquisitions of PP&E in accordance with IAS 16 *Property, Plant and Equipment*, intangible assets in accordance with IAS 38 *Intangible Assets* and investment property in accordance with IAS 40 *Investment Property*.

Applying the requirements of IFRS 3 *Business Combinations*, the 'consideration transferred' in a business combination comprises the sum of the acquisition-date fair values of assets transferred by the acquirer, liabilities incurred by the acquirer to the former owners of the acquiree, and equity interests issued by the acquirer. This includes any liability (or asset) for contingent consideration, which is measured and recognised at fair value at the acquisition date. Subsequent changes in the measurement of the liability (or asset) are recognised in profit or loss (see Chapter 10 at section 7.1).

How we see it

In our view, the guidance in IFRS 3 referred to above can be applied to contingent consideration arrangements for the purchase of an associate or a joint venture, i.e., the initial carrying amount of an associate or joint venture includes the fair value of any contingent consideration arrangement. Consequently, subsequent changes in the contingent consideration would be accounted for under IFRS 9.

Further guidance on accounting for contingent consideration when determining the cost of an asset can be found in Chapter 18 at section 4.5 and Chapter 19 at section 4.1.9.

The considerations regarding applying the cost requirements of other standards have previously been discussed by the IFRS IC, and the discussions are summarised in Chapter 9 at section 2.1.1.

The IFRS IC agenda decision did not provide any specific guidance in relation to a step acquisition of an associate or a joint venture. This is discussed further in section 6.2.3 below.

5 Agenda decision, July 2009. Potential effect of IFRS 3 Business Combinations (as revised in 2008) and IAS 27 Consolidated and Separate Financial Statements (as amended in 2008) on equity method accounting.

6.2.1 Measurement period on acquisition of an associate or joint venture

IAS 28 does not provide guidance when the accounting as required by IAS 28.32 is incomplete by the end of the reporting period in which the acquisition of the investment occurs.

How we see it

We believe that when the initial accounting for the acquisition of an associate or joint venture is incomplete at the reporting date, an entity could use by analogy the guidance in IFRS 3 regarding provisional accounting in the measurement period (see Chapter 10 at section 12).

Hence, the entity estimates and discloses provisional amounts for the items for which the accounting is incomplete. Those provisional amounts are adjusted retrospectively in the following reporting period to reflect new information obtained about facts and circumstances that existed at the acquisition date that, if known, would have affected the amounts recognised at that date. This is because the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate or a joint venture. *[IAS 28.26]*.

6.2.2 Initial carrying amount of an associate or joint venture following loss of control of an entity

A parent might lose control of its subsidiary as a result of a transaction with a third party or a downstream transaction (i.e., a transaction with its associate or joint venture, see section 7.5 below).

If a parent loses control of a subsidiary that constitutes a business in a transaction that is not a downstream transaction and the retained interest is an investment in an associate or joint venture, then it applies IFRS 10.25.

Under IFRS 10, when an entity loses control of a subsidiary and retains an interest in an associate or joint venture, the retained interest is remeasured at its fair value and included in the calculation of the gain or loss on disposal of the subsidiary. This fair value becomes the cost on initial recognition of the associate or joint venture. *[IFRS 10.25]*. The gain or loss on disposal is recognised in full and not restricted as would be the case in certain downstream transactions as explained below.

Under IAS 28, the investor that sells or contributes assets to its equity-accounted associate or joint venture is required to restrict any gain arising on its own assets to the gain attributable to the other party to the associate or joint venture. *[IAS 28.28]*. This results in an adjustment to the carrying amount of the investment in the associate or joint venture.

In certain scenarios in which a parent loses control of a subsidiary in a downstream transaction (see examples in Figure 6-1 below), there is a conflict between the above requirements of IFRS 10 and IAS 28.

In September 2014, the IASB issued *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (amendments to IFRS 10 and IAS 28) to address the conflict between IFRS 10 and IAS 28.[6] The amendments state that:

- Partial gain or loss recognition for transactions between an investor and its associate or joint venture applies only to a gain or loss resulting from the sale or contribution of assets that do not constitute a business as defined in IFRS 3.
- The gain or loss resulting from the sale or contribution of assets that constitute a business as defined in IFRS 3 to an associate or joint venture is recognised in full. *[IAS 28.31A]*.

In addition, the amendments address when an entity sells or contributes assets in two or more transactions. When determining whether assets that are sold or contributed constitute a business as defined in IFRS 3, an entity considers whether the sale or contribution of those assets is part of multiple arrangements that are accounted for as a single transaction in accordance with the requirements in IFRS 10.B97. *[IAS 28.31B]*.

In December 2015, the IASB deferred the effective date of these amendments indefinitely due to feedback that the recognition of a partial gain or loss when a transaction involves assets that do not constitute a business, even if these assets are housed in a subsidiary, is inconsistent with the initial measurement requirements of IAS 28.32(b): "Any excess of the entity's share of the net fair value of the investee's identifiable assets and liabilities over the cost of the investment is included as income in the determination of the entity's share of the associate or joint venture's profit or loss in the period in which the investment is acquired". This issue is in the scope of the equity method project (see section 13 below). However, entities can apply the amendments before the effective date.

6 *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture (amendments to IFRS 10 and IAS 28)*, IASB, September 2014.

How we see it

Until the amendments to IAS 28 become mandatorily effective, we believe that entities have an accounting policy choice to apply either IFRS 10 or IAS 28 to the contribution of an interest in a subsidiary that constitutes a business. Once selected, the entity must apply the policy consistently.

6.2.2.A Initial accounting for the investment in an associate or joint venture using the IFRS 10 approach and the IAS 28 approach

When the IFRS 10 approach is applied to a loss of control transaction, an investor accounts for a retained equity method investment as if it had acquired the retained investment at fair value at the date that control is lost. *[IFRS 10.25, IAS 28.32].* Therefore, the accounting is the same as for the initial acquisition of an investment in an associate according to IAS 28.32 (see section 5 above). The investor applying the equity method also needs to consider the requirements in IAS 28.32 regarding initial investment in an associate or joint venture. On initial recognition, the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate or joint venture and fair values are applied to measure all the identifiable assets and liabilities in calculating any goodwill or bargain purchase that exists. *[IAS 28.26, IAS 28.32]*. Accordingly, to apply the equity method from the date control is lost, an investor remeasures all the identifiable assets and liabilities underlying the investment at their fair values (or other measurement basis required by IFRS 3 at that date), i.e., the investor performs a new purchase price allocation.

Illustration 6-1 below demonstrates the accounting under the IFRS 10 approach. Although it shows the loss of control of a business with a retained interest in an associate, the accounting would be the same if the retained interest were a joint venture.

Illustration 6-1: Accounting for retained interest in an associate following loss of control of a subsidiary that is a business due to sale of shares to third party

Entity A owns 100% of the shares of Entity B. B meets the definition of a business. On its reporting date, A sells 60% of the shares in B to Entity C for CU1.3m. As a result of the sale, A loses control over B. A retains a 40% equity interest in B and determines that it has significant influence over B.

At the date of disposal, the carrying amount of the net identifiable assets of B in A's consolidated financial statements is CU1.2m and the fair value of A's retained interest of 40% of the shares of B is CU800,000.

Upon A's sale of 60% of the shares of B, it deconsolidates B and accounts for its investment in B as an associate using the equity method of accounting, as follows:

Dr	Cash		CU1,300,000	
Dr	Associate		CU800,000	
	Cr	Net assets of subsidiary		CU1,200,000
	Cr	Gain on disposal		CU900,000

When the IAS 28 approach is applied to a loss of control transaction, the retained equity method investment is adjusted to restrict any gain arising on the investor's own assets to the gain attributable to the other party to the associate or joint venture. Therefore, the investment is not initially measured at its fair value. For an illustration of the IAS 28 approach, see section 7.5.2 below.

6.2.2.B Loss of control scenarios in which the retained investment is an associate or joint venture

As discussed in more detail in Chapter 8 at section 3.3.2.A, examples of situations that result in the loss of control of a subsidiary and the interest retained is an associate or joint venture accounted for using the equity method, include:

- Scenario 1 - a 'downstream' sale or contribution of the investment in the subsidiary (which is a business) to an existing associate or joint venture.
- Scenario 2 - a 'downstream' sale or contribution of the investment in the subsidiary (which is not a business) to an existing associate or joint venture.
- Scenario 3 - a direct sale or dilution of the investment in the subsidiary (which is a business) for cash in a transaction involving a third party with a retained interest in an associate or joint venture.
- Scenario 4 - a direct sale or dilution of the investment in the subsidiary (which is not a business) for cash in a transaction involving a third party with a retained interest in an associate or joint venture.

The contribution of non-monetary assets to an associate or joint venture, which could include the contribution of a subsidiary, is discussed at 7.5 below.

In certain of these scenarios noted below there is a conflict between the requirements of IFRS 10.25 and those of IAS 28.28. This conflict is described at section 6.2.2 above.

How we see it

In our view, the context of which is discussed more fully in Chapter 8 at 3.3.2.A, the following accounting policy determinations are needed:

(a) Do the requirements of IFRS 10.25 apply to:
- A loss of control of a subsidiary that is a business ('narrow view')

Or
- A loss of control of a subsidiary (whether a business or not) ('wide view')?

(b) Where there is a conflict between the requirements of IFRS 10.25 ('IFRS 10 approach') and IAS 28.28 ('IAS 28 approach'), which accounting standard takes precedence?

(c) Where the transaction falls within the scope of neither IFRS 10.25 nor IAS 28.28, what accounting policy is applied?

Scenarios 1 and 3 fall within the scope of IFRS 10.25, whether a 'wide view' or 'narrow view' is taken at (a) above. However, Scenarios 2 and 4 will fall within the scope of IFRS 10 only if a 'wide view' is taken. Only Scenarios 1 and 2 fall within the scope of IAS 28.28. This is because this requirement in IAS 28 applies only to 'downstream' transactions with an associate or joint venture accounted for using the equity method and not to all transactions where the retained interest in the former subsidiary is an associate or joint venture accounted for using the equity method.

Figure 6-1 below summarises how the above policy determinations apply to the four scenarios where the September 2014 amendments are not applied. Application of the September 2014 amendments is discussed at 6.2.2 above.

Figure 6-1: Loss of control transactions where the retained interest in the former subsidiary is an associate or joint venture accounted for using the equity method

	Subsidiary meets the definition of a business	Subsidiary does not meet the definition of a business
Sale or contribution of investment in former subsidiary in downstream transaction with existing associate or joint venture	**Scenario 1** ▸ Both IFRS 10.25 (as the subsidiary is a business) and IAS 28.28 (as this is a 'downstream' transaction) apply to this scenario, so a conflict arises. ▸ An entity would need to develop an accounting policy to resolve the conflict, which would result in either applying full gain recognition (IFRS 10 approach) or partial gain recognition (IAS 28 approach).	**Scenario 2** ▸ IAS 28.28 (as this is a 'downstream' transaction) applies to this scenario. Therefore, partial gain recognition applies. ▸ However, if a 'wide view' is taken on the scope of IFRS 10.25, a conflict arises. An entity would then need to develop an accounting policy to resolve the conflict, which would result in either applying full gain recognition (IFRS 10 approach) or partial gain recognition (IAS 28 approach).
Sale or dilution of investment in former subsidiary for cash in transaction with third party	**Scenario 3** ▸ IAS 28.28 does not apply (as this is not a 'downstream' transaction). ▸ IFRS 10.25 applies (as the subsidiary is a business). ▸ Therefore, an entity applies full gain recognition (IFRS 10 approach) to the transaction.	**Scenario 4** ▸ IAS 28.28 does not apply (as this is not a 'downstream transaction'). ▸ IFRS 10.25 only applies if a 'wide view' is taken. ▸ Therefore, if a 'wide view' over the scope of IFRS 10.25 applies, an entity applies full gain recognition (IFRS 10 approach) to the transaction. ▸ If a 'narrow view' over the scope of IFRS 10.25 applies, an entity must develop and apply an appropriate accounting policy that provides relevant and reliable information in accordance with IAS 8.

How we see it

Where it is determined that a loss of control transaction falls within the scope of neither IFRS 10.25 nor IAS 28.28 (which might be the case for Scenario 4 if a 'narrow view' of the scope of IFRS 10.25 is taken), management will need to use judgement in developing and applying an appropriate accounting policy that results in relevant and reliable information, which must be consistently applied.

Please see further discussion of matters relating to developing an appropriate accounting policy in Chapter 8 at section 3.3.2.A.

6.2.3 Step acquisition of an associate or joint venture (financial instrument becoming an associate or joint venture)

An entity might gain significant influence or joint control over an existing investment upon acquisition of a further interest or due to a change in circumstances. IAS 28 is unclear on how an investor accounts for an existing investment that is accounted for under IFRS 9 and that subsequently becomes an associate or a joint venture, to be accounted for under the equity method.

How we see it

In our view, when accounting for the step acquisition of an associate or a joint venture, an investor applies either:

(a) An 'accumulated cost' approach

Or

(b) A 'fair value as deemed cost' approach

Once selected, the investor must apply the selected policy consistently.

The rationale for each of these approaches is discussed in more detail below.

As discussed in section 6.2 above, the IFRS IC, in July 2009, clarified that the initial cost of an equity accounted investment comprises the purchase price and directly attributable expenditures necessary to obtain it. Although the implications for the step acquisition of an associate are not explicitly addressed, it appeared that, since the IFRS IC considered that the initial recognition of the associate is based on its cost, the accounting reflects an 'accumulated cost' approach.

However, in July 2010, the IFRS IC received a request to address the accounting for an investment in an associate when the investment was purchased in stages and classified as available-for-sale (AFS) in terms of IAS 39 *Financial Instruments: Recognition and Measurement* until it became an associate.[7] The Staff Paper recommended that "the fair value of an investment classified as AFS prior to the investor obtaining significant influence over that investment should be the deemed cost of that pre-existing interest at the date the investor obtains significant influence over the associate. The accumulated changes in fair value accounted for in OCI should be reclassified to profit or loss at that date." The Staff Paper further recommended that a clarification of IAS 28 to that effect be included within the Annual Improvements project.[8] Thus, the Staff was recommending a 'fair value as deemed cost' approach. However, due to the acknowledged diversity in practice in accounting for associates purchased in stages, the IFRS IC did not reach a conclusion and to date there has been no amendment to IAS 28.[9]

In January 2019, the IFRS IC issued an agenda decision regarding the step acquisition of an investment in a subsidiary accounted for at cost in the separate financial statements of the parent. In the request, the initial interest was an equity instrument of another entity and was measured at fair value in accordance with IFRS 9. The IFRS IC concluded that a reasonable reading of the requirements in IFRS accounting standards could result in the application of either one of the two approaches to determine 'cost': the 'fair value as deemed cost' approach or the 'accumulated cost' approach. These approaches are discussed in more detail below. The IFRS IC concluded that, when the accumulated cost approach is applied, any difference between the fair value of the initial interest at the date of obtaining control of the subsidiary and its original consideration meets the definitions of income or expenses in the *Conceptual Framework for Financial Reporting*. Accordingly, applying paragraph 88 of IAS 1 *Presentation of Financial Statements*, the entity recognises this difference in profit or loss, regardless of whether, before obtaining control, the entity had presented subsequent changes in fair value of the initial interest in profit or loss or in OCI.[10]

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7 *IFRIC Update*, July 2010, available on the IFRS Foundation's website.

8 IASB Staff Paper 16, Project: *Annual Improvements Project - 2009-2011 cycle*, Paper topic: *IAS 28* - Investments in Associates - *Purchase in stages - fair value as deemed cost*, IFRS IC Meeting, July 2010, paras. 24 and 29. Available on the IFRS Foundation's website.

9 *IFRIC Update*, July 2010, available on the IFRS Foundation's website.

10 *IFRIC Update*, January 2019, available on the IFRS Foundation's website.

How we see it

The January 2019 agenda decision related specifically to investments in subsidiaries in the separate financial statements of the parent. However, we believe it is also relevant to step acquisitions of equity accounted associates and joint ventures, because IAS 28.3 also requires investments in associates and joint ventures to be measured at cost.

The scope of the equity method project (see section 13 below), includes measuring the cost of an investment when an investor obtains significant influence and has a previously held interest in the investee. Readers should monitor developments.[11]

6.2.3.A Applying an accumulated cost approach

When an accumulated cost approach is applied to account for a step acquisition of an associate or a joint venture, this involves the determination of:

(a) The cost of the investment

(b) Whether or not any catch-up adjustment is required when first applying equity accounting (i.e., an adjustment for the share of investee's profits and other equity movements as if the previously held interest had been equity accounted)

(c) The date(s) at which the goodwill implicit in the investment (or gain on bargain purchase) is measured

Not all of these aspects of the accounting for a step acquisition of an associate or a joint venture were addressed by the IFRS IC agenda decisions in 2009 and 2019.

How we see it

In our view, there are four possible accumulated cost approaches that can be applied to a step acquisition of an associate or a joint venture. Once selected, the investor must apply the selected policy consistently.

In all accumulated cost approaches, cost is the sum of the consideration given for each tranche together with any directly attributable costs. However, because of the answers to (b) and (c) above, the four accumulated cost approaches are as follows:

	Catch-up equity accounting adjustment for previously held interest	Determination of goodwill/gain on bargain purchase
Approach 1	None	Difference between sum of the consideration and share of fair value of net identifiable assets at date investment becomes an associate or joint venture
Approach 2	None	Difference between the cost of each tranche and the share of fair value of net identifiable assets acquired in each tranche
Approach 3	For profits (less dividends), and changes in OCI	
Approach 4	For profits (less dividends), changes in OCI and unrecognised changes in fair value of net identifiable assets	

The basis for using the above accumulated cost approaches can be set out as follows. The explanations below assume that the step acquisition has occurred in two tranches; the second acquisition resulting in the entity obtaining significant influence. When an entity purchases multiple tranches prior to obtaining significant influence, references below to the 'first tranche' apply to all tranches prior to obtaining significant influence.

11 IASB Update, April 2022, available on the IFRS Foundation's website.

Approach 1

IAS 28.32 (see section 5 above) states that an investment is accounted for using the equity method "from the date on which it becomes an associate or a joint venture." Recognising any catch-up adjustments can be interpreted as a form of equity accounting for a period prior to gaining significant influence, which contradicts this principle of IAS 28.

IAS 28.32 also states that any notional goodwill or gain on a bargain purchase is determined "on acquisition of the investment". However, it does not specify on which date the fair values of the net identifiable assets are determined. It can be interpreted to mean only at the date that the investment becomes an associate or a joint venture. This is also consistent with the approach in IFRS 3, whereby the underlying fair values of net identifiable assets are determined at one time only, rather than determining them several times for individual transactions leading to the change in the economic event.

Approach 2

No catch-up adjustment is recognised, for the same reasons as noted in Approach 1.

IAS 28.32 is interpreted to mean that the fair values of the associate's or joint venture's net identifiable assets are determined at a date that corresponds to the date at which consideration was given. Therefore, the fair values are determined for each tranche. This might require the fair values to be determined for previous periods when no such exercise was performed at the date of the original purchase.

Approach 3

A catch-up adjustment is recognised to reflect the application of the equity method as described in IAS 28.10 (see section 5 above), with respect to the first tranche (i.e., the share of the associate's results that would have been recognised by the investor if the first tranche of 10% had always been equity accounted). However, the application of that paragraph restricts the adjustment to only the share of profits (less dividends) and OCI relating to the first tranche. That is, there is no catch-up adjustment made for changes in the fair value of the net identifiable assets not recognised by the investee (except for any adjustments necessary to give effect to uniform accounting policies).

The determination of goodwill is the same as for Approach 2.

Approach 4

This approach is based on the underlying philosophy of equity accounting, which is to reflect the investor's share of the underlying net identifiable assets plus goodwill inherent in the purchase price. Therefore, when the investment was acquired in tranches, IAS 28.32 is interpreted to mean that a catch-up adjustment in respect of the first tranche is necessary, in order to apply equity accounting from the date the investment becomes an associate or a joint venture. The catch-up adjustment reflects not only the post-acquisition share of profits and OCI relating to the first tranche (i.e., the share of the associate's or joint venture's results that would have been recognised by the investor if the first tranche of 10% had always been equity accounted), but also the share of the unrecognised fair value adjustments based on the fair values of the net identifiable assets at the date of becoming an associate or a joint venture. The determination of goodwill is the same as for Approach 2.

Example of cost accumulation approaches

The above four accumulated cost approaches are shown in Illustration 6-2 below. Although, the example illustrates the step acquisition of an associate, the accounting would be the same if the transaction had resulted in the step acquisition of a joint venture.

Illustration 6-2: Accounting for existing financial instruments on the step acquisition of an associate (cost-based approach)

An investor acquired a 10% interest in an investee for CU100 on 1 January 20X1, which increased to a fair value of CU150 as of 31 December 20X3. Until 31 December 20X3, the investor accounted for its initial 10% interest at fair value in accordance with IFRS 9 and recognised the difference between the fair value of CU150 and the cost of the first tranche of CU100 of CU50 and the dividends received for its 10% interest of CU20 (CU200 * 10%) in profit or loss.

Three years later, on 1 January 20X4, the investor acquired an additional 15% interest in the investee for CU225. The investor now holds a 25% interest and has the ability to exercise significant influence. For the purposes of the example, directly attributable transaction costs and any deferred tax implications have been ignored.

The financial information relating to the investee can be summarised as follows:

	1 January 20X1	Movements in period of 10% ownership				1 January 20X4
		Profit	Dividends	Increase in fair value of land	Increase in fair value of goodwill	
	CU	CU	CU	CU	CU	CU
Book value of investee's assets	600	500	(200)			900
Investor's fair value adjustment to net identifiable assets (land*)	200			100		300
Investor's goodwill	200				100	300
Fair value of investee	1,000					1,500
Consideration paid	100					225

* For simplicity, the example includes fair value adjustments only on a non-depreciable asset.

The accounting for this step acquisition under each of the accumulated cost approaches is as follows (all amounts in CU):

	Catch-up equity accounting adjustment	Initial equity accounted amount	Goodwill in initial amount of associate
Approach 1	0	100 + 225 = 325	Consideration less share of fair value of net identifiable assets at time investment becomes an associate 325 - (25% × 1200) = 25
Approach 2	0	100 + 225 = 325	Cost less share of fair value of net identifiable assets at each tranche: 100 - (10% × 800) = 20 + 225 - (15% × 1200) = 45 Total = 65
Approach 3	10% of profits (less dividends) 10% × (500 - 200) = 30	325 + 30 = 355	
Approach 4	10% of profits (less dividends) and changes in unrecognised fair value of net identifiable assets 10% × (500 - 200 + 100) = 40	325 + 40 = 365	

The result in both the separate and consolidated financial statements is as follows:

Cost of investment

In all four accumulated cost approaches, the difference of CU50, between the fair value of the original 10% of CU150 and the cost of the first tranche of CU100, is reversed against profit or loss on 1 January 20X4 (the date of the transaction) to bring the asset back to its original cost of CU100.

Catch-up adjustment

For the accumulated cost approaches 3 and 4, the 'catch-up' equity accounting adjustment relating to the first tranche is recognised against the appropriate balance within equity - that is, retained earnings, or other equity reserve, depending on the nature of the 'catch up'. For example, an adjustment relating to the investee's profits would be recognised against retained earnings and an adjustment relating to the investee's OCI, for example, foreign currency translation, would be recognised against the relevant equity reserve.

The combined journal entry at 1 January 20X4 under each of the four approaches is as follows:

	Approach 1	Approach 2	Approach 3	Approach 4
Associate	Dr 325 *(of which equity method goodwill is 25)*	Dr 325 *(of which equity method goodwill is 65)*	Dr 355 *(of which equity method goodwill is 65)*	Dr 365 *(of which equity method goodwill is 65)*
Cash (Credit)	Cr 225	Cr 225	Cr 225	Cr 225
Investment (IFRS 9) (Credit)	Cr 150	Cr 150	Cr 150	Cr 150
Profit or loss	Dr 50 *(reversing prior fair value increases)*	Dr 50 *(reversing prior fair value increases)*	Dr 50 *(reversing prior fair value increases)*	Dr 50 *(reversing prior fair value increases)*
Retained earnings or other equity reserve	*No change to prior equity method income or dividend income*	*No change to prior equity method income or dividend income*	Cr 50 *(cumulative equity method income)* Dr 20 *(reversing prior dividend income)*	Cr 50 *(cumulative equity method income)* Cr 10 *(unrecognised increase in fair value of net identifiable assets)* Dr 20 *(reversing prior dividend income)*

6.2.3.B Applying a fair value as deemed cost approach

When a fair value as deemed cost approach is applied to accounting for a step acquisition of an associate or a joint venture, the fair value of the previously held interest at the date that significant influence or joint control is obtained is deemed to be the cost for the initial application of equity accounting. Since the investment would already be measured at fair value under IFRS 9, there is no further change to its carrying value.

- If the investment had been accounted for at fair value through OCI under IFRS 9, amounts accumulated in equity are not reclassified to profit or loss at the date that significant influence is obtained, although the cumulative gain or loss can be transferred within equity. *[IFRS 9.5.2.1, IFRS 9.5.7.5, IFRS 9.B5.7.1, IFRS 9.B5.7.3]*.
- If the investment had been accounted for at fair value through profit or loss under IFRS 9, any changes from original cost would already be reflected in profit or loss.

Consistent with the guidance in IFRS 3 for acquisitions achieved in stages, the calculation of goodwill at the date the investor obtains significant influence or joint control is made only at that date, using information available at that date.

The fair value as deemed cost approach is shown in Illustration 6-3 below. Although the example illustrates the step acquisition of an associate, the accounting would be the same if the transaction had resulted in the step acquisition of a joint venture.

Illustration 6-3: Accounting for existing financial instruments on the step acquisition of an associate (fair value (IFRS 3) approach)

Using the same information as in Illustration 6-2 above, under a fair value as deemed cost approach to an acquisition in stages, in the consolidated financial statements of the investor, the fair value of the 10% existing interest would be deemed to be part of the cost for the initial application of equity accounting.

Equity method goodwill is calculated as the difference between the initial equity method investment of CU375 (the fair value of the existing 10% interest of CU150 and the cost of the additional 15% interest of CU225) and CU300 (25% of the fair value of net identifiable assets of CU1,200, at the date significant influence is attained).

The combined journal entry at 1 January 20X4 is as follows:

Dr	Associate		CU375	
	Cr	Investment		CU150
	Cr	Cash		CU225

Additionally, if the investor measured the original investment at fair value through OCI, any amount in OCI relating to this interest can be reclassified within equity.

The methodology shown in Illustration 6-3 above is consistent with the accounting that is required by IAS 28 in the reverse situation; i.e., when there is a loss of significant influence in an associate (or loss of joint control in a joint venture), resulting in the discontinuance of the equity method (see section 9 below).

6.2.4 Step increase in an existing associate or joint venture without a change in status of the investee

An entity might acquire an additional interest in an existing associate that continues to be an associate accounted for under the equity method. Similarly, an entity might acquire an additional interest in an existing joint venture that continues to be a joint venture accounted for under the equity method. IAS 28 does not explicitly deal with such transactions.

How we see it

When an investor acquires an additional interest in an existing associate that continues to be accounted for under the equity method, we believe that the purchase price paid for the additional interest is added to the existing carrying amount of the associate or the joint venture and the existing interest in the associate or joint venture is not remeasured.

This increase in the investment must still be split notionally between goodwill and the additional interest in the fair value of the net identifiable assets of the associate or joint venture. This split is based on the fair value of the net identifiable assets at the date of the increase in the associate or joint venture. However, no remeasurement is made for previously unrecognised changes in the fair values of net identifiable assets. The treatment is shown in Illustration 6-4 below.

This accounting differs from the treatment required by IFRS 3 when an increased investment in an associate or joint venture results in the investor obtaining control over the investee. IFRS 3 is clear that when an entity acquires an additional interest in an existing associate or joint venture that gives it control, the entity is required to revalue the previously held interest in that investment and any gain or loss is recognised in profit or loss. *[IFRS 3.41, IFRS 3.42]*. This treatment reflects the significant change in the nature of, and economic circumstances surrounding, that investment, which therefore warrants a change in the classification and measurement of that investment. *[IFRS 3.BC384]*.

By contrast, when an investor increases its ownership interest in an existing associate or joint venture and that investment's classification remains unchanged, there is no significant change in the nature and economic circumstances of the investment. Hence, there is no justification for remeasurement of the existing ownership interest at the time of the increase. Rather the investor applies an accumulated cost approach equivalent to Approach 2 discussed in section 6.2.3.A above; i.e., the purchase price paid for the additional interest is added to the existing carrying amount of the associate or joint venture and the existing interest in the associate or joint venture is not remeasured.

IAS 28.32 (see section 5 above) establishes the requirement that the cost of an investment in an associate or joint venture is allocated between the share of the fair value of net identifiable assets and the goodwill. This requirement is not limited to the initial application of equity accounting but applies to each acquisition of an investment. However, this requirement does not result in any revaluation of the existing share of net assets in a step increase transaction without a change in status.

Rather, the existing ownership interests are accounted for under IAS 28.10 and IAS 28.32, whereby the carrying value is adjusted only for the investor's share of the associate or joint venture's profits or losses and other recognised equity transactions.

Although, Illustration 6-4 below illustrates an increase in ownership of an associate that continues to be an associate, the accounting would be the same if the transaction had been an increase in ownership of a joint venture.

Illustration 6-4: Accounting for an increase in the ownership of an associate

Entity A obtains significant influence over Entity B by acquiring an investment of 25% at a cost of CU3,000. At the date of the acquisition, the fair value of the associate's net identifiable assets is CU10,000, which equals their carrying amounts. Therefore, the difference between the amount paid of CU3,000 and A's share of the fair value of B's net assets of CU2,500 is attributable entirely to goodwill. The investment is accounted for under the equity method in the consolidated financial statements of A.

Two years later, A acquires an additional investment of 20% in B at a cost of CU4,000, increasing its total investment in B to 45%. The investment is still an associate and accounted for using the equity method of accounting.

For the purposes of the example, directly attributable costs have been ignored and it is assumed that no profit or loss arose during the period since the acquisition of the first 25%. Therefore, the carrying amount of the investment immediately prior to the additional investment is CU3,000. However, an asset held by the associate has increased in value by CU5,000 so that the fair value of the associate's net identifiable assets is now CU15,000.

To summarise, amounts are as follows:

	CU
Fair value of net identifiable assets of Entity B at acquisition	10,000
Increase in fair value	5,000
Fair value of net identifiable assets of Entity B two years later	15,000

Because of the additional investment, the equity-accounted amount for the associate increases by CU4,000. The notional goodwill applicable to the second tranche of the acquisition is CU1,000 [CU4,000 - (20% × CU15,000)].

The impact of the additional investment on A's equity-accounted amount for B is summarised as follows:

	% held	Carrying amount	Share of net identifiable assets	Goodwill included in investment
		CU	CU	CU
Existing investment	25	3,000	2,500	500
Additional investment	20	4,000	3,000	1,000
Total investment	45	7,000	5,500	1,500

The accounting for an increase in an associate or a joint venture that becomes a subsidiary is discussed in Chapter 10 at section 9.

6.2.5 Existing associate that becomes a joint venture, or vice versa

In the situations discussed in section 6.2.4 above, the acquisition of the additional interests did not result in a change in status of the investee, i.e., the associate remained an associate or the joint venture remained a joint venture. However, an associate could become a joint venture, either by the acquisition of an additional interest, or through a contractual agreement that gives the investor joint control. Alternatively, a contractual agreement could end, or part of an interest could be disposed of and a joint venture could become an associate. In all these situations, IAS 28 requires that the entity continues to apply the equity method and does not remeasure the retained interest. *[IAS 28.24]*. Therefore, the accounting described in Illustration 6-4 above would apply.

6.2.6 Common control transactions involving sales of associates

IFRS 3 and IAS 28 are not clear about how to apply the equity method of accounting when an investor acquires an investment in an associate from an entity that is under common control. Therefore, there is an interpretation of whether, and how, to apply IFRS 3 principles to investments in associates.

How we see it

We believe there are two possible approaches when an investor acquires an investment in an associate from an entity that is under common control: acquisition accounting and pooling of interests. An entity accounts for such transactions using a consistent accounting policy.

These approaches are discussed further in Chapter 11 at section 5.

6.3 Share of the investee

6.3.1 Accounting for potential voting rights

In applying the equity method and determining the share of the investee's earnings or losses to be recognised, the proportionate share of the associate or joint venture to be accounted for is generally based on the investor's ownership interest in the ordinary shares.

This is also generally the case when the investor holds potential voting rights, or other derivatives containing potential voting rights, in addition to the single investment in the ordinary shares. This is because an entity's interest in an associate or a joint venture is determined solely based on existing ownership interests and does not reflect the possible exercise or conversion of potential voting rights and other derivative instruments. *[IAS 28.12]*.

However, as an exception to this, IAS 28 recognises that: *[IAS 28.13]*

Extract from IAS 28

13 In some circumstances, an entity has, in substance, an existing ownership as a result of a transaction that currently gives it access to the returns associated with an ownership interest. In such circumstances, the proportion allocated to the entity is determined by taking into account the eventual exercise of those potential voting rights and other derivative instruments that currently give the entity access to the returns.

The standard does not provide an example of such circumstances, but the assessment of whether a potential voting right or other derivative instrument gives the holder present access to returns associated with the ownership interest in the shares is discussed in Chapter 8 at sections 6.1, 6.2.2 and 6.3 in the context of options over NCI. Similar considerations apply to the assessment of whether a potential voting right or other derivative instrument gives the holder present access to returns associated with the ownership interest in the shares under IAS 28.

IFRS 9 does not apply to interests in associates and joint ventures that are accounted for using the equity method. When instruments containing potential voting rights in substance currently give access to the returns associated with an ownership interest in an associate or a joint venture, the instruments are not subject to IFRS 9. In all other cases, instruments containing potential voting rights in an associate or a joint venture are accounted for in accordance with IFRS 9. *[IAS 28.14]*. Once the potential voting rights are exercised and the share in the investee increases, the fair value of such instruments at the exercise date is part of the cost to be recognised in accounting for the step increase (see section 6.2.3 above).

6.3.2 Cumulative preference shares held by parties other than the investor

If an associate or joint venture has outstanding cumulative preference shares that are held by parties other than the investor and that are classified as equity, the investor computes its share of profits or losses after adjusting for the dividends on such shares, whether or not the dividends have been declared. *[IAS 28.37]*.

Although Illustration 6-5 below illustrates cumulative preference shares issued by an associate, the accounting would be the same if the shares were issued by a joint venture.

Illustration 6-5: Cumulative preference shares issued by an associate

An entity holds an investment of 30% in the ordinary shares of an associate that has net assets of CU200,000 and net profit for the year of CU24,500. The associate has issued 5,000 cumulative preference shares with a nominal value of CU10 which entitle its holders to a 9% cumulative preference dividend. The cumulative preference shares are classified by the associate as equity in accordance with the requirements of IAS 32 *Financial Instruments: Presentation*. The associate has not declared dividends on the cumulative preference shares in the past two years.

The investor calculates its share of the associate's net assets and net profit as follows:

	CU
Net assets	200,000
9% Cumulative preference shares	(50,000)
Undeclared dividend on cumulative preference shares 2 years × 9% × CU50,000 =	(9,000)
Net assets value attributable to ordinary shareholders	141,000
Investor's 30% share of the net assets	42,300
Net profit for the year	24,500
Share of profit of holders of cumulative preference shares 9% of CU50,000 =	(4,500)
Net profit attributable to ordinary shareholders	20,000
Investor's 30% share of the net profit	6,000

If the investor also owned all the cumulative preference shares, then it would assess whether those preference shares are accounted for under IFRS 9 or IAS 28 (see section 6.3.1 above). Assuming that the preference shares are accounted for under IAS 28, the investor's share in the net assets of the associate would be CU42,300 + CU50,000 + CU9,000 = CU101,300. Its share in the net profit would be CU6,000 + CU4,500 = CU10,500.

6.3.3 Several classes of equity and substantive profit sharing arrangements

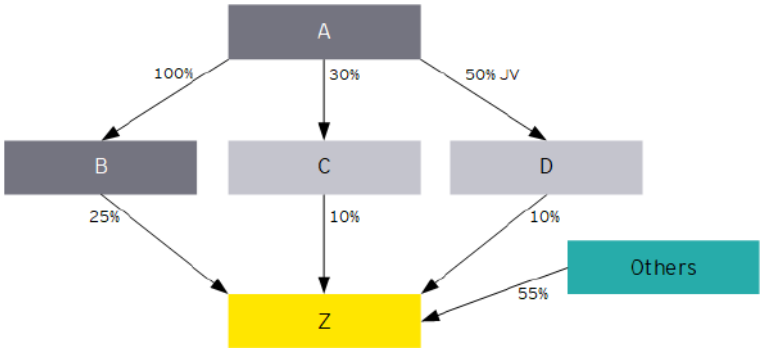
When an associate or joint venture has a complicated equity structure with several classes of equity shares that have varying entitlements to net profits, equity or liquidation preferences, or substantive profit sharing arrangements, the investor needs to assess carefully the rights attaching to each class of equity and the arrangements in determining the appropriate amount to recognise for its share of the investee's profit or losses.

6.3.4 Where the reporting entity is a group (indirect interests)

A group's share in an associate or joint venture is the aggregate of the holdings in that associate or joint venture by the parent and its subsidiaries. The holdings of the group's other associates or joint ventures are ignored for this purpose. *[IAS 28.27]*. Illustration 6-6 below illustrates the group's share in an associate when investments are also held by other entities in the group.

Illustration 6-6: Share in an associate or a joint venture when the reporting entity is a group

Parent A holds a 100% investment in Subsidiary B, which in turn holds a 25% investment in Associate Z. In addition, A also holds a 30% investment in Associate C and a 50% investment in Joint Venture D, each of which holds a 10% investment in Z.



In its consolidated financial statements, A accounts for a 25% investment in Z under the equity method because:

- The investments in Z held by C and D are not considered
- A consolidates the assets of B, which include a 25% investment in Z

A's indirect interests in Z held via its interests in C and D are accounted for via its accounting for C and D.

6.3.5 Where the investee is a group: non-controlling interests in an associate's or joint venture's consolidated financial statements

When an associate or joint venture itself has subsidiaries, the profits or losses, OCI and net assets considered in applying the equity method are those recognised in the associate's or joint venture's consolidated financial statements, but after any adjustments necessary to give effect to uniform accounting policies (see section 8.2 below). *[IAS 28.27]*.

An associate or joint venture might not own all the shares in some of its subsidiaries, in which case its consolidated financial statements will include non-controlling interests (NCI). Under IFRS 10, any NCI are presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent. Profit or loss and each component of OCI are attributed to the owners of the parent and to the NCI. *[IFRS 10.22, IFRS 10.B94]*. The profit or loss and OCI reported in the associate's or joint venture's consolidated financial statements will include 100% of the amounts relating to the subsidiaries, but the overall profit or loss and total comprehensive income will be split between the amounts attributable to the owners of the parent (i.e., the associate or joint venture) and those attributable to the NCI. The net assets in the consolidated statement of financial position will also include 100% of the amounts relating to the subsidiaries, with any NCI in the net assets presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent.

IAS 28 does not explicitly say whether the investor bases the accounting for its share of the associate's or joint venture's profits, OCI and net assets under the equity method on the amounts before or after any NCI in the associate's or joint venture's consolidated accounts. However, the implementation guidance to IAS 1 indicates that the amounts disclosed for 'share of profits of associates' and 'share of other comprehensive income of associates' represent the amounts "attributable to owners of the associates, i.e., it is after tax and non-controlling interests in the associates".[12]

How we see it

Therefore, in our view, when an investee does not wholly own its subsidiaries, since the investor's interest in the associate or joint venture is as an owner of the parent, its share of its associate's or joint venture's profits is based on the amounts that are reported as attributable to the owners of the parent (controlling interest) in the associate's or joint venture's consolidated financial statements, i.e., after any amounts attributable to the NCI.

12 IAS 1 IG6 *XYZ Group - Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7 (illustrating the presentation of profit and loss and other comprehensive income in one statement and the classification of expenses within profit by function).*

7 Transactions between the reporting entity and its associates or joint ventures

7.1 Elimination of 'upstream' and 'downstream' transactions

IAS 28 requires certain eliminations of transactions between an investor and its associate.

Extract from IAS 28

28 Gains and losses resulting from 'upstream' and 'downstream' transactions between an entity (including its consolidated subsidiaries) and its associate or joint venture are recognised in the entity's financial statements only to the extent of unrelated investors' interests in the associate or joint venture. 'Upstream' transactions are, for example, sales of assets from an associate or a joint venture to the investor. 'Downstream' transactions are, for example, sales or contributions of assets from the investor to its associate or its joint venture. The investor's share in the associate's or joint venture's gains or losses resulting from these transactions is eliminated.

[IAS 28.28].

How we see it

We believe that an appropriate approach for presenting these entries is as follows:

- In the statement of profit or loss and other comprehensive income, the adjustment is taken against either the investor's profit or the share of the associate's or joint venture's profit, whichever is the entity that recorded the profit on the transaction.
- In the statement of financial position, the adjustment is made against the asset which was the subject of the transaction if it is held by the investor, or against the carrying amount of the associate or joint venture if the asset is held by the associate or joint venture.

However, certain of these presentations have drawbacks, discussed in more detail below. The selected accounting policy must be consistently applied and disclosed in the financial statements.

This approach is consistent with the approach required by IAS 28 in dealing with the elimination of unrealised gains and losses arising on contributions of non-monetary assets to an associate or joint venture in exchange for an equity interest in the associate or joint venture (see section 7.5 below).

Illustration 7-1 and Illustration 7-2 below show our suggested approach to this requirement of IAS 28. Although these examples illustrate transactions between the reporting entity and an associate, the accounting would be the same if the transactions occurred between the reporting entity and a joint venture.

Illustration 7-1: Elimination of profit on sale by investor to associate ('downstream transaction')

One month before its reporting date, Entity H sells inventory costing CU750,000 to Associate A for CU1m, all of which remains in A's inventory at the reporting date. H owns 40% of A.

H recorded revenue of CU1m and cost of sales of CU750,000, a profit of CU250,000. However since, at the reporting date, the inventory is still held by A, only 60% of this transaction is regarded by IAS 28 as having taken place (in effect with the other shareholders of A). This is reflected by the elimination accounting entry:

Dr	Revenue		CU400,000	
	Cr	Cost of sales		CU300,000
	Cr	Investment in A		CU100,000

This entry effectively defers recognition of 40% of the profit on sale (CU250,000 × 40%) and offsets the deferred profit against the carrying amount of H's investment in A.

After the reporting date, when the inventory is sold to a third party for CU1.2m by A, this deferred profit can be released by H, reflected by the following equity accounting entry:

Dr	Investment in A		CU100,000	
Dr	Cost of sales		CU300,000	
	Cr	Revenue		CU400,000

An alternative approach would be to eliminate the profit on 40% of the sale against the cost of sales. Before the reporting date, this is reflected by the equity accounting entry:

Dr	Cost of sales	CU100,000	
	Cr Investment in A		CU100,000

After the reporting date, when the inventory is sold to a third party for CU1.2m by A, this deferred profit can be released by H, reflected by the following equity accounting entry:

Dr	Investment in A	CU100,000	
	Cr Cost of sales		CU100,000

An argument in favour of the alternative approach is that the revenue figures are not adjusted because the sales to associates or joint ventures are disclosed as related party transactions. However, this approach causes volatility in H's reported gross margin, as revenue and the related net margin are not recognised in the same accounting period.

Illustration 7-2: Elimination of profit on sale by associate to reporting entity ('upstream transaction')

This is the mirror image of the transaction in Illustration 7-1 above. Before H's reporting date, A sells inventory costing CU750,000 to H for CU1m.

A recognised a profit of CU250,000 (CU1m - CU750,000), 40% of which (CU100,000) is regarded under IAS 28 as unrealised by H, and is therefore deferred and offset against inventory:

Dr	Equity method earnings in A	CU100,000	
	Cr Inventory		CU100,000

In the following period, when the inventory is sold to a third party for CU1.2m by H, the entry is reversed:

Dr	Inventory	CU100,000	
	Cr Equity method earnings in A		CU100,000

Under this approach, at the reporting date, the investment in A will have increased by CU100,000 more than the share of profit of associates as reported in group profit or loss (and in the following period by CU100,000 less). This is because the adjustment to the statement of financial position at the reporting date is to inventory rather than the carrying value of the investment in A, reflecting the fact that A has, indeed, made a profit. It might therefore be necessary to disclose the reasons for this difference in the notes to the financial statements.

A transaction between an investor and its associate or joint venture could indicate a reduction in the net realisable value or an impairment loss of the asset that is the subject of the transaction. IAS 28 requires that when this is the case in a downstream transaction, those losses are recognised in full by the investor. Similarly, when an upstream transaction provides evidence of a reduction in the net realisable value of the assets to be purchased or of an impairment loss of those assets, the investor recognises its share of those losses. *[IAS 28.29]*.

The effect of these requirements is shown in Illustration 7-3 and Illustration 7-4 below. Although these examples illustrate transactions between the reporting entity and a joint venture, the accounting would be the same if the transactions occurred between the reporting entity and an associate.

Illustration 7-3: Sale of asset from venturer to joint venture at a loss

Two entities, A and B, establish Joint Venture C in which A and B each hold 50%. A and B each contribute CU5m in cash to C in exchange for equity shares. C then uses CU8m of its CU10m cash to acquire a property from A recorded in the financial statements of A at CU10m. CU8m is agreed to be the fair value of the property.

The required accounting entry by A is as follows:

		CU m	CU m
Dr	Cash(1)	3	
Dr	Investment in C(2)	5	
Dr	Loss on sale(3)	2	
	Cr Property(4)		10

(1) CU8m received from C less CU5m contributed to C.

(2) Represented by 50% of C's cash CU2m (CU10m from A and B minus CU8m to A), plus 50% of CU8m (carrying value of the property in books of C).

(3) Loss on sale of property CU2m (CU8m received from C less CU10m carrying value = CU2m) recognised in full because the transaction indicated an impairment of the property. In effect, it is the result that would have been obtained if A had recognised an impairment charge immediately prior to the sale and then recognised no gain or loss on the sale.

(4) Derecognition of A's original property.

Illustration 7-4: Sale of asset from joint venture to venturer at a loss

On 1 January 20X2, two entities A and B establish Joint Venture C in which A and B each hold 50%. A and B each contribute CU5m in cash to C in exchange for equity shares. C then uses CU8m of its CU10m cash to acquire a property from an independent third-party D. Property prices fall during 20X2 and on 31 December 20X2, the property is sold to A for CU7m settled in cash, which is agreed to be its fair value.

The required accounting entry by A for both transactions combined is as follows:

		CU m	CU m
Dr	Property (1)	7.0	
Dr	Investment in C(2)	4.5	
Dr	Share of loss of C(3)	0.5	
	Cr Cash (4)		12.0

(1) CU7m paid to C.

(2) Represented by 50% of C's cash CU9m (CU10m from A and B minus CU8m to D plus CU7m received from A).

(3) Loss in C's books is CU1m (CU8m cost of property less CU7m proceeds of sale). A recognises its 50% share because the transaction indicates an impairment of the asset, which is recognised by C as an impairment charge immediately prior to the sale.

(4) CU5m cash contributed to C plus CU7m consideration for property.

7.1.1 Elimination of 'downstream' unrealised profits in excess of the investment

Occasionally an investor's share of the unrealised profit on the sale of an asset to an associate or a joint venture exceeds the carrying value of the investment held. In that case, to what extent is any profit in excess of the carrying value of the investment eliminated?

IAS 28 is unclear about the elimination of 'downstream' unrealised gains in excess of the investment. Consequently, the IFRS IC received a request asking for clarification of the accounting treatment when the amount of gains to eliminate in a 'downstream' transaction in accordance with IAS 28.28 exceeds the amount of the entity's interest in the joint venture. The request specifically asked whether:

- The gain from the transaction is eliminated only to the extent that it does not exceed the carrying amount of the entity's interest in the joint venture

  Or

- The remaining gain in excess of the carrying amount of the entity's interest in the joint venture is also eliminated and if so, what it would be eliminated against

The IFRS IC determined that the entity eliminates the gain from a 'downstream' transaction to the extent of the related investor's interest in the joint venture, even if the gain to be eliminated exceeds the carrying amount of the entity's interest in the joint venture, as required by IAS 28.28. Any eliminated gain that is in excess of the carrying amount of the entity's interest in the joint venture is recognised as deferred income.[13] In July 2013, the IASB tentatively agreed with the views of the IFRS IC and directed the staff to draft amendments to IAS 28.[14] However, in June 2015, the IASB tentatively decided to defer further work on this topic to the equity method project. This is discussed further in section 13 below.

How we see it

We believe that, until the IASB issues an amendment to IAS 28, the investor can either recognise the excess, referred to above, as 'deferred income' or restrict the elimination to the amount required to reduce the investment to zero. The treatment chosen is based on the investor's accounting policy choice for dealing with other situations when IAS 28 is unclear, reflecting whether the investor considers the equity method of accounting to be primarily a method of consolidation (which would be consistent with recognition of the excess as deferred income) or a method of valuing an investment (which would be consistent with restricting the elimination to the amount that reduces the investment to zero). The investor applies a consistent policy to such situations.

7.1.1.A Method of consolidation approach

This approach gives precedence to the requirements in IAS 28.26, which is also consistent with the general requirement to apply IFRS 10 consolidation elimination principles. *[IAS 28.26]*. Although IAS 28.38 requires an investor to discontinue application of the equity method when an investor's share of losses equals or exceeds its interest in the associate (see section 8.3 below), *[IAS 28.38]*, the elimination does not represent a real 'loss' to the investor but is simply the non-recognition of a gain because of normal consolidation principles. Therefore, IAS 28.38 is subordinate to the requirement to eliminate unrealised profits.

7.1.1.B Method of valuing investment approach

This approach views the requirements of IAS 28.38 as taking precedence over the requirements of IAS 28.28 to eliminate unrealised profits from a transaction between the investor and the associate. The elimination of the full amount of the share of unrealised profit effectively results in the recognition of a 'loss' to the investor. Furthermore, by deferring the 'loss', the investor is effectively recognising a negative investment balance, which is not permitted or required under IAS 28 when the investor does not have any further legal or constructive obligations in relation to the asset or the associate.

7.1.1.C Examples

Although the following Illustrations show transactions between the reporting entity and an associate, the accounting would be the same if the transactions occurred between the reporting entity and a joint venture.

13 *IFRIC Update*, May 2013, available on the IFRS Foundation's website.

14 *IASB Update*, July 2013, available on the IFRS Foundation's website.

Illustration 7-5: Elimination of downstream unrealised profits in excess of the investment

An investor has a 40% investment in an associate, which it carries in its statement of financial position at CU800,000. The investor sells a property to the associate in exchange for cash, which results in a profit of CU3m. After the sale, 40% of that profit (i.e., CU1.2m) is unrealised from the investor's perspective.

It is assumed that the requirements for determining when a performance obligation is satisfied in IFRS 15 *Revenue from Contracts with Customers* have been met. Great care needs to be taken when the investor has any continuing involvement with the transferred asset - for example, guaranteeing limited recourse debt funding used to acquire the asset - to ensure that the requirements in IFRS 15 have been satisfied for revenue to be recognised.

The two approaches for determining to what extent a profit in excess of the carrying value of the investment are eliminated are as follows:

Method of consolidation approach - excess of the unrealised profit over the carrying value of the investment recognised as 'deferred income'

The investor eliminates the investor's total share of the unrealised profit against the carrying amount of the investment in the associate until reaching zero, recognising the excess as a 'deferred income' or similar balance, as follows:

Dr	Profit on sale of property[(1)]		CU1,200,000	
	Cr	Investment in associate		CU800,000
	Cr	'Deferred income'		CU400,000

(1) This adjustment could be presented in the income statement as an adjustment to revenue and cost of sales or to cost of sales only as discussed at Illustration 7-1 above.

This leaves a net profit of CU1.8m recognised in the consolidated financial statements. The investor recognises deferred income as the asset or the investment in the associate is realised (e.g., upon disposal of the investor's investment in the associate, or upon the disposal or depreciation of the asset by the associate).

Method of valuing investment approach - restricts the elimination to the amount required to reduce the investment to zero

If the investor does not have any further legal or constructive obligations in relation to the asset or the associate, no liability exists, and no further profit is deferred. The investor eliminates the unrealised profit to the extent that it reduces the carrying value of the investment to zero, as follows:

Dr	Profit on sale of property[(1)]		CU800,000	
	Cr	Investment in associate		CU800,000

(1) This adjustment could be presented in the statement of profit or loss and other comprehensive income as an adjustment to revenue and cost of sales or to cost of sales only as discussed at Illustration 7-1 above.

This leaves a net profit of CU2,200,000 recognised in the consolidated financial statements. The investor does not recognise further profits in the associate until they exceed the unrecognised unrealised profits of CU400,000.

7.1.2 Transactions between associates and/or joint ventures

Transactions could take place between associates and/or joint ventures held by the same investor. Although IAS 28.28 refers only to upstream and downstream transactions between an investor and its associate or its joint venture, we consider these to be examples of typical transactions to be eliminated as a result of the requirements of IAS 28.26 which says that "Many of the procedures that are appropriate for the application of the equity method are similar to the consolidation procedures described in IFRS 10". They are not the only transactions requiring elimination as a result of applying the principle in IAS 28.26. Therefore, applying the principles in IAS 28.28 and IFRS 10.B86, the unrealised profit in the investor's financial statements arising from any transaction between the associates (and/or joint ventures) is eliminated to the extent of the related investor's interests in the associates (and/or joint ventures) as appropriate.

How we see it

When transactions take place between associates and/or joint ventures, which are accounted for under the equity method, we believe the investor applies the requirements of IAS 28 and IFRS 10 by analogy and eliminate its share of any unrealised profits or losses. In practice, however, it might be difficult to determine whether such transactions have taken place.

Illustration 7-6:	Elimination of profits and losses resulting from transactions between associates and/or joint ventures

Entity H has a 25% interest in Associate A and a 30% interest in Joint Venture B.

During the reporting period, A sold inventory costing CU1m to B for CU1.2m. All of the inventory remains on B's statement of financial position at the end of the reporting period.

H eliminates CU15,000 (i.e., 30% × 25% × CU200,000) as its share of the profit that is unrealised.

7.2 Reciprocal interests

Reciprocal interests (or 'cross-holdings') arise when an associate or joint venture itself holds an investment in the reporting entity. Although the discussion below refers to a reciprocal interest between the reporting entity and an associate, the discussion below would apply equally to a joint venture.

7.2.1 Reciprocal interests in reporting entity accounted for under the equity method by the associate

When the associate's investment in the reporting entity is such that the associate in turn has significant influence over the reporting entity and accounts for that investment under the equity method, a literal interpretation of IAS 28.27 is that an investor records its share of an associate's profits and net assets, including the associate's equity accounted profits and net assets of its investment in the investor. The reciprocal interests can therefore give rise to a measure of double counting of profits and net assets between the investor and its associate.

The elimination of reciprocal interests was discussed by the IFRS IC in August 2002. The IFRS IC agreed not to require publication of an Interpretation on this issue but did state that "like the consolidation procedures applied when a subsidiary is consolidated, the equity method requires reciprocal interests to be eliminated."[15]

How we see it

Therefore, we believe that the requirement in IFRS 10.B86 to eliminate intragroup balances, transactions, income and expenses is applied by analogy when reciprocal interests exist.

Neither IFRS 10 nor IAS 28 explains how an entity eliminates the double counting that arises from reciprocal holdings. We believe that a direct holding only (or net approach) is applicable, whereby the profit of the investor is calculated by adding its direct investment in the associate to its trading profits, as shown in Illustration 7-7 below.

This method takes up the investor's share of the associate's profits excluding the equity income arising on the reciprocal shareholdings and eliminates only the effects of an entity's indirect investment in its own shares.

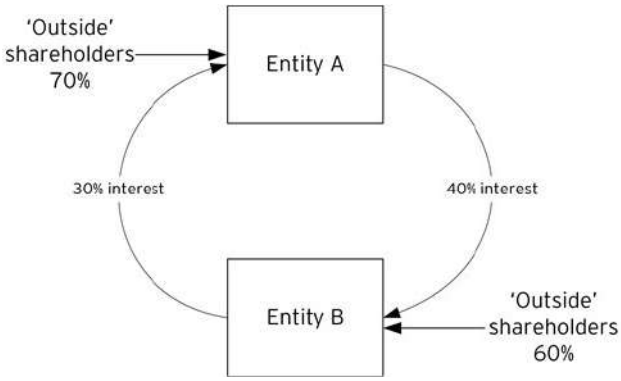
The investor also eliminates the reciprocal interest in calculating earnings per share (EPS), consistent with the treatment of treasury shares. The associate is not part of the group and therefore, the shares held in the investor are not 'treasury shares' as defined. However, applying IAS 28.26, the reciprocal shareholdings are eliminated as they would be if a subsidiary held shares in its parent, under IFRS 10.B86(c).

15 *IFRIC Update*, August 2002, p.3, available on the IFRS Foundation's website.

Illustration 7-7: Elimination of equity-accounted reciprocal interests

Entity A has a 40% equity interest in Entity B and conversely, B has a 30% interest in A.

The structure of the reciprocal holdings is shown in the diagram below:



Entity A	
Share in equity of B	40%
Shares in A held by 'outside' shareholders	70%
Trading profit of A (before share in profit of B)	CU60,000
Net assets of A (before share in net assets of B)	CU600,000
Number of shares in issue	100,000

Entity B	
Share in equity of A	30%
Shares in B held by 'outside' shareholders	60%
Trading profit of B (before share in profit of A)	CU110,000
Net assets of B (before share in net assets of A)	CU1,100,000
Number of shares in issue	40,000

Income

The profit for the period is calculated by adding the direct interest in the associate's profit:

- Profit of A:
  Trading profit of A + 40% × trading profit of B = CU60,000 + 40% × CU110,000 = CU104,000
- Profit of B:
  Trading profit of B + 30% × trading profit of A = CU110,000 + 30% × CU60,000 = CU128,000

Statement of financial position

A similar approach can be applied to calculate the net assets of A and B:

- Net assets of A including share in B without eliminations:
  CU600,000 + 40% × CU1.1m = CU1.04m
- Net assets of B including share in A without eliminations:
  CU1.1m + 30% × CU600,000 = CU1.28m

EPS

It is necessary to adjust the number of shares to eliminate the reciprocal holdings: For A it can be argued that it indirectly owns 40% of B's 30% interest, i.e., A indirectly owns 12% (= 40% × 30%) of its own shares. Those shares are ignored for the purposes of the EPS calculation.

- Number of A shares after elimination of 'treasury shares':
  100,000 × (100% - 12%) = 88,000 shares

Similarly, B indirectly owns 30% of A's 40% interest, i.e., B indirectly owns 12% (= 30% × 40%) of its own shares.

- Number of B shares after elimination of 'treasury shares':
  40,000 × (100% - 12%) = 35,200 shares

The EPS for the shareholders of A and B is calculated as follows:

- EPS A:

  CU104,000 ÷ 88,000 = CU1.18

- EPS B:

  CU128,000 ÷ 35,200 = CU3.64

The EPS is equivalent to the hypothetical dividend per share in the case of full distribution of all profits.

Conclusion

The financial statements reflect both the interests of the 'outside' shareholders and the interests that B shareholders have in A. It is worthwhile noting that the combined underlying trading profit of A and B is only CU170,000 (i.e., CU60,000 + CU110,000), whereas their combined reported profit is CU232,000 (i.e., CU104,000 + CU128,000). Similarly, the combined underlying net assets of A and B are only CU1,700,000, whereas the combined reported net assets are CU2,320,000.

7.2.2 Reciprocal interests in reporting entity not accounted for under the equity method by the associate

In some situations, the associate's investment in the reporting entity is such that the associate does not have significant influence over the reporting entity and accounts for that investment under IFRS 9, either as at fair value through OCI or at fair value through profit or loss. Although the associate is not applying the equity method, the reciprocal interest can still result in double counting of profits and net assets between the investor and its associate when the investor accounts for its share of the profits and net assets of the associate. Again, IAS 28.26 states that many of the procedures appropriate for the application of the equity method are similar to the consolidation procedures described in IFRS 10.

How we see it

In our view, the requirement in IFRS 10.B86 to eliminate intragroup balances, transactions, income and expenses is applied by analogy to reciprocal interests in the reporting entity accounted for under IFRS 9. Accordingly, in its equity accounting, the investor eliminates income from the associate's investment in the investor. This elimination includes dividends and changes in fair value recognised either in profit or loss or OCI. The investor also eliminates the reciprocal interest in calculating EPS.

Illustration 7-8: Elimination of reciprocal interests not accounted for under the equity method

Investor A has a 20% interest in an Associate B. B has a 10% interest in A, which does not give rise to significant influence.

Scenario 1

B recognises a profit of CU1,300 for the year, which includes a dividend of CU100 received from A and a gain of CU200 from measuring its investment in A at fair value through profit or loss.

In this scenario, A's equity method share of B's profit is CU200, being 20% of B's profit of CU1,000 after excluding income (dividend of CU100 plus fair value gain of CU200) on its investment in A.

Scenario 2

B recognises a profit of CU1,100 for the year, which includes a dividend of CU100 received from A and recognises CU200 in OCI from measuring its investment in A as a financial asset at fair value through OCI.

In this scenario, A's equity method share of B's profit is CU200, being 20% of B's profit of CU1,000 after excluding income (dividend of CU100) on its investment in A. A's share of B's OCI also excludes the gain of CU200 recognised in OCI arising from its investment in A.

In both scenarios, A also reduces its equity balance and its investment in B by its effective 2% interest in its own shares and uses the reduced number of shares in determining EPS.

7.3 Loans and borrowings between the reporting entity and its associates or joint ventures

The requirement in IAS 28.28 to eliminate partially unrealised profits or losses on transactions with associates or joint ventures is expressed in terms of transactions involving the transfer of assets. The requirement for partial elimination of profits could be read to not apply to items such as interest paid on loans and borrowings between the reporting entity and its associates or joint ventures since such loans and borrowings do not involve the transfer of assets giving rise to gains or losses. Moreover, they are not normally regarded as part of the investor's share of the net assets of the associate or joint venture, but as separate transactions (except in the case of loss-making associates or joint ventures, see section 8.3 below).

How we see it

We believe that loans and borrowings between the reporting entity and its associates or joint ventures generally are not eliminated in the reporting entity's consolidated financial statements when the interest income and expense are recognised by both parties.

However, if the associate or joint venture has capitalised the borrowing costs then the investor would need to eliminate a relevant share of its interest income and realise it as the associate depreciates the qualifying asset. The same principle applies to eliminate a share of capitalised management or advisory fees charged to an associate or joint venture.

7.4 Statement of cash flows

Changes in cash and cash equivalents relating to associates or joint ventures accounted for under the equity method affect the entity's statement of cash flows only to the extent of the cash flows between the group and the investee (for example, to dividends and advances). *[IAS 7.37, IAS 7.38]*. The same concept applies to associates or joint ventures carried at fair value (see section 3 above).

In the consolidated statement of cash flows, no elimination adjustment is made in respect of the cash flows relating to transactions with associates or joint ventures. This contrasts with the requirement in any consolidated statement of cash flows to eliminate the cash flows between members of the group.

7.5 Contributions of non-monetary assets to an associate or a joint venture

It is fairly common for an entity to create or change its interest in an associate or a joint venture by contributing some of the entity's existing non-monetary assets to that associate or joint venture. This raises several questions as to how such transactions are accounted for, in particular whether they are accounted for at book value or fair value.

IAS 28 requires the contribution of a non-monetary asset to an associate or a joint venture in exchange for an equity interest in the associate or joint venture to be accounted for in accordance with IAS 28.28, except when the contribution lacks commercial substance, as described in IAS 16 (see section 7.5.1 below and Chapter 19 at section 4.4). *[IAS 28.30]*. IAS 28.28 requires gains and losses resulting from transactions between an entity and its associate or joint venture to be recognised only to the extent of unrelated interests in the associate or joint venture. The investor's share in the associate's or joint venture's gains or losses resulting from those transactions is eliminated (see section 7.1 above for a discussion of the requirements relating to these transactions). However, there is a conflict between the requirements of IAS 28 and the requirements in IFRS 10 relating to accounting for the loss of control of a subsidiary, when a subsidiary is contributed by the investor to an associate or joint venture and control of the subsidiary is consequently lost. This conflict is discussed below in section 7.5.3.

If a contribution lacks commercial substance, the gain or loss is regarded as unrealised and is not recognised unless IAS 28.31 (see below) also applies. The unrealised gains and losses are eliminated against the investment accounted for using the equity method and are not presented as deferred gains or losses in the entity's consolidated statement of financial position or in the entity's statement of financial position in which investments are accounted for using the equity method. *[IAS 28.30]*. When 'unrealised' losses are eliminated in this way, the effect will be to apply what is sometimes referred to as 'asset swap' accounting. In other words, the carrying value of the investment in the associate or joint venture will be the same as the carrying value of the non-monetary assets transferred in exchange for it, subject to any necessary provision for impairment uncovered by the transaction.

If, in addition to receiving an equity interest in an associate or a joint venture, an entity receives monetary or non-monetary assets, the entity recognises in full, in profit or loss, the portion of the gain or loss on the non-monetary contribution relating to the monetary or non-monetary assets received. *[IAS 28.31]*.

If the terms of a transaction provide evidence that the entity's interest in the associate, or the asset that was contributed, might be impaired, a charge is recognised, as discussed in section 7.1 above and in section 7.5.4 below.

7.5.1 'Commercial substance'

IAS 28 requires that a transaction is not treated as realised when it lacks commercial substance as described in IAS 16. *[IAS 28.30]*.

Extract from IAS 16

25 An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

(a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or

(b) the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange; and

(c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

For the purpose of determining whether an exchange transaction has commercial substance, the entity-specific value of the portion of the entity's operations affected by the transaction shall reflect post-tax cash flows. The result of these analyses may be clear without an entity having to perform detailed calculations.

[IAS 16.25].

The Board included the 'commercial substance' test in IAS 16 in order to "help to give users … assurance that the substance of a transaction in which the acquired asset is measured at fair value (and often, consequentially, a gain on the disposal of the transferred asset is recognised in income) is the same as its legal form." *[IAS 16.25, IAS 16.BC21]*.

The first step when assessing whether a transaction has commercial substance is to determine the cash flows both of the asset given up and of the asset acquired (the latter being the interest in the associate or joint venture). This determination could be sufficient by itself to satisfy (a) above, as it might be obvious that there are significant differences in the configuration of the cash flows. The type of income might have changed. For example, if the entity contributed a non-monetary asset such as a property or intangible asset to the associate or joint venture, the reporting entity might now be receiving a rental or royalty stream from the associate or joint venture, whereas previously the asset contributed to the cash flows of the cash-generating unit of which it was a part.

However, determining the cash flows might not result in a clear-cut conclusion, in which case the entity-specific value will have to be calculated. This is not the same as a value in use calculation under IAS 36 *Impairment of Assets*, in that the entity can use a discount rate based on its own assessment of the risks specific to the operations, not those that reflect current market assessments, *[IAS 16.BC22]*, and post-tax cash flows. *[IAS 16.25]*. The calculation might not be highly sensitive to the discount rate as the same rate is used to calculate the entity-specific value of both the asset surrendered and the entity's interest in the associate or joint venture.

However, if the entity considers that a high discount rate is appropriate, this will have an impact on whether or not the difference is significant relative to the fair value of the assets exchanged. The transaction will have commercial substance if the entity-specific value of both the asset surrendered and the entity's interest in the associate or joint venture are not only different to one another but also significant compared to the fair values of the assets exchanged. *[IAS 16.25]*.

How we see it

We believe that transactions entered into with genuine commercial purposes in mind are likely to pass the 'commercial substance' tests outlined in IAS 16.25 above. Testing transactions for their commercial substance will require entities to focus on the fair value of the transaction as a whole and not to follow the strict legal form.

7.5.2 Contributions of non-monetary assets - IAS 28 approach

IAS 28 does not give an example of the accounting treatment that it envisages when a gain is treated as 'realised'. We believe that the intended approach is that set out in Illustration 7-9 below. In essence, this approach reflects the fact that the reporting entity:

(a) Has acquired an interest in an associate or joint venture and therefore the entity's share of the fair value of the net identifiable assets must be accounted for at fair value (see section 5 above)

And

(b) Is required by IAS 28 to restrict any gain arising from transactions between the reporting entity and its associate or joint venture relating to assets that remain on the books of the associate. Such gains are recognised only to the extent that the gain is attributable to the other investor in the associate or joint venture. This leads to an adjustment of the carrying amount of the investment in the associate or joint venture

In Illustration 7-9 below, we show the accounting by Entity A when the non-monetary assets it has contributed are intangible assets that are not in a subsidiary. See section 7.5.3 below for guidance when the assets contributed are in a subsidiary.

Although Illustration 7-9 below is based on a transaction resulting in the formation of a joint venture, the accounting treatment by Entity A would be the same if it had obtained an interest in an associate.

Illustration 7-9: Contribution of non-monetary assets to form a joint venture

A and B are two major pharmaceutical companies, which agree to form a joint venture (JV Co) as defined in IAS 28. A will own 40% of the joint venture, and B, 60%. The total fair value of the new business of JV Co is CU250m.

A's contribution to the venture is several intangible assets that are not in a subsidiary, with a carrying amount of CU60m. The fair value of the intangible assets contributed by A is CU100m, i.e., equivalent to 40% of the total fair value of JV Co of CU250m.

B contributes a business in a subsidiary, with separable net identifiable assets of CU85m and goodwill of CU15m. The fair value of the separable net identifiable assets is CU120m. The fair value of the business contributed is CU150m (60% of total fair value of JV Co of CU250m). See section 7.5.3 below for guidance on B's accounting.

The book and fair values of the assets/businesses contributed by A and B can therefore be summarised as follows:

	A		B	
(CU million)	Book value	Fair value	Book value	Fair value
Intangible assets	60	100		
Separable net identifiable assets			85	120
Goodwill			15	30
Total	60	100	100	150

IAS 28.32 requires A to recognise the identifiable assets at fair value upon the acquisition of its 40% interest in the new venture. However, as noted above, any gain or loss recognised by A must reflect only the disposal of the assets to the other partners in the venture (i.e., in this case, 60% - the extent to which A's intangible assets are effectively transferred to B through B's 60% interest in the new venture). *[IAS 28.30, IAS 28.32]*.

This gives rise to the following accounting entry.

		CU m	CU m
Dr	Investment in JV Co:		
	▸ Share of net identifiable assets of JV Co (1)	72	
	▸ Goodwill (2)	12	
	Cr Intangible assets contributed to JV Co (3)		60
	Cr Gain on disposal (4)		24

(1) 40% of fair value of separable net identifiable assets (including A's intangible assets) of new entity CU88m (40% of [CU100m + CU120m] as in table above) less elimination of 40% of gain on disposal CU16m (40% of CU40m, being the difference between the book value [CU60m] and fair value [CU100m] of A's intangible assets, as in table above, contributed to JV Co) = CU72m.

This is equivalent to, and perhaps more easily calculated as, 40% of [book value of A's intangible assets + fair value of B's separable net identifiable assets], i.e., 40% × [CU60m + CU120m] = CU72m.

Under the equity method, this CU72m together with the CU12m of goodwill (see (2) below) would be included as the equity accounted amount of JV Co.

(2) Fair value of consideration given CU100m (as in table above) less fair value of 40% share of separable net identifiable assets of JV Co acquired CU88m (see (1) above) = CU12m.

This is equivalent to, and perhaps more easily calculated as, 40% of the fair value of B's goodwill, i.e., 40% × CU30m = CU12m.

Under the equity method, as noted at (1) above, this CU12m together with the CU72m relating to the separable net identifiable assets would be included as the equity accounted amount of JV Co.

(3) Previous carrying amount of intangible assets contributed by A, now deconsolidated.

(4) Fair value of business acquired CU100m (40% of CU250m) less book value of intangible assets disposed of CU60m (as in table above) = CU40m, less 40% of gain eliminated (CU16m) = CU24m. The CU16m eliminated reduces A's share of JV Co's separable net identifiable assets by CU16m (see (1) above).

It is common when joint ventures are set up in this way for the fair value of the assets contributed not to be exactly in proportion to the fair values of the venturers' agreed relative shares. Cash 'equalisation' payments are then made between the venturers so that the overall financial position of the venturer does correspond to the agreed relative shares in the venture.

How we see it

We believe that an appropriate treatment of cash equalisation payments, in which a proportion of the gain on disposal is eliminated equal to the investor's ownership interest, in the context of a transaction within the scope of IAS 28, is shown in Illustration 7-10 below.

Although the example is based on a transaction resulting in the formation of a joint venture, the accounting treatment by party A would be the same if it had obtained an interest in an associate.

Illustration 7-10: Contribution of non-monetary assets to form a joint venture with cash equalisation payment between venturers/investors

Suppose that the transaction in Illustration 7-9 above was varied so that A has a 36% interest in JV Co. However, as shown by the introductory table in Illustration 7-9 above, A is contributing intangible assets worth 40% of the total fair value of JV Co. Accordingly, B makes good the shortfall by making a cash payment to A - equivalent to 4% of the fair value of JV Co, i.e., CU10m (4% of CU250m).

This would require A to make the following accounting entries.

		CU m	CU m
Dr	Investment in JV Co:		
	▸ Share of net identifiable assets of JV Co (1)	64.8	
	▸ Goodwill (2)	10.8	
Dr	Cash (equalisation payment from B)	10.0	
	Cr Intangible assets contributed to JV Co (3)		60.0
	Cr Gain on disposal (4)		25.6

(1) 36% of fair value of separable net identifiable assets of new entity CU79.2m (36% of [CU100m + CU120m] as in table in Illustration 7-9 above) less elimination of 36% of gain on disposal CU14.4m (36% of CU40m, being the difference between the book value [CU60m] and fair value [CU100m] of A's intangible assets, as in table in Illustration 7-9 above, contributed to JV Co) = CU64.8m.

This is equivalent to, and perhaps more easily calculated as, 36% of [book value of A's intangible assets + fair value of B's separable net identifiable assets], i.e., 36% × [CU60m + CU120m] = CU64.8m.

Under the equity method, this CU64.8m together with the CU10.8m of goodwill (see (2) below) would be included as the equity accounted amount of JV Co.

(2) Fair value of consideration given CU100m (as in table in Illustration 7-9 above), less cash equalisation payment received CU10m = CU90m less fair value of 36% share of separable net identifiable assets of JV Co acquired CU79.2m (see (1) above) = CU10.8m.

This is equivalent to, and perhaps more easily calculated as, 36% of the fair value of B's goodwill, i.e., 36% × CU30m = CU10.8m.

Under the equity method, as noted at (1) above, this CU10.8m together with the CU64.8m relating to the separable net identifiable assets would be included as the equity accounted amount of JV Co.

(3) Previous carrying amount of intangible assets contributed by A, now deconsolidated.

(4) Fair value of business acquired CU90m (36% of CU250m) plus cash equalisation payment CU10m = CU100m, less book value of intangible assets disposed of CU60m (as in table in Illustration 7-9 above) = CU40m, less 36% of gain eliminated (CU14.4m) = CU25.6m. The CU14.4m eliminated reduces A's share of JV Co's separable net identifiable assets by CU14.4m (see (1) above).

7.5.3 Conflict between IAS 28 and IFRS 10

In Illustration 7-9 above, we considered the accounting by Entity A when the non-monetary assets it has contributed are intangible assets that are not in a subsidiary. Entity B has contributed an interest in a subsidiary that is a business. The accounting for Entity B is subject to the conflict between IFRS 10 and IAS 28, as described at section 6.2.2 above and in more detail in Chapter 8 at section 3.3.2. Consequently, Entity B has a policy choice between full and partial gain recognition described at section 6.2.2.B above.

In Illustration 7-11 below, we illustrate how Entity B, which has contributed a subsidiary that constitutes a business in return for its interest in the joint venture in the transaction set out in Illustration 7-9 above, would account for the transaction by applying the requirements of IFRS 10. I.e., Entity B has elected to apply IFRS 10 to the loss of control transaction even though it is a downstream transaction. Although, the example is based on a transaction resulting in the formation of a joint venture, the accounting treatment by Entity B would be the same if it had obtained an interest in an associate.

Illustration 7-11: Contribution of subsidiary to form a joint venture - applying IFRS 10

A and B are two major pharmaceutical companies, which agree to form a joint venture (JV Co). A will own 40% of the joint venture, and B 60%. The parties agree that the total value of the new business of JV Co is CU250m.

A's contribution to the venture is several intangible assets, with a carrying amount of CU60m. The fair value of the intangible assets contributed by A is CU100m, i.e., equivalent to 40% of the total fair value of JV Co of CU250m.

B contributes a subsidiary that is a business with separable net identifiable assets of CU85m and goodwill of CU15m. The fair value of the separable net identifiable assets is CU120m. The implicit fair value of the business contributed is CU150m (60% of total fair value of JV Co of CU250m).

The book and fair values of the assets/businesses contributed by A and B can therefore be summarised as follows:

	A		B	
(in CU m)	Book value	Fair value	Book value	Fair value
Intangible assets	60	100		
Separable net identifiable assets			85	120
Goodwill			15	30
Total	60	100	100	150

Applying IFRS 10 to the transaction results in B reflecting the following accounting entry.

		CU m	CU m
Dr	Investment in JV Co:		
	▸ Share of net identifiable assets of JV Co (1)	132	
	▸ Goodwill (2)	18	
	Cr Separable net identifiable assets and goodwill contributed to JV Co (3)		100
	Cr Gain on disposal (4)		50

(1) 60% of fair value of separable net identifiable assets of new entity CU132m (60% of [CU100m + CU120m] as in table above). There is no elimination of 60% of the gain on disposal.

Under the equity method, this CU132m together with the CU18m of goodwill (see (2) below) would be included as the equity accounted amount of JV Co.

(2) Fair value of consideration given of CU60m (being 40% of CU150m as in table above) plus fair value of retained interest of CU90m (being 60% of CU150m) less fair value of 60% share of separable net identifiable assets of JV Co acquired CU132m (see (1) above).

Under the equity method, as noted at (1) above, this CU18m together with the CU132m relating to the separable net identifiable assets would be included as the equity accounted amount of JV Co.

(3) Previous carrying amount of net identifiable assets contributed by B as in table above, now deconsolidated. There would be a number of entries to deconsolidate these on a line-by-line basis.

(4) Fair value of consideration received of CU60m (being 60% of CU100m as in table above) plus fair value of retained interest of CU90m (being 60% of CU150m) less book value of assets disposed of CU100m (see (3) above) = CU50m.

7.5.4 Accounting for the acquisition of a business on formation of a joint venture

IFRS 3 does not apply to business combinations that arise on the formation of a joint venture. *[IFRS 3.2(a)]*. Therefore, it is not clear under IFRS accounting standards how the acquisition by a joint venture of the former business of a venturer is accounted for in the financial statements of the joint venture itself.

How we see it

We believe that under the GAAP hierarchy in IAS 8 the pooling of interests method is available when accounting for the businesses acquired on the formation of a joint venture. However, there are other acceptable approaches (including the acquisition method) that give a fair presentation in particular circumstances.

When a new company is formed to create a joint venture and both venturers contribute a business, we believe that it would also be acceptable under the GAAP hierarchy in IAS 8.11 (see Chapter 3 at section 4.3) to apply the acquisition method to both businesses, as IFRS accounting standards do not prevent entities from doing this and it provides useful information to investors.

The entity makes disclosures that are sufficient for users of the financial statements to understand the transaction fully.

In Illustration 7-9 above, if JV Co were to apply the acquisition method, it could mean that the equity-accounted amounts included in the financial statements of B bear little relation to its share of the net assets of the joint venture as reported in the underlying financial statements of the investee. This would be the case if B accounted for the transaction by applying IAS 28 rather than IFRS 10 (see section 7.5.3 above). For example, B's share of any amortisation charge recorded by JV Co must be based on the carrying amount of B's share of JV Co's intangible assets, not as recorded in JV Co's books (i.e., at fair value) but as recorded in B's books, which will be based on book value for intangible assets contributed by B and at fair value for intangible assets contributed by A. Accordingly it would be necessary for B to keep a 'memorandum' set of books for equity accounting purposes reflecting its share of assets that were originally its own at book value and those originally of A at fair value.

In Illustration 7-9 above, JV Co must account for the intangibles contributed by A at fair value because the transaction represents a share-based payment transaction in terms of IFRS 2 *Share-based Payment*. Therefore, A will need to keep a 'memorandum' record relating to these intangibles, so that it can make the necessary adjustments in its equity accounting to reflect amortisation charges based on its original book values.

Alternatively, if JV Co were to apply the pooling of interests method and therefore reflect assets contributed from both A and B at their book values, A would need to keep a 'memorandum' set of books for equity accounting purposes because its share of assets that were originally those of B are carried at fair value rather than carry-over cost.

7.5.5 Contributions to an associate that is under common control

Frequently asked questions

Question 7-1: How does an entity account for a contribution of PP&E to a newly formed associate in exchange for shares in the associate when the entity and the fellow investors in the associate are entities under common control?

In January 2018, the IFRS IC was asked how an entity accounts for a transaction in which it contributes PP&E to a newly formed associate in exchange for shares in the associate. In the fact pattern described in the request, the entity and the fellow investors in the associate are entities under common control. The investors each contribute items of PP&E to the new entity in exchange for shares in that entity.

The IFRS IC firstly observed that unless a standard specifically excludes common control transactions from its scope, an entity applies the applicable requirements in the standard to common control transactions. In terms of IAS 28.28, the entity recognises gains and losses resulting from the downstream transactions only to the extent of unrelated investors' interests in the associate.

Finally, the IFRS IC observed that if there is initially any indication that the fair value of the PP&E contributed might differ from the fair value of the acquired equity interest, the entity first assesses the reasons for this difference and reviews the procedures and assumptions it has used to determine fair value. The entity recognises a gain or loss on contributing the PP&E and a carrying amount for the investment in the associate that reflects the determination of those amounts based on the fair value of the assets contributed, unless the transaction provides objective evidence that the entity's interest in the associate might be impaired. If this is the case, the entity also considers the impairment requirements in IAS 36. If, having reviewed the procedures and assumptions used to determine fair value, the fair value of the PP&E is more than the fair value of the acquired interest in the associate, this would provide objective evidence that the entity's interest in the associate might be impaired.

The IFRS IC concluded that the principles and requirements in IFRS accounting standards provide an adequate basis for an entity to account for the contribution of non-monetary assets to an associate in the fact pattern described in the request and did not add any items to its agenda.[16]

16 *IFRIC Update*, January 2018, available on the IFRS Foundation's website.

8 Practical matters applying the equity method

8.1 Non-coterminous accounting periods

In applying the equity method, the investor uses the most recent financial statements of the associate or joint venture. When the reporting dates of the investor and the associate or joint venture are different, IAS 28 requires the associate or joint venture to prepare, for the use of the investor, financial statements as of the same date as those of the investor unless it is impracticable to do so. *[IAS 28.33]*.

When the financial statements of an associate or joint venture used in applying the equity method are prepared as at a different reporting date from that of the investor, adjustments must be made for the effects of significant transactions or events (for example a sale of a significant asset or a major loss on a contract) that occurred between that date and the date of the investor's financial statements. In no circumstances can the difference between the reporting date of the associate or the joint venture and that of the investor be more than three months. *[IAS 28.34, IAS 28.BCZ19]*. It is not necessary for such a non-coterminous period to end before that of the investor.

How we see it

There are no exemptions from the requirement above despite the fact that it could be quite onerous in practice, for example, because:

- The associate or joint venture might need to produce interim financial statements so that the investor can comply with this requirement.

  Or

- The associate or joint venture could be a listed company in its own right whose financial information is considered price-sensitive, which means that the associate or joint venture might not be able to provide detailed financial information to one investor without providing equivalent information to all other investors at the same time.

The length of the reporting periods and any difference in the reporting dates must be the same from period to period. *[IAS 28.34]*. The requirement in IAS 28.34 implies that, when an associate or joint venture was previously equity accounted for based on non-coterminous financial statements and is now equity accounted for using coterminous financial statements, it is necessary to restate comparative information so that financial information in respect of the associate or joint venture is included in the investor's financial statements for an equivalent period in each period presented.

How we see it

We believe that other approaches not involving restatement of comparatives would be acceptable, particularly when the comparative information has already reflected the effects of significant transactions or events during the period between the date of the associate's or joint venture's financial statements and the date of the investor's financial statements. When comparatives are not restated, additional disclosures might be needed about the treatment adopted and the impact on the current period of including information for the associate or joint venture for a period different from that of the investor.

8.2 Consistent accounting policies

IAS 28 requires the investor's financial statements to be prepared using uniform accounting policies for like transactions and events in similar circumstances. *[IAS 28.35]*. If an associate or joint venture uses different accounting policies from those of the investor for like transactions and events in similar circumstances, adjustments must be made to conform the associate's or joint venture's accounting policies to those of the investor when the associate's or joint venture's financial statements are used by the investor in applying the equity method. *[IAS 28.36]*.

In practice, using consistent accounting policies might be easier said than done, since the investor has only significant influence, and not control, over the associate, and therefore might not have access to the relevant underlying information in sufficient detail to make such adjustments with certainty. Restating the financial statements of an associate to IFRS accounting standards could require extensive detailed information that might not be required under the associate's local GAAP (for example, in respect of business combinations, share-based payments, financial instruments and revenue recognition). Although there could be some practical difficulties when the entity has joint control over a joint venture, we would expect this to arise less often, as joint control is likely to give the investor more access to the information required.

8.2.1 Exemption for associates or joint ventures that are investment entities

If an entity that is not itself an investment entity has an interest in an associate or joint venture that is an investment entity, the entity can, when applying the equity method, elect to retain the fair value measurement applied by that investment entity associate or joint venture to the investment entity associate's or joint venture's interests in subsidiaries. This election is made separately for each investment entity associate or joint venture, at the later of the date on which:

(a) The investment entity associate or joint venture is initially recognised

(b) The associate or joint venture becomes an investment entity

(c) The investment entity associate or joint venture first becomes a parent *[IAS 28.36A]*

8.3 Loss-making associates or joint ventures

An investor in an associate or joint venture recognises its share of the losses of the associate or joint venture until its share of losses equals or exceeds its interest in the associate or joint venture, at which point the investor discontinues recognising its share of further losses. For this purpose, the investor's interest in an associate or joint venture is the carrying amount of the investment in the associate or joint venture under the equity method together with any long-term interests that, in substance, form part of the investor's net investment in the associate or joint venture. For example, an item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension of the entity's investment in that associate or joint venture. *[IAS 28.38]*. The items that form part of the net investment are discussed further in Chapter 16 at section 6.3.1. The IASB argued that this requirement ensures that investors are not able to avoid recognising the loss of an associate or joint venture by restructuring their investment to provide the majority of funding through non-equity investments. *[IAS 28.BCZ39, IAS 28.BCZ40]*.

Such items include:

- Preference shares
- Long-term receivables or loans (unless supported by adequate collateral)

But do not include:

- Trade receivables
- Trade payables
- Any long-term receivables for which adequate collateral exists, such as secured loans *[IAS 28.38]*

Once the investor's share of losses recognised under the equity method has reduced the investor's investment in ordinary shares to zero, its share of any further losses is applied to reduce the other components of the investor's interest in an associate or joint venture in the reverse order of their seniority (i.e., priority in liquidation). *[IAS 28.38]*.

Once the investor's interest is reduced to zero, additional losses are provided for, and a liability is recognised, only to the extent that the investor has incurred legal or constructive obligations or made payments on behalf of the associate or joint venture. If the associate or joint venture subsequently reports profits, the investor resumes recognising its share of those profits only after its share of the profits equals the share of losses not recognised. *[IAS 28.39]*.

How we see it

Whilst IAS 28.39 does not say so explicitly, we believe that, when profits begin to be recognised again, they are applied to write back the various components of the investor's interest in the associate or joint venture in the reverse order to that in which they were written down (i.e., in order of their priority in a liquidation).

IAS 28 is not explicit about the allocation of losses recognised in the income statement and losses incurred in OCI. Therefore, management will need to develop an appropriate policy. The policy chosen is disclosed and consistently applied.

In addition to the recognition of losses arising from application of the equity method, an investor in an associate or joint venture must consider the additional requirements of IAS 28 in respect of impairment losses (see section 10 below).

Illustration 8-1: Accounting for a loss-making associate

At the beginning of the year Entity H invests CU5m to acquire a 30% equity interest in Associate A. In addition, H lends CU9m to A, but does not provide any guarantees or commit itself to provide further funding. How does H account for the CU20m loss that A made during the year?

H's share in A's loss is CU20m × 30% = CU6m. If H's loan to A is considered part of the net investment in A then the carrying amount of the associate is reduced by CU6m, from CU14m (= CU5m + CU9m) to CU8m. That is, the equity interest is reduced to nil and the loan is reduced to CU8m.

Conversely, if the loan is not part of the net investment in A, then H accounts for the loss as follows:

- The equity interest in the associate is reduced from CU5m to zero.
- A loss of CU1m remains unrecognised because H did not provide any guarantees and has no commitments to provide further funding.
- If, in the second year, A were to make a profit of CU10m then H would recognise a profit of only CU2m (= CU10m × 30% - CU1m).
- Alternatively, if, in the second year, H were to provide a CU1.5m guarantee to A and A's net profit were nil, then H would need to recognise an immediate loss of CU1m (i.e., the lower of the unrecognised loss of CU1m and the guarantee of CU1.5m) because it now has a legal obligation to pay A's debts.
- As there are several indicators of impairment, the loan from H to A is tested for impairment in accordance with IFRS 9.

8.4 Distributions received in excess of the carrying amount

When an associate or joint venture makes dividend distributions to the investor in excess of the investor's carrying amount, it is not clear how the excess is accounted for.

How we see it

In our view, a liability under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* is recognised only if the investor is obliged to refund the dividend, has incurred a legal or constructive obligation to or has made payments on behalf of the associate. In the absence of such obligations, it is appropriate that the investor recognises the excess in net profit for the period. When the associate or joint venture subsequently makes profits, the investor starts recognising profits only when they exceed the excess cash distributions recognised in net profit plus any previously unrecognised losses (see section 8.3 above).

8.5 Equity transactions in an associate's or joint venture's financial statements

The financial statements of an associate or joint venture that are used for the purposes of equity accounting by the investor might include items within its statement of changes in equity that are not reflected in the profit or loss or other components of comprehensive income, for example, dividends or other forms of distributions, issues of equity instruments and equity-settled share-based payment transactions. When the associate or joint venture has subsidiaries and consolidated financial statements are prepared, those financial statements might include the effects of changes in the parent's (i.e., the associate's or joint venture's) ownership interest and NCI in a subsidiary that did not arise from a transaction that resulted in loss of control of that subsidiary.

Although the description of the equity method in IAS 28 requires that the investor's share of the profit or loss of the associate or joint venture is recognised in the investor's profit or loss, and the investor's share of changes in items of OCI of the associate or joint venture is recognised in OCI of the investor, *[IAS 28.10]*, no explicit reference is made to other items that the associate or joint venture might have in its statement of changes in equity. The following sections provide guidance in determining an appropriate accounting treatment for certain common transactions.

8.5.1 Dividends or other forms of distributions

Although IAS 28.10 does not explicitly refer to dividends or other forms of distribution that are reflected in the associate's statement of changes in equity, it does state that distributions received from an investee reduce the carrying amount of the investment. Generally, the distributions received will be the equivalent of the investor's share of the distributions made to the owners of the associate reflected in the associate's statement of changes in equity. Thus, they are effectively eliminated as part of applying the equity method.

However, this might not always be the case. For example, when an associate declares scrip dividends which are not taken up by the investor, the investor's proportionate interest in the associate is reduced. In this situation, the investor accounts for this as a deemed disposal (see section 9.6 below).

8.5.2 Issues of equity instruments

When an associate or joint venture has issued equity instruments, the effect on its net assets will be reflected in the associate's or joint venture's statement of changes in equity. When the investor has participated in the issue of these equity instruments, it will account for its cost of doing so by increasing the carrying amount of its associate or joint venture. If participation in such a transaction leads to the investor increasing its percentage ownership interest in an existing associate or joint venture without obtaining control, the investor accounts for this as an increase in an associate or joint venture without a change in status (see section 6.2.4 above).

If the investor has not participated in the issue of equity instruments reflected in the associate's or joint venture's statement of changes in equity, for example, shares have been issued to third parties or the investor has not taken up its full allocation of a rights issue by the associate or joint venture, the investor's proportionate interest in the associate or joint venture is reduced.

How we see it

In situations in which the investor has not participated in the issue of equity instruments reflected in the associate's or joint venture's statement of changes in equity, we believe that it accounts for the transaction as a deemed disposal (see section 9.6 below).

8.5.3 Equity-settled share-based payment transactions

Another item arising in an associate's or joint venture's statement of changes in equity is the credit entry relating to any equity-settled share-based payment transactions of the associate or joint venture; the debit entry of such transactions is recognised by the associate or joint venture as an expense within its profit or loss.

As the share-based payment expense is included within the profit or loss of the associate or joint venture, this will be reflected in the share of the associate's or joint venture's profit or loss recognised in the investor's profit or loss. *[IAS 28.10]*. The credit to equity that is recognised in the associate's or joint venture's statement of changes in equity is not part of comprehensive income and therefore does not automatically get reflected in the investor's financial statements. Therefore, there are two possible approaches for the credit entry:

- Do not reflect the credit entry that arises in the associate's or joint venture's statement of changes in equity

  Or

- Reflect the investor's share of the credit entry as a 'share of other changes in equity of associates or joint ventures' in the investor's statement of changes in equity

The description of the equity method in IAS 28 states that "the carrying amount [of the investment in an associate or a joint venture] is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition. ... Adjustments to the carrying amount may also be necessary for changes in the investor's proportionate interest in the investee arising from changes in the investee's other comprehensive income." *[IAS 28.10]*.

How we see it

The credit to shareholders' equity recognised by the associate or joint venture in accordance with IFRS 2 is not part of comprehensive income. IAS 28.10 implies that the investor recognises only its share of the elements of profit or loss and of OCI; therefore, we believe that the investor does not recognise its proportion of the credit to shareholders' equity recognised by the associate or joint venture. That is, we believe the credit entry is ignored, rather than recognised in the investor's equity accounting.

Ignoring the credit entry results in the carrying amount of the equity investment no longer corresponding to the proportionate share of the net assets of the investee (as reported by the investee). However, this approach is consistent with the requirement in IAS 28 for dealing with undeclared dividends on cumulative preference shares held by parties other than the investor (see section 6.3.2 above). *[IAS 28.37]*. In that situation, the undeclared dividends have not yet been recognised by the investee at all, but the investor still reduces its share of the profit or loss (and therefore its share of net assets).

If the options are exercised, the investor will account for its reduction in its proportionate interest as a deemed disposal (see section 8.5.2 above and section 9.6 below). *[IAS 28.10]*.

The approach of ignoring the credit entry is shown in Illustration 8-2 below. Although the example is based on an equity-settled share-based payment transaction of an associate, the accounting treatment would be the same if it were a joint venture.

Illustration 8-2: Equity-settled share-based payment transactions of associate

Entity A holds a 30% interest in Entity B and accounts for its interest in B as an associate using the equity method. Assume for simplicity that there are no fair value adjustments required related to the assets of B in A's consolidated financial statements and its equity-accounted amount represents an original cost of CU1,500 (30% of B's issued equity of CU5,000) together with A's 30% share of B's retained profits of CU5,000. Also assume that A has CU21,000 in other assets and assume for simplicity that A has no other profit or loss except for its equity method earnings and losses.

B issues share options to its employees which are accounted for by B as an equity-settled share-based payment transaction. The options entitle the employees to subscribe for shares of B, representing an additional 20% interest in the shares of B. If the options are exercised, the employees will pay CU2,400 for the shares. The grant date fair value of the options issued is CU900 and, for the purposes of the example, it is assumed that the options are immediately vested. Accordingly, B has recognised a share-based payment expense of CU900 in profit or loss and a credit to equity of the same amount.

The impact of accounting for this equity-settled share-based payment transaction on B's financial statements and on A's consolidated financial statements is summarised below.

Immediately before the granting of the options

B's financial statements			
	CU		**CU**
Net assets	10,000	Issued equity	5,000
		Retained earnings	5,000
Total	10,000	Total	10,000

A's consolidated financial statements			
	CU		**CU**
Investment in B	3,000	Issued equity	10,000
Other net assets	21,000	Retained earnings	14,000
Total	24,000	Total	24,000

Immediately after the granting of the options*

B's financial statements			
	CU		**CU**
Net assets	10,000	Issued equity	5,000
		Retained earnings	5,000
		Loss for period	(900)
		Share-based payment reserve	900
Total	10,000	Total	10,000

A's consolidated financial statements			
	CU		CU
Investment in B	2,730	Issued equity	10,000
Other net assets	21,000	Retained earnings	14,000
		Loss for period	(270)
Total	23,730	Total	23,730

* For the purposes of Illustration, B's expense and the corresponding credit to equity have been shown separately within equity as 'loss for period' and 'share-based payment reserve' respectively. A's 30% share of the expense has similarly been shown separately within equity.

Immediately after exercise of the options†

B's financial statements			
	CU		CU
Net assets	10,000	Issued equity	5,000
Cash on exercise of options	2,400	Additional equity on exercise of options	2,400
		Retained earnings	5,000
		Loss for period	(900)
		Share-based payment reserve	900
Total	12,400	Total	12,400

A's consolidated financial statements			
	CU		CU
Investment in B	3,100	Issued equity	10,000
Other net assets	21,000	Retained earnings	14,000
		Loss for period	(270)
		Gain on deemed disposal	370
Total	24,100	Total	24,100

† As a result of the employees exercising the options for CU2,400, assume that A's proportionate interest in B has reduced from 30% to 25%. A is considered still to have significant influence over B, which remains an associate of A. This deemed disposal results in A recognising a gain on deemed disposal in its profit or loss for the period. This gain is computed by comparing A's proportionate share of net assets of B before and after the exercise of the options as follows:

	CU	
Net assets attributable to A's 30% interest	2,730	(30% of CU9,100)
Net assets attributable to A's 25% interest	3,100	(25% of CU12,400)
Gain on deemed disposal	370	

In Illustration 8-2 above, there were no basis differences (for example, fair value adjustments arising on initial acquisition of the interest in the associate). If there had been, the calculation of the gain on deemed disposal would be calculated based on the equity method amounts including the basis differences, rather than as the share of the associate's net assets as stated in the associate financial statements, as shown in the Illustration above.

How we see it

When an investor's interest in an associate is diluted through the exercise of share options or similar instruments, we believe the investor proportionately reduces its equity method basis differences for the effect of dilution. Additionally, because of the transaction, the investor adjusts its basis differences in the underlying net assets of the investee, if necessary. Adjustments to the investor's basis differences resulting from dilution will reduce the amount of future amortisation or impairment of the investor's basis differences.

As indicated in Illustration 8-2 above, when the options are exercised, the investor accounts for the reduction in its proportionate interest in the associate or joint venture as a deemed disposal (see section 9.6 below).

8.5.4 Effects of changes in parent/non-controlling interests in subsidiaries

The consolidated financial statements of an associate or a joint venture might include NCI related to its subsidiaries that are not wholly owned. Under IFRS 10, any NCI are presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent. Profit or loss and each component of OCI are attributed to the owners of the parent and to the NCI. *[IFRS 10.22, IFRS 10.B94]*. The profit or loss and OCI reported in the associate's or joint venture's consolidated financial statements include 100% of the amounts relating to the subsidiaries, but the overall profit or loss and total comprehensive income is split between the amounts attributable to the owners of the parent (i.e., the associate or joint venture) and those attributable to the NCI. The net assets in the consolidated statement of financial position also include 100% of the amounts relating to the subsidiaries, with any NCI in the net assets presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent. NCI is discussed in more detail in Chapter 8 at section 5.

The issue of whether the investor's share of the associate's or joint venture's profits, OCI and net assets under the equity method is based on the amounts before or after any NCI in the associate's or joint venture's consolidated accounts is discussed in section 6.3.5 above. As the investor's interest in the associate or joint venture is as an owner of the parent, it is appropriate that the share recognised by an investor is based on the profit or loss, comprehensive income and equity (net assets) that are reported as being attributable to the owners of the parent in the associate's or joint venture's consolidated financial statements, i.e., after any amounts attributable to the NCI.

Under IFRS 10, changes in a parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions. *[IFRS 10.23]*. In such circumstances, the carrying amounts of the controlling and non-controlling interests are adjusted to reflect the changes in their relative interests in the subsidiary. Any difference between the amount by which the NCI are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the parent. *[IFRS 10.B96]*.

How is such an amount attributed to the owners of the parent that is recognised in the associate's or joint venture's statement of changes in equity be reflected by the investor in equity accounting for the associate or joint venture?

How we see it

In our view, the investor may account for its share of the change of interest in the net assets/equity of the associate or joint venture because of the associate's or joint venture's equity transaction by applying either of the approaches set out below:

(a) Reflect it as part of the share of other changes in equity of associates or joint ventures in the investor's statement of changes in equity

Or

(b) Reflect it as a gain or loss within the share of associate's or joint venture's profit or loss included in the investor's profit or loss

Once selected, the investor applies the selected policy consistently.

Approach (a) reflects the view that although IAS 28.10 refers to the investor accounting for its share of the investee's profit or loss and other items of comprehensive income only, this approach is consistent with the equity method as described in IAS 28.10 because it:

- Reflects the post-acquisition change in the net assets of the investee *[IAS 28.3]*
- Faithfully reflects the investor's share of the associate's transaction as presented in the associate's consolidated financial statements *[IAS 28.27]*

Under this view, since the transaction does not change the investor's ownership interest in the associate, it is not a deemed disposal (see section 9.6 below) and, therefore, no gain or loss is recognised.

By contrast, Approach (b) reflects the view that:

- The investor reflects the post-acquisition change in the net assets of the investee. *[IAS 28.3]*.
- From the investor's perspective, the transaction is not a transaction "with owners in their capacity as owners", *[IFRS 10.23]*, because the investor does not equity account for the NCI (see section 6.3.5 above). Therefore, whilst the investee must reflect the transaction as an equity transaction, from the investor's point of view the increase in the investment is a gain. This is consistent with the treatment of unrealised profits between a reporting entity and an associate (see section 7.1 above). The NCI's ownership is treated as an 'external' ownership interest to the investor's group. Consequently, any transaction which is, from the investor's perspective, a transaction with an 'external' ownership interest can give rise to a gain or loss.
- The increase in the investee's equity is also not an item of OCI as referred to in IAS 28.10.
- Any increase in the amount of an asset is recognised in profit or loss if not otherwise stated in IFRS accounting standards. IAS 1.88 states that an "entity shall recognise all items of income and expense in a period in profit or loss unless an IFRS requires or permits otherwise."

These approaches are shown in Illustration 8-3 below. Although the example is based on a transaction by an associate, the accounting would be the same if it were a joint venture.

Illustration 8-3: Accounting for the effect of transactions with non-controlling interests recognised through equity by an associate

Entity A holds a 20% interest in Entity B (an associate) that in turn has a 100% ownership interest in Subsidiary C. The net assets of C included in B's consolidated financial statements are CU1,000. For the purposes of the example all other assets and liabilities in B's financial statements and in A's consolidated financial statements are ignored.

B sells 20% of its interest in C to a third party for CU300. B accounts for this transaction as an equity transaction in accordance with IFRS 10, giving rise to a credit in equity of CU100 that is attributable to the owners of B. The credit is the difference between the proceeds of CU300 and the share of net assets of C that are now attributable to the NCI of CU200 (20% of CU1,000).

The financial statements of A and B before the transaction are summarised below:

Before

A's consolidated financial statements

	CU		CU
Investment in B	200	Equity	200
Total	200	Total	200

B's consolidated financial statements

	CU		CU
Assets (from C)	1,000	Equity	1,000
Total	1,000	Total	1,000

The financial statements of B after the transaction are summarised below:

After

B's consolidated financial statements

	CU		CU
Assets (from C)	1,000	Equity	1,000
Cash	300	Equity transaction with NCI	100
		Equity attributable to owners	1,100
		NCI	200
Total	1,300	Total	1,300

As a result of the sale of B's 20% interest in C, B's net assets attributable to the owners of B have increased from CU1,000 to CU1,100. Although A has not participated in the transaction, its share of net assets in B has increased from CU200 to CU220.

A accounts for the increase in net assets arising from this equity transaction using either of the following approaches:

Approach (a) – 'share of other changes in equity' in investor's statement of changes in equity

The change of interest in the net assets/equity of B resulting from B's equity transaction is reflected in A's financial statements as 'share of other changes in equity of associates' in its statement of changes in equity.

Therefore, A reflects its CU20 share of the change in equity and maintains the same classification as the associate i.e., a direct credit to equity.

Approach (b) – gain or loss within share of associate's profit or loss included in investor's profit or loss

The change of interest in the net assets/equity of B resulting from B's equity transaction is reflected in A's financial statements as a 'gain' in profit or loss.

Therefore, A reflects its CU20 share of the change in equity in profit or loss.

9 Discontinuing the use of the equity method

An investor discontinues the use of the equity method on the date that its investment ceases to be either an associate or a joint venture. The subsequent accounting depends upon the nature of the retained investment. If the investment becomes a subsidiary, it will be accounted for in accordance with IFRS 10 and IFRS 3 as discussed in section 9.1 below. If the retained investment is a financial asset, it will be accounted for in accordance with IFRS 9 as discussed in section 9.3 below. *[IAS 28.22]*. If an investment in an associate becomes an investment in a joint venture, or an investment in a joint venture becomes an investment in an associate, the entity continues to apply the equity method, as discussed in section 9.4 below. *[IAS 28.24]*.

When an investment in an associate or a joint venture (or a portion thereof) meets the criteria to be classified as held for sale, the entity applies IFRS 5 as discussed in section 4 above. *[IAS 28.20]*.

9.1 Investment in associate or joint venture that is a business becoming a subsidiary

If an increased investment in an associate or joint venture that is a business, or a change in circumstances, leads to an investor obtaining control over the investee, the investment becomes a subsidiary. The entity discontinues the use of the equity method and accounts for its investment in accordance with IFRS 3 and IFRS 10. *[IAS 28.22]*. In this situation, IFRS 3 requires revaluation of the previously held interest in the equity accounted investment at its acquisition-date fair value, with recognition of any gain or loss in profit or loss. *[IFRS 3.41, IFRS 3.42]*. The accounting for an increase in an associate or joint venture that becomes a subsidiary is discussed further in Chapter 10 at section 9.

In addition, the entity accounts for all amounts previously recognised in OCI in relation to that investment on the same basis as would have been required if the investee had directly disposed of the related assets or liabilities. *[IAS 28.22]*.

Therefore, if a gain or loss previously recognised in OCI by the investee would be reclassified to profit or loss on the disposal of the related assets or liabilities, the entity reclassifies the gain or loss from equity to profit or loss (as a reclassification adjustment) when the equity method is discontinued. For example, if an associate or a joint venture has cumulative exchange differences relating to a foreign operation and the entity discontinues the use of the equity method, the entity shall reclassify to profit or loss the gain or loss that had previously been recognised in OCI in relation to the foreign operation. *[IAS 28.23]*.

9.2 Investment in associate or joint venture that is not a business becoming a subsidiary

Current accounting standards do not address the accounting treatment for an acquisition in stages from associate or joint venture to subsidiary that is considered an asset acquisition rather than a business combination. This raises questions as to how to measure the previously held interest and the NCI on acquisition. There is more than one acceptable approach for the measurement of both the previously held interest and the NCI on acquisition. These are discussed in detail in Chapter 8 at section 3.1.2.

How we see it

In our view, as described in section 9.1 above, the investor accounts for all amounts previously recognised in OCI related to the investment on the same basis as would have been required if the investee had directly disposed of the related asset or liabilities. That is, certain amounts previously recognised in OCI (such as cumulative translation differences relating to a foreign operation) must be recycled to profit or loss upon disposal of the investment.

9.3 Retained investment in the former associate or joint venture is a financial asset

If an investor disposes of a portion of its investment or there is a change in circumstances, such that it no longer has significant influence or joint control over the investee, it will discontinue the use of the equity method. If the retained interest is a financial asset, the entity measures the retained interest at fair value. The fair value of the retained interest is regarded as its fair value on initial recognition as a financial asset in accordance with IFRS 9.

In such situations, the entity recognises in profit or loss any difference between:

- The fair value of any retained interest and any proceeds from disposing of a part interest in the associate or joint venture

  And

- The carrying amount of the investment at the date the equity method was discontinued

Furthermore, the entity accounts for all amounts previously recognised in OCI in relation to that investment on the same basis as would have been required if the investee had directly disposed of the related assets or liabilities. *[IAS 28.22]*.

Therefore, if a gain or loss previously recognised in OCI by the investee would be reclassified to profit or loss on the disposal of the related assets or liabilities, the entity reclassifies the gain or loss from equity to profit or loss (as a reclassification adjustment) when the equity method is discontinued. For example, if an associate or a joint venture has cumulative exchange differences relating to a foreign operation and the entity discontinues the use of the equity method, the entity reclassifies to profit or loss the gain or loss that had previously been recognised in OCI in relation to the foreign operation. *[IAS 28.23]*.

After the partial disposal of an interest in a joint venture (or an associate) that includes a foreign operation, if the retained interest is a financial asset that itself includes a foreign operation, IAS 21 *The Effects of Changes in Foreign Exchange Rates* requires it to be accounted for as a disposal. *[IAS 21.48A]*. As a result, the reclassification adjustment from equity to profit or loss is for the full amount that is in OCI and not just a proportionate amount based upon the interest disposed of. The Basis for Conclusions to IAS 21 explains that the loss of significant influence or joint control is a significant economic event that warrants accounting for the transaction as a disposal under IAS 21, *[IAS 21.BC33, IAS 21.BC34]*, and hence the transfer of the full exchange difference rather than just the proportionate share that would be required if this was accounted for as a partial disposal under IAS 21.

The accounting described above applies not only when an investor disposes of an interest in an associate or joint venture, but also when it ceases to have significant influence due to a change in circumstances. For example, when an associate issues shares to third parties, changes to the board of directors might result in the investor no longer having significant influence over the associate. In this scenario, the investor discontinues the use of the equity method.

9.4 Investment in associate becomes a joint venture (or vice versa)

Extract from IAS 28	
24	**If an investment in an associate becomes an investment in a joint venture or an investment in a joint venture becomes an investment in an associate, the entity continues to apply the equity method and does not remeasure the retained interest.**

When the change in status of the investment results from the acquisition of an additional interest in the investee, the increase in the investment is accounted for as discussed in section 6.2.5 above. When the change in status results from the disposal of an interest in the investee, this is accounted for as explained in section 9.5 below. *[IAS 28.24]*.

As discussed in sections 4 and 9 above, if a portion of an interest in an associate or joint venture fulfils the criteria for classification as held for sale, it is only that portion that is accounted for under IFRS 5. An entity maintains the use of the equity method for the retained interest until the portion classified as held for sale is finally sold.

9.5 Partial disposals of interests in associate or joint venture when the equity method continues to be applied

IAS 28 does not explicitly state that an entity recognises a gain or loss when it disposes of a part of its interest in an associate or a joint venture, but the entity continues to apply the equity method. However, as explained below, it is evident that a gain or loss is recognised on the partial disposal.

The standard requires that when an entity's ownership interest in an associate or a joint venture is reduced, but the entity continues to apply the equity method, the entity reclassifies to profit or loss the proportion of the gain or loss that had previously been recognised in OCI relating to that reduction in ownership interest if that gain or loss would be required to be reclassified to profit or loss on the disposal of the related assets or liabilities. *[IAS 28.25]*.

In addition, IAS 21 requires for such partial disposals that the investor reclassifies "to profit or loss only the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income". *[IAS 21.48C]*.

That means that the investor recognises in profit or loss an amount proportionate to the interest disposed, of:

- Foreign exchange differences recognised in OCI under IAS 21
- Accumulated hedging gains and losses recognised in OCI under IFRS 9 (see Chapter 49) (or IAS 39)
- Any other amounts previously recognised in OCI that would have been recognised in profit or loss if the associate had directly disposed of the assets to which they relate

IAS 21 requires that the proportion of the foreign exchange differences are reclassified "when the gain or loss on disposal is recognised". *[IAS 21.48]*. In addition, the IFRS IC in the context of deemed disposals (see section 9.6 below), noted that reclassification of amounts to profit or loss from OCI is generally required as part of determining the gain or loss on a disposal. Amounts previously recognised in OCI that are not recycled to profit or loss on disposal (or partial disposal), such as a revaluation reserve on property, plant and equipment that are remeasured to fair value are transferred to retained earnings to reflect the proportion no longer held.

IFRS 10 requires that the partial disposal of a subsidiary when control is retained is accounted for as an equity transaction (see Chapter 8 at section 4). In contrast, the partial disposal of an equity method investment is not an equity transaction because, an investor accounts only for its own interest.

Illustration 9-1: Partial disposal of an associate when equity method continues to be applied

An investor purchases a 45% investment in the ordinary shares of an investee on 1 January 20X2 and accounts for the investment as an associate. On 30 June 20X2, the investor sells a 15% interest in the investee to a third party for CU250,000, reducing its interest to 30%. The investor retains the ability to exercise significant influence over the investee after the decrease in its interest (the presumption that significant influence exists is not overcome). Therefore, the investor continues to apply the equity method.

At the date of sale, the carrying amount of the associate was CU600,000. In addition, there was a CU120,000 credit included in the cash flow hedge reserve (accumulated other comprehensive income within equity), representing the investor's share of the associate's cash flow hedging activity, and CU240,000 credit in the revaluation reserve (accumulated other comprehensive income within equity), representing the investor's share of the associate's revaluation on property that is measured at fair value.

To proportionately reduce its investment in the associate from a 45% interest to a 30% interest and reclassify a proportionate amount to profit or loss from those amounts recorded in OCI in accordance with IAS 28.25, the investor records the following:

Dr	Cash		CU250,000	
Dr	Cash flow hedge reserve/OCI (1)		CU40,000	
Dr	Revaluation reserve on property (2)		CU80,000	
	Cr	Associate (3)		CU200,000
	Cr	Gain on sale (profit or loss) (4)		CU90,000
	Cr	Retained earnings (5)		CU80,000

(1) 15/45 of 120,000

(2) 15/45 of 240,000

(3) 15/45 of 600,000

(4) CU250,000 minus CU200,000 plus CU40,000 recycled from the cash flow hedge reserve.

(5) In accordance with IAS 16.41, amounts recorded in the revaluation reserve are not recycled to profit or loss on disposal (or partial disposal) of the related PP&E. IAS 16 allows a transfer to retained earnings to reflect the proportion no longer held.

The investor continues to account for its retained 30% interest, which would have a carrying amount of CU400,000, using the equity method. Prospectively from 30 June 20X2, the investor recognises its share of earnings and losses of the associate to reflect that it owns only 30%. In determining its equity method earnings or losses, the investor includes adjustments (e.g., depreciation, amortisation) related to the proportionately reduced purchase price allocation adjustments (basis differences).

9.6 Deemed disposals

An investor's interest in an associate or a joint venture might be reduced other than by an actual disposal. Such a reduction in interest, which is commonly referred to as a deemed disposal, gives rise to a 'dilution' gain or loss. Deemed disposals arise for several reasons, including:

- The investor does not take up its full allocation in a rights issue by the associate or joint venture.
- The associate or joint venture declares scrip dividends which are not taken up by the investor so that its proportional interest is reduced.
- Another party exercises its options or warrants issued by the associate or joint venture.
- The associate or joint venture issues shares to third parties.

In some situations, the dilution might cause the investor to lose the ability to exercise significant influence over the investee. In that case, the investor will account for the transaction as a disposal, with a retained interest in a financial asset measured at fair value in accordance with IFRS 9. This is described in section 9.3 above. However, in other situations, the deemed disposal will give rise to only a partial disposal, such that the investor will continue to equity account for the investee.

As discussed in more detail in section 9.5 above, although IAS 28 does not explicitly state that an entity recognises a gain or loss on partial disposal of its interest in an associate or a joint venture when the entity continues to apply the equity method, it is evident that a gain or loss is recognised on partial disposals.

How we see it

In the absence of further guidance, we believe that gains or losses on deemed disposals of an associate or joint venture are recognised in profit or loss, and this will include amounts reclassified from OCI.

It also is not clear whether any of the notional goodwill component of the carrying amount of the associate or joint venture is considered in the calculation of the gain or loss on the deemed disposal. This is because IAS 28 defines the equity method as "a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post acquisition change in the investor's share of the investee's net assets. ..." *[IAS 28.3]*. This definition suggests that in calculating the loss on dilution, the investor takes account of only the change in its share of the associate's or joint venture's net assets and does not account for a change in the notional goodwill component.

However, IAS 28.42 specifically states that goodwill included in the carrying amount of an investment in an associate or a joint venture is not separately recognised. *[IAS 28.42]*. Although the IASB did not explicitly consider accounting for deemed disposals of associates or joint ventures, IAS 28.26 refers to the concepts underlying the procedures used in accounting for the acquisition of a subsidiary in accounting for acquisitions of an investment in an associate or joint venture. Therefore, it is appropriate to consider the notional goodwill component when accounting for deemed disposals of associates or joint ventures in the same way as for deemed disposals of subsidiaries.

How we see it

We believe that it is appropriate to consider the entire carrying amount of the associate or joint venture, i.e., including the notional goodwill, when determining the gain or loss on deemed disposal.

This accounting is shown in Illustration 9-2 below. Although the example is based on a deemed disposal of an associate, the accounting would be the same if it were a joint venture.

Illustration 9-2: Deemed disposal of an associate

At the start of the reporting period, Investor A acquired a 30% interest in Entity B at a cost of CU500,000. A has significant influence over B and accounts for its investment in B under the equity method. B has net identifiable assets of CU1m at the date of acquisition, which have a fair value of CU1.2m. During the year, B recognised a post-tax profit of CU200,000 and paid a dividend of CU18,000. B also recognised foreign exchange losses of CU40,000 in OCI.

B's net assets at the end of the reporting period can be determined as follows:

	CU
Net identifiable assets - opening balance	1,000,000
Profit for year	200,000
Dividends paid	(18,000)
Foreign exchange losses	(40,000)
B's net assets - closing balance	1,142,000

A's interest in B at the end of the reporting period is calculated as follows:

	CU
On acquisition (including goodwill of CU140,000 = CU500,000 - (30% × CU1.2m)):	500,000
Share of profit after tax (30% × CU200,000)	60,000
Elimination of dividend (30% of CU18,000)	(5,400)
A's share of exchange differences (30% × CU40,000)	(12,000)
A's interest in B at the end of the reporting period under the equity method	542,600

Which can also be determined as follows:

	CU
A's share of B's net identifiable assets (30% × CU1.142m)	342,600
Goodwill	140,000
A's share of fair value uplift (30% × CU200,000)*	60,000
A's interest in B at the end of the reporting period	542,600

* This assumes for simplicity that none of the difference in the fair value of the identifiable net assets over their carrying amount upon initial investment related to depreciable assets, such that the CU200,000 did not diminish after the acquisition.

At the start of the next reporting period, B has a rights issue that A does not participate in. The rights issue brings in an additional CU400,000 in cash and dilutes A's interest in B to 25%.

Consequently, B's net assets at this date are:

	CU
B's net assets before the rights issue	1,142,000
Additional cash	400,000
B's net assets after the rights issue	1,542,000

The loss on the deemed disposal, considering the entire carrying amount of the associate, including the notional goodwill is calculated as follows:

	CU	CU
Carrying amount of the investment before the deemed disposal		**542,600**
Cost of deemed disposal (CU542,600 × (30% - 25%) ÷ 30%)	(90,433)	
Share of the contribution (CU400,000 × 25%)	100,000	
Increase in carrying amount of associate	9,567	9,567
Reclassification of share in currency translation: (CU40,000 × 30% × (25% - 30%) ÷ 30%)	(2,000)	
Gain on deemed disposal	7,567	
Carrying amount of the investment after the deemed disposal		**552,167**

10 Impairment losses

10.1 General

Determining whether an investment in an associate or joint venture is impaired involves carrying out several separate impairment assessments, as applicable:

- Assets of the associate or joint venture

  It is generally not appropriate for the investor simply to multiply the amount of the impairment recognised in the investee's own books by the investor's percentage of ownership when recognising its share of the investee's profit or loss. This is because the investor measures its interest in an associate's or joint venture's identifiable net assets at fair value at the date of acquisition of an associate or a joint venture as discussed in section 6.2 above. Therefore, if the value that the investor attributes to the associate's or joint venture's net assets differs from the carrying amount of those net assets in the associate's or joint venture's own books, the investor adjusts its share of any impairment losses recognised by the associate or joint venture for such basis differences. This is shown in Illustration 10-1 below.

  Any goodwill recognised on the statement of financial position of an associate or joint venture needs to be separated into two elements:

  - Goodwill that existed at the date the investor acquired its interest in the associate or joint venture

    And

  - Goodwill that arises on subsequent acquisitions by the associate or joint venture

  Goodwill that existed at the date the investor acquired its interest is not an identifiable asset of the associate or joint venture from the perspective of the investor. It is combined with the investor's goodwill on the acquisition of its interest in the associate or joint venture.

  Goodwill that arises on subsequent acquisitions by the associate or joint venture is accounted for in the books of the associate or joint venture, including being tested for impairment in accordance with IAS 36. The investor does not make any adjustments to the associate's or joint venture's accounting for that goodwill.

- Investment in the associate or joint venture

  After application of the equity method, including recognising the associate's or joint venture's losses (see section 8.3 above) inclusive of any impairments recognised by the associate or joint venture (adjusted for basis differences for those assets), the entity applies the requirements discussed in section 10.2 below to determine whether there is any objective evidence that its net investment in the associate or joint venture is impaired. *[IAS 28.40]*.

- Other interests that are not part of the net investment in the associate or joint venture

The entity applies the impairment requirements in IFRS 9 (see Chapter 47) to its other interests in the associate or joint venture that are in the scope of IFRS 9 and that do not constitute part of the net investment (see section 10.2 below). *[IFRS 9.2.1(a)]*.

How we see it

It is unlikely that any impairment charge recognised in respect of an associate or joint venture will simply be the investor's share of any impairment charge recognised by the associate or joint venture itself, even when the associate or joint venture complies with IFRS accounting standards, considering the factors described above.

Illustration 10-1 below demonstrates the effect on the equity method accounting when an asset of an associate is impaired. Although the example illustrates the accounting in relation to an associate, it would be the same if it were a joint venture.

Illustration 10-1: Impairment of assets of the associate

Investor A acquires a 25% equity interest in Associate B. The cost of the investment was CU95, including transaction costs. To simplify this Illustration, assume that the only assets held by B are PP&E and there is no equity method goodwill. At the acquisition date, the fair value of the PP&E is CU380 and A's share of this is CU95 (25% of CU380). On that date, the book value of the PP&E of B is CU300 and A's share of this is CU75 (25% of CU300). The CU20 difference between A's cost of CU95 and its share of the book value of net assets of B of CU75 relates entirely to the PP&E. Depreciation, transactions between A and B and the effect of income taxes have been ignored to simplify this example.

	B's book value	A's 25% share of B's book value	Fair value of B's net assets	Difference between book value and fair value (basis difference)	A's 25% of basis difference
	CU	CU	CU	CU	CU
PP&E	300	75	380	80	20

Subsequently, B determines that the PP&E is impaired and the recoverable amount of the PP&E at the date of impairment is CU280. Therefore, B recognises an impairment charge of CU20 to reduce the book value of the PP&E to its recoverable amount. A's share of the revised book value of the PP&E is CU70 (25% of CU280).

In the ordinary course of recording its share of B's profits under the equity method, A records its share of the impairment charge CU5 (25% of CU20). That is, the impairment charge recorded by B is included in its profit or loss, which is the basis for A to determine its share of B's profits.

In addition, A assesses the effect of the impairment on the fair value adjustment recorded on acquisition of its investment in B. Because A's share of the fixed assets of CU90 (CU95 less the impairment charge of CU5) exceeds its share of the recoverable amount of the PP&E (CU70), A recognises an additional impairment charge of CU20. Therefore, the total impairment charge recognised by A is CU25 (CU5 that was included in A's share of B's profit plus CU20 additional loss related to the fair value adjustment). While A does not assess individual underlying assets for impairment, when B recognises an impairment, A adjusts the impairment charge to reflect its share in the underlying assets. After recording the impairment charge, A's share in the PP&E of B is as follows:

	B's book value (after impairment)	A's 25% share of B's book value	Recoverable amount of B's net assets	Difference between recoverable amount and book value	A's 25% of difference
	CU	CU	CU	CU	CU
PP&E (after impairment)	280	70	280	-	-

	CU
Cost of original 25% equity method investment	95
A's equity method loss from B (25% of CU20)	(5)
Additional equity method loss for impairment [(CU95 - CU5) - (25% of CU280)]	(20)
A's equity method carrying amount of B	70

10.2 Investment in the associate or joint venture

IAS 28 requires: *[IAS 28.43]*

Extract from IAS 28

43 The recoverable amount of an investment in an associate or a joint venture shall be assessed for each associate or joint venture, unless the associate or joint venture does not generate cash inflows from continuing use that are largely independent of those from other assets of the entity.

After application of the equity method, including recognising its share of the associate's or joint venture's losses (see section 8.3 above), the entity applies the following requirements to determine whether there is any objective evidence that its net investment in the associate or joint venture is impaired. *[IAS 28.40]*. The entity applies the impairment requirements in IFRS 9 (see Chapter 47) to its other interests in the associate or joint venture that are in the scope of IFRS 9 and that do not constitute part of the net investment. *[IFRS 9.2.1(a)]*.

Extract from IAS 28

41A The net investment in an associate or joint venture is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the net investment (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows from the net investment that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognised. Objective evidence that the net investment is impaired includes observable data that comes to the attention of the entity about the following loss events:

(a) significant financial difficulty of the associate or joint venture;

(b) a breach of contract, such as a default or delinquency in payments by the associate or joint venture;

(c) the entity, for economic or legal reasons relating to its associate's or joint venture's financial difficulty, granting to the associate or joint venture a concession that the entity would not otherwise consider;

(d) it becoming probable that the associate or joint venture will enter bankruptcy or other financial reorganisation; or

(e) the disappearance of an active market for the net investment because of financial difficulties of the associate or joint venture.

41B The disappearance of an active market because the associate's or joint venture's equity or financial instruments are no longer publicly traded is not evidence of impairment. A downgrade of an associate's or joint venture's credit rating or a decline in the fair value of the associate or joint venture, is not of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information.

41C In addition to the types of events in paragraph 41A, objective evidence of impairment for the net investment in the equity instruments of the associate or joint venture includes information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the associate or joint venture operates, and indicates that the cost of the investment in the equity instrument may not be recovered. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment.

[IAS 28.41A, IAS 28.41B, IAS 28.41C].

Goodwill that forms part of the carrying amount of the net investment in an associate or a joint venture is not separately recognised and therefore is not tested for impairment separately. Instead, the entire carrying amount of the investment is tested for impairment in accordance with IAS 36 as a single asset, by comparing its recoverable amount (the higher of value in use and fair value less costs to sell) with its carrying amount whenever indicators of impairment exist, as described in the bullets above. Any impairment loss is not allocated to any asset, including goodwill, that forms part of the carrying amount of the net investment in the associate or joint venture. Accordingly, any reversal of that impairment loss is recognised in accordance with IAS 36 to the extent that the recoverable amount of the net investment subsequently increases. In determining the value in use of the net investment, an entity estimates:

- Its share of the present value of the estimated future cash flows expected to be generated by the associate or joint venture, including the cash flows from the operations of the associate or joint venture and the proceeds from the ultimate disposal of the investment.

  Or

- The present value of the estimated future cash flows expected to arise from dividends to be received from the investment and from its ultimate disposal.

Using appropriate assumptions, both methods give the same result. *[IAS 28.42]*.

In effect, IAS 28 requires the investor to regard its investment in an associate or joint venture as a single cash-generating unit, rather than 'drilling down' into the separate cash-generating units determined by the associate or joint venture. The IASB does not explain why it adopted this approach, although it might have been because although an investor has significant influence over an associate, it does not have control and therefore might not have access to the relevant underlying information. Furthermore, IAS 28 requires the investment as a whole to be reviewed for impairment as if it were a financial asset.

10.2.1 Assessing an equity accounted investment for impairment on transition to IFRS accounting standards

A first-time adopter of IFRS accounting standards is required by IFRS 1 *First-time Adoption of International Financial Reporting Standards* to perform an impairment test in accordance with IAS 36 to any goodwill recognised at the date of transition to IFRS accounting standards, regardless of whether there is any indication of impairment, unless a first-time adopter applies IFRS 3 retrospectively to the related past business combinations, see Chapter 6 at section 7.9.1. *[IFRS 1.C4(g)(ii)]*. IFRS 1 extends the exemption for past business combinations to past acquisitions of investments in associates, interests in joint ventures and interests in joint operations (in which the activity of the joint operation constitutes a business, as defined in IFRS 3). *[IFRS 1.C5]*.

How we see it

We believe that an impairment review for investments in associates or joint ventures whose carrying value includes an element of goodwill must be undertaken at the date of transition on the basis required by IAS 28 as described in section 10.1 above.

10.3 Other interests that are not part of the net investment in the associate or joint venture

The IASB issued an amendment to IAS 28 clarifying that an entity applies IFRS 9 to long-term interests in an associate or joint venture to which the equity method is not applied but that, in substance, form part of the net investment in the associate or joint venture (long-term interests). This clarification is relevant because it implies that the expected credit loss model in IFRS 9 applies to such long-term interests. The IASB also clarified that, in applying IFRS 9, an entity does not take account of any losses of the associate or joint venture, or any impairment losses on the net investment, recognised as adjustments to the net investment in the associate or joint venture that arise from applying IAS 28. *[IAS 28.14A]*.

To illustrate how entities apply the requirements in IAS 28 and IFRS 9 with respect to long-term interests, the Board published an illustrative example, on which Illustration 10-2, below, is based.

Illustration 10-2: Long-term interests in associates and joint ventures

An investor has the following three types of interests in an associate:

(a) O Shares

Ordinary shares representing a 40% ownership interest to which the investor applies the equity method. This interest is the least senior of the three interests, based on their relative priority in liquidation.

(b) P Shares

Non-cumulative preference shares that form part of the net investment in the associate and that the investor measures at fair value through profit or loss applying IFRS 9.

(c) LT Loan

A long-term loan that forms part of the net investment in the associate and that the investor measures at amortised cost applying IFRS 9, with a stated interest rate and an effective interest rate of 5% a year. The associate makes interest-only payments to the investor each year. The LT Loan is the most senior of the three interests.

The LT Loan is not an originated credit-impaired loan. Throughout the years illustrated, there has not been any objective evidence that the net investment in the associate is impaired applying IAS 28, nor does the LT Loan become credit-impaired applying IFRS 9.

The associate does not have any outstanding cumulative preference shares classified as equity, as described in IAS 28.37. Throughout the years illustrated, the associate neither declares nor pays dividends on O Shares or P Shares.

The investor has not incurred any legal or constructive obligations, nor made payments on behalf of the associate, as described in IAS 28.39. Accordingly, the investor does not recognise its share of the associate's losses once the carrying amount of its net investment in the associate is reduced to zero.

The amount of the investor's initial investment in O Shares is CU200, in P Shares is CU100 and in the LT Loan is CU100. On acquisition of the investment, the cost of the investment equals the investor's share of the net fair value of the associate's identifiable assets and liabilities.

This table summarises the carrying amount at the end of each year for P Shares and the LT Loan applying IFRS 9 but before applying IAS 28, and the associate's profit (loss) for each year. The amounts for the LT Loan are shown net of the loss allowance.

At the end of year	P Shares applying IFRS 9 (fair value)	LT Loan applying IFRS 9 (amortised cost)	Profit (Loss) of the Associate
	CU	CU	CU
1	110	90	50
2	90	70	(200)
3	50	50	(500)
4	40	50	(150)
5	60	60	-
6	80	70	500
7	110	90	500

The table below summarises the amounts recognised in the investor's profit or loss. When recognising interest revenue on the LT Loan in each year, the investor does not take account of any adjustments to the carrying amount of the LT Loan that arose from applying IAS 28 (IAS 28.14A). Accordingly, the investor recognises interest revenue on the LT Loan based on the effective interest rate of 5% each year.

	Items recognised			
During year	Impairment (losses), including reversals, applying IFRS 9	Gains (losses) of P Shares applying IFRS 9	Share of profit (loss) of the associate recognised applying the equity method	Interest revenue applying IFRS 9
	CU	CU	CU	CU
1	(10)	10	20	5
2	(20)	(20)	(80)	5
3	(20)	(40)	(200)	5
4	-	(10)	(30)	5
5	10	20	(30)	5
6	10	20	200	5
7	20	30	200	5

(1) In Year 1, the increase in fair value of the P Shares of CU10 is the difference between the CU110 and CU100; the increase in the loss allowance of the LT Loan of (CU10) is the difference between CU90 and CU100; and the investor's share of profit of CU20 is CU50 × 40%. At the end of Year 1, the carrying amount of the O Shares is CU220, P Shares is CU110 and the LT Loan (net of loss allowance) is CU90.

(2) In Year 2, the decrease in fair value of the P Shares of (CU20) is the difference between the CU90 and CU110; the increase in the loss allowance of the LT Loan of (CU20) is the difference between CU70 and CU90; and the investor's share of losses of CU80 is CU200 × 40%. At the end of Year 2, the carrying amount of the O Shares is CU140, P Shares is CU90 and the LT Loan (net of loss allowance) is CU70.

(3) Applying IAS 28.14A, the investor applies IFRS 9 to the P Shares and the LT Loan before it applies IAS 28.38. Accordingly, in Year 3 the decrease in fair value of the P Shares of (CU40) is the difference between the CU50 and CU90; the increase in the loss allowance of the LT Loan of (CU20) is the difference between CU50 and CU70; and the investor's share of losses of CU200 is CU500 × 40%. The investor recognises its share of the associate's loss in reverse order of seniority as specified in IAS 28.38 and allocates CU140 to the O Shares, CU50 to the P Shares and CU10 to the LT Loan. At the end of Year 3, the carrying amount of the O Shares is zero, P Shares is zero and the LT Loan (net of loss allowance) is CU40.

(4) In Year 4, the decrease in fair value of the P Shares of (CU10) is the difference between the CU40 and CU50. Recognition of the change in fair value of CU10 in Year 4 results in the carrying amount of P Shares being negative CU10. Consequently, the investor reverses a portion of CU10 of the associate's losses previously allocated to P Shares. Applying IAS 28.38, the investor limits the recognition of the associate's losses to CU40 because the carrying amount of its net investment in the associate is then zero. At the end of Year 4, the carrying amount of the O Shares is zero, P Shares is zero and the LT Loan (net of loss allowance) is zero. There is also an unrecognised share of the associate's losses of CU30 (the investor's share of the associate's cumulative losses of CU340 - CU320 losses recognised cumulatively + CU10 losses reversed).

(5) In Year 5, the increase in fair value of the P Shares of CU20 is the difference between the CU60 and CU40; the decrease in the loss allowance of CU10 is the difference between CU60 and CU50. After applying IFRS 9 to the P Shares and the LT Loan, these interests have a positive carrying amount. Consequently, the investor allocates the previously unrecognised share of the associate's losses of CU30 to these interests, being CU20 to the P Shares and CU10 to the LT Loan. At the end of Year 5, the carrying amount of the O Shares is zero, P Shares is zero and the LT Loan (net of loss allowance) is zero.

(6) In Year 6, the increase in fair value of the P Shares of CU20 is the difference between the CU80 and CU60; the decrease in the loss allowance of CU10 is the difference between CU70 and CU60; and the investor's share of the associate's profit of CU200 is CU500 × 40%. The investor allocates the associate's profit to each interest in the order of seniority. The investor limits the amount of the associate's profit it allocates to the P Shares and the LT Loan to the amount of equity method losses previously allocated to those interests, which in this example is CU60 for both interests. The balancing CU60 is allocated to the investment in the O Shares. At the end of Year 6, the carrying amount of the O Shares is CU80, P Shares is CU80 and the LT Loan (net of loss allowance) is CU70.

(7) In Year 7, the increase in fair value of the P Shares of CU30 is the difference between the CU110 and CU80; the decrease in the loss allowance of CU20 is the difference between CU90 and CU70; and the investor's share of the associate's profit of CU200 is CU500 × 40%, allocated in full to the investment in the O Shares. At the end of Year 7, the carrying amount of the O Shares is CU280, P Shares is CU110 and the LT Loan (net of loss allowance) is CU90.

11 Separate financial statements

IAS 27 allows entities the option to account for investments in subsidiaries, associates and joint ventures using the equity method of accounting.

Separate financial statements are defined in IAS 27 as those presented by an entity in which the entity could elect to account for its investments in subsidiaries, joint ventures and associates either at cost, in accordance with IFRS 9 or using the equity method as described in IAS 28. *[IAS 28.4]*.

An investment in an associate or joint venture is accounted for in the entity's separate financial statements in accordance with IAS 27.10. *[IAS 28.44]*. IAS 27 requires that, in separate financial statements, investments in subsidiaries, associates or joint ventures are accounted for either:

- At cost
- In accordance with IFRS 9

  Or
- Using the equity method as described in IAS 28

The entity applies the same accounting for each category of investments. Investments accounted for at cost or using the equity method are accounted for in accordance with IFRS 5 when they are classified as held for sale (or included in a disposal group that is classified as held for sale). *[IAS 27.10]*.

If an entity elects, in accordance with IAS 28.18, to measure its investments in associates or joint ventures at fair value through profit or loss in accordance with IFRS 9 (see section 3.3 above) it also accounts for those investments in the same way in its separate financial statements. *[IAS 27.11]*.

IAS 27 requires the investor to recognise all dividends in profit or loss within its separate financial statements once the right to receive payment has been established, unless the equity method is elected, in which case the dividend is recognised as a reduction from the carrying amount of the investment. *[IAS 27.12]*. The investor then needs to consider whether there are indicators of impairment as set out in IAS 36.12 (see Chapter 9 at section 2.4.1).

The detailed requirements for separate financial statements as set out in IAS 27 are discussed more fully in Chapter 9.

11.1 Impairment of investments in associates or joint ventures in separate financial statements

An issue considered by the IFRS IC and the IASB is how impairments of investments in associates are determined in the separate financial statements of the investor. In January 2013, the IFRS IC issued an agenda decision[17] stating that according to IAS 36.4, IAS 36.5 and IAS 39.2(a) (now IFRS 9.2.1(a)), investments in subsidiaries, joint ventures, and associates that are not accounted for in accordance with IFRS 9 are within the scope of IAS 36 for impairment purposes. Consequently, in its separate financial statements, an entity applies the provisions of IAS 36 to test for impairment its investments in subsidiaries, joint ventures, and associates that are carried at cost or using the equity method. See 21 at section 12.4.

17 *IFRIC Update*, January 2013, available on the IFRS Foundation's website.

12 Presentation and disclosures

12.1 Presentation

12.1.1 Statement of financial position

Unless an investment, or a portion of an investment, in an associate or a joint venture is classified as held for sale in accordance with IFRS 5 (see section 4 above), the investment, or any retained interest in the investment not classified as held for sale, is classified as a non-current asset. *[IAS 28.15]*. The aggregate of investments in associates and joint ventures accounted for using the equity method are presented as a discrete line item in the statement of financial position. *[IAS 1.54(e)]*.

IAS 28 does not explicitly define what is meant by "investment … in an associate or a joint venture". However, IAS 28.38 states that "…The interest in an associate or a joint venture is the carrying amount of the investment in the associate or joint venture determined using the equity method together with any long-term interests that, in substance, form part of the entity's net investment in the associate or joint venture… Such items may include preference shares and long-term receivables or loans but do not include trade receivables, trade payables or any long-term receivables for which adequate collateral exists, such as secured loans. …" *[IAS 28.38]*. Some have interpreted this as a requirement to present the investment in ordinary shares and other long-term interests in associates within the same line item. However, when associates are profitable, long-term interests such as loans are normally accounted for under IFRS 9 rather than under the equity method. Therefore, it is generally considered acceptable to present the investment in ordinary shares in associates and joint ventures and other long-term interests in associates and joint ventures in separate line items.

Goodwill relating to an associate or joint venture is included in the carrying amount of the investment, *[IAS 28.32]*, as is illustrated in Practical example 12-1 below.

Practical example 12-1: RWE Aktiengesellschaft (2023) **Germany**

Annual Report 2023 [extract]
4 Consolidated financial statements [extract]
4.6. Notes [extract]
Consolidation principles [extract]

…

For investments accounted for using the equity method, goodwill is not reported separately, but rather included in the value recognised for the investment. In other respects, the consolidation principles described above apply analogously. If impairment losses on the equity value become necessary, we report such under income from investments accounted for using the equity method.

12.1.2 Profit or loss

In the statement of comprehensive income or separate income statement, the aggregate of the investor's share of the profit or loss of associates and joint ventures accounted for using the equity method must be shown. *[IAS 1.82(c)]*. 'Profit or loss' in this context is interpreted in the implementation guidance to IAS 1 as meaning the 'profit attributable to owners' of the associates and joint ventures, i.e., it is after tax and non-controlling interests in the associates or joint ventures.[18] There is no requirement as to where in the statement of comprehensive income or separate income statement the investor's share of the profit or loss of associates and joint ventures accounted for using the equity method is shown, and different approaches are therefore seen in practice. As discussed in Chapter 3 at section 3.2.2.A, some entities present operating income on the face of the statement of comprehensive income. In this case, equity accounted investments might form part of operating activities with their results included in that measure and with non-operating investments excluded from it. Another acceptable alternative is to exclude the results of all associates and joint ventures from operating profit.

18 IAS 1 IG6 *XYZ Group - Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7 (illustrating the presentation of profit and loss and other comprehensive income in one statement and the classification of expenses within profit by function).*

Nokia Corporation for example includes its share of the (post-tax) results of associates after operating profit, but before pre-tax profit:

Practical example 12-2: Nokia Corporation (2023) — **Finland**

Nokia in 2023 [extract]
Financial statements [extract]
Consolidated financial statements [extract]
Consolidated income statement [extract]

EURm	Note	2023	2022	2021
...				
Operating profit		**1 688**	**2 318**	**2 158**
Share of results of associates and joint ventures	6.4	(39)	(26)	9
Financial income[1]	2.4	425	178	69
Financial expenses[1]	2.4	(575)	(286)	(310)
Profit before tax		**1 499**	**2 184**	**1 926**
...				

(1) In 2023, Nokia changed the presentation of net interest income on defined benefit plans within financial income and expenses. The comparative amounts for 2022 and 2021 have been recast accordingly. Refer to Note 2.4. Financial income and expenses for more information.

...

In contrast, Nestlé S.A. includes its share of the post-tax results of associates below tax expense:

Practical example 12-3: Nestlé S.A. (2023) — **Switzerland**

Financial Statements 2023 [extract]
Consolidated Financial Statements of the Nestlé Group 2023 [extract]
Consolidated income statement for the year ended December 31, 2023 [extract]

In millions of CHF	Notes	2023	2022
...			
Taxes	13	(2 314)	(2 730)
Income from associates and joint ventures	14	1 120	1 040
Profit for the year		**11 509**	9 596
...			

12.1.2.A Impairment of associates or joint ventures

It is unclear where impairments of associates or joint ventures are presented in the statement of comprehensive income or separate income statement. IAS 28 requires an impairment test to be performed "after application of the equity method", *[IAS 28.40]*, which could be read as implying that impairment of an associate or joint venture is not part of the investor's share of the profit or loss of an associate or joint venture accounted for using the equity method. On the other hand, the guidance on accounting for impairment losses on associates is presented under the heading "Application of the equity method" in IAS 28, which suggests that accounting for impairments of associates is part of the equity method. In practice, both interpretations appear to have gained a degree of acceptance.

RWE Aktiengesellschaft, for example, reports impairment losses on associates within income from investments accounted for using the equity method (see Practical example 12-1 in section 12.1.1 above).

12.1.3 Other items of comprehensive income

The investor's share of items recognised in OCI by the associate or joint venture is recognised in the investor's OCI. *[IAS 28.10]*.

IAS 1.82A clarifies that entities must present the share of OCI of associates and joint ventures accounted for using the equity method, separated into the share of items that, in accordance with other IFRS accounting standards:

- Will not be subsequently reclassified to profit or loss

  And

- Will be reclassified subsequently to profit or loss when specific conditions are met *[IAS 1.82A]*

In this context, OCI is interpreted in the implementation guidance to IAS 1 as meaning the "other comprehensive income attributable to owners" of the associates and joint ventures, i.e., it is after tax and non-controlling interests in the associates or joint ventures.[19]

12.1.4 Statement of cash flows

IAS 7 *Statement of Cash Flows* notes that for an equity accounted investment, reporting in the cash flow statement is limited to cash flows between the investor and the investee, such as dividends received. The question arises as to whether dividends received are recognised as operating or investing cash flows. As discussed in Chapter 36 at section 4.4.1, IAS 7 is not prescriptive; however, entities select an accounting policy and apply it consistently.

12.1.5 IFRS 18 *Presentation and Disclosure in Financial Statements*

In April 2024, the IASB issued IFRS 18 to replace IAS 1. IFRS 18 is effective for annual reporting periods beginning on or after 1 January 2027, with earlier application permitted (subject to jurisdictional endorsement). See Chapter 4 for further details on IFRS 18.

12.2 Disclosures

The disclosure requirements for associates and joint ventures are dealt with in IFRS 12, together with the disclosure requirements for subsidiaries and unconsolidated structured entities. The disclosure requirements in relation to associates and joint ventures are discussed in Chapter 14 at section 5.

In May 2024, the IASB issued IFRS 19, a voluntary IFRS accounting standard for use by eligible subsidiaries that prepare financial statements applying IFRS accounting standards. IFRS 19 specifies which disclosure requirements apply to a subsidiary that does not have public accountability and whose parent produces consolidated financial statements that comply with IFRS accounting standards and are available for public use. IFRS 19 is effective for annual reporting periods beginning on or after 1 January 2027, with earlier application permitted (subject to jurisdictional endorsement). See Chapter 4 at section 7 for further details on IFRS 19.

19 IAS 1 IG6 *XYZ Group - Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7 (illustrating the presentation of profit and loss and other comprehensive income in one statement and the classification of expenses within profit by function).*

13 Future developments

As discussed in section 5.1 above, many procedures appropriate for the application of the equity method are similar to the consolidation procedures described in IFRS 10 (see Chapter 8). Furthermore, IAS 28 explains that the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate or a joint venture. *[IAS 28.26]*. This does raise several practical difficulties, and there has been an ongoing debate about whether the equity method of accounting is a consolidation method or a measurement method. Although IAS 28 generally adopts consolidation principles it nevertheless retains features of a valuation methodology.

In September 2024, the IASB published an exposure draft[20] addressing application issues relating to the equity method of accounting. The project objectives are:

- To reduce diversity in practice by answering application questions on the equity method of accounting
- To improve the understandability of IAS 28 Investments in Associates and Joint Ventures

The exposure draft addresses application questions in the following areas:

- Initial recognition
- Changes in ownership
- Transactions with associates and joint ventures
- Impairment indicators
- Separate financial statements

The IASB also proposes certain improvements to disclosure requirements for investments in associates and joint ventures. Readers should monitor developments.

20 Exposure Draft ED/2024/7: Equity Method of Accounting, available on the IFRS Foundation's website

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Appendix C - Defined terms

Extract from IAS 28

3 The following terms are used in this Standard with the meanings specified:

An *associate* is an entity over which the investor has significant influence.

Consolidated financial statements are the financial statements of a group in which assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

The *equity method* is a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income.

A *joint arrangement* is an arrangement of which two or more parties have joint control.

Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

A *joint venture* is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

A *joint venturer* is a party to a joint venture that has joint control of that joint venture.

Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.

Chapter 13 Joint arrangements

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Overview

This chapter deals with joint arrangements. An entity might pursue an economic activity with another entity (or entities) and share decision-making relating to those activities. IFRS 11 *Joint Arrangements* applies when the arrangement establishes joint control over an activity between two or more of the parties involved.

IFRS 11 classifies joint arrangements into one of two types: joint operations and joint ventures. Parties that jointly control a joint operation have rights to the assets and obligations for the liabilities of the operation. By contrast, parties that jointly control a joint venture have rights to the net assets of the arrangement.

The accounting for joint operations is set out in IFRS 11 and involves the joint operator recognising the assets it has a right to and the obligations it incurs as a result of the joint operation and its share of the joint operation's assets held and liabilities incurred jointly. It also recognises its share of revenue and expenses.

An investor that jointly controls a joint venture applies the equity method of accounting to its investment as described in IAS 28 *Investments in Associates and Joint Ventures*, which is discussed in Chapter 12.

What you need to know

- A joint arrangement is classified as either a joint operation or a joint venture; this determination might require significant judgement depending on the nature of the arrangement.
- If facts and circumstances change, a joint operator/joint venturer in a joint arrangement reassesses whether it still has joint control of the arrangement and whether the classification of the joint arrangement has changed.
- The equity method of accounting is applied to investments in joint ventures in the consolidated financial statements of the joint venturers.
- A joint venturer has an accounting policy choice for the measurement of joint ventures in its separate financial statements at cost, in accordance with IFRS 9 *Financial Instruments* or using the equity method.
- In both consolidated and separate financial statements, a joint operator recognises its share of assets, liabilities, revenue and expenses, each of which are accounted for by applying the relevant IFRS accounting standard.

1 Introduction

A joint arrangement is an arrangement that has the following characteristics:

- The parties are bound by a contractual arrangement.
- The contractual arrangement gives two or more of those parties joint control of the arrangement. *[IFRS 11.5]*.

A joint arrangement is classified as either a joint operation or a joint venture. *[IFRS 11.6]*. Joint operators have rights to the assets of the operation and obligations for its liabilities. Joint venturers have rights to the net assets of the arrangement. *[IFRS 11 Appendix A, IFRS 11.BC24]*.

The terms 'joint arrangement', 'joint control', 'joint operation' and 'joint venture' are specifically defined by IFRS 11 (see Appendix C below) and have important accounting consequences. However, these terms are often used loosely in practice and might appear in legal documents and public statements by management with a different meaning from the IFRS 11 terms.

How we see it

No matter the terminology used to describe the arrangement, or its purpose, management needs to evaluate the terms of the arrangement, and the relevant facts and circumstances, to determine whether it is a joint arrangement as defined in IFRS 11.

FASB differences

IFRS 11 is not converged with US GAAP. The characteristics of a joint venture in US GAAP are similar to those in IFRS accounting standard, but certain differences exist. Key differences are highlighted in this section, but this is not an exhaustive list of possible differences. Further detail can be found in the US GAAP/IFRS accounting differences identifier tool.[1]

- Joint control is defined in IFRS 11, but not in US GAAP. In contrast to US GAAP, joint control can be established through means other than an equity interest.
- US GAAP does not contain the concept of a joint operation, although proportionate consolidation is permitted to account for interests in unincorporated entities in certain industries. Proportionate consolidation is not permitted by IFRS 11, however, a joint operator recognises its share of assets, liabilities, revenue and expenses (a methodology similar to proportionate consolidation).
- In US GAAP, joint ventures are entities whose operations and activities are jointly controlled by their equity investors and have certain other characteristics. In IFRS accounting standards, joint ventures are separate vehicles and the joint venturers have rights to the vehicle's net assets.
- In IFRS accounting standards, joint venturers cannot have direct rights and obligations with respect to the underlying assets and liabilities of the joint venture, but this is not relevant to the determination of whether an investment is a joint venture under US GAAP.
- Joint venturers generally measure their investment using the equity method of accounting under both IFRS and US GAAP. However, US GAAP provides an accounting policy choice to measure joint ventures at fair value, whereas this election is restricted to certain entities under IFRS accounting standards.

1 *US GAAP/IFRS accounting differences identifier tool*, EY, December 2024, available on ey.com.

2 Objective and scope of IFRS 11

2.1 Objective

The objective of IFRS 11 is to establish principles for financial reporting by entities that have an interest in a joint arrangement. *[IFRS 11.1]*. As a result, the standard defines and provides guidance on:

- What a joint arrangement is and when joint control is present (see sections 3 and 4 below).
- The two types of joint arrangements and how to classify an arrangement (see section 5 below).
- How to account for each type of joint arrangement in the financial statements of a party to a joint arrangement (see sections 6, 7 and 8 below). *[IFRS 11.2]*.

2.2 Scope

IFRS 11 applies to all entities that are a party to a joint arrangement. *[IFRS 11.3]*. A 'party to a joint arrangement' is defined as "An entity that participates in a joint arrangement, regardless of whether that entity has joint control of the arrangement." *[IFRS 11 Appendix A]*. Therefore, an entity could be required to apply IFRS 11 to an arrangement even though it does not have joint control of it (see section 6.4 below).

2.2.1 Application by venture capital organisations and similar entities

IFRS 11 applies to all entities that are party to a joint arrangement, including venture capital organisations, mutual funds, unit trusts, investment-linked insurance funds and similar entities (referred to hereafter as 'venture capital organisations'). However, venture capital organisations can choose to measure investments in joint ventures at fair value under the measurement exemption in IAS 28 (see Chapter 12 at section 3.3), but remain subject to the disclosure requirements of IFRS 12 *Disclosure of Interests in Other Entities* (see Chapter 14 at section 5). *[IFRS 11.BC15-BC18]*.

A venture capital organisation that is an 'investment entity' as defined in IFRS 10 *Consolidated Financial Statements* and holds investments in subsidiaries and associates/joint ventures measures its investments in associates/ joint ventures at fair value through profit or loss. *[IFRS 10.B85L(b)]*. Investment entities are discussed in Chapter 7 at section 10.

2.2.2 Application to joint arrangements held for sale

As discussed in section 8.2.7 below, an investment in a joint venture (or portion thereof) that is classified as held for sale under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* is accounted for under IFRS 5. *[IAS 28.20]*. Similarly, a joint operation that is held for sale under IFRS 5 is accounted for under IFRS 5, see section 8.3.6 below. *[IFRS 11.21, IFRS 5.2]*.

2.2.3 Accounting by a joint operation

The scope of IFRS 11 does not address the accounting by the joint operation itself.

Frequently asked questions

Question 2-1: How does a joint operation that is a separate vehicle account for the assets and liabilities of the joint operation in its financial statements?

In March 2015, the IFRS IC published its agenda decision[2] on the accounting by a joint operation that is a separate vehicle in its financial statements. Joint operators recognise their share of assets and liabilities held by the joint operation, which leads to the question of whether those same assets and liabilities are also recognised in the financial statements of the joint operation itself. The IFRS IC decided not to add the issue to its agenda, because the following guidance exists:

- IFRS 11 applies only to the accounting by the joint operators and not to the accounting by a separate vehicle that is a joint operation.
- The financial statements of the separate vehicle would therefore be prepared in accordance with applicable IFRS accounting standards. Note that IFRS 3 *Business Combinations* does not apply to "the accounting for the formation of a joint arrangement in the financial statements of the joint arrangement itself." (see Chapter 10 at section 2.2.1). *[IFRS 3.2(a)]*.
- Company law often requires a legal entity or separate vehicle to prepare financial statements. Consequently, the financial statements would include the assets, liabilities, revenues and expenses of that legal entity or separate vehicle. The determination of which assets and liabilities to recognise and their measurement will depend on rights and obligations of the separate vehicle and specific facts and circumstances.

2 *IFRIC Update*, March 2015, available on the IFRS Foundation's website.

3 Joint arrangement

IFRS 11 defines a joint arrangement as "An arrangement of which two or more parties have joint control." *[IFRS 11 Appendix A]*.

The contractual arrangement that binds the parties together is often, but not always, in writing. Unwritten agreements are rare in practice. Laws can also create enforceable arrangements, with or without a contract. *[IFRS 11.B2]*. A joint arrangement can be structured through a separate vehicle (see section 5.1 below). That entity's articles, charter or by-laws also might include aspects of the contractual arrangement. *[IFRS 11.B3]*.

Contractual arrangements generally specify the following:

- Purpose, activity and duration of the joint arrangement
- Appointment of members of the board of directors (or equivalent governing body)
- Decision-making processes
  - Matters requiring decisions from the parties
  - Voting rights of the parties

    And
  - Required level of agreement for those matters
- Capital or other contribution requirements
- Sharing of assets, liabilities, revenues, expenses or profit or loss relating to the joint arrangement *[IFRS 11.B4]*

How we see it

Understanding the terms of the contractual arrangement is crucial in determining whether joint control exists (see section 4 below) and, if so, in deciding whether the joint arrangement is a joint operation or joint venture (see section 5 below).

In addition, a contract to receive goods or services might be entered into by a joint arrangement or on behalf of a joint arrangement. The terms and conditions of the joint arrangement could impact how the contract to receive goods or services is accounted for. See Chapter 24 at section 3.1.1.

3.1 Unit of account

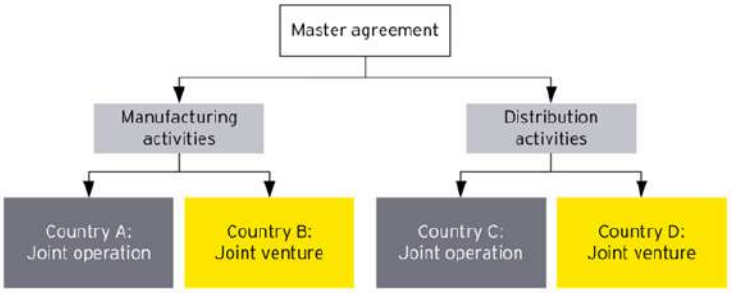
The unit of account of a joint arrangement is the activity that two or more parties have agreed to control jointly. A party to the arrangement assesses its rights to the assets and obligations for the liabilities relating to that activity, regardless of whether the activity is conducted in a separate vehicle. *[IFRS 11.BC20, IFRS 11.BC35]*.

The purpose and design of an arrangement might provide insight into how to identify the unit of account. For example, a framework agreement can establish multiple joint arrangements of different types. *[IFRS 11.18]*. The possibility also exists that, within the same separate vehicle, parties to the arrangement might undertake different activities in which they have different rights to the assets, and obligations for the liabilities, resulting in different types of joint arrangements conducted within the same separate vehicle. The IASB believes such situations would be rare in practice. *[IFRS 11.BC36]*. Scenarios in which the activity is larger than a single entity or separate vehicle are referred to as 'layered agreements' in this chapter and are discussed in Illustration 4-9 in section 4.4.2 below.

Illustration 3-1 below describes a case in which a master agreement is accounted for as several distinct joint arrangements, each of which is classified as either a joint operation or a joint venture.

Illustration 3-1: Master agreement for manufacturing and distribution

A single contract between two parties specifies the terms and conditions related to manufacturing and distribution activities and dictates how these activities are carried out in various jurisdictions through several entities. The activities are carried out concurrently and not sequentially (see section 4.1.1 below). In each entity, the parties jointly control the relevant activities.



The parties determine that the master agreement contains several discrete joint arrangements (one for each activity in each jurisdiction, which corresponds to an entity). If the terms and conditions relating to each activity are distinct for each separate vehicle then each entity would be classified as a joint venture or joint operation in accordance with IFRS 11.

In some cases, multiple contractual agreements between parties relate to the same activities, which would need to be analysed together to determine whether a joint arrangement exists and, if so, the type of joint arrangement.

In other cases, there might be a single master agreement between two parties that covers several different activities. Some of these activities might be controlled solely by one of the two parties, while the parties might jointly control other activities.

How we see it

IFRS 11 does not define 'activity'. Therefore, careful analysis is required to determine the unit of account and to assess whether any of the arrangements are jointly controlled.

Illustration 3-2 below illustrates a contract that contains multiple agreements, only some of which are joint arrangements.

Illustration 3-2: Agreements with control and joint control

Assume the same information as in Illustration 3-1 above with the following variation: One party has the ability to direct the manufacturing activities of the entity in Country A and the other party to direct those in Country B. As in Illustration 3-1, in Countries C and D the parties jointly control the relevant activities.

In this case, each party controls its respective entities in Countries A and B and therefore these entities are not joint arrangements. The distribution activities conducted in the entities in Countries C and D are still joint arrangements and each is classified as either a joint operation or a joint venture. See Illustration 5-6 in section 5.5 below for a case when two parties have two joint arrangements and each joint arrangement relates to a specific activity.

4 Joint control

A crucial element in a joint arrangement is joint control.

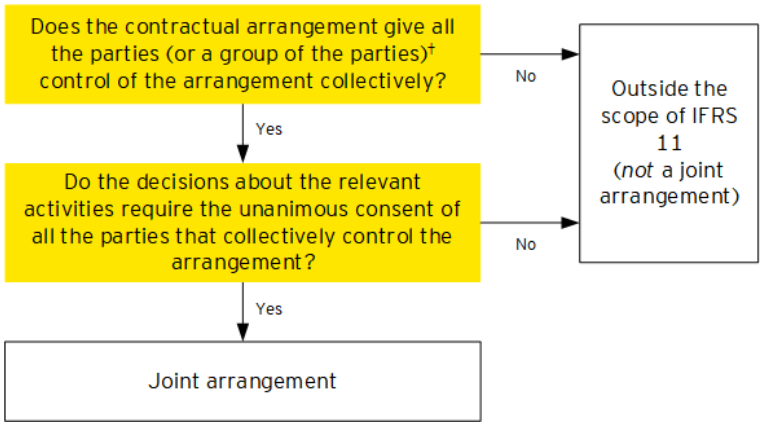
Joint control is defined as: *[IFRS 11.7, IFRS 11 Appendix A]*

Extract from IFRS 11	
7	**Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.**

[IFRS 11.7].

As discussed in section 2.2 above, not all the parties to the joint arrangement need to have joint control of the relevant activities for the arrangement to be classified as a joint arrangement. Therefore, IFRS 11 distinguishes between parties that have joint control of a joint arrangement and those that do not. *[IFRS 11.11]*. A joint operator and a joint venturer refer to parties that have joint control of a joint operation and joint venture respectively. *[IFRS 11 Appendix A]*. IFRS 11 does not explicitly define a party that participates in, but does not have joint control of, a joint arrangement. We refer to these parties as 'parties without joint control'. IFRS 11 specifies the accounting for parties without joint control (see sections 6.4 and 7.1 below).

The following flowchart provided in IFRS 11 illustrates how a party to a joint arrangement evaluates whether joint control exists. *[IFRS 11.B10]*.



† The reference to 'a group of the parties' refers to a situation in which there is joint control between two or more parties, but there are other parties to the joint arrangement that do not participate in joint control.

We discuss key aspects of joint control within this chapter, as follows:

- Contractual arrangement - See section 3 above
- Assessing control - See section 4.1 below
- Rights to control collectively - See section 4.2 below
- Unanimous consent - See section 4.3 below
- Other practical issues with assessing joint control - See section 4.4 below

All facts and circumstances are considered when assessing whether all the parties, or a group of the parties, have joint control of an arrangement and judgement is required. *[IFRS 11.12]*.

In some cases, it will be clear that there is no collective control, or no unanimous consent. If neither criterion is met, the activity is not a joint arrangement. For example, an advertising cost-sharing agreement between a retailer and a wholesaler that does not establish joint control over the advertising activities would not meet the definition of a joint arrangement.

How we see it

We believe that it would be rare for a publicly listed entity to be subject to joint control, since it would be unusual to have a contractual agreement among all the shareholders to direct the activities of such an entity.

When it is not clear whether joint control exists, a party to a joint arrangement needs to exercise judgement to determine whether there is joint control. *[IFRS 11.12]*. In such cases, IFRS 12 requires an entity to disclose information about the significant judgements and assumptions made (see Chapter 14 at section 3). *[IFRS 12.7]*.

When an arrangement is outside the scope of IFRS 11, an entity accounts for its interest in the arrangement in accordance with relevant IFRS accounting standard, such as IFRS 10, IAS 28 or IFRS 9 *Financial Instruments*. *[IFRS 11.B11]*.

4.1 Assessing control

The first step in evaluating joint control is to assess whether the contractual arrangement gives a single party control of the arrangement. *[IFRS 11.10]*. The IASB believes that the definition of control and the application requirements to assess control in IFRS 10 will assist an entity in determining whether it unilaterally controls an arrangement or whether it jointly controls an arrangement along with other parties. *[IFRS 11.BC14]*. Therefore, if one of the parties to the arrangement is exposed, or has rights, to variable returns from its involvement in the arrangement and has the ability to affect those returns through its power, it controls the arrangement and joint control is not possible. *[IFRS 11.10, IFRS 11.B5]*.

In assessing control, the following factors within IFRS 10 are considered:

- The purpose and design of the arrangement (see Chapter 7 at section 3.2)
- What the relevant activities of the arrangement are and how decisions about those activities are made (see Chapter 7 at section 4.1)
- Whether the rights of the party give it the current ability to direct the relevant activities (see Chapter 7 at sections 4.2 to 4.6)
- Whether the party is exposed, or has rights, to variable returns from its involvement with the arrangement (see Chapter 7 at section 5)
- Whether the party has the ability to use its power over the investee to affect the amount of its returns (see Chapter 7 at section 6). *[IFRS 10.B3]*.

4.1.1 Sequential activities

The determination of the relevant activities of an arrangement might be complicated when the arrangement includes different activities that occur at different times. For example, some joint arrangements operate in sequential production phases, such as those in the mining, construction, real estate, and life-sciences industries. These arrangements generally fall into two types of situations:

- Parties have rights to direct different activities

  Or

- Parties collectively direct all of the activities

In the first situation, each party assesses whether it has the rights to direct the activities that most significantly affect returns, and therefore whether it controls the arrangement (see Chapter 7 at section 4.1.1). This assessment is reconsidered if relevant facts or circumstances change. *[IFRS 11.13]*.

Illustrations 4-1 and 4-2 below illustrate the above principles. They are based on an example taken from IFRS 10. *[IFRS 10.B13 Example 1]*.

Illustration 4-1: Directing sequential activities separately

Companies A and B enter into an arrangement, structured through a separate vehicle, to develop and market a medical product. A is responsible for developing and obtaining regulatory approval for the medical product. This includes having the unilateral ability to make all decisions relating to the development of the product and to obtain regulatory approval. Once the regulator has approved the product, B will manufacture and market it and has the unilateral ability to make all decisions about the manufacturing and marketing of the project. All of the activities - developing and obtaining regulatory approval as well as manufacturing and marketing of the medical product - are relevant activities. A and B determine that the activity that most significantly affects returns at the time of the assessment is the developing and obtaining regulatory approval of the medical product.

In Illustration 4-1 above, there is no joint control because the parties to the arrangement do not collectively direct the activity that most significant affects returns of the arrangement. Rather, one party directs each activity. However, if the fact pattern were different such that they collectively directed that activity, then there would be joint control. This is described in Illustration 4-2 below.

Illustration 4-2: Directing sequential activities jointly

Companies A and B enter into an arrangement, structured through a separate vehicle, to develop and market a medical product. A and B are responsible for developing and obtaining regulatory approval for the medical product. The arrangement establishes joint control over the decisions relating to the development of the product and to obtain regulatory approval. Once the regulator has approved the product, B will manufacture and market it and have the unilateral ability to make all decisions about the manufacturing and marketing of the project. All of the activities - developing and obtaining regulatory approval as well as manufacturing and marketing of the medical product - are relevant activities. A and B determine that the activity that most significantly affects returns at the time of the assessment is the developing and obtaining regulatory approval of the medical product.

4.2 Rights to control collectively

Joint control can exist only when the parties collectively control the arrangement. *[IFRS 11.B5]*.

Extract from IFRS 11

8 An entity that is a party to an arrangement shall assess whether the contractual arrangement gives all the parties, or a group of the parties, control of the arrangement collectively. All the parties, or a group of the parties, control the arrangement collectively when they must act together to direct the activities that significantly affect the returns of the arrangement (ie the relevant activities).

Acting together to direct the relevant activities is referred to as 'collective control' and is discussed further in the following sections. *[IFRS 11.8]*.

4.2.1 Protective rights, including some veto rights

IFRS 10 defines protective rights as "Rights designed to protect the interest of the party holding those rights without giving that party power over the entity to which those rights relate". *[IFRS 10 Appendix A]*.

Protective rights relate to fundamental changes to the activities of the arrangement or apply in exceptional circumstances. Since power is an essential element of control, protective rights do not give a party control over the arrangement. Holding protective rights cannot prevent another party from having power over an arrangement (see Chapter 7 at section 4.2.2). *[IFRS 10.B26, IFRS 10.B27]*.

Accordingly, when assessing whether a group of the parties collectively control an arrangement, consideration must be given to whether rights held by any of the parties are:

- Protective - in which case, the other parties might collectively control the arrangement, and those parties might have joint control

  Or

- Substantive - in which case, such rights could prevent the other parties from having joint control, and possibly give the holder of those rights control

Illustration 4-3 below illustrates this point with veto rights, which are often protective rights.

Illustration 4-3: Protective rights and joint control

Companies A, B and C enter into a joint arrangement to conduct an activity in Entity Z. The contractual agreement between A and B states that they must agree to direct all the activities of Z. The agreement of C is not required, except that C has the right to veto the issuance of debt or equity instruments by Z. The ability to veto the issuance of equity and debt instruments is considered a protective right because the right is designed to protect C's interest without giving C the ability to direct the activities that most significantly affect Z's returns.

In this fact pattern, A and B have joint control over Z because collectively they have the ability to direct Z and the contractual agreement requires their unanimous consent. Although C is a party to the joint arrangement, C does not have joint control because C holds only a protective right with respect to Z.

An arrangement might be structured such that, rather than giving some parties protective rights, one party has the deciding vote in case of a tie or disagreement (see section 4.3.2 below).

4.2.2 Potential voting rights and joint control

Common examples of potential voting rights include options, forward contracts, and conversion features of a convertible instrument that, if exercised, would change the decision-making rights of the parties to the arrangement.

How we see it

IFRS 11 does not explicitly address how to deal with potential voting rights when assessing whether there is joint control. However, since joint control requires the parties collectively to have 'control' as defined in IFRS 10, a party to a joint arrangement must consider the requirements of IFRS 10 regarding potential voting rights.

To evaluate whether a potential voting right is substantive, and whether joint control exists, it is necessary to understand the purpose and design of the potential voting right and the context in which it was issued or granted. Guidance on how to assess whether a potential voting right is substantive is discussed further in Chapter 7 at section 4.3.4.

If the potential voting right is substantive, then the holder could have joint control together with the other parties, if the terms of the contractual arrangement confer joint control.

4.2.3 Other evidence of joint control

In some cases, it might be difficult to determine whether the rights of a group of the parties give them collective power over an arrangement. In such cases, the parties consider other evidence to indicate whether they have the current ability to direct the relevant activities collectively. IFRS 10 lists several examples of this evidence (see Chapter 7 at section 4.5).

How we see it

Whether the parties can obtain the financial information needed to account for the arrangement (e.g., to apply the equity method in the case of a joint venture) and to provide the required disclosures might also be relevant when determining whether the parties have joint control. If the group of the parties cannot obtain information regarding an arrangement (e.g., because management of that arrangement refuses to provide it), this might indicate that the parties do not have collective control (and therefore, no joint control) over that arrangement.

4.2.4 Delegated decision-making

In some cases, one of the parties might be appointed as the operational manager of the arrangement. This commonly occurs in the extractive and real estate industries, for example, when one of the parties has extensive experience in the type of activities conducted. The operational manager is frequently referred to as the 'operator', but since IFRS 11 uses the terms 'joint operation' and 'joint operator' with specific meaning, to avoid confusion we refer to such a party as the 'manager'. The other parties to the arrangement might delegate some or all the decision-making rights to this manager.

To evaluate joint control, a party to the arrangement assesses whether the contractual arrangement gives the manager control of the arrangement (see section 4.1 above). IFRS 10 also describes how to assess whether the manager is acting as a principal or an agent on behalf of all, or a group of, the parties to the arrangement. Careful consideration of the following is required (see Chapter 7 at section 6):

- The scope of the manager's decision-making authority
- The rights held by others (e.g., protective rights and removal rights)
- The manager's exposure to the variable returns of the arrangement through management fees earned
- The manager's exposure to the variable returns of the arrangement through other interests, for example, a direct investment held by the manager in the joint arrangement *[IFRS 10.B60]*

See Chapter 39 at section 7.1 for discussion of the application of IFRS 11 to entities in the extractive industries where this situation is more common.

Therefore, depending on the facts and circumstances, it is possible that joint control exists even when a manager is appointed if the arrangement requires contractually agreed unanimous consent for decisions about the relevant activities. Accordingly, arrangements in which the manager appears to have power over the relevant activities must be analysed carefully to determine whether joint control exists and, if so, which parties share in the joint control.

4.2.5 Related parties and *de facto* agents

One party to an arrangement might act as a *de facto* agent for another party (see Chapter 7 at section 7). *De facto* agents can include related parties (as defined in IAS 24 *Related Party Disclosures*). Determining whether joint control is established includes assessing whether any of the parties to the arrangement is acting as a *de facto* agent of another party. Illustration 4-4 below illustrates this point.

Illustration 4-4: *De facto* agents in joint control

A contractual arrangement has three parties: A has 50% of the voting rights and B and C each have 25%. The contractual arrangement between A, B and C specifies that at least 75% of the voting rights are required to make decisions about the relevant activities of the arrangement.

Analysis

A, B and C collectively control the relevant activities of the arrangement. However, there is neither control nor joint control, because more than one combination of parties can reach 75% and therefore direct the relevant activities.

Variation

If the facts and circumstances changed, such that C is a *de facto* agent of B, then A and B would have joint control, because effectively B would direct 50% (in combination with C's 25%) and A would need B to agree to direct the relevant activities.

How we see it

Identifying *de facto* agents can be complex and requires judgement and a careful evaluation of all the facts and circumstances.

4.2.6 Role of a government

In some countries, the government might retain a substantial interest in certain arrangements.

How we see it

When a government entity is party to an arrangement, the arrangement needs to be evaluated carefully to determine whether joint control or control exists.

This is illustrated in Illustration 4-5 below.

Illustration 4-5: Role of a government

A government owns land, which is believed to contain oil reserves. The government enters into a contractual arrangement with an oil company to drill for oil and sell the product, which the oil company does through a separate vehicle. The oil company evaluates the contractual terms of the arrangement closely to determine whether it has joint control, control, or some other type of interest. The ownership percentages in the separate vehicle do not necessarily determine whether there is control by one party or joint control.

In some cases, the contractual terms might give all final decision-making authority over the relevant activities to the government, in which case, the government would have control.

However, in other cases, the decision-making authority might require unanimous consent by the government and the oil company to direct the activities, in which case, they would have joint control.

4.3 Unanimous consent

Extract from IFRS 11

9	Once it has been determined that all the parties, or a group of the parties, control the arrangement collectively, joint control exists only when decisions about the relevant activities require the unanimous consent of the parties that control the arrangement collectively.

[IFRS 11.9].

Assessing whether the arrangement is jointly controlled by all of its parties or by a group of the parties, or controlled by one of the parties individually, can require judgement. It is not necessary for every party to the arrangement to have joint control. Only those parties that collectively control the arrangement must agree. *[IFRS 11.9, IFRS 11.B6]*.

In a joint arrangement, no single party controls the arrangement. A party with joint control of an arrangement can prevent any of the other parties, or a group of the parties, from controlling the arrangement. *[IFRS 11.10]*. In other words, the requirement for unanimous consent means that any party with joint control of the arrangement can prevent any of the other parties, or a group of the parties, from making unilateral decisions (about the relevant activities) without its consent. *[IFRS 11.B9]*.

IFRS 11 provides additional guidance on when unanimous consent exists. For example, a contractual arrangement can establish unanimous consent implicitly when the proportion of the voting rights needed to make decisions about the relevant activities effectively requires a specified combination of the parties to agree. *[IFRS 11.B7]*. When that minimum proportion of voting rights can be achieved by more than one combination of the parties agreeing, the arrangement is not a joint arrangement unless it specifies which parties (or combination of parties) are required to agree unanimously to decisions about the relevant activities of the arrangement. *[IFRS 11.B8]*. IFRS 11 provides some examples to illustrate this point. Examples 1 and 2 are summarised in the following table. *[IFRS 11.B8 Example 1, IFRS 11.B8 Example 2]*.

Example 1	Example 2
Minimum voting requirement	**Minimum voting requirement**
75% vote to direct relevant activities	75% vote to direct relevant activities
Party A - 50%	Party A - 50%
Party B - 30%	Party B - 25%
Party C - 20%	Party C - 25%
Conclusion	**Conclusion**
Joint control - A and B collectively control the arrangement (since their votes, and only their votes, together meet the requirement). Since there is only one combination of parties that collectively control the arrangement, it is clear that A and B must unanimously agree. C is a 'party without joint control' (see section 4 above).	*No joint control* - multiple combinations of parties could collectively control the arrangement (i.e., A and B or A and C could vote together to meet the requirement). Since there are multiple combinations, and the contractual agreement does not specify which parties must agree, there is no unanimous consent.

4.3.1 Arrangements involving parties without joint control

Unanimous consent needs to be established by contract. For example, two parties, A and B, each have 35% of the voting rights in an arrangement with the remaining 30% being widely dispersed and decisions about the relevant activities require approval by a majority of the voting rights. In this situation, A and B have joint control of the arrangement only if the contractual arrangement specifies that decisions about the relevant activities of the arrangement require agreement of both A and B. *[IFRS 11.B8 Example 3]*. The fact that the remaining 30% of the voting rights are widely dispersed does not implicitly create joint control.

4.3.2 Ultimate voting authority (tie-breakers)

Sometimes an arrangement provides all parties with a voting right, but in the case of a deadlock, or disagreement, one party has the deciding vote (i.e., the final decision or override powers). If any single party could direct the relevant activities unilaterally, there would not be joint control. Illustration 4-6 below illustrates this point.

Illustration 4-6: Ultimate decision-making authority - no joint control (1)

Companies G and H enter into an arrangement and set up a joint steering committee. H has ultimate decision-making authority when the joint steering committee cannot reach an agreement. In this case, there would not be joint control because the agreement of G is not needed.

To evaluate whether H has control, it would also need to assess whether it has exposure to variable returns, and the ability to affect those returns through its power, as required by IFRS 10 (see Chapter 7).

Just because one party has a deciding vote does not necessarily mean that it has control, particularly if other parties can act without the agreement of that party. This is illustrated in Illustration 4-7 below.

Illustration 4-7: Ultimate decision-making authority - no joint control (2)

Companies I, J and K enter into an arrangement and set up a joint steering committee. Each party has one vote, and two votes are needed to carry a motion. K has ultimate decision-making authority when the joint steering committee cannot reach an agreement. For example, if no combination of I, J and K can agree with each other, K would have the ultimate decision-making authority.

There is no joint control, since there are multiple combinations of parties that could vote together, and the contractual agreement does not specify which parties must agree. For example, I and J could agree together, without the agreement of K. In addition, K does not control the arrangement, even though it has a deciding vote when the joint steering committee cannot reach an agreement, because I and J can act without the agreement of K.

4.3.3 Arbitration

Contractual arrangements often include terms and conditions relating to the resolution of disputes and might provide for arbitration. The existence of such terms and conditions does not prevent the arrangement from being jointly controlled and, consequently, from being a joint arrangement. *[IFRS 11.B10]*. A party to a joint arrangement evaluates the facts and circumstances related to the arbitration procedures to determine the implications for joint control. For example, if the arbitration process is neutral to both parties, which might be achieved by using a mutually agreed upon arbitrator, there might be joint control. Alternatively, arbitration procedures that favour one party might indicate that there is no joint control.

4.3.4 Statutory mechanisms

Statutory mechanisms can create legally enforceable rights and obligations (see section 3 above). Therefore, when evaluating whether an arrangement implicitly results in joint control, an entity considers the statutory requirements in the relevant jurisdiction under which the contractual arrangement was established.

4.4 Other practical issues with assessing joint control

4.4.1 Undivided interests or a joint arrangement

Entities sometimes acquire undivided interests (a share in a commonly-owned asset, such as land or real estate) or enter into joint arrangements with a common economic goal: to share in the benefits and obligations of owning an asset. The appropriate accounting depends on the facts and circumstances and might require judgement.

Undivided interests are common in the extractives industry and are discussed in Chapter 39 at section 7.2. They are usually subject to joint control and can, therefore, be accounted for as joint operations. However, some arrangements do not establish joint control but are, instead, based on some form of supermajority voting whereby a qualified majority (e.g., 75%) of the participants can approve decisions. This situation usually arises when the group of participants is too large for joint control to be practical or when the main investor wants to retain a certain level of influence.

Where joint control does not exist, such undivided interests cannot be accounted for as joint operations in the scope of IFRS 11. Instead, the appropriate accounting treatment by the investor depends on the nature of the arrangement.

Illustration 4-8 below illustrates a scenario in which the accounting depends on the nature of the arrangement.

Illustration 4-8: Joint purchase of an aircraft

Five parties jointly buy an aircraft. By contractual agreement, each party has the right to use the aircraft for a certain number of days each year and shares proportionately in the maintenance costs. They share decision-making regarding the maintenance and disposal of the aircraft, which are the relevant activities for that aircraft. Those decisions require agreement of parties holding 75% of the voting rights. There are multiple combinations of how the 75% threshold can be achieved and the contractual agreement does not specify which parties must agree. Therefore, there is no unanimous consent.

Analysis

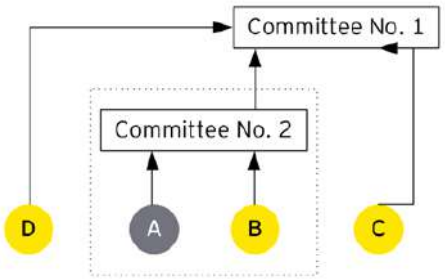
The agreement is not a joint arrangement, as the contractual agreement does not establish joint control. The appropriate accounting depends on the rights and obligations of each party under the contractual agreement.

4.4.2 Evaluating multiple agreements together

Sometimes it is necessary to evaluate multiple agreements together, to understand the purpose and design of an arrangement, and to determine whether there is joint control. A party might appear to have joint control of a joint arrangement when considering one agreement in isolation, but that party might not have joint control when considered in the full context of its purpose and design. Illustration 4-9 below illustrates this point.

Illustration 4-9: Layered agreements

Companies A, B, C and D enter into Agreement No.1 to undertake oil and gas exploration. Committee No.1 is formed to direct all related activities, including review and approval of annual budgets and operating policies. Committee No.1 consists of six members, of whom D nominates three members. A, B, and C each nominate one of the remaining three members. The decisions of Committee No.1 require the unanimous vote of the members.



A and B enter into Agreement No.2, which establishes Committee No.2 to coordinate cooperation between A and B, with respect to the same oil and gas exploration activity. A and B each appoint one representative to Committee No.2. Committee No.2 has the power to make decisions to be submitted for approval to Committee No.1. Any matter to be decided by Committee No.2 requires the consent of both parties. However, if agreement cannot be reached between A and B, B has the deciding vote. The decisions made in Committee No.2 are binding on A and B and they must vote accordingly in Committee No.1.

In this fact pattern, there are two separate contractual agreements. However, they are evaluated together to determine if there is a joint arrangement, because they relate to the same oil and gas exploration activity. For example, if Agreement No.1 were considered in isolation, it would appear that A, B, C and D all have joint control over the arrangement because its decisions require the unanimous vote of the members.

However, Agreement No.1 is evaluated together with Agreement No.2. Accordingly, only B, C and D have joint control over the joint arrangement. B can effectively direct A how to vote (by virtue of Agreement No.2) in Committee No.2, so A does not have joint control with the other parties. A is effectively a *de facto* agent of B and represents a 'party without joint control' (see section 4.2.5 above).

5 Classification of a joint arrangement: joint operations and joint ventures

A joint arrangement is classified as either a joint operation or a joint venture. *[IFRS 11.14, IFRS 11.6]*.

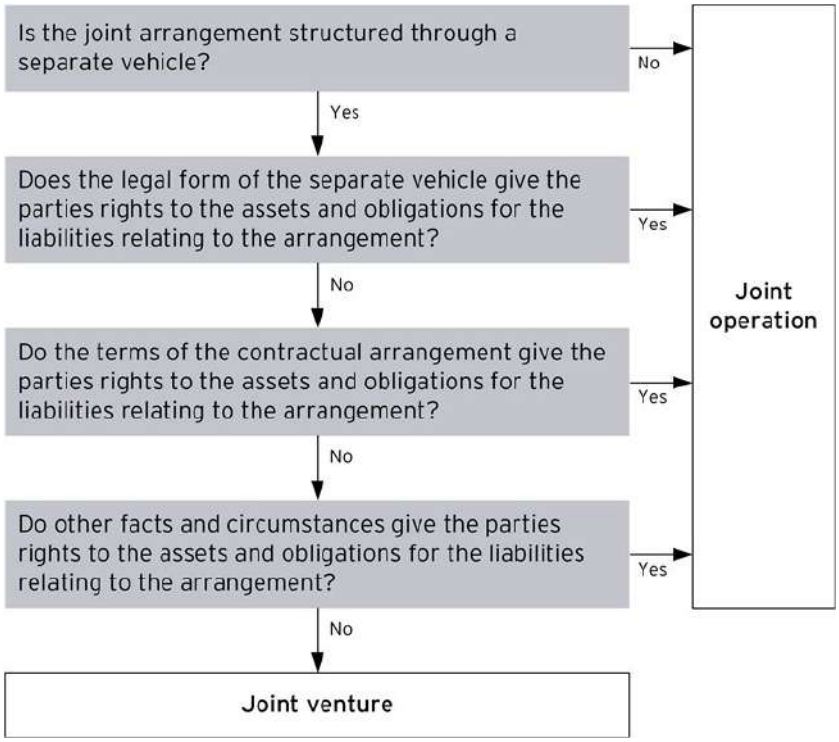
Extract from IFRS 11	
14	**An entity shall determine the type of joint arrangement in which it is involved. The classification of a joint arrangement as a joint operation or a joint venture depends upon the rights and obligations of the parties to the arrangement.**

The table below compares the two types of joint arrangements and provides an overview of the accounting for each under IFRS 11.

Type of arrangement	Joint operation	Joint venture
Definition	A joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement. *[IFRS 11 Appendix A]*.	A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. *[IFRS 11 Appendix A]*.
Parties with joint control	A joint operator is a party with joint control in a joint operation. *[IFRS 11.15]*.	A joint venturer is a party with joint control in a joint venture. *[IFRS 11.16]*.
Accounting overview	Each party to the arrangement, i.e., joint operators and parties without joint control, accounts for the following in accordance with the applicable IFRS accounting standard: ▸ Its assets, including its share of any assets held jointly ▸ Its liabilities, including its share of any liabilities incurred jointly ▸ Its revenue from the sale of its share of the output arising from the joint operation ▸ Its share of revenue from the sale of the output by the joint operation ▸ Its expenses, including its share of any expenses incurred jointly. *[IFRS 11.20, IFRS 11.23]*. Accounting for joint operations is discussed further at section 6 below.	A joint venturer accounts for its investment in the joint venture applying IAS 28. Parties without joint control account for the investment in accordance with IFRS 9, unless the parties have significant influence, in which case the parties apply IAS 28. *[IFRS 11.24, IFRS 11.25]*. Accounting for joint ventures is discussed further at section 7 below.

The process to classify a joint arrangement is illustrated in the following flowchart, which includes the criteria to be met for the joint arrangement to be a joint venture. *[IFRS 11.B21]*.

Figure 5-1: Classifying a joint arrangement



We discuss key aspects of the classification process within this section as follows:

- Separate vehicle - see section 5.1 below
- Legal form of the separate vehicle - see section 5.2 below
- Contractual terms - see section 5.3 below
- Other facts and circumstances - see section 5.4 below *[IFRS 11.17, IFRS 11.B15]*

Judgement is required in assessing whether a joint arrangement is a joint operation or a joint venture. An entity evaluates its rights and obligations arising from a joint arrangement in order to classify it. *[IFRS 11.17]*. IFRS 12 requires an entity to disclose information when it makes significant judgements and assumptions to classify the type of joint arrangement, specifically when the arrangement has been structured through a separate vehicle (see Chapter 14 at section 3). *[IFRS 12.7]*.

IFRS 11 also includes examples illustrating this evaluation, some within the application guidance and others as illustrative examples accompanying the standard (see section 5.5 below).

How we see it

When classifying a joint arrangement, parties to the joint arrangement would normally reach the same conclusion regarding classification. To reach different conclusions regarding the classification of a joint arrangement would mean that one party has rights to assets and obligations for the liabilities while the other has rights to the net assets, within the same separate vehicle.

The classification of joint arrangements depends upon the parties' rights and obligations arising from the arrangement in the normal course of business. *[IFRS 11.B14]*. These concepts are discussed in more detail in the context of analysing the contractual terms of the arrangement, and the other facts and circumstances in sections 5.3 and 5.4 below, respectively.

The requirement to classify a joint arrangement based on the normal course of business is consistent with the requirement to consider the purpose and design of an investee in IFRS 10 (see Chapter 7 at section 3.2).

How we see it

We believe that the purpose and design of a joint arrangement is an important consideration in determining the appropriate classification.

5.1 Separate vehicle or not

The first factor in classifying a joint arrangement is the assessment of whether a separate vehicle exists. A joint arrangement in which the assets and liabilities relating to the arrangement are held in a separate vehicle can be either a joint venture or a joint operation. *[IFRS 11.B19, IFRS 11.B20]*.

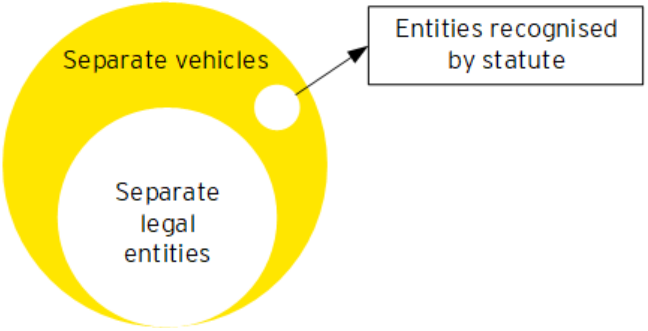
A separate vehicle is defined in IFRS 11 as "A separately identifiable financial structure, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality." *[IFRS 11 Appendix A]*. Apart from those entities mentioned in the definition, IFRS 11 does not provide any examples of what might constitute a 'separate vehicle', and there is no clear definition of what constitutes a 'separately identifiable financial structure'. The existence of a separate vehicle does not depend on whether the assets and liabilities within the vehicle meet the definition of a 'business' in IFRS 3. *[IFRS 11.BC29]*.

The desired economic substance often drives the selection of a particular legal form of a separate vehicle. However, the choice might be driven by tax, regulatory requirements or other reasons that can alter the intended economic substance, necessitating that the parties use contractual arrangements to modify the effects that the legal form would otherwise have on their rights and obligations. *[IFRS 11.BC32]*.

Many common arrangements, such as partnerships, corporations, trusts and syndicates, are likely to be considered separate vehicles, although local laws are also considered. In some jurisdictions, an oral agreement is considered sufficient to create a contractual partnership, and thus, the hurdle for having a separate vehicle could be quite low.

A contract alone can create a separate vehicle, such as when it creates a deemed separate entity (referred to as a 'silo' in IFRS 10) or creates a partnership. A silo exists when specified assets of an arrangement are the only source of payment for specified liabilities of an arrangement, and parties other than those with the specified liability do not have rights or obligations related to the specified assets or to residual cash flows from those assets. That is, a silo exists when, in substance, all the assets, liabilities and equity of that deemed separate entity are ring-fenced from the 'host' arrangement. The identification of silos is discussed further in Chapter 7 at section 8.1.

The term 'separate vehicle' is broader than an 'entity' as illustrated in the diagram below. We understand that this was done primarily to address concerns that, in some jurisdictions, separate vehicles created to establish a joint arrangement are not necessarily legal reporting entities.



The IASB concluded that it would be rare that a joint arrangement would give the parties rights to the net assets without having a separate vehicle and therefore no further assessment is required in this scenario; when there is no separate vehicle, the arrangement is a joint operation. *[IFRS 11.BC27]*.

5.2 Legal form of the separate vehicle

Once it is determined that a separate vehicle exists, the second step is to analyse its legal form to determine whether it gives the parties rights to the net assets or rights to the assets and obligations for the liabilities of the arrangement. *[IFRS 11.B21]*. In other words, does the separate vehicle confer separation between the parties and the separate vehicle?

The legal form of the separate vehicle is relevant as an initial indicator of the parties' rights to the assets, and obligations for the liabilities, relating to the arrangement. When the legal form of the separate vehicle does not confer separation between the parties and the vehicle, the arrangement is a joint operation. *[IFRS 11.B24, IFRS 11.BC31]*.

When separation between the parties and the separate vehicle exists, this is not determinative. The terms agreed by the parties in their contractual arrangement (see section 5.3 below) and other facts and circumstances (see section 5.4 below) can override the assessment of the rights and obligations conferred upon the parties by the legal form of the separate vehicle and the arrangement can still be classified as a joint operation. *[IFRS 11.B23]*.

Local laws can affect the form of the separate vehicle. For example, in many countries, a corporation confers separation between the parties and the separate vehicle and provides the parties with rights to net assets. The liabilities of the corporation are limited to the corporation and creditors do not have recourse to the investors in the corporation for those liabilities. These are indicators that a corporation that is jointly controlled is a joint venture.

By contrast, partnerships that have unlimited liability, which are common in many countries, often do not confer separation between the parties and the separate vehicle. They provide the partners with rights to the assets and obligations for the liabilities, indicating that the arrangement is a joint operation. When creditors of the partnership have direct recourse to the joint arrangement partners, the partners are the primary obligors, which is indicative of a joint operation. However, in a partnership when creditors have recourse to the partners only after the partnership has defaulted, there is separation between the partners and the vehicle. The liability of the partners as secondary obligor is akin to a guarantee. This is an indicator of a joint venture.

In March 2015, the IFRS IC published an agenda decision[3] in which it observed that two seemingly similar joint arrangements from an operational perspective might be classified differently because one is structured through a separate vehicle and the other is not. The legal form of the separate vehicle could affect the rights and obligations of the parties to the joint arrangement and thereby affect the economic substance of the rights and obligations of the parties to the joint arrangement. *[IFRS 11.B22, IFRS 11.BC43]*.

5.3 Contractual terms

The next step in classifying a joint arrangement structured through a separate vehicle is to examine the contractual terms of the arrangement. While the legal form of the separate vehicle gives certain rights and obligations to each of the parties, the contractual terms of the joint arrangement can unwind the effects of the legal form and give the parties different rights and obligations.

IFRS 11 includes examples (which are not exhaustive) of common contractual terms found in joint arrangements and indicates whether these are examples of joint operations or joint ventures. These are included in the table below. *[IFRS 11.B27]*.

Joint operation	Joint venture
Terms of the contractual arrangement	
The parties are provided with rights to the assets, and obligations for the liabilities, relating to the arrangement.	The parties are provided with rights to the net assets of the arrangement (i.e., it is the separate vehicle, not the parties, that has rights to the assets and obligations for the liabilities relating to the arrangement).
Rights to assets	
The parties share all interests (e.g., rights, title or ownership) in the assets relating to the arrangement in a specified proportion (e.g., in proportion to the parties' ownership interest in the arrangement or in proportion to the activity carried out through the arrangement that is directly attributed to them).	The assets brought into the arrangement or subsequently acquired by the joint arrangement are the arrangement's assets. The parties have no interests (i.e., no rights, title or ownership) in the assets of the arrangement.

3 *IFRIC Update*, March 2015, available on the IFRS Foundation's website.

Joint operation	Joint venture
Obligations for liabilities	
The parties share all liabilities, obligations, costs and expenses in a specified proportion (e.g., in proportion to the parties' ownership interest in the arrangement or in proportion to the activity carried out through the arrangement that is directly attributed to them).	The joint arrangement is liable for the debts and obligations of the arrangement. The parties are liable under the arrangement only to the extent of their respective investments in the arrangement, or to their respective obligations to contribute any unpaid or additional capital to the arrangement, or both.
The parties are liable for claims raised by third parties.	Creditors of the joint arrangement do not have rights of recourse against any party with respect to debts or obligations of the arrangement.
Revenues and expenses and profits or losses	
Each party receives an allocation of revenues and expenses based on the relative performance of each party to the joint arrangement. For example, the contractual arrangement might establish that revenues and expenses are allocated based on the capacity that each party uses in a plant operated jointly, which could differ from their ownership interest in the joint arrangement. In other instances, the parties might have agreed to share the profit or loss relating to the arrangement based on a specified proportion such as the parties' ownership interest in the arrangement. This would not prevent the arrangement from being a joint operation if the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement.	Each party has a share in the profit or loss relating to the activities of the arrangement.
Guarantees	
The parties to joint arrangements are often required to provide guarantees to third parties that, for example, receive a service from, or provide financing to, the joint arrangement. The provision of such guarantees, or the commitment by the parties to provide them, does not determine, by itself, that the joint arrangement is a joint operation. The feature that determines whether the joint arrangement is a joint operation or a joint venture is whether the parties have obligations for the liabilities relating to the arrangement (for some of which the parties might or might not have provided a guarantee). See section 5.3.1 below.	

In many cases, the rights and obligations agreed to by the parties in their contractual arrangements are consistent, or do not conflict, with the rights and obligations conferred on the parties by the legal form of the separate vehicle. *[IFRS 11.B25]*. However, as discussed in section 5.2 above, this is not always the case, *[IFRS 11.B26]*, as shown in Illustration 5-1 below. *[IFRS 11.B26 Example 4]*.

Illustration 5-1: Modification of legal form by contractual terms

Companies A and B jointly start a Corporation C, over which they have joint control. The legal form of the separate vehicle (a corporation) preliminarily indicates that C is a joint venture.

However, the contractual arrangement states that A and B have rights to the assets of C and are obligated for the liabilities of C in a specified proportion. Effectively, this contractual term unwinds the effects of the legal form (corporation). Therefore, C is a joint operation.

When the contractual arrangement specifies that the parties have rights to the assets, and obligations for the liabilities, relating to the joint arrangement, they are parties to a joint operation, and do not further consider other facts and circumstances when classifying the joint arrangement. *[IFRS 11.B28]*.

5.3.1 Guarantees

Parties to joint arrangements might provide guarantees to third parties. For example, a guarantee or commitment that:

- Services provided by the joint arrangement to the third party will be of a certain quality or nature
- It will support the joint arrangement in the event of distress

Or

- It will repay funding received from the third party

IFRS 11 is clear that the issuance of guarantees, or a commitment by the parties to provide guarantees, does not, by itself, determine that the joint arrangement is a joint operation. *[IFRS 11.B27]*. This is because the guarantee does not give the guarantor a present obligation for the underlying liabilities.

If the issuer of the guarantee must pay or perform under that guarantee, this might indicate that facts and circumstances have changed, or this event might be accompanied by a change in the contractual terms of the arrangement. These changes would trigger a reassessment of whether the arrangement is still subject to joint control and, if so, whether the joint arrangement is a joint operation or a joint venture, as discussed in section 8 below.

When a guarantee meets the definition of a 'financial guarantee' (see Chapter 41 at section 2.4), the party issuing the guarantee accounts for the guarantee in accordance with IFRS 9, irrespective of the classification of the joint arrangement.

5.3.2 Contractual terms upon liquidation or dissolution of joint arrangement

In some joint arrangements, the parties contribute assets to the joint arrangement to use in the activity while it continues to operate. However, if the joint arrangement is liquidated or dissolved, the contributed assets revert to the contributing party. The question is whether this contractual term gives the parties rights to the assets. If so, the joint arrangement is classified as a joint operation.

How we see it

All relevant facts and circumstances are considered in reaching a conclusion. In our view, a contractual agreement whereby assets contributed to a joint arrangement revert to the contributing party upon liquidation or dissolution of the joint arrangement, does not necessarily mean that the arrangement is a joint operation because the contributing party does not have rights to the contributed assets in the normal course of business, based on its purpose and design (see section 5 above).

If the party contributing the asset has a currently exercisable call option on that asset, it includes this fact in the analysis. The call option is accounted for in accordance with the relevant IFRS.

5.4 Other facts and circumstances

When the legal form of the separate vehicle and the terms of the contractual arrangement do not specify that the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement, then the parties must consider all other facts and circumstances to assess whether the arrangement is a joint operation or a joint venture. *[IFRS 11.B29, IFRS 11.B30]*. The 'other facts and circumstances' must be substantive and demonstrate that the parties have rights to the assets and obligations for the liabilities of the separate vehicle to classify the joint arrangement as a joint operation.

In March 2015, the IFRS IC published agenda decisions[4], incorporated into the discussions in sections 5.4.1 and 5.4.2 below, that provide a helpful overview of the issues that require judgement and guidance to consider. The assessment of 'other facts and circumstances' can be challenging in practice.

4 *IFRIC Update*, March 2015, available on the IFRS Foundation's website.

5.4.1 How and why particular facts and circumstances create rights and obligations

Frequently asked questions

Question 5-1: How does an entity evaluate the other facts and circumstances when classifying a joint arrangement that is structured through a separate vehicle whose legal form causes the separate vehicle to be considered in its own right?

The IFRS IC noted the following regarding a joint arrangement that is structured through a separate vehicle whose legal form causes the separate vehicle to be considered in its own right:[5]

(a) The assessment of other facts and circumstances is performed when there is no contractual arrangement to reverse or modify the rights and obligations conferred by the legal form of the separate vehicle through which the arrangement has been structured.

(b) The assessment focuses on whether the other facts and circumstances establish, for each party to the joint arrangement, rights to the assets and obligations for the liabilities relating to the joint arrangement.

(c) Parties to the joint arrangement have rights to the assets of the joint arrangement through other facts and circumstances when they: *[IFRS 11.B31, IFRS 11.B32, IFRS 11.B33]*

  (i) Have rights to substantially all of the economic benefits (for example, 'output') of assets of the arrangement

  And

  (ii) Have obligations to acquire those economic benefits and thus assume the risks relating to those economic benefits (for example, the risks relating to the output).

(d) Parties to the joint arrangement have obligations for liabilities of the joint arrangement through other facts and circumstances when: *[IFRS 11.B14, IFRS 11.B32, IFRS 11.B33]*

  (i) Because of their rights to, and obligations for, the assets of the joint arrangement, they provide cash flows that are used to settle liabilities of the joint arrangement

  And

  (ii) Settlement of the liabilities of the joint arrangement occurs on a continuous basis.

A joint arrangement structured through a separate vehicle is classified as a joint operation only when each party to the joint arrangement meets the above criteria and therefore has both rights to the assets of the joint arrangement and obligations for the liabilities of the joint arrangement through other facts and circumstances.

Although the IFRS IC decided not to add this issue to its agenda, it observed that a joint arrangement could be classified as a joint operation based on other facts and circumstances, only if an entity is able to demonstrate that:

(a) Each party to the joint arrangement has rights and obligations relating to economic benefits of the assets of the arrangement.

  And

(b) Each party is obliged to provide cash to the arrangement through enforceable obligations, which is used to settle the liabilities of the joint arrangement on a continuous basis.

The IFRS IC observed that the concept of 'economic substance' might not be consistently understood or applied in practice in the context of this assessment. It confirmed that assessing other facts and circumstances focuses on whether each party has rights to the assets, and obligations for the liabilities, relating to the joint arrangement. It is not a test of how closely or fully involved each party is with the operation of the separate vehicle, but instead analyses whether other facts and circumstances override the rights and obligations conferred on each party by the legal form of the separate vehicle. It is therefore irrelevant whether the activities of the separate vehicle are closely related to the activities of the parties on their own, or whether the parties are closely involved in the operations of the arrangements. *[IFRS 11.BC43]*.

5 *IFRIC Update*, March 2015, available on the IFRS Foundation's website.

In March 2014, the IFRS IC discussed a staff paper that examined common features of 'project entities' in the context of assessing 'other facts and circumstances.' As noted in Question 5-1 above, the IFRS IC decided not to add this issue to its agenda but noted that the examples are fact-specific, and consequently it is unclear if the Board agreed with all elements of the staff analysis that follows.

The staff's analysis[6] argued that, in this hypothetical example, these features did not result in classification as a joint operation by the parties to the joint arrangement ('the parties'), for the following reasons:

- Certain features do not relate to the parties' rights to the assets and obligations for the liabilities: The nature of the project entity's assets and liabilities, the fact that the separate vehicle is thinly capitalised, has no workforce of its own, is a limited-life entity and obtains customers through the parties' resources.
- The parties are entitled to the net cash amount from the sale of output, indicating that the parties have rights to 'net' economic benefits.
- The parties are responsible for delivering the services to the ultimate customer, subcontracted by the separate vehicle. This is a subcontractor relationship and does not indicate rights to the assets of the separate vehicle.
- The separate vehicle has primary obligation for its liabilities, therefore the parties do not settle the liabilities of the separate vehicle on a continuous basis.
- The parties finance the separate vehicle for any loss or cash needs. This indicates an obligation, but obligations are not independent of rights and so this feature alone does not give the parties obligations for the liabilities.
- Non-completion and litigations risks are similar to the risks inherent in the role of guarantor and so do not indicate that the parties settle the liabilities of the separate vehicle on a continuous basis.

In July 2014, the IFRS IC discussed the classification of a specific type of joint arrangement structure established for a bespoke construction project to deliver a construction service to a single customer. The IFRS IC noted[7] that the features analysed[8] would not indicate that the parties to the joint arrangement have, in substance, direct rights to the assets of the joint arrangement, but could indicate that the parties to the joint arrangement have, in substance, direct obligations for the liabilities of the joint arrangement, depending on the nature of the parties' obligations. Therefore, the joint arrangement illustrated would not be classified as a joint operation.

Frequently asked questions

Question 5-2: Are constructive obligations considered when classifying a joint arrangement?

IFRS 11 uses the word 'obligation', therefore these obligations can be legal or constructive. One feature of obligations is that an entity has no realistic alternative to settling the obligation. In its comment letter analysis[9], the staff noted that evaluating the existence of obligations includes consideration of the design and purpose of the joint arrangement, its business needs and its past practices to the extent that they affect the existence of obligations, including constructive obligations.

The agenda decision summarised at Question 5-1 above clarified that the assessment of other facts and circumstances focuses on whether they create enforceable rights to the assets and obligations for the liabilities. The assessment does not also consider the design and purpose of the joint arrangement, the entity's business needs and its past practices. However, when evaluating the existence of liabilities, these matters are considered.

6 IASB Staff Paper 5B, Project: *IFRS 11* Joint Arrangements, Paper topic: *Consideration of some common joint arrangement structures*, IFRS IC Meeting, March 2014. Available on the IFRS Foundation's website.

7 IFRIC Update, July 2014, available on the IFRS Foundation's website.

8 IASB Staff Paper 2B, Project: *IFRS 11* Joint Arrangements, Paper topic: *Consideration of a specific type of joint arrangement structure*, Interpretations Committee Meeting, July 2014. Available on the IFRS Foundation's website.

9 IASB Staff Paper 4, Project: *IFRS 11* Joint Arrangements, Paper topic: *Tentative agenda decision comment letter analysis*, IFRS Interpretations Committee Meeting, March 2015. Available on the IFRS Foundation's website.

5.4.2 Facts and circumstances indicating rights to assets

Extract from IFRS 11	
B31	When the activities of an arrangement are primarily designed for the provision of output to the parties, this indicates that the parties have rights to substantially all the economic benefits of the assets of the arrangement. The parties to such arrangements often ensure their access to the outputs provided by the arrangement by preventing the arrangement from selling output to third parties.

[IFRS 11.B31].

5.4.2.A Output not taken in proportion to ownership

In March 2015, the IFRS IC published an agenda decision[10] that addressed the accounting treatment when the joint operator's share of output purchased differs from its share of ownership interest in the joint operation. The IFRS IC specifically considered a variation to Example 5 of the application guidance to IFRS 11. Example 5 considers a joint arrangement structured through a separate vehicle from which the parties to the joint arrangement have committed to purchase substantially all the output produced at a price designed to achieve a break-even result. In that example, the parties to the joint arrangement are considered to have rights to the assets and obligations for the liabilities and the arrangement is classified as a joint operation. *[IFRS 11.B32 Example 5]*. In the variation considered, the parties' percentage ownership interest in the separate vehicle differs from the percentage share of the output produced, which each party is obliged to purchase.

The IFRS IC identified several issues:

- When the joint arrangement agreement does not specify the allocation of assets, liabilities, revenues or expenses, does the share of assets, liabilities, revenue and expenses recognised reflect the percentage of ownership of the legal entity or does it reflect the percentage of output purchased by each joint operator?
- When the share of output purchased by each party varies over the life of the joint arrangement, over what time horizon is the share of output considered?
- If the joint operators made a substantial investment in the joint operation that differed from their ownership interest, it would be necessary to determine the other elements of the arrangements that could explain why there is a difference between the percentage of ownership interest and the percentage share of the output produced that each party is obliged to purchase.

The IFRS IC noted that it is important to understand why the share of the output purchased differs from the ownership interests in the joint operation and that judgement would be needed to determine the appropriate classification and accounting for the joint arrangement. However, the IFRS IC decided not to add the issue to its agenda because it would require the development of additional guidance.[11]

5.4.2.B Substantially all of the output

In March 2015, the IFRS IC published another agenda decision[12] applying the other facts and circumstances test to specific fact patterns. Parties to the joint arrangement have rights to the assets of the joint arrangement when they have rights to substantially all of the economic benefits (for example, 'output') of the assets of the arrangement. The IFRS IC noted that the economic benefits of the assets of the joint arrangement relate to the cash flows arising from the parties' rights to, and obligations for, the assets. *[IFRS 11.B31, IFRS 11.B32]*. Therefore, the term 'substantially all of the output' is based on the monetary value of the output, rather than physical quantities.

10 *IFRIC Update*, March 2015, available on the IFRS Foundation's website.

11 *IFRIC Update*, March 2015, available on the IFRS Foundation's website.

12 *IFRIC Update*, March 2015, available on the IFRS Foundation's website.

5.4.3 Facts and circumstances indicating obligations for liabilities

"When the parties are substantially the only source of cash flows contributing to the continuity of the operations of the arrangement, this indicates that the parties have an obligation for the liabilities relating to the arrangement." *[IFRS 11.B32]*.

The parties to a joint arrangement might be substantially the only source of cash flows, for example, when the parties:

- Make payments to third parties under previously issued guarantees on behalf of the joint arrangement
- Are obliged to provide loan financing or working capital funding in the normal course of business
- Commit to provide cash calls in the future (see section 5.4.3.A below)

Or

- Are obliged to purchase all the output produced by the joint arrangement, which they can but are not required to resell to third parties (see section 5.4.3.B below)

5.4.3.A Assessing the obligation related to cash calls or capital contributions

Questions have arisen as to whether parties would be considered 'substantially the only source of cash flows' if they provide cash flows at inception of a joint arrangement, but are not expected to do so thereafter, and no other parties are expected to provide cash flows until the end of an activity. Alternatively, parties might provide cash flows through a series of 'cash calls' throughout the arrangement. When a party is liable only to the extent of an obligation to contribute unpaid or additional capital to a joint arrangement, that is an indicator that the arrangement is a joint venture. *[IFRS 11.B27]*.

How we see it

Notwithstanding IFRS 11.B27, in our view, the provision of cash flows at the inception of a joint arrangement, and/or the expectation that no other parties will provide cash flows until the end of an activity, are not conclusive in determining whether the party has rights to the net assets. That is, it is not conclusive whether the joint arrangement is a joint operation or a joint venture (see Illustration 5-2 below).

Illustration 5-2: Construction and real estate sales

Two parties established a separate vehicle over which they have joint control. Neither the legal form nor the contractual terms of the joint arrangement give the parties rights to the assets or obligations for the liabilities of the arrangement. Other facts and circumstances are as follows:

- The purpose of the joint arrangement is to construct a residential complex for selling residential units to the public.
- Contributed equity by the parties is sufficient to purchase land and raise debt finance from third parties to fund construction.
- Sales proceeds will be used in the following priority:
  - Repayment of external debt
  - Remaining profit distributed to parties

Analysis

Since there is a separate vehicle, and because neither the legal form nor the contractual terms of the joint arrangement give the parties rights to the assets or obligations for the liabilities of the vehicle, the preliminary analysis indicates that this is a joint venture. The fact that the parties are the only source of cash flows at inception does not necessarily indicate that the parties have rights to the assets or obligations for the liabilities. More information is needed and judgement will be required in determining whether this is a joint venture or a joint operation.

Variation

The contributed equity is not sufficient to purchase the land and raise debt financing. There is an expectation or requirement, that the parties will contribute cash to the joint arrangement through a series of cash calls. The fact that the parties are expected to be a source of cash flows is not conclusive that the parties have rights to the assets and/or obligations for the liabilities. More information is needed before concluding whether this is a joint venture or a joint operation.

The above example includes the fact that third party financing is available to fund construction. In March 2015, the IFRS IC considered the effect of third party financing on the classification of a joint arrangement.

Frequently asked questions

Question 5-3: Does financing from a third party prevent a joint arrangement from being classified as a joint operation?

No. The IFRS IC discussed how 'other facts and circumstances' should be applied to specific fact patterns. It subsequently published an agenda decision confirming that, if the cash flows to the joint arrangement from the sale of output to the parties, along with any other funding that the parties are obliged to provide, satisfy the joint arrangement's liabilities, then third party financing alone would not affect the classification of the joint arrangement. This conclusion is appropriate irrespective of whether the financing occurs at inception or during the course of the joint arrangement's operations. The IFRS IC noted that in this situation, "the joint arrangement will, or may, settle some of its liabilities using cash flows from third-party financing, but the resulting obligation to the third-party finance provider will, in due course, be settled using cash flows that the parties are obliged to provide."

5.4.3.B Assessing the obligation to purchase all the output produced by the joint arrangement

If the parties to the joint arrangement are obliged to purchase all the output produced by the joint arrangement, the effect of the arrangement is that, in substance, the liabilities of the joint arrangement are satisfied by the cash flows received from the parties. When the parties are substantially the only source of cash flows contributing to the continuity of the operations of the arrangement, this indicates that the parties have obligations for the liabilities of the arrangement. *[IFRS 11.B32, IFRS 11.B32 Example 5].*

In March 2015, the IFRS IC discussed the following matters related to this assessment.

Frequently asked questions

Question 5-4: Does the fact that the output from the joint arrangement is sold to the parties to the joint arrangement at a market price prevent the joint arrangement from being classified as a joint operation, when assessing other facts and circumstances?

No. The IFRS IC observed that the sale of output from the joint arrangement to the parties at market price, on its own, is not a determinative factor for the classification of the joint arrangement. Instead, the parties would need to exercise judgement and consider whether the cash flows provided to the joint arrangement through the parties' purchase of the output from the joint arrangement at market price, along with any other funding that the parties are obliged to provide, would be sufficient to enable the joint arrangement to settle its liabilities on a continuous basis.

Question 5-5: Does the nature of the output (i.e., fungible versus bespoke or custom) produced by the joint arrangement determine the classification of a joint arrangement when assessing other facts and circumstances?

No. The IFRS IC noted that whether the output that is produced by the joint arrangement and purchased by the parties is fungible or bespoke (or custom), is not a determinative factor for the classification of the joint arrangement. IFRS 11 focuses rather on the existence of cash flows flowing from the parties to satisfy the joint arrangement's liabilities.

5.4.4 Comprehensive example illustrating evaluation of facts and circumstances

Illustration 5-3 below (summarised from Example 5 of IFRS 11) illustrates how the facts and circumstances might indicate that the joint arrangement is a joint operation, even if the legal form and contractual terms point towards the joint arrangement being a joint venture. *[IFRS 11.B32, IFRS 11.B32 Example 5]*.

Illustration 5-3: Modification of legal form and contractual arrangement by facts and circumstances

Companies A and B jointly establish a Corporation C, over which they have joint control. The legal form of C, an incorporated entity, initially indicates that the assets and liabilities held in C are the assets and liabilities of C. The contractual arrangement between the parties does not specify that the parties have rights to the assets or obligations for the liabilities of C. Accordingly, the legal form of C and the terms of the contractual arrangement indicate that the arrangement is a joint venture.

However, A and B agree to the following:

- A and B will purchase all the output produced by C in a ratio of 50:50.
- C cannot sell any of the output to third parties, unless A and B approve this. The purpose of the arrangement is to provide A and B with the output they require, so sales to third parties are expected to be uncommon and not material.
- The price of the output sold to A and B is set by the parties at a level that is designed to cover the costs of production and administrative expenses incurred by C. The arrangement is intended to operate at a break-even level.

Analysis

- The obligation of A and B to purchase all the output produced by C reflects the exclusive dependence of C upon A and B for the generation of cash flows and, thus, implicitly that A and B have an obligation for the liabilities of C.
- The fact that A and B have rights to all the output produced by C means that they are consuming, and therefore have rights to, all the economic benefits of the assets of C.

These facts and circumstances indicate that the arrangement is a joint operation.

Variation 1

If, instead of A and B using their share of the output themselves, they sold their share of the output to third parties, C would still be a joint operation because C remains exclusively dependent on A and B for generation of cash flows.

Variation 2

If A and B changed the terms of the contractual arrangement so that the arrangement was able to sell output to third parties, this would result in C assuming demand, inventory and credit risks, such that A and B would not have substantially all of the economic benefits of C's assets. In this case, it is likely that the joint arrangement would be a joint venture.

5.5 Illustrative examples accompanying IFRS 11

IFRS 11 provides several examples that illustrate aspects of IFRS 11, but are not intended to provide interpretative guidance. The examples portray hypothetical situations illustrating the judgements that might be used when applying IFRS 11 in different situations. *[IFRS 11.IE1]*. Illustration 5-4 to Illustration 5-9 are based on these illustrative examples accompanying IFRS 11. *[IFRS 11.IE2-IE52, IFRS 11.IE Example 1-6]*.

Illustration 5-4: Construction services

Companies A and B (the parties) provide many types of public and private construction services. They set up a contractual arrangement to design and construct a road between two cities for a government. The contractual arrangement determines the participation shares of A and B and establishes joint control of the arrangement, the purpose of which is the delivery of the road.

The parties set up a separate vehicle (Entity Z) through which to conduct the arrangement. On behalf of A and B, Z enters into the contract with the government. In addition, the assets and liabilities relating to the arrangement are held in Z. The main feature of Z's legal form is that the parties, not Z, have rights to the assets, and obligations for the liabilities, of Z.

The contractual arrangement between A and B also establishes that:

(a) The rights to all the assets needed to undertake the activities of the arrangement are shared by the parties based on their participation shares in the arrangement.

(b) The parties have several and joint responsibility for all operating and financial obligations relating to the activities of the arrangement based on their participation shares in the arrangement.

(c) The profit or loss resulting from the activities of the arrangement is shared by A and B based on their participation shares in the arrangement.

For the purposes of coordinating and overseeing the activities, A and B appoint an operator, who will be an employee of one of the parties. After a specified time, the role of the operator will rotate to an employee of the other party. A and B agree that the activities will be executed by the operator's employees on a 'no gain or loss' basis.

In accordance with the terms specified in the contract with the government, Z invoices the construction services to the government on behalf of the parties.

Analysis

The joint arrangement is carried out through a separate vehicle whose legal form does not confer separation between the parties and the separate vehicle (i.e., the assets and liabilities held in Z are the parties' assets and liabilities). This is reinforced by the terms agreed by the parties in their contractual arrangement, which state that A and B have rights to the assets, and obligations for the liabilities, relating to the arrangement that is conducted through Z.

The joint arrangement is a joint operation.

A and B each recognise in their financial statements their share of the assets (e.g., property, plant and equipment (PP&E), accounts receivable) and their share of any liabilities resulting from the arrangement (e.g., accounts payable to third parties) based on their agreed participation share.

Each also recognises its share of the revenue and expenses resulting from the construction services provided to the government through Z.

Illustration 5-5: Shopping centre operated jointly

Two real estate companies (the parties) set up a separate vehicle (Entity X) for acquiring and operating a shopping centre. The contractual arrangement between the parties establishes joint control of the activities that are conducted in X. The main feature of X's legal form is that the entity, not the parties, has rights to the assets, and obligations for the liabilities, relating to the arrangement. The activities include the rental of the retail units, managing the car park, maintaining the centre and its equipment, such as lifts, and building the reputation and customer base for the centre as a whole.

The terms of the contractual arrangement are such that:

(a) X owns the shopping centre. The contractual arrangement does not specify that the parties have rights to the shopping centre.

(b) The parties are not liable in respect of the debts, liabilities or obligations of X. If X is unable to pay any of its debts or other liabilities or to discharge its obligations to third parties, the liability of each party to any third party will be limited to the unpaid amount of that party's capital contribution.

(c) The parties have the right to sell or pledge their interests in X.

(d) Each party receives a share of the income from operating the shopping centre (which is the rental income net of the operating costs) in accordance with its interest in X.

Analysis

The joint arrangement is carried out through a separate vehicle whose legal form causes the separate vehicle to be considered in its own right (i.e., the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and liabilities of the parties). In addition, the terms of the contractual arrangement do not specify that the parties have rights to the assets, or obligations for the liabilities, relating to the arrangement. Instead, the terms of the contractual arrangement establish that the parties have rights to the net assets of X.

Based on the description above, there are no other facts and circumstances that indicate that the parties have rights to substantially all the economic benefits of the assets relating to the arrangement, and that the parties have an obligation for the liabilities relating to the arrangement.

The joint arrangement is a joint venture.

The parties recognise their rights to the net assets of X as investments and account for them under IAS 28.

Illustration 5-6: Joint manufacturing and distribution of a product

Companies A and B (the parties) have set up a strategic and operating agreement (the framework agreement) that sets the terms by which they will conduct the manufacturing and distribution of product P in different markets.

The parties have agreed to conduct manufacturing and distribution activities by establishing joint arrangements, as described below:

(a) Manufacturing activity: the parties have agreed to undertake the manufacturing activity through a joint arrangement (the manufacturing arrangement). The manufacturing arrangement is structured in a separate vehicle (Entity M) whose legal form causes it to be considered in its own right (i.e., the assets and liabilities held in M are the assets and liabilities of M and not the assets and liabilities of the parties). In accordance with the framework agreement, the parties have committed themselves to purchasing the whole production of product P manufactured by the manufacturing arrangement in accordance with their ownership interests in M. The parties subsequently sell product P to another arrangement, jointly controlled by the two parties themselves, that has been established exclusively for the distribution of product P as described below. Neither the framework agreement nor the contractual arrangement between A and B dealing with the manufacturing activity specifies that the parties have rights to the assets, and obligations for the liabilities, relating to the manufacturing activity.

(b) Distribution activity: the parties have agreed to undertake the distribution activity through a joint arrangement (the distribution arrangement). The parties have structured the distribution arrangement in a separate vehicle (Entity D) whose legal form causes it to be considered in its own right (i.e., the assets and liabilities held in D are the assets and liabilities of D and not the assets and liabilities of the parties). In accordance with the framework agreement, the distribution arrangement orders its requirements for product P from the parties according to the needs of the different markets where the distribution arrangement sells the product. Neither the framework agreement nor the contractual arrangement between A and B dealing with the distribution activity specifies that the parties have rights to the assets, and obligations for the liabilities, relating to the distribution activity.

In addition, the framework agreement establishes:

(a) That the manufacturing arrangement will produce product P to meet the requirements for product P that the distribution arrangement places on the parties

(b) The commercial terms relating to the sale of product P by the manufacturing arrangement to the parties. The manufacturing arrangement will sell product P to the parties at a price agreed by A and B that covers all production costs incurred. Subsequently, the parties sell the product to the distribution arrangement at a price agreed by A and B

(c) That any cash shortages that the manufacturing arrangement may incur will be financed by the parties in accordance with their ownership interests in M.

Analysis

The framework agreement sets up the terms under which parties A and B conduct the manufacturing and distribution of product P. These activities are undertaken through joint arrangements whose purpose is either the manufacturing or the distribution of product P.

The parties carry out the manufacturing arrangement through M whose legal form confers separation between the parties and the entity. In addition, neither the framework agreement nor the contractual arrangement dealing with the manufacturing activity specifies that the parties have rights to the assets, and obligations for the liabilities, relating to the manufacturing activity. However, when considering the following facts and circumstances the parties have concluded that the manufacturing arrangement is a joint operation:

(a) The parties have committed themselves to purchasing the whole production of product P manufactured by the manufacturing arrangement. Consequently, A and B have rights to substantially all the economic benefits of the assets of the manufacturing arrangement.

(b) The manufacturing arrangement manufactures product P to meet the quantity and quality needs of the parties so that they can fulfil the demand for product P of the distribution arrangement. The exclusive dependence of the manufacturing arrangement upon the parties for the generation of cash flows and the parties' commitments to provide funds when the manufacturing arrangement incurs any cash shortages indicate that the parties have an obligation for the liabilities of the manufacturing arrangement, because those liabilities will be settled through the parties' purchases of product P or by the parties' direct provision of funds.

The parties carry out the distribution activities through D, whose legal form confers separation between the parties and the entity. In addition, neither the framework agreement nor the contractual arrangement dealing with the distribution activity specifies that the parties have rights to the assets, and obligations for the liabilities, relating to the distribution activity.

There are no other facts and circumstances that indicate that the parties have rights to substantially all the economic benefits of the assets relating to the distribution arrangement or that the parties have an obligation for the liabilities relating to that arrangement.

The distribution arrangement is a joint venture.

A and B each recognise in their financial statements their share of the assets (e.g., PP&E, cash) and their share of any liabilities resulting from the manufacturing arrangement (e.g., accounts payable to third parties) based on their ownership interest in M. Each party also recognises its share of the expenses resulting from the manufacture of product P incurred by the manufacturing arrangement and its share of the revenues relating to the sales of product P to the distribution arrangement.

The parties recognise their rights to the net assets of the distribution arrangement as investments and account for them under IAS 28.

Variation

Assume that the parties agree that the manufacturing arrangement described above is responsible not only for manufacturing product P, but also for its distribution to third party customers.

The parties also agree to set up a distribution arrangement, like the one described above, to distribute product P exclusively to assist in widening the distribution of product P in additional specific markets.

The manufacturing arrangement also sells product P directly to the distribution arrangement. No fixed proportion of the production of the manufacturing arrangement is committed to be purchased by, or to be reserved to, the distribution arrangement.

Analysis

The variation has affected neither the legal form of the separate vehicle in which the manufacturing activity is conducted nor the contractual terms relating to the parties' rights to the assets, and obligations for the liabilities, relating to the manufacturing activity. However, it causes the manufacturing arrangement to be a self-financed arrangement because it can undertake trade on its own behalf, distributing product P to third party customers and, consequently, assuming demand, inventory and credit risks. Even though the manufacturing arrangement might also sell product P to the distribution arrangement, in this scenario the manufacturing arrangement is not dependent on the parties to be able to carry out its activities on a continuous basis.

In this case, the manufacturing arrangement is a joint venture.

The variation has no effect on the classification of the distribution arrangement as a joint venture.

The parties recognise their rights to the net assets of the manufacturing arrangement and their rights to the net assets of the distribution arrangement as investments and account for them under IAS 28.

Illustration 5-7: Bank operated jointly

Banks A and B (the parties) agreed to combine their corporate, investment banking, asset management and services activities by establishing a separate vehicle (Bank C). Both parties expect the arrangement to benefit them in different ways. A believes that the arrangement could enable it to achieve its strategic plans to increase its size, offering an opportunity to exploit its full potential for organic growth through an enlarged offering of products and services. B expects the arrangement to reinforce its offering in financial savings and market products.

The main feature of C's legal form is that it causes the separate vehicle to be considered in its own right (i.e., the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and liabilities of the parties). A and B each have a 40% ownership interest in C, with the remaining 20% being listed and widely held. The shareholders' agreement between A and B establishes joint control of the activities of C. In addition, A and B entered into an irrevocable agreement under which, even in the event of a dispute, both banks agree to provide the necessary funds in equal amount and, if required, jointly and severally, to ensure that C complies with the applicable legislation and banking regulations, and honours any commitments made to the banking authorities. This commitment represents the assumption by each party of 50% of any funds needed to ensure that C complies with legislation and banking regulations.

Analysis

The joint arrangement is carried out through a separate vehicle whose legal form confers separation between the parties and the separate vehicle. The terms of the contractual arrangement do not specify that the parties have rights to the assets, or obligations for the liabilities, of C, but it establishes that the parties have rights to the net assets of C. The commitment by the parties to provide support if C is not able to comply with the applicable legislation and banking regulations is not by itself a determinant that the parties have an obligation for the liabilities of C. There are no other facts and circumstances that indicate that the parties have rights to substantially all the economic benefits of the assets of C and that the parties have an obligation for the liabilities of C.

The joint arrangement is a joint venture.

Both A and B recognise their rights to the net assets of C as investments and account for them under IAS 28.

Illustration 5-8: Oil and gas exploration, development and production activities

Companies A and B (the parties) set up a separate vehicle (Entity H) and a Joint Operating Agreement (JOA) to undertake oil and gas exploration, development and production activities in country O. The main feature of H's legal form is that it causes the separate vehicle to be considered in its own right (i.e., the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and liabilities of the parties).

Country O has granted H permits for the oil and gas exploration, development and production activities to be undertaken in a specific assigned block of land (fields).

The shareholders' agreement and JOA agreed by the parties establish their rights and obligations relating to those activities. The main terms of those agreements are summarised below.

Shareholders' agreement

The board of H consists of a director from each party. Each party has a 50% shareholding in H. The unanimous consent of the directors is required for any resolution to be passed.

Joint Operating Agreement (JOA)

The JOA establishes an Operating Committee. This Committee consists of one representative from each party. Each party has a 50% participating interest in the Operating Committee.

The Operating Committee approves the budgets and work programmes relating to the activities, which also require the unanimous consent of the representatives of each party. One of the parties is appointed as operator and is responsible for managing and conducting the approved work programmes.

The JOA specifies that the rights and obligations arising from the exploration, development and production activities are shared among the parties in proportion to each party's shareholding in H. In particular, the JOA establishes that the parties share:

(a) The rights and the obligations arising from the exploration and development permits granted to H (e.g., the permits, rehabilitation liabilities, any royalties and taxes payable)

(b) The production obtained

(c) All costs associated with all work programmes

The costs incurred in relation to all the work programmes are covered by cash calls on the parties. If either party fails to satisfy its monetary obligations, the other is required to contribute to H the amount in default. The amount in default is regarded as a debt owed by the defaulting party to the other party.

Analysis

The parties carry out the joint arrangement through a separate vehicle whose legal form confers separation between the parties and the separate vehicle. The parties reversed the initial assessment of their rights and obligations arising from the legal form of the separate vehicle in which the arrangement is conducted. They have done this by agreeing terms in the JOA that entitle them to rights to the assets (e.g., exploration and development permits, production, and any other assets arising from the activities) and obligations for the liabilities (e.g., all costs and obligations arising from the work programmes) that are held in H.

The joint arrangement is a joint operation.

Both A and B recognise in their financial statements their own share of the assets and of any liabilities resulting from the arrangement based on their agreed participating interest. On that basis, each party also recognises its share of the revenue (from the sale of their share of the production) and its share of the expenses.

Illustration 5-9: Liquefied natural gas arrangement

Company A owns an undeveloped gas field that contains substantial gas resources. Company A determines that the gas field will be economically viable only if the gas is sold to customers in overseas markets. To do so, a liquefied natural gas (LNG) facility must be built to liquefy the gas so that it can be transported by ship to the overseas markets.

A enters into a joint arrangement with Company B to develop and operate the gas field and the LNG facility. Under that arrangement, A and B (the parties) agree to contribute the gas field and cash, respectively, to a new separate vehicle, C. In exchange for those contributions, the parties each take a 50% ownership interest in C. The main feature of C's legal form is that it causes the separate vehicle to be considered in its own right (i.e., the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and liabilities of the parties).

The contractual arrangement between the parties specifies that:

(a) A and B must each appoint two members to the board of C. The board of directors must unanimously agree the strategy and investments made by C.

(b) Day-to-day management of the gas field and LNG facility, including development and construction activities, will be undertaken by the staff of B in accordance with the directions jointly agreed by the parties. C will reimburse B for the costs it incurs in managing the gas field and LNG facility.

(c) C is liable for taxes and royalties on the production and sale of LNG as well as for other liabilities incurred in the ordinary course of business, such as accounts payable, site restoration and decommissioning liabilities.

(d) A and B have equal shares in the profit from the activities carried out in the arrangement and are entitled to equal shares of any dividends distributed by C.

The contractual arrangement does not specify that either party has rights to the assets, or obligations for the liabilities, of C.

The board of C decides to enter into a financing arrangement with a syndicate of lenders to help fund the development of the gas field and construction of the LNG facility. The estimated total cost of the development and construction is CU1,000m.

The lending syndicate provides C with a CU700m loan. The arrangement specifies that the syndicate has recourse to A and B only if C defaults on the loan arrangement during the development of the field and construction of the LNG facility. The lending syndicate agrees that it will not have recourse to A and B once the LNG facility is in production because it has assessed that the cash inflows that C should generate from LNG sales will be sufficient to meet the loan repayments. Although at this time the lenders have no recourse to A and B, the syndicate maintains protection against default by C by taking a lien on the LNG facility.

Analysis

The joint arrangement is carried out through a separate vehicle whose legal form confers separation between the parties and the separate vehicle. The terms of the contractual arrangement do not specify that the parties have rights to the assets, or obligations for the liabilities, of C, instead they establish that the parties have rights to the net assets of C. The recourse nature of the financing arrangement during the development of the gas field and construction of the LNG facility (i.e., A and B providing separate guarantees during this phase) does not, by itself, impose on the parties an obligation for the liabilities of C (i.e., the loan is a liability of C). A and B have separate liabilities, which are their guarantees to repay that loan if C defaults during the development and construction phase.

There are no other facts and circumstances that indicate that the parties have rights to substantially all the economic benefits of the assets of C and that the parties have an obligation for the liabilities of C.

The joint arrangement is a joint venture. The parties recognise their rights to the net assets of entity C as investments and account for them under IAS 28.

6 Accounting for joint operations

Extract from IFRS 11

20 A joint operator shall recognise in relation to its interest in a joint operation:

(a) its assets, including its share of any assets held jointly;

(b) its liabilities, including its share of any liabilities incurred jointly;

(c) its revenue from the sale of its share of the output arising from the joint operation;

(d) its share of the revenue from the sale of the output by the joint operation; and

(e) its expenses, including its share of any expenses incurred jointly.

IFRS 11 requires each of these items to be accounted for in accordance with the applicable IFRS accounting standard. *[IFRS 11.20, IFRS 11.21]*. Careful consideration must be given to the nature of the rights to the assets, and the obligations for the liabilities (or the share of assets, liabilities, revenues, and expenses) if any, of the joint operation (see section 6.3 below).

6.1 Joint arrangements not structured through a separate vehicle

For joint arrangements not structured through a separate vehicle, the contractual arrangement establishes the parties' rights to the assets, and obligations for the liabilities, relating to the arrangement, and the parties' rights to the corresponding revenues and obligations for the corresponding expenses. *[IFRS 11.B16]*.

A contractual arrangement often describes the nature of the activities that are the subject of the arrangement and how the parties intend to undertake those activities together. For example, the parties could conduct an activity together, with each party being responsible for a specific task and each using its own assets and incurring its own liabilities and the parties share revenues and expenses. In such a case, each joint operator recognises in its financial statements the assets and liabilities used for the specific task and recognises its share of the revenues and expenses in accordance with the contractual arrangement. *[IFRS 11.B17]*. When the parties agree, for example, to share and operate an asset together and share the output or revenue from the asset and operating costs, each joint operator accounts for its share of the joint asset, its agreed share of any liabilities, and of the output, revenues and expenses in accordance with the contractual arrangement. *[IFRS 11.B18]*.

6.2 Accounting for rights and obligations

An entity's rights and obligations for the assets, liabilities, revenues and expenses relating to a joint operation as specified in the contractual arrangement are the basis for accounting for a joint operation under IFRS 11. This might differ from its ownership interest in the joint operation. *[IFRS 11.BC38]*.

When the joint operator has differing rights (and percentages) to various assets, and/or differing obligations for various liabilities, these are reflected in its financial statements even when those rights and obligations differ from the joint operator's proportion of equity ownership. Illustration 6-1 below illustrates joint operation accounting in this case.

Illustration 6-1: Accounting for rights to assets and obligations for liabilities

Entities D and E establish Joint Arrangement F, using a separate vehicle, classified as a joint operation. Accordingly, D and E account for their rights to assets and their obligations for liabilities relating to F in accordance with the relevant IFRS accounting standard.

D and E each own 50% of the equity (e.g., shares) in F. However, the contractual terms of the joint arrangement state that D has the rights to all of Building No. 1 and the obligation to pay all the third party debt in F. D and E have rights to all other assets in F, and obligations for all other liabilities in F in proportion to their equity interests (i.e., 50%). F's balance sheet is as follows (in CUs):

Assets		Liabilities and equity	
Cash	20	Debt	120
Building No. 1	120	Employee benefit plan obligation	50
Building No. 2	100	Equity	70
Total assets	240	**Total liabilities and equity**	240

Under IFRS 11, D records the following in its financial statements, to account for its rights to the assets in F and its obligations for the liabilities in F. This differs from consolidating a blended percentage of all assets and liabilities or using the equity ownership percentages.

Assets		Liabilities and equity	
Cash	10	Debt (2)	120
Building No. 1 (1)	120	Employee benefit plan obligation	25
Building No. 2	50	Equity	35
Total assets	**180**	**Total liabilities and equity**	**180**

(1) Since D has the rights to all of Building No. 1, it records that amount in its entirety.
(2) D's obligations are for the third party debt in its entirety.

6.3 Determining the relevant IFRS accounting standard

As noted in section 6 above, joint operators are required to recognise their rights to assets and their obligations for liabilities in accordance with the relevant IFRS accounting standard. In some cases, the relevant IFRS accounting standard is clear, but questions have arisen in other cases.

6.3.1 Right of use

The illustrative examples of joint operations in IFRS 11 refer to recognising the joint operator's share of assets, such as PP&E, accounts receivable and cash, rather than recognising a 'right of use'. *[IFRS 11.IE8, IFRS 11.IE21]*. Therefore, a joint operator recognises its share of an asset in accordance with IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*, as applicable. When the contractual terms of the joint operation provide a joint operator with a right to use an asset, not a share of the asset itself, the joint operator applies IFRS 16 *Leases* (see Chapter 24).

6.3.2 Liability for entire balance of certain liabilities

One of the joint operators might have obligations for the entire balance of certain liabilities of the joint operation. It might also have a right to reimbursement from the other parties for their share of that liability of the joint operation. The joint operator recognises 100% of the joint operation's liabilities and a receivable for the reimbursement due from the other parties for their share of the liability.
IFRS accounting standards prohibit the offsetting of the liability against the receivable. If the other parties were unable to pay, the joint operator would not be able to recognise a receivable for the full amount due. Accordingly, the receivable would be impaired, which would result in a reduction in profit in the joint operator's financial statements.
This principle was emphasised in March 2019 when the IFRS IC finalised an agenda decision[13] dealing with liabilities in relation to a joint operator's interest in a joint operation. In the fact pattern described in the request, the joint operation is not structured through a separate vehicle. One of the joint operators, as the sole signatory, enters into a lease contract with a third party lessor for an item of PP&E that will be operated jointly as part of the joint operation's activities. The joint operator that signed the lease contract has the right to recover a share of the lease costs from the other joint operators in accordance with the contractual arrangement to the joint operation. The request asked about the recognition of liabilities by the joint operator that signed the lease agreement. In relation to its interest in a joint operation, a joint operator recognises its liabilities, including its share of any liabilities incurred jointly. *[IFRS 11.20(b)]*. Accordingly, a joint operator identifies and recognises both:

- Liabilities it incurs in relation to its interest in the joint operation
- Its share of any liabilities incurred jointly with other parties to the joint arrangement

Identifying the liabilities that a joint operator incurs and those incurred jointly requires an assessment of the terms and conditions in all contractual agreements that relate to the joint operation, including consideration of the laws pertaining to those agreements. The IFRS IC observed that the liabilities a joint operator recognises include those for which it has primary responsibility. Based on this agenda decision, the joint operator that is the sole signatory of the lease agreement recognises the full lease liability and corresponding right-of-use asset in its financial statements. The agenda decision did not address how the joint operator accounts for its right to recover a share of the lease costs from the other joint operators in accordance with the contractual arrangement to the joint operation. The joint operator assesses the relevant IFRS accounting standard to apply to this right, for example, whether it represents a sub-lease of the right-of-use asset to the other joint operators.

13 *IFRIC Update*, March 2019, available on the IFRS Foundation's website.

6.3.3 Jointly and severally liable

In some cases, the joint arrangement (or legal form of the separate vehicle, if applicable) gives joint and several liability for the obligations of the arrangement. That is, an entity is not only responsible for its proportionate share, but it is also liable for the other party's or parties' share(s) should it/they be unable or unwilling to pay. In this scenario, each party not only takes up its proportionate share of the decommissioning/restoration obligation, they are also required to assess the likelihood that the other party (or parties) will not be able or willing to meet their obligation for their share. The facts and circumstances are assessed in each case and the liability accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. This can result in the joint operator recognising the entire obligation due, not just its share of the obligation.

6.3.4 Obligation to reimburse other parties

A party to the joint arrangement that has an obligation to reimburse another party recognises a financial liability for the amount related to the reimbursement.

6.3.5 Sales to other joint operators

A joint operator might receive income from sales to another joint operator (or operators) for providing goods or services to the other joint operator(s).

If a joint operator provides goods or services to another joint operator, it assesses whether a vendor/customer relationship exists. IFRS 15 *Revenue from Contracts with Customers* explains that a contract with a collaborator or a partner in a joint arrangement could also be within the scope of IFRS 15 if that collaborator or partner meets the definition of a customer for some or all of the terms of the arrangement. *[IFRS 15.BC55]*. Therefore, judgement is applied to determine whether the income is in the scope of IFRS 15, depending on the facts and circumstances, and if not, which IFRS accounting standard applies. That is, the existence of a joint operation does not remove the need to determine whether IFRS 15 applies to an element of a contract that includes a joint arrangement.

6.3.6 Sales by a joint operation to a joint operator

A joint operation might have sales to the joint operator for providing output to the joint operator. This scenario can raise the question as to whether the joint operator should recognise revenue for its share of the following:

- The joint operator's revenue on the output that it has received from the joint operation
- The output that it has not yet received, but is entitled to under the terms of the joint arrangement

Regarding the first question, in March 2015, the IFRS IC published an agenda decision[14] that addressed the issue of revenue recognition by a joint operator. If a joint arrangement is structured through a separate vehicle, classified as a joint operation, the joint operators' purchase of all the output from the joint operation is in effect a sale to themselves. The IFRS IC stated that a joint operator recognises its share of the joint operation's revenue only when the joint operation sells its output to third parties (i.e., parties that are not investors in the joint operation), see section 6.6 below. *[IFRS 11.20(d)]*.

Regarding the second question, in March 2019, the IFRS IC finalised an agenda decision[15] dealing with the recognition of revenue by a joint operator for output arising from a joint operation when the output it receives in a reporting period is different from the output to which it is entitled. This is commonly known in the oil and gas industry as an over-lift or under-lift (see Chapter 39 at section 12.4).

In the fact pattern described in the request, the joint operator has the right to receive a fixed proportion of the output arising from the joint operation and is obliged to pay for a fixed proportion of the production costs incurred. For operational reasons, the output received by the joint operator and transferred to its customers in a particular reporting period is different from the output to which it is entitled. That difference will be settled through future deliveries of output arising from the joint operation, it cannot be settled in cash. Applying IFRS 15, the joint operator recognises revenue as a principal for the transfer of all the output to its customers.

14 *IFRIC Update*, March 2015, available on the IFRS Foundation's website.

15 *IFRIC Update*, March 2019, available on the IFRS Foundation's website.

A joint operator recognises its revenue from the sale of its share of the output arising from the joint operation. *[IFRS 11.20(c)]*. Therefore, the IFRS IC concluded that, in the fact pattern described in the request, the joint operator recognises revenue that depicts only the transfer of output to its customers in each reporting period, i.e., revenue recognised applying IFRS 15. The joint operator does not recognise revenue for the output to which it is entitled but which it has not received from the joint operation and sold.

The agenda decision did not address the cost of goods sold and hence diversity in practice will continue in this respect. See Chapter 39 at section 12.4.2 and Chapter 28, Question 2-12 at section 2.5 for more detail.

6.4 Interest in a joint arrangement without joint control

A party without joint control (see section 4 above) is not a joint operator. However, if that party has rights to assets and obligations for liabilities, the accounting is the same as that for a joint operator, as discussed at section 6 above. *[IFRS 11.23]*.

If the party without joint control does not have rights to the assets and obligations for the liabilities relating to the joint operation, it accounts for its interest in the joint operation in accordance with other applicable IFRS accounting standards. *[IFRS 11.23]*. For example, if it has an interest in:

(a) A separate vehicle over which it has significant influence, it applies IAS 28

(b) A separate vehicle over which it does not have significant influence, the interest is a financial asset under IFRS 9

Or

(c) An arrangement without a separate vehicle, it applies other applicable IFRS accounting standards (see section 4.4.1 above)

The disclosure requirements of IFRS 12 are discussed in Chapter 14 at section 5.

6.5 Joint operation with a party without joint control

When a joint operation conducted through a separate vehicle involves a party without joint control (see sections 4 and 6.4 above), each joint operator recognises its share of any assets held jointly and its obligations for its share of any liabilities incurred jointly. A joint operator does not recognise the rights to assets and obligations for the liabilities attributable to the party that does not have joint control nor does it recognise a higher percentage with a 'non-controlling interest'. Illustration 6-2 below illustrates this point.

Illustration 6-2: Joint operation with a party without joint control

Entities A and B enter into a joint operation that is structured through a separate vehicle Z. Each of the two entities owns 40% of the shares of the separate vehicle. The remaining 20% of Z is owned by C, which participates in the joint arrangement but does not have joint control. C has rights to the assets and obligations for the liabilities of Z.

Accordingly, A, B and C (see sections 6 and 6.4 above) recognise their assets, including their share of any assets held jointly, and their liabilities, including their share of any liabilities incurred jointly, in accordance with relevant IFRS accounting standards.

In A's financial statements, it recognises its assets, liabilities, revenues and expenses in Z, which is 40% of Z's assets, liabilities, revenues and expenses, in accordance with the relevant IFRS accounting standard. A does not recognise a 'non-controlling interest' related to C's interest in Z.

6.6 Transactions between a joint operator and a joint operation

IFRS 11 addresses transactions such as the sale, contribution or purchase of assets between a joint operator and a joint operation. *[IFRS 11.22]*.

When a joint operator enters into a transaction with its joint operation, such as a sale or contribution of assets to the joint operation, the joint operator is transacting with the other parties to the joint operation. The joint operator recognises gains and losses resulting from the transaction only to the extent of the other parties' interests in the joint operation. *[IFRS 11.B34]*.

When a joint operator sells to its joint operation, it does not recognise revenue for the portion that is effectively sold to itself (see IFRS IC's discussions referred to below and at section 6.3.6 above). The joint operator applies IFRS 15 to assess whether revenue is recognised for the portion effectively sold to the other parties to the joint operation. *[IFRS 11.BC55]*.

However, when these transactions provide evidence of a reduction in the net realisable value of the assets to be sold or contributed to the joint operation, or of an impairment loss of those assets, those losses are recognised fully by the joint operator. *[IFRS 11.B35]*.

When a joint operator enters into a transaction with its joint operation, such as a purchase of assets from the joint operation, it does not recognise its share of the gains and losses until the it resells those assets to a third party. *[IFRS 11.B36]*.

However, when these transactions provide evidence of a reduction in the net realisable value of the assets to be purchased, or of an impairment loss of those assets, a joint operator recognises its share of those losses. *[IFRS 11.B37]*.

When there is a transaction between a joint operator and a joint operation, consideration is given to whether the transaction changes the nature of the joint operator's rights to assets or obligations for liabilities. Any such change is reflected in the joint operator's financial statements and the new assets and liabilities are accounted for in accordance with the relevant IFRS accounting standard.

As described at 6.3.6 above, in March 2015, the IFRS IC published an agenda decision[16] on the recognition of revenue by a joint operator in relation to output purchased from the joint operation. The sale of output by the joint operation to the joint operator would mean selling to itself and therefore, the joint operator does not recognise a share of the revenue from the sale of that output by the joint operation.

6.7 Accounting for a joint operation in separate financial statements

In the separate financial statements, both a joint operator and a party without joint control (see section 6.4 above) account for their interests in the same manner as accounting for a joint operation in consolidated financial statements. Regardless of whether the joint operation is structured through a separate vehicle, the party recognises in its separate financial statements:

- Assets, including its share of any assets held jointly
- Liabilities, including its share of any liabilities incurred jointly
- Revenue from the sale of its share of the output arising from the joint operation
- Its share of the revenue from the sale of the output by the joint operation

  And
- Expenses, including its share of any expenses incurred jointly *[IFRS 11.26(a), IFRS 11.27(a)]*

The guidance in sections 6 to 6.6 above also applies to accounting for joint operations in separate financial statements.

16 *IFRIC Update*, March 2015, available on the IFRS Foundation's website.

7 Accounting for joint ventures

Extract from IFRS 11

24 **A joint venturer shall recognise its interest in a joint venture as an investment and shall account for that investment using the equity method in accordance with IAS 28 *Investments in Associates and Joint Ventures* unless the entity is exempted from applying the equity method as specified in that standard.**

[IFRS 11.24].

A joint venturer accounts for its interest in a joint venture in accordance with IAS 28, applying the equity method unless an exemption in IAS 28 applies. *[IFRS 11.24]*. IFRS 11 does not describe how to apply the equity method. The requirements of IAS 28, including the accounting for transactions between a joint venturer and its joint venture, are discussed in Chapter 12.

As discussed in section 2.2.1 above, venture capital organisations, mutual funds, unit trusts and similar entities, including investment-linked insurance funds, can choose to measure investments in joint ventures at fair value or apply the equity method under IAS 28. This is a measurement exemption under IFRS 11 and IAS 28 (see Chapter 12 at section 3.3). Such entities remain subject to the disclosure requirements for joint ventures set out in IFRS 12 (see Chapter 14 at section 5).

Although the exemption in IAS 28 is optional for venture capital organisations and similar entities, IFRS 10 requires an 'investment entity' (as defined in IFRS 10) to elect the exemption from applying the equity method in IAS 28 for its investments in associates and joint ventures. *[IFRS 10.B85L(b)]*.

7.1 Interest in a joint venture without joint control

IAS 28 applies when a party has significant influence over an entity, including when a party participates in a joint venture without having joint control (see section 6.4 above). *[IFRS 11.25]*.

However, if the joint venture is structured through a separate vehicle that is **not** an entity (see section 5.1 above), IAS 28 does not apply and the investor applies the relevant IFRS accounting standard.

An investor in a joint venture that has neither joint control nor significant influence accounts for its interest as a financial asset under IFRS 9. *[IFRS 11.25]*.

7.2 Contributions of non-monetary assets to a joint venture

When an entity contributes a non-monetary asset or liability to a joint venture in exchange for an equity interest in the joint venture, it recognises the portion of the gain or loss attributable to the other parties to the joint venture except when the contribution lacks commercial substance. This is discussed in more detail in Chapter 12 at section 7.5.

When the contributed non-monetary asset is a subsidiary of an entity, a conflict arises between the requirements of IAS 28 and IFRS 10. This is discussed in Chapter 12 at section 6.2.2 and in section 8.2.3 below.

7.3 Accounting for a joint venture in separate financial statements

In its separate financial statements, a joint venturer accounts for its interest in the joint venture at cost, as a financial asset under IFRS 9 or under the equity method. *[IFRS 11.26(b), IAS 27.10]*. The requirements for separate financial statements are discussed in Chapter 9 at section 2.

In its separate financial statements, a party without joint control of a joint venture (see section 6.4 above) accounts for its interest as a financial asset under IFRS 9, unless it has significant influence over the joint venture. *[IFRS 11.27(b)]*. In this case, the joint venture is accounted for either at cost, as a financial asset under IFRS 9 or using the equity method. *[IAS 27.10]*.

However, if an entity elects in accordance with IAS 28 to measure its investments in associates or joint ventures at fair value through profit or loss in accordance with IFRS 9, it also accounts for those investments in the same way in its separate financial statements. *[IAS 27.11]*.

7.4 Accounting by the joint venture in its financial statements

In its financial statements, the joint venture accounts for its activities using the applicable IFRS accounting standard.

If a non-monetary asset is contributed by an investor (see section 7.2 above), the measurement of that asset depends on the method of settlement. When the consideration given by the joint venture is its own shares, the transaction is an equity-settled share-based payment transaction in the scope of IFRS 2 *Share-based Payment*. As a result, the joint venture measures the non-monetary asset received at its fair value. When the consideration given by the joint venture is not its own shares, the transaction is outside the scope of IFRS 2.

How we see it

When the transaction is outside the scope of IFRS 2, we believe the joint venture measures the non-monetary asset received at its cost, which is the fair value of the consideration given. In the rare cases when the fair value of the asset received by the joint venture does not equal the fair value of the consideration given (whether cash or shares), an assessment of all facts and circumstances is needed to determine whether it is appropriate to recognise a capital contribution or whether other accounting applies. These facts and circumstances include the actions and obligations of the other venturers, other services provided by the venturer, future rebates on delivery of goods and relationships between the venturers.

8 Continuous assessment

IFRS 11 incorporates the notion of continuous assessment, consistent with the requirements in IFRS 10. *[IFRS 11.13, IFRS 11.19]*.

Extract from IFRS 11	
13	If facts and circumstances change, an entity shall reassess whether it still has joint control of the arrangement.
19	If facts and circumstances change, an entity shall reassess whether the type of joint arrangement in which it is involved has changed.

8.1 When to reassess under IFRS 11

A party reassesses whether it has joint control and whether the classification of the joint arrangement has changed whenever facts and circumstances change. *[IFRS 11.13, IFRS 11.19]*.

Reassessment of a joint arrangement occurs upon a change in:

- Ownership - For example, Company A has a 50% interest in a joint venture over which it has joint control and purchases an additional 20% interest. Reassessment would be required to evaluate whether A now controls the joint venture.
- How activities are directed - For example, Company A sets up Company Z to develop a new product or technology. Initially, Z had a Board of Directors elected by shareholders, separate management and the relevant activities were directed by voting rights held exclusively by A. If A enters into an agreement with Company B so that A and B must agree on all decisions (e.g., they replace the Board and make decisions for management), reassessment would be required to evaluate whether A and B have joint control of Z.
- Legal form - For example, a separate vehicle that initially did not confer separation between the parties and the vehicle (e.g., a general partnership) and was considered a joint operation, is converted into a separate vehicle that now does confer separation between the parties and the vehicle (e.g., a corporation). Reassessment would be required to evaluate whether this indicates a change in classification from a joint operation to a joint venture.
- Contractual terms - For example, the terms of a joint arrangement are renegotiated such that the parties have rights to the assets or obligations for the liabilities. Reassessment would be required to evaluate whether this indicates a change in classification to a joint operation.
- Other facts and circumstances - For example, the terms and conditions of a joint operation are renegotiated such that a joint arrangement can sell output to third party customers, where previously sales were permitted only to the parties of the joint arrangement. Reassessment would be required to evaluate whether this indicates a change in classification from a joint operation to a joint venture.

As discussed in section 5.3.1 above, another event that might trigger reassessment would be an event that leads a guarantor to have to pay (or perform) under a guarantee.

8.1.1 Changes in classification

The accounting for changes in classification of a joint arrangement depends firstly on whether the underlying assets and liabilities constitute a 'business' as defined in IFRS 3. Secondly, it depends on the type of interest held before and after the change in classification occurred. Finally, it depends on whether the change in classification is results from a change in ownership interest or other factors.

The matrix below provides a reference for additional guidance when there is a change in ownership interest and the assets and liabilities meet the definition of a business. It contains references to general guidance that is useful to consider when assessing the accounting for the transaction concerned. However, there are several permutations possible for each transaction depending on the facts and circumstances and the nature of the investor's interest before and after the transaction. Therefore, the matrix is not intended to serve as a comprehensive accounting analysis. The key questions that arise on these transactions are:

- Is a cost-based approach or a fair value (IFRS 3) approach being used?
- Is any previously held (retained) interest remeasured?
- Is a profit on sale recognised and, if so, how is it measured?

Matrix of transactions involving changes of ownership interest in a joint arrangement that is a business

To: From:	Financial asset	Associate or joint venture (equity accounted)	Joint operation	Subsidiary
Financial asset	Not applicable to joint arrangements	IFRS accounting standards not clear See section 8.2.5 below and Chapter 12 at section 6.2.3	IFRS accounting standards not clear See sections 8.3.1 and 8.3.4.A below	Not applicable to joint arrangements
Associate or joint venture (equity accounted)	IAS 28 and IFRS 9 See section 8.2.5 below and Chapter 12 at section 9.3	IAS 28 See section 8.2.4 below and Chapter 12 at sections 6.2.4, 6.2.5, 9.4 and 9.5	IFRS accounting standards not clear See sections 8.3.1 and 8.3.4.A below	IFRS 3 and IAS 28 See section 8.2.2 below, Chapter 12 at section 9.1 and Chapter 10 at section 9
Joint operation	IFRS accounting standards not clear See section 8.3.4.A below		IFRS accounting standards not clear See sections 8.3.1 and 8.5.2 below	See section 8.3.2 below
Subsidiary	Not applicable to joint arrangements	IFRS 10 and IAS 28 See section 8.2.3 below, Chapter 12 at section 6.2.2 and Chapter 8 at section 3.3.2	IFRS accounting standards not clear See section 8.3.3 below and Chapter 8 at section 3.3.3	Not applicable to joint arrangements

In sections 8.2 and 8.3 below, we discuss changes in ownership in joint ventures and joint operations that constitute a business, respectively.

When there is a change in:

- Ownership interest in a joint arrangement that is not a business, see section 8.4 below
- Classification arising from circumstances other than a change in ownership interests, see section 8.5 below

8.2 Changes in ownership of a joint venture that constitutes a business

8.2.1 Acquisition of an interest in a joint venture

The acquisition of an interest in a joint venture that meets the definition of a business is accounted for under IAS 28 (see Chapter 12 at section 6.2) and the procedures are similar to those applied to the acquisition of a business in IFRS 3.

However, the formation of a joint venture that constitutes a business, in the financial statements of the joint venture itself, is outside the scope of IFRS 3. *[IFRS 3.2(a)]*.

8.2.2 Gaining control over a former joint venture

If an entity gains control over a former joint venture, and the acquisition meets the definition of a business combination, the entity applies IFRS 3 (see Chapter 10 at section 9).

8.2.3 Former subsidiary becomes a joint venture

Under IFRS 10, if a parent entity loses control of a subsidiary that constitutes a business in a transaction that is not a downstream transaction (i.e., one between the investor and its joint venture), the retained interest is remeasured at its fair value and this fair value becomes the cost on initial recognition of an investment in the joint venture. *[IFRS 10.25]*. IFRS 10 requires any gain or loss on loss of control of the subsidiary to be recognised in full. IAS 28 applies to downstream transactions between an investor and its joint venture. IAS 28 requires an investor to restrict any gain arising on disposal of its own assets to the amount attributable to the other party to the joint venture (see section 7.2 above). That is, IAS 28 requires partial gain recognition. Therefore, when a former subsidiary becomes a joint venture through a downstream transaction, these requirements in IFRS 10 and IAS 28 conflict. This is discussed in greater detail in Chapter 12 at section 6.2.2 and Chapter 8 at section 3.3.2.A.

In September 2014, the IASB issued *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (amendments to IFRS 10 and IAS 28) to address the conflict between IFRS 10 and IAS 28.[17] The amendments state that:

- Partial gain or loss recognition for transactions between an investor and its associate or joint venture applies only to a gain or loss resulting from the sale or contribution of assets that do not constitute a business as defined in IFRS 3.
- The gain or loss resulting from the sale or contribution of assets that constitute a business as defined in IFRS 3, between an investor and its associate or joint venture is recognised in full.

In December 2015, the IASB deferred the effective date of these amendments indefinitely due to feedback that the recognition of a partial gain or loss when a transaction involves assets that do not constitute a business, even if these assets are housed in a subsidiary, is inconsistent with the initial measurement requirements of IAS 28. This matter is discussed in more detail in Chapter 12 at section 6.2.2 including illustrations of the different approaches.

8.2.4 Joint venture becomes an associate (or *vice versa*)

A joint venturer that loses joint control but retains an interest in an associate continues to apply the equity method. An entity does not remeasure its retained interest in an associate when it loses joint control over a joint venture. The same applies when an entity gains joint control over an associate that becomes an investment in a joint venture. *[IAS 28.24]*. While the nature of the investor-investee relationship changes upon changing from joint venture to associate (or *vice versa*), since the investment continues to be accounted for using the equity method (i.e., there is no change in the measurement requirements) and there is no change in the group, it is not an event that warrants remeasurement of the retained interest at fair value. *[IAS 28.BC30]*.

If an entity's ownership interest in an associate or a joint venture is reduced, but the equity method continues to be applied, a gain or loss is recognised on partial disposal. This is discussed in more detail in Chapter 12 at section 9.5.

8.2.5 Joint venture becomes a financial asset (or *vice versa*)

If a joint venture becomes a financial asset, the measurement method changes. An entity measures its retained interest in the financial asset at fair value, which becomes its fair value on initial recognition as a financial asset.

The entity recognises in profit or loss any difference between:

(a) The fair value of any retained interest and any proceeds from disposing of a part interest in the joint venture
And

(b) The carrying amount of the interest in the joint venture at the date the equity method was discontinued

If a gain or loss previously recognised by the entity in OCI would be reclassified to profit or loss on the disposal of the related assets or liabilities, IAS 28 requires the entity to reclassify the gain or loss from equity to profit or loss when the equity method is discontinued. For example, gains and losses related to foreign currency translation adjustments accumulated in equity would be reclassified to profit or loss. *[IAS 28.22, IAS 28.23]*. This is also discussed in Chapter 12 at section 9.3.

When a financial asset becomes a joint venture, IAS 28 is unclear how to account for the step acquisition of a joint venture. This is discussed in Chapter 12 at section 6.2.3.

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17 *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture (amendments to IFRS 10 and IAS 28)*, IASB, September 2014.

8.2.6 Disposal of its interest in a joint venture

When an entity disposes of its interest in a joint venture and loses joint control, it ceases to apply the equity method as of that date. It also derecognises its interest and recognises any gain or loss upon sale, as discussed in section 8.2.5 above. *[IAS 28.22, IAS 28.23]*. The entity uses the equity method up to the date that the joint venturer disposes of its interest in the joint venture. I.e., it does not restate its financial statements for the period (or the comparative period) as if it did not have joint control during the reporting period.

8.2.7 Interest in a joint venture held for sale

When a joint venturer plans to dispose of all or part of its interest in a joint venture, it applies IFRS 5 (see Chapter 5). The joint venturer continues to account for the retained interest in the joint venture (if any) using the equity method until the disposal of the interest classified as held for sale occurs. This is because an entity continues to have joint control over its entire interest in the joint venture until it disposes of that interest. Upon disposal, it reassesses the nature of any retained interest and accounts for that interest accordingly (e.g., as a financial asset if joint control is lost). *[IAS 28.20]*.

If an interest (or a portion of an interest) in a joint venture no longer meets the criteria to be classified as held for sale, the interest is accounted for using the equity method retrospectively from the date of its classification as held for sale. *[IAS 28.21]*.

These requirements are also discussed in Chapter 12 at section 4.

8.3 Changes in ownership of a joint operation that is a business

8.3.1 Acquisition of an interest in a joint operation

An entity that acquires an interest in a joint operation that is a business as defined in IFRS 3 is required to apply, to the extent of its share, the principles of IFRS 3 and other IFRS accounting standards that do not conflict with IFRS 11, which include:

(a) Measuring identifiable assets and liabilities at fair value, other than items for which exceptions are given in IFRS 3 and other IFRS accounting standards

(b) Recognising acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with the exception that the costs to issue debt or equity securities are recognised in accordance with IAS 32 *Financial Instruments: Presentation* and IFRS 9

(c) Recognising deferred tax assets and deferred tax liabilities that arise from the initial recognition of assets or liabilities, except for deferred tax liabilities that arise from the initial recognition of goodwill

(d) Recognising as goodwill (or negative goodwill) any excess (or shortfall) of the consideration transferred over the net amount of identifiable assets acquired and the liabilities assumed

(e) Testing for impairment a cash-generating unit to which goodwill has been allocated at least annually and whenever there is an indication that the unit might be impaired, as required by IAS 36 *Impairment of Assets*. *[IFRS 11.B33A]*.

In addition, the entity discloses the information that is required in those IFRS accounting standards in relation to business combinations.

Although the acquisition of an interest in a joint operation does not meet the definition of a business combination in IFRS 3, the IASB concluded that this was the most appropriate approach to account for an acquisition of an interest in a joint operation whose activity meets the definition of a business, as defined in IFRS 3. *[IFRS 11.BC45E, IFRS 11.BC45F]*.

The above approach also applies to the formation of a joint operation, but only if an existing business (as defined in IFRS 3) is contributed by one of the parties that participates in the joint operation. In other words, the above approach is not applied if the parties that participate in the joint operation contribute only (groups of) assets that do not constitute businesses to the joint operation on its formation. *[IFRS 11.B33B]*. The requirements apply to the acquisition of both the initial interest and additional interests in a joint operation (while still maintaining joint control) in which the activity of the joint operation constitutes a business. *[IFRS 11.21A]*.

If a joint operator increases its interest in a joint operation that is a business (as defined in IFRS 3) by acquiring an additional interest while still retaining joint control, it does not remeasure its previously held interest in that joint operation. *[IFRS 11.B33C]*.

The requirements discussed above, to apply the principles of IFRS 3 and other relevant IFRS accounting standards, do not apply to "the acquisition of an interest in a joint operation when the parties sharing joint control, including the entity acquiring the interest in the joint operation, are under the common control of the same ultimate controlling party or parties both before and after the acquisition, and that control is not transitory." *[IFRS 11.B33D]*.

8.3.2 Obtaining control or joint control over a joint operation that is a business

When a party to a joint operation obtains control over the joint operation that meets the definition of a business, it applies the requirements for a business combination achieved in stages. This includes remeasuring previously held interests in the assets and liabilities of the joint operation at fair value. In doing so, the acquirer remeasures its entire previously held interest in the joint operation. *[IFRS 3.42A]*.

A party without joint control of a joint operation that is a business and that has rights to assets and obligations for liabilities, might obtain joint control. In this scenario, in contrast to that described above, the previously held interest in that joint operation is not remeasured. *[IFRS 11.B33CA]*

8.3.3 Former subsidiary becomes a joint operation

IFRS accounting standards are not clear about the accounting when an entity loses control of a subsidiary and retains an interest in a joint operation.

In July 2016, the IFRS IC discussed this issue and noted that IFRS 11, which states that a joint operator recognises gains and losses resulting from the transaction only to the extent of the other parties' interests in the joint operation *[IFRS 11.B34]* (see section 6.6 above) could be viewed as conflicting with the requirements in IFRS 10, which specify that an entity remeasures any retained interest when it loses control of a subsidiary. *[IFRS 10.25]*. The IASB decided not to add this issue to its agenda but instead to recommend that the Board consider the issue at the same time the Board further considers the accounting for the sale or contribution of assets to an associate or a joint venture. This application issue was identified as part of the equity method project (see Chapter 12 at section 13).

How we see it

In our view, when a parent loses control over a subsidiary and retains an interest in a joint operation that is a business, entities have an accounting policy choice whether or not to remeasure the retained interest at fair value.

8.3.4 Joint operation becomes an associate or a financial instrument and vice versa

IFRS 11 does not explicitly address the accounting when a joint operation becomes an equity method associate or a financial instrument and vice versa. A former joint operation could become an equity method associate or financial instrument, for example, when a separate vehicle is accounted for as a joint operation in accordance with IFRS 11 and then a change in ownership interest results in joint control being lost and the separate vehicle being accounted for under IFRS 9 or IAS 28. In this scenario, it is generally appropriate to derecognise the assets and liabilities previously recognised in accordance with IFRS 11 and account for the new interest based on the applicable IFRS accounting standard at that date.

When an associate or financial instrument becomes a joint operation, it is not clear how the previously held interest is accounted for, i.e., whether remeasured to fair value or not.

8.3.5 Disposal of interest in a joint operation

When an entity disposes of its interest in a joint operation, it ceases to account for the rights to assets and obligations for liabilities and recognises any gain or loss as of the disposal date, in accordance with the relevant IFRS accounting standard (see section 6 above). The only exception would be if the same rights to assets or obligations for liabilities replaced that interest directly. In this case, there would be no change in accounting, because, in both cases, the assets and liabilities are recognised in accordance with the relevant IFRS accounting standard.

Consistent with the treatment of joint ventures (see section 8.2.6 above) an entity continues to reflect its interest in a joint operation for the reporting period (and comparative period) in which it held that interest. An entity does not restate its financial statements as if it never held the interest in the disposed joint operation.

8.3.6 Interest in a joint operation held for sale

When a joint operator plans to dispose of all or part of its interest in a joint operation, it applies IFRS 5 to those assets and liabilities within the scope of IFRS 5 (see Chapter 5).

If an interest in a joint operation (or portion thereof) no longer meets the criteria to be classified as held for sale, an entity restates the financial statements for the periods since classification as held for sale, (see Chapter 5 at sections 2.2.5 and 4.2). *[IFRS 5.28]*.

8.4 Changes in ownership of a joint arrangement that does not constitute a business

8.4.1 Joint operator obtains control or parties without joint control obtain joint control

At its January 2016 meeting, the IFRS IC discussed whether previously held interests in the assets and liabilities of a joint operation, which does not constitute a business, are remeasured when:

- A joint operator or a party without joint control obtains control of a joint operation

  And
- A change of interests resulting in a party without joint control obtaining joint control over the joint operation

The IFRS IC noted in an asset acquisition in which the asset or group of assets do not meet the definition of a business, a cost-based approach is used and the existing assets generally are not remeasured (see Chapter 10 at section 2.2.2). *[IFRS 3.2(b)]*. The IFRS IC also observed that it was not aware of significant diversity in practice and, therefore, decided not to add this issue to its agenda.[18]

8.5 Changes in classification of a joint arrangement

8.5.1 Equity method joint venture becomes a joint operation and vice versa

IFRS 11 does not explicitly address the accounting when an equity method joint venture becomes a joint operation, or vice versa. For example, when a separate vehicle is accounted for as a joint venture under IAS 28 and then a change in the terms governing the arrangement result in the separate vehicle being accounted for as a joint operation. In this scenario, it is generally appropriate to derecognise the equity method joint venture and recognise the joint operation in accordance with IFRS 11 and section 8.3.1 above. IFRS accounting standards are not clear how the previously held interest is accounted for.

When a joint operation becomes a joint venture, as described at section 8.3.5 above, the joint operator ceases to account for the rights to assets and obligations for liabilities and recognises any gain or loss as of the disposal date, in accordance with the relevant IFRS accounting standard. The equity method joint venture is recognised in accordance with IAS 28.

8.5.2 The rights to assets or obligations for liabilities of a joint operation change

A joint operator's rights to assets or obligations for liabilities could change, for example, when other operators obtain rights to the assets or assume obligations for those liabilities or when joint operators amend the terms governing their rights to assets or obligations for liabilities. To account for such changes, the joint operator generally:

- Derecognises the relevant portion of the assets and liabilities
- Recognises the fair value of any consideration received
- Recognises the resulting gain or loss
- Recognises any rights to assets it acquires from other joint operators and obligations it assumes from other joint operators or from the joint arrangement itself

18 *IFRIC Update*, January 2016, available on the IFRS Foundation's website.

9 Disclosures

The disclosure requirements regarding joint arrangements accounted for under IFRS 11 are included in IFRS 12 and are discussed in Chapter 14 at section 5. IFRS 12 combines the disclosure requirements for an entity's interests in subsidiaries, joint arrangements, associates and structured entities into one comprehensive disclosure standard.

In May 2024, the IASB issued IFRS 19 *Subsidiaries without Public Accountability: Disclosures*, a voluntary IFRS accounting standard for use by eligible subsidiaries that prepare financial statements applying IFRS accounting standards. IFRS 19 specifies which disclosure requirements apply to a subsidiary that does not have public accountability and whose parent produces consolidated financial statements that comply with IFRS accounting standards and are available for public use. IFRS 19 is effective for annual reporting periods beginning on or after 1 January 2027, with earlier application permitted (subject to jurisdictional endorsement). See Chapter 4 at section 7 for further details on IFRS 19.

10 Future developments

In September 2024, the IASB published an exposure draft[19] addressing application issues relating to the equity method of accounting, which is relevant to the accounting for joint ventures. This is discussed in Chapter 12 at section 13.

19 Exposure Draft ED/2024/7: Equity Method of Accounting, available on the IFRS Foundation's website.

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Appendix C - Defined terms

Extract from IFRS 11

Appendix A
Defined terms

joint arrangement	An arrangement of which two or more parties have **joint control.**
joint control	The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.
joint operation	A **joint arrangement** whereby the parties that have **joint control** of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.
joint operator	A party to a **joint operation** that has **joint control** of that joint operation.
joint venture	A **joint arrangement** whereby the parties that have **joint control** of the arrangement have rights to the net assets of the arrangement.
joint venturer	A party to a **joint venture** that has **joint control** of that joint venture.
party to a joint arrangement	An entity that participates in a **joint arrangement**, regardless of whether that entity has **joint control** of the arrangement.
separate vehicle	A separately identifiable financial structure, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality.

Chapter 14 Disclosure of interests in other entities

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Overview

This Chapter discusses the requirements of IFRS 12 *Disclosure of Interests in Other Entities*.

IFRS 12 is a disclosure standard that must be applied by entities that have an interest in subsidiaries, joint arrangements, associates, and unconsolidated structured entities. IFRS 12 does not provide any recognition or measurement guidance. The standard was issued as the disclosure requirements of certain standards overlapped in many areas and it was thought inappropriate that the disclosure requirements for interests in unconsolidated structured entities would be located in a consolidation standard. Therefore, a combined disclosure standard for interests in other entities would make it easier to understand and apply the disclosure requirements for subsidiaries, joint ventures, associates and unconsolidated structured entities. *[IFRS 12.BC7]*.

In order to determine the appropriate recognition and measurement of subsidiaries, joint arrangements and associates, entities should refer to IFRS 10 *Consolidated Financial Statements* (see Chapter 7 and Chapter 8), IFRS 11 *Joint Arrangements* (see Chapter 13), IAS 27 *Separate Financial Statements* (see Chapter 9) and IAS 28 *Investments in Associates and Joint Ventures* (see Chapter 12) respectively.

What you need to know

- IFRS 12 requires an entity to disclose information that enables users of its financial statements to evaluate the nature of, and risks associated with, its interests in other entities and the effects of those interests on its financial position, financial performance and cash flows.
- An interest in another entity refers to contractual and non-contractual involvement that exposes the entity to variable returns.
- IFRS 12 contains disclosure requirements for interests in subsidiaries, joint arrangements and associates, as well as disclosures of interests in unconsolidated structured entities.

1 Introduction

IFRS 12 is a disclosure standard, issued in May 2011. It includes all of the disclosure requirements related to interests in subsidiaries, joint arrangements, associates and consolidated and unconsolidated structured entities.

Differences between IFRS 12 and US GAAP disclosure requirements are not addressed in this chapter.

The recognition and measurement of subsidiaries, joint arrangements and associates are dealt with in IFRS 10, IFRS 11, IAS 27 and IAS 28 (see Chapter 7, Chapter 8, Chapter 9, Chapter 12 and Chapter 13 respectively).

2 Objective and scope of IFRS 12

2.1 Objective

The stated objective and how to meet the objective of IFRS 12 are as follows: *[IFRS 12.1, IFRS 12.2]*.

Extract from IFRS 12

1 **The objective of this IFRS is to require an entity to disclose information that enables users of its financial statements to evaluate:**

(a) the nature of, and risks associated with, its interests in other entities; and

(b) the effects of those interests on its financial position, financial performance and cash flows.

2 To meet the objective in paragraph 1, an entity shall disclose:

(a) the significant judgements and assumptions it has made in determining:

(i) the nature of its interest in another entity or arrangement;

(ii) the type of joint arrangement in which it has an interest (paragraphs 7-9);

(iii) that it meets the definition of an investment entity if applicable (paragraph 9A); and

(b) information about its interests in:

(i) subsidiaries (paragraphs 10-19);

(ii) joint arrangements and associates (paragraphs 20-23); and

(iii) structured entities that are not controlled by the entity (unconsolidated structured entities) (paragraphs 24-31).

If the disclosures required by the standard, together with the disclosures required by other IFRS accounting standards, do not meet the objective of IFRS 12, an entity must disclose whatever additional information is necessary to meet that objective. *[IFRS 12.3]*. This requirement reiterates the notion already stated in IAS 1 *Presentation of Financial Statements* that additional information shall be disclosed when necessary for an understanding of the financial statements. *[IAS 1.17(c), IAS 1.31, IAS 1.112(c)]*.[1]

How we see it

IFRS 12 provides no illustrative examples to support any of its disclosure requirements. In addition, several of the terms used in the standard are undefined. Therefore, judgement will be required by entities in interpreting the requirements.

2.1.1 Interim Financial Reporting

IAS 34 *Interim Financial Reporting* (see Chapter 37) allows an entity to include either a complete set of financial statements in the interim report or, which is predominant practice, a condensed version. *[IAS 34.4]*. In interim financial statements, entities must provide information about events and transactions in the interim period that are significant to an understanding of the changes in financial position and performance since the last annual reporting period (see Chapter 37 at section 4.1). *[IAS 34.15]*. In addition, a number of specific disclosures are required to be given in the notes to the interim financial statements or elsewhere in the interim financial report (see Chapter 37 at section 4.2). *[IAS 34.16A]*. For example, entities becoming or ceasing to be investment entities, as defined in IFRS 10, have to disclose the information required in IFRS 12.9B (see section 4.6.2 below). *[IAS 34.16A(k)]*. Certain disclosures about the effect of changes in the composition of the entity during the interim period and obtaining or losing control of subsidiaries and long-term investments are also required. *[IAS 34.16A(i)]*.

The disclosures required by IAS 34 apply to both complete and condensed financial statements presented for an interim period. A complete set of financial statements, prepared for an interim period, would include all of the disclosures required by IAS 34 as well as those required by other IFRS accounting standards, including IFRS 12. *[IAS 34.7]*.

1 The same is required according to IAS 8(2027).6C(c), IFRS 18.20 and IFRS 18.113(c), once effective.

2.2 Scope

IFRS 12 applies to any entity that has an interest in any of the following:

(a) Subsidiaries

(b) Joint arrangements (i.e., joint operations or joint ventures)

(c) Associates

And

(d) Unconsolidated structured entities *[IFRS 12.5]*

Despite the broad title of IFRS 12, there are several interests in other entities to which IFRS 12 does not apply (see section 2.2.3 below).

2.2.1 Definitions

The definitions that are relevant to the application of IFRS 12 and included within Appendix A of the standard are likewise included in Appendix C of this chapter. A list of these terms is produced below, in alphabetical order.

- Income from a structured entity
- Interest in another entity
- Structured entity

In addition, Appendix A to IFRS 12 provides a list of terms defined in IAS 27, IAS 28, IFRS 10 and IFRS 11, which are used in IFRS 12 with the meanings specified in those IFRS accounting standards. These definitions are included in Chapter 7, Chapter 8, Chapter 9, Chapter 12 and Chapter 13 respectively.

2.2.1.A Interests in other entities

An interest in another entity refers to contractual and non-contractual involvement that exposes the reporting entity to variability of returns from the performance of the other entity (i.e., the investee). Consideration of the purpose and design of the other entity may help the reporting entity when assessing whether it has an interest in that entity and, therefore, whether it is required to provide the disclosures in IFRS 12. That assessment must include consideration of the risks that the other entity was designed to create and the risks that the other entity was designed to pass on to the reporting entity and other parties. *[IFRS 12.B7]*.

IFRS 10 defines 'variability of returns'. As discussed in more detail in Chapter 7 at section 5, IFRS 10 explains that variable returns are returns that are not fixed and have the potential to vary as a result of the performance of an investee. Variable returns can be only positive, only negative or both positive and negative. An investor assesses whether returns from an investee are variable and how variable these returns are, on the basis of the substance of the arrangement and regardless of the legal form of the returns. For example, an investor can hold a bond with fixed interest payments. The fixed interest payments are variable returns for the purpose of IFRS 10 because they are subject to default risk and they expose the investor to the credit risk of the issuer of the bond. The amount of variability (i.e., how variable those returns are) depends on the credit risk of the bond. Similarly, fixed performance fees for managing an investee's assets are variable returns because they expose the investor to the performance risk of the investee. The amount of variability depends on the investee's ability to generate sufficient income to pay the fee. *[IFRS 10.B56]*.

How we see it

The definition of an 'interest' in IFRS 12 is much wider than only equity instruments in an entity. As IFRS 12 requires disclosures of interests that a reporting entity holds in other entities, preparers will need to ensure that their reporting systems and processes are sufficient to identify those 'interests'.

IFRS 12 clarifies that a reporting entity is typically exposed to variability of returns from the performance of another entity by holding instruments (such as equity or debt instruments issued by the other entity) or having another involvement that absorbs variability. *[IFRS 12.B8]*. This is illustrated in Illustration 2-1 below.

Illustration 2-1: Variability of returns arising from issue of credit default swap (1)

A reporting entity issues a credit default swap to a structured entity. The credit default swap protects the structured entity from the default of interest and principal payments on its loan portfolio.

The reporting entity has an involvement in the structured entity that exposes it to variability of returns from the performance of the structured entity because the credit default swap absorbs variability of returns of the structured entity. *[IFRS 12.B8]*.

Some instruments are designed to transfer risk from the reporting entity to another entity. Such instruments create variability of returns for the other entity but do not typically expose the reporting entity to variability of returns from the performance of the other entity. *[IFRS 12.B9]*. This is illustrated in Illustration 2-2 below.

Illustration 2-2: Variability of returns arising from issue of credit default swap (2)

A reporting entity (Entity Z) enters into a credit default swap with a structured entity. The credit default swap gives the structured entity exposure to Entity Z's credit risk. The purpose of the arrangement is to give the investors in the structured entity exposure to Entity Z's credit risk (Entity Z is unrelated to any other party involved in the arrangement).

Entity Z does not have any involvement with the structured entity that exposes it to variable returns from the structured entity because the credit default swap transfers variability to the structured entity rather than absorbing variability of returns of the structured entity.

Purchased call options and written put options (in each case unless the exercise price is at fair value) would also be interests in other entities, because these instruments typically absorb variability created by assets held in the entity. In contrast, some derivative instruments, such as interest rate swaps, can both create and absorb variability and judgement will need to be exercised in determining whether these derivatives are interests in other entities.

How we see it

We believe that plain vanilla swaps and other derivatives that both create and absorb variability, based on market rates or indices and which rank senior to the issued notes, do not absorb the risks the entity was designed to pass on, and are not an exposure to variable returns. They are therefore unlikely to be interests in other entities that would require disclosure under IFRS 12. See Chapter 7 at section 5.3.1.

An entity does not necessarily have an interest in another entity because of a typical customer-supplier relationship. However, as explained above, IFRS 10 states that fixed performance fees for managing an investee's assets create variable returns for the investor. The fixed performance fees are 'variable' because they expose the investor to the performance risk of the investee. *[IFRS 10.B56]*. Therefore, investment management fees and other fees based on assets under management are treated as variable interests.

2.2.1.B Structured entities

Whether an entity is a structured entity or not is important because additional disclosures are required by IFRS 12 for interests in structured entities. These disclosures are discussed in section 4.4 and section 6 below.

The IASB's rationale for including specific disclosures of investments in structured entities is that users requested such disclosures because they believed involvement with these entities posed more risk than involvement with traditional operating entities. The increased risk exposure arises because, for example, the structured entity may have been created to pass risks and returns arising from specified assets to investors, or may have insufficient equity to fund losses on its assets, if they arise. *[IFRS 12.BC84]*.

As defined in Appendix A of IFRS 12 (see Appendix C of this chapter), a structured entity is an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

IFRS 12 states that a structured entity often has some or all of the following features or attributes:

(a) Restricted activities

(b) A narrow and well-defined objective, such as:
  (i) To effect a tax-efficient lease
  (ii) To carry out research and development activities
  (iii) To provide a source of capital or funding to an entity
  Or
  (iv) To provide investment opportunities for investors by passing on risks and rewards associated with the assets of the structured entity to investors

(c) Insufficient equity to permit the structured entity to finance its activities without subordinated financial support
  And

(d) Financing in the form of multiple contractually linked instruments to investors that create concentrations of credit or other risks (tranches) *[IFRS 12.B22]*

Appendix B of IFRS 12 provides the following examples of structured entities: *[IFRS 12.B23]*

Extract from IFRS 12

B23 Examples of entities that are regarded as structured entities include, but are not limited to:

(a) securitisation vehicles.

(b) asset-backed financings.

(c) some investment funds.

The Basis for Conclusions explains that the type of entity the Board envisages being characterised as a structured entity is an entity created to accomplish a narrow and well-defined objective, listing as examples entities established to effect a lease, entities established for research and development activities or entities established for the securitisation of financial assets. *[IFRS 12.BC82]*. The IFRS 12 definition of a structured entity implies that any entity which is not controlled by voting or similar rights is a structured entity. Conversely, any entity controlled by voting or similar rights cannot be a structured entity.

It is not clear what the IASB means by 'similar' (to voting) rights in the definition of a structured entity. No illustrative examples are provided. This will therefore require the exercise of judgement by reporting entities; consequently, there may be diversity in practice about what constitutes a 'similar' right and therefore, whether an entity is a structured entity. One example of 'similar' rights is an investment fund for which investors can vote to remove the manager of the fund without cause as long as a certain proportion of investors demand such a vote. The assessment of whether this right (to remove the fund manager) could be considered substantive, and therefore, whether the investment fund is a structured entity, would depend on the number of investors who would need to collaborate in order to force the vote, as well as other facts and circumstances. See Chapter 7 at section 4.1 and section 4.2 for additional guidance on identifying the significant activities of an entity, the rights to make decisions about those activities, and evaluating whether those rights are substantive.

How we see it

IFRS 12 does not state whether the 'features or attributes' of structured entities discussed above are determinative as to whether an entity is a structured entity or whether the features or attributes should always be subordinate to the definition (i.e., if the entity was controlled by voting or similar rights then the features or attributes would be irrelevant). Our view is that the features and attributes are subordinated to the definition. However, the features or attributes are often present in a structured entity.

The IASB considered, but rejected, defining a structured entity in a way similar to a variable interest entity (VIE) in US GAAP. That approach, in the IASB's opinion, would have introduced complicated guidance solely for disclosure purposes that was not previously in IFRS accounting standards. *[IFRS 12.BC83]*. US GAAP defines a VIE, in essence, as an entity whose activities are not directed through voting or similar rights, whose total equity is not sufficient to permit the entity to finance its activities without additional subordinated financial support, or whose equity is structured with non-substantive voting rights. The IASB had two reasons for not making the definition of a structured entity dependent on total equity at risk (as in US GAAP). First, including insufficient equity at risk in the definition of a structured entity would require extensive application guidance to help determine the sufficiency of the equity, to which the IASB was opposed. Second, the IASB feared that some traditional operating entities might be caught by this definition when this was not its intention. *[IFRS 12.BC83, IFRS 12.BC84, IFRS 12.BC85]*.

IFRS 12 clarifies that an entity that is controlled by voting rights is not a structured entity simply because, for example, it receives funding from third parties following a restructuring. *[IFRS 12.B24]*. However, such funding is likely to give the investor a variable interest in the restructured entity that may still be a subsidiary as defined by IFRS 10.

2.2.1.C Interaction of IFRS 12 and IFRS 5

The requirements in IFRS 12, except as described in IFRS 12.B17, apply to an entity's interests listed in IFRS 12.5 (see section 2.2 above) that are classified (or included in a disposal group that is classified) as held for sale or discontinued operations in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. *[IFRS 12.5A]*.

An entity is not required to disclose summarised financial information, for its interests in a subsidiary, a joint venture or an associate in accordance with IFRS 12.B10-B16 when the entity's interest in that subsidiary, joint venture or associate (or a portion of its interest in a joint venture or an associate) is classified or included in a disposal group that is classified as held for sale in accordance with IFRS 5. *[IFRS 12.B17]*.

2.2.2 Interests disclosed under IFRS 12

Extract from IFRS 12

B4 An entity shall present information separately for interests in:

(a) subsidiaries;

(b) joint ventures;

(c) joint operations;

(d) associates; and

(e) unconsolidated structured entities.

[IFRS 12.B4].

A reporting entity has to consider the level of detail necessary to satisfy the disclosure objective (see section 2.1 above) and how much emphasis to place on each of the requirements of IFRS 12. Disclosures can be aggregated or disaggregated so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics. *[IFRS 12.4]*. However, a reporting entity must disclose how it has aggregated its interests in similar entities. *[IFRS 12.B3]*.

In determining whether to aggregate information, an entity must consider qualitative and quantitative information about the different risk and return characteristics of each entity it is considering for aggregation and the significance of each entity to itself. The entity must present the disclosures in a manner that clearly explains to users of the financial statements the nature and extent of its interests in those other entities. *[IFRS 12.B5]*.

Examples of aggregation levels within the classes of entities shown above that IFRS 12 considers appropriate are:

- Nature of activities (e.g., a research and development entity, a revolving credit card securitisation entity)
- Industry classification

  And
- Geography (e.g., country or region) *[IFRS 12.B6]*

This aggregation guidance above implies latitude for entities to exercise their judgement in determining the appropriate level of disclosure. However, summarised financial information is required separately for each material partly-owned subsidiary, each material joint venture and associate whilst minimum disclosures are required for interests in unconsolidated structured entities (see section 6.2 below).

2.2.2.A Subsidiaries

IFRS 10 defines a subsidiary as "an entity that is controlled by another entity". *[IFRS 10 Appendix A]*. IFRS 10 provides guidance as to the circumstances in which an entity is controlled by another entity. See Chapter 7 at section 3.

2.2.2.B Joint arrangements

Extract from IFRS 11

Appendix A
Defined terms

joint arrangement	An arrangement of which two or more parties have **joint control**.
joint control	The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.
joint operation	A **joint arrangement** whereby the parties that have **joint control** of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.
joint venture	A **joint arrangement** whereby the parties that have **joint control** of the arrangement have rights to the net assets of the arrangement.

[IFRS 11 Appendix A].

IFRS 11 provides guidance as to the circumstances in which joint control exists and on the characteristics of joint operations and joint ventures. See Chapter 13.

Interests in joint arrangements which are not structured entities and where the reporting entity does not have joint control or significant influence over the joint arrangement, are outside the scope of IFRS 12. See section 2.2.3.C below.

2.2.2.C Associates

IAS 28 defines an associate as "an entity over which the investor has significant influence". *[IAS 28.3]*. IAS 28 provides guidance on the circumstances in which significant influence exists. See Chapter 12 at section 2.

2.2.2.D Unconsolidated structured entities

The term 'unconsolidated structured entities' refers to all structured entities which are not consolidated by a reporting entity. Therefore, it includes structured entities that are joint arrangements and associates (unless specially excluded from the scope of the standard - see section 2.2.3 below), structured entities that are subsidiaries of parents that prepare separate but not consolidated financial statements (see section 2.2.3.B below), and structured entities over which the reporting entity does not have significant influence.

Where an unconsolidated structured entity is a joint venture or an associate, then the disclosures required for unconsolidated structured entities in section 6 below apply in addition to the disclosures in section 5 below for interests in joint ventures and associates. The IASB concluded that an entity should capture most, and in some cases all, of the disclosures required for interests in unconsolidated structured entities by providing the disclosures for interests in joint ventures and associates. Accordingly, the IASB considers that the requirement to make both sets of disclosures where applicable is not expected to result in a significant increase in the amount of information that an entity would be required to provide. *[IFRS 12.BC77]*.

As discussed in section 2.2.1.A above, the definition of a variable interest is widely drawn so that a derivative issued to a structured entity may result in an interest in an unconsolidated structured entity, depending on the purpose and design of the entity. This interest would require disclosures under IFRS 12 that would not apply to an identical instrument issued to an entity which is not a structured entity. The disclosures focus on an entity's exposure to risk from interests in structured entities that the entity rightly does not consolidate because it does not control them. *[IFRS 12.BC69]*.

2.2.3 Interests not within the scope of IFRS 12

IFRS 12 clarifies that certain interests are not within its scope as discussed in sections 2.2.3.A, 2.2.3.B, 2.2.3.C and 2.2.3.D below.

2.2.3.A Employee benefit plans

Post-employment benefit plans or other long-term employee benefit plans to which IAS 19 *Employee Benefits* applies are not within the scope of IFRS 12. *[IFRS 12.6(a)]*. Without this exemption, some employee benefit plans might meet the definition of a structured entity.

2.2.3.B Separate financial statements

An entity's separate financial statements to which IAS 27 applies are not within the scope of IFRS 12. The purpose of this exemption is to prevent a parent duplicating IFRS 12 disclosures in both its consolidated and separate financial statements. See Chapter 9 for guidance on separate financial statements.

However, an entity that has interests in unconsolidated structured entities and prepares separate financial statements as its only financial statements, is required to make the disclosures in IFRS 12.24-31 in respect of the unconsolidated structured entities (see section 6 below). As discussed in section 2.2.2.D above, unconsolidated structured entities include subsidiaries, joint ventures and associates that are structured entities.

In addition, an investment entity that prepares financial statements in which all of its subsidiaries are measured at fair value through profit or loss (i.e., an investment entity which has subsidiaries but does not prepare consolidated financial statements) must make the disclosures relating to investment entities discussed in section 4.6 below. *[IFRS 12.6(b)]*.

The financial statements of an entity that does not have an interest in a subsidiary, associate or a joint venturer's interest in a joint venture are not separate financial statements. *[IAS 27.7]*. These financial statements are within the scope of IFRS 12. In practice, the only disclosures that apply to these entities are those related to unconsolidated structured entities (see section 6 below).

2.2.3.C Interests in joint arrangements that result in neither joint control nor significant influence and are not interests in structured entities

An interest held by an entity that participates in, but does not have joint control of, a joint arrangement is outside the scope of IFRS 12 unless that interest results in significant influence in that arrangement or is an interest in a structured entity. *[IFRS 12.6(c)]*.

IFRS 11 states that an arrangement can be a joint arrangement even though not all of the parties have joint control of the arrangement. It distinguishes between parties that have joint control of a joint arrangement (joint operators or joint venturers) and parties that participate in, but do not have joint control of, a joint arrangement. *[IFRS 11.11]*.

Determining whether an interest in a joint arrangement (which is not a structured entity) results in neither joint control nor significant influence will be a matter of judgement based on the facts and circumstances. See Chapter 13 at section 4 for guidance on assessing joint control and Chapter 12 at section 2 for guidance on assessing significant influence.

2.2.3.D Interests in other entities accounted for in accordance with IFRS 9

An interest in another entity that is accounted for under IFRS 9 *Financial Instruments* is outside the scope of IFRS 12; such interest is subject to the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* (see Chapter 50) and, if measured at fair value, IFRS 13 *Fair Value Measurement* (see Chapter 15). However, IFRS 12 applies to the following interests:

(i) Interests in associates or joint ventures measured at fair value through profit or loss in accordance with IAS 28

Or

(ii) Interests in unconsolidated structured entities *[IFRS 12.6(d)]*

In addition, IFRS 12 requires specific disclosures for unconsolidated subsidiaries of an investment entity measured at fair value through profit and loss. See section 4.6 below.

Interests in unconsolidated structured entities which are not subsidiaries, joint arrangements or associates would normally be accounted for in accordance with IFRS 9. See Chapter 45 for guidance on recognition and initial measurement of financial instruments in accordance with IFRS 9.

3 Disclosure of significant judgements and assumptions

Extract from IFRS 12

7 An entity shall disclose information about significant judgements and assumptions it has made (and changes to those judgements and assumptions) in determining:

(a) that it has control of another entity, ie an investee as described in paragraphs 5 and 6 of IFRS 10 *Consolidated Financial Statements*;

(b) that it has joint control of an arrangement or significant influence over another entity; and

(c) the type of joint arrangement (ie joint operation or joint venture) when the arrangement has been structured through a separate vehicle.

[IFRS 12.7].

The significant judgements and assumptions disclosed in accordance with the requirements above include those made by an entity when changes in facts and circumstances are such that the conclusion about whether it has control, joint control or significant influence changes during the reporting period. *[IFRS 12.8]*.

In order to comply with the requirements above, an entity must disclose, for example, significant judgements and assumptions made in determining that:

- It does not control another entity even though it holds more than half of the voting rights of the other entity.
- It controls another entity even though it holds less than half of the voting rights of the other entity.
- It is an agent or principal as defined by IFRS 10 (see Chapter 7 at section 6).
- It does not have significant influence even though it holds 20% or more of the voting rights of another entity.
- It has significant influence even though it holds less than 20% of the voting rights of another entity. *[IFRS 12.9]*.

The following extract from BP p.l.c.'s financial statements illustrates disclosure of the significant judgements and assumptions used in determining significant influence with a less than 20% holding of voting rights.

Practical example 3-1: BP p.l.c. (2023) United Kingdom

bp Annual Report and Form 20-F 2023 [extract]

Notes on financial statements [extract]

1. Material accounting policy information, significant judgements, estimates and assumptions [extract]

Interests in other entities [extract]

Interests in associates [extract]

Significant judgement: investment in Aker BP

Judgement is required in assessing the level of control or influence over another entity in which the group holds an interest. For bp, the judgement that the group has significant influence over Aker BP, a Norwegian oil and gas company, is significant.

As a consequence of this judgement, bp uses the equity method of accounting for its investment and bp's share of Aker BP's oil and natural gas reserves is included in the group's estimated net proved reserves of equity-accounted entities. If significant influence was not present, the investment would be accounted for as an investment in an equity instrument measured at fair value as described under 'Financial assets' below and no share of Aker BP's oil and natural gas reserves would be reported.

Significant influence is defined in IFRS as the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those decisions. Significant influence is presumed when an entity owns 20% or more of the voting power of the investee. Significant influence is presumed not to be present when an entity owns less than 20% of the voting power of the investee.

bp owned 15.9% of the voting shares at 31 December 2023. bp's group chief executive officer, Murray Auchincloss, has been a member of the Aker BP board since 2017. bp's other nominated director, group chief financial officer, Kate Thomson, has been a member of the Aker BP board since formation of that company in 2016. She is also a member of the Aker BP board's Audit and Risk Committee. bp also holds the voting rights at general meetings of shareholders conferred by its stake in Aker BP. bp's management considers, therefore, that the group continues to have significant influence at 31 December 2023.

The following Illustration shows disclosure of significant judgements and assumptions made by an entity in determining whether a joint arrangement is a joint operation or a joint venture.

Illustration 3-1: Illustrative example of disclosure of significant judgements and assumptions made in determining the type of joint arrangement

The directors have determined that the Group's investment in ABC Inc. should be accounted for as a joint operation rather than a joint venture. Although the legal form of ABC Inc. and the contractual terms of the joint arrangement indicate that the arrangement is a joint venture, sales to third parties by ABC Inc. are expected to be uncommon and not material. In addition, the price of the output sold to the venturers is set by all parties at a level that is designed to cover only the costs of production and administrative expenses incurred by ABC Inc. On this basis, the directors consider that, in substance, the arrangement gives the venturers rights to the economic benefits of the assets, and obligations to fund the settlement of the liabilities, relating to the arrangement and not rights to the net assets of the arrangements and therefore is a joint operation.

When a parent determines that it is an investment entity in accordance with IFRS 10, the investment entity must disclose information about significant judgements and assumptions it has made in determining that it is an investment entity. If the investment entity does not have one or more of the typical characteristics of an investment entity (as per IFRS 10), it must disclose the reasons for concluding that it is nevertheless an investment entity. *[IFRS 12.9A]*. The definition of an investment entity is discussed in Chapter 7 at section 10.1.

The following extract from 3i Group plc's financial statements illustrates disclosure of these significant judgements and assumptions.

Practical example 3-2: 3i Group plc (2024) United Kingdom

Annual report and accounts 2024 [extract]

Audited financial statements [extract]

Material accounting policies [extract]

C Critical accounting judgements and estimates [extract]

(a) Critical judgements [extract]

I. Assessment as an investment entity

The Board has concluded that the Company continues to meet the definition of an investment entity, as its strategic objective of investing in portfolio investments and providing investment management services to investors for the purpose of generating returns in the form of investment income and capital appreciation remains unchanged.

IAS 1 requires an entity to disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. *[IAS 1.122]*.[2] IFRS 12 adds to those general requirements by specifically requiring an entity to disclose all significant judgements and estimates made in determining the nature of its interest in another entity or arrangement, and in determining the type of joint arrangement in which it has an interest. The IASB's intention is that disclosure is required for all situations in which an entity exercises significant judgement in assessing the nature of its interest in another entity. *[IFRS 12.BC16]*.

There is no requirement for a reporting entity to disclose significant judgements and assumptions made in determining whether an entity in which it has an interest is a structured entity. Such a judgement or assumption affects disclosure only and not the determination of control, joint control or significant influence.

How we see it

Where judgements or assumptions made in determining whether an entity in which it has an interest is a structured entity have a significant impact on the volume of disclosures in the financial statements, we believe that it would be useful for a reader of the financial statements for such judgements or assumptions to be disclosed, consistent with the requirements of IAS 1.

There is no requirement to disclose quantitative information to help assess the accounting consequences of an entity's decision to consolidate (or not to consolidate) another entity. IFRS 3 *Business Combinations* already requires disclosures about the nature and effect of a business combination when an entity obtains control of another entity. Where an entity requires significant judgement to conclude that it does not control another entity, the IASB observed that the entity will often conclude that it has either joint control or significant influence over that other entity. IFRS 12 already requires disclosures of quantitative information about an entity's interests in joint ventures and associates and information about risk exposures to unconsolidated structured entities. Therefore, based on this, the IASB concluded that there was no need for a separate disclosure requirement. *[IFRS 12.BC19]*.

2 The consequential amendments resulting from IFRS 18, once effective, moves this guidance to IAS 8(2027).27G.

4 Disclosure of interests in subsidiaries

Extract from IFRS 12

10 An entity shall disclose information that enables users of its consolidated financial statements

(a) to understand:

(i) the composition of the group; and

(ii) the interest that non-controlling interests have in the group's activities and cash flows (paragraph 12); and

(b) to evaluate:

(i) the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group (paragraph 13);

(ii) the nature of, and changes in, the risks associated with its interests in consolidated structured entities (paragraphs 14-17);

(iii) the consequences of changes in its ownership interest in a subsidiary that do not result in a loss of control (paragraph 18); and

(iv) the consequences of losing control of a subsidiary during the reporting period (paragraph 19).

[IFRS 12.10].

4.1 Disclosure about the composition of the group

IFRS 12 does not elaborate on what is meant by information that enables users 'to understand' the composition of the group. Judgement will therefore be required as to the extent of the disclosures made.

It may be helpful to users of the financial statements to illustrate the composition of the group via a diagram or group organisation chart.

In interpreting the requirement to disclose information that enables users to understand the composition of the group for subsidiaries with immaterial or no non-controlling interests, preparers might wish to refer to the non-financial disclosures required for subsidiaries with non-controlling interests that are material to the reporting entity (see section 4.2 below). Applying these disclosures to other material subsidiaries would mean disclosing:

- The names of those entities
- The principal place of business (and country of incorporation, if different) of those entities

  And
- The proportion of ownership interest (and the proportion of the voting rights, if different) held in those entities

Users of the financial statements might also benefit from a description of the nature of the operations and principal activities of each material subsidiary and an indication of the operating segment(s) to which each material subsidiary has been allocated. A description of the nature of the group's operations and its principal activities is required by IAS 1. *[IAS 1.138(b)]*.[3]

3 The same is required according to IFRS 18.116(b), once effective.

Practical example 4.1 shows UBS Group AG's disclosure of individually significant subsidiaries.

Practical example 4-1: UBS Group AG (2023) **Switzerland**

Annual Report 2023 [extract]

Consolidated financial statements [extract]

Notes to the UBS Group AG consolidated financial statements [extract]

Note 29 Interests in subsidiaries and other entities [extract]

a) Interests in subsidiaries [extract]

UBS defines its significant subsidiaries as those entities that, either individually or in aggregate, contribute significantly to the Group's financial position or results of operations, based on a number of criteria, including the subsidiaries' equity and contribution to the Group's total assets and profit or loss before tax, in accordance with the requirements set by IFRS 12, Swiss regulations and the rules of the US Securities and Exchange Commission (the SEC).

Individually significant subsidiaries

The two tables below list the Group's individually significant subsidiaries as of 31 December 2023. Unless otherwise stated, the subsidiaries listed below have share capital consisting solely of ordinary shares held entirely by the Group, and the proportion of ownership interest held is equal to the voting rights held by the Group.

The country where the respective registered office is located is also the principal place of business. UBS AG and Credit Suisse AG operate through a global branch network and a significant proportion of their business activity is conducted outside Switzerland, including in the UK, the US, Singapore, the Hong Kong SAR and other countries. UBS Europe SE has branches and offices in a number of EU Member States, including Germany, France, Italy, Luxembourg and Spain. Share capital is provided in the currency of the legally registered office.

Individually significant subsidiaries of UBS Group AG as of 31 December 2023

Company	Registered office	Share capital in million		Equity interest accumulated in %
UBS AG	Zurich and Basel, Switzerland	USD	385.8	100.0
UBS Business Solutions AG[1]	Zurich, Switzerland	CHF	1.0	100.0
Credit Suisse AG	Zurich, Switzerland	CHF	4,399.7	100.0
Credit Suisse Services AG	Zurich, Switzerland	CHF	1.0	100.0

1 UBS Business Solutions AG holds subsidiaries in China, India, Israel and Poland.

Individually significant subsidiaries of UBS AG as of 31 December 2023[1]

Company	Registered office	Primary business	Share capital in million		Equity interest accumulated in %
UBS Americas Holding LLC	Wilmington, Delaware, USA	Group Items	USD	2,900.0[2]	100.0
UBS Americas Inc.	Wilmington, Delaware, USA	Group Items	USD	0.0	100.0
UBS Asset Management AG	Zurich, Switzerland	Asset Management	CHF	43.2	100.0
UBS Bank USA	Salt Lake City, Utah, USA	Global Wealth Management	USD	0.0	100.0
UBS Europe SE	Frankfurt, Germany	Global Wealth Management	EUR	446.0	100.0
UBS Financial Services Inc.	Wilmington, Delaware, USA	Global Wealth Management	USD	0.0	100.0
UBS Securities LLC	Wilmington, Delaware, USA	Investment Bank	USD	1,283.1[3]	100.0
UBS Switzerland AG	Zurich, Switzerland	Personal & Corporate Banking	CHF	10.0	100.0

1 Includes direct and indirect subsidiaries of UBS AG. 2 Consists of common share capital of USD 1,000 and non-voting preferred share capital of USD 2,900,000,000. 3 Consists of common share capital of USD 100,000 and non-voting preferred share capital of USD 1,283,000,000.

Individually significant subsidiaries of Credit Suisse AG as of 31 December 2023

Company	Registered office	Primary business	Share capital in million		Equity interest accumulated in %
Credit Suisse International	London, United Kingdom	Non-core and Legacy	USD	7,267.5	97.6[1]
Credit Suisse (Schweiz) AG	Zurich, Switzerland	Personal & Corporate Banking	CHF	100.0	100.0
Credit Suisse Holdings (USA), Inc.	Wilmington, United States	Investment Bank	USD	0.0	100.0

1 UBS Group AG owns the remaining 2.4%.

...

When the financial statements of a subsidiary used in the preparation of the consolidated financial statements are as of a date or for a period that is different from that of the consolidated financial statements, an entity must disclose:

- The date of the reporting period of the financial statements of that subsidiary

  And
- The reason for using a different date or period *[IFRS 12.11]*

4.2 Disclosure of interests of non-controlling interests

IFRS 12 requires that a reporting entity must disclose, for each of its subsidiaries that have non-controlling interests that are material:

(a) The name of the subsidiary

(b) The principal place of business (and country of incorporation if different from the principal place of business) of the subsidiary

(c) The proportion of ownership interests held by non-controlling interests

(d) The proportion of voting rights held by non-controlling interests, if different to the proportion of ownership interests held

(e) The profit or loss allocated to the non-controlling interests of the subsidiary during the reporting period

(f) Accumulated non-controlling interests of the subsidiary at the end of the reporting period

And

(g) Summarised financial information about the subsidiary (see below) *[IFRS 12.12]*

The summarised financial information required to be disclosed is as follows:

(a) Dividends paid to non-controlling interests

And

(b) Summarised financial information about the assets, liabilities, profit or loss and cash flows of the subsidiary that enables users to understand the interest that non-controlling interests have in the group's activities and cash flows. The information might include but is not limited to, for example, current assets, non-current assets, current liabilities, non-current liabilities, revenue, profit or loss and total comprehensive income. *[IFRS 12.B10]*.

The summarised financial information must be presented before inter-company eliminations. *[IFRS 12.B11]*.

The IASB believes that these disclosures will help users when estimating future profit or loss and cash flows by identifying, for example, the assets and liabilities that are held by subsidiaries, the risk exposures of particular group entities (e.g., by identifying which subsidiaries hold debt) and those subsidiaries that generate significant cash flows. *[IFRS 12.BC27]*.

The IASB does not believe the requirement to provide information about subsidiaries with a material non-controlling interest is particularly onerous on the grounds that an entity is expected to have the information available in preparing its consolidated financial statements. *[IFRS 12.BC29]*. However, the IASB believes a requirement to disclose information about subsidiaries with immaterial or no non-controlling interests might prove to be onerous to prepare without any significant benefit for users. *[IFRS 12.BC28]*.

Non-controlling interest is equity in a subsidiary not attributable, directly or indirectly, to a parent. *[IFRS 10 Appendix A]*. This means that these disclosures do not apply to instruments that might have the legal characteristics of equity, but which are classified as financial liabilities under IFRS accounting standards. This would also apply to instruments that are classified as equity in the separate financial statements of a subsidiary but that are classified as financial liabilities in the consolidated financial statements. Similarly, when a parent has concluded that it already has a present ownership interest in shares held by a non-controlling interest by virtue of call or put options in respect of those shares (see Chapter 8 at section 6), then IFRS 12 disclosures in respect of those shares are not required by the parent because there is no non-controlling interest in the financial statements.

IFRS 12 is clear that this information is required only in respect of non-controlling interests that are material to the group. A subsidiary may have a significant non-controlling interest in a lower tier subsidiary, but disclosure is not required if that interest is not material at group level. Similarly, these disclosures do not apply to non-controlling interests that are material in aggregate but not individually.

Frequently asked questions

Question 4-1: Disclosures for a subsidiary with a material non-controlling interest

In January 2015, the IFRS IC discussed a request to clarify the level at which the financial information required by (e) to (g) of IFRS 12.12 should be provided where a subsidiary has non-controlling interests that are material to the group. The issue was whether the information provided should be either:

- At the subsidiary (i.e., entity) level based on the separate financial statements of the subsidiary.

  Or

- At a subgroup level for the subgroup of the subsidiary and based on either (i) the amounts of the subgroup included in the consolidated financial statements of the parent or, (ii) the amounts included in the consolidated financial statements of the subgroup. In both (i) and (ii), transactions and balances between the subgroup and other subsidiaries of the reporting entity outside the subgroup would not be eliminated.

The IFRS IC noted that the decision on which approach is used to present the disclosures required by (e) to (g) of IFRS 12.12 should reflect the one that best meets the disclosure objective (see IFRS 12.10(a)) in the circumstances.

In respect of (e) and (f) of IFRS 12.12, the IFRS IC observed that a reporting entity should apply judgement in determining the level of disaggregation of information about subsidiaries that have a material non-controlling interest. That is, whether:

- The entity presents this information about the subgroup of the subsidiary.

  Or

- Whether it is necessary in achieving the disclosure objective to disaggregate the information further to present information about the individual subsidiaries that have a material non-controlling interest within that subgroup.

In respect of (g) of IFRS 12.12, the IFRS IC observed that, in order to meet the overall disclosure requirement, information would need to be prepared on a basis that was consistent with the information included in the consolidated financial statements from the perspective of the reporting entity. This would mean, for example, that if the subsidiary was acquired in a business combination, the amounts disclosed should reflect the effects of the acquisition accounting (e.g., goodwill and fair value adjustments). The IFRS IC further observed that in providing the information, an entity would apply judgement in determining whether this information was presented at a subgroup level or whether further disaggregation was necessary about individual subsidiaries that have a material non-controlling interest within that subgroup. However, the IFRS IC noted that the information supplied would include transactions between the subgroup/subsidiary and other members of the reporting entity's group without elimination, but that transactions within the subgroup would be eliminated.

On the basis of the above analysis, the IFRS IC concluded that neither an Interpretation nor an amendment to IFRS 12 was necessary and decided not to add the issue to its agenda.[4]

Robert Bosch Gesellschaft mit beschränkter Haftung's financial statements illustrate disclosure of summarised financial information in respect of subsidiaries that have material non-controlling interests.

4 *IFRIC Update*, January 2015, p.5-7, available on the IFRS Foundation's website.

Practical example 4-2: Robert Bosch Gesellschaft mit beschränkter Haftung (2022) Germany

Annual report 2022 [extract]

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]

Principles and methods [extract]

06 Consolidation [extract]

Consolidated group [extract]

Condensed financial information on fully consolidated subsidiaries with material non-controlling interests

in millions of euros T11

	Bosch Powertrain Systems Co., Ltd., Wuxi, China		United Automotive Electronic Systems Co., Ltd., Shanghai, China	
	2022	2021	2022	2021
Current assets	2,117	2,046	2,436	2,205
Non-current assets	475	469	1,555	1,456
Current liabilities	1,195	1,202	1,667	1,486
Non-current liabilities	7	4	252	214
Sales revenue	1,972	2,115	4,313	3,434
Profit after tax	426	445	476	406
Comprehensive income	397	564	431	615
Cash flows from operating activities	406	285	582	559
Cash flows from investing activities	−73	−70	−353	−152
Cash flows from financing activities	−333	−215	−210	−276
Share of capital attributable to non-controlling interests	34.0%	34.0%	49.0%	49.0%
Profit/loss after tax attributable to non-controlling interests	145	151	233	199
Equity attributable to non-controlling interests	473	445	1,015	961
Dividends paid to non-controlling interests	108	73	159	130

in millions of euros T12

	Bosch HUAYU Steering Systems Group, Shanghai, China		Bosch Ltd., Bengaluru, India	
	2022	2021	2022	2021
Current assets	1,204	1,287	1,032	964
Non-current assets	627	601	951	979
Current liabilities	1,058	1,103	558	559
Non-current liabilities	1	12	40	39
Sales revenue	1,836	1,529	1,695	1,303
Profit after tax	209	176	176	143
Comprehensive income	195	255	114	230
Cash flows from operating activities	144	106	211	48
Cash flows from investing activities	−110	−76	−49	−19
Cash flows from financing activities	−168	−218	−96	−41
Share of capital attributable to non-controlling interests	49.0%	49.0%	29.5%	29.5%
Profit/loss after tax attributable to non-controlling interests	102	86	52	42
Equity attributable to non-controlling interests	378	379	409	397
Dividends paid to non-controlling interests	69	61	22	12

...

IFRS 12 does not address disclosure of non-controlling interests in the primary statements. IAS 1 requires disclosure of total non-controlling interests within equity in the statement of financial position, profit or loss and total comprehensive income for the period attributable to non-controlling interests and a reconciliation of the opening and closing carrying amount of each component of equity (which would include non-controlling interests) in the statement of changes in equity. *[IAS 1.54, IAS 1.81B, IAS 1.106]*.[5]

4.3 Disclosure of the nature and extent of significant restrictions

Extract from IFRS 12

The nature and extent of significant restrictions

13 An entity shall disclose:

(a) significant restrictions (eg statutory, contractual and regulatory restrictions) on its ability to access or use the assets and settle the liabilities of the group, such as:

(i) those that restrict the ability of a parent or its subsidiaries to transfer cash or other assets to (or from) other entities within the group.

(ii) guarantees or other requirements that may restrict dividends and other capital distributions being paid, or loans and advances being made or repaid, to (or from) other entities within the group.

(b) the nature and extent to which protective rights of non-controlling interests can significantly restrict the entity's ability to access or use the assets and settle the liabilities of the group (such as when a parent is obliged to settle liabilities of a subsidiary before settling its own liabilities, or approval of non-controlling interests is required either to access the assets or to settle the liabilities of a subsidiary).

(c) the carrying amounts in the consolidated financial statements of the assets and liabilities to which those restrictions apply.

[IFRS 12.13].

The Basis for Conclusions clarifies that these disclosures are intended to be limited to information about the nature and effect of significant restrictions on an entity's ability to access and use assets or settle liabilities of the group. They are not intended, in the IASB's opinion, to require an entity to disclose, for example, a list of all the protective rights held by non-controlling interests that are embedded in law and regulation. *[IFRS 12.BC32]*.

The IASB also considers that the restrictions required to be disclosed by IFRS 12 are those that exist because of legal boundaries within the group. They are not, in the IASB's opinion, intended to replicate those in other IFRS accounting standards relating to restrictions such as those in IAS 16 *Property, Plant and Equipment* or IAS 40 *Investment Property*. *[IFRS 12.BC33]*.

5 The same is required according to IFRS 18.104, IFRS 18.76, IFRS 18.87, IFRS 18.107, once effective.

Deutsche Bank Aktiengesellschaft makes the following disclosures about significant restrictions to access or use the group's assets:

Practical example 4-3: Deutsche Bank Aktiengesellschaft (2023) Germany

Annual Report 2023 [extract]
Consolidated Financial Statements [extract]
Additional Notes [extract]
37 - Information on Subsidiaries [extract]

Significant restrictions to access or use the Group's assets

Statutory, contractual or regulatory requirements as well as protective rights of noncontrolling interests might restrict the ability of the Group to access and transfer assets freely to or from other entities within the Group and to settle liabilities of the Group.

The following contractual restrictions impact the Group's ability to use assets and the table below reflects the volume of those restricted assets:

- The Group has pledged assets to collateralize its obligations under repurchase agreements, securities financing transactions, collateralized loan obligations and for margining purposes for OTC derivative liabilities
- The assets of consolidated structured entities are held for the benefit of the parties that have bought the notes issued by these entities

Restricted assets

	Dec 31, 2023		Dec 31, 2022	
in € m.	Total assets	Restricted assets	Total assets	Restricted assets
Interest-earning deposits with banks	163,454	41	164,136	108
Financial assets at fair value through profit or loss	465,252	58,452	482,376	40,346
Financial assets at fair value through other comprehensive income	35,546	7,655	31,675	2,771
Loans at amortized cost	473,705	54,372	483,700	73,500
Other	174,374	8,861	174,902	3,592
Total	1,312,331	129,381	1,336,788	120,317

In addition to the above and in line with the regulation on Liquidity Coverage Ratio (LCR) (Commission Delegated Regulation (EU) 2015/61), the Group identifies if assets held in third country are subject to restrictions to their free transferability. The Group, identifies the volume of High Quality Liquid Assets (HQLA) in excess of net cash outflows held in the third countries which are not freely transferable and excludes them from the HQLA. The aggregated amount of such HQLA that are held at entities in third countries and considered restricted is € 13.3 billion as of December 31, 2023 (€ 21.8 billion as of December 31, 2022). During 2023, the Group has transitioned its risk appetite from liquidity reserves to HQLA.

4.4 Disclosure of the nature of the risks associated with interests in consolidated structured entities

IFRS 12 requires a number of disclosures in respect of financial or other support provided to consolidated structured entities. In short, the standard requires disclosure of certain intra-group transactions that are eliminated on consolidation and details of certain commitments by a group to itself. For groups with a number of structured entities, it is important that consolidation reporting packages capture the necessary information, as these transactions may have already been eliminated on consolidation.

The detailed disclosures that are required in respect of interests in consolidated structured entities are discussed in sections 4.4.1, 4.4.2, 4.4.3 and 4.4.4 below.

4.4.1 Terms of contractual arrangements to provide financial support

An entity must disclose the terms of any contractual arrangements that could require the parent or its subsidiaries to provide financial support to a consolidated structured entity, including events or circumstances that expose the reporting entity to a loss (e.g., liquidity arrangements or credit rating triggers associated with obligations to purchase assets of the structured entity or provide financial support). *[IFRS 12.14]*. The IASB concluded that this disclosure would help users of financial statements to understand an entity's exposure to risks. *[IFRS 12.BC34]*. For the same reason, the IASB concluded that an entity must disclose its risk exposure from non-contractual obligations to provide support to both consolidated and unconsolidated structured entities. *[IFRS 12.BC35]*.

It is unclear which 'reporting entity' the IASB considers has suffered a 'loss' in the context of a consolidated structured entity since a group does not suffer a loss as a result of the parent or a subsidiary providing financial support to another subsidiary as that is an intra-group transaction which is eliminated on consolidation.

How we see it

We believe it is the potential for a 'loss' to the equity holders of the parent from these transactions (rather than a 'loss' to the group) that the IASB is trying to highlight. Consequently, a reporting entity would need to consider all of the non-controlling interests held in the entities involved in these transactions, as the differing shares held in those entities could affect the overall profit and comprehensive income attributable to non-controlling interests and owners of the parent.

Illustration 4-1: Illustrative example of disclosure of a contractual arrangement that could require parental support to a consolidated structured entity

The parent company has given a contractual commitment to its subsidiary, SE Limited, whereby if the assets held as collateral by SE Limited for its issued loan notes fall below a credit rating of 'AAA' then the parent will substitute assets of an equivalent fair value with an 'AAA' rating. The maximum fair value of assets to be substituted is CU10,000,000.

The following extract from HSBC Holdings plc's financial statements illustrates disclosure of financial support to consolidated structured entities.

Practical example 4-4: HSBC Holdings plc (2022) — **United Kingdom**

Annual Report and Accounts 2022 [extract]

Notes on the financial statements [extract]

20 Structured entities [extract]

Consolidated structured entities

Total assets of HSBC's consolidated structured entities, split by entity type

	Conduits	Securitisations	HSBC managed funds	Other	Total
	$bn	$bn	$bn	$bn	$bn
At 31 Dec 2022	**4.2**	**7.2**	**4.8**	**7.5**	**23.7**
At 31 Dec 2021	4.4	10.0	6.3	8.4	29.1

Conduits

HSBC has established and manages two types of conduits: securities investment conduits ('SICs') and multi-seller conduits.

Securities investment conduits

The SICs purchase highly rated ABSs to facilitate tailored investment opportunities.

- At 31 December 2022, Solitaire, HSBC's principal SIC, held $1.3bn of ABSs (2021: $1.6bn). It is currently funded entirely by commercial paper ('CP') issued to HSBC. At 31 December 2022, HSBC held $1.5bn of CP (2021: $1.8bn).

Multi-seller conduit

HSBC's multi-seller conduit was established to provide access to flexible market-based sources of finance for its clients. Currently, HSBC bears risk equal to the transaction-specific facility offered to the multi-seller conduit, amounting to $6.2bn at 31 December 2022 (2021: $6.7bn). First loss protection is provided by the originator of the assets, and not by HSBC, through transaction-specific credit enhancements. A layer of secondary loss protection is provided by HSBC in the form of programme-wide enhancement facilities.

4.4.2 Financial or other support with no contractual obligation

If, during the reporting period, a parent or any of its subsidiaries has, without having any contractual obligation to do so, provided financial or other support to a consolidated structured entity (e.g., purchasing assets of or instruments issued by the structured entity), the entity must disclose:

(a) The type and amount of support provided, including situations in which the parent or its subsidiaries assisted the structured entity in obtaining financial support

And

(b) The reasons for providing the support *[IFRS 12.15]*

The transactions requiring disclosure are intra-group transactions eliminated on consolidation.

'Support' is not defined in IFRS accounting standards. A literal reading of 'purchasing assets of or instruments issued' is that any transfer of consideration to a structured entity in exchange for an asset is the provision of support requiring disclosure by the standard. The Basis for Conclusions explains that the IASB did not define 'support' because a definition would either be so broad that it would be an ineffective definition, or it would invite structuring so as to avoid the disclosure. The IASB believes that support is widely understood as a provision of resources to another entity, either directly or indirectly. In the case of implicit agreements, the support is provided without having the contractual obligation to do so. However, in order to address respondents' concerns about distinguishing the provision of financial support from any other commercial transaction, the IASB clarified that disclosure is required when an entity has provided non-contractual support to a consolidated or unconsolidated structured entity in which it previously had or currently has an interest. *[IFRS 12.BC105, IFRS 12.BC106]*.

Examples of the type of support that the IASB envisages being disclosed for unconsolidated structured entities (see section 6.3 below) are liquidity arrangements or credit rating triggers associated with obligations to purchase assets of the structured entity or provide financial support.

How we see it

In our view, these examples imply that the IASB does not intend transactions in the ordinary course of business to be caught by the requirement to disclose support provided to consolidated structured entities. We believe that 'asset purchases' mean a 'forced' purchase caused by, for example, liquidity or credit rating triggers.

Interpreting financial support is therefore likely to involve judgement. One possible interpretation is that 'support' includes:

- An equity investment
- A long-term loan
- Forgiveness of debt
- A transaction carried out on non-market terms resulting in a net outflow of resources from the reporting entity, including any transaction involving the gifting of funds
- A transaction not made in the ordinary course of business

  Or
- Implicit or explicit guarantees of a structured entity's performance

IFRS 12 does not explain whether 'other support' extends to such non-financial support as the provision of human resources or management services outside of the ordinary course of business.

Illustration 4-2: Illustrative example of disclosure of financial or other support provided to a consolidated structured entity

During the reporting period the parent provided financial support in the form of assets with a fair value of CU12,000,000 (20X0: CU0) and a credit rating of 'AAA' to its subsidiary, SE 2 Limited, in exchange for assets with an equivalent fair value. There was no contractual obligation to exchange these assets. The transaction was initiated because the assets held by SE 2 Limited had a credit rating of less than 'AA' and a further ratings downgrade could potentially trigger calls on loan notes issued by SE 2 Limited. The parent did not suffer a loss on the transaction.

These disclosures are also required in respect of unconsolidated structured entities. See sections 6.2.2 and 6.3 below.

4.4.3 Financial or other support which resulted in consolidation

If, during the reporting period, a parent or any of its subsidiaries has, without having a contractual obligation to do so, provided financial or other support to a previously unconsolidated structured entity and that provision of support resulted in the entity controlling the structured entity, the entity (i.e., the reporting entity) must disclose an explanation of the relevant factors in making that decision. *[IFRS 12.16]*.

The comments in section 4.4.2 above regarding the definition of 'support' apply here also.

4.4.4 Current intentions to provide financial or other support

An entity must disclose any current intentions to provide financial or other support to a consolidated structured entity, including intentions to assist the structured entity in obtaining financial support. *[IFRS 12.17]*.

IFRS 12 does not define 'intentions'. The Basis for Conclusions states that it means "the entity has decided" to provide financial support (i.e., it has current intentions to do this). *[IFRS 12.BC104]*.

How we see it

This implies that a decision to provide support has been approved at an appropriately senior level at the entity. Judgement will be required by entities in interpreting this requirement and defining the meaning of 'intention' in this context.

The wording in the Basis for Conclusions does not require any such 'intention' to have been communicated to the structured entity that will receive the support or that a constructive obligation has been established, as defined in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

The comments in section 4.4.2 above in respect of the definition of 'support' apply here also.

These disclosures are also required in respect of unconsolidated structured entities. See section 6.2.2 below.

4.5 Disclosure of changes in ownership interests in subsidiaries

4.5.1 Changes that do not result in loss of control

An entity must present a schedule that shows the effects on the equity attributable to owners of the parent of any changes in its ownership interests in a subsidiary that do not result in loss of control. *[IFRS 12.18]*. This schedule must be presented in addition to the information required by IAS 1 in the statement of changes in equity.

IAS 1 requires an entity to present, for each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control. *[IAS 1.106(d)]*.[6]

Despite this existing disclosure requirement, the IASB decided to require that if a parent has equity transactions with non-controlling interests, it must disclose in a separate schedule the effects of those transactions on the equity of the owners of the parent. See Chapter 8 at section 4 for guidance on the accounting for equity transactions with non-controlling interests.

The IASB's rationale for this duplication is that many respondents to a 2005 exposure draft, which proposed amendments to a previous version of IAS 27, requested more prominent disclosure of the effects of transactions with non-controlling interests on the equity of the owners of the parent. *[IFRS 12.BC38, IFRS 12.BC39]*.

IFRS 12 does not prescribe a format for this additional schedule. An example of the type of disclosure required is illustrated below.

Illustration 4-3: Illustrative example of disclosure of changes in ownership interest in subsidiary that does not result in loss of control

On 5 October 20X1 the Group, which had a 95% ownership interest, disposed of 25% of the ownership interests of Subsidiary Limited. Following the disposal, the Group still controls Subsidiary Limited and retains 70% of the ownership interests.

The transaction has been accounted for as an equity transaction with non-controlling interests (NCI), resulting in the following:

	CU'000
Proceeds from sale of 25% ownership interest	550
Net assets attributable to NCI	(500)
Increase in equity attributable to parent	**50**
Represented by:	
Decrease in currency revaluation reserve	(250)
Decrease in fair value reserve of financial assets at FVOCI	(100)
Increase in retained earnings	400
	50

6 The same is required according to IFRS 18.107(c), once effective.

4.5.2 Changes that do result in loss of control

Extract from IFRS 12

Consequences of losing control of a subsidiary during the reporting period

19 An entity shall disclose the gain or loss, if any, calculated in accordance with paragraph 25 of IFRS 10, and:

(a) the portion of that gain or loss attributable to measuring any investment retained in the former subsidiary at its fair value at the date when control is lost; and

(b) the line item(s) in profit or loss in which the gain or loss is recognised (if not presented separately).

[IFRS 12.19].

See Chapter 8 at section 3.2 for more guidance on accounting for a loss of control of a subsidiary under IFRS 10.

4.6 Disclosures required by investment entities

An investment entity that prepares financial statements in which all of its subsidiaries are measured at fair value through profit or loss must make the disclosures relating to investment entities discussed below. *[IFRS 12.6(b)(ii)]*.

If an investment entity has a subsidiary that it consolidates because that subsidiary is not an investment entity and its main purpose and activities are providing services related to the investment entity's investment activities, the disclosure requirements in IFRS 12 apply to the financial statements in which the investment entity consolidates that subsidiary. *[IFRS 12.BC61I]*.

An investment entity that is required by IFRS 10 to apply the exception from consolidation and instead account for its investment in a subsidiary at fair value through profit or loss must disclose that fact. *[IFRS 12.19A]*.

Disclosure requirements regarding significant judgements and assumptions in determining the investment entity status are discussed in section 3 above.

4.6.1 Disclosures about the composition of the group

For each unconsolidated subsidiary, an investment entity must disclose:

(a) The subsidiary's name

(b) The principal place of business (and country of incorporation if different from the principal place of business) of the subsidiary

And

(c) The proportion of ownership interest held by the investment entity and, if different, the proportion of voting rights held *[IFRS 12.19B]*

If an investment entity is the parent of another investment entity, the parent must also provide the disclosures (a) to (c) of IFRS 12.19B above for investments that are controlled by its investment entity subsidiary. The disclosures may be provided by including, in the financial statements of the parent, the financial statements of the subsidiary that contain the information required in IFRS 12.19B. *[IFRS 12.19C]*.

There is no explicit requirement in IFRS 12 to disclose this information in respect of consolidated subsidiaries with no material non-controlling interests (see section 4.1 above).

4.6.2 Disclosures required when investment entity status changes

When an entity becomes, or ceases to be, an investment entity it must disclose:

- The change of investment entity status

  And

- The reasons for the change

In addition, an entity that becomes an investment entity must disclose the effect of the change of status on the financial statements for the period presented, including:

- The total fair value, as of the date of change of status, of the subsidiaries that cease to be consolidated
- The total gain or loss, if any, calculated in accordance with IFRS 10.B101

  And
- The line item(s) in profit or loss in which the gain or loss is recognised (if not presented separately) *[IFRS 12.9B]*

The accounting effect of becoming or ceasing to become an investment entity is discussed in Chapter 7 at section 10.3.1.

4.6.3 Disclosures required in respect of significant restrictions, commitments and financial and other support

Extract from IFRS 12

19D An investment entity shall disclose:

(a) the nature and extent of any significant restrictions (eg resulting from borrowing arrangements, regulatory requirements or contractual arrangements) on the ability of an unconsolidated subsidiary to transfer funds to the investment entity in the form of cash dividends or to repay loans or advances made to the unconsolidated subsidiary by the investment entity; and

(b) any current commitments or intentions to provide financial or other support to an unconsolidated subsidiary, including commitments or intentions to assist the subsidiary in obtaining financial support.

19E If, during the reporting period, an investment entity or any of its subsidiaries has, without having a contractual obligation to do so, provided financial or other support to an unconsolidated subsidiary (eg purchasing assets of, or instruments issued by, the subsidiary or assisting the subsidiary in obtaining financial support), the entity shall disclose:

(a) the type and amount of support provided to each unconsolidated subsidiary; and

(b) the reasons for providing the support.

[IFRS 12.19D, IFRS 12.19E].

In addition, an investment entity must disclose the terms of any contractual arrangements that require the entity or its unconsolidated subsidiaries to provide financial support to an unconsolidated, controlled, structured entity, including events and circumstances that could expose the reporting entity to a loss (e.g., liquidity arrangements or credit rating triggers associated with obligations to purchase assets of the structured entity or to provide financial support). *[IFRS 12.19F]*.

During a reporting period an investment entity or any of its unconsolidated subsidiaries may have, without having a contractual obligation to do so, provided financial or other support to an unconsolidated structured entity that the investment entity did not control. In such a situation, if that provision of financial support resulted in the investment entity controlling the structured entity, the investment entity must provide an explanation of the relevant factors considered in reaching the decision to provide that support. *[IFRS 12.19G]*.

These disclosures are similar to those required for consolidated subsidiaries, including consolidated structured entities discussed in sections 4.3, 4.4.1, 4.4.2 and 4.4.4 above - see the comments in these sections.

4.6.4 Valuation methodologies and nature of investing activities

IFRS 12 does not require any disclosure of fair value measurements made by investment entities. This information is already required by IFRS 7 and by IFRS 13 when reporting investments at fair value through profit or loss or other comprehensive income in accordance with IFRS 9. *[IFRS 12.BC61C]*.

5 Disclosure of interests in joint arrangements and associates

Extract from IFRS 12

20 An entity shall disclose information that enables users of its financial statements to evaluate:

(a) the nature, extent and financial effects of its interests in joint arrangements and associates, including the nature and effects of its contractual relationship with the other investors with joint control of, or significant influence over, joint arrangements and associates (paragraphs 21 and 22); and

(b) the nature of, and changes in, the risks associated with its interests in joint ventures and associates (paragraph 23).

[IFRS 12.20].

These requirements, explained in detail in sections 5.1 and 5.2 below, apply in full to both consolidated financial statements and individual financial statements of entities with joint arrangements and associates.

IFRS 12 does not address the presentation of joint ventures and associates in the primary statements. IAS 1 requires separate presentation of investments accounted for using the equity method on the face of the statement of financial position, although it does not require a split of those investments between joint ventures and associates. *[IAS 1.54]*.[7] IAS 1 also requires a reporting entity's post-tax share of the profit or loss of associates and joint ventures accounted for using the equity method to be disclosed on the face of the statement of comprehensive income. *[IAS 1.82]*.[8] In addition, IAS 1 specifically requires that entities must present the share of other comprehensive income items of their equity method investees, in aggregate, as single line items within the 'to be reclassified' and the 'not to be reclassified' groups. *[IAS 1.82A]*.[9]

5.1 Disclosure of the nature, extent and financial effects of interests

An entity must disclose:

(a) For each joint arrangement and associate that is material to the reporting entity:
   (i) The name of the joint arrangement or associate
   (ii) The nature of the entity's relationship with the joint arrangement or associate (by, for example, describing the nature of the activities of the joint arrangement or associate and whether they are strategic to the entity's activities)
   (iii) The principal place of business (and country of incorporation, if applicable and different from the principal place of business) of the joint arrangement or associate

   And

   (iv) The proportion of ownership interest held by the entity and, if different, the proportion of voting rights held (if applicable)

(b) For each joint venture (but not a joint operation) and associate that is material to the reporting entity:
   (i) Whether the investment in the joint venture or associate is measured using the equity method or at fair value
   (ii) Summarised financial information about the joint venture or associate (see section 5.1.1 below)

   And

   (iii) If the joint venture or associate is accounted for using the equity method, the fair value of the investment in the joint venture or associate, if there is a quoted market price for the investment

(c) Financial information (see section 5.1.2 below) about the entity's investments in joint ventures and associates that are not individually material:
   (i) In aggregate for all individually immaterial joint ventures and, separately
   (ii) In aggregate for all individually immaterial associates *[IFRS 12.21]*

7 The same is required according to IFRS 18.103, once effective. In addition, IFRS 18.53 and IFRS 18.55(a) require entities to classify income and expenses specified in IFRS 18.54 from investments in associates and joint ventures accounted for applying the equity method in the investing category.

8 The same is required according to IFRS 18.75, once effective.

9 The same is required according to IFRS 18.89, once effective.

Disclosures (b) and (c) are not required by an investment entity. *[IFRS 12.21A]*.

Frequently asked questions

Question 5-1: Disclosure of summarised financial information about material joint ventures or associates

In January 2015, the IFRS IC discussed a request to clarify the requirement described above to disclose summary financial information about material joint ventures and associates and its interaction with the aggregation principle of IFRS 12 (see section 2.2.2 above). The issues raised were:

- Whether the summary financial information can be disclosed in aggregate for all material joint ventures and associates, or whether such information should be disclosed individually for each material joint venture or associate.

  And

- Whether an investor should be excused from disclosing information related to a listed joint venture or associate if the local regulatory requirements prevented the investor from disclosing such information until the joint venture or associate has released its own financial statements.

In respect of the first issue, the IFRS IC noted that it expected the requirement to prepare summarised financial information about a joint venture or an associate in IFRS 12 to lead to the disclosure of summarised information on an individual basis for each joint venture or associate that is material to the reporting entity (i.e., this information should not be presented in aggregate for all material joint ventures or associates). The IFRS IC observed that this reflects the IASB's intentions as described in the Basis for Conclusions to IFRS 12.

In respect of the second issue, the IFRS IC also noted that there is no provision in IFRS 12 that permits non-disclosure of this information (on the grounds of confidentiality or local regulatory requirements) and that outreach performed indicated that there was no significant diversity observed in practice on this issue.

Consequently, the IFRS IC determined that neither an Interpretation nor an amendment to a standard was necessary and decided not to add these issues to its agenda.[10]

Extract from IFRS 12

22 An entity shall also disclose:

(a) the nature and extent of any significant restrictions (eg resulting from borrowing arrangements, regulatory requirements or contractual arrangements between investors with joint control of or significant influence over a joint venture or an associate) on the ability of joint ventures or associates to transfer funds to the entity in the form of cash dividends, or to repay loans or advances made by the entity.

(b) when the financial statements of a joint venture or associate used in applying the equity method are as of a date or for a period that is different from that of the entity:

  (i) the date of the end of the reporting period of the financial statements of that joint venture or associate; and

  (ii) the reason for using a different date or period.

(c) the unrecognised share of losses of a joint venture or associate, both for the reporting period and cumulatively, if the entity has stopped recognising its share of losses of the joint venture or associate when applying the equity method.

[IFRS 12.22].

The implication from this wording is that these disclosures in respect of significant restrictions, reporting dates and unrecognised losses are required separately for each material joint venture or associate.

10 *IFRIC Update*, January 2015, p.7, available on the IFRS Foundation's website.

A summary of the disclosures required for individually material and, collectively for immaterial joint ventures and associates is shown in the table below.

Topic	Material joint ventures and associates	Individually immaterial joint ventures and associates
Accounting policy	✓	X
Summarised financial information	✓	✓ (in aggregate)
Fair value, if quoted market price is available	✓	X
Restrictions on ability to transfer funds	✓	✓ (in aggregate)
Date of financial statements, if different from entity	✓	✓
Unrecognised share of losses	✓	✓ (in aggregate)

5.1.1 Summarised financial information of individually material joint ventures and associates

The summarised financial information specified by IFRS 12.21(b)(ii) (see section 5.1 above) for each material joint venture and associate is as follows:

Extract from IFRS 12

B12 For each joint venture and associate that is material to the reporting entity, an entity shall disclose:

(a) dividends received from the joint venture or associate.

(b) summarised financial information for the joint venture or associate (see paragraphs B14 and B15) including, but not necessarily limited to:

(i) current assets.

(ii) non-current assets.

(iii) current liabilities.

(iv) non-current liabilities.

(v) revenue.

(vi) profit or loss from continuing operations.

(vii) post-tax profit or loss from discontinued operations.

(viii) other comprehensive income.

(ix) total comprehensive income.

B13 In addition to the summarised financial information required by paragraph B12, an entity shall disclose for each joint venture that is material to the reporting entity the amount of:

(a) cash and cash equivalents included in paragraph B12(b)(i).

(b) current financial liabilities (excluding trade and other payables and provisions) included in paragraph B12(b)(iii).

(c) non-current financial liabilities (excluding trade and other payables and provisions) included in paragraph B12(b)(iv).

(d) depreciation and amortisation.

(e) interest income.

(f) interest expense.

(g) income tax expense or income.

[IFRS 12.B12, IFRS 12.B13].

The summarised financial information presented must be the 100% amounts included in the IFRS financial statements of the joint venture or associate (and not the entity's share of those amounts). However, if the entity accounts for the joint venture or associate using the equity method:

(a) The amounts included in the IFRS financial statements of the joint venture or associate must be adjusted to reflect adjustments made by the entity when using the equity method, such as the fair value adjustments made at the time of acquisition and adjustments for differences in accounting policies.

And

(b) The entity must provide a reconciliation of the summarised financial information presented to the carrying amount of its interest in the joint venture or associate. *[IFRS 12.B14]*.

IFRS 12 does not specifically require a reporting entity's share of (a) to (d) of IFRS 12.B16 (see section 5.1.2 below) to be disclosed in total for material joint ventures or associates.

Frequently asked questions

Question 5-2: Where the investee is a group: On which basis should an entity prepare the required summarised financial information about material joint ventures or associates?

In January 2015, the IFRS IC discussed the basis on which an entity should prepare the required summarised financial information for joint ventures and associates. The question raised was whether summarised financial information should be presented for each material joint venture or associate on an individual basis, or whether this information should be disclosed for the subgroup of the joint venture or associate together with its investees. The IFRS IC observed that a reporting entity should present the summarised financial information required about a joint venture or an associate that is material to the reporting entity based on the consolidated financial statements for the joint venture or associate, if it has subsidiaries. If it does not have subsidiaries, the presentation should be based on the financial statements of the joint venture or associate in which its own joint ventures or associates are equity accounted. The IFRS IC noted that these views are consistent with IFRS 12.B14(a), which requires that the amounts included in the financial statements of the joint venture or associate must be adjusted to reflect adjustments made by the reporting entity using the equity method, such as fair value adjustments made at the time of acquisition and adjustments for differences in accounting policies. Consequently, the IFRS IC decided that neither an interpretation nor an amendment to a standard was necessary and decided not to add this issue to its agenda.[11]

The standard does not specify what components are to be included in the reconciliation of the summarised financial information presented to the carrying amount of the entity's interest in the joint venture or associate. As clarified by the IFRS IC, the amounts included in the IFRS financial statements of the joint venture or associate must be adjusted to reflect fair value and accounting policy adjustments per IFRS 12.B14(a). Therefore, any pre-existing goodwill in the books of the joint venture or associate at the time it became a joint venture or an associate of the reporting entity must be eliminated from the amounts in IFRS 12.B14(a) as a fair value adjustment.

How we see it

The implications regarding the reporting entity's goodwill attributable to the joint venture or associate that is included in the carrying amount of the investment are less clear. Such goodwill could be included in the summarized financial information as a fair value adjustment per IFRS 12.B14(a) or in the reconciliation per IFRS 12.B14(b). Care will therefore be needed in adequately explaining how the summarised IFRS financial information reconciles to the carrying amount of the reporting entity's interest in the joint venture or associate.

An entity may present the summarised financial information required on the basis of the joint venture's or associate's financial statements if:

(a) The entity measures its interest in the joint venture or associate at fair value in accordance with IAS 28.

And

(b) The joint venture or associate does not prepare IFRS financial statements and preparation on that basis would be impracticable or cause undue cost. In that case, the entity must disclose the basis on which the summarised financial information has been prepared. *[IFRS 12.B15]*.

This implies that the summarised financial information of the joint venture or associate can be prepared on a non-IFRS basis in those circumstances where both conditions (a) and (b) of IFRS 12.B15 are satisfied.

11 *IFRIC Update*, January 2015, p.7, available on the IFRS Foundation's website.

Where a joint venture or an associate measured at fair value in accordance with IAS 28 does prepare IFRS financial statements, or where the preparation of IFRS financial information would not be impracticable or cause undue cost, the summarised financial information disclosed are the unadjusted IFRS numbers of the joint venture or associate (as compared to the adjusted basis used where the equity method is applied).

In principle, the IASB concluded that the disclosure requirements for joint ventures and associates will be the same for all entities regardless of whether those entities are venture capital organisations, mutual funds, unit trusts or similar entities which are permitted by IAS 28 to hold investments in joint ventures and associates at fair value. *[IFRS 12.BC60]*.

Nevertheless, the minimum line item disclosures required for material associates are less than those required for material joint ventures on the grounds that, in the IASB's opinion, an entity is generally more involved with joint ventures than with associates because joint control means that an entity has a veto over decisions relating to the relevant activities of the joint venture. Accordingly, the IASB considers that the different nature of the relationship between a joint venturer and its joint ventures from that between an investor and its associates warrants a different level of detail in the disclosures of summarised financial information. *[IFRS 12.BC51]*.

Summarised financial information is not required for material joint operations since assets and liabilities arising from joint operations are the reporting entity's own assets and liabilities and consequently are recognised separately in the entity's financial statements. They are accounted for in accordance with the requirements of applicable IFRS accounting standards and are therefore subject to the disclosure requirements of those standards. *[IFRS 12.BC52]*. See Chapter 13 at section 6 for guidance on accounting for joint operations.

In the below extract, Heidelberg Materials AG discloses summarised financial information for a material joint venture.

Practical example 5-1: Heidelberg Materials AG (2023) **Germany**

Annual and Sustainability Report 2023 [extract]
Consolidated financial statements [extract]
Group Notes [extract]
7 Notes to the income statement [extract]
7.6 Results from equity accounted investments [extract]

The following table shows the statement of comprehensive income (100% values).

Statement of comprehensive income Cement Australia

€m	2022	2023
Revenue	830.2	857.6
Depreciation and amortisation	-43.3	-42.1
Result from current operations	**161.6**	**218.4**
Additional ordinary result		-0.5
Earnings before interest and taxes (EBIT)	**161.6**	**217.9**
Interest expenses	-15.7	-25.8
Other financial income and expenses	-1.1	-0.1
Profit before tax	**144.8**	**192.0**
Income taxes	7.6	-15.0
Profit for the financial year	**152.4**	**177.0**
Other comprehensive income	-3.7	7.4
Total comprehensive income	**148.7**	**184.4**

The assets and liabilities (100% values), the reconciliation to the total carrying amount of the interest, and the dividend received are shown in the following table.

Additional financial information Cement Australia

€m	2022	2023
Intangible assets	21.6	36.3
Property, plant and equipment	487.1	485.4
Financial fixed assets	37.1	35.5
Other non-current assets	1.9	1.9
Total non-current assets	**547.7**	**559.1**
Cash and cash equivalents	4.4	0.5
Other current assets	166.8	164.9
Total current assets	**171.2**	**165.4**
Total assets	**718.9**	**724.5**
Non-current financial liabilities	338.2	218.0
Non-current provisions	6.5	21.7
Other non-current liabilities	7.2	9.9
Total non-current liabilities	**351.9**	**249.6**
Current financial liabilities	36.8	138.4
Current provisions	9.3	8.8
Trade payables	108.8	92.3
Other current liabilities	70.5	76.8
Total current liabilities	**225.4**	**316.3**
Total liabilities	**577.3**	**565.9**
Net assets	**141.6**	**158.6**
Group share in %	50.0	50.0
Group share of net assets	70.8	79.3
Goodwill	349.1	338.5
Total carrying amount of the interest	**419.9**	**417.8**
Dividends received	80.8	77.9

5.1.2 Financial information of individually immaterial joint ventures and associates

Extract from IFRS 12

B16 An entity shall disclose, in aggregate, the carrying amount of its interests in all individually immaterial joint ventures or associates that are accounted for using the equity method. An entity shall also disclose separately the aggregate amount of its share of those joint ventures' or associates':

(a) profit or loss from continuing operations.

(b) post-tax profit or loss from discontinued operations.

(c) other comprehensive income.

(d) total comprehensive income.

An entity provides the disclosures separately for joint ventures and associates.

[IFRS 12.B16].

In the below extract, Bayer Aktiengesellschaft has provided a summary of aggregated information related to immaterial associates and, separately, immaterial joint ventures:

Practical example 5-2: Bayer Aktiengesellschaft (2023) Germany

Annual Report 2023 [extract]
B/ Consolidated Financial Statements [extract]
Notes to the Statements of Financial Position [extract]

16. Investments accounted for using the equity method

Some 42 (2022: 43) associates and four (2022: five) joint ventures were accounted for in the consolidated financial statements using the equity method. A list of these companies is available at www.bayer.com/shareownership2023.

The following table contains a summary of the aggregated income statement data and aggregated carrying amounts of the associates and joint ventures accounted for using the equity method:

B 16/1

Earnings Data and Carrying Amounts of Companies Accounted for Using the Equity Method

	Associates		Joint ventures	
€ million	2022	2023	2022	2023
Income after income taxes	(586)	(832)	(62)	(14)
Other comprehensive income after income taxes	16	–	–	–
Total comprehensive income after income taxes	(570)	(832)	(62)	(14)
Share of income after income taxes[1]	**(117)**	**(155)**	**(33)**	**(7)**
Share of total comprehensive income after income taxes	(104)	(155)	(33)	(7)
Carrying amount as of December 31	**826**	**791**	**67**	**59**

[1] Also including gains from remeasurement of investments accounted for using the equity method due to the loss of significant influence and the fact that they then ceased being accounted for using the equity method

5.2 Risks associated with interests in joint ventures and associates

An entity must disclose:

(a) Commitments that it has relating to its joint ventures separately from the amount of other commitments And

(b) Contingent liabilities (as defined in IAS 37) relating to its interests in joint ventures or associates (including its share of contingent liabilities incurred jointly with other investors with joint control of, or significant influence over, the joint ventures and associates) separately from the amount of other contingent liabilities *[IFRS 12.23]*

5.2.1 Disclosure of commitments relating to joint ventures

IAS 24 *Related Party Disclosures* already requires aggregate commitments relating to joint ventures to be disclosed separately from other commitments. *[IAS 24.18, IAS 24.19]*. IFRS 12 clarifies that the commitments required to be disclosed under IAS 24 include an entity's share of commitments made jointly with other investors with joint control of a joint venture. Commitments are those that may give rise to a future outflow of cash or other resources. *[IFRS 12.B18]*.

IFRS 12 provides the following examples of unrecognised commitments that must be disclosed under IAS 24:

(a) Unrecognised commitments to contribute funding or resources as a result of, for example:
   (i) The constitution or acquisition agreements of a joint venture (that, for example, require an entity to contribute funds over a specific period)
   (ii) Capital intensive projects undertaken by a joint venture
   (iii) Unconditional purchase obligations, comprising procurement of equipment, inventory or services that an entity is committed to purchasing from, or on behalf of, a joint venture
   (iv) Unrecognised commitments to provide loans or other financial support to a joint venture
   (v) Unrecognised commitments to contribute resources to a joint venture, such as assets or services
   (vi) Other non-cancellable unrecognised commitments relating to a joint venture

   And

(b) Unrecognised commitments to acquire another party's ownership interest (or a portion of that ownership interest) in a joint venture if a particular event occurs or does not occur in the future *[IFRS 12.B19]*

There is no requirement to disclose these commitments for individual joint ventures. However, IAS 24 requires disclosure of information about those transactions and outstanding balances, including commitments, necessary for users to understand the potential effect of the relationship on the financial statements. *[IAS 24.18]*. This implies that there is to be separate disclosure of different types of significant commitments. IAS 24 does not require the names of any joint ventures to be disclosed.

In the below extract, BP p.l.c. has provided information about commitments made to joint ventures and associates:

Practical example 5-3: BP p.l.c. (2023) **United Kingdom**

bp Annual Report and Form 20-F 2023 [extract]

Notes on financial statements [extract]

13. Capital commitments

Authorized future capital expenditure for property, plant and equipment (excluding right-of-use assets) by group companies for which contracts had been signed at 31 December 2023 amounted to $10,354 million (2022 $9,381 million, 2021 $8,208 million). bp has contracted capital commitments amounting to $1,580 million (2022 $1,764 million, 2021 $1,075 million) in relation to joint ventures and $105 million (2022 $18 million, 2021 $126 million) in relation to associates.

5.2.2 Disclosure of contingent liabilities relating to joint ventures and associates

IFRS 12 requires disclosure of the same information as required by IAS 37 for contingent liabilities relating to an entity's interests in joint ventures and associates, separately from an entity's other contingent liabilities. *[IFRS 12.23(b)]*.

IAS 37 requires, for each class of contingent liability at the end of a reporting period, a brief description of the nature of the contingent liability and, where practicable:

(a) An estimate of its financial effect, measured under the requirements of the standard

(b) An indication of the uncertainties relating to the amount or timing of any outflow

   And

(c) The possibility of any reimbursement *[IAS 37.86]*

IAS 37 further defines what is intended by 'class' and the circumstances in which aggregation of disclosures of contingent liabilities is appropriate.

The definition of a contingent liability can be found in Chapter 27 at section 3.2.1 with further detail on contingent liabilities contained in Chapter 27 at section 7.2.

6 Disclosure of interests in unconsolidated structured entities

Extract from IFRS 12

24 An entity shall disclose information that enables users of its financial statements:

(a) to understand the nature and extent of its interests in unconsolidated structured entities (paragraphs 26-28); and

(b) to evaluate the nature of, and changes in, the risks associated with its interests in unconsolidated structured entities (paragraphs 29-31).

[IFRS 12.24].

These disclosures are not required by an investment entity for an unconsolidated structured entity that it controls and for which it presents the disclosures required in section 4.6 above. *[IFRS 12.25A]*.

Disclosure requirements in respect of risks associated with interests in consolidated structured entities are discussed in section 4.4 above.

As discussed in section 2.2.2.D above, these disclosures also apply to interests in joint ventures and associates that are structured entities, in addition to the disclosures required in section 5 above for joint ventures and associates.

The information required by IFRS 12.24(b) includes information about an entity's exposure to risk from involvement that it had with unconsolidated structured entities in previous periods (e.g., sponsoring the structured entity) even if the entity no longer has any contractual involvement with the structured entity at the reporting date. *[IFRS 12.25]*.

Some of the disclosure requirements for unconsolidated structured entities overlap with those of IFRS 7, since many interests in unconsolidated structured entities are financial assets within the scope of IFRS 7. However, IFRS 12 and IFRS 7 require different types of risk disclosure. IFRS 7 requires disclosures about risks associated with financial instruments. IFRS 12 adopts a different perspective and requires an entity to disclose its exposure to risks from its interest in a structured entity. *[IFRS 12.BC72]*. The IASB therefore considered the disclosure requirements in both standards to complement each other. *[IFRS 12.BC74]*.

6.1 Disclosure of the nature and extent of interests

6.1.1 Disclosure of the nature, purpose, size, activities and financing

An entity must disclose qualitative and quantitative information about its interests in unconsolidated structured entities, including, but not limited to, the nature, purpose, size and activities of the structured entity and how the structured entity is financed. *[IFRS 12.26]*.

The IASB concluded that this requirement will provide users with sufficient information about the assets held by structured entities and the funding of those assets without requiring specific disclosures of the assets of unconsolidated structured entities in which the entity has an interest in all circumstances. If relevant to an assessment of its exposure to risk, an entity would be required to provide additional information about the assets and funding of structured entities. *[IFRS 12.BC96]*.

6.1.1.A Nature and purpose

Examples of the nature and purpose of a structured entity might include:

- To manage balance sheet exposure and risk, including securitisation of assets
- To provide investors with a synthetic exposure to debt and equity instruments such as credit linked notes and equity linked notes
- To provide investors with a variety of investment opportunities through managed investment strategies

  And
- To obtain and facilitate funding

Quilter plc discloses the nature, purpose and type of interest in unconsolidated structured entities in a narrative format as follows:

Practical example 6-1: Quilter plc (2022) **United Kingdom**

Annual Report 2022 [extract]

Notes to the consolidated financial statements [extract]

21: Structured entities [extract]

21(a): Group's involvement in structured entities

The Group invests in collective investment vehicles, including open-ended investment companies ("OEICs") and unit trusts, in order to match unit-linked investment contract liabilities. This means that all of the investment risk associated with these assets is borne by policyholders and any change in the value of these assets is closely matched by a corresponding change in liability due to policyholders. As the Group earns management fees based on the market value of unit-linked assets, any change in asset values will increase or decrease the Group's revenues. The Group has not provided any non-contractual support to any consolidated or unconsolidated structured entities during 2021 or 2022.

As at 31 December 2021 and 31 December 2022, the Group has no obligation or intention to provide financial support to structured entities that could expose the Group to a loss.

In addition, shareholder funds are also invested in collective investment vehicles, principally in respect of money market funds as an alternative to bank deposits.

The Group's holdings in collective investment vehicles are subject to the terms and conditions of the respective investment vehicles' offering documentation and are susceptible to market price risk arising from uncertainties about the future values of those investment vehicles. All of the investment vehicles in the investment portfolios are managed by portfolio managers who are compensated by the respective investment vehicles for their services. Such compensation generally consists of an asset-based fee and a performance-based incentive fee and is reflected in the valuation of the investment vehicles.

These structured entities are not consolidated where the Group determines that it does not have control.

6.1.1.B Size

The requirement to disclose the size of a structured entity is often met by providing information about the total value of the assets of the entity. However, the Basis for Conclusions states that IFRS 12 does not require specific disclosure of the reported assets of unconsolidated structured entities in which the entity has an interest. *[IFRS 12.BC96]*. This suggests that other measures of size would be acceptable, including the principal amount of securities issued by structured entities.

6.1.1.C Activities

When disclosing the activities of a structured entity, these activities must include the primary activities for which the entity was designed, which are the activities that significantly affect the entity's returns. See Chapter 7 at sections 3.2 and 4.1 for guidance on purpose and design of an investee and relevant activities, respectively, as described in IFRS 10.

For example, the activities that could significantly affect the entity's returns, include:

- Providing a source of long-term capital to an entity or funding to support a reporting entity's ongoing major or central operations through issuing notes.

  Or

- Providing a supply of goods and services that is consistent with a reporting entity's ongoing major or central operations which, without the existence of the structured entity, would have to be provided by the reporting entity itself.

6.1.1.D Financing

This disclosure requirement is not limited to financing provided by the reporting entity to the structured entity and would include financing received by the structured entity from unrelated third parties. It is also not limited to equity financing and includes all forms of financing that allow the structured entity to conduct its business activities.

6.1.2 Disclosures of sponsored structured entities for which no interest is held at the reporting date

If an entity has sponsored an unconsolidated structured entity for which it does not disclose the risk information required by section 6.2 below (e.g., because it does not have an interest in the entity at the reporting date), the entity must disclose:

(a) How it has determined which structured entities it has sponsored

(b) Income from those structured entities during the reporting period, including a description of the types of income presented

And

(c) The carrying amount (at the time of transfer) of all assets transferred to those structured entities during the reporting period *[IFRS 12.27]*

The information required by (b) and (c) of IFRS 12.27 must be presented in a tabular format unless some other format is more appropriate and the sponsoring activities must be classified into relevant categories. *[IFRS 12.28]*.

The rationale for this disclosure requirement is that sponsoring a structured entity can create risks for a reporting entity, even though the entity may not retain an interest in the structured entity. The Basis for Conclusions states that "if the structured entity encounters difficulties, it is possible that the sponsor could be challenged on its advice or actions, or might choose to act to protect its reputation." *[IFRS 12.BC87]*.

IFRS 12 does not define 'sponsor'. However, an illustrative example in IFRS 10 uses the word 'sponsor' in a similar context when it states that "a decision maker (the sponsor) sponsors a multi-seller conduit". In the IFRS 10 example, the sponsor establishes the terms of the conduit and manages the operations of the conduit for a market-based fee. *[IFRS 10.B72 Example 16]*.

Factors that may indicate that a reporting entity has sponsored a structured entity include:

- The reporting entity established and set up the entity.

  And

- The reporting entity was involved in the creation and design of the structured entity.

  Or

- The reporting entity is the majority user of the structured entity.

  Or

- The reporting entity's name appears in the name of the structured entity or on the products issued by the structured entity.

Determining whether the reporting entity is the sponsor of a structured entity will be a matter of individual facts and circumstances and may require judgement to be exercised.

Many financial institutions define 'sponsor' for the purpose of their IFRS 12 disclosures as illustrated by this disclosure from HSBC Holdings plc's financial statements.

Practical example 6-2: HSBC Holdings plc (2022) **United Kingdom**

Annual Report and Accounts 2022 [extract]

Notes on the financial statements [extract]

1. Basis of preparation and significant accounting policies [extract]

1.2 Summary of significant accounting policies [extract]

(a) Consolidation and related policies [extract]

HSBC sponsored structured entities

HSBC is considered to sponsor another entity if, in addition to ongoing involvement with the entity, it had a key role in establishing that entity or in bringing together relevant counterparties so the transaction that is the purpose of the entity could occur. HSBC is generally not considered a sponsor if the only involvement with the entity is merely administrative.

The information required by (a) and (b) of IFRS 12.27 must be disclosed whether or not any assets were transferred to the structured entity during the reporting period. There is no time limit set for these disclosures so, in theory, they could continue indefinitely after the cessation of any interest in the structured entity. IFRS 12 does not specify whether (c) of IFRS 12.27 refers to assets transferred to the structured entity by the reporting entity or to the total assets transferred to the structured entity irrespective of who the transferor may be. However, the Basis for Conclusions states that the IASB concluded that the asset information disclosed must refer not only to assets transferred by the sponsor but to all assets transferred to the structured entity during the reporting period. *[IFRS 12.BC90]*.

Income received from structured entities would not be confined to the income derived from the reporting entity's 'interest(s)' as defined by IFRS 12 but would cover all types of income received and reported by the entity. IFRS 12 states that 'income from a structured entity' includes, but is not limited to:

- Recurring and non-recurring fees (structuring fees, management fees, placing agent fees, etc.)
- Interest
- Dividends
- Gains or losses on the remeasurement or derecognition of interests in structured entities

  And
- Gains or losses from the transfer of assets or liabilities to the structured entity. *[IFRS 12 Appendix A]*.

There is no requirement for a quantitative split of the fee income by type although it may be useful for users of the financial statements.

An illustrative example of the disclosures required by (a) to (c) of IFRS 12.27 is shown below.

Illustration 6-1: Illustrative example of disclosures for sponsored structured entities where no interest exists at the reporting date

The Group considers itself the sponsor of a number of structured entities. The Group designed and established these entities. In some cases, it also transferred assets to them, in others it markets products associated with the entities in its own name and/or provides guarantees regarding the performance of the entities.

For some structured entities, the Group has no interest at the reporting date. However, it has sold assets to those entities during the reporting period in such a way that it has no continuing involvement in those assets and has earned fees for selling those assets and for other transactions carried out for the entities. The table below presents the Group's income recognised during the reporting period and the carrying amounts (at the time of transfer) of any assets transferred to those structured entities during the reporting period as follows:

Income from unconsolidated structured entities in which no interest is held at 31 December 20X3	Income	Income
	20X3	20X2
	CU'000	CU'000
Commissions and fees	69	50
Interest income	48	47
Gains and losses on sale of assets	66	-
	183	**97**
Split by:		
Mortgage-backed securitisations	75	41
CDOs and CLOs	50	20
Asset-backed commercial paper	25	30
Property, credit-related and other investing	33	6
	183	**97**

Carrying amounts (at the time of transfer) of assets transferred to unconsolidated structured entities in reporting period	Transferred in year	Transferred in year
	20X3	20X2
	CU'000	CU'000
Mortgage-backed securitisations	3,065	-
CDOs and CLOs	2,536	-
Asset-backed commercial paper	1,325	3,000
Property, credit-related and other investing	178	-
	7,104	**3,000**

UBS Group AG makes the following disclosures in respect of sponsored unconsolidated structured entities in which UBS did not have an interest at the year-end.

Practical example 6-3: UBS Group AG (2023) — Switzerland

Annual Report 2023 [extract]
Consolidated financial statements [extract]
Notes to the UBS Group AG consolidated financial statements [extract]
Note 29 Interests in subsidiaries and other entities [extract]
c) Unconsolidated structured entities [extract]

Sponsored unconsolidated structured entities in which UBS did not have an interest at year-end
During 2023 and 2022, the Group did not earn material income from sponsored unconsolidated SEs in which UBS did not have an interest at year-end.

During 2023 and 2022, UBS and third parties did not transfer any assets into sponsored securitization vehicles created in those years. UBS and third parties transferred assets, alongside deposits and debt issuances (which are assets from the perspective of the vehicle), of USD 0.5bn and USD 0.5bn, respectively, into sponsored client vehicles created in 2023 (2022: USD 1bn and USD 3bn, respectively). For sponsored investment funds, transfers arose during the period as investors invested and redeemed positions, thereby changing the overall size of the funds, which, when combined with market movements, resulted in a total closing net asset value of USD 137bn (31 December 2022: USD 38bn).

...

Aviva plc made the following disclosures in respect of investment management fees earned in respect of its asset management business.

Practical example 6-4: Aviva plc (2022) — United Kingdom

Annual Report and Accounts 2022 [extract]
Notes to the consolidated financial statements [extract]
25 - Interests in structured entities [extract]

(c) Other interests in unconsolidated structured entities
The Group receives management fees and other fees in respect of its asset management businesses. The Group does not sponsor any of the funds or investment vehicles from which it receives fees. Management fees received for investments that the Group manages, but does not have a holding in, also represent an interest in unconsolidated structured entities. As these investments are not held by the Group, the investment risk is borne by the external investors and therefore the Group's maximum exposure to loss relates to future management fees. The table below shows the assets under management of entities that the Group manages but does not have a holding in and the fees earned from those entities.

	2022		2021	
	Assets under management £m	Investment management fees £m	Assets under management £m	Investment management fees £m
Specialised investment vehicles:	**5,623**	**22**	6,036	24
Analysed as:				
OEICs	398	1	253	2
PLPs	4,165	17	4,257	16
SICAVs	1,060	4	1,526	6
Total	**5,623**	**22**	6,036	24

6.2 Minimum disclosures regarding the nature of risks

The IASB decided that, although it agreed with the concept that an entity is generally allowed to tailor its disclosures to meet the specific information needs of its users, disclosure requirements relating to an entity's risk from its interests in unconsolidated structured entities must contain a minimum set of requirements that must be applied by all entities. In making this decision, the IASB was convinced by comments from users who pointed out that without any specific disclosure requirements, comparability would be impaired, and an entity might not disclose information that users find important. *[IFRS 12.BC94]*.

These minimum disclosures are discussed in sections 6.2.1 and 6.2.2 below.

Depending on the circumstances, an entity might need to provide additional disclosures to meet the disclosure objective to disclose information that allows users of a reporting entity's financial statements to evaluate the nature of, and changes to, the risks associated with its interests in unconsolidated structured entities. Examples provided by the standard are discussed in section 6.3 below.

6.2.1 Disclosures of interests and of the maximum exposure to loss

Extract from IFRS 12

29 An entity shall disclose in tabular format, unless another format is more appropriate, a summary of:

(a) the carrying amounts of the assets and liabilities recognised in its financial statements relating to its interests in unconsolidated structured entities.

(b) the line items in the statement of financial position in which those assets and liabilities are recognised.

(c) the amount that best represents the entity's maximum exposure to loss from its interests in unconsolidated structured entities, including how the maximum exposure to loss is determined. If an entity cannot quantify its maximum exposure to loss from its interests in unconsolidated structured entities it shall disclose that fact and the reasons.

(d) a comparison of the carrying amounts of the assets and liabilities of the entity that relate to its interests in unconsolidated structured entities and the entity's maximum exposure to loss from those entities.

[IFRS 12.29].

Disclosure of an entity's maximum exposure to loss was considered necessary by the IASB as it was concerned that, if only information about expected losses was required, an entity might often identify a positive expected value of returns from its interests in unconsolidated structured entities and, as a consequence, would not disclose any loss exposure. *[IFRS 12.BC97]*.

IFRS 12 does not define maximum exposure to loss. The IASB decided not to provide such a definition of 'loss' but to leave it to the entity to identify what constitutes a loss in the particular context of that reporting entity. Therefore, the entity has to disclose how it has determined maximum loss exposure. The IASB acknowledged that an entity might not always be able to calculate the maximum exposure to loss, such as when a financial instrument exposes an entity to theoretically unlimited losses. The IASB decided that when this is the case an entity must disclose the reasons why it is not possible to calculate the maximum exposure to loss. *[IFRS 12.BC98, IFRS 12.BC99]*.

How we see it

In our view 'maximum exposure to loss' refers to the maximum loss that an entity could be required to record in its statement of comprehensive income as a result of its involvement with a structured entity. Further, this maximum possible loss must be disclosed regardless of the probability of such losses actually being incurred. IFRS 12 is silent on whether the maximum exposure is gross or net of collateral or hedging instruments held that would mitigate any loss. Consistent with the equivalent disclosures required by IFRS 7.36, we believe that the maximum exposure to loss should be disclosed gross of any collateral or hedging instruments and that separate disclosure should be made in respect of instruments held that would mitigate the loss on a net basis.

The IASB also decided to require an entity to disclose a comparison of the carrying amounts of the assets and liabilities in its statement of financial position and its maximum exposure to loss. This is because the information will provide users with a better understanding of the differences between the maximum loss exposure and the expectation of whether it is likely that an entity will bear all or only some of the losses. The IASB reasoned that this information would help an entity explain why the maximum exposure to loss is unrepresentative of its actual exposure if that is the case. *[IFRS 12.BC100]*.

6.2.2 Disclosures of actual and intended financial and other support

Extract from IFRS 12

30 If during the reporting period an entity has, without having a contractual obligation to do so, provided financial or other support to an unconsolidated structured entity in which it previously had or currently has an interest (for example, purchasing assets of or instruments issued by the structured entity), the entity shall disclose:

(a) the type and amount of support provided, including situations in which the entity assisted the structured entity in obtaining financial support; and

(b) the reasons for providing the support.

[IFRS 12.30].

An entity must also disclose any current intentions to provide financial or other support to an unconsolidated structured entity, including intentions to assist the structured entity in obtaining financial support. *[IFRS 12.31]*.

See sections 4.4.2 and 4.4.4 above for discussion of these disclosure requirements.

Illustration 4-2 in section 4.4.2 above is an illustrative disclosure of the provision of financial support to a structured entity.

6.3 Additional disclosures regarding the nature of risks

In addition to the requirements in section 6.2 above, IFRS 12 also requires an entity to disclose additional information that is necessary to meet the disclosure objective to disclose information that allows users of a reporting entity's financial statements to evaluate the nature of, and changes to, the risks associated with its interests in unconsolidated structured entities.

IFRS 12 provides the following examples of additional information that, depending on the circumstances, might be relevant to an assessment of the risks to which a reporting entity is exposed where it has an interest in an unconsolidated structured entity:

(a) The terms of an arrangement that could require the entity to provide support to an unconsolidated structured entity (e.g., liquidity arrangements or credit rating triggers associated with obligations to purchase assets of the structured entity or provide financial support) including:
   (i) A description of the events or circumstances that could expose the reporting entity to a loss
   (ii) Whether there are any terms that would limit the obligation
   (iii) Whether there are any other parties that provide financial support and, if so, how the reporting entity's obligation ranks with those of other parties

(b) Losses incurred by the entity during the reporting period relating to its interests in unconsolidated structured entities

(c) The types of income the entity received during the reporting period from its interests in unconsolidated structured entities

(d) Whether an entity is required to absorb losses of an unconsolidated structured entity before other parties, the maximum limit of such losses for the entity and (if relevant) the ranking and amounts of potential losses borne by parties whose interests rank lower than the entity's interest in the unconsolidated structured entity

(e) Information about any liquidity requirements, guarantees or other commitments with third parties that may affect the fair value or risk of the entity's interests in unconsolidated structured entities

(f) Any difficulties an unconsolidated structured entity has experienced in financing its activities during the reporting period

   And

(g) In relation to the funding of an unconsolidated structured entity, the forms of funding (e.g., commercial paper or medium-term notes) and their weighted-average life. That information might include maturity analyses of the assets and funding of an unconsolidated structured entity if the structured entity has longer-term assets funded by shorter-term funding. *[IFRS 12.B25, IFRS 12.B26]*.

No prescriptive format is required for these disclosures. Therefore, a reporting entity will have to decide whether a tabular or narrative format is suitable depending on its individual circumstances. The examples above are not exhaustive.

The IASB does not intend each item in the list of examples above to apply in all circumstances. The IASB's intention regarding the disclosure of risk is that each entity ought to disclose information that is important when assessing that exposure but not to cloud the information with unnecessary detail that would be considered irrelevant. If an entity has a large exposure to risk because of transactions with a particular unconsolidated structured entity, then the Board would expect extensive disclosure about that exposure. In contrast, if the entity has very little exposure to risk, little disclosure would be required. Therefore, the list of additional information above is a list of examples of information that might be relevant and not a list of requirements that must be applied regardless of the circumstances. *[IFRS 12.BC113, IFRS 12.BC114]*.

Given that this information is required in respect of structured entities that the reporting entity does not control, and over which it may not exercise significant influence, some of the disclosures suggested in respect of (d), (f) and (g) of IFRS 12.B26 may be difficult to provide. This is because they require current information about the activities of the structured entity, rather than information about the interests held by the reporting entity.

Comments on some of the suggested disclosures are in sections 6.3.1 to 6.3.7 below.

6.3.1 Disclosure of support

Illustration 4-1 above illustrates disclosure of a contractual arrangement that could require support to a structured entity.

Illustration 4-2 above illustrates disclosure of support provided to a structured entity where there is no contractual obligation to provide such support.

The meaning of 'support' is discussed in section 4.4.2 above.

6.3.2 Disclosure of losses incurred

How we see it

IFRS 12 does not elaborate on 'losses incurred' but we believe that it refers to both realised and unrealised losses and losses recognised in both profit and loss and other comprehensive income. It may be informative to explain to users of the financial statements the line items in the primary statements in which the losses have been recognised. It would also be informative to disclose the aggregate losses incurred in respect of investments held at the reporting date as well as the losses incurred in the reporting period for those interests disposed of during the period.

Illustration 6-2: Illustrative example of disclosure of losses incurred from investments in unconsolidated structured entities

The Group has incurred the following realised and unrealised losses in respect of its investments in unconsolidated structured entities:

	20X1	20X0
	CU'000	CU'000
Realised losses	200	200
Unrealised losses (profit and loss)	400	300
Unrealised losses (other comprehensive income)	500	400
	1,100	**900**
Split by:		
Collateralised debt obligations	800	700
Credit card receivables	300	200
	1,100	**900**

Aggregate losses incurred	Transferred in year	Transferred in year
	20X1	20X0
	CU'000	CU'000
Collateralised debt obligations	2,300	1,500
Credit card receivables	1,700	1,400
	4,000	**2,900**

6.3.3 Disclosure of the types of income received

This disclosure is similar to the disclosure discussed in section 6.1.2 above in respect of unconsolidated structured entities for which the reporting entity does not have an interest at the reporting date. However, subparagraph (c) of IFRS 12.B26 refers only to the types of income received and does not refer to the need for a specific quantification of the income received.

'Income from a structured entity' includes, but is not limited to:

- Recurring and non-recurring fees (structuring fees, management fees, placing agent fees, etc.)
- Interest
- Dividends
- Gains or losses on the remeasurement or derecognition of interests in structured entities

  And
- Gains or losses from the transfer of assets or liabilities to the structured entity *[IFRS 12 Appendix A]*

6.3.4 Disclosure of the maximum limit, ranking and amounts of potential losses

Disclosure is required of the maximum limit of losses for a reporting entity where a reporting entity is required to absorb losses of a structured entity before other parties. This requirement is likely to be relevant for reporting entities which hold notes in securitised structured entities or where the interests in the structured entity are in the form of multiple contractually linked or 'tranched' notes.

An example of the type of disclosure that could be made is shown below.

Illustration 6-3: Illustrative example of disclosure of maximum exposure to and ranking of loss exposure by type of structured entity

The following table shows the maximum exposure to loss for ABC Bank by type of structured entity and by seniority of interest, where ABC Bank's interest ranks lower than interests of other investors, therefore, ABC Bank absorbs losses before other parties.

	Seniority of interests				
CU'000	Subordinated interests	Mezzanine interests	Senior interests	Most senior interests	Total
Mortgage backed securitisations					
i) ABC Bank's maximum exposure to loss	150	592	850	346	1,938
ii) Potential losses borne by more junior interests	-	897	7,875	10,332	19,104
CDOs and CLOs					
i) ABC Bank's maximum exposure to loss	60	167	243	32	502
ii) Potential losses borne by more junior interests	27	456	4,787	5,311	10,581
Asset backed commercial paper					
i) ABC Bank's maximum exposure to loss	-	-	-	379	379
ii) Potential losses borne by more junior interests	-	-	-	25	25

6.3.5 Disclosure of liquidity arrangements

This disclosure might include:

- Liquidity arrangements, guarantees or other commitments provided by third parties to the structured entity which affect the fair value or risk of the reporting entity's interests in the structured entity.

  And

- Liquidity arrangements, guarantees or other commitments provided by third parties to the reporting entity which affect the risks of the reporting entity's interests in the structured entity.

How we see it

We do not believe that this disclosure is intended to include liquidity arrangements, guarantees or other commitments made by the structured entity to third parties. While an arrangement provided to a third party may itself qualify as an interest in a structured entity, it would not normally affect the fair value of an entity's interests in an unconsolidated structured entity.

6.3.6 Disclosure of funding difficulties

Disclosure of 'any difficulties' that a structured entity has experienced in financing its activities during a reporting period could potentially be wide-ranging. In practice, we believe that such a disclosure is likely to focus on issues of debt (including short-term commercial paper) and equity securities that have failed either in whole or in part.

6.3.7 Disclosure of the forms of funding

This disclosure appears to refer to the overall funding of the structured entity including forms of funding in which the reporting entity has not participated. A tabular presentation may be the most appropriate way of making this disclosure.

7 Future developments

In April 2024, the IASB issued IFRS 18 *Presentation and Disclosure in Financial Statements* to replace IAS 1. IFRS 18 is effective for annual reporting periods beginning on or after 1 January 2027, with earlier application permitted (subject to jurisdictional endorsement). See Chapter 4 for further details on the new concepts and requirements in IFRS 18.

IFRS 19 *Subsidiaries without Public Accountability: Disclosures* was issued by the IASB in May 2024 to simplify the preparation of financial statements by eligible subsidiaries. Eligible subsidiaries that elect to apply IFRS 19 are allowed to provide reduced disclosures while still applying the recognition, measurement and presentation requirements in other IFRS accounting standards. IFRS 19 is effective for annual reporting periods beginning on or after 1 January 2027, with earlier application permitted (subject to jurisdictional endorsement). See Chapter 4 at section 7 for further details on the requirements of IFRS 19.

In September 2024, the IASB published for public comment the exposure draft ED/2024/7 *Equity Method of Accounting* which, amongst other improvements, proposes changes to disclosure requirements for investments in joint ventures and associates accounted for using the equity method.

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Appendix C - Defined terms

Extract from IFRS 12

Appendix A
Defined terms

income from a structured entity	For the purpose of this IFRS, income from a **structured entity** includes, but is not limited to, recurring and non-recurring fees, interest, dividends, gains or losses on the remeasurement or derecognition of interests in structured entities and gains or losses from the transfer of assets and liabilities to the structured entity.
interest in another entity	For the purpose of this IFRS, an interest in another entity refers to contractual and non-contractual involvement that exposes an entity to variability of returns from the performance of the other entity. An interest in another entity can be evidenced by, but is not limited to, the holding of equity or debt instruments as well as other forms of involvement such as the provision of funding, liquidity support, credit enhancement and guarantees. It includes the means by which an entity has control or joint control of, or significant influence over, another entity. An entity does not necessarily have an interest in another entity solely because of a typical customer supplier relationship. Paragraphs B7-B9 provide further information about interests in other entities. Paragraphs B55-B57 of IFRS 10 explain variability of returns.
structured entity	An entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. Paragraphs B22-B24 provide further information about structured entities.

Chapter 15 Fair value measurement

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Overview

Many IFRS accounting standards permit or require entities to measure or disclose the fair value of assets, liabilities or equity instruments. However, until 2011 there was limited guidance in IFRS on how to measure fair value and, in some cases, the guidance was conflicting. To remedy this, the International Accounting Standards Board (IASB or the Board) issued IFRS 13 *Fair Value Measurement* in May 2011. The standard was the result of a convergence project between the IASB and the US Financial Accounting Standards Board (FASB) (collectively, the Boards). The standard first applied to annual periods beginning on or after 1 January 2013. *[IFRS 13.C1]*.

IFRS 13 defines fair value, provides principles-based guidance on how to measure fair value under IFRS and requires information about those fair value measurements to be disclosed. *[IFRS 13.1]*. IFRS 13 does not attempt to remove the judgement that is involved in estimating fair value; however, it provides a framework that is intended to reduce inconsistency and increase comparability in the fair value measurements used in financial reporting.

IFRS 13 does not address which assets or liabilities to measure at fair value or when those measurements must be performed; an entity must look to the other standards in that regard. The standard applies to all fair value measurements, when fair value is required or permitted by IFRS, with some limited exceptions. The standard also applies to measurements, such as fair value less costs to sell, that are based on fair value. However, it does not apply to similar measurement bases, such as value in use.

This chapter outlines the requirements of IFRS 13, its definitions, measurement framework and disclosure requirements. It addresses some of the key questions that are being asked about how to apply IFRS 13, recognising that some aspects of the standard are still unclear and different views may exist. Further issues and questions may be raised in the future as entities continue to apply the standard and practices evolve. Significant differences to the US GAAP fair value requirements are discussed in Appendix D and highlighted throughout the chapter.

Fair value measurement may be affected by economic and market disruptions caused by war and pandemics. Similarly, climate change can potentially affect the fair value of an asset or liability. Please refer to our publications *Applying IFRS: Accounting considerations related to geopolitical events and uncertainty*; *Applying IFRS: and Connected Financial Reporting: Accounting for Climate Change*.[1]

What you need to know

- IFRS 13 applies to all fair value measurements, when fair value is required or permitted by IFRS (whether recognised or only disclosed), with limited exceptions.
- IFRS 13 does not specify when an entity is required to use fair value, but rather, provides guidance on *how* to measure the fair value of financial and non-financial assets and liabilities when required or permitted by IFRS.
- Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
- The fair value framework in IFRS 13 is based on a number of key concepts, including unit of account, exit price, valuation premise, highest and best use, principal market, market participant assumptions and the fair value hierarchy.
- IFRS 13 includes extensive disclosure requirements.
- IFRS 13 is largely converged with US GAAP on how to measure fair value.

1 Available on ey.com/IFRS.

1 Introduction

1.1 Overview of IFRS 13

The framework of IFRS 13 is based on a number of key concepts including unit of account, exit price, valuation premise, highest and best use, principal market, market participant assumptions and the fair value hierarchy. The requirements incorporate financial theory and valuation techniques but are solely focused on how these concepts are to be applied when determining fair value for financial reporting purposes.

IFRS 13 does not address the issues of what to measure at fair value and when to measure fair value. The IASB separately considers these issues on a project-by-project basis. Other IFRS accounting standards, therefore, specify which items must be measured at fair value and when. IFRS 13 addresses how to measure fair value. The principles in IFRS 13 provide the IASB with a consistent definition that, together with the *Conceptual Framework for Financial Reporting* (see Chapter 2 at section 9), will assist in determining whether fair value is the appropriate measurement basis to be used in any given future project.

The definition of fair value in IFRS 13 is based on an exit price notion, which incorporates the following key concepts:

- Fair value is the price to sell an asset or transfer a liability and, therefore, represents an exit price, not an entry price.
- The exit price for an asset or liability is conceptually different from its transaction price (an entry price). While exit and entry prices may be identical in many situations, the transaction price is not presumed to represent the fair value of an asset or liability on its initial recognition.
- Fair value is an exit price in the principal market, i.e., the market with the highest volume and level of activity. In the absence of a principal market, it is assumed that the transaction to sell the asset or transfer the liability would occur in the most advantageous market. This is the market that would maximise the amount that would be received to sell an asset or minimise the amount that would be paid to transfer a liability, taking into account transport and transaction costs. In either case, the entity must have access to the market on the measurement date.

  While transaction costs are considered in determining the most advantageous market, they do not form part of a fair value measurement (i.e., they are not added to or deducted from the price used to measure fair value). However, an exit price would be adjusted for transportation costs if location is a characteristic of the asset or liability being measured. This is discussed further in section 8 below.
- Fair value is a market-based measurement, not an entity-specific measurement. When determining fair value, management uses the assumptions that market participants would use when pricing the asset or liability. However, an entity need not identify specific market participants.

These key concepts and the following aspects of the guidance in IFRS 13 require particular focus when applying the standard:

- If another standard provides a fair value measurement exemption that applies when fair value cannot be measured reliably, an entity may need to consider the measurement framework in IFRS 13 in order to determine whether fair value can be reliably measured (see section 2 below).
- If there is a principal market for the asset or liability, a fair value measurement represents the price in that market at the measurement date (regardless of whether that price is directly observable or estimated using another valuation technique), even if the price in a different market is potentially more advantageous (see section 5 below).
- Fair value measurements should take into consideration the characteristics of the asset or liability being measured, but not characteristics of the transaction to sell the asset or transfer a liability. Transportation costs, for example, must be deducted from the price used to measure fair value when location is a characteristic of the item being measured at fair value (see sections 4 and 8 below). This principle also clarifies when a restriction on the sale or use of an asset or transfer of a liability affects the measurement of fair value (see section 4 below) and when premiums and discounts can be included. In particular, an entity is prohibited from making adjustments for the size of an entity's holding in comparison to current trading volumes (i.e., blockage factors, see section 14 below).
- The fair value measurement of non-financial assets must reflect the highest and best use of the asset from a market participant's perspective, which might be its current use or some alternative use. This establishes whether to assume a market participant would derive value from using the non-financial asset on its own or in combination with other assets or with other assets and liabilities (see section 9 below).

- The standard clarifies that a fair value measurement of a liability must consider non-performance risk (which includes, but is not limited to, an entity's own credit risk, see section 10 below).
- IFRS 13 provides guidance on how to measure the fair value of an entity's own equity instruments (see section 10 below) and aligns it with the fair value measurement of liabilities. If there are no quoted prices available for the transfer of an identical or a similar liability or entity's own equity instrument, but the identical item is held by another party as an asset, an entity uses the fair value of the corresponding asset (from the perspective of the market participant that holds that asset) to measure the fair value of the liability or equity instrument. When no corresponding asset exists, the fair value of the liability is measured from the perspective of a market participant that owes the liability (see section 10 below).
- A measurement exception in IFRS 13 allows entities to measure financial instruments with offsetting risks on a portfolio basis, provided certain criteria are met both initially and on an ongoing basis (see section 11 below).
- The requirements of IFRS 13 in relation to valuation techniques apply to all methods of measuring fair value. Traditionally, references to valuation techniques in IFRS have indicated a lack of market-based information with which to value an asset or liability. Valuation techniques as discussed in IFRS 13 are broader and, importantly, include market-based approaches (see section 13 below). When selecting inputs to use, an entity must prioritise observable inputs over unobservable inputs (see section 15 below).
- IFRS 13 provides application guidance to assist entities measuring fair value in situations where there has been a decrease in the volume or level of activity (see section 7 below).
- Categorisation within the fair value hierarchy is required for all fair value measurements. Disclosures required by IFRS 13 are substantially greater for those fair value measurements that are categorised within Level 3 (see sections 15 and 19 below).

1.2 Objective of IFRS 13

A primary goal of IFRS 13 is to increase the consistency and comparability of fair value measurements used in financial reporting under IFRS. It provides a common objective whenever IFRS permits or requires a fair value measurement, irrespective of the type of asset or liability being measured or the entity that holds it.

The objective of a fair value measurement is to estimate the price at which an orderly transaction would take place between market participants under the market conditions that exist at the measurement date. *[IFRS 13.2]*.

By highlighting that fair value considers market conditions that exist at the measurement date, the IASB is emphasising that the intent of the measurement is to convey the current value of the asset or liability at the measurement date and not its potential value at some future date. In addition, a fair value measurement does not consider management's intent to sell the asset or transfer the liability at the measurement date. Instead, it represents a market-based measurement that contemplates a hypothetical transaction between market participants at the measurement date (these concepts are discussed further in sections 5 to 8 below). *[IFRS 13.3]*.

IFRS 13 makes it clear that the objective of a fair value measurement remains the same, regardless of the reason for the fair value measurement (e.g., impairment testing or a recurring measurement) or the extent of observable information available to support the measurement. While the standard requires that the inputs used to measure fair value be prioritised based on their relative observability (see section 15 below), the nature of the inputs does not affect the objective of the measurement. That is, the requirement to determine an exit price under current market conditions is not relaxed because the reporting entity cannot observe similar assets or liabilities being transacted at the measurement date. *[IFRS 13.2]*.

Even when fair value is estimated using significant unobservable inputs (because observable inputs do not exist), the goal is to determine an exit price based on the assumptions that market participants would consider when transacting for the asset or liability on the measurement date, including assumptions about risk. This might require the inclusion of a risk premium in the measurement to compensate market participants for the uncertainty inherent in the expected cash flows of the asset or liability being measured. *[IFRS 13.3]*.

IFRS 13 generally does not provide specific rules or detailed 'how-to' guidance. Given the broad use of fair value measurements in accounting for various kinds of assets and liabilities (both financial and non-financial), providing detailed valuation guidance was not deemed practical. As such, the application of IFRS 13 requires significant judgement; but this judgement is applied using the core concepts of the standard's principles-based framework for fair value measurements.

1.3 Post-implementation review

During 2018, the IASB concluded its post-implementation review (PIR) of IFRS 13, which was intended to assess the effect of the standard on financial reporting. In particular, the Board's aim was to assess "whether:

- the information required by IFRS 13 is useful to users of financial statements;
- areas of IFRS 13 present implementation challenges and might result in inconsistent application of the requirements; and
- unexpected costs have arisen when preparing, auditing or enforcing the requirements of IFRS 13 or when obtaining the information that the Standard requires entities to provide."[2]

Areas of focus in the PIR included: the usefulness of disclosures about fair value measurements; whether to prioritise unit of account or the use of Level 1 inputs; applying the requirements for highest and best use in fair value measurements of non-financial assets; and the use of judgement in relation to specific areas of IFRS 13 (e.g., assessing whether a market is active (see section 7.1.1 below), determining whether an unobservable input is significant when categorising a fair value measurement within the hierarchy (see section 15.2.1 below).[3]

In December 2018, the IASB released its Report and Feedback Statement on the PIR of IFRS 13, in which it stated its conclusion that IFRS 13 is working as it intended. As a result of the PIR, the Board decided to:[4]

(a) Feed the PIR findings regarding the usefulness of disclosures into the Board's work on Better Communication in Financial Reporting, in particular, into the Targeted Standards-level Review of Disclosures and the Primary Financial Statements projects

(b) Continue liaising with the valuation profession, monitor new developments in practice and promote knowledge development and sharing

(c) Conduct no other follow-up activities as a result of findings from the PIR

In 2018, the Board selected IFRS 13 as one of the two Standards (the other was IAS 19 *Employee Benefits*) on which to test the draft guidance for the Board to use when developing and drafting disclosure objectives and requirements in future. During 2019 and 2020, the Board decided to propose amendments to the disclosure objective of IFRS 13 and items of information that could be used to meet those objectives. In March 2021, the Board issued an Exposure Draft ED/2021/3, *Disclosure Requirements in IFRS Standards - A Pilot Approach (Proposed amendments to* IFRS 13 *and* IAS 19*)* (the ED). However, in October 2022, the Board decided not to proceed with any amendments (see section 19.6 below for more detail).

2 IFRS Project Report and Feedback Statement, *Post-implementation Review of IFRS 13* Fair Value Measurement, IASB, December 2018, p.6. Available on the IFRS Foundation's website.

3 IFRS Project Report and Feedback Statement, *Post-implementation Review of IFRS 13* Fair Value Measurement, IASB, December 2018, p.6. Available on the IFRS Foundation's website.

4 IFRS Project Report and Feedback Statement, *Post-implementation Review of IFRS 13* Fair Value Measurement, IASB, December 2018, p.3. Available on the IFRS Foundation's website.

2 Scope

IFRS 13 applies whenever another IFRS requires or permits the measurement or disclosure of fair value, or a measure that is based on fair value (such as fair value less costs to sell), *[IFRS 13.5]*, with the following exceptions:

(a) The measurement and disclosure requirements do not apply to: *[IFRS 13.6]*
- Share-based payment transactions within the scope of IFRS 2 *Share-based Payment*
- Leasing transactions accounted for in accordance with IFRS 16 *Leases* (see section 2.2.2 below)
- Measurements that are similar to fair value, but are not fair value, such as net realisable value in IAS 2 *Inventories* or value in use in IAS 36 *Impairment of Assets* (see section 2.2.3 below)

(b) The measurement requirements in IFRS 13 apply, but the disclosure requirements do not apply to: *[IFRS 13.7]*
- Plan assets measured at fair value in accordance with IAS 19
- Retirement benefit plan investments measured at fair value in accordance with IAS 26 *Accounting and Reporting by Retirement Benefit Plans*
- Assets for which recoverable amount is fair value less costs of disposal in accordance with IAS 36 (see section 2.2.4 below)

2.1 Items in the scope of IFRS 13

2.1.1 Fair value measurements

The measurement framework in IFRS 13 applies to both fair value measurements on initial recognition and subsequent fair value measurements, if permitted or required by another IFRS. *[IFRS 13.8]*. This includes both assets and liabilities, as well as an entity's own equity instruments measured at fair value. *[IFRS 13.4]*. Fair value measurement at initial recognition is discussed further in section 12 below.

IFRS 13 establishes how to measure fair value. It does not prescribe:
- What should be measured at fair value
- When to measure fair value (i.e., the measurement date)

  Nor
- How (or whether) to account for any subsequent changes in fair value (e.g., in profit or loss or in other comprehensive income) - however, the standard does partly address day one gains or losses on initial recognition at fair value, requiring that they be recognised in profit or loss immediately unless the IFRS that permits or requires initial measurement at fair value specifies otherwise

An entity must consider the relevant IFRS accounting standards (e.g., IFRS 3 *Business Combinations*, IFRS 9 *Financial Instruments*, IAS 40 *Investment Property*) for each of these requirements.

2.1.2 Fair value disclosures

The scope of IFRS 13 includes disclosures of fair value. This refers to situations where an entity is permitted, or may be required, by a standard or interpretation to disclose the fair value of an item whose carrying amount in the financial statements is not fair value. Examples include:
- IAS 40, which requires the fair value to be disclosed for investment properties measured using the cost model. *[IAS 40.79(e)]*.
- IFRS 7 *Financial Instruments: Disclosures*, which requires the fair value of financial instruments that are subsequently measured at amortised cost in accordance with IFRS 9 (including amortised cost hedged items that are fair valued for the hedged risk) to be disclosed. *[IFRS 7.25]*.

In such situations, the disclosed fair value must be measured in accordance with IFRS 13 and an entity would also need to make certain disclosures about that fair value measurement in accordance with IFRS 13 (see section 19 below).

In certain circumstances, IFRS 7 provides relief from the requirement to disclose the fair value of a financial instrument that is not measured subsequently at fair value. An example is when the carrying amount is considered a reasonable approximation of fair value. *[IFRS 7.29]*. In these situations, an entity would not need to measure the fair value of the financial asset or financial liability for disclosure purposes. However, it would need to consider the requirements of IFRS 13 in order to determine whether the carrying amount is a reasonable approximation of fair value.

2.1.3 Measurements based on fair value

The measurement of amounts (whether recognised or only disclosed) that are based on fair value, such as fair value less costs to sell, are within the scope of IFRS 13. This includes the following:

- A non-current asset (or disposal group) held for sale measured at fair value less costs to sell in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, when the fair value less costs to sell is lower than its carrying amount (see Chapter 5)
- Commodity inventories that are held by commodity broker-traders and measured at fair value less costs to sell, as discussed in IAS 2 (see Chapter 23)
- Where the recoverable amount for an asset or cash-generating unit(s), determined in accordance with IAS 36, is its fair value less costs of disposal. This includes impairment testing of investments in associates accounted for in accordance with IAS 28 *Investments in Associates and Joint Ventures*, when that standard requires the test to be performed in accordance with IAS 36 (see Chapter 21)
- Biological assets (including produce growing on a bearer plant), and agricultural produce at the point of harvest measured at fair value less costs to sell in accordance with IAS 41 *Agriculture* (see Chapter 38)

In each of these situations, the fair value component is measured in accordance with IFRS 13. Costs to sell or costs of disposal are determined in accordance with the applicable standard, for example, IFRS 5.

2.1.4 Short-term receivables and payables

Prior to the issuance of IFRS 13, the then extant IFRS 9 allowed entities to measure short-term receivables and payables with no stated interest rate at invoice amounts without discounting, when the effect of not discounting was immaterial. *[IFRS 9(2012).B5.4.12]*. That paragraph was deleted as a consequence of the IASB issuing IFRS 13. In the absence of that paragraph, some questioned whether discounting would be required for such short-term receivables and payables. The IASB amended IFRS 13, as part of its 2010-2012 cycle of *Improvements to IFRSs,* to clarify that, when making those amendments to IFRS 9, it did not intend to remove the ability to measure such short-term receivables and payables at their invoice amount. The Board also noted that, when the effects of applying accounting policies set out in IFRS accounting standards are immaterial, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* permits entities not to apply them. *[IFRS 13.BC138A, IAS 8.8]*.

2.2 Scope exclusions

2.2.1 Share-based payments

IFRS 2 requires certain share-based payments to be measured at grant date fair value (see Chapter 30). However, the objective of an IFRS 2 fair value measurement is not entirely consistent with IFRS 13. Rather than trying to distinguish between these two measures, the IASB decided to exclude share-based payment transactions that are accounted for in accordance with IFRS 2 from the scope of IFRS 13. The grant date fair value of such share-based payments is, therefore, measured and disclosed in accordance with IFRS 2, not IFRS 13. *[IFRS 13.BC21]*.

2.2.2 Lease transactions

As noted in section 2 above, IFRS 13 does not apply to any leasing transactions accounted for in accordance with IFRS 16. The fair value measurement and disclosure requirements in IFRS 16 apply instead (see Chapter 24 for further discussion on IFRS 16). This scope exception does not extend to lease assets acquired or liabilities assumed in a business combination in accordance with IFRS 3. IFRS 13 would apply to that measurement of fair value. In addition, after adoption of IFRS 16, an entity may need to apply IFRS 13 to sale and leaseback transactions.

While it is clear that leasing transactions that are within the scope of IFRS 16 are excluded from IFRS 13, lease liabilities (for lessees) and finance lease receivables (for lessors) are financial instruments, per IAS 32 *Financial Instruments: Presentation*, and are, therefore, within the scope of IFRS 7. *[IFRS 7.4, IAS 32.AG9]*. As discussed in section 2.1.2 above, IFRS 7.25 requires an entity to disclose, for each class of financial asset and financial liability, a comparison of fair value to carrying amount (except where the carrying amount is a reasonable approximation of fair value). *[IFRS 7.25, IFRS 7.29(a)]*. Lease liabilities are explicitly excluded from this disclosure requirement. *[IFRS 7.29(d)]*. However, finance lease receivables are not. Therefore, since IFRS 7 is not excluded from the scope of IFRS 13, lessors will need to measure the fair value of finance lease receivables in accordance with IFRS 13 in order to provide the IFRS 7 disclosure (unless the carrying amount is a reasonable approximation for fair value).

2.2.3 Measurements similar to fair value

Some IFRS accounting standards permit or require measurements that are similar to fair value but are not fair value. These measures are excluded from the scope of IFRS 13. Such measures may be derived using techniques that are similar to those permitted in IFRS 13. IAS 36, for example, requires value in use to be determined using discounted cash flows (see Chapter 21). An entity may also consider the selling price of an asset, for example, in determining net realisable value for inventories in accordance with IAS 2 (see Chapter 23). Despite these similarities, the objective is not to measure fair value. Therefore, IFRS 13 does not apply to these measurements.

2.2.4 Exemptions from the disclosure requirements of IFRS 13

As noted in section 2 above, IFRS 13's disclosure requirements do not apply to plan assets measured at fair value in accordance with IAS 19, retirement benefit plan investments measured at fair value in accordance with IAS 26 and assets for which the recoverable amount is fair value less costs of disposal in accordance with IAS 36.

In addition, the disclosure requirements in IFRS 13 do not apply to any fair value measurements at initial recognition. That is, the disclosure requirements of IFRS 13 apply to fair value measurements after initial recognition (this is discussed further in section 19 below).

The fair value measurement requirements of IFRS 13 still apply to each of these items above, even though the disclosure requirements do not. Therefore, an entity would measure the item in accordance with IFRS 13 and then make the required disclosures in accordance with the applicable standard (i.e., IAS 19, IAS 26 and IAS 36) or the standard that requires fair value at initial recognition. For example, an entity that acquires a brand as part of a business combination would be required by IFRS 3 to measure the intangible asset at fair value at initial recognition. The acquirer would measure the asset's fair value in accordance with IFRS 13 but would disclose information about that fair value measurement in accordance with IFRS 3 (since those fair values are measured at initial recognition), not IFRS 13.

2.3 Present value techniques

IFRS 13 provides guidance for using present value techniques, such as a discounted cash flow analysis, to measure fair value (see section 20 below for additional discussion on the application of present value techniques). However, the use of present value techniques does not always result in a fair value measurement. As discussed in section 2.2.3 above, some IFRS accounting standards use present value techniques to measure assets and liabilities at amounts that are not intended to represent a fair value measurement. Unless the objective is to measure fair value, IFRS 13 does not apply.

2.4 Fair value measurement exceptions and practical expedients in other standards

2.4.1 Fair value measurement exceptions

Some standards provide an exception to a requirement to measure an asset or liability at fair value. IFRS 13 does not eliminate these exceptions. *[IFRS 13.BC8]*.

IFRS typically limits fair value measurement exceptions to circumstances where fair value is not reliably measurable and, where applied, requires the application of a cost model. For example, IAS 41 permits the use of a cost model if, on initial recognition of a biological asset, an entity is able to rebut the presumption that fair value can be reliably measured. In addition, it requires an entity to revert to the fair value model if fair value subsequently becomes reliably measurable. *[IAS 41.30]*. Additional disclosures are often required to explain why fair value cannot be reliably measured and, if possible, the range of estimates within which fair value is highly likely to lie, as is required in IAS 40 for investment properties, for example. *[IAS 40.79(e)(iii)]*.

In these situations, an entity would need to consider the requirements of IFRS 13 in order to determine whether fair value can be reliably measured. If the entity concludes that it could reliably measure fair value based on the requirements of IFRS 13, even in situations where observable information is not available, it would not be able to apply these exceptions.

2.4.2 Practical expedient for impaired financial assets carried at amortised cost

Prior to the issuance of IFRS 9, IAS 39 *Financial Instruments: Recognition and Measurement* allowed, as a practical expedient, creditors to measure the impairment of a financial asset carried at amortised cost based on an instrument's fair value using an observable market price. *[IAS 39(2017).AG84]*. If the practical expedient was used, IFRS 13 applied to the measurement of fair value. When the practical expedient was not used, the measurement objective was not intended to be fair value (and IFRS 13 did not apply). Instead, IAS 39's requirements for measuring the impairment of the financial asset carried at amortised cost applied.

Under IFRS 9, entities are allowed to use observable market information to estimate the credit risk of a particular financial instrument and as a consequence the fair value can no longer be used as an approximation of amortised cost. Instead, IFRS 9's requirements for measuring the impairment of the financial asset carried at amortised cost would apply.

2.5 Practical expedients and measurement exceptions within IFRS 13

2.5.1 Practical expedients in IFRS 13

In addition to the various practicability exceptions discussed in section 2.4 above, IFRS 13 provides two practical expedients to assist with applying the fair value framework in certain instances. These practical expedients, each of which is discussed separately in this chapter, are the use of mid-market pricing within a bid-ask spread (see section 14.3.1 below) and the use of alternative pricing methods (e.g., matrix pricing) when an entity holds a large number of similar assets and liabilities for which quoted prices exist but are not easily accessible (see section 16.2 below).

2.5.1.A Use of net asset value to measure fair value

Under IFRS, net asset value (NAV) cannot be presumed to equal fair value, as the asset that is being measured (i.e., the unit of account) is the equity investment in an investment entity (e.g., each individual share per IFRS 9), not the underlying assets (and liabilities) of the investment entity itself. *[IFRS 13.14]*. While NAV may represent the fair value of the equity interest in certain situations (e.g., in situations where an open-ended fund provides a source of liquidity through ongoing subscriptions and redemptions at NAV), one cannot presume this to be the case. Instead, the characteristics of the investment being measured need be considered when determining its fair value. *[IFRS 13.11]*.

FASB differences

Under US GAAP, the equivalent standard, Topic 820, *Fair Value Measurement* in the FASB Accounting Standards Codification (ASC 820), provides a practical expedient to measure the fair value of certain investments in investment companies using NAV or its equivalent if certain criteria are met. IFRS 13 does not explicitly permit the use of NAV to estimate the fair value. *[IFRS 13.BC238(a)]*.

If a quoted price in an active market for an identical instrument is available (i.e., a Level 1 input), the fair value of the equity instrument would need to be measured using that price multiplied by the quantity held (i.e., price × quantity), without adjustment, even if this deviates from NAV. *[IFRS 13.77]*. An example of when the Level 1 input may differ from NAV is shares in certain closed-end funds that trade on exchanges at prices that differ from the reported NAV of the funds. In some cases, if the investment trades in an active market, the quoted price may be equal to the NAV (for example, for some open-ended mutual funds); however, the principle remains that the quoted price will be the input used to determine fair value, rather than the NAV.

In situations where there is no quoted price for an identical instrument, reported NAV may represent a starting point in estimating fair value. However, adjustments may be required to reflect the specific characteristics that market participants would consider in pricing the equity investment in an investment entity. *[IFRS 13.11]*.

How we see it

It may be helpful to understand the factors that would reconcile a reported NAV of the investment entity to the fair value used by the reporting entity in order to provide explanations to investors, if necessary, and to support disclosures required by IFRS 13 and other IFRS accounting standards. Factors to consider include, but are not limited to, the following:

(a) Is the reported NAV an appropriate input for use in measuring fair value?

(b) Are adjustments to reported NAV needed to reflect characteristics that market participants would consider in pricing an equity investment?

Each of these is discussed in more detail below.

(a) Is the reported NAV an appropriate input for use in measuring fair value?

Before concluding that the reported NAV is an appropriate input when measuring fair value, a reporting entity should evaluate the effectiveness of the investment entity's valuation practices, by considering the valuation techniques and inputs used by the investment entity when estimating NAV. This assists in determining whether the investment entity's valuation practices and inputs are aligned with those that would need to be used by a market participant in respect of the equity instruments of the investment entity.

Sources for information on valuation practices and inputs that may be helpful to consider include, but are not limited to, the following:

- Evidence gathered during the initial due diligence and ongoing monitoring procedures
- The investment entity's fair value estimation processes and control environment, as well as its policies and procedures for estimating fair value of underlying investments, and any changes to those processes, the control environment, or policies and procedures
- The use of independent third-party valuation experts by the investment entity
- The portion of the underlying securities that are actively traded
- Comparison of historical realisations to last reported fair value
- Professional reputation and standing of the investment entity's service providers
- Whether there is a history of significant adjustments to the NAV

The sources of information above may help an investor consider the appropriateness of making use of a reported NAV as an input in its determination of the fair value of the equity instrument and whether market participants would make adjustment(s) to NAV.

(b) Are adjustments to reported NAV needed to reflect characteristics that market participants would consider in pricing an equity investment?

A reporting entity should consider the characteristics of the equity investment that are not reflected in reported NAV. The fair value of the underlying assets within an investment entity would, for example, ignore any restrictions or possible obligations imposed on the holder of an equity investment in an investment entity. Obligations may take the form of commitments to contribute further capital, as and when called for by the investment entity. If market participants would be expected to place a discount or premium on the reported NAV because of features, risk or other factors relating to the equity investment, then the fair value measurement of the investment would need to be adjusted for those factors.

However, in some cases adjustments to NAV may not be required. For example, if a fund is open to new investors, presumably the fair value of the fund investment would not be expected to exceed the amount that a new investor would be required to invest directly with the fund to obtain a similar interest. Similarly, the hypothetical seller of a fund investment would not be expected to accept lower proceeds than it would receive by redeeming its investment directly with the fund (if possible). As such, the willingness and ability of an investment entity to provide a source of liquidity for the investment through subscriptions and redemptions are important considerations in assessing whether adjustments to NAV would be required in determining the exit price of an investment.

Information related to relevant secondary market transactions should be considered unless they are determined to be disorderly. Limited Partners in such funds may seek to sell their investments for a variety of reasons, including mergers or acquisitions, the need for liquidity or a change in strategy, among others. While premiums have been observed in practice, discounts on sales of investments in investment entities are also common.

In addition to the specific characteristics of equity investments noted above, premiums or discounts on the reported NAV can also arise based on the following factors:

- Type of investment entity, specific portfolio investments in the investment entity, market conditions and the reputation of the fund manager
- An evaluation of the fund manager's valuation methodology (e.g., if a fund manager's valuations were deemed to be conservative, a premium or lower discount may result)
- How difficult it is to value the investment entity's underlying portfolio investments
- The seller's motivation in observed sales, which may/may not indicate a distressed sale. There are many reasons why investors sell their investments, market observers cannot merely assume that an observed sale is distressed

Likewise, sales of an investment in an investment entity to independent third parties at the reported NAV without a premium or discount, may suggest that no adjustment is needed.

2.5.2 Measurement exception to the fair value principles for financial instruments

IFRS 13 makes it clear that the concepts of 'highest and best use' and 'valuation premise' only apply to the measurement of non-financial assets. Such concepts could have significantly changed the valuation of some over-the-counter (OTC) derivatives, many of which are measured on a portfolio basis. That is, reporting entities typically determine valuation adjustments related to bid-ask spreads and credit risk for OTC derivative contracts considering the net exposure of a portfolio of contracts to a particular market risk or credit risk (as defined in IFRS 7, see Chapter 50). To address this concern, IFRS 13 provides an exception to the principles of fair value when measuring financial instruments with offsetting risks if certain criteria are met.

The exception allows an entity to estimate the fair value of a portfolio of financial instruments based on the sale or transfer of its net position for a particular market risk exposure (rather than to the individual instruments in the portfolio). The exception also enables an entity to consider its credit exposure to a particular counterparty on a net basis, provided there is an arrangement in place that mitigates credit risk upon default (e.g., a master netting agreement).

See section 11 below for additional discussion on measuring the fair value of financial assets and financial liabilities with offsetting risks.

3 The fair value framework

3.1 Definition of fair value

Fair value is defined as follows: *[IFRS 13.9]*

Extract from IFRS 13	
9	**This IFRS defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.**

The definition of fair value in IFRS 13 is not significantly different from the previous definition in IFRS, which was "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction". *[IFRS 13.BC29]*. However, the definition in IFRS 13 and its guidance in the fair value framework clarify the following:

- The definition of fair value in IFRS 13 is a current exit price, not an entry price. *[IFRS 13.BC36]*. The exit price for an asset or liability is conceptually different from its transaction price (an entry price). While exit and entry prices may be identical in many situations, the transaction price is not presumed to represent the fair value of an asset or liability on its initial recognition as measured in accordance with IFRS 13.
- The exit price objective of a fair value measurement applies regardless of the reporting entity's intent and/or ability to sell the asset or transfer the liability at the measurement date. *[IFRS 13.BC39, IFRS 13.BC40]*. Fair value is the exit price in the principal market (or in the absence of a principal market, the most advantageous market - see section 5 below - in which the reporting entity would transact). However, the price in the exit market should not be adjusted for transaction costs - i.e., transaction costs incurred to acquire an item are not added to the price used to measure fair value and transaction costs incurred to sell an item are not deducted from the price used to measure fair value. *[IFRS 13.25]*.
- Fair value is a market-based measurement, not an entity-specific measurement, and, as such, is determined based on the assumptions that market participants would use when pricing the asset or liability. *[IFRS 13.BC31]*.
- A fair value measurement contemplates the sale of an asset or transfer of a liability, not a transaction to offset the risks associated with an asset or liability (see section 7 below for further discussion).
- The transaction to sell the asset or transfer the liability is a hypothetical transaction as at the measurement date that is assumed to be orderly and considers an appropriate period of exposure to the market (see section 7 below for further discussion). *[IFRS 13.15]*.
- The objective of a fair value measurement does not change based on the level of activity in the exit market or the valuation technique(s) used. That is, fair value remains a market-based exit price that considers the current market conditions as at the measurement date, even if there has been a significant decrease in the volume and level of activity for the asset or liability. *[IFRS 13.2, IFRS 13.B41]*.

3.2 The fair value measurement framework

In addition to providing a single definition of fair value, IFRS 13 includes a framework for applying this definition to financial reporting. Many of the key concepts used in the fair value framework are interrelated and their interaction should be considered in the context of the entire approach.

As discussed in section 1.2 above, the objective of a fair value measurement is "to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions". *[IFRS 13.B2]*.

In light of this objective, when measuring fair value, an entity must determine all of the following: *[IFRS 13.B2]*

(a) The particular asset or liability that is the subject of the measurement (consistent with its unit of account - see section 4 below)

(b) For a non-financial asset, the valuation premise that is appropriate for the measurement (consistent with its highest and best use - see section 9 below)

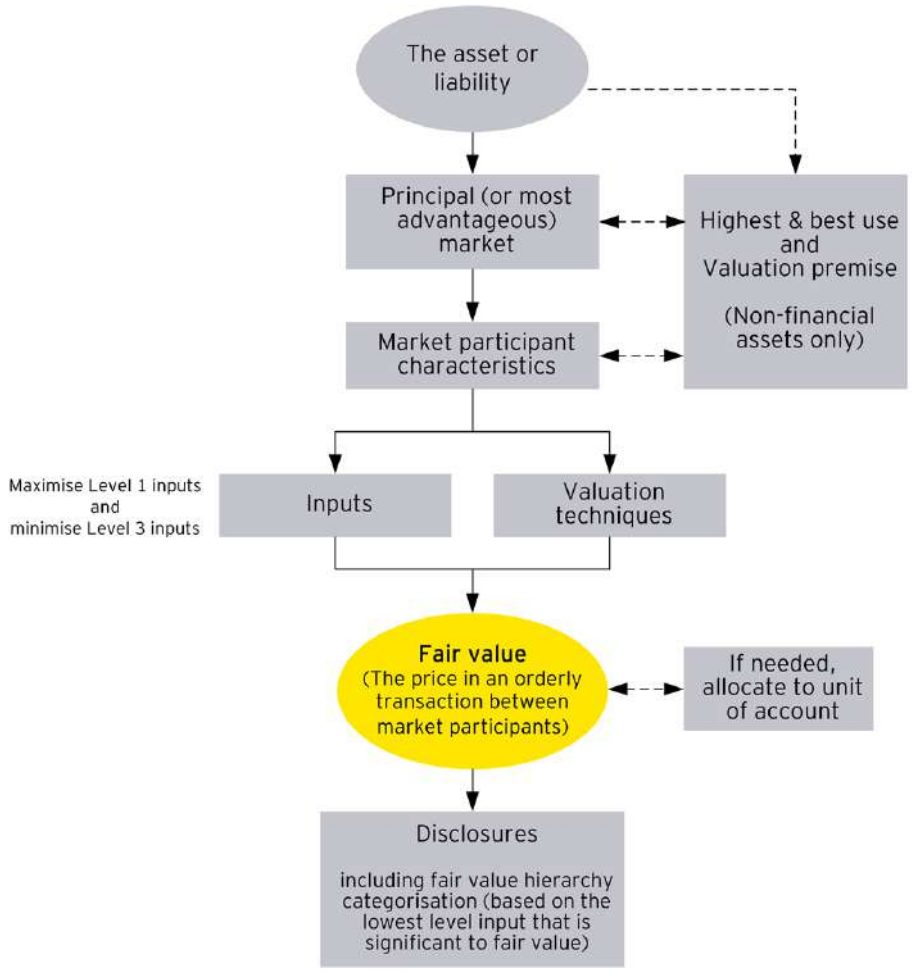
(c) The principal (or most advantageous) market for the asset or liability (see section 5 below)

(d) The valuation technique(s) appropriate for the measurement (see section 13 below), considering the availability of data with which to develop inputs (see section 14 below) that represent the assumptions that market participants would use when pricing the asset or liability (see section 6 below) and the level of the fair value hierarchy within which the inputs are categorised (see section 15 below)

How we see it

The following diagram illustrates our view of the interdependence of the various components of the fair value measurement framework in IFRS 13.

Figure 3-1: The fair value measurement framework



In practice, navigating the fair value framework may be more straightforward for certain types of assets (e.g., assets that trade in a formalised market) than for others (e.g., intangible assets). For non-financial assets that derive value when used in combination with other assets or for which a developed market does not exist, resolving the circular nature of the relationship between valuation premise, highest and best use and exit market is important in applying the fair value framework (refer to section 9 below for additional discussion on the fair value measurement of non-financial assets).

IFRS 13 clarifies that the concepts of 'highest and best use' and 'valuation premise' are only applicable when determining the fair value of non-financial assets. Therefore, the fair value framework is applied differently to non-financial assets versus other items, such as financial instruments, non-financial liabilities and instruments classified in a reporting entity's shareholders' equity (refer to section 11 below for additional discussion on the fair value of financial instruments with offsetting positions and to section 10 below for the fair value measurement of liabilities and instruments classified as own equity). Although there are differences in the application of the fair value framework for non-financial assets, the objective of the fair value measurement remains the same, that is, an exit price in the principal (or most advantageous) market.

As discussed in more detail in section 11 below, IFRS 13 provides an exception to the principles of fair value, allowing entities to measure a group of financial instruments based on the price to sell (or transfer) its net position for a particular risk exposure, if certain criteria are met. The use of this exception may require a reporting entity to allocate portfolio-level valuation adjustments to the appropriate unit of account.

4 The asset or liability

IFRS 13 states that a fair value measurement is for a particular asset or liability, which is different from the price to offset certain of the risks associated with that particular asset or liability. This is an important distinction, particularly in the valuation of certain financial instruments that are typically not 'exited' through a sale or transfer, but whose risks are hedged through other transactions (e.g., derivatives). However, IFRS 13 does allow for financial instruments with offsetting risks to be measured based on their net risk exposure to a particular risk, in contrast to the assets or liabilities that give rise to this exposure (see section 11 below for additional discussion on the criteria to qualify for this measurement exception and application considerations).

4.1 The unit of account

The identification of exactly what asset or liability is being measured is fundamental to determining its fair value. Fair value may need to be measured for either:

- A stand-alone asset or liability (e.g., a financial instrument or an operating asset)

  Or

- A group of assets, a group of liabilities, or a group of assets and liabilities (e.g., a cash-generating unit (CGU) or a business)

The unit of account defines what is being measured for financial reporting purposes. It is an accounting concept that determines the level at which an asset or liability is aggregated or disaggregated for the purpose of applying IFRS 13, as well as other standards.

Unless specifically addressed in IFRS 13 (see sections 4.1.1 and 4.1.2 below), the appropriate unit of account is determined by the applicable IFRS (i.e., the standard that permits or requires the fair value measurement or disclosure). *[IFRS 13.13, IFRS 13.14]*. Assume, for example, that an investment property is valued at CU100. Further assume that the investment property is owned by a single asset entity (or corporate wrapper) and the shares in the entity are only valued at CU90. If another entity were to acquire the shares of the single asset entity for CU90, at acquisition, the entity would allocate the purchase price to the property inside it. The property would, therefore, initially be recognised at CU90. Assume that, at year-end, the fair value of the property is CU110 and that the entity measures the property at fair value in accordance with IAS 40. Assume that the fair value of the shares in the single asset entity are CU99 at year end. IAS 40 requires that an entity measure an investment property, not the shares of a single entity that owns it. *[IAS 40.33]*. As such, the property would be measured at its fair value of CU110 rather than at the fair value of the shares in the entity.

The fair value should be consistent with the unit of account being measured and ensure that the measurement appropriately considers the relevant risks that market participants would consider. Those risks are ones that could potentially affect the fair value of an asset or liability, whether the risk or opportunity is real or perceived. For example, entities need to understand to which assets and/or liabilities climate-related factors are attributable and ensure they do not double count or omit relevant factors. Anticipated increases in costs due to climate-related developments may affect the value of an item of property, plant or equipment held by a mining company and also a related rehabilitation provision. However, when measuring the fair value of an item of property, plant or equipment, the entity would need to consider only the inputs that market participants would consider when pricing the asset.

Frequently asked questions

Question 4-1: Does IFRS 13 allow fair value to be measured by reference to an asset's (or liability's) components?

IFRS 13 states that the objective of a fair value measurement is to determine the price that would be received for an asset or paid to transfer a liability at the measurement date. That is, a fair value measurement is to be determined for a particular asset or liability. The unit of account determines what is being measured by reference to the level at which the asset or liability is aggregated (or disaggregated) for accounting purposes.

How we see it

Unless separation of an asset (or liability) into its component parts is required or allowed under IFRS (e.g., a requirement to separate under IFRS 9), we generally do not believe it is appropriate to consider the unit of account at a level below that of the legal form of the asset or liability being measured. In addition, if fair value can be determined for an asset or liability as a whole, we would generally not expect that an entity would use a higher amount to measure fair value because the sum of the parts exceeds the whole.

A valuation methodology that uses a 'sum-of-the-parts' approach may still be appropriate under IFRS 13; for example, when measuring complex financial instruments, entities often use valuation methodologies that attempt to determine the value of the entire instrument based on its component parts. However, in situations where fair value can be determined for an asset or liability as a whole, we would generally not expect that an entity would use a higher amount to measure fair value because the sum of the parts exceeds the whole. Using a higher value inherently suggests that the asset would be broken down and the various components, or risk attributes, transferred to different market participants who would pay more for the pieces than a market participant would for the asset or liability as a whole. Such an approach is not consistent with IFRS 13's principles, which contemplate the sale of an asset or transfer of a liability (consistent with its unit of account) in a single transaction. *[IFRS 13.B2]*.

4.1.1 Unit of account and P×Q

IFRS 13 does specify the unit of account to be used when measuring fair value in relation to a reporting entity that holds a position in a single asset or liability that is traded in an active market (including a position comprising a large number of identical assets or liabilities, such as a holding of financial instruments). In this situation, IFRS 13 requires an entity to measure the asset or liability based on the product of the quoted price for the individual asset or liability and the quantity held (P×Q).

This requirement is generally accepted when the asset or liability being measured is a financial instrument in the scope of IFRS 9. However, when an entity holds an investment in a listed subsidiary, joint venture or associate, some believe the unit of account is the entire holding and the fair value should include an adjustment (e.g., a control premium) to reflect the value of the investor's control, joint control or significant influence over their investment as a whole.

Questions have also arisen on how this requirement applies to CGUs that are equivalent to listed investments. Some argue that, because IAS 36 requires certain assets and liabilities to be excluded from a CGU, the unit of account is not identical to a listed subsidiary, joint venture or associate and an entity can include adjustments that are consistent with the CGU as a whole. Similarly, some argue that approach is appropriate because in group financial statements an entity is accounting for the assets and liabilities of consolidated entities, rather than the investment. However, others argue that if the CGU is effectively the same as an entity's investment in a listed subsidiary, joint venture or associate, the requirement to use P×Q should apply.

IFRS 13 requires entities to select inputs that are consistent with the characteristics of the asset or liability being measured and would be considered by market participants when pricing the asset or liability (see section 6.2 below). Apart from block discounts (which are specifically prohibited), determining whether a premium or discount applies to a particular fair value measurement requires judgement and depends on specific facts and circumstances.

As discussed in section 14.2 below, the standard indicates that premiums or discounts should not be incorporated into fair value measurements unless all of the following conditions are met:

- The application of the premium or discount reflects the characteristics of the asset or liability being measured
- Market participants, acting in their economic best interest, would consider these premiums or discounts when pricing the asset or liability
- The inclusion of the premium or discount is not inconsistent with the unit of account in the IFRS that requires (or permits) the fair value measurement

How we see it

Therefore, when an entity holds an investment in a listed subsidiary, joint venture or associate, if the unit of account is the entire holding, it would be appropriate to include, for example, a control premium when determining fair value, provided that market participants would take this into consideration when pricing the asset. If, however, the unit of account is the individual share of the listed subsidiary, joint venture or associate, the requirement to use P×Q (without adjustment) to measure the fair value would override the requirements in IFRS 13 that permit premiums or discounts to be included in certain circumstances.

In September 2014, in response to these questions regarding the unit of account for an investment in a listed subsidiary, joint venture or associate, the IASB proposed amendments to clarify that:[5]

- The unit of account for investments in subsidiaries, joint ventures and associates should be the investment as a whole and not the individual financial instruments that constitute the investment.
- For investments that are comprised of financial instruments for which a quoted price in an active market is available, the requirement to use P×Q would take precedence, irrespective of the unit of account. Therefore, for all such investments, the fair value measurement would be the product of P×Q, even when the reporting entity has an interest that gives it control, joint control or significant influence over the investee.
- When testing CGUs for impairment, if those CGUs correspond to an entity whose financial instruments are quoted in an active market, the fair value measurement would be the product of P×Q.

  When testing for impairment in accordance with IAS 36, the recoverable amount of a CGU is the higher of its value in use or fair value less costs of disposal. The fair value component of fair value less costs of disposal is required to be measured in accordance with IFRS 13.

  When a CGU effectively corresponds to a listed entity, the same issue arises regarding whether the requirement to use P×Q, without adjustment, to measure fair value applies.

  Consistent with its proposal in relation to listed investments in subsidiaries, joint ventures and associates, the IASB proposed that, if the CGU corresponds to an entity whose financial instruments are quoted in an active market, the requirement to use P×Q would apply.

The exposure draft also included proposed clarifications for the portfolio exception, discussed in section 4.1.2 below.

The IASB proposed the following transition requirements:

- For quoted investments in subsidiaries, joint ventures and associates, an entity would recognise a cumulative catch-up adjustment to opening retained earnings for the period in which the proposed amendments are first applied. The entity would then recognise the change in measurement of the quoted investments during that period in profit or loss (i.e., retrospective application).
- For impairment testing in accordance with IAS 36, an entity would apply the requirements on a prospective basis. If an entity incurs an impairment loss or reversal during the period of initial application, it would provide quantitative information about the likely effect on the impairment loss, or reversal amount, had the amendments been applied in the immediately preceding period presented.

5 Exposure Draft ED/2014/4: *Measuring Quoted Investments in Subsidiaries, Joint Ventures and Associates at Fair Value: Proposed amendments to IFRS 10, IFRS 12, IAS 27, IAS 28, IAS 36 and Illustrative Examples for IFRS 13*, IASB, September 2014. Available on the IFRS Foundation's website.

The exposure draft did not include a proposed effective date. However, permitting early adoption was proposed. Furthermore, the Board proposed that a first-time adopter of IFRS be able to apply the amendments at the beginning of the earliest period for which it presents full comparative information under IFRS in its first IFRS financial statements (i.e., prospectively from the date of the first-time adopter's transition to IFRS). The comment period for this exposure draft ended on 16 January 2015 and the Board began redeliberations in March 2015. During redeliberations, additional research was undertaken on fair value measurements of investments in subsidiaries, associates and joint ventures that are quoted in an active market and on the measurement of the recoverable amount of CGUs on the basis of fair value less costs of disposal when the CGU is an entity that is quoted in an active market.

Following the redeliberations, in its January 2016 meeting, the IASB concluded that the research would be fed into the PIR of IFRS 13.[6] As part of its PIR of IFRS 13, the IASB specifically asked about prioritising Level 1 inputs in relation to the unit of account. The feedback was discussed at the IASB's March 2018 meeting. In respect of the valuation of quoted subsidiaries, associates and joint ventures, the PIR found that there were continuing differences in views between users and preparers over whether to prioritise Level 1 inputs or the unit of account. The issue is not pervasive in practice according to the PIR findings. However, respondents noted it can have a material effect when it does occur. Some stakeholders said that there are material differences between measuring an investment using the P×Q and a valuation using a method such as discounted cash flows. Respondents indicated the reasons for such differences include that share prices do not reflect market liquidity for the shares nor the value of control and/or synergies. A few respondents also noted that markets may lack depth and are, therefore, susceptible to speculative trading, asymmetrical information and other factors.[7]

As noted in section 1.3 above, the IASB released its Report and Feedback Statement on the PIR in December 2018. The Board decided not to conduct any follow-up activities as a result of findings from the PIR and stated, as an example, that it will not do any further work on the issue of unit of account versus P×Q because the costs of such work would outweigh the benefits for the following reasons:

- The Board's previous significant work on the topic and the PIR suggest the issue is narrow and affects only a limited population of entities.
- Users have not expressed major concerns with reporting in practice, although they would like better transparency.
- There are differences in views between preparers and users, meaning any follow-up work would be likely to require significant resource. Thus, this project may be possible only as part of a major amendment to IFRS 13 or other IFRS accounting standards.[8]

How we see it

In the absence of prescriptive guidance from the IASB, some diversity in practice will continue. The amendments the IASB had proposed in the exposure draft may assist preparers of financial statements in determining an appropriate accounting policy.

4.1.2 Unit of account and the portfolio exception

There is some debate about whether IFRS 13 prescribes the unit of account in relation to the portfolio exception. Under IFRS 13, a reporting entity that manages a group of financial assets and financial liabilities with offsetting risks on the basis of its net exposure to market or credit risks is allowed to measure the group based on the price that would be received to sell its net long position, or paid to transfer its net short position, for a particular risk (if certain criteria are met).

Some believe the portfolio exception in IFRS 13 specifies the unit of measurement for any financial instruments within the portfolio(s), i.e., that the net exposure of the identified group to a particular risk, and not the individual instruments within the group, represents the new unit of measurement. This may have a number of consequences. For example, the entity may be able to include premiums or discounts in the fair value measurement of the portfolio that are consistent with that unit of account, but not the individual instruments that make up the portfolio. In addition, because the net exposure for the identified group may not be actively traded (even though some financial instruments within the portfolio may be) P×Q may not be applied to the actively traded instruments within the portfolio.

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6 *IASB Update*, January 2016, available on the IFRS Foundation's website.

7 IASB Staff Paper 7B: Project: *Post-implementation Review of IFRS 13* Fair Value Measurement, Paper topic*: Background - Detailed analysis of feedback received*, IASB Meeting, March 2018; and IASB Staff Paper 7D: Project: *Post-implementation Review of IFRS 13 Fair Value Measurement*, Paper topic*: Background - Prioritising Level 1 inputs or the unit of account*, IASB meeting, March 2018. Available on the IFRS Foundation's website.

8 IFRS Project Report and Feedback Statement, *Post-implementation Review of IFRS 13* Fair Value Measurement, IASB, December 2018, p.14. Available on the IFRS Foundation's website.

Others believe that the portfolio exception does not override the unit of account as provided in IFRS 9. Therefore, any premiums or discounts that are inconsistent with this unit of account, i.e., the individual financial instruments within the portfolio, would be excluded from the fair value measurement under the portfolio exception, including any premiums or discounts related to the size of the portfolio.

Regardless of which view is taken, it is clear in the standard that the portfolio exception does not change the financial statement presentation requirements (see section 11 below for further discussion on the portfolio exception and section 14.2 below for further discussion on premiums and discounts). In the US, ASC 820 has been interpreted by many as prescribing the unit of measurement when the portfolio exception is used. That is, when the portfolio approach is used to measure an entity's net exposure to a particular market risk or credit risk, the net position becomes the unit of measurement. This view is consistent with how many US financial institutions determined the fair value of their over-the-counter derivative portfolios prior to the amendments to ASC 820 (ASU 2011-04)[9] (see Appendix D below). We understand that the IASB did not intend application of the portfolio exception to override the requirements in IFRS 13 regarding the use of P×Q to measure instruments traded in active markets and the prohibition on block discounts, which raises questions as to how the portfolio exception would be applied to Level 1 instruments.

In 2013, the IFRS IC referred a request to the Board on the interaction between the use of Level 1 inputs and the portfolio exception. The IASB noted that this issue had similarities with the issues of the interaction between the use of Level 1 inputs and the unit of account that arises when measuring the fair value of investments in listed subsidiaries, joint ventures and associates (see section 4.1.1 above). The IASB discussed this issue in December 2013, but only in relation to portfolios that comprise only Level 1 financial instruments whose market risks are substantially the same. For that specific circumstance, the Board tentatively decided that the measurement of such portfolios should be the one that results from multiplying the net position by the Level 1 prices (e.g., multiplying the net long or short position by the Level 1 price for either a gross long or short position). Given this tentative decision, in September 2014 the IASB proposed adding a non-authoritative example to illustrate the application of the portfolio exception in this specific circumstance.[10] However, after reviewing the comments received on the proposal, the Board concluded that it was not necessary to add the proposed non-authoritative illustrative example to IFRS 13 (see section 11.2 below for further discussion) because the example would have been non-authoritative and the comments received did not reveal significant diversity in practice for the specific circumstance of portfolios that comprise only Level 1 financial instruments whose market risks are substantially the same.[11]

4.1.3 Unit of account versus the valuation premise

In valuing non-financial assets, the concepts of 'unit of account' and 'valuation premise' are distinct, even though both concepts deal with determining the appropriate level of aggregation (or disaggregation) for assets and liabilities. The unit of account identifies what is being measured for financial reporting and drives the level of aggregation (or disaggregation) for presentation and disclosure purposes (e.g., whether categorisation in the fair value hierarchy is determined at the individual asset level or for a group of assets). Valuation premise is a valuation concept that addresses how a non-financial asset derives its maximum value to market participants, either on a stand-alone basis or through its use in combination with other assets and liabilities.

Since financial instruments do not have alternative uses and their fair values typically do not depend on their use within a group of other assets or liabilities, the concepts of highest and best use and valuation premise are not relevant for financial instruments. As a result, the fair value for financial instruments should be largely based on the unit of account prescribed by the standard that requires (or permits) the fair value measurement.

The distinction between these two concepts becomes clear when the unit of account of a non-financial asset differs from its valuation premise. Consider an asset (e.g., customised machinery) that was acquired other than by way of a business combination, along with other assets as part of an operating line. Although the unit of account for the customised machinery may be as a stand-alone asset (i.e., it is presented for financial reporting purposes at the individual asset level in accordance with IAS 16 *Property, Plant and Equipment*), the determination of the fair value of the machinery may be derived from its use with other assets in the operating line (see section 9.2 below for additional discussion on the concept of valuation premise).

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9 FASB Accounting Standards Update 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*.

10 Exposure Draft ED/2014/4: *Measuring Quoted Investments in Subsidiaries, Joint Ventures and Associates at Fair Value: Proposed amendments to IFRS 10, IFRS 12, IAS 27, IAS 28, IAS 36 and Illustrative Examples for IFRS 13*, IASB, September 2014. Available on the IFRS Foundation's website.

11 *IASB Update*, April 2015, available on the IFRS Foundation's website.

4.2 Characteristics of the asset or liability

When measuring fair value, IFRS 13 requires an entity to consider the characteristics of the asset or liability. For example, age and miles flown are attributes to be considered in determining a fair value measure for an aircraft. Examples of such characteristics could include:

- The condition and location of an asset
- Restrictions, if any, on the sale or use of an asset or transfer of a liability (see sections 4.2.2, 9.1 and 10.4 below)

The fair value of the asset or liability must take into account those characteristics that market participants would take into consideration when pricing the asset or liability at the measurement date. *[IFRS 13.11, IFRS 13.12]*. For example, when valuing individual shares in an unlisted company, market participants might consider factors such as the nature of the company's operations; its performance to date and forecast future performance; and how the business is funded, including whether it is highly leveraged.

The requirement to consider the characteristics of the asset or liability being measured is not new to fair value measurement under IFRS. For example, prior to the issuance of IFRS 13, IAS 41 referred to measuring the fair value of a biological asset or agricultural produce in its present location and condition and IAS 40 stated that an entity should identify any differences between the investment property being measured at fair value and similar properties for which observable market prices are available and make the appropriate adjustments for those differences. *[IFRS 13.BC46]*.

4.2.1 Condition and location

An asset may not be in the condition or location that market participants would require for its sale at an observable market price. In order to determine the fair value of the asset as it currently exists, the market price needs to be adjusted to the price market participants would be prepared to pay for the asset in its current condition and location. This includes deducting the cost of transporting the asset to the market if location is a characteristic of the asset being measured, and may include deducting the costs of converting or transforming the asset, as well as a normal profit margin.

For non-financial assets, condition and location considerations may influence, or be dependent on, the highest and best use of an asset (see section 9 below). That is, an asset's highest and best use may require an asset to be in a different condition. However, the objective of a fair value measurement is to determine the price for the asset in its current form. Therefore, if no market exists for an asset in its current form, but there is a market for the converted or transformed asset, an entity could adjust this market price for the costs a market participant would incur to re-condition the asset (after acquiring the asset in its current condition) and the compensation they would expect for the effort. Illustration 4-1 below provides an example of how costs to convert or transform an asset might be considered in determining fair value based on the current use of the asset.

Illustration 4-1: Adjusting fair value for condition and location

An entity owns a pine forest. The pine trees take approximately 25 years to mature, after which they can be cut down and sold. The average age of the trees in the forest is 14 years at the end of the reporting period. The current use of the forest is presumed to be its highest and best use.

There is no market for the trees in their current form. However, there is a market for the harvested timber from trees aged 25 years or older. To measure the fair value of the forest, the entity uses an income approach and uses the price for 25-year-old harvested timber in the market today as an input. However, since the trees are not yet ready for harvest, the cash flows must be adjusted for the costs a market participant would incur. Therefore, the estimated cash flows include costs to manage the forest (including silviculture activities, such as fertilising and pruning the trees) until the trees reach maturity; costs to harvest the trees; and costs to transport the harvested logs to the market. The entity estimates these costs using market participant assumptions. The entity also adjusts the value for a normal profit margin because a market participant acquiring the forest today would expect to be compensated for the cost and effort of managing the forest for the period (i.e., 11 years) before the trees will be harvested and the timber is sold (i.e., this would include compensation for costs incurred and a normal profit margin for the effort of managing the forest).

4.2.2 Restrictions on assets or liabilities

IFRS 13 indicates that the effect on fair value of a restriction on the sale or use of an asset will differ depending on whether the restriction is deemed to be a characteristic of the asset or the entity holding the asset. A restriction that would transfer with the asset in an assumed sale would generally be deemed a characteristic of the asset and, therefore, would likely be considered by market participants when pricing the asset. Conversely, a restriction that is specific to the entity holding the asset would not transfer with the asset in an assumed sale and, therefore, would not be considered when measuring fair value. Determining whether a restriction is a characteristic of the asset or of the entity holding the asset may be contractual in some cases. In other cases, this determination may require judgement based on the specific facts and circumstances.

The following illustrative examples based on the standard highlight the distinction between restrictions that are characteristics of the asset and those of the entity holding the asset, including how this determination affects the fair value measurement. *[IFRS 13.IE Example 8, IFRS 13.IE28, IFRS 13.IE Example 9, IFRS 13.IE29]*. Restrictions on non-financial assets are discussed further in section 9 below.

Illustration 4-2: Restrictions on assets

An entity holds an equity instrument for which sale is legally restricted for a specified period. The restriction is a characteristic of the instrument that would transfer to market participants. As such, the fair value of the instrument would be measured based on the quoted price for an otherwise identical unrestricted equity instrument that trades in a public market, adjusted for the effect of the restriction. The adjustment would reflect the discount market participants would demand for the risk relating to the inability to access a public market for the instrument for the specified period. The adjustment would vary depending on:

- The nature and duration of the restriction
- The extent to which buyers are limited by the restriction
- Qualitative and quantitative factors specific to both the instrument and the issuer

Illustration 4-3: Entity-specific restrictions on assets

A donor of land specifies that the land must be used by a sporting association as a playground in perpetuity. Upon review of relevant documentation, the association determines that the donor's restriction would not transfer to market participants if the association sold the asset (i.e., the restriction on the use of the land is specific to the association). Furthermore, the association is not restricted from selling the land. Without the restriction on the use of the land, the land could be used as a site for residential development. In addition, the land is subject to an easement (a legal right that enables a utility to run power lines across the land).

Under these circumstances, the effect of the restriction and the easement on the fair value measurement of the land is as follows:

(a) Donor restriction on use of land - The donor restriction on the use of the land is specific to the association and thus would not be transferred to market participants. Therefore, regardless of the restriction on the use of the land by the association, the fair value of the land would be measured based on the higher of its indicated value either:

  (i) As a playground (i.e., the maximum value of the land is through its use in combination with other assets or with other assets and liabilities)

  Or

  (ii) As a residential development (i.e., the fair value of the asset would be maximised through its use by market participants on a stand-alone basis)

(b) Easement for utility lines - Because the easement for utility lines is a characteristic of the land, this easement would be transferred to market participants with the land. The fair value of the land would include the effect of the easement, regardless of whether the land's valuation premise is as a playground or as a site for residential development.

In contrast to Illustration 4-2 above, Illustration 4-3 illustrates a restriction on the use of donated land that applies to a specific entity, but not to other market participants.

The calculation of the fair value should take account of any restrictions on the sale or use of an asset, if those restrictions relate to the asset rather than to the holder of the asset and the market participant would take those restrictions into account in his determination of the price that he is prepared to pay. For example, if a portion of a forest is restricted from harvest as part of a carbon capture scheme, this restriction would be considered as part of the fair value since it represents a characteristic of the asset (the forest) being measured.

A liability or an entity's own equity instrument may be subject to restrictions that prevent the transfer of the item. When measuring the fair value of a liability or equity instrument, IFRS 13 does not allow an entity to include a separate input (or an adjustment to other inputs) for such restrictions. This is because the effect of the restriction is either implicitly or explicitly included in other inputs to the fair value measurement. Restrictions on liabilities and an entity's own equity are discussed further in section 10.4 below.

IFRS 13 has different treatments for restrictions on assets and those over liabilities. The IASB believes this is appropriate because restrictions on the transfer of a liability relate to the performance of the obligation (i.e., the entity is legally obliged to satisfy the obligation and needs to do something to be relieved of the obligation), whereas restrictions on the transfer of an asset generally relate to the marketability of the asset. In addition, nearly all liabilities include a restriction preventing the transfer of the liability. In contrast, most assets do not include a similar restriction. As a result, the effect of a restriction preventing the transfer of a liability, theoretically, would be consistent for all liabilities and, therefore, would require no additional adjustment beyond the factors considered in determining the original transaction price. If an entity is aware that a restriction on the transfer of a liability is not already reflected in the price (or in the other inputs used in the measurement), it would adjust the price or inputs to reflect the existence of the restriction. *[IFRS 13.BC99, IFRS 13.BC100]*. However, this would be rare because nearly all liabilities include a restriction and, when measuring fair value, market participants are assumed by IFRS 13 to be sufficiently knowledgeable about the liability to be transferred.

Frequently asked questions

Question 4-2: In determining the fair value of a restricted security, is it appropriate to apply a constant discount percentage over the entire life of the restriction?

How we see it

We generally do not believe a constant discount percentage needs to be used to measure the fair value of a restricted security because market participants would consider the remaining time on the security's restriction and that time period changes from period to period. Market participants, for example, would generally not assign the same discount for a restriction that terminates in one month, as they would for a two-year restriction.

One approach to value the restriction may be through an option pricing model that explicitly incorporates the duration of the restriction and the characteristics of the underlying security. The principal economic factor underlying a discount for lack of marketability is the increased risk resulting from the inability to return the investment, quickly and efficiently, to a cash position (i.e., the risk of a price decline during the restriction period). One way in which the price of this risk may be determined is by using an option pricing model that estimates the value of a protective put option. For example, restricted or non-marketable securities are acquired along with a separate option that provides the holder with the right to sell those shares at the current market price for unrestricted securities. The holder of such an option has, in effect, purchased marketability for the shares. The value of the put option may be considered an estimate of the discount for the lack of marketability associated with the restricted security. Other techniques or approaches may also be appropriate in measuring the discount associated with restricted securities.

Question 4-3: Considerations when a restriction is present on a call option for its entire contractual life

In certain instances, there may be a legal restriction preventing sale for an asset's entire life. Consider the following example where an entity holds a call option to acquire a controlling stake in its associate. The call option is an integral part of the shareholders' agreement to acquire the associate and, therefore, cannot be sold or transferred to a third party. The call option is not currently exercisable and is, therefore, accounted for under IFRS 9 and measured at fair value. The call option is assumed to have a positive fair value because the strike price per share of the option is significantly lower than the fair value per share of the associate. The entity needs to consider whether and, if so, how the effect of this restriction should be incorporated into the measurement of fair value for the call option.

This restriction is contractually specified and is, therefore, considered a characteristic of the asset and would be considered by market participants when pricing the call option. Therefore, it must be considered when measuring the fair value of the call option.

To understand how the restriction should be incorporated into the fair value measurement, the entity needs to consider how market participants would view it. Unlike the situation in Illustration 4-2 above, the restriction is not for a portion of the instrument's life, but instead for the entire contractual life (i.e., until the option expires). In contrast to an investment in shares, market participant holders of a call option can realise the value of the option both through its sale and by exercising it. In this example, although there is a restriction on sale, there is no restriction on exercise. That is, the entity could assume that market participants would realise value from exercising the option. Therefore, in this example, no adjustment related to the sale restriction would be made to the fair value of the call option.

When considering what market participants would assume, an entity should not consider its own intentions. For example, the entity determines that in this case, the strategic risks or costs involved are too great to justify the decision to exercise the option to realise its value. As discussed in section 6.2 below, fair value must be determined from the perspective of a market participant. Therefore, the fair value would not be nil solely because the entity does not intend to exercise the option.

5 The principal (or most advantageous) market

A fair value measurement contemplates an orderly transaction to sell the asset or transfer the liability in either: *[IFRS 13.16]*

- The principal market for the asset or liability

  Or

- In the absence of a principal market, the most advantageous market for the asset or liability

IFRS 13 is clear that, if there is a principal market for the asset or liability, the fair value measurement represents the price in that market at the measurement date (regardless of whether that price is directly observable or estimated using another valuation technique). The price in the principal market must be used even if the price in a different market is potentially more advantageous. *[IFRS 13.18]*. This is illustrated in Illustration 5-1 below, adapted from Example 6 in the standard. *[IFRS 13.IE Example 6, IFRS 13.IE19, IFRS 13.IE20]*.

Illustration 5-1: Determining the principal market

An asset is sold in two different active markets at different prices. An entity enters into transactions in both markets and can access the price in those markets for the asset at the measurement date.

	Market A	Market B
	CU	CU
Price that would be received	26	25
Transaction costs in that market	(3)	(1)
Costs to transport the asset to the market	(2)	(2)
Net amount that would be received	21	22

If Market A is the principal market for the asset (i.e., the market with the greatest volume and level of activity for the asset), the fair value of the asset would be measured using the price that would be received in that market, even though the net proceeds in Market B are more advantageous. In this case, the fair value would be CU24, after taking into account transport costs excluding transactions costs.

The identification of a principal (or most advantageous) market could be impacted by whether there are observable markets for the item being measured. However, even where there is no observable market, fair value measurement assumes a transaction takes place at the measurement date. The assumed transaction establishes a basis for estimating the price to sell the asset or to transfer the liability. *[IFRS 13.21]*.

5.1 The principal market

The principal market is the market for the asset or liability that has the greatest volume or level of activity for the asset or liability. *[IFRS 13 Appendix A]*. There is a general presumption that the principal market is the one in which the entity would normally enter into a transaction to sell the asset or transfer the liability, unless there is evidence to the contrary. In practice, an entity would first consider the markets it can access. Then it would determine which of those markets has the greatest volume and liquidity in relation to the particular asset or liability. *[IFRS 13.17]*.

Management is not required to perform an exhaustive search to identify the principal market; however, it cannot ignore evidence that is reasonably available when considering which market has the greatest volume and level of activity. *[IFRS 13.17]*. For example, it may be appropriate to take into account information available in trade journals, if reliable market information about volumes transacted is available in such journals. Absent evidence to the contrary, the principal market is presumed to be the market in which an entity normally enters into transactions for the asset and liability.

The principal market is considered from the perspective of the reporting entity, which means that the principal market could be different for different entities (this is discussed further in Question 5-1 below). For example, a securities dealer may exit a financial instrument by selling it in the inter-dealer market, while a manufacturing company would sell a financial instrument in the retail market. The entity must be able to access the principal market as at the measurement date. Therefore, continuing with our example, it would not be appropriate for a manufacturing company to assume that it would transact in the inter-dealer market (even when considering a hypothetical transaction) because the company does not have access to this market.

Because IFRS 13 indicates that the principal market is determined from the perspective of the reporting entity, some have questioned whether the principal market should be determined on the basis of: (a) entity-specific volume (i.e., the market where the reporting entity has historically sold, or intends to sell, the asset with the greatest frequency and volume); or (b) market-based volume and activity. However, IFRS 13 is clear that the principal market for an asset or liability should be determined based on the market with the greatest volume and level of activity that the reporting entity can access. It is not determined based on the volume or level of activity of the reporting entity's transactions in a particular market. That is, the determination as to which market(s) a particular entity can access is entity-specific, but once the accessible markets are identified, market-based volume and activity determine the principal market. *[IFRS 13.BC52]*.

The recognition in IFRS 13 that different entities may sell identical instruments in different markets (and therefore at different exit prices) has important implications, particularly with respect to the initial recognition of certain financial instruments, such as derivatives. For example, a derivative contract between a dealer and a retail customer would likely be initially recorded at different fair values by the two entities, as they would exit the derivative in different markets and, therefore, at different exit prices. Day one gains and losses are discussed further in section 12.2 below.

Although an entity must be able to access the market at the measurement date, IFRS 13 does not require an entity to be able to sell the particular asset or transfer the particular liability on that date. *[IFRS 13.20]*. For example, if there is a restriction on the sale of the asset, IFRS 13 simply requires that the entity be able to access the market for that asset when that restriction ceases to exist. It is important to note that the existence of the restriction may still affect the price a market participant would pay (see section 4.2.2 above for discussion on restrictions on assets and liabilities).

In general, the market with the greatest volume and deepest liquidity will probably be the market in which the entity most frequently transacts. In these instances, it is likely that the principal market would be the same as the most advantageous market (see section 5.2 below).

Prior to the adoption of IFRS 13, some entities determined fair value based solely on the market where they transact with the greatest frequency (without considering other markets with greater volume and deeper liquidity). As noted above, IFRS 13 requires an entity to consider the market with the greatest volume and deepest liquidity for the asset. Therefore, an entity cannot presume a commonly used market is the principal market. For example, if an entity previously measured the fair value of agricultural produce based on its local market, but there is a deeper and more liquid market for the same agricultural produce (for which transportation costs are not prohibitive), the latter market would be deemed the principal market and would be used when measuring fair value.

In a speech[12], a member of the SEC staff highlighted the importance of determining the principal or most advantageous market because it drives the identification of market participants and the set of information and assumptions that a market participant would use in determining fair value. While traditional markets (e.g., equities, commodities) have a limited number of transaction venues, the staff member noted that this is not necessarily the case for crypto assets due to the evolving nature of the crypto markets. He highlighted that characteristics such as pricing, regulatory oversight, and the general availability and reliability of information vary across different crypto assets and entities. As a result, thought is required when determining fair value for crypto assets.

12 Remarks by Gaurav Hiranandani, Senior Associate Chief Accountant, SEC Office of the Chief Accountant, 4 December 2024. Refer to our publication, *2023 AICPA & CIMA Conference on Current SEC and PCAOB Developments - Compendium of significant accounting and reporting issues*, available on Accounting Link.

Frequently asked questions

Question 5-1: Can an entity have more than one principal market for the same asset or liability?

IFRS 13 states that "because different entities (and businesses within those entities) with different activities may have access to different markets, the principal (or most advantageous) market for the same asset or liability might be different for different entities (and businesses within those entities). Therefore, the principal (or most advantageous) market (and thus, market participants) shall be considered from the perspective of the entity, thereby allowing for differences between and among entities with different activities." *[IFRS 13.19]*.

Therefore, in certain instances it may be appropriate for a reporting entity to determine that it has different principal markets for the same asset or liability. However, such a determination would need to be based on the reporting entity's business units engaging in different activities to ensure they were accessing different markets.

How we see it

Determining the principal market is not based on management's intent. Therefore, we would not expect a reporting entity to have different principal markets for identical assets held within a business unit solely because management has different exit strategies for those assets.

Consider Illustration 5-2 below, in which multiple exit markets exist for an asset and the reporting entity has access to all of the various exit markets. The fact that a reporting entity (or business unit within a reporting entity) has historically exited virtually identical assets in different markets does not justify the entity utilising different exit markets in determining the fair value of these assets, unless the entity has different business units engaging in different activities. Instead, the concept of a principal market (and most advantageous market) implies that one consistent market should generally be considered in determining the fair value of these identical assets.

Illustration 5-2: Determining the principal market - consistent principal market

The following three markets exist for a particular asset. The company has the ability to transact in all three markets (and has historically done so).

Market	Price
A	CU30,000
B	CU25,000
C	CU22,000

Under the principal market concept, it would not be appropriate to value identical assets at different prices solely because management intends to sell the assets in different markets. Likewise, a consistent fair value measurement for each asset utilising a blended price that is determined based on the proportion of assets that management intends to sell in each market would not be appropriate. Instead, each of the assets would be measured at the price in the market determined to be the company's principal market.

If Market B were determined to represent the principal market for the asset being measured, each asset would be valued at CU25,000. Selling the assets in either Market A or Market C would result in a gain or loss for the company. We believe this result is consistent with one of the fundamental concepts in the fair value framework. That is, the consequences of management's decisions (or a company's comparative advantages or disadvantages) should be recognised when those decisions are executed (or those advantages or disadvantages are achieved).

Question 5-2: In situations where an entity has access to multiple markets, is the determination of the principal market based on entity-specific volume and activity or market-based volume and activity?

In most instances, the market in which a reporting entity would sell an asset (or transfer a liability) with the greatest frequency will also represent the market with the greatest volume and deepest liquidity for all market participants. In these instances, the principal market would be the same regardless of whether it is determined based on entity-specific volume and activity or market-based volume and activity. However, when this is not the case, a reporting entity's principal market is determined using market-based volume.

Different entities engage in different activities. Therefore, some entities have access to certain markets that other entities do not. For example, an entity that does not function as a wholesaler would not have access to the wholesale market and, therefore, would need to look to the retail market as its principal market.

Once the markets to which a particular entity has access have been identified, the determination of the principal market is not based on management's intent or entity-specific volume, but rather it is based on the market with the greatest volume and level of activity for the asset or liability. *[IFRS 13.19]*.

Illustration 5-3: Determining the principal market - market-based versus entity-specific volume

The following three markets exist for Entity A's fleet of vehicles. Entity A has the ability to transact in all three markets (and has historically done so). As at the measurement date, the entity has 100 vehicles (same make, model and mileage) that it needs to measure at fair value. Volumes and prices in the respective markets are as follows:

Market	Price	The entity's volume for the asset in the market (based on history and/or intent)	Total market-based volume for the asset
A	CU30,000	60%	15%
B	CU25,000	25%	75%
C	CU22,000	15%	10%

Based on this information, Market B would be the principal market as this is the market in which the majority of transactions for the asset occur. As such, the fair value of the 100 cars as at the measurement date would be CU2.5 million (i.e., CU25,000 per car). Actual sales of the assets in either Market A or C would result in a gain or loss to the entity, i.e., when compared to the fair value of CU25,000.

5.2 The most advantageous market

As noted above, if there is a principal market for the asset or liability being measured, fair value is determined using the price in that market, even if the price in a different market is more advantageous at the measurement date.

Only in situations where there is no principal market for the asset or liability being measured, can an entity consider the most advantageous market. *[IFRS 13.16]*.

The most advantageous market is the one that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after considering transaction costs and transport costs. *[IFRS 13 Appendix A]*.

This definition reasonably assumes that most entities transact with an intention to maximise profits or net assets. Assuming economically rational behaviour, the IASB observed that the principal market would generally represent the most advantageous market. However, when this is not the case, the IASB decided to prioritise the price in the most liquid market (i.e., the principal market) as this market provides the most representative input to determine fair value and also serves to increase consistency among reporting entities. *[IFRS 13.BC52]*.

When determining the most advantageous market, an entity must take into consideration the transaction costs and transportation costs it would incur to sell the asset or transfer the liability. The market that would yield the highest price after deducting these costs is the most advantageous market. This is illustrated in Illustration 5-4, adapted from Example 6 in the standard. *[IFRS 13.IE Example 6, IFRS 13.IE19, IFRS 13.IE20, IFRS 13.IE21, IFRS 13.IE22]*.

Illustration 5-4: Determining the most advantageous market

Consider the same facts as in Illustration 5-1 above. If neither market is the principal market for the asset, the fair value of the asset would be measured using the price in the most advantageous market.

The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account transaction costs and transport costs (i.e., the net amount that would be received in the respective markets).

	Market A	Market B
	CU	CU
Price that would be received	26	25
Transaction costs in that market	(3)	(1)
Costs to transport the asset to the market	(2)	(2)
Net amount that would be received	21	22

Because the entity would maximise the net amount that *would be received* for the asset in Market B (CU22), that is the most advantageous market. Market B is the most advantageous market even though the fair value that would be recognised in that market (CU23 = CU25 - CU2) is lower than in Market A (CU24 = CU26 - CU2).

It is important to note that, while transaction costs and transportation costs are considered in determining the most advantageous market, the treatment of these costs in relation to measuring fair value differs (transaction costs and transportation costs are discussed further in section 8 below).

6 Market participants

When measuring fair value, an entity is required to use the assumptions that market participants would use when pricing the asset or liability. However, IFRS 13 does not require an entity to identify specific market participants. Instead, an entity must identify the characteristics of market participants that would generally transact for the asset or liability being measured. Determining these characteristics takes into consideration factors that are specific to the asset or liability; the principal (or most advantageous) market; and the market participants in that market. *[IFRS 13.22, IFRS 13.23]*. This determination, and how these characteristics affect a fair value measurement, may require significant judgement.

The principal (or most advantageous) market is determined from the perspective of the reporting entity (or business units within a reporting entity). As a result, other entities within the same industry as the reporting entity will most likely be considered market participants. However, market participants may come from outside of the reporting entity's industry, especially when considering the fair value of assets on a stand-alone basis. For example, a residential real estate development entity may be considered a market participant when measuring the fair value of land held by a manufacturing company if the highest and best use of the land is deemed to be residential real estate development.

Entities may need to re-assess the market or market participant characteristics if facts and circumstances change; for example, with the gradual decline in demand for diesel, market participants may lose their ability to sell products in the diesel market and turn to alternative markets.

6.1 Characteristics of market participants

IFRS 13 defines market participants as "buyers and sellers in the principal (or most advantageous) market for the asset or liability". *[IFRS 13 Appendix A]*.

IFRS 13 assumes that market participants have all of the following characteristics: *[IFRS 13 Appendix A, IFRS 13.BC55-BC59]*

- They are independent of each other, that is, they are not related parties, as defined in IAS 24 *Related Party Disclosures* (see Chapter 35)
- They are knowledgeable, having a reasonable understanding about the asset or liability using all available information, including information obtained through usual and customary due diligence efforts
- They are able to enter into a transaction for the asset or liability
- They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so

Since market participants are independent of each other, the hypothetical transaction is assumed to take place between market participants at the measurement date, not between the reporting entity and another market participant. While market participants are not related parties, the standard does allow the price in a related party transaction to be used as an input in a fair value measurement provided the entity has evidence the transaction was entered into at market terms. *[IFRS 13.BC57]*.

Market participants in the principal (or most advantageous) market should have sufficient knowledge about the asset or liability for which they are transacting. The appropriate level of knowledge does not necessarily need to come from publicly available information, but could be obtained in the course of a normal due diligence process.

When determining potential market participants, certain characteristics should be considered. These include the legal capability and the operating and financial capacity to purchase the asset or assume the liability. Market participants must have both the willingness and the ability to transact for the item being measured. For example, when measuring the fair value less costs of disposal of a CGU, as part of testing the CGU for impairment in accordance with IAS 36, the market participants considered in the analysis should be in both a financial and operating position to purchase the CGU.

6.2 Market participant assumptions

IFRS 13 specifies that fair value is not the value specific to one entity, but rather is meant to be a market-based measurement. If market participants would consider adjustments for the inherent risk of the asset or liability or consider the risk in the valuation technique used to measure fair value, then such risk adjustments should be considered in the fair value assumptions. For example, when measuring the fair value of certain financial instruments, market participants may include adjustments for liquidity, climate-related risks, uncertainty and/or non-performance risk.

Fair value is not the value specific to the reporting entity and it is not the specific value to one market participant whose risk assessment or specific synergies may differ from other market participants. The reporting entity needs to consider those factors that market participants, in general, would consider. Fair value is not measured based on a single market participant's assumptions or their specific intent or use of the asset or liability. To illustrate, assume a single market participant, Market Participant A, is willing to pay a higher price for an asset than the remaining market participants, due to specific synergies that only Market Participant A could achieve. In such a situation, fair value would not be the price that Market Participant A would be willing to pay for the asset. Instead, fair value would be the price that typical market participants would pay for the asset.

The underlying assumptions used in a fair value measurement are driven by the characteristics of the market participants who would transact for the item being measured and the factors those market participants would consider when pricing the asset or liability. Importantly, IFRS 13 notes that fair value is based on assumptions that market participants acting in their 'economic best interest' would use when pricing an asset or liability. *[IFRS 13.22]*. That is, market participants are assumed to transact in a manner that is consistent with the objective of maximising the value of their business, their net assets or profits. In certain instances, this may result in market participants considering premiums or discounts (e.g., control premiums or discounts for lack of marketability) when determining the price at which they would transact for a particular asset or liability (see section 14.2 below for additional discussion on the consideration of premiums and discounts in a fair value measurement). For example, a market participant may factor a discount into the valuation of a fossil fuel asset in relation to climate-risk.

In situations where market observable data is not available, the reporting entity can use its own data as a basis for its assumptions. This might be relevant to climate-related variables which an entity may factor into the value of its assets although inputs are largely unobservable at this stage. However, adjustments need to be made to the entity's own data if readily available market data indicates that market participant assumptions would differ from the assumptions specific to that reporting entity (see section 18 below for further discussion regarding Level 3 inputs). With the global drive towards increased transparency in relation to climate-related risks, for example, the recent publication of IFRS S2 Climate-related Disclosures by the International Sustainability Standards Board (ISSB), more information will be available to market participants when valuations are undertaken. Determining the impact of that information on market participant assumptions, inputs and sensitivities, is likely to require significant judgement. For example, a 'green' building could command a rental premium, however, judgement would be required in determining whether the premium is due to the green qualities of the building or due to other factors such as the building's location.

The intended use and risk assumptions for an asset or asset group may differ among market participants transacting in the principal market for the asset. For example, the principal market in which the reporting entity would transact may contain both strategic and financial buyers. Both types of buyers would be considered in determining the characteristics of market participants; however, the fair value measurement of an asset may differ among these two types of market participants. The following example from the standard illustrates this point. *[IFRS 13.IE Example 1, IFRS 13.IE3, IFRS 13.IE4, IFRS 13.IE5, IFRS 13.IE6]*.

Extract from IFRS 13

Example 1-Asset group

An entity acquires assets and assumes liabilities in a business combination. One of the groups of assets acquired comprises Assets A, B and C. Asset C is billing software integral to the business developed by the acquired entity for its own use in conjunction with Assets A and B (ie the related assets). The entity measures the fair value of each of the assets individually, consistently with the specified unit of account for the assets. The entity determines that the highest and best use of the assets is their current use and that each asset would provide maximum value to market participants principally through its use in combination with other assets or with other assets and liabilities (ie its complementary assets and the associated liabilities). There is no evidence to suggest that the current use of the assets is not their highest and best use.

In this situation, the entity would sell the assets in the market in which it initially acquired the assets (ie the entry and exit markets from the perspective of the entity are the same). Market participant buyers with whom the entity would enter into a transaction in that market have characteristics that are generally representative of both strategic buyers (such as competitors) and financial buyers (such as private equity or venture capital firms that do not have complementary investments) and include those buyers that initially bid for the assets. Although market participant buyers might be broadly classified as strategic or financial buyers, in many cases there will be differences among the market participant buyers within each of those groups, reflecting, for example, different uses for an asset and different operating strategies.

As discussed below, differences between the indicated fair values of the individual assets relate principally to the use of the assets by those market participants within different asset groups:

(a) Strategic buyer asset group. The entity determines that strategic buyers have related assets that would enhance the value of the group within which the assets would be used (ie market participant synergies). Those assets include a substitute asset for Asset C (the billing software), which would be used for only a limited transition period and could not be sold on its own at the end of that period. Because strategic buyers have substitute assets, Asset C would not be used for its full remaining economic life. The indicated fair values of Assets A, B and C within the strategic buyer asset group (reflecting the synergies resulting from the use of the assets within that group) are CU360,[1] CU260 and CU30, respectively. The indicated fair value of the assets as a group within the strategic buyer asset group is CU650.

(b) Financial buyer asset group. The entity determines that financial buyers do not have related or substitute assets that would enhance the value of the group within which the assets would be used. Because financial buyers do not have substitute assets, Asset C (ie the billing software) would be used for its full remaining economic life. The indicated fair values of Assets A, B and C within the financial buyer asset group are CU300, CU200 and CU100, respectively. The indicated fair value of the assets as a group within the financial buyer asset group is CU600.

The fair values of Assets A, B and C would be determined on the basis of the use of the assets as a group within the strategic buyer group (CU360, CU260 and CU30). Although the use of the assets within the strategic buyer group does not maximise the fair value of each of the assets individually, it maximises the fair value of the assets as a group (CU650).

1 In these examples, monetary amounts are denominated in 'currency units (CU)'.

The example above illustrates that the principal (or most advantageous) market for an asset group may include different types of market participants (e.g., strategic and financial buyers), who would make different assumptions in pricing the assets.

When there are two or more different types of market participants that would transact for the asset, or the asset group, separate fair value estimates of the assets should generally be performed for each type of market participant in order to identify which type of market participant (and the appropriate related assumptions) should be considered in the fair value measurement.

In each of these analyses, the intended use of the asset and any resulting market participant synergies are considered. These include synergies among the assets in the asset grouping and synergies in combination with other assets held by (or available to) market participants generally. The selection of the appropriate market participants is based on the type of market participants that generate the maximum value for the asset group, in aggregate.

This is illustrated in Example 1 in the standard (in the extract above). Fair value would be measured by reference to assumptions made by the Strategic Buyer because the fair value of the group of assets (CU650) exceeds that of the Financial Buyer (CU600). Consequently, the fair value of the individual assets within the asset grouping would be estimated based on the indicated values related to the market participants with the highest overall value for the asset grouping. In other words, once the assets are appropriately grouped based on their valuation premise, they should be valued using a consistent set of assumptions (i.e., the assumptions for the same type of market participants and the same related use). As shown in the example, this is true even though the fair value measurement of a specific asset, Asset C in the example, is deemed to be higher for the Financial Buyer.

Example 1 (in the extract above) also highlights the interdependence between the key concepts within the IFRS 13 fair value framework. Understanding the interrelationships between market participants, exit market and the concepts of valuation premise and highest and best use is important when measuring the fair value of non-financial assets (the concepts of 'valuation premise' and 'highest and best use' are discussed in section 9 below).

In the example, the indicated value for the assets as a group is determined based on the valuation premise (i.e., their use in combination with other assets) and market participant assumptions that would maximise the value of the asset group as a whole (i.e., assumptions consistent with strategic buyers). The valuation premise for Assets A, B and C is based on their use in combination with each other (or with other related assets and liabilities held by or available to market participants), consistent with the highest and best use of these assets.

The example also highlights the distinction between the unit of account (i.e., what is being measured and presented for financial reporting purposes) and the valuation premise, which forms the basis of how assets are grouped for valuation purposes (i.e., as a group or on a stand-alone basis). The unit of account may be the individual assets (i.e., Asset A, separate from Asset B and Asset C), but the valuation premise is the asset group comprised of Assets A, B and C. Therefore, the indicated value of the assets in combination (CU650) must be attributed to the assets based on their unit of account, resulting in the fair value measurement to be used for financial reporting purposes.

7 The transaction

As at the measurement date, the transaction to sell an asset or transfer a liability is, by definition, a hypothetical transaction for the particular asset or liability being measured at fair value. If the asset had actually been sold or the liability actually transferred as at the measurement date, there would be no asset or liability for the reporting entity to measure at fair value.

IFRS 13 assumes this hypothetical transaction will take place in the principal (or most advantageous) market (see section 5 above) and will: *[IFRS 13.15]*

- Be orderly in nature
- Take place between market participants that are independent of each other, but knowledgeable about the asset or liability (see section 6 above for additional discussion on market participants)
- Take place under current market conditions
- Occur on the measurement date

These assumptions are critical in ensuring that the estimated exit price in the hypothetical transaction is consistent with the objective of a fair value measurement. For example, the concept of an orderly transaction is intended to distinguish a fair value measurement from the exit price in a distressed sale or forced liquidation. Unlike a forced liquidation, an orderly transaction assumes that the asset or liability is exposed to the market prior to the measurement date for a period that is usual and customary to allow for information dissemination and marketing. That is, the hypothetical transaction assumes that market participants have sufficient knowledge and awareness of the asset or liability, including that which would be obtained through customary due diligence even if, in actuality, this process may not have begun yet (or may never occur at all, if the entity does not sell the asset or transfer the liability).

The hypothetical transaction between market participants does not consider whether management actually intends to sell the asset or transfer the liability at the measurement date; nor does it consider the reporting entity's ability to enter into the transaction on the measurement date. *[IFRS 13.20]*. To illustrate, consider a hypothetical transaction to sell a security that, due to a restriction, cannot be sold as at the measurement date. Although the restriction may affect the measurement of fair value, it does not preclude the entity from assuming a hypothetical transaction to sell the security (see section 4.2.2 above for further discussion on restrictions).

An orderly transaction assumes there will be adequate market exposure, so that market participants would be sufficiently knowledgeable about the asset or liability. This does not mean the hypothetical exchange takes place at some point in the future. A fair value measurement considers market conditions as they exist at the measurement date and is intended to represent the current value of the asset or liability, not the potential value of the asset or liability at some future date. The transaction is therefore assumed to take place on the measurement date and the entity assumes that the marketing activities and due diligence activities have already been performed. For example, assume an entity is required to re-measure an asset to fair value at its reporting date of 31 December 2022. The customary marketing activities and due diligence procedures required for the asset to be sold take six months. The asset's fair value should not be based on the price the entity expects to receive for the asset in June 2023. Instead, it must be determined based on the price that would be received if the asset were sold on 31 December 2022, assuming adequate market exposure had already taken place.

Although a fair value measurement contemplates a price in an assumed transaction, pricing information from actual transactions for identical or similar assets and liabilities is considered in measuring fair value. IFRS 13 establishes a fair value hierarchy (discussed in section 15 below) to prioritise the inputs used to measure fair value, based on the relative observability of those inputs. The standard requires that valuation techniques maximise the use of observable inputs and minimise the use of unobservable inputs. As such, even in situations where the market for a particular asset is deemed to be inactive (e.g., due to liquidity issues), relevant prices or inputs from this market should still be considered in the measurement of fair value. It would not be appropriate for an entity to default solely to a model's value based on unobservable inputs (a Level 3 measurement), when Level 2 information is available. Judgement is required in assessing the relevance of observable market data to determine the priority of inputs under the fair value hierarchy, particularly in situations where there has been a significant decrease in market activity for an asset or liability, as discussed in section 7.1 below.

Assessing whether a transaction is orderly can require significant judgement. The Boards believe this determination can be more difficult if there has been a significant decrease in the volume or level of activity for the asset or liability in relation to normal market activity. As such, IFRS 13 provides various factors to consider when assessing whether there has been a significant decrease in the volume or level of activity in the market (see section 7.1 below) as well as circumstances that may indicate that a transaction is not orderly (see section 7.2 below). Making these determinations is based on the weight of all available evidence. *[IFRS 13.B43]*.

7.1 Evaluating whether there has been a significant decrease in the volume and level of activity for an asset or liability

There are many reasons why the trading volume or level of activity for a particular asset or liability may decrease significantly. For example, shifts in supply and demand dynamics, changing levels of investors' risk appetites and liquidity constraints of key market participants could all result in a significant reduction in the level of activity for certain items or class of items. While determining fair value for any asset or liability that does not trade in an active market often requires judgement, the application guidance in IFRS 13 is primarily focused on assets and liabilities in markets that have experienced a significant reduction in volume or activity. Prior to a decrease in activity, a market approach is often the primary valuation approach used to estimate fair value for these items, given the availability and relevance of observable data. Under a market approach, fair value is based on prices and other relevant information generated by market transactions involving assets and liabilities that are identical or comparable to the item being measured. As transaction volume or activity for the asset decreases significantly, application of the market approach can prove more challenging and the use of additional valuation techniques may be warranted.

The objective of a fair value measurement remains the same even when there has been a significant decrease in the volume or level of activity for the asset or liability. IFRS 13.B37 provides a number of factors that should be considered when evaluating whether there has been a significant decrease in the volume or level of activity for the asset or liability. *[IFRS 13.B37]*.

Extract from IFRS 13

B37 The fair value of an asset or a liability might be affected when there has been a significant decrease in the volume or level of activity for that asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities). To determine whether, on the basis of the evidence available, there has been a significant decrease in the volume or level of activity for the asset or liability, an entity shall evaluate the significance and relevance of factors such as the following:

(a) There are few recent transactions.

(b) Price quotations are not developed using current information.

(c) Price quotations vary substantially either over time or among market-makers (eg some brokered markets).

(d) Indices that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability.

(e) There is a significant increase in implied liquidity risk premiums, yields or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the entity's estimate of expected cash flows, taking into account all available market data about credit and other non-performance risk for the asset or liability.

(f) There is a wide bid-ask spread or significant increase in the bid-ask spread.

(g) There is a significant decline in the activity of, or there is an absence of, a market for new issues (ie a primary market) for the asset or liability or similar assets or liabilities.

(h) Little information is publicly available (eg for transactions that take place in a principal-to-principal market).

These factors are not intended to be all-inclusive and should be considered along with any additional factors that are relevant based on the individual facts and circumstances. Determining whether the asset or liability has experienced a significant decrease in activity is based on the weight of the available evidence.

IFRS 13 is clear that a decrease in the volume or level of activity, on its own, does not necessarily indicate that a transaction price or quoted price does not represent fair value or that a transaction in that market is not orderly. Additional analysis is required in these instances to assess the relevance of observed transactions or quoted prices in these markets. When market volumes decrease, adjustments to observable prices (which could be significant) may be necessary (see section 7.3 below). As discussed in section 15 below, an adjustment based on unobservable inputs that is significant to the fair value measurement in its entirety would result in a Level 3 measurement. Observed prices associated with transactions that are not orderly would not be deemed to be representative of fair value. As part of the PIR feedback some respondents highlighted this as an issue where additional guidance is required, however as noted in section 1.3 above the IASB has decided that no follow-up actions will be undertaken. In their view, the requirements are principle-based, and there will always be a need for exercise of judgement, the challenges raised are detailed valuation assessments and an accounting standard-setter may not be best placed to provide guidance in this area. Lastly, there is evidence of practice having developed guidance to aid these assessments. Those aids are used by some and promote consistent application.

7.1.1 Can a market exhibit a significant decrease in volume or level of activity and still be considered active?

A significant decrease in the volume of transactions does not automatically imply that a market is no longer active. IFRS 13 defines a market as active if transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. While the same factors may be used to assess whether a market has experienced a significant decrease in activity and to determine whether a market is active or inactive, these are separate and distinct determinations.

The determination that a market has experienced a significant decrease in volume does not change the requirements of IFRS 13 related to the use of relevant observable data from active markets. That is, despite a decrease from recent (or historical) levels of activity, transactions for an asset or liability in a particular market may still occur with sufficient frequency and volume to provide pricing information on an ongoing basis, thereby qualifying as an active market. If there has been a significant decrease in activity, but a market is still deemed to be active, entities would continue to measure the fair value of identical instruments that trade in this market using P×Q (Level 1 measurement).

An example of this is related to 2011 trading activity for Greek sovereign bonds. During that calendar year, the economic situation in Greece had deteriorated and some had questioned whether the Greek sovereign bonds were still being actively traded. In a public statement, ESMA indicated that, "Based on trading data obtained from the Bank of Greece, it [was their] opinion that, as of 30 June 2011, the market was active for some Greek sovereign bonds but could be judged inactive for some others."[13] While ESMA provided no predictions about the level of trading activity as at 31 December 2011, ESMA clearly stated their expectation that a fair value measurement of Greek sovereign bonds, in interim and annual financial statements during 2011 should be a Level 1 measurement in situations where there was still an active market. Furthermore, ESMA expected entities to use a Level 2 measurement method that maximises the use of observable market data to measure the fair value of those bonds that were traded in inactive markets.

Similarly, securities trading sanctions with the consequence of restricting trades in the affected markets could lead to questions on whether those markets remain active.

Determining whether a particular market is considered liquid or active versus illiquid or inactive may require significant judgement and consider a variety of factors (e.g., what the bid-ask spread represents, how deep the bid-ask spread has to be to signal an inactive market, what is the sufficient level of trade volume to signify an active market). This can be particularly challenging in emerging markets.

While traditionally, the focus of such assessments has been public markets and listed securities, an active market is not confined to regulated markets and listed securities. We have observed that sometimes trading in unlisted securities may be more active than in some listed securities.[14] In its 2008 report, the IASB Expert Advisory Panel noted "There is no bright line between active markets and inactive markets. However, the biggest distinction between prices observed in active markets and prices observed in inactive markets is typically that, for inactive markets, an entity needs to put more work into the valuation process to gain assurance that the transaction price provides evidence of fair value or to determine the adjustments to transaction prices that are necessary to measure the fair value of the instrument.

"The issue to be addressed, therefore, is not about market activity *per se*, but about whether the transaction price observed represents fair value. Characteristics of an inactive market include a significant decline in the volume and level of trading activity, the available prices vary significantly over time or among market participants or the prices are not current. However, these factors alone do not necessarily mean that a market is no longer active. An active market is one in which transactions are taking place regularly on an arm's length basis. What is 'regularly' is a matter of judgement and depends upon the facts and circumstances of the market for the instrument being measured at fair value".[15]

13 European Securities and Markets Authority public statement ESMA/2011/397, *Sovereign Debt in IFRS Financial Statements*, issued in November 2011.

14 Financial Times article, *Value of private companies hits high of $490bn as tech start-ups shun markets*, 29 May 2017: '…said Peter Christiansen, a former Blackrock director who now heads research at Scenic. "We expect the trend will be towards private markets looking more and more like the public markets." '

15 Report of the IASB Expert Advisory Panel: *Measuring and disclosing the fair value of financial instruments in markets that are no longer active*, IASB, October 2008, paragraphs 17-18. Available on the IFRS Foundation's website.

Similar challenges exist for entities assessing whether a market is active for thinly traded investments. While trading volumes may be low, it may be challenging to conclude a market is not active when it regularly provides pricing information. For example, IAS 38 *Intangible Assets* mentions that an active market may exist for taxi licences and production quotas. *[IAS 38.78]*. These may not be traded every day suggesting that the threshold for an active market is fairly low. However, this may be particularly difficult in some emerging markets, therefore, significant judgement will be needed to assess whether a market is active based on the weight of evidence available.

Determining whether a market is active may be more challenging if regulators challenge an entity's judgement. For example, in its July 2015 enforcement report, ESMA noted that, in order to assess the existence of an active market, the entity had "calculated a number of ratios and compared them against the following benchmarks:

- daily % of average value of trades / capitalisation lower than 0.05%;
- daily equivalent value of trades lower than CU50,000;
- daily bid-ask spread higher or equal to 3%;
- maximum number of consecutive days with unvaried prices higher than 3;
- % of trading days lower than 100%."[16]

After performing this analysis and considering the limited trading volume, the issuer concluded that shares held in three of its listed available-for-sale investments were not traded in active markets. As a result, it measured fair value using a valuation technique based on Level 3 inputs. The enforcer disagreed with the issuer's assessment of whether the markets were active and thought that the quoted prices for these investments should have been used to measure fair value. In reaching this decision, the enforcer specifically noted that "the indicators used by the issuer were insufficient to conclude that the transaction price did not represent fair value or that transactions occurred with insufficient frequency and volume. … [T]he issuer did not gather sufficient information to determine whether transactions were orderly or took place with sufficient frequency and volume to provide pricing information. Therefore, based on available data, it was not possible to conclude that the markets, where the investments were listed, were not active and further analysis should have been performed to measure fair value."[17] The enforcer also raised concerns that the valuations based on Level 3 inputs were much higher than the quoted prices. Care will be needed when reaching a conclusion that a market is not active as this is a high hurdle.

During the PIR on IFRS 13, many respondents indicated they found the assessment of whether a market is active to be challenging and asked for additional guidance. The IASB decided not to provide additional guidance, noting in particular that the requirements are principles-based and, as such, judgement will always be needed in their application.[18]

7.2 Identifying transactions that are not orderly

IFRS 13 defines an orderly transaction as "a transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (eg a forced liquidation or distress sale)". *[IFRS 13 Appendix A]*. This definition includes two key components:

(i) Adequate market exposure is required in order to provide market participants the ability to obtain an awareness and knowledge of the asset or liability necessary for a market-based exchange

(ii) The transaction should involve market participants that, while being motivated to transact for the asset or liability, are not compelled to do so

IFRS 13 includes the following: *[IFRS 13.B43, IFRS 13.B44]*

16 European Securities and Markets Authority report ESMA/2015/1135: *17th Extract from the EECS's Database of Enforcement*, July 2015, Decision ref EECS/0115-03, pp.7.

17 European Securities and Markets Authority report ESMA/2015/1135: *17th Extract from the EECS's Database of Enforcement*, July 2015, Decision ref EECS/0115-03, pp.8.

18 IFRS Project Report and Feedback Statement, *Post-implementation Review of IFRS 13* Fair Value Measurement, IASB, December 2018, p.16. Available on the IFRS Foundation's website.

Extract from IFRS 13

B43 The determination of whether a transaction is orderly (or is not orderly) is more difficult if there has been a significant decrease in the volume or level of activity for the asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities). In such circumstances it is not appropriate to conclude that all transactions in that market are not orderly (ie forced liquidations or distress sales).Circumstances that may indicate that a transaction is not orderly include the following:

(a) There was not adequate exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities under current market conditions.

(b) There was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant.

(c) The seller is in or near bankruptcy or receivership (ie the seller is distressed).

(d) The seller was required to sell to meet regulatory or legal requirements (ie the seller was forced).

(e) The transaction price is an outlier when compared with other recent transactions for the same or a similar asset or liability.

An entity shall evaluate the circumstances to determine whether, on the weight of the evidence available, the transaction is orderly.

B44 An entity shall consider all the following when measuring fair value or estimating market risk premiums:

(a) If the evidence indicates that a transaction is not orderly, an entity shall place little, if any, weight (compared with other indications of fair value) on that transaction price.

(b) If the evidence indicates that a transaction is orderly, an entity shall take into account that transaction price. The amount of weight placed on that transaction price when compared with other indications of fair value will depend on the facts and circumstances, such as the following:

(i) the volume of the transaction.

(ii) the comparability of the transaction to the asset or liability being measured.

(iii) the proximity of the transaction to the measurement date.

(c) If an entity does not have sufficient information to conclude whether a transaction is orderly, it shall take into account the transaction price. However, that transaction price may not represent fair value (ie the transaction price is not necessarily the sole or primary basis for measuring fair value or estimating market risk premiums). When an entity does not have sufficient information to conclude whether particular transactions are orderly, the entity shall place less weight on those transactions when compared with other transactions that are known to be orderly.

An entity need not undertake exhaustive efforts to determine whether a transaction is orderly, but it shall not ignore information that is reasonably available. When an entity is a party to a transaction, it is presumed to have sufficient information to conclude whether the transaction is orderly.

IFRS 13 acknowledges that the determination of whether a transaction is orderly may be more difficult if there has been a significant decrease in the volume or level of activity. However, the standard is clear that, even when there has been a significant decrease in the volume or level of activity for an asset or liability, it is not appropriate to conclude that all transactions in that market are not orderly (i.e., distressed or forced). *[IFRS 13.B43]*. Instead, further assessment as to whether an observed transaction is not orderly generally needs to be made at the individual transaction level.

IFRS 13 does not require an entity to undertake all possible efforts in assessing whether a transaction is orderly. However, information that is available without undue cost and effort cannot be ignored. For instance, when an entity is party to a transaction, the standard presumes it would have sufficient information to conclude whether the transaction is orderly. *[IFRS 13.B44]*. Conversely, the lack of transparency into the details of individual transactions occurring in the market, to which the entity is not a party, can pose practical challenges for many entities in making this assessment. Recognising this difficulty, the IASB provided additional guidance in IFRS 13, which indicates that while observable data should not be ignored when the reporting entity does not have sufficient information to conclude on whether the transaction is orderly, the entity should place less weight on those transactions in comparison to other transactions that the reporting entity has concluded are orderly (see section 7.3 below for further discussion). *[IFRS 13.B44(c)]*.

Frequently asked questions

Question 7-1: Are all transactions entered into to meet regulatory requirements or transactions initiated during bankruptcy assumed to be not orderly?

Although an entity may be viewed as being compelled to sell assets to comply with regulatory requirements, such transfers are not necessarily disorderly. If the entity was provided with the usual and customary period of time to market the asset to multiple potential buyers, the transaction price may be representative of the asset's fair value. Similarly, transactions initiated during bankruptcy are not automatically assumed to be disorderly. The determination of whether a transaction is not orderly requires a thorough evaluation of the specific facts and circumstances, including the exposure period and the number of potential buyers.

Question 7-2: Is it possible for orderly transactions to take place in a 'distressed' market?

How we see it

While there may be increased instances of transactions that are not orderly when a market has undergone a significant decrease in volume, it is not appropriate to assume that all transactions that occur in a market during a period of dislocation are distressed or forced. This determination is made at the individual transaction level and requires the use of judgement based on the specific facts and circumstances.

While market factors such as an imbalance in supply and demand can affect the prices at which transactions occur in a given market, such an imbalance, in and of itself, does not indicate that the parties to a transaction were not knowledgeable and willing market participants or that a transaction was not orderly. For example, a transaction in a dislocated market is less likely to be considered a 'distressed sale' when multiple buyers have bid on the asset.

In addition, while a fair value measurement incorporates the assumptions that sellers, as well as buyers, would consider in pricing the asset or liability, an entity's conclusion that it would not sell its own asset (or transfer its own liability) at prices currently observed in the market does not mean these transactions should be presumed to be distressed. IFRS 13 makes clear that fair value is a market-based measurement, not an entity-specific measurement, and notes that the entity's intention to hold an asset or liability is not relevant in estimating its fair value. The objective of a fair value measurement is to estimate the exit price in an orderly transaction between willing market participants at the measurement date under current market conditions. This price should include a risk premium that reflects the amount market participants would require as compensation for bearing any uncertainty inherent in the cash flows, and this uncertainty (as well as the compensation demanded to assume it) may be affected by current marketplace conditions. The objective of a fair value measurement does not change when markets are inactive or in a period of dislocation.

An example of the application of this principle relates to 2020 trading activity in many public markets during the outset of the coronavirus pandemic. The pandemic resulted in downturns and significant volatility in the financial and commodities markets worldwide. Despite the downturns seen in many public markets, this did not generally translate into significant decreases in volume in those markets. Therefore, even if a financial instrument's value declined, since the markets remained active, entities had to continue using a Level 1 measurement as they could not presume the transactions were distressed. While volatility in the financial markets may suggest that the prices are aberrations and do not reflect fair value, it would not be appropriate for an entity to disregard market prices at the measurement date. IFRS 13 makes it clear that fair value is a market-based measurement, not an entity-specific measurement, and notes that the reporting entity's intention to hold an asset or liability in a market downturn is not relevant. *[IFRS 13.3]*.

7.3 Estimating fair value when there has been a significant decrease in the volume and level of activity

Estimating the price at which market participants would be willing to enter into a transaction if there has been a significant decrease in the volume or level of activity for the asset or liability will depend on the specific facts and circumstances and will require judgement. However, the core concepts of the fair value framework continue to apply. For example, an entity's intentions regarding the asset or liability (e.g., to sell an asset or settle a liability), are not relevant when measuring fair value because that would result in an entity-specific measurement. *[IFRS 13.B42]*.

If there has been a significant decrease in the volume or level of activity for the asset or liability, it may be appropriate to reconsider the valuation technique being used or to use multiple valuation techniques, for example, the use of both a market approach and a present value technique (see section 7.3.2 below for further discussion). *[IFRS 13.B40]*.

If quoted prices provided by third parties are used, an entity must evaluate whether those quoted prices have been developed using current information that reflects orderly transactions or a valuation technique that reflects market participant assumptions, including assumptions about risk. This evaluation must take into consideration the nature of a quote (e.g., whether the quote is an indicative price or a binding offer). In weighting a quoted price as an input to a fair value measurement, more weight is given to quotes that reflect the result of actual transactions or those that represent binding offers. Less weight is given to quotes that are not binding, reflect indicative pricing or do not reflect the result of transactions.

In some instances, an entity may determine that a transaction or quoted price requires an adjustment, such as when the price is stale or when the price for a similar asset requires significant adjustment to make it comparable to the asset being measured. *[IFRS 13.B38]*. The impact of these adjustments may be significant to the fair value measure and, if so, would affect its categorisation in the fair value hierarchy (see section 15.2 below for further discussion on categorisation within the fair value hierarchy).

7.3.1 Assessing the relevance of observable data

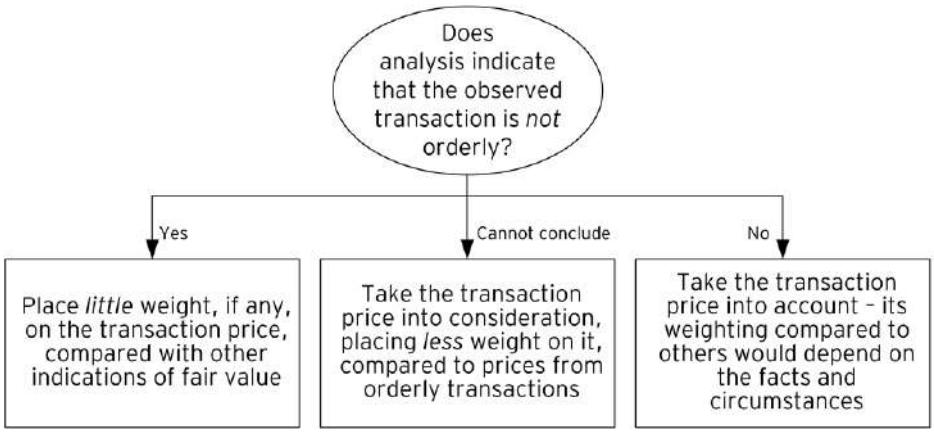
While observable prices from inactive markets may not be representative of fair value in all cases, this data should not be ignored. Instead, IFRS 13 clarifies that additional analysis is required to assess the relevance of the observable data. *[IFRS 13.B38, IFRS 13.B44]*. The relevance of a quoted price from an inactive market is dependent on whether the transaction is determined to be orderly. If the observed price is based on a transaction that is determined to be forced or disorderly, little, if any, weight should be placed on it compared with other indications of value.

If the quoted price is based on a transaction that is determined to be orderly, this data point should be considered in the estimation of fair value. However, the relevance of quoted prices associated with orderly transactions can vary based on factors specific to the asset or liability being measured and the facts and circumstances surrounding the price. Some of the factors to be considered include:

- Condition and/or location of the asset or liability
- Similarity of the transactions to the asset or liability being measured (e.g., the extent to which the inputs relate to items that are comparable to the asset or liability)
- Size of the transactions
- Volume or level of activity in the markets within which the transactions are observed
- Proximity of the transactions to the measurement date
- Whether the market participants involved in the transaction had access to information about the asset or liability that is usual and customary

If the adjustments made to the observable price are significant and based on unobservable data, the resulting measurement would represent a Level 3 measurement.

Figure 7-1: Orderly transactions: measuring fair value and estimating market risk premiums



7.3.2 Selection and use of valuation techniques when there has been a significant decrease in volume or level of activity

As discussed above, when activity has significantly decreased for an asset or liability, an assessment of the relevance of observable market data will be required and adjustments to observable market data may be warranted. A significant decrease in volume or activity can also influence which valuation technique(s) are used and how those techniques are applied.

The following example from IFRS 13 highlights some key valuation considerations for assets that trade in markets that have experienced a significant decrease in volume and level of activity. *[IFRS 13.IE Example 14, IFRS 13.IE49-IE58]*.

Extract from IFRS 13

Example 14-Estimating a market rate of return when the volume or level of activity for an asset has significantly decreased

Entity A invests in a junior AAA-rated tranche of a residential mortgage-backed security on 1 January 20X8 (the issue date of the security). The junior tranche is the third most senior of a total of seven tranches. The underlying collateral for the residential mortgage-backed security is unguaranteed non-conforming residential mortgage loans that were issued in the second half of 20X6.

At 31 March 20X9 (the measurement date) the junior tranche is now A-rated. This tranche of the residential mortgage-backed security was previously traded through a brokered market. However, trading volume in that market was infrequent, with only a few transactions taking place per month from 1 January 20X8 to 30 June 20X8 and little, if any, trading activity during the nine months before 31 March 20X9.

Entity A takes into account the factors in paragraph B37 of the IFRS to determine whether there has been a significant decrease in the volume or level of activity for the junior tranche of the residential mortgage-backed security in which it has invested. After evaluating the significance and relevance of the factors, Entity A concludes that the volume and level of activity of the junior tranche of the residential mortgage-backed security have significantly decreased. Entity A supported its judgement primarily on the basis that there was little, if any, trading activity for an extended period before the measurement date.

Because there is little, if any, trading activity to support a valuation technique using a market approach, Entity A decides to use an income approach using the discount rate adjustment technique described in paragraphs B18-B22 of the IFRS to measure the fair value of the residential mortgage-backed security at the measurement date. Entity A uses the contractual cash flows from the residential mortgage-backed security (see also paragraphs 67 and 68 of the IFRS).

Entity A then estimates a discount rate (ie a market rate of return) to discount those contractual cash flows. The market rate of return is estimated using both of the following:

(a) the risk-free rate of interest.

(b) estimated adjustments for differences between the available market data and the junior tranche of the residential mortgage-backed security in which Entity A has invested. Those adjustments reflect available market data about expected non-performance and other risks (eg default risk, collateral value risk and liquidity risk) that market participants would take into account when pricing the asset in an orderly transaction at the measurement date under current market conditions.

Entity A took into account the following information when estimating the adjustments in paragraph IE53(b):

(a) the credit spread for the junior tranche of the residential mortgage-backed security at the issue date as implied by the original transaction price.

(b) the change in the credit spread implied by any observed transactions from the issue date to the measurement date for comparable residential mortgage-backed securities or on the basis of relevant indices.

(c) the characteristics of the junior tranche of the residential mortgage-backed security compared with comparable residential mortgage-backed securities or indices, including all the following:

  (i) the quality of the underlying assets, ie information about the performance of the underlying mortgage loans such as delinquency and foreclosure rates, loss experience and prepayment rates;

  (ii) the seniority or subordination of the residential mortgage-backed security tranche held; and

  (iii) other relevant factors.

(d) relevant reports issued by analysts and rating agencies.

(e) quoted prices from third parties such as brokers or pricing services.

Entity A estimates that one indication of the market rate of return that market participants would use when pricing the junior tranche of the residential mortgage-backed security is 12 per cent (1,200 basis points). This market rate of return was estimated as follows:

(a) Begin with 300 basis points for the relevant risk-free rate of interest at 31 March 20X9.

(b) Add 250 basis points for the credit spread over the risk-free rate when the junior tranche was issued in January 20X8.

(c) Add 700 basis points for the estimated change in the credit spread over the risk-free rate of the junior tranche between 1 January 20X8 and 31 March 20X9. This estimate was developed on the basis of the change in the most comparable index available for that time period.

(d) Subtract 50 basis points (net) to adjust for differences between the index used to estimate the change in credit spreads and the junior tranche. The referenced index consists of subprime mortgage loans, whereas Entity A's residential mortgage-backed security consists of similar mortgage loans with a more favourable credit profile (making it more attractive to market participants). However, the index does not reflect an appropriate liquidity risk premium for the junior tranche under current market conditions. Thus, the 50 basis point adjustment is the net of two adjustments:

    (i) the first adjustment is a 350 basis point subtraction, which was estimated by comparing the implied yield from the most recent transactions for the residential mortgage-backed security in June 20X8 with the implied yield in the index price on those same dates. There was no information available that indicated that the relationship between Entity A's security and the index has changed.

    (ii) the second adjustment is a 300 basis point addition, which is Entity A's best estimate of the additional liquidity risk inherent in its security (a cash position) when compared with the index (a synthetic position). This estimate was derived after taking into account liquidity risk premiums implied in recent cash transactions for a range of similar securities.

As an additional indication of the market rate of return, Entity A takes into account two recent indicative quotes (ie non-binding quotes) provided by reputable brokers for the junior tranche of the residential mortgage-backed security that imply yields of 15-17 per cent. Entity A is unable to evaluate the valuation technique(s) or inputs used to develop the quotes. However, Entity A is able to confirm that the quotes do not reflect the results of transactions.

Because Entity A has multiple indications of the market rate of return that market participants would take into account when measuring fair value, it evaluates and weights the respective indications of the rate of return, considering the reasonableness of the range indicated by the results.

Entity A concludes that 13 per cent is the point within the range of indications that is most representative of fair value under current market conditions. Entity A places more weight on the 12 per cent indication (ie its own estimate of the market rate of return) for the following reasons:

(a) Entity A concluded that its own estimate appropriately incorporated the risks (eg default risk, collateral value risk and liquidity risk) that market participants would use when pricing the asset in an orderly transaction under current market conditions.

(b) The broker quotes were non-binding and did not reflect the results of transactions, and Entity A was unable to evaluate the valuation technique(s) or inputs used to develop the quotes.

In Example 14 from the standard (in the extract above), Entity A uses an income approach (i.e., discount rate adjustment technique, see section 20 below for further discussion regarding present value techniques) to estimate the fair value of its residential mortgage-backed security (RMBS), because limited trading activity precluded a market approach as at the measurement date.

Example 14 above illustrates that the entity's use of an income approach does not change the objective of the fair value measurement, which is a current exit price. Valuation models should take into account all the factors that market participants would consider when pricing an asset or liability. The discount rate used by Entity A, for example, tries to incorporate all of the risks (e.g., liquidity risk, non-performance risk) market participants would consider in pricing the RMBS under current market conditions. Liquidity, credit or any other risk factors market participants would consider in pricing the asset or liability may require adjustments to model values if such factors are not sufficiently captured in the model.

Entity A prioritises observable inputs (to the extent available) over unobservable inputs in its application of the income approach. Entity A assesses market-based data from various sources to estimate the discount rate. For example, the entity estimates the change in the credit spread of the RMBS since its issuance based on spread changes observed from the most comparable index, for which trades continue to occur. Using the best available market information, the entity adjusts this input to account for differences between the observed index and the RMBS. These adjustments include the entity's assessment of the additional liquidity risk inherent in the RMBS compared to the index.

IFRS 13 indicates that an entity may use its own internal assumptions when relevant observable market data does not exist. *[IFRS 13.89]*. However, if reasonably available data indicates that market participant assumptions would differ, the entity should adjust its assumptions to incorporate that information. Relevant market data is not limited to transactions for the identical asset or liability being measured.

In Example 14 above, Entity A is unable to use a market approach because of limited trading activity for the RMBS. Therefore, Entity A considers implied liquidity risk premiums from recent transactions for a range of similar securities to estimate the incremental premium market participants would demand for its RMBS in the current market (as compared to the benchmark spread). In addition, Entity A considers two indicative broker quotes to estimate an appropriate discount rate for its RMBS. Although these quotes are specific to the RMBS being valued, Entity A puts less weight on these quotes since they are not binding and are not based on actual transactions. Furthermore, Entity A was unable to evaluate the valuation techniques and underlying data used by the brokers.

Importantly, the illustrative example is not intended to imply that an entity's own assumptions carry more weight than non-binding broker quotes. Rather, the example illustrates that each indication of value needs to be assessed based on the extent these indications rely on observable versus unobservable inputs.

Even though the market approach could not be used because of limited trading activity for the RMBS, Entity A was able to corroborate many of the assumptions used in developing the discount rate with relevant observable market data. As a result, the decision by the entity to place additional weight on its own market-corroborated assumptions (and less on the broker quotes) was warranted. When differences between broker quotes or pricing service data and an entity's own determination of value are significant, management should seek to understand the reasons behind these differences, if possible.

8 The price

IFRS 13 states the following: *[IFRS 13.24]*

Extract from IFRS 13

24 **Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (ie an exit price) regardless of whether that price is directly observable or estimated using another valuation technique.**

IFRS 13 requires the entity to estimate fair value based on the price that would be received to sell the asset or transfer the liability being measured (i.e., an exit price). While the determination of this price may be straightforward in some cases (e.g., when the identical instrument trades in an active market), in others it will require significant judgement. However, IFRS 13 makes it clear that the price used to measure fair value shall not be adjusted for transaction costs, but would consider transportation costs. *[IFRS 13.25, IFRS 13.26]*.

The standard's guidance on the valuation techniques and inputs to these techniques used in determining the exit price (including the prohibition on block discounts) is discussed in sections 13 and 14 below.

8.1 Transaction costs

Transaction costs are defined as the costs to sell an asset or transfer a liability in the principal (or most advantageous) market for the asset or liability that are directly attributable to the disposal of an asset or the transfer of the liability. In addition, these costs must be incremental, i.e., they would not have been incurred by the entity had the decision to sell the asset or transfer the liability not been made. *[IFRS 13 Appendix A]*. Examples of transaction costs include commissions or certain due diligence costs. As noted above, transaction costs do not include transportation costs.

Fair value is not adjusted for transaction costs. This is because transaction costs are not a characteristic of an asset or a liability; they are a characteristic of the transaction. While not deducted from fair value, an entity considers transaction costs in the context of determining the most advantageous market in the absence of a principal market (see section 5.2 above) because in this instance the entity is seeking to determine the market that would maximise the net amount that would be received for the asset.

Frequently asked questions

Question 8-1: Are transaction costs in IFRS 13 the same as 'costs to sell' in other IFRS accounting standards?

As discussed in section 2.1.3 above, some IFRS accounting standards permit or require measurements based on fair value, where costs to sell or costs of disposal are deducted from the fair value measurement. IFRS 13 does not change the measurement objective for assets accounted for at fair value less cost to sell. The 'fair value less cost to sell' measurement objective includes: (1) fair value; and (2) cost to sell. The fair value component is measured in accordance with IFRS 13.

Consistent with the definition of transaction costs in IFRS 13, IAS 36 describes costs of disposal as "incremental costs directly attributable to the disposal of an asset or cash-generating unit, excluding finance costs and income tax expense". *[IAS 36.6]*. IAS 41 and IFRS 5 similarly define costs to sell.

As such, transaction costs excluded from the determination of fair value in accordance with IFRS 13 will generally be consistent with costs to sell or costs of disposal, determined in other IFRS accounting standards (listed in section 2.1.3 above), provided they exclude transportation costs.

Since the fair value component is measured in accordance with IFRS 13, the standard's disclosure requirements apply in situations where the fair value less cost to sell measurement is required subsequent to the initial recognition, unless specifically exempt from the disclosure requirements (see section 19 below). In addition, IFRS 13 clarifies that adjustments used to arrive at measurements based on fair value (e.g., the cost to sell when estimating fair value less cost to sell) should not be considered when determining where to categorise the measurement in the fair value hierarchy (see section 15 below).

Question 8-2: Transaction costs in IFRS 13 versus acquisition-related transaction costs in other IFRS accounting standards

The term 'transaction costs' is used in many IFRS accounting standards, but sometimes it refers to transaction costs actually incurred when acquiring an item and sometimes to transaction costs expected to be incurred when selling an item. While the same term might be used, it is important to differentiate between these types of transaction costs.

IAS 36, IAS 41 and IFRS 5 discuss costs to sell or dispose of an item (as discussed in Question 8-1 above). In contrast, other standards refer to capitalising or expensing transaction costs incurred in the context of acquiring an asset, assuming a liability or issuing an entity's own equity (a buyer's perspective). IFRS 3, for example, requires acquisition-related costs to be expensed in the period incurred. *[IFRS 3.53]*.

IFRS 13 indicates that transaction costs are not included in a fair value measurement. As such, actual transaction costs (e.g., commissions paid) that are incurred by an entity when acquiring an asset would not be included at initial recognition when fair value is the measurement objective. Likewise, transaction costs that would be incurred in a hypothetical sales transaction would also not be included in a fair value measurement.

Some standards permit acquisition-related transaction costs to be capitalised at initial recognition, then permit or require the item, to which those costs relate, to be subsequently measured at fair value. In those situations, some or all of the acquisition-related transaction costs that were capitalised will effectively be expensed as part of the resulting fair value gain or loss. This is consistent with current practice. For example, IAS 40 permits transaction costs to be capitalised as part of an investment property's cost on initial recognition. *[IAS 40.20]*. However, if the fair value model is applied to the subsequent measurement of the investment property, transaction costs would be excluded from the fair value measurement (see Chapter 20 at section 6).

Similarly, at initial recognition, financial assets or liabilities in the scope of IFRS 9 are generally measured at their "fair value plus or minus, in the case of a financial asset or liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or liability". *[IFRS 9.5.1.1]*. For those items subsequently measured at amortised cost, these transaction costs will be captured as part of the instrument's effective interest rate.

8.2 Transportation costs

Transportation costs represent those that would be incurred to transport an asset or liability to (or from) the principal (or most advantageous) market. If location is a characteristic of the asset or liability being measured (e.g., as might be the case with a commodity), the price in the principal (or most advantageous) market should be adjusted for transportation costs. The following simplified example illustrates this concept.

Illustration 8-1: Transportation costs

Entity A holds a physical commodity measured at fair value in its warehouse in Europe. For this commodity, the London exchange is determined to be the principal market as it represents the market with the greatest volume and level of activity for the asset that the entity can reasonably access.

The exchange price for the asset is CU25. However, the contracts traded on the exchange for this commodity require physical delivery to London. Entity A determines that it would cost CU5 to transport the physical commodity to London and the broker's commission would be CU3 to transact on the London exchange.

Since location is a characteristic of the asset and transportation to the principal market is required, the fair value of the physical commodity would be CU20 - the price in the principal market for the asset of CU25, less transportation costs of CU5. The CU3 broker commission represents a transaction cost that would not adjust the price in the principal market.

9 Application to non-financial assets

Many non-financial assets, either through the initial or subsequent measurement requirements of an IFRS or the requirements of IAS 36 for impairment testing (if recoverable amount is based on fair value less costs of disposal), are either permitted or required to be measured at fair value (or a measure based on fair value). For example, management may need to measure the fair value of non-financial assets and liabilities when completing the purchase price allocation for a business combination in accordance with IFRS 3. First-time adopters of IFRS might need to measure fair value of assets and liabilities if they use a 'fair value as deemed cost' approach in accordance with IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

In addition to the principles described in the sections above, the fair value measurement of non-financial assets must reflect the highest and best use of the asset from a market participant's perspective.

The highest and best use of an asset establishes the valuation premise used to measure the fair value of the asset. In other words, whether to assume market participants would derive value from using the non-financial asset (based on its highest and best use) on its own or in combination with other assets or with other assets and liabilities. As discussed below, this might be its current use or some alternative use.

As discussed in section 3.2 above, the concepts of highest and best use and valuation premise in IFRS 13 are only relevant for non-financial assets (and not financial assets and liabilities). This is because: *[IFRS 13.BC63]*

- Financial assets have specific contractual terms; they do not have alternative uses. Changing the characteristics of the financial asset (i.e., changing the contractual terms) causes the item to become a different asset and the objective of a fair value measurement is to measure the asset as it exists as at the measurement date.
- The different ways by which an entity may relieve itself of a liability are not alternative uses. In addition, entity-specific advantages (or disadvantages) that enable an entity to fulfil a liability more or less efficiently than other market participants are not considered in a fair value measurement.
- The concepts of highest and best use and valuation premise were developed within the valuation profession to value non-financial assets, such as land.

9.1 Highest and best use

Highest and best use refers to "the use of a non-financial asset by market participants that would maximise the value of the asset or the group of assets and liabilities (eg a business) within which the asset would be used". *[IFRS 13 Appendix A]*. The standard includes the following guidance on highest and best use: *[IFRS 13.27, IFRS 13.28]*

Extract from IFRS 13

27 **A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use.**

28 The highest and best use of a non-financial asset takes into account the use of the asset that is physically possible, legally permissible and financially feasible, as follows:

(a) A use that is physically possible takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (eg the location or size of a property).

(b) A use that is legally permissible takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (eg the zoning regulations applicable to a property).

(c) A use that is financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.

Highest and best use is a valuation concept that considers how market participants would use a non-financial asset to maximise its benefit or value. The maximum value of a non-financial asset to market participants may come from its use: (a) in combination with other assets or with other assets and liabilities; or (b) on a stand-alone basis.

In determining the highest and best use of a non-financial asset, IFRS 13.28 indicates uses that are physically possible, legally permissible (see section 9.1.1 below for further discussion) and financially feasible should be considered. As such, when assessing alternative uses, entities should consider the physical characteristics of the asset, any legal restrictions on its use and whether the value generated provides an adequate investment return for market participants.

Provided there is sufficient evidence to support these assertions, alternative uses that would enable market participants to maximise value should be considered, but a search for potential alternative uses need not be exhaustive. In addition, any costs to transform the non-financial asset (e.g., obtaining a new zoning permit or converting the asset to the alternative use) and profit expectations from a market participant's perspective are also considered in the fair value measurement.

If there are multiple types of market participants who would use the asset differently, these alternative scenarios must be considered before concluding on the asset's highest and best use. While applying the fair value framework may be straightforward in many situations, in other instances, an iterative process may be needed to consistently apply the various components. This may be required due to the interdependence among several key concepts in IFRS 13's fair value framework (see Figure 3-1 in section 3.2 above). For example, the highest and best use of a non-financial asset determines its valuation premise and affects the identification of the appropriate market participants. Likewise, the determination of the principal (or most advantageous) market can be important in determining the highest and best use of a non-financial asset.

Determining whether the maximum value to market participants would be achieved either by using an asset in combination with other assets and liabilities as a group, or by using the asset on a stand-alone basis, requires judgement and an assessment of the specific facts and circumstances.

A careful assessment is particularly important when the highest and best use of a non-financial asset is in combination with one or more non-financial assets. As discussed in section 9.2 below, assets in an asset group should all be valued using the same valuation premise. For example, if the fair value of a piece of machinery on a manufacturing line is measured assuming its highest and best use is in conjunction with other equipment in the manufacturing line, those other non-financial assets in the asset group (i.e., the other equipment on the manufacturing line) would also be valued using the same premise. As highlighted by Illustration 9-2 in section 9.2.2 below, once it is determined that the value for a set of assets is maximised when considered as a group, all of the assets in that group would be valued using the same premise, regardless of whether any individual asset within the group would have a higher value on a stand-alone basis.

During the PIR, some respondents noted application of this concept as challenging and requested further guidance on for example what is meant by legally permissible however the Board concluded that there was insufficient evidence of inconsistent application of requirements and that it is doubtful whether supporting material would be helpful in the situations when the application of the highest and best use is challenging.[19]

9.1.1 Highest and best use: determining what is legally permissible

To be legally permissible, the standard indicates a use of a non-financial asset need not be legal (or have legal approval) at the measurement date, but it must not be legally prohibited in the jurisdiction. *[IFRS 13.BC69]*.

What is legally permissible is a matter of law. However, the IASB seems to be distinguishing between a use that is explicitly prohibited and a use that would be permitted if the jurisdiction's specific legal requirements were met. However, in some situations it may be difficult to determine whether a use is capable of being legally permitted when, at the measurement date, it is subject to legal restrictions that are not easily overcome.

The standard gives the example of a land development. Assume the government has prohibited building on or developing certain land (i.e., the land is a protected area). For the entity to develop the land, a change of law would be required. Since development of this land would be illegal, it cannot be the highest and best use of the land. Alternatively, assume the land has been zoned for commercial use, but nearby areas have recently been developed for residential use and, as such, market participants would consider residential development as a potential use of the land. Since re-zoning the land for residential development would only require approval from an authority and that approval is usually given, this alternative use could be deemed to be legally permissible.

19 IFRS Project Report and Feedback Statement, *Post-implementation Review of IFRS 13* Fair Value Measurement, IASB, December 2018, p.15. Available on the IFRS Foundation's website.

It is assumed that market participants would consider all relevant factors, as they exist at the measurement date, in determining whether the legally permissible use of the non-financial asset may be something other than its current use. That is, market participants would consider the probability, extent and timing of different types of approvals that may be required in assessing whether a change in the legal use of the non-financial asset could be obtained.

The scenarios, of protected land and re-zoning of land, considered above illustrate either end of the spectrum; uses that are unlikely and likely to be legally permissible, respectively. However, consider the protected land example above. Assume the government were expected to change the law in the near future to permit residential development, but there had not been any similar changes in law to date. An entity would need to consider the weight of evidence available and whether market participants would have similar expectations. This may be more difficult without past history of similar changes in law. However, an entity might consider factors such as whether expectations are based on verbal assurances or written evidence; whether the process to change the law has begun; and the risk that the change in law will not be approved. It may also help to determine whether market participants would pay for this potential. However, this fact, on its own, is unlikely to be sufficient to support a use being legally permissible.

How we see it

In our view, an entity would need to have sufficient evidence to support its assumption about the potential for an alternative use, particularly in light of IFRS 13's presumption that the highest and best use is an asset's current use.

In the example above of re-zoning land for residential development, the entity's belief that re-zoning was possible (or even likely) is unlikely to be sufficient evidence that the re-zoning is legally permissible. However, the fact that nearby areas had recently been re-zoned for residential use may provide additional evidence as to the likelihood that the land being measured could similarly be re-zoned. If obtaining re-zoning permission is not merely perfunctory, there may be a significant burden on the entity to prove that market participants would consider commercial use of the land 'legally permissible'.

9.1.2 Highest and best use versus current use

Although IFRS 13 presumes that an entity's current use of an asset is its highest and best use, market or other factors may suggest that a different use by market participants would maximise the value of that asset. *[IFRS 13.29]*. Because the highest and best use of an asset is determined based on market participants' expectations, reporting entities may need to consider alternative uses of an asset (e.g., land) in their analysis of fair value. An entity's current or intended use of a non-financial asset might not be the highest and best use of the asset, and thus would not determine its premise of value. Instead, the highest and best use of the asset (or asset group) should be determined based on how market participants would maximise the asset's value. For example, market participants may maximise the value of land, currently used as a site for a manufacturing facility, for residential housing instead.

The consideration of alternative uses is not intended to be exhaustive. It is not necessary that all possible alternatives be considered. Instead, judgement is required in assessing those alternative uses that market participants would consider in pricing the asset. As noted above, consideration of what is physically possible, legally permissible and financially feasible would be part of this assessment. Illustration 9-1 below, which is based on Example 2 in IFRS 13, illustrates this further. If an entity determines that the highest and best use of an asset is different from its current use, IFRS 13 requires that fact to be disclosed as well as the reason why the non-financial asset is being used in a manner that differs from its highest and best use (disclosures are discussed further in section 19 below). *[IFRS 13.93(i)]*.

It is important to note that even if the current use of a non-financial asset is the same as its highest and best use, the underlying assumptions used to value the asset should not be entity-specific, but instead should be based on the assumptions that market participants would use when transacting for the asset in its current condition. Entity-specific synergies, if they would differ from market participant synergies, would not be considered in the determination of the highest and best use of the asset. This is illustrated in Illustration 9-1 below. *[IFRS 13.IE Example 2, IFRS 13.IE7, IFRS 13.IE8]*.

Illustration 9-1: Highest and best use versus current use

Entity X acquires land in a business combination. The land is currently developed for industrial use as a site for a factory. The current use of the land is presumed to be its highest and best use unless market or other factors suggest a different use. Nearby sites have recently been developed for residential use as sites for high-rise apartment buildings. On the basis of that development and recent zoning and other changes to facilitate that development, Entity X determines that the land currently used as a site for a factory could be developed as a site for residential use (i.e., for high-rise apartment buildings) because market participants would take into account the potential to develop the site for residential use when pricing the land.

The highest and best use of the land would be determined by comparing both of the following:

(a) The value of the land as currently developed for industrial use (i.e., the land would be used in combination with other assets, such as the factory, or with other assets and liabilities)

(b) The value of the land as a vacant site for residential use, taking into account the costs of demolishing the factory and other costs (including the uncertainty about whether Entity X would be able to convert the asset to the alternative use) necessary to convert the land to a vacant site (i.e., the land is to be used by market participants on a stand-alone basis)

The highest and best use of the land would be determined on the basis of the higher of those values. In situations involving real estate appraisal, the determination of highest and best use might consider factors relating to the factory operations, including its assets and liabilities.

Assume that the fair value of the land in-use as a manufacturing operation is determined to be CU4,000,000 and that the fair value for the land as a vacant site that can be used for residential purposes is CU5,000,000. In order to convert the land from a manufacturing operation to a vacant site for residential use, the manufacturing facility must be removed. Assuming demolition and other costs of CU500,000.* In order to determine the fair value of the land, the price of the land as a residential development site (CU5,000,000) would need to be adjusted for the transformation costs (CU500,000) necessary to prepare the land for residential use. Therefore, the amount of CU4,500,000 must be used as the fair value of the land.

* For simplicity purposes, this example does not specifically discuss other types of costs that may need to be considered in determining the fair value of the land for residential use (such as the effect of intangible or other assets related to the manufacturing facility).

9.1.3 Highest and best use versus intended use (including defensive value)

An entity's intended use of an asset, at the time it is acquired, may not be the same as how market participants would use the asset. If the highest and best use and the entity's intended use of an asset are not the same, it could result in differences between the price to acquire the asset and fair value measured in accordance with IFRS 13 (see section 12 below). IFRS 13 requires that the highest and best use of an asset be determined from the perspective of market participants, even if management intends a different use, *[IFRS 13.29, IFRS 13.30]*, as is illustrated in Illustration 9-2 below.

In certain instances, the highest and best use of an asset may be to not actively use it, but instead to lock it up or 'shelve it' (commonly referred to as a defensive asset). That is, the maximum value provided by an asset may be its defensive value. IFRS 13 clarifies that the fair value of an asset used defensively is not assumed to be zero or a nominal amount. Instead, an entity should consider the incremental value such a use provides to the assets being protected, such as the incremental value provided to an entity's existing brand name by acquiring and shelving a competing brand. Generally speaking, a nominal fair value is appropriate only when an asset is abandoned (i.e., when an entity would be willing to give the asset away for no consideration).

Importantly, an entity's decision to use an asset defensively does not mean that market participants would necessarily maximise the asset's value in a similar manner. Likewise, an entity's decision to actively use an asset does not preclude its highest and best use to market participants as being defensive in nature. The following example from IFRS 13 illustrates these points. *[IFRS 13.IE Example 3, IFRS 13.IE9]*.

Extract from IFRS 13

Example 3-Research and development project

An entity acquires a research and development (R&D) project in a business combination. The entity does not intend to complete the project. If completed, the project would compete with one of its own projects (to provide the next generation of the entity's commercialised technology). Instead, the entity intends to hold (ie lock up) the project to prevent its competitors from obtaining access to the technology. In doing this the project is expected to provide defensive value, principally by improving the prospects for the entity's own competing technology. To measure the fair value of the project at initial recognition, the highest and best use of the project would be determined on the basis of its use by market participants. For example:

(a) The highest and best use of the R&D project would be to continue development if market participants would continue to develop the project and that use would maximise the value of the group of assets or of assets and liabilities in which the project would be used (ie the asset would be used in combination with other assets or with other assets and liabilities). That might be the case if market participants do not have similar technology, either in development or commercialised. The fair value of the project would be measured on the basis of the price that would be received in a current transaction to sell the project, assuming that the R&D would be used with its complementary assets and the associated liabilities and that those assets and liabilities would be available to market participants.

(b) The highest and best use of the R&D project would be to cease development if, for competitive reasons, market participants would lock up the project and that use would maximise the value of the group of assets or of assets and liabilities in which the project would be used. That might be the case if market participants have technology in a more advanced stage of development that would compete with the project if completed and the project would be expected to improve the prospects for their own competing technology if locked up. The fair value of the project would be measured on the basis of the price that would be received in a current transaction to sell the project, assuming that the R&D would be used (ie locked up) with its complementary assets and the associated liabilities and that those assets and liabilities would be available to market participants.

(c) The highest and best use of the R&D project would be to cease development if market participants would discontinue its development. That might be the case if the project is not expected to provide a market rate of return if completed and would not otherwise provide defensive value if locked up. The fair value of the project would be measured on the basis of the price that would be received in a current transaction to sell the project on its own (which might be zero).

The fair value of the in-process research and development project in Example 3 above depends on whether market participants would use the asset offensively, defensively or abandon it (as illustrated by points (a), (b) and (c) in the example, respectively). If the highest and best use in Example 3 (in the extract above) was (a), then that is the value that the entity must ascribe to the R&D project, even though its intended use is to lock-up the project.

As discussed in section 9.1 above, if there are multiple types of market participants who would use the asset differently, these alternative scenarios must be considered before concluding on the asset's highest and best use.

9.2 Valuation premise for non-financial assets

Dependent on its highest and best use, the fair value of the non-financial asset will either be measured based on the value it would derive on a stand-alone basis or in combination with other assets or other assets and liabilities - i.e., the asset's valuation premise.

9.2.1 Valuation premise - stand-alone basis

If the highest and best use of the asset is to use it on a stand-alone basis, an entity measures the fair value of the asset individually. In other words, the asset is assumed to be sold to market participants for use on its own. Fair value is the price that would be received in a current transaction under those circumstances. *[IFRS 13.31(b)]*. For instance, alternative (c) of Example 3 from the standard (extracted in section 9.1.3 above) suggests the highest and best use of the research and development project could be to cease development. Since its highest and best use is on a stand-alone basis, the fair value of the project would be the price that would be received in a current transaction to sell the project on its own and assuming a market participant would cease development of the project. In addition, the asset should be measured based only on its current characteristics, potentially requiring an adjustment for transformation costs. For example, if land that is used as a factory site is to be valued on a stand-alone basis, transformation costs (e.g., the cost of removing the factory) should be considered in the fair value measurement.

When the valuation premise of one non-financial asset in an asset group is valued on a stand-alone basis, all of the other assets in the group should also be valued using a consistent valuation premise. For example, based on Illustration 9-1 in section 9.1.2 above, if the highest and best use of the land is determined to be on a stand-alone basis (i.e., as vacant land), the fair value of the equipment in the factory could be determined under two alternative valuation premises: (a) stand-alone (i.e., the value of the equipment sold on a stand-alone basis); or (b) in conjunction with other equipment on the operating line, but in a different factory (i.e., not in combination with the land, since the land would be valued on a stand-alone basis). Regardless of the valuation premise used to measure the equipment, market participant assumptions regarding the cost of redeployment, such as costs for disassembling, transporting and reinstalling the equipment should be considered in the fair value measurement.

9.2.2 Valuation premise - in combination with other assets and/or liabilities

If the highest and best use of a non-financial asset is in combination with other assets as a group or in combination with other assets and liabilities, the fair value of the asset is the price that would be received in a current transaction to sell the asset and would assume that: *[IFRS 13.31(a)(i)]*

(i) Market participants would use the asset together with other assets or with other assets and liabilities

(ii) Those assets and liabilities (i.e., its complementary assets and the associated liabilities) would be available to market participants - that is, the fair value of the asset would be measured from the perspective of market participants who are presumed to hold the complementary assets and liabilities (see section 9.2.3 below for further discussion regarding associated liabilities)

Once an entity determines that the valuation premise for a non-financial asset is its use in combination with a set of assets (or assets and liabilities), all of the complementary non-financial assets in that group should be valued using the same valuation premise (i.e., assuming the same highest and best use), regardless of whether any individual asset within the group would have a higher value under another premise. *[IFRS 13.31(a)(iii)]*. Illustration 9-2 below illustrates this further.

Illustration 9-2: Consistent assumptions about highest and best use in an asset group

A wine producer owns and manages a vineyard and produces its own wine onsite. The grapes growing on the vines are measured at fair value less costs to sell in accordance with IAS 41 at the end of each reporting period. At the point of harvest, the grapes are measured at the point of harvest at fair value less costs to sell in accordance with IAS 41 (being the grapes' 'cost' when transferred to IAS 2). The wine producer elects to measure its land and vines using IAS 16's revaluation model (fair value less any subsequent accumulated depreciation and accumulated impairment). All other non-financial assets are measured at cost.

At the end of the reporting period, the entity assesses the highest and best use of the grapes growing on the vines, the vines and the land from the perspective of market participants. The grapes growing on the vines, vines and land could continue to be used, in combination with the entity's other assets and liabilities, to produce and sell its wine (i.e., its current use). Alternatively, the land could be converted into residential property. Conversion would include removing the grapes growing on the vines, vines and plant and equipment from the land.

Scenario A

The entity determines that the highest and best use of these assets in combination is as a vineyard (i.e., its current use). The entity must make consistent assumptions for assets in the group (for which highest and best use is relevant, i.e., non-financial assets). Therefore, the highest and best use of all non-financial assets in the group is to produce and sell wine, even if conversion into residential property might yield a higher value for the land on its own.

Scenario B

The entity determines that the highest and best use of these assets is to convert the land into residential property, even if the current use might yield a higher value for the grapes growing on the vines and/or the vines. The entity would need to consider what a market participant would do to convert the land, which could include the cost of rezoning, selling cuttings from the vines or simply removing the vines and the grapes growing thereon, and the sale of the buildings and equipment, either individually or as an asset group.

Since the highest and best use of these assets is not their current use in this scenario, the entity would disclose that fact, as well as the reason why those assets are being used in a manner that differs from their highest and best use.

When the asset's highest and best use is in combination with other items, the effect of the valuation premise on the measurement of fair value will depend on the specific circumstances. The following extract from IFRS 13 provides some examples: *[IFRS 13.B3]*

Extract from IFRS 13

Valuation premise for non-financial assets (paragraphs 31-33)

B3 When measuring the fair value of a non-financial asset used in combination with other assets as a group (as installed or otherwise configured for use) or in combination with other assets and liabilities (eg a business), the effect of the valuation premise depends on the circumstances. For example:

(a) the fair value of the asset might be the same whether the asset is used on a stand-alone basis or in combination with other assets or with other assets and liabilities. That might be the case if the asset is a business that market participants would continue to operate. In that case, the transaction would involve valuing the business in its entirety. The use of the assets as a group in an ongoing business would generate synergies that would be available to market participants (ie market participant synergies that, therefore, should affect the fair value of the asset on either a stand-alone basis or in combination with other assets or with other assets and liabilities).

(b) an asset's use in combination with other assets or with other assets and liabilities might be incorporated into the fair value measurement through adjustments to the value of the asset used on a stand-alone basis. That might be the case if the asset is a machine and the fair value measurement is determined using an observed price for a similar machine (not installed or otherwise configured for use), adjusted for transport and installation costs so that the fair value measurement reflects the current condition and location of the machine (installed and configured for use).

(c) an asset's use in combination with other assets or with other assets and liabilities might be incorporated into the fair value measurement through the market participant assumptions used to measure the fair value of the asset. For example, if the asset is work in progress inventory that is unique and market participants would convert the inventory into finished goods, the fair value of the inventory would assume that market participants have acquired or would acquire any specialised machinery necessary to convert the inventory into finished goods.

(d) an asset's use in combination with other assets or with other assets and liabilities might be incorporated into the valuation technique used to measure the fair value of the asset. That might be the case when using the multi-period excess earnings method to measure the fair value of an intangible asset because that valuation technique specifically takes into account the contribution of any complementary assets and the associated liabilities in the group in which such an intangible asset would be used.

(e) in more limited situations, when an entity uses an asset within a group of assets, the entity might measure the asset at an amount that approximates its fair value when allocating the fair value of the asset group to the individual assets of the group. That might be the case if the valuation involves real property and the fair value of improved property (ie an asset group) is allocated to its component assets (such as land and improvements).

Although the approach used to incorporate the valuation premise into a fair value measurement may differ based on the facts and circumstances, the determination of a non-financial asset's valuation premise (based on its highest and best use) and the inputs applied in the valuation technique used to estimate fair value should always be considered from the perspective of market participants, not the reporting entity.

9.2.3 How should associated liabilities be considered when measuring the fair value of a non-financial asset?

As discussed in section 9.2.2 above, an asset's highest and best use might be in combination with associated liabilities and complementary assets in an asset group. For example, many intangible assets do not generate independent cash inflows as individual assets and so they might be tested for impairment under IAS 36 with other assets of the CGU of which they are a part. A trademark, for example, will generate largely independent cash inflows if it is licensed to a third party but more commonly its highest and best use will be to use it with other assets and liabilities of a CGU. Please refer to section 3.3 of Chapter 21 for more information on testing intangible assets for impairment subsequent to initial recognition.

IFRS 13.B3(d) notes that an asset's use in combination with other assets and liabilities might be incorporated when using the multi-period excess earnings method to measure the fair value of an intangible asset that has been acquired in a business acquisition. *[IFRS 13.B3]*. The multi-period excess earnings method specifically takes into account the contribution of any complementary assets and the associated liabilities in the group in which such an intangible asset would be used.

'Associated liabilities' is not defined and IFRS 13 provides limited guidance on the types of liabilities that could be considered associated to a non-financial asset. IFRS 13 provides some guidance, stating that associated liabilities can include those that fund working capital, but must exclude liabilities used to fund assets other than those within the group of assets. *[IFRS 13.31(a)(ii)]*.

Entities will need to exercise judgement in determining which liabilities to include or exclude from the group, based on the specific facts and circumstances. This assessment must reflect what market participants would consider when determining the non-financial asset's highest and best use. Entities will need to be careful to exclude entity-specific assumptions when valuing liabilities, particularly if valuation techniques are used that are based on their own data (valuation techniques are discussed further in section 13 below).The requirement to consider associated liabilities when measuring the fair value of non-financial assets was generally intended to align the guidance in IFRS 13 with previous practice for measuring the fair value of certain non-financial assets (e.g., intangible assets) and generally did not result in significant changes to the valuation of most non-financial assets. For example, real estate should generally be valued independently from any debt used to finance the property.

9.2.4 Unit of account versus the valuation premise

Fair value measurement of a non-financial asset assumes the asset is sold consistently with its unit of account (as specified in other IFRSs), irrespective of its valuation premise. This assumption applies even if the highest and best use of the asset is in combination with other assets and/or liabilities. This is because the fair value measurement contemplates the sale of the individual asset to market participants that already hold, or are able to obtain, the complementary assets and liabilities. *[IFRS 13.32]*. Only when the unit of account of the item being measured at fair value is an asset group (which may be the case when measuring non-financial assets for impairment as part of a CGU), can one consider the sale of an asset group. That is, the valuation premise for a non-financial asset does not override the unit of account as defined by the applicable IFRS. However, this can be confusing in practice as both concepts deal with determining the appropriate level of aggregation or disaggregation for assets and liabilities.

Unit of account is an accounting concept. It identifies what is being measured for financial reporting purposes. When applying IFRS 13, this drives the level of aggregation (or disaggregation) for presentation and disclosure purposes, for example, whether the information presented and disclosed in the financial statements is for an individual asset or for a group of assets.

The valuation premise is a valuation concept (sometimes referred to as the 'unit of valuation'). It determines how the asset or liability is measured, i.e., based on the value it derives on a stand-alone basis or the value it derives in conjunction with other assets and liabilities. As discussed above, the unit of account established by an IFRS may be an individual item. However, that item may need to be grouped with others for the purpose of measuring fair value, i.e., the valuation premise may differ from the unit of account.

For example, an entity may own an investment property that is attached to land and contains other assets, such as fixtures and fittings. The unit of account for the investment property would likely be the stand-alone asset in accordance with IAS 40. However, the value of this asset on a stand-alone basis may have little meaning since it is physically attached to the land and derives its benefit in combination with the fixtures and fittings in the building. Therefore, when determining fair value, the valuation premise would likely reflect its use in combination with other assets.

It is important to note that when the valuation premise for measuring the fair value of a non-financial asset (or group of assets and corresponding liabilities) differs from its unit of account, categorisation within IFRS 13's fair value hierarchy (for disclosure purposes) must be determined at a level consistent with the unit of account for the asset or liability (see section 15.2 below).

10 Application to liabilities and an entity's own equity

IFRS 13 applies to liabilities, both financial and non-financial, and an entity's own equity whenever an IFRS requires those instruments to be measured at fair value. For example, in accordance with IFRS 3, in a business combination management might need to determine the fair value of liabilities assumed, when completing the purchase price allocation, and the fair value of its own equity instruments to measure the consideration given.

For financial liabilities and an entity's own equity that are within the scope of IAS 32 or IFRS 9, it is important to note that IFRS 13 would apply to any initial and subsequent fair value measurements that are recognised in the statement of financial position. In addition, if those instruments are not subsequently measured at fair value in the statement of financial position, for example financial liabilities may be subsequently measured at amortised cost, an entity may still need to disclose their fair value in the notes to the financial statements. At a minimum, this would be a requirement for financial liabilities. In these situations, IFRS 13 would also need to be applied to measure the instruments' fair value for disclosure.

The classification of an instrument as either a liability or equity instrument by other IFRS accounting standards may depend on the specific facts and circumstances, such as the characteristics of the transaction and the characteristics of the instrument. Examples of these instruments include contingent consideration issued in a business combination in accordance with IFRS 3 or equity warrants issued by an entity in accordance with IFRS 9. In developing the requirements in IFRS 13 for measuring the fair value of liabilities and an entity's own equity, the Boards concluded the requirements should generally be consistent between these instruments. That is, the accounting classification of an instrument, as either a liability or own equity, should not affect that instrument's fair value measurement. *[IFRS 13.BC106]*.

Prior to the issuance of IFRS 13, IFRS did not provide guidance on how to measure the fair value of an entity's own equity instruments. While IFRS 13 may be consistent with how many entities valued their own equity prior to adoption of IFRS 13, it changed practice for entities that concluded the principal market for their own equity (and therefore the assumption of market participants in that market) would be different when valuing the instrument as an asset. For example, this might have been the case if an entity measuring the fair value of a warrant previously assumed a volatility that differs from the volatility assumptions market participants would use in pricing the warrant as an asset.

10.1 General principles

IFRS 13 includes the following general principles for fair value measurement of a liability or an entity's own equity instrument: *[IFRS 13.34]*

Extract from IFRS 13

34 **A fair value measurement assumes that a financial or non-financial liability or an entity's own equity instrument (eg equity interests issued as consideration in a business combination) is transferred to a market participant at the measurement date. The transfer of a liability or an entity's own equity instrument assumes the following:**

(a) A liability would remain outstanding and the market participant transferee would be required to fulfil the obligation. The liability would not be settled with the counterparty or otherwise extinguished on the measurement date.

(b) An entity's own equity instrument would remain outstanding and the market participant transferee would take on the rights and responsibilities associated with the instrument. The instrument would not be cancelled or otherwise extinguished on the measurement date.

10.1.1 Fair value of a liability

IFRS 13 states that the fair value measurement of a liability contemplates the transfer of the liability to a market participant at the measurement date. The liability is assumed to continue (i.e., it is not settled or extinguished), and the market participant to whom the liability is transferred would be required to fulfil the obligation.

The fair value of a liability also reflects the effect of non-performance risk. Non-performance risk is the risk that an obligation will not be fulfilled. This risk includes, but may not be limited to, the entity's own credit risk (see section 10.3 below). The requirement that non-performance risk remains unchanged before and after the transfer implies that the liability is hypothetically transferred to a market participant of equal credit standing.

The clarification in IFRS 13 that fair value is not based on the price to settle a liability with the existing counterparty, but rather to transfer it to a market participant of equal credit standing, affects the assumptions about the principal (or most advantageous) market and the market participants in the exit market for the liability (see section 10.1.3 below for further detail on the distinction between the settlement notion for liabilities and the transfer notion in IFRS 13).

10.1.2 Fair value of an entity's own equity

For an entity's own equity, IFRS 13 states that the fair value measurement would contemplate a transfer of the equity instrument. The equity instrument would remain outstanding and the market participant transferee would take on the rights and responsibilities associated with the instrument. The instrument would not be cancelled or otherwise extinguished on the measurement date.

The requirements for measuring the fair value of an entity's own equity are generally consistent with the requirements for measuring liabilities, except for the requirement to incorporate non-performance risk, which does not apply directly to an entity's own equity.

10.1.3 Settlement value versus transfer value

While IFRS 13 requires the use of an exit price to measure fair value, an entity might not intend (or be able) to transfer its liability to a third party. For example, it might be more beneficial for the entity to fulfil or settle a liability or the counterparty might not permit the liability to be transferred to another party. The issuer of an equity instrument may only be able to exit from that instrument if it ceases to exist or if the entity repurchases the instrument from the holder. Even if an entity is unable to transfer a liability, the IASB believes the transfer notion is necessary for measuring fair value, because it "captures market participants' expectations about the liquidity, uncertainty and other factors associated with the liability, whereas a settlement notion may not because it may incorporate entity-specific factors". *[IFRS 13.BC82]*.

Under a transfer notion, the fair value of a liability is based on the price that would be paid to market participants to assume the obligation. The guidance is clear that an entity's intention to settle or otherwise fulfil the liability or exit the equity instrument is not relevant when measuring its fair value. Because the fair value of the liability is considered from the perspective of market participants, and not the entity itself, any relative efficiencies (or inefficiencies) of the reporting entity in settling the liability would not be considered in the fair value measurement.

Unlike a transfer notion, a settlement notion may allow for the consideration of a reporting entity's specific advantages (or disadvantages) in settling (or performing) the obligation. However, the Boards concluded that "when a liability is measured at fair value, the relative efficiency of an entity in settling the liability using its own internal resources appears in profit or loss over the course of its settlement, and not before". *[IFRS 13.BC81]*.

While similar thought processes are needed to estimate both the amount to settle a liability and the amount to transfer that liability, *[IFRS 13.BC82]*, IFRS 13 requires the fair value of a liability to be measured on the assumption that the liability is transferred to a market participant. Therefore, an entity cannot presume that the fair value of a liability is the same as its settlement value. In particular, the requirement to reflect the effect of non-performance risk in the fair value measurement of a liability could result in a difference between the fair value of a liability and the settlement value because it is unlikely that the counterparty would accept a different amount as settlement of the obligation if the entity's credit standing changed (i.e., the settlement value would not necessarily consider changes in credit risk).

At its January 2020 meeting, the IASB added a project to its work plan to amend aspects of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. In April 2024, the IASB proposed an amendment to IAS 37 to specify that when measuring a provision, the discount rate reflects the time value of money, represented by a risk-free rate with no adjustment for non-performance risk.[20] The proposal would, therefore, retain a difference between the settlement and transfer value. The IASB will consider the feedback from the Accounting Standards Advisory Forum received in July 2024[21] and from other stakeholders before the expected publication of an exposure draft in Q4 2024.

20 Staff paper IASB Agenda ref (April 2024): 22C, paragraph 10 in ap3c-provisions-discount-rates.pdf (ifrs.org)

21 Accounting Standards Advisory Forum Meeting Summary, paragraph 17, asaf-meeting-summary-july-2024.pdf (ifrs.org)

10.2 Measuring the fair value of a liability or an entity's own equity when quoted prices for the liability or equity instruments are not available

In many cases, there may be no quoted prices available for the transfer of an instrument that is identical or similar to an entity's own equity or a liability, particularly as liabilities are generally not transferred. For example, this might be the case for debt obligations that are legally restricted from being transferred, or for decommissioning liabilities that the entity does not intend to transfer. In such situations, an entity must determine whether the identical item is held by another party as an asset:

- If the identical item is held by another party as an asset - an entity is required to measure the fair value of a liability or its own equity from the perspective of a market participant that holds the asset (see section 10.2.1 below). *[IFRS 13.35, IFRS 13.37]*.
- If the identical item is not held by another party as an asset - an entity measures the fair value of the liability or equity instrument using a valuation technique from the perspective of a market participant that owes the liability or has issued the claim on equity (see section 10.2.2 below). *[IFRS 13.40]*.

Regardless of how an entity measures the fair value of a liability or its own equity, the entity is required to maximise the use of relevant observable inputs and minimise the use of unobservable inputs to meet the objective of a fair value measurement. That is, it must estimate the price at which an orderly transaction to transfer the liability or its own equity would take place between market participants at the measurement date under current market conditions. *[IFRS 13.36]*.

10.2.1 Liabilities or an entity's own equity that are held by other parties as assets

If there are no quoted prices available for the transfer of an identical or a similar liability or the entity's own equity instrument and the identical item is held by another party as an asset, an entity uses the fair value of the corresponding asset to measure the fair value of the liability or equity instrument. *[IFRS 13.37]*. The fair value of the asset should be measured from the perspective of the market participant that holds that asset at the measurement date. This approach applies even when the identical item held as an asset is not traded (i.e., when the fair value of the corresponding asset is a Level 3 measurement). For example, under the guidance in IFRS 13, the fair value of a contingent consideration liability should equal its fair value when held as an asset despite the fact that the asset would likely be a Level 3 measurement.

In these situations, the entity measures the fair value of the liability or its own equity by: *[IFRS 13.38]*

(a) Using the quoted price in an active market for the identical item held by another party as an asset if that price is available - this is illustrated in Example 12 in the standard (included in the extract below)

(b) If that price is not available, using other observable inputs, such as the quoted price in a market that is not active for the identical item held by another party as an asset

Or

(c) If the observable prices in (a) and (b) are not available, using another valuation technique (see section 13 below for further discussion), such as:

(i) An income approach, as is illustrated in Example 13 in the standard (included in the extract below)

Or

(ii) A market approach

As with all fair value measurements, inputs used to determine the fair value of a liability or an entity's own equity from the perspective of a market participant that holds the identical instrument as an asset must be prioritised in accordance with the fair value hierarchy. Accordingly, IFRS 13 indicates that the fair value of a liability or equity instrument held by another party as an asset should be determined based on the quoted price of the corresponding asset in an active market, if available. This is illustrated in Example 12 in the extract below. If such a price is not available, other observable inputs for the identical asset would be used, such as a quoted price in an inactive market. In the absence of quoted prices for the identical instrument held as an asset, other valuation techniques, including an income approach (as is illustrated in Example 13 in the extract below) or a market approach, would be used to determine the liability's or equity's fair value. In these instances, the objective is still to determine the fair value of the liability or equity from the perspective of a market participant that holds the identical instrument as an asset.

In some cases, the corresponding asset price may need to be adjusted for factors specific to the identical item held as an asset but not applicable to the liability, such as the following: *[IFRS 13.39]*

- The quoted price for the asset relates to a similar (but not identical) liability or equity instrument held by another party as an asset. IFRS 13 gives the example of a liability or equity instrument where the credit quality of the issuer is different from that reflected in the fair value of the similar liability or equity instrument held as an asset.
- The unit of account for the asset is not the same as for the liability or equity instrument. For instance, assume the price for an asset reflected a combined price for a package that comprised both the amounts due from the issuer and a third-party credit enhancement. If the unit of account for the liability is only its own liability, not the combined package, the entity would adjust the observed price for the asset to exclude the effect of the third-party credit enhancement.

In addition, IFRS 13 states that when using the price of a corresponding asset to determine the fair value of a liability or entity's own equity, the fair value of the liability or equity should not incorporate the effect of any restriction preventing the sale of that asset. *[IFRS 13.39]*. If the quoted price did reflect the effect of a restriction, it would need to be adjusted. That is, all else being equal, the liability's or equity's fair value would be the same as the fair value of an otherwise unrestricted corresponding asset.

The fair value of a liability may also differ from the price of its corresponding asset when the instrument is priced within a bid-ask spread. In these instances, the liability should be valued based on the price within the bid-ask spread that is most representative of where the liability would be exited, not the corresponding asset (see section 14.3 below for discussion on pricing within the bid-ask spread).

The Boards believe the fair value of a liability or equity instrument will equal the fair value of a properly defined corresponding asset (i.e., an asset whose features mirror those of the liability), assuming an exit from both positions in the same market. This assumes markets are efficient and arbitrage free. For example, if the prices differed for a liability and the corresponding asset, the market participant taking on the liability would be able to earn a profit by financing the purchase of the asset with the proceeds received by taking on the liability. In an efficient market, the price for the liability and the price for the asset would adjust until the arbitrage opportunity was eliminated. In the Boards' view, the price for the liability or equity instrument and the corresponding asset would generally only differ if the entity was measuring an asset relating to a similar (not identical) instrument or the unit of account was different. The Boards did consider whether the effects of illiquidity could create a difference but noted that they are difficult to differentiate from credit-related effects. *[IFRS 13.BC88, IFRS 13.BC89]*.

The following two examples extracted from IFRS 13 include factors to consider when measuring the fair value of a liability or entity's own equity by estimating the fair value of the corresponding asset held by another party. The first example highlights how entities need to assess whether the quoted price for a corresponding asset includes the effects of factors not applicable to the liability. However, for the sake of simplicity, the example does not consider bid-ask spread considerations. *[IFRS 13.IE Example 12, IFRS 13.IE40, IFRS 13.IE41, IFRS 13.IE42]*.

Extract from IFRS 13

Example 12-Debt obligation: quoted price

On 1 January 20X1 Entity B issues at par a CU2 million BBB-rated exchange-traded five-year fixed rate debt instrument with an annual 10 per cent coupon. Entity B designated this financial liability as at fair value through profit or loss.

On 31 December 20X1 the instrument is trading as an asset in an active market at CU929 per CU1,000 of par value after payment of accrued interest. Entity B uses the quoted price of the asset in an active market as its initial input into the fair value measurement of its liability (CU929 × [CU2 million ÷ CU1,000] = CU1,858,000).

In determining whether the quoted price of the asset in an active market represents the fair value of the liability, Entity B evaluates whether the quoted price of the asset includes the effect of factors not applicable to the fair value measurement of a liability, for example, whether the quoted price of the asset includes the effect of a third-party credit enhancement if that credit enhancement would be separately accounted for from the perspective of the issuer. Entity B determines that no adjustments are required to the quoted price of the asset. Accordingly, Entity B concludes that the fair value of its debt instrument at 31 December 20X1 is CU1,858,000. Entity B categorises and discloses the fair value measurement of its debt instrument within Level 1 of the fair value hierarchy.

The second example provides factors that would be incorporated when using a present value technique to estimate the fair value of a financial liability (e.g., changes in credit spreads for the liability), as well as factors that would be excluded (e.g., adjustments related to transferability restrictions or profit margin). *[IFRS 13.IE Example 13, IFRS 13.IE43-IE47]*.

Extract from IFRS 13

Example 13-Debt obligation: present value technique

On 1 January 20X1 Entity C issues at par in a private placement a CU2 million BBB-rated five-year fixed rate debt instrument with an annual 10 per cent coupon. Entity C designated this financial liability as at fair value through profit or loss.

At 31 December 20X1 Entity C still carries a BBB credit rating. Market conditions, including available interest rates, credit spreads for a BBB-quality credit rating and liquidity, remain unchanged from the date the debt instrument was issued. However, Entity C's credit spread has deteriorated by 50 basis points because of a change in its risk of non-performance. After taking into account all market conditions, Entity C concludes that if it was to issue the instrument at the measurement date, the instrument would bear a rate of interest of 10.5 per cent or Entity C would receive less than par in proceeds from the issue of the instrument.

For the purpose of this example, the fair value of Entity C's liability is calculated using a present value technique. Entity C concludes that a market participant would use all the following inputs (consistently with paragraphs B12-B30 of the IFRS) when estimating the price the market participant would expect to receive to assume Entity C's obligation:

(a) the terms of the debt instrument, including all the following:
    (i) coupon of 10 per cent;
    (ii) principal amount of CU2 million; and
    (iii) term of four years.
(b) the market rate of interest of 10.5 per cent (which includes a change of 50 basis points in the risk of non-performance from the date of issue).

On the basis of its present value technique, Entity C concludes that the fair value of its liability at 31 December 20X1 is CU1,968,641.

Entity C does not include any additional input into its present value technique for risk or profit that a market participant might require for compensation for assuming the liability. Because Entity C's obligation is a financial liability, Entity C concludes that the interest rate already captures the risk or profit that a market participant would require as compensation for assuming the liability. Furthermore, Entity C does not adjust its present value technique for the existence of a restriction preventing it from transferring the liability.

While Example 13 above assumes that relevant market data on the non-performance risk of the debt obligation is readily available, estimating the appropriate credit spreads is often the most challenging aspect of using a present value technique to value a debt instrument. Credit spreads on identical or similar liabilities issued by the same obligor represent high quality market data. But even when issued by the same obligor, credit spreads on liabilities with significantly different features or characteristics may not appropriately capture the credit risk of the liability being measured. When spreads on identical instruments do not exist and data from comparable debt instruments (e.g., option adjusted spreads (OAS)) is used, the specific characteristics of these comparable liabilities (e.g., tenor, seniority, collateral, coupon, principal amortisation, covenant strength) should be analysed carefully. In addition, credit default swap (CDS) spreads, which represent the compensation required by the CDS issuer to accept the default risk of a debt issuer (i.e., the reference obligor), may also provide useful market data.

In some instances, observable market data is not available for a specific debt issuer, but the issuer has a reported credit rating. In these circumstances, credit spreads or CDS spreads of similarly rated entities or debt instruments may be used as a proxy to evaluate the credit risk of the liability being measured. In other instances, an entity lacking a published rating might use the rating of its parent as a proxy. In such cases, it would then be necessary to adjust this proxy rating to accurately reflect the entity's own credit profile. Once again, the specific characteristics of these similar debt instruments and the subject liability should be compared.

Other situations may involve a liability with no observable credit quality measures (e.g., credit spreads) issued by an entity that is not rated. In these circumstances, techniques such as a regression or other quantitative analysis may be performed to determine the credit quality of the issuer. Comparing financial metrics such as profit margins, leverage ratios, and asset sizes between the non-rated issuer of the liability being measured to rated entities may allow a credit rating to be estimated. Once a credit rating has been determined, an appropriate credit spread could be quantified from other comparable (i.e., similarly rated) debt instruments.

10.2.2 Liabilities or an entity's own equity not held by other parties as assets

While many liabilities are held by market participants as corresponding assets, some are not. For example, there is typically no corresponding asset holder for a decommissioning liability. When no observable price is available for a liability and no corresponding asset exists, the fair value of the liability is measured from the perspective of a market participant that owes the liability, using an appropriate valuation technique (e.g., a present value technique). *[IFRS 13.40]*.

Generally, an instrument classified as an entity's own equity would have a corresponding asset. However, if no corresponding asset exists and no observable price is available for an entity's own equity, fair value is measured from the perspective of a market participant that has issued the claim on equity, using an appropriate valuation technique.

IFRS 13 gives two examples of what an entity might take into account in measuring fair value in this situation: *[IFRS 13.41]*

(a) The future cash outflows that a market participant would expect to incur in fulfilling the obligation (i.e., a present value technique). This includes any compensation a market participant would require for taking on the obligation. This approach is discussed further in section 10.2.2.A below.

(b) The amount that a market participant would receive to enter into an identical liability or issue an identical equity instrument. This approach is discussed further in section 10.2.2.B below.

10.2.2.A Use of present value techniques to measure fair value for liabilities and an entity's own equity instruments not held by other parties as assets

If an entity uses a present value technique to measure the fair value of a liability or its own equity not held by other parties as assets, IFRS 13 requires the entity to estimate the future cash outflows that a market participant would expect to incur in fulfilling the obligation, among other things. The estimated cash flows include: *[IFRS 13.B31]*

- Market participants' expectations about the costs of fulfilling the obligation
- Compensation that a market participant would require for taking on the obligation - this compensation includes the return that a market participant would require for the following:
  - (i) Undertaking the activity (i.e., the value of fulfilling the obligation) - for example, by using resources that could be used for other activities
  - (ii) Assuming the risk associated with the obligation (i.e., a *risk premium* that reflects the risk that the actual cash outflows might differ from the expected cash outflows)

In some cases, the components of the return a market participant would require will be indistinguishable from one another. In other cases, an entity will need to estimate those components separately. For example, assume an entity uses the price a third-party contractor would charge as part of the discounted cash flows. If the contract is priced on a fixed fee basis, both the return for undertaking the activity and the risk premium would be indistinguishable. However, as is shown in Example 11 in the standard (included in the extract below), if the contractor would charge on a cost-plus basis, an entity would need to estimate the components separately, because the contractor in that case would not bear the risk of future changes in costs. *[IFRS 13.B32]*.

A risk premium can be included in such fair value measurements, either by:

(a) Adjusting the cash flows (i.e., as an increase in the amount of cash outflows)

Or

(b) Adjusting the rate used to discount the future cash flows to their present values (i.e., as a reduction in the discount rate)

However, an entity must ensure adjustments for risk are not double-counted or omitted. *[IFRS 13.B33]*.

IFRS 13 provides the following example, which illustrates how these considerations would be captured when using a valuation technique to measure the fair value of a liability not held by another party as an asset. *[IFRS 13.IE Example 11, IFRS 13.IE35-IE39]*.

Extract from IFRS 13

Example 11-Decommissioning liability

On 1 January 20X1 Entity A assumes a decommissioning liability in a business combination. The entity is legally required to dismantle and remove an offshore oil platform at the end of its useful life, which is estimated to be 10 years.

On the basis of paragraphs B23-B30 of the IFRS, Entity A uses the expected present value technique to measure the fair value of the decommissioning liability.

If Entity A was contractually allowed to transfer its decommissioning liability to a market participant, Entity A concludes that a market participant would use all the following inputs, probability-weighted as appropriate, when estimating the price it would expect to receive:

(a) labour costs;

(b) allocation of overhead costs;

(c) the compensation that a market participant would require for undertaking the activity and for assuming the risk associated with the obligation to dismantle and remove the asset. Such compensation includes both of the following:

  (i) profit on labour and overhead costs; and

  (ii) the risk that the actual cash outflows might differ from those expected, excluding inflation;

(d) effect of inflation on estimated costs and profits;

(e) time value of money, represented by the risk-free rate; and

(f) non-performance risk relating to the risk that Entity A will not fulfil the obligation, including Entity A's own credit risk.

The significant assumptions used by Entity A to measure fair value are as follows:

(a) Labour costs are developed on the basis of current marketplace wages, adjusted for expectations of future wage increases, required to hire contractors to dismantle and remove offshore oil platforms. Entity A assigns probability assessments to a range of cash flow estimates as follows:

Cash flow estimate (CU)	Probability assessment	Expected cash flows (CU)
100,000	25%	25,000
125,000	50%	62,500
175,000	25%	43,750
		CU131,250

The probability assessments are developed on the basis of Entity A's experience with fulfilling obligations of this type and its knowledge of the market.

(b) Entity A estimates allocated overhead and equipment operating costs using the rate it applies to labour costs (80 per cent of expected labour costs). This is consistent with the cost structure of market participants.

(c) Entity A estimates the compensation that a market participant would require for undertaking the activity and for assuming the risk associated with the obligation to dismantle and remove the asset as follows:

  (i) A third-party contractor typically adds a mark-up on labour and allocated internal costs to provide a profit margin on the job. The profit margin used (20 per cent) represents Entity A's understanding of the operating profit that contractors in the industry generally earn to dismantle and remove offshore oil platforms. Entity A concludes that this rate is consistent with the rate that a market participant would require as compensation for undertaking the activity.

  (ii) A contractor would typically require compensation for the risk that the actual cash outflows might differ from those expected because of the uncertainty inherent in locking in today's price for a project that will not occur for 10 years. Entity A estimates the amount of that premium to be 5 per cent of the expected cash flows, including the effect of inflation.

(d) Entity A assumes a rate of inflation of 4 per cent over the 10-year period on the basis of available market data.

(e) The risk-free rate of interest for a 10-year maturity on 1 January 20X1 is 5 per cent. Entity A adjusts that rate by 3.5 per cent to reflect its risk of non-performance (ie the risk that it will not fulfil the obligation), including its credit risk. Therefore, the discount rate used to compute the present value of the cash flows is 8.5 per cent.

Entity A concludes that its assumptions would be used by market participants. In addition, Entity A does not adjust its fair value measurement for the existence of a restriction preventing it from transferring the liability. As illustrated in the following table, Entity A measures the fair value of its decommissioning liability as CU194,879.

	Expected cash flows (CU) 1 January 20X1
Expected labour costs	131,250
Allocated overhead and equipment costs (0.80 × CU131,250)	105,000
Contractor's profit mark-up [0.20 × (CU131,250 + CU105,000)]	47,250
Expected cash flows before inflation adjustment	283,500
Inflation factor (4% for 10 years)	1.4802
Expected cash flows adjusted for inflation	419,637
Market risk premium (0.05 × CU419,637)	20,982
Expected cash flows adjusted for market risk	440,619
Expected present value using discount rate of 8.5% for 10 years	194,879

In practice, estimating the risk premium for a decommissioning liability, such as in Example 11 above, requires significant judgement, particularly in circumstances where the decommissioning activities will be performed many years in the future. Information about the compensation market participants would demand to assume decommissioning liability may be limited, because very few decommissioning liabilities are transferred in the manner contemplated by IFRS 13 in a separate transaction.

Because of these data limitations, entities might look to risk premiums observed from business combinations where decommissioning liabilities are assumed, including their own business combination transactions. IFRS 13 indicates that when market information is not reasonably available, an entity may consider its own data in developing assumptions related to the market risk premium (see section 18 below for additional discussion on the use of an entity's own data to determine unobservable inputs).

Alternatively, as noted above, the market risk premium might be estimated by considering the difference between a fixed-price arrangement and a cost-plus arrangement with a third party to complete the remediation and monitor the site. The difference between the fixed-price arrangement and the cost-plus arrangement may provide insight into the risk premium market participants would demand to fulfil the obligation.

How we see it

While all available evidence about market participant assumptions regarding the market risk premium needs to be considered, circumstances may exist when an explicit assumption cannot be determined. In such cases, based on the specific guidance in IFRS 13 - which acknowledges that explicit assumptions in some cases may not be able to be incorporated into the measurement of a decommissioning liability - we believe the market risk premium might already be incorporated into the fair value measurement on an implicit basis. This means it is assumed that market participants might already have factored the market risk premium into their assumptions.

10.2.2.B Consideration of an entry price in measuring a liability or entity's own equity not held as an asset

Although fair value represents an exit price, IFRS 13 indicates that in certain situations an entry price may be considered in estimating the fair value of a liability or an entity's own equity instrument. This approach uses assumptions that market participants would use when pricing the identical item (e.g., having the same credit characteristics) in the principal (or most advantageous) market - that is, the principal (or most advantageous) market for issuing a liability or equity instrument with the same contractual terms.

The standard allows for entry prices to be considered in estimating the fair value of a liability because the IASB believes that a liability's entry and exit prices will be identical in many instances. As a result, the price at which a market participant could enter into the identical liability on the measurement date (e.g., an obligation having the same credit characteristics) may be indicative of its fair value.

However, an entry price may differ from the exit price for a liability for a number of reasons. For example, an entity may transfer the liability in a different market from that in which the obligation was incurred. When entry and exit prices differ, IFRS 13 is clear that the objective of the measurement remains an exit price.

10.3 Non-performance risk

IFRS 13 requires a fair value measurement of a liability to incorporate non-performance risk (i.e., the risk that an obligation will not be fulfilled). Conceptually, non-performance risk encompasses more than just an entity's credit risk. It may also include other risks, such as settlement risk. In the case of non-financial instruments, such as commodity contracts, non-performance risk could represent the risk associated with physically extracting and transferring an asset to the point of delivery. When measuring the fair value of a liability, an entity must:

- Take into account the effect of its credit risk (credit standing) and any other factors that could influence the likelihood whether or not the obligation will be fulfilled. *[IFRS 13.43]*.
- Assume that non-performance risk will be the same before and after the transfer of a liability. *[IFRS 13.42]*.
- Ensure the effect of non-performance risk on the fair value of the liability is consistent with its unit of account for financial reporting purposes. *[IFRS 13.44]*.

  If a liability is issued with a third-party credit enhancement that the issuer accounts for separately from the liability, the fair value of the liability does not include the effect of the credit enhancement (e.g., a third-party guarantee of debt). That is, the issuer would take into account its own credit standing and not that of the third-party guarantor when measuring the fair value of the liability (see section 10.3.1 below). *[IFRS 13.44]*.

An entity takes into account the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value because market participants valuing the entity's obligations as assets would take into account the effect of the entity's credit standing when estimating the prices at which they would transact. *[IFRS 13.IE31]*. Valuation techniques continue to evolve and new concepts are developing in relation to considering non-performance risk. Whether an entity should incorporate them into an IFRS 13 fair value measurement depends on whether market participants would take them into account.

Incorporating non-performance risk into subsequent fair value measurements of a liability is also consistent with the notion that credit risk affects the initial measurement of a liability. Since the terms of a liability are determined based on an entity's credit standing at the time of issuance (and since IFRS 13 assumes the liability is transferred to another party with the same credit standing at the measurement date), subsequent changes in an entity's credit standing will result in the obligation's terms being favourable or unfavourable relative to the market requirements at initial recognition. The standard gives the following example illustrating how the fair value of the same instrument could be different depending on the credit risk of the issuer. *[IFRS 13.IE32]*.

Extract from IFRS 13

IE32	For example, assume that Entity X and Entity Y each enter into a contractual obligation to pay cash (CU500) to Entity Z in five years. Entity X has a AA credit rating and can borrow at 6 per cent, and Entity Y has a BBB credit rating and can borrow at 12 per cent. Entity X will receive about CU374 in exchange for its promise (the present value of CU500 in five years at 6 per cent). Entity Y will receive about CU284 in exchange for its promise (the present value of CU500 in five years at 12 per cent). The fair value of the liability to each entity (ie the proceeds) incorporates that entity's credit standing.

The effect of non-performance risk on the fair value measurement of the liability will depend on factors, such as the terms of any related credit enhancement or the nature of the liability - that is, whether the liability is an obligation to deliver cash (a financial liability) or an obligation to deliver goods or services (a non-financial liability).

The following example, from the standard, illustrates changes in fair value measurement due to changes in non-performance risk. As indicated in this example, changes to an entity's non-performance risk does not require there to be a change in credit rating. Instead, such changes are often based on changes in credit spreads. *[IFRS 13.IE Example 10, IFRS 13.IE34]*.

Extract from IFRS 13

Example 10-Structured note

On 1 January 20X7 Entity A, an investment bank with a AA credit rating, issues a five-year fixed rate note to Entity B. The contractual principal amount to be paid by Entity A at maturity is linked to an equity index. No credit enhancements are issued in conjunction with or otherwise related to the contract (ie no collateral is posted and there is no third-party guarantee). Entity A designated this note as at fair value through profit or loss. The fair value of the note (ie the obligation of Entity A) during 20X7 is measured using an expected present value technique. Changes in fair value are as follows:

(a) *Fair value at 1 January 20X7*. The expected cash flows used in the expected present value technique are discounted at the risk-free rate using the government bond curve at 1 January 20X7, plus the current market observable AA corporate bond spread to government bonds, if non-performance risk is not already reflected in the cash flows, adjusted (either up or down) for Entity A's specific credit risk (ie resulting in a credit-adjusted risk-free rate). Therefore, the fair value of Entity A's obligation at initial recognition takes into account non-performance risk, including that entity's credit risk, which presumably is reflected in the proceeds.

(b) *Fair value at 31 March 20X7*. During March 20X7 the credit spread for AA corporate bonds widens, with no changes to the specific credit risk of Entity A. The expected cash flows used in the expected present value technique are discounted at the risk-free rate using the government bond curve at 31 March 20X7, plus the current market observable AA corporate bond spread to government bonds, if non-performance risk is not already reflected in the cash flows, adjusted for Entity A's specific credit risk (ie resulting in a credit-adjusted risk-free rate). Entity A's specific credit risk is unchanged from initial recognition. Therefore, the fair value of Entity A's obligation changes as a result of changes in credit spreads generally. Changes in credit spreads reflect current market participant assumptions about changes in non-performance risk generally, changes in liquidity risk and the compensation required for assuming those risks.

(c) *Fair value at 30 June 20X7*. As of 30 June 20X7 there have been no changes to the AA corporate bond spreads. However, on the basis of structured note issues corroborated with other qualitative information, Entity A determines that its own specific creditworthiness has strengthened within the AA credit spread. The expected cash flows used in the expected present value technique are discounted at the risk-free rate using the government bond yield curve at 30 June 20X7, plus the current market observable AA corporate bond spread to government bonds (unchanged from 31 March 20X7), if non-performance risk is not already reflected in the cash flows, adjusted for Entity A's specific credit risk (ie resulting in a credit-adjusted risk-free rate). Therefore, the fair value of the obligation of Entity A changes as a result of the change in its own specific credit risk within the AA corporate bond spread.

The standard's assumption that the non-performance risk related to a liability is the same before and after its transfer is not intended to reflect reality. In most cases, the reporting entity and the market participant transferee will have different credit standings. However, this assumption is important when measuring fair value under IFRS 13 for the following reasons: *[IFRS 13.BC94]*

- If the transaction results in changes to the non-performance risk associated with the liability, the market participant taking on the obligation would not enter into the transaction without reflecting that change in the price.

  IFRS 13 gives the following examples; a creditor would not generally permit a debtor to transfer its obligation to another party of lower credit standing, nor would a transferee of higher credit standing be willing to assume the obligation using the same terms negotiated by the transferor if those terms reflect the transferor's lower credit standing.
- If IFRS 13 did not specify the credit standing of the entity taking on the obligation, there could be fundamentally different fair values for a liability depending on an entity's assumptions about the characteristics of the market participant transferee.
- Those who might hold the entity's liability as an asset would consider the effect of the entity's credit risk and other risk factors when pricing those assets (see section 10.2.1 above).

In developing IFRS 13, there was some debate among constituents about the usefulness of including non-performance risk after initial recognition because this might lead to counter-intuitive and potentially confusing reporting (i.e., gains for credit deterioration and losses for credit improvements). However, in the IASB's view, this does not affect how to measure fair value, but rather whether an IFRS should require fair value measurement subsequent to initial recognition, which is outside the scope of IFRS 13. The standard is clear that a measurement that does not consider the effect of an entity's non-performance risk is not a fair value measurement. *[IFRS 13.BC95]*. The adoption of IFRS 9 may have resolved some of these concerns. For financial liabilities designated at fair value through profit or loss (using the fair value option), IFRS 9 requires fair value changes that are the result of changes in an entity's own credit risk to be presented in other comprehensive income, unless doing so would introduce an accounting mismatch. If it would introduce an accounting mismatch, the whole fair value change is presented in profit or loss (see Chapter 46 at section 2.4.2 for further discussion). *[IFRS 9.5.7.7]*.

10.3.1 Liabilities issued with third-party credit enhancements

As discussed in section 10.3 above, IFRS 13 requires entities to measure the fair value of a liability issued with an inseparable third-party credit enhancement that is accounted for separately from the liability from the issuer's perspective, i.e., considering the issuer's credit risk rather than that of the third-party providing the credit enhancement. *[IFRS 13.44]*. This would apply in situations where a credit enhancement (or guarantee) is purchased by an issuer, then combined with a liability and issued as a combined security to an investor. IFRS 13's requirements are based on the fact that the third-party credit enhancement does not relieve the issuer of its ultimate obligation under the liability. Generally, if the issuer fails to meet its payment obligations to the investor, the guarantor has an obligation to make the payments on the issuer's behalf and the issuer has an obligation to the guarantor. By issuing debt combined with a credit enhancement, the issuer is able to market its debt more easily and can either reduce the interest rate paid to the investor or receive higher proceeds when the debt is issued.

IFRS 13 requires the fair value measurement of a liability to follow the unit of account of the liability for financial reporting purposes. The standard anticipates that there may be instances where, even though it may be inseparable, the credit enhancement may need to be separated (i.e., separately recognised) for financial reporting purposes. However, this assumes that: (i) the unit of account is clear in other standards, which may not be the case; and (ii) that standards, such as IFRS 9, may permit or require separation when a credit enhancement is inseparable.

As discussed in Figure 10-1 below, if the unit of account excludes the credit enhancement, the fair value of the liability measured from the issuer's perspective in accordance with IFRS 13, will not equal its fair value as a guaranteed liability held by another party as an asset. The fair value of the asset held by the investor considers the credit standing of the guarantor. However, under the guarantee, any payments made by the guarantor result in a transfer of the issuer's debt obligation from the investor to the guarantor. That is, the amount owed by the issuer does not change; the issuer must now pay the guarantor instead of the investor. Therefore, as discussed in section 10.2.1 above, if the fair value of a third-party guaranteed liability is measured based on the fair value of the corresponding asset, it would need to be adjusted. *[IFRS 13.BC96, IFRS 13.BC97, IFRS 13.BC98]*.

Figure 10-1: Liabilities with credit enhancements

	Issuer's perspective (i.e., the obligor)	Perspective of the entity that holds the corresponding asset
Credit enhancement provided by the issuer (e.g., collateral or master netting agreement)		
Separate unit of account?	Dependent on the relevant IFRS (e.g., IFRS 9). Depending on the nature of the credit enhancement, it may be recognised (e.g., collateral recognised as an asset in the financial statements of the issuer) or unrecognised (e.g., a master netting agreement).	Dependent on the relevant IFRS (e.g., IFRS 9) and the nature of the credit enhancement.
Considered in the fair value measurement?	Generally, yes. The fair value measurement of a liability takes into consideration the credit standing of the issuer. The effect may differ depending on the terms of the related credit enhancement.	Possibly. If the credit enhancement is not accounted for separately, the fair value of the corresponding asset would take into consideration the effect of the related credit enhancement.
Credit enhancement provided by a third-party (e.g., financial guarantee)		
Separate unit of account?	Dependent on the relevant IFRS (e.g., IFRS 9). Likely to be a separate unit of account and remain unrecognised unless the issuer fails to meet its obligations under the liability.	Dependent on the relevant IFRS (e.g., IFRS 9) and the nature of the credit enhancement.
Considered in the fair value measurement?	Generally, no. If the credit enhancement is accounted for separately from the liability, the issuer would take into account its own credit standing and not that of the third-party guarantor when measuring the fair value of the liability.	Possibly. If the credit enhancement is not accounted for separately, the fair value of the corresponding asset would take into consideration the effect of the related third-party credit enhancement.

Frequently asked questions

Question 10-1: Do the requirements of IFRS 13 regarding third-party credit enhancements in a fair value measurement apply to liabilities other than debt?

The requirements of IFRS 13 for liabilities issued with third-party credit enhancements apply to all liabilities that are measured or disclosed at fair value on a recurring basis. Although the requirements would not affect financial liabilities after their initial recognition if they are subsequently measured at amortised cost in accordance with IFRS 9, it would apply to the disclosure of the fair value of those liabilities, as required by IFRS 7.

While an issuer's accounting for guaranteed debt may be the most common application of this guidance, the clarification with respect to the unit of account for certain types of credit enhancements could affect other liabilities, including derivative instruments measured at fair value in accordance with IFRS 9. Many OTC derivative contracts are subject to credit support requirements under an International Swaps and Derivatives Association[22] (ISDA) Master Agreement between the derivative counterparties. The application of this guidance to OTC derivatives will depend on the nature of the credit support provided. For example, while credit support is typically provided through the posting of collateral, in certain industries posting a letter of credit (LOC) for the benefit of a derivative counterparty is not uncommon.

In those instances where a LOC is posted for the benefit of a derivative counterparty, we believe the requirement in IFRS 13.44, to consider the issuer's credit risk rather than that of the third party providing the LOC, would generally apply. *[IFRS 13.44]*. If an entity defaults on its derivative contracts, the bank issuing the LOC will pay the counterparty and the entity's obligation merely transfers from the original counterparty to the issuing bank. In other words, the entity will have a continuing obligation, even in the event it defaults on the derivative. As such, the entity's non-performance risk (not that of the bank providing the LOC) would be considered in determining the fair value of the derivative liability.

How we see it

We believe the above generally would apply even if the LOC were deemed separable from the derivative contract. In our view, including the effect of separable credit enhancements while excluding the effect of inseparable credit enhancements would contradict the principles of IFRS 13.

Question 10-2: Does IFRS 13 require an entity to consider the effects of both counterparty credit risk and its own credit risk when valuing its derivative transactions?

IFRS 13 addresses the issue of credit risk both explicitly and implicitly. As discussed in section 10.3 above, in relation to an entity's own credit risk in the valuation of liabilities, the guidance is explicit; the fair value of a liability should reflect the effect of non-performance risk, which includes own credit risk.

The standard's requirements are less explicit regarding counterparty credit risk. IFRS 13 requires the fair value of an asset or liability to be measured based on market participant assumptions. Because market participants consider counterparty credit risk in pricing a derivative contract, an entity's valuation methodology should incorporate counterparty credit risk in its measurement of fair value.

10.3.2 How should an entity incorporate credit risk into the valuation of its derivative contracts?

As discussed in section 10.3 above, IFRS 13 requires entities to consider the effects of credit risk when determining a fair value measurement, e.g., by calculating a debit valuation adjustment (DVA) or a credit valuation adjustment (CVA) on their derivatives.

As no specific method is prescribed in IFRS 13, various approaches are used in practice by derivatives dealers and end-users to estimate the effect of credit risk on the fair value of OTC derivatives.

22 The International Swaps and Derivatives Association (ISDA) agreement is part of a framework of documents designed to enable OTC derivatives to be documented fully and flexibly. The ISDA master agreement sets out the standard terms that apply to all transactions and is published by the International Swaps and Derivatives Association.

The degree of sophistication in the credit adjustment valuation method used by a reporting entity is influenced by the qualitative factors noted below. Estimation can be complex and requires the use of significant judgement, which is often influenced by various qualitative factors, including:

- Materiality of the entity's derivative's carrying value to its financial statements
- Number and type of contracts for derivatives in the entity's portfolio and the specific terms of those instruments (e.g., maturity dates, fixed and/or variable payments)
- Specific timing and amounts of expected cash flows and the extent to which derivative instruments are either deeply in or out of the money
- Existence and terms of credit mitigation arrangements (e.g., collateral arrangements in place)
- Cost and availability of technology to model complex credit exposures
- Cost and consistent availability of suitable input data to calculate an accurate credit adjustment
- Creditworthiness of the entity and its counterparties

While the degree of sophistication and complexity may differ by entity and by the size and nature of the derivative portfolio, any inputs used under any methodology should be consistent with assumptions market participants would use. For example, the CVA measurement might need to be adjusted when a counterparty is materially exposed to climate-related risks and the adjustment is consistent with those that market participants would make. The complexity and judgement involved in selecting and consistently applying a method may require entities to provide additional disclosures to assist users of financial statements (see section 19 below). Section 10.3.3.A to 10.3.3.B below provide further insights into some of the considerations for determining valuation adjustments for credit risk on derivatives measured at fair value, except for which a quoted price in an active market is available (i.e., over-the-counter derivatives).

In situations where an entity has a master netting agreement or credit support annex[23] (CSA) with a counterparty, the entity may consider the credit risk of its derivative instruments with that counterparty on a net basis if it qualifies to use the measurement exception noted in section 2.5.2 above (see section 11 below for more detail on applying the measurement exception for financial instruments with offsetting credit risks).

10.3.2.A How do credit adjustments work?

In simple terms, the requirement for a credit adjustment as a component of fair value measurement can be analogised to the need for a provision on a trade receivable or an impairment charge on an item of property, plant and equipment. Whilst this analogy helps conceptualise the requirement, the characteristics of derivatives mean that the calculation itself can be significantly more complex than for assets measured at amortised cost.

Consistent with the fact that credit risk affects the initial measurement of a derivative asset or liability, IFRS 13 requires that changes in counterparty credit risk or an entity's own credit standing be considered in subsequent fair value measurements. It cannot be assumed that the parties to the derivative contract will perform.

The terms of the asset or liability were determined based on the counterparty's or entity's credit standing at the time of entering into the contract. In addition, IFRS 13 assumes a liability is transferred to another party with the same credit standing at the measurement date. As a result, subsequent changes in a counterparty's or entity's credit standing will result in the derivative's terms being favourable or unfavourable relative to the market conditions at initial recognition.

Unlike the credit exposure of a 'vanilla' receivable, which generally remains constant over time (typically at the principal amount of the receivable), the bilateral nature of the credit exposure in many derivatives varies, whereby both parties to the contract may face potential exposure in the future. As such, many instruments may possibly have a value that is either positive (a derivative asset) or negative (a derivative liability) at different points in time based on changes in the underlying variables of the contract.

23 A credit support annex (CSA) is a legal document that regulates the credit support (collateral) for derivative transactions and forms part of an ISDA Master Agreement.

Figure 10-2 below illustrates the effect on the income statement and on the statement of financial position of CVA and DVA adjustments as a component of fair value measurement on a single derivative asset or liability.

Figure 10-2: Accounting for CVA and DVA

	Derivative asset example - CVA	CU		Derivative liability example - DVA	CU
Derivative position valued using the risk-free curve (1)	Risk-free derivative asset	100,000		Risk-free derivative liability	(100,000)
Credit adjustment required (2)	Counterparty credit adjustment	(10,000)		Debit adjustment based on own credit	5,000
Credit-adjusted derivative position	Derivative asset	90,000		Derivative liability	(95,000)
Subsequent credit movements					
Counterparty credit improves	A gain arises in the income statement and is reflected by a larger derivative asset in the statement of financial position		Own credit improves	A loss arises in the income statement and is reflected by a larger derivative liability in the statement of financial position	
Counterparty credit deteriorates	A further CVA charge is required in the income statement and is reflected by a reduced derivative asset in the statement of financial position		Own credit deteriorates	A further DVA credit is required to the income statement and is reflected by a reduced derivative liability in the statement of financial position	

Notes:

(1) The table represents a point-in-time during the life of a derivative asset or liability

(2) For illustrative purposes, we have assumed the counterparty credit valuation adjustment is CU10,000 and the debit valuation adjustment is CU5,000. These credit adjustments are not intended to reflect reality

10.3.2.B Valuation methods

The determination of a credit adjustment can be complex. Part of the complexity stems from the particular nature of credit risk in many OTC derivative contracts. Credit risk associated with a derivative contract is similar to other forms of credit risk in that the cause of economic loss is an obligor's default on its contractual obligation. However, for many derivative products, two features set credit risk in OTC derivative contracts apart from traditional forms of credit risk in instruments such as debt:

- Uncertainty of the future exposure associated with the instrument - this is due to the uncertainty of future changes in value of the derivative, as the cash flows required under the instrument stem from: (a) movements in underlying variables that drive the value of the contract; and (b) the progression of time towards the contract's expiry.
- Bilateral nature of credit exposure in many derivatives, whereby both parties to the contract may face potential exposure in the future - this can occur in instruments, such as swaps and forwards, given the potential for these derivatives to 'flip' from an asset to a liability (or *vice versa*), based on changes in the underlying variables to the contract (e.g., interest rates or foreign exchange rates).

As previously noted in section 10.3.2 above, IFRS does not prescribe any specific valuation methods to quantify the impact of non-performance risk on derivatives' fair value. IFRS 13 is a principles-based standard intended to provide a general framework for measuring fair value. It was not intended to provide detailed application guidance for calculating the fair value of various types of assets and liabilities. Likewise, IFRS 9 does not provide specific valuation guidance related to derivatives. As a result, extensive judgement needs to be applied, potentially resulting in diversity in the methods and approaches used to quantify credit risk, particularly as it pertains to derivatives. As discussed in section 10.3.2 above, a variety of factors may influence the method an entity chooses for estimating credit adjustments. In addition, the cost and availability of technology and input data to model complex credit exposures will also be a contributing factor.

Some derivative dealers include a funding valuation adjustment (FVA) in the valuation of their uncollateralised derivative positions, as is illustrated in the extract from the financial statements of ING Groep N.V. included in Practical example 10-1 below. FVA is included in order to capture the funding cost (or benefit) that results from posting (or receiving) collateral on inter-bank transactions that are used to economically hedge the market risk associated with these uncollateralised trades. The methods for determining FVA can vary. As such, determining whether these methods comply with IFRS 13 requires judgement based on the specific facts and circumstances.

A number of valuation adjustments have also emerged in addition to CVA, DVA and FVA. Examples include self-default potential hedging (LVA), collateral (CollVA) and market hedging positions (HVA), as well as capital value adjustments (KVA), which collectively are now referred to as X-Value Adjustments (XVA). It is important to note that some of these valuation adjustments may be useful for internal reporting, but may not be appropriate to use when measuring fair value in accordance with IFRS 13. As noted above, the inputs used in measuring fair value must reflect the assumptions of market participants transacting for the asset or liability in the principal (or most advantageous) market at the measurement date and many of these adjustments are specific to the entity (for example, their regulatory position).

Practical example 10-1: ING Groep N.V. (2023) **Netherlands**

Annual Report 2023 [extract]

Consolidated financial statements [extract]

Notes to the Consolidated financial statements [extract]

1 Basis of preparation and material accounting policy information [extract]

1.5 Financial instruments [extract]

1.5.3 Fair values of financial assets and liabilities

All financial assets and liabilities are recognised initially at fair value. The fair value of a financial instrument on initial recognition is generally its transaction price (that is, the fair value of the consideration given or received). However, if there is a material difference between the transaction price and the fair value of financial instruments whose fair value is based on a valuation technique using significant unobservable inputs, the entire day one difference (a 'Day One Profit or Loss') is deferred. ING Group defers the Day One Profit or Loss relating to financial instruments classified as Level 3 and financial instruments with material unobservable inputs into CVA which are not necessarily classified as Level 3. The deferred Day One Profit or Loss is recognised in the statement of profit or loss over the life of the transaction until the transaction matures, or until the significant unobservable inputs become observable, or until the significant unobservable inputs become non-significant. In all other cases, ING Group recognises the difference as a gain or loss at inception.

Subsequently, except for financial assets and financial liabilities measured at amortised cost, all the other financial assets and liabilities are measured at fair value.

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It assumes that market participants would use and take into account the characteristics of the asset or liability when pricing the asset or liability. Fair values of financial assets and liabilities are based on unadjusted quoted market prices where available. Such quoted market prices are primarily obtained from exchange prices for listed financial instruments. Where an exchange price is not available, quoted prices in an active market may be obtained from independent market vendors, brokers, or market makers. In general, positions are valued at the bid price for a long position and at the offer price for a short position or are valued at the price within the bid-offer spread that is most representative of fair value in the circumstances. In some cases where positions are marked at mid-market prices, a fair value adjustment is calculated.

For certain financial assets and liabilities, quoted market prices are not available. For such instruments, fair value is determined using valuation techniques. These range from discounting of cash flows to various valuation models, where relevant pricing factors including the market price of underlying reference instruments, market parameters (volatilities, correlations and credit ratings), and customer behaviour are taken into account. ING Group maximises the use of market observable inputs and minimises the use of unobservable inputs in determining the fair value. It can be subjective dependent on the significance of the unobservable input to the overall valuation. All valuation techniques used are subject to internal review and approval. Most data used in these valuation techniques are validated on a daily basis when possible.

When a group of financial assets and liabilities are managed on the basis of their net risk exposures, the fair value of a group of financial assets and liabilities are measured on a net portfolio level.

To include credit risk in fair value, ING Group applies both Credit and Debit Valuation Adjustments (CVA, DVA, also known as Bilateral Valuation Adjustments or BVA). Own issued debt and structured notes that are designated at FVPL are adjusted for ING Group's own credit risk by means of a DVA. To include the funding risk, ING Group applies an additional 'Funding Valuation Adjustment' (FVA) to the uncollateralised derivatives based on the market price of funding liquidity.ING Group also applies to certain positions other valuation adjustments to arrive at the fair value: Bid-Offer adjustments, Model Risk Adjustments and Collateral Valuation Adjustments (CollVA).

Significant judgements and critical accounting estimates and assumptions:

- Even if market prices are available, when markets are less liquid there may be a range of prices for the same security from different price sources. Selecting the most appropriate price requires judgement and could result in different estimates of fair value.
- Valuation techniques are subjective in nature and significant judgement is involved in establishing fair values for certain financial assets and liabilities. Valuation techniques involve various assumptions regarding pricing factors. The use of different valuation techniques and assumptions could produce significantly different estimates of fair value.
- Price testing is performed to assess whether the process of valuation has led to an appropriate fair value of the position and to minimise the potential risks of economic losses due to incorrect or misused models.
- Assessing whether a market is active, and whether an input is observable and significant, requires judgement. ING Group categorises its financial instruments that are either measured in the statement of financial position at fair value or of which the fair value is disclosed, into a three-level hierarchy based on the observability and significance of the valuation inputs. The use of different approaches to assess whether a market is active, whether an input is observable, and whether an unobservable input is significant could produce different classification within the fair value hierarchy as well as potentially different deferral of the Day One Profit or Loss.
- Reference is made to Note 35 'Fair value of assets and liabilities ' and to the 'Market risk' paragraph in the 'Risk management' section of the Annual Report for the basis of the determination of the fair value of financial instruments and related sensitivities.

10.3.2.C Data challenges

In addition to the method employed to determine a credit adjustment, the inputs used in the various approaches can often require significant judgement. Regardless of the method used, probability of default, loss given default (i.e., the amount that one party expects not to recover if the other party defaults) or credit spread assumptions are important inputs. While the sources of information may vary, the objective remains unchanged - i.e., to incorporate inputs that reflect the assumptions of market participants in the current market.

Where available, IFRS 13 requires entities to make maximum use of market-observable credit information. For example, credit default swap (CDS) spreads may provide a good indication of the market's current perception of a particular reporting entity's or counterparty's creditworthiness. However, CDS spreads will likely not be available for smaller public companies or private entities. In these instances, reporting entities may need to consider other available indicators of creditworthiness, such as publicly traded debt or loans.

In the absence of any observable indicator of creditworthiness, a reporting entity may be required to combine a number of factors to arrive at an appropriate credit valuation adjustment. For example, it may be necessary to determine an appropriate credit spread using a combination of own issuance credit spread data, publicly available information on competitors' debt pricing, sector specific CDS spreads or relevant indices, or historical company or sector-specific probabilities of default.

In all cases, identifying the basis for selecting the proxy, benchmark or input, including any analysis performed and assumptions made, should be documented. Such an analysis may include calculating financial ratios to evaluate the reporting entity's financial position relative to its peer group and their credit spreads. These metrics may consider liquidity, leverage and general financial strength, as well as comparable attributes such as credit ratings, similarities in business mix and level of regulation or geographic footprint.

The use of historical default rates would seem to be inconsistent with the exit price notion in IFRS 13, particularly when credit spread levels in the current environment differ significantly from historical averages. Therefore, when current observable information is unavailable, management should adjust historical data to arrive at its best estimate of the assumptions that market participants would use to price the instrument in an orderly transaction in the current market.

Figure 10-3 below highlights some of the common sources of credit information and the advantages and disadvantages of using each input for the credit adjustment calculation.

Figure 10-3: Credit data requirements

Data requirements	Advantages	Disadvantages
CDS curve (own or counterparty)	▸ Market observable ▸ Information is current (for counterparties with adequate CDS trading volume) ▸ Easy to source from third party data providers ▸ Exposure specific data available for most banking counterparties	▸ Not available for many entities ▸ May not be representative of all the assets of the entity ▸ May have liquidity issues due to low trading volumes, resulting in higher-than-expected spreads and additional volatility in calculations ▸ CDS quotes may be indicative quotes, not necessarily reflective of actual trades
Current debt credit spread	▸ Market observable ▸ Available for some publicly traded debt instruments ▸ Easy to source from third party data providers	▸ May require an adjustment for illiquidity ▸ May require a judgemental adjustment due to maturity mismatch and amount of security of debt issuance and derivative to be valued
Sector-specific CDS Index or competitor CDS Curve	▸ Market-observable ▸ Information is current ▸ Easy to source from third party data providers ▸ Proxy CDS curve mapping is possible for almost all entities	▸ Not exposure-specific; may require judgemental adjustments to reflect differences between proxy and entity (e.g., size, credit rating) ▸ Index CDS curves can be influenced by macro-economic factors, which do not affect entity or affect entity to a lesser or greater extent
Debt issuance credit spread	▸ Market observable ▸ Information can be current, when a recent issuance can be referenced (or when pricing terms are available ahead of debt issuance) ▸ Easy to source from third party data providers and/or from treasurer, through communications with the banks	▸ Information can be outdated and may require an adjustment for illiquidity ▸ As it is not always possible to reference a recent issuance, a judgemental adjustment may be required to bridge gap between debt issue date and derivative valuation date (i.e., financial reporting date) ▸ May require a judgemental adjustment due to maturity mismatch of debt issuance and derivative to be valued
Credit rating/historical default information (e.g., Moody's publication of Historic Probability of Default)	▸ Rating agency data available for most entities ▸ Easy to source from third party data providers	▸ Information can be outdated ▸ Conversion to probability of default may be based on historical information ▸ May require an adjustment from long-term average measure to a 'point-in-time' measure ▸ Not associated with a specific maturity; ratings are generally long-term average estimates of creditworthiness, which may not be appropriate for short term derivatives
Internal credit risk analysis	▸ May be applied by most entities ▸ Ability to customise internal models	▸ Based on unobservable information ▸ Information can be outdated ▸ May not be consistent with what other market participants would use

10.3.3 Does the existence of master netting agreements and/or CSAs eliminate the need to consider an entity's own credit risk when measuring the fair value of derivative liabilities?

IFRS 13 is clear that non-performance risk should be considered from the perspective of the liability being measured, not the entity obligated under the liability. As such, non-performance risk may differ for various liabilities of the same entity. This difference may result from the specific terms of the liability (e.g., seniority or priority in the event of liquidation) or from specific credit enhancements related to the liability (e.g., collateral).

Bilateral collateral arrangements, master netting agreements and other credit enhancement or risk mitigation tools will reduce the credit exposure associated with a liability (or asset) and should be considered in determining the fair value of the liability. Although these agreements reduce credit exposure, they typically do not eliminate the exposure completely. For example, most CSAs do not require collateral to be posted until a certain threshold has been reached, and once reached require collateral only for the exposure in excess of the threshold. Therefore, while the existence of master netting agreements or CSAs mitigates the effect of own credit risk on the fair value of a liability, their presence alone would not enable an entity to ignore its own credit risk. Entities should assess their credit exposure to a specific liability when determining how their own credit risk would affect its fair value.

10.3.3.A Portfolio approaches and credit mitigation arrangements

When calculating derivative credit adjustments, reporting entities may factor in their ability to reduce their counterparty exposures through any existing netting or collateral arrangements. The measurement exception in IFRS 13 (see section 11 below) allows a reporting entity to measure the net credit risk of a portfolio of derivatives to a single counterparty, assuming there is an enforceable arrangement in place that mitigates credit risk upon default (e.g., a master netting agreement). *[IFRS 13.48]*.

- *Netting arrangements*

  A master netting agreement is a legally binding contract between two counterparties to net exposures under other agreements or contracts (e.g., relevant ISDA agreements, CSAs and any other credit enhancements or risk mitigation arrangements in place) between the same two parties. Such netting may be effected with periodic payments (payment netting), settlement payments following the occurrence of an event of default (close-out netting) or both. In cases of default, such an agreement serves to protect the parties from paying out on the gross amount of their payable positions, while receiving less than the full amount on their gross receivable positions with the same counterparty.

  IFRS 7 requires disclosure of the effects of set-off and related netting on an entity's financial position (see Chapter 50 for further discussion).

  In situations where an entity meets the criteria to apply the measurement exception in IFRS 13 (discussed in section 11 below), it will still need to assess whether it has the practical ability to implement a credit valuation method which reflects the net counterparty exposure. This can be challenging, particularly for those entities that do not have systems in place to capture the relevant net positions by debtor/counterparty. Also, an allocation of the portfolio level adjustments is required, as discussed in section 10.3.3.B below.

  A further complication arises if the net exposure represents the position across different classes of derivatives (e.g., interest rate swaps and foreign exchange forwards). Basic valuation methods can attempt to approximate a net position through the creation of an appropriate 'modelled net position' representing the net risk.

- *Collateral arrangements*

  In many instances, counterparty credit exposure in derivative transactions can be further reduced through collateral requirements. Such arrangements serve to limit the potential exposure of one counterparty to the other by requiring the out-of-the-money counterparty to post collateral (e.g., cash or liquid securities) to the in-the-money counterparty. While these and other credit mitigation arrangements often serve to reduce credit exposure, they typically do not eliminate the exposure completely.

  Many collateral agreements, for example, do not require collateral to be posted until a certain threshold has been reached, and then, collateral is required only for the exposure in excess of the threshold. In addition, even when transactions with a counterparty are subject to collateral requirements, entities remain exposed to what is commonly referred to as 'gap risk' (i.e., the exposure arising from fluctuations in the value of the derivatives before the collateral is called and between the time it is called and the time it is actually posted).

Finally, collateral arrangements may be either unilateral or bilateral. Unilateral arrangements require only one party to the contract to post collateral. Under bilateral agreements, both counterparties are subject to collateral requirements, although potentially at different threshold levels.

Given their ability to reduce credit exposure, netting and collateral arrangements are typically considered in determining the CVA for a portfolio of derivatives. This can add to the complexity of the calculation as total expected credit exposure should be determined not just for a single derivative contract (whose value changes over time), but for a portfolio of derivative contracts (which can include both derivative assets and derivative liabilities). Simply taking the sum of the CVA of individual trades could dramatically overstate the potential credit exposure, as it would not take into account positions in the portfolio with offsetting exposures. Consequently, when netting agreements and collateral arrangements are in place, and a company has elected to measure its derivative positions with offsetting credit risk using the measurement exception in IFRS 13, the expected exposure is generally analysed at the portfolio level (i.e., on a net basis).

10.3.3.B Portfolio-level credit adjustments

The measurement exception (the portfolio approach) permits measuring non-performance risk of derivatives with the same counterparty on a portfolio basis (see section 11 below), allowing the mitigating effect of CSAs and master netting agreements to have their full effect in the financial statements taken as a whole. The use of the measurement exception does not change the fact that the unit of account is the individual derivative contract, a concept particularly important when an individual derivative is designated as a hedging instrument in a hedging relationship.

There is no specific guidance under IFRS on how portfolio level credit adjustments should be allocated to individual derivatives. A number of quantitative allocation methods have been observed in practice and have been accepted as long as a reporting entity is able to support that the method is: (a) reasonable in the circumstances; and (b) applied consistently. *[IFRS 13.50].* Given the continued focus on credit adjustments and changing banking regulation, it is likely that sophisticated valuation methods will become more widespread and standardised.

10.4 Restrictions preventing the transfer of a liability or an entity's own equity

A liability or an entity's own equity may be subject to restrictions that prevent the transfer of the item. When measuring the fair value of a liability or equity instrument, IFRS 13 does not allow an entity to include a separate input (or an adjustment to other inputs) for such restrictions. This is because the effect of the restriction is either implicitly or explicitly included in other inputs to the fair value measurement. The standard gives the example of both a creditor and an obligor accepting a transaction price for a liability with full knowledge that the obligation includes a restriction that prevents its transfer. In this case, the restriction is implicitly included in the price. Therefore, further adjustment would be inappropriate. *[IFRS 13.45, IFRS 13.46]*. In Example 11 in the standard (extracted in section 10.2.2.A above), the fair value of the decommissioning liability was not adjusted for the existence of a restriction because that restriction was contemplated in developing the inputs to the valuation techniques used to measure fair value.

IFRS 13 states that a separate adjustment for lack of transferability is not necessary for either the initial or subsequent fair value measurement of a liability. This differs from the treatment of asset restrictions. *[IFRS 13.46]*. IFRS 13 considers liability restrictions and asset restrictions differently because:

- Restrictions on the transfer of a liability relate to the performance of the obligation (i.e., the entity is legally obliged to satisfy the obligation and needs to do something to be relieved of the obligation), whereas restrictions on the transfer of an asset relate to the marketability of the asset.
- Unlike assets, virtually all liabilities include a restriction preventing their transfer. As a result, the effect of a restriction preventing the transfer of a liability would, in theory, be consistent for all liabilities.

The standard also appears to assume that the effect of a restriction on the fair value of a liability remains constant over the life of the liability. Therefore, no additional adjustments are required in subsequent measurements if the effect of the restriction was already captured in the initial pricing of the liability. Unlike restrictions on assets, which typically expire and whose effect on fair value changes over time, restrictions on liabilities usually remain throughout the life of the obligation.

How we see it

The Basis for Conclusions to IFRS 13 states that if an entity is aware that a restriction on transfer is not already reflected in the price (or in the other inputs used in the measurement), it would adjust the price or inputs to reflect the existence of the restriction. However, in our view this would be rare because nearly all liabilities include a restriction and, when measuring fair value, market participants are assumed by IFRS 13 to be sufficiently knowledgeable about the liability to be transferred.

10.5 Financial liability with a demand feature

IFRS 13 states the following: *[IFRS 13.47]*

Extract from IFRS 13	
47	The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

This requirement is consistent with the requirements in IFRS 9. In many cases, the observed market price for these financial liabilities would be the demand amount, i.e., the price at which they are originated between the customer and the deposit-taker. Recognising such a financial liability at less than the demand amount may give rise to an immediate gain on the origination of the deposit, which the IASB believes is inappropriate. *[IFRS 13.BCZ102, IFRS 13.BCZ103]*.

11 Financial assets and liabilities with offsetting positions

IFRS 13 specifies that the concepts of 'highest and best use' and 'valuation premise' are not relevant when measuring the fair value of financial instruments. Therefore, the fair value of financial assets and financial liabilities is based on the unit of account prescribed by the IFRS that requires (or permits) the fair value measurement, which is generally the individual financial instrument. However, IFRS 13 provides a measurement exception that allows an entity to determine the fair value of a group of financial assets and liabilities with offsetting risks based on the sale or transfer of its *net* exposure to a particular risk (or risks), if certain criteria are met. *[IFRS 13.48]*. This measurement approach is an exception to the principles of fair value because it represents an entity-specific measure (i.e., an entity's net risk exposure is a function of the other financial instruments specifically held by that entity and its unique risk preferences).

It may be possible for entities to offset multiple risks (e.g., both market and credit risks) within the same portfolio. In addition, since the focus is on offsetting risks, entities may offset credit and market risks stemming from a group of financial instruments at different levels of aggregation. For example, under IFRS 13, management could continue its existing practice of offsetting credit risk at the counterparty level (e.g., based on its portfolio of interest rate swaps with a particular counterparty) while offsetting market risks on a more aggregated portfolio basis (e.g., based on its portfolio of interest rate swaps with all counterparties), provided all of the criteria in section 11.1 below are met.

This guidance is largely consistent with practice under IFRS prior to adoption of IFRS 13 when determining valuation adjustments for derivative instruments related to bid-ask spreads and credit risk.

11.1 Criteria for using the portfolio approach for offsetting positions

Entities that hold a group of financial assets and liabilities are generally exposed to market risks (e.g., interest rate risk, currency risk or other price risk) and to the credit risk of each of its counterparties. IFRS 13 allows entities to make an accounting policy choice (see section 11.1.1 below) to measure the fair value of a group of financial assets and liabilities based on the price that would be received to sell a net long position or transfer a net short position for a particular risk exposure (that is, a portfolio approach). In order to use the portfolio approach, entities are required to meet all of the following criteria, both initially and on an ongoing basis: *[IFRS 13.49]*

- The entity manages the group of financial assets and financial liabilities on the basis of the entity's net exposure to a particular market risk(s) or credit risk, in accordance with the entity's documented risk management or investment strategy
- The entity provides information based on the group of financial assets and financial liabilities to the entity's key management personnel (as defined in IAS 24, see Chapter 35)
- The entity measures (either by requirement or by choice) the financial assets and financial liabilities at fair value in the statement of financial position at each reporting date

The measurement exception for offsetting positions only applies to financial assets and financial liabilities within the scope of IFRS 9. *[IFRS 13.52]*. Also, as indicated by these criteria, the portfolio approach only applies to financial instruments with offsetting risks. As such, a group of financial instruments comprised of only financial assets (e.g., a portfolio of loans) would not qualify for the exception and would need to be valued in a manner consistent with the appropriate unit of account. However, an entity need not maintain a static portfolio to use the measurement exception, i.e., the entity could have assets and liabilities within the portfolio that are traded.

When the standard was issued, IFRS 13.52 stated that the measurement exception only applied to financial assets and financial liabilities within the scope of IFRS 9. However, it was not the Boards' intention to exclude contracts to buy or sell a non-financial item (e.g., physically settled commodity derivative contracts) that are within the scope of IFRS 9 (and that are measured at fair value) from the scope of the measurement exception. *[IFRS 13.BC119A, IFRS 13.BC119B]*. If a contract to buy or sell a non-financial item is within the scope of IFRS 9, those standards treat that contract as if it were a financial instrument. Therefore, the IASB amended IFRS 13.52 to clarify that all contracts within the scope of IFRS 9 are eligible for the measurement exception, regardless of whether they meet the definitions of financial assets or financial liabilities in IAS 32. *[IFRS 13.52]*.

Frequently asked questions

Question 11-1: Is there a minimum level of offset required to use the portfolio approach?

While there are explicit criteria that an entity must meet in order to use the portfolio approach, IFRS 13 does not specify any minimum level of offset within the group of financial instruments.

How we see it

If, for example, an entity has positions with offsetting credit risk to a particular counterparty, we believe use of the portfolio approach is appropriate even if the extent of offset is minimal (provided that the entity has in place a legally enforceable agreement, as discussed in section 11.2.2 below, that provides for offsetting upon default and all the other required criteria are met). To illustrate, even if the gross credit exposure was CU100,000 (long) and CU5,000 (short), upon counterparty default the entity would be exposed to a credit loss of only CU95,000 under the terms of its master netting agreement.

With respect to market risk, considering the degree of offset may require additional judgement. Entities should assess the appropriateness of using the portfolio approach based on the nature of the portfolio being managed (e.g., derivative versus cash instruments) and its documented risk management policies (or investment strategies). An entity should use the portfolio approach in a manner consistent with the IASB's basis for providing the measurement exception and not in a manner to circumvent other principles within the standard.

Question 11-2: Can Level 1 instruments be included in a portfolio of financial instruments with offsetting risks when calculating the net exposure to a particular market risk?

It is our understanding that Level 1 instruments can be included when using the exception to value financial instruments with offsetting risks. An entity is allowed to consider the effect of holding futures contracts when evaluating its net exposure to a particular market risk, such as interest rate risk. IFRS 13.54 gives an example stating that 'an entity would not combine the interest rate risk associated with a financial asset with the commodity price risk associated with a financial liability because doing so would not mitigate the entity's exposure to interest rate risk or commodity price risk'. *[IFRS 13.54]*.

We understand that some constituents believe that the requirement in IFRS 13 to measure instruments that trade in active markets based on P×Q does not apply to the measurement of the net exposure when the portfolio exception is used, since the net exposure does not trade in an active market. As such, these constituents argue that the measurement of the net exposure and the allocation of this value back to the instruments that comprise the group are not constrained by the price at which the individual instruments trade in active markets. Others believe that although Level 1 instruments, such as futures contracts, may be considered when calculating an entity's net exposure to a particular market risk, the quoted price (unadjusted) for these Level 1 instruments should be used when allocating the fair value to the individual units of account for presentation and disclosure purposes, to comply with the requirement in IFRS 13 to measure Level 1 instruments at P×Q. However, depending on the extent of Level 1 instruments in the group, it may not always be possible to allocate the fair value determined for the net exposure back to the individual instruments in a manner that results in each of these instruments being recorded at P×Q. For this reason, there are constituents who believe that the use of the portfolio exception should never result in the measurement of Level 1 instruments at an amount other than P×Q. That is, the determination of the fair value of the net exposure is constrained by the requirement that all Level 1 instruments within the group are recorded at a value based on P×Q.

As discussed in section 4.1.2 above, we understand that the IASB did not intend the portfolio exception to change existing practice under IFRS or override the requirement in IFRS 13 to measure Level 1 instruments at P×Q or the prohibition on block discounts. However, given the lack of clarity, some have asked questions about how these requirements would apply in practice. In 2013, the IFRS IC referred a request to the Board on the interaction between the use of Level 1 inputs and the portfolio exception. The IASB discussed this issue in December 2013, but only in relation to portfolios that comprise only Level 1 financial instruments whose market risks are substantially the same. The Board tentatively decided that the measurement of such portfolios should be the one that results from multiplying the net position by the Level 1 prices. Therefore, in September 2014, the IASB proposed adding a non-authoritative example to illustrate the application of the portfolio exception in these circumstances (included in section 11.2 below).

As discussed in section 4.1.2 above and section 11.2 below, in April 2015, after considering responses to this proposal from constituents, the IASB concluded it was not necessary to add the proposed illustrative example to IFRS 13.

11.1.1 Accounting policy considerations

As noted above, the use of the portfolio approach is an accounting policy decision, to be made in accordance with IAS 8 (see Chapter 3), which must include an entity's policy regarding measurement assumptions - i.e., for both allocating bid-ask adjustments and credit adjustments (see section 11.2 below).

An entity can choose to use the portfolio approach on a portfolio-by-portfolio basis. In addition, if entities choose this policy for a particular portfolio, they are not required to apply the portfolio approach to all of the risks of the financial assets and liabilities that make up the particular group. For example, an entity could choose to measure only the credit risk associated with a group of financial instruments on a net basis, but not the group's exposure to market risk.

An entity may also decide to apply the portfolio approach to only certain market risks related to the group. For example, an entity that is exposed to both interest rate and foreign currency risk in a portfolio of financial assets and liabilities could choose to measure only its interest rate risk exposure on a net basis.

The accounting policy decision can be changed if an entity's risk exposure preferences change, for example, a change in strategy to have fewer offsetting positions. In that case, the entity can decide not to use the exception but instead to measure the fair value of its financial instruments on an individual instrument basis. We generally expect that an entity's use of the portfolio approach would be consistent from period to period as changes in risk management policies are typically not common. *[IFRS 13.51, IFRS 13.BC121]*.

11.1.2 Presentation considerations

IFRS 13 is clear that applying the portfolio approach for measurement purposes does not affect financial statement presentation. For example, an entity might manage a group of financial assets and liabilities based on the net exposure(s) for internal risk management or investment strategy purposes, but be unable to present those instruments on a net basis in the statement of financial position because the entity does not have a positive intention and ability to settle those instruments on a net basis, as is required by IAS 32. *[IAS 32.42]*.

If the requirements for presentation of financial instruments in the statement of financial position differ from the basis for the measurement, an entity may need to allocate the portfolio-level adjustments (see section 11.2 below) to the individual assets or liabilities that make up the portfolio. Entities may also need to allocate portfolio-level adjustments for disclosure purposes when items in the group would be categorised within different levels of the fair value hierarchy (see section 15 below for additional discussion on the allocation of portfolio-level adjustments related to the fair value hierarchy disclosures).

IFRS 13 does not prescribe any methodologies for allocating portfolio-level adjustments; instead, it states that the allocation should be performed in a reasonable and consistent manner that is appropriate in the circumstances. *[IFRS 13.50]*.

11.2 Measuring fair value for offsetting positions

If the portfolio approach is used to measure an entity's net exposure to a particular market risk, the net risk exposure becomes the unit of measurement. That is, the entity's net exposure to a particular market risk (e.g., the net long or short Euro interest rate exposure within a specified maturity bucket) represents the asset or liability being measured.

In applying the portfolio approach, an entity must assume an orderly transaction between market participants to sell or transfer the net risk exposure at the measurement date under current market conditions. The fair value of the portfolio is measured on the basis of the price that would be received to sell a net long position (i.e., an asset) for a particular risk exposure or transfer a net short position (i.e., a liability) for a particular risk exposure. *[IFRS 13.48]*. That is, the objective of the valuation is to determine the price that market participants would pay (or receive) in a single transaction for the entire net risk exposure, as defined.

Some argue that, as a result, an adjustment based on the size of the net exposure could be considered in the valuation if market participants would incorporate such an adjustment when transacting for the net exposure. Since the unit of measurement is the net exposure, size is considered a characteristic of the asset (net long position) or liability (net short position) being measured, not a characteristic of the entity's specific holdings. Many have interpreted the equivalent requirements in US GAAP in this way.

Others believe that the portfolio exception does not override the unit of account guidance provided in IFRS 9 and, therefore, any premiums or discounts that are inconsistent with that unit of account, i.e., the individual financial instruments within the portfolio, must be excluded. This would include any premiums or discounts related to the size of the portfolio. As discussed in section 4.1.2 above, we understand the IASB did not intend the portfolio exception to override the requirement in IFRS 13 to measure Level 1 instruments at P×Q or the prohibition on block discounts which raises questions as to how the portfolio exception would be applied to Level 1 instruments.

In 2013, the IFRS IC referred a request to the Board on the interaction between the use of Level 1 inputs and the portfolio exception. The IASB discussed this issue in December 2013, but only in relation to portfolios that comprise only Level 1 financial instruments whose market risks are substantially the same. The Board tentatively decided that the measurement of such portfolios should be the one that results from multiplying the net position by the Level 1 prices. In September 2014, the IASB proposed adding the following non-authoritative example to illustrate the application of the portfolio exception in these circumstances.[24]

Extract from Exposure draft: ED/2014/4 *Measuring Quoted Investments in Subsidiaries, Joint Ventures and Associates at Fair Value*

Example 13A-Applying the exception in paragraph 48 of the IFRS to a group of financial assets and financial liabilities whose market risks are substantially the same and whose fair value measurement is categorised within Level 1 of the fair value hierarchy

Entity A holds a group of financial assets and financial liabilities consisting of a long position of 10,000 financial assets and a short position of 9,500 financial liabilities whose market risks are substantially the same. Entity A manages that group of financial assets and financial liabilities on the basis of its net exposure to market risks. The fair value measurement of all the financial instruments in the group is categorised within Level 1 of the fair value hierarchy.

The mid-price and the most representative bid and ask prices are as follows:

CU	Bid	Mid	Ask
Most representative exit price	99	100	101

Entity A applies the exception in paragraph 48 of the IFRS that permits Entity A to measure the fair value of the group of financial assets and financial liabilities on the basis of the price that would be received to sell, in this particular case, a net long position (ie an asset) in an orderly transaction between market participants at the measurement date under current market conditions.

Accordingly, Entity A measures the net long position (500 financial assets) in accordance with the corresponding Level 1 prices. Because the market risks arising from the financial instruments are substantially the same, the measurement of the net position coincides with the measurement of the exposure arising from the group of financial assets and financial liabilities. Consequently, Entity A measures the group of financial assets and financial liabilities on the basis of the price that it would receive if it would exit or close out its outstanding exposure as follows:

	Quantity held (Q)	Level 1 price (CU) (P)	(CU) P×Q
Net long position	500	99	49,500

Entity A would have also achieved the same measurement of CU49,500 by measuring the net long position at the mid-price (ie CU100 × 500 = CU50,000) adjusted by a bid-offer reserve (CU1 × 500 = CU500).

Entity A allocates the resulting measurement (ie CU49,500) to the individual (10,000) financial assets and (9,500) financial liabilities. In accordance with paragraph 51 of the IFRS, Entity A performs this allocation on a reasonable basis that is consistent with previous allocations of that nature using a methodology appropriate to the circumstances.

24 Exposure Draft ED/2014/4: *Measuring Quoted Investments in Subsidiaries, Joint Ventures and Associates at Fair Value: Proposed amendments to IFRS 10, IFRS 12, IAS 27, IAS 28, IAS 36 and Illustrative Examples for IFRS 13*, IASB, September 2014, Proposed illustrative example 13A, paragraphs IE47A-IE47G. Available on the IFRS Foundation's website.

In response to this proposal, some respondents raised concerns because they believed there was a risk that constituents may infer principles from this simple example that could lead to unintended consequences. Respondents noted that the illustrative example did not address:

- Other scenarios and circumstances to which the portfolio approach would apply. For example, situations where the instruments in the portfolio are categorised within Level 2 or Level 3 of the fair value hierarchy or for which different Level 1 prices are available.

  Nor

- Allocation of the resulting measurement to each instrument in the portfolio for disclosure purposes

The proposed illustrative example also raised questions about the interaction between the portfolio exception and the use of mid-market pricing as a practical expedient in accordance with IFRS 13.71 and may have required clarification of the term 'bid-offer reserve adjustment' used in the example. Despite these concerns, the majority of the respondents agreed that the proposed additional illustrative example appropriately illustrated application of the portfolio approach.[25]

As discussed in section 4.1.2 above, in April 2015, after considering responses to this proposal from constituents, the IASB concluded that it was not necessary to add the proposed illustrative example to IFRS 13. However, in reaching this decision, the Board noted that the proposed illustrative example appropriately illustrated the application of the portfolio approach. "That is, if an entity elects to use the exception in paragraph 48 of IFRS 13, the appropriate fair value measurement of the net risk exposure arising from a group of financial assets and financial liabilities whose market risks are substantially the same, and whose fair value measurement is categorised within Level 1 of the fair value hierarchy, would be determined by multiplying the financial instruments included in the resulting net position by the corresponding unadjusted Level 1 price".[26] *[IFRS 13.48]*.

How we see it

While the proposed non-authoritative example provides one approach to consider, in light of the above discussion, entities will need to use judgement to determine the most appropriate approach to employ when applying the portfolio exception.

When measuring fair value using the portfolio approach, IFRS 13 also requires that the market risks be substantially the same (see section 11.2.1 below) and that the fair value measurement must take into consideration any exposure to the credit risk of a particular counterparty (see section 11.2.2 below).

It is also important to note that when applying the portfolio approach, entities may offset credit and market risks at different levels of aggregation. This approach is consistent with risk management practices employed by many entities. Such an approach may be required because it is unlikely that all of the financial assets and liabilities giving rise to the net exposure for a particular market risk will be with the same counterparty. The example below illustrates this concept.

25 IASB Staff Paper 6: Project: *Measuring Quoted Investments in Subsidiaries, Joint Ventures and Associates at Fair Value: Proposed amendments to IFRS 10, IFRS 12, IAS 27, IAS 28 and IAS 36 and Illustrative Examples for IFRS 13*, IASB meeting, April 2015, Illustrative Example for IFRS 13 - Portfolios. Available on the IFRS Foundation's website.

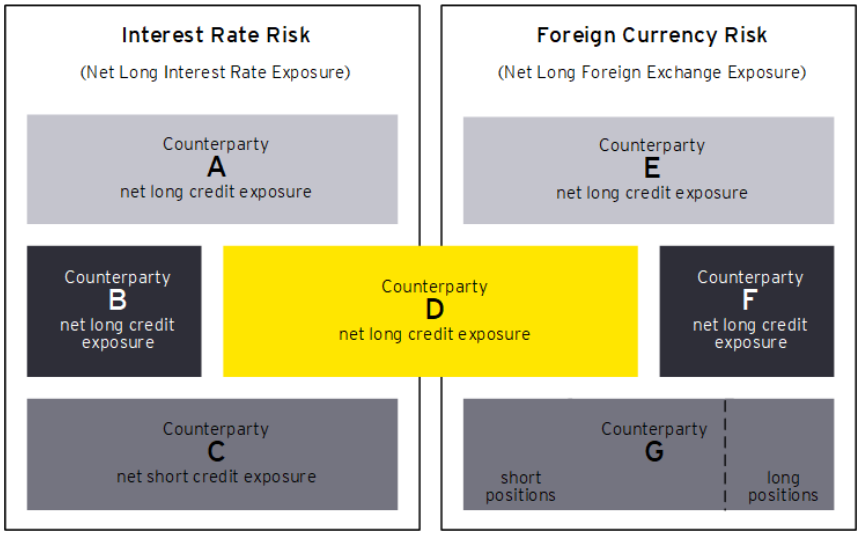
26 *IASB Update*, April 2015, available on the IFRS Foundation's website.

Illustration 11-1: Calculating net exposure

Entity XYZ holds a portfolio of long and short derivative positions (USD interest rate swaps and USD/JPY foreign currency forwards) with various counterparties as follows:

- Counterparties A, B and C: only interest rate swaps.
- Counterparty D: interest rate swaps and foreign currency forwards.
- Counterparties E, F and G: only foreign currency forwards.

Entity XYZ has executed master netting agreements in respect of credit risk with each of its counterparties except counterparty G. In addition, the agreement in place with counterparty D can be applied across products.



Using the measurement exception, Entity XYZ may consider its credit risk exposure to each individual counterparty except counterparty G on a net basis (i.e., net long credit exposure to Counterparty A, net short credit exposure to Counterparty C, etc).

At the same time, the entity may consider its net long exposure to USD interest rate risk from its portfolio of derivatives with counterparties A, B, C and D. The entity may also consider its net long exposure to foreign currency risk (Japanese yen risk) from its portfolio of derivatives with counterparties D, E, F and G.

11.2.1 Exposure to market risks

When measuring fair value using the measurement exception for offsetting positions, the entity is required to ensure the following in relation to market risks:

- Market risk (or risks), to which the entity is exposed within that portfolio, is substantially the same. For example, combining the interest rate risk associated with a financial asset with the commodity price risk associated with a financial liability would not be appropriate because it would not mitigate the entity's exposure to interest rate risk or commodity price risk.

  The standard requires any basis risk resulting from the market risk parameters not being identical to be taken into account in the fair value measurement of the financial assets and financial liabilities within the group. *[IFRS 13.54]*.
- The duration of the entity's exposure to a particular market risk (or risks) must be substantially the same. *[IFRS 13.55]*.

  The standard gives the example of an entity that uses a 12-month futures contract against the cash flows associated with 12 months' worth of interest rate risk exposure on a five-year financial instrument. The futures and five-year financial instruments are within a group that is made up of only those financial assets and financial liabilities. The entity measures the fair value of the exposure to 12-month interest rate risk on a net basis and the remaining interest rate risk exposure (i.e., years 2-5) on a gross basis.

Management selects the price within the bid-ask spread that is most representative of fair value in the circumstances to the entity's net exposure to the particular market risk(s) (pricing within the bid-ask spread is discussed further in section 14.3 below). *[IFRS 13.53]*.

11.2.2 Exposure to the credit risk of a particular counterparty

In some cases, an entity might enter into an arrangement to mitigate the credit risk exposure in the event of default, for example, a master netting agreement with the counterparty or the exchange of collateral on the basis of each party's net exposure to the credit risk of the other party.

An entity is not required to prove that such agreements will be legally enforceable in all jurisdictions to use the measurement exception. Instead, an entity should consider market participant expectations about the likelihood that such an arrangement would be legally enforceable in the event of default when valuing the net credit exposure. *[IFRS 13.56]*.

When market participants would take into account any of these existing arrangements, the fair value measurement (using the measurement exception for offsetting positions) must include the effect of the entity's net exposure to the credit risk of that counterparty and/or the counterparty's net exposure to the credit risk of the entity.

12 Fair value at initial recognition

12.1 Exit price versus entry price

IFRS 13 defines fair value as the price that would be received to sell the asset or paid to transfer the liability; this is an exit price notion. When an entity acquires an asset, or assumes a liability, the price paid (or the transaction price) is an entry price. Conceptually, entry prices and exit prices are different. Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them. This distinction is significant and can have important implications on the initial recognition of assets and liabilities at fair value. However, IFRS 13 acknowledges that, in many cases, an entry price may equal an exit price (e.g., when the transaction takes place in the entity's principal market); since one party is selling an asset, that transaction is also an exit transaction. *[IFRS 13.57, IFRS 13.58]*.

12.1.1 Assessing whether the transaction price equals fair value at initial recognition

Prior to the issuance of IFRS 13, it was common for entities to use the transaction price as fair value of an asset or liability on its initial recognition. While IFRS 13 acknowledges that in many situations, an entry price may equal an exit price, it does not presume that these prices are equal. Therefore, an entity must determine whether the transaction price represents the fair value of an asset or liability at initial recognition. *[IFRS 13.59]*.

IFRS 13.B4 provides certain factors that an entity should consider in making this determination. For example, a transaction price may not represent fair value if the unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value. *[IFRS 13.B4(c)]*. This may be the case with a complex financial instrument where the transaction price includes a fee for structuring the transaction or when an entity acquires a block and the transaction price includes a block discount.

Another factor to consider is whether the market in which an entity acquired the asset (or assumed the liability) is different from the principal (or most advantageous) market in which the entity will sell the asset (or transfer the liability). *[IFRS 13.B4(d)]*. For example, a securities dealer may acquire an asset in the retail market but sell it in the inter-dealer market. However, the fair value measurement should consider the fact that, while the inter-dealer price (i.e., the exit price in a hypothetical transaction) may differ from the retail price (i.e., transaction price), another dealer would also expect to earn a profit on the transaction. Accordingly, a pricing model's value should incorporate assumptions regarding the appropriate profit margin that market participants (i.e., other dealers) would demand when estimating the instrument's fair value at inception.

Other examples identified by IFRS 13.B4 when assessing whether the transaction price equals fair value include the following: *[IFRS 13.B4(a)-(b)]*

- The transaction is between related parties - although IFRS 13 does allow the price in a related party transaction to be used as an input into a fair value measurement if the entity has evidence that the transaction was entered into at market terms
- The transaction takes place under duress or the seller is forced to accept the price in the transaction - for example, if the seller is experiencing financial difficulty

In addition, the measurement of fair value in accordance with IFRS 13 should take into consideration market participant assumptions about risk. Adjustments for uncertainty associated with a valuation technique or certain inputs used to measure fair value are required if market participants would incorporate such risk adjustments when pricing the asset or liability. A measurement (e.g., a 'mark-to-model' measurement) that ignores these market participant adjustments for risk is not representative of fair value.

While helpful in identifying the factors, entities should consider in assessing whether a transaction price would equal fair value, the examples provided in the standard are not intended to be exhaustive.

12.2 Day one gains and losses

IFRS 13's measurement framework applies to initial fair value measurements, if permitted or required by another IFRS. At initial recognition, if the measurement of fair value in accordance with IFRS 13 and the transaction price differ, the entity recognises the resulting gain or loss in profit or loss unless the related IFRS (i.e., the IFRS that permits or requires the initial measurement at fair value) specifies otherwise. *[IFRS 13.60]*. As noted in Example 7 in the standard (extracted in section 12.2.1 below), IFRS 9 has specific requirements with regard to the recognition of inception (or 'day one') gains and losses for financial instruments within the scope of the standard when fair value is determined using unobservable inputs (see Chapter 45). *[IFRS 9.B5.1.2A]*. In developing IFRS 13, the IASB did not change the recognition threshold in those standards in relation to day one gains or losses. However, IFRS 9 was amended to clarify that an entity: (i) measures the fair value of financial instruments at initial recognition in accordance with IFRS 13, then; (ii) considers the requirements of IFRS 9 in determining whether (and when) the resulting difference (if any) between fair value at initial recognition and the transaction price is recognised. *[IFRS 13.BC138]*.

FASB differences

US GAAP contains no specific threshold regarding the observability of fair value inputs. As such, US GAAP does not specifically prohibit the recognition of day-one gains or losses even when the fair value measurement is based on significant unobservable inputs.

12.2.1 Day one losses for over-the-counter derivative transactions

The definition of fair value as an exit price affects the accounting by retail customers as much as financial institutions (i.e., dealers). For example, retail customers whose entry and exit market for a financial asset (or financial liability) measured at fair value is with a wholesaler (e.g., a dealer) could experience a day one loss, because the price at which a wholesaler would sell a financial asset to a retail customer would generally exceed the price a wholesaler would pay to acquire that financial asset from a retail customer (this difference in price is commonly referred to as the bid-ask spread in many financial markets).

The following example from IFRS 13 discusses how an interest rate swap at initial recognition may be measured differently by a retail counterparty (i.e., an end-user) and a dealer. *[IFRS 13.IE Example 7, IFRS 13.IE24, IFRS 13.IE25, IFRS 13.IE26]*.

Extract from IFRS 13

Example 7-Interest rate swap at initial recognition

Entity A (a retail counterparty) enters into an interest rate swap in a retail market with Entity B (a dealer) for no initial consideration (ie the transaction price is zero). Entity A can access only the retail market. Entity B can access both the retail market (ie with retail counterparties) and the dealer market (ie with dealer counterparties).

From the perspective of Entity A, the retail market in which it initially entered into the swap is the principal market for the swap. If Entity A were to transfer its rights and obligations under the swap, it would do so with a dealer counterparty in that retail market. In that case the transaction price (zero) would represent the fair value of the swap to Entity A at initial recognition, ie the price that Entity A would receive to sell or pay to transfer the swap in a transaction with a dealer counterparty in the retail market (ie an exit price). That price would not be adjusted for any incremental (transaction) costs that would be charged by that dealer counterparty.

From the perspective of Entity B, the dealer market (not the retail market) is the principal market for the swap. If Entity B were to transfer its rights and obligations under the swap, it would do so with a dealer in that market. Because the market in which Entity B initially entered into the swap is different from the principal market for the swap, the transaction price (zero) would not necessarily represent the fair value of the swap to Entity B at initial recognition. If the fair value differs from the transaction price (zero), Entity B applies IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments* to determine whether it recognises that difference as a gain or loss at initial recognition.

This example seems to indicate that a retail counterparty may not have any gain or loss at initial recognition because the retail counterparty would likely be presumed to transact both at inception and on disposal (i.e., a hypothetical exit) in the same principal market (i.e., the retail market with securities dealers). However, this example does not address the bid-ask spread.

The bid-ask spread is the difference between the price a prospective dealer is willing to pay for an instrument (the 'bid' price) and the price at which the dealer would sell that same instrument (the 'ask' price), allowing the dealer to earn a profit for its role as a 'market maker' in the over-the-counter marketplace. The bid-ask spread may differ by dealer, as well as by the market and type of instrument that is being transacted.

IFRS 13 requires that instruments that trade in markets with bid-ask spreads (e.g., a dealer market) be measured at the price within the bid-ask spread that is most representative of fair value in the circumstances (pricing within the bid-ask spread is discussed further in section 14.3 below). Therefore, an inception loss could be experienced by the retail counterparty due to a difference in the price within the bid-ask spread that the retail counterparty could hypothetically exit the instrument and the price within the bid-ask spread that the retail counterparty actually transacted.

The IASB has acknowledged that the fair value of a financial instrument may differ from its transaction price because of the bid-ask spread, even when the entry and exit markets for the instrument are identical. *[IFRS 13.BC165]*. In addition to the bid-ask spread, retail counterparties may recognise additional losses or expenses at the inception of derivative contracts. For example, if the transaction price for a complex derivative includes a structuring fee, the retail counterparty would likely recognise a loss when measuring the fair value of the derivative. Because the transaction price includes the price for the derivative instrument, as well as the fee paid by the retail counterparty to the dealer for structuring the transaction, the unit of account represented by the transaction price differs from the unit of account for the instrument being measured, as discussed in IFRS 13. *[IFRS 13.B4(c)]*.

12.2.2 Day one gains and losses when entry and exit markets for the transaction are deemed to be the same

IFRS 13 contains no explicit prohibitions on the recognition of day one gains or losses, even in situations where the entry and exit markets are the same. For example, it may be acceptable in certain situations for a dealer to recognise a day one gain or loss on a transaction where the entry and exit markets are deemed to be the same (e.g., inter-dealer market). A difference in the price within the bid-ask spread at which a dealer could exit a transaction versus where it entered the transaction could be one reason to record an inception gain or loss. IFRS 13 clarifies that the exit price within the bid-ask spread that is most representative of fair value in the circumstances should be used to measure fair value, regardless of where in the fair value hierarchy the input falls (pricing within the bid-ask spread is discussed further in section 14.3 below).

Notwithstanding the guidance in IFRS 13, IFRS 9 provides specific requirements in relation to the recognition of any day one gains or losses. For example, where fair value is not measured using a quoted price in an active market (without adjustment), recognition of day one gains or losses is generally prohibited (see Chapter 45).

12.3 Related party transactions

As discussed in section 6 above, the definition of market participants makes it clear that buyers and sellers for the item being measured are not related parties (as defined in IAS 24, see Chapter 35). That is, the hypothetical transaction used to determine fair value in IFRS 13 is assumed to take place between market participants that are independent from one another. However, IFRS 13 indicates that the price in a related party transaction may be used as an input into a fair value measurement if there is evidence, the transaction was entered into at market terms. The Boards believe such an approach is consistent with the requirements of IAS 24. As with disclosures made in accordance with IAS 24, evidence to support that a related party transaction was executed at market terms may be difficult to substantiate absent corroborating market data from transactions between independent parties.

13 Valuation techniques

There are two key distinctions between the way previous IFRSs considered valuation techniques and the approach in IFRS 13. On adoption of the standard, these distinctions, in and of themselves, may not have changed practice. However, they may have required management to reconsider their methods of measuring fair value.

Firstly, IFRS 13's requirements in relation to valuation techniques apply to all methods of measuring fair value. Traditionally, references to valuation techniques in IFRS have indicated a lack of market-based information with which to value an asset or liability. Valuation techniques as discussed in IFRS 13 are broader and, importantly, include market-based approaches.

Secondly, IFRS 13 does not prioritise the use of one valuation technique over another, unlike previous fair value requirements, or require the use of only one technique (with the exception of the requirement to measure identical financial instruments that trade in active markets at price multiplied by quantity (P×Q)). Instead, the standard establishes a hierarchy for the inputs used in those valuation techniques, requiring an entity to maximise observable inputs and minimise the use of unobservable inputs (the fair value hierarchy is discussed further in section 15 below). *[IFRS 13.74]*. In some instances, the approach in IFRS 13 may be consistent with previous requirements in IFRS. For example, the best indication of fair value continues to be a quoted price in an active market. However, since IFRS 13 indicates that multiple techniques should be used when appropriate and sufficient data is available, judgement will be needed to select the techniques that are appropriate in the circumstances. *[IFRS 13.61]*.

13.1 Selecting appropriate valuation techniques

IFRS 13 recognises the following three valuation approaches to measure fair value:

- *Market approach:* based on market transactions involving identical or similar assets or liabilities
- *Income approach:* based on future amounts (e.g., cash flows or income and expenses) that are converted (discounted) to a single present amount
- *Cost approach:* based on the amount required to replace the service capacity of an asset (frequently referred to as current replacement cost)

IFRS 13 requires that an entity use valuation techniques that are consistent with one or more of the above valuation approaches (these valuation approaches are discussed in more detail in sections 13.2 to 13.4 below). *[IFRS 13.62]*. These approaches are consistent with generally accepted valuation methodologies used outside financial reporting. Not all of the approaches will be applicable to all types of assets or liabilities. However, when measuring the fair value of an asset or liability, IFRS 13 requires an entity to use valuation techniques that are appropriate in the circumstances and for which sufficient data is available. As a result, the use of multiple valuation techniques may be required. *[IFRS 13.61, IFRS 13.62]*.

The determination of the appropriate technique(s) to be applied requires significant judgement, sufficient knowledge of the asset or liability and an adequate level of expertise regarding the valuation techniques. Within the application of a given approach, there may be a number of possible valuation techniques. For instance, there are a number of different techniques used to value intangible assets under the income approach (such as the multi-period excess earnings method and the relief-from-royalty method - see Chapter 10 at section 5.5.2.F) depending on the nature of the asset.

As noted above, the fair value hierarchy does not prioritise the valuation techniques to be used; instead, it prioritises the inputs used in the application of these techniques. As such, the selection of the valuation technique(s) to apply should consider the exit market (i.e., the principal (or most advantageous) market) for the asset or liability and use valuation inputs that are consistent with the nature of the item being measured. Regardless of the technique(s) used, the objective of a fair value measurement remains the same - i.e., an exit price under current market conditions from the perspective of market participants. *[IFRS 13.2]*.

Selection, application, and evaluation of the valuation techniques can be complex. As such, reporting entities may need assistance from valuation professionals.

13.1.1 Single versus multiple valuation techniques

The standard does not contain a hierarchy of valuation techniques because particular valuation techniques might be more appropriate in some circumstances than in others.

Selecting a single valuation technique may be appropriate in some circumstances, for example, when measuring a financial asset or liability using a quoted price in an active market. However, in other situations, more than one valuation technique may be deemed appropriate and multiple approaches should be applied. For example, it may be appropriate to use multiple valuation techniques when measuring fair value less costs of disposal for a CGU to test for impairment. *[IFRS 13.63]*.

The nature of the characteristics of the asset or liability being measured and the availability of observable market prices may contribute to the number of valuation techniques used in a fair value analysis. For example, the fair value of a business is often estimated by giving consideration to multiple valuation approaches; such as an income approach that derives value from the present value of the expected future cash flows specific to the business and a market approach that derives value from market data (such as EBITDA or revenue multiples) based on observed transactions for comparable assets. On the other hand, financial assets that frequently trade in active markets are often valued using only a market approach given the availability and relevance of observable data.

Even when the use of a single approach is deemed appropriate, entities should be aware of changing circumstances that could indicate using multiple approaches may be more appropriate. For example, this might be the case if there is a significant decrease in the volume and level of activity for an asset or liability in relation to normal market activity. Observable transactions that once formed the basis for the fair value estimate may cease to exist altogether or may not be determinative of fair value and, therefore, require an adjustment to the fair value measurement (this is discussed further in section 7.3 above). As such, the use of multiple valuation techniques may be more appropriate.

13.1.2 Using multiple valuation techniques to measure fair value

When the use of multiple valuation techniques is considered appropriate, their application is likely to result in a range of possible values. IFRS 13 requires that management evaluate the reasonableness of the range and select the point within the range that is most representative of fair value in the circumstances. *[IFRS 13.63]*.

As with the selection of the valuation techniques, the evaluation of the results of multiple techniques requires significant judgement. The merits of each valuation technique applied, and the underlying assumptions embedded in each of the techniques, will need to be considered. Evaluation of the range does not necessarily require the approaches to be calibrated to one another (i.e., the results from different approaches do not have to be equal). The objective is to find the point in the range that most reflects the price to sell an asset or transfer a liability between market participants.

If the results from different valuation techniques are similar, the issue of weighting multiple value indications becomes less important since the assigned weights will not significantly alter the fair value estimate. However, when indications of value are disparate, entities should seek to understand why significant differences exist and what assumptions might contribute to the variance. IFRS 13 indicates that when evaluating results from multiple valuation approaches, a wide range of fair value measurements may be an indication that further analysis is needed. *[IFRS 13.B40]*. For example, divergent results between a market approach and income approach may indicate a misapplication of one or both of the techniques and would likely necessitate additional analysis.

The standard gives two examples that illustrate situations where the use of multiple valuation techniques is appropriate and, when used, how different indications of value are assessed.

Firstly, an entity might determine that a technique uses assumptions that are not consistent with market participant assumptions (and, therefore, is not representative of fair value). This is illustrated in Example 5 in the standard (included in the extract below), where the entity eliminates use of the cost approach because it determines a market participant would not be able to construct the asset itself. *[IFRS 13.IE Example 5, IFRS 13.IE15, IFRS 13.IE16, IFRS 13.IE17]*.

Extract from IFRS 13

Example 5-Software asset

An entity acquires a group of assets. The asset group includes an income-producing software asset internally developed for licensing to customers and its complementary assets (including a related database with which the software asset is used) and the associated liabilities. To allocate the cost of the group to the individual assets acquired, the entity measures the fair value of the software asset. The entity determines that the software asset would provide maximum value to market participants through its use in combination with other assets or with other assets and liabilities (ie its complementary assets and the associated liabilities). There is no evidence to suggest that the current use of the software asset is not its highest and best use. Therefore, the highest and best use of the software asset is its current use. (In this case the licensing of the software asset, in and of itself, does not indicate that the fair value of the asset would be maximised through its use by market participants on a stand-alone basis.)

The entity determines that, in addition to the income approach, sufficient data might be available to apply the cost approach but not the market approach. Information about market transactions for comparable software assets is not available. The income and cost approaches are applied as follows:

(a) The income approach is applied using a present value technique. The cash flows used in that technique reflect the income stream expected to result from the software asset (licence fees from customers) over its economic life. The fair value indicated by that approach is CU15 million.

(b) The cost approach is applied by estimating the amount that currently would be required to construct a substitute software asset of comparable utility (ie taking into account functional and economic obsolescence). The fair value indicated by that approach is CU10 million.

Through its application of the cost approach, the entity determines that market participants would not be able to construct a substitute software asset of comparable utility. Some characteristics of the software asset are unique, having been developed using proprietary information, and cannot be readily replicated. The entity determines that the fair value of the software asset is CU15 million, as indicated by the income approach.

Secondly, as is illustrated in Example 4 in the standard (included in the extract below), *[IFRS 13.IE Example 4, IFRS 13.IE11, IFRS 13.IE12, IFRS 13.IE13, IFRS 13.IE14]*, an entity considers the possible range of fair value measures and considers what is most representative of fair value by taking into consideration that:

- One valuation technique may be more representative of fair value than others
- Inputs used in one valuation technique may be more readily observable in the marketplace or require fewer adjustments (inputs are discussed further in section 14 below)
- The resulting range in estimates using one valuation technique may be narrower than the resulting range from other valuation techniques

  And
- Divergent results from the application of the market and income approaches would indicate that additional analysis is required, as one technique may have been misapplied, or the quality of inputs used in one technique may be less reliable

Extract from IFRS 13

Example 4-Machine held and used

An entity acquires a machine in a business combination. The machine will be held and used in its operations. The machine was originally purchased by the acquired entity from an outside vendor and, before the business combination, was customised by the acquired entity for use in its operations. However, the customisation of the machine was not extensive. The acquiring entity determines that the asset would provide maximum value to market participants through its use in combination with other assets or with other assets and liabilities (as installed or otherwise configured for use). There is no evidence to suggest that the current use of the machine is not its highest and best use. Therefore, the highest and best use of the machine is its current use in combination with other assets or with other assets and liabilities.

The entity determines that sufficient data are available to apply the cost approach and, because the customisation of the machine was not extensive, the market approach. The income approach is not used because the machine does not have a separately identifiable income stream from which to develop reliable estimates of future cash flows. Furthermore, information about short-term and intermediate-term lease rates for similar used machinery that otherwise could be used to project an income stream (ie lease payments over remaining service lives) is not available. The market and cost approaches are applied as follows:

(a) The market approach is applied using quoted prices for similar machines adjusted for differences between the machine (as customised) and the similar machines. The measurement reflects the price that would be received for the machine in its current condition (used) and location (installed and configured for use). The fair value indicated by that approach ranges from CU40,000 to CU48,000.

(b) The cost approach is applied by estimating the amount that would be required currently to construct a substitute (customised) machine of comparable utility. The estimate takes into account the condition of the machine and the environment in which it operates, including physical wear and tear (ie physical deterioration), improvements in technology (ie functional obsolescence), conditions external to the condition of the machine such as a decline in the market demand for similar machines (ie economic obsolescence) and installation costs. The fair value indicated by that approach ranges from CU40,000 to CU52,000.

The entity determines that the higher end of the range indicated by the market approach is most representative of fair value and, therefore, ascribes more weight to the results of the market approach. That determination is made on the basis of the relative subjectivity of the inputs, taking into account the degree of comparability between the machine and the similar machines. In particular:

(a) the inputs used in the market approach (quoted prices for similar machines) require fewer and less subjective adjustments than the inputs used in the cost approach.

(b) the range indicated by the market approach overlaps with, but is narrower than, the range indicated by the cost approach.

(c) there are no known unexplained differences (between the machine and the similar machines) within that range.

Accordingly, the entity determines that the fair value of the machine is CU48,000.

If customisation of the machine was extensive or if there were not sufficient data available to apply the market approach (eg because market data reflect transactions for machines used on a stand-alone basis, such as a scrap value for specialised assets, rather than machines used in combination with other assets or with other assets and liabilities), the entity would apply the cost approach. When an asset is used in combination with other assets or with other assets and liabilities, the cost approach assumes the sale of the machine to a market participant buyer with the complementary assets and the associated liabilities. The price received for the sale of the machine (ie an exit price) would not be more than either of the following:

(a) the cost that a market participant buyer would incur to acquire or construct a substitute machine of comparable utility; or

(b) the economic benefit that a market participant buyer would derive from the use of the machine.

Both Example 4 and Example 5, extracted above, highlight situations where it was appropriate to use more than one valuation approach to estimate fair value. Although the indication of value from the cost approach was ultimately not given much weight in either example, performing this valuation technique was an important part of the estimation process. Even when a particular valuation technique is given little weight, its application can highlight specific characteristics of the item being measured and may help in assessing the value indications from other techniques.

How we see it

Determining the point in a range of values that is 'most representative of fair value' can be subjective and requires the use of judgement by management. In addition, although Example 4 in the standard (extracted above) refers to 'weighting' the results of the valuation techniques used, in our view, this is not meant to imply that an entity must explicitly apply a percentage weighting to the results of each technique to determine fair value. However, this may be appropriate in certain circumstances.

The standard does not prescribe a specific weighting methodology (e.g., explicit assignment of percentages versus qualitative assessment of value indications). As such, evaluating the techniques applied in an analysis will require judgement based on the merits of each methodology and their respective assumptions.

Identifying a single point within a range is not the same as finding the point within the range that is most representative of fair value. As such, simply assigning arbitrary weights to different indications of value is not appropriate. The weighting of multiple value indications is a process that requires significant judgement and a working knowledge of the different valuation techniques and inputs. Such knowledge is necessary to properly assess the relevance of these methodologies and inputs to the asset or liability being measured. For example, in certain instances it may be more appropriate to rely primarily on the fair value indicated by the technique that maximises the use of observable inputs and minimises the use of unobservable inputs. In all cases, entities should document how they considered the various indications of value, including how they evaluated qualitative and quantitative factors, in determining fair value.

13.1.3 Valuation adjustments

In certain instances, adjustments to the output from a valuation technique may be required to appropriately determine a fair value measurement in accordance with IFRS 13. An entity makes valuation adjustments if market participants would make those adjustments when pricing an asset or liability (under the market conditions at the measurement date). This includes any adjustments for measurement uncertainty (e.g., a risk premium).

Valuation adjustments may include the following: *[IFRS 13.BC145]*

(a) An adjustment to a valuation technique to take into account a characteristic of an asset or a liability that is not captured by the valuation technique. The need for such an adjustment is typically identified during calibration of the value calculated using the valuation technique with observable market information (see section 13.1.3.A below).

(b) Applying the point within the bid-ask spread that is most representative of fair value in the circumstances (see section 14.3 below).

(c) An adjustment to take into account credit risk (e.g., an entity's non-performance risk or the credit risk of the counterparty to a transaction) (see section 10.3 above).

(d) An adjustment to take into account measurement uncertainty (e.g., when there has been a significant decrease in the volume or level of activity when compared with normal market activity for the asset or liability, or similar assets or liabilities, and the entity has determined that the transaction price or quoted price does not represent fair value).

Practical example 13-1 below, demonstrates the use of valuation adjustments.

Practical example 13-1: UBS Group AG (2023) **Switzerland**

Annual Report 2023 [extract]
Financial statements [extract]
Consolidated financial statements [extract]
UBS Group AG consolidated financial statements [extract]
Notes to the UBS Group AG consolidated financial statements [extract]
Additional information [extract]
Note 21 Fair value measurement [extract]
d) Valuation adjustments and other items [extract]

Other valuation adjustments

Instruments that are measured as part of a portfolio of combined long and short positions are valued at mid-market levels to ensure consistent valuation of the long- and short-component risks. A liquidity valuation adjustment is then made to the overall net long or short exposure to move the fair value to bid or offer as appropriate, reflecting current levels of market liquidity. The bid–offer spreads used in the calculation of this valuation adjustment are obtained from market transactions and other relevant sources and are updated periodically.

Uncertainties associated with the use of model-based valuations are incorporated into the measurement of fair value through the use of model reserves. These reserves reflect the amounts that the Group estimates should be deducted from valuations produced directly by models to incorporate uncertainties in the relevant modeling assumptions, in the model and market inputs used, or in the calibration of the model output to adjust for known model deficiencies. In arriving at these estimates, the Group considers a range of market practices, including how it believes market participants would assess these uncertainties. Model reserves are reassessed periodically in light of data from market transactions, consensus pricing services and other relevant sources.

Other valuation adjustment reserves on the balance sheet

	As of		
USD m	31.12.23	31.12.22	31.12.21
Credit valuation adjustments[1]	(145)	(33)	(44)
Funding and debit valuation adjustments	(116)	(46)	(47)
Other valuation adjustments	(2,654)	(839)	(913)
of which: liquidity	*(2,051)*	*(311)*	*(341)*
of which: model uncertainty	*(603)*	*(529)*	*(571)*

1 Amount does not include reserves against defaulted counterparties.

Credit valuation adjustments and Funding and debit valuation adjustments include USD 108m and USD 34m respectively, attributable to the Credit Suisse Group. Liquidity and model uncertainty adjustments in Credit Suisse amount to USD 1,741m and USD 181m, respectively.

13.1.3.A Adjustments to valuation techniques that use unobservable inputs

Regardless of the valuation technique(s) used, the objective of a fair value measurement remains the same - i.e., an exit price under current market conditions from the perspective of market participants. *[IFRS 13.2]*. As such, if the transaction price is determined to represent fair value at initial recognition (see section 12 above) and a valuation technique that uses unobservable inputs will be used to measure the fair value of an item in subsequent periods, the valuation technique must be calibrated to ensure the valuation technique reflects current market conditions. *[IFRS 13.64]*. In other words, at initial recognition the output from the valuation technique should be adjusted to equal the transaction price.

Calibration ensures that a valuation technique incorporates current market conditions. The calibration also helps an entity to determine whether an adjustment to the valuation technique is necessary by identifying potential deficiencies in the valuation model. For example, there might be a characteristic of the asset or liability that is not captured by the valuation technique.

If an entity measures fair value after initial recognition using a valuation technique (or techniques) that uses unobservable inputs, an entity must ensure the valuation technique(s) reflects observable market data (e.g., the price for a similar asset or liability) at the measurement date. *[IFRS 13.64]*. That is, it should be calibrated to observable market data, when available.

13.1.4 Making changes to valuation techniques

The standard requires that valuation techniques used to measure fair value be applied on a consistent basis among similar assets or liabilities and across reporting periods. *[IFRS 13.65]*. This is not meant to preclude subsequent changes, such as a change in its weighting when multiple valuation techniques are used or a change in an adjustment applied to a valuation technique.

An entity can make a change to a valuation technique or its application (or a change in the relative importance of one technique over another), provided that change results in a measurement that is equally representative (or more representative) of fair value in the circumstances.

IFRS 13 provides the following examples of circumstances that may trigger a change in valuation technique or relative weights assigned to valuation techniques: *[IFRS 13.65]*

(a) New markets develop

(b) New information becomes available

(c) Information previously used is no longer available

(d) Valuation techniques improve

(e) Market conditions change

In addition, a change in the exit market, characteristics of market participants that would transact for the asset or liability, or the highest and best use of an asset by market participants could also warrant a change in valuation techniques in certain circumstances.

Changes to fair value resulting from a change in the valuation technique or its application are accounted for as a change in accounting estimate in accordance with IAS 8. However, IFRS 13 states that the disclosures in IAS 8 for a change in accounting estimate are not required for such changes. *[IFRS 13.66]*. Instead, information would be disclosed in accordance with IFRS 13 (see section 19.3.5 below for further discussion). If a valuation technique is applied in error, the correction of the technique would be accounted as a correction of an error in accordance with IAS 8.

13.2 Market approach

IFRS 13 describes the market approach as a widely used valuation technique: *[IFRS 13.B5]*

Extract from IFRS 13	
B5	The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (ie similar) assets, liabilities or a group of assets and liabilities, such as a business.

The market approach uses prices that market participants would pay or receive for the transaction, for example, a quoted market price. The market price may be adjusted to reflect the characteristics of the item being measured, such as its current condition and location, and could result in a range of possible fair values.

Valuation techniques consistent with the market approach use prices and other market data derived from observed transactions for the same or similar assets, for example, revenue, or EBITDA multiples. Multiples might be in ranges with a different multiple for each comparable asset or liability. The selection of the appropriate multiple within the range requires judgement, considering qualitative and quantitative factors specific to the measurement. *[IFRS 13.B6]*.

Another example of a market approach is matrix pricing. Matrix pricing is a mathematical technique used principally to value certain types of financial instruments, such as debt securities, where specific instruments (e.g., CUSIPs) may not trade frequently. The method derives an estimated price of an instrument using transaction prices and other relevant market information for benchmark instruments with similar features (e.g., coupon, maturity or credit rating). *[IFRS 13.B7]*.

13.3 Cost approach

The cost approach (or current replacement cost) is typically used to measure the fair value of tangible assets, such as plant or equipment. IFRS 13 states: *[IFRS 13.B8]*

Extract from IFRS 13	
B8	The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).

From the perspective of a market participant seller, the price that would be received for the asset is based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.

Obsolescence is broader than depreciation, whether for financial reporting or tax purposes. According to the standard, obsolescence encompasses: *[IFRS 13.B9]*

- Physical deterioration
- Functional (technological) obsolescence
- Economic (external) obsolescence

Physical deterioration and functional obsolescence are factors specific to the asset. Physical deterioration refers to wear, tear or abuse. For example, machines in a factory might deteriorate physically due to high production volumes or a lack of maintenance. Something is functionally obsolete when it does not function in the manner originally intended (excluding any physical deterioration). For example, layout of the machines in the factory may make their use, in combination, more labour intensive, increasing the cost of those machines to the entity. Functional obsolescence also includes the impact of technological change, for example, if newer, more efficient and less labour-intensive models were available, demand for the existing machines might decline, along with the price for the existing machines in the market.

Economic obsolescence arises from factors external to the asset. An asset may be less desirable or its economic life may reduce due to factors such as regulatory changes, excess supply or a decrease in demand due to climate change. Consider the machines in the factory; assume that, after the entity had purchased its machines, the supplier had flooded the market with identical machines. If demand was not as high as the supplier had anticipated, it could result in an oversupply and the supplier would be likely to reduce the price in order to clear the excess stock.

13.3.1 Use of depreciated replacement cost to measure fair value

The depreciated replacement cost method measures the cost to replace the asset at the measurement date in light of its current use, location and condition, using depreciation as a proxy for obsolescence. Use of this method to measure fair value would necessarily assume that:

- Exit and entry markets are the same (in order for the entry and exit prices to be equal)
- Highest and best use of the asset is its current use
- Depreciation charge appropriately reflects physical deterioration, functional (technological) obsolescence and economic (external) obsolescence
- Inputs used are consistent with market participant assumptions about the asset

Consider an entity that provides port freight and logistics services. Its plant or equipment comprises highly specialised assets from which the entity earns berthing and tonnage fees. The entity accounts for these assets in accordance with IAS 16 using the revaluation model. At the end of the reporting period, the assets are tested for impairment under IAS 36. As part of determining the assets' recoverable amount, the entity may need to determine their fair value less costs of disposal. However, there are no readily available observable transactions and/or inputs available to use in measuring fair value because of the highly specialised nature of the assets and because there is no history of such assets ever being sold, other than as part of a business combination.

As discussed in section 13.3 above, IFRS 13 permits the use of a cost approach for measuring fair value. However, care is needed in using depreciated replacement cost to ensure the resulting measurement is consistent with the requirements of IFRS 13 for measuring fair value.

How we see it

Before using depreciated replacement cost as a method to measure fair value, an entity needs to ensure that both:

- Highest and best use of the asset is its current use (see section 9 above)
- Exit market for the asset (i.e., the principal market or in its absence, the most advantageous market, see section 5 above) is the same as the entry market (i.e., the market in which the asset was/will be purchased)

In addition, an entity needs to ensure that both:

- The inputs used to determine replacement cost are consistent with what market participant buyers would pay to acquire or construct a substitute asset of comparable utility
- The replacement cost has been adjusted for obsolescence that market participant buyers would consider - i.e., that the depreciation adjustment reflects all forms of obsolescence (i.e., physical deterioration, technological (functional) and economic obsolescence), which is broader than depreciation calculated in accordance with IAS 16

Even after considering these factors, the resulting depreciated replacement cost must be assessed to ensure market participants would actually transact for the asset, in its current condition and location, at this price. Example 4 in the standard (extracted and discussed in section 13.1.2 above) reflects this stating that "the price received for the sale of the machine (i.e., an exit price) would not be more than either of the following:

(a) the cost that a market participant buyer would incur to acquire or construct a substitute machine of comparable utility; or

(b) the economic benefit that a market participant buyer would derive from the use of the machine." *[IFRS 13.IE14]*.

In light of the above, the port freight and logistics services entity in our example above might conclude that depreciated replacement cost be used to measure fair value, but only in situations where it represents a current exit price for its assets rather than their cost.

13.4 Income approach

IFRS 13 states the following about the income approach: *[IFRS 13.B10, IFRS 13.B11]*

Extract from IFRS 13

B10 The income approach converts future amounts (eg cash flows or income and expenses) to a single current (ie discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts.

B11 Those valuation techniques include, for example, the following:

(a) present value techniques (see paragraphs B12-B30);

(b) option pricing models, such as the Black-Scholes-Merton formula or a binomial model (ie a lattice model), that incorporate present value techniques and reflect both the time value and the intrinsic value of an option; and

(c) the multi-period excess earnings method, which is used to measure the fair value of some intangible assets.

IFRS 13.B11 provides a number of examples that are consistent with the income approach; however, the standard does not limit the valuation techniques that are consistent with the income approach to these examples. An entity may consider other valuation techniques. The standard provides some application guidance, but only in relation to present value techniques (see section 20 below for further discussion regarding this application guidance).

14 Inputs to valuation techniques

14.1 General principles

When selecting the inputs to use in a valuation technique, IFRS 13 requires that they: *[IFRS 13.69]*

- Be consistent with the characteristics of the asset or liability that market participants would take into account (see section 4.2 above)
- Exclude premiums or discounts that reflect size as a characteristic of the entity's holding, rather than a characteristic of the item being measured (for example, blockage factors)
- Exclude other premiums or discounts if they are inconsistent with the unit of account (see section 4.1 above for discussions regarding unit of account)

Premiums, discounts and blockage factors are discussed further in section 14.2 below.

In all cases, if there is a quoted price in an active market (i.e., a Level 1 input) for the identical asset or a liability, an entity shall use that price without adjustment when measuring fair value. Adjustments to this price are only permitted in certain circumstances, which are discussed in section 16.1 below.

Regardless of the valuation techniques used to estimate fair value, IFRS 13 requires that these techniques maximise the use of relevant observable inputs and minimise the use of unobservable inputs. *[IFRS 13.67]*. This requirement is consistent with the idea that fair value is a market-based measurement and, therefore, is determined using market-based observable data, to the extent available and relevant.

The standard provides some examples of markets in which inputs might be observable: *[IFRS 13.68, IFRS 13.B34]*

(a) *Exchange markets*, where closing prices are both readily available and generally representative of fair value (e.g., the Hong Kong Stock Exchange)

(b) *Dealer markets*, where dealers stand ready to trade for their own account (e.g., over-the-counter markets, for which prices are publicly reported) - typically, bid and ask prices (see section 14.3 below) are more readily available than closing prices

(c) *Brokered markets*, where brokers attempt to match buyers with sellers but do not stand ready to trade for their own account (e.g., electronic communication networks in which buy and sell orders are matched, commercial and residential real estate markets) - typically, the broker knows the prices bid and asked by the respective parties, but each party is unaware of another party's price requirements, though prices for completed transactions may be available

(d) *Principal-to-principal markets*, where transactions, both new and re-sales, are negotiated independently with no intermediary - little, if any, information about these transactions in these markets may be publicly available

The standard clarifies that the relevance of market data must be considered when assessing the priority of inputs in the fair value hierarchy. When evaluating the relevance of market data, the number and range of data points should be considered, as well as whether this data is directionally consistent with pricing trends and indications from other more general market information.

Relevant market data reflects the assumptions that market participants would use in pricing the asset or liability being measured. Recent transaction prices for the reference asset or liability (or similar assets and liabilities) are typically considered to represent relevant market data, unless the transaction is determined not to be orderly (see section 7 above for a discussion of factors to consider when determining if a transaction is orderly). However, even in situations where a transaction is considered to be orderly, observable transaction prices from inactive markets may require adjustment to address factors, such as timing differences between the transaction date and the measurement date or differences between the asset being measured and a similar asset that was the subject of the transaction. In those instances where the adjustments to observable data are significant and are determined using unobservable data, the resulting measurement would be considered a Level 3 measurement.

Whether observable or unobservable, all inputs used in determining fair value should be consistent with a market-based measurement. As such, the use of unobservable inputs is not intended to allow for the inclusion of entity-specific assumptions in a fair value measurement. While IFRS 13 acknowledges that unobservable inputs may sometimes be developed using an entity's own data, the guidance is clear that these inputs should reflect market participant assumptions. When valuing an intangible asset using unobservable inputs, for example, an entity should take into account the intended use of the asset by market participants, even though this may differ from the entity's intended use. The entity may use its own data, without adjustment, if it determines that market participant assumptions are consistent with its own assumptions (see section 18.1 below for additional discussion on how an entity's own assumptions may be applied in a fair value measurement).

The term 'input' is used in IFRS 13 to refer broadly to the assumptions that market participants would use when pricing an asset or liability, rather than to the data entered into a pricing model. This important distinction implies that an adjustment to a pricing model's value (e.g., an adjustment for the risk that a pricing model might not replicate a market price due to the complexity of the instrument being measured) represents an input, which should be evaluated when determining the measurement's category in the fair value hierarchy. For example, when measuring a financial instrument, an adjustment for model risk would be considered an input (most likely a Level 3 input) that, if deemed significant (see section 15.2.1 below for further discussion on assessing the significance of inputs) may render the entire fair value estimate a Level 3 measurement.

It is also important to note that an input is distinct from a characteristic. IFRS 13 requires an entity to consider the characteristics of the asset or liability (if market participants would take those characteristics into account when pricing the asset or liability at the measurement date). As discussed in section 4.2 above, examples of such characteristics could include: *[IFRS 13.11]*

- Condition and location of an asset
- Restrictions, if any, on the sale or use of an asset or transfer of a liability

To draw out the distinction between an input and a characteristic, consider the example of a restricted security that has the following characteristics, which would be considered by a market participant:

- The issuer is a listed entity
- The security is restricted

An entity is required to select inputs in pricing the asset or liability that are consistent with its characteristics. In some cases, those characteristics result in the application of an adjustment, such as a premium or discount. In our example, the inputs could be:

- Quoted price for an unrestricted security
- Discount adjustment (to reflect the restriction)

The quoted price for the unrestricted security may be an observable and a Level 1 input. However, given the restriction and the standard's requirement that inputs be consistent with the characteristics of the asset or liability being measured, the second input in measuring fair value is an adjustment to the quoted price to reflect the restriction. If this input is unobservable, it would be a Level 3 input and, if it is considered to be significant to the entire measurement, the fair value measurement of the asset would also be categorised within Level 3 of the fair value hierarchy.

14.2 Premiums and discounts

IFRS 13 indicates that when measuring fair value, entities should select inputs that: (i) are consistent with the characteristics of the asset or liability being measured; and (ii) would be considered by market participants when pricing the asset or liability. In certain instances, these characteristics could result in a premium or discount being incorporated into the fair value measurement.

Determining whether a premium or discount applies to a particular fair value measurement requires judgement and depends on specific facts and circumstances.

IFRS 13 distinguishes between premiums or discounts that reflect size as a characteristic of the entity's holding (specifically, a blockage factor) and control premiums, discounts for non-controlling interests and discounts for lack of marketability that are related to characteristics of the asset or liability being measured.

Control premiums, discounts for non-controlling interests and discounts for lack of marketability reflect characteristics of the asset or liability being measured at fair value. Provided these adjustments are consistent with the unit of account (see section 4.1 above) of the asset or liability being measured they can be taken into consideration when measuring fair value. *[IFRS 13.69]*.

Apart from block discounts (discussed in section 14.2.1 below), IFRS 13 does not provide explicit guidance on the types of premiums or discounts that may be considered, or when they should be applied to a fair value measurement. Instead, the guidance indicates that premiums and discounts (e.g., control premiums or discounts for lack of marketability) should be incorporated into non-Level 1 fair value measurements if all of the following conditions are met:

- Application of the premium or discount reflects the characteristics of the asset or liability being measured
- Market participants, acting in their 'economic best interest' (see section 6.2 above), would consider these premiums or discounts when pricing the asset or liability
- Inclusion of the premium or discount is not inconsistent with the unit of account in the IFRS that requires (or permits) the fair value measurement (see section 4.1 above)

IFRS 13 emphasises that prices of instruments that trade in active markets (i.e., Level 1 measurements) should generally not be adjusted and should be measured based on the quoted price of the individual instrument multiplied by the quantity held (P×Q).

Figure 14-1: Differentiating between blockage factors and other premiums and discounts

Examples of premiums and discounts	Blockage factor (or block discount)	Control premium	Discount for lack of marketability
Can fair value be adjusted for the premium or discount?	No.	Yes, in certain circumstances.	Yes, in certain circumstances.
In what situations would these arise?	When an entity sells a large holding of instruments such that the market's normal daily trading volume is not sufficient to absorb the entire quantity (i.e., flooding the market). IFRS 13 does not permit an entity to take block discounts into consideration in the measurement of fair value.	When an entity transacts for a controlling interest in another entity (and the unit of account is deemed to be the controlling interest and not the individual shares).	When an asset or liability is not readily marketable, for example, where there is no established market of readily available buyers and sellers or as a result of restrictions.
Example	An entity holds a 20% investment in a listed company. The normal daily trading for those shares on the exchange is 1-2%. If the entity were to sell its entire holding, the price per share would be expected to decrease by 30%.	An entity transacts for a controlling interest in a private business and determines that the fair value of the business is greater than the aggregate value of the individual shares due to its ability to control the acquired entity.	The shares of a private company for which no liquid market exists.
What does the premium or discount represent?	The difference between the price to sell the individual asset or liability, and an entity's entire holding. IFRS 13 does not permit an entity to include such a difference in the measurement of fair value.	The difference between the price to sell the individual shares in the controlled entity, and the entire controlling interest.	The difference between the price to sell an asset or liability that does not trade in a liquid market, and an identical asset or liability for which a liquid market exists.

14.2.1 Blockage factors (or block discounts)

IFRS 13 explicitly prohibits the consideration of blockage factors (or block discounts) in a fair value measurement. *[IFRS 13.69, IFRS 13.80]*. While the term blockage factor may be subject to different interpretations, during their deliberations the Boards indicated that they view a blockage factor as an adjustment to the quoted price of an asset or liability because the market's normal trading volume is not sufficient to absorb the quantity held by a reporting entity.

Regardless of the hierarchy level in which a measurement is categorised, blockage factors are excluded from a fair value measurement because such an adjustment is specific to the size of an entity's holding and its decision to transact in a block. That is, the Boards believe such an adjustment is entity-specific in nature. *[IFRS 13.BC157]*. However, the standard clarifies that there is a difference between size being a characteristic of the asset or liability being measured (based on its unit of account) and size being a characteristic of the reporting entity's holding. While any adjustment for the latter is not permitted, the former should be considered if it is consistent with how market participants would price the asset or liability. *[IFRS 13.69]*.

The following example illustrates how IFRS 13 distinguishes between size as a characteristic of the item being measured and size as a characteristic of an entity's holding.

Illustration 14-1: Blockage factors

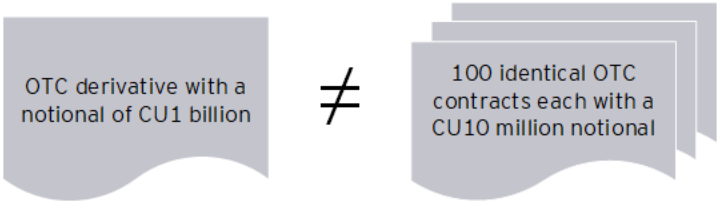
Bank X has one outstanding OTC derivative contract with Dealer A.

The notional amount of this contract is CU1 billion, which is significantly larger than the market norm for these types of contracts.

Bank Y has 100 identical OTC derivative contracts outstanding with various dealers (whose risks are not offsetting because all the contracts are assets and therefore are not measured using the measurement exception).

Each of the 100 contracts has a notional amount of CU10 million, which is consistent with the market norm for these types of contracts.

Although Bank X and Bank Y have virtually identical market exposures (ignoring credit risk for simplicity), IFRS 13 would allow Bank X to consider a discount for lack of marketability but would preclude Bank Y from applying a similar discount.



For Bank X, the large notional amount (CU1 billion) is a characteristic of the instrument being measured and would likely be considered by market participants when transacting for the derivative based on its unit of account (the derivative contract). As such, the fair value of the individual derivative should incorporate an adjustment for size if market participants would consider one in pricing the instrument.

In contrast, the unit of account for Bank Y's 100 derivative contracts is the individual OTC contracts, not the aggregate gross exposure stemming from the 100 contracts (i.e., the block). In pricing the individual contracts, market participants would likely not consider a discount associated with the size of the contracts, since the notional amount for each contract is consistent with the market norm. In accordance with IFRS 13, Bank Y would be prohibited from applying a discount based on the size of its entire holding (i.e., the 100 contracts) as this would represent a block discount that cannot be considered in a fair value measurement.

As discussed in section 4.1 above, the unit of account is determined by the relevant IFRS that permits or requires an asset or liability to be measured at fair value, unless IFRS 13 states otherwise. In some cases, the unit of account may be clear, for example, the unit of account for financial instruments in the scope of IFRS 9 is typically the individual instrument. However, it may be less clear in other standards, for example, the unit of account for a CGU when testing non-financial assets for impairment in accordance with IAS 36. In December 2018, the IASB concluded its PIR of IFRS 13, in which it had considered issues relating to prioritising Level 1 inputs or the unit of account. This is discussed further in section 4.1.1 above.

14.3 Pricing within the bid-ask spread

The 'bid price' represents the price at which a dealer or market maker is willing to buy an asset (or dispose of a liability). The 'ask price' (or offer price) represents the price at which a dealer or market maker is willing to sell an asset (or assume a liability). The spread between these two prices represents the profit a dealer requires for making a market in a particular security (i.e., providing two-way liquidity).

The use of bid prices to measure assets and ask prices to measure liabilities is permitted, but not required. Instead, for assets and liabilities that are bought and sold in markets where prices are quoted using a bid-ask spread (e.g., over-the-counter markets), the entity must use the price within the bid-ask spread that is most representative of fair value in the circumstances to measure fair value. In making this assessment, entities should evaluate their recent transaction history to support where in the bid-ask spread they are able to exit their positions. For some entities this could result in valuing assets at the bid price and liabilities at the ask price, but in other instances judgement is required to determine the point in the bid-ask spread that is most indicative of fair value (see Practical example 10-1 above for an illustrative disclosure). The use of the price within the bid-ask spread that is most representative of fair value applies regardless of whether the input (i.e., the bid or ask price) is observable or not (i.e., regardless of its categorisation in the fair value hierarchy - see section 15 below for further discussion). *[IFRS 13.70]*.

Entities need to be consistent in their application of this concept. It would not be appropriate for an entity to measure similar assets at different prices within the bid-ask spread, without evidence indicating that the exit prices for those assets would be at different points within the bid-ask spread.

14.3.1 Mid-market pricing

As a practical expedient, IFRS 13 allows the use of mid-market pricing, or other pricing conventions that are used by market participants, when measuring fair value within the bid-ask spread. *[IFRS 13.71]*. Use of a mid-market pricing convention results in a valuation of an asset or liability at the mid-point of the bid-ask spread. Practical example 10-1 in section 10.3.2.B above illustrates use of mid-market pricing.

The Standard does not limit or restrict the use of mid-market pricing to specific types of instruments or entities. However, as discussed in section 13 above, valuation techniques used to measure fair value should be consistently applied. *[IFRS 13.65]*.

Frequently asked questions

Question 14-1: What does the bid-ask spread include?

The commentary in the Basis for Conclusions acknowledges that the previous guidance in IAS 39 only includes transaction costs in the bid-ask spread. The Boards chose not to specify what is included in the bid-ask spread, except for transaction costs. However, they did make it clear that, in their view, the bid-ask spread does not include adjustments for counterparty credit risk. *[IFRS 13.BC164]*.

The IASB has not provided any clarity regarding the interaction between the guidance in IFRS 13 on transaction costs (i.e., transaction costs are not considered an attribute of the asset or liability and, accordingly, are excluded from fair value measurements) and the guidance on the use of prices within the bid-ask spread. If transaction costs are included in the bid-ask spread, measuring an asset at the bid price would include certain future transaction costs in the fair value measurement for the asset.

Given the lack of any specific guidance on this issue, there may be some diversity in practice between entities with respect to how transaction costs are considered. However, we would expect an entity to apply a consistent approach to all of its own fair value measurements.

14.4 Risk premiums

IFRS 13 defines a risk premium as "compensation sought by risk-averse market participants for bearing the uncertainty inherent in the cash flows of an asset or a liability". *[IFRS 13 Appendix A]*. Regardless of the valuation technique(s) used, a fair value measurement is intended to represent an exit price and, as such, should include a risk premium that reflects the compensation market participants would demand for bearing the uncertainty inherent in the cash flows of an asset or liability. *[IFRS 13.B16, IFRS 13.B39]*. While this risk premium should reflect compensation required in an orderly transaction (not a forced or distressed sale), it should also capture market participant assumptions regarding risk under current market conditions. Example 14 in the standard (extracted and discussed in section 7.3.2 above) illustrates that this risk adjustment may include assumptions about liquidity and uncertainty based on relevant market data.

IFRS 13 states the following: *[IFRS 13.B16]*

Extract from IFRS 13

B16	Market participants generally seek compensation (ie a risk premium) for bearing the uncertainty inherent in the cash flows of an asset or a liability. A fair value measurement should include a risk premium reflecting the amount that market participants would demand as compensation for the uncertainty inherent in the cash flows. Otherwise, the measurement would not faithfully represent fair value. In some cases determining the appropriate risk premium might be difficult. However, the degree of difficulty alone is not a sufficient reason to exclude a risk premium.

The objective of a risk premium is often misunderstood. Many incorrectly assume that a risk premium is unnecessary when fair value is determined using probability-weighted cash flows. That is, they believe it is appropriate to discount probability-weighted cash flows using a risk-free rate under the assumption that all uncertainty is captured by probability-weighting the cash flows. While expected cash flows (i.e., the probability-weighted average of possible future cash flows) incorporate the uncertainty in the instrument's cash flows, they do not incorporate the compensation that market participants demand for bearing that uncertainty. *[IFRS 13.B25-B29]*. In order to capture this required compensation in the measurement, a market risk premium must be added (either as an adjustment to the discount rate or to the expected cash flows). IFRS 13's application guidance addresses this point when discussing systematic and unsystematic risk and certainty-equivalent cash flows (see section 20 below for additional discussion on how risk premiums are applied in a present value technique).

It is important to note that increased risk associated with an asset generally decreases the fair value of that asset, whereas increased risk associated with a liability generally increases the fair value of that liability (with the exception of non-performance risk). Uncertainty associated with an asset reduces the amount a market participant would pay for the asset. In contrast, all else being equal, compensation for an uncertainty related to a liability results in an increase to the amount that the market participant would expect to receive for assuming the obligation. If that compensation is accounted for in the discount rate, rather than in the cash flows, it would result in an increase in the discount rate used to measure the fair value of an asset. However, it would result in a reduction of the discount rate used in the fair value measurement of the liability (i.e., the discount rate must be lower so that the resulting fair value of the liability is higher). *[IFRS 13.BC91]*. This concept only applies when measuring the fair value of a liability that does not have a corresponding asset using an income approach. As discussed in section 10.2.1 above, when a quoted price for the transfer of an identical or similar liability or entity's own equity instrument is held by another party as an asset, the fair value of this liability or own equity instrument should be determined from the perspective of the market participant that holds the identical item as an asset.

14.5 Broker quotes and pricing services

When quoted prices from brokers or pricing services are used to measure fair value, it is the entity's responsibility to understand the source and nature of this information to accurately assess its relevance. When there has been a significant decrease in the volume or level of activity for the asset or liability, management should evaluate whether the prices received from brokers or pricing services are based on current information from orderly transactions or valuation techniques that appropriately reflect market participant assumptions regarding risk. IFRS 13 states that entities should place less reliance on third-party quotes that are not based on transactions, compared to other value indications that are based on market transactions. *[IFRS 13.B46]*.

When information from brokers and pricing services is based on transaction data, entities should assess whether, and to what extent, the observed prices are a result of orderly transactions when determining the weight to place on these data points, compared to other value indications (see section 7.2 above for additional information on the factors an entity may consider when assessing whether transactions are orderly). Facts and circumstances will determine the weight that an entity should place on a transaction price, including:

- Comparability of the transaction to the asset or liability being measured at fair value
- Proximity of the transaction to the measurement date
- Size of the transaction
- Nature of the quote (e.g., binding versus indicative quote) and the number of quotes received

See section 15.2.3 below for additional discussion on fair value hierarchy considerations when using quoted prices from brokers and pricing services.

Frequently asked questions

Question 14-2: How should values provided by central clearing organisations for margin purposes be evaluated when determining the fair value of centrally cleared derivatives for financial reporting?

For OTC derivatives that are centrally cleared, counterparties are typically required on an ongoing basis to post collateral based on the change in value of the derivative (sometimes referred to as 'variation margin').[27] As a result, entities with centrally cleared OTC derivatives will periodically receive a 'value mark' from a clearing organisation that states the amount of variation margin to be posted or received.

How we see it

This 'value mark' cannot be presumed to represent fair value (an exit price) in accordance with IFRS 13. Different clearing organisations may have different approaches for calculating variation margin requirements and while practice may continue to evolve, it is our understanding that the 'value marks' provided generally do not represent an actual transaction price (i.e., a price at which the reporting entity could execute a trade to buy or sell the contract). Instead, this value might be based on a clearing organisation's analysis of information provided by clearing members and certain of its own assumptions.

While this value may potentially be an appropriate estimate of fair value in certain instances, the reporting entity should understand how this value is determined and evaluate whether it includes only those factors that would be considered by market participants in an orderly transaction to sell or transfer the derivative. For example, to provide themselves with additional protection, some clearing organisations may include an incremental amount in their variation margin requirement in excess of the 'true' change in the value of the derivative.

As with pricing information provided by brokers or third-party pricing services, reporting entities are responsible for understanding the source and nature of information provided by central clearing organisations. An entity should assess whether the value indication represents fair value in accordance with IFRS 13 or whether an adjustment may be needed. See section 15.2.4 below for a discussion of the categorisation of centrally cleared OTC derivatives in the fair value hierarchy.

27 Note that for certain centrally cleared derivatives, commonly referred to as settled-to-market (STM) contracts, the variation margin payments are legally characterised as settlements of the derivatives' exposure, as opposed to collateral. The fair value (exit price) of these contracts will generally approximate zero as the change in the instrument's fair value is essentially settled daily.

15 The fair value hierarchy

The fair value hierarchy is intended to increase consistency and comparability in fair value measurements and the related disclosures. *[IFRS 13.72]*. Application of the hierarchy requires an entity to prioritise observable inputs over those that are unobservable when measuring fair value. In addition, for disclosures, it provides a framework for users to consider the relative subjectivity of the fair value measurements made by the reporting entity.

15.1 The fair value hierarchy

The fair value hierarchy classifies the inputs used to measure fair value into three levels, which are described in Figure 15-1 below.

Figure 15-1: Fair value hierarchy

	Level 1	Level 2	Level 3
Definition *[IFRS 13 Appendix A]*	Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.	Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly.	Unobservable inputs for the asset or liability.
Example	The price for a financial asset or financial liability for the identical asset that is traded on an active market (e.g., Tokyo Stock Exchange).	Interest rates and yield curves observable at commonly quoted intervals, implied volatilities, and credit spreads.	Projected cash flows used in a discounted cash flow calculation.

Valuation techniques used to measure fair value must maximise the use of relevant observable inputs and minimise the use of unobservable inputs. The best indication of fair value is a quoted price in an active market (i.e., "a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis". *[IFRS 13 Appendix A]*).

The fair value hierarchy focuses on prioritising the inputs used in valuation techniques, not the techniques themselves. *[IFRS 13.74]*. While the availability of inputs might affect the valuation technique(s) selected to measure fair value, as discussed in section 13 above, IFRS 13 does not prioritise the use of one technique over another (with the exception of the requirement to measure identical financial instruments that trade in active markets at P×Q). The determination of the valuation technique(s) to be used requires significant judgement and will be dependent on the specific characteristics of the asset or liability being measured and the principal (or most advantageous) market in which market participants would transact for the asset or liability.

Although the valuation techniques themselves are not subject to the fair value hierarchy, a risk adjustment that market participants would demand to compensate for a risk inherent in a particular valuation technique (e.g., a model adjustment) is considered an input that must be assessed within the fair value hierarchy. As discussed in section 15.2 below, if this type of risk adjustment is included, it should be considered when categorising the fair value measurement within the fair value hierarchy.

15.2 Categorisation within the fair value hierarchy

IFRS 13 distinguishes between where in the fair value hierarchy an individual input to a valuation technique may fall and where the entire measurement is categorised for disclosure purposes.

Inputs used in a valuation technique may fall into different levels of the fair value hierarchy. However, for disclosure purposes, the fair value measurement must be categorised in its entirety (i.e., the fair value measure for the asset or liability or the group of assets and/or liability, depending on the unit of account) within the hierarchy. Categorising the entire measurement (and the required disclosure of this information, see section 19.3.3 below) provides users of financial statements with an indication of the overall observability or subjectivity of a fair value measurement.

Categorisation of a fair value measurement (as a whole) within the hierarchy, therefore, is dependent on what constitutes an 'observable' input and a 'significant' input. Observability affects all levels of the hierarchy and is important for classifying each input (discussed in sections 16 to 18 below). The significance of an unobservable input affects categorisation of the measurement (as a whole) within Level 2 and Level 3 of the hierarchy (see section 15.2.1 below).

It is important to note that the categorisation of fair value measurement within the fair value hierarchy does not provide information about asset quality. Rather, it provides information about the observability of the significant inputs used in a fair value measurement.

The appropriate categorisation may be obvious when only a single input is used, for example, when measuring fair value using a quoted price in an active market, without adjustment. However, an asset or liability that is not traded in an active market with a quoted price will often require more than one input to determine its fair value. For example, an over-the-counter option on a traded equity security measured at fair value using an option pricing model requires the following market-based inputs: (i) expected volatility; (ii) expected dividend yield; and (iii) the risk-free rate of interest.

IFRS 13 clarifies that the hierarchy categorisation of a fair value measurement, in its entirety, is determined based on the lowest level input that is significant to the entire measurement. The standard also makes it clear that adjustments to arrive at measurements based on fair value (e.g., 'costs to sell' when measuring fair value less costs to sell) are not be taken into account in this determination. *[IFRS 13.73]*. In the over-the-counter equity option example, assume that the risk-free interest rate and the dividend yield were determined to be Level 2 inputs, but the expected volatility was determined to be a Level 3 input. If expected volatility was determined to be significant to the overall value of the option, the entire measurement would be categorised within Level 3 of the fair value hierarchy.

If an observable input requires an adjustment using an unobservable input and that adjustment actually results in a significantly higher or lower fair value measurement, the standard is clear that the resulting fair value measurement would be categorised within Level 3 of the fair value hierarchy. *[IFRS 13.75]*. Consider our example of a restricted security discussed in section 14.1 above. While the quoted price for the unrestricted security may be observable, if Level 3 inputs are needed to determine the effect of the restriction on the instrument's fair value, and this effect is significant to the measurement, the asset would be categorised within Level 3 of the fair value hierarchy. In addition, as discussed in section 7 above, in certain situations adjustments to a transaction price in an inactive market may be required. If these adjustments are based on unobservable inputs and significant to the measurement, the item would be categorised within Level 3 of the fair value hierarchy.

It is important to understand that the determination of the hierarchy level in which the fair value measure falls (and, therefore, the category in which it will be disclosed - see section 19.3.3 below) is based on the fair value measurement for the specific item being measured, which will be dependent on the unit of account for the asset or liability. This may create practical challenges in relation to fair value measurements for non-financial assets and financial assets and liabilities with offsetting risk measured using the measurement exception discussed in section 11 above. For example, in situations where the unit of account for a non-financial asset is the individual item, but the valuation premise is in combination with other assets (or other assets and liabilities), the value of the asset group would need to be attributed to the individual assets or liabilities or to the various instruments within each level of the fair value hierarchy. For example, consider Illustration 9-2 in section 9.2.2 above. The unit of account for the grapes growing on the vines was that specified by IAS 41 and the vines and the land was that specified by IAS 16. However, their highest and best use was in combination, together and with other assets. The value of that group would need to be attributed to each of the assets, including the grapes growing on the vines, the vines and land, as the fair value of these individual assets should be categorised within the fair value hierarchy.

In its final report on the PIR on IFRS 13, the IASB noted that "some respondents reported a perception that the fair value hierarchy implies that information about items on Level 1 or Level 2 is always more relevant to users than information about items on Level 3. They indicated that this perception puts pressure on classification. They also said that this perception can be mistaken, as evidenced by academic research." Furthermore, respondents noted that categorisation within the hierarchy may be affected by some negative perceptions associated with categorisation within Level 3 of the fair value hierarchy (e.g., including the volume of disclosure required).[28] There are measurement uncertainties for both Level 2 and Level 3 fair value measurements, as both may include unobservable inputs. Therefore, significant judgement is often needed to determine whether a particular asset or liability should be categorised within Level 2 or Level 3 of the fair value hierarchy. It may be particularly challenging for entities to determine the level of evidence required to support a Level 2 classification, especially when the measurement is determined using information received from third parties (see section 15.2.3 below).

28 IFRS Project Report and Feedback Statement, *Post-implementation Review of IFRS 13* Fair Value Measurement, IASB, December 2018, p.16, 18. Available on the IFRS Foundation's website.

15.2.1 Assessing the significance of inputs

Assessing the significance of a particular input to the entire measurement requires judgement and consideration of factors specific to the asset or liability (or group of assets and/or liabilities) being measured. *[IFRS 13.73]*.

IFRS 13 does not provide specific guidance on how entities should evaluate the significance of individual inputs. This determination will require judgement and consideration of factors specific to the asset or liability (or group of assets and liabilities) being measured. In the absence of any 'bright lines' for determining significance, there may be a lack of comparability between different entities with fair value measurements that use the same inputs.

How we see it

The standard is clear that it considers significance in relation to 'the entire measurement'. In our view, this requires the assessment to consider the fair value measure itself, rather than any resulting change in fair value, regardless of whether that change is recognised (i.e., in profit or loss or other comprehensive income) or unrecognised.

Assume, for example, an investment property is measured at fair value at the end of each reporting period. In the current reporting period, the fair value of the investment property reduces by CU200,000 to CU500,000. The significance of any inputs to the fair value measurement would be assessed by reference to the CU500,000, even though CU200,000 is the amount that will be recognised in profit or loss. However, a reporting entity may deem it appropriate to also consider significance in relation to the change in fair value from prior periods, in addition to considering the significance of an input in relation to the entire fair value measurement. Such an approach may be helpful in relation to cash-based instruments (e.g., loans or structured notes with embedded derivatives) whose carrying amounts, based on fair value, are heavily affected by their principal or face amount.

As noted in section 15.2 above, if an observable input requires an adjustment using an unobservable input and that adjustment actually results in a significantly higher or lower fair value measurement, the standard is clear that the resulting fair value measurement would be categorised within Level 3 of the hierarchy. *[IFRS 13.75]*. What is not clear, however, is the appropriate categorisation when an observable input requires an adjustment using an unobservable input and: (a) that adjustment does not actually result in a significantly higher or lower fair value in the current period; but (b) the potential adjustment from using a different unobservable input would result in a significantly higher or lower fair value measurement. As noted in section 15.2 above, the categorisation of a fair value measurement indicates the overall observability or subjectivity of a measurement, in its entirety. To this end, in some cases, the use of sensitivity analysis or stress testing (i.e., using a range of reasonably possible alternative input values as of the measurement date) might be appropriate to assess the effects of unobservable inputs on a fair value measure. In situations where more than one unobservable input is used in a fair value measure, the assessment of significance should be considered based on the aggregate effect of all the unobservable inputs.

During the PIR on IFRS 13, many respondents indicated they found the assessment of whether an unobservable input is significant to the measurement as a whole challenging and asked for additional guidance. Some indicated that this assessment may be affected by negative perceptions associated with categorisation within Level 3 of the fair value hierarchy (e.g., including the volume of disclosure required). The IASB decided not to provide additional guidance, noting in particular that the requirements are principles-based and, as such, judgement will always be needed in their application.[29]

Entities should have a documented policy with respect to their approach to determining the significance of unobservable inputs on its fair value measurements and apply that policy consistently. This is important in light of the disclosure requirements in IFRS 13, particularly for fair value measurements categorised within Level 3 of the fair value hierarchy (see section 19.3 below).

15.2.2 Transfers between levels within the fair value hierarchy

For assets or liabilities that are measured at fair value (or measurements based on fair value) at the end of each reporting period, their categorisation within the fair value hierarchy may change over time. This might be the case if the market for a particular asset or liability that was previously considered active (Level 1) becomes inactive (Level 2 or Level 3) or if significant inputs used in a valuation technique that were previously unobservable (Level 3) become observable (Level 2) given transactions that were observed around the measurement date. Such changes in categorisation within the hierarchy are referred to in IFRS 13 as transfers between levels within the fair value hierarchy.

29 IFRS Project Report and Feedback Statement, *Post-implementation Review of IFRS 13* Fair Value Measurement, IASB, December 2018, p.16. Available on the IFRS Foundation's website.

An entity is required to select, and consistently apply, a policy for determining when transfers between levels of the fair value hierarchy are deemed to have occurred, that is, the timing of recognising transfers. This policy must be the same for transfers into and out of the levels. Examples of policies for determining the timing of transfers include: *[IFRS 13.95]*

- Date of the event or change in circumstances that caused the transfer
- Beginning of the reporting period

  Or
- End of the reporting period

An illustration is given below in Practical example 15-1.

Practical example 15-1: Beazley plc (2023) **United Kingdom**

Annual report and accounts 2023 [extract]
Financial statements [extract]
Notes to the financial statements [extract]
18 Financial assets and liabilities [extract]

18e Transfers

The Group determines whether transfers have occurred between levels in the fair value hierarchy by assessing categorisation at the end of the reporting period. The following transfers between levels 1 & 2 for the period ended 31 December 2023 reflect the level of trading activities including frequency and volume derived from market data obtained from an independent external valuation tool. There were no transfers into or out of level 3 in the year to 31 December 2023 (2022: no transfers).

31 December 2023 vs 31 December 2022 transfer from level 2 to level 1	Level 1 $m	Level 2 $m
– Corporate Bonds – Investment grade	446.0	(446.0)

...

The standard requires an entity to disclose this policy (see section 19.2 below). In addition, the selected timing (i.e., when transfers are deemed to have occurred) has a direct impact on the information an entity needs to collate in order to meet the disclosure requirements in IFRS 13 - specifically those required by IFRS 13.93(c) and IFRS 13.93(e)(iv) - for both transfers between Levels 1 and 2 and transfers into and out of Level 3 (these disclosure requirements are discussed in section 19.3.2 below). *[IFRS 13.93(c), IFRS 13.93(e)(iv)]*.

15.2.3 Information provided by third-party pricing services or brokers

IFRS 13 does not preclude the use of quoted prices provided by third parties, such as pricing services or brokers, provided those quoted prices are developed in accordance with the standard. Quoted prices provided by third parties represent an important source of information in estimating fair value for many entities. While not precluded, the standard makes it clear that the use of broker quotes, third-party pricing services, or a third-party valuation specialist does not alleviate management's responsibility for the fair value measurements (and the related disclosures) that will be included in its financial statements. *[IFRS 13.B45]*.

It is important for entities to understand the source of information received from brokers and pricing services, particularly when there has been a significant decrease in the volume or level of activity for the asset or liability, as management needs to assess the relevance of these quotes. This is discussed further in section 7.3 above.

As discussed in section 14.5 above, an entity should evaluate whether quotes from brokers and pricing services are based on current information that reflects orderly transactions or were determined using valuation techniques that appropriately reflect market participant assumptions regarding risk. Entities should place less weight on third-party quotes that are not based on transactions compared to fair value indications that are based on market transactions.

How we see it

Determining the level in which assets and liabilities are categorised within the fair value hierarchy for disclosure purposes often requires judgement. Information provided by third-party pricing services or brokers could represent Level 1, Level 2, or Level 3 inputs depending on the source of the information and the type of instrument being measured. For example, pricing services may provide quoted market prices (e.g., closing price) for financial instruments traded in active markets. These prices are Level 1 measurements.

Alternatively, a pricing service may provide an entity with consensus pricing information (e.g., information obtained by polling dealers for indications of mid-market prices for a particular asset class). The non-binding nature of consensus pricing would generally result in its categorisation as Level 3 information, assuming no additional corroborating evidence.

Pricing services may also use valuation models to estimate values for certain instruments. For example, pricing services may use matrix pricing to determine the value of many fixed-income securities. The hierarchy level in which these instruments would be categorised depends on the observability of the valuation model's inputs. Therefore, entities that use pricing services should understand the data sources and valuation methods used to derive those third-party quotes. This information will determine where the entity's instruments would be categorised within the fair value hierarchy.

Similarly, the level within the hierarchy in which a broker quote is categorised depends on the nature of the quote. *[IFRS 13.B47]*. In certain brokered markets, firm quotes are disclosed and an entity has the ability to 'hit' or execute a transaction at the quoted price. Depending on the level of activity in these markets, those quotes may be categorised as Level 1 or Level 2. However, when an entity has to solicit a quote from a broker, the quotes are often non-binding and may include a disclaimer that releases the broker from being held to that price in an actual transaction. On their own, non-binding quotes would generally represent a Level 3 input. In addition, when the quote includes explanatory language or a disclaimer, the entity should assess whether the quote represents fair value (exit price) or whether an adjustment is needed.

If an entity uses multiple quotes within a narrow range when measuring fair value, it will likely provide stronger evidence of fair value than a single quote or quotes that are widely dispersed. However, the number of quotes should not, in and of itself, affect the categorisation within the fair value hierarchy. An entity would still need to consider the nature of those quotes. For example, multiple Level 3 inputs, within a reasonable range, would not result in a Level 2 measurement without additional observable corroborating evidence.

In August 2014, the IFRS IC received a request to clarify the circumstances in which a fair value measurement, in its entirety, that uses prices that are provided by third parties (e.g., consensus prices) could be categorised within Level 1 of the fair value hierarchy, particularly in relation to debt securities that are actively traded. The submitter highlighted that categorisation within the fair value hierarchy for debt securities is not straightforward and that there were divergent views on the appropriate level within the hierarchy such fair value measurements should be categorised.

After considering the analyses and outreach performed by its staff, the IFRS IC decided not to add this issue to its agenda, noting the following:[30]

- The guidance in IFRS 13 relating to the categorisation within the fair value hierarchy was sufficient to draw an appropriate conclusion on this issue.
- The fair value hierarchy prioritises the inputs to valuation techniques, not the valuation techniques used to measure fair value. When the fair value of assets or liabilities is measured based on prices provided by third parties, the categorisation of those measurements within the fair value hierarchy depends on the evaluation of the inputs used by the third party to derive those prices; not on the pricing methodology the third party has used.

Only unadjusted quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date qualify as Level 1 measurement. Therefore, a fair value measurement that is based on prices provided by third parties can only be categorised within Level 1 of the fair value hierarchy if that measurement relies solely on unadjusted quoted prices in an active market for an identical instrument that the entity can access at the measurement date (i.e., P×Q, without adjustment).

30 *IFRIC Update*, January 2015, available on the IFRS Foundation's website.

15.2.4 Categorisation of over-the-counter derivative instruments

Depending on the observability of the inputs used, fair value measurements of over-the-counter derivatives that are not centrally cleared would likely be within either Level 2 or Level 3 of the fair value hierarchy.

Although over-the-counter derivative instruments may initially be executed in active markets, quoted prices for the identical asset or liability will often not be available when measuring fair value subsequently. For example, consider a 10-year plain vanilla interest-rate swap entered into on 1 January 2021 that is not centrally cleared. While there may be quoted prices for 10-year swaps, when measuring the fair value of the swap on 31 March 2021, the subject instrument would represent a 9.75-year swap for which quoted prices are generally not available. As a result, most over-the-counter derivative contracts that are not centrally cleared are valued based on inputs used in pricing models.

In addition, centrally cleared derivatives would not be categorised within Level 1 unless their fair value was determined based on an unadjusted quoted price in active markets for an identical instrument. See section 14.5 above for additional discussion on the consideration of values provided by central clearing organisations when determining the fair value.

16 Level 1 inputs

"Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date". *[IFRS 13.76]*. According to IFRS 13, this price represents the most reliable evidence of fair value. If a quoted price in an active market is available, an entity must use this price to measure fair value without adjustment; although adjustments are permitted in limited circumstances (see section 16.3 below). *[IFRS 13.77]*.

16.1 Use of Level 1 inputs

As a general principle, IFRS 13 mandates the use of quoted prices in active markets for identical assets and liabilities whenever available. With limited exceptions, quoted prices in active markets should not be adjusted when determining the fair value of identical assets and liabilities, as the IASB believes these prices provide the most reliable evidence of fair value.

Adjustments can only be made to a quoted price in an active market (a Level 1 input) in the following circumstances: *[IFRS 13.79]*

(a) *When an entity holds a large number of similar (but not identical) assets or liabilities (e.g., debt securities) that are measured at fair value and a quoted price in an active market is available but is not readily accessible for each of those assets or liabilities individually*

Since the assets or liabilities are not identical and given the large number of similar assets or liabilities held by the entity, it would be difficult to obtain pricing information for each individual asset or liability at the measurement date. In this situation, IFRS 13 provides a practical expedient allowing an entity to measure fair value using an alternative pricing method that does not rely exclusively on quoted prices (e.g., matrix pricing - see section 13.2 above).

(b) *When a quoted price in an active market does not represent fair value at the measurement date*

This may be the case if significant events (e.g., transactions in a principal-to-principal market, trades in a brokered market or announcements), take place after the close of a market, but before the measurement date. An entity must establish and consistently apply a policy for identifying those events that might affect fair value measurements.

(c) *When measuring the fair value of a liability or an entity's own equity instrument using the quoted price for the identical item traded as an asset in an active market and that price needs to be adjusted for factors specific to the item or the asset*

These exceptions are discussed further in sections 16.1.1, 16.2 and 16.3 below. Level 1 inputs are most commonly associated with financial instruments, for example, shares that are actively traded on a stock exchange. It may be that an asset or liability is traded in multiple active markets, for example, shares that are listed on more than one stock exchange. In light of this, the standard emphasises the need within Level 1 to determine both, the principal (or most advantageous) market (see section 5 above) and whether the entity can enter into a transaction for the asset or liability at the price in that market at the measurement date (see section 7 above). *[IFRS 13.78]*.

As discussed in section 15.2 above, if no adjustment is made to a Level 1 input, the result is the entire fair value measurement being categorised within Level 1 of the fair value hierarchy. However, any adjustment made to a Level 1 input or use of the practical expedient in (a) above would result in categorisation within a lower level of the fair value hierarchy. If the adjustment uses significant unobservable inputs, it would need to be categorised within Level 3. *[IFRS 13.75]*.

16.1.1 Level 1 liabilities and instruments classified in an entity's own equity

Quoted prices in active markets for identical liabilities and instruments classified as an entity's own equity are Level 1 measurements. These instruments would likewise be categorised within Level 1 when a quoted price exists for the identical instrument traded as an asset in an active market, provided no adjustment to the quoted price is required.

The fair value of corporate debt issued by a reporting entity, for example, would be a Level 1 measurement if the asset corresponding to the issuer's liability (i.e., the corporate bond) trades in an active market and no adjustment is made to the quoted price. While the liability itself is not transferred in an active market, the IASB concluded that Level 1 categorisation is appropriate when the identical instrument trades as an asset in an active market.

If an adjustment to the corresponding asset's price is required to address differences between the asset and the liability or equity instrument (as discussed in section 10 above), *[IFRS 13.79(c)]*, the adjusted price would not be a Level 1 measurement. For example, an adjustment to the quoted price of an asset that includes the effect of a third-party credit enhancement would be warranted when measuring the fair value of the liability. In this case, the corresponding asset and the liability would have different units of account (as discussed in section 10.3.1 above).

16.2 Alternative pricing methods

When an entity holds a large number of similar assets and liabilities for which quoted prices exist, but are not easily accessible, IFRS 13 allows for the use of alternative pricing methods (e.g., matrix pricing) as a practical expedient. *[IFRS 13.79(a)]*. The IASB provided this practical expedient to ease the administrative burden associated with obtaining quoted prices for each individual instrument. However, if the practical expedient is used, the resulting fair value measurement would not be considered a Level 1 measurement.

16.3 Quoted prices in active markets that are not representative of fair value

IFRS 13 recognises that in certain situations a quoted price in an active market might not represent the fair value of an asset or liability, such as when significant events occur before or on the measurement date, but after the close of trading. In these situations, entities would adjust the quoted price to incorporate this new information into the fair value measurement. *[IFRS 13.79(b)]*. The relevance of observable data (e.g., the most recent transaction prices, including transactions occurring after the measurement date that provide valuable insight into the assumptions used in estimating fair value as of the measurement date) must be considered when assessing how much weight to ascribe to this information when estimating fair value. However, if the quoted price is adjusted, the resulting fair value measurement would no longer be considered a Level 1 measurement.

An entity's valuation policies and procedures should address how these 'after-hour' events will be identified and assessed. Controls should be put in place to ensure that any adjustments made to quoted prices are appropriate under IFRS 13 and are applied in a consistent manner.

16.4 Unit of account

Although the unit of account is generally determined in accordance with other IFRSs, IFRS 13 addresses the unit of account for Level 1 assets and liabilities. IFRS 13 states that "if an entity holds a position in a single asset or liability (including a position comprising a large number of identical assets or liabilities, such as a holding of financial instruments) and the asset or liability is traded in an active market, the fair value of the asset or liability shall be measured within Level 1 as the product of the quoted price for the individual asset or liability and the quantity held by the entity". *[IFRS 13.80]*. By dictating that fair value be determined based on P×Q, IFRS 13 effectively prescribes the unit of account as the individual asset or liability in these situations.

This requirement is generally accepted when the asset or liability being measured is a financial instrument in the scope of IFRS 9. However, when an entity holds an investment in a listed subsidiary, joint venture or associate, some believe the fair value should include an adjustment (e.g., a control premium) to reflect the value of the investor's control, joint control or significant influence over their investment as a whole. In September 2014, the IASB issued an exposure draft that proposed clarifying that the requirement in IFRS 13 to use P×Q, without adjustment, to measure fair value would apply even in situations where the unit of account is the entire investment. After considering the responses from constituents, the IASB had directed its staff to perform additional research before they deliberated further. That research was fed into the PIR of IFRS 13. In December 2018, the IASB concluded its PIR and decided to do no further work on this topic. This is discussed further in section 4.1.1 above.

16.5 Examples of Level 1 inputs

Below are examples of fair value measurements of financial instruments that use Level 1 inputs, along with the considerations for determining whether an input qualifies as Level 1.

Asset or Liability	Example of a Level 1 Input
A unit in an investment fund quoted in an active market, whose investments are classified at Levels 2 and 3 in the fair value hierarchy.	The fund's units - The valuation of the fund's assets and liabilities is not relevant to the assessment as the fund's units are quoted in an active market.
An instrument traded in an active market for which one or more market participants provide a binding price quotation on the balance sheet date.	The binding quote - a binding quote is a bid price and is evidence of the amount for which an asset could be exchanged, between knowledgeable, willing parties, in an arm's length transaction (see section 14.5 above).
An instrument whose fair value is provided by a pricing service, vendor or broker or custodian.	For these services it is important to understand the methodology employed by the pricing service or vendor that provides the data. The conclusion depends on the methodology and liquidity of the market in which the financial asset or liability is traded. If the price provider uses only transaction prices of transactions occurring in an active market on the valuation date of the same instrument, the transaction price would be a Level 1 input (see section 14.5 above).

17 Level 2 inputs

17.1 Use of Level 2 inputs

Level 2 inputs include quoted prices (in non-active markets or in active markets for similar assets or liabilities), observable inputs other than quoted prices and inputs that are not directly observable, but are corroborated by observable market data. *[IFRS 13.82]*.

The inclusion of market-corroborated inputs is significant because it expands the scope of Level 2 inputs beyond those directly observable for the asset or liability. Inputs determined through mathematical or statistical techniques, such as correlation or regression, may be categorised as Level 2 if the inputs into, and/or the results from, these techniques can be corroborated with observable market data.

IFRS 13 requires that a Level 2 input be observable (either directly or indirectly through corroboration with market data) for substantially the full contractual term of the asset or liability being measured. *[IFRS 13.81]*. Therefore, a long-term input extrapolated from short-term observable market data (e.g., a 30-year yield extrapolated from the observable 5-, 10- and 15-year points on the yield curve) would generally not be considered a Level 2 input.

17.2 Examples of Level 2 inputs

IFRS 13's application guidance provides a number of examples of Level 2 inputs for specific assets or liabilities. These examples are included in Figure 17-1 below, which is adapted from IFRS 13. *[IFRS 13.B35]*.

Figure 17-1: Examples of Level 2 inputs

Asset or Liability	Example of a Level 2 Input
Receive-fixed, pay-variable interest rate swap based on the Interbank Offered Rate (IBOR) swap rate	The IBOR swap rate if that rate is observable at commonly quoted intervals for substantially the full term of the swap.
Receive-fixed, pay-variable interest rate swap based on a yield curve denominated in a foreign currency	The swap rate based on a yield curve denominated in a foreign currency that is observable at commonly quoted intervals for substantially the full term of the swap. This would be a Level 2 input if the term of the swap is 10 years and that rate is observable at commonly quoted intervals for 9 years, provided that any reasonable extrapolation of the yield curve for year 10 would not be significant to the fair value measurement of the swap in its entirety.
Receive-fixed, pay-variable interest rate swap based on a specific bank's prime rate	The bank's prime rate derived through extrapolation if the extrapolated values are corroborated by observable market data, for example, by correlation with an interest rate that is observable over substantially the full term of the swap.
Three-year option on exchange-traded shares	The implied volatility for the shares derived through extrapolation to year 3 if both of the following conditions exist: (i) Prices for one-year and two-year options on the shares are observable. (ii) The extrapolated implied volatility of a three-year option is corroborated by observable market data for substantially the full term of the option. In this situation, the implied volatility could be derived by extrapolating from the implied volatility of the one-year and two-year options on the shares and corroborated by the implied volatility for three-year options on comparable entities' shares, provided that correlation with the one-year and two-year implied volatilities is established.
Licensing arrangement	For a licensing arrangement that is acquired in a business combination and was recently negotiated with an unrelated party by the acquired entity (the party to the licensing arrangement), a Level 2 input would be the royalty rate in the contract with the unrelated party at inception of the arrangement.
Cash-generating unit	A valuation multiple (e.g., a multiple of earnings or revenue or a similar performance measure) derived from observable market data, e.g., multiples derived from prices in observed transactions involving comparable (i.e., similar) businesses, taking into account operational, market, financial and non-financial factors.
Finished goods inventory at a retail outlet	For finished goods inventory that is acquired in a business combination, a Level 2 input would be either a price to customers in a retail market or a price to retailers in a wholesale market, adjusted for differences between the condition and location of the inventory item and the comparable (i.e., similar) inventory items so that the fair value measurement reflects the price that would be received in a transaction to sell the inventory to another retailer that would complete the requisite selling efforts. Conceptually, the fair value measurement will be the same, whether adjustments are made to a retail price (downward) or to a wholesale price (upward). Generally, the price that requires the least amount of subjective adjustments should be used for the fair value measurement.
Building held and used	The price per square metre for the building (a valuation multiple) derived from observable market data, e.g., multiples derived from prices in observed transactions involving comparable (i.e., similar) buildings in similar locations.

The following table contains other examples of Level 2 inputs.

Figure 17-2: Examples of Level 2 inputs

Asset or Liability	Example of a Level 2 Input
An instrument for which there is currently no active market. An observable, recent transaction took place in this particular instrument.	The price in the recently observed transaction could be considered Level 2.
An instrument for which there is currently no active market. An observable, recent transaction took place for a similar instrument.	The price of the similar instrument.
An instrument whose fair value is provided by a pricing service, vendor or broker or custodian.	If the price provider uses a valuation technique and the inputs are observable, the inputs could be considered Level 2.For these services, it is important to understand the methodology employed by the pricing service or vendor that provides the data.

17.3 Market corroborated inputs

Level 2 inputs, as discussed in section 17.1 above, include market-corroborated inputs. That is, inputs that are not directly observable for the asset or liability, but, instead, are corroborated by observable market data through correlation or other statistical techniques.

IFRS 13 does not provide any detailed guidance regarding the application of statistical techniques, such as regression or correlation, when attempting to corroborate inputs to observable market data (Level 2) inputs. However, the lack of any specific guidance or 'bright lines' for evaluating the validity of a statistical inference by the IASB should not be construed to imply that the mere use of a statistical analysis (such as linear regression) would be deemed valid and appropriate to support Level 2 categorisation (or a fair value measurement for that matter). Any statistical analysis that is relied on for financial reporting purposes should be evaluated for its predictive validity. That is, the statistical technique should support the hypothesis that the observable input has predictive value with respect to the unobservable input.

In Figure 17-1 in section 17.2 above, for the three-year option on exchange-traded shares, the implied volatility derived through extrapolation has been categorised as a Level 2 input because the input was corroborated (through correlation) to an implied volatility based on an observable option price of a comparable entity. In this example, the determination of an appropriate proxy (i.e., a comparable entity) is a critical component in supporting that the implied volatility of the actual option being measured is a market-corroborated input.

In practice, identifying an appropriate benchmark or proxy requires judgement that should appropriately incorporate both qualitative and quantitative factors. For example, when valuing equity-based instruments (e.g., equity options), an entity should consider the industry, nature of the business, size, leverage and other factors that would qualitatively support the expectation that the benchmarks are sufficiently comparable to the subject entity. For example, equity valuation of an investment in an oil company that has invested heavily in developing a renewable energy product offering is likely to be impacted differently by climate-related risk factors than a similar oil company that does not have a transition plan to develop its product offering.

Qualitative considerations may differ depending on the type of input being analysed or the type of instrument being measured (e.g., a foreign exchange option versus an equity option).

In addition to the qualitative considerations discussed above, quantitative measures are used to validate a statistical analysis. For example, if a regression analysis is used as a means of corroborating non-observable market data, the results of the analysis can be assessed based on statistical measures.

17.4 Making adjustments to a Level 2 input

The standard acknowledges that, unlike a Level 1 input, adjustments to Level 2 inputs may be more common, but will vary depending on the factors specific to the asset or liability. *[IFRS 13.83]*.

There are a number of reasons why an entity may need to make adjustments to Level 2 inputs. Adjustments to observable data from inactive markets (see section 7 above), for example, might be required for timing differences between the transaction date and the measurement date, or differences between the asset being measured and a similar asset that was the subject of the transaction. In addition, factors such as the condition or location of an asset should also be considered when determining if adjustments to Level 2 inputs are warranted.

If the Level 2 input relates to an asset or liability that is similar, but not identical to the asset or liability being measured, the entity would need to consider what adjustments may be required to capture differences between the item being measured and the reference asset or liability. For example, if they have different characteristics, such as credit quality of the issuer in the case of a bond, adjustments may be needed for differences between the two. *[IFRS 13.83]*.

If an adjustment to a Level 2 input is significant to the entire fair value measurement, it may affect the fair value measurement's categorisation within the fair value hierarchy for disclosure purposes. If the adjustment uses significant unobservable inputs, it would need to be categorised within Level 3 of the hierarchy. *[IFRS 13.84]*.

17.5 Recently observed prices in an inactive market

Valuation technique(s) used to measure fair value must maximise the use of *relevant* observable inputs and minimise the use of unobservable inputs. While recently observed transactions for the same (or similar) items often provide useful information for measuring fair value, transactions or quoted prices in inactive markets are not necessarily indicative of fair value. A significant decrease in the volume or level of activity for the asset or liability may increase the chances of this. However, transaction data should not be ignored, unless the transaction is determined to be disorderly (see section 7 above).

The relevance of observable data, including last transaction prices, must be considered when assessing the weight this information should be given when estimating fair value and whether adjustments are needed (as discussed in section 17.4 above). Adjustments to observed transaction prices may be warranted in some situations, particularly when the observed transaction is for a similar, but not identical, instrument. Therefore, it is important to understand the characteristics of the item being measured compared with an item being used as a benchmark.

When few, if any, transactions can be observed for an asset or liability, an index may provide relevant pricing information if the underlying risks of the index are similar to the item being measured. While the index price may provide general information about market participant assumptions regarding certain risk features of the asset or liability, adjustments are often required to account for specific characteristics of the instrument being measured or the market in which the instrument would trade (e.g., liquidity considerations). While this information may not be determinative for the particular instrument being measured, it can serve to either support or contest an entity's determination regarding the relevance of observable data in markets that are not active.

IFRS 13 does not prescribe a methodology for applying adjustments to observable transactions or quoted prices when estimating fair value. Judgement is needed when evaluating the relevance of observable market data and determining what (if any) adjustments should be made to this information. However, the application of this judgement must be within the confines of the stated objective of a fair value measurement within the IFRS 13 framework. Since fair value is intended to represent the exit price in a transaction between market participants in the current market, an entity's intent to hold the asset due to current market conditions, or any entity-specific needs, is not relevant to a fair value measurement and is not a valid reason to adjust observable market data.

18 Level 3 inputs

All unobservable inputs for an asset or liability are Level 3 inputs. The standard requires an entity to minimise the use of Level 3 inputs when measuring fair value. As such, they should only be used to the extent that relevant observable inputs are not available, for example, in situations where there is limited market activity for an asset or liability. *[IFRS 13.86, IFRS 13.87]*.

18.1 Use of Level 3 inputs

A number of IFRS accounting standards permit or require the use of fair value measurements regardless of the level of market activity for the asset or liability as at the measurement date (e.g., the initial measurement of intangible assets acquired in a business combination). As such, IFRS 13 allows for the use of unobservable inputs to measure fair value in situations where observable inputs are not available. In these cases, the IASB recognises that the best information available with which to develop unobservable inputs may be an entity's own data. However, IFRS 13 is clear that while an entity may begin with its own data, this data should be adjusted if: *[IFRS 13.89]*

- Reasonably available information indicates that other market participants would use different data

  Or
- There is something particular to the entity that is not available to other market participants (e.g., an entity-specific synergy)

For example, when measuring the fair value of an investment property, we would expect that a reporting entity with a unique tax position would consider the typical market participant tax rate in its analysis. While this example is simplistic and is meant only to illustrate a concept, in practice significant judgement will be required when evaluating what information about unobservable inputs or market data may be reasonably available.

It is important to note that an entity is not required to undertake exhaustive efforts to obtain information about market participant assumptions when pricing an asset or liability. Nor is an entity required to establish the absence of contrary data. As a result, in those situations where information about market participant assumptions does not exist or is not reasonably available, a fair value measurement may be based primarily on the reporting entity's own data. *[IFRS 13.89]*.

Even in situations where an entity's own data is used, the objective of the fair value measurement remains the same - i.e., an exit price from the perspective of a market participant that holds the asset or owes the liability. *[IFRS 13.2]*. As such, unobservable inputs should reflect the assumptions that market participants would use, which includes the risk inherent in a particular valuation technique (such as a pricing model) and the risk inherent in the inputs. This may be more challenging if risks are not yet priced in a market. For example, providing climate information is expected to improve investor sentiment towards an entity but the impact of that sentiment on the entity might be difficult to quantify. As discussed in section 6.2 above, if a market participant would consider those risks in pricing an asset or liability, an entity must include that risk adjustment; otherwise the result would not be a fair value measurement. When categorising the entire fair value measurement within the fair value hierarchy, an entity would need to consider the significance of the model adjustment as well as the observability of the data supporting the adjustment. *[IFRS 13.87, IFRS 13.88]*.

18.2 Examples of Level 3 inputs

IFRS 13's application guidance provides a number of examples of Level 3 inputs for specific assets or liabilities, as outlined in Figure 18-1 below. *[IFRS 13.B36]*.

Figure 18-1: Examples of Level 3 inputs

Asset or Liability	Example of a Level 3 Input
Long-dated currency swap	An interest rate in a specified currency that is not observable and cannot be corroborated by observable market data at commonly quoted intervals or otherwise for substantially the full term of the currency swap. The interest rates in a currency swap are the swap rates calculated from the respective countries' yield curves.
Three-year option on exchange-traded shares	Historical volatility, i.e., the volatility for the shares derived from the shares' historical prices. Historical volatility typically does not represent current market participants' expectations about future volatility, even if it is the only information available to price an option.
Interest rate swap	An adjustment to a mid-market consensus (non-binding) price for the swap developed using data that are not directly observable and cannot otherwise be corroborated by observable market data.
Decommissioning liability assumed in a business combination	A current estimate using the entity's own data about the future cash outflows to be paid to fulfil the obligation (including market participants' expectations about the costs of fulfilling the obligation and the compensation that a market participant would require for taking on the obligation to dismantle the asset) if there is no reasonably available information that indicates that market participants would use different assumptions. That Level 3 input would be used in a present value technique together with other inputs, e.g., a current risk-free interest rate or a credit-adjusted risk-free rate if the effect of the entity's credit standing on the fair value of the liability is reflected in the discount rate rather than in the estimate of future cash outflows.
Cash-generating unit	A financial forecast (e.g., of cash flows or profit or loss) developed using the entity's own data if there is no reasonably available information that indicates that market participants would use different assumptions.

The following table contains other examples of Level 3 inputs.

Figure 18-2: Examples of Level 3 inputs

Asset or Liability	Example of a Level 3 Input
An instrument for which there is currently no active market. The entity uses a valuation model that is accepted in the market/industry.	A credit spread that is based on historical default statistics and a credit rating assigned by an agency would be a Level 3 input.
An instrument for which there is currently no active market. A consensus pricing mechanism is used to determine its fair value.	The prices are usually Level 3. The consensus pricing mechanism gets its inputs from market participants who may determine the fair value using models with unobservable inputs. The quotes that the participants provide to the consensus pricing mechanism are not binding bids and are not necessarily supported by prices from observable current market transactions.
An instrument for which there is currently no active market. The entity obtains non-binding quotes from different sources.	The non-binding quotes would not be regarded as "observable" transactions. These would be Level 3 unless evidence can be provided that the quotes are supported by observable transactions or inputs.
An equity instrument for which there is currently no active market.	The entity uses a valuation technique that is accepted in the market/industry based on a price/earnings ratio for similar entities. Although the calculation of a price/earnings ratio is usually based on market transactions, the application of the ratio is not evidence of market transactions in the same instrument.
A loan or debt instrument for which no active market exists. The entity uses a discounted cash flow model to calculate the fair value.	Risk-free interest rate plus an unobservable credit spread that is significant to the measurement. The credit spread is unobservable because the entity does not have quoted debt.

19 Disclosures

The disclosure requirements in IFRS 13 apply to fair value measurements recognised in the statement of financial position, after initial recognition, and disclosures of fair value (i.e., those items that are not measured at fair value in the statement of financial position, but whose fair value is required to be disclosed). However, as discussed in section 2.2.4 above, IFRS 13 provides a scope exception in relation to disclosures for:

- Plan assets measured at fair value in accordance with IAS 19
- Retirement benefit plan investments measured at fair value in accordance with IAS 26
- Assets for which recoverable amount is fair value less costs of disposal in accordance with IAS 36

In addition to these scope exceptions, the IASB decided not to require the IFRS 13 disclosures for items that are recognised at fair value only at initial recognition. Disclosure requirements in relation to fair value measurements at initial recognition are covered by the standard that is applicable to that asset or liability. For example, IFRS 3 requires disclosure of the fair value measurement of assets acquired and liabilities assumed in a business combination. *[IFRS 13.BC184]*.

However, it should be noted that, unlike IAS 19, IAS 26 and IAS 36, there is no scope exemption for IFRS 3 or other standards that require fair value measurements (or measures based on fair value) at initial recognition. Therefore, if those standards require fair value measurements (or measures based on fair value) after initial recognition, IFRS 13's disclosure requirements would apply.

This section assumes an entity applies IAS 1 *Presentation of Financial Statements*, not IFRS 18 *Presentation and Disclosure in Financial Statements*. For considerations under IFRS 18, refer to Chapter 4.

19.1 Disclosure objectives

IFRS 13 requires a number of disclosures designed to provide users of financial statements with additional transparency regarding:

- Extent to which fair value is used to measure assets and liabilities
- Valuation techniques, inputs and assumptions used in measuring fair value
- Effect of Level 3 fair value measurements on profit or loss (or other comprehensive income)

The standard establishes a set of broad disclosure objectives and provides the minimum disclosures an entity must make (see section 19.2 to 19.5 below for discussion regarding the minimum disclosure requirements in IFRS 13).

The objectives of IFRS 13's disclosure requirements are to: *[IFRS 13.91]*

(a) Enable users of financial statements to understand the valuation techniques and inputs used to develop fair value measurements

(b) Help users to understand the effect of fair value measurements on profit or loss and other comprehensive income for the period when fair value is based on unobservable inputs (Level 3 inputs)

After providing the minimum disclosures required by IFRS 13 and other standards, such as IAS 1 or IAS 34 *Interim Financial Reporting*, an entity must assess whether its disclosures are sufficient to meet the disclosure objectives in IFRS 13. If not, additional information must be disclosed in order to meet those objectives. *[IFRS 13.92]*. This assessment requires judgement and will depend on the specific facts and circumstances of the entity and the needs of the users of its financial statements.

An entity must consider all the following: *[IFRS 13.92]*

- Level of detail needed to satisfy the disclosure requirements
- How much emphasis to place on each of the various requirements
- Level of aggregation or disaggregation (see section 19.1.2 below)
- Whether users of financial statements need additional information to evaluate the quantitative information disclosed

An entity might, for example, disclose the nature of the item being measured at fair value, including the characteristics of the item being measured that are taken into account in the determination of relevant inputs. For example, if climate risk factors have a material impact on the fair value measurements, an entity might disclose whether and how climate-related factors have been incorporated within the methodologies and inputs. In addition, when describing the valuation techniques and inputs used for fair value measurements categorised within Levels 2 and 3, the entity might disclose how third-party information (such as broker quotes, pricing services, net asset values and relevant market data) was taken into account when measuring fair value. For example, for residential mortgage-backed securities, an entity might disclose the following: *[IFRS 13.IE64(a)]*

- Types of underlying loans (e.g., prime loans or sub-prime loans)
- Collateral
- Guarantees or other credit enhancements
- Seniority level of the tranches of securities
- Year of issue
- Weighted-average coupon rate of the underlying loans and the securities
- Weighted-average maturity of the underlying loans and the securities
- Geographical concentration of the underlying loans
- Information about the credit ratings of the securities

IFRS 13 includes the above example to illustrate the type of additional information an entity might disclose based on the considerations outlined in IFRS 13.92. These additional disclosures are intended to help financial statement users better understand and evaluate the quantitative information provided by the entity (e.g., the quantitative information the entity disclosed regarding the valuation of its residential mortgage-backed securities holdings).

19.1.1 Format of disclosures

IFRS 13's requirements, with regard to the format of disclosures, are limited to the presentation of quantitative information. An entity is required to use a tabular format to present the quantitative disclosures required by IFRS 13, unless another format is more appropriate. *[IFRS 13.99]*.

19.1.2 Level of disaggregation

IFRS 13 requires disclosures to be presented by class of asset or liability (the definition of a class of asset or liability is discussed in section 19.1.2.A below). Unlike certain other IFRSs, IFRS 13 does not specify the level of aggregation or disaggregation an entity must use when complying with its disclosure requirements. Instead, as discussed below, it simply provides the basis for making this determination. As such, the appropriate class of assets and liabilities may depend on the entity's specific facts and circumstances and the needs of users of its financial statements.

According to the standard, a class of assets and liabilities will often require greater disaggregation than the line items presented in the statement of financial position. Therefore, an entity must present information in sufficient detail to permit reconciliation back to the statement of financial position. *[IFRS 13.94]*. Such a reconciliation could be presented through the use of subtotals that correspond to line items disclosed in the statement of financial position; however, other approaches may be acceptable.

During the PIR of IFRS 13, respondents indicated that the level of aggregation or disaggregation was a challenge. In particular, respondents said that the information was less useful if aggregated too much and suggested more guidance and examples would be helpful to promote more appropriate levels of aggregation. This was considered as part of the Board's Primary Financial Statements project (see section 19 above).

19.1.2.A Determining appropriate classes of assets and liabilities for disclosure

Determining appropriate classes of assets and liabilities requires judgement. An entity bases this determination on the nature, characteristics and risks of the asset or liability and the level of the fair value hierarchy within which the fair value measurement is categorised (see section 15.2 above for further discussion). *[IFRS 13.94]*. In addition, the standard specifies that the number of classes may need to be greater for fair value measurements categorised within Level 3 of the fair value hierarchy because they have a greater degree of uncertainty and subjectivity.

Other IFRS accounting standards may specify classes for asset or liability. For example, IAS 16 and IAS 38 require disclosures by class of property, plant and equipment or intangible respectively. If another IFRS specifies the class for an asset or a liability and that class meets the requirements for determining a class in accordance with IFRS 13, an entity may use that class in providing IFRS 13's required disclosures. *[IFRS 13.94]*.

The determination of a class includes considering the fair value measurement's categorisation within the fair value hierarchy as noted above with respect to Level 3 measurements. IFRS 13 requires disclosure of this categorisation for each class of asset or liability (see sections 19.3 to 19.4 below). While an entity takes the fair value categorisation into consideration when determining a class, this does not mean assets or liabilities within a single class cannot be categorised within different levels of the hierarchy. For example, assume an entity has grouped all its buildings within one class in accordance with IAS 16 and measures all those buildings using the revaluation approach in that standard. Further assume that the fair value measurements of some buildings are categorised within Level 2 while others are categorised within Level 3, based on the availability of observable inputs used in the fair value measurement. In and of itself, the assets' categorisation within two levels of the hierarchy does not necessarily mean the entity would need to further disaggregate the IAS 16 class of buildings into two classes for disclosure in accordance with IFRS 13. However, it may be appropriate to do that if the differing categorisation indicated the buildings categorised within Level 2 were different in their nature, characteristics or risks compared to those categorised within Level 3.

The Practical example below illustrates classes of financial instruments for assets categorised within level 3 of the fair value hierarchy for the purpose of these disclosures.

Practical example 19-1: Barclays PLC (2021) **United Kingdom**

Annual Report 2021 [extract]

Consolidated financial statements [extract]

Consolidated balance sheet [extract]

As at December 31	Notes	2021 £m	2020 £m
Assets			
Cash and balances at central banks		**238,574**	191,127
Cash collateral and settlement balances		**92,542**	101,367
Loans and advances at amortised cost	19	**361,451**	342,632
Reverse repurchase agreements and other similar secured lending		**3,227**	9,031
Trading portfolio assets	12	**147,035**	127,950
Financial assets at fair value through the income statement	13	**191,972**	175,151
Derivative financial instruments	14	**262,572**	302,446
Financial assets at fair value through other comprehensive income	15	**61,753**	78,688
Investments in associates and joint ventures	36	**999**	781
Goodwill and intangible assets	22	**8,061**	7,948
Property, plant and equipment	20	**3,555**	4,036
Current tax assets		**261**	477
Deferred tax assets	9	**4,619**	3,444
Retirement benefit assets	33	**3,879**	1,814
Other assets		**3,785**	2,622
Total assets		**1,384,285**	1,349,514

...

Notes to the financial statements [extract]

17 Fair value of financial instruments [extract]

Valuation [extract]

Assets and liabilities held at fair value

	2021 Valuation technique using				2020 Valuation technique using			
As at 31 December	Level 1 £m	Level 2 £m	Level 3 £m	Total £m	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Trading portfolio assets	**80,926**	**63,828**	**2,281**	**147,035**	60,671	65,416	1,863	127,950
Financial assets at fair value through the income statement	**5,093**	**177,167**	**9,712**	**191,972**	4,503	162,142	8,506	175,151
Derivative financial assets	**6,150**	**252,412**	**4,010**	**262,572**	9,155	288,822	4,469	302,446
Financial assets at fair value through other comprehensive income	**22,009**	**39,706**	**38**	**61,753**	19,792	58,743	153	78,688
Investment property	**—**	**—**	**7**	**7**	—	—	10	10
Total assets	**114,178**	**533,113**	**16,048**	**663,339**	94,121	575,123	15,001	684,245
Trading portfolio liabilities	**(27,529)**	**(26,613)**	**(27)**	**(54,169)**	(24,391)	(22,986)	(28)	(47,405)
Financial liabilities designated at fair value	**(174)**	**(250,376)**	**(410)**	**(250,960)**	(159)	(249,251)	(355)	(249,765)
Derivative financial liabilities	**(6,571)**	**(244,253)**	**(6,059)**	**(256,883)**	(8,762)	(285,774)	(6,239)	(300,775)
Total liabilities	**(34,274)**	**(521,242)**	**(6,496)**	**(562,012)**	(33,312)	(558,011)	(6,622)	(597,945)

...

The following table shows the Group's Level 3 assets and liabilities that are held at fair value disaggregated by product type:

Level 3 assets and liabilities held at fair value by product type

	2021		2020	
	Assets	Liabilities	Assets	Liabilities
	£m	£m	£m	£m
Interest rate derivatives	**1,091**	**(1,351)**	1,613	(1,615)
Foreign exchange derivatives	**376**	**(374)**	144	(143)
Credit derivatives	**323**	**(709)**	196	(351)
Equity derivatives	**2,220**	**(3,625)**	2,498	(4,112)
Corporate debt	**1,205**	**(21)**	698	(3)
Reverse repurchase and repurchase agreements	**13**	**(172)**	—	(174)
Non-asset backed loans	**6,405**	**—**	6,394	—
Asset backed securities	**558**	**—**	767	(24)
Equity cash products	**393**	**—**	542	—
Private equity investments	**1,095**	**(6)**	873	(14)
Other[a]	**2,369**	**(238)**	1,276	(186)
Total	**16,048**	**(6,496)**	15,001	(6,622)

...

19.1.3 Differentiating between 'recurring' and 'non-recurring'

IFRS 13 has different disclosure requirements for those fair value measurements that are recognised (rather than just disclosed), depending on whether those measurements are recurring or non-recurring in nature (see section 19.3 below). Therefore, it is important to understand the distinction.

- *Recurring* fair value measurements are those that another IFRS requires or permits to be recognised in the statement of financial position at the end of each reporting period. *[IFRS 13.93(a)]*. For example, the fair value of a financial asset classified as fair value through profit or loss in accordance with IFRS 9 would need to be measured at the end each reporting period. Other examples include a liability to distribute non-cash assets to shareholders, measured at fair value in accordance with IFRIC 17 *Distributions of Non-cash Assets to Owners*.

  #### How we see it

  In our view, revaluations of property, plant and equipment in accordance with IAS 16 represent a recurring fair value measurement. The revaluation model in IAS 16 requires that revaluations be made "with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period". Furthermore, "the frequency of revaluations depends upon the changes in fair values of the items of property, plant and equipment being revalued. When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is required". Therefore, while an entity might not revalue an asset each year, the objective is to ensure the carrying amount approximates fair value, subject to materiality.

- *Non-recurring* fair value measurements are those that another IFRS requires or permits to be recognised in the statement of financial position in particular circumstances. For example, IFRS 5 requires an entity to measure an asset held for sale at the lower of its carrying amount and fair value less costs to sell. Since the asset's fair value less costs to sell is only recognised in the statement of financial position when it is lower than its carrying amount, that fair value measurement is non-recurring. *[IFRS 13.93(a)]*. However, it should be noted that in a disposal group, not all assets and liabilities are subject to the measurement requirements of IFRS 5. If financial assets categorised as fair value through other comprehensive income in accordance of IFRS 9 were included in a disposal group, an entity would continue to measure these assets in accordance with IFRS 9 at fair value. These fair value measurements would continue to be recurring.

19.2 Accounting policy disclosures

In general, the requirements to disclose an entity's accounting policies will be addressed by the standard that requires or permits an item to be measured at fair value. The disclosure requirements of IAS 8 would address any changes to an entity's accounting policies (see Chapter 3). In addition to these, IFRS 13 requires the disclosure of the following two policies:

- Firstly, if an entity makes an accounting policy decision to use the exception in relation to the measurement of fair value for financial assets and financial liabilities with offsetting positions, it must disclose that fact (see section 11 above for further discussion regarding the measurement exception and criteria for selecting this accounting policy choice). *[IFRS 13.96]*.
- Secondly, an entity must disclose its policy for determining when transfers between levels of the fair value hierarchy are deemed to have occurred (see section 15.2.2 above for further discussion regarding this policy choice). *[IFRS 13.95]*.

As discussed in section 13.1.4 above, changes to fair value resulting from a change in the valuation technique or its application are accounted for as a change in accounting estimate in accordance with IAS 8 (unless the valuation technique is applied in error, which would be accounted for as a correction of an error in accordance with IAS 8). However, information would be disclosed in accordance with IFRS 13, not IAS 8; specifically, that there has been a change in valuation technique and the reasons for the change (see section 19.3.5 below for further discussion). *[IFRS 13.93(d)]*. This is illustrated in the extract from the financial statements of ING Groep N.V. in the Practical example below.

Practical example 19-2: ING Groep N.V. (2014) **Netherlands**

Annual Report 2014 [extract]

Notes to the consolidated annual accounts [extract]

1 Accounting policies [extract]

Critical accounting policies [extract]

Fair values of real estate

Real estate investments are reported at fair value. The fair value of real estate investments is based on regular appraisals by independent qualified valuers. The fair values are established using valuation methods such as: comparable market transactions, capitalisation of income methods or discounted cash flow calculations. The underlying assumption used in the valuation is that the properties are let or sold to third parties based on the actual letting status. The discounted cash flow analyses and capitalisation of income method are based on calculations of the future rental income in accordance with the terms in existing leases and estimations of the rental values for new leases when leases expire and incentives like rental free periods. The cash flows are discounted using market based interest rates that reflect appropriately the risk characteristics of real estate.

Market conditions in recent years have led to a reduced level of real estate transactions. Transaction values were significantly impacted by low volumes of actual transactions. As a result comparable market transactions have been used less in valuing ING's real estate investments by independent qualified valuers. More emphasis has been placed on discounted cash flow analysis and capitalisation of income method.

Reference is made to Note 43 'Fair value of assets and liabilities' for more disclosure on fair values of real estate investments.

The valuation of real estate involves various assumptions and techniques. The use of different assumptions and techniques could produce significantly different valuations. Consequently, the fair values presented may not be indicative of the net realisable value. In addition, the calculation of the estimated fair value is based on market conditions at a specific point in time and may not be indicative of future fair values. To illustrate the uncertainty of our real estate investments valuation, a sensitivity analysis on the changes in fair value of real estate is provided in the 'Risk management' section.

19.3 Disclosures for recognised fair value measurements

IFRS 13.93 establishes the minimum disclosure requirements for fair value measurements (and those based on fair value) that are recognised in the statement of financial position after initial recognition. The requirements vary depending on whether the fair value measurements are recurring or non-recurring and their categorisation within the fair value hierarchy (i.e., Level 1, 2, or 3 - see section 15 above for further discussion regarding the fair value hierarchy).

Irrespective of the frequency with which the fair value is measured, the disclosures under IFRS 13 are intended to provide financial statement users with additional insight into the relative subjectivity of various fair value measurements and enhance their ability to broadly assess an entity's quality of earnings.

In order to meet the disclosure objectives, the following information, at a minimum, must be disclosed for all fair value measurements. Disclosures are required for each class of asset and liability, whether recurring or non-recurring, that are recognised in the statement of financial position after initial recognition: *[IFRS 13.93]*

(a) The fair value measurement at the end of the reporting period (see Example 15 in the standard, discussed in section 19.3.3 below)

(b) For non-financial assets, if the highest and best use differs from its current use, an entity must disclose that fact and why the non-financial asset is being used in a manner that differs from its highest and best use

(c) The fair value measurement's categorisation within the fair value hierarchy (Level 1, 2 or 3 - see Example 15 in the standard, discussed in section 19.3.3 below)

(d) If categorised within Level 2 or Level 3 of the fair value hierarchy:
   (i) A description of the valuation technique(s) used in the fair value measurement
   (ii) The inputs used in the fair value measurement
   (iii) If there has been a change in valuation technique (e.g., changing from a market approach to an income approach or the use of an additional valuation technique), disclose the change and the reason(s) for making it

(e) Quantitative information about the significant unobservable inputs used in the fair value measurement for those categorised within Level 3 of the fair value hierarchy (see Example 17 in the standard and section 19.3.5.A below)

(f) If categorised within Level 3 of the fair value hierarchy, a description of the valuation processes used by the entity (including, how an entity decides its valuation policies and procedures and analyses changes in fair value measurements from period to period) - this requirement focuses on valuation processes rather than the specific valuation techniques, which are covered by the requirements in (d) above

In addition to these requirements, an entity must provide the disclosures discussed in sections 19.3.1 and 19.3.2 below depending on whether the measurement is recurring or non-recurring.

19.3.1 Disclosures for recognised recurring fair value measurements

The disclosure requirements in IFRS 13.93 (see section 19.3 above and sections 19.3.1.A and 19.3.1.B below) apply to all fair value measurements that are recognised in the financial statements on a recurring basis. Given the increased subjectivity, IFRS 13 requires additional disclosures for fair value measurements categorised within Level 3 of the fair value hierarchy than for those categorised within Levels 1 or 2 (see section 19.3.1.B below).

The IASB had proposed additional disclosures for Level 2 fair value measurements that are closer in terms of measurement uncertainty to Level 3 of the fair value hierarchy as part of Exposure Draft ED/2021/3 (see Section 19.6 below) as users of financial statements noted that limited information is often provided about material fair value measurements. However, respondents to the Exposure Draft asked for more guidance on identifying the Level 2 fair value measurements that are closer to Level 3 of the fair value hierarchy, whilst others were concerned that additional costs would be incurred to collate the information for measurements outside of Level 3 of the fair value hierarchy.[31]

19.3.1.A Recurring fair value measurements categorised as Level 1 or Level 2

For recurring fair value measurements that are categorised within either Level 1 or Level 2 of the fair value hierarchy, an entity must disclose both of the following:

- Information required to comply with the disclosure requirements discussed in section 19.3 above
- For any transfers between Level 1 and Level 2 of the fair value hierarchy:
   (i) The amounts of any transfers between Level 1 and Level 2 of the fair value hierarchy
   (ii) The reasons for those transfers
   (iii) The entity's policy for determining when transfers between levels are deemed to have occurred (see sections 15.2.2 and 19.2 above for further discussion)

   The standard requires transfers into each level to be disclosed and discussed separately from transfers out of each level. *[IFRS 13.93]*.

31 Project Summary and Feedback Statement, *Disclosure Initiative-Targeted Standards-level Review of Disclosures*, IASB, March 2023, p. 28. Available on the IFRS Foundation's website.

19.3.1.B Recurring fair value measurements categorised as Level 3

In addition to the disclosure requirements listed in section 19.3 above, recurring fair value measurements that are categorised within Level 3 of the fair value hierarchy are subject to additional disclosure requirements: *[IFRS 13.93]*

(a) A reconciliation from the opening balances to the closing balances, disclosing separately changes during the period (also referred to as the Level 3 roll-forward)

(b) A narrative description of the sensitivity of Level 3 fair value measurements to changes in unobservable inputs

(c) For financial assets and financial liabilities only, quantitative sensitivity analysis for Level 3 fair value measurements

These additional disclosure requirements for Level 3 fair value measurements are discussed further in sections 19.3.5 to 19.3.8 below.

19.3.2 Disclosures for recognised non-recurring fair value measurements

Certain disclosure requirements in IFRS 13 do not apply to fair value measurements that are non-recurring in nature (e.g., a non-current asset (or disposal group) held for sale measured at fair value less costs to sell in accordance with IFRS 5 where the fair value less costs to sell is lower than its carrying amount). Specifically, the following disclosures are *not* required for non-recurring recognised fair value measurements: *[IFRS 13.93]*

- Information about any transfers between Level 1 and Level 2 of the fair value hierarchy
- A reconciliation of the opening balances to the closing balances for Level 3 measurements (also referred to as the Level 3 roll-forward)
- A narrative description of the sensitivity of Level 3 fair value measurements to changes in unobservable inputs
- For financial assets and financial liabilities, quantitative sensitivity analysis for Level 3 fair value measurements

Information regarding transfers between hierarchy levels and the Level 3 reconciliation do not lend themselves to non-recurring measurements and, therefore, are not required. While discussing the sensitivity of Level 3 measurements to changes in unobservable inputs might provide financial statement users with some information about how the selection of these inputs affects non-recurring valuations, the Boards ultimately decided that this information is most relevant for recurring measurements.

However, entities are required to disclose the reason for any non-recurring fair value measurements made subsequent to the initial recognition of an asset or liability. *[IFRS 13.93]*. For example, the entity may intend to sell or otherwise dispose of it, thereby resulting in the need for its measurement at fair value less costs to sell based on the requirements of IFRS 5, if lower than the asset's carrying amount.

While obvious for recurring measurements, determining the periods in which the fair value disclosures should be made for non-recurring measurements is less clear. For example, assume a listed entity classifies a building as held for sale in accordance with IFRS 5 at the end of its second quarter and appropriately decreases the carrying value of the asset to its then fair value less costs to sell. In its interim financial statements, the entity would make all of the disclosures required by IFRS 13 for non-recurring fair value measurements. During the second half of the financial year, the sale falls through and the asset is no longer held for sale. In accordance with IFRS 5, the asset is measured at its carrying amount before the asset (or disposal group) was classified as held for sale, adjusted for any depreciation, as this is lower than its recoverable amount. The entity continues to account for the asset in accordance with IAS 16. While the carrying value of the asset at the end of the financial year is no longer *at* fair value less costs to sell, the asset was adjusted to fair value less costs to sell during the year. Therefore, in its annual financial statements, the entity would again disclose the information required by IFRS 13 for non-recurring fair value measurements.

How we see it

While not explicit in IFRS 13, we believe the above approach is consistent with the interim and annual disclosure requirements for assets subsequently measured under the revaluation model in IAS 34 and IFRS 5.

In these situations, we recommend that the disclosures clearly indicate that the fair value information presented is not current, but rather as at the date fair value was measured. Entities should also indicate whether the carrying amount of the asset no longer equals its fair value.

19.3.3 Fair value hierarchy categorisation

IFRS 13 requires entities to disclose the fair value hierarchy level in which each fair value measurement is categorised. As noted in section 15.2 above, the categorisation of a fair value measurement of an asset or liability in the fair value hierarchy is based on the lowest level input that is significant to the fair value measurement in its entirety. Although the hierarchy disclosure is presented by class of asset or liability, it is important to understand that the determination of the hierarchy level in which a fair value measurement falls (and therefore the category in which it will be disclosed) is based on the fair value measurement for the specific item being measured and is, therefore, driven by the unit of account for the asset or liability.

For example, in situations where the unit of account for a financial instrument is the individual item, but the measurement exception for financial instruments is used (as discussed in section 11 above), entities may need to allocate portfolio-level adjustments to the various instruments that make up the net exposure for purposes of hierarchy categorisation.

This may seem inconsistent to certain constituents given the discussion in section 11 above about the consideration of size as a characteristic of the net risk exposure when the measurement exception for financial instruments is used. However, the IASB and FASB staffs have indicated that the determination of the net risk exposure as the unit of measurement applies only for measurement considerations and was not intended to change current practice with respect to disclosures. As such, the entire net exposure would not be categorised within a single level of the fair value hierarchy (e.g., Level 2), unless all of the individual items that make up the net exposure fell within that level.

To illustrate, consider an individual derivative that is valued using the measurement exception as part of a group of derivative instruments with offsetting credit risk (due to the existence of a legally enforceable netting agreement). Assuming the portfolio included instruments that on their own must be categorised within different levels of the fair value hierarchy (i.e., Level 2 and Level 3), for disclosure purposes, the portfolio-level adjustment for credit risk (considering the effect of master netting agreements) may need to be attributed to the individual derivative transactions within the portfolio or to the group of transactions that fall within each of the levels of the hierarchy. This example assumes that the portfolio-level adjustment for credit risk is based on observable market data. If the portfolio-level adjustment was determined using unobservable inputs, the significance of the adjustment to the measurement of the individual derivative instruments would need to be considered in order to determine if categorisation in Level 2 or Level 3 was appropriate.

IFRS 13 provides an example illustrating how an entity might disclose, in tabular format, the fair value hierarchy category for each class of assets and liabilities measured at fair value at the end of each reporting period. *[IFRS 13.IE Example 15, IFRS 13.IE60]*. In that example, the gain or loss recognised during the period for assets and liabilities measured at fair value on a non-recurring basis would be separately disclosed in the notes to the financial statements.

19.3.4 Transfers between hierarchy levels for recurring fair value measurements

IFRS 13 requires entities to disclose information regarding all transfers between fair value hierarchy levels (i.e., situations where an asset or liability was categorised within a different level in the fair value hierarchy in the previous reporting period). *[IFRS 13.93(c), IFRS 13.93(e)(iv)]*. However, this disclosure requirement only applies to assets and liabilities held at the end of the reporting period which are measured at fair value on a recurring basis. Information regarding transfers into or out of Level 3 is captured in the Level 3 reconciliation (discussed in section 19.3.6 below) as these amounts are needed to roll forward Level 3 balances from the beginning to the end of the period being disclosed. The amounts of any transfers between Level 1 and Level 2 of the fair value hierarchy are also required to be disclosed. Regardless of the hierarchy levels involved, transfers into each level of the hierarchy are disclosed separately from transfers out of each level. That is, all transfers are required to be presented on a gross basis by hierarchy level, whether included in the Level 3 reconciliation or disclosed separately.

For all transfer amounts disclosed, an entity is required to discuss the reasons why the categorisation within the fair value hierarchy has changed (i.e., transferred between hierarchy levels). *[IFRS 13.93(c), IFRS 13.93(e)(iv)]*. Reasons might include the market for a particular asset or liability previously considered active (Level 1) becoming inactive (Level 2 or Level 3), or significant inputs used in a valuation technique that were previously unobservable (Level 3) becoming observable (Level 2) given transactions that were observed around the measurement date.

As discussed in sections 15.2.2 and 19.2 above, IFRS 13 also requires that entities disclose and consistently follow their policy for determining when transfers between fair value hierarchy levels are deemed to have occurred. That is, an entity's policy about the timing of recognising transfers into the hierarchy levels should be the same as the policy for recognising transfers out, and this policy should be used consistently from period to period. IFRS 13.95 includes the following examples of potential policies: the actual date of the event or change in circumstances that caused the transfer, the beginning of the reporting period or the end of the reporting period. In practice, some variation of these approaches may also be used by entities. For example, some entities may use an intra-period approach using a transfer amount based on the fair value as at the month-end in which the transfer occurred, as opposed to the actual date within the month. *[IFRS 13.95]*. The following illustrative example demonstrates the differences between the three methods noted above.

Illustration 19-1: Comparison of policies for recognising transfers

Assume an entity acquires an asset at 31 December 20X0 for CU1,000 that was categorised within Level 2 of the fair value hierarchy at year end 20X0 and throughout Q1 20X1. At the end of Q1 20X1, the fair value of the asset based on market observable information was CU950, and, as such, the asset was excluded from the Level 3 reconciliation. During Q2 20X1, observable market information was no longer available, so the entity categorised the asset in Level 3 at the end of Q2 20X1. During Q2 20X1, the fair value of the asset decreased from CU950 to CU750, with CU50 of the change in fair value arising subsequent to the time when market observable information was no longer available.

Under the three approaches described above, the Level 3 reconciliation for Q2 20X1 would be as follows:

	Transferred to Level 3 at:		
	Beginning of the period	Actual date	End of the period
Beginning fair value	-	-	-
Purchases, issuances and settlements	-	-	-
Transfers in	CU950	CU800	CU750
Total losses	(CU200)	(CU50)	-
Ending fair value	**CU750**	**CU750**	**CU750**

How we see it

As previously noted, the disclosures under IFRS 13 are intended to provide information that enables users to identify the effects of fair value measurements that are more subjective in nature on reported earnings, and, thereby, enhance financial statement users' ability to make their own assessment regarding earnings quality. We believe that this objective is best met by considering the level of observability associated with the fair value measurement made at the end of the reporting period (i.e., the observability of the inputs used to determine fair value on the last day in the period). As such, while no specific approach is required under IFRS, we note the following about the approaches mentioned in the standard.

We believe a beginning-of-period approach for recognising transfers provides greater transparency on the effect that unobservable inputs have on fair value measurements and reported earnings. Under this view, all changes in fair value that arise during the reporting period of the transfer are disclosed as a component of the Level 3 reconciliation. However, any unrealised gains or losses for items that move from Level 3 to Level 2 during the reporting period would not be reflected.

While the 'actual date' approach more precisely captures the date on which a change in the observability of inputs occurred, its application can be more operationally complex. In addition, in our view, it does not necessarily provide more decision-useful information than the beginning-of-period approach. This is because, for a given period, the intra-period approach results in an allocation of the fair value changes between hierarchy levels that is inconsistent with the actual categorisation of the item as at the end of the reporting period. As such, the intra-period approach implies that a portion of the earnings recognised during the period is of a higher (or lower) quality solely because there was observable information regarding the value of the instrument at some point during the period.

To further illustrate this point, assume an entity acquires an investment in a private company in Q1 for CU1,000. In the middle of Q2, the company completes an initial public offering that values the investment at CU1,500. At the end of Q2, the fair value of the investment is CU2,200 based on a quoted market price. Under the intra-period approach for the six-month period ended Q2, CU500 would be included as an unrealised gain in the Level 3 reconciliation, despite the fact that the entire CU1,200 unrealised gain recognised during the six-month period is supported by observable market information (i.e., a quoted price less cash paid).

Of the three alternatives, we believe the end-of-period approach is the least effective in achieving IFRS 13's disclosure objectives. Under this approach, the Level 3 reconciliation would not reflect any unrealised gains or losses for items that move from Level 2 to Level 3 during the reporting period.

19.3.5 Disclosure of valuation techniques and inputs

Entities are required to describe the valuation techniques and inputs used to measure the fair value of items categorised within Level 2 or Level 3 of the fair value hierarchy. In addition, entities are required to disclose instances where there has been a change in the valuation technique(s) used during the period, and the reason for making the change. As discussed in section 19.3.5.A below, the standard also requires quantitative information about the significant unobservable inputs to be disclosed for Level 3 fair value measurements. *[IFRS 13.93(d)]*.

Importantly, the disclosures related to valuation techniques and inputs (including the requirement to disclose quantitative information about unobservable inputs) apply to both recurring and non-recurring fair value measurements. *[IFRS 13.93(d)]*.

19.3.5.A Significant unobservable inputs for Level 3 fair value measurements

For Level 3 measurements, IFRS 13 specifically requires that entities provide quantitative information about the significant unobservable inputs used in the fair value measurement. *[IFRS 13.93(d)]*. For example, an entity with asset-backed securities categorised within Level 3 would be required to quantitatively disclose the inputs used in its valuation models related to prepayment speed, probability of default, loss given default and discount rate (assuming these inputs were all unobservable and deemed to be significant to the valuation).

Consistent with all of the disclosures in IFRS 13, entities are required to present this information separately for each class of assets or liabilities based on the nature, characteristics and risks of their Level 3 measurements. *[IFRS 13.93]*. As such, we expect that entities will likely disclose both the range and weighted average of the unobservable inputs used across a particular class of Level 3 assets or liabilities. In addition, entities should assess whether the level of disaggregation at which this information is provided results in meaningful information to users, consistent with the objectives of IFRS 13.

In some situations, significant unobservable inputs may not be developed by the reporting entity itself, such as when an entity uses third-party pricing information without adjustment. In these instances, IFRS 13 states that an entity is not required to create quantitative information to comply with its disclosure requirements. However, when making these disclosures, entities cannot ignore information about significant unobservable inputs that is 'reasonably available'.

Determining whether information is 'reasonably available' will require judgement, and there may be some diversity in practice stemming from differences in entities' access to information and information vendors may be willing or able to provide. If the valuation has been developed, either by the entity or an external valuation expert at the direction of the entity, quantitative information about the significant unobservable inputs would be expected to be reasonably available and therefore should be disclosed. As a result, entities need to ensure any valuers they use provide them with sufficient information to make the required disclosures.

In contrast, when an entity receives price quotes or other valuation information from a third-party pricing service or broker, the specific unobservable inputs underlying this information may not always be reasonably available to the entity. While determining whether information is reasonably available in these instances will require judgement, we would expect entities to make good-faith efforts to obtain the information needed to meet the disclosure requirements in IFRS 13. In addition, some diversity in practice may stem from differences in entities' access to information and the nature of information that various vendors may be willing or able to provide. However, in all cases, any adjustments made by an entity to the pricing data received from a third party should be disclosed if these adjustments are not based on observable market data and are deemed to be significant to the overall measurement.

IFRS 13 provides an example illustrating the type of information an entity might provide to comply with the requirement to disclose quantitative information about Level 3 fair value measurements. *[IFRS 13.IE Example 17, IFRS 13.IE63]*. Practical example 19-4 from Standard Chartered PLC and Practical example 19-5 from Centrica plc in section 19.3.8.A below also illustrate this disclosure in relation to derivatives categorised within Level 3.

19.3.6 Level 3 reconciliation

IFRS 13 requires a reconciliation (also referred to as the Level 3 roll-forward) of the beginning and ending balances for any recurring fair value measurements that utilise significant unobservable inputs (i.e., Level 3 inputs). Therefore, any asset or liability (measured at fair value on a recurring basis) that was determined to be a Level 3 measurement at either the beginning or the end of a reporting period would need to be considered in the Level 3 reconciliation.

To reconcile Level 3 balances for the period presented, entities must present the following information for each class of assets and liabilities:

- Balance of Level 3 assets or liabilities (as at the beginning of the period)
- Total gains or losses
- Purchases, sales, issues and settlements (presented separately)
- Transfers in and/or out of Level 3 (presented separately)
- Balance of Level 3 assets or liabilities (as at the end of the period)

In addition, entities are required to separately present gains or losses included in earnings from those gains or losses recognised in other comprehensive income, and to describe in which line items these gains or losses are reported in profit or loss, or in other comprehensive income. To enhance the ability of financial statement users to assess an entity's quality of earnings, IFRS 13 also requires entities to separately disclose the amount of total gains and losses reported in profit or loss (for the period) that are attributable to changes in unrealised gains and losses for assets and liabilities categorised within Level 3 and are still held at the end of the reporting period. Effectively, this requires an entity to distinguish its unrealised gains and losses from its realised gains and losses for Level 3 measurements.

IFRS 13 provides an example illustrating how an entity could comply with the Level 3 reconciliation requirements. *[IFRS 13.IE Example 16, IFRS 13.IE61]*. IFRS 13 also provides an example to illustrate how an entity could comply with the requirements to separately disclose the amount of total gains and losses reported in profit or loss that are attributable to changes in unrealised gains and losses for assets and liabilities categorised within Level 3 and are still held at the end of the reporting period. *[IFRS 13.IE Example 16, IFRS 13.IE62]*. Practical example 19-4 from Standard Chartered PLC and Practical example 19-5 from Centrica plc in section 19.3.8.A below also illustrate these disclosure requirements in relation to derivatives categorised within Level 3.

19.3.7 Disclosure of valuation processes for Level 3 measurements

Entities are required to describe the valuation processes used for fair value measurements categorised within Level 3 of the fair value hierarchy, whether on a recurring or non-recurring basis. This is illustrated in the extract from the financial statements of UBS Group AG below. The Boards decided to require these disclosures for Level 3 measurements because they believe this information, in conjunction with the other Level 3 disclosures, will help users assess the relative subjectivity of these measurements.

Practical example 19-3: UBS Group AG (2023) **Switzerland**

Annual Report 2023 [extract]
Financial statements [extract]
Consolidated financial statements [extract]
UBS Group AG consolidated financial statements [extract]
Notes to the UBS Group AG consolidated financial statements [extract]
Additional information [extract]
Note 21 Fair value measurement [extract]

b) Valuation governance

UBS's fair value measurement and model governance framework includes numerous controls and other procedural safeguards that are intended to maximize the quality of fair value measurements reported in the financial statements. New products and valuation techniques must be reviewed and approved by key stakeholders from the risk and finance control functions. Responsibility for the ongoing measurement of financial and non-financial instruments at fair value is with the business divisions.

Fair value estimates are validated by the risk and finance control functions, which are independent of the business divisions. Independent price verification is performed by Finance through benchmarking the business divisions' fair value estimates with observable market prices and other independent sources. A governance framework and associated controls are in place in order to monitor the quality of third-party pricing sources where used. For instruments where valuation models are used to determine fair value, independent valuation and model control groups within Finance and Risk Control evaluate UBS's models on a regular basis, including valuation and model input parameters, as well as pricing. As a result of the valuation controls employed, valuation adjustments may be made to the business divisions' estimates of fair value to align with independent market data and the relevant accounting standard.

› **Refer to Note 21d for more information**

IFRS 13 provides an example of how an entity could comply with the requirements to disclose the valuation processes for its Level 3 fair value measurements, suggesting this disclosure might include the following: *[IFRS 13.IE65]*

(i) For the group within the entity that decides the entity's valuation policies and procedures:
- Its description
- To whom that group reports
- The internal reporting procedures in place (e.g., whether and, if so, how pricing, risk management or audit committees discuss and assess the fair value measurements)

(ii) The frequency and methods for calibration, back testing and other testing procedures of pricing models

(iii) The process for analysing changes in fair value measurements from period to period

(iv) How the entity determined that third-party information, such as broker quotes or pricing services, used in the fair value measurement was developed in accordance with the IFRS

(v) The methods used to develop and substantiate the unobservable inputs used in a fair value measurement

19.3.8 Sensitivity of Level 3 measurements to changes in significant unobservable inputs

IFRS 13 requires entities to provide a narrative description of the sensitivity of recurring Level 3 fair value measurements to changes in the unobservable inputs used, if changing those inputs would significantly affect the fair value measurement. As part of Exposure Draft ED/2021/3 (see Section 19.6 below), the IASB had proposed replacing this disclosure with information about reasonably possible alternative fair value measurements, such as the range of alternative fair value measurements using inputs that were reasonably possible at the reporting date. Some respondents commented that sensitivity analysis is critical information and ought to be required, whilst others commented that the new disclosures would be difficult and costly to prepare - the Board decided not to proceed with the proposals.[32]

Except in relation to financial instruments (see section 19.3.8.A below) there is no requirement to quantify the extent of the change to the unobservable input, or the quantitative effect of this change on the measurement (i.e., only discuss directional change).

32 Project Summary and Feedback Statement, Disclosure Initiative-Targeted Standards-level Review of Disclosures, IASB, March 2023, p. 28. Available on the IFRS Foundation's website.

At a minimum, the unobservable inputs quantitatively disclosed based on the requirements described in section 19.3.5 above must be addressed in the narrative description. In addition, entities are required to describe any interrelationships between the unobservable inputs and discuss how they might magnify or mitigate the effect of changes on the fair value measurement.

This disclosure, combined with the quantitative disclosure of significant unobservable inputs, is designed to enable financial statement users to understand the directional effect of certain inputs on an item's fair value and to evaluate whether the entity's views about individual unobservable inputs differ from their own. The Boards believe these disclosures can provide meaningful information to users who are not familiar with the pricing models and valuation techniques used to measure a particular class of assets or liabilities (e.g., complex structured instruments).

The following example from IFRS 13 illustrates how an entity could comply with the disclosure requirements related to the sensitivity of Level 3 measurements to changes in significant unobservable inputs. *[IFRS 13.IE Example 19, IFRS 13.IE66]*.

Extract from IFRS 13

Example 19-Information about sensitivity to changes in significant unobservable inputs

For recurring fair value measurements categorised within Level 3 of the fair value hierarchy, the IFRS requires an entity to provide a narrative description of the sensitivity of the fair value measurement to changes in significant unobservable inputs and a description of any interrelationships between those unobservable inputs. An entity might disclose the following about its residential mortgage-backed securities to comply with paragraph 93(h)(i) of the IFRS:

The significant unobservable inputs used in the fair value measurement of the entity's residential mortgage-backed securities are prepayment rates, probability of default and loss severity in the event of default. Significant increases (decreases) in any of those inputs in isolation would result in a significantly lower (higher) fair value measurement. Generally, a change in the assumption used for the probability of default is accompanied by a directionally similar change in the assumption used for the loss severity and a directionally opposite change in the assumption used for prepayment rates.

We note that the above example is fairly general in nature, because no numbers relating to how the unobservable inputs might be changed, or how such a change would affect fair value, are required to be disclosed. However, in making this disclosure we would encourage entities to avoid over-generalisations that may not hold true in all cases.

19.3.8.A Quantitative sensitivity of Level 3 measurements of financial instruments to changes in significant unobservable inputs

In addition to the qualitative sensitivity analysis, IFRS 13 requires quantitative sensitivity analysis for Level 3 fair value measurements of financial assets and financial liabilities (as noted in section 19.3.1.B above, this is only for recurring fair value measurements), which is generally consistent with the existing disclosure requirement in IFRS 7 (see Chapter 50). If changing one or more of the unobservable inputs to reflect reasonably possible alternative assumptions would change fair value significantly, an entity must disclose the fact and the effect of those changes.

The entity must also disclose how the effect of a change to reflect a reasonably possible alternative assumption was calculated. For the purpose of this disclosure requirement, significance is judged with respect to profit or loss, and total assets or total liabilities, or, when changes in fair value are recognised in other comprehensive income, total equity. *[IFRS 13.93(h)(ii)]*

The following extracts from Standard Chartered PLC and Centrica plc illustrate the disclosures required for Level 3 measurements.

Practical example 19-4: Standard Chartered PLC — United Kingdom

Annual Report 2021 [extract]

Financial statements [extract]

Notes to the financial statements [extract]

13. Financial instruments [extract]

Sensitivities in respect of the fair values of Level 3 assets and liabilities

Sensitivity analysis is performed on products with significant unobservable inputs. The Group applies a 10 per cent increase or decrease on the values of these unobservable inputs, to generate a range of reasonably possible alternative valuations. The percentage shift is determined by statistical analysis performed on a set of reference prices based on the composition of the Group's Level 3 inventory as the measurement date. Favourable and unfavourable changes (which show the balance adjusted for input change) are determined on the basis of changes in the value of the instrument as a result of varying the levels of the unobservable parameters. The Level 3 sensitivity analysis assumes a one-way market move and does not consider offsets for hedges.

	Held at fair value through profit or loss			Fair value through other comprehensive income		
	Net exposure $million	Favourable changes $million	Unfavourable changes $million	Net exposure $million	Favourable changes $million	Unfavourable changes $million
Financial instruments held at fair value						
Loans and advances	**1,366**	**1,398**	**1,328**	**–**	**–**	**–**
Reverse repurchase agreements and other similar secured lending	**1,566**	**1,579**	**1,550**	**–**	**–**	**–**
Asset-backed securities	**–**	**–**	**–**	**–**	**–**	**–**
Debt securities, alternative tier one and other eligible bills	**349**	**366**	**332**	**40**	**41**	**38**
Equity shares	**186**	**205**	**168**	**493**	**541**	**442**
Other assets	**26**	**29**	**24**	**–**	**–**	**–**
Derivative financial instruments	**(4)**	**10**	**(16)**	**–**	**–**	**–**
Customer accounts	**(454)**	**(447)**	**(461)**	**–**	**–**	**–**
Deposits by banks	**(283)**	**(278)**	**(287)**	**–**	**–**	**–**
Debt securities in issue	**(821)**	**(764)**	**(879)**	**–**	**–**	**–**
Other liabilities	**(1)**	**(1)**	**(1)**	**–**	**–**	**–**
At 31 December 2021	**1,930**	**2,097**	**1,758**	**533**	**582**	**480**
Financial instruments held at fair value						
Loans and advances	918	947	867	–	–	–
Reverse repurchase agreements and other similar secured lending	1,064	1,089	1,040	–	–	–
Asset-backed securities	87	94	80	–	–	–
Debt securities, alternative tier one and other eligible bills	171	183	159	40	40	39
Equity shares	279	307	251	381	418	345
Other assets	–	–	–	–	–	–
Derivative financial instruments	(111)	(98)	(126)	–	–	–
Customer accounts	(21)	(18)	(24)	–	–	–
Deposits by banks	(146)	(146)	(146)	–	–	–
Debt securities in issue	(160)	(154)	(167)	–	–	–
Other liabilities	–	–	–	–	–	–
At 31 December 2020	2,081	2,204	1,934	421	458	384

The reasonably possible alternatives could have increased or decreased the fair values of financial instruments held at fair value through profit or loss and those classified as fair value through other comprehensive income by the amounts disclosed below.

Financial instruments	Fair value changes	31.12.21 $million	31.12.20 $million
Held at fair value through profit or loss	Possible increase	**167**	123
	Possible decrease	**(172)**	(147)
Fair value through other comprehensive income	Possible increase	**49**	37
	Possible decrease	**(53)**	(37)

Practical example 19-5: Centrica plc (2023) **United Kingdom**

ANNUAL REPORT AND ACCOUNTS 2023 [extract]

Financial statements [extract]

Notes to the Financial Statements [extract]

Supplementary Information [extract]

S6. FAIR VALUE OF FINANCIAL INSTRUMENTS [extract]

(a) Fair value hierarchy [extract]

...

The reconciliation of the Level 3 fair value measurements during the year is as follows:

	2023		2022	
	Financial assets £m	Financial liabilities £m	Financial assets £m	Financial liabilities £m
Level 3 financial instruments				
1 January	610	(946)	501	(290)
Total realised and unrealised (losses)/gains:				
Recognised in Group Income Statement	(297)	252	10	(784)
Recognised in Other Comprehensive Income	(1)	–	–	–
Net movement in contingent consideration liability	–	(27)	–	(96)
Purchases, sales, issuances and settlements (net)	2	194	(4)	–
Transfers between Level 3 and Level 2 (i)	(96)	131	101	224
Foreign exchange movements	(1)	1	2	–
31 December	217	(395)	610	(946)
Total (losses)/gains for the year for Level 3 financial instruments held at the end of the reporting period	(297)	252	10	(784)

(i) Transfers between levels are deemed to occur at the beginning of the reporting year.

(b) Valuation techniques used to derive Level 2 and Level 3 fair values and Group valuation process [extract]

Level 2 interest rate derivatives and foreign exchange derivatives comprise interest rate swaps and forward foreign exchange contracts. Interest rate swaps are fair valued using forward interest rates extracted from observable yield curves. Forward foreign exchange contracts are fair valued using forward exchange rates that are quoted in an active market, with the resulting market value discounted back to present value using observable yield curves.

Level 2 energy derivatives are fair valued by comparing and discounting the difference between the expected contractual cash flows for the relevant commodities and the quoted prices for those commodities in an active market. The average discount rate applied to value this type of contract during the year was 5% per annum (2022: average discount rate of 5% per annum).

For Level 3 energy derivatives, the main input used by the Group pertains to deriving expected future commodity prices in markets that are not active as far into the future as some of our contractual terms. This applies to certain contracts within Europe and North America. Fair values are then calculated by comparing and discounting the difference between the expected contractual cash flows and these derived future prices using an average discount rate of 5% (Europe) and 5% (North America) per annum (2022: average discount rate of 5% (Europe) and 5% (North America) per annum).

Active period of markets	Gas	Power	Coal	Emissions	Oil
UK (years)	4	4	3	3	3

Because the Level 3 energy derivative valuations involve the prediction of future commodity market prices, sometimes a long way into the future, reasonably possible alternative assumptions for gas, power, coal, emissions or oil prices may result in a higher or lower fair value for Level 3 financial instruments. The impact of reasonably possible changes in commodity prices on profit and loss are included in note S3. Other than commodity prices there are no other unobservable inputs which would have a material impact.

...

S3. FINANCIAL RISK MANAGEMENT [extract]

(d) Sensitivity analysis [extract]

(iv) Commodity price risk – proprietary trades

As at 31 December 2023 the VaR associated with proprietary trading was £4 million (2022: £5 million). This represents the statistical downside risk associated with the proprietary trade and associated hedging positions. The changes in the year only relate to changes in commodity prices. Intra-day trading positions are monitored using a live time risk management system.

The impacts of reasonably possible changes using probability-based high and low price curves applied to level 3 proprietary trades are as follows:

Incremental profit/(loss)	2023 Impact on profit (i) £m	2022 Impact on profit (i) £m
Level 3 proprietary trades – increase/(decrease) (ii)	24/(24)	891/(877)

(i) The reasonably possible change in variable and the impact on profit are calculated using both the active and inactive market curves for energy prices, see note 7(c) for detail on market curves.

(ii) The level 3 proprietary financial instruments' sensitivity has been valued in Secure Environment and excludes associated hedges which would mitigate this impact.

19.3.9 Highest and best use

As discussed in section 9 above, if the highest and best use of a non-financial asset differs from its current use, entities are required to disclose this fact and why the non-financial asset is being used in a manner that differs from its highest and best use. *[IFRS 13.93(i)]*. The Boards believe this information is useful to financial statement users who project expected cash flows based on how an asset is actually being used.

19.4 Disclosures for unrecognised fair value measurements

For each class of assets and liabilities not measured at fair value in the statement of financial position, but for which the fair value is disclosed (e.g., financial assets carried at amortised cost whose fair values are required to be disclosed in accordance with IFRS 7), entities are required to disclose the following: *[IFRS 13.97]*

(a) The level of the fair value hierarchy within which the fair value measurements are categorised in their entirety (Level 1, 2 or 3)

(b) If categorised within Level 2 or Level 3 of the fair value hierarchy:
   (i) Description of the valuation technique(s) used in the fair value measurement
   (ii) Description of the inputs used in the fair value measurement
   (iii) If there has been a change in valuation technique (e.g., changing from a market approach to an income approach or the use of an additional valuation technique):
      - The change
      - The reason(s) for making it

(c) For non-financial assets, if the highest and best use differs from its current use, an entity must disclose that fact and why the non-financial asset is being used in a manner that differs from its highest and best use

None of the other IFRS 13 disclosures are required for assets and liabilities whose fair value is only disclosed. For example, even though certain fair value disclosures are categorised within Level 3, entities are not required to provide quantitative information about the unobservable inputs used in their valuation because these items are not measured at fair value in the statement of financial position.

19.5 Disclosures regarding liabilities issued with an inseparable third-party credit enhancement

IFRS 13 includes an additional disclosure requirement for liabilities measured at fair value that have been issued with an inseparable third-party credit enhancement (see section 10.3.1 above for further discussion regarding these instruments). The standard requires that an issuer disclose the existence of the third-party credit enhancement and whether it is reflected in the fair value measurement of the liability. *[IFRS 13.98]*.

19.6 Proposed amendments resulting from the *Disclosure Initiative-Targeted Standards-level Review of Disclosures* project

On 25 March 2021, the Board issued an Exposure Draft ED/2021/3, *Disclosure Requirements in IFRS Standards - A Pilot Approach (Proposed amendments to* IFRS 13 *and* IAS 19*)* (the ED), in which the Board proposed guidance for its own use when developing and drafting disclosure requirements in IFRS accounting standards. In its pilot application of the guidance, amendments to IFRS 13 and IAS 19 were proposed. The Board was aiming to address the concern about the current disclosures in financial statements, which are sometimes referred to as 'disclosure overload', 'disclosure ineffectiveness' or, as described in the ED, the 'disclosure problem'. If the pilot was successful, the intention was to develop similar proposals for other IFRS accounting standards.

The proposed amendments to IFRS 13 suggested an overall disclosure objective that, "An entity shall disclose information that enables users of financial statements to evaluate the entity's exposure to uncertainties associated with fair value measurements of classes of assets and liabilities measured at fair value in the statement of financial position after initial recognition".[33] This information was intended to enable users to understand the significance of the classes of assets and liabilities on the entity's financial position and financial performance, how fair value measurements have been determined and how changes could affect the entity's financial position.

33 Exposure Draft ED/2021/3: *Disclosure Requirements in IFRS Standards - A Pilot Approach: Proposed amendments to IFRS 13 and IAS 19*, IASB, March 2021, Proposed overall disclosure objective, paragraph 100. Available on the IFRS Foundation's website.

The overall disclosure objectives were supplemented by proposed specific disclosure objectives and items of information intended to ensure compliance with the overall disclosure objective, including requiring information:[34]

- About the amount, nature and other characteristics of assets and liabilities measured at fair value after initial recognition and how those characteristics relate to the categorisation of assets and liabilities in the fair value hierarchy
- That enables users to understand the significant techniques and inputs used in determining the fair value measurements for each class of assets and liabilities measured at fair value after initial recognition
- For recurring fair value measurements, that would allow users to understand alternative fair value measurements, using inputs that were reasonably possible at the end of the reporting period
- About the reason for changes in fair value measurements

For assets and liabilities not measured at fair value, but for which the fair values are disclosed in the notes, the Board proposed disclosure of "the amount, nature and other characteristics of each class of assets and liabilities…and how the characteristics relate to the categorisation of those classes of assets and liabilities in the fair value hierarchy".[35]

The comment period for the ED ended on 12 January 2022.[36] During the comment period, 50 companies participated in fieldwork by applying the proposed disclosure requirements for either, or both, of IFRS 13 and IAS 19. In February 2022, the IASB discussed feedback from the preparer fieldwork participants and users of financial statements:

- Some participants from all industries supported the proposed amendments to IFRS 13 and found the disclosure objectives useful in explaining user needs and making their disclosures more useful. Others said the proposals enabled them to restructure, streamline or simplify their notes to better respond to user needs
- Some users supported the approach of having disclosure objectives, rather than prescriptive disclosure requirements, although many other users raised concerns about losing information that they get today, and about the effects on comparability. Some suggested the use of a combination of both disclosure objectives and minimum prescriptive disclosure requirements. A few users preferred to have prescriptive disclosure requirements for highly technical and quantitative information

In May 2022, the IASB discussed feedback provided in comment letters. For assets and liabilities measured at fair value in the statement of financial position, many respondents agreed with the proposed overall disclosure objective. However, some respondents believed it to be too generic and similar to the current disclosure objective in IFRS 13.

The specific disclosure objectives and items of information for these assets and liabilities received a mixed response. A few respondents said the proposals would result in more relevant information for users about movements and uncertainties in fair value measurements, whilst many thought the scope of the disclosures should be restricted to avoid irrelevant disclosures being made. Some respondents expressed concern about the clarity of the specific disclosure objective for assets and liabilities within each level of the fair value hierarchy.

Some respondents disagreed with the proposal to disclose reasonably possible alternative fair value measurements on the grounds of cost, usefulness and the consequent undermining of the credibility of an entity's fair value measurement.

For assets and liabilities for which fair value is only disclosed in the notes, many respondents agreed with the proposed specific disclosure objective and items of information, whilst others questioned how useful the disclosures would be.

34 Exposure Draft ED/2021/3: *Disclosure Requirements in IFRS Standards - A Pilot Approach: Proposed amendments to IFRS 13 and IAS 19*, IASB, March 2021, Proposed specific disclosure objectives, paragraphs 103, 107, 111, 114. Available on the IFRS Foundation's website.

35 Exposure Draft ED/2021/3: *Disclosure Requirements in IFRS Standards - A Pilot Approach: Proposed amendments to IFRS 13 and IAS 19*, IASB, March 2021, Proposed paragraph 118. Available on the IFRS Foundation's website.

36 *IASB Update*, July 2021, available on the IFRS Foundation's website.

In October 2022, the IASB decided not to proceed with any further work on the disclosure requirements in IFRS 13 because:

- The standard had been selected primarily to test the proposed guidance for developing and drafting disclosure requirements
- The PIR of IFRS 13 found that disclosures relating to fair value measurements are useful to users
- If information about measurement uncertainty relating to an entity's Level 2 fair value measurements was material to users of its financial statements, then applying the requirements in IAS 1.31 would result in the entity disclosing that information
- The IASB's Third Agenda Consultation hadn't identified amendments to the disclosures a priority[37]

37 Project Summary and Feedback Statement, *Disclosure Initiative-Targeted Standards-level Review of Disclosures*, IASB, March 2023. Available on the IFRS Foundation's website.

20 Application guidance - present value techniques

This section focuses on the application guidance in IFRS 13 regarding the use of present value techniques to estimate fair value.

20.1 General principles for use of present value techniques

A present value technique is an application of the income approach, which is one of the three valuation approaches prescribed by IFRS 13. Valuation techniques under the income approach, such as present value techniques or option pricing models, convert expected future amounts to a single present amount. That is, a present value technique uses the projected future cash flows of an asset or liability and discounts those cash flows at a rate of return commensurate with the risk(s) associated with those cash flows. Present value techniques, such as discounted cash flow analyses, are frequently used to estimate the fair value of business entities, non-financial assets and non-financial liabilities, but are also useful for valuing financial instruments that do not trade in active markets.

The standard does not prescribe the use of a single specific present value technique, nor does it limit the use of present value techniques to those discussed. The selection of a present value technique will depend on facts and circumstances specific to the asset or liability being measured at fair value and the availability of sufficient data. *[IFRS 13.B12]*.

The application guidance in IFRS 13 regarding the use of present value techniques specifically focuses on three techniques: a discount rate adjustment technique and two methods of the expected cash flow (expected present value) technique. These approaches are summarised in the following table.

Figure 20-1: Comparison of present value techniques described in IFRS 13

	Discount rate adjustment technique (see section 20.3 below)	Expected present value technique	
		Method 1 (see section 20.4 below)	Method 2 (see section 20.4 below)
Nature of cash flows	Conditional cash flows - may be contractual or promised or the most likely cash flows	Expected cash flows	Expected cash flows
Cash flows based on probability weighting?	No	Yes	Yes
Cash flows adjusted for certainty?	No	Yes - cash risk premium is deducted. Cash flows represent a certainty-equivalent cash flow	No
Cash flows adjusted for other market risk?	No	Yes	Yes - to the extent not already captured in the discount rate
Discount rate adjusted for the uncertainty inherent in the cash flows?	Yes - uses an observed or estimated market rate of return, which includes adjustment for the possible variation in cash flows	No - already captured in the cash flows	No - already captured in the cash flows
Discount rate adjusted for the premium a market participant would require to accept the uncertainty?	Yes	No - represents time value of money only (i.e., the risk-free rate is used)	Yes - represents the expected rate of return (i.e., the risk-free rate is adjusted to include the risk premium)

Additional considerations when applying present value techniques to measuring the fair value of a liability and an entity's own equity instrument not held by other parties as assets are discussed in section 10 above. The Board conducted a research project on discount rates used in IFRS accounting standards and published their findings in February 2019. In that summary they noted that the output from the research would be used as an input for the Targeted Standard-level Review of Disclosures project for present values measures which includes IFRS 13 (see section 19.6 above).[38]

20.2 The components of a present value measurement

Present value measurements use future cash flows or values to estimate amounts in the present, using a discount rate. Present value techniques can vary in complexity depending on the facts and circumstances of the item being measured. Nevertheless, for the purpose of measuring fair value in accordance with IFRS 13, the standard requires a present value technique to capture all the following elements from the perspective of market participants at the measurement date: *[IFRS 13.B13]*

- An estimate of future cash flows for the asset or liability being measured
- Expectations about the uncertainty inherent in the future cash flows (i.e., the possible variations in the amount and timing of the cash flows)
- The time value of money - represented by a risk-free interest rate. That is, the rate on risk-free monetary assets that have maturity dates (or durations) that coincide with the period covered by the cash flows and pose neither uncertainty in timing nor risk of default to the holder
- A risk premium (i.e., the price for bearing the uncertainty inherent in the cash flows)
- Other factors that market participants would take into account in the circumstances
- For a liability, the non-performance risk relating to that liability, including the entity's (i.e., the obligor's) own credit risk

For example, when estimating future cash flows from an investment property, the estimate would incorporate the effects of climate change, which may affect assumptions such as the cost of energy, the rental income that is achievable from the property, the vacancy rates and expenditure on maintenance.

Since present value techniques may differ in how they capture these elements, IFRS 13 sets out the following general principles that govern the application of any present value technique used to measure fair value: *[IFRS 13.B14]*

(a) Both cash flows and discount rates should:
- Reflect assumptions that market participants would use when pricing the asset or liability
- Take into account only the factors attributable to the asset or liability being measured
- Have internally consistent assumptions

  For example, if the cash flows include the effect of inflation (i.e., nominal cash flows), they would be discounted at a rate that includes the effect of inflation, for example, a rate built off the nominal risk-free interest rate. If cash flows exclude the effect of inflation (i.e., real cash flows), they should be discounted at a rate that excludes the effect of inflation. Similarly, post-tax and pre-tax cash flows should be discounted at a rate consistent with those cash flows.

(b) Discount rates should also:
- Be consistent with the underlying economic factors of the currency in which the cash flows are denominated
- Reflect assumptions that are consistent with those assumptions inherent in the cash flows

  This principle is intended to avoid double-counting or omitting the effects of risk factors.

  For example, a discount rate that reflects non-performance (credit) risk is appropriate if using contractual cash flows of a loan (i.e., a discount rate adjustment technique - see section 20.3 below). The same rate would not be appropriate when using probability-weighted cash flows (i.e., an expected present value technique - see section 20.4 below) because the expected cash flows already reflect assumptions about the uncertainty in future defaults. Similarly, a discount rate would be adjusted for climate-related risk if the risk is not captured within the cash flows (assuming market participants would make such an adjustment).

38 IFRS Standards Project summary: *Discount Rates in IFRS Standards*, IASB, February 2019. Available on the IFRS Foundation's website.

20.2.1 Time value of money

The objective of a present value technique is to convert future cash flows into a present amount (i.e., a value as at the measurement date). Therefore, time value of money is a fundamental element of any present value technique. *[IFRS 13.B13(c)]*. A basic principle in finance theory, time value of money holds that 'a dollar today is worth more than a dollar tomorrow', because the dollar today can be invested and earn interest immediately. Therefore, the discount rate in a present value technique must capture, at a minimum, the time value of money. For example, a discount rate equal to the risk-free rate of interest encompasses only the time value element of a present value technique. If the risk-free rate is used as a discount rate, the expected cash flows must be adjusted into certainty-equivalent cash flows to capture any uncertainty associated with the item being measured and the compensation market participants would require for this uncertainty.

20.2.2 Risk and uncertainty in a present value technique

At its core, the concept of value measures expected rewards against the risks of realising those rewards. Present value techniques implicitly contain uncertainty as they generally deal with estimates rather than known amounts. In many cases, both the amount and timing of the cash flows are uncertain. The standard notes that even contractually fixed amounts are uncertain if there is risk of default. *[IFRS 13.B15]*.

Market participants generally require compensation for taking on the uncertainty inherent in the cash flows of an asset or a liability. This compensation is known as a risk premium. IFRS 13 states that in order to faithfully represent fair value, a present value technique should include a risk premium. The standard acknowledges that determining the appropriate risk premium might be difficult. However, the degree of difficulty alone is not a sufficient reason to exclude a risk premium if market participants would demand one. *[IFRS 13.B16]*.

Depending on the present value technique used, risk may be incorporated in the cash flows or in the discount rate. However, identical risks should not be captured in both the cash flows and the discount rate in the same valuation analysis. For example, if the probability of default and loss given default for a liability are already incorporated in the discount rate (i.e., a risk-adjusted discount rate), the projected cash flows should not be further adjusted for the expected losses.

The present value techniques discussed in the application guidance to IFRS 13 differ in how they adjust for risk and in the type of cash flows they use, as follows: *[IFRS 13.B17]*

- The discount rate adjustment technique uses a risk-adjusted discount rate and contractual, promised or most likely cash flows (see section 20.3 below).
- Method 1 of the expected present value technique uses certainty-equivalent cash flows and a risk-free rate (see section 20.4 below).
- Method 2 of the expected present value technique uses expected cash flows that are not risk-adjusted and a discount rate adjusted to include the risk premium that market participants require. That rate is different from the rate used in the discount rate adjustment technique (see section 20.4 below).

If the risks are accounted for fully and appropriately, the three present value techniques noted above should all produce an identical fair value measurement, regardless of whether risk is captured in the cash flows or the discount rate (see Illustration 20-1 in section 20.4.1 below for a numerical example illustrating this point).

20.3 Discount rate adjustment technique

The discount rate adjustment technique attempts to capture all of the risk associated with the item being measured in the discount rate and is most commonly used to value assets and liabilities with contractual payments, such as debt instruments. This technique uses a single set of cash flows from the range of possible estimated amounts and discounts those cash flows using a rate that reflects all of the risk related to the cash flows.

According to the standard, the cash flows may be contractual or promised or the most likely cash flows. In all cases, those cash flows are conditional upon the occurrence of specified events. For example, contractual or promised cash flows for a bond are conditional on the event of no default by the debtor. *[IFRS 13.B18]*.

The discount rate is derived from observable rates of return for comparable assets and liabilities that are traded in the market and incorporates all of the following:

- The risk-free interest rate
- Market participants' expectations about possible variations in the amount or timing of the cash flows
- The price for bearing the uncertainty inherent in these cash flows (or risk premium)
- Other risk factors specific to the asset or liability

As such, under this technique the cash flows are discounted at an observed or estimated market rate appropriate for such conditional cash flows (that is, a market rate of return).

The discount rate adjustment technique requires an analysis of market data for comparable assets or liabilities. Comparability is established by considering: *[IFRS 13.B19]*

- The nature of the cash flows - for example, whether the cash flows are contractual or non-contractual and whether the cash flows are likely to respond similarly to changes in economic conditions
- Other factors, such as credit standing, collateral, duration, restrictive covenants and liquidity

Alternatively, if a single comparable asset or liability does not fairly reflect the risk inherent in the cash flows of the asset or liability being measured, it may be possible to derive a discount rate using a 'build-up' approach. That is, the entity should use data for several comparable assets or liabilities in conjunction with the risk-free yield curve. The extract in section 20.3.1 below illustrates this further.

If the discount rate adjustment technique is applied to fixed receipts or payments, the adjustment for any risk inherent in the cash flows is included in the discount rate. In some applications of the discount rate adjustment technique to cash flows that are not fixed receipts or payments, an entity may need to make an adjustment to the cash flows to achieve comparability with the observed asset or liability from which the discount rate is derived. *[IFRS 13.B22]*.

Although IFRS 13 does not prescribe when a particular present value technique should be used, the extent of market data available for a particular type of asset or liability will influence when use of the discount rate adjustment technique is appropriate. IFRS 13 states that the "discount rate adjustment technique requires an analysis of market data for comparable assets or liabilities". *[IFRS 13.B19]*. Therefore, certain assets and liabilities may not lend themselves to the use of the discount rate adjustment technique, even though it may be possible to derive discount rates using market data from several comparable items when no single observable rate of return reflects the risk inherent in the item being measured.

The most challenging aspect of applying this technique is the identification of market observable rates of return that appropriately capture the risk inherent in the asset or liability being measured. Understanding the various risk factors associated with certain types of assets and liabilities is not always easy and quantifying the effect of these factors is even more difficult. However, it may be helpful to deconstruct a discount rate into its component parts to understand what risks are being considered; beginning with the risk-free rate, which represents the time value of money. In addition to the risk-free rate, entities should consider credit or non-performance risk if the subject asset or liability requires performance in the future (including, but not limited to, a cash payment). For example, in the case of a financial asset, the discount rate would include compensation required by market participants to assume the risk that the counterparty will be unable to fulfil its obligation. Not all discount rates require an explicit adjustment for credit (or non-performance) risk. Equity interests, for example, may assume perpetual residual cash flows from the operations of a business, rather than a contractual future payment. In this case, an additional component of risk is captured through an equity risk premium, instead of a credit risk adjustment. The long-term incremental rate of return of equity interests over long-term risk-free interest rates may generally represent an identifiable component of risk.

When applying the discount rate adjustment technique, the credit spread (above the risk-free rate) will implicitly include assumptions about probabilities of default and losses given default without requiring an adjustment to the projected cash flows used in the analysis. However, a credit adjusted risk-free rate may not sufficiently capture all the risk related to the subject asset or liability. Depending on facts and circumstances of the item being measured, the observable rate of return should also capture other potential variability with respect to the timing and amount of the cash flows (e.g., potential variability due to prepayment risk for financial instruments such as mortgage backed securities) and the price for bearing such uncertainty (risk premium).

In addition, when assessing discount rates, it is important to keep in mind the exit price objective of a fair value measurement in IFRS 13. Because the discount rate represents the rate of return required by market participants in the current market, it should also incorporate factors such as illiquidity and the current risk appetite of market participants.

20.3.1 Illustrative example of the discount rate adjustment technique

The following example from IFRS 13 illustrates how a build-up approach is applied when using the discount rate adjustment technique. *[IFRS 13.B20, IFRS 13.B21]*.

Extract from IFRS 13

B20 To illustrate a build-up approach, assume that Asset A is a contractual right to receive CU800[1] in one year (ie there is no timing uncertainty). There is an established market for comparable assets, and information about those assets, including price information, is available. Of those comparable assets:

(a) Asset B is a contractual right to receive CU1,200 in one year and has a market price of CU1,083. Thus, the implied annual rate of return (ie a one-year market rate of return) is 10.8 per cent [(CU1,200 / CU1,083) - 1].

(b) Asset C is a contractual right to receive CU700 in two years and has a market price of CU566. Thus, the implied annual rate of return (ie a two-year market rate of return) is 11.2 per cent [(CU700 / CU566)^0.5 - 1].

(c) All three assets are comparable with respect to risk (ie dispersion of possible pay-offs and credit).

B21 On the basis of the timing of the contractual payments to be received for Asset A relative to the timing for Asset B and Asset C (ie one year for Asset B versus two years for Asset C), Asset B is deemed more comparable to Asset A. Using the contractual payment to be received for Asset A (CU800) and the one-year market rate derived from Asset B (10.8 per cent), the fair value of Asset A is CU722 (CU800 / 1.108). Alternatively, in the absence of available market information for Asset B, the one-year market rate could be derived from Asset C using the build-up approach. In that case the two-year market rate indicated by Asset C (11.2 per cent) would be adjusted to a one-year market rate using the term structure of the risk-free yield curve. Additional information and analysis might be required to determine whether the risk premiums for one-year and two-year assets are the same. If it is determined that the risk premiums for one-year and two-year assets are not the same, the two-year market rate of return would be further adjusted for that effect.

1 In this IFRS monetary amounts are denominated in 'currency units (CU)'.

As evidenced in the extract above, using a build-up approach requires that market data for comparable assets be available. In addition, when applying the build-up approach, significant judgement may be required in determining comparability between the item being measured and the available benchmarks, as well as quantifying the appropriate adjustments necessary to account for any differences that may exist between the item being measured and the applicable benchmark (e.g., differences in credit risks, nature and timing of the cash flows).

20.4 Expected present value technique

The expected present value technique is typically used in the valuation of business entities, assets and liabilities with contingent or conditional payouts and items for which discount rates cannot be readily implied from observable transactions.

This technique uses, as a starting point, a set of cash flows that represent the probability-weighted average of all possible future cash flows (i.e., the expected cash flows). Unlike the cash flows used in the discount rate adjustment technique (i.e., contractual, promised or most likely amounts), expectations about possible variations in the amount and/or timing of the cash flows are explicitly incorporated in the projection of the expected cash flows themselves, rather than solely in the discount rate. *[IFRS 13.B23]*.

The application guidance in IFRS 13 identifies two types of risk, based on portfolio theory: *[IFRS 13.B24]*

(a) *Unsystematic (diversifiable) risk* - the risk specific to a particular asset or liability

(b) *Systematic (non-diversifiable) risk* - the common risk shared by an asset or a liability with the other items in a diversified portfolio (i.e., market risk)

According to portfolio theory, in a market in equilibrium, market participants will be compensated only for bearing the systematic risk inherent in the cash flows. If the market is inefficient or is out of equilibrium, other forms of return or compensation might be available.

While, in theory, all possible future cash flows are meant to be considered, in practice, a discrete number of scenarios are often used to capture the probability distribution of potential cash flows. The number of possible outcomes to be considered will generally depend on the characteristics of the specific asset or liability being measured. For example, the outcome of a contingency may be binary, therefore, only two possible outcomes need be considered. In contrast, certain complex financial instruments are valued using option pricing models, such as Monte Carlo simulations, that generate thousands of possible outcomes. Estimating the probability distribution of potential outcomes requires judgement and will depend on the nature of the item being measured.

Assuming the entity's use of the asset is consistent with that of market participants, an entity might look to its own historical performance, current and expected market environments (including expectations of volatility) and budgetary considerations to develop expectations about future cash flows and appropriate weightings. However, as discussed in section 18.1 above, the use of an entity's own data can only be a starting point when measuring fair value. Adjustments may be needed to ensure that the measurement is consistent with market participant assumptions. For example, synergies that can be realised by the entity should not be considered unless they would similarly be realised by market participants.

The concept of a risk premium is just as important under an expected present value technique as it is under the discount rate adjustment technique. The use of probability-weighted cash flows under an expected present value technique does not remove the need to consider a market risk premium when estimating fair value. While 'expected cash flows' capture the uncertainty in the amount and timing of the future cash flows, the probability weighting does not include the compensation market participants would demand for bearing this uncertainty. For example, assume Asset A is a contractual right to receive CU10,000. Asset B has a payout that is conditional upon the toss of a coin: if 'heads', Asset B pays CU20,000; and if 'tails' it pays nothing. Assuming no risk of default, both assets have an expected value of CU10,000 (i.e., CU10,000 × 100% for Asset A, and CU20,000 × 50% + CU0 × 50% for Asset B). However, risk-averse market participants would find Asset A more valuable than Asset B, as the cash-certain payout of CU10,000 for Asset A is less risky than the expected cash flow of CU10,000 for Asset B.

Although the variability in the cash flows of Asset B has been appropriately captured by probability-weighting all the possible cash flows (i.e., there is no subjectivity involved in the determination of the probability weighting in the simplified example since the payout is based on a coin toss), Asset B's expected value does not capture the compensation market participants would require for bearing the uncertainty in the cash flows. As such, all else being equal, the price for Asset B would be lower than the price for Asset A. That is, the required rate of return for Asset B would be higher than that for Asset A, in order to compensate the holder for the incremental risk in Asset B's cash flows (relative to Asset A).

20.4.1 Expected present value technique - method 1 and method 2

The standard describes two methods of the expected present value technique:

- *Method 1* - the expected cash flows are adjusted for the systematic (market) risk by subtracting a cash risk premium. This results in risk-adjusted expected cash flows that represent a certainty-equivalent cash flow. The cash flows are then discounted at a risk-free interest rate. *[IFRS 13.B25]*.

  Because all of the risk factors have been incorporated into the cash flows under Method 1, the discount rate used would only capture the time value of money. That is, use of a risk-free discount rate is appropriate when using this technique, provided that credit risk considerations are not applicable or have already been considered in the cash flows.

  A certainty-equivalent cash flow is an expected cash flow adjusted for risk so that a market participant is indifferent to trading a certain cash flow for an expected cash flow. For example, if a market participant was willing to trade an expected cash flow of CU1,200 for a cash flow that the market participant is certain to receive of CU1,000, the CU1,000 is the certainty-equivalent of the CU1,200 (i.e., the CU200 would represent the cash risk premium). *[IFRS 13.B25]*.

- *Method 2* - adjusts for systematic (market) risk by applying a risk premium to the risk-free interest rate (i.e., the risk premium is captured in the discount rate). As such, the discount rate represents an expected rate of return (i.e., the expected rate associated with probability-weighted cash flows). In Method 2, the expected cash flows are discounted using this rate. *[IFRS 13.B26]*.

  The use of a risk-free discount rate is not appropriate under Method 2, because the expected cash flows, while probability weighted, do not represent a certainty-equivalent cash flow. The standard suggests that models used for pricing risky assets, such as the capital asset pricing model, could be used to estimate the expected rate of return. As discussed in section 20.3 above, the discount rate used in the discount rate adjustment technique also uses a rate of return, but it is related to conditional cash flows. A discount rate determined in accordance with the discount rate adjustment technique is likely to be higher than the discount rate used in Method 2, which is an *expected* rate of return relating to expected or probability-weighted cash flows. *[IFRS 13.B26]*.

The key difference between Method 1 and Method 2 is where the market risk premium is captured. Capturing the risk premium in the cash flows versus the discount rate has no effect on relative fair values under each method. That is, Method 1 and Method 2 should result in the same fair value measurement, all else being equal.

The extract below illustrates the application of Method 1 and Method 2 when measuring fair value. *[IFRS 13.B27, IFRS 13.B28, IFRS 13.B29]*.

Extract from IFRS 13

B27 To illustrate Methods 1 and 2, assume that an asset has expected cash flows of CU780 in one year determined on the basis of the possible cash flows and probabilities shown below. The applicable risk-free interest rate for cash flows with a one-year horizon is 5 per cent, and the systematic risk premium for an asset with the same risk profile is 3 per cent.

Possible cash flows	Probability	Probability-weighted cash flows
CU500	15%	CU75
CU800	60%	CU480
CU900	25%	CU225
Expected cash flows		CU780

B28 In this simple illustration, the expected cash flows (CU780) represent the probability-weighted average of the three possible outcomes. In more realistic situations, there could be many possible outcomes. However, to apply the expected present value technique, it is not always necessary to take into account distributions of all possible cash flows using complex models and techniques. Rather, it might be possible to develop a limited number of discrete scenarios and probabilities that capture the array of possible cash flows. For example, an entity might use realised cash flows for some relevant past period, adjusted for changes in circumstances occurring subsequently (eg changes in external factors, including economic or market conditions, industry trends and competition as well as changes in internal factors affecting the entity more specifically), taking into account the assumptions of market participants.

B29 In theory, the present value (ie the fair value) of the asset's cash flows is the same whether determined using Method 1 or Method 2, as follows:

(a) Using Method 1, the expected cash flows are adjusted for systematic (ie market) risk. In the absence of market data directly indicating the amount of the risk adjustment, such adjustment could be derived from an asset pricing model using the concept of certainty equivalents. For example, the risk adjustment (ie the cash risk premium of CU22) could be determined using the systematic risk premium of 3 per cent (CU780 - [CU780 × (1.05 / 1.08)]), which results in risk-adjusted expected cash flows of CU758 (CU780 - CU22). The CU758 is the certainty equivalent of CU780 and is discounted at the risk-free interest rate (5 per cent). The present value (ie the fair value) of the asset is CU722 (CU758 / 1.05).

(b) Using Method 2, the expected cash flows are not adjusted for systematic (ie market) risk. Rather, the adjustment for that risk is included in the discount rate. Thus, the expected cash flows are discounted at an expected rate of return of 8 per cent (ie the 5 per cent risk-free interest rate plus the 3 per cent systematic risk premium). The present value (ie the fair value) of the asset is CU722 (CU780 / 1.08).

The selection of Method 1 or Method 2 will depend on facts and circumstances specific to the asset or liability being measured, the extent to which sufficient data are available and the judgements applied. *[IFRS 13.B30]*. However, in practice, Method 1 is rarely used because in most cases, to mathematically estimate the cash certainty adjustment, one must already know the market risk premium that would be applied to the discount rate under Method 2.

In Illustration 20-1 below, we have expanded the example from IFRS 13 to include the discount rate adjustment technique (described in section 20.3 above). Illustration 20-1 shows how all three techniques converge to the same fair value measurement, while highlighting the difference in the discount rates applied under each approach.

Illustration 20-1: Comparison of present value techniques

An entity is estimating the fair value of an asset that will expire in one year and has determined that the probability distribution of the future cash flows is as follows:

Possible cash flows	Probability	Probability-weighted cash flows
CU		CU
500	15%	75
800	60%	480
900	25%	225
	Expected cash flows	780

Assume that the risk-free interest rate is 5% and the risk premium is 3%. The table below shows that all three present value techniques yield identical results:

Method	Contractual cash flows	Most likely cash flows	Expected cash flows	Certainty-equivalent adjustment	Certainty-equivalent cash flows	Discount rate	Present value
Discount rate adjustment technique	N/A	CU800	N/A	N/A	N/A	10.8%	CU722
EPV Method 1[(a)]	N/A	N/A	CU780	CU(22)	CU758	5.0%	CU722
EPV Method 2[(b)]	N/A	N/A	CU780	N/A	N/A	8.0%	CU722

(a) Adjust expected cash flows for risk premium
(b) Adjust discount rate for risk premium

Method	Fair value	Calculation
Discount rate adjustment technique	CU722	= Most likely cash flow / (1 + risk-free rate + adjustment for cash flow uncertainty + risk premium)
EPV Method 1	CU722	= (Expected cash flow - certainty-equivalent adjustment[(a)]) / (1 + risk-free rate)
EPV Method 2	CU722	= Expected cash flow / (1 + risk-free rate + risk premium)

(a) Certainty-equivalent adjustment = Expected cash flow - [Expected cash flow × (1 + risk-free rate) / (1 + risk-free rate + risk premium)]

The three techniques differ in the manner in which the risks in the cash flows are captured, but not the level of the risk inherent in those cash flows. In the discount rate adjustment technique, the most likely cash flow (CU800) is discounted at a rate that reflects all the risk inherent in the investment (i.e., time value of money, possible variations in the amount of cash flows, risk premium).

Method 1 of the expected present value technique incorporates asset-specific and systematic uncertainty directly into the cash flows (certainty-equivalent cash flow of CU758) and therefore uses the risk-free rate for discounting, as all the risks associated with the investment are incorporated in the cash flows. The adjustment to the cash flows for systematic risk is based on the 3% risk premium.

Instead of using the risk premium to estimate a certainty-equivalent cash flow, Method 2 of the expected present value technique incorporates the risk premium in the discount rate. The difference between the discount rate in Method 1 and Method 2 is the market risk premium.

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Appendix C - Defined terms

Extract from IFRS 13

Appendix A
Defined terms

This appendix is an integral part of the IFRS.

active market	A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.
cost approach	A valuation technique that reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).
entry price	The price paid to acquire an asset or received to assume a liability in an exchange transaction.
exit price	The price that would be received to sell an asset or paid to transfer a liability.
expected cash flow	The probability-weighted average (ie mean of the distribution) of possible future cash flows.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
highest and best use	The use of a non-financial asset by market participants that would maximise the value of the asset or the group of assets and liabilities (eg a business) within which the asset would be used.
income approach	Valuation techniques that convert future amounts (eg cash flows or income and expenses) to a single current (ie discounted) amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts.
inputs	The assumptions that market participants would use when pricing the asset or liability, including assumptions about risk, such as the following: (a) the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model); and (b) the risk inherent in the inputs to the valuation technique. Inputs may be observable or unobservable.
Level 1 inputs	Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.
Level 2 inputs	Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
Level 3 inputs	Unobservable inputs for the asset or liability.
market approach	A valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable (ie similar) assets, liabilities or a group of assets and liabilities, such as a business.
market-corroborated inputs	Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

market participant	Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics: (a) They are independent of each other, ie they are not related parties as defined in IAS 24, although the price in a related party transaction may be used as an input to a fair value measurement if the entity has evidence that the transaction was entered into at market terms. (b) They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary. (c) They are able to enter into a transaction for the asset or liability. (d) They are willing to enter into a transaction for the asset or liability, ie they are motivated but not forced or otherwise compelled to do so.
most advantageous market	The market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs.
non-performance risk	The risk that an entity will not fulfil an obligation. Non-performance risk includes, but may not be limited to, the entity's own credit risk.
observable inputs	Inputs that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability.
orderly transaction	A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (eg a forced liquidation or distress sale).
principal market	The market with the greatest volume and level of activity for the asset or liability.
risk premium	Compensation sought by risk-averse market participants for bearing the uncertainty inherent in the cash flows of an asset or a liability. Also referred to as a 'risk adjustment'.
transaction costs	The costs to sell an asset or transfer a liability in the principal (or most advantageous) market for the asset or liability that are directly attributable to the disposal of the asset or the transfer of the liability and meet both of the following criteria: (a) They result directly from and are essential to that transaction. (b) They would not have been incurred by the entity had the decision to sell the asset or transfer the liability not been made (similar to costs to sell, as defined in IFRS 5).
transport costs	The costs that would be incurred to transport an asset from its current location to its principal (or most advantageous) market.
unit of account	The level at which an asset or a liability is aggregated or disaggregated in an IFRS for recognition purposes.
unobservable inputs	Inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability.

Appendix D - Convergence with US GAAP

D.1 The development of IFRS 13

IFRS 13 was the result of a convergence project between the IASB and the US Financial Accounting Standards Board (FASB). However, the Boards began developing their fair value measurement standards separately. The FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157, now ASC 820) in 2006. The IASB's initial discussion paper issued in 2006 and subsequent exposure draft issued in 2009, were developed using the requirements of SFAS 157. However, the proposed requirements were not wholly consistent with that guidance and responses from constituents emphasised the need for a common set of requirements regarding the determination of fair value measurements under both IFRS and US GAAP. As a result, the Boards began joint discussions in 2010. From the IASB's perspective, the project had "the following objectives:

(a) to establish a single set of requirements for all fair value measurements required or permitted by IFRSs to reduce complexity and improve consistency in their application, thereby enhancing the comparability of information reported in financial statements;

(b) to clarify the definition of fair value and related guidance to communicate the measurement objective more clearly;

(c) to enhance disclosures about fair value measurements that will help users of financial statements assess the valuation techniques and inputs used to develop fair value measurements; and

(d) to increase the convergence of IFRSs and US generally accepted accounting principles (GAAP)". *[IFRS 13.BC6]*.

The Boards' joint discussions resulted in the issuance of IFRS 13 and Accounting Standards Update (ASU) 2011-04 and created a generally uniform framework for applying fair value measurement in both IFRS and US GAAP (refer to section D.2 below for further discussion of the differences).

IFRS 13 was also part of the IASB's response to G20 requests in relation to the financial crisis. Therefore, the disclosures required by the standard are intended to help users assess the valuation techniques and inputs used to measure fair value. The IASB had originally proposed to require entities to disclose a quantitative sensitivity analysis for non-financial assets and liabilities measured at fair value. While the proposed disclosures were favoured by users and were consistent with the recommendations from the IASB's Expert Advisory Panel, the proposals were heavily criticised by preparers. Their concerns included the additional cost involved. Therefore, the Boards decided not to include this requirement and sensitivity disclosures are only required for financial assets and liabilities (this continues the current disclosure requirements in IFRS 7). *[IFRS 13.BC202-208]*.

As part of the PIR of IFRS 13, the board received feedback that maintaining convergence with US GAAP was important in that it leads to increased comparability for financial statements globally. This increased comparability is facilitating efficient capital markets, increased user confidence and reduced compliance costs. It was also indicated that the convergence has led to more material to be available for stakeholders around fair value measurements.[39]

D.2 US GAAP differences

As noted above, the Boards' joint fair value measurement project resulted in both the issuance of IFRS 13 and amendments to particular aspects of ASC 820. These standards now have a consistent definition of fair value and represent converged guidance in relation to how to measure fair value. However, some differences still remain. The main differences are discussed in sections D.2.1 to D.2.5 below.

It is also worth noting that there continue to be differences between IFRS and US GAAP as to what is measured at fair value, but those differences were outside the scope of the joint project, which focused on how to measure fair value.

39 IFRS Project Report and Feedback Statement, *Post-implementation Review of IFRS 13* Fair Value Measurement, IASB, December 2018, p.17. Available on the Accounting Foundation's website.

In 2014, the Financial Accounting Foundation issued its post-implementation review of SFAS 157, concluding that the standard met its intended objectives.[40] While agreeing that a comprehensive review of the fair value guidance was not needed, the FASB noted that it plans to potentially address more challenging aspects of the standard in the years ahead.[41] The FASB issued an amendment *Fair Value Measurement (Topic 820) Disclosure Framework* (ASU 2018-13) in August 2018 that eliminates, adds and modifies certain disclosure requirements for fair value measurements as part of its disclosure framework project.

The amendments were effective for all entities for fiscal years beginning after 15 December 2019 and for interim periods within those fiscal years. An entity was permitted to early adopt either the entire standard or only the provisions that eliminate or modify requirements. The IASB has not made similar amendments to IFRS 13, as the discussions confirmed through the PIR, the Board is aware of all the issues the FASB identified. As discussed in section 19 above, the IASB has fed the PIR findings regarding the usefulness of disclosures into the work on Better Communications in Financial Reporting.

D.2.1 Practical expedient for alternative investments

ASC 820 provides a practical expedient to measure the fair value of certain investments in investment companies (e.g., investments in hedge funds or private equity funds that do not have readily determinable fair values) using NAV, without adjustment.[42] Furthermore, in May 2015, the FASB issued ASU 2015-07 - *Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*, which eliminates the requirement to categorise in the fair value hierarchy investments measured using the NAV practical expedient.[43] While this exemption provides some relief for entities, they now have additional disclosure requirements specific to investments that are measured using the NAV practical expedient. These requirements are intended to help financial statement users reconcile amounts reported to the face of the financial statements and better understand the nature and risk of these investments, including whether the investments, if sold, are likely to be sold at amounts different from their NAV.

IFRS 13 does not have a similar practical expedient. Nor does it provide a similar disclosure exemption or requirements specific to such investments. Therefore, IFRS preparers cannot presume that NAV, or an equivalent measure, will be the same as fair value as measured in accordance with IFRS 13 (this is discussed further in section 2.5.1.A above). In addition, entities will need to categorise such investments within the fair value hierarchy and comply with the general disclosure requirements in IFRS 13.

At the time IFRS 13 was issued, the IASB believed it would be difficult to identify when such a practical expedient would be applied, given the different practices entities across the world use to calculate NAV. This difference was expected to be addressed as part of the IASB's project on Investment Entities. However, when the IASB issued *Investment Entities (Amendments to* IFRS 10*,* IFRS 12 *and* IAS 27*)* in October 2012, a footnote was added to the Basis for Conclusions to IFRS 13 which confirmed it had reconsidered providing a net asset value practical expedient, but decided against providing one because of the different calculation methods around the world and because it was outside the scope of the Investment Entities project to provide fair value measurement guidance for investments in investment entities. *[IFRS 13.BC238(a)]*.

40 Post-Implementation Review Report: *FASB Statement No. 157, Fair Value Measurements (Codified in Accounting Standards Codification Topic 820, Fair Value Measurements and Disclosures)*, Financial Accounting Foundation, February 2014, p.10. Available on the IFRS Foundation's website.

41 FASB, *Response to the Financial Accounting Foundation's Post-implementation Review Report of FAS 157 on Fair Value Measurement* dated 10 March 2014. Available on the Accounting Foundation's website.

42 FASB Accounting Standards Codification Topic 820, *Fair Value Measurements and Disclosures,* FASB, sections 10-35-59 to 10-35-62.

43 FASB Accounting Standards Codification Topic 820, *Fair Value Measurements and Disclosures,* FASB, section 10-35-54B, which was added by ASU 2015-07, *Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent).*

D.2.2 Fair value of liabilities with a demand feature

The guidance in IFRS on measuring the fair value of a financial liability with a demand feature differs slightly from US GAAP. IFRS 13 states that the fair value of a liability with a demand feature cannot be less than the present value of the amount payable on demand, which was consistent with the existing requirements in IFRS. US GAAP has specific industry guidance for banks and depository institutions.[44] The industry specific guidance states that the fair value of deposit liabilities with no defined maturities is the amount payable on demand at the reporting date. Since deposit liabilities, withdrawable on demand, of banks and depository institutions are excluded from the scope of the fair value option guidance in ASC 825, the industry guidance in US GAAP around how to fair value these liabilities is applicable to disclosure only. *[IFRS 13.BC238(b)]*.

D.2.3 Recognition of day-one gains and losses

While fair value is defined in IFRS 13 as an exit price (which can differ from an entry price), the standard defers to other IFRS accounting standards on whether to recognise any difference between fair value and transaction price at initial recognition, that is, day-one gains or losses. IFRS 9 restricts the recognition of day-one gains and losses when fair value is determined using unobservable inputs.

US GAAP contains no specific threshold regarding the observability of fair value inputs. As such, US GAAP does not specifically prohibit the recognition of day-one gains or losses even when the fair value measurement is based on significant unobservable inputs (i.e., a Level 3 measurement - see section 15.2 above for further discussion regarding categorisation within the fair value hierarchy).

D.2.4 Fair value of equity securities subject to contractual sale restrictions

If an equity security is subject to a contractual sale restriction, an IFRS preparer must assess whether it is a characteristic of the asset or the holder, as is discussed in section 4.2.2 above. The requirements in IFRS and US GAAP are generally converged in this area. However, in June 2022, the FASB issued an amendment to ASC 820[45] to specify that, under US GAAP, a contractual sale restriction (e.g., restrictions on the sale of securities issued in capital-raising and other transactions, such as business combinations) does not affect the fair value of an equity security. After adopting the amendment, these securities will be measured in the same way as identical equity securities that are not subject to such a restriction (e.g., based on the quoted price). This is because the amendment specifies that such a contractual sale restriction is a characteristic of the entity holding the security, rather than a characteristic of the asset.

The amendment is intended to eliminate diversity in practice under US GAAP in the measurement of the fair value of equity securities subject to contractual sale restrictions. To value these securities, some US GAAP stakeholders previously applied a discount to the fair value of an identical equity security that is not subject to a contractual sale restriction, while others believed the application of such a discount was inconsistent with the fair value measurement principles in ASC 820.

No similar amendment has been proposed under IFRS. Therefore, entities could account for similar restrictions differently under US GAAP and IFRS if an IFRS preparer concludes the contractual sale restriction is a characteristic of the asset.

D.2.5 Disclosures

IFRS 13 and ASC 820 have some differences in the disclosure requirements for fair value measurements. For example, IFRS 13 does not provide exceptions to its disclosure requirements for non-public entities, whereas ASC 820 does. However, *IFRS for Small and Medium-Sized Entities* addresses the accounting for entities that do not have public accountability, and the disclosures about their fair value measurements. *[IFRS 13.BC238(c)]*.

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44 FASB Accounting Standards Codification Topic 825, *Financial Instruments* and Topic 942, *Financial Services - Depository and Lending*, FASB.

45 FASB Accounting Standards Update 2022-03, *Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions*, FASB. The amendment will be applied prospectively for fiscal years beginning after 15 December 2023 for public business entities (as defined), with early adoption permitted. All other entities have a one-year deferral, with early adoption permitted. The transition requirements differ depending on whether an entity is an investment company.

Chapter 16 Foreign exchange

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Overview

An entity can engage in foreign currency activities in the following two ways:

- It may enter directly into transactions which are denominated in foreign currencies, the results of which need to be translated into the currency in which the company measures its results and financial position.
- It may conduct foreign operations through a foreign entity, such as a subsidiary, associate, joint arrangement or branch which keeps its accounting records in terms of its own currency. In this case the entity will need to translate the financial statements of the foreign entity for the purposes of inclusion in its consolidated financial statements.

In addition, an entity may choose to present its financial statements in a different currency.

IAS 21 *Foreign Currencies* sets out the requirements for all of these situations and this chapter addresses all aspects of that standard.

IAS 21 does not address the accounting for hedges of foreign currency risk, that being addressed in IFRS 9 *Financial Instruments* (see Chapter 49).

Nor does IAS 21 address the reporting of foreign currency cash flows in the statement of cash flows - that is addressed in IAS 7 *Statement of Cash Flows* although the approach set out in IAS 7 (see Chapter 36) is broadly consistent with IAS 21.

What you need to know

- Each entity, whether a standalone entity, a parent with foreign operations or a foreign operation such as a subsidiary determines its functional currency.
- An entity's functional currency is the currency of the primary economic environment in which the entity operates.
- An entity draws up its financial statements initially by translating foreign currency items into its functional currency.
- Most of the exchange differences arising from this process are recognised in profit or loss.
- When preparing financial statements the results and financial position of the entity (or, in the case of consolidated financial statements, each entity within the group) are translated into a presentation currency, which may be different to the entity's (or parent's) functional currency.
- Exchange differences arising from this process are recognised in other comprehensive income.
- Exchange differences recognised in other comprehensive income are reclassified to profit or loss on disposal of a foreign operation.

1 Introduction

1.1 Background

An entity can engage in foreign currency activities in two ways. It may enter directly into transactions which are denominated in foreign currencies, the results of which need to be translated into the currency in which the company measures its results and financial position. Alternatively, it may conduct foreign operations through a foreign entity, such as a subsidiary, associate, joint arrangement or branch which keeps its accounting records in terms of its own currency. In this case it will need to translate the financial statements of the foreign entity for the purposes of inclusion in the consolidated financial statements.

Before an international standard was developed, there were four distinct methods which could be used in the translation process:

(a) *Current rate method* - all assets and liabilities are translated at the current rate of exchange, i.e., the exchange rate at the end of the reporting period

(b) *Temporal method* - assets and liabilities carried at current prices (e.g., cash, receivables, payables, and investments at market value) are translated at the current rate of exchange. Assets and liabilities carried at past prices (e.g., property, investments at cost, prepayments) are translated at the rate of exchange in effect at the dates to which the prices pertain

(c) *Current/non-current method* - all current assets and current liabilities are translated at the current rate of exchange. Non-current assets and liabilities are translated at historical rates, i.e., the exchange rate in effect at the time the asset was acquired or the liability incurred

(d) *Monetary/non-monetary method* - monetary assets and liabilities, i.e., items which represent the right to receive or the obligation to pay a fixed amount of money, are translated at the current rate of exchange. Non-monetary assets and liabilities are translated at the historical rate

There was no consensus internationally on the best theoretical approach to adopt. In essence, the arguments surround the choice of exchange rates to be used in the translation process and the subsequent treatment of the exchange differences which arise.

1.2 Relevant pronouncements

The principal international standard dealing with this topic is IAS 21 *The Effects of Changes in Foreign Exchange Rates,* the original version of which dates back to 1983. In December 2003, the IASB issued a revised version of IAS 21 as part of a wide ranging project to improve its standards and this forms the core of the current standard. IAS 21 has been subject to a number of subsequent amendments since then, the most extensive of which was published in August 2023 and addresses the determination of an exchange rate when exchangeability between two currencies is lacking (see section 7 below).

One interpretation of the earlier version of IAS 21 issued by the SIC remains applicable. SIC-7 *Introduction of the Euro* deals with the application of IAS 21 to the changeover from the national currencies of participating Member States of the European Union to the euro and is covered in section 9 below. IFRIC 16 *Hedges of a Net Investment in a Foreign Operation* is not actually an interpretation of IAS 21, but provides guidance on applying certain aspects of the standard and is discussed in sections 6.1.4 and 6.6.3 below.

IFRIC 22 *Foreign Currency Transactions and Advance Consideration* provides guidance on determining the date of a transaction for the purposes of applying IAS 21 when consideration is paid or received in advance. This interpretation is primarily discussed in section 5.1.2 below.

2 IAS 21: Objective, scope and definitions

2.1 Objective of the standard

An entity may carry on foreign activities in two ways. It may have transactions in foreign currencies or it may have foreign operations. In addition, an entity may present its financial statements in a foreign currency. IAS 21 does not set out what the objective of foreign currency translation is, but just states that the objective of the standard is "to prescribe how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency". *[IAS 21.1]*.

It also indicates that the principal issues to be addressed are "which exchange rate(s) to use and how to report the effects of changes in exchange rates in the financial statements". *[IAS 21.2]*.

2.2 Scope

IAS 21 is applied: *[IAS 21.3]*

(a) In accounting for transactions and balances in foreign currencies, except for those derivative transactions and balances that are within the scope of IFRS 9

(b) In translating the results and financial position of foreign operations that are included in the financial statements of the entity by consolidation or the equity method

(c) In translating an entity's results and financial position into a presentation currency

IFRS 9 applies to many foreign currency derivatives and, accordingly, these are excluded from the scope of IAS 21. However, those foreign currency derivatives that are not within the scope of IFRS 9 (e.g., some foreign currency derivatives that are embedded in other contracts) are within the scope of IAS 21. In addition, IAS 21 applies when an entity translates amounts relating to derivatives from its functional currency to its presentation currency. *[IAS 21.4]*.

IAS 21 also does not apply to hedge accounting for foreign currency items, including the hedging of a net investment in a foreign operation. *[IAS 21.5]*. This is dealt with in IFRS 9 (or IAS 39 *Financial Instruments: Recognition and Measurement*[1]) which has detailed rules on hedge accounting that are different from the requirements of IAS 21 (see Chapter 49). *[IAS 21.27]*.

The requirements of IAS 21 are applicable to financial statements that are described as complying with International Financial Reporting Standards. They do not apply to translations of financial information into a foreign currency that do not meet these requirements, although the standard does specify information to be disclosed in respect of such 'convenience translations' (see section 11.3 below). *[IAS 21.6]*.

IAS 21 does not apply to the presentation in a statement of cash flows of the cash flows arising from transactions in a foreign currency, or to the translation of cash flows of a foreign operation. *[IAS 21.7]*. These are dealt with in IAS 7 *Statement of Cash Flows* (see Chapter 36 at section 6).

1 After applying IFRS 9 an entity can actually continue applying some or all of the hedge accounting requirements of IAS 39. These options are considered further in Chapter 40 in sections 3 and 5 and in Chapter 49 at section 10.2 but are not dealt with any further in this chapter.

2.3 Definitions of terms

The definitions of terms which are contained in IAS 21 are as follows: *[IAS 21.8]*

Extract from IAS 21	
8	The following terms are used in this Standard with the meanings specified: *Closing rate* is the spot exchange rate at the end of the reporting period. A currency is *exchangeable* into another currency when an entity is able to obtain the other currency within a time frame that allows for a normal administrative delay and through a market or exchange mechanism in which an exchange transaction would create enforceable rights and obligations. *Exchange difference* is the difference resulting from translating a given number of units of one currency into another currency at different exchange rates. *Exchange rate* is the ratio of exchange for two currencies. *Fair value* is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See *IFRS 13 Fair Value Measurement*.) *Foreign currency* is a currency other than the functional currency of the entity. *Foreign operation* is an entity that is a subsidiary, associate, joint arrangement or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity. *Functional currency* is the currency of the primary economic environment in which the entity operates. A *group* is a parent and all its subsidiaries. *Monetary items* are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency. *Net investment in a foreign operation* is the amount of the reporting entity's interest in the net assets of that operation. *Presentation currency* is the currency in which the financial statements are presented. *Spot exchange rate* is the exchange rate for immediate delivery.

The terms 'exchangeable', 'functional currency', 'monetary items' and 'net investment in a foreign operation' are elaborated on further within the standard. These are discussed in sections 7, 4, 5.4 and 6.3.1 below, respectively.

3 Summary of the approach required by IAS 21

Many reporting entities comprise a number of individual entities (e.g., a group is made up of a parent and one or more subsidiaries). Various types of entities, whether members of a group or otherwise, may have investments in associates or joint arrangements. They may also have branches or divisions (see section 4.4 below). It is necessary for the results and financial position of each individual entity included in the reporting entity to be translated into the currency in which the reporting entity presents its financial statements (if this presentation currency is different from the individual entity's functional currency). *[IAS 21.18]*.

In preparing financial statements, the following approach is followed:

- Each entity - whether a stand-alone entity, an entity with foreign operations (such as a parent) or a foreign operation (such as a subsidiary or branch) - determines its functional currency. *[IAS 21.17]*. This is discussed in section 4 below.

  In the case of group financial statements, it is emphasised that there is not a 'group' functional currency; each entity included within the group financial statements, be it the parent, or a subsidiary, associate, joint arrangement (whether a joint venture or joint operation) or branch, has its own functional currency.
- Where an entity enters into a transaction denominated in a currency other than its functional currency, it translates those foreign currency items into its functional currency and reports the effects of such translation in accordance with the provisions of IAS 21 discussed in section 5 below. *[IAS 21.17]*.
- The results and financial position of any individual entity within the reporting entity whose functional currency differs from the presentation currency are translated in accordance with the provisions of IAS 21 discussed in section 6 below. *[IAS 21.18]*.

  IAS 21 permits the presentation currency of a reporting entity to be any currency (or currencies), although relevant laws or regulations might restrict that choice. Therefore, this translation process will also apply to the parent's figures if its functional currency is different from the presentation currency.

  The standard also permits a stand-alone entity preparing financial statements or an entity preparing separate financial statements in accordance with IAS 27 Separate Financial Statements to present its financial statements in any currency (or currencies). If the entity's presentation currency differs from its functional currency, its results and financial position are also translated into the presentation currency in accordance with this process. *[IAS 21.19]*.

4 Determination of an entity's functional currency

4.1 General

Functional currency is defined as the currency of "the primary economic environment in which the entity operates" (see section 2.3 above). This will normally be the one in which it primarily generates and expends cash. *[IAS 21.9]*.

IAS 21 sets out a number of factors or indicators that any entity considers in determining its functional currency. When the factors or indicators are mixed and the functional currency is not obvious, management uses its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions. As part of this approach, management gives priority to the primary indicators before considering the other indicators, which are designed to provide additional supporting evidence to determine an entity's functional currency. *[IAS 21.12]*.

The primary factors that IAS 21 requires an entity to consider in determining its functional currency are as follows: *[IAS 21.9]*

Extract from IAS 21

9 The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. An entity considers the following factors in determining its functional currency:

(a) the currency:

(i) that mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and

(ii) of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.

(b) the currency that mainly influences labour, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled).

Where the functional currency of the entity is not obvious from the above, the following factors may also provide evidence of an entity's functional currency: *[IAS 21.10]*

(a) The currency in which funds from financing activities (i.e., issuing debt and equity instruments) are generated

(b) The currency in which receipts from operating activities are usually retained

An operation that is 'integral' to its parent, i.e., it carries on business as if it were an extension of the parent's operations, will always have the same functional currency as the parent. (In this context, the term parent is drawn broadly and is the entity that has the foreign operation as its subsidiary, branch, associate or joint arrangement). *[IAS 21.BC6]*. Therefore, the following additional factors are also considered in determining the functional currency of a foreign operation, particularly whether its functional currency is the same as that of the reporting entity: *[IAS 21.11]*

(a) Whether the activities of the foreign operation are carried out as an extension of the reporting entity, rather than being carried out with a significant degree of autonomy. An example of the former is when the foreign operation only sells goods imported from the reporting entity and remits the proceeds to it. An example of the latter is when the operation accumulates cash and other monetary items, incurs expenses, generates income and arranges borrowings, all substantially in its local currency.

(b) Whether transactions with the reporting entity are a high or a low proportion of the foreign operation's activities.

(c) Whether cash flows from the activities of the foreign operation directly affect the cash flows of the reporting entity and are readily available for remittance to it.

(d) Whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligations without funds being made available by the reporting entity.

Although the standard says that these factors 'are' considered in determining the functional currency of a foreign operation, this contradicts the requirement in the standard that management gives priority to the primary indicators before considering the other indicators. If it is obvious from the primary indicators what the entity's functional currency is, then there is no need to consider any of the other factors.

Illustration 4-1: Factors to be considered when determining the functional currency

A French entity (Parent A) has a US subsidiary (Subsidiary B) that produces and sells knitwear in the United States.

It is clear from the primary factors in IAS 21 that Subsidiary B's functional currency is the US dollar, because the US dollar mainly influences sales prices for goods, labour, material and other costs of providing goods, and the competitive forces and regulations that mainly determine the sales prices of the goods are located in the United States.

However, suppose Subsidiary B is financed by an inter-company loan denominated in euros granted from Parent A and the cash flows generated by Subsidiary B are transferred to Parent A on a regular basis. Would these additional factors be taken into account in determining the functional currency of Subsidiary B?

How we see it

In our view, these additional factors are not taken into account in determining the functional currency of Subsidiary B. They are only considered when it is not obvious from the primary factors what Subsidiary B's functional currency is.

However, in practice, there are occasions when the functional currency is not completely clear from the primary factors and it will often be necessary to consider the other indicators. For example, if Subsidiary B was not producing the knitwear itself, but purchasing it from sources outside of the US (such that its operating costs were not predominantly in US dollars) this would mean that it was no longer obvious based on the primary factors that its functional currency was the US dollar and the additional factors would be taken into account in determining Subsidiary B's functional currency.

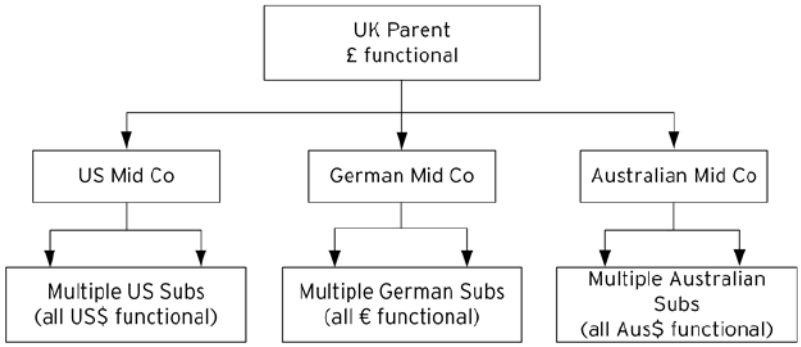
Since an entity's functional currency reflects the underlying transactions, events and conditions that are relevant to it, once it is determined, IAS 21 requires that the functional currency is not changed unless there is a change in those underlying transactions, events and conditions. *[IAS 21.13]*. The implication of this is that management of an entity cannot decree what the functional currency is - it is a matter of fact, albeit subjectively determined fact based on management's judgement of all the circumstances.

4.2 Intermediate holding companies or finance subsidiaries

For many entities the determination of functional currency may be relatively straightforward. However, for some entities, particularly entities within a group, this is not always the case. One particular difficulty is the determination of the functional currency of an intermediate holding company or finance subsidiary within an international group.

Illustration 4-2: Functional currency of intermediate holding companies or finance subsidiaries

An international group is headquartered in the UK. The UK parent entity has a functional currency of pound sterling, which is also the group's presentation currency. The group has three international sub-operations, structured as follows:



What is the functional currency of the three Mid Cos?

There are a variety of factors to be considered for intermediate holding companies or finance subsidiaries when deciding on the appropriate functional currency. Therefore, there will not be a single analysis applicable to all such entities.

IAS 21 defines a 'foreign operation' as "an entity that is a subsidiary…the activities of which are based or conducted in a country or currency other than those of the reporting entity" (see section 2.3 above). This definition would seem to suggest that a foreign operation must have its own 'activities'.

Also, IAS 21.9 states that the functional currency is "the currency of the primary economic environment in which the entity operates". However, under IAS 21.9 this is determined by reference to the currency that mainly influences sales prices and the operation's costs, and is therefore not directly relevant to intermediate holding companies or finance subsidiaries (see section 4.1 above). Paragraphs 10 and 11 set out a number of factors to consider in determining the functional currency of a foreign operation. The theme running through these factors is the extent to which the activities and cash flows of the foreign operation are independent of those of the reporting entity.

How we see it

In the case of an intermediate holding company or finance subsidiary, the acid-test question to consider is whether it is an extension of the parent and performing the functions of the parent - i.e., whether its role is simply to hold the investment in, or provide finance to, the foreign operation on behalf of the parent company or whether its functions are essentially an extension of a local operation (e.g., performing selling, payroll or similar activities for that operation) or indeed it is undertaking activities on its own account.

This means that subsidiaries that do nothing but hold investments or borrow money on behalf of the parent will normally have the functional currency of the parent. The borrowings of such companies are frequently guaranteed by the parent, which is itself likely to be a relevant factor. In other words, on whose credit is the lender relying? If the lender is looking to the ultimate parent, then the functional currency is likely to be that of the ultimate parent. However, if the lender is looking to the sub-group, then the functional currency of the companies in the sub-group will be relevant.

How we see it

Any analysis that such a company has a functional currency other than that of the parent will require careful consideration of the features of the entity which give rise to that conclusion. Complex situations are likely to require the application of careful management judgement as indicated by the standard.

As for other entities within a group, the particular circumstances of each entity are reviewed against the indicators and factors set out in the standard. This review requires management to use its judgement in determining the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions applicable to that entity.

4.3 Investment holding companies

A similar, but subtly different, issue arises in situations where a group comprises an investment holding company incorporated in one jurisdiction and a number of operating subsidiaries which operate in a different jurisdiction and have the local currency as their functional currency. The question is how to determine the functional currency of the investment holding company which is often little more than a 'shell' with few transactions of its own.

This issue is common for parent companies established in Hong Kong (where the Hong Kong dollar is the local currency) that have subsidiaries operating in Mainland China (where Renminbi is the local currency), although very similar situations arise in other jurisdictions. Often the investment holding company will be listed in Hong Kong, incur some expenses, e.g., directors' remuneration, limited staff costs and office rental payments, in Hong Kong dollars and raise capital (shares and borrowings) in Hong Kong dollars. Furthermore, dividends from subsidiaries will either be received in Hong Kong dollars or be converted into Hong Kong dollars on receipt.

In 2010, the IFRS IC was asked to consider this issue and the staff identified two broad approaches being used in practice, namely:

- The parent uses the currency of its local environment, i.e., the one in which its operating expenses are denominated, it receives dividends from its subsidiaries and it raises funding
- The parent uses the currency of the local environment of its subsidiaries as its functional currency as this is the environment which drives the dividend income it receives, which is its primary source of revenue, i.e., the parent is seen as an extension of its subsidiaries

The IFRS IC chose not to take the issue onto its agenda because any guidance it could provide would be in the nature of application guidance and simply emphasised that judgement needed to be applied.[2] In practice the judgement will often be based on whether the holding company's operations are considered sufficiently substantive to enable it to have a different functional currency from its subsidiaries.

4.4 Branches and divisions

IAS 21 uses the term 'branch' to describe an operation within a legal entity that may have a different functional currency from the entity itself. However, it contains no definition of that term, nor any further guidance on what arrangements are regarded as a branch.

Many countries' governments have established legal and regulatory regimes that apply when a foreign entity establishes a place of business (often called a branch) in that country.

How we see it

Where an entity has operations that are subject to such a regime, it will normally be appropriate to regard them as a branch and evaluate whether those operations have their own functional currency. In this context, the indicators in IAS 21.11 used to assess whether an entity has a functional currency that is different from its parent (see section 4.1 above) will be particularly relevant.

An entity may also have an operation, e.g., a division, that operates in a different currency environment to the rest of the entity but which is not subject to an overseas branch regime.

How we see it

If that operation represents a business unit with a significant degree of autonomy it may be appropriate to view it as a branch and evaluate whether it has a functional currency that is different to the rest of the legal entity. However, in our experience, this situation will not be a common occurrence.

4.5 Documentation of judgements made

Since the determination of an entity's functional currency is critical to the translation process under IAS 21, we believe that it is appropriate for an entity to clearly document its decision about its functional currency, setting out the factors taken into account in making that determination, particularly where it is not obvious from the primary factors set out in IAS 21.9. We recommend that the ultimate parent entity of a group does this for each entity within the group and agree that determination with the local management of those entities, particularly where those entities are presenting financial statements in accordance with IFRS accounting standards. Although the determination of functional currency is a judgemental issue, it would be expected that within the group the same determination would be made as to the functional currency of a particular entity. If local management has come up with a different analysis of the facts from that of the parent, both parties discuss this to ensure that they have considered all the relevant facts and circumstances before a final determination is made.

By documenting the decision about the functional currency of each entity, and the factors taken into account in making that determination, the reporting entity will be better placed in the future to determine whether a change in the underlying transactions, events and conditions relating to that entity warrant a change in its functional currency.

2 *IFRIC Update*, March 2010; IASB Staff Paper 13: Project: *IAS 21 The Effects of Changes in Foreign Exchange Rates*, Topic: *Tentative agenda decision - Determining the functional currency of an investment holding company*, IFRS IC Meeting, January 2010; and IASB Staff Paper 4A: Project: *Agenda decision*, Topic: *IAS 21* The Effects of Changes in Foreign Exchange Rates - *Determining the functional currency of an investment holding company*, IFRS IC Meeting, March 2010. Available on the IFRS Foundation's website.

5 Reporting foreign currency transactions in the functional currency of an entity

Where an entity enters into a transaction denominated in a currency other than its functional currency then it will have to translate those foreign currency items into its functional currency and report the effects of such translation. The general requirements of IAS 21 are as follows.

5.1 Initial recognition

Extract from IAS 21

20 A foreign currency transaction is a transaction that is denominated or requires settlement in a foreign currency, including transactions arising when an entity:

(a) buys or sells goods or services whose price is denominated in a foreign currency;

(b) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency; or

(c) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

21 **A foreign currency transaction shall be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction.**

The date of a transaction is the date on which it first qualifies for recognition in accordance with IFRS accounting standards. For convenience, an average rate for a week or month may be used for all foreign currency transactions occurring during that period, if the exchange rate does not fluctuate significantly. *[IAS 21.20, IAS 21.21, IAS 21.22]*.

In most cases determining an exchange rate will be a relatively straightforward exercise, but this will not always be the case, particularly where there are restrictions on entities wishing to exchange one currency for another. This issue is covered in section 7 below, including information on amendments to IAS 21 published in August 2023.

5.1.1 Identifying the date of transaction

The date of a transaction is the date on which it first qualifies for recognition in accordance with IFRS accounting standards. Although this sounds relatively straightforward, the following Illustration shows the difficulty that can sometimes arise in determining the transaction date:

Illustration 5-1: Establishing the transaction date (1)

A Belgian entity buys an item of inventory from a Canadian supplier. The dates relating to the transaction, and the relevant exchange rates, are as follows:

Date	Event	€1=C$
14 April 20X2	Goods are ordered	1.50
5 May 20X2	Goods are shipped from Canada and invoice dated that day	1.53
7 May 20X2	Invoice is received	1.51
10 May 20X2	Goods are received	1.54
14 May 20X2	Invoice is recorded	1.56
7 June 20X2	Invoice is paid	1.60

IAS 2 *Inventories* does not make any reference to the date of initial recognition of inventory. However, IFRS 9 deals with the initial recognition of financial liabilities. It requires the financial liability to be recognised when, and only when, the entity becomes a party to the contractual provisions of the instrument. *[IFRS 9.3.1.1]*. In discussing firm commitments to purchase goods, it indicates that an entity placing the order does not recognise the liability at the time of the commitment, but delays recognition until the ordered goods have been shipped or delivered, *[IFRS 9.B3.1.2(b)]*, normally on the date that the risks and rewards of ownership are considered to have passed.

Accordingly, using the date the goods are ordered as the date of the transaction is unlikely to be correct.

If the goods are shipped free on board (f.o.b.) then the risks and rewards of ownership are normally considered to pass on shipment (5 May) and this date would be used. If, however, the goods are not shipped f.o.b. then the risks and rewards of ownership will often be considered to pass on delivery (10 May) and therefore the date the goods are received would be treated as the date of the transaction. In practice, the transaction date will depend on the precise terms of the agreement (which are often based on standardised agreements such as the Incoterms rules).

The dates on which the invoice is received and is recorded are irrelevant to when the risks and rewards of ownership pass and therefore are not in principle considered to be the date of the transaction. In practice, it may be acceptable as a matter of administrative convenience that the exchange rate at the date the invoice is recorded is used, particularly if there is no undue delay in processing the invoice. If this is done then care is taken to ensure that the exchange rate used is not significantly different from that ruling on the 'true' date of the transaction.

It is clear from IAS 21 that the date the invoice is paid is not the date of the transaction because if it were then no exchange differences would arise on unsettled transactions.

In the Illustration above, one of the difficulties in identifying the date of transaction is the fact that IAS 2 contains little guidance on determining when purchased inventory is recognised as an asset. Some standards, particularly those published more recently such as IFRS 15 *Revenue from Contracts with Customers* contain more detailed guidance in this respect. Nevertheless, determining the date of transaction may still require the application of judgement and the date that a transaction is recorded in an entity's books and records will not necessarily be the same as the date at which it qualifies for recognition under IFRS accounting standards. Other situations where this issue is likely to arise is where an entity is recording a transaction that relates to a period, rather than one being recognised at a single point in time, as illustrated below:

Illustration 5-2: Establishing the transaction date (2)

On 30 September 20X2 Company A, whose functional currency is the euro, acquires a US dollar bond for US$8,000 which is measured at amortised cost. The bond carries fixed interest of 5% per annum paid quarterly, i.e., US$100 per quarter. The exchange rate on acquisition is US$1 to €1.50.

On 31 December 20X2, the US dollar has appreciated and the exchange rate is US$1 to €2.00. Interest received on the bond on 31 December 20X2 is US$100 (= €200).

Although the interest might only be recorded on 31 December 20X2, the rate on that date is not the spot rate ruling at the date of the transaction. Since the interest has accrued over the 3 month period, it is translated at the spot rates applicable to the accrual of interest during the 3 month period. Accordingly, a weighted average rate for the 3 month period is used. Assuming that the appropriate average rate is US$1 to €1.75 the interest income is €175 (= US$100 × 1.75).

Accordingly, there is also an exchange gain on the interest receivable of €25 (= US$100 × [2.00 - 1.75]) to be reflected in profit or loss. The journal entry for recording the receipt of the interest on 31 December 20X2 is therefore as follows:

Dr	Cash		€200	
	Cr	Interest income (profit or loss)		€175
	Cr	Exchange gain (profit or loss)		€25

5.1.2 Deposits and other consideration received or paid in advance

An entity might receive (or pay) a deposit in a foreign currency in advance of delivering (or receiving) goods or services in circumstances where the resulting liability (or asset) is considered a non-monetary item (see section 5.4.1 below). IFRIC 22 explains that, in general, the appropriate application of IAS 21 in these circumstances is to use the exchange rate at the date the advance payment is recognised, normally the payment date, rather than a subsequent date (or dates) when the goods or services are actually delivered. *[IFRIC 22.8]*. If there are multiple payments or receipts in advance, an entity determines a date of transaction for each payment or receipt of advance consideration. *[IFRIC 22.9]*.

IFRIC 22 applies to a foreign currency transaction (or part of it) when an entity recognises a non-monetary asset or non-monetary liability arising from the payment or receipt of advance consideration before the related asset, expense or income (or part of it) is recognised. *[IFRIC 22.4]*. It does not apply when an entity measures the asset, income or expense arising from the advance payment at fair value or at the fair value of the consideration paid or received at a date other than the date of initial recognition of the non-monetary asset or non-monetary liability, for example the measurement of goodwill when applying IFRS 3 *Business Combinations*. *[IFRIC 22.5]*.

The interpretation need not be applied to income taxes or insurance contracts (including reinsurance contracts) issued or reinsurance contracts held. *[IFRIC 22.6]*. Application of IFRS 17 *Insurance Contracts*, which was required for periods commencing on or after 1 January 2023, specifies how the foreign currency effects of a group of insurance contracts are accounted for. These requirements, as well as guidance on accounting for groups of insurance contracts that generate cash flows in more than one currency, are addressed in section 5.3.1 and section 5.4.8 below as well as in Chapter 51 at section 8.3.

5.1.3 Using average rates

Rather than using the actual rate ruling at the date of the transaction IAS 21 notes that "an average rate for a week or month may be used for all foreign currency transactions occurring during that period" if the exchange rate does not fluctuate significantly (see section 5.1 above). *[IAS 21.22]*. For entities which engage in a large number of foreign currency transactions it will be more convenient for them to use an average rate rather than using the exact rate for each transaction. If an average rate is to be used, what guidance can be given in choosing and using such a rate?

(a) Length of period

As an average rate is only used as an approximation of actual rates then care has to be taken that significant fluctuations in the day-to-day exchange rates do not arise in the period selected. For this reason the period chosen is not to be too long.

How we see it

We believe that it would be inappropriate to use a period of more than one month and where there is volatility of exchange rates it will be better to set rates more frequently, say on a weekly basis, especially where the value of transactions is significant.

(b) Estimate of average rate relevant to date of transaction

The estimation of the appropriate average rate will depend on whether the rate is to be applied to transactions which have already occurred or to transactions which will occur after setting the rate. Obviously, if the transactions have already occurred then the average rate used relates to the period during which those transactions occurred, e.g., purchase transactions for the previous week are translated using the average rate for that week, not an average rate for the week the invoices are being recorded.

If the rate is being set for the following period the rate selected is a reasonable estimate of the expected exchange rate during that period. This could be done by using the closing rate at the end of the previous period or by using the actual average rate for the previous period.

How we see it

We would suggest that the former be used. Whatever means is used to estimate the average rate, the actual rates during the period need to be monitored and if there is a significant move in the exchange rate away from the average rate then the rate being applied is revised.

(c) Application of average rate to type of item

How we see it

We believe that average rates are to be used only as a matter of convenience where there are a large number of transactions.

Even where an average rate is used, therefore, we recommend that the actual rate is used for large one-off transactions such as the purchase of a fixed asset or an overseas investment or taking out a foreign loan. Where the number of foreign currency transactions is small it will probably not be worthwhile setting and monitoring average rates and therefore actual rates are to be used.

5.1.4 Dual rates

One of the practical difficulties in translating foreign currency amounts that was noted above is where there is more than one exchange rate for that particular currency depending on the nature of the transaction. In some cases the difference between the exchange rates can be small and therefore it probably does not matter which rate is actually used. However, in other situations the difference can be quite significant.

In these circumstances, what rate is to be used? IAS 21 states that: *[IAS 21.26]*

Extract from IAS 21

26 When several exchange rates are available, the rate used is that at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date. …

Companies therefore look at the nature of the transaction and apply the appropriate exchange rate.

5.2 Reporting at the ends of subsequent reporting periods

Extract from IAS 21

23 At the end of each reporting period:

(a) foreign currency monetary items shall be translated using the closing rate;

(b) non-monetary items that are measured in terms of historical cost in a foreign currency shall be translated using the exchange rate at the date of the transaction; and

(c) non-monetary items that are measured at fair value in a foreign currency shall be translated using the exchange rates at the date when the fair value was measured.

The carrying amount of an item is determined in conjunction with the relevant requirements of other IFRS accounting standards. For example, property, plant and equipment may be measured in terms of fair value or historical cost in accordance with IAS 16 *Property, Plant and Equipment*. Irrespective of whether the carrying amount is determined on the basis of historical cost or fair value, if the amount is determined in a foreign currency, IAS 21 requires that amount to be translated into the entity's functional currency. *[IAS 21.23, IAS 21.24]*.

The carrying amount of some items is determined by comparing two or more amounts. For example, IAS 2 requires the carrying amount of inventories to be determined as the lower of cost and net realisable value. Similarly, in accordance with IAS 36 *Impairment of Assets* the carrying amount of an asset for which there is an indication of impairment is the lower of its carrying amount before considering possible impairment losses and its recoverable amount. When such an asset is non-monetary and is measured in a foreign currency, the carrying amount is determined by comparing:

- The cost or carrying amount, as appropriate, translated at the exchange rate at the date when that amount was determined (i.e., the rate at the date of the transaction for an item measured in terms of historical cost) with
- The net realisable value or recoverable amount, as appropriate, translated at the exchange rate at the date when that value was determined (e.g., the closing rate at the end of the reporting period)

The effect of this comparison may be that an impairment loss is recognised in the functional currency but would not be recognised in the foreign currency, or *vice versa*. *[IAS 21.25]*.

5.3 Treatment of exchange differences

5.3.1 Monetary items

The general rule in IAS 21 is that exchange differences on the settlement or retranslation of monetary items are recognised in profit or loss in the period in which they arise. *[IAS 21.28]*.

When monetary items arise from a foreign currency transaction and there is a change in the exchange rate between the transaction date and the date of settlement, an exchange difference results. When the transaction is settled within the same accounting period as that in which it occurred, all the exchange difference is recognised in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference recognised in each period up to the date of settlement is determined by the change in exchange rates during each period. *[IAS 21.29]*.

These requirements can be shown in the following Illustrations:

Illustration 5-3: Reporting an unsettled foreign currency transaction in the functional currency

A French entity purchases plant and equipment on credit from a Canadian supplier for C$328,000 in January 20X2 when the exchange rate is €1=C$1.64. The entity records the asset at a cost of €200,000. At the French entity's year end at 31 March 20X2 the account has not yet been settled. The closing rate is €1=C$1.61. The amount payable would be retranslated at €203,727 in the statement of financial position and an exchange loss of €3,727 would be reported as part of the profit or loss for the period. The cost of the asset would remain as €200,000.

Illustration 5-4: Reporting a settled foreign currency transaction in the functional currency

A UK entity sells goods to a German entity for €87,000 on 28 February 20X2 when the exchange rate is £1=€1.45. It receives payment on 31 March 20X2 when the exchange rate is £1=€1.50. On 28 February the UK entity will record a sale and corresponding receivable of £60,000. When payment is received on 31 March the actual amount received is only £58,000. The loss on exchange of £2,000 would be reported as part of the profit or loss for the period.

There are situations where the general rule above will not be applied. The first exception relates to exchange differences arising on a monetary item that, in substance, forms part of an entity's net investment in a foreign operation (see section 6.3.1 below). In this situation the exchange differences are recognised initially in other comprehensive income until the disposal of the investment (see section 6.6 below). However, this treatment only applies in the financial statements that include the foreign operation and the reporting entity (e.g., consolidated financial statements when the foreign operation is a consolidated subsidiary or equity method investment). It does not apply to the reporting entity's separate financial statements or the financial statements of the foreign operation. Rather, the exchange differences will be recognised in profit or loss in the period in which they arise in the financial statements of the entity that has the foreign currency exposure. *[IAS 21.32]*. This is discussed further in section 6.3.1 below.

The next exception relates to hedge accounting for foreign currency items, to which IFRS 9 applies. The application of hedge accounting requires an entity to account for some exchange differences differently from the treatment required by IAS 21. For example, IFRS 9 requires that exchange differences on monetary items that qualify as hedging instruments in a cash flow hedge or a hedge of a net investment in a foreign operation are recognised initially in other comprehensive income to the extent the hedge is effective. Hedge accounting is discussed in more detail in Chapter 49.

Another situation where exchange differences on monetary items are not recognised in profit or loss in the period they arise would be where an entity capitalises borrowing costs under IAS 23 *Borrowing Costs* since that standard requires exchange differences arising from foreign currency borrowings to be capitalised to the extent that they are regarded as an adjustment to interest costs (see Chapter 22 at section 5.4). *[IAS 23.6]*.

One example of a monetary item given by IAS 21 is 'provisions that are to be settled in cash'. In most cases it will be appropriate for the exchange differences arising on provisions to be recognised in profit or loss in the period they arise. However, it may be that an entity has recognised a decommissioning provision under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. One practical difficulty with such a provision is that due to the long timescale of when the actual cash outflows will arise, an entity might not be able to say with any certainty the currency in which the transaction will actually be settled. Nevertheless, if it is determined that the provision is expected to be settled in a foreign currency it will be a monetary item. The main issue then is what happens to any exchange differences. IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* applies to any decommissioning or similar liability that has been both included as part of the cost of an asset and measured as a liability in accordance with IAS 37 (see Chapter 27 at section 6.3.1). IFRIC 1 requires, *inter alia*, that any adjustment to such a provision resulting from changes in the estimated outflow of resources embodying economic benefits (e.g., cash flows) required to settle the obligation is not recognised in profit or loss as it occurs, but is added to or deducted from the cost of the asset to which it relates. The requirement of IAS 21 to recognise the exchange differences arising on the provision in profit or loss in the period in which they arise conflicts with this requirement in IFRIC 1.

How we see it

We believe that either approach set out above, i.e., the one set out in IFRIC 1 or the one set out in IAS 21, could be applied as an accounting policy choice. However, in our experience, such exchange differences are most commonly dealt with in accordance with IFRIC 1, particularly by entities with material long-term provisions.

As set out in section 5.4.8 below, IFRS 17 requires an insurance contract to be treated as a monetary item. However, IFRS 17 specifies that exchange differences are recognised in other comprehensive income if they relate to changes in the carrying amounts of groups of insurance contracts that are themselves recognised in other comprehensive income (see Chapter 51 at section 8.3 and section 15.3). *[IFRS 17.92]*.

5.3.2 Non-monetary items

When non-monetary items are measured at fair value in a foreign currency they are translated using the exchange rate as at the date when the fair value was determined. Therefore, any re-measurement gain or loss will include an element relating to the change in exchange rates. In this situation, the exchange differences are recognised as part of the gain or loss arising on the fair value re-measurement.

When a gain or loss on a non-monetary item is recognised in other comprehensive income, any exchange component of that gain or loss is recognised in other comprehensive income. *[IAS 21.30]*. For example, IAS 16 requires some gains and losses arising on a revaluation of property, plant and equipment to be recognised in other comprehensive income (see Chapter 19 at section 6.2). When such an asset is measured in a foreign currency, the revalued amount is translated using the rate at the date the value is determined, resulting in an exchange difference that is also recognised in other comprehensive income. *[IAS 21.31]*.

Conversely, when a gain or loss on a non-monetary item is recognised in profit or loss, e.g., financial instruments that are measured at fair value through profit or loss in accordance with IFRS 9 (see Chapter 46 at section 2.4) or an investment property accounted for using the fair value model (see Chapter 20 at section 6), any exchange component of that gain or loss is recognised in profit or loss. *[IAS 21.30]*.

An example of an accounting policy dealing with the reporting of foreign currency transactions in the functional currency of an entity is illustrated below.

Practical example 5-1: ING Groep N.V. (2022) — The Netherlands

Annual Report 2022 [extract]

Notes to the Consolidated financial statements [extract]

1 Basis of preparation and significant accounting policies [extract]

1.10 Foreign currency translation

Functional and presentation currency

Items included in the financial statements of each of ING Group's entities are measured using the currency of the primary economic environment in which the entity operates (the functional currency). The Consolidated financial statements are presented in euros, which is ING Group's presentation currency.

Transactions and balances

Foreign currency transactions are translated into the functional currency using the exchange rate prevailing at the date of the transactions. Exchange rate differences resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the statement of profit or loss, except when deferred in equity as part of qualifying cash flow hedges or qualifying net investment hedges.

Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction.

5.4 Determining whether an item is monetary or non-monetary

Extract from IAS 21

16 The essential feature of a monetary item is a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples include: pensions and other employee benefits to be paid in cash; provisions that are to be settled in cash; lease liabilities; and cash dividends that are recognised as a liability. Similarly, a contract to receive (or deliver) a variable number of the entity's own equity instruments or a variable amount of assets in which the fair value to be received (or delivered) equals a fixed or determinable number of units of currency is a monetary item. Conversely, the essential feature of a non-monetary item is the absence of a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples include: amounts prepaid for goods and services; goodwill; intangible assets; inventories; property, plant and equipment; right-of-use assets; and provisions that are to be settled by the delivery of a non-monetary asset.

IAS 21 generally requires that monetary items denominated in foreign currencies be retranslated using closing rates at the end of the reporting period and non-monetary items are not retranslated (see section 5.2 above). Monetary items are defined as "units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency". *[IAS 21.8]*. The standard elaborates further on this by stating that "the essential feature of a monetary item is a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency". Examples given by IAS 21 are pensions and other employee benefits to be paid in cash; provisions that are to be settled in cash; cash dividends that are recognised as a liability; and lease liabilities. *[IAS 21.16]*. More obvious examples are cash and bank balances; trade receivables and payables; and loan receivables and payables.

IFRS 9 also indicates that where a foreign currency bond is held as a debt instrument measured at fair value through other comprehensive income, it is first accounted for at amortised cost in the underlying currency, thus effectively treating that amount as if it was a monetary item. This guidance is discussed further in Chapter 46 at section 4.1.

IAS 21 also states that "a contract to receive (or deliver) a variable number of the entity's own equity instruments or a variable amount of assets in which the fair value to be received (or delivered) equals a fixed or determinable number of units of currency is a monetary item". *[IAS 21.16]*. No examples of such contracts are given in IAS 21. However, it would seem to embrace those contracts settled in the entity's own equity shares that under IAS 32 *Financial Instruments: Presentation* would be presented as financial assets or liabilities (see Chapter 43 at section 5.2).

Conversely, the essential feature of a non-monetary item is the absence of a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples given by the standard are amounts prepaid for goods and services; goodwill; intangible assets; inventories; property, plant and equipment; provisions that are to be settled by the delivery of a non-monetary asset; and right-of-use assets. *[IAS 21.16]*. IFRS 9 states that investments in equity instruments are non-monetary items. *[IFRS 9.B5.7.3]*. It follows that equity investments in subsidiaries, associates or joint ventures are non-monetary items.

Even with this guidance there will clearly be a number of situations where the distinction is not altogether clear.

5.4.1 Deposits or progress payments

Entities may be required to pay deposits or progress payments when acquiring certain assets, such as property, plant and equipment or inventories, from foreign suppliers. The question then arises as to whether such payments are retranslated as monetary items or not.

Illustration 5-5: Deposits or progress payments

A Dutch entity contracts to purchase an item of plant and machinery for US$10,000 on the following terms:

Payable on signing contract (1 August 20X2)	- 10%
Payable on delivery (19 December 20X2)	- 40%
Payable on installation (7 January 20X3)	- 50%

At 31 December 20X2 the entity has paid the first two amounts on the due dates when the respective exchange rates were €1=US$1.25 and €1=US$1.20. The closing rate at the end of its reporting period, 31 December 20X2, is €1=US$1.15.

		(i)	(ii)
		€	€
First payment	- US$1,000	800	870
Second payment	- US$4,000	3,333	3,478
		4,133	**4,348**

(i) If the payments made are regarded as prepayments or as progress payments then the amounts are treated as non-monetary items and included in the statement of financial position at €4,133. This would appear to be consistent with US GAAP which in defining 'transaction date' states: "A long-term commitment may have more than one transaction date (for example, the due date of each progress payment under a construction contract is an anticipated transaction date)."

(ii) If the payments made are regarded as deposits, and are refundable, then the amounts could possibly be treated as monetary items and included in the statement of financial position at €4,348 and an exchange gain of €215 recognised in profit or loss. A variant of this would be to only treat the first payment as a deposit until the second payment is made, since once delivery is made it is less likely that the asset will be returned and a refund sought from the supplier.

How we see it

In practice, it will often be necessary to consider the terms of the contract to ascertain the nature of the payments made in order to determine the appropriate accounting treatment and this may well require the application of judgement, something acknowledged in IFRIC 22 (see section 5.1.2 above).

5.4.2 Deposits and advance payments for actively traded commodities

In most cases the analysis in section 5.4.1 above will be equally relevant for deposits or payments made in advance for commodities that are actively traded and have an observable market price. However, the fact that a market price for a commodity is available means it is easier for entities to enter into contracts to purchase or sell such items that give rise to monetary items as shown in the following Illustration.

Illustration 5-6: Deposit paid for future delivery of gold

Company X is a German entity which has the euro as its functional currency. It manufactures and sells jewellery using various metals including gold. On 1 October 20X2, when the quoted price of gold is US$100,000/kg, Company X enters into two contracts, each involving the purchase of 2kg of gold to be delivered on 31 January 20X3. The gold will be used to make jewellery so the contracts will be treated as normal purchases rather than derivatives within the scope of IFRS 9 (see Chapter 41 at section 3.3). Each contract requires Company X to pay a deposit of US$40,000 to the supplier immediately and this amount will be deducted from the total price which is due to be paid on 28 February 20X3.

Fixed price contract

The first contract specifies that the total amount to be paid for the gold is US$200,000 with the remaining US$160,000 becoming payable in February.

The nature of this contract is no different to that of the one illustrated in Illustration 5-5 in section 5.4.1 above. The deposit represents a prepayment of 20% of the cost of gold and will consequently be accounted for as a non-monetary asset. Therefore, Company X will not retranslate the balance between payment in October 20X1 and delivery in January 20X2. At the point of delivery Company X will recognise a payable of US$160,000, which will be a monetary liability.

Variable price contract

The second contract, which secures supply rather than price, specifies that the total price to be paid for the gold is determined by the US dollar denominated spot price on 31 January 20X3. If the spot price on delivery is below US$20,000/kg, the total amount due for the gold will be less than the US$40,000 deposit and the supplier will either repay Company X any excess or apply the excess against a future order.

Although this second contract may seem very similar to the first, the analysis is somewhat different. The cost of the gold can only be determined on 31 January 20X3 and, regardless of the market price of gold, the remaining amount Company X has to settle is the 'market value of the gold on 31 January 20X3' minus US$40,000. Therefore, as the deposit does not expose Company X to the price of gold and it merely reduces the future payable by US$40,000, it is considered to be a monetary item.

If the market price of gold is below US$20,000/kg at the point of delivery, Company X will receive gold and cash or credit that together are worth US$40,000.

In other words, Company X will always receive US$40,000 of value for its US$40,000 deposit at the date of delivery. Therefore, the deposit paid in respect of the second contract represents a US dollar denominated monetary asset.

5.4.3 Investments in preference shares

Entities may invest in preference shares of other entities. Whether such shares are monetary items or not will depend on the rights attaching to the shares. IFRS 9 states that investments in equity instruments are non-monetary items (see section 5.4 above). *[IFRS 9.B5.7.3]*. Thus, if the terms of the preference shares are such that they are classified by the issuer as equity, rather than as a financial liability, then they are non-monetary items. However, if the terms of the preference shares are such that they are classified by the issuer as a financial liability (e.g., a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date) and by the holder as a financial asset measured at amortised cost or at fair value through other comprehensive income (see Chapter 46 at section 4.1), they are treated as monetary items.

5.4.4 Foreign currency share capital

An entity may issue share capital denominated in a currency that is not its functional currency or, due to changes in circumstances that result in a re-determination of its functional currency, may find that its share capital is no longer denominated in its functional currency. Neither IAS 21, IAS 32 nor IFRS 9 address the treatment of translation of share capital denominated in a currency other than the functional currency. In theory two treatments are possible: the foreign currency share capital (and any related share premium or additional paid-in capital) could be maintained at a fixed amount by being translated at a historical rate of exchange, or at each reporting date it could be retranslated at the closing rate as if it were a monetary amount. In the latter case a second question would arise: whether to recognise the difference arising on translation in profit or loss or in other comprehensive income or to deal with it within equity.

Where the shares denominated in a foreign currency are ordinary shares, or are otherwise irredeemable and classified as equity instruments, in our experience the most commonly applied view is that the shares are translated at historical rates and not remeasured. This view reflects the fact that the effect of rate changes is not expected to have an impact on the entity's cash flows associated with those shares. Such capital items are included within the examples of non-monetary items listed in US GAAP (FASB ASC 830 *Foreign Currency Matters*) as accounts to be remeasured using historical exchange rates when the temporal method is being applied. IAS 21 requires non-monetary items that are measured at historical cost in a foreign currency to be translated using the historical rate (see section 5.2 above).

How we see it

Where such share capital is retranslated at the closing rate, we do not believe that it is appropriate for the exchange differences to be recognised in profit or loss, since they do not affect the cash flows of the entity. Further, because the retranslation of such items has no effect on assets or liabilities it is not an item of income or expense to be recognised in other comprehensive income. Instead, the exchange differences are taken to equity.

Consequently, whether such share capital is maintained at a historical rate, or is dealt with in this way, the treatment has no impact on the overall equity of the entity.

Where the shares are not classified as equity instruments, but as financial liabilities, under IAS 32, e.g., preference shares that provide for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, then, as with investments in such shares (see section 5.4.3 above), they are treated as monetary items and translated at the closing rate. Any exchange differences will be recognised in profit or loss, unless the shares form part of a hedging relationship and IFRS 9 would require the exchange differences to be accounted for differently (see Chapter 49).

5.4.5 Deferred tax

One of the examples of a monetary item included within the exposure draft that preceded IAS 21 was deferred tax.[3] However, this was dropped from the list of examples in the final standard. No explanation is given in IAS 21 as to why this is the case. Until 2007, IAS 12 *Income Taxes* suggested that any deferred foreign tax assets or liabilities are monetary items since it stated that "where exchange differences on deferred foreign tax liabilities or assets are recognised in the income statement, such differences may be classified as deferred tax expense (income) if that presentation is considered to be the most useful to financial statement users".[4] The reference to 'income statement' has now been changed to 'statement of comprehensive income', although the suggestion remains the same. The Basis for Conclusions to IFRIC 7 *Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies* also acknowledges that deferred tax items may meet the definition of monetary items. *[IFRIC 7.BC22]*.

5.4.6 Post-employment benefit plans - foreign currency assets

For most entities, benefits payable under a defined benefit post-employment plan will be payable in the functional currency of the entity. However, such a plan may have monetary assets that are denominated in a foreign currency and/or non-monetary assets, the fair value of which are determined in a foreign currency. Where benefits are payable in a currency that is different to the entity's functional currency, the considerations in section 5.4.7 below will be relevant.

Consider, for example, a UK company with the pound sterling as its functional currency which has a funded pension scheme in which benefit payments are based on the employees' sterling denominated salaries and are paid in sterling. The majority of plan assets comprise a mix of sterling denominated bonds, UK equities and UK properties. However, those assets also include a number of US dollar denominated bonds and equities issued by US companies that are listed on a US stock exchange. IAS 19 *Employee Benefits* requires all these assets to be measured at their fair value at the end of the reporting period, but how does the entity deal with any exchange differences or changes in fair value attributable to changes in exchange rates arising on the US assets?

IAS 21 gives as an example of a monetary item "pensions and other employee benefits to be paid in cash". Further, the accounting for defined benefit schemes under IAS 19 requires an entity to reflect net interest on the net defined benefit asset or liability in profit or loss and any difference between this amount and the actual return on plan assets in other comprehensive income (see Chapter 31 at sections 10.3 and 10.4.2). *[IAS 19.120, IAS 19.127(b)]*.

How we see it

It would consequently seem appropriate to view the net pension asset or liability as a single unit of account measured in sterling. Therefore, the gains and losses on all the US plan assets attributable to changes in foreign exchange rates would be dealt with as remeasurements in accordance with IAS 19 and recognised in other comprehensive income.

5.4.7 Post-employment benefit plans - foreign currency plans

For some entities the pension benefits payable under a post-employment benefit plan will not be payable in the functional currency of the entity. For example, a UK entity in the oil and gas industry may determine that its functional currency is the US dollar, but its employee costs including the pension benefits are payable in sterling. How does such an entity account for its post-employment benefit plan?

3 Exposure Draft of Revised IAS 21, IASB, May 2002, para. 14.

4 IAS 12 (2007), Income Taxes, 2007 Bound Volume, IASB, para. 78.

One of the examples of a monetary item given by IAS 21 is "pensions and other employee benefits to be paid in cash". However, the standard does not expand on this, and does not appear to make any distinction between pensions provided by defined contribution plans or defined benefit plans. Nor does it distinguish between funded or unfunded defined benefit plans.

Clearly for pensions that are payable under a defined contribution plan (or one that is accounted for as such) this is straightforward. Any liability for outstanding contributions at the end of the reporting period is a monetary item that is translated at the closing rate, with any resulting exchange differences recognised in profit or loss. For an unfunded defined benefit plan in which the benefit payments are denominated in a foreign currency, applying IAS 21 would also seem to be straightforward. The defined benefit obligation is regarded as a monetary liability and exchange differences on the entire balance are recognised in profit or loss.

A funded defined benefit plan is a more a complex arrangement to assess under IAS 21, particularly if the plan assets include items that considered in their own right would be non-monetary and/or foreign currency monetary items. However, in the light of the guidance in IAS 21 noted above, one approach is to consider such arrangements as a single monetary item denominated in the currency in which the benefit payments are made. Therefore, the requirements of IAS 19 will be applied in the currency in which the benefit payments are denominated and foreign currency gains or losses on the net asset or liability would be recognised in profit or loss.

Another approach would be to argue that a funded scheme is more akin to a non-monetary item and the exchange differences relating to the defined benefit obligation are similar to actuarial gains and losses. The calculation of the obligation under IAS 19 would be based on actuarial assumptions that reflect the currency of the obligation to the employee (for example, the discount rate used "shall be consistent with the currency and estimated term" of the obligation *[IAS 19.83]*). Any variations from those assumptions on both the obligation and the assets would be dealt with in the same way under IAS 19. Actuarial assumptions are "an entity's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits" and include financial assumptions. *[IAS 19.76]*. Although IAS 19 does not refer to exchange rates, it is clearly a variable that will determine the ultimate cost to the entity of providing the post-employment benefits. On that basis, the exchange differences relating to the defined benefit obligation would be accounted for in a similar manner to actuarial gains and losses.

How we see it

Our preferred approach in these circumstances is to view the funded defined benefit plan as a single monetary item denominated in the currency in which the benefit payments are made. Although not our preferred accounting treatment we consider the second approach, which views the exchange rate as an actuarial assumption, to be acceptable.

Some might argue that the plan is to be regarded as a 'foreign operation' under IAS 21 (see section 2.3 above). However, in this situation it is very difficult to say that its 'functional currency' can be regarded as being different from that of the reporting entity given the relationship between the plan and the reporting entity (see section 4 above). Thus, it would appear that the entity cannot treat the plan as a foreign operation with a different functional currency from its own.

5.4.8 Insurance contracts

IFRS 17 specifies that a group of insurance contracts that generates cash flows in a foreign currency is treated as a monetary item. This applies to both the fulfilment cash flows and the contractual service margin. *[IFRS 17.30]*.

What is less clear is how to apply IAS 21 and IFRS 17 to groups of insurance contracts that generate cash flows in more than one currency. In September 2022, the IFRS IC published an agenda decision setting out its conclusion that an entity uses its judgement and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to develop an accounting policy to determine on initial recognition the single currency or multiple currencies in which the group (including the contractual service margin) is denominated. Further information about this issue is included in Chapter 51 at section 8.3.[5]

5 *IFRIC Update*, September 2022, available on the IFRS Foundation's website.

5.5 Change in functional currency

IAS 21 requires management to use its judgement to determine the entity's functional currency such that it most faithfully represents the economic effects of the underlying transactions, events and conditions that are relevant to the entity (see section 4 above). Accordingly, once the functional currency is determined, it may be changed only if there is a change to those underlying transactions, events and conditions. For example, a change in the currency that mainly influences the sales prices of goods and services may lead to a change in an entity's functional currency. *[IAS 21.36]*.

IAS 21 indicates: *[IAS 21.35]*

Extract from IAS 21

35 **When there is a change in an entity's functional currency, the entity shall apply the translation procedures applicable to the new functional currency prospectively from the date of the change.**

In other words, an entity translates all items into the new functional currency using the exchange rate at the date of the change. The resulting translated amounts for non-monetary items are treated as their historical cost. Exchange differences arising from the translation of a foreign operation recognised in other comprehensive income are not reclassified from equity to profit or loss until the disposal of the operation (see section 6.6 below). *[IAS 21.37]*.

Illustration 5-7: Change in functional currency

The management of Entity A has considered the functional currency of the entity to be the euro. However, as a result of a change in circumstances affecting the operations of the entity, management determines that on 1 January 2022 the functional currency of the entity is now the US dollar. The exchange rate at that date is €1=US$1.20. Entity A's statement of financial position at 1 January 2022 in its old functional currency is as follows:

	€
Property, plant and equipment	200,000
Current assets	
Inventories	10,000
Receivables	20,000
Cash	5,000
	35,000
Current liabilities	
Payables	15,000
Taxation	3,000
	18,000
Net current assets	17,000
	217,000
Long-term loans	120,000
	97,000

Included within the statement of financial position at 1 January 2022 are the following items:

- Equipment with a cost of €33,000 and a net book value of €16,500. This equipment was originally purchased for £20,000 in 2016 and has been translated at the rate ruling at the date of purchase of £1=€1.65.
- Inventories with a cost of €6,000. These were purchased for US$6,000 and have been translated at the rate ruling at the date of purchase of €1=US$1.00.
- Payables of €5,000 representing the US$6,000 due in respect of the above inventories, translated at the rate ruling at 1 January 2022.
- Long-term loans of €15,000 representing the outstanding balance of £10,000 on a loan originally taken out to finance the acquisition of the above equipment, translated at £1=€1.50, the rate ruling at 1 January 2022.

Entity A applies the translational procedures applicable to its new functional currency prospectively from the date of change. Accordingly, all items in its statement of financial position at 1 January 2022 are translated at the rate of €1=US$1.20 giving rise to the following amounts:

	$
Property, plant and equipment	240,000
Current assets	
Inventories	12,000
Receivables	24,000
Cash	6,000
	42,000
Current liabilities	
Payables	18,000
Taxation	3,600
	21,600
Net current assets	20,400
	260,400
Long-term loans	144,000
	116,400

As far as the equipment that was originally purchased for £20,000 is concerned, the cost and net book value in terms of Entity A's new functional currency are US$39,600 and US$19,800 respectively, being €33,000 and €16,500 translated at €1=US$1.20. Entity A does not go back and translate the £20,000 cost at whatever the £ sterling/US dollar exchange rate was at the date of purchase and calculate a revised net book value on that basis.

Similarly, the inventories purchased in US dollars are included at $7,200, being €6,000 translated at €1=US$1.20. This is despite the fact that Entity A knows that the original cost was $6,000.

As far as the payables in respect of the inventories are concerned, these are included at $6,000, being €5,000 translated at €1=US$1.20. This represents the original amount payable in US dollars. However, this is logical since the original payable had been translated into euros at the rate ruling at 1 January 2022 and has just been translated back into US dollars at the same rate. The impact of the change in functional currency is that whereas Entity A had recognised an exchange gain of €1,000 while the functional currency was the euro, no further exchange difference will be recognised in respect of this amount payable. Exchange differences will now arise from 1 January 2022 on those payables denominated in euros, whereas no such differences would have arisen on such items prior to that date.

Similarly, the £10,000 amount outstanding on the loan will be included at $18,000, being €15,000 translated at €1=US$1.20. This is equivalent to the translation of the £10,000 at a rate of £1=US$1.80, being the direct exchange rate between the two currencies at 1 January 2022. In this case, whereas previously exchange gains and losses would have been recognised on this loan balance based on movements of the £/€ exchange rate, as from 1 January 2022 the exchange gains and losses will be recognised based on the £/$ exchange rate.

Often an entity's circumstances change gradually over time and it might not be possible to determine a precise date on which the functional currency changes. In these circumstances an entity will need to apply judgement to determine an appropriate date from which to apply the change, which might coincide with the beginning or end of an interim or annual accounting period.

Where an entity's functional currency changes, its management will often choose to align the entity's presentation currency with the new functional currency. The approach to be adopted when changing presentation currency is covered in section 8 below.

5.6 Books and records not kept in functional currency

Occasionally, an entity may keep its underlying books and records in a currency that is not its functional currency under IAS 21. For example, it could record its transactions in terms of the local currency of the country in which it is located, possibly as a result of local requirements. In these circumstances, at the time the entity prepares its financial statements all amounts are converted into the functional currency in accordance with the requirements of the standard discussed in sections 5.1 to 5.3 above.[6] This process is intended to produce the same amounts in the functional currency as would have occurred had the items been recorded initially in the functional currency. For example, monetary items are translated into the functional currency using the closing rate, and non-monetary items that are measured on a historical cost basis are translated using the exchange rate at the date of the transaction that resulted in their recognition which will result in local currency denominated transactions giving rise to exchange differences. *[IAS 21.34]*.

6 In this context, IAS 21 does not actually refer to those requirements relating to the treatment of exchange differences arising from the translation process. However, we believe that any resulting exchange differences are recognised as discussed in section 5.3 above.

6 Use of a presentation currency other than the functional currency

An entity may, subject to the requirements of relevant laws and regulations, present its financial statements in any currency (or currencies) (see section 3 above). *[IAS 21.38]*.

Extract from IAS 21	
38	An entity may present its financial statements in any currency (or currencies). If the presentation currency differs from the entity's functional currency, it translates its results and financial position into the presentation currency. For example, when a group contains individual entities with different functional currencies, the results and financial position of each entity are expressed in a common currency so that consolidated financial statements may be presented.

There is no concept of a 'group' functional currency. Each entity within the group has its own functional currency, and the results and financial position of each entity have to be translated into the presentation currency that is used for the consolidated financial statements. *[IAS 21.18]*.

The requirements of IAS 21 in respect of this translation process are discussed below. The procedures to be adopted apply not only to the inclusion of foreign subsidiaries in consolidated financial statements but also to the incorporation of the results of associates and joint arrangements. *[IAS 21.44]*. They also apply when the results of a foreign branch are to be incorporated into the financial statements of an individual entity or a stand-alone entity preparing financial statements or when an entity preparing separate financial statements in accordance with IAS 27 presents its financial statements in a currency other than its functional currency.

In addition to these procedures, IAS 21 has additional provisions that apply when the results and financial position of a foreign operation are translated into a presentation currency so that the foreign operation can be included in the financial statements of the reporting entity by consolidation or the equity method. *[IAS 21.44]*. These additional provisions are covered in sections 6.3 to 6.5 below.

6.1 Translation to the presentation currency

Under IAS 21, the method of translation depends on whether the entity's functional currency is that of a hyperinflationary economy or not, and if it is, whether it is being translated into a presentation currency which is that of a hyperinflationary economy or not. A hyperinflationary economy is defined in IAS 29 *Financial Reporting in Hyperinflationary Economies* (see Chapter 17 at section 2.3). The requirements of IAS 21 discussed below can be summarised as follows:

	Presentation currency	
	Non-hyperinflationary	**Hyperinflationary**
Non-hyperinflationary functional currency		
Assets/liabilities		
▸ Current period	Closing rate (current B/S date)	Closing rate (current B/S date)
▸ Comparative period	Closing rate (comparative B/S date)	Closing rate (comparative B/S date)
Equity items		
▸ Current period	Not specified	Not specified
▸ Comparative period	Not specified	Not specified
Income/expenses (including those recognised in other comprehensive income)		
▸ Current period	Actual rates (or appropriate average for current period)	Actual rates (or appropriate average for current period)
▸ Comparative period	Actual rates (or appropriate average for comparative period)	Actual rates (or appropriate average for comparative period)
Exchange differences	Separate component of equity	Separate component of equity

	Presentation currency	
	Non-hyperinflationary	Hyperinflationary
Hyperinflationary functional currency		
Assets/liabilities		
▸ Current period	Closing rate (current B/S date)	Closing rate (current B/S date)
▸ Comparative period	Closing rate (comparative B/S date)	Closing rate (current B/S date)
Equity items		
▸ Current period	Closing rate (current B/S date)	Closing rate (current B/S date)
▸ Comparative period	Closing rate (comparative B/S date)	Closing rate (current B/S date)
Income/expenses (including those recognised in other comprehensive income)		
▸ Current period	Closing rate (current B/S date)	Closing rate (current B/S date)
▸ Comparative period	Closing rate (comparative B/S date)	Closing rate (current B/S date)
Exchange differences	Not specified	Not applicable

In June 2022 the IFRS IC discussed how the requirements summarised above apply to a parent with a hyperinflationary functional and presentation currency that consolidates a subsidiary with a non-hyperinflationary functional currency. The specific matter considered was whether, in addition to applying the requirements in IAS 21, the parent would then apply IAS 29 and restate the non-hyperinflationary subsidiary's results and financial position in terms of the measuring unit current at the end of the reporting period. Initially the IFRS IC concluded that the parent could select an accounting policy to restate or a policy not to restate.[7]

However, after further research, the IFRS IC recommended that the IASB develop a narrow-scope amendment addressing the matter above as well as the related matter of an entity whose functional currency is the currency of a non-hyperinflationary economy but that presents its financial statements in the currency of a hyperinflationary economy.[8] Consequently, in July 2024, the IASB published an exposure draft of proposals to amend IAS 21 which is discussed in more detail in Chapter 17 at section 12 and in section 12.1 below.

In most cases determining an exchange rate will be a relatively straightforward exercise, but this will not always be the case, particularly where there are restrictions on entities wishing to exchange one currency for another. This issue is covered in section 7 below, including information on amendments to IAS 21 published in August 2023.

6.1.1 Functional currency is not that of a hyperinflationary economy

The results and financial position of an entity whose functional currency is not the currency of a hyperinflationary economy are translated into a different presentation currency using the following procedures: *[IAS 21.39]*

(a) Assets and liabilities for each statement of financial position presented (i.e., including comparatives) are translated at the closing rate at the reporting date

(b) Income and expenses for each statement of comprehensive income or separate income statement presented (i.e., including comparatives) are translated at exchange rates at the dates of the transactions

(c) All resulting exchange differences are recognised in other comprehensive income

7 *IFRIC Update*, June 2022, available on the IFRS Foundation's website.

8 *IFRIC Update*, June 2023, available on the IFRS Foundation's website.

For practical reasons, the reporting entity may use a rate that approximates the actual exchange rate, e.g., an average rate for the period, to translate income and expense items. However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate. *[IAS 21.40]*.

As discussed in section 5.1.2 above, IFRIC 22 explains how to determine the "date of transaction" for the purposes of an entity recording a foreign currency transaction in its functional currency, particularly when payments are made or received in advance of the associated transaction occurring.

How we see it

In our view, the guidance noted above does not apply to the translation of an entity's results into a presentation currency; instead the date of transaction for this purpose is the date on which income or expense is recorded in profit or loss or other comprehensive income of the foreign operation.

A foreign operation may have reclassification adjustments to profit or loss of gains or losses previously recognised in other comprehensive income, for example as a result of the application of cash flow hedge accounting. However, IAS 21 does not explicitly address how these adjustments are translated into the presentation currency. In our experience the most commonly applied approach is to regard them as income or expenses of the foreign operation to be translated at the exchange rate at the date of reclassification in accordance with IAS 21.39(b). For cash flow hedges, this better reflects the hedge accounting reported in the foreign operation's own financial statements. Nevertheless, some would argue that reclassification adjustments do not represent income or expenses. Consequently, IAS 21.39(b) would not apply and the reclassification is translated using the historical exchange rates at the dates the original gains or losses arose.

How we see it

In our view, each of the approaches described above represents an acceptable accounting policy choice.

The translational process above makes only limited reference to the translation of equity items, although the selection of accounting policy for translating reclassification adjustments is likely to influence whether an entity translates the associated equity balance in order to prevent a residual amount being left within the reserve. The treatment of such items is discussed in section 6.2 below.

IAS 21 indicates that the exchange differences referred to in item (c) above result from: *[IAS 21.41]*

- Translating income and expenses at the exchange rates at the dates of the transactions and assets and liabilities at the closing rate. Such exchange differences arise both on income and expense items recognised in profit or loss and on those recognised in other comprehensive income
- Translating the opening net assets at a closing rate that differs from the previous closing rate

This is not in fact completely accurate since if the entity has had any transactions with equity holders that have resulted in a change in the net assets during the period there are likely to be further exchange differences that need to be recognised to the extent that the closing rate differs from the rate used to translate the transaction. This will particularly be the case where a parent has subscribed for further equity shares in a subsidiary.

The reason why these exchange differences are not recognised in profit or loss is because the changes in exchange rates have little or no direct effect on the present and future cash flows from operations. *[IAS 21.41]*.

The application of these procedures is shown in the following Illustration.

Illustration 6-1: Translation of a non-hyperinflationary functional currency to a non-hyperinflationary presentation currency

An Australian entity owns 100% of the share capital of a foreign entity which was set up a number of years ago when the exchange rate was A$1=FC2. It is consolidating the financial statements of the subsidiary in its consolidated financial statements for the year ended 31 December 20X2. The exchange rate at the year-end is A$1=FC4 (20X1: A$1=FC3). For the purposes of illustration, it is assumed that exchange rates have not fluctuated significantly and the appropriate weighted average rate for the year was A$1=FC3.5, and that the currency of the foreign entity is not that of a hyperinflationary economy. The income statement of the subsidiary for that year and its statement of financial position at the beginning and end of the year in its functional currency and translated into Australian dollars are as follows:

Income statement		
	FC	A$
Sales	35,000	10,000
Cost of sales	(33,190)	(9,483)
Depreciation	(500)	(143)
Interest	(350)	(100)
Profit before taxation	960	274
Taxation	(460)	(131)
Profit after taxation	500	143

Statements of financial position	20X1	20X2	20X1	20X2
	FC	FC	A$	A$
Property, plant and equipment	6,000	5,500	2,000	1,375
Current assets				
Inventories	2,700	3,000	900	750
Receivables	4,800	4,000	1,600	1,000
Cash	200	600	67	150
	7,700	7,600	2,567	1,900
Current liabilities				
Payables	4,530	3,840	1,510	960
Taxation	870	460	290	115
	5,400	4,300	1,800	1,075
Net current assets	2,300	3,300	767	825
	8,300	8,800	2,767	2,200
Long-term loans	3,600	3,600	1,200	900
	4,700	5,200	1,567	1,300
Share capital	1,000	1,000	500	500
Retained profits*	3,700	4,200	1,500	1,643
Exchange reserve*			(433)	(843)
	4,700	5,200	1,567	1,300

* The opening balances for 20X1 in A$ have been assumed and represent cumulative amounts since the foreign entity was set up.

The movement of A$(410) in the exchange reserve included as a separate component of equity is made up as follows:

(i) The exchange loss of A$392 on the opening net investment in the subsidiary, calculated as follows:

Opening net assets at opening rate	- FC4,700 at FC3 = A$1 =	A$1,567
Opening net assets at closing rate	- FC4,700 at FC4 = A$1 =	A$1,175
Exchange loss on net assets		A$392

(ii) The exchange loss of A$18, being the difference between the income account translated at an average rate, i.e., A$143, and at the closing rate, i.e., A$125.

When the exchange differences relate to a foreign operation that is consolidated but not wholly-owned, accumulated exchange differences arising from translation and attributable to non-controlling interests are allocated to, and recognised as part of, non-controlling interests in the consolidated statement of financial position. *[IAS 21.41]*.

An example of an accounting policy dealing with the translation of entities whose functional currency is not that of a hyperinflationary economy is illustrated in the following Practical example.

Practical example 6-1: Lloyds Banking Group plc (2022) — United Kingdom

Annual Report and Accounts 2022 [extract]

Financial statements [extract]

Notes to the consolidated financial statements [extract]

Note 2: Accounting policies [extract]

(N) Foreign currency translation

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the functional currency). Foreign currency transactions are translated into the appropriate functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except when recognised in other comprehensive income as qualifying cash flow or net investment hedges. Non-monetary assets that are measured at fair value are translated using the exchange rate at the date that the fair value was determined. Translation differences on equities and similar non-monetary items held at fair value through profit and loss are recognised in profit or loss as part of the fair value gain or loss. Translation differences on non-monetary financial assets measured at fair value through other comprehensive income, such as equity shares, are included in the fair value reserve in equity unless the asset is a hedged item in a fair value hedge.

The results and financial position of all Group entities that have a functional currency different from the presentation currency are translated into the presentation currency as follows: the assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on the acquisition of a foreign entity, are translated into sterling at foreign exchange rates ruling at the balance sheet date; and the income and expenses of foreign operations are translated into sterling at average exchange rates unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions, in which case income and expenses are translated at the dates of the transactions.

Foreign exchange differences arising on the translation of a foreign operation are recognised in other comprehensive income and accumulated in a separate component of equity together with exchange differences arising from the translation of borrowings and other currency instruments designated as hedges of such investments (see (F)(3) above). On disposal or liquidation of a foreign operation, the cumulative amount of exchange differences relating to that foreign operation is reclassified from equity and included in determining the profit or loss arising on disposal or liquidation.

The IASB had considered an alternative translation method, which would have been to translate all amounts (including comparatives) at the most recent closing rate. This was considered to have several advantages: it is simple to apply; it does not generate any new gains and losses; and it does not change ratios such as return on assets. Supporters of this method believed that the process of merely expressing amounts in a different currency preserves the same relationships among amounts as measured in the functional currency. *[IAS 21.BC17]*. These views were probably based more on the IASB's proposals for allowing an entity to present its financial statements in a currency other than its functional currency, rather than the translation of foreign operations for inclusion in consolidated financial statements. Such an approach does have theoretical appeal. However, the major drawback is that it would require the comparatives to be restated from those previously reported.

The IASB rejected this alternative and decided to require the method that the previous version of IAS 21 required for translating the financial statements of a foreign operation. *[IAS 21.BC20]*. It is asserted that this method results in the same amounts in the presentation currency regardless of whether the financial statements of a foreign operation are first translated into the functional currency of another group entity and then into the presentation currency or translated directly into the presentation currency. *[IAS 21.BC18]*. We agree that it will result in the same amounts for the statement of financial position, regardless of whether the translation process is a single or two-stage process. However, it does not necessarily hold true for income and expense items particularly if an indirectly held foreign operation is disposed of - this is discussed further in sections 6.1.4 and 6.6.3 below. Differences will also arise between the two methods if an average rate is used, although these are likely to be insignificant.

The IASB states that the method chosen avoids the need to decide the currency in which to express the financial statements of a multinational group before they are translated into the presentation currency. In addition, it produces the same amounts in the presentation currency for a stand-alone entity as for an identical subsidiary of a parent whose functional currency is the presentation currency. *[IAS 21.BC19]*. For example, if a Swiss entity with the Swiss franc as its functional currency wishes to present its financial statements in euros, the translated amounts in euros would be the same as those for an identical entity with the Swiss franc as its functional currency that are included within the consolidated financial statements of its parent that presents its financial statements in euros.

6.1.2 Functional currency is that of a hyperinflationary economy

The results and financial position of an entity whose functional currency is the currency of a hyperinflationary economy are translated into a different presentation currency using the following procedures: *[IAS 21.42]*

(a) All amounts (i.e., assets, liabilities, equity items, income and expenses, including comparatives) are translated at the closing rate at the date of the most recent statement of financial position, except that:

(b) When amounts are translated into the currency of a non-hyperinflationary economy, comparative amounts are those that were presented as current year amounts in the relevant prior year financial statements (i.e., not adjusted for subsequent changes in the price level or subsequent changes in exchange rates).

Similarly, in the period during which the functional currency of a foreign operation such as a subsidiary becomes hyperinflationary and applies IAS 29 for the first time, the parent's consolidated financial statements for the comparative period are not restated for the effects of hyperinflation. Nor are any exchange differences associated with such a foreign operation that were accumulated in a separate component of equity reclassified within equity. Instead they will be reclassified to profit or loss on disposal or partial disposal of the foreign operation as set out in section 6.6 below.[9]

When an entity's functional currency is the currency of a hyperinflationary economy, the entity restates its financial statements in accordance with IAS 29 before applying the translation method set out above, except for comparative amounts that are translated into a currency of a non-hyperinflationary economy (see (b) above). *[IAS 21.43]*.

When the economy ceases to be hyperinflationary and the entity no longer restates its financial statements in accordance with IAS 29, it uses as the historical costs for translation into the presentation currency the amounts restated to the price level at the date the entity ceased restating its financial statements. *[IAS 21.43]*.

Illustration 6-2: Translation of a hyperinflationary functional currency to a non-hyperinflationary presentation currency

Using the same basic facts as Illustration 6-1 in section 6.1.1 above, but assuming that the functional currency of the subsidiary is that of a hyperinflationary economy, the income statement of the subsidiary for that year and its statement of financial position at the beginning and end of the year in its functional currency and translated into Australian dollars are as shown below. The IAS 29 hyperinflation adjustments have not been illustrated below. For a discussion of these adjustments, see Chapter 17, particularly at section 11 which explains how they may be presented in a situation such as this.

Income statement	FC	A$
Sales	35,000	8,750
Cost of sales	(33,190)	(8,298)
Depreciation	(500)	(125)
Interest	(350)	(87)
Profit before taxation	960	240
Taxation	(460)	(115)
Profit after taxation	500	125

9 *IFRIC Update*, March 2020, available on the IFRS Foundation's website.

Statements of financial position	20X1	20X2	20X1	20X2
	FC	FC	A$	A$
Property, plant and equipment	6,000	5,500	2,000	1,375
Current assets				
Inventories	2,700	3,000	900	750
Receivables	4,800	4,000	1,600	1,000
Cash	200	600	67	150
	7,700	7,600	2,567	1,900
Current liabilities				
Payables	4,530	3,840	1,510	960
Taxation	870	460	290	115
	5,400	4,300	1,800	1,075
Net current assets	2,300	3,300	767	825
	8,300	8,800	2,767	2,200
Long-term loans	3,600	3,600	1,200	900
	4,700	5,200	1,567	1,300
Share capital	1,000	1,000	333	250
Consolidation adjustment*			167	250
Retained profits**	3,700	4,200	1,500	1,625
Exchange reserve**			(433)	(825)
	4,700	5,200	1,567	1,300

* The consolidation adjustment plus the restated A$ amount of share capital eliminates against the parent's investment in subsidiary recorded at the historical exchange rate of A$1=FC2, i.e., A$500. If the example incorporated the IAS 29 hyperinflation adjustments, this difference would include both translation and hyperinflation effects.

** The opening balances for 20X1 in A$ have been assumed and represent cumulative amounts since the foreign entity was set up.

The movement in retained profits is represented by the A$125 profit for the year and the movement in the exchange reserve is an exchange loss of A$392 which represents the reduction in opening net assets due to the movements in exchange, calculated as follows:

Opening balance at opening rate	- FC4,700 at FC3 = A$1 =	A$1,567
Opening balance at closing rate	- FC4,700 at FC4 = A$1 =	A$1,175
Exchange loss		A$(392)

Historically it was considered unclear what happens to such an exchange difference (and also the movement in share capital caused by the change in exchange rates) since IAS 21.42 makes no reference to any possible exchange differences arising from this process. Typically, they were recognised, in aggregate with the related adjustment arising from applying IAS 29 (which in the Illustration above are ignored), in other comprehensive income or directly in equity.[10]

However, in March 2020 the IFRS IC clarified that the exchange differences above are recognised in other comprehensive income. The agenda decision also addressed how the adjustments from applying IAS 29 are presented and a more extensive discussion of this issue is included in Chapter 17 at section 11, although in summary they would be recognised in other comprehensive income if considered exchange differences and directly in equity otherwise.[11]

10 IASB Staff Paper 4A: Project: *Translating a Hyperinflationary Foreign Operation (IAS 21 and IAS 29)*, Paper topic: *Initial consideration--Presenting Exchange Differences when a Foreign Operation is Hyperinflationary*, IFRS IC Meeting, September 2019. Available on the IFRS Foundation's website.

11 *IFRIC Update*, March 2020, available on the IFRS Foundation's website.

An example of an accounting policy dealing with the translation of entities whose functional currency is that of a hyperinflationary economy is illustrated in the following Practical example.

Practical example 6-2: Unilever PLC (2021) **United Kingdom**

Unilever Annual Report and Accounts 2021 [extract]

Financial statements [extract]

Notes to the Consolidated Financial Statements Unilever Group [extract]

1. Accounting information and policies [extract]

Foreign currencies

The consolidated financial statements are presented in euros. The functional currency of PLC is pound sterling. Items included in the financial statements of individual group companies are recorded in their respective functional currency which is the currency of the primary economic environment in which each entity operates.

Foreign currency transactions in individual group companies are translated into functional currency using exchange rates at the date of the transaction. Foreign exchange gains and losses from settlement of these transactions, and from translation of monetary assets and liabilities at year-end exchange rates, are recognised in the income statement except when deferred in equity as qualifying hedges.

In preparing the consolidated financial statements, the balances in individual group companies are translated from their functional currency into euros. Apart from the financial statements of group companies in hyperinflationary economies (see below), the income statement, the cash flow statement and all other movements in assets and liabilities are translated at average rates of exchange as a proxy for the transaction rate, or at the transaction rate itself if more appropriate. Assets and liabilities are translated at year-end exchange rates.

The financial statements of group companies whose functional currency is the currency of a hyperinflationary economy are adjusted for inflation and then translated into euros using the balance sheet exchange rate. Amounts shown for prior years for comparative purposes are not modified. To determine the existence of hyperinflation, the Group assesses the qualitative and quantitative characteristics of the economic environment of the country, such as the cumulative inflation rate over the previous three years.

The ordinary share capital of PLC is translated to euro using the historical rate at the date the shares were issued (see note 15B on page 146).

The effect of exchange rate changes during the year on net assets of foreign operations is recorded in equity. For this purpose, net assets include loans between group companies and any related foreign exchange contracts where settlement is neither planned nor likely to occur in the foreseeable future.

The Group applies hedge accounting to certain exchange differences arising between the functional currencies of a foreign operation and the functional currency of the parent entity, regardless of whether the net investment is held directly or through an intermediate parent. Differences arising on retranslation of a financial liability designated as a foreign currency net investment hedge are recorded in equity to the extent that the hedge is effective. These differences are reported within profit or loss to the extent that the hedge is ineffective.

Cumulative exchange differences arising since the date of transition to IFRS of 1 January 2004 are reported as a separate component of other reserves. In the event of disposal or part disposal of an interest in a group company either through sale or as a result of a repayment of capital, the cumulative exchange difference is recognised in the income statement as part of the profit or loss on disposal of group companies.

6.1.3 Calculation of average rate

When translating the results of an entity whose functional currency is not that of a hyperinflationary economy, for practical reasons, the reporting entity may use a rate that approximates the actual exchange rate, e.g., an average rate for the period, to translate income and expense items. *[IAS 21.40]*.

The standard does not give any guidance on the factors that are to be taken into account in determining what may be an appropriate average rate for the period - it merely says that "if exchange rates fluctuate significantly, the use of the average rate for the period is inappropriate". *[IAS 21.40]*. What methods are, therefore, available to entities to use in calculating an appropriate average rate? Possible methods might be:

(a) Mid-year rate

(b) Average of opening and closing rates

(c) Average of month end/quarter end rates

(d) Average of monthly average rates

(e) Monthly/quarterly results at month end/quarter end rates

(f) Monthly/quarterly results at monthly/quarterly averages

Illustration 6-3: Calculation of average rate

A Spanish entity has a foreign subsidiary and is preparing its consolidated financial statements for the year ended 30 April 20X2. It intends to use an average rate for translating the results of the subsidiary. The relevant exchange rates for €1=FC are as follows:

Month	Month end	Average for month	Average for quarter	Average for year
April 20X1	1.67			
May 20X1	1.63	1.67		
June 20X1	1.67	1.64		
July 20X1	1.64	1.65	1.65	
August 20X1	1.67	1.64		
September 20X1	1.70	1.63		
October 20X1	1.67	1.68	1.65	
November 20X1	1.65	1.70		
December 20X1	1.66	1.66		
January 20X2	1.64	1.67	1.68	
February 20X2	1.60	1.65		
March 20X2	1.61	1.63		
April 20X2	1.61	1.62	1.63	1.65

Average of month end rates - 1.65

Average of quarter end rates - 1.64

The results of the subsidiary for each of the 12 months to 30 April 20X2 and the translation thereof under each of the above methods (using monthly figures where appropriate) are shown below:

Method (a)	FC31,050 @ 1.67 = €18,593
Method (b)	FC31,050 @ 1.64 = €18,933
Method (c) - monthly	FC31,050 @ 1.65 = €18,818
Method (c) - quarterly	FC31,050 @ 1.64 = €18,933
Method (d)	FC31,050 @ 1.65 = €18,818

		(e) quarterly	(e) monthly	(f) quarterly	(f) monthly
Month	**FC**	**€**	**€**	**€**	**€**
May 20X1	1,000		613		599
June 20X1	1,100		659		671
July 20X1	1,200	2,012	732	2,000	727
August 20X1	1,300		778		793
September 20X1	1,300		765		798
October 20X1	1,350	2,365	808	2,394	804
November 20X1	1,400		848		824
December 20X1	1,400		843		843
January 20X2	2,000	2,927	1,220	2,857	1,198
February 20X2	5,000		3,125		3,030
March 20X2	10,000		6,211		6,135
April 20X2	4,000	11,801	2,484	11,656	2,469
Total	31,050	19,105	19,086	18,907	18,891

It can be seen that by far the simplest methods to use are the methods (a) to (d).

How we see it

In our view methods (a) and (b) are not normally used as it is unlikely in times of volatile exchange rates that they will give appropriate weighting to the exchange rates which have been in existence throughout the period in question. They are only likely to give an acceptable answer if the exchange rate has been static or steadily increasing or decreasing throughout the period.

Method (c) based on quarter end rates has similar drawbacks and therefore is not normally used.

Method (c) based on month end rates and method (d) are better than the previous methods as they do take into account more exchange rates which have applied throughout the year, with method (d) being more precise, as this will have taken account of daily exchange rates. Method (d) will normally give reasonable and acceptable results when there are no seasonal variations in items of income and expenditure.

Average monthly rates for most major currencies are likely to be given in publications issued by the government, banks and other sources and therefore it is unnecessary for entities to calculate their own. The work involved in calculating an average for the year, therefore, is not very onerous.

Where there are seasonal variations in items of income and expenditure, using a single average rate for the entire reporting period is unlikely to result in a reasonable approximation of applying actual rates. In these situations appropriate exchange rates are applied to the appropriate items. This can be done by using either of methods (e) or (f) preferably using figures and rates for each month. Where such a method is being used care is to be taken to ensure that the periodic accounts are accurate and that cut-off procedures have been adequate, otherwise significant items may be translated at the wrong average rate.

Where there are significant one-off items of income and expenses then it is likely that actual rates at the date of the transaction will need to be used to translate such items.

6.1.4 Accounting for foreign operations where sub-groups exist

A reporting entity comprising a group with intermediate holding companies may adopt either the direct or the step-by-step method of consolidation. The direct method involves the financial statements of foreign operations being translated directly into the presentation currency of the ultimate parent. The step-by-step method involves the financial statements of the foreign operation first being translated into the functional currency of any intermediate parent(s) and then into the presentation currency of the ultimate parent. *[IFRIC 16.17]*.

It is asserted that both methods will result in the same amounts being reported in the presentation currency. *[IAS 21.BC18]*. However, as set out in section 6.6.3 below, particularly in Illustration 6-11, and as acknowledged by the IFRS IC,[12] this assertion is demonstrably untrue in certain situations.

Whilst the various requirements of the standard appear to indicate that the direct method is to be used and the IFRS IC has indicated it is the conceptually correct method,[13] IAS 21 does not require an entity to use the direct method or to make adjustments to produce the same result. Rather, an entity has an accounting policy choice as to which of the two methods it uses and the method selected is to be used consistently for all net investments. *[IFRIC 16.17]*.

6.2 Translation of equity items

The method of translation of the results and financial position of an entity whose functional currency is not the currency of a hyperinflationary economy is discussed in section 6.1.1 above. The translation process makes only limited reference to the translation of equity items. The exposure draft that preceded the standard had proposed that "... equity items other than those resulting from income and expense recognised in the period ... shall be translated at the closing rate". However, the IASB decided not to specify in the standard the translation rate for equity items,[14] but no explanation has been given in the Basis for Conclusions about this matter.

So how are entities to deal with the translation of equity items?

6.2.1 Share capital

Where an entity presents its financial statements in a currency other than its functional currency, the same issues arise as they do when an entity issues foreign currency share capital (see section 5.4.4 above).

In these circumstances it would also seem more appropriate that the entity's share capital (whether they are ordinary shares, or are otherwise irredeemable and classified as equity instruments) are translated at historical rates of exchange. Such capital items are included within the examples of non-monetary items listed in US GAAP as accounts to be remeasured using historical exchange rates when the temporal method is being applied (see section 5.4.4 above). IAS 21 requires non-monetary items that are measured at historical cost in a foreign currency to be translated using the historical rate (see section 5.2 above). Translation at an historical rate would imply using the rate ruling at the date of the issue of the shares. However, where a subsidiary is presenting its financial statements in the currency of its parent, it may be that the more appropriate historical rate for share capital that was in issue at the date it became a subsidiary would be that ruling at the date it became a subsidiary of the parent, rather than at earlier dates of issue.

How we see it

Where such share capital is retranslated at the closing rate, we do not believe that it is appropriate for the exchange differences to be recognised in other comprehensive income nor for them to be taken to the separate component of equity required by IAS 21 (since to do so could result in them being reclassified from equity to profit or loss upon disposal of part of the entity's operations in the future), but are either taken to retained earnings or some other reserve.

Consequently, whether such share capital is maintained at a historical rate, or is dealt with in this way, the treatment has no impact on the overall equity of the entity.

6.2.2 Other equity balances resulting from transactions with equity holders

In addition to share capital, an entity may have other equity balances resulting from the issue of shares, such as a share premium account (additional paid-in capital). Like share capital, the translation of such balances could be done at either historical rates or at the closing rate.

12 *IFRIC Update*, March 2008, p.2. Available on the IFRS Foundation's website.

13 *IFRIC Update*, March 2008, p.2. Available on the IFRS Foundation's website.

14 *IASB Update*, February 2003, p.5. Available on the IFRS Foundation's website.

How we see it

We believe that whichever method is adopted it is to be consistent with the treatment used for share capital. Again, where exchange differences arise through using the closing rate, we believe that it is not appropriate for them to be recognised in other comprehensive income or taken to the separate component of equity required by IAS 21.

A similar approach is adopted where an entity has acquired its own equity shares and has deducted those 'treasury shares' from equity as required by IAS 32 (see Chapter 43 at section 9).

6.2.3 Other equity balances resulting from income and expenses being recognised in other comprehensive income

Under IAS 21, income and expenses recognised in other comprehensive income are translated at the exchange rates ruling at the dates of the transaction. *[IAS 21.39(b), IAS 21.41]*. Examples of such items include certain gains and losses on:

- Revalued property, plant and equipment under IAS 16 (see Chapter 19 at section 6.2) and revalued intangible assets under IAS 38 *Intangible Assets* (see Chapter 18 at section 8.2)
- Debt instruments measured at fair value through other comprehensive income, investments in equity instruments designated at fair value through other comprehensive income and financial liabilities designated at fair value through profit or loss under IFRS 9 (see Chapter 46 at sections 2.3, 2.5 and 2.4 respectively)
- Gains and losses on cash flow hedges under IFRS 9 (see Chapter 49)
- Any amounts of current and deferred tax recognised in other comprehensive income under IAS 12 (see Chapter 29 at section 10)

This would suggest that where these gains and losses are accumulated within a separate reserve or component of equity, then any period-end balance will represent the cumulative translated amounts of such gains and losses. However, as IAS 21 is silent on the matter it would seem to be acceptable to translate these equity balances at the closing rate.

The treatment of equity balances that are subsequently reclassified to profit or loss, for example cash flow hedge reserves of a foreign operation, typically depends on the exchange rate used to translate the reclassification adjustments (a topic which is discussed in section 6.1.1 above). Where reclassification adjustments are translated using the exchange rate at the date of reclassification, translating the equity balance at closing rate means no residual balance is left in the reserve once the hedge accounting is completely accounted for. Conversely, where reclassification adjustments are translated using exchange rates at the dates the original gains or losses arose, an entity would avoid a residual balance remaining in the reserve by not retranslating the equity balance. However, whether such balances are maintained at the original translated rates, or are translated at closing rates, the treatment has no impact on the overall equity of the entity.

6.3 Exchange differences on intragroup balances

The incorporation of the results and financial position of a foreign operation with those of the reporting entity follows normal consolidation procedures, such as the elimination of intragroup balances and intragroup transactions of a subsidiary. *[IAS 21.45]*. On this basis, there is a tendency sometimes to assume that exchange differences on intragroup balances do not impact on the reported profit or loss for the group in the consolidated financial statements. However, an intragroup monetary asset (or liability), whether short-term or long-term, cannot be eliminated against the corresponding intragroup liability (or asset) without the entity with the currency exposure recognising an exchange difference on the intragroup balance.

This exchange difference will be reflected in that entity's profit or loss for the period (see section 5.3.1 above) and, except as indicated below, IAS 21 requires this exchange difference to continue to be included in profit or loss in the consolidated financial statements. This is because the monetary item represents a commitment to convert one currency into another and exposes the reporting entity to a gain or loss through currency fluctuations.

6.3.1 Monetary items included as part of the net investment in a foreign operation

An exception to the general rule in section 6.3 above applies where an exchange difference arises on a balance that, in substance, forms part of an entity's net investment in a foreign operation, for example an intragroup balance with a subsidiary. Instead, the exchange difference is not recognised in profit or loss in the consolidated financial statements, but is recognised in other comprehensive income and accumulated in a separate component of equity until the disposal of the foreign operation (see section 6.6 below). *[IAS 21.32, IAS 21.45]*.

The 'net investment in a foreign operation' is defined as being "the amount of the reporting entity's interest in the net assets of that operation". *[IAS 21.8]*. This will include a monetary item that is receivable from or payable to a foreign operation for which settlement is neither planned nor likely to occur in the foreseeable future (often referred to as a 'permanent as equity' loan) because it is, in substance, a part of the entity's net investment in that foreign operation. Such monetary items may include long-term receivables or loans. They do not include trade receivables or trade payables. *[IAS 21.15]*.

6.3.1.A Trade receivables or payables included as part of the net investment in a foreign operation

How we see it

In spite of what IAS 21 says about trade receivables and payables, in our view they can be included as part of the net investment in the foreign operation, but only if cash settlement is not made or planned to be made in the foreseeable future. However, if a subsidiary makes payment for purchases from its parent, but is continually indebted to the parent as a result of new purchases, then in these circumstances, since individual transactions are settled, no part of the inter-company balance is regarded as part of the net investment in the subsidiary.

Accordingly, exchange differences on such balances are recognised in profit or loss.

These requirements and our view are shown in the following Illustration.

Illustration 6-4: Receivables/payables included as part of net investment in a foreign operation

A UK entity, A, has a Belgian subsidiary, B. A has a receivable due from B amounting to £1,000,000.

In each of the following scenarios, could the receivable be included as part of A's net investment in B?

Scenario 1

The receivable arises from the sale of goods, together with interest payments and dividend payments which have not been paid in cash but have been accumulated in the inter-company account. A and B agree that A can claim at any time the repayment of this receivable. It is likely that there will be a settlement of the receivable in the foreseeable future.

Although the standard states that trade receivables and payables are not included, we do not believe that it necessarily precludes deferred trading balances from being included. In our view, such balances can be included as part of the net investment in the foreign operation, but only if cash settlement is not made or planned to be made in the foreseeable future.

In this scenario, the settlement of A's receivable due from B is not planned; however, it is likely that a settlement will occur in the foreseeable future. Accordingly, the receivable does not qualify to be treated as part of A's net investment in B. The term 'foreseeable future' is not defined and no specific time period is implied. It could be argued that the receivable is only to be considered as part of the net investment if it will be repaid only when the reporting entity disinvests from the foreign operation. However, it is recognised that in most circumstances this would be unrealistic and therefore a shorter time span is considered in determining the foreseeable future.

Scenario 2

The receivable represents a loan made by A to B and it is agreed that the receivable will be repaid in 20 years.

In this scenario, A's receivable due from B has a specified term for repayment. This suggests that settlement is planned. Accordingly, the receivable does not qualify to be treated as part of A's investment in B.

Scenario 3

A and B have previously agreed that the receivable under scenario 2 will be repaid in 20 years but A now decides that it will replace the loan on maturity either with a further inter-company loan or with an injection of equity. This approach is consistent with A's intention to maintain the strategic long-term investment in B.

In this scenario, the words from IAS 21.15 "… settlement is neither planned nor likely to occur in the foreseeable future …" are potentially problematic, since a loan with a fixed maturity must, *prima facie*, have a planned settlement. However, from the date A decides that it will re-finance the inter-company debt upon maturity with a further long-term instrument, or replace it with equity, the substance of the inter-company loan is that it is part of the entity's net investment in the foreign operation, and there is no actual 'intent' to settle the investment without replacement. On this basis, loans with a stated maturity may qualify to be treated in accordance with IAS 21.32, with foreign currency gains and losses recognised in other comprehensive income and accumulated in a separate component of equity in the consolidated financial statements. However, in our view, management's intention to refinance the loan must be documented appropriately, for example in the form of a minute of a meeting of the management board or board of directors. In addition, any established historical pattern of the entity demanding repayment of such inter-company debt without replacement would be inconsistent with treatment in accordance with IAS 21.32.

Consequently, when the purpose of the loan is to fund a long-term strategic investment then it is the entity's overall intention with regard to the investment and ultimate funding thereof, rather than the specific terms of the inter-company loan funding the investment, that is considered.

Scenario 4

The receivable arises from the sale of goods, together with interest payments and dividend payments which have not been paid in cash but have been accumulated in the inter-company account. However, in this scenario, A and B agree that A can claim the repayment of this receivable only in the event that the subsidiary is disposed of. A has no plans to dispose of entity B.

In this scenario, the settlement of A's receivable due from B is not planned nor is it likely to occur in the foreseeable future. Although the term 'foreseeable future' is not defined, it will not go beyond a point of time after the disposal of a foreign operation. Accordingly, the receivable does qualify for being treated as part of a net investment in a foreign operation.

The question of whether or not a monetary item is as permanent as equity can, in certain circumstances, require the application of significant judgement.

6.3.1.B Manner of settlement of monetary items included as part of the net investment in a foreign operation

The meaning of the term 'settlement' is set out in certain IFRS accounting standards for specific purposes. For instance, IAS 1 *Presentation of Financial Statements* and IFRS 18 *Presentation and Disclosure in Financial Statements,* the latter of which supersedes IAS 1 for periods beginning on or after 1 January 2027, refer to the meaning of settlement for the purpose of classifying a liability as current or non-current (see Chapter 3 at section 3.1.4) and this would include extinguishment of a liability by the entity issuing its own equity instruments. *[IAS 1.76A, IFRS 18.B107]*. In addition, until 2018, the IASB's conceptual framework suggested that settlement may occur when one liability is replaced with another. However, IFRS accounting standards contain no general definition.

How we see it

We believe it can be appropriate to use a different meaning of settlement when applying IAS 21 if it is clear the substance of a monetary item is that it forms part of an entity's net investment in a foreign operation. This will be the case if an entity expects a monetary item to be settled in a manner that does not actually change the substance of its net investment in a foreign operation.

For example, consider a parent that makes a three-year loan to a subsidiary that is a foreign operation. If it is both planned and likely that (a) the original loan will be settled at maturity but immediately replaced with another three-year loan from the parent for the same amount and (b) any such replacement loan will be similarly rolled over for the foreseeable future, the original and replacement loans would, in substance, represent part of the parent's net investment in the subsidiary. Likewise, if the loan is expected (or even contractually required) to be settled by the subsidiary issuing equity shares to the parent, the loan would still represent part of the parent's net investment in the subsidiary.

6.3.1.C Currency of monetary items included as part of the net investment in a foreign operation

When a monetary item is considered to form part of a reporting entity's net investment in a foreign operation and is denominated in the functional currency of the reporting entity, an exchange difference will be recognised in profit or loss for the period when it arises in the foreign operation's individual financial statements. If the item is denominated in the functional currency of the foreign operation, an exchange difference will be recognised in profit or loss for the period when it arises in the reporting entity's separate financial statements. Such exchange differences are only recognised in other comprehensive income and accumulated in a separate component of equity in the financial statements that include the foreign operation and the reporting entity (i.e., financial statements in which the foreign operation is consolidated or accounted for using the equity method). *[IAS 21.32, IAS 21.33]*.

Illustration 6-5: Monetary item in functional currency of either the reporting entity or the foreign operation

A UK entity has a Belgian subsidiary. On the last day of its financial year, 31 March 20X1, the UK entity lends the subsidiary £1,000,000. Settlement of the loan is neither planned nor likely to occur in the foreseeable future, so the UK entity regards the loan as part of its net investment in the Belgian subsidiary. The exchange rate at 31 March 20X1 was £1=€1.40. Since the loan was made on the last day of the year there are no exchange differences to recognise for that year. At 31 March 20X2, the loan has not been repaid and is still regarded as part of the net investment in the Belgian subsidiary. The relevant exchange rate at that date was £1=€1.50. The average exchange rate for the year ended 31 March 20X2 was £1=€1.45.

In the UK entity's separate financial statements no exchange difference is recognised since the loan is denominated in its functional currency of pound sterling. In the Belgian subsidiary's financial statements, the liability to the parent is translated into the subsidiary's functional currency of euros at the closing rate at €1,500,000, giving rise to an exchange loss of €100,000, i.e., €1,500,000 less €1,400,000 (£1,000,000 @ £1=€1.40). This exchange loss is reflected in the Belgian subsidiary's profit or loss for that year. In the UK entity's consolidated financial statements, this exchange loss included in the subsidiary's profit or loss for the year will be translated at the average rate for the year, giving rise to a loss of £68,966 (€100,000@ £1=€1.45). This will be recognised in other comprehensive income and accumulated in the separate component of equity together with an exchange gain of £2,299, being the difference between the amount included in the Belgian subsidiary's income statement translated at average rate, i.e., £68,966, and at the closing rate, i.e., £66,667 (€100,000@ £1=€1.50). The overall exchange loss recognised in other comprehensive income is £66,667. This represents the exchange loss on the increased net investment of €1,400,000 in the subsidiary made at 31 March 20X1, i.e., £1,000,000 (€1,400,000 @ £1=€1.40) less £933,333 (€1,400,000 @ £1=€1.50).

If, on the other hand, the loan made to the Belgian subsidiary had been denominated in the equivalent amount of euros at 31 March 20X1, i.e., €1,400,000, the treatment would have been as follows:

In the UK entity's separate financial statements, the amount receivable from the Belgian subsidiary would be translated at the closing rate at £933,333 (€1,400,000 @ £1=€1.50), giving rise to an exchange loss of £66,667, i.e., £1,000,000 (€1,400,000 @ £1=€1.40) less £933,333, which is included in its profit or loss for the year. In the Belgian subsidiary's financial statements, no exchange difference is recognised since the loan is denominated in its functional currency of euros. In the UK entity's consolidated financial statements, the exchange loss included in its profit or loss for the year in its separate financial statements will be recognised in other comprehensive income and accumulated in the separate component of equity. As before, this represents the exchange loss on the increased net investment of €1,400,000 in the subsidiary made at 31 March 20X1, i.e., £1,000,000 (€1,400,000 @ £1=€1.40) less £933,333 (€1,400,000 @ £1=€1.40).

In most situations, intragroup balances for which settlement is neither planned nor likely to occur in the foreseeable future will be denominated in the functional currency of either the reporting entity or the foreign operation. However, this will not always be the case. If a monetary item is denominated in a currency other than the functional currency of either the reporting entity or the foreign operation, the exchange difference arising in the reporting entity's separate financial statements and in the foreign operation's individual financial statements are also recognised in other comprehensive income and accumulated in the separate component of equity in the financial statements that include the foreign operation and the reporting entity (i.e., financial statements in which the foreign operation is consolidated or accounted for using the equity method). *[IAS 21.33]*.

6.3.1.D Treatment in the individual financial statements of monetary items included as part of the net investment in a foreign operation

The exception for exchange differences on monetary items forming part of the net investment in a foreign operation applies only in the financial statements that include the foreign operation (for example consolidated financial statements when the foreign operation is a subsidiary). In the individual financial statements of the entity (or entities) with the currency exposure the exchange differences have to be reflected in that entity's profit or loss for the period.

6.3.1.E Monetary items transacted by other members of the group

As shown in Illustrations 6-4 and 6-5 in sections 6.3.1.A and 6.3.1.C above respectively, the requirements of IAS 21 whereby exchange differences on a monetary item that forms part of the net investment in a foreign operation are recognised in other comprehensive income clearly apply where the monetary item is transacted between the parent preparing the consolidated financial statements and the subsidiary that is the foreign operation. However, loans from any entity (and in any currency) qualify for net investment treatment, so long as the conditions of IAS 21.15 are met. *[IAS 21.15A]*.

6.3.1.F Monetary items becoming part of the net investment in a foreign operation

An entity's plans and expectations in respect of an intragroup monetary item may change over time and the status of such items are assessed each period. For example, a parent may decide that its subsidiary requires refinancing and instead of investing more equity capital in the subsidiary decides that an existing inter-company account, which has previously been regarded as a normal monetary item, will become a long-term deferred trading balance and no repayment of such amount will be requested within the foreseeable future.

How we see it

In our view, such a 'capital injection' is regarded as having occurred at the time it is decided to redesignate the inter-company account. Consequently, the exchange differences arising on the account up to that date are recognised in profit or loss and the exchange differences arising thereafter are recognised in other comprehensive income on consolidation.

This is discussed further in the following Illustration.

Illustration 6-6: Monetary item becoming part of the net investment in a foreign operation

A UK entity has a wholly owned Canadian subsidiary whose net assets at 31 December 20X1 were C$2,000,000. These net assets were arrived at after taking account of a liability to the UK parent of £250,000. Using the closing exchange rate of £1=C$2.35 this liability was included in the Canadian company's statement of financial position at that date at C$587,500. On 30 June 20X2, when the exchange rate was £1=C$2.45, the parent decided that in order to refinance the Canadian subsidiary it would regard the liability of £250,000 as a long-term liability which would not be called for repayment in the foreseeable future. Consequently, the parent thereafter regarded the loan as being part of its net investment in the subsidiary. In the year ended 31 December 20X2 the Canadian company made no profit or loss other than any exchange difference to be recognised on its liability to its parent. The relevant exchange rate at that date was £1=C$2.56. The average exchange rate for the year ended 31 December 20X2 was £1=C$2.50.

The financial statements of the subsidiary in C$ and translated using the closing rate are as follows:

Statement of financial position	31 December 20X2		31 December 20X1	
	C$	£	C$	£
Assets	2,587,500	1,010,742	2,587,500	1,101,064
Amount due to parent	640,000	250,000	587,500	250,000
Net assets	1,947,500	760,742	2,000,000	851,064
Income statement				
Exchange difference	(52,500)			

If the amount due to the parent is not part of the parent's net investment in the foreign operation, this exchange loss would be translated at the average rate and included in the consolidated profit and loss account as £21,000. As the net investment was C$2,000,000 then there would have been an exchange loss recognised in other comprehensive income of £69,814, i.e., £851,064 less £781,250 (C$2,000,000 @ £1=C$2.56), together with an exchange gain of £492, being the difference between profit or loss translated at average rate, i.e., £21,000, and at the closing rate, i.e., £20,508.

However, the parent now regards the amount due as being part of the net investment in the subsidiary. The question then arises as to when this is to be regarded as having happened and how the exchange difference on it is calculated. No guidance is given in IAS 21.

In our view, the 'capital injection' is regarded as having occurred at the time it is decided to redesignate the inter-company account. The exchange differences arising on the account up to that date are recognised in profit or loss. Only the exchange difference arising thereafter would be recognised in other comprehensive income on consolidation. The inter-company account that was converted into a long-term loan becomes part of the entity's (UK parent's) net investment in the foreign operation (Canadian subsidiary) at the moment in time when the entity decides that settlement is neither planned nor likely to occur in the foreseeable future, i.e., 30 June 20X2. Accordingly, exchange differences arising on the long-term loan are recognised in other comprehensive income and accumulated in a separate component of equity from that date. The same accounting treatment would have been applied if a capital injection had taken place at the date of redesignation.

At 30 June 20X2 the subsidiary would have translated the inter-company account as C$612,500 (£250,000 @ £1=C$2.45) and therefore the exchange loss up to that date was C$25,000. Translated at the average rate this amount would be included in consolidated profit or loss as £10,000, with only an exchange gain of £234 recognised in other comprehensive income, being the difference between profit or loss translated at average rate, i.e., £10,000, and at the closing rate, i.e., £9,766. Accordingly, £11,000 (£21,000 less £10,000) offset by a reduction in the exchange gain on the translation of profit or loss of £258 (£492 less £234) would be recognised in other comprehensive income. This amount represents the exchange loss on the 'capital injection' of C$612,500. Translated at the closing rate this amounts to £239,258 which is £10,742 less than the original £250,000.

Some might argue that an approach of regarding the 'capital injection' as having occurred at the beginning of the accounting period would have the merit of treating all of the exchange differences for this year in the same way. However, for the reasons provided above we do not regard such an approach as being acceptable.

Suppose, instead of the inter-company account being £250,000, it was denominated in dollars at C$587,500. In this case the parent would be exposed to the exchange risk; what would be the position?

The subsidiary's net assets at both 31 December 20X1 and 20X2 would be:

Assets	C$2,587,500
Amount due to parent	C$587,500
Net assets	C$2,000,000

As the inter-company account is expressed in Canadian dollars, there will be no exchange difference thereon in the subsidiary's profit or loss.

There will, however, be an exchange loss in the parent as follows:

C$587,500	@ 2.35 =	£250,000
	@ 2.56 =	£229,492
		£20,508

Again, in the consolidated financial statements as the inter-company account is now regarded as part of the equity investment some of this amount is recognised in other comprehensive income. For the reasons stated above, in our view it is only the exchange differences that have arisen after the date of redesignation, i.e., 30 June 20X2, that are recognised in other comprehensive income.

On this basis, the exchange loss would be split as follows:

C$587,500	@ 2.35 =	£250,000	
	@ 2.45 =	£239,796	
			£10,204
	@ 2.45 =	£239,796	
	@ 2.56 =	£229,492	
			£10,304

The exchange loss up to 30 June 20X2 of £10,204 would be recognised in consolidated profit or loss and the exchange loss thereafter of £10,304 would be recognised in other comprehensive income. This is different from when the account was expressed in sterling because the 'capital injection' in this case is C$587,500 whereas before it was effectively C$612,500.

6.3.1.G Monetary items ceasing to be part of the net investment in a foreign operation

The previous section dealt with the situation where a pre-existing monetary item was subsequently considered to form part of the net investment in a foreign operation. However, what happens where a monetary item ceases to be considered part of the net investment in a foreign operation, either because the circumstances have changed such that it is now planned or is likely to be settled in the foreseeable future or indeed that the monetary item is in fact settled?

Where the circumstances have changed such that the monetary item is now planned or is likely to be settled in the foreseeable future, then similar issues to those discussed in section 6.3.1.F above apply; i.e., are the exchange differences on the intragroup balance to be recognised in profit or loss only from the date of change or from the beginning of the financial year?

How we see it

For the same reasons set out in section 6.3.1.F above, including in Illustration 6-6 above, in our view, the monetary item ceases to form part of the net investment in the foreign operation at the moment in time when the entity decides that settlement is planned or is likely to occur in the foreseeable future. Accordingly, exchange differences arising on the monetary item up to that date are recognised in other comprehensive income and accumulated in a separate component of equity. The exchange differences that arise after that date are recognised in profit or loss.

Consideration also needs to be given as to the treatment of the cumulative exchange differences on the monetary item that have been recognised in other comprehensive income, including those that had been recognised in other comprehensive income in prior years. The treatment of these exchange differences is to recognise them in other comprehensive income and accumulate them in a separate component of equity until the disposal of the foreign operation. *[IAS 21.45]*. The principle question is whether the change in circumstances or actual settlement in cash of the intragroup balance represents a disposal or partial disposal of the foreign operation and this is considered in more detail in section 6.6 below.

6.3.2 Dividends

If a subsidiary pays a dividend to the parent during the year the parent records the dividend at the rate ruling when the dividend was declared. An exchange difference will arise in the parent's own financial statements if the exchange rate moves between the declaration date and the date the dividend is actually received. This exchange difference is required to be recognised in profit or loss and will remain there on consolidation.

The same will apply if the subsidiary declares a dividend to its parent on the last day of its financial year and this is recorded at the year-end in both entities' financial statements. There is no problem in that year as both the intragroup balances and the dividends will eliminate on consolidation with no exchange differences arising. However, as the dividend will not be received until the following year an exchange difference will arise in the parent's financial statements in that year if exchange rates have moved in the meantime. Again, this exchange difference remains in consolidated profit or loss as it is no different from any other exchange difference arising on intragroup balances resulting from other types of intragroup transactions. It is not recognised in other comprehensive income.

It may seem odd that the consolidated results can be affected by exchange differences on inter-company dividends. However, once the dividend has been declared, the parent now effectively has a functional currency exposure to assets that were previously regarded as part of the net investment. In order to minimise the effect of exchange rate movements entities would, therefore, need to arrange for inter-company dividends to be paid on the same day the dividend is declared, or as soon after the dividend is declared as possible.

6.3.3 Unrealised profits on intragroup transactions

The other problem area is the elimination of unrealised profits resulting from intragroup transactions when one of the parties to the transaction is a foreign subsidiary.

Illustration 6-7: Unrealised profits on an intragroup transaction

An Italian parent has a wholly owned Swiss subsidiary. On 30 November 20X2 the subsidiary sold goods to the parent for CHF1,000. The cost of the goods to the subsidiary was CHF700. The goods were recorded by the parent at €685 based on the exchange rate ruling on 30 November 20X2 of €1=CHF1.46. All of the goods are unsold by the year-end, 31 December 20X2. The exchange rate at that date was €1=CHF1.52. How is the intragroup profit to be eliminated?

IAS 21 contains no specific guidance on this matter. However, US GAAP requires the rate ruling at the date of the transaction to be used.

The profit shown by the subsidiary is CHF300 which translated at the rate ruling on the transaction of €1=CHF1.46 equals €205. Consequently, the goods will be included in the statement of financial position at:

Per parent company statement of financial position	€685
Less unrealised profit eliminated	€205
	€480

It can be seen that the resulting figure for inventory is equivalent to the original euro cost translated at the rate ruling on the date of the transaction. Whereas if the subsidiary still held the inventory it would be included at €461 (CHF700 @ €1=CHF1.52).

If in the above example the goods had been sold by the Italian parent to the Swiss subsidiary then the approach in US GAAP would say the amount to be eliminated is the amount of profit shown in the Italian entity's financial statements. Again, this will not necessarily result in the goods being carried in the consolidated financial statements at their original cost to the group.

6.4 Non-coterminous period ends

IAS 21 recognises that in preparing consolidated financial statements it may be that a foreign operation is consolidated on the basis of financial statements made up to a different date from that of the reporting entity (see Chapter 8 at section 2.5). In such a case, the standard initially states that the assets and liabilities of the foreign operation are to be translated at the exchange rate at the end of the reporting period of the foreign operation rather than at the date of the consolidated financial statements. However, it then goes on to say that adjustments are made for significant changes in exchange rates up to the end of the reporting period of the reporting entity in accordance with IFRS 10 *Consolidated Financial Statements*. The same approach is used in applying the equity method to associates and joint ventures in accordance with IAS 28 *Investments in Associates and Joint Ventures* (see Chapters 12 and 13). *[IAS 21.46]*.

The rationale for this approach is not explained in IAS 21. The initial treatment is that required by US GAAP and the reason given in that standard is that this presents the functional currency performance of the subsidiary during the subsidiary's financial year and its position at the end of that period in terms of the parent company's reporting (presentation) currency. The subsidiary may have entered into transactions in other currencies, including the functional currency of the parent, and monetary items in these currencies will have been translated using rates ruling at the end of the subsidiary's reporting period. The income statement of the subsidiary will reflect the economic consequences of carrying out these transactions during the period ended on that date. In order that the effects of these transactions in the subsidiary's financial statements are not distorted, the financial statements are translated using the closing rate at the end of the subsidiary's reporting period.

However, an alternative argument could have been advanced for using the closing rate ruling at the end of the parent's reporting period. All subsidiaries within a group will normally prepare financial statements up to the same date as the parent entity so that the parent can prepare consolidated financial statements that present fairly the financial performance and financial position about the group as that of a single entity. The use of financial statements of a subsidiary made up to a date earlier than that of the parent is only an administrative convenience and a surrogate for financial statements made up to the proper date. Arguably, therefore the closing rate to be used is that which would have been used if the financial statements were made up to the proper date, i.e., that ruling at the end of the reporting period of the parent. Another reason for using this rate is that there may be subsidiaries that have the same functional currency as the subsidiary with the non-coterminous year end that do make up their financial statements to the same date as the parent company and therefore in order to be consistent with them the same rate is to be used.

6.5 Goodwill and fair value adjustments

The treatment of goodwill and fair value adjustments arising on the acquisition of a foreign operation depends on whether they are part of: *[IAS 21.BC27]*

(a) The assets and liabilities of the acquired entity (which would imply translating them at the closing rate)

Or

(b) The assets and liabilities of the parent (which would imply translating them at the historical rate)

In the case of fair value adjustments these clearly relate to the acquired entity. However, in the case of goodwill, historically different views have been held as set out in the following Illustration.

Illustration 6-8: Translation of goodwill

A UK company acquires all of the share capital of an Australian company on 30 June 20X2 at a cost of A$3m. The fair value of the net assets of the Australian company at that date was A$2.1m. In the consolidated financial statements at 31 December 20X2 the goodwill is recognised as an asset in accordance with IFRS 3. The relevant exchange rates at 30 June 20X2 and 31 December 20X2 are £1=A$2.61 and £1=A$2.43 respectively. At what amount is the goodwill on consolidation to be included in the statement of financial position?

		(i)	(ii)
	A$	£	£
Goodwill	900,000	344,828	370,370

(i) This method regards goodwill as being an asset of the parent and therefore translated at the historical rate. Supporters of this view believe that, in economic terms, the goodwill is an asset of the parent because it is part of the acquisition price paid by the parent, particularly in situations where the parent acquires a multinational operation comprising businesses with many different functional currencies. *[IAS 21.BC30]*.

(ii) This method regards goodwill as being part of the parent's net investment in the acquired entity and therefore translated at the closing rate. Supporters of this view believe that goodwill is treated no differently from other assets of the acquired entity, in particular intangible assets, because a significant part of the goodwill is likely to comprise intangible assets that do not qualify for separate recognition; the goodwill arises only because of the investment in the foreign entity and has no existence apart from that entity; and the cash flows that support the continued recognition of the goodwill are generated in the entity's functional currency. *[IAS 21.BC31]*.

The IASB was persuaded by the arguments set out in (ii) above. *[IAS 21.BC32]*. Accordingly, IAS 21 requires that any goodwill arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation are treated as assets and liabilities of the foreign operation. Thus they are expressed in the functional currency of the foreign operation and are translated at the closing rate in accordance with the requirements discussed in section 6.1 above. *[IAS 21.47]*.

Clearly, if an entity acquires a single foreign entity this will be a straightforward exercise. Where, however, the acquisition is of a multinational operation comprising a number of businesses with different functional currencies this will not be the case. The goodwill needs to be allocated to the level of each functional currency of the acquired operation. However, the standard gives no guidance on how this is to be done.

In our experience, the most commonly applied way of allocating goodwill to different functional currencies is an economic value approach. This approach effectively calculates the goodwill relating to each different functional currency operation by allocating the cost of the acquisition to the different functional currency operations on the basis of the relative economic values of those businesses and then deducting the fair values that have been attributed to the net assets of those businesses as part of the fair value exercise in accounting for the business combination (see Chapter 10 at section 5).

How we see it

We consider that any basis for allocating goodwill to different functional currencies other than one based on the economic value as set out above would need to be substantiated.

The level to which goodwill is allocated for the purpose of foreign currency translation may be different from the level at which the goodwill is tested for impairment under IAS 36 (see Chapter 21 at section 8.1). *[IAS 21.BC32]*. In many cases the allocation under IAS 21 will be at a lower level. This will apply not only on the acquisition of a multinational operation but could also apply on the acquisition of a single operation where the goodwill is allocated to a larger cash generating unit under IAS 36 that is made up of businesses with different functional currencies.

As a consequence of this different level of allocation one particular difficulty that entities are likely to face is how to deal with an impairment loss that is recognised in respect of goodwill under IAS 36. If the impairment loss relates to a larger cash generating unit made up of businesses with different functional currencies, again some allocation of this impairment loss will be required to determine the amount of the remaining carrying amount of goodwill in each of the functional currencies for the purposes of translation under IAS 21.

6.6 Disposal or partial disposal of a foreign operation

The requirements relating to disposals and partial disposals of foreign operations have been amended a number of times in recent years and the current requirements are considered in sections 6.6.1 and 6.6.2 below. However, these amendments have given rise to a number of application issues, some of which were considered by the IFRS IC in 2010, although their deliberations were ultimately inconclusive.

6.6.1 Disposals and transactions treated as disposals

6.6.1.A Disposals of a foreign operation

Exchange differences resulting from the translation of a foreign operation to a different presentation currency are to be recognised in other comprehensive income and accumulated within a separate component of equity (see section 6.1 above).

On the disposal of a foreign operation, the exchange differences relating to that foreign operation that have been recognised in other comprehensive income and accumulated in the separate component of equity are recognised in profit or loss when the gain or loss on disposal is recognised. *[IAS 21.48]*. This will include exchange differences arising on an intragroup balance that, in substance, forms part of an entity's net investment in a foreign operation (see section 6.3 above).

Illustration 6-9: Disposal of a foreign operation

A German entity has a Swiss subsidiary which was set up on 1 January 20X0 with a share capital of CHF200,000 when the exchange rate was €1=CHF1.55. The subsidiary is included in the parent's separate financial statements at its original cost of €129,032. The profits of the subsidiary, all of which have been retained by the subsidiary, for each of the three years ended 31 December 20X2 were CHF40,000, CHF50,000 and CHF60,000 respectively, so that the net assets at 31 December 20X2 are CHF350,000. In the consolidated financial statements the results of the subsidiary have been translated at the respective average rates of €1=CHF1.60, €1=CHF1.68 and €1=CHF1.70 and the net assets at the respective closing rates of €1=CHF1.71, €1=CHF1.65 and €1=CHF1.66. All exchange differences have been recognised in other comprehensive income and accumulated in a separate exchange reserve. The consolidated reserves have therefore included the following amounts in respect of the subsidiary:

	Retained profit	Exchange reserve
	€	€
1 January 20X0	-	-
Movement during 20X0	25,000	(13,681)
31 December 20X0	25,000	(13,681)
Movement during 20X1	29,762	5,645
31 December 20X1	54,762	(8,036)
Movement during 20X2	35,294	(209)
31 December 20X2	90,056	(8,245)

The net assets at 31 December 20X2 of CHF350,000 are included in the consolidated financial statements at €210,843.

On 1 January 20X3 the subsidiary is sold for CHF400,000 (€240,964), thus resulting in a gain on disposal in the parent entity's books of €111,932, i.e., €240,964 less €129,032.

In the consolidated financial statements for 20X3, IAS 21 requires the cumulative exchange losses of €8,245 to be recognised in profit or loss for that year. Assuming they were included as part of the gain on disposal (which was explicitly required by earlier versions of IAS 27)[15] this gain would be reduced to €21,876, being €30,121 (the difference between the proceeds of €240,964 and net asset value of €210,843 at the date of disposal) together with the cumulative exchange losses of €8,245.

In this example, this gain on disposal of €21,876 represents the parent's profit of €111,932 less the cumulative profits already recognised in group profit or loss of €90,056.

15 IAS 27 (2007), Consolidated and Separate Financial Statements, IASB, 2007 Bound Volume, para. 30.

The accounting policies of Pearson plc reflect these requirements as shown below.

Practical example 6-3: Pearson plc (2023) **United Kingdom**

Annual report and accounts 2023 [extract]
Financial statements [extract]
Notes to the consolidated financial statements [extract]
1a. Accounting policies [extract]
Foreign currency translation [extract]

3. Group companies – The results and financial position of all Group companies that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

— Assets and liabilities are translated at the closing rate at the date of the balance sheet;

— Income and expenses are translated at average exchange rates; and

— All resulting exchange differences are recognised as a separate component of equity.

On consolidation, exchange differences arising from the translation of the net investment in foreign entities, and of borrowings and other currency instruments designated as hedges of such investments, are taken to shareholders' equity. The Group treats specific inter-company loan balances, which are not intended to be repaid in the foreseeable future, as part of its net investment. When a foreign operation is sold, such exchange differences are recognised in the income statement as part of the gain or loss on sale.

The principal overseas currency for the Group is the US dollar. The average rate for the year against sterling was $1.25 (2022: $1.24; 2021: $1.38) and the year-end rate was $1.27 (2022: $1.21; 2021: $1.35).

This treatment is to be adopted not only when an entity sells an interest in a foreign entity, but also when it disposes of its interest through liquidation, repayment of share capital, or abandonment of that entity. *[IAS 21.49]*.

The requirement to reclassify the cumulative exchange differences to profit or loss cannot be avoided, for example, by an entity merely disposing of the net assets and business of the foreign operation, rather than disposing of its interest in the legal entity that is the foreign operation. This is because IAS 21.49 refers to the disposal of a foreign operation, and a foreign operation as defined by IAS 21 must have 'activities' (see section 2.3 above). Following the disposal of the net assets and business, there no longer are 'activities'. Furthermore, a foreign operation need not be an incorporated entity but may be a branch, the disposal of which would necessarily take the form of an asset sale. The legal form of the entity makes no difference to the accounting treatment of exchange differences, including the reclassification of cumulative exchange differences from equity to profit or loss. It also follows that reclassification of exchange differences could potentially be required on the disposal of a branch or similar operation within a legal entity if it represents a separate foreign operation (see section 4.4 above).

Where it is a subsidiary that is disposed of, the related exchange differences that have been attributed to the non-controlling interests are derecognised and therefore included in the calculation of the gain or loss on disposal, but are not reclassified to profit or loss. *[IAS 21.48B]*. This is shown in the following Illustration.

Illustration 6-10: Disposal of a partially owned foreign subsidiary

Entity P, which is incorporated in France and has the euro as its functional currency, owns 80% of Entity S which has US dollars as its functional currency. In P's consolidated financial statements, the following amounts have been recognised in relation to its investment in S:

- Net assets of €1,000 and associated non-controlling interests of €200
- Foreign exchange gains of €100 were recognised in other comprehensive income, of which €20 was attributable to non-controlling interests and is therefore included in the €200 non-controlling interests
- €80 of foreign exchange gains have therefore been accumulated in a separate component of equity relating to P's 80% share in S

P sells its 80% interest in S for €1,300 and records the following amounts:

Dr	Cash		€1,300	
Dr	NCI		€200	
Dr	OCI		€80	
	Cr	Net assets		€1,000
	Cr	Profit on disposal		€580

It can be seen that €80 of the foreign currency gains previously recognised in OCI, i.e., the amount attributed to P, is reclassified to profit or loss (profit on disposal) and reported as a loss in OCI. However, the €20 of such gains attributed to the non-controlling interests is not reclassified in this way and is simply derecognised along with the rest of the NCI balance.

If Entity P had originally held a 60% interest in Entity S and subsequently increased its holding to 80%, the accounting set out in the above Illustration would not change. In other words, although some of the €80 of accumulated foreign exchange gains would originally have been allocated to non-controlling interests, those gains would have been reallocated to the parent when the interest in Entity S increased and therefore are reclassified to profit or loss when control of the subsidiary is lost (see Chapter 8 at section 4.1, including Illustration 4-3).

6.6.1.B Transactions treated as disposals

In addition to the disposal of an entity's entire interest in a foreign operation, the following partial disposals are accounted for as disposals: *[IAS 21.48A]*

(a) When the partial disposal involves the loss of control of a subsidiary that includes a foreign operation, regardless of whether the entity retains a non-controlling interest in its former subsidiary after the partial disposal

(b) When the retained interest after the partial disposal of an interest in a joint arrangement or a partial disposal of an interest in an associate that includes a foreign operation is a financial asset that includes a foreign operation

Therefore, all exchange differences accumulated in the separate component of equity relating to that foreign operation are reclassified on its disposal even if the disposal results from a sale of only part of the entity's interest in the operation, for example if a parent sold 60% of its shares in a wholly owned subsidiary which as a result became an associate.

The requirement at (a) above mirrors IFRS 10 which specifies that an entity recognises in full gains and losses when an entity loses control of a subsidiary but retains an interest in that subsidiary that is subject to equity accounting. However, as a result of a conflict between IFRS 10 and IAS 28, there are circumstances in which such an entity might recognise a gain or loss in respect of only the proportion of the subsidiary disposed of (see Chapter 8 at section 3.3.2).

How we see it

In the circumstances an entity recognises only a proportionate gain or loss in respect of the proportion disposed of, our view is that only a proportion of the accumulated exchange differences is reclassified (see Chapter 8 at section 3.3.2.C).

The treatment of exchange differences relating to an investment in an associate or joint venture that becomes a subsidiary in a business combination is not clearly specified in IAS 21.

How we see it

In these circumstances, IAS 28 clearly requires the reclassification of equity accounted exchange differences of the associate or joint venture that were recognised in other comprehensive income (see Chapter 10 at section 9 and Chapter 12 at sections 9.1 and 9.2) and, in our view, the same treatment applies to the exchange differences arising on the associate or joint venture itself.

6.6.2 Partial disposals

6.6.2.A What constitutes a partial disposal?

A partial disposal of an entity's interest in a foreign operation is any reduction in its ownership interest, except for those that are accounted for as disposals (see section 6.6.1 above). *[IAS 21.48D]*.

A write-down of the carrying amount of a foreign operation, either because of its own losses or because of an impairment recognised by the investor, does not constitute a partial disposal, therefore no deferred exchange difference is reclassified from equity to profit or loss at the time of the write-down. *[IAS 21.49]*. Similarly, it is implicit in the requirement of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* for separate disclosure of cumulative gains and losses recognised in equity relating to a disposal group (see Chapter 5 at section 2.2.4) that the classification of a foreign operation as held for sale under IFRS 5 does not give rise to a reclassification of foreign exchange differences to profit or loss at that time.

Also, a dividend made by a foreign operation that is accounted for as revenue by its parent, investor or venturer in its separate financial statements (see Chapter 9 at section 2.4.1) is not treated as a disposal or partial disposal of a net investment. *[IAS 21.BC35]*.

The term 'ownership interest' is not defined within IFRS accounting standards, although it is used in a number of standards,[16] normally to indicate an investor's proportionate interest in an entity. This might seem to indicate that a partial disposal arises only when an investor reduces its proportionate interest in the foreign operation. However, the IFRS IC has indicated that a partial disposal may also be interpreted to mean an absolute reduction in ownership interest[17] (other than those indicated above), for example the repayment by a foreign operation of a permanent as equity loan made to it by the reporting entity.

How we see it

In our view, entities will need to apply judgement and select an appropriate accounting policy for determining what constitutes a partial disposal, particularly whether an absolute reduction in ownership interest represents a partial disposal.

6.6.2.B Partial disposal of a proportionate interest in a subsidiary

On the partial disposal of a proportionate interest in a subsidiary that includes a foreign operation, the proportionate share of the cumulative amount of exchange differences recognised in other comprehensive income is reattributed to the non-controlling interests in that foreign operation. *[IAS 21.48C]*. In other words, these exchange differences will not be reclassified to profit or loss. Further, if the entity subsequently disposes of the remainder of its interest in the subsidiary, the exchange differences reattributed will not be reclassified to profit or loss at that point either (see section 6.6.1 above).

6.6.2.C Repayment of a permanent as equity loan by a subsidiary

Where an entity considers the repayment by a subsidiary of a permanent as equity loan a partial disposal (see section 6.6.2.A above), IAS 21 is unclear whether related foreign currency differences are reclassified from equity to profit and loss.

IAS 21 requires only that an entity reattribute to the non-controlling interests any exchange differences in that foreign operation. *[IAS 21.48C]*. Following this approach would lead an entity not to reclassify exchange differences on the repayment of a permanent as equity loan.

16 For example, IAS 27 *Separate Financial Statements*, IASB, paras. 16(b)(iii) and 17(b)(iii), IFRS 3 *Business Combinations*, IASB, para. B63(e) and IFRS 10 *Consolidated Financial Statements*, IASB, para. 23.

17 *IFRIC Update*, September 2010, p.2. Available on the IFRS Foundation's website.

However, in analysing the issue for the IFRS IC in 2010, the IFRIC staff indicated, albeit without any technical analysis, that in their opinion exchange differences are to be reclassified to profit or loss on settlement of such a monetary item[18] and the IFRS IC, which did not take the issue onto its agenda, noted that diversity may exist in practice.[19]

How we see it

In our opinion, an entity may select either of the above two approaches as its accounting policy, although in our experience the first is the one most commonly applied.

A logical extension of the second approach would be that exchange differences are reclassified as a result of similar transactions, for example the repayment of share capital by a foreign subsidiary.

6.6.2.D Partial disposal of interest in an associate or joint arrangement

In a partial disposal of an associate or joint arrangement where the retained interest remains or becomes an associate or joint arrangement, the proportionate share of the cumulative amount of exchange differences recognised in other comprehensive income are reclassified from equity to profit or loss. *[IAS 21.48C]*. There is an equivalent requirement in IAS 28 applying to all gains and losses recognised in other comprehensive income that would be reclassified to profit or loss on disposal of the related assets or liabilities. *[IAS 28.25]*. In this context, the IFRS IC has concluded that this treatment applies however an investor's ownership interest is reduced, for example if an associate that is a foreign operation issues shares to third parties.[20]

Whether the repayment by an associate or joint arrangement of a permanent as equity loan made to it by the reporting entity results in reclassification of exchange differences to profit or loss depends on whether the reporting entity considers such a transaction to represent a partial disposal (see section 6.6.2.A above). In other words, it will be an entity's accounting policy choice.

6.6.3 Comparison of the effect of step-by-step and direct methods of consolidation on accounting for disposals

We illustrated the basic requirement to reclassify cumulative exchange differences from equity to profit or loss on the disposal of a foreign operation in Illustration 6-9 in section 6.6.1.A above where a parent sold a direct interest in a subsidiary. This requirement also applies on the sale of an indirect subsidiary. However, where the intermediate holding company and the subsidiary each have different functional currencies, the method of consolidation can have an impact on the amount of exchange differences reclassified from equity to profit or loss on the disposal of the subsidiary.

If the step-by-step method is used, this amount will have been measured based on the functional currencies of the intermediate holding company and the subsidiary. The translation of that amount into the presentation currency of the ultimate parent will not be the same as if the ultimate parent had consolidated the subsidiary individually. In this second case (the direct method), the exchange differences on translation of the subsidiary would have been measured based on the functional currency of the subsidiary and the presentation currency used by the ultimate parent. This is shown in the following Illustration.

18 IASB Staff Paper 7D: Project: *IAS 21* The Effects of Changes in Foreign Exchange Rates, Topic: *CTA Recycling in IAS 27R Transactions*, IFRS IC Meeting, March 2010; and IASB Staff Paper 11: Project: *IAS 21* The Effects of Changes in Foreign Exchange Rates, Topic: *Repayment of investment/CTA*, IFRS IC Meeting, July 2010, paras. 10(a) and 11. Available on the IFRS Foundation's website.

19 *IFRIC Update*, September 2010, p.2. Available on the IFRS Foundation's website.

20 *IFRIC Update*, July 2009, available on the IFRS Foundation's website.

Illustration 6-11: Disposal of an indirectly held foreign operation

On 1 January 20X1, Entity A is incorporated in the UK with share capital of £300m. It sets up a wholly-owned Swiss subsidiary, Entity B, on the same day with share capital of CHF200m. Entity B in turn sets up a wholly-owned German subsidiary, Entity C, with share capital of €45m. All of the capital subscribed in each of the entities, to the extent that it has not been invested in a subsidiary, is used to acquire operating assets in their country of incorporation. The functional currency of each of the entities is therefore pound sterling, the Swiss franc and the euro respectively. The relevant exchange rates at 1 January 20X1 are £1=CHF2.50=€1.50.

For the purposes of the example, it is assumed that in the year ended 31 December 20X1 each of the entities made no profit or loss. The relevant exchange rates at that date were £1=CHF3.00=€1.25.

On 1 January 20X2, the German subsidiary, Entity C, is sold by Entity B for €45m.

The exchange differences relating to Entity C that will be reclassified from equity to profit or loss in the consolidated financial statements of the Entity A group for the year ended 31 December 20X2 on the basis that each of the subsidiaries are consolidated individually (the direct method) will be as follows:

Consolidating each subsidiary individually (the direct method)

The opening consolidated statement of financial position of the Entity A group at 1 January 20X1 is as follows:

	Entity A		Entity B		Entity C	Adjustments	Consolidated
Millions	**£**	**CHF**	**£**	**€**	**£**	**£**	**£**
Investment in B	80.0					(80.0)	
Investment in C		75.0	30.0			(30.0)	
Other net assets	220.0	125.0	50.0	45.0	30.0		300.0
	300.0	200.0	80.0	45.0	30.0		300.0
Share capital	300.0						300.0
Share capital		200.0	80.0			(80.0)	
Share capital				45.0	30.0	(30.0)	

The consolidated statement of financial position of the Entity A group at 31 December 20X1 is as follows:

	Entity A		Entity B		Entity C	Adjustments	Consolidated
Millions	**£**	**CHF**	**£**	**€**	**£**	**£**	**£**
Investment in B	80.0					(80.0)	
Investment in C		75.0	25.0			(25.0)	
Other net assets	220.0	125.0	41.7	45.0	36.0		297.7
	300.0	200.0	66.7	45.0	36.0		297.7
Share capital	300.0						300.0
Share capital		200.0	80.0			(80.0)	
Share capital				45.0	30.0	(30.0)	
Exchange - B			(13.3)			5.0	(8.3)
Exchange - C					6.0		6.0
	300.0	200.0	66.7	45.0	36.0		297.7

The exchange differences in respect of Entity B and Entity C are only shown for illustration purposes; the consolidated statement of financial position would only show the net amount of £(2.3)m as a separate component of equity. The exchange difference of £6.0m in respect of Entity C is that arising on the translation of its opening net assets of €45m into the presentation currency of pound sterling based on the opening and closing exchange rates of £1=€1.50 and £1=€1.25 respectively, as required by IAS 21.39. Accordingly, it is this amount of £6.0m that will be reclassified from equity to profit or loss for the year ended 31 December 20X2 upon the disposal of Entity C as required by IAS 21.48.

If the consolidated statement of financial position for the Entity A group at 31 December 20X1 had been prepared on the basis of a sub-consolidation of the Entity B sub-group incorporating Entity C, the position would have been as follows.

Consolidating using a sub-group consolidation (the step-by-step method)

The exchange rates at 1 January 20X1 and 31 December 20X1 are the equivalent of €1=CHF1.667 and €1=CHF2.400.

The sub-consolidation of Entity B and Entity C at 31 December 20X1 is as follows:

	Entity B		Entity C	Adjustments	Consolidated
Millions	**CHF**	**€**	**CHF**	**CHF**	**CHF**
Investment in C	75.0			(75.0)	
Other net assets	125.0	45.0	108.0		233.0
	200.0	45.0	108.0		233.0
Share capital	200.0				200.0
Share capital		45.0	75.0	(75.0)	
Exchange - C			33.0		33.0
	200.0	45.0	108.0		233.0

The exchange difference of CHF33.0m in respect of Entity C is that arising on the translation of its opening net assets of €45m into the functional currency of that of Entity B, the Swiss franc, based on the opening and closing exchange rates of €1=CHF1.667 and €1=CHF2.400 respectively.

In the consolidated financial statements of the Entity B sub-group for the year ended 31 December 20X2, it is this amount of CHF33.0m that would be reclassified from equity to profit or loss upon the disposal of Entity C.

The consolidated statement of financial position of the Entity A group at 31 December 20X1 prepared using this sub-consolidation would be as follows:

	Entity A		Entity B sub-group	Adjustments	Consolidated
Millions	**£**	**CHF**	**£**	**£**	**£**
Investment in B	80.0			(80.0)	
Other net assets	220.0	233.0	77.7		297.7
	300.0	233.0	77.7		297.7
Share capital	300.0				300.0
Share capital		200.0	80.0	(80.0)	
Exchange - C		33.0	11.0		11.0
Exchange - B group			(13.3)		(13.3)
	300.0	233.0	77.7		297.7

The exchange differences in respect of Entity C and those for the Entity B sub-group are only shown for illustration purposes; the consolidated statement of financial position would only show the net amount of £(2.3)m as a separate component of equity. As can be seen, the consolidated position for the Entity A group is the same as that using the direct method. However, using the step-by-step method, the exchange difference of £11.0m in respect of Entity C is the exchange difference of CHF33.0m included in the Entity B sub-consolidation translated into the presentation currency used in the Entity A consolidated financial statements.

As indicated above, it is this amount of CHF33.0m that would be reclassified from equity to profit or loss upon the disposal of Entity C in the consolidated financial statements of the Entity B sub-group for the year ended 31 December 20X2. In the consolidated financial statements of the Entity A group for the year ended 31 December 20X2, it would be the translated amount of exchange differences of £11.0m that would be reclassified from equity to profit or loss on the disposal of Entity C.

Although the IFRS IC has indicated that the direct method is conceptually correct, IFRIC 16 permits the use of either approach as an accounting policy choice (see section 6.1.4 above).

In certain situations, the methods of consolidation seem to result in more extreme differences. For example, consider the disposal of a US subsidiary by a US intermediate holding company (both of which have the US dollar as their functional currency) within a group headed by a UK parent (which has sterling as its functional and presentation currency). The US subsidiary that is disposed of is a foreign operation so exchange differences accumulated in the separate component of equity relating to it are reclassified from equity to profit or loss on its disposal. Under the direct method of consolidation, this amount will represent exchange differences arising from translating the results and net assets of the US subsidiary directly into sterling. However, under the step-by-step method, these exchange differences will be entirely attributable to the intermediate parent undertaking and so there would be no reclassification from equity to profit or loss.

7 Lack of exchangeability

In most cases determining an exchange rate will be a relatively straightforward exercise, but this will not always be the case, particularly where there are restrictions on entities wishing to exchange one currency for another, typically a local currency for a foreign currency. For example:

- Legal restrictions might permit sales of local currency only at an official rate rather than a rate that reflects more fully market participants' views of the currency's relative value or its underlying economics. Those official rates might or might not be pegged to another country's currency, for example the US dollar.
- Exchange rates set by governments might vary according to the nature of the underlying transaction.
- The volume of currency that can be exchanged through official mechanisms may be limited by formal or informal restrictions imposed by government, often designed to help manage the government's sometimes scarce foreign exchange reserves.

These situations are often encountered in countries that have more of a closed economy and which may be experiencing a degree of economic strain. High inflation or even hyperinflation and devaluations can be symptomatic of these situations as can the development of a so called 'black market' in foreign currencies, the use of which could to some extent be unlawful. Determining an appropriate exchange rate to use in these circumstances can be difficult.

In more extreme cases of economic strain or hyperinflation a country may eventually replace its local currency completely or even adopt a third country's currency as its own. Examples of the latter include Ecuador and Zimbabwe which have both in recent times effectively adopted the US dollar as their official currency for periods of time. In addition to the underlying economic problems these actions are designed to address they may also go some way towards addressing some of the associated financial reporting issues.

It is also important to recognise that economic characteristics such as those mentioned above are not always associated with difficult economic conditions, e.g., many successful economies have a currency that to some extent is, or has been, pegged to another currency or is otherwise linked to a different currency.

Following a number of submissions to the IFRS IC over several years, the IASB embarked on a project to address the issue of determining the spot exchange rate an entity uses when a currency lacks exchangeability. As a result, amendments to IAS 21 were published in August 2023 with a mandatory effective date of periods commencing on or after 1 January 2025, and these are discussed in more detail in sections 7.1 to 7.5 below. The position prior to these amendments being applied, including guidance issued by the IFRS IC, is addressed in section 7.6 below.

It is clear that the new requirements and transitional relief cannot be seen as mere interpretations of the previous version of IAS 21. Consequently, entities applying a version of IFRS accounting standards that require local endorsement of new and amended standards and for which this is a material issue, cannot apply accounting in line with the amendments until they have been endorsed.

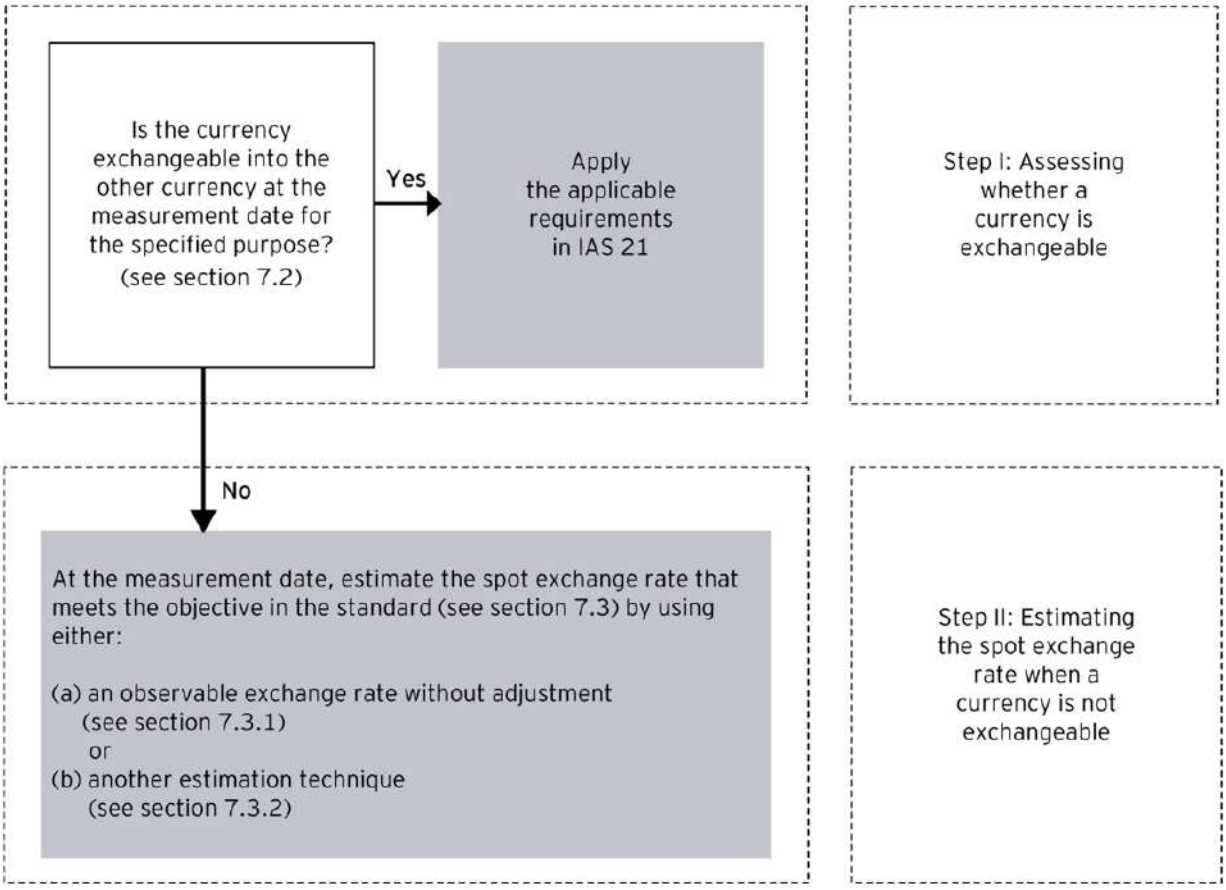
7.1 Overview of approach required by the amendments

The amendments first require an entity to assess whether a currency is exchangeable into another currency at a measurement date and for a specified purpose (Step I). *[IAS 21.8A]*. A currency is defined as being exchangeable into another currency when an entity is able to obtain the other currency within a time frame that allows for a normal administrative delay and through a market or exchange mechanism in which an exchange transaction would create enforceable rights and obligations. *[IAS 21.8]*. If the entity is able to obtain no more than an insignificant amount of the other currency at the measurement date for the specified purpose, the currency is not considered exchangeable into the other currency. *[IAS 21.8B]*. Step I is considered further in section 7.2 below.

When a currency is not exchangeable into another currency at a particular measurement date, the entity is required to estimate the spot exchange rate (Step II). The objective in estimating the spot exchange rate is to reflect the rate at which an orderly exchange transaction would take place at the measurement date between market participants under prevailing economic conditions. *[IAS 21.19A]*. Step II is considered further in section 7.3 below.

The following diagram, based on the application guidance to IAS 21, is intended to help entities assess whether a currency is exchangeable and estimate the spot exchange rate when a currency is not exchangeable. *[IAS 21.A1]*.

Figure 7-1: Assessing exchangeability and estimating a spot exchange rate



7.2 Assessing whether a currency is exchangeable (Step I)

The standard acknowledges that an entity might determine a currency is not exchangeable into another currency, even though that other currency might be exchangeable in the other direction. For example, an entity might determine that currency PC is not exchangeable into currency LC, even though currency LC is exchangeable into currency PC. *[IAS 21.A2]*. This reflects a commonly experienced situation whereby it is much easier to exchange a hard currency such as the US dollar into a weaker currency than vice versa.

A spot exchange rate is defined as the exchange rate for immediate delivery (see section 2.3 above). However, an exchange transaction might not always complete instantaneously because of legal or regulatory requirements, or for practical reasons such as public holidays. A normal administrative delay in obtaining the other currency does not preclude a currency from being exchangeable into that other currency. What constitutes a normal administrative delay will depend on facts and circumstances *[IAS 21.A3]* and this concept is illustrated below.

Illustration 7-1: Time frame

In the following illustration, Entity X's functional and presentation currency is PC and it prepares consolidated financial statements. Entity X has a subsidiary, Entity Y, that is a foreign operation. Entity Y's functional currency is LC, the currency of the jurisdiction in which Entity Y operates. The relevant authority administers the exchangeability of LC for other currencies. *[IAS 21.IE2]*.

The relevant authority in Entity Y's jurisdiction makes PC available to entities in exchange for LC only after completion of an administrative process. The authority requires entities wishing to obtain PC to explain how they intend to use PC when submitting a request for PC. In usual circumstances, an entity obtains PC after N days, i.e., N days is the time the authority needs, under its administrative process, to perform checks and provide PC. *[IAS 21.IE3]*.

Entity X considers N days to be a normal administrative delay applying to a transaction to exchange LC for PC through this exchange mechanism. Subject to the other requirements addressed in this section 7.2 (those in paragraphs A2 to A10), Entity X considers LC to be exchangeable into PC if it is able to obtain PC within N days of requesting it. *[IAS 21.IE4]*.

This illustration, and subsequent ones that build on it, explain how an entity might apply some of the requirements in IAS 21 in hypothetical situations based on the limited facts presented. Although some aspects of the illustrations might be present in actual fact patterns, the fact patterns in the illustrations are simplified and an entity would need to evaluate all relevant facts and circumstances when applying IAS 21. *[IAS 21.IE1]*.

In assessing whether a currency is exchangeable into another currency, an entity is required to consider its ability to obtain the other currency, rather than its intention or decision to do so. Subject to the other requirements addressed in this section, a currency is exchangeable into another currency if an entity is able to obtain the other currency, either directly or indirectly, even if it intends or decides not to do so. For example, subject to the other requirements addressed in this section, regardless of whether the entity intends or decides to obtain PC, currency LC is exchangeable into currency PC if an entity is able to either exchange LC for PC, or exchange LC for another currency (FC) and then exchange FC for PC. *[IAS 21.A4]*.

In assessing whether a currency is exchangeable into another currency, an entity is permitted to consider only markets or exchange mechanisms in which a transaction to exchange the currency for the other currency would create enforceable rights and obligations. Enforceability is a matter of law. Whether an exchange transaction in a market or exchange mechanism would create enforceable rights and obligations depends on facts and circumstances. *[IAS 21.A5]*. Although the IASB doesn't use these terms in the standard, this effectively means that many so-called unofficial, parallel or black markets are not to be considered in Step I.[21]

Illustration 7-2: Markets and exchange mechanisms

Continuing from Illustration 7-1 above, the relevant authority in Entity Y's jurisdiction is now unable to meet demand for PC and temporarily stops making PC available through the exchange mechanism it administers. In the absence of this exchange mechanism, individual resellers settle transactions to exchange LC for PC at an exchange rate that is not set by the authority. These exchange transactions do not create enforceable rights and obligations, and no other markets or exchange mechanisms exist in which a transaction to exchange LC for PC would create such rights and obligations. *[IAS 21.IE5]*.

In assessing whether LC is exchangeable into PC, Entity X considers only markets or exchange mechanisms in which a transaction to exchange LC for PC would create enforceable rights and obligations. Entity X concludes that LC is not exchangeable into PC because the exchange transactions with individual resellers do not create enforceable rights and obligations, and no other markets or exchange mechanisms exist in which a transaction to exchange LC for PC would create such rights and obligations. *[IAS 21.IE6]*.

21 *IASB Update*, December 2022, available on the IFRS Foundation's website.

The standard explains that different exchange rates might be available for different uses of a currency. For example, a jurisdiction facing pressure on its balance of payments might wish to deter capital remittances (such as dividend payments) to other jurisdictions but encourage imports of specific goods from those jurisdictions. In such circumstances, the relevant authorities might: *[IAS 21.A6]*

- Set a preferential exchange rate for imports of those goods and a 'penalty' exchange rate for capital remittances to other jurisdictions, thus resulting in different exchange rates applying to different exchange transactions

  Or
- Make the other currency available only to pay for imports of those goods and not for capital remittances to other jurisdictions

Accordingly, therefore, whether a currency is exchangeable into another currency could depend on the purpose for which the entity obtains (or hypothetically might need to obtain) the other currency. In assessing exchangeability: *[IAS 21.A7]*

- When an entity reports foreign currency transactions in its functional currency the entity is required to assume its purpose in obtaining the other currency is to realise or settle individual foreign currency transactions, assets or liabilities.
- When an entity uses a presentation currency other than its functional currency, the entity assumes its purpose in obtaining the other currency is to realise or settle its net assets or net liabilities.
- When an entity translates the results and financial position of a foreign operation into the presentation currency, the entity assumes its purpose in obtaining the other currency is to realise or settle its net investment in the foreign operation.

It is further explained that an entity's net assets or net investment in a foreign operation might be realised by, for example:

- The distribution of a financial return to the entity's owners
- The receipt of a financial return from the entity's foreign operation
- The recovery of the investment by the entity or the entity's owners, such as through disposal of the investment *[IAS 21.A8]*

This assessment of whether a currency is exchangeable into another currency is required to be performed separately for each of the three purposes specified above. For example, an entity assesses exchangeability for the purpose of reporting foreign currency transactions in its functional currency separately from exchangeability for the purpose of translating the results and financial position of a foreign operation. *[IAS 21.A9]*.

Illustration 7-3: Purpose of obtaining the other currency

Continuing from Illustration 7-2 above, the relevant authority in Entity Y's jurisdiction continues to prevent entities from obtaining PC for most purposes, but does allow it for importing food and medicine. *[IAS 21.IE7]*.

In translating the results and financial position of Entity Y, Entity X assesses whether it is able to obtain PC for the purpose of realising its net investment in Entity Y. Because Entity X is prevented from obtaining PC for this purpose, Entity X concludes that LC is not exchangeable into PC. Entity X's ability to obtain PC for the purpose of importing food and medicine is irrelevant to the assessment. *[IAS 21.IE8]*.

As noted in section 7.1 above, a currency is not considered exchangeable into another currency if, for a particular purpose, an entity is able to obtain no more than an insignificant amount of the other currency. Significance is to be assessed by reference to the amount of the other currency the entity is able to obtain for a specified purpose by comparing that amount with the total amount of the other currency required for that purpose. For example, consider an entity with a functional currency of LC that has liabilities denominated in currency FC. The entity assesses whether the total amount of FC it can obtain for the purpose of settling those liabilities is no more than an insignificant amount compared with the aggregated amount (the sum) of its liability balances denominated in FC. *[IAS 21.A10]*.

At the time of writing, few entities had applied the amendments, but it seems likely a number of practical issues will arise when they do. It is demonstrably the case that exchangeability can be lost or gained over a very short period of times, normally because of government actions. For example, exchange controls that are necessary to maintain an artificially high exchange rate are often relaxed once a government decides to accept a devaluation of the currency. It is also apparent from the requirements above that the answer to the question: Is currency X exchangeable into currency Y? is entity specific and will depend on specific circumstances, not just the identity of currency X and currency Y. In particular, not all entities or sectors will have equal access to exchange mechanisms with entities such as banks or other financial institutions often having a greater practical ability to exchange currencies than other entities.

7.3 Estimating the spot rate when a currency is not exchangeable (Step II)

As noted in section 7.1 above, where an entity is required to estimate a spot exchange rate, the objective is to reflect the rate at which an orderly exchange transaction would take place at the measurement date between market participants under prevailing economic conditions. *[IAS 21.19A]*. However, IAS 21 does not specify how an entity estimates the spot exchange rate to meet this objective, stating only that an entity can use an observable exchange rate without adjustment (see section 7.3.1 below) or another estimation technique (see section 7.3.2 below). *[IAS 21.A11]*.

7.3.1 Using an observable rate without adjustment

When estimating a spot exchange rate, an entity may use an observable exchange rate without adjustment if that observable exchange rate meets the objective in the standard, i.e., it reflects the rate at which an orderly exchange transaction would take place at the measurement date between market participants under prevailing economic conditions. Examples of an observable exchange rate include: *[IAS 21.A12]*

- A spot exchange rate for a purpose other than that for which an entity assesses exchangeability
- The first exchange rate at which an entity is able to obtain the other currency for the specified purpose after exchangeability of the currency is restored (referred to as the first subsequent exchange rate)

A currency that is not exchangeable into another currency for one purpose might, the standard explains, be exchangeable into that currency for another purpose. For example, an entity might be able to obtain a currency to import specific goods but not to pay dividends. In such situations, the entity might conclude that an observable exchange rate for another purpose meets the objective in the standard. If the rate meets that objective, an entity may use that rate as the estimated spot exchange rate. *[IAS 21.A13]*.

In assessing whether such an observable exchange rate meets the objective, an entity is required to consider, among other factors: *[IAS 21.A14]*

- whether several observable exchange rates exist

  The existence of more than one observable exchange rate might indicate that exchange rates are set to encourage, or deter, entities from obtaining the other currency for particular purposes. These observable exchange rates might include an 'incentive' or 'penalty' and therefore might not reflect the prevailing economic conditions.
- the purpose for which the currency is exchangeable

  If an entity is able to obtain the other currency only for limited purposes (such as to import emergency supplies), the observable exchange rate might not reflect the prevailing economic conditions.
- the nature of the exchange rate

  A free-floating observable exchange rate is more likely to reflect the prevailing economic conditions than an exchange rate set through regular interventions by the relevant authorities.
- the frequency with which exchange rates are updated

  An observable exchange rate unchanged over time is less likely to reflect the prevailing economic conditions than an observable exchange rate that is updated on a daily basis (or even more frequently).

The following illustration shows how these factors might be considered in practice.

Illustration 7-4: Using an observable exchange rate for another purpose

Fact pattern

Continuing from Illustrations 7-1 to 7.3 in section 7.2 above, at 31 December 20X1 the relevant authority in Entity Y's jurisdiction continues to prevent entities from obtaining PC for the purpose of realising a net investment in an entity operating in that jurisdiction. However, other than that restriction, entities are now able to obtain PC and the LC:PC exchange rate is free-floating. Only one exchange rate applies to transactions for exchanges of LC for PC and it is updated several times a day. *[IAS 21.IE9]*.

At the measurement date of 31 December 20X1 Entity X is unable to obtain PC to realise its net investment in Entity Y. Therefore, Entity X concludes that LC is not exchangeable into PC. *[IAS 21.IE10]*.

Estimating the spot exchange rate

Because Entity X concludes that LC is not exchangeable into PC, Entity X is required to estimate the spot exchange rate that meets the objective in the standard. *[IAS 21.IE11]*.

Applying the guidance above, Entity X considers whether it might use the observable LC:PC exchange rate for the purpose of realising a net investment in an entity. To do so, it assesses whether that observable exchange rate meets the specified objective and considers: *[IAS 21.IE12]*

- whether several exchange rates exist

  In this case, only one observable exchange rate exists between LC and PC.
- the purpose for which the currency is exchangeable

  Entity X is able to obtain PC for any transaction other than a transaction that would result in the realisation of its net investment in Entity Y.
- the nature of the exchange rate

  The observable exchange rate here is free-floating.
- the frequency with which exchange rates are updated

  The observable exchange rate is updated several times a day.

Considering these factors, Entity X determines that the observable LC:PC exchange rate meets the objective in the standard. Therefore, Entity X may use that observable exchange rate as the estimated spot exchange rate when it translates the results and financial position of Entity Y. *[IAS 21.IE13]*.

A currency that is not exchangeable into another currency at the measurement date for a specified purpose might subsequently become exchangeable into that currency for that purpose. In such situations, an entity might conclude that the first subsequent exchange rate meets the objective in the standard. If the rate meets that objective, an entity may use that rate as the estimated spot exchange rate. *[IAS 21.A15]*.

In assessing whether the first subsequent exchange rate meets the objective, an entity is required to consider, among other factors:

- the time between the measurement date and the date at which exchangeability is restored

  The shorter this period, the more likely the first subsequent exchange rate will reflect the prevailing economic conditions.

  And
- inflation rates

  When an economy is subject to high inflation, including when an economy is hyperinflationary (as specified in IAS 29), prices often change quickly, perhaps several times a day. Accordingly, the first subsequent exchange rate for a currency of such an economy might not reflect the prevailing economic conditions. *[IAS 21.A16]*.

The following illustration shows how these factors might be considered in practice.

Illustration 7-5: Using the first subsequent exchange rate

Fact pattern

Continuing from Illustration 7-4 above, and as previously noted, at 31 December 20X1 the relevant authority in Entity Y's jurisdiction prevents entities from obtaining PC for the purpose of realising a net investment in an entity operating in that jurisdiction. The jurisdiction in which Entity Y operates is also subject to hyperinflation. However, from 30 April 20X2, the authority allows entities to obtain PC for the purpose of realising a net investment. *[IAS 21.IE14]*.

At the measurement date of 31 December 20X1 Entity X is unable to obtain PC to realise its net investment in Entity Y. Therefore, Entity X concludes that LC is not exchangeable into PC. *[IAS 21.IE15]*.

Estimating the spot exchange rate

Because Entity X concludes that LC is not exchangeable into PC, Entity X is required to estimate the spot exchange rate that meets the objective set out in section 7.3 above. *[IAS 21.IE16]*.

Applying the guidance above, Entity X considers whether it might use the first exchange rate at which it is able to obtain the other currency after exchangeability of the currency is restored (i.e., the first subsequent exchange rate). To do so, it assesses whether the first subsequent exchange rate meets the objective and considers: *[IAS 21.IE17]*

- the time between the measurement date and the date at which exchangeability is restored

  Exchangeability in this case is restored four months after the measurement date.
- inflation rate

  The jurisdiction in which Entity Y operates is subject to hyperinflation.

Considering these factors, Entity X determines that the first subsequent exchange rate does not reflect the prevailing economic conditions at the measurement date. Therefore, the first subsequent exchange rate does not meet the objective in the standard for the purpose of realising Entity X's net investment in Entity Y. However, Entity X could adjust that rate, as necessary, to estimate a rate that meets the objective for realising its net investment in Entity Y. *[IAS 21.IE18]*.

7.3.2 Using another estimation technique

An entity using another estimation technique may use any observable exchange rate, including rates from exchange transactions in markets or exchange mechanisms that do not create enforceable rights and obligations, and adjust that rate, as necessary, to meet the objective set out in section 7.3 above. *[IAS 21.A17]*. In other words, in contrast to the position in Step I, entities are not prohibited from considering many so-called unofficial, parallel or black markets in Step II.

If both exchange rates and inflation rates are required to be estimated for a currency that is hyperinflationary (see Chapter 17, particularly at section 11), consistent assumptions should be used in making both estimates.

7.4 Disclosure requirements when a currency is not exchangeable

When an entity estimates a spot exchange rate because a currency is not exchangeable into another currency, the entity is required to disclose information that enables users of its financial statements to understand how the currency not being exchangeable into the other currency affects, or is expected to affect, the entity's financial performance, financial position and cash flows. To achieve this objective, an entity discloses information about: *[IAS 21.57A]*

- The nature and financial effects of the currency not being exchangeable into the other currency
- The spot exchange rate(s) used
- The estimation process
- The risks to which the entity is exposed because of the currency not being exchangeable into the other currency

An entity considers how much detail is necessary to satisfy the disclosure objective above. It also discloses the information set out below and any additional information necessary to meet the disclosure objective. *[IAS 21.57B, IAS 21.A18]*.

To comply with the requirements above, an entity discloses: *[IAS 21.57B, IAS 21.A19]*

- The currency and a description of the restrictions that result in that currency not being exchangeable into the other currency
- A description of affected transactions
- The carrying amount of affected assets and liabilities
- The spot exchange rates used and whether those rates are observable exchange rates without adjustment (see section 7.3.1 above) or spot exchange rates estimated using another estimation technique (see section 7.3.2 above)
- A description of any estimation technique the entity has used, and qualitative and quantitative information about the inputs and assumptions used in that estimation technique
- Qualitative information about each type of risk to which the entity is exposed because the currency is not exchangeable into the other currency, and the nature and carrying amount of assets and liabilities exposed to each type of risk

When a foreign operation's functional currency is not exchangeable into the presentation currency or, if applicable, the presentation currency is not exchangeable into a foreign operation's functional currency, an entity is required to disclose: *[IAS 21.57B, IAS 21.A20]*

- The name of the foreign operation; whether the foreign operation is a subsidiary, joint operation, joint venture, associate or branch; and its principal place of business
- Summarised financial information about the foreign operation
- The nature and terms of any contractual arrangements that could require the entity to provide financial support to the foreign operation, including events or circumstances that could expose the entity to a loss

7.5 Effective date and transition

Entities are required to apply the amendments for annual reporting periods beginning on or after 1 January 2025. Earlier application is permitted, although if an entity does so, that fact is to be disclosed. *[IAS 21.60L]*.

The transition requirements use the term 'date of initial application' which is the beginning of the annual reporting period in which an entity first applies the amendments. *[IAS 21.60L]*. An entity does not restate comparative information when first applying the amendments. Instead: *[IAS 21.60M]*

- When the entity reports foreign currency transactions in its functional currency, and, at the date of initial application, concludes that its functional currency is not exchangeable into the foreign currency or, if applicable, concludes that the foreign currency is not exchangeable into its functional currency, at the date of initial application, the entity:
  - Translates affected foreign currency monetary items, and non-monetary items measured at fair value in a foreign currency, using the estimated spot exchange rate at that date

    And
  - Recognises any effect of initially applying the amendments as an adjustment to the opening balance of retained earnings
- When the entity uses a presentation currency other than its functional currency, or translates the results and financial position of a foreign operation, and, at the date of initial application, concludes that its functional currency (or the foreign operation's functional currency) is not exchangeable into its presentation currency or, if applicable, concludes that its presentation currency is not exchangeable into its functional currency (or the foreign operation's functional currency), at the date of initial application, the entity:
  - Translates affected assets and liabilities using the estimated spot exchange rate at that date
  - Translates affected equity items using the estimated spot exchange rate at that date if the entity's functional currency is hyperinflationary

    And
  - Recognises any effect of initially applying the amendments as an adjustment to the cumulative amount of translation differences accumulated in a separate component of equity

7.6 Relevant guidance prior to adopting the amendments

Prior to adoption of the amendments discussed in sections 7.1 to 7.5 above, the extant standard addresses the situation where for some reason exchangeability between two currencies is temporarily lacking at the transaction date or subsequently at the end of the reporting period. In this case, IAS 21 requires that the rate to be used is "the first subsequent rate at which exchanges could be made" *[IAS 21.26]* (a requirement that is withdrawn once the amendments are applied). However, the standard did not address the situation where there is a longer-term lack of exchangeability and the rate has not been restored.

The IFRS IC considered this in the context of a number of issues associated with the Venezuelan currency, the Bolivar. A number of official exchange mechanisms have been operating in the country, each with different exchange rates and each theoretically available for specified types of transaction. In practice, however, there have for a number of years been significant restrictions on entities' ability to make more than limited remittances out of the country using these mechanisms.

When the IFRS IC considered the issue in 2018 it described the circumstances in Venezuela in the following terms:

- The exchangeability of the foreign operation's functional currency with other currencies is administered by jurisdictional authorities and this exchange mechanism incorporates the use of (an) exchange rate(s) set by the authorities, i.e., (an) official exchange rate(s)
- The foreign operation's functional currency is subject to a long-term lack of exchangeability with other currencies, i.e., the exchangeability is not temporarily lacking; it has not been restored after the end of the reporting period
- The lack of exchangeability with other currencies has resulted in the foreign operation being unable to access foreign currencies using the exchange mechanism described above

In order to comply with IAS 21, the IFRS IC decided the rate to be used in these circumstances is the one which an entity would have access to through a legal exchange mechanism at the end of the reporting period (or at the date of a transaction). Consequently, an entity assesses whether any of the official exchange rates represent such a rate and uses that rate if it does.[22]

The IFRS IC did not say what rates are to be used if using the official exchange rate(s) did not comply with IAS 21. However, some entities have used an estimated exchange rate, an approach that is not precluded in the circumstances described above and which has been accepted by at least one European regulator.[23]

The IFRS IC noted that in general economic conditions are constantly evolving and highlighted the importance of reassessing at each reporting date whether any of the official exchange rates are to be used. It also drew attention to disclosure requirements in IFRS accounting standards that might be relevant in these circumstances and these are covered in section 11.4 below.[24]

The extreme circumstances in Venezuela which has led some entities to estimate an exchange rate rather than use an official or otherwise observable rate could in theory arise elsewhere. However, such situations would occur only rarely.[25]

Until the amendments are applied, the standard made no reference to the problems noted above in the context of translating the results and financial position of an entity into a different presentation currency, particularly where the results and financial position of a foreign operation are being translated for inclusion in the financial statements of the reporting entity by consolidation or the equity method.

22 *IFRIC Update*, September 2018, available on the IFRS Foundation's website.

23 IASB Staff Paper 2: Project: *IAS 21 - Extreme long-term lack of exchangeability*, Paper topic: *Item for continuing consideration* IFRS IC Meeting, June 2018; IASB Staff Paper 10: Project: *IAS 21 - Determination of the exchange rate when there is a long-term lack of exchangeability*, Paper topic: *Agenda decision to finalise*, IFRS IC Meeting, September 2018. Available on the IFRS Foundation's website.
22nd Extract from EECS's database of enforcement decisions, ESMA, April 2018, Decision Ref. EECS/0118-09.

24 *IFRIC Update*, September 2018, available on the IFRS Foundation's website.

25 IASB Staff Paper 10: Project: *IAS 21 - Determination of the exchange rate when there is a long-term lack of exchangeability*, Paper topic: *Agenda decision to finalise*, IFRS IC Meeting, September 2018. Available on the IFRS Foundation's website.

Where the problem is one of a temporary suspension of rates, the IFRS IC noted that the predominant practice is for the requirement in IAS 21 relating to transactions and balances to be followed; i.e., by using 'the first subsequent rate at which exchanges could be made'. In this context the rate will be the one at which future cash flows could be settled when viewing the net investment as a whole.[26] This approach is broadly consistent with US GAAP which states that the rate to be used to translate foreign financial statements is, in the absence of unusual circumstances, the rate applicable to dividend remittance.

Where there is a longer-term lack of exchangeability, the discussion above will be relevant and determining the appropriate exchange rate to use will require the application of judgement. The rate selected will depend on the entity's individual facts and circumstances, particularly its legal ability to convert currency or to settle transactions using a specific rate and its intent to use a particular mechanism, including whether the rate available through that mechanism is published or readily determinable. The disclosure requirements highlighted by the IFRS IC and covered in section 11.4 below will also be relevant in these circumstances.

26 *IFRIC Update*, November 2014; and IASB Staff Paper 16: Project: *IAS 21*-The Effects of Changes in Foreign Exchange Rates, Paper topic: *Foreign exchange restrictions and hyperinflation*, IFRS IC Meeting, July 2014. Available on the IFRS Foundation's website.

8 Change of presentation currency

IAS 21 does not address how an entity approaches presenting its financial statements if it changes its presentation currency. This is a situation that is commonly faced when the reporting entity determines that its functional currency has changed (the accounting implications of which are set out in IAS 21 and discussed in section 5.5 above). However, it can occur in other situations too.

How we see it

Changing presentation currency is, in our view, similar to a change in accounting policy, the requirements for which are set out in IAS 8. Therefore, when an entity chooses to change its presentation currency, we consider it appropriate to follow the approach in IAS 8 which requires retrospective application except to the extent that this is impracticable (see Chapter 3 at sections 4.4 and 4.7).

Consequently, changing presentation currency will also require the presentation of a statement of financial position at the beginning of the comparative period (see Chapter 3 at sections 2.3 and 2.4). However, the fact that IAS 21 allows a free choice of presentation currency means an entity need not demonstrate that using a different presentation currency provides reliable and more relevant information as it would for a voluntary change of accounting policy (see Chapter 3 at section 4.4).

It almost goes without saying that the comparatives are restated and presented in the new presentation currency. Further, applying the change retrospectively in line with IAS 8 means they are determined as if this had always been the entity's presentation currency (at least to the extent practicable). The SEC, the US regulator, also requires a change in presentation currency to be approached in this way.[27]

The main issue arising in practice is determining the amount of the different components of equity, particularly the exchange differences that IAS 21 requires to be accumulated in a separate component of equity, and how much of those differences relate to each operation within the group. The following Illustration shows the impact of a change in presentation currency of a relatively simple group.

Illustration 8-1: Change of presentation currency

A Canadian parent, P, was established on 1 January 20X0 and issued new shares for C$20 million. On the same date it established two wholly owned subsidiaries, S1 and S2 incorporated in Canada and the UK respectively and subscribed C$10 million and £4.5 million for their entire share capital. The functional currency of each group company was determined to be its local currency, i.e., Canadian dollars for P and S1 and the pound sterling for S2.

During 20X0, S1 made a profit of C$800,000, S2 made a profit of £350,000 and P made a loss of C$25,000. On 30 September 20X0, P issued new shares for C$10 million of which £4 million was used immediately to subscribe for additional shares in S2.

During 20X1, S1 made a profit of C$700,000, S2 made a profit of £750,000 and P made a loss of C$30,000 before dividends received from S2. On 30 June 20X1, S2 paid dividends (out of profits then made) of £700,000 to P and on 30 September 20X1 P paid dividends of C$1,000,000 to its shareholders.

The relevant exchange rates for C$1=£ were as follows:

1 January 20X0	2.10
30 September 20X0	2.28
31 December 20X0	2.35
Average for 20X0	2.24
30 June 20X1	2.55
30 September 20X1	2.63
31 December 20X1	2.40
Average for 20X1	2.52

27 Financial Reporting Manual, SEC, July 2019, para. 6630.1.

Consequently, the statement of changes in equity in P's consolidated financial statements for 20X0 and 20X1 can be summarised as follows:

	Paid-in capital	Retained earnings	Foreign exchange	Total
	C$	C$	C$	C$
1 January 20X0	-	-	-	-
Issue of shares	30,000,000	-	-	30,000,000
Comprehensive income	-	1,559,000	1,443,500	3,002,500
31 December 20X0	30,000,000	1,559,000	1,443,500	33,002,500
Comprehensive income	-	2,560,000	457,500	3,017,500
Dividends	-	(1,000,000)	-	(1,000,000)
31 December 20X1	30,000,000	3,119,000	1,901,000	35,020,000

The comprehensive income reflected within retained earnings represents the profit for each year, calculated as follows:

20X0: C$800,000 + (£350,000 × 2.24) - C$25,000 = C$1,559,000

20X1: C$700,000 + (£750,000 × 2.52) - C$30,000 = C$2,560,000

The foreign exchange differences recognised in other comprehensive income, which are entirely attributable to S2, can be calculated as follows:

	20X0			20X1		
	£	Rate	C$	£	Rate	C$
Opening net assets*	4,500,000	2.10	9,450,000	8,850,000	2.35	20,797,500
		2.35	10,575,000		2.40	21,240,000
Exchange gain			1,125,000			442,500
Additional capital	4,000,000	2.28	9,120,000	-	-	-
		2.35	9,400,000		-	-
Exchange gain			280,000			-
Dividend	-	-	-	(700,000)	2.55	(1,785,000)
		-	-		2.40	(1,680,000)
Exchange gain			-			105,000
Profit	350,000	2.24	784,000	750,000	2.52	1,890,000
		2.35	822,500		2.40	1,800,000
Exchange gain/(loss)			38,500			(90,000)
	8,850,000		**1,443,500**	**8,900,000**		**457,500**

* For 20X0, includes the proceeds received for issuing shares on 1 January.

For the year ended 31 December 20X2, P decided to change its presentation currency to sterling. This might or might not have coincided with a change of P's functional currency. In P's consolidated financial statements for the year ended 31 December 20X2, what amounts are to be included in respect of the comparative period?

Direct method

If P's accounting policy was to use the direct method of consolidation (see section 6.1.4 above), its financial statements for 20X0 and 20X1 would have been prepared by translating the financial statements of each entity within the group directly into sterling (where necessary). The revised statement of changes in equity in P's consolidated financial statements can be summarised as follows and these are the amounts that will be reflected as comparative amounts in P's consolidated financial statements for the year ended 31 December 20X2:

	Paid-in capital	Retained earnings	Foreign exchange	Total
	£	£	£	£
1 January 20X0	-	-	-	-
Issue of shares	13,909,775	-	-	13,909,775
Comprehensive income	-	695,982	(562,140)	133,842
31 December 20X0	13,909,775	695,982	(562,140)	14,043,617
Comprehensive income	-	1,015,873	(87,595)	928,278
Dividends	-	(380,228)	-	(380,228)
31 December 20X1	13,909,775	1,331,627	(649,735)	14,591,667

The table above assumes that P will record its paid-in capital at historical exchange rates (£13,909,775 = C$20,000,000 ÷ 2.10 + C$10,000,000 ÷ 2.28). Alternatively, P could retranslate those amounts at year end rates although any difference arising would simply be recorded in another component of equity (but not the foreign exchange reserve) and this difference would not affect profit or loss or other comprehensive income in any period (see sections 6.2.1 and 6.2.2 above).

The calculations showing how these amounts have been determined are shown below.

The comprehensive income reflected within retained earnings represents the profit for each year, calculated as follows:

20X0: (C$800,000 ÷ 2.24) + £350,000 - (C$25,000 ÷ 2.24) = £695,982

20X1: (C$700,000 ÷ 2.52) + £750,000 - (C$30,000 ÷ 2.52) = £1,015,873

In this case, the profit calculated in this way results in the same amount as translating the consolidated profit of C$1,559,000 and C$2,560,000 presented in Canadian dollars at the average rate for the period of C$2.24=£1 and C$2.52=£1 respectively. In practice minor differences can arise as a result of imperfections in the average rates used.

Similarly, the net assets presented above are the same as the amounts obtained by translating consolidated net assets of C$33,002,500 and C$35,020,000 at the closing rates at the end of the relevant period, C$2.35=£1 and C$2.40=£1 respectively. This would always be the case.

However, the foreign exchange reserve is fundamentally different to that in the financial statements presented in Canadian dollars. In this case it represents exchange differences arising from the translation of both P's and S1's financial statements into sterling whereas previously it represented exchange differences arising from the translation of S2's financial statements into Canadian dollars.

The foreign exchange differences recognised in other comprehensive income that are attributable to P can be calculated as follows:

	20X0			20X1		
	C$	Rate	£	C$	Rate	£
Opening net assets*	550,000	2.10	261,905	1,405,000	2.35	597,872
		2.35	234,042		2.40	585,417
Exchange loss			(27,863)			(12,455)
Additional capital**	880,000	2.28	385,965	-	-	-
		2.35	374,468		-	-
Exchange loss			(11,497)			-
Dividend received	-	-	-	1,785,000	2.55	700,000
		-	-		2.40	743,750
Exchange gain			-			43,750
Dividend paid	-	-	-	(1,000,000)	2.63	(380,228)
		-	-		2.40	(416,667)
Exchange loss			-			(36,439)
Loss	(25,000)	2.24	(11,161)	(30,000)	2.52	(11,905)
		2.35	(10,638)		2.40	(12,500)
Exchange gain/(loss)			523			(595)
	1,405,000		**(38,837)**	**2,160,000**		**(5,739)**

* For 20X0, includes the proceeds received for issuing shares on 1 January (C$20,000,000) less amounts invested in S1 (C$10,000,000) and S2 (C$9,450,000 = £4,500,000 × 2.10) on the same date.

** Reduced by the amounts invested in S2 on the same date.

The foreign exchange differences recognised in other comprehensive income that are attributable to S1 can be calculated as follows:

	20X0			20X1		
	C$	Rate	£	C$	Rate	£
Opening net assets*	10,000,000	2.10	4,761,905	10,800,000	2.35	4,595,745
		2.35	4,255,319		2.40	4,500,000
Exchange loss			(506,586)			(95,745)
Profit	800,000	2.24	357,143	700,000	2.52	277,778
		2.35	340,426		2.40	291,667
Exchange (loss)/gain			(16,717)			13,889
	10,800,000		**(523,303)**	**11,500,000**		**(81,856)**

* For 20X0, includes the proceeds received for issuing shares on 1 January.

Therefore the total foreign exchange loss arising in 20X0 is £562,140 (£38,837 + £523,303) and in 20X1 is £87,595 (£5,739 + £81,856).

Under this method amounts in the foreign exchange reserve would be reclassified to profit or loss on the subsequent disposal of S1, but not on the subsequent disposal of S2.

Step-by-step method

If P's accounting policy was to use the step-by-step method of consolidation (see section 6.1.4 above), the first step in producing its consolidated financial statements for 20X0 and 20X1 would have been to translate the financial statements of S2 into Canadian dollars, the functional currency of P, to produce consolidated financial statements in Canadian dollars (effectively those that P had prepared historically). The second step involves translating these consolidated financial statements into sterling.

These financial statements (and hence the comparative amounts included in the financial statements for the year ended 31 December 20X2) will appear to be the same as those produced under the direct method (assuming equity items are dealt with similarly, i.e., paid-in capital is translated at the relevant rate at the date of issue and that retained earnings represent each element translated at the relevant rates, being 20X0 and 20X1 profit at the average rate for the year, and dividends at the date of payment). However, the balance on the foreign exchange reserve will be attributable to different entities within the group (see section 6.6.3 above). The calculations showing how these amounts have been determined are shown below.

The foreign exchange differences recognised in other comprehensive income in the financial statements presented in Canadian dollars that are attributable to S2 will remain attributable to S2, albeit that they are translated into sterling at the average rate:

20X0: C$1,443,500 ÷ 2.24 = £644,420

20X1: C$457,500 ÷ 2.52 = £181,548

The remaining exchange differences recognised in other comprehensive income, which arise from retranslating P's consolidated financial statements presented in Canadian dollars into sterling, are attributable to P. They can be calculated as follows:

	20X0			20X1		
	C$	Rate	£	C$	Rate	£
Opening net assets*	20,000,000	2.10	9,523,809	33,002,500	2.35	14,043,617
		2.35	8,510,638		2.40	13,751,042
Exchange loss			(1,013,171)			(292,575)
Additional capital	10,000,000	2.28	4,385,965	-	-	-
		2.35	4,255,319		-	-
Exchange loss			(130,646)			-
Dividend paid	-	2.24	-	(1,000,000)	2.63	(380,228)
		2.35	-		2.40	(416,667)
Exchange loss			-			(36,439)
Comprehensive	3,002,500	2.24	1,340,402	3,017,500	2.52	1,197,421
Income		2.35	1,277,660		2.40	1,257,292
Exchange (loss)/gain			(62,742)			59,871
	33,002,500		**(1,206,559)**	**35,020,000**		**(269,143)**

* For 20X0, includes the proceeds received for issuing shares on 1 January.

In contrast to the direct method, under this method amounts in the foreign exchange reserve would be reclassified to profit or loss on the subsequent disposal of S2, but not on the subsequent disposal of S1.

In the Illustration above, it was reasonably straightforward to recreate the consolidated equity balances and identify the amounts of accumulated exchange differences related to each entity within the group using the new presentation currency. This is because the group had a very simple structure with operations having only two functional currencies, a short history and few (external and internal) equity transactions. Whilst a theoretically perfect restatement is the goal to aim for, in practice it is unlikely to be such an easy exercise.

As noted above, where an accounting policy is changed, IAS 8 requires retrospective application except to the extent that this is impracticable, in which case an entity adjusts the comparative information to apply the new accounting policy prospectively from the earliest practicable date.

How we see it

Applying a similar approach to that in IAS 8 is, in our view, appropriate when an entity changes its presentation currency. In this context the most important component of equity to determine correctly (or as near correctly as possible) is normally the foreign exchange reserve because that balance, or parts of it, are reclassified from equity to profit or loss in the event of any future disposal of the relevant foreign operation, and could therefore affect future earnings.

Where an entity applies the direct method of consolidation, it could be impracticable to determine precisely the amount of exchange differences accumulated within the separate component of equity relating to each individual entity within the group. In these circumstances, approximations will be necessary to determine the amounts at the beginning of the earliest comparative period presented, although all subsequent exchange differences are accumulated in accordance with the requirements of IAS 21. For an entity that set its foreign exchange reserve to zero on transition to IFRS accounting standards (see Chapter 6 at section 5.6) it may be able to go back to that date and recompute the necessary components of equity. This is likely to be less of an issue for entities applying the step-by-step method.

UBS and CRH changed their presentation currency in 2018 and 2020 respectively and included the following explanations in their accounting policies.

Practical example 8-1: UBS Group AG (2018) **Switzerland**

Annual Report 2018 [extract]

Notes to the UBS Group AG consolidated financial statements [extract]

Note 1 Summary of significant accounting policies [extract]

1) Changes in functional and presentation currency [extract]

1) Changes in functional and presentation currency

Change in functional currencies

As a consequence of legal entity structural changes over recent years – notably the transfer of the Personal & Corporate Banking and Global Wealth Management businesses booked in Switzerland from UBS AG to UBS Switzerland AG, and the creation of UBS Business Solutions AG, which houses a significant portion of the employees and associated costs that were previously held in UBS AG's Head Office in Switzerland and UBS AG's London Branch – a concentration of US dollar-influenced and -managed business activities now exist in UBS AG's Head Office in Switzerland and UBS AG's London Branch. In addition, from the fourth quarter of 2018, for risk management purposes UBS adopted the US dollar as the risk-neutral currency and has adjusted its structural risk positions accordingly. As a result of these changes, effective from 1 October 2018, the functional currency of UBS Group AG and UBS AG's Head Office in Switzerland changed prospectively from Swiss francs to US dollars and that of UBS AG's London Branch changed from British pounds to US dollars, in compliance with the requirements of IAS 21, *The Effects of Changes in Foreign Exchange Rates*.

Change in presentation currency

In 2018, the presentation currency of UBS Group AG's consolidated financial statements has changed from Swiss francs to US dollars to align with the functional currency changes of significant Group entities. UBS has restated prior periods for this voluntary presentational change in line with IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, from 1 January 2004. This point in time represented the earliest date from which it was practicable to perform a restatement, given the lack of sufficiently reliable data for earlier periods. As a consequence, foreign currency translation (FCT) gains or losses prior to 2004 have been disregarded, with FCT effects first calculated from 1 January 2004 onward. In addition, UBS has included a second comparative balance sheet as of 1 January 2017 in line with IAS 1, *Presentation of Financial Statements*.

Income and expenses as well as *Other comprehensive income* (OCI) were translated to US dollars at the respective average exchange rates prevailing for the relevant periods. Additionally, *Other income* was restated to reflect releases of FCT gains or losses from OCI to the income statement when calculated under the new US dollar presentation currency. The effect of such restatements for 2018, 2017 and 2016 was not material to the income statements of these periods.

Assets, liabilities and total equity were translated at closing exchange rates prevailing on the respective balance sheet dates, after reflection of deferred tax effects relating to the restatement. Share capital issued, share premium and treasury shares held were translated at historic average rates, whereby differences between historic average rate and closing exchange rate realized upon repayment of share capital or disposal of treasury shares were reported as *Share premium*. Cumulative amounts recognized in OCI in respect of cash flow hedges and financial assets measured at FVOCI (prior to 1 January 2018: financial assets classified as available for sale) were translated at closing exchange rate as of respective balance sheet dates, with any translation effects adjusted through *Retained earnings*.

The restated FCT balance as of 1 October 2018 included a cumulative gain of USD 767 million related to previously applied net investment hedges entered into by UBS Group AG or UBS AG's Head Office to hedge investments in foreign operations against their former Swiss franc functional currency.

The restated basic and diluted earnings per share (EPS) were USD 0.26 and USD 0.25 for the year ended 31 December 2017, which compares to CHF 0.28 and CHF 0.27 basic and diluted EPS under the previous Swiss franc presentation currency. For the year ended 31 December 2016, restated basic and diluted EPS were USD 0.90 and USD 0.88, which compares to CHF 0.86 and CHF 0.84 basic and diluted EPS under the previous Swiss franc presentation currency.

Practical example 8-2: CRH public limited company (2020) **Ireland**

2020 Annual Report and Form 20-F [extract]

Financials [extract]

Accounting policies (including key accounting estimates and assumptions) [extract]

Change in presentation currency

On 28 February 2020, the Group announced that with effect from 1 January 2020 it would be changing the currency in which it presents its financial results from euro to US Dollar. Within our current portfolio of businesses, our euro denominated earnings, while sizeable, are a relatively lower proportion of overall earnings. To reduce the potential for foreign exchange volatility in our future reported earnings, the Board determined that, with effect from 1 January 2020, CRH will present its results in US Dollar. Given the current composition of the Group's activities, this change is expected to reduce the impact of currency movements on reported results.

Accordingly, to satisfy the requirements of IAS 21 *The Effects of Changes in Foreign Exchange Rates*, the reported results for the years ended

31 December 2019 and 31 December 2018 have been translated from euro to US Dollar using the following procedures:

- Assets and liabilities denominated in non-US Dollar currencies were translated into US Dollar at the relevant closing rates of exchange;
- The trading results of subsidiaries whose functional currency was other than US Dollar were translated into US Dollar at the relevant average rates of exchange;
- Movements in other reserves were translated into US Dollar at the relevant average rates of exchange;
- Significant business divestments were translated at the spot rates prevailing on the date of divestment;
- Share capital, share premium, Treasury Shares/ own shares and dividends were translated at the historic rates prevailing on the date of each transaction; and
- The cumulative translation reserve was set to nil at 1 January 2004, the date of transition to IFRS, and has been restated on the basis that the Group has reported in US Dollar since that date

A change in presentation currency represents a change in accounting policy under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* which is accounted for retrospectively. An opening balance sheet has been presented showing the impact of the change in presentation currency on 31 December 2018. The average and closing rates used for this exercise are provided on page 146.

9 Introduction of the euro

From 1 January 1999, the effective start of Economic and Monetary Union (EMU), the euro became a currency in its own right and the conversion rates between the euro and the national currencies of those countries who were going to participate in the first phase were irrevocably fixed, such that the risk of subsequent exchange differences related to these currencies was eliminated from that date on.

In October 1997, the SIC issued SIC-7 which deals with the application of IAS 21 to the changeover from the national currencies of participating Member States of the European Union to the euro. Consequential amendments have been made to this interpretation as a result of the IASB's revised version of IAS 21.

Although the Interpretation is no longer relevant with respect to the national currencies of those countries that participated in the first phase, SIC-7 makes it clear that the same rationale applies to the fixing of exchange rates when countries join EMU at later stages. *[SIC-7.3]*.

Under SIC-7, the requirements of IAS 21 regarding the translation of foreign currency transactions and financial statements of foreign operations are to be strictly applied to the changeover. *[SIC-7.3]*.

This means that, in particular:

(a) Foreign currency monetary assets and liabilities resulting from transactions continue to be translated into the functional currency at the closing rate. Any resultant exchange differences are recognised as income or expense immediately, except that an entity continues to apply its existing accounting policy for exchange gains and losses related to hedges of the currency risk of a forecast transaction. *[SIC-7.4]*.

The effective start of the EMU after the reporting period does not change the application of these requirements at the end of the reporting period; in accordance with IAS 10 *Events after the Reporting Period* it is not relevant whether or not the closing rate can fluctuate after the reporting period. *[SIC-7.5]*.

Like IAS 21, the Interpretation does not address how foreign currency hedges are accounted for. The effective start of EMU, of itself, does not justify a change to an entity's established accounting policy related to hedges of forecast transactions because the changeover does not affect the economic rationale of such hedges. Therefore, the changeover does not alter the accounting policy where gains and losses on financial instruments used as hedges of forecast transactions are initially recognised in other comprehensive income and reclassified from equity to profit or loss to match with the related income or expense in a future period. *[SIC-7.6]*.

(b) Cumulative exchange differences relating to the translation of financial statements of foreign operations recognised in other comprehensive income remain accumulated in a separate component of equity and be reclassified from equity to profit or loss only on the disposal (or partial disposal) of the net investment in the foreign operation. *[SIC-7.4]*.

The fact that the cumulative amount of exchange differences will be fixed under EMU does not justify immediate recognition as income or expenses since the wording and the rationale of IAS 21 clearly preclude such a treatment. *[SIC-7.7]*.

10 Tax effects of all exchange differences

Extract from IAS 21

Tax effects of all exchange differences

50 Gains and losses on foreign currency transactions and exchange differences arising on translating the results and financial position of an entity (including a foreign operation) into a different currency may have tax effects. IAS 12 *Income Taxes* applies to these tax effects.

The requirements of IAS 12 are discussed in Chapter 29. *[IAS 21.50]*. In broad terms the tax effects of exchange differences will follow the reporting of the exchange differences, i.e., they will be recognised in profit or loss except to the extent they relate to exchange differences recognised in other comprehensive income, in which case they will also be recognised in other comprehensive income. *[IAS 12.58]*.

The tax base of a non-monetary asset such as property, plant or equipment, will sometimes be determined in a currency other than the entity's functional currency. Consequently, changes in the exchange rate will give rise to temporary differences that result in a recognised deferred tax liability or asset (subject to recoverability). The resulting deferred tax is recognised in profit or loss, *[IAS 12.41]*, and presented with other deferred taxes rather than with foreign exchange gains or losses (see Chapter 29 at section 10.1.1).[28]

28 *IFRIC Update*, January 2016, available on the IFRS Foundation's website.

11 Presentation and disclosure requirements

11.1 Exchange differences

IAS 21 requires the amount of exchange differences recognised in profit or loss (except for those arising on financial instruments measured at fair value through profit or loss in accordance with IFRS 9) to be disclosed. *[IAS 21.52]*.

Neither IAS 21 nor IAS 1 specify where such exchange differences are presented in the income statement and, prior to adoption of IFRS 18, entities apply judgement in the light of the requirements of IAS 1 to determine the appropriate line item(s) in which exchange differences are included. For example, an entity which has an operating and a financing section within its income statement might include exchange differences arising on operating items (such as trade payables and receivables) in other operating income or expense and exchange differences on financing items (such as loans and borrowings) in the financing section.

How we see it

In the light of this need to apply judgement, we recommend that entities in disclosing the amount of such exchange differences indicate the line item(s) in which they are included.

Further, the classification of exchange differences (both gains and losses) arising from transactions of a similar nature are to be classified consistently throughout the periods presented.

IFRS 18 replaces IAS 1 for periods commencing on or after 1 January 2027. It is more prescriptive about the structure of the income statement and where within that structure foreign exchange gains and losses are presented. In summary, exchange differences are normally presented in the same category of the income statement as the income and expenses from the items that gave rise to them. The main exception is when this would involve undue cost or effort, in which case the foreign exchange differences are presented in the operating category. *[IFRS 18.48, IFRS 18.B65, IFRS 18.B68]*. The standard contains further requirements and guidance on presenting exchange differences within profit and loss categories, including those that are reclassified to profit or loss on disposal of a foreign operation, matters which are addressed more fully in Chapter 4, primarily at section 3.2.7.

IAS 21 also requires disclosure of the net exchange differences recognised in other comprehensive income and accumulated in a separate component of equity, and a reconciliation of such amounts at the beginning and end of the period. *[IAS 21.52]*.

11.2 Presentation and functional currency

IAS 21 requires: *[IAS 21.53]*

Extract from IAS 21	
53	**When the presentation currency is different from the functional currency, that fact shall be stated, together with disclosure of the functional currency and the reason for using a different presentation currency.**

For this purpose, in the case of a group, the references to 'functional currency' are to that of the parent. *[IAS 21.51]*.

When there is a change in the functional currency of either the reporting entity or a significant foreign operation, that fact and the reason for the change in functional currency is disclosed. *[IAS 21.54]*.

11.3 Convenience translations of financial statements or other financial information

Paragraph 55 of IAS 21 indicates that when an entity presents its financial statements in a currency that is different from its functional currency, it describes the financial statements as complying with IFRS accounting standards only if they comply with all the requirements of each applicable standard and interpretation of those standards, including the translation method set out in IAS 21 (see section 6.1 above). *[IAS 21.55]*.

However, the standard recognises that an entity sometimes presents its financial statements or other financial information in a currency that is not its functional currency without meeting the above requirements. Examples noted by IAS 21 are where an entity converts into another currency only selected items from its financial statements or where an entity whose functional currency is not the currency of a hyperinflationary economy converts the financial statements into another currency by translating all items at the most recent closing rate. Such conversions are not in accordance with IFRS accounting standards; nevertheless IAS 21 requires disclosures to be made. *[IAS 21.56]*.

The standard requires that when an entity displays its financial statements or other financial information in a currency that is different from either its functional currency or its presentation currency and the requirements of IAS 21.55 are not met, it is to: *[IAS 21.57]*

(a) Clearly identify the information as supplementary information to distinguish it from the information that complies with IFRS accounting standards

(b) Disclose the currency in which the supplementary information is displayed

(c) Disclose the entity's functional currency and the method of translation used to determine the supplementary information

For the purpose of these requirements, in the case of a group, the references to 'functional currency' are to that of the parent. *[IAS 21.51]*.

11.4 Judgements made in applying IAS 21 and related disclosures

IAS 1 or, for entities applying IFRS 18, IAS 8 requires disclosure of the significant judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements (see Chapter 3 at section 5.1.1.A). *[IAS 1.122, IAS 8(2027).27G]*. The application of IAS 21 can, in certain circumstances, require the exercise of significant judgement, particularly the determination of functional currency (see section 4 above) and assessing whether intragroup monetary items are permanent as equity (see section 6.3.1 above). Where relevant, information about these particular judgements is disclosed.

Section 7.4. sets out the disclosure requirements for entities applying the amendments to IAS 21 issued in August 2023 that address a currency's lack of exchangeability. For entities not yet adopting those amendments the IFRS IC drew attention to a number of disclosure requirements in IFRS accounting standards that might be relevant when an entity has material foreign operations subject to extensive currency controls, multiple exchange rates and/or a long-term lack of exchangeability. In particular, the IFRS IC highlighted the importance of providing information that is relevant to an understanding of the entity's financial statements. *[IAS 1.122]*.

In addition to disclosing the significant judgements in applying an entity's accounting policies, the IFRS IC also considered the following disclosures to be important:[29]

- Significant accounting policies applied *[IAS 1.117-121]*
- Sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year, which may include a sensitivity analysis *[IAS 1.125-133]*
- The nature and extent of significant restrictions on an entity's ability to access or use assets and settle the liabilities of the group, or in relation to its joint ventures or associates *[IFRS 12.10, IFRS 12.13, IFRS 12.20, IFRS 12.22]*

Finally, the following may also be relevant:[30]

- The nature and extent of risks (including foreign exchange risk) arising from financial instruments (from a qualitative and quantitative perspective and including sensitivity analyses) *[IFRS 7.31-42, IFRS 7.B6-B24]*
- Significant cash held by the entity that is not available for use by the group, including due to exchange controls *[IAS 7.48, IAS 7.49]*
- The amount of foreign exchange differences recognised in profit or loss and other comprehensive income *[IAS 21.52]*

29 *IFRIC Update*, November 2014 and *IFRIC Update*, September 2018. Available on the IFRS Foundation's website.

30 IASB Staff Paper 16: Project: *IAS 21-The Effects of Changes in Foreign Exchange Rates*, Paper topic: *Foreign exchange restrictions and hyperinflation*, IFRS IC Meeting, July 2014. Available on the IFRS Foundation's website.

11.5 Subsidiaries without public accountability

IFRS 19 *Subsidiaries without Public Accountability: Disclosures* was issued by the IASB in May 2024 to simplify the preparation of financial statements by eligible subsidiaries. Eligible subsidiaries that elect to apply IFRS 19 are allowed to provide reduced disclosure while still applying the recognition, measurement and presentation requirements in other IFRS Accounting Standards. IFRS 19 is effective for annual reporting periods beginning on or after 1 January 2027, with earlier application permitted (subject to jurisdictional endorsement). Further details on IFRS 19, including the relevant eligibility criteria, are addressed in Chapter 4 at section 7.

IFRS 19 contains substantially the same disclosure requirements as IAS 21, the one exception being that those addressing convenience translations and related information (see section 11.3 above) are not included. An exposure draft published in July 2024 proposes limited amendments to the disclosure requirements applying when a currency lacks exchangeability (see section 7.4 above). The disclosure objective would be removed, along with guidance about the level of detail to be given to achieve that objective, but all other requirements would remain.

12 Future developments

12.1 Translation to a Hyperinflationary Presentation Currency

As set out in section 6.1 above, in July 2024 the IASB published *Translation to a Hyperinflationary Presentation Currency,* an exposure draft of proposals to amend IAS 21 that would specify how a parent with a hyperinflationary presentation currency accounts for a non-hyperinflationary foreign operation. It would also specify the approach to be taken in the related situation where an entity whose functional currency is the currency of a non-hyperinflationary economy presents its financial statements in the currency of a hyperinflationary economy.

The exposure draft proposes the following:

- When an entity's presentation currency is the currency of a hyperinflationary economy, but its functional currency is the currency of a non-hyperinflationary economy, all amounts relating to the entity's results and financial position (i.e., assets, liabilities, equity items, income and expenses, including comparatives) are translated into the presentation currency at the closing rate at the date of the entity's most recent statement of financial position.
- In those circumstances, the following disclosures would be required:
  - The fact that all amounts (i.e., assets, liabilities, equity items, income and expenses, including comparatives) in the entity's financial statements or in the results and financial position of its foreign operation (or operations) have been translated at the closing rate at the date of its most recent statement of financial position.
  - Summarised financial information about the foreign operation(s) for which the results and financial position have been translated using the above approach, to enable users of the financial statements to assess the effect of these foreign operations on the entity's results and financial position.
- If the economy whose currency is the entity's presentation currency ceases to be hyperinflationary and the entity's functional currency continues to be the currency of a non-hyperinflationary economy, in the reporting period in which the change occurs the entity would apply the normal approach set out in section 6.1.1 above (paragraph 39 of IAS 21), prospectively from the beginning of that reporting period without restating amounts arising before the beginning of that reporting period. The entity would also be required to disclose that its presentation currency ceased to be the currency of a hyperinflationary economy.

These requirements would be applied retrospectively in accordance with IAS 8, although disclosure of the effect on each financial statement line item of these requirements would not be required.

12.2 Other developments

In its Third Agenda Consultation, launched in March 2021, foreign currencies were described as one topic (of many) that had been frequently identified as potential projects for the IASB's work programme. In particular, it had been suggested that the following matters could be considered:

- Reviewing the factors used to determine a company's functional currency
- Clarifying the accounting for foreign currency derivatives within the scope of IAS 21
- Deciding whether the accounting requirements for long-term payables and receivables denominated in a foreign currency are appropriate when the currency is volatile and thinly traded
- Developing enhanced disclosures about the effect of changes in foreign exchange rates on the financial statements

However, the IASB's Feedback Statement to the consultation, which was published in July 2022, explained that many respondents identified projects on foreign currency as low priority and no such project has been added to the IASB's work plan. Therefore it seems unlikely there will be any major standard setting work in the area of foreign currencies over the next few years.

The IASB's other projects can touch on the application of IAS 21. For example, an IFRS accounting standard is being developed to address rate regulated activities and, at the time of writing, this is expected to be published sometime in 2025. In May 2023, it was tentatively agreed that any regulatory assets or regulatory liabilities arising from regulated rates denominated in a foreign currency would be treated as monetary items when applying IAS 21.[31]

31 *IASB Update*, May 2023, available on the IFRS Foundation's website.

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Appendix B - Defined terms

Extract from IAS 21

8 The following terms are used in this Standard with the meanings specified:

Closing rate is the spot exchange rate at the end of the reporting period.

A currency is *exchangeable* into another currency when an entity is able to obtain the other currency within a time frame that allows for a normal administrative delay and through a market or exchange mechanism in which an exchange transaction would create enforceable rights and obligations.

Exchange difference is the difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Exchange rate is the ratio of exchange for two currencies.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13 *Fair Value Measurement*.)

Foreign currency is a currency other than the functional currency of the entity.

Foreign operation is an entity that is a subsidiary, associate, joint arrangement or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.

Functional currency is the currency of the primary economic environment in which the entity operates.

A *group* is a parent and all its subsidiaries.

Monetary items are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.

Net investment in a foreign operation is the amount of the reporting entity's interest in the net assets of that operation.

Presentation currency is the currency in which the financial statements are presented.

Spot exchange rate is the exchange rate for immediate delivery.

Chapter 17 Hyperinflation

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Overview

This chapter addresses the requirements of IAS 29 *Financial Reporting in Hyperinflationary Economies*.

In an environment where significant levels of inflation exist, the usefulness of reporting is hindered. Changes in the 'real' growth of revenues and expenses cannot be discerned, and the values of assets and liabilities ordinarily measured on an historical cost basis are not reflective of their true value at the reporting date. In addition, the loss in value of items of a monetary nature is not reflected.

IAS 29 addresses these challenges by providing a framework for identifying currencies that are sufficiently inflationary to warrant adjustment for inflation, as well as the methods for making such adjustments. The standard outlines when hyperinflation exists, as identified by a number of common characteristics of the economy. For periods when hyperinflation is present, IAS 29 requires that all items are restated from their amounts as determined by other standards, by a measure of the inflation from the transaction or measurement date to the reporting date. This also applies to comparative figures, which are to be restated in terms of the measuring unit current at the end of the current reporting period.

To perform the required restatement of financial statements, assets and liabilities are separated into those that are monetary and non-monetary, with non-monetary items further divided into those measured on either a current or historical basis. Monetary items and non-monetary but current items are already measured at the monetary unit present at the reporting date and therefore do not require restatement. The restatement required by the standard therefore applies to non-monetary historical value assets and liabilities, as well as transactions. This process has consequential impacts on a number of items, including the calculation of deferred tax and the testing for impairments. The gain or loss in the value of monetary items for the period is reflected in profit or loss.

The application of this standard requires numerous judgements. Some of these require consensus with the broader reporting community, such as when the use of IAS 29 is required, while others would need to be evaluated based on the circumstances of a particular entity. The standard acknowledges this complexity by conceding that the consistent application of these inflation accounting procedures and judgements from period to period is more important than the precise accuracy of the resulting amounts included in the restated financial statements.

The application of IAS 29 is particularly complex where a significant amount of historical information is required. In addition, areas that may require additional attention from preparers include the first-time application of the standard; the computation of deferred tax; groups with both hyperinflationary and non-hyperinflationary entities; and interim reporting.

Entities facing hyperinflation are often also affected by complexities relating to foreign currency translation, which are discussed further in Chapter 16.

What you need to know

- The need to apply IAS 29 is assessed at a currency level, rather than a reporting entity level, and therefore this standard shall only be applied where consensus has been reached for a given currency.
- The application of this standard requires judgement in both the interpretation, where specific guidance is not provided, as well as application, and therefore consistency is prioritised over precision.
- Given the complexity of the reporting process, preparers of IAS 29 financial statements should be mindful of the requirement to disclose significant judgements and estimates.

1 Introduction

1.1 Background

Accounting standards are applied on the assumption that the value of money (the unit of measurement) is constant over time, which normally is an acceptable practical assumption. However, when the effect of inflation on the value of money is no longer negligible, the usefulness of historical cost based financial reporting is often significantly reduced. High rates of inflation give rise to a number of problems for entities that prepare their financial statements on a historical cost basis, for example:

- Historical cost figures expressed in terms of monetary units do not show the 'value to the business' of assets.
- Holding gains on non-monetary assets that are reported as operating profits do not represent real economic gains.
- Financial information presented for the current period is not comparable with that presented for the prior periods.

  And
- 'Real' capital can be reduced because profits reported do not take account of the higher replacement costs of resources used in the period. Therefore, if calculating a nominal 'return on capital' based on profit, and not distinguishing this properly from a real 'return of capital', the erosion of capital may go unnoticed in the financial statements. This is the underlying point in the concept of capital maintenance.

The IASB's *The Conceptual Framework for Financial Reporting* discusses the concept of capital maintenance, which raises the issue of how an entity defines capital. In general terms, an entity maintains its capital if it has as much capital at the end of the period as it had at the beginning, the issue being how this evaluation is measured. Whilst there are different concepts of capital maintenance, the IFRS accounting standards are ultimately based on the financial capital maintenance concept.

Under the financial capital maintenance concept, the capital of the entity will be maintained if the financial amount of net assets at the end of a period is at least equal to the financial amount of net assets at the beginning of that period, excluding contributions from and distributions to owners during the period. *[CF 8.3(a)]*. To facilitate the evaluation of capital maintenance in a hyperinflationary environment, IAS 29 was adopted in April 2001.

The IASB and IFRS IC subsequently made changes to the standards regarding the subject of hyperinflation only to clarify the provisions of the standard. In 2005, IFRIC 7 *Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies* was issued to provide guidance on applying IAS 29 in the reporting period in which an entity's functional currency first becomes hyperinflationary (see section 10.1 below). In 2010 the IASB issued an amendment to IFRS 1 *First-time Adoption of International Financial Reporting Standards* for countries that exit severe hyperinflation (see section 10.3 below).

FASB differences

Differences between the IFRS and US GAAP guidance on this topic are not addressed in this chapter as the standards are not converged. Therefore, differences between IFRS and US GAAP may exist that are not discussed in this chapter.

1.2 Hyperinflationary economies

In some countries, inflation has reached such levels that the local currency is no longer a useful measure of value in the economy and the general population may prefer not to hold its wealth in the local currency. Instead, they hold their wealth in a stable foreign currency or non-monetary assets. Such a condition is often referred to as hyperinflation.

There are several characteristics that need to be considered under IFRS accounting standards to determine whether hyperinflation exists. The IASB does not monitor inflation rates in specific jurisdictions, nor does it conclude on the applicability of the characteristics to these jurisdictions. Where the assessment of the characteristics is unclear, consensus is at times facilitated by local regulators and professional bodies.

1.3 Restatement approach

The problems of historical cost based financial reporting may reach such a magnitude under hyperinflationary circumstances that financial reporting in the hyperinflationary currency is no longer useful. Therefore, a solution is needed to allow meaningful financial reporting by entities that operate in these hyperinflationary economies.

IAS 29 requires a restatement approach, whereby financial information recorded in the hyperinflationary currency is adjusted by applying a general price index and expressed in the measuring unit current at the end of the reporting period (i.e., the accounting value is adjusted for a factor of current purchasing power). This process aims to improve comparability between periods by restating financial information for changes in the purchasing power of money.

2 The requirements of IAS 29

2.1 The context of IAS 29

The underlying premise of IAS 29 is that "reporting of operating results and financial position in the local [hyperinflationary] currency without restatement is not useful". *[IAS 29.2]*. The standard's approach is therefore to require that:

(a) The financial statements of an entity whose functional currency is the currency of a hyperinflationary economy shall be stated in terms of the measuring unit current at the end of the reporting period.

(b) The corresponding figures for the previous period required by IAS 1 *Presentation of Financial Statements* and any information in respect of earlier periods shall also be stated in terms of the measuring unit current at the end of the reporting period.

And

(c) The gain or loss on the net monetary position shall be included in profit or loss and separately disclosed. *[IAS 29.8, IAS 29.9]*.

IAS 29 requires amounts recorded in the statement of financial position, not already expressed in terms of the measuring unit current at the end of the reporting period, to be restated in terms of the current measuring unit at the end of the reporting period, by applying a general price index. *[IAS 29.11]*. The Illustration below illustrates how this would apply to the statement of financial position of an entity:

Illustration 2-1: Accounting for hyperinflation under IAS 29

An entity that operates in a hyperinflationary economy is required under IAS 29 to restate all non-monetary items in its statement of financial position to the measuring unit current at the end of the reporting period by applying a general price index as follows:

	Before restatement (HC)	Historical general price index*	Year-end general price index	After restatement (HC)
Plant and equipment	225	150	600	900
Inventory	250	500	600	300
Cash	100			100
Total assets	**575**			**1,300**
Accounts payable	180			180
Long-term debt	250			250
Equity **	145			870
	575			**1,300**

* General price index at the date of purchase

** The restatement of equity is not illustrated here, but is discussed in section 5 below.

The simplified Illustration above already raises a number of questions, such as:

- Which items are monetary, and which are non-monetary?
- How does the entity select the appropriate general price index?
- What was the general price index when the assets were acquired?

The standard provides guidance on the restatement to the measuring unit current at the end of the reporting period, but concedes that the consistent application of these inflation accounting procedures and judgements from period to period is more important than the precise accuracy of the resulting amounts included in the restated financial statements. *[IAS 29.10]*. The requirements of the standard look deceptively straightforward but their application may represent a considerable challenge. These difficulties and other aspects of the practical application of the IAS 29 method of accounting for hyperinflation are discussed below.

2.2 Scope

IAS 29 must be applied by all entities whose functional currency is the currency of a hyperinflationary economy. *[IAS 29.1]*.

The standard should be applied in an entity's separate financial statements (if prepared) and its consolidated financial statements, as well as by parents that include such an entity in their consolidated financial statements.

If an entity whose functional currency is that of a hyperinflationary economy wishes to present the financial statements in a different presentation currency, or if their parent has a different presentation currency, the financial statements of the entity first must be restated under IAS 29. Only then, can the financial statements be translated under IAS 21 *The Effects of Changes in Foreign Exchange Rates* (see section 11 below).

Almost all entities operating in hyperinflationary economies will be subject to the accounting regime of IAS 29, unless they can legitimately argue that the local hyperinflationary currency is not their functional currency as defined by IAS 21 (see Chapter 16 at section 4). *[IAS 21.14]*.

2.3 Definition of hyperinflation

Determining whether an economy is hyperinflationary in accordance with IAS 29, and when it becomes so, requires judgement. *[IAS 29.3, IAS 29.4]*.

Extract from IAS 29

3 This Standard does not establish an absolute rate at which hyperinflation is deemed to arise. It is a matter of judgement when restatement of financial statements in accordance with this Standard becomes necessary. Hyperinflation is indicated by characteristics of the economic environment of a country which include, but are not limited to, the following:

(a) the general population prefers to keep its wealth in non-monetary assets or in a relatively stable foreign currency. Amounts of local currency held are immediately invested to maintain purchasing power;

(b) the general population regards monetary amounts not in terms of the local currency but in terms of a relatively stable foreign currency. Prices may be quoted in that currency;

(c) sales and purchases on credit take place at prices that compensate for the expected loss of purchasing power during the credit period, even if the period is short;

(d) interest rates, wages and prices are linked to a price index; and

(e) the cumulative inflation rate over three years is approaching, or exceeds, 100%.

4 It is preferable that all entities that report in the currency of the same hyperinflationary economy apply this Standard from the same date. Nevertheless, this Standard applies to the financial statements of any entity from the beginning of the reporting period in which it identifies the existence of hyperinflation in the country in whose currency it reports.

Identifying when a currency becomes hyperinflationary, and, just as importantly, when it ceases to be so, is not easy in practice and is frequently hampered by a lack of reliable statistics. The consideration of trends and the application of common sense is important in this judgement, as are consistency of measurement and of presentation. Transition into and out of hyperinflationary economies are discussed further in section 10 below.

How we see it

As at June 2024, the currencies of the following countries were widely considered to be hyperinflationary: Argentina, Ethiopia, Ghana, Haiti, Islamic Republic of Iran, Lebanon, Sierra Leone, South Sudan, Sudan, Suriname, Turkey, Venezuela and Zimbabwe. Preparers should be aware that this list may change by the time of their reporting date. Countries whose currencies should be more closely monitored for a change in the hyperinflationary status of their currency at this date were Burundi, Egypt, Lao P.D.R., Malawi, Nigeria, Pakistan, Sri Lanka and Syria.

2.4 The IAS 29 restatement process

Restatement of financial statements in accordance with IAS 29 can be seen as a process comprising the following steps:

(a) Selection of a general price index (see section 3 below)

(b) Analysis and restatement of the statement of financial position (see section 4 below)

(c) Restatement of the statement of changes in equity (see section 5 below)

(d) Restatement of the statement of profit or loss and other comprehensive income (see section 6 below)

(e) Calculation of the gain or loss on the net monetary position (see section 6.3 below)

And

(f) Restatement of the statement of cash flows (see section 7 below)

IAS 29 requires comparative figures to be restated to the monetary unit current at the reporting date (see section 8 below). In practice, the restatement of comparatives is integral to the restatement of current year figures, and thus is the first step in the process after a general price index has been selected.

In the year of initial application of the standard, the retrospective nature of IAS 29 requires the restatement of all historical amounts from varying dates at which they were last current - which is often the date of acquisition, many years ago - and is generally a time consuming and complex process.

In subsequent years, the restatement process is considerably less onerous, as the previously reported figures are only adjusted for the inflation in the current period, and information about items recognised in the current period is more readily available. The restatement of comparative information is best completed as the first step in applying IAS 29 as certain items rely on this restated information to determine current year amounts. Some examples would include the closing balance of property plant and equipment, which is often calculated as the sum of the restated opening balance and movements (see Illustration 4-1 in section 4.1.4 below), and fair value gains on non-monetary items, which are determined taking into consideration the restated opening balance (as discussed in section 6.2 below).

3 Selection of a general price index

The standard requires entities to use a general price index that reflects changes in general purchasing power. Ideally all entities that report in the same hyperinflationary currency should use the same price index. *[IAS 29.37]*.

3.1 Selecting a general price index

It is generally accepted practice to use a Consumer Price Index (CPI) for this purpose, unless that index is clearly flawed. National statistical offices in most countries issue several price indices that potentially could be used for the purposes of IAS 29. Important characteristics of a good general price index include the following:

- A wide range of goods and services has been included in the price index
- Reflective of currency-wide, rather than regional, purchasing power
- Continuity and consistency of measurement techniques and underlying assumptions
- Free from bias
- Frequently updated

  And
- Available for a long period

The entity shall use the above criteria to choose the most reliable and most readily available general price index and use that index consistently. It is important that the index selected is representative of the real position of the hyperinflationary currency concerned.

In practice, a country's national price index that is monitored by the International Monetary Fund, and is incorporated in its World Economic Outlook publication, is used as the basis for IAS 29 accounting.

3.2 General price index not available for all periods

IAS 29 requires an entity to make an estimate of the price index if the general price index is not available for all periods for which the restatement of long-lived assets is required. The entity could base the estimate, for example, on the movements in the exchange rate between the functional currency and a relatively stable foreign currency. *[IAS 29.17]*. It should be noted that this method is only appropriate if the currency of the hyperinflationary economy is freely exchangeable, i.e., not subject to currency controls and 'official' exchange rates. Entities should also be mindful that, especially in the short term, the exchange rate may fluctuate significantly in response to factors other than changes in the domestic price level.

How we see it

In a scenario where there is a wide spread consensus that all available general price indices do not meet the minimum criteria for reliability (e.g., because the national statistical office in the hyperinflationary economy may be subject to significant political bias) and thus are fatally flawed, or in the absence of a general price index, entities could use an estimate based on currency movements, similar to the approach to that described in IAS 29.17. In these instances, prepares must consider the reliability of the movements in the currency as an inflation proxy. Where this is also not appropriate, the use of other sources of economic data or even the use of experts may be required.

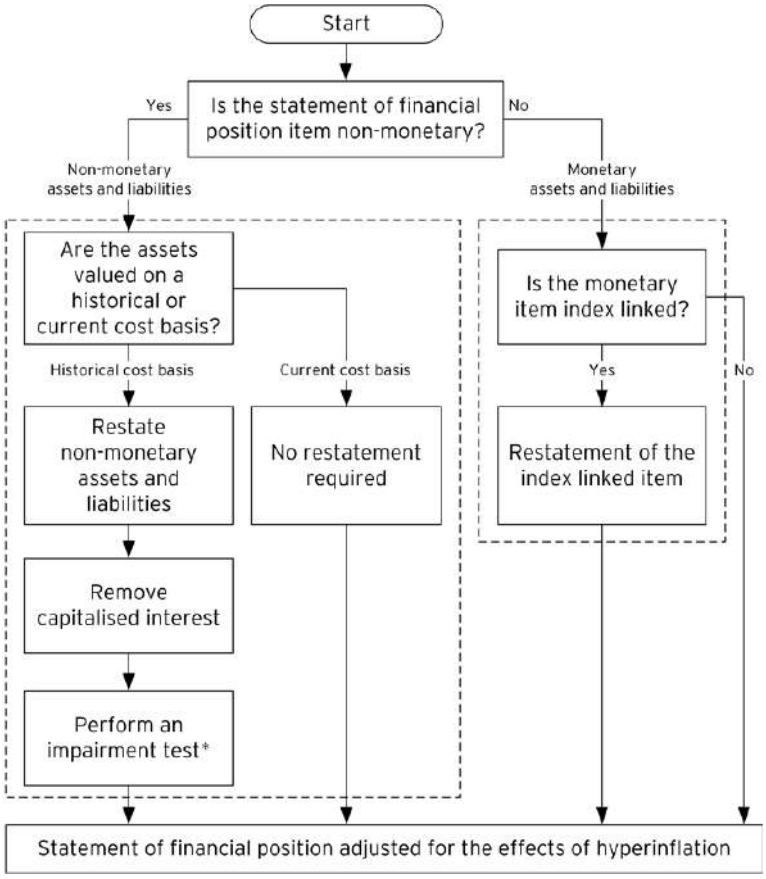
3.3 Delayed availability of a general price index

Inflation statistics are published shortly after the end of the reporting period, but in some jurisdictions the statistics are published several weeks or months later. When considering the requirements of IAS 10 *Events after the Reporting Period*, the release of this data is an event after the reporting date that provides evidence of conditions that existed at the end of the reporting period (see Chapter 34 at section 2.1.2). This is therefore an adjusting event that is to be taken into consideration in preparing the financial statements.

If the publication of these statistics is significantly delayed, preparers may either need to wait for the statistics to become available or will need to make an estimate of the inflation index at the reporting date. The basis of such an estimate could be previous months' inflation statistics, movements in foreign exchange rates for the period in question, or the opinion of economic experts.

4 Analysis and restatement of the statement of financial position

A broad outline of the process to restate assets and liabilities in the statement of financial position in accordance with the requirements of IAS 29 is shown in the diagram below:



* IAS 29 requires the restated amount of a non-monetary item to be reduced in accordance with the appropriate IFRS when the restated amount exceeds its recoverable amount. *[IAS 29.19]*.

The above flowchart does not illustrate the restatement of investees and subsidiaries (see section 4.3 below), deferred taxation (see section 4.4 below) and equity (see section 5 below).

4.1 Monetary and non-monetary items

4.1.1 Monetary or non-monetary distinction

Monetary items are not restated as they are already expressed in the measurement unit current at the end of the reporting period. Therefore, an entity needs to determine whether or not an item is monetary in nature. Most statement of financial position items are readily classified as either monetary or non-monetary as is shown in the table below:

Monetary items	Non-monetary items
Assets	**Assets**
Cash and cash equivalents Debt securities Loans Trade and other receivables	Property, plant and equipment Right-of-use assets Intangible assets Investments in equity securities Inventories Construction contract work-in-progress Prepaid costs Investment properties

Monetary items	Non-monetary items
Liabilities	**Liabilities**
Trade and other payables Borrowings Tax payable	Deferred income

However, there are instances where classification of items as either monetary or non-monetary is not always straightforward. IAS 29 defines monetary items as "money held and items to be received or paid in money". *[IAS 29.12]*. IAS 21 expands on this definition by defining monetary items as: *[IAS 21.8]*

Extract from IAS 21

8 The following terms are used in this Standard with the meanings specified:

...

***Monetary items* are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.**

...

IAS 21 further states that the essential feature of a monetary item is a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples given by IAS 21 are pensions and other employee benefits to be paid in cash, provisions that are to be settled in cash and cash dividends that are recognised as a liability. *[IAS 21.16]*. More obvious examples are cash and bank balances, trade receivables and payables, and loan receivables and payables.

IAS 21 also states that "a contract to receive (or deliver) a variable number of the entity's own equity instruments or a variable amount of assets in which the fair value to be received (or delivered) equals a fixed or determinable number of units of currency is a monetary item." *[IAS 21.16]*. Although no examples of such contracts are given in IAS 21, it should include those contracts settled in the entity's own equity shares that would be presented as financial assets or liabilities under IAS 32 *Financial Instruments: Presentation*.

Conversely, the essential feature of a non-monetary item is the absence of a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples given by IAS 21 are amounts prepaid for goods and services (e.g., prepaid rent); goodwill; intangible assets; inventories; property, plant and equipment; right-of-use assets; and provisions that are to be settled by the delivery of a non-monetary asset. *[IAS 21.16]*. IFRS 9 *Financial Instruments* states that all equity instruments are non-monetary. *[IFRS 9.B5.7.3]*. Therefore, equity investments in subsidiaries, associates or joint ventures would also be considered non-monetary items. IAS 29 provides separate rules on restatement of such investees (see section 4.3 below).

Even with this guidance there may be situations where the distinction is not clear. Certain assets and liabilities may require careful analysis before they can be classified. Examples of items that are not easily classified as either monetary or non-monetary include:

(a) *Provisions:* these can be monetary, non-monetary or partly monetary. For example, a warranty provision would be:

  (i) Entirely monetary when customers only have a right to return the product and obtain a cash refund equal to the amount they originally paid

  (ii) Non-monetary when customers have the right to have any defective product replaced

  And

  (iii) Partly monetary if customers can choose between a refund and a replacement of the defective product

  Classification as either a monetary or a non-monetary item is not acceptable in (iii) above. To meet the requirements of IAS 29, part of the provision should be treated as a non-monetary item and the remainder as a monetary item.

(b) *Deferred tax assets and liabilities*: characterising these as monetary or non-monetary can be difficult as explained in section 4.4 below.

(c) *Associates and joint ventures*: IAS 29 provides separate rules on restatement of investees that do not rely on the distinction between monetary and non-monetary items (see section 4.3 below).

(d) *Deposits or progress payments paid or received*: if the payments made are regarded as prepayments or as progress payments then the amounts should be treated as non-monetary items. However, if the payments made are in effect refundable deposits, then the amounts should probably be treated as monetary items.

(e) *Insurance contract assets and liabilities*: While IFRS 17 *Insurance Contracts* states that groups of insurance contracts, including the contractual service margin should be treated as a monetary item when applying IAS 21, *[IFRS 17.30]*, it is not clear from the wording in the standard if insurance contracts should also be considered monetary for the purposes of the application of IAS 29.

And

(f) *Index-linked assets and liabilities*: classification is particularly difficult when interest rates, lease payments or prices are linked to a price index.

How we see it

The practical application of the monetary/non-monetary distinction, discussed above, can be complex and will require judgement on the part of preparers of financial statements. Further examples of problem areas in the application of the monetary/non-monetary distinction are discussed in Chapter 16 at section 5.4.

4.1.2 Monetary items

Generally, monetary items are not restated to reflect the effect of inflation because they already reflect their purchasing power at the end of the reporting period. However, monetary assets and liabilities linked by agreement to changes in prices, such as index-linked bonds and loans, should be adjusted in accordance with the terms of the underlying agreement to show the repayment obligation at the end of the reporting period. *[IAS 29.13]*. This adjustment should be offset against the gain or loss on the net monetary position (see section 6.3 below). *[IAS 29.28]*.

This type of restatement is not a hyperinflation accounting adjustment, but rather a gain or loss on a financial instrument. Accounting for inflation-linked bonds and loans under IFRS 9 may well lead to complexity in financial reporting. Depending on the specific wording of the inflation adjustment clause, such contracts may give rise to embedded derivatives and gains or losses will have to be recorded either in profit or loss or other comprehensive income depending on how the instrument is classified under IFRS 9 (see Chapter 42 at section 4.1.5 and Chapter 44 at section 5.3.5).

4.1.3 Non-monetary items carried at current cost

Non-monetary items carried at current cost are not restated because they are already expressed in terms of the measuring unit current at the end of the reporting period. *[IAS 29.29]*. Current cost is not defined by the standard, but the IASB's *Conceptual Framework* provides the following definition: "The current cost of an asset is the cost of an equivalent asset at the measurement date, comprising the consideration that would be paid at the measurement date plus the transaction costs that would be incurred at that date. The current cost of a liability is the consideration that would be received for an equivalent liability at the measurement date minus the transaction costs that would be incurred at that date". *[CF 6.21]*. IAS 29 expands this definition by including net realisable value and fair value into the concept of "amounts current at the end of the reporting period". *[IAS 29.14]*. In summary, this would include items carried at a value that reflects purchasing power at the balance sheet date.

It is important to note that non-monetary items that were revalued at some earlier date are not necessarily carried at current cost, and need to be restated from the date of their latest revaluation. *[IAS 29.18]*. This may include items such as assets impaired to a recoverable amount in an earlier reporting period, which should be adjusted for inflation from the date of such impairment. Likewise, in the case of a non-monetary prepayment for an asset, it may be that the date of the prepayment, rather than the date of initial recognition of the asset, is the date at which the value was current, and therefore the date from which the asset should be adjusted for inflation. Categorisation of prepayments as monetary or non-monetary is discussed in section 4.1.1 above.

In hyperinflationary economies, national legislation may require entities to adjust historical cost based financial information in a way that is not in accordance with IAS 29 (for example, national legislation may require entities to adjust the carrying amount of tangible fixed assets by applying a multiplier). Though financial information adjusted in accordance with national legislation is sometimes described as 'current cost' information, it will seldom meet the definition of current cost in accordance with the *Conceptual Framework*. *[CF 6.21]*. Where this is the case, entities must first determine the carrying value on the historical cost basis for these assets and liabilities before applying the requirements of IAS 29.

4.1.4 Non-monetary items carried at historical cost

Non-monetary items carried at historical cost, or cost less depreciation, are stated at amounts that were current at the date of their acquisition. The restated cost, or cost less depreciation, of those items is calculated as follows:

$$\text{net book value restated for hyperinflation} = \text{net book value based on historical cost} \times \frac{\text{general price index at the end of the reporting period}}{\text{general price index at the date of acquisition}}$$

This formula would be applied to property, plant and equipment, inventories of raw materials and merchandise, goodwill, patents, trademarks and similar assets. *[IAS 29.15]*. While this appears to be straightforward, it does require detailed records of the acquisition dates of these assets and accurate price indices at those dates. It should be noted though that IAS 29 permits certain approximations as long as the procedures and judgements are consistent from period to period. *[IAS 29.10]*. Where sufficiently detailed records are not available or capable of estimation, IAS 29 suggests that it may be necessary to obtain an 'independent professional assessment' of the value of the items as the basis for their restatement in the first period of application of the standard, but also notes that this will only be in rare circumstances. *[IAS 29.16]*.

Illustration 4-1: Restatement of property, plant and equipment

The table below illustrates how the restatement of a non-monetary item (for example, property, plant and equipment or right-of-use assets) would be calculated in accordance with the requirements of IAS 29. When IAS 29 is first applied, the item is restated from the date of acquisition. In subsequent periods it is restated from the previous reporting period as shown below.

	Historical restatements	Conversion factor	Restated for hyperinflation	
Net book value of property, plant and equipment				
Opening balance, 1 January	510	2.40	1,224	(a)
- Additions (May)	360	1.80	648	(b)
- Disposals (March)	(105)	2.40	(252)	(c)
- Depreciation	(200)		(448)	(d)
Closing balance, 31 December	**565**		**1,172**	(e)

(a) The opening balance is restated by adjusting the balance reported per IAS 29 in the prior period for the increase in the price index between the beginning and the end of the reporting period.

(b) The additions are restated for the increase in the price index from May to December.

(c) The disposals are restated for the increase in the price index between the beginning and the end of the reporting period, assuming all disposals were acquired in a previous reporting period.

(d) Depreciation has been recalculated using the cost balance restated for hyperinflation on an asset-by-asset basis as a starting point.

(e) The closing balance is in practice determined by adding up items (a)-(d). Alternatively, the entity could calculate the closing balance by restating the acquisition cost and related accumulated depreciation of the individual assets for the change in the price index during the period of ownership.

The calculations described under (a)-(e) all require estimates regarding the general price index at given dates and are sometimes based on averages or best estimates of the actual date of the transaction.

When an entity purchases an asset and payment is deferred beyond normal credit terms, it would normally recognise the present value of the cash payment as its cost. *[IAS 16.23]*. When it is impracticable to determine the amount of interest, IAS 29 provides relief by allowing such assets to be restated from the payment date rather than the date of purchase. *[IAS 29.22]*.

Once the calculation discussed above has been completed, additional adjustments may need to be made. To arrive at the final restated cost of the non-monetary items, the provisional restated cost needs to be adjusted for borrowing costs and impairment, if applicable, as follows: *[IAS 29.19, IAS 29.21]*

$$\text{restated costs} = \text{net book value restated for hyperinflation} - \text{borrowing costs that compensate for inflation capitalised under IAS 23} - \text{adjustment to recoverable amount}$$

IAS 29 only permits partial capitalisation of borrowing costs, unlike the full capitalisation that is ordinarily required by IAS 23 *Borrowing Costs* (see Chapter 22), because of the risk of double counting as the entity would both restate the capital expenditure financed by borrowing and capitalise that part of the borrowing costs that compensates for the inflation during the same period. *[IAS 29.21]*. The difficulty when borrowing costs are capitalised is that IAS 29 only permits capitalisation of borrowing costs to the extent that those costs do not compensate for inflation. The standard does not provide any guidance on how an entity should go about determining the component of borrowing costs that compensates for the effects of inflation. Therefore, entities will need to develop an appropriate methodology.

It is possible that an IAS 29 inflation adjustment based on the general price index leads to non-monetary assets being stated above their recoverable amount. Therefore, IAS 29 requires that the restated amount of a non-monetary item is reduced, in accordance with the appropriate accounting standard, when it exceeds its recoverable amount from the item's future use (including sale or other disposal). *[IAS 29.19]*. Any overstatement of non-monetary assets not within the scope of IFRS 9 is calculated and accounted for in accordance with IAS 36 *Impairment of Assets* or the measurement provisions of IAS 2 *Inventories* (see section 4.2 below). That is, the asset is written down to its recoverable amount or net realisable value and the loss is recognised in profit or loss.

The existence of hyperinflation in an economy is not explicitly mentioned as an indicator of impairment, but the resulting economic conditions increase the likelihood of other indicators of impairment being present, so additional care and attention will need to be paid to the impairment testing process.

The Illustration below illustrates how, after it has restated the historical cost based carrying amount of property, plant and equipment by applying the general price index, an entity adjusts the net book value restated for hyperinflation for these considerations:

Illustration 4-2: Borrowing costs and net realisable value adjustments

After the entity has restated the historical cost based carrying amount of property, plant and equipment by applying the general price index, it needs to adjust the net book value restated for hyperinflation to take account of borrowing costs capitalised since the acquisition of the asset as follows:

Net book value restated for hyperinflation (inclusive of borrowing costs)		1,725	
Borrowing costs capitalised at historical cost under IAS 23	42		
Borrowing costs that compensated for inflation	(30)		
Borrowing costs permitted to be capitalised under IAS 29	12		
Borrowing costs that compensated for inflation	(30)		
Restate borrowing cost assuming conversion factor of 2.1		(63)	(a)
Net book value restated for hyperinflation and after adjustment of capitalised borrowing costs		1,662	
Net book value restated for hyperinflation and after adjustment of capitalised borrowing costs	1,662		
Amount recoverable from the item's future use	1,550		
	112		
Adjustment to lower recoverable amount		(112)	(b)
Carrying amount restated under IAS 29		1,550	

(a) The portion of the borrowing costs capitalised in the original historical cost financial statements that compensate for inflation are reversed, as they are not permitted to be capitalised under IAS 29.

(b) To the extent that the 'net book value restated for hyperinflation and after adjustment of capitalised borrowing costs' exceeds the 'amount recoverable from the item's future use', the restated amount should be reduced to the lower 'amount recoverable from the item's future use'.

Where an entity's functional currency becomes hyperinflationary and it applies IAS 29 for the first time, IFRIC 7 requires the application of IAS 29 as if the economy had always been hyperinflationary. *[IFRIC 7.3]*. Therefore, in the year of initial application of the standard, such an entity should consider whether an impairment trigger is present at the beginning of the current period and, if any impairment is identified, determine whether it relates to the current period or whether it should have been recognised earlier. In making such a determination in practice there are likely to be a number of complexities including the degree of hindsight that might be involved.

4.2 Inventories

Inventories of finished and partly finished goods are restated from the dates on which the costs of purchase and of conversion were incurred. *[IAS 29.15]*. This means that the individual components of finished goods are restated from their respective purchase dates. Similarly, if production takes place in several distinct phases, the costs associated with each of those phases are restated from the date that the cost was incurred.

Given the large number of transactions affecting an entity's inventory position, it may be difficult to determine the date of acquisition of individual items of inventory. Therefore, entities commonly approximate the ageing of inventories based on inventory turnover. Similarly, the level of the general price index at the date of acquisition is often determined at the average level for the month because an up-to-date price index is not available for each day of the month. Determining the appropriate level of the general price index can be difficult when the price index is updated relatively infrequently and the entity's business is highly seasonal.

IAS 29 requires restatement of inventory by applying a general price index, which could result in an overvaluation when the price of inventory items increases at a different rate from the general price index. At the end of each period, it is therefore essential to ensure that items of inventory are not valued in excess of their net realisable value. Any overstated inventories shall be written down to net realisable value under IAS 2. *[IAS 29.19]*.

4.3 Restatement of associates, joint ventures and subsidiaries

IAS 29 provides separate rules for the restatement of associates and joint ventures that are accounted for under the equity method. If the investee itself operates in a hyperinflationary currency, the entity restates the statement of financial position, statement of profit or loss and other comprehensive income of the investee in accordance with the requirements of IAS 29 in order to calculate its share of the investee's net assets and results of operations. *[IAS 29.20]*. The standard does not permit the investment in the investee to be treated as a single indivisible item for the purposes of the IAS 29 restatement. In addition, IAS 29 requires that when financial statements with different reporting dates are consolidated, all items, whether non-monetary or monetary are restated into the measuring unit current at the date of the consolidated financial statements. *[IAS 29.36]*.

Restating the financial statements of an associate before application of the equity method will often be difficult because the investor may not have access to the detailed information required. The fact that the investor can exercise significant influence or has joint control over an investee often does not mean that the investor has unrestricted access to the investee's books and records at all times.

The various combinations of investors and investees are discussed below.

4.3.1 Non-hyperinflationary investor and hyperinflationary investee

When the investor does not operate in the hyperinflationary currency, but the investee does, the same processes described above are still required to be completed prior to the equity accounting process.

Once restated, the results of a foreign currency investee are translated into the investor's presentation currency at the closing rate. *[IAS 29.20]*. IAS 21 contains a similar provision that requires that all current year amounts related to an entity (i.e., investee), whose functional currency is the currency of a hyperinflationary economy, to be translated at the closing rate at the date of the most recent statement of financial position (see Chapter 16 at section 6.1). *[IAS 21.42]*.

4.3.2 Hyperinflationary investor and investee

If a parent that reports in the currency of a hyperinflationary economy has a subsidiary that also reports in the currency of a hyperinflationary economy, then the financial statements of that subsidiary must first be restated by applying a general price index of the country in whose currency it reports before they are included in the consolidated financial statements issued by its parent. *[IAS 29.35]*. When an investor has a subsidiary whose functional currency is the currency of a hyperinflationary economy, IAS 21 further clarifies that all current year amounts related to the subsidiary are translated at the closing rate at the date of the most recent statement of financial position (see Chapter 16 at section 6.1). *[IAS 21.42]*. The restatement of related comparative amounts is discussed in section 11.3 below.

4.3.3 Hyperinflationary investor and non-hyperinflationary investee

If a parent that reports in the currency of a hyperinflationary economy has a subsidiary that reports in a currency that is not hyperinflationary, the financial statements of that subsidiary are translated in accordance with IAS 21.39 (see Chapter 16 at section 6.1). *[IAS 21.39]*. This is discussed in further detail in section 12 below.

4.4 Calculation of deferred taxation

Determining whether deferred tax assets and liabilities are monetary or non-monetary is difficult because:

- Deferred taxation could be seen as a valuation adjustment that is either monetary or non-monetary depending on the asset or liability it relates to.

  Or

- It could also be argued that any deferred taxation payable or receivable in the very near future is almost identical to current tax payable and receivable. Therefore, at least the short-term portion of deferred taxation, if payable or receivable, is treated as if it were monetary.

IFRIC 7 provides guidance to facilitate the first-time application of IAS 29. Although the interpretation notes that there continues to be a difference of opinion as to whether deferred taxation is monetary or non-monetary, *[IFRIC 7.BC21, IFRIC 7.BC22]*, the debate has been settled for practical purposes because:

- IAS 12 *Income Taxes* requires deferred taxation in the closing statement of financial position for the year to be calculated based on the difference between the carrying amount and the tax base of assets and liabilities, without making a distinction between monetary and non-monetary items.

  And

- IFRIC 7 requires an entity to remeasure the deferred tax items in any comparative period in accordance with IAS 12 after it has restated the nominal carrying amounts of its non-monetary items at the date of the opening statement of financial position of the reporting period by applying the measuring unit at that date. These remeasured deferred tax items are then restated for the change in the measuring unit between the beginning and the end of reporting period. *[IFRIC 7.4]*.

The following Illustration, which is based on the illustrative example in IFRIC 7, shows how an entity restates its deferred taxation in the comparative period. *[IFRIC 7.IE1-IE6]*.

Illustration 4-3: Restatement of deferred taxation

Entity A owns a building that it acquired in December 20X0. The carrying amount and tax base of the building, and the deferred tax liability are as follows:

Before IAS 29 restatement	20X2	20X1
Building (not restated)	300	400
Tax base	200	333
Tax rate	30%	30%
Deferred tax liability:		
(300 - 200) × 30% =	30	
(400 - 333) × 30% =		20

Entity A has identified the existence of hyperinflation in 20X2 and therefore applies IAS 29 retrospectively and is required to calculate the deferred tax balance at the beginning of 20X2. Entity A will use the following general price index and conversion factors to restate its financial statements:

	General price index
December 20X0	95
December 20X1	135
December 20X2	223

The table below shows the method required by IFRIC 7:

	20X2	20X1	
Building (not restated)	300	400	
Building (restated in 20X2 financial statements):			
300 × (223 ÷ 95) =	704		
400 × (223 ÷ 95) =		939	
Building (restated in 20X1 financial statements):			
400 × (135 ÷ 95) =		568	(a)
Tax base	200	333	(b)
Deferred tax liability (restated in 20X2 financial statements):			
(704 - 200) × 30% =	151		
(568 - 333) × 30% = 71; 71 × (223 ÷ 135) =		117	

Entity A measures the temporary difference at the end of 20X1 by comparing (a) the restated carrying amount of the building in 20X1 accounts to (b) its tax base at that date. The temporary difference calculated in that manner is then multiplied by the applicable tax rate and the resulting amount is then adjusted for the hyperinflation during 20X2, resulting in a deferred tax liability of 117.

After Entity A has restated its financial statements for a given year, all corresponding figures in the financial statements for a subsequent reporting period, including deferred tax items, are restated by applying the change in the measuring unit for that subsequent reporting period only to the restated financial statements for the previous reporting period. *[IFRIC 7.5]*.

IAS 29 refers to IAS 12 for guidance on the calculation of deferred taxation by entities operating in hyperinflationary economies. *[IAS 29.32]*. IAS 12 recognises that IAS 29 restatements of assets and liabilities may give rise to temporary differences when equivalent adjustments are not allowed for tax purposes. *[IAS 12.IE.A18]*. Where IAS 29 adjustments give rise to temporary differences, IAS 12 requires the following accounting treatment:

- The deferred tax income or expense is recognised in profit or loss.

  And

- If, in addition to the restatement, non-monetary assets are also revalued, the deferred tax movement relating to the revaluation is recognised in other comprehensive income and the deferred tax relating to the restatement is recognised in profit or loss. *[IAS 12.IE.A18]*.

For example, deferred taxation arising on the revaluation of property, plant and equipment is recognised in other comprehensive income, just as it would be if the entity were not operating in a hyperinflationary economy. On the other hand, a restatement in accordance with IAS 29 of property, plant and equipment that is measured at historical cost is recognised in profit or loss. Thus, the treatment of deferred taxation related to non-monetary assets valued at historical cost and those that are revalued, is consistent with the general requirements of IAS 12.

Tax authorities in countries that are hyperinflationary may give taxpayers some relief from taxation on inflated nominal profits by increasing tax bases of assets. The implications of such increases in the tax bases, which in turn affect temporary differences, are discussed in Chapter 29 at section 10.1.

5 Restatement of the statement of changes in equity

When an entity first applies IAS 29, it restates the components of owners' equity at the beginning of the earliest period presented as follows:

- The components of owners' equity, except retained earnings and any revaluation surplus, are restated by applying a general price index from the dates the components were contributed or otherwise arose.
- Any revaluation surplus that arose in previous periods is eliminated.

  And
- Restated retained earnings are derived from all the other amounts in the restated statement of financial position. *[IAS 29.24]*.

At the end of the first period and in subsequent periods, all components of owners' equity are restated by applying a general price index from the beginning of the period or the date of contribution, if later. *[IAS 29.25]*. Subsequent revaluations may give rise to a revaluation surplus within equity.

IFRS does not define a revaluation surplus and it is not always clear which reserves might meet this definition. Depending on how broadly the concept of 'revaluation' is applied, this may include reserves relating to, for example, financial instruments at fair value through other comprehensive income, or actuarial gains and losses, if these are presented separately. The approach taken on initial application as well as in subsequent years affects, in particular, those reserves reclassified to profit or loss, and is discussed in section 6.4 below.

Likewise, IFRS does not define retained earnings and many jurisdictions require entities to appropriate part of the balance into specific (often non-distributable) reserves. In such cases, entities will need to apply judgement to determine whether these reserves are essentially part of retained earnings (and so are not restated by applying the general price index as described in IAS 29.24). If they are considered a separate component of equity, then they are restated by applying the general price index as explained above, both at the beginning of the first period when an entity applies IAS 29 and at the end of the first period and subsequent periods.

Where entities have made such judgements concerning the types of reserves held and these judgements have a significant effect on the amounts recognised in the financial statements, IAS 1 requires disclosure to users of the financial statements. *[IAS 1.122]*.

Though IAS 29 provides guidance on the restatement of assets, liabilities and individual components of shareholders' equity, national laws and regulations with which the entity needs to comply might not permit such revaluations. This can mean that IAS 29 may require restatement of distributable reserves, but that from the legal point of view in the jurisdiction concerned, those same reserves remain unchanged. That is, it is possible that 'restated retained earnings' under IAS 29 will not all be legally distributable.

It may therefore be unclear to users of financial statements restated under IAS 29 to what extent components of equity are distributable. Because of its global constituents, the IASB's standards cannot deal with specific national legal requirements relating to a legal entity's equity.

How we see it

In jurisdictions with laws or regulations governing the categories of equity and particularly, which categories of equity may be distributed, entities reporting under IAS 29 should disclose the extent to which components of equity are distributable where this is not obvious from the financial statements. In our view, it is important for entities to give supplementary information in the circumstances where the IAS 29 adjustments have produced large apparently distributable reserves that are in fact not distributable.

Illustration 5-1: Restatement of equity

The table below shows the effect of a hypothetical IAS 29 restatement on individual components of equity on initial application of IAS 29. Issued share capital and share premium increase by applying the general price index, the revaluation reserve is eliminated as required, and retained earnings is the balancing figure derived from all other amounts in the restated statement of financial position.

	Amounts before restatement	Amounts after IAS 29 restatement	Components of equity under national law
Issued capital and share premium	1,500	3,150	1,500
Revaluation reserve	800	-	800
Retained earnings	350	1,600	350
Total equity	**2,650**	**4,750**	**2,650**

A user of the financial statements of the entity might get the impression, based on the information restated in accordance with IAS 29, that distributable reserves have increased from 350 to 1,600. However, if national law does not permit revaluation of assets, liabilities and components of equity, then distributable reserves remain unchanged.

6 Restatement of the statement of profit or loss and other comprehensive income

IAS 29 requires that all items in historical cost-based statements of profit and loss and other comprehensive income be expressed in terms of the measuring unit current at the end of the reporting period. *[IAS 29.26]*. The standard contains a similar requirement for current cost-based statements of profit and loss and other comprehensive income, because the underlying transactions or events are recorded at current cost at the time they occurred rather than in the measuring unit current at the end of the reporting period. *[IAS 29.30]*. Therefore, all amounts in the statement of profit or loss and other comprehensive income need to be restated as follows:

$$\text{restated amount} = \text{amount before restatement} \times \frac{\text{general price index at the end of the reporting period}}{\text{general price index when the underlying income or expenses were initially recorded}}$$

Actually performing the above calculation on a real set of financial statements is often difficult because an entity would need to keep a very detailed record of when it entered into transactions and when it incurred expenses. Instead of using the exact price index for a transaction it may be more practical to use an average price index that approximates the actual rate at the date of the transaction. For example, an average rate for a week or a month might be used for all transactions occurring during that period. However, it must be stressed that if price indices fluctuate significantly, the use of an average for the period may be inappropriate.

There may be items in statements of profit and loss and other comprehensive income, e.g., interest income and expense that comprise an element that is intended to compensate for the effect of hyperinflation. However, even those items need to be restated as IAS 29 specifically requires that 'all amounts need to be restated' (see section 6.1 below). *[IAS 29.26, IAS 29.30]*.

Illustration 6-1 below shows how an entity might, for example, restate its revenue to the measuring unit current at the end of the reporting period. A similar calculation would work well for other items in statements of profit and loss and other comprehensive income, with some exceptions, as discussed in sections 6.2 and 6.4 below:

Illustration 6-1: Restatement of historical cost statement of profit or loss and other comprehensive income

An entity would restate its revenue for the period ending 31 December 20X2, when the general price index was 2,880, as shown in the table below.

	General price index	Conversion factor	Revenue before restatement	Restated revenue
31 January 20X2	1,315	(2,880 ÷ 1,315) = 2.19	40	87.6
28 February 20X2	1,345	(2,880 ÷ 1,345) = 2.14	35	74.9
31 March 20X2	1,371	etc. = 2.10	45	94.5
30 April 20X2	1,490	1.93	45	86.9
31 May 20X2	1,600	1.80	65	117.0
30 June 20X2	1,846	1.56	70	109.2
31 July 20X2	1,923	1.50	70	105.0
31 August 20X2	2,071	1.39	65	90.4
30 September 20X2	2,163	1.33	75	99.8
31 October 20X2	2,511	1.15	75	86.3
30 November 20X2	2,599	1.11	80	88.8
31 December 20X2	2,880	1.00	80	80.0
			745	**1,120.4**

How we see it

Inevitably, in practice there is some approximation in this process because of the assumptions that the entity is required to make, for example the use of weighted averages rather than more detailed calculations and assumptions as to the timing of the underlying transactions (e.g., the calculation above assumes the revenues for the month are earned on the final day of the month, which is not realistic). A number of factors may need to be considered in determining the appropriate level of detail to be applied:

- The level of data available: most jurisdictions only make inflation statistics available on a monthly basis. In addition, when the hyperinflation process requires data from long ago e.g., for a property that was purchased decades ago), even monthly information may not be available.
- The materiality of the item being adjusted for inflation: a more detailed calculation should be performed for more material items. For example, revenue should be adjusted for inflation using a more detailed calculation than a low value expense account.
- Frequency of transactions: more specific inflation data would be more appropriate for one-off transactions, especially where these are material. For example, more attention should be paid to the inflation data on the date of a material business combination than to data related to purchases made relatively consistently throughout the year.

Other factors to be considered would include the regularity of transactions and the level of variation in the inflation rate.

6.1 Restatement of interest and exchange differences

A common question is whether an entity should restate exchange differences under IAS 29, because the standard considers that "foreign exchange differences related to invested or borrowed funds, are also associated with the net monetary position". *[IAS 29.28]*. Nevertheless, the standard requires that all items in the statement of profit or loss and other comprehensive income are expressed in terms of the measuring unit current at the end of the reporting period. "Therefore, all amounts need to be restated by applying the change in the general price index from the dates when the items of income and expenses were initially recorded in the financial statements". *[IAS 29.26]*.

Interest and exchange differences are therefore restated for the effect of inflation, consistent with most other items in the statement of profit or loss and other comprehensive income, and are separately disclosed. However, it may be helpful if they are presented together with the gain or loss on net monetary position in the statement of profit or loss and other comprehensive income. *[IAS 29.28]*.

6.2 Income and expenses where the general approach is not applied

Certain items of income and expenses cannot be adjusted for inflation by applying the general approach discussed in section 6 above. This typically is the case where the line item is derived from the value of an asset or liability and therefore the application of IAS 29 to the asset or liability drives the measurement of the income or expense, for example:

- *Cost of sales* is a calculation based on opening and closing inventory balances as well as purchases during the period. To reflect the IAS 29 value of inventory sold, each component in this calculation is restated and the calculation reperformed.
- *Depreciation and amortisation* are recalculated using the cost for the related asset restated for hyperinflation on an asset-by-asset basis. The alternative approach, to restate the depreciation charge by applying a conversion factor to the charge for the year, might seem easier to apply but this factor would not reflect all inflation since this cost was last current (i.e., the acquisition date of the asset). Similarly, the gain or loss on disposal on such assets must be calculated based on the proceeds restated from the disposal date less the carrying value restated as shown in Illustration 4-1 above.
- *Gains and losses on non-monetary items* measured at fair value are typically calculated as the difference between the restated opening balance, or if acquired during the year, the restated acquisition date value, and the fair value on the reporting date.
- *Deferred taxation* amounts in profit or loss are calculated based on the movements in the deferred tax balance, determined as per Illustration 4-3 above.

  And

- The *net monetary gain or loss* that results from the IAS 29 restatements (see section 6.3 below).

6.3 Calculation of the gain or loss on the net monetary position

In theory, hyperinflation only affects the value of money and monetary items and does not affect the value, as distinct from the price, of non-monetary items. Therefore, any gain or loss because of hyperinflation will be the gain or loss on the net monetary position of the entity. By arranging the items in an ordinary statement of financial position, it can be shown that the monetary position minus the non-monetary position is always equal to zero:

	Total	Monetary items	Non-monetary items
Monetary assets	280	280	
Non-monetary assets	170		170
Monetary liabilities	(200)	(200)	
Non-monetary liabilities	(110)		(110)
Assets minus liabilities	140		
Shareholders' equity	(140)		(140)
Net position	**0**	**80**	**(80)**

Theoretically, the gain or loss on the net monetary position can be calculated by applying the general price index to the entity's monetary assets and liabilities. This would require the entity to determine its net monetary position on a daily basis, which would be entirely impracticable given the resources required to prepare daily IFRS compliant accounts as well as the difficulties in making the monetary/non-monetary distinction (see section 4.1 above). The standard therefore allows the gain or loss on the net monetary position to be estimated by applying the change in a general price index to the weighted average for the period of the difference between monetary assets and monetary liabilities. *[IAS 29.27, IAS 29.31]*. Due care should be exercised in estimating the gain or loss on the net monetary position, as a calculation based on averages for the period (or monthly averages) can be unreliable if addressed without accurate consideration of the pattern of hyperinflation and the volatility of the net monetary position.

However, as shown in the above table, any restatement of the non-monetary items must be met by an equal restatement of the monetary items. Therefore, in preparing financial statements it is more practical to assume that the gain or loss on the net monetary position is exactly the reverse of the restatement of the non-monetary items, equity items and items in the statement of comprehensive income. A stand-alone calculation of the net gain or loss can be used to verify the reasonableness of the restatement of the non-monetary items.

The gain or loss on the net monetary position as calculated above, as well as any adjustments on inflation-linked instruments (see section 4.1.2 above), is included in profit or loss and disclosed separately. It may be helpful to present it together with items that are also associated with the net monetary position such as interest income and expense, and foreign exchange differences related to invested or borrowed funds. *[IAS 29.28]*.

6.4 Measurement of reclassification adjustments within equity

IAS 29 does not provide guidance on the measurement basis of reclassifications from other comprehensive income. For example, it is not clear when a debt instrument at fair value through other comprehensive income is sold, whether the amount reclassified into profit and loss is based on the amounts historically recorded in other comprehensive income, or alternatively based on an inflation adjusted amount. Another example is the case of cash flow hedges where gains or losses in an earlier reporting period are recycled to profit and loss to offset against the gains or losses of the hedged item at a later date.

The conflict arises due to the need to classify items in other comprehensive income as amounts to be recycled, or not. This requirement would indicate that amounts initially recorded in other comprehensive income should be recycled at the amounts originally recorded. While this may satisfy the requirements for other comprehensive income, this leads to a loss of relevant information in the statement of profit or loss and other comprehensive income. Using the examples cited above, the gain or loss on disposal of a debt instrument at fair value through other comprehensive income would no longer be presented in terms of the index being used for purposes of restating amounts in profit or loss. In the case of a cash flow hedge, the offset that would also be expected in profit or loss is also lost. The alternative view would be to recycle amounts that have been restated in terms of the current index that is being applied. This is demonstrated in the Illustration below.

Illustration 6-2: Measurement of reclassification adjustments

An entity issued a three-year CU100,000 fixed (15%) rate bond on 31 December 20X0. Before the bond was issued, the entity entered into a fully effective cash flow hedge of changes in three-year interest rates that resulted in a gain of CU6,000 being recognised in other comprehensive income. The entity would reclassify this gain from equity to profit or loss as a reclassification adjustment in the same period or periods during which the bond affects profit or loss, i.e., over three years assuming it is repaid at maturity. Therefore, in a non-hyperinflationary environment, for each of these three years, CU2,000 would be reclassified from other comprehensive income to profit or loss as an adjustment to interest expense (assuming a straight-line approach was considered appropriate).

IAS 29 is not explicit on whether the reclassification from other comprehensive income should be adjusted for the effects of hyperinflation. The following example illustrates the difference between adjusting and not adjusting the reclassification of the cash flow hedge gains for the effect of hyperinflation. For the purpose of this example, assume the general price index was 100 at 31 December 20X1 and 150 at 31 December 20X2.

	20X2 Hyperinflationary	20X2 Hyperinflationary	20X2 Non-hyperinflationary
	Adjusted	Non-Adjusted	
	CU	CU	CU
Net profit:			
Interest expense	...	...	...
Reclassification of cash flow hedge gains	(a) 3,000	2,000	2,000
Other comprehensive income:			
Reclassification of cash flow hedge gains	(3,000)	(2,000)	(2,000)

(a) 6,000 × (150/100) ÷ 3

The basic accounting requirements before the application of IAS 29 for this example is currently contained in IFRS 9 (or IAS 39 *Financial Instruments: Recognition and Measurement* if the hedge accounting requirements of IFRS 9 have not yet been adopted).

While the approach of adjusting for hyperinflation would ensure relevant information in the statement of profit or loss and other comprehensive income, it would lead to different amounts being originally recorded and subsequently recycled in other comprehensive income.

How we see it

As no direct guidance is given in IAS 29, the development of an accounting policy for measuring reclassifications from other comprehensive income in terms of the IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* hierarchy would be required. In developing such an accounting policy an entity would need to apply judgement and consider the objective of the standard that gives rise to the amounts that are recycled to profit or loss.

Understanding the objective of hedge accounting and what risks have been hedged in the designated relationship would be relevant inputs in developing an appropriate accounting policy.

Once developed, the general recommendation of IFRS accounting standards to apply procedures and judgements consistently should be followed for a particular class of equity reclassification. As there are numerous different types of reclassifications within equity, an entity may need to determine a relevant policy for each class of adjustment that could occur. *[IAS 8.10]*.

7 Restatement of the statement of cash flows

The standard requires that all items in the statement of cash flows be expressed in terms of the measuring unit current at the end of the reporting period. *[IAS 29.33]*. This is a difficult requirement to fulfil in practice.

IAS 7 *Statement of Cash Flows* requires the following information to be presented:

- Cash flows from operating activities, which are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.
- Cash flows from investing activities, which are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

  And
- Cash flows from financing activities, which are activities that result in changes in the size and composition of the equity capital and borrowings of the entity. *[IAS 7.6, IAS 7.10]*.

In effect IAS 29 requires restatement of most items in a statement of cash flows, therefore implying that the actual cash flows at the time of the transactions will be different from the numbers presented in the statement of cash flows itself. However, not all items are restated using the same method and many of the restatements are based on estimates. For example, items in the statement of profit or loss and other comprehensive income are restated using an estimate of the general price index at the time that the revenues were earned and the costs incurred. Unavoidably, this will give rise to some inconsistencies. Similarly, the restatement of statement of financial position items will give rise to discrepancies because some items are not easily classified as either monetary or non-monetary. This raises the question of how an entity should classify the monetary gain or loss relating to a statement of financial position item in its statement of cash flows.

It is not clear from IAS 29 how a monetary gain or loss should be presented in the statement of cash flows. In practice, the most commonly applied approach restates cash flows by attributing the effect of inflation on operating, investing and financing cash flows to the underlying item and presenting the monetary gain or loss on cash and cash equivalents separately. However, given the lack of guidance in the IFRS accounting standards, and given the complexity of determining the monetary gains or losses specific to cash and cash equivalents, other approaches might be acceptable.

How we see it

Irrespective of the method chosen to present a statement of cash flows under IAS 29, users of such statement prepared in the currency of a hyperinflationary economy should be mindful of the fact that figures presented in the statement may have been restated in accordance with IAS 29 and may differ from the actual underlying cash flows on the date of the transaction.

In our view, it is important for entities that have a significant proportion of their activities in hyperinflationary economies to consider whether it provides sufficient additional disclosures to ensure that the financial statements can be understood correctly. Whether this is limited to a general explanation of the mismatch between reported and actual amounts, or specific information on major transactions is provided, would depend on the nature and materiality of transactions affected.

8 Restatement of comparative figures

The standard requires that all financial information be presented in terms of the measurement unit current at the end of the current reporting period, therefore:

- Corresponding figures for the previous reporting period, whether they were based on a historical cost approach or a current cost approach, are restated by applying a general price index.

  And

- Information that is disclosed in respect of earlier periods is also expressed in terms of the measuring unit current at the end of the reporting period. *[IAS 29.34]*.

Where IAS 29 was applied in the previous reporting period, this will be a straightforward mathematical computation to apply the measuring unit current at the end of the reporting period to the prior year comparative figures. An example of this can be seen in the restatement of the opening balance of property, plant and equipment in Illustration 4-1 above. When IAS 29 is applied for the first time, this is a more complex process, as discussed in section 10.1 below.

9 Interim reporting

The illustrative examples to IAS 34 *Interim Financial Reporting* state that interim financial reports in hyperinflationary economies are prepared using the same principles as at financial year end. *[IAS 34.IE B32]*. This means that the financial statements must be stated in terms of the measuring unit current at the end of the interim period and that the gain or loss on the net monetary position is included in net income (profit or loss). The comparative financial information reported for prior periods must also be restated to the current measuring unit. *[IAS 34.IE B33]*. Hence, an entity that reports quarterly information must restate the comparative statements of financial position, statement of profit or loss and other comprehensive income, and other primary financial statements each quarter.

In restating its financial information an entity may not 'annualise' the recognition of the gain or loss on the net monetary position or use an estimated annual inflation rate in preparing an interim financial report in a hyperinflationary economy. *[IAS 34.IE B34]*.

Interim reporting of a group containing a subsidiary that reports in a hyperinflationary currency results in particular issues in the year that the subsidiary's functional currency becomes hyperinflationary. These are discussed further in section 11.3 below.

10 Transition

10.1 Economies becoming hyperinflationary

When the functional currency of an entity becomes hyperinflationary it must start applying IAS 29. The standard requires that the financial statements and any information in respect of earlier periods are stated in terms of the measuring unit current at the end of the reporting period. *[IAS 29.8]*. IFRIC 7 clarifies that items are restated fully retrospectively. In the first year in which the entity identifies the existence of hyperinflation, the requirements of IAS 29 are applied as if the economy had always been hyperinflationary. The opening statement of financial position at the beginning of the earliest period presented in the financial statements are restated as follows:

- Non-monetary items measured at historical cost are restated to reflect the effect of inflation from the date the assets were acquired and the liabilities were incurred or assumed.

  And
- Non-monetary items carried at amounts current at dates other than those of acquisition or incurrence are to be restated to reflect the effect of inflation from the dates those carrying amounts were determined. *[IFRIC 7.3]*.

In practice, the process of applying IAS 29 fully retrospectively requires a number of steps to determine the appropriate comparative values, and specifically the opening equity reserves, to ensure the correct balances at the reporting date.

Supposing an entity, with a 31 December reporting date, became hyperinflationary in its 20X2 reporting period, the statement of financial position at 1 January 20X1 (i.e., the beginning of the earliest comparative period), restated to the monetary unit present at that date, would need to be calculated, as well as the components of equity restated to derive the restated retained earnings position at that date (as discussed in section 5 above). This process would require an entity to consider whether the restated values of items subject to comparison against a recoverable amount, as discussed in section 4.1.4 above, would require impairment. In completing this assessment, care should be taken to ensure that such a test is performed by comparing carrying and recoverable amounts stated using financial information measured at consistent dates. For example, the restated carrying amount as calculated at 1 January 20X1 (i.e., the beginning of the earliest comparative period) is compared to the recoverable amount determined at that date. The resulting carrying value would then be restated to the monetary unit present at 31 December 20X2.

To calculate the gain or loss on net monetary position for the 20X1 comparative statement of profit or loss and other comprehensive income:

- All items in the opening statement of financial position, including items carried at amounts current at that date, are adjusted for the inflation during the year to the monetary unit present at 31 December 20X1.
- The 20X1 financial statements are restated to the monetary unit at 31 December 20X1.

  And
- The gain or loss on the net monetary position is calculated as discussed in section 6.3 above.

The financial information determined in this way would then be adjusted for hyperinflation during 20X2 to the monetary unit present at 31 December 20X2, including items carried at amounts current at the previous reporting dates, to correctly establish the comparatives to be reported.

Other areas that are more complex in the period of initial application arise in group reporting environments where a non-hyperinflationary parent controls a hyperinflationary subsidiary. This raises questions on the accounting for the initial restatement process (discussed in Section 11 below) as well as the impact on interim reporting considerations in the period the subsidiary becomes hyperinflationary (discussed in Section 11.3 below).

10.1.1 Presentation of statement of financial position at the beginning of the comparative period

As discussed above, upon transition to IAS 29, the statement of financial position at the beginning of the earliest comparative period is required to be calculated as the base of all subsequent reporting. IAS 1 requires an entity to present a statement of financial position as at the beginning of the preceding period when it "applies an accounting policy retrospectively" or "makes retrospective restatements of items" and this has a material effect on the information in the statement of financial position at the beginning of the preceding period. *[IAS 1.10(f)]*.

This raises the question as to whether the initial application of IAS 29 should be seen as the adoption of a new accounting policy. The application of IFRS requires all standards to be adopted, whether applicable or not. Therefore, the initial application of IAS 29 is not a change in accounting policy but rather the first time that the standard is required to be used. IFRIC 7 describes the initial application of IAS 29 as both a change in status as well as "similar to the retrospective application of a change in accounting policy". *[IFRIC 7.BC17]*. This could be interpreted to excuse preparers from the requirement to present the statement of financial position at the beginning of the earliest comparative period, on the grounds that is it not a policy change, or alternatively, to imply that the similarity is such that the disclosure is required.

How we see it

Preparers of financial statements should consider the extent to which the presentation of a statement of financial position as at the beginning of the preceding period provides information that is useful to the users thereof. Where this additional statement would add meaningful context to the financial statements that is not provided in the notes thereto, its inclusion would be beneficial. In practice, we see limited instances of this additional statement being presented.

Where such an opening statement would be required for another reason, such as the retrospective application of a change in policy, the initial application of IAS 29 would not absolve preparers of this requirement.

10.2 Economies ceasing to be hyperinflationary

Determining when a currency stops being hyperinflationary is not easy in practice. It is important to review trends, not just at the end of the reporting period but also subsequently. In addition, consistency demands that the financial statements do not unnecessarily fall in and out of a hyperinflationary presentation, where a more careful judgement would have avoided it.

When an economy ceases to be hyperinflationary, entities discontinue preparation and presentation of financial statements in accordance with IAS 29. The amounts expressed in the measuring unit current at the end of the previous reporting period will be treated as the basis of the carrying amounts of items in its subsequent statement of financial position. *[IAS 29.38]*.

The previous reporting period used as the basis for the carrying amounts going forward may be the last annual reporting period or it may be an interim period depending on whether the entity prepares interim reports. Therefore, for interim reporters, it should be noted that, an amalgamation of interim periods during which IAS 29 was applied with those where it was not, may result in financial statements that are difficult to interpret. This is shown in Illustration 10-1 below.

Illustration 10-1: Economies ceasing to be hyperinflationary in an interim period

An entity has a financial year end of 31 December and prepares interim financial statements on a quarterly basis. The last annual financial statements were prepared for the period ending 31 December 20X1 when the economy was hyperinflationary. In August 20X2 the economy ceased to be hyperinflationary. The table below shows the impact on the financial statements.

Period	Impact on financial statements
Annual 31 December 20X1	Hyperinflationary accounting.
Interim 31 March 20X2	Hyperinflationary accounting.
Interim 30 June 20X2	Hyperinflationary accounting.
Interim 30 September 20X2	No longer in the scope of IAS 29. Balances at 30 June 20X2 used as the basis for carrying amounts going forward. Comparatives will include adjustments for hyperinflation up to 30 June 20X2.
Annual 31 December 20X2	No longer in the scope of IAS 29. Balances at 31 December 20X2 will use 30 June 20X2 as the basis for carrying amounts going forward. Comparatives will include adjustments for hyperinflation up to 30 June 20X2.

10.3 Economies exiting severe hyperinflation

IFRS 1 includes an exemption for entities that have been subject to severe hyperinflation before the date of transition to IFRS, or on reapplication into IFRS after being unable to prepare IFRS compliant financial statements. *[IFRS 1.D26, IFRS 1.D27]*.

Extract from IFRS 1

D26 If an entity has a functional currency that was, or is, the currency of a hyperinflationary economy, it shall determine whether it was subject to severe hyperinflation before the date of transition to IFRSs. This applies to entities that are adopting IFRSs for the first time, as well as entities that have previously applied IFRSs.

D27 The currency of a hyperinflationary economy is subject to severe hyperinflation if it has both of the following characteristics:

(a) a reliable general price index is not available to all entities with transactions and balances in the currency.

(b) exchangeability between the currency and a relatively stable foreign currency does not exist.

This exemption was included in response to a specific issue that occurred in Zimbabwe in 2008. In Zimbabwe the ability to produce financial statements had been completely undermined by severe hyperinflation. In response to this situation, an exemption was created in IFRS 1 which would be available to any entity that is either adopting IFRS for the first time, or is reapplying IFRS due to severe hyperinflation. This exemption allows an entity in this situation to elect to measure all assets and liabilities held before the functional currency normalisation date at fair value on the date of transition to IFRSs. *[IFRS 1.D29]*. In practice, the existence of severe hyperinflation (as described by the standard) is a rare economic occurrence (see Chapter 6 at section 5.16).

The characteristics of severe hyperinflation were changed slightly with the issuance of *Lack of Exchangeability* (Amendments to IAS 21 *The Effects of Changes in Foreign Exchange Rates*) in August of 2023.

11 Translation of a hyperinflationary entity into a different presentation currency

IAS 21 requires an entity to determine its functional currency as the currency of the primary economic environment in which it operates. If the functional currency is that of a hyperinflationary economy, the entity's financial statements are restated in accordance with IAS 29. An entity cannot avoid restatement by adopting as its functional currency, a currency other than the functional currency as determined in accordance with IAS 21. *[IAS 21.14]*.

However, an entity is permitted to present its financial statements in any presentation currency it chooses. Likewise, when a group contains individual entities with different functional currencies, the results and financial position of each entity are expressed in a common currency so that consolidated financial statements may be presented. *[IAS 21.38]*. A different presentation currency will not alter the entity's functional currency or the requirement to apply IAS 29.

It is noted that jurisdictions considered to be hyperinflationary are frequently subject to severe exchange controls and therefore determining an appropriate exchange rate for translation to a presentation currency may be difficult. Where judgement has been used to determine an appropriate rate, this should be disclosed. In 2014, the IFRS IC noted that predominant practice is to apply by extension the principle in IAS 21.26 (see Chapter 16 at section 5.1.4), which gives guidance on which exchange rate to use when reporting foreign currency transactions in the functional currency when several exchange rates are available.[1] In August 2023, the IASB issued *Lack of Exchangeability* (Amendments to IAS 21 *The Effects of Changes in Foreign Exchange Rates*). These amendments propose more detailed guidance on determining appropriate exchange rates in such situations (see Chapter 16 at section 7). If both exchange rates and inflation rates are required to be estimated, consistent assumptions should be used in making both estimates.

If an entity, whose functional currency is hyperinflationary, wants to translate its financial statements into a different presentation currency it must first restate its financial statements in accordance with IAS 29, *[IAS 21.43]*, and then apply the following procedures under IAS 21: *[IAS 21.42]*.

Extract from IAS 21

42 The results and financial position of an entity whose functional currency is the currency of a hyperinflationary economy shall be translated into a different presentation currency using the following procedures:

(a) all amounts (ie assets, liabilities, equity items, income and expenses, including comparatives) shall be translated at the closing rate at the date of the most recent statement of financial position, except that

(b) when amounts are translated into the currency of a non-hyperinflationary economy, comparative amounts shall be those that were presented as current year amounts in the relevant prior year financial statements (ie not adjusted for subsequent changes in the price level or subsequent changes in exchange rates).

In other words, when an entity that applies IAS 29 translates its financial statements into a non-hyperinflationary presentation currency, the comparative information is not restated under IAS 29. Instead, IAS 21 should be applied and the comparative amounts are those that were presented as current year amounts in the prior period. The following table summarises the impact of hyperinflation on various scenarios of translation into an alternative presentation currency.

1 *IFRIC Update*, November 2014, p.8. Available on the IFRS Foundation's website.

	Translation to non-hyperinflationary presentation currency	Consolidation into non-hyperinflationary group	Consolidation into hyperinflationary group
Example	Argentinian entity* presenting its financial statements in euros	Argentinian subsidiary consolidated by parent presenting its financial statements in euros	Argentinian subsidiary consolidated by a Venezuelan parent*
Restate comparatives for hyperinflation	No	No	Yes
Exchange rate to use for comparative period	Closing rate at comparative balance sheet date	Closing rate at comparative balance sheet date	Closing rate at current balance sheet date
Restatement upon initial application of IAS 29 recognised in	Opening balance sheet of current period	Opening balance sheet of current period	Opening balance sheet of earliest comparative period

* At the time of writing both the Argentinian Peso and Venezuelan Bolivar were considered to be hyperinflationary.

All exchange differences that arise on the translation of an entity whose functional currency is not the currency of a hyperinflationary economy are recognised in other comprehensive income (see Chapter 16 at section 6.1). *[IAS 21.39]*. IAS 21 does not however stipulate the same treatment for exchange differences arising on translation of an entity whose functional currency is hyperinflationary. *[IAS 21.42]*.

In March 2020, the IFRS IC issued an agenda decision on the appropriate treatment of such exchange differences. It was noted that the translation of a hyperinflationary entity into a non-hyperinflationary currency may result in a change in the entity's net investment in the hyperinflationary foreign operation. This change would include two effects:

- A restatement effect resulting from restating the entity's interest in the equity of the hyperinflationary foreign operation as required by IAS 29.

  And

- A translation effect resulting from translating the entity's interest in the equity of the hyperinflationary foreign operation (excluding the effect of any restatement required by IAS 29) at a closing rate that differs from the previous closing rate.

They noted that IAS 1 states that components of other comprehensive income include gains and losses arising from translating the financial statements of a foreign operation. *[IAS 1.7]*. IAS 21 explains that exchange differences arising from translating the financial statements of a non-hyperinflationary foreign operation are recognised in other comprehensive income and not in profit or loss because the changes in exchange rates have little or no direct effect on the present and future cash flows from operations. *[IAS 21.41]*. The IFRS IC observed that this explanation is also relevant if the foreign operation's functional currency is hyperinflationary. Accordingly, the Committee concluded that an entity presents:

- The IAS 29 restatement effect and the IAS 21 translation effect in other comprehensive income, if the entity considers that the combination of those two effects meets the definition of an exchange difference in IAS 21.

  Or

- The IAS 21 translation effect in other comprehensive income if the entity considers that only the translation effect meets the definition of an exchange difference in IAS 21. In this case, consistent with the requirements in IAS 29.25, the entity presents the IAS 29 restatement effect in equity. *[IAS 29.25]*.[2]

2 *IFRIC Update*, March 2020, available on the IFRS Foundation's website.

The illustration below shows the changes of the net assets of an entity with a hyperinflationary functional currency being translated into a non-hyperinflationary presentation currency.

Illustration 11-1: Translation to non-hyperinflationary presentation currency

The table below illustrates the translation of the financial information of an entity with a hyperinflationary functional currency (FC) to a non-hyperinflationary presentation currency (assumed to be Australian dollars), focusing on the impact on the statement of changes in equity. For the purposes of the illustration these currencies are indicated as FC and A$ respectively. In this example, the entity is assumed to be in scope of IAS 29 in both the current and prior periods and to have a 31 December year end.

Financial information in hyperinflationary functional and presentation currency:

Statement of financial position

Reporting period and date of reporting	20x5 at 20x5	20x4 at 20x5	20x4 at 20x4
Currency	FC	FC	FC
- Land	400	400	267
- Bank	1,000	1,500	1,000
- Equity	1,400	1,900	1,267

Statement of profit or loss

Monetary loss	- 500
Net profit	- 500

Assumed foreign exchange rates (FC: A$)

1 January 20x5	1.0
31 December 20x5	0.8

Movements in net asset value in presentation currency

	Functional currency		Exchange rate		Presentation currency	
	FC				A$	
Opening equity at 1 January 20x5	**1,267**	**(a)**	**1**	**(b)**	**1,267**	
Movement in foreign exchange rate (OCI)					- 253	(c)
Uplift to IAS 29 opening balance (OCI / Equity)	633	(d)	0.8	(e)	507	(f)
Net profit	- 500	(g)	0.8	(e)	- 400	
Closing equity at 31 December 20x5	**1,400**		**0.8**	**(e)**	**1,120**	

(a) As comparative amounts are those that were presented as current year amounts in the relevant prior year financial statements, the opening balance for the current year is the closing balance reported in 20x4 as restated to this date. This will not be the same as the opening balance as reported in the 20x5 year in the financial statements presented in the hyperinflationary currency (i.e., the FC 1,900).

(b) As comparative amounts are those that were presented as current year amounts in the relevant prior year financial statements, the opening balance for the current year translated at the closing exchange rate of the prior period.

(c) This amount represents the change in currency for the opening balance and is calculated as the opening balance multiplied by the closing exchange rate less the opening exchange rate, in this case FC 1,269 x (0.8 - 1) = A$ 253 loss, representing the devaluation of the FC currency during the year. This would be an IAS 21 translation effect and is presented in other comprehensive income.

(d) This amount represents the difference between the closing balance of net assets as reported in the prior year in the hyperinflationary functional currency and the opening balance of net assets as reported in the current year. The difference results from the restatement of the comparative information as described in sections 5 and 8 above.

(e) As required by IAS 21.42, all amounts other than those relating to comparatives shall be translated at the closing rate at the date of the most recent statement of financial position, in this case the rate at 31 December 20x5.

(f) The movement in net assets for the uplift to the IAS 29 opening balance as reported in the functional currency financial information, translated into the presentation currency could be presented within either other comprehensive income or equity depending on whether the adjustment is considered to meet the definition of an exchange difference in IAS 21 or not, respectively, as discussed above.

(g) Net profit is based on the amounts as reported in the hyperinflationary functional currency. No adjustments to this amount are required as a result of the process of translating to the non-hyperinflationary functional currency.

Had the entity not been in scope of IAS 29 in the prior period, the same principles would be applied, but the amount calculated in (d) above would be the cumulative catch up from the number previously reported without any inflationary uplift to the current period opening balance restated in terms of IAS 29.

In practice, clearly differentiating between an exchange difference and equity adjustment (per notes c and d in the illustration above) can be difficult, particularly as hyperinflation and exchange rate effects are inversely correlated and that the split may differ depending on the timing and frequency of reporting.

11.1 Translation on initial application and ceasing application of IAS 29

Related questions arise in the year an entity first becomes hyperinflationary, as the retrospective application of IAS 29 gives rise to an adjustment for the initial application of the standard. As discussed in section 5 above, retained earnings are restated to an amount derived from all the other amounts in the statement of financial position. It could be argued that the impact of initial adoption of IAS 29, being the net asset value reported at the end of the prior year and the opening net asset value as restated per IAS 29, should be recognised directly in equity similar to a change in accounting policy. However, as the adjustment is normally closely related to (past) changes in exchange rates, an argument could also be made that this adjustment could be presented in other comprehensive income.

It is also unclear how to deal with the accumulated foreign currency translation reserve that relates to the now hyperinflationary foreign operation. The agenda decision issued in March 2020 by the IFRS IC also addresses the question whether an entity reclassifies within equity the cumulative pre-hyperinflation exchange differences when a foreign operation becomes hyperinflationary. That is, whether the entity transfers the cumulative pre-hyperinflation exchange differences to a component of equity that is not subsequently reclassified to profit or loss.

Paragraph 41 of IAS 21 requires an entity to present the cumulative amount of exchange differences recognised in other comprehensive income in a separate component of equity until disposal of the foreign operation. *[IAS 21.41]*. Furthermore, IAS 21.48 and 48C require an entity to reclassify the cumulative amount of those exchange differences from equity to profit or loss on disposal or partial disposal of a foreign operation in certain circumstances.

Accordingly, the IFRS IC concluded that an entity presents the cumulative amount of the exchange differences as a separate component of equity until disposal or partial disposal of the foreign operation and does not reclassify within equity the cumulative pre-hyperinflation exchange differences once the foreign operation becomes hyperinflationary.[3] If an entity considers that the combination of the IAS 29 restatement effect and the IAS 21 translation effects meet the definition of an exchange difference in IAS 21 (as discussed in section 11 above) then, upon initial application of IAS 29, both those effects are accounted as part of the cumulative amount of the exchange differences.

3 *IFRIC Update*, March 2020, available on the IFRS Foundation's website.

When the economy ceases to be hyperinflationary, and restatement in accordance with IAS 29 is no longer required, an entity uses the amounts restated to the price level at the date it ceased restating its financial statements as the historical costs for translation into the presentation currency. *[IAS 21.43]*.

11.2 Fair value adjustments and goodwill on business combinations

When a hyperinflationary foreign operation that was acquired in a business combination (as defined in IFRS 3 *Business Combinations*) is being consolidated, the provisions of IAS 29 also need to be considered.

As described in Chapter 10 at sections 5.1 and 6, respectively, most identifiable assets acquired and liabilities assumed of the acquiree are initially recognised by the acquirer at fair value at the acquisition date, and goodwill may be recognised. Any goodwill arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation shall be treated as assets and liabilities of the foreign operation. *[IAS 21.47]*. Therefore, as assets and liabilities of the foreign operation (which were current at the date of acquisition), it follows that these are restated for any subsequent inflation in accordance with the provisions of IAS 29. Any related deferred tax is to be remeasured as discussed in section 4.4 above.

11.3 Presentation currency considerations for comparative information

Given that IAS 29 requires a hyperinflationary entity to restate its comparative figures, the question arises as to how an entity (a parent) that does not operate in a hyperinflationary economy, should account for the restatement of an entity (a subsidiary) that operates in an economy that became hyperinflationary in the current reporting period when incorporating it within its consolidated financial statements. This issue has been clarified by IAS 21 which specifically prohibits restatement of comparative figures when the presentation currency is not hyperinflationary. *[IAS 21.42(b)]*. This means that when the financial statements of a hyperinflationary subsidiary are translated into the non-hyperinflationary presentation currency for consolidation into the financial statements of the parent, the comparative amounts in annual and interim financial statements are not adjusted.

However, the impact on interim financial statements of such a parent may be more difficult to resolve. For example, a non-hyperinflationary parent (with a December year-end) may own a subsidiary whose functional currency is considered hyperinflationary from, say, 1 July 20X2 onwards. The subsidiary's second quarter results would not have been adjusted for the impact of hyperinflation, while its third quarter results would reflect the effects of hyperinflation for the period from the beginning of the year to the reporting date. This results in the parent needing to reflect a 'catch up effect' in its third quarter or full year reporting. As the prior year comparative figures cannot be restated under IAS 21, the full effect would be included in the current period. *[IAS 21.42(b)]*. However, IAS 29.4 specifically states that the standard "…applies to the financial statements of any entity from the beginning of the reporting period in which it identifies the existence of hyperinflation in the country in whose currency it reports".

If separate information is presented for each quarter, it is not clear how this effect should be taken into consideration in preparing the parent's third quarter results, specifically whether the year-to-date results are adjusted as though the subsidiary was hyperinflationary from the beginning of the year or only from the beginning of the third quarter. Possible approaches would include:

- Reporting the difference between the year-to-date profit for the third quarter and the year-to-date profit for the second quarter in which the subsidiary is restated under IAS 29 (i.e., with purchasing power adjustments to 30 June).

  Or

- Reporting the third quarter profits as the difference between the year-to-date profit in which the subsidiary is restated under IAS 29, less the year-to-date second quarter profits as they were actually reported (i.e., non-hyperinflation based results).

The first approach is consistent with the requirement that the year-end accounts will be prepared as if the economy had been hyperinflationary from the beginning of 20X2, will provide a better basis for comparison in 20X2 and will result in individual quarters in 20X1 being more comparable. Nevertheless, IAS 34 does not specifically address the issue of restating previous interim periods upon first application of IAS 29 and we consider the second approach to also be acceptable.

How we see it

As there is no clear guidance on the appropriate method of quantification, entities shall adopt a consistent approach and disclose this judgement and the impact thereof on the financial statements if it has a significant impact, as required by IAS 1. If the hyperinflationary subsidiary is relatively small within the overall consolidated accounts of the parent, the benefit of restating previous interim periods will often be limited.

Additional questions arising in respect of the preparation of quarterly interim financial statements in the scenario described above would include:

- Would the parent entity need to re-issue interim reports that had been issued earlier in the current year?
- In the period that the subsidiary's economy becomes hyperinflationary, would the parent entity adjust the comparative interim information for hyperinflation (and year to date interim information) for the same interim period in the prior year?
- In the first quarter of the following financial period (20X3), would the parent entity adjust the comparative information for hyperinflation (and year to date interim information) for the same interim period in the prior year (20X2)?

Although the subsidiary will apply the requirements of IAS 29 on a retrospective basis, the parent will incorporate the results of the subsidiary into the group financial statements as required by IAS 21. Hyperinflation only commenced after the end of the interim reports. This is a non-adjusting event in accordance with IAS 10. Hence, in response to the first question, the interim financial statements were compliant with the requirements of the standards, and the parent would not be required to re-issue prior interim financial statements in the year that the subsidiary's functional currency becomes hyperinflationary, although we believe re-issue is permissible.

Hyperinflationary adjustments would only occur in the interim financial statements of the parent from the date that the subsidiary became hyperinflationary onwards. Further, IAS 21 would preclude the restatement of comparative interim financial statements as contemplated in the second question above. *[IAS 21.42(b)]*.

The issue addressed in the third question is not specifically addressed by IAS 21 or IAS 34. We consider that the parent entity is allowed but not required to restate its comparative (20X2) interim statements in its 20X3 reporting. The IFRS IC discussed a request on this issue, noting little diversity in practice with the majority of respondents not restating comparative information, and therefore declined to add the matter to its standard setting agenda.[4] These specific requirements of IAS 34 are considered in Chapter 37 at section 9.6.2.

4 *IFRIC Update*, March 2020, available on the IFRS Foundation's website.

12 Translation of a non-hyperinflationary entity into a hyperinflationary group

In June 2022, the IFRS IC discussed a paper about the accounting applied by a parent whose functional currency is the currency of a hyperinflationary economy, when it consolidates a subsidiary whose functional currency is the currency of a non-hyperinflationary economy. The Committee considered whether, in preparing its consolidated financial statements, the parent applies IAS 29 to restate the current year and comparative amounts presented for its non-hyperinflationary subsidiary. If the parent were to restate the current year and comparative amounts, it would express those amounts in terms of the measuring unit current at the end of the reporting period (the reporting date).

The two approaches discussed by the Committee were[5]:

- *The parent does not restate the results and financial position of its non-hyperinflationary subsidiary in terms of the measuring unit current at the reporting date*: the current year financial information is only adjusted by applying the appropriate exchange rate for the period, as discussed in Chapter 16 at section 6.1. When the current year becomes the comparative period, the financial information of the hyperinflationary parent is restated while the financial information of the non-hyperinflationary subsidiary is not, and therefore, the consolidation for this period, as well as the opening statement of financial performance, is required to be reperformed.
- *The parent restates the results and financial position of its non-hyperinflationary subsidiary in terms of the measuring unit current at the reporting date*: the current year financial information is adjusted by applying the appropriate exchange rate for the period, as discussed in Chapter 16 at section 6.1. The information in the statement of financial position is considered current and therefore, does not require restatement, while the statement of comprehensive income is adjusted for inflation and expressed in the measuring unit current at the reporting date. When the current year becomes the comparative period, the consolidated comparatives are restated by applying the measuring unit current at the end of the reporting period.

The Committee commented that, applying the requirements in IAS 21 and IAS 29 to the submitted fact pattern, the parent could restate or not restate the subsidiary's results and financial position in terms of the measuring unit current at the end of the reporting period.[6] The IFRS IC recommended that the IASB develop a narrow-scope amendment addressing the matter above as well as the related matter of an entity whose functional currency is the currency of a non-hyperinflationary economy but that presents its financial statements in the currency of a hyperinflationary economy.[7] In July 2024, an exposure draft, IASB ED/2024/4 *Translation to a Hyperinflationary Presentation Currency*, addressing this issue was released.

This exposure draft proposes that when an entity translates amounts from a functional currency that is the currency of a non-hyperinflationary economy to a presentation currency that is the currency of a hyperinflationary economy, the entity translates those amounts, including comparative amounts, using the closing rate at the date of the most recent statement of financial position. The IASB expects this translation method would result in an entity presenting amounts subject to translation in terms of a current measuring unit. The document also proposes certain disclosures for groups in this scenario.[8]

Until this exposure draft is finalised, preparers should ensure that the approach taken is clearly outlined in the accounting policies.

5 IASB Staff Paper 2, Project: *Consolidation of a Non-Hyperinflationary Subsidiary by a Hyperinflationary Parent (IAS 21 and IAS 29)*, Paper topic: *Initial consideration*, IFRS IC meeting, June 2022. Available on the IFRS Foundation's website.

6 *IFRIC Update*, June 2022, available on the IFRS Foundation's website.

7 *IFRIC Update*, June 2023, available on the IFRS Foundation's website.

8 Exposure Draft ED/2024/4, *Translation to a Hyperinflationary Presentation Currency*, IASB, July 2024. Available on the IFRS Foundation's website.

13 Elimination of intergroup transactions

When transactions take place between hyperinflationary and non-hyperinflationary entities within a group, the restatement process of IAS 29 and the translation requirements of IAS 21 result in complexities in eliminating these transactions on consolidation as required by IFRS 10 *Consolidated Financial Statements* and discussed at (Chapter 8 at section 2.4). *[IFRS 10.B86(c)]*.

The elimination of intercompany receivables or payables is straightforward, as balances are translated at closing rates and therefore, the amounts reflected for each entity in the consolidation would be equal to that reflected by the counterparty. In contrast, an intercompany income or expense is affected by the requirement to use different exchange rates and the restatement for inflation. For example, if a management fee, denominated in a hyperinflationary currency, is charged by a subsidiary in a hyperinflationary currency to a fellow subsidiary in a non-hyperinflationary currency:

- *The hyperinflationary subsidiary would restate its income for the effects of hyperinflation (see section 6 above) and translate the income at the closing rate into the presentation currency for consolidation purposes (see section 4.3.1 above).*
- *The non-hyperinflationary subsidiary would not restate its expense for hyperinflation and likely apply the average exchange rate to translate the expense into the presentation currency for consolidation purposes (see Chapter 16 at section 5.1.3).*

As a result, the amounts reflected for each entity in the consolidation would not be equal to that reflected by the counterparty. The question therefore arises as to how this difference should be treated upon consolidation. The IFRS IC observed in March 2020 that an entity presents in other comprehensive income any exchange difference resulting from the translation of a hyperinflationary foreign operation.[9]

How we see it

In the absence of specific guidance, the Committee's observation, as discussed in more detail in section 11 above, provides the clearest guidance. To the extent the difference caused by the IAS 29 restatement effect and the IAS 21 translation effect in combination meet the definition of an exchange difference, applying the principles of this observation, the difference would be eliminated against other comprehensive income. To the extent that the entity considers only the IAS 21 impact to meet the definition of an exchange difference, this portion is eliminated against other comprehensive income and the impact of the restatement for inflation is recognised directly in equity. Under this approach, as only the hyperinflationary entity is exposed to a monetary gain or loss, this is not eliminated on consolidation.

9 *IFRIC Update*, March 2020, available on the IFRS Foundation's website.

14 Disclosures

Extract from IAS 29

39 The following disclosures shall be made:

(a) the fact that the financial statements and the corresponding figures for previous periods have been restated for the changes in the general purchasing power of the functional currency and, as a result, are stated in terms of the measuring unit current at the end of the reporting period;

(b) whether the financial statements are based on a historical cost approach or a current cost approach; and

(c) the identity and level of the price index at the end of the reporting period and the movement in the index during the current and the previous reporting period.

[IAS 29.39].

It should be noted that disclosure of financial information that is restated under IAS 29 as a supplement to unrestated financial information is not permitted. This is to prevent entities from giving the historical cost based financial information greater prominence than the information that is restated under IAS 29. The standard also discourages separate presentation of unrestated financial information, but does not explicitly prohibit it. *[IAS 29.7]*. However, such unrestated financial statements would not be in accordance with IFRS and shall be clearly identified as such. An entity that is required (for example by local tax authorities or stock exchange regulators) to present unrestated financial statements needs to ensure that the IFRS financial statements are perceived to be the main financial statements rather than mere supplemental information.

The following excerpts illustrate the disclosure of the gain or loss on net monetary position, the basis of preparation and the required disclosures in respect of the relevant price index.

Practical example 14-1: D-MARKET Elektronik Hizmetler ve Ticaret Anonim Şirketi (2023) **Turkey**

Form 20-F [extract]

Part III [extract]

ITEM 19. EXHIBITS [extract]

CONSOLIDATED FINANCIAL STATEMENTS [extract]

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME/(LOSS)
FOR THE YEARS ENDED 31 DECEMBER 2023, 2022 AND 2021
(Amounts expressed in thousands of Turkish Lira ("TRY") in the terms of purchasing power of the TRY at 31 December 2023, as described in note 2.1 unless otherwise indicated.)

	Notes	1 January – 31 December 2023	1 January – 31 December 2022	1 January – 31 December 2021
Revenues	17	35,558,521	26,478,009	24,792,125
Operating expenses				
Cost of inventory sold		(24,788,674)	(20,723,995)	(19,437,507)
Shipping and packaging expenses		(3,323,926)	(2,629,327)	(3,129,641)
Payroll and outsource staff expenses		(3,504,010)	(2,949,586)	(2,615,881)
Advertising expenses		(2,427,752)	(2,908,700)	(4,862,066)
Technology expenses		(412,177)	(302,220)	(204,238)
Depreciation and amortization	10, 11, 12	(1,174,133)	(844,891)	(637,012)
Other operating income	18	478,979	129,600	262,337
Other operating expenses	18	(1,131,805)	(1,361,640)	(944,750)
Operating loss		**(724,977)**	**(5,112,750)**	**(6,776,633)**
Financial income	19	3,539,610	3,153,151	6,630,917
Financial expenses	20	(4,010,055)	(2,817,667)	(3,277,178)
Monetary gains/ (losses)		1,270,956	(13,421)	92,814
Income/(loss) before income taxes		**75,534**	**(4,790,687)**	**(3,330,080)**

...

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS AT 31 DECEMBER 2023, 2022 AND 2021 [extract]

NOTE 2 - BASIS OF PRESENTATION OF CONSOLIDATED FINANCIAL STATEMENTS [extract]

2.1 Basis of preparation [extract]

The consolidated financial statements are prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"). Hepsiburada and its subsidiaries maintain their books of account in Turkish Lira ("TRY") based on the Turkish Commercial Code ("TCC"), Turkish tax legislation and the Uniform Chart of Accounts issued by the Ministry of Finance of Türkiye. These consolidated financial statements are based on the statutory records, which are maintained under the historical cost convention except for the financial investments which are measured at fair value, with adjustments and reclassifications for the purpose of fair presentation in accordance with IFRS.

The preparation of consolidated financial statements in accordance with IFRS requires the use of certain critical accounting estimates. It also requires judgment in the process of applying the Group's accounting policies. The areas involving a higher degree of judgment or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements are disclosed in Note 2.2.

Financial reporting in hyperinflationary economy

Since the beginning of 2021, inflation in Türkiye has increased significantly. With the cumulative effect of increasing inflation in recent three years, it has become necessary for entities operating in Türkiye to apply International Accounting Standards ("IAS") 29 – Financial Reporting in Hyperinflationary Economies starting from 30 June 2022. One of the important indicators for the application of IAS 29 is a three-year compound inflation rate approaching or exceeding 100%. Three-year cumulative increase in Consumer Price Index (CPI) as of June 2022 has been 136% in Türkiye according to inflation data published by Statistical Institute of Türkiye on 4 July 2022.

Adjustments have been made in accordance with the terms of IAS 29 "Financial Reporting in Hyperinflationary Economies" regarding the changes in the general purchasing power of the Turkish Lira as of 31 December 2023. The terms of IAS 29 require that financial statements prepared in the currency in the economy with hyperinflation should be expressed in terms of the measuring unit current at the end of the reporting period and the amounts for the corresponding previous periods should also be stated in terms of the measuring unit current at the end of the reporting period.

For the application of IAS 29, the Group used the conversion coefficient derived from the CPI in Türkiye published by the Statistical Institute of Türkiye. The indices and coefficients used to prepare the consolidated financial statements are as follows:

Date	Index	Adjustment Coefficient	Three years compound inflation rates
31 December 2023	1859.38	1.000	268 %
31 December 2022	1128.45	1.648	156 %
31 December 2021	686.95	2.707	74 %

...

Telefónica, S.A. is an example of a parent entity that has subsidiaries that operate in an economy subject to hyperinflation. As a parent entity, Telefónica, S.A. would not restate the comparative amounts and, therefore, has reported a reconciling item for the effect of hyperinflation adjustments.

Practical example 14-2: Telefónica, S.A. (2023) **Spain**

Consolidated Annual Report 2023 [extract]

Consolidated financial statements 2023 [extract]

Notes to the consolidated financial statements (consolidated annual accounts) for the year ended December 31, 2023 [extract]

Note 25. Tax matters [extract]

Deferred taxes movement

The movements in deferred taxes in the Telefónica Group in 2023 and 2022 are as follows:

Millions of euros	Deferred tax assets	Deferred tax liabilities
Balance at December 31, 2022	**4,884**	**3,067**
Additions	2,040	383
Disposals	(760)	(673)
Transfers	15	21
Translation differences and hyperinflation adjustments	61	(92)
Company movements and others	—	(4)
Balance at December 31, 2023	**6,240**	**2,702**

...

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Chapter 18 Intangible assets

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Overview

IAS 38 *Intangible Assets* prescribes the accounting treatment for intangible assets that are not specifically dealt with by another standard. There is a wide range of intangible assets, including software, brands and trademarks, customer relationship assets, licences and intellectual property.

This chapter explains the recognition and measurement requirements under IAS 38, providing detailed guidance on when an intangible asset must be recognised and what forms part of the cost of such an asset. These requirements differ depending on whether an intangible asset is acquired separately, acquired as part of a business combination, or is internally developed by an entity. IAS 38 also requires that certain costs must be recognised as an expense by an entity, for example training and start-up costs.

This chapter also covers the requirements in IAS 38 in relation to subsequent measurement, including detailed guidance on determining an appropriate amortisation period and method. IAS 38 has extensive disclosure requirements and this chapter contains several Practical examples of these disclosures.

The chapter also provides guidance on specific issues that affect many entities, including rate-regulated activities, emissions trading schemes and green certificates, Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH) costs, crypto-assets, and cloud computing arrangements.

What you need to know

- The objective of IAS 38 is to prescribe the accounting treatment for intangible assets that are not specifically dealt with in another standard.
- An intangible asset is defined as "an identifiable non-monetary asset without physical substance".
- The essential characteristics of intangible assets are that they are controlled by the entity, will give rise to future economic benefits for the entity, lack physical substance, and are identifiable.
- The recognition and measurement rules under IAS 38 differ depending on whether an intangible asset is acquired separately, acquired as part of a business combination, or is internally developed by an entity.
- IAS 38 specifies that certain costs must be expensed, including start-up costs (unless they qualify for recognition as an asset under IAS 16 *Property, Plant and Equipment*), training costs, advertising and promotional costs, and relocation and reorganisation costs.
- After initial recognition, intangible assets are subsequently measured using either the cost model, or the revaluation model.
- Intangible assets with an indefinite life must not be amortised, and instead are subject to an annual impairment test.

1 Introduction

1.1 Background

IAS 38 is structured along similar lines as IAS 16.

Prior to IAS 38, accounting practice for intangible assets had largely developed on an issue-by-issue basis, with the result being a variety of treatments for particular types of intangible assets. There have been many topical issues over the years: research and development (as long ago as the 1970s), brands and similar assets (particularly those arising in business combinations), and assets and costs that are directly and indirectly related to the internet and personal communications. In time, it became apparent that two different types of intangible rights shared characteristics that made a single standard meaningful.

Firstly, there are internal costs incurred by entities from which they expect to benefit in the future. The critical issue is identifying whether, when and how much of these costs must be recognised as assets, and how much must be recognised immediately as expenses. For example, there are many types of expenditure from which an entity may expect to benefit in the future, but it is not possible to identify an asset, or the relationship between the cost and future benefits is too tenuous to allow capitalisation.

Secondly, there are intangible rights acquired separately or as part of business combinations. For intangible rights acquired in a business combination, a key issue is whether the intangible rights are distinguishable from goodwill and must be recognised separately. This became more important as a consequence of goodwill not being amortised, which means that entities must identify as separate intangible assets certain rights, e.g., customer relationships that had historically been subsumed within goodwill.

Unlike IAS 16, the scope of which is defined by its title (it applies to property, plant and equipment), IAS 38 includes a definition of the assets to which it applies. However, this is so general (an intangible asset is an identifiable non-monetary asset without physical substance) that the standard must exclude certain assets and items of expenditure that would otherwise fall within it. The definition could include assets generated by other standards, which are therefore excluded from scope. Incidentally, this shows just how broad the definition could be as the list of scope exemptions includes deferred tax assets, leases and assets arising from employee benefits which are within scope of, respectively, IAS 12 *Income Taxes*, IFRS 16 *Leases,* and IAS 19 *Employee Benefits*. *[IAS 38.3]*. Additional clarification comes from the prohibition on recognising internally generated goodwill. This means that expenditure on brands and similar assets cannot be recognised as an intangible asset, as it is not possible to distinguish these costs from the costs of developing the business as a whole. *[IAS 38.63, IAS 38.64]*. However, arguably the opposite approach is taken with the intangible assets identified in a business combination, where the standard encourages separate recognition through a broad approach given to concepts such as separability. This remains a difficult and controversial area, discussed in section 5 below. The requirements of IFRS 3 *Business Combinations* are discussed in Chapter 10.

This chapter addresses the specific provisions of IAS 38, with the requirements relating to intangible assets acquired as part of a business combination being covered both in section 5 below and in Chapter 10. IFRS 13 *Fair Value Measurement* includes the guidance relating to the determination of fair values (see Chapter 15). Impairment of intangible assets is addressed in IAS 36 *Impairment of Assets*, covered in Chapter 21.

Other intangible assets are dealt with by specific accounting pronouncements. The amount spent on the operation and development of websites led to the issue of SIC-32 *Intangible Assets - Web Site Costs,* which is discussed in section 6.2.5 below. Although IAS 38 addresses acquisition by way of government grant, this has not proved sufficient to address accounting for various schemes designed to influence business behaviour, especially in environmental areas. Emissions trading schemes give rise to intangible rights and the attempts to devise a satisfactory accounting model for these and similar schemes are considered in section 11.2 below.

Recent years have seen an increase in the use and trading of crypto-assets such as Bitcoin and Ether. These may meet the relatively wide definition of intangible assets and can be accounted for under IAS 38. Crypto-assets are discussed in section 11.6 below.

Cloud computing arrangements, which are becoming increasingly common as an alternative to on-site software and computing infrastructure, are discussed in section 11.7 below.

In April 2024, the IASB announced that it had commenced a comprehensive review of the accounting requirements for intangibles.[1] This project will assess whether the requirements of IAS 38 remain relevant and continue to fairly represent current business models, or if improvements to the standard are required. The initial research and planning phase of the project aims to define the scope of issues to be explored and determine the most appropriate approach to plan and organise the work to be carried out under the project. This project is in response to feedback received as part of the IASB's Third Agenda Consultation, which notes that stakeholders highlighted deficiencies in the reporting of intangibles, and the fact that some of the matters raised have a pervasive effect given that they affect so many companies in many jurisdictions.[2] In June 2024, the IFRS IC discussed the proposed project and provided input to the IASB on a number of areas.[3] Common areas of suggested focus included the accounting for, crypto assets, carbon credits and emission rights, and cloud computing.

1 *IASB Update*, April 2024, available on the IFRS Foundation's website.

2 IASB, *Third Agenda Consultation Feedback Statement*, July 2022, available on the IFRS Foundation's website.

3 *IFRIC Update*, June 2024, available on the IFRS Foundation's website.

1.2 Terms used in IAS 38

The following terms are used in IAS 38 with the meanings specified: *[IAS 38.8, IAS 38.12]*

Extract from IAS 38

8 The following terms are used in this Standard with the meanings specified:

Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

An *asset* is a resource:

(a) controlled by an entity as a result of past events; and

(b) from which future economic benefits are expected to flow to the entity.[1]

Carrying amount is the amount at which an asset is recognised in the statement of financial position after deducting any accumulated amortisation and accumulated impairment losses thereon.

Cost is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction, or, when applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, eg IFRS 2 *Share-based Payment*.

Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value.

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

Entity-specific value is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13 *Fair Value Measurement*.)

An *impairment loss* is the amount by which the carrying amount of an asset exceeds its recoverable amount.

An *intangible asset* is an identifiable non-monetary asset without physical substance.

Monetary assets are money held and assets to be received in fixed or determinable amounts of money.

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

The *residual value* of an intangible asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Useful life is:

(a) the period over which an asset is expected to be available for use by an entity; or

(b) the number of production or similar units expected to be obtained from the asset by an entity.

12 An asset is identifiable if it either:

(a) is separable, ie is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

1 The definition of an asset in this Standard was not revised following the revision of the definition of an asset in the *Conceptual Framework for Financial Reporting* issued in 2018.

In addition to the above definitions, IAS 38 also defines control as "the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits". *[IAS 38.13]*.

2 Objective and scope of IAS 38

The objective of IAS 38 is to prescribe the accounting treatment for intangible assets that are not specifically dealt with in another standard. *[IAS 38.1]*.

IAS 38 does not apply to accounting for:

(a) Intangible assets that are within the scope of another standard

(b) Financial assets, as defined in IAS 32 *Financial Instruments: Presentation*

(c) The recognition and measurement of exploration and evaluation assets within the scope of IFRS 6 *Exploration for and Evaluation of Mineral Resources*

And

(d) Expenditure on the development and extraction of, minerals, oil, natural gas and similar non-regenerative resources. *[IAS 38.2]*.

Examples of specific types of intangible asset that fall within the scope of another standard include: *[IAS 38.3]*

(a) Intangible assets held by an entity for sale in the ordinary course of business, to which IAS 2 *Inventories* applies (see Chapter 23).

(b) Deferred tax assets, which are governed by IAS 12 (see Chapter 29).

(c) Leases of intangible assets accounted for in accordance with IFRS 16 (see Chapter 24). Rights held by a lessee under licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights that are outside the scope of IFRS 16, *[IFRS 16.3(e)],* are within the scope of IAS 38. *[IAS 38.6]*.

(d) Assets arising from employee benefits, for which IAS 19 is relevant (see Chapter 31).

(e) Financial assets as defined in IAS 32. The recognition and measurement of some financial assets are covered by IFRS 10 *Consolidated Financial Statements,* IAS 27 *Separate Financial Statements,* and IAS 28 *Investments in Associates and Joint Ventures* (see Chapter 7, Chapter 9, Chapter 12 and Chapter 40 to Chapter 50).

(f) Goodwill acquired in a business combination, which is determined under IFRS 3 (see Chapter 10).

(g) Contracts within the scope of IFRS 17 *Insurance Contracts* and any assets for insurance acquisition cash flows as defined in IFRS 17 (see Chapter 51).

(h) Non-current intangible assets classified as held for sale, or included in a disposal group that is classified as held for sale, in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* (see Chapter 5).

And

(i) Assets arising from contracts with customers that are recognised in accordance with IFRS 15 *Revenue from Contracts with Customers (see Chapter 28).*

IAS 38 excludes insurance contracts and expenditure on the exploration for, or development and extraction of oil, gas and mineral deposits in extractive industries from its scope, because activities or transactions in these areas are so specialised that they give rise to accounting issues that need to be dealt with in a different way. However, the standard does apply to other intangible assets used in extractive industries or by insurers (such as computer software), and other expenditure incurred by them (such as start-up costs). *[IAS 38.7]*.

Finally, the standard makes it clear that it applies to expenditures on advertising, training, start-up and research and development activities. *[IAS 38.5]*.

2.1 What is an intangible asset?

IAS 38 defines an asset as "a resource controlled by an entity as a result of past events; and from which future economic benefits are expected to flow to the entity[4]". *[IAS 38.8]*. Intangible assets form a sub-section of this group and are further defined as "an identifiable non-monetary asset without physical substance". *[IAS 38.8]*. The IASB considers that the essential characteristics of intangible assets are that they are:

- Controlled by the entity
- Will give rise to future economic benefits for the entity
- Lack physical substance

  And
- Are identifiable

An item with these characteristics is classified as an intangible asset regardless of the reason why an entity might hold that asset. *[IAS 38.BC5]*. There is one exception: intangible assets held for sale (either in the ordinary course of business or as part of a disposal group) and accounted for under IAS 2 or IFRS 5 are specifically excluded from the scope of IAS 38. *[IAS 38.3]*.

Businesses frequently incur expenditure on all sorts of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge, trademarks, brand names and publishing titles. Examples that fall under these headings include computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty schemes, market share and marketing rights. *[IAS 38.9]*.

Although these items are mentioned by the standard, not all of them will meet the standard's eligibility criteria for recognition as an intangible asset, which requires identifiability, control over a resource and the existence of future economic benefits. Expenditure on items that do not meet all three criteria will be expensed when incurred, unless they have arisen in the context of a business combination as discussed in section 5 below. *[IAS 38.10]*.

2.1.1 Identifiability

IAS 38's requirement that an intangible asset must be 'identifiable' was introduced to try to distinguish it from internally generated goodwill (which, outside a business combination, must not be recognised as an asset *[IAS 38.48]*), but also to emphasise that, especially in the context of a business combination, there will be previously unrecorded items that must be recognised in the financial statements as intangible assets separately from goodwill. *[IAS 38.BC7, IAS 38.BC8]*.

IFRS 3 defines goodwill as "representing the future economic benefits arising from other assets acquired in a **business combination** that are not individually identified and separately recognised". *[IFRS 3 Appendix A]*. For example, future economic benefits may result from synergy between the identifiable assets acquired or from assets that, individually, do not qualify for recognition in the financial statements. *[IAS 38.11]*.

IAS 38 states: *[IAS 38.12]*

Extract from IAS 38

12 **An asset is identifiable if it either:**

(a) is separable, ie is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

4 "The definition of an asset in this Standard was not revised following the revision of the definition of an asset in the *Conceptual Framework for Financial Reporting* issued in 2018."

The explicit requirement to recognise assets arising from contractual rights alone confirms the IASB's position that the existence of contractual or legal rights is a characteristic that distinguishes an intangible asset from goodwill, even if those rights are not readily separable from the entity as a whole. The Board cites as an example of such an intangible asset a licence that, under local law, is not transferable except by sale of the entity as a whole. *[IAS 38.BC10]*. Therefore, the search for intangible assets is not restricted to rights that are separable.

However, preparers must not restrict their search for intangible assets to those embodied in contractual or other legal rights, since the definition of identifiability merely requires such rights to be capable of separation. Non-contractual rights are required to be recognised as an intangible asset if the right could be sold, transferred, licensed, rented or exchanged. In considering the responses to Exposure Draft *ED 3 Business Combinations*, the Board observed that the existence of an exchange transaction for a non-contractual relationship provides evidence both that the item is separable, and that the entity is able to control the expected future economic benefits flowing from it, meaning that the relationship must be recognised as an intangible asset. Only in the absence of exchange transactions for the same or similar non-contractual customer relationships would an entity be unable to demonstrate that such relationships are separable, or that it can control the expected future economic benefits flowing from those relationships. *[IAS 38.BC13]*.

2.1.2 Control

IAS 38 defines control as the power to obtain the future economic benefits generated by the resource and the ability to restrict the access of others to those benefits. Control normally results from legal rights, in the way that copyright, a restraint of trade agreement or a legal duty on employees to maintain confidentiality protects the economic benefits arising from market and technical knowledge. *[IAS 38.13, IAS 38.14]*. While it will be more difficult to demonstrate control in the absence of legal rights, the standard is clear that legal enforceability of a right is not a necessary condition for control, because an entity may be able to control the future economic benefits in some other way. *[IAS 38.13]*. The existence of exchange transactions for similar non-contractual rights can provide sufficient evidence of control to require separate recognition as an asset. *[IAS 38.16]*. Obviously, determining that this is the case in the absence of observable contractual or other legal rights requires the exercise of judgement based on an understanding of the specific facts and circumstances involved.

For example, the standard acknowledges that an entity usually has insufficient control over the future economic benefits arising from an assembled workforce (i.e., a team of skilled workers, or specific management or technical talent) or from training, for these items to meet the definition of an intangible asset. *[IAS 38.15]*. There would have to be other legal rights before control could be demonstrated.

Illustration 2-1: Demonstrating control over the future services of employees

Entity A acquires a pharmaceutical company. A critical factor in the entity's decision to acquire the company was the reputation of its team of research chemists, who are renowned in their field of expertise. However, in the absence of any other legal rights, it would not be possible to show that the entity can control the economic benefits embodied in that team and its skills because any or all of those chemists could leave. Therefore, it is most unlikely that Entity A could recognise an intangible asset in relation to the acquiree's team of research chemists.

Entity B acquires a football club. A critical factor in the entity's decision to acquire the club was the reputation of its players, many of whom are regularly selected to play for their country. A footballer cannot play for a club unless he is registered with the relevant football authority. It is customary to see exchange transactions involving players' registrations. The payment to a player's previous club in connection with the transfer of the player's registration enables the acquiring club to negotiate a playing contract with the footballer that covers a number of seasons and prevents other clubs from using that player's services. In these circumstances, Entity B would be able to demonstrate sufficient control to recognise the cost of obtaining the players' registrations as an intangible asset.

In neither of the above examples is an asset being recognised for the assembled workforce. In the case of the football team, the asset being recognised comprises the economic benefits embodied in the players' registrations, arising from contractual rights. In particular, it is the ability to prevent other entities from using that player's services (i.e., restricting the access of others to those benefits), *[IAS 38.13]*, combined with the existence of exchange transactions involving similar players' registrations, *[IAS 38.16]*, that distinguishes this type of arrangement from a normal contract of employment. In cases when the transfer fee is a stand-alone payment and not part of a business combination, i.e., when an entity separately acquires the intangible resource, it is much more likely that it can demonstrate that its purchase meets the definition of an asset (see section 4 below).

Similarly, an entity would not usually be able to recognise an asset for an assembled portfolio of customers or a market share. In the absence of legal rights to protect or other ways to control the relationships with customers or the loyalty of its customers, the entity usually has insufficient control over the expected economic benefits from these items to meet the definition of an intangible asset. However, exchange transactions, other than as part of a business combination, involving the same or similar non-contractual customer relationships may provide evidence of control over the expected future economic benefits in the absence of legal rights. In that case, those customer relationships could meet the definition of an intangible asset. *[IAS 38.16]*. IFRS 3 includes a number of examples of customer-related intangible assets acquired in business combinations that meet the definition of an intangible asset, which are discussed in more detail in section 5 below. *[IFRS 3.IE23-IE31]*.

It is worth emphasising that intangible assets must be recognised, if and only if, they meet both the definition of an intangible asset and the applicable recognition criteria in IAS 38, *[IAS 38.18]*, which are discussed in section 3.1 below. All that is established in the discussion above is whether the intangible right meets the definition of an asset.

The Practical example below illustrates the range of intangible assets that require recognition under IAS 38.

Practical example 2-1: RELX PLC (2023) **United Kingdom**

Annual Report including Financial Statements and Corporate Responsibility Report [extract]
Financial statements and shareholder information [extract]
Financial statements and other information [extract]
Notes to the consolidated financial statements [extract]
14 Intangible assets [extract]
Accounting policy [extract]

...

Management judgement is required to identify intangible assets acquired as part of business combinations which comprise: market-related assets (e.g. trademarks, imprints, brands); customer-related assets (e.g. subscription bases, customer lists, customer relationships); editorial content; software and systems (e.g. application infrastructure, product delivery platforms, in-process research and development); and other intangible assets mainly comprising contract and rights-related assets.

...

2.1.3 Future economic benefits

Future economic benefits include not only future revenues from the sale of products or services but also cost savings or other benefits resulting from the use of the asset by the entity. For example, the use of intellectual property in a production process may reduce future production costs rather than increase future revenues. *[IAS 38.17]*.

2.2 Determining whether there is an intangible asset

In IAS 38 an asset is defined as "a resource controlled by an entity as a result of past events; and from which future economic benefits are expected to flow to the entity". *[IAS 38.8]*. Intangible assets form a sub-section of this group and are further defined as "an identifiable non-monetary asset without physical substance". *[IAS 38.8]*. As we have discussed earlier, this definition could include assets covered by another standard which are therefore excluded from its scope (see section 2 above). However, in some circumstances it is not clear whether IAS 38 or another standard applies.

2.2.1 Whether to record a tangible or intangible asset

Before the advent of IAS 38 many entities used to account for assets without physical substance in the same way as property, plant and equipment. Indeed, the standard notes that intangible assets can be contained in or on a physical medium such as a compact disc (in the case of computer software), legal documentation (in the case of a licence or patent) or film, requiring an entity to exercise judgement in determining whether to apply IAS 16 or IAS 38. *[IAS 38.4]*. For example:

- Software that is embedded in computer-controlled equipment that cannot operate without it is an integral part of the related hardware and is treated as property, plant and equipment. *[IAS 38.4]*.
- Application software that is being used on a computer is treated as an intangible asset because it is generally easily replaced and is not an integral part of the related hardware, whereas the operating system normally is integral to the computer and is included in property, plant and equipment. *[IAS 38.4]*.

- A database that is stored digitally is considered to be an intangible asset where the value of the physical medium is wholly insignificant compared to that of the data collection.
- Research and development expenditure may result in an asset with physical substance (e.g., a prototype), but as the physical element is secondary to its intangible component, the related knowledge, it is treated as an intangible asset. *[IAS 38.5]*.

It is worthwhile noting that the 'parts approach' in IAS 16 requires an entity to account for significant parts of an asset separately because they have a different economic life or are often replaced, *[IAS 16.44]*, (see Chapter 19). This raises 'boundary' problems between IAS 16 and IAS 38 when software and similar expenditure is involved.

How we see it

We believe that where IAS 16 requires an entity to identify parts of an asset and account for them separately, the entity needs to evaluate whether any intangible-type part is actually integral to the larger asset or whether it is really a separate asset in its own right. The intangible part is more likely to be an asset in its own right if it was developed separately or if it can be used independently of the item of property, plant and equipment of which it apparently forms part.

This view is consistent with that taken in IFRS 3, when it asserts that related tangible and intangible components of an asset with similar useful lives (meaning that IAS 16 would not require separate accounting of parts of an asset) can be combined into a single asset for financial reporting purposes. *[IFRS 3.B32(b)]*.

2.2.2 Classification of programme and other broadcast rights as inventory or intangible assets

Broadcasters purchase programmes under a variety of different arrangements. Often, they commit to purchasing programmes that are at a very early stage of development, perhaps merely being concepts. The broadcaster may have exclusive rights over the programme or perhaps only have the rights to broadcast for a set period of time or on a set number of occasions. IFRS accounting standards are not clear on how these rights must be classified and when they must be recognised.

Programme and other broadcast rights meet the definition of intangible assets because they are identifiable non-monetary assets without physical substance. IAS 38 specifically includes within its scope rights under licensing agreements for items such as motion picture films and video recordings. *[IAS 38.6]*. In addition, a broadcast right meets the other criteria for recognition as an intangible asset, being identifiable, as it arises from contractual rights, *[IAS 38.12(b)],* and is controlled by the entity. *[IAS 38.13]*.

Rights to programmes held exclusively for sale to other parties also meet the definition of inventory and are therefore within the scope of IAS 2 (see Chapter 23). *[IAS 38.3]*. It is possible to argue that programmes held with a view to broadcasting them to an audience are comparable to "materials or supplies to be consumed in the production process or in the rendering of services", *[IAS 2.6]*, which would mean that they could also be treated as inventory. Equally, it can be argued that such programme rights are intangible assets as they are used in the production or supply of services but are not necessarily consumed because they can be used again.

Without specific guidance in IFRS accounting standards, there is diversity among broadcasters in practice when classifying broadcast rights as either inventories or intangible assets. Entities will have to consider the particular facts and circumstances when classifying such rights, for example, it may be more appropriate to classify a right acquired for a single broadcast of a movie or sporting event without a rerun as inventory. In contrast, it may be more appropriate to classify acquired rights to an episodic series with a high rerun value, for example children's cartoons, as an intangible asset.

How we see it

The appropriate classification of broadcast rights depends on the particular facts and circumstances applicable to each case. We believe that an entity may either treat these rights as intangible assets and classify them under IAS 38 or classify them as inventory under IAS 2 (see Chapter 23 at section 2.3.1.B), depending on the particular facts and circumstances applicable to the entity.

Accordingly, where a broadcast right is classified as an intangible asset:

- It is classified in the statement of financial position as current or non-current according to the entity's operating cycle (see section 10.2 below).
- The intangible asset is amortised, with amortisation included in the statement of profit or loss within the depreciation and amortisation expense, or within a functional expense category (such as cost of sales).
- In the cash flow statement, payments for the acquisition of intangible broadcast rights are classified as an investing activity (if the asset is classified as non-current on acquisition) or as an operating activity if the asset is classified as current. This is because cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. Therefore, they generally result from the transactions and events that enter into the determination of profit or loss. *[IAS 7.14]*.

  And

- Rights are measured at a revalued amount only if the criteria in IAS 38 are met (see section 8.2 below). Otherwise, the asset is carried at cost less accumulated amortisation and impairments. Any impairment of the asset is determined in accordance with IAS 36.

When classified as inventory, the rights would be presented within current assets if the rights are expected to be sold, consumed or realised as part of the normal operating cycle, even if the intention is not to consume them within 12 months. *[IAS 1.66, IAS 1.68]*.

Paragraph 68 of IAS 1 *Presentation of Financial Statements*[5] defines the operating cycle of an entity as "the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. When the entity's normal operating cycle is not clearly identifiable, it is assumed to be twelve months". *[IAS 1.68]*. The distinction between current and non-current assets is discussed in Chapter 3 at section 3.1.1.

As with costs of other inventory, the cash outflows from acquisition will be classified as operating cash flows as they are primarily derived from the principal revenue-producing activities and the expense will be presented within cost of sales when the right is consumed.

Given the typical significance of broadcast rights for broadcasters, presenting these assets as a separate line item in the statement of financial position is also an alternative presentation observed in practice in accordance with IAS 1.57(a).

Both of these classifications are found in practice. Vivendi SE accounts for its film and television rights catalogues as intangible assets (see Practical example 3-1 in section 3.1.1 below). ITV plc on the other hand, presents its programme rights as current assets under the caption 'Programme rights and other inventory'.

5 IFRS 18 *Presentation and Disclosure in Financial Statements*, which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted) was issued by the IASB in April 2024.

Practical example 2-2: ITV plc (2023) **United Kingdom**

ITV plc Annual Report and Accounts 2023 [extract]
Financial Statements [extract]
Notes to the Financial Statements [extract]
Section 3: Operating Assets and Liabilities [extract]
3.1. Working capital [extract]
3.1.1 Programme rights and commitments [extract]
Programme rights [extract]

The Group's policies with respect to programme rights recognise that the pattern of consumption on linear and streaming (ITVX) varies. Consumption of content varies based on the type of programme right as well as the type of platform it is transmitted on. Programme rights are expensed through operating costs reflecting the pattern in which management expects the right to be consumed.

The Group has defined policies on how programme rights are allocated to linear and streaming based on a pattern of viewing. There are also distinct policies across the platforms when these programme rights are recognised in the Consolidated Statement of Financial Position; when these costs are released to the Consolidated Income Statement; and the impairment review of the carrying values of programme rights held.

Type of programme	Streaming policy	Linear policy
Acquired content	Cost charged to the Income Statement on a declining-balance method over the licence period	Cost charged to the Income Statement over a number of linear transmissions (episodic)
Commissioned content	Cost charged to the Income Statement on a declining-balance method over the licence period	Cost charged to the Income Statement on first linear transmission (episodic)
Sports rights	Cost charged to the Income Statement on first transmission	Cost charged to the Income Statement on first linear transmission
Current affairs, live events, soaps	Cost charged to the Income Statement on first transmission	Cost charged to the Income Statement on first linear transmission
Library of content (ITVX only)	Straight-line amortisation over licence windows	

Acquired programme rights are purchased for the primary purpose of broadcasting on the ITV family of channels, including ad-funded streaming service and subscription streaming service platforms. These are recognised within current assets the earlier of when payments are made or when the rights are ready for exploitation.

Commissions, which primarily comprise programmes purchased, based on editorial specification and over which the Group has some control, are recognised in current assets as payments are made.

...

Programme rights and other inventory at the year end are shown in the table below:

	2023 £m	2022 £m
Acquired programme rights	**284**	225
Commissions	**83**	103
Sports rights	**46**	49
	413	377

£nil relates to stock that will be transmitted in 2025 and beyond (2022: £6 million transmitted in 2024 and beyond).

...

3 Recognition and measurement

3.1 Recognition

An item that meets the definition of an intangible asset (see section 2.1 above) must be recognised, if and only if, at the time of initial recognition of the expenditure:

(a) It is probable that the expected future economic benefits that are attributable to the asset will flow to the entity

And

(b) The cost of the asset can be measured reliably *[IAS 38.21]*

Although IAS 38 does not define 'probable', it is defined in other standards as "more likely than not". *[IAS 37.23, IFRS 5 Appendix A]*. In assessing whether expected future economic benefits are probable, the entity must use reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset. *[IAS 38.22]*. In making this judgement the entity considers the evidence available at the time of initial recognition, giving greater weight to external evidence. *[IAS 38.23]*.

This test (that the item meets both the definition of an intangible asset and the criteria for recognition) is performed each time an entity incurs potentially eligible expenditures, whether to acquire or internally generate an intangible asset or to add to, replace part of, or service it subsequent to initial recognition. *[IAS 38.18]*. If these criteria are not met at the time the expenditure is incurred, an expense is recognised and it is never reinstated as an asset. *[IAS 38.68, IAS 38.71]*.

The guidance in IAS 38 on the recognition and initial measurement of intangible assets takes account of the way in which an entity obtained the asset. Separate rules for recognition and initial measurement apply for intangible assets depending on whether they were:

- Acquired separately (see section 4 below)
- Acquired by way of government grant (see section 4.6 below)
- Obtained in an exchange of assets (see section 4.7 below)
- Acquired as part of a business combination (see section 5 below)

Or

- Generated internally (see section 6 below) *[IAS 38.19]*

The difficulties that may arise in applying these criteria when an entity enters into a contract to buy an intangible asset for delivery in some future period are discussed in detail (in the context of programme and other broadcast rights) in section 3.1.1 below.

For recognition purposes IAS 38 does not distinguish between an internally generated and an acquired intangible asset other than when considering the treatment of goodwill. When the definition of an intangible asset and the relevant recognition criteria are met, all such assets must be recognised. *[IAS 38.BCZ40]*. Preparers do not have the option to decide, as a matter of policy, that costs relating to internally generated intangible assets are expensed if the recognition criteria in the standard are met. *[IAS 38.BCZ41]*.

3.1.1 When to recognise programme and other broadcast rights

Television stations frequently enter into contracts to buy programme rights related to long-running television series or future sports events that are not yet available for broadcast, sometimes over a specified period or for a certain number of showings or viewings. Payments might be made at the beginning of or during the broadcast period, which raises the question of when those programme rights and the related obligations for payment must be recognised in the statement of financial position.

In accordance with paragraph 4.3 of the *Conceptual Framework for Financial Reporting* (revised in 2018), an asset is a present economic resource controlled by an entity as a result of past events. *[CF 4.3]*.

Hence, it is necessary to determine when control is obtained. Under IFRS accounting standards, executory contracts, where both parties are still to perform (such as purchase orders where neither payment nor delivery has taken place), do not generally result in the recognition of assets and liabilities. When a broadcaster initially contracts to purchase a programme, it will not usually result in immediate recognition of an asset relating to that programme. At this point there will not normally be an asset under the control of the broadcaster. A broadcaster may have to consider whether the underlying resource is sufficiently developed to be identifiable (for example, whether the manuscript or screenplay has been written, and whether directors and actors have been hired).

How we see it

In the absence of specific guidance in IAS 38 on how to determine the timing of obtaining control of broadcast rights, an entity must make reference to the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*[6] (see Chapter 3 at section 4.3) when deciding on an accounting policy and refer to guidance in other standards, for example IFRS 15, to determine the point in time when control of broadcast rights is obtained.

Where there is difficulty in determining when control of the asset is obtained it may be helpful to assess at what point any liability arises, since a liability will generally indicate that an asset has been acquired. In practice an entity might recognise an asset and a liability for a specific broadcast right, for example:

- When a screening certificate is obtained
- When programming is available for exhibition
- At the beginning of the season
- At the beginning of the licence period

  Or
- At the date the event occurs (e.g., on a game-by-game basis)

The issue of when a licensor recognises revenue under IFRS 15 on the sale of such broadcast rights is covered in Chapter 28 at section 8.

Illustration 3-1: Determining when to recognise a broadcast right

A sporting competition - rights secured over a number of seasons

Entity A (the licensee) signs a contract with a licensor for the exclusive rights to broadcast matches in a long-established sporting competition covering the whole season for a number of years. The entity is required to pay agreed amounts at the start of each season, with the rights to that season and future seasons reverting to the licensor if payment is not made on time. Entity A concludes that an obligation does not exist until the beginning of each season for the amount payable to secure rights for that season.

The entity concludes that it has an asset for the rights to broadcast matches in each season and recognises that asset at the start of each season. The entity discloses a commitment for amounts payable in future years without recognising any asset or liability at that time.

Rights to broadcast the future output of a film production company

Entity B (the licensee) signs a contract with a film production company (the licensor) whereby the entity agrees to pay amounts in the future for a specified number of films that the licensor will release in that year, but neither the licensee not the licensor knows which films will be released when they sign the contract.

Based on an evaluation of the facts and circumstances, Entity B concludes that the underlying resource (the films) is not sufficiently developed to be identifiable at the time of signing the contract. Instead, the entity concludes that the criteria for recognising an intangible asset are not met until delivery of the films by the licensor.

6 The consequential amendments resulting from IFRS 18 *Presentation and Disclosure in Financial Statements*, once effective, changes the title of IAS 8 to *'Basis of Preparation of Financial Statements'* to better reflect the amended content of IAS 8. See Chapter 4 for further details on the requirements of IFRS 18.

This approach is illustrated in the extract from Vivendi SE's annual report below, which distinguishes between contracts requiring recognition and commitments to pay amounts in future periods when content is delivered.

Practical example 3-1: Vivendi SE (2023) **France**

FINANCIAL REPORT FOR THE YEAR 2023 [extract]

Financial Report and Audited Consolidated Financial Statements for the year ended December 31, 2023 [extract]

III- Audited Consolidated Financial Statements for the year ended December 31, 2023 [extract]

Notes to the Consolidated Financial Statements [extract]

Note 11 Content assets and commitments [extract]

11.2 Contractual content commitments [extract]

Commitments given recorded in the Statement of Financial Position: content liabilities

Content liabilities are mainly recorded in "Trade accounts payable and other" or in "Other non-current liabilities" whether they are current or non-current, as applicable.

	Minimum future payments as of December 31, 2023				Total minimum future payments as of December 31, 2022
		Payments due in			
(in millions of euros)	Total	2024	2025-2028	After 2028	
Film and television rights	213	213	-	-	183
Sports rights	476	476	-	-	520
Other	319 (a)	319	-	-	15
Content liabilities	**1,008**	**1,008**	**-**	**-**	**718**

...

Off-balance sheet commitments given/(received)

	Minimum future payments as of December 31, 2023				Total minimum future payments as of December 31, 2022
		Payments due in			
(in millions of euros)	Total	2024	2025-2028	After 2028	
Film and television rights (a)	2,761	1,241	1,505	15	3,234
Sports rights (b)	3,217 (b)	841	2,248	128	3,912
Other	-	-	-	-	5
Given commitments	**5,978**	**2,082**	**3,753**	**143**	**7,151**
Film and television rights (a)	(248)	(159)	(89)	-	(204)
Sports rights	(81)	(75)	(6)	-	(224)
Other	-	-	-	-	-
Received commitments	**(329)**	**(234)**	**(95)**	**-**	**(428)**
Total net	**5,649**	**1,848**	**3,658**	**143**	**6,723**

...

As illustrated in Practical example 2-2 in section 2.2.2 above, ITV plc follows a similar type of approach for acquired programme rights under which an asset is recognised as payments are made and is recognised in full when the acquired programming is available for transmission.

3.2 Measurement

On initial recognition an intangible asset must be measured at cost. *[IAS 38.24]*. The standard defines this as the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction. When the nature of the consideration given is governed by other IFRS accounting standards, the cost of the asset is the amount initially recognised in accordance with the specific requirements of that standard, e.g., IFRS 2 *Share-based Payment*. *[IAS 38.8]*.

IAS 38's initial measurement depends, in part, on the manner in which the asset is acquired, this is discussed in more detail in sections 4 to 6 below. The components of the cost of an internally generated intangible asset are discussed in more detail in section 6.3 below.

3.3 Subsequent expenditure

Although IAS 38 is based on a general recognition principle that applies to both initial acquisition and subsequent expenditures, the hurdle for the recognition of subsequent expenditure as an addition to an intangible asset is set higher, because it must first be confirmed that the expenditure is not associated with the replacement of an existing asset (see section 9.5.1 below) or the creation of an internally generated intangible that would not be eligible for recognition under the standard (see section 6 below). The standard presumes that only rarely will subsequent expenditure, i.e., expenditure incurred after the initial recognition of an acquired intangible asset or after completion of an internally generated intangible asset, be recognised in the carrying amount of an asset. In most cases, subsequent expenditures are likely to maintain the expected future economic benefits embodied in an existing intangible asset rather than meet the definition of an intangible asset and the recognition criteria in IAS 38. The standard also notes that it is often difficult to attribute subsequent expenditure directly to a particular intangible asset rather than to the business as a whole. *[IAS 38.20]*.

Capitalisation of subsequent expenditure on brands, mastheads, publishing titles, customer lists and similar items is expressly forbidden even if they were initially acquired externally, which is consistent with the general prohibition on recognising them if internally generated. This is because the standard argues that such expenditure cannot be distinguished from the cost of developing the business of which they are a part. *[IAS 38.20, IAS 38.63]*. Thus, at best such expenditure creates unrecognised internally generated goodwill that might be crystallised only in a business combination.

4 Separate acquisition

4.1 Recognition

Separately acquired intangible rights will normally be recognised as assets. IAS 38 assumes that the price paid to acquire an intangible asset usually reflects expectations about the probability that the future economic benefits embodied in it will flow to the entity. In other words, the entity always expects there to be a flow of economic benefits, even if it is uncertain about the timing or amount. *[IAS 38.25]*. Therefore, the standard assumes that the cost of a separately acquired intangible asset can usually be measured reliably, especially in the case of cash or other monetary purchase considerations. *[IAS 38.26]*.

Not all external costs incurred to secure intangible rights automatically qualify for capitalisation as separately acquired assets, because they do not meet the definition of an intangible asset in the first place. An entity that subcontracts the development of intangible assets (e.g., development-and-supply contracts or research and development contracts) to other parties (its suppliers) must exercise judgement in determining whether it is acquiring an intangible asset or whether it is obtaining goods and services that are being used in the development of an intangible asset by the entity itself. In the latter case, the entity will only be able to recognise an intangible asset if the expenditure meets IAS 38's requirements for internally generated assets (see section 6 below).

In determining whether a supplier is providing services to develop an internally generated intangible asset, the terms of the supply agreement must be examined to see whether the supplier is bearing a significant proportion of the risks associated with a failure of the project. For example, if the supplier is always compensated under a development-and-supply contract for development services and tool costs irrespective of the project's outcome, the entity on whose behalf the development is undertaken must account for those activities as its own.

If the entity pays the supplier upfront or by milestone payments during the course of a project, it will not necessarily recognise an intangible asset on the basis of those payments. Some payments may represent prepayments for goods and services to be received in the future, and are recognised as prepayments when made. The entity then recognises the goods or services when received. In addition, only costs incurred after it becomes probable that economic benefits are expected to flow to the entity will be part of the cost of an intangible asset (see section 6.2 below).

4.2 Components of cost

The standard sets out what the cost of a separately acquired intangible asset comprises: *[IAS 38.27, IAS 38.28]*

Extract from IAS 38

27 The cost of a separately acquired intangible asset comprises:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and

(b) any directly attributable cost of preparing the asset for its intended use.

28 Examples of directly attributable costs are:

(a) costs of employee benefits (as defined in IAS 19) arising directly from bringing the asset to its working condition;

(b) professional fees arising directly from bringing the asset to its working condition; and

(c) costs of testing whether the asset is functioning properly.

Capitalisation of expenditure ceases when the asset is in the condition necessary for it to be capable of operating in the manner intended by management. *[IAS 38.30]*. This may well be before the date on which it is brought into use.

If payment for an intangible asset is deferred beyond normal credit terms, its cost is the cash price equivalent. The difference between this amount and the total payments is recognised as interest expense over the period of credit unless it is capitalised in accordance with IAS 23 *Borrowing Costs* (see Chapter 22). *[IAS 38.32]*.

4.3 Costs to be expensed

The following types of expenditure are not considered to be part of the cost of a separately acquired intangible asset:

- Costs of introducing a new product or service, including costs of advertising and promotional activities
- Costs of conducting business in a new location or with a new class of customer, including costs of staff training
- Administration and other general overhead costs
- Costs incurred in using or redeploying an intangible asset
- Costs incurred while an asset capable of operating in the manner intended by management has yet to be brought into use

  And
- Initial operating losses, such as those incurred while demand for the asset's output builds up *[IAS 38.29, IAS 38.30]*

Accordingly, start-up costs, training costs, advertising and promotional activities, and relocation or reorganisation costs must be expensed (see section 7 below).

4.4 Income from incidental operations while an asset is being developed

When an entity generates income while it is developing or constructing an asset, the question arises as to whether this income must reduce the initial carrying value of the asset being developed or be recognised in profit or loss. IAS 38 requires an entity to consider whether the activity giving rise to income is necessary to bring the asset to the condition necessary for it to be capable of operating in the manner intended by management, or not. The income and related expenses of incidental operations (being those not necessary to develop the asset for its intended use) must be recognised immediately in profit or loss and included in their respective classifications of income and expense. *[IAS 38.31]*. Such incidental operations can occur before or during the development activities. The example below illustrates these requirements.

Illustration 4-1: Incidental operations

Entity A is pioneering a new process for the production of a certain type of chemical. Entity A will be able to patent the new production process. During the development phase, A is selling quantities of the chemical that are produced as a by-product of the development activities that are taking place. The expenditure incurred comprises labour, raw materials, assembly costs, costs of equipment and professional fees.

The revenues and costs associated with the production and sale of the chemical are accounted for in profit or loss for the period, while the development costs that meet the strict recognition criteria of IAS 38 are recognised as an intangible asset. Development costs that fail the IAS 38 recognition test are also expensed.

As the above example suggests, identifying the revenue from incidental operations will often be much easier than allocating costs to incidental operations. Furthermore, it will often be challenging to determine when exactly a project moves from the development phase into its start-up phase.

IAS 38 is not explicit on how to account for income earned in relation to activity that is determined necessary to bring the intangible asset into its intended use. IAS 16 however does provide guidance in relation to this for items of property, plant and equipment that are under construction (see Chapter 19 at section 4.2.1). IAS 16 requires that the proceeds, together with the cost of those items measured in accordance with IAS 2, from selling items produced while bringing an asset to the location and condition necessary for it to be capable of operating in the manner intended by management, are to be recognised in profit or loss in accordance with applicable standards. *[IAS 16.20A]*. In the absence of specific guidance in IAS 38, an entity must refer to the hierarchy in IAS 8 to develop an appropriate accounting policy (see Chapter 3 at section 4.3). The hierarchy requires an entity to firstly consider the requirements in IFRS accounting standards dealing with similar and related issues. *[IAS 8.11]*. Therefore, an entity should consider the extent to which it could apply the guidance in IAS 16, discussed above, to income earned in relation to activity that is determined necessary to bring the intangible asset into its intended use.

An example of such income would be where income is generated from the sale of samples produced during the testing of a new process or from the sale of a production prototype. However, care must be taken to confirm whether the incidence of income indicates that the intangible asset is ready for its intended use, in which case capitalisation of costs would cease, revenue would be recognised in profit or loss and the related costs of the activity would include a measure of amortisation of the asset.

4.5 Measurement of intangible assets acquired for variable or contingent consideration

The purchase price of an intangible asset might include variable or contingent amounts. Transactions involving variable or contingent consideration are often very complex and payment may depend on a number of factors. Examples include variable or contingent payments based on an index or rate, variable or contingent payments that depend on the purchasers' future actions, variable or contingent payments related to the condition of the asset, or variable or contingent payments related to the asset's performance. Some arrangements may contain more than one source of variability or contingency. Further complexity can also arise when arrangements are akin to profit sharing agreements, which are not addressed in any standard.

The topic of variable payments for an asset purchase was discussed by the IFRS IC between 2011 and 2016, and an agenda decision was published in March 2016. The Committee's discussions considered both the accounting at the date of purchasing the asset and subsequently, and distinguished between variable payments that depend on the purchaser's future activity and those that do not. The Committee determined that the issue was too broad for it to address within the confines of existing standards and recommended that the IASB address the accounting for variable payments comprehensively. In May 2016, the IASB tentatively agreed that this issue would be included in the research pipeline between 2017 and 2021.[7] At the time of writing this is not listed as an active research project on the IASB's work plan.[8]

A critical step in analysing the accounting for the purchase of an intangible asset in an arrangement involving variable or contingent consideration is to fully understand the contractual arrangements, and understanding the nature of the contingent or variable payments. This includes developing a full understanding of whether those contingent or variable payments are linked to the initial value of the asset or to its future performance, whether the contingency or variability is within or outside of the purchaser's control and whether the variable or contingent payment is a payment for some other goods or services from the seller. Sometimes a contract may establish an obligation for the variable or contingent payment at the outset, whilst in others it might be determined that the arrangement is an executory contract, and the liability for the variable or contingent payments is only recognised later once either party fulfils its obligations under the contract.

The two key questions with regards to the accounting for variable or contingent consideration in an asset purchase are 1) whether and when to recognise a liability for that variable or contingent consideration, and 2) whether subsequent changes to the estimate of variable or contingent consideration should be accounted for as part of the cost of the acquired asset.

Looking at the first question of when a liability to make variable or contingent payments would be recognised, if the arrangement is not considered to be an executory contract, one consideration is whether those payments are dependent on the entity's future activity, or not. IAS 32 stipulates that where the contingency is outside the control of both the issuer and the holder, a contingent obligation to deliver cash meets the definition of a financial liability (see Chapter 43 at section 4.3). *[IAS 32.25]*. Therefore, if the obligation to make the variable payment does not depend on the acquiring entity's future activity, it would seem appropriate to recognise a financial liability in respect of the contingent amounts. However, it is acknowledged that whilst this view was tentatively agreed during the course of the IFRS IC discussions on the topic, ultimately, this was not clarified or confirmed as part of the final agenda decision. Furthermore, the final agenda decision notes that there are questions about the accounting for variable payments subsequent to the purchase of the asset, and in making that statement the IFRS IC did not distinguish between the different types of variable payments.

How we see it

In light of the discussions held by the IFRS IC, and in the absence of clear guidance in the final agenda decision, entities will need to develop and apply an accounting policy in respect of whether and when the obligation to make contingent payments is recognised as a liability. The policy selected should result in information that is relevant and reliable in the particular circumstances and must be consistently applied to similar transactions. Different payments may have different types of variability. Therefore, it might be appropriate for an entity to have different policies for dissimilar transactions. If information about the selected accounting policy is expected to be material to users of the financial statements, that accounting policy information should be disclosed.

7 *IASB Update*, May 2016, available on the IFRS Foundation's website.

8 *IFRS Foundation work plan*, available on the IFRS Foundation's website (accessed 25 September 2024).

As described above, there is no explicit guidance on the treatment of variable or contingent consideration in the acquisition of an asset and there is diversity in practice for these types of arrangements. Therefore, examples of some accounting policies an entity may want to consider regarding initial recognition of the asset include the following:

- The cost of the asset on initial recognition includes the fair value of all variable or contingent consideration at the date of acquisition. A corresponding liability is recognised for the same amount.
- The cost of the asset on initial recognition excludes any variable or contingent payments. Accordingly, no liability is recognised for those contingent or variable amounts.

The second question that needs to be addressed is how the entity must account for subsequent payments and changes to the estimate of variable or contingent consideration. Depending on the facts and circumstances of the arrangement an entity may determine that:

1) Variability arises from exchange rates, time value of money, or embedded derivatives - Changes in the carrying amount of a recognised liability that arise from exchange rates are accounted for in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates* and IFRIC 22 *Foreign Currency Transactions and Advance Consideration*, while the time value of money and embedded derivatives are accounted for in accordance with IFRS 9 *Financial Instruments*;
2) Variability is directly linked to the quality or quantity of the asset(s) received - In these cases, the initial recognition of the asset and liability would have been based on an accounting estimate that is subsequently updated in accordance with IAS 8.37; or
3) The variability in the arrangement does not fall under (1) or (2) above and an accounting policy needs to be developed to address it.

In the latter case, an entity will need to apply the requirements of IAS 8 to develop an accounting policy that it should apply consistently to all similar transactions. The accounting policy developed will need to address whether the change in the estimate of variable or contingent consideration should be capitalised as part of the cost of the asset or expensed. This determination is usually based on the reason for the contingent payment and entities should consider the substance of the arrangement in determining the appropriate treatment.

It is only appropriate for subsequent changes to a recognised liability to be recognised as part of the cost of the asset to the extent that it relates to future economic benefits embodied in the asset initially received. For example, if the contingency or variability is viewed as being linked to the quality or quantity of the asset initially received. Variability arising due to other factors, such as its use over time, would generally be expensed.

How we see it

Until this matter is resolved by the IASB, where the accounting for the variability or contingency is not prescribed in another standard, an entity should develop and apply a consistent accounting policy in relation to whether subsequent payments or changes to the measurement of a recognised liability to make contingent or variable payments are included as part of the cost of an acquired asset or expensed as incurred, in accordance with the hierarchy in IAS 8.

An entity should exercise judgement in developing and consistently applying an accounting policy that results in information that is relevant and reliable in the particular circumstances.

If information about the selected accounting policy is expected to be material to users of the financial statements, that accounting policy information should be disclosed.

For intangible assets, the approaches discussed above are shown in the following Illustration. Note that this example does not include a number of common contingent payments, e.g., those related to usage or revenue, or those related to changes in exchange rates or the time value of money.

Illustration 4-2: Contingent consideration relating to a football player's registration

Entity A is a football club which signs a new player on a 4 year contract. In securing the registration of the new player, Entity A agrees to make the following payments to the player's former club:

(1) CU5.5 million on completion of the transfer

(2) CU2.8 million on the first anniversary of the transfer

(3) CU1 million as soon as the player has made 25 appearances for the club

(4) CU0.2 million if the player is first selected to play for his country

And

(5) 25% of the gross proceeds from any onward sale of the player before the expiry of the initial contract term

It is determined that the expenditure meets the definition of an intangible asset because it allows Entity A to negotiate a playing contract with the footballer that covers 4 seasons and prevents other clubs from using that player's services over that time. How does Entity A determine the cost of the player registration?

Example accounting policy 1

All of the above payments are contractual, and a financial liability arises under IFRS 9 as soon as that player signs for the club. Accordingly, Entity A selects an accounting policy where the cost of the intangible asset comprises the initial payment of CU5.5 million, plus an amount representing the present value of the CU2.8 million deferred consideration payable in one year and an amount to reflect the fair value of the other contingent payments (for example, determined using some kind of probability-weighted estimation technique). Entity A will need to select an accounting policy to recognise subsequent changes in the liability either as part of the cost of the intangible asset (because the contingency or variability is considered to be linked to the quality or quantity of the asset initially received), or in profit or loss (because the contingency or variability is considered to be due to other factors, such as its use over time).

Example accounting policy 2

Entity A selects an accounting policy in which both the CU5.5 million payable on completion of the transfer, and the CU2.8 million deferred consideration, is recognised as part of the initial cost of the intangible asset. No liability is recognised at acquisition for the contingent and variable payments that have been agreed. Once the contingency or variability is resolved Entity A will need to select an accounting policy to recognise the payment as either as part of the cost of the intangible asset (because the contingency or variability is considered to be linked to the quality or quantity of the asset initially received), or in profit or loss (because the contingency or variability is considered to be due to other factors, such as its use over time).

MERCK Kommanditgesellschaft auf Aktien has developed an accounting policy for contingent consideration linked to both milestone payments, and sales-based royalties, in relation to the acquisition of intangible assets outside of a business combination.

Practical example 4-1: MERCK Kommanditgesellschaft auf Aktien (2023) Germany

ANNUAL REPORT 2023 [extract]
Consolidated Financial Statements [extract]
Notes to the Consolidated Financial Statements [extract]
Operating Assets, Liabilities, and Contingent Liabilities [extract]
(19) Other intangible assets [extract]
Accounting and measurement policies [extract]
Recognition and initial measurement of purchased intangible assets [extract]

...

Contingent consideration linked to milestone payments in connection with the purchase of intangible assets arising outside a business combination is recognized as an intangible asset and as a financial liability once the milestone is reached. Contingent consideration in the form of sales-based royalties is expensed when incurred.

...

4.6 Acquisition by way of government grant

An intangible asset may sometimes be acquired free of charge, or for nominal consideration, by way of a government grant. Governments frequently allocate airport-landing rights, licences to operate radio or television stations, emission rights (see section 11.2 below), import licences or quotas, or rights to access other restricted resources. *[IAS 38.44]*.

Government grants must be accounted for under IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* which permits initial recognition of intangible assets received either at fair value or a nominal amount. *[IAS 20.23]*.

This represents an accounting policy choice for an entity that must be applied consistently to all intangible assets acquired by way of a government grant.

It may not be possible to measure reliably the fair value of all of the permits allocated by governments because they may have been allocated for no consideration, may not be transferable and may only be bought and sold as part of a business. Some of the issues surrounding the determination of fair value in the absence of an active market are considered in Chapter 15. Other allocated permits, such as milk quotas in certain countries, are freely traded and therefore do have a readily ascertainable fair value.

4.7 Exchanges of assets

Asset exchanges are transactions that have challenged standard-setters for many years. An entity might swap certain intangible assets that it does not require or is no longer allowed to use for those of a counterparty that has other surplus assets. For example, it is not uncommon for airlines and media groups to exchange landing slots and newspaper titles, respectively, to meet demands of competition authorities. It is also not uncommon for professional football clubs to exchange player registration rights. The question arises whether such transactions must be recorded at cost or fair value, which in the latter case would give rise to a gain in circumstances where the fair value of the incoming asset exceeds the carrying amount of the outgoing one. Equally, it is possible that a transaction could be arranged with no real commercial substance, solely to boost apparent profits (see section 4.7.2 below).

Three separate standards contain virtually identical guidance on accounting for exchanges of assets: IAS 16 (see Chapter 19), IAS 40 *Investment Property* (see Chapter 20) and IAS 38.

4.7.1 Measurement of assets exchanged

In the context of asset exchanges, the standard contains guidance on the reliable determination of fair values in the circumstances where market values do not exist. Note that while fair value is defined by reference to IFRS 13 (see Chapter 15), the requirements in this section are specific to asset exchanges in IAS 38.

IAS 38 requires all acquisitions of intangible assets in exchange for non-monetary assets, or a combination of monetary and non-monetary assets, to be measured at fair value. The acquired intangible asset is measured at fair value unless: *[IAS 38.45]*

(a) The exchange transaction lacks commercial substance

Or

(b) The fair value of neither the asset received, nor the asset given up, is reliably measurable

The acquired asset is measured in this way even if an entity cannot immediately derecognise the asset given up. If an entity is able to reliably determine the fair value of either the asset received or the asset given up, then it uses the fair value of the asset given up to measure cost unless the fair value of the asset received is more clearly evident. *[IAS 38.47]*. If the fair value of neither the asset given up, nor the asset received can be measured reliably, the acquired intangible asset is measured at the carrying amount of the asset given up. *[IAS 38.45]*.

In this context, the fair value of an intangible asset is reliably measurable if the variability in the range of reasonable fair value measurements is not significant for that asset or the probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value. *[IAS 38.47]*.

4.7.2 Commercial substance

A gain or loss is only recognised on an exchange of non-monetary assets if the transaction is determined to have commercial substance. Otherwise, the acquired asset is measured at the cost of the asset given up. *[IAS 38.45]*.

The commercial substance test for asset exchanges was put in place to prevent gains being recognised in income when the transaction had no discernible effect on the entity's economics. *[IAS 16.BC21]*. The commercial substance of an exchange is determined by forecasting and comparing the future cash flows expected to be generated by the incoming and outgoing assets. Commercial substance means that there must be a significant difference between the two forecasts.

The standard explains when an exchange transaction has commercial substance: *[IAS 38.46]*

Extract from IAS 38

46 An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

(a) the configuration (ie risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or

(b) the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange; and

(c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

For the purpose of determining whether an exchange transaction has commercial substance, the entity-specific value of the portion of the entity's operations affected by the transaction shall reflect post-tax cash flows. The result of these analyses may be clear without an entity having to perform detailed calculations.

IAS 38 defines the entity-specific value of an intangible asset as the present value of the cash flows an entity expects to arise from its continuing use and from its disposal at the end of its useful life. *[IAS 38.8]*. In determining whether an exchange transaction has commercial substance, the entity-specific value of the portion of the entity's operations affected by the transaction must reflect post-tax cash flows. *[IAS 38.46]*. This is different from the calculation of an asset's value in use under IAS 36 (see Chapter 21), as it uses a post-tax discount rate based on the entity's own risks rather than IAS 36, which requires use of the pre-tax rate that the market would apply to a similar asset.

The standard acknowledges that the result of this analysis might be clear without having to perform detailed calculations. *[IAS 38.46]*.

5 Acquisition as part of a business combination

The requirements of IFRS 3 apply to intangible assets acquired in a business combination. The recognition and initial measurement requirements are discussed in detail in Chapter 10 and a summary is given below. The emphasis in IFRS 3 is that, in effect, it does not matter whether assets meeting the definition of an intangible asset have to be combined with other intangible assets, incorporated into the carrying value of a complementary item of property, plant and equipment with a similar useful life or included in the assessment of the fair value of a related liability. The important requirement is that the intangible asset is recognised separately from goodwill.

The process of identifying intangible assets in a business combination might involve, for example:

- Reviewing the list of items that meet the definition of an intangible asset in IFRS 3 (see section 5.2 below)
- A review of documents such as those related to the acquisition, other internal documents produced by the entity, public filings, press releases, analysts' reports, and other externally available documents

  And
- Comparing the acquired business to similar businesses and their intangible assets

Intangible assets that are used differ considerably between industries and between individual entities. Therefore, considerable expertise and careful judgement is required in determining whether there are intangible assets that need to be recognised and valued separately.

IFRS 3 provides a long list of items that must be recognised separately from goodwill (see section 5.2 below). The list is not intended to be exhaustive.

5.1 Recognition of intangible assets acquired in a business combination

As noted in section 3.1 above, an intangible asset must only be recognised if: *[IAS 38.21]*

(a) It is probable that the expected future economic benefits that are attributable to the asset will flow to the entity

  And

(b) The cost of the asset can be measured reliably

5.1.1 Probable inflow of benefits

In the case of a business combination, the probability recognition criterion is always considered to be satisfied. The cost of the intangible asset is its fair value at the acquisition date. The standard indicates that the fair value reflects expectations about the probability that the future economic benefits embodied in the asset will flow to the entity. *[IAS 38.33]*. In other words, the existence of a fair value means that an inflow of economic benefits is considered to be probable, in spite of any uncertainties about timing or amount.

5.1.2 Reliability of measurement

Under IFRS 3, the cost of the intangible asset acquired in a business combination can always be measured reliably. *[IAS 38.BC19A]*.

In developing IFRS 3, the Board concluded that the needs of users were better served by recognising intangible assets, on the basis of an estimate of fair value, rather than subsuming them in goodwill, even if a significant degree of judgement is required to estimate fair value. *[IAS 38.BC19B]*. Accordingly, if an asset acquired in a business combination is separable or arises from contractual or other legal rights, there is sufficient information to measure reliably the fair value of the asset. Thus, the requirement in section 3.1 above for reliable measurement of cost is always considered to be satisfied for intangible assets acquired in business combinations. *[IAS 38.33]*.

5.1.3 Identifiability in relation to an intangible asset acquired in a business combination

Intangible assets need to be identifiable to distinguish them from goodwill. The two elements of identifiability are the existence of contractual or other legal rights and separability. Separability means that the asset is capable of being sold, transferred, licensed, rented or exchanged without having to dispose of the whole business. An intangible asset is considered to be separable regardless of whether the entity intends to sell or otherwise transfer it. *[IAS 38.12]*.

If an intangible asset acquired in a business combination is separable or arises from contractual or other legal rights, sufficient information exists to measure reliably the fair value of the asset. Where there are a range of possible outcomes with different probabilities in estimating an intangible asset's fair value, this uncertainty must be factored into the measurement of the asset's fair value. *[IAS 38.35]*.

The IASB recognised that an intangible asset acquired in a business combination might be separable, but only together with a related contract, identifiable asset or liability. In such cases, IAS 38 requires the acquirer to recognise the intangible asset separately from goodwill, but together with the related contract, asset or liability. *[IAS 38.36]*.

Acquirers are permitted to recognise a group of complementary intangible assets as a single asset provided the individual assets in the group have similar useful lives. For example, the terms 'brand' and 'brand name' are often used as synonyms for trademarks and other marks. However, 'brands' are regarded as general marketing terms that are typically used to refer to a group of complementary assets such as a trademark or service mark and its related trade name, formulas, recipes and technological expertise. *[IAS 38.37]*. Anheuser-Busch InBev NV/SA, for example, acknowledges the relationship between trademarks and other complementary assets such as formulas, recipes or technological expertise acquired in business combinations.

Practical example 5-1: Anheuser-Busch InBev NV/SA (2023) — Belgium

Annual Report 2023 [extract]
Financial report [extract]
Consolidated financial statements [extract]
Notes to the consolidated financial statements [extract]
3. Summary of significant accounting policies [extract]
(F) INTANGIBLE ASSETS [extract]

Brands

If part of the consideration paid in a business combination relates to trademarks, trade names, formulas, recipes or technological expertise these intangible assets are considered as a group of complementary assets that is referred to as a brand for which one fair value is determined. Expenditure on internally generated brands is expensed as incurred.

IFRS 3 contains additional guidance on the application of the contractual-legal and separability criteria that indicate how far the IASB expects entities to go to ensure that intangible assets acquired in a business combination are recognised separately from goodwill.

5.1.3.A Contractual-legal rights

An intangible asset that arises from contractual or other legal rights is recognised separately from goodwill even if it is not transferable or separable from the acquiree or from other rights and obligations. For example:

(a) An acquiree owns and operates a nuclear power plant. The licence to operate that power plant is an intangible asset that meets the contractual-legal criterion for recognition separately from goodwill, even if the acquirer cannot sell or transfer it separately from the acquired power plant. However, IFRS 3 goes on to say that an acquirer may recognise the fair value of the operating licence and the fair value of the power plant as a single asset for financial reporting purposes if the useful lives of those assets are similar.

(b) An acquiree owns a technology patent. It has licensed that patent to others for their exclusive use outside the domestic market, receiving a specified percentage of future foreign revenue in exchange. Both the technology patent and the related licence agreement meet the contractual-legal criterion for recognition separately from goodwill even if selling or exchanging the patent and the related licence agreement separately from one another would not be practical. *[IFRS 3.B32]*.

5.1.3.B Separability

IFRS 3 emphasises that the separability criterion means that an acquired intangible asset is capable of being separated or divided from the acquiree, regardless of the intentions of the acquirer. It adds that an acquired intangible asset is recognised separately from goodwill if there is evidence of exchange transactions for that type of asset or an asset of a similar type, even if those transactions are infrequent and regardless of whether the acquirer is involved in them. For example, customer and subscriber lists are frequently licensed and thus merit recognition as intangible assets. The standard acknowledges that an acquiree might try to distinguish its customer lists from those that are frequently licensed generally, in order to justify no recognition. However, in the absence of a truly distinguishing feature, such as confidentiality or other agreements that prohibit an entity from selling, leasing or otherwise exchanging information about its customers, these non-contractual rights must be recognised separately from goodwill. *[IFRS 3.B33]*.

An intangible asset that is not individually separable from the acquiree or combined entity must still be recognised separately from goodwill if it could be separable in combination with a related contract, identifiable asset or liability. For example, an acquiree owns a registered trademark and documented but unpatented technical expertise used to manufacture the trademarked product. The entity could not transfer ownership of the trademark without everything else necessary for the new owner to produce an identical product or service. Because the unpatented technical expertise must be transferred if the related trademark is sold, it is separable and not included in the carrying value of goodwill. *[IFRS 3.B34]*.

The requirements described above demonstrate how IFRS 3 and IAS 38 define intangible assets in a way that eliminates as much as possible any barrier to recognising them separately from goodwill.

5.2 Examples of intangible assets acquired in a business combination

IFRS 3 provides a long list of examples of items acquired in a business combination that meet the definition of an intangible asset and must therefore be recognised separately from goodwill. *[IFRS 3.IE16-IE44]*. The list is not intended to be exhaustive and other items acquired in a business combination might still meet the definition of an intangible asset. *[IFRS 3.IE16]*.

The table below summarises the items included in the IASB's Illustrative Example. Reference should be made to the Illustrative Example itself for any further explanation about some of these items.

Intangible assets arising from contractual or other legal rights (regardless of being separable)	Other intangible assets that are separable
Marketing-related	
▸ Trademarks, trade names, service marks, collective marks and certification marks ▸ Internet domain names ▸ Trade dress (unique colour, shape or package design) ▸ Newspaper mastheads ▸ Non-competition agreements	
Customer-related	
▸ Order or production backlog ▸ Customer contracts and the related customer relationships	▸ Customer lists ▸ Non-contractual customer relationships
Artistic-related	
▸ Plays, operas and ballets ▸ Books, magazines, newspapers and other literary works ▸ Musical works such as compositions, song lyrics and advertising jingles ▸ Pictures and photographs ▸ Video and audio-visual material, including films, music videos and television programmes	

Intangible assets arising from contractual or other legal rights (regardless of being separable)	Other intangible assets that are separable
Contract-based	
▸ Licensing, royalty and standstill agreements ▸ Advertising, construction, management, service or supply contracts ▸ Construction permits ▸ Franchise agreements ▸ Operating and broadcast rights ▸ Servicing contracts such as mortgage servicing contracts ▸ Employment contracts that are beneficial contracts from the perspective of the employer because the pricing of those contracts is below their current market value ▸ Use rights such as drilling, water, air, mineral, timber-cutting and route authorities ▸ Advertising, construction, management, service or supply contracts	
Technology-based	
▸ Patented technology ▸ Computer software and mask works ▸ Trade secrets such as secret formulas, processes and recipes	▸ Unpatented technology ▸ Databases, including title plants

Further details on the requirements relating to intangible assets acquired as part of a business combination are covered in Chapter 10.

5.3 Measuring the fair value of intangible assets acquired in a business combination

IFRS 3 assumes that there will always be sufficient information to measure reliably the fair value of an intangible asset acquired in a business combination if it is separable or arises from contractual or other legal rights.

The issues underlying the initial measurement of these intangible assets are discussed further in Chapter 10. The requirements of IFRS 13 are discussed in Chapter 15, which also addresses the challenges of applying IFRS 13 at initial recognition since fair value is defined as an exit price. In particular, the selection of appropriate valuation techniques, inputs to those valuation techniques and the application of the fair value hierarchy are discussed in Chapter 15.

5.4 Customer relationship intangible assets acquired in a business combination

Further guidance on customer relationships acquired in a business combination is provided by IFRS 3 in the Illustrative Examples, which form the basis of the example below. These demonstrate how the contractual-legal and separability criteria, discussed in section 2.1.1 above, interact in the recognition of acquired customer relationships. *[IFRS 3.IE30]*.

Illustration 5-1: Customer relationship intangible assets acquired in a business combination

Supply agreement

Acquirer Company (A) acquires Target Company (T) in a business combination. T has a five-year agreement to supply goods to Customer (C). Both T and A believe that C will renew the supply agreement at the end of the current contract. The supply agreement is not separable.

Because T establishes its relationship with C through a contract, not only the supply agreement (whether cancellable or not) but also T's customer relationship with C meet the contractual-legal criterion for identification as an intangible asset. Therefore, both the supply agreement and the customer relationship intangible asset are recognised separately from goodwill.

Sporting goods and electronics

A acquires T in a business combination. T manufactures goods in two distinct lines of business: sporting goods and electronics. Customer (C) purchases both sporting goods and electronics from T. T has a contract with C to be its exclusive provider of sporting goods, but has no contract for the supply of electronics to C. Both T and A believe that there is only one overall customer relationship between T and C.

As in the previous example, both the contract for the exclusive supply of sporting goods (whether cancellable or not) and the related customer relationship qualify for identification as an intangible asset because the contractual-legal criterion is met. Because T and A believe that there is only one customer relationship, the fair value of the intangible asset incorporates assumptions regarding T's relationship with C for both sporting goods and electronics.

However, if A determined that there were two customer relationships with C - one for sporting goods and another for electronics - the customer relationship for electronics would only be recognised if it meets the separability criterion for identification as an intangible asset (because there is not a current or past contract it can be linked to).

Order backlog and recurring customers

A acquires T in a business combination on 31 December 20X1. T does business with its customers solely through purchase and sales orders. At 31 December 20X1, T has a backlog of customer purchase orders from 60% of its customers, all of whom are recurring customers. The other 40% of T's customers are also recurring customers. However, as of 31 December 20X1, T has no open purchase orders or other contracts with those customers.

The purchase orders from 60% of T's customers (whether cancellable or not) meet the contractual-legal criterion, so the order backlog is recognised as an intangible asset separate from goodwill. Additionally, because T has a practice of establishing contracts (purchase and sales orders) with all of its customers, its relationship with all of its customers (not just the 60% in respect of which there is a backlog of purchase orders) also arises through contractual rights, and therefore meets the contractual-legal criterion for identification as an intangible asset, even though T does not have contracts with 40% of those customers at 31 December 20X1.

Motor insurance contracts

A acquires T, an Insurer, in a business combination. T has a portfolio of one-year motor insurance contracts that are cancellable by policyholders.

Because T establishes its relationships with policyholders through insurance contracts, the customer relationship with policyholders meets the contractual-legal criterion for identification as an intangible asset.

One of the most difficult areas of interpretation is whether an arrangement is contractual or not. Contractual customer relationships are always recognised separately from goodwill, but non-contractual customer relationships are recognised only if they are separable. Consequently, determining whether a relationship is contractual is critical to identifying and measuring customer relationship intangible assets and different conclusions could result in substantially different accounting outcomes. This is discussed in more detail in Chapter 10 at section 5.5.2.B.

Given the widespread confusion, the matter was referred to the IASB and the FASB with a recommendation to review and amend IFRS 3 by:

- Removing the distinction between 'contractual' and 'non-contractual' customer-related intangible assets recognised in a business combination

  And

- Reviewing the indicators that identify the existence of a customer relationship in IFRS 3.IE28 and including them in the standard

When it considered the issue in March 2009, the IFRS IC was unable to develop an interpretation clarifying the distinction between contractual and non-contractual.

The IASB deferred both recommendations of the IFRS IC to the post-implementation review (PIR) of IFRS 3, which was completed in June 2015. As a result of the PIR of IFRS 3 the issue of the identification and fair value measurement of intangible assets such as customer relationships and brand names was added to the IASB's active agenda within its *Goodwill and Impairment* research project. In April 2018, the IASB decided not to consider allowing any identifiable intangible assets acquired in a business combination to be included within goodwill.[9] The Exposure Draft *Business Combinations-Disclosures, Goodwill and Impairment* is covered in further detail in Chapter 10 at sections 1.2.1 and 5.5.2.B.

Despite the IASB's decision there will be divergent treatments in practice, depending on how entities interpret 'contractual' and 'non-contractual' customer-related intangible assets in a particular business combination.

5.5 In-process research and development

The term 'in-process research and development' (IPR&D) refers to those identifiable intangible assets resulting from research and development activities that are acquired in a business combination. An acquirer must recognise IPR&D separately from goodwill if the project meets the definition of an intangible asset. This is the case when the IPR&D project meets the definition of an asset and is identifiable, i.e., it is separable or arises from contractual or other legal rights. *[IAS 38.34]*.

IPR&D projects, whether or not recognised by the acquiree, are protected by legal rights and are clearly separable, as they can be bought and sold by entities in the normal course of business.

Any subsequent expenditure incurred on the project after its acquisition must be accounted for in accordance with the general rules in IAS 38 on internally generated intangible assets which are discussed in section 6.2 below. *[IAS 38.42]*. In summary, this means that the subsequent expenditure is accounted for as follows: *[IAS 38.43]*

- Research expenditure is recognised as an expense when incurred.
- Development expenditure that does not satisfy the criteria for recognition as an intangible asset is recognised as an expense when incurred.

  And
- Development expenditure that satisfies the recognition criteria is added to the carrying value of the acquired in-process research or development project.

This approach results in some IPR&D projects acquired in business combinations being treated differently from similar projects started internally because there are different criteria for recognition. The IASB acknowledged this point but decided that it could not support a treatment that allowed acquired IPR&D to be subsumed within goodwill. *[IAS 38.BC82]*. Until the Board finds time to address this issue, users of financial statements will have to live with the problem that an asset can be recognised for acquired research and development projects despite the fact that the entity might recognise as an expense the costs of internal projects at a similar stage of development.

The implication is that if an acquired project is ultimately successful, the asset recognised will have a higher carrying amount and related amortisation charged to profit and loss over its useful life than an equivalent internal project.

If the carrying value cannot be justified, the acquired asset will be impaired. An impairment test will be performed before the end of the period of acquisition and annually thereafter in accordance with the requirements of IAS 36 for intangible assets not yet available for use (see Chapter 21). *[IAS 36.10]*. Any impairment loss will be reflected in the entity's statement of profit or loss as a post-acquisition event.

9 *IASB Update*, April 2018, available on the IFRS Foundation's website.

6 Internally generated intangible assets

6.1 Internally generated goodwill

IAS 38 explicitly prohibits the recognition of internally generated goodwill as an asset because internally generated goodwill is neither separable nor does it arise from contractual or legal rights. *[IAS 38.48]*. As such, it is not an identifiable resource controlled by the entity that can be measured reliably at cost. *[IAS 38.49]*. It therefore does not meet the definition of an intangible asset under the standard or that of an asset under the IASB's *Conceptual Framework*. The standard maintains that the difference between the fair value of an entity and the carrying amount of its identifiable net assets at any time may capture a range of factors that affect the fair value of the entity, but that such differences do not represent the cost of intangible assets controlled by the entity. *[IAS 38.50]*.

6.2 Internally generated intangible assets

The IASB recognises that it may be difficult to decide whether an internally generated intangible asset qualifies for recognition because of problems in:

(a) Confirming whether and when there is an identifiable asset that will generate expected future economic benefits

And

(b) Determining the cost of the asset reliably, especially in cases where the cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the entity's internally generated goodwill or of running day-to-day operations *[IAS 38.51]*

To avoid the inappropriate recognition of an asset, IAS 38 requires that internally generated intangible assets are not only tested against the general requirements for recognition and initial measurement (discussed in section 3 above), but also meet criteria which confirm that the related activity is at a sufficiently advanced stage of development, is both technically and commercially viable and includes only directly attributable costs. *[IAS 38.51]*. Those criteria comprise detailed guidance on accounting for intangible assets in the research phase (see section 6.2.1 below), the development phase (see section 6.2.2 below) and on components of cost of an internally generated intangible asset (see section 6.3 below).

If the general recognition and initial measurement requirements are met, the entity classifies the generation of the internally developed asset into a research phase and a development phase. *[IAS 38.52]*. Only expenditure arising from the development phase can be considered for capitalisation, with all expenditure on research being recognised as an expense when it is incurred. *[IAS 38.54]*. If it is too difficult to distinguish an activity between a research phase and a development phase, all expenditure is treated as research. *[IAS 38.53]*.

The standard distinguishes between research and development activities as follows:

"*Research* is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding." *[IAS 38.8]*.

The standard gives examples of research activities: *[IAS 38.56]*

Extract from IAS 38

56 Examples of research activities are:

(a) activities aimed at obtaining new knowledge;

(b) the search for, evaluation and final selection of, applications of research findings or other knowledge;

(c) the search for alternatives for materials, devices, products, processes, systems or services; and

(d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

"*Development* is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use." *[IAS 38.8]*.

The standard gives examples of development activities: *[IAS 38.59]*

Extract from IAS 38

59 Examples of development activities are:

(a) the design, construction and testing of pre-production or pre-use prototypes and models;

(b) the design of tools, jigs, moulds and dies involving new technology;

(c) the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and

(d) the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

6.2.1 Research phase

An entity cannot recognise an intangible asset arising from research or from the research phase of an internal project. Instead, any expenditure on research or the research phase of an internal project must be expensed as incurred because the entity cannot demonstrate that there is an intangible asset that will generate probable future economic benefits. *[IAS 38.54, IAS 38.55]*.

If an entity cannot distinguish the research phase from the development phase, it must treat the expenditure on that project as if it were incurred in the research phase only and recognise an expense accordingly. *[IAS 38.53]*.

6.2.2 Development phase

The standard requires recognition of an intangible asset arising from development (or the development phase of an internal project), while it imposes stringent conditions that restrict recognition. These tests create a balance, ensuring that the entity does not recognise unrecoverable costs as an asset. The criteria, all of which need to be met, are set out in the extract from the standard below: *[IAS 38.57]*

Extract from IAS 38

57 An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale.

(b) its intention to complete the intangible asset and use or sell it.

(c) its ability to use or sell the intangible asset.

(d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

(f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.

The fact that an entity can demonstrate that the asset will generate probable future economic benefits distinguishes development activity from the research phase, where it is unlikely that such a demonstration would be possible. *[IAS 38.58]*.

It may be challenging to obtain objective evidence on each of the above conditions because:

- Condition (b) relies on management intent.
- Conditions (c), (e) and (f) are entity-specific (i.e., whether development expenditure meets any of these conditions depends both on the nature of the development activity itself and the financial position of the entity).

  And
- Condition (d) above is more restrictive than is immediately apparent because the entity needs to assess the probable future economic benefits using the principles in IAS 36, i.e., using discounted cash flows. If the asset will generate economic benefits only in conjunction with other assets, the entity must apply the concept of cash-generating units. *[IAS 38.60]*. The application of IAS 36 is discussed in Chapter 21. Even if a discounted cash flow estimate, applying the principles of IAS 36, indicates that the asset under development will generate future economic benefits, there may exist significant uncertainties in relation to the successful completion of the project, estimated costs, future regulatory approvals, and future market conditions, that may call into question whether the expected future economic benefits can be deemed to be probable. This is illustrated in Illustration 6-1 below.

IAS 38 indicates that evidence may be available in the form of:

- A business plan showing the technical, financial and other resources needed and the entity's ability to secure those resources
- A lender's indication of its willingness to fund the plan confirming the availability of external finance *[IAS 38.61]*

  And

- Detailed project information demonstrating that an entity's costing systems can measure reliably the cost of generating an intangible asset internally, such as salary and other expenditure incurred in securing copyrights or licences or developing computer software *[IAS 38.62]*

In any case, an entity must maintain books and records in sufficient detail that allow it to prove whether it meets the conditions set out by IAS 38.

Certain types of product (e.g., pharmaceuticals, aircraft and electrical equipment) require regulatory approval before they can be sold. Regulatory approval is not one of the criteria for recognition under IAS 38 and the standard does not prohibit an entity from capitalising its development costs in advance of approval. However, in some industries, regulatory approval is vital to commercial success and its absence indicates significant uncertainty around the possible future economic benefits. This is the case in the pharmaceuticals industry, where it is rarely possible to determine whether a new drug will secure regulatory approval until it is actually granted. Accordingly, it is common practice in this industry for costs to be expensed until such approval is obtained. See Illustration 6-1, Practical example 6-2 and the discussion in section 6.2.3 below.

Illustration 6-1: Recognition of development costs in a pharmaceutical projects

Entity X is a pharmaceutical company that is developing a drug (drug A) to treat a rare disease. Development of drug A is its only project. It has no sales revenues but expects to have sufficient cash to be able complete development without raising additional capital.

Entity X classifies drug development into three different phases, clinical Phase 1, 2 and 3. In clinical Phase 3 a large-scale trial is undertaken to verify the results achieved in clinical Phase 1 and 2. Before the drugs can be sold in the market Regulatory review and approval must be obtained, and such approval requires a positive outcome in the clinical Phase 3 trial.

At the end of 20X1 drug A is in clinical Phase 1. Phase 2 is expected to commence in 20X2, and Phase 3 expected to commence in 20X4. Regulatory approval is not expected to be obtained until 20X8 following the completion of successful trials in Phase 3.

During 20X1 as development costs are incurred, Entity X considers whether the expenditure meets the recognition criteria in paragraph 57 of IAS 38. Throughout 20X1, Entity X determines that criteria (b), (c), (f) and (e) are met. Criteria (a) and (d) however are not deemed to be met. As a result Entity X expenses all development costs incurred in the 20X1.

Criteria (a), the technical feasibility of completing the intangible asset, is not met. This is on the basis that final regulatory approval is dependent on external parties and is not within the control of Entity X. In addition, the remaining development activities for drug A are subject to a complex verification and registration process that require a significant amount of work and time, which also indicates that technical feasibility is not certain.

Criteria (d), that the intangible asset will generate probable future economic benefits, is not met. Although Entity X obtains an external valuation based on a discounted cash flow estimate, applying the principles of IAS 36, which indicates that the asset under development will generate future economic benefits, there exist significant uncertainties in relation to the successful completion of the project, estimated costs, future regulatory approvals, and future market conditions. These uncertainties result in Entity X being unable to conclude during 20X1 that it is probable that future economic benefits will be generated.

The standard does not define the terms 'research phase' and 'development phase' but explains that they have a broader meaning than 'research' and 'development' which it does define. *[IAS 38.52]*. The features characterising the research phase have less to do with what activities are performed, but relate more to an inability to demonstrate at that time that there is an intangible asset that will generate probable future benefits. *[IAS 38.55]*. This means that the research phase may include activities that do not necessarily meet the definition of 'research'. For example, the research phase for IAS 38 purposes may extend to the whole period preceding a product launch, regardless of the fact that activities that would otherwise characterise development are taking place at the same time, because certain features that would mean the project has entered its development phase are still absent (such as confirming an ability to use or sell the asset;

demonstrating sufficient market demand for a product; or uncertainty regarding the source of funds to complete the project). As a result, an entity might not be able to distinguish the research phase from the development phase of an internal project to create an intangible asset, in which case it must treat the expenditure on that project as if it were incurred in the research phase only and recognise an expense accordingly. *[IAS 38.53]*. It also means that the development phase may include activities that do not necessarily meet the definition of 'development'. The example below illustrates how an entity would apply these rules in practice.

Illustration 6-2: Research phase and development phase under IAS 38

Entity K is working on a project to create a database containing images and articles from newspapers around the world, which it intends to sell to customers over the internet. K has identified the following stages in its project:

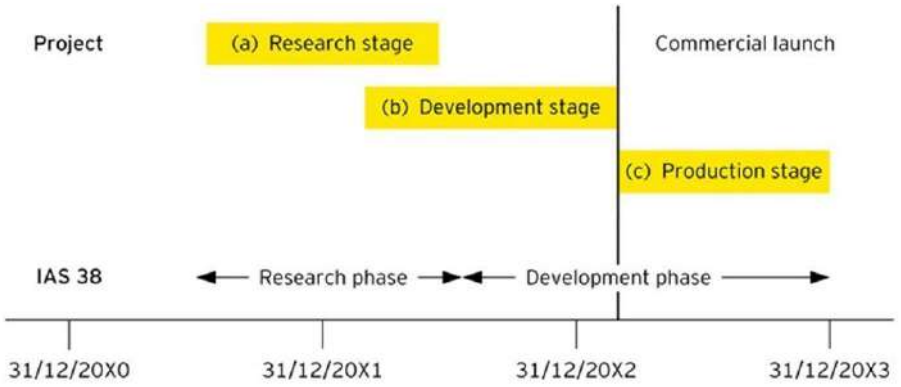
(a) Research stage - gaining the technical knowledge necessary to transfer images to customers and assessing whether the project is feasible from a technological point of view

(b) Development stage - performing market analysis to identify potential demand and customer requirements; developing the ability to exploit the image capture technology, including configuration of the required database software and acquiring the required data to populate the database, designing the customer interface and testing a prototype of the system

And

(c) Production stage - before and after the commercial launch of the service, debugging the system and improving functionality to service higher user volumes; updating and managing the database to ensure its currency

The above can be summarised as follows:



The activities in the research stage included under (a) meet the definition of research under IAS 38 and would be accounted for as part of the research phase of the project, as an expense.

The activities in the development stage included under (b) meet the definition of development under IAS 38. However, whilst K has started to plan the commercial exploitation of its image and data capture technology, it will not be immediately apparent that the project is economically viable. Until this point is reached, for example when the entity has established there is demand for the database and it is likely that a working prototype of the system will be available, the development activities cannot be distinguished from the research activities taking place at the same time. Accordingly, the initial development activities are accounted for as if they were incurred in the research phase. Only once it becomes possible to demonstrate the existence of an intangible asset that will generate future income streams, can project expenditure be accounted for under IAS 38 as part of the development phase.

There may be a period after the commercial launch of the service that would still be accounted for as part of the development phase. For example, activities to improve functionality to deal with higher actual customer volumes could constitute development. This does not necessarily mean that K can capitalise all this expenditure because it needs to pass the double hurdle of:

- The presumption in IAS 38.20 that "there are no additions to such an asset or replacements of part of it"

  And

- The six criteria in IAS 38.57 for recognition of development costs as an asset (see above)

Activity to ensure that the database is up-to-date is a routine process that does not involve major innovations or new technologies. Therefore, these activities in the production stage do not meet the definition of 'research' or 'development' and the related costs are recognised as an expense.

As the above example illustrates, the guidance in IAS 38 seems to take a somewhat restricted view as to how internally generated intangible assets are created and managed in practice, as well as the types of internally generated intangible assets. It requires activity to be classified into research and development phases, but this analysis does not easily fit with intangible assets that are created for use by the entity itself. The standard therefore does not address the everyday reality for entities such as software companies, television production companies, newspapers and data vendors that produce intangible assets in industrial-scale routine processes.

Many of the intangible assets produced in routine processes (e.g., software, television programmes, newspaper content and databases) meet the recognition criteria in the standard, but no specific guidance is available that could help an entity in dealing with the practical problems that arise when accounting for them.

Generally, entities disclose little detail of the nature of their research and development activities and the costs that they incur, instead focusing on the requirements of IAS 38 that must be met before development expenditure can be capitalised. This is Illustrated in Practical example 6-1 below:

Practical example 6-1: Sanofi (2023) France

FORM 20-F [extract]

2023 Consolidated financial statements [extract]

Notes to the Consolidated Financial Statements [extract]

B/ Summary of significant accounting policies [extract]

B.4. Other intangible assets [extract]

B.4.1. Research and development not acquired in a business combination [extract]

Internally generated research and development

Under IAS 38, research expenses are recognized in profit or loss when incurred.

Internally generated development expenses are recognized as an intangible asset if, and only if, all the following six criteria can be demonstrated: (a) the technical feasibility of completing the development project; (b) Sanofi's intention to complete the project; (c) Sanofi's ability to use the project; (d) the probability that the project will generate future economic benefits; (e) the availability of adequate technical, financial and other resources to complete the project; and (f) the ability to measure the development expenditure reliably.

...

The difficulty in applying the IAS 38 recognition criteria for development costs in the pharmaceutical industry are discussed further in section 6.2.3 below. Technical and economic feasibility are typically established very late in the process of developing a new product, which means that usually only a small proportion of the development costs is capitalised.

When the development phase ends will also influence how the entity recognises revenue from the project. As noted in section 4.4 above, during the development phase an entity must recognise income from incidental operations, being those not necessary to develop the asset for its intended use, as revenue in profit or loss. *[IAS 38.31]*.

IAS 38 is not explicit on how to account for income earned in relation to activity that is determined necessary to bring the intangible asset into its intended use. IAS 16 however does provide guidance in relation to this for items of property, plant and equipment that are under construction (see Chapter 19 at section 4.2.1). IAS 16 requires that the proceeds, together with the cost of those items measured in accordance with IAS 2, from selling items produced while bringing an asset to the location and condition necessary for it to be capable of operating in the manner intended by management, are to be recognised in profit or loss in accordance with applicable standards. *[IAS 16.20A]*. In the absence of specific guidance in IAS 38, an entity must refer to the hierarchy in IAS 8 to develop an appropriate accounting policy (see Chapter 3 at section 4.3). The hierarchy requires an entity to firstly consider the requirements in IFRS accounting standards dealing with similar and related issues. *[IAS 8.11]*. Therefore, an entity considers the extent to which it could apply the guidance in IAS 16, discussed above, to income earned in relation to activity that is determined necessary to bring the intangible asset into its intended use.

Examples of income earned in relation to activity that is determined necessary to bring the intangible asset into its intended use include income from the sale of samples produced during the testing of a new process or from the sale of a production prototype.

Care must be taken to confirm whether the incidence of income indicates that the intangible asset is ready for its intended use, in which case capitalisation of costs would cease, revenue would be recognised in profit or loss and the related costs of the activity would include a measure of amortisation of the asset.

Many entities use third parties to perform limited or substantial parts of their research and development activities. Contracts relating to research and development activities can be structured in many ways, but in many cases, include upfront and/or milestone payments. The entity pays specific amounts upon completion of a pre-determined amount of work or upon achievement of a target milestone by the third party. Considerations related to such situations are discussed in section 4.1 above.

6.2.3 Research and development in the pharmaceutical industry

Entities in the pharmaceutical industry consider research and development to be of primary importance to their business. Consequently, these entities spend a considerable amount on research and development every year and one might expect them to carry significant internally generated development intangible assets on their statement of financial position. However, their financial statements reveal that they often consider the uncertainties in the development of pharmaceuticals to be too great to permit capitalisation of development costs.

One of the problems is that, in the case of true 'development' activities in the pharmaceutical industry, the final outcome can be uncertain and the technical and economic feasibility of new products or processes is typically established very late in the development phase, which means that only a small proportion of the total development costs can ever be capitalised. In particular, many products and processes require approval by a regulator such as the US Food and Drug Administration (FDA) before they can be applied commercially and until that time, the entity may be uncertain of their success. After approval, of course, there is often relatively little in the way of further development expenditure.

In the pharmaceutical sector, the capitalisation of development costs for new products or processes usually begins at the date on which the product or process receives regulatory approval. In most cases that is the point when the IAS 38 criteria for recognition of intangible assets are met. It is unlikely that these criteria will have been met before approval is granted by the regulator.

Practical example 6-2 and Practical example 6-3 below illustrate some of the difficulties in applying the IAS 38 recognition criteria for development costs in the pharmaceutical industry.

Practical example 6-2: MERCK Kommanditgesellschaft auf Aktien (2023) Germany

ANNUAL REPORT 2023 [extract]
Consolidated Financial Statements [extract]
Notes to the Consolidated Financial Statements [extract]
Operating Assets, Liabilities, and Contingent Liabilities [extract]
(19) Other intangible assets [extract]
Accounting and measurement policies [extract]

Recognition and initial measurement of internally generated intangible assets

Owing to the high level of uncertainty until pharmaceutical products are approved, the criteria for the capitalization of development costs in accordance with IAS 38 are not met in the Healthcare business sector for the development of drug candidates. Costs incurred after regulatory approval are insignificant and are therefore not recognized as intangible assets. In the Life Science and Electronics business sectors, development expenses are capitalized as soon as all the recognition criteria are met and can be verified accordingly. This also includes expenses that are required for REACH registration. Furthermore, development expenses for internal software projects and the enhancement of purchased ERP programs are capitalized providing that the relevant criteria have been fulfilled.

Practical example 6-3: Roche Holding Ltd (2023) **Switzerland**

Finance Report 2023 [extract]

Roche Group Consolidated Financial Statements [extract]

Notes to the Roche Group Consolidated Financial Statements [extract]

34. Accounting policies [extract]

Research and development

Internal research and development activities are expensed as incurred for the following:

- Internal research costs incurred for the purpose of gaining new scientific or technical knowledge and understanding.
- Internal development costs incurred for the application of research findings or other knowledge to plan and develop new products for commercial production. The development projects undertaken by the Group are subject to technical, regulatory and other uncertainties, such that, in the opinion of management, the criteria for capitalisation as intangible assets are not met prior to obtaining marketing approval by the regulatory authorities in major markets.
- Post-marketing studies after regulatory approval, such as phase IV costs in the pharmaceuticals business, generally involve safety surveillance and ongoing technical support of a drug after it receives marketing approval to be sold. They may be required by regulatory authorities or may be undertaken for safety or commercial reasons. The costs of such post-marketing studies are not capitalised as intangible assets as, in the opinion of management, they do not generate separately identifiable incremental future economic benefits that can be reliably measured.

...

6.2.4 Internally generated brands, mastheads, publishing titles and customer lists

IAS 38 considers internally generated brands, mastheads, publishing titles, customer lists and items similar in substance to be indistinguishable from the cost of developing a business as a whole, so it prohibits their recognition. *[IAS 38.63, IAS 38.64]*. As discussed in section 3.3 above, the same applies to subsequent expenditures incurred in connection with such intangible assets even when originally acquired externally. *[IAS 38.20]*. For example, expenditure incurred in redesigning the layout of newspapers or magazines, which represent subsequent expenditure on publishing titles and mastheads, must not be capitalised.

6.2.5 Website costs (SIC-32)

SIC-32 clarifies how IAS 38 applies to costs in relation to websites designed for use by the entity in its business. An entity's own website that arises from development and is for internal or external access is an internally generated intangible asset under the standard. *[SIC-32.7]*. A website designed for external access may be used for various purposes such as to promote and advertise an entity's own products and services, provide electronic services to customers, and sell products and services. A website may be used within the entity to give staff access to company policies and customer details, and allow them to search for relevant information. *[SIC-32.1]*.

SIC-32 does not apply to items that are accounted for under another standard, such as the development or operation of a website (or website software) for sale to another entity (IAS 2 and IFRS 15); acquiring or developing hardware supporting a website (IAS 16); or a website (or website software) subject to a leasing arrangement (IFRS 16). *[SIC-32.5, SIC-32.6]*.

Under SIC-32, an intangible asset must be recognised for website development costs if and only if it meets the general recognition requirements in IAS 38 (see section 3.1 above) and the six conditions for recognition as development costs (see section 6.2.2 above). Most important of these is the requirement to demonstrate how the website will generate probable future economic benefits. *[SIC-32.8]*. The interpretation deems an entity unable to demonstrate this for a website developed solely or primarily for promoting and advertising its own products and services. All expenditure on developing such a website must be recognised as an expense when incurred. Accordingly, it is unlikely that costs will be eligible for capitalisation unless an entity can demonstrate that the website is used directly in the income-generating process, for example where customers can place orders on the entity's website. *[SIC-32.8]*.

The following stages of a website's development are identified by the interpretation: *[SIC-32.2, SIC-32.9]*

(a) *Planning* includes undertaking feasibility studies, defining objectives and specifications, evaluating alternatives and selecting preferences. Expenditures incurred in this stage are similar in nature to the research phase and must be recognised as an expense when they are incurred.

(b) *Application and infrastructure development* includes obtaining a domain name, purchasing and developing hardware and operating software, installing developed applications and stress testing. The requirements of IAS 16 are applied to expenditure on physical assets. Other costs are recognised as an expense, unless they can be directly attributed, or allocated on a reasonable and consistent basis, to preparing the website for its intended use and the project to develop the website meets the SIC-32 criteria for recognition as an intangible asset.

(c) *Graphical design development* includes designing the appearance of web pages. Costs incurred at this stage must be accounted for in the same way as expenditure incurred in the 'application and infrastructure development' stage described under (b) above.

(d) *Content development* includes creating, purchasing, preparing and uploading information, either textual or graphical in nature, on the website before the completion of the website's development. The costs of content developed to advertise and promote an entity's own products and services are always expensed as incurred. Other costs incurred in this stage must be recognised as an expense unless the criteria for recognition as an asset described in (b) above are satisfied.

And

(e) The *operating stage*, which starts after completion of the development of a website, when an entity maintains and enhances the applications, infrastructure, graphical design and content of the website. *[SIC-32.3]*. Expenditure incurred in this stage must be expensed as incurred unless it meets the asset recognition criteria in IAS 38.

In making these assessments, the entity must evaluate the nature of each activity for which expenditure is incurred, independently of its consideration of the website's stage of development. *[SIC-32.9]*. This means that even where a project has been determined to qualify for recognition as an intangible asset, not all costs incurred in relation to a qualifying stage of development are eligible for capitalisation. For example, whilst the direct costs of developing an online ordering system might qualify for recognition as an asset, the costs of training staff to operate that system must be expensed because training costs are deemed not necessary to creating, producing or preparing the website for it to be capable of operating (see section 6.3 below). *[IAS 38.67]*. Examples of other costs that would be recognised as an expense regardless of the stage of the project are given in the Illustrative Example to SIC-32, including:

(a) Selling, administrative and other general overhead expenditure unless it can be directly attributed to preparing the website for use to operate in the manner intended by management

(b) Clearly identified inefficiencies in the project, such as those relating to alternative solutions explored and rejected

And

(c) Initial operating losses incurred before the website achieves planned performance

A website qualifying for recognition as an intangible asset must be measured after initial recognition by applying the cost model or the revaluation model in IAS 38 as discussed in sections 8.1 and 8.2 below. In respect of the useful life of website assets, the expectation is that it should be short. *[SIC-32.10]*.

The criteria for recognition as an asset are restrictive. On-line fashion retailer, ASOS Plc, does not capitalise website development costs, as demonstrated in the Practical example below.

Practical example 6-4: ASOS Plc (2023) **United Kingdom**

ASOS Plc Annual Report and Accounts 2023 [extract]

Financial Statements [extract]

Notes to the Consolidated Financial Statements [extract]

11 GOODWILL AND OTHER INTANGIBLE ASSETS [extract]

Accounting policy [extract]

Computer software [extract]

...

The cost of acquiring and developing software that is not integral to the related hardware is capitalised separately as an intangible asset. This does not include internal website development and maintenance costs, which are expensed as incurred unless representing a technological advance leading to future economic benefit. Capitalised software costs include external direct costs of material and services and the payroll and payroll-related costs for employees who are directly associated with the project. Software under development is held at cost less any recognised impairment loss.

6.2.6 Agile software development

A similar assessment process to that discussed in section 6.2.5 above needs to be undertaken in accounting for agile software development, where there are similar challenges in determining whether expenditures must be recognised as an intangible asset or be expensed as incurred. Agile software development is an iterative development process, where the software is delivered in small, but functional, increments. This is in contrast to traditional software development where the sequence of the phases in which the software is developed is linear and focuses on the delivery of a fully functioning complete software product in accordance with the original plans and specifications. Agile software development also has further complexities that must be carefully considered, for example:

- It is difficult to determine a relevant unit of account (i.e., the unit of account could be the entire suite of software applications, individual applications, functional elements, or lines of code). The determination of the unit of account is likely to have an impact on the determination as to the whether the recognition criteria in paragraph 57 of IAS 38 have been met (see section 6.2.2 above), the determination of the costs eligible for capitalisation (see section 6.3.2 below), the useful economic life of the asset (see section 9.1 below), the amortisation period (see section 9.2.1 below), and impairment (see section 9.4 below) and derecognition (see section 9.5 below) considerations.
- An entity may not have clear budgets for its agile software development, so there is an increased risk of incorrectly recognising inefficiencies and cost overruns as part of the resulting intangible asset. Identified inefficiencies do not form part of the cost of an internally generated asset (see section 6.3.2 below). *[IAS 38.67].*
- It can be difficult to maintain the appropriate balance between capitalising new development costs (see section 6.3 below), derecognising past development costs (see section 9.5 below), and determining the amortisation period of the asset (see section 9.2.1 below).

  And
- Some of the steps in the continuous update process applied in agile software development are more akin to maintenance and must therefore be expensed as incurred.

6.3 Cost of an internally generated intangible asset

On initial recognition, an intangible asset must be measured at cost, *[IAS 38.24]*, which the standard defines as the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction. When applicable, cost is the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRS accounting standards, e.g., IFRS 2. *[IAS 38.8]*. It is important to ensure that cost includes only the expenditure incurred after the recognition criteria are met and to confirm that only costs directly related to the creation of the asset are capitalised.

6.3.1 Establishing the time from which costs can be capitalised

The cost of an internally generated intangible asset is the sum of the expenditure incurred from the date when the intangible asset first meets the recognition criteria of the standard, *[IAS 38.65]*, and meets the detailed conditions for recognition of development phase costs as an asset (see section 6.2.2 above).

Costs incurred before these criteria are met are expensed, *[IAS 38.68]*, and cannot be reinstated retrospectively, *[IAS 38.65]*, because IAS 38 does not permit recognition of past expenses as an intangible asset at a later date. *[IAS 38.71]*.

The following Illustration, which is taken from IAS 38, shows how these above rules must be applied in practice.

Illustration 6-3: Recognition of internally generated intangible assets

An entity is developing a new production process. During 20X1, expenditure incurred was CU1,000, of which CU900 was incurred before 1 December 20X1 and CU100 was incurred between 1 December 20X1 and 31 December 20X1. The entity is able to demonstrate that, at 1 December 20X1, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be CU500.

At the end of 20X1, the production process is recognised as an intangible asset at a cost of CU100 (expenditure incurred since the date when the recognition criteria were met, that is, 1 December 20X1). The CU900 expenditure incurred before 1 December 20X1 is recognised as an expense because the recognition criteria were not met until 1 December 20X1. This expenditure does not form part of the cost of the production process recognised in the statement of financial position.

During 20X2, expenditure incurred is CU2,000. At the end of 20X2, the recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be CU1,900.

At the end of 20X2, the cost of the production process is CU2,100 (CU100 expenditure recognised at the end of 20X1 plus CU2,000 expenditure recognised in 20X2). The entity recognises an impairment loss of CU200 to adjust the carrying amount of the process before impairment loss (CU2,100) to its recoverable amount (CU1,900). This impairment loss will be reversed in a subsequent period if the requirements for the reversal of an impairment loss in IAS 36 are met.

6.3.2 Determining the costs eligible for capitalisation

The cost of an internally generated intangible asset comprises all directly attributable costs necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by management. Examples of directly attributable costs are:

(a) Costs of materials and services used or consumed in generating the intangible asset

(b) Costs of employee benefits arising from the generation of the intangible asset

(c) Fees to register a legal right

(d) Amortisation of patents and licences that are used to generate the intangible asset

And

(e) Borrowing costs that meet the criteria under IAS 23 for recognition as an element of cost *[IAS 38.66]*

The standard also specifically prohibits recognition of the following items as a component of cost:

(a) Selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to preparing the asset for use

(b) Identified inefficiencies and initial operating losses incurred before the asset achieves planned performance

And

(c) Expenditure on training staff to operate the asset *[IAS 38.67]*

For these purposes it does not make any difference whether the costs are incurred directly by the entity or relate to services provided by third parties.

An example of administrative and other general overhead expenditure that may be considered directly attributable to preparing an asset for use would be the depreciation of a research and development facility and the associated overheads such as electricity or insurance, if this facility was used in the creation of internally generated intangible assets.

7 Recognition of an expense

Unless expenditure is incurred in connection with an item that meets the criteria for recognition as an intangible asset, and is an eligible component of cost, it must be expensed. The only exception is in connection with a business combination, where the cost of an item that cannot be recognised as an intangible asset will form part of the carrying amount of goodwill at the acquisition date. *[IAS 38.68]*.

Some of the ineligible components of cost are identified in sections 4.3 and 6.3.1 above and include costs that are not directly related to the creation of the asset, such as costs of introducing a new product or costs incurred to redeploy an asset. IAS 38 provides other examples of expenditure that is recognised as an expense when incurred:

(a) Start-up costs, unless they qualify for recognition as part of the cost of property, plant and equipment under IAS 16 (see Chapter 19). Start-up costs recognised as an expense may consist of establishment costs such as legal and secretarial costs incurred in setting up a legal entity, expenditure to open a new facility or business or expenditures for starting new operations or launching new products or processes

(b) Training costs

(c) Advertising and promotional activities (including mail order catalogues)

And

(d) Relocation or reorganisation costs *[IAS 38.69]*

For these purposes no distinction is made between costs that are incurred directly by the entity and those that relate to services provided by third parties. However, the standard does not prevent an entity from recording a prepayment if it pays for the delivery of goods before obtaining a right to access those goods. Similarly, a prepayment can be recognised when payment is made before the services are received. *[IAS 38.70]*.

In March 2020 the IFRS IC considered whether training costs to fulfil a contract must be recognised as an asset or expensed. The costs in the fact pattern submitted to the IFRS IC were those incurred to train an entity's employees so that they understand the customer's equipment and processes. The IFRS IC noted that IAS 38.69(b) includes expenditure on training activities as an example of expenditure that is incurred to provide future economic benefits to an entity, but no intangible asset or other asset is acquired or created that can be recognised. Consequently, IAS 38.69 states that such expenditure on training activities is recognised as an expense when incurred. Paragraph 15 of IAS 38 explains that an entity usually has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training for these items to meet the definition of an intangible asset. In addition, in explaining the requirements in IFRS 15 regarding costs to fulfil a contract, IFRS 15.BC307 states that "if the other Standards preclude the recognition of any asset arising from a particular cost, an asset cannot then be recognised under IFRS 15". Accordingly, the IFRS IC concluded that, in the fact pattern submitted, the entity recognises the training costs to fulfil the contract with the customer as an expense when incurred. The IFRS IC noted that the entity's ability to charge to the customer the costs of training does not affect that conclusion.[10] This issue is discussed in more detail in Chapter 28 at section 9.3.2.

7.1 Catalogues and other advertising costs

The Board considers that advertising and promotional activities do not qualify for recognition as an intangible asset because their purpose is to enhance or create internally generated brands or customer relationships, which themselves cannot be recognised as intangible assets. *[IAS 38.BC46B]*. An entity has a different asset, a prepayment, if it has paid for goods or services before they are provided, as described above. However, the Board did not believe this justified an asset being recognised beyond the point at which the entity gained the right to access the related goods or had received the related services. *[IAS 38.BC46D]*. Entities cannot, therefore, maintain a prepayment asset and defer recognising an expense in the period between receiving the material from a supplier and delivery to its customers or potential customers. *[IAS 38.BC46E]*.

10 *IFRIC Update*, March 2020, available on the IFRS Foundation's website.

Accordingly, the IASB is deliberate in using the phrase 'obtaining the right to access those goods' when it defines the point at which an expense is recognised. This is because the date of physical delivery could be altered without affecting the substance of the commercial arrangement with the supplier. *[IAS 38.BC46E]*. Recognition is determined by the point when the goods have been constructed by the supplier in accordance with the terms of the customer contract and the entity could demand delivery in return for payment. *[IAS 38.69A]*. Therefore, an entity must recognise an expense for customer catalogues once they are ready for delivery from the printer, even if the entity has arranged for the printer to send catalogues directly to customers when advised by the entity's sales department. Similarly, in the case of services, an expense is recognised when those services are received by the entity, and not deferred until the entity uses them in the delivery of another service, for example, to deliver an advertisement to its customers. *[IAS 38.69A]*.

The Board rejected calls to make a special case for mail order catalogues, where it was argued that they created a distribution network, on the grounds that their primary objective was to advertise goods to customers. *[IAS 38.BC46G]*. For this reason, the wording in the standard cites mail order catalogues as an example of expenditure on advertising and promotional activities that is recognised as an expense. *[IAS 38.69]*.

Standard marketing activities may consist of mailings, advertisements in print media, TV and a continuous internet presence. The respective contractual agreements usually include a clearly identifiable service or asset and include only advertising and promotional costs. As discussed above, the costs must be expensed when the goods or services are received. However, the timing of the receipt of the goods and services may be unclear, particularly in situations where multiple suppliers are used to deliver the marketing activity. For example, where an entity engages an advertising agency to conceptualise a television, radio or print media advertisement, but also engages other parties to produce the material. An entity will need to carefully examine such arrangements to determine when it obtains the right to access to the goods and services provided by the respective party(ies) to determine when the cost must be expensed.

Advertising and promotional activities can take a number of different forms, encompassing multiple rights and obligations. For example, some sponsorship arrangements may include separable rights that are not advertising and promotional costs, such as exclusive distribution rights of products at an event or in a location, or the right to use the logo of the event. Providing the recognition criteria in IAS 38 are met, these rights may be eligible to be recognised as an intangible asset. Entities need to consider in each case what service or right is being received, together with when the payments are made and, in some circumstances, it may be appropriate to recognise a prepayment or intangible asset for those expenditures.

Some companies use celebrities (e.g., athletes, models and actors) to promote their brands and products. Contracts often cover a term of several years and may contain multiple performance obligations for the celebrity and several different payment obligations for the company. Entities will need to apply judgement and consider the facts and circumstances of each contract to determine whether it has received the services at a point in time or whether there is an ongoing performance for which an intangible asset must be recognised.

Some companies, especially in the food and beverages and personal care sector, provide their customers with marketing and promotional materials ranging from samples (e.g., small perfume bottles that are distributed free of charge to the end customers) to long-lived assets (e.g., large umbrellas with the logo of the beverage brand used in garden restaurants or large advertising signs). These costs are usually expensed when the company has a right to access those goods (not when they are distributed to customers), as it does not get any benefit from them other than marketing and brand promotion.

8 Measurement after initial recognition

IAS 38, in common with a number of other IFRS accounting standards, provides an entity the option to choose between two alternative treatments: *[IAS 38.72]*

- The *cost model*, which requires measurement at cost less any accumulated amortisation and any accumulated impairment losses *[IAS 38.74]*

  Or

- The *revaluation model*, which requires measurement at a revalued amount, being its fair value at the date of the revaluation, less any subsequent accumulated amortisation and any subsequent accumulated impairment losses *[IAS 38.75]*

The revaluation option is only available if there is an active market for the intangible asset. *[IAS 38.75, IAS 38.81, IAS 38.82]*. Active market is defined by IFRS 13: *[IFRS 13 Appendix A]*

Extract from IFRS 13

Appendix A
Defined terms

active market	A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

There are no provisions in IAS 38 that allow fair value to be determined indirectly, for example by using the techniques and financial models applied to estimate the fair value of intangible assets acquired in a business combination. Therefore, in accordance with IFRS 13, an entity must measure the fair value of an intangible under the revaluation model using the price in an active market for an identical asset, i.e., a Level 1 price. For further guidance on the price in an active market, see Chapter 15 at section 16. If an entity chooses an accounting policy to measure an intangible asset at revalued amount, it must apply the revaluation model to all the assets in that class, unless there is no active market for those other assets. *[IAS 38.72]*. A class of intangible assets is a grouping of assets of a similar nature and use in an entity's operations. *[IAS 38.73]*. Examples of separate classes of intangible asset are given in the standard: *[IAS 38.119]*

Extract from IAS 38

119 A class of intangible assets is a grouping of assets of a similar nature and use in an entity's operations. Examples of separate classes may include:

(a) brand names;

(b) mastheads and publishing titles;

(c) computer software;

(d) licences and franchises;

(e) copyrights, patents and other industrial property rights, service and operating rights;

(f) recipes, formulae, models, designs and prototypes; and

(g) intangible assets under development.

The classes mentioned above are disaggregated (aggregated) into smaller (larger) classes if this results in more relevant information for the users of the financial statements.

The standard requires assets in the same class to be revalued at the same time, as to do otherwise would allow selective revaluation of assets and the reporting of a mixture of costs and values as at different dates within the same asset class. *[IAS 38.73]*.

8.1 Cost model for measurement of intangible assets

Under the cost model, after initial recognition, the carrying amount of an intangible asset is its cost less any accumulated amortisation and accumulated impairment losses. *[IAS 38.74]*. The rules on amortisation of intangible assets are discussed in sections 9.2 and 9.3 below; and impairment is discussed in section 9.4 below.

8.2 Revaluation model for measurement of intangible assets

An entity can only apply the revaluation model if the fair value can be determined by reference to an active market. *[IAS 38.75, IAS 38.81, IAS 38.82]*. An active market will rarely exist for intangible assets (see section 8.2.1 below). *[IAS 38.78]*.

After initial recognition an intangible asset must be carried at a revalued amount, which is its fair value at the date of the revaluation less any subsequent accumulated amortisation and any subsequent accumulated impairment losses. *[IAS 38.75]*. To prevent an entity from circumventing the recognition rules of the standard, the revaluation model does not allow:

- The revaluation of intangible assets that have not previously been recognised as assets

  Or

- The initial recognition of intangible assets at amounts other than cost *[IAS 38.76]*

These rules are designed to prevent an entity from recognising at a 'revalued' amount an intangible asset that was never recorded because its costs were expensed, as they did not at the time meet the recognition rules. As noted in section 6.3.1 above, IAS 38 does not permit recognition of past expenses as an intangible asset at a later date. *[IAS 38.71]*.

However, it is permitted to apply the revaluation model to the whole of an intangible asset even if only part of its cost was originally recognised as an asset because it did not meet the criteria for recognition until part of the way through the process. *[IAS 38.77]*. Since the prohibition on initial recognition of intangible assets at amounts other than cost would also prevent the revaluation of quotas and permits allocated by governments and similar bodies - which are amongst the few intangible assets that do have an active market - the standard specifically makes an exception and allows the revaluation model to be applied to "an intangible asset that was received by way of a government grant and recognised at a nominal amount". *[IAS 38.77]*.

The example below illustrates how this would work in practice.

Illustration 8-1: Application of revaluation model to intangible assets that are partially recognised or received by way of government grant

Entity C spent CU12,000,000 in preparing its application for a number of taxi licences, which it expensed because of the uncertain outcome of the process. The application was successful, and C was granted a number of freely transferable taxi licences and paid a nominal registration fee of CU50,000, which it recognised as an asset. There is an active and liquid market in these taxi licences.

C can apply the revaluation model under IAS 38 to these taxi licences, because it previously recognised the licence (even if it only recognised part of the costs as an asset) and there is an active market in these licences.

Entity D obtained a number of freely transferable fishing quotas free of charge, which it recognised at a nominal amount as permitted under IAS 20. There is an active and liquid market in these quotas.

D can apply the revaluation model under IAS 38 to these fishing quotas, because it previously recognised the quota (even if it only recognised it at a nominal amount) and there is an active market in these quotas.

8.2.1 Revaluation is only allowed if there is an active market

An entity can only elect to apply the revaluation model if the fair value can be determined by reference to an active market for the intangible asset. *[IAS 38.81, IAS 38.82]*. An active market is defined in IFRS 13 as one in which transactions for the item take place with sufficient frequency and volume to provide pricing information on an ongoing basis. *[IFRS 13 Appendix A]*.

Few intangible assets will be eligible for revaluation and indeed the standard concedes that such an active market would be uncommon. Nevertheless, in some jurisdictions, an active market may exist for freely transferable taxi licences, fishing licences or production quotas. *[IAS 38.78]*. However, by their very nature most intangible assets are unique or entity-specific. The standard lists brands, newspaper mastheads, music and film publishing rights, patents or trademarks as items that are ineligible for revaluation because each such asset is unique. *[IAS 38.78]*. The existence of a previous sale and purchase transaction is not sufficient evidence for the market to be regarded as active because of the requirement in the definition for a sufficient frequency and volume of transactions to allow the provision of ongoing pricing information. The standard notes that where contracts are negotiated between individual buyers and sellers or when transactions are relatively infrequent, the price of a previous transaction for one intangible asset may not provide sufficient evidence of the fair value of another. In addition, if prices are not available to the public, this is taken as evidence that an active market does not exist. *[IAS 38.78]*.

An entity must stop revaluing an asset if the market used to determine its fair value ceases to meet the criteria for an active market. The valuation is 'frozen' from that date, and reduced thereafter by subsequent amortisation and any subsequent impairment losses. *[IAS 38.82]*. The IASB believes that the disappearance of a previously active market may indicate that the asset needs to be tested for impairment in accordance with IAS 36. *[IAS 38.83]*.

If an active market for the previously revalued asset emerges at a later date, the entity is required to apply the revaluation model from that date. *[IAS 38.84]*.

8.2.2 Frequency of revaluations

IAS 38 requires revaluations to be performed "with such regularity that at the end of the reporting period the carrying amount of the asset does not differ materially from its fair value". *[IAS 38.75]*. The standard lets entities judge for themselves the frequency of revaluations depending on the volatility of the fair values of the underlying intangible assets. Significant and volatile movements in fair value would necessitate annual revaluation, whereas a less frequent update would be required for intangibles whose price is subject only to insignificant movements. *[IAS 38.79]*. Nevertheless, since an entity can only revalue assets for which a price is quoted in an active market, there must be no impediment to updating that valuation at each reporting date. As noted above, when an entity has a number of items in the same class of intangible assets, the standard requires that they are all valued at the same time. *[IAS 38.73]*.

8.2.3 Accounting for revaluations

Increases in an intangible asset's carrying amount as a result of a revaluation must be credited to other comprehensive income, except to the extent that the revaluation reverses a revaluation decrease of the same asset that was previously recognised in profit or loss. *[IAS 38.85]*. Conversely, decreases in an intangible asset's carrying amount as a result of a revaluation must be recognised in profit or loss, unless the decrease reverses an earlier upward revaluation, in which case the decrease must first be recognised in other comprehensive income to extinguish the revaluation surplus in respect of the asset. *[IAS 38.86]*. The example below illustrates how this works.

Illustration 8-2: Accounting for upward and downward revaluations

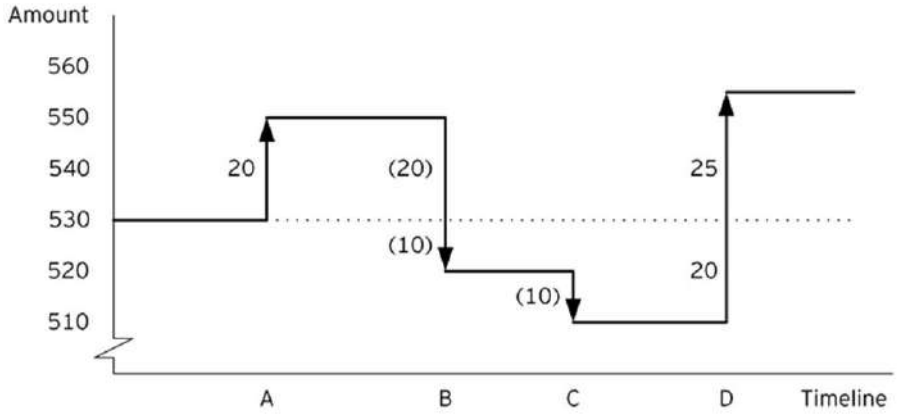
Entity E acquired an intangible asset that it accounts for under the revaluation model. The fair value of the asset changes as follows:

	CU	CU Change
Acquisition	530	-
Date A	550	+20
Date B	520	-30
Date C	510	-10
Date D	555	+45

The table below shows how Entity E must account for the upward and downward revaluations.

	Value of asset CU	Cumulative revaluation reserve CU	Revaluation recognised in other comprehensive income CU	Revaluation recognised in profit or loss CU
Acquisition	530	-	-	-
Date A	550	20	20	-
Date B	520	-	(20)	(10)
Date C	510	-	-	(10)
Date D	555	25	25	20

The diagram below summarises this information (the impact of amortisation on the carrying amount and revaluation surplus has been ignored in this example for the sake of simplicity).



The upward revaluation at Date A is accounted for in other comprehensive income. The downward revaluation at Date B first reduces the revaluation reserve for that asset to nil and the excess of CU10 is recognised as a loss in profit or loss. The second downward revaluation at Date C is recognised as a loss in profit or loss. The upward revaluation at Date D first reverses the cumulative loss recognised in profit or loss and the excess is accounted for in other comprehensive income.

In the Illustration above, the impact of amortisation on the carrying amount of the assets and the revaluation surplus was ignored for the sake of simplicity. However, the cumulative revaluation surplus included in other comprehensive income may be transferred directly to retained earnings when the surplus is realised, which happens either on the retirement or disposal of the asset, or as the asset is used by the entity. *[IAS 38.87]*. In the latter case, the amount of the surplus regarded as realised is the amount of amortisation in excess of what would have been charged based on the asset's historical cost. *[IAS 38.87]*. See Chapter 19 at section 6.2 for an example. In practice this means two things:

- An entity applying the revaluation model would need to track both the historical cost and revalued amount of an asset to determine how much of the revaluation surplus has been realised.

  And

- Any revaluation surplus is amortised over the life of the related asset. Therefore, in the case of a significant downward revaluation there is a smaller revaluation surplus available against which the downward revaluation can be offset before recognition in the statement of profit or loss.

The transfer from revaluation surplus to retained earnings is not made through profit or loss. *[IAS 38.87]*. It is not the same as recycling a gain or loss previously recognised in other comprehensive income. Accordingly, the transfer will appear as a line item in the Statement of Changes in Equity rather than in other comprehensive income.

When an intangible asset is revalued, the carrying amount of that asset is adjusted to the revalued amount. At the date of the revaluation, the asset is treated in one of the following ways:

(a) The gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. For example, the gross carrying amount may be restated by reference to observable market data or it may be restated proportionately to the change in the carrying amount. The accumulated amortisation at the date of the revaluation is adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses.

  Or

(b) The accumulated amortisation is eliminated against the gross carrying amount of the asset. *[IAS 38.80]*.

The example below illustrates how the adjustments are calculated.

Illustration 8-3: Restatement of accumulated amortisation after a revaluation

Entity F revalued an intangible asset from its carrying amount of CU120 to its fair value of CU150. The gross carrying amount is adjusted to CU345 by reference to the observable market data. The adjustment is in a manner consistent with the revaluation of the intangible asset. Under the observable market data approach (in the column, approach (a)), the accumulated amortisation is adjusted to CU195, which is the difference between the gross revalued amount of CU345 and the net revalued amount of CU150. The proportionate restatement approach (in the column, approach (b)) leads to 'grossing-up' of both the gross carrying amount and the accumulated amortisation. The elimination approach (in the column, approach (c)) results in elimination of the accumulated amortisation.

	Before revaluation	After revaluation		
		Observable market data	*Proportionate restatement*	*Eliminating amortisation*
		(a)	*(b)*	*(c)*
	CU	CU	CU	CU
Gross carrying amount	300	345	375	150
Accumulated amortisation	(180)	(195)	(225)	-
Net carrying amount	120	150	150	150

9 Amortisation of intangible assets

9.1 Assessing the useful life of an intangible asset as finite or indefinite

IAS 38 defines the useful life of an intangible asset as:

(a) The period over which an asset is expected to be available for use by an entity

Or

(b) The number of production or similar units expected to be obtained from the asset by an entity *[IAS 38.8]*

The standard requires an entity to assess whether the useful life of an intangible asset is finite or indefinite. *[IAS 38.88]*. An intangible asset with a finite useful life is amortised over its useful life or the number of production units (or similar units) constituting that useful life, whereas an intangible asset with an indefinite useful life is not amortised. *[IAS 38.89]*.

The standard requires an intangible asset to be classified as having an indefinite useful life "when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity". *[IAS 38.88]*. Therefore, for this purpose the term 'indefinite' does not mean 'infinite'. *[IAS 38.91]*.

Entities must not confuse the absence of a foreseeable limit to an asset's life with an ability to renew, refresh or upgrade an asset to ensure it continues to generate future cash flows. Some intangible assets are based on legal rights that are conveyed in perpetuity rather than for finite terms, whether or not those terms are renewable. If the cash flows are expected to continue indefinitely, the useful life is indefinite. *[IAS 38.BC62]*.

An important underlying assumption in making the assessment of the useful life of an intangible asset is that it "reflects only that level of future maintenance expenditure required to maintain the asset at its standard of performance assessed at the time of estimating the asset's useful life, and the entity's ability and intention to reach such a level. A conclusion that the useful life of an intangible asset is indefinite must not depend on planned future expenditure in excess of that required to maintain the asset at that standard of performance." *[IAS 38.91]*. Determining exactly what constitutes the level of expenditure 'required to maintain the asset at that standard of performance' is a matter of judgement. However, a clear distinction exists between this type of expenditure and costs that might be incurred to renew, refresh or upgrade an asset to ensure it continues to generate future cash flows. Expenditure to ensure that an intangible asset does not become obsolete is not the type of maintenance expenditure that, though very necessary to ensure continuing future cash flows, would be indicative of an indefinite life. Indeed, the standard asserts that assets subject to technological change would be expected to have a short useful life. *[IAS 38.92]*.

9.1.1 Factors affecting the useful life

The standard identifies a number of factors that may affect the useful life of an intangible asset: *[IAS 38.90]*

Extract from IAS 38

90 Many factors are considered in determining the useful life of an intangible asset, including:

(a) the expected usage of the asset by the entity and whether the asset could be managed efficiently by another management team;

(b) typical product life cycles for the asset and public information on estimates of useful lives of similar assets that are used in a similar way;

(c) technical, technological, commercial or other types of obsolescence;

(d) the stability of the industry in which the asset operates and changes in the market demand for the products or services output from the asset;

(e) expected actions by competitors or potential competitors;

(f) the level of maintenance expenditure required to obtain the expected future economic benefits from the asset and the entity's ability and intention to reach such a level;

(g) the period of control over the asset and legal or similar limits on the use of the asset, such as the expiry dates of related leases; and

(h) whether the useful life of the asset is dependent on the useful life of other assets of the entity.

The standard explicitly warns against both:

- Overestimating the useful life of an intangible asset. For example, a history of rapid changes in technology means that the useful lives of computer software and many other intangible assets that are susceptible to technological obsolescence will be short. *[IAS 38.92]*.

  And

- Underestimating the useful life of an intangible asset. Whilst uncertainty justifies estimating the useful life of an intangible asset on a prudent basis, it does not justify choosing a life that is unrealistically short. *[IAS 38.93]*.

Where an intangible asset is acquired in a business combination, but the acquiring entity does not intend to use it to generate future cash flows, it is unlikely that it could have anything other than a finite useful life.

How we see it

In our view, where an intangible asset is acquired in a business combination, but the acquiring entity does not intend to use it to generate future cash flows, an entity would not recognise an immediate impairment loss on acquisition. However, the estimated useful life of the asset is likely to be relatively short (see Chapter 10 at section 5.5.6).

The following Illustrations, based on those in IAS 38's Illustrative Examples, show how some of the features that affect the useful life are taken into account in assessing that life.

Illustration 9-1: Assessing the useful life of an intangible asset

Acquired customer list

A direct-mail marketing company acquires a customer list and expects that it will be able to derive benefit from the information on the list for at least one year, but no more than three years.

The customer list would be amortised over management's best estimate of its useful life, say 18 months. Although the direct-mail marketing company may intend to add customer names and other information to the list in the future, the expected benefits of the acquired customer list relate only to the customers on that list at the date it was acquired. The customer list also would be reviewed for indicators of impairment in accordance with IAS 36 at the end of each reporting period. *[IAS 36.9]*.

An acquired trademark used to identify and distinguish a leading consumer product that has been a market-share leader for the past eight years

The trademark has a remaining legal life of five years but is renewable every 10 years at little cost. The acquiring entity intends to renew the trademark continuously and evidence supports its ability to do so. An analysis of product life cycle studies, market, competitive and environmental trends, and brand extension opportunities provides evidence that the trademarked product will generate net cash inflows for the acquiring entity for an indefinite period.

The trademark would be treated as having an indefinite useful life because it is expected to contribute to net cash inflows indefinitely. Therefore, the trademark would not be amortised until its useful life is determined to be finite. It would be tested for impairment in accordance with IAS 36 annually and whenever there is an indication that it may be impaired. *[IAS 36.10]*.

It is clear from the above discussion that despite the fairly detailed guidance in the standard, an entity will need to exercise judgement in estimating the useful life of intangible assets.

9.1.2 Useful life of contractual or other legal rights

Where an intangible asset arises from contractual or other legal rights, the standard requires an entity to take account of both economic and legal factors influencing its useful life and determine the useful life as the shorter of:

- The period of the contractual or other legal rights

  And

- The period (determined by economic factors) over which the entity expects to obtain economic benefits from the asset *[IAS 38.94, IAS 38.95]*

If the contractual or other legal rights can be renewed, the useful life of the intangible asset must include the renewal period only if there is evidence to support renewal by the entity without significant cost. *[IAS 38.94]*. If this is not the case, then the original asset's useful life ends at the contracted renewal date and the renewal cost is treated as the cost to acquire a new intangible asset. *[IAS 38.96]*. An entity needs to exercise judgement in assessing what it regards as a significant cost.

The existence of the following factors may indicate that an entity is able to renew the contractual or other legal rights without significant cost:

(a) There is evidence, possibly based on experience, that the contractual or other legal rights will be renewed. If renewal is contingent upon the consent of a third party, this includes evidence that the third party will give its consent.

(b) There is evidence that any conditions necessary to obtain renewal will be satisfied.

And

(c) The cost to the entity of renewal is not significant when compared with the future economic benefits expected to flow to the entity from renewal. *[IAS 38.96].*

In the case of a reacquired contractual right recognised as an intangible asset in a business combination accounted for under IFRS 3, its useful life is the remaining contractual period of the contract in which the right was granted. Renewal periods must not be taken into account. *[IAS 38.94]*.

The following Illustrations are derived from those in IAS 38's Illustrative Examples and show the effect of contractual or other legal rights on the useful life of an intangible asset, when assessed together with other factors. The useful life may be shorter than the legal rights or, if supported by facts and circumstances, renewal rights could mean that the intangible asset's life is indefinite.

Illustration 9-2: Legal rights and useful life

An acquired copyright that has a useful life that is shorter than its remaining legal life of 50 years

An analysis of consumer habits and market trends provides evidence that the copyrighted material will generate net cash inflows for only 30 more years.

The copyright would be amortised over its 30-year estimated useful life and not over the term of the legal rights of 50 years. The copyright also would be reviewed for impairment in accordance with IAS 36 by assessing at the end of each reporting period whether there is any indication that it may be impaired.

An acquired broadcasting licence that expires in five years but is assessed as having an indefinite useful life

The broadcasting licence is renewable every 10 years if the entity provides at least an average level of service to its customers and complies with the relevant legislative requirements. The licence may be renewed indefinitely at little cost and has been renewed twice before the most recent acquisition. The acquiring entity intends to renew the licence indefinitely and evidence supports its ability to do so. Historically, there has been no compelling challenge to the licence renewal. The technology used in broadcasting is not expected to be replaced by another technology at any time in the foreseeable future. Therefore, the licence is expected to contribute to the entity's net cash inflows indefinitely.

The broadcasting licence would be treated as having an indefinite useful life because it is expected to contribute to the entity's net cash inflows indefinitely. Therefore, the licence would not be amortised until its useful life is determined to be finite. The licence would be tested for impairment in accordance with IAS 36 annually (as part of a cash-generating unit) and whenever there is an indication that it may be impaired.

An acquired airline route authority between two European cities that expires in three years but is assessed as having an indefinite useful life

The route authority may be renewed every five years, and the acquiring entity intends to comply with the applicable rules and regulations surrounding renewal. Route authority renewals are routinely granted at a minimal cost and historically have been renewed when the airline has complied with the applicable rules and regulations. The acquiring entity expects to provide service indefinitely between the two cities from its hub airports and expects that the related supporting infrastructure (airport gates, slots, and terminal facility leases) will remain in place at those airports for as long as it has the route authority. An analysis of demand and cash flows supports those assumptions.

Because the facts and circumstances support the acquiring entity's ability to continue providing air service indefinitely between the two cities, the intangible asset related to the route authority is treated as having an indefinite useful life. Therefore, the route authority would not be amortised until its useful life is determined to be finite. It would be tested for impairment in accordance with IAS 36 annually (as part of a cash-generating unit) and whenever there is an indication that it may be impaired.

9.2 Intangible assets with a finite useful life

9.2.1 Amortisation period and method

Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life. The depreciable amount is the cost of an asset, or other amount substituted for cost (e.g., revaluation), less its residual value. *[IAS 38.8]*. The depreciable amount of an intangible asset with a finite useful life must be allocated on a systematic basis over its useful life in the following manner: *[IAS 38.97]*

- Amortisation must begin when the asset is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, even if an entity is not using the asset, it must still be amortised because it is available for use, although there may be exceptions from this general rule (see section 9.2.3 below).
- Amortisation must cease at the earlier of:
  - The date that the asset is classified as held for sale, or included in a disposal group that is classified as held for sale, in accordance with IFRS 5.

    And
  - The date that the asset is derecognised.
- The amortisation method must reflect the pattern of consumption of the economic benefits that the intangible asset provides. If that pattern cannot be reliably determined, a straight-line basis must be used.

Amortisation of an intangible asset with a finite useful life continues until the asset has been fully depreciated or is classified as held for sale, as noted above, or derecognised. Amortisation does not cease simply because an asset is not being used, *[IAS 38.117]*, although this fact might give rise to an indicator of impairment.

The standard allows a variety of amortisation methods to be used to depreciate the asset on a systematic basis over its useful life, such as the straight-line method, the diminishing balance method, and the unit of production method. *[IAS 38.98]*. The factors to consider in determining the most appropriate amortisation method are similar to those that are relevant for the depreciation of property, plant and equipment in accordance with IAS 16 (see Chapter 19 at section 5.6). For example, entities can adopt a 'sum of the digits' methodology, where amortisation reflects higher consumption of benefits in the earlier part of the asset's useful life, as this is a variant of the diminishing balance method (see Chapter 19 at section 5.6.3).

In selecting an appropriate amortisation method for intangible assets acquired in a business combination, entities must ensure consistency with any assumptions that were used in determining the fair value of the asset. For example, a customer relationship asset may be valued by taking into account an assumed churn-rate that implies a higher level of customer relationships ending in the earlier periods following the business combination. These factors may indicate that a straight-line method of amortisation is not the most appropriate method to reflect the pattern of consumption of the economic benefits that the intangible asset provides, as the valuation assumed that benefit to be frontloaded.

The amortisation charge for each period must be recognised in profit or loss unless an IFRS accounting standard specifically permits or requires it to be capitalised as part of the carrying amount of another asset (e.g., inventory or work in progress). *[IAS 38.97, IAS 38.99]*.

There is a rebuttable presumption that an amortisation method based on the pattern of expected revenues is not appropriate. This is because a revenue-based method reflects a pattern of generation of economic benefits from operating the business (of which the asset is a part), rather than the consumption of the economic benefits embodied in the asset itself (see section 9.2.2 below). By contrast, an amortisation method based on estimated total output (a unit of production method) is appropriate.

The future economic benefits of some intangible assets are clearly consumed on a declining balance basis. This often applies to customer relationships and similar assets acquired as part of a business combination. Both the fair value and the future economic benefits from the customer relationship or similar asset decline over time as the consumption of the economic benefits embodied in the asset declines. Therefore, amortising the customer relationship on a declining balance method would be appropriate.

It is important to distinguish this from an asset whose fair value shows a declining balance profile over its life but where the future economic benefits are consumed on a time basis, e.g., a motor vehicle where the entity will obtain as much benefit in year 4 as in year 1. A straight-line method of amortisation properly reflects the consumption of benefits from the motor vehicle.

9.2.1.A Amortising customer relationships and similar intangible assets

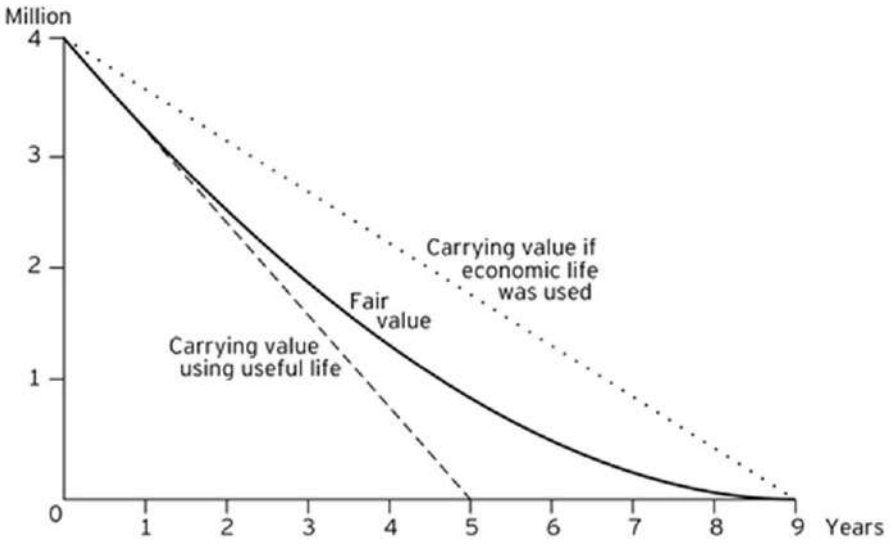
As discussed above, in selecting an appropriate amortisation method for intangible assets acquired in a business combination, entities must ensure consistency with any assumptions used in determining the fair value of the asset.

In practice entities rarely use declining balance methods for amortisation. One reason for customer relationships and similar intangible assets is the uncertainty about the future economic benefits that might arise several years in the future and the difficulty in distinguishing them from cash flows that have been generated by internally generated assets of the business. As a pragmatic solution, supported by valuations experts, entities often use a straight-line method over a shorter period so that at all points the amortised carrying amount of the asset is below the curve for the expected benefits. This is shown in the following Illustration and chart. As long as the benefits expected to arise in the period after the intangible asset is fully amortised are not expected to be significant and the entity applies the requirements of IAS 38 to review the useful life and amortisation method (see section 9.2.3 below), this method will give a reasonable approximation of the consumption of economic benefits.

Illustration 9-3: Amortisation method and useful life for customer relationships

An entity identifies a customer relationship on acquiring another business. The entity completes its initial accounting at the end of 20X0 and the customer relationship is valued at CU4 million. The valuations expert consulted by the entity assesses the total period from which benefits will be derived from the customer relationship to be 9 years, but that the benefits will show a declining balance over this period. After discussions with the valuer, the entity concludes that the best estimate of the useful life of the customer relationship for accounting purposes is 5 years and a straight-line method over this period will adequately reflect the consumption of future economic benefits from the customer relationship, given that the amount and timing of benefits after 5 years is inherently uncertain as to timing or amount. The entity notes that a straight-line method over 9 years would not adequately reflect the consumption of future economic benefits.

The relationship between the total economic life, useful life and amortisation method is illustrated in the following chart.



9.2.1.B Amortisation of programme and other broadcast rights

The value of programme and other broadcast rights diminishes because the programmes or events have been broadcast to the same audience before and as result of the passage of time, e.g., audiences lose interest in old programmes or repeats of events for which the result is known or the right is for a limited period. In accounting for this diminution in value, in practice, entities usually take into account how often a programme has been broadcast and, less frequently, the passage of time as such.

When an entity accounts for broadcast rights as inventory, the problem arises that IAS 2 requires valuation 'at the lower of cost and net realisable value' and does not appear to recognise the concept of amortisation of inventories. *[IAS 2.9]*. However, it has been argued that a programme right embodies a series of identifiable components, i.e., first transmission, second transmission, etc., which an entity would account for separately. This appears to be the approach that ITV plc applies in writing off its programme rights (see Practical example 2-2 in section 2.2.2 above).

An entity that accounts for programme and other broadcast rights as intangible assets would need to comply with the requirements of IAS 38, which requires that the amortisation method reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. *[IAS 38.97]*. As discussed in section 9.2.1 above, the standard permits a range of amortisation methods (e.g., the straight-line method, the diminishing balance method and the unit of production method), provided that the chosen method reflects the pattern in which the asset's future economic benefits are expected to be consumed. *[IAS 38.97, IAS 38.98]*.

RAI - Radiotelevisione italiana SpA. is an example of a company that amortises some of its programme rights on a straight-line basis.

Practical example 9-1: RAI - Radiotelevisione italiana SpA. (2022) Italy

Report and Financial Statements as at 31 December 2022 [extract]
Consolidated Financial Statements as at 31 December 2022 [extract]
Financial statements of the Rai Group [extract]
Notes to the Consolidated Financial Statements as at 31 December 2022 [extract]
4 Evaluation criteria [extract]
Activities [extract]
Intangible assets [extract]

...

The intangible assets having a defined useful life are systematically amortised along their useful life meant as the estimate of the period in which the assets will be used by the Group, and are broken down into:

a) Programmes – Audiovisual Works: the costs for acquiring and producing TV programmes, of audiovisual, cinema and multimedia works, made up of the external costs directly allocated to each production and the costs of the internal resources used to make single programmes, are represented according to the following criteria:
   1) costs referring to television productions with repeat utility and with contractual rights exceeding 12 months are capitalised as intangible assets and, if these productions are ready for use at year-end, are amortised on a straight-line basis, starting from the month they are ready or the right becomes available, with regard to the duration of their expected useful life. If, on the other hand, these productions with repeat utility are not yet usable at year-end or rights become available in the future, their costs are deferred as work in progress and payments on account.

...

The above is in contrast to Vivendi SE, which has rebutted the presumption in IAS 36 that a revenue-based amortisation method is inappropriate (see section 9.2.2 below), and amortises its film and television rights to be sold to third parties using such a method.

Practical example 9-2: Vivendi SE (2023) France

FINANCIAL REPORT FOR THE YEAR 2023 [extract]
Financial Report and Audited Consolidated Financial Statements for the year ended December 31, 2023 [extract]
III- Audited Consolidated Financial Statements for the year ended December 31, 2023 [extract]
Notes to the Consolidated Financial Statements [extract]
NOTE 1 Accounting policies and valuation methods [extract]
1.3 Principles governing the preparation of the Consolidated Financial Statements [extract]
1.3.6 Assets [extract]
1.3.6.3 Content assets [extract]
Canal+ Group [extract]

Theatrical films and television rights produced or acquired to be sold to third parties

Theatrical films and television rights produced or acquired before their initial exhibition, which are to be sold to third parties, are recorded as content assets at capitalized cost (mainly direct production and overhead costs) or at their acquisition cost. The cost of theatrical films and television rights are amortized, and other related costs are expensed, pursuant to the estimated revenue method (i.e., based on the ratio of the current period's gross revenues to estimated total gross revenues from all sources on an individual production basis). Vivendi considers that amortization pursuant to the estimated revenue method reflects the rate at which the entity plans to consume the future economic benefits related to the asset, and that there is a high correlation between revenue and the consumption of the economic benefits embodied in the intangible assets.

...

Only in specific circumstances will it be appropriate to use a revenue-based method of amortisation. These circumstances are discussed in section 9.2.2 below.

9.2.2 Revenue-based amortisation

Consumption of the future economic benefits of an asset is the principle on which amortisation is based. Whether this completely precluded revenue-based methods of amortisation had become a matter of debate, particularly in the context of service concession arrangements that are accounted for using the intangible asset model (see Chapter 26 at section 4.3.1).

In May 2014, the IASB clarified IAS 38 by introducing a rebuttable presumption that a revenue-based approach is not appropriate. Revenue reflects the output of the intangible asset, but it also measures the impact of other factors, such as changes in sales volumes and selling prices, the effects of selling activities and changes to inputs and processes. The price component of revenue may be affected by inflation. *[IAS 38.98A]*.

The following Illustration shows how a revenue-based method of amortisation diverges from the units-of-production method when the price per unit is not fixed.

Illustration 9-4: Output-based versus revenue-based amortisation

Entity Z acquires a five-year licence to manufacture a product for a cost of CU1,220,000. It is expected that the production line used for making the product has a capacity of 100,000 units per year. The entity plans to produce at full capacity each year and to sell all of its output. However, it expects the price per unit to be CU10 in year 1 and increase by 10% each year thereafter. On this basis, the profile of amortisation on a units of production (UoP) basis and on a revenue basis would be as follows:

	Units	UoP charge	Revenue	Charge
		CU	CU	CU
Year 1	100,000	244,000	1,000,000	200,000
Year 2	100,000	244,000	1,100,000	220,000
Year 3	100,000	244,000	1,210,000	242,000
Year 4	100,000	244,000	1,330,000	266,000
Year 5	100,000	244,000	1,460,000	292,000
Total	500,000	1,220,000	6,100,000	1,220,000

The IASB acknowledged certain 'limited circumstances' that would allow revenue-based amortisation. Therefore, the presumption that they are not acceptable is rebuttable only:

(a) When the rights embodied in that intangible asset are expressed as a measure of revenue

Or

(b) When it can be demonstrated that revenue and the consumption of the economic benefits embodied in the intangible asset are highly correlated *[IAS 38.98A]*

A 'highly correlated' outcome would only be achieved where a revenue-based method of amortisation is expected to give a similar answer as one of the other methods permitted by IAS 38. For example, if revenue is earned evenly over the expected life of the asset, the pattern of amortisation would be similar to a straight-line basis. In situations where unit prices are fixed and all production is sold, the pattern of amortisation would replicate the use of the units-of-production method (i.e., there is a high degree of correlation between revenue and the consumption of the economic benefits embodied in the asset). However, when unit prices are not fixed, revenue would not provide the same answer and its use would therefore be inappropriate (as in the Illustration above). *[IAS 38.98B, IAS 38.98C]*. The revised standard notes that revenue is the predominant limiting factor that is inherent in the intangible asset in circumstances in which it is appropriate to use it as the basis of amortisation. In other words, in these circumstances, revenue determines the useful life of the asset, rather than, for example, a number of years or the number of units produced.

The amended standard includes two examples in which revenue earned can be regarded as a measure of consumption of an intangible asset:

- A contract may allow the extraction of gold from a mine until total cumulative revenue from the sale of gold reaches CU2 billion

  Or

- The right to operate a toll road could be based on a fixed total amount of revenue to be generated from cumulative tolls, i.e., the operator can collect up to CU100 million from the tolls collected *[IAS 38.98C]*

Some respondents had argued that a units of production method did not seem practicable when the units of production were not homogeneous. For example, a producer of a motion picture generates revenue through showing the picture in theatres, selling DVDs, licensing the rights to characters to toy manufacturers and licensing the broadcast rights to television. The IASB acknowledges that such situations require the exercise of judgement. The Board did consider whether an intangible asset must be divided into components for amortisation purposes "but refrained from developing guidance in this respect for intangible assets". *[IAS 38.BC72H, IAS 38.BC72I]*.

9.2.3 Review of amortisation period and amortisation method

An entity must review the amortisation period and the amortisation method for an intangible asset with a finite useful life at least at each financial year-end. If the expected useful life of the asset has changed, the amortisation period must be changed accordingly. *[IAS 38.104]*. An entity may, for example, consider its previous estimate of the useful life of an intangible asset inappropriate upon recognition of an impairment loss on the asset. *[IAS 38.105]*.

If the expected pattern of consumption of the future economic benefits embodied in the asset has changed, the amortisation method must be changed to reflect the new pattern. *[IAS 38.104]*. The standard provides two examples of when this might happen:

- If it becomes apparent that a diminishing balance method of amortisation is appropriate rather than a straight-line method. *[IAS 38.106]*.

  And

- If use of the rights represented by a licence is deferred pending action on other components of the business plan. In this case, economic benefits that flow from the asset may not be received until later periods. *[IAS 38.106]*. This implies that circumstances may exist in which it is appropriate not to recognise an amortisation charge in relation to an intangible asset, because the entity may not yet be ready to use it. For example, telecommunication companies acquired UMTS (3G) licences, before constructing the physical network necessary to use the licence. Note that an entity must perform an impairment test at least annually for any intangible asset that has not yet been brought into use. *[IAS 36.10]*.

Both changes in the amortisation period and the amortisation method must be accounted for as changes in accounting estimates in accordance with IAS 8, which requires such changes to be recognised prospectively by revising the amortisation charge in the current period and for each future period during the asset's remaining useful life. *[IAS 8.36, IAS 8.38, IAS 38.104]*.

9.2.4 Residual value

The residual value of an intangible asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life. *[IAS 38.8]*.

IAS 38 requires entities to assume a residual value of zero for an intangible asset with a finite useful life, unless there is a commitment by a third party to purchase the asset at the end of its useful life, or there is an active market (as defined by IFRS 13) for the asset from which to determine its residual value and it is probable that such a market will exist at the end of the asset's useful life. *[IAS 38.100]*. This presumption has been retained from the previous version of IAS 38 as an anti-abuse measure to prevent entities from circumventing the requirement to amortise all intangible assets. *[IAS 38.BC59]*.

Given the definition of 'active market' (see section 8.2.1 above) it seems highly unlikely that, in the absence of a commitment by a third party to buy the asset, an entity will ever be able to prove that the residual value is other than zero. A residual value other than zero implies that the entity intends to dispose of the asset before the end of its economic life. *[IAS 38.101]*. Third party commitments can be found in contracts in the scope of IFRIC 12 *Service Concession Arrangements* (see Chapter 26) and one of IAS 38's Illustrative Examples includes a residual value; see Illustration 9-5 below.

If an entity can demonstrate a case for estimating a residual value other than zero, its estimate must be based on current prices for the sale of a similar asset that has reached the end of its useful life and has operated under conditions similar to those in which the asset will be used. *[IAS 38.102]*. The standard requires a review of the residual value at each financial year end. This review can result in an upward or downward revision of the estimated residual value and thereby affect the depreciable amount of the asset; that change to depreciation must be accounted for prospectively as a change in an accounting estimate in accordance with IAS 8. *[IAS 38.102]*.

The following Illustration is based on one of IAS 38's Illustrative Examples. The intangible asset being considered has a residual value at the end of its useful life.

Illustration 9-5: Amortisation of an intangible asset with a residual value

An acquired patent that expires in 15 years

A product protected by patented technology is expected to be a source of net cash inflows for at least 15 years. The entity has a commitment from a third party to purchase that patent in five years for 60% of the fair value of the patent at the date it was acquired, and the entity intends to sell the patent to that third party in five years.

The patent will be amortised over its five-year useful life to the entity, with a residual value equal to 60% of the patent's fair value at the date it was acquired. The patent will also be reviewed for impairment in accordance with IAS 36 by assessing at the end of each reporting period whether there is any indication that it may be impaired.

The standard does not permit negative amortisation in the event that the residual value of an intangible asset increases to an amount greater than the asset's carrying amount. Instead, the asset's amortisation charge will be zero until its residual value decreases to an amount below the asset's carrying amount. *[IAS 38.103]*.

9.3 Intangible assets with an indefinite useful life

IAS 38 prohibits amortisation of an intangible asset with an indefinite useful life. *[IAS 38.107]*. Instead, IAS 36 requires such an asset to be tested for impairment annually and whenever there is an indication that the intangible asset may be impaired. *[IAS 38.108]*.

An entity must review and validate at the end of each reporting period its decision to classify the useful life of an intangible asset as indefinite. *[IAS 38.109]*. If events and circumstances no longer support an indefinite useful life, the change from indefinite to finite life must be accounted for as a change in accounting estimate under IAS 8, *[IAS 38.109]*, which requires such changes to be recognised prospectively (i.e., in the current and future periods). *[IAS 8.36]*. Furthermore, reassessing the useful life of an intangible asset as finite rather than indefinite is an indicator that the asset may be impaired. *[IAS 38.110]*. See Chapter 21 for a discussion on impairment.

The following Illustrations from IAS 38's Illustrative Examples show circumstances in which an entity considers whether the useful life of an intangible asset is still indefinite.

Illustration 9-6: Review of indefinite useful lives

A broadcasting licence is no longer to be renewed

The facts are as in Illustration 9-2 (see section 9.1.2 above). A licensing authority has allowed broadcast licences to be renewed indefinitely at little cost and an entity, having renewed the licence twice, had concluded that it had an indefinite useful life. However, the licensing authority subsequently decides that it will no longer renew broadcasting licences, but rather will auction the licences. At the time the licensing authority's decision is made, the entity's broadcasting licence has three years until it expires. The entity expects that the licence will continue to contribute to net cash inflows until the licence expires.

Because the broadcasting licence can no longer be renewed, its useful life is no longer indefinite. Thus, the acquired licence would be amortised over its remaining three-year useful life and immediately tested for impairment in accordance with IAS 36.

A trademark for a line of products acquired several years ago in a business combination

At the time of the business combination, the acquiree had been producing the line of products for 35 years with many new models developed under the trademark. At the acquisition date, the acquirer expected to continue producing the line, and an analysis of various economic factors indicated there was no limit to the period the trademark would contribute to net cash inflows, so the trademark was not amortised by the acquirer. However, management has recently decided that production of the product line will be discontinued over the next four years.

Because the useful life of the acquired trademark is no longer regarded as indefinite, the carrying amount of the trademark would be tested for impairment in accordance with IAS 36, written down to recoverable amount as appropriate and the carrying amount amortised over its remaining four-year useful life.

9.4 Impairment losses

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount. *[IAS 38.8]*. An entity applies IAS 36 in determining whether an intangible asset is impaired (see Chapter 21). *[IAS 38.111]*.

IAS 36 requires an entity to perform an annual impairment test on every intangible asset that has an indefinite useful life and every intangible asset that is not yet available for use. Many intangible assets with indefinite lives do not generate independent cash inflows as individual assets and so are tested for impairment with other assets of the cash-generating unit of which they are part (see Chapter 21). *[IAS 36.10, IAS 36.22]*. This means that impairment losses, if any, will be allocated in accordance with IAS 36 and, if any goodwill allocated to the cash-generating unit has been written off, the other assets of the cash-generating unit, including the intangible asset, will be reduced *pro rata* to their carrying amount (see Chapter 21 at section 11.2). *[IAS 36.104]*.

Illustration 9-7: Impairment of an intangible asset with an indefinite useful life

A trademark acquired 10 years ago that distinguishes a leading consumer product

The trademark was regarded as having an indefinite useful life when it was acquired because the trademarked product was expected to generate cash inflows indefinitely. However, unexpected competition has recently entered the market and will reduce future sales of the product. Management estimates that cash inflows generated by the product will be 20% less for the foreseeable future. However, management expects that the product will continue to generate cash inflows indefinitely at those reduced amounts.

As a result of the projected decrease in future cash inflows, the entity determines that the estimated recoverable amount of the trademark and the assets that comprise the cash-generating unit is less than its carrying amount. An impairment loss is recognised for the cash-generating unit of which it is a part. Because it is still regarded as having an indefinite useful life, the trademark would continue not to be amortised but would be tested for impairment in accordance with IAS 36 annually, i.e., as part of the cash-generating unit, and whenever there is an indication that it may be impaired.

Note that a trademark may generate independent cash inflows if, for example, it is licenced to another party; otherwise, as in Illustration 9-7 above, it will be part of a cash-generating unit.

9.5 Retirements and disposals

An intangible asset must be derecognised on disposal (e.g., by sale, by entering into a finance lease, or by donation) or when no future economic benefits are expected from its use or disposal. *[IAS 38.112, IAS 38.114]*.

The date of disposal of an intangible asset is the date the recipient obtains control of that asset in accordance with the requirements for determining when a performance obligation is satisfied in IFRS 15. *[IAS 38.114]*. In the case of a disposal by a sale and leaseback, an entity must apply IFRS 16 (see Chapter 24).

The gain or loss on derecognition, which is determined as the difference between the net disposal proceeds and the carrying amount of the asset, must be accounted for in profit or loss unless IFRS 16 requires otherwise on a sale and leaseback. Gains on disposal must not be presented as revenue. *[IAS 38.113]*. For intangible assets measured under the revaluation model, any gain or loss on disposal is not expected to be significant. This is due to the fact that IAS 38 requires revaluations to be performed with such regularity that at the end of a reporting period the carrying amount of the asset does not differ materially from its fair value (see section 8.2.2 above). *[IAS 38.75]*.

In June 2020, the IFRS IC issued an agenda decision on the recognition of player transfer payments received by a football club. In the fact pattern considered by the IFRS IC, the entity recognised the player registration right as an intangible asset applying IAS 38. Accordingly, the IFRS IC concluded that the entity must apply the requirements of IAS 38.113 and recognise the transfer payment received as part of the gain or loss arising from the derecognition of the registration right. The agenda decision stated that the entity must not recognise the transfer payment received, or any gain arising, as revenue applying IFRS 15.[11]

11 *IFRIC Update*, June 2020, available on the IFRS Foundation's website.

Although the agenda decision only addressed the accounting for intangible assets in connection with player registration rights, the same accounting would also apply to other types of intangible assets that are sold.

For an entity whose ordinary activities include the development and transfer of players, it is conceivable that circumstances exist in which registration rights associated with some players meet the definition of inventories. In applying that definition, on initial recognition such an entity would consider whether the registration right is acquired for development and sale in the ordinary course of business (and therefore would be recognised as inventory under IAS 2, rather than an intangible asset under IAS 38). Whether a registration right meets the definition of inventories requires an assessment of the facts and circumstances.[12]

The consideration to be included in the calculation of the gain or loss is determined in accordance with the requirements for determining the transaction price in IFRS 15.47 to IFRS 15.72 (see Chapter 28 at section 5). *[IAS 38.116]*. If the transaction price includes variable consideration, subsequent changes to the estimated amount of the consideration included in the gain or loss on disposal are accounted for in accordance with the requirements for changes in the transaction price in IFRS 15 (see Chapter 28 at section 5.9). *[IAS 38.116]*.

If the receipt of the consideration does not match the timing of the transfer of the asset (e.g., the consideration is prepaid or paid after the date of disposal), then the arrangement may also contain a financing component for which the transaction price will need to be adjusted, if significant (see Chapter 28 at section 5.5).

In the case of a reacquired contractual right, recognised as an intangible asset in a business combination accounted for under IFRS 3, if the right is subsequently reissued or sold to a third party, any gain or loss is determined using the remaining carrying amount of the reacquired right. *[IAS 38.115A]*.

9.5.1 Derecognition of parts of intangible assets

The standard requires an entity to recognise the cost of replacing a part of an intangible asset as a component of the asset's carrying amount and to derecognise that component when the part is replaced: *[IAS 38.115]*

Extract from IAS 38	
115	If in accordance with the recognition principle in paragraph 21 an entity recognises in the carrying amount of an asset the cost of a replacement for part of an intangible asset, then it derecognises the carrying amount of the replaced part. If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or internally generated.

As noted by the standard, the nature of intangible assets is such that, in many cases, there are no additions or replacements that would meet its recognition criteria, so this will be an unlikely event (see section 3.3 above). *[IAS 38.20]*.

However, this requirement raises the question of how to account for the disposal of a part of a larger intangible item, acquired in a single transaction but capable of being subdivided for separate disposal. An example would be the division of the global rights to sell a particular product into a number of agreements providing exclusive rights over a particular continent or other geographic territory. In this case, the part disposed of is an identifiable and separable part of the original intangible asset. Because the rights are exclusive, the part still meets the definition of an intangible asset because it is embodied in legal rights that allow the acquirer to control the benefits arising from the asset, either by providing access to earn revenues in that geographic market or by restricting the access of others to that market. *[IAS 38.13]*. In that case, an entity would apply the requirements above for the derecognition of a replacement part of an asset, by determining the carrying amount of the separate part or, if to do so is impracticable, deducting the proceeds of disposal from the depreciated replacement cost of the original asset as a whole (in effect treating the value of the newly separated part as an indicator of its original cost within the whole original asset) to estimate the book value of the part being disposed of.

12 *IFRIC Update*, November 2019, available on the IFRS Foundation's website.

Where the subdivision of rights is not established on an exclusive basis, it would be more difficult to regard a separable component of the original intangible as having been disposed of. For example, rights might be assigned to a third party over a geographic area, but the entity retains the ability to sell goods in that market as well. In such circumstances it may not be appropriate to derecognise a portion of the original intangible asset. Instead, the entity may have transferred a right of use (or lease) over the asset to the third party, or entered into a form of joint arrangement. The issues raised by the partial disposal of previously undivided interests in property, plant and equipment are discussed in Chapter 19.

Accounting for the partial derecognition of goodwill on the disposal of an operation that forms part of a cash-generating unit is discussed in Chapter 21 at section 8.5.

10 Disclosure

The main disclosure requirements in IAS 38 are set out below, but it may be necessary to refer to:

- The disclosure requirements of IFRS 5 in Chapter 5.
- The disclosure requirements of IAS 36 in Chapter 21 in the event of a disposal or impairment.
- The fair value disclosures in IFRS 13 in Chapter 15 when fair value is used or disclosed.

10.1 General disclosures

IAS 38 requires certain disclosures to be presented by class of intangible assets. A class of intangible assets is defined as a grouping of assets of a similar nature and use in an entity's operations. The standard provides examples of classes of assets, which may be disaggregated (or aggregated) into smaller (or larger) groups if this results in more relevant information for the users of the financial statements (see section 8 above for examples of classes of intangible assets). *[IAS 38.119]*. Although separate information is required for internally generated intangible assets and other intangible assets, these categories are not considered to be separate classes when they relate to intangible assets of a similar nature and use in an entity's operations. Hence the standard requires the following disclosures to be given for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets: *[IAS 38.118]*

Extract from IAS 38

118 An entity shall disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

(a) whether the useful lives are indefinite or finite and, if finite, the useful lives or the amortisation rates used;

(b) the amortisation methods used for intangible assets with finite useful lives;

(c) the gross carrying amount and any accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period;

(d) the line item(s) of the statement of comprehensive income in which any amortisation of intangible assets is included;

(e) a reconciliation of the carrying amount at the beginning and end of the period showing:

(i) additions, indicating separately those from internal development, those acquired separately, and those acquired through business combinations;

(ii) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with IFRS 5 and other disposals;

(iii) increases or decreases during the period resulting from revaluations under paragraphs 75, 85 and 86 and from impairment losses recognised or reversed in other comprehensive income in accordance with IAS 36 (if any);

(iv) impairment losses recognised in profit or loss during the period in accordance with IAS 36 (if any);

(v) impairment losses reversed in profit or loss during the period in accordance with IAS 36 (if any);

(vi) any amortisation recognised during the period;

(vii) net exchange differences arising on the translation of the financial statements into the presentation currency, and on the translation of a foreign operation into the presentation currency of the entity; and

(viii) other changes in the carrying amount during the period.

The standard permits an entity to present the reconciliation required under (e) above either for the net carrying amount or separately for the gross carrying amount and the accumulated amortisation and impairments.

Paragraph 38 of IAS 1 requires comparative information for the reconciliation in (e) above.

An entity may want to consider separate disclosure of intangible assets acquired by way of government grant or obtained in an exchange of assets, even though disclosure is not specifically required under (e)(i) above.

An example of these general disclosures is given by International Consolidated Airlines Group, S.A.

Practical example 10-1:	International Consolidated Airlines Group, S.A. (2023)	Spain

ANNUAL REPORT AND ACCOUNTS 2023 [extract]

Financial Statements [extract]

Notes to the accounts [extract]

2. Significant accounting policies [extract]

Intangible assets

a Goodwill

Goodwill arises on the acquisition of subsidiaries, associates and joint ventures and represents the excess of the consideration paid over the net fair value of the identifiable assets and liabilities of the acquiree. Where the net fair value of the identifiable assets and liabilities of the acquiree is in excess of the consideration paid, a gain on bargain purchase is recognised immediately in the income statement.

For the purpose of assessing impairment, goodwill is grouped at the lowest levels for which there are separately identifiable cash flows (cash generating units). Goodwill is tested for impairment annually and whenever indicators exist that the carrying value may not be recoverable.

b Brands

Brands arising on the acquisition of subsidiaries are initially recognised at fair value at the acquisition date. Long established brands that are expected to be used indefinitely are not amortised but assessed annually for impairment.

c Customer loyalty programmes

Customer loyalty programmes arising on the acquisition of subsidiaries are initially recognised at fair value at the acquisition date. A customer loyalty programme with an expected useful life is amortised over the expected remaining useful life. Established customer loyalty programmes that are expected to be used indefinitely are not amortised but assessed annually for impairment.

d Landing rights

Landing rights acquired in a business combination are recognised at fair value at the acquisition date. Landing rights acquired from other airlines are capitalised at cost.

Capitalised landing rights based outside of the UK and the EU are amortised on a straight-line basis over a period not exceeding 20 years. Capitalised landing rights based within the UK and the EU are not amortised, as regulations provide that these landing rights are perpetual.

e Contract-based intangibles

Contract-based intangibles acquired in a business combination are recognised initially at fair value at the acquisition date and amortised over the remaining life of the contract.

f Software

The cost to purchase or develop computer software that is separable from an item of related hardware is capitalised separately and amortised on a straight-line basis generally over a period not exceeding five years, with certain specific software developments amortised over a period of up to ten years.

In certain instances, the Group enters into cloud computing arrangements with third-party providers, such as software as a service (SaaS), where the Group is provided the right to access and use the application software over the contract term. At inception of the contract, the Group will assess whether such an arrangement gives rise to the recognition of a software intangible asset.

Where the Group determines that no software intangible asset should be recognised, the cloud computing arrangement is determined to be a service contract and the associated fees paid are expensed as incurred. In addition, the costs incurred for both the customisation and configuration of the application software are generally expensed as incurred.

...

17. Intangible assets and impairment review [extract]

a Intangible assets

€ million	Goodwill	Brand	Customer loyalty programmes	Landing rights[1]	Software	ETS assets	Other	Total
Cost								
Balance at 1 January 2022	596	451	253	1,605	1,674	62	87	4,728
Additions	–	–	–	14	218	360	1	593
Disposals	–	–	–	(6)	(52)	(9)	–	(67)
Exchange movements	(1)	–	–	(25)	(34)	(6)	–	(66)
Balance at 31 December 2022	595	451	253	1,588	1,806	407	88	5,188
Additions	–	–	–	–	365	264	1	630
Disposals	–	–	–	(6)	(49)	(96)	–	(151)
Reclassifications	–	–	–	–	23	–	(15)	8
Exchange movements	1	–	–	11	18	2	–	32
31 December 2023	**596**	**451**	**253**	**1,593**	**2,163**	**577**	**74**	**5,707**
Amortisation and impairment								
Balance at 1 January 2022	249	–	–	142	1,032	–	66	1,489
Amortisation charge for the year	–	–	–	6	210	–	2	218
Disposals	–	–	–	–	(50)	–	–	(50)
Exchange movements	–	–	–	(2)	(23)	–	–	(25)
Balance at 31 December 2022	249	–	–	146	1,169	–	68	1,632
Amortisation charge for the year	–	–	–	6	185	–	2	193
Disposals	–	–	–	–	(39)	–	–	(39)
Exchange movements	–	–	–	1	11	–	–	12
31 December 2023	**249**	**–**	**–**	**153**	**1,326**	**–**	**70**	**1,798**
Net book values								
31 December 2023	**347**	**451**	**253**	**1,440**	**837**	**577**	**4**	**3,909**
31 December 2022	346	451	253	1,442	637	407	20	3,556

1 The net book value includes non-UK and non-EU based landing rights of €63 million (2022: €69 million) that have a definite life. The remaining average life of these landing rights is 12 years.

In addition to the disclosures required above, any impairment of intangible assets is to be disclosed in accordance with IAS 36, which is discussed in Chapter 21 at section 13, *[IAS 38.120]*, while the nature and amount of any change in useful life, amortisation method or residual value estimates must be disclosed in accordance with the provisions of IAS 8 (see Chapter 3 at section 5.2.2). *[IAS 38.121]*.

There are a number of additional disclosure requirements, some of which only apply in certain circumstances:

(a) For an intangible asset assessed as having an indefinite useful life, the carrying amount of that asset and the reasons supporting the assessment of an indefinite useful life. In giving these reasons, the entity must describe the factor(s) that played a significant role in determining that the asset has an indefinite useful life

(b) A description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the entity's financial statements

(c) For intangible assets acquired by way of a government grant and initially recognised at fair value (see section 4.6 above):

  (i) The fair value initially recognised for these assets

  (ii) Their carrying amount

  And

  (iii) Whether they are measured after recognition under the cost model or the revaluation model

(d) The existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities

(e) The amount of contractual commitments for the acquisition of intangible assets *[IAS 38.122]*

In describing the factors (as required under (a) above) that played a significant role in determining that the useful life of an intangible asset is indefinite, an entity considers the list of factors in IAS 38.90 (see section 9.1.1 above). *[IAS 38.123]*.

Finally, an entity is encouraged, but not required, to disclose the following information:

(a) A description of any fully amortised intangible asset that is still in use

And

(b) A brief description of significant intangible assets controlled by the entity but not recognised as assets because they did not meet the recognition criteria in this Standard or because they were acquired or generated before the version of IAS 38 issued in 1998 was effective *[IAS 38.128]*

10.2 Statement of financial position presentation

IAS 1 uses the term 'non-current' to include tangible, intangible and financial assets of a long-term nature, although it does not prohibit the use of alternative descriptions as long as the meaning is clear. *[IAS 1.67]*. Although most intangible assets are non-current, an intangible asset may meet the definition of a current asset (i.e., it has an economic life of less than 12 months) when it is acquired and must be classified accordingly.

IAS 1 requires intangible assets to be shown as a separate category of asset on the face of the statement of financial position. *[IAS 1.54]*. Intangible assets will, therefore, normally appear as a separate category of asset in the statement of financial position at a suitable point within non-current assets, or at a point in an undifferentiated statement of financial position that reflects their relative liquidity, *[IAS 1.60]*, that is, the time over which they are to be amortised or sold. An entity that holds a wide variety of different intangible assets may need to present these in separate line items on the face of the statement of financial position if such presentation is relevant to an understanding of the entity's financial position. *[IAS 1.55]*.

While the figure for intangible assets may include goodwill, the relevant standards require more detailed disclosures of the constituent elements to be included in the notes to the financial statements. In many cases though, entities will be able to aggregate the intangible assets into slightly broader categories in order to reduce the number of lines items on the face of their statement of financial position.

Nestlé S.A. is an example of an entity that chooses to present goodwill separately from other intangible assets on the face of the statement of financial position.

Practical example 10-2: Nestlé S.A. (2023) **Switzerland**

Financial Statements 2023 [extract]

Consolidated Financial Statements of the Nestlé Group 2023 [extract]

Consolidated balance sheet as at December 31, 2023 [extract]

In millions of CHF

	Notes	2023	2022
...			
Non-current assets			
Property, plant and equipment	8	30 467	30 141
Goodwill	9	28 693	31 262
Intangible assets	9	18 225	20 237
Investments in associates and joint ventures	14	13 088	13 023
Financial assets	12	2 947	3 253
Derivative assets	12	130	—
Employee benefits assets and reimbursement rights	10	962	1 161
Deferred tax assets	13	1 181	1 043
Total non-current assets		**95 693**	**100 120**
Total assets		**126 550**	**135 182**
...			

10.3 Profit or loss presentation

No specific guidance is provided within IAS 1, and only limited guidance is available within IAS 38, on the presentation of amortisation, impairment, and gains or losses related to intangible assets in the statement of profit or loss:

- Gains on the sale of intangible assets must not be presented within revenue. *[IAS 38.113]*.
- An entity must disclose the line item(s) of the statement of comprehensive income in which any amortisation of intangible assets is included. *[IAS 38.118(d)]*.

In the absence of detailed guidance on how to present such items in the statement of profit or loss, it will, in practice, usually be appropriate to present them in a similar way as those related to property, plant and equipment.

10.4 Additional disclosures when the revaluation model is applied

IAS 38 requires an entity, which accounts for intangible assets at revalued amounts, to disclose the following additional information: *[IAS 38.124]*

Extract from IAS 38

124 **If intangible assets are accounted for at revalued amounts, an entity shall disclose the following:**

(a) by class of intangible assets:

(i) the effective date of the revaluation;

(ii) the carrying amount of revalued intangible assets; and

(iii) the carrying amount that would have been recognised had the revalued class of intangible assets been measured after recognition using the cost model in paragraph 74; and

(b) the amount of the revaluation surplus that relates to intangible assets at the beginning and end of the period, indicating the changes during the period and any restrictions on the distribution of the balance to shareholders.

(c) [deleted]

Classes of revalued assets can be aggregated for disclosure purposes. However, an entity cannot combine classes of intangible asset measured under the revaluation model with other classes measured at cost. *[IAS 38.125]*. Where assets are carried at fair value, an entity will also have to comply with the disclosure requirements of IFRS 13, as appropriate. These requirements are discussed in Chapter 15.

10.5 Disclosure of research and development expenditure

An entity must disclose the aggregate total amount of research or development expenditure (see section 6.2 above) that is recognised in profit or loss as an expense during the period. *[IAS 38.126, IAS 38.127]*.

11 Specific issues regarding intangible assets

11.1 Rate-regulated activities

In many countries the provision of utilities (e.g., water, natural gas or electricity) to consumers is regulated by the national government. Regulations differ between countries but often regulators operate a cost-plus system under which a utility is allowed to make a fixed return on investment. A regulator may allow a utility to recoup its investment by increasing the prices over a defined period. Consequently, the future price that a utility is allowed to charge its customers may be influenced by past cost levels and investment levels.

Under a number of national GAAPs accounting practices have developed whereby an entity accounts for the effects of regulation by recognising a 'regulatory' asset or liability that reflects the increase or decrease in future prices approved by the regulator. Such 'regulatory assets' may have been classified as intangible assets under those national GAAPs.

This issue has been a matter of significant interest for entities in those countries adopting IFRS, because the recognition of these regulatory assets and liabilities is prohibited under IFRS. Just as the requirement to charge a lower price for the delivery of goods and services in the future does not meet the definition of a past obligating event, or a liability, in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (see Chapter 27), the ability to charge higher prices for goods services to be rendered in the future does not meet the definition of an intangible asset in IAS 38. In particular, the right obtained from the regulator to set higher prices is not accompanied by a legal requirement for a customer to buy those goods and services in future, meaning that the entity cannot demonstrate sufficient control over the related benefits to meet the definition of an intangible asset.

IFRS 14 *Regulatory Deferral Accounts* permits certain assets and liabilities to be recognised under very limited circumstances to ease the adoption of IFRS for rate-regulated entities. It allows rate-regulated entities to continue recognising regulatory deferral accounts in connection with their first-time adoption of IFRS, e.g., Canadian utility entities. First-time adopters do not need to make major changes in accounting policy for regulatory deferral accounts on transition to IFRS until a comprehensive IASB project is completed, but existing IFRS preparers are prohibited from adopting the standard. Entities that adopt IFRS 14 must present the regulatory deferral accounts as separate line items on the statement of financial position and present movements in these account balances as separate line items in the statement of profit or loss and other comprehensive income. The standard requires disclosures on the nature of, and risks associated with, the entity's rate regulation and the effects of that rate regulation on its financial statements. The further application of IFRS 14 is discussed in Chapter 6.

The Board is currently undertaking a standard-setting project to develop a new accounting model to provide users of financial statements with useful information about an entity's rights and obligations arising from a defined rate regulation that are not captured by existing IFRS accounting standards requirements.

On 28 January 2021, the Board issued an exposure draft (ED) *Regulatory Assets and Regulatory Liabilities*. The ED set out proposals for the recognition, measurement, presentation and disclosure of regulatory assets, regulatory liabilities, regulatory income and regulatory expense.

Under the accounting model proposed in the ED, when an entity has an enforceable right to add an amount in determining the regulated rate in future periods, because part of the total allowed compensation for goods and services already supplied will be included in revenue in the future, it must recognise this as a regulatory asset. Conversely, a regulatory liability exists when an entity has an enforceable present obligation to deduct an amount in determining the regulated rate in future periods because the revenue already recognised includes an amount that will provide part of the total allowed compensation for goods or services to be supplied in the future.

Comments on the ED were due by 30 July 2021 and since then the Board has been discussing the feedback received and redeliberating the proposals in the ED. The Board completed its deliberations in July 2024 and the new standard, which will replace IFRS 14, is expected to be published in the second half of 2025. Until a new standard is issued and becomes effective, regulatory assets and liabilities continue not to be eligible for recognition under IFRS accounting standards, unless the entity is a first-time adopter that can apply IFRS 14.

For further discussion of the IASB's rate-regulated activities project see Chapter 28 at section 2.6.4.

11.2 Emissions trading schemes

Governments around the world have introduced, or are in the process of developing, schemes to encourage corporations and individuals to reduce emissions of pollutants. These schemes comprise tradable emissions rights or allowances, an example of which is a 'cap and trade' model whereby participants are allocated emission rights or allowances equal to a cap (i.e., a maximum level of allowable emissions, usually less than the entity's current quantity) and are permitted to trade those rights/allowances.

There are variants to these arrangements, which may differ from jurisdiction to jurisdiction.

Cap and trade emission rights schemes typically have the following features:

- An entity participating in the scheme (the participant) sets a target to reduce its Greenhouse Gases emissions to a specified level (the cap). The participant is issued emission rights equal in number to its cap by a government or government agency. These rights may be issued free of charge, or participants may have to pay the government for them (see below).
- The scheme operates for defined compliance periods.
- Participants are free to buy and sell emission rights at any time.
- If, at the end of the compliance period, a participant's actual emissions exceed its emission rights, the participant will have to buy additional rights in the market, or it will incur a penalty.
- In some schemes, emission rights surpluses and deficits may be carried forward to future periods.

  And
- The scheme may provide for brokers - who are not themselves participants - to buy and sell emission rights.

The EU Emissions Trading Scheme ("EU ETS"), still by far the biggest international scheme for trading greenhouse gas emission rights, now allocates many rights by auction, not free allocation.[13]

The terms and conditions of the emissions schemes may also determine the way the rights granted to an entity may be used. This may affect the measurement of a provision for an entity's emission obligation under a so-called 'net liability' approach (see section 11.2.3 below). As noted above, under the EU ETS, entities can use the rights to settle their emissions lability or sell them in the market. Other schemes might restrict use of the rights by the entity to settling their emission liability only.

A number of attempts have been made by the IFRS IC and the IASB to formulate guidance on how these schemes might be accounted for without reaching a definitive conclusion. IFRIC 3 *Emission Rights* was issued in 2004 (see section 11.2.2 below). However, the interpretation met with significant resistance and was withdrawn in 2005, despite the IASB considering it to be an appropriate interpretation of existing IFRS.[14]

Until the IASB completes a new project on emissions trading schemes, an entity has the option either:

(a) To apply IFRIC 3, which despite having been withdrawn, is considered to be an appropriate interpretation of existing IFRS

  Or

(b) To develop its own accounting policy for cap and trade schemes based on the hierarchy of authoritative guidance in IAS 8

13 *European Commission website* (accessed on 25 September 2024).

14 *IASB Update*, June 2005, available on the IFRS Foundation's website.

In April 2016, the IASB provided an update on its Pollutant Pricing Mechanisms (formerly referred to as Emissions Trading Schemes) Project in which it noted the diversity in how Pollutant Pricing Mechanisms (which include emissions trading schemes) are accounted for and that some of the issues identified related to possible gaps and inconsistencies in IFRSs.[15] In July 2022, the IASB concluded its third agenda consultation, which set out the IASB's priorities for its work plan and activities for the period 2022 - 2026. While many respondents considered this a high priority, the Board concluded that it should be included on the reserve list and noted that additional research would be needed before considering whether to undertake a standard setting project.[16] The IASB met in June 2024 to discuss information gathered as part of horizon scanning activities to help it decide in the future whether to prioritise a project on Pollutant Pricing Mechanisms.[17] At the time of writing no further work on the project had been performed by the IASB and this was not an active research project.[18] The IFRS IC however did issue an agenda decision on negative low emission vehicle credits in July 2022. That agenda decision discussed the existence of events that create a present obligation leading to the recognition of a liability and how held resources (e.g., carbon credits or allowances) should be considered in the process of liability recognition (see section 11.2.3. below).[19] The FASB has an ongoing project in relation the accounting for environmental credits under compliance and voluntary programmes. The FASB intends to draft a proposed Accounting Standards Update for comment.[20]

11.2.1 Emissions schemes - Schemes that only include a cap on emissions

Emissions schemes that only have a cap might have the following features:

- The entity is subject to monitoring with regards to its emissions. The monitoring is mostly carried out by the responsible government authorities.
- The entity is assigned an emission limit.
- The entity is either not granted any rights by the government or government agency or it receives emissions rights corresponding to the assigned emission limit.
- Although the entity is not permitted to sell the emission rights granted to it, it can purchase additional rights from the government at a price set by the government. These purchased rights may be used to offset its emissions made.
- If the entity has emissions above the assigned limit, it is required to offset the excess by paying the government or by surrendering purchased emission rights. The amount to be transferred to the government is determined based on only the excess of actual emissions over the set limit.
- If the entity stays below the predetermined limit, there is no obligation to pay the government, nor is the entity eligible to receive any compensation; the entity is also not eligible to sell the surplus of emissions rights to a third party if it has emissions below the predetermined limit.

In such schemes, no liability is recognised until the limit is exceeded. Upon exceeding the set limit, the liability is measured at the best estimate of the cost to settle it. This is consistent with IFRIC 21 Levies.

Illustration 11-1: Emissions trading schemes - no rights received from the government and liability based on excess of emissions over a specified level

Company B has been permitted by the government to emit 10,000 tonnes of CO_2 for the year to 31 December 20X1. It has not received any emission rights from the government. The emission scheme requires the entity to pay the government in cash for any emissions above the 10,000 tonnes limit. The government has set a charge of CU12 per tonne of CO_2 emitted above this limit.

The expected emissions for the full year are 12,000 tonnes of CO_2. At the end of the third quarter, Company B has emitted 9,000 tonnes of CO_2.

While the entity has emissions during the year, until it exceeds the limit set by the government, there is no obligating event. Therefore, the liability at the end of the first, second and third quarters would be nil, because the set 10,000 tonnes limit has not yet been exceeded.

Once the entity exceeds the emissions limit of 10,000 tonnes of CO_2, the company would estimate the cost to settle its emissions liability. At year end, the total emissions above the set limit amounted to 2,000 tonnes and the company is obliged to pay CU12 per tonne emitted above the set limit. It, therefore, recognises a liability of CU24,000.

15 IASB Staff Paper 20, Project: *Pollutant Pricing Mechanisms*, Paper topic: *Project update and response to the Agenda Consultation*, IASB meeting, April 2016, available on the IFRS Foundation's website.

16 IASB, Feedback Statement, *Third Agenda Consultation*, issued 29 July 2022, pages 31-32, available on the IFRS Foundation's website.

17 *IASB Update*, June 2024, available on the IFRS Foundation's website.

18 *IFRS Foundation work plan*, available on the IFRS Foundation's website (accessed 25 September 2024).

19 *IFRIC Update*, June 2022, available on the IFRS Foundation's website.

20 *Accounting for Environmental Credit Programs project page*, available on the FASB website (accessed 25 September 2024).

Illustration 11-2: Emissions trading schemes - rights granted are non-tradeable

Company A received from the government emission rights representing the right to emit 10,000 tonnes of CO_2 for the year to 31 December 20X1. The received rights were recorded at their nominal amount (i.e., nil). The expected emissions for the full year are 12,000 tonnes of CO_2. At the end of the third quarter, Company A has emitted 9,000 tonnes of CO_2.

The terms and conditions of the emission scheme require the entity to only use the received rights to settle its emission liability. Additional rights however can be purchased from the government at a price set by the government. The price to purchase additional rights from the government at the end of each quarter is CU7/tonne.

The liability at the end of the first, second and third quarters would be nil as the emission limit of 10,000 tonnes of CO_2 has not been exceeded. Although the entity holds rights, these cannot be traded, and therefore do not represent economic resources of the entity. Until the emission limit is exceeded, there is no liability to recognise as there is not transfer of economic resources required.

In the fourth quarter, there is an obligating event upon exceeding the emission limit of 10,000 tonnes of CO_2 and a liability is recognised. It is measured at the cost of purchasing additional rights to settle the liability in relation to the excess tonnage emitted, at 2,000 tonnes × CU7/tonne = CU14,000.

In both Illustration 11-1 and Illustration 11-2 above, the company cannot anticipate the future shortfall of 2,000 tonnes before the fourth quarter by accreting the provision over the year, nor can it recognise on day one the full provision for the 2,000 tonnes expected shortfall. This is because the entity is unable to trade the rights received from the government and must use them to settle the liability. As a result, until the emission limit is exceeded there is no obligating event and, therefore, no liability should be recognised.

11.2.2 'Cap and trade' emissions trading schemes - IFRIC 3

IFRIC 3 dealt with accounting for cap and trade schemes by entities that participated in them.[21] The provisions of the interpretation were also considered to be relevant to other schemes designed to encourage reduced levels of emissions and share some of the features outlined above.[22]

IFRIC 3 took the view that a cap and trade scheme did not give rise to a net asset or liability, but that it gave rise to various items that were to be accounted for separately:[23]

(a) *An asset for rights held* - Rights, whether allocated by government or purchased, were to be regarded as intangible assets and accounted for under IAS 38. Rights issued for less than fair value were to be measured initially at their fair value.[24]

(b) *A government grant* - When rights are issued for less than fair value, the difference between the amount paid and fair value was a government grant that must be accounted for under IAS 20. Initially the grant was to be recognised as deferred income in the statement of financial position and subsequently recognised as income on a systematic basis over the compliance period for which the rights were issued, regardless of whether the rights were held or sold.[25]

(c) *A liability for the obligation to deliver rights equal to emissions that have been made* - As emissions are made, a liability was to be recognised as a provision that falls within the scope of IAS 37. The liability was to be measured at the best estimate of the expenditure required to settle the present obligation at the reporting date. This would usually be the present market price of the number of rights required to cover emissions made up to the reporting date.[26]

The interpretation also noted that the existence of an emission rights scheme could represent an indicator of impairment of the related assets, requiring an IAS 36 impairment test to be performed, because the additional costs of compliance could reduce the cash flows expected to be generated by those assets.[27]

Those who called for the withdrawal of IFRIC 3 identified a number of accounting mismatches arising from its application:[28]

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21 IFRIC 3, *Emission Rights*, 2005 Bound Volume, IASB, para. 2.

22 IFRIC 3.3.

23 IFRIC 3.5.

24 IFRIC 3.6.

25 IFRIC 3.7.

26 IFRIC 3.8.

27 IFRIC 3.9.

28 *IASB Update*, June 2005, available on the IFRS Foundation's website.

- A measurement mismatch between the assets and liabilities recognised in accordance with IFRIC 3
- A mismatch in the location in which the gains and losses on those assets are reported

  And
- A possible timing mismatch because rights would be recognised when they are obtained - typically at the start of the year - whereas the emission liability would be recognised during the year as it is incurred

In light of these accounting mismatches, it is perhaps no surprise that in practice very few companies have applied IFRIC 3 on a voluntary basis. Instead, companies have developed a range of different approaches in accounting for cap and trade emission rights schemes, which are discussed below:

- The so-called 'Net liability' approaches
- 'Government grants' approach

Whatever approach is used, companies must disclose their accounting policies regarding grants of emission rights, the emission rights themselves, the liability for the obligation to deliver rights equal to emissions that have been made and the presentation in the statement of profit or loss. *[IAS 1.117]*.

11.2.3 'Cap and trade' emissions trading schemes - Net liability approaches

Under IAS 37, a provision can only be recorded if the recognition criteria in that standard are met, including that the entity has a present obligation as a result of a past event, that it is probable that an outflow of economic resources will be required to settle the obligation, and that a reliable estimate can be made, *[IAS 37.14]*, (see Chapter 27).

The obligating event and the probability of outflow of resources will depend on the specific terms and conditions of each emission scheme. Under IAS 37 the entire obligation to deliver rights must be measured on the basis of the best estimate of the expenditure required to settle the present obligation at the end of the reporting period (see Chapter 27) taking into account the cost of any allowances currently held (both granted and purchased). Or, if lower, any regulatory penalty. *[IAS 37.36]*.

In 'cap and trade' schemes every tonne of emissions made creates an obligation. In such schemes, allowances received from the government represent economic resources of the entity (because they can be used for an alternative purpose, for example sale to a third party) and, therefore, as the entity emits it is probable there will be an outflow of economic resources (i.e., the allowances) to settle the obligation. In this situation, a liability is recognised as the entity emits.

In practice, two net liability approaches have gained acceptance:

(1) The 'net liability/carrying value' approach:

Under this approach, the allowances (or emission rights) received by way of a grant are recorded at a nominal amount (in most cases nil) and purchased rights are initially recognised at cost; the liability component is the best estimate of the cost to settle the liability taking into account the cost of any allowances currently held (both granted and purchased);

(2) The 'net liability/reimbursement rights' approach:

Under this approach, the allowances (or emission rights) received by way of a grant are also recorded initially at a nominal amount (in most cases nil) and purchased rights are also initially recognised at cost, but the entity remeasures (to fair value) the emission rights (or allowances) that it holds and can use to settle the liability up the amount of emission made in the period; the liability component is measured at the best estimate of the cost to settle the liability taking into account the cost of any allowances currently held (and remeasured to fair value).

How we see it

On initial recognition, we believe that an entity can apply the approaches as described above because in the absence of specific guidance on the accounting for emission rights, IAS 20 allows non-monetary government grants and the related asset (in this case, the emission rights) received to be measured at a nominal amount (i.e., nil).

(1) The 'net liability/carrying value' approach

Under a 'net liability/carrying value' approach, an entity measures the liability at the best estimate of the cost to settle the liability taking into account the cost of any allowances currently held. For example, if the entity holds allowances granted to it by a government and recorded at their nominal amount, then the measurement of the liability will be the nominal amount of the rights held (in most cases nil). The liability for any emissions exceeding the allowances held are measured at the current market price of the required number of emission allowances.

The emission rights received by way of a grant are recorded at a nominal amount (in most cases nil) Purchased rights are initially recognised at cost. The measurement of the emissions liability can be estimated on a FIFO (see Illustration 11-3 below) or on a weighted average basis (see Illustration 11-4 below).

In its July 2022 agenda decision on negative low emission vehicle credits,[29] the IFRS IC noted that the existence of a liability depends on an entity's past actions and not on its future actions, which will only determine the means by which the entity settles its present obligation. This liability is measured by reference to the assets and costs required to settle it, taking into account both the assets held by the entity and/or the cost to acquire any additional assets necessary to settle the liability. The IFRS IC clarified that an outflow of resources embodying economic benefits occurs when an entity surrenders existing rights as these credits could have been used by the entity for other purposes, for example sale to a third party.

FIFO basis

Using FIFO basis, an entity measures the liability taking into account the allowances held at the end of the (interim or annual) reporting period first, and then includes the expected cost per unit, using the current market price, for the actual shortfall at the end of the reporting period.

Illustration 11-3: Application of 'net liability/carrying value' approach - granted allowances are tradeable - FIFO basis

Company C received allowances representing the right to emit 10,000 tonnes of CO_2 for the year to 31 December 20X1. The received allowances were recorded at the nominal amount (i.e., nil). The expected emissions for the full year are 12,000 tonnes of CO_2. At the end of the third quarter, Company C has emitted 9,000 tonnes of CO_2. The market price of the allowances at the end of each quarter is CU10/tonne, CU12/tonne, CU14/tonne and CU16/tonne respectively. The scheme permits Company C to freely sell and buy allowances.

Scenario A - Company C does not sell any of its allowances

Under the 'net liability/carrying value' approach using a FIFO basis, the liability at the end of the first, second and third quarters would be nil. The obligating event occurred in the first quarter by emitting the first tonne of CO_2, and it was probable that there would be an outflow of resources, being the allowances received. The measurement of the liability first takes into consideration only the carrying value of allowances held. Therefore, as the carrying value of the allowances held is nil, the best estimate of outflow of resources was nil for each quarter.

In the fourth quarter, the liability is remeasured. Company C calculates the best estimate of the amount to settle the obligation first using the allowances held (10,000 tonnes × nil) and then the actual shortfall at the current market price (2,000 tonnes × CU16/tonne = CU32,000). As a result, the liability at year end is CU32,000.

Scenario B - Company C sells allowances during the third quarter

Consistent with Scenario A, under the 'net liability/carrying value' approach using a FIFO basis, the liability at the end of the first and second quarters would be nil in this scenario.

At the end of the third quarter, Company C sells allowances received representing the right to emit 2,000 tonnes of CO_2 (see section 11.2.7 for discussion on sale of emission rights) resulting in the recognition of a gain of CU28,000 (2,000 tonnes x CU14). At the end of the third quarter, Company C remeasures the liability, calculating the best estimate of the amount to settle the obligation first using the allowances held (8,000 tonnes × nil) and then the actual shortfall at the current market price (1,000 tonnes × CU14/tonne = CU14,000). As a result, the liability at the end of the third quarter is CU14,000, and Company C recognises an expense of CU14,000.

In the fourth quarter, the liability is remeasured first using the allowances held (8,000 tonnes × nil) and then the actual shortfall at the current market price (4,000 tonnes × CU16/tonne = CU64,000). As a result, the liability in at year end is CU64,000, and Company C recognises an expense of CU50,000 in the fourth quarter.

29 *IFRIC Update*, June 2022, available on the IFRS Foundation's website

Weighted average basis

Using weighted average basis, an entity measures the liability by calculating the weighted average cost per unit of expected emissions over the entire compliance period (i.e., including the estimated shortfall). Therefore, the entity would need to:

- Estimate the expected total emissions for the entire compliance period
- Compare the total expected emissions for the compliance period with the number of allowances held by the entity for that compliance period (either granted by the government or/and purchased) to determine the expected shortfall (if any) in the compliance period
- Measure the value of shortfall of allowance by reference to the market value as at the end of the (interim or annual) reporting period

  And
- Calculate the weighted average cost per unit of emissions for the compliance period by determining the sum of: (i) carrying amount of allowances held and (ii) cost of shortfall of allowances, and dividing that amount by the estimated expected total emissions for the compliance period

The liability at the end of the reporting period is then calculated by multiplying the cost per unit of emissions as determined based on the above steps with the cumulative volume of emissions at the end of that period.

Illustration 11-4: Application of 'net liability/carrying value' approach - granted allowances are tradeable - weighted average basis

Company D received allowances representing the right to emit 10,000 tonnes of CO_2 for the year to 31 December 20X1. The received allowances were recorded at nil. The expected emissions for the full year are 12,000 tonnes of CO_2.

The emissions at each of the quarter are as follows:

- First quarter - 2,500 tonnes (cumulative emissions for the compliance period - 2,500 tonnes)
- Second quarter - 3,500 tonnes (cumulative emissions for the compliance period - 6,000 tonnes)
- Third quarter - 3,000 tonnes (cumulative emissions for the compliance period - 9,000 tonnes)
- Fourth quarter - 3,000 tonnes (cumulative emissions for the compliance period - 12,000 tonnes)

The market price of the allowances at the end of each quarter is CU10/tonne, CU12/tonne, CU14/tonne and CU16/tonne respectively. The scheme permits Company D to freely sell and buy allowances.

Scenario A - Company D does not sell any of its allowances

Under the 'net liability/carrying value' approach using a weighted average basis, the liability at the end of each quarter and for the annual period would be:

- First quarter - CU4,166 ((10,000 x 0 + 2,000 x 10)/12,000 x 2,500)
- Second quarter - CU12,000 ((10,000 x 0 + 2,000 x 12)/12,000 x 6,000)
- Third quarter - CU21,000 ((10,000 x 0 + 2,000 x 14)/12,000 x 9,000)
- Fourth quarter - CU32,000 ((10,000 x 0 + 2,000 x 16)/12,000 x 12,000)

Therefore, a liability of CU32,000 would be reported in the annual financial statements.

Scenario B - Company D sells allowances during the third quarter

Consistent with Scenario A, under the 'net liability/carrying value' approach on a weighted average basis, the liability at the end of the first and second quarters would be CU4,166 and CU12,000, respectively.

At the end of the third quarter, Company D sells allowances received representing the right to emit 2,000 tonnes of CO_2 (see section 11.2.7 for discussion on sale of emission rights), resulting in the recognition of a gain of CU28,000 (2,000 tonnes x CU14). The liability for the remaining quarters would be as follows:

- Third quarter - CU42,000 ((8,000 x 0 + 4,000 x 14)/12,000 x 9,000)
- Fourth quarter - CU64,000 ((8,000 x 0 + 4,000 x 16)/12,000 x 12,000)

How we see it

The measurement of the liability should reflect the best estimate of the expenditure required to settle the obligation, taking into account the terms and conditions of the emission schemes. Or, if lower, any regulatory penalty.

Some schemes operate over a period of more than one year, such that the entity is unconditionally entitled to receive emission rights for, say, a 3-year period, and it is possible to carry over unused emission rights from one year to the next.

These circumstances would justify application of the net liability approaches for the entire period covered by the scheme, not just the reporting period for which emission rights have been transferred to the entity.

The entity can measure the liability either using a FIFO or weighted average basis as described above. Whichever basis is followed, it should be applied consistently in both annual periods and in the entity's interim reporting under IAS 34 *Interim Financial Reporting*.

(2) The 'net liability/reimbursement rights' approach

As discussed above, the measurement of purchased emission rights would generally follow the requirements of the applicable standard (IAS 2 or IAS 38) under the 'net liability/carrying value' approach. However, the entity may consider the emission rights it holds as a reimbursement right under IAS 37.53, which is recognised at an amount not exceeding the related provision (see Chapter 27).

Therefore, under this alternative 'net liability/reimbursement rights' approach, the entity would remeasure through profit or loss (to fair value) the emission rights that it holds up to the amount of emissions made in the period. Remeasuring (to fair value) all rights held, including those in excess of the emissions made, would be inconsistent with the principles of the net liability approach, and the requirement in IAS 37 for reimbursement rights not to exceed the value of the associated provision.

The liability component is measured at the best estimate of the cost to settle the liability taking into account the cost of any allowances currently held (and remeasured to fair value).

Illustration 11-5: Application of a 'net liability/reimbursement rights' approach

Company E received allowances representing the right to emit 10,000 tonnes of CO_2 for the year to 31 December 20X1. The received allowances were recorded at the nominal amount (i.e., nil). The expected emissions for the full year are 12,000 tonnes of CO_2. At the end of the third quarter, it has emitted 9,000 tonnes of CO_2. The market price of the allowances at the end of each quarter is CU10/tonne, CU12/tonne, CU14/tonne and CU16/tonne respectively. The scheme permits Company E to freely sell and buy allowances.

The emissions at each of the quarter are as follows:

- First quarter - 2,500 tonnes (cumulative emissions for the compliance period - 2,500 tonnes)
- Second quarter - 3,500 tonnes (cumulative emissions for the compliance period - 6,000 tonnes)
- Third quarter - 3,000 tonnes (cumulative emissions for the compliance period - 9,000 tonnes)
- Fourth quarter - 3,000 tonnes (cumulative emissions for the compliance period - 12,000 tonnes)

At the end of the third quarter the entity purchased emission rights corresponding to 2,000 tonnes of CO_2 at the cost of CU14/tonne and recognised the emission rights assets at CU28,000.

Under the 'net liability/carrying value' approach using a FIFO basis, the liability at the end of the first, second and third quarters would be nil. The obligating event occurred in the first quarter by emitting the first tonne of CO_2, and it was probable that there would be an outflow of resources, being the allowances received. The measurement of the liability first takes into consideration only the value of allowances held. Therefore, as the carrying value of the allowances held is nil, the best estimate of outflow of resources was nil for each quarter. In the fourth quarter, a liability is recognised. The entity measures the liability at the value of emission rights purchased, i.e.,2,000 tonnes × CU14/tonne = CU28,000.

However, applying the 'net liability/reimbursement rights' approach, the entity remeasures the emission rights it holds up to the amount of emissions made in the period and recognises the provision at the amount of estimated resource outflow taking into account the value of any allowances held.

Under the 'net liability/reimbursement rights' approach, the value of the emission rights held and provision at the end of each quarter and for the annual period would be:

	First quarter	Second Quarter	Third quarter	Fourth quarter
Reimbursement rights	2,500 tonnes x CU10/tonne = CU25,000	6,000 tonnes x CU12/tonne = CU CU72,000	9,000 tonnes x CU14/tonne = CU126,000	12,000 tonnes x CU16/tonne = CU192,000
Emissions Liability	2,500 tonnes x CU10/tonne = CU25,000	6,000 tonnes x CU12/tonne = CU CU72,000	9,000 tonnes x CU14/tonne = CU126,000	12,000 tonnes x CU16/tonne = CU192,000
Income statement impact				
Rights remeasurement	CU25,000[1]	CU47,000[1]	CU54,000[1]	CU38,000[2]
Expense - Remeasurement of emissions liability	(25,000)[3]	(47,000)[3]	(54,000)[3]	(66,000)[3]
Net expense	0	0	0	(28,000)

1 This is the difference between the balances at the end of reporting periods.

2 12,000 tonnes x CU16/tonne - 11,000 tonnes x CU14/tonne (Q3 valuation) = CU38,000

3 The expense is the quarterly difference of the value of emissions liability recognised in the statement of financial position.

At the end of the fourth quarter, the value of expense recognised in profit or loss under both approaches is the same.

In the Practical example below, MOL Hungarian Oil and Gas Plc. applies a 'net liability/carrying value' approach, i.e., emission rights granted free of charge are accounted for at their nominal value of zero and no government grant is recognised. A liability for the obligation to deliver emission rights is only recognised when the level of emissions exceed the level of rights granted. MOL Hungarian Oil and Gas Plc. measures the liability at the cost of purchased rights up to the level of purchased rights held, and then at the market price of rights ruling at the reporting date, with movements in the liability recognised in operating profit.

Practical example 11-1: MOL Hungarian Oil and Gas Plc. (2023) **Hungary**

MOL GROUP INTEGRATED ANNUAL REPORT 2023 [extract]
CONSOLIDATED FINANCIAL STATEMENTS 2023 [extract]
NOTES TO THE FINANCIAL STATEMENTS [extract]
NON-FINANCIAL ASSETS AND LIABILITIES [extract]
9. Property, plant and equipment, investment property and intangible assets [extract]
c) Intangible assets [extract]
Accounting policies [extract]

...

Free granted quotas are not recorded in the financial statements, while purchased emission quotas are initially recorded as intangible assets at cost less impairment, if any, taking into consideration the residual value. The quotas recognised are not amortised if the residual value is at least equal to carrying value.

16. Provisions [extract]

Provision for Emission quotas

The Group recognises provision for the estimated CO_2 emissions costs when actual emission exceeds the emission rights granted and still held. When actual emission exceeds the amount of emission rights granted, provision is recognised for the exceeding emission rights based on carrying amount of purchased quotas held for compliance, the purchase price of allowance concluded in forward contracts, and for any residual excess at market quotations at the reporting date. In addition, the Group recognises provision for estimated costs of Upstream emission reduction quotas (UER) intended to be used to fulfil obligations stipulated by EU Fuel Quality Directive.

11.2.4 Emissions trading schemes - Government grant approach

Another approach which has gained acceptance in practice is to recognise the emission rights granted by the government initially at their fair value and record a corresponding government grant in the statement of financial position. The government grant element is subsequently recognised as income in accordance with the requirements of IAS 20. To that extent, the approach follows that required by IFRIC 3. However, rather than measuring the liability for the obligation to deliver allowances at the present market price of those allowances, the liability is measured instead by reference to the amounts recorded when those rights were first granted.

Critics have argued that the government grant approach would not be in line with the 'best estimate' determined under IAS 37 as the amount that an entity would rationally pay to settle the obligation at the reporting date or to transfer it to a third party at that time. *[IAS 37.37]*. The counter argument to this is that the allowances held that an entity will use to settle the obligation are not revalued, therefore if the measurement of the liability reflects the market price of the allowances held then there would be a mismatch.

Repsol, S.A. initially recognises the emission rights at fair value as a government grant under IAS 20 and illustrates clearly that the measurement of the liability follows that of the related emission rights. To the extent that emissions are not covered by emission rights, the liability is recognised at the fair value of such rights at the reporting date.

Practical example 11-2: Repsol, S.A. (2022) **Spain**

Consolidated financial statements at 31 December 2022 [extract]

NOTES TO THE 2022 FINANCIAL STATEMENTS [extract]

CURRENT ASSETS AND LIABILITIES [extract]

(16) Inventories [extract]

Emission allowances are recognized as inventory and are initially recognized at acquisition cost. Those allowances free of charge received under the emissions trading system for the 2013-2020 period, are initially recognized as inventory at the market price prevailing at the beginning of the year in which they are issued, against deferred income as a grant. As the corresponding tons of CO_2 are issued, the deferred income is reclassified to profit or loss.

The Group records an expense under *"Other operating expenses"* in the income statement for the CO_2 emissions released during the year, recognizing a provision calculated based on the tons of CO_2 emitted above those emission allowances at zero cost, measured at: (i) their carrying amount in the case of the allowances that the Group has at year end; and (ii) the closing list price in the case of allowances that it does not yet have at year end.

When the emissions allowances for the tons of CO_2 emitted are delivered to the authorities, the inventories and their corresponding provision are derecognized from the balance sheet without any effect on the income statement. When CO_2 emission allowances are actively managed to take advantage of market trading opportunities, the trading allowances portfolio is classified as *"trading"* inventories.

...

The fair value on initial recognition of emission rights that are accounted as intangible assets will be based on the requirements of IFRS 13 which are discussed in Chapter 15. If there is no active market for emission rights, the selection of appropriate valuation techniques, inputs to those valuation techniques and the application of the fair value hierarchy are discussed in Chapter 15.

11.2.5 Amortisation and impairment testing of emission rights

In the case of cap and trade schemes, emission rights that are accounted for as intangible assets are unlikely to be amortised as their depreciable amount is usually nil. Their expected residual value at inception will be equal to their fair value. Thereafter, although their residual value is equal to their market value, there is no consumption of economic benefit while the emission right is held. The economic benefits are realised instead by surrendering the rights to settle obligations under the scheme for emissions made, or by selling rights to another party. It is necessary to perform an IAS 36 impairment test whenever there is an indication of impairment (see Chapter 21). If the market value of an emission right drops below its carrying amount, this does not automatically result in an impairment charge because emission rights are likely to be tested for impairment as part of a larger cash generating unit.

11.2.6 Emission rights acquired in a business combination

At the date of acquisition of a business, an acquirer is required to recognise the acquiree's identifiable intangible assets, which would include any emission rights, at their fair values. *[IFRS 3.18]*.

However, an acquirer must only recognise a provision for actual emissions that have occurred up to that date. This means that an acquirer can apply the 'net liability' approach (see section 11.2.3 above) to emission rights acquired in a business combination. However, an acquirer must treat acquired emission rights in the same way as purchased emission rights and initially recognise them at their fair value. An acquirer that applies IFRIC 3 or the 'government grant' approach would recognise acquired emission rights at their fair value, but cannot recognise a deferred credit for a 'government grant' as it acquired the emission rights by way of a business combination.

Consequently, an acquirer may report a higher emission expense in its statement of profit or loss in the compliance period in which it acquires a business.

11.2.7 Sale of emission rights

The sale of emission rights that are accounted for as intangible assets must be recognised in accordance with IAS 38. This means that they must be derecognised on disposal or when no future economic benefits are expected from their use or disposal. *[IAS 38.112]*. The gain or loss arising from derecognition of the emission rights must be determined as the difference between the net disposal proceeds and the carrying amount of emission rights. *[IAS 38.113]*.

Prior to the sale the entity may not have recognised the obligation, to deliver emission rights equal to the emissions caused, at its fair value at the date of derecognition. If that were the case, then the entity would need to ensure that the liability in excess of the emission rights held by the company after the sale is recognised at the present fair value of the emission rights.

Both the gain or loss on the derecognition of the emission rights and the adjustment of the liability must be recognised when the emission rights are derecognised. Any gain must not be classified as revenue. *[IAS 38.113]*.

If an entity that applies the 'net liability' approach were to sell all its emission rights at the start of the compliance period, it would not be permitted to defer the gain on that sale even if it was certain that the entity would need to repurchase emission rights later in the year to cover actual emissions. A gain is recognised immediately on the sale and a provision is recognised as gases are emitted.

If an entity enters into a forward contract to sell an emission right, it may be acting effectively as a broker-trader. The entity must determine whether the contract is a derivative within the scope of IFRS 9 by applying the requirements in that standard (see Chapter 42).

11.2.8 Accounting for emission rights by brokers and traders

IFRIC 3 did not address accounting by brokers and traders that are not themselves participants in a cap and trade scheme. However, they hold emission rights as assets held for sale in the ordinary course of business, which means that they meet the definition of inventories in IAS 2. *[IAS 2.6]*. Under that standard a broker-trader may choose between measuring emission rights at the lower of cost and net realisable value or at fair value less costs to sell. Commodity broker-traders who measure their inventories at fair value less costs to sell recognise changes in fair value less costs to sell in profit or loss in the period of the change. *[IAS 2.3]*.

When an entity trades derivatives based on the emission rights, they fall within the scope of IFRS 9 and are accounted for at fair value through profit or loss unless they hedge the fair value of the emission rights granted to the entity or qualify for the 'own use exemption'. *[IFRS 9.2.4]*.

When an entity holds emission rights for own use and also has a trading department trading in emission rights, the entity must split the books between emission rights held for own use and those held for trading. An entity can elect, as its accounting policy, to classify the emission rights held for own use as either intangible assets or inventory (if they are held for sale in the ordinary course of business or to settle an emissions liability in the ordinary course of business). The emission rights held for trading must be classified as inventory. This is illustrated in Practical example 11-2 (see section 11.2.4 above).

Income from the sale of emission rights that are accounted for as inventories must be recognised as revenue in accordance with IFRS 15.

11.3 Accounting for green certificates or renewable energy certificates - government schemes

Some governments have launched schemes to promote power production from renewable sources, based on green certificates, renewable energy certificates, green tags or tradable renewable certificates. There are similarities between green certificates and emission rights, except that whilst emission rights are granted to reflect a future limit on emissions, green certificates are awarded on the basis of the amount of green energy already produced.

In a typical scheme, producers of electricity are granted certificates by the government based on the power output (kWh) derived from renewable sources. The producer may use these certificates in the current and future compliance periods, as defined by the particular scheme. Entities distributing electricity (produced from both renewable and traditional sources) are required to hand over to the government a number of certificates based on the total kWh of electricity sold to consumers during the year, or pay a penalty to the extent that an insufficient number of certificates is rendered. It is this requirement that creates a valuable market for the certificates, allowing producers to sell their certificates to distributors, using the income to subsidise in effect the higher cost of generation from renewable sources. The value of the green certificates depends on many variables but primarily on the required number of certificates that have to be delivered relative to the amount of power that is produced from renewable sources, and the level of penalty payable if the required number of certificates are not remitted.

11.3.1 Accounting by producers using renewable energy sources

As in the case of emission rights, the award of green certificates is treated as a government grant by a producer. The producer may elect, as its accounting policy, to recognise either an intangible asset or inventory (if the green certificates are held for sale in the ordinary course of business or to settle an emissions liability in the ordinary course of business) representing an entitlement to that grant the point in time when the green electricity is produced. As with any government grant, the entitlement is initially measured at either fair value or a nominal amount, depending on the entity's chosen policy. *[IAS 20.23]*.

Where the entitlement asset is initially recognised at fair value, a credit entry is recorded in the statement of profit or loss as either a reduction in production costs for the period (on the basis that the purpose of the grant is to compensate the producer for the higher cost of using renewable energy sources) or as other income, but not as revenue. *[IAS 20.29]*. Subsequent revaluation of the intangible asset is only allowed if an active market exists for the green certificates, and the other requirements of IAS 38 are applied (see section 8.2 above). The intangible asset (or inventory) is derecognised when the certificate is sold by the producer.

11.3.2 Accounting by distributors of renewable energy

When the distributor is also a producer of renewable energy, it has the option to use certificates granted to it or to sell them in the market. Accordingly, the permissible accounting treatments of green certificates are in principle the same as those for emission rights discussed in section 11.2 above. The distributor is obliged to remit certificates and therefore recognises a provision as sales are recorded (in the same way that a provision for emission rights is recognised as emissions are made). The distributor might apply a 'net liability' approach, discussed in section 11.2.3 above, and only start to recognise a provision once it has achieved a level of sales exceeding that covered by certificates granted to the entity in its capacity as a producer.

If a distributor is not also a producer of renewable energy, it recognises a provision as sales are made, measured at the fair value of green certificates to be remitted. A corresponding cost is included in cost of sales. The provision is remeasured to fair value at each reporting date. If the entity purchases certificates in the market, the distributor can elect, as its accounting policy, to recognise them as either an intangible asset or inventory (if the green certificates are held for sale in the ordinary course of business or to settle an emissions liability in the ordinary course of business), initially measured at cost. Subsequent revaluation is only allowed if they are classified as an intangible asset and an active market exists for the green certificates, and the other requirements of IAS 38 are applied (see section 8.2 above). IAS 36 is applied to determine when an entity must recognise an impairment in relation to the green certificates held.

Alternatively, as discussed in Illustration 11-5 in section 11.2.3 above, the asset held may be designated by management as a reimbursement right in respect of the associated liability, allowing remeasurement to fair value. Similarly, the entity could apply a carrying value method, measuring the provision based on the value and extent of certificates already held and applying fair value only to the extent that it has an obligation to make further purchases in the market or to incur a penalty if it fails to do so.

11.3.3 Accounting by brokers and traders

As discussed in section 11.2.8 above, brokers and traders must apply IAS 2 where green certificates are held for sale in the ordinary course of business; account for derivatives based on green certificates in accordance with IFRS 9; and properly distinguish those held for own use (which an entity can elect, as its accounting policy, to classify as either intangible assets, or inventory if they are held for sale or to settle an emissions liability in the ordinary course of business) from certificates held for trading (included in inventory).

11.4 Accounting considerations for voluntary carbon credits

Carbon markets are broadly split into two types of markets: compliance markets and voluntary markets. Hybrid markets are also possible and can include governments strongly encouraging the use of voluntary markets, or governments accepting voluntary carbon credits in lieu of cash payments to settle emissions obligations.

Voluntary markets function outside the compliance markets. Carbon credits are verified by independent verifiers (e.g., Gold Standard, Verra), each with their own models and verification requirements, and credits in these markets are not intended to be used for compliance purposes. Entities are not required by law or regulation to use these markets, but do so voluntarily, for example, to be able to state to their clients that they are carbon neutral.

Projects that generate carbon credits are generally categorised into those that reduce emissions (e.g., generation of energy from renewable sources) and those that remove emissions (e.g., regenerative farming projects, carbon capture and storage).

Currently, there are no explicit requirements that address the accounting for voluntary carbon credits. The IASB has a project in its pipeline for pollutant pricing mechanisms in which it would aim to develop specific requirements for such mechanisms. At the time of writing, this was not an active research project and was on the IASB's reserve list of projects. Projects on the reserve list will only be added to the work plan if additional capacity becomes available before the IASB's next five-yearly agenda consultation.[30]

While there are no explicit requirements, several standards provide relevant guidance that entities need to consider. Appropriately accounting for voluntary carbon credits depends on the specific features (e.g., whether the credits can be traded.) and the role the entity plays in those markets (e.g., project developer, broker/dealer, emitter).

As with mandatory carbon credits, voluntary carbon credits might be inventory or intangible assets for the entity, depending on whether the credits are held for sale in the ordinary course of business, or the entity intends to use the credit itself.

How an entity obtains the credit will be important in determining when to recognise an asset and at what value.

The accounting considerations for voluntary carbon credits are discussed in further detail in our publication *Applying IFRS Connected Financial Reporting: Accounting for Climate Change*.[31]

11.5 Accounting for REACH costs

The European Regulation[32] concerning the Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH) requires manufacturers or importers of substances to register them with a central European Chemicals Agency (ECHA).[33] An entity will not be able to manufacture or supply unregistered substances. As a consequence, entities will incur different types of costs, such as:

- Costs of identifying the substances that need to be registered
- Testing and other data collection costs, including outsourcing services from external laboratories, costs of tests in own laboratories - testing materials, labour costs and related overheads
- Registration fees payable to ECHA

  And
- Legal fees

30 IFRS Foundation website, *IASB pipeline projects* (accessed 25 September 2024).

31 Available on ey.com/IFRS, accessed 26 September 2024.

32 Regulation (EC) No. 1907/2006 of the European Parliament and of the Council of 18 December 2006 concerning the Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH), establishing a European Chemicals Agency, amending Directive 1999/45/EC and repealing Council Regulation (EEC) No. 793/93 and Commission Regulation (EC) No. 1488/94 as well as Council Directive 76/769/EEC and Commission Directives 91/155/EEC, 93/67/EEC, 93/105/EC and 2000/21/EC.

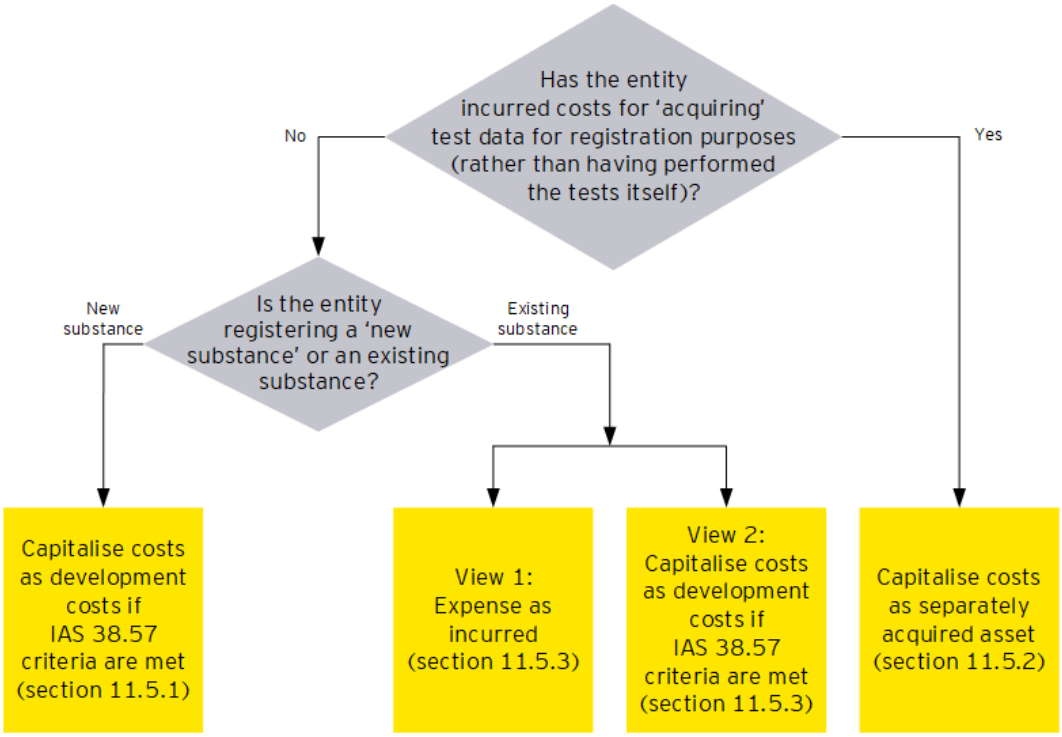
33 The key principles of the EU REACH Regulation were retained in UK REACH following the UK's withdrawal from the EU, however both regulations operate independently from each other.

These costs may be part of the development of a new manufacturing process or product, or in the use of a new chemical in an existing manufacturing process or product. They might be incurred solely by an entity or shared with other entities (clients, partners or even competitors). Under the REACH legislation, cost sharing might be achieved by the submission of a joint registration (whereby testing and other data collection costs are shared before the registration is filed) or by reimbursement (whereby an entity pays an existing registrant for access to the registration and testing data used in its earlier application for registration). Accordingly, questions arise as to whether such costs must be capitalised or recognised as an expense and, if capitalised, on what basis the related intangible asset must be amortised.

How we see it

In our view, a registration under the REACH regulation is an intangible asset as defined by IAS 38. As it gives rise to a legal right, the registration is identifiable. Because a registration cannot be arbitrarily withdrawn and also establishes intellectual property rights over the data used in the application for registration, a resource is controlled. The future economic benefits relating to the registration arise from either the right to reimbursement for the use by others of data supporting the entity's earlier application; or from the revenues to be earned and cost savings to be achieved by the entity from the use of registered substances in its business activities.

The appropriate accounting treatment under IAS 38 depends upon whether the required data is collected by the entity or acquired from an existing registrant and on whether the registration being completed is for a substance already used in an existing process or product (an existing substance) or intended to be used for the first time or in a new process or product (a new substance). The flow chart below demonstrates how these different features interact with the requirements of IAS 38.



11.5.1 Costs of registering a new substance performed by the entity itself

If the entity itself incurs REACH costs, these activities meet the definition of development in IAS 38. *[IAS 38.8]*. Accordingly, the entity must also meet the rigorous rules in the standard described in section 6.2.2 above which confirm that the related development project is at a sufficiently advanced stage, is economically viable and includes only directly attributable costs. *[IAS 38.57]*.

Costs of identifying the substances that need to be registered would have to be recognised as an expense when incurred, as this activity is regarded as research. *[IAS 38.56]*.

11.5.2 Costs of acquiring test data from an existing registrant

An entity may acquire test data from an existing registrant that has already been used by it in its earlier application for registration. These costs must be capitalised as a separately acquired intangible asset (see section 4 above).

11.5.3 Costs of registering an existing substance performed by the entity itself

How we see it

Two alternative treatments are acceptable. If the costs of obtaining a REACH registration for existing substances used in existing processes are regarded as subsequent expenditure on an existing intangible asset, the related costs must be recognised as an expense as incurred, (see section 3.3 above). As unregistered substances will no longer be available for use, this might indicate that the registration maintains the economic benefits associated with the related production process or product and does not improve it.

Alternatively, it could be argued that the cost of registering existing substances must be regarded as no different to the cost of registering a new product. Accordingly, for the reasons noted in section 11.5.1 above, such costs must be capitalised as an internally generated intangible asset.

11.6 Crypto-assets

At the time of writing, many different crypto-coins and tokens were traded or listed on various crypto exchanges. The terms and application of these crypto-assets vary widely and could change over time. It is important to re-evaluate the accounting as terms and conditions change.

Some crypto-assets entitle the holder to an underlying good or service from an identifiable counterparty. For example, some crypto-assets entitle the holder to a fixed weight of gold from a custodian bank. In those cases, the holder is able to obtain economic benefits by redeeming the crypto-asset for the underlying. While not money as such, these crypto-assets share many characteristics with representative money.

Other crypto-assets (e.g., Bitcoin) do not entitle the holder to an underlying good or service and have no identifiable counterparty. The holder of such a crypto-asset has to find a willing buyer that will accept the crypto-asset in exchange for cash, goods or services in order to realise the economic benefits from the crypto-asset.

How we see it

Crypto-assets have diverse terms and conditions. The purpose for holding crypto-assets also differs among the entities, and even among business models within the same entities, that hold them. Hence, the accounting treatment will depend on the particular facts and circumstances and the relevant analysis could be complex.

Many crypto-assets would meet the relatively wide definition of an intangible asset. However, not all crypto-assets that meet the definition of an intangible asset are within the scope of IAS 38, as the standard is clear that it does not apply to items that are in the scope of another standard. For example, some entities could hold crypto-assets for sale in the ordinary course of business and, as such, would be able to recognise these as inventory. Commodity broker-traders, who acquire and sell crypto-assets principally to generate profit from fluctuations in price or broker-traders' margin, and recognise these crypto-assets as inventory, also have the option of measuring them at fair value less costs to sell.

In addition to sections 11.6.1 to 11.6.3 below, refer to our publication *Applying IFRS: Accounting by holders of crypto assets* for further guidance on accounting for crypto-assets.

This section deals with crypto-assets that meet the definition of intangible assets and have been classified as such. For crypto-assets that are classified as inventories refer to Chapter 23 at section 2.3.1.F.

11.6.1 Crypto-assets - Recognition and initial measurement

Crypto-assets that meet the definition of an intangible asset and are being accounted for under IAS 38 are only recognised if it is probable that future economic benefits will flow to the entity and its cost can be measured reliably (see section 3.1 above). Separately acquired intangible assets will normally be recognised, as IAS 38 assumes that the acquisition price reflects the expectation about future economic benefits. Thus, an entity always expects future economic benefits, for these intangibles, even if there is uncertainty about the timing or amount (see section 4.1 above).

Crypto-assets that meet the definition of an intangible asset and are being accounted for under IAS 38 are initially measured at cost (see section 3.2 above).

The cost of acquiring crypto-assets would typically include the purchase price (after deducting trade discounts and rebates if any) and the related transaction costs, which could include blockchain processing fees. Where an intangible asset is acquired in exchange for another non-monetary asset, the cost is measured at fair value, unless the transaction lacks commercial substance or the fair value of neither the asset acquired nor the asset given up can be measured reliably. In such instances, the cost of the intangible asset is measured as the carrying amount of the asset given up.

11.6.2 Crypto-assets - Subsequent measurement

As discussed in section 8 above, there are two subsequent measurement approaches under IAS 38 that can be applied as an accounting policy choice to each class of intangible asset, namely:

- Cost model
- Revaluation model (subject to criteria as discussed below)

An entity that holds different types of crypto-assets would need to assess whether they constitute different classes of intangible assets as the rights and underlying economics of different crypto-assets vary widely.

11.6.2.A Crypto-assets - Cost model

The cost model under IAS 38 entails subsequent measurement at cost less any amortisation and impairment (see section 8.1 above).

Many crypto-assets such as Bitcoin do not have an expiry date, and there appears to be no foreseeable limit to the period over which they could be exchanged with a willing counterparty for cash or other goods or services.

A holder will therefore need to consider if there is a foreseeable limit to the period over which such a crypto-asset is expected to generate net cash inflows for the entity. If there is no foreseeable limit, such a crypto-asset could be considered to have an indefinite useful life and, as a result, no amortisation is required. However, intangible assets with an indefinite useful life need to be tested for impairment at least annually and whenever there is an indication of impairment (see section 9.3 above).

Where there is a foreseeable limit to the period over which a crypto-asset is expected to generate net cash inflows for the holder, a useful life must be estimated and the cost of the crypto-asset, less any residual value, must be amortised on a systematic basis over this useful life (see section 9.2 above). In addition, such a crypto-asset is also subject to IAS 36 impairment testing whenever there is an indication of impairment.

11.6.2.B Crypto-assets - Revaluation model

An entity can only apply the revaluation model if the fair value can be determined by reference to an active market (see section 8.2 above), which IFRS 13 defines as "a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis".

There are no provisions in IAS 38 that allow for the fair value of an intangible asset to be determined indirectly, for example by using valuation techniques and financial models with less observable inputs such as those applied to estimate the fair value of intangible assets acquired in a business combination. Consequently, if no observable price in an active market for an identical asset exists (i.e., a Level 1 price under IFRS 13), the holder will need to apply the cost method to crypto-assets held.

How we see it

Entities need to consider the guidance in IFRS 13 (see Chapter 15) to determine whether the market is active for their crypto-assets. Many trades on crypto-exchanges are non-cash transactions in which one crypto-asset is exchanged for another and the holder may find it difficult to convert the crypto-asset into cash.

Under the revaluation model, intangible assets are measured at their fair value on the date of revaluation less any subsequent amortisation and impairment losses.

The net increase in fair value over the initial cost of the intangible asset is recorded in the revaluation reserve via other comprehensive income. A net decrease below cost is recorded in profit or loss. The cumulative revaluation reserve may be transferred directly to retained earnings upon derecognition, and possibly by transferring the additional amortisation on the revalued amount to retained earnings as the asset is used, but IAS 38 does not allow the revaluation reserve to be transferred via profit or loss.

11.6.3 Crypto-assets - Standard setter activity

Accounting standard setters are monitoring the development of crypto-assets and the related accounting practices by holders. Some standard setters have undertaken research into the accounting for crypto-assets, while some have expressed a view on what they consider to be appropriate accounting under IFRS accounting standards. For example, in Japan the standard setter has issued guidance for the accounting of virtual currencies under local GAAP.

In November 2018, the IASB decided not to add to its work plan a project on holdings of cryptocurrencies or initial coin offerings, but instead would monitor the development of crypto-assets. The IASB asked the IFRS IC to consider publishing an agenda decision on how entities apply existing IFRS accounting standards to holdings of cryptocurrencies, a subset of crypto assets.[34]

In June 2019, the IFRS IC published an agenda decision on this matter. The IFRS IC observed that a holding of cryptocurrency meets the definition of an intangible asset under IAS 38 because it is capable of being separated from the holder and sold or transferred individually, and does not give the holder a right to receive a fixed or determinable number of units of currency. The IFRS IC concluded that where cryptocurrencies are held for sale in the ordinary course of business, then IAS 2 applies, otherwise they must be accounted for under IAS 38.

The IFRS IC determined that cryptocurrencies are not financial assets as they are not cash or equity instruments of another entity. They also do not give rise to a contractual right for the holder, and they are not a contract that will or may be settled in the holder's own equity instruments.[35]

In March 2023, the accounting standard setter in the United States of America, the FASB, issued an exposure draft that proposed requiring entities to measure certain crypto assets at fair value each reporting period and reflect the changes in fair value in net income. Entities would have to present crypto assets measured at fair value separately from other intangible assets on the balance sheet and changes in fair value of crypto assets separately from changes in the carrying amounts of other intangible assets in the income statement. They would also be required to provide interim and annual disclosures about the type of crypto assets they hold and changes in their holdings of crypto assets. However, it is important to note that IFRS reporters cannot analogise to future FASB accounting standards when determining an appropriate accounting treatment under IFRS accounting standards.

11.7 Cloud computing

The guidance set out in sections 11.7.1 to 11.7.5.B below summarises the detailed guidance on accounting for cloud based arrangements and the associated costs that can be found in our publication, *Applying IFRS: Accounting for cloud computing costs*.

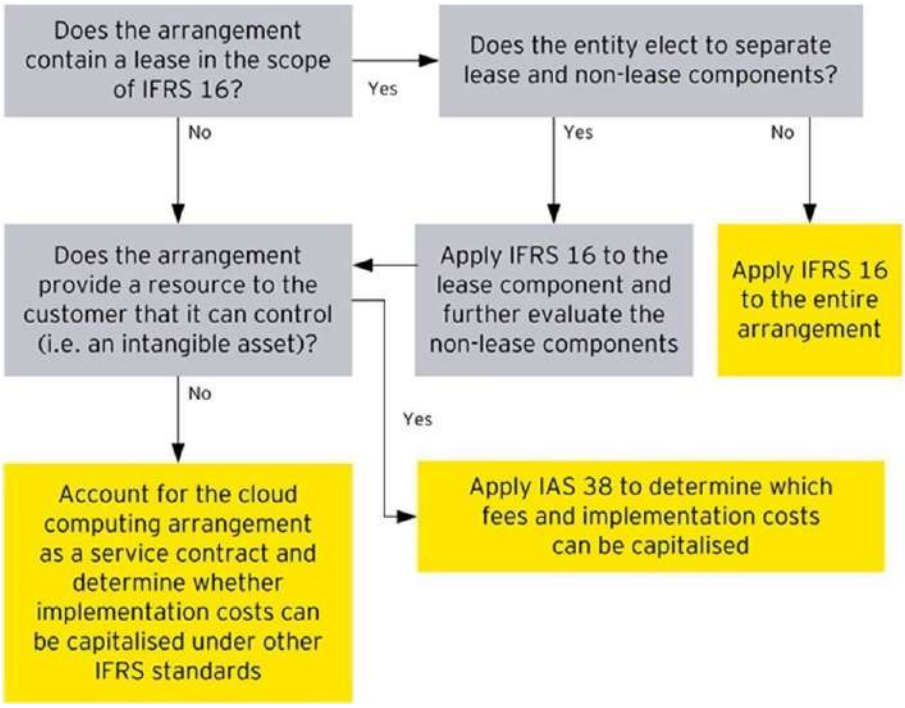
11.7.1 Types of cloud computing arrangement and determination of applicable IFRS accounting standards

As the use of technology, data and connectivity expands, cloud computing arrangements are becoming more common. Cloud computing arrangements are arrangements in which the customer does not currently have possession of the underlying software used in the arrangement. Rather, the customer accesses and uses the software on an as-needed basis (e.g., through the internet, or via a dedicated line). Examples of cloud computing arrangements include software as a service, platform as a service, infrastructure as a service and other hosting arrangements. IFRS accounting standards do not contain explicit guidance on a customer's accounting for cloud computing arrangements or the costs to implement them. A customer in a cloud computing arrangement will need to carefully evaluate which IFRS accounting standards to apply when accounting for the costs of a cloud computing arrangement, and may need to apply various

34 *IASB Update*, November 2018, available on the IFRS Foundation's website.

35 *IFRIC Update*, June 2019, available on the IFRS Foundation's website.

IFRS accounting standards, including IAS 16, IAS 38, IFRS 15, and IFRS 16. The following diagram summarises the accounting for cloud computing arrangements.



The IFRS IC received a submission about the customer's accounting for a 'Software as a service' cloud computing arrangement, which was discussed at IFRS IC meetings in September 2018, November 2018, and March 2019. In the IASB staff's analysis of the submission, it noted that an entity should first evaluate whether the rights granted in the cloud computing arrangement are within the scope of IAS 38 or IFRS 16. Otherwise, the arrangement is generally a service contract.[36]

11.7.2 Evaluating whether a cloud computing arrangement contains a lease

IFRS 16 defines a lease as "a contract, or part of a contract, that conveys the right to use an asset (the **underlying asset**) for a period of time in exchange for consideration". *[IFRS 16 Appendix A]*. A contract conveys the right to use an asset if, throughout the period of use, the customer has both:

(a) The right to obtain substantially all the economic benefits from use of the asset (an identified asset) And

(b) The right to direct the use of that asset *[IFRS 16.9, IFRS 16.B9]*

Paragraphs B9 to B31 of IFRS 16 provide application guidance on the definition of a lease. Among other requirements, that application guidance specifies that a customer generally has the right to direct the use of an asset by having decision-making rights to change how and for what purpose the asset is used throughout the period of use. Accordingly, in a contract that contains a lease the supplier has given up those decision-making rights and transferred them to the customer at the lease commencement date.

Therefore, an entity should evaluate whether a cloud computing arrangement includes the right to use an asset (e.g., underlying servers or other tangible assets) for which it has the right to obtain substantially all the economic benefits from use of the asset and the right to direct the use of that asset. There are differing views about whether a licence of software is excluded from the scope of IFRS 16 based on interpretations of IFRS 16.3(e). If an entity determines a licence of software is not excluded from the scope of IFRS 16, IFRS 16.4 permits, but does not require, an entity to account for the licence of software as a lease.

If the cloud computing arrangement contains a lease of an asset other than a licence of software (or the entity has determined a licence of software is not excluded from the scope of IFRS 16 and has elected to account for leases of intangible assets under IFRS 16), an entity should apply the provisions of IFRS 16 to the cloud computing arrangement (see Chapter 24). This includes identifying and separating lease and non-lease components and allocating contract consideration.

36 IASB Staff Paper 5, Project: *Cloud computing arrangements*, Paper topic: *Initial consideration*, IFRS IC meeting, September 2018; and *IFRIC Update*, September 2018, available on the IFRS Foundation's website.

An entity that elects to separate non-lease components will then need to evaluate whether the non-lease components provide a resource to the customer that it can control (i.e., an intangible asset). See section 11.7.3 below.

In evaluating whether the right to use underlying software in a cloud computing arrangement is a lease, the IFRIC agenda decision issued in March 2019 stated, "The Committee observed that a right to receive future access to the supplier's software running on the supplier's cloud infrastructure does not in itself give the customer any decision-making rights about how and for what purpose the software is used - the supplier would have those rights by, for example, deciding how and when to update or reconfigure the software, or deciding on which hardware (or infrastructure) the software will run. Accordingly, if a contract conveys to the customer only the right to receive access to the supplier's application software over the contract term, the contract does not contain a software lease."[37]

11.7.3 Evaluating whether a cloud computing arrangement contains an intangible asset

IAS 38 defines an intangible asset as "an identifiable non-monetary asset without physical substance". *[IAS 38.8]*. An asset is a resource controlled by the entity, and an entity controls an intangible asset if it has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. *[IAS 38.13]*.

Therefore, an entity should evaluate whether a cloud computing arrangement provides the customer a resource that it can control (i.e., if the customer has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits). If the customer receives a resource that it can control, then it should apply the guidance in IAS 38 to that resource (assuming it is not accounting for the intangible asset as a lease - see section 11.7.2 above).

IFRS accounting standards do not provide specific guidance on whether a cloud computing arrangement provides the customer a resource that it can control (i.e., an intangible asset). One situation in which an intangible asset for a software licence exists in a cloud computing arrangement (and is therefore substantive) is when both of the following are met at the inception of the arrangement:

- The customer has the contractual right to take possession of the software during the hosting period without significant penalty

  And

- It is feasible for the customer to run the software on its own hardware or contract with another party unrelated to the supplier to host the software

These facts indicate that the customer controls the underlying licence even if it is hosted by the supplier. There may be other possible situations in which a customer concludes that a cloud computing arrangement provides the customer with a resource that it can control. However, the fact that an arrangement conveys to the customer a licence of software hosted by the supplier is not, in and of itself, a sufficient basis to conclude that the arrangement contains an intangible asset. The licence must be substantive.

The evaluation of the facts listed above is performed at the inception of the arrangement (or upon a modification of the arrangement) because the evaluation of whether an arrangement includes an intangible asset should be based on the facts and circumstances when the arrangement is entered into.

In evaluating whether the customer has the right to take possession of the software during the hosting period without a significant penalty, and the right is therefore substantive, an entity may consider whether it has both of the following:

- The ability to take delivery of the software without incurring significant costs

  And

- The ability to use the software separately without a significant diminution in utility or value

37 *IFRIC Update*, March 2019, available on the IFRS Foundation's website.

This evaluation is reflected in Tesco PLC's accounting policy for cloud software arrangements:

Practical example 11-3: Tesco PLC (2024) **United Kingdom**

TESCO PLC Annual Report and Financial Statements 2024 [extract]
Financial statements [extract]
Notes to the Group financial statements [extract]
Note 1 Accounting policies, judgements and estimates [extract]

Cloud software licence agreements
Licence agreements to use cloud software are treated as service contracts and expensed in the Group income statement, unless the Group has both a contractual right to take possession of the software at any time without significant penalty, and the ability to run the software independently of the host vendor. In such cases the licence agreement is capitalised as software within intangible assets.

Costs to configure or customise a cloud software licence are expensed alongside the related service contract in the Group income statement, unless they create a separately identifiable resource controlled by the Group, in which case they are capitalised.

...

To support the view that a customer has the ability to take delivery of software included in a cloud computing arrangement without incurring significant costs, an entity may consider the following factors:

- Whether financial penalties or operational barriers act as a significant disincentive to the customer taking possession of the software. An example of such a barrier is a contractual requirement that significant fees or penalties must be paid to the supplier in connection with taking possession of the software. Another form of penalty may be a requirement to pay or forfeit a significant amount of 'unused' hosting fees on cancellation of the cloud computing contract. Accordingly, a cloud computing arrangement should be evaluated carefully to determine if the amount of fees that the customer must either 1) pay on cancellation, or 2) forfeit if fees are prepaid represents a 'significant cost'.
- The evaluation of whether a penalty is significant should be based on whether the amount of the penalty creates a sufficiently large disincentive such that the customer would not incur the penalty to take possession of the software. In evaluating whether any fees or penalties are significant, an entity may evaluate the amount of the fees or penalties in the context of the overall arrangement economics.
- Whether there is an explicit, reasonable mechanism in the contractual arrangement by which the customer can exercise a right to take possession of the software.
- Whether other economic barriers or costs exist that act as a significant disincentive to the customer taking possession of the software. For example, new hardware may be required to run the software, but the cost of obtaining that hardware is so high that a significant disincentive exists. Furthermore, if specialised technicians are needed to run the software, the cost to hire the technicians also may be a significant disincentive.

  And

- Whether there is an absence of an adequate number of qualified replacement service providers. A lack of service providers that could host the licenced software due to: (i) unique features, functionality or operating system requirements of the software; (ii) the need to hire specialised technicians to run the software at a significant cost; or (iii) other factors that may be significant disincentives.

To support the view that a customer has the ability to use the software separately without a significant diminution in utility or value, an entity may consider the following factors:

- Whether the customer can utilise all of the functionality of the software if the software is not hosted by the supplier. For example, if the software would not be able to process substantially the same number of transactions in approximately the same period if not hosted by the supplier, this may indicate that the customer cannot use the software separately from the supplier's hosting services without a significant diminution in utility or value.

  And

- Whether software upgrades are only available to customers for whom the supplier hosts the software. If the functionality provided by upgrades to the software is important to customers, and such upgrades would not be made available if the software is not hosted by the supplier, the utility of the software to a customer is likely significantly diminished if the supplier's hosting services are discontinued.

If the cloud computing arrangement does not provide the customer with an intangible asset for the software (and does not contain a lease), then the right to access the underlying software in the cloud computing arrangement is generally a service contract. However, when an arrangement conveys to the customer only a right to access and the customer pays the supplier before it receives the service, that prepayment gives the customer a right to future service and would be recognised as a prepaid asset by the customer.

11.7.4 Accounting for a cloud computing arrangement that includes an intangible asset

11.7.4.A Fees in the arrangement

Under IAS 38, an item that meets the definition of an intangible asset should only be recognised if, at the time of initial recognition of the expenditure it meets the following criteria: *[IAS 38.21]*

Extract from IAS 38

21 **An intangible asset shall be recognised if, and only if:**

(a) it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and

(b) the cost of the asset can be measured reliably.

This test (that the item meets both the definition of an intangible asset and the criteria for recognition) is performed when an entity incurs potentially eligible expenditures, whether to acquire or internally generate an intangible asset or to add to, replace part of, or service it subsequent to initial recognition.

Separately acquired intangible rights (i.e., software licences in cloud computing arrangements) will normally be recognised as assets. IAS 38 assumes that the price paid to acquire an intangible asset usually reflects expectations about the probability that the future economic benefits embodied in it will flow to the entity. That is, the entity always expects there to be a flow of economic benefits, even if it is uncertain about the timing or amount. Therefore, the standard assumes that the cost of a separately acquired intangible asset can usually be measured reliably, especially where the purchase consideration is in the form of cash or other monetary assets.

In some cases, entities enter into a cloud computing arrangement that requires them to pay the cloud computing supplier or other third party to provide implementation activities and other services such as training employees to use the software, maintenance work to be performed by the third party, rights to future upgrades and enhancements, data conversion, and hardware.

An entity should allocate the fee in a cloud computing arrangement to these implementation activities and other services. One way an entity could allocate the fees in a cloud computing arrangement to each element in the contract (e.g., software licence, hosting, implementation activities) is based on the relative standalone price or relative fair value of each element in the contract. The statement of work for the implementation activities can often be complicated, so an entity will need to apply judgement to determine the components of implementation costs to which the purchase consideration should be allocated, which will determine the amounts that should be capitalised and the amounts that should be expensed as incurred.

Elements that meet both the definition of an intangible asset and the criteria for recognition should be accounted for in accordance with IAS 38. Elements outside the scope of IAS 38 (e.g., hosting) should be accounted for based on other IFRS accounting standards. In addition, IAS 38 specifically states that certain expenditures should be expensed as incurred (i.e., training costs, start-up costs), see section 7 above.

The asset recognised for the software licence should be the present value of the licence obligation if the cloud computing arrangement is to be paid for over time. An entity should record a liability to the extent that all or a portion of the amount allocated to the software licence is not paid on or before the recognition of the licence.

11.7.4.B Implementation costs

Customers often incur implementation costs to get a cloud computing arrangement ready for use. Implementation costs can include the following:

- Research costs (e.g., needs assessment and software evaluation)
- Hardware costs
- Costs to configure or customise the underlying software
- Changes to other entity systems
- Training costs
- Data conversion

  And
- Testing

Costs incurred by customers to implement a cloud computing arrangement that includes a software licence are accounted for based on the nature of the costs. The guidance in IAS 38 should be applied by customers that obtain software licences to evaluate whether to capitalise or expense certain costs.

Costs that are recognised as an asset for developing software or obtaining a software licence included in a cloud computing arrangement include external direct costs of materials and services incurred in developing or obtaining the software and payroll and payroll related costs (benefits) for employees who are directly involved with and who devote time to developing the cloud computing system, to the extent the time is spent directly on the project's development activities. External direct costs include, among others, fees paid to develop the software or supplemental software (e.g., to write programme code), cost to purchase the cloud computing software licence from third parties and travel expenses incurred by employees in their duties directly associated with developing the cloud computing system. Examples of employee activities include programme coding and testing during development.

11.7.5 Accounting for a cloud computing arrangement that does not include an intangible asset

11.7.5.A Fees in the arrangement

If a cloud computing arrangement does not contain a lease in the scope of IFRS 16 and does not contain an intangible asset in the scope of IAS 38, then the right to access the underlying software in the cloud computing arrangement is generally a service contract. Therefore, an entity should expense the fees paid for the cloud computing arrangement as the service is provided.

Entities generally recognise an asset for costs they prepay that relate to a service they will receive over time, which may be the case for cloud computing arrangements. For example, a customer that makes payments to a supplier of cloud computing services in advance of the related service period may determine that it is appropriate to recognise a prepaid asset (e.g., prepaid service contract) for those costs. Importantly, these costs are considered a prepaid asset that should be subsequently recognised as operating expense (and not presented as amortisation that is used to calculate EBITDA) as the services are provided.

Up-front payments the customer makes to the cloud computing supplier that relate to enhancing the functionality of the cloud computing service to be received over time should also generally be treated as a prepaid asset that is expensed over the term of the arrangement.

Careful consideration of the services provided under a long-term cloud computing service or other arrangement is required to determine the appropriate accounting for the related costs. This includes gaining an understanding of what the services are (e.g., the long-term service versus component implementation services rendered at the start of the arrangement) and when they are provided so that the costs of the service arrangement are recognised in the appropriate period.

In situations where the cloud computing supplier provides component implementation services, it may be difficult to identify and allocate consideration to the component implementation services.

11.7.5.B Internal and third-party implementation costs

In a cloud computing service arrangement (i.e., an arrangement without a software licence), a customer may incur implementation and other up-front costs to get the cloud computing arrangement ready for use and directly or indirectly relate to the software service received over time. These costs may relate to activities performed by the customer's internal personnel or third parties.

Implementation costs can include the following:

- Research costs (e.g., needs assessment and software evaluation)
- Hardware costs
- Costs to configure the underlying software
- Customisation of software
- Changes to other entity systems
- Training costs
- Data conversion
- Testing

The guidance in IAS 38 addresses how customers that obtain software licences evaluate whether to capitalise or expense certain costs, but it does not apply when software is accounted for as a service (i.e., service arrangements that do not include a software licence). Entities incur implementation and other up-front costs for a variety of service arrangements. As a result, entities will need to carefully review both the services they will receive, and the implementation costs they will incur.

Careful consideration will be required if a customer contracts with a third-party supplier (unrelated to the software service supplier), or incurs internal costs to perform certain activities that are directly or indirectly related to a software service arrangement. Customers should carefully evaluate these types of costs to determine whether the costs should be expensed, recognised as a prepaid asset, or capitalised.

As part of this evaluation, an entity first needs to determine which goods or services should be accounted for separately. IAS 38 does not include guidance on identifying separate goods or services that the customer receives. The IFRS IC received a submission about the customer's accounting for configuration and customisation costs in a cloud computing arrangement, which was discussed at IFRS IC meetings in December 2020 and March 2021. The IFRS IC's agenda decision published as an addendum to the March 2021 *IFRIC Update* indicated the following about the identification of separate services the customer receives:

"IAS 38 includes no requirements that deal with the identification of the services the customer receives in determining when the supplier performs those services in accordance with the contract to deliver them. Paragraphs 10-11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* require the customer to refer to, and consider the applicability of, the requirements in IFRS Standards that deal with similar and related issues. The Committee observed that IFRS 15 *Revenue from Contracts with Customers* includes requirements that suppliers apply in identifying the promised goods or services in a contract with a customer. For the fact pattern described in the request, those requirements in IFRS 15 deal with issues similar and related to those faced by the customer in determining when the supplier performs the configuration or customisation services in accordance with the contract to deliver those services."

IFRS 15 requires an entity to identify the promised goods or services in a contract. The statement of work for implementation activities performed by the cloud computing service supplier or a third-party can often be complicated, so customers need to apply judgement to identify the promised implementation goods or services received.

How we see it

The Committee's agenda decision that states that IFRS 15 is applied to determine the identification of the separate services the customer receives in a cloud computing arrangement that does not include an intangible asset, may result in a change in accounting policy for some entities.

In March 2019, the IFRS IC discussed the circumstance in which an entity might determine that it needs to change an accounting policy as a result of an agenda decision issued by the IFRS IC. Under IAS 8, a change of accounting policy is applied retrospectively; that is, it is applied to transactions, other events and conditions as if it had always been applied. The particular point of discussion by the IFRS IC was the timing of such a change in accounting policy. In announcing its decision not to add the matter to its agenda in the March 2019 IFRIC Update, it stated: "The Board expects that an entity would be entitled to sufficient time to make that determination and implement any change (for example, an entity may need to obtain new information or adapt its systems to implement a change)".

IFRS 15 requires promised goods or services to be accounted for separately (i.e., as performance obligations) if the goods or services are distinct (by themselves, or as part of a bundle of goods or services). If a promised good or service is not distinct, an entity is required to combine that good or service with other promised goods or services until it identifies a bundle of goods or services that, together, is distinct.

Refer to Chapter 28 at section 4, and our publication, *Applying IFRS: A closer look at IFRS 15 the revenue recognition standard*, for a further discussion of the determination of whether a good or service is distinct.

It is important to note that IFRS 15 is applied at the contract level. Therefore, if the implementation services are provided internally or by a party unrelated to the cloud computing service supplier (and neither party is acting as an agent, such as some subcontractors), the third-party service contract cannot be combined with the cloud computing arrangement. That is, the implementation services received from an unrelated third party would always be considered distinct from the cloud computing service. However, an entity would still need to determine whether the specific implementation services received from the unrelated third party are distinct from each other.

An entity should allocate the fee in a cloud computing arrangement (if the implementation services are received from the cloud computing supplier) or the fee in the third-party service contract (if the implementation services are received from a third party) to distinct goods or services identified to determine when the allocated amounts should be recognised as an expense. One way an entity could allocate the fees to each element in the contract (e.g., right to access the application software of the supplier, implementation activities) is based on the relative standalone price or relative fair value of each element in the contract.

How we see it

Careful consideration of the services received under a long-term cloud computing service or other arrangement is required to determine the appropriate accounting for the related costs. This includes gaining an understanding of what the services are (e.g., the long-term service versus component implementation services rendered at the start of the arrangement) and when they are received so that the costs of the service arrangement are recognised in the appropriate period.

In situations where the cloud computing supplier provides component implementation services, it may be difficult to identify and allocate consideration to the component implementation services.

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Appendix B - Defined terms

Extract from IAS 38

8 The following terms are used in this Standard with the meanings specified:

Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

An *asset* is a resource:

(a) controlled by an entity as a result of past events; and

(b) from which future economic benefits are expected to flow to the entity.[1]

Carrying amount is the amount at which an asset is recognised in the statement of financial position after deducting any accumulated amortisation and accumulated impairment losses thereon.

Cost is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction, or, when applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, eg IFRS 2 *Share-based Payment*.

Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value.

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

Entity-specific value is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13 *Fair Value Measurement*.)

An *impairment loss* is the amount by which the carrying amount of an asset exceeds its recoverable amount.

An *intangible asset* is an identifiable non-monetary asset without physical substance.

Monetary assets are money held and assets to be received in fixed or determinable amounts of money.

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

The *residual value* of an intangible asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Useful life is:

(a) the period over which an asset is expected to be available for use by an entity; or

(b) the number of production or similar units expected to be obtained from the asset by an entity.

12 An asset is identifiable if it either:

(a) is separable, ie is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

1 The definition of an asset in this Standard was not revised following the revision of the definition of an asset in the *Conceptual Framework for Financial Reporting* issued in 2018.

Chapter 19 Property, plant and equipment

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Overview

IAS 16 *Property, plant and equipment* prescribes the accounting treatment for property, plant and equipment (PP&E).

The principal issues in accounting for PP&E are determining the appropriate initial recognition and cost of assets, subsequent measurement of carrying amounts and depreciation charges and impairment losses to be recognised in relation to them. *[IAS 16.1]*. IAS 16 also prescribes the disclosures that an entity should provide about PP&E.

This chapter discusses how IAS 16 is applied, and covers important aspects of the standard, including the recognition of PP&E, measurement at recognition, measurement after recognition under the cost model and under the revaluation model respectively, depreciation, derecognition and disposal of PP&E, as well as the disclosure requirements.

Impairment is a major consideration in accounting for PP&E, as this is intended to ensure PP&E costs that are not fully recoverable are immediately written down to a level that is recoverable. Impairment is covered by IAS 36 *Impairment of Assets* and dealt with as a separate topic in Chapter 21. In addition, there is a separate standard, IAS 40 *Investment Property* that deals with that particular category of PP&E which is discussed in Chapter 20.

IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* deals with the accounting required when items of PP&E are held for sale and is discussed in Chapter 5.

What you need to know

- IAS 16 applies to all property, plant and equipment, unless explicitly excluded from its scope.
- Other standards may require items similar to PP&E to be recognised on a different basis from that required by IAS 16 (e.g., IFRS 16 *Leases* which prescribes the accounting treatment for right-of-use assets).
- The standard allows one of two alternatives to be chosen as the accounting policy for measurement of PP&E after initial recognition:
  - The cost model

    Or
  - The revaluation model

  The choice must be applied to an entire class of PP&E.

1 Introduction

One fundamental topic in financial reporting is how to account periodically for performance when many of the expenditures an entity incurs in the current period also contribute to that in future accounting periods. Expenditure on property, plant and equipment ('PP&E') is among the best examples of this issue.

The accounting conventions permitted by the IASB under IAS 16 are the subject of this chapter, with the underlying broad principles involved being among the first that accountants learn in their professional life.

The cost of an item of PP&E is capitalised when acquired (i.e., recorded in the statement of financial position as an asset); then subsequently a proportion of the cost is charged each year to profit or loss (i.e., the cost is spread over the future accounting periods expected to benefit from the item). After initial recognition, entities have an accounting policy choice for measurement of PP&E, applying either the cost model or the revaluation model (by class of asset). Ideally, at the end of the item's working life the carrying amount remaining on the statement of financial position should be equal to the disposal proceeds of the item or be zero if there are none.

The principal standard is IAS 16. The objective of this standard is to prescribe the accounting treatment for PP&E so that users of the financial statements can discern information about an entity's investment in its PP&E and the changes in such investment over time. The principal issues in accounting for PP&E are the recognition of the assets, the determination of their carrying amounts and the depreciation charges and impairment losses to be recognised in relation to them. *[IAS 16.1]*.

FASB differences

Differences between the IFRS and US GAAP guidance on this topic are generally not addressed in this chapter as the standards are not converged. Therefore, differences between IFRS and US GAAP may exist that are not discussed in this chapter. For more information, refer to our US GAAP/IFRS accounting differences identifier tool, which helps entities to identify some of the more common accounting differences between US GAAP and IFRS.

2 The requirements of IAS 16

2.1 Scope

IAS 16 defines PP&E as tangible items that are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes and are expected to be used during more than one period. *[IAS 16.6]*. All PP&E is within the scope of IAS 16 except as follows:

- When another standard requires or permits a different accounting treatment, for example, IAS 40 for investment properties held at fair value (but investment properties held using the cost model under IAS 40 should use the cost model in IAS 16 which is discussed in section 5 below)
- PP&E classified as held for sale in accordance with IFRS 5
- Biological assets related to agricultural activity (covered by IAS 41 *Agriculture*) other than bearer plants (see section 3.1.7 below)
- The recognition and measurement of exploration and evaluation assets (covered by IFRS 6 *Exploration for and Evaluation of Mineral Resources*)
- Mineral rights and mineral reserves such as oil, natural gas, and similar 'non-regenerative' resources *[IAS 16.2, IAS 16.3, IAS 16.5]*

Although the standard scopes out non-bearer plant biological assets, exploration and evaluation assets and mineral rights and reserves, it includes any PP&E used in developing or maintaining such resources. *[IAS 16.3]*. Therefore, PP&E used in exploration activities is included in the scope of the standard (see Chapter 39), as is agricultural PP&E (see Chapter 38).

The accounting treatment of collectibles, for example paintings or sculptures, depends on the purpose for which the entity is holding the collectibles. Items collected for administrative or aesthetic purposes and not traded in the ordinary course of business meet the definition of an item of property, plant, and equipment in IAS 16. *[IAS 16.6]*. For further discussion see Chapter 23 at section 2.3.1.J.

Other standards may require an item of PP&E to be recognised on a basis different from that required by IAS 16. For example under IFRS 16, lessees will recognise most leases in their statement of financial position as lease liabilities with corresponding right-of-use assets (see section 8.4 below). Consequently, accounting for right-of-use assets should be in accordance with IFRS 16 (see Chapter 24).

2.2 Definitions used in IAS 16

IAS 16 defines the main terms it uses throughout the standard as follows: *[IAS 16.6]*

Extract from IAS 16

Definitions

6 The following terms are used in this Standard with the meanings specified:

A *bearer plant* is a living plant that:

(a) is used in the production or supply of agricultural produce;

(b) is expected to bear produce for more than one period; and

(c) has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.

(Paragraphs 5A-5B of IAS 41 elaborate on this definition of a bearer plant.)

Carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation and accumulated impairment losses.

Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, eg IFRS 2 *Share-based Payment*.

Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value.

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

Entity-specific value is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13 *Fair Value Measurement*.)

An *impairment loss* is the amount by which the carrying amount of an asset exceeds its recoverable amount.

Property, plant and equipment are tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than one period.

Recoverable amount is the higher of an asset's fair value less costs of disposal and its value in use.

The *residual value* of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Useful life is:

(a) the period over which an asset is expected to be available for use by an entity; or

(b) the number of production or similar units expected to be obtained from the asset by an entity.

These definitions are discussed in the relevant sections below.

3 Recognition

An item of PP&E should be recognised (i.e., its cost included as an asset in the statement of financial position) only if it is probable that future economic benefits associated with the item will flow to the entity and its cost can be measured reliably. *[IAS 16.7]*.

Practical example 3-1 below describes Skanska AB's criteria for the recognition of PP&E, as disclosed in their 2022 Annual and Sustainability Report.

Practical example 3-1: Skanska AB (2022) **Sweden**

Annual and Sustainability Report 2022 [extract]
Financial information [extract]
Notes including accounting and valuation principles [extract]
Note 1. Consolidated accounting and valuation principles [extract]
IAS 16 Property, Plant and Equipment [extract]

Property, plant and equipment are recognized as assets if it is probable that future economic benefits from them will flow to the Group and the cost of the assets can be reliably calculated. Property, plant and equipment are recognized at cost minus accumulated depreciation and any impairment losses.

Cost includes the purchase price plus expenses directly attributable to the asset in order to bring it to the location and condition to be used in the intended manner. Examples of directly attributable expenses are delivery and handling costs, installation, ownership documents, consultant fees and legal services. Borrowing costs are included in the cost of property, plant and equipment produced by the Group. Impairment losses are applied in accordance with IAS 36.

The cost of property, plant and equipment produced by the Group includes expenditures for materials and remuneration to employees, and other applicable manufacturing costs that are considered attributable to the asset.

Further expenditures are added to cost only if it is probable that the Group will derive future economic benefits from the asset and the cost can be reliably calculated. All other further expenditures are recognized as expenses in the period when they arise.

The decisive factor in determining when a further expenditure is added to cost is whether the expenditure is related to replacement of identified components, or parts thereof, at which time such expenditures are capitalized. In cases where a new component is created, this expenditure is also added to cost. Any undepreciated carrying amounts for replaced components, or parts thereof, are disposed of and recognized as an expense at the time of replacement. If the cost of the removed component cannot be determined directly, its cost may be estimated as the cost of the new component adjusted by a suitable price index to take into account inflation. Repairs are recognized as expenses on a continuous basis.

3.1 Aspects of recognition

3.1.1 Spare parts and minor items

Items such as spare parts, stand-by equipment and servicing equipment are inventory unless they meet the definition of PP&E (see section 2.2 above). *[IAS 16.8]*. This treatment is illustrated in Practical example 3-2 below.

Practical example 3-2: Heineken N.V. (2023) **The Netherlands**

Annual Report 2023 [extract]
Financial Statements 2023 [extract]
Notes to the Consolidated Financial Statements [extract]
8. Non-current assets [extract]
8.2 Property, plant and equipment [extract]
Accounting policies [extract]

Owned assets

A fixed asset is recognised when it is probable that future economic benefits associated with the P,P&E item will flow to HEINEKEN and when the cost of the P,P&E can be reliably measured. The majority of the P,P&E of HEINEKEN are owned assets, rather than leased assets.

P,P&E are recognised at historical cost less accumulated depreciation and impairment losses. Historical cost includes all costs directly attributable to the purchase of an asset. The cost of self-constructed assets includes all directly attributable costs to make the asset ready for its intended use. Spare parts that meet the definition of P,P&E are capitalised and accounted for accordingly. If spare parts do not meet the recognition criteria of P,P&E, they are either carried in inventory or consumed and recorded in profit or loss.

Subsequent costs are capitalised only when it is probable that the expenses will lead to future economic benefits and can be measured reliably. The carrying amount of any component accounted

...

Materiality judgements are considered when deciding how an item of PP&E should be accounted for. Major spare parts may, for example, be considered as qualifying as PP&E, while smaller spares may be carried as inventory and as a practical matter many companies have a minimum value for capitalising assets.

Some types of business may have a very large number of minor items of PP&E such as spare parts, tools, pallets and returnable containers, which nevertheless are used in more than one accounting period. There are practical problems in recording them on an asset-by-asset basis in an asset register; they are difficult to control and frequently lost. The main consequence is that it becomes very difficult to depreciate them. Generally, entities write off such immaterial assets as expenses in the period of addition. Skanska AB in Practical example 5-1 (see section 5.2 below) immediately depreciates such minor equipment, achieving the same result. The standard notes that there are issues concerning what constitutes a single item of PP&E. The 'unit of measure' for recognition is not prescribed and entities have to apply judgement in defining an item of PP&E in their specific circumstances. The standard suggests that it may be appropriate to aggregate individually insignificant items (such as tools, moulds and dies) and to apply the standard to the aggregate amount (presumably without having to identify the individual assets). *[IAS 16.9]*.

3.1.2 Environmental and safety equipment

The standard acknowledges that there may be expenditures forced upon an entity by legislation that requires it to buy items of PP&E that do not directly increase the future economic benefits expected to flow to the entity. Examples would be safety or environmental protection equipment. IAS 16 explains that these expenditures qualify for recognition as they allow an entity to derive future economic benefits from related assets in excess of those that would flow if such expenditure had not been made. For example, a chemical manufacturer may install new chemical handling processes to comply with environmental requirements for the production and storage of dangerous chemicals; related plant enhancements are recognised as an asset because without them the entity is unable to manufacture and sell the chemicals or a plant might have to be closed down if these safety or environmental expenditures were not made. *[IAS 16.11]*.

How we see it

An entity may voluntarily invest in environmental equipment even though it is not required by law to do so. Although not explicitly stated in IAS 16, we believe the entity can capitalise those investments in environmental and safety equipment in the absence of a legal requirement as long as:

- The expenditure meets the definition of an asset.

  Or

- There is a constructive obligation to invest in the equipment.

If the entity can demonstrate that the equipment is likely to increase the economic life of the related asset, or enables the entity to derive additional economic benefit from other assets, the expenditure meets the definition of an asset. Otherwise, the expenditure can be capitalised when the entity can demonstrate all of the following:

- That a constructive obligation exists to invest in environmental and safety equipment (e.g., it is standard practice in the industry, environmental groups are likely to raise issues or employees demand certain equipment to be present).
- The expenditure is directly related to improvement of the asset's environmental and safety standards.

  And

- The expenditure is not related to repairs and maintenance or form part of period costs or operational costs.

Whenever safety and environmental assets are capitalised, the standard requires the resulting carrying amount of the asset, and any related asset, to be reviewed for impairment in accordance with IAS 36 (see section 5.7 below). *[IAS 16.11]*.

3.1.3 Economic benefits and costs associated with property developments

The standard requires that PP&E only be recognised when it is probable that future economic benefits associated with the item will flow to the entity. *[IAS 16.7]*.

For example, in relation to property development, many jurisdictions require permissions prior to development whilst developers, including entities developing property for their own use, typically incur significant costs prior to such permissions being granted.

In assessing whether such pre-permission expenditures can be capitalised - assuming they otherwise meet the criteria - a judgement must be made at the date the expenditure is incurred of whether it is sufficiently probable that the relevant permission will be granted. Such expenditure does not become part of the cost of the land; to the extent that it can be recognised it is part of the costs of a separate building.

How we see it

If during the application and approval process of such permits it is no longer expected that necessary permits will be granted, capitalisation of pre-permission expenditure should cease, any related amounts that were previously capitalised should be written off in accordance with IAS 36 and accordingly, the carrying amount of any related item of PP&E subject to development or redevelopment (or, if appropriate, the cash generating unit where such an asset belongs) should be tested for impairment, where applicable (see section 5.7 below).

3.1.4 Classification as PP&E or intangible asset

Certain intangible assets may be embedded or contained within an item of PP&E, and this can raise questions in determining whether such assets should be accounted for under IAS 16 or IAS 38 *Intangible Assets*. In practice, items such as computer software purchased by entities are frequently capitalised as part of a tangible asset, for example as part of an accounting or communications infrastructure. Equally, internally written software may be capitalised as part of a tangible production facility, and so on. Judgement must be exercised in deciding whether such items are to be accounted for under IAS 16 or IAS 38 and this distinction becomes increasingly important if the two standards prescribe differing treatments in any particular case.

IAS 16 does not refer to this type of asset. In contrast, IAS 38 contains explicit guidance, stating that where an asset incorporates both intangible and tangible elements, an entity needs to exercise judgement to assess which element is more significant in order to determine whether the asset should be treated as PP&E under IAS 16 or as an intangible asset under IAS 38, for example:

- Computer software that is embedded in computer-controlled equipment that cannot operate without that specific software is an integral part of the related hardware and is treated as PP&E.
- Software which is not an integral part of the related hardware is treated as an intangible asset. For example, application software that is being used on a computer is generally easily replaced and is not an integral part of the related hardware. In contrast, the operating system normally is integral to the computer and is included in PP&E.
- A database that is stored on a compact disc is considered to be an intangible asset because the value of the physical medium is wholly insignificant compared to that of the data collection. *[IAS 38.4]*.

It is worthwhile noting that as the 'parts approach' in IAS 16 requires an entity to account for significant parts of an asset separately, this raises 'boundary' problems between IAS 16 and IAS 38 when software and similar expenditure are involved.

How we see it

We believe that where IAS 16 requires an entity to identify significant parts of an asset and account for them separately, the entity needs to evaluate whether any software-type intangible part is integral to the larger asset or whether it is really a separate asset in its own right. The intangible part is more likely to be an asset in its own right if it was developed separately or if it can be used independently of the item of PP&E.

3.1.5 Classification of items as inventory or PP&E when minimum levels are maintained

Entities may acquire items of inventory on a continuing basis, either for sale in the ordinary course of business or to be consumed in a production process or when rendering services.

This means there will always be a core stock of that item (i.e., a minimum level of inventory is maintained). This does not in itself turn that inventory into an item of PP&E since each individual item will be consumed within a single operating cycle. However, there may be cases where it is difficult to judge whether an item is part of inventory or is an item of PP&E. This may have implications on measurement because, for example, PP&E has a revaluation option (see section 6 below) that is not available for inventory.

How we see it

In our view, an item of inventory is accounted for as an item of PP&E if it:

- Is not held for sale in the ordinary course of business or consumed in a production process or during the process of rendering services
- Is necessary to operate or benefit from another asset during more than one operating cycle

  And
- Either cannot be recouped through sale (or is significantly impaired after it has been used to operate the asset or benefit from that asset)

This applies even if the part of inventory that is an item of PP&E cannot be physically separated from the rest of inventories.

Consider the following examples:

- An entity acquires the right to use an underground cave for gas storage purposes for a period of 50 years. The cave is filled with gas, but a substantial part (25%) of that gas will only be used to keep the cave under pressure in order to be able to get gas out of the cave. It is not possible to distinguish the gas that will be used to keep the cave under pressure from the rest of the gas. Gas will be turned around on a continuing basis. Still, it is possible to measure the part of the gas that will not be recoupable from the cave for selling purposes.
- An entity operates an oil refining plant. In order for the refining process to take place, the plant must contain a certain minimum quantity of oil. This can only be taken out once the plant is abandoned and would then be polluted to such an extent that the oil's value is significantly reduced (it can only be sold as sludge).
- An entity sells gas and has at any one time a certain quantity of gas in its gas distribution network.

In the first example the total volume of gas must be virtually split into (i) gas held for sale and (ii) gas held to keep the cave under pressure. The former must be accounted for under IAS 2 *Inventories*. The latter must be accounted for as PP&E and depreciated over the period the cave is expected to be used.

In the second example the part of the crude that is necessary to operate (in technical terms) the plant and cannot be recouped (or can be recouped but would then be significantly impaired), even when the plant is abandoned, should be considered as an item of PP&E and amortised over the life of the plant.

The arguments for the conclusions in these two examples are that the items do not meet the definition of inventories, and although it is not possible to identify the molecules in each of the two categories, there is no reason why one should not distinguish assets with a different use, and account for them differently. Further, the items are necessary to bring another item of PP&E to the condition necessary for it to be capable of operating in the manner intended by management and this meets the definition of cost of an item of PP&E in IAS 16.16(b). Recognising these items as inventories would lead to an immediate loss because these items cannot be sold or consumed in a production process or during the process of rendering services. This does not properly reflect the fact that the items are necessary to operate another asset over more than one operating cycle. *[IAS 2.6, IAS 16.6, IAS 16.16(b)]*.

In the third example the gas in the pipeline is not necessary to operate the pipeline. It is held for sale or to be consumed in the production process or process of rendering services. Therefore, this gas is accounted for as inventory.

3.1.6 Production stripping costs of surface mines

IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine* states that costs associated with a 'stripping activity asset' (i.e., the costs associated with gaining access to a specific section of an ore body) are accounted for as an additional component of an existing asset. *[IFRIC 20.10]*. Other routine stripping costs are accounted for as current costs of production (i.e., inventory).

The IFRS IC's intention was to maintain the principle of IAS 16 by requiring identification of the component of the ore body for which access had been improved, as part of the criteria for recognising stripping costs as an asset. An entity will have to allocate the stripping costs between the amount capitalised (as it reflects the future access benefit) and the amount that relates to the current-period production of inventory. This allocation should be based on a relevant production measure. *[IFRIC 20.13]*.

This component approach follows the principle of separating out parts of an asset that have costs that are significant in relation to the entire asset and when the useful lives of those parts are different. *[IAS 16.43, IAS 16.44, IAS 16.45]*.

This interpretation is discussed in more detail in Chapter 39 at section 15.5.

3.1.7 Bearer plants

Bearer plants are defined as living plants that are used in the production or supply of agricultural produce, are expected to bear produce for more than one period and have a remote likelihood of being sold as a plant or harvested as agricultural produce (except for incidental scrap sales such as for use as firewood). *[IAS 16.6, IAS 41.5, IAS 41.5B]*. Examples of bearer plants may include tea bushes, grape vines, oil palms and rubber trees.

Bearer plants are within the scope of IAS 16 and subject to all of the requirements therein. This includes the ability to choose between the cost model and revaluation model for subsequent measurement. Agricultural produce growing on bearer plants, e.g., the fruit growing on a tree, remains within the scope of IAS 41 (see Chapter 38). *[IAS 16.3(b), IAS 41.5C]*.

The following are not included within the definition of bearer plants and instead fall under the scope of IAS 41:

- Plants cultivated to be harvested as agricultural produce, e.g., trees grown for use as lumber.
- Plants cultivated to produce agricultural produce when there is more than a remote likelihood that the entity will also harvest and sell the plant as agricultural produce, other than as incidental scrap sales, e.g., trees that are cultivated both for their fruit and their lumber.
- Annual crops such as maize and wheat. *[IAS 41.5A]*.

Bearer plants are accounted for in the same way as self-constructed items of PP&E before they are brought to the location and condition necessary to be capable of operating in the manner intended by management. Consequently, references to 'construction' in IAS 16, with respect to bearer plants, cover the activities that are necessary to cultivate such plants before they are brought to the location and condition necessary to be capable of operating in the manner intended by management, which is typically when they are mature. *[IAS 16.22A]*.

Bearer plants are subject to the requirements of IAS 16, and so entities will need to consider the correct unit of account, analyse which costs can be capitalised prior to maturity, set useful lives for depreciation purposes and consider the possibility of impairment.

For a more detailed discussion of the requirements, including some of the measurement challenges for bearer plants under IAS 16, see Chapter 38 at sections 1, 2.2.1.A, 2.3.3, and 3.2.3.A.

3.1.8 Accounting for trees held to generate carbon offsets for use or sale

As part of their sustainability related activities, some entities are buying or planting trees that will absorb carbon dioxide (i.e., act as 'carbon sinks'). Others are choosing to defer or cease planned harvests to generate carbon offsets. The entities undertaking these activities can then sell or use the carbon offsets generated. An entity that directly owns such trees (rather than indirectly through investments in entities that own the trees) will need to determine whether the trees are:

- Biological assets related to agricultural activity to which IAS 41 applies
- Bearer plants related to agricultural activity to which IAS 16 applies

  Or
- Assets not related to agricultural activity, in which case, it is likely an entity would apply the requirements in IAS 16.

Determining the nature of the asset is fundamental to this assessment. To be within the scope of IAS 41 or to be a bearer plant within the scope of IAS 16, the trees must relate to agricultural activity, which is defined as "the management by an entity of the biological transformation and harvest of biological assets for sale or for conversion into agricultural produce or into additional biological assets". *[IAS 41.1(a), IAS 41.5].*

For the definition of agricultural activity in IAS 41 to be met, both the management of change (which may include activities such as planting, pruning, thinning, and fertilising) and the harvest of agricultural produce are required. As such, whether the entity manages the trees and harvests any agricultural produce will be key to determining the nature of the asset and the appropriate standard to apply.

How we see it

While carbon dioxide is absorbed and oxygen is produced by the trees, the oxygen cannot be captured at the point of production and detached in the manner contemplated by the definition of agricultural produce in IAS 41. Similarly, in our view, carbon offsets are not the agricultural produce of trees.

IAS 41 does not provide guidance on the extent of harvest needed to qualify as an agricultural activity. As a result, it may not always be clear the extent to which any felling undertaken might constitute harvesting of agricultural produce and entities will need to apply judgement in determining whether the trees are engaged in agricultural activity. Further guidance on assessing the nature of the asset in such cases is provided at Chapter 38 at section 2.3.7. Where it is determined that the trees are bearer plants, the requirements at section 3.1.7 above would apply. Where it is determined that the trees are not held in relation to agricultural activity, it is likely an entity would apply the general requirements in IAS 16.

How we see it

If the trees are held solely to generate carbon offsets, whether these are sold or used by the entity, determining the nature of the asset may require judgement.

After initial recognition, it is not clear whether reassessment might be required should circumstances change. For example, assume an entity had no intention of felling the trees, but that subsequently changed for some of the trees due to windthrow. If a change in circumstances were to arise, an entity would need to apply the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to develop an appropriate policy.

If, having assessed the nature of the assets, it is determined that IAS 16 applies and the asset is not a bearer plant, the assets shall be initially measured at their accumulated cost until they are available for use, which, in contrast to the treatment outlined above for bearer plants, will generally be as soon as they are planted.

3.1.9 Expenditure on the development of infrastructure relating to new technologies

An entity may incur expenditure on the development of infrastructure relating to new technologies. One instance in which this may be particularly relevant is those entities incurring expenditure arising from the need to address impacts of climate change (e.g., hydrogen processing or carbon capture and storage (CCS) facilities). Such development costs are recognised as an item of PP&E if it is probable that future economic benefits associated with the item will flow to the entity and the cost of the item can be measured reliably. The entity will need to consider at which point there is sufficient and reliable information to meet the PP&E recognition criteria. This is key as there will likely be more uncertainty about the total project costs of assets relating to new technologies compared to existing technologies. Therefore, there is greater potential for significant time and cost overruns.

3.1.10 Aggregation of items of PP&E

Entities may have items of PP&E that are considered insignificant at group level because the group is of such a size that the individual assets are considered insignificant to the group as a whole. As described in section 3.1.1 above, IAS 16 does not prescribe the 'unit of measure' for recognition, i.e., what constitutes an item of PP&E and the extent to which items can be aggregated. *[IAS 16.9]*. The standard notes that it may be appropriate to aggregate individually insignificant items such as moulds, tools and dies, and to apply the standard to the aggregate value, but is silent on whether this approach may be used to aggregate properties or similar assets that are individually immaterial.

There are instances in which the aggregation of items on the grounds that they are immaterial to the entity purely by virtue of their size may result in accounting that is inconsistent with the broader requirements of IAS 16. For example, the aggregation of individually immaterial assets into a single asset could lead to a factory being considered a single asset, instead of distinguishing between the land, buildings, plant and machinery, which would clearly be against both the letter and spirit of IAS 16. The following Illustration shows another situation:

Illustration 3-1: Aggregation of individual properties

An entity owns a large number of individual properties from which it earns both rental income and other trading income, such that the properties do not meet the definition of investment properties under IAS 40. The entity applies the revaluation model for subsequent measurement of its properties.

Each property is individually immaterial to the entity. Nevertheless, each property is recorded separately in the entity's books and records, is monitored separately by management and generates individual cash flows. Therefore, each individual property is regarded as a separate item of PP&E under IAS 16.

If such an entity did aggregate all its properties, any downward revaluations on individual properties to the income statement would be inappropriately offset by revaluation gains arising on other properties within the aggregated group.

How we see it

Paragraph 9 of IAS 16 applies to small items (such as tools) that are capitalised together into a single amount and are not subsequently viewed by management or monitored as single assets. In our view, the paragraph cannot be used to justify the aggregation of individual assets if the entity itself views and monitors the assets individually, the assets generate separately identifiable cashflows or the assets are subject to separate contractual arrangements.

3.2 Accounting for parts ('components') of assets

IAS 16 requires 'significant parts' of an asset to be depreciated separately. These are parts that have a cost that is significant in relation to the total cost of the asset. Therefore, on initial recognition, an entity will have to identify the significant parts of the asset in order to depreciate each part of the asset properly. *[IAS 16.43, IAS 16.44]*. There is no requirement to identify all parts. The process of identifying and separately recognising the major parts of an item PP&E is often referred to as 'componentisation'.

'Parts' are distinguished from day-to-day servicing, but they are not otherwise defined by the standard; moreover, as described in section 3.1.1, the unit of measurement to which the standard applies (i.e., what comprises an item of PP&E) is not itself defined.

Components may be physical components, but where relevant, non-physical parts may also be identified to reflect the need for the asset to undergo major inspections or overhauls. Major inspections are discussed further in section 3.3.2 below. The separation of an asset into major physical components is illustrated in illustration 3-2:

Illustration 3-2: Identification of component parts

An entity buys a property with an estimated useful life of 25 years for CU4 million. The property's roof is expected to require replacement every 10 years at an estimated cost of CU250,000. The building is also internally configured using partition walls in order to create the required workspaces (such as open plan areas and meeting rooms), and this internal configuration is expected to be replaced every 7 years at an estimated cost of CU350,000.

The entity is required under IAS 16 to allocate the amount initially recognised to its significant parts, and therefore it determines that it shall:

- Regard the roof as a significant part with a cost of CU250,000 and a useful life of 10 years;
- Regard the internal partitioning as a significant part with a cost of CU350,000 and a useful life of 7 years; and
- The remaining cost of CU3.4 million should be allocated to the building component with a useful life of 25 years.

This parts approach is illustrated by International Consolidated Airlines Group, S.A. in Practical example 3-3 below and by Skanska AB in Practical example 5-1 (see section 5.2 below).

Practical example 3-3: International Consolidated Airlines Group, S.A. (2023) Spain

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a Fleet

All aircraft are stated at the fair value of the consideration given after taking account of manufacturers' credits and pre-delivery instalment payments (referred to as progress payments). Fleet assets owned or right of use ('ROU') assets are disaggregated into separate components and depreciated at rates calculated to write down the cost of each component to the estimated residual value at the end of their planned operational lives (which is the shorter of their useful life or lease term) on a straight-line basis. Depreciation rates are specific to aircraft type, based on the Group's fleet plans, within overall parameters of 23 years and up to 5 per cent residual value for short-haul aircraft and between 23 and 29 years (depending on aircraft) and up to 5 per cent residual value for long-haul aircraft.

Right of use assets are depreciated over the shorter of the lease term and the aforementioned depreciation rates. Where the lease includes a purchase option, at the discretion of the Group, where it is expected that the purchase option will be exercised, the associated right of use asset is depreciated using the aforementioned depreciation rates to reflect the reasonably certain life of the aircraft, irrespective of the lease term.

Cabin interior modifications, including those required for brand changes and relaunches, are depreciated over the lower of 12 years and the remaining economic life of the aircraft, whether owned or leased.

Aircraft and engine spares acquired on the introduction or expansion of a fleet, as well as rotable spares purchased separately, are carried as property, plant and equipment and generally depreciated in line with the fleet to which they relate.

In addition to the requirement to componentise for depreciation purposes, IAS 16 requires entities to derecognise an existing part when it is replaced, regardless of whether it has been depreciated separately. The accounting for subsequent expenditure on replacement of parts is discussed further at 3.3.1 below.

3.3 Initial and subsequent expenditure

IAS 16 makes no distinction in principle between the initial costs of acquiring an asset and any subsequent expenditure relating to it. In both cases, any and all expenditure has to meet the recognition criteria and be expensed in profit or loss if it does not. *[IAS 16.10]*.

Extract from IAS 16

10 An entity evaluates under this recognition principle all its property, plant and equipment costs at the time they are incurred. These costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service it. The cost of an item of property, plant and equipment may include costs incurred relating to leases of assets that are used to construct, add to, replace part of or service an item of property, plant and equipment, such as depreciation of right-of-use assets.

The standard draws a distinction between servicing and more major expenditures. Day-to-day servicing, by which is meant the repair and maintenance of PP&E that largely comprises labour costs, consumables and other minor parts, should be recognised in profit or loss as incurred. *[IAS 16.12]*. However, if the expenditure involves replacing a significant part of the asset, this part should be capitalised as part of the PP&E, if the recognition criteria are met. The carrying amount of the part that has been replaced should be derecognised (see section 3.3.1 and section 7). *[IAS 16.13]*.

Examples of the treatment of major maintenance expenditure are shown in Practical example 3-4 and Practical example 3-5 below (see section 3.3.2). Further guidance on the accounting for major inspections and overhauls is provided at 3.3.2.

Practical example 3-4: Akzo Nobel N.V. (2023) The Netherlands

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FINANCIAL STATEMENTS [extract]
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]
Note 1: SUMMARY OF MATERIAL ACCOUNTING POLICIES [extract]
Property, plant and equipment (Note 11) [extract]

Costs of major maintenance activities are capitalized and depreciated over the estimated useful life. Maintenance costs which cannot be separately defined as a component of property, plant and equipment are expensed in the period in which they occur. We

...

3.3.1 Subsequent expenditure on replacement of parts

When discussing subsequent expenditure, IAS 16 identifies two particular types of 'parts' of assets. The first is an item that requires replacement at regular intervals during the life of the asset such as relining a furnace after a specified number of hours of use, or replacing the interiors of an aircraft (e.g., seats and galleys) several times during the life of the airframe. The second type involves less frequently recurring replacements, such as replacing the interior walls of a building.

IAS 16 does not state that replacement expenditures necessarily qualify for recognition. Rather, it says that an entity recognises the cost of replacing part of such an item in the carrying amount of an item of PP&E when that cost is incurred, if the recognition criteria are met. Some of its examples, such as aircraft interiors, are clearly best treated as separate assets as they have a useful life different from that of the asset of which they are part. With the other examples, such as interior walls, it may be less clear why they meet the recognition criteria. However, replacing internal walls or similar expenditures may extend the useful life of a building while upgrading machinery may increase its capacity, improve the quality of its output, or reduce operating costs. Hence, this type of expenditure may give rise to future economic benefits.

Entities are required to derecognise the carrying amount of an existing part when it is replaced, regardless of whether it has been depreciated separately, and the standard allows the carrying value of the part that has been replaced to be estimated, if necessary:

"If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or constructed." *[IAS 16.70]*

As such, if the entity has no better information than the cost of the replacement part, it is permitted to use a depreciated replacement cost basis to calculate the amount derecognised in respect of the original asset.

As a consequence, an entity may not actually identify the parts of an asset until it incurs the replacement expenditure, as in the following Illustration:

Illustration 3-3: Recognition and derecognition of replacement parts

An entity buys a piece of machinery with an estimated useful life of ten years for CU10 million. The asset contains two identical pumps, which are assumed to have the same useful life as the machine of which they are a part. After seven years one of the pumps fails and is replaced at a cost of CU200,000. The entity had not identified the pumps as separate parts and does not know the original cost. It uses the cost of the replacement part to estimate the carrying value of the original pump. With the help of the supplier, it estimates that the cost would have been approximately CU170,000 and that this would have a remaining carrying value after seven year's depreciation of CU51,000. Accordingly, it derecognises CU51,000 and capitalises the cost of the replacement.

3.3.2 Major inspections and overhauls

It may be necessary to perform major inspections of an item of PP&E at regular intervals as a condition of continuing to use the asset. In such circumstances, when a major inspection or overhaul is performed, the standard allows a separate part (distinct from physical parts) to be recognised for the cost of such inspections if the recognition criteria are satisfied, regardless of whether any physical parts of the asset are replaced. *[IAS 16.14]*.

The reason for this approach is to maintain a degree of consistency with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* which prohibits an entity from making provisions if there are no obligations. Therefore, an entity is prohibited by IAS 37 from making, for example, a provision to overhaul an owned aircraft engine by annually providing for a quarter of the cost for four years and then utilising the provision when the engine is overhauled in the fourth year. *[IAS 37 IE Example 11A, IAS 37 IE Example 11B]*. Instead, the cost of a major inspection is added to the asset's cost if the recognition criteria are satisfied and then depreciated over the period until the next major inspection. This approach is illustrated in Practical example 3-5:

Practical example 3-5: International Consolidated Airlines Group, S.A. (2023) Spain

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f Maintenance, repairs and overhaul [extract]

Owned aircraft
Major overhaul expenditure, including replacement spares and labour costs for airframes and engines, is capitalised and amortised over the expected life between major overhauls or to the end of the useful life of the asset.

All other replacement spares and other costs relating to maintenance of owned fleet assets (including maintenance provided under 'pay-as-you-go' contracts) are charged to the Income statement on consumption or as incurred respectively.

'Pay-as-you-go' contracts, as referenced in the above examples, are common in the aerospace industry and refer to comprehensive turbine engine maintenance and overhaul contracts, which are usually based on a fixed fee for each hour flown and include loan engines when required.

When a major inspection or overhaul is performed, any amount remaining from the previous inspection (as distinct from physical parts) is derecognised. In the same way as described at 3.3.1 for replacement parts more generally, this process of recognition and derecognition should take place regardless of whether the cost of the previous inspection was identified (and considered a separate part) when the asset was originally acquired or constructed.

If the element relating to the inspection had previously been identified, it would have been depreciated between that time and the current overhaul and it's carrying amount would be known. However, if it had not previously been identified, the carrying amount of the component to be derecognised will need to be estimated. In arriving at this estimate, the standard allows the cost of a future similar inspection to be used as an indication of what the cost of the existing inspection component was when the item was acquired or constructed. *[IAS 16.14]*. However, an entity is not precluded from reconstructing the carrying amount of the previous inspection (i.e., to estimate the net depreciated carrying value of the previous inspection that will be derecognised) rather than simply using a depreciated replacement cost approach.

These principles may need to be considered by entities which are required to undertake major overhauls or redesigns of items of PP&E as a result of the impacts of climate change on their business. To the extent that such activities result in the replacement of asset parts, entities will need to apply the 'major inspection and overhaul' principles of IAS 16 in determining the appropriate treatment.

4 Measurement at recognition

IAS 16 draws a distinction between measurement at recognition (i.e., the initial recognition of an item of PP&E on acquisition) and measurement after recognition (i.e., the subsequent treatment of the item). Measurement after recognition is discussed in sections 5 and 6 below.

The standard states that "an item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost". *[IAS 16.15]*. What may be included in the cost of an item is discussed below.

4.1 Elements of cost and cost measurement

IAS 16 sets out what constitutes the cost of an item of PP&E on its initial recognition: *[IAS 16.16]*

Extract from IAS 16

16 The cost of an item of property, plant and equipment comprises:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

(b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

(c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

One practical example of (c) above may arise in connection with dilapidation obligations in lease agreements, under which a lessee is obliged to return premises to the landlord in an agreed condition. Arguably, a provision is required whenever the 'damage' is incurred. Therefore, if an entity rents a building and constructs a dividing wall to convert the single building into two premises and has an obligation to make good at the end of the lease term, the tenant should immediately provide for the costs of so doing. The 'other side' of the provision entry is capitalised and will be amortised over the lease term. This reflects the fact that the cost to the tenant of the leasehold improvement includes both the cost of constructing the dividing wall, but also the resulting costs which the entity will have to incur in the future to restore the property.

Dilapidation and other provisions relating to leased assets are discussed in more detail in Chapter 27 at section 6.9.

Obligations that arise, for example due to damage caused, as a result of using the asset to produce inventories during a particular period are not capitalised as part of the item of PP&E. These are production costs and are included in the cost of inventories. *[IAS 16.18]*. Obligations that arise due to general use (for example, costs associated with wear and tear arising from the use of a leasehold building for administrative purposes) are expensed as incurred.

4.1.1 'Directly attributable' costs

This is the key issue in the measurement of cost. *[IAS 16.16]*. The standard gives examples of types of expenditure that are, and are not, considered to be directly attributable: *[IAS 16.17, IAS 16.19]*

Extract from IAS 16

17 Examples of directly attributable costs are:

(a) costs of employee benefits (as defined in IAS 19 *Employee Benefits*) arising directly from the construction or acquisition of the item of property, plant and equipment;

(b) costs of site preparation;

(c) initial delivery and handling costs;

(d) installation and assembly costs;

(e) costs of testing whether the asset is functioning properly (ie assessing whether the technical and physical performance of the asset is such that it is capable of being used in the production or supply of goods or services, for rental to others, or for administrative purposes); and

(f) professional fees.

Only costs that are directly attributable can be capitalised, and capitalisation must cease when the asset is in the location and condition necessary for it to be capable of operating in the manner intended by management. For further discussion see sections 4.1.3 and 4.1.4.

IAS 16 requires the costs of testing to be added to the carrying value of the asset. Directly attributable testing costs comprise testing costs incurred when assessing whether the technical and physical performance of the asset is such that it is capable of being used in the production or supply of goods or services, for rental to others, or for administrative purposes. *[IAS 16.17(e)]*. IAS 16 does not provide guidance on assessing the point at which an asset is capable of being used in the manner intended, and therefore, judgement may be required in determining the period during which testing costs should be capitalised.

The cost of an item of PP&E includes costs incurred relating to leases of assets that are used to construct, add to, or replace part of an item of PP&E, such as depreciation of right-of-use assets, where those lease costs are "directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management …". *[IAS 16.10, IAS 16.16]*.

When, for example, an entity leases real estate (land or building) in relation to the construction of real estate or leasehold improvements that meet the definition of PP&E, the entity needs to determine whether the depreciation cost of the right-of-use asset represents a cost that is directly attributable to bringing the asset to a condition necessary for it to be capable of operating in a manner intended by management. If the entity concludes this is the case, the depreciation expense incurred in relation to the right-of-use asset for the lease during the construction period would be capitalised as part of the construction cost of the item of PP&E. *[IAS 16.10, IAS 16.16(b)]*.

Depreciation of a right-of-use asset begins at commencement of the lease, which may be before the completed asset is available for use in circumstances in which real estate or leasehold improvements are being constructed. This differs from the requirement in respect of PP&E, where depreciation of the asset begins when it is available for use in the manner intended by management (see further discussion in section 5.5 below).

Where an entity concludes that the depreciation cost of the right-of-use asset does not represent a directly attributable cost of the asset, the entity should expense the costs as incurred.

Examples of such considerations are shown in Illustration 4-1 and Illustration 4-2 below.

How we see it

The cost of an item of PP&E includes the depreciation of right-of-use assets, where that depreciation expense is directly attributable to bringing the item to the location and condition necessary for it to be capable of operating in the manner intended by management. Determining whether the depreciation expense associated with a right-of-use asset is directly attributable requires judgement, taking into account all relevant facts and circumstances.

Certain types of expenditure are not directly attributable costs associated with an item of PP&E and therefore, cannot be recognised as part of the cost of an asset. This should be considered in assessing whether a lease cost is included in the cost of an item of PP&E. Some specific examples of ineligible costs are discussed further at section 4.1.3 below.

Illustration 4-1: Depreciation charge for right-of-use asset - owner-occupied building

On 1 January 20X0, an entity enters into a lease of land for a term of 40 years.

The entity intends to construct a building on the land and plans to occupy the building itself once construction is completed. The entity must obtain planning permission for the building, and this process takes three years. Therefore, the land lease commences on 1 January 20X0. Construction of the building begins on 1 January 20X3 and is completed two years later, on 1 January 20X5. The entity applies the cost model for its PP&E.

The entity needs to determine whether the depreciation cost of the right-of-use asset represents a cost that is directly attributable to bringing the asset to a condition necessary for it to be capable of operating in the manner intended by management as specified in IAS 16. *[IAS 16.16(b)]*. In this scenario the depreciation charge during the construction period is an unavoidable cost of developing the property, because without the lease of the land no construction of the building can occur.

Therefore, the depreciation charge related to the right-of-use asset for the land lease incurred during the period from 1 January 20X3 to 31 December 20X4 is capitalised. Thereafter, the depreciation charge is recognised in expense. Depreciation in the period prior to 1 January 20X3 is expensed as incurred as depreciation during that time is not directly attributable to the construction of the asset itself.

Illustration 4-2: Depreciation charge for right-of-use asset - leasehold improvements

On 1 January 20X0, an entity enters into a 10-year lease of a building. To make the building suitable for its requirements, the entity makes leasehold improvements beginning on the commencement date of the lease. From lease commencement, the entity cannot begin its intended operations until the work to construct the leasehold improvements is completed. On 1 April 20X0, the building is available to begin the entity's operations.

Considerable judgement may be required in examples such as this one, where an entity is required to assess whether the depreciation expense incurred on a leased building is directly attributable to the cost of associated leasehold improvements. Factors an entity needs to consider may include the condition of the leased asset prior to making the leasehold improvements (for example, whether it is merely a shell building which cannot be operated), the nature of the asset prior to the leasehold improvements and the significance of the improvements to be made (for example, whether the changes are relatively minor or superficial, or whether they involve a full repurposing of the asset to enable its use). In addition, IAS 16 is clear that certain 'start up' costs, which include 'the costs of opening a new facility' are not costs of an item of PP&E. Therefore, there may also be significant judgement in determining whether the depreciation should be viewed as a 'start-up' cost and expensed as incurred on that basis.

If, having made this assessment, the entity concludes that the depreciation is directly attributable to bringing the asset to a condition necessary for it to be capable of operating in the manner intended by management, the entity would capitalise the depreciation expense as part of construction costs. Otherwise, the entity should expense the costs as incurred.

Once the entity begins operations, the depreciation charge related to right-of-use asset is expensed as incurred.

4.1.2 Borrowing costs

Borrowing costs must be capitalised in respect of certain qualifying assets if those assets are measured at cost. A qualifying asset is "an asset that necessarily takes a substantial period of time to get ready for its intended use or sale". *[IAS 23.5]*. Assets that are ready for their intended use or sale when acquired are not qualifying assets. *[IAS 23.7]*. Therefore, an entity will capitalise borrowing costs on a self-constructed item of PP&E if it meets the criteria in IAS 23 *Borrowing Costs*. *[IAS 16.22]*. Further considerations in respect of self-built assets are discussed in section 4.1.5 below.

The treatment of borrowing costs is discussed separately in Chapter 22.

Entities are not required to capitalise borrowing costs in respect of assets that are measured at fair value. This includes revalued PP&E which is measured at fair value through Other Comprehensive Income ('OCI'). Generally, an item of PP&E within the scope of IAS 16 will only be carried at revalued amount once construction is completed, so capitalisation of borrowing costs will have ceased (see section 4.1.4 below). This is not necessarily the case with investment property in the course of construction (see Chapter 20 at section 2.5).

The cost of an asset, before adopting a policy of revaluation, will include capitalised borrowing costs. Thereafter, IAS 23 does not prohibit capitalisation of eligible borrowing costs for assets carried at fair value as a matter of accounting policy. *[IAS 23.4(a), IAS 23.BC4].* To the extent that entities choose to capitalise borrowing costs in respect of assets still in the course of construction that are carried at fair value, the methods allowed by IAS 23 should be followed.

For disclosure purposes, an entity will still need to monitor the carrying amount of PP&E measured under the revaluation model, including those borrowing costs that would have been recognised, had such an asset been carried under the cost model (see section 8.2 below).

4.1.3 Start up costs, administration and other general overheads

Administration and other general overhead costs are not costs of an item of PP&E. This means that employee costs not related to a specific asset, such as site selection activities and general management time do not qualify for capitalisation. Entities are also not allowed to recognise so-called 'start up costs' as part of the item of PP&E. These include costs related to opening a new facility, introducing a new product or service (including costs of advertising and promotional activities), conducting business in a new territory or with a new class of customer (including costs of staff training) and similar items. *[IAS 16.19]*. These costs should be accounted for in the same way as similar costs incurred as part of the entity's on-going activities (in general, expensed as incurred).

4.1.4 Cessation of capitalisation

Cost recognition ceases once an item of PP&E is in the location and condition necessary for it to be capable of operating in the manner intended by management. This will usually be the date of practical completion of the physical asset. IAS 16, therefore prohibits the recognition of relocation and reorganisation costs, costs incurred in using the asset or during the run up to full use once the asset is ready to be used, and any initial operating losses. *[IAS 16.20]*.

An entity is not precluded from continuing to capitalise costs during an initial commissioning period that is necessary for running in machinery or testing equipment. In contrast, no new costs should be capitalised if the asset is fully operational but is not yet achieving its targeted output, usage or profitability because demand is still building up, for example in a new hotel that initially has high room vacancies or a partially let investment property. In these cases, the asset is clearly in the location and condition necessary for it to be capable of operating in the manner intended by management.

Entities need to identify the point at which major assets are considered to be in the location and condition necessary for it to be capable of operating in the manner intended by management and apply that policy consistently.

4.1.5 Self-built assets

If an asset is self-built by the entity, the same general principles apply as for an acquired asset. The costs of abnormal amounts of wasted resources, whether labour, materials or other resources, are not included in the cost of such self-built assets. If the same type of asset is made for resale by the business, the cost of such an asset to be held as property, plant and equipment is usually the same as the cost of constructing that asset for sale, i.e., without including any internal profit element but including attributable overheads in accordance with IAS 2 (see Chapter 23). IAS 23, discussed in Chapter 22, contains criteria relating to the recognition of any interest as a component of the carrying amount of a self-built item of PP&E. *[IAS 16.22]*.

Kendrion N.V. provides an example of an accounting policy for self-built assets.

Practical example 4-1: Kendrion N.V. (2023) **The Netherlands**

Annual Integrated Report 2023 [extract]
FINANCIAL STATEMENTS [extract]
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]
Significant accounting policies [extract]
(c) Property, plant and equipment [extract]
(i) Owned assets [extract]

(i) Owned assets

Items of property, plant and equipment are measured at cost or assumed cost less accumulated depreciation and accumulated impairment losses (see accounting policy g). The cost includes expenditure that is directly attributable to the acquisition of the asset. The cost of self-constructed assets includes the cost of materials, direct labour, the initial estimate, where relevant, of the costs of dismantling and removing the items and reinstating the site on which they are located, a reasonable proportion of production overheads, and capitalized borrowing costs.

...

4.1.6 Deferred payment

IAS 16 specifically precludes the capitalisation of hidden credit charges as part of the cost of an item of PP&E, so the cost of an item of PP&E is its cash price equivalent at the recognition date. This means that if payment is made in some other manner, the cost to be capitalised is the normal cash price. Thus, if the payment terms are extended beyond 'normal' credit terms, the cost to be recognised must be the cash price equivalent and any difference between the cash price equivalent and the total payment must be treated and recognised as an interest expense over the period of credit unless such interest is capitalised in accordance with IAS 23 (see section 4.1.2 above). *[IAS 16.23]*. Right-of-use assets under IFRS 16 are discussed in Chapter 24. Assets partly paid for by government grants are discussed in Chapter 25.

4.1.7 Land and buildings to be redeveloped

It is common for property developers to acquire land with an existing building where the planned redevelopment necessitates the demolition of that building and its replacement with a new building that is to be held to earn rentals or will be owner occupied.

How we see it

IAS 16 requires that the building and land be classified as two separate items (see section 5.4.2 below). In our view it is appropriate, if the existing building is unusable or likely to be demolished by any party acquiring it, that the entire or a large part of the purchase price be allocated to the land. Similarly, subsequent demolition costs should be treated as being attributable to the cost of the land.

Entities replacing an existing building with a building held to earn rentals or capital appreciation or a building to be sold in the ordinary course of their business will deal with the land and buildings under IAS 40 (see Chapter 20 at section 4.2.1) or IAS 2 (see Chapter 23 at section 4.2.2), respectively.

Owner-occupiers may also take the decision to replace existing buildings which they have previously occupied with new facilities for their own use, to rent to others or to be held for capital appreciation or sold in the ordinary course of the entity's business.

How we see it

Here the consequences are different and the carrying amount of the existing building cannot be rolled into the costs of the new development. In this case, the land and buildings have already previously been separately recognised as assets under IAS 16. The existing building must be depreciated over its remaining useful life to reduce the carrying amount of the asset to its residual value (presumably nil) at the point at which it is demolished.

Consideration will have to be given as to whether the asset is impaired in accordance with IAS 36 (see section 5.7 below). Many properties do not directly generate independent cash inflows (i.e., they are part of a cash-generating unit) and reducing the useful life will not necessarily lead to an impairment of the cash-generating unit (meaning the property itself may initially be shielded from impairment). However, by the time the asset has been designated for demolition it may no longer be part of a cash-generating unit (see Chapter 21 at sections 2.1.3 and 3).

4.1.8 Transfers of assets from customers

An entity may be entitled to consideration in the form of goods, services or other non-cash consideration (e.g., PP&E), in exchange for transferring goods or services to a customer. Examples include:

- A supplier who receives a contribution to the development costs of specific tooling equipment from another manufacturer to whom the supplier will sell parts, using that specific tooling equipment under a supply agreement.
- Suppliers of utilities who receive items of PP&E from customers that are used to connect them to a network through which they will receive ongoing services (e.g., electricity, gas, water or telephone services). A typical arrangement is one in which a builder or individual householder must pay for power cables, pipes, or other connections.
- In outsourcing arrangements, the existing assets are often contributed to the service provider, or the customer must pay for assets, or both.

This raises questions about recognising assets for which the entity has not paid. In what circumstances should the entity recognise these assets, how should it be measured on initial recognition and how is the 'other side' of the accounting entry dealt with? Is it revenue and if so, how and over what period is it recognised? There are a number of potential answers to this and, unsurprisingly, there is variety in practice.

When an entity (i.e., the seller or vendor) receives, or expects to receive, non-cash consideration from a customer in relation to a revenue contract that is within the scope of IFRS 15 *Revenue from Contracts with Customers*, the fair value of the non-cash consideration is included in the transaction price. *[IFRS 15.66]*. The IFRS 15 requirements regarding non-cash consideration are discussed in detail in Chapter 28 at section 5.6. The Basis for Conclusions on IFRS 15 states that "once recognised, any asset arising from the non-cash consideration would be measured and accounted for in accordance with other relevant requirements …" (e.g., IAS 16). *[IFRS 15.BC253]*. As such, the fair value measured in accordance with IFRS 15 would be the deemed cost of the item of PP&E on initial recognition.

4.1.9 Variable and contingent consideration

The purchase price of an item of PP&E might include variable or contingent amounts. Transactions involving variable or contingent consideration are often very complex and payment may depend on a number of factors. Examples include variable or contingent payments based on an index or rate, variable or contingent payments which depend upon the purchasers' future actions, variable or contingent payments related to the condition of the asset, or variable or contingent payments related to the asset's performance. Some arrangements may contain more than one source of variability. Further complexity can also arise when arrangements are akin to profit sharing agreements which are not addressed in any standard.

The topic of variable payments for an asset purchase was discussed by the IFRS IC between 2011 and 2016, and an agenda decision was published in March 2016. The IFRS IC's discussions considered both the accounting at the date of purchasing the asset and subsequently, and distinguished between those variable payments that depend on the purchaser's future activity and those that do not. The IFRS IC determined that the issue was too broad for it to address within the confines of existing standards and recommended that the IASB address the accounting for variable payments comprehensively. In May 2016, the IASB tentatively agreed that this issue would be included in the research pipeline between 2017 and 2021. At the time of writing this is not listed as an active research project on the IASB's work plan.

A critical step in analysing the accounting for the purchase of an item of PP&E in an arrangement involving variable or contingent consideration is to fully understand the contractual arrangements, understanding the nature of the contingent or variable payments. This includes developing a full understanding of whether those contingent payments are linked to the initial value of the asset, or to its future performance, whether the contingency or variability is within or outside of the purchasers' control and whether the variable payment is a payment for some other goods or services from the seller. In some cases, the contract may establish an obligation for the contingent payment at the outset, whilst in others it might be determined that the arrangement is an executory contract, and the liability to make the contingent payments is only recognised later once either party fulfils its obligations under the contract.

The two key issues with regards to the accounting for variable consideration in an asset purchase are 1) whether and when to recognise a liability for that variable consideration, and 2) whether subsequent changes to the estimate of variable or contingent consideration should be accounted for as part of the cost of the acquired asset.

Looking at the first question of when a liability to make variable or contingent payments would be recognised, if the arrangement is not considered to be an executory contract, one consideration is whether those payments are dependent on the entity's future activity, or not.

IAS 32.25 stipulates that where the contingency is outside the control of both the issuer and the holder, a contingent obligation to deliver cash meets the definition of a financial liability (see Chapter 43 at section 4.3). Therefore, if the obligation to make the variable payment does not depend on the acquiring entity's future activity, it would seem appropriate to recognise a financial liability in respect of the contingent amounts. *[IAS 32.25].* However, it is acknowledged that whilst this view was tentatively agreed during the course of the IFRS IC discussions on the topic, ultimately, this was not clarified or confirmed as part of the final agenda decision. Furthermore, the final agenda decision notes that there are questions about the accounting for variable payments subsequent to the purchase of the asset, and in making that statement the IFRS IC did not distinguish between the different types of variable payments.

How we see it

In light of the discussions held by the IFRS IC and the absence of clear guidance in the final agenda decision, entities will need to develop and apply an accounting policy in respect of whether and when the obligation to make contingent payments is recognised as a liability. In doing so, entities will need to apply the hierarchy in IAS 8. The policy selected should result in information that is relevant and reliable in the particular circumstances and must be consistently applied to similar transactions. Different payments may have different types of variability. Therefore, it might be appropriate for an entity to have different policies for dissimilar transactions.

If information about the selected accounting policy is expected to be material to users of the financial statements, that accounting policy information should be disclosed.

As described above, there is no explicit guidance on the treatment of variable or contingent consideration in the acquisition of an asset and there is diversity in practice for these types of arrangements. Therefore, examples of some accounting policies an entity may want to consider regarding initial recognition of the asset include the following:

- The cost of the asset on initial recognition includes the fair value of all variable or contingent consideration at the date of acquisition. A corresponding liability is recognised for the same amount.
- The cost of the asset on initial recognition excludes any variable or contingent payments. Accordingly, no liability is recognised for those contingent or variable amounts.

The second question that needs to be addressed is how the entity must account for subsequent payments and changes to the estimate of variable or contingent consideration. Depending on the facts and circumstances of the arrangement an entity may determine that:

1. Variability arises from exchange rates, time value of money, or embedded derivatives - Changes in the carrying amount of a recognised liability that arise from exchange rates are accounted for in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates* and IFRIC 22 *Foreign Currency Transactions and Advance Consideration*, while the time value of money and embedded derivatives are accounted for in accordance with IFRS 9 *Financial Instruments*;
2. Variability is directly linked to the quality or quantity of the asset(s) received - In these cases the initial recognition of the asset and liability were based on an accounting estimate that is subsequently updated in accordance with IAS 8.37; or
3. The variability in the arrangement does not fall under (1) or (2) above and an accounting policy needs to be developed to address it.

In the latter case, an entity will need to apply the requirements of IAS 8 to develop an accounting policy that it should apply consistently to all similar transactions. The accounting policy developed will need to address whether the change in the estimate of variable or contingent consideration should be capitalised as part of the cost of the asset or expensed. This determination is usually based on the reason for the contingent payment and entities should consider the substance of the arrangement in determining the appropriate treatment.

It is only appropriate for subsequent changes to a recognised liability to be recognised as part of the cost of the asset to the extent that it relates to future economic benefits embodied in the asset initially received. For example, if the contingency or variability is viewed as being linked to the quality or quantity of the asset initially received. Variability arising due to other factors, such as its use over time, would generally be expensed.

How we see it

Until this matter is resolved by the IASB, where the accounting for the variability or contingency is not prescribed in another standard, an entity should adopt and apply a consistent accounting policy in relation to whether subsequent payments or changes to the measurement of a recognised liability to make contingent or variable payments are included as part of the cost of an acquired asset or expensed as incurred, in accordance with the hierarchy in IAS 8.

An entity should exercise judgement in developing and consistently applying an accounting policy that results in information that is relevant and reliable in the particular circumstances.

If information about the selected accounting policy is expected to be material to users of the financial statements, that accounting policy information should be disclosed.

4.1.10 Acquisition of a group of assets

The purchase price of an individual item of PP&E may be an allocation of the price paid for a group of assets. If an entity acquires a group of assets that do not comprise a business ('the group'), such a transaction is outside the scope of IFRS 3 *Business Combinations*, but nonetheless, IFRS 3 sets out specific principles to be applied in order to allocate the entire cost to individual items (see Chapter 10 at section 2.2.2). These principles differ from the approach required for a business combination. In such cases, the acquirer should identify and recognise the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, intangible assets in IAS 38) and liabilities assumed. The cost of the group should be allocated to the individual identifiable assets and liabilities based on their relative fair values at the date of purchase. Such a transaction or event does not give rise to goodwill. *[IFRS 3.2(b)]*.

Frequently asked questions

Question 4-1: How does an entity account for the acquisition of a group of assets that does not constitute a business?

In November 2017, the IFRS IC issued an agenda decision that clarified how to account for a group of assets that does not constitute a business. The agenda decision more specifically addressed how to allocate the transaction price to the identifiable assets acquired and liabilities assumed when the sum of the individual fair values of the identifiable assets and liabilities is different from the transaction price, and the group includes identifiable assets and liabilities initially measured both at cost and at an amount other than cost.

The IFRS IC concluded that a reasonable reading of the requirements in IFRS 3.2(b) (as described above) on the acquisition of the group, is that there are two possible approaches.[1] These two approaches are discussed in detail in Chapter 10 at section 2.2.2. See also similar discussion relating to investment property in Chapter 20 at section 4.1.1.

4.1.11 Dismantling and restoration costs

If an asset is used to produce inventories during a particular period, the costs of obligations that are incurred during that period to dismantle, remove or restore the site on which such asset has been located are not capitalised as part of the item of PP&E. Instead, these are costs of producing inventory and are dealt with in accordance with IAS 2 (see Chapter 23). *[IAS 16.18]*.

Site restoration costs and other environmental restoration and similar costs arising from the construction or commissioning of an asset must be estimated and capitalised at initial recognition, even if the expenditure will only be incurred at the end of the item's life. In addition, in some cases an obligation for such costs may arise later in the asset's life, for example as a result of changes in legislation. Such costs would also be capitalised as part of the cost of the item of PP&E. The obligations are calculated in accordance with IAS 37 and IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* (see section 4.3 below and Chapter 27 at section 6.3). *[IAS 16.16]*. This is illustrated in Practical example 4-2 below.

Practical example 4-2: E.ON SE (2023) Germany

Integrated Annual Report 2023 [extract]
Consolidated Financial Statements [extract]
Notes [extract]
(1) Summary of Significant Accounting Policies [extract]
Property, Plant and Equipment [extract]

Property, plant and equipment are initially measured at acquisition or production cost, including decommissioning or restoration cost that must be capitalized, and are depreciated over the expected useful lives of the components, generally using the straight-line method, unless a different method of depreciation is deemed more suitable in certain exceptional cases. Useful lives are regularly

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1 *IFRIC Update*, November 2017, available on the IFRS Foundation's website.

Provisions for Asset Retirement Obligations and Other Miscellaneous Provisions [extract]

Obligations arising from the decommissioning or dismantling of property, plant and equipment are recognized during the period of their occurrence at their discounted settlement amounts, provided that the obligation can be reliably estimated, whereby no negative discount rates are applied. The carrying amounts of the respective property, plant and equipment are increased by the same amounts. In subsequent periods, capitalized asset retirement costs are amortized over the expected remaining useful lives of the assets, and the provision is accreted to its present value on an annual basis. Advance payments remitted are deducted from the provisions.

...

4.1.12 Cost of property, plant and equipment acquired in a business combination

When property, plant and equipment is acquired as part of a business combination, those items are initially measured at their acquisition-date fair values. This acquisition date fair value forms the cost of the asset for the purposes of subsequent measurement. The accounting for business combinations under IFRS 3 is discussed in Chapter 10.

4.2 Incidental and non-incidental income

Under IAS 16, the cost of an item of PP&E includes any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. *[IAS 16.16(b)]*. However, before or during the construction of an asset, an entity may enter into incidental operations that are not, in themselves, necessary to meet this objective. *[IAS 16.21]*.

The standard gives the example of income earned by using a building site as a car park prior to starting construction. Because these incidental operations are not required in order to bring an asset to the location or condition necessary for it to be capable of operating in the manner intended by management, the resulting income and related expenses are recognised in profit or loss and included in their respective classifications of income and expense. *[IAS 16.21]*. Such incidental income and related expenses are not included in determining the cost of the asset.

If the asset is already in the location and condition necessary for it to be capable of being used in the manner intended by management then IAS 16 requires capitalisation to cease and depreciation to start. *[IAS 16.20, IAS 16.55]*. In these circumstances, all income earned from using the asset must be recognised as revenue in profit or loss and the related costs should include an element of depreciation of the asset.

4.2.1 Income earned before the asset is available for use

Proceeds from selling items produced whilst bringing an item of PP&E into the location and condition necessary for it to be capable of operating in the manner intended by management, and the cost of those items, shall be recognised in profit or loss. The cost of those items shall be determined by applying the measurement requirements of IAS 2. *[IAS 16.20A]*.

The Board decided to require the application of IAS 2 in determining the cost of selling such items because:

- IAS 2 sets out a framework for measuring cost without being overly prescriptive; and
- an entity would already be required to apply IAS 2 in measuring cost if the entity were to determine that the sale of items produced is an output of its ordinary activities - in this case, the items produced would meet IAS 2's definition of inventories. The Board noted that it would be useful to apply the same requirements to the cost of items produced irrespective of whether the sale of those items is an output of an entity's ordinary activities. *[IAS 16.BC16I]*.

How we see it

IAS 16 requires entities to apply IAS 2 in determining the cost of output produced while bringing an item of PP&E to the location and condition necessary for it to be capable of operating in the manner intended by management.

IAS 2 sets out a framework to identify production costs, but its application requires judgement. The cost of inventories comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition, which includes a systematic allocation of fixed and variable production overheads. In our view, it would not be appropriate for entities to limit the costs included in the measurement of such items to only those that are incremental. The term 'incremental costs' is not defined in IAS 2 and therefore judgement will be required. The measurement of cost of inventories is discussed in further detail in Chapter 23 at section 3.

4.2.2 Liquidated damages during construction

Income may arise in other ways, for example, liquidated damages received as a result of delays by a contractor constructing an asset.

Normally, purchasing PP&E does not give rise to income. Therefore, in the absence of specific reference to compensating for losses in a liquidated damage clause, the liquidated damages received are treated as a reduction in the cost of the related assets.

The rationale for this approach is consistent with the conclusion that, rather than damages for delay, the contract provides for an additional payment in the event of early completion. For example, a contract having a value of CU1,000 in which the supplier incurs a CU100 penalty for late delivery after 1 January 20X0 is in substance the same as a contract with a value of CU900 in which the supplier is entitled to an additional payment of CU100 for an early completion before 1 January 20X0. Therefore, the cost of the asset is the total price paid to acquire it, including the premium for early completion (i.e., CU1,000 if finished before 1 January 20X0 and CU900 if finished after 1 January 20X0). This gives the same result as with liquidated damages.

However, when the liquidated damages clause in a contract refers to compensating the affected party for any revenue lost or reimbursement of specific costs incurred because of delay in the completion of the project, then recognising as income or deducting against specifically reimbursed costs is more consistent with the purpose of the liquidated damages clause.

How we see it

Normally, such damages received should be set off against the asset cost - the purchase price of the asset is reduced to compensate for delays in delivery. However, if the agreement specifically provides liquidated damages to compensate for loss of revenue arising because of contract delays, and the basis is clearly related to income lost, then the damages received are recognised as income.

4.3 Accounting for changes in decommissioning and restoration costs

IAS 16 requires the initial estimate of the costs of dismantling and removing an item of PP&E and restoring the site on which it is located to be included as part of the item's cost. This applies regardless of whether the obligation is incurred when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period. *[IAS 16.16]*. See section 4.1.11 above. However, IAS 16 does not address the extent to which an item's carrying amount should be affected by changes in the estimated amount of dismantling and site restoration costs that occur after the estimate made upon initial measurement. This issue is the subject of IFRIC 1, which applies to any decommissioning, restoration or similar liability that has been both included as part of the cost of an asset measured in accordance with IAS 16 and recognised as a liability in accordance with IAS 37. *[IFRIC 1.2]*. IFRIC 1 deals with the impact of events that change the measurement of an existing decommissioning, restoration or similar liability. Events include a change in the estimated cash flows, a change in the discount rate and the unwinding of the discount. *[IFRIC 1.3]*. Changes to the measurement of a decommissioning liability arising from the periodic unwinding of the discount must be recognised in profit or loss as a finance cost, and thus do not impact the measurement of the related asset. The impact of other changes depends on whether the cost or the revaluation model has been applied.

This is discussed in detail in Chapter 27 at section 6.3.

The effects of climate change may have implications for an entity's decommissioning liabilities. If the useful life of an item of PP&E is shorter than previously expected (see section 5.4.5 below), this would result in earlier decommissioning and would increase both the decommissioning provision and the decommissioning component of the asset as a result of the discounting effect. In addition, it should be noted that IFRIC 1 creates profit and loss volatility in the case of end-of-life assets, which have a carrying amount that is small compared to the potential movements in the decommissioning liability.

4.4 Exchanges of assets

An entity might swap an asset it does not require in a particular area, for one it does in another - the opposite being the case for the counterparty. Such exchanges are not uncommon in the telecommunications, media and leisure businesses, particularly after an acquisition, as well as in extractive industries (see Chapter 39 at section 6.3). Governmental competition rules sometimes require such exchanges. The question arises whether such transactions give rise to a gain in circumstances where the carrying value of the outgoing facility is less than the fair value of the incoming one. This can occur when carrying values are less than market values, although it is possible that a transaction with no real commercial substance could be arranged solely to boost apparent profits.

IAS 16 requires all acquisitions of PP&E in exchange for non-monetary assets, or a combination of monetary and non-monetary assets, to be measured at fair value, subject to conditions:

"The cost of such an item of property, plant and equipment is measured at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received, nor the asset given up is reliably measurable. The acquired item is measured in this way even if an entity cannot immediately derecognise the asset given up." *[IAS 16.24]*.

The IASB concluded that the recognition of income from an exchange of assets does not depend on whether the assets exchanged are dissimilar. *[IAS 16.BC19]*.

If at least one of the two fair values can be measured reliably, then the fair value of the asset given up is used to measure the cost of the asset received, unless the fair value of the asset received is more clearly evident. *[IAS 16.26]*. If not, then the exchange is measured at the carrying value of the asset the entity no longer owns. *[IAS 16.24]*. For example, if the new asset's fair value is higher than the carrying amount of the old asset, a gain may be recognised.

This requirement is qualified by a 'commercial substance' test. If it is not possible to demonstrate that the transaction has commercial substance as defined by the standard (see section 4.4.1 below), assets received in exchange transactions will be recorded at the carrying value of the asset given up. *[IAS 16.24]*.

If the transaction passes the 'commercial substance' test, then IAS 16 requires the exchanged asset to be recorded at its fair value, as shown in illustration 4-3 below:

Illustration 4-3: Exchange of assets

An entity has land and office buildings with an aggregate carrying value of CU600,000 and a fair value of CU750,000. It exchanges the land and buildings for land and buildings (a manufacturing facility) in another location with a fair value of CU1 million, and makes an additional cash payment of CU250,000. The transaction has commercial substance.

The entity should recognise the land and buildings received at a cost of CU1 million (its fair value) and should recognise a profit on disposal of the land and buildings of CU150,000, calculated as shown below:

Fair value of asset received	1,000,000
Less:	
Carrying value of asset given up	(600,000)
Cash paid	(250,000)
Gain on disposal	150,000

As discussed in section 7 below, the standard requires gains or losses on items that have been derecognised to be included in profit or loss in the period of derecognition but does not allow gains on derecognition to be classified as revenue, except for certain assets previously held for rental. *[IAS 16.68, IAS 16.68A]*. It gives no further indication regarding their classification in profit or loss. Such exchanges of goods and services are also excluded from the scope of IFRS 15 if the non-monetary exchange is between entities in the same line of business to facilitate sales to customers or potential customers (see Chapter 28 at section 2.1.1). *[IFRS 15.5(d)]*.

4.4.1 Commercial substance

The commercial substance test was put in place as an anti-abuse provision to prevent gains from being recognised in income when the transaction had no discernible effect on the entity's economics. *[IAS 16.BC21]*. The commercial substance of an exchange is to be determined by forecasting and comparing the future cash flows budgeted to be generated by the incoming and outgoing assets. For there to be commercial substance, there must be a significant difference between the two forecasts. The standard sets out this requirement as follows: *[IAS 16.25]*

Extract from IAS 16

25 An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

(a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or

(b) the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange; and

(c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

For the purpose of determining whether an exchange transaction has commercial substance, the entity-specific value of the portion of the entity's operations affected by the transaction shall reflect post-tax cash flows. The result of these analyses may be clear without an entity having to perform detailed calculations.

As set out in the definitions of the standard, entity-specific value in item (b) above is the net present value of the future predicted cash flows from continuing use and disposal of the asset (see section 2.2 above). Post-tax cash flows should be used for this calculation. The standard contains no guidance on the discount rate to be used for this exercise, nor on any of the other parameters involved, but it does suggest that the result of these analyses might be clear without having to perform detailed calculations. *[IAS 16.25]*.

Particular care will have to be taken to ensure that the transaction has commercial substance as defined in the standard if an entity receives an item of PP&E in exchange for a similar asset of its own. Commercial substance may be difficult to demonstrate if the entity is exchanging an asset for a similar one in a similar location. In many cases, the risk, timing and amount of cash flows associated with similar assets in similar locations would not be significantly different. Similarly, it would be unusual if the entity-specific values of similar assets differed enough in any arm's length exchange transaction to meet condition (c). However, the risk, timing and amount of cash flows could differ if one asset were available for sale and the entity intended to sell it whereas the previous asset could not be realised by sale or only sold over a much longer timescale. It is feasible that such a transaction could meet conditions (a) and (c) above.

Other types of exchange are more likely to pass the 'commercial substance' test, for example exchanging an interest in an investment property for one that the entity uses for its own purposes. The entity has exchanged a rental stream and instead has an asset that contributes to the cash flows of the cash-generating unit of which it is a part. In this case, it is probable that the risk, timing and amount of the cash flows of the asset received would differ from the configuration of the cash flows of the asset transferred.

4.4.2 Reliably measurable

In the context of asset exchanges, the standard contains guidance on the reliable determination of fair values in the circumstances where market values do not exist. The 'reliable measurement' test for using fair value was included to measure these exchanges to minimise the risk that entities could 'manufacture' gains by attributing inflated values to the assets exchanged. *[IAS 16.BC23]*. Note that fair value is defined by reference to IFRS 13 *Fair Value Measurement* and that the requirements below are specific to asset exchanges in IAS 16.

Extract from IAS 16

26 The fair value of an asset is reliably measurable if (a) the variability in the range of reasonable fair value measurements is not significant for that asset or (b) the probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value. If an entity is able to measure reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure the cost of the asset received unless the fair value of the asset received is more clearly evident.

If the fair value of neither the asset given up nor the asset received can be measured reliably (i.e., neither (a) nor (b) above are met), the cost of the asset is measured at the carrying amount of the asset given up; this means there is no gain on the transaction. *[IAS 16.24]*.

No further guidance is given in IAS 16 on how to assemble a "range of reasonable fair value measurements" and the guidance in IFRS 13 should be followed (see Chapter 15). *[IAS 16.26]*.

4.5 Assets held under leases

IFRS 16 requires lessees to initially measure the right-of-use asset at the amount of the initial measurement of the lease liability, adjusted for lease prepayments, lease incentives received, initial direct costs and an estimate of restoration, removal and dismantling costs. IFRS 16 is discussed in detail in Chapter 24.

4.6 Assets acquired with the assistance of government grants

The carrying amount of an item of PP&E may be reduced by government grants in accordance with IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. *[IAS 16.28]*. This is one of the accounting treatments available which are discussed further in Chapter 25.

5 Measurement after recognition: Cost model and depreciation

IAS 16 allows one of two alternatives to be chosen as the accounting policy for measurement of PP&E after initial recognition. The choice made must be applied to an entire class of PP&E, which means that not all classes are required to have the same policy. *[IAS 16.29]*.

The first alternative is the cost model whereby the item, after recognition as an asset, is carried at cost less any accumulated depreciation and less any accumulated impairment losses. *[IAS 16.30]*. The second alternative is the revaluation model, whereby items of PP&E are carried at fair value at the date of the revaluation, less any subsequent accumulated depreciation and subsequent accumulated impairment losses. *[IAS 16.31]* The revaluation model is discussed in section 6 below.

An entity that uses the cost model for its investment property, as allowed by IAS 40, should apply the cost model in IAS 16 for owned investment property. *[IAS 16.5]*. Investment property held by a lessee as a right-of-use asset will be measured in accordance with IFRS 16 (see Chapter 24 at section 5.3.1.B).

Upon adoption of IFRS 17, an exemption from the requirement to apply either the cost model or the revaluation model under IAS 16 was introduced, which permits entities to elect to measure certain owner-occupied properties as if they were investment properties measured at fair value through profit or loss in accordance with IAS 40. *[IAS 16.29A, IAS 16.29B]*. This election is only available in certain specific circumstances and is discussed further in section 6 below.

5.1 Depreciation

After initial recognition, the standard requires the depreciable amount of an asset 'to be allocated on a systematic basis over its useful life'. *[IAS 16.50]*. Depreciable amount, residual value and useful life are all key concepts in determining the depreciation charge and are discussed at sections 5.3 and 5.4 below. Depreciation methods are discussed at 5.6.

The standard makes it clear that depreciation must be charged on all items of PP&E, including those carried under the revaluation model, even if the fair value of an asset is higher than its carrying amount, as long as the residual value of the asset is lower than its carrying amount. *[IAS 16.30, IAS 16.31, IAS 16.52]*. If the residual value exceeds the carrying amount, no depreciation is charged until the residual value once again decreases to less than the carrying amount (see section 5.3 below). *[IAS 16.54]*. IAS 16 makes it clear that the repair and maintenance of an asset do not, of themselves, negate the need to depreciate it. *[IAS 16.52]*.

There is no requirement in IAS 16 for an automatic impairment review if no depreciation is charged.

The depreciation charge for each period is recognised in profit or loss unless it forms part of the cost of another asset and is included in its carrying amount. *[IAS 16.48]*. Sometimes, the future economic benefits embodied in an asset are absorbed in producing other assets, for example, the depreciation of manufacturing plant and equipment is included as part of the cost of conversion of finished manufactured goods held in inventory in accordance with IAS 2, and similarly, depreciation of PP&E used for development activities may be included as part of the cost of an intangible asset recognised in accordance with IAS 38. *[IAS 16.49]*.

5.2 Depreciation of component parts of assets

Each part of an asset with a cost that is significant in relation to the total cost of the item must be depreciated separately, which means that the initial cost must be allocated between the significant parts by the entity. *[IAS 16.43, IAS 16.44]*. The standard refers to the airframe and engines of an aircraft as an example of parts that may be appropriate to depreciate separately. It also notes that similarly if an entity acquires PP&E subject to an operating lease in which it is the lessor, it may be appropriate to depreciate separately amounts reflected in the cost of that item that are attributable to favourable or unfavourable lease terms relative to market terms (see section 5.2.1 below). *[IAS 16.44]*.

A determination of the significant parts of office buildings can be seen in Practical example 5-1 below from Skanska AB. This policy may have been based on the construction methods used for the particular buildings as it is unusual to see a separation between foundation and frame for office buildings.

Practical example 5-1:	Skanska AB (publ) (2023)	Sweden

Annual and Sustainability Report 2023 [extract]

Financial information [extract]

Notes including accounting and valuation principles [extract]

Note 1. Consolidated accounting and valuation principles [extract]

IAS 16 Property, Plant and Equipment [extract]

IAS 16 Property, Plant and Equipment

Property, plant and equipment that consist of parts with different useful lives are treated as separate components of property, plant and equipment. Depreciation is performed on a straight-line basis during the estimated useful life, or based on degree of use, taking into account any residual value at the end of the period. The depreciation periods applied for office buildings breaks down as follows: foundation and frame, 50 years; installations, 35 years; and non-weight-bearing components, 15 years. In general, industrial buildings are depreciated over a 20-year period without allocation into separate components. Stone crushing and asphalt plants as well as concrete mixing plants are depreciated over 10 to 25 years depending on their condition when acquired and without being divided into separate components. For other buildings and equipment, division into separate components occurs only if major components with different useful lives can be identified. For other plant and equipment, the depreciation period is normally between three and 10 years. Minor equipment is recognized as an expense immediately. Gravel pits and stone quarries are depreciated as materials are removed. Land is not depreciated. Assessments of an asset's residual value and useful life are performed annually.

...

Because parts of an item of PP&E are identified by reference to the significance of their rather than their effect on depreciation, some parts may have the same useful lives and depreciation method as other significant parts of the same item. The standard allows them to be grouped for depreciation purposes. *[IAS 16.45]*. To the extent that an entity separately depreciates some parts of an item of PP&E, it also separately depreciates the remainder of the item. The remainder of such an asset consists of other parts that are individually not significant. If the entity has varying expectations for these parts, it may need to use approximation techniques to calculate an appropriate depreciation method for these parts in order to depreciate the remainder in a manner that faithfully represents the consumption pattern and/or useful life of such parts. *[IAS 16.46]*. The standard also allows an entity to separately depreciate such parts that are not significant in relation to the total cost of the whole asset. *[IAS 16.47]*.

5.2.1 Component accounting for in-place leases

IAS 16 sets out that if an entity acquires PP&E subject to an operating lease in which it is the lessor, it may be appropriate to separately depreciate amounts reflected in the cost of that item that are attributable to favourable or unfavourable lease terms relative to market terms. *[IAS 16.44]*.

This could be interpreted to mean that the 'favourable or unfavourable lease terms relative to market terms' should be considered as the only additional component other than the components that represent the physical substance of the building. However, the phrase could also be interpreted to mean that the intangible components are not limited to 'favourable or unfavourable lease terms relative to market terms', but that further components can be identified in respect of in-place leases at market terms. This component would reflect the potential cost savings with respect to direct costs associated with obtaining a new tenant and opportunity costs associated with lost rentals.

Two approaches have developed in practice:

- Identify the favourable/unfavourable leases as a separate component, but do not identify the in-place leases at market terms as a separate component.

  Or

- Identify both the favourable/unfavourable leases and the in-place leases at market terms as separate components.

Under either approach, the entity includes the depreciation of any identified component in depreciation expense rather than revenue.

These approaches are shown in Illustration 5-1 below.

How we see it

For the purpose of applying the component approach with respect to in-place leases, we believe either of the two approaches referred to above is acceptable. The accounting policy must be applied consistently.

Illustration 5-1: Applying the component approach for in-place leases

As part of a business combination, an entity acquires a building that is currently let to several lessees under operating leases (i.e., the acquiree is the lessor). Some of the in-place leases are at non-market terms (i.e., are at favourable or unfavourable terms relative to current market terms). The building itself is considered to be one component.

The entity initially measures the investment property at fair value in accordance with IFRS 3. After initial recognition, the entity applies the cost model to the investment property under IAS 40. The entity may use either of the two following approaches when applying the component approach with respect to in-place leases:

Approach 1

After initial recognition, the entity identifies the favourable/unfavourable leases as a separate component of the investment property in accordance with IAS 16.44 but does not identify the in-place leases at market terms as a separate component. The carrying amount of the tangible components of the building (e.g., roof, façade, electricity cables, and remaining structure), would in this case exclude the effects of favourable and unfavourable leases, but would include the in-place leases at market terms. The combined amount of all components will equal the carrying amount of the investment property. Each component is depreciated separately.

Approach 2

After initial recognition, the entity identifies both the favourable/unfavourable leases and the in-place leases at market terms as separate components. The carrying amount of the tangible components of the building would in this case exclude both the effects of favourable and unfavourable leases as well as the in-place leases at market terms. The combined amount of all components will equal the carrying amount of the investment property. Each component is depreciated separately.

5.3 Depreciable amount and residual values

The depreciable amount of an item of PP&E is its cost, or other amount substituted for cost (e.g., valuation), less its estimated residual value. *[IAS 16.6]*. The standard states that an entity should review the residual value of an item of PP&E, and therefore all parts of it, at least at each financial year-end. If the estimated residual value differs from the previous estimate, the change should be accounted for prospectively as a change in accounting estimate in accordance with IAS 8 (see Chapter 3 at section 4.5). *[IAS 16.51]*.

The residual value of an item of PP&E is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and assuming that it was already in the condition it will be in at the end of its useful life. *[IAS 16.6]*. Therefore, IAS 16 contains an element of continuous updating of residual values because it is the current disposal amount (e.g., value at financial reporting date) of an asset's future state (i.e., asset's condition in the future when the entity expects to dispose of it). This means that only the changes up to the financial reporting date are taken into account and that expected future changes in residual value other than the effects of expected wear and tear are not taken into account. *[IAS 16.BC29]*.

Climate change has the potential to affect the residual value of PP&E and such considerations should form a part of an entity's continuous assessment of residual values. For example, while residual values of PP&E assets are generally fairly predictable, this is not necessarily the case if there are relatively few buyers of second-hand PP&E assets that use technologies that are being phased out before a legal deadline. In Practical example 5-2 below, easyJet Plc describes how the residual values of its fleet are affected by climate change:

Practical example 5-2: easyJet plc (2023) **United Kingdom**

Annual Report and Accounts 2023 [extract]

Financials statements [extract]

NOTES TO THE FINANCIAL STATEMENTS [extract]

1. ACCOUNTING POLICIES, JUDGEMENTS AND ESTIMATES [extract]

1A. SIGNIFICANT ACCOUNTING POLICIES [extract]

Property, plant and equipment [extract]

> Residual values are reviewed annually, at the end of the reporting period, against prevailing market rates for assets of an equivalent age, and the depreciation applied is adjusted accordingly on a prospective basis. The carrying value of PPE assets is part of the Airline CGU and is therefore reviewed for impairment at least annually or when there is any indication of impairment within the CGU. For aircraft, easyJet is dependent on Airbus as its sole supplier. This gives rise to an increased valuation risk, which crystallises when aircraft exit the fleet, where easyJet is reliant on the future demand for second-hand aircraft and specifically Airbus aircraft. Future developments, such as the impact of climate change on the market, technological, economic or legal environment, are considered when assessing residual values and UELs.
>
> ...

As any change in the residual value directly affects the depreciable amount, it may also affect the depreciation charge. This is because the depreciable amount (i.e., the amount actually charged to profit or loss over the life of the asset) is calculated by deducting the residual value from the cost (or other amount substituted for cost, such as valuation) of the asset. Sometimes, the residual value of an asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the residual value is capped at the asset's carrying amount. This means that in such a case, the asset's depreciation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount. *[IAS 16.53, IAS 16.54]*.

In practice, many items of PP&E have a negligible residual value. This is usually because they are kept for substantially all of their economic lives, such that the useful life as assessed under IAS 16 is consistent with the assets' total economic life. Residual values are of no relevance if the entity intends to keep the asset until it is of no use to anyone else. If an entity uses residual values based on prices fetched in the market for a type of asset that it holds, it must be able to demonstrate that there is a viable manner and an intention to dispose of that asset before the end of its economic life. However, one example in which residual values are expected to be more significant would be in the case of collectibles meeting the definition of PP&E (see section 2.1 above). At initial recognition, the residual value of a collectible is often close to its purchase price, and therefore, the depreciable amount of such a collectible is negligible.

The requirement concerning the residual values of assets highlights how important it is that residual values are considered and reviewed in conjunction with the review of useful lives. The useful life is the period over which the entity expects to use the asset, not the asset's economic life.

As discussed above, the residual value of an item of PP&E is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal. IAS 16 does not define 'costs of disposal'. For many entities the estimated cost of disposal will be immaterial, but an entity that incurs more significant costs associated with disposing of PP&E will need to apply judgement in determining the appropriate costs to include. Entities may apply the hierarchy in IAS 8 to develop an appropriate policy in this area. This may be particularly relevant to certain types of entity, such as leasing companies that incur significant selling costs in routinely disposing of assets previously held for rental (see section 7.2 below for further discussion).

5.4 Useful lives

One of the critical assumptions on which the depreciation charge depends is the useful life of the asset. The standard requires the useful life of an asset to be estimated on a realistic basis and reviewed at least at the end of each financial year. The effects of changes in useful life are to be recognised prospectively as changes in accounting estimates in accordance with IAS 8 (see Chapter 3 at section 4.5), over the remaining useful life of the asset. *[IAS 16.51]*.

As described in section 2.2 above, the useful life of an asset is defined in terms of the asset's expected utility to the entity. *[IAS 16.57]*. It is the period over which the present owner will benefit from using the asset and not the total potential life of the asset; the two will often not be the same.

It is quite possible for an asset's useful life to be shorter than its economic life. The estimation of the useful life of the asset is a matter of judgement based on the experience of the entity with similar assets. Many entities have an asset management policy that may involve disposal of assets after a specified time or after consumption of a specified proportion of the future economic benefits embodied in the assets. *[IAS 16.57]*. This is particularly common with property and motor vehicles, where there are effective second-hand markets, but less usual for plant and machinery. For example, an entity may have a policy of replacing all of its motor vehicles after three years, so this will be their estimated useful life for depreciation purposes. The entity will depreciate them over this period down to the estimated residual value. The residual values of motor vehicles are often easy to obtain and the entity will be able to reassess these residuals in line with the requirements of the standard. Thus, the estimation of the useful life of the asset is a matter of judgement based on the experience of the entity with similar assets. *[IAS 16.57]*.

The future economic benefits embodied in an asset are consumed principally through usage. Other factors, however, should be taken into account such as technical or commercial obsolescence and wear and tear while an asset remains idle because they often result in the diminution of the economic benefits expected to be obtained from the asset. Consequently, IAS 16 provides guidance that all the following factors are to be considered when estimating the useful life of an asset: *[IAS 16.56]*

Extract from IAS 16

56 The future economic benefits embodied in an asset are consumed by an entity principally through its use. However, other factors, such as technical or commercial obsolescence and wear and tear while an asset remains idle, often result in the diminution of the economic benefits that might have been obtained from the asset. Consequently, all the following factors are considered in determining the useful life of an asset:

(a) expected usage of the asset. Usage is assessed by reference to the asset's expected capacity or physical output.

(b) expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle.

(c) technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset. Expected future reductions in the selling price of an item that was produced using an asset could indicate the expectation of technical or commercial obsolescence of the asset, which, in turn, might reflect a reduction of the future economic benefits embodied in the asset.

(d) legal or similar limits on the use of the asset, such as the expiry dates of related leases.

ArcelorMittal is an example of an entity depreciating an asset over its expected usage by reference to the production period:

Practical example 5-3: ArcelorMittal (2023) Luxembourg

Annual Report 2023 [extract]
Consolidated Financial Statements [extract]
Notes to the consolidated financial statements [extract]
NOTE 5: GOODWILL, INTANGIBLE AND TANGIBLE ASSETS [extract]
5.2 Property, plant and equipment and biological assets [extract]

Property, plant and equipment used in mining activities is depreciated over its useful life or over the remaining life of the mine, if shorter, and if there is no alternative use. For the majority of assets used in mining activities, the economic benefits from the asset are consumed in a pattern which is linked to the production level and accordingly, assets used in mining activities are primarily depreciated on a units-of-production basis. A unit-of-production is based on the available estimate of proven and probable reserves.

...

5.4.1 Repairs and maintenance

The initial assessment of the useful life of the asset will take into account the expected routine spending on repairs and expenditure necessary for it to achieve that life. Although IAS 16 implies that this refers to an item of plant and machinery, care and maintenance programmes are relevant to assessing the useful lives of many other types of assets. For example, an entity may assess the useful life of a railway engine at thirty-five years on the assumption that it has a major overhaul every seven years. Without this expenditure, the life of the engine would be much less certain and could be much shorter. Maintenance necessary to support the fabric of a building and its service potential will also be taken into account in assessing its useful life. Eventually, it will always become uneconomic for the entity to continue to maintain the asset so, while the expenditure may lengthen the useful life, it is unlikely to make it indefinite.

Note that this applies whether the expenditure is capitalised because it meets the definition of a 'major inspection' (see section 3.3.2 above) or if it is repairs and maintenance that is expensed as incurred.

5.4.2 Land

The standard requires the land and the building elements of property to be accounted for as separate components, even when they are acquired together. Land, which usually has an unlimited life, is not usually depreciated, while buildings are depreciable assets because they have limited useful life. IAS 16 states that the determination of the depreciable amount and useful life of a building is not affected by an increase in the value of the land on which it stands. *[IAS 16.58]*.

There are circumstances in which depreciation may be applied to land. In those instances, in which land has a finite life (e.g., land that is used either for extractive purposes such as a quarry or mine, or for some purpose such as landfill), it will be depreciated in an appropriate manner that reflects the benefits to be derived from it. *[IAS 16.58]*. Further, the cost of land may include an element for site dismantlement, removal or restoration, e.g., the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, and any subsequent changes thereto (described in section 4.3 above). *[IAS 16.16]*. This element will have to be separated from the land element and depreciated over an appropriate period. The standard describes this as "the period of benefits obtained by incurring these costs …" which will often be the estimated useful life of the site for its purpose and function. *[IAS 16.59]*. An entity engaged in landfill on a new site may make a provision for restoring it as soon as it starts preparation by removing the overburden. It will separate the land from the 'restoration asset' and depreciate the restoration asset over the landfill site's estimated useful life. If the land has an infinite useful life, an appropriate depreciation basis will have to be chosen that reflects the period of benefits obtained from the restoration asset.

If the estimated costs are revised in accordance with IFRIC 1, the adjusted depreciable amount of the asset is depreciated over its useful life. Therefore, once the related asset has reached the end of its useful life, all subsequent changes in the liability will be recognised in profit or loss as they occur, irrespective of whether the entity applies the cost or revaluation model. *[IFRIC 1.7]*.

5.4.3 Technological change

A current or expected future reduction in the market demand for the product or service output of an asset may be evidence of technical or commercial obsolescence, which, in turn, might reflect a reduction of the future economic benefits embodied in the asset. If an entity anticipates such technical or commercial obsolescence, it should reassess both the useful life of an asset and the pattern of consumption of future economic benefits. *[IAS 16.56(c), IAS 16.61]*. In such cases, it might be more appropriate to use a diminishing balance method of depreciation to reflect the pattern of consumption (see section 5.6.3 below).

The effects of technological change are often underestimated. It affects many assets, not only high technology plant and equipment. For example, many offices that have been purpose-built can become obsolete long before their fabric has physically deteriorated, for reasons such as the difficulty of introducing computer network infrastructures or air conditioning, poor environmental performance or an inability to meet new legislative requirements such as access for people with disabilities. Another example might be climate-related factors driving technological change. Therefore, the estimation of an asset's useful life is a matter of judgement and the possibility of technological change must be taken into account. *[IAS 16.56(c), IAS 16.57]*.

5.4.4 Depreciation period of leasehold improvements

All the factors listed in IAS 16.56 should be considered when estimating the useful life of an asset (see section 5.4 above). *[IAS 16.56]*. Factor (d)) states that the "expiry dates of related leases …" is considered when determining the asset's useful life. Generally, the useful life of the leasehold improvement is the same or less than the lease term.

The interaction between the useful life of leasehold improvements and the term of the associated lease was discussed by the IFRS IC in November 2019. The IFRS IC concluded that an entity applies IAS 16.56 and 57 in determining the useful life of non-removable leasehold improvements. If the lease term of the related lease is shorter than the economic life of those leasehold improvements, the entity considers whether it expects to use the leasehold improvements beyond that lease term. If the leasehold improvements are not expected to be used beyond the lease term, then an entity should conclude that the useful life of the non-removable leasehold improvements is the same as the lease term.[2] This issue is discussed in Chapter 24 at section 4.4.1.B in the context of cancellable leases. 'Lease term' under IFRS 16 is discussed in Chapter 24 at section 4.4.1.

However, if the leasehold improvements are expected to be used beyond the lease term, we believe two approaches to determine the useful life of the leasehold improvements are acceptable. The two approaches are shown in Illustration 5-2 below. The entity must adopt one of the approaches to determine the useful life of the leasehold improvement. This approach should be applied consistently to similar leasehold improvements with similar fact patterns.

Illustration 5-2: Depreciation period of leasehold improvements

A lessee enters into a lease for an office property. The lease has a non-cancellable term of 5 years and contains an option for the lessee to extend the lease for a further 5 years. The rentals for the period under the extension option (i.e., years 6-10) are at market rates.

Upon commencement of the lease term, the lessee incurs CU100,000 constructing immoveable leasehold improvements specific to the property. The useful life of the leasehold improvement is 7 years. At the commencement date of the lease, the lessee expects, but is not reasonably certain, to exercise the extension option. At the commencement date of the lease, the lessee appropriately considered the potential economic penalty associated with abandoning the leasehold improvements when determining the lease term is 5 years.

In our fact pattern, the lessee's investment in the leasehold improvement does not create a significant economic penalty that would affect the lease term for accounting purposes. That is, the economic penalty of abandoning the leasehold improvement at the end of the non-cancellable term of the lease is not so significant as to make exercise of the renewal option reasonably certain.

The relevant requirements may be subject to two different interpretations:

Approach (1):

The lessee may depreciate the leasehold improvements over a period that is the shorter of the lease term or the assets' useful life (i.e., the lessee depreciates the leasehold improvement over the lease term of 5 years in the fact pattern).

This approach is based on the following interpretation: In this fact pattern, at the commencement date of the lease, the lessee appropriately considered all relevant facts and circumstances (including the economic penalty associated with abandoning the leasehold improvements) and concluded it expects but is not reasonably certain to exercise the option to extend the lease. Therefore, for the purpose of IFRS 16, the lease term is 5 years. *[IFRS 16 Appendix A]*. One of the factors in determining the useful life of the leasehold improvement is the expiry date of the related lease. *[IAS 16.6, IAS 16.56(d)]*. The expected utility of the leasehold improvement should be consistent with the lease term as determined in accordance with IFRS 16. Therefore, the useful life of the leasehold improvements is 5 years.

Approach (2):

The lessee may depreciate the leasehold improvements over the expected useful life of the leasehold improvement (i.e., the lessee depreciates the leasehold improvement over 7 years in the fact pattern).

While IAS 16.56(d) should be considered when determining the asset's useful life, the factor regarding "expected usage of the asset …" in IAS 16.56(a) is equally relevant. The condition contained in IAS 16.56(d) reflects the necessity to consider the existence of legal or other externally imposed limitations on an asset's useful life. However, in the fact pattern, the ability to extend the lease term is within the control of the lessee and is at market rates so there are no significant costs or impediments to renewal.

In this fact pattern, after considering the potential economic penalty associated with the loss of the leasehold improvements, the lease term as determined in accordance with IFRS 16 does not include the extension period because, at the commencement date of the lease, the lessee determined it is not reasonably certain it will exercise the renewal option. However, a different threshold (i.e., the expected usage of the asset) is used for the determination of the useful life of an asset in the scope of IAS 16 (i.e., the leasehold improvement).

2 *IFRIC Update*, November 2019, available on the IFRS Foundation's website.

The term 'expected usage of the asset' for the determination of useful life of an asset indicates a lower threshold than the 'reasonably certain' threshold for including the extension period in the lease term for accounting purposes. As a result, although the accounting lease term is 5 years, the leasehold improvement is depreciated over the period over which the lessee expects to use the asset (as it expects to extend the lease to 10 years), which is 7 years.

How we see it

The relevant requirements may be subject to two different interpretations. Hence, when the leasehold improvements are expected to be used beyond the lease term, it is acceptable to depreciate the leasehold improvements either over (i) the shorter lease term or (ii) their expected useful life.

The determination of the useful life and lease term may require significant judgement. Hence, it is important to ensure that all facts and circumstances are taken into account when determining the useful life of the leasehold improvement and the lease term based on the relevant guidance under IAS 16 and IFRS 16 respectively and each conclusion needs to be supported with appropriate evidence.

For instance, if approach (2) is adopted in Illustration 5-2 above, the entity would have to carefully evaluate the reason to construct leasehold improvements with significant expected economic value at the end of 5 years, and yet conclude that the economic penalty associated with abandoning such assets at the end of year 5 is not so significant that it renders the renewal option reasonably certain of exercise. The useful life of the leasehold improvement generally would not exceed the total of the non-cancellable period and the period covered by (a) renewal option(s) (i.e., 10 years in the fact pattern). This conclusion is consistent with the requirement in IAS 38.94 (which addresses the assessment of the useful life of an intangible asset).

5.4.5 The effects of climate change

Climate change, including associated legislation, may affect how and for how long items of PP&E are used. Entities will need to consider climate-related factors annually when determining the expected useful life of their assets. An entity would need to assess whether it expects, for example, the early closure of fossil-fuel producing assets (e.g., coal producing assets) or continued use of carbon-emitting assets (e.g., high emission ships). Similarly, an entity would need to consider if its PP&E assets could be indirectly affected if, for example, it is used to provide services to customers in high emission industries.

In Practical example 5-4 A.P. Møller - Mærsk A/S explains that it considers the impact of decarbonisation and climate related risks as part of its assessment of useful lives:

Practical example 5-4: A.P. Møller - Mærsk A/S (2023) Denmark

Annual Report 2023 [extract]
Financials [extract]
Consolidated financial statements [extract]
Notes [extract]
3.Invested capital [extract]
Note 3.2 Property, plant and equipment [extract]

ⓘ SIGNIFICANT ACCOUNTING ESTIMATES

Useful life and residual values

Useful lives are estimated based on experience. When an asset's useful life changes, Management revises the estimates for individual assets or groups of assets with similar characteristics due to factors such as quality of maintenance and repair, technical development, or environmental requirements. Management has also considered the impact of decarbonisation and climate-related risks on the useful lives of existing assets. Such risks include new climate-related legislation restricting the use of certain assets, new technology demanded by climate-related legislation and the increase in restoration costs for terminal sites due to new and/or more comprehensive policies. The useful lives of vessels and related assets that operate on bunker fuel have been considered in conjunction with the net zero by 2040 target.

...

Changes to useful lives have a direct impact on depreciation charges. In Practical example 5-5 National Grid plc illustrates the sensitivity on the depreciation charge for certain of its segments, where a shorter UEL presumed for its gas assets:

Practical example 5-5: National Grid plc (2023) — United Kingdom

Annual Report and Accounts 2022/23 [extract]
Consolidated financial statements [extract]
Financial statements [extract]
Notes to the consolidated financial statements [extract]
13. Property, plant and equipment [extract]

(c) Gas asset lives

The role that our US gas networks play in the pathway to achieving the greenhouse gas emissions reductions targets set in the jurisdictions in which we operate is currently uncertain. In the year, policymakers in New York and Massachusetts have indicated an increase in electrification and a strategic downsizing of gas networks in their formal plans to meet their respective decarbonisation targets. As a result, there is a risk that the UELs of certain elements of our gas networks may be shortened in line with future legislation.

We believe the gas assets which we own and operate today will continue to have a crucial role in maintaining security, reliability and affordability of energy beyond 2050, although the scale and purpose for which the networks will be used is dependent on technological, legal and regulatory developments.

In the US, our gas distribution asset lives are assessed as part of detailed depreciation studies completed as part of each separate rate proceeding. Depreciation studies consider the physical condition of assets and the expected operational life of an asset. We believe these assessments are our best estimate of the UEL of our gas network assets in the US.

The weighted average remaining UEL for our US gas distribution fixed asset base is circa 52 years; however, a sizeable proportion of our assets are assumed to have UELs which extend beyond 2080. We continue to believe the lives identified by rate proceedings are the best estimate of the assets' UELs, although we continue to keep this assumption under review as we gain more certainty about policy-driven legislation. We continue to actively engage and support our regulators to enable the clean energy transition in a safe, reliable and affordable way.

Asset depreciation lives feed directly into our US regulatory recovery mechanisms, such that any shortening of asset lives and regulatory recovery periods as agreed with regulators should be recoverable through future rates, subject to agreement, over future periods, as part of wider considerations around ensuring the continuing affordability of gas in our service territories.

Given the uncertainty described relating to the UELs of our gas assets, below we provide a sensitivity on the depreciation charge for our New York and New England segments were a shorter UEL presumed. It should be noted that all net zero pathways suggest some role of gas in heating buildings beyond 2050, so our sensitivity analysis for 2050 illustrates an unlikely worst-case scenario:

	Increase in depreciation expense for the year ended 31 March 2023		Increase in depreciation expense for the year ended 31 March 2022	
	New York £m	New England £m	New York £m	New England £m
ULEs limited to 2050	185	54	140	40
ULEs limited to 2060	90	21	67	15
ULEs limited to 2070	42	3	31	1

Note that this sensitivity calculation excludes any assumptions regarding the residual value for our asset base and the effect that shortening asset depreciation lives would be expected to have on our regulatory recovery mechanisms. In the event that any of the US gas distribution assets are stranded, the Group would expect to recover the associated costs. While recovery is not guaranteed and is determined by regulators in the US, there are precedents for stranded asset cost recovery for US utility companies.

5.5 When depreciation starts

The standard is clear on when depreciation should start and finish, and sets out the requirements as follows:

- Depreciation of an item of property, plant and equipment begins when it is available for use, which is defined by the standard as occurring when the asset is in the location and condition necessary for it to be capable of operating in the manner intended by management. This is usually the point at which capitalisation of costs relating to the asset ceases as the physical asset is operational or ready for intended use (see section 4.1.4 above). In contrast, depreciation of a right-of-use asset begins from the commencement date of the lease. *[IFRS 16.32]*.
- Depreciation of an asset ceases at the earlier of the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 and the date that the asset is derecognised (see section 7 below). *[IAS 16.55]*.

Therefore, an entity does not stop depreciating an asset merely because it has become idle or has been retired from active use unless the asset is fully depreciated. However, if the entity is using a usage method of depreciation (e.g., the unit-of-production method), the charge can be zero while there is no production. *[IAS 16.55]*. Of course, a prolonged period in which there is no production may raise questions as to whether the asset is impaired because an asset becoming idle is a specific example of an indication of impairment in IAS 36 (see Chapter 21 at section 2.1). *[IAS 36.12(f)]*.

Assets held for sale under IFRS 5 are discussed in section 7.1 below.

Depreciation of stand-by equipment commences from the date at which the equipment is available for use, and its useful life is determined based on the useful life of the item for which it serves as a back-up. Depreciation of spare parts commences when the part is put into use.

5.6 Depreciation methods

There are a variety of depreciation methods that can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. The standard is not prescriptive about what methods of depreciation should be used. It simply says that "the depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity", mentioning the possible methods that can be used such as the straight-line method (which is the most common method where the depreciation results in a constant charge over the useful life if the asset's residual value does not change, see 5.6.1 below), the units of production method (see section 5.6.2 below) and the diminishing balance method (see section 5.6.3 below). *[IAS 16.60, IAS 16.62]*. The overriding requirement is to select the depreciation method that most closely reflects the expected pattern of consumption of the future economic benefits the asset brings over its useful life; and that the selected method is applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits. *[IAS 16.60, IAS 16.62]*.

The essence of choosing a fair depreciation method is to reflect the consumption of economic benefits provided by the asset concerned. In most cases the straight-line basis will give perfectly acceptable results, and the vast majority of entities use this method. Where there are instances, such as the extraction of a known proportion of a mineral resource, or the use of a certain amount of the total available number of working hours of a machine, it may be that a unit of production method will give fairer results. When assessing the appropriateness of any method, entities should consider how the economic benefits of a particular asset are consumed, for example, through wear and tear, output produced or other factors such as technological obsolescence.

IAS 16 contains an explicit requirement that the depreciation method be reviewed at least at each financial year-end to determine if there has been a significant change in the pattern of consumption of an asset's future economic benefits. If there has been such a change, the depreciation method should be changed to reflect it. *[IAS 16.61]*. Under IAS 8, this change is a change in accounting estimate and not a change in accounting policy (see Chapter 3 at section 4.5). *[IAS 8.32(d)]*. This means that the consequent depreciation adjustment should be made prospectively, i.e., the asset's depreciable amount should be written off over current and future periods using the new and more appropriate method of depreciation. *[IAS 8.36]*.

A revenue-based approach, e.g., using the ratio of revenue generated to total revenue expected to be generated, is not a suitable basis for depreciation. Depreciation is an estimate of the economic benefits of the asset consumed in the period. The revenue generated by an activity that requires the use of an asset generally reflects factors other than the consumption of the economic benefits of the asset. Revenue reflects the output of the asset, but it also reflects other factors that do not affect depreciation, such as changes in sales volumes and selling prices, the effects of selling activities and other inputs and processes. The price component of revenue may be affected by inflation or foreign currency exchange rates. This means that revenue does not, as a matter of principle, reflect how an asset is used or consumed. *[IAS 16.62A]*. While revenue-based methods of depreciation are considered inappropriate under IAS 16, the standard does permit other methods of depreciation that reflect the level of activity, such as the unit-of-production method (see section 5.6.2 below).

5.6.1 Straight line method

The straight-line method is the most common method and results in a constant charge over the useful life of the asset if it's residual value does not change. Depreciation on a straight-line basis is explained in Illustration 5-3 below:

Illustration 5-3: Straight line depreciation

An asset costs CU12,000 and has a useful life of five years and a residual value of CU1,000. The depreciable amount is CU11,000 (CU12,000 - CU1,000). The annual depreciation charge under the straight-line method is calculated at 2,200 (CU11,000/5).

		CU
Year 1	Cost	12,000
	Depreciation at 1/5 of 11,000	(2,200)
	Net book value	**9,800**
Year 2	Depreciation at 1/5 of 11,000	(2,200)
	Net book value	**7,600**
Year 3	Depreciation at 1/5 of 11,000	(2,200)
	Net book value	**5,400**
Year 4	Depreciation at 1/5 of 11,000	(2,200)
	Net book value	**3,200**
Year 5	Depreciation at 1/5 of 11,000	(2,200)
	Net book value	**1,000**

5.6.2 Units of production method

Under this method, the asset is written off in line with its expected use or estimated total output. *[IAS 16.62]*. By relating depreciation to the proportion of productive capacity utilised to date, it reflects the fact that the useful economic life of certain assets, principally machinery, is more closely linked to its usage and output than to time. This method is normally used in extractive industries, for example, to amortise the costs of development of productive oil and gas facilities. Further details of the units of production method can be found in Chapter 39 at sections 16.1.3 and 16.1.3.A.

5.6.3 Diminishing balance methods

The diminishing balance method involves determining a percentage depreciation that will write off the asset's depreciable amount over its useful life. This involves solving for a rate that will reduce the asset's net book value to its residual value at the end of the useful life. The diminishing balance method results in a decreasing depreciation charge over the useful life of the asset. *[IAS 16.62]*. One approach to applying the diminishing balance method is shown in Illustration 5-4:

Illustration 5-4: Diminishing balance depreciation

An asset costs CU6,000 and has a life of four years and a residual value of CU1,500. The entity calculates that the appropriate depreciation rate on the declining balance is 29.3% and that the depreciation charge in years 1-4 will be as follows:

		CU
Year 1	Cost	6,000
	Depreciation at 29.3% of CU6,000	(1,757)
	Net book value	**4,243**
Year 2	Depreciation at 29.3% of CU4,243	(1,243)
	Net book value	**3,000**
Year 3	Depreciation at 29.3% of CU3,000	(879)
	Net book value	**2,121**
Year 4	Depreciation at 29.3% of CU2,121	(621)
	Net book value	**1,500**

The sum of digits method is another form of the diminishing balance method, but one that is based on the estimated life of the asset, and which can easily be applied if the asset has a residual value. If an asset has an estimated useful life of four years then the digits 1, 2, 3, and 4 are added together, giving a total of 10. Depreciation of four-tenths, three-tenths and so on, of the cost of the asset, less any residual value, will be charged in the respective years. The method is sometimes called the 'rule of 78', 78 being the sum of the digits 1 to 12. Illustration 5-5 demonstrate the application of the sum of digits method:

Illustration 5-5: Sum of the digits depreciation

An asset costs CU10,000 and is expected to be sold for CU2,000 after four years. The depreciable amount is CU8,000 (CU10,000 - CU2,000). Depreciation is to be provided over four years using the sum of the digits method. The depreciation charge in years 1-4 will be as follows:

		CU
Year 1	Cost	10,000
	Depreciation at 4/10 of CU8,000	(3,200)
	Net book value	**6,800**
Year 2	Depreciation at 3/10 of CU8,000	(2,400)
	Net book value	**4,400**
Year 3	Depreciation at 2/10 of CU8,000	(1,600)
	Net book value	**2,800**
Year 4	Depreciation at 1/10 of CU8,000	(800)
	Net book value	**2,000**

5.7 Impairment

All items of PP&E accounted for under IAS 16 are subject to the impairment requirements of IAS 36. Impairment is discussed in Chapter 21. *[IAS 16.63]*.

The question has arisen about the treatment of any compensation an entity may be due to receive as a result of an asset being impaired. For example, an asset that is insured might be destroyed in a fire, so repayment from an insurance company might be expected. IAS 16 states that these events - the impairments or losses of items of PP&E, the related claims for or payments of compensation from third parties and any subsequent purchase or construction of replacement assets - are 'separate economic events' and should be accounted for separately as follows:

- Impairments of PP&E are recognised in accordance with IAS 36 (see Chapter 21).
- Derecognition of items of PP&E retired or disposed of should be determined in accordance with IAS 16 (see section 7 below).
- Compensation from third parties for items of PP&E that were impaired, lost or given up is included in determining profit and loss when it becomes receivable.
- The cost of items of PP&E restored, purchased or constructed as replacements is determined in accordance with IAS 16 (see sections 3 and 4 above). *[IAS 16.65, IAS 16.66]*.

6 Measurement after recognition: revaluation model

As discussed at section 5 above, after initial recognition, an accounting policy choice exists which is available to all entities (by class of asset) to measure PP&E using either the cost model or the revaluation model at the end of subsequent reporting periods. If the revaluation model is adopted, PP&E is initially recognised at cost and subsequently carried at a revalued amount, being its fair value (if it can be measured reliably) at the date of the revaluation, less subsequent accumulated depreciation and impairment losses. *[IAS 16.29, IAS 16.31]*. Fair value shall be determined in accordance with the requirements of IFRS 13, and is discussed further at section 6.1 below.

The use of the revaluation model can result in deferred taxation complexities. Examples in this chapter ignore the effects of deferred tax. See Chapter 29, Section 7.4 for guidance on recognition of deferred tax in respect of assets carried at fair value or revalued amount.

How we see it

There is no requirement for a professional external valuation or even for a professionally qualified valuer to perform the appraisal, although in practice professional advice is often sought. Entities are required to disclose whether an independent valuer was involved.

Valuation frequency is not prescribed by IAS 16. Instead, it states that revaluations are to be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period. *[IAS 16.31]*. Therefore, the frequency of revaluations depends upon the changes in fair values of the items of PP&E being revalued. When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is necessary. The standard suggests that some items of PP&E have frequent and volatile changes in fair value and these should be revalued annually. This is true for property assets in many jurisdictions, but even in such cases there may be quieter periods in which there is little movement in values. If there are only insignificant changes in fair value, frequent revaluations are unnecessary and it may only be necessary to perform revaluations at three or five-year intervals. *[IAS 16.34]*.

If the revaluation model is adopted, IAS 16 specifies that all items within a class of PP&E are to be revalued simultaneously to prevent selective revaluation of assets and the reporting of amounts in the financial statements that are a mixture of costs and values as at different dates. However, revaluations of a class of assets on a rolling basis is permitted in certain circumstances, as discussed further below. *[IAS 16.36, IAS 16.38]*. A class of PP&E is a grouping of assets of a similar nature and use in an entity's operations. This is not a precise definition. IAS 16 suggests that the following are examples of separate classes of PP&E:

(i) Land
(ii) Land and buildings
(iii) Machinery
(iv) Ships
(v) Aircraft
(vi) Motor vehicles
(vii) Furniture and fixtures
(viii) Office equipment
(ix) Bearer plants *[IAS 16.37]*

These are very broad categories of PP&E and it is possible for them to be classified further into groupings of assets of a similar nature and use. Office buildings and factories or hotels and fitness centres, could for instance be separate classes of asset.

If the entity used the same type of asset in two different geographical locations, e.g., clothing manufacturing facilities for similar products or products with similar markets, say in Sri Lanka and Guatemala, it is likely that these would be seen as part of the same class of asset. However, if the entity manufactured pharmaceuticals and clothing, both in European facilities, then few would argue that these could not be assets with a sufficiently different nature and use to be separate classes. Ultimately, whether similar assets are sufficiently different to be a separate class of assets is a matter of judgement in the context of the specific operations of individual entities. *[IAS 16.37]*.

IAS 16 permits a rolling valuation of a class of assets provided the revaluation of such class of assets is completed within a short period of time and "provided the revaluations are kept up to date …". *[IAS 16.38]*. The standard is clear that the required frequency of revaluations depends upon the changes in fair values of the PP&E being revalued, and that when the value changes very little, valuations may only be required every three to five years. No further guidance is provided on what is meant by the requirement that the revaluation of a class of assets be completed "within a short period."

6.1 The meaning of fair value

Fair value is defined in IFRS 13. IFRS 13 does not prescribe when to measure fair value but provides guidance on how to measure it when fair value is required or permitted by IFRS Accounting Standards.

IFRS 13 clarifies that fair value is an exit price from the perspective of market participants. 'Fair value' is defined as: *[IAS 16.6, IFRS 13 Appendix A]*

Extract from IFRS 13

Appendix A
Defined terms

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

6.1.1 Revaluing assets under IFRS 13

IFRS 13 specifies that "fair value is a market-based measurement, not an entity-specific measurement …". *[IFRS 13.2]*. Some of the principles that affect the revaluation of PP&E are the concept of highest and best use and the focus of the fair value hierarchy on the inputs used in valuation techniques, which are categorised into three levels. IFRS 13 also requires a significant number of disclosures, including the categorisation of a fair value measurement with the fair value measurement hierarchy.

The requirements of IFRS 13 are discussed in Chapter 15.

The following sections consider some of the key considerations when measuring the fair value of an item of PP&E.

6.1.1.A Highest and best use

Extract from IFRS 13

27	**A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its *highest and best use* or by selling it to another market participant that would use the asset in its highest and best use.**

This evaluation will include uses that are "physically possible, legally permissible and financially feasible …". *[IFRS 13.27, IFRS 13.28]*.

The highest and best use is determined from the perspective of market participants that would be acquiring the asset, but the starting point is the asset's current use. It is presumed that an entity's current use of the asset is the asset's highest and best use, unless market or other factors suggest that a different use of the asset by market participants would maximise its value. *[IFRS 13.29]*.

Prior to the adoption of IFRS 13, IAS 16 did not imply that fair value and market value were synonymous, which allowed a broader meaning of the term 'fair value'. The term could certainly have been interpreted as encompassing the following two commonly used, market derived, valuation bases:

- Market value in existing use, an entry value for property in continuing use in the business which is based on the concept of net current replacement cost.
- Open market value, which is an exit value and based on the amount that a property that is surplus to requirements could reach when sold.

Both of these bases are market-derived, yet they can differ for a variety of reasons. A property may have a higher value on the open market if it could be redeployed to a more valuable use. On the other hand, the present owner may enjoy some benefits that could not be passed on in a sale, such as planning consents that are personal to the present occupier. Market value in existing use will be presumed to be fair value under IFRS 13 for many types of business property unless market or other factors suggest that open market value is higher (i.e., open market value represents highest and best use). For most retail sites market value in existing use will be fair value; if there is market evidence that certain types of property have an alternative use with a higher value, e.g., pubs or warehouses that can be converted to residential use, this will have to be taken into account.

The fair value of an item of PP&E will either be measured based on the value it would derive on a stand-alone basis or in combination with other assets or other assets and liabilities, i.e., the asset's 'valuation premise'. 'Valuation premise' is a valuation concept that addresses how a non-financial asset derives its maximum value to market participants. The highest and best use of an item of PP&E "might provide maximum value to market participants through its use in combination with other assets as a group (as installed or otherwise configured for use) or in combination with other assets and liabilities (e.g., a business) …" or it "might have maximum value to market participants on a stand-alone basis …". *[IFRS 13.31(a), IFRS 13.31(b)]*.

The following Illustration is derived from IFRS 13 and shows highest and best use in establishing fair value. *[IFRS 13.IE7, IFRS 13.IE8]*.

Illustration 6-1: Highest and best use

An entity acquires land in a business combination. The land is currently developed for industrial use as a site for a factory. The current use of land is presumed to be its highest and best use unless market or other factors suggest evidence for a different use.

Scenario (1):

In the particular jurisdiction, it can be difficult to obtain consents to change use from industrial to residential use for the land and there is no evidence that the area is becoming desirable for residential development. The fair value is based on the current industrial use of the land.

Scenario (2):

Nearby sites have recently been developed for residential use as sites for high-rise apartment buildings. On the basis of that development and recent zoning and other changes that facilitated the residential development, the entity determines that the land currently used as a site for a factory could also be developed as a site for residential use because market participants would take into account the potential to develop the site for residential use when pricing the land.

This determination can be highly judgemental. For further discussion on highest and best use and valuation premise see Chapter 15 at section 9.

6.1.1.B Valuation approaches

IFRS 13 does not limit the types of valuation techniques an entity might use to measure fair value but instead focuses on the types of inputs that will be used. The standard requires the entity to use the valuation technique that maximises the use of relevant observable inputs and minimises the use of unobservable inputs. *[IFRS 13.61]*. The objective is that the best available inputs should be used in valuing the assets. These inputs could be used in any valuation technique provided they are consistent with the three valuation approaches in the standard: the market approach, the cost approach and the income approach. *[IFRS 13.62, IFRS 13.B5, IFRS 13.B8, IFRS 13.B10]*.

Extract from IFRS 13

B5 The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (ie similar) assets, liabilities or a group of assets and liabilities, such as a business.

For PP&E, market techniques will usually involve market transactions in comparable assets or, for certain assets valued as businesses, market multiples derived from comparable transactions. *[IFRS 13.B6]*.

Extract from IFRS 13

B8 The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).

It is based on what a market participant buyer would pay to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. Obsolescence includes physical deterioration, functional (technological) and economic (external) obsolescence so it is broader than and not the same as depreciation under IAS 16. *[IFRS 13.B8, IFRS 13.B9]*.

Extract from IFRS 13

B10 The income approach converts future amounts (eg cash flows or income and expenses) to a single current (ie discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts.

In the case of PP&E, this will usually mean using a present value (i.e., discounted cash flow) technique. *[IFRS 13.B11]*.

See Chapter 15 at section 13 for a further discussion of these valuation techniques.

IFRS 13 does not place any preference on the techniques. An entity can use any valuation technique, or use multiple techniques, as long as it applies the valuation technique consistently. A change in a valuation technique is considered a change in an accounting estimate in accordance with IAS 8. *[IFRS 13.66]*.

The inputs used to measure the fair value of an asset have a hierarchy. Level 1 inputs are those that are quoted prices in active markets (i.e., markets in which transactions take place with sufficient frequency and volume to provide pricing information on an ongoing basis) for identical assets that the entity can access at the measurement date. *[IFRS 13.76]*. Level 1 inputs have the highest priority, followed by inputs, other than quoted prices, that are observable for the asset either directly or indirectly (Level 2). The lowest priority inputs are those based on unobservable inputs (Level 3). *[IFRS 13.86, IFRS 13.72]*. The valuation techniques, referred to above, will use a combination of inputs to determine the fair value of the asset.

As stated above, land and buildings are the most commonly revalued items of PP&E. These types of assets use a variety of inputs such as other sales, multiples or discounted cash flows. While some of these may be Level 1 inputs, we generally expect the fair value measurement as a whole to be categorised within Level 2 or Level 3 of the fair value hierarchy for disclosure purposes (see section 8.2 below).

IFRS 13 also requires additional disclosure in the financial statements that are discussed in section 8.2 below and in Chapter 15 at section 19.

6.1.1.C The cost approach - current replacement cost

IFRS 13 permits the use of a cost approach for measuring fair value, for example current replacement costs. Before using current replacement cost as a method to measure fair value, an entity should ensure that both:

- The highest and best use of the assets is consistent with their current use.

  And

- The exit market for the asset (i.e., the principal market or in its absence, the most advantageous market) is the same as the entry market (i.e., the market in which the asset was/will be purchased)

The principal market is the market for the asset that has the greatest volume or level of activity for the asset or liability. The most advantageous market is the one that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after considering transaction costs and transport costs. *[IFRS 13 Appendix A]*.

The resulting depreciated replacement cost should also be assessed to ensure market participants would actually transact for the asset in its current condition and location at this price. In particular, an entity should ensure that both:

- The inputs used to determine replacement cost are consistent with what market participant buyers would pay to acquire or construct a substitute asset of comparable utility.

  And

- The replacement cost has been adjusted for obsolescence that market participant buyers would consider so that the adjustment reflects all forms of obsolescence (i.e., physical deterioration, technological (functional) and economic obsolescence and environmental factors), which is broader than depreciation calculated in accordance with IAS 16.

For further discussion see Chapter 15 at section 13.3.

How we see it

We believe depreciated replacement cost may be used to measure the fair value of an item of property, plant and equipment in accordance with IFRS 13, but only in limited circumstances (see Chapter 15 at section 13.3.1).

6.2 Accounting for valuation surpluses and deficits

Increases in the carrying amount of PP&E as a result of revaluations should be credited to OCI and accumulated in a revaluation surplus account in equity, except to the extent that a revaluation increase of an asset reverses a revaluation decrease of the same asset that was previously recognised as an expense in profit or loss, whereby such increase should be credited to income in profit or loss. *[IAS 16.39]*. Decreases in valuation should be charged to profit or loss, except to the extent that they reverse the existing accumulated revaluation surplus on the same asset and therefore such decrease is recognised in OCI. The decrease recognised in OCI reduces the amount accumulated in equity under revaluation surplus account. *[IAS 16.40]*. This means that it is not permissible under the standard to carry a negative revaluation reserve in respect of any item of PP&E. Revaluation increases cannot be offset against revaluation decreases on other assets, even if they are within the same class of asset.

The same rules apply to impairment losses. An impairment loss on a revalued asset is first used to reduce the revaluation surplus for that asset. Only when the impairment loss exceeds the amount in the revaluation surplus for that same asset is any further impairment loss recognised in profit or loss (see Chapter 21 at section 11.1). *[IAS 36.61]*.

IAS 16 generally retains a model in which the revalued amount substitutes for cost in both the statement of financial position and the statement of profit or loss and on derecognition there is no recycling to profit and loss of amounts taken directly to OCI. The revaluation surplus included within equity in respect of an item of PP&E may be transferred directly to retained earnings when the asset is derecognised (i.e., transferring the whole of the surplus when the asset is retired or disposed of). *[IAS 16.41]*.

IAS 16 also allows some of the revaluation surplus to be transferred to retained earnings as the asset is used by an entity. In such a case, the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on its original cost may be transferred from revaluation surplus to retained earnings in equity. This is shown in Illustration 6-2 below. This recognises that any depreciation on the revalued part of an asset's carrying value has been realised by being charged to profit or loss. Thus, a transfer should be made of an equivalent amount from the revaluation surplus to retained earnings. Any remaining balance may also be transferred when the asset is disposed of. These transfers should be made directly from revaluation surplus to retained earnings and not through the statement of profit or loss. *[IAS 16.41]*.

Illustration 6-2: Effect of depreciation on the revaluation reserve

On 1 January 20X0 an entity acquired an asset for CU1,000. The asset has an economic life of ten years and is depreciated on a straight-line basis. The residual value is assumed to be CU nil. At 31 December 20X3 (when the cost net of accumulated depreciation is CU600) the asset is valued at CU900. The entity accounts for the revaluation by debiting the carrying value of the asset (using either of the methods discussed in the section below this Illustration and further explained in Illustrations 6-3 to 6-5) CU300 and crediting CU300 to OCI and accumulating the increase in the revaluation reserve. At 31 December 20X3 the useful life of the asset is considered to be the remainder of its original life (i.e., six years) and its residual value is still considered to be CU nil. In the year ended 31 December 20X4 and in later years, the depreciation charged to profit or loss is CU150 (CU900/6 years remaining).

The usual treatment thereafter for each of the remaining 6 years of the asset's life, is to transfer CU50 (CU300/6 years) each year from the revaluation reserve to retained earnings (not through profit or loss). This avoids the revaluation reserve being maintained indefinitely even after the asset ceases to exist, which does not seem sensible.

The deferred tax impact of the revaluation of assets has been ignored for the purposes of the examples in this chapter. In practice, any effect on taxation, both current and deferred, resulting from the revaluation of PP&E is recognised and disclosed in accordance with IAS 12 *Income Taxes*. *[IAS 16.42]*. This is dealt with in Chapter 29.

When an item of PP&E is revalued, the carrying amount of that asset is adjusted to the revalued amount. As alluded to in Illustration 6-2 above, there are two methods of accounting for accumulated depreciation when an item of PP&E is revalued. At the date of revaluation, the asset is treated in one of the following ways:

- The accumulated depreciation is eliminated against gross carrying amount of the asset.

  Or

- The gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. For example, the gross carrying amount may be restated by reference to observable market data or it may be restated proportionately to the change in the carrying amount. The accumulated depreciation at the date of the revaluation is adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses. *[IAS 16.35]*.

These possible approaches are illustrated in Illustrations 6-3, 6-4 and 6-5 below. The first method available eliminates the accumulated depreciation against the gross carrying amount of the asset. After the revaluation, the gross carrying amount and the net carrying amount are same (i.e., reflecting the revalued amount). This is illustrated in Illustration 6-3:

Illustration 6-3: Revaluation by eliminating accumulated depreciation

On 31 December, a building has a carrying amount of CU40,000, being the original cost of CU70,000 less accumulated depreciation of CU30,000. A revaluation is performed and the fair value of the asset is CU50,000. The entity would record the following journal entry:

Dr	Accumulated depreciation		CU30,000	
	Cr	Building		CU20,000
	Cr	Asset revaluation reserve (through OCI)		CU10,000

	Before	After
	CU	CU
Building at cost	70,000	
Building at valuation		50,000
Accumulated depreciation	30,000	-
Net book value	40,000	50,000

Illustration 6-4 and 6-5 provide alternative approaches to recognising the revaluation of the asset by adjusting the gross carrying amount in a manner that is consistent with the revaluation of the carrying amount of the asset. In Illustration 6-4, the gross carrying amount is restated by reference to observable market data:

Illustration 6-4: Revaluation by restating the gross carrying amount by reference to observable market data

As in Illustration 6-3, on 31 December, a building has a carrying amount of CU40,000, being the original cost of CU70,000 less accumulated depreciation of CU30,000. A revaluation is performed, and the fair value of the asset is CU50,000.

Rather than accounting for the revaluation by eliminating the accumulated depreciation against gross carrying amount of the asset, the gross carrying amount is restated to CU75,000 by reference to observable market data. The accumulated depreciation then has to be adjusted to CU25,000 (i.e., the gross carrying amount of CU75,000 less the carrying amount adjusted to its revalued amount of CU50,000). As such, the entity would record the following journal entry:

Dr	Accumulated depreciation		CU5,000	
Dr	Building		CU5,000	
	Cr	Asset revaluation reserve (through OCI)		CU10,000

	Before	After
	CU	CU
Building at cost	70,000	
Building at valuation		75,000
Accumulated depreciation	30,000	25,000
Net book value	40,000	50,000

Illustration 6-5 provides another possible approach to recognising the revaluation of the asset by adjusting the gross carrying amount in a manner that is consistent with the revaluation of the carrying amount of the asset. In this case, the gross carrying amount is restated proportionately to the change in the carrying amount:

Illustration 6-5: Revaluation by restating the gross proportionately to the change in the carrying amount

As in Illustrations 6-3 and 6-4, on 31 December, a building has a carrying amount of CU40,000, being the original cost of CU70,000 less accumulated depreciation of CU30,000. A revaluation is performed, and the fair value of the asset is CU50,000.

In this case, the revaluation is recorded by restating gross carrying amount proportionately to the change in carrying amount. As the fair value of the asset is CU50,000 and the carrying amount is CU40,000 at the date of the revaluation, this gives rise to a 25% uplift. This method results in the same revaluation gain as the methods in Illustrations 6-3 and 6-4 above but the cost and accumulated depreciation carried forward reflect the gross cost of the asset of CU87,500 and accumulated depreciation of CU37,500. This method may be used if an asset is revalued using an index to determine its depreciated replacement cost (see section 6.1.1.C above).

As such, the entity would record the following journal entry:

Dr	Building		CU17,500	
	Cr	Accumulated depreciation		CU7,500
	Cr	Asset revaluation reserve (through OCI)		CU10,000

	Before	After
	CU	CU
Building at cost	70,000	
Building at valuation		87,500
Accumulated depreciation	30,000	37,500
Net book value	40,000	50,000

Notice that the revaluation gain recognised remained at CU10,000 whichever method described above is used.

6.3 Reversals of downward valuations

IAS 16 requires that, if an asset's carrying amount is increased as a result of a revaluation, the increase should be credited directly to OCI and accumulated in equity under the heading of revaluation surplus. However, the increase should be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss (see section 6.2 above). *[IAS 16.39]*.

The same rules apply to a reversal of an impairment loss - see discussion in Chapter 21 at section 11.4.2.

How we see it

If the revalued asset is being depreciated, we consider that the full amount of any reversal should not be taken to profit or loss. Rather, the reversal should take account of the depreciation that would have been charged on the previously higher book value.

The text of IAS 16 does not specify this treatment but other interpretations would be inconsistent with IAS 36, which states: *[IAS 36.117]*

Extract from IAS 36

117 The increased carrying amount of an asset other than goodwill attributable to a reversal of an impairment loss shall not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years.

The following Illustration demonstrates a way in which this could be applied.

Illustration 6-6: Reversal of a downward valuation

An asset has a cost of CU1,000,000, a useful life of 10 years and a residual value of CU nil. At the end of year 3, when the asset's net book value (NBV) is CU700,000, it is revalued to CU350,000. This write down below cost of CU350,000 is taken through profit or loss.

The entity then depreciated its asset by CU50,000 per annum, so as to write off the carrying value of CU350,000 over the remaining 7 years.

At the end of year 6, the asset's depreciated cost is CU200,000 (being the carrying value at the end of year 3 of CU350,000, less three years of depreciation at CU50,000 per annum) but it is now revalued to CU500,000. The effect on the entity's asset is as follows (in this Illustration, the revaluation is recorded by eliminating accumulated depreciation):

	CU000
Valuation	
At the beginning of year 6	350
Surplus on revaluation	150
At the end of the year	500
Accumulated depreciation	
At beginning of year 6*	100
Charge for the year	50
Accumulated depreciation written back on revaluation	(150)
At the end of the year	-
Net book value at the end of year 6 based on valuation	500
Net book value immediately before revaluation	200

* Two years' depreciation (years 4 and 5) at CU50,000 per annum.

The total credit for the uplift in value is CU300,000 on the revaluation in year 6 (i.e., CU500,000 less CU200,000). However, only CU200,000 is taken through profit or loss. This is because the reversal recognised in profit and loss is restricted to take account of the depreciation that would have been charged on the previously higher book value, achieving the same overall effect that would have been reached had the original downward revaluation not occurred.

In this case, had the previous downwards revaluation not occurred, the total cumulative charges reported in profit or loss at the end of year 6 would have been CU600,000 (comprising 6 years of depreciation at CU100,000 per annum), and the carrying value of the asset would have been CU400,000.

Instead, a total of CU800,000 has been recognised in profit or loss, reflecting the CU350,000 downwards revaluation and a total of CU450,000 of depreciation (comprising 3 years of depreciation at CU100,000 per annum and 3 years at the reduced amount of CU50,000 per annum). Therefore, the total reversal through profit or loss is restricted to the difference between these two figures, of CU200,000. The remaining CU100,000 will be credited to OCI and taken to the revaluation surplus.

From the beginning of year 7, the asset at revalued amount of CU500,000 will be written off over the remaining four years at CU125,000 per annum.

In the Illustration the amount of the revaluation that is credited to the revaluation surplus through OCI represents the difference between the net book value that would have resulted had the asset been held on a cost basis (CU400,000) and the net book value on a revalued basis (CU500,000).

Of course, this is an extreme example. Most assets that are subject to a policy of revaluation would not show such marked changes in value and it would be expected that there would be valuation movements in the intervening years rather than dramatic losses and gains in years 3 and 6. However, we consider that in principle this is the way in which downward valuations should be recognised.

There may be major practical difficulties for any entity that finds itself in the position of reversing revaluation deficits on depreciating assets, although whether in practice this eventuality often occurs is open to doubt. If there is any chance that it is likely to occur, the business would need to continue to maintain asset registers on the original, pre-write down basis.

6.4 Adopting a policy of revaluation

Although the initial adoption of a policy of revaluation by an entity that has previously used the cost model is a change in accounting policy, it is not dealt with as a prior period adjustment in accordance with IAS 8. Instead, the change is treated as a revaluation during the current period as set out in section 6.2 above. *[IAS 8.17]*. This means that the entity is not required to obtain valuation information about comparative periods.

This is an exception to the general principle in IAS 8 (whereby changes in accounting policy shall be recognised retrospectively), and it only applies to a change to a policy of revaluation. If an entity changes its accounting policy from the revaluation model to the cost model, the usual requirements applicable to changes in accounting policies apply, meaning the effect of the change is calculated retrospectively as if the cost model had always been applied. For further discussion of changes in accounting policy, see Chapter 3, Section 4.4.

6.5 Assets held under leases

Under IFRS 16 lessees are required to recognise most leases in their statement of financial position as lease liabilities with corresponding right-of-use assets. A lessee subsequently measures the right-of-use asset using a cost model under IFRS 16 (applying the depreciation requirements in IAS 16, but subject to the specific requirements in IFRS 16.32), unless it applies one of the following measurement models allowed by IFRS 16 (see Chapter 24 at section 5.3.1):

- The fair value model in IAS 40, but only if the lessee applies this to its investment property and the right-of-use asset meets the definition of investment property in IAS 40.

  Or

- If the lessee applies the revaluation model in IAS 16 to a class of PP&E, the lessee would also have the option to revalue all of the right-of-use assets that relate to that class of PP&E. *[IFRS 16.29, IFRS 16.34, IFRS 16.35]*.

6.6 Measurement alternative for certain owner-occupied properties held as investment fund assets or underlying items

On adoption of IFRS 17, the subsequent measurement requirements in IAS 16 were amended by adding paragraphs 29A and 29B. These paragraphs provide an exemption from the requirement to apply either the cost or the revaluation model under IAS 16, but this exemption is only available in certain specific circumstances.

Some entities operate, either internally or externally, an investment fund that provides investors with benefits determined by units in the fund. Similarly, some entities issue groups of insurance contracts with direct participation features and hold the underlying items. Some such funds or underlying items include owner-occupied property. For many contracts that specify a link to returns on underlying items, those underlying items include a mix of assets that are almost all measured at fair value through profit or loss. Accordingly, the IASB decided that measurement of such owner-occupied property at fair value through profit or loss would be consistent with the measurement of the majority of the underlying assets and would prevent accounting mismatches. *[IFRS 17.BC65(c)]*.

Consequently, paragraphs 29A and 29B have been added to permit entities to elect to measure owner-occupied properties in such specified circumstances as if they were investment properties measured at fair value through profit or loss in accordance with IAS 40. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. An entity shall treat owner-occupied property measured using the investment property fair value model as a separate class of PP&E. *[IAS 16.29A, IAS 16.29B]*.

7 Derecognition and disposal

Derecognition, i.e., removal of the carrying amount of an item of PP&E from the financial statements of the entity, occurs when an item of PP&E is either disposed of, or when no further economic benefits are expected to flow from its use or disposal. *[IAS 16.67]*. The disposal of an item of PP&E may occur in a variety of ways (e.g., by sale, by entering into a finance lease or by donation). The actual date of disposal of an item of PP&E is the date the recipient obtains control of that item, being when the performance obligation is satisfied in IFRS 15 (see Chapter 28 at section 7). IFRS 16 applies to a disposal by way of a sale and leaseback. *[IAS 16.69]*.

All gains and losses on derecognition must be included in profit and loss for the period when the item is derecognised, unless IFRS 16 requires otherwise. A sale and leaseback transaction might not give rise to a gain (see Chapter 24 at section 8). *[IAS 16.68]*.

Gains are not to be classified as revenue, although in some limited circumstances presenting gross revenue on the sale of certain assets may be appropriate (see section 7.2 below). *[IAS 16.68, IAS 16.68A]*. Gains and losses are to be calculated as the difference between any net disposal proceeds and the carrying value of the item of PP&E. *[IAS 16.71]*. This means that any revaluation surplus in equity relating to the asset disposed of is transferred directly to retained earnings when the asset is derecognised and not reflected in profit or loss (see section 6.2 above). *[IAS 16.41]*.

Replacement of 'parts' of an asset requires derecognition of the carrying value of the replaced part, even if that part had not been depreciated separately. In these circumstances, the standard allows the cost of the replacement part to be a guide in estimating the original cost of the replaced part at the time it was acquired or constructed, if that cannot be determined. *[IAS 16.70]*.

The amount of consideration to be included in the gain or loss arising from the derecognition of an item of PP&E is determined in accordance with the requirements for determining the transaction price in IFRS 15.47 to 72 (see Chapter 28 at section 5). Any subsequent changes to the estimated amount of the consideration included in the gain or loss should be accounted for in accordance with the requirements for changes in the transaction price in IFRS 15 (see Chapter 28 at section 5.9). *[IAS 16.72]*.

7.1 IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

IFRS 5 introduced a category of asset, 'held for sale', and PP&E within this category is outside the scope of IAS 16, although IAS 16 requires certain disclosures about assets held for sale to be made, as set out in section 8.1 below.

IFRS 5 requires that an item of PP&E should be classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than continuing use, though continuing use is not in itself precluded for assets classified as held for sale. *[IFRS 5.6]*. An asset can also be part of a 'disposal group' (that is a group of assets that are to be disposed of together as a group in a single transaction), in which case such a group can be treated as a whole. Once this classification has been made, depreciation ceases, even if the asset is still being used, but the assets must be carried at the lower of their previous carrying amount and fair value less costs to sell. *[IFRS 5.15, IFRS 5.25]*. For assets (or disposal group) to be classified as held for sale, they must be available for immediate sale in their present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups), and the sale must be highly probable. *[IFRS 5.7]*.

For the sale to be considered highly probable, the sale should be expected to complete within one year from the date of classification as held for sale, management at an 'appropriate level' must be committed to the plan, and an active programme of marketing the assets at current fair value must have been started. *[IFRS 5.8]*.

The requirements of IFRS 5 are dealt with in Chapter 5. IFRS 5 does not apply when assets that are held for sale in the ordinary course of business are transferred to inventories (see section 7.2 below). *[IAS 16.68A]*.

7.2 Sale of assets held for rental

If an entity, in the course of its ordinary activities, routinely sells PP&E that it has held for rental to others, it should transfer such assets to inventories at their carrying amount when they cease to be rented and are then held for sale. The proceeds from the sale of such assets should be recognised as revenue in accordance with IFRS 15. *[IAS 16.68A]*. In contrast, the sale of investment property is generally not recognised as revenue. The rationale and possible treatment of investment property in such cases is discussed in detail in Chapter 20 at sections 9 and 10.

A number of entities sell assets that have previously been held for rental, for example, car rental companies that may acquire vehicles with the intention of holding them as rental cars for a period of time and then selling them. An issue was whether the sale of such assets, which arguably have a dual purpose of being rented out and then sold, should be presented gross (revenue and cost of sales) or net (gain or loss) in profit or loss.

The IASB concluded that the presentation of gross revenue, rather than a net gain or loss, would better reflect the ordinary activities of such entities.

IAS 7 *Statement of Cash Flows* further requires that both (i) the cash payments to manufacture or acquire assets held for rental and subsequently held for sale; and (ii) the cash receipts from rentals and sales of such assets are presented as cash flows from operating activities. *[IAS 7.14]*. The intention behind this requirement is to avoid initial expenditure on purchases of assets being classified as investing activities while inflows from sales are recorded within operating activities.

As discussed in section 5.4 above, where an entity has a policy that involves disposing of assets after a specified time, the entity will depreciate them over this time period down to the estimated residual value. As set out in section 2.2 and 5.3, residual value is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

IAS 16 does not define the 'estimated cost of disposal' or provide guidance on the costs to be included. In contrast, in respect of identifying the costs of disposal to be included when determining the net realisable value of inventories, the IFRS IC published an agenda decision in June 2021 (Costs Necessary to Sell Inventories (IAS 2 Inventories)) which provides specific guidance and makes it explicit that it is not appropriate for entities to limit such costs to only those that are incremental.

In the absence of a definition under IAS 16, an entity may apply the hierarchy in IAS 8 and consider the requirements in other standards in determining the cost of disposal when estimating residual value under IAS 16. There may be different outcomes depending which standard a preparer looks to. For example, whilst the IFRS IC's agenda decision in respect of costs of disposal under IAS 2 makes clear that entities should not limit such costs to only those that are incremental, the IFRS 5 definition of "costs to sell" a non-current asset and the IAS 36 definition of "costs of disposal" limit such costs to those that are incremental and directly attributable to the disposal of an asset. Therefore, an entity which has referred to the definition in IFRS 5 or IAS 36 may have assessed costs of disposal at a lower amount than those applying an IAS 2 definition, and as such, a loss could arise on the transfer of the asset from PP&E to inventories.

The interpretation of the definition of cost to sell may be particularly important, for example, for entities whose primary business is to lease assets (e.g., vehicles). Those entities may incur significant costs which are associated with the subsequent sale of the assets once they have reached the end of leases, but which are not incremental to an individual sale (e.g., costs associated with in-house teams or external support managing the sales process). Such costs would be considered in determining the cost to sell under IAS 2, but are non-incremental and therefore would not be included in costs of disposal under IFRS 5 or IAS 36.

How we see it

The absence of a consistent definition of costs of disposal could theoretically result in a loss arising when an entity transfers assets from PP&E to inventories. However, in our view, since the term is not defined in IAS 16, an entity would not be precluded from considering the guidance in IAS 2 in determining the costs necessary to sell inventories in its assessment of residual values.

7.3 Partial disposals and undivided interests

IAS 16 requires an entity to derecognise 'an item' of PP&E on disposal or when it expects no future economic benefits from its use or disposal. *[IAS 16.67]*.

Items of PP&E are recognised when their costs can be measured reliably and it is probable that future benefits associated with the asset will flow to the entity. *[IAS 16.7]*. The standard "does not prescribe the unit of measure for recognition, i.e. what constitutes an item of property, plant and equipment …". *[IAS 16.9]*.

However, items that are derecognised are not necessarily items that were identified separately on initial recognition. The item that is being disposed of may be part of a larger 'item' bought in a single transaction that can be subdivided into parts (i.e., separate items) for separate disposal; an obvious example is land or many types of property. The principle is the same as for the replacement of parts, which may only be identified and derecognised so that the cost of the replacement part may be recognised (see section 3.3 above). The entity needs to identify the cost of the part disposed of by allocating the carrying value on a systematic and appropriate basis.

In these cases, the part disposed of is a physical part of the original asset. The standard assumes that disposal will be of a physical part (except in the specific case of major inspections and overhauls - see section 3.3.2 above). However, some entities enter into arrangements in which they dispose of part of the benefits that will be derived from the assets.

Although IAS 16 defines an asset by reference to the future economic benefits that will be controlled by the entity as a result of the acquisition, it does not address disposals of a proportion of these benefits. An entity may dispose of an undivided interest in the whole asset (sometimes called an ownership 'in common' of the asset). This means that all owners have a proportionate share of the entire asset (e.g., the purchaser of a 25% undivided interest in 100 acres of land owns 25% of the whole 100 acres). These arrangements are common in, but are not restricted to, the extractive and property sectors. Vendors have to determine how to account for the consideration they have received from the purchaser. This will depend on the details of the arrangement and, in particular, whether the entity continues to control the asset or there is joint control.

7.3.1 Joint control

In some cases, after a partial disposal of an item of PP&E there may be joint control over the asset, in which case IFRS 11 *Joint Arrangements* shall be considered in determining how the entity shall account for the disposal and the subsequent accounting. Joint control is discussed in detail in Chapter 13 at section 4.

The accounting treatment may depend on whether the disposing entity holds an asset directly or holds it within a single-asset subsidiary.

If an entity sells a directly held asset into a joint operation in which it is a joint operator, it is entering into a transaction with the other parties to the joint operation and therefore the vendor will only recognise gains and losses to the extent of the other parties' interests. *[IFRS 11.B34]*. In other words, it will recognise a partial disposal. Similarly, if an entity sells a directly held asset into a joint venture in which it is a joint venturer, it recognises only the portion of the gain or loss attributable to the other parties to the joint venture.

An entity subsequently accounts for a joint operation by accounting for its own assets, liabilities, revenue etc. while it will apply the equity method to account for its interests in a joint venture (see Chapter 13 at sections 6 and 7, respectively).

However, in many jurisdictions it is common for certain assets, particularly properties, to be bought and sold by transferring ownership of a separate legal entity formed to hold the asset (a single-asset entity) rather than the asset itself. If the entity is disposing of an interest in an asset that is held within a single-asset subsidiary and if the retained interest represents an investment in an entity, a gain or loss is typically recognised as if 100% of asset had been sold because control of the subsidiary has been lost.

However, if the asset is held in a single-asset subsidiary entity that becomes a joint venture, there is a conflict between the requirements of IFRS 10 *Consolidated Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures*.

This is because, under IFRS 10, if a parent entity loses control of a subsidiary a gain or loss is recognised as if 100% of asset had been sold. In contrast, under IAS 28, an investor is required to restrict any gain arising on disposal of its own assets to the amount attributable to the other party to the joint venture. That is, IFRS 10 requires full gain recognition whilst IAS 28 requires partial gain recognition.

In September 2014, the IASB issued amendments to IFRS 10 and IAS 28 on the recognition of the sale or contribution of assets between an investor and its associate or joint venture. The main consequence of the amendments is that a full gain or loss is recognised when a transaction involves a business (whether it is housed in a subsidiary or not). A partial gain or loss is recognised when a transaction involves assets that do not constitute a business, even if these assets are housed in a subsidiary. The amendments were to be applied prospectively for transactions occurring in annual periods commencing on or after 1 January 2016, with earlier application permitted.[3] However, in December 2015, the IASB issued a further amendment *Effective Date of Amendments to* IFRS 10 *and* IAS 28. This amendment defers the effective date of the September 2014 amendment until the IASB has finalised any revisions that result from the IASB's research project on the equity method. *[IFRS 10.BC190N]*. Nevertheless, the IASB has continued to allow early application of the September 2014 amendment as it did not wish to prohibit the application of better financial reporting. *[IFRS 10.BC190O]*. This issue is discussed further in Chapter 8 at section 3.3.2.A and Chapter 12 at section 6.2.2.

In May 2023 the IASB moved its Equity Method project from the research programme to the standard-setting work plan, and an Exposure Draft was issued in September 2024. See Chapter 12, Section 13 for further discussion.

7.3.2 Vendor retains control

If the asset is not jointly controlled in the subsequent arrangement, the vendor might retain control over the asset. The vendor will recognise revenue or it will be a financing arrangement. If it is the former, then the issue is the period and pattern over which revenue is recognised.

If the vendor retains control, then it will not meet the requirements in IFRS 15 for treating the transaction as a sale of the asset, i.e., recognising revenue at a point in time on entering into the arrangement. IFRS 15 requires that revenue (and a gain or loss on disposal of a non-current asset not in the ordinary course of business) be recognised upon satisfaction of a performance obligation by transferring control (see Chapter 28 at section 7).

The arrangement could be akin to a lease, especially if the disposal is for a period of time. However, arrangements are only within the scope of IFRS 16 if they relate to an identified asset. Generally, a portion of a larger asset that is not physically distinct is not considered to be an identified asset. The related detailed requirements of IFRS 16 are discussed in Chapter 24 at section 3.1.2.

If it is not a lease and the vendor continues to control the asset, the arrangement might be best characterised as a performance obligation for services to be spread over the term of the arrangement. That is, the initial receipt would be a liability and recognised in profit and loss over time.

Alternatively, it could be a financing-type arrangement, in which case the proceeds would be classified as a financial liability. In effect, the vendor is trading a share of any revenue to which it is entitled in exchange for funding by the purchaser of one or more activities relating to the asset. The purchaser receives a return that is comparable to a lender's rate of return out of the proceeds of production. This could be by receiving a disproportionate share of output until it has recovered its costs (the financing it has provided) as well as the agreed rate of return for the funding. These arrangements are found in the extractive sector, e.g., carried interests and farm-outs (see Chapter 39 at section 6). In the development stage of a project, the asset in question will be classified as PP&E or as an intangible asset under IAS 38. Under a carried interest arrangement, the carried party transfers a portion of the risks and rewards of a property, in exchange for a funding commitment from the carrying party.

7.3.3 Partial disposal

In some circumstances it is argued that the rights transferred by the vendor are such that it neither controls nor jointly controls the whole of the original asset and the question arises as to whether there is a part disposal of the asset. Classification as a joint operation would allow a part disposal of an item of PP&E, but the arrangement cannot be accounted for as a joint operation as there is no joint control. However, it is noted that a party that participates in a joint operation and has rights to the assets, and obligations for the liabilities, but does not have joint control records its interests in the same way as a participant in a joint operation, accounting for its own assets and liabilities. *[IFRS 11.23]*. This is unaffected by the fact that the asset in question may be an interest in an undivided asset; it will still classify its interest in the asset as an item of PP&E. In those sectors where these arrangements are common and where an entity will be simultaneously vendor and acquirer in different arrangements, it is argued that the transactions should be treated symmetrically, i.e., as a part disposal of the undivided asset and an acquisition of an interest in PP&E. However, this interpretation depends entirely on the vendor ceding control of part of its rights and applying IAS 16 principles to obtain symmetry of accounting between acquisitions and disposals.

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3 *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture: Amendments to IFRS 10 and IAS 28*, IASB, September 2014, IFRS 10.C1C and IAS 28.45C.

7.4 Derecognition and replacement of insured assets

Situations may arise where insured assets are destroyed in a fire, or similar destructive incident, and compensation (either in the form of cash or a replacement asset) from an insurance company is expected.

IAS 16 states that these events - the losses of items of PP&E, the related claims for or payments of compensation from third parties and any subsequent purchase or construction of replacement assets - are 'separate economic events' and should be accounted for separately as follows:

- Derecognition of the items of PP&E that are destroyed with a corresponding loss recognised in profit and loss.
- Compensation from the insurer or other third parties for the items of PP&E that are destroyed is recognised as an asset when it becomes receivable with a corresponding gain recognised in profit and loss.
- The cost of items of PP&E restored, purchased or constructed as replacements are recognised in accordance with the requirements of IAS 16 (see sections 3 and 4 above). *[IAS 16.65, IAS 16.66]*.

The items of PP&E that are destroyed will be reflected in the financial statements as a write-off rather than an impairment. Practical example 7-1 below illustrates these requirements.

Practical example 7-1: Avinor AS (2021) **Norway**

Annual and Sustainability Report 2021 [extract]
NOTES TO THE FINANCIAL STATEMENTS [extract]
NOTE 20 Contingencies and uncertainties [extract]

INSURANCE SETTLEMENT PARKING GARAGE STAVANGER AIRPORT

The parking garage at Stavanger Airport was damaged in a fire on 7 January 2020. The parking garage was fully insured, and the insurance covers the cost of rebuilding a similar building in accordance with current regulations. The building of a new parking garage started in January 2022. Expected completion of the parking garage is in the summer of 2023.

In the financial statements for 2020, assets which were considered lost as a result of the fire based were fully impaired. The impairment as at 31 December 2020 amounted to NOK 176.1. Furthermore, a provision for expected demolition expenses of MNOK 20 was made. Avinor received in 2020 a preliminary insurance settlement that fully covered the costs mentioned. The preliminary insurance settlement was presented as a reduction of the impairment charge of MNOK 176.1 and demolition expenses of MNOK 20 in the income statement. The effect of the fire in the income statement for 2020 was therefore zero.

Avinor is in dialogue with the insurance company regarding the rest of the insurance settlement, but the final financial and accounting consequences of the fire will not be known until the insurance settlement is fully completed.

8 IAS 16 presentation and disclosure requirements

The main disclosure requirements of IAS 16 are set out below, but it should be noted that the related disclosure requirements in other standards such as IFRS 13, IAS 1 *Presentation of Financial Statements* and IAS 36 may also be relevant. See Chapters 15, 3 and 21, respectively.

8.1 General disclosures

For each class of PP&E the following should be disclosed in the financial statements:

(a) The measurement bases used for determining the gross carrying amount (e.g., cost or revaluation). *[IAS 16.73(a)]*. When more than one basis has been used, the gross carrying amount for that basis in each category may have to be disclosed (however the standard requires that if revaluation is adopted the entire class of PP&E must be revalued).

(b) The depreciation methods used. Selection of the depreciation method adopted is a matter of judgement and its disclosure provides information that allows users of financial statements to review the policies selected by management and enables them to compare with other entities. For similar reasons, it is necessary to disclose depreciation (in item (e)(vii) below), whether recognised in profit or loss or as a part of the cost of other assets, during a period; and accumulated depreciation at the end of the period (in item (d) below). *[IAS 16.73(b), IAS 16.75]*.

(c) The useful lives or the depreciation rates used. Selection of the useful lives or depreciation rates used is a matter of judgement and its disclosure provides information that allows users of financial statements to review the policies selected by management and enables them to compare with other entities. *[IAS 16.73(c), IAS 16.75]*.

(d) The gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period. *[IAS 16.73(d)]*.

(e) A reconciliation of the carrying amount at the beginning and end of the period showing:

  (i) Additions

  (ii) Disposals, and assets classified as held for sale or included in a disposal group held for sale in accordance with IFRS 5

  (iii) Acquisitions through business combinations

  (iv) Increases or decreases resulting from revaluations and from impairment losses recognised or reversed directly in other comprehensive income under IAS 36

  (v) Impairment losses recognised in profit or loss during the period under IAS 36

  (vi) Impairment losses reversed in profit or loss during the period under IAS 36

  (vii) Depreciation

  (viii) The net exchange differences arising on the translation of the financial statements from the functional currency into a different presentation currency, including the translation of a foreign operation into the presentation currency of the reporting entity

  And

  (ix) Other changes *[IAS 16.73(e)]*

Practical example 8-1 below illustrates an accounting policy on PP&E together with the movement and reconciliation note (a comparative is provided in the financial statements but is not reproduced here).

Practical example 8-1: Lucas Bols N.V. (2023) **The Netherlands**

ANNUAL REPORT 2022-2023 [extract]
Financial Statements [extract]
Consolidated financial statements 2022/23 [extract]
Notes to the consolidated financial statements [extract]
3. General accounting policies [extract]

(i) Property, plant and equipment

(I) Recognition and measurement

Items of property, plant and equipment are measured at cost less accumulated depreciation and accumulated impairment losses.

(II) Subsequent costs

The cost of replacing part of an item of property, plant and equipment is recognised in the carrying amount of the item if it is probable that the future economic benefits embodied within the part will flow to the Group and its cost can be measured reliably. The costs of the day-to-day servicing of property, plant and equipment are recognised in the profit or loss as incurred.

Any gain or loss on disposal of an item of property, plant and equipment is recognised in profit or loss.

(III) Depreciation

Depreciation is recognised in profit or loss on a straight-line basis over the estimated useful life of each part of an item of property, plant and equipment.

The estimated useful life is as follows:

- Fixtures and leasehold improvements 10 years
- Furniture 10 years
- Equipment 5 years
- Computers 3 years

The depreciation methods, residual value and useful life are reviewed annually and adjusted if appropriate.

17. Property, plant and equipment [extract]

AMOUNTS IN EUR '000	RIGHT-OF-USE ASSETS	EQUIPMENT	FIXTURES AND FITTINGS	FURNITURE	TOTAL
Cost					
Balance at 1 April 2022	8,799	3,008	3,956	189	**15,952**
Additions	–	191	98	11	**300**
Additions through acquisitions	–	–	65	–	**65**
Lease modifications and remeasurements	84	–	–	–	**84**
Disposals	–	–	–	–	**–**
Reclassification	–	–	–	–	**–**
Effect of movement in exchange rates	12	(56)	1	–	**(43)**
Balance at 31 March 2023	**8,895**	**3,143**	**4,120**	**200**	**16,358**
Accumulated depreciation					
Balance at 1 April 2022	(2,857)	(1,762)	(2,231)	(127)	**(6,977)**
Depreciation for the year	(786)	(223)	(404)	(6)	**(1,419)**
Additions through acquisitions	–	–	(35)	–	**(35)**
Disposals	–	–	–	–	**–**
Reclassification	–	–	–	–	**–**
Effect of movement in exchange rates	4	57	48	(18)	**91**
Balance at 31 March 2023	**(3,639)**	**(1,928)**	**(2,622)**	**(151)**	**(8,340)**
Carrying amounts					
At 1 April 2022	**5,942**	**1,246**	**1,725**	**62**	**8,975**
At 31 March 2023	**5,256**	**1,215**	**1,498**	**49**	**8,018**

...

The carrying value of right-of-use assets mainly consists of buildings and includes an amount of EUR 17 thousand relating to office equipment (31 March 2022: EUR 37 thousand) and EUR 34 thousand relating to lease cars (31 March 2022: EUR 46 thousand). Short-term lease expenses and low-value lease expenses of EUR 104 thousand (31 March 2022: EUR 54 thousand) are included in 'Other administrative expenses'. Refer to note 24 and note 27 for further details on the lease liability.

Security

At 31 March 2023 properties with a carrying amount of EUR 2,762 thousand (31 March 2022: EUR 3,033 thousand) were subject to a registered debenture that serves as security for bank loans (see note 23).

IAS 16 also requires the disclosure of the following information, which is useful to gain a fuller understanding of the entire position of the entity's holdings of and its commitments to purchase property plant and equipment: *[IAS 16.74, IAS 16.74A]*

Extract from IAS 16

74 The financial statements shall also disclose:

(a) the existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;

(b) the amount of expenditures recognised in the carrying amount of an item of property, plant and equipment in the course of its construction; and

(c) the amount of contractual commitments for the acquisition of property, plant and equipment.

74A If not presented separately in the statement of comprehensive income, the financial statements shall also disclose:

(a) the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in profit or loss; and

(b) the amounts of proceeds and cost included in profit or loss in accordance with paragraph 20A that relate to items produced that are not an output of the entity's ordinary activities, and which line item(s) in the statement of comprehensive income include(s) such proceeds and cost.

The standard also requires that, in accordance with IAS 8, an entity discloses the nature and effect of any change in an accounting estimate (e.g., depreciation methods, useful lives, residual values, and the estimated cost of dismantling, removing or restoring items of PP&E) that has an effect on the current period or is expected to have an effect in future periods. *[IAS 16.76]*.

8.2 Additional disclosures for revalued assets

In addition to the disclosures required by IFRS 13, if the revaluation method is adopted IAS 16 requires an entity to disclose:

(a) The effective date of the revaluation

(b) Whether an independent valuer was involved

(c) For each revalued class of PP&E, the carrying amount that would have been recognised had the assets been carried under the cost model

And

(d) The revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders *[IAS 16.77]*

In particular the requirement under (c) is quite onerous for entities, as it entails their keeping asset register information in some detail in order to meet it.

In May 2014, the IFRS IC received a request to clarify whether an entity is required to reflect the capitalisation of borrowing costs to meet the disclosure requirement of IAS 16 for assets stated at revalued amounts and for which borrowing costs are not capitalised. Since the capitalisation of borrowing costs for such assets is not required (see Chapter 22 at section 3.2), the determination of the amount of borrowing costs that would have been capitalised under a cost model - solely to meet a disclosure requirement - might be considered burdensome.

The IFRS IC noted that the requirements in IAS 16.77(e) (i.e., item (c) above) are clear. This paragraph requires an entity to disclose the amount at which assets stated at revalued amounts would have been stated had those assets been carried under the cost model. The amount to be disclosed includes borrowing costs capitalised in accordance with IAS 23 (see Chapter 22).[4]

IFRS 13 has a number of disclosure requirements for assets measured at fair value. Some of the significant disclosures under IFRS 13 which would apply to revalued PP&E are: *[IFRS 13.93]*

- If the highest and best use differs from its current use, an entity must disclose that fact and why the asset is being used in a manner different from its highest and best use.
- The fair value measurement's categorisation within the fair value measurement hierarchy (i.e., Level 1, 2 or 3).
- If categorised within Level 2 or 3 of the fair value hierarchy (which most revalued PP&E is likely to be):
  - (i) A description of the valuation technique(s) used in the fair value measurement
  - (ii) The inputs used in the fair value measurement
  - (iii) If there has been a change in the valuation technique (e.g., changing from a market approach to an income approach or use of an additional technique):
    - The change

      And
    - The reason(s) for making it
- Quantitative information about the significant unobservable inputs used in the fair value measurement for those categorised within Level 3 of the fair value measurement hierarchy.
- If categorised within Level 3 of the fair value measurement hierarchy, a description of the valuation processes used by the entity (including, for example, how an entity decides its valuation policies and procedures and analyses changes in fair value measurements from period to period).

4 *IFRIC Update*, May 2014, available on the IFRS Foundation's website.

In addition to these requirements, an entity must also provide the disclosures depending on whether the fair value measurement is recurring or non-recurring. Revalued PP&E are considered recurring fair value measurements and are subject to additional disclosure requirements, which include a qualitative sensitivity analysis. The disclosures for revalued PP&E categorised under Level 3 include a reconciliation from the opening balance to the closing balance, disclosing separately changes during the period to the following:

(i) Total gains and losses for the period recognised in profit or loss, and the line item(s) in profit or loss in which these gains or losses are recognised

(ii) Total gains and losses for the period recognised in other comprehensive income, and the line item(s) in other comprehensive income in which those gains or losses are recognised

(iii) Purchases, sales, issues and settlements (separately disclosing each of those types of changes)

(iv) Transfers into or out of Level 3 of the fair value hierarchy (separately disclosing and discussing transfers into Level 3 from those out of Level 3) including:

- The amounts of any transfers into or out of Level 3
- The reasons for those transfers
- The entity's policy for determining when transfers between levels are deemed to have occurred *[IFRS 13.93]*

These requirements and examples of the requirements are discussed in more detail in Chapter 15 at section 19.

8.3 Other disclosures

In addition to the disclosures required by IAS 1, IAS 16 and IFRS 13 (i.e., those discussed in sections 8.1 and 8.2 above), the standard emphasises that entities are also required to disclose information on impaired PP&E in accordance with IAS 36 (see Chapter 21 at sections 13.2.1 and 13.2.2). *[IAS 16.78]*.

As users of financial statements may find other information relevant to their needs, the standard encourages, but does not require, entities to disclose other additional information such as the carrying amount of any temporarily idle PP&E, the gross carrying amount of any fully depreciated PP&E that is still in use and the carrying amount of any PP&E retired from active use but not classified as held for disposal in accordance with IFRS 5. For any PP&E measured using the cost model, the disclosure of its fair value is also encouraged when this is materially different from the carrying amount. *[IAS 16.79]*.

In addition, entities need to consider the impacts of climate change on PP&E and make disclosures as necessary to meet the needs of the users of the financial statements. The IASB has an active project that aims to improve the reporting of climate-related and other uncertainties in financial statements. In September 2023, the board identified a number of actions to achieve this objective, one of which was to develop examples to illustrate how to apply requirements in IFRS Accounting Standards to reporting the effects of climate-related and other uncertainties. With regards to PP&E, the examples that have since been developed by the staff highlight that where items of PP&E have sufficiently dissimilar risk characteristics, it may be necessary to disaggregate the information in the PP&E disclosures.

8.4 IFRS 16 and the presentation of right-of-use assets

Lessees can present right-of-use assets in the statement of financial position either:

(a) Separately from other assets

Or

(b) Include them within the same line item as that within which the corresponding assets would be presented if they were owned *[IFRS 16.47]*

Lessees can, therefore, include the leased right-of-use assets within PP&E on the face of the statement of financial position.

If right-of-use assets are not presented separately from other assets in the statement of financial position, an entity must disclose which line items include the right-of-use assets. *[IFRS 16.47]*.

The requirements above do not apply to right-of-use assets that meet the definition of investment property, which are presented in the statement of financial position as investment property. *[IFRS 16.48]*.

Presentation of right-of-use assets is discussed further in Chapter 24 at section 5.7.

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Appendix C - Defined terms

Extract from IAS 16

Definitions

6 The following terms are used in this Standard with the meanings specified:

A *bearer plant* is a living plant that:

(a) is used in the production or supply of agricultural produce;

(b) is expected to bear produce for more than one period; and

(c) has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.

(Paragraphs 5A-5B of IAS 41 elaborate on this definition of a bearer plant.)

Carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation and accumulated impairment losses.

Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, eg IFRS 2 *Share-based Payment*.

Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value.

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

Entity-specific value is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13 *Fair Value Measurement*.)

An *impairment loss* is the amount by which the carrying amount of an asset exceeds its recoverable amount.

Property, plant and equipment are tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than one period.

Recoverable amount is the higher of an asset's fair value less costs of disposal and its value in use.

The *residual value* of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Useful life is:

(a) the period over which an asset is expected to be available for use by an entity; or

(b) the number of production or similar units expected to be obtained from the asset by an entity.

Chapter 20 Investment property

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Appendix B - Defined terms 1508

Overview

This chapter covers the requirements of IAS 40 *Investment Property* which prescribes the accounting treatment and related disclosures for investment property, i.e., a property (land or a building - or part of a building - or both) held (by the owner or by the lessee as a right-of-use asset) to earn rentals or for capital appreciation or both. *[IAS 40.1, IAS 40.5]*. Accordingly, this standard must be applied in the recognition, measurement and disclosure of investment property. *[IAS 40.2]*.

On initial recognition, investment properties are measured at cost. Subsequently, these assets could be measured using a cost model or a fair value model as a policy choice. Fair value is determined in accordance with IFRS 13 *Fair Value Measurement* and any gains and losses from periodic revaluation under the fair value model are recognised in profit or loss. The requirements of IFRS 13 are discussed in detail in Chapter 15.

With certain exceptions, the chosen measurement model applies to all investment properties of an entity. IAS 40 provides a specific exception applicable to insurance companies and other entities that hold specified investment properties whose fair value or return is directly linked to the return paid on specific liabilities. IAS 40 also provides an exception when, and only in exceptional cases, the entity concluded on initial recognition that it will not be able to reliably measure the investment property's fair value on a continuing basis.

A property is required to be transferred to, or from, investment property but only when there is a change in use. This transfer occurs when the property meets, or ceases to meet, the definition of investment property and there is evidence of the change in use.

Accounting for properties in the scope of IAS 16 *Property, Plant and Equipment* is covered in Chapter 19 and accounting for properties in the scope of IAS 2 *Inventories* is covered in Chapter 23.

What you need to know

- IAS 40 applies to any property that meets the investment property definition, irrespective of the nature of the business of the reporting entity.
- Judgement is required in determining whether a property qualifies as investment property; an entity develops criteria so that it can exercise that judgement consistently, and, when classification is difficult, discloses these criteria.
- A Level 3 categorisation of IFRS 13 fair value hierarchy is likely to be the most common for investment property due to the lack of an active market for identical assets.
- The definition of 'fair value' in IFRS 13 is consistent with 'market value' as defined in International Valuation Standards (IVS). But, perhaps confusingly, it differs from the IVS definition of fair value. Management needs to be aware of the conceptual differences between IFRS 13 and IVS to ensure any values used for financial reporting that are obtained from appraisals, whether external or internal, are consistent with the objective of fair value measurement in accordance with IFRS 13.
- Whichever model is chosen, fair value or cost, IAS 40 requires all entities to disclose the fair value of their investment property. The extent and nature of IFRS 13 disclosures require exercise of judgement of management.

1 Introduction

IAS 40 is an example of the particular commercial characteristics of an industry resulting in the special accounting treatment of a certain category of asset, i.e., investment property. However, it is not only investment property companies that hold investment property; any property that meets the investment property definition in IAS 40 is so classified, irrespective of the nature of the business of the reporting entity. This standard must be applied in the recognition, measurement and disclosure of investment property. *[IAS 40.1, IAS 40.2]*.

The original standard, which was approved in 2000, was the first international standard to introduce the possibility of applying a fair value model for non-financial assets where all valuation changes from one period to the next are reported in profit or loss. This contrasts with the revaluation approach allowed under IAS 16 (see Chapter 19 at section 6) where increases above cost, and their reversals, are recognised in Other Comprehensive Income ('OCI').

The exposure draft that preceded IAS 40 proposed that fair value must be the sole measurement model for investment property. However, some respondents were concerned that, in certain parts of the world, property markets were not sufficiently liquid to support fair value measurement for financial reporting purposes. Consequently, the cost option was introduced into the standard, as the Board believed, at that stage, that it was impracticable to require a fair value model for all investment property.

Despite the free choice of model available, IAS 40 has a rebuttable presumption that, other than in exceptional cases, an entity can measure the fair value of a completed investment property reliably on a continuing basis.

The question of the reliability of valuations was given greater focus following the change in scope of the standard in 2009 to include investment property under construction (see section 2.5 below) because, following that change, the standard allows investment property under construction to be measured at cost until such time as the fair value becomes reliably measurable or construction is completed (whichever comes earlier) provided that the fair value of the investment property under construction is not reliably measurable but the fair value of such property is expected to be reliably measurable when construction is complete (see section 6.3 below).

This chapter discusses the revised version of IAS 40, which was published in December 2003, as subsequently updated by various narrow-scope amendments and minor consequential amendments arising from other standards.

Differences between IAS 40 and US GAAP guidance on accounting for investment property are not addressed in this chapter as the standards are not converged. Therefore, differences between IAS 40 and the corresponding US GAAP guidance may exist that are not discussed in this chapter.

2 Definitions and scope

The relevant terms defined by IAS 40 are as follows: *[IAS 40.5]*

Extract from IAS 40

Definitions

5 The following terms are used in this Standard with the meanings specified:

Carrying amount is the amount at which an asset is recognised in the statement of financial position.

Cost is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, eg IFRS 2 *Share-based Payment*.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13 *Fair Value Measurement*).

Investment property is property (land or a building - or part of a building - or both) held (by the owner or by the lessee as a right-of-use asset) to earn rentals or for capital appreciation or both, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes; or

(b) sale in the ordinary course of business.

Owner-occupied property is property held (by the owner or by the lessee as a right-of-use asset) for use in the production or supply of goods or services or for administrative purposes.

The IAS 40 definition for investment property above means that any entity, whatever the underlying nature of its business, can hold investment property assets if its intention on initial recognition (either by acquisition or change in use - see section 9 below) is to hold them for rent or for capital appreciation or both. Subsequent to initial recognition, assets might be reclassified into and from investment property (see section 9 below). It is also worthy of note that a property interest held by a lessee as a right-of-use asset under an operating lease can be an investment property (see section 2.1 below).

How we see it

An entity's intention of holding a property plays an important role in determining whether it meets the definition of investment property or not. Such intention affects classification of the property at initial recognition, i.e., either when recognising an asset for the first time, or when an existing asset is to be transferred to, or from, investment property provided such change in intention is supported by evidence of change in use of that asset (see section 9 below).

In contrast, 'owner-occupied' property as defined above falls outside the scope of IAS 40 and is accounted for under IAS 16 (see section 2.4 below and Chapter 19), together with IFRS 16 *Leases* (see Chapter 24), if relevant. Property held, or being constructed, with the intention of sale in the ordinary course of business also falls outside the scope of IAS 40 and is accounted for under IAS 2 (see section 2.6 below and Chapter 23). Accordingly, the definition of investment property in IAS 40 ensures that all property is covered by one, and only one standard, that is either IAS 2, IAS 16 or IAS 40. *[IAS 40.B30, IAS 40.B31]*.

IAS 40 applies to the measurement in a lessor's financial statements of investment property provided to a lessee under an operating lease (see section 2.3 below). IAS 40 also applies to the subsequent measurement in a lessee's financial statements of investment property interests held under a lease if the lessee applies the fair value model in IAS 40 to its investment property (see section 2.1 below). However, it does not deal with other accounting matters that are dealt with in IFRS 16 (see Chapter 24), including:

- Classification of leases as finance or operating leases by a lessor
- Recognition of lease income arising from the leasing of investment property
- Initial measurement in a lessee's financial statements of property interests held under a lease
- Measurement in a lessor's financial statements of its net investment in a finance lease
- Accounting for sale and leaseback transactions
- Disclosure of information about leases by lessors and lessees

IAS 40 does not apply to:

- Biological assets related to agricultural activity (see IAS 41 *Agriculture* and IAS 16)
- Mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources *[IAS 40.4]*

Biological assets that are physically attached to land (for example, trees in a plantation forest) are measured at their fair value less estimated point-of-sale costs separately from the land. *[IAS 41.12]*. However, the land related to the agricultural activity is accounted for either as property under IAS 16 or investment property under IAS 40. *[IAS 41.2]*.

What primarily distinguishes investment property from other types of property interest is that it generates cash flows (from rental or sale) that are largely independent of those from other assets held by the entity. By contrast, owner-occupied property used by an entity for administrative purposes or for the production or supply of goods or services does not generate cash flows that are attributable only to itself but does so only in conjunction with other assets used in the production or supply process. IAS 16 applies to owned owner-occupied property and IFRS 16 applies to owner-occupied property held by a lessee as a right-of-use asset. *[IAS 40.7]*.

Even with the distinction described above, it is sometimes difficult to distinguish investment property from owner-occupied property. The standard therefore gives guidance to help determine whether or not an asset is an investment property (see sections 2.1 to 2.11 below).

Circumstances are not always straightforward particularly if at initial recognition the intention of holding a property is mixed or undetermined (except for land - see section 2.2 below). For example, entities that are not in the property industry may not be within the scope of IAS 40 if they sublease a property under an operating lease with the intention of subsequently using the property within their own business. Such a property would not meet the definition of an investment property in IAS 40 because it would not be held solely for rentals, capital appreciation or both. *[IFRS 16.BC179(b)]*. In this example, the intended use of the property as an owner-occupied property would even be clearer if the sublease of the property would only be for a short period of time in relation to the remaining lease term of the head lease.

How we see it

Considering how an entity's principal activities and its business strategy for the property, including the length of the lease to a tenant, impact the determination of the intended use of the property (and therefore, whether the property meets the definition of an investment property under IAS 40) may require the exercise of judgement based on specific facts and circumstances. An entity develops criteria so that it can exercise that judgement consistently in accordance with the definition of investment property and the related guidance in IAS 40. Such criteria are required to be disclosed when classification is difficult (see section 12.1 below).

It is also worthy of note that the IFRS IC has discussed the accounting for a structure that 'lacks the physical characteristics of a building', i.e., whether it should be accounted for as investment property in accordance with IAS 40. This primarily related to an emerging business model in which an entity owns telecommunication towers and leases spaces in the towers to telecommunication operators to which the operators attach their own devices. The entity may also provide some basic services to the telecommunication operators such as maintenance services.[1]

The request specifically sought clarification on whether a telecommunication tower should be viewed as a 'building' and thus 'property', as described in IAS 40.5 and how any service element in the leasing agreement and business model of the entity should be taken into consideration when analysing the issue.

The IFRS IC observed that the tower has some of the characteristics of investment property, in that spaces in the tower were let to tenants to earn rentals (e.g., leasing of spaces for telecommunication operators to which operators attach their own devices) but questioned whether the tower qualifies as a 'building' because it lacks features usually associated with a building such as walls, floors and a roof. They also observed that the same question could arise about other structures, such as gas storage tanks and advertising billboards.[2]

The IFRS IC observed that there would be merit in exploring approaches to amending IAS 40 to include structures that lack the physical characteristics associated with a building.[3] However, following research on this issue, the IASB decided not to pursue this issue because there appeared to be limited demand for fair value accounting for these types of structures and limited diversity in practice.[4]

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1 *IFRIC Update*, September 2012, available on the IFRS Foundation's website.

2 *IFRIC Update*, September 2012, available on the IFRS Foundation's website.

3 *IFRIC Update*, January 2013, available on the IFRS Foundation's website.

4 *IASB Update*, December 2014, available on the IFRS Foundation's website.

2.1 Property interest held under a lease

Leases of property are included in the scope of IFRS 16 (see Chapter 24). Under IFRS 16, lessees apply a single model for most leases, i.e., unlike lessors, lessees do not need to classify leases as finance leases or as operating leases. IFRS 16 requires lessees to recognise most leases in their statement of financial position as lease liabilities with corresponding right-of-use assets.

Properties held by lessees as right-of-use assets that meet the definition of investment property, as described in section 2 above, are included in the scope of IAS 40. This results in lessees using either the cost model and disclosing fair value, or using the fair value model, depending on whether the lessee accounts for the remainder of its investment property under the cost model or the fair value model. In the IASB's view, this approach will provide useful information to users of financial statements about the fair value of investment property held by a lessee as a right-of-use asset, which is consistent with information provided about owned investment property. *[IFRS 16.BC178]*.

An investment property held by a lessee as a right-of-use asset is recognised in accordance with IFRS 16. *[IAS 40.19A]*. IFRS 16 requires a lessee to measure right-of-use assets arising from leased property in accordance with the fair value model of IAS 40 if the leased property meets the definition of investment property and the lessee elects to apply the fair value model in IAS 40 as an accounting policy (see sections 6 and 6.7 below). *[IFRS 16.34]*.

When a lessee uses the fair value model to measure an investment property that is held as a right-of-use asset, it will measure the right-of-use asset, and not the underlying property, at fair value. *[IAS 40.40A]*.

If the lessee elects to apply the cost model to measure its investment property, the lessee must measure its right-of-use assets that meet the definition of investment property in IAS 40 using the cost model in IFRS 16 (see section 7 below) unless such assets are held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* (see section 8 below). *[IAS 40.56]*.

If the right-of-use assets meet the definition of investment property, these are presented in the statement of financial position as investment property (see Chapter 24 at section 5.7). *[IFRS 16.48]*. In addition to the relevant disclosure requirements in IFRS 16 (see Chapter 24 at section 5.8), a lessee also applies the disclosure requirements in IAS 40 for such right-of-use assets (see section 12 below). *[IFRS 16.56]*.

Subsequent to initial recognition, the IASB indicated that a lease liability should be accounted for in a manner similar to other financial liabilities (i.e., on an amortised cost basis). *[IFRS 16.BC182]*.

For further discussion on subsequent measurements of lease liabilities and right-of-use assets, see Chapter 24 at section 5.3.

2.2 Land

Land is investment property if it is held to earn rentals or for capital appreciation or for both; or for a currently undetermined future use. This is in contrast to land that is held for sale in the ordinary course of business (typically in the shorter term) or held for the production or supply of goods and services or for administrative purposes. *[IAS 40.7, IAS 40.8]*.

If, on initial recognition, land is held for a currently undetermined future use, i.e., if an entity has not determined whether it will use the land as owner-occupied property, or for sale in the ordinary course of business, or to earn rentals or for capital appreciation, it is deemed to be held for capital appreciation and must be classified as investment property. *[IAS 40.8]*.

2.3 Property leased to others

Properties leased to other parties under one or more operating lease are generally investment properties, whether they are owned freehold by the reporting entity or are right-of-use assets relating to properties held by the reporting entity (see sections 2 and 2.1 above). This will also apply if the property is currently vacant while tenants are being sought. *[IAS 40.8]*.

In the real estate industry, properties might have been held for sale in the ordinary course of business since their initial recognition (either by acquisition or change in use - see section 9 below) but are leased out prior to sale in order to minimise cash outflows whilst the entity seeks a buyer; and because prospective buyers may view the existence of such lease contracts positively, especially those that wish to acquire property for investment purposes.

How we see it

In our view, such properties described above - notwithstanding that they are leased to tenants under operating leases - are accounted for as inventories under IAS 2 as long as it remains the intention of the entity to hold such properties for sale in the ordinary course of business (see section 2.6 below). The rent received would be recorded as operating lease income in profit or loss and would not be treated as a reduction in the cost of inventory. See Chapter 23 at section 4.1 for further discussion.

When an entity no longer intends to sell an inventory property, IAS 40 requires the property to be transferred from inventories to investment properties when, and only when, there is a change in use evidenced, for example, by the commencement of an operating lease to another party (see section 9 below).

Property that is leased to another party under a finance lease is not an investment property but is accounted for under IFRS 16 (see Chapter 24). *[IAS 40.9]*.

2.4 Property held for own use ('owner-occupied')

As noted above, owner-occupied property, that is property held for use in the production or supply of goods or services or for administrative purposes, is specifically excluded from being treated as investment property and is subject to the provisions of IAS 16 and IFRS 16. Owner-occupied property includes (among other things):

- Property that is going to be owner-occupied in the future (whether or not it has first to be developed)
- Property occupied by employees (whether or not they pay rent at market rates)
- Owner-occupied property awaiting disposal *[IAS 40.9]*

Note that the treatment in the consolidated financial statements can be different from the treatment in standalone financial statements of individual group entities. For example, it may be the case that a property owned by one group company is held for occupation by another group company. This will be owner-occupied from the perspective of the group as a whole but can be classified as an investment property in the financial statements of the individual entity that owns it, provided it meets the definition of an investment property. *[IAS 40.15]*. This classification in the individual entity's financial statements will apply even if the rental is not at arm's length and the individual entity is not in a position to benefit from capital appreciation. *[IAS 40.B23, IAS 40.B24]*.

How we see it

A property, that meets the investment property definition (see section 2 above), which is owned by a group but occupied by an associate or a joint venture would be accounted for as investment property in the consolidated financial statements. This is because associates and joint ventures are not part of the group.

2.5 Investment property under construction

Property that is being constructed or developed for future use as investment property ('investment property under construction') is in the scope of IAS 40. *[IAS 40.8]*.

The fair value of investment property under construction is further discussed in section 6.3 below.

2.6 Property held or under construction for sale in the ordinary course of business

Property held, or being constructed, with the intention of sale in the ordinary course of business is not an investment property. This includes, for example, property acquired exclusively for sale in the near future or for development and resale (such property is accounted for as inventory under IAS 2 (see Chapter 23)). *[IAS 40.9]*.

The Board rejected proposals of commentators to the Exposure Draft of IAS 40 to treat property held for sale in the ordinary course of business as investment property, rather than as inventories (covered by IAS 2). The arguments of these commentators, were that:

"(a) it is difficult to distinguish property held for sale in the ordinary course of business from property held for capital appreciation; and

"(b) it is illogical to require a fair value model for land and buildings held for long-term capital appreciation (investment property) when a cost model is still used for land and buildings held for short-term sale in the ordinary course of business (inventories)." *[IAS 40.B32]*.

The Board rejected this suggestion because:

"(a) if fair value accounting is used for property held for sale in the ordinary course of business, this would raise wider questions about inventory accounting that go beyond the scope of this project; and

"(b) it is arguably more important to use fair value accounting for property that may have been acquired over a long period and held for several years (investment property) than for property that was acquired over a shorter period and held for a relatively short time (inventories). With the passage of time, cost-based measurements become increasingly irrelevant. Also, an aggregation of costs incurred over a long period is of questionable relevance." *[IAS 40.B33]*.

It was the Board's clear intention that property held for short-term sale is covered only by IAS 2 and therefore be treated as inventories. This is also irrespective of whether the property is let out or not, as discussed in section 2.3 above.

How we see it

While the Board did not quantify 'short-term', it seems reasonable to define this period based on an entity's operating cycle. That is, as long as an asset is a current asset in terms of paragraph 66 of IAS 1 *Presentation of Financial Statements*[5] (see Chapter 3 at section 3.1.3), an entity could conclude that the asset is held for a short term.

An entity, whose principal business activity is to buy and sell property for short-term gains, may, in some circumstances, buy property (or reclassify existing property following a change in use - see section 9 below) with the intention of holding it for long-term capital appreciation. Investment property is defined as property held to earn rentals or for capital appreciation or both, rather than for sale in the ordinary course of business (see section 2 above). *[IAS 40.5]*. The fact that the entity's principal business activity is the buying and selling of property for short-term gains does not, under this definition, prohibit it from classifying properties that are held for long-term capital appreciation as investment properties.

In practice, the classification between investment property and property intended for sale in the ordinary course of business can be a difficult judgement. There is only a fine line between:

- A property held for capital appreciation, and therefore classified as investment property

  And

- A property intended for sale in the ordinary course of business, which would be classified as inventory

For example, the owner will undertake activities to increase the property's value prior to sale or where there is uncertainty in obtaining permits required from relevant authorities prior to commencing construction activities. In the latter case, the property, e.g., land, may continue to appreciate in value during the period when there are no development activities - see section 3.1 below.

Another example is where an entity acquires a tenanted property with a view to redevelop the property and to resell it in the future, but active development will only commence after the existing lease reaches the end of its term, i.e., the entity receives rent payments during the intervening period. As set out in section 2.3 above, the receipt of rental income from a property would not necessarily be the deciding factor. Certainly, other than for land (see section 2.2 above), IAS 40 provides no explicit 'default' classification when the future use of a property has not yet been determined (see also discussion in section 2 above).

5 IFRS 18 *Presentation and Disclosure in Financial Statements*, which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted), was issued by the IASB in April 2024. See Chapter 4 for further details on the new concepts and requirements of IFRS 18.

How we see it

While the IASB envisioned different treatments for short-term and long-term holdings of property, sometimes significant judgement is involved in determining whether a property qualifies as investment property or is inventory, not least because the intentions of management are a critical factor. Exercise of judgement is also important because whilst IAS 40.57 requires property held as inventory to be reclassified as investment property when, and only when, there is evidence of a change in use such as the inception of an operating lease to another party, in contrast, a reclassification from investment property to inventories would require a different evidence of a change in use such as the commencement of a development with a view to sale (see sections 8, 9 and 9.1 below).

Accordingly, an entity develops criteria so that it can exercise that judgement consistently in accordance with the definition of investment property and the related guidance in IAS 40. Such criteria are required to be disclosed when classification is difficult (see section 12.1 below). *[IAS 40.14]*.

2.7 Property with dual uses

A property may be used partly to derive rental income and partly as owner-occupied property. For example, an office tower could be sub-divided by the owner with some floors being rented to tenants whilst retaining others for own use. Similarly with industrial/commercial property, an owner could sub-divide and subsequently sell or rent out some portions and retain other portions for own use.

IAS 40 states that if a property has both investment property and non-investment property uses, providing the parts of the property could be sold or leased out under a finance lease separately, they are accounted for separately. *[IAS 40.10]*.

How we see it

To meet the above requirements, we consider that a property must actually be in a state and condition to enable the owner to dispose of it or lease it out separately at the end of the reporting period.

The fact that a property could be divided in future periods if the owner so chose is insufficient to conclude that the portions can be accounted for separately. Consequently, if a property requires sub-division before the portions could be disposed of separately, then those parts are not accounted for as separate portions and the entire property must be accounted for as either an investment property or as a non-investment property (e.g., as an owner-occupied property or as an inventory property) until such sub-division occurs or unless sub-division is a non-substantive legal requirement.

In certain instances, portions of a property are leased out under operating leases rather than under finance leases.

How we see it

In our view, an intention to lease out, or the action of leasing out a portion of a property under an operating lease (rather than a finance lease) is *prima facie* evidence that, if it so wished, the entity could also lease out the property under a finance lease - the difference between the two commonly being just the length of the lease. Accordingly, this does not prohibit the application of IAS 40 to that portion. If, however, there is evidence that the portion of the property could not be leased out under a finance lease, then IAS 40 could not be applied to that portion and further assessment of the facts and circumstances may be needed.

It also seems clear that 'separately' needs to be assessed both in terms of the physical separation (e.g., mezzanine floors and partitioning walls) of the property and to legal separation (e.g., legally defined property boundaries and/or registered separately).

In many jurisdictions, properties that are physically sub-divided into different portions (for example, different floors) are registered in a Land or Property registry as one single property and need to be legally sub-divided before a portion can be leased out to another party or disposed of. Often, these legal proceedings are undertaken only at or near the point of sale of, or the assignment of a lease on, that portion of the property concerned. At the end of the reporting period the legal sub-division might not have occurred.

How we see it

For a property that is already physically sub-divided into different portions, we believe that judgement is required to determine whether the legal separation is a substantive requirement that will restrict the portion of the property concerned being currently separable or whether it is a non-substantive requirement where it is currently separable.

For example:

- If the entity owning the property could not be prevented from legally sub-dividing the property, then it is already in a condition to be sold separately and this would not prevent the portion of the property concerned being accounted for as investment property. This would be the case where, for example: the process of sub-dividing the property was entirely within the control of the entity and did not require permission from a third party (which would include the relevant authorities); or if permission from a third party was required, but this was no more than a formality.
- Conversely, if the entity was required to obtain the permission of third parties before legally sub-dividing the property, and such permission could realistically be withheld, the portions of the property concerned are not accounted for separately until such legal sub-division occurs.

Therefore, if the portion of the property concerned otherwise meets the definition of investment property at the end of the reporting period, judgement is required to assess the legal position of the property in determining whether it is appropriate to account for a portion separately under IAS 40. Criteria used in the assessment are required to be disclosed and applied consistently (see section 12.1 below). *[IAS 40.14]*.

In the event that no separation is possible (i.e., portions could not be sold or leased out separately under a finance lease), the property is an investment property only if an insignificant portion is used for non-investment property purposes. *[IAS 40.10]*. IAS 40 does not provide further guidance to clarify what constitutes an 'insignificant portion' for this purpose. The Board concluded that quantitative guidance would create arbitrary distinctions. *[IAS 40.B39]*.

How we see it

If the portions could not be sold or leased out separately under a finance lease, classification and accounting of the entire property depends on the significance of the portions used for non-investment property purposes; but IAS 40 does not provide further guidance on this. Therefore, the setting of a threshold to evaluate whether or not something is 'significant' or 'insignificant' depends on judgement and circumstances. Significant judgement and criteria used in the assessment are required to be disclosed and applied consistently (see section 12.1 below).

In the Practical example 2-1 below, PSP Swiss Property Ltd discloses its judgement about dealing with property that it partially uses, but other entities will need to make their own assessment.

Practical example 2-1: PSP Swiss Property Ltd (2023) — Switzerland

Annual report 2023 [extract]
Consolidated financial statements [extract]
Notes to the consolidated financial statements [extract]
2 Summary of significant accounting policies [extract]
2.6 Accounting and valuation principles [extract]

Own-used properties

Own-used properties are carried at historical cost and depreciated over their useful economic life, broken down into significant components. The depreciation period (straight-line method) is 40 years for buildings and 20 years for operating equipment (such as air conditioning, elevators, ventilation, etc.). Associated land is not depreciated. In the case of partial own-use of a property, an area share of less than 25% is considered insignificant, with the result that the entire property is reported in the balance sheet as an investment property at fair value.

2.8 Property with the provision of ancillary services

If the owner supplies ancillary services to the user of the investment property, the property will not qualify as an investment property unless these services are an insignificant component of the arrangement as a whole. For example, security and maintenance services provided by the owner of an office building to the lessees who occupy that building are described by the standard as being insignificant. *[IAS 40.11]*.

The crucial issue is the extent to which the owner is involved with the underlying business and retains significant exposure to the risks of running a business. IAS 40 does not provide further guidance on when ancillary services are 'significant' (which would result in exclusion of the property from its scope). The Board concluded that quantitative guidance would create arbitrary distinctions. *[IAS 40.B39]*.

The standard, however, uses the example of a hotel. An owner-managed hotel, for example, would be precluded from being an investment property as the services provided to guests are a significant component of the commercial arrangement as a whole. Therefore, an owner-managed hotel is owner-occupied property, rather than investment property. *[IAS 40.12]*.

It may be difficult to determine whether ancillary services are so significant that a property does not qualify as investment property. For example, the owner of a hotel sometimes transfers some responsibilities to third parties under a management contract and the terms of such contracts may vary widely. However, the nature of the asset in question is not the key factor; rather it is the nature of the owner's involvement and interest in the asset. If the owner's position is, in substance, that of a passive investor, a property would be treated as investment property. If, in contrast, the owner has outsourced day-to-day functions while retaining significant exposure to variation in the cash flows generated by the operations that are being executed in the property, such a property would rather be treated as owner-occupied property. *[IAS 40.13]*.

How we see it

IAS 40 refers to owner-managed hotels as being precluded from being investment property. Hotel properties that are leased on arm's length terms to hotel operators may, however, fall to be accounted for as investment property. This is more likely to be the case when:

- The payments under the lease are not significantly determined by the results of the hotel operator (see section 2.9 below), rather they reflect the general market for such properties

  And
- The nature of the owner's rights in the arrangements with the operator is not divergent from those usually expected under a property lease

IAS 40 acknowledges that this question of significance can require judgements to be made. It specifies that an entity develops consistent criteria for use in such instances that reflect the provisions described above. These criteria must be disclosed in those cases where classification is difficult. *[IAS 40.14]*.

2.9 Property where rentals are determined by reference to the operations in the property

It may also be inappropriate to consider a property as investment property if the owner is significantly exposed to the operation of the business in the property through a linkage between the rentals charged and the performance of the business.

For a property that is leased out to a retailer under a lease contract in which rentals are being determined by reference to turnover or profit, the appropriate classification of the property can be difficult.

How we see it

In the case described above, if the turnover- or profit-related element is a very significant proportion of total rental, then consideration must be given to whether the landlord is so involved with the underlying business as to make classification of the property as investment property inappropriate. This will be a matter of judgement based on any other specific facts and circumstances (for example, the length of the lease, the level of exposure to the performance of the underlying business or the degree of involvement in the management of the underlying business).

An entity develops criteria so that it can exercise that judgement consistently in accordance with the definition of investment property and the related guidance in IAS 40. Such criteria are required to be disclosed when classification is difficult (see section 12.1 below). *[IAS 40.14]*.

2.10 Group of assets leased out under a single operating lease

It is sometimes the case in practice that a group of assets comprising land, buildings and 'other assets' is leased out by a lessor under a single lease contract in order to earn rental income. In such a case, the 'other assets' would generally comprise assets that relate to the manner in which the land and buildings are used under the lease. The issue that arises is under what circumstances the 'other assets' must be regarded by the lessor as part of an investment property rather than as a separate item of property, plant and equipment (or another asset). This is shown in the following Illustration:

Illustration 2-1: Definition of an investment property: a group of assets leased out under a single operating lease

A lessor enters into the following two single contract leases in order to earn rental income. All the individual assets subject to the leases meet the test of being classified as an operating lease. The lessor applies the fair value measurement model for subsequent measurement of investment property.

Lease 1: Vineyard and winery

A vineyard including a winery is leased out under an operating lease. The vineyard comprises the following assets:

- Land
- Vineyard infrastructure (e.g., trellises)
- Winery building structures
- Winery plant and machinery (crushing equipment, distilling equipment)
- Vines (grapes are excluded, as they belong to the lessee)

Lease 2: Port

A port is leased out under an operating lease. The port comprises the following assets:

- Land
- Warehouses
- Transport infrastructure to and from the port (roads, rail tracks, bridges)
- Wharves
- Light towers (that enable the 24-hour operation of the port)
- Specialised container cranes (to be able to move containers around)

To what extent can the 'other assets' included in the leases (but which are not considered to constitute a piece of land or a building) be included in the investment property definition under IAS 40?

The consequence of including plant and equipment in the definition of investment property is that if the investment property is accounted for at fair value, changes in the fair value of that plant and equipment will, like changes in the fair value of the land and buildings, be recognised in profit or loss.

From a literal reading of the definition of an investment property in IAS 40.5, it could be argued that an investment property can consist only of a building (or part of a building), a piece of land, or both and cannot include 'other assets'. However, such an interpretation is inconsistent with IAS 40.50, which implies that a broader interpretation is more appropriate.

Paragraphs 50(a) and (b) of IAS 40 read as follows: *[IAS 40.50(a), IAS 40.50(b)]*

Extract from IAS 40

50 In determining the carrying amount of investment property under the fair value model, an entity does not double-count assets or liabilities that are recognised as separate assets or liabilities. For example:

(a) equipment such as lifts or air-conditioning is often an integral part of a building and is generally included in the fair value of the investment property, rather than recognised separately as property, plant and equipment.

(b) if an office is leased on a furnished basis, the fair value of the office generally includes the fair value of the furniture, because the rental income relates to the furnished office. When furniture is included in the fair value of investment property, an entity does not recognise that furniture as a separate asset.

(c) ...

Although IAS 40.50 addresses the fair valuation of investment property, it nevertheless implies that other assets that are integral to the land and buildings or are otherwise required to be included in the lease in order to generate rental income under the lease concerned must also be regarded as being part of the investment property. Further, the separation of this group of assets in two parts - one part being classified as investment property and the other part being classified as an item of property, plant and equipment - might be misleading, as the entire group of assets generates a single stream of revenue.

Consequently, an item other than a piece of land or a building must be regarded by a lessor as being part of an investment property if this item is an integral part of it, that is, it is necessary for the land and buildings to be used by a lessee in the manner intended and is leased to the lessee on the same basis (e.g., as a package with the same lease term) as the land and buildings. In determining whether all the assets can be classified as investment property, the following conditions must be considered:

- The land and buildings must be the 'dominant assets' that form the investment property.
- The 'other assets' are leased to the lessee together with the land and building as a whole.

  And
- The entire group of assets is generating the income stream from the lease contract.

How we see it

The determination as to whether or not an item constitutes an integral part of an investment property requires judgement and will depend on the particular facts and circumstances. However, it is our view that in order for all the assets to be classified as investment property, all the conditions referred to above must be present.

This means that, in the case of Lease 1, if the entire group of assets is leased with the purpose of enabling the lessee to produce grapes and, subsequently, wine, the investment property comprises the land, the vineyard infrastructure, the winery building structures and the winery plant and machinery. The vineyard infrastructure (e.g., trellises as they are essential to support the vines) is integral to the investment property, as it is necessary in order for the property to function properly (it is necessary for growing the grapes). The winery plant and machinery (crushing equipment, distilling equipment) are also integral to the investment property, as plant and machinery are necessary to process the grapes in order to make wine. Vines, which meet the definition of biological assets, are subject to the requirements of IAS 41. They are excluded because 'biological assets related to agricultural activity' are outside the scope of IAS 40. *[IAS 40.4(a)]*.

In the case of Lease 2, if the entire group of assets is leased with the purpose of enabling the lessee to use the assets to operate them as a port, the investment property comprises all of the assets, i.e., the land, the warehouses, the transport infrastructure, the wharves, the light towers, and the specialised container cranes. This is because all the assets are necessary for the port to function as intended.

2.11 Property acquired with the assistance of government grants

IAS 40 applies to a property acquired and let for social housing if it meets the definition of investment property (see section 2 above). Grants associated with investment property are accounted for in accordance with IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* (see Chapter 25). The model used to measure the investment property may impact the recognition of these grants as shown in Illustration 3-7 in Chapter 25 at section 3.6.1.

3 Recognition

IAS 40 sets out the following recognition criteria for investment property: *[IAS 40.16]*

Extract from IAS 40

16 An owned investment property shall be recognised as an asset when, and only when:

(a) it is probable that the future economic benefits that are associated with the investment property will flow to the entity; and

(b) the cost of the investment property can be measured reliably.

These recognition criteria apply for any costs incurred, whether initially or subsequently. This means that all costs related to investment property, whether on initial recognition or thereafter (for example, to add to, or replace part of, or service a property) must meet the recognition criteria at the point at which the expenditure is incurred if they are to be capitalised. *[IAS 40.17]*.

An investment property held by a lessee as a right-of-use asset is recognised in accordance with IFRS 16. *[IAS 40.19A]*.

3.1 Expenditure prior to planning permissions/zoning consents

In many jurisdictions, permissions from relevant authorities are required prior to development of new or existing property, and the ability to start physical construction of the development depends on these permissions.

Application for such permissions supports the entity's intention as to the use of the property and may be considered as a factor in classifying the asset. However, unless an entity is considering a number of possible uses of the asset at its initial recognition, the uncertainty in obtaining the relevant permission would usually not affect the classification of the property which, as set out in section 2 above, is mainly based on the entity's intention when the property is first acquired. Subsequent to initial recognition, assets might be reclassified into and from investment property (see section 9 below).

The likelihood of obtaining such permissions, however, is relevant in recognition and measurement of any additional costs to the property. Developers typically incur significant costs prior to such permissions being granted and such permissions are rarely guaranteed.

How we see it

In assessing whether pre-permission expenditure can be capitalised - assuming it otherwise meets the criteria - a judgement must be made, at the date the expenditure is incurred, of whether there is sufficient probability that the relevant permissions will be granted.

Conversely, if during the application and approval process of such permits it is no longer expected that necessary permits will be granted, capitalisation of pre-permission expenditure must cease and any related amounts that were previously capitalised and that will not be recovered in the future would be written off (either through determining the subsequent fair value of the property, if applying the fair value model in IAS 40 (see section 6 below), or through impairment assessment in accordance with IAS 36 *Impairment of Assets*, if the cost model is applied (see section 7.3 below)).

In addition to the discussion above, if the cost model is used, the carrying amount of any related property subject to development or redevelopment (or, if appropriate, the cash generating unit where such an asset belongs) must be tested for impairment, where applicable, in accordance with IAS 36 (see Chapter 21).

3.2 Other aspects of cost recognition

3.2.1 Repairs and maintenance

Day-to-day servicing, by which is meant the repairs and maintenance of the property which largely comprises labour costs, consumables and minor parts, are recognised in profit or loss as incurred. *[IAS 40.18]*. However, the treatment is different if large parts of the properties have been replaced - the standard cites the example of interior walls that are replacements of the original walls. In this case, the cost of replacing the original part will be recognised at the time that cost is incurred if the recognition criteria are met, while the carrying amount of the original part is derecognised (see section 10.3 below). *[IAS 40.19]*.

The inference is that by restoring the asset to its originally assessed standard of performance, the new part will meet the recognition criteria and future economic benefits will flow to the entity once the old part is replaced. The inference is also that replacement is needed for the total asset to be operative. This being the case, the new walls will therefore meet the recognition criteria and the cost will therefore be capitalised.

Other than interior walls, large parts that might have to be replaced include elements such as lifts, escalators and air conditioning equipment.

3.2.2 Allocation into parts

IAS 40 does not explicitly require an analysis of investment properties into components or parts. However, this analysis is needed for the purposes of recognition and derecognition of all expenditure after the asset has initially been recognised and (if the parts are significant) for depreciation of those parts (see Chapter 19 at sections 3.2 and 5.2). Some of this is not relevant to property held under the fair value model that is not depreciated because the standard expects the necessary adjustments to the carrying amount of the asset as a whole to be made via the fair value mechanism (see section 6 below). However, entities that apply the cost model are obliged to account for properties after initial recognition in accordance with the requirements of IAS 16. The cost model is discussed further in section 7 below.

3.3 Acquisition of investment property or a business combination?

In July 2011, the IFRS IC discussed a request seeking clarification on whether the acquisition of a single investment property, with lease agreements with multiple tenants over varying periods and associated processes, such as cleaning, maintenance and administrative services such as rent collection, constitutes a business as defined in IFRS 3 *Business Combinations*.

The IFRS IC noted that the issue raises the question of whether there is any interaction between IAS 40 and IFRS 3. It discussed services that are 'ancillary services' (as discussed in IAS 40.11 to 14 - see section 2.8 above) that are not so significant as to disqualify a property from being an investment property but could nonetheless be considered 'processes' (as discussed in IFRS 3.B7 to B12) that could result in the acquired set of activities constituting a business.[6]

IAS 40 notes, in relation to the need to distinguish investment property from owner-occupied property, that where certain ancillary processes exist in connection with an investment property, they are often insignificant to the overall arrangement (see section 2.8 above). Consequently, it may be appropriate to conclude that, where such acquired processes are considered by IAS 40 to be insignificant, an investment property acquisition is within the scope of IAS 40 rather than IFRS 3. However, it should be noted that IAS 40 and IFRS 3 are not mutually exclusive and this determination is not the specific purpose of the standard's observation about ancillary services. *[IAS 40.BC19, IAS 40.BC20]*.

Consequently, the IASB issued the *Annual Improvements to IFRSs 2011-2013 Cycle* on 12 December 2013 which amended IAS 40 to state explicitly that the judgement required to determine whether the acquisition of investment property is the acquisition of an asset or a group of assets - or a business combination within the scope of IFRS 3 - should only be made with reference to IFRS 3. *[IAS 40.14A]*.

This clarified that the discussion about 'ancillary services' in IAS 40.7 to 14 (see section 2.8 above) relates to whether or not a property is owner-occupied property or investment property and not to determining whether or not a property is a business as defined in IFRS 3. Determining whether a specific transaction meets the definition of a business combination as defined in IFRS 3 and includes an investment property as defined in IAS 40 requires the separate application of both standards. *[IAS 40.14A]*.

IFRS 3 establishes different accounting requirements for a business combination as opposed to the acquisition of an asset or a group of assets that does not constitute a business (see section 4.1.1 below). Therefore, determining whether an acquired investment property is a business or not, could result in significantly different accounting outcomes, both at the date of acquisition (i.e., at initial recognition) and subsequently. If dealt with as an acquisition of a business, then the initial accounting for investment property is considerably more complex. For example, amongst other requirements:

- Initial direct costs are expensed (IAS 40 requires these to be capitalised - see section 4.1 below)
- The initial recognition exception for deferred taxation does not apply (IAS 12 *Income Taxes* does not allow deferred taxation to be provided on existing temporary differences for acquisitions that are not business combinations and at the time of the transaction, affect neither accounting profit nor taxable profit (tax loss))
- Goodwill is recognised (often itself 'created' by the provision of deferred taxation)

6 *IFRIC Update*, July 2011, available on the IFRS Foundation's website.

Judging whether an acquisition is a business combination or not is therefore of considerable importance. *[IAS 40.14A]*.

How we see it

It will be a matter of judgement for preparers to conclude that, when applying the guidance in IFRS 3, if acquired processes are considered to be insignificant (whether by reference to guidance in IAS 40 or otherwise) an investment property acquisition is within the scope of IAS 40 rather than IFRS 3. This judgement will rest upon the facts and circumstances of each acquisition. If significant, disclosure of this judgement would be required by IAS 1.

The definition of a business (see section 3.3.1 below) is applied regardless of whether the entity purchases a property directly or, in the case of consolidated financial statements, via the shares in another entity.

See also discussion in Chapter 41 at section 2.7.2 for forward contracts to purchase an entity that owns a single asset such as investment property which does not constitute a business.

3.3.1 Definition of a business

IFRS 3 defines a business as "An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities". *[IFRS 3 Appendix A]*.

The IASB recognises the difficulties in determining whether an acquisition of an integrated set of activities and assets meets the definition of a business - which are not just limited to acquisition of an investment property or a group of properties. Accordingly, IFRS 3 sets out an optional fair value concentration test (the 'concentration test') designed to simplify the evaluation of whether an acquired integrated set of activities and assets is not a business. Entities may elect whether or not to apply the concentration test on a transaction-by-transaction basis. *[IFRS 3.B7A]*.

If the concentration test is met, the set of activities and assets is determined not to be a business and no further assessment is needed. If the concentration test is not met, or if an entity elects not to apply the concentration test, a detailed assessment must be performed applying the normal requirements in IFRS 3. As such, the concentration test never determines that a transaction is a business combination. *[IFRS 3.B7A, IFRS 3.BC21Y]*.

IFRS 3 also provides a series of illustrative examples to assist in applying the guidance in IFRS 3 on the definition of business. These illustrative examples accompany the standard and address, among other things, the application of the optional concentration test and the assessment whether an acquired process is substantive. The concentration test and assessment of whether an acquired process is substantive are discussed in detail in Chapter 10 at sections 3.2.3 and 3.2.4, respectively.

One of the illustrative examples demonstrates the application of optional concentration test in the acquisition of real estate. It describes an entity that purchases a portfolio of 10 single-family homes that each have an in-place lease. The fair value of the consideration paid is equal to the aggregate fair value of the 10 single-family homes acquired. Each single-family home includes the land, building and property improvements. Each home has a different floor area and interior design. The 10 single-family homes are located in the same area and the classes of customers (e.g., tenants) are similar. The risks associated with operating in the real estate market of the homes acquired are not significantly different. No employees, other assets, processes or other activities are transferred. *[IFRS 3.IE74]*.

After electing and applying the optional concentration test (see Chapter 10 at section 3.2.3), the entity concludes that each single-family home is considered a single identifiable asset because the building and property improvements are attached to the land and cannot be removed without incurring significant cost. Also, the building and the in-place lease are considered a single identifiable asset because they would be recognised and measured as a single identifiable asset in a business combination. The entity also concludes that the group of 10 single-family homes is a group of similar identifiable assets because the assets (all single-family homes) are similar in nature and the risks associated with managing and creating outputs are not significantly different. This is because the types of homes and classes of customers are not significantly different.

Consequently, substantially all of the fair value of the gross assets acquired is concentrated in a group of similar identifiable assets. *[IFRS 3.IE75]*. Therefore, the entity concludes that the acquired set of activities and assets is not a business. *[IFRS 3.IE76]*.

A second example assumes the same facts described above except that the entity also purchases a multi-tenant corporate office park with six 10-storey office buildings that are fully leased. The additional set of activities and assets acquired includes the land, buildings, leases and contracts for outsourced cleaning, security and maintenance. No employees, other assets, other processes or other activities are transferred. The aggregate fair value associated with the office park is similar to the aggregate fair value associated with the 10 single-family homes. The processes performed through the contracts for outsourced cleaning and security are ancillary or minor within the context of all the processes required to create outputs. *[IFRS 3.IE77]*.

After electing and applying the optional concentration test, the entity concludes that the single-family homes and the office park are not similar identifiable assets because they differ significantly in the risks associated with operating the assets, obtaining tenants and managing tenants. In particular, the scale of operations and risks associated with the two classes of customers are significantly different. Consequently, the fair value of the gross assets acquired is not substantially all concentrated in a group of similar identifiable assets, because the fair value of the office park is similar to the aggregate fair value of the 10 single-family homes. In this case, the entity must perform a detailed assessment applying the normal requirements in IFRS 3.B8 to B12D and assess whether the acquired set of activities and assets meets the minimum requirements to be considered a business. *[IFRS 3.IE78]*.

See Chapter 10 at section 3.2 for the detailed guidance in determining whether an acquisition of an integrated set of activities and assets meets the definition of a business combination.

4 Initial measurement

4.1 Attributable costs

IAS 40 requires an owned investment property to be measured initially at cost, which includes transaction costs. *[IAS 40.20]*. If a property is purchased, cost means purchase price and any directly attributable expenditure such as professional fees, property transfer taxes and other transaction costs. *[IAS 40.21]*.

How we see it

For investment property under construction (see section 2.5 above), although there is no specific reference to IAS 16, we consider that the principles in IAS 16 must still be applied to the recognition of costs in IAS 40. This means that only those elements of cost that were allowed by IAS 16 could be capitalised and that capitalisation ceases when the asset has reached the condition necessary for it to be capable of operating in the manner intended by management.

The recognition principles in IAS 16 referred to above, are set out in detail in Chapter 19 at section 4.

For investment property held by a lessee as a right-of-use asset, see section 4.5 below.

4.1.1 Acquisition of a group of assets that does not constitute a business ('the group')

The purchase price of an investment property may result from an allocation of the price paid for a group of assets. If an entity acquires a group of assets that does not comprise a business, the principles in IFRS 3 are applied to allocate the entire cost to individual items (see Chapter 10 at section 2.2.2). In such cases the acquirer must identify and recognise the individual identifiable assets acquired and liabilities assumed and allocate the cost of the group to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase. Such a transaction or event does not give rise to goodwill. *[IFRS 3.2(b)]*.

In June 2017, the IFRS IC considered a request for clarification on how to allocate the transaction price to the identifiable assets acquired and liabilities assumed when:

(a) The sum of individual fair values of the identifiable assets and liabilities is different from the transaction price

And

(b) The group includes identifiable assets and liabilities initially measured both at cost and at an amount other than cost

The IFRS IC noted the requirement of IFRS 3.2(b) as described above and also noted that other IFRS accounting standards include initial measurement requirements for particular assets and liabilities, including IAS 40 for investment property. It observed that if an entity initially considers that there might be a difference as described in (a) above, the entity first reviews the procedures it has used to determine those individual fair values to assess whether such a difference truly exists before allocating the transaction price.

The IFRS IC considered two possible ways of accounting for the acquisition of the group of assets. These two approaches are discussed in detail in Chapter 10 at section 2.2.2.

Under the first approach an entity:

- Identifies the individual identifiable assets acquired and liabilities assumed that it recognises at the date of the acquisition
- Determines the individual transaction price for each identifiable asset and liability by allocating the cost of the group based on the relative fair values of those assets and liabilities at the date of the acquisition

And then

- Applies the initial measurement requirements in applicable standards to each identifiable asset acquired and liability assumed. The entity accounts for any difference between the amount at which the asset or liability is initially measured and its individual transaction price applying the relevant requirements.

Applying the second approach, for any identifiable asset or liability initially measured at an amount other than cost, an entity initially measures that asset or liability at the amount specified by the applicable standard. The entity deducts from the transaction price of the group the amounts allocated to the assets and liabilities initially measured at an amount other than cost, and then allocates the residual transaction price to the remaining identifiable assets and liabilities based on their relative fair values at the date of acquisition.[7]

7 *IFRIC Update*, June 2017, available on the IFRS Foundation's website.

In November 2017, the IFRS IC concluded that a reasonable reading of the requirements in IFRS 3.2(b) on the acquisition of the group results in one of the two approaches outlined above (i.e., a policy choice) and that an entity would apply its reading of the requirements consistently to all acquisitions of a group of assets that does not constitute a business. An entity would also disclose the selected approach applying IAS 1.117 to 124 if that disclosure would assist users of financial statements in understanding how those transactions are reflected in reported financial performance and financial position.

In the light of its analysis, the IFRS IC decided not to add this matter to its standard-setting agenda. However, the IFRS IC observed that the amendment to the definition of a business in IFRS 3 (see section 3.3.1 above) is likely to increase the population of transactions that constitute the acquisition of a group of assets so this matter will be monitored.[8]

4.1.2 Deferred taxes when acquiring a 'single asset' entity that is not a business

In many jurisdictions, it is usual for investment property to be bought and sold by transferring ownership of a separate legal entity formed to hold the asset (a 'single asset' entity) rather than the asset itself.

When an entity acquires all of the shares of another entity that has an investment property as its only asset (i.e., the acquisition of a 'single asset' entity that is not a business) and the acquiree had recognised in its statement of financial position a deferred tax liability arising from measuring the investment property at fair value as allowed by IAS 40, a specific issue arises as to whether or not the acquiring entity must recognise a deferred tax liability on initial recognition of the transaction.

This specific situation was considered by the IFRS IC and, in March 2017, it was concluded that the initial recognition exception in IAS 12.15(b) applies because the transaction is not a business combination. Accordingly, on acquisition, the acquiring entity recognises only the investment property and not a deferred tax liability in its consolidated financial statements. The acquiring entity therefore allocates the entire purchase price to the investment property.[9]

For an example and further discussions on the application of the initial recognition exception to assets acquired in the circumstances described above, see Chapter 29 at section 7.2.8.

4.2 Start-up costs and self-built property

IAS 40 specifies that start-up costs (unless necessary to bring the property into working condition) and operating losses incurred before the investment property achieves the planned occupancy level, are not to be capitalised. *[IAS 40.23(a), IAS 40.23(b)]*.

IAS 40 therefore prohibits a practice of capitalising costs until a particular level of occupation or rental income is achieved because at the date of physical completion the asset would be capable of operating in the manner intended by management. This forestalls an argument, sometimes advanced in the past, that the asset being constructed was not simply the physical structure of the building but a fully tenanted investment property, and its cost correspondingly included not simply the construction period but also the letting period.

If a property is self-built by an entity, the same general principles apply as for an acquired property (see section 4.1 above). However, IAS 40 prohibits capitalisation of abnormal amounts of wasted material, labour or other resources incurred in constructing or developing the property. *[IAS 40.23(c)]*.

4.2.1 Cost of a building to be demolished in connection with the construction of a new building

It is not uncommon for property companies to acquire land with an existing building where the planned redevelopment requires the demolition of that building and its replacement with a new building that is to be held as investment property. Whether the acquired land and building will be accounted for as a single asset or two separate assets will depend on the subsequent accounting model applied by the entity.

If the entity measures the investment property under the fair value model (see section 6 below), the entity classifies the land and building on initial recognition as one item of investment property under IAS 40 and measures the investment property based on its cost (see section 4.1 above). *[IAS 40.20]*. Subsequently, the land and building are measured as one item at fair value at each reporting date (see section 6 below). *[IAS 40.33]*. If the entity measures the investment property under the cost model (see section 7 below), it will account for the land and building separately and measures the land and building based on cost, allocated to each of land and building on a relative fair value basis at the date of purchase (see Chapter 19 at sections 4.1.10 and 5.4.2). *[IFRS 3.2(b), IAS 16.58]*.

8 *IFRIC Update*, November 2017, available on the IFRS Foundation's website.

9 *IFRIC Update*, March 2017, available on the IFRS Foundation's website.

How we see it

If an entity that measures investment property under the cost model acquires land with an existing building and, depending on the facts and circumstances, the existing building is unusable or likely to be demolished by any party acquiring it, then it would be appropriate, in our view, to allocate the entire or a large part of the purchase price to the land acquired. This is because the fair value of the existing building, if accounted for separately, will likely be minimal or the fair value of the combined investment properties, comprising both land and building, may be close to that of the land. Similarly, subsequent demolition costs are treated as being attributable to the cost of the land as part of site preparation costs (see Chapter 19 at sections 4.1.1 and 4.1.7).

Entities holding investment properties may also decide to replace existing buildings with new ones and continue to hold these as investment properties. If an entity uses the cost model to measure its investment properties, the carrying amount of the existing building cannot be rolled into the costs of the new building. This is because IAS 16 requires an asset to be derecognised when no future economic benefits are expected from its use. *[IAS 16.67]*. At that date, the entity is required to cease depreciation. *[IAS 16.55]*. Also, consideration will have to be given as to whether the asset is impaired in accordance with IAS 36 (see section 7.3 below and Chapter 19 at section 5.7). Furthermore, IAS 16 requires the entity to review the useful life if expectations differ from previous estimates. *[IAS 16.51]*. The entity is therefore required to reassess the useful life at the date of the decision to demolish at a future point in time. *[IAS 16.57]*. Application of the new useful life would ensure that the carrying amount over the remaining life of the building is reduced to the expected residual value at the date on which the demolition is expected to take place or when appropriate, to the expected residual value at the date when it is expected to be derecognised (e.g., at the date when tenants moved out of the investment property and it is determined that no future economic benefits are expected from the use of such investment property). Therefore, the existing building must be depreciated over its remaining useful life (the period before it is expected to be demolished or derecognised) to reduce the carrying amount of the asset to its residual value at the point at which it is demolished or derecognised (presumably nil as it is being demolished). The above accounting is consistent with the accounting treatment for a scenario where an entity takes the decision to demolish an existing owner-occupied building, which is accounted for under IAS 16, and replace it with a new building which will be held as investment property measured using the cost model under IAS 40. For further IAS 16 guidance, see relevant discussions in Chapter 19 at sections 4.1.7, 5 and 7.

In contrast, if an entity that uses the fair value model to measure its investment properties decides to replace an existing building with a new one but will continue to hold it as investment property, then the highest and best use of the land might not match the current use of the land. The value of the land may increase by constructing a different property (for example with more floors or with a different purpose). When determining the fair value of the investment property, the entity takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use (see section 6.8 below). *[IFRS 13.27]*. Therefore, the existing building and land will be measured as one single asset based on its fair value. As the new building is constructed, the property (land and building) will continue to be measured as one single asset based on fair value from a market participant's perspective.

Entities replacing an existing building with a building for their own use or a building to be sold in the ordinary course of their business will deal with the land and buildings under IAS 16 (see Chapter 19 at section 4.1.7) or IAS 2 (see Chapter 23 at section 4.2.2), respectively.

4.3 Deferred payments

If payment for a property is deferred, the cost to be recognised is the cash price equivalent at the recognition date. Any difference between the cash price and the total payments to be made is recognised as interest expense over the credit period. *[IAS 40.24]*.

How we see it

In practice, 'cash price equivalent' means the present value of the deferred payments due. See also Chapter 19 at section 4.1.6 for further discussion.

4.4 Reclassifications from property, plant and equipment or from inventory

When an entity uses the cost model, transfers between investment property, owner-occupied property and inventories do not change the carrying amount of the property transferred and they do not change the cost of that property for measurement or disclosure purposes. *[IAS 40.59]*.

The treatment of transfers of properties measured using the revaluation option in IAS 16 to investment property is set out in section 9.2 below.

4.5 Initial measurement of property held under a lease

An investment property held by a lessee as a right-of-use asset must be measured initially at its cost in accordance with IFRS 16 (see Chapter 24 at section 5.2.1). *[IAS 40.29A]*. The treatment of initial direct costs by a lessee applying IFRS 16 is discussed in section 4.9.2 below.

4.6 Initial measurement of assets acquired in exchange transactions

The requirements of IAS 40 for investment properties acquired in exchange for non-monetary assets, or a combination of monetary and non-monetary assets, are the same as those of IAS 16. *[IAS 40.27, IAS 40.28, IAS 40.29]*. These provisions are discussed in detail in Chapter 19 at section 4.4.

4.7 Initial recognition of tenanted investment property subsequently measured using the cost model

During the development of the current IFRS 3, the IASB considered whether it would be appropriate for any favourable or unfavourable lease aspect of an investment property to be recognised separately.

The IASB concluded that this was not necessary for investment property that will be measured at fair value because the fair value of investment property takes into account rental income from leases and therefore the contractual terms of leases and other contracts in place.

However, a different position has been taken for investment property measured using the cost model. In this case the IASB observed that the cost model requires:

- The use of a depreciation or amortisation method that reflects the pattern in which the entity expects to consume the asset's future economic benefits

  And

- Each part of an item of property, plant and equipment that has a cost that is significant in relation to the total cost of the item to be depreciated separately

Therefore, an acquirer of investment property in a business combination that is subsequently measured using the cost model will need to adjust the depreciation method for the investment property to reflect the timing of cash flows attributable to the underlying leases. *[IFRS 3.BC148]*.

How we see it

In a business combination, an investment property is initially measured at fair value. If this investment property comprises favourable or unfavourable leases and is subsequently measured using the cost model, the acquirer will need to adjust the depreciation method for the investment property to reflect the timing of cash flows attributable to the underlying favourable or unfavourable leases. In effect, therefore, this requires that the favourable or unfavourable lease aspect of the investment property - measured with reference to market conditions at the date of the business combination - be separately identified in order that it may be subsequently depreciated or amortised, usually over the remaining lease term. Any such amount is not presented separately in the financial statements. Depreciation of any identified component is recognised as depreciation expense rather than as an adjustment to rental income.

The approach discussed above has also been extended to acquisition of all property, i.e., including those acquired outside a business combination (see section 7.1.2 below).

For more related discussions of key accounting considerations, including general approaches applied in practice, see Chapter 10 at section 5.5.1 and Chapter 19 at section 5.2.1.

4.8 Borrowing costs

IAS 23 *Borrowing Costs* generally mandates capitalisation of borrowing costs in respect of qualifying assets. However, application of IAS 23 to borrowing costs directly attributable to the acquisition, construction or production of qualifying assets that are measured at fair value, such as investment property, is not required because it would not affect the measurement of the investment property in the statement of financial position; it would only affect presentation of interest expense and fair value gains and losses in the income statement. Nevertheless, IAS 23 does not prohibit capitalisation of eligible borrowing costs to such assets as a matter of accounting policy. *[IAS 23.4(a)]*.

To the extent that entities choose to capitalise eligible borrowing costs in respect of investment property measured under the fair value model, the methods allowed by IAS 23 must be followed.

The treatment of borrowing costs is discussed further in Chapter 22.

4.9 Lease incentives and initial direct costs of leasing a property

In negotiating a new or renewed operating lease, the lessor may provide incentives for the lessee to enter into the agreement. The lessor or the lessee (or both) may also incur costs that are directly attributable to negotiating and arranging a lease. However, IAS 40 provides no specific guidance on accounting for lease incentives and initial costs of obtaining a lease.

4.9.1 Lease incentives

Lease incentives are defined as: *[IFRS 16 Appendix A]*

Extract from IFRS 16

Appendix A
Defined terms

lease incentives	Payments made by a **lessor** to a **lessee** associated with a **lease**, or the reimbursement or assumption by a lessor of costs of a lessee.

In practice, examples of such incentives are an up-front cash payment to the lessee or the reimbursement or assumption by the lessor of costs of the lessee (such as relocation costs, leasehold improvements and costs associated with a pre-existing lease commitment of the lessee). Alternatively, initial periods of the lease term may be agreed to be rent-free or at a reduced rent.

Under IFRS 16, lease incentives are deducted from 'lease payments' made by a lessee to a lessor relating to a right-of-use asset during the lease term. *[IFRS 16 Appendix A]*. Accordingly, for lessees, lease incentives that are received by the lessee at or before the lease commencement date reduce the initial measurement of a lessee's right-of-use asset. *[IFRS 16.24(b)]*. Lease incentives that are receivable by the lessee at lease commencement date reduce a lessee's lease liability (and therefore the right-of-use asset as well). *[IFRS 16.27(a)]*.

For lessors, lease incentives that are paid or payable to the lessee are also deducted from lease payments. Lease payments under operating leases are recognised by lessors as income on either a straight-line basis or another systematic basis. *[IFRS 16.81]*. Accordingly, for operating leases, lessors defer any lease incentives paid or payable to the lessee and recognise the resulting accrual as a reduction to lease income over the lease term in order to recognise the lease payments as income at an amount that is net of lease incentives. This means that such accrued rental income will be recovered as part of the cash payments to be received from the lessee over the remaining lease term.

The accounting for lease incentives applied in practice by lessors of investment property measured at fair value is illustrated below.

Illustration 4-1: Lessor accounting for lease incentives under the IAS 40 fair value model

On 1 January 20X0, an investor acquires a property with an acquisition cost of CU80 million, which is assumed to be its fair value at the date of acquisition. On the same day, the investor leases the property under an operating lease to a lessee with a five-year term. The market rent for such a property is assessed to be CU4 million per annum, representing a yield of 5%. The lessor and lessee agree to the following lease payments and conditions:

- Year 1 (20X0): rent free
- Year 2: CU5 million
- Year 3: CU5 million
- Year 4: CU5 million
- Year 5: CU5 million

The rent for years 2 to 5 is paid at the beginning of each year. As the lease incentive (the rent-free period) is an integral component of the lease agreement it is assumed that, in exchange for the rent-free period, the lessee provides a flow of lease rental payments to the lessor in years 2 to 5 that are higher than what they would be if no incentive was provided.

The lessor measures its investment properties at fair value in accordance with IAS 40.33. Assume that the rent-free period is taken into account by the appraiser in arriving at the fair value of the property on the date of acquisition. In the example, the fair value of the investment property as at 31 December 20X0 (end of year 1) and 31 December 20X1 (end of year 2) is assumed to be CU82 million.

There are two acceptable approaches for a lessor of investment property measured at fair value to account for lease incentive (e.g., a rent-free period):

Approach A

The investment property is recorded at fair value (e.g., based on the expected cash flows). On the basis that the property is to be recorded at its fair value, the lease payments according to the operating lease contract are taken into account by the valuer in arriving at the fair value of the property. As the lease incentive is related to the consideration for the use of the asset, it affects the rental income as presented in the income statement. The lessor would record the following journal entries ('JE') in 20X0 and 20X1:

Extracts from the ledgers for the years ended 31 December 20X0 and 20X1

(*All figures in CU millions*)

		20X0				20X1		
Balance sheet	**As at 1 Jan 20X0**	JE (1)	JE (2)	JE (3)	**As at 31 Dec 20X0**	JE (4)	JE (5)	**As at 31 Dec 20X1**
Investment property	-	80	2	-	82	-	-	82
Cash	80	(80)	-	-	-	5	-	5
Net Assets	80	-	2	-	82	5	-	87
Share capital	80	-	-	-	80	-	-	80
Retained earnings	-	-	-	-	-	-	-	2
Net income	-	-	2	-	2	5	-	5
Total Equity	80	-	2	-	82	5	-	87
Income statement								
Gains or (losses) from fair value adjustments	-	-	2	(4)	(2)	-	1	1
Rental income	-	-	-	4	4	5	(1)	4
Net income	-	-	2	-	2	5	-	5

Reconciliation of the carrying amount of the investment property

Net book value	78	79
Plus: tenant lease incentives	4	3
Market value	82	82

Journals:

(1) Paragraph 20 of IAS 40 requires investment property to be measured initially at its cost (see section 4.1 above), which is CU80 million in the fact pattern.

(2) Since the fair value model is applied by the lessor, at the balance sheet date the investment property must be measured at fair value in accordance with IFRS 13, which is CU82 million. The change in fair value is recognised in profit and loss. See sections 5 and 6 below for further discussions on subsequent measurement of an investment property under the fair value model.

(3) In line with IAS 40.40, the fair value of investment property reflects 'other assumptions that market participants would use when pricing investment property under current market conditions' (see section 6.1 below). A market participant, using an income approach to value its investment property, would consider the expected cash flows that the lessee will pay. It will not consider income recognised in prior periods associated with the lease incentive. As such, the expected future cash flows are taken into account in determining the fair value of the investment property.

Appendix A to IFRS 16 notes that lease payments are "Payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following: (a) fixed payments (including in-substance fixed payments), less any lease incentives…". Paragraph 81 of IFRS 16 states that "A lessor shall recognise lease payments from operating leases as income on either a straight-line basis or another systematic basis. The lessor shall apply another systematic basis if that basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished."

Therefore, in order to recognise the lease payments from operating leases (including any deductions related to lease incentives) as income on a straight-line basis, the total rental income over the period of the lease (CU20 million) is apportioned evenly over the five-year period: rental income of CU4 million is recognised each year.

(4) The cash received of CU5 million for the second year of the lease term is recorded.

(5) To continue to recognise the rental income in accordance with IFRS 16, an entry is made reducing the rental income to the appropriate amount (i.e., CU4 million in the fact pattern). The offsetting entry is to the gain or loss from change in fair value of the investment property.

Approach B

A separate asset is recorded to straight line the cost of the consideration in the form of the lease incentive (rent-free period) over the term of the lease. To avoid double-counting, the lessor adjusts the carrying amount of the investment property downwards to take into account the fact that the actual return to the lessor will be lower because the lessor has agreed to offer a rent-free period and has recorded this lease incentive separately as an asset:

Extracts from the ledgers for the years ended 31 December 20X0 and 20X1

(All figures in CU millions)

		20X0					20X1			
Balance sheet	**As at 1 Jan 20X0**	JE (1)	JE (2)	JE (3)	JE (4)	**As at 31 Dec 20X0**	JE (5)	JE (6)	JE (7)	**As at 31 Dec 20X1**
Investment property	-	80	2	-	(4)	**78**	-	-	1	**79**
Other assets	-	-	-	-	4	4	-	(1)	-	**3**
Cash	**80**	(80)	-	-	-	**-**	5	-	-	**5**
Net Assets	**80**	-	2	-	-	**82**	5	(1)	1	**87**

Share capital	80	-	-	-	-	80	-	-	-	80
Retained earnings	-	-	-	-	-	-	-	-	-	2
Net income	-	-	2	-	-	2	5	(1)	1	5
Total Equity	80	-	2	-	-	82	5	(1)	1	87
Income statement										
Gains or (losses) from fair value adjustments	-	-	2	(4)	-	(2)	-	-	1	1
Rental income	-	-	-	4	-	4	5	(1)	-	4
Net income	-	-	2	-	-	2	5	(1)	1	5

Journals:

(1), (2) and (3) are the same as in Approach A above.

(4) Paragraph 50 of IAS 40 specifies that in determining the carrying amount of investment property under the fair value model, an entity does not double-count assets or liabilities that are recognised as separate assets or liabilities. For example, the fair value of investment property excludes prepaid or accrued operating lease income, because the entity recognises it as a separate liability or asset (see section 6.6 below). Therefore, a reclassification is made to separate the other asset (i.e., lease incentive) that arises from straight-lining the lease payments from the investment property.

(5) The cash received of CU5 million for the second year of the lease term is recorded.

(6) To continue to recognise the rental income in accordance with IFRS 16, the decrease of the carrying amount of the separate asset that arises from straight-lining the lease incentive is recognised as reduction of rental income over the lease term.

(7) At the end of 20X1 the fair value of the investment property in the fact pattern is CU82 million. The combined carrying amount of the investment property and separately recognised lease incentive asset is CU81 million. Therefore, in order to continue to measure the investment property at fair value in accordance with IAS 40.33 and 50, an increase in the fair value of the investment property of CU1 million is recognised as a gain from fair value adjustments.

How we see it

For an entity using the fair value model to measure its investment property, Approach A and Approach B discussed above, in our view, are both acceptable approaches when accounting for lease incentives provided to lessees and thus, either can be applied as a matter of accounting policy choice. Such policy choice is applied consistently and if considered material to users of the financial statements, disclosure would be required by IAS 1.

Consequently, some lessors present any accrued rental income (i.e., outstanding unamortised deferred lease incentives) as a separate asset, but other lessors present these together with (or as part of) the related investment property - see Illustration 4-1 above. However, lease incentives do not form part of the cost of the investment property (see also section 6.6.1 below for the requirement to adjust the fair value of an investment property to avoid 'double counting' in circumstances where a lease incentive exists and is recognised separately). It is therefore relevant to distinguish between lease incentives and other capital expenditure.

There is no additional guidance in IFRS 16 to assist in the identification of incentives, but a similar requirement existed in previous United Kingdom GAAP (in UITF abstract 28 *Operating lease incentives*) and provides helpful additional detail:

"A payment (or other transfer of value) from a lessor to (or for the benefit of) a lessee should be regarded as a lease incentive when that fairly reflects its substance. A payment to reimburse a lessee for fitting-out costs should be regarded as a lease incentive where the fittings are suitable only for the lessee and accordingly do not add to the value of the property to the lessor. On the other hand, insofar as a reimbursement of expenditure enhances a property generally and causes commensurate benefit to flow to the lessor, it should be treated as reimbursement of expenditure on the property. For example, where the lifts in a building are to be renewed and a lease has only five years to run, a payment made by the lessor may not be an inducement to enter into a lease but payment for an improvement to the lessor's property."[10]

The distinction between costs that enhance the value of the property, and those that are of value to the tenant, can be seen in Practical example 4-1 below.

Practical example 4-1: The British Land Company PLC (2015) **United Kingdom**

Annual Report and Accounts 2015 [extract]

Primary statements and notes [extract]

NOTES TO THE ACCOUNTS [extract]

1 Basis of preparation, significant accounting policies and accounting judgements [extract]

Net rental income [extract]

Where a lease incentive payment, including surrender premia paid, does not enhance the value of a property, it is amortised on a straight-line basis over the period from the date of lease commencement to the earliest termination date. Upon receipt of a surrender premium

...

For further discussions on lease incentives, see Chapter 24 at sections 4.5.2, 5.2.1 and 5.2.2.

4.9.2 Initial direct costs of obtaining a lease

Lessors and lessees apply the same definition of initial direct costs.

Under IFRS 16, the requirement on initial direct costs is consistent with the concept of incremental costs of obtaining a contract in IFRS 15 *Revenue from Contracts with Customers* (see Chapter 28 at section 9.3.1). IFRS 16 defines initial direct costs as "Incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained …". *[IFRS 16 Appendix A]*. Examples of such costs are commissions and contingent fees that would not have been incurred if the lease had not been obtained. Accordingly, in addition to excluding allocated costs (e.g., salaries), initial direct costs exclude costs incurred regardless of whether the lease is successfully finalised (e.g., fees for certain legal advice, estate agent fees not contingent upon success). Example 13 of the Illustrative Examples to IFRS 16 also indicates that certain payments made by a lessee to an existing tenant to incentivise that tenant to terminate its lease could also be regarded by the lessee as initial direct costs incurred to obtain a new lease.

Under IFRS 16, lessors are required to add initial direct costs incurred in obtaining an operating lease to the carrying amount of the underlying asset. These initial direct costs are recognised as an expense over the lease term on the same basis as lease income. *[IFRS 16.83]*. For lessees, IFRS 16 requires initial direct costs to be included in the initial measurement of the right-of-use asset. *[IFRS 16.24]*.

While IAS 40 does not contain specific guidance on the accounting treatment of initial direct costs of arranging leases over a property (e.g., legal and agency fees), due to the requirements of IFRS 16 mentioned above, such costs must be recognised as an expense over the term of the resultant lease. This treatment can also be seen in Practical example 4-2 below.

10 UITF abstract 28 - Operating lease incentives, UK Accounting Standards Board, February 2001, para. 3.

Practical example 4-2:	Accelerate Property Fund Limited (2024)	South Africa

2024 INTEGRATED REPORT [extract]
Consolidated and Separate Audited Annual Financial Statements [extract]
Accounting Policies [extract]
1.8 Leases [extract]

Accelerate as lessor – operating leases

Operating lease income is recognised as income on a straight-line basis over the lease term.

Initial direct costs incurred in negotiating and arranging operating leases are added to the carrying amount of the leased asset and recognised as an expense over the lease term on the same basis as the lease income.

Income for leases is disclosed under revenue in profit or loss.

In practice, this means, if the cost model is used, such costs are presented as part of the cost of the investment property, even if they do not strictly form part of it and are then amortised separately over the lease term.

An entity using the fair value model must also initially include these costs as part of the carrying amount of the investment property. However, at the next reporting date such initial costs could be recognised in profit and loss in the reported fair value gain or loss, as they would otherwise exceed the fair value of the related investment property. This is consistent with the treatment of transaction costs incurred on acquisition of a property discussed in section 6.4 below.

Alternatively, for an entity using the fair value model, we also believe that the initial direct costs included in the carrying amount of the investment property could be recognised subsequently as an expense over the lease term on the same basis as the lease income. Accordingly, the amortisation of the initial direct costs is presented separately from the gain or loss from fair value adjustments on investment property. In addition, the gain or loss on fair value adjustments is credited by the same amount as the amortisation charge in each period to ensure that the carrying amount of the investment property (including the unamortised initial direct costs) is equal to its fair value at each reporting date.

The accounting for initial direct costs of operating leases applied in practice by lessors of investment property measured at fair value is illustrated below.

Illustration 4-2: Lessor accounting for initial direct costs of operating leases under the IAS 40 fair value model

On 1 January 20X0, an investor acquires a property at a cost of CU100 million. On the same day, the investor leases the property under an operating lease to a lessee with a five-year term for a yearly rent of CU5 million. The lessor incurs legal fees of CU4 million in arranging the lease contract. The lessor measures its investment properties at fair value in accordance with IAS 40.33. According to an appraisal by an independent valuer, the fair values of the property as at 31 December 20X0 and 31 December 20X1 is CU100 million.

There are two acceptable approaches for a lessor of investment property measured at fair value to account for initial direct costs of operating leases:

Approach A

On acquisition, the initial direct costs would be capitalised into the investment property, but subsequently, they are expensed through the change in the fair value of the investment property.

The lessor would record the following journal entries ('JE') in 20X0 and 20X1 (time value of money is ignored):

Extracts from the ledgers for the years ended 31 December 20X0 and 20X1

(*All figures in CU millions*)

		20X0					20X1	
Balance sheet	**As at 1 Jan 20X0**	JE (1)	JE (2)	JE (3)	JE (4)	**As at 31 Dec 20X0**	JE (5)	**As at 31 Dec 20X1**
Investment property	-	100	4	-	(4)	**100**	-	**100**
Cash	**100**	(100)	(4)	5	-	**1**	5	**6**
Net Assets	**100**	-	-	5	(4)	**101**	5	**106**
Share capital	**100**	-	-	-	-	**100**	-	**100**
Retained earnings	-	-	-	-	-	-	-	**1**
Net income	-	-	-	5	(4)	**1**	5	**5**
Total Equity	**100**	-	-	5	(4)	**101**	5	**106**
Income statement								
Gains or (losses) from fair value adjustments	-	-	-	-	(4)	**(4)**	-	-
Rental income	-	-	-	5	-	**5**	5	**5**
Net income	-	-	-	5	(4)	**1**	5	**5**

Journals:

(1) Paragraph 20 of IAS 40 states that an investment property is measured initially at its cost and transaction costs are included in the initial measurement (see section 4.1 above).

(2) IAS 40 does not contain specific guidance on the accounting treatment of initial direct costs that are incurred in arranging a lease contract for an investment property that is measured at fair value. Therefore, it seems appropriate to apply the guidance for the accounting of initial direct costs incurred by a lessor under an operating lease that is included in IFRS 16. Paragraph 83 of IFRS 16 requires a lessor to add initial direct costs incurred in obtaining an operating lease to the carrying amount of the underlying asset and recognise those costs as an expense over the lease term on the same basis as the lease income. Initial direct costs (e.g., legal fees) would initially be added to the carrying amount of the investment property when incurred, similar to transaction costs discussed in IAS 40.20 and 21 (see section 4.1 above). Therefore, the initial direct costs of CU4 million must be added to the carrying amount of the investment property.

(3) The rental income for the first year of the lease term (CU5 million) is recognised.

(4) Subsequently, the investment property, which includes the initial direct costs, is measured at fair value. Paragraph 5 of IAS 40 refers to IFRS 13 and defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Paragraph 25 of IFRS 13 states that "The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs…". Therefore, the subsequent measurement of the investment property would exclude transaction costs.

In order to adjust the investment property to its fair value (CU100 million), an adjustment of CU4 million is recognised in profit and loss as required by IAS 40.35.

(5) The cash received of CU5 million for the second year of the lease term is recorded.

Approach B

On acquisition, the initial direct costs, generally, are added to the carrying amount of the leased asset and subsequently recognised as an expense over the lease term on the same basis as the lease income. The amortisation of the initial direct costs is presented separately from the gain or loss from fair value adjustments. In addition, the gain or loss on fair value adjustments is credited by the same amount as the amortisation charge in each period to ensure that the carrying amount of the investment property (including the unamortised initial direct costs) is equal to its fair value at each reporting date.

The lessor would record the following journal entries ('JE') in 20X0 and 20X1 (time value of money is ignored):

Extracts from the ledgers for the years ended 31 December 20X0 and 20X1

(*All figures in CU millions*)

		20X0						20X1		
Balance sheet	**As at 1 Jan 20X0**	JE (1)	JE (2)	JE (3)	JE (4)	JE (5)	**As at 31 Dec 20X0**	JE (6)	JE (7)	**As at 31 Dec 20X1**
Investment property	-	100	4	-	(4)	-	**100**	-	-	**100**
Cash	**100**	(100)	(4)	5	-	-	**1**	5	-	**6**
Net Assets	**100**	-	-	5	(4)	-	**101**	5	-	**106**
Share capital	**100**	-	-	-	-	-	**100**	-	-	**100**
Retained earnings	-	-	-	-	-	-	-	-	-	**1**
Net income	-	-	-	5	(4)	-	**1**	5	-	**5**
Total Equity	**100**	-	-	5	(4)	-	**101**	5	-	**106**
Income statement										
Gains or (losses) from fair value adjustments	-	-	-	-	(4)	0.8	**(3.2)**	-	0.8	**0.8**
Amortisation of initial direct costs	-	-	-	-	-	(0.8)	**(0.8)**	-	(0.8)	**(0.8)**
Rental income	-	-	-	5	-	-	**5**	5	-	**5**
Net income	-	-	-	5	(4)	-	**1**	5	-	**5**

Journals:

(1), (2), (3) and (4) are the same as in Approach A above.

(5) According to IFRS 16.83 and IAS 40.33, in order to recognise initial direct costs as an expense over a five-year term on a straight-line basis, the total amount of initial direct costs (CU4 million) is apportioned evenly over the five-year period and thus, an amortisation expense of CU0.8 million is recognised each year. It is appropriate to present this separately from the gain or loss from fair value adjustments.

The gain or loss on fair value adjustments is credited by the same amount as the amortisation expense in each period to ensure that the carrying amount of the investment property (including the unamortised initial direct costs) is stated at fair value at reporting date.

(6) The cash received of CU5 million for the second year of the lease term is recorded.

(7) To continue to recognise amortisation of initial direct costs and the investment property at its fair value at each reporting date, as required by IAS 40.33, reclassifications of the appropriate amounts based on the amortisation expense are made at each reporting date (i.e., CU0.8 million in the fact pattern).

How we see it

For an entity using the fair value model to measure its investment property, Approach A and Approach B discussed above, in our view, are acceptable approaches when accounting for initial direct costs of operating leases and thus, either can be applied as a matter of accounting policy choice. Such policy choice is applied consistently and if considered material to users of the financial statements, disclosure would be required by IAS 1.

For further discussions on initial direct costs of obtaining a lease, see Chapter 24 at sections 4.7, 5.2.1 and 6.4.

4.10 Variable and contingent consideration

The terms of purchase of investment property may sometimes include a variable or contingent amount that cannot be determined at the date of acquisition. For example, the vendor may have the right to additional consideration from the purchaser in the event that a certain level of income is generated from the property; or its value reaches a certain level; or if certain legislative hurdles, such as the receipt of zoning or planning permission, are achieved.

The two key issues with regards to the accounting for variable or contingent consideration in an asset purchase are 1) whether and when to recognise a liability for that variable or contingent consideration, and 2) whether subsequent changes to the estimate of that variable or contingent consideration are accounted for as part of the cost of the acquired asset.

IAS 40 has no explicit guidance on the treatment of variable or contingent payments to be incurred in connection with the purchase of investment property. As discussed in section 4.1 above, the principles in IAS 16 relating to determining the attributable costs in an asset purchase apply to the recognition of costs in IAS 40. Accordingly, for the detailed discussions of key accounting considerations related to the treatment of variable or contingent payments in an asset purchase, including the general approaches applied in practice and the related discussions by the IFRS IC and the IASB, see Chapter 19 at section 4.1.9.

How we see it

Consistent with the discussions in Chapter 19 at section 4.1.9, entities will need to develop and apply an accounting policy in respect of whether and when the obligation to make contingent payments is recognised as a liability. In doing so, entities will need to apply the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*[11]. The policy selected must result in information that is relevant and reliable in the particular circumstances and must be consistently applied to similar transactions. Different payments may have different types of variability. Therefore, it might be appropriate for an entity to have different policies for dissimilar transactions.

Until explicit guidance is released by the IASB, where the accounting for variability or contingency is not prescribed in another IFRS accounting standard (see Chapter 19 at section 4.1.9), an entity must adopt and apply a consistent accounting policy in relation to whether subsequent payments or subsequent changes to the measurement of a recognised liability to make variable or contingent payments are included as part of the cost of the acquired asset (e.g., investment property) or expensed as incurred, in accordance with the hierarchy in IAS 8. An entity must exercise judgement in developing and consistently applying an accounting policy that results in information that is relevant and reliable in its particular circumstances.

If information about the selected accounting policy is expected to be material to users of the financial statements, that accounting policy information must be disclosed.

11 The consequential amendments resulting from IFRS 18 *Presentation and Disclosure in Financial Statements*, once effective, changes the title of IAS 8 to '*Basis of Preparation of Financial Statements*' to better reflect the amended content of IAS 8. See Chapter 4 for further details on the requirements of IFRS 18.

Of course, for investment property held at fair value, capitalising or expensing the remeasurements of any liability recognised for the variable or contingent consideration primarily affects classification within the income statement.

It is important to note that developing a policy (as described above) is not available for the contingent costs of acquiring investment property as part of a business combination. The treatment of contingent costs in these circumstances is described in Chapter 10 at section 7.1.

4.11 Income from tenanted property during development

An entity may have acquired an investment property, which has been generating rental income, but subsequently intends to redevelop it with the same purpose of renting it out in the future. An issue that can arise is whether rental and similar income generated by existing tenants in a property development may be capitalised and offset against the cost of developing that property.

IAS 16 requires that the income and related expenses of incidental operations are recognised in profit or loss and included in their respective classifications of income and expense (see Chapter 19 at section 4.2). *[IAS 16.21]*. We consider that rental and similar income from existing tenants are incidental operations to the development. The existence of the tenant is not a necessary condition for the property to be developed to a state capable of operating in the manner intended by management; management could have developed the property in the absence of any existing tenants.

How we see it

In our view, there must not be a measurement difference between the cost of a property development dealt with under IAS 40 and the cost of a property development dealt with under IAS 16.

Therefore, rental and similar income generated by existing tenants in a property dealt with under IAS 40 and now intended for redevelopment must not be capitalised against the costs of the development. Rather, rental and similar income are recognised in profit or loss in accordance with the requirements of IFRS 16 (see Chapter 24), together with any related expenses. For these purposes, it is irrelevant whether the investment property is held at cost or fair value.

4.12 Payments by the vendor to the purchaser

On occasion, a transaction for the purchase of an investment property may include an additional element where the vendor repays fixed or variable amounts to the purchaser - e.g., when the vendor agrees to compensate the purchaser for specific transaction costs incurred or perhaps described as representing a rental equivalent for a period of time such as rental guarantees.

The question then arises whether, in the financial statements of the purchaser, these payments are recorded as income (albeit perhaps recognised over a period of time) or as a deduction from the acquisition cost of the investment property on initial recognition.

How we see it

In our view, such amounts described above are an integral part of the acquisition transaction and must invariably be treated as a deduction from the acquisition cost of the investment property because the payment is an element of a transaction between a vendor and purchaser of the property (rather than, for example, a landlord and tenant in respect of rental guarantees).

In the event that the repayments by the vendor are spread over time, the fair value of the right to receive those payments is deducted from the cost of the investment property and an equivalent financial asset is recognised. The financial asset would be accounted for in accordance with IFRS 9 *Financial Instruments* which could lead to it being classified as financial asset at amortised cost or at fair value through profit or loss (see Chapter 44 at section 1.1).

5 Measurement after initial recognition

Once recognised, IAS 40 allows an entity to choose one of the two methods of accounting for investment property as its accounting policy:

- Fair value model (see section 6 below)

  Or

- Cost model (see section 7 below)

An entity has to choose one model or the other, and apply it to all its investment property (unless the entity is an insurer or similar entity, in which case there are exemptions that are described briefly in section 5.1 below). *[IAS 40.30]*. This is because measuring all investment properties on the same basis provides more useful information than allowing an entity to choose the measurement basis for each property. *[IFRS 16.BC178]*.

The standard does not identify a preferred alternative; although the fair value model currently seems to be the more widely applied model among entities in the real estate sector (see section 7.2 below).

The standard discourages changes from the fair value model to the cost model, stating that it is highly unlikely that this will result in a more relevant presentation, which is a requirement of IAS 8 for any voluntary change in accounting policy. *[IAS 40.31]*.

All entities, regardless of which measurement option is chosen, are required to determine the fair value of their investment property, because even those entities that use the cost model are required to disclose the fair value of their investment property (see section 12.3 below). *[IAS 40.32, IAS 40.79(e)]*.

5.1 Measurement by insurers and similar entities

There is an exception to the requirement that an entity must apply its chosen measurement policy to all of its investment properties. This is applicable to insurance companies and other entities that hold specified assets, including investment properties, whose fair value or return is directly linked to the return paid on specific liabilities (i.e., liabilities that are secured by such investment properties). These entities are permitted to choose either the fair value or the cost model for all such properties without it affecting the choice available for all other investment properties that they may hold. *[IAS 40.32A]*.

However, for some entities that operate, either internally or externally, an investment fund that provides investors with benefits determined by units in the fund, all properties within such a fund must be measured on the same basis because IAS 40.32A (as discussed above) does not permit an entity to measure the property held by the fund partly at cost and partly at fair value. Similarly, for some entities that issue insurance contracts with direct participation features, for which the underlying items include investment property, IAS 40.32A (as discussed above) does not permit an entity to measure property that is an underlying item partly at cost and partly at fair value. *[IAS 40.32B]*.

For the purposes of applying the paragraphs above i.e., IAS 40.32A and IAS 40.32B only, insurance contracts include investment contracts with discretionary participation features. Note that the terms used in the amended IAS 40.32B are defined in IFRS 17 *Insurance Contracts* (see Chapter 51). *[IAS 40.32B]*.

If an entity elected a model for those properties described in IAS 40.32A (as discussed above) that is different from the model used for the rest of its investment properties, sales of investment properties between these pools of assets are to be recognised at fair value with any applicable cumulative change in fair value recognised in profit or loss. Consequently, if an investment property is sold from a pool in which the fair value model is used into a pool in which the cost model is used, the fair value of the property sold at the date of the sale becomes its deemed cost. *[IAS 40.32C]*.

For the detailed discussions and requirements of IFRS 17, see Chapter 51.

6 The fair value model

Under this model, all investment property is measured at its fair value at the end of the reporting period (except in the cases described in sections 6.2 and 6.3 below) and a gain or loss arising from changes in the fair value in the reporting period is recognised in profit or loss for that period. *[IAS 40.33, IAS 40.35]*.

IFRS 13 provides a fair value measurement framework that applies whenever fair value measurement is permitted or required (see Chapter 15). IFRS 13 does not specify when an entity is required to use fair value, but rather, provides guidance on how to measure fair value under IFRS accounting standards when fair value is required or permitted by IFRS accounting standards.

IFRS 13 defines fair value as: *[IFRS 13.9, IFRS 13 Appendix A, IAS 40.5]*

Extract from IFRS 13

Appendix A
Defined terms

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

How we see it

While entities cannot presume this always to be the case, in practice, the fair value estimate arrived at under IFRS 13 may be similar to that estimated for 'market value' as defined by the Royal Institution of Chartered Surveyors ('RICS') and the International Valuation Standards Council ('IVSC'). Their definition of 'market value' being "the estimated amount for which an asset and/or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's-length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion."[12]

The price in the principal (or most advantageous) market used to measure fair value must not be adjusted for transaction costs. This is because transaction costs are not a characteristic of an asset or a liability; rather, they are specific to a transaction and will differ depending on how an entity enters into a transaction for the asset or liability. *[IFRS 13.25]*.

Transaction costs incurred by a purchaser on acquisition are dealt with in section 6.4 below and in Chapter 15 at section 8.1.

6.1 Estimating fair value

Many entities use an external valuer to estimate fair value based on the RICS and/or IVSC Valuation Standards. Indeed, the use of an independent valuer with a recognised and relevant professional qualification and with recent experience in the location and category of the investment property being valued is encouraged by IAS 40, albeit not required. *[IAS 40.32]*. This approach is supported by the Board's conclusion that an independent valuation was not always necessary. *[IAS 40.B56]*.

How we see it

Management needs to be aware of the conceptual differences between IFRS 13 and International Valuation Standards to ensure any values used for financial reporting that are obtained from appraisals, whether external or internal, are consistent with the objective of fair value measurement in accordance with IFRS 13.

Although an appraisal is normally undertaken by professionally qualified valuers and IAS 40 encourages entities to determine the fair value of investment property on the basis of a valuation by a recognised, professionally qualified and experienced independent valuer, an appraiser does not need to be independent of the reporting entity. If the internal appraisals are of such a quality that the fair values of investment property are reliably measured in accordance with IFRS 13, then no additional appraisals by an independent valuer are required.

12 IVS 102 Bases of Value, International Valuation Standards, IVSC, effective 31 January 2025, Appendix: IVS-Defined Basis of Value, para. A10.01, p.24.

How we see it

We acknowledge that a fair value measured by the entity itself may be less reliable than a fair value measured by an independent valuer. However, we believe that the users of financial statements are made aware of this potential weakness and its possible impact on a true and fair presentation by the disclosure requirements in IAS 40.75(e) which requires disclosures to be made about the extent of involvement of independent valuers in measuring fair values (see section 12.1 below).

When estimating the fair value of the property in accordance with IFRS 13, the objective is to estimate the price that would be received to sell an investment property in an orderly transaction between market participants at the measurement date under current market conditions. *[IFRS 13.2]*. This objective applies regardless of the techniques and inputs used to measure fair value.

IAS 40 has certain requirements in addition to those in IFRS 13. In particular, IAS 40 requires that the fair value reflects, among other things, rental income from current leases and other assumptions that market participants would use when pricing investment property under current market conditions. *[IAS 40.40]*. For example, in a transaction to sell an investment property, it is likely that market participants would consider the existing lease agreements in place.

This is consistent with the general requirement in IFRS 13 that an entity must measure the fair value using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest. *[IFRS 13.22]*.

Practical example 6-1 below describes Unibail-Rodamco-Westfield SE's approach to valuations:

Practical example 6-1: Unibail-Rodamco-Westfield SE (2023) France

Universal Registration Document 2023 [extract]

5.2 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]

NOTE 5. INVESTMENT PROPERTIES, TANGIBLE AND INTANGIBLE ASSETS, GOODWILL [extract]

5.1 INVESTMENT PROPERTIES [extract]

5.1.1 ACCOUNTING PRINCIPLES

INVESTMENT PROPERTIES (IAS 40 AND IFRS 13)

In accordance with IAS 40, investment properties are shown at their fair value. According to IFRS 13, the fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (i.e. an exit price). Expectations about future improvements or modifications to be made to the property interest to reflect its highest and best use have to be considered in the appraisal, such as the renovation of or an extension to the property interest.

URW complies with the IFRS 13 fair value measurement rule and the position paper(1) on IFRS 13 established by the European Public Real Estate Association ("EPRA"), the representative body of the publicly listed real estate industry in Europe.

Transaction costs incurred for an asset deal are capitalised in the value of the investment property. Capitalised expenses include capital expenditures, eviction costs, capitalised financial interests, external letting fees invoiced by third parties and other internal costs related to development projects.

In accordance with IFRS 16 and IAS 40, the right-of-use assets arising from leased property which meet the definition of an investment property are measured at fair value.

IPUC are covered by IAS 40 and are eligible to be measured at fair value. In accordance with the Group's investment properties valuation method, they are measured at fair value by a qualified independent external appraiser twice a year. As part of the recommendations of the Royal Institution of Chartered Surveyors ("RICS"), URW applies a rotation on the appraisal mandates on a regular basis; the last rotation occurred in 2021. Projects for which the fair value is not reliably determinable are measured at cost until such time that a fair value measurement becomes reliable, or until 1 year before the construction completion.

According to the Group, a development project is eligible for a fair value measurement once all 3 of the following criteria are fulfilled:

- All administrative authorisations needed to complete the project are obtained;
- The construction has started and costs are committed toward the contractor; and
- Substantial uncertainty in future rental income has been eliminated.

If the time to delivery is less than 1 year, the project is accounted for at fair value.

For properties measured at fair value, the market value adopted by URW is determined on the basis of appraisals by qualified independent external experts, who value the Group's portfolio as at June 30 and December 31 of each year. The gross value is reduced by disposal costs and transfer taxes(2), depending on the country and on the tax situation of the property, in order to arrive at a net market value.

For the Shopping Centres and Offices & Others portfolios, the independent appraisers determine the fair market value based on the results of 2 methods: the discounted cash flow ("DCF") methodology as well as the yield methodology. Furthermore, the resulting valuations are cross-checked against the initial yield, value per square metre and the fair market values established through actual market transactions.

Appraisers have been given access to all information relevant for valuations, such as the Group's confidential rent rolls, including information on vacancy, break options, expiry dates and lease incentives, performance indicators (e.g. footfall and sales where available), letting evidence and the Group's cash flow forecasts from annually updated detailed asset business plans. A significant amount of information has been made available to the appraisers in relation to several ESG KPIs on an asset-by-asset basis(3) in connexion with a new AFREXIM ESG scorecard built by main valuation firms, international shopping centres landlords and some French institutions representing a large scope of retail market participants (see 2.3.2 "Impact on financial statements").

On that basis, appraisers make their independent assessments of current and forward-looking cash flow profiles, and usually reflect risk either in the cash flow forecasts (e.g. future rental levels, growth, investment requirements, void periods and incentives, rent relief), in the applied required returns or discount rates and in the yield applied to capitalise the exit rent to determine an exit value.

The sites of the C&E portfolio are qualified as investment property.

For the C&E portfolio, the valuation methodology adopted is mainly based on a DCF model applied to the total net income projected over the life of the concession, or over the life of the long-term lease (notably the Porte de Versailles long-term lease) or leasehold if it exists, or otherwise over a 10-year period, with an estimate of the asset value at the end of the given time period, based either on the residual contractual value for concessions or on capitalised cash flows over the last year. The valuations carried out by the appraisers took into account total net income, which comprised net rents and ancillary services, as well as net income from car parks. The cost of maintenance works, major repairs, refurbishments, redevelopments and extensions, as well as concession or leasehold fees, are included in projected cash flow figures.

(1) EPRA position paper on IFRS 13 – Fair value measurement and illustrative disclosures, February 2013.
(2) Transfer taxes are valued on the assumption that the property is sold directly, even though the cost of these taxes would, in certain cases, be reduced if the property's holding company would be sold.
(3) For European shopping centres.

The income statement for a given year (Y) records the change in value for each property, which is determined as follows:
market value Y – market value Y-1 + amount of works and other costs capitalised in year Y.

Capital gains on disposals of investment properties are calculated by comparison with their latest market value recorded in the closing statement of financial position for the previous financial year.

Properties under construction carried at cost are subject to impairment tests, determined on the basis of the estimated recoverable value of the project. The recoverable value of a project is assessed, for significant projects by a qualified independent external appraiser and for others internally by the Development & Investment teams through the expected delivery date, expected development costs, and considering a market exit capitalisation rate and the expected net rents. When the estimated recoverable value is lower than net book value, an impairment provision is recorded.

Properties held for sale are identified separately in the statement of financial position according to IFRS 5.

As discussed in section 2.1 above, the fair value of right-of-use assets that meet the definition of investment property will need to be determined (whether for disclosure and/or measurement purposes). The IASB acknowledged that there might be costs involved with determining the fair value of right-of-use assets, particularly for entities that are not in the property industry but sublease property, for example, because that property is not needed for use within their business. *[IFRS 16.BC179]*. However, the IASB views the determination of the fair value of right-of-use assets as relatively straightforward, even for an entity that is not in the property industry, if the sublease does not contain any options or variable lease payments. Determining the fair value would involve projecting the cash flows that the entity expects to receive from subleasing the asset. The IASB concluded that determining these cash flows would normally be relatively straightforward because it is likely that a sublease would already be in place. *[IFRS 16.BC180]*.

Further, if leases have variable and optional payments, or if there is no active market for the right-of-use asset, the IASB views that the principles in IFRS 13 and IAS 40 are sufficient to help lessees to measure the fair value of those right-of-use assets. In particular, the IASB noted that IAS 40.50(d) explains when to include in the measurement of the right-of-use asset options and variable lease payments that are not included in the measurement of the lease liability. *[IFRS 16.BC181]*. Paragraph 40.50(d) of IAS 40 states that the fair value of investment property held by a lessee as a right-of-use asset reflects expected cash flows, including variable lease payments that are expected to become payable. Accordingly, if a valuation obtained for a property is net of all payments expected to be made, it will be necessary to add back any recognised lease liability, to arrive at the carrying amount of the investment property using the fair value model (see section 6.7 below). *[IAS 40.50]*.

It is also worth noting that fair value measurement may be affected by economic and market disruptions caused by war and pandemics. Similarly, climate change can potentially affect the fair value of an asset or liability. Please refer to our publications *Applying IFRS: Accounting considerations related to geopolitical events and uncertainty* and *Applying IFRS: Connected Financial Reporting: Accounting for Climate Change* for further guidance on these topics.[13]

6.1.1 Methods of estimation

IFRS 13 does not specify or rank the techniques an entity must use to measure fair value. However, it requires them to be consistent with one or more of the three broad approaches: the market approach; the income approach; and the cost approach. *[IFRS 13.62]*. As discussed in section 6.1.2 below, IFRS 13 does require an entity to prioritise observable inputs over unobservable inputs. See Chapter 15 at section 13 for further discussion on selecting appropriate techniques and inputs.

IFRS 16 specifies the basis for initial recognition of the cost of an investment property held by a lessee as a right-of-use asset (see section 4.5 above). In line with the discussion in section 6 above, IAS 40.33 requires the investment property held by a lessee as a right-of-use asset to be remeasured, if necessary, to fair value if the entity chooses the fair value model. *[IAS 40.41]*. When a lessee uses the fair value model to measure an investment property that is held as a right-of-use asset, it will measure the right-of-use asset, and not the underlying property, at fair value. *[IAS 40.40A]*. When lease payments are at market rates, the fair value of an investment property held by a lessee as a right-of-use asset at acquisition, net of all expected lease payments (including those relating to recognised lease liabilities), should be zero. Thus, remeasuring a right-of-use asset from cost in accordance with IFRS 16 to fair value (taking into account the requirements in IAS 40.50 - see section 6.1.4 below) should not give rise to any initial gain or loss, unless fair value is measured at different times. This could occur when an election to apply the fair value model is made after initial recognition. *[IAS 40.41]*.

When an entity first acquires an investment property (or when an existing property first becomes investment property after a change in use - see section 9 below) there could be an indication that its fair value will not be reliably measurable on a continuing basis. For example, there might be clear evidence that the variability in the range of reasonable fair value measurements will be so great, and the probabilities of the various outcomes so difficult to assess, that the usefulness of a single measure of fair value will be negated. However, it cannot be over-emphasised that IAS 40 describes such circumstances as 'exceptional cases'. *[IAS 40.48]*. This is discussed further in section 6.2 below.

6.1.2 Observable data

When selecting the most appropriate inputs to a fair value measurement from multiple available inputs, those that maximise the use of observable data, rather than unobservable data, must be selected. *[IFRS 13.67]*. Just because the volume or level of activity in a market has significantly decreased, it does not mean that transactions in that market are not orderly or do not represent fair value. *[IFRS 13.B43]*.

13 Available on ey.com/IFRS.

Entities will need to consider the individual facts and circumstances in making this assessment. Notwithstanding the need for judgement, an entity must have a reasonable basis for concluding that a current observable market price can be ignored based on a view that it represents a liquidation or distressed sale value. *[IFRS 13.B43]*. This is discussed further in Chapter 15 at section 7.

6.1.3 Comparison with value in use and net realisable value

Fair value is not the same as 'value in use' as defined in IAS 36. In particular, fair value does not take account of the entity specific factors of the holder that would not generally be available to knowledgeable willing buyers such as additional value derived from holding a portfolio of investment property assets, synergies between the properties and other assets or legal rights or tax benefits or burdens pertaining to the current owner. Fair value is also not the same as net realisable value as, for example, net realisable value does not have to take account of market required returns but would have to take into account cost to sell. *[IFRS 13.6(c), IFRS 13.BC24]*. See also Chapter 15 at section 2.2.3 and the discussion in section 7.3 below.

6.1.4 'Double counting'

An entity must take care, when determining the carrying amount of investment property under the fair value model, not to double count assets or liabilities that are recognised separately. IAS 40 describes a number of situations where this might otherwise happen as follows:

- Equipment such as lifts or air-conditioning is often an integral part of a building and is generally included in the fair value of the investment property, rather than recognised separately as property, plant and equipment (see section 6.5 below).
- If an office is leased on a furnished basis, the fair value of the office generally includes the fair value of the furniture, because the rental income relates to the furnished office. When furniture is included in the fair value of investment property, an entity does not recognise that furniture as a separate asset (see section 6.5 below).
- The fair value of investment property excludes prepaid or accrued operating lease income, because the entity recognises it as a separate liability or asset (see section 6.6 below).
- The fair value of investment property held by a lessee as a right-of-use asset reflects expected cash flows, including variable lease payments that are expected to become payable. Accordingly, if a valuation obtained for a property is net of all payments expected to be made, it will be necessary to add back any recognised lease liability, to arrive at the carrying amount of the investment property using the fair value model (see section 6.7 below). *[IAS 40.50]*.

6.2 Inability to determine fair value of completed investment property

It is a rebuttable presumption that an entity can determine the fair value of a property reliably on a continuing basis, that is, on each subsequent occasion in which it records the investment property in its financial statements. *[IAS 40.53]*.

The standard emphasises that it is only in exceptional cases and only on initial recognition (either by acquisition or change in use - see section 9 below) that the entity will be able to conclude that it will not be able to reliably measure the investment property's fair value on a continuing basis. *[IAS 40.53]*.

Additionally, entities are strongly discouraged from arguing that fair value cannot be reliably measured. It may be a possible argument when, and only when, the market for comparable properties is inactive (e.g., there are few recent transactions, price quotations are not current or observed transaction prices indicate that the seller was forced to sell) and alternative reliable measurements of fair value (for example, based on discounted cash flow projections) are not available. In such exceptional cases, the property must be measured using the cost model in IAS 16 for owned investment property (see Chapter 19 at section 5), or cost model in accordance with IFRS 16 for investment property held by a lessee as a right-of-use asset (see Chapter 24 at section 5.3.1), until its disposal and assumed to have a nil residual value. *[IAS 40.53]*. This means that an owned investment property has to be carried at cost and the building and its component parts depreciated over their useful lives (see section 7 below). In these circumstances, IAS 16's revaluation model, under which assets may be revalued to fair value, is specifically ruled out. If this exceptional situation occurs, the cost model in IAS 16 or in IFRS 16 must continue to be applied until disposal of such property. *[IAS 40.53]*. This also means that if this exceptional situation occurs, investment property will continue to be measured at cost even if a reliable measure of fair value subsequently becomes available (such treatment is different for investment property under construction - see section 6.3 below). Although an entity measures an individual property at cost for this reason, all other investment property must continue to be carried at fair value. *[IAS 40.54]*.

The above exception is not permitted for investment property that has been previously measured using the fair value model. Once a property is initially recognised at its fair value, it must always be so recognised until disposed of or reclassified for owner-occupation or development for subsequent sale in the ordinary course of the business, even if comparable market transactions become less frequent or market prices become less easily available. *[IAS 40.55]*.

6.3 The fair value of investment property under construction

Entities who wish to measure their completed investment property at fair value will also need to measure their investment property under construction at fair value (subject to fair value being reliably determinable). *[IAS 40.33, IAS 40.53]*.

How we see it

Determining the fair value of investment property under construction will often be more judgemental than for completed property because:

- There are generally few or limited observable transactions for investment property under construction. Where such assets are transacted, this is typically when they are in the very early stages of development or when they are nearly complete and substantially let.
- Additional assumptions must be made about the risks and costs of any incomplete construction.

It is worth noting that, in light of the requirements of IFRS 13, an entity will have to determine whether fair value can be reliably measured or not under the requirements in that standard. This is discussed in Chapter 15 at section 2.4.1.

In any event, some entities do consider that not all of their investment property under construction can be reliably measured and have developed criteria to make that assessment, see Practical example 6-1 above for an example.

There were persistent concerns that, in some situations, the fair value of investment property under construction could not be measured reliably. Where an entity that chooses the fair value model for its investment property determines that the fair value of an investment property under construction is not reliably measurable but it expects the fair value to be reliably measurable when construction is complete, the IASB decided to allow such investment property under construction to be measured at cost until such time as the fair value becomes reliably measurable or construction is completed (whichever comes earlier). *[IAS 40.53]*.

IAS 40 also sets out the following:

- Once an entity becomes able to measure reliably the fair value of an investment property under construction that it has previously measured at cost (see section 7 below), it must measure that property at its fair value. *[IAS 40.53A]*.
- Once construction of such property is complete, it is presumed that fair value can be measured reliably. If this is not the case, and this will be only in exceptional situations, the property must be accounted for using the cost model in accordance with IAS 16 for owned investment property (see section 7 below) or cost model in accordance with IFRS 16 for investment property held by a lessee as a right-of-use asset (see Chapter 24 at section 5.3.1), together with the other requirements discussed in section 6.2 above, i.e., use the cost model until disposal of the property (even if subsequently its fair value becomes reliably determinable) and assume that it has a nil residual value. *[IAS 40.53A]*.
- The presumption that the fair value of investment property under construction can be measured reliably can be rebutted only on initial recognition. Therefore, an entity that has measured an item of investment property under construction at fair value may not subsequently conclude that the fair value of the completed investment property cannot be measured reliably. *[IAS 40.53B]*.

6.4 Transaction costs incurred by the purchaser of an investment property

An issue that arises in practice is whether transaction costs that have been incurred by the reporting entity on purchase of an investment property must be taken into account in determining the subsequent fair value of the property when applying the fair value model. This is shown in the following Illustration:

Illustration 6-1: The fair value model and transaction costs incurred at acquisition

On 1 January 20X1 Entity A acquired an investment property for a purchase price of CU10,000. In addition, Entity A incurred legal costs of CU200 in connection with the purchase and paid property transfer tax of CU400. Accordingly, the investment property was initially recorded at CU10,600. Entity A applies the fair value model for subsequent measurement of investment property:

	Development of prices in property market	Appraised market value of property	Cost of property initially recognised	Difference
		CU	CU	CU
Scenario 1	Unchanged	10,000	10,600	(600)
Scenario 2	Slightly increased	10,250	10,600	(350)
Scenario 3	Significantly increased	11,000	10,600	400
Scenario 4	Decreased	9,500	10,600	(1,100)

The issue that arises in practice is whether or not the acquisition-related transaction costs that were incurred by Entity A on 1 January 20X1 can be considered in determining the fair value of the investment property at the next reporting date.

The acquisition-related transaction costs incurred by Entity A would not be considered separately in determining the fair value of an investment property in accordance with IFRS 13. In the example above, on the next reporting date the carrying amount to be recorded in the statement of financial position is its fair value, measured in accordance with IFRS 13. Changes from the initial carrying amount to the appraised market value at the subsequent reporting date (reflected in the 'Difference' column in the table) are recognised in profit or loss. *[IAS 40.35]*.

Although IAS 40 states that transaction costs incurred by a purchaser on the acquisition of an investment property are included in the cost of the investment property at initial recognition, *[IAS 40.21]*, if an entity applies the fair value model, the same investment property that was recorded at cost on initial recognition is subsequently measured at fair value in accordance with IFRS 13. The fact that the cost of the investment property recorded on initial recognition included legal and other transaction costs is irrelevant to the subsequent fair value measurement of the asset.

IFRS 13 clarifies that: *[IFRS 13.25]*

Extract from IFRS 13

25 The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. Transaction costs shall be accounted for in accordance with other IFRSs. Transaction costs are not a characteristic of an asset or a liability; rather, they are specific to a transaction and will differ depending on how an entity enters into a transaction for the asset or liability.

Likewise, when measuring the fair value of an investment property, it is not appropriate to add the acquisition-related transaction costs incurred by the purchaser to fair value, as these have no relevance to the fair value of the property. Therefore, some or all of the transaction costs incurred when acquiring the investment property that were capitalised in accordance with IAS 40 will effectively be expensed as part of the subsequent fair value gain or loss.

See Chapter 15 at section 8.1 for further discussion.

6.5 Fixtures and fittings subsumed within fair value

Fixtures and fittings such as lifts or air conditioning units are usually reflected within the fair value of the investment property rather than being accounted for separately. *[IAS 40.50(a)]*. In other cases, additional assets may be necessary in order that the property can be used for its specific purposes. The standard refers to furniture within a property that is being let as furnished offices, and argues that this is not recognised as a separate asset if it has been included in the fair value of the investment property. *[IAS 40.50(b)]*.

The entity may have other assets that have not been included within the valuation, in which case these will be recognised separately and accounted for in accordance with IAS 16.

6.6 Prepaid and accrued operating lease income

6.6.1 Accrued rental income and lease incentives

The requirement in IAS 40 not to double-count assets or liabilities recognised separately is most commonly encountered when the carrying amount of an investment property is reduced below its fair value to the extent that a separate asset arises under IFRS 16. For example, when an entity offers an initial rent-free period to a lessee, it will accrue an asset during the rent-free period and then amortise it over the remaining lease term, thereby spreading the reduction in rental income over the term of the lease. If such asset is separately recognised from the investment property, the amount of that separate asset is excluded from the fair value of the investment property in order to avoid double counting (see section 4.9.1 above). *[IAS 40.50(c)]*.

Wereldhave N.V. explains the treatment in its accounting policies:

Practical example 6-2: Wereldhave N.V. (2023) Netherlands

Integrated Annual Report 2023 [extract]
Notes to the consolidated financial statements [extract]
3 Accounting policies [extract]
3.6 Investment property [extract]

Lease incentives, rent-free periods and other leasing expenses
Rent-free periods and investments made, or allowances granted to tenants by Wereldhave ("lease incentives") are allocated on a linear basis over the lease term. The lease term consists of the period until the first break option for the tenants, which period can be extended by management with the expected prolongation of the leases. In determining the property at fair value capitalized lease incentives are adjusted for the valuation results, to avoid double counting.

This treatment can also be seen in Practical example 6-3 below where lease incentives, which are separately recognised, are excluded from the fair value of the investment property to arrive at the carrying amount of the investment property for the purposes of the financial statements.

6.6.2 Prepaid rental income

The same principles as discussed in sections 4.9.1 and 6.6.1 above are applied when rental income arising from an operating lease is received in advance i.e., as a policy choice, the resulting liability could be recognised either separately from, or included in, the carrying amount of the investment property. The latter treatment is demonstrated in the Illustration below:

Illustration 6-2: Investment property and rent received in advance

A company owns land with an estimated value of CU10 million as at 1 January 20X1 that is accounted for as investment property. The company applies the fair value option in IAS 40 and has a reporting period ending on 31 December each year.

The land was not let until, on 30 December 20X1, a lease of 50 years was granted for consideration of CU9.5 million received in advance. The lease is considered to be an operating lease. No rental income was recognised in 20X1 as it was considered immaterial. An external valuer estimated that, after the grant of the 50-year lease, the fair value of the company's interest in the land as at 31 December 20X1 was CU1 million. As at 31 December 20X2 the external valuer estimated the fair value of the interest in the property was CU1.2 million.

The resultant accounting entries are summarised below.

Extracts from the ledgers for the year ended 31 December 20X1

(All figures in CU millions)

	As at 1 January 20X1	Journal (1)	Journal (2)	Journal (3)	As at 31 December 20X1
Investment property	10.0	-	(9.0)	9.5	10.5
Cash	-	9.5	-	-	9.5
Deferred income	-	(9.5)	-	-	(9.5)
Net Assets	10.0	-	(9.0)	9.5	10.5
Share capital	10.0	-	-	-	10.0
Retained profit	-	-	(9.0)	9.5	0.5
Total Equity	10.0	-	(9.0)	9.5	10.5

Journals:

(1) Issue of lease (CU9.5m received on issue of lease).

(2) Write down investment property to CU1m external valuation.

(3) Write up book value of property by the amount of unamortised deferred revenue in the statement of financial position.

Extracts from the ledgers for the year ended 31 December 20X2

(All figures in CU millions)

	As at 1 January 20X2	Journal (1)	Journal (2)	Journal (3)	As at 31 December 20X2
Investment property	**10.5**	-	(9.3)	9.31	**10.51**
Cash	**9.5**	-	-	-	**9.5**
Deferred income	**(9.5)**	0.19	-	-	**(9.31)**
Net Assets	**10.5**	0.19	(9.3)	9.31	**10.7**
Share capital	**10.0**	-	-	-	**10.0**
Retained profit	**0.5**	0.19	(9.3)	9.31	**0.7**
Total Equity	**10.5**	0.19	(9.3)	9.31	**10.7**

Journals:

(1) Amortise rent (one year of the CU9.5m received for 50 years).

(2) Write down investment property to CU1.2m external valuation.

(3) Write up the book value of property by the amount of unamortised deferred revenue in the statement of financial position (CU9.31m).

6.7 Valuation adjustment to the fair value of properties held under a lease

IAS 40 states that the fair value of investment property held by a lessee as a right-of-use asset will reflect expected cash flows, including variable lease payments that are expected to become payable. Accordingly, if a valuation obtained for a property is net of all payments expected to be made, it will be necessary to add back any recognised lease liability, to arrive at the carrying amount of the investment property using the fair value model. *[IAS 40.50(d)]*.

Therefore, if the entity obtains a property valuation net of the valuer's estimate of the present value of future lease obligations (which is usual practice), to the extent that the lease obligations have already been accounted for in the statement of financial position as a lease obligation, an amount is to be added back to arrive at the carrying amount of the investment property for the purposes of the financial statements.

The valuation adjustment referred to above is achieved by adjusting for the lease liability recognised in the financial statements.

This is shown using the information in the following Illustration:

Illustration 6-3: Valuation of a property held under a lease

Entity A pays CU991,000 for a 50-year leasehold interest in a property which is classified as an investment property using the fair value model. In addition, a ground rent of CU10,000 is payable annually during the lease term, the present value of which is calculated at CU99,000 using a discount rate of 10% which reflects the rate implicit in the lease at that time. The company has initially recognised the investment property at the following amount:

	CU'000
Amount paid	991
Present value of the ground rent obligation on acquisition	99
Cost recorded for financial reporting purposes	1,090

Assume at the next reporting date the leasehold interest in the property has a fair value of CU1,006,000 measured (based on market participant assumptions) as follows:

	CU'000
Present value of estimated future lease income	1,089
Less: Present value of the ground rent obligation at the reporting date *	(83)
Fair value	1,006

* The market required yield has changed to 12%. Therefore, the present value of the ground rent obligations of CU10,000 per annum for the remaining 49 years is now CU83,000.

At the same time the ground rent lease liability has reduced to CU98,000 as payments are made.

This would give the following results:

	CU'000
Fair value	1,006
Add recognised lease liability	98
Carrying amount for financial reporting purposes	1,104

The statement of financial position of Entity A would therefore contain the following items:

	Investment property	Lease liability
	CU'000	CU'000
On acquisition	1,090	99
End of year 1	1,104	98

An example of this in practice can be seen in in Practical example 6-3 below where lease liabilities related to head leases, which are separately recognised, are added back to arrive at the carrying amount of the investment property for the purposes of the financial statements:

Practical example 6-3: Land Securities Group PLC (2024) **United Kingdom**

Landsec Annual Report 2024 [extract]

NOTES TO THE FINANCIAL STATEMENTS [extract]

SECTION 3 - PROPERTIES [extract]

14 › INVESTMENT PROPERTIES [extract]

The market value of the Group's investment properties, as determined by the Group's external valuers, differs from the net book value presented in the balance sheet due to the Group presenting tenant finance leases, head leases and lease incentives separately. The following table reconciles the net book value of the investment properties to the market value.

	2024				2023			
	Group £m	Joint ventures' £m	Adjustment for non-wholly owned subsidiaries £m	Combined Portfolio £m	Group £m	Joint ventures' £m	Adjustment for non-wholly owned subsidiaries £m	Combined Portfolio £m
Market value	9,465	616	(118)	9,963	9,745	655	(139)	10,259
Less: properties treated as finance leases	(18)	–	–	(18)	(17)	–	–	(17)
Plus: head leases capitalised	77	1	–	78	107	1	–	108
Less: tenant lease incentives	(194)	(32)	–	(226)	(175)	(55)	–	(230)
Net book value	9,330	585	(118)	9,797	9,658	601	(139)	10,120

...

6.8 Future capital expenditure and development value ('highest and best use')

It is common for the value of land to reflect its potential future use and the value of land may increase in the event that the owner obtains any required permissions for a change in the use of that land.

It may be, for example, that a permission to change from an industrial to residential use will increase the value of the property as a whole, notwithstanding that the existing industrial buildings are still in place. This increase in value is typically attributable to the land, rather than the buildings.

It is therefore important to note that IFRS 13 requires consideration of all relevant factors in determining whether the highest and best use of a property can be something other than its current use at the measurement date. IFRS 13 presumes that an entity's current use of an asset is generally its highest and best use unless market or other factors suggest that a different use of that asset by market participants would maximise its value. *[IFRS 13.29]*. IFRS 13 states: *[IFRS 13.27, IFRS 13.28]*

Extract from IFRS 13

27 **A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use.**

28 The highest and best use of a non-financial asset takes into account the use of the asset that is physically possible, legally permissible and financially feasible, as follows:

(a) A use that is physically possible takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (eg the location or size of a property).

(b) A use that is legally permissible takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (eg the zoning regulations applicable to a property).

(c) A use that is financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.

How we see it

Considerable judgement may have to be applied in determining when an anticipated change is legally permissible. For example, if approval is required for rezoning land or for an alternative use of existing property interests, it may be necessary to assess whether such approval is a substantive legal requirement or not. See Chapter 15 at section 9.1 for further discussion on determining highest and best use and the assessment of 'legally permissible'.

If management determines that the highest and best use of an asset differs from its current use, certain valuation matters must be considered. Appraisals that reflect the effect of a reasonably anticipated change in what is legally permissible must be carefully evaluated. If the appraised value assumes that a change in use can be obtained, the valuation must also reflect the cost associated with obtaining approval for the change in use and transforming the asset, as well as capture the risk that the approval might not be granted (that is, uncertainty regarding the probability and timing of the approval).

Expectations about future improvements or modifications to be made to the property to reflect its highest and best use may be considered in the appraisal, such as the renovation of the property or the conversion of an office into condominiums, but only if and when other market participants would also consider making these investments and reflect only the cash flows that market participants would take into account when assessing fair value.

See Chapter 15 at section 9 for further discussion on application of IFRS 13 requirements to non-financial assets which includes determining highest and best use.

6.9 Negative present value

In some cases, an entity expects that the present value of its payments relating to an investment property (other than payments relating to recognised liabilities) will exceed the present value of the related cash receipts. An entity applies IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to determine whether to recognise a liability and, if so, how to measure that liability. *[IAS 40.52]*.

6.10 Deferred taxation for property held by a 'single asset' entity

It is common in many jurisdictions for investment property to be bought and sold by transferring ownership of a separate legal entity formed to hold the asset (a 'single asset' entity) rather than the asset itself. In addition to the issue on initial recognition discussed in section 4.1.2 above, this matter created diversity in practice when determining the expected manner of recovery of the asset for the purposes of IAS 12, i.e., whether or not the parent entity must reflect the fact that an asset held by a single asset entity is likely to be disposed of by selling the shares of the entity rather than the asset itself, and if so, whether the deferred taxation would be recognised with reference to the shares rather than the underlying property.

The IFRS IC clarified in July 2014 that IAS 12 requires the parent to recognise in its consolidated financial statements both the deferred tax related to the property inside the single asset entity and the deferred tax related to the shares of that single asset entity (the outside), if:

- Tax law attributes separate tax bases to the asset inside and to the shares
- In the case of deferred tax assets, the related deductible temporary differences can be utilised

  And
- No specific exceptions in IAS 12 apply[14]

Accordingly, in determining the expected manner of recovery of a property held by a single asset entity for the purposes of IAS 12, the parent entity must have regard to both the asset itself and the shares (subject to the exemption relating to investments in subsidiaries in IAS 12.39). In line with this, the shares of the single asset entity and the underlying asset it holds cannot be treated as a single item for deferred taxation purposes. Accordingly, it would not be appropriate to measure the deferred taxation related to the underlying property with reference to selling the shares of the single asset entity.

How we see it

In a similar way to the principles discussed above, when determining the fair value of the underlying property, it would not be appropriate to include the related beneficial tax effects of purchasing shares of the single asset entity in the fair valuation of the underlying property. This is also because, when determining the fair value of the property, the unit of account is the underlying property itself (see Chapter 15 at section 4.1).

For further discussions on recognition of deferred taxes for investment property and for single asset entities, see Chapter 29 at sections 8.4.7 and 8.4.10, respectively.

14 *IFRIC Update*, July 2014, available on the IFRS Foundation's website.

7 The cost model

Extract from IAS 40

Cost model

56 After initial recognition, an entity that chooses the cost model shall measure investment property:

(a) in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* if it meets the criteria to be classified as held for sale (or is included in a disposal group that is classified as held for sale);

(b) in accordance with IFRS 16 if it is held by a lessee as a right-of-use asset and is not held for sale in accordance with IFRS 5; and

(c) in accordance with the requirements in IAS 16 for the cost model in all other cases.

Except in the cases described in section 8 below, the cost model requires that investment property held by a lessee as a right-of-use asset be measured after initial recognition in accordance with IFRS 16 and under the cost model set out in IAS 16 for owned investment property. *[IAS 40.56]*.

For further discussion on subsequent measurement of a right-of-use asset applying the cost model under IFRS 16, see Chapter 24 at section 5.3.1.

Applying the cost model under IAS 16 means that the owned asset must be recognised at cost, depreciated systematically over its useful life and impaired when appropriate. *[IAS 16.30]*. The residual value and useful life of each owned investment property must be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the changes must be accounted for as a change in accounting estimate in accordance with IAS 8. *[IAS 16.51]*. For further discussion on applying the cost model under IAS 16, see Chapter 19 at section 5.

If an entity applies the cost model, the fair value of its investment property must be disclosed (see section 12.3 below).

7.1 Initial recognition

7.1.1 Identification of physical parts

The cost of the property must be analysed into appropriate significant components, each of which will have to be depreciated separately (see also Chapter 19 at sections 3.2 and 5.2).

The analysis into significant components is rarely a straightforward exercise since properties typically contain a large number of components with varying useful lives. Icade, which applied the cost model for measuring its investment property prior to 2021 (see section 7.2 below), disclosed the typical components it identified for its investment properties as well as the ranges of useful lives for each component - see Practical example 7-1 below.

Practical example 7-1: Icade (2020) France

2020 UNIVERSAL REGISTRATION DOCUMENT [extract]
Notes to the consolidated financial statements [extract]
Note 5. Property portfolio and fair value [extract]
5.1. Property portfolio [extract]
5.1.1. Investment property [extract]
Accounting principles [extract]

The gross value of an investment property is split into separate components which each have their own useful lives.

Investment property is depreciated using the straight-line method over periods which correspond to their expected useful life. Land is not depreciated. The depreciation periods used by the Group (in years) are as follows:

	Office and business parks			
Components	"Haussmann" buildings	Other properties	Healthcare facilities	Other assets[a]
Roads, networks, distribution	100	40-60	80	15-50
Structural works	100	60	80	30-50
External structures	30	30	20-40	20-25
General and technical equipment	20-25	10-25	20-35	10-25
Internal fittings	10-15	10-15	10-20	10-25
Specific equipment	10-30	10-30	20-35	10-25

(a) Other assets consist of hotels, homes and business premises.

Useful lives are revised at each reporting date, particularly in respect of investment property which is the subject of a restoration decision.

[illegible]

...

An entity is also required to recognise replacement parts and derecognise the replaced part as described in Chapter 19 at section 7.

7.1.2 Identification of non-physical parts

IAS 16 sets out that if an entity acquires property, plant and equipment subject to an operating lease in which it is the lessor, it may be appropriate to depreciate separately amounts reflected in the cost of that item that are attributable to favourable or unfavourable lease terms relative to market terms (see Chapter 19 at section 5.2.1). *[IAS 16.44]*. This will therefore apply to investment property accounted for under the cost model (see section 4.7 above).

7.2 Incidence of use of the cost model

It appears less common for entities to measure investment property using the cost model than the fair value model.

How we see it

In previous years, EY real estate financial statement surveys have consistently found that over 90% of the companies in those surveys used the fair value model (e.g., about 98% based on the survey published in 2019). There also seems to be a general, although not universal, market consensus among existing entities reporting under IFRS accounting standards that the fair value model is the more appropriate. For example, in its latest *Best Practices Recommendations Guidelines* issued in September 2024, the European Public Real Estate Association ('EPRA') recommends to its members that "Real estate companies should account for their property investments based upon the fair value model."[15]

Some entities reporting under IFRS accounting standards have moved from the cost model. For example, Icade SA applied the cost model until 2021 when the fair value model was applied. It made the following disclosure in its 2021 financial statements:

15 *Best Practices Recommendations: Guidelines*, EPRA, September 2024, section 4.1, p.35. Available on the EPRA's website.

Practical example 7-2: Icade SA (2021) **France**

2021 UNIVERSAL REGISTRATION DOCUMENT [extract]

1. Consolidated financial statements [extract]

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]

Note 1. General principles [extract]

1.2 Accounting standards [extract]

1.2.1. Change in accounting policy: valuation of investment property using the fair value model

IAS 40 "Investment property" provides for two possible accounting policies to measure investment property after initial recognition:

- the fair value model measures investment property at fair value, in accordance with IFRS 13; or
- the cost model measures investment property using the cost model as set out in IAS 16 "Property, plant and equipment" (or in accordance with IFRS 16 in the case of a right to use, or IFRS 5 in the case of property classified as held for sale).

The latter method was the one applied by the Icade group in its historical financial statements.

The Group has elected to apply the fair value model for the measurement of investment property for the first time in the financial statements for the year ended December 31, 2021, believing that this change in policy provides more relevant information on the value of its property assets and aligns the Group with its peers. In accordance with IAS 8 "Accounting Policies, Changes in Accounting Estimates and Errors", this change in policy was applied retrospectively, based on property asset valuations used for historical information. As a result, the 2020 financial statements presented have been restated using the new policy for comparative purposes.

The relevant accounting principles applied in accordance with IAS 40 are set out in note 5.

The main effects arising from this change in policy include:

- unless the standard requires otherwise, all investment property is measured using the fair value model in the statement of financial position;
- any gain or loss arising from a change in the fair value of investment property is presented as a separate line item in the consolidated income statement, between EBITDA and operating profit/(loss).

Such assets measured at fair value are no longer depreciated or impaired.

The impact of this change in policy on the Group's opening consolidated equity as of January 1, 2020 amounted to €4,281.7 million, of which €3,530.4 million on a proportionate consolidation basis. The removal of the depreciation and impairment charges recognised in respect of investment property, the recognition of the change in the fair value of the property assets and adjustments to gains or losses on disposals led to an increase in the Group's consolidated net profit for the financial year 2020 of €123.2 million, of which €55.3 million attributable to the Group (i.e. €0.75 per share).

...

How we see it

The use of the cost model (rather than the fair value model) removes the need to recognise gains from increases in the fair value of property within profit or loss. However, it is unlikely to insulate an entity from reporting falls in the fair value of investment property below the depreciated cost of the property, in profit or loss - see section 7.3 below.

7.3 Impairment

Investment property measured at cost is subject to the requirements of IAS 36 in respect of impairment. As set out in Chapter 21 at section 5, IAS 36 requires a recoverable amount to be determined as the higher of (i) value in use and (ii) fair value less costs of disposal. *[IAS 36.18]*.

Both value in use calculation and fair value calculation (where there is no price quoted for identical assets on an active market) are typically based on discounted cash flow models. The former will typically use entity specific cash flows, whilst the latter would generally use market expected cash flows. Both would use a market determined discount rate.

For a rental generating asset such as an investment property, the future cash flows to be taken into account in any projection would, in simple terms, be (i) the rental stream under the existing lease arrangements and (ii) an estimate of any rental stream and/or sales proceed from selling the investment property thereafter.

The cash flows expected to be generated from the existing lease would be the same whether the basis was entity specific or market expected cash flows.

The estimate of any rental stream thereafter would also be the same unless the entity forecast it would outperform the market and achieve superior cash flows. This is unlikely to be an acceptable basis for a forecast as no entity can realistically expect to outperform the market for its whole portfolio or do so for more than the short term. Therefore, a forecast that cash flows from individual properties will outperform the market would have to be considered with scepticism.

How we see it

We would regard it as being a rare circumstance where the value in use of an individual investment property could be said to be higher than the fair value of that property. Indeed, in some circumstances - for example, where a fair value is partly dependent on a gain from planned future development (see section 6.8 above) but where that expenditure is not to be allowed to be considered in a value in use calculation - value in use may be lower than fair value.

8 IFRS 5 and investment property

Investment property measured using the cost model (under IAS 16 or IFRS 16 - see section 7 above) which meets the criteria to be classified as held for sale or held for distribution to owners, or is included within a disposal group classified as held for sale or held for distribution to owners, is measured in accordance with IFRS 5. *[IAS 40.56]*. This means that such property will be held at the lower of carrying amount and fair value less costs to sell, and depreciation of the asset will cease. *[IFRS 5.15, IFRS 5.25]*.

As set out in Chapter 5 at section 2.2.1, investment property measured at fair value is not subject to the measurement requirements of IFRS 5. However, such property is subject to the classification and presentation requirements of that standard. Consequently, investment property that meets the criteria to be classified as held for sale or held for distribution to owners is required to be presented separately from other assets in the statement of financial position (see Chapter 5 at section 2.2.4).

An example of an entity applying the presentation requirements of IFRS 5 to investment property measured at fair value is General Property Trust in its 2023 financial statements - see Practical example 8-1 below.

Practical example 8-1: General Property Trust (2023) — **Australia**

2023 Annual Report [extract]

Financial Report [extract]

Consolidated Statement of Financial Position [extract]

	Note	31 Dec 23 $M
Assets		
Current assets		
Cash and cash equivalents		67.9
Trade receivables	4(a)	55.5
Other receivables	4(b)	57.5
Intangible assets	5	0.8
Inventories	6	86.2
Derivative assets	14(a)	49.0
Prepayments		14.3
Other assets		29.6
Current tax assets	9(c)	-
		360.8
Assets classified as held for sale – investment properties	2(a)(v)	296.1
Total current assets		**656.9**
Non-current assets		
Investment properties	2(a)	11,265.3
Equity accounted investments	3	3,849.1
Intangible assets	5	21.9
Inventories	6	93.5
Property, plant and equipment		8.5
Derivative assets	14(a)	314.7
Right-of-use assets		14.6
Deferred tax assets	9(d)	26.7
Other assets		28.6
Total non-current assets		**15,622.9**
Total assets		**16,279.8**

...

Investment property measured using the cost model is subject to the classification, measurement and presentation requirements of IFRS 5. Icade, which used the cost model for measuring its investment property prior to 2021 (see section 7.2 above), provided an accounting policy for such property held for sale in its 2017 financial statements - see Practical example 8-2 below.

Practical example 8-2: Icade (2017) **France**

REGISTRATION DOCUMENT 2017 [extract]

2. Notes to the consolidated financial statements [extract]

Note 1. Accounting principles [extract]

1.10. Assets held for sale and discontinued operations

In accordance with IFRS 5, if the Group decides to dispose of an asset or group of assets, it should be classified as held for sale if:

- the asset or group of assets is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets;
- it is highly likely to be sold within one year.

Consequently, this asset or group of assets is shown separately as "Assets held for sale" on the balance sheet. The liabilities related to this asset or group of assets are also shown separately on the liabilities side of the balance sheet.

For the Group, only assets meeting the above criteria and subject to a formal disposal decision at the appropriate management level are classified as assets held for sale. The accounting consequences are as follows:

- the asset (or group of assets) held for sale is measured at the lower of carrying amount and fair value less costs to sell;
- the asset stops being depreciated with effect from the date of transfer.

In addition to the disclosure requirements for investment property discussed in section 12 below, IFRS 5 requires further disclosures of applicable information in the notes to the financial statements in the period in which an investment property measured using the fair value model has been either classified as held for sale, or included in a disposal group classified as held for sale, or sold. These additional disclosures required by IFRS 5 are discussed in Chapter 5 at section 5. *[IFRS 5.41, IFRS 5.42]*.

On the other hand, IFRS 5 specifies the disclosures required in respect of investment property measured using the cost model that has been either classified as held for sale or included in a disposal group classified as held for sale (see Chapter 5 at section 5). The disclosure requirements discussed in section 12 below do not apply to such investment property, except for the requirement in IAS 40.79(d)(iii) to show assets classified as held for sale, or included in a disposal group classified as held for sale, when disclosing the reconciliation of the carrying amount of investment property at the beginning and end of the period. *[IFRS 5.5B]*.

9 Transfer of assets to or from investment property

IAS 40 specifies the circumstances in which a property, including property under construction or development, becomes, or ceases to be, an investment property as follows: *[IAS 40.57]*

Extract from IAS 40

57 An entity shall transfer a property to, or from, investment property when, and only when, there is a change in use. A change in use occurs when the property meets, or ceases to meet, the definition of investment property and there is evidence of the change in use. In isolation, a change in management's intentions for the use of a property does not provide evidence of a change in use. Examples of evidence of a change in use include:

(a) commencement of owner-occupation, or of development with a view to owner-occupation, for a transfer from investment property to owner-occupied property;

(b) commencement of development with a view to sale, for a transfer from investment property to inventories;

(c) end of owner-occupation, for a transfer from owner-occupied property to investment property; and

(d) inception of an operating lease to another party, for a transfer from inventories to investment property.

(e) [deleted]

For the requirements of (d) above, see other considerations discussed in section 2.3 above.

Practical example 9-1 below describes how Land Securities Group PLC dealt with the requirements of (b) above.

Practical example 9-1: Land Securities Group PLC (2024) United Kingdom

Landsec Annual Report 2024 [extract]

NOTES TO THE FINANCIAL STATEMENTS [extract]

SECTION 3 - PROPERTIES [extract]

A ACCOUNTING POLICY [extract]

TRANSFERS BETWEEN INVESTMENT PROPERTIES AND TRADING PROPERTIES

When the Group begins to redevelop an existing investment property for continued future use as an investment property, the property continues to be held as an investment property. When the Group begins to redevelop an existing investment property with a view to sell, the property is transferred to trading properties and held as a current asset. The property is remeasured to fair value as at the date of the transfer with any gain or loss being taken to the income statement. The remeasured amount becomes the deemed cost at which the property is then carried in trading properties.

Paragraph 57 of IAS 40, as described above, establishes a guiding principle regarding transfers to or from investment property based on whether there is evidence of a change in use and provides a non-exhaustive list of examples of such evidence. It reflects the principle that a change in use would involve:

(a) An assessment of whether a property meets, or has ceased to meet, the definition of investment property

And

(b) Supporting evidence that a change in use has occurred

Applying this principle, an entity transfers property under construction or development to, or from, investment property when, and only when, there is a change in the use of such property, supported by evidence. *[IAS 40.BC25, IAS 40.BC26]*.

Accordingly, a change in management's intentions, in isolation, would not be enough to support a transfer of property. This is because management's intentions, alone, do not provide evidence of a change in use. Observable actions toward effecting a change in use must have been taken by the entity during the reporting period to provide evidence that such a change has occurred. *[IAS 40.BC27]*.

The assessment of whether a change in use has occurred is based on an assessment of all the facts and circumstances, and judgement is needed to determine whether a property qualifies as investment property. *[IAS 40.BC28]*. If it is determined that a change in use has occurred, IAS 40 requires an entity to transfer the property to, or from, investment property.

We illustrate the application of this principle with an example below:

Illustration 9-1: Transfers from inventory

In 20X1, an entity purchased land with the intention of constructing an apartment building on the land and selling the apartments to private customers. Accordingly, the land was classified as inventory. During 20X1, the prices for residential properties decreased and the entity decided to change its original business plans at the beginning of 20X2. Instead of constructing an apartment building and selling the apartments, the entity decided to construct an office building that it would lease out to tenants. The entity holds and manages other investment property as well.

During the first half of 20X2, the entity obtained permission from the relevant authorities to commence the construction and hired an architect to design the office building. The physical construction of the office building began in August 20X2. No operating leases had been agreed with other parties for the lease of office space. However, negotiations had been held with potential tenants.

The inception of an operating lease is generally evidence of a change in use for a transfer from inventories to investment property. *[IAS 40.57(d)]*. However, even in the absence of the inception of an operating lease, there may be other circumstances that provide evidence of a change in use. In determining whether there is sufficient evidence for a change in use from inventory to investment property, all of the following criteria must be considered:

- The entity has prepared a business plan that reflects the future rental income generated by the property and this is supported with evidence that there is demand for rental space.
- The entity can demonstrate that it has the resources, including the necessary financing or capital, to hold and manage an investment property (which requires different skills than developing a property). If the entity also owns other investment property, this could be more easily demonstrated. However, if this property would be the entity's only investment property, it may be harder to demonstrate this.
- The change in use is legally permissible. That is, the entity has obtained permission from relevant authorities for the change in use. In cases where the approval of the change in use is merely a routine or a non-substantive legal requirement (i.e., not at the discretion of the authorities), the entity's request for permission may be sufficient evidence.

  And
- If the property must be further developed for the change in use, development has commenced.

How we see it

Judgement is required when the change in use is evidenced by circumstances other than the inception of an operating lease. We would generally conclude that there is sufficient evidence for a change in use from inventory to investment property if all of the criteria referred to above are met.

For the scenario described in the fact pattern above, the entity met the above criteria at the point in time when it obtained permission from the relevant authorities to change the use of the property and commenced development of the property by hiring an architect. At that time, the land would be transferred from inventory to investment property as it is now held to earn rentals rather than sale proceeds.

9.1 Transfers from investment property to inventory

Transfers to inventory are more difficult to deal with by way of the application of a general principle since IFRS 5 explicitly deals with investment property held for sale. IAS 40 allows a transfer to inventory only when there is a change in use as evidenced, for example, by the start of development with a view to subsequent sale. *[IAS 40.57]*.

If an entity decides to dispose of an investment property without development with a view to sale, it is unlikely to be transferred to inventory as IFRS 5 is applied to property held for sale to the extent that the requirements therein are met (see section 8 above).

The IASB is aware of this inconsistency in the application of IFRS 5 and IAS 2 to investment property and in 2010 it asked the IFRS IC to consider any necessary interpretation to resolve it. However, the IFRS IC decided to recommend proposals that indicated no change to existing practice.

Consequently, this means that, unless there is development with a view to sale, it will not be possible to reclassify investment property as inventory even if the entity holding that property changes its intentions and is no longer holding that property for rental or capital appreciation. Accordingly, when an entity decides to dispose of an investment property without development, it continues to classify the property as an investment property until it is derecognised (see section 10 below) and does not reclassify it as inventory. Similarly, if an entity begins to redevelop an existing investment property for continued future use as investment property, the property remains an investment property and is not reclassified as owner-occupied property during the redevelopment. *[IAS 40.58]*.

9.2 Accounting treatment of transfers

When an entity uses the cost model for investment property, transfers between investment property, owner-occupied property and inventories do not change the carrying amount of the property transferred and they do not change the cost of that property for measurement or disclosure purposes. *[IAS 40.59]*.

Transfers to and from investment property under the fair value model are accounted for as follows:

- *Transfers from inventory:* any difference between the fair value of the property at the date of change in use and its previous carrying amount must be recognised in profit or loss. *[IAS 40.63]*. This treatment is consistent with the treatment of sales of inventories. *[IAS 40.64]*.
- *Transfers to inventory or owner-occupation:* the cost for subsequent accounting for inventories under IAS 2, or for owner-occupied property under IAS 16 or IFRS 16, must be the property's fair value at the date of change in use. *[IAS 40.60]*.
- *Transfers from owner-occupation:* IAS 16 will be applied for owned property and IFRS 16 for property held by a lessee as a right-of-use asset up to the date of change in use. At that date, any difference between the carrying amount under IAS 16 or IFRS 16 and the fair value must be treated in the same way as a revaluation under IAS 16. *[IAS 40.61]*.

How we see it

In relation to the first bullet point above, IAS 40.64 states that "The treatment of transfers from inventories to investment property that will be carried at fair value is consistent with the treatment of sales of inventories." However, this does not mean that revenue is recognised upon transfer of a property from inventory to investment property because control of the property is not transferred to a customer (i.e., the same property remains with the entity) and it is not a transaction that has commercial substance.

If the owner-occupied property had not previously been revalued, the transfer does not imply that the entity has now chosen a policy of revaluation for other property accounted for under IAS 16 in the same class. The treatment depends on whether it is a decrease or increase in value and whether the asset had previously been revalued or is impaired in value.

The treatment required by IAS 40 is as follows: *[IAS 40.62]*

Extract from IAS 40

62 Up to the date when an owner-occupied property becomes an investment property carried at fair value, an entity depreciates the property (or the right-of-use asset) and recognises any impairment losses that have occurred. The entity treats any difference at that date between the carrying amount of the property in accordance with IAS 16 or IFRS 16 and its fair value in the same way as a revaluation in accordance with IAS 16. In other words:

(a) any resulting decrease in the carrying amount of the property is recognised in profit or loss. However, to the extent that an amount is included in revaluation surplus for that property, the decrease is recognised in other comprehensive income and reduces the revaluation surplus within equity.

(b) any resulting increase in the carrying amount is treated as follows:

(i) to the extent that the increase reverses a previous impairment loss for that property, the increase is recognised in profit or loss. The amount recognised in profit or loss does not exceed the amount needed to restore the carrying amount to the carrying amount that would have been determined (net of depreciation) had no impairment loss been recognised.

(ii) any remaining part of the increase is recognised in other comprehensive income and increases the revaluation surplus within equity. On subsequent disposal of the investment property, the revaluation surplus included in equity may be transferred to retained earnings. The transfer from revaluation surplus to retained earnings is not made through profit or loss.

IAS 40 also reconfirms that when an entity completes the construction or development of a self-constructed investment property that will be carried at fair value (i.e., no actual reclassification to investment property), any difference between the fair value of the property at that date and its previous carrying amount must be recognised in profit or loss. *[IAS 40.65]*.

10 Disposal of investment property

IAS 40 requires: *[IAS 40.66]*

Extract from IAS 40	
66	**An investment property shall be derecognised (eliminated from the statement of financial position) on disposal or when the investment property is permanently withdrawn from use and no future economic benefits are expected from its disposal.**

A disposal of an investment property may be achieved by:

- Its sale
- When it becomes the subject of a finance lease (the owner becoming the lessor)

  Or
- When it becomes the subject of a sale and leaseback deal (the original owner becoming the lessee) *[IAS 40.67]*

These derecognition rules also apply to a part of the investment property that has been replaced (see section 10.3 below).

IFRS 16 applies if a property is disposed of by the owner becoming a lessor in a finance lease (see Chapter 24 at section 6.3), or if a property is the subject of a sale and leaseback transaction (see Chapter 24 at section 8). *[IAS 40.67]*.

If disposal of investment property is achieved by sale, the determination of the timing of recognition of any gain or loss must be in accordance with IFRS 15. Consequently, the date of disposal for investment property that is sold is the date the recipient obtains control of the investment property in accordance with the requirements for determining when a performance obligation is satisfied in IFRS 15. *[IAS 40.67]*. IFRS 15 requires revenue (and a gain or loss on disposal of a non-current asset not in the ordinary course of business) to be recognised when a performance obligation is satisfied, which will be when control of the asset is transferred to the customer. *[IFRS 15.31]*. Control may be transferred at a point in time or over time. *[IFRS 15.32]*. Accordingly, entities that dispose of an investment property through sale must recognise a gain or loss on disposal when control of the property transfers, which may be at a point in time. In many cases, control will transfer when the buyer obtains legal title and physical possession of the asset. However, this may occur prior to legal settlement if it can be demonstrated that control has passed to the buyer before that date.

Practical example 10-1 below describes how Land Securities Group PLC dealt with the requirements described above.

Practical example 10-1: Land Securities Group PLC (2024) **United Kingdom**

Landsec Annual Report 2024 [extract]
NOTES TO THE FINANCIAL STATEMENTS [extract]
SECTION 3 - PROPERTIES [extract]
A ACCOUNTING POLICY [extract]

DISPOSAL OF PROPERTIES

Properties are treated as disposed when control of the property is transferred to the buyer. Typically, this will either occur on unconditional exchange or on completion. Where completion is expected to occur significantly after exchange, or where the Group continues to have significant outstanding obligations after exchange, the control will not usually transfer to the buyer until completion.

...

For the detailed discussion and requirements of IFRS 15 on satisfaction of performance obligations, see Chapter 28 at section 7.

10.1 Calculation of gain or loss on disposal

Gains and losses on retirement or disposal of investment property are calculated based on the difference between the net disposal proceeds (after deducting direct costs of disposal) and the carrying amount of the asset. *[IAS 40.69]*. IAS 40 does not give guidance on how to determine the carrying amount of the asset. Possible alternatives would include the use of (i) the carrying amount in the financial statements of the last full period of account, or (ii) the carrying amount in the latest interim financial statements, or (iii) the updated carrying amount at the date of disposal.

How we see it

In our view, determining the carrying amount of the asset using any of the possible alternatives described above is a policy choice for an entity to make and is primarily a matter of income statement presentation to the extent that an entity presents gains and losses on disposal separately from gains and losses on revaluation.

This policy choice is illustrated in Practical example 6-1 above where Unibail-Rodamco-Westfield SE uses the 'full period of account' approach (i.e., alternative (i) above).

Gains and losses on retirement or disposal of investment property are recognised in profit or loss, unless it is a sale and leaseback and IFRS 16 requires a different treatment, in the period of retirement or disposal (see also section 12.4 below). *[IAS 40.69]*. Refer to Chapter 24 at section 8 for a discussion of sale and leaseback under IFRS 16.

The amount of consideration to be included in the gain or loss arising from the derecognition of an investment property is determined in accordance with the requirements for determining the transaction price in IFRS 15.47 to 72. *[IAS 40.70]*. Under IFRS 15, an entity is required to consider the terms of the contract and its customary business practices in determining the transaction price. Transaction price is defined as the amount of consideration to which an entity expects to be entitled in exchange for transferring the property to a buyer, excluding amounts collected on behalf of third parties (e.g., sales taxes). The consideration in a contract may include fixed amounts, variable amounts, or both. *[IFRS 15.47]*.

In many cases, the transaction price may be readily determined if the entity receives payment when it transfers the property and the price is fixed. In other situations, it could be more challenging as it may be affected by the nature, timing and amounts of consideration.

Determining the transaction price is discussed in detail in Chapter 28 at section 5.

Subsequent changes to the estimated amount of the consideration included in the gain or loss must be accounted for in accordance with the requirements for changes in the transaction price in IFRS 15. *[IAS 40.70]*. This is further discussed in Chapter 28 at section 6.5.

If an entity retains any liabilities after disposing of an investment property these are measured and accounted for in accordance with IAS 37 or other relevant standards, as appropriate. *[IAS 40.71]*. Accounting for such liabilities depends on specific facts and circumstances as such a liability may represent a provision (e.g., assurance-type warranty provisions) or a contingent liability under IAS 37, or a financial liability under IFRS 9, or a separate performance obligation (e.g., service-type warranties) or variable consideration (e.g., fines and penalties) under IFRS 15. See also related discussions in Question 5-4 in Chapter 28 at section 5.2.1.

10.2 Sale prior to completion of construction

It should be noted that property that is subject to sale prior to completion of construction, if not previously classified as investment property, is likely to be property intended for sale in the ordinary course of business (see section 2.6 above) and is therefore not likely to be investment property. Accordingly, the requirements in IFRS 15 must be followed.

If, however, the property subject to sale prior to completion of construction is previously classified as investment property, guidance in IAS 40 would be followed - see discussions in sections 10 and 10.1 above. Any consequent construction services to be provided by the seller would likely be subjected to the requirements of IFRS 15.

For further discussion of IFRS 15, see Chapter 28.

10.3 Replacement of parts of investment property

When an entity that applies the fair value model wishes to capitalise a replacement part (provided it meets the criteria in section 3 above), the question arises of how to deal with the cost of the new part and the carrying amount of the original. The basic principle in IAS 40 is that the entity derecognises the carrying amount of the replaced part. However, the problem frequently encountered is that even if the cost of the old part is known, its carrying amount - at fair value - is usually by no means clear. It is possible also that the fair value may already reflect the loss in value of the part to be replaced, because the valuation reflected the fact that an acquirer would reduce the price accordingly. *[IAS 40.68]*.

As all fair value changes are taken to profit or loss, the standard concludes that it is not necessary to identify separately the elements that relate to replacements from other fair value movements. Therefore, if it is not practical to identify the amount by which fair value should be reduced for the part replaced, the cost of the replacement is added to the carrying amount of the asset and the fair value of the investment property as a whole is reassessed. The standard notes that this is the treatment that would be applied to additions that did not involve replacing any existing part of the property. *[IAS 40.68]*.

If the investment property is carried under the cost model, then the entity derecognises the carrying amount of the original part. A replaced part may not be a part that was depreciated separately, in which case, if it is not practicable to determine the carrying amount of the replaced part, the standard allows the entity to use the cost of the replacement as an indication of an appropriate carrying amount. This does not mean that the entity has to apply depreciated replacement cost, rather that it can use the cost of the replacement as an indication of the original cost of the replaced part in order to reconstruct a suitable carrying amount for the replaced part. *[IAS 40.68]*.

10.4 Compensation from third parties

IAS 40 applies the same rules as IAS 16 to the treatment of compensation from third parties if property has been impaired, lost or given up (see Chapter 19 at section 5.7). It stresses that impairments or losses of investment property, related claims for or payments of compensation from third parties and any subsequent purchase or construction of replacement assets are separate economic events that have to be accounted for separately. *[IAS 40.73]*.

Impairment of investment property will be recorded automatically if the fair value model is used; but if the property is accounted for using the cost model, it is to be calculated in accordance with IAS 36 (see section 7.3 above and Chapter 21). If the entity no longer owns the asset, for example, because it has been destroyed or subject to a compulsory purchase order, it will be derecognised (see section 10 above). Compensation from third parties (for example, from an insurance company) for property that was impaired, lost or given up is recognised in profit or loss when it becomes receivable. The cost of assets restored, purchased or constructed as replacements is accounted for wholly on its own merits according to the recognition and measurement rules covered in sections 3 and 4 above. *[IAS 40.72, IAS 40.73]*.

11 Interim reporting and IAS 40

IAS 34 *Interim Financial Reporting* requires the use of the same principles for the recognition and the definitions of assets, liabilities, income and expenses for interim periods as will be used in annual financial statements.

IAS 40 requires, for those entities using the fair value model, investment property to be presented at fair value at the end of the reporting period. Accordingly, investment property measured using the fair value model must also be measured at fair value in any interim financial reports. IAS 34 expects this as it includes the following guidance in Part C of the illustrative examples accompanying the standard:

"IAS 16 *Property, Plant and Equipment* allows an entity to choose as its accounting policy the revaluation model whereby items of property, plant and equipment are revalued to fair value. IFRS 16 *Leases* allows a lessee to measure right-of-use assets applying the revaluation model in IAS 16 if those right-of-use assets relate to a class of property, plant and equipment to which the lessee applies the revaluation model in IAS 16. Similarly, IAS 40 *Investment Property* requires an entity to measure the fair value of investment property. For those measurements, an entity may rely on professionally qualified valuers at annual reporting dates though not at interim reporting dates." *[IAS 34.IE C7]*.

The United Kingdom regulator made a similar point in its 2009 report on its activities. It stated that:

"A key principle of IAS 34, 'Interim Financial Reporting', is that interim accounts should be prepared applying the same accounting policies as those applied to the annual accounts. IAS 40, 'Investment Property' requires companies applying the fair value model to carry their properties at fair value with changes reported in the income statement. Properties are therefore required to be carried at fair value at the half-year stage."[16]

For those entities using the cost model in annual financial statements, IAS 40 requires the disclosure of the fair value of investment property (see section 12.3 below). For interim financial statements prepared under IAS 34, there is no such explicit disclosure requirement. Preparers of the financial statements must therefore consider the principle of IAS 34 which is that:

"Timely and reliable interim financial reporting improves the ability of investors, creditors, and others to understand an entity's capacity to generate earnings and cash flows and its financial condition and liquidity." *[IAS 34 Objective]*.

It is likely that an understanding of the fair value of investment property at the end of an interim reporting period would help this purpose.

In addition, Part C of the illustrative examples to IAS 34 sets out that IAS 40 requires an entity to estimate the fair value of investment property. It does not distinguish between those entities that measure investment property at fair value and those entities that use the cost model and disclose fair value.

How we see it

In line with the discussions above, it is our view that the fair value of investment property at the end of the interim period is usually expected to be disclosed in interim financial reports for those entities using the cost model in IAS 40.

IAS 34 is discussed in more detail in Chapter 37.

16 *Review Findings and Recommendations - 2009*, Financial Reporting Review Panel, July 2009, p.11. Available on the Financial Reporting Council's website.

12 Presentation and disclosure requirements for investment property

The main disclosure requirements of IAS 40 are set out below, but it may be necessary to refer to relevant presentation and/or disclosure requirements in other standards such as IAS 1, IAS 10 *Events after the Reporting Period*, IFRS 5, IFRS 13 and IFRS 16.

When material, investment property is presented as a separate line item on the face of the statement of financial position as required by IAS 1 (see Chapter 3 at section 3.1.5). *[IAS 1.54(b)]*. For fair value changes and gains or losses on disposal of investment property that may be presented on the face of the income statement, see discussions in sections 12.2.1 and 12.4 below. It is worth noting that IFRS 18 *Presentation and Disclosure in Financial Statements*, which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted), was issued by the IASB in April 2024. IFRS 18 might have an impact on the income statement presentation of income and expenses of entities holding investment property, which will depend on an assessment of whether an entity has a specified main business activity of investing in investment property. See Chapter 4 for further details on the new concepts and requirements of IFRS 18.

For entities that apply the fair value option in IAS 40, attention will focus on the judgemental and subjective aspects of property valuations, because they will be reported in profit or loss. IFRS 13 also expands the disclosures related to fair value. Both IAS 40 and IFRS 13 require significant amounts of information to be disclosed about these judgements and the cash-related performance of the investment property, as set out below.

It is also worth noting that on 25 March 2021, the Board issued an Exposure Draft ED/2021/3, *Disclosure Requirements in IFRS Standards - A Pilot Approach (Proposed amendments to IFRS 13 and IAS 19)* (the ED), in which the Board proposed guidance for its own use when developing and drafting disclosure requirements in IFRS accounting standards. The proposed amendments to IFRS 13 suggested an overall disclosure objective which is supplemented by proposed specific disclosure objectives and items of information intended to ensure compliance with the overall disclosure objective. For further discussions related to the ED, see Chapter 15 at section 19.6.

Note also that the disclosures below apply in addition to those in IFRS 16 which require the owner of an investment property to provide lessors' disclosures about leases into which it has entered. IAS 40 also requires a lessee that holds an investment property as a right-of-use asset to provide lessees' disclosures as required by IFRS 16 and lessors' disclosures as required by IFRS 16 for any operating leases into which it has entered. *[IAS 40.74]*. Accordingly, see Chapter 24 at sections 5.8 and 6.8 for the required disclosures of lessees and lessors, respectively.

For investment property that has been either classified as held for sale, or included in a disposal group classified as held for sale, or sold, additional disclosures are required by IFRS 5 (see Chapter 5 at section 5) and, depending on the subsequent measurement model used for such investment property (fair value model or cost model), the disclosures discussed below may or may not be required. See further discussion in section 8 above.

If a decline in fair value of investment property between the end of the reporting period and the date when the financial statements are authorised for issue is material, an entity may need to give additional disclosure related to non-adjusting events as required by IAS 10 (see Chapter 34 in sections 2.1.3 and 2.3).

IFRS 19 *Subsidiaries without Public Accountability: Disclosures* was issued by the IASB in May 2024 to simplify the preparation of financial statements by eligible subsidiaries. Eligible subsidiaries that elect to apply IFRS 19 are allowed to provide reduced disclosures while still applying the recognition, measurement and presentation requirements in other IFRS accounting standards. IFRS 19 is effective for annual reporting periods beginning on or after 1 January 2027, with earlier application permitted (subject to jurisdictional endorsement). See Chapter 4 at section 7 for further details on the requirements of IFRS 19.

12.1 Disclosures under both fair value and cost models

Whichever model is chosen, fair value or cost, IAS 40 requires all entities to disclose the fair value of their investment property. Therefore, the following disclosures are required by IAS 40 in both instances: *[IAS 40.75]*

Extract from IAS 40

75 An entity shall disclose:

(a) whether it applies the fair value model or the cost model.

(b) [deleted]

(c) when classification is difficult (see paragraph 14), the criteria it uses to distinguish investment property from owner-occupied property and from property held for sale in the ordinary course of business.

(d) [deleted]

(e) the extent to which the fair value of investment property (as measured or disclosed in the financial statements) is based on a valuation by an independent valuer who holds a recognised and relevant professional qualification and has recent experience in the location and category of the investment property being valued. If there has been no such valuation, that fact shall be disclosed.

(f) the amounts recognised in profit or loss for:

(i) rental income from investment property;

(ii) direct operating expenses (including repairs and maintenance) arising from investment property that generated rental income during the period;

(iii) direct operating expenses (including repairs and maintenance) arising from investment property that did not generate rental income during the period; and

(iv) the cumulative change in fair value recognised in profit or loss on a sale of investment property from a pool of assets in which the cost model is used into a pool in which the fair value model is used (see paragraph 32C).

(g) the existence and amounts of restrictions on the realisability of investment property or the remittance of income and proceeds of disposal.

(h) contractual obligations to purchase, construct or develop investment property or for repairs, maintenance or enhancements.

An example of the disclosure required in (e) above i.e., "If there has been no such valuation, that fact shall be disclosed." would be a statement that the fair value of investment property is based on internal appraisals rather than on a valuation by an independent valuer as described in (e) above. See also discussion in section 6.1 above.

12.1.1 Methods and assumptions in fair value estimates

IFRS 13 includes a fair value hierarchy which prioritises the inputs used in a fair value measurement. The hierarchy is defined as follows:

- Level 1 inputs - Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date
- Level 2 inputs - Inputs other than quoted prices included with Level 1 that are observable for the asset or liability, either directly or indirectly

  And
- Level 3 inputs - Unobservable inputs for the asset or liability *[IFRS 13 Appendix A]*

IFRS 13 also uses its fair value hierarchy to categorise each fair value measurement in its entirety for disclosure purposes. Categorisation within the hierarchy is based on the lowest level input that is significant to the fair value measurement as a whole. This is discussed further in Chapter 15 at section 15.2.

Significant differences in disclosure requirements apply to fair value measurements categorised within each level of the hierarchy to provide users with insight into the observability of the fair value measurement (the full disclosure requirements of IFRS 13 are discussed further in Chapter 15 at section 19).

How we see it

In our view, it would be rare for real estate to be categorised within Level 1 of the fair value hierarchy, as typically, there are no active markets for identical real estate assets (due to the uniqueness of each real estate asset).

In market conditions where similar real estate is actively purchased and sold, and the transactions are observable, the fair value measurement might be categorised within Level 2. This categorisation will be unusual for real estate, but that determination will depend on the facts and circumstances, including the significance of adjustments to observable data.

In this regard, IFRS 13 provides a real estate specific example stating that a Level 2 input would be the price per square metre for the property interest derived from observable market data, e.g., multiples derived from prices in observed transactions involving comparable (i.e., similar) property interests in similar locations. *[IFRS 13.B35(g)]*. Accordingly, in active and transparent markets for similar assets (perhaps those that exist in some of the capital cities of developed economies), real estate valuations might be able to be categorised within Level 2, provided that no significant adjustments have been made to the observable data.

However, and likely to be much more common for real estate, if an adjustment to an observed transaction is based on unobservable data and that adjustment is significant to the fair value measurement as a whole, the fair value measurement would be categorised within Level 3 of the fair value hierarchy for disclosure purposes.

How we see it

Considerable judgement may be required to determine whether the adjustments to the fair value measurement as a whole, are significant.

For fair value measurement of investment property, a Level 3 categorisation is likely to be the most common. For example, in February 2013, EPRA published its position paper on IFRS 13 - *EPRA Position Paper on IFRS 13, Fair Value Measurement & Illustrative Disclosures*. In this publication it is stated that:

"Estimating the fair value of an investment property inevitably requires a significant range of methodologies, inputs, and adjustments to reflect the wide range of factors which contribute towards the value of a property e.g. state and condition, location, in-place leases, development potential, infrastructure, etc. Consequently, even in the most transparent and liquid markets - and depending on the valuation technique - it is very likely that valuers will use one or more significant unobservable inputs or make at least one significant adjustment to an observable input. Accordingly, it is likely that the vast majority of property valuations will fall within the level 3 category."[17]

IFRS 13 expands the disclosures related to fair value to enable users of financial statements to understand the valuation techniques and inputs used to develop fair value measurements.

In summary, it requires the following additional disclosures for all entities regardless of the model of measurement or the valuation technique used in measuring investment property:

- The level of the fair value hierarchy within which the fair value measurement in its entirety is categorised *[IFRS 13.93(b)]*
- For Level 2 and Level 3 measurements, valuation technique and the inputs used, and changes in the valuation technique, if applicable, and the reasons for those changes *[IFRS 13.93(d)]*

  And
- If the highest and best use of a non-financial asset differs from its current use, disclose that fact and the reason for it *[IFRS 13.93(i)]*

17 *EPRA Position Paper on IFRS 13: Fair Value Measurement & Illustrative Disclosures*, EPRA, February 2013, p.4. Available on the EPRA's website.

For entities applying the fair value model in measuring investment property, the following additional disclosure must be made:

- For Level 3 measurements, quantitative information regarding the significant unobservable inputs *[IFRS 13.93(d)]*
- Amount of transfers between Level 1 and Level 2, the reasons and related accounting policies *[IFRS 13.93(c)]*
- For Level 3 measurements, a reconciliation from the opening balances to the closing balances (including gains and losses, purchases, sales, issues, settlements, transfers in and out of Level 3 and reasons and policies for transfer and where all such amounts are recognised) *[IFRS 13.93(e)]*
- For Level 3 measurements, the total gains or losses included in profit or loss that are attributable to the change in unrealised gains or losses relating to those assets and liabilities held at the reporting date, and a description of where such amounts are recognised *[IFRS 13.93(f)]*
- For Level 3 measurements, a description of the valuation process used by the entity *[IFRS 13.93(g)]*

  And
- For Level 3 measurements, a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs might result in a significantly different amount and, if applicable, a description of interrelationships between those inputs and other unobservable inputs and of how they might magnify or mitigate the effect of changes in the unobservable inputs *[IFRS 13.93(h)]*

Unibail-Rodamco-Westfield SE included the following disclosures in its 2023 financial statements, in addition to those disclosed in Practical example 6-1 above.

Practical example 12-1: Unibail-Rodamco-Westfield SE (2023) France

Universal Registration Document 2023 [extract]

5.2 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]

NOTE 5. INVESTMENT PROPERTIES, TANGIBLE AND INTANGIBLE ASSETS, GOODWILL [extract]

5.1 INVESTMENT PROPERTIES [extract]

5.1.2 INVESTMENT PROPERTIES AT FAIR VALUE – IFRS BASIS

Westfield Hamburg, previously classified as Investment Property Under Construction at cost, is assessed at fair value since June 30, 2023.

(€ Mn)	Dec. 31, 2023	Dec. 31, 2022
Shopping Centres	**32,015.9**	**33,025.6**
France	10,841.3	11,858.5
Spain	3,329.9	3,402.2
US	4,577.8	5,184.5
Central Europe	3,888.9	3,795.2
Austria	2,056.5	2,159.8
Germany	2,169.7	1,856.9
Nordics	2,427.5	2,514.1
The Netherlands	1,453.2	1,519.0
UK	1,271.2	1,195.4
Offices & Others	**2,404.2**	**2,327.1**
France	1,511.9	1,779.6
Other countries	892.3	547.5
Convention & Exhibition	**2,492.7**	**2,478.1**
Total	**36,912.8**	**37,830.8**

The decrease is explained in the table below.

(€ Mn)	Shopping Centres	Offices & Others	Convention & Exhibition	Total investment properties	Properties held for sale	Total

...

Dec. 31, 2022	33,025.6	2,327.1	2,478.1	37,830.8	–	37,830.8
Acquisitions	21.5	–	–	21.5	–	21.5
Entry into scope of consolidation(1)	112.9	–	–	112.9	–	112.9
Capitalised expenses(2)	730.4	214.8	56.9	1,002.1	–	1,002.1
Disposals/exits from the scope of consolidation(3)	(668.4)	(94.8)	–	(763.2)	–	(763.2)
Reclassification and transfer of category(4)	566.3	329.8	66.8	962.9	33.9	996.8
Discounting impact	0.1	–	–	0.1	–	0.1
Valuation movements	(1,626.2)	(375.9)	(109.2)	(2,111.3)	–	(2,111.3)
Currency translation	(146.3)	3.3	–	(142.9)	–	(142.9)
Dec. 31, 2023	**32,015.9**	**2,404.2**	**2,492.7**	**36,912.8**	**33.9**	**36,946.7**

(1) Relates to the change of consolidation method of Croydon and the entry of fully consolidated companies.
(2) Capitalised expenses mainly relate to:
- Shopping centres in Germany, France and US;
- Offices in France; and
- C&E sites such as the Parc des Expositions in Porte de Versailles.

(3) Includes the disposals of Polygone Riviera, Westfield Brandon, Versailles Chantiers and the foreclosure of San Francisco Centre (see note 1.1.1 Disposals in 2023).
(4) Includes mainly:
- The reclassification of Westfield Hamburg from IPUC at cost to IPUC at fair value; and
- The revaluation of the financial lease of LAX Airport (€92.8 Mn), the Parc des Expositions in Porte de Versailles (€55.3 Mn) and Le Bourget (€11.5 Mn).

VALUATION ASSUMPTIONS AND SENSITIVITY OF THE FULLY CONSOLIDATED ASSETS

Considering the limited public data available, the complexity of real estate asset valuations, as well as the fact that appraisers use in their valuations the non-public rent rolls of the Group's assets, URW believes it is appropriate to classify its assets under Level 3 as per IFRS 13. In addition, unobservable inputs, including appraisers' assumption on growth rates and exit capitalisation rates, are used by appraisers to determine the fair value of URW's assets.

As at December 31, 2023, 99% of URW's portfolio was appraised by qualified independent external appraisers.

The net outstanding balances of deferred lease incentives and key money amortised over the expected term of the lease, which corrected the appraisal value, represented -€185.8 Mn (-€159.3 Mn as at December 31, 2022).

The following tables provide a number of quantitative elements used by the appraisers to assess the fair valuation of the Group's assets.

SHOPPING CENTRES

All shopping centres are valued using the DCF and/or yield methodologies.

The table below only includes fully consolidated assets.

Shopping Centres – Dec. 31, 2023		Net Initial Yield	Rent in € per sqm(a)	Discount Rate(b)	Exit Capitalisation Rate(c)	CAGR of NRI(d)
France	Max	7.8%	968	10.0%	20.0%	21.2%
	Min	3.5%	160	6.7%	4.7%	4.3%
	Weighted average	4.9%	632	6.9%	4.9%	5.3%
Spain	Max	10.6%	620	14.0%	9.5%	4.2%
	Min	5.0%	136	7.9%	5.3%	2.7%
	Weighted average	5.8%	411	8.4%	5.6%	3.4%
Central Europe	Max	9.2%	734	9.8%	9.5%	2.3%
	Min	6.0%	306	7.5%	5.6%	1.5%
	Weighted average	6.3%	509	7.9%	5.9%	2.0%
Austria	Max	5.4%	449	7.0%	5.1%	4.4%
	Min	5.3%	343	7.0%	5.1%	3.0%
	Weighted average	5.3%	393	7.0%	5.1%	3.7%
Germany	Max	7.6%	528	9.4%	7.3%	4.8%
	Min	5.0%	201	6.6%	5.0%	1.4%
	Weighted average	5.8%	336	7.4%	5.5%	3.3%
Nordics	Max	6.4%	467	7.9%	5.9%	4.9%
	Min	4.6%	296	6.9%	4.9%	3.4%
	Weighted average	5.1%	390	7.1%	5.1%	3.6%
The Netherlands	Max	8.1%	397	8.3%	7.1%	3.3%
	Min	5.2%	283	6.5%	5.0%	1.3%
	Weighted average	5.6%	369	6.7%	5.4%	2.9%
US	Max	5.4%	1,438	7.5%	6.0%	9.5%
	Min	3.2%	476	6.8%	5.0%	3.2%
	Weighted average	4.6%	841	7.1%	5.3%	4.9%

Net Initial Yield ("NIY"), Discount Rate ("DR") and Exit Capitalisation Rate ("ECR") weighted by GMV. Vacant assets, assets considered at bid value, and assets under restructuring are not included in Min. and Max. calculation. Assets under development or not controlled by URW and the airport activities are not included in this table neither the UK asset.

(a) Average annual rent (minimum guaranteed rent ("MGR") + sales-based rent ("SBR")) per asset per square meter.
(b) Rate used to calculate the net present value of future cash flows.
(c) Rate used to capitalise the exit rent to determine the exit value of an asset.
(d) Compound annual growth rate ("CAGR") of Net Rental Income ("NRI") determined by the appraiser (duration of the DCF model used either 6 or 10 years).

...

The tables below show the sensitivity on URW's Shopping Centres portfolio value for assets fully consolidated, excluding assets under development and the airport activities.

The percentages below are indicative of evolutions in case of various evolutions of NIY, DR, ECR and appraisers' Estimated Rental Value (ERV).

Sensitivity	Impact in €Mn	Impact in %
+25 bps in NIY	(1,466)	(4.5)%
+25 bps in DR	(522)	(1.6)%
+10 bps in ECR	(395)	(1.2)%
-5% in appraisers' ERV	(1,270)	(3.9)%

Sensitivity	Impact in €Mn	Impact in %
-25 bps in NIY	+1,612	+5.0%
-25 bps in DR	+534	+1.6%
-10 bps in ECR	+420	+1.3%
+5% in appraisers' ERV	+1,031	+3.2%

OFFICES & OTHERS

Appraisers value the Group's Offices & Others using the DCF and yield methodologies.

The tables below show the sensitivity on URW's Offices & Others portfolio value for assets fully consolidated, excluding assets under development.

The percentages below are indicative of evolutions in case of various evolutions of NIY.

Sensitivity	Impact in €Mn	Impact in %
+25 bps in NIY	(82)	(4.5)%
-25 bps in NIY	+90	+4.9%

CONVENTION & EXHIBITION

The table shows below the sensitivity of the C&E portfolio related to the weighted average cost of capital ("WACC").

Sensitivity	Impact in €Mn	Impact in %
+25 bps in "WACC"	(77)	(3.7)%
-25 bps in "WACC"	+82	+4.0%

5.1.3 INVESTMENT PROPERTIES UNDER CONSTRUCTION AT COST – IFRS BASIS

(€ Mn)	Dec. 31, 2023	[illegible]
Shopping Centres	**307.2**	[illegible]
France	138.7	[illegible]
Spain	110.4	[illegible]
US	2.7	[illegible]
Central Europe	44.3	[illegible]
Austria	–	[illegible]
Germany	1.8	[illegible]
Nordics	9.3	[illegible]
The Netherlands	–	[illegible]
UK	–	[illegible]
Offices & Others	**98.3**	[illegible]
France	24.0	[illegible]
Other countries	74.3	[illegible]
Convention & Exhibition	–	[illegible]
Total	**405.4**	[illegible]

Assets still stated at cost were subject to impairment tests as at December 31, 2023. Allowances were recorded for a total amount of -€114.0 Mn in 2023. It mainly corresponds to Sisters in La Défense.

€ Mn)	Gross value	Impairment	Total investment properties at cost	Properties held for sale	Total
	...				
Dec. 31, 2022	**1,676.2**	**(513.6)**	**1,162.6**	**–**	**1,162.6**
Acquisitions	(0.3)	–	(0.3)	–	(0.3)
Capitalised expenses[1]	216.6	–	216.6	–	216.6
Disposals/exits from the scope of consolidation	(20.0)	11.8	(8.1)	–	(8.1)
Reclassification and transfer of category[2]	(1,053.4)	203.2	(850.2)	9.4	(840.8)
Write-off	(2.2)	–	(2.2)	–	(2.2)
Impairment/reversal[3]	–	(114.0)	(114.0)	–	(114.0)
Currency translation	1.8	(0.7)	1.1	–	1.1
Dec. 31, 2023	**818.7**	**(413.3)**	**405.4**	**9.4**	**414.8**

(1) Capitalised expenses mainly refer to investments in Westfield Hamburg.
(2) Includes mainly the reclassification of Westfield Hamburg from IPUC at cost to IPUC at fair value.
(3) Impairment mainly relates to Sisters in La Défense.

After providing the minimum disclosures required by IFRS 13 and other IFRS accounting standards, such as IAS 1, an entity must assess whether additional information must be disclosed in order to help financial statement users better understand and evaluate the quantitative information provided by the entity (see Chapter 15 at section 19.1). *[IFRS 13.92]*. This assessment requires judgement and will depend on the specific facts and circumstances of the entity and the needs of the users of its financial statements. For example, if climate risk factors have a material impact on the fair value measurements, an entity might disclose whether and how climate-related factors have been incorporated within the methodologies and inputs.

12.1.2 Level of disaggregation for IFRS 13 disclosures

IFRS 13 disclosures are required for each class of assets (and liabilities). These classes are determined based on:

- The nature, characteristics and risks of the asset or liability

  And

- The level of the fair value hierarchy within which the fair value measurement is categorised *[IFRS 13.94]*

The determination of the appropriate class of assets will require significant judgement. See Chapter 15 at section 19.1.2 for further discussion on this determination.

At one end of the spectrum, the properties in an operating segment (as defined by IFRS 8 *Operating Segments*) may be a class of assets for the purpose of the disclosures required by IFRS 13. This may be the case if the properties have the same risk profile (for example, the segment comprises residential properties in countries with property markets of similar characteristics) even if there are a large number of properties in the segment.

At the other end of the spectrum, IFRS 13 disclosures may be required for individual properties or small groups of properties if the individual properties or groups of properties have different risk profiles (for example, a real estate entity with two properties - an office building in a developed country and a shopping centre in a developing country).

The number of classes may need to be greater for fair value measurements categorised within Level 3 of the fair value hierarchy because those measurements have a greater degree of uncertainty and subjectivity.

A class of assets and liabilities will often require greater disaggregation than the line items presented in the statement of financial position. However, sufficient information must be provided to permit reconciliation to the line items presented in the statement of financial position.

When determining the appropriate classes, entities must also consider all of the following:

- The level of detail necessary to satisfy the disclosure requirements
- How much emphasis to place on each of the various requirements
- How much aggregation or disaggregation to undertake

  And

- Whether users of financial statements need additional information to evaluate the quantitative information disclosed *[IFRS 13.92]*

Determining appropriate classes of assets and liabilities for which disclosures about fair value measurements must be provided requires considerable judgement. *[IFRS 13.94]*.

12.1.3 Disclosure of direct operating expenses

As set out in section 12.1 above, entities are required to disclose both the direct operating expenses arising from investment property that generated rental income during the period and the amounts arising from investment property that did not generate rental income during the period.

How we see it

In practice, the disclosure requirement referred to above can be interpreted in different ways and the outcome will depend upon a number of judgements, for example, the unit of account for the investment property. In the instance of a multi-tenanted property, the relevant unit may be considered either the entire building or a separately let floor.

It will therefore be necessary for an entity to interpret this requirement and apply that interpretation, as an accounting policy and judgement, consistently.

12.2 Additional disclosures for the fair value model

A reconciliation between the carrying amounts of investment property at the start and end of the period must be given showing the following:

- Additions, disclosing separately those additions resulting from acquisitions and those resulting from subsequent expenditure recognised in the carrying amount of an asset
- Additions resulting from acquisitions through business combinations
- Assets classified as held for sale or included in a disposal group classified as held for sale in accordance with IFRS 5 and other disposals
- Net gains or losses from fair value adjustments
- The net exchange differences arising on the translation of the financial statements into a different presentation currency, and on translation of a foreign operation into the presentation currency of the reporting entity
- Transfers to and from inventories and owner-occupied property

  And
- Other changes *[IAS 40.76]*

When a valuation obtained for investment property is adjusted significantly for the purpose of the financial statements, for example to avoid double-counting of assets or liabilities that are recognised separately (see section 6.1.4 above), the entity must disclose a reconciliation between the valuation obtained and the adjusted valuation included in the financial statements, showing separately the aggregate amount of any recognised lease liabilities that have been added back, and any other significant adjustments. *[IAS 40.77]*. Practical example 6-3 above provides an example of such disclosure.

12.2.1 Presentation of changes in fair value

Neither IAS 1 nor IAS 40 specifies how changes in the fair value of investment property must be presented in the income statement. The Practical examples below show two different approaches. In Practical example 12-2 below the change in fair value is presented together with the profit or loss on disposal of properties (here referred to as a "Loss on revaluation and profit on sale of investment property") with an analysis of the components included in the notes to the financial statements. By contrast, in Practical example 12-3 below, the change in fair value is analysed and presented separately from the profit or loss on disposal of properties.

Practical example 12-2: Shaftesbury Capital PLC (2023) — United Kingdom

2023 Annual Report [extract]

Financial statements [extract]

Consolidated income statement [extract]

	Note	2023 £m	2022 £m
Revenue	4	195.1	74.1
Costs[1]	4	(53.2)	(16.8)
Gross profit	4	141.9	57.3
Other income	5	2.7	13.5
Administration expenses	6	(83.6)	(40.6)
Loss on revaluation and profit on sale of investment property	7	(65.0)	(0.8)
Change in value of investments and other receivables	8	(12.5)	(7.9)
Change in fair value of financial assets through profit or loss	17	52.0	(239.5)
Operating profit/(loss)		35.3	(218.0)

...

1. Included in costs is £2.0 million provision (2022: £1.6 million reversal) of expected credit loss in relation to rent receivables.

Notes to the financial statements [extract]

7 Loss on revaluation and profit on sale of investment property

	2023 £m	2022 £m
Loss on revaluation of investment property	(58.5)	(0.8)
Profit on sale of investment property	3.5	-
Loss on revaluation and profit on sale of investment property	(55.0)	(0.8)

Practical example 12-3: Unibail-Rodamco-Westfield SE (2023) — France

Universal Registration Document 2023 [extract]

5.1 CONSOLIDATED FINANCIAL STATEMENTS [extract]

5.1.1 CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME [extract]

Consolidated statement of comprensive income (€Mn)	Notes	2023	2022
Gross rental income	4.2.1/4.4.1	2,322.1	2,231.3
Ground rents paid	*4.2.1/4.4.2*	*(37.7)*	*(38.3)*
Service charge income	*4.2.1/4.4.2*	*364.8*	*320.5*
Service charge expenses	*4.2.1/4.4.2*	*(424.1)*	*(384.6)*
Property operating expenses	*4.2.1/4.4.2*	*(431.8)*	*(353.3)*
Operating expenses and net service charges		(528.7)	(455.7)
Net rental income		**1,793.4**	**1,775.6**
Property development and project management revenue		90.0	162.1
Property development and project management costs		(59.0)	(130.0)
Net property development and project management income	**4.4.4**	**30.9**	**32.1**
Property services and other activities revenues		284.1	289.9
Property services and other activities expenses		(226.1)	(211.8)
Net property services and other activities income	**4.2.1/4.4.3**	**58.0**	**78.0**
Share of the result of companies accounted for using the equity method		(169.6)	(51.8)
Income on financial assets		48.8	31.0
Contribution of companies accounted for using the equity method	**6.2**	**(120.8)**	**(20.8)**
Corporate expenses		(199.3)	(210.4)
Depreciation of other tangible and intangible assets		(31.9)	(32.4)
Administrative expenses	**4.4.5**	**(231.2)**	**(242.8)**
Acquisition and other costs	**4.4.6**	**(8.9)**	**2.6**
Proceeds from disposal of investment properties		356.5	1,046.4
Carrying value of investment properties sold		(366.8)	(1,015.5)
Result on disposal of investment properties and loss of control[1]	**3.4.2**	**(10.3)**	**30.9**
Valuation gains on assets		239.4	403.6
Valuation losses on assets		(2,485.4)	(1,514.2)
Valuation movements on assets	**5.5**	**(2,246.0)**	**(1,110.6)**
Impairment of goodwill	**5.4**	**(234.0)**	**–**
NET OPERATING RESULT		**(968.9)**	**545.0**

...

(1) The result on disposal of investment properties includes both the result on disposal of assets and the result on disposal of shares.

...

When it is relevant to an understanding of the entity's financial performance, additional line items, headings and subtotals are presented in the income statement. *[IAS 1.85]*. Some companies may elect to disclose the results of operating activities, or a similar line item, even though this term is not defined. In such cases, the Board notes that the entity should ensure that the amount disclosed is representative of activities that would normally be regarded as 'operating' (see Chapter 3 at section 3.2.2.A). *[IAS 1.BC56]*. Accordingly, the same analysis is applied when presenting changes in the fair value of investment properties in the income statement. An entity that presents a measure of operating profit in its income statement must determine whether changes in the fair value of its investment property form part of operating activities of the entity and therefore, include such changes in fair value in that measure.

In line with this, it is worth noting that one European regulator has concluded that fair value changes arising from investment property must be taken into account when determining operating results. This decision was reported in the European Securities and Markets Authority's ('ESMA') *Report - 11th Extract from the EECS's Database of Enforcement (ESMA/2011/265)*. The regulator's rationale for this decision was that fair value changes in investment property are a normal part of the activities of a real estate company and feature in the description of the business model of that real estate business.[18]

As discussed in section 12 above, once IFRS 18 is effective, it might have an impact on the income statement presentation of fair value changes arising from investment property. For example, if an entity invests in investment property as a main business activity (such as investment property holding companies), it is required to classify remeasurement of fair value of its investment property in the operating category of the income statement. Otherwise, if investing in investment property is not a main activity of an entity, such remeasurements of fair value of investment property will be classified in the investing category of the income statement (see Chapter 4 at sections 3.3.2 and 3.3.2.B). IFRS 18 was issued by the IASB in April 2024 and will supersede IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted). See Chapter 4 for further details on the new concepts and requirements of IFRS 18.

12.2.2 Extra disclosures where fair value cannot be determined reliably

If an entity chooses the fair value model, but in an exceptional case cannot measure the fair value of the property reliably and accounts for the property under the cost model in IAS 16 or in accordance with IFRS 16, the reconciliation described in section 12.2 above must disclose the amounts for such investment property separately from amounts relating to other investment property. In addition to this, the following must be disclosed:

- A description of the investment property
- An explanation of why fair value cannot be measured reliably
- If possible, the range of estimates within which fair value is highly likely to lie

  And
- On disposal of investment property not carried at fair value:
  - The fact that the entity has disposed of investment property not carried at fair value
  - The carrying amount of that investment property at the time of sale

    And
  - The amount of gain or loss recognised *[IAS 40.78]*

The standard makes it clear that this situation, at least for completed investment property, would be exceptional (see section 6.2 above). The situation for investment property under construction is discussed in section 6.3 above.

18 Report: *11th Extract from the EECS's Database of Enforcement (ESMA/2011/265),* ESMA, August 2011, paras. 76-81. Available on the ESMA's website.

12.3 Additional disclosures for the cost model

If investment property is measured using the cost model, the following disclosures are required by IAS 40 in addition to those in section 12.1 above: *[IAS 40.79]*

Extract from IAS 40

Cost model

79 In addition to the disclosures required by paragraph 75, an entity that applies the cost model in paragraph 56 shall disclose:

(a) the depreciation methods used;

(b) the useful lives or the depreciation rates used;

(c) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period;

(d) a reconciliation of the carrying amount of investment property at the beginning and end of the period, showing the following:

(i) additions, disclosing separately those additions resulting from acquisitions and those resulting from subsequent expenditure recognised as an asset;

(ii) additions resulting from acquisitions through business combinations;

(iii) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with IFRS 5 and other disposals;

(iv) depreciation;

(v) the amount of impairment losses recognised, and the amount of impairment losses reversed, during the period in accordance with IAS 36;

(vi) the net exchange differences arising on the translation of the financial statements into a different presentation currency, and on translation of a foreign operation into the presentation currency of the reporting entity;

(vii) transfers to and from inventories and owner-occupied property; and

(viii) other changes.

(e) the fair value of investment property. In the exceptional cases described in paragraph 53, when an entity cannot measure the fair value of the investment property reliably, it shall disclose:

(i) a description of the investment property;

(ii) an explanation of why fair value cannot be measured reliably; and

(iii) if possible, the range of estimates within which fair value is highly likely to lie.

12.4 Presentation of sales proceeds

IAS 16 requires an entity that, in the course of its ordinary activities, routinely sells items of property, plant and equipment that it has held for rental to transfer such assets to inventories at their carrying amount when they cease to be rented and become held for sale. The proceeds from the sale of such assets are then recognised as revenue in accordance with IFRS 15 (see Chapter 19 at section 7.2). *[IAS 16.68A]*.

How we see it

However, investment property, by definition, is held to earn rentals or for capital appreciation rather than for sale in the ordinary course of business. Consequently, we consider that the accounting treatment set out in IAS 16.68A, as described above, must not be applied by analogy to IAS 40 and proceeds from the sale of investment property would not be presented as revenue.

Despite this, however, it may be appropriate to present separately, the material gains or losses on retirement or disposal of investment property elsewhere in the financial statements, either as part of the income statement or in the notes. *[IAS 1.97]*. For example, Unibail-Rodamco-Westfield SE has chosen to present proceeds from disposal of investment properties, together with the carrying amount derecognised and the net gain/loss on disposal on the face of its statement of comprehensive income (see Practical example 12-3 above).

As discussed in section 12 above, once IFRS 18 is effective, it might have an impact on the income statement presentation of gains and losses arising from disposal of investment property. For example, if an entity invests in investment property as a main business activity (such as investment property holding companies), it is required to classify gains and losses on disposal of investment property in the operating category of the income statement. Otherwise, if investing in investment property is not a main activity of an entity, such gains and losses arising from disposal of investment property will be classified in the investing category of the income statement (see Chapter 4 at sections 3.3.2 and 3.3.2.B). IFRS 18 was issued by the IASB in April 2024 and will supersede IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted). See Chapter 4 for further details on the new concepts and requirements of IFRS 18.

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Appendix B - Defined terms

Extract from IAS 40

Definitions

5 The following terms are used in this Standard with the meanings specified:

Carrying amount is the amount at which an asset is recognised in the statement of financial position.

Cost is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, eg IFRS 2 *Share-based Payment*.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13 *Fair Value Measurement*).

Investment property is property (land or a building - or part of a building - or both) held (by the owner or by the lessee as a right-of-use asset) to earn rentals or for capital appreciation or both, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes; or

(b) sale in the ordinary course of business.

Owner-occupied property is property held (by the owner or by the lessee as a right-of-use asset) for use in the production or supply of goods or services or for administrative purposes.

Chapter 21 Impairment of fixed assets and goodwill

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Overview

This chapter addresses the requirements of the IFRS accounting standard IAS 36 *Impairment of Assets* (the standard). IAS 36 sets out the procedures that entities must apply to ensure that those assets in the scope of the standard are carried at no more than the amounts expected to be recovered through the use or sale of the assets. If circumstances arise which indicate assets could be impaired, the standard requires a review of their cash generating abilities (an impairment test). Irrespective of whether there is any indication of impairment, IAS 36 requires that certain assets (goodwill, intangible assets not yet available for use and intangible assets with indefinite useful life) be tested for impairment at least annually. In many cases, individual assets will not have individually identifiable and independent cash inflows and therefore would need to be assessed for impairment on a cash-generating unit (CGU) level. An impairment test would require an entity to determine the recoverable amount which is the higher of fair value less costs of disposal (FVLCD) and value in use (VIU) of the asset/CGU. The recoverable amount is compared with the assets'/CGUs carrying value, and if the carrying value is higher, the difference must be written off as an impairment loss in the statement of comprehensive income. The provisions within IAS 36 that set out exactly how this is to be done, and how the figures involved are to be calculated, are detailed and quite complex and discussed in detail in this chapter. While the detailed guidance around the calculation of VIU is covered in IAS 36, IFRS 13 *Fair Value Measurement* deals with the detailed guidance around determining fair values (see Chapter 15).

The final section of this chapter addresses the IASB's project on goodwill and impairment and the potential consequences for IAS 36.

Differences between the IFRS accounting standards and US GAAP guidance on this topic are not addressed in this chapter as the accounting standards are not converged.

What you need to know

- IAS 36 sets out the requirements to account for and report impairment of most non-current non-financial assets.
- IAS 36 specifies when an entity needs to perform an impairment test, how to perform it, the recognition and reversal of any impairment losses and the related disclosures.
- IAS 36 requires entities to test all assets that are within its scope for potential impairment when indicators of impairment exist or, at least, annually for goodwill, intangible assets not yet available for use and intangible assets with indefinite useful lives.
- IAS 36 requires that assets be carried at no more than their recoverable amount, which is defined as the higher of fair value less costs of disposal and value in use.
- In many cases assets will be tested for impairment on a CGU level.
- While the main principles of IAS 36 are very clear, the practical application of IAS 36 is proving to be challenging, due to the judgements and estimates required in assessing whether there are indications of impairment, in identifying the CGUs and in determining the recoverable amount of assets.

1 Introduction

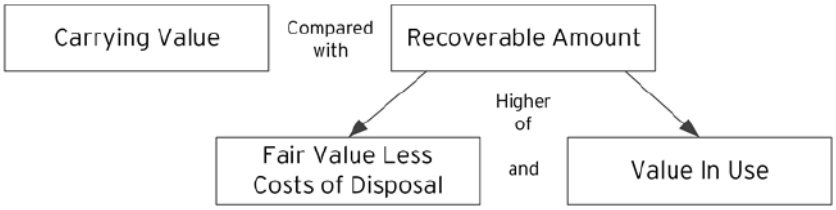
1.1 The theory behind the standard

The purpose of the standard is to ensure that intangible assets, including goodwill, and tangible assets are not carried at a figure greater than their recoverable amount (RA). This recoverable amount is compared with the carrying value (or carrying amount (CA)) of the asset to determine if the asset is impaired. *[IAS 36.1]*.

Recoverable amount is defined as the higher of fair value less costs of disposal (FVLCD) and value in use (VIU); the underlying concept being that an asset cannot be carried at more than the amount it could raise, either from selling it now or from using it. *[IAS 36.74]*.

Fair value less costs of disposal essentially means what the asset could be sold for, having deducted costs of disposal (incrementally incurred direct selling costs). Value in use is defined in terms of discounted future cash flows, as the present value of the cash flows expected from the future use and eventual sale of the asset at the end of its useful life. As the recoverable amount is to be expressed as a present value, not in nominal terms, discounting is a central feature of the impairment test.

Diagrammatically, this comparison between carrying value and recoverable amount, and the definition of recoverable amount, can be portrayed as follows:



It will not always be necessary to identify both VIU and FVLCD, as if either of VIU or FVLCD is higher than the carrying amount then there is no impairment, and no impairment loss is recognised. Thus, if FVLCD is greater than the carrying amount then no further consideration need be given to VIU, or to the need to recognise an impairment loss. The more complex issues arise when the FVLCD is not greater than the carrying value, and so a VIU calculation is necessary.

1.2 Key features of the standard

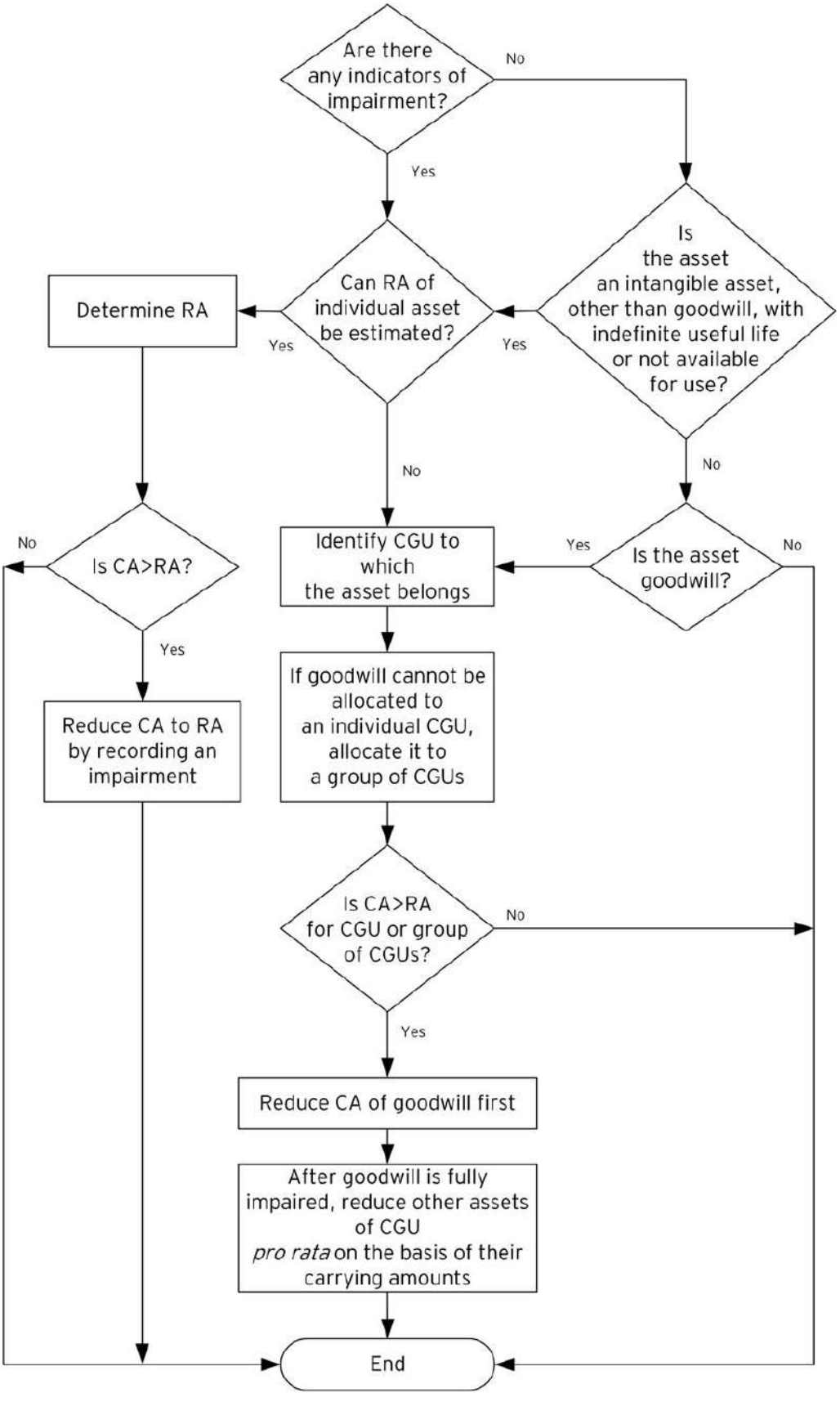
Although an impairment test can theoretically be conducted on individual assets, this will not always be possible. Goodwill does not have a separate FVLCD at all. Even if FVLCDs can be obtained for individual items of property, plant and equipment, estimates of VIUs usually cannot be. This is because the cash flows necessary for the VIU calculation are not usually generated by single assets, but by groups of assets being used together.

Often, therefore, the impairment test cannot be done at the level of the individual asset, and it must be applied to a group of assets. IAS 36 uses the term cash-generating unit (CGU) for the smallest identifiable group of assets that together have cash inflows that are largely independent of the cash inflows from other assets and that therefore can be the subject of a VIU calculation. This focus on the CGU is fundamental, as it has the effect of making the impairment test essentially a business-value test. Goodwill cannot always be allocated to an individual CGU, but to a group of CGUs. IAS 36 has detailed guidance in respect of the level at which goodwill is tested for impairment which is discussed in section 8 below.

Most assets and CGUs need only be tested for impairment if there are indicators of impairment. The 'indications' of impairment relate to either the assets themselves or to the economic environment in which they are operated. IAS 36 gives examples of indications of impairment, but makes it clear this is not an exhaustive list, and states explicitly that the entity can identify other indications that an asset is impaired, that would equally trigger an impairment test. *[IAS 36.13]*. There are more onerous requirements for goodwill, intangible assets with an indefinite useful life and intangible assets that are not yet available for use on the reporting date. These must be tested for impairment at least on an annual basis, irrespective of whether there are any impairment indicators. This is because the first two, goodwill and intangible assets with indefinite useful lives, are not subject to annual amortisation while it is argued that intangible assets are intrinsically subject to greater uncertainty before they are available for use. Impairment losses are recognised as expenses in profit or loss except in the case of an asset carried at a revalued amount where the impairment loss is recorded first against any previously recognised revaluation gains in respect of that asset in other comprehensive income.

Figure 1-1 below illustrates the key stages in the process of measuring and recognising impairment losses under IAS 36. The key components of the diagram are discussed in detail in the remainder of this chapter.

Figure 1-1: Determining and accounting for impairment



The entity assesses at each reporting date, whether an impairment assessment is required and acts accordingly:

- If there is an indication that an asset could be impaired, an impairment test is required.
- For goodwill, intangible assets with an indefinite useful life and intangible assets that are not yet available for use on the reporting date an annual impairment test is required.
- An asset is assessed for impairment either at an individual asset level or the level of a CGU depending on the level at which the recoverable amount can be determined, meaning the level at which independent cash inflows are generated.
- If the impairment test is performed at a CGU level, the entity needs to be divided into CGUs.
- After the identification of the CGUs, the carrying amount of the CGUs is determined.
- If goodwill is not monitored at the level of an individual CGU, then it is allocated to the group of CGUs that represent the lowest level within the entity at which goodwill is monitored for internal management purposes, but not at a level that is larger than an operating segment.
- The recoverable amount of the asset or CGU assessed for impairment is established and compared with the carrying amount.
- The asset or CGU is impaired if its carrying amount exceeds its recoverable amount, defined as the higher of FVLCD and VIU.
- For assets carried at cost, any impairment loss is recognised as an expense in profit or loss.
- For assets carried at revalued amount, any impairment loss is recorded first against any previously recognised revaluation gains in other comprehensive income in respect of that asset.
- Impairment losses in a CGU are first recorded against goodwill and second, if the goodwill has been written off, on a *pro rata* basis to the carrying amount of other assets in the CGU. However, the carrying amount of an asset cannot be reduced below the highest of its FVLCD, VIU or zero. If the preceding rule is applied, further allocation of the impairment loss is made *pro rata* to the other assets of the unit (group of units).
- Extensive disclosure is required for the impairment test and any impairment loss that has been recognised.
- An impairment loss for an asset other than goodwill recognised in prior periods must be reversed if there has been a change in the estimates used to determine the asset's recoverable amount.

The application of the guidance in IAS 36 may require significant judgement, for example in relation to the determination of the recoverable amount. Where this does not result in a materially different outcome, simplifications and approximations are applied in practice to reduce the complexity of the exercise. Some of these will be addressed in more detail in the relevant sections of the chapter.

1.3 Scope

The standard is a general impairment standard, and its provisions are referred to in other IFRS accounting standards, for example IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets,* IFRS 16 *Leases* and IFRS 3 *Business Combinations,* where impairment is to be considered.

The standard has a general application to all assets, but scopes out certain assets. This is set out in IAS 36.2: *[IAS 36.2]*

Extract from IAS 36

2 **This Standard shall be applied in accounting for the impairment of all assets, other than:**

- **(a) inventories (see** IAS 2 *Inventories***);**
- **(b) contract assets and assets arising from costs to obtain or fulfil a contract that are recognised in accordance with** IFRS 15 *Revenue from Contracts with Customers***;**
- **(c) deferred tax assets (see** IAS 12 *Income Taxes***);**
- **(d) assets arising from employee benefits (see** IAS 19 *Employee Benefits***);**
- **(e) financial assets that are within the scope of** IFRS 9 *Financial Instruments***;**
- **(f) investment property that is measured at fair value (see** IAS 40 *Investment Property***);**
- **(g) biological assets related to agricultural activity within the scope of** IAS 41 *Agriculture* **that are measured at fair value less costs to sell;**
- **(h) contracts within the scope of IFRS 17** *Insurance Contracts* **that are assets and any assets for insurance acquisition cash flows as defined in IFRS 17; and**
- **(i) non-current assets (or disposal groups) classified as held for sale in accordance with** IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations***.**

This, the standard states, is because these assets are subject to specific recognition and measurement requirements. *[IAS 36.3]*. The effect of these exclusions is to reduce the scope of IAS 36.

While investment properties measured at fair value are exempt, investment properties not carried at fair value are in the scope of IAS 36.

If a company has recorded oil and mineral exploration and evaluation assets and has chosen to carry them at cost, then these assets are to be tested under IAS 36 for impairment, once they have been assessed for impairment indicators in accordance with IFRS 6 *Exploration for and Evaluation of Mineral Resources*. *[IFRS 6.2(b)]*.

Financial assets classified as subsidiaries as defined in IFRS 10 *Consolidated Financial Statements*, joint ventures as defined in IFRS 11 *Joint Arrangements* and associates as defined in IAS 28 *Investments in Associates and Joint Ventures* are within its scope. *[IAS 36.4]*. This will generally mean only those `investments in the separate financial statements of the parent. However, interests in joint ventures and associates included in the consolidated accounts by way of the equity method are brought into scope by IAS 28. *[IAS 28.42]*.

The standard applies to assets carried at revalued amounts, e.g., under IAS 16 (or rarely IAS 38). See section 6.1.3 below. *[IAS 36.5]*.

A lessee shall apply IAS 36 to determine whether a right-of-use asset is impaired and to account for any impairment loss identified. *[IFRS 16.33]*.

Contracts within the scope of IFRS 17 are excluded from the scope of IAS 36. See Chapter 51 at section 2.3 for more information on the scope of IFRS 17.

Unlike biological assets within the scope of IAS 41, items of property, plant and equipment within the scope of IAS 16 are not scoped out of IAS 36. See Chapter 38 at section 3.2.3.A for more information on the application of IAS 36 to bearer plants in the scope of IAS 16.

2 When an impairment test is required

There is an important distinction in IAS 36 between assessing whether there are indications of impairment and actually carrying out an impairment test. The standard has two requirements governing when an impairment test has to be carried out:

- For goodwill and all intangible assets with an indefinite useful life the standard requires an annual impairment test, even if there is no indication of impairment. The impairment test can be performed at any time in the annual reporting period, but it must be performed at the same time every year. Different intangible assets can be tested for impairment at different times. *[IAS 36.10]*.

  In addition, the carrying amount of an intangible asset that is not yet available for use must be tested for impairment at least annually. This, the standard argues, is because intangible assets are intrinsically subject to greater uncertainty before they are available for use. *[IAS 36.11]*.
- For all (groups of) assets or CGUs within the scope of IAS 36, the entity is required to assess at each reporting date (at year-end and at any interim period end) whether there are any indications of impairment. If at a reporting date any indication is present, an entity is required to perform an impairment test, even if the entity already performed an impairment test during that reporting period (for example when the mandatory impairment test on goodwill was performed at a different time). *[IAS 36.8, IAS 36.9]*.

The particular requirements of IAS 36 concerning the impairment testing of goodwill and of intangible assets with an indefinite useful life or not yet available for use are discussed separately in section 8 below (goodwill) and section 10 below (intangible assets with indefinite useful life or not yet available for use), however the methodology used is identical for all types of assets.

For all assets (including goodwill and intangible assets), an impairment test, i.e., a formal estimate of the asset's recoverable amount as set out in the standard, must be performed if indications of impairment exist. *[IAS 36.9]*. The only exception is where there was sufficient headroom in a previous impairment calculation that would not have been eroded by subsequent events or the asset or CGU is not sensitive to a particular indicator; the indicators and these exceptions are discussed further in the following section. *[IAS 36.15]*.

2.1 Indicators of impairment

Identifying indicators of impairment is a crucial stage in the impairment assessment process. IAS 36 lists examples of indicators but stresses that they represent the minimum indicators and that the list is not exhaustive. *[IAS 36.12, IAS 36.13]*. They are divided into external and internal indicators.

External sources of information:

(a) A decline in an asset's value during the period that is significantly more than would be expected from the passage of time or normal use.

(b) Significant adverse changes that have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.

(c) An increase in the period in market interest rates or other market rates of return on investments if these increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially.

(d) The carrying amount of the net assets of the entity exceeds its market capitalisation.

Internal sources of information:

(e) Evidence of obsolescence or physical damage of an asset.

(f) Significant changes in the extent to which, or manner in which, an asset is used or is expected to be used, that have taken place in the period or soon thereafter and that will have an adverse effect on it. These changes include the asset becoming idle, plans to dispose of an asset sooner than expected, reassessing its useful life as finite rather than indefinite or plans to restructure the operation to which the asset belongs.

(g) Internal reports that indicate that the economic performance of an asset is, or will be, worse than expected. *[IAS 36.12]*.

The standard amplifies and explains relevant evidence from internal reporting that indicates that an asset can be impaired:

(a) Cash flows for acquiring the asset, or subsequent cash needs for operating or maintaining it, are significantly higher than originally budgeted

(b) Operating profit or loss or actual net cash flows are significantly worse than those budgeted

(c) A significant decline in budgeted net cash flows or operating profit, or a significant increase in budgeted loss

Or

(d) Operating losses or net cash outflows for the asset, if current period amounts are aggregated with budgeted amounts for the future *[IAS 36.14]*

The presence of indicators of impairment will not necessarily mean that the entity has to calculate the recoverable amount of the asset in accordance with IAS 36. A previous calculation can have shown that an asset's recoverable amount was significantly greater than its carrying amount and it can be clear that subsequent events have been insufficient to eliminate this headroom. Similarly, previous analysis can show that an asset's recoverable amount is not sensitive to one or more of these indicators. *[IAS 36.15]*.

If there are indications that the asset is impaired, it can also be necessary to examine the remaining useful life of the asset, its residual value and the depreciation method used, to consider whether these need to be adjusted even if no impairment loss is recognised (see Chapter 19 at section 5.3). *[IAS 36.17]*.

The complete destruction of a non-current asset would result in the derecognition of that asset rather than an impairment. That is because the complete destruction of an asset means that no future economic benefits are expected either from its use or disposal (except for disposal benefits, e.g., from metal content in the scrap). See Chapter 19 at section 7 for more information on the derecognition guidance in IAS 16.

2.1.1 Market capitalisation

If market capitalisation is lower than the carrying value of equity, this is a powerful indicator of impairment as it suggests that the market considers that the business value is less than the carrying value. However, the market can have taken account of factors other than the return that the entity is generating on its assets. For example, an individual entity with a high level of debt that it is unable to service fully. A market capitalisation below equity will not necessarily be reflected in an equivalent impairment loss. An entity's response to this indicator depends very much on facts and circumstances. Most entities cannot avoid examining their CGUs in these circumstances unless there was sufficient headroom in a previous impairment calculation that would not have been eroded by subsequent events or none of the assets or CGUs is sensitive to market capitalisation as an indicator. If a formal impairment test is required when the market capitalisation is below equity, great care must be taken to ensure that the discount rate used to calculate VIU is consistent with current market assessments. IAS 36 does not require a formal reconciliation between market capitalisation of the entity, FVLCD and VIU. However, entities need to be able to understand the reason for the shortfall and consider whether they have made sufficient disclosures describing those factors that could result in an impairment in the next periods. *[IAS 36.134(f)]*.

2.1.2 Future performance

Another significant element is an explicit reference in (b), (c) and (d) above to internal evidence that future performance will be worse than expected. Thus IAS 36 requires an impairment test to be undertaken if performance is or will be significantly below that previously budgeted. In particular, there can be indicators of impairment even if the asset is profitable in the current period if budgeted results for the future indicate that there will be losses or net cash outflows when these are aggregated with the current period results.

2.1.3 Individual assets or part of CGU?

Some of the indicators are aimed at individual fixed assets rather than the CGU of which they are a part, for example a decline in the value of an asset or evidence that it is obsolete or damaged. Such indicators can also imply that a wider impairment test of the business or CGU is required. However, this is not always the case. For example, if there is a slump in property prices and the market value of the entity's new head office falls below its carrying value this would constitute an indicator of impairment and trigger an impairment test. At the level of the individual asset, as FVLCD is below carrying amount, this can indicate that a write-down is necessary. However, the building's recoverable amount has to be considered in the context of a CGU of which it is a part. In this example it is not necessary to re-estimate an asset's recoverable amount if it is obvious that the CGU has suffered no impairment. In short, it can be irrelevant to the recoverable amount of the CGU that it contains a head office whose market value has fallen. Similarly, if a machine has been damaged but continues to form part of a factory, being the CGU (i.e., the damage did not result in the asset's derecognition), no impairment loss will be recognised as long as the factory is not impaired.

2.1.4 Interest rates

Including interest rates as indicators of impairment could imply that assets are judged to be impaired if they are no longer expected to earn a market rate of return, even though they generate the same cash flows as before. However, an upward movement in general interest rates will not give rise to a write-down in assets if they do not affect the rate of return expected from the asset or CGU itself. The standard indicates that it is possible that the asset's recoverable amount is not sensitive to a particular indicator.

The discount rate used in a VIU calculation has to be based on the rate specific for the asset. An entity is not required to make a formal estimate of an asset's recoverable amount if the discount rate used in calculating the asset's VIU is unlikely to be affected by the increase in market rates. For example, it is possible that the recoverable amount for an asset with a long remaining useful life is not materially affected by increases in short-term rates. Further an entity is not required to make a formal estimate of an asset's recoverable amount if previous sensitivity analyses of the recoverable amount showed that it is unlikely that there will be a material decrease in the recoverable amount because future cash flows are also likely to increase to compensate for the increase in market rates. Consequently, the potential decrease in the recoverable amount can simply be unlikely to result in a material impairment loss. *[IAS 36.16]*.

Geopolitical events (such as a war) can result in a significant increase in interest rates in the affected countries. This may affect an entity's discount rate when using a discounted cash flow model, as it could impact current market assessments of the time value of money and the risks specific to the asset(s) or cash-generating unit(s) for which the future cash flow estimates have not been adjusted.

3 Dividing the entity into cash-generating units (CGUs)

If an impairment assessment is required, one of the first tasks will be to identify the individual assets affected and if those assets do not have individually identifiable and independent cash inflows, to divide the entity into CGUs. The standard requires the group of assets that is considered together to be as small as is reasonably practicable, i.e., the entity must be divided into as many CGUs as possible, and an entity must identify the lowest aggregation of assets that generate largely independent cash inflows. *[IAS 36.6, IAS 36.68]*.

It must be stressed that CGUs are identified from cash inflows, not from net cash flows or indeed from any basis on which costs can be allocated (this is discussed further below).

The existence of a degree of flexibility over what constitutes a CGU is obvious. Indeed, the standard acknowledges that the identification of CGUs involves judgement. *[IAS 36.68]*. The guidance offered by the standard is that CGU selection will be influenced by "how management monitors the entity's operations (such as by product lines, businesses, individual locations, districts or regional areas) or how management makes decisions about continuing or disposing of the entity's assets and operations".

How we see it

While monitoring by management and how management makes decisions about continuing or disposing of the entity's assets and operations helps identifying CGUs, in our view it does not override the requirement that the identification of CGUs is based on the lowest level at which largely independent cash inflows are generated.

Illustration 3-1: Identification of CGUs and largely independent cash inflows

An entity obtains a contract to deliver mail to all users within a country, for a price that depends solely on the weight of the item, regardless of the distance between sender and recipient. It makes a significant loss in deliveries to outlying regions. Because of the entity's contractual service obligations, the CGU is the whole region covered by its mail services.

The division cannot go beyond the level at which each income stream is capable of being separately monitored. For example, it can be difficult to identify a level below an individual factory as a CGU but of course an individual factory can or cannot be a CGU.

An entity can identify independent cash inflows for individual factories or other assets or groups of assets such as offices, retail outlets or assets that directly generate revenue such as those held for rental or hire.

Intangible assets such as brands, customer relationships and trademarks used by an entity for its own activities are unlikely to generate largely independent cash inflows and will therefore be tested together with other assets at a CGU level. This is also the case with intangible assets with indefinite useful lives and those that are not yet available for use, even though the carrying amount must be tested at least annually for impairment (see section 2 above).

Focusing on cash inflows avoids a common misconception in identifying CGUs. Management can argue that the costs for each of their retail outlets are not largely independent because of purchasing synergies and therefore these outlets cannot be separate CGUs. In fact, this will not be the deciding feature. IAS 36 explicitly refers to the allocation of cash outflows that are necessarily incurred to generate the cash inflows. If they are not directly attributed, cash outflows can be 'allocated on a reasonable and consistent basis'. *[IAS 36.39(b)]*. Goodwill and corporate assets have to be allocated to CGUs as described in sections 8.1 and 4.2 below.

Management can consider that the primary way in which they monitor their business is for the entity as a whole or on a regional or segmental basis, which could result in CGUs being set at too high a level. It is undoubtedly true, in one sense, that management monitors the business as a whole but in most cases, they also monitor at a lower level that can be identified from the lowest level of independent cash inflows. For example, while management of a chain of cinemas will make decisions that affect all the cinemas such as the selection of films and catering arrangements, it will also monitor individual cinemas. Management of a chain of branded restaurants will monitor both the brand and the individual restaurants. In both cases, it is possible that management monitors at an intermediate level, e.g., a level based on regions. In most cases, each restaurant or cinema will be a CGU, as illustrated in Illustration 3-2 - Scenario B below, because each will generate largely independent cash inflows, but it is possible that brands and goodwill are tested at a higher level.

In Illustration 3-2 below, Scenario A illustrates a practical approach which involves working down to the smallest group of assets for which a stream of cash inflows can be identified. These groups of assets will be CGUs unless the performance of their cash inflow-generating assets is dependent on those generated by other assets, or their cash inflows are affected by those of other assets. If the cash inflows generated by the group of assets are not largely independent of those generated by other assets, other assets must be added to the group to form the smallest collection of assets that generates largely independent cash inflows.

Illustration 3-2: Identification of CGUs

Scenario A - newspapers

An entity publishes 10 suburban newspapers, each with a different masthead, across 4 distinct regions within a city centre. The price paid for a purchased masthead is recognised as an intangible asset. The newspapers are distributed to residents free of charge. No newspaper is distributed outside its region. All of the revenue generated by each newspaper comes from advertising sales. An analysis of advertising sales shows that for each masthead:

- Approximately 90% of sales come from advertisers purchasing 'bundled' advertisements that appear in all those newspapers published in one particular region of the city
- Approximately 6% of sales come from advertisers purchasing 'bundled' advertisements that appear in all 10 newspapers in the city centre

  And
- Approximately 4% of sales come from advertisers purchasing advertisements that appear in one newspaper only

What is the CGU for an individual masthead?

Identify the smallest aggregation of assets for which a stream of cash inflows can be identified.

The fact that it is possible to use a *pro rata* allocation basis to determine the cash inflows attributable to each newspaper means that each masthead is likely to represent the smallest aggregation of assets for which a stream of cash inflows can be identified.

Are the cash inflows generated by an individual masthead largely independent of those of other mastheads and, conversely, is that individual masthead affecting the cash inflows generated by other mastheads?

As approximately 96% of cash inflows for each masthead arise from 'bundled' advertising sales across multiple mastheads, the cash inflows generated by an individual masthead are not largely independent.

Therefore, the individual mastheads would most likely need to be aggregated to form the smallest collection of assets that generates largely independent cash inflows. On the basis that approximately 90% of cash inflows for each masthead arise from 'bundled' advertising sales across all of the newspapers published in a particular region, it is likely that those mastheads published in one region will together form a CGU.

Scenario B - retail outlets

An entity has a chain of retail outlets located in the same country. The business model of the entity is highly integrated and the majority of the entity's revenue generating decisions, such as decisions about investments and monitoring of performance, are carried out at an entity level by the executive committee, with some decisions (such as product range and marketing) delegated to the regional or store levels. The majority of the operations, such as purchasing, are centralised. Management operates its business on a regional basis; but sales are monitored at the individual store level.

The outlets are usually bought and sold in packages of outlets that are subject to common economic characteristics, e.g., outlets of similar size or location such as a shopping centre or city or region. Only in rare situations has the entity sold or closed down an individual outlet.

The determining factor for CGUs is the level at which largely independent cash inflows are generated, and not the manner in which the entity's operations are organised and monitored. The fact that operations and costs are managed centrally does not in itself affect the source and independence of the cash inflows. The interdependence of cash outflows is unlikely to be relevant to the identification of CGUs.

The key issue in deciding whether CGUs must be identified at the level of the individual store as opposed to a group of stores is whether, if a store is closed down, all the customers of that store would seek out another of the entity's stores such that there is no significant 'leakage' of customers from the store closure. Unless the customers transfer their business to another of the entity's stores, the individual stores are separate CGUs.

Management in Scenario B can consider that the primary way in which they monitor their business is on a regional or segmental basis, but cash inflows are monitored at the level of an individual store. Individual stores generate independent cash inflows in most circumstances and the overriding requirement under IAS 36 is that the identification of CGUs is based on largely independent cash inflows. This means that in many circumstances an entity will need to conclude that an individual store represents a separate CGU.

3.1 Omni-channel business model in the retail sector

The business models of some retailers have significantly changed over the last years and with the increased importance of internet sales will probably further change in the years ahead. The following Illustration shows a new evolving omni-channel business model and its potential impact on the identification of CGUs in the retail sector.

Illustration 3-3: Omni-channel business model

Retailer A sells a wide range of general household merchandise online and through its retail stores which are located in most large and medium-sized cities in the same country. In order to cater to the changing habits of consumers and significant growth of online shoppers, A established an online platform. Retailer A offers the same products in each of its stores and on the online platform.

A uses the 'click and collect' business model. With 'click and collect' a customer is able to place an order online for items and then choose from which store to collect. If the preferred store runs out of an item, the customer can choose another store in the same city instead of waiting until the item arrives in its preferred store. This is the case for both customers buying online for store collection and for customers wanting to purchase the product directly in the store. The customer could either choose to pay online for the goods or make payment in store at the point of pick up. The customer could also purchase an item online and wait for it to be delivered in 3 working days. Sales generated online account for a significant portion of total sales, ranging from 20% to 25% depending on the city, and are projected to grow steadily in the coming years. The stores also serve as a point of return for products that customers ordered online. A product purchased online or in a store can be returned in any store and experience shows that customers make use of this option by returning products to stores in the same city where the product was originally purchased, picked up or delivered. The customers can exchange the products returned with products from the store shelves or they can purchase other products within the store when picking up or returning products. Hence, the activity of picking up and returning products also triggers sales in the stores. Retailer A considers the stores as well as showrooms for the online business whereby customers get professional buying advice and are able to experience the look and feel of the products, but then acquire the products only later through the online platform. For supply chain optimisation purposes Retailer A through its store personnel also encourages its customers to order online.

The performance of the stores together with the relevant online sales is assessed by city and not on an individual store-level. The employees of the stores are paid on an hourly basis and have performance-based compensation which is based on sales in all stores in one city together with online sales generated by customers located in the same city.

In assessing the CGU level for impairment purposes the key question is at which level of the retailer's organisation are independent cash inflows generated? In the specific fact pattern above, customers treat stores in the same city as an alternative means of making purchases and transacting returns which seems to indicate that all stores in one city represent a single CGU. In addition, in the above described integrated omni-channel business model, the cash-inflows generated by stores and the cash-inflows generated by the online channel are not largely independent from each other as the online revenues influence the store revenues and *vice versa*. Online customers treat stores as a collection and return point for online sales and as showrooms to experience the products. All of this together, as well as the fact that the performance of the stores and of the employees is assessed by city including online sales for the city, suggests that independent cash inflows are generated at the city level. Therefore, in the specific fact pattern above, it would be reasonable to treat the stores in a city together with the allocated assets of the online sales channel as one CGU for impairment testing purposes. The recoverable amount would consider the sales in the stores in a city plus the online sales to customers in the city.

Alternatively, if the sales generated online are an insignificant component of total sales and stores are not treated to a large extent as substitutes for each other by customers, then each single store will be considered a CGU for impairment testing purposes, even if the performance of the stores are monitored together at a higher level.

As explained above, IAS 36 states that the identification of CGUs involves judgement and that in identifying CGUs an entity considers various factors including how management monitors the entity's operations (such as by product line, business, individual location, district or regional area) or how management makes decisions about continuing or disposing of the entity's assets and operations. *[IAS 36.68, IAS 36.69]*.

Applying this guidance, the following quantitative and qualitative criteria can be considered in determining the appropriate CGUs in an omni-channel business model for impairment testing purposes:

- Whether the interdependency of the revenues from different sales channels (online, stores) is evidenced in the business model (examples of questions to consider include: are online sales fulfilled through store shipments, store collections or through a central distribution centre? Can online sales be returned or exchanged in any store? Will online sales picked up, returned or exchange in stores result in additional sales in stores?).
- Whether the retailer is able to measure the interdependencies of the revenues (i.e., online and stores).
- Whether the business model provides evidence that the sales channels are monitored together (e.g., on the level of customers allocated based on ZIP-Codes to stores in an area).
- Whether the profitability as well as the remuneration system are monitored/assessed on the combined basis of online and store revenues on a regional level (e.g., cities in Illustration 3-3 above).
- Whether in deciding about store openings and closures, the revenues of the online business in the region (city in the Illustration 3-3 above) are considered.
- Whether online revenues are reaching a significant quantitative proportion of the overall revenues of the retailer's CGUs. It is important to note that IAS 36 does not give any specific guidance on when cash inflows are largely independent and therefore judgement is required. The level of interdependent online sales in Illustration 3-3 above is not meant to be a bright line but rather part of the specific fact pattern in the Illustration and in practice the determination of CGUs will have to be made in the context of the overall facts and circumstances.

In most circumstances individual stores generate largely independent cash inflows, therefore each store would be a separate CGU (see Illustration 3-2 Scenario B - retail outlets above). However, most retailers do offer nowadays customers the possibility to place online orders with different means to obtain, exchange or return the goods purchased. This raises the question how different business models impact the CGU identification and the determination of recoverable amounts. The following table gives examples of possible business models:

Business model	CGU identification and determination of recoverable amount considerations
The company has two independently operating sales channels: - The online sales platform where all sales and returns are managed from a central distribution centre dedicated to the online sales channel. - Brick-and-mortar stores, which only fulfil physical sales from their shelves and are serviced by a separate central distribution centre. The stores are all located in different cities. While some store customers would buy online if a store is closed down, significant 'leakage' of customers occurs in practice when a store is closed.	The online sales platform and the individual stores are generating largely independent cash inflows. Store closures result in significant loss of customers. Consequently, a separate CGU exists for each individual store. In addition, the online sales channel forms a separate CGU.
The company's sales channels include the online sales platform and brick-and-mortar stores located in different cities. Online sales are being fulfilled by individual stores located closest to the customers by either delivering goods from the stores shelves or by offering customers collections (click-and-collect) of goods from its shelves. A customer can just choose to click-and-collect or have an item delivered from a store if the individual store has the item in its inventory. Online sales fulfilled by stores range between 10-20% of total sales per store. Goods purchased in store and online can only be returned to the store from which the sale was made, delivered or picked-up. When customers collect or return goods purchased online, there are significant purchases of additional items displayed in the store. As the stores are all located in different cities, significant 'leakage' of customers occurs in practice when a store is closed.	Individual stores generate largely independent cash inflows. While the online sales are centrally captured through the online sales platform, the actual fulfilment is at an individual store level. Consequently, each individual store is a separate CGU. Assets from the online sale platform would need to be allocated on a reasonable and consistent basic to the CGUs (see section 4.2 below). The recoverable amount of each store CGU would consider the sales in the store plus the online sales shipped or collected from this store.

Business model	CGU identification and determination of recoverable amount considerations
The company's sales channels include the online sales platform and brick-and-mortar stores located in different cities. Online sales and returns are managed from a central distribution centre dedicated to the online sales channel. Customers have the option to place an order online to collect (click-and-collect) at a store. In such a case the good is dispatched from the central distribution centre dedicated to the online sales channel to the store for customer collection. The click-and-collect online sales do not represent a significant proportion of the stores' activities in comparison with the physical sales of the individual stores and no significant number of additional purchases are generated in stores by customers collection of goods purchased online. As the stores are all located in different cities, significant 'leakage' of customers occurs in practice when a store is closed.	The online sales platform and the individual stores are generating largely independent cash inflows. Consequently, a separate CGU exists for each individual store. In addition, the online sales channel forms a separate CGU. Click-and-collect online sales are most likely to be allocated to the online sales channel. In such a case it can be appropriate to consider arm's length intragroup-recharges for the click-and-collect services the stores provide for the online sales channel (see section 3.6.2 below).
Same as previous fact pattern with the additional fact pattern that online sales can be returned/exchanged in any store without resulting in a significant number of additional purchases. The online sales/returns do not represent a significant proportion of the stores' activities in comparison with the physical sales of the individual stores.	Same as previous fact pattern.
The company runs it operations as an omni-channel. See Illustration 3-3: Omni-channel business model above.	See Illustration 3-3: Omni-channel business model above.
The company's main sales channel is the online sales platform. While the company has a few stores located in major cities, these stores act exclusively as showrooms to display items for customers that want to experience the product before buying it online. Customers cannot place orders in the showrooms. All sales are made via the online sales platform with deliveries, returns and collections fulfilled through one central distribution centre. The percentage of customers visiting showrooms before placing an order online is low in comparison to overall sales. Important to note: this fact pattern is different to one where orders are placed in stores, with bulky merchandise being fulfilled through a warehouse, in which case the respective store can be a separate CGU.	The online sales platform represents a CGU as it generates independent cash inflows. As the showrooms will not generate any cash inflows, the showrooms would meet the definition of a corporate asset and assessed for impairment as such (see section 4.2 below) together with the online sales platform CGU.

The table above gives only some of the examples which can be encountered in practice, and differences in facts and circumstances can result in different conclusions being reached. Significant judgement can be required in the determination of the CGU.

3.2 Grouping of assets

As shown in Illustration 3-4 below, it is possible that the entity is capable of identifying individual cash inflows from assets. However, as stated in section 3 above, the process to identify a CGU is based on the presence of individually identifiable and independent cash inflows. It is possible that the individually identifiable cash inflows are not independent when the allocation of cash inflows to individual assets is solely based on a management decision.

Illustration 3-4: Identification of CGUs - grouping of assets

Scenario A - A tour operator's hotels

A tour operator owns three hotels of a similar class near the beach at a large holiday resort. These hotels are advertised as alternatives in the operator's brochure, at the same price. Holidaymakers are frequently transferred from one to another and there is a central booking system for independent travellers. In this case, the hotels can be regarded as offering genuinely substitutable products by a sufficiently high proportion of potential guests and can be grouped together as a single CGU. Effectively, the hotels are being run as a single hotel on three sites. The entity will have to bear in mind that disposal decisions can still be made on a hotel-by-hotel basis and have to weigh this appropriately in its determination of its CGUs.

Scenario B - Container ships

A shipping company operates a series of container vessels of similar size in a specific region that it considers to be a single CGU. As well as this shipping business, it has other types and regions of shipping operations where CGUs are established on an appropriate basis.

Management can identify the actual cash inflows from the individual vessels, but it determines that the following are the principal features that indicate that these container ships comprise a single CGU:

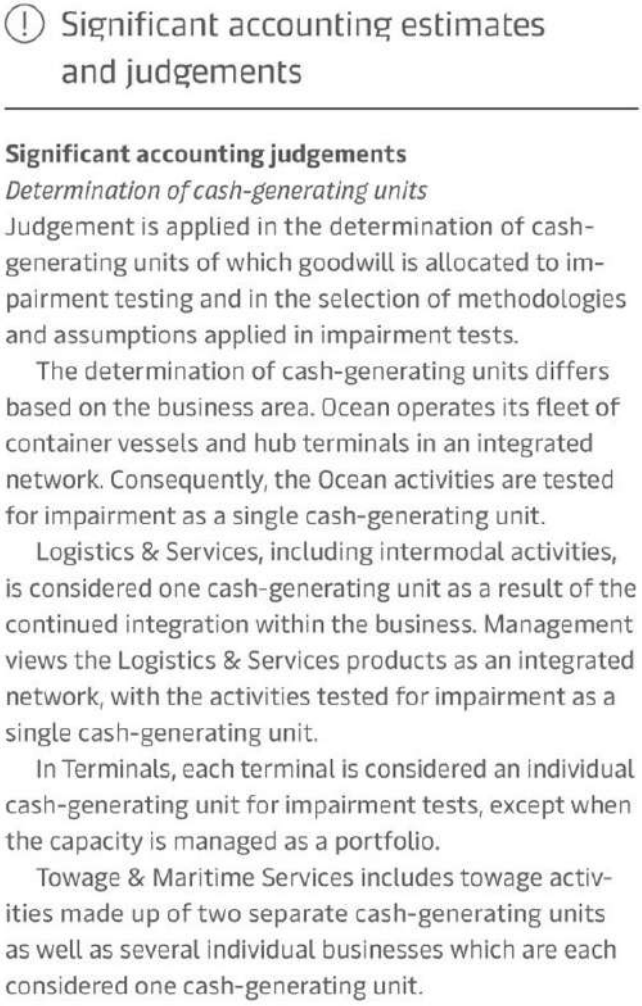
- The vessels are interchangeable within the contracts and none is on a long-term hire to any individual client
- The pricing of the contract is not vessel specific
- A reasonable portion of the contracts require the operator to have a certain level of capacity available, comprising multiple vessels
- The investment, continuance and disposal decisions are made by class of vessel and not linked to the actual revenue generated by that vessel
- The class of vessels has a clear and distinctive market and management views and makes decisions by reference to the CGU, not individual assets

The fact that one or more of the assets could be used individually, i.e., taken out of the 'pool', would not in itself prevent the assets being considered part of a single CGU. Management concluded that, as the allocation of contracts to individual vessels is solely based on a management decision, the individual container vessel does not generate independent cash inflows. The container vessels therefore need to be tested together at a CGU level.

An example of Scenario B is given in Practical example 3-1 below by A.P. Møller - Mærsk A/S. The following extract from the annual report of A.P. Møller - Mærsk A/S refers to the judgement applied in determination of cash-generating units.

Practical example 3-1: A.P. Møller - Mærsk A/S (2022) Denmark

Annual Report 2022 [extract]
Consolidated financial statements [extract]
Notes [extract]
Note 3.1 Intangible assets [extract]



Significant accounting estimates and judgements

Significant accounting judgements

Determination of cash-generating units

Judgement is applied in the determination of cash-generating units of which goodwill is allocated to impairment testing and in the selection of methodologies and assumptions applied in impairment tests.

The determination of cash-generating units differs based on the business area. Ocean operates its fleet of container vessels and hub terminals in an integrated network. Consequently, the Ocean activities are tested for impairment as a single cash-generating unit.

Logistics & Services, including intermodal activities, is considered one cash-generating unit as a result of the continued integration within the business. Management views the Logistics & Services products as an integrated network, with the activities tested for impairment as a single cash-generating unit.

In Terminals, each terminal is considered an individual cash-generating unit for impairment tests, except when the capacity is managed as a portfolio.

Towage & Maritime Services includes towage activities made up of two separate cash-generating units as well as several individual businesses which are each considered one cash-generating unit.

In Scenario B above, an analogy can be made to the conclusion in illustrative example IE11-IE16 of IAS 36 that plants B and C of entity M are part of one CGU which is illustrated in the following Illustration 3-5:

Illustration 3-5: Identification of CGUs - single product entity

Entity M produces a single product and owns plants A, B, C. Each plant is located in a different continent. A produces a component that is assembled in either B or C. The combined capacity of B and C is not fully utilised. M's products are sold worldwide from either plant B or C. For example, B's product can be sold in C's continent if the products can be delivered faster from B than from C. Utilisation levels from B and C depend on the allocation of sales between the two sites. There is no active market for A's products.

Most likely A, B and C together, therefore M as a whole, are the smallest identifiable group of assets that generates cash inflows that are largely independent. This is due to:

(a) A's cash inflows depending on sales of the final product by B and C

And

(b) Cash inflows for B and C depend on the allocation of the production across the two sites

As explained in section 3.3 below, the conclusion would be different if an active market for A's product existed, resulting in A being one CGU and B and C together another CGU.

As a result of applying the methodology illustrated in Illustration 3-2 above, an entity could identify a large number of CGUs. However, the standard allows reasonable approximations and one way in which entities can apply this in practice is to group together assets that are separate CGUs, but which if considered individually for impairment would not be material. Retail outlets, usually separate CGUs, can be grouped if they are all subject to the same economic circumstances and grouping them together rather than examining them individually will have an immaterial effect. However, the entity will still have to scrutinise the individual CGUs to ensure that those that it intends to sell or that have significantly underperformed are not supported by the others with which they are grouped. They would need to be identified and dealt with individually.

In practice, different entities will inevitably have varying approaches when determining their CGUs. There is judgement to be exercised in determining an income stream and in determining whether it is largely independent of other streams. Given this, entities tend towards larger rather than smaller CGUs, to keep the complexity of the process within reasonable bounds.

IAS 36 also requires that identification of CGUs be consistent from period to period unless the change is justified; if changes are made and the entity records or reverses an impairment, disclosures are required. *[IAS 36.72, IAS 36.73]*.

Assets held for sale cannot remain part of a CGU. They generate independent cash inflows being the proceeds expected to be generated by sale. Once they are classified as held for sale, they will be accounted for in accordance with IFRS 5 and carried at an amount that cannot exceed their FVLCD (see section 5.1 below and Chapter 5 for a further discussion of IFRS 5's requirements).

3.3 CGUs and intangible assets

IAS 36 requires certain intangible assets to be tested at least annually for impairment (see section 2 above). These are intangible assets with an indefinite useful life and intangible assets that are not yet available for use. *[IAS 36.10, IAS 36.11]*.

Although these assets must be tested for impairment at least once a year, this does not mean that they have to be tested by themselves. The same requirements apply as for all other assets. The recoverable amount is the higher of the FVLCD or VIU of the individual asset or of the CGU to which the asset belongs (see section 3 above). If the individual intangible asset's FVLCD is lower than the carrying amount and it does not generate largely independent cash inflows, the CGU to which it belongs will be reviewed for impairment.

Many intangible assets do not generate independent cash inflows as individual assets and so they are tested for impairment with other assets of the CGU of which they are part. A trademark, for example, will generate largely independent cash inflows if it is licensed to a third party but more commonly it will be part of a CGU.

If impairment is tested by reference to the FVLCD or VIU of the CGU, impairment losses, if any, will be allocated in accordance with IAS 36. Any goodwill allocated to the CGU has to be written off first. After that, the other assets of the CGU, including the intangible asset, will be reduced *pro rata* based on their carrying amount (see section 11.2 below). *[IAS 36.104]*. However, the carrying amount of an asset cannot be reduced below the highest of its FVLCD, VIU or zero. If the preceding rule is applied, further allocation of the impairment loss is made *pro rata* to the other assets of the unit (group of units).

If the intangible asset is no longer useable then it must be written off, e.g., an in-process research and development project that has been abandoned, so it is no longer part of the larger CGU, and its own recoverable amount is nil. Intangible assets held for sale are treated in the same way as all other assets held for sale, see section 5.1 below.

3.3.1 Intangible assets as corporate assets

As discussed in section 3.1 above, many intangible assets do not generate independent cash inflows as individual assets and must therefore be tested for impairment with other assets of the CGU of which they are part. However, one question an entity would need to assess beforehand, is whether the intangible asset in question meets the corporate assets definition of IAS 36 "…assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units" or whether the intangible asset is a core asset to the cash-generating nature of a CGU? The judgement made in this respect can have a significant impact on the level at which CGUs are identified and therefore at which level assets are assessed for impairment. A careful consideration of all facts and circumstances is required to avoid carrying out impairment tests at a level that is too high with the result of masking potential impairments.

Assume a scenario where entity A acquires entity B. Entity B operates in a different industry to A. The reason for the acquisition was diversification with no expected cross synergies between A's and B's operations. Entity B sells product X under a European wide well-known brand and operates across Europe. Each country has its own manufacturing site from which mainly small local companies in the same country are served. Before the acquisition, entity B concluded that every manufacturing site in each country is a separate CGU. On acquisition of entity B an intangible asset for the brand is recorded in entity's A group financial statements. No goodwill was recorded. At which level is entity A required to set the CGUs for the acquired business? In this specific example, the single brand would not result in a determination that the CGU(s) of entity B's business are at the overall level of B. There are individual production sites in each European country from which customers in the same country are served and there is no cross selling of products to customers in other European countries, therefore independent cash inflows can be identified on a country level resulting in the identification of CGUs on a country level. The treatment of the brand would follow the guidance as set out in section 4.2 below for corporate assets, either because the brand is considered to be a corporate asset or by analogy.

On the other hand, if in the example above B was a professional services company operating across Europe and entity B's brand identifies entity B as one integrated pan-European service provider and markets itself to customers as such, the determination of CGU(s) of entity B's business at an overall level of B including the brand can be appropriate, particularly where a majority of the customers have a presence in multiple European countries and are looking for one supplier that can serve each local presence.

As explained above, the identification of CGUs involves judgement and a careful consideration of all facts and circumstances is required.

How we see it

In our view, significant judgement can be required when making the distinction between what constitutes a corporate asset and what is a core asset to the cash-generating nature of a group of assets. This is particularly true when it comes to intangible assets. Careful consideration of all facts and circumstances is required. When it comes to intangible assets like (corporate) brands and trademarks an entity often concludes that their nature is more akin to corporate assets to avoid setting the CGU level too high with the potential risk of masking impairments. This together with the requirement to allocate corporate assets to CGUs would avoid as well that these intangible assets are tested at a level that is too high.

On the other hand, an entity can have a brand driven business model and previous business acquisitions that resulted in the recognition of significant amounts of intangible assets with indefinite useful lives for brands and trademarks. In such a case, an entity can conclude that the main drivers for the CGU definition are the (individual) brands and trademarks. It is important to note that this does not mean that the brands and trademarks are tested on a stand-alone basis, they would rather be the driver for the CGU identification with allocation of all other assets needed to generate the largely independent cash inflows.

3.4 Leased assets and CGUs

Many right-of-use assets recorded under IFRS 16 will be assessed for impairment on a CGU level rather than on individual asset level. While there can be instances where leased assets generate largely independent cash inflows, many leased assets will be used by an entity as an input in its main operating activities whether these are service providing or production of goods related. If a right-of-use asset is tested on a stand-alone basis and is fully impaired, the entity would have to assess the need to recognise an additional onerous lease provision for amounts not already recognised in the lease liability (see Chapter 27 at section 6.2.1).

One question that can arise, particularly in relation to real estate leases, is what the unit of account for impairment purposes is. In other words, whether the right-of-use asset(s) resulting from a lease governed by one lease contract needs to be assessed and treated consistently on the overall contract level or whether for example the usage of different areas or floors of a leased building for different purposes could result in separate right-of-use assets for impairment assessments. Next to the general principle in IAS 36 on how assets contribute to the generation of independent cash inflows (individual asset, part of a CGU or as corporate asset), the answer to this question depends on whether the lease contract is over identifiable asset(s) portions that are physically distinct and therefore could effectively be separate units of account. In making this assessment, the guidance in IFRS 16.B20, IFRS 16.B32 (see Chapter 24 at sections 3.1.2 and 3.2.1) and IAS 40.10 (see Chapter 20 at section 2.7) could be considered. For leased assets/buildings that are used in parts for different purposes and where these portions are physically distinct, the usage and therefore the generation of independent cash inflows will drive the considerations under IAS 36. Judgement can be needed to determine the units of accounts of the right-of-use asset(s), and their allocation to different CGUs. This is shown in the following Illustration:

Illustration 3-6: Identification of CGUs - leased assets

Retail store chain M leases 5 floors in a 10-storey building. The floors are used as follows by M:

- Ground floor: used for M's store X, leasehold improvements were made at the beginning of the lease
- First floor and second floor: used for M's HR and marketing department
- Third floor: originally it was planned that the space would be utilised together with the fourth floor for the payroll department, but then floor four was sub-let to a law firm
- Fourth floor: currently unoccupied. While M tried to lease this floor, it has been difficult to find a tenant and M now expects that the floor will be empty through the end of the lease

Entity M signed one lease contract with the lessor for the five floors. The lease specifies the rent per floor, which equals the stand-alone price per floor. The building is configured in a way that every floor could be closed off, leased and used separately from the rest of the building.

As the five leased floors are used by entity M for different purposes and each floor is a physically distinguishable unit, M concluded that it needs to assess them separately in its CGU determination exercise.

In identifying CGUs for the stores, M considers whether, for example

(a) Internal management reporting is organised to measure performance on a store-by-store basis

(b) The business is run on a store-by-store profit basis or on a region/city basis

The leased ground floor is used for retail store X. The ground floor does not generate largely independent cash inflows from the store and is therefore assessed for impairment together with the store. All M's stores are in different neighbourhoods and were determined to have different customer bases. Although store X is managed at a corporate level, X generates cash inflows that are largely independent of those of M's other stores. M therefore concluded that store X is a separate CGU.

The leased first and second floor are used for marketing and human resources corporate functions. The part of the right-of-use-asset in relation to these floors is a corporate asset and is allocated on a reasonable and consistent basis to the CGUs to which it relates (see section 4.2.1 below).

The leased third floor is sub-let to a law firm. M assessed under the guidance of IFRS 16 whether the sublease is classified as a finance lease, resulting in de-recognition of the right-of-use asset and recording of a lease receivable equal to the amount of the net investment in the lease, or an operating lease, with continuing recognition of the right-of-use asset (see Chapter 24 at section 7.3). M's assessment classified the sub-lease as an operating lease. M elects to account for the investment property in relation to third floor under the cost model (see Chapter 20 at sections 2.1 and 7). Due to the sub-lease, this part of the right-of-use-asset generates largely independent cash inflows and must be assessed for impairment on a stand-alone basis. Floor four is unoccupied and not used for M's operating activities. M therefore determines that this part of the right-of-use asset needs to be assessed for impairment on a stand-alone basis by comparing the carrying amount with the recoverable amount (higher of VIU and FVLCD). As the floor is expected to be unoccupied through the end of the lease the VIU will be zero. The fact that M expects not to use the fourth floor or is no longer looking for a tenant does not necessarily mean the FVLCD is zero. M would need to determine the fair value under consideration of IFRS 13 (see Chapter 15) and in addition M would need to consider the need for any accelerated depreciation.

3.4.1 Decision to change the use of or abandon a right-of-use asset

When entities decide to change the use of or abandon right-of-use assets, they need to consider how such a decision must be assessed from an IAS 36 point of view. As highlighted in section 2 above, IAS 36.12(f) states that significant changes in the manner in which an asset is used, or expected to be used, is an internal source of information for indication of impairment. The entity's decision to change the use of the right-of-use asset (or the entity's conclusion that it has no realistic alternative but to do so) would, therefore, also indicate that an asset, a group of assets or CGU(s) can be impaired. This is particularly true when a store is to be closed or where the decision impacts the level at which the right-of-use asset is assessed for impairment. The existence of an impairment indicator would require an entity to perform an impairment test for the asset or CGU.

To perform an impairment test, an entity would first need to assess at which level such an impairment test must be performed. An entity's decision to change the expected use of a right-of-use asset raises the question of whether the expected use has changed in such a way that it affects the composition of the CGU and, if it does, when this change in the CGU determination is reflected. A decision to abandon or sublease a right-of-use asset impacts the CGU identification differently depending on the nature of the asset and how it is used by the entity. For example, each retail store is often determined to be a separate CGU. In contrast, administrative offices are often tested together with other assets in a CGU or classified as corporate assets and allocated on a reasonable and consistent basis to the CGUs to which they belong.

If an entity concludes that it needs to update its CGU(s), the entity first has to assess when the expected change in use would impact the CGU determination. One important consideration is whether and when the decision to change the use has been made by the level of management that is authorised to make such decisions. This will often be executive management and/or the board of directors. In addition, it would need to be assessed whether the entity has the ability to change the use in the expected manner or whether the lessor's approval is required.

The impact of the change in use will be different depending on the timing of the decision. In particular for real estate leases used as part of a larger CGU, it is important to consider how long the right-of-use asset is expected to be used within the current CGU and, therefore, continues to support the generation of cash inflows of the CGU. In addition, entities have to take into account the length of the remaining lease term and any other facts and circumstances that are relevant to the CGU assessment. Significant judgement will often be required and can, therefore, warrant additional disclosures in the financial statements.

The guidance in IAS 36.22(b), which requires an entity to determine the recoverable amount for an individual asset, even where an asset does not generate largely independent cash inflows, if the asset's value in use (VIU) can be estimated to be close to its fair value less costs of disposal (FVLCD) and its FVLCD can be measured, is of particular importance when it comes to real estate leases. *[IAS 36.22]*. In many jurisdictions, the real estate market is well developed and, therefore, the FVLCD of a right-of-use asset for real estate can be measured. The condition in IAS 36.22(b) that VIU can be estimated to be close to FVLCD for a right-of-use asset for real estate can be judged to be fulfilled where a right-of-use asset is to be used within its current CGU for only a short period of time before the abandonment or sublease occurs. In such circumstances, the right-of-use asset will have to be tested for impairment on a stand-alone basis.

When the right-of-use asset is to be used within the original CGU for only a short period of time before the abandonment or sublease occurs, one can, depending on facts and circumstances, also judge that the right-of-use asset and the CGU generate largely independent cash inflows. This would also mean that the right-of-use asset has to be tested for impairment on a stand-alone basis.

The longer the time between the decision to abandon or sublease the right-of-use asset and the actual change in use occurring, the less likely it is that the decision will immediately impact the level at which any impairment assessment has to be performed. The shorter the time between making the decision and the expected change in use occurring, the more likely it is that the expected change in use currently has to be reflected in the CGU determination and the resulting impairment test. If, having considered all facts and circumstances, it is concluded that the decision will not immediately impact the level at which any impairment assessment is performed, then an entity would still need to reassess the useful lives and residual values of the affected assets.

Illustration 3-7: Decision to change the use of or abandon a right-of-use asset

Scenario A - Abandonment of a right-of-use real estate asset

Entity X ('the entity') recognises a right-of-use asset for a building that it currently occupies as office space. The entity has occupied the building for nine years and has three years remaining on the original 12-year lease. The lease does not include an option to extend or terminate the lease. The right-of-use asset was always tested for impairment as part of CGU 1 as it was not generating largely independent cash inflows. There is significant headroom (i.e., the amount by which the recoverable amount exceeds the carrying amount) in CGU 1. As such, no impairment is identified at the level of CGU 1. It is assumed that the FVLCD of the right-of-use asset is measurable. With many employees working from home, the space is used in a substantially reduced way. Immediately prior to Entity X's year-end of 31 December 20X2, its board (in conjunction with management) made a final decision to permanently cease using the space. There will be a period of five months before the entity vacates the property where the space will continue to be used by CGU 1 to facilitate the transition. Entity X is not able to sublease the space given the location, relatively short remaining lease term and market conditions for office space.

The entity concludes that the decision is an impairment trigger for the right-of-use asset at the balance sheet date as it is considered an internal indicator of impairment as per IAS 36.12(f). In this fact pattern, a final decision to vacate the space has been made. The period between the decision and the date at which the entity will vacate the property is short and, therefore, its contribution to the cash inflows of the CGU is not expected to be significant. As the property cannot be subleased for the remaining lease term, the entity concludes that the right-of-use asset's FVLCD is also not expected to be significant and is expected to be close to the right-of-use asset's value in use. Therefore, the entity concludes that the right-of-use asset has to be tested separately from CGU 1 when the decision to vacate is made.

Scenario B - Subleasing of a right-of-use real estate asset

Entity X ('the entity') recognises a right-of-use asset for a building that it currently occupies as office space. The entity has occupied the building for nine years and has eleven years remaining on the original 20-year lease. The lease does not include an option to extend or terminate the lease. The right-of-use asset was always tested for impairment as part of CGU 1 as it was not generating largely independent cash inflows. There is significant headroom (i.e., the amount by which the recoverable amount exceeds the carrying amount) in CGU 1. As such, no impairment is identified at the level of CGU 1. It is assumed that the FVLCD of the right-of-use asset is measurable. With many employees working from home, the space is used in a substantially reduced way. Immediately prior to Entity X's year-end of 31 December 20X2, its board (in conjunction with management) made a final decision to permanently cease using the space. There will be a period of five months before the entity vacates the property where the space will continue to be used by CGU 1 to facilitate the transition. Entity X is permitted to sublease the property and has therefore engaged a property consultant who confirmed that there is a strong demand for properties in the area of the leased property.

The entity concludes that the decision is an impairment trigger for the right-of-use asset at the balance sheet date as it is considered an internal indicator of impairment as per IAS 36.12(f). In this fact pattern, a final decision to vacate the space has been made. The period between the decision and the date at which the entity will vacate the property is short and, therefore, its contribution to the cash inflows of the CGU are not expected to be significant as such the VIU of the right-of-use asset will mainly be driven by the achievable sublease rental income. The entity concludes that the right-of-use asset's FVLCD is expected to be close to the right-of-use asset's value in use. Therefore, the entity concludes that the right-of-use asset has to be tested separately from CGU 1 when the decision to vacate is made. Alternatively, due to the short period of own use of five months, the entity can also conclude that the right-of-use asset and the CGU generate largely independent cash inflows and therefore that the right-of-use asset has to be tested on a stand-alone basis for impairment.

The conclusion would likely be different, if in Scenario B the fact pattern were that the entity expected to use the right-of-use asset for another 30 months before vacating it and the start of a potential lease.

How we see it

Entities need to assess the potential impact of their decision to change the use of a right-of-use asset on their CGUs and, therefore, the level at which impairment assessments are performed. A decision to change the use of a right-of-use asset can result in the need to test the right-of-use asset on a stand-alone basis and, as such, can result in impairment. The shorter the time between the decision and the actual change in use occurring, the more likely the decision will impact the CGU identification.

3.5 Active markets and identifying CGUs

The standard stresses the significance of an active market for the output of an asset or group of assets in identifying a CGU. An active market is a market in which transactions take place with sufficient frequency and volume to provide pricing information on an ongoing basis. *[IFRS 13 Appendix A]*. If there is an active market for the output produced by an asset or group of assets, the assets concerned are identified as a CGU, even if some or all of the output is used internally. *[IAS 36.70]*. The reason given for this rule is that the existence of an active market means that the assets or CGU could generate cash inflows independently from the rest of the business by selling on the active market. *[IAS 36.71]*. It is important to note that IAS 36.71 states "…. if the entity could sell the output on an active market…" thereby making the ability of the entity to access the active market and sell its output on it an important consideration. If substantial restrictions to accessing the active market exist, then this must be considered when assessing the CGU determination and the relevant guidance of IAS 36.70 to 71. For example, if an output could not be sold on an active market without having essential infrastructure in place that would take significant time and effort to be developed, then this would impact the entity's ability to sell on the active market.

How we see it

When assessing the active market guidance of IAS 36.70 and the impact it has on the CGU determination, an entity would, in our view, need to consider substantial restrictions that exists which impacts the entity's ability to sell its output on an active market. While any restriction must be considered in determining whether the entity could sell its output on an active market, the restriction would need to be substantive to override IAS 36.70.

There are active markets for many metals, energy products (various grades of oil product, natural gas) and other commodities that are freely traded.

When estimating cash inflows for the selling CGU or cash outflows for the buying CGU, the entity will replace internal transfer prices with management's best estimate of the price in a future arm's length transaction. Note that this is a general requirement for all assets and CGUs subject to internal transfer pricing (see section 7.1.6 below).

Scenario A below, based on Example IE5 in IAS 36's accompanying section of illustrative examples, illustrates the point. Scenario B below describes circumstances in which the existence of an active market does not necessarily lead to the identification of a separate CGU.

Illustration 3-8: Identification of CGUs - internally-used products

Scenario A - Production of electricity for internal consumption

In the context of an entity's energy transition, an entity makes significant investments to create plant X, a solar photovoltaic power plant. The electricity produced by plant X will be used in plant Y's production process. X's output is sold to Y at an internal price that passes all margins to X. Transfer pricing is discussed in section 7.1.6 below.

If X can sell its electricity in an active market and generate cash inflows that are largely independent of the cash inflows from Y, it is likely that X is a CGU even though its electricity is used by Y. Therefore, its cash inflows can be regarded as being largely independent. It is likely that Y is also a separate CGU. However, internal transfer prices do not reflect market prices for X's electricity. Therefore, in determining value in use of both X and Y, the entity adjusts financial budgets/forecasts to reflect management's best estimate of future prices that could be achieved in arm's length transactions for those of X's products that are used internally.

If, on the other hand, X does not have the ability to sell its electricity on an active market, it is likely that the recoverable amount of each plant cannot be assessed independently of the recoverable amount of the other plant. The majority of X's production is used internally and cannot be sold in an active market. Cash inflows of X depend on demand for Y's products. Therefore, X cannot be considered to generate cash inflows that are largely independent of those of Y. In addition, the two plants are managed together. As a consequence, it is likely that X and Y together are the smallest group of assets that generates cash inflows that are largely independent. *[IAS 36.IE5-10]*.

Scenario B - 'Market' for intermediate product not relevant to identification of a separate CGU

A vertically integrated operation located in Australia produces an intermediate product that is fully used internally to manufacture the end product. The Australian market is the principal market for the intermediate product and there is no active market as defined by IFRS 13 (see Chapter 15) for it in Australia. The entity has only one other competitor in Australia, which is also vertically integrated and, likewise, uses the intermediate product internally. Both entities are, and have always been, very profitable when looking at their vertically integrated manufacturing processes to the end-stage product.

There is an active market for the intermediate product in China, but the prices at which the product can be sold are so low that a company based in Australia whose sole activity is to sell the intermediate product into China would never be profitable and a company would never set up manufacturing operations in Australia in order to sell into China.

Each of the Australian companies will occasionally sell small surpluses of their intermediate products into the active market in China, rather than make that product available to their competitor in Australia.

The existence of an active market for the intermediate product in China suggests that the operations involved have to be treated as a separate CGU. However, the mere existence of an active market somewhere in the world does not mean that the asset or CGU could realistically generate cash inflows independently from the rest of the business by selling on that active market. If such sales are a genuine incidental activity (i.e., if it is genuinely a case of obtaining some proceeds from excess product that would otherwise be scrapped), it can be appropriate not to regard that market as an active market for the intermediate product for IAS 36 purposes.

If the market is not regarded as an active market for IAS 36 purposes, the assets/operations involved in producing the intermediate product will not be treated as a separate CGU.

3.6 Flagship stores

Retailers can open and run so-called flagship stores in which case questions can arise on whether these stores are separate cash-generating units for the purpose of impairment testing and which cash flows to include in the test. While no formal definition of flagship stores exists, the retail sector identifies them as such as they share some common characteristics and purpose. In particular, these stores are frequently different from other stores in terms of location, size, decor, product offerings, services, purpose they serve and expectations about direct returns.

Flagship stores are seen to play a key role in a company's brand strategy and are the lead stores for retailers acting as a showcase for the brand. Over and above making sales, their purpose is to attract customers to the brand, create brand awareness, customer loyalty and to act as a marketing instrument. In addition, they are often used to test the market, re-position the brand, trial new products, assess retail store design concepts and act as a host venue for a range of promotional activities.

Common key characteristics are:

- Often the largest stores in a retailer's chain
- Situated in a prestigious location or high footfall area
- Experimental, inspirational and/or luxurious/opulent
- The size of the store, capital expenditures to build out the store and its operating costs are often significantly in excess of the retailer's other stores and often not justified by the level of expected direct sales from the store
- Inflow of economic benefits from flagship stores can be expected in the retailer's other stores or via online sales (see above Illustration 3-3: Omni-channel business model)

Not all of the above characteristics need to be present for a store to be considered a flagship store and it is possible that some are present to a larger or smaller extent.

Retailers can have more than one flagship store, whether that's one in each territory, or even more than one in the same city covering different prime locations. While some flagship stores do generate sufficient cash inflows to support the amounts spent on setting up and running the store and to generate a profit, many are budgeted to be loss making from the outset or do not require the same return as other stores.

Testing flagship stores for impairment is faced with the challenge of the dual nature of the stores, i.e., as a sales-generating unit and also playing a key role in a company's overall brand strategy. This dual nature can require a significant level of management judgement when assessing flagship stores for impairment.

3.6.1 Flagship store - CGU considerations

While flagship stores often play a key role in a company's overall brand strategy, their sales generating nature would need to be assessed under the IAS 36 definition of cash-generating unit.

How we see it

In our view, a flagship store generating largely independent cash inflows would need to be considered to be a separate CGU as the definition of a CGU under IAS 36 would be met.

It can be possible to argue for the aggregation of a flagship store with other stores in the area, the same neighbourhood or the same city into a single CGU, if the store has a local function to enhance the image of the brand, and therefore provides benefits to these stores as the cash inflows from these stores are not considered to be largely independent of each other. In rare circumstances, flagship stores are set up in a way that no or negligible independent cash inflows are generated via the store. For example, this is the case for experimental stores where the main purpose is for customers to experience an entity's new innovative products, but sales are expected to be generated via other channels. In such a case the flagship store would meet the definition of a corporate asset and assessed for impairment as such (see section 4.2 below).

3.6.2 Flagship store - Recoverable amount considerations - VIU

As mentioned above, some flagship stores are budgeted to be loss-making from the outset or do not require the same return as other stores. Management's investment decision for setting up the stores in such cases is in general supported by the benefits these stores provide to the overall business. This raises the question whether and how the provision of additional benefits to the overall business has to be considered in determining the VIU of a flagship store that is a separate CGU.

One can take the view that the added function of flagship stores does not have to be considered in determining the recoverable amount as it is largely marketing. As marketing expenditures are in general expensed when incurred, it would not necessarily be inconsistent to take an impairment loss when flagship stores are budgeted to be loss making. Under this view, an entity has to consider whether it must capitalise the costs of the flagship stores in the first place.

Alternatively, one can take the view that management's business rationale for setting up the stores could be considered in determining the VIU. In such a case, it can be appropriate to include arm's length charges in the VIU calculation for the services provided to other CGUs using the guidance in IAS 36.71. This is to reflect the amounts the flagship store could generate if it were to recharge for the benefits provided to other CGUs. To ensure consistency the benefiting CGUs would need to incorporate these charges in their recoverable amount model as well. Careful consideration would be required to determine which CGUs benefit from the flagship store and therefore which could be recharged for the services provided. While some flagship stores provide some level of benefit to the overall business of an entity, it is more likely that they support the territory they are located in especially for businesses that have more than one flagship store. In such a case we would expect the incorporation of the recharge to be limited to those stores.

How we see it

When assessing a flagship store for impairment, an entity could in our view incorporate arm's length charges in the value in use calculation to reflect the service provided to other CGUs. To ensure consistency an entity would need to reflect these recharges as costs when determining the VIU of the benefiting CGUs.

We would expect that the basis of an entity's impairment testing a flagship store is well documented from the outset, this is particularly important for cases where it is assumed that the strategy and corporate function of the flagship store warrants the inclusion of intragroup recharges. We would not expect a store to become a flagship store later in life of the store.

The following table provides an overview of the discussion above:

	Flagship store budgeted to generate largely independent cash inflows sufficient to support the amounts spent on setting up and running the store	Flagship store generates cash inflows interdependently with other stores in close vicinity	Flagship store generates largely independent cash inflows, but is budgeted to be loss making or much lower expected return than usual and provides benefits to the wider business	Flagship store does not generate largely cash inflows
Separate CGU?	Yes	No	Yes	No
Separate impairment test of flagship store?	Yes	No	Yes	No
Separate impairment test for non-flagship stores?	Yes	No, for the ones in close vicinity	Yes	Yes
Incorporation of intercompany recharges?	No	No	View A: No View B: Yes, can be appropriate to impute arm's length intragroup recharges.	No
Impairment test on a combined basis of flagship store and other stores?	No	Yes, with the ones in close vicinity	No	Yes, under consideration of the corporate asset guidance (see section 4.2 below).

4 Identifying the carrying amount of CGU assets

After an entity has established its CGU(s) for the impairment assessment, it needs to determine the carrying amount of the CGU(s). The carrying amount must be determined on a basis that is consistent with the way in which the recoverable amount is determined. *[IAS 36.75]*.

The carrying amount of a CGU includes only those assets that can be attributed directly or allocated on a reasonable and consistent basis. These must be the assets that will generate the future cash inflows used in determining the CGU's recoverable amount. It does not include the carrying amount of any recognised liability, unless the recoverable amount of the cash-generating unit cannot be determined without taking it into account. Both FVLCD and VIU of a CGU are determined excluding cash flows that relate to assets that are not part of the cash-generating unit and liabilities that have been recognised. *[IAS 36.76]*.

The standard emphasises the importance of completeness in the allocation of assets to CGUs. Every asset used in generating the cash flows of the CGU being tested must be included in the CGU; otherwise, an impaired CGU can appear to be unimpaired, as its carrying value would be understated by having missed out assets. *[IAS 36.77]*.

There are exceptions to the rule that recognised liabilities are not included in arriving at the CGU's carrying value or VIU. If the buyer would have to assume a liability if it acquired an asset or group of assets, then the FVLCD would be the price to sell the assets or group of assets and the liability together. The liability would then need to be deducted from the CGU's carrying amount and VIU. This will enable a meaningful comparison between carrying amount and recoverable amount, whether the latter is based on FVLCD or VIU. *[IAS 36.78]*. See section 4.1.1 below.

For practical reasons the entity can determine the recoverable amount of a CGU after taking into account assets and liabilities such as receivables or other financial assets, trade payables, pensions and other provisions that are outside the scope of IAS 36 and therefore not part of the CGU. *[IAS 36.79]*. If the VIU calculation for a CGU or its FVLCD are determined taking into account these sorts of items, then it is essential that the carrying amount of the CGU is determined on a consistent basis. However, this frequently causes confusion in practice, as described in section 4.1 below.

It is possible that other assets such as goodwill and corporate assets cannot be attributed on a reasonable and consistent basis. The standard has separate rules regarding their treatment. The allocation of goodwill is dealt with separately in section 8.1 below and corporate assets in section 4.2 below.

4.1 Consistency and the impairment test

Consistency is a very important principle underlying IAS 36. In testing for impairment entities must ensure that the carrying amount of the CGU is consistent for VIU and FVLCD calculations. In calculating VIU, or using a discounted cash flow methodology for FVLCD, entities must ensure that there is consistency between the assets and liabilities of the CGU and the cash flows taken into account, as there must also be between the cash flows and discount rate.

There are exceptions to the rule that recognised liabilities are not included in arriving at the CGU's carrying value. If the buyer would have to assume a liability if it acquired an asset or group of assets (CGU), then the fair value less costs of disposal of the CGU would be the price to sell the assets of the CGU and the liability together, less the costs of disposal. *[IAS 36.78]*. To provide a meaningful comparison this liability must then be deducted as well from the VIU and the carrying amount of the asset or group of assets (CGU).

The requirement in IAS 36 to deduct the liability from both the CGU's carrying amount and from its VIU avoids the danger of distortion that can arise when cash flows that will be paid to settle the contractual obligation are included in the VIU discounted cash flow calculation. If the liability cash flows are included in the VIU discounted cash flow calculation, they would potentially be discounted using a different discount rate to the rate used to calculate the carrying value of the liability causing distortion. See section 4.1.1 below for further discussion.

From a practical point of view an entity could simply calculate the VIU of a CGU excluding the liability cash outflows and compare that to the CGU carrying amount excluding the liability. While this would mean that the VIU is not comparable to the FVLCD, this would not cause an issue as long as the calculated VIU is above the CGU's carrying amount, therefore providing evidence that the CGU is not impaired.

It is also accepted in IAS 36 that an entity for practical reasons determines the recoverable amount of a CGU after taking into account assets and liabilities such as receivables or other financial assets, trade payables, pensions and other provisions that are outside the scope of IAS 36.

In all cases:

- The carrying amount of the CGU must be calculated on the same basis for VIU and FVLCD, i.e., including the same assets and liabilities.

  And

- It is essential that cash flows are prepared on a consistent basis to the assets and liabilities within CGUs.

In addition, some of these assets and liabilities have themselves been calculated using discounting techniques. Therefore, a danger of distortion arises resulting from differing discount rates, as discussed above.

4.1.1 Environmental provisions and similar provisions and liabilities

Paragraph 78 of IAS 36 illustrates liabilities that must be deducted from the carrying amount of the assets of a CGU because a buyer would assume the liability using an example of a mine in a country in which there is a legal obligation for the owner to restore the site by replacing the overburden. The restoration provision, which is the present value of the restoration costs, has been provided for and deducted from the carrying value of the assets of the CGU. It will be taken into account in the estimation of FVLCD but must also be deducted in arriving at VIU so that both methods of estimating recoverable amount are calculated on a comparable basis that aligns with the carrying amount of the CGU. *[IAS 36.78]*.

There are other provisions for liabilities that would be taken over by the purchaser of a CGU, e.g., property dilapidations or similar contractual restoration provisions. The provision will be accrued as the 'damage' is incurred and hence expensed over time rather than capitalised. If the provision is deducted from the assets of the CGU, then it must also be deducted in arriving at VIU and it has to be taken into account in the estimation of FVLCD.

Indeed, many provisions made in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* can be reflected in the CGU's carrying amount as long as they will be treated appropriately in arriving at the recoverable amount of the CGU.

Including the cash outflows that will be paid to settle the contractual obligation in the VIU discounted cash flow calculation bears the danger of distortion as the cash flows for impairment purposes will be discounted using a different rate to the rate used to calculate the provision itself. The carrying amount of this class of liability will reflect a discount rate suitable for provisions, based on the time value of money and the risks relating to the provisions. This is likely to be considerably lower than a suitable discount rate for an asset and the distortion caused by this would have to be considered and adjusted if the effect is significant. A simple illustration is that the present value of a cash outflow of CU100 in 10 years' time is CU39 discounted at 10% but CU68 if a discount rate of 4% is used. Deducting the respective cash flows discounted at the asset discount rate could result in an overstatement of the CGU's recoverable amount.

Therefore, to avoid the danger of distortion and to allow for a meaningful comparison between the carrying amount of the CGU and the recoverable amount, IAS 36 requires the carrying amount of the provision to be deducted in determining both the CGU's carrying amount and its VIU. *[IAS 36.78]*.

In 2015, the IFRS IC received a request to clarify the application of IAS 36.78. The submitter observed that the approach of deducting the liability from both the VIU and the CGU's carrying amount would produce a null result and therefore asked whether this was really the intention or whether an alternative approach was required.

In its November 2015 meeting, the IFRS IC observed that when the CGU's fair value less costs of disposal (FVLCD) considers a recognised liability then IAS 36.78 requires both the CGU's carrying amount and its VIU to be adjusted by the carrying amount of the liability. In the IFRS IC's view this approach provides a straightforward and cost-effective method to perform a meaningful comparison of the recoverable amount and the carrying amount of the CGU. Moreover, it observed that this approach is consistent with the requirement in IAS 36 to reflect the risks specific to the asset in the present value measurement of the assets in the CGU and the requirements in IAS 37 to reflect the risk specific to the liability in the present value calculation of the liability.

The IFRS IC therefore decided that neither an interpretation nor an amendment to a Standard was necessary and did not add this issue to its agenda.

As mentioned in section 4.1 above from a practical point of view an entity could calculate the VIU of a CGU without deducting the liability cash outflow and compare that to the CGU excluding the liability. As long as the calculated VIU is above the CGU's carrying amount no impairment would be required and the lack of comparability to the FVLCD would not cause an issue.

4.1.2 Lease liabilities under IFRS 16

A CGU can include a right-of-use asset recorded under IFRS 16. Right-of-use assets are assessed for impairment by applying IAS 36.

When it comes to lease arrangements, in most cases a CGU would be disposed of together with the associated lease arrangements. FVLCD for the CGU would consider the associated lease arrangements and therefore the need to make the contractual lease payments. This would require deducting the carrying amount of the lease liabilities when determining the carrying amount of the CGU.

It is important to note that lease payments reflected in the lease liability recorded in the statement of financial position will have to be excluded from the VIU calculation. If the carrying amount of the lease liabilities is deducted to arrive at the carrying amount of the CGU, the same carrying amount of the lease liabilities would need to be deducted from the VIU. IAS 36 does not allow the calculation of the VIU on a net basis directly, through reducing the future cash flows by the lease payments as this bears the risk of distortion that will arise due to the difference in the discount rate used for the VIU calculation and the discount rate used to calculate the carrying amount of the lease liability. *[IAS 36.78]*. See section 7.1.8 below for further discussion around VIU and lease payments.

4.1.3 Trade debtors and creditors

Whether an entity includes or excludes trade debtors and creditors in the assets of the CGU, it must avoid double counting the cash flows that will repay the receivable or pay those liabilities. This can be tricky because cash flows do not normally distinguish between cash flows that relate to working capital and other items. A practical solution often applied is to include working capital items in the carrying amount of the CGU and include the effect of changes in the working capital balances in the cash flow forecast.

The following simplified example is based on a finite life CGU and illustrates the effects of including and excluding initial working capital items.

Illustration 4-1: The effects of working capital on impairment tests

At the end of the year, Entity A's net assets comprise:

	CU
Carrying value of assets in CGU	100,000
Working capital: net liability	(800)

Its budgeted cash flows before interest and tax for the following five years, including and excluding changes in working capital, and their net present value using a 10% discount rate are as follows:

Year	1	2	3	4	5	6
	CU	CU	CU	CU	CU	CU
Pre-tax cash flow (1)	10,000	20,000	30,000	40,000	50,000	
Opening working capital	(800)	(1,500)	(3,000)	(4,500)	(6,000)	(7,500)
Closing working capital	(1,500)	(3,000)	(4,500)	(6,000)	(7,500)	
Change in working capital	700	1,500	1,500	1,500	1,500	(7,500)

Notes

(1) Cash flow before interest, excluding working capital changes

Year 5's closing working capital is treated as a cash outflow in year 6.

Cash flow including opening working capital	10,700	21,500	31,500	41,500	51,500	(7,500)
NPV at 10% discount rate	**107,251**					
Cash flow excluding opening working capital	11,500	21,500	31,500	41,500	51,500	(7,500)
NPV at 10% discount rate	**107,979**					

Including opening working capital:

	CU
Carrying value of CGU net of working capital	99,200
NPV of cash flow including opening working capital	107,251
Headroom	**8,051**

Excluding working capital:

	CU
Carrying value of CGU	100,000
NPV of cash flow excluding opening changes in working capital	107,979
Headroom	**7,979**

Note that the headroom is not exactly the same in both cases, due to the discounting effect of differences in the periods in which cash flows are incurred. Typically, the distortion caused by discounting will not be significant in relation to short-term working capital items. However, if significant, such distortion has to be adjusted.

Any other combination will not treat assets and cash flows consistently and will either overstate or understate headroom, e.g., it would be incorrect to compare the carrying value of the CGU net of the working capital (99,200) and the cash flows excluding the opening changes in working capital (107,979).

Illustration 4-1 above is based on a limited life CGU and therefore considers a cash outflow in the last year to settle the negative working capital balance. For a CGU with an indefinite life for which the value in use calculation includes a terminal value, a sustainable level of working capital investment in the terminal year of the cash flow forecast would need to be assumed.

In some industries it is common for companies to operate on a negative working capital basis. Negative working capital provides a cash flow benefit in earlier years that reverses in later years, and at the latest at the end of its life for a limited life CGU. This increases the value of the CGU in question. For a CGU for which the value in use calculation includes a terminal value, effectively assuming a perpetual life, careful consideration is required in determining the extent to which negative working capital balances are expected to continue into perpetuity and in determining a sustainable level of negative working capital balances to avoid overstating the value in use for the CGU in question.

4.1.4 Pensions

As mentioned in section 4 above, recognised liabilities are in general not included in arriving at the recoverable amount or carrying amount of a CGU.

Paragraph 79 of IAS 36 mentions pension obligations as items that for practical reasons can be included in calculating the recoverable amount of a CGU. In such a case, the carrying amount of the CGU is decreased by the carrying amount of those liabilities. *[IAS 36.79]*.

In practice, including cash flows for a pension obligation in the recoverable amount could be fraught with difficulty, especially if it is a defined benefit scheme, as there can be so many differences between the measurement basis of the pension liability and the cash flows that relate to pensions. Deducting the carrying amount of the pension obligation from both the value in use and the carrying amount of the CGU avoids this issue. If the pension liability is excluded from the carrying amount of the CGU, then any cash flows in relation to it cannot be considered in the value in use calculation and the pension liability cannot be deducted from the VIU.

Cash flows in relation to future services on the other hand, whether for defined contribution or defined benefit arrangements, always have to be included in calculating the recoverable amount as these are part of the CGU's ongoing employee costs. In practice, it can be difficult to distinguish between cash flows reflecting repayment of the pension liability and cash flows that are future employee costs of the CGU.

4.1.5 Cash flow hedges

In the case of a cash flow hedge in relation to highly probable forecasted transactions, it often makes no significant difference for short-term hedging arrangements if the hedging asset or liability and the hedging cash flows are included in the calculation of recoverable amount. The result is to gross up or net down the assets of the CGU and the relevant cash flows by an equivalent amount, after taking account of the distorting effects of differing discount rates. However, some entities argue to take into account cash flows from instruments hedging their sales or purchases that are designated as cash flow hedges under IFRS 9

because not to do so misrepresents their economic position. In order to do this, entities include the cash flows and either exclude the derivative asset or liability from the CGU or, alternatively, include the derivative asset or liability and reflect the related cash flow hedge reserve in the CGU as well (this latter treatment would not be a perfect offset to the extent of ineffectiveness). They argue that the cash flow hedges protect the fair value of assets through their effect on price risk. They also note that not taking cash flows from instruments hedging their sales or purchases introduces a profit or loss mismatch by comparison with instruments that meet the 'normal purchase/normal sale' exemption under which the derivative remains off balance sheet until exercised.

Although logical from an income perspective, IAS 36 does not support these arguments. The derivative asset or liability can only be included in the CGU as a practical expediency and the hedge reserve is neither an asset nor liability to be reflected in the CGU. As the carrying amount of the hedge instrument is a net present value, any impairment loss can be similar to that calculated by excluding the derivative financial instrument and its cash flows. However, there can be a difference between the two due to different discount rates being applied in the determination of the derivative's fair value and the determination of the VIU. IFRS 9 would not permit an entity to mitigate the effects of impairment by recycling the appropriate amount from the hedging reserve. Finally, entities must be aware that cash flow hedges can have negative values as well as positive ones.

Illustration 4-2: Cash flow hedges and testing for impairment

Entity A, which only has one CGU, enters into derivative contracts to hedge its commodity sales. These derivatives are accounted for as cash flow hedges and there is no ineffectiveness.

The entity is required to perform an impairment test.

Entity A's statement of financial position as at the impairment testing date is as follows:

	CU
Asset/CGU	3,000
Derivatives fair value	1,125
Equity - other reserves	(3,000)
Equity - cash flow hedge reserve	(1,125)

As at the impairment testing date, the entity's cash flow forecasts are as follows:

Year	20X0	20X1	20X2	20X3
	CU	CU	CU	CU
Forecast sales cash inflows		750	750	750
Forecast hedge cash inflows		450	450	450
Total cash inflows		**1,200**	**1,200**	**1,200**
NPV sales cash inflows	1,875	1,307	684	0
NPV total cash inflows (sales plus hedge cash inflows)	3,000	2,091	1,094	0
Fair value of hedge	**1,125**	**784**	**410**	**0**

IAS 36 requires the entity to exclude the cash flows from hedge transactions when calculating VIU. The carrying amount of the derivative is therefore excluded from the carrying amount of the cash-generating unit. The entity recognises an impairment loss of CU1,125 as follows:

	CU
Asset carrying amount	3,000
Recoverable amount (VIU)	1,875
Impairment loss	**(1,125)**

The entity is not prohibited from including within the VIU calculation the cash flows from a hedge instrument, provided the instrument's carrying amount is included within the carrying amount of the cash-generating unit and the effects of discounting are taken into account, thereby ensuring that the cash flows and carrying amount are consistently discounted. This approach would result in the same impairment of CU1,125.

4.2 Corporate assets

An entity can have assets that do not generate cash inflows independently of other assets or groups of assets and that contribute to more than one CGU, such as headquarters buildings or central IT facilities. IAS 36 calls such assets corporate assets. Corporate assets are defined as "…assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units". Corporate assets can include intangible assets like brands and trademarks (see section 3.3.1 above).

The characteristics that distinguish corporate assets are that they do not generate cash inflows independently of other assets or groups of assets and their carrying amount cannot be fully attributed to the CGU under review. *[IAS 36.100]*. Nevertheless, in order to test properly for impairment, the corporate asset's carrying value has to be tested for impairment along with the CGUs. Corporate assets therefore have to be allocated to the CGUs to which they belong and then tested for impairment along with those CGUs. *[IAS 36.101]*.

This presents a problem in the event of those assets themselves showing indications of impairment. It also raises a question of what those indications can be, in the absence of cash inflows directly relating to this type of asset. Some, but not all, of these assets can have relatively easily determinable fair values but while this is usually true of a headquarters building, it could not be said for a central IT facility. We have already noted in section 2.1.3 above that a decline in value of the asset itself does not always trigger a need for an impairment test, in particular when it is obvious that the CGUs of which corporate assets are a part are not showing any indications of impairment - unless, of course, management has decided to dispose of the asset. It is most likely that a corporate asset will show indications of impairment if the CGU or group of CGUs to which it relates are showing indications and this is reflected in the methodology by which corporate assets are tested.

If possible, the corporate assets are to be allocated to individual CGUs on a 'reasonable and consistent basis'. *[IAS 36.102]*. This is not expanded upon and affords some flexibility, although consistency is vital; the same criteria must be applied at all times. If the carrying value of a corporate asset can be allocated on a reasonable and consistent basis between individual CGUs, each CGU has its impairment test done separately and its carrying value includes its share of the corporate asset. When allocating corporate assets, entities should ensure there is no double counting by eliminating any intra-group charges for the use of the corporate assets from the CGU's cash flows. Some entities include a charge for the use of corporate assets rather than allocating the assets to CGUs or groups of CGUs. This is an acceptable approximation as long as entities ensure that the allocation is reasonable and that the total charge has the same NPV as the carrying amount of those assets and there is no impairment. Otherwise, there could be double counting or the omission of assets or cash outflows from CGUs or the misallocation of impairment to the assets of the CGU. Overheads are discussed further in section 7.1.7 below.

If the corporate asset's carrying value cannot be allocated on a reasonable and consistent basis to an individual CGU, there are three steps to consider:

1) The CGU (excluding the corporate asset) is tested for impairment and any impairment is recognised.
2) The smallest group of CGUs is identified to which, as a group, all or part of the carrying value of the corporate asset can be allocated on a reasonable and consistent basis. This group must include the CGU that was the subject of the first test.
3) All CGUs in this group have to be tested to determine if the group's carrying value (including the allocation of the corporate asset's carrying value) is in excess of the group's recoverable amount. *[IAS 36.102]*. If it is not sufficient, the impairment loss will be allocated *pro rata*, subject to the limitations of IAS 36.105, to all assets in the group of CGUs and the allocated portion of the corporate asset, as described in section 11.2 below.

In IAS 36's accompanying section of illustrative examples, Example 8 has a fully worked example of the allocation of corporate assets and calculation of a VIU. *[IAS 36.IE69-IE79]*. The table below is included in the example, and serves to illustrate the allocation of the corporate asset to CGUs:

Illustration 4-3: Allocation of corporate assets

An entity comprises three CGUs and a headquarters building. The carrying amount of the headquarters building of 150 is allocated to the carrying amount of each individual cash-generating unit. A weighted allocation basis is used because the estimated remaining useful life of A's cash-generating unit is 10 years, whereas the estimated remaining useful lives of B and C's cash-generating units are 20 years.

Schedule 1. Calculation of a weighted allocation of the carrying amount of the headquarters building

End of 20X0	A	B	C	Total
Carrying amount	CU100	CU150	CU200	**CU450**
Remaining useful life	10 years	20 years	20 years	
Weighting based on useful life	1	2	2	
Carrying amount after weighting	CU100	CU300	CU400	**CU800**
Pro rata allocation of the building	(100 ÷ 800)= 12%	(300 ÷ 800)= 38%	(400 ÷ 800)= 50%	**100%**
Allocation of the carrying amount of the building (based on *pro rata* above)	CU19	CU56	CU75	**CU150**
Carrying amount (after allocation of the building)	CU119	CU206	CU275	**CU600**

The standard does not require the allocation to be based on carrying value. In certain circumstances, financial measures such as revenue, employee numbers or a time basis are considered a valid basis.

One effect of this *pro rata* allocation process is that the amount of the head office allocated to each CGU will change as the useful lives and carrying values change. In the above example, the allocation of the head office to CGU A will be redistributed to CGUs B and C as A's remaining life shortens. Similar effects will be observed if the sizes of any other factor on which the allocation to the CGUs is made change relative to one another.

4.2.1 Leased corporate assets

Companies frequently enter into lease arrangements on a corporate level, such as a leased corporate headquarters or leased IT equipment. Under IFRS 16 these lease arrangements will result in the recognition of right-of-use assets. Similar to other corporate assets, the right-of-use assets carrying values have to be tested for impairment along with the CGUs they serve. An entity will frequently need to allocate the carrying amount of corporate right-of-use assets to (groups of) CGUs when performing the impairment test. As discussed in section 4.2 above, some entities include a charge for the use of corporate assets rather than allocating the assets to CGUs or groups of CGUs.

5 Recoverable amount

The standard requires the carrying amount of the asset or CGU to be compared with the recoverable amount, which is the higher of VIU and FVLCD. *[IAS 36.18]*. If either the FVLCD or the VIU is higher than the carrying amount, no further action is necessary as the asset is not impaired. *[IAS 36.19]*.

Recoverable amount is calculated for an individual asset, unless that asset does not generate cash inflows that are largely independent of those from other assets or groups of assets, in which case the recoverable amount is determined for the CGU to which the asset belongs. When the asset's value in use can be estimated to be close to its fair value less costs of disposal and the asset's fair value less costs of disposal can be measured, the recoverable amount of the individual asset must be determined. *[IAS 36.22]*.

Recoverable amount is the higher of FVLCD and VIU. IAS 36 defines VIU as the present value of the future cash flows expected to be derived from an asset or CGU. FVLCD is the fair value as defined in IFRS 13, being the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, less the costs of disposal. *[IAS 36.6]*.

Estimating the VIU of an asset involves estimating the future cash inflows and outflows that will be derived from the use of the asset and from its ultimate disposal and discounting them at an appropriate rate. *[IAS 36.31]*. There are complex issues involved in determining the cash flows and choosing a discount rate and often there is no agreed methodology to follow (see sections 7.1 and 7.2 below for a discussion of some of these difficulties).

Entities can estimate FVLCD, even in the absence of quoted prices in an active market for an identical asset. However, if there is no basis for making a reliable estimate then the value of an asset must be based on its VIU. *[IAS 36.20]*.

There are two practical points to emphasise. First, IAS 36 allows the use of estimates, averages and computational shortcuts to provide a reasonable approximation of FVLCD or VIU. *[IAS 36.23]*. Second, if the FVLCD is greater than the asset's/CGU's carrying value, no VIU calculation is necessary. It is not uncommon for the FVLCD of an asset to be readily obtainable while the asset itself does not generate largely independent cash inflows, as is the case with many property assets held by entities. If the FVLCD of the asset is lower than its carrying value, then the recoverable amount will have to be calculated by reference to the CGU of which the asset is a part. However, as explained in section 2.1.3 above, it can be obvious that the CGU to which the property belongs has not suffered an impairment. In such a case it would not be necessary to assess the recoverable amount of the CGU.

5.1 Impairment of assets held for sale

The standard describes circumstances in which it is appropriate to use an asset or CGU's FVLCD without calculating its VIU, as the measure of its recoverable amount. If there is no significant difference between FVLCD and VIU, the asset's FVLCD must be used as its recoverable amount. This is the case, for example, if management is intending to dispose of the asset or CGU, as apart from its disposal proceeds there will be few if any cash flows from further use. *[IAS 36.21]*.

The asset can also be held for sale as defined by IFRS 5, by which stage it will be outside the scope of IAS 36, although IFRS 5 requires such assets to be measured immediately before their initial classification as held for sale 'in accordance with applicable IFRS accounting standards'. *[IFRS 5.18]*. A decision to sell is a triggering event for an impairment test, which means that any existing impairment will be recognised at the point of classification and not be rolled into the gain or loss on disposal of the asset. See Chapter 5 for a description of the subsequent measurement of the carrying amounts of the assets.

Clearly IFRS 5's requirement to test for impairment prior to reclassification is intended to avoid impairment losses being recognised as losses on disposal. However, one effect is that this rule can result in the recognition of impairment losses on individual assets that form part of a single disposal group subsequently sold at a profit, as in the following Illustration.

Illustration 5-1: Impairment of assets held for sale

Entity A decided to sell three assets in one transaction to the same acquirer. Each asset had been part of a different CGU. The decision to sell was made on 20 December 20X0, just prior to Entity A's year end of 31 December. The assets met IFRS 5's requirements for classification as a disposal group on 10 January 20X1.

The information about the carrying amounts and fair values less cost of disposal of individual assets on 20 December 20X0 and the disposal group on 10 January 20X1 is summarised below. There was no change in the fair values of these assets between the two dates.

Asset	Carrying amount	FVLCD of separate assets	Aggregate of the lower of the carrying amount and FVLCD	Fair value of the group
	CU	CU	CU	CU
X	4,600	4,300	4,300	n/a
Y	5,700	5,800	5,700	n/a
Z	2,400	2,500	2,400	n/a
Total	**12,700**	**12,600**	**12,400**	**12,600**

Although these assets were classified as held for sale subsequent to the year end, the decision to sell them was an indicator of impairment. Accordingly, it is necessary to determine whether the three assets together comprise a new CGU. If so, impairment would be assessed on the three assets together, prior to reclassification and remeasurement under IFRS 5.

If the three assets together do not comprise a CGU, they would have to be tested for impairment individually at the year end, which would result in an impairment loss on Asset X of CU300. As there is no change in the recoverable amount between the year end and immediately before the classification under IFRS 5, the aggregate value of these assets prior to classification under IFRS 5 would be CU12,400 (4,300 + 5,700 + 2,400). The FVLCD of the disposal group at the date of the first application of IFRS 5 (10 January 20X1) is CU12,600. Therefore, according to the measurement criteria under IFRS 5 the carrying amount of the disposal group remains at CU12,400.

IAS 36 does not allow an asset to be written down below the higher of its VIU or FVLCD. *[IAS 36.105]*. An entity can, however, expect to sell a CGU for less than the apparent aggregate FVLCD of individual assets, e.g., because the potential buyer expects further losses. If this happens, the carrying amount of the disposal group under IFRS 5 is capped at the FVLCD of the disposal group as a whole so the impairment loss is allocated to all non-current assets, even if their carrying amounts are reduced below their individual FVLCD. See Chapter 5.

6 Fair value less costs of disposal (FVLCD)

IFRS 13 specifies how to measure fair value but does not change when fair value is required or permitted under IFRS accounting standards. IFRS 13 is discussed in detail in Chapter 15.

The standard defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It is explicitly an exit price. *[IFRS 13.2]*. When measuring FVLCD, fair value is measured in accordance with IFRS 13. Costs of disposal are calculated in accordance with IAS 36.

IFRS 13 specifically excludes VIU from its scope. *[IFRS 13.6]*.

Fair value, like FVLCD, is not an entity-specific measurement but is focused on market participants' assumptions for a particular asset or liability. *[IFRS 13.11]*. For non-financial assets, fair value has to take account of the highest and best use by a market participant to which the asset could be put. *[IFRS 13.27]*. An entity's current use of a non-financial asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximise the value of the asset. *[IFRS 13.29]*.

Entities are exempt from the disclosures required by IFRS 13 when the recoverable amount is FVLCD. *[IFRS 13.7(c)]*. IAS 36's disclosure requirements are broadly aligned with those of IFRS 13. See IAS 36's disclosure requirements in section 13 below.

While IFRS 13 makes it clear that transaction costs are not part of a fair value measurement, in all cases, FVLCD must take account of estimated disposal costs. IAS 36 defines costs of disposal as incremental costs directly attributable to the disposal of an asset or cash-generating unit, excluding finance costs and income tax expense. *[IAS 36.6]*. These include legal costs, stamp duty and other transaction taxes, costs of removing the asset and direct incremental costs to bring an asset into condition for its sale. Business reorganisation costs and employee termination costs (as defined in IAS 19, see Chapter 31) cannot be treated as costs of disposal. *[IAS 36.28]*.

If the disposal of an asset would entail the buyer assuming a liability and there is only a single FVLCD for both taken together, then, to enable a meaningful comparison, the obligation must also be taken into account in calculating VIU and the carrying value of the asset. This is discussed in section 4.1 above. *[IAS 36.29, IAS 36.78]*.

6.1 Estimating FVLCD

IFRS 13 does not limit the types of valuation techniques an entity can use to measure fair value but instead focuses on the types of inputs that will be used. The standard requires the entity to use the valuation technique that is"…maximising the use of relevant observable inputs and minimising the use of unobservable inputs". *[IFRS 13.61]*. The objective is that the best available inputs are used in valuing the assets. These inputs could be used in any valuation technique provided they are consistent with one of the three valuation approaches in the standard: the market approach, the cost approach and the income approach. *[IFRS 13.62]*. IFRS 13 does not place any preference on the techniques that are used as long as the entity achieves the objective of a fair value measurement, which means it must use the best available inputs. In some cases, a single valuation technique will be appropriate, while in other cases, multiple valuation techniques will need to be used to meet this objective. An entity must apply the valuation technique(s) consistently. A change in a valuation technique is considered a change in an accounting estimate in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.[1] *[IFRS 13.66]*.

The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (i.e., similar) assets, liabilities or a group of assets and liabilities, such as a business. *[IFRS 13.B5]*. For items within scope of IAS 36, market techniques will usually involve market transactions in comparable assets or, for certain assets valued as businesses, market multiples derived from comparable transactions. *[IFRS 13.B5, IFRS 13.B6]*.

The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (i.e., current replacement cost). It is based on what a market participant buyer would pay to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. Obsolescence includes physical deterioration, technological (functional) and economic obsolescence so it is not the same as depreciation under IAS 16. *[IFRS 13.B8, IFRS 13.B9]*. See also section 6.1.2 below.

1 The consequential amendments resulting from IFRS 18 *Presentation and Disclosure in Financial Statements*, once effective, changes the title of IAS 8 to 'Basis of Preparation of Financial Statements' to better reflect the amended content of IAS 8. See Chapter 4 for further details on the requirements of IFRS 18.

The income approach converts future amounts (e.g., cash flows or income and expenses) to a single discounted amount. The fair value reflects current market expectations about those future amounts. This will usually mean using a discounted cash flow technique or one of the other techniques that fall into this classification (e.g., option pricing and multi-period excess earnings methods). *[IFRS 13.B10, IFRS 13.B11]*.

See Chapter 15 for a further discussion of these valuation approaches.

The inputs used in these valuation techniques to measure the fair value of an asset have a hierarchy. Those that are quoted prices in an active market for identical assets (Level 1) have the highest priority, followed by inputs, other than quoted prices, that are observable (Level 2). The lowest priority inputs are those based on unobservable inputs (Level 3). *[IFRS 13.72]*. The valuation techniques, referred to above, will use a combination of inputs to determine the fair value of the asset.

An active market is a market in which transactions take place with sufficient frequency and volume to provide pricing information on an ongoing basis. *[IFRS 13 Appendix A]*.

Using the approach in IFRS 13, most estimates of fair value for IAS 36 purposes will use Level 2 inputs that are directly or indirectly observable and Level 3 inputs that are not based on observable market data but reflect assumptions used by market participants, including risk.

If Level 2 information is available then entities must take it into account in calculating FVLCD because this is a relevant observable input. Entities cannot base their valuation on Level 3 information only if Level 2 information is available.

IFRS 13 allows entities to use unobservable inputs, which can include the entity's own data, to calculate fair value, as long as the objectives (an exit price from the perspective of a market participant) and assumptions about risk are met. *[IFRS 13.87, IFRS 13.88, IFRS 13.89]*. This means that a discounted cash flow technique can be used if this is commonly used in that industry to estimate fair value. Cash flows used when applying the model can only reflect cash flows that market participants would take into account when assessing fair value. This includes the type, e.g., future capital expenditure, as well as the estimated amount of such cash flows. For example, an entity would like to take into account cash flows relating to future capital expenditure, which are not permitted for a VIU calculation (see section 7.1.2 below). These cash flows must be included if, and only if, other market participants would consider them when evaluating the asset. It is not permissible to include assumptions about cash flows or benefits from the asset that would not be available to or considered by a typical market participant.

The entity cannot ignore external evidence. It must use the best information that is available to it and adjust its own data if "…reasonably available information indicates that other market participants would use different data or there is something particular to the entity that is not available to other market participants such as an entity-specific synergy". An entity need not undertake exhaustive efforts to obtain information about market participant assumptions. "However, an entity shall take into account all information about market participant assumptions that is reasonably available." *[IFRS 13.89]*. This means using a relevant model, which requires consideration of industry practice. For example, multiples based on occupancy, revenue and EBITDA can be inputs in estimating the fair value of a hotel, but the value of an oilfield would depend on its reserves. The fair value of an oil field would include the costs that would be incurred in accessing those reserves based on the costs a market participant expects to incur instead of the entity's own specific cost structure.

IAS 36 notes that sometimes it is not possible to obtain reliable evidence regarding the assumptions and techniques that market participants would use (IAS 36 uses the phrase "…no basis for making a reliable estimate…"); if so, the recoverable amount of the asset must be based on its VIU. *[IAS 36.20]*. Therefore, the IASB accepts that there are some circumstances in which market conditions are such that it will not be possible to calculate a reliable estimate of the price at which an orderly transaction to sell the asset would take place under current market conditions. *[IAS 36.20]*. IFRS 13 includes guidance for identifying transactions that are not orderly. *[IFRS 13.B43]*. These are discussed in Chapter 15 at section 7.2.

6.1.1 FVLCD and the unit of account

In determining FVLCD it is critical to determine the relevant unit of account appropriately. This issue is discussed in detail in Chapter 15 at section 4.1.1.

6.1.2 Depreciated replacement cost or current replacement cost as FVLCD

Cost approaches, e.g., depreciated replacement cost (DRC) or current replacement cost, are one of the three valuation approaches that IFRS 13 considers to be appropriate for establishing FVLCD. Yet, the Basis for Conclusions of IAS 36 indicates that DRC is not suitable:

> "Some argue that the replacement cost of an asset should be adopted as a ceiling for its recoverable amount. They argue that the value of an asset to the business would not exceed the amount that the enterprise would be willing to pay for the asset at the balance sheet date."
>
> "IASC believed that replacement cost techniques are not appropriate to measuring the recoverable amount of an asset. This is because replacement cost measures the cost of an asset and not the future economic benefits recoverable from its use and/or disposal." *[IAS 36.BCZ28, IAS 36.BCZ29]*.

We do not consider that this means that FVLCD cannot be based on DRC. Rather, this means that DRC can only be used if it meets the objective of IFRS 13 by being a current exit price and not the cost of an asset. If the entity can demonstrate that the price that would be received for the asset is based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence, then (and only then) is DRC an appropriate basis for FVLCD. See Chapter 15 at section 13.3.1.

6.1.3 FVLCD consideration for assets that are carried at revalued amount

As stated in section 1.3 above, IAS 36 applies to assets carried at revalued amounts, e.g., under IAS 16 (or rarely IAS 38). The standard highlights that the only difference between an asset's fair value and its fair value less costs of disposal is the incremental costs directly attributable to the disposal of the asset. It further explains that if the disposal costs are negligible, the recoverable amount of the revalued asset is necessarily close to, or greater than, its revalued amount. In this case, after revaluation requirements have been applied, it is unlikely that the revalued asset is impaired and recoverable amount need not to be estimated. On the other hand, if the disposal costs are not negligible, the FVLCD is necessarily less than its fair value. Therefore, it cannot be concluded whether the revalued asset is impaired. In this case, after the revaluation requirements have been applied, an entity applies IAS 36 to assess whether the asset has indications of impairment and, if necessary, the CGU identification and VIU. *[IAS 36.5]*.

7 Determining value in use (VIU)

IAS 36 defines VIU as the present value of the future cash flows expected to be derived from an asset or CGU. The following IAS 36 extract states the required elements an entity would need to reflect in the VIU calculation: *[IAS 36.30]*

Extract from IAS 36

30 The following elements shall be reflected in the calculation of an asset's value in use:

(a) an estimate of the future cash flows the entity expects to derive from the asset;

(b) expectations about possible variations in the amount or timing of those future cash flows;

(c) the time value of money, represented by the current market risk-free rate of interest;

(d) the price for bearing the uncertainty inherent in the asset; and

(e) other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

The calculation requires the entity to estimate the future cash flows and discount them at an appropriate rate. *[IAS 36.31]*. It also requires uncertainty as to the timing of cash flows or the market's assessment of risk in those assets ((b), (d) and (e) above) to be taken into account either by adjusting the cash flows or the discount rate. *[IAS 36.32]*. The intention is that the VIU represents the expected present value of those future cash flows.

If possible, recoverable amount is calculated for the individual asset. However, it will frequently be necessary to calculate the VIU of the CGU of which the asset is a part. *[IAS 36.66]*. This is because the single asset often does not generate largely independent cash inflows. *[IAS 36.67]*.

Goodwill cannot be tested by itself, so it always has to be tested as part of a CGU or group of CGUs (see section 8 below).

Where a CGU is being reviewed for impairment, this will involve calculation of the VIU of the CGU as a whole unless a reliable estimate of the CGU's FVLCD can be made and the resulting FVLCD is above the total carrying amount of the CGU's net assets.

VIU calculations at the level of the CGU will thus be required when no satisfactory FVLCD is available or FVLCD is below the CGU's carrying amount and one of the following three apply:

- The CGU includes goodwill, intangibles with indefinite useful lives or intangibles not yet available for use which must be tested annually for impairment.
- A CGU itself is suspected of being impaired.

  Or
- Intangible assets or other fixed assets are suspected of being impaired and individual future cash flows cannot be identified for them.

The standard contains detailed requirements concerning the data to be assembled to calculate VIU that can best be explained and set out as a series of steps. The steps also contain a discussion of the practicalities and difficulties in determining the VIU of an asset. The steps in the process are:

1) Dividing the entity into CGUs (see section 3 above).
2) Allocating goodwill to CGUs or groups of CGUs (see section 8.1 below).
3) Identifying the carrying amount of CGU assets (see section 4 above).
4) Estimating the future pre-tax cash flows of the CGU under review (see section 7.1 below).
5) Identifying an appropriate discount rate and discounting the future cash flows (see section 7.2 below).
6) Comparing carrying value with VIU (assuming FVLCD is lower than carrying value) and recognising impairment losses (if any) (see sections 11.1 and 11.2 below).

Although this process describes the determination of the VIU of a CGU, steps 3 to 6 are the same as those that would be applied to an individual asset if it generated cash inflows independently of other assets. Impairment of goodwill is discussed in section 8 below.

7.1 Estimating the future pre-tax cash flows of the CGU under review

In order to calculate the VIU the entity needs to estimate the future cash flows that it will derive from its use and consider possible variations in their amount or timing. *[IAS 36.30]*. In estimating future cash flows the entity must consider the following guidance in IAS 36: *[IAS 36.33]*

Extract from IAS 36

33 In measuring value in use an entity shall:

(a) base cash flow projections on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset. Greater weight shall be given to external evidence.

(b) base cash flow projections on the most recent financial budgets/forecasts approved by management, but shall exclude any estimated future cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance. Projections based on these budgets/forecasts shall cover a maximum period of five years, unless a longer period can be justified.

(c) estimate cash flow projections beyond the period covered by the most recent budgets/forecasts by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified. This growth rate shall not exceed the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used, unless a higher rate can be justified.

7.1.1 Budgets and cash flows

The standard describes in some detail the responsibilities of management towards the estimation of cash flows. Management is required to ensure that the assumptions on which its current cash flow projections are based are consistent with past actual outcomes by examining the causes of differences between past cash flow projections and actual cash flows. If actual cash flows have been consistently below projected cash flows, then management has to investigate the reason for it and assess whether the current cash flow projections are realistic or require adjustment. *[IAS 36.34]*.

IAS 36 states that the cash flows must be based on the most recent budgets and forecasts for a maximum of five years because reliable forecasts are rarely available for a longer period. If management is confident that its projections are reliable and can demonstrate this from past experience, it can use a longer period. *[IAS 36.35]*. In using budgets and forecasts, management is required to consider whether these really are the best estimate of economic conditions that will exist over the remaining useful life of the asset. *[IAS 36.38]*. In particular the standard observes that estimated cash flows and discount rates must be free from both bias and factors unrelated to the asset in question. *[IAS 36.A3]*.

An example of the use of cash flow projections for a period shorter than five years is given by Crayon Group Holding ASA. The following extract from the annual report of Crayon Group Holding ASA refers to the financial budget covering a single year.

Practical example 7-1: Crayon Group Holding ASA (2023) Norway

Annual Report 2023 [extract]
Financials [extract]
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS [extract]
NOTE 9 Goodwill [extract]

Budget and forecast period
The basis for the projection of the future cash flows estimated is based on the financial budget of one year. The budget in combination with the forecasts represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset. Previous year budgets are tested for reliability and adjusted in case of underperformance. The remaining four years of the forecast period are estimated based on budget and projected performance.

How we see it

While IAS 36 requires cash flow projections to be based on the most recent financial budgets/forecasts approved by management, in our view it is usually appropriate and required to revise forecasts where the economic environment or conditions have changed since the most recent financial budgets and forecasts were approved by management. As the frequency and impact of revisions increases, entities need to consider reducing the period included in the cash flow projections.

This stage of the impairment test illustrates the point that it is not only fixed assets that are being assessed. The future cash flows to be forecast are all cash flows - receipts from sales, purchases, administrative expenses, etc. It is akin to a free cash flow valuation of a business with the resulting valuation then being compared to the carrying value of the assets in the CGU.

As explained in the following standard extract, the cash flow forecast must include three elements: *[IAS 36.39]*

Extract from IAS 36

39 **Estimates of future cash flows shall include:**

(a) projections of cash inflows from the continuing use of the asset;

(b) projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset (including cash outflows to prepare the asset for use) and can be directly attributed, or allocated on a reasonable and consistent basis, to the asset; and

(c) net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life.

Cash flows can be estimated by taking into account general price changes caused by inflation (nominal terms), or on the basis of stable prices (real terms). If inflation is excluded from the cash flow, then the discount rate selected must also be adjusted to remove the inflationary effect. *[IAS 36.40]*. Generally, entities will use whichever method is most convenient to them that is consistent with the method they use in their budgets and forecasts. It is, of course, fundamental that cash flows and discount rate are both estimated on a consistent basis.

An example of the inclusion of general price changes caused by inflation is given by CARLSBERG A/S. The following extract from the annual report of Carlsberg A/S refers to the effects of inflationary pressure on both sales prices and input costs.

Practical example 7-2: CARLSBERG A/S (2023) **Denmark**

ANNUAL REPORT 2023 [extract]
CONSOLIDATED FINANCIAL STATEMENTS [extract]
Notes [extract]
SECTION 2 ASSET BASE AND RETURNS [extract]
SECTION 2.2 IMPAIRMENT [extract]
2.2.3 IMPAIRMENT TEST OF GOODWILL [extract]
ACCOUNTING ESTIMATES AND JUDGEMENTS [extract]
Key assumptions [extract]

Sales prices

The level of market premiumisation and the locally available portfolio are key drivers in identifying price points. When planning pricing structures, factors including price elasticity, local competition and inflation expectations can also impact the projection. Increases in excise duties are typically passed on to the customers immediately or with a delay of no more than a few months. Since the increase is a pass-through cost and thereby compensated for by price increases at the time of implementation, it does not impact the long-term sales price growth and is therefore not taken into consideration in the projections unless circumstances specifically indicate otherwise. No changes to duties in the short or medium term are taken into consideration unless there is a firm plan to introduce changes.

Recent significant inflationary pressure has meant revenue growth compensating for rising input costs, especially in Europe. The short- and medium-term forecast includes the risk of delays in increasing sales prices to compensate for future rises in input costs.

Input costs

Input costs in the budget and target plans are based on past experience and on:

- Contracted raw and packaging materials
- Contracted services within sales, marketing, production and logistics
- Planned commercial investments
- Cost optimisations not related to restructurings
- Expected inflation

The recent years' elevated level of inflation has increased the overall input cost level, especially in Europe. The short- and medium-term forecast incorporates continued pressure on input costs.

In the long term, projections follow the level of inflation unless long-term contracts are in place.

Whereas IAS 36 requires the cash flow projections to be based on the most recent financial budgets/forecasts approved by management, significant adjustments can be necessary to ensure the resulting future cash flows satisfy the requirements of the standard (for example the exclusion of lease payments included in lease liabilities or cash flows that are expected to arise from improving or enhancing the asset's performance). Depending on the entity's facts and circumstances, these adjustments can require significant effort and judgement. It is important for entities to consider materiality when determining the extent to which the task can be simplified.

In some cases, entities are receiving government grants and these cash flows are part of the recoverable amount, for example government grants intended to compensate the asset or CGU's operating costs such as employee benefits or commodities. Entities should carefully consider the conditions of any government grant in order to assess whether the inclusion of such amounts in the impairment test is based on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset or CGU.

To avoid the danger of double counting, the future cash flows exclude those relating to financial assets, including receivables and liabilities such as payables, pensions and provisions. *[IAS 36.43]*. However, section 4 above notes that IAS 36.79 allows the inclusion of such assets and liabilities for practical reasons, in which case the cash flows must be reflected as well, and includes a discussion of some of the assets and liabilities that entities can choose to reflect together with the implications of doing so. *[IAS 36.79]*.

The expected future cash flows of the CGU being assessed for impairment must not include cash inflows or outflows from financing activities (including lease payments included in lease liabilities) or tax receipts or payments. This is because financing costs are considered by discounting the estimated future cash flows (hence, the time value of money is already considered), hence including cash inflows or outflows from financing activities would result in double counting. *[IAS 36.50, IAS 36.51]*.

7.1.2 Cash inflows and outflows from improvements and enhancements

Whilst a part-completed asset must have the costs to complete it included in the cash flows, *[IAS 36.42]*, the general rule is that future cash flows must be forecasted for CGUs or assets in their current condition. Forecasts must not include estimated future cash inflows or outflows that are expected to arise from improving or enhancing the asset's performance. *[IAS 36.44]*. Projections of cash flow must include costs of day-to-day servicing that can be reasonably attributed to the use of the asset (for overheads see section 7.1.7 below). *[IAS 36.41]*.

While the restriction on enhanced performance is understandable, it adds an element of unreality that is hard to reconcile with other assumptions made in the VIU process. For example, the underlying future cash flows that the standard requires management to use will obviously be based on the business as it is actually expected to develop in the future, growth, improvements and all. Producing a special forecast based on unrealistic assumptions, even for this limited purpose, can be difficult.

Nevertheless, IAS 36.48 explicitly states that improvements to the current performance of an asset cannot be included in the estimates of future cash flows until the entity incurs the expenditure that provides those improvements. The treatment of such expenditure is illustrated in Example 6 in the standard's accompanying section of illustrative examples. *[IAS 36.48]*. The implication of this requirement is that if an asset is impaired, and even if the entity is going to make the future expenditure to reverse that impairment, the asset will still have to be written down. Subsequently, the asset's impairment can be reversed, to the degree appropriate, after the expenditure has taken place. Reversal of asset impairment is discussed in section 11.4 below.

IAS 36 makes it clear that for a part-completed asset, all expected cash outflows required to make the asset ready for use or sale must be considered in the estimate of future cash flows and mentions a building under construction or a development project as examples. *[IAS 36.42]*. The standard is also clear that the estimate of future cash flows must not include the estimated future cash inflows that are expected to arise from the increase in economic benefits associated with cash outflows to improve or enhance an asset's performance until an entity incurs these cash outflows. *[IAS 36.48]*. This raises the question of what to do once a project to enhance or improve the performance of an asset or a CGU has commenced, and it has started to incur cash outflows.

How we see it

In our view, once an entity is committed to a future restructuring or an asset is under construction (but not yet ready for use or sale), an entity must consider future cash inflows that are expected to arise from the increase in economic benefits associated with the cash outflows to improve or enhance the asset. Important to note is that it must take into consideration all future cash outflows required to complete the project and any risks in relation with the project, reflected either in the cash flows or the discount rate.

An assumption of new capital investment is in practice intrinsic to the VIU test. What has to be assessed are the future cash flows of a productive unit such as a factory or hotel. The cash flows, out into the far future, will include the sales of product, cost of sales, administrative expenses, etc. They must necessarily include capital expenditure as well, at least to the extent required to keep the CGU functioning as forecast. This is explicitly acknowledged in the standard: *[IAS 36.49]*

Extract from IAS 36

49 Estimates of future cash flows include future cash outflows necessary to maintain the level of economic benefits expected to arise from the asset in its current condition. When a cash-generating unit consists of assets with different estimated useful lives, all of which are essential to the ongoing operation of the unit, the replacement of assets with shorter lives is considered to be part of the day-to-day servicing of the unit when estimating the future cash flows associated with the unit. Similarly, when a single asset consists of components with different estimated useful lives, the replacement of components with shorter lives is considered to be part of the day-to-day servicing of the asset when estimating the future cash flows generated by the asset.

Accordingly, some capital expenditure cash flows must be built into the future cash flows. Whilst improving capital expenditure cannot be recognised, routine or replacement capital expenditure necessary to maintain the function of the asset or assets in the CGU has to be included. Entities must therefore distinguish between maintenance, replacement and enhancement expenditure. This distinction is not always easy to draw in practice, as shown in the following Illustration.

Illustration 7-1: Distinguishing enhancement and maintenance expenditure

A telecommunications company provides fixed line, telephone, television and internet services. It must develop its basic transmission infrastructure (by overhead wires or cables along streets or railway lines, etc.) and in order to service a new customer it will have to connect the customer's home via cable and other equipment. It will extend its network to adjoining areas and perhaps acquire an entity with its own network. It will also reflect changes in technology, e.g., fibre optic cables replacing copper ones.

Obviously, when preparing the budgets which form the basis for testing the network for impairment, it will make assumptions regarding future revenue growth and will include the costs of connecting those customers. However, its infrastructure maintenance spend will inevitably include replacing equipment with the current technology. There is no option of continuing to replace equipment with something that has been technologically superseded. Once this technology exists, it will be reflected in the entity's budgets and taken into account in its cash flows when carrying out impairment tests, even though this new equipment will enhance the performance of the transmission infrastructure.

How we see it

Where an asset is damaged, IAS 36 considers this physical damage as an indicator of impairment. As a second step, in some cases, as noted above, the replacement or repair of the asset is considered to meet the definition of maintenance expenditure that is included in the future cash flows. We believe in that case any related insurance recoveries should also be included in the future cash flows in case this relates to the repair or replacement of the damaged asset and the inclusion of such amounts in the impairment test is based on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset.

Illustration 7-2: Insurance recovery for damage incurred

Directors' report - Material business risks

The entity's operating facility is located in an area prone to flooding, which could significantly damage the asset. To manage this exposure, the entity enters into insurance contracts.

Financial statements - Impairment

The entity has a 31 December 20X1 financial year end. In November 20X1, the entity's operating facility was physically damaged due to a flood.

The carrying value of the operating facility was reduced following the derecognition of the damaged components. Although the entity has insurance covering the damage, on 31 December 20X1, it was not virtually certain this would be received (e.g., subject to the insurer accepting the claim). Therefore, the entity has not recognised an insurance receivable.

Management identified the impact of the flooding as an impairment indicator and used a value in use calculation to determine the recoverable amount. For impairment testing purposes, management determined the operating facility doesn't generate largely independent cash inflows from other production assets. Hence, the impairment test is performed at the level of the whole production site, being the smallest identifiable CGU.

The cash flow forecast considered the impact of flooding by:

- increasing insurance premiums,
- expense to repair damage caused to bring the asset back into the same state as before the damage (i.e., not enhancing the asset), and
- insurance recovery.

The cash flow forecast is based on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the operating facility.

When the entity repairs the operating facility, it accounts for the expenses in accordance with IAS 16. Once the entity becomes virtually certain of being reimbursed by the insurer, it recognises a receivable in accordance with IAS 37.

At the next reporting period end, the entity again identifies impairment indicators and performs an impairment test. The carrying value of the CGU containing the operating facility is assumed to have increased because of the capitalisation of the replacement components. The receipt of insurance proceeds decreases the recoverable amount. The reason is that the cashflow forecast no longer includes the cash inflows from the insurance proceeds as they are now received and recognised as a receivable. If consequently the recoverable value of the CGU has reduced below its carrying value, an impairment expense needs to be recognised.

Further examples indicate another problem area - the effects of future expenditure that the entity has identified but which the entity has not yet incurred. One example is an entity that has acquired an asset with the intention of enhancing it in future and, therefore, has paid for future synergies which will be reflected in the calculation of goodwill. Another example is an entity with plans for an asset that involve expenditure that will enhance its future performance and without which the asset is impaired.

Examples could include:

- A social media company that, in acquiring another, would expect to pay for the future right to migrate users from the competing platform to its own platform.

  Or

- An aircraft manufacturer that expects to be able to use one of the acquired plants for a new model at a future point, a process that will involve replacing much of the current equipment.

In both cases the long-term plans reflect both the capital spent and the cash flows that will flow from it. There is no obvious alternative to recognising an impairment when calculating the VIU of the CGU or group of CGUs as IAS 36 insists that the impairment test has to be performed for the asset in its current condition. This means that it is not permitted to include the benefit of improving or enhancing the asset's performance in calculating its VIU.

An entity in this situation can avoid or reduce an impairment loss by calculating the appropriate FVLCD, as this is not constrained by rules regarding future capital expenditure. As discussed above, these cash flows can be included only to the extent that other market participants would consider them when evaluating the asset. It is not permissible to include assumptions about cash flows or benefits from the asset that would not be available to or considered by a typical market participant.

An example of the inclusion of capital expenditure cash flows in the forecasted cash flows is given by ArcelorMittal. The following extract from the annual report of ArcelorMittal refers to the inclusion of future decarbonization capital expenditures.

Practical example 7-3: ArcelorMittal (2023) **Luxembourg**

Annual Report 2023 [extract]

Consolidated Financial Statements [extract]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS [extract]

NOTE 5: GOODWILL, INTANGIBLE AND TANGIBLE ASSETS [extract]

5.3 Impairment of intangible assets, including goodwill, and tangible assets [extract]

The Company considered its exposure to certain climate-related risks which could affect its estimates of future cash flow projections applied for the determination of the recoverable amount of its GCGUs and CGUs. With the switch to electric vehicles and the move to wind and solar power generation, the Company sees also additional opportunities as customers deepen their understanding of embedded and lifecycle emissions of the materials where steel compares favorably.

The Company is committed to the objectives of the Paris agreement and announced its ambition to reduce carbon emissions by 35% in Europe and 25% group-wide by 2030 and achieve group-wide carbon neutrality by 2050. These announced goals will require significant long-term investments which require global level playing field, access to abundant and affordable clean energy, facilitating necessary energy infrastructure, access to sustainable finance for low-emissions steelmaking and accelerated transition to a circular economy. In addition, the Company considered the legal obligation of carbon neutrality by 2050 effective within the EU and in Canada following adoption of the Climate Law and the Net Zero Emission Accountability Act, respectively. Accordingly, with respect to its flat steel operations in the EU and in Canada, ArcelorMittal concluded that future decarbonization capital expenditures, which correspond essentially to the construction of DRI-EAF facilities, are necessary to maintain the level of economic benefits expected to arise from the assets in their current condition and should therefore be included in the Company's assumptions for future cash flows of the recoverable amount of the respective GCGUs and CGUs. At the same time, the Company is engaged in developing in the near to medium term a range of innovative low-emission technologies for the transition to decarbonized steel including the Smart Carbon route and the Hydrogen-DRI route and required investments are considered in the Company's future cash flow projections. ArcelorMittal acknowledges that CGUs and GCGUs applying the BF-BOF route in other jurisdictions than the EU and Canada will apply decarbonization at a different pace. They may also not yet be subject to a legal obligation of carbon neutrality, as a result of which the future estimated decarbonization cost for such operations is reflected through an additional risk premium embedded in discount rates until they are able to accelerate their decarbonization strategy to meet the 2050 carbon neutrality objective and a legal obligation arises in the relevant jurisdiction.

...

7.1.3 Restructuring

The standard contains similar rules with regard to any future restructuring that affects the VIU of the asset or CGU. The prohibition on including the results of restructuring applies only to those plans to which the entity is not committed. Again, this is because of the general rule that the cash flows must be based on the asset in its current condition so future events that change that condition are not to be taken into account. *[IAS 36.44, IAS 36.45]*. When an entity becomes committed to a restructuring (as set out in IAS 37 see Chapter 27), IAS 36 then allows an entity's estimates of future cash inflows and outflows to reflect the cost savings and other benefits from the restructuring, based on the most recent financial budgets/forecasts approved by management. *[IAS 36.46, IAS 36.47]*. Treatment of such a future restructuring is illustrated by Example 5 in the standard's accompanying section of illustrative examples. The standard specifically points out that the increase in cash inflows as a result of such a restructuring is not taken into account until after the entity is committed to the restructuring. *[IAS 36.47]*.

Entities will sometimes be required to recognise impairment losses that will be reversed once the expenditure has been incurred and the restructuring completed.

7.1.4 Future cash flows after the forecast period

In the case of non-current assets, a large component of value attributable to an asset or CGU arises from its terminal value, which is the net present value of all of the forecasted free cash flows that are expected to be generated by the asset or CGU after the explicit forecast period. IAS 36 includes specific requirements if the asset is to be sold at the end of its useful life. The disposal proceeds and costs must be based on current prices and costs for similar assets, adjusted if necessary for price level changes if the entity has chosen to include this factor in its forecasts and selection of a discount rate. The entity must take care that its estimate is based on a proper assessment of the amount that would be received in an arm's length transaction. *[IAS 36.52, IAS 36.53]*.

Whether the life of an asset or CGU is considered to be finite or indefinite will have a material impact on the terminal value. It is therefore of the utmost importance for management to assess carefully the cash generating ability of the asset or CGU and whether the period over which this asset or CGU is capable of generating cash flows is defined or not. While many CGUs containing goodwill will have an indefinite life, the same is not necessarily true for CGUs without allocated goodwill. For example, if a CGU has one main operating asset with a finite life, as in the case of a mine, the cash flow period needs to be limited to the life of the mine. Whether it would be reasonable to assume that an entity would replace the principal assets of a CGU and therefore whether it would be appropriate to calculate the terminal value under consideration of cash flows into perpetuity will depend on the specific facts and circumstances.

In the case of assets or CGUs with indefinite useful lives, the terminal value is calculated by having regard to the forecasted maintainable cash flows that are expected to be generated by the assets or CGUs in the final year of the explicit forecast period ('the terminal year'). It is essential that the terminal year cash flows reflect maintainable cash flows as otherwise any material one-off or abnormal cash flows that are forecast for the terminal year will inappropriately increase or decrease the valuation.

The maintainable cash flow expected to be generated by the asset or CGU is then capitalised by a perpetuity factor based on either:

- The discount rate if cash flows are forecast to remain relatively constant

  Or

- The discount rate less the long-term growth rate if cash flows are forecast to grow

Care is required in assessing the growth rate to ensure consistency between the long-term growth rate used and the assumptions used by the entity generally in its business planning. IAS 36 requires an entity to use in the VIU calculation a steady or declining growth rate for subsequent years, unless an increasing rate can be justified. This growth rate must not exceed the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used, unless a higher rate can be justified. *[IAS 36.33]*.

Only in exceptional circumstances can an increasing growth rate be used or can the period before a steady or declining growth rate be assumed to extend to more than the next five years. This five-year rule is based on general economic theory that postulates above-average growth rates will only be achievable in the short-term, because such above-average growth will lead to competitors entering the market. This increased competition will, over a period of time, lead to a reduction of the growth rate, towards the average for the economy as a whole. IAS 36 suggests that entities will find it difficult to exceed the average historical growth rate for the products, countries or markets over the long-term, say twenty years. *[IAS 36.37]*.

7.1.5 Foreign currency cash flows

Foreign currency cash flows are first estimated in the currency in which they will be generated and then discounted using a discount rate appropriate for that currency. An entity translates the present value calculated in the foreign currency using the spot exchange rate at the date of the value in use calculation. *[IAS 36.54]*. This is to avoid the problems inherent in using forward exchange rates, which are based on differential interest rates. Using such a rate would result in double-counting the time value of money, first in the discount rate and then in the forward rate. *[IAS 36.BCZ49]*. However, the method requires an entity to perform, in effect, separate impairment tests for cash flows generated in different currencies but make them consistent with one another so that the combined effect is meaningful. This is an extremely difficult exercise. Many different factors need to be taken into account including relative inflation rates and relative interest rates as well as appropriate discount rates for the currencies in question. Because of this, the possibility for error is great and the greatest danger is understating the present value of cash outflows by using too high a discount rate. In practice, valuers can assist entities to obtain a sufficiently accurate result by assuming that cash flows are generated in a single currency even though they are received or paid in another. Significantly, the rate used to translate the cash flows could well be different from that used to translate the foreign currency assets, goodwill and liabilities of a subsidiary at the period end. For example, a non-monetary asset such as an item of property, plant and equipment can be carried at an amount based on exchange rates on the date on which it was acquired but generates foreign currency cash flows. In order to determine its recoverable amount if there are indicators of impairment, IAS 21 *The Effects of Changes in Foreign Exchange Rates* states that the recoverable amount will be calculated in accordance with IAS 36 and the present value of the cash flows translated at the exchange rate at the date when that value was determined. *[IAS 21.25]*. IAS 21 notes that this can be the rate at the reporting date. The VIU is then compared to the carrying value and the item is then carried forward at the lower of these two values.

7.1.6 Internal transfer pricing

If the cash inflows generated by the asset or CGU are based on internal transfer pricing, the best estimate of an external arm's length transaction price must be used in estimating the future cash flows to determine the asset's or CGU's VIU. *[IAS 36.70]*. Note that this applies to any cash inflow once a CGU has been identified; it is not restricted to CGUs that have been identified because there is an active market for their outputs, which are described in section 3.3 above.

In practice, transfer pricing can be based on estimated market values, perhaps with a discount or other adjustment, be a cost-based price or be based on specific negotiation between the group companies. Transfer prices will reflect the taxation consequences to the transferring and acquiring companies and the prices can be agreed with the relevant taxation authorities. This is especially important to multinational companies but can also affect transfer prices within a single jurisdiction.

Transfer pricing is extremely widespread. The following Illustration describes a small number of bases for the pricing and the ways entities verify whether they approximate an arm's length transaction price. Even where the methodology is appropriate, it is still necessary to ensure that the inputs into the calculation are reasonable. It is possible that an arm's length price is not a particular price point but rather a range of prices.

Illustration 7-3: Internal transfer prices in the future cash flows to determine the VIU

A vehicle manufacturer, Entity A has a CGU that manufactures parts, transferring them to the vehicle assembly division. The parts are specific to the manufacturer's vehicles and the manufacturer cannot immediately source them on the open market. However, Entity A and other manufacturers in the sector do enter into parts supply arrangements with third parties, which set up the specific tooling necessary to manufacture the parts and could provide an external comparable transaction to help validate that the parts' internal transfer price is equivalent to an arm's length transaction. If not, the forecasts must be adjusted.

Entity B is an oil company that transfers crude oil from the drilling division to the refinery, to be used in the production of gasoline. There are market prices for crude oil that can be used to estimate cash inflows in the drilling division CGU and cash outflows for the refinery CGU.

7.1.7 Overheads

When calculating the VIU, entities include projections of cash outflows that are:

(i) Necessarily incurred to generate the cash inflow from continuing use of the asset (or CGU)

And

(ii) Can be directly attributed, or allocated on a reasonable and consistent basis to the asset (or CGU) *[IAS 36.39(b)]*

Projections of cash outflows include those for the day-to-day servicing of the asset/CGU as well as future overheads that can be attributed directly, or allocated on a reasonable and consistent basis, to the use of the asset/CGU. *[IAS 36.41]*.

How we see it

In our view, all overhead costs must be considered, and most must be allocated to CGUs when testing for impairment. Judgements can however be required to determine how far down to allocate some overhead costs and in determining an appropriate allocation basis. This is particularly important when it comes to stewardship costs and overhead costs incurred at a far higher level in a group to the CGU/asset assessed for impairment. Careful consideration of the entity's specific relevant facts and circumstances and cost structure is needed.

Generally, overhead costs that provide identifiable services to a CGU (e.g., IT costs from a centralised function) as well as those that would be incurred by a CGU if it needed to perform the related tasks when operating on a 'stand-alone basis' (e.g., financial reporting function) must be allocated to the CGU being tested for impairment.

Conversely, overhead costs that are incurred with a view to acquire and develop a new business (e.g., costs for corporate development such as M&A activities) would generally not be allocated. These costs are similar in nature to future cash inflows and outflows that are expected to arise from improving or enhancing a CGU's performance which are not considered in the VIU according to IAS 36.44. *[IAS 36.44]*.

The selection of a reasonable and consistent allocation basis of overhead costs will require analysis of various factors including the nature of the CGU itself. A reasonable allocation basis for identifiable services can be readily apparent, for example in some cases volume of transaction processing for IT services or headcount for human resource services can be appropriate. However, a reasonable allocation basis for stewardship costs that are determined to be necessarily incurred by the CGU to generate cash inflows can require more analysis. For example, an allocation basis for stewardship costs such as revenue or headcount can be inappropriate when CGUs have different regulatory environments, (i.e., more regulated CGUs can require more governance time and effort) or maturity stages (i.e., CGUs in mature industries can require less governance effort). The allocation basis can differ by type of cost and in some cases can reflect an average metric over a period of time rather than a metric for a single period or can reflect future expected, rather than historic, metrics.

Overheads not fully pushed down to the lowest level of CGUs need to be included in an impairment test at a higher-level group of CGUs if it can be demonstrated that the overhead costs are necessarily incurred and can be attributed directly or allocated on a reasonable and consistent basis at that higher level. After a careful analysis, there could be instances when certain overhead costs are excluded from cash flow projections on the basis that they do not meet the criteria under IAS 36.39(b).

Many entities make internal charges, often called 'management charges', which purport to transfer overhead charges to other group entities. Care must be taken before using these charges as a surrogate for actual overheads as they are often based on what is permitted, (e.g., by the taxation authorities), rather than actual overhead costs. There is also the danger of double counting if a management charge includes an element for the use of corporate assets that have already been allocated to the CGU being tested, e.g., an internal rent charge.

In certain situations, it can be argued that some stewardship costs are already included in the impairment test through the discount rate used. This would among other factors depend on the way the discount rate has been determined, and whether the relevant stewardship cost is regarded more as a shareholder cost covered in the shareholders' expected return rather than a cost necessarily incurred by the CGU to generate the relevant cash flows. Due to the complexity of such an approach, it would need to be applied with appropriate care.

7.1.8 Share-based payments

In many jurisdictions employees' remuneration packages include share-based payments. Share-based payments are cash-settled, equity-settled or give the entity or the counterparty the choice of settlement in equity or in cash. In practice, many share-based payment transactions undertaken by entities are awards of equity-settled shares and options. This gives the entity the possibility of rewarding employees without incurring any cash outflows and instead the cash costs are ultimately borne by the shareholders through dilution of their holdings.

When it comes to impairment assessment, a question that entities often face is whether and how to consider share-based payments in the recoverable amount, in particular the VIU calculation. IAS 36 itself does not provide any specific guidance as to whether or how share-based payments are considered in determining the recoverable amount.

As IAS 36 focuses on cash flows in determining VIU, it seems that expected cash outflows in relation to cash-settled share-based payments would need to be reflected in the VIU calculation. As noted in section 4.1 above, consistency is a very important principle underlying IAS 36. Therefore, in relation to cash-settled share-based payments, entities must be consistent in the extent to which cash flows resulting from these arrangements are included in the carrying amount of the CGU and the cash flows used to determine the value in use. Where the future expected cash flows used in determining the value in use are limited to the expected cash outflows in excess of the liability already recognised at that date in the VIU calculation, the liability already recognised at the date of the VIU determination cannot be included in the carrying amount of the CGU. In contrast, if the entity includes all the future expected cash outflows in determining the value in use, the liability already recognised at the date of the VIU determination must be included in the carrying amount of the CGU in order to be consistent.

Assume for example a cash-settled share-based payment plan with total expected cash outflow of CU90 of which CU30 has already been recognised in a liability. If CU60 is included in the cash flows used to determine the value in use, the liability of CU30 cannot be included in the carrying amount of the CGU. If on the other hand CU90 is included in the cash flows used to determine the value in use, the liability of CU30 must be included in the carrying amount of the CGU.

While theoretically this seems to be straight forward, in practice it can be quite a challenging and judgemental task, in particular when the entity consists of a large number of CGUs. Share-based payments are in general awarded by the parent to employees within the group. It is possible that there is no correlation between any change in the value of share-based payments after the grant date and the performance of the employing CGU. This can be relevant in assessing whether and how such changes in value and the ultimate expected cash flows are allocated to a specific CGU.

What is even less clear is how an entity reflects equity-settled share-based payments in the VIU calculation. Such share-based payment transactions may never result in any cash outflows for the entity - for example when newly issued shares are used to settle the equity-settled share-based payment plan, and therefore a literal reading of IAS 36 can indicate that they can be ignored in determining the recoverable amount. However, some argue an entity must appropriately reflect all share-based payments in the VIU calculation, whether or not these result in a real cash outflow to the entity. They note that share-based payments are part of an employee's remuneration package and therefore represent costs (in line with the treatment under IFRS 2 *Share-based Payment*) incurred by the entity for services from the employee. Others argue that they need to be considered through adjusting the discount rate in order to reflect a higher return to equity holders to counter the dilutive effects of equity settled share-based payment awards. This also depends on the way the discount rate is determined, and whether the level of equity-settled share-based plans are in line with the peer group used to determine the discount rate. If this is not the case it is likely adjustments are needed in order to reflect the higher return in the current market assessment. In practice this can be very difficult and judgmental to determine.

IAS 36 mentions averages, and computational short cuts may provide reasonable approximations of the detailed computations. In certain situations, IAS 36 allows for elements to be included either in the discount rate or in the cash flows. Based on this it might be possible to adjust the cash flows in order to get to a reasonable approximation of the effect on value in use. *[IAS 36.23, IAS 36.32]*.

The time span over which the recoverable amount is calculated is often much longer than the time period for which share-based payments have been awarded. Companies and their employees would often expect that further share-based payment awards will be made in the future during the time period used for the recoverable amount calculation. Depending on the respective facts and circumstances an entity would need to consider how to include the effect of share-based payments over a longer period, considering the discussion above.

How we see it

IAS 36 itself does not provide any specific guidance as to whether or how share-based payments are considered in determining the recoverable amount. As IAS 36 focuses on cash flows in determining VIU, it is our view that share-based payments that result in cash outflows (for example cash-settled share-based payments) would need to be reflected in the VIU calculation.

What is less clear in our view is how an entity reflects equity-settled share-based payments in the VIU calculation when these will not result in a cash outflow for the entity (for example where employees receive newly issued shares of the entity to settle equity-settled share-based payments). A significant amount of judgement can be required to assess how to appropriately reflect such share-based payments in VIU calculations, either by adjusting the cash flows or adjusting the discount rate.

7.1.9 Lease payments

7.1.9.A Lease payments during the lease term

As mentioned in section 4.1.2 above, the VIU calculation does not consider any cash flows for lease liabilities recorded in the statement of financial position. If the carrying amount of the lease liability is deducted to arrive at the carrying value of the CGU, the same carrying amount of the lease liability would need to be deducted from the VIU. *[IAS 36.78]*.

It is important to note that, while under IFRS 16 in-substance fixed lease payments in connection with lease arrangements are reflected in the lease liability, other lease payments are not. Variable lease payments that do not depend on an index or a rate, such as those based on performance or usage of the underlying asset, are not reflected in the recognised lease liability. These contractual payments therefore would still need to be reflected in the cash flow forecast used for the VIU calculation.

An entity accounts for each non-lease component within a contract separately from the lease component of the contract, unless the lessee applies the practical expedient in IFRS 16.15. Therefore, unless the practical expedient is applied, the non-lease components would need to be considered in the VIU calculation. If the practical expedient in IFRS 16.15 is applied, then the same guidance as discussed above for variable lease payments would apply to variable payments in relation to non-lease components.

In addition, IFRS 16 has certain exemptions for low-value assets and short-term leases. If a lessee elects to use these exemptions and therefore not to record a right-of-use asset and a lease liability on the balance sheet for these leases, then the cash flows in relation to these leases would still need to be included in the VIU cash flow forecast.

7.1.9.B Lease payments beyond the current lease term

When testing (groups) of CGUs it will frequently occur that cash flow forecasts in a VIU model are for a longer period than the lease term of the right-of-use assets included in the carrying amount of the CGU.

An assumption of new capital investments is in practice intrinsic to the VIU test. What has to be assessed are the future cash flows of the CGU. The cash flows, out into the future, will include sales of products or services, the cost of sales or services and all other cash flows necessary to generate independent cash inflows. They must necessarily include capital expenditure as well, at least to the extent required to keep the CGU functioning as forecasted.

In cases where the cash flows of the CGU are dependent on the underlying right-of-use assets, but the lease term will end during the cash flow forecast period, renewal, extension or replacement of the underlying right-of-use asset will have to be assumed. This can be done either by assuming a new lease will be entered into and therefore considering lease payments for this replacement lease in the cash flow forecast or terminal value or by assuming a replacement asset will be purchased. This will depend on the entity's planned course of action, including the consideration of any already committed leases that have not yet commenced. It would be inappropriate not to reflect such replacement needs in the CGU's cash flows if the CGU's future cash inflows depend thereon.

Special attention is required when a terminal value calculation is used, where the terminal value is calculated before the end of the lease term. For example, the terminal value can be based on the extrapolation of the cash flow expected for year 5, while the lease term ends at the end of year 8. This means that the cash flow at the end of year 5 does not represent a sustainable cash flow going forward. This can be addressed by including replacement leases or capital expenditures in the terminal year, and separately calculating an adjustment to reflect that some of these expenditures will only start after year 8 (if material).

7.1.10 Events after the reporting period

Events after the reporting period and information received after the end of the reporting period must be considered in the impairment assessment only if changes in assumptions provide additional evidence of conditions that existed at the end of the reporting period. Judgement of all facts and circumstances is required to make this assessment.

Information available after the year end can provide evidence that conditions were much worse than assumed. Whether an adjustment to the impairment assessment would be required or not would depend on whether the information casts doubt on the assumptions made in the estimated cash flows for the impairment assessment.

Competitive pressures resulting in price reductions after the year end do not generally arise overnight but normally occur over a period of time and can represent a reaction to conditions that already existed at the year-end in which case management would reflect this in the year end impairment assessment.

IAS 10 *Events after the Reporting Period* distinguishes events after the reporting period between adjusting and non-adjusting events (see Chapter 34). IAS 10 mentions abnormally large changes after the reporting period in asset prices or foreign exchange rates as examples of non-adjusting events and therefore these changes would in general not be a reason to update year end impairment calculations. The standard implies that abnormally large changes must be due to an event that occurred after the period end and therefore more or less assumes that the cause of such abnormally large changes are not conditions that already existed at the year-end. However, management would need to carefully assess the reason for the abnormally large change and consider whether it is due to conditions which already existed at the period end.

As stated in section 7.1 above, cash flow projections used for the impairment test are based on recent financial budgets/forecasts approved by management. This begs the question what to do if a new budget/forecast is approved by management after the reporting period end but before the accounts are authorised for issue? A similar question arises in group scenarios where subsidiaries' accounts are authorised for issue a significant time after the group accounts were authorised for issue. In both scenarios the same general considerations as explained above would apply. An entity would need to assess whether the revised budget/forecast is due to conditions that already existed at the reporting period end and therefore would need to be considered in the impairment assessment, or whether the change in budget/forecast is due to circumstances that arose after the end of the reporting period and therefore would only be considered in subsequent impairment tests. In a group scenario, this could lead to a situation where the revised budget/forecast would need to be considered on a subsidiary level when the subsidiaries' accounts are authorised for issue after the revised budget was approved, despite the fact that the group accounts were already authorised for issue based on the previous budget.

7.1.11 Risk in present value: 'traditional' and 'expected cash flow' approaches

The elements that must be taken into account in calculating VIU are described in section 7 above. IAS 36 requires an estimate of the future cash flows the entity expects to derive from the asset and the time value of money, represented by the current market risk-free rate of interest, to be reflected in the VIU calculation. However, the other elements that must be taken into account, all of which measure various aspects of risk, are dealt with either as adjustments to the discount rate or to the cash flows. These elements are:

- Expectations about possible variations in the amount or timing of those future cash flows
- The price for bearing the uncertainty inherent in the asset

  And
- Other factors, such as illiquidity that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset *[IAS 36.30]*

Adjusting for these factors in the discount rate is termed the 'traditional approach' in Appendix A to IAS 36. Alternatively, under the 'expected cash flow' approach these adjustments are made in arriving at the risk-adjusted cash flows. Either method can be used to compute the VIU of an asset or CGU. *[IAS 36.A2]*.

The traditional approach uses a single set of estimated cash flows and a single discount rate, often described as 'the rate commensurate with the risk'. This approach assumes that a single discount rate convention can incorporate all expectations about the future cash flows and the appropriate risk premium and therefore places most emphasis on the selection of the discount rate. *[IAS 36.A4]*.

Due to the problems and difficulties around capturing and reflecting all of the variables into a single discount rate (for example, when there is significant uncertainty related to future events), IAS 36 notes that the expected cash flow approach could be the more effective measurement tool. *[IAS 36.A6, IAS 36.A7]*.

The expected cash flow approach is a probability weighted net present value approach. This approach uses all expectations about possible cash flows instead of a single most likely cash flow and assigns probabilities to each cash flow scenario to arrive at a probability weighted net present value. The use of probabilities is an essential element of the expected cash flow approach. *[IAS 36.A10]*. The discount rate then considers the risks and variability for which the cash flows have not been adjusted. Appendix A notes some of the downsides of this approach, e.g., that the probabilities are highly subjective and that it can be inappropriate for measuring a single item or one with a limited number of outcomes. Nonetheless, it considers the most valid objection to the method to be the costs of obtaining additional information when weighed against its 'greater reliability'. *[IAS 36.A10, IAS 36.A11, IAS 36.A12, IAS 36.A13]*.

Even where an expected cash flow approach is used, an entity would still need to consider adjusting the discount rate for the general uncertainties and risks not reflected in the cash flows. The key message is therefore that an entity needs to ensure that consistent assumptions are used for the estimation of cash flows and the selection of an appropriate discount rate in order to avoid any double-counting or omissions. *[IAS 36.51]*.

An example of the use of the expected cash flow approach is given by Tesco PLC. The following extract from the annual report of Tesco PLC refers to scenarios reflecting different outcomes from risks presented by Brexit, COVID-19, a macroeconomic downturn and climate change.

Practical example 7-4: Tesco PLC (2022) **United Kingdom**

Annual Report 2022

Notes to the Group financial statements [extract]

Note 15 Impairment of non-current assets [extract]

Impairment methodology [extract]

Value in use [extract]

Retail [extract]

The Group applies an expected cash flow approach by probability-weighting different cash flow scenarios. The greatest probability weighting is applied to the cash flows derived from the three-year internal forecasts. Additional scenarios take account of the risks presented by macroeconomic downturns, global supply pressures and climate change, consistent with the viability statement scenarios (see the Longer term viability statement in the Strategic report) as well as an upside scenario.

...

7.2 Identifying an appropriate discount rate and discounting the future cash flows

The present value of the future cash flows of the CGU is determined by allocating the future cash flows to different periods and then determining their current value by applying a discount rate. IAS 36 defines the discount rate as a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the future cash flow estimates have not been adjusted. *[IAS 36.55]*.

This means the discount rate to be applied is an estimate of the rate that the market would expect on an equally risky investment. The standard states:

> "A rate that reflects current market assessments of the time value of money and the risks specific to the asset is the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the entity expects to derive from the asset." *[IAS 36.56]*.

Therefore, if at all possible, the rate is to be obtained from market transactions or market rates, which means the rate implicit in current market transactions for similar assets or the weighted average cost of capital (WACC) of a listed entity that has a single asset (or a portfolio of assets) with similar service potential and risks to the asset under review. *[IAS 36.56]*. If such a listed entity could be found, care would have to be taken in using its WACC as, to determine the VIU, the standard requires the use of a pre-tax discount rate that is independent of the entity's capital structure and the way it financed the purchase of the asset (see section 7.2.1 below). The effect of gearing and its effect on calculating an appropriate WACC is illustrated in Illustration 7-4 below.

Only in rare cases (e.g., property assets) can such market rates be obtained. If an asset-specific rate is not available from the market, surrogates are to be used. *[IAS 36.A16]*. The discount rate that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the entity expects to derive from the asset will not be easy to determine. IAS 36 suggests that, as a starting point, the entity takes into account the following rates: *[IAS 36.A17]*

Extract from IAS 36

A17 As a starting point in making such an estimate, the entity might take into account the following rates:

(a) the entity's weighted average cost of capital determined using techniques such as the Capital Asset Pricing Model;

(b) the entity's incremental borrowing rate; and

(c) other market borrowing rates.

Appendix A also gives the following guidelines for selecting the appropriate discount rate:

- It must be adjusted to reflect the specific risks associated with the projected cash flows (such as country, currency, price and cash flow risks) and to exclude risks that are not relevant. *[IAS 36.A18]*.
- To avoid double counting, the discount rate does not reflect risks for which future cash flow estimates have been adjusted. *[IAS 36.A18]*.
- The discount rate is independent of the entity's capital structure and the way it financed the purchase of the asset. *[IAS 36.A19]*.
- If the basis for the rate is post-tax (such as a weighted average cost of capital), it is adjusted for the VIU calculation to reflect a pre-tax rate. *[IAS 36.A20]*.

  And

- Normally the entity uses a single discount rate, but it must use separate discount rates for different future periods if the VIU is sensitive to different risks for different periods or to the term structure of interest rates. *[IAS 36.A21]*.

The discount rate specific for the asset or CGU will take account of the period over which the asset or CGU is expected to generate cash inflows and it is possible that the rate is not sensitive to changes in short-term rates - this is discussed in section 2.1.4 above. *[IAS 36.16]*.

It is suggested that the incremental borrowing rate of the business is relevant to the selection of a discount rate. This could only be a starting point as the appropriate discount rate must be independent of the entity's capital structure or the way in which it financed the purchase of the asset (including the use of leases to finance its operations). In addition, the incremental borrowing rate includes an element of default risk for the entity as a whole, which is not relevant in assessing the return expected from the assets.

IAS 36 requires that the future cash flows are before tax and finance costs, though it is more common in discounted cash flow valuations to use cash flows after tax. However, as pre-tax cash flows are being used, the standard requires a pre-tax discount rate to be used. *[IAS 36.55]*. This will theoretically involve discounting higher future cash flows (before deduction of tax) with a higher discount rate. This higher discount rate is the post-tax rate adjusted to reflect the specific amount and timing of the future tax flows. In other words, the pre-tax discount rate is the rate that gives the same present value when discounting the pre-tax cash flows as the post-tax cash flows discounted at the post-tax rate of return. *[IAS 36.BCZ85]*.

When the post-tax discount rate is determined, the pre-tax discount rate can be calculated. If a simple gross up is appropriate, it can be calculated by applying the fraction 1/(1-t). Thus, if the post-tax discount rate is assumed to be 10%, the pre-tax discount rate will be 10% divided by 0.7, if the relevant tax rate for the reporting entity is 30%, which will give a pre-tax rate of 14.3%. However, the standard warns that in many circumstances a gross up will not give a good enough answer as the pre-tax discount rate also depends on the timing of future tax cash flows and the useful life of the asset; these tax flows can be scheduled and an iterative process used to calculate the pre-tax discount rate. *[IAS 36.BCZ85]*. The relationship between pre- and post-tax rates is discussed further in section 7.2.2 below.

The selection of discount rates leaves considerable room for judgement in the absence of more specific guidance, and it is likely that many very different approaches will be applied in practice, even though this is not always evident from the financial statements. However, once the discount rate has been chosen, the future cash flows are discounted in order to produce a present value figure representing the VIU of the CGU or individual asset that is the subject of the impairment test. *[IAS 36.55]*.

7.2.1 Discount rates and the weighted average cost of capital

In practice, many entities use the weighted average cost of capital (WACC) to estimate the appropriate discount rate. The appropriate way to calculate the WACC is an extremely technical subject, and one about which there is much academic literature and no general agreement. The selection of the rate is obviously a crucial part of the impairment testing process and in practice, it will probably not be possible to obtain a theoretically perfect rate. The objective, therefore, must be to obtain a rate which is sensible and justifiable. There are probably a number of acceptable methods of arriving at the appropriate rate and one method is set out below.

While this Illustration appears to be quite complex, it has been written at a fairly general level. Where entities find the calculation of the appropriate discount rate to be difficult, we recommend seeking specialist advice.

Illustration 7-4: Calculating a discount rate

This example illustrates how to estimate a discount rate (WACC) for a CGU. As it is highly unlikely that a listed company with a similar risk profile to the CGU in questions exists, the WACC has to be simulated by looking at a hypothetical company with a similar risk profile.

When estimating the WACC for the CGU, the following three elements need to be determined; Gearing (i.e., the ratio of market value of debt to market value of equity), Cost of debt and Cost of equity. The three elements are discussed in more detail below.

Gearing

Gearing can best be obtained by reviewing quoted companies operating predominantly in the same industry as the CGU and identifying an average level of gearing for such companies. The companies need to be quoted so that the market value of equity can be readily determined.

Cost of debt

Where companies in the sector typically have quoted debt, the cost of such debt can be determined directly. In order to calculate the cost of debt for bank loans and borrowings more generally (including lease liabilities), one method is to take the rate implicit in fixed interest government bonds - with a period to maturity similar to the expected life of the assets being reviewed for impairment - and to add to this rate a bank's margin, i.e., the commercial premium that would be added to the bond rate by a bank lending to the hypothetical company in this sector. In some cases, the margin being charged on existing borrowings to the company in question will provide evidence to help with establishing the bank's margin. Obviously, the appropriateness of this will depend upon the extent to which the risks facing the CGU being tested are similar to the risks facing the company or group as a whole.

The additional bank's margin to add would be a matter for judgement but would vary according to the ease with which the sector under review was generally able to obtain bank finance and, as noted above, there can be evidence from the borrowings actually in place of the likely margin that would be chargeable. In general, the presence of tangible assets such as properties that are readily available as security for borrowings is expected to result in a lower margin.

Cost of equity

Cost of equity is the hardest component of the cost of capital to determine. One technique referred to in the standard, frequently used in practice and written up in numerous textbooks is the 'Capital Asset Pricing Model' (CAPM). The theory underlying this model is that the cost of equity is equal to the risk-free rate plus a market risk premium multiplied by a systematic risk factor, known as the beta, representing in total the equity risk premium. The risk-free rate is usually the same as that used to determine the nominal cost of debt and described above as being obtainable from government bond yields with an appropriate period to redemption. The market risk premium is the premium that investors require for investing in equities rather than government bonds. In certain cases, the equity risk premium is increased, for instance to take account of specific risks in the CGU in question that are not reflected in its market sector generally. Such increases are typically made when determining the cost of equity for a small company or to reflect differences in liquidity. The beta for a quoted company is a number that is greater or less than one according to whether market movements generally are reflected in a proportionately greater (beta more than one) or smaller (beta less than one) movement in the particular stock in question.

Various bodies, such as The London Business School, publish betas on a regular basis both for individual stocks and for industry sectors in general. Published betas are in general levered, i.e., they reflect the level of gearing in the company or sector concerned (although unlevered betas (based on risk as if financed with 100% equity) are also available and care must be taken not to confuse the two).

In addition to the volatility expressed in the beta, investors also reflect the exposure of the stock to a limited niche sector or exposure to a limited customer base. As a result, size premium could be required when the CGU is smaller than its direct competitors.

The cost of equity for the hypothetical company having a similar risk profile to the CGU is:

Cost of equity = risk-free rate + (levered beta × market risk premium) + size premium (if deemed required)

Having determined the component costs of debt and equity and the appropriate level of gearing, the WACC for the hypothetical company having a similar risk profile to the CGU in question is:

$$WACC = (1 - t) \times D \times \frac{g}{1 + g} + E \times \left[1 - \frac{g}{1 + g}\right]$$

Where:

D Is the cost of debt

E Is the cost of equity

g Is the gearing level (i.e., the ratio of debt to equity) for the sector

And

t Is the rate of tax relief available on the debt servicing payments

Use of the WACC is usually acceptable to auditors as it is supported by valuation experts and is an accepted methodology based on a well-known formula and widely available information. In addition, many entities already know their own WACC. However, it can only be used as a starting point for determining an appropriate discount rate and some of the issues that must be taken into account are as follows:

- The WACC is a post-tax rate and IAS 36 requires VIU to be calculated using pre-tax cash flows and a pre-tax rate. In the majority of cases, converting the former into the latter is not simply a question of grossing up the post-tax rate by the effective tax rate.
- An entity's own WACC is not suitable as a discount rate if there is anything atypical about the entity's capital structure compared with 'typical' market participants (for example the extent to which debts are used to finance the operations may deviate from market practice).
- The WACC must reflect the risks specific to the asset and not the risks relating to the entity as a whole, such as default risk.

  And
- The entity's WACC is an average rate derived from its existing business, yet entities frequently operate in more than one sector. Within a sector, different types of projects can have different levels of risk (e.g., a start-up as against an established product).

These issues are discussed further below.

One of the most difficult areas in practice is the effect of taxation on the WACC. In order to determine an appropriate pre-tax discount rate, it is likely to be necessary to adjust the entity's actual tax cash flows.

Ultimately, the appropriate discount rate to select is one that reflects current market assessments of the time value of money and the risks specific to the asset in question, including taxation. Such a rate is one that reflects "...the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the entity expects to derive from the asset". *[IAS 36.56]*.

An example of the determination of the WACC is given by Eni SpA. The following extract from the annual report of Eni SpA explains how its discount rate is determined.

Practical example 7-5: Eni SpA (2023) **Italy**

Annual Report 2023 [extract]

CONSOLIDATED FINANCIAL STATEMENTS [extract]

NOTES ON CONSOLIDATED FINANCIAL STATEMENTS [extract]

15 Reversals (Impairments) of tangible and intangible assets and right-of-use-assets. Sensitivity of outcomes to decarbonisation scenarios [extract]

...

The discount rate of the future cash flows of the CGUs was estimated as the weighted average cost of equity (Ke) and net borrowings, based on the Capital Asset Pricing Model methodology. Specifically, the cost of equity considers both a premium for the non-diversifiable market risk measured on the basis of the long-term returns of the S&P500, and an additional premium that considers exposure to operational risks of the countries of activity and the risks of the energy transition. For 2023, a Group cost of capital ("WAAC") of approximately 7% was estimated and was substantially unchanged compared to 2022 due to a lower cost of equity as a consequence of the reduction in the company's financial risk, which offset the increased yields on risk-free assets. The Group WACC is adjusted to account for the specific operational risks of each geography against the average portfolio, where oil&gas activities are conducted, by adding a corrective factor (WACC adjusted on a Country-by-Country basis).

...

7.2.2 Calculating a pre-tax discount rate

VIU is primarily an accounting concept rather than a business valuation of the asset or CGU. One fundamental difference is that IAS 36 requires pre-tax cash flows to be discounted using a pre-tax discount

rate. Why not calculate VIU on a post-tax basis? The reason is the complexities created by tax losses carried forward, temporary tax differences and deferred taxes.

The standard explains in the Basis for Conclusions that future income tax cash flows can affect recoverable amount. It is convenient to analyse future tax cash flows into two components:

(a) The future tax cash flows that would result from any difference between the tax base of an asset (the amount attributed to it for tax purposes) and its carrying amount, after recognition of any impairment loss. Such differences are described in IAS 12 as 'temporary differences'.

And

(b) The future tax cash flows that would result if the tax base of the asset were equal to its recoverable amount. *[IAS 36.BCZ81]*.

The concept is complex but refers to the following issues.

An impairment test, say at the end of 20X1, takes account of estimated future cash flows. The actual tax cash flows that an entity expects to pay in future years can depend on tax depreciation that the entity has already taken (or is yet to take) in respect of the asset or CGU being tested for impairment. The value of the asset to the business on a post-tax basis must take account of all tax effects including those relating to the past and not only those that will only arise in future.

Although these 'temporary differences' are accounted for as deferred taxation, IAS 12:

- Does not allow entities to recognise all deferred tax liabilities or deferred tax assets
- Does not recognise deferred tax assets using the same criteria as deferred tax liabilities

And

- Does not recognise deferred tax on a discounted basis

Therefore, deferred taxation as provided in the income statement and statement of financial position is not sufficient to take account of the actual temporary differences relating to the asset or CGU.

At the same time, an asset valuation implicitly assumes that the carrying amount of the asset is deductible for tax. For example, if the tax rate is 25%, an entity must receive pre-tax cash flows with a present value of 400 in order to recover a carrying amount of 300. *[IAS 36.BCZ88]*. In principle, therefore, VIU on a post-tax basis would include the present value of the future tax cash flows that would result if the tax base of the asset were equal to its value in use. Hence, IAS 36 indicates that the appropriate tax base to calculate VIU in a post-tax setting, is the VIU itself. *[IAS 36.BCZ84]*. Therefore, the calculated VIU must also be used to derive the pre-tax discount rate. It follows from this that the 'tax cash flows' to be taken into account will be those reflected in the post-tax VIU, so they will be neither the tax cash flows available in relation to the asset (based on its cost) nor the actual tax cash flows payable by the entity.

For these reasons, the IASC (which was replaced by the IASB in 2001) decided to require an entity to determine value in use by using pre-tax future cash flows and a pre-tax discount rate.

This means that there is a different problem, calculating an appropriate pre-tax discount rate because there are no observable pre-tax discount rates. Two important points must be taken into account:

- The pre-tax discount rate is not always the post-tax discount rate grossed up by a standard rate of tax. There are some circumstances in which a gross-up will give a reasonable approximation, discussed further in section 7.2.4 below.
- The pre-tax discount rate is not the post-tax rate grossed up by the effects of the entity's actual tax cash flows. As discussed above, a post-tax discount rate such as the WACC is based on certain assumptions about the tax-deductibility of the asset and not the actual tax cash flows experienced by the entity.

Recognising this, IAS 36.BCZ85 states that "…in theory, discounting post-tax cash flows at a post-tax discount rate and discounting pre-tax cash flows at a pre-tax discount rate should give the same result, as long as the pre-tax discount rate is the post-tax discount rate adjusted to reflect the specific amount and timing of the future tax cash flows". *[IAS 36.BCZ85]*.

Therefore, the only accurate way to calculate a pre-tax WACC is to calculate the VIU by applying a post-tax rate to post-tax cash flows, tax cash flows being based on the allowances and charges available to the asset and to which the revenue is subject (see discussion in section 7.2.3 below). The effective pre-tax rate is calculated by removing the tax cash flows and, by iteration, one can identify the pre-tax rate that makes the present value of the adjusted cash flows equal the VIU calculated using post tax cash flows.

Paragraph BCZ85 includes an example of how to calculate a pre-tax discount rate where the tax cash flows are irregular because of the availability of tax deductions for the asset's capital cost. See also the calculations in Illustration 7-5 below - (a) illustrates a calculation of a pre-tax discount rate. This is a relatively straightforward calculation for a single asset at the inception of the relevant project.

It can be far more complex at a later date. This is the case when entities attempt to calculate a discount rate starting with post-tax cash flows and a post-tax discount rate at a point in time when there are already temporary differences relating to the asset. A discount rate based on an entity's prospective tax cash flows under- or overstates IAS 36's impairment charge unless it reflects these previous allowances or disallowances. This is the same problem that will be encountered if an entity attempts to test VIU using post-tax cash flows as described in section 7.2.3 below.

A notional adjustment will have to be made if the entity is not paying tax because it is making, or has made, tax losses. It is unwarranted to assume that the post- and pre-tax discount rates will be the same if the entity pays no tax because of its own tax losses as this will be double counting. It is taking advantage of the losses in the cash flows but excluding that value from the assets of the CGU.

Entities can attempt to deal with the complexity of determining a pre-tax rate by trying to calculate VIU on a post-tax basis but this approach means addressing the many difficulties that have been identified by the IASB and the reasons why it mandated a pre-tax approach in testing for impairment in the first place.

Some approximations and short cuts that can give an acceptable answer in practice are dealt with in section 7.2.4 below.

7.2.3 Calculating VIU using post-tax cash flows

Because of the challenges in calculating an appropriate pre-tax discount rate and because it aligns more closely with their normal business valuation approach, some entities attempt to perform a VIU calculation based on a post-tax discount rate and post-tax cash flows.

In support of the post-tax approach, the example in IAS 36.BCZ85, which explains how to calculate a pre-tax discount rate, is mistakenly understood as a methodology for a post-tax VIU calculation using an entity's actual tax cash flows.

Entities that try a post-tax approach generally use the year-end WACC and estimated post-tax cash flows for future years that reflect the actual tax that they expect to pay in those years. A calculation on this basis will only by chance correspond to an impairment test in accordance with IAS 36 because it is based on inappropriate assumptions, i.e., it does not take account of the temporary differences that affect the entity's future tax charges and will not be based on the assumption that the VIU is tax deductible. Some include in the post-tax calculation the benefit of tax deductions or tax losses by bringing them into the cash flows in the years in which the tax benefit is expected to be received. In these cases, the calculation will not correctly take account of the timing differences reflected in the tax cash flows and not accurately reflect the differences created by the assumption that the VIU is tax deductible.

In order to calculate a post-tax VIU that is the equivalent to the VIU required by IAS 36, an entity will usually have to make adjustments to the actual tax cash flows or otherwise adjust its actual post-tax cash flows.

There are two approaches that can give a post-tax VIU that is equivalent to IAS 36's pre-tax calculation:

(1) Post-tax cash flows based on notional tax cash flows. The assumptions that need to be made are the same as those used in calculating a pre-tax discount rate as described in IAS 36.BCZ85. Therefore, there must be no temporary differences associated with the asset which means including only the future cash flows that would result if the tax base of the asset were equal to its VIU. In addition, no account is taken of the existing tax losses of the entity. Both of these assumptions will probably mean making appropriate notional adjustments.

(2) Post-tax cash flows reflecting actual tax cash flows. The relevant deferred tax asset or liability, discounted as appropriate, must be treated as part of the net assets of the relevant CGU.

It is very important to note that these are methodologies to determine IAS 36's required VIU, and they will only be acceptable if the result can be shown to be materially the same as a pre-tax impairment calculation as required by IAS 36.

How we see it

When measuring the value in use using post-tax inputs, there are two approaches, in our view, that can give a post-tax VIU that is equivalent to IAS 36's pre-tax calculation. Either using post-tax cash flows based on notional tax cash flows that would result if the tax base of the asset were equal to its VIU or post-tax cash flows reflecting actual tax cash flows with inclusion of the discounted deferred tax asset or liability as part of the carrying value of the CGU.

Note that for illustrative purposes all of the following Illustrations assume that there is no headroom, i.e., the NPV of the relevant cash flows is exactly equal to the carrying value of the asset. This is to make it easier to observe the relationship between pre- and post-tax calculations. See section 7.2.5 below for worked examples including headroom.

Illustration 7-5: Impairment calculations using pre- and post-tax cash flows and discount rates

The following examples illustrate impairment calculations using pre- and post-tax cash flows and discount rates.

(a) Comparing pre- and post-tax rates

An entity has invested CU2,139 in a facility with a 10-year useful life. Revenue and operating costs are expected to grow by 5% annually. The net present value of the post-tax future cash flows, discounted at the WACC of 8.1%, is equal to the cost of the plant.

The budgeted pre-tax cash flows are as follows:

Year	1	2	3	4	5	6	7	8	9	10
	CU	CU	CU	CU	CU	CU	CU	CU	CU	CU
Revenues	500	525	551	579	608	638	670	703	739	776
Operating expenses	(200)	(210)	(220)	(232)	(243)	(255)	(268)	(281)	(296)	(310)
Pre-tax cash flow	300	315	331	347	365	383	402	422	443	466

The following tax amortisation and tax rate apply to the business:

Tax and accounting depreciation	straight line
Tax rate	30%

These apply to the budgeted cash flows as follows:

Year	1	2	3	4	5	6	7	8	9	10
	CU	CU	CU	CU	CU	CU	CU	CU	CU	CU
Tax amortisation	214	214	214	214	214	214	214	214	214	214
Taxation	(26)	(30)	(35)	(40)	(45)	(51)	(56)	(62)	(69)	(75)
Post-tax cash flow	274	285	296	307	320	332	346	360	374	391

The pre-tax rate can be calculated using an iterative calculation and this can be compared to a gross up using the standard rate of tax. The NPV using these two rates is as follows:

Pre-tax rate (day 1) - iterative calculation	10.92%
Cost of investment at NPV future cash flows	CU2,139
Standard gross up (day 1) (8.1% ÷ 70%).	11.57%
NPV at standard gross up	CU2,077

The NPV of the pre-tax cash flows at 11.57% is CU2,077. This is only 2.9% lower than the number calculated using the true pre-tax rate. In many circumstances, this difference would not have a material effect.

If the tax and accounting depreciation are straight line then the distortion introduced by a standard gross-up can be relatively small and could be of less significance to an impairment test than, for example, the potential variability in cash flows. See also section 7.2.4 below.

(b) Comparing pre- and post-tax rates when the asset is impaired

Assume that the facility is much less successful than had previously been assumed and that the revenues are 20% lower than the original estimates. The pre- and post-tax cash flows are as follows:

Year	1	2	3	4	5	6	7	8	9	10
	CU	CU	CU	CU	CU	CU	CU	CU	CU	CU
Revenues	400	420	441	463	486	511	536	563	591	621
Operating expenses	(200)	(210)	(220)	(231)	(243)	(256)	(268)	(282)	(296)	(311)
Pre-tax cash flow	200	210	221	232	243	255	268	281	295	310
Tax amortisation	214	214	214	214	214	214	214	214	214	214
Taxation	4	1	(2)	(5)	(9)	(12)	(16)	(20)	(24)	(29)
Post-tax cash flow	204	211	219	227	234	243	252	261	271	281

The asset is clearly impaired as the previous cash flows were just sufficient to recover the carrying amount of the investment. If these revised cash flows are discounted using the pre- and post-tax discount rates discussed above, the resulting impairment is as follows:

		NPV	Impairment	Deferred tax	Net loss
		CU	CU	CU	CU
Original investment		2,139			
Pre-tax cash flows, discounted at pre-tax discount rate	10.92%	1,426	713	214	499
Post-tax cash flows discounted at post-tax discount rate	8.1%	1,569	570	171	399

Unless adjustments are made to the post-tax calculation, it will understate the impairment loss by 143 (pre-tax) and 100 (post-tax, assuming full provision for the deferred tax asset). This difference is the present value of the deferred tax on the actual impairment loss, a point explored in more detail in (d) below.

(c) Impairment and variable tax cash flows

The assumption of straight-line amortisation for taxation and accounting purposes does not reflect the circumstances of certain sectors, particularly where there are significant deductions for tax for the cost of the asset being tested for impairment, e.g., in the extractive sector. Impairment tests have to be calculated on assets with finite useful lives and variable tax cash flows. In many jurisdictions there are, or have been, substantial tax allowances for the construction of the asset but high rates of tax in the production phase.

The following example assumes that the entity gets a tax deduction for the cost of the asset in year 1. Once again, this assumes that in year 1 the cost of the investment is equal to the NPV of the cash flows.

Year	1	2	3	4	5	6	7	8	9	10
	CU	CU	CU	CU	CU	CU	CU	CU	CU	CU
Revenues	500	525	551	579	608	638	670	704	739	776
Operating expenses	(200)	(210)	(220)	(232)	(243)	(255)	(268)	(281)	(296)	(310)
Pre-tax cash flow	300	315	331	347	365	383	402	422	443	465
Tax amortisation	2,367									
Taxation	620	(95)	(99)	(104)	(109)	(115)	(121)	(127)	(133)	(140)
Post-tax cash flow	920	220	232	243	256	268	281	295	310	325

Assuming the same post-tax WACC of 8.1%, the pre-tax WACC is now considerably lower owing to the effect of the tax deduction in the first year. It can be calculated using an iterative process at 8.76%, rather than 10.92%, which is the pre-tax rate in (a) and (b) above. Therefore, the NPV of the pre- and post-tax cash inflows is CU2,367 rather than CU2,139 - the first-year tax allowances enhance the VIU of the project. If the entity discounted the pre-tax cash flows at 11.57%, the post-tax rate grossed up at the standard rate of taxation, these cash flows would have a NPV of CU2,077, which is approximately 12% lower than the actual NPV. It is clear that a standardised gross up will not give a reasonable approximation in these circumstances.

(d) Correctly measuring impairment using post-tax information

If an entity applies a post-tax rate to post-tax cash flows, what can it do to ensure that impairment is correctly measured in accordance with IAS 36?

Assume, in example (c) above, that cash inflows decline by 20% commencing at the beginning of year 2. The net present value of the pre-tax cash flows at 8.76% is CU1,516.

Year	2	3	4	5	6	7	8	9	10
	CU	CU	CU	CU	CU	CU	CU	CU	CU
Pre-tax cash flow	210	221	232	243	255	268	281	295	310
Taxation	(63)	(66)	(69)	(73)	(77)	(80)	(84)	(89)	(93)
Post-tax cash flows	147	155	163	170	178	188	197	206	217

The asset's book value at the end of year 1, assuming straight line depreciation over 10 years, is CU2,130. Impairment calculated using pre-tax cash flows and discount rates is as follows:

		CU
Original investment		2,367
Net book value (end of year 1)		2,130
Pre-tax cash flows, discounted at pre-tax discount rate	8.76%	1,516
Impairment		614
Deferred tax asset (reduction in deferred tax liability)		(184)
Net impairment loss		430

A post-tax calculation overstates the impairment, as follows:

		CU
Original investment		2,367
Net book value (end of year 1)		2,130
Post-tax cash flows, discounted at post-tax discount rate	8.1%	1,092
Impairment - overstated by 424		1,038
Deferred tax asset (reduction in deferred tax liability)		(311)
Net impairment loss - overstated by 297		727

It can be seen that unless adjustments are made to the post-tax calculation, it will overstate the impairment loss. There are two ways in which the post-tax calculation can be adjusted so as to give the right impairment charge.

Method (1): Post-tax cash flows based on notional tax cash flows. The assumptions that need to be made are the same as those used in calculating a pre-tax discount rate. Therefore, there must be no temporary differences associated with the asset which means including only the future cash flows that would result if the tax base of the asset were equal to its VIU.

This means assuming that the VIU of the asset (1,516) is deductible for tax purposes in year 2. This would usually be calculated iteratively.

Year	2	3	4	5	6	7	8	9	10
	CU	CU	CU	CU	CU	CU	CU	CU	CU
Pre-tax cash flow	210	221	232	243	255	268	281	295	310
Deemed tax amortisation	1,516								
Taxation	392	(66)	(69)	(73)	(77)	(80)	(84)	(89)	(93)
Post-tax cash flows	602	155	163	170	178	188	197	206	217

The present value of the notional post-tax cash flows at the post-tax discount rate of 8.1% is now CU1,516, i.e., the VIU of the asset is fully deductible for tax purposes, so the impairment charge, before taxation, is CU614, which is the same impairment as calculated above under the pre-tax cash flow model.

Method (2): Post-tax cash flows reflecting actual tax cash flows as adjusted for deferred tax. Again, this is an iterative calculation.

Year	2	3	4	5	6	7	8	9	10
	CU	CU	CU	CU	CU	CU	CU	CU	CU
Pre-tax cash flow	210	221	232	243	255	268	281	295	310
Deferred tax	(455)								
Taxation	(63)	(66)	(69)	(73)	(77)	(80)	(84)	(89)	(93)
Post-tax cash flows	147	155	163	170	178	188	197	206	217
Post-tax cash flows as adjusted for deferred tax	602	155	163	170	178	188	197	206	217

The net present value of the post-tax cash flows at the post-tax discount rate is CU1,092. The NPV of the post-tax cash flows as adjusted for deferred tax (see bottom line in the table), which is the VIU of the asset being tested for impairment, is CU1,516 and the gross deferred tax liability relating to the asset is 1,516 at 30%, i.e., CU455. The NPV of CU455, discounted for one year at the post-tax discount rate of 8.1%, is CU424. The deferred tax liability is discounted for one year due to the assumption used that all tax cash flows take place at the end of the year. Revised, the post-tax calculation is as follows:

		CU
Original investment		2,367
Net book value (end of year 1)		2,130
Post-tax cash flows, discounted at post-tax discount rate	8.1%	1,092
Discounted deferred tax		424
Impairment (2,130 - (1,092 + 424))		614

The impairment loss will impact the deferred tax calculation in the usual way, i.e., 614 at 30% = CU184.

It will rarely be practicable to apply this methodology to calculate a discount rate for a CGU, as so many factors need to be taken into account. Even if all assets within the CGU are individually acquired or self-constructed, they can have a range of useful lives for depreciation and tax amortisation purposes, up to and including indefinite useful lives.

If goodwill is being tested, it has an indefinite useful life. However, the underlying assets in the CGU or group of CGUs to which it has been allocated will usually have finite useful lives. It is likely that a reasonable approximation to the 'true' discount rate is the best that can be achieved, and this is discussed further below.

7.2.4 Approximations and short cuts

The examples in Illustration 7-5 in section 7.2.3 above are of course simplified, and in reality, it is unlikely that entities will need to schedule all of the tax cash flows and tax consequences in order to calculate a pre-tax discount rate every time they perform an impairment test. In practice, it will probably not be possible to obtain a rate that is theoretically perfect - the task is just too intractable for that. The objective, therefore, must be to obtain a rate which is sensible and justifiable. Some of the following can make the exercise a bit easier.

An entity can calculate a pre-tax rate using adjusted tax cash flows based on the methods and assumptions described above and then apply that rate to discount pre-tax cash flows for the VIU calculation. This pre-tax rate will only need to be reassessed in following years when there is an external factor that affects risks, relevant market rates or the taxation basis of the asset or CGU.

The market can conclude that the risks relating to a particular asset are higher or lower than had previously been assumed. Such risk adjustments can occur if, for example, a new project, process or product proves to be successful or if there were previously unforeseen problems with an activity. Relevant changes in market rates are those for instruments with a period to maturity similar to the expected useful life of the assets being reviewed for impairment, so these will not necessarily need to be recalculated every time an impairment test is carried out. Short-term market rates can increase or decrease without affecting the rate of return that the market would require on long-term assets. Significant changes in the basis of taxation could also affect the discount rate, e.g., if tax deductions are applied or removed for all of a class of asset or activity. The discount rate will not necessarily be affected if the entity ceases to make taxable profits.

Valuation practitioners often use approximations when computing tax cash flows that can also make the task more straightforward. It is often a valid approximation to assume that the tax amortisation of assets equals their accounting depreciation. Tax cash flows will be based on the relevant corporate tax rate and the forecast earnings before interest and taxation to give post-tax 'cash flows' that can then be discounted using a post-tax discount rate. The circumstances in which this could lead to a material distortion (perhaps in the case of an impairment test for an individual asset) will probably be obvious. This approach is consistent with the overall requirement of IAS 36, which is that the appropriate discount rate to select is one that reflects current market assessments of the risks specific to the asset in question.

The circumstances in which a standardised gross up at the corporation tax rate will give the relevant discount rate are:

- No growth in cash flows
- A perpetuity calculation

  And
- Tax cash flows that are a constant percentage of total cash flows

As long as these conditions remain unchanged, it will be straightforward to determine the discount rate for an impairment test at either the pre- or post-tax level.

A close approximation to these criteria is possible for some CGUs, particularly if accounting and tax amortisation of assets is similar. This is illustrated in Illustration 7-6 below - see the comparison of discount rates at the end of the example. A simple gross up can be materially correct. The criteria are unlikely to apply to the VIU of individual assets because these are rarely perpetuity calculations, and it is possible that the deductibility for tax purposes does not resemble accounting depreciation. If it is inappropriate to make such a gross up, an iterative calculation can be necessary to compute the appropriate pre-tax discount rate.

7.2.5 Disclosing pre-tax discount rates when using a post-tax methodology

If an entity calculates impairment using a post-tax methodology, it must still disclose the appropriate pre-tax discount rate. *[IAS 36.134(d)(v)]*. There is a widely held view that the relevant pre-tax discount rate is the rate that will discount the pre-tax cash flows to the same VIU as the post-tax cash flows discounted using the post-tax discount rate. This will not necessarily give an answer that is consistent with IAS 36, which makes it clear that pre- and post-tax discount rates will only give the same answer if "the pre-tax discount rate is the post-tax discount rate adjusted to reflect the specific amount and timing of the future tax cash flows". *[IAS 36.BCZ85]*. It is no different in principle whether grossing up for a pre-tax rate or grossing up for disclosure purposes.

IAS 36 indicates that the appropriate tax base to calculate VIU in a post-tax setting, is the VIU itself. Therefore, the calculated (post-tax) VIU also has to be used to derive the pre-tax discount rate. Depreciation for tax purposes must also be based on the calculated VIU.

Assuming that there is no impairment, the post-tax VIU will be higher than the carrying value of the asset. To calculate the pre-tax rate, the tax amortisation must be based on this figure. If tax amortisation is based on the cost of the asset, the apparent pre-tax discount rate will show a rising trend over the useful life of the asset as the ratio of pre- to post-tax cash flows changes and the effect of discounting becomes smaller. These effects can be very marked.

Illustration 7-6: Calculating pre-tax discount rates from post-tax VIUs

The assumptions underlying these calculations are as follows:

	CU
Tax rate	25%
Post-tax discount rate	10%
Carrying amount beginning of year 1	1,500
Remaining useful life (years)	5
Straight line tax amortisation	

If the tax amortisation is based on the cost of the asset, the apparent pre-tax discount rate in each of the five years is as follows:

Year	1	2	3	4	5
	CU	CU	CU	CU	CU
Revenue	1,000	1,020	1,040	1,061	1,082
Pre-tax cash flow	500	510	520	531	541
Tax amortisation	(300)	(300)	(300)	(300)	(300)
Taxation	50	53	55	58	60
Post-tax cash flows	450	457	465	473	481
NPV of post-tax cash flows using a 10% discount rate	1,756	1,484	1,175	827	437

The apparent pre-tax discount rate in any year will be the rate that discounts the pre-tax cash flows to the same NPV as the post-tax cash flows using the post-tax discount rate.

Apparent pre-tax discount rate	14.4%	15.4%	16.7%	19.1%	23.8%

It is quite clear that these apparent pre-tax discount rates are incorrect. Although pre-tax rates are not observable in the market, they are derived from market rates and would not increase in a mechanical fashion over the useful life of the asset.

The correct way to calculate the tax amortisation is based on the VIU. Years 1 and 2 are illustrated in the following table:

Year	1	2	3	4	5
	CU	CU	CU	CU	CU
Revenue	1,000	1,020	1,040	1,061	1,082
Pre-tax cash flow	500	510	520	531	541
Year 1					
Notional tax amortisation (VIU 1,819 ÷ 5)	(364)	(364)	(364)	(364)	(364)
Taxation	34	37	39	42	44
Post-tax cash flows	466	473	481	489	497
Year 2					
Notional tax amortisation (VIU 1,554 ÷ 4)		(389)	(389)	(389)	(389)
Taxation		30	33	36	38
		480	487	495	503

The NPV of the post-tax cash flows, which is the VIU of the asset being tested for impairment, is CU1,819 in year 1 and CU1,554 in year 2, and the tax base allowing for a tax amortisation is based on these VIUs as well, both solved iteratively. Years 3, 4 and 5 are calculated in the same way, with tax amortisation based on the VIUs in the following table:

Year	1	2	3	4	5
VIU (NPV of post-tax cash flows)	CU1,819	CU1,554	CU1,247	CU890	CU478
Annual depreciation for remaining term	CU364	CU389	CU416	CU445	CU478
	(1,819 ÷ 5)	(1,554 ÷ 4)	(1,247 ÷ 3)	(890 ÷ 2)	478
Pre-tax discount rate	13.1%	13.1%	13.2%	13.3%	13.3%

We can now compare the correct and incorrectly computed pre-tax discount rates. A rate based on grossing up the post-tax rate at the standard rate of tax is included for comparison.

Year	1	2	3	4	5
Post-tax discount rate	10%	10%	10%	10%	10%
Pre-tax discount rate - correct	13.1%	13.1%	13.2%	13.3%	13.3%
Pre-tax discount rate - incorrect, based on cost	14.4%	15.4%	16.7%	19.1%	23.8%
Pre-tax rate - approximation based on gross-up	13.3%	13.3%	13.3%	13.3%	13.3%

Note that in circumstances where tax amortisation is equal to accounting depreciation, a straightforward gross-up at the tax rate can give a satisfactory discount rate.

A rate based on actual post-tax cash flows will also vary from year to year depending on the tax situation.

Neither of these distortions is consistent with the principle that the pre-tax discount rate is the rate that reflects current market assessments of the time value of money and the risks specific to the asset. *[IAS 36.55]*.

7.2.6 Determining pre-tax rates taking account of tax losses

A common problem relates to the effect of tax losses on the impairment calculation, as they can reduce the total tax paid in the period under review or even eliminate it altogether. As noted above, however, a post-tax discount rate is based on certain assumptions about the tax-deductibility of the asset and not the actual tax cash flows. It is therefore unwarranted to assume that the post- and pre-tax discount rates will be the same if the entity pays no tax because of its own tax losses. As the pre-tax rate does not include the benefit of available tax benefits, any deferred tax asset arising from tax losses carried forward at the reporting date must be excluded from the assets of the CGU if the impairment test is based on VIU. Similarly, if the entity calculates a post-tax VIU (see section 7.2.3 above), it will also make assumptions about taxation and not base the calculation on the actual tax cash flows.

In many circumstances, the past history of tax losses affects the level of risk in the cash flows in the period under review, but one must take care not to increase the discount rate to reflect risks for which the estimated cash flows have been adjusted. *[IAS 36.A15]*. To do so would be to double count.

How we see it

In our view, tax losses carried forward do not impact the outcome of an impairment test regardless of whether deferred tax assets have been recognised for them. Any difference in value between otherwise identical CGUs, with or without tax losses, relates to the value of the tax losses and not to the value of the assets subject to impairment testing. Any such losses must, therefore, be excluded from the impairment test.

7.2.7 Entity-specific WACCs and different project risks within the entity

The entity's WACC is an average rate derived from its existing business, yet entities frequently operate in more than one sector. Within a sector, different types of projects can have different levels of risk, e.g., a start-up against an established product. Therefore, entities must ensure that the different business risks of different CGUs are properly taken into account when determining the appropriate discount rates.

It must be noted that these areas of different risk will not always coincide with the assets or CGUs that are being tested for impairment as this is a test for impairment and not necessarily a determination of business value.

Illustration 7-7: Different project risks and CGUs

An aircraft manufacturer makes both civilian and military aircraft. The risks for both sectors are markedly different as they are much lower for defence contractors than for the civilian market. The assembly plants for civilian and military aircraft are separate CGUs. In this sector there are entities that are based solely in one or other of these markets, i.e., they are purely defence or civilian contractors, so there will be a basis for identifying the different discount rates for the different activities. If the entity makes its own components, then the defence CGU or CGUs could include the manufacturing activity if defence is vertically integrated and components are made solely for military aircraft. Manufacturing could be a separate CGU if components are used for both activities and there is an external market for the products.

A manufacturer of soft drinks uses the same plant to produce various flavours of carbonated and uncarbonated drinks. Because the market for traditional carbonated drinks is declining, it develops and markets a new uncarbonated 'health' drink, which is still produced using the same plant. The risks of the product are higher than those of the existing products, but it is not a separate CGU.

Many sectors generate many new products but have a high attrition rate as most of their new products fail (pharmaceuticals and biotechnology, for example) and this is likely built into industry WACCs. If the risk of failure is not reflected in the industry WACC because the entity is not typical of the industry, then either the WACC or the cash flows ought to be adjusted to reflect the risk (but not so as to double count).

7.2.8 Entity-specific WACCs and capital structure

The discount rate is a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the future cash flow estimates have not been adjusted. *[IAS 36.55]*. An entity's own WACC is not suitable as a discount rate if there is anything atypical about the entity's capital structure compared with 'typical' market participants (for example, the entity's use of leases to finance its operations). In other words, would the market assess the cash flows from the asset or unit as being riskier or less risky than the entity-wide risks reflected in the entity-wide WACC? Some of the risks that need to be thought about are country risk, currency risks and price risk.

Country risk will reflect the area in which the assets are located. In some areas assets are frequently nationalised by governments or the area is politically unstable and prone to violence. In addition, the potential impact of physical instability such as weather or earthquakes, and the effects of currency volatility on the expected return from the asset, must be considered.

Two elements of price risk are the gearing ratio of the entity in question (if, for example, it is much more or less geared than average) and any default risk built into its cost of debt. However, IAS 36 explicitly notes that the discount rate is independent of the entity's capital structure and the way the entity financed the purchase of the asset, because the future cash flows expected to arise from an asset do not depend on these features. *[IAS 36.A19]*.

Illustration 7-8: Effect of entity default risk on its WACC

The formula for calculating the (post tax) WACC, as given in Illustration 7-4 in section 7.2 above, is:

$$WACC = (1 - t) \times D \times \frac{g}{1 + g} + E \times \left[1 - \frac{g}{1 + g}\right]$$

Where:

t Is the rate of tax relief available on the debt servicing payments

D Is the pre-tax cost of debt

E Is the cost of equity

And

g Is the gearing level (i.e., the ratio of debt to equity) for the sector

The cost of equity is calculated as follows:

Cost of equity = risk-free rate + (levered beta (β*) × market risk premium) + size premium (if deemed required)

Assume that the WACC of a typical sector participant is as follows:

Cost of equity	
Risk free rate	4%
Levered beta (β)	1.1
Market risk premium	6%
Cost of equity after tax (market risk premium × β + risk-free rate)	10.6%
Cost of debt	
Risk free rate	4%
Credit spread	3%
Tax rate	25%
Cost of debt (pre-tax)	7%
Cost of debt (post-tax)	5.25%
Capital structure	
Debt ÷ (debt + equity)	25%
Equity ÷ (debt + equity)	75%
Post-tax cost of equity (10.6 × 75%)	8%
Post-tax cost of debt (5.25 × 25%)	1.3%
WACC (Post tax, nominal)	**9.3%**

* The beta is explained in Illustration 7-4 in section 7.2 above.

However, the company has borrowed heavily and is in some financial difficulties. Its gearing ratio is 75% and its actual cost of debt, based on the market price of its listed bonds, is 18% (13.5% after taking account of tax at 25%). This makes its individual post-tax WACC 12.8% (10.6 × 25% + 13.5 × 75%). As a matter of fact, the entity's individual post-tax WACC can be even higher than 12.8% as this rate is based on a levered beta for a typical sector participant, while the entity's own beta will probably be higher. Having said this, the entity's WACC is not an appropriate WACC for impairment purposes because it does not represent a market rate of return *on the assets*. Its entity WACC has been increased by default risk.

Ultimately, it can be acceptable to use the entity's own WACC, but an entity cannot conclude on this without going through the exercise of assessing for risk each of the assets or units and concluding on whether or not they contain additional risks that are not reflected in the WACC.

7.2.9 Use of discount rates other than the WACC

IAS 36 allows an entity to use rates other than the WACC as a starting point in calculating the discount rate. These include:

- The entity's incremental borrowing rate

  And

- Other market borrowing rates *[IAS 36.A17]*

If borrowing rates (which are, of course, pre-tax) were used as a starting point, could this avoid some of the problems associated with adjusting the WACC for the effects of taxation? Unfortunately, this is unlikely. Debt rates reflect the entity's capital structure and do not reflect the risk inherent in the asset. A pure asset/business risk would be obtained from an entity funded solely by equity and equity risk premiums are always observed on a post-tax basis. Therefore, the risk premium that must be added to reflect the required (increased) return over and above a risk-free rate by an investor will always have to be adjusted for the effects of taxation.

It must be stressed that the appropriate discount rate, which is the one that reflects current market assessments of the time value of money and the risks specific to the asset in question, ought to be the same whatever the starting point for the calculation of the rate.

7.3 Differences between fair value and value in use

IFRS 13 is explicit that it does not apply to value in use, noting that its measurement and disclosure requirements do not apply to "measurements that have some similarities to fair value, such as … value in use …". *[IFRS 13.6(c)]*. IAS 36 includes an explanation of the ways in which fair value is different to value in use. Fair value, it notes, "reflects the assumptions market participants would use when pricing the asset. In contrast, value in use reflects the effects of factors that may be specific to the entity and not applicable to entities in general." *[IAS 36.53A]*. It gives a number of specific examples of factors that are excluded from fair value to the extent that they would not be generally available to market participants: *[IAS 36.53A]*

- The additional value derived from the grouping of assets. IAS 36's example is of the creation of a portfolio of investment properties in different locations
- Synergies between the asset being measured and other assets
- Legal rights or legal restrictions that are specific only to the current owner of the asset

  And
- Tax benefits or tax burdens that are specific to the current owner of the asset

By contrast, an entity calculating FVLCD includes cash flows that are not permitted in a VIU calculation but only to the extent that other market participants would consider them when evaluating the asset. For example, cash inflows and outflows relating to future capital expenditure could be included if they would be taken into account by market participants (see section 7.1.2 above).

8 Impairment of goodwill

8.1 Goodwill and its allocation to cash-generating units

By definition, goodwill can only generate cash inflows in combination with other assets which means that an impairment test cannot be carried out on goodwill alone. Testing goodwill for impairment requires it to be allocated to a CGU or to a group of CGUs of the acquirer. This is quite different to the process by which CGUs themselves are identified as that depends on identifying the smallest group of assets generating largely independent cash inflows. The cash flows of the CGU, or those of a group of CGUs if appropriate, must be sufficient to support the carrying value both of the assets and any allocated goodwill.

IFRS 3 states that the acquirer measures goodwill acquired in a business combination at the amount recognised at the acquisition date less any accumulated impairment losses and refers to IAS 36. *[IFRS 3.B63(a)]*. Initial recognition and measurement of goodwill acquired in a business combination is discussed in Chapter 10 at section 6.

From the acquisition date, acquired goodwill is to be allocated to each of the acquirer's CGUs, or to a group of CGUs, that are expected to benefit from the synergies of the combination. This is irrespective of whether other assets or liabilities of the acquiree are assigned to those CGUs or group of CGUs. *[IAS 36.80]*.

IAS 36 does not provide any methods for allocating goodwill. This means that once the acquirer's CGUs or groups of CGUs that benefit from the synergies have been identified, discussed in section 8.1.2 below, the entity must use an appropriate methodology to allocate that goodwill between them. Some approaches are described in section 8.1.3 below.

The standard recognises that goodwill sometimes cannot be allocated on a non-arbitrary basis to an individual CGU, so permits it to be allocated to a group of CGUs. However, the standard states that each CGU or group of CGUs to which the goodwill is so allocated must:

(a) Represent the lowest level within the entity at which the goodwill is monitored for internal management purposes

And

(b) Not be larger than an operating segment determined in accordance with IFRS 8 *Operating Segments* before aggregation *[IAS 36.80, IAS 36.81]*

How we see it

Groups that do not have publicly traded equity or debt instruments are not required to apply IFRS 8. However, in our view, these entities are still obliged to allocate goodwill to CGUs or groups of CGUs in the same way as entities that have to apply IFRS 8 as the restriction in IAS 36 refers to the definition of operating segment in IFRS 8, not to entities within the scope of that standard.

All CGUs or groups of CGUs to which goodwill has been allocated have to be tested for impairment on an annual basis.

The standard takes the view that applying these requirements results in goodwill being tested for impairment at a level that reflects the way an entity manages its operations and with which the goodwill would naturally be associated. Therefore, the development of additional reporting systems is typically not necessary. *[IAS 36.82]*.

This is, of course, consistent with the fact that entities do not monitor goodwill directly. Rather, they monitor the business activities, which means that goodwill allocated to the CGUs or groups of CGUs that comprise those activities will be 'monitored' indirectly. This also means, because goodwill is measured as a residual, that the goodwill balance in the statement of financial position can include elements other than goodwill relating to synergies. Some of these issues and their implications are discussed in section 8.1.1 below. It also means that internally generated goodwill will be taken into account when calculating the recoverable amount because the impairment test itself does not distinguish between purchased and internally generated goodwill.

How we see it

In our view, the difficulties with the concept of monitoring goodwill do not mean that entities can default to testing at an arbitrarily high level, e.g., at the operating segment level or for the entire entity by arguing that goodwill is not monitored. Entities do often 'monitor' goodwill indirectly by monitoring the business activities to which goodwill belongs. This would need to be considered when assessing the level at which goodwill will be tested for impairment.

IAS 36 emphasises that a CGU to which goodwill is allocated for the purpose of impairment testing can differ from the level at which goodwill is allocated in accordance with IAS 21 for the purpose of measuring foreign currency gains and losses (see Chapter 16). *[IAS 36.83]*. In many cases, the allocation under IAS 21 will be at a lower level. This will apply not only on the acquisition of a multinational operation but could also apply on the acquisition of a single operation where the goodwill is allocated to a larger cash-generating unit under IAS 36 that is made up of businesses with different functional currencies. However, IAS 36 clarifies that the entity is not required to test the goodwill for impairment at that same level unless it also monitors the goodwill at that level for internal management purposes. *[IAS 36.83]*.

8.1.1 The composition of goodwill

IAS 36 requires an entity to allocate goodwill to the CGUs that are expected to benefit from the synergies of the business combination, a challenging task because, in accounting terms, goodwill is measured as a residual (see Chapter 10). This means that in most cases goodwill includes elements other than the synergies on which the allocation to CGUs is based.

The IASB and FASB argue that what it refers to as 'core goodwill' is an asset. *[IFRS 3.BC323]*.

Core goodwill, conceptually, comprises two components: *[IFRS 3.BC313]*

(a) The fair value of the going concern element of the acquiree's existing business. It is stated in IFRS 3.BC313 "The going concern element represents the ability of the established business to earn a higher rate of return on an assembled collection of net assets than would be expected if those net assets had to be acquired separately. That value stems from the synergies of the net assets of the business, as well as from other benefits (such as factors related to market imperfections, including the ability to earn monopoly profits and barriers to market entry - either legal or because of transaction costs - by potential competitors)".

And

(b) The fair value of the expected synergies and other benefits from combining the acquirer's and acquiree's net assets and businesses. Those synergies and other benefits are unique to each combination, and different combinations would produce different synergies and, hence, different values.

The problem for the allocation process is, firstly, that (a) relates to the acquired business taken as a whole and any attempt to allocate it to individual CGUs or groups of CGUs in the combined entity can be futile. IFRS 3 refers to part of element (a) above, the value of an assembled workforce, which is not recognised as a separate intangible asset. This is the existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date without having to hire and train a workforce. *[IFRS 3.B37]*. This has to be allocated to all the CGUs or groups of CGUs that benefit from the synergies.

Secondly, synergies themselves fall into two broad categories, operating synergies, which allow businesses to increase their operating income, e.g., through economies of scale or higher growth, or financial synergies that result in a higher cash flow or lower cost of capital and includes tax benefits. Some financial synergies are quite likely to relate to the combined business rather than individual CGUs or groups of CGUs. Even though the expected future cash flows of the CGU being assessed for impairment cannot include cash inflows or outflows from financing activities or tax receipts, *[IAS 36.50, IAS 36.51]*, there is no suggestion in IAS 36 that these synergies cannot be taken into account in allocating goodwill.

In addition, goodwill measured as a residual can include amounts that do not represent core goodwill. IFRS 3 attempts to minimise these amounts by requiring an acquirer:

- To measure the consideration accurately, thus reducing any overvaluation of the consideration paid
- To recognise the identifiable net assets acquired at their fair values rather than their carrying amounts

  And
- To recognise all acquired intangible assets meeting the relevant criteria so that they are not subsumed into the amount initially recognised as goodwill *[IFRS 3.BC317]*

However, this process is not perfect. The acquirer can for example attribute value to potential contracts the acquiree is negotiating with prospective customers at the acquisition date, but these are not recognised under IFRS 3 and neither are contingent assets, so their fair value is subsumed into goodwill. *[IFRS 3.B38, IFRS 3.BC276]*. Employee benefits and share-based payments are not recognised at their fair value. *[IFRS 3.26, IFRS 3.30]*. In practice, the most significant mismatch arises from deferred taxation, which is not recognised at fair value and can lead to the immediate recognition of goodwill. This is discussed in section 8.3.1 below.

In summary, this means that the goodwill that is allocated to a CGU or group of CGUs can include an element that relates to the whole of the acquired business or to an inconsistency in the measurement process as well as the synergies that follow from the acquisition itself. This point has been acknowledged by the IASB during the development of the standard:

> "However, the Board was concerned that in the absence of any guidance on the precise meaning of 'allocated on a reasonable and consistent basis', some might conclude that when a business combination enhances the value of all of the acquirer's pre-existing cash-generating units, any goodwill acquired in that business combination should be tested for impairment only at the level of the entity itself. The Board concluded that this should not be the case." *[IAS 36.BC139]*.

In spite of the guidance in the standard, the meaning of the monitoring of goodwill as well as the allocation process remains somewhat elusive. Nevertheless, all goodwill arising in a business combination must be allocated to CGUs or groups of CGUs that benefit from the synergies, none can be allocated to CGUs or groups of CGUs that do not benefit and entities are not permitted to test at the level of the entity as a whole as a default. This means that identifying CGUs and groups of CGUs that benefit from the synergies is a crucial step in the process of testing goodwill for impairment.

8.1.2 Identifying synergies and identifying CGUs or groups of CGUs for allocating goodwill

IAS 36 requires goodwill to be allocated to CGUs or groups of CGUs that are expected to benefit from the synergies of the combination and only to those CGUs or groups of CGUs. This is irrespective of whether other assets or liabilities of the acquiree are assigned to those CGUs or group of CGUs. *[IAS 36.80]*.

Operating synergies fall into two broad groups, those that improve margin (e.g., through cost savings and economies of scale) and those that give an opportunity for future growth (e.g., through the benefits of the combined talent and technology).

Illustration 8-1: Identifying synergies

In all of the following cases, the acquiring entity can identify the synergies and the CGU or group of CGUs that benefits from them. Goodwill will be allocated to the relevant CGU or group of CGUs.

- A mining entity (group) extracts a metal ore that does not have an active market until it has been through a smelting and refining process. The entity considers the CGU to comprise the smelter together with the individual mines. When the entity acquires a mine, the synergies relate to cost savings as the mine's fixed costs are already covered by the existing refining operations. Goodwill is therefore allocated to the CGU comprising the smelter, the existing mines and the newly acquired mine.
- An airline is subject to cost pressures common in the sector. It acquires another operation with similar international operations on the basis that it can reduce its workforce and asset base. It will combine its operational management, including its sales, reporting and human resources functions, into one head office and consolidate all aircraft maintenance in a single site that currently has capacity. These cost savings are the synergies of the business combination and goodwill would therefore be allocated to the CGU or group of CGUs that benefit from these cost savings.
- A global consumer products company, which allocates goodwill at the operating segment level, purchases a company best-known for razors and razor blades. It has not previously manufactured razors although its 'grooming products' operating segment does manufacture other shaving products. The acquirer expects that it will be able to increase sales of its shaving products through association with the target company's razors and through branding. No assets of the acquired business are allocated to the grooming products operating segment, but this segment will benefit from the synergies of the business combination and therefore goodwill from the acquisition will be allocated to it.

The process is further shown in the following Illustration which shows the differences for the purposes of testing impairment between the CGU/groups of CGUs to which goodwill is allocated and the identification of CGUs.

Illustration 8-2: Allocating goodwill and identifying CGUs

Entity A operates three different types of fish restaurant: fifteen restaurants, twenty-five pubs that contain restaurants serving fish and forty fish bars. Each is separately branded, although the brand is clearly identified with the Entity A identity, e.g., the restaurant range is branded 'Fish by A'. Each brand is identified as a separate operating segment: restaurants, pubs and fish bars.

Entity A acquired Entity B, which had a similar range of restaurants and bars (thirty in total) although that entity had not applied any branding to the types of restaurants.

Entity A recognised goodwill on acquisition and determined that ten of Entity B's outlets were to be allocated to each of its brands where they would be rebranded and included in the relevant operating segment.

Each restaurant, pub or fish bar is a separate CGU because it has separately identifiable largely independent cash inflows.

Management notes that it manages the 'A' brand at group (entity) level. This is not appropriate for testing goodwill as IAS 36 states that CGUs or groups of CGUs to which goodwill is allocated cannot be larger than an operating segment determined in accordance with IFRS 8. Also, management monitors operating segments that correspond to the three individual brands to which it has allocated the acquired outlets.

There are costs that cannot be clearly identified as relating to an individual restaurant, including marketing costs, sourcing of fish for the different brands and bulk purchasing. However, these costs are related to the brands which underlie Entity A's operating segments and the branding is evidence that there are synergies at this level. It is appropriate to allocate goodwill to the operating segments in order to test it for impairment. This does not prevent the separate outlets being identified as CGUs as IAS 36 allows an apportionment of costs. The independence of cash inflows is decisive.

8.1.3 Measuring the goodwill allocated to CGUs or groups of CGUs

Although goodwill has to be allocated, IAS 36 does not provide any allocation methodologies. One allocation method is a 'direct' method, which is based on the difference between the fair value of the net assets and the fair value of the acquired business (or portion thereof) to be assigned to the CGUs, thereby calculating goodwill directly by reference to the allocated net assets. However, this method will not allocate any goodwill to a CGU if no assets or liabilities are assigned to the CGU and, arguably, it will allocate too little goodwill to CGUs that benefit disproportionately because of synergies with the acquired business. A method that does not have these shortcomings is a 'with and without' method that requires the entity to calculate the fair value of the CGU or groups of CGUs that are expected to benefit before and after the acquisition; the difference represents the amount of goodwill to be allocated to that reporting unit. This will take account of buyer-specific synergies that relate to a CGU or group of CGUs. These methods are shown in the following Illustration.

Illustration 8-3: Allocating goodwill to more than one CGU

Entity A acquires Entity B for CU50 million, of which CU35 million is the fair value of the identifiable assets acquired and liabilities assumed. The acquisition is to be integrated into two of Entity A's CGUs with the net assets being allocated as follows:

	CGU 1	CGU 2	Total
	CU m	CU m	CU m
Acquired identifiable tangible and intangible assets	25	10	35

In addition to the net assets acquired that are assigned to CGU 2, the acquiring entity expects CGU 2 to benefit significantly from certain synergies related to the acquisition (e.g., CGU 2 is expected to realise higher sales of its products because of access to the acquired entity's distribution channels), while CGU 1 is expected to benefit from synergies to a lesser extent. There is no synergistic goodwill attributable to other CGUs.

Entity A calculates that the fair value of the acquired businesses allocated to CGU 1 and CGU 2 is CU33 million and CU17 million respectively. If goodwill is allocated to the CGUs based on the difference between the fair value of the net assets and the fair value of the acquired business, i.e., the direct method, the allocation would be as follows:

	CGU 1	CGU 2	Total
	CU m	CU m	CU m
Acquired identifiable tangible and intangible assets	25	10	35
Fair value of acquired business allocated based on direct method	33	17	50
Goodwill assigned to CGUs	**8**	**7**	**15**

Alternatively, Entity A assigns goodwill to the CGUs based on the difference between the fair value of the net assets to be assigned and the fair value of the acquired business (or portion thereof), including the significant beneficial synergies that CGU 2 is expected to achieve. In this case, the fair value of the acquired business (or portion thereof) is determined using a 'with and without' method.

	CGU 1	CGU 2	Total
	CU m	CU m	CU m
Fair value of CGU after acquisition	90	85	175
Fair value of CGU prior to acquisition	(62)	(63)	(125)
Fair value of acquired business allocated based on the 'with and without' method	28	22	50
Acquired identifiable tangible and intangible assets	(25)	(10)	(35)
Goodwill assigned to CGUs	**3**	**12**	**15**

In this case, the 'with and without' method can be more appropriate, but this would depend on the availability and reliability of inputs. The 'direct' method can give in other circumstances a reasonable allocation of goodwill.

8.1.4 The effect of IFRS 8 *Operating Segments* on impairment tests

Goodwill to be tested for impairment cannot be allocated to a CGU or group of CGUs larger than an operating segment as defined by IFRS 8. *[IAS 36.80, IAS 36.81, IFRS 8.11, IFRS 8.12]*. IFRS 8 is discussed in Chapter 32.

Organisations managed on a matrix basis cannot test goodwill for impairment at the level of internal reporting, if this level crosses more than one operating segment as defined in IFRS 8. *[IFRS 8.5]*. In addition, it is possible that the operating segments selected by the entities does not correspond with their CGUs.

Matrix organisations manage their businesses simultaneously on two different bases. For example, some managers are responsible for different product and service lines while others are responsible for specific geographical areas. IFRS 8 notes that the characteristics that define an operating segment can apply to two or more overlapping sets of components for which managers are held responsible. Financial information can be available for both, and the chief operating decision maker can regularly review both sets of operating results of components. In spite of this, IFRS 8 requires the entity to characterise one of these bases as determining its operating segments. *[IFRS 8.10]*. In doing so, entities should consider IFRS 8's intention that, for those entities that monitor goodwill at or below the segment level, there should be a link between the level at which goodwill is tested for impairment and the level of internal reporting that reflects the way an entity manages its operations. *[IAS 36.BC140]*.

8.1.4.A Changes to operating segments

Changes to the way in which an entity manages its activities can result in changes to its operating segments. It is possible that an entity needs to reallocate goodwill if it changes its operating segments, particularly if the entity has previously allocated goodwill at or close to segment level. Such a reallocation of goodwill is due to a change in circumstances and therefore will not be a change in accounting policy under IAS 8. *[IAS 8.34]*. This means that the previous impairment test will not need to be re-performed retrospectively.

In two situations, the disposal of an operation within a CGU and a change in the composition of CGUs due to a reorganisation, which are described in section 8.5 below, IAS 36 proposes a reallocation based on relative values, unless another basis is more appropriate. *[IAS 36.86, IAS 36.87]*.

How we see it

A reallocation of goodwill driven by the identification of new operating segments is another form of reorganisation of the reporting structure, therefore the same methodology is appropriate in our view. The entity is required to use a relative value approach, unless it can demonstrate that some other method better reflects the goodwill associated with the reorganised units (see section 8.5.1 below).

This means a method based on the activities in their current state, e.g., an entity is not allowed to revert to the historical goodwill as it arose on the various acquisitions.

Generally, an impairment test would be performed prior to the reallocation of goodwill.

An important issue in practice is the date from which the revised goodwill allocation applies. The goodwill allocation must be based on the way in which management is actually monitoring activities and cannot be based on management intentions. Under IFRS 8, operating segments are identified on the basis of internal reports that are regularly reviewed by the entity's chief operating decision maker in order to allocate resources to the segment and assess its performance. *[IFRS 8.5]*. Therefore, goodwill cannot be allocated to the revised operating segments until it can be demonstrated that the chief operating decision maker is receiving the relevant internal reports for the revised segments.

8.1.4.B Aggregation of operating segments for disclosure purposes

IFRS 8 allows an entity to aggregate two or more operating segments into a single reporting segment if this is 'consistent with the core principles' and, in particular, if the segments have similar economic characteristics. *[IFRS 8.12]*. Whilst this is specifically in the context of segmental reporting, in isolation, it can be interpreted as suggesting that individual operating segments could also be aggregated to form one operating segment that would also apply for impairment purposes. However, the 'unit of accounting' for goodwill impairment is before any aggregation. *[IAS 36.80(b)]*.

8.1.5 Goodwill initially unallocated to cash-generating units

IFRS 3 allows a 'measurement period' after a business combination to provide the acquirer with a reasonable time to obtain the information necessary to identify and measure all of the various components of the business combination as of the acquisition date in accordance with the standard. *[IFRS 3.46]*. The measurement period ends as soon as the acquirer receives the information it is seeking and cannot exceed one year from the acquisition date. *[IFRS 3.45]*.

IAS 36 recognises that in such circumstances, it is possible that the initial allocation of the goodwill to a CGU or group of CGUs for impairment purposes cannot be completed before the end of the annual period in which the combination is effected. *[IAS 36.85]*. Where this is the case the goodwill (or part of it) is left unallocated for that period. Goodwill must then be allocated before the end of the first annual period beginning after the acquisition date. *[IAS 36.84]*. The standard requires disclosure of the amount of the unallocated goodwill together with an explanation as to why that is the case (see section 13.3 below).

The question arises as to whether the entity ought to test, in such circumstances, the goodwill acquired during the current annual period before the end of the current annual period or in the following year if the annual impairment testing date is before the allocation of goodwill is completed.

It will depend on whether an entity is able during the 'measurement period' and until the initial allocation of goodwill is completed to quantify goodwill with sufficient accuracy and allocate goodwill on a provisional basis to CGUs or group of CGUs.

If the entity is able to quantify goodwill with sufficient accuracy, a provisional allocation of goodwill could be made in the following circumstances:

- The entity knows that all goodwill relates to a single CGU or to a group of CGUs no larger than a single operating segment.

  Or

- The entity knows that the initial accounting for the combination is complete in all material respects, although some details remain to be finalised.

In circumstances where a provisional allocation of goodwill could be made, an entity is required to test this provisional goodwill for impairment in accordance with IAS 36 during the annual period in which the acquisition occurred and in the following year's annual impairment test, even if this is before the allocation of goodwill is completed.

In addition, an entity is required to carry out an impairment test where there are indicators of impairment. This is the case even if the fair values have not been finalised and the goodwill amount is only provisional or goodwill has not necessarily been allocated to the relevant CGUs or groups of CGUs and the test therefore has to be carried out at a higher, potentially even at the reporting entity level.

An entity would not need to test the goodwill for impairment until the allocation of goodwill has been finalised, if a provisional allocation of goodwill could not be made and there are no indications of impairment.

How we see it

In our view, an entity needs to consider performing an impairment test on goodwill even where the initial allocation of the goodwill to a CGU or group of CGUs is not completed. Although the standard does not deal with an interim reporting period in this regard, we believe the same considerations would need to be applied at each reporting date and not just the annual reporting periods.

When the allocation of goodwill is only finalised in the first annual period after the acquisition date, the entity must consider appropriate actions for each (annual and interim) reporting date between the acquisition date and the date the goodwill is finalised.

In some circumstances, the acquirer is required to test the final allocated goodwill for impairment retrospectively, on the basis that the test on provisional goodwill was in fact the first impairment test applying IAS 36. In the following cases an entity must update the prior year's impairment test retrospectively:

- If the entity allocated provisional goodwill to CGUs, although it had not completed its fair value exercise, and tested provisional goodwill of impairment in accordance with IAS 36.

  Or

- If the entity did not allocate provisional goodwill to the related CGUs but there were indicators of impairment and the entity tested the provisional goodwill potentially at a different level to the ultimate allocation and the impairment test resulted in an impairment.

If the entity did not allocate provisional goodwill to CGUs, there were indicators of impairment and the impairment test at a higher, potentially entity level, did not result in an impairment, the entity can choose whether to update the prior year's impairment test retrospectively, but is not required to do so.

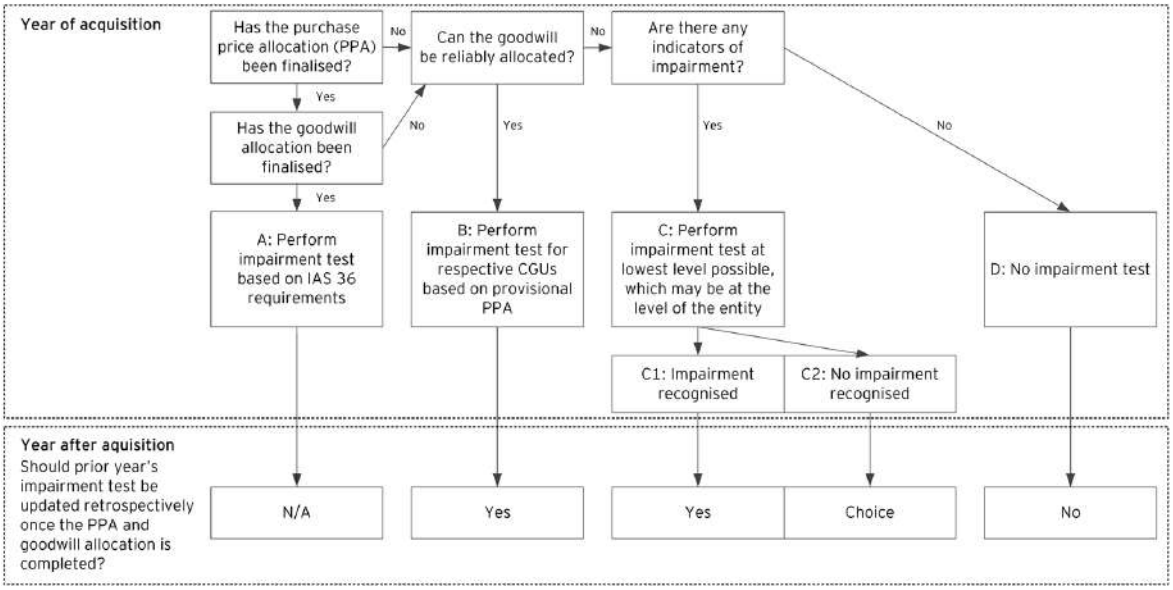
In all other scenarios, the acquirer performs only a current year impairment test (i.e., after the allocation has been completed) on a prospective basis.

How we see it

If the acquirer updates the prior year's impairment test as outlined above, this update could decrease the original goodwill impairment recognised. In our view, such a decrease is an adjustment to the original goodwill impairment. This will not qualify as a reversal and does not violate the prohibition on reversing any goodwill impairments in IAS 36.124. (See section 11.3 below).

The above explained approach is illustrated below:

Figure 8-1: Goodwill initially unallocated to cash-generating units



If an entity were to change its annual reporting date, it could mean that it has a shorter period in which to allocate goodwill as IAS 36 requires that allocation of goodwill for impairment purposes is completed by the end of the first annual period after the acquisition and not within 12 months as required by IFRS 3. *[IAS 36.84]*.

Illustration 8-4: Impact of shortened accounting period

Entity A prepares its financial statements for annual periods ending on 31 December. It acquired Entity B on 30 September 20X0. In accounting for this business combination in its financial statements for the year ended 31 December 20X0, Entity A has only been able to determine the fair values to be assigned to Entity B's assets, liabilities and contingent liabilities on a provisional basis and has not allocated the resulting provisional amount of goodwill arising on the acquisition to any CGU (or group of CGUs). During 20X1, Entity A changes its annual reporting date to June and is preparing its financial statements as at its new period end of 30 June 20X1. IFRS 3 does not require the fair values assigned to Entity B's net assets (and therefore the initial amount of goodwill) to be finalised by that period end, since Entity A has until 30 September 20X1 to finalise the values. However, IAS 36 would appear to require the allocation of the goodwill to CGUs for impairment purposes be completed by the date of the 30 June 20X1 financial statements since these are for the first annual period beginning after the acquisition date, despite the fact that the initial accounting under IFRS 3 is not yet complete. The entity would therefore need to test goodwill for impairment for the financial reporting period ending 30 June 20X1.

8.2 When to test cash-generating units with goodwill for impairment

IAS 36 requires a CGU or group of CGUs to which goodwill has been allocated to be tested for impairment annually by comparing the carrying amount of the CGU or group of CGUs, including the goodwill, with its recoverable amount. *[IAS 36.90]*. The requirements of the standard in relation to the timing of such an annual impairment test (which need not be at the period end) are discussed below. This annual impairment test is not a substitute for management being aware of events occurring or circumstances changing between annual tests that suggest that goodwill is impaired. *[IAS 36.BC162]*. IAS 36 requires an entity to assess at each reporting date whether there is an indication that a CGU may be impaired. *[IAS 36.9]*. So, whenever there is an indication that a CGU or group of CGUs may be impaired it is to be tested for impairment by comparing the carrying amount, including the goodwill, with its recoverable amount. *[IAS 36.90]*.

If the carrying amount of the CGU (or group of CGUs), including the goodwill, exceeds the recoverable amount of the CGU (or group of CGUs), then an impairment loss has to be recognised in accordance with IAS 36.104 (see section 11.2 below). *[IAS 36.90]*.

8.2.1 Timing of impairment tests

IAS 36 requires an annual impairment test of CGUs or groups of CGUs to which goodwill has been allocated. The impairment test does not have to be carried out at the end of the reporting period. The standard permits the annual impairment test to be performed at any time during an annual period, provided the test is performed at the same time every year. Different CGUs can be tested for impairment at different times. However, if some or all of the goodwill allocated to a CGU or group of CGUs was acquired in a business combination during the current annual period, that unit must be tested for impairment before the end of the current annual period. *[IAS 36.96]*.

The IASB observed that acquirers can sometimes 'overpay' for an acquiree, so that the amount initially recognised for the business combination and the resulting goodwill exceeds the recoverable amount of the investment. The Board was concerned that without this requirement it is possible for entities to delay recognising such an impairment loss until the annual period after the business combination. *[IAS 36.BC173]*.

It has to be said that the wording of the requirement does not achieve that result if the goodwill is not allocated to a CGU in the period in which the business combination occurs. The time allowed for entities to allocate goodwill can mean that this is not completed until the period following the business combination. *[IAS 36.84]*. The potential consequences of this are discussed in section 8.1.5 above.

Consider also the following Illustration.

Illustration 8-5: Testing for impairment of goodwill allocated in the period after acquisition after the annual impairment testing date

Entity A prepares its financial statements for annual reporting periods ending on 31 December. It performs its annual impairment test for all cash-generating units (CGUs) to which it has allocated goodwill on 30 September.

On 31 October 20X0, Entity A acquires Entity B. Entity A completes the initial allocation of goodwill to CGUs on 31 October 20X1, before the end of the annual reporting period on 31 December 20X1. Therefore, Entity A does not allocate the goodwill until after its annual date for testing goodwill, 30 September 20X1.

There are no indicators of impairment of goodwill on 31 December 20X0. If there is any such indicator, Entity A is required to test goodwill for impairment at that date, regardless of the date of its annual impairment test. On 31 December 20X0, the entity had not yet allocated its goodwill and did not test it for impairment, because there were no impairment indications at that time. During 20X1, Entity A receives the information it was seeking about facts and circumstances that existed as of the acquisition date, but it does not finalise the fair values assigned to Entity B's net assets (and therefore the initial amount of goodwill) until 31 October 20X1. IAS 36 requires Entity A to allocate the goodwill to CGUs by the end of the financial year. It does this by December 20X1.

In this case, at the time of carrying out its annual impairment tests on 30 September 20X1, Entity A has not yet allocated the goodwill relating to Entity B; therefore no impairment test of that goodwill needs to be carried out at that time, provided there are no indicators of impairment. When it does allocate the goodwill by December 20X1, the requirement to perform an impairment test for the CGUs to which this goodwill is allocated does not seem to be applicable since the goodwill does not relate to a business combination during the current annual period. It actually relates to a business combination in the previous period; it is just that it has only been allocated for impairment purposes in the current period. Nevertheless, Entity A must perform an updated impairment test for the CGUs to which this goodwill is allocated for the purposes of its financial statements for the year ended 31 December 20X1 since this would seem to be the intention of the IASB. Not to do so, would mean that the goodwill would not be tested for impairment until 30 September 20X2, nearly 2 years after the business combination.

IAS 36 requires the annual impairment test for a CGU to which goodwill has been allocated to be performed at the same time every year but is silent on whether an entity can change the timing of the impairment test.

How we see it

In our view, a change in timing of the annual impairment test is acceptable if there are valid reasons for the change, the period between impairment tests does not exceed 12 months and the change is not made to avoid an impairment charge. The requirement that the period between impairment tests cannot exceed 12 months could mean that an entity would need to test a CGU twice in a year if, for example, it wanted to change the date of the test from October to December. In our view, it would in general not be appropriate to change the date of the impairment test again in consecutive years.

8.2.2 Sequence of impairment tests for goodwill and other assets

When a CGU to which goodwill has been allocated is tested for impairment, there can also be an indication of impairment of an asset within the unit. IAS 36 requires the entity to test the asset for impairment first and recognise any impairment loss on it before carrying out the impairment test for the goodwill, although this is unlikely to have any practical impact as the assets within the CGU by definition will not generate separate cash flows. An entity will have to go through the same process if there is an indication of an impairment of a CGU within a group of CGUs containing the goodwill. The entity must test the CGU for impairment first, and recognise any impairment loss for that CGU, before testing the group of CGUs to which the goodwill is allocated. *[IAS 36.97, IAS 36.98]*.

8.2.3 Carry forward of a previous impairment test calculation

IAS 36 permits the most recent detailed calculation of the recoverable amount of a CGU or group of CGUs to which goodwill has been allocated to be carried forward from a preceding period provided certain criteria are met (see the following IAS 36 extract): *[IAS 36.99]*

Extract from IAS 36

99 The most recent detailed calculation made in a preceding period of the recoverable amount of a cash-generating unit to which goodwill has been allocated may be used in the impairment test of that unit in the current period provided all of the following criteria are met:

(a) the assets and liabilities making up the unit have not changed significantly since the most recent recoverable amount calculation;

(b) the most recent recoverable amount calculation resulted in an amount that exceeded the carrying amount of the unit by a substantial margin; and

(c) based on an analysis of events that have occurred and circumstances that have changed since the most recent recoverable amount calculation, the likelihood that a current recoverable amount determination would be less than the current carrying amount of the unit is remote.

The Basis for Conclusions indicates that the reason for this dispensation is to reduce the costs of applying the impairment test, without compromising its integrity. *[IAS 36.BC177]*. However, clearly it is a matter of judgement as to whether each of the criteria is actually met.

8.2.4 Reversal of impairment loss for goodwill prohibited

Once an impairment loss has been recognised for goodwill, IAS 36 prohibits its reversal in a subsequent period. *[IAS 36.124]*. The standard justifies this on the grounds that any reversal "is likely to be an increase in internally generated goodwill, rather than a reversal of the impairment loss recognised for the acquired goodwill", and IAS 38 prohibits the recognition of internally generated goodwill. *[IAS 36.125]*. The impairment test itself though does not distinguish between purchased and internally generated goodwill.

8.3 Impairment of assets and goodwill recognised on acquisition

There are a number of circumstances in which the fair value of assets or goodwill acquired as part of a business combination is measured at a higher amount through recognition of deferred tax or notional tax benefits. This raises the question of how to test for impairment and even whether there is, in fact, a 'day one' impairment in value. In other circumstances, deferred tax assets can or cannot be recognised as part of the fair value exercise and this, too, can affect subsequent impairment tests of the assets and goodwill acquired as part of the business combination.

8.3.1 Testing goodwill 'created' by deferred tax for impairment

As described in Chapter 29 at section 12, the requirement of IAS 12 to recognise deferred tax on all temporary differences arising on net assets acquired in a business combination can have an impact on the amount of goodwill recognised. In a business combination, there is no initial recognition exemption for deferred tax and the corresponding accounting entry for a deferred tax asset or liability forms part of the goodwill arising or the bargain purchase gain recognised. *[IAS 12.22(a)]*. Where an intangible asset, which was not recognised in the acquiree's financial statements, is acquired in a business combination and the intangible asset's tax base is zero, a deferred tax liability based on the fair value of the intangible asset and the prevailing tax rate will be recognised. The corresponding debit entry will increase goodwill. This then begs the question of how to consider this in the VIU when performing an impairment test on that goodwill and whether there is indeed an immediate impairment that would need to be recognised. We explore the issues in the following Illustrations.

Illustration 8-6: Apparent 'day one' impairment arising from recognition of deferred tax in a business combination

Entity A, which is taxed at 40%, acquires Entity B for CU100m in a transaction that is a business combination. For simplicity assume the only asset of the entity is an intangible asset with a fair value of CU60m.

It is assumed that the entity cannot get a deduction for tax purposes for the goodwill and the intangible asset, as is often the case for assets that arise only on consolidation. It is also assumed that the fair value of the intangible asset does not reflect the benefits of any tax deductions had the asset been tax deductible, which can be an inappropriate assumption and is discussed further below.

The fair value and tax base of the intangible are as follows:

	Fair value	Tax base
	CU m	CU m
Intangible asset	60	nil

This will give rise to the following initial entries on consolidation:

			CU m	CU m
Dr	Goodwill (balance)		64	
Dr	Intangible asset		60	
	Cr	Deferred tax liability[1]		24
	Cr	Cost of investment		100

[1] *40% of CU60m*

Of the goodwill of CU64m, CU24m is created through deferred tax on the intangible asset.

The carrying value of the consolidated assets of the subsidiary (excluding deferred tax) is now CU124m consisting of goodwill of CU64m and the intangible asset of CU60m. However, the fair value of the subsidiary is only CU100m. Clearly CU24m of the goodwill arises solely from the recognition of deferred tax. However, IAS 36.50, explicitly requires tax to be excluded from the estimate of future cash flows used to calculate any impairment. This raises the question of whether there must be an immediate impairment write-down of the assets to CU100m.

We think that immediately recognising an impairment loss on goodwill created by deferred tax arising from fair value adjustments in a business combination, is unlikely to have been the intention of IAS 36. In order to remove the tax effects, the carrying amount of goodwill that relates to taxation and was created via the related deferred tax liability would be removed when comparing the carrying value of the CGU with the recoverable amount to determine any potential impairment. This means, in effect, that at the point of acquisition, the goodwill can be reduced by the deferred tax liability arising from fair value adjustments in a business combination in order to measure any impairment. As a result, the entity does not have to recognise an immediate impairment loss. Important to note is that this would not override the general IAS 36 requirement of impairing (all) goodwill first, when in subsequent period an impairment is identified.

How we see it

In our view, a day one impairment cannot arise purely because of recognised deferred tax liabilities in a business combination. To avoid an immediate impairment, goodwill would be reduced by the nominal versus fair value difference of the deferred tax liability when measuring any impairment. Alternatively, an entity could measure the recoverable amount based on fair value less costs of disposal.

Not recognising an immediate impairment loss is consistent with the fact that the goodwill due to deferred tax that is being recognised as part of this acquisition is not part of 'core goodwill' (see section 8.1.1 above), but is a consequence of the exceptions in IFRS 3 to the basic principle that assets and liabilities be measured at fair value, deferred tax being one of these exceptions (see section 8.1.1 above and Chapter 10 at section 5.6.2).

Another way of describing this is that the lack of tax basis inherent in the asset has already been reflected in the fair value assigned to the asset. As a result, the incremental fair value of the deferred tax liability is nil. Goodwill is reduced by the nominal versus fair value difference of the deferred tax liability which in this case is the full amount of the deferred tax liability related to the intangible.

Continuing with this simplified example, if it is assumed that the intangible asset is amortised over a finite useful life then the deferred tax relating to that asset (CU24m in this example) will be released over that useful life with the effect that the net amount charged to the income statement of CU36m (total amortisation less deferred tax, CU60m - CU24m) will be the same as if the amortisation charge were tax deductible.

At future impairment testing dates, one would adjust for any remaining deferred tax liability at the impairment testing date that resulted in an increase in goodwill at the acquisition date.

In many jurisdictions the amortisation of intangible assets is deductible for tax purposes. This generates additional benefits, called tax amortisation benefit (TAB), impacting the fair value of the intangible. Therefore, the fair value as part of a business acquisition for many intangible assets includes assumptions about the tax amortisation benefit that would be available if the asset were acquired separately. For example, the value of a trademark using the 'relief from royalty' method would be assumed to be the net present value of post-tax future royalty savings, under consideration of TAB, in the consolidated financial statements, based on the hypothetical case of not owning the trademark. In order to reach the fair value of the asset, its value before amortisation would be adjusted by a tax amortisation factor reflecting the corporate tax rate, a discount rate and a tax amortisation period (this is the period allowed for tax purposes, which is not necessarily the useful life for amortisation purposes of the asset). In a market approach, fair value is estimated from market prices paid for comparable assets and the prices will contain all benefits of owning the assets, including any tax amortisation benefit.

This means that the difference between the tax amortisation benefit and the gross amount of the deferred tax liability remains part of goodwill.

This is demonstrated in the following Illustration:

Illustration 8-7: Impairment testing assets whose fair value reflects tax amortisation benefits

Assume that the entity in Illustration 8-6 above has acquired an intangible asset that would be tax deductible if separately acquired but that has a tax base of zero.

The entity concludes that the fair value of the intangible will reflect the tax benefit, whose gross amount is CU40m (CU60m × 40% ÷ 60%) but in calculating the fair value this will be discounted to its present value - say CU30m. The initial entry is now as follows:

			CU m	CU m
Dr	Goodwill (balance)		46	
Dr	Intangible asset (CU(60m + 30m))		90	
	Cr	Deferred tax liability[1]		36
	Cr	Cost of investment		100

1 *40% of CU90m*

Overall, the assets that cost CU100m will now be recorded at CU136m, as against the total of CU124m in Illustration 8-6. This increase has come about because of recognition of deferred tax of CU12m, which is 40% of CU30m, the assumed tax amortisation benefit.

In this example, only CU6m goodwill results from the recognition of deferred tax [CU46m - (CU100m - CU60m)] and its treatment is discussed above. The CU6m represents the difference between the nominal amount of deferred tax of CU36m and the fair value of the tax amortisation benefit included in the intangible asset of CU30m.

Unlike goodwill, the intangible asset will only have to be tested for impairment if there are indicators of impairment, if it has an indefinite useful life or if it is not yet available for use. *[IAS 36.10]*. If the intangible asset is being tested by itself for impairment, i.e., not as part of a CGU, its FVLCD would need to be determined on the same basis as for the purposes of the business combination, making the same assumptions about taxation. If FVLCD exceeds the carrying amount, there is no impairment.

However, as mentioned in section 3.1 above, many intangible assets do not generate independent cash inflows as individual assets and so they are tested as part of a CGU. Assuming there is no goodwill in the CGU being tested, then the VIU of the CGU can be calculated on an after-tax basis using notional tax cash flows assuming the asset's tax basis is equal to its VIU as discussed in section 7.2.3 above.

When goodwill is included in the CGU, the carrying amount of goodwill that results from the recognition of deferred tax (e.g., the CU6m in Illustration 8-7 above) must be removed for impairment testing purposes. At future impairment testing dates, one must adjust for any remaining difference between the nominal deferred tax liability at the impairment testing date and the original fair value of the assumed tax basis embedded in the intangible asset carrying value that remains at the impairment testing date. This is consistent with the assumption that it could not have been the IASB's intention to have an immediate impairment at the time of acquisition and the same logic and approach is being carried forward from day 1 to future impairment tests.

Another way of describing this is that the fair value of the deferred tax liability in the above example is equal to 30, being the tax amortisation benefit embedded in the fair value of the intangible asset. This tax amortisation benefit does not actually exist given the intangible asset's tax basis is in fact nil. Goodwill is reduced by the nominal versus fair value difference of the deferred tax liability which in this case is 6. If one tests the CGU (including both the intangible asset and goodwill) for impairment, when calculating the VIU following the approach in section 7.2.3 above on an after-tax basis (using notional tax cash flows assuming a tax basis equal to VIU) this cannot lead to day 1 impairment, given the VIU calculation assumes a full tax basis similar to that assumed in the intangible carrying value, as goodwill has been reduced by the nominal versus fair value difference of the deferred tax liability of 6.

An entity cannot continue to make this adjustment if it becomes impracticable to identify reliably the amount of the adjustment, in which case the entity would use VIU without this adjustment or use FVLCD of the CGU as the recoverable amount.

This is shown in the following Illustration:

Illustration 8-8: Impairment testing assets whose fair value reflects tax amortisation benefits (continued)

Assume that the entity in Illustration 8-7 above amortises the intangible asset on a straight-line basis over 10 years. When the entity performs its impairment test at the end of year one the carrying amount of the deferred tax liability and remaining fair value of the tax benefits embedded in the carrying amount of the intangible are as follow:

	Acquisition date	Amortisation year 1	End of year 1
	CU m	CU m	CU m
Intangible asset	60.0	6.0	54.0
Tax amortisation benefit (TAB)	30.0	3.0	27.0
Carrying value of intangible asset incl. TAB	90.0	9.0	81.0
Deferred tax[1]	36.0	3.6	32.4

[1] Year 1: 40% of CU90m and end of year 1 40% of CU81m

In the impairment test at the end of year 1, goodwill would be adjusted for the difference between the remaining nominal deferred tax liability of CU32.4m and the remaining tax benefit reflected in the carrying value of the intangible asset of CU27m resulting in an adjustment of CU5.4m to goodwill. The impairment test would therefore incorporate goodwill of CU40.6m (CU46m - CU5.4m).

The disclosure requirements of IAS 36 including the pre-tax discount rate, principally described in section 13.3 below, will apply.

8.3.2 Deferred tax assets and losses of acquired businesses

Deferred tax assets arising from tax losses carried forward at the reporting date must be excluded from the assets of the CGU for the purpose of calculating its VIU. However, it is possible that tax losses do not meet the criteria for recognition as deferred tax assets in a business combination, which means that their value is initially subsumed within goodwill. Under IFRS 3 and IAS 12, only acquired deferred tax assets that are recognised within the measurement period (through new information about circumstances at the acquisition date) are to reduce goodwill, with any excess once goodwill has been reduced to zero being taken to profit or loss. After the end of the measurement period, all other acquired deferred tax assets are taken to profit or loss. *[IFRS 3.67, IAS 12.68]*.

Unless and until the deferred tax asset is recognised, this raises the same problems as in section 8.3.1 above. Certain assumptions regarding future taxation are built into the carrying value of goodwill and one must consider excluding these amounts from the carrying amount of the CGU when testing for impairment. However, if at a later date it transpires that any tax losses carry forwards subsumed in goodwill cannot be utilised, then excluding these amounts from the carrying amount of the CGU for impairment testing is not appropriate and can lead to an impairment.

8.4 Impairment testing when a CGU crosses more than one operating segment

While IAS 36 is clear that goodwill cannot be tested at a level that is larger than an operating segment determined in accordance with IFRS 8, it does not contain similar guidance for other assets. Therefore, the basic principle of IAS 36 applies, meaning assets or a group of assets are tested at the lowest level at which largely independent cash inflows can be identified. In practice a CGU determined based on the lowest level of independent cash inflows could be larger than an operating segment and therefore could cross more than one operating segment. For example, in the telecom industry, the entire telecom fixed line network can be one CGU, while at the same time an entity can identify its operating segments based on types of clients (e.g., individual clients, business clients, other operators, etc.). The general guidance in IAS 36 would require an entity to assess at each reporting date whether there are impairment indicators for the CGU and if such impairment indicators exist, perform a formal impairment assessment at CGU level. Regardless of whether a CGU crosses more than one operating segment, goodwill would need to be tested at a lower operating segment level. For this operating segment level impairment test, the assets of the larger CGU, in particular the cross operating segment assets e.g., the fixed line network, would need to be allocated to the operating segments. The application of these principles in practice can be complex and require judgement.

8.5 Disposal of operation within a cash-generating unit to which goodwill has been allocated

If goodwill has been allocated to a CGU (or a group of CGUs) and the entity disposes of an operation within that CGU, IAS 36 requires that the goodwill associated with the operation disposed of is included in the carrying amount of the operation when determining the gain or loss on disposal. For that purpose, the standard requires that the amount to be included is measured on the basis of the relative values of the operation disposed of and the portion of the CGU retained, unless the entity can demonstrate that some other method better reflects the goodwill associated with the operation disposed of. *[IAS 36.86]*.

The standard refers to the 'relative values' of the parts without specifying how these are to be calculated. The recoverable amount of the part that it has retained will be based on the principles of IAS 36, i.e., at the higher of FVLCD and VIU. This means that it is possible that the VIU or FVLCD of the part retained has to be calculated as part of the allocation exercise on disposal.

In addition, the VIU and FVLCD of the part disposed of will be materially the same. This is because the VIU will consist mainly of the net disposal proceeds; it cannot be based on the assumption that the sale would not take place.

Illustration 8-9: Goodwill attributable to the disposal of an operation based on relative values

An entity sells for CU100 an operation that was part of a CGU to which goodwill of CU60 has been allocated. The goodwill allocated to the CGU cannot be identified or associated with an asset group at a level lower than that CGU, except arbitrarily. The recoverable amount of the portion of the CGU retained is CU300. Because the goodwill allocated to the CGU cannot be non-arbitrarily identified or associated with an asset group at a level lower than that CGU, the goodwill associated with the operation disposed of is measured on the basis of the relative values of the operation disposed of and the portion of the CGU retained. Therefore, 25% of the goodwill allocated to the CGU, i.e., CU15 is included in the carrying amount of the operation that is sold.

It will not necessarily follow, for example, that the business disposed of generated 25% of the net cash flows of the combined CGU. Therefore, the relative value method suggested by the standard to be applied in most circumstances can be based on a mismatch in the valuation bases used on the different parts of the business, reflecting the purchaser's assessment of the value of the part disposed of at the point of sale rather than that of the vendor at purchase.

The standard allows the use of some other method if it better reflects the goodwill associated with the part disposed of. The IASB had in mind a scenario in which an entity buys a business, integrates it with an existing CGU that does not include any goodwill in its carrying amount and immediately sells a loss-making part of the combined CGU. It is accepted that in these circumstances it is reasonable to conclude that no part of the carrying amount of the goodwill has been disposed of. *[IAS 36.BC156]*. The loss-making business being disposed of could, of course, have been owned by the entity before the acquisition or it could be part of the acquired business. However, the standard is not clear in what other circumstances a base other than relative values would better reflect the goodwill associated with the part disposed of. Any other method must take account of the basic principle, which is that this is an allocation of the carrying amount of goodwill and not an impairment test. It is not relevant, for example, that the part retained has sufficient headroom for all of the goodwill without any impairment. One has to bear in mind that any basis of allocation of goodwill on disposal other than that recommended by the standard could be an indication that goodwill must have been allocated on a different basis on acquisition. It could suggest that there was a reasonable basis of allocating goodwill to the CGUs within a group of CGUs.

However, as demonstrated in Illustration 8-11 below, in some circumstances the allocation based on relative values can lead to an immediate impairment which is not intuitive and therefore an alternative method can, depending on facts and circumstances, better reflect the goodwill associated with the operation disposed of.

How we see it

In our view, an approach that is based on current relative values of notional goodwill in the part disposed of and the part retained could, depending on facts and circumstances, be seen as an acceptable alternative for the goodwill allocation as illustrated in section 8.5.1 below.

8.5.1 Changes in composition of cash-generating units

If an entity reorganises the structure of its operations in a way that changes the composition of one or more CGUs to which goodwill has been allocated, IAS 36 requires that the goodwill be reallocated to the units affected. For this purpose, the standard requires the reallocation to be performed using a relative value approach similar to that discussed above when an entity disposes of an operation within a CGU, unless the entity can demonstrate that some other method better reflects the goodwill associated with the reorganised units. *[IAS 36.87]*. Generally, an impairment test would need to be performed prior to the reallocation of goodwill. As a result, if the reorganisation is triggered by underperformance in any of the affected operations, it cannot mask any impairment.

Illustration 8-10: Reallocation of goodwill to CGUs based on relative values

Goodwill of CU160 had previously been allocated to CGU A. A is to be divided and integrated into three other CGUs, B, C and D. Because the goodwill allocated to A cannot be non-arbitrarily identified or associated with an asset group at a level lower than A, it is reallocated to CGUs B, C and D on the basis of the relative values of the three portions of A before those portions are integrated with B, C and D. The recoverable amounts of these portions of A before integration with the other CGUs are CU200, CU300 and CU500 respectively. Accordingly, the amounts of goodwill reallocated to CGUs B, C and D are CU32, CU48 and CU80 respectively.

When goodwill is reallocated based on relative values, it can be necessary to assess impairment immediately following the reallocation, as the recoverable amount of the CGUs will be based on the principles of IAS 36 and the reallocation could lead to an immediate impairment.

Again, the standard gives no indication as to what other methods better reflect the goodwill associated with the reorganised units.

As illustrated in Illustration 8-11 below, the reallocation based on relative values could lead to an immediate impairment after the reallocation. This is not intuitive given that an impairment test would have been performed immediately before the goodwill reallocation and the restructuring of a business would not be expected to result in an impairment of goodwill.

As stated in section 8.5 above, an allocation based on the relative current value of notional goodwill could, depending on facts and circumstances, be seen as an acceptable alternative to the IAS 36 suggested approach of relative values. This method calculates the current value of notional goodwill in each of the components to be allocated to new CGUs by performing a notional purchase price allocation for each affected CGU. To do this the components fair value is compared with the fair value of the net identifiable assets to obtain the current value of notional goodwill. The carrying amount of the goodwill to be reallocated is then allocated to the new CGUs based on the relative current values of notional goodwill. This approach together with an example of circumstances under which the approach can be acceptable is illustrated in Illustration 8-11:

Illustration 8-11: Reallocation of goodwill to CGUs based on relative current values of notional goodwill

A US company acquired a European sub-group in 20X0 and recorded goodwill of CU30 million. At the time Europe was a new market for the company and goodwill was fully allocated to one CGU A based on the geographic location Europe. Two years later the group fundamentally restructured its business in Europe. The restructuring resulted in the split of the existing CGU into three new CGUs B, C and D based on products. The goodwill of CU30 million was assessed for impairment immediately prior to the restructuring and no impairment was identified.

The recoverable amounts of the net identifiable assets and the recoverable amounts of each new CGU are given in the following table:

CGU	B	C	D	Total
	CU m	CU m	CU m	
Fair value of net identifiable assets	20	40	40	100
Book value of net identifiable assets	10	35	35	80
Recoverable amount	40	80	40	160

The allocation based on the relative values of the three components of A allocated to B, C and D, as the required default method by the standard, would result in the following allocation of goodwill:

CGU	B	C	D	Total
	CU m	CU m	CU m	
Goodwill allocation	7.5	15	7.5	30
Book value of net identifiable assets	10	35	35	80
Total	17.5	50	42.5	110
Recoverable amount	40	80	40	160
Immediate impairment	-	-	2.5	2.5

Goodwill of CU7.5m (goodwill of CU30m × recoverable amount CU40m ÷ overall recoverable amount CU160m) is allocated to CGU B and D and CU15m (goodwill of CU30m × recoverable amount CU80m ÷ overall recoverable amount CU160m) to CGU C. As can be seen, the relative value approach would result in an immediate impairment of CU2.5m in CGU D. This is not intuitive, given that no impairment existed immediately prior to the restructuring and the restructuring of the business would not be expected to result in an immediate impairment. Another method of allocation can therefore better reflect the goodwill associated with the reorganised units. An allocation based on relative current values of notional goodwill could be an acceptable alternative method in this case. This would lead to the following allocation:

CGU	B	C	D	Total
	CU m	CU m	CU m	
CGU's fair value	40	80	40	160
Fair value net identifiable assets	20	40	40	100
Current value of notional goodwill	20	40	-	60
Historic goodwill allocated	10	20	-	30

This would allocate goodwill of CU10m (goodwill of CU30m × relative current value of notional goodwill CU20 ÷ overall current value of notional goodwill CU60m) to CGU B, CU20m (goodwill of CU30m × relative current value of notional goodwill CU40 ÷ overall current value of notional goodwill CU60m) to CGU C and CU0m (goodwill of CU30m × relative current value of notional goodwill CU0 ÷ overall current value of notional goodwill CU60m) to CGU D. This allocation would not cause an immediate impairment directly after the reallocation as the following table shows.

CGU	B	C	D	Total
	CU m	CU m	CU m	
Goodwill allocation	10	20	-	30
Book value of net identifiable assets	10	35	35	80
Total	20	55	35	110
Recoverable amount	40	80	40	160
Immediate impairment	-	-	-	-

The above example is based on a fact pattern where an existing CGU is split into three new CGUs. However, the method could be applied as well in circumstances where components of an existing CGU are allocated to other existing CGUs. The current values of notional goodwill used for reallocation purposes in such a case would need to be based only on the goodwill in the components being reallocated ignoring any goodwill in the existing CGUs to which the components are being allocated.

While the method illustrated above can be seen as an alternative method for goodwill reallocation it requires an entity to perform notional purchase price allocations for the components of each affected CGU and therefore potentially involves a significant time, effort and cost commitment. It is important to note that IAS 36 is not entirely clear whether an entity would need to use an alternative method that better reflects the goodwill associated with the reorganised units, if the entity is aware of it, or whether an entity could always just default to the IAS 36.87 stated relative value method.

In practice, situations can be considerably more complex than Illustration 8-9, Illustration 8-10 and Illustration 8-11 above. For example, when, after an acquisition, a combination of disposal of acquired businesses together with a reorganisation and integration arises. The entity can sell some parts of its acquired business immediately but also use the acquisition in order to replace part of its existing capacity, disposing of existing elements. In addition, groups frequently undertake reorganisations of their statutory entities. It is often the case that CGUs do not correspond to these individual entities and the reorganisations can be undertaken for taxation reasons so the ownership structure within a group does not correspond to its CGUs. This makes it clear how important it is that entities identify their CGUs and the allocation of goodwill to them, so that they already have a basis for making any necessary allocations when an impairment issue arises or there is a disposal.

9 Non-controlling interests - the impact on goodwill impairment testing

The amount of goodwill recorded by an entity when it acquires a controlling stake in a subsidiary that is less than 100% of its equity depends on which of the two following methods have been used to calculate it. Under IFRS 3 an entity has a choice between two methods:

- Goodwill attributable to the non-controlling interests is not recognised in the parent's consolidated financial statements as the non-controlling interest is stated at its proportion of the net fair value of the net identifiable assets of the acquiree.

  Or

- The non-controlling interest is measured at its acquisition-date fair value, which means that its share of goodwill will also be recognised.

Under the first method above the carrying amount of that CGU comprises:

- The parent's interest and the non-controlling interest in the identifiable net assets of the CGU.

  And

- The parent's interest in goodwill.

  But part of the recoverable amount of the CGU determined in accordance with IAS 36 is attributable to the non-controlling interest in goodwill.

IFRS 3 allows both measurement methods. The choice of method is to be made for each business combination, rather than being a policy choice, and could have a significant effect on the amount recognised for goodwill. *[IFRS 3.19, IAS 36.C1]*.

Previous acquisitions under IFRS 3 (2007) were required to be accounted for using the first method above and were not restated on transition to the revised standard. *[IFRS 3.64]*.

These methods are described in more detail in Chapter 10 at section 8.

The IASB itself has noted that there are likely to be differences arising from measuring the non-controlling interest at its proportionate share of the acquiree's net identifiable assets, rather than at fair value. First, the amounts recognised in a business combination for the non-controlling interest and goodwill are likely to be lower (as shown in the Illustration given in Chapter 10 at section 8.3). Second, if a CGU to which the goodwill has been allocated is subsequently impaired, any impairment of goodwill recognised through income is likely to be lower than it would have been if the non-controlling interest had been measured at fair value.

The Standard is clear that not all of the goodwill arising will necessarily be allocated to a CGU or group of CGUs which includes the subsidiary with the non-controlling interest. *[IAS 36.C2]*.

Guidance is given on the allocation of impairment losses:

- If a subsidiary, or part of a subsidiary, with a non-controlling interest is itself a CGU, the impairment loss is allocated between the parent and the non-controlling interest on the same basis as that on which profit or loss is allocated. *[IAS 36.C6]*.
- If it is part of a larger CGU, goodwill impairment losses are allocated to the parts of the CGU that have a non-controlling interest and the parts that do not on the following basis: *[IAS 36.C7]*
  - To the extent that the impairment relates to goodwill in the CGU, the relative carrying values of the goodwill of the parts before the impairment.
  - To the extent that the impairment relates to identifiable assets in the CGU, the relative carrying values of these assets before the impairment. Any such impairment is allocated to the assets of the parts of each unit *pro rata* on the basis of the carrying amount of each asset in the part.

    In those parts that have a non-controlling interest the impairment loss is allocated between the parent and the non-controlling interest on the same basis as that on which profit or loss is allocated.

However, it is not always clear how an entity tests for impairment when there is NCI. The issues include:

- Calculating the 'gross up' of the carrying amount of goodwill because NCI is measured at its proportionate share of net identifiable assets and hence its share of goodwill is not recognised (see section 9.1 below)
- Allocation of impairment losses between the parent and NCI
- Reallocation of goodwill between NCI and controlling interests after a change in a parent's ownership interest in a subsidiary that does not result in a loss of control

Each of these issues arises in one or more of the following situations:

- NCI is measured on a proportionate share, rather than fair value
- Because of the existence of a control premium there are indications that it would be appropriate to allocate goodwill between the parent and NCI on a basis that is disproportionate to the percentage of equity owned by the parent and the NCI shareholders
- There are subsequent changes in ownership between the parent and NCI shareholders, but the parent maintains control

Increases in the parent's share are discussed in section 9.1.1 below, as is the sale of an interest without the loss of control.

The IFRS IC considered these issues in 2010 but declined to propose an amendment to IAS 36 as part of the Annual Improvements. They were concerned that there could be possible unintended consequences of making any changes, and recommended that the Board considers the implication of these issues as part of the IFRS 3 post-implementation review.[2] While these issues were not specifically addressed in the IFRS 3 post-implementation review, participants informed the Board that in their view the required impairment test is complex, time-consuming and expensive and involves significant judgements. The Board therefore decided to undertake research to consider improvements, in particular on whether there is scope for simplification when it comes to impairment testing. At the time of writing, this research is still ongoing. We refer to section 14 below for more information.

How we see it

In the absence of any guidance, we consider that an entity is not precluded from grossing up goodwill on a basis other than ownership percentages if to do so is reasonable. A rational gross up will result in a goodwill balance that most closely resembles the balance that would have been recorded had non-controlling interest been recorded at fair value. This is explored further in section 9.3 below.

9.1 Testing for impairment in entities with non-controlling interests measured at the proportionate share of net identifiable assets

If an entity measures NCI at its proportionate interest in the net identifiable assets of a subsidiary at the acquisition date, rather than at the fair value, goodwill attributable to the NCI is included in the recoverable amount of the CGU but is not recognised in the consolidated financial statements. To enable a like-for-like comparison, IAS 36 requires the carrying amount of a non-wholly owned CGU to be notionally adjusted by grossing up the carrying amount of goodwill allocated to the CGU to include the amount attributable to the non-controlling interest. This notionally adjusted carrying amount is then compared with the recoverable amount. *[IAS 36.C3, IAS 36.C4]*. If there is an impairment, the entity allocates the impairment loss as usual, first reducing the carrying amount of goodwill allocated to the CGU (see section 11.2 below). However, because only the parent's goodwill is recognised, the impairment loss is apportioned between that attributable to the parent and that attributable to the non-controlling interest, with only the former being recognised. *[IAS 36.C8]*.

If any impairment loss remains, it is allocated in the usual way to the other assets of the CGU *pro rata* on the basis of the carrying amount of each asset in the CGU (the allocation of impairment losses to CGUs is discussed in section 11.2 below). *[IAS 36.104]*.

These requirements are shown in the following Illustration. *[IAS 36.IE62-68]*. Note that in these examples goodwill allocation and impairment is based on the ownership interests. In section 9.3 below we discuss alternative allocation methodologies when there is a control premium.

Illustration 9-1: A CGU with goodwill and non-controlling interest

Entity X acquires an 80% ownership interest in Entity Y for CU1,600 on 1 January 20X0. At that date, Entity Y's identifiable net assets have a fair value of CU1,500. Entity X recognises in its consolidated financial statements:

(a) Goodwill of CU400, being the difference between the cost of the business combination of CU1,600 and the non-controlling interest of CU300 (20% of CU1,500) and the identifiable net assets of Entity Y of CU1,500

(b) Entity Y's identifiable net assets at their fair value of CU1,500

(c) A non-controlling interest of CU300

2 *IFRIC Update*, September 2010, available on the IFRS Foundation's website.

At the end of 20X0 the carrying amount of Entity Y's identifiable assets has reduced to CU1,350 (excluding goodwill) and Entity X determines that the recoverable amount of CGU Y is CU1,000.

The carrying amount of CGU Y must be notionally adjusted to include goodwill attributable to the non-controlling interest, before being compared with the recoverable amount of CU1,000. Goodwill attributable to Entity X's 80% interest in Entity Y at the acquisition date is CU400. Therefore, goodwill notionally attributable to the 20% non-controlling interest in Entity Y at the acquisition date is CU100, being (CU400 ÷ 80% × 20%).

Testing CGU Y for impairment at the end of 20X0 gives rise to an impairment loss of CU850 calculated as follows:

	Goodwill	Identifiable net assets	Total
	CU	CU	CU
Carrying amount	400	1,350	1,750
Unrecognised non-controlling interest	100	-	100
Notionally adjusted carrying amount	500	1,350	1,850
Recoverable amount			1,000
Impairment loss			850

The impairment loss of CU850 is allocated to the assets in the CGU by first reducing the carrying amount of goodwill to zero. Therefore, CU500 of the CU850 impairment loss for the CGU is allocated to the goodwill. However, because Entity X only holds an 80% ownership interest in Entity Y, it recognises only 80% of that goodwill impairment loss (i.e., CU400). The remaining impairment loss of CU350 is recognised by reducing the carrying amounts of Entity Y's identifiable assets, as follows:

	Goodwill	Identifiable net assets	Total
	CU	CU	CU
Carrying amount	400	1,350	1,750
Impairment loss	(400)	(350)	(750)
Carrying amount after impairment loss	-	1,000	1,000

Of the impairment loss of CU350 relating to Entity Y's identifiable assets, CU70 (i.e., 20% thereof) would be attributed to the non-controlling interest.

In this example the same result would have been achieved by just comparing the recoverable amount of CU1,000 with the carrying amount of CU1,750. However, what if the recoverable amount of the CGU had been greater than the carrying amount of the identifiable net assets prior to recognising the impairment loss?

Assume the same facts as above, except that at the end of 20X0, Entity X determines that the recoverable amount of CGU Y is CU1,400. In this case, testing CGU Y for impairment at the end of 20X0 gives rise to an impairment loss of CU450 calculated as follows:

	Goodwill	Identifiable net assets	Total
	CU	CU	CU
Carrying amount	400	1,350	1,750
Unrecognised non-controlling interest	100	-	100
Notionally adjusted carrying amount	500	1,350	1,850
Recoverable amount			1,400
Impairment loss			450

All of the impairment loss of CU450 is allocated to the goodwill. However, Entity X recognises only 80% of that goodwill impairment loss, i.e., CU360. This allocation of the impairment loss results in the following carrying amounts for CGU Y in the financial statements of Entity X at the end of 20X0:

	Goodwill	Identifiable net assets	Total
	CU	CU	CU
Carrying amount	400	1,350	1,750
Impairment loss	(360)	-	(360)
Carrying amount after impairment loss	40	1,350	1,390

Of the impairment loss of CU360, none of it is attributable to the non-controlling interest since it all relates to the majority shareholder's goodwill.

In this case the total carrying amount of the identifiable net assets and the goodwill has not been reduced to the recoverable amount of CU1,400, but is actually less than the recoverable amount. This is because the recoverable amount of goodwill relating to the non-controlling interest (20% of [CU500 - CU450]) is not recognised in the consolidated financial statements.

9.1.1 Acquisitions or sale of non-controlling interests measured at the proportionate share of net identifiable assets

As described in section 9.1 above, in order to enable a like-for-like comparison, IAS 36 requires the carrying amount of a non-wholly-owned CGU to be notionally adjusted by grossing up the carrying amount of goodwill allocated to the CGU to include the amount attributable to the non-controlling interest.

What happens if the non-controlling interest is acquired by the entity so that it is now wholly owned? IFRS 10 requires these purchases to be reflected as equity transactions, which means that there is no change to goodwill. *[IFRS 10.23]*. Other methods can have been used in the past that can still be reflected in the carrying amounts of goodwill. These methods could have partially or wholly reflected the fair value of the additional interest acquired.

No notional adjustment to goodwill is required when the remaining non-controlling interest is acquired.

In situations where only a portion but not the full outstanding non-controlling interest is acquired or where a portion of an existing holding is sold without loss of control, the question is whether goodwill must be grossed up based on the new non-controlling interest percentage after the transaction or the original percentage. The answer to this question depends on whether a purchase of an additional non-controlling interest or a sale of a portion of an existing holding occurred.

Assume a situation where entity A owns 80% of entity B, goodwill was recorded at 80 and the non-controlling interest was measured at the proportionate interest in the net identifiable assets. In previous impairment tests goodwill would have been grossed up to 100 (80 × 100% ÷ 80%). When entity A later acquires 10% of the remaining ownership interest in Entity B, leaving a non-controlling interest of 10%, must goodwill for future impairment assessments be grossed up using the current 10% or the previous 20% non-controlling interest? Using the current non-controlling interest holding of 10% would lead to grossed up goodwill of 88.9 (80 × 100% ÷ 90%). This would make an impairment less likely. The alternative is to gross up goodwill with the original non-controlling interest percentage of 20% meaning goodwill could continue to be grossed up to 100.

How we see it

We believe both approaches (using the current or the initial rate of non-controlling interest) are acceptable in practice in situations where an additional non-controlling interest is acquired.

However, if instead entity A sold 20% of the ownership in entity B, resulting in a non-controlling interest of 40% the answer is different. The original non-controlling interest percentage of 20% must be used leading to grossed up goodwill of 100. Using an approach where goodwill is grossed up with the new non-controlling interest percentage, would lead to a goodwill of 133.3 (80 × 100% ÷ 60%). We do not believe it would be appropriate to use this grossed up amount, as no additional goodwill was created through the transaction.

Grossing up of goodwill can be complex in situations where subsequent transactions occur which can entail a combination of non-controlling interests measured initially at fair value and at proportionate interest of net identifiable assets or where there are multiple subsequent transactions involving non-controlling interests. Careful consideration of all facts and circumstances are required to come to an appropriate solution in such cases.

9.2 Testing for impairment in entities with non-controlling interests initially measured at fair value

The following Illustrations in which the non-controlling interest is initially measured at fair value, are based on the Examples 7B and 7C in IAS 36's Illustrative Examples and illustrate the requirements for testing for impairment when non-controlling interest is initially measured at fair value. Note that in these examples goodwill impairment is allocated on the basis of the ownership interests. In section 9.3 below we discuss alternative allocation methodologies when there is a control premium.

Illustration 9-2: Non-controlling interests measured initially at fair value

Entity X acquires an 80% ownership interest in Entity Y for CU2,100 on 1 January 20X0. At that date, Entity Y's identifiable net assets have a fair value of CU1,500. Entity X chooses to measure the non-controlling interests at its fair value of CU350. Goodwill is CU950, which is the aggregate of the consideration transferred and the amount of the non-controlling interests (CU2,100 + CU350) less the net identifiable assets (CU1,500).

(a) The acquired subsidiary is a stand-alone CGU

Entity Y is a CGU, but part of the goodwill is allocated to other CGUs of Entity X that are expected to benefit from the synergies of the combination. Of the total goodwill of CU950 (CU2,450 - CU1,500), CU450 is allocated to the Entity Y CGU and CU500 to the other CGUs.

At the end of 20X0, the carrying amount of Entity Y's identifiable assets excluding goodwill has reduced to CU1,350 and Entity X determines that the recoverable amount of CGU Y is CU1,650.

	Goodwill	Identifiable net assets	Total
	CU	CU	CU
Carrying amount	450	1,350	1,800
Recoverable amount			1,650
Impairment loss			150

Of the goodwill impairment loss of CU150, CU30 (20%) will be allocated to the non-controlling interest because the goodwill is allocated to the controlling interest and non-controlling interest on the same basis as profit or loss.

(b) The acquired subsidiary is part of a larger CGU

Entity Y becomes part of a larger CGU, Z. As before, CU500 of the goodwill is allocated to other CGUs of Entity X that are expected to benefit from the synergies of the combination. Goodwill of CU450 is allocated to Z. Z's goodwill related to previous business combinations is CU800.

At the end of 20X0, Parent determines that the recoverable amount of the Z CGU is CU3,300. The carrying amount of its net assets excluding goodwill is CU2,250.

	Goodwill	Identifiable net assets	Total
	CU	CU	CU
Carrying amount	1,250	2,250	3,500
Recoverable amount			3,300
Impairment loss			200

All of the impairment loss of CU200 is allocated to the goodwill. As the partially owned subsidiary forms part of a larger CGU, the goodwill impairment loss must be allocated first to the parts of the cash-generating unit Z, and then to the controlling and non-controlling interests of Entity Y.

The impairment loss is allocated on the basis of the relative carrying values of the goodwill of the parts before the impairment. Entity Y is allocated 36% of the impairment (450 ÷ 1,250), in this case CU72, of which CU14.40 (20%) will be allocated to the non-controlling interest.

9.3 Testing for impairment in entities with non-controlling interests: alternative allocation methodologies

In section 9 above we noted that in the absence of any guidance, we consider that an entity is not precluded from grossing up goodwill on a basis other than ownership percentages if to do so is reasonable. A rational gross up will result in a goodwill balance that most closely resembles the balance that would have been recorded had non-controlling interest been recorded at fair value.

There are therefore two broad methods of grossing up goodwill for impairment testing purposes when non-controlling interest is measured at its proportionate interest in the net identifiable assets of the subsidiary at the acquisition date:

- A 'mechanical' gross up of the controlling interest's goodwill on the basis of ownership interests

  And
- A 'rational' gross up of the controlling interest's goodwill that takes into account the acquirer's control premium, if any

Similarly, there are two broad methods of allocating goodwill impairment:

- A 'mechanical' allocation in which the impairment loss is allocated on the basis of ownership interests.

  And

- A 'rational' allocation, in which the entity applies an allocation methodology that recognises the disproportionate sharing of the controlling and non-controlling interests in the goodwill book value. The rational allocation takes into account the acquirer's control premium, if any.

When non-controlling interest is measured at its proportionate interest in the net identifiable assets of the subsidiary, there are alternatives for both the gross up and allocation methods. The following are all acceptable:

- Rational gross up and rational allocation
- Rational gross up and mechanical allocation

  And

- Mechanical gross up and mechanical allocation

A mechanical gross up and a rational allocation is not appropriate because a mechanical gross up results in the controlling and non-controlling interests having goodwill carrying values which are proportionate to their ownership interests.

Although the above methods of allocating goodwill and grossing up the NCI are acceptable, entities would be expected to be consistent year on year in the approach that they apply in testing any particular CGU or group of CGUs. This does not prevent an entity from applying different approaches to different CGUs or groups of CGUs, if that is appropriate in the circumstances. Both Illustration 9-1 and Illustration 9-2 in sections 9.1 and 9.2 above are examples of mechanical allocation of impairment losses. In Illustration 9-2 the NCI is recorded initially at fair value, so there is no gross up methodology for goodwill but in Illustration 9-1, goodwill is grossed up mechanically.

The examples below illustrate the various methods. Depending on the circumstances, the gross up and allocation process could be much more complex than in the Illustration below. For example, where goodwill is being tested for impairment for a group of CGUs with multiple non-controlling interests measured at both fair value and proportionate interest in net identifiable assets, other (practical) approaches, not illustrated below can result in a reasonable measurement and allocation of goodwill impairment. Also, it is possible that detailed records need to be maintained to facilitate the gross up and allocation process.

Illustration 9-3: Measurement and allocation of goodwill impairment losses when there are non-controlling interests

An entity purchases 80% of a business for CU160. The controlling and non-controlling interests share in profits on the basis of their ownership interests. The fair value of the net identifiable assets is CU140, and the fair value of the non-controlling interest is CU36. Goodwill is fully allocated to the business acquired.

Subsequent to the acquisition, the entity performs an impairment test and determines that the recoverable amount of the CGU is CU160.

Scenario 1 - Non-controlling interest recorded at fair value

The entity elects to record the non-controlling interest at fair value, rather than the non-controlling interest's proportionate share of the recognised amounts of the acquiree's identifiable net assets. Accordingly, goodwill of CU56 is recorded (= CU160 + CU36 - CU140).

The initial carrying amount of the CGU is CU196 (= CU140 + CU56). Assuming for simplicity that at the time of the impairment test the carrying amounts are unchanged, there is impairment of CU36 (= CU196 - CU160). The entire impairment loss is applied against the goodwill balance of CU56, reducing recorded goodwill to CU20. The entity is required to allocate the impairment loss between the controlling and non-controlling interests.

Rational allocation: the goodwill impairment loss is allocated on a rational basis using a methodology that recognises the disproportionate sharing of the controlling and non-controlling interests in the goodwill book value. The rational allocation takes into account the acquirer's control premium, if any. Goodwill of CU48 (= CU160 - (CU140 × 80%)) relates to the controlling interest and goodwill of CU8 (= CU36 - (CU140 × 20%)) relates to the non-controlling interest. Therefore, a rational allocation method would result in impairment of CU48 ÷ CU56 × CU36 = CU31 being allocated to the controlling interest and impairment of CU8 ÷ CU56 × CU36 = CU5 being allocated to the non-controlling interest.

Mechanical allocation: the goodwill impairment loss is allocated on the basis of ownership interests. Therefore, impairment of CU29 (= CU36 × 80%) is allocated to the controlling interest while impairment of CU7 (= CU36 × 20%) is allocated to the non-controlling interest [Note 1].

Scenario 2 - Non-controlling interest recorded at its proportionate share of fair value of identifiable assets

The entity elects to record non-controlling interest at its proportionate share of the fair value of the acquiree's identifiable net assets, i.e., CU28 (= CU140 × 20%). Therefore, goodwill of CU48 is recorded (= CU160 + CU28 - CU140). In this case, the carrying amount of the CGU is CU188 (= CU140 + CU48). The entity is required to gross up the carrying amount of the CGU for the purposes of determining whether the CGU is impaired.

Rational gross up and rational allocation: goodwill attributable to the non-controlling interest is calculated by grossing up the recognised goodwill using a factor which takes into account the premium, if any, relating to the fact that the entity has a controlling 80% interest. Assume the relevant gross up factor results in goodwill attributable to the non-controlling interest of CU8 [Note 2]. Therefore, the adjusted carrying value of the reporting unit is CU196 (= CU188 + CU8). There is impairment of CU36 (= CU196 - CU160). The total impairment of CU36 is then allocated between the controlling and non-controlling interest on a rational basis. Using the same rational allocation methodology as in Scenario 1 results in impairment of CU31 being allocated to the controlling interest and impairment of CU5 being allocated to the non-controlling interest. The impairment of CU5 associated with the non-controlling interest is not recognised because no goodwill is recorded in the financial statements relating to the non-controlling interest.

Rational gross up and mechanical allocation: as above, assume the relevant gross up factor results in goodwill attributable to the non-controlling interest of CU8 and the adjusted carrying value of the reporting unit is CU196 (= CU188 + CU8). The total impairment of CU36 is then allocated between the controlling and non-controlling interest based on their ownership interests, resulting in impairment of CU29 (= CU36 × 80%) being allocated to the controlling interest and impairment of CU7 (= CU36 × 20%) being allocated to the non-controlling interest. The impairment of CU7 associated with the non-controlling interest is not recognised because no goodwill is recorded in the financial statements relating to the non-controlling interest.

Mechanical gross up and mechanical allocation: goodwill attributable to the non-controlling interest is CU12 (= CU48 ÷ (80 ÷ 20)). Therefore, the adjusted carrying value of the reporting unit is CU200 (= CU188 + CU12). There is impairment of CU40 (= CU200 (adjusted carrying value) less CU160 (= recoverable amount). Impairment of CU32 (= 80% × CU40) is allocated to the controlling interest and impairment of CU8 (= 20% × CU40) is allocated to the non-controlling interest. The impairment of CU8 associated with the non-controlling interest is not recognised because no goodwill is recorded in the financial statements relating to the non-controlling interest.

Note [1]: As a further illustration of the difference between the two methods, suppose that the entity determined that the recoverable amount was nil. In this case, under the rational allocation in Scenario 1, the non-controlling interest of CU36 would be reduced to zero, as an impairment of CU8 to goodwill and an impairment of CU28 (= 20% of CU140) to other identifiable assets would be each allocated to non-controlling interest. However, under mechanical allocation in Scenario 1, the non-controlling interest would be reduced by CU39 (= 20% of the carrying value of CU196) with the result being a non-controlling interest debit balance of CU3.

Note [2]: Note that this results in total adjusted goodwill of CU56, which is the same goodwill figure that is recorded in Scenario 1 when non-controlling interest is recorded at fair value.

10 Impairment of intangible assets with an indefinite useful life or not yet available for use

IAS 38 makes the point that 'indefinite' does not mean 'infinite', and unforeseeable factors can affect the entity's ability and intention to maintain the asset at its standard of performance assessed at the time of estimating the asset's useful life. *[IAS 38.91]*. The requirements of IAS 36 for this type of asset can be summarised as follows:

- All intangible assets with indefinite useful lives must be tested for impairment at least once per year and at the same time each year. *[IAS 36.10]*.
- Any intangible asset with an indefinite useful life recognised during the reporting period must be tested for impairment before the end of the period. *[IAS 36.10]*.
- Any intangible asset (regardless of whether it has an indefinite useful life or not) that is not yet available for use recognised during the reporting period must be tested for impairment before the end of the period. *[IAS 36.10, IAS 36.11]*.
- If an intangible asset that has an indefinite useful life or is not yet available for use can only be tested for impairment as part of a CGU, then that CGU must be tested for impairment at least annually. *[IAS 36.89]*.
- If there are indicators of impairment a period end test must also be performed. *[IAS 36.9]*.

  And

- For an intangible asset that has an indefinite useful life that is part of a CGU, there are specific concessions, discussed below, allowing an impairment test in a previous period to be used if that test showed sufficient headroom. *[IAS 36.24]*.

Any intangible asset not yet available for use must be tested annually because its ability to generate sufficient future economic benefits to recover its carrying amount is usually subject to greater uncertainty before the asset is available for use than after it is available for use. *[IAS 36.11]*.

This will obviously affect any entity that capitalises development expenditure in accordance with IAS 38 where the period of development can cover more than one accounting period. The requirement will also apply to in-process research and development costs recognised in a business combination (see Chapter 10 at section 5.5.2.D).

When an intangible asset with an indefinite useful life generates independent cash inflows as an individual asset, the impairment testing procedure for a single asset as set out in section 7 above applies. However, most intangible assets form part of the assets within a CGU, in which case the procedures relevant to testing a CGU as set out above apply. In particular IAS 36 makes it clear that if an intangible asset with an indefinite useful life, or any intangible asset not yet available for use, is included in the assets of a CGU, then that CGU has to be tested for impairment annually. *[IAS 36.89]*. As with other assets, it is possible that the FVLCD of the intangible asset with an indefinite useful life can be ascertained but the asset itself does not generate largely independent cash flows. If its individual FVLCD is lower than the carrying amount, this does not necessarily mean that the asset is impaired. The impairment test is still based on the CGU of which the asset is a part, and if the recoverable amount of the CGU is higher than the carrying amount of the CGU, there is no impairment loss.

IAS 36 allows a concession that applies to those intangible assets with an indefinite useful life that form part of a CGU, which is similar to the concession for goodwill. It allows the most recent detailed calculation of such an asset's recoverable amount made in a preceding period to be used in the impairment test in the current period if certain criteria are met. The IAS 36 guidance is set out in the following IAS 36 extract: *[IAS 36.24]*

Extract from IAS 36

Measuring the recoverable amount of an intangible asset with an indefinite useful life

24 Paragraph 10 requires an intangible asset with an indefinite useful life to be tested for impairment annually by comparing its carrying amount with its recoverable amount, irrespective of whether there is any indication that it may be impaired. However, the most recent detailed calculation of such an asset's recoverable amount made in a preceding period may be used in the impairment test for that asset in the current period, provided all of the following criteria are met:

(a) if the intangible asset does not generate cash inflows from continuing use that are largely independent of those from other assets or groups of assets and is therefore tested for impairment as part of the cash-generating unit to which it belongs, the assets and liabilities making up that unit have not changed significantly since the most recent recoverable amount calculation;

(b) the most recent recoverable amount calculation resulted in an amount that exceeded the asset's carrying amount by a substantial margin; and

(c) based on an analysis of events that have occurred and circumstances that have changed since the most recent recoverable amount calculation, the likelihood that a current recoverable amount determination would be less than the asset's carrying amount is remote.

Thus, if there was sufficient headroom on the last calculation and little has changed in the CGU to which the asset belongs, it can be revisited and re-used rather than having to start entirely from scratch, which considerably reduces the work involved in the annual test. The impairment test cannot be rolled forward forever, of course, and an entity will have to take a cautious approach to estimating when circumstances have changed sufficiently to require a new test.

Impairment losses experienced on intangible assets are recognised exactly as set out in section 11 below, either as an individual asset or as part of a CGU, depending upon whether the intangible concerned is part of a CGU or not. Note that there is an important distinction concerning the allocation of losses in a CGU between the treatment of goodwill and that of intangible assets. If goodwill forms part of the assets of a CGU, any impairment loss first reduces the goodwill and thereafter the remaining assets are reduced *pro rata*. However, if an intangible asset is part of a CGU that is impaired, entities are not allowed to allocate impairment losses to the intangible asset before the other assets in the CGU, rather impairment losses are allocated to all assets *pro rata*. For the *pro rata* allocation, it is important to keep in mind that the carrying amount of an asset cannot be reduced below the highest of its fair value less costs of disposal, value in use or zero. If the preceding rule is applied, further allocation of the impairment loss is made *pro rata* to the other assets of the unit (group of units).

11 Recognising and reversing impairment losses

If the carrying value of an individual asset or of a CGU is equal to or less than its calculated VIU, there is no impairment. On the other hand, if the carrying value of the CGU is greater than its recoverable amount, an impairment write-down must be recognised.

There are three scenarios: an impairment loss on an individual asset, an impairment loss on an individual CGU and an impairment loss on a group of CGUs. The last of these occurs where there are corporate assets (see section 4.2 above) or goodwill (see section 11.2 below) that have been allocated to a group of CGUs rather than to individual ones.

11.1 Impairment losses on individual assets

For individual assets IAS 36 states: *[IAS 36.59, IAS 36.60]*

Extract from IAS 36	
59	**If, and only if, the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable amount. That reduction is an impairment loss.**
60	**An impairment loss shall be recognised immediately in profit or loss, unless the asset is carried at revalued amount in accordance with another Standard (for example, in accordance with the revaluation model in IAS 16). Any impairment loss of a revalued asset shall be treated as a revaluation decrease in accordance with that other Standard.**

If there is an impairment loss on an asset that has not been revalued, it is recognised in profit or loss. An impairment loss on a revalued asset is first used to reduce the revaluation surplus in other comprehensive income for that asset. Only when the impairment loss exceeds the amount in the revaluation surplus for that same asset is any further impairment loss recognised in profit or loss. *[IAS 36.63]*.

IAS 36 does not require impairment losses to be shown in any particular position in the income statement, although the requirements of IAS 1 *Presentation of Financial Statements*[3] must always be considered. An entity is required to add an appropriate line item in profit or loss if it is relevant for an understanding of the entity's financial performance. *[IAS 1.85]*.

Any amounts written off a fixed asset must be shown as part of the accumulated depreciation when an entity discloses the gross carrying amount and the accumulated depreciation at the beginning and the end of the period. *[IAS 16.73(d)]*. In the reconciliation required by IAS 16.73(e) any impairment recognised or reversed through profit and loss must be shown in a separate line item. If the asset is held at revalued amount, then any impairment losses recognised or reversed must be shown in the reconciliation in one line item together with the revaluations. *[IAS 16.73(e)(iv)]*.

An impairment loss greater than the carrying value of the asset does not give rise to a liability unless another standard requires it, presumably as this would be equivalent to providing for future losses. *[IAS 36.62]*. An impairment loss will reduce the depreciable amount of an asset and the revised amount will be depreciated or amortised prospectively over the remaining useful life. *[IAS 36.63]*. However, an entity ought also to review the useful life and residual value of its impaired asset, as it is possible that both of these have to be revised. The circumstances that give rise to impairments frequently affect these as well.

Finally, an impairment loss will have implications for any deferred tax calculation involving the asset. The standard makes clear that if an impairment loss is recognised then any related deferred tax assets or liabilities are determined in accordance with IAS 12, by comparing the revised carrying amount of the asset with its tax base. *[IAS 36.64]*. Example 3 in the standard's accompanying section of illustrative examples, on which the following is based, illustrates the possible effects.

3 IFRS 18 *Presentation and Disclosure in Financial Statements*, which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted), was issued by the IASB in April 2024. See Chapter 4 for further details on the new concepts and requirements of IFRS 18.

Illustration 11-1: Recognition of an impairment loss creates a deferred tax asset

An entity has an asset with a carrying amount of CU2,000 whose recoverable amount is CU1,300. The tax rate is 30% and the tax base of the asset is CU1,500. Impairment losses are not deductible for tax purposes. The effect of the impairment loss is as follows:

	Before impairment	Effect of impairment	After impairment
	CU	CU	CU
Carrying amount	2,000	(700)	1,300
Tax base	1,500	-	1,500
Taxable (deductible) temporary difference	500	(700)	(200)
Deferred tax liability (asset) at 30%	150	(210)	(60)

The entity will recognise the deferred tax asset to the extent that the respective recognition criteria of IAS 12 are met.

11.2 Impairment losses and CGUs

Impairment losses in a CGU can occur in two ways:

(i) An impairment loss is incurred in a CGU on its own, and that CGU can have corporate assets or goodwill included in its carrying value.

(ii) An impairment loss is identified that must be allocated across a group of CGUs because a corporate asset or goodwill is involved whose carrying value could only be allocated to a group of CGUs as a whole, rather than to individual CGUs (the allocation of corporate assets to CGUs is discussed in section 4.2 above, and goodwill is discussed in section 8 above). Note that if there are indicators of impairment in connection with a CGU with which goodwill is associated, i.e., the CGU is part of a group of CGUs to which the goodwill is allocated, this CGU must be tested and any necessary impairment loss taken, before goodwill is tested for impairment (see section 8.2.2 above). *[IAS 36.88]*.

The relevant paragraphs from the standard deal with both instances but are readily understandable only if the above distinction is appreciated. The standard lays down that impairment losses in CGUs must be recognised to reduce the carrying amount of the assets of the unit (group of units) in the following order:

- First, to reduce the carrying amount of any goodwill allocated to the CGU or group of units.
- Second, if the goodwill has been written off, to reduce the other assets of the CGU (or group of CGUs) *pro rata* to their carrying amount, subject to the limitation that the carrying amount of an asset cannot be reduced below the highest of fair value less costs of disposal, value in use or zero. *[IAS 36.104, IAS 36.105]*.

The important point is to be clear about the order set out above. Goodwill must be written down first, and if an impairment loss remains, the other assets in the CGU or group of CGUs are written down *pro rata* to their carrying values subject to the limitation that the carrying amount of an asset cannot be reduced below the highest of fair value less costs of disposal, value in use or zero.

This pro-rating is in two stages if a group of CGUs is involved:

(i) The loss reduces goodwill (which by definition in this instance is unallocated to individual CGUs in the group).

(ii) Any remaining loss is pro-rated between the carrying values of the individual CGUs in the group and within each individual CGU the loss is again pro-rated between the individual assets' carrying values.

Unless it is possible to estimate the recoverable amount of each individual asset within a CGU, it is necessary to allocate impairment losses to individual assets in such a way that the revised carrying amounts of these assets correspond with the requirements of the standard. Therefore, the entity does not reduce the carrying amount of an individual asset below the highest of its FVLCD or VIU (if these can be established), or zero. The amount of the impairment loss that would otherwise have been allocated to the asset is then allocated *pro rata* to the other assets of the CGU or group of CGUs. *[IAS 36.105]*. The standard argues that this arbitrary allocation to individual assets when their recoverable amount cannot be individually assessed is appropriate because all assets of a CGU 'work together'. *[IAS 36.106]*.

If corporate assets are allocated to a CGU or group of CGUs, then any remaining loss (i.e., after allocation to goodwill) is pro-rated against the allocated share of the corporate asset and the other assets in the CGU.

This process, then, writes down the carrying value attributed or allocated to a CGU until the carrying value of the net assets is equal to the computed recoverable amount. Due to the restriction of not reducing the carrying amount of an asset below its FVLCD or VIU, it is logically possible, after all assets and goodwill are either written off or down to their FVLCD or VIU, for the carrying value of the CGU to be higher than the computed recoverable amount. There is no suggestion that the net assets must be reduced any further because at this point the FVLCD would be the relevant impairment figure. The remaining amount will only be recognised as a liability if that is a requirement of another standard. *[IAS 36.108]*.

IAS 36 includes in the standard's accompanying section of illustrative examples Example 2 which illustrates the calculation, recognition and allocation of an impairment loss across CGUs.

However, the standard stresses that no impairment loss can be reflected against an individual asset if the CGU to which it belongs has not been impaired, even if its carrying value exceeds its FVLCD. This is expanded in the following Illustration, based on that in IAS 36.107:

Illustration 11-2: Individually impaired assets within CGUs

A machine has suffered physical damage but is still working, although not as well as before it was damaged. The machine's FVLCD is less than its carrying amount. The machine does not generate independent cash inflows. The smallest identifiable group of assets that includes the machine and generates cash inflows that are largely independent of the cash inflows from other assets is the production line to which the machine belongs. The recoverable amount of the production line shows that the production line taken as a whole is not impaired.

Assumption 1: budgets/forecasts approved by management reflect no commitment of management to replace the machine.

The recoverable amount of the machine alone cannot be estimated because its VIU is different from its FVLCD (because the entity is going to continue to use it) and can be determined only for the CGU to which it belongs (the production line).

As the production line is not impaired, no impairment loss is recognised for the machine. Nevertheless, the entity needs to reassess the depreciation period or the depreciation method for the machine. Perhaps a shorter depreciation period or a faster depreciation method is required to reflect the expected remaining useful life of the machine or the pattern in which economic benefits are expected to be consumed by the entity.

Assumption 2: budgets/forecasts approved by management reflect a commitment of management to replace the machine and sell it in the near future.

Cash flows from continuing use of the machine until its disposal are estimated to be negligible. The machine's VIU can be estimated to be close to its FVLCD. Therefore, the recoverable amount of the machine can be determined, and no consideration is given to the CGU (the production line) to which it belongs. As the machine's carrying amount exceeds its FVLCD, an impairment loss is recognised to write it down to FVLCD. *[IAS 36.107]*.

Note that it is assumed that the asset is still useable (otherwise it would not be contributing to the cash flows of the CGU and would have to be written off) and that it is not held for sale as defined by IFRS 5. If the asset is no longer part of the CGU, it will have to be tested for impairment on a stand-alone basis. For IFRS 5's requirements when an asset is held for sale, see section 5.1 above.

11.3 Reversal of impairment loss relating to goodwill prohibited

As mentioned in section 8.2.4 above, IAS 36 does not permit an impairment loss on goodwill to be reversed under any circumstances. *[IAS 36.124]*. The standard justifies this on the grounds that such a reversal would probably be an increase in internally generated goodwill, rather than a reversal of the impairment loss recognised for the acquired goodwill, and that recognition of internally generated goodwill is prohibited by IAS 38. *[IAS 36.125]*.

Illustration 11-3: Impairment of goodwill

Company A has a CGU that has a carrying value of CU2,000,000 on 31 December 20X0. This carrying value comprises CU500,000 relating to goodwill and CU1,500,000 relating to net tangible assets.

In 20X1, as a result of losses, net tangible assets have decreased to CU1,400,000 reducing the total carrying value of the unit to CU1,900,000. Changes in the regulatory framework surrounding its business mean that the cash-generating unit has a recoverable amount of CU1,600,000 and has thus suffered an impairment loss of CU300,000. This is charged to profit or loss. The carrying value of goodwill is reduced to CU200,000.

In 20X2 the company develops a new product with the result that the recoverable amount of the cash-generating unit rises to CU1,700,000. Net tangible assets have remained at CU1,400,000. Despite the recoverable amount of the business unit now being CU1,700,000 compared to its carrying value of CU1,600,000, it is not possible to reverse any portion of the prior year's impairment loss of CU300,000, as this would represent a reversal of impairment losses on goodwill.

11.4 Reversal of impairment losses relating to assets other than goodwill

For all other assets, including intangible assets with an indefinite useful life or not yet available for sale, IAS 36 requires entities to assess at each reporting date whether there is any indication that an impairment loss no longer exists or has decreased. If there is any such indication, the entity has to recalculate the recoverable amount of the asset. *[IAS 36.110]*.

Therefore, if there are indications that a previously recognised impairment loss has disappeared or reduced, it is necessary to determine again the recoverable amount (i.e., the higher of FVLCD or VIU) so that the reversal can be quantified. The standard sets out examples of what it notes are in effect 'reverse indications' of impairment. *[IAS 36.111]*. These are the reverse of those set out in IAS 36.12 as indications of impairment (see section 2.1 above). *[IAS 36.112]*. They are arranged, as in IAS 36.12, into two categories: *[IAS 36.111]*

External sources of information:

(a) A significant increase in the asset's value.

(b) Significant changes during the period or expected in the near future in the entity's technological, market, economic or legal environment that will have a favourable effect.

(c) Decreases in market interest rates or other market rates of return on investments and those decreases are likely to affect the discount rate used in calculating the asset's value in use and increase the asset's recoverable amount materially.

Internal sources of information:

(d) Significant changes during the period or expected in the near future that will affect the extent to which, or manner in which, the asset is used. These changes include costs incurred during the period to improve or enhance the asset's performance or restructure the operation to which the asset belongs.

(e) Evidence from internal reporting that the economic performance of the asset is, or will be, better than expected.

Compared with IAS 36.12, there are two notable omissions from this list of 'reverse indicators', one external and one internal.

The external indicator not included is the mirror of the impairment indicator "the carrying amount of the net assets of the reporting entity is more than its market capitalisation". No explanation is provided as to why, if a market capitalisation below shareholders' funds is an indication of impairment, its reversal is not automatically an indication of a reversal. However, the most likely reason is that all of the facts and circumstances need to be considered before assuming that an impairment has reversed.

The internal indicator omitted from the list of 'reverse indicators' is that evidence of obsolescence or physical deterioration has been reversed. Once again, no reason is given. It is possible that the standard-setters have assumed that no such reversal could take place without the entity incurring costs to improve or enhance the performance of the asset or the CGU so that this is, in effect, covered by indicator (d) above.

The standard also reminds preparers that a reversal, like an impairment, is evidence that the depreciation method or residual value of the asset must be reviewed and possibly adjusted, whether or not the impairment loss is reversed. *[IAS 36.113]*.

A further restriction is that impairment losses are reversed only if there has been a change in the estimates used to determine the impairment loss, e.g., a change in cash flows or discount rate (for VIU) or a change in FVLCD. The 'unwinding' of the discount will increase the present value of future cash flows as they become closer, but IAS 36 does not allow the mere passage of time to trigger the reversal of an impairment. In other words, the 'service potential' of the asset must genuinely improve if a reversal is to be recognised. *[IAS 36.114, IAS 36.115, IAS 36.116]*. However, this inability to recognise the rise in value can lead to what is in effect a double recognition of losses, which can seem illogical, as demonstrated by the following Illustration:

Illustration 11-4: Double counted losses

At the end of 20X0, an entity with a single CGU is carrying out an impairment test. The discounted future cash flows for years 20X2 and onwards would be just enough to support the carrying value of the entity's assets. However, 20X1 is forecasted to produce a loss and net cash outflow. The discounted value of this amount is accordingly written off the carrying value of the fixed assets in 20X0 as an impairment loss. It is then suffered again in 20X1 (at a slightly higher amount being now undiscounted) as the actual loss. Once that loss is past, the future cash flows are sufficient to support the original unimpaired value of the fixed assets. Nevertheless, the assets cannot be written back up through profit or loss to counter the double counting effect as the increase in value does not derive from a change in economic conditions or in the expected use of an asset.

In this type of scenario, which is common in practice, the entity will only 'benefit' as the assets are depreciated or amortised at a lower amount.

Subsequent depreciation or amortisation can result in a scenario where the VIU in subsequent years is higher than the carrying amount of the asset/CGU. However, the requirement of improvement to the asset's 'service potential' to reverse an impairment, means that subsequent deprecation or amortisation on its own cannot be considered to be an indication of impairment reversal.

If, on the other hand, the revival in cash flows is the result of expenditure by the entity to improve or enhance the performance of the asset or the CGU or of a restructuring of the CGU, there can be an obvious improvement in the service potential that allows the entity to reverse some or all of the impairment losses.

If, and only if, an entity concludes that there are impairment reversal indicators due to the increase in service potential of the asset or CGU in questions, it would measure the impairment reversal by the amount by which the recoverable amount exceeds the carrying amount asset or CGU. It would not need to distinguish which portion results from the increase of the service potential of the assets or CGU, e.g., improvement in the cash flow forecast, and which portion is due to passage of time or subsequent deprecation or amortisation.

In the event of an individual asset's impairment being reversed, the reversal cannot raise the carrying value above the carrying amount that would have been determined (net of amortisation or depreciation), if no impairment had originally been recognised. *[IAS 36.117]*. Any increase above this figure would really be a revaluation, which would have to be accounted for in accordance with the standard relevant to the asset concerned. *[IAS 36.118]*.

Illustration 11-5: Reversal of impairment losses

At the beginning of year 1 an entity acquires an asset with a useful life of 10 years for CU1,000. The asset generates net cash inflows that are largely independent of the cash inflows of other assets or groups of assets. At the end of year 3, when the carrying amount after depreciation is CU700, the entity recognises that there has been an impairment loss of CU210. The entity writes the asset down to CU490. As the useful life is not affected, the entity commences amortisation at CU70 per annum which, if applied in each of the years 4-10, would amortise the carrying value over the remaining useful life, as follows:

Table 1	Year									
	1	2	3	4	5	6	7	8	9	10
	CU	CU	CU	CU	CU	CU	CU	CU	CU	CU
NBV - beginning of the year	1,000	900	800	490	420	350	280	210	140	70
Depreciation	100	100	100	70	70	70	70	70	70	70
Impairment			210							
NBV - end of the year	900	800	490	420	350	280	210	140	70	-
NBV without impairment	900	800	700	600	500	400	300	200	100	-

At the beginning of year 5, before depreciation for the year, the asset's carrying value is CU420. Thanks to improvements in technology, the entity is able to increase the asset's VIU to CU550 by spending CU120 on parts that improve and enhance its performance.

At the end of year 5, the asset can therefore be written up to the *lower* of:

- CU600, which is the net book value of the asset after the additional expenditure, assuming that there had never been any impairment. This is the balance brought forward at the beginning of year 5 of CU600 (Table 1 bottom row) plus expenditure of CU120 less depreciation for the year of (720 ÷ 6) = CU120.

  And
- CU550, which is the VIU at the end of year 5.

Therefore, it can write the asset's net book value back up to CU550. The entity can reverse CU100 of the impairment loss and amortise the remaining net book value of the asset of CU550 to zero over the remaining five years, year 6 to year 10, at CU110 per annum (see Table 2 below).

Table 2	Year					
	5	6	7	8	9	10
	CU	CU	CU	CU	CU	CU
Cost	1,000	1,120	1,120	1,120	1,120	1,120
Expenditure in the year	120					
Cost carried forward	1,120	1,120	1,120	1,120	1,120	1,120
Accumulated depreciation brought forward	580	570	680	790	900	1,010
Charge for the year (70 + 20 (120 ÷ 6))	90	110	110	110	110	110
Reversal of impairment	(100)					
Accumulated depreciation carried forward	570	680	790	900	1,010	1,120
NBV	550	440	330	220	110	-

The standard includes an illustration of the reversal of an impairment loss in Example 4 of the standard's accompanying section of illustrative examples.

All reversals are to be recognised in the income statement immediately, except for revalued assets which are dealt with in section 11.4.2 below. *[IAS 36.119]*.

If an impairment loss is reversed against an asset, its depreciation or amortisation is adjusted to allocate its revised carrying amount less residual value over its remaining useful life. *[IAS 36.121]*.

11.4.1 Reversals of impairments - cash-generating units

Where an entity recognises a reversal of an impairment loss on a CGU, the increase in the carrying amount of the assets of the unit must be allocated by increasing the carrying amount of the assets, other than goodwill, in the unit on a *pro rata* basis. However, the carrying amount of an individual asset cannot be increased above the lower of its recoverable amount (if determinable) and the carrying amount that would have resulted had no impairment loss been recognised in prior years. Any 'surplus' reversal is to be allocated to the remaining assets *pro rata*, always remembering that goodwill, if allocated to an individual CGU, cannot be increased under any circumstances. *[IAS 36.122, IAS 36.123]*.

11.4.2 Reversals of impairments - revalued assets

If an asset is recognised at a revalued amount under another standard, any reversal of an impairment loss must be treated as a revaluation increase under that other standard. Thus, a reversal of an impairment loss on a revalued asset is credited to other comprehensive income. However, to the extent that an impairment loss on the same revalued asset was previously recognised as an expense in the income statement, a reversal of that impairment loss is recognised as income in the income statement. *[IAS 36.119, IAS 36.120]*.

As with assets carried at cost, after a reversal of an impairment loss is recognised on a revalued asset, the depreciation charge must be adjusted in future periods to allocate the asset's revised carrying amount, less any residual value, on a systematic basis over its remaining useful life. *[IAS 36.121]*.

12 Subgroup and separate financial statement issues

The application of IAS 36 in group situations is not always straight forward and can give rise to a number of challenging questions. We explore some of these questions in the following sections, including:

- How to identify CGUs and relevant cash flows in the financial statements of an individual entity within a group, the consolidated financial statements of a subgroup, or when impairment testing equity accounted investments or those carried at cost.

  And

- Whether the cash flows mentioned above need to be on an arm's length basis, i.e., at fair value, and the extent the restrictions imposed by IAS 36 need to be applied.

Note that we have used the term 'individual financial statements' for any stand-alone financial statements that apply IFRS accounting standards, prepared by any entity within a group, whether or not those financial statements are within scope of IAS 27 *Separate Financial Statements*. The term 'individual financial statements' includes separate financial statements, individual financial statements for subsidiary companies with no investments and, for a subsidiary that does not have any subsidiaries, unconsolidated financial statements whose associates and joint ventures are accounted for using the equity method.

The distinction between individual financial statements and 'separate financial statements', a term that applies only to financial statements prepared in accordance with the provisions of IAS 27, is explained in Chapter 9 at section 1.

12.1 VIU: intra-group transactions (transfer pricing)

When required by the relevant IFRS, an impairment test is performed to:

- Equity accounted investments
- Investments in subsidiaries, associates or joint ventures carried at cost in the separate financial statements of the parent

  Or

- Assets/CGUs in an individual group company's or subgroup's financial statements

When performing those impairment tests, the key questions are how to determine the cash flows for intra-group transactions and whether those cash flows need to be on an arm's length basis.

Many individual group companies or subgroups do not have truly independent cash flows because of the way in which groups allocate activities between group entities. Transactions between a parent entity and its subsidiaries, between subsidiaries within a group or between subsidiaries/parents and investments in associates and joint ventures can be carried out at terms that differ from an arm's length basis. Entities can benefit from transactions entered into by others that are not reflected in their financial statements, e.g., management and other facilities provided by another group company, or can incur those expenses on their behalf without recharge.

In the context of impairment testing, this means that an entity needs to consider whether the relevant cash flows are those actually generated by the asset (investment in subsidiary, joint venture, associate or individual asset or CGU) or those that it could generate on an arm's length basis. IAS 36 gives no clear answer to this question. There are two broad approaches, and preference for one from the other will often depend on local jurisdictions. Either:

- The VIU must be based on the cash flows directly generated under current arrangements, e.g., those received and receivable.

  Or

- The cash flows must take into consideration the manner in which the group has organised its activities and make notional adjustments to reflect arm's length amounts.

Those arguing that notional adjustments are required, refer to the IAS 36 requirement to replace transfer prices with arm's length prices for CGUs within the same reporting entity/group once a CGU has been identified (see section 7.1.6 above). *[IAS 36.70]*. The argument is that the same principle applies in intra-group arrangements and therefore the internal transfer prices of the group entities in question must be substituted with arm's length prices. This is not always straightforward in practice, as it can be difficult to allocate arm's length prices in intra-group arrangements where there is often a 'bundle' of goods and services and where some transactions do not have commercial equivalents.

When making these adjustments, one method that can work in practice, as it reflects the arm's length prices of inputs and outputs, and therefore the substitution of transfer prices, is to start from the VIU of the CGU in the consolidated financial statements, of which the subsidiary being tested for impairment is a part, and allocate it to the various subsidiaries. This, however, is not a straightforward exercise. It is necessary to avoid potential pitfalls:

- Taking account of a notional increase in income or VIU to one subsidiary but neglecting to reflect the notional increase in costs or loss of VIU to another.
- Including benefits or costs that cannot be converted into cash flows to the entity. This can be particularly problematic when testing goodwill, including the carrying value of investments when the purchase price reflects goodwill on acquisition. Most would consider this a constraint on the cash flows reflected in this impairment test. This can be revealed if there is a major difference between the subsidiary-based and CGU-based recoverable amount as there could be cash flows or synergies elsewhere in the group that cannot be reasonably attributed to the subsidiary or subgroup in question.
- As explained in section 12.4.2.B below, the entity's investment reflects the net assets of the subsidiary while the CGU reflects the assets and liabilities on a gross basis, so appropriate adjustments will have to be made.

Those arguing notional adjustments are not required refer to the lack of guidance in IAS 36. The argument is that it is not clear that the same principle must apply, particularly in circumstances when using the contractual agreed cash flows would lead to an impairment which would be avoided by substitution of contractual agreed cash flows with arm's length prices.

How we see it

As we believe IAS 36 gives no clear answer, it is important for an entity to disclose sufficient information to enable users of financial statements to understand which approach was applied and how this impacted the entity's financial statements. These disclosures may include a description of the entity's facts and circumstances, how the approach was applied, the basis for selecting an approach and the impact on the financial statements.

12.2 Testing goodwill in a group company's or subgroup's financial statements

In many jurisdictions, subsidiary entities are not exempt from preparing financial statements and these can be required to comply with IFRSs. These can be consolidated accounts for the subgroup that it heads. When such individual financial statements or the consolidated financial statements of a subgroup include goodwill, an annual impairment test is required. Along with the question of whether intra-group cash flows need to be on an arm's length basis for impairment testing purposes, as discussed in section 12.1 above, other principal questions are:

- How to treat synergies arising outside of the reporting entity/subgroup (see section 12.2.1 below)?
- Whether the guidance in IFRS 8 applies in determining the level at which goodwill has to be tested for impairment in the consolidated financial statements of the subgroup or in individual financial statements (see section 12.2.2 below)?

  And
- How to deal with goodwill, arising at a subgroup level, in the group financial statements (see section 12.2.3 below)?

12.2.1 Goodwill synergies arising outside of the reporting entity/subgroup

If goodwill is being tested in the consolidated financial statements of a subgroup or individual financial statements, it is possible that the synergies that gave rise to the goodwill are in another part of the larger group because the subgroup is part of a CGU containing other subsidiary companies. It is possible that some synergies such as economies of scale cannot be translated into cash flows to the entity or subgroup in question. Although there is no impairment at the level of the CGU in the group consolidated financial statements, it is possible that the entity cannot avoid writing down the goodwill in the individual financial statements or consolidated financial statements of a subgroup statements at the time the first impairment test is performed in the year of the acquisition.

How we see it

In our view, it is not appropriate to consider synergies arising outside the individual financial statements or consolidated financial statements of a subgroup when testing impairment in the individual financial statements or consolidated financial statements of a subgroup unless these synergies are available to market participants and therefore are built into the FVLCD. Whether this impairment loss needs to be recorded in the statement of profit or loss or whether it is appropriate to treat it as an equity transaction in the form of a distribution to the parent is a matter of judgement.

12.2.2 The effect of IFRS 8 *Operating Segments* when allocating goodwill to CGUs in individual financial statements or consolidated financial statements of a subgroup

As discussed in section 8.1 above, goodwill is not necessarily tested at the lowest level of CGUs (however defined in the context of these group entities or subgroups), but at the level of a group of CGUs at which goodwill is monitored. However, that group of CGUs cannot be larger than an operating segment before aggregation (see section 8.1.4 above). *[IAS 36.80]*.

How we see it

We believe that for the purposes of testing goodwill in the individual financial statements or the consolidated financial statements of a subgroup, companies must apply the guidance in IFRS 8 to determine its operating segments even if IFRS 8 is not applicable because the subsidiary (subgroup) is not public.

Therefore, if the application of IFRS 8 would result in the identification of separate operating segments in the individual financial statements or consolidated financial statements of a subgroup, goodwill cannot be tested for impairment at a level above the operating segments in those financial statements (i.e., the operating segments would serve as a ceiling). It would not be appropriate to apply IAS 36.80 in these circumstances based on the operating segments as determined by the ultimate parent entity for its consolidated financial statements.

However, the CGU/group of CGUs for the purposes of goodwill impairment testing could be at a level lower than the subgroup's operating segments.

Illustration 12-1: A subgroup with goodwill that is not an operating segment for the group

A mining entity (group) extracts a metal ore that does not have an active market until it has been through a smelting and refining process. Each mine is held in a separate subsidiary, as is the refinery, and in two joint ventures. The refinery, subsidiaries and joint ventures are located in several different countries. The entity considers the CGU to comprise the subsidiary that holds the smelter together with the subsidiaries that hold the individual mines and the interests in the joint ventures.

The entity acquires a group of mine-holding subsidiaries in a country where there is a requirement to prepare consolidated financial statements at the highest level within that country. These consolidated financial statements, which are prepared using the acquisition method by the relevant intermediate parent, include goodwill. The entity does not consider the subgroup to be an operating segment. However, in the subgroup's consolidated financial statements, first of all the relevant operating segments would need to be determined from the subgroup's perspective. If it was concluded that from the subgroup's perspective there was only one operating segment, this would be the maximum level at which goodwill is tested for impairment in the subgroup's consolidated financial statements.

12.2.3 Acquisitions by subsidiaries and determining the level at which the group tests goodwill for impairment

IAS 36 requires goodwill to be allocated to the lowest level within the entity at which the goodwill is monitored for internal management purposes. If a subsidiary undertakes acquisitions and recognises goodwill in its own financial statements, the level at which the subsidiary's management monitors the goodwill can differ from the level at which the parent's or group's management monitors goodwill from the group's perspective.

If a subsidiary's management monitors its goodwill at a lower level than the level at which the parent's or group's management monitors its goodwill, a key issue is whether that lower level must, from the group's perspective, be regarded as the 'lowest level within the entity at which the goodwill is monitored for internal management purposes'? The answer is not necessarily, as is demonstrated in the following Illustration.

Illustration 12-2: Monitoring goodwill arising from acquisitions by subsidiaries

A parent acquired 100% of the issued shares of a company that operates autonomously and is required to prepare IFRS-compliant financial statements. The subsidiary has acquired various businesses both before and after becoming part of the group. Those business combinations have included significant amounts of goodwill.

The subsidiary's management monitors its acquired goodwill at the level of the subsidiary's operating segments identified in accordance with IFRS 8. However, management of the parent/group monitors its acquired goodwill at the level of the group's operating segments, which is a higher level than the subsidiary's operating segments. The subsidiary's operations form part of two of the group's six operating segments.

The subsidiary's goodwill comprises goodwill arising on its acquisitions, some of which took place *before*, and some *after*, the subsidiary became part of the group.

In contrast, the goodwill recognised by the group comprises:

- Goodwill acquired by the parent in the acquisition of the subsidiary
- Goodwill acquired by the subsidiary since becoming part of the group
- Goodwill acquired by the parent in other operating combinations (i.e., goodwill that relates to other subsidiaries and businesses that make up the group)

The goodwill acquired in the acquisition of the subsidiary that is recognised by the parent in its consolidated financial statements is therefore different from the goodwill recognised by the subsidiary (which relates only to the acquisitions made by the subsidiary itself and was measured at the date of the acquisition concerned, as any other goodwill would be internally generated goodwill from the subsidiary's perspective and therefore not recognised by the subsidiary).

In such circumstances the actions of the subsidiary's management in deciding the level at which it tests its goodwill for impairment will *not* cause the group to be 'locked in' to testing goodwill at the same level in the consolidated financial statements.

Rather, the group must test its goodwill for impairment at the level at which management of the group (i.e., of the parent) monitors its various investments in goodwill, namely, in this example, at the group's operating segment level.

12.3 Intra-group transfer of investments in subsidiaries

A common form of group reorganisation involves the transfer of the entire business of a subsidiary to another subsidiary of the same parent. These transactions often take place at the book value of the transferor's assets rather than at fair value. If the original carrying value was a purchase price that included an element of goodwill, the remaining 'shell', i.e., an entity that no longer has any trade or activities, can have a carrying value in the parent company's statement of financial position in excess of its net worth/recoverable amount. It could be argued that as the subsidiary is now a shell with no possibility in its current state of generating sufficient profits to support its value, a loss must be recognised by the parent in its separate financial statements to reduce its investment in the shell company to its net worth/recoverable amount. However, the transfer of part of the group's business from one controlled entity to another has no substance from the perspective of the group and will have no effect in the consolidated accounts. There has also been no loss overall to the parent as a result of this reorganisation as the loss in net worth/recoverable amount in one subsidiary results in an increase in the net worth/recoverable amount in the other subsidiary.

This is, of course, a transaction between companies under common control as all of the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory. *[IFRS 3.B1]*. This means that the treatment by the acquirer is scoped out of IFRS 3.

From the transferor entity's perspective, the transaction combines a sale of its assets at an undervalue to the acquirer, by reference to the fair value of the transferred assets, and a distribution of the shortfall in value to its parent. It is possible that the fair value of those assets to the parent is not reflected in the transferor's own statement of financial position because there is no push-down accounting under IFRS. The transferor is not obliged to record the 'distribution' to its parent at fair value. IFRIC 17 *Distributions of Non-cash Assets to Owners* requires gains or losses measured by reference to fair value of the assets distributed to be taken to profit or loss but, amongst other restrictions, excludes from its scope non-cash distributions made by wholly-owned group companies (see Chapter 9 at section 2.4.2).

This interpretation of the transferor's transaction (as a sale at an undervalue and a deemed distribution to the parent) is wholly consistent with a legal analysis in some jurisdictions, for example the United Kingdom, where a company that does not have zero or positive distributable reserves is unable to sell its assets at an undervalue because it cannot make any sort of distribution.

The parent, in turn, could be seen as having made a capital contribution of the shortfall in value to the acquirer. The parent can choose to record the distribution from the transferor (and consequent impairment in its carrying value) and the contribution to the acquirer (and consequent increase in its carrying value). This is consistent with our analysis in Chapter 9 at section 4.3.1 regarding intra-group transactions.

The acquirer will not necessarily record the capital contribution even if this is an option available to it.

However, the underlying principles are not affected by whether or not the acquirer makes this choice - there has been a transfer of value from one subsidiary to another. This demonstrates why the business transfer alone does not necessarily result in an impairment charge in the parent entity.

If the above analysis is not supportable in a particular jurisdiction, then an impairment loss has to be recognised.

Actual circumstances can be less straightforward. In particular, when the transferor and the acquirer are not held directly by the same parent. This can make it necessary to record an impairment against the carrying value of the transferor ('shell') company in its intermediate parent to reflect its loss in value, which will be treated as an expense or as a distribution, depending on the policy adopted by the entity and the relevant facts and circumstances. See Chapter 9 at section 4.1 for a discussion of the policy choices available to the entity. There can be another, higher level within the group at which the above arguments against impairment will apply.

Illustration 12-3: Group reorganisations and impairment

Topco has two directly held subsidiaries, Tradeco and Shellco. It acquired Shellco for CU30 million and immediately thereafter transferred all of its trade and assets to its fellow subsidiary Tradeco for book value of CU10 million with the proceeds being left outstanding on intercompany account. Shellco now has net assets of CU10 million (its intercompany receivable) but a carrying value in Topco of CU30 million. On the other hand, the value of Tradeco has been enhanced by its purchase of the business at an undervalue.

There are two acceptable ways in which Tradeco can account for this. The cost of the investment in Tradeco's individual financial statements can be the fair value of the cash given as consideration, i.e., CU10 million. Alternatively, it is the fair value of the cash given as consideration (CU10 million), together with a deemed capital contribution received from Topco for the difference up to the fair value of the business of Shellco of CU20 million, which will be recognised in equity, giving a total consideration of CU30 million.

The capital contribution measured under the second method represents the value distributed by Shellco to its parent Topco and thence to Tradeco. Meanwhile Topco could record a transfer of CU20 million from the carrying value of Shellco to the carrying value of Tradeco.

If there is an intermediate holding company between Topco and Shellco but all other facts remain the same, then it would appear that an impairment ought to be made against the carrying value of Shellco in its immediate parent, which will be treated as an expense or as a distribution, depending on the policy adopted by the entity and the relevant facts and circumstances. The argument against impairment would still apply in Topco.

12.4 Investments in subsidiaries, associates and joint ventures

Investments in subsidiaries, associates and joint ventures carried at cost in separate financial statements of the parent and equity accounted investments are within the scope of IAS 36.

However, IAS 27 also permits entities to account for investments in subsidiaries, associates and joint ventures in separate financial statements in accordance with IFRS 9 or by applying the equity method. *[IAS 36.4, IAS 27.10]*.

The recoverable amount for investments carried at cost or under the use of the equity method is the higher of FVLCD and VIU. Specific questions around FVLCD are dealt with in section 12.4.1 below. Challenges in respect of VIU for investments carried at cost or under the equity method are dealt with in section 12.4.2 below.

It is important to note that testing an investment in an associate or joint venture carried under the equity method using IAS 28 in group financial statements cannot always provide assurance about the recoverability of the cost of shares in the investor's separate financial statements, if they are carried at cost. *[IAS 27.10(a)]*. Accounting for the group's share of losses can take the equity interest below cost and an impairment test could reveal no need for an impairment loss in the consolidated financial statements. This does not necessarily provide any assurance about the (higher) carrying value of the shares in the separate financial statements.

12.4.1 Fair value less costs of disposal (FVLCD) for investments in subsidiaries, associates and joint ventures

In order to establish FVLCD an entity must apply IFRS 13's requirements as outlined in section 6 above and described in detail in Chapter 15.

If an entity holds a position in a single asset or liability that is traded in an active market, IFRS 13 requires an entity to measure fair value using that price, without adjustment. This requirement is accepted when the asset or liability being measured is a financial instrument in the scope of IFRS 9. However, when an entity holds an investment in a subsidiary, joint venture or associate the question is what the unit of account is, the individual shares or the investment as a whole, and whether it would be appropriate to include a control premium when determining fair value provided that market participants take this into consideration when pricing the asset. See section 6.1.1 above and Chapter 15 at section 4.1.1 for considerations and recent developments in respect of this.

Unlike investments with quoted prices, discussed above, there are less issues if FVLCD is used to determine the recoverable amount of an asset that does not have a quoted price in an active market and is either:

- An investment in a subsidiary, joint venture or associate

  Or

- A CGU comprising the investment's underlying assets

Using FVLCD can avoid some of the complexities of determining appropriate cash flows related to transfer pricing and other intra-group transaction issues, described in section 12.1 above and section 12.4.2 below.

12.4.2 VIU for investments in subsidiaries, associates and joint ventures

Unlike most other assets, an investment in a subsidiary, joint venture or associate can be viewed as either:

- An individual asset that can generate income, e.g., in the form of dividends

  Or

- As an asset that represents the underlying assets and liabilities that are under the control of the subsidiary, joint venture or the associate

IAS 28 acknowledges this by stating:

> "…In determining the value in use of the investment, an entity estimates:
>
> "(a) its share of the present value of the estimated future cash flows expected to be generated by the associate or joint venture, including the cash flows from the operations of the associate or joint venture and the proceeds on the ultimate disposal of the investment; or
>
> "(b) the present value of the estimated future cash flows expected to arise from dividends to be received from the investment and from its ultimate disposal.
>
> "Under appropriate assumptions, both methods give the same result." *[IAS 28.42]*.

This means that there are broadly two approaches in testing for impairment: one focuses on the investment and the cash flows the parent receives (dividends and ultimate disposal proceeds) and the other considers the recoverable amount of the underlying assets of the investment and the cash flows generated by these assets. These two approaches are considered in sections 12.4.2.A and 12.4.2.B below respectively. Whichever view is taken, the entity needs to ensure that the cash flows are appropriate (see section 12.1 above in respect of considerations around intra-group transfer pricing).

It is important to note that, whether an entity calculates VIU using its share of the present value of estimated cash flows of the underlying assets or the dividends expected to be received, it is necessary to adjust them to reflect IAS 36 restrictions, e.g., those in respect of improvements and enhancements (see section 7.1.2 above), restructuring (see section 7.1.3 above), growth (see sections 7.1 and 7.1.1 above) and discount rates (see section 7.2 above). It can be a practical challenge to obtain sufficiently detailed information to make such adjustments for investments in entities that are not controlled by the parent, in which case it is possible that the entity needs to use FVLCD to establish the recoverable amount.

12.4.2.A VIU of investments in subsidiaries, associates and joint ventures using dividend discount models

IAS 28 allows the VIU of the equity accounted interest to be based on the present value of the estimated future cash flows expected to arise from dividends to be received from the investment. *[IAS 28.42]*. This describes in broad terms what is also known as a dividend discount model (DDM). DDMs are financial models frequently used by financial institutions to value shares at the discounted value of future dividend payments. These models value a company on the basis of future cash flows that are expected to be distributed to the shareholders in compliance with the capital requirements provided by law, discounted at a rate expressing the cost and risk of capital. By analogy this approach can be used to calculate the VIU for investments in subsidiaries, associates and joint ventures carried at cost in the separate financial statements of a parent and for equity accounted investments.

The IFRS IC considered the use of DDMs in testing for impairment under IAS 36. The IFRS IC rejected 'in general' the use of DDMs as an appropriate basis for calculating the VIU of a CGU in consolidated financial statements.[4] It was of the view that calculations using DDMs can be appropriate when calculating the VIU of a single asset, for example when determining whether an investment is impaired in the separate financial statements of an entity. It did not consider whether the cash flows used in the DDMs must be adjusted to reflect IAS 36 assumptions and restrictions, as discussed more fully in section 12.4.2 above. However, in order to use a DDM for calculating VIU, IAS 36's requirements must be reflected in the future dividends calculated for use in the model.

12.4.2.B VIU of investments in subsidiaries, associates and joint ventures based on cash flows generated by underlying assets

When testing investments in subsidiaries, associates and joint ventures based on cash flows generated by underlying assets entities need to ensure that the cash flows are appropriate (see section 12.1 above in respect of intra-group transfer pricing) and that the restrictions of IAS 36 are appropriately applied (see section 12.4.2 above).

If an entity is testing its investments in subsidiaries, associates and joint ventures for impairment and it can demonstrate that the investment contains one or more CGUs in their entirety then it can in some circumstances be able to use the results of the group impairment tests of the underlying CGUs to test the investment for impairment. If the aggregate VIU (or FVLCD) of the CGU or CGUs is not less than the carrying value of the investment, this can be an indication that the investment is not impaired. Note that the entity's investment reflects the net assets of the subsidiary, associates or joint venture while the CGU reflects the assets and liabilities on a gross basis, so appropriate adjustments will have to be made (one example are financing liabilities, however section 4.1 also refers to receivables or other financial assets, trade payables, pensions and other provisions, as examples of items that may warrant closer attention). In addition, when it comes to investments in associates and joint ventures, an investor with a minority holding will need to assess the impact of holding a minority stake without control.

It is not always so straightforward in practice. There are particular problems if the asset (the investment) and the underlying CGU are not the same. CGUs can overlap individual subsidiaries so, for example, a single CGU contains more than one such subsidiary. Even if the CGU and investment coincide, it is possible that the shares have been acquired in a business combination. It is quite possible that the synergies that gave rise to goodwill on acquisition are in another part of the group not controlled by the intermediate parent in question. In such a case it is possible that an entity is not able to use the result of the group impairment test and so would have to calculate the recoverable amount of the investment.

12.4.3 Equity accounted investment and indicators of impairment

In connection with issuing IFRS 9, the IASB amended IAS 28 to include the impairment indicators an entity needs to use to determine whether it is necessary to recognise any additional impairment loss once it has accounted for losses, if any, under IAS 28. *[IAS 28.40, IAS 28.41A]*.

The indicators of impairment require "objective evidence of impairment as a result of one or more events that have occurred after the initial recognition". *[IAS 28.41A]*. However, one would not expect any significant difference in the impairment indicators under IAS 36 and IAS 28 because both look for objective evidence, sometimes in virtually identical terms and neither claims that its list of indicators is exclusive. *[IAS 36.13, IAS 28.41A]*. This means that an impairment test cannot be avoided because an impairment indicator is not mentioned specifically in IAS 28.

4 *IFRIC Update*, September 2010, available on the IFRS Foundation's website.

If an entity has reason to believe that the carrying amount of an investment in an associate or joint venture is higher than the recoverable amount, this is most likely a sufficient indicator on its own to require an impairment test.

12.4.4 Equity accounted investments and long-term loans

Investors frequently make long-term loans to associates or joint ventures that, from their perspective, form part of the net investment in the associate or joint venture. In October 2017, the IASB issued *Long-term Interests in Associates and Joint Ventures* (Amendments to IAS 28) to clarify that an entity applies IFRS 9, in addition to IAS 28, to long-term interests that form part of the net investment. *[IAS 28.14A]*.

To illustrate how entities apply the requirements in IAS 28 and IFRS 9 with respect to long-term interests, the Board also published an illustrative example when it issued the amendments.

These requirements are described in detail in Chapter 12 at section 10.3. The illustrative example is shown in Illustration 10-2 of that section.

12.4.5 Equity accounted investments and CGUs

IAS 28 states that the recoverable amount of an investment in an associate or a joint venture must be assessed for each associate or joint venture, unless it does not generate cash inflows from continuing use that are largely independent of those from other assets of the entity. *[IAS 28.43]*. This means that each associate or joint venture is a separate CGU unless it is part of a larger CGU including other assets, which could include other associates or joint ventures.

Illustration 12-4: Joint ventures are part of larger CGU

A mining entity (group) extracts a metal ore that does not have an active market until it has been through a smelting and refining process. Each mine is held in a separate subsidiary, as is the refinery, and in two joint ventures. The refinery, subsidiaries and joint ventures are located in several different countries. The entity considers the CGU to comprise the subsidiary that holds the smelter together with the subsidiaries that hold the individual mines and the interests in the joint ventures.

If there is goodwill in the carrying amount of an associate or joint venture, this is not tested separately. *[IAS 28.42]*. However, there can be additional goodwill in the group that will be allocated to a CGU that includes an associate or joint venture, that will be tested for impairment by reference to the combined cash flows of assets and associates and joint ventures.

12.4.6 Equity accounted investments and testing goodwill for impairment

When calculating its share of an equity accounted investee's results, an investor makes adjustments to the investee's profit or loss to reflect depreciation and impairments of the investee's identifiable assets based on their fair values at the date the investor acquired its investment. This is covered in IAS 28 which states that:

> "Appropriate adjustments to the investor's share of the associate's or joint venture's profits or losses after acquisition are also made to account, for example, for depreciation of the depreciable assets, based on their fair values at the acquisition date. Similarly, appropriate adjustments to the investor's share of the associate's or joint venture's profits or losses after acquisition are made for impairment losses recognised by the associate, such as for goodwill or property, plant and equipment." *[IAS 28.32]*.

Although this refers to 'appropriate adjustments' for goodwill impairment losses, this does not mean requiring the investor to recalculate the goodwill impairment on a similar basis to depreciation and impairment of tangible and intangible assets. The 'appropriate adjustment' is to reverse that goodwill impairment that relates to pre-acquisition goodwill in the investee before calculating the investor's share of the investee's profit. After application of the equity method the entire equity-accounted carrying amount of the investor's investment, including the goodwill included in that carrying amount, is tested for impairment in accordance with IAS 28. *[IAS 28.40, IAS 28.41, IAS 28.42, IAS 28.43]*. Note that there is no requirement to test investments in associates or joint ventures for impairment annually but only when there are indicators of impairment. These requirements are described in detail in Chapter 12 at section 10.

Impairment write-offs made against investments accounted for under the equity method can be reversed if an impairment loss no longer exists or has decreased (see section 11.4 above). Although IAS 36 does not allow impairments of goodwill to be reversed, *[IAS 36.124]*, this impairment is not a write-off against goodwill, but a write-off against the equity investment, so this prohibition does not apply. IAS 28 states that 'an impairment loss recognised in those circumstances is not allocated to any asset, including goodwill, that forms part of the carrying amount of the investment in the associate or joint venture. Accordingly, any reversal of that impairment loss is recognised in accordance with IAS 36 to the extent that the recoverable amount of the investment subsequently increases'. *[IAS 28.42]*.

13 Disclosures required by IAS 36

13.1 Introduction

This section sets out the principal disclosures for impairment required in financial statements as set out in IAS 36. Any disclosures required relating to impairment by other IFRS accounting standards are dealt with in the chapters concerned. Disclosures required by other authorities such as national statutes or listing authorities are not included.

In particular, we refer to the general requirement in IAS 1 on the disclosure of information about the assumptions concerning the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year (see Chapter 3 at section 5.2.1). *[IAS 1.125]*.

13.2 IAS 36 disclosures

The disclosures required fall into two broad categories:

(i) Disclosures concerning any actual impairment losses or reversals made in the period, that are obviously only required if such a loss or reversal has occurred, regardless of the type of asset involved. *[IAS 36.126-132]*.

And

(ii) Yearly disclosures concerning the annual impairment tests required for goodwill and intangible assets with an indefinite useful life, that are required regardless of whether an impairment adjustment to these types of assets has occurred or not. *[IAS 36.133, IAS 36.134, IAS 36.135, IAS 36.136]*.

13.2.1 Disclosures required for impairment losses or reversals

For each class of assets, the entity must disclose: *[IAS 36.126, IAS 36.127, IAS 36.128, IAS 36.129]*

Extract from IAS 36

126 **An entity shall disclose the following for each class of assets:**

(a) the amount of impairment losses recognised in profit or loss during the period and the line item(s) of the statement of comprehensive income in which those impairment losses are included.

(b) the amount of reversals of impairment losses recognised in profit or loss during the period and the line item(s) of the statement of comprehensive income in which those impairment losses are reversed.

(c) the amount of impairment losses on revalued assets recognised in other comprehensive income during the period.

(d) the amount of reversals of impairment losses on revalued assets recognised in other comprehensive income during the period.

127 A class of assets is a grouping of assets of similar nature and use in an entity's operations.

128 The information required in paragraph 126 may be presented with other information disclosed for the class of assets. For example, this information may be included in a reconciliation of the carrying amount of property, plant and equipment, at the beginning and end of the period, as required by IAS 16.

129 **An entity that reports segment information in accordance with IFRS 8 shall disclose the following for each reportable segment:**

(a) the amount of impairment losses recognised in profit or loss and in other comprehensive income during the period.

(b) the amount of reversals of impairment losses recognised in profit or loss and in other comprehensive income during the period.

13.2.2 Material impairments

If an impairment loss for an individual asset or a cash-generating unit is recognised or reversed during the period and is material to the financial statements of the reporting entity as a whole, the following disclosures are required: *[IAS 36.130]*

Extract from IAS 36

130 An entity shall disclose the following for an individual asset (including goodwill) or a cash-generating unit, for which an impairment loss has been recognised or reversed during the period:

(a) the events and circumstances that led to the recognition or reversal of the impairment loss.

(b) the amount of the impairment loss recognised or reversed.

(c) for an individual asset:

(i) the nature of the asset; and

(ii) if the entity reports segment information in accordance with IFRS 8, the reportable segment to which the asset belongs.

(d) for a cash-generating unit:

(i) a description of the cash-generating unit (such as whether it is a product line, a plant, a business operation, a geographical area, or a reportable segment as defined in IFRS 8);

(ii) the amount of the impairment loss recognised or reversed by class of assets and, if the entity reports segment information in accordance with IFRS 8, by reportable segment; and

(iii) if the aggregation of assets for identifying the cash-generating unit has changed since the previous estimate of the cash-generating unit's recoverable amount (if any), a description of the current and former way of aggregating assets and the reasons for changing the way the cash-generating unit is identified.

(e) the recoverable amount of the asset (cash-generating unit) and whether the recoverable amount of the asset (cash-generating unit) is its fair value less costs of disposal or its value in use.

(f) if the recoverable amount is fair value less costs of disposal, the entity shall disclose the following information:

(i) the level of the fair value hierarchy (see IFRS 13) within which the fair value measurement of the asset (cash-generating unit) is categorised in its entirety (without taking into account whether the 'costs of disposal' are observable);

(ii) for fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) used to measure fair value less costs of disposal. If there has been a change in valuation technique, the entity shall disclose that change and the reason(s) for making it; and

(iii) for fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, each key assumption on which management has based its determination of fair value less costs of disposal. Key assumptions are those to which the asset's (cash-generating unit's) recoverable amount is most sensitive. The entity shall also disclose the discount rate(s) used in the current measurement and previous measurement if fair value less costs of disposal is measured using a present value technique.

(g) if recoverable amount is value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value in use.

It is logically possible for impairment adjustments in aggregate to be material, yet no single one material in itself, in which case the previous requirement that relates to individual assets or CGUs could theoretically be circumvented. Therefore, the following 'catch all' requirement is added: *[IAS 36.131]*

Extract from IAS 36

131 An entity shall disclose the following information for the aggregate impairment losses and the aggregate reversals of impairment losses recognised during the period for which no information is disclosed in accordance with paragraph 130:

(a) the main classes of assets affected by impairment losses and the main classes of assets affected by reversals of impairment losses.

(b) the main events and circumstances that led to the recognition of these impairment losses and reversals of impairment losses.

In addition, in these circumstances, if there are any cases of impairment adjustments where intangible assets with indefinite useful life and goodwill are not involved, IAS 36 encourages the disclosure of key assumptions made in the recoverable amount calculations used to determine any impairments recognised in the period. *[IAS 36.132]*. However, as set out below, an entity is required to give this type of disclosure when goodwill or intangible assets with an indefinite useful life are tested for impairment.

13.3 Annual impairment disclosures required for goodwill and intangible assets with an indefinite useful life

Paragraph 84 of IAS 36 accepts the possibility that following a business combination the entity was not able to allocate all the goodwill to individual CGUs or groups of CGUs by the end of the period in which the acquisition has been made (see section 8.1.5 above). In these circumstances the standard requires that the amount of any such unallocated goodwill be disclosed, together with the reasons why it has not been allocated. *[IAS 36.133]*.

The annual disclosures are intended to provide the user with information about the types of estimates that have been used in arriving at the recoverable amounts of goodwill and intangible assets with an indefinite useful life, that are included in the assets of the entity at the period end. They are divided into two broad categories:

(i) Those concerning individual CGUs or group of CGUs in which the carrying amount of goodwill or of intangible assets with an indefinite useful life is 'significant' in comparison with the entity's total carrying amount of these items. In this category disclosures are to be made separately for each significant CGU or group of CGUs. *[IAS 36.134]*.

(ii) Those concerning CGUs or groups of CGUs in which the carrying amount of goodwill or of intangible assets with an indefinite useful life is not 'significant' individually in comparison with the entity's total carrying amount of these items. In this case the disclosures can be made in aggregate. *[IAS 36.135]*.

For each cash-generating unit or group of units for which the carrying amount of goodwill or intangible assets with indefinite useful lives allocated to that unit or group of units is significant, the following disclosures are required every year: *[IAS 36.134]*

Extract from IAS 36

134 An entity shall disclose the information required by (a)-(f) for each cash-generating unit (group of units) for which the carrying amount of goodwill or intangible assets with indefinite useful lives allocated to that unit (group of units) is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives:

(a) the carrying amount of goodwill allocated to the unit (group of units).

(b) the carrying amount of intangible assets with indefinite useful lives allocated to the unit (group of units).

(c) the basis on which the unit's (group of units') recoverable amount has been determined (i.e. value in use or fair value less costs of disposal).

(d) if the unit's (group of units') recoverable amount is based on value in use:

(i) each key assumption on which management has based its cash flow projections for the period covered by the most recent budgets/forecasts. Key assumptions are those to which the unit's (group of units') recoverable amount is most sensitive.

(ii) a description of management's approach to determining the value(s) assigned to each key assumption, whether those value(s) reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information.

(iii) the period over which management has projected cash flows based on financial budgets/forecasts approved by management and, when a period greater than five years is used for a cash-generating unit (group of units), an explanation of why that longer period is justified.

(iv) the growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets/forecasts, and the justification for using any growth rate that exceeds the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market to which the unit (group of units) is dedicated.

(v) the discount rate(s) applied to the cash flow projections.

(e) if the unit's (group of units') recoverable amount is based on fair value less costs of disposal, the valuation technique(s) used to measure fair value less costs of disposal. An entity is not required to provide the disclosures required by IFRS 13. If fair value less costs of disposal is not measured using a quoted price for an identical unit (group of units), an entity shall disclose the following information:

(i) each key assumption on which management has based its determination of fair value less costs of disposal. Key assumptions are those to which the unit's (group of units') recoverable amount is most sensitive.

(ii) a description of management's approach to determining the value (or values) assigned to each key assumption, whether those values reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information.

(iiA) the level of the fair value hierarchy (see IFRS 13) within which the fair value measurement is categorised in its entirety (without giving regard to the observability of 'costs of disposal').

(iiB) if there has been a change in valuation technique, the change and the reason(s) for making it.

If fair value less costs of disposal is measured using discounted cash flow projections, an entity shall disclose the following information:

(iii) the period over which management has projected cash flows.

(iv) the growth rate used to extrapolate cash flow projections.

(v) the discount rate(s) applied to the cash flow projections.

(f) if a reasonably possible change in a key assumption on which management has based its determination of the unit's (group of units') recoverable amount would cause the unit's (group of units') carrying amount to exceed its recoverable amount:

(i) the amount by which the unit's (group of units') recoverable amount exceeds its carrying amount.

(ii) the value assigned to the key assumption.

(iii) the amount by which the value assigned to the key assumption must change, after incorporating any consequential effects of that change on the other variables used to measure recoverable amount, in order for the unit's (group of units') recoverable amount to be equal to its carrying amount.

As set out above, there are separate disclosure requirements for those CGUs or groups of CGUs that taken individually do not have significant amounts of goodwill in comparison with the total carrying value of goodwill or of intangible assets with an indefinite useful life. *[IAS 36.135]*.

Extract from IAS 36

135 If some or all of the carrying amount of goodwill or intangible assets with indefinite useful lives is allocated across multiple cash-generating units (groups of units), and the amount so allocated to each unit (group of units) is not significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives, that fact shall be disclosed, together with the aggregate carrying amount of goodwill or intangible assets with indefinite useful lives allocated to those units (groups of units). In addition, if the recoverable amounts of any of those units (groups of units) are based on the same key assumption(s) and the aggregate carrying amount of goodwill or intangible assets with indefinite useful lives allocated to them is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives, an entity shall disclose that fact, together with:

(a) the aggregate carrying amount of goodwill allocated to those units (groups of units).

(b) the aggregate carrying amount of intangible assets with indefinite useful lives allocated to those units (groups of units).

(c) a description of the key assumption(s).

(d) a description of management's approach to determining the value(s) assigned to the key assumption(s), whether those value(s) reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information.

(e) if a reasonably possible change in the key assumption(s) would cause the aggregate of the units' (groups of units') carrying amounts to exceed the aggregate of their recoverable amounts:

(i) the amount by which the aggregate of the units' (groups of units') recoverable amounts exceeds the aggregate of their carrying amounts.

(ii) the value(s) assigned to the key assumption(s).

(iii) the amount by which the value(s) assigned to the key assumption(s) must change, after incorporating any consequential effects of the change on the other variables used to measure recoverable amount, in order for the aggregate of the units' (groups of units') recoverable amounts to be equal to the aggregate of their carrying amounts.

Example 9 in IAS 36's Illustrative Examples gives an indication of the types of assumptions and other relevant information the IASB envisages being disclosed under this requirement. The IASB expects disclosure of: budgeted gross margins, average gross margins, expected efficiency improvements, whether values assigned to key assumptions reflect past experience, what improvements management believes are reasonably achievable each year, forecast exchange rates during the budget period, forecast consumer price indices during the budget period for raw materials, market share and anticipated growth in market share.

If a reasonably possible change in a key assumption would cause the CGU's carrying amount to exceed its recoverable amount, then the standard requires an entity to disclose the value assigned to this key assumption and the amount by which the value assigned to the key assumption must change in order to cause an impairment. This is particularly relevant to cases where the CGU's carrying amount is equal to its recoverable amount, as any negative change to the recoverable amount would result in the recognition of an impairment loss. *[IAS 36.134(f)(ii)]*.

How we see it

When the CGU's carrying amount is equal to its recoverable amount, entities should consider whether the disclosure requirements of IAS 1 would require additional disclosures if this represents a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

As explained in sections 8.2.3 and 10 above, the standard allows to carry forward a previous impairment test when certain criteria are met. The standard makes it clear that when this is the case, the information for that asset or CGU that is incorporated into the disclosures as required by IAS 36.134 and 135 relates to the carried forward calculation of the recoverable amount. *[IAS 36.136]*.

An example of disclosures including key assumptions used in determining the value in use and sensitivities is given by Vodafone Group Plc. The following extract from the annual report of Vodafone Group Plc focuses on the current period disclosures. While disclosures for comparative years are required and given by Vodafone Group Plc in the annual report, these were not included in the following extract for simplicity purposes.

Practical example 13-1: Vodafone Group Plc (2023) **United Kingdom**

Annual Report 2023 [extract]

Financials [extract]

Notes to the consolidated financial statements [extract]

4. Impairment losses [extract]

Goodwill

The remaining carrying value of goodwill at 31 March was as follows:

	2023 €m	2022 €m
Germany	20,335	20,335
Italy	2,481	2,481
Vantage Towers Germany	–	2,565
Other	4,799	6,503
	27,615	**31,884**

Key assumptions used in the value in use calculations

The key assumptions used in determining the value in use are:

Assumption	How determined
Projected adjusted EBITDAaL	Projected adjusted EBITDAaL has been based on past experience adjusted for the following: - In Europe, mobile revenue is expected to benefit from increased usage as customers transition to higher data bundles, and new products and services are introduced. Fixed revenue is expected to continue to grow as penetration is increased and more products and services are sold to customers; - Outside of Europe, revenue is expected to continue to grow as the penetration of faster data-enabled devices rises along with higher data bundle attachment rates, and new products and services are introduced; and - Margins are expected to be impacted by negative factors such as the cost of acquiring and retaining customers in increasingly competitive markets and by positive factors such as the efficiencies expected from the implementation of Group initiatives.
Projected capital expenditure	The cash flow forecasts for capital expenditure are based on past experience and include the ongoing capital expenditure required to maintain our networks, provide products and services in line with customer expectations, including of higher data volumes and speeds, and to meet the population coverage requirements of certain of the Group's licences. In Europe, capital expenditure is required to roll out capacity-building next generation 5G and gigabit networks. Outside of Europe, capital expenditure will be required for the continued rollout of current and next generation mobile networks in emerging markets. Capital expenditure includes cash outflows for the purchase of owned property, plant and equipment and computer software.
Projected licence and spectrum payments	To enable the continued provision of products and services, the cash flow forecasts for licence and spectrum payments for each relevant cash-generating unit include amounts for expected renewals and newly available spectrum. Beyond the five year forecast period, a long-run cost of spectrum is assumed.
Long-term growth rate	For the purposes of the Group's value in use calculations, a long-term growth rate into perpetuity is applied immediately at the end of the five year forecast period and is based on the lower of: - the nominal GDP growth rate forecasts for the country of operation; and - the long-term compound annual growth rate in adjusted EBITDAaL as estimated by management. Long-term compound annual growth rates determined by management may be lower than forecast nominal GDP growth rates due to the following market-specific factors: competitive intensity levels, maturity of business, regulatory environment or sector-specific inflation expectations.
Pre-tax discount rate	The pre-tax discount rate for each cash-generating unit is derived such that when applied to pre-tax cash flows it gives the same result as when the observable post-tax weighted average cost of capital is applied to post-tax cash flows. The assumptions used to develop discount rates for each cash-generating unit are benchmarked to externally available data. - The risk free rate is derived from an average yield of a ten year bond issued by the government in each cash-generating unit's respective country of operations. - The forward-looking equity market risk premium (an investor's required rate return over and above a risk free rate) is based on studies by independent economists, the long-term average equity market risk premium and the market risk premiums typically used by valuation practitioners. - The asset beta reflecting the systematic risk of the telecommunications segment relative to the market as a whole is determined from betas observed for comparable listed telecommunications companies. - The region-specific leverage ratios are estimated from ratios observed for comparable listed telecommunications companies. Each cash-generating unit's discount rate is determined in nominal terms in order to match their nominal estimates of future cash flows. Rising risk free interest rates and lower asset betas have, respectively, increased and decreased the cash-generating unit discount rates in the current year.

Year ended 31 March 2023

The Group performs its annual impairment test for goodwill and indefinite lived intangible assets at 31 March and when there is an indicator of impairment of an asset. At each reporting period date judgement is exercised by management in determining whether any internal or external sources of information observed are indicative that the carrying amount of any of the Group's cash generating units is not recoverable. For changes to the Group's cash-generating units in the current year see note 27 'Acquisitions and disposals'.

Climate change

As a large owner of infrastructure and consumer of energy, the Group has exposure to climate change related risks such as energy cost increases, asset damage and service disruption. The long range plans used in the Group's impairment testing include forecast energy costs and other costs that are embedded in the planning process to deliver the Group's zero carbon targets. The long range plans also include capital expenditure in relation to the Group's use of durable and energy efficient infrastructure and the costs of the Group's extensive and ongoing network maintenance programme. Climate change has not had a material impact on the outcome of the Group's impairment testing.

Indus Towers Limited

The Group's investment in Indus Towers was tested for impairment at 31 March 2023 following a decline in Indus Towers' quoted share price in the current year. Management concluded that fair value less costs of disposal is the appropriate basis to determine the recoverable amount of the Group's investment. Indus Towers' share price is observable in a quoted market and is considered a level 1 input under the IFRS 13 fair value hierarchy. The share price of INR143.00 per share implied a recoverable amount of INR 81 billion (€0.9 billion) which was lower than the carrying value of the investment at the same date. An impairment charge of €64 million was recognised to reduce the carrying value of the Group's investment to the recoverable amount in the Group's consolidated statement of financial position.

Value in use assumptions

The table below shows key assumptions used in the value in use calculations, and separately presented cash-generating units for which the carrying amount of goodwill is significant in comparison with the Group's total carrying amount of goodwill:

	Assumptions used in value in use calculations	
	Germany %	Italy %
Pre-tax discount rate	7.8	8.9
Long-term growth rate	0.6	1.5
Projected adjusted EBITDAaL CAGR[1]	1.8	1.0
Projected capital expenditure[2]	19.4-19.8	16.5-17.9

Sensitivity analysis

The estimated recoverable amounts of the Group's operations in Germany, Italy, the UK, and Spain exceed their carrying values by €3.2 billion, €0.2 billion, €1.3 billion, and €0.4 billion respectively. If the assumptions used in the impairment review were changed to a greater extent than as presented in the following table, the changes would, in isolation, lead to an impairment loss being recognised for the year ended 31 March 2023.

	Change required for carrying value to equal recoverable amount			
	Germany pps	Italy pps	UK pps	Spain pps
Pre-tax discount rate	0.6	0.2	1.6	0.5
Long-term growth rate	(0.6)	(0.2)	(1.9)	(0.6)
Projected adjusted EBITDAaL CAGR[1]	(1.8)	(0.5)	(4.1)	(1.5)
Projected capital expenditure[2]	5.5	0.9	4.2	2.2

Notes:
1 Projected adjusted EBITDAaL CAGR is expressed as the compound annual growth rates in the initial five years for all cash-generating units of the plans used for impairment testing.
2 Projected capital expenditure, which excludes licences and spectrum, is expressed as capital expenditure as a percentage of revenue in the initial five years for all cash-generating units of the plans used for impairment testing.

For the Group's operations in Italy and Spain management has prepared the following sensitivity analysis for changes in pre-tax discount rate and projected adjusted EBITDAaL CAGR[1] assumptions. The associated impact of the change in each key assumption does not consider any consequential impact on other assumptions used in the impairment review.

	Recoverable amount less carrying value	
	Italy €bn	Spain €bn
Base case as at 31 March 2023	0.2	0.4
Change in pre-tax discount rate		
Decrease by 1pps	1.4	1.3
Increase by 1pps	(0.8)	(0.3)
Change in projected adjusted EBITDAaL CAGR[1]		
Decrease by 5pps	(1.6)	(0.8)
Increase by 5pps	2.3	1.8

Note:
1 Projected adjusted EBITDAaL CAGR is expressed as the compound annual growth rates in the initial five years for all cash-generating units of the plans used for impairment testing.

An example of disclosures including key assumptions used in determining the fair value less costs of disposal and sensitivities is given by Vicinity Limited.

Practical example 13-2: Vicinity Limited (2022) **Australia**

ANNUAL REPORT 2022 [extract]
FINANCIAL REPORT [extract]
NOTES TO THE FINANCIAL STATEMENTS [extract]
OTHER DISCLOSURES [extract]
17. INTANGIBLE ASSETS [extract]

Impairment testing
The recoverable amount of the SP CGU is determined using a fair value less cost of disposal (fair value) approach. This is performed using a collective discounted cash flow (DCF) valuation of the cash flows generated from external asset and funds management contracts which is based on the following key assumptions:

Key assumption	30 Jun 22	30 Jun 21
Post-tax external management contract cash flows	5 years	5 years
Terminal value growth rate	2.10%	2.10%
Post-tax discount rate range	6.55% – 7.05%	6.69% – 7.19%

The impairment test at 30 June 2022 determined that the recoverable amount of the SP CGU exceeded its carrying value and no impairment was required.

Sensitivity to changes in assumptions
Sensitivities to the key assumptions within the external management contracts DCF were also tested and the Group has determined that due to the long-term nature of the asset management contracts and associated cashflows, no reasonably possible changes would give rise to impairment at 30 June 2022. A disposal of a significant value of directly owned or equity accounted investment property assets, where the Group also gives up any future management rights under existing finite or indefinite life contracts, may lead to the full or partial derecognition of the intangible asset balance, as external asset management fees earned by the Group may no longer be sufficient to support the current carrying value of these intangible assets.

Process for determination of key assumptions
The key inputs, which are considered Level 3 in the fair value hierarchy, used in determining the recoverable amounts were determined as follows:

- The discount rates were calculated based on the Group's estimated weighted average cost of capital, with reference to the Group's long-term average cost of debt and estimated cost of equity which is derived with reference to external sources of information and the Group's target gearing ratio, adjusted for specific risk factors to the relevant CGU.
- Terminal value growth rates were estimated with reference to long-term expectations of macro-economic conditions (including consideration of equity analyst estimates) and the Group's expected long-term earnings growth.
- Five year forecast operating, asset and funds management cash flows based on the values determined by the Group's budgeting and planning process. Given the uncertainty as to the impacts of the COVID-19 pandemic over the short, medium and long-term, the Group assessed the outcomes of a number of cash flow scenarios particularly with varying degree of reduction in property management fees over the forecast period, when conducting impairment testing at 30 June 2022.

The determination of the key assumptions and inputs to the impairment testing process as outlined above requires a significant level of estimation. As a result, the recoverable amount of the SP CGU (as determined by the impairment testing processes outlined above) are subject to variability in these key assumptions or inputs. A change in one or more of the key assumptions or inputs could result in a change in assessed recoverable amount.

14 Developments

In response to feedback received from the Post-Implementation Review of IFRS 3, the IASB launched a goodwill and impairment research project. In accordance with the project's objectives set by the Board in July 2018, the discussions were focused on the following areas:

- Better disclosures for business combinations
- Reintroduction of amortisation of goodwill
- Presentation of total equity before goodwill subtotal
- Relief from mandatory annual impairment test
- Considering cash flows from a future restructuring or a future enhancement in value in use calculations

  And
- Removal of the explicit requirement to use pre-tax inputs and pre-tax discount rates in the value in use calculation

In March 2020, the IASB issued the Discussion Paper *Business Combinations-Disclosures, Goodwill and Impairment*. The IASB's preliminary views included that it should not reintroduce amortisation of goodwill. The stakeholder feedback to this view was mixed.

In March 2024, the IASB issued the Exposure Draft *Business Combinations - Disclosures, Goodwill and Impairment*. The IASB confirmed its preliminary review on retaining the current model in IAS 36. In addition, the IASB is proposing amendments to IFRS 3 and IAS 36 that primarily relate to:

- The disclosure requirements in IFRS 3 - in particular, to require entities to report information about the performance of business combinations and quantitative information about the synergies expected to arise from a business combination. However, entities would not be required to disclose information that could compromise their acquisition-date key objectives.
- The impairment test in IAS 36 - in particular, to make targeted amendments relating to the calculation of value in use, the allocation of goodwill to cash-generating units, and the disclosure requirements.

For a discussion on the proposed changes to IFRS 3, we refer to Chapter 10 at section 1.2.1.

The IASB proposes to amend IAS 36 by:

- clarifying how an entity allocates goodwill to CGUs that is expected to help reduce shielding;
- requiring an entity to disclose in which reportable segment a CGU or group of CGUs containing goodwill is included that should help improve the application of IAS 36 and mitigate concerns about management over-optimism in relation to the assumptions used in the impairment test; and
- changing the calculation of value in use by:
  - removing the restriction on including cash flows from uncommitted future restructurings or asset enhancements; and
  - removing the requirement to calculate value in use on a pre-tax basis.

The IASB believes that the changes to the calculation of value in use would bring inputs used in the impairment test closer to the information used by management, which should result in investors receiving more relevant information.

At the time of writing, the IASB expects to issue a feedback statement addressing the comments received in response to the exposure draft in the fourth quarter of 2024.

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Appendix B - Definitions

Extract from IAS 36

Definitions

6 The following terms are used in this Standard with the meanings specified:

Carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.

A *cash-generating unit* is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

Corporate assets are assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units.

Costs of disposal are incremental costs directly attributable to the disposal of an asset or cash-generating unit, excluding finance costs and income tax expense.

Depreciable amount is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.

Depreciation (Amortisation) is the systematic allocation of the depreciable amount of an asset over its useful life.[1]

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13 *Fair Value Measurement*.)

An *impairment loss* is the amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount.

The *recoverable amount* of an asset or a cash-generating unit is the higher of its fair value less costs of disposal and its value in use.

Useful life is either:

(a) the period of time over which an asset is expected to be used by the entity; or

(b) the number of production or similar units expected to be obtained from the asset by the entity.

Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.

1 In the case of an intangible asset, the term 'amortisation' is generally used instead of 'depreciation'. The two terms have the same meaning.

Chapter 22 Borrowing costs

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Overview

This chapter covers the requirements of IAS 23 *Borrowing Costs* and particularly under which circumstances borrowing costs must be capitalised as part of the cost of an asset. Borrowing costs include interest and other costs that an entity incurs in connection with borrowing funds such as interest expense calculated using the effective interest method, interest in respect of lease liabilities and exchange differences arising from foreign currency borrowings that are considered to be an adjustment to interest costs.

Borrowing costs must be included as part of the cost of a qualifying asset to the extent that they are considered directly attributable to the acquisition, construction or production of the qualifying asset.

Not all assets would be considered a qualifying asset under IAS 23. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

The chapter highlights key considerations when:

- Identifying qualifying assets
- Determining when borrowing costs are eligible for capitalisation or when capitalisation needs to be suspended or ceased altogether
- Applying disclosure requirements

What you need to know

- IAS 23 deals with the treatment of borrowing costs in general, rather than solely focusing on capitalising borrowing costs as part of the carrying value of assets.
- IAS 23 mandates capitalisation of borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset. However, IAS 23 allows, but does not require entities to capitalise eligible borrowing costs to qualifying assets measured at fair value and to certain inventories that would otherwise be qualifying assets but are routinely manufactured or produced in large quantities on a repetitive basis.
- IAS 23 prescribes separate requirements for borrowing costs incurred from specific borrowings and general borrowings.
- Applying the standard sometimes requires significant judgement, particularly when identifying a direct relationship between particular borrowings and a qualifying asset and when evaluating whether the borrowings could otherwise have been avoided.

1 Introduction

A common question when determining the initial measurement of an asset is whether or not finance costs incurred on its acquisition or during the period of its construction must be capitalised. There have always been a number of strong arguments in favour of the capitalisation of directly attributable finance costs. For example, it is argued that they are just as much a cost as any other directly attributable cost; that expensing finance costs distorts the choice between purchasing and constructing an asset; that capitalising the costs leads to a carrying value that is far more akin to the market value of the asset; and that the financial statements are more likely to represent the true results of the project.

IAS 23, as issued by the IASB in March 2007, mandates capitalisation of borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset. This was done to achieve convergence in principle with US GAAP. *[IAS 23.BC2]*. It thereby eliminated some (but not all) of the differences with SFAS 34 *Capitalization of Interest Cost*.[1]

Differences between the IFRS accounting standards and US GAAP guidance on this topic are generally not addressed in detail in this chapter as the standards are not fully converged. Therefore, differences between IFRS accounting standards and US GAAP could exist that are not discussed in this chapter.

1 Effective from 15 September 2009, FASB Statement No. 34 (SFAS 34) *Capitalization of Interest Cost* was superseded by FASB Accounting Standards Codification (ASC) Topic 835-20 *Capitalization of Interest*, a subtopic to FASB ASC Topic 835 - Interest.

2 The requirements of IAS 23

2.1 Core principle

IAS 23 requires borrowing costs to be capitalised if they are directly attributable to the acquisition, construction or production of a qualifying asset (whether or not the funds have been borrowed specifically to finance these activities). These borrowing costs are included in the cost of the qualifying asset; all other borrowing costs are recognised as an expense in the period in which they are incurred. *[IAS 23.1, IAS 23.8]*.

2.2 Scope

IAS 23 deals with the treatment of borrowing costs in general, rather than solely focusing on capitalising borrowing costs as part of the carrying value of assets. *[IAS 23.2]*.

The standard does not deal with the actual or imputed costs of equity, including preferred capital and other financial instruments not classified as a liability, that are used to fund the acquisition or construction of an asset. *[IAS 23.3]*. This means that any distributions or other payments made in respect of equity instruments, as defined by IAS 32 *Financial Instruments: Presentation*, are not within the scope of IAS 23. Conversely, interest and dividends payable on instruments that are legally equity but classified as financial liabilities under IAS 32 appear to be within the scope of the standard (see section 5.5.4 below).

An entity is not required to apply the standard (i.e., application is optional) to borrowing costs directly attributable to the acquisition, construction or production of:

- A qualifying asset measured at fair value (see section 3.2 below)

  Or
- Inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis (see section 3.1 below) *[IAS 23.4]*

3 Qualifying assets

Determining whether an asset is considered a qualifying asset is a key step when evaluating whether borrowing costs must be capitalised. IAS 23 defines a qualifying asset as follows: *[IAS 23.5]*

Extract from IAS 23

5 **This Standard uses the following terms with the meanings specified:**

...

A *qualifying asset* is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

How we see it

IAS 23 does not define 'substantial period of time' and this will therefore require the exercise of judgement after considering the specific facts and circumstances. In our view, an asset that normally takes twelve months or more to be ready for its intended use or sale will usually be a qualifying asset.

The standard indicates that, depending on the circumstances, the following could be qualifying assets: manufacturing plants, power generation facilities, investment properties, inventories, intangible assets and bearer plants. *[IAS 23.7]*.

Assets that are ready for their intended use or sale when acquired are not qualifying assets. *[IAS 23.7]*.

3.1 Inventories

Inventories are within the scope of IAS 23 as long as they meet the definition of a qualifying asset and require a substantial period of time to bring them to a saleable condition. This means inventories that are manufactured, or otherwise produced, over a short period of time are not qualifying assets and are out of scope of IAS 23. *[IAS 23.7]*. However, even if inventories meet the definition of a qualifying asset and take a substantial period of time to get ready for sale, an entity is not required to apply the standard to borrowing costs directly attributable to the acquisition, construction or production of inventories if these are routinely manufactured or otherwise produced in large quantities on a repetitive basis. *[IAS 23.4(b), IAS 23.BC6]*.

Therefore, an entity could choose whether to apply the requirements of IAS 23 to such inventories as a matter of accounting policy. This optional scope exemption has been allowed because of the difficulty of determining the amount to be capitalised to such inventories and continuously monitoring these borrowing costs until the inventory is sold, i.e., the costs of capitalisation are likely to exceed the potential benefits. *[IAS 23.BC6]*. There are many examples of such inventories, including large manufactured or constructed items that take some time to complete but are routinely sold as standard items, such as aircraft and large items of equipment, or food and drink that take a long time to mature, such as cheese or alcohol that matures in bottle or cask.

Conversely, IAS 23 is required to be applied to bespoke inventories (i.e., those made according to the unique specifications of a particular customer) that are occasionally manufactured or produced on a single item by item basis and take a substantial period of time to get ready for sale.

See also further discussion in Chapter 28 at Question 5-28.

3.2 Assets measured at fair value

IAS 23 does not require entities to capitalise borrowing costs directly attributable to the acquisition, construction or production of assets measured at fair value that would otherwise be qualifying assets, for example, biological assets within the scope of IAS 41 *Agriculture*. *[IAS 23.4(a)]*. If the assets are held under a fair value model (or a fair value less costs to sell model) with all changes included in profit or loss, then capitalisation would not affect measurement of such assets in the statement of financial position and would involve no more than a reallocation between finance costs and the fair value movement in profit or loss. However, this scope exemption is optional and would still allow an entity to choose whether to apply the requirements of IAS 23 to such assets as a matter of accounting policy.

IAS 23 does not restrict the exemption to assets where the fair value movement is included in profit or loss. Assets measured at fair value that fall under the revaluation model of IAS 16 *Property, Plant and Equipment* are also eligible for this scope exemption even though the revaluation gain or loss is included in other comprehensive income, not profit or loss (see Chapter 19 at section 4.1.2). While such assets could be subject to the scope exemption, the revaluation model in IAS 16 is only applied subsequent to initial recognition. *[IAS 16.31]*. Therefore, such assets might be qualifying assets at initial recognition, but subject to the scope exemption subsequently.

For example, assume that an entity borrows specific funds to construct a building, that the building is a qualifying asset and that the entity has a policy of revaluing all its land and buildings. When the constructed building is initially recognised, it will be measured at cost, which would include the directly attributable borrowing costs. *[IAS 16.15, IAS 16.16(b)]*. Assume that the entity subsequently renovates the building, that the renovation takes a substantial amount of time to complete and that those costs qualify for capitalisation under IAS 16. Since the asset is being revalued it would fall under the scope exemption in IAS 23. Therefore, the entity would not be required to capitalise any directly attributable borrowing costs relating to this subsequent renovation even if it takes a substantial amount of time to complete.

However, for disclosure purposes, an entity will still need to monitor the carrying amount of such an asset, including those borrowing costs that would have been recognised had such an asset been carried under the cost model.

In May 2014 the IFRS IC received a request for clarification as to whether an entity is required to reflect the capitalisation of borrowing costs to meet the disclosure requirement of IAS 16 for assets stated at revalued amounts (see Chapter 19 at section 8.2) and for which borrowing costs are not capitalised. Since, as discussed above, the capitalisation of borrowing costs for such assets is not required, the determination of the amount of borrowing costs that would have been capitalised under a cost model - solely to meet a disclosure requirement - might be considered burdensome.

The IFRS IC noted that the requirements in IAS 16.77(e) are clear. This paragraph requires an entity to disclose the amount at which assets stated at revalued amounts would have been stated had those assets been carried under the cost model. The amount to be disclosed includes borrowing costs capitalised in accordance with IAS 23. *[IAS 16.77(e)]*.

The IFRS IC determined that, in the light of the existing IFRS accounting standard requirements, neither an interpretation nor an amendment to a standard was necessary and consequently decided not to add this issue to its agenda.[2]

3.3 Financial assets

IAS 23 excludes all financial assets from the definition of qualifying assets. *[IAS 23.7]*.

How we see it

We consider that financial assets include equity accounted investments and these are therefore, also excluded from the definition of qualifying assets.

3.4 Transfer of constructed asset over time

In November 2018, the IFRS IC discussed a request it received about the capitalisation of borrowing costs in relation to the construction of a residential multi-unit real estate development (building). In the fact pattern described in the request:

- A real estate developer (entity) constructs the building and sells the individual units in the building to customers.
- The entity borrows funds specifically for the purpose of constructing the building and incurs borrowing costs in connection with that borrowing.
- Before construction begins, the entity signs contracts with customers for the sale of some of the units in the building (sold units).
- The entity intends to enter into contracts with customers for the remaining part-constructed units (unsold units) as soon as it finds suitable customers.
- The terms of, and relevant facts and circumstances relating to, the entity's contracts with customers (for both the sold and unsold units) are such that, applying paragraph 35(c) of IFRS 15 *Revenue from Contracts with Customers* the entity transfers control of each unit over time and, therefore, recognises revenue over time (see Chapter 28 at section 7.1.3). The consideration promised by the customer in the contract is in the form of cash or another financial asset. *[IFRS 15.35(c)]*.

The request asked whether the entity has a qualifying asset as defined in IAS 23 and, therefore, capitalises any directly attributable borrowing costs.

2 *IFRIC Update*, May 2014, available on the IFRS Foundation's website.

Applying IAS 23.8 an entity capitalises borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset (see section 5.1 below). *[IAS 23.8]*. Paragraph 5 of IAS 23 defines a qualifying asset as "an asset that necessarily takes a substantial period of time to get ready for its intended use or sale" (see section 3 above). *[IAS 23.5]*.

Accordingly, the entity assesses whether, in the fact pattern described in the request, it recognises an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Depending on the particular facts and circumstances, the entity might recognise a receivable, a contract asset and/or inventory.[3]

The IFRS IC concluded that, in the fact pattern described in the request:

- A receivable that the entity recognises is not a qualifying asset. Paragraph 7 of IAS 23 specifies that financial assets are not qualifying assets (see section 3.3 above). *[IAS 23.7]*.
- A contract asset that the entity recognises is not a qualifying asset. The contract asset (as defined in Appendix A to IFRS 15 - see Chapter 28 at Appendix C) would represent the entity's right to consideration that is conditional on something other than the passage of time in exchange for transferring control of a unit. The intended use of the contract asset - to collect cash or another financial asset - is not a use for which it necessarily takes a substantial period of time to get ready.
- Inventory (work-in-progress) for unsold units under construction that the entity recognises is not a qualifying asset. In the fact pattern described in the request, this asset is ready for its intended sale in its current condition (such an asset is not a qualifying asset, see sections 3 and 3.1 above) - i.e., the entity intends to sell the part-constructed units as soon as it finds suitable customers and, on signing a contract with a customer, will transfer control of any work-in-progress relating to that unit to the customer.

The IFRS IC concluded that the principles and requirements in IAS 23 provide an adequate basis for an entity to determine whether to capitalise borrowing costs in the fact pattern described in the request. Consequently, in March 2019, the IFRS IC decided not to add this matter to its standard-setting agenda.[4]

See also further discussion in Chapter 28 at Question 5-28.

3 *IFRIC Update*, November 2018, available on the IFRS Foundation's website.

4 *IFRIC Update*, March 2019, available on the IFRS Foundation's website.

4 Definition of borrowing costs

4.1 The definition of borrowing costs in IAS 23

The definition of borrowing costs in IAS 23 is broad and includes all costs incurred as a result of borrowing funds. The standard does however provide specific examples as to what could be considered borrowing costs.

Extract from IAS 23

5 **This Standard uses the following terms with the meanings specified:**

***Borrowing costs* are interest and other costs that an entity incurs in connection with the borrowing of funds.**

…

6 Borrowing costs may include:

(a) interest expense calculated using the effective interest method as described in IFRS 9;

(b) [deleted]

(c) [deleted]

(d) interest in respect of lease liabilities recognised in accordance with IFRS 16 *Leases*; and

(e) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

The definition requires careful consideration on when interest and other costs would be considered borrowing costs and eligible for capitalisation.

The standard addresses whether or not to capitalise borrowing costs as part of the cost of the asset. *[IAS 23.8, IAS 23.9]*. The identification and measurement of finance costs are not dealt with in IAS 23 (see section 4.2 below).

The treatment of exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs is discussed in section 5.4 below. *[IAS 23.5, IAS 23.6]*.

According to IAS 23, borrowing costs are "interest and other costs that an entity incurs in connection with the borrowing of funds". *[IAS 23.5, IAS 23.6]*. Interest expense arising from customer contracts with a significant financing component might qualify as borrowing costs eligible for capitalisation if they are directly attributable to the acquisition, construction or production of a qualifying asset (see the discussion in Chapter 28 at Question 5-28).

Treatment of borrowing costs incurred by an operator in a service concession arrangement will depend on the accounting model used by the operator in accordance with IFRIC 12 *Service Concession Arrangements*, see the discussions in Chapter 26 at sections 4.2 and 4.3.

4.2 Other finance costs

IAS 23 does not address many of the ways in which an entity could finance its operations or other finance costs that it might incur. For example, the standard does not address any of the following:

- The many derivative financial instruments such as interest rate swaps, floors, caps and collars that are commonly used to manage interest rate risk on borrowings
- Gains and losses on derecognition of borrowings, for example early settlement of directly attributable borrowings that have been renegotiated prior to completion of an asset in the course of construction

  And
- Dividends payable on shares classified as financial liabilities (such as certain redeemable preference shares)

The eligibility of these other finance costs for capitalisation under IAS 23 is discussed in section 5.5 below.

IAS 23 does not preclude the classification of costs, other than those it identifies, as borrowing costs. However, they must meet the basic criterion in the standard, i.e., that they are costs that are directly attributable to the acquisition, construction or production of a qualifying asset, which would, therefore, preclude treating the unwinding of discounts as borrowing costs.

Many of the effects of the unwinding of discounts are treated as finance costs in profit or loss. These include discounts relating to various provisions such as those for onerous contracts and decommissioning costs. These finance costs will not be borrowing costs under IAS 23 because they do not arise in respect of funds borrowed by the entity that can be attributed to a qualifying asset. Therefore, they cannot be capitalised.

5 Borrowing costs eligible for capitalisation

5.1 Directly attributable borrowing costs

Borrowing costs are eligible for capitalisation as part of the cost of an asset if they are directly attributable to the acquisition, construction or production of a qualifying asset, when it is probable that such costs will result in future economic benefits to the entity and the costs can be measured reliably. *[IAS 23.8, IAS 23.9]*.

IAS 23 starts from the premise that borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those that would have been avoided if the expenditure on the qualifying asset had not been made. *[IAS 23.10]*. Recognising that it might not always be easy to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided, the standard includes separate requirements for specific borrowings and general borrowings (see sections 5.2 and 5.3, respectively, below).

5.2 Specific borrowings

When an entity borrows funds specifically to obtain a particular qualifying asset, the borrowing costs that are directly related to that qualifying asset can be readily identified. The borrowing costs eligible for capitalisation would be the actual borrowing costs incurred on that specific borrowing during the period. *[IAS 23.10, IAS 23.12]*.

Entities frequently borrow funds in advance of expenditure on qualifying assets and could temporarily invest the borrowings. The standard makes it clear that any investment income earned on the temporary investment of those borrowings needs to be deducted from the borrowing costs incurred and only the net amount capitalised (see Illustration 5-2 below). *[IAS 23.12, IAS 23.13]*.

How we see it

There is no restriction in IAS 23 on the type of investment in which the funds can be invested but, in our view, to maintain the conclusion that the funds are specific borrowings, the investment must be of a nature that does not expose the principal amount to the risk of not being recovered. The riskier the investment, the greater is the likelihood that the borrowing is not specific to the qualifying asset. If the investment returns a loss rather than income, such losses are not added to the borrowing costs to be capitalised.

5.3 General borrowings

IAS 23 concedes that there could be practical difficulties in identifying a direct relationship between particular borrowings and a qualifying asset and in determining the borrowings that could otherwise have been avoided. *[IAS 23.11]*.

This could be the case, for example, if the financing activity of an entity is co-ordinated centrally, with borrowings arranged to meet its funding requirements as a whole, the construction of the qualifying asset is therefore financed out of general borrowings.

Other circumstances that might cause difficulties are identified by the standard as follows:

- A group has a treasury function that uses a range of debt instruments to borrow funds at varying rates of interest and lends those funds on various bases to other entities in the group.

  Or

- Loans are denominated in or linked to foreign currencies and the group operates in highly inflationary economies or there are fluctuations in exchange rates. *[IAS 23.11]*.

In these circumstances, determining the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset could be difficult and require judgement. *[IAS 23.11]*.

When general borrowings are used in part to obtain a qualifying asset, IAS 23 requires the application of a capitalisation rate to the expenditure on that qualifying asset in determining the amount of borrowing costs eligible for capitalisation. However, the amount of borrowing costs capitalised during a period cannot exceed the amount of borrowing costs incurred during that period. *[IAS 23.14]*.

The capitalisation rate applied is the weighted average of the borrowing costs applicable to all borrowings of the entity that are outstanding during the period, excluding borrowing costs applicable to borrowings made specifically for the purpose of obtaining a qualifying asset until substantially all the activities necessary to prepare that asset for its intended use or sale are complete (see section 5.3.1.A below). *[IAS 23.14]*. The capitalisation rate is then applied to the expenditure on the qualifying asset. The capitalisation rate is discussed further in section 5.3.2 below.

Expenditure on a qualifying asset includes only that expenditure resulting in the payment of cash, the transfer of other assets or the assumption of interest-bearing liabilities. Such expenditure must be reduced by any progress payments and grants received in connection with the asset (see IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* and Chapter 25). The standard accepts that, when funds are borrowed generally, the average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditure to which the capitalisation rate is applied in that period. *[IAS 23.18]*.

In contrast to investment income earned on specific borrowings (see section 5.2 above), the standard does not provide specific guidance regarding interest income earned from temporarily investing excess general funds.

How we see it

We believe that any interest income earned from temporarily investing excess general funds is unlikely to be directly attributable to the acquisition or construction of a qualifying asset. In addition, the capitalisation rate required by IAS 23 focuses on the borrowings of the entity outstanding during the period of construction or acquisition and does not include temporary investments. As such, borrowing costs capitalised must not be reduced by interest income earned from the investment of general borrowings nor can such income be included in determining the appropriate capitalisation rate.

In some circumstances, it is appropriate for all borrowings made by the group (i.e., borrowings of the parent and its subsidiaries) to be taken into account in determining the weighted average of the borrowing costs. In other circumstances, it is appropriate for each subsidiary to use a weighted average of the borrowing costs applicable to its own borrowings. *[IAS 23.15]*. It is likely that this will largely be determined by the extent to which borrowings are made centrally (and, perhaps, interest expenses met in the same way) and passed through to individual group companies via intercompany accounts and intra-group loans.

5.3.1 Definition of general borrowings

5.3.1.A Borrowing costs on borrowings related to completed qualifying assets

As noted in section 5.3 above, determining general borrowings will not always be straightforward and, as a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset could be difficult and judgement is required.

The question has arisen as to whether a specific borrowing undertaken to obtain a qualifying asset ever changes its nature into a general borrowing. Historically, different views existed as to whether or not borrowings change their nature throughout the period they are outstanding. Some considered that once the asset for which the borrowing was incurred has been completed, and the entity chooses to use its funds on constructing other assets rather than repaying the loan, this changes the nature of the loan into a general borrowing. However, to the extent that the contract links the repayment of the loan to specific proceeds generated by the entity, its nature as a specific borrowing would be preserved. Others took the view that once the borrowing has been classified as specific, its nature does not change while it remains outstanding.

To address this diversity in practice, the IASB amended the relevant part of IAS 23.14 to read as follows (emphasis added):

"The capitalisation rate shall be the weighted average of the borrowing costs applicable to *all* borrowings of the entity that are outstanding during the period. *However, an entity shall exclude from this calculation borrowing costs applicable to borrowings* made specifically for the purpose of obtaining a qualifying asset *until substantially all the activities necessary to prepare that asset for its intended use or sale are complete*."[5]

5 *Annual Improvements to IFRS Standards 2015-2017 Cycle*, IASB, December 2017, p15.

The IASB concluded that the reference to "borrowings made specifically for the purpose of obtaining a qualifying asset" in IAS 23.14 prior to the amendment should not apply to a borrowing originally made specifically to obtain a qualifying asset if that qualifying asset is now ready for its intended use or sale. *[IAS 23.BC14B]*.

The IASB observed that IAS 23.8 requires an entity to capitalise borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. *[IAS 23.8]*. Paragraph 10 of IAS 23 states that borrowing costs are directly attributable to a qualifying asset if those borrowing costs would have been avoided had the expenditure of the qualifying asset not been made. *[IAS 23.10]*. In other words, an entity could have repaid that borrowing if the expenditure on the qualifying asset had not been made. Accordingly, IAS 23.14 requires an entity to use all outstanding borrowings in determining the capitalisation rate, except those made specifically to obtain a qualifying asset not yet ready for its intended use or sale. *[IAS 23.14, IAS 23.BC14C]*.

The IASB concluded that if a specific borrowing remains outstanding after the related qualifying asset is ready for its intended use or sale, it becomes part of the funds an entity borrows generally. Accordingly, the IASB amended IAS 23.14 as described above, to clarify this requirement. *[IAS 23.BC14D]*.

Refer also to further discussion in section 6.3 below to determine when all the activities necessary to prepare the qualifying asset for its intended use or sale are 'substantially' complete.

5.3.1.B General borrowings related to specific non-qualifying assets

Prior to amendments referred to in section 5.3.1.A above, another question arose regarding the treatment of general borrowings used to purchase a specific asset other than a qualifying asset for the purpose of capitalising borrowing costs in accordance with IAS 23.

In July 2009, the IFRS IC noted that because IAS 23.14 prior to the amendment refers only to qualifying assets:

- Some conclude that borrowings related to specific assets other than qualifying assets cannot be excluded from determining the capitalisation rate for general borrowings.

  And

- Others note the general principle in IAS 23.10 that the borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made.[6]

The IASB subsequently considered the issue of whether debt incurred specifically to acquire a non-qualifying asset could be excluded from general borrowings and noted that IAS 23 excludes only debt used to acquire qualifying assets from the determination of the capitalisation rate.[7]

Consequently, in June 2017, the IFRS IC recommended, and the IASB subsequently agreed, to clarify this issue when finalising the amendments to IAS 23.14 discussed in section 5.3.1.A above.[8] As a result, the IASB clarified that an entity includes funds borrowed specifically to obtain an asset other than a qualifying asset as part of general borrowings. As described in section 5.3.1.A above, the amendments to IAS 23.14 referring to 'all' borrowings clarify the requirements in this respect. *[IAS 23.BC14E]*.

5.3.2 Calculation of capitalisation rate

As the standard acknowledges that determining general borrowings will not always be straightforward, it will be necessary to exercise judgement to meet the main objective, i.e., a reasonable measure of the directly attributable finance costs.

Illustration 5-1 below sets out the practical application of the method of calculating the amount of finance costs to be capitalised:

6 *IFRIC Update*, July 2009, available on the IFRS Foundation's website.

7 *IASB Update*, July 2009, available on the IFRS Foundation's website.

8 *IFRIC Update*, June 2017, available on the IFRS Foundation's website.

Illustration 5-1: Calculation of capitalisation rate (no investment income)

On 1 April 20X2 a company engages in the development of a property, which is expected to take five years to complete, at a cost of CU6,000,000. The statements of financial position at 31 December 20X1 and 31 December 20X2, prior to capitalisation of interest, are as follows:

	31 December 20X1	31 December 20X2
	CU	CU
Development property	-	1,200,000
Other assets	6,000,000	6,000,000
	6,000,000	7,200,000
Loans		
5.5% debenture stock	2,500,000	2,500,000
Bank loan at 6% p.a.	-	1,200,000
Bank loan at 7% p.a.	1,000,000	1,000,000
	3,500,000	4,700,000
Shareholders' equity	2,500,000	2,500,000

The bank loan with an effective interest rate of 6% was drawn down to match the development expenditure on 1 April 20X2, 1 July 20X2 and 1 October 20X2.

Expenditure was incurred on the development as follows:

	CU
1 April 20X2	600,000
1 July 20X2	400,000
1 October 20X2	200,000
	1,200,000

As the bank loan at 6% p.a. is a new borrowing specifically to finance the development, the amount of interest to be capitalised for the year ended 31 December 20X2 would be the amount of interest charged by the bank of CU42,000 ((CU600,000 × 6% × 9/12) + (CU400,000 × 6% × 6/12) + (CU200,000 × 6% × 3/12)).

However, if all the borrowings were general (i.e., the bank loan at 6% was not specific to the development) and would have been avoided but for the development, then the amount of interest to be capitalised would be:

$$\frac{\text{Total interest expense for period}}{\text{Weighted average total borrowings}} \times \text{Development expenditure}$$

Total interest expense for the period:

	CU
CU2,500,000 × 5.5%	137,500
CU1,200,000 (as above)	42,000
CU1,000,000 × 7%	70,000
	249,500

Therefore, the capitalisation rate would be calculated as:

$$\frac{249{,}500}{3{,}500{,}000 + 700{,}000^{*}} = 5.94\%$$

* Weighted average amount of total borrowings is computed as the sum of CU3,500,000 (or CU3,500,000 × 12/12) and CU700,000 (or (CU600,000 × 9/12) + (CU400,000 × 6/12) + (CU200,000 × 3/12)).

The capitalisation rate would then be applied to the expenditure on the qualifying asset, resulting in an amount to be capitalised of CU41,580 as follows:

	CU
CU600,000 × 5.94% × 9/12	26,730
CU400,000 × 5.94% × 6/12	11,880
CU200,000 × 5.94% × 3/12	2,970
	41,580

In the Illustration above, all borrowings are at fixed rates of interest and the period of construction extends at least until the end of the period, and the general borrowings have remained unchanged during the year, simplifying the calculation. The same principle is applied if borrowings are at floating rates i.e., only the interest costs incurred during that period, and the weighted average borrowings for that period, will be taken into account.

Note that the company's shareholders' equity (i.e., equity instruments - see further discussion in section 5.5.4 below) cannot be taken into account. All of the outstanding borrowings are presumed to be general borrowings - unless they are specific borrowings used to obtain the same or another qualifying asset not yet ready for its intended use or sale (see discussions in sections 5.3.1.A and 5.3.1.B above).

The above Illustration also assumes that loans are drawn down to match expenditure on the qualifying asset. If, however, a loan is drawn down immediately and investment income is received on the unapplied funds, then the calculation differs from that in Illustration 5-1 above. This is explained further in Illustration 5-2 below.

Illustration 5-2: Calculation of amount to be capitalised - specific borrowings with investment income

On 1 April 20X2 a company engages in the development of a property, which is expected to take five years to complete, at a cost of CU6,000,000. In this scenario, a bank loan of CU6,000,000 with an effective interest rate of 6% was taken out on 31 March 20X2 and fully drawn. The total interest charge for the year ended 31 December 20X2 was consequently CU270,000.

However, investment income was also earned at 3% on the unapplied funds during the period as follows (assume the same timings and expenditures incurred as in Illustration 5-1 above):

	CU
CU5,400,000 × 3% × 3/12	40,500
CU5,000,000 × 3% × 3/12	37,500
CU4,800,000 × 3% × 3/12	36,000
	114,000

Consequently, the amount of interest to be capitalised for the year ended 31 December 20X2 is:

	CU
Total interest charge	270,000
Less: investment income	(114,000)
	156,000

5.3.3 Accrued costs and trade payables

As noted in section 5.3 above, IAS 23 states that expenditure on qualifying assets includes only that expenditure resulting in the payment of cash, the transfer of other assets or the assumption of interest-bearing liabilities. *[IAS 23.18]*. Therefore, in principle, costs of a qualifying asset that have only been accrued but have not yet been paid in cash must be excluded from the amount on which interest is capitalised, as by definition no interest can have been incurred on an accrued payment. The same principle can be applied to non-interest-bearing liabilities e.g., non-interest-bearing trade payables or retention money that is not payable until the asset is completed.

The effect of applying this principle is often merely to delay the commencement of the capitalisation of interest since the capital expenditure will be included in the calculation once it has been paid in cash. If the time between incurring the cost and cash payment is not that large, the impact of this might not be material.

5.3.4 Assets carried below cost in the statement of financial position

An asset can be recognised in the financial statements during the period of production on a basis other than cost, i.e., it might have been written down below cost as a result of being impaired. An asset is impaired when its carrying amount or expected ultimate cost, including costs to complete and the estimated capitalised interest thereon, exceeds its estimated recoverable amount or net realisable value (see section 6.2.1 below).

The question then arises as to whether the calculation of interest to be capitalised is based on cost or the carrying amount of the impaired asset.

How we see it

We believe that the calculation of interest to be capitalised must be based on the cost as this is the amount that the entity or group has had to finance. In the case of an impaired asset, the continued capitalisation based on the cost of the asset could necessitate a further impairment. Accordingly, although the amount capitalised will be different, this will not affect net profit or loss as this is simply an allocation of costs between finance costs and impairment expense.

5.4 Exchange differences as a borrowing cost

An entity might borrow funds in a currency that is not its functional currency e.g., a US dollar loan financing a development in a company which has the Indian Rupee as its functional currency. This might have been done on the basis that, over the period of the development, the borrowing costs, even after allowing for exchange differences, were expected to be less than the interest cost of an equivalent Rupee loan.

IAS 23 defines borrowing costs as including exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs. *[IAS 23.6(e)]*. The standard does not expand on this point. In January 2008, the IFRS IC considered a request for guidance on the treatment of foreign exchange gains and losses and on the treatment of any derivatives used to hedge such foreign exchange exposures. The IFRS IC noted that the principle set out in IAS 23.8 states "an entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset". *[IAS 23.8]*. It also noted that IAS 23.11 states "the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset is difficult and the exercise of judgement is required". *[IAS 23.11]*. Consequently, how an entity applies IAS 23 to foreign currency borrowings is a matter of accounting policy requiring the exercise of judgement. IAS 1 requires clear disclosure of significant accounting policies and judgements that are relevant to an understanding of the financial statements.

The IFRS IC decided not to add the issue to its agenda because:

- The standard acknowledges that judgement will be required in its application and appropriate disclosure of accounting policies and judgements would provide users with the information they need to understand the financial statements.

  And

- The IASB had considered this issue when revising IAS 23 in 2007 and had decided not to provide any guidance.[9]

How we see it

In our view, as exchange rate movements are partly a function of differential interest rates, in many circumstances the foreign exchange differences on directly attributable borrowings will be an adjustment to interest costs that can meet the definition of borrowing costs. However, care is needed if there are fluctuations in exchange rates that cannot be attributed to interest rate differentials. In such cases, we believe that a practical approach is to limit exchange losses taken as borrowing costs such that the total borrowing costs capitalised do not exceed the amount of borrowing costs that would be incurred on functional currency equivalent borrowings, taking into consideration the corresponding market interest rates and other conditions that existed at inception of the borrowings.

If the approach discussed above is used - if exchange losses taken as borrowing cost has been limited - and the construction of the qualifying asset takes more than one accounting period, there could be situations where in one period only a portion of foreign exchange differences could be capitalised (i.e., discrete period approach). However, in subsequent years, if the borrowings are assessed on a cumulative basis, foreign exchange losses previously expensed might now meet the recognition criteria (i.e., cumulative approach).

How we see it

In our view, whether foreign exchange gains and losses are assessed on a discrete period basis or cumulatively over the construction period as described above, is a matter of accounting policy which must be consistently applied.

9 *IFRIC Update*, January 2008, available on the IFRS Foundation's website.

The impact of the two approaches described above are demonstrated in Illustration 5-3 below.

Illustration 5-3: Foreign exchange differences in more than one period

Method A - The discrete period approach

The amount of foreign exchange differences eligible for capitalisation is determined for each period separately. Foreign exchange losses that did not meet the criteria for capitalisation in previous years are not capitalised in subsequent years.

Method B - The cumulative approach

The borrowing costs to be capitalised are assessed on a cumulative basis based on the cumulative amount of interest expense that would have been incurred had the entity borrowed in its functional currency. The amount of foreign exchange differences capitalised cannot exceed the amount of foreign exchange losses incurred on a cumulative basis at the end of the reporting period. The cumulative approach looks at the construction project as a whole as the unit of account ignoring the occurrence of reporting dates. Consequently, the amount of the foreign exchange differences eligible for capitalisation as an adjustment to the borrowing cost in the period is an estimate, which can change as the exchange rates vary over the construction period.

As discussed above, care is needed if there are fluctuations in exchange rates that cannot be attributed to interest rate differentials. In such cases, a practical approach is to limit exchange losses taken as borrowing costs such that the total borrowing costs capitalised do not exceed the amount of borrowing costs that would be incurred on functional currency equivalent borrowings, taking into consideration the corresponding market interest rates and other conditions that existed at inception of the borrowings. Applying this approach, an illustrative calculation of the amount of foreign exchange differences that might be capitalised under Method A and Method B is set out below.

	Year 1	Year 2	Total
	CU	CU	CU
Interest expense in foreign currency (A)	25,000	25,000	50,000
Hypothetical interest expense in functional currency (B)	30,000	30,000	60,000
Foreign exchange loss (C)	6,000	3,000	9,000
Method A - Discrete Approach			
Foreign exchange loss capitalised - lower of C and (B minus A)	5,000	3,000	8,000
Foreign exchange loss expensed	1,000	-	1,000
Method B - Cumulative Approach			
Foreign exchange loss capitalised	†5,000	*4,000	9,000
Foreign exchange loss expensed	1,000	(1,000)	-

† Lower of C and (B minus A) in Year 1.

* Lower of C and (B minus A) in total across the two years. In this Illustration this represents the sum of the foreign exchange loss of CU3,000 capitalised using the discrete approach plus the CU1,000 not capitalised in year 1.

In line with the agenda decision discussed above, IAS 1 *Presentation of Financial Statements* requires clear disclosure of significant accounting policies and judgements that are relevant to an understanding of the financial statements (see section 7.2 below).

5.5 Other finance costs as a borrowing cost

5.5.1 Derivative financial instruments

The most straightforward and commonly encountered derivative financial instrument used to manage interest rate risk is a floating to fixed interest rate swap, as explained in the following Illustration.

Illustration 5-4: Floating to fixed interest rate swap

Entity A has borrowed CU4 million for five years at a floating interest rate to fund the construction of a building. In order to hedge the cash flow interest rate risk arising from these borrowings, Entity A has entered into a matching pay-fixed receive-floating interest rate swap, based on the same underlying nominal sum and duration as the original borrowing, that effectively converts the interest on the borrowings to fixed rate. The net effect of the periodic cash settlements resulting from the hedged item and hedging instruments is as if Entity A had borrowed CU4 million at a fixed rate of interest.

These instruments are not addressed in IAS 23. IFRS 9 *Financial Instruments* sets out the basis on which such instruments are recognised and measured. See Chapter 49 regarding how to account for effective hedges and the conditions that these instruments must meet.

An entity might consider that a specific derivative financial instrument, such as an interest rate swap, is directly attributable to the acquisition, construction or production of a qualifying asset. If the instrument does not meet the conditions for hedge accounting, then the effects on profit or loss will be different from those if it does, and they will also be dissimilar from year to year. What is the impact of the derivative on borrowing costs eligible for capitalisation? In particular, does the accounting treatment of the derivative financial instrument affect the amount available for capitalisation? If hedge accounting is not adopted, does this affect the amount available for capitalisation?

The following Illustration highlights the potential implication of these questions.

Illustration 5-5: Cash flow hedge of variable-rate debt using an interest rate swap

Entity A is constructing a building and expects it to take 18 months to complete. To finance the construction, on 1 January 20X1 the entity issues an eighteen-month, CU20,000,000 variable-rate note payable, due on 30 June 20X2 at a floating rate of interest plus a margin of 1%. At that date the market rate of interest is 8%. Interest payment dates and interest rate reset dates occur on 1 January and 1 July until maturity. The principal is due at maturity. On 1 January 20X1, the entity also enters into an eighteen-month interest rate swap with a notional amount of CU10,000,000 from which it will receive periodic payments at the floating rate and make periodic payments at a fixed rate of 9%, with settlement and rate reset dates every 30 June and 31 December. The fair value of the swap is zero at inception.

On 1 January 20X1, the debt is recorded at CU20,000,000. No entry is required for the swap on that date because its fair value was zero at inception.

During the eighteen-month period, floating interest rates change as follows:

	Floating rate	Rate paid by Entity A on note payable
Period to 30 June 20X1	8%	9%
Period to 31 Dec 20X1	8.5%	9.5%
Period to 30 June 20X2	9.75%	10.75%

Under the interest rate swap, Entity A receives interest at the market floating rate as above and pays interest at 9% on the nominal amount of CU10,000,000 throughout the period. Note that this Illustration excludes the effect of issue costs and discounting. In addition, it is assumed that, if Entity A is entitled to, and applies, hedge accounting, there will be no ineffectiveness.

At 31 December 20X1, the swap has a fair value of CU37,500, reflecting the fact that it is now in the money as Entity A is expected to receive a net cash inflow of this amount in the period until the instrument is terminated. There are no further changes in interest rates prior to the maturity of the swap and the fair value of the swap declines to zero at 30 June 20X2.

The cash flows incurred by the entity on its borrowing and interest rate swap are as follows:

	Cash payments		
	Interest on principal	Interest rate swap (net)	Total
	CU	CU	CU
30 June 20X1	900,000	50,000	950,000
31 Dec 20X1	950,000	25,000	975,000
30 June 20X2	1,075,000	(37,500)	1,037,500
Total	2,925,000	37,500	2,962,500

There are a number of different ways in which Entity A could calculate the borrowing costs eligible for capitalisation, including the following:

(i) The interest rate swap meets the conditions for, and entity A applies, hedge accounting. The finance costs eligible for capitalisation as borrowing costs will be CU1,925,000 in the year to 31 December 20X1 and CU1,037,500 in the period ended 30 June 20X2.

(ii) Entity A does not apply hedge accounting. Therefore, it will reflect the fair value of the swap in profit or loss in the year ended 31 December 20X1, reducing the net finance costs by CU37,500 to CU1,887,500 and increasing the finance costs by an equivalent amount for the 6 months to 30 June 20X2 to CU1,075,000. Under this method, it will not be appropriate to reflect the cash payments received in 20X2 for the settlement of the fair value of the swap in the borrowing costs eligible for capitalisation in the period ended 30 June 20X2 because the fair value of the swap is recognised in the income statement and already reflected in the amount of borrowing costs capitalised in 20X1.

However, if Entity A considers that it is inappropriate to reflect the fair value of the swap in borrowing costs eligible for capitalisation, it capitalises costs based on the net cash cost on an accrual accounting basis. In this case this will give the same result as in (i) above.

(iii) Entity A does not apply hedge accounting and considers only the costs incurred on the borrowing, not the interest rate swap, as eligible for capitalisation. The borrowing costs eligible for capitalisation would be CU1,850,000 in 20X1 and CU1,075,000 in 20X2.

How we see it

In our view, all the methods explained in the Illustration above are valid interpretations of IAS 23; however, the preparer will need to consider the most appropriate method in the particular circumstances after taking into consideration the discussion below. It is important to note that IAS 1 requires clear disclosure of significant accounting policies and judgements that are relevant to an understanding of the financial statements (see section 7.2 below).

If using method (ii), it is necessary to demonstrate that the gains or losses on the derivative financial instrument are directly attributable to the construction of a qualifying asset. In making this assessment it is necessary to consider the term of the derivative and this method might not be appropriate if the derivative has a different term to the underlying directly attributable borrowing. If the entity is not hedge accounting for the derivative financial instrument but considers its fair value movement to be directly attributable to the construction of a qualifying asset, then it will have to consider whether part of such fair value movement of the derivative relates to a period after the construction is completed and, therefore, excludes this part of the fair value movement when determining the borrowing costs eligible for capitalisation.

Based on the facts in the Illustration above, and assuming that entering into the derivative financial instrument is considered to be related to the borrowing activities of the entity, method (iii) might not be an appropriate method to use because it appears to be inconsistent with the underlying principle of IAS 23 that the costs eligible for capitalisation are those costs that would have been avoided if the expenditure on the qualifying asset had not been made. *[IAS 23.10]*. However, method (iii) could be an appropriate method to use in certain circumstances where it is not possible to demonstrate that the gains or losses on a specific derivative financial instrument are directly attributable to a particular qualifying asset, rather than being used by the entity to manage its interest rate exposure on a more general basis.

Note that the discussions above mainly relate to derivative financial instruments entered into to manage the interest rate risk on specific borrowings.

How we see it

In our view, the same methods and considerations can be applied when determining the borrowing costs eligible for capitalisation when derivative financial instruments were entered into to manage the interest rate risk in relation to general borrowings.

Note also that method (i) appears to be permitted under US GAAP for fair value hedges. IAS 23 makes reference in its Basis for Conclusions that, under US GAAP, derivative gains and losses (arising from the effective portion of a derivative instrument that qualifies as a fair value hedge) are considered to be part of the capitalised interest cost. IAS 23 does not address such derivative gains and losses. *[IAS 23.BC21]*.

Whichever policy is chosen by an entity, it needs to be consistently applied in similar situations.

5.5.2 Gains and losses on derecognition of borrowings

If an entity repays borrowings early, in whole or in part, then it could recognise a gain or loss on the early settlement. Such gains or losses include amounts attributable to expected future interest rates; in other words, the settlement includes an estimated prepayment of the future cash flows under the instrument. The gain or loss is a function of relative interest rates and how the interest rate of the instrument differs from current and anticipated future interest rates. There might be circumstances in which a loan is repaid while the qualifying asset is still under construction. IAS 23 does not address this issue.

IFRS 9 requires that gains and losses on extinguishment of debt must be recognised in profit or loss (see Chapter 48 at section 6.3).

How we see it

In our view, gains and losses on derecognition of borrowings are not eligible for capitalisation. It would be extremely difficult to determine an appropriate amount to capitalise and it would be inappropriate thereafter to capitalise any interest amounts (on specific or general borrowings) if doing so would amount to double counting. Decisions to repay borrowings early are not usually directly attributable to the qualifying asset but are attributable to other circumstances of the entity.

The same approach would be applied to gains and losses arising from a refinancing when there is a substantial modification of the terms of borrowings as this is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability (see Chapter 48 at section 6.2 to section 6.3).

5.5.3 Gains or losses on termination of derivative financial instruments

If an entity terminates a derivative financial instrument, for example, an interest rate swap, before the end of the term of the instrument, it will usually have to either make or receive a payment, depending on the fair value of the instrument at that time. This fair value is typically based on expected future interest rates; in other words, it is an estimated prepayment of the future cash flows under the instrument.

The treatment of the gain or loss for the purposes of capitalisation will depend on the following:

- The basis on which the entity capitalises the gains and losses associated with derivative financial instruments attributable to qualifying assets (see section 5.5.1 above)

  And

- Whether the derivative is associated with a borrowing that has also been terminated

Entities must adopt a treatment that is consistent with their policy for capitalising the gains and losses from derivative financial instruments that are attributable to qualifying assets (see section 5.5.1 above).

The accounting under IFRS 9 will differ depending on whether the instrument has been designated as a hedge or not. Assuming the instrument has been designated as a cash flow hedge and that the borrowing has not also been repaid, the entity will usually maintain the cumulative gain or loss on the hedging instrument, subject to reclassification to profit or loss during the same period that the hedged cash flows affect profit or loss. In such a case, the amounts that are reclassified from other comprehensive income will be eligible for capitalisation for the remainder of the period of construction. On the other hand, if the borrowing has been repaid, the cumulative gain or loss in the cash flow hedge equity reserve will be reclassified immediately to profit or loss but will not be eligible for capitalisation. This aligns to the view that gains and losses on derecognition of borrowings are not eligible for capitalisation (see section 5.5.2 above).

Similarly, assuming the instrument has been designated as a fair value hedge and that the borrowing has not also been repaid, entities would continue to recognise the cumulative gain or loss on the hedging instrument in the carrying amount of the hedged item and this amount would form part of the ongoing determination of amortised cost of the financial liability using the effective interest rate method. Interest expense calculated using the effective interest method is eligible for capitalisation for the remainder of the period of construction (see section 4.1 above).

If the entity has not applied hedge accounting for the derivative financial instrument and the borrowing has not also been repaid, but the entity considers it to be directly attributable to the construction of the qualifying asset then it will have to consider whether part of the gain or loss relates to a period after construction is complete.

If the underlying borrowing is also terminated then the gain or loss will not be capitalised and the treatment will mirror that applied on derecognition of the borrowing, as described in section 5.5.2 above.

5.5.4 Dividends payable on shares classified as financial liabilities

An entity might finance its operations in whole or in part by the issue of preference or other types of shares and in some circumstances, these will be classified as financial liabilities (see Chapter 43 at section 4.5). In some circumstances, the dividends payable on these instruments would meet the definition of borrowing costs. For example, an entity might have funded the development of a qualifying asset by issuing preference shares that are classified as financial liabilities under IAS 32 (see Chapter 43 at section 4.5). In this case, the 'dividends' would be treated as interest and meet the definition of borrowing costs and so must be capitalised following the principles on specific borrowings discussed in section 5.2 above.

Companies with outstanding preference shares which are treated as liabilities under IAS 32 might subsequently obtain a qualifying asset. In such cases, these preference share liabilities would be considered to be part of the company's general borrowings. The related 'dividends' would meet the definition of borrowing costs and could be capitalised following the principles on general borrowings discussed in section 5.3 above - i.e., that they are directly attributable to a qualifying asset.

Capitalisation of dividends or other payments made in respect of any instruments that are classified as equity in accordance with IAS 32 is not appropriate as these instruments would not meet the definition of financial liabilities. In addition, the actual or imputed cost of equity, including preferred capital not classified as a liability is specifically scoped out of IAS 23 as described in section 2.2 above. *[IAS 23.3]*.

5.6 Capitalisation of borrowing costs in hyperinflationary economies

In situations where IAS 29 *Financial Reporting in Hyperinflationary Economies* applies, an entity needs to distinguish between borrowing costs that compensate for inflation and those incurred in order to acquire or construct a qualifying asset. *[IAS 29.21]*.

Extract from IAS 29	
21	The impact of inflation is usually recognised in borrowing costs. It is not appropriate both to restate the capital expenditure financed by borrowing and to capitalise that part of the borrowing costs that compensates for the inflation during the same period. This part of the borrowing costs is recognised as an expense in the period in which the costs are incurred.

Accordingly, IAS 23 specifies that when an entity applies IAS 29, the borrowing costs that can be capitalised must be restricted and the entity must expense the part of borrowing costs that compensates for inflation during the same period in accordance with IAS 29.21 (as described above). *[IAS 23.9]*.

For detailed discussion and requirements of IAS 29, see Chapter 17.

5.7 Group considerations

5.7.1 Borrowings in one company and development in another

A question that can arise in practice is whether it is appropriate to capitalise interest in the group financial statements on borrowings that appear in the financial statements of a different group entity from that carrying out the development.

How we see it

Based on the underlying principle of IAS 23, capitalisation of interest in the group financial statements in circumstances described above would only be appropriate if the amount capitalised fairly reflected the interest cost of the group on borrowings from third parties that could have been avoided if the expenditure on the qualifying asset were not made.

Although it would be appropriate to capitalise interest in the group financial statements, the entity carrying out the development must not capitalise any interest if it has no borrowings in its own financial statements. If, however, the entity has intra-group borrowings or other external borrowings then interest on such borrowings would be capitalised in its own financial statements.

5.7.2 Qualifying assets held by joint arrangements

A number of sectors carry out developments through joint arrangements (see Chapter 13) - this is particularly common with property developments. In such cases, the joint arrangement might be financed principally by equity and the joint operators or joint venturers might have financed their participation in this equity through borrowings.

In situations where the joint arrangement is classified as a joint venture in accordance with IFRS 11 *Joint Arrangements*, it is not appropriate to capitalise interest in the joint venture on the borrowings of the venturers as the interest charge is not a cost of the joint venture. Neither would it be appropriate to capitalise interest in the financial statements of the venturers, whether separate or consolidated financial statements, because the qualifying asset does not belong to them. The investing entities have an investment in a financial asset (i.e., an equity accounted investment), which is excluded by IAS 23 from being a qualifying asset (see section 3.3 above).

In situations where loans and borrowings exist between the reporting entity and a joint venture, see discussion in Chapter 12 at section 7.3.

In situations where the joint arrangement is classified as a joint operation in accordance with IFRS 11 and the operators are accounting for their own share of the assets, liabilities, revenue and expenses of the joint operation, then the operators must capitalise borrowing costs incurred that relate to their share of any qualifying asset. Borrowing costs eligible for capitalisation would be based on the operator's obligation for the loans of the joint operation together with any direct borrowings of the operator itself if the operator funds part of the acquisition of the joint operation's qualifying asset.

6 Commencement, suspension and cessation of capitalisation

6.1 Commencement of capitalisation

IAS 23 identifies several conditions that must be met before an entity can begin to capitalise eligible borrowing cost. These conditions are set out below: *[IAS 23.17]*

Extract from IAS 23

17 An entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date. The commencement date for capitalisation is the date when the entity first meets all of the following conditions:

(a) it incurs expenditures for the asset;

(b) it incurs borrowing costs; and

(c) it undertakes activities that are necessary to prepare the asset for its intended use or sale.

The standard is explicit that only the expenditure on a qualifying asset that has resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities, is included in determining borrowing costs (see section 5.3.3 above). Such expenditure must be reduced by any progress payments and grants received in connection with the asset (see section 5.3 above). *[IAS 23.18]*.

The activities necessary to prepare an asset for its intended use or sale can include more than the physical construction of the asset. Necessary activities can start before the commencement of physical construction and include, for example, technical and administrative work such as the activities associated with obtaining permits prior to the commencement of the physical construction. *[IAS 23.19]*. However, this does not mean that borrowing costs can be capitalised if the permits that are necessary for the construction are not expected to be obtained. Consistent with the general principle in capitalisation and recognition of an asset, borrowing costs are capitalised as part of the cost of an asset when it is probable that they will result in future economic benefits to the entity and the costs can be measured reliably. *[IAS 23.9]*.

How we see it

In assessing whether borrowing costs can be capitalised in advance of obtaining permits - assuming the borrowing costs otherwise meet the criteria - a judgement must be made, at the date the expenditure is incurred, as to whether it is sufficiently probable that the relevant permits will be granted.

In line with the discussion above, if during the application and approval process of such permits it is no longer expected that the necessary permits will be granted, capitalisation of borrowing costs must cease, and accordingly, the carrying amount of any related qualifying asset subject to development or redevelopment, including any related borrowing costs that were previously capitalised, (or, if appropriate, the cash generating unit where such an asset belongs) will be tested for impairment, where applicable (see section 6.2.1 below).

Borrowing costs cannot be capitalised during a period in which there are no activities that change the condition of the asset. For example, a house-builder or property developer would not capitalise borrowing costs on its 'land bank' i.e., that land which is held for future development. Borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity represent a holding cost of the land. Such costs do not qualify for capitalisation and hence would be considered a period cost (i.e., expensed as incurred). *[IAS 23.19]*.

An entity might make a payment to a third-party contractor before that contractor commences construction activities. It is unlikely to be appropriate to capitalise borrowing costs in such a situation until the contractor commences activities that are necessary to prepare the asset for its intended use or sale. However, that would not preclude the payment being classified as a prepayment until such time as construction activities commence.

In its accounting policy, Fresnillo plc describes the period during which borrowing costs are capitalised, as well as noting that it uses either an actual rate or a weighted average cost of borrowings.

Practical example 6-1: Fresnillo plc (2023) **United Kingdom**

Annual Report and Accounts 2023 [extract]
Financial Statements [extract]
Notes to the consolidated financial statements [extract]
2. Significant accounting policies [extract]

(s) Borrowing costs
Borrowing costs directly attributable to the acquisition, construction or production of an asset that necessarily takes 12 or more months to get ready for its intended use or sale (a qualifying asset) are capitalised as part of the cost of the respective asset. Borrowing costs consist of interest and other costs that an entity incurs in connection with the borrowing of funds.

Where funds are borrowed specifically to finance a project, the amount capitalised represents the actual borrowing costs incurred. Where surplus funds are available for a short term from funds borrowed specifically to finance a project, the income generated from the temporary investment of such amounts is also capitalised and deducted from the total capitalised borrowing cost. Where the funds used to finance a project form part of general borrowings, the amount capitalised is calculated using a weighted average of rates applicable to relevant general borrowings of the Group during the period.

All other borrowing costs are recognised in the income statement in the period in which they are incurred.

6.1.1 Expenditures on a qualifying asset

In June 2018, the IFRS IC discussed a request it received about the amount of borrowing costs eligible for capitalisation when an entity uses general borrowings to obtain a qualifying asset. In the fact pattern described in the request:

- An entity constructs a qualifying asset
- The entity has no borrowings at the start of the construction of the qualifying asset
- Partway through construction, it borrows funds generally and uses them to finance the construction of the qualifying asset

  And
- The entity incurs expenditures on the qualifying asset both before and after it incurs borrowing costs on the general borrowings

The request asked whether an entity includes expenditures on a qualifying asset incurred before obtaining general borrowings in determining the amount of borrowing costs eligible for capitalisation.

The IFRS IC observed that an entity applies IAS 23.17 to determine the commencement date for capitalising borrowing costs. This paragraph requires an entity to begin capitalising borrowing costs when it meets all of the following conditions:

- It incurs expenditures for the asset
- It incurs borrowing costs

  And
- It undertakes activities that are necessary to prepare the asset for its intended use or sale (see also section 6.1 above) *[IAS 23.17]*

Applying IAS 23.17 to the fact pattern described in the request, the entity would not begin capitalising borrowing costs until it incurs borrowing costs.[10] *[IAS 23.17]*.

Once the entity incurs borrowing costs and therefore satisfies all the three conditions in IAS 23.17 as described above, it then applies IAS 23.14 (see section 5.3 above) to determine the expenditures on the qualifying asset to which it applies the capitalisation rate. *[IAS 23.17, IAS 23.14]*. The IFRS IC observed that in doing so the entity does not disregard expenditures on the qualifying asset incurred before it obtains the general borrowings.

In September 2018, the IFRS IC concluded that the principles and requirements in IFRS accounting standards provide an adequate basis for an entity to determine the amount of borrowing costs eligible for capitalisation in the fact pattern described in the request. Consequently, the IFRS IC decided not to add this matter to its standard-setting agenda.[11]

10 *IFRIC Update*, June 2018, available on the IFRS Foundation's website.

11 *IFRIC Update*, September 2018, available on the IFRS Foundation's website.

Illustration 6-1 sets out the application of the principles described above.

Illustration 6-1: Expenditures on a qualifying asset before general borrowings are obtained

Construction on Entity A's building begins on 1 January 20X1 and ends on 30 June 20X2. The building meets the definition of a qualifying asset. Entity A incurs the following expenditures on constructing the building:

	CU
1 January 20X1	250,000
30 June 20X1	450,000
31 December 20X1	480,000
	1,180,000
31 May 20X2	120,000
	1,300,000

On 1 July 20X1, Entity A issues three-years corporate bonds of CU1,500,000 with interest payable annually at 3.5% every 30 June. The bonds form part of Entity A's general borrowings. A portion of the proceeds is used to finance the construction of the qualifying asset. Entity A had no general or specific borrowings before 1 July 20X1 and did not incur any borrowing costs before that date.

Using the information above, Entity A incurred CU700,000 of expenditure before obtaining general borrowings on 1 July 20X1 and another CU600,000 of expenditure after that date.

Applying IAS 23.17, Entity A begins to capitalise borrowing costs only after it has obtained the general borrowings, i.e., only when it starts incurring borrowing costs (see section 6.1 above). Entity A does not capitalise borrowing costs before 1 July 20X1 (the day it issues the bonds) even though it has undertaken activities necessary to prepare the asset for its intended use or sale and has incurred expenditures for the asset before that date. This is because it did not incur any borrowing costs before 1 July 20X1.

Since Entity A has no other borrowings, the capitalisation rate is 3.5%. The capitalisation rate is applied to the expenditure on the qualifying asset, resulting in an amount eligible for capitalisation of CU12,250 for the year ending 31 December 20X1. This is computed as follows:

	CU
CU250,000 × 3.5% × 6/12	4,375
CU450,000 × 3.5% × 6/12	7,875
CU480,000 × 3.5% × 0/12	-
	12,250

In the table above, Entity A does not disregard expenditures on the qualifying asset incurred before it obtained the general borrowings. However, since Entity A cannot capitalise borrowing costs before 1 July 20X1 (the day it started incurring borrowing costs), the eligible capitalisation period runs from 1 July 20X1 to 31 December 20X1 for the CU700,000 of expenditure incurred before 1 July 20X1.

The accumulated expenditure as at beginning of 20X2 is CU1,180,000 and the building construction is completed on 30 June 20X2. Accordingly, the amount eligible for capitalisation for the year ending 31 December 20X2 is computed as follows:

	CU
CU1,180,000 × 3.5% × 6/12	20,650
CU120,000 × 3.5% × 1/12	350
	21,000

6.2 Suspension of capitalisation

An entity might incur borrowing costs during an extended period in which it suspends the activities necessary to prepare an asset for its intended use or sale. In such a case, IAS 23 states that capitalisation of borrowing costs must be suspended during extended periods in which active development is interrupted. *[IAS 23.20, IAS 23.21]*. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, the standard distinguishes between extended periods of interruption (when capitalisation would be suspended) and periods of temporary delay that are a necessary part of preparing the asset for its intended purpose (when capitalisation is not normally suspended). *[IAS 23.21]*.

An entity does not normally suspend capitalising borrowing costs during a period when it carries out substantial technical and administrative work. Also, capitalising borrowing costs would not be suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalisation would continue during the extended period in a situation where construction of a bridge is delayed by temporary adverse weather conditions or high water levels, if such conditions are common during the construction period in the geographical region involved. *[IAS 23.21]*. Similarly, capitalisation continues during periods when inventory is undergoing slow transformation - the example is given of inventories taking an extended time to mature (presumably such products as Scotch whisky or Cognac, although the relevance of this might be limited as these products are likely to meet the optional exemption for 'routinely manufactured' products - see section 3.1 above).

Borrowing costs incurred during extended periods of interruption caused, for example, by a lack of funding or a strategic decision to hold back project developments during a period of economic downturn are not considered a necessary part of preparing the asset for its intended purpose and must not be capitalised.

Other circumstances might not be as straightforward as the examples described above.

How we see it

Considering how the nature of the interruption, its length of duration, and the level of development activities during such period impact the determination as to whether the delay is a necessary part of the process of bringing the qualifying asset ready for its intended use or sale (and therefore, whether continuous capitalisation of eligible borrowing costs during such period is appropriate) would require judgement to be exercised based on particular facts and circumstances. Disclosure of this judgement is required if it is significant to the understanding of the financial statements (see section 7.2 below).

6.2.1 Impairment considerations

When it is determined that capitalisation is appropriate, an entity continues to capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of the asset even if the capitalisation causes the expected ultimate cost of the asset to exceed its recoverable amount or net realisable value.

When the carrying amount of the qualifying asset exceeds its recoverable amount or net realisable value (depending on the type of asset), the carrying amount of the asset must be written down or written off in accordance with the relevant IFRS accounting standards. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those relevant IFRS accounting standards. If the asset is incomplete, this assessment is performed by considering the expected ultimate cost of the asset. *[IAS 23.16]*. The expected ultimate cost, which will be compared to recoverable amount or net realisable value, must include costs to complete and the estimated capitalised interest thereon.

IAS 36 *Impairment of Assets* will apply if the qualifying asset is property, plant and equipment accounted for in accordance with IAS 16 or if the asset is otherwise within the scope of IAS 36 (see Chapter 21). For inventories that are qualifying assets, the requirements of IAS 2 *Inventories* on net realisable value will apply (see Chapter 23).

6.3 Cessation of capitalisation

The standard requires capitalisation of borrowing costs to cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. *[IAS 23.22]*.

An asset is normally ready for its intended use or sale when the physical construction of the asset is complete, even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the purchaser's or user's specification, are all that are outstanding, this indicates that substantially all the activities are complete. *[IAS 23.23]*.

How we see it

In some cases, there might be a requirement for inspection (e.g., to ensure that the asset meets safety requirements) before the asset can be used. Usually 'substantially all the activities' would have been completed before this point in order to be ready for inspection. In such a situation, capitalisation would cease prior to the inspection.

When the construction of a qualifying asset is completed in parts and each part is capable of being used while construction continues on other parts, capitalisation must cease for the borrowing costs on the portion of borrowings attributable to that part when substantially all the activities necessary to prepare that part for its intended use or sale are completed. *[IAS 23.24]*. An example of this might be a business park comprising several buildings, each of which is capable of being fully utilised individually while construction continues on other parts. *[IAS 23.25]*. This principle also applies to single buildings where one part is capable of being fully utilised even if the building as a whole is incomplete (for example, individual floors of a high-rise office building).

For a qualifying asset that needs to be complete in its entirety before any part can be used as intended, it would be appropriate to capitalise related borrowing costs until all the activities necessary to prepare the entire asset for its intended use or sale are substantially complete. An example of this is an industrial plant, such as a steel mill, involving several processes which are carried out in sequence at different parts of the plant within the same site. *[IAS 23.25]*. However, other circumstances might not be as straightforward.

How we see it

Because neither IAS 23 nor IAS 16 provide guidance on what constitutes a 'part', it will therefore depend on particular facts and circumstances and would require the exercise of judgement as to what constitutes a 'part'. Disclosure of this judgement is required if it is significant to the understanding of the financial statements (see section 7.2 below).

6.3.1 Borrowing costs on 'land expenditures'

In June 2018, the IFRS IC discussed a request it received about when an entity ceases capitalising borrowing costs on land. In the fact pattern described in the request:

- An entity acquires and develops land and thereafter constructs a building on that land - the land represents the area on which the building will be constructed.
- Both the land and the building meet the definition of a qualifying asset.

  And
- The entity uses general borrowings to fund the expenditures on the land and construction of the building.

The request asked whether the entity ceases capitalising borrowing costs incurred in respect of expenditures on the land ('land expenditures') once it starts constructing the building or whether it continues to capitalise borrowing costs incurred in respect of land expenditures while it constructs the building.

The IFRS IC observed that in applying IAS 23 to determine when to cease capitalising borrowing costs incurred on land expenditures an entity considers:

- The intended use of the land

  And
- In applying IAS 23.24, whether the land is capable of being used for its intended purpose while the construction continues on the building *[IAS 23.24]*

Land and buildings are used for owner-occupation (and therefore recognised as property, plant and equipment applying IAS 16); rent or capital appreciation (and therefore recognised as investment property applying IAS 40 *Investment Property*); or for sale (and therefore recognised as inventory applying IAS 2). The intended use of the land is not simply for the construction of a building on the land, but rather to use it for one of these three purposes.

If the land is not capable of being used for its intended purpose while construction continues on the building, the entity considers the land and the building together to assess when to cease capitalising borrowing costs on the land expenditures. In this situation, the land would not be ready for its intended use or sale until substantially all the activities necessary to prepare both the land and building for that intended use or sale are complete (see section 6.3 above).[12]

In September 2018, the IFRS IC concluded that the principles and requirements in IFRS accounting standards provide an adequate basis for an entity to determine when to cease capitalising borrowing costs on land expenditures. Consequently, the IFRS IC decided not to add this matter to its standard-setting agenda.[13]

12 *IFRIC Update*, June 2018, available on the IFRS Foundation's website.

13 *IFRIC Update*, September 2018, available on the IFRS Foundation's website.

7 Disclosure requirements

7.1 The requirements of IAS 23

Extract from IAS 23

Disclosure

26 An entity shall disclose:

(a) the amount of borrowing costs capitalised during the period; and

(b) the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

Glencore plc discloses in its 'Property, plant and equipment' note, in the narrative that follows the table, the amount of borrowing costs capitalised during the period and its capitalisation rate used to determine its borrowing costs. *[IAS 23.26]*.

Practical example 7-1: Glencore plc (2023) **United Kingdom**

Annual Report 2023 [extract]
Financial Statements [extract]
Notes to the financial statements [extract]
9. Property, plant and equipment [extract]

2023

US$ million	Notes	Freehold land and buildings	Plant and equipment	Right-of-use assets	Mineral and petroleum rights	Exploration and evaluation	Deferred mining costs	Total
Gross carrying amount:								
1 January 2023		6,504	45,850	3,198	27,255	413	15,094	98,314
Business combination	26	8	541	6	969	–	2	1,526
Disposal of subsidiaries	26	(1)	(71)	–	(133)	–	–	(205)
Additions		46	3,571	821	145	–	772	5,355
Disposals		(52)	(818)	(491)	(81)	–	(569)	(2,011)
Effect of foreign currency exchange movements		(8)	(178)	–	(156)	(1)	(31)	(374)
Other movements[1]		122	(1,110)	(24)	905	13	886	792
31 December 2023		**6,619**	**47,785**	**3,510**	**28,904**	**425**	**16,154**	**103,397**
Accumulated depreciation and impairment:								
1 January 2023		2,807	29,142	1,726	14,347	362	10,366	58,750
Disposal of subsidiaries	26	–	(56)	–	(105)	–	–	(161)
Disposals		(50)	(721)	(444)	(72)	–	(561)	(1,848)
Depreciation		301	2,179	665	1,440	1	1,271	5,857
Impairment	7	72	334	–	980	29	295	1,710
Effect of foreign currency exchange movements		(4)	(89)	–	(67)	–	(10)	(170)
Other movements[1]		17	(112)	(12)	(12)	–	145	26
31 December 2023		**3,143**	**30,677**	**1,935**	**16,511**	**392**	**11,506**	**64,164**
Net book value 31 December 2023		**3,476**	**17,108**	**1,575**	**12,393**	**33**	**4,648**	**39,233**

1 Primarily consists of increases in rehabilitation provision of $780 million and reclassifications within the various property, plant and equipment headings.

Plant and equipment includes expenditure for construction in progress of $4,640 million (2022: $3,731 million). Depreciation expenses included in cost of goods sold are $5,805 million (2022: $6,782 million) and in selling and administrative expenses, $52 million (2022: $46 million).

During 2023, $51 million (2022: $31 million) of interest was capitalised. With the exception of project-specific borrowings, the rate used to determine the amount of borrowing costs eligible for capitalisation was 6.1% (2022: 3.5%).

As at 31 December 2023, with the exception of leases, no property, plant or equipment was pledged as security for borrowings (2022: $Nil).

...

7.2 Disclosure requirements in other IFRS accounting standards

In addition to the disclosure requirements in IAS 23, an entity needs to disclose additional information in relation to its borrowing costs in order to comply with requirements in other IFRS accounting standards. For example, disclosures required by IAS 1 include:

- The nature and amount of material items included in profit or loss. *[IAS 1.97]*.
- The measurement bases used in preparing the financial statements and other accounting policies used that are relevant to an understanding of the financial statements (see Practical example 6-1 in section 6.1 above). *[IAS 1.117]*.

  And
- The significant judgements made in the process of applying an entity's accounting policies that have the most significant effect on the recognised amounts (e.g., criteria in determining a qualifying asset or a 'part' of a qualifying asset, including definition of 'substantial period of time'). *[IAS 1.122]*.

As noted in section 5.4 above, the IFRS IC considered a request for guidance on the treatment of foreign exchange gains and losses and on the treatment of any derivatives used to hedge such foreign exchange exposures.

The IFRS IC decided not to add the issue to its agenda but concluded both that (i) how an entity applies IAS 23 to foreign currency borrowings is a matter of accounting policy requiring an entity to exercise judgement and (ii) IAS 1 requires disclosure of significant accounting policies and judgements that are relevant to an understanding of the financial statements.[14] The requirements of IAS 1 are discussed in Chapter 3.

14 *IFRIC Update*, January 2008, available on the IFRS Foundation's website.

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Appendix B - Defined terms

Extract from IAS 23	
5	This Standard uses the following terms with the meanings specified: *Borrowing costs* are interest and other costs that an entity incurs in connection with the borrowing of funds. A *qualifying asset* is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Chapter 23 Inventories

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Overview

IAS 2 *Inventories* prescribes the accounting treatment for inventories. Inventories are assets held for sale in the ordinary course of business; in the process of production for such sale; or in the form of materials or supplies to be consumed in the production process or in the rendering of services. The term 'inventories' includes raw materials, work in progress, finished goods and goods for resale in the ordinary course of business.

Inventories can include all types of goods purchased and held for resale and may also include tangible and intangible assets held by an entity for sale in the ordinary course of business.

This chapter only deals with inventories within the scope of IAS 2, which applies to all inventories in financial statements except financial instruments and biological assets related to agricultural produce at the point of harvest.

IAS 2 does not apply to the measurement of inventories held by producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at net realisable value in accordance with well-established practices in those industries as well as inventories held by commodity broker-traders who measure their inventories at fair value less costs to sell.

The standard's basic rule is that inventories are measured at the lower of cost and net realisable value, except those inventories scoped out of its measurement requirements. The costs attributed to inventories under IAS 2 comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

IAS 2 specifically allows the use of techniques for the measurement of cost of inventories such as the standard cost method or the retail method, provided that the result approximates cost. Where it is necessary to use a cost-flow assumption (i.e., when there are large numbers of ordinarily interchangeable items), IAS 2 requires either a first-in, first-out (FIFO) or a weighted average cost formula to be used.

What you need to know

- In many industries, inventories are one of the more significant classes of assets and their accounting treatment may have a material impact on the statement of financial position and operating results.
- The use of significant judgements or assumptions may be required in classifying assets, determining costs to be included in inventory and determining the relevant net realisable value that meets the objectives of the standard.

1 Introduction

IAS 2 prescribes the accounting treatment for inventories. The term 'inventories' includes raw materials, work in progress, finished goods and goods for resale in the ordinary course of business. Biological assets related to agricultural activity and agricultural produce at the point of harvest are however dealt with in IAS 41 *Agriculture* (see Chapter 38). This chapter only deals with inventories within the scope of IAS 2.

Costs of inventories comprise expenditure which has been incurred in bringing the inventory to its present location and condition. All costs incurred in respect of inventories are charged as period costs, except for those which relate to those unconsumed inventories which are expected to be of future benefit to the entity. These are carried forward as an asset, until the entity transfers control to a third party, at which point revenue is recognised in accordance with IFRS 15 *Revenue from Contracts with Customers* (see Chapter 28).

IAS 2 was last revised in 2003 primarily to clarify its scope and prohibit the use of the last-in, first-out (LIFO) formula to measure the cost of inventories. When IAS 2 was revised, all references to matching and to the historical cost system were deleted, even though historical cost was retained as the primary measurement approach for IAS 2 inventories.

There are some differences between IFRS accounting standards and US GAAP accounting standards on inventories, which are not addressed in this chapter as the standards are not converged.

2 Objective, definitions and scope

2.1 Objective

The objective of IAS 2 is to prescribe the accounting treatment for inventories. The standard notes that a primary issue in accounting for inventories is the cost to be recognised as an asset and carried forward until the related revenues are recognised. The standard provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-down to net realisable value. Further to this, it provides guidance on the cost formulas that are used to assign costs to inventories. *[IAS 2.1]*.

2.2 Definitions

IAS 2 uses the following terms with the meanings specified below: *[IAS 2.6]*

Extract from IAS 2

6 The following terms are used in this Standard with the meanings specified:

Inventories are assets:

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

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

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13 *Fair Value Measurement*.)

Fair value measurement is addressed in Chapter 15.

2.3 Scope

IAS 2 sets out its scope as follows: *[IAS 2.2, IAS 2.3]*

Extract from IAS 2

2 This Standard applies to all inventories, except:

(a) [deleted]

(b) financial instruments (see IAS 32 F*inancial Instruments: Presentation* and IFRS 9 *Financial Instruments*); and

(c) biological assets related to agricultural activity and agricultural produce at the point of harvest (see IAS 41 *Agriculture*).

3 This Standard does not apply to the measurement of inventories held by:

(a) producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at net realisable value in accordance with well-established practices in those industries. When such inventories are measured at net realisable value, changes in that value are recognised in profit or loss in the period of the change.

(b) commodity broker-traders who measure their inventories at fair value less costs to sell. When such inventories are measured at fair value less costs to sell, changes in fair value less costs to sell are recognised in profit or loss in the period of the change.

The recognition, measurement, presentation and disclosure of financial instruments is addressed in Chapters 40 to 50.

The accounting treatment of biological assets related to agricultural activity and agricultural produce at the point of harvest is addressed in Chapter 38. IAS 41 defines 'harvest' as the detachment of produce from a biological asset or the cessation of a biological asset's life processes. *[IAS 41.5]*. IAS 2 applies to agricultural produce that has been harvested by the entity from its biological assets. Such produce is initially recognised at its fair value less costs to sell at the point of harvest, as set out in IAS 41 (see Chapter 38). This value becomes the cost of inventories at that date under IAS 2. *[IAS 2.20]*.

The measurement provisions of IAS 2 do not apply to the measurement of inventories held by entities referred to in IAS 2.3. However, in both cases, the standard stresses that these inventories are excluded from only its measurement requirements. The standard's other requirements, such as disclosures, continue to apply. *[IAS 2.4]*.

The inventories referred to in IAS 2.3(a) are measured at net realisable value at certain stages of production. This occurs, for example, when agricultural crops have been harvested or minerals have been extracted and sale is assured under a forward contract or a government guarantee, or when an active market exists and there is a negligible risk of failure to sell. *[IAS 2.4]*. However, in practice this approach is not common.

Commodity broker-traders referred to in IAS 2.3(b) are defined as those who buy or sell commodities for others or on their own account and these inventories are principally acquired with the purpose of selling in the near future and generating a profit from fluctuations in price or broker-traders' margin. *[IAS 2.5]*. Fair value and net realisable value are discussed in section 3 below.

Inventories can include all types of goods purchased and held for resale including, for example, merchandise purchased by a retailer and other tangible assets such as land and other property held for resale, although investment property accounted for under IAS 40 *Investment Property* is not treated as an inventory item. The term also encompasses finished goods produced, or work in progress being produced, by the entity and includes materials and supplies awaiting use in the production process, for example, unused office supplies. Costs incurred to fulfil a contract with a customer that do not give rise to inventories (or assets within the scope of another standard) are accounted for in accordance with IFRS 15. *[IAS 2.8]*. Inventories may also include items of property, plant and equipment initially held for rental and subsequently transferred to inventories when they cease to be rented, *[IAS 16.68A]*, and intangible assets held by an entity for sale in the ordinary course of business. *[IAS 38.3(a)]*.

There is a separate standard, IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* that governs the accounting treatment of non-current assets held for sale, for example a group of assets held for sale as part of a business being disposed of. An entity would apply IFRS 5 to any inventories that form part of a disposal group. IFRS 5 is discussed in Chapter 5.

2.3.1 Practical application of the scope and recognition requirements of IAS 2

2.3.1.A Core inventories and spare parts

In certain industries, for example the non-ferrous metals, gas extraction and petrochemical sectors, certain processes or storage arrangements always require a minimum amount of material to be present in the system during the production process in order to permit plants to operate or for production to be maintained. For example, cushion gas is required to maintain minimum storage pressure in gas cavern storage facilities and, in order for a crude oil refining process to take place, the plant must contain a certain minimum quantity of oil which can only be taken out if the pipeline is interrupted. Such materials have been referred to as 'core inventories' or 'minimum fill'. The issue with such minimum amounts of material is whether they should be accounted for as inventory in accordance with IAS 2 or as property, plant and equipment in accordance with IAS 16 *Property, Plant and Equipment*.

The IFRS IC discussed the issue of 'core inventories' or 'minimum fill' at its March 2014 meeting and tentatively decided to develop an interpretation. The IFRS IC further directed the staff to define the scope of what is considered to be core inventories and to analyse the applicability of the concept to a range of industries.[1] At its July 2014 meeting, the IFRS IC discussed the feedback received from informal consultations with IASB members, the proposed scope of core inventories and the staff analysis of the applicability of the issue to a range of industries. In its redeliberations, the IFRS IC observed that what might constitute core inventories, and how they are accounted for, can vary between industries and that significant judgement might be needed in determining the appropriate accounting. The IFRS IC noted that it did not have clear evidence that the differences in accounting were caused by differences in how IAS 2 and

1 *IFRIC Update*, March 2014, available on the IFRS Foundation's website.

IAS 16 were being applied and, in the absence of such evidence, the IFRS IC decided not to continue with the development of an interpretation and to remove this item from its agenda.[2]

How we see it

In our view, an item that is not held for sale in the ordinary course of business or to be consumed in a production process should be accounted for as an item of property, plant and equipment under IAS 16 if it is necessary to operate or benefit from an asset during more than one operating cycle and its cost either cannot be recouped through sale or it is significantly impaired after it has been used to operate the asset. This applies even if the part of inventory that is deemed to be an item of property, plant and equipment cannot physically be separated from other inventories.

Core inventories are discussed further in Chapter 39 at section 14.3 in the context of extractive industries.

By contrast, spare parts are classified as inventories unless they meet the definition of property, plant and equipment. The recognition of spare parts as property, plant and equipment and the accounting treatment of core inventories are discussed further in Chapter 19 at sections 3.1.1 and 3.1.5 respectively.

2.3.1.B Broadcast rights

Broadcasters purchase programmes under a variety of arrangements. Often, they commit to purchasing programmes that are at a very early stage of development, perhaps merely being concepts. The broadcaster may have exclusive rights over the programme or perhaps only have the rights to broadcast for a set period of time or on a set number of occasions. IFRS accounting standards are not clear on how these rights should be classified and when they should be recognised.

Broadcast rights meet the definition of intangible assets because they are identifiable non-monetary assets without physical substance. *[IAS 38.8]*. IAS 38 *Intangible Assets* specifically includes within its scope rights under licensing agreements for items such as motion picture films and video recordings. *[IAS 38.6]*. Rights to programmes held for sale in the ordinary course business to other parties meet the definition of inventory and are therefore within the scope of IAS 2. *[IAS 2.6, IAS 38.3]*. It is possible to conclude that acquired rights to programmes held for a broadcaster's programming schedule are comparable to "materials or supplies to be consumed in the production process or in the rendering of services", which also meet the definition of inventory in the scope of IAS 2. *[IAS 2.6]*.

Without specific guidance in IFRS accounting standards, there is diversity among broadcasters in practice when classifying broadcast rights as either inventories or intangible assets. Entities will have to consider the particular facts and circumstances when classifying such rights, for example, it may be more appropriate to classify a right acquired for a single broadcast of a movie or sporting event without a rerun as inventories. In contrast, it may be more appropriate to classify acquired rights to an episodic series with a high rerun value, for example children's cartoons, as an intangible asset.

How we see it

The appropriate classification of broadcast rights depends on the particular facts and circumstances applicable to each case. We believe that, depending on the facts and circumstances applicable to the entity, it may be appropriate to either treat these rights as inventory under IAS 2 or as intangible assets and classify them under IAS 38 (see Chapter 18 at section 2.2.2).

When classified as inventory, the rights would be presented within current assets if the rights are expected to be sold, consumed or realised as part of the normal operating cycle, even if the intention is not to consume them within 12 months. *[IAS 1.66, IAS 1.68]*.

Paragraph 68 of IAS 1 *Presentation of Financial Statements* defines the operating cycle of an entity as "the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. When the entity's normal operating cycle is not clearly identifiable, it is assumed to be twelve months". *[IAS 1.66]*. The distinction between current and non-current assets is discussed in Chapter 3 at section 3.1.1.

As with costs of other inventory the cash outflows from acquisition will be classified as operating cash flows as they are primarily derived from the principal revenue-producing activities and the expense will be presented within cost of sales when the right is consumed.

2 *IFRIC Update*, November 2014, available on the IFRS Foundation's website.

Given the typical significance of broadcast rights for broadcasters, presenting these assets as a separate line item in the statement of financial position is also an alternative presentation observed in practice in accordance with IAS 1.57(a).

There is also the issue of the timing of recognition of these rights. In accordance with paragraph 4.3 of the *Conceptual Framework for Financial Reporting* an asset is a present economic resource controlled by an entity as a result of past events. *[CF 4.3]*.

Hence, it is necessary to determine when control is obtained. Under IFRS accounting standards, executory contracts where both parties are still to perform (such as purchase orders where neither payment nor delivery has taken place) do not generally result in the recognition of assets and liabilities. When a broadcaster initially contracts to purchase a programme, it will not usually result in immediate recognition of an asset relating to that programme. At this point there will not normally be an asset under the control of the broadcaster. A broadcaster may have to consider whether the underlying resource is sufficiently developed to be identifiable (for example, whether the manuscript or screenplay has been written, and whether directors and actors have been hired).

How we see it

In the absence of specific guidance in IAS 2 on how to determine the timing of obtaining control of broadcast rights, an entity should make reference to the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (see Chapter 3 at section 4.3) when deciding on an accounting policy and refer to guidance in other standards, for example IFRS 15, to determine the point in time when control of broadcast rights is obtained.

Where there is difficulty in determining when control of the asset is obtained it may be helpful to assess at what point any liability arises, since a liability will generally indicate that an asset has been acquired. In practice an entity might recognise an asset and a liability for a specific broadcast right, for example:

- When a screening certificate is obtained
- When programming is available for exhibition
- At the beginning of the season
- At the beginning of the licence period

  Or
- At the date the event occurs (e.g., game-by-game basis)

The issue of when a licensor recognises revenue under IFRS 15 on the sale of such broadcast rights is covered in Chapter 28 at section 8.

2.3.1.C Emission rights

In order to encourage entities to reduce emissions of pollutants, governments around the world have introduced schemes that comprise tradeable emissions allowances or permits. These schemes are discussed further in Chapter 18 at section 11.2.

How we see it

It might be appropriate to recognise emission rights, whether granted by the government or purchased by an entity, as inventory in accordance with IAS 2 if they are held for sale in the ordinary course of business or to settle an emissions liability in the ordinary course of business.

Entities using emission rights for their own purposes might elect to record the rights as intangible assets, whether at cost, revalued amount or, under the so-called 'net liability' approach, as rights that are re-measured to fair value. See Chapter 18 at section 11.2.

If the purchased emission rights are recognised as inventories, they are subsequently measured at the lower of cost or net realisable value in accordance with IAS 2, unless they are held by commodity broker-traders.

Broker-traders account for emission rights as inventory. A broker-trader may recognise emission rights either at the lower of cost and net realisable value, or at fair value less costs to sell as permitted by IAS 2. An integrated entity may hold emission rights both for own-use and for trading. An entity accounts for these emission rights separately.

2.3.1.D Accounting for green certificates or renewable energy certificates

Some governments have launched schemes to promote power production from renewable sources, based on green certificates, renewable energy certificates, green tags or tradable renewable certificates. There are similarities between green certificates and emission rights, except that whilst emission rights are granted to reflect a future limit on emissions, green certificates are awarded on the basis of the amount of green energy already produced. These schemes are discussed further in Chapter 18 at section 11.3.

How we see it

It might be appropriate to recognise green certificates, whether granted by the government or purchased by an entity, as inventory in accordance with IAS 2 if they are held for sale in the ordinary course of business or to settle an emissions liability in the ordinary course of business.

Entities entitled to an award of green certificates might elect to recognise an intangible asset representing an entitlement to a government grant. The intangible asset is recognised at the point in time when the green electricity is produced at either cost or revalued amount. Entities that have the option to use or sell certificates granted to them may also apply the 'net liability' approach. See Chapter 18 at section 11.3.

Green certificates recognised as inventories are subsequently measured at the lower of cost or net realisable value in accordance with IAS 2, unless they are held by commodity broker-traders.

Broker-traders may recognise green certificate inventories either at the lower of cost and net realisable value, or at fair value less costs to sell as permitted by IAS 2.

2.3.1.E Treatment of green feedstock purchased in order to label products as 'green'

An entity might be engaged in producing goods that use inputs sourced as either 'green' or 'grey' (sustainable or non-sustainable, respectively) in its production process. The entity might also produce under a certified production process that provides the right to label products as green, even if the actual production inputs used in the final product were grey.

The inputs might have the same physical characteristics and therefore be stored together. Sourcing green inputs is generally more expensive compared to grey inputs. Therefore, there are often questions about how to account for the additional costs involved.

How we see it

In our view, if the 'green' attributes grant only the right to label goods as 'green', and such right cannot be sold separately, then they do not result in a separable intangible asset for the entity to recognise. Therefore, the cost attached to the right to label products as 'green' should be included in the cost of the finished inventory.

2.3.1.F Crypto-assets

How we see it

Crypto-assets have diverse terms and conditions, and the purpose for holding them differs among holders. As a result, the holders of crypto-assets will need to evaluate their own facts and circumstances in determining which IFRS classification and measurement requirements should be applied. Depending on the relevant accounting standard, the holder may also need to assess its business model in order to determine the appropriate classification and measurement.[3]

Cryptocurrencies represent a subset of crypto-assets. In recent years, numerous cryptocurrencies (for example Bitcoin) and crypto-tokens have been launched. In June 2019, the IFRS IC discussed how IFRS accounting standards apply to holdings of a subset of crypto-assets with all the following characteristics:

- A digital or virtual currency recorded on a distributed ledger that uses cryptography for security
- Not issued by a jurisdictional authority or other party

  And
- Does not give rise to a contract between the holder and another party

3 The classification of crypto-assets is considered in detail in our publication *Applying IFRS: Accounting by holders of crypto assets, Updated October 2021, available on* ey.com/ifrs.

For the purpose of their discussion, the IFRS IC referred to crypto-assets with these characteristics as 'cryptocurrency'. The IFRS IC concluded that IAS 2 applies to cryptocurrencies when they are held for sale in the ordinary course of business. If IAS 2 is not applicable, an entity applies IAS 38 to holdings of cryptocurrencies.[4]

The IFRS IC observed that a holding of cryptocurrency would meet the definition of an intangible asset in IAS 38 on the grounds that: a) it is capable of being separated from the holder and sold or transferred individually; and b) it does not give the holder a right to receive a fixed or determinable number of units of currency.

Other crypto-assets that do not have the characteristics of cryptocurrency considered by the IFRS IC (and therefore not in scope of the agenda decision) may also meet the relatively wide definition of an intangible asset. The accounting for crypto-assets as intangible assets is discussed in Chapter 18 at section 11.6.

However not all intangible assets are within the scope of IAS 38 as the standard is clear that it does not apply to items that are in the scope of another standard. For example, IAS 38 excludes from its scope intangible assets held by an entity for sale in the ordinary course of business, which are within scope of IAS 2, *[IAS 38.3(a)]*, and financial assets as defined in IAS 32 *Financial Instruments: Presentation*. *[IAS 38.3(e)]*.

The IFRS IC considered the definition of a financial asset in accordance with IAS 32 and concluded that a holding of cryptocurrency is not a financial asset. This is because a cryptocurrency is not cash. Nor is it an equity instrument of another entity. It does not give rise to a contractual right for the holder and it is not a contract that will or may be settled in the holder's own equity instruments. The definition of a financial asset in accordance with IAS 32 is discussed in Chapter 41 at section 1.

Although this is often assumed, IAS 2 does not require inventory to be tangible. The IFRS IC observed that cryptocurrencies could be held for sale in the ordinary course of business, for example, by a commodity broker-trader. In that circumstance, a holding of cryptocurrency is inventory for the entity, and IAS 2 applies to that holding.

Whether cryptocurrencies and other crypto-assets are held for sale in the ordinary course of business would depend on the specific facts and circumstances of the holder.

In practice, cryptocurrencies and other crypto-assets are generally not used in the production of inventory and, thus, would not be considered materials and supplies to be consumed in the production process.

How we see it

In limited circumstances, we believe that a crypto-asset could be held for consumption in the rendering of a service. For example, a crypto-asset, not readily convertible to cash, that only entitles the holder to a specific service (for example, server capacity) could be considered inventory if the holder uses the underlying service to deliver its own services in the ordinary course of its business.

The measurement of cryptocurrencies and other crypto-assets that meet the definition of inventory is addressed in section 3.4 below.

If an entity has made judgements regarding its accounting for holdings of cryptocurrencies, and those judgements have a significant effect on the amounts recognised in the financial statements, those judgements should be disclosed in accordance with the requirements of paragraph 122 of IAS 1 (see section 6.2 below).[5] Such judgements may relate to the classification of cryptocurrency as inventory or intangible assets, and may also be relevant to holdings of other crypto-assets outside the scope of the IFRS IC's discussions.

2.3.1.G Transfers of rental assets to inventory

An entity may, in the course of its ordinary activities, routinely sell items that had previously been held for rental and classified as property, plant and equipment. For example, car rental companies may acquire vehicles with the intention of holding them as rental cars for a limited period and then selling them. IAS 16 requires that when such items become held for sale in the ordinary course of business rather than for rental, they should be transferred to inventory at their carrying value. *[IAS 16.68A]*. Revenue from the subsequent sale is then recognised gross rather than net, as discussed in Chapter 19 at section 7.2.

4 *IFRIC Update*, June 2019, available on the IFRS Foundation's website.

5 *IFRIC Update*, June 2019, available on the IFRS Foundation's website.

2.3.1.H Consignment stock and sale and repurchase agreements

A manufacturer may enter into an arrangement with a distributor where the distributor sells inventory on behalf of the manufacturer. Under such arrangements, a manufacturer (consignor) may deliver inventory on a consignment basis to a distributor or dealer (consignee). The consignor retains the legal title to the inventory and consignee acts as a selling agent. Such consignment arrangements are common in certain industries, such as the automotive industry. Under IFRS 15, revenue will not be recognised for stock delivered to the consignee because control has not yet transferred (see Chapter 28 at section 7.4), and the consignor would continue to account for the consignment inventory until control has passed.

Similarly, an entity may enter into sale and repurchase agreements with a customer where the entity agrees to repurchase inventory under particular circumstances. For example, the entity may agree to repurchase any inventory that the customer has not sold to a third party after six months. IFRS 15 contains complex guidance, explained in Chapter 28 at section 7.3, which can result in the entity accounting for such arrangements as financing arrangements, as leases, or as a sale with a right of return.

When an arrangement is accounted for as a financing arrangement, the seller will continue to recognise the inventory on its balance sheet and will also recognise a financial liability for the consideration received. If IFRS 15 requires the arrangement to be accounted for as a lease, the arrangement must be accounted for in accordance with IFRS 16 *Leases*. In this case, if the seller is considered to be acting as the lessor in an operating lease, the seller will continue to recognise the inventory on balance sheet. For arrangements that are considered to be a sale with a right of return, inventory will be derecognised and the seller will instead recognise a right of return asset. Sales with a right of return are considered further in section 2.3.1.I below.

The entity will also have to consider appropriate disclosure for material amounts of inventories that are held on consignment or sale and return at a third party's premises.

Consignment stock may also be found in situations other than distribution agreements, for example, when an entity (consignor) outsources part of its production process and transfers the legal title of inventories to a third party (consignee) in a sale transaction to enable that consignee to perform an outsourced task, with the inventories subsequently repurchased by the consignor. This may arise, for example, in the pharmaceutical industry, where a pharmaceutical entity may legally sell large quantities of an active drug principle in bulk to enable repackaging into smaller quantities which are subsequently repurchased by the consignor. Although the transaction takes the legal form of a sale, the seller (consignor) does not transfer control of the goods and therefore, does not derecognise the inventories. IFRS 15 provides specific application guidance for a promise to deliver goods on a consignment basis to other parties (see Chapter 28 at section 7.4) and principal versus agent considerations (see Chapter 28 at section 4.4).

2.3.1.I Sales with a right of return

An entity may provide its customers with a right to return goods that it has sold to them. The right may be contractual, or an implicit right that exists due to the entity's customary business practice, or a combination of both. Offering a right of return in a sales agreement obliges the selling entity to stand ready to accept any returned product. Under IFRS 15, the potential for customer returns needs to be considered when an entity estimates the transaction price because potential returns are a component of variable consideration. IFRS 15 also requires that the selling entity recognise the amount received or receivable that is expected to be returned to the customer as a refund liability and recognise a return asset for its right to recover goods returned by the customer.

How we see it

While IFRS 15 does not explicitly state this, we believe that the return asset would generally be presented separately from inventory.

Sales with a right of return are discussed further in Chapter 28 at section 4.7, Chapter 28 at section 5.4 and Chapter 28 at section 7.7.

2.3.1.J Collectibles

The accounting treatment of collectibles, for example paintings or sculptures, depends on the purpose for which the entity is holding the collectibles. The definition of inventories in IAS 2.6(a) encompasses assets held for sale in the ordinary course of business. Collectibles held for the purposes of sale in the ordinary course of business are therefore within the scope of IAS 2 and accordingly should be measured at the lower of cost and net realisable value in accordance with IAS 2.9. Items collected for administrative or aesthetic purposes and not traded in the ordinary course of business are within the scope of IAS 16 (see Chapter 19 at section 2.1). Collectibles held for long-term investment purposes and not traded in the ordinary course of business are similar to investment property, therefore entities may apply the requirements of IAS 40 by analogy (see Chapter 20 for further discussions on the requirements of IAS 40).

How we see it

Our view is that an entity should apply judgement, considering the purpose for which collectibles are held and other relevant facts and circumstances, when deciding on an accounting policy for collectibles by reference to the hierarchy in IAS 8 (see Chapter 3 at section 4.3).

3 Measurement

The standard's basic rule is that inventories are measured at the lower of cost and net realisable value, except those inventories scoped out of its measurement requirements as explained in section 2.3 above. *[IAS 2.9]*. Net realisable value is "the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale". *[IAS 2.6]*. This is different to fair value, which IAS 2 defines in accordance with IFRS 13 *Fair Value Measurement* as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date". *[IAS 2.6]*.

The standard points out that net realisable value is an entity-specific value, the amount that the entity actually expects to realise from selling that particular inventory in the ordinary course of business, while fair value is not. Fair value reflects the price at which an orderly transaction to sell the same inventory in the principal (or most advantageous) market for that inventory would take place between market participants at the measurement date. Therefore, net realisable value may not equal fair value less costs to sell. *[IAS 2.7]*. This is illustrated in the following Practical example in which AngloGold Ashanti Limited discloses that net realisable value is based on estimated future sales prices of the product.

Practical example 3-1: AngloGold Ashanti Limited (2023) **South Africa**

ANNUAL FINANCIAL STATEMENTS 2023 [extract]
Group financial statements [extract]
GROUP - NOTES TO THE FINANCIAL STATEMENTS [extract]
17 INVENTORIES [extract]
SIGNIFICANT ACCOUNTING JUDGEMENTS AND ESTIMATES [extract]
STOCKPILES AND METALES IN PROCESS [extract]

Costs that are incurred in or benefit the production process are accumulated in stockpiles and metals in process values. Net realisable value tests are performed at least annually and represent the estimated future sales price of the product, based on prevailing and long-term metals prices, less estimated costs to complete production and bring the product to sale.

...

If there has been a downturn in a cyclical business such as real estate, an entity may argue that net realisable value is higher than fair value because the entity intends to hold the asset until prices recover. This is rarely supportable as the decline in fair value usually indicates that the price that will be achieved in the ordinary course of business has declined and time taken to dispose of assets has increased. Net realisable value is discussed in section 3.3 below.

This basic measurement rule inevitably raises the question of what may be included in the cost of inventory.

3.1 What may be included in cost?

The costs attributed to inventories under IAS 2 comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. *[IAS 2.10]*. This definition allows for significant judgement of the costs to be included in inventory.

3.1.1 Costs of purchase

IAS 2 states that: *[IAS 2.11]*

Extract from IAS 2

Costs of purchase

11 The costs of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other similar items are deducted in determining the costs of purchase.

An example of an incentive deducted in determining the costs of purchase of inventories is where a supplier may pay cash upfront to its customer when entering into a contract. This form of incentive should be accounted for as a liability by the customer until it receives the related inventory, which is then shown at cost net of this incentive. Similarly, discounts for prompt settlement of invoices should be accounted for as a reduction of the cost of purchase and deducted from the costs of any unsold inventories.

There may be instances in which it is not clear whether payments received from suppliers are a discount, rebate or another similar item, nor whether they relate to inventories, another asset or something else. Unlike IFRS 15, which addresses the supplier's accounting for such payments, the accounting for the customer/purchaser receiving such a payment is not comprehensively addressed in IFRS accounting standards. IAS 2 does not provide guidance on accounting for such payments beyond noting that discounts, rebates and other similar items are deducted from the purchase price. In the absence of guidance, judgement might be needed. For further discussion on the considerations for payments received from suppliers refer to our publication *Applying IFRS: Accounting for Payments from Suppliers*.[6]

IAS 2 does not provide guidance on how to estimate trade discounts or rebates if they are variable. Discretionary rebates and rebates contingent on future purchases cannot be recognised because the resulting asset would not meet the recognition criteria in the IASB's Conceptual Framework. The IFRS IC discussed in November 2004 whether volume rebates should be recognised only when threshold volumes are achieved, or proportionately where achievement is assessed as probable. The IFRS IC tentatively agreed that there was insufficient evidence of diversity in practice and, therefore, decided not to add this issue to its agenda.[7]

How we see it

In our view, if it is probable that conditions to earn a trade discount or rebate will be met, and the amount can be estimated reliably, the discount or rebate should be recognised as a reduction in the cost of purchase. It follows that such trade discounts or rebates are recognised as an asset with a corresponding deduction from the cost of inventory. Estimating the amount of the rebate to be received often requires the use of judgement.

3.1.2 Costs of conversion

Costs of conversion include direct costs such as direct labour and materials, as well as an allocation of fixed and variable production overheads. It must be remembered that the inclusion of overheads is not optional. Overheads may comprise indirect labour and materials or other indirect costs of production. For the most part there are few problems over the inclusion of direct costs in inventories, although difficulties may arise over the inclusion of certain types of overheads and over the allocation of overheads into the cost of inventory. Overhead costs must be apportioned using a "systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods". *[IAS 2.12]*. Overheads should be allocated to the cost of inventory on a consistent basis from year to year, regardless of whether this will result in costs being above net realisable value.

Variable production overheads are indirect costs of production that vary directly, or nearly directly, with the volume of production such as indirect material and indirect labour. *[IAS 2.12]*. Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities. *[IAS 2.13]*.

Fixed production overheads are indirect costs that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of buildings, equipment and right-of-use assets used in the production process, and factory management expenses. *[IAS 2.12]*.

The allocation of fixed production overheads is based on the normal capacity of the facilities. Normal capacity is defined as "the production expected to be achieved on average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance". *[IAS 2.13]*. While actual capacity may be used if it approximates normal capacity, overheads may not be fully allocated to production as a result of low output or idle capacity. In these cases, the unallocated overheads must be expensed. Similarly, in periods of abnormally high production, the fixed overhead absorption rate must be reduced, otherwise inventories would be recorded at an amount in excess of cost. *[IAS 2.13]*.

The occurrence of a disruptive event, such as a natural disaster, epidemic or war may often result in changes to an entity's operations, for example, by interrupting supply chains, restricting operations or increasing operating costs. If production volumes are lower than normal because of such events, the entity must not increase the amount of fixed overhead costs allocated to each unit of production. Rather, any unallocated overheads are recognised as an expense in the period in which they are incurred. Conversely, entities may have abnormally high production for certain products, for example due to panic-buying. In these circumstances, an entity needs to decrease the amount of fixed overhead allocated to each unit of production so that inventories are not measured above cost.

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6 Available on ey.com/IFRS.

7 *IFRIC Update*, November 2004, available on the IFRS Foundation's website.

Entities need to assess whether wasted materials, labour, or other production costs are abnormal and, if so, they must be expensed as incurred. Entities may incur wasted materials, for example, to repackage goods that were originally destined for the wholesale market now redirected for retail sale to consumers (see section 3.1.3.A below).

In computing the costs to be allocated using the overhead recovery rate, costs such as distribution and selling must be excluded, together with the cost of storing raw materials and work in progress, unless it is necessary that storage costs be incurred prior to further processing, which may occasionally be the case (see section 3.1.3.A below).

How we see it

Although not specifically addressed in IAS 2, when the revaluation model in IAS 16 is applied, depreciation of property, plant and equipment is based on the revalued amount, less the residual value of the asset. Our view is that the depreciation based on the revalued amounts should be used in determining the costs of conversion for inventory measurement purposes.

IAS 2 mentions the treatment to be adopted when a production process results in the simultaneous production of more than one product, for example, when joint products are produced or when there is a main product and a by-product. If the costs of converting each product are not separately identifiable, they should be allocated between the products on a rational and consistent basis. For example, this might be the relative sales value of each of the products either at the stage in the production process when the products become separately identifiable, or at the completion of production. If the method of allocating costs to by-products subsequently changes, this is a change in an accounting estimate rather than a change in accounting policy, as changes in measurement techniques are considered to be changes in accounting estimates under IAS 8. *[IAS 8.34A]*. In contrast, a change in a cost formula would be a change in accounting policy, as discussed in section 3.2.2 below.

If the value of the by-product is immaterial, it may be measured at net realisable value and this value deducted from the cost of the main product. *[IAS 2.14]*. In the extractive industries, it is common for more than one product to be extracted from the same reserves therefore, joint and by-products are further discussed in Chapter 39 at section 14.2 in the context of such industries.

3.1.3 Other costs

Other costs are to be included in inventories only to the extent that they are incurred to bring them to their present location and condition. Often judgement will be necessary to make this assessment. An example is given in IAS 2 of design costs for a special order for a particular customer and the standard notes that it may be appropriate to include such costs or other non-production overheads. *[IAS 2.15]*. However, a number of examples are given of costs that are specifically disallowed. The standard states the following: *[IAS 2.16]*

Extract from IAS 2

16 Examples of costs excluded from the cost of inventories and recognised as expenses in the period in which they are incurred are:

(a) abnormal amounts of wasted materials, labour or other production costs;

(b) storage costs, unless those costs are necessary in the production process before a further production stage;

(c) administrative overheads that do not contribute to bringing inventories to their present location and condition; and

(d) selling costs.

The amount of inventories recognised as an expense during the period, which is often referred to as cost of sales, consists of those costs previously included in the measurement of inventory that have been sold as well as unallocated production overheads and abnormal amounts of production costs of inventories. *[IAS 2.38]*.

3.1.3.A Storage and distribution costs

Storage costs are excluded from the cost of inventory unless they are necessary in the production process. *[IAS 2.16(b)]*. This prohibits, for example, including the overheads of a retail outlet as part of inventory.

However, where it is necessary to store raw materials or work in progress prior to a further processing or manufacturing stage (e.g., maturing stocks, such as cheese, wine or whisky), the costs of such storage should be included in production overheads.

Distribution costs are a cost of bringing an item to its present location, however, judgement may need to be applied in identifying which costs are necessarily incurred to bring the inventories to their present location and condition. For example, in the context of large retailers with distribution centres (e.g., supermarkets), the transport and logistics involved are essential to their ability to put goods on sale at a particular location in an appropriate condition. In these circumstances, costs to receive, repackage and transport goods from central or regional warehouses to retail outlets are considered a cost of bringing the asset to the point of sale and hence capitalised in the cost of inventories. Conversely:

- The cost of moving inventories from one retail outlet to another cannot be included in the carrying value of inventory.
- Entities may incur additional costs to store inventories due to lower than expected demand. Such costs need to be expensed when incurred as storage costs can only be capitalised when they are necessary to the production process before further processing.
- The cost of storing goods at central warehouses before they are shipped to customers upon receipt of an order (for example, for internet sales) or until they are moved to retail outlets for local storage, display or collection by customers cannot be included in the carrying value of inventory.
- Costs of distribution to the customer are excluded from the cost of inventory as they are not incurred to bring inventories to their point of sale.

The appropriate presentation of distribution costs in the income statement depends on whether the entity presents an analysis of expenses using a classification based on their nature or function in accordance with IAS 1 (see Chapter 3 at section 3.2.3.B) and the particular facts and circumstances. For example:

- The cost of transportation from central or regional warehouses to retail outlets is capitalised in the cost of inventories in accordance with IAS 2 and included in cost of sales when inventories are sold.
- If an entity determines that shipping and handling activities are related to a promised good or service to a customer and the entity is acting as principal, we believe it is appropriate to present these as cost of sales, changes in contract costs, or similar, because the costs would be incurred to fulfil a revenue obligation (see Chapter 28 at section 10.3).
- Shipping and handling costs that are not incurred to bring inventories to their point of sale and not related to a promised good or service to the customer are outside the scope of IAS 2 and IFRS 15. An entity might need to apply judgement to distinguish such costs from those within the scope of IAS 2 or IFRS 15, and where to present such costs (see Chapter 28 at section 10.3).
- The presentation of shipping and handling costs is considered further in Chapter 28 at section 10.3.

3.1.3.B General and administrative overheads

IAS 2 specifically disallows administrative overheads that do not contribute to bringing inventories to their present location and condition. *[IAS 2.16(c)]*. Other costs and overheads that do contribute are allowable as costs of production. There is a judgement to be made about such matters, as under a very broad interpretation any department could be considered to make a contribution. For example, the accounts department will normally support the following functions:

(a) Production - by paying direct and indirect production wages and salaries, by controlling purchases and related payments, and by preparing periodic financial statements for the production units

(b) Marketing and distribution - by analysing sales and by controlling the sales ledger

And

(c) General administration - by preparing management accounts and annual financial statements and budgets, through controlling cash resources and planning investments

Only those costs of the accounts department that can be allocated to the production function can be included in the cost of conversion. Part of the management and overhead costs of a large retailer's logistical department may be included in cost if it can be related to bringing the inventory to its present location and condition. These types of costs are unlikely to be material in the context of the total inventory held by organisations. An entity determining that it needs to include a material amount of overhead of a borderline nature must ensure it can sensibly justify its inclusion under the provisions of IAS 2 by presenting an analysis of the function and its contribution to the production process similar to the above.

3.1.3.C Borrowing costs and purchases on deferred terms

IAS 2 states that IAS 23 *Borrowing Costs* identifies limited circumstances where borrowing costs are to be included in the cost of inventories. *[IAS 2.17]*. IAS 23 requires that borrowing costs be capitalised on qualifying assets but the standard provides an exemption for inventories that are manufactured in large quantities on a repetitive basis. *[IAS 23.4, IAS 23.8]*. In addition, IAS 23 clarifies that inventories manufactured, or otherwise produced, over a short period of time, are not qualifying assets. *[IAS 23.7]*. However, any manufacturer that is producing small quantities over a long time period (e.g., maturing stocks of wine or whisky) has to capitalise borrowing costs. This is further discussed in Chapter 22 at section 3.1.

IAS 2 also states that, on some occasions, an entity might purchase inventories on deferred settlement terms, accompanied by a price increase that effectively makes the arrangement a combined purchase and financing arrangement. Under these circumstances the price difference is recognised as an interest expense over the period of the financing. *[IAS 2.18]*.

Entities might also make prepayments for inventory, particularly raw materials in long-term supply contracts, raising the question of whether there is a financing component that should be accounted for separately.

If a purchaser accretes interest on long-term prepayments by recognising interest income, this will result in an increase in the cost of inventories and, ultimately, the cost of sales. The IFRS IC considered this in July 2015, noting that IAS 16 and IAS 38 include similar requirements to IAS 2 when payment for an asset is deferred (see Chapter 19 at section 4.1.6 and Chapter 18 at section 4.2).

Historically, there has been no explicit requirement in IFRS accounting standards to accrete interest income but the IFRS IC noted that IFRS 15 includes the requirement that the financing component of a transaction should be recognised separately in circumstances of both prepayment and deferral of payment (see Chapter 28 at section 5.5). They concluded, therefore, that when a financing component is identified in a long-term supply contract of raw materials, that financing component should be accounted for separately. They acknowledged that judgement is required to identify when individual arrangements contain a financing component.[8]

As stated in section 3.1.1 above, discounts for prompt settlement of suppliers' invoices should be deducted from the cost attributed to inventories.

3.1.3.D Service providers

Before IFRS 15 became effective, IAS 2 included the notion of work in progress (or 'inventory') of a service provider. However, this was consequentially removed from IAS 2 and replaced with the relevant requirements in IFRS 15. Costs to fulfil a contract, as defined in IFRS 15, are divided into two categories: (a) costs that give rise to an asset; and (b) costs that are expensed as incurred (see Chapter 28 at section 9.3.2). *[IFRS 15.95, IFRS 15.96]*. When determining the appropriate accounting treatment for such costs, IAS 2 (or any other more specific IFRS accounting standard) is considered first and if costs incurred in fulfilling the contract are within the scope of this standard, those costs should be accounted for in accordance with IAS 2 (or other IFRS accounting standard). If costs incurred to fulfil a contract are not within the scope of IAS 2 or any other applicable standard, an entity would need to consider the criteria in IFRS 15 for capitalisation of such costs (see Chapter 28 at section 9.3.2).

IFRS 15 does not specifically deal with the classification and presentation of contract costs. In the absence of a standard that specifically deals with the classification and presentation of these costs, entities would need to apply the requirements in IAS 8 to select an appropriate classification (see Chapter 3 at section 4.3). As discussed in Chapter 28 at section 9.3.2, we believe that costs to fulfil a contract must be presented as a separate asset in the statement of financial position. However, an entity needs to consider the aggregation requirements of IAS 1 when determining whether the separate classes of assets must be presented together with other assets (see Chapter 3 at sections 3.1.5 and 3.1.6).

Entities that are applying IFRS 18 *Presentation and Disclosure in Financial Statements* early need to consider the requirements in that IFRS accounting standard on whether items must be presented in the statement of financial position or disclosed in the notes. Specifically, paragraph B111 of IFRS 18 lists inventories as a class of assets that might have sufficiently dissimilar characteristics that disaggregating them into separate line items in the statement of financial position might be necessary. Examples of such line items could be "merchandise, production supplies, materials, work in progress and finished goods". *[IFRS 18.B111]*. Entities that apply IFRS 18 early also need to consider the consequential amendments to paragraph 39 of IAS 2. See Chapter 4 for further discussion of IFRS 18.

8 *IFRIC Update*, July 2015, available on the IFRS Foundation's website.

3.1.3.E Forward contracts to purchase inventory

The standard scopes out commodity broker-traders that measure inventory at fair value less costs to sell from its measurement requirements (see section 2.3 above). If a broker-trader had a forward contract for purchase of inventory this contract would be accounted for as a derivative under IFRS 9 *Financial Instruments* since it would not meet the normal purchase or sale exemption (see Chapter 41 at section 3.3) and when the contract is physically settled by taking delivery, the inventory would likewise be measured at fair value less costs to sell. *[IAS 2.3(b)]*. However, if such an entity were not measuring inventory at fair value less costs to sell it would be subject to the measurement requirements of IAS 2 and would therefore have to record the inventory at the lower of cost and net realisable value. This raises a question as to what cost is when such an entity takes delivery of inventory that has been purchased with a forward contract?

On delivery, the cash paid (i.e., the fixed price agreed in the forward contract) is in substance made up of two elements:

(i) An amount that settles the forward contract

And

(ii) An amount that represents the 'cost of purchase', being the market price at the date of purchase

This 'cost of purchase' represents the forward contract price adjusted for the derivative asset or liability. For example, assume that the broker-trader was purchasing oil and the forward contracted price was CU40 per barrel of oil, but at the time of delivery the spot price of oil was CU50 and the forward contract had a fair value of CU10 at that date. The oil would be recorded at the fair value on what is deemed to be the purchase date of CU50. The CU40 cash payment would in substance consist of CU50 payment for the inventory offset by a CU10 receipt on settlement of the derivative contract, which would be separately accounted for. This is exactly the same result as if the entity had been required to settle the derivative immediately prior to, and separate from, the physical delivery of the oil. The requirement to recognise inventory at the amount of cash paid (CU40) plus the fair value of the derivative at the settlement date (CU10), when the normal sale and purchase exemption does not apply and the derivative is not designated as part of a hedge relationship, was confirmed by the IFRS IC in the March 2019 agenda decision addressing physical settlement of contracts to buy or sell a non-financial item.[9]

If the entity purchasing the oil in the example above is not a broker-trader, and the acquisition meets the normal purchase or sale exemption given in IAS 32, the purchase of oil would be recognised at the entity's cost thereof in terms of IAS 2, that is CU40 per barrel of oil.

3.1.3.F Drug production costs within the pharmaceutical industry

After the development stage, pharmaceutical companies often commence production of drugs prior to obtaining the necessary regulatory approval to sell them (so called 'pre-launch inventories'). These drugs are produced in advance so that the sales of the newly authorised drug may commence as soon as regulatory approval is obtained. It is unlikely that a pharmaceutical company can demonstrate that the sale of a drug will generate future cash flows with sufficient certainty before it files the request for the new drug approval. Therefore, drug production costs incurred before the filing are generally not recognised as an asset. After filing the request for regulatory approval, the various development phases are generally completed and the entity is likely to have an effective process for producing of the drug. Consequently, the product has the potential to contribute to the future cash flows of the entity.

How we see it

In our view, if the regulatory approval has been applied for and it is believed highly likely that this will be successfully obtained then it is appropriate for a pharmaceutical company to recognise an asset for the drug production costs and classify this as inventory. This would typically be the case if the drug manufacturer has already received regulatory approval to sell the same drug in a different jurisdiction and the criteria for approval are similar in both jurisdictions.

The capitalised drug production costs incurred are classified as inventory and measured at the lower of cost and net realisable value in accordance with the requirements of IAS 2. If the likelihood of obtaining the approval declines, these inventories are written-down with the write-down recognised in 'cost of sales'. If regulatory approval is subsequently obtained, the write-down is reversed to the extent that the original cost is realisable (see section 3.3.1.C below for further guidance on reversal of write-downs). *[IAS 2.33]*.

9 *IFRIC Update*, March 2019, available on the IFRS Foundation's website.

Prior to this application for regulatory approval being made, any costs would usually be classified as research and development costs rather than inventory. However, such costs may be capitalised as an asset if the criteria in IAS 38 for recognising internally generated intangible assets have been satisfied, e.g., the entity can demonstrate the technological feasibility of completing the drug development prior to filing for regulatory approval and the likelihood of obtaining the approval is high. Similar to the above, this would typically be the case if the drug manufacturer has already received regulatory approval to sell the same drug in a different jurisdiction and the criteria for approval are similar in both jurisdictions (see Chapter 18 at section 6.2.3).

Production costs of a new drug incurred before regulatory approval is obtained may be higher than the standard production costs expected after the approval, once the normal production process has started. In such a case, the full cost of inventory may not be recoverable and a write-down may be required.

3.2 Measurement of cost

3.2.1 Techniques for the measurement of cost

IAS 2 specifically allows the use of techniques for the measurement of cost of inventories such as the standard cost method or the retail method, provided that the result approximates cost. *[IAS 2.21]*.

These techniques require an entity to use judgements or assumptions in developing an accounting estimate that meets the measurement objective, i.e., cost. The effects of a change in an input or in a measurement technique used to develop an accounting estimate is accounted for as a change in accounting estimate provided the change is not arising as a result of a correction of prior period errors. In this respect, a change in accounting estimate that results from new information or more experience is not the correction of an error.

3.2.1.A Standard cost

Standard costs should take into account normal levels of materials and supplies, labour, efficiency and capacity utilisation. They must be regularly reviewed and revised where necessary. *[IAS 2.21]*. Normal levels of activity are discussed in section 3.1.2 above.

3.2.1.B Retail method

The retail method is often used in the retail industry for measuring inventories with high volumes of rapidly changing items with similar margins for which it is impracticable to use other measurement techniques. *[IAS 2.22]*. In these circumstances, the cost of inventory is determined by converting selling prices to cost by adjusting for a normal margin.

This technique involves applying judgement regarding the granularity of inputs required in determining the appropriate margin rate adjustments which would result in an acceptable approximation of cost. Paragraph 22 of IAS 2 states that an average percentage for each retail department is often used when applying this technique. *[IAS 2.22]*.

Inputs used in this technique must be consistent with how the entity determines appropriate write-downs. Using average margin rates and selling prices that are determined inconsistently may result in anomalies such as items of inventory being measured above their cost. For example, in the garment industry, any remaining items from a past seasonal collection will often be sold through alternative distribution channels (i.e., other than in the entity's retail outlets or distributors) such as discounters. In this case, applying an average margin rate from sales in the main distribution channels to the selling price in these points of sale would require the entity to also determine any required write-downs in a second step. Therefore, using average margin rates from all sales including sales to discounters and applying these rates to catalogue selling prices would result in measuring items above their cost because the margin rates used to convert selling prices to cost are inappropriately reduced.

3.2.2 Cost formulas

The standard states the following: *[IAS 2.23, IAS 2.24]*

Extract from IAS 2	
23	**The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects shall be assigned by using specific identification of their individual costs.**
24	Specific identification of cost means that specific costs are attributed to identified items of inventory. This is the appropriate treatment for items that are segregated for a specific project, regardless of whether they have been bought or produced. However, specific identification of costs is inappropriate when there are large numbers of items of inventory that are ordinarily interchangeable. In such circumstances, the method of selecting those items that remain in inventories could be used to obtain predetermined effects on profit or loss.

In practice, the specific identification method of valuation discussed in IAS 2.23 is relatively unusual, as the clerical effort required does not make it feasible unless there are relatively few high value items being bought or produced. Consequently, it would normally be used where the inventory comprised items such as antiques, jewellery and automobiles in the hands of dealers. The standard clarifies that this method is inappropriate where there are large numbers of items that are ordinarily interchangeable, as specific identification of costs could distort the profit or loss arising from these inventories through the method applied to selecting items that remain in inventories. *[IAS 2.24]*.

Where it is necessary to use a cost-flow assumption (i.e., when there are large numbers of ordinarily interchangeable items), IAS 2 allows either a FIFO (first-in, first-out) or a weighted average cost formula to be used: *[IAS 2.25]*

Extract from IAS 2	
25	**The cost of inventories, other than those dealt with in paragraph 23, shall be assigned by using the first-in, first-out (FIFO) or weighted average cost formula. An entity shall use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formulas may be justified.**

The standard makes it clear that the same cost formula should be used for all inventories having a similar nature and use to the entity, although items with a different nature and use may justify the use of a different cost formula. *[IAS 2.25]*. For example, the standard acknowledges that the use of inventories in one operating segment may differ from the same type of inventories used in another operating segment. However, differences in geographical location, and respective taxes rules, of inventories are not sufficient, on their own, to justify the use of different cost formulas. *[IAS 2.26]*.

An entity may choose, as a result of particular facts and circumstances, to change its cost formula, for instance, from a FIFO-based cost formula to a weighted average cost formula. The change in a cost formula represents a change in the basis on which the value of the inventory has been determined, rather than a change in valuation of the inputs used to determine the cost of the inventory. An accounting policy is defined in IAS 8 as including specific bases applied by an entity in preparing and presenting financial statements. *[IAS 8.5]*. Therefore, a change in the cost formula represents a change in accounting policy which should only be made if it results in the financial statements providing reliable and more relevant information. *[IAS 8.14]*. If material, a change in accounting policy should be applied retrospectively, that is applied to transactions, other events and conditions as if it had always been applied in accordance with IAS 8 (see Chapter 3 at section 4.4).

As stated in IAS 2.36(a) and confirmed by IAS 8.BC53, selecting a cost formula constitutes selecting an accounting policy. *[IAS 8.BC53]*.

3.2.2.A First-in, first-out (FIFO)

In the vast majority of businesses, it will not be practicable to keep track of the cost of identical items of inventory on an individual unit basis; nevertheless, it is desirable to approximate to the actual physical flows as far as possible. The FIFO method probably gives the closest approximation to actual cost flows, since it is assumed that when inventories are sold or used in a production process, the oldest are sold or used first. Consequently, the balance of inventory on hand at any point represents the most recent purchases or production. *[IAS 2.27]*. This can best be illustrated in the context of a business which deals in perishable goods (for example food retailers) since clearly such a business will use the first goods received earliest. The FIFO method, by allocating the earliest costs incurred against revenue, matches actual cost flows with the physical flow of goods reasonably accurately. In any event, even in the case of businesses which do not deal in perishable goods, this would reflect what would probably be a sound management policy. In practice, the FIFO method is generally used where it is not possible to value inventory on an actual cost basis.

3.2.2.B Weighted average cost

The weighted average method, which like FIFO is suitable where inventory units are identical or nearly identical, involves the computation of an average unit cost by dividing the total cost of units by the number of units. The average unit cost then has to be revised with every receipt of inventory, or alternatively at the end of predetermined periods. *[IAS 2.27]*. In practice, weighted average systems are widely used in packaged inventory systems that are computer controlled, although its results are not very different from FIFO in times of relatively low inflation, or where inventory turnover is relatively quick.

3.2.2.C Last-in, first-out (LIFO)

LIFO, as its name suggests, is the opposite of FIFO and assumes that the most recent purchases or production are used first. In certain cases, this could represent the physical flow of inventory (e.g., if a store is filled and emptied from the top). However, IAS 2 prohibits the use of the LIFO method. *[IAS 2.BC9]*. LIFO is an attempt to match current costs with current revenues so that profit or loss excludes the effects of holding gains or losses. Essentially, therefore, LIFO is an attempt to achieve something closer to replacement cost accounting for the statement of profit or loss, whilst disregarding the statement of financial position. Consequently, the period-end balance of inventory on hand represents the earliest purchases of the item, resulting in inventories being stated in the statement of financial position at amounts which may bear little relationship to recent cost levels. Unlike IFRS accounting standards, US GAAP allows LIFO and it is popular in the United States of America as the Internal Revenue Service officially recognises LIFO as an acceptable method for the computation of tax provided that it is used consistently for tax and financial reporting purposes.

3.3 Net realisable value

IAS 2 requires an entity to measure its inventories at the lower of cost and net realisable value. *[IAS 2.9]*. The standard defines net realisable value as "the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale". *[IAS 2.6]*. The difference between net realisable value and fair value is discussed in section 3 above. The standard contains substantial guidance on the estimation of net realisable value, particularly on how to determine the estimated selling price in the ordinary course of business. Estimated costs of completion and the estimated costs necessary to make the sale are discussed further in section 3.3.1.B below.

When net realisable value is below cost, inventory must be written down: *[IAS 2.28]*

Extract from IAS 2	
28	The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs to be incurred to make the sale have increased. The practice of writing inventories down below cost to net realisable value is consistent with the view that assets should not be carried in excess of amounts expected to be realised from their sale or use.

Writing inventory down to net realisable value should normally be done on an item-by-item basis. IAS 2 specifically states that it may be appropriate to group similar or related items but it is not appropriate to write down an entire class of inventory, such as finished goods, or all the inventory of a particular segment. However, it may be necessary to write down an entire product line or group of inventories in a given geographical area if the items cannot be practicably evaluated separately. *[IAS 2.29]*.

3.3.1 Determining net realisable value

Estimates of net realisable value must be based on the most reliable evidence available and take into account fluctuations of price or cost after the end of the period only to the extent that they confirm conditions existing at the end of the period. *[IAS 2.30, IAS 10.9(b)(ii)]*. A loss realised on a sale of a product after the end of the period may provide evidence of the net realisable value of that product at the end of the period. However, if the selling price of this product is, for example, correlated to an exchange-traded commodity, and the loss realised can be attributed to a fall in prices of that commodity after the period end date, then this loss would not provide evidence of the net realisable value at the period end date. The impact of post balance sheet events in determining the net realisable value of inventories is discussed further in Chapter 34 at section 3.1.

Disruptive events, such as natural disasters, epidemics and wars may affect consumer behaviour, for example, some entities may encounter periods of high demand as customers panic-buy whilst other entities may have to offer discounts to attract customers. As a result of such events, estimates of net realisable value may be subject to increased estimation uncertainty, and determining the appropriate assumptions may require significant judgement. Entities with perishable goods, for example, may have to dispose of goods they are unable to store or sell during such periods. Other entities may have to determine whether to write-down their inventories to net realisable value if they become wholly or partially obsolete, or if their selling prices have declined. Also, estimates of net realisable value should take into account estimated costs of completion and the estimated costs necessary to make the sale, for example, additional future storage costs, which may reduce the net realisable value of inventories. Estimated costs of completion and the estimated costs necessary to make the sale are discussed further in section 3.3.1.B below.

Estimates of net realisable value must also take into account the purpose for which the inventory is held. Therefore, the net realisable value of inventory held for a particular contract should be determined based on the contract price, and only the net realisable value of any excess inventory held would be based on current market prices. If there is a firm contract to sell quantities in excess of inventory quantities that the entity holds or is able to obtain under a firm purchase contract, this may give rise to an onerous contract liability that should be provided for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (see Chapter 27 at section 6.2). *[IAS 2.31]*. For inventory such as unused office supplies that are held for internal use and not for sale to third parties, the replacement cost is the best available measure of their net realisable value.

3.3.1.A Materials and other supplies held for use in the production of inventories

IAS 2 explains that materials and other supplies held for use in the production of inventories are not written down below cost if the final product in which they are to be used is expected to be sold at or above cost. *[IAS 2.32]*. This is the case even if these materials in their present condition have a net realisable value that is below cost and would therefore otherwise require write-down. Thus, a whisky distiller would not write down an inventory of grain held for the production of whisky because of a fall in the grain price, so long as the cost of the whisky is not expected to exceed its net realisable value. If a decline in the price of materials indicates that the cost of the final product will exceed net realisable value, then a write-down is necessary and the replacement cost of those materials may be the best measure of their net realisable value. *[IAS 2.32]*. If an entity writes down any of its finished goods, the carrying value of any related raw materials should also be reviewed to determine if they too need to be written down.

Often raw materials are used to make a number of different products. In these cases, it is normally not possible to arrive at a particular net realisable value for each item of raw material based on the selling price of any one type of finished item. If the current replacement cost of those raw materials is less than their historical cost, a provision is only required to be made if the finished goods into which they will be made are expected to be sold at a loss. No provision should be made just because the anticipated profit will be less than normal.

3.3.1.B Estimated costs of completion and the estimated costs necessary to make the sale

IAS 2 provides detailed guidance on determining net realisable value, however, the standard does not provide further guidance on how to determine "estimated costs necessary to make the sale", a key component of the definition of net realisable value (see section 3.3 above). Without detailed guidance on which costs to include when estimating net realisable value, entities need to apply judgement, which may include considering the nature of their products, sales channel (for example, in-store or online sales) and industry. This has led to diversity in practice. Incremental costs are often the starting point before considering whether additional costs need to be included and, in some cases, entities may have only considered those costs that are incremental.

The IFRS IC received a request for clarification on how to determine which costs should be included as part of the costs necessary to make the sale when determining the net realisable value in accordance with IAS 2. In June 2021, the IFRS IC decided not to add the matter to its standard-setting agenda. The IFRS IC observed that IAS 2.28 describes the objective of writing inventories down to their net realisable value which is to avoid inventories being carried 'in excess of amounts expected to be realised from their sale'. *[IAS 2.28]*. The IFRS IC further observed that the requirement in IAS 2.28 does not allow an entity to limit such costs to only those that are incremental, thereby potentially excluding costs the entity must incur to sell its inventories but that are not incremental to a particular sale. Including only incremental costs could fail to achieve the objective set out in that paragraph of the standard. Judgement will be needed to determine which costs are necessary to make the sale considering each entity's specific facts and circumstances, including the nature of the inventories.[10] There are a range of possibilities beyond the incremental cost approach: from direct costs at the point of sale (which might include, for example, a portion of the cost of internal sales staff or the cost of a special promotion campaign) to full costs (which might include costs such as depreciation or amortisation).

10 *IFRIC Update*, June 2021, Addendum. Available on the IFRS Foundation's website.

Furthermore, within that range, direct costs at the point of sale may be quite similar to incremental costs. Which costs are considered necessary to sell inventories may vary by entity, depending on the nature of the inventories, the applicable industry, sales channel and cost structure.

How we see it

The incremental cost approach is no longer permitted if it excludes non-incremental costs that must be incurred to sell inventories. We do not believe it would be possible to limit which other approaches might be considered appropriate, depending on the specific facts and circumstances. This is because IAS 2 does not specify which costs to consider.

Given the judgement involved and the diverse business models of entities, the agenda decision is unlikely to eliminate all diversity, but may help to reduce it.

3.3.1.C Reversal of net realisable value write-downs

When the circumstances that previously caused inventories to be written down below cost no longer exist, or when there is clear evidence of an increase in net realisable value because of changed economic circumstances, the amount of the write-down is reversed. The reversal cannot be greater than the amount of the original write-down, so that the new carrying amount will always be the lower of the cost and the revised net realisable value. *[IAS 2.33]*.

Practical example 3-2 below shows how CRH plc describes its inventory valuation policies, including estimation of net realisable value.

Practical example 3-2: CRH plc (2022) **Republic of Ireland**

2022 Annual Report and Form 20-F [extract]
Accounting Policies [extract]
Other Significant Accounting Policies [extract]

Inventories – Note 16

Inventories are stated at the lower of cost and net realisable value. Cost is based on the first-in/first-out principle (and weighted average, where appropriate) and includes all expenditure incurred in acquiring the inventories and bringing them to their present location and condition. Raw materials are valued on the basis of purchase cost on a first-in/first-out basis. In the case of finished goods and work-in-progress, cost includes direct materials, direct labour and attributable overheads based on normal operating capacity and excludes borrowing costs.

Net realisable value is the estimated proceeds of sale less all further costs to completion, and less all costs to be incurred in marketing, selling and distribution. Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made, taking into consideration fluctuations of price or cost directly relating to events occurring after the end of the period, the likelihood of short-term changes in buyer preferences, product obsolescence or perishability (all of which are generally low given the nature of the Group's products) and the purpose for which the inventory is held.

Climate change and policy risks and uncertainties as set out on page 142 may also result in additional costs, changes to selling prices or product obsolescence impacting the valuation of inventories in future years. However, due to the short inventory turnover cycle there were no material write-downs of inventories required in this regard during the current financial year.

Materials and other supplies held for use in the production of inventories are not written down below cost if the finished goods, in which they will be incorporated, are expected to be sold at or above cost.

3.4 Measurement of crypto-assets within the scope of IAS 2

As discussed in section 2.3.1.F above, crypto-assets each have their own terms and conditions and, as a result, the holders of a crypto-asset will need to evaluate these terms and conditions to determine which IFRS accounting standard recognition and measurement requirements should be applied. In some cases, crypto-assets may meet the definition of inventory.

The value of holdings of cryptocurrencies and other crypto-assets can fluctuate significantly. Where the fair value of a cryptocurrency or other crypto-asset holding has changed significantly after the end of the reporting period, the holder should consider whether the changes in fair value are of such significance that non-disclosure could influence the economic decisions of users of the financial statement. If so, the holder should consider whether the change in fair value should be disclosed as a non-adjusting post balance sheet event, in accordance with IAS 10 *Events after the Reporting Period*.[11] IAS 10 is discussed in Chapter 34.

3.4.1 Cost or lower net realisable value

The costs of purchased crypto-asset inventories would typically comprise the purchase price, irrecoverable taxes and other costs directly attributable to the acquisition of the inventory (for example blockchain processing fees). Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the crypto-asset inventories to their present location and condition. The cost of inventory excludes anticipated selling costs as well as storage expenses *[IAS 2.16]* (for example costs of holding a wallet or other crypto-account), unless storage between production stages is necessary in the production process, which is unlikely to apply to crypto-assets.

The cost of crypto-assets recorded as inventory may not be recoverable if those crypto-assets have become wholly or partially obsolete (due to declining interest in the crypto-asset or its application) or if their selling prices have declined. Similarly, the cost of crypto-asset inventory may not be fully recoverable if the estimated costs to sell them have increased.

An entity holding crypto-asset inventory will need to estimate the net realisable value at each reporting period. For crypto-assets quoted on a crypto-asset exchange, the net realisable value would typically comprise the current quoted price less the estimated selling costs. Estimating selling costs for crypto-assets classified as inventory may present challenges for a holder as these selling costs can fluctuate significantly depending on the current demand for processing on the particular blockchain.

Where the net realisable value is below cost, the inventory should be written down to its net realisable value with the write-down being recorded in profit or loss. A previous write-down of inventory is reversed when circumstances have improved, but the reversal is limited to the amount previously written down so that the carrying amount never exceeds the original cost.

3.4.2 Fair value less costs to sell

In June 2019, the IFRS IC observed that an entity may act as a broker-trader of cryptocurrencies.[12]

While there is no definition of a commodity under IFRS accounting standards, crypto-assets that are fungible and immediately marketable at quoted prices could potentially be considered commodities if they were held by broker-traders. However, judgement should be exercised in determining whether a particular crypto-asset can be regarded as a commodity.

The quoted prices of crypto-assets may vary considerably between exchanges. A broker-trader measuring crypto-assets at fair value less costs to sell will need to determine the principal (or most advantageous) market for those assets, and whether they could enter into a transaction for the crypto-asset at the price in that market at the measurement date. Measuring fair value without an active market could be challenging for a crypto-asset that does not entitle the holder to an underlying good or service from an identifiable counterparty. As the crypto-asset is only able to generate cash flows through a sale to a third party, an entity that is unable to use a market approach may need to use less observable inputs. The determination of the principal (or most advantageous) market is discussed in Chapter 15 at section 5.

When a broker-trader measures its inventory at fair value less costs to sell, any changes in the recognised amount should be included in profit or loss for the period. *[IAS 2.3(b)]*. A broker-trader holder of a crypto-asset will need to estimate the costs to sell the crypto-asset at each reporting date, taking into consideration the transaction cost on the relevant blockchain and other fees required in order to convert the crypto-asset into cash. These fees could fluctuate significantly from period to period depending on the current demand for processing on the relevant blockchain.

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11 *IFRIC Update*, June 2019, available on the IFRS Foundation's website.

12 *IFRIC Update*, June 2019, available on the IFRS Foundation's website.

4 Real estate inventory

4.1 Classification of real estate as inventory

Many real estate businesses develop and construct residential properties for sale, and these developments often consist of several units. The strategy is to make a profit from the development and construction of the property rather than to make a profit in the long term from general price increases in the property market. The intention is to sell the property units as soon as possible following their construction and the sale is therefore in the ordinary course of the entity's business. When construction is complete it is not uncommon for individual property units to be leased at market rates to earn revenue to partly cover expenses such as interest, management fees, and real estate taxes. Large-scale buyers of commercial property, such as insurance companies, are often reluctant to buy unless a property has been let, as this assures immediate cash flows from the investment.

How we see it

Our view is that if it is in the entity's ordinary course of business (supported by its strategy) to hold property for short-term sale rather than for long-term capital appreciation or rental income, the entire property (including the leased units) should be accounted for and presented as inventory. This will continue to be the case as long as it remains the intention to sell the property in the short term.

Rent received should be included in other income as it does not represent a reduction in the cost of inventory. The entity does not capitalise rental and related income generated by tenants against the cost of development as this is incidental to the development of the property and not a 'by-product' of the development process.

Investment property is defined in IAS 40 as "property … held … to earn rentals or for capital appreciation or both, rather than for … use in the production or supply of goods or services or for administrative purposes; or … sale in the ordinary course of business". *[IAS 40.5]*. Therefore, in the case outlined above, the property does not meet the definition of investment property. Properties intended for sale in the ordinary course of business, whether leased out or not, are outside the scope of IAS 40. However, if a property is not intended for sale, IAS 40 requires it to be transferred from inventory to investment property when there is a change in use. The change can be evidenced by the commencement of an operating lease to another party (see Chapter 20 at section 9).

4.2 Costs of real estate inventory

4.2.1 Allocation of costs to individual units in multi-unit developments

A real estate developer of a multi-unit complex will be able to track and record various costs that are specific to individual units, such as individual fit out costs. However, there will also be various costs that are incurred which are not specific to any individual unit, such as the costs of land and any shared facilities, and a methodology will be required to allocate these costs to the individual units. This will of course impact the profit that is recognised on the sale of each individual unit.

There are two general approaches to this allocation:

(i) The first approach is to allocate these non-unit specific costs based on some relative cost basis. A reasonable proxy of relative cost is likely to be the size of each unit and hence an appropriate methodology would be to allocate the non-unit specific cost per square metre to the individual units based upon the floor area of each unit. Another proxy of (total) relative cost may be the use of the specific cost of each unit. Marking up the specific cost that is attributable to each unit by a fixed percentage so as to cover and account for the non-unit specific costs would also seem reasonable. This relative cost approach is consistent with the guidance under IAS 2 in respect of allocation of overheads which requires a "systematic allocation of fixed and variable production overheads". *[IAS 2.12]*.

(ii) The second approach would be to allocate these non-unit specific costs based on the relative sales value of each unit. This methodology is specifically referred to by the standard in the context of a production process that results in more than one product being produced simultaneously. *[IAS 2.14]*.

How we see it

In our view, both approaches discussed above are acceptable under IAS 2 when allocating non-unit specific costs to individual units in a multi-unit complex. Whichever approach is adopted it must be applied consistently. In addition, the developer must initially, as far as is practicable, segregate the non-unit specific costs between any commercial, retail and residential components before applying these methodologies.

These approaches are only appropriate when the entity constructs the units in the multi-unit real estate development simultaneously, as part of the same construction process, and allocates costs arising to the units on a rational and consistent basis.

4.2.2 Property demolition and lease costs

During the course of a property redevelopment project, an existing building may need to be demolished in order for the new development to take place. Should the cost of the building to be demolished be capitalised as part of the construction cost for the new building or should the cost be charged to profit or loss?

In all such cases an entity will need to exercise judgement in assessing the facts and circumstances. There are three distinct scenarios to consider:

(a) The entity is the owner-occupier, in which case the matter falls under IAS 16 (see chapter 19 at section 4.1.7)

(b) The entity holds the property to earn rentals or for capital appreciation, in which case the matter falls under IAS 40 (see chapter 20 at section 4.2.1)

Or

(c) The entity sells such properties in its ordinary course of business

If it is the strategy of the developer to sell the developed property after construction, the new development falls within the scope of IAS 2, as it would be considered held for sale in the ordinary course of business by the developer. If the entity purchased the property in question consisting of land and an old building, the entity classifies the land and building as two separate items of property, plant and equipment under IAS 16, and measures the land and building based on cost, allocated to the land and building on a relative fair value basis, consistent with the measurement at initial recognition in IFRS 3.2(b). *[IFRS 3.2(b)]*.

How we see it

In our view, the cost of the old building as well as demolition costs and costs of developing the new one would be treated as inventory if:

- At the time of purchase, it is the entity's intention to demolish the existing building

  And

- The building will not be used or leased out prior to its demolition

The cost of the new development will still be subject to the normal 'lower of cost and net realisable value' requirements.

If the property in question was purchased in a prior reporting period and subsequently occupied, the land and building would have been separately recognised in accordance with the requirements of IAS 16 in that period. Depending on the facts and circumstances, if the existing building was unusable, or likely to be demolished by any party acquiring it, the entity might have concluded that a large part of the purchase price related to the land. In such cases, the carrying amount of the existing building will likely be minimal. If the existing building is demolished in subsequent periods in order for the new development to take place, the carrying amount of the old building will be derecognised in accordance with IAS 16 (see Chapter 19 at section 4.1.7).

How we see it

Whilst IAS 16 requires that land and buildings should be accounted for separately, even when they are acquired together, we believe that it may be appropriate for the acquirer to allocate a large proportion of the purchase price to the land if the existing building is unusable or likely to be demolished.

When the building is demolished under the circumstances described above, our view is that its carrying amount which is derecognised in accordance with IAS 16 cannot be capitalised as part of the cost of the new building.

If a new development within the scope of IAS 2 is being constructed on land that is leased, the entity needs to determine whether the depreciation charge relating to the right-of-use asset represents a cost of conversion in bringing the inventories to their present location and condition as specified in IAS 2.12. If the entity concludes that this is the case, a systematic allocation of the depreciation of the right-of-use asset relating to that leased land used in the development process is included in the cost of the inventories. *[IAS 2.12]*.

5 Recognition in profit or loss

IAS 2 states the following: *[IAS 2.34]*

Extract from IAS 2	
34	**When inventories are sold, the carrying amount of those inventories shall be recognised as an expense in the period in which the related revenue is recognised. The amount of any write-down of inventories to net realisable value and all losses of inventories shall be recognised as an expense in the period the write-down or loss occurs. The amount of any reversal of any write-down of inventories, arising from an increase in net realisable value, shall be recognised as a reduction in the amount of inventories recognised as an expense in the period in which the reversal occurs.**

The standard specifies that when inventory is sold, the carrying amount of the inventory must be recognised as an expense in the period in which the revenue is recognised. Judging when to recognise revenue, and therefore, when to recognise the related cost of sales, is one of the more complex accounting issues that can arise (see Chapter 28 for further discussions on this).

Consignment stock and sale and repurchase agreements are discussed in section 2.3.1.H above, and sales with a right of return are discussed in section 2.3.1.I above. In addition, revenue recognition in accordance with IFRS 15 is dealt with in Chapter 28, to which reference should be made in considering such issues.

Inventory used to create another asset, for instance into a self-constructed item of property, plant or equipment, would form part of the cost of that asset. Subsequently these costs are expensed through the depreciation of that item of property, plant and equipment during its useful life. *[IAS 2.35]*.

Any write-downs or losses of inventory must be recognised as an expense when the write-down or loss occurs. Reversals of previous write-downs are recognised as a reduction in the inventory expense recognised in the period in which the reversal occurs. *[IAS 2.34]*.

6 Disclosure requirements of IAS 2

6.1 General requirements

The following are the IAS 2 disclosure requirements: *[IAS 2.36]*

Extract from IAS 2

36 The financial statements shall disclose:

(a) the accounting policies adopted in measuring inventories, including the cost formula used;

(b) the total carrying amount of inventories and the carrying amount in classifications appropriate to the entity;

(c) the carrying amount of inventories carried at fair value less costs to sell;

(d) the amount of inventories recognised as an expense during the period;

(e) the amount of any write-down of inventories recognised as an expense in the period in accordance with paragraph 34;

(f) the amount of any reversal of any write-down that is recognised as a reduction in the amount of inventories recognised as expense in the period in accordance with paragraph 34;

(g) the circumstances or events that led to the reversal of a write-down of inventories in accordance with paragraph 34; and

(h) the carrying amount of inventories pledged as security for liabilities.

IAS 2 does not specify the precise classifications that must be used to comply with the requirements in IAS 2.36(b) as shown above. However, it states that "information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users", and suggests suitable examples of common classifications such as merchandise, production supplies, materials, work in progress, and finished goods. *[IAS 2.37]*.

Practical example 6-1 below shows how Unilever PLC disclosed the relevant information.

Practical example 6-1: Unilever PLC (2022) — United Kingdom

Unilever Annual Report and Accounts 2022 [extract]

Notes to the Consolidated Financial Statements Unilever Group [extract]

12. Inventories

Inventories are valued at the lower of weighted average cost and net realisable value. Cost comprises direct costs and, where appropriate, a proportion of attributable production overheads. Net realisable value is the estimated selling price less the estimated costs necessary to make the sale.

Inventories	€ million 2022	€ million 2021
Raw materials and consumables	2,062	1,598
Finished goods and goods for resale	4,248	3,393
Total inventories	6,310	4,991
Provision for inventories	(379)	(308)
	5,931	4,683

Provision for inventories	€ million 2022	€ million 2021
1 January	308	284
Charge to income statement	164	65
Reduction/(releases)	(66)	(56)
Currency translations	(12)	9
Others[a]	(15)	6
31 December	379	308

(a) Others include the amount relating to the acquisition/disposal of businesses and transfers.

Inventories with a value of €189 million (2021: €163 million) are carried at net realisable value, this being lower than cost. During 2022, a total expense of €407 million (2021: €281 million) was recognised in the income statement for inventory write-downs and losses.

The amount of inventory recognised as an expense in the period is normally included in cost of sales. This category includes unallocated production overheads and abnormal costs as well as the costs of inventories that have been sold. The circumstances of the entity may warrant the inclusion of distribution or other costs in cost of sales. *[IAS 2.38]*. Hence when a company presents its profit or loss based upon this IAS 1 'function of expense' or 'cost of sales' method it will normally be disclosing costs that are greater than those that have previously been classified as inventory.

Practical example 6-2 below shows how Stora Enso Oyj classified its inventories in its 2022 financial statements.

Practical example 6-2: Stora Enso Oyj (2022) **Republic of Finland**

Annual Report 2022 [extract]

Notes to the consolidated financial statements [extract]

Note 16 Inventories

Accounting principles

Inventories are reported at lower of cost and net realisable value with the cost determined by the first-in first-out (FIFO) method or, alternatively, by the weighted average cost where it approximates FIFO. The same cost formula is used for all inventories having a similar nature and use to the Group. The cost of finished goods and work in progress comprises raw material, direct labour, depreciation, other direct costs and related production overheads, but excludes interest expenses. Net realisable value is the estimated selling price in the ordinary course of business, less the costs of completion and sale.

Where market conditions result in the manufacturing costs of a product exceeding its net realisable value, a valuation allowance is made. Valuation allowances are also made for old, slow moving and obsolete finished goods and spare parts when needed. Such valuation allowances are deducted from the carrying value of the inventories in the consolidated statement of financial position.

	As at 31 December	
EUR million	**2022**	**2021**
Materials and supplies	501	422
Work in progress	84	97
Finished goods	962	689
Spare parts and consumables	337	331
Other inventories	25	23
Advance payments and cutting rights	63	55
Obsolescence allowance - spare parts and consumables	-103	-125
Obsolescence allowance - finished goods	-19	-9
Net realisable value allowance	-40	-5
Total	**1,810**	**1,478**

EUR 6,576 (EUR 5,740) million of inventories in total have been expensed during the year. EUR 78 (EUR 29) million of inventory write-downs have been recognised as an expense. EUR 9 (EUR 16) million have been recognised as a reversal of previous write-downs.

Some entities adopt a format for profit or loss that results in amounts other than the cost of inventories being disclosed as an expense during the period. This will happen if an entity presents an analysis of expenses using a classification based on the nature of expenses. The entity then discloses the costs recognised as an expense for raw materials and consumables, labour costs and other costs together with the amount of the net change in inventories for the period. *[IAS 2.39]*.

Formats for the presentation of profit or loss are discussed in Chapter 3.

The requirement to disclose the amount of any write-down of inventories recognised as an expense in the period in IAS 2.36(e) only relates to write-downs of inventory held at the end of the reporting period. The notion of 'write-down' is used in the context of the lower of cost and net realisable value test. An entity only performs this test at a reporting date.

6.2 Additional disclosure requirements for crypto-assets

In June 2019, the IFRS IC noted the following disclosure requirements in the context of holdings of cryptocurrencies in addition to the disclosures required by IAS 2 for cryptocurrencies held for sale in the ordinary course of business (see section 6 above):

- IAS 38 disclosures for holdings of cryptocurrencies to which it applies IAS 38 (see Chapter 18).
- IFRS 13 disclosures if an entity measures its holdings of cryptocurrencies at fair value less costs to sell (see Chapter 15).
- IAS 1 disclosures when an entity has made judgements regarding its accounting for holdings of cryptocurrencies, if they are part of the judgements that had the most significant effect on the amounts recognised in the financial statements (see chapter 3).[13]
- IAS 10 disclosures for any material non-adjusting events after the reporting period, including information about the nature of the event and an estimate of its financial effect (or a statement that such an estimate cannot be made) (see Chapter 34). For example, an entity holding cryptocurrencies would consider whether changes in the fair value of those holdings after the reporting period are of such significance that non-disclosure could influence the economic decisions that users of the financial statements make on the basis of the financial statements.[14]

13 IFRS 18 *Presentation and Disclosure in Financial Statements*, which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted) was issued by the IASB in April 2024. See Chapter 4 for further details on the new concepts and requirements of IFRS 18.

14 *IFRIC Update*, June 2019, available on the IFRS Foundation's website.

Appendix A - Defined terms

Extract from IAS 2

6 The following terms are used in this Standard with the meanings specified:

Inventories are assets:

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

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

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13 *Fair Value Measurement*.)

Chapter 24 Leases

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Overview

This chapter discusses the requirements of IFRS 16 *Leases* and how the standard is to be applied. IFRS 16 gives the accounting requirements for the recognition, measurement, presentation, and disclosure of leases and applies to both lessees and lessors. It has a single lessee accounting model and requires lessees to recognise assets and liabilities for most leases on their statements of financial position. Lessors, however, classify leases as operating or finance leases depending on whether the risks and rewards incidental to ownership of the underlying asset are transferred to the customer and account for the lease accordingly.

Under IFRS 16, leases are accounted for based on a 'right-of-use model'. The model reflects that, at the commencement date, a lessee has a financial obligation to make lease payments to the lessor for its right to use the underlying asset during the lease term. The lessor conveys that right to use the underlying asset at lease commencement, which is the time when it makes the underlying asset available for use by the lessee.

This chapter discusses how IFRS 16 is applied and is intended to help entities consider the effects of applying it.

What you need to know

- IFRS 16 requires lessees to put most leases on their statements of financial position.
- Lessees apply a single accounting model for all leases, with certain exemptions.
- Lessors classify leases as operating or finance leases depending on whether the risks and rewards incidental to ownership of the underlying asset are transferred to the customer and account for the lease accordingly.
- Entities need to focus on whether an arrangement contains a lease or a service agreement because there are significant differences in the accounting. Although we believe that the assessment of whether a contract contains a lease is straightforward in most arrangements, judgement may be required in applying the definition of a lease to certain arrangements, particularly those that include significant services.

1 Introduction

The International Accounting Standards Board (IASB or the Board) issued IFRS 16 after joint deliberations with the Financial Accounting Standards Board (FASB), which issued a similar standard (ASC 842 Leases). However, there are significant differences between the IASB and FASB standards (e.g., lessees classify leases as finance or operating leases under the FASB standard). These differences will result in certain transactions being accounted for differently under IFRS accounting standards and US GAAP. The key differences between IFRS 16 and ASC 842 are summarised in this chapter in the section in which they arise (see Appendix D for an overview).

2 Objective and scope of IFRS 16

2.1 Objective of IFRS 16

IFRS 16 sets out the principles for the recognition, measurement, presentation, and disclosure of leases. The objective is to ensure that lessees and lessors provide relevant information in a manner that faithfully represents those transactions. This information gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of an entity. *[IFRS 16.1]*.

IFRS 16 requires an entity to consider the terms and conditions of contracts and all relevant facts and circumstances, and to apply the standard consistently to contracts with similar characteristics and in similar circumstances. *[IFRS 16.2]*.

2.2 Scope of IFRS 16

IFRS 16 paragraph 3 applies to all leases, including leases of right-of-use assets in a sublease, except for the following:

(a) Leases to explore for, or use, minerals, oil, natural gas and similar non-regenerative resources (see Chapter 39)

(b) Leases of biological assets within the scope of IAS 41 *Agriculture* held by a lessee (see Chapter 38 at section 2.3.5)

(c) Service concession arrangements within the scope of IFRIC 12 *Service Concession Arrangements* (see Chapter 26). Entities should evaluate the applicability of IFRIC 12 before evaluating whether an arrangement contains a lease.

(d) Licences of intellectual property granted by a lessor within the scope of IFRS 15 *Revenue from Contracts with Customers* (see Chapter 28 at section 8)

(e) Rights held by a lessee under licensing agreements within the scope of IAS 38 *Intangible Assets* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights (see Chapter 18) *[IFRS 16.3]*

A lessee may, but is not required to, apply IFRS 16 to leases of intangible assets not covered by the exceptions above. *[IFRS 16.4]*. Therefore, a lessee could choose to account for leases of such intangible assets under IFRS 16 (see Chapter 18).

There are differing views about whether other intangible assets (for example, a licence of software), not specifically referred to in IFRS 16.3(e) above are excluded from the scope of IFRS 16 based on interpretations of that paragraph. If an entity determines that an intangible asset is not excluded from the scope of IFRS 16, IFRS 16.4 permits, but does not require, an entity to account for the intangible asset as a lease.

If a cloud computing arrangement contains a lease of an asset other than a licence of software (or the entity has determined that a licence of software is not excluded from the scope of IFRS 16 and has elected to account for leases of intangible assets under IFRS 16), an entity should apply the provisions of IFRS 16 to the cloud computing arrangement. This includes identifying and separating lease and non-lease components and allocating contract consideration, which is discussed in section 3.2.2 below.

FASB differences

As discussed above, a lessee may, but is not required to, apply IFRS 16 to leases of intangible assets, other than rights held by a lessee under licensing agreements within the scope of IAS 38 for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights. Lessors are required to apply IFRS 16 to leases of intangible assets, except for licences of intellectual property that are in the scope of IFRS 15. All leases of intangible assets are excluded from the scope of ASC 842.

2.3 Recognition exemptions

IFRS 16 allows a lessee to elect not to apply the recognition requirements to:

(a) Short-term leases

And

(b) Leases for which the underlying asset is of low value *[IFRS 16.5]*

These recognition exemptions are discussed further in section 5.1 below.

3 What is a lease?

IFRS 16 defines a lease as a contract, or part of a contract, which conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration. *[IFRS 16 Appendix A]*. The determination of whether an arrangement contains a lease is performed at the inception of the contract. *[IFRS 16.9]*.

The assessment of whether a contract is or contains a lease will be straightforward in most arrangements. However, judgement may be required in applying the definition of a lease to certain arrangements. For example, in contracts that include significant services, determining whether the contract conveys the right to direct the use of an identified asset may be challenging. We discuss this further below.

3.1 Determining whether an arrangement contains a lease

Extract from IFRS 16

Appendix A
Defined terms

lease	A contract, or part of a contract, that conveys the right to use an asset (the **underlying asset**) for a period of time in exchange for consideration.
period of use	The total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time).

Terms defined in other Standards and used in this Standard with the same meaning

contract	An agreement between two or more parties that creates enforceable rights and obligations.

[IFRS 16 Appendix A].

At inception of a contract, an entity assesses whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. *[IFRS 16.9]*. See section 3.1.2 below for additional discussion on identified assets.

A period of time may be described in terms of the amount of use of an identified asset (for example, the number of production units that an item of equipment will be used to produce). *[IFRS 16.10]*.

To assess whether a contract conveys the right to control the use of an identified asset for a period of time, an entity assesses whether, throughout the period of use, the customer has both of the following:

(a) The right to obtain substantially all of the economic benefits from use of the identified asset (see section 3.1.4 below).

And

(b) The right to direct the use of the identified asset (see section 3.1.5 below). *[IFRS 16.B9]*.

If the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term. *[IFRS 16.B10]*.

An entity assesses whether a contract contains a lease for each potential separate lease component. *[IFRS 16.B12]*. See section 3.2 below.

FASB differences

In accordance with ASC 842, entities classify and account for related party leases (including sale and leaseback transactions) based on the legally enforceable terms and conditions of the lease. In addition, private companies and certain not-for-profit entities can elect a practical expedient to use the written terms and conditions of a common control arrangement to determine whether a lease exists and to classify and account for the lease. IFRS 16 does not include guidance on related party leases or a practical expedient for common control arrangements.

3.1.1 Joint arrangements

Entities often enter into joint arrangements with other entities for certain activities (e.g., exploration of oil and gas fields, development of pharmaceutical products).

A contract for the use of an asset by a joint arrangement might be entered into in a number of different ways, including:

- Directly by the joint arrangement, if the joint arrangement has its own legal identity.
- By each of the parties to the joint arrangement (i.e., the lead operator and the other parties, commonly referred to as the non-operators) individually signing the same arrangement.
- By one or more of the parties to the joint arrangement on behalf of the joint arrangement. Generally, this would be evidenced in the contract and the parties to the joint arrangement would have similar rights and obligations as they would if they individually signed the arrangement. In these situations, the facts and circumstances, as well as the legal position of each entity, need to be evaluated carefully.
- By the lead operator of the joint arrangement in its own name, i.e., as principal. This may occur when the lead operator leases equipment which it then uses in fulfilling its obligations as the lead operator of the joint arrangement and/or across a range of unrelated activities, including other joint arrangements with unrelated activities, such as with other joint operating parties.

A contract to receive goods or services may be entered into by a joint arrangement or on behalf of a joint arrangement, as defined by IFRS 11 *Joint Arrangements*. In this case, the joint arrangement is considered to be the customer in the contract. *[IFRS 16.B11]*. Accordingly, in determining whether such a contract contains a lease, an assessment needs to be made as to which party (e.g., the joint arrangement or the lead operator) has the right to control the use of an identified asset throughout the period of use.

If the parties to the joint arrangement collectively have the right to control the use of an identified asset throughout the period of use as a result of their collective control of the operation, the joint arrangement is the customer to the contract that may contain a lease. It would be inappropriate to conclude that the contract does not contain a lease on the grounds that each of the parties to the joint arrangement either has rights to a non-physically distinct portion of an underlying asset and, therefore, does not have the right to substantially all of the economic benefits from the use of that underlying asset or does not unilaterally direct its use. Determining if the parties to the joint arrangement collectively have the right to control the use of an identified asset throughout the period of use would require a careful analysis of the rights and obligations of each party.

In the first three scenarios above, if it has been determined that a contract is, or contains, a lease, each of the parties to the joint arrangement (i.e., the joint operators comprising the lead operator and the non-operators) will account for their respective interests in the joint arrangement (including any leases) under IFRS 11.20 to 23. Therefore, they will account for their individual share of any right-of-use assets and lease liabilities, and associated depreciation and interest.

In the fourth scenario (i.e., where the lead operator enters the arrangement in its own name), the lead operator will need to assess whether the arrangement is, or contains, a lease. If the lead operator controls the use of the identified asset, it would recognise the entire right-of-use asset and lease liability on its statement of financial position. This would be the case even if it is entitled to bill the non-operator parties their proportionate share of the costs under the joint operating agreement (JOA).

If the lead operator determines that it is the lessee, it would also evaluate whether it has entered into a sublease with the joint arrangement (as the customer to the sublease). For example, the lead operator may enter into a five-year equipment lease with a supplier, but may then enter into a two-year arrangement with one of its joint arrangements, thereby yielding control of the right to use the equipment to the joint arrangement during the two-year period. In many cases, the lead operator will not meet the requirements to recognise a sublease because the arrangement does not create legally enforceable rights and obligations that convey the right to control the use of the asset to the joint arrangement. However, the conclusion as to whether the joint arrangement is a customer, i.e., the lessee in a contract with a lead operator, by virtue of the JOA, would be impacted by the individual facts and circumstances.

If the lead operator subleases an asset to the joint arrangement, IFRS 11 requires the non-operators to recognise their respective share of the joint arrangement's right-of-use asset and lease liability and the lead operator accounts for its sublease to the joint arrangement separately. However, if there is no sublease, the non-operators recognise joint interest payables when incurred for their share of the costs incurred by the lead operator in respect of the leased asset.

In limited cases, the lead operator and non-operators will enter into a contract directly with the supplier, in which the lead operator and non-operators are proportionately liable for their share of the arrangement. In this case, the parties with interests in the joint operation would recognise their proportionate share of the leased asset, liability and lease expense in accordance with IFRS 11.

Frequently asked questions

Question 3-1: Should the lead operator in an unincorporated joint operation recognise in full the lease liability for a contract into which it alone has the primary obligation to make payments to the lessor?

In March 2019, the IFRS IC published an agenda decision regarding how a lead operator (the party responsible for undertaking the operations on behalf of the other joint operators) of a joint operation (JO), which is not structured through a separate vehicle, recognises a lease liability. The question specifically focused on situations where the lead operator, as the sole signatory, enters into a lease contract with a third-party supplier (lessor) for an item of property, plant and equipment that will be operated jointly as part of the JO's activities. The lead operator has the right to recover a share of the lease costs from the other joint operators in accordance with the contractual and other arrangements governing the JO.

The IFRS IC concluded, that in accordance with IFRS 11, a joint operator identifies and recognises both:

(a) Liabilities it incurs in relation to its interest in the JO

And

(b) Its share of any liabilities incurred jointly with other parties to the joint arrangement

The IFRS IC observed that identifying the liabilities that a joint operator incurs and those incurred jointly, requires an assessment of the terms and conditions in all contractual arrangements that relate to the JO, including consideration of the laws pertaining to those agreements. The IFRS IC further observed, in accordance with IFRS 11, the liabilities a joint operator recognises include those for which it has primary responsibility. Therefore, as sole signatory and where a lead operator has primary responsibility for a lease, the lead operator recognises 100% of the lease liability.

The IFRS IC also highlighted the importance of disclosing information about joint operations that is sufficient for a user of financial statements to understand the activities of the joint operation and a joint operator's interest in that operation. Therefore, the IFRS IC concluded that the principles and requirements in IFRS accounting standards provide an adequate basis for the lead operator to identify and recognise its liabilities in relation to its interest in a JO and did not add this matter to its standard-setting agenda.

Joint arrangements are particularly common in extractive industries and the implications of this agenda decision are discussed further in Chapter 39 at section 18.

3.1.2 Identified asset

An arrangement only contains a lease if there is an identified asset.

An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer. *[IFRS 16.B13]*.

Illustration 3-1: Implicitly specified asset

Customer X enters into a five-year contract with Supplier Y for the use of rolling stock specifically designed for Customer X. The rolling stock is designed to transport materials used in Customer X's production process and is not suitable for use by other customers. The rolling stock is not explicitly specified in the contract, but Supplier Y owns only one rolling stock that is suitable for Customer X's use. If the rolling stock does not operate properly, the contract requires Supplier Y to repair or replace the rolling stock. Assume that Supplier Y does not have a substantive substitution right. Refer to section 3.1.3.

Analysis: The rolling stock is an identified asset. While the rolling stock is not explicitly specified in the contract (e.g., by serial number), it is implicitly specified because Supplier Y must use it to fulfil the contract.

Illustration 3-2: Identified asset - implicitly specified at the time the asset is made available for use by the customer

Customer X enters into a five-year contract with Supplier Y for the use of a car. The specification of the car is specified in the contract (brand, type, colour, options etc.). At inception of the contract the car is not yet built.

Analysis: The car is an identified asset. Although the car cannot be identified at inception of the contract, it is apparent that it will be identifiable at the commencement of the lease. The car is identified by being implicitly specified at the time that it is made available for use by the customer (i.e., at the commencement date).

A capacity portion of an asset is an identified asset if it is physically distinct (e.g., a floor of a building). A capacity or other portion of an asset that is not physically distinct (e.g., a capacity portion of a fibre optic cable) is not an identified asset unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset. *[IFRS 16.B20]*.

Some contracts allow the use of an identified asset for specified, non-consecutive periods. This is discussed further at section 4.4.1.A below.

Some contracts involve a dedicated cable that is part of the larger network infrastructure (e.g., unbundled network element arrangements for the 'last mile' to a customer location, 'special access' arrangements for a dedicated connection between two locations). IFRS 16 does not specify or provide examples that clarify that these arrangements are identified assets. However, the FASB's standard ASC 842 includes an additional example that is similar to a dedicated cable (i.e., a segment of a pipeline that connects a single customer to a larger pipeline). The example clarifies that such segments of a larger pipeline are identified assets.

How we see it

As the IASB has stated that both it and the FASB have reached the same conclusions on the definition of a lease, we believe that, under IFRS 16, the last mile of a network that connects a single customer to a larger network may be an identified asset. However, such arrangements may, or may not, meet the definition of a lease. Entities will need to consider the facts and circumstances of each arrangement to determine whether there is an identified asset and whether the arrangement meets the definition of a lease.

Illustration 3-3: Identified asset - physically distinct portion of a larger asset

Customer X enters into a 12-year contract with Supplier Y for the right to use three fibres within a fibre optic cable between New York and London. The contract identifies three of the cable's 20 fibres for use by Customer X. The three fibres are dedicated solely to Customer X's data for the duration of the contract term. Assume that Supplier Y does not have a substantive substitution right (refer to section 3.1.3).

Analysis: The three fibres are identified assets because they are physically distinct and explicitly specified in the contract.

Illustration 3-4: Identified asset - capacity portion of an asset

Scenario A

Customer X enters into a five-year contract with Supplier Y for the right to transport oil from Country A to Country B through Supplier Y's pipeline. The contract provides that Customer X will have the right to use of 95% of the pipeline's capacity throughout the term of the arrangement.

Analysis: The capacity portion of the pipeline is an identified asset. While 95% of the pipeline's capacity is not physically distinct from the remaining capacity of the pipeline, it represents substantially all of the capacity of the entire pipeline and thereby provides Customer X with the right to obtain substantially all of the economic benefits from use of the pipeline.

Scenario B

Assume the same facts as in Scenario A, except that Customer X has the right to use 60% of the pipeline's capacity throughout the term of the arrangement.

Analysis: The capacity portion of the pipeline is not an identified asset because 60% of the pipeline's capacity is less than substantially all of the capacity of the pipeline. Customer X does not have the right to obtain substantially all of the economic benefits from use of the pipeline.

Land easements or rights of way are rights to use, access or cross another entity's land for a specified purpose. For example, a land easement might be obtained for the right to construct and operate a pipeline or other assets (e.g., railway line, utility pipes or telecommunication lines) over, under or through an existing area of land or body of water while allowing the landowner continued use of the land for other purposes (e.g., farming), as long as the landowner does not interfere with the rights conveyed in the land easement. A land easement may be perpetual or for a specified term. It may provide for exclusive or non-exclusive use of the land and may be prepaid or paid over a defined term.

Perpetual easements are outside the scope of IFRS 16, as the definition of a lease requires the contract to be for a period of time. Therefore, entities must carefully evaluate easement contracts to determine whether the contract is perpetual or for a period of time. Examples of contracts that may appear perpetual but are term-based include:

- Very long-term contracts (e.g., the FASB indicated in the Basis for Conclusions (BC113) to ASC 842 that very long-term leases of land (e.g., 999 years) are in the scope of ASC 842).
- Contracts with a stated non-cancellable lease term that 'automatically renews' if the lessee pays a periodic renewal fee. This is an in-substance fixed term contract with optional renewal periods.
- Contracts that define the period of use as the period over which the assets are used (e.g., as long as natural gas flows through a gathering system) are a fixed term contract (i.e., terminated when production ceases) rather than a perpetual contract because the gas reserves will ultimately be depleted.

When determining whether a contract for a land easement or right of way is a lease, entities will need to assess whether there is an identified asset and whether the customer obtains substantially all of the economic benefits of the identified asset and has the right to direct the use of that asset throughout the period of use.

Frequently asked questions

Question 3-2: Does IFRS 16 apply to the right to place an oil pipeline in underground space for a period of time in exchange for consideration?

In June 2019, the IFRS IC discussed a contract for subsurface rights. In the contract described, a pipeline operator obtains the right to place an oil pipeline in underground space for 20 years in exchange for consideration. The contract specifies the exact location and dimensions (path, width and depth) of the underground space within which the pipeline will be placed. The landowner retains the right to use the surface of the land above the pipeline, but it has no right to access or otherwise change the use of the specified underground space throughout the 20-year period of use. The customer has the right to perform inspection, repairs and maintenance work (including replacing damaged sections of the pipeline when necessary).

The IFRS IC noted the following in the agenda decision:

- Paragraph 3 of IFRS 16 requires an entity to apply IFRS 16 to all leases, with limited exceptions. In the contract described in the request, none of the exceptions in IFRS 16.3 and 4 apply (see section 2.2 above). In particular, the IFRS IC noted that the underground space is tangible. Accordingly, if the contract contains a lease, IFRS 16 applies to that lease. If the contract does not contain a lease, the entity would then consider which other IFRS accounting standard applies.
- Applying IFRS 16.B9, to meet the definition of a lease, the customer must have both:
- The right to obtain substantially all the economic benefits from use of an identified asset throughout the period of use

  And
- The right to direct the use of the identified asset throughout the period of use
- The specified underground space is physically distinct from the remainder of the land. The contract's specifications include the path, width and depth of the pipeline, thereby defining a physically distinct underground space. The space being underground does not in itself affect whether it is an identified asset - the specified underground space is physically distinct in the same way that a specified area of space on the land's surface would be physically distinct. As the landowner does not have the right to substitute the underground space throughout the period of use, the IFRS IC concluded that the specified underground space is an identified asset as described in IFRS 16.B13 to B20.
- The customer has the right to obtain substantially all the economic benefits from use of the specified underground space throughout the 20-year period of use. The customer has exclusive use of the specified underground space throughout that period of use.
- The customer has the right to direct the use of the specified underground space throughout the 20-year period of use because the customer has the right to operate the asset throughout the period of use without the supplier having the right to change those operating instructions. How and for what purpose the specified underground space will be used (i.e., to locate the pipeline with specified dimensions through which oil will be transported) is predetermined in the contract. The customer has the right to operate the specified underground space by having the right to perform inspection, repairs and maintenance work. The customer makes all the decisions about the use of the specified underground space that can be made during the 20-year period of use.

Consequently, the IFRS IC concluded that the contract described in the request contains a lease as defined in IFRS 16. The customer would therefore apply IFRS 16 in accounting for that lease.

3.1.3 Substantive substitution rights

Even if an asset is specified, a customer does not have the right to use an identified asset if, at inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use (i.e., the total period of time that an asset is used to fulfil a contract with a customer, including the sum of any non-consecutive periods of time). *[IFRS 16 Appendix A]*. A supplier's right to substitute an asset is substantive when both of the following conditions are met:

- The supplier has the practical ability to substitute alternative assets throughout the period of use (e.g., the customer cannot prevent the supplier from substituting an asset and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time).
- The supplier would benefit economically from the exercise of its right to substitute the asset (i.e., the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset). *[IFRS 16.B14]*.

The IASB indicated in the Basis for Conclusions to IFRS 16 that the conditions above are intended to differentiate between substitution rights that result in a supplier controlling the use of an asset, rather than the customer, and rights that do not change the substance or character of the contract. *[IFRS 16.BC113]*.

If the supplier has a right or an obligation to substitute the asset only on or after either a particular date, or the occurrence of a specified event, the supplier's substitution right is not substantive because the supplier does not have the practical ability to substitute alternative assets throughout the period of use. *[IFRS 16.B15]*.

An entity's evaluation of whether a supplier's substitution right is substantive is based on facts and circumstances at inception of the contract. At inception of the contract, an entity should not consider future events that are not likely to occur. IFRS 16 provides the following examples of circumstances that, at inception of the contract, are not likely to occur and, thus, are excluded from the evaluation of whether a supplier's substitution right is substantive throughout the period of use:

- An agreement by a future customer to pay an above market rate for use of the asset
- The introduction of new technology that is not substantially developed at inception of the contract
- A substantial difference between the customer's use of the asset, or the performance of the asset, and the use or performance considered likely at inception of the contract
- A substantial difference between the market price of the asset during the period of use, and the market price considered likely at inception of the contract *[IFRS 16.B16]*

In many cases, it will be clear that the supplier will not benefit from the exercise of a substitution right because of the costs associated with substituting an asset. *[IFRS 16.BC113]*.The physical location of the asset may affect the costs associated with substituting the asset. For example, if an asset is located at the customer's premises, the cost associated with substituting it is generally higher than the cost of substituting a similar asset located at the supplier's premises. *[IFRS 16.B17]*. However, simply because a supplier concludes that the cost of substitution is not significant does not automatically mean that it would economically benefit from the right of substitution.

IFRS 16 further clarifies that a customer should presume that a supplier's substitution right is not substantive when the customer cannot readily determine whether the supplier has a substantive substitution right. *[IFRS 16.B19]*. This requirement is intended to clarify that a customer is not expected to exert undue effort to provide evidence that a substitution right is not substantive.

How we see it

We believe that suppliers cannot presume that their substitution rights are non-substantive because suppliers should have sufficient information to make such a determination.

Contract terms that allow or require a supplier to substitute alternative assets only when the underlying asset is not operating properly (e.g., a normal warranty provision) or when a technical upgrade becomes available do not create a substantive substitution right. *[IFRS 16.B18]*.

Illustration 3-5: Substitution rights

Scenario A

Assume that an electronic data storage provider (supplier) provides services through a centralised data centre, that involve the use of a specified server (Server No. 9). The supplier maintains many identical servers in a single accessible location and determines, at inception of the contract, that it is permitted to and can easily substitute another server without the customer's consent throughout the period of use. Further, the supplier would benefit economically from substituting an alternative asset, because doing this would allow the supplier to optimise the performance of its network at only a nominal cost. In addition, the supplier has made clear that it has negotiated this right of substitution as an important right in the arrangement, and the substitution right affected the pricing of the arrangement.

Analysis: The customer does not have the right to use an identified asset because, at the inception of the contract, the supplier has the practical ability to substitute the server and would benefit economically from such a substitution. However, if the customer could not readily determine whether the supplier had a substantive substitution right (e.g., there is insufficient transparency into the supplier's operations), the customer would presume the substitution right is not substantive and conclude that there is an identified asset.

Scenario B

Assume the same facts as in Scenario A except that Server No. 9 is customised, and the supplier does not have the practical ability to substitute the customised asset throughout the period of use. Additionally, it is unclear whether the supplier would benefit economically from sourcing a similar alternative asset.

Analysis: Because the supplier does not have the practical ability to substitute the asset and there is no evidence of economic benefit to the supplier for substituting the asset, the substitution right is non-substantive, and Server No. 9 would be an identified asset. In this case, neither of the conditions of a substitution right is met. As a reminder, both conditions must be met for the supplier to have a substantive substitution right.

Frequently asked questions

Question 3-3: Does a contract contain a lease when the supplier has substitution rights that are not substantive throughout the period of use?

In March 2023, the IFRS IC discussed a fact pattern in which a customer enters into a 10-year contract with a supplier for 100 similar batteries used in electric buses. The supplier has the practical ability to substitute alternative assets throughout the contract term and would be required to compensate the customer for any revenue lost or costs incurred while the substitution takes place. At inception of the contract, it is expected that the supplier would benefit economically from substituting the battery once it has been used for three years or more but not before.

The IFRS IC noted that the customer is able to benefit from the use of each battery together with a bus that is readily available to it, and each battery is neither highly dependent on, or highly interrelated with the other batteries in the contract. The supplier has the practical ability to substitute alternative batteries throughout the period of use. However, because the supplier is not expected to benefit economically from substituting a battery for at least the first three years of the contract, the supplier does not have a substantive substitution right throughout the period of use.

Therefore, in the fact pattern presented, the IFRS IC concluded that each battery is an identified asset. It follows that, in evaluating whether the contract contains a lease, the requirements in IFRS 16 need to be applied to assess whether, throughout the period of use, the customer has the right to obtain substantially all the economic benefits from use, and direct the use, of each battery.

3.1.4 Right to obtain substantially all of the economic benefits from use of the identified asset

To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use (e.g., by having exclusive use of the asset throughout that period). A customer can obtain economic benefits either directly or indirectly (e.g., by using, holding or subleasing the asset). Economic benefits include the asset's primary outputs (i.e., goods or services) and any by-products (e.g., renewable energy credits that are generated through the use of the asset), including potential cash flows derived from these items. Economic benefits also include benefits from using the asset that could be realised from a commercial transaction with a third party (e.g., subleasing the asset). *[IFRS 16.B21]*.

However, economic benefits arising from construction or ownership of the identified asset (e.g., tax benefits related to excess tax depreciation and investment tax credits) are not considered economic benefits derived from the use of the asset. Therefore, they are not considered when assessing whether a customer has the right to obtain substantially all of the economic benefits.

When assessing the right to obtain substantially all of the economic benefits from use of an asset, an entity considers the economic benefits that result from use of the asset within the defined scope of a customer's right to use the asset. For example:

(a) If a contract limits the use of a motor vehicle to only one particular territory during the period of use, an entity considers only the economic benefits from use of the motor vehicle within that territory, and not beyond.

Or

(b) If a contract specifies that a customer can drive a motor vehicle only up to a particular number of miles during the period of use, an entity considers only the economic benefits from use of the motor vehicle for the permitted mileage, and not beyond. *[IFRS 16.B22]*.

If a contract requires a customer to pay the supplier or another party a portion of the cash flows derived from use of an asset as consideration, those cash flows paid as consideration are considered to be part of the economic benefits that the customer obtains from use of the asset. For example, if the customer is required to pay the supplier a percentage of sales from use of retail space as consideration for that use, that requirement does not prevent the customer from having the right to obtain substantially all of the economic benefits from use of the retail space. This is because the cash flows arising from those sales are considered to be economic benefits that the customer obtains from use of the retail space, a portion of which it then pays to the supplier as consideration for the right to use that space. *[IFRS 16.B23]*.

Frequently asked questions

Question 3-4: Does an electricity retailer, applying IFRS 16.B9(a), have the right to obtain substantially all the economic benefits from use of a windfarm throughout the term of an agreement with a windfarm generator?

In December 2021, the IFRS IC discussed a fact pattern in which, an electricity retailer (customer) and a windfarm generator (supplier) are registered participants in an electricity market, in which customers and suppliers are unable to enter into contracts directly with each other for the purchase and sale of electricity. Instead, customers and suppliers transact directly with the market's electricity grid to make purchases and sales at the spot price which is set by the market operator. In a separate agreement the customer and supplier swap the spot price per megawatt of electricity the windfarm supplies to the grid during the 20-year term of the agreement for a fixed price per megawatt, which is settled net in cash. The separate agreement also transfers to the customer all renewable energy credits that accrue from use of the windfarm.

The IFRS IC observed that, in the fact pattern described in the request, the economic benefits from use of the windfarm include the electricity it produces (as its primary output) and the renewable energy credits (as a by-product or other economic benefit from use of the windfarm). The agreement results in the customer settling with the supplier the difference between the fixed price and the spot prices per megawatt of electricity the windfarm supplies to the grid throughout the 20-year term of the agreement. That agreement, however, gives rise to neither the right nor the obligation for the customer to obtain any of the electricity the windfarm produces and supplies to the grid. Although the customer has the right to obtain the renewable energy credits (which represent a portion of the economic benefits from use of the windfarm), the customer does not have the right to obtain substantially all the economic benefits from use of the windfarm because it has no right to obtain any of the electricity the windfarm produces throughout the period of the agreement. The IFRS IC therefore concluded that, in the fact pattern described in the request, the customer does not have the right to obtain substantially all the economic benefits from use of the windfarm. Consequently, the contract does not contain a lease.

3.1.5 Right to direct the use of the identified asset

A customer has the right to direct the use of an identified asset throughout the period of use when either:

- The customer has the right to direct how and for what purpose the asset is used throughout the period of use.
- The relevant decisions about how and for what purpose an asset is used are predetermined and the customer either: (1) has the right to operate the asset, or to direct others to operate the asset in a manner that it determines, throughout the period of use, without the supplier having the right to change those operating instructions; or (2) designed the asset, or specific aspects of the asset, in a way that predetermines how and for what purpose the asset will be used throughout the period of use. *[IFRS 16.B24]*.

3.1.5.A The right to direct how and for what purpose an asset is used throughout the period of use

Extract from IFRS 16

B25 A customer has the right to direct how and for what purpose the asset is used if, within the scope of its right of use defined in the contract, it can change how and for what purpose the asset is used throughout the period of use. In making this assessment, an entity considers the decision-making rights that are most relevant to changing how and for what purpose the asset is used throughout the period of use. Decision-making rights are relevant when they affect the economic benefits to be derived from use. The decision-making rights that are most relevant are likely to be different for different contracts, depending on the nature of the asset and the terms and conditions of the contract.

A customer has the right to direct the use of an identified asset whenever it has the right to direct how and for what purpose the asset is used throughout the period of use (i.e., it can change how and for what purpose the asset is used throughout the period of use). *[IFRS 16.B25]*. How and for what purpose an asset is used is a single concept (i.e., 'how' an asset is used is not assessed separately from 'for what purpose' an asset is used). *[IFRS 16.BC120]*.

When evaluating whether a customer has the right to change how and for what purpose the asset is used throughout the period of use, the focus should be on whether the customer has the decision-making rights that will most affect the economic benefits that will be derived from the use of the asset. The decision-making rights that are most relevant are likely to depend on the nature of the asset and the terms and conditions of the contract.

The IASB has indicated that decisions about how and for what purpose an asset is used can be viewed as similar to the decisions made by a board of directors. Decisions made by a board of directors about the operating and financing activities of an entity are generally the most relevant decisions rather than the actions of individuals in implementing those decisions. *[IFRS 16.BC120]*.

IFRS 16 provides the following examples of decision-making rights that grant the right to change how and for what purpose an asset is used:

- The right to change the type of output that is produced by the asset (e.g., deciding whether to use a shipping container to transport goods or for storage, deciding on the mix of products sold from a retail unit)
- The right to change when the output is produced (e.g., deciding when an item of machinery or a power plant will be used)
- The right to change where the output is produced (e.g., deciding on the destination of a truck or a ship, deciding where a piece of equipment is used or deployed)
- The right to change whether the output is produced and the quantity of that output (e.g., deciding whether to produce energy from a power plant and how much energy to produce from that power plant). *[IFRS 16.B26]*.

IFRS 16 also provides the following examples of decision-making rights that do not grant the right to change how and for what purpose an asset is used:

- Maintaining the asset
- Operating the asset

Although the decisions about maintaining and operating the asset are often essential to the efficient use of that asset, the right to make those decisions, in and of itself, does not result in the right to change how and for what purpose the asset is used throughout the period of use. *[IFRS 16.B27]*.

The customer does not need the right to operate the underlying asset to have the right to direct its use. That is, the customer may direct the use of an asset that is operated by the supplier's personnel. However, as discussed in section 3.1.5.B below, the right to operate an asset will often provide the customer the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used are predetermined.

How we see it

We believe that the assessment of whether a contract is or contains a lease will be straightforward in most arrangements. However, judgement may be required in applying the definition of a lease to certain arrangements. For example, in contracts that include significant services, we believe that determining whether the contract conveys the right to direct the use of an identified asset may be challenging.

3.1.5.B The relevant decisions about how and for what purpose an asset is used are predetermined

In some cases, it will not be clear whether the customer has the right to direct the use of the identified asset. This could be the case when the most relevant decisions about how and for what purpose an asset is used are predetermined by contractual restrictions on the use of the asset (e.g., the decisions about the use of the asset are agreed to by the customer and the supplier in negotiating the contract, and those decisions cannot be changed). This could also be the case when the most relevant decisions about how and for what purpose an asset is used are, in effect, predetermined by the design of the asset. The IASB indicated that it would expect decisions about how and for what purpose an asset is used to be predetermined in relatively few cases. *[IFRS 16.BC121]*. In such cases, a customer has the right to direct the use of an identified asset throughout the period of use when the customer either:

- Has the right to operate the asset, or direct others to operate the asset in a manner it determines, throughout the period of use without the supplier having the right to change those operating instructions
- Designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use *[IFRS 16.B24]*

Significant judgement may be required to assess whether a customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use. Example 9 in IFRS 16 illustrates the evaluation of whether a customer designed the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

Frequently asked questions

Question 3-5: Does a customer have the right to direct the use of a ship in accordance with IFRS 16?

In January 2020, the IFRS IC issued an agenda decision about whether the customer has the right to direct the use of a ship throughout the five-year term of a contract. In the fact pattern described in the request:

(a) There is an identified asset (the ship) applying IFRS 16.B13 to B20.

(b) The customer has the right to obtain substantially all of the economic benefits from use of the ship throughout the five-year period of use applying IFRS 16.B21 to B23.

(c) Many, but not all, decisions about how, and for what purpose, the ship is used are predetermined in the contract. The customer has the right to make the remaining decisions about how, and for what purpose, the ship is used throughout the period of use (i.e., the order of the voyages to the designated ports during the contract term). In the fact pattern described in the request, the customer has determined that this decision-making right is relevant because it affects the economic benefits to be derived from use of the ship.

(d) The supplier operates and maintains the ship throughout the period of use.

The IFRS IC observed that, in the fact pattern described in the request, because not all relevant decisions about how and for what purpose the ship is used are predetermined, the customer considers IFRS 16.B24(a) in assessing whether it has the right to direct the use of the ship.

Paragraph B24(a) specifies that a customer has the right to direct the use of an identified asset throughout the period of use if it has "the right to direct how and for what purpose the asset is used throughout the period of use (as described in IFRS 16.B25 to B30)". To have the right to direct how and for what purpose the asset is used, within the scope of its right of use defined in the contract, the customer must be able to change how and for what purpose the asset is used throughout the period of use (IFRS 16.B25). In assessing whether that is the case, an entity considers rights to make decisions during the period of use that are most relevant to changing how and for what purpose the asset is used throughout that period. Decision-making rights are relevant when they affect the economic benefits to be derived from use (IFRS 16.B25). An entity does not consider decisions that are predetermined before the period of use unless the conditions in IFRS 16.B24(b)(ii) exist (IFRS 16.B29).

The IFRS IC observed that, in the fact pattern described in the request, the customer has the right to direct how and for what purpose the ship is used throughout the period of use. Within the scope of its right of use defined in the contract, the customer can change how and for what purpose the ship is used (i.e., the customer can change the order of the voyages to the designated ports during the contract term). Despite many decisions about how and for what purpose the ship is used being predetermined, such decisions define the scope of the customer's right of use. Therefore, in this fact pattern, the customer has the right to make the decisions that are most relevant to changing how and for what purpose the ship is used.

The IFRS IC also observed that, although the operation and maintenance of the ship are essential to its efficient use, the supplier's decisions in this regard do not give it the right to direct how and for what purpose the ship is used.

The IFRS IC concluded that, in the fact pattern described in the request, the customer has the right to direct the use of the ship throughout the period of use. Consequently, the contract contains a lease.

3.1.5.C Specifying the output of an asset before the period of use

Extract from IFRS 16

Decisions determined during and before the period of use

B28 The relevant decisions about how and for what purpose the asset is used can be predetermined in a number of ways. For example, the relevant decisions can be predetermined by the design of the asset or by contractual restrictions on the use of the asset.

B29 In assessing whether a customer has the right to direct the use of an asset, an entity shall consider only rights to make decisions about the use of the asset during the period of use, unless the customer designed the asset (or specific aspects of the asset) as described in paragraph B24(b)(ii). Consequently, unless the conditions in paragraph B24(b)(ii) exist, an entity shall not consider decisions that are predetermined before the period of use. For example, if a customer is able only to specify the output of an asset before the period of use, the customer does not have the right to direct the use of that asset. The ability to specify the output in a contract before the period of use, without any other decision-making rights relating to the use of the asset, gives a customer the same rights as any customer that purchases goods or services.

[IFRS 16.B28, IFRS 16.B29].

If a customer can only specify the output from an asset before the beginning of the period of use and cannot change that output throughout the period of use, the customer does not have the right to direct the use of that asset unless it designed the asset, or specific aspects of the asset, as contemplated in IFRS 16.B24(b)(ii). If the customer did not design the asset or aspects of it, the customer's ability to specify the output in a contract that does not give it any other relevant decision-making rights relating to the use of the asset (e.g., the ability to change when, whether and what output is produced) gives the customer the same rights as any customer that purchases goods or services in an arrangement (i.e., a contract that does not contain a lease).

3.1.5.D Protective rights

A contract may include terms and conditions designed to protect the supplier's interest in the asset or other assets, to protect its personnel, or to ensure the supplier's compliance with laws or regulations. These are examples of protective rights. For example, a contract may (i) specify the maximum amount of use of an asset or limit where or when the customer can use the asset, (ii) require a customer to follow particular operating practices, or (iii) require a customer to inform the supplier of changes in how an asset will be used. Protective rights typically define the scope of the customer's right of use but do not, in isolation, prevent the customer from having the right to direct the use of an asset. *[IFRS 16.B30]*.

Illustration 3-6: Right to direct the use of an asset

Customer X enters into a contract with Supplier Y to use a vehicle for a three-year period. The vehicle is identified in the contract. Supplier Y cannot substitute another vehicle unless the specified vehicle is not operational (e.g., it breaks down).

Under the contract:

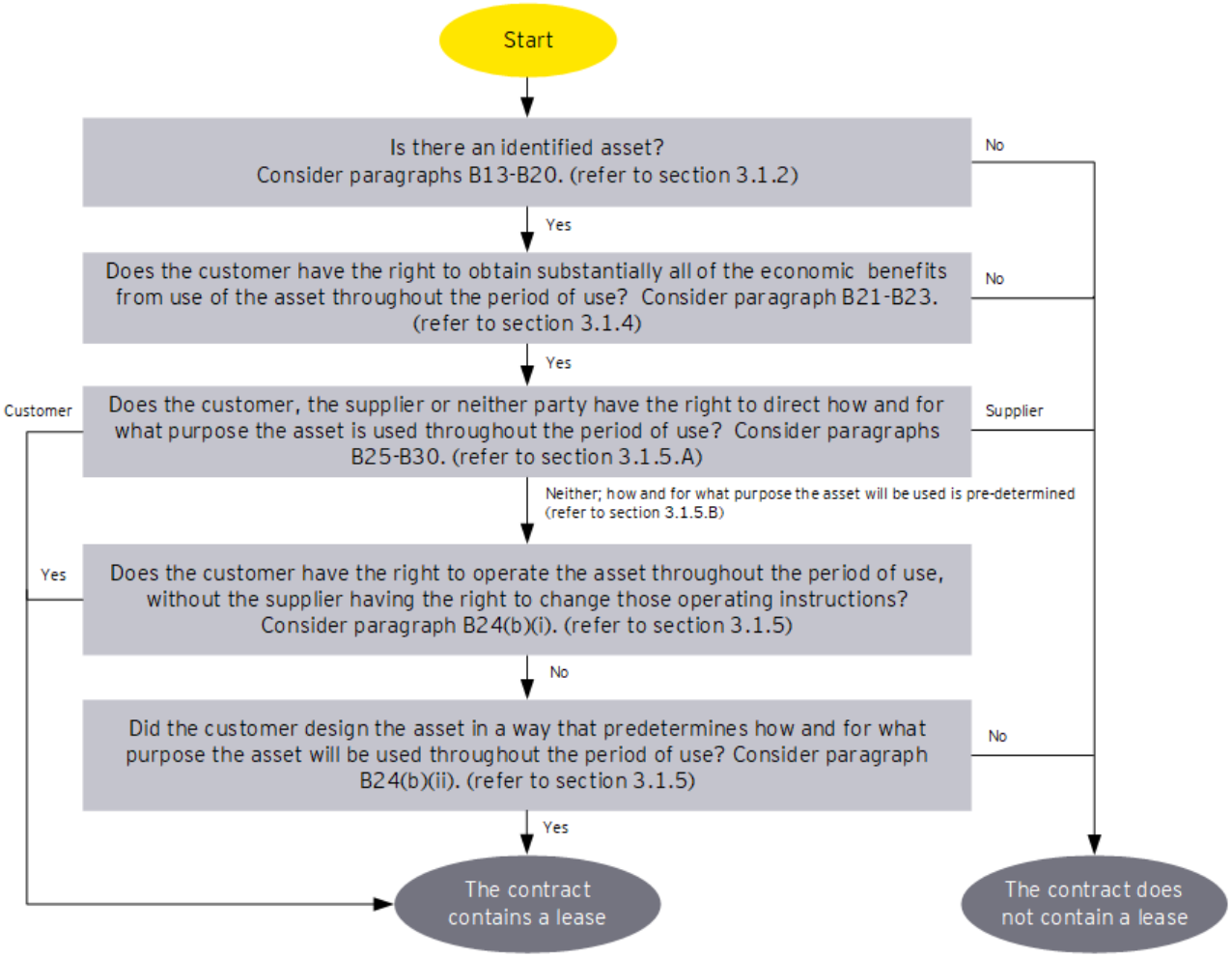
- Customer X operates the vehicle (i.e., drives the vehicle) or directs others to operate the vehicle (e.g., hires a driver).
- Customer X decides how to use the vehicle (within contractual limitations, discussed below). For example, throughout the period of use, Customer X decides where the vehicle goes, as well as when or whether it is used and what it is used for. Customer X can also change these decisions throughout the period of use.
- Supplier Y prohibits certain uses of the vehicle (e.g., moving it overseas) and modifications to the vehicle to protect its interest in the asset.

Analysis: Customer X has the right to direct the use of the identified vehicle throughout the period of use. Customer X has the right to direct the use of the vehicle because it has the right to change how the vehicle is used, when or whether the vehicle is used, where the vehicle goes and what the vehicle is used for.

Supplier Y's limits on certain uses for the vehicle and modifications to it are considered protective rights that define the scope of Customer X's use of the asset, but do not affect the assessment of whether Customer X directs the use of the asset.

3.1.6 Flowchart

The following flowchart is based on the one included in IFRS 16's application guidance, *[IFRS 16.B31]*, and depicts the decision-making process for determining whether an arrangement is or contains a lease:



3.1.7 Reassessment of the contract

Under IFRS 16, an entity reassesses whether a contract is or contains a lease only if the terms and conditions of the contract are changed. *[IFRS 16.11]*. A change in the terms and conditions of a contract does not include the exercise of an option (e.g., renewal option) or failure to exercise an option that is included in the contract.

3.2 Identifying and separating lease and non-lease components of a contract and allocating contract consideration

3.2.1 Identifying and separating lease components of a contract

Extract from IFRS 16	
12	For a contract that is, or contains, a lease, an entity shall account for each lease component within the contract as a lease separately from non-lease components of the contract, unless the entity applies the practical expedient in paragraph 15. Paragraphs B32-B33 set out guidance on separating components of a contract.

For contracts that contain the rights to use multiple assets (e.g., a building and equipment, multiple pieces of equipment), the right to use each asset is considered a separate lease component if both of the following criteria are met:

- The lessee can benefit from the use of the asset either on its own or together with other resources that are readily available to the lessee (i.e., goods or services that are sold or leased separately, by the lessor or other suppliers, or that the lessee has already obtained from the lessor or in other transactions or events).

  And

- The underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract. *[IFRS 16.12, IFRS 16.B32]*.

If one or both of these criteria are not met, the right to use multiple assets is considered a single lease component.

A contract may include an amount payable by the lessee for activities and costs that do not transfer a good or service to the lessee. For example, a lessor may include in the total amount payable a charge for administrative tasks, or other costs it incurs associated with the lease, that do not transfer a good or service to the lessee. Such amounts payable does not give rise to a separate component of the contract, but are considered to be part of the total consideration that is allocated to the separately identified components of the contract. *[IFRS 16.B33]*.

Illustration 3-7: Identifying and separating lease components

Scenario A

Assume that a lessee enters into a lease of an excavator and the related accessories (e.g., excavator attachments) that are used for mining purposes. The lessee is a local mining company that intends to use the excavator at a copper mine.

Analysis: From the perspective of the lessee, the contract contains one lease component. The lessee would be unable to benefit from the use of the excavator without also using the accessories. Therefore, the excavator is dependent upon the accessories.

Scenario B

Assume the same facts as in Scenario A, except that the contract also conveys the right to use an additional loading truck. This loading truck could be deployed by the lessee for other uses (e.g., to transport iron ores at another mine).

Analysis: From the perspective of the lessee, the contract contains two lease components: a lease of the excavator (together with the accessories) and a lease of the loading truck. Because the loading truck could be deployed for other uses independent of the excavator, the lessee can benefit from the loading truck on its own or together with other readily available resources. The lessee can also benefit from the use of the excavator on its own or together with other readily available resources.

For contracts that involve the right to use land and land improvements (e.g., buildings), IFRS 16 requires a lessor to classify (see section 6.1 below) and account for the right to use land as a separate lease component, unless the accounting effect of doing so is immaterial to the lease. *[IFRS 16.B57]*. For example, separation of the land may not be necessary when the amount that would be recognised for the land lease component is immaterial to the lease. If the lease payments cannot be allocated reliably between the land and the buildings, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases (i.e., the entire lease is classified as an operating lease). *[IFRS 16.B56]*.

How we see it

An entity that leases an entire building (i.e., 100% of the building) is inherently leasing the land underneath the building and would potentially account for the land and the building as separate lease components. However, when an entity only leases part of the building (e.g., one floor of a multi-storey building) the land may not be a separate lease component as the lessee does not control substantially all the benefits of the shared land.

3.2.2 Identifying and separating lease from non-lease components of a contract

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components). The non-lease components are identified and accounted for separately from the lease component in accordance with other standards (except when a lessee applies the practical expedient as discussed in section 3.2.2.B below). *[IFRS 16.16]*. For example, the non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to IFRS 15 by lessors (suppliers). Non-lease components are also within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, as discussed in Chapter 27 at section 6.2.1. Some contracts contain items that do not relate to the transfer of goods or services by the lessor to the lessee (e.g., fees or other administrative costs a lessor charges a lessee). These items are not considered separate lease or non-lease components, and lessees and lessors do not allocate consideration in the contract to these items. *[IFRS 16.B33]*. Refer to sections 3.2.3.B and 3.2.4.B below.

However, if the lessor provides services (e.g., maintenance, supply of utilities) or operates the underlying asset (e.g., vessel charter, aircraft wet lease), the contract would generally contain non-lease components.

3.2.2.A Lessee reimbursements

Under IFRS 16, payments for maintenance activities, including common area maintenance (e.g., cleaning the common areas of a building, removing snow from a car park for employees and customers) and other goods or services transferred to the tenant (e.g., providing utilities or rubbish removal) are considered non-lease components because they provide the lessee with a service.

In some leases, a lessee also may reimburse (or make certain payments on behalf of) the lessor for costs that relate to the leased asset for activities and costs that do not transfer a good or service to the lessee (e.g., payments made for real estate taxes that would be owed by the lessor regardless of whether it leased the building and regardless of who the lessee is, payments made for insurance that protects the lessor's investment in the asset and the landlord will receive the proceeds from any claim). Under IFRS 16, such costs are not separate components of the contract because they do not represent payments for goods or services and are considered to be part of the total consideration that is allocated to the separately identified components of the contract (i.e., the lease and non-lease components). Entities also need to evaluate whether such payments are fixed (or in-substance fixed) lease payments or variable lease payments. Refer to section 4.5 below.

Illustration 3-8: Activities that are not components of a lease contract

Scenario A

A lessee enters into a three-year lease of equipment, with fixed annual payments of CU12,000. The contract itemises the fixed annual payments as follows: CU9,000 for rent, CU2,500 for maintenance and CU500 of administrative tasks.

Analysis: The contract contains two components - a lease component (lease of equipment) and a non-lease component (maintenance). The amount paid for administrative tasks does not transfer a good or service to the lessee. Therefore, the total consideration in the contract of CU36,000 will be allocated to the lease component (equipment) and the non-lease component (maintenance).

Scenario B

Assume the fact pattern as in scenario A except that, in addition, the contract requires the lessee to pay for the restoration of the equipment to its original condition.

Analysis: The contract still contains two components - a lease component (lease of equipment) and a non-lease component (maintenance). Similar to the amount paid for administrative tasks, the restoration does not transfer a good or service to the lessee as it is only performed at the end of the lease term. Therefore, the total consideration in the contract will be allocated to the lease component (equipment) and the non-lease component (maintenance). See section 5.2.1 below for further discussion on the inclusion of restoration costs to the initial measurement of the right-of-use asset.

3.2.2.B Practical expedient - lessees

IFRS 16 provides a practical expedient that permits lessees to make an accounting policy election, by class of underlying asset, to account for each separate lease component of a contract and any associated non-lease components as a single lease component. *[IFRS 16.15]*. IFRS 16 provides this expedient to alleviate concerns that the costs and administrative burden of allocating consideration to separate lease and non-lease components may not be justified by the benefit of more precisely reflecting the right-of-use asset and the lease liability. Furthermore, the Board expects the practical expedient to most often be used when the non-lease components of a contract are not significant when compared with the lease components of a contract. *[IFRS 16.BC135(b)]*. The practical expedient does not allow lessees to account for multiple lease components of a contract (refer to section 3.2.1 above) as a single lease component. Refer to section 5 below for a discussion of measurement of right-of-use assets and lease liabilities.

How we see it

Although it is not explicitly stated, we believe that non-lease components relate to services contained within the lease contract. Paragraphs BC133 and BC135 of the Basis for Conclusions to IFRS 16 refer to non-lease components being service components. Therefore, when a lease includes a component related to the purchase of inventory or another asset such as property, plant and equipment or an intangible asset, we believe an entity should separate asset purchases from the lease components and other non-lease components.

The separate asset purchases would not be combined with lease and other non-lease components, even if the entity has elected to apply the practical expedient to combine lease and non-lease components to the class of underlying asset to which the lease relates. For example, if a contract contains a lease as well as non-lease components related to a service and the purchase of sheet metal to be used in the construction of inventory, we believe the purchase of the sheet metal should be accounted for as a component of inventory rather than together with the lease component as the purchase of a physical good is not a 'non-lease component associated with that lease component'.

Lessees that make the policy election to account for each separate lease component of a contract and any associated non-lease components as a single lease component allocate all of the contract consideration to the lease component. Therefore, the initial and subsequent measurement of the lease liability and right-of-use asset is higher than if the policy election was not applied.

FASB differences

IFRS 16 does not include a practical expedient for lessors. Under ASC 842, a lessor can elect, by class of underlying asset, not to separate lease and related non-lease components if certain criteria are met. Additionally, if the non-lease component is the predominant component of the combined component, the combined component is accounted for in accordance with ASC 606 *Revenue from Contracts with Customers*.

3.2.3 Determining and allocating the consideration in the contract - lessees

3.2.3.A Determining the consideration in the contract

IFRS 16 does not define 'consideration' in a lease contract, nor is 'consideration' defined in the IFRS Glossary.

How we see it

We believe that the consideration in a contract for a lessee includes the lease payments as defined in Appendix A to IFRS 16 (described in section 4.5 below) as well as variable payments that do not depend on an index or a rate and any other amounts in the contract that are not included in lease payments. Only those amounts that meet the definition of lease payments are included in the lease liability at their present value (see section 5.2.2 below).

3.2.3.B Allocating the consideration in the contract - lessees

Lessees that do not make an accounting policy election (by class of underlying asset) to use the practical expedient (discussed in section 3.2.2.B above) to account for each separate lease component of a contract and any associated non-lease components as a single lease component are required to allocate the consideration in the contract to the lease and non-lease components on a relative stand-alone price basis. Lessees are required to use observable stand-alone prices (i.e., prices at which a customer would purchase a component of a contract separately) when available. If observable stand-alone prices are not readily available, lessees estimate stand-alone prices, maximising the use of observable information. Although a contractually stated price may be the stand-alone price for a good or service, it is not presumed to be for accounting purposes. *[IFRS 16.13, IFRS 16.14]*.

Illustration 3-9: Allocating contract consideration to lease and non-lease components - lessees

A lessee enters into a lease of equipment. The contract stipulates the lessor will perform maintenance of the leased equipment and receive consideration for that maintenance service. The contract includes the following fixed prices for the lease and non-lease component:

Lease	CU80,000
Maintenance	CU10,000
Total	CU90,000

Assume the stand-alone prices cannot be readily observed, so the lessee makes estimates, maximising the use of observable information, of the lease and non-lease components, as follows:

Lease	CU85,000
Maintenance	CU15,000
Total	CU100,000

Analysis: The stand-alone price for the lease component represents 85% of total estimated stand-alone prices. The lessee allocates the consideration in the contract (CU90,000), as follows:

Lease	CU76,500(1)
Maintenance	CU13,500(2)
Total	CU90,000

(1) 85% × CU90,000
(2) 15% × CU90,000

3.2.4 Determining and allocating the consideration in the contract - lessors

3.2.4.A Determining the consideration in the contract - lessors

As discussed in section 3.2.3.A above, IFRS 16 does not define 'consideration' in a lease contract, nor is 'consideration' defined in the IFRS Glossary.

How we see it

We believe that the consideration in a lease contract for a lessor would include the following:

- Lease payments (refer to section 4.5)
- Any other fixed payments (e.g., monthly service charges, non-lease components such as maintenance) or in-substance fixed payments made during the lease term, less any incentives paid or payable to the lessee
- Any other variable payments that depend on an index or a rate made during the lease term and initially measured using the index or rate at the commencement date (refer to section 4.2)
- Any other variable payment amounts that would be included in the transaction price in accordance with the requirements on variable consideration in IFRS 15

Variable consideration is described broadly in IFRS 15 and can take many forms. Consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items. It is important for lessors to appropriately identify the different types of variable consideration included in the contract because estimating variable consideration requires lessors to apply a constraint to each type of variable consideration. See Chapter 28 at section 5.2 for further discussion on variable consideration under IFRS 15.

3.2.4.B Allocating the consideration in the contract - lessors

When applying IFRS 16, lessors are required to apply IFRS 15.73 to 86 to allocate the consideration in the contract between the lease and non-lease components on a relative stand-alone selling price basis. In addition, lessors are required to apply IFRS 15.87 to 90 to allocate any subsequent changes in the consideration of the contract between the lease and non-lease components. The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. When stand-alone selling prices are not directly observable, the lessor must estimate the stand-alone selling price. Paragraph 79 of IFRS 15 provides suitable methods for estimating the stand-alone selling price. *[IFRS 16.17]*. See Chapter 28 at section 6.1 for further discussion on determining stand-alone selling prices under IFRS 15.

How we see it

Personnel responsible for an entity's revenue recognition policies (including revenue recognition policies associated with arrangements that include a lease) may need to obtain information from personnel beyond those in the accounting or finance departments to estimate stand-alone selling prices. That is, they may need to gain information and an understanding of an entity's pricing decisions in order to determine estimated stand-alone selling prices, especially when there are limited or no observable inputs.

FASB differences

IFRS 16 does not give guidance on allocating variable consideration related to the lease component. Under US GAAP, if the terms of a variable payment that is not dependent on an index or rate relate, even partially, to the lease component, the lessor will recognise those payments (allocated to the lease component) as income in profit or loss in the period when the changes in facts and circumstances on which the variable payment is based occur (e.g., when the lessee's sales on which the amount of the variable payment depends occur). When the changes in facts and circumstances on which the variable payment is based occur, the lessor will allocate those payments to the lease and non-lease components of the contract. The allocation is on the same basis as the initial allocation of the consideration in the contract or the most recent modification not accounted for as a separate contract unless the variable payment meets the criteria in ASC 606-10-32-40 to be allocated only to the lease component(s).

3.2.5 Examples - Identifying and separating components of a contract and determining and allocating the consideration in the contract

IFRS 16 provides the following example to illustrate how lessees identify and separate lease and non-lease components of a contract, and determine and allocate the consideration in the contract. *[IFRS 16.IE4, IFRS 16.IE Example 12]*.

Extract from IFRS 16 Illustrative Examples

Example 12-Lessee allocation of consideration to lease and non-lease components of a contract

Lessor leases a bulldozer, a truck and a long-reach excavator to Lessee to be used in Lessee's mining operations for four years. Lessor also agrees to maintain each item of equipment throughout the lease term. The total consideration in the contract is CU600,000(a), payable in annual instalments of CU150,000, and a variable amount that depends on the hours of work performed in maintaining the long-reach excavator. The variable payment is capped at 2 per cent of the replacement cost of the long-reach excavator. The consideration includes the cost of maintenance services for each item of equipment.

Lessee accounts for the non-lease components (maintenance services) separately from each lease of equipment applying paragraph 12 of IFRS 16. Lessee does not elect the practical expedient in paragraph 15 of IFRS 16. Lessee considers the requirements in paragraph B32 of IFRS 16 and concludes that the lease of the bulldozer, the lease of the truck and the lease of the long-reach excavator are each separate lease components. This is because:

(a) Lessee can benefit from use of each of the three items of equipment on its own or together with other readily available resources (for example, Lessee could readily lease or purchase an alternative truck or excavator to use in its operations); and

(b) although Lessee is leasing all three items of equipment for one purpose (ie to engage in mining operations), the machines are neither highly dependent on, nor highly interrelated with, each other. Lessee's ability to derive benefit from the lease of each item of equipment is not significantly affected by its decision to lease, or not lease, the other equipment from Lessor.

Consequently, Lessee concludes that there are three lease components and three non-lease components (maintenance services) in the contract. Lessee applies the guidance in paragraphs 13-14 of IFRS 16 to allocate the consideration in the contract to the three lease components and the non-lease components.

Several suppliers provide maintenance services for a similar bulldozer and a similar truck. Accordingly, there are observable standalone prices for the maintenance services for those two items of leased equipment. Lessee is able to establish observable stand-alone prices for the maintenance of the bulldozer and the truck of CU32,000 and CU16,000, respectively, assuming similar payment terms to those in the contract with Lessor. The long-reach excavator is highly specialised and, accordingly, other suppliers do not lease or provide maintenance services for similar excavators. Nonetheless, Lessor provides four-year maintenance service contracts to customers that purchase similar long-reach excavators from Lessor. The observable consideration for those four-year maintenance service contracts is a fixed amount of CU56,000, payable over four years, and a variable amount that depends on the hours of work performed in maintaining the long-reach excavator. That variable payment is capped at 2 per cent of the replacement cost of the long-reach excavator. Consequently, Lessee estimates the stand-alone price of the maintenance services for the long-reach excavator to be CU56,000 plus any variable amounts. Lessee is able to establish observable stand-alone prices for the leases of the bulldozer, the truck and the long-reach excavator of CU170,000, CU102,000 and CU224,000, respectively.

Lessee allocates the fixed consideration in the contract (CU600,000) to the lease and non-lease components as follows:

CU	Bulldozer	Truck	Long-reach excavator	Total
Lease	170,000	102,000	224,000	**496,000**
Non-lease				**104,000**
Total fixed consideration				**600,000**

Lessee allocates all of the variable consideration to the maintenance of the long-reach excavator, and, thus, to the non-lease components of the contract. Lessee then accounts for each lease component applying the guidance in IFRS 16, treating the allocated consideration as the lease payments for each lease component.

(a) In these Illustrative Examples, currency amounts are denominated in 'currency units' (CU).

FASB differences

In Example 12 in IFRS 16, as shown above, the variable consideration is allocated entirely to the non-lease component of the contract. Under ASC 842, a lessee must allocate variable consideration not dependent on an index or rate to the lease and non-lease components of a contract on a relative stand-alone price basis.

3.3 Contract combinations

IFRS 16 requires that two or more contracts entered into at or near the same time with the same counterparty (or related parties of the counterparty) be considered a single contract if any one of the following criteria is met:

- The contracts are negotiated as a package with an overall commercial objective that cannot be understood without considering the contracts together
- The amount of consideration to be paid in one contract depends on the price or performance of the other contract
- The rights to use the underlying assets conveyed in the contracts (or some of the rights to use underlying assets conveyed in each of the contracts) are a single lease component (refer to section 3.2.1 above) *[IFRS 16.B2]*

The IASB developed these criteria to address concerns that separately accounting for multiple contracts may not result in a faithful representation of the combined transaction. *[IFRS 16.BC130, IFRS 16.BC131, IFRS 16.BC132]*.

A lease-leaseback transaction, also referred to as a lease-in lease-out (LILO) transaction, in which the owner of an asset leases the asset to a third party and then leases it back, often for tax-driven purposes, is an example of when the contract combination guidance should be assessed. When the contract combination guidance is met in a lease-leaseback transaction, it is often determined that a lease does not exist, as the right to control the use of the asset is not conveyed from the owner to the third party when both the original lease out and the leaseback are considered a single arrangement. For example, an entity leases its medical equipment with a 10-year useful life to a third party and then leases the equipment back for the first seven years. In this case, the right to control the use of the equipment is not transferred to the third party until the completion of the leaseback period (i.e., the first seven years). Therefore, the entity would record the transaction as a financing during the leaseback period and then account for the lease to the third party at the end of the leaseback period (and allocate the consideration in the contract accordingly).

4 Key concepts

Lessees and lessors generally apply the same key concepts for the purposes of identifying, recognising and measuring lease contracts.

4.1 Inception of a contract

At the inception of a contract, an entity assesses whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Paragraphs B9-B31 set out guidance on the assessment of whether a contract is, or contains, a lease. *[IFRS 16.9]*.

IFRS 16 requires customers and suppliers to determine whether a contract is or contains a lease at the inception of the contract. The inception date of a lease is the earlier of the date of a lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease. *[IFRS 16 Appendix A]*.

After the inception of the lease, but before the commencement date (refer to section 4.2), the requirements in IAS 37 apply to any contract (and, hence, any lease contract) that becomes onerous as defined in that standard. *[IFRS 16.BC72]*.

4.2 Commencement date of the lease

Extract from IFRS 16

Appendix A
Defined terms

commencement date of the lease (commencement date)	The date on which a **lessor** makes an **underlying asset** available for use by a **lessee**.
underlying asset	An asset that is the subject of a **lease**, for which the right to use that asset has been provided by a **lessor** to a **lessee**.

The commencement date is the date on which the lessor makes an underlying asset (i.e., the asset that is subject to the lease) available for use by the lessee. *[IFRS 16 Appendix A]*. In some cases, the commencement date of the lease may be before the date stipulated in the lease agreement (e.g., the date on which rents become due and payable). This often occurs when the leased space is modified by the lessee prior to commencing operations in the leased space (e.g., during the period a lessee uses the leased space to construct its own leasehold improvements). If a lessee takes possession of, or is given control over, the use of the underlying asset before it begins operations or making lease payments under the terms of the lease, the lease term has commenced even if the lessee is not required to pay rent or the lease arrangement states the lease commencement date is a later date. The timing of when lease payments begin under the contract does not affect the commencement date of the lease. For example, a lessee (except for a lessee applying the short-term lease or low-value asset exemption discussed in section 5.1.1 and section 5.1.2 below) initially recognises a lease liability and related right-of-use asset on the commencement date and a lessor (for finance leases) initially recognises its net investment in the lease on the commencement date.

4.3 Lessee involvement with the underlying asset before the commencement date

An entity may negotiate a lease before the underlying asset is available for use by the lessee. For some leases, the underlying asset may need to be constructed or redesigned for use by the lessee. Depending on the terms and conditions of the contract, a lessee may be required to make payments relating to the construction or design of the asset. *[IFRS 16.B43]*.

If the lessee incurs costs relating to the construction or design of an underlying asset, the lessee accounts for those costs applying other IFRS accounting standards, such as IAS 16 *Property, Plant and Equipment*. Costs relating to the construction or design of an underlying asset do not include payments made by the lessee for the right to use the underlying asset. Payments for the right to use an underlying asset are payments for a lease, regardless of the timing of those payments. *[IFRS 16.B44]*.

The lessee may obtain legal title to an underlying asset before that legal title is transferred to the lessor and the asset is leased to the lessee. Obtaining legal title does not in itself determine how to account for the transaction. *[IFRS 16.B45]*.

If the lessee controls (or obtains control of) the underlying asset before that asset is transferred to the lessor, the transaction is a sale and leaseback transaction that is accounted for as described in section 8 below. *[IFRS 16.B46]*.

However, if the lessee does not obtain control of the underlying asset before the asset is transferred to the lessor, the transaction is not a sale and leaseback transaction. For example, this may be the case if a manufacturer, a lessor and a lessee negotiate a transaction for the purchase of an asset from the manufacturer by the lessor, which is in turn leased to the lessee. The lessee may obtain legal title to the underlying asset before legal title transfers to the lessor. In this case, if the lessee obtains legal title to the underlying asset, but does not obtain control of the asset before it is transferred to the lessor, the transaction is not accounted for as a sale and leaseback transaction, but as a lease. *[IFRS 16.B47]*.

4.4 Lease term and purchase options

4.4.1 Lease term

The lease term begins at the lease commencement date and is determined on that date based on the non-cancellable term of the lease, together with both of the following:

- The periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option
- The periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option *[IFRS 16.18]*

Purchase options should be assessed in the same way as options to extend the lease term or terminate the lease. The IASB indicated that an option to purchase an underlying asset is economically similar to an option to extend the lease term for the remaining economic life of the underlying asset. *[IFRS 16.BC173]*.

The lease term begins at the commencement date and includes any rent-free periods provided to the lessee by the lessor. *[IFRS 16.B36]*.

At the commencement date, an entity assesses whether the lessee is reasonably certain to exercise an option to extend the lease or to purchase the underlying asset, or not to exercise an option to terminate the lease. *[IFRS 16.19, IFRS 16.B37]*.The entity considers all relevant facts and circumstances that create an economic incentive for the lessee to exercise, or not to exercise, the option, including any expected changes in facts and circumstances from the commencement date until the exercise date of the option. Examples of factors to consider include, but are not limited to:

(a) Contractual terms and conditions for the optional periods compared with market rates, such as:
   (i) The amount of payments for the lease in any optional period
   (ii) The amount of any variable payments for the lease or other contingent payments, such as payments resulting from termination penalties and residual value guarantees

   And
   (iii) The terms and conditions of any options that are exercisable after initial optional periods (for example, a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates)

(b) Significant leasehold improvements undertaken (or expected to be undertaken) over the term of the contract that are expected to have significant economic benefit for the lessee when the option to extend or terminate the lease, or to purchase the underlying asset, becomes exercisable

(c) Costs relating to the termination of the lease, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee's needs, costs of integrating a new asset into the lessee's operations, or termination penalties and similar costs, including costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location

(d) The importance of that underlying asset to the lessee's operations, considering, for example, whether the underlying asset is a specialised asset, the location of the underlying asset and the availability of suitable alternatives

   And

(e) Conditionality associated with exercising the option (i.e., when the option can be exercised only if one or more conditions are met), and the likelihood that those conditions will exist. *[IFRS 16.B37]*.

4.4.1.A Evaluating lease term and purchase options

When evaluating whether a lessee is reasonably certain to exercise an option to renew the lease, not terminate the lease or to purchase the underlying asset, lessees and lessors are required to assess all relevant factors that create an economic incentive for the lessee to exercise lease renewal, termination or purchase options. The phrase reasonably certain is generally interpreted as a high threshold.

The longer the period from commencement of the lease (refer to section 4.2 above) to the exercise date of an option, the more difficult it will be, in certain cases, to determine whether the exercise of the option is reasonably certain. The difficulty arises from several factors. For example, a lessee's estimates of its future needs for the leased asset become less precise the further into the future the forecast goes. Also, the future fair value of certain assets such as those involving technology is more difficult to predict than the future fair value of a relatively stable asset, such as a fully leased commercial office building located in a prime area.

The further into the future that the option date is, the lower the option price must be in relation to the estimated future fair value to conclude that the lessee is reasonably certain to exercise the option. The difference between the option price and the estimated future fair value of an asset that is subject to significant changes in value also should be greater than would be the case for an asset with a relatively stable value.

An artificially short lease term (e.g., a lease of a corporate headquarters, distribution facility, manufacturing plant or other key property with a four- year lease term), may effectively create a significant economic incentive for the lessee to exercise a purchase or renewal option. This may be evidenced by the significance of the underlying asset to the lessee's continuing operations and whether, absent the option, the lessee would have entered into such a lease.

Similarly, the significance of the underlying asset to the lessee's operations may affect a lessee's decisions about whether it is reasonably certain to exercise a purchase or renewal option. For example, an entity that leases a specialised facility (e.g., manufacturing plant, distribution facility, corporate headquarters) and does not exercise a purchase or renewal option would face a significant economic penalty if an alternative facility is not readily available. This would potentially have an adverse effect on the entity while it searched for a replacement asset.

An option to extend or terminate a lease may be combined with one or more other contractual features (for example, a residual value guarantee) such that the lessee guarantees the lessor a minimum or fixed cash return that is substantially the same regardless of whether the option is exercised. In such cases, and notwithstanding the guidance on in-substance fixed payments (see section 4.5.1 below), an entity assumes that the lessee is reasonably certain to exercise the option to extend the lease, or not to exercise the option to terminate the lease. *[IFRS 16.B38]*.

The shorter the non-cancellable period of a lease, the more likely a lessee is to exercise an option to extend the lease or not to exercise an option to terminate the lease. This is because the costs associated with obtaining a replacement asset are likely to be proportionately higher the shorter the non-cancellable period. *[IFRS 16.B39]*.

A lessee's past practice regarding the period over which it has typically used particular types of assets (whether leased or owned), and its economic reasons for doing so, may provide information that is helpful in assessing whether the lessee is reasonably certain to exercise, or not to exercise, an option. For example, if a lessee has typically used particular types of assets for a particular period of time or if the lessee has a practice of frequently exercising options on leases of particular types of underlying assets, the lessee considers the economic reasons for that past practice in assessing whether it is reasonably certain to exercise an option on leases of those assets. *[IFRS 16.B40]*.

A lessee may enter into a lease contract for non-consecutive periods. This is seen in the retail industry when retailers enter into contracts with shopping centres to lease the same retail space for certain non-consecutive months of the year (e.g., during an annual holiday period). Similar arrangements also exist when sports teams lease a sports stadium for particular non-consecutive days of the year. These arrangements will usually meet the definition of a lease because during the agreed period of use, the customer controls the right to use the underlying asset. In these arrangements, the lease term is the aggregate of the non-consecutive periods, as shown in Illustration 4-1, Scenario C below.

Illustration 4-1: Determining the lease term

Scenario A

Entity P enters into a lease for equipment that includes a non-cancellable term of four years and a two-year fixed-priced renewal option with future lease payments that are intended to approximate market rates at lease inception. There are no termination penalties or other factors indicating that Entity P is reasonably certain to exercise the renewal option.

Analysis: At the lease commencement date, the lease term is four years.

Scenario B

Entity Q enters into a lease for a building that includes a non-cancellable term of four years and a two-year, market-priced renewal option. Before it takes possession of the building, Entity Q pays for leasehold improvements. The leasehold improvements are expected to have significant value at the end of four years, and that value can only be realised through continued occupancy of the leased property.

Analysis: At lease commencement, Entity Q determines that it is reasonably certain to exercise the renewal option because it would suffer a significant economic penalty if it abandoned the leasehold improvements at the end of the initial non-cancellable period. At lease commencement, Entity Q concludes that the lease term is six years.

Scenario C

Entity R enters into a lease for an identified retail space in a shopping centre. The retail space will be available to Entity R for only the months of October, November and December during a non-cancellable term of five years. The lessor agrees to provide the same retail space for each of the five years.

Analysis: At the lease commencement date, the lease term is 15 months (three months per year over the five annual periods specified in the contract).

4.4.1.B Cancellable leases

Extract from IFRS 16

B34 In determining the lease term and assessing the length of the non-cancellable period of a lease, an entity shall apply the definition of a contract and determine the period for which the contract is enforceable. A lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

B35 If only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term. If only a lessor has the right to terminate a lease, the non-cancellable period of the lease includes the period covered by the option to terminate the lease.

Any non-cancellable periods (by the lessee and the lessor) in contracts that meet the definition of a lease are considered part of the lease term. If only the lessor has the right to terminate a lease, the period covered by the option to terminate the lease is included in the non-cancellable period of the lease. If only the lessee has the right to terminate a lease, that right is a termination option that is considered when determining the lease term. Refer to section 4.4.1.A. *[IFRS 16.B34, IFRS 16.B35]*.

An arrangement is not enforceable if both the lessor and lessee each have the right to terminate the lease without permission from the other party and with no more than an insignificant penalty. The question arises as to whether penalty should be interpreted to include only the contractual amount payable by one party to the other if the termination option is exercised (i.e., the narrow interpretation) or whether significant economic disincentives should also be considered a penalty (i.e., the wide interpretation). With respect to the determination of the lease term, IFRS 16 requires an entity to consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise, or not to exercise, the option and thus suggests that all aspects of termination penalties, whether contractual or financial in nature, should be considered.

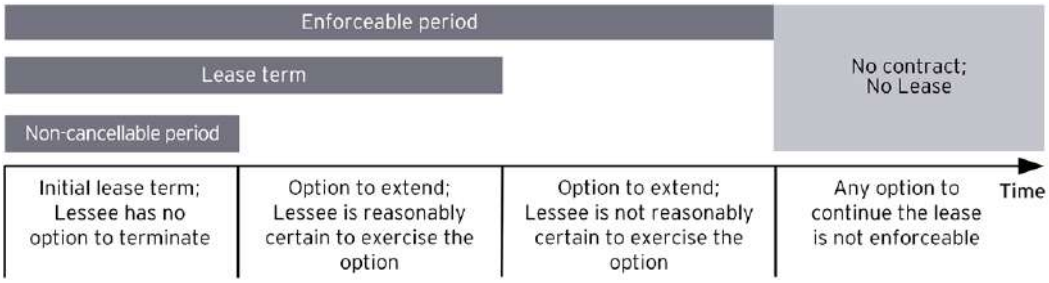
Frequently asked questions

Question 4-1: How is the lease term determined in a cancellable lease? Specifically, when applying IFRS 16.B34 and assessing 'no more than an insignificant penalty', does an entity consider the broader economics of the contract, and not only contractual termination payments?

In November 2019, the IFRS IC issued an agenda decision about how to determine the lease term of a cancellable lease. Specifically, when applying IFRS 16.B34 and assessing 'no more than an insignificant penalty' the question considered how an entity determines penalties. That is, does the entity consider only the termination payments identified in the contract or does it consider the broader economics of the contract when evaluating whether a more than insignificant penalty exists. Such broader economic considerations might include the cost of abandoning or dismantling leasehold improvements. Another example may be the importance of the asset to the lessee's operations.

Paragraph B34 states that in determining the lease term and assessing the length of the non-cancellable period of a lease, an entity applies the definition of a contract and determines the period for which it is enforceable. A lease is no longer enforceable when the lessee and lessor each have the right to terminate the lease without permission from the other party and with no more than an insignificant penalty.

To determine the lease term, an entity determines the non-cancellable period and the enforceable period. It then determines where the lease term falls, depending on the likelihood of exercising the options to extend or terminate using the reasonably certain threshold. The impact of extension options is shown in the diagram below, taken from the IFRS IC's agenda paper:



The IFRS IC noted that in applying IFRS 16.B34 and determining the enforceable period of the lease, an entity considers:

- The broader economics of the contract (i.e., not only the contractual termination payments). For example, if either party has an economic incentive not to terminate the lease such that it would incur a more than insignificant penalty on termination, the contract is enforceable beyond the date on which the contract can be terminated.
- Whether each of the parties has the right to terminate the lease without permission from the other party with no more than an insignificant penalty. Applying IFRS 16.B34, a lease is no longer enforceable only when both parties have such a right. Consequently, if only one party has the right to terminate the lease without permission from the other party with no more than an insignificant penalty, the contract is enforceable beyond the date on which the contract can be terminated by that party.

If an entity concludes that the contract is enforceable beyond the notice period of a cancellable lease, it then applies IFRS 16.19 and IFRS 16.B37 to B40 to assess whether the lessee is reasonably certain not to exercise the option to terminate the lease.

Interaction between useful life and the lease term

The IFRS IC noted that in assessing whether a lessee is reasonably certain to extend (or not to terminate) a lease, IFRS 16.B37 requires an entity to consider all relevant facts and circumstances that create an economic incentive for the lessee. This includes significant leasehold improvements undertaken (or expected to be undertaken) over the term of the contract that are expected to have significant economic benefit for the lessee when an option to extend or terminate the lease becomes exercisable (IFRS 16.B37(b)). In addition, as noted above, an entity considers the broader economics of the contract when determining the enforceable period of a lease. This includes, for example, the costs of abandoning or dismantling non-removable leasehold improvements. If an entity expects to use non-removable leasehold improvements beyond the date on which the contract can be terminated, the existence of those leasehold improvements indicates that the entity might incur a more than insignificant penalty if it terminates the lease. Consequently, applying IFRS 16.B34, an entity considers whether the contract is enforceable for at least the period of expected utility of the leasehold improvements.

The agenda decision discussed above also considered the question of whether the useful life of leasehold improvements is limited to the lease term. This is discussed further in Chapter 19 at section 5.4.4.

In many jurisdictions, property leases are subject to local property laws in addition to the contractual terms of the lease arrangement. That is, local laws and regulations may give the lessee legal renewal options not stated in the lease contract. Examples of where the local law may provide lessees such rights include airport terminal and retail shopping space. When assessing the lease term, entities need to consider whether local laws and regulations create enforceable rights and obligations that need to be included in the evaluation of the lease term.

IFRS 16 applies to contracts that are referred to as 'cancellable', 'month-to-month', 'at will', 'evergreen', 'perpetual' or 'rolling' if they create enforceable rights and obligations. These types of lease generally allow for the contract to continue beyond a non-cancellable period until one party gives notice to terminate the contract (e.g., the contract will roll monthly until the lessee or the lessor elect to terminate the contract). If both the lessee and the lessor can terminate the contract without more than an insignificant penalty at any time at or after the end of the non-cancellable term, then there are no enforceable rights and obligations beyond the non-cancellable term (i.e., the lease term is limited to the non-cancellable term). However, if only the lessee holds a renewal option, there may be other factors to consider in order to determine whether the lessee is reasonably certain to extend the lease, including economic disincentives discussed above.

Illustration 4-2: Cancellable leases

A lease contract has an initial non-cancellable period of one year and an extension for an additional year if both the lessee and the lessor agree. There is no penalty if the lessee and the lessor do not agree to extend for the additional year. The initial one-year non-cancellable period meets the definition of a contract because it creates enforceable rights and obligations. However, the one-year extension period does not meet the definition of a contract because both the lessee and the lessor could unilaterally elect to not extend the arrangement without a more than insignificant penalty. That is, at lease commencement, neither party has enforceable rights and obligations beyond the initial non-cancellable period.

4.4.2 Reassessment of the lease term and purchase options

4.4.2.A Reassessment of the lease term and purchase options- lessees

After lease commencement (refer to section 4.2), IFRS 16 requires lessees to monitor leases for significant changes that could trigger a change in the lease term. Lessees are required to reassess the lease term upon the occurrence of either a significant event or a significant change in circumstances that:

- Is within the control of the lessee
- Affects whether the lessee is reasonably certain to exercise an option not previously included in its determination of the lease term, or not to exercise an option previously included in its determination of the lease term *[IFRS 16.20]*

Examples of significant events or significant changes in circumstances within the lessee's control include:

- Constructing significant leasehold improvements that are expected to have significant economic value for the lessee when the option becomes exercisable
- Making significant modifications or customisations to the underlying asset
- Making a business decision that is directly relevant to the lessee's ability to exercise, or not to exercise, an option (e.g., extending the lease of a complementary asset or disposing of an alternative asset) *[IFRS 16.B41]*
- Subleasing the underlying asset for a period beyond the exercise date of the option

Changes in market-based factors (e.g., a change in market rates to lease or purchase a comparable asset) are not within the lessee's control, and they therefore do not trigger a reassessment by themselves.

IFRS 16 also requires lessees to revise the lease term when the lessee either exercises an option that it previously deemed it was not reasonably certain to exercise or does not exercise an option that it previously deemed it was reasonably certain to exercise. Furthermore, the lease term is revised if an event occurs that contractually obliges the lessee to exercise an option not previously included in the entity's determination of the lease term or an event occurs that contractually prohibits the lessee from exercising an option previously included in the entity's determination of the lease term. *[IFRS 16.21]*.

As the lessee is required to reassess the lease term upon the occurrence of either a significant event or a significant change in circumstances that is within the control of the lessee, the revision of the lease term often happens before the actual exercise of the option in these circumstances. Additionally, if the reassessment of lease term or the exercise of a purchase option results in a change, the lessee would remeasure the lease liability, using revised inputs (e.g., discount rate,) at the reassessment date, and would adjust the right-of-use asset. However, if the right-of-use asset is reduced to zero, the lessee would recognise any remaining amount in profit or loss. Refer to section 4.5.12.

4.4.2.B Reassessment of the lease term and purchase options - lessors

IFRS 16 requires the lessor to revise the lease term to account for the lessee's exercise of an option to extend or terminate the lease or purchase the underlying asset, when exercise of such options was not already included in the lease term.

4.5 Lease payments

Lease payments are payments, made by a lessee to a lessor, relating to the right to use an underlying asset during the lease term and include the following amounts:

- Fixed (including in-substance fixed) payments, less any lease incentives receivable from the lessor (refer to section 4.5.1 and section 4.5.2)
- Variable lease payments that depend on an index or a rate (refer to section 4.5.3)
- The exercise price of a purchase option if the lessee is reasonably certain to exercise that purchase option (refer to section 4.5.4)
- Payments for penalties for terminating a lease, if the lease term reflects the lessee exercising an option to terminate the lease (refer to section 4.5.5)
- Amounts expected to be payable by the lessee under residual value guarantees (lessee only) (refer to section 4.5.6)
- Residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee (lessor only) (refer to section 4.5.7) *[IFRS 16 Appendix A]*

Lease payments generally also include payments made by a lessee to a third party on behalf of the lessor. Lease payments do not include payments allocated to non-lease components of a contract, unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component.

IFRS 16 does not specifically address non-cash consideration that may be part of the consideration provided to the lessor. For example, a lessee may lease land to construct its own building and agree to transfer, at the end of the construction period, certain equipment used in construction. The transfer of such equipment supplements the cash consideration for use of the underlying land.

How we see it

We believe that non-cash consideration provided to the lessor is included in total consideration for purposes of initially recognising and measuring lease related assets and liabilities. This is because the total cost to the lessee, negotiated by the lessee and lessor, includes all forms of consideration, including any non-cash consideration. Applying this to the example above, the non-cash consideration is treated as a fixed payment, as the contract requires delivery of the equipment at the end of the construction period. Therefore, the consideration is measured at lease commencement at the fair value of the promise to deliver, at the end of the lease term, the equipment as stipulated in the contract.

4.5.1 In-substance fixed lease payments

Extract from IFRS 16

In-substance fixed lease payments (paragraphs 27(a), 36(c) and 70(a))

B42 Lease payments include any in-substance fixed lease payments. In-substance fixed lease payments are payments that may, in form, contain variability but that, in substance, are unavoidable. In-substance fixed lease payments exist, for example, if:

(a) payments are structured as variable lease payments, but there is no genuine variability in those payments. Those payments contain variable clauses that do not have real economic substance. Examples of those types of payments include:

(i) payments that must be made only if an asset is proven to be capable of operating during the lease, or only if an event occurs that has no genuine possibility of not occurring; or

(ii) payments that are initially structured as variable lease payments linked to the use of the underlying asset but for which the variability will be resolved at some point after the commencement date so that the payments become fixed for the remainder of the lease term. Those payments become in-substance fixed payments when the variability is resolved.

(b) there is more than one set of payments that a lessee could make, but only one of those sets of payments is realistic. In this case, an entity shall consider the realistic set of payments to be lease payments.

(c) there is more than one realistic set of payments that a lessee could make, but it must make at least one of those sets of payments. In this case, an entity shall consider the set of payments that aggregates to the lowest amount (on a discounted basis) to be lease payments.

Some lease agreements include payments that are described as variable, or may appear to contain variability, but are in-substance fixed payments because the contract terms ensure that the payment of a fixed amount is unavoidable. Such payments are included in the lease payments at lease commencement and thus used to measure entities' lease assets and lease liabilities. *[IFRS 16.B42]*.

4.5.2 Lease incentives

Extract from IFRS 16

Appendix A
Defined terms

lease incentives	Payments made by a **lessor** to a **lessee** associated with a **lease**, or the reimbursement or assumption by a lessor of costs of a lessee.

[IFRS 16 Appendix A].

A lease agreement with a lessor might include incentives for the lessee to sign the lease, such as an upfront cash payment to the lessee, payment of costs for the lessee (such as moving expenses) or the assumption by the lessor of the lessee's pre-existing lease with a third party.

For lessees, lease incentives that are received by the lessee at or before the lease commencement date reduce the initial measurement of a lessee's right-of-use asset. *[IFRS 16.24(b)]*.

In some circumstances, a lease incentive may reduce the initial measurement of the right-of-use asset below zero. For example, this may occur if all the consideration is variable lease payments that do not depend on an index or rate, such as payments based on usage of the asset, and the lessee receives a lease incentive upfront, such as a cash payment from the lessor.

How we see it

We believe that when, as a result of the lease incentive, the initial measurement of the right-of-use asset is reduced to less than zero, the excess amount of the lease incentive is deferred and allocated over the lease term.

Section 5.4 below discusses IFRS 16.39, which relates to the remeasurement of a lease liability and the related adjustment to the previously recognised right-of-use asset. However, this paragraph applies to remeasurements after the commencement date, not to lease incentives at lease commencement.

Lease incentives that are receivable by the lessee at lease commencement date reduce a lessee's lease liability (and therefore, the right-of-use asset as well). *[IFRS 16.27(a)]*.

How we see it

We believe that lease incentives received or receivable at the date of a lease modification would also reduce the measurement of the right-of-use asset and the lease liability (if receivable) at the effective date of the modification.

For lessors, lease incentives that are paid or payable to the lessee are also deducted from lease payments and affect the lease classification test. For finance leases, lease incentives that are payable to the lessee reduce the expected lease receivables at the commencement date and, thereby, the initial measurement of the lessor's net investment in the lease. *[IFRS 16.70(a)]*. For operating leases, lessors should defer the cost of any lease incentives paid or payable to the lessee and recognise that cost as a reduction to lease income over the lease term. Refer to section 5 and section 6, for lessees and lessors respectively.

In May 2020, the IASB issued *Annual Improvements to IFRS Standards 2018 - 2020*, which includes an amendment to Example 13 in IFRS 16 to remove the illustration of the reimbursement of leasehold improvements by the lessor. This was removed because of concerns that the example did not explain clearly enough the conclusion as to whether the reimbursement would meet the definition of a lease incentive in IFRS 16.

4.5.3 Variable lease payments that depend on an index or rate

A lessee remeasures the lease liability by discounting the revised lease payments if there is a change in future lease payments resulting from a change in an index or a rate used to determine those payments, including for example a change to reflect changes in market rental rates following a market rent review. The lessee remeasures the lease liability to reflect those revised lease payments only when there is a change in the cash flows (i.e., when the adjustment to the lease payments takes effect). A lessee determines the revised lease payments for the remainder of the lease term based on the revised contractual payments. *[IFRS 16.42(b)]*.

In applying IFRS 16.42, a lessee uses an unchanged discount rate, unless the change in lease payments results from a change in floating interest rates. In that case, the lessee uses a revised discount rate that reflects changes in the interest rate. *[IFRS 16.43]*.

Variable lease payments that depend on an index or a rate include, for example, payments linked to a consumer price index (CPI), payments linked to a benchmark interest rate (such as a nearly risk-free interest rate) or payments that vary to reflect changes in market rental rates. *[IFRS 16.28]*. The payments are included in the lease payments and are measured using the prevailing index or rate at the measurement date (e.g., lease commencement date for initial measurement). The IASB indicated in the Basis for Conclusions that, despite the measurement uncertainty associated with changes to index- or rate-based payments, the payments meet the definition of an asset (lessor) and a liability (lessee) because they are unavoidable and do not depend on any future activity of the lessee. *[IFRS 16.BC165]*. Lessees subsequently remeasure the lease liability if there is a change in the cash flows (i.e., when the adjustment to the lease payments takes effect) for future payments resulting from a change in index or rate used to determine lease payments. *[IFRS 16.42(b)]*. Refer to section 5.4.

FASB differences

Applying ASC 842, changes in variable lease payments based on an index or rate result in a remeasurement of the lease liability when the lease liability is remeasured for another reason (e.g., a change in the lease term). Under US GAAP, when lease payments are based on an index or rate and there is a change to the index or rate, an entity does not remeasure its lease payments and instead recognises the effect of the change in index or rate in expense. However, under IFRS 16, such change will result in the remeasurement of the lease liability.

Illustration 4-3: Variable lease payments that depend on an index or rate

Entity A enters into a 10-year lease of property. The lease payment for the first year is CU1,000. The lease payments are linked to the consumer price index (CPI), i.e., not a floating interest rate. The CPI at the beginning of the first year is 100. Lease payments are updated at the end of every second year. At the end of year one, the CPI is 105. At the end of year two, the CPI is 108.

Analysis: At the lease commencement date, the lease payments are CU1,000 per year for 10 years. Entity A does not take into consideration the potential future changes in the index. At the end of year one the payments have not changed, so the liability is not updated. At the end of year two, when the lease payments change, Entity A updates the remaining eight lease payments to CU1,080 per year (CU1,000 ÷ 100 × 108) and does not change its discount rate to remeasure the lease liability (and right-of-use asset).

Lease contracts, particularly those relating to property, may include market rent reviews at future dates. The following Illustration shows how these clauses may be treated.

Illustration 4-4: Property leases with market rent reviews

Entity A enters into a 5-year lease of property. The lease payment for the first year is CU1,000. In years 2 and 3, there is a fixed escalation of 4%. At the beginning of year 4, there is a market rent review that will determine the lease payment in years 4 and 5.

Analysis: The lease payments included in the lease liability and right-of-use asset at the lease commencement date are determined, as follows:

- Year 1 - CU1,000
- Year 2 - CU1,000 + 4% fixed escalation = CU1,040
- Year 3 - CU1,040 + 4% fixed escalation = CU1,082

The market rent review applicable to years 4 and 5 is a variable lease payment that depends on an index or a rate (as described in IFRS 16.28). Entity A assesses the market rent at commencement date for the lease of the property for a period of two years, which is the length of the remaining lease term. This is determined to be CU1,035 per annum for years 4 and 5.

4.5.4 The exercise price of a purchase option

If the lessee is reasonably certain to exercise a purchase option, the exercise price is included as a lease payment. That is, entities consider the exercise price of asset purchase options included in lease contracts consistently with the evaluation of lease renewal and termination options (refer to section 4.4).

4.5.5 Payments for penalties for terminating a lease

If it is reasonably certain that the lessee will not terminate a lease, the lease term is determined assuming that the termination option would not be exercised, and any termination penalty is excluded from the lease payments. Otherwise, the lease termination penalty is included as a lease payment. The determination of whether to include lease termination penalties as lease payments is similar to the evaluation of lease renewal options.

4.5.6 Amounts expected to be payable under residual value guarantees - lessees only

IFRS 16 requires lessees to include amounts expected to be payable to the lessor under residual value guarantees as lease payments.

A lessee may provide a guarantee to the lessor that the value of the underlying asset it returns to the lessor at the end of the lease will be at least a specified amount. Such guarantees are enforceable obligations that the lessee has assumed by entering into the lease. Uncertainty related to a lessee's guarantee of a lessor's residual value affects the measurement of the obligation rather than the existence of an obligation. *[IFRS 16.BC170]*.

A lessee is required to remeasure the lease liability if there is a change in the amounts expected to be payable under a residual value guarantee. *[IFRS 16.42(a)]*. Refer to section 4.5.12.

Illustration 4-5: Residual value guarantee included in lease payments

Entity R (lessee) enters into a lease and guarantees that the lessor will realise CU15,000 from selling the asset to another party at the end of the lease. At lease commencement, based on Entity R's estimate of the residual value of the underlying asset, Entity R determines that it expects that it will owe CU6,000 at the end of the lease.

Analysis: Because it is expected that it will owe the lessor CU6,000 under the residual value guarantee, Entity R includes that amount as a lease payment.

How we see it

IFRS 16 does not state how frequently reassessment should occur for expected changes under residual value guarantees. We would expect entities to apply judgement to determine the frequency of reassessment based on the relevant facts and circumstances.

4.5.7 Residual value guarantees - lessors only

IFRS 16 requires lessors to include in the lease payments, any residual value guarantees provided to the lessor by the lessee, a party related to the lessee, or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee. *[IFRS 16.70(c)]*. This amount included in the lease payments is different from that for a lessee which only includes the amount expected to be payable (refer to section 4.5.6).

4.5.8 Variable lease payments that do not depend on an index or rate

Variable lease payments that do not depend on an index or rate and are not, in substance, fixed (refer to section 4.5.1 above), such as those based on performance (e.g., a percentage of sales) or usage of the underlying asset (e.g., the number of hours flown, the number of units produced), are not included as lease payments. Instead, they are recognised in profit or loss (unless they are included in the carrying amount of another asset in accordance with other IFRS accounting standards) in the period in which the event that triggers the payment occurs. *[IFRS 16.38(b)]*.

In some cases, the variability may be resolved during the lease term, so that payments become fixed for the remainder of the lease term. The new fixed payments are then used to remeasure the lease liability (with an offset to the right-of-use asset).

How we see it

In some cases, a contract specifies that when a contingency is resolved, the lessee is required to make an immediate catch-up payment. The catch-up payment relates specifically to the lessee's prior use of the asset. In this case, we believe, when the contingency is resolved, the catch-up obligation is recognised as part of the lease liability and is expensed immediately (rather than adjusting the right-of-use asset).

Illustration 4-6: Variable lease payments that do not depend on an index or rate

Entity A is a medical equipment manufacturer and a supplier of the related consumables. Customer B operates a medical centre. Under the agreement entered into by both parties, Entity A grants Customer B the right to use a medical laboratory machine at no cost and Customer B purchases consumables for use in the equipment from Entity A at CU100 each. The consumables can only be used for that equipment and Customer B cannot use other consumables as substitutes. There is no minimum purchase amount required in the contract.

Based on its historical experience, Customer B estimates that it is highly likely to purchase at least 8,000 units of consumables annually. Customer B has appropriately assessed that the arrangement contains a lease of medical equipment. There are no residual value guarantees or other forms of consideration included in the contract.

Analysis: There are two components in the arrangement, a lease of equipment and the purchase of consumables.

Even though Customer B may believe that it is highly unlikely to purchase fewer than 8,000 units of consumables every year, in this example, there are no lease payments for purposes of initial measurement (Entity A and Customer B) and lease classification (Entity A).

Entity A and Customer B would allocate the payments associated with the future payments to the lease and consumables component of the contract.

Lease payments do not include payments allocated to the non-lease components of a contract. However, lease payments include amounts that would otherwise be allocable to the non-lease components (other than the purchase of goods) of a contract when the lessee makes an accounting policy election to account for the lease and non-lease components as a single lease component. Refer to section 3.2.2 above.

4.5.9 Security deposits

At the commencement of a lease, a lessee may be required to pay a security deposit to the lessor. As long as the deposit is a true deposit and not a prepaid lease payment, the deposit gives the lessee a right to receive the money back in cash from the lessor and is, therefore, a financial asset for the lessee and a financial liability for the lessor and is within the scope of IFRS 9 *Financial Instruments*. The deposit must initially be accounted for at fair value. The fair value of the deposit is determined based on the prevailing market rate of interest for a similar loan to the lessor, considering the lessor's credit-worthiness and, depending on facts and circumstances, any additional security available to the lessee, in accordance with IFRS 9.B5.1.1.

When the deposit earns interest below the market rate, the excess of the principal amount of the deposit over its fair value is accounted for by both the lessee and lessor as a prepaid lease payment. It is therefore considered by the lessor in determining whether the lease is an operating or finance lease. The lessee includes this amount in the cost of its right-of-use asset at the lease commencement date. For the lessor, if the lease is classified as an operating lease, the prepaid lease payment is included in the total lease payments that are recognised as income on either a straight-line basis or another systematic basis, if that basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished. If the lease is classified as a finance lease, the lessor includes the prepaid lease payment in the consideration for the lease (i.e., lease payments) and, therefore, in the determination of the gain or loss on derecognition of the underlying asset, if any.

Interest on the deposit is accounted for using the effective interest method by both the lessee and the lessor.

Illustration 4-7: Accounting for deposits paid by a lessee to a lessor

A lessee is required to pay a deposit of CU100 to the lessor at lease commencement, for which no interest accrues to the lessee. The fixed lease term is 10 years. The market interest rate is 5% per annum (i.e., that is the interest rate the lessor would have to pay each year if it borrowed CU100 for a 10-year term from a third party).

Analysis:

Lessee accounting

At lease commencement:

Dr	Deposit receivable*		CU61	
Dr	Right-of-use asset		CU39	
	Cr	Cash		CU100

To record the deposit receivable at fair value on initial recognition and to record the prepaid lease payment as part of the right-of-use asset. There is no impact on profit or loss at lease commencement.

* *Deposit of CU100 discounted at the market rate of interest (5% per annum) for the lease term of 10 years)*

Year 1:

Dr	Deposit receivable#		CU3	
	Cr	Interest income		CU3

To recognise interest income on the deposit using the effective interest method

Dr	Depreciation expenses		CU4	
	Cr	Right-of-use asset		CU4

To depreciate over the ten-year lease term the additional rent included in the right-of-use asset

\# *Estimated based on a 5% per annum effective interest rate*

Lessor accounting in an operating lease

At lease commencement:

Dr	Cash		CU100	
	Cr	Deferred lease income		CU39
	Cr	Deposit payable		CU61

To record the deposit payable at fair value on initial recognition and to record the prepaid lease payment as part of deferred lease income. There is no impact on profit or loss at lease commencement.

Year 1:

Dr	Interest expense		CU3	
	Cr	Deposit payable		CU3

To recognise interest expense on the deposit using the effective interest method.

Dr	Deferred lease income		CU4	
	Cr	Rental income		C4

To recognise the additional rent on a straight-line basis over the lease term

Lessor accounting in a finance lease

Assume the carrying amount of the underlying asset is CU600; the initial carrying amount of the net investment in the lease (i.e., the present value of the lease payments not yet received at the commencement date) is CU700; total lease payments including the effect of discounting the deposit is CU739, and the present value of the unguaranteed residual value is CU60.

At lease commencement:

Dr	Cash		CU100	
Dr	Net investment in the lease		CU760	
	Cr	Underlying asset		CU600
	Cr	Deposit payable		CU61
	Cr	Gain on disposal		CU199

To recognise the lease transaction at commencement of the lease.

Year 1:

Dr	Interest expense		CU3	
	Cr	Deposit payable		CU3

To recognise interest expense on the deposit using the effective interest method. The additional journals to adjust the net investment in the lease for accrued interest and cash receipts have been excluded for simplicity.

4.5.10 Non-recoverable value added tax and property taxes

When a lessee enters into a lease contract the lessor may be required to charge the lessee VAT in accordance with the local tax regulations. In many jurisdictions, the lessor charges VAT on behalf of the tax authority and payment is remitted to the tax authority. In circumstances when the VAT is the obligation of the lessee (i.e., not the lessor's obligation) the VAT charged is not a lease payment. From a lessee's perspective, typically the lessee only incurs a liability for the VAT when the lessor invoices the lease payment. Therefore, the payments do not meet the definition of an initial direct cost as they are incurred as a consequence of using the asset during the lease term, not obligations that arise to obtain the lease.

In some cases, VAT is not fully recoverable by the lessee, usually because either the activities of the lessee prohibit the recovery of VAT or recovery is prohibited due to the nature of the leased asset. The IFRS IC discussed this in March 2021. However, the IFRS IC did not obtain evidence that the matter had widespread effect or a material effect on entities and so decided not to add a standard-setting project to the work plan.

How we see it

Generally, we expect that lessees will not include non-recoverable VAT in lease payments. Non-recoverable VAT payments are in the scope of IFRIC 21 *Levies*. See Chapter 27 at section 6.8.

In some circumstances, a lessee may enter into a contract to lease property and the lessor is required to pay property taxes levied by a local government authority. For example, the lease contract may specify that the lessee pays an additional amount to cover the lessor's property tax costs. Property tax that is reimbursable by the lessee to the lessor as the owner of the office building, according to the contract, does not transfer any goods or services to the lessee and, as such, it is not a separate component of the contract. Rather, it is part of the total consideration and should be allocated to the separately identified components of the contract. If any portion of the reimbursable amount meets the definition of a lease payment (for example, the first-year tax reimbursement may be known at lease commencement) it is included in the lease liability. If the reimbursable amount is variable and does not depend on an index or rate (for example, because it depends on the actual tax owed by the lessor as determined by the taxing authority each period) it is accounted for as a variable payment that does not depend on an index or rate as described in section 4.5.8 above. Unlike the non-recoverable VAT payments discussed above, the property tax reimbursable by the lessee to the lessor is not a collection of tax by the lessor on behalf of the tax authority. The obligation to pay the property tax rests with the lessor as the owner (regardless of whether the lessee ends up making any payments to the lessor). That is, the property tax is a cost of ownership and the lessee's payment to the lessor simply compensates the lessor for the use of the office building.

4.5.11 Co-tenancy clauses

A co-tenancy clause is a clause in a lease contract that could result in changes in a lessee's lease payments if certain events involving other tenants occur (e.g., if key tenants, or a certain number of tenants, leave a retail shopping centre). A co-tenancy clause, if triggered, may temporarily reduce a lessee's lease payments or contractually change the lease payments from fixed lease payments to variable lease payments (e.g., payments that were previously fixed are changed to a percentage of sales). Generally, when the co-tenancy clause is resolved (e.g., the anchor tenant is replaced or occupancy levels return to a stated percentage), the lease payments will revert back to the previous amounts.

IFRS 16 requires a lessee to remeasure lease payments when a contingency, upon which some or all of the variable lease payments that will be paid over the remainder of the lease term are based, is resolved and those payments now meet the definition of lease payments. A co-tenancy clause would typically result in the inverse scenario because it would temporarily lower the lease payment or temporarily cause fixed payments to become variable.

How we see it

If after lease commencement, a co-tenancy clause is triggered, we believe a lessee generally would not remeasure the lease payments. We believe any temporary change in lease payments that results from a co-tenancy clause being triggered should be recognised in profit or loss similar to variable lease payments.

However, in certain circumstances, when it is likely the co-tenancy clause will not be resolved (e.g., the lease space is an aging shopping centre with a low likelihood of locating replacement tenants that comply with the clause), we believe a lessee may reasonably conclude it should remeasure the lease payments.

In the example where the lease space is an ageing shopping centre with a low likelihood of locating replacement tenants that comply with the clause and the lessee concludes it should remeasure the lease payments, the lessee would reduce the existing lease liability with an adjustment to the right-of-use asset. The effect of a co-tenancy clause when reassessing lease payments will depend on facts and circumstances.

4.5.12 Reassessment of the lease liability

IFRS 16 contains specific requirements about how to remeasure the lease liability to reflect changes to the lease payments (see section 5.4 below). A lessee recognises the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset. However, if the carrying amount of the right-of-use asset is reduced to zero and there is a further reduction in the measurement of the lease liability, a lessee recognises any remaining amount of the remeasurement in profit or loss. *[IFRS 16.39]*.

4.5.13 Remeasurement by lessors

Lessors remeasure the lease payments upon a modification (i.e., a change in the scope of a lease, or the consideration for a lease that was not part of its original terms and conditions) that is not accounted for as a separate contract. Refer to section 6.5.

4.6 Discount rates

Extract from IFRS 16

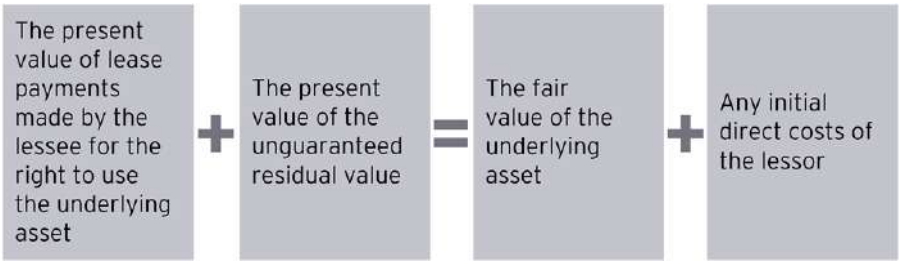
Appendix A
Defined terms

interest rate implicit in the lease	The rate of interest that causes the present value of (a) the **lease payments** and (b) the **unguaranteed residual value** to equal the sum of (i) the **fair value** of the **underlying asset** and (ii) any **initial direct costs** of the lessor.
lessee's incremental borrowing rate	The rate of interest that a **lessee** would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the **right-of-use asset** in a similar economic environment.

[IFRS 16 Appendix A].

Discount rates are used to determine the present value of the lease payments, which are used to determine lease classification (refer to section 6.1 below) and to measure a lessor's net investment in the lease and a lessee's lease liability.

For a lessor, the discount rate for the lease is the interest rate implicit in the lease, which is the rate that causes the following:



Initial direct costs, other than those incurred by manufacturer or dealer lessors, are included in the initial measurement of the net investment in the lease and reduce the amount of income recognised over the lease term. Refer to section 6 and section 4.7 below.

For lessees, lease payments are discounted using the interest rate implicit in the lease as described above if that rate can be readily determined. If that rate cannot be readily determined, the lessee uses the incremental borrowing rate. *[IFRS 16.26]*.

How we see it

The interest rate implicit in the lease is not necessarily the rate stated in the contract and reflects, among other things, the lessor's initial direct costs and estimates of residual value. Therefore, lessees may find it difficult to determine the interest rate implicit in the lease, in which case, they will need to determine the incremental borrowing rate.

The term readily determinable is not equivalent to estimable. Therefore, when the interest rate implicit in the lease can only be determined by using estimates and/or assumptions, then the interest rate implicit in the lease is not readily determinable.

The lessee's incremental borrowing rate is the rate of interest that the lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment. *[IFRS 16 Appendix A]*.

In determining the incremental borrowing rate, the lessee considers borrowings with a similar term and security to the right-of-use asset, not the underlying asset. For example, in the case of a five-year property lease, the lessee considers borrowings with a similar term to the five year right-of-use asset, not the property itself, which may have a significantly longer life. Observable rates, such as a property yield can be used as a starting point to determine the incremental borrowing rate, but adjustments need to be considered for an asset with a value similar to the right-of-use asset. Other potential sources of adjustment may include the credit profile of the lessee, the borrowing currency, or the length of the lease term. It is likely that in some cases significant judgement will be needed to determine the incremental borrowing rate.

How we see it

Market interest rates, particularly risk-free rates, can be negative. IFRS 16 does not contain a floor of zero for the discount rate and therefore it is possible that a lessee's incremental borrowing rate could be below zero. However, as stated above, observable borrowings with negative nominal interest rates may be a starting point and entities will need to consider all potential sources of adjustment (e.g., its own credit rating, lease term, currency) to determine its own incremental borrowing rate.

In certain cases, particularly for high value assets, the incremental borrowing rate may be lower than the lessee would expect the lessor's interest rate implicit in the lease to be, because the lessor is exposed to the residual value risk of the asset at the end of the lease term. This asset risk premium is not adjusted for as it does not meet the definition of the incremental borrowing rate in IFRS 16.

As explained above, the lessee's incremental borrowing rate reflects the rate of interest that a lessee would have to pay, among others, in a similar economic environment. This is generally a nominal discount rate. If the contract requires lease payments to be made in a currency other than the functional currency of the lessee, the incremental borrowing rate of the lessee should be determined based on a borrowing of a similar amount in that foreign currency. Leases denominated in a foreign currency are discussed further in section 5.6.2 below.

In June and September 2019, the IFRS IC discussed whether a lessee's incremental borrowing rate is required to reflect the interest rate on a loan with both a similar maturity to the lease and a similar payment profile to the lease. Specifically, whether an entity should use the interest rate for an amortising loan (whereby the principal and interest are paid down over time) or the interest rate for a bullet repayment loan, (whereby the interest is paid over time with a single bullet payment of the principal at the end of the loan). Interest rates for bullet repayment loans are often higher than those for amortising loans.

The IFRS IC noted that the lessee's incremental borrowing rate is a lease-specific rate that the Board defined "to take into account the terms and conditions of the lease". *[IFRS 16.BC162]*. The definition of a lessee's incremental borrowing rate in IFRS 16 does not explicitly require a lessee to determine its incremental borrowing rate to reflect the interest rate on a loan with a similar payment profile to the lease payments. Nonetheless, the IFRS IC observed that it would be consistent with the Board's objective (when developing the definition of incremental borrowing rate) for a lessee to refer, as a starting point, to a readily observable rate for a loan with a similar payment profile to that of the lease.

How we see it

Given the lack of prescriptive guidance, we believe that the use of an amortising loan rate that has a similar payment profile to the lease is always acceptable. The use of other rates (e.g., bullet loan rates) may also be acceptable depending on the facts and circumstances (e.g., when the use of such rates aligns with the lessee's normal borrowing practices).

FASB differences

IFRS 16 does not address whether the lessee considers the effect of lease term options (e.g., purchase and renewal options) that are not included in the lease term, in the determination of the incremental borrowing rate. Under ASC 842, a lessee may consider the effect of lease term options (e.g., purchase and renewal options) that are not included in the lease term.

Entities that are not public business entities may, under ASC 842, elect to use a risk-free rate by class of underlying asset for initial and subsequent measurement of the lease liability. However, a lessee is required to use the rate implicit in the lease when it is readily determinable, even if they make the risk-free rate election.

4.6.1 Determination of the incremental borrowing rate by a subsidiary with centralised treasury functions

Some groups maintain centralised treasury functions and all funding requirements for the group are managed by the parent entity. Under IFRS 16, subsidiaries participating in a centralised treasury function cannot default to their parent's incremental borrowing rate. Rather, all facts and circumstances should be considered to determine the subsidiary/lessee's incremental borrowing rate. The existence of guarantees of the subsidiary's obligations may result in a rate that is similar to the parent's rate as if the parent had entered into the lease directly.

4.6.2 Reassessment of the discount rate

The discount rate for a lessee is reassessed in the following situations:

- A change in the lease term
- A change in the assessment of an option to purchase the underlying asset
- A modification that is not accounted for as a separate lease
- A change in lease payments resulting from a change in floating interest rates

Refer to section 4.5.12 and section 5.5.

IFRS 16 does not include specific requirements on the reassessment of the discount rate for lessors.

4.7 Initial direct costs

Extract from IFRS 16

Appendix A
Defined terms

initial direct costs	Incremental costs of obtaining a **lease** that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer **lessor** in connection with a **finance lease**.

[IFRS 16 Appendix A].

Under IFRS 16, initial direct costs are incremental costs that would not have been incurred if the lease had not been obtained (e.g., commissions, certain payments made to an existing lessee to incentivise that lessee to terminate its lease). Lessees and lessors apply the same definition of initial direct costs. The requirements under IFRS 16 for initial direct costs are consistent with the concept of incremental costs in IFRS 15.

4.7.1 Lessor accounting for initial direct costs

IFRS 16 requires lessors, other than manufacturer or dealer lessors, to include initial direct costs in the initial measurement of their net investments in finance leases and reduce the amount of income recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease and they are not added separately. Initial direct costs related to finance leases incurred by manufacturer or dealer lessors are expensed at lease commencement. *[IFRS 16.69]*.

IFRS 16 requires lessors to include initial direct costs in the carrying amount of the underlying asset in an operating lease. These initial direct costs are recognised as an expense over the lease term on the same basis as lease income.

4.7.2 Lessee accounting for initial direct costs

IFRS 16 requires lessees to include their initial direct costs in their initial measurement of the right-of-use asset.

Certain costs associated with acquiring an asset within the scope of IAS 16 are required to be capitalised upon initial recognition. See Chapter 19 at section 4.1. However, IFRS 16 does not address the accounting for lessees' costs incurred directly attributable to bringing a right-of-use asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

How we see it

To the extent that costs related to acquiring a right-of-use asset are not subject to capitalisation under other IFRS accounting standards (e.g., IAS 16), it remains to be seen in practice whether they are charged to profit or loss when incurred or capitalised by analogy to IAS 16. For example, a lessee may incur costs when leasing an asset, by paying a third party to ship the asset, prepare the site and install the underlying asset. We believe lessees may analogise to IAS 16 to determine if such costs can be capitalised.

4.8 Economic life

Extract from IFRS 16

Appendix A
Defined terms

economic life	Either the period over which an asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from an asset by one or more users.

[IFRS 16 Appendix A].

4.9 Fair value

Extract from IFRS 16

Appendix A
Defined terms

fair value	For the purpose of applying the **lessor** accounting requirements in this Standard, the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

[IFRS 16 Appendix A].

5 Lessee accounting

5.1 Initial recognition

At the commencement date, a lessee recognises a right-of-use asset and a lease liability. *[IFRS 16.22]*.

IFRS 16 requires lessees to recognise a liability to make lease payments and an asset representing the right to use the underlying asset (i.e., the right-of-use asset) during the lease term for all leases, except for short-term leases (refer to section 5.1.1 below) and leases of low-value assets (refer to section 5.1.2 below) if they choose to apply such exemptions.

FASB differences

Under IFRS 16, all leases are accounted for using the right-of-use model (unless a recognition exemption is applied). ASC 842 similarly requires recognition of a right-of-use asset and lease liability at commencement date. However, under ASC 842 recognised leases are classified as either finance or operating at the lease commencement date, which will affect the subsequent measurement of the right-of-use asset.

5.1.1 Short-term leases

A short-term lease is defined as a lease that, at the commencement date, has a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease. *[IFRS 16 Appendix A]*.

The short-term lease exemption can be made by class of underlying asset to which the right of use relates. A class of underlying asset is a grouping of underlying assets of a similar nature and use in an entity's operations. *[IFRS 16.8]*.

A lessee that makes this accounting policy election does not recognise a lease liability or right-of-use asset on its statement of financial position. Instead, the lessee recognises the lease payments associated with those leases as an expense on either a straight-line basis over the lease term or another systematic basis. The lessee is required to apply another systematic basis if that basis is more representative of the pattern of the lessee's benefit. *[IFRS 16.6]*.

When determining whether a lease qualifies as a short-term lease, a lessee evaluates the lease term in the same manner as all other leases. Refer to section 4.4 above. That is, the lease term includes the non-cancellable term of the lease, periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option, and periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option. As the determination is made at commencement date, a lease cannot be classified as short-term if the lease term is subsequently reduced to less than 12 months. In addition, to qualify as a short-term lease, the lease cannot include an option to purchase the underlying asset.

FASB differences

Under IFRS 16, a lease does not qualify as a short-term lease if it includes an option to purchase the underlying asset. Under ASC 842, a lease does not qualify as a short-term lease if it includes a purchase option that is reasonably certain to be exercised.

A lease that at commencement qualified as a short-term lease is considered to be a new lease if there is a lease modification or a change in a lessee's assessment of the lease term (e.g., the lessee exercises an option not previously included in the determination of the lease term). *[IFRS 16.7]*. The new lease is evaluated to determine whether it qualifies for the short-term exemption, similar to any other new lease.

FASB differences

Under ASC 842, a lease no longer qualifies as a short-term lease when there is a change in a lessee's assessment of either of the following:

- The lease term so that, after the change, the remaining lease term extends more than 12 months from the end of the previously determined lease term
- Whether the lessee is reasonably certain to exercise an option to purchase the underlying asset

The short-term lease accounting policy election is intended to reduce the cost and complexity of applying IFRS 16. However, a lessee that makes the election must make certain quantitative and qualitative disclosures about short-term leases. Refer to section 5.8 below.

Once a lessee establishes a policy for a class of underlying assets, all future short-term leases for that class are required to be accounted for in accordance with the lessee's policy. A lessee evaluates any potential change in its accounting policy in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Illustration 5-1: Short-term lease

Scenario A

A lessee enters into a lease with a nine-month non-cancellable term with an option to extend the lease for four months. The lease does not have a purchase option. At the lease commencement date, the lessee concludes that it is reasonably certain to exercise the extension option because the monthly lease payments during the extension period are significantly below market rates.

Analysis: The lease term is greater than 12 months (i.e., 13 months). Therefore, the lessee may not account for the lease as a short-term lease.

Scenario B

Assume the same facts as Scenario A except, at the lease commencement date, the lessee concludes that it is not reasonably certain to exercise the extension option because the monthly lease payments during the optional extension period are at what the lessee expects to be market rates and there are no other factors that would make exercise of the renewal option reasonably certain.

Analysis: The lease term is 12 months or less, i.e., nine months. Therefore, the lessee may (subject to its accounting policy, by class of underlying asset) account for the lease under the short-term lease exemption, i.e., it recognises lease payments as an expense on a either a straight-line basis over the lease term or another systematic basis and does not recognise a lease liability or right-of-use asset on its statement of financial position.

5.1.2 Leases of low-value assets

Lessees can also make an election for leases for which the underlying asset is of low value (i.e., low-value assets). This election can be made on a lease-by-lease basis. *[IFRS 16.8]*. A lessee that makes this election does not recognise a lease liability or right-of-use asset on its statement of financial position. Instead, the lessee recognises the lease payments associated with those leases as an expense on either a straight-line basis over the lease term or another systematic basis, if that basis is more representative of the pattern of the lessee's benefit. *[IFRS 16.6]*.

A lessee assesses the value of an underlying asset based on the value of the asset when it is new, regardless of the age of the asset being leased. *[IFRS 16.B3]*. The assessment of whether an underlying asset is of low value is performed on an absolute basis. Leases of low-value assets qualify for the exemption regardless of whether those leases are material to the lessee. The assessment is not affected by the size, nature or circumstances of the lessee. Accordingly, different lessees are expected to reach the same conclusion about whether a particular underlying asset is of low-value. *[IFRS 16.B4]*. At the time of reaching its decisions about the exemption, the IASB had in mind leases of underlying assets with a value, when new, of US$5,000 or less. *[IFRS 16.BC100]*. Examples of low-value assets include desktop and laptop computers, small items of office furniture, telephones and other low-value equipment and excludes cars because a new car would typically not be of low value. *[IFRS 16.B6]*.

An underlying asset can only be of low-value if both:

- The lessee can benefit from use of the assets on their own, or together with, other resources that are readily available to the lessee
- The underlying asset is not dependent on, or highly interrelated with, other assets *[IFRS 16.B5]*

For example, an entity may lease a truck for use in its business and the lease includes the use of the tyres attached to the truck. To use the tyres for their intended purpose, they can only be used with the truck and as such, they are dependent on, or highly interrelated with the truck. Therefore, the tyres would not qualify for the low-value asset exemption.

An intermediate lessor who subleases, or expects to sublease an asset, cannot account for the head lease as a lease of a low-value asset. *[IFRS 16.B7]*.Refer to section 7.2 below.

FASB differences

Under ASC 842, there is no recognition exemption for leases based on the value of the underlying asset.

5.2 Initial measurement

5.2.1 Right-of-use assets

A lessee initially measures the right-of-use asset at cost, which consists of all of the following:

- The amount of the initial measurement of the lease liability (refer to section 5.2.2 below)
- Any lease payments made to the lessor at or before the commencement date, less any lease incentives received from the lessor (refer to section 4.5.2 above)
- Any initial direct costs incurred by the lessee (refer to section 4.7 above)
- An estimate of the costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which the underlying asset is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories. *[IFRS 16.23, IFRS 16.24]*.

On initial measurement, a lessee is required to recognise dismantling, removal and restoration costs as part of the right-of-use asset. Costs may be incurred at lease commencement or during a particular period as a consequence of having used an underlying asset. Costs that are incurred during a particular period as a consequence of having used the right-of-use asset to produce inventories are accounted for under IAS 2 *Inventories*. The liability associated with dismantling, removal and restoration costs is recognised and measured in accordance with IAS 37. *[IFRS 16.25]*.

In certain retail property leases, a lessee may sign a lease contract with a lessor and also make a payment to the existing lessee in return for vacating the property. This is sometimes referred to as key money. The existing lessee is released from all obligations under the lease contract with the lessor (i.e., this is not a sublease arrangement). The new lessee also has the right to transfer its rights and obligations in the lease contract to another party in exchange for payment, which would also release the new lessee from all obligations with the lessor. On initial recognition of the lease contract, the payment to the previous lessee is accounted for as an initial direct cost and is included in the measurement of the right-of-use asset. The payment is not in the scope of IAS 38. The new lessee applies the requirements described in section 5.3.1 below to the subsequent measurement of the right-of-use asset.

5.2.2 Lease liabilities

Extract from IFRS 16

26 **At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are not paid at that date. The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate.**

27 At the commencement date, the lease payments included in the measurement of the lease liability comprise the following payments for the right to use the underlying asset during the lease term that are not paid at the commencement date:

(a) fixed payments (including in-substance fixed payments as described in paragraph B42), less any lease incentives receivable;

(b) variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date (as described in paragraph 28);

(c) amounts expected to be payable by the lessee under residual value guarantees;

(d) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option (assessed considering the factors described in paragraphs B37-B40); and

(e) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease

At the commencement date, a lessee initially measures the lease liability at the present value of the lease payments to be made over the lease term. Lessees apply the concepts previously described in section 3 and section 4 above to identify the lease components and to determine the lease term, lease payments and discount rate as of the commencement date of the lease. *[IFRS 16.26, IFRS 16.27]*.

5.3 Subsequent measurement

5.3.1 Right-of-use assets

A lessee subsequently measures the right-of-use asset using a cost model, unless it applies one of the other measurement models discussed below. *[IFRS 16.29]*.

5.3.1.A Cost model

To apply the cost model, a lessee measures the right-of-use asset at cost:

- Less any accumulated depreciation and any accumulated impairment losses

  And

- Adjusted for any remeasurement of the lease liability described in section 5.4 below

When a lessee applies the cost model, the right-of-use asset is subsequently measured at cost less accumulated depreciation and accumulated impairment losses.

A lessee applies the depreciation requirements in IAS 16 in depreciating the right-of-use asset, subject to the following requirements:

If the lease transfers ownership of the underlying asset to the lessee by the end of the lease term, or if the cost of the right-of-use asset reflects that the lessee will exercise a purchase option, the lessee depreciates the right-of-use asset from the commencement date to the end of the useful life of the underlying asset. *[IFRS 16.31]*. Otherwise, the lessee depreciates the right-of-use asset from the commencement date to the earlier of the end of the useful life of the right-of -use asset or the end of the lease term. *[IFRS 16.32]*. The leased asset is depreciated from the commencement date of the lease even if the lessee chooses not to use the asset from the commencement date, for example, because leasehold improvements are being constructed.

Depreciation of the right-of-use asset is recognised in a manner consistent with existing standards for property, plant and equipment. IAS 16 is not prescriptive about the methods of depreciation, mentioning straight line, diminishing balance and units of production as possibilities. The overriding requirement of IAS 16 is that the depreciation charge reflects the pattern of consumption of the benefits the asset brings over its useful life and is applied consistently from period to period.

IAS 16 also requires that each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item is depreciated separately. An entity allocates the amount initially recognised with respect to an item of property, plant and equipment to its significant parts and separately depreciates each such part. For example, as noted in IAS 16, it may be appropriate to depreciate separately the airframe and engines of an aircraft. In many cases, the right-of-use asset will relate to one underlying asset or significant part and so a component approach may not be necessary. However, entities will need to assess whether it should be applied for right-of-use assets that have significant parts with different useful economic lives.

FASB differences

Under ASC 842, component depreciation is also permitted but is not common.

A lessee applies IAS 36 *Impairment of Assets* to determine whether the right-of-use asset is impaired and to account for any impairment loss identified. *[IFRS 16.33]*.

5.3.1.B Other measurement models

If a lessee applies the fair value model in IAS 40 *Investment Property* to its investment property, the lessee also applies the fair value model to right-of-use assets that meet the definition of investment property in IAS 40. *[IFRS 16.34]*.

If right-of-use assets relate to a class of property, plant and equipment to which the lessee applies the revaluation model in IAS 16, the lessee may elect to apply that revaluation model to all the right-of-use assets that relate to that class of property, plant and equipment. *[IFRS 16.35]*.

5.3.2 Lease liabilities

Extract from IFRS 16

36 After the commencement date, a lessee shall measure the lease liability by:

(a) increasing the carrying amount to reflect interest on the lease liability;

(b) reducing the carrying amount to reflect the lease payments made; and

(c) remeasuring the carrying amount to reflect any reassessment or lease modifications specified in paragraphs 39-46, or to reflect revised in-substance fixed lease payments (see paragraph B42).

Interest on the lease liability in each period during the lease term, is the amount that produces a constant periodic rate of interest on the remaining balance of the lease liability. The periodic rate of interest is the discount rate determined at commencement unless a reassessment requiring a change in the discount rate has been triggered. *[IFRS 16.36, IFRS 16.37]*. Lease payments reduce the lease liability when paid. Refer to section 5.4 and section 5.5, respectively.

5.3.3 Expense recognition

After the commencement date, the lessee recognises depreciation and impairment of the right-of-use asset in profit or loss, unless depreciation is permitted to be capitalised (e.g., to inventory) under other IFRS accounting standards (or the lessee applies the fair value model described in section 5.3.1.B above).

A lessee also recognises in profit or loss, unless the costs are included in the carrying amount of another asset applying other IFRS accounting standards, both:

(a) Interest on the lease liability

And

(b) Variable lease payments not included in the measurement of the lease liability in the period in which the event or condition that triggers those payments occurs. *[IFRS 16.38]*.

When a lessee depreciates the right-of-use asset on a straight-line basis, the total periodic expense (i.e., the sum of interest and depreciation expense) is generally higher in the early periods and lower in the later periods. Because a constant interest rate is applied to the lease liability, interest expense decreases as cash payments are made during the lease term and the lease liability decreases. Therefore, more interest expense is incurred in the early periods and less in the later periods. This trend in the interest expense, combined with straight-line depreciation of the right-of-use asset, results in a front-loaded expense recognition pattern.

If a lessee determines that a right-of-use asset is impaired, it recognises an impairment loss and measures the right-of-use asset at its carrying amount immediately after the impairment. A lessee subsequently depreciates, generally on a straight-line basis, the right-of-use asset from the date of the impairment to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term. However, the depreciation period is the remaining useful life of the underlying asset if the lessee is reasonably certain to exercise an option to purchase the underlying asset or if the lease transfers ownership of the underlying asset to the lessee by the end of the lease term. Refer to section 5.6.1 below, for additional discussion of impairment of right-of-use assets.

5.3.4 Example - lessee accounting

Illustration 5-2: Lessee accounting

Entity H (lessee) enters into a three-year lease of equipment. Entity H agrees to make the following annual payments at the end of each year: CU10,000 in year one, CU12,000 in year two and CU14,000 in year three. For simplicity, there are no other elements to the lease payments (e.g., purchase options, lease incentives from the lessor or initial direct costs). The initial measurement of the right-of-use asset and lease liability is CU33,000 (present value of lease payments using a discount rate of approximately 4.235%). Entity H uses its incremental borrowing rate because the interest rate implicit in the lease cannot be readily determined. Entity H depreciates the right-of-use asset on a straight-line basis over the lease term.

Analysis:

At lease commencement, Entity H would recognise the lease-related asset and liability:

Dr	Right-of-use asset		CU33,000	
	Cr	Lease liability		CU33,000

To initially recognise the lease-related asset and liability

The following journal entries would be recorded in the first year:

Dr	Interest expense		CU1,398	
	Cr	Lease liability		CU1,398

To record interest expense and accrete the lease liability using the interest method (CU33,000 × 4.235%)

Dr	Depreciation expense		CU11,000	
	Cr	Right-of-use asset		CU11,000

To record depreciation expense on the right-of-use asset (CU33,000 ÷ 3 years)

Dr	Lease liability		CU10,000	
	Cr	Cash		CU10,000

To record lease payment

A summary of the lease contract's accounting (assuming no changes due to reassessment) is, as follows:

	Initial	Year 1	Year 2	Year 3
Cash lease payments		CU10,000	CU12,000	CU14,000
Lease expense recognised				
Interest expense		CU1,398	CU1,033	CU569
Depreciation expense		11,000	11,000	11,000
Total periodic expense		CU12,398	CU12,033	CU11,569
Statement of financial position				
Right-of-use asset	CU33,000	CU22,000	CU11,000	-
Lease liability	(CU33,000)	(CU24,398)	(CU13,431)	-

5.4 Remeasurement of lease liabilities

Extract from IFRS 16

39 After the commencement date, a lessee shall apply paragraphs 40-43 to remeasure the lease liability to reflect changes to the lease payments. A lessee shall recognise the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset. However, if the carrying amount of the right-of-use asset is reduced to zero and there is a further reduction in the measurement of the lease liability, a lessee shall recognise any remaining amount of the remeasurement in profit or loss.

40 A lessee shall remeasure the lease liability by discounting the revised lease payments using a revised discount rate, if either:

(a) there is a change in the lease term, as described in paragraphs 20-21. A lessee shall determine the revised lease payments on the basis of the revised lease term; or

(b) there is a change in the assessment of an option to purchase the underlying asset, assessed considering the events and circumstances described in paragraphs 20-21 in the context of a purchase option. A lessee shall determine the revised lease payments to reflect the change in amounts payable under the purchase option.

41 In applying paragraph 40, a lessee shall determine the revised discount rate as the interest rate implicit in the lease for the remainder of the lease term, if that rate can be readily determined, or the lessee's incremental borrowing rate at the date of reassessment, if the interest rate implicit in the lease cannot be readily determined.

42 A lessee shall remeasure the lease liability by discounting the revised lease payments, if either:

(a) there is a change in the amounts expected to be payable under a residual value guarantee. A lessee shall determine the revised lease payments to reflect the change in amounts expected to be payable under the residual value guarantee.

(b) there is a change in future lease payments resulting from a change in an index or a rate used to determine those payments, including for example a change to reflect changes in market rental rates following a market rent review. The lessee shall remeasure the lease liability to reflect those revised lease payments only when there is a change in the cash flows (ie when the adjustment to the lease payments takes effect). A lessee shall determine the revised lease payments for the remainder of the lease term based on the revised contractual payments.

43 In applying paragraph 42, a lessee shall use an unchanged discount rate, unless the change in lease payments results from a change in floating interest rates. In that case, the lessee shall use a revised discount rate that reflects changes in the interest rate.

[IFRS 16.39-43].

IFRS 16 requires lessees to remeasure lease liabilities when there is a lease modification (i.e., a change in the scope of a lease, or the consideration for a lease that was not part of the original terms and conditions of the lease) that is not accounted for as a separate contract. Refer to section 5.5 below. Lessees are also required to remeasure lease payments upon a change in any of the following:

- The lease term (refer to section 4.4.1 above)
- The assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset (refer to section 4.4.1.A above)
- The amounts expected to be payable under residual value guarantees (refer to section 4.5.6 above)
- Future lease payments resulting from a change in an index or rate (refer to section 4.5.3 above)
- In-substance fixed lease payments (refer to section 4.5.1 above)

Lessees use a revised discount rate when lease payments are updated for a change in the lease term or a revised assessment of a purchase option. *[IFRS 16.40]*. The revised discount rate is based on the interest rate implicit in the lease for the remainder of the lease term. If that rate cannot be readily determined, the lessee uses its incremental borrowing rate. *[IFRS 16.41]*. Lessees use the original discount rate when lease payments are updated for a change in expected amounts for residual value guarantees, payments dependent on an index or rate and changes to in-substance fixed lease payments, unless the rate is a floating interest rate. *[IFRS 16.42, IFRS 16.43]*.

How we see it

When a lease includes a market rate adjustment (a market rent review), the negotiations between the lessee and the lessor may take some time to complete (the negotiation period). We believe any adjustment is recognised as an adjustment to lease payments when the market rent review is finalised and the change in contractual cash flows takes effect.

For example, consider a 10-year lease that has a market rate adjustment that applies from the end of year 5. The market rent review negotiations begin during year 5, but are not completed until September in year 6. During year 6, while the negotiation is ongoing, the lessee is required to pay the original contractual lease payments. At the conclusion of the negotiation period in September of year 6 (i.e., upon a final determination of the lease payments for year 6 until year 10), the new lease payments apply retrospectively from the beginning of year 6. Under this view, the lessee does not adjust the lease payments at the beginning of year 6 for the expected increase in rent. Instead, the lease payments are adjusted in September of year 6 when they are finalised. The lease liability is remeasured at this date and the additional cost is recognised as an adjustment to the right-of-use asset for the future lease payments.

How we see it

We believe the difference between the original lease payments and the new lease payments for the period when the new lease payments are applied retrospectively (from the beginning of year 6 to September of year 6 in the example above) may be recognised in profit or loss at the date the negotiations are finalised. Alternatively, the difference may be recognised as an adjustment to the right-of-use asset. In this case, it may also be necessary to consider the recoverability of the right-of-use asset.

How we see it

Under IFRS 16.45(a), the consideration in the contract is reallocated when a lease is modified. IFRS 16 is silent on reallocation when a lease liability is remeasured for other reasons (e.g., a change in lease term). However, we believe, when a lease liability is remeasured for other reasons, the allocation of the revised consideration in the contract is not updated at the remeasurement date (i.e., the revised consideration in the contract is allocated using the relative stand-alone prices previously determined at lease commencement or the most recent modification date). Allocation of the consideration in the contract is discussed at section 3.2.3.B above.

FASB differences

Under ASC 842, the consideration in the contract is reallocated when a lease is modified or a lease liability is remeasured. Therefore, the revised lease payments are allocated based on the standalone price of the lease and non-lease components at the date of remeasurement (or effective date of the modification).

5.5 Lease modifications

Extract from IFRS 16

Appendix A
Defined terms

lease modification	A change in the scope of a **lease**, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more **underlying assets**, or extending or shortening the contractual **lease term**).

[IFRS 16 Appendix A].

If a lease is modified (i.e., a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease), the modified contract is evaluated to determine whether it is or contains a lease. Refer to section 3.1.7 above. If a lease continues to exist, lease modification can result in:

- A separate lease. Refer to section 5.5.1 below.
- A change in the accounting for the existing lease (i.e., not a separate lease). Refer to section 5.5.2 below.

The exercise of an existing purchase or renewal option or a change in the assessment of whether such options are reasonably certain to be exercised are not lease modifications but can result in the remeasurement of lease liabilities and right-of-use assets. Refer to section 4.5.12 above.

5.5.1 Determining whether a lease modification results in a separate lease

A lessee accounts for a lease modification (i.e., a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease) as a separate lease (i.e., separate from the original lease) when both of the following conditions are met:

- The modification increases the scope of the lease by adding the right to use one or more underlying assets.
- The consideration for the lease increases commensurate with the stand-alone price for the increase in scope and any adjustments to that stand-alone price reflect the circumstances of the particular contract. *[IFRS 16.44]*.

If both of these conditions are met, the lease modification results in two separate leases, the unmodified original lease and a separate new lease. Lessees account for the separate contract that contains a lease in the same manner as other new leases. The accounting for the unmodified lease is not changed. Refer to IFRS 16's Example 15 that illustrates this concept in section 5.5.3 below.

If either of the conditions are not met, the modified lease is not accounted for as a separate lease. Refer to section 5.5.2 below.

The first condition above, is met if there is an additional right of use that was not included in the original lease. For example, if an existing lease for one floor of a building is modified to add a second floor, the right to use the second floor would meet the first condition as this adds a right of use that was not included in the original contract. Conversely, a modification that grants the lessee the right to use only the existing floor for an additional period of time does not meet the first condition above.

A lessee that terminates an existing lease and at the same time enters into a new lease arrangement with the same landlord evaluates the contract combination guidance discussed in section 3.3 above.

Illustration 5-3: Lessee accounting for an immediate termination and new lease with the same landlord

On 1 January 20X0, Retailer entered into a 10-year lease with Landlord for retail store A in a shopping mall. Retail store A is 10,000 square feet. The lease requires Retailer to make fixed monthly payments at the beginning of each month, but the amount increases each year. There are no initial direct costs or incentives associated with the lease, and there are no non-lease components in the contract.

On 1 January 20X2, Retailer and Landlord negotiate a new contract to immediately terminate the lease for retail store A and at the same time enter into a new lease for retail store B (i.e., the termination of retail store A lease is dependent on obtaining retail store B). Retail store B is 5,000 square feet and is located in a more desirable location. The term of the new lease is eight years, consistent with the remaining term of the retail store A lease. There are no lease termination payments for retail store A, and no lease prepayments, initial direct costs or lease incentives associated with the retail store B lease. There are no non-lease components in the contract for the retail store B lease. Retailer determines that the contract combination guidance is met.

On 1 January 20X2, immediately before the parties signed the new lease agreement, Retailer has a remaining right-of-use asset of CU115,000 and a lease liability of CU120,000. The lease for retail store A is not impaired.

Based on the terms of the retail store B lease agreement, the initial measurement of the lease liability is CU70,000, which represents the lease payments in the new lease, discounted using Retailer's incremental borrowing rate at the commencement date of the new lease.

Analysis: Under IFRS 16, Retailer accounts for the change as a termination of the existing lease of retail store A by removing the right-of-use asset and the lease liability from the balance sheet and including any difference between the right-of-use asset and the lease liability as part of the right-of-use asset it recognises for the new lease of retail store B (which in this case is similar to a lease incentive received to enter into the retail store B lease). Retailer records the following entries:

Dr	Lease liability (existing lease)		CU120,000	
	Cr	Right-of-use asset (existing lease)		CU115,000
Dr	Right-of-use asset (new lease)		CU65,000[(a)]	
	Cr	Lease liability (new lease)		CU70,000

(a) Recognition of the right-of-use asset associated with the new lease of retail store B at the initial measurement of the lease liability of CU70,000 less the difference between the lease liability and right-of-use asset from retail store A lease of CU5,000 (i.e., which in this case is similar to a lease incentive received to enter into the retail store B lease).

5.5.2 Lessee accounting for a modification that does not result in a separate lease

For those lease modifications that do not result in a separate lease, lessees allocate the consideration in the contract (refer to section 3.2.3.B) and remeasure the lease liability (using the lease term of the modified lease and the discount rate (i.e., the interest rate implicit in the lease for the remainder of the lease term if that rate can be readily determined or if not the lessee's incremental borrowing rate) as determined at the effective date of the modification). *[IFRS 16.45, IFRS 16.46]*.

For a modification that fully or partially decreases the scope of the lease (e.g., reduces the square footage of leased space), IFRS 16 requires a lessee to decrease the carrying amount of the right-of-use asset to reflect partial or full termination of the lease. Any difference between those adjustments is recognised in profit or loss at the effective date of the modification. Refer to IFRS 16's Examples 17 and 18 in section 5.5.3 below.

How we see it

In some circumstances, a lessee may purchase the underlying asset from the lessor during the lease term but the contract did not include a purchase option. In such circumstances, we believe, consistent with IAS 16, the lessee recognises the purchase price plus the difference between carrying amounts of the lease liability and the right-of-use asset immediately before the purchase, to initially measure the purchased asset. That is, there is no P&L impact as a result of the transaction.

For all other lease modifications which are not accounted for as a separate lease, IFRS 16 requires the lessee to recognise the amount of the remeasurement of the lease liability as an adjustment to the corresponding right-of-use asset without affecting profit or loss. Refer to IFRS 16's Examples 16, 18 and 19 that illustrate this concept in section 5.5.3 below.

In the IASB's view, this approach results in accounting outcomes that faithfully represent the substance of a lease modification and closely aligns gain or loss recognition with a corresponding change in the lessee's rights and obligations under the lease. This is because a lease gives rise to both a right-of-use asset and a lease liability. Accordingly, a lease modification can result in a change to the lessee's rights (i.e., a change to the right-of-use asset), a change to the lease liability, or both. *[IFRS 16.BC204]*.

In some cases, the lessee and lessor may agree to a modification to the lease contract that starts at a later date (i.e., the terms of the modification take effect at a date later than the date when both parties agreed to the modification). For example, a lessee enters into a lease arrangement with a lessor to lease an asset for 10 years. At the beginning of year 8, the lessee and lessor agree to a modification to the contract that will take effect from the beginning of year 9.

- If the modification is an increase in the scope that does not result in a separate lease, the lessee will re-allocate the consideration in the modified contract to each of the existing lease and non-lease components and remeasure the lease liability at the date both parties agreed to the modification (the beginning of year 8).
- If the modification results in a separate lease component, the lessee will allocate the consideration in the modified contract to each of the existing and new lease and non-lease components at the date both parties agreed to the modification (the beginning of year 8). The lessee will remeasure the lease liability for the existing lease components at that date as well. However, recognition of the lease liability and right-of-use asset for any new lease component occurs at the commencement date of the new lease component (the beginning of year 9).
- If the modification is a decrease in the scope, the lessee will re-allocate the consideration in the modified contract to each existing lease and non-lease component and remeasure the lease liability and right-of-use asset at the effective date of the modification (the beginning of year 8).

5.5.3 Examples - lessees' accounting for lease modifications

IFRS 16 provides the following examples to illustrate how lessees account for lease modifications.
[IFRS 16.IE7, IFRS 16.IE Example 15, IFRS 16.IE Example 16, IFRS 16.IE Example 17, IFRS 16.IE Example 18, IFRS 16.IE Example 19].

Extract from IFRS 16 Illustrative Examples

Example 15-Modification that is a separate lease

Lessee enters into a 10-year lease for 2,000 square metres of office space. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to include an additional 3,000 square metres of office space in the same building. The additional space is made available for use by Lessee at the end of the second quarter of Year 6. The increase in total consideration for the lease is commensurate with the current market rate for the new 3,000 square metres of office space, adjusted for the discount that Lessee receives reflecting that Lessor does not incur costs that it would otherwise have incurred if leasing the same space to a new tenant (for example, marketing costs).

Lessee accounts for the modification as a separate lease, separate from the original 10-year lease. This is because the modification grants Lessee an additional right to use an underlying asset, and the increase in consideration for the lease is commensurate with the stand-alone price of the additional right-of-use adjusted to reflect the circumstances of the contract. In this example, the additional underlying asset is the new 3,000 square metres of office space. Accordingly, at the commencement date of the new lease (at the end of the second quarter of Year 6), Lessee recognises a right-of-use asset and a lease liability relating to the lease of the additional 3,000 square metres of office space. Lessee does not make any adjustments to the accounting for the original lease of 2,000 square metres of office space as a result of this modification.

Example 16-Modification that increases the scope of the lease by extending the contractual lease term

Lessee enters into a 10-year lease for 5,000 square metres of office space. The annual lease payments are CU100,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6 per cent per annum. At the beginning of Year 7, Lessee and Lessor agree to amend the original lease by extending the contractual lease term by four years. The annual lease payments are unchanged (ie CU100,000 payable at the end of each year from Year 7 to Year 14). Lessee's incremental borrowing rate at the beginning of Year 7 is 7 per cent per annum.

At the effective date of the modification (at the beginning of Year 7), Lessee remeasures the lease liability based on: (a) an eight-year remaining lease term, (b) annual payments of CU100,000 and (c) Lessee's incremental borrowing rate of 7 per cent per annum. The modified lease liability equals CU597,130. The lease liability immediately before the modification (including the recognition of the interest expense until the end of Year 6) is CU346,511. Lessee recognises the difference between the carrying amount of the modified lease liability and the carrying amount of the lease liability immediately before the modification (CU250,619) as an adjustment to the right-of-use asset.

Example 17-Modification that decreases the scope of the lease

Lessee enters into a 10-year lease for 5,000 square metres of office space. The annual lease payments are CU50,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6 per cent per annum. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease to reduce the space to only 2,500 square metres of the original space starting from the end of the first quarter of Year 6. The annual fixed lease payments (from Year 6 to Year 10) are CU30,000. Lessee's incremental borrowing rate at the beginning of Year 6 is 5 per cent per annum.

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability based on: (a) a five-year remaining lease term, (b) annual payments of CU30,000 and (c) Lessee's incremental borrowing rate of 5 per cent per annum. This equals CU129,884.

Lessee determines the proportionate decrease in the carrying amount of the right-of-use asset on the basis of the remaining right-of-use asset (ie 2,500 square metres corresponding to 50 per cent of the original right-of-use asset).

50 per cent of the pre-modification right-of-use asset (CU184,002) is CU92,001. Fifty per cent of the pre-modification lease liability (CU210,618) is CU105,309. Consequently, Lessee reduces the carrying amount of the right-of-use asset by CU92,001 and the carrying amount of the lease liability by CU105,309. Lessee recognises the difference between the decrease in the lease liability and the decrease in the right-of-use asset (CU105,309 - CU92,001 = CU13,308) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Lessee recognises the difference between the remaining lease liability of CU105,309 and the modified lease liability of CU129,884 (which equals CU24,575) as an adjustment to the right-of-use asset reflecting the change in the consideration paid for the lease and the revised discount rate.

Example 18-Modification that both increases and decreases the scope of the lease

Lessee enters into a 10-year lease for 2,000 square metres of office space. The annual lease payments are CU100,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6 per cent per annum. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease to (a) include an additional 1,500 square metres of space in the same building starting from the beginning of Year 6 and (b) reduce the lease term from 10 years to eight years. The annual fixed payment for the 3,500 square metres is CU150,000 payable at the end of each year (from Year 6 to Year 8). Lessee's incremental borrowing rate at the beginning of Year 6 is 7 per cent per annum.

The consideration for the increase in scope of 1,500 square metres of space is not commensurate with the stand-alone price for that increase adjusted to reflect the circumstances of the contract. Consequently, Lessee does not account for the increase in scope that adds the right to use an additional 1,500 square metres of space as a separate lease.

The pre-modification right-of-use asset and the pre-modification lease liability in relation to the lease are as follows.

	Lease liability				Right-of-use asset		
	Beginning balance	6% interest expense	Lease payment	Ending balance	Beginning balance	Depreciation charge	Ending balance
Year	CU	CU	CU	CU	CU	CU	CU
1	**736,009**	44,160	(100,000)	**680,169**	**736,009**	(73,601)	**662,408**
2	**680,169**	40,810	(100,000)	**620,979**	**662,408**	(73,601)	**588,807**
3	**620,979**	37,259	(100,000)	**558,238**	**588,807**	(73,601)	**515,206**
4	**558,238**	33,494	(100,000)	**491,732**	**515,206**	(73,601)	**441,605**
5	**491,732**	29,504	(100,000)	**421,236**	**441,605**	(73,601)	**368,004**
6	**421,236**				**368,004**		

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability on the basis of: (a) a three-year remaining lease term, (b) annual payments of CU150,000 and (c) Lessee's incremental borrowing rate of 7 per cent per annum. The modified liability equals CU393,647, of which (a) CU131,216 relates to the increase of CU50,000 in the annual lease payments from Year 6 to Year 8 and (b) CU262,431 relates to the remaining three annual lease payments of CU100,000 from Year 6 to Year 8.

Decrease in the lease term

At the effective date of the modification (at the beginning of Year 6), the pre-modification right-of-use asset is CU368,004. Lessee determines the proportionate decrease in the carrying amount of the right-of-use asset based on the remaining right-of-use asset for the original 2,000 square metres of office space (ie a remaining three-year lease term rather than the original five-year lease term). The remaining right-of-use asset for the original 2,000 square metres of office space is CU220,802 (ie CU368,004 ÷ 5 × 3 years).

At the effective date of the modification (at the beginning of Year 6), the pre-modification lease liability is CU421,236. The remaining lease liability for the original 2,000 square metres of office space is CU267,301 (ie present value of three annual lease payments of CU100,000, discounted at the original discount rate of 6 per cent per annum).

Consequently, Lessee reduces the carrying amount of the right-of-use asset by CU147,202 (CU368,004 - CU220,802), and the carrying amount of the lease liability by CU153,935 (CU421,236 - CU267,301). Lessee recognises the difference between the decrease in the lease liability and the decrease in the right-of-use asset (CU153,935 - CU147,202 = CU6,733) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Lease liability	CU153,935	
Right-of-use asset		CU147,202
Gain		CU6,733

At the effective date of the modification (at the beginning of Year 6), Lessee recognises the effect of the remeasurement of the remaining lease liability reflecting the revised discount rate of 7 per cent per annum, which is CU4,870 (CU267,301 - CU262,431), as an adjustment to the right-of-use asset.

Lease liability	CU4,870	
Right-of-use asset		CU4,870

Increase in the leased space

At the commencement date of the lease for the additional 1,500 square metres of space (at the beginning of Year 6), Lessee recognises the increase in the lease liability related to the increase in scope of CU131,216 (ie present value of three annual lease payments of CU50,000, discounted at the revised interest rate of 7 per cent per annum) as an adjustment to the right-of-use asset

Right-of-use asset	CU131,216	
Lease liability		CU131,216

The modified right-of-use asset and the modified lease liability in relation to the modified lease are as follows.

	Lease liability				Right-of-use asset		
	Beginning balance	7% interest expense	Lease payment	Ending balance	Beginning balance	Depreciation charge	Ending balance
Year	CU	CU	CU	CU	CU	CU	CU
6	**393,647**	27,556	(150,000)	**271,203**	**347,148**	(115,716)	**231,432**
7	**271,203**	18,984	(150,000)	**140,187**	**231,432**	(115,716)	**115,716**
8	**140,187**	9,813	(150,000)	-	**115,716**	(115,716)	-

Example 19-Modification that is a change in consideration only

Lessee enters into a 10-year lease for 5,000 square metres of office space. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to reduce the lease payments from CU100,000 per year to CU95,000 per year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6 per cent per annum. Lessee's incremental borrowing rate at the beginning of Year 6 is 7 per cent per annum. The annual lease payments are payable at the end of each year.

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability based on: (a) a five-year remaining lease term, (b) annual payments of CU95,000, and (c) Lessee's incremental borrowing rate of 7 per cent per annum. Lessee recognises the difference between the carrying amount of the modified liability (CU389,519) and the lease liability immediately before the modification (CU421,236) of CU31,717 as an adjustment to the right-of-use asset.

FASB differences

As shown in Example 18 in IFRS 16 above, lease modifications that do not result in a separate contract and shorten the contractual lease term result in the recognition of a gain or loss for the difference between the decrease in the lease liability and the proportionate decrease in the right-of-use asset. Under ASC 842, lease modifications that do not result in a separate contract and shorten the contractual lease term do not result in the recognition of a gain or loss. A lessee recognises the amount of the remeasurement of the lease liability as an adjustment to the corresponding right-of-use asset without affecting profit or loss. However, if the right-of-use asset is reduced to zero, a lessee would recognise any remaining amount in profit or loss.

5.5.4 Assessing whether a rent concession is a lease modification

As discussed above, a lease modification is defined in IFRS 16 as a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease.

In April 2020, the IASB issued a non-authoritative educational document, *IFRS 16 and covid-19: Accounting for covid-19-related rent concessions applying IFRS 16 Leases*, to support the consistent application of requirements of IFRS 16 upon changes in lease payments that occur, or are expected to occur, as a result of the covid-19 pandemic. Although the educational document was issued in response to the covid-19 pandemic, it includes perspectives that may be helpful when evaluating certain rent concessions that arise in circumstances unrelated to covid-19 including certain circumstances discussed below.

In many cases, rent concessions will meet the definition of a lease modification, in which case, the lease modification requirements are applied from the effective date of the modification, as discussed in section 5.5.4.B below.

A change in the scope of a lease

In assessing whether there has been a change in the scope of a lease, an entity considers whether there has been a change in the right of use conveyed to the lessee by the contract. A change in the scope of a lease includes adding or terminating the right to use one or more underlying assets or extending or shortening the contractual lease term. A lease payment deferral, lease payment holiday or lease payment reduction alone is not, in isolation, a change in the scope of a lease.

A change in the consideration for a lease

In assessing whether there has been a change in the consideration for a lease, an entity considers the overall effect of any change in the lease payments. For example, a lessor-granted concession may allow a lessee not to make lease payments for a three-month period, but the lease payments for periods thereafter are increased proportionally in a way that means that the consideration for the lease is unchanged. Such a lease payment deferral, with no change in the total consideration for the lease, or the scope of the lease, would not, based on the IASB's April 2020 non-authoritative educational document, be a lease modification. We believe that increases to subsequent lease payments to take account solely of the time value of money would not be a substantive change in the consideration for the lease. For example, if a lessor deferred a lease payment for June 2022 and required it to be paid in January 2023 plus an interest charge at a rate to reasonably compensate the lessor for the time value of money, that would not be a substantive change in the consideration for the lease. However, if there are other substantive changes in the consideration (e.g., forgiveness of rents payable/receivable) and/or a change in the scope of a lease (e.g., adding an additional floor to a leased office space), the lease modification guidance in IFRS 16 applies to the entire change. That is, an entity cannot bifurcate and account for a lease payment deferral separately from other contemporaneous changes to the contract.

FASB differences

Applying ASC 842, a substantive change in the timing of lease payments is a lease modification because there is a substantive change in the terms and conditions of the contract. This may be interpreted differently under IFRS 16 because there is no change to the total amount of consideration for the lease.

Illustration 5-4: Deferral of lease payments - considering the IASB's April 2020 non-authoritative educational document

Restaurant A leases space in a shopping mall from Lessor B. Under the terms of the lease, Restaurant A makes fixed lease payments of CU100 to Lessor B at the beginning of each month. The non-cancellable lease term ends on 28 February 2024. The contract does not include any extension, termination or purchase options. For simplicity, the discount rate is assumed to be 0% at the commencement date and thus the lease liability at 30 June 2022 for the remaining 20 monthly lease payments is CU2,000.

Assume that Restaurant A's right-of-use asset is not impaired before or during the periods described.

On 1 July 2022, Lessor B agrees to defer the three months of lease payments originally due in July, August and September 2022 to 1 January 2023. There are no non-lease components to the contract and there are no other changes to the terms and conditions of the lease.

Analysis: Under IFRS 16, a lease modification is defined as a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease. Given that the only change is the timing of the cash outflows, there is no change in the scope of the lease. Restaurant A next considers whether there is a change in the consideration for the lease by reference to the overall effect of any change in the lease payments. In this fact pattern, Restaurant A does not make lease payments for a period of three months from July 2022 and will increase the lease payment due on 1 January 2023 by the same amount as the deferral. Therefore, the consideration for the lease remains substantively unchanged and the rent concession does not constitute a lease modification.

A change that is, or is not, part of the original terms and conditions of the lease

When evaluating if there has been a change in either the scope of, or the consideration for, the lease, an entity is required to consider the terms and conditions of contracts and all relevant facts and circumstances, including the applicable law governing such contracts. When a lessee and lessor agree to a change to a lease that is not contemplated by the original terms and conditions of the lease, the change is accounted for as a lease modification. In this case, lessees would follow IFRS 16.44 to 46 and lessors would consider the guidance in IFRS 16.79 and 80 (for finance leases) or IFRS 16.87 (for operating leases).

However, if a change is limited solely to the changes contemplated in the existing terms and conditions of the lease, there is no lease modification for the purposes of IFRS 16.

Entities should carefully consider terms in their contracts as they may contain clauses (e.g., a force majeure clause) that result in changes to lease payments if particular events occur or circumstances arise. For example, a contract may include a clause providing the lessee with a right to reduced lease payments upon government action requiring the closure of retail stores for a period of time. Changes in lease payments that result from clauses in the original contract (or in applicable law) would not be lease modifications for the purposes of IFRS 16.

Existing contracts may not specifically contemplate particular circumstances (for example the effect of a global pandemic) and, as such, there could be legal ambiguities when evaluating lease contracts. Therefore, to determine the appropriate accounting for a lease concession, it is important to carefully identify and consider the rights and obligations of the lessee and lessor, taking into account the terms and conditions of the contract and the applicable legal framework.

Questions have been asked as to whether lease concessions mandated by changes to applicable law constitute a lease modification. For example, when a government introduces new laws mandating certain rent concessions. Some stakeholders believe that, in these cases, there is a change in the consideration for the lease which was not part of the original terms and conditions of the lease and, thus, modification accounting is required. However, other stakeholders believe that when the lessee and lessor agree to a lease contract, subject to the law of a jurisdiction, the parties have also agreed to be bound by any future changes in the applicable law. Thus, any changes made to comply with a change in law are contemplated in the contract and should not be considered to constitute a lease modification.

How we see it

Given that IFRS 16 does not specifically address whether changes to the law constitute a lease modification, we believe there is likely to be diversity in practice and both approaches explained above are acceptable. However, entities should consider the disclosure objectives in IFRS 16 and disclose their policies and the effect of such policies related to lease concessions.

5.5.4.A Rent concessions that change the consideration in the contract

Some forms of rent concessions may change the consideration of the lease beyond what was contemplated in the original terms and conditions of the lease and, thus, require lease modification accounting to be applied.

Illustration 5-5: Change of lease payments from fixed to partially variable

Restaurant A leases space in a shopping mall from Lessor B. Under the terms of the lease, Restaurant A makes fixed lease payments of CU100 to Lessor B at the beginning of each month. The non-cancellable lease term ends on 28 February 2024. The contract does not include any extension, termination or purchase options. For simplicity, the discount rate is assumed to be 0% at the commencement date and thus the lease liability at 30 June 2022 for the remaining 20 monthly lease payments is CU2,000.

Assume that Restaurant A's right-of-use asset is not impaired before or during the periods described.

On 1 July 2022, Lessor B agrees to change the terms and conditions of the lease contract with Restaurant A, such that fixed lease payments are reduced to CU25 per month, plus an additional variable lease payment based on 3% of the monthly turnover of Restaurant A at that shopping mall.

Analysis: In this fact pattern, the consideration for the lease has changed from solely fixed lease payments to a combination of fixed and variable lease payments, which were not part of the original terms and conditions of the contract. Therefore, the change constitutes a lease modification.

5.5.4.B Lessee accounting for rent concessions that are lease modifications

As discussed in section 5.5.2 above, for a lease modification that is not accounted for as a separate lease, a lessee applies modification accounting at the effective date of the lease modification. In such a case, a lessee allocates the consideration in the modified contract to the lease and non-lease components (where applicable), determines the lease term of the modified lease and remeasures the lease liability by discounting the revised lease payments using a revised discount rate determined on that date. The revised discount rate is the rate of interest implicit in the lease for the remainder of the lease term, or if that rate cannot be readily determined, the lessee's incremental borrowing rate.

If the modification decreases the scope of the lease (e.g., a change that reduces total leased space or shortens the lease term), the lessee remeasures the lease liability and reduces the right-of-use asset to reflect the partial or full termination of the lease (e.g., a 50% reduction in leased space would reduce the right-of-use asset by 50%). Any difference between those two adjustments is recognised in profit or loss at the effective date of the modification. For all other modifications, the lessee recognises the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset, without affecting profit or loss.

Illustration 5-6: Lessee accounting for rent concessions that are a lease modification

Scenario 1 - Forgiveness of lease payments and extension of the lease term

Restaurant A leases space in a shopping mall from Lessor B.

Under the terms of the lease, Restaurant A makes fixed lease payments of CU100 to Lessor B at the beginning of each month. The non-cancellable lease term ends on 28 February 2024. The contract does not include any extension, termination or purchase options. For simplicity, the discount rate is assumed to be 0% at the commencement date and thus the lease liability at 30 June 2022 for the remaining 20 monthly lease payments is CU2,000.

Assume that Restaurant A's right-of-use asset is not impaired before or during the periods described.

On 1 July 2022, Lessor B agrees to forgive the three months of lease payments originally due in July, August and September 2022. There are no non-lease components to the contract and there are no other changes to the terms and conditions of the lease.

Assume the parties agree to extend the lease term by three months at the same monthly lease payment of CU100 per month. The lease term will now end on 31 May 2024.

Analysis: There is no overall effect of any change in the lease payments in this scenario. Thus, there is no change in the consideration for the lease. However, the scope of the lease has changed as the lease term has been extended by three months, which was not part of the original terms and conditions of the lease. Therefore, the rent concession in this scenario constitutes a lease modification.

On the effective date of modification (i.e., 1 July 2022), Restaurant A applies lease modification accounting and remeasures the lease liability by discounting the revised lease payments using a revised discount rate, determined at the effective date of the modification. A corresponding adjustment is made to the right-of-use asset.

Depreciation of the right-of-use asset continues over the revised remaining lease term.

Scenario 2 - Forgiveness of lease payments

Assume the same fact pattern as above, except for the following:

On 1 July 2022, Lessor B agrees to waive the three months of lease payments originally due in July, August and September 2022. There are no other changes to the terms and conditions of the lease.

Analysis: In this fact pattern, there is a reduction in the consideration for the lease which was not part of the original terms and conditions of the lease. Therefore, there is a lease modification.

On the effective date of the modification (i.e., 1 July 2022), Restaurant A applies lease modification accounting and remeasures the lease liability by discounting the revised lease payments using a revised discount rate, determined at the effective date of the modification. Restaurant A accounts for the remeasurement of the lease liability by adjusting the carrying amount of the right-of-use asset, as follows (assuming the revised discount rate is 0%):

Dr	Lease liability (100 × 3)	CU300	
	Cr Right-of-use asset		CU300

Depreciation of the revised right-of-use asset continues over the remaining lease term.

How we see it

The modification of a lease often requires the remeasurement of the lease liability using a revised discount rate. Given that the interest rate implicit in the lease is generally not readily determinable by the lessee, it is usually necessary for the lessee to determine a revised incremental borrowing rate.

5.5.4.C Application of IFRS 9 to rent concessions

In 2022, the IFRS IC discussed a submission on lessee accounting when the lessee is legally released by the lessor from its obligation to make specifically identified lease payments with no other changes being made to the lease. The submission asked whether the lessee applies the derecognition requirements in IFRS 9, or the lease modification requirements in IFRS 16 in accounting for the rent concession. The IFRS IC observed that there is more than one way for a lessee to read the principles and requirements in IFRS in accounting for the rent concession in the submitted fact pattern. The IFRS IC therefore referred the issue to the IASB. The IASB considered the issue, and in July 2024, as part of the *Annual Improvements to IFRS Accounting Standards - Volume 11*, the IASB amended paragraph 2.1(b)(ii) of IFRS 9 to include a cross reference to paragraph 3.3.3 of IFRS 9. This amendment clarifies that when a lessee has determined that a lease liability has been extinguished applying IFRS 9, the lessee is required to recognise any resulting gain or loss in profit or loss in accordance with paragraph 3.3.3 of IFRS 9. The amendment does not address how a lessee distinguishes between a lease modification as defined in IFRS 16 and an extinguishment of a lease liability in accordance with IFRS 9. The amendment applies to annual reporting periods beginning on or after 1 January 2026, with earlier application permitted.

How we see it

As discussed in section 5.5.4 above, in many cases, rent concessions will meet the definition of a lease modification, in which case, the lease modification requirements are applied from the effective date of the modification, as discussed in section 5.5.4.B. We believe that when a lease modification includes both a reduction in the lessee's obligation to make specifically identified lease payments and other changes to the lease contract (for example, changing the lease term, adding a right to use additional underlying assets), the entirety of modification is accounted for in accordance with IFRS 16 (rather than IFRS 9).

5.5.5 Temporary exception arising from interest rate benchmark reform

In August 2020, the IASB published *Interest Rate Benchmark Reform - Phase 2, Amendments to* IFRS 9, IAS 39, IFRS 7, IFRS 4 *and* IFRS 16. The amendments provide temporary reliefs which address the financial reporting effects when an interbank offered rate (IBOR) is replaced with an alternative nearly risk-free interest rate (RFR).

The amendments to IFRS 16 provide relief from the need to apply modification accounting. As a practical expedient, a lessee applies IFRS 16.42 to account for a lease modification required by interest rate benchmark reform. This practical expedient applies only to such modifications. For this purpose, a lease modification is required by interest rate benchmark reform if, and only if, both of these conditions are met

- The modification is necessary as a direct consequence of interest rate benchmark reform, and
- The new basis for determining lease payments is 'economically equivalent' to the previous basis (i.e., the basis immediately preceding the modification). *[IFRS 16.105]*.

If the modifications to the contract includes changes beyond those required by interest rate benchmark reform, a lessee applies the requirements in IFRS 16 to account for all lease modifications made at the same time, including those required by interest rate benchmark reform. *[IFRS 16.106]*. Interest rate benchmark reform is further discussed in Supplement: IBOR Reform.

5.6 Other lessee matters

5.6.1 Impairment of right-of-use assets

Extract from IFRS 16	
33	A lessee shall apply IAS 36 *Impairment of Assets* to determine whether the right-of-use asset is impaired and to account for any impairment loss identified.

Lessees' right-of-use assets are subject to existing impairment requirements in IAS 36. *[IFRS 16.33]*.

IAS 36 requires an impairment indicator analysis at each reporting period. If any indicators are present, the entity is required to estimate the recoverable amount of the asset (or the cash-generating unit (CGU) of which the asset is a part). The entity has to recognise an impairment loss if the recoverable amount of the CGU is less than the carrying amount of the CGU. After an impairment loss is recognised, the adjusted carrying amount of the right-of-use asset would be its new basis for depreciation.

Subsequent reversal of a previously recognised impairment loss needs to be assessed if there is any indication that an impairment loss recognised in prior periods may no longer exist or may have decreased. In recognising any reversal, the increased carrying amount of the asset must not exceed the carrying amount that would have been determined after depreciation, had there been no impairment.

5.6.2 Leases denominated in a foreign currency

Lessees apply IAS 21 *The Effects of Changes in Foreign Exchange Rates*, to leases denominated in a foreign currency. As they do for other monetary liabilities, lessees remeasure the foreign currency-denominated lease liability using the exchange rate at each reporting date. Any changes to the lease liability due to exchange rate changes are recognised in profit or loss. Because the right-of-use asset is a non-monetary asset measured at historical cost, it is not affected by changes in the exchange rate.

The IASB acknowledged that this approach could result in volatility in profit or loss from the recognition of foreign currency exchange gains or losses, but it will be clear to users of financial statements that the gains or losses result solely from changes in exchange rates. *[IFRS 16.BC199]*.

5.6.3 Portfolio application

IFRS 16 applies to individual leases. However, entities that have a large number of leases of similar assets (e.g., leases of a fleet of similar rolling stock) may face practical challenges in applying the leases model on a lease-by-lease basis. The IASB acknowledged the concerns and included a practical expedient that allows entities to use a portfolio approach for leases with similar characteristics if the entity reasonably expects that the effects on the financial statements would not differ materially from the application of the standard to the individual leases in that portfolio. *[IFRS 16.B1, IFRS 16.BC83]*.

How we see it

The IASB included the portfolio approach to be consistent with IFRS 15. A decision to use the portfolio approach is similar to a decision to expense, rather than capitalise, certain assets when the accounting difference is, and would continue to be, immaterial to the financial statements.

5.6.4 Income tax accounting

IFRS 16 can affect lessees' accounting for income taxes. For lessees, IFRS 16 requires recognition of lease-related assets and liabilities and can change the measurement of other lease-related assets and liabilities. These changes affect certain aspects of accounting for income taxes such as the following:

- Recognition and measurement of deferred tax assets and liabilities
- Assessment of the recoverability of deferred tax assets

Deferred tax assets and liabilities are further discussed in Chapter 29 at sections 7 and 8.

5.7 Presentation

Extract from IFRS 16

Presentation

47 A lessee shall either present in the statement of financial position, or disclose in the notes:

(a) right-of-use assets separately from other assets. If a lessee does not present right-of-use assets separately in the statement of financial position, the lessee shall:

(i) include right-of-use assets within the same line item as that within which the corresponding underlying assets would be presented if they were owned; and

(ii) disclose which line items in the statement of financial position include those right-of-use assets.

(b) lease liabilities separately from other liabilities. If the lessee does not present lease liabilities separately in the statement of financial position, the lessee shall disclose which line items in the statement of financial position include those liabilities.

48 The requirement in paragraph 47(a) does not apply to right-of-use assets that meet the definition of investment property, which shall be presented in the statement of financial position as investment property.

49 In the statement of profit or loss and other comprehensive income, a lessee shall present interest expense on the lease liability separately from the depreciation charge for the right-of-use asset. Interest expense on the lease liability is a component of finance costs, which paragraph 82(b) of IAS 1 *Presentation of Financial Statements* requires to be presented separately in the statement of profit or loss and other comprehensive income.

50 In the statement of cash flows, a lessee shall classify:

(a) cash payments for the principal portion of the lease liability within financing activities;

(b) cash payments for the interest portion of the lease liability applying the requirements in IAS 7 *Statement of Cash Flows* for interest paid; and

(c) short-term lease payments, payments for leases of low-value assets and variable lease payments not included in the measurement of the lease liability within operating activities.

[IFRS 16.47, IFRS 16.48, IFRS 16.49, IFRS 16.50].

Right-of-use assets and lease liabilities are subject to the same considerations as other assets and liabilities in classifying them as current and non-current in the statement of financial position.

The following table summarises how lease-related amounts and activities are presented in lessees' financial statements:

Financial statement	Lessee presentation
Statement of financial position	▸ Right-of-use assets presented either: ▸ Separately from other assets (e.g., owned assets) ▸ Together with other assets as if they were owned, with disclosures of the statement of financial position line items that include right-of-use assets and their amounts ▸ Right-of-use assets that meet the definition of investment property are presented as investment property ▸ Lease liabilities presented either: ▸ Separately from other liabilities ▸ Together with other liabilities with disclosure of the statement of financial position line items that include lease liabilities and their amounts
Statement of profit or loss	Lease-related depreciation and lease-related interest expense are presented separately (i.e., lease-related depreciation and lease-related interest expense cannot be combined). Interest expense on the lease liability is a component of finance costs.

Financial statement	Lessee presentation
Statement of cash flows	▸ Cash payments for the principal portion of the lease liability are presented within financing activities ▸ Cash payments for the interest portion of the lease liability are presented based on an accounting policy election in accordance with IAS 7 *Statement of Cash Flows* ▸ Lease payments for short-term leases and leases of low-value assets not recognised on the statement of financial position and variable lease payments not included in the lease liability are presented within operating activities ▸ Non-cash activity (e.g., the initial recognition of the lease at commencement) is disclosed as a supplemental non-cash item

5.8 Disclosure

5.8.1 Disclosure objective

The objective of lessee disclosures is to enable financial statement users to assess the effect that leases have on a lessee's financial statements (e.g., the amount, timing and uncertainty of cash flows arising from leases). The IASB believes that if a lessee is required to assess whether the overall quality and informational value of its lease disclosures are sufficient to meet the stated objective, the lessees' interpretation and implementation of the disclosure requirements will be improved. *[IFRS 16.51, IFRS 16.BC215]*.

IFRS 16 requires lessees to present all disclosures in a single note or separate section in the financial statements. The IASB believes this will often be the most effective way to present information about leases in the manner required by IAS 1.113. *[IFRS 16.BC228]*.

5.8.2 Disclosures of assets, liabilities, expenses and cash flows

Lessees are required to disclose the following information, which users of financial statements identified as being most useful to their analyses:

- Carrying amount of right-of-use assets and depreciation charge for those assets, split by class of underlying asset
- Interest expense on lease liabilities
- Short-term lease expense for such leases with a lease term greater than one month
- Low-value asset lease expense (except for portions related to short-term leases)
- Variable lease expense (i.e., for variable lease payments not included in the lease liability)
- Income from subleasing right-of-use assets
- Total cash outflow for leases
- Additions to right-of-use assets
- Gains and losses arising from sale and leaseback transactions
- Carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset *[IFRS 16.53]*

All of the above disclosures are required to be presented in tabular format, unless another format is more appropriate. The amounts disclosed include costs that a lessee has included in the carrying amount of another asset during the reporting period. *[IFRS 16.54]*.

In Practical example 5-1 below, Deutsche Post AG presents disclosures of right-of-use assets in the notes to the accounts.

Practical example 5-1: Deutsche Post AG (2021) Germany

2021 Annual Report [extract]

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS OF DEUTSCHE POST AG [extract]

Lease disclosures

41 Lease disclosures

Currency translation income on lease liabilities totalled €16 million (previous year: €28 million), whilst the related expenses amounted to €49 million (previous year: €25 million). Gains from sale-and-leaseback transactions came in at €105 million (previous year: €149 million) with €96 million (previous year: €131 million) attributable to real estate development projects. The right-of-use assets carried as non-current assets resulting from leases are presented separately in the following table:

Right-of-use assets

€m

	Land and buildings	Technical equipment and machinery	IT systems, operating and office equipment	Aircraft	Transport equipment	Advance payments and assets under development	Total
31 December 2020							
Accumulated cost	11,431	227	8	2,079	899	0	**14,644**
of which additions	1,874	83	1	534	266	1	**2,759**
Accumulated depreciation and impairment losses	3,543	90	6	632	402	0	**4,673**
Carrying amount	**7,888**	**137**	**2**	**1,447**	**497**	**0**	**9,971**
31 December 2021							
Accumulated cost	12,472	236	9	3,016	1,098	251	**17,082**
of which additions	2,116	24	1	543	310	86	**3,080**
Accumulated depreciation and impairment losses	4,318	117	7	961	511	0	**5,914**
Carrying amount	**8,154**	**119**	**2**	**2,055**	**587**	**251**	**11,168**

In the real estate area, the Group primarily leases warehouses, office buildings and mail and parcel centres. The leased aircraft are predominantly deployed in the air network of the Express segment. The additions also relate to the renewal of the aircraft fleet. Leased transport equipment also includes the leased vehicle fleet. The real estate leases in particular are long-term leases. The Group had 79 real estate leases with remaining lease terms of more than 20 years as at 31 December 2021 (previous year: 62 leases). Aircraft leases have remaining lease terms of up to 14 years. Leases may include extension and termination options, note 7. The leases are negotiated individually and include a wide range of different conditions. Lease liabilities are presented in the following table:

€m

	2020	2021
Non-current lease liabilities	8,638	9,841
Current lease liabilities	1,821	1,964
Total	**10,459**	**11,805**

Future cash outflows amounted to €14 billion (previous year: €13 billion) as at the reporting date, note 43. Possible future cash outflows amounting to €2.6 billion (previous year: €2.0 billion) were not included in lease liabilities because it is not reasonably certain that the leases will be extended (or not terminated). Leases that the Group has entered into as a lessee but that have not yet commenced result in possible future payment outflows totalling €1.6 billion (previous year: €0.2 billion), which primarily result from the renewal of the aircraft fleet. Additional information on the lessee required under IFRS 16 can be found in note 12, 14, 18 and 42.

Lessees also are required to disclose a maturity analysis of lease liabilities in accordance with paragraphs 39 and B11 of IFRS 7 *Financial Instruments: Disclosures*. Lessees are required to disclose this maturity analysis separately from the maturity analyses of other financial liabilities. *[IFRS 16.58]*. The IASB believes that because the lessee accounting model is based on the premise that a lease liability is a financial liability, it is appropriate for lessees to apply the same maturity analysis disclosure requirements to lease liabilities as to those applied to other financial liabilities. *[IFRS 16.BC222]*.

A lessee is required to disclose the amount of its lease commitments for short-term leases when short-term lease commitments at the end of the reporting period are dissimilar to same period's short-term lease expense (that is otherwise required to be disclosed). *[IFRS 16.55]*.

A lessee is not required to provide the disclosures required in IFRS 16.53(a), (f), (h) or (j) for right-of-use assets that meet the definition of investment property. Instead, a lessee applies the disclosure requirements in IAS 40. *[IFRS 16.56]*.

If a lessee measures right-of-use assets at revalued amounts when applying IAS 16, the lessee is required to disclose the information required by IAS 16.77 for those right-of-use assets. *[IFRS 16.57]*.

How we see it

IFRS 16 requires disclosure of the total cash outflow for leases. It does not explicitly state that leases of low-value assets and short-term leases are excluded. Therefore, we believe the cash outflows related to those leases should be included in the disclosure.

5.8.3 Additional disclosures

Extract from IFRS 16

59 In addition to the disclosures required in paragraphs 53-58, a lessee shall disclose additional qualitative and quantitative information about its leasing activities necessary to meet the disclosure objective in paragraph 51 (as described in paragraph B48). This additional information may include, but is not limited to, information that helps users of financial statements to assess:

(a) the nature of the lessee's leasing activities;

(b) future cash outflows to which the lessee is potentially exposed that are not reflected in the measurement of lease liabilities. This includes exposure arising from:

(i) variable lease payments (as described in paragraph B49);

(ii) extension options and termination options (as described in paragraph B50);

(iii) residual value guarantees (as described in paragraph B51); and

(iv) leases not yet commenced to which the lessee is committed.

(c) restrictions or covenants imposed by leases; and

(d) sale and leaseback transactions (as described in paragraph B52).

60 A lessee that accounts for short-term leases or leases of low-value assets applying paragraph 6 shall disclose that fact.

[IFRS 16.59, IFRS 16.60].

In Practical examples 5-2 below, Nestle S.A. describes the nature of its leasing activities.

Practical example 5-2: Nestlé S.A. (2023) **Switzerland**

Financial Statements 2023 [extract]
Consolidated Financial Statements of the Nestlé Group 2023 [extract]
Notes [extract]
8. Property, plant and equipment [extract]
8.2 Leases - Group as a lessee [extract]

8.2a Description of lease activities

Real estate leases

The Group leases land and buildings for its office and warehouse space and retail stores. Lease terms are negotiated on an individual basis and contain a wide range of different terms and conditions. Leases are typically made for a fixed period of 5–15 years and may include extension options which provide operational flexibility. If the Group exercised all extension options not currently included in the lease liability, the additional payments would amount to CHF 0.9 billion (undiscounted) as at December 31, 2023.

Vehicle leases

The Group leases trucks for distribution in specific businesses and cars for management and sales functions. The average contract duration is 6 years for trucks and 3 years for cars.

Other leases

The Group also leases machinery and equipment, and tools, furniture and other equipment that are each insignificant to the total leased asset portfolio.

In providing additional information, lessees are required to consider:

(a) Whether that information is relevant to users of financial statements. The additional information specified above is included only if that information is expected to be relevant to users of financial statements. In this context, this is likely to be the case if it helps those users to understand:
    (i) The flexibility provided by leases. Leases may provide flexibility if, for example, a lessee can reduce its exposure by exercising termination options or renewing leases with favourable terms and conditions
    (ii) Restrictions imposed by leases. Leases may impose restrictions, for example, by requiring the lessee to maintain particular financial ratios
    (iii) Sensitivity of reported information to key variables. Reported information may be sensitive to, for example, future variable lease payments
    (iv) Exposure to other risks arising from leases
    (v) Deviations from industry practice. Such deviations may include, for example, unusual or unique lease terms and conditions that affect a lessee's lease portfolio
(b) Whether that information is apparent from information either presented in the primary financial statements or disclosed in the notes. A lessee need not duplicate information that is already presented elsewhere in the financial statements *[IFRS 16.B48]*

Additional information relating to variable lease payments that, depending on the circumstances, may be needed to satisfy the disclosure objective could include information that helps users of financial statements to assess, for example:

(a) The lessee's reasons for using variable lease payments and the prevalence of those payments
(b) The relative magnitude of variable lease payments to fixed payments
(c) Key variables upon which variable lease payments depend and how payments are expected to vary in response to changes in those key variables
(d) Other operational and financial effects of variable lease payments *[IFRS 16.B49]*

Additional information relating to extension options or termination options that, depending on the circumstances, may be needed to satisfy the disclosure objective could include information that helps users of financial statements to assess, for example:

(a) The lessee's reasons for using extension options or termination options and the prevalence of those options
(b) The relative magnitude of optional lease payments to lease payments
(c) The prevalence of the exercise of options that were not included in the measurement of lease liabilities
(d) Other operational and financial effects of those options *[IFRS 16.B50]*

Optional lease payments are payments made by a lessee to a lessor for the right to use an underlying asset during periods covered by an option to extend or terminate a lease that are not included in the lease term. *[IFRS 16 Appendix A]*.

Additional information relating to residual value guarantees that, depending on the circumstances, may be needed to satisfy the disclosure objective could include information that helps users of financial statements to assess, for example:

(a) The lessee's reasons for providing residual value guarantees and the prevalence of those guarantees
(b) The magnitude of a lessee's exposure to residual value risk
(c) The nature of underlying assets for which those guarantees are provided
(d) Other operational and financial effects of those guarantees *[IFRS 16.B51]*

5.8.4 Disclosures required by IAS 1

In addition to the disclosure requirements under IFRS 16 described above, an entity is required to make disclosures in accordance with IAS 1.

An entity is required to disclose its significant accounting policies comprising:

(a) The measurement basis (or bases) used in preparing the financial statements

    And

(b) The other accounting policies used that are relevant to an understanding of the financial statements *[IAS 1.117]*

An entity discloses, along with its significant accounting policies or other notes, the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. *[IAS 1.122]*. An entity also discloses information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes include details of:

(a) Their nature

And

(b) Their carrying amount as at the end of the reporting period *[IAS 1.125]*

There are a number of judgements and estimates that entities may make in applying IFRS 16, which may require disclosure in accordance with IAS 1. These include, but are not limited to, application of the definition of a lease, determination of the lease term and determination of the incremental borrowing rate.

6 Lessor accounting

6.1 Lease classification

Extract from IFRS 16	
61	**A lessor shall classify each of its leases as either an *operating lease* or a *finance lease*.**
62	**A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.**
B53	The classification of leases for lessors in this Standard is based on the extent to which the lease transfers the risks and rewards incidental to ownership of an underlying asset. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions. Rewards may be represented by the expectation of profitable operation over the underlying asset's economic life and of gain from appreciation in value or realisation of a residual value.
B54	A lease contract may include terms and conditions to adjust the lease payments for particular changes that occur between the inception date and the commencement date (such as a change in the lessor's cost of the underlying asset or a change in the lessor's cost of financing the lease). In that case, for the purposes of classifying the lease, the effect of any such changes shall be deemed to have taken place at the inception date.

[IFRS 16.61, IFRS 16.62, IFRS 16.B53, IFRS 16.B54].

At inception, lessors classify all leases as finance leases or operating leases. Lease classification determines how and when a lessor recognises lease income and what assets are recorded. The criteria used for lease classification are discussed in detail below.

As classification is assessed at lease inception, lessors must also determine the interest rate implicit in the lease at lease inception.

FASB differences

In accordance with ASC 842, leases are classified by a lessor as operating, direct financing or sales-type leases at the lease commencement date. As a consequence, under ASC 842, lessors also determine the discount rate at the lease commencement date.

6.1.1 Criteria for lease classification

The classification of leases in IFRS 16 is based on the extent to which the risks and rewards incidental to ownership of the underlying asset lie with the lessor or the lessee. It depends on the substance of the transaction rather than the form of the contract. IFRS 16 lists a number of examples that individually, or in combination, would normally lead to a lease being classified as a finance lease:

- The lease transfers ownership of the asset to the lessee by the end of the lease term
- The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception date, that the option will be exercised
- The lease term is for the major part of the economic life of the asset even if title is not transferred
- At the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the asset
- The asset is of such a specialised nature that only the lessee can use it without major modifications *[IFRS 16.63]*

IFRS 16 does not provide quantitative indicators or thresholds for the assessment of the terms 'major part' and 'substantially all' to determine that a lease should be classified as a finance lease rather than as an operating lease. Under IFRS 16, entities apply qualitative, rather than quantitative, assessments to determine whether the risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee. Accordingly, assessing whether a lease term is for the major part of the economic life of an asset or whether the present value of the lease payments amounts to at least substantially all of the fair value of a leased asset is a matter of judgement.

Similarly, determining whether the exercise price in a lessee's option to purchase the underlying asset is expected to be 'sufficiently lower' than the fair value of the underlying asset at the date the option becomes exercisable, is a matter of judgement and depends on the facts and circumstances of the particular lease.

Paragraph 63 of IFRS 16 is clear that these are "examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease". Consequently, it is possible that the existence of certain of the situations, on their own, may determine the classification of a lease, whereas other leases may need to be evaluated in combination with other situations or indicators. The overriding consideration is whether the lease transfers from the lessor to the lessee substantially all the risks and rewards incidental to ownership of an underlying asset.

FASB differences

Unlike IFRS 16, under ASC 842, each classification criteria is determinative. After the adoption of Accounting Standards Update 2021-05 Leases (Topic 842): Lessors - Certain Leases with Variable Lease Payments, lessors are also required to classify a lease, under ASC 842, as an operating lease if the lease has variable lease payments that do not depend on an index or rate and would result in selling losses if the lease were to be classified as a sales-type or direct financing lease otherwise. IFRS 16 does not include additional guidance for a lessor's classification of a lease that results in a loss at lease commencement.

IFRS 16 also lists the following indicators of situations that, individually or in combination, could also lead to a lease being classified as a finance lease:

- If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee
- Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (e.g., in the form of a rent rebate that is equal to most of the sale proceeds at the end of the lease)
- The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent *[IFRS 16.64]*

Assessing the substance of the transaction involves considering all relevant factors. This includes considering the probability of different gain and loss outcomes relating to the residual accruing to the lessee and is not limited to the maximum possible amount at risk.

Illustration 6-1: Gains and losses from the fluctuation in the fair value of the residual

At the end of a lease, the underlying asset (the item of equipment) of a lease will be disposed of. The lessee is entitled to a rent rebate equalling 100% of the sales proceeds with a cap of CU1,000. The distribution of the probability of the sales proceeds is as follows:

Sales proceeds	Probability %
Up to CU1,000	95
CU1,000 to CU2,000	5
Over CU2,000	0

Analysis: The sales proceeds could be as high as CU2,000 and the rent rebate is capped at CU1,000. However, the probability assessment suggests that it would be unlikely for the sales proceeds to exceed the capped amount. Therefore, it would be appropriate to conclude the gains or losses from the fluctuation in the fair value of the residual generally accrue to the lessee.

How we see it

In our view, other considerations that could be made in determining the economic substance of the lease arrangement include the following:

- Are the lease rentals based on a market rate for use of the asset (which would indicate an operating lease) or a financing rate for use of the funds, which would be indicative of a finance lease?
- Is the existence of put and call options a feature of the lease? If so, are they exercisable at a predetermined price or formula (indicating a finance lease) or are they exercisable at the market price at the time the option is exercised (indicating an operating lease).

FASB differences

ASC 842 states that collectability of lease payments is considered when determining if a lease is classified as a direct financing or an operating lease. IFRS 16 does not include explicit guidance for considering collectability of lease payments.

6.1.2 Lease classification test for land and buildings

For a lease that includes both land and buildings elements, the lessor separately assesses the classification of each element as a finance lease or an operating lease, noting that land normally has an indefinite economic life. *[IFRS 16.B55]*.The lessor allocates lease payments between the land and the buildings elements in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease at the inception date. If the lease payments cannot be allocated reliably between these two elements, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case, the entire lease is classified as an operating lease. *[IFRS 16.B56]*.

For a lease of land and buildings in which the amount for the land element is immaterial to the lease, the lessor may treat the land and buildings as a single unit for the purpose of lease classification and classify it as a finance lease or an operating lease. In such a case, the lessor regards the economic life of the buildings as the economic life of the entire underlying asset. *[IFRS 16.B57]*.

6.1.3 Residual value guarantees included in the lease classification test

In evaluating IFRS 16's lease classification criteria, lessors are required to include in the 'substantially all' test any (i.e., the maximum obligation) residual value guarantees provided by both lessees and any other third party unrelated to the lessor.

6.1.4 Reassessment of lease classification

Lessors are required to reassess the lease classification only if there is a lease modification (i.e., a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease). Lessors reassess lease classification as at the effective date of the modification using the modified conditions at that date. If a lease modification results in a separate new lease, that new lease would be classified in the same manner as any new lease. *[IFRS 16.66]*.

FASB differences

ASC 842 requires lessors to reassess lease classification if lessees exercise an existing option to renew the lease (i.e., change in assessment of lease term) or to purchase the underlying asset when it was previously determined it was not reasonably certain to do so. Under IFRS 16, lease classification is reassessed only if there is a lease modification that is not accounted for as a separate contract.

6.2 Key concepts applied by lessor

Extract from IFRS 16

Appendix A
Defined terms

gross investment in the lease	The sum of: (a) the **lease payments** receivable by a **lessor** under a **finance lease**; and (b) any **unguaranteed residual value** accruing to the lessor.
net investment in the lease	The **gross investment in the lease** discounted at the **interest rate implicit in the lease**.
unguaranteed residual value	That portion of the residual value of the **underlying asset**, the realisation of which by a **lessor** is not assured or is guaranteed solely by a party related to the lessor.

[IFRS 16 Appendix A].

At lease commencement, lessors apply the key concepts described in section 4 above such as determining the initial direct costs, lease term, lease payments, fair value of the underlying asset and the interest rate implicit in the lease. Lessors also apply the following lessor accounting concepts to recognise and measure their leases.

Gross investment in the lease

The lessor's gross investment in a finance lease consists of the following undiscounted amounts:

- Lease payments receivable by the lessor under a finance lease. Refer to section 4.5 above.
- Any unguaranteed residual value accruing to the lessor - the unguaranteed residual value is the portion of the residual value of the underlying asset, the realisation of which by a lessor is not assured or is guaranteed solely by a party related to the lessor.

Net investment in the lease

A lessor's net investment in a finance lease consists of the gross investment in the lease discounted at the interest rate implicit in the lease.

6.3 Finance leases

6.3.1 Initial recognition and measurement

Extract from IFRS 16

67	**At the commencement date, a lessor shall recognise assets held under a finance lease in its statement of financial position and present them as a receivable at an amount equal to the *net investment in the lease*.**
	Initial measurement
68	The lessor shall use the interest rate implicit in the lease to measure the net investment in the lease. In the case of a sublease, if the interest rate implicit in the sublease cannot be readily determined, an intermediate lessor may use the discount rate used for the head lease (adjusted for any initial direct costs associated with the sublease) to measure the net investment in the sublease.
69	Initial direct costs, other than those incurred by manufacturer or dealer lessors, are included in the initial measurement of the net investment in the lease and reduce the amount of income recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease; there is no need to add them separately.
	Initial measurement of the lease payments included in the net investment in the lease
70	At the commencement date, the lease payments included in the measurement of the net investment in the lease comprise the following payments for the right to use the underlying asset during the lease term that are not received at the commencement date: (a) fixed payments (including in-substance fixed payments as described in paragraph B42), less any lease incentives payable; (b) variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date; (c) any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee; (d) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option (assessed considering the factors described in paragraph B37); and (e) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

[IFRS 16.67, IFRS 16.68, IFRS 16.69, IFRS 16.70].

Illustration 6-2: The lessor's gross and net investment in the lease

Details of a non-cancellable lease are, as follows:

- The asset has a fair value of CU10,000
- The lessee is required to make five annual rentals payable in advance of CU2,100
- The unguaranteed estimated residual value at the end of five years is CU1,000
- There is no guaranteed residual value

The lessor's direct costs have been excluded for simplicity.

The interest rate implicit in the lease is that which gives a present value of CU10,000 for the five rentals plus the total estimated residual value at the end of year 5. This rate is 6.62%.

Year	Net investment in the lease at start of period	Rental received	Finance income (6.62% per annum)	Gross investment at end of period	Gross earnings allocated to future periods	Net investment in the lease at end of period
	CU	CU	CU	CU	CU	CU
1	10,000	2,100	523	9,400	977	8,423
2	8,423	2,100	419	7,300	558	6,742
3	6,742	2,100	307	5,200	251	4,949
4	4,949	2,100	189	3,100	62	3,038
5	3,038	2,100	62	1,000	-	1,000
		10,500	1,500			

The lessor's gross investment in the lease is the total rents receivable of CU10,500 and the unguaranteed residual value of CU1,000. The gross earnings are therefore CU1,500.

The gross investment in the lease at any point in time comprises the aggregate of the rentals receivable in future periods and the unguaranteed residual value, e.g., at the end of year 2, the gross investment of CU7,300 is three years' rental of CU2,100 plus the unguaranteed residual of CU1,000. The net investment, which is the amount at which the debtor will be recorded in the statement of financial position, is CU7,300 less the earnings allocated to future periods of CU558 = CU6,742.

At lease commencement, a lessor accounts for a finance lease, as follows:

- Derecognises the carrying amount of the underlying asset
- Recognises the net investment in the lease
- Recognises, in profit or loss, any selling profit or selling loss

FASB differences

IFRS 16 does not distinguish between sales-type and direct financing leases. Under IFRS 16, selling profit on finance leases is recognised at lease commencement. In accordance with ASC 842, selling profit on direct financing leases is deferred at lease commencement and amortised into income over the lease term.

For finance leases (other than those involving manufacturer and dealer lessors), initial direct costs are included in the initial measurement of the finance lease receivable. Initial direct costs are included in the interest rate implicit in the lease and are not added separately. *[IFRS 16.69]*.

FASB differences

In accordance with ASC 842, lessors expense initial direct costs for sales-type leases if the fair value of the underlying asset is different from the carrying amount of the underlying asset at lease commencement.

The net investment in the lease is initially measured as the sum of: (1) the present value of both the lease payments (section 4.5); and (2) the present value of the unguaranteed residual asset, both discounted using the interest rate implicit in the lease (section 4.6). Any selling profit or loss is measured as the difference between the fair value of the underlying asset or the lease receivable, if lower, and the carrying amount of the underlying asset, net of any unguaranteed residual asset.

FASB differences

IFRS 16 does not include explicit guidance for considering collectability of lease payments. In accordance with ASC 842, collectability of lease payments is assessed for purposes of initial recognition and measurement of sales-type leases.

6.3.2 Manufacturer or dealer lessors

Extract from IFRS 16

71 At the commencement date, a manufacturer or dealer lessor shall recognise the following for each of its finance leases:

(a) revenue being the fair value of the underlying asset, or, if lower, the present value of the lease payments accruing to the lessor, discounted using a market rate of interest;

(b) the cost of sale being the cost, or carrying amount if different, of the underlying asset less the present value of the unguaranteed residual value; and

(c) selling profit or loss (being the difference between revenue and the cost of sale) in accordance with its policy for outright sales to which IFRS 15 applies. A manufacturer or dealer lessor shall recognise selling profit or loss on a finance lease at the commencement date, regardless of whether the lessor transfers the underlying asset as described in IFRS 15.

[IFRS 16.71].

Manufacturers or dealers often offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to profit or loss equivalent to the profit or loss resulting from an outright sale of the underlying asset, at normal selling prices, reflecting any applicable volume or trade discounts. *[IFRS 16.72]*.

Manufacturer or dealer lessors sometimes quote artificially low rates of interest to attract customers. The use of such a rate would result in a lessor recognising an excessive portion of the total income from the transaction at the commencement date. If artificially low rates of interest are quoted, a manufacturer or dealer lessor shall restrict selling profit to that which would apply if a market rate of interest were charged. *[IFRS 16.73]*.

A manufacturer or dealer lessor recognises as an expense, costs incurred in connection with obtaining a finance lease at the commencement date because they are mainly related to earning the manufacturer or dealer's selling profit. Costs incurred by manufacturer or dealer lessors in connection with obtaining a finance lease are excluded from the definition of initial direct costs and, thus, are excluded from the net investment in the lease. *[IFRS 16.74]*.

As discussed at section 4.1 above, after inception of a lease, but before the commencement date, the requirements in IAS 37 apply to a contract that becomes onerous.

Illustration 6-3: Manufacturer or dealer lessors

A company manufactures specialised machinery. The company offers customers the choice of either buying or leasing the machinery. A customer chooses to lease the machinery. Details of the arrangement are, as follows:

(i) The lease commences on 1 January 20X1 and lasts for three years.

(ii) The lessee is required to make three annual rentals payable in arrears of CU57,500.

(iii) The leased machinery is returned to the lessor at the end of the lease.

(iv) The fair value of the machinery is CU150,000, which is equivalent to the selling price of the machinery.

(v) The machinery cost CU100,000 to manufacture. The lessor incurred costs of CU2,500 to negotiate and arrange the lease.

(vi) The expected useful life of the machinery is 3 years. The machinery has an expected residual value of CU10,000 at the end of year three.

(vii) The interest rate implicit in the lease is 10.19%.

The lessor classifies the lease as a finance lease.

The cost to the lessor of providing the machinery for lease consists of the book value of the machinery (CU100,000), plus the initial direct costs associated with entering into the lease (CU2,500), less the future income expected from disposing of the machinery at the end of the lease (the present value of the unguaranteed residual value of CU10,000, being CU7,475). This gives a cost of sale of CU95,025.

The lessor records the following entries at the commencement of the lease:

Dr	Net investment in the lease		CU150,000	
Dr	Cost of sales		CU95,025	
	Cr	Inventory		CU100,000
	Cr	Revenue		CU142,525
	Cr	Creditors/cash (initial direct costs)		CU2,500

The sales profit recognised by the lessor at the commencement of the lease is therefore CU47,500 (CU142,525 - CU95,025). This is equal to the fair value of the machinery of CU150,000, less the book value of the machinery (CU100,000) and the initial direct costs of entering into the lease (CU2,500). Revenue is equal to the net investment in the lease (CU150,000), less the present value of the unguaranteed residual value (CU7,475).

Lease payments received from the lessee will then be allocated over the lease term, as follows:

Year	Net investment in the lease at the start of the year (CU)	Lease payments (CU)	Interest income (10.19% per annum) (CU)	Decrease in net investment in the lease (CU)	Net investment in the lease at the end of the year (CU)
	(a)	(b)	(c)	(d)=(b)-(c)	(e)=(a)-(d)
1	150,000	57,500	15,280	42,220	107,780
2	107,780	57,500	10,980	46,520	61,260
3	61,260	57,500	6,240	51,260	10,000

The lessor will record the following entries:

Year 1

Dr	Cash		CU57,500	
	Cr	Lease receivable		CU42,220
	Cr	Interest income		CU15,280

Year 2

Dr	Cash		CU57,500	
	Cr	Lease receivable		CU46,520
	Cr	Interest income		CU10,980

Year 3

Dr	Cash		CU57,500	
	Cr	Lease receivable		CU51,260
	Cr	Interest income		CU6,240

At the end of the three-year lease term, the leased machinery will be returned to the lessor, who will record the following entries:

Dr	Inventory		CU10,000	
	Cr	Lease receivable		CU10,000

6.3.3 Subsequent measurement

Extract from IFRS 16

75 **A lessor shall recognise finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease.**

76 A lessor aims to allocate finance income over the lease term on a systematic and rational basis. A lessor shall apply the lease payments relating to the period against the *gross investment in the lease* to reduce both the principal and the *unearned finance income*.

[IFRS 16.75, IFRS 16.76].

After lease commencement, a lessor accounts for a finance lease, as follows:

- Recognises finance income (in profit or loss) over the lease term in an amount that produces a constant periodic rate of return on the remaining balance of the net investment in the lease (i.e., using the interest rate implicit in the lease). Income is recognised on the components of the net investment in the lease, including:
- Interest on the lease receivable
- Interest via accretion of the unguaranteed residual asset to its expected value at the end of the lease
- Reduces the net investment in the lease for lease payments received (net of finance income calculated above)
- Separately recognises income from variable lease payments that are not included in the net investment in the lease (e.g., performance- or usage-based variable payments) in the period in which that income is earned
- Recognises any impairment of the net investment in the lease

The question as to whether the finance income should be calculated based on the gross lease receivable or the net amount of the lease receivable less any expected credit loss is not explicitly addressed.

How we see it

We believe the staging approach in IFRS 9 (see Chapter 47 at section 3.1) can be applied to determine how finance income recognised over the lease term is calculated:

- On a gross basis (excluding the effect of expected credit losses) for lease receivables in stages 1 or 2 of the expected credit loss model in IFRS 9

  And

- On a net basis (based on the net investment in the lease less expected credit losses) for lease receivables in stage 3 of the expected credit loss model in IFRS 9

The election (or non-election) of the simplified approach allowed by IFRS 9 does not affect this conclusion.

In the absence of prescriptive guidance in IFRS accounting standards, we believe entities may apply the above accounting as an accounting policy choice. However, alternative approaches may also be acceptable.

Credit losses should be presented separately in the income statement in accordance with IAS 1.82.

The net investment in the lease should generally be presented net of the loss allowance. However, a separate presentation of the net investment in the lease, gross of the lease allowance and the loss allowance itself may be appropriate when the presentation is relevant to understanding the entity's financial position. For example, where the loss allowance has significantly reduced an otherwise material net investment in the lease.

The following Illustration shows how a lessor accounts for a finance lease that gives rise to selling profit:

Illustration 6-4: Lessor accounting for a finance lease (dealer-lessor case)

Assume Lessor enters into a 10-year lease of equipment with Lessee. The equipment is not specialised in nature and is expected to have alternative use to Lessor at the end of the 10-year lease term. Under the lease:

- Lessor receives annual lease payments of CU15,000, payable at the end of the year
- Lessor expects the residual value of the equipment to be CU20,000 at the end of the 10-year lease term
- Lessee provides a residual value guarantee that protects Lessor from the first CU10,000 of loss for a sale at a price below the estimated residual value at the end of the lease term (i.e., CU20,000)

The equipment has an estimated remaining economic life of 12 years, a carrying amount of CU100,000 and a fair value of CU111,000

The lease does not transfer ownership of the underlying asset to Lessee at the end of the lease term or contain an option to purchase the underlying asset

The interest rate implicit in the lease is 7.8%.

Also, assume the lessor determined it should classify the lease as a finance lease.

At lease commencement, Lessor accounts for the finance lease, as follows:

To record the net investment in the finance lease and derecognise the underlying asset:

Dr	Net investment in the lease	CU111,000[a]		
Dr	Cost of goods sold	CU95,281[b]		
	Cr Revenue		CU106,281[c]	
	Cr Property held for lease		CU100,000[d]	

(a) The net investment in the lease consists of (1) the present value of the 10 annual payments of CU15,000 plus the guaranteed residual value of CU10,000, both discounted at the interest rate implicit in the lease, which equals CU106,281 (i.e., the lease payment) and (2) the present value of unguaranteed residual asset of CU10,000, which equals CU4,719. Note that the net investment in the lease is subject to the same considerations as other assets in classification as current or non-current assets in a classified statement of financial position (refer to section 6.7)

(b) Cost of goods sold is the carrying amount of the equipment of CU100,000 less the present value of the unguaranteed residual asset of CU4,719

(c) Revenue equals the net investment in the lease of CU111,000 less the present value of the unguaranteed residual value of CU4,719

(d) The carrying amount of the underlying asset

At lease commencement, Lessor recognises selling profit of CU11,000 which is calculated as the lease payment of CU106,281 less the carrying amount of the asset (CU100,000), net of any unguaranteed residual asset (CU4,719), which equals CU95,281.

Year 1 journal entries for a finance lease:

Dr	Cash		CU15,000[(e)]	
	Cr	Net investment in the lease		CU6,341[(f)]
	Cr	Interest income		CU8,659[(g)]

(e) Receipt of annual lease payments at the end of the year

(f) Reduction of the net investment in the lease for lease payments received of (CU15,000), net of interest income of CU8,659

(g) Interest income is the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease. See computation below

The following table summarises the interest income from this lease and the related amortisation of the net investment over the lease term:

Year	Annual rental payment CU	Annual interest income(h) CU	Net investment at end of year CU
Initial net investment	-	-	111,000
1	15,000	8,659	104,659
2	15,000	8,164	97,822
3	15,000	7,631	90,453
4	15,000	7,056	82,509
5	15,000	6,436	73,945
6	15,000	5,768	64,713
7	15,000	5,048	54,761
8	15,000	4,272	44,033
9	15,000	3,435	32,467
10	15,000	2,533	20,000 (i)

(h) Interest income equals 7.8% of the net investment in the lease at the beginning of each year. For example, Year 1 annual interest income is calculated as CU111,000 (initial net investment) × 7.8%.

(i) The estimated residual value of the equipment at the end of the lease term.

6.3.4 Unguaranteed residual values

Income recognition by lessors can be extremely sensitive to the amount recognised as the asset's residual value. This is because the amount of the residual value directly affects the computation of the amount of finance income earned over the lease term - this is shown in Illustration 6-5 below. The standard gives no guidance regarding the estimation of unguaranteed residual values, but it does require them to be reviewed regularly. If there has been a reduction in the estimated value, the income allocation over the lease term is revised and any reduction in respect of amounts accrued is recognised immediately. *[IFRS 16.77]*.

Illustration 6-5: Reduction in residual value

At lease commencement, the lessor accounts for the finance lease, as follows:

Details of a non-cancellable lease are:

- The asset has a fair value of CU10,000
- The lessee is required to make five annual rentals payable in advance of CU2,100
- The unguaranteed estimated residual value at the end of five years is CU1,000.

The lessor's direct costs have been excluded for simplicity.

Year	Net investment in lease at start of period	Rental received	Finance income (6.62% per annum)	Gross investment at end of period	Gross earnings allocated to future periods	Net investment in lease at end of period
	CU	CU	CU	CU	CU	CU
1	10,000	2,100	523	9,400	977	8,423
2	8,423	2,100	419	7,300	558	6,742
3	6,742	2,100	307	5,200	251	4,949
4	4,949	2,100	189	3,100	62	3,038
5	3,038	2,100	62	1,000	-	1,000
		10,500	1,500			

The gross investment in the lease at any point in time comprises the aggregate of the rentals receivable in future periods and the unguaranteed residual value, e.g., at the end of year 2, the gross investment of CU7,300 is three years' rental of CU2,100 plus the unguaranteed residual of CU1,000. The net investment, which is the amount that will be recorded in the statement of financial position, is CU7,300 less the earnings allocated to future periods of CU558 = CU6,742. The gross earnings allocated to future periods is the total finance income of CU1,500 less the finance income already recognised.

The lessor concludes at the end of year 2 that the residual value of the asset is only CU500 and revises the income allocation over the lease term accordingly at the original discount rate of 6.62%.

Year	Net investment in lease at start of period	Rental received	Finance income (6.62% per annum)	Gross investment at end of period*	Gross earnings allocated to future periods	Net investment in lease at end of period
	CU	CU	CU	CU	CU	CU
2	8,423	2,100	419	6,800	471	6,329
3	6,329	2,100	280	4,700	191	4,509
4	4,509	2,100	160	2,600	31	2,569
5	2,569	2,100	31	500	-	500

* The gross investment in the lease now takes account of the revised unguaranteed residual of CU500, rather than the original CU1,000.

The lessor will have to write off CU413, being the difference between the carrying amount of the receivable and the revised balance above (CU6,742 - CU6,329). This is the present value as at the end of year 2 of CU500 and represents the part of the unguaranteed residual written off.

6.3.5 Remeasurement of the net investment in the lease

After lease commencement, the net investment in a lease is remeasured when the following occurs:

- The lease is modified (i.e., a change in the scope of the lease, or the consideration for the lease, that was not part of its original terms and conditions) and the modified lease is not accounted for as a separate contract. Refer to section 6.5.
- The lease term is revised when there is a change in the non-cancellable period of the lease. Refer to section 4.4.2.B.
- There is a change in the estimated unguaranteed residual value. Refer to section 6.3.4.

A lessor includes in its initial measurement of the net investment in the lease, variable lease payments that depend on an index or rate.

How we see it

IFRS 16 is silent on the accounting for any subsequent changes in future cash flows resulting from a change in an index or rate or variable lease payments becoming in-substance fixed. In the absence of further guidance, we believe lessors have an accounting policy choice regarding whether variable lease payments that depend on an index or rate are remeasured.

6.4 Operating leases

Under IFRS 16, lessors continue to recognise the underlying asset and do not recognise a net investment in the lease on the statement of financial position or initial profit (if any) on the income statement. The underlying asset continues to be accounted for in accordance with applicable accounting standards (e.g., IAS 16).

Lessors subsequently recognise lease payments over the lease term on either a straight-line basis or another systematic and rational basis if that basis better represents the pattern in which benefit is expected to be derived from the use of the underlying asset. If the lessor pays the lessee an incentive to enter the lease, this is accounted for as described in section 4.5.2 above. *[IFRS 16.81]*. After lease commencement, lessors recognise variable lease payments that do not depend on an index or rate (e.g., performance- or usage- based payments) as they are earned.

A lessor recognises costs, including depreciation, incurred in earning the lease income as an expense. IFRS 16 also requires lessors of operating leases to defer initial direct costs at lease commencement and recognise them over the lease term on the same basis as lease income. *[IFRS 16.82, IFRS 16.83]*.

The depreciation policy for depreciable underlying assets subject to operating leases must be consistent with the lessor's normal depreciation policy for similar assets. A lessor calculates depreciation in accordance with IAS 16 and IAS 38. *[IFRS 16.84]*. A lessor applies IAS 36 to determine whether an underlying asset subject to an operating lease is impaired and to account for any impairment loss identified. *[IFRS 16.85]*.

A manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale. *[IFRS 16.86]*.

6.4.1 Operating lease income

Unlike other standards such as IFRS 15, IFRS 16 does not refer to collectability to determine whether (and when) lease income should be recognised.

How we see it

We believe that a lessor may continue to recognise operating lease income even when collectability is not probable. However, other approaches may also be appropriate when there is significant doubt about collectability. Therefore, there could be diversity in practice, and it is important to consider the views of local regulators.

Regardless of the approach followed, IFRS 9's guidance on credit losses continues to be applicable to recognised lease receivables (see Chapter 47 at section 10.2).

FASB differences

In accordance with ASC 842, collectability of lease payments is evaluated to determine the income recognition pattern of operating leases.

Illustration 6-6: Operating lease income not expected to be fully collectible

Restaurant A leases space in a shopping mall from Lessor B. Lessor B classifies the lease as an operating lease.

Under the terms of the lease, Restaurant A makes fixed lease payments of CU100 to Lessor B at the beginning of each month. The non-cancellable lease term ends on 28 February 2022. The contract does not include any non-lease components, extension, termination or purchase options.

Due to significant financial difficulties, at the end of June, Restaurant A has indicated that it will only pay 25% of the lease receivable due for the month of July 2020. Up to 31 July 2020, CU25 has been collected and Lessor B does not expect the remaining amount of CU75 due in respect of July to be recovered considering Restaurant A's financial condition.

Analysis

Approach 1 - Recognising the full operating lease income

Lessor B recognises the full operating lease income on a straight-line basis of CU100 per month in accordance with IFRS 16.81.

Lessor B recognises a lease receivable and an impairment loss of CU75 reflecting the remote likelihood of collection in accordance with IFRS 9.

Under this approach, Lessor B records the following entries:

Dr	Lease receivable		CU100	
	Cr	Operating lease income		CU100
To record the operating lease income and lease receivable for July 2020				
Dr	Impairment loss on lease receivable		CU75	
	Cr	Impairment allowance on lease receivable		CU75
To record an impairment loss against the lease receivable				
Dr	Cash		CU25	
	Cr	Lease receivable		CU25
To record receipt of CU25 from the lessee				

Approach 2 - Recognition of operating lease income to the extent collectible

Under this approach, Lessor B accounts for the monthly lease income to the extent collectible. This approach reflects the high uncertainty related to the collectability of the full lease payments and Lessor B's concerns about the appropriateness of reporting income when the likelihood of collecting the full amount is considered to be remote.

Under this approach, Lessor B records the following entries:

Dr	Lease receivable		CU25	
	Cr	Operating lease income		CU25
To record the operating lease income for July 2020				
Dr	Cash		CU25	
	Cr	Lease receivable		CU25
To record receipt of CU25 from the lessee				

6.5 Lease modifications

If a finance lease is modified (i.e., there is a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and condition of the lease), the modified lease is evaluated to determine whether it is or contains a lease. *[IFRS 16 Appendix A]*. Refer to section 3.1. If a lease continues to exist, a modification to a finance lease may result in:

- A separate lease (refer to section 6.5.1.A)
- A change in the accounting for the existing lease (i.e., not a separate lease) (refer to section 6.5.1.B)

If an operating lease is modified, it is treated as a new lease from the effective date of the modification. Refer to section 6.5.2.

6.5.1 Modifications to a finance lease

6.5.1.A Determining whether a lease modification results in a separate lease

Extract from IFRS 16

79 A lessor shall account for a modification to a finance lease as a separate lease if both:

(a) the modification increases the scope of the lease by adding the right to use one or more underlying assets; and

(b) the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

[IFRS 16.79].

If both of these conditions are met, the lease modification results in two separate leases, the unmodified original finance lease and a separate lease. Lessors account for the separate lease in the same manner as other new leases. If either of the conditions is not met, the lease modification does not result in a separate lease. The accounting for a modification that does not result in a separate lease is discussed further in section 6.5.1.B below.

6.5.1.B Lessor accounting for a modification that does not result in a separate lease

If a finance lease is modified and does not result in a separate lease, lessors account for the modification depending on the classification of the modified lease. If the lease would have been classified as an operating lease had the modification been in effect at the inception date, lessors account for such modifications as the creation of a new lease that commences on the effective date of the modification. The carrying amount of the underlying asset is measured as the net investment in the original lease immediately before the effective date of the modification. Otherwise, the net investment in the lease is accounted for in accordance with IFRS 9. *[IFRS 16.80]*.

FASB differences

In accordance with ASC 842, if the modification of a sales-type or direct financing lease is not accounted for as a separate contract, the entity reassesses the classification of the lease as of the effective date of the modification based on the modified terms and conditions, and the facts and circumstances as of that date. ASC 842 then specifies how to account for the modified lease based on the classification of the modified lease.

6.5.2 Modification to an operating lease

If an operating lease is modified and the arrangement continues to be or contains a lease, it is treated as a new lease from the effective date of the modification. *[IFRS 16.87]*. Accounting for the new lease includes identifying and separating the lease and non-lease components of the contract as discussed in section 3.2 above.

Upon modification, the classification criteria are reassessed (refer to section 6.1 above). As a result, the new lease may be an operating lease or a finance lease. Any remaining prepaid or accrued lease payments relating to the original lease are included as part of the lease payments for the new lease.

Illustration 6-7 shows how the modification guidance is applied for a concession that involves the forgiveness of future lease payments.

Illustration 6-7: Forgiveness of future lease payments on an operating lease

Restaurant A leases space in a shopping mall from Lessor B. Lessor B classifies the lease as an operating lease.

Under the terms of the lease, Restaurant A makes fixed lease payments of CU100 to Lessor B at the beginning of each month. The non-cancellable lease term ends on 28 February 2025. The contract does not include any non-lease components, extension, termination or purchase options.

All lease payments due up to 30 June 2023 have been received in a timely manner. On 30 June 2023, in compensation for the closure of the shopping mall. Lessor B agrees to forgive Restaurant A's future lease payments for the months of July, August and September 2023.

Analysis:

The rent concession results in a decrease in the total lease payments. Thus, there has been a change in the consideration for a lease that was not part of the original terms and conditions of the contract. Therefore, the rent concession constitutes a lease modification. The modification does not change the classification of the lease as an operating lease.

On the effective date of the modification (i.e., 30 June 2023), Lessor B accounts for the modification as a new lease, as follows:

- The remaining lease payments under the modified lease comprise CU1,700 (lease payments of CU100 per month from October 2023 to February 2025).
- The remaining lease term is 20 months.
- The monthly operating lease income to be recognised over the remaining lease term is therefore CU1,700 ÷ 20 months = CU85.

Frequently asked questions

Question 6-1: How does a lessor apply the expected credit loss model in IFRS 9 to an operating lease receivable before a rent concession is granted, if it expects to forgive payments due from the lessee under the lease contract? Does a lessor apply the derecognition requirements in IFRS 9 or the lease modification requirements in IFRS 16 in accounting for a rent concession?

In September 2022, the IFRS IC discussed a fact pattern in which a rent concession is agreed by a lessor and a lessee, which changes the original terms and conditions of a lease contract that is classified by the lessor as an operating lease. The lessor legally releases the lessee from its obligation to make specifically identified lease payments. Some of these lease payments are amounts contractually due but not paid and are recognised as operating lease receivables. Some of these lease payments are not yet contractually due. No other changes are made to the lease contract, nor are there any other negotiations between the lessor and the lessee that might affect the accounting for the rent concession.

Applying the expected credit loss model in IFRS 9 to the operating lease receivable

The IFRS IC noted that in the fact pattern described, the lessor applies the impairment requirements in IFRS 9 to the operating lease receivable. The lessor estimates expected credit losses on the operating lease receivable by measuring 'all cash shortfalls', which are the difference between:

(a) All contractual cash flows due to the lessor in accordance with the lease contract, and included in the gross carrying amount of the operating lease receivable; and

(b) All the cash flows the lessor expects to receive, determined using 'reasonable and supportable information' about 'past events, current conditions and forecasts of future economic conditions'.

Therefore, the IFRS IC concluded that before the rent concession is granted, the lessor measures expected credit losses on the operating lease receivable in a way that reflects 'an unbiased and probability-weighted amount', 'the time value of money', and 'reasonable and supportable information' (as required by IFRS 9.5.5.17).

Accounting for the rent concession - IFRS 9 and IFRS 16

The agenda decision published in October 2022 also addresses the issue of whether the lessor applies the derecognition requirements in IFRS 9, or the lease modification requirements in IFRS 16, in accounting for the rent concession when operating lease payments are forgiven.

In the rent concession described in the request, the lessor legally releases the lessee from its obligation to make specifically identified lease payments, some of which the lessor has recognised as an operating lease receivable. Accordingly, on granting the rent concession, the lessor concludes that the requirements in paragraph 3.2.3(a) of IFRS 9 have been met (i.e., its contractual rights to the cash flows from the operating lease receivable expire) because it has agreed to legally release the lessee from its obligation and thus has given up its contractual rights to those specifically identified cash flows. Therefore, on the date the rent concession is granted, the lessor remeasures expected credit losses on the remaining operating lease receivable (and recognises any change to the expected credit loss allowance in profit or loss) and derecognises the operating lease receivable (and associated expected credit loss allowance).

The rent concession also meets the definition of a lease modification in IFRS 16. Therefore, the lessor applies IFRS 16.87 and accounts for the modified lease as a new lease from the date the rent concession is granted. The IFRS IC observed that lease payments contractually due from the lessee that the lessor has recognised as an operating lease receivable (to which the derecognition and impairment requirements in IFRS 9 apply) are not accrued lease payments. Consequently, neither those lease payments nor their forgiveness are considered, applying IFRS 16.87, as part of the lease payments for

the new lease. In accounting for the modified lease as a new lease, a lessor applies IFRS 16.81 and recognises the lease payments (including any prepaid or accrued lease payments relating to the original lease) as income on either a straight-line basis or another systematic basis.

Therefore, the IFRS IC concluded that the lessor accounts for the rent concession described in the fact pattern, on the date it is granted, by applying:

(a) The derecognition requirements in IFRS 9 to forgiven lease payments that the lessor has recognised as an operating lease receivable, and

(b) The lease modification requirements in IFRS 16 to forgiven lease payments that the lessor has not recognised as an operating lease receivable.

Expected credit losses (ECL) are discussed further in Chapter 47 at section 10.2 and section 14.1.1.

6.6 Other lessor matters

6.6.1 Impairment of the net investment in the lease

Extract from IFRS 16	
77	A lessor shall apply the derecognition and impairment requirements in IFRS 9 to the net investment in the lease. A lessor shall review regularly estimated unguaranteed residual values used in computing the gross investment in the lease. If there has been a reduction in the estimated unguaranteed residual value, the lessor shall revise the income allocation over the lease term and recognise immediately any reduction in respect of amounts accrued.

Lessors evaluate their net investment in the lease for impairment by applying the derecognition and impairment requirements in IFRS 9. *[IFRS 16.77]*.

6.6.2 Portfolio application

IFRS 16 specifies the accounting for an individual lease. However, as a practical expedient, an entity may apply it to a portfolio of leases with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying IFRS 16 to the portfolio would not differ materially from applying it to the individual leases within that portfolio. If accounting for a portfolio, an entity shall use estimates and assumptions that reflect the size and composition of the portfolio. *[IFRS 16.B1]*.

Entities that have a large number of leases of similar assets (e.g., leases of a fleet of similar rolling stock) may face practical challenges in applying the leases model on a lease-by-lease basis. The IASB in the Basis for Conclusions acknowledged the concerns and included a practical expedient that allows entities to use a portfolio approach to leases with similar characteristics if the entity reasonably expects that the effects on the financial statements would not differ materially from the application of the standard to the individual leases in that portfolio. *[IFRS 16.BC83]*.

A decision to use the portfolio approach would be similar to a decision some entities already make to expense, rather than capitalise, certain assets when the accounting difference is, and would continue to be, immaterial to the financial statements.

6.7 Presentation

Lessors recognise assets held under a finance lease in the statements of financial position and present them as a receivable at an amount equal to the net investment in the lease under IFRS 16. *[IFRS 16.67]*. In addition, lessors are required under IFRS 16 to present underlying assets subject to operating leases according to the nature of that asset in the statement of financial position. *[IFRS 16.88]*.

The net investment in the lease is subject to the same considerations as other assets in classification as current or non-current assets in the statement of financial position.

6.8 Disclosure

Extract from IFRS 16

Disclosure

89 **The objective of the disclosures is for lessors to disclose information in the notes that, together with the information provided in the statement of financial position, statement of profit or loss and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessor. Paragraphs 90-97 specify requirements on how to meet this objective.**

90 A lessor shall disclose the following amounts for the reporting period:

(a) for finance leases:

(i) selling profit or loss;

(ii) finance income on the net investment in the lease; and

(iii) income relating to variable lease payments not included in the measurement of the net investment in the lease.

(b) for operating leases, lease income, separately disclosing income relating to variable lease payments that do not depend on an index or a rate.

91 A lessor shall provide the disclosures specified in paragraph 90 in a tabular format, unless another format is more appropriate.

92 A lessor shall disclose additional qualitative and quantitative information about its leasing activities necessary to meet the disclosure objective in paragraph 89. This additional information includes, but is not limited to, information that helps users of financial statements to assess:

(a) the nature of the lessor's leasing activities; and

(b) how the lessor manages the risk associated with any rights it retains in underlying assets. In particular, a lessor shall disclose its risk management strategy for the rights it retains in underlying assets, including any means by which the lessor reduces that risk. Such means may include, for example, buy-back agreements, residual value guarantees or variable lease payments for use in excess of specified limits.

Finance leases

93 A lessor shall provide a qualitative and quantitative explanation of the significant changes in the carrying amount of the net investment in finance leases.

94 A lessor shall disclose a maturity analysis of the lease payments receivable, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor shall reconcile the undiscounted lease payments to the net investment in the lease. The reconciliation shall identify the unearned finance income relating to the lease payments receivable and any discounted unguaranteed residual value.

Operating leases

95 For items of property, plant and equipment subject to an operating lease, a lessor shall apply the disclosure requirements of IAS 16. In applying the disclosure requirements in IAS 16, a lessor shall disaggregate each class of property, plant and equipment into assets subject to operating leases and assets not subject to operating leases. Accordingly, a lessor shall provide the disclosures required by IAS 16 for assets subject to an operating lease (by class of underlying asset) separately from owned assets held and used by the lessor.

96 A lessor shall apply the disclosure requirements in IAS 36, IAS 38, IAS 40 and IAS 41 for assets subject to operating leases.

97 A lessor shall disclose a maturity analysis of lease payments, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years.

[IFRS 16.89-97].

The objective of the disclosures is for lessors to disclose information that gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessor. *[IFRS 16.89]*.

IFRS 16 requires a lessor to disclose quantitative and qualitative information about its leases, the significant judgements made in applying IFRS 16 and the amounts recognised in the financial statements related to the leases.

Lessors may need to exercise judgement to determine the appropriate level at which to aggregate, or disaggregate, disclosures so that meaningful information is not obscured by insignificant details or by grouping items with different characteristics.

7 Subleases

7.1 Definition

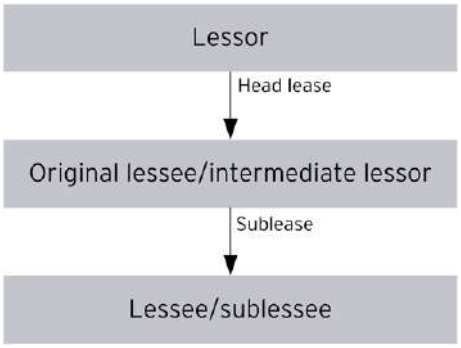
Extract from IFRS 16

Appendix A
Defined terms

sublease	A transaction for which an **underlying asset** is re-leased by a **lessee** ('intermediate lessor') to a third party, and the **lease** ('head lease') between the head lessor and lessee remains in effect.

[IFRS 16 Appendix A].

Lessees often enter into arrangements to sublease a leased asset to a third party while the original lease contract is in effect. In these arrangements, one party acts as both the lessee and lessor of the same underlying asset. The original lease is often referred to as a head lease, the original lessee is often referred to as an intermediate lessor or sublessor and the ultimate lessee is often referred to as the sublessee.



In some cases, the sublease is a separate lease agreement. In other cases, a third party assumes the original lease, but the original lessee remains the primary obligor under the original lease.

7.2 Intermediate lessor accounting

Extract from IFRS 16

B7 If a lessee subleases an asset, or expects to sublease an asset, the head lease does not qualify as a lease of a low-value asset.

Sublease classification

B58 In classifying a sublease, an intermediate lessor shall classify the sublease as a finance lease or an operating lease as follows:

(a) if the head lease is a short-term lease that the entity, as a lessee, has accounted for applying paragraph 6, the sublease shall be classified as an operating lease.

(b) otherwise, the sublease shall be classified by reference to the right-of- use asset arising from the head lease, rather than by reference to the underlying asset (for example, the item of property, plant, or equipment that is the subject of the lease).

If an underlying asset is re-leased by a lessee to a third party and the original lessee retains the primary obligation under the original lease, the transaction is a sublease. That is, the original lessee generally continues to account for the original lease (the head lease) as a lessee and accounts for the sublease as the lessor (intermediate lessor).

When the head lease is a short-term lease, the sublease is classified as an operating lease. Otherwise, the sublease is classified using the classification criteria in section 6 above by reference to the right-of-use asset in the head lease (and not the underlying asset of the head lease). *[IFRS 16.B7, IFRS 16.B58]*.

FASB differences

In accordance with ASC 842, the sublessor classifies the sublease based on the underlying asset rather than the right-of-use asset arising on the head lease.

Illustration 7-1: Classification of a sublease

Entity F (original lessee/intermediate lessor) leases a building for five years. The building has an economic life of 30 years. Entity F subleases the building for four years. The sublease is classified with reference to the right-of-use asset in the head lease (and not the underlying building). For example, when assessing the useful life criterion, the sublease term of four years is compared with five year right-of-use asset in the head lease and not with 30-year economic life of the building which may result in the sublease being classified as a finance lease.

The intermediate lessor accounts for the sublease as follows:

- If the sublease is classified as an operating lease, the original lessee continues to account for the lease liability and right-of-use asset on the head lease like any other lease. Refer to section 5. If the total remaining carrying amount of the right-of-use asset on the head lease exceeds the anticipated sublease income, this may indicate that the right- of-use asset associated with the head lease is impaired. A right-of-use asset is assessed for impairment under IAS 36.
- If the sublease is classified as a finance lease, the original lessee derecognises the right-of-use asset on the head lease at the sublease commencement date and continues to account for the original lease liability in accordance with the lessee accounting model. Refer to section 5. The original lessee, as the sublessor, recognises a net investment in the sublease and evaluates it for impairment. Refer to section 6.6.1 above.

In a sublease, an intermediate lessor may use the discount rate for the head lease (adjusted for any initial direct costs associated with the sublease) to measure the net investment in the sublease, if the interest rate implicit in the lease cannot be readily determined. *[IFRS 16.68]*.

When contracts are entered into at or near the same time, an intermediate lessor is required to consider the criteria for combining contracts (e.g., when the contracts are negotiated as a package with a single commercial objective, or when the consideration to be paid in one contract depends on the price or performance of the other contract). If the contracts are required to be combined, the intermediate lessor accounts for the head lease and sublease as a single combined transaction. Refer to section 3.3 above.

An intermediate lessor who subleases, or expects to sublease an asset, cannot account for the head lease as a lease of a low-value asset even when the criteria, as discussed in section 5.1.2 above, are satisfied.

IFRS 16 gives the following two examples of applying the requirements to an intermediate lessor that enters into a head lease and a sublease of the same underlying asset. *[IFRS 16.IE8, IFRS 16.IE Example 20, IFRS 16.IE Example 21]*.

Extract from IFRS 16 Illustrative Examples

Example 20- Sublease classified as a finance lease

Head lease - An intermediate lessor enters into a five-year lease for 5,000 square metres of office space (the head lease) with Entity A (the head lessor).

Sublease - At the beginning of Year 3, the intermediate lessor subleases the 5,000 square metres of office space for the remaining three years of the head lease to a sublessee.

The intermediate lessor classifies the sublease by reference to the right-of- use asset arising from the head lease. The intermediate lessor classifies the sublease as a finance lease, having considered the requirements in paragraphs 61-66 of IFRS 16.

When the intermediate lessor enters into the sublease, the intermediate lessor:

(a) derecognises the right-of-use asset relating to the head lease that it transfers to the sublessee and recognises the net investment in the sublease;

(b) recognises any difference between the right-of-use asset and the net investment in the sublease in profit or loss; and

(c) retains the lease liability relating to the head lease in its statement of financial position, which represents the lease payments owed to the head lessor.

During the term of the sublease, the intermediate lessor recognises both finance income on the sublease and interest expense on the head lease.

Example 21- Sublease classified as an operating lease

Head lease-An intermediate lessor enters into a five-year lease for 5,000 square metres of office space (the head lease) with Entity A (the head lessor).

Sublease-At commencement of the head lease, the intermediate lessor subleases the 5,000 square metres of office space for two years to a sublessee.

The intermediate lessor classifies the sublease by reference to the right- of-use asset arising from the head lease. The intermediate lessor classifies the sublease as an operating lease, having considered the requirements in paragraphs 61-66 of IFRS 16.

When the intermediate lessor enters into the sublease, the intermediate lessor retains the lease liability and the right-of-use asset relating to the head lease in its statement of financial position.

During the term of the sublease, the intermediate lessor:

(a) recognises a depreciation charge for the right-of-use asset and interest on the lease liability; and

(b) recognises lease income from the sublease.

7.3 Sublessee accounting

A sublessee accounts for its lease in the same manner as any other lease (i.e., as a new lease subject to IFRS 16's recognition and measurement provisions). Refer to section 5.

7.4 Presentation

According to IAS 1.32, an entity cannot offset assets and liabilities or income and expenses, unless required or permitted by an IFRS accounting standard. *[IAS 1.32]*. Therefore, intermediate lessors are not permitted to offset lease liabilities and lease assets that arise from a head lease and a sublease, respectively, unless those liabilities and assets meet the requirements in IAS 1 for offsetting. *[IFRS 16.BC235]*. Similarly, intermediate lessors are not permitted to offset depreciation and interest expenses and lease income relating to a head lease and a sublease of the same underlying asset, respectively, unless the requirements for offsetting in IAS 1 are met. *[IFRS 16.BC236]*. For example, intermediate lessors apply the principal-versus-agent application guidance in IFRS 15 to determine whether sublease revenue needs to be presented on a gross or net basis (i.e., reduced for head lease expenses).

How we see it

We believe that intermediate lessors generally will not meet the principal-versus-agent application guidance in IFRS 15 to present sublease income on a net basis and therefore, will generally present sublease revenue on a gross basis. See Chapter 28 at section 4.4.

7.5 Disclosure

Under IFRS 16, entities including intermediate lessors are required to disclose qualitative and quantitative information which gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessor. Refer to section 5.8 for lessees and section 6.8 for lessors, respectively.

8 Sale and leaseback transactions

Extract from IFRS 16

98 If an entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and leases that asset back from the buyer-lessor, both the seller-lessee and the buyer-lessor shall account for the transfer contract and the lease applying paragraphs 99-103.

[IFRS 16.98].

A sale and leaseback transaction involves the transfer of an asset by an entity (the seller-lessee) to another entity (the buyer-lessor) and the leaseback of the same asset by the seller-lessee. Because IFRS 16 requires lessees to recognise most leases on the statement of financial position, sale and leaseback transactions may no longer provide lessees with a source of off-balance sheet financing. Both the seller-lessee and the buyer-lessor are required to apply IFRS 15 to determine whether to account for a sale and leaseback transaction as a sale and purchase of an asset.

The presentation in the statement of cash flows of sale and leaseback transactions is discussed in Chapter 36 at section 8.4.

The IFRS IC discussed a question about the applicability of the sale and leaseback requirements in IFRS 16 to a transaction in which an entity sells its equity interest in a subsidiary that holds only a real estate asset and then leases that real estate back. The question asked was whether the entity applies the sale and leaseback requirements in IFRS 16 and accordingly recognises only the amount of the gain that relates to the rights transferred to the buyer-lessor, rather than recognising the full gain on the sale. In September 2020, the IFRS IC published a tentative agenda decision that concluded that in the fact pattern described, the entity would apply IFRS 10 *Consolidated Financial Statements* to account for the loss of control of the subsidiary. The tentative agenda decision also noted that the transfer of the building satisfies the requirements in IFRS 15 to be accounted for as a sale of the building and the entity therefore applies the sale and leaseback requirements of IFRS 16 and recognises only the amount of the gain that relates to the rights transferred to the buyer-lessor. The IFRS IC received a number of comment letters on the tentative agenda decision that raised concerns about the accounting requirements. Therefore, in February 2021, the IFRS IC decided to refer the matter to the Board for further consideration of narrow scope standard setting. At the time of writing, the Board has not yet discussed the issue.

How we see it

In the absence of further guidance, we believe entities should consider the views of local regulators before establishing an initial accounting policy for transactions involving the transfer or acquisition of a controlling interest in an entity that holds an underlying asset that will be leased back to the transferor. Entities also need to carefully consider the disclosure of these transactions to ensure that users of the financial statements can assess the impact. The disclosure requirements for sale and leaseback transactions are discussed at section 8.4 below.

8.1 Determining whether the transfer of an asset is a sale

When determining whether the transfer of an asset should be accounted for as a sale or purchase, both the seller-lessee and the buyer-lessor apply the requirements in IFRS 15 on when an entity satisfies a performance obligation by transferring control of an asset. *[IFRS 16.99]*. If control of an underlying asset passes to the buyer-lessor, the transaction is accounted for as a sale or purchase of the asset and a lease. If not, both the seller-lessee and the buyer-lessor account for the transaction as a financing transaction. See Chapter 28 for determining when a performance obligation is satisfied under requirements of IFRS 15.

IFRS 15 includes the following to help entities determine whether control of the asset has been transferred. *[IFRS 15.31-34, IFRS 15.38]*.

Extract from IFRS 15

31 An entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (ie an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.

32 For each performance obligation identified in accordance with paragraphs 22-30, an entity shall determine at contract inception whether it satisfies the performance obligation over time (in accordance with paragraphs 35-37) or satisfies the performance obligation at a point in time (in accordance with paragraph 38). If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

33 Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services). Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by:

(a) using the asset to produce goods or provide services (including public services);

(b) using the asset to enhance the value of other assets;

(c) using the asset to settle liabilities or reduce expenses;

(d) selling or exchanging the asset;

(e) pledging the asset to secure a loan; and

(f) holding the asset.

34 When evaluating whether a customer obtains control of an asset, an entity shall consider any agreement to repurchase the asset (see paragraphs B64-B76).

Performance obligations satisfied at a point in time

38 If a performance obligation is not satisfied over time in accordance with paragraphs 35-37, an entity satisfies the performance obligation at a point in time. To determine the point in time at which a customer obtains control of a promised asset and the entity satisfies a performance obligation, the entity shall consider the requirements for control in paragraphs 31-34. In addition, an entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

(a) The entity has a present right to payment for the asset-if a customer is presently obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.

(b) The customer has legal title to the asset-legal title may indicate which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.

(c) The entity has transferred physical possession of the asset - the customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls. Paragraphs B64-B76, B77-B78 and B79-B82 provide guidance on accounting for repurchase agreements, consignment arrangements and bill-and-hold arrangements, respectively.

(d) The customer has the significant risks and rewards of ownership of the asset-the transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity shall exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.

(e) The customer has accepted the asset-the customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. To evaluate the effect of a contractual customer acceptance clause on when control of an asset is transferred, an entity shall consider the guidance in paragraphs B83-B86.

None of the indicators above individually determine whether the buyer-lessor has obtained control of the underlying asset. Both the seller-lessee and the buyer-lessor must consider all relevant facts and circumstances to determine whether control has transferred. Furthermore, not all of the indicators must be present to determine that the buyer-lessor has gained control. Rather, the indicators are factors that are often present when a customer has obtained control of an asset and the list is meant to help entities apply the principle of control. See Chapter 28.

The IASB noted that, in considering whether a transaction should be accounted for as a sale and leaseback transaction, an entity should consider not only those transactions structured in the form of a legal sale and leaseback, but should also consider other forms of transactions for which the economic effect is the same as a legal sale and leaseback. *[IFRS 16.BC261]*.

FASB differences

Under US GAAP, to determine whether an asset transfer is a sale and purchase, a seller-lessee and a buyer-lessor consider the following:

- Whether the transfer meets the sale criteria under ASC 606 (however, certain fair value repurchase options would not result in a failed sale)
- Whether the leaseback would be classified as a sales-type lease by the buyer-lessor or a finance lease by the seller-lessee (i.e., a sale and purchase does not occur when the leaseback is classified as a sales-type lease by the buyer-lessor or as a finance lease by the seller-lessee)

The IASB noted that the existence of a leaseback, in isolation, does not preclude a sale. This is because a lease is different from the sale or purchase of an underlying asset, as a lease does not transfer control of the underlying asset. Instead, it transfers the right to control the use of the underlying asset for the period of the lease. However, if the seller-lessee has a substantive repurchase option for the underlying asset (i.e., a right to repurchase the asset), no sale has occurred because the buyer-lessor has not obtained control of the asset. *[IFRS 16.BC262]*.

How we see it

IFRS 16 does not address whether a lessee's renewal options (e.g., fixed price, fair value at the date of exercise) permitting the seller-lessee to extend the lease for substantially all of the remaining economic life of the underlying asset precludes sale accounting. We believe one acceptable view is that when the exercise price of a renewal option(s) is not at fair value, determined at the time the renewal option is exercised, the existence of the renewal option(s) would prohibit sale accounting in the same way a seller's repurchase agreement (i.e., a forward or call option) would preclude sale accounting under IFRS 15. However, there may be other reasonable approaches to evaluate whether control is transferred to the buyer under IFRS 15 when a renewal option that extends a lease for substantially all of the remaining economic life of the underlying asset is present.

8.2 Transactions in which the transfer of an asset is a sale

Extract from IFRS 16

Transfer of the asset is a sale

100 If the transfer of an asset by the seller-lessee satisfies the requirements of IFRS 15 to be accounted for as a sale of the asset:

(a) the seller-lessee shall measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee shall recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor.

(b) the buyer-lessor shall account for the purchase of the asset applying applicable Standards, and for the lease applying the lessor accounting requirements in this Standard.

101 If the fair value of the consideration for the sale of an asset does not equal the fair value of the asset, or if the payments for the lease are not at market rates, an entity shall make the following adjustments to measure the sale proceeds at fair value:

(a) any below-market terms shall be accounted for as a prepayment of lease payments; and

(b) any above-market terms shall be accounted for as additional financing provided by the buyer-lessor to the seller-lessee.

102 The entity shall measure any potential adjustment required by paragraph 101 on the basis of the more readily determinable of:

(a) the difference between the fair value of the consideration for the sale and the fair value of the asset; and

(b) the difference between the present value of the contractual payments for the lease and the present value of payments for the lease at market rates.

[IFRS 16.100, IFRS 16.101, IFRS 16.102].

8.2.1 Accounting for the sale

If the transfer of the asset is a sale, the seller-lessee will:

- Derecognise the underlying asset
- Recognise the gain or loss, if any, that relates to the rights transferred to the buyer-lessor and adjusted for off-market terms

A buyer-lessor accounts for the purchase of the asset in accordance with other standards based on the nature of the asset (e.g., IAS 16 for property, plant and equipment).

How we see it

IFRS 16 requires a seller-lessee to measure the right-of-use asset from the leaseback at the portion of the previous carrying amount of the asset that relates to the right of use retained but does not prescribe how the portion retained should be measured. Therefore, judgement may be required to measure the portion retained. Examples 24 and 25 in IFRS 16 (shown at section 8.2.4 below) show methodologies for determining the gain on sale.

Frequently asked questions

Question 8-1: When the lease payments relating to a leaseback are totally variable and not based on an index or rate, how is 'the proportion of the previous carrying amount of the asset that relates to right-of-use retained by the lessee' determined?

The IFRS IC issued an agenda decision in June 2020 related to a sale and leaseback transaction with variable payments. In the transaction described in the request, an entity (seller-lessee) enters into a sale and leaseback transaction whereby it transfers an item of property to another entity (buyer-lessor) and leases the asset back for five years. The transfer of the property satisfies the requirements in IFRS 15 to be accounted for as a sale of the property. The amount paid by the buyer-lessor to the seller-lessee in exchange for the property equals the property's fair value at the date of the transaction. Payments for the lease (which are at market rates) include variable payments (not based on an index or rate), calculated as a percentage of the seller-lessee's revenue generated using the property during the five-year lease term. The seller-lessee has determined that the variable payments are not in-substance fixed payments as described in IFRS 16. The request asked how, in the transaction described, the seller-lessee measures the right-of-use asset arising from the leaseback and determines the amount of any gain or loss recognised at the date of the transaction.

The IFRS IC observed that the requirements applicable to the transaction described in the request are in IFRS 16.100. Paragraph 100 states that, "... if the transfer of an asset by the seller-lessee satisfies the requirements of IFRS 15 to be accounted for as a sale of the asset: (a) the seller-lessee measures the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee recognises only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor."

Consequently, to measure the right-of-use asset arising from the leaseback, the seller-lessee determines the proportion of the property transferred to the buyer-lessor that relates to the right of use retained. It does so by comparing, at the date of the transaction, the right of use it retains via the leaseback to the rights comprising the entire property. IFRS 16 does not prescribe a method for determining that proportion. In the transaction described in the request, the seller-lessee could determine the proportion by comparing, for example: (a) the present value of expected lease payments (including those that are variable and not based on an index or rate); with (b) the fair value of the property at the date of the transaction.

The gain or loss the seller-lessee recognises at the date of the transaction is a consequence of its measurement of the right-of-use asset arising from the leaseback. Because the right of use the seller-lessee retains is not remeasured as a result of the transaction (it is measured as a proportion of the property's previous carrying amount), the amount of the gain or loss recognised relates only to the rights transferred to the buyer-lessor. Applying IFRS 16.53(i), the seller-lessee discloses gains or losses arising from sale and leaseback transactions.

The seller-lessee also recognises a liability at the date of the transaction, even if all the payments for the lease are variable and do not depend on an index or rate. The initial measurement of the liability is a consequence of how the right-of-use asset is measured - and the gain or loss on the sale and leaseback transaction determined - applying IFRS 16.100(a).

Illustration 8-1: Sale and leaseback with variable payments - extract from June 2020 IFRIC update

Seller-lessee enters into a sale and leaseback transaction whereby it transfers an asset (PPE) to Buyer-lessor, and leases that PPE back for five years. The transfer of the PPE satisfies the requirements in IFRS 15 to be accounted for as a sale of the PPE.

The carrying amount of the PPE in Seller-lessee's financial statements at the date of the transaction is CU1,000,000, and the amount paid by Buyer-lessor for the PPE is CU1,800,000 (the fair value of the PPE at that date). All the payments for the lease (which are at market rates) are variable, calculated as a percentage of Seller-lessee's revenue generated using the PPE during the five-year lease term. At the date of the transaction, the present value of the expected payments for the lease is CU450,000. There are no initial direct costs.

Seller-lessee determines that it is appropriate to calculate the proportion of the PPE that relates to the right of use retained using the present value of expected payments for the lease. On this basis, the proportion of the PPE that relates to the right of use retained is 25%, calculated as CU450,000 (present value of expected payments for the lease) ÷ CU1,800,000 (fair value of the PPE). Consequently, the proportion of the PPE that relates to the rights transferred to Buyer-lessor is 75%, calculated as (CU1,800,000 − CU450,000) ÷ CU1,800,000.

Applying IFRS 16.100(a), Seller-lessee:

(a) Measures the right-of-use asset at CU250,000, calculated as CU1,000,000 (previous carrying amount of the PPE) × 25% (proportion of the PPE that relates to the right of use it retains).

(b) Recognises a gain of CU600,000 at the date of the transaction, which is the gain that relates to the rights transferred to Buyer-lessor. This gain is calculated as CU800,000 (total gain on sale of the PPE (CU1,800,000 - CU1,000,000)) × 75% (proportion of the PPE that relates to rights transferred to Buyer-lessor).

Applying IFRS 16.100(a), the right-of-use asset would not be measured at zero at the date of the transaction because zero would not reflect the proportion of the previous carrying amount of the PPE (CU1,000,000) that relates to the right of use retained by Seller-lessee.

At the date of the transaction, Seller-lessee accounts for the transaction as follows:

Dr	Cash		CU1,800,000	
Dr	Right-of-use asset		CU250,000	
	Cr	PPE		CU1,000,000
	Cr	Liability		CU450,000
	Cr	Gain on rights transferred		CU600,000

The IFRS IC concluded that the principles and requirements in IFRS 16 provide an adequate basis for an entity to determine, at the date of the transaction, the accounting for the sale and leaseback transaction described in the request and, therefore, decided not to add the matter to its standard-setting agenda.

How we see it

Although not explicitly stated in IFRS 16, we believe that if the sale and leaseback transaction is expected to result in a loss to the seller-lessee, that loss will not be deferred. In addition, the seller-lessee may also need to consider whether the underlying asset may have been impaired prior to the sale and leaseback and the transaction would require the asset to have been classified as held-for-sale under IFRS 5 (see Chapter 5) and, hence, subject to potential impairment prior to the transaction.

The IFRS IC's discussions above highlighted that IFRS 16 does not specify the measurement of the liability that arises in such a sale and leaseback transaction. To address this, the IASB issued *Lease Liability in a Sale and Leaseback (Amendments to* IFRS 16*)* (the amendment) in September 2022. The amendment to IFRS 16 specifies that a seller-lessee applies IFRS 16.36 to IFRS 16.46 to subsequently measure the lease liability arising from the leaseback. The amendment does not change the accounting for leases unrelated to sale and leaseback transactions. *[IFRS 16.102A]*.

Extract from IFRS 16

102A After the commencement date, the seller-lessee shall apply paragraphs 29-35 to the right-of-use asset arising from the leaseback and paragraphs 36-46 to the lease liability arising from the leaseback. In applying paragraphs 36-46, the seller-lessee shall determine 'lease payments' or 'revised lease payments' in a way that the seller-lessee would not recognise any amount of the gain or loss that relates to the right of use retained by the seller-lessee. Applying the requirements in this paragraph does not prevent the seller-lessee from recognising in profit or loss any gain or loss relating to the partial or full termination of a lease as required by paragraph 46(a).

The amendment clarifies that the seller-lessee subsequently measures the right-of-use asset and lease liability arising from the leaseback in accordance with the existing requirements in IFRS 16.

Effective date and transition

A seller-lessee applies the amendment above to annual reporting periods beginning on or after 1 January 2024. Earlier application is permitted. If an entity applies the amendment for an earlier period, it discloses that fact. A seller-lessee applies the amendment retrospectively in accordance with IAS 8 to sale and leaseback transactions entered into after the date of initial application. The date of initial application is the beginning of the annual reporting period in which an entity first applies IFRS 16.

The Illustrative Examples accompanying IFRS 16 have also been updated to amend Example 24 and include a new Example 25. These examples are reproduced in section 8.2.4 below. *[IFRS 16.IE11, IFRS 16.IE Example 24] [IFRS 16.IE12, IFRS 16.IE Example 25]*

FASB differences

In accordance with ASC 842, the seller-lessee recognises any gain or loss, adjusted for off-market terms, immediately.

8.2.2 Accounting for the leaseback

When a sale occurs, both the seller-lessee and the buyer-lessor account for the leaseback in the same manner as any other lease (refer to section 5 and section 6, respectively), with adjustments for any off-market terms. Specifically, a seller-lessee recognises a lease liability and right-of-use asset for the leaseback.

8.2.3 Adjustment for off-market terms

The sale transaction and the ensuing lease are generally interdependent and negotiated as a package. Consequently, some transactions could be structured with a negotiated sales price that is above or below the asset's fair value and with lease payments for the ensuing lease that are above or below the market rates. These off-market terms could distort the gain or loss on the sale and the recognition of lease expense and lease income for the lease. To ensure that the gain or loss on the sale and the lease-related assets and liabilities associated with such transactions are neither understated nor overstated, IFRS 16 requires adjustments for any off-market terms of sale and leaseback transactions, on the more readily determinable basis of the difference between the fair value of the consideration for the sale and the fair value of the

asset and the difference between the present value of the contractual payments for the lease and the present value of payments for the lease at market rates. *[IFRS 16.102]*.

When the sale price is less than the underlying asset's fair value or the present value of the lease payments is less than the present value of the market lease payments, using the more readily determinable basis, a seller-lessee recognises the difference as an increase to the sales price and the initial measurement of the right-of-use asset as a lease prepayment. When the sale price is greater than the underlying asset's fair value or the present value of the lease payments is greater than the present value of the market lease payments, using the more readily determinable basis, a seller-lessee recognises the difference as a reduction in the sales price and an additional financing received from the buyer-lessor.

Buyer-lessors are also required to adjust the purchase price of the underlying asset for any off-market terms. Such adjustments are recognised as lease prepayments made by the seller-lessee or as additional financing provided to the seller-lessee.

8.2.4 Illustrative Examples

IFRS 16 provides the following two examples of the accounting for a sale and leaseback transaction: *[IFRS 16.IE11, IFRS 16.IE Example 24, IFRS 16.IE12, IFRS 16.IE Example 25]*

Extract from IFRS 16 Illustrative Examples

Example 24 - Sale and leaseback transaction with fixed payments and above-market terms

An entity (Seller-lessee) sells a building to another entity (Buyer-lessor) for cash of CU2,000,000. Immediately before the transaction, the building is carried at a cost of CU1,000,000. At the same time, Seller-lessee enters into a contract with Buyer-lessor for the right to use the building for 18 years, with annual payments of CU120,000 payable at the end of each year. The terms and conditions of the transaction are such that the transfer of the building by Seller-lessee satisfies the requirements of IFRS 15 *Revenue from Contracts with Customers to be accounted for as a sale of the building. Accordingly, Seller-lessee and Buyer-lessor account for the transaction as a sale and leaseback.*

The fair value of the building at the date of sale is CU1,800,000. Because the consideration for the sale of the building is not at fair value, Seller-lessee and Buyer-lessor make adjustments to measure the sale proceeds at fair value. Applying paragraph 101(b) of IFRS 16, the amount of the excess sale price of CU200,000 (CU2,000,000 - CU1,800,000) is recognised as additional financing provided by Buyer-lessor to Seller-lessee.

The interest rate implicit in the lease is 4.5 per cent per annum, which is readily determinable by Seller-lessee. The present value of the annual payments (18 payments of CU120,000, discounted at 4.5 per cent per annum) is CU1,459,200, of which CU200,000 relates to the additional financing and CU1,259,200 relates to the lease-corresponding to 18 annual payments of CU16,447 and CU103,553, respectively.

Buyer-lessor classifies the lease of the building as an operating lease.

Seller-lessee

Applying paragraph 100(a) of IFRS 16, at the commencement date, Seller-lessee measures the right-of-use asset arising from the leaseback of the building at the proportion of the previous carrying amount of the building that relates to the right-of-use retained by Seller-lessee, which is CU699,555. Seller-lessee calculates this amount as: CU1,000,000 (the carrying amount of the building) × CU1,259,200 (the discounted lease payments for the 18-year right-of-use asset) ÷ CU1,800,000 (the fair value of the building).

Seller-lessee recognises only the amount of the gain that relates to the rights transferred to Buyer-lessor of CU240,355 calculated as follows. The gain on sale of the building amounts to CU800,000 (CU1,800,000 - CU1,000,000), of which:

(a) CU559,645 (CU800,000 × CU1,259,200 ÷ CU1,800,000) relates to the right to use the building retained by Seller-lessee; and

(b) CU240,355 (CU800,000 × (CU1,800,000 - CU1,259,200) ÷ CU1,800,000) relates to the rights transferred to Buyer-lessor.

At the commencement date, Seller-lessee accounts for the transaction, as follows:

Cash	CU2,000,000	
Right-of-use asset	CU699,555	
Building		CU1,000,000
Lease liability		CU1,259,200
Financial liability		CU200,000
Gain on rights transferred		CU240,355

Buyer-lessor

At the commencement date, Buyer-lessor accounts for the transaction, as follows:

Building	CU1,800,000	
Financial asset	CU200,000 (18 payments of CU16,447, discounted at 4.5 per cent per annum)	
Cash		CU2,000,000

After the commencement date, Buyer-lessor accounts for the lease by treating CU103,553 of the annual payments of CU120,000 as lease payments. The remaining CU16,447 of annual payments received from Seller-lessee are accounted for as (a) payments received to settle the financial asset of CU200,000 and (b) interest revenue.

Example 25 - Subsequent measurement of a right-of-use asset and lease liability in a sale and leaseback transaction with variable lease payments that do not depend on an index or rate

An entity (Seller-lessee) sells a building to another entity (Buyer-lessor) for cash of CU1,800,000 (the fair value of the building at the date of sale). Immediately before the transaction, the building is carried at a cost of CU1,000,000. At the same time, Seller-lessee enters into a contract with Buyer-lessor for the right to use the building for five years. Lease payments - payable annually - comprise fixed payments and variable payments that do not depend on an index or rate.

The terms and conditions of the transaction are such that the transfer of the building by Seller-lessee satisfies the requirements of IFRS 15 Revenue from Contracts with Customers *to be accounted for as a sale of the building. Accordingly, Seller-lessee accounts for the transaction as a sale and leaseback.*

The interest rate implicit in the lease cannot be readily determined. Seller-lessee's incremental borrowing rate is 3 per cent per annum.

Applying paragraph 100(a) of IFRS 16, Seller-lessee determines the proportion of the building transferred to Buyer-lessor that relates to the right of use it retains as 25 per cent.[(a)] *Consequently, at the commencement date Seller-lessee accounts for the transaction as follows.*

Cash	*CU1,800,000*	
Right-of-use asset (CU1,000,000 x 25 per cent)	*CU250,000*	
Building		*CU1,000,000*
Lease liability		*CU450,000*
Gain on rights transferred ((CU1,800,000 - CU1,000,000) x 75 per cent)		*CU600,000*

Seller-lessee expects to consume the right-of-use asset's future economic benefits evenly over the lease term and, thus, depreciates the right-of-use asset on a straight-line basis.

In measuring the lease liability applying paragraphs 36-46 of IFRS 16, Seller-lessee develops an accounting policy for determining 'lease payments' in a way that it would not recognise any amount of the gain that relates to the right of use it retains. Depending on the circumstances (including the method Seller-lessee used - applying paragraph 100(a) of IFRS 16 - for determining the measurement of the right-of-use asset and the gain recognised on the transaction at the commencement date), either Approach 1 or Approach 2 could meet the requirements in paragraph 102A.

Approach 1 - Expected lease payments at the commencement date

Applying paragraph 102A of IFRS 16, Seller-lessee determines 'lease payments' to reflect the expected lease payments at the commencement date that, when discounted using its incremental borrowing rate, result in the carrying amount of the lease liability at that date of CU450,000.

The lease liability and the right-of-use asset arising from the leaseback are:

Year	Lease liability				Right-of-use asset		
	Beginning balance	Lease payments[b]	3 per cent interest expense[c]	Ending balance	Beginning balance	Depreciation charge	Ending balance
	CU	CU	CU	CU	CU	CU	CU
1	**450,000**	(95,902)	13,500	**367,598**	**250,000**	(50,000)	**200,000**
2	**367,598**	(98,124)	11,028	**280,502**	**200,000**	(50,000)	**150,000**
3	**280,502**	(99,243)	8,415	**189,674**	**150,000**	(50,000)	**100,000**
4	**189,674**	(100,101)	5,690	**95,263**	**100,000**	(50,000)	**50,000**
5	**95,263**	(98,121)	2,858	**0**	**50,000**	(50,000)	**0**

In applying paragraph 102A and paragraph 38(b) of IFRS 16, Seller-lessee recognises in profit or loss the difference between the payments made for the lease and the lease payments that reduce the carrying amount of the lease liability. For example, if Seller-lessee pays CU99,321 for the use of the building in Year 2, it recognises CU1,197 (CU99,321 - CU98,124) in profit or loss.

Approach 2 - Equal lease payments over the lease term

Applying paragraph 102A of IFRS 16, Seller-lessee determines 'lease payments' to reflect equal periodic payments over the lease term that, when discounted using its incremental borrowing rate, result in the carrying amount of the lease liability at the commencement date of CU450,000.

The lease liability and the right-of-use asset arising from the leaseback are:

Year	Lease liability				Right-of-use asset		
	Beginning balance	Lease payments[d]	3 per cent interest expense[c]	Ending balance	Beginning balance	Depreciation charge	Ending balance
	CU	CU	CU	CU	CU	CU	CU
1	**450,000**	(98,260)	13,500	**365,240**	**250,000**	(50,000)	**200,000**
2	**365,240**	(98,260)	10,957	**277,937**	**200,000**	(50,000)	**150,000**
3	**277,937**	(98,260)	8,338	**188,015**	**150,000**	(50,000)	**100,000**
4	**188,015**	(98,260)	5,640	**95,395**	**100,000**	(50,000)	**50,000**
5	**95,395**	(98,260)	2,865	**0**	**50,000**	(50,000)	**0**

In applying paragraph 102A and paragraph 38(b) of IFRS 16, Seller-lessee recognises in profit or loss the difference between the payments made for the lease and the lease payments that reduce the carrying amount of the lease liability. For example, if Seller-lessee pays CU99,321 for the use of the building in Year 2, it recognises CU1,061 (CU99,321 - CU98,260) in profit or loss.

(a) Applying paragraph 100(a) of IFRS 16, Seller-lessee determines the proportion of the building transferred to Buyer-lessor that relates to the right of use retained by comparing, at the commencement date, the right of use it retains via the leaseback to the rights comprising the entire building. Paragraph 100(a) does not prescribe a particular method for determining that proportion.

(b) Applying paragraph 102A and paragraph 36(b) of IFRS 16, Seller-lessee reduces the carrying amount of the lease liability with 'lease payments' that reflect the expected lease payments estimated at the commencement date and, when discounted, result in the carrying amount of the lease liability at that date of CU450,000.

(c) Applying paragraph 102A and paragraph 36(a) of IFRS 16, Seller-lessee increases the carrying amount of the lease liability to reflect interest on the lease liability using its incremental borrowing rate.

(d) Applying paragraph 102A and paragraph 36(b) of IFRS 16, Seller-lessee reduces the carrying amount of the lease liability with 'lease payments' that reflect equal periodic payments over the lease term that, when discounted, result in the carrying amount of the lease liability at the commencement date of CU450,000.

8.3 Transactions in which the transfer of an asset is not a sale

If the transfer of an asset is not a sale, the seller-lessee accounts for the transaction as a financing transaction. The seller-lessee keeps the transferred asset subject to the sale and leaseback transaction on its statement of financial position and accounts for amounts received as a financial liability in accordance with IFRS 9. The seller-lessee decreases the financial liability by the payments made less the portion considered interest expense.

If the transfer of an asset is not a sale, the buyer-lessor does not recognise the transferred asset and accounts for the amounts paid as a receivable in accordance with IFRS 9. *[IFRS 16.103]*.

How we see it

A sale and leaseback transaction that includes a repurchase option does not qualify as a sale under IFRS 15 and therefore is not accounted for as a sale and leaseback under IFRS 16. However, IFRS 16 does not explicitly specify whether a buyer and seller would reassess a failed sale when a repurchase option expires unexercised. We believe it is acceptable to reassess whether there is a sale (or purchase) in accordance with IFRS 15 in this scenario and if so, apply the sale and leaseback guidance in IFRS 16 at the time the control transfers to the buyer.

In developing an accounting policy in accordance with IAS 8, entities may look to ASC 842 's *Implementation Guidance and Illustrations* (ASC 842-40-55-31 to 38) which provides an illustration of the accounting for a failed sale transaction. In the example, the existence of a repurchase option is the only reason the transfer of an asset in a sale and leaseback transaction is not accounted for as a sale. However, when the repurchase option expires unexercised, the seller recognises the sale and the buyer recognises the purchase and both apply sale and leaseback accounting.

FASB differences

Asset transfers that do not qualify as sales should be treated as financings by the lessor and lessee. ASC 842 provides additional guidance for seller-lessees on adjusting the interest rate in certain circumstances (e.g., to ensure there is not a built-in loss).

8.4 Disclosure

Extract from IFRS 16

B52 Additional information relating to sale and leaseback transactions that, depending on the circumstances, may be needed to satisfy the disclosure objective in paragraph 51 could include information that helps users of financial statements to assess, for example:

(a) the lessee's reasons for sale and leaseback transactions and the prevalence of those transactions;

(b) key terms and conditions of individual sale and leaseback transactions;

(c) payments not included in the measurement of lease liabilities; and

(d) the cash flow effect of sale and leaseback transactions in the reporting period.

[IFRS 16.B52].

A seller-lessee may be required to provide additional qualitative and quantitative information about its leasing activities that is necessary to meet the disclosure objective in IFRS 16. Refer to section 5.8 on lessee disclosure requirements.

A seller-lessee is also required to disclose any gains and losses arising from sale and leaseback transactions separately from gains and losses on disposals of other assets under IFRS 16.53(i).

9 Business combinations

9.1 Acquiree in a business combination is a lessee

Extract from IFRS 3

Leases in which the acquiree is the lessee

28A The acquirer shall recognise right-of-use assets and lease liabilities for leases identified in accordance with IFRS 16 in which the acquiree is the lessee. The acquirer is not required to recognise right-of-use assets and lease liabilities for:

(a) leases for which the lease term (as defined in IFRS 16) ends within 12 months of the acquisition date; or

(b) leases for which the underlying asset is of low value (as described in paragraphs B3-B8 of IFRS 16).

28B The acquirer shall measure the lease liability at the present value of the remaining lease payments (as defined in IFRS 16) as if the acquired lease were a new lease at the acquisition date. The acquirer shall measure the right-of-use asset at the same amount as the lease liability, adjusted to reflect favourable or unfavourable terms of the lease when compared with market terms.

[IFRS 3.28A, IFRS 3.28B].

9.1.1 Initial measurement of a lease

IFRS 3 *Business Combinations* specifies the initial measurement requirements for leases that are acquired in a business combination.

The acquirer measures the acquired lease liability as if the lease contract were a new lease at the acquisition date. That is, the acquirer applies IFRS 16's initial measurement provisions, using the present value of the remaining lease payments at the acquisition date. The acquirer follows the requirements for determining the lease term, lease payments and discount rate as discussed in section 4 above. The discount rate is determined from the perspective of the acquiree, as the acquiree is the customer in the lease contract. However, the determination of the lessee's incremental borrowing rate will take into account that the acquiree is now part of the new group. This is discussed further in section 4.6.1 above.

The right-of-use asset is measured at an amount equal to the recognised liability, adjusted to reflect the favourable or unfavourable terms of the lease, relative to market terms. Because the off-market nature of the lease is captured in the right-of-use asset, the acquirer does not separately recognise an intangible asset or liability for favourable or unfavourable lease terms relative to market. *[IFRS 16.BC298]*.

The acquirer is not required to recognise right-of-use assets and lease liabilities for leases with lease terms which end within 12 months of the acquisition date and leases for low-value assets. The IASB considered whether to require an acquirer to recognise assets and liabilities relating to off-market terms for short-term leases and leases of low-value assets. However, the IASB indicated that the effect of off-market terms would rarely be material for short-term leases and leases of low-value assets and so decided not to require this. *[IFRS 16.BC298]*.

9.1.2 Subsequent measurement of a lease

The subsequent measurement requirements for an acquired lease liability and right-of-use asset are the same as the requirements for any other existing lease arrangement.

9.2 Acquiree in a business combination is a lessor

Extract from IFRS 3

17 This IFRS provides two exceptions to the principle in paragraph 15:

(a) classification of a lease contract in which the acquiree is the lessor as either an operating lease of a finance lease in accordance with IFRS 16 *Leases*.

(b) [deleted]

The acquirer shall classify those contracts on the basis of the contractual terms and other factors at the inception of the contract (or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date).

Assets subject to operating leases in which the acquiree is the lessor

B42 In measuring the acquisition-date fair value of an asset such as a building or a patent that is subject to an operating lease in which the acquiree is the lessor, the acquirer shall take into account the terms of the lease. The acquirer does not recognise a separate asset or liability if the terms of an operating lease are either favourable or unfavourable when compared with market terms.

[IFRS 3.17, IFRS 3.B42].

IFRS 16 requires an acquirer to classify acquired lessor leases as either finance or operating leases using the contractual terms and conditions at the inception of the lease, or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification. Therefore, the classification is not changed as a result of a business combination unless a lease is modified. Refer to section 6.5.

10 Effective date and transition

10.1 Effective date

IFRS 16 was effective for annual periods beginning on or after 1 January 2019. Early application was permitted for entities that applied IFRS 15 as at or before the date of initial application of IFRS 16. *[IFRS 16.C1]*.

10.2 Transition

IFRS 16 contained a number of transition provisions, some optional and some required that were applied at the beginning of the annual reporting period in which the entity first applied the standard.

The transition provisions most significantly impacted the prior operating leases of a lessee. IFRS 16 required retrospective application for lessees. However, it allowed either a 'full retrospective' adoption (in which the standard was applied retrospectively to all periods presented in accordance with IAS 8 or a 'modified retrospective' adoption (in which the standard was applied retrospectively to only the most current period presented in the financial statements). Under both transition methods, the IASB granted transition practical expedients to provide relief. *[IFRS 16.C5-C10]*.

With the exception of subleases, on transition, a lessor was not required to make any adjustments for leases in which it is a lessor. From the date of initial application, the lessor accounted for those leases applying IFRS 16.

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Appendix C - IFRS 16 Defined terms

The following table summarises the terms that are defined in Appendix A of IFRS 16.

Extract from IFRS 16

Appendix A
Defined terms

This appendix is an integral part of the Standard.

commencement date of the lease (commencement date)	The date on which a **lessor** makes an **underlying asset** available for use by a **lessee**.
economic life	Either the period over which an asset is expected to be economically usable by one or more users, or the number of production or similar units expected to be obtained from an asset by one or more users.
effective date of the modification	The date when both parties agree to a **lease modification**.
fair value	For the purpose of applying the **lessor** accounting requirements in this Standard, the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
finance lease	A **lease** that transfers substantially all the risks and rewards incidental to ownership of an **underlying asset**.
fixed payments	Payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** during the **lease term**, excluding **variable lease payments**.
gross investment in the lease	The sum of: (a) the **lease payments** receivable by a **lessor** under a **finance lease**; and (b) any **unguaranteed residual value** accruing to the lessor.
inception date of the lease (inception date)	The earlier of the date of a **lease** agreement and the date of commitment by the parties to the principal terms and conditions of the lease.
initial direct costs	Incremental costs of obtaining a **lease** that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a **finance lease**.
interest rate implicit in the lease	The rate of interest that causes the present value of (a) the **lease payments** and (b) the **unguaranteed residual value** to equal the sum of (i) the **fair value** of the **underlying asset** and (ii) any **initial direct costs** of the lessor.
lease	A contract, or part of a contract, that conveys the right to use an asset (the **underlying asset**) for a period of time in exchange for consideration.
lease incentives	Payments made by a **lessor** to a **lessee** associated with a **lease**, or the reimbursement or assumption by a lessor of costs of a lessee.
lease modification	A change in the scope of a **lease**, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more **underlying assets**, or extending or shortening the contractual **lease term**).

lease payments	Payments made by a **lessee** to a **lessor** relating to the right to use an **underlying asset** during the **lease term**, comprising the following: (a) **fixed payments** (including in-substance fixed payments), less any **lease incentives**; (b) **variable lease payments** that depend on an index or a rate; (c) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and (d) payments of penalties for terminating the **lease**, if the lease term reflects the lessee exercising an option to terminate the lease. For the lessee, lease payments also include amounts expected to be payable by the lessee under **residual value guarantees**. Lease payments do not include payments allocated to non-lease components of a contract, unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component. For the lessor, lease payments also include any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee. Lease payments do not include payments allocated to non-lease components.
lease term	The non-cancellable period for which a **lessee** has the right to use an **underlying asset**, together with both: (a) periods covered by an option to extend the **lease** if the lessee is reasonably certain to exercise that option; and (b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.
lessee	An entity that obtains the right to use an **underlying asset** for a period of time in exchange for consideration.
lessee's incremental borrowing rate	The rate of interest that a **lessee** would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the **right-of-use asset** in a similar economic environment.
lessor	An entity that provides the right to use an **underlying asset** for a period of time in exchange for consideration.
net investment in the lease	The **gross investment in the lease** discounted at the **interest rate implicit in the lease**.
operating lease	A **lease** that does not transfer substantially all the risks and rewards incidental to ownership of an **underlying asset**.
optional lease payments	Payments to be made by a **lessee** to a **lessor** for the right to use an **underlying asset** during periods covered by an option to extend or terminate a **lease** that are not included in the **lease term**.
period of use	The total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time).
residual value guarantee	A guarantee made to a **lessor** by a party unrelated to the lessor that the value (or part of the value) of an **underlying asset** at the end of a **lease** will be at least a specified amount.
right-of-use asset	An asset that represents a **lessee's** right to use an **underlying asset** for the **lease term**.
short-term lease	A **lease** that, at the **commencement date**, has a **lease term** of 12 months or less. A lease that contains a purchase option is not a short-term lease.
sublease	A transaction for which an **underlying asset** is re-leased by a **lessee** ('intermediate lessor') to a third party, and the **lease** ('head lease') between the head lessor and lessee remains in effect.
underlying asset	An asset that is the subject of a **lease**, for which the right to use that asset has been provided by a **lessor** to a **lessee**.

unearned finance income	The difference between: (a) the **gross investment in the lease**; and (b) the **net investment in the lease**.
unguaranteed residual value	That portion of the residual value of the **underlying asset**, the realisation of which by a **lessor** is not assured or is guaranteed solely by a party related to the lessor.
variable lease payments	The portion of payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** during the **lease term** that varies because of changes in facts or circumstances occurring after the **commencement date**, other than the passage of time.

Terms defined in other Standards and used in this Standard with the same meaning

contract	An agreement between two or more parties that creates enforceable rights and obligations.
useful life	The period over which an asset is expected to be available for use by an entity; or the number of production or similar units expected to be obtained from an asset by an entity.

Appendix D - Key differences between IFRS 16 and ASC 842

The IASB issued IFRS 16 after joint deliberations with the US FASB, which issued a similar standard, ASC 842 *Leases*. While IFRS 16 and ASC 842 both require lessees to put most leases on their statements of financial position, there are a number of differences between the standards. The following table summarises the key differences and includes references to the IASB's and FASB's discussion of the differences in the Basis for Conclusions for each standard (i.e., IFRS 16 and ASU 2016-2).

	IFRS 16	US GAAP ASC 842
Scope and measurement exceptions		
Low-value asset exemption[1] Section 5.1.2	Lessees may elect, on a lease-by-lease basis, not to recognise leases when the value of the underlying asset is low (e.g., US$5,000 or less when new).	There is no recognition exemption for leases based on the value of the underlying asset.
Scope exemption for intangible assets[2] Section 2.2	Lessees may apply IFRS 16 to leases of intangible assets other than rights held by a lessee under licensing agreements within the scope of IAS 38, for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights. Lessors are required to apply IFRS 16 to leases of intangible assets, except for licences of intellectual property that are in the scope of IFRS 15 *Revenue from Contracts with Customers*.	All leases of intangible assets are excluded from the scope of ASC 842.
Key concepts		
Lease liability - reassessment of variable lease payments[3] Section 4.5.3	Changes in variable lease payments based on an index or rate result in a remeasurement of the lease liability whenever there is a change in the cash flows (i.e., when the adjustment to the lease payments take effect).	Changes in variable lease payments based on an index or rate result in a remeasurement of the lease liability when the lease liability is remeasured for another reason (e.g., a change in the lease term).
Determination of the discount rate Section 6.1	Lessees determine the discount rate at lease commencement but lessors determine the rate implicit in the lease at the lease inception date. That is because a lessor determines lease classification at the lease inception date.	Lessees and lessors determine the discount rate at the lease commencement date.
Determination of a lessee's incremental borrowing rate Section 4.6	IFRS 16 does not address whether a lessee may consider the effect of lease term options (e.g., purchase and renewal options) that are not included in the lease term. IFRS 16 does not provide accounting alternatives for private companies.	A lessee may consider the effect of lease term options (e.g., purchase and renewal options) that are not included in the lease term. Entities that are not public business entities (PBEs) may elect to use a risk-free rate by class of underlying asset for initial and subsequent measurements of the lease liability. However, a lessee is required to use the rate implicit in the lease when it is

1 IFRS 16 BC308 and ASC 842 BC421.

2 ASC 842 BC431.

3 IFRS 16 BC309 and ASC 842 BC425.

	IFRS 16	US GAAP ASC 842
		readily determinable, even if they make the risk-free rate election.
Initial direct costs (IDCs) Section 6.3.1	IDCs are incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained. However, costs incurred by a manufacturer or dealer lessor in connection with a finance lease are expensed as incurred.	IDCs are incremental costs that would not have been incurred if the lease had not been obtained. Lessors expense IDCs for sales-type leases if the fair value of the underlying asset is different from the carrying amount of the underlying asset at lease commencement.
Lease classification		
Lessee lease classification[4] Section 5.1	All recognised leases are accounted for based on a right-of-use model (similar to finance leases under ASC 842).	Recognised leases are classified as either finance or operating. Lessees classify leases at the lease commencement date.
Lessor lease classification Section 6.1	Leases are classified as operating or finance leases at the inception date of the lease.	Leases are classified as operating, direct financing or sales-type leases at the lease commencement date.
Lessor - lease classification criteria Section 6.1.1	All classification criteria can be considered individually or in combination. IFRS 16 provides examples and indicators of situations that can be considered individually, or in combination, and would result in a lease being classified as a finance lease. Meeting a single criterion would not automatically result in the lease being classified as a finance lease. IFRS 16 does not include additional guidance for a lessor's classification of a lease that results in a selling loss.	Each classification criterion is determinative. After the adoption of Accounting Standards Update 2021-05, *Leases (Topic 842): Lessors - Certain Leases with Variable Lease Payments*, lessors are also required to classify a lease as an operating lease if the lease has variable lease payments that do not depend on an index or rate and would result in a selling loss if the lease were to be classified as a sales-type or direct financing lease otherwise.
Lessor - reassessment of lease classification Section 6.1.4	As long as the existing option is part of the original terms and conditions of the lease (i.e., not a lease modification), lessors do not reassess lease classification if lessees exercise an existing option to renew the lease (i.e., change in assessment of lease term) or to purchase the underlying asset when it was previously determined it was not reasonably certain to do so. Lease classification is determined at lease inception and reassessed only if there is a lease modification that is not accounted for as a separate contract.	Lessors are required to reassess lease classification if lessees exercise an existing option to renew the lease (i.e., change in assessment of lease term) or to purchase the underlying asset when it was previously determined it was not reasonably certain to do so.
Collectability Section 6.1.1	IFRS 16 does not include explicit guidance for considering collectability of lease payments.	Collectability of lease payments is considered when determining if a lease is classified as a direct financing or an operating lease.
Subleases Section 7.2	When classifying a sublease, a sublessor classifies the sublease based	When classifying a sublease, the sublessor classifies the sublease based

4 IFRS 16 BC304 and ASC 842 BC420.

	IFRS 16	US GAAP ASC 842
	on the right-of-use asset recognised as part of the head lease rather than the underlying asset subject to the sublease.	on the underlying asset rather than the right-of-use asset on the head lease.
Lessee accounting		
Short-term leases - existence of a purchase option Section 5.1.1	A lease does not qualify as a short-term lease if it includes a purchase option, regardless of whether the lessee is reasonably certain to exercise the option.	A lease does not qualify as a short-term lease if it includes a purchase option that is reasonably certain to be exercised.
Short-term leases - change in lease term Section 5.1.1	A change in the terms of a short-term lease creates a new lease. If that new lease has a lease term greater than 12 months, it cannot qualify as a short-term lease.	A lease no longer qualifies as a short-term lease when there is a change in a lessee's assessment of either of the following: ▸ The lease term so that, after the change, the remaining lease term extends more than 12 months from the end of the previously determined lease term ▸ Whether the lessee is reasonably certain to exercise an option to purchase the underlying asset.
Allocating variable consideration not dependent on an index or rate between lease and non-lease components of a contract Section 3.2.5	Under IFRS 16 lessees may allocate variable consideration not dependent on an index or rate entirely to a non-lease component of a contract. Refer to Example 12 in IFRS 16	Lessees allocate variable consideration not dependent on an index or rate to the lease and non-lease components of a contract on a relative stand-alone price basis.
Lease modifications that do not result in a separate contract and shorten the contractual lease term Section 5.5.3	Lease modifications that do not result in a separate contract and shorten the contractual lease term result in the recognition of a gain or loss for the difference between the decrease in the lease liability and the proportionate decrease in the right-of-use asset. Refer to Example 18 in IFRS 16.	Lease modifications that do not result in a separate contract and shorten the contractual lease term do not result in the recognition of a gain or loss. A lessee recognises the amount of the remeasurement of the lease liability as an adjustment to the corresponding right-of-use asset without affecting profit or loss. However, if the right-of-use asset is reduced to zero, a lessee would recognise any remaining amount in profit or loss.
Componentisation Section 5.3.1.A	A lessee applies the depreciation requirements in IAS 16 in depreciating right-of-use assets, which requires that each item of property, plant and equipment with a cost that is significant in relation to the total cost of the item be separately depreciated (i.e., a component approach).	Component depreciation is permitted but not common.
Reallocation of consideration in the contract upon a change in the lease	The consideration in the contract is reallocated only when a lease is modified. Therefore, when a lease liability is remeasured for other	The consideration in the contract is reallocated when a lease is modified or a lease liability is remeasured. Therefore, the revised lease payments

	IFRS 16	US GAAP ASC 842
term, the assessment of whether a purchase option is reasonably certain to be exercised, or the amounts probable of being owed under a residual value guarantee Section 5.4	reasons (e.g., a change in lease term), the revised lease payments are allocated based on the standalone price of the lease and non-lease components at lease commencement.	are allocated based on the standalone price of the lease and non-lease components at the date of remeasurement (or effective date of the modification).
Capitalisation of lease costs during the construction of a lessee asset	IFRS 16 does not provide guidance on the capitalisation of lease costs during the construction of a lessee asset.	ASC 842-10-55-21 prohibits an entity from capitalising lease costs during the construction of a lessee asset, unless an entity is able to capitalise those costs under ASC 970 on real estate projects for sale or rental.
Amortisation of leasehold improvements associated with a lease between entities under common control	IFRS 16 does not provide specific guidance on amortisation of leasehold improvements associated with a lease between entities under common control.	A lessee is required to amortise leasehold improvements associated with common control leases over their useful life to the common control group, as long as the lessee controls the use of the underlying asset through a lease.
Lessor accounting		
Practical expedient to not separate lease and non-lease components Section 3.2.2.B	IFRS 16 does not include a practical expedient for lessors.	A lessor can elect, by class of underlying asset, not to separate lease and related non-lease components if certain criteria are met. Additionally, if the non-lease component is the predominant component of the combined component, the combined component is accounted for in accordance with ASC 606 *Revenue from Contracts with Customers*.
Recognition of selling profit for direct financing leases[5] Section 6.3.1	IFRS 16 does not distinguish between sales-type and direct financing leases. Selling profit on finance leases is recognised at lease commencement.	Selling profit on direct financing leases is deferred at lease commencement and amortised into income over the lease term.
Collectability - sales-type leases and operating leases Section 6.3.1 and section 6.4.1	IFRS 16 does not include explicit guidance for considering collectability of lease payments.	Collectability of lease payments is assessed for purposes of initial recognition and measurement of sales-type leases. It is also evaluated to determine the income recognition pattern of operating leases.
Modification of a sales-type or direct financing lease[6] *(under US GAAP) or a finance lease (under IFRS*	If the modification of a finance lease is not accounted for as a separate contract, the accounting for the modification depends on whether the finance lease would have been classified as an operating lease had the	If the modification of a sales-type or direct financing lease is not accounted for as a separate contract, the entity reassesses the classification of the lease as of the effective date of the modification based on the modified

5 ASC 842 BC427.

6 IFRS 16.80 and ASC 842 BC429.

	IFRS 16	US GAAP ASC 842
accounting standards) that does not result in a separate contract Section 6.5.1.B	modification been in effect at lease inception. IFRS 16 then specifies how to account for the modified lease based on that classification.	terms and conditions, and the facts and circumstances as of that date. ASC 842 then specifies how to account for the modified lease based on the classification of the modified lease.
Allocating variable consideration not dependent on an index or rate between lease and non-lease components of a contract Section 3.2.4.B	IFRS 16 does not give guidance for variable consideration related to the lease component. Lessors would allocate the consideration in the contract based on the guidance in IFRS 15.73 to 90, which is to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.	If the terms of a variable payment that is not dependent on an index or rate relate, even partially, to the lease component, the lessor will recognise those payments (allocated to the lease component) as income in profit or loss in the period when the changes in facts and circumstances on which the variable payment is based occur (e.g., when the lessee's sales on which the amount of the variable payment depends occur). When the changes in facts and circumstances on which the variable payment is based occur, the lessor will allocate those payments to the lease and non-lease components of the contract. The allocation is on the same basis as the initial allocation of the consideration in the contract or the most recent modification not accounted for as a separate contract unless the variable payment meets the criteria in ASC 606-10-32-40 to be allocated only to the lease component(s).
Sale of lease receivables when the lessor retains an interest in the unguaranteed residual asset	IFRS 16 does not include similar guidance. The lessor's net investment in the lease, which includes any unguaranteed residual value, is subject to the derecognition and impairment requirements in IFRS 9.	If a lessor sells substantially all of the lease receivable associated with a sales-type lease or a direct financing lease and retains an interest in the unguaranteed residual asset, the lessor no longer accretes the unguaranteed residual asset to its estimated value over the remaining lease term under ASC 842. Instead, the lessor reports any remaining unguaranteed residual asset at its carrying amount at the date of the sale of the lease receivable and applies ASC 360 to determine whether the unguaranteed residual asset is impaired.
Sale and leaseback transactions		
Assessing if a transfer of an asset is a sale in a sale/purchase and leaseback transaction Section 8.1	To determine whether the transfer of an asset is accounted for as a sale, a seller-lessee and a buyer-lessor apply the requirements in IFRS 15 (including those for repurchase agreements) to assess whether the buyer-lessor has obtained control of the asset. IFRS 16 does not contain the same lease classification criteria included in US GAAP, which precludes sale accounting if the leaseback would be	To determine whether an asset transfer is a sale and purchase, a seller-lessee and a buyer-lessor consider the following: ▸ Whether the transfer meets the sale criteria under ASC 606 (however, certain fair value repurchase options would not result in a failed sale) ▸ Whether the leaseback would be classified as a sales-type lease by

	IFRS 16	US GAAP ASC 842
	classified as a sales-type lease by the buyer-lessor or a finance lease by the seller-lessee. However, entities should carefully consider the requirements in IFRS 15 (i.e., whether the buyer-lessor obtains control of the asset) to determine whether the transfer of an asset is accounted for as a sale and purchase. Entities may often reach similar conclusions on whether a sale and purchase have occurred under both standards.	the buyer-lessor or a finance lease by the seller-lessee (i.e., a sale and purchase does not occur when the leaseback is classified as a sales-type lease by the buyer-lessor or as a finance lease by the seller-lessee)
Gain or loss recognition in sale and leaseback transactions[7] Section 8.2.1	The seller-lessee recognises only the amount of any gain or loss, adjusted for off-market terms, that relates to the rights transferred to the buyer-lessor.	The seller-lessee recognises any gain or loss, adjusted for off-market terms, immediately.
Failed sales - seller/lessee Section 8.3	Asset transfers that do not qualify as sales should be accounted for as financings in accordance with IFRS 9 *Financial Instruments* by the lessor and lessee. IFRS 16 does not provide additional guidance on interest rate adjustments.	Asset transfers that do not qualify as sales should be accounted for as financings by the lessor and lessee. ASC 842 provides additional guidance on adjusting the interest rate in certain circumstances (e.g., to ensure there is not a built-in loss).
Other considerations		
Related party transactions	IFRS 16 does not address related party lease transactions. IAS 24 *Related Party Disclosures* contains guidance on related party disclosures.	Entities classify and account for related party leases (including sale and leaseback transactions) based on the legally enforceable terms and conditions of the lease. Disclosure of related party transactions is required.
Practical expedient to use the written terms and conditions of common control arrangement	IFRS 16 does not include a practical expedient for common control arrangements.	Private companies and certain not-for-profit entities can elect a practical expedient to use the written terms and conditions of a common control arrangement to determine whether a lease exists and to classify and account for the lease.
Leveraged leases	Leveraged lease accounting is not permitted under IFRS 16.	Leveraged lease accounting is eliminated for leases that commence on or after the effective date of ASC 842. However, leveraged leases that commenced before the effective date are grandfathered. If an existing leveraged lease is modified on or after the effective date, the lease would no longer be accounted for as a leveraged lease but would instead be accounted for under ASC 842. Refer to section 11.4.5 of Financial Reporting Developments Business Combinations.

7 IFRS 16 BC306 and ASC 842 BC430.

Chapter 25 Government grants

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Overview

IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* applies to the accounting for, and the disclosure of, government grants and to the disclosure of other forms of government assistance. *[IAS 20.1]*. The distinction between government grants and other forms of government assistance is important because the standard's accounting requirements only apply to the former.

Government grants are a specific form of government assistance and relate to the transfers of resources to an entity in return for past or future compliance with certain conditions relating to the entity's operating activities. *[IAS 20.3]*. The purpose of government grants, which may be called subsidies, subventions or premiums, *[IAS 20.6]*, and other forms of government assistance is often to encourage a private sector entity to take a course of action that it would not normally have taken if the assistance had not been provided. *[IAS 20.4]*. Government grants are also used to provide financial support as was abundantly illustrated during the coronavirus pandemic when governments all over the world introduced measures to provide financial assistance to businesses in an effort to mitigate the significant impact of the pandemic on their economies.

The main accounting issue that arises from government grants is how to deal with the benefit that the grant represents. IAS 20 adopts an income approach, whereby grants are recognised in profit or loss in the same periods as the entity recognises as expenses the costs that the grants are intended to compensate. *[IAS 20.12]*.

This chapter covers the requirements of IAS 20 regarding recognition, measurement and presentation of government grants and looks at specific examples of government grants including low interest and forgivable loans. It also covers disclosure requirements for grants and other forms of government assistance.

What you need to know

- Grants are not recognised until there is reasonable assurance that the entity is eligible as a result of a past event.
- IAS 20 adopts an income approach to the recognition of government grants, regardless of whether the grant is received in cash, as a reduction in a liability to the government or in the form of a transfer of a non-monetary asset.
- Grants relating to specific expenses are recognised in profit or loss in the same periods as those expenses, and grants relating to depreciable assets are recognised in profit or loss in the same periods as the related depreciation expense.
- Grants relating to assets must be presented in the statement of financial position either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset.
- Grants relating to income must be presented in the income statement either separately or by deduction in reporting the related expense.
- A grant received in the form of a non-monetary asset can be recognised at fair value or, alternatively, at a nominal amount.
- The nature of significant other forms of government assistance that do not meet the definition of a government grant must be disclosed.

1 Introduction

IAS 20 was applicable for the first time in 1984. *[IAS 20.41]*. The only substantive amendment since issue was in 2008, requiring entities to quantify the benefit of a government loan at a below-market rate of interest. *[IAS 20.10A, IAS 20.43]*.

IAS 20 defines government grants in terms of "transfers of resources to an entity in return for meeting certain conditions relating to the operating activities of the entity". *[IAS 20.3]*. SIC-10 *Government Assistance - No Specific Relation to Operating Activities* was issued in 1998 to clarify that IAS 20 applies even if the only condition is a requirement to operate in certain regions or industry sectors (see section 2.2.2 below).

Government grants related to biological assets are excluded from the scope of IAS 20 and are dealt with in IAS 41 *Agriculture*, which has different accounting requirements (see section 5 below and Chapter 38 at section 3.3). *[IAS 20.2(d)]*.

The standard pre-dates the IASB's *Conceptual Framework* and, as the IASB itself has noted, is inconsistent with it,[1] resulting in the recognition in the statement of financial position of deferred credits that do not meet the *Framework's* definitions of liabilities and allowing alternatives to initial measurement that could result in an asset being understated by reference to the *Framework*. IAS 20 is the only standard left that takes an income approach instead of the balance sheet approach for the recognition of income and expense applied in the rest of the IFRS accounting standards.

The standard recognises that an entity may receive other forms of government assistance which cannot reasonably have a value placed upon them. Rather than prescribe how these must be accounted for, it requires disclosure about such assistance. *[IAS 20.34, IAS 20.36]*. However, since the issuance of IFRS 13 *Fair Value Measurement,* the challenge of placing a value on forms of assistance has reduced (see section 3.8 below). For example, IAS 20 cites free technical or marketing advice and the provision of guarantees as examples of government assistance that cannot reasonably have a value placed on them and hence are excluded from the definition of grants. *[IAS 20.35]*. Nevertheless, where it can be demonstrated that a fair value can be determined for these items, then they must be accounted as a government grant (see section 3.5 below for further discussion about guarantees).

1 *IASB Update*, February 2006, available on the IFRS Foundation's website.

1.1 Terms used in this chapter

The following terms from IAS 20 and IAS 41 are used in this chapter with the meanings specified: *[IAS 20.3, IAS 41.5]*

Extract from IAS 20

3 The following terms are used in this Standard with the meanings specified:

Government refers to government, government agencies and similar bodies whether local, national or international.

Government assistance is action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria. Government assistance for the purpose of this Standard does not include benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints on competitors.

Government grants are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.[2]

Grants related to assets are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

Grants related to income are government grants other than those related to assets.

Forgivable loans are loans which the lender undertakes to waive repayment of under certain prescribed conditions.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13 *Fair Value Measurement.)*

2 See also SIC-10 *Government Assistance-No Specific Relation to Operating Activities*.

Extract from IAS 41

5 The following terms are used in this Standard with the meanings specified:

...

A *bearer plant* is a living plant that:

(a) is used in the production or supply of agricultural produce;

(b) is expected to bear produce for more than one period; and

(c) has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.

A *biological asset* is a living animal or plant.

...

Costs to sell are the incremental costs directly attributable to the disposal of an asset, excluding finance costs and income taxes.

...

Government grants are sometimes called by other names such as subsidies, subventions, or premiums. *[IAS 20.6]*. In addition, a non-monetary government grant is a government grant that takes the form of a transfer of a non-monetary asset, such as land or other resources, for the use of the entity. *[IAS 20.23]*.

2 Scope of IAS 20

IAS 20 applies in accounting for, and in the disclosure of, government grants and in the disclosure of other forms of government assistance. *[IAS 20.1]*. The distinction between government grants and other forms of government assistance is important because the standard's accounting requirements only apply to the former.

The standard regards the term 'government' to include government agencies and similar bodies whether local, national or international. *[IAS 20.3]*. However, IAS 20 gives no further guidance on what is meant by 'similar bodies', therefore the assessment of whether a body providing support to an entity is regarded as a 'similar body' under IAS 20 is a judgemental area dependent on the specific facts and circumstances.

2.1 Government assistance

Government assistance is defined as action by government designed to provide an economic benefit to an entity or range of entities qualifying under certain criteria. *[IAS 20.3]*. Government assistance takes many forms "varying both in the nature of the assistance given and in the conditions which are usually attached to it". *[IAS 20.4]*.

However, such assistance does not include benefits provided indirectly through action affecting general trading conditions, such as the provision of infrastructure (e.g., transport, communications networks or utilities) in development areas or that are available for the benefit of an entire local community or the imposition of trading constraints on competitors (see section 3.8 below). *[IAS 20.3, IAS 20.38]*.

2.2 Government grants

2.2.1 Definitions

Government grants are a specific form of government assistance. Under IAS 20, government grants represent assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. *[IAS 20.3]*. The standard identifies grants related to assets and grants related to income, as follows:

Extract from IAS 20

3 **The following terms are used in this Standard with the meanings specified:**

...

Grants related to assets **are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.**

Grants related to income **are government grants other than those related to assets.**

...

Government grants exclude:

(a) Assistance to which no value can reasonably be assigned

And

(b) Transactions with government that cannot be distinguished from the normal trading transactions of the entity, e.g., where the entity is being favoured by a government's procurement policy *[IAS 20.3, IAS 20.34, IAS 20.35]*

Such excluded items are to be treated as falling only within the standard's disclosure requirements for government assistance (see section 3.8 below).

The benefit of loans at below-market interest rates is also deemed to be a form of government grant. The standard requires entities to measure and record the loan in accordance with IFRS 9 *Financial Instruments* (i.e., at fair value) and account for the benefit of the below-market rate of interest as a grant. *[IAS 20.10A]*. The accounting consequences are discussed in section 3.4 below.

Grants of emission rights may meet the definition of government grants under IAS 20. Grants of renewable energy certificates can also meet the definition of government grants, in some cases. The rights and certificates themselves might be classified as intangible assets under IAS 38 *Intangible Assets* or, if they meet the definition of inventory under IAS 2 *Inventories*, it might be appropriate to classify them as inventory rather than intangible assets. Accounting for emission rights and renewable energy certificates is discussed in Chapter 18 at sections 11.2 and 11.3 and in Chapter 23 at sections 2.3.1.C and 2.3.1.D.

There are other emerging schemes in a number of regions, for example schemes relating to carbon credit projects. It is important that the specific facts and circumstances of a scheme are determined to be able to assess whether the scheme involves a government grant or not. Factors to consider include the primary reason for the scheme, whether there is a transfer of economic benefit from the government and, if so, what conditions are attached and what type of expense the government support may be compensating for.

2.2.2 Grants with no specific relation to operating activities (SIC-10)

SIC-10 addresses the situation in some countries where government assistance is provided to entities, but without there being any conditions specifically relating to their operating activities, other than to operate in certain regions or industry sectors. It determined that such forms of government assistance are to be treated as government grants. *[SIC-10.3]*. This ruling was made to avoid any suggestion that such forms of assistance were not governed by IAS 20 and could be credited directly to equity.

2.2.3 Determining the recipient of a government grant

It may not always be clear who the recipient of a government grant is due to the involvement of multiple parties. In certain cases, an entity might receive cash from the government but is merely acting as a 'facilitator' to ensure the benefit of the cash is passed on to the intended beneficiary of the government support. In cases where there are multiple parties, it is important to have a full understanding of the terms of the relevant government support scheme to determine which party should be recognising a government grant.

Illustration 2-1: Recipient of a government grant

A government has a scheme in place whereby they will provide CU1,000 of financial support to commercial electricity users over 12 months. This support will be provided by way of part settlement of their energy bills. The government provides cash to energy suppliers, and this must be used only for the partial settlement of customer bills. The terms of the scheme state that it does not reduce the amount the energy supplier is able to charge its electricity customers. Any cash remaining after the 12 months must be returned to the government.

In this case, who is the recipient of the government grant, is it the supplier or the electricity users?

Although the energy supplier receives a resource (cash) from the government, it is required to pass that resource on to its customer. The energy supplier still has a right to supply energy at the price in the customer contract, so the provision of support does not affect the supplier's contract with its customer. It is merely, the settlement party that has changed, i.e., the energy bill is now part settled by the customer and part settled by the government. This is consistent with the discussion in the Basis for Conclusions on paragraph BC187 in IFRS 15 *Revenue from Contracts with Customers* which clarifies that the amounts to which the entity has rights under the present contract can be paid by any party. It is therefore appropriate, in this case, to consider the customer (not the supplier) as the grant recipient. The supplier is merely facilitating the provision of support to the customer and recognises a liability upon receiving cash from the government that it must use for the partial settlement of customer bills.

2.3 Scope exclusions

2.3.1 General considerations

IAS 20 does not deal with:

(a) Accounting for government grants if the entity prepares financial information that reflects the effects of changing prices, whether as financial statements or in supplementary information of a similar nature

(b) Government assistance in the form of benefits that are available in determining taxable profit or loss or are determined or limited on the basis of income tax liability, e.g., income tax holidays, investment tax credits, accelerated depreciation allowances and reduced income tax rates

(c) Government participation in the ownership of the entity

And

(d) Government grants covered by IAS 41 *[IAS 20.2]*

The accounting treatment of government assistance either provided by way of a reduction in taxable profit or loss, or determined or limited according to an entity's income tax liability, is discussed in the context of investment tax credits in section 2.3.2 below and in Chapter 29 at section 4.3.

In the case of exclusion (c) above, for an entity in which the government is a shareholder, it will be necessary to determine whether any assistance being provided to the entity is being given by the government acting in its capacity as a shareholder. If so, such assistance will not be within the scope of IAS 20 and will be accounted for in equity, in common with other shareholder transactions (see Chapter 3 at section 3.3).

The reason for exclusion (d) above is that the presentation permitted by IAS 20 of deducting government grants from the carrying amount of the asset (see section 4.1 below) was considered inconsistent with a fair value model, which must be used in the measurement of biological assets. *[IAS 41.B66]*. The IASB decided to deal with government grants related to agricultural activity in IAS 41 rather than initiate a wider review of IAS 20. *[IAS 41.B67]*. The requirements of IAS 41 in relation to government grants are set out in section 5 below and in Chapter 38 at section 3.3.

There are no similar exclusions for government grants in IAS 40 *Investment Property* which includes a similar fair value model (see Chapter 20), nor was IAS 20 revised to deal with the matter. This is probably because government grants in the investment property sector are relatively rare compared to the agricultural sector. However, governments do on occasion provide grants and subsidised loans to finance the acquisition of social housing that meets the definition of investment property. The discount on these subsidised loans is considered to be a government grant, as described in section 3.4 below.

2.3.2 Investment tax credits

IAS 20 excludes from its scope government assistance either provided by way of a reduction in taxable profit or determined or limited according to an entity's income tax liability, citing income tax holidays, investment tax credits, accelerated depreciation allowances and reduced income tax rates as examples. *[IAS 20.2(b)]*. IAS 12 *Income Taxes* states that it does not deal with the methods of accounting for government grants or investment tax credits, although any temporary differences that arise from them are in the scope of the standard. *[IAS 12.4]*. Accordingly, if government assistance is described as an investment tax credit, but it is neither determined or limited by reference to the entity's income tax liability nor provided in the form of an income tax deduction, the requirements of IAS 20 apply.

This raises the question as to how an entity should account for those forms of government incentives for specific kinds of investment that are delivered through the tax system. The fact that both IAS 20 and IAS 12 use the term 'investment tax credits' to describe items excluded from their scope requires entities to carefully consider the nature of such incentives and the conditions attached to them to determine which standard the particular tax credit is excluded from and, therefore, whether they fall in the scope of IAS 20 or IAS 12.

How we see it

In our view, the determination of which framework to apply to a particular investment tax credit (IAS 12 or IAS 20) is a matter of judgement and all facts and circumstances relating to the specific incentive need to be considered in assessing the substance of the arrangement.

The following factors will often be relevant, but this list of factors must not be considered exhaustive, and entities may identify other factors which they consider to be more important than those listed below.

Feature of credit	Indicator of IAS 20 treatment	Indicator of IAS 12 treatment
Method of realisation	Directly settled in cash where there are insufficient taxable profits to allow credit to be fully recovered, or available for set off against non-income taxes, such as payroll taxes, sales taxes or other amounts owed to government.	Only available as a reduction in income taxes payable (i.e., benefit is forfeited if there are insufficient income taxes payable). However, a lengthy period allowed for carrying forward unused credits may make this indicator less relevant.
Number of non-income tax conditions attached to initial receipt of grant (e.g., minimum employment, ongoing use of purchased assets)	Many	None or few
Restrictions as to nature of expenditure required to receive the grant	Highly specific	Broad criteria encompassing many different types of qualifying expenditure
Income tax status of grant income	Taxable	Not taxable

In group accounts, in which entities from several different jurisdictions may be consolidated, it may be desirable that all 'investment tax credits' are consistently accounted for, either as an IAS 20 government grant or as an income tax under IAS 12. However, the judgement as to which standard applies is made by reference to the nature of each type of investment tax credit and the conditions attached to it. This may mean that the predominant practice in a particular jurisdiction for a specific type of investment tax credit has evolved differently from the consensus in another jurisdiction for what could appear to be a substantially similar credit. We believe that, in determining whether the arrangement is of a type that falls within the scope of IAS 20 or IAS 12, an entity must consider the following factors in the order listed below:

- If there is a predominant local treatment for a specific investment tax credit as to whether a specific credit in the relevant tax jurisdiction falls within the scope of IAS 20 or IAS 12, this must take precedence.
- If there is no predominant local treatment, the group-wide approach to determining the standard that applies to such a credit must be applied.
- In the absence of a predominant local consensus or a group-wide approach to making the determination, the indicators listed in the table above provide guidance.

This may mean that an entity operating in several territories adopts different accounting treatments for apparently similar arrangements in different countries, but it at least ensures a measure of comparability between different entities operating in the same tax jurisdiction.

How we see it

It is important to note that this is not an accounting policy choice. Accordingly, an entity operating in several territories could be required to adopt different accounting treatments for apparently similar arrangements in different countries if predominant local practice for a specific type of investment tax credit has evolved differently from the consensus in another jurisdiction.

For investment tax credits subject to IAS 20 and therefore treated as government grants, if the related expenditure is charged directly to the income statement under IFRS accounting standards, the tax credit/grant must be reflected in the income statement, either separately or under a general heading such as 'other income'; or as a deduction against the related expenditure. If the related expenditure is capitalised and amortised, the grant must be presented either by setting up the credit as deferred income or by deducting it from the carrying amount of the asset in accordance with IAS 20. It must not be included within deferred tax. The income statement will reflect the grant as 'other income' or as a reduction in the amortisation expense of the asset concerned on a systematic basis over the life of the asset. If the credit will be received in future periods without compensation for the time value of money, the notional amount of the asset must be reduced through application of an appropriate discount rate.

An example of the accounting policy disclosure of a company accounting for a type of investment tax credit as a government grant is shown below.

Practical example 2-1: Aston Martin Lagonda Global Holdings plc (2023) United Kingdom

ANNUAL REPORT AND ACCOUNTS 2023 [extract]
NOTES TO THE FINANCIAL STATEMENTS [extract]
2. ACCOUNTING POLICIES [extract]
Government Grants [extract]

> Research and development tax relief in the form of the Research and Development Expenditure Credit ("RDEC") is recognised in the Income Statement over the periods in which the qualifying expenditure giving rise to the RDEC claim is recognised, as the Group's assessment of the conditions of receipt of the RDEC concludes that it meets the definition of a Government grant. Certain expenses within the scope of RDEC are capitalised as part of the Groups development costs. Where this is the case, the Group defers the income associated with the claim to deferred income and releases it to the Income Statement in line with the amortisation profile of the associated asset. Claims are submitted annually based on the qualifying expenditure for a given accounting period. The cash benefit from the claim is received in the year of the claim and presented in operating cash flows.

The treatment of investment tax credits accounted for under IAS 12 is discussed in Chapter 29 at section 4.3.

2.4 Interaction of IAS 20 with IFRS 15

The situation can arise whereby a contract with a customer, accounted for under IFRS 15, also includes a government grant that falls within the scope of IAS 20, for example as illustrated below:

Illustration 2-2: Contract with a customer contains a government grant

A pharmaceutical entity has a contract with the government of the jurisdiction within which it operates. The contract includes a grant relating to the development of a vaccine and an obligation to deliver a specific quantity of vaccines, with an option to purchase additional vaccines at a discount.

How does the entity allocate the contract between IFRS 15 and IAS 20?

IFRS 15 applies to all contracts with customers, except when certain other standards apply. *[IFRS 15.5]*. When these other standards apply, entities are required to consider firstly the other standard before applying IFRS 15. *[IFRS 15.7]*. IAS 20 is not included in this list of other standards and accordingly the requirements of IFRS 15.7 do not apply for such contracts (this is discussed in detail in Chapter 28 at section 2.5). IAS 20 does provide initial measurement and/or separation requirements in respect of three scenarios (low-interest loans, *[IAS 20.10A]*, non-monetary grants, *[IAS 20.23],* and forgivable loans, *[IAS 20.10]*) which are discussed in section 3 below but does not specify how to separate the components of a contract between IFRS 15 and IAS 20 as in the scenario in Illustration 2-2 above. An entity would therefore need to apply the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to develop an accounting policy to determine how to separate the parts of such a contract between IFRS 15 and IAS 20. When developing its policy, an entity is required to refer to, and consider the applicability of requirements in IFRS accounting standards that deal with similar and related issues. *[IAS 8.11]*.

How we see it

In developing an accounting policy under IAS 8, in this case to separate a contract into IFRS 15 and IAS 20 components, we believe it would be appropriate to refer to IAS 20.10A by analogy. Hence, the benefit of the government grant must be measured as the difference between the total contract value and the consideration for the portion of the contract that is within the scope of IFRS 15, measured in accordance with IFRS 15 (at stand-alone selling price).

3 Recognition and measurement

3.1 General requirements of IAS 20

IAS 20 requires that: *[IAS 20.7]*

Extract from IAS 20

7 Government grants, including non-monetary grants at fair value, shall not be recognised until there is reasonable assurance that:

(a) the entity will comply with the conditions attaching to them; and

(b) the grants will be received.

The standard does not define 'reasonable assurance', which raises the question of whether or not it means the same as 'probable' (or 'more likely than not'). *[IAS 37.15]*. The phrase 'reasonable assurance' is generally interpreted as being a high threshold which implies a significantly higher probability than 'more likely than not'. Therefore, an entity cannot recognise government grants before it is significantly more likely than probable that the entity will comply with the conditions attached to them and that the grants will be received. In assessing the likelihood of compliance with conditions attached to the grant, it is acknowledged the conditions may relate to future performance and other future events.

For a grant related to an asset, a grant cannot be recognised before the asset is acquired, regardless of how likely the acquisition of the asset is. If the grant is also conditional on maintaining a number of jobs to operate the asset, the grant must be recognised as soon as the asset is acquired as long as there is (and continues to be throughout the period during which the grant can be claimed back by government) reasonable assurance that the jobs will be maintained as required.

The standard notes that receiving a grant does not of itself provide conclusive evidence that the conditions attaching to the grant have been or will be fulfilled. *[IAS 20.8]*. This is particularly true since there sometimes exists a supranational legal framework to comply with in addition to the eligibility criteria in local jurisdictions. For example, in the EU, Member State aids also need to comply with EU laws, e.g., in the context of the coronavirus pandemic. A grant may need to be recognised before it is received (in cash or otherwise) or even before the entity formally files a request to receive the grant (i.e., as soon as it becomes eligible to receive the grant). The grant receivable would not generally be a financial asset as it does not arise from contractual rights but rather arises due to government legislation.

The assessment about the existence of a 'reasonable assurance' must be made before the initial recognition of any grant income as well as subsequently, on a continuous basis, until the end of the period during which any grant received could be claimed back by the government. Such assessment requires the entity to understand fully the exact conditions that apply before it can make a valid judgement on whether it is entitled to the grant, and to what extent.

The Illustration below considers two examples.

Illustration 3-1: Recognition of a government grant

(a) A government has announced that, as a result of the coronavirus pandemic, it is introducing a scheme whereby entities will receive financial support for their employee costs. This support is available to all companies, there are no performance conditions and once the entity submits details of all their employees, there is a routine verification process to confirm the identity of the applicant and the grant is automatically paid.

In this Illustration, there are no conditions attached and the scheme is very simple by design so that the outcome is known by the entity with certainty. Hence, assessing whether there is 'reasonable assurance' is relatively straight-forward.

(b) A government, with the aim of driving investment in artificial intelligence, has announced a scheme whereby they will provide entities in this industry financial support for the next two years but only for very specific cost types. The application process is complex and requires applicants to submit detailed cost information and forecasts alongside the specific amount of funding they will require to cover both past and future costs. Once the submission is made, there is an extensive approval process by an independent reviewer, which may require further information to be submitted by the entity as the approval process progresses. As this is a new scheme, there is no past experience of approvals that the industry can consider.

In this Illustration, once due care has been applied by the entity to identify eligible projects and costs as set out in the scheme rules, and provide appropriate documentation, it will normally be reasonably assured that the entity will **comply with the conditions attaching to the grant**. However, caution may need to be exercised when measuring the amount expected to be received.

When the terms and conditions of a grant have been communicated before the end of a reporting period, then in determining whether it is reasonably assured that the entity will comply with the conditions attached to a grant and that the grant will be received as per IAS 20.7, information obtained after the reporting period, (e.g., confirmation of the entity receiving the grant), may provide evidence of an adjusting subsequent event.

Conversely, no 'reasonable assurance' can exist if the terms and conditions of a grant have not been communicated before the end of a reporting period.

How we see it

In our view, entitlement to a grant does not exist before the terms of the grant have been established by the government and clearly communicated publicly, or confirmed to the entity for entity-specific grants.

If a new law or regulation introduces a government grant after the end of the reporting period, it will represent a non-adjusting subsequent event.

Illustration 3-2: Date of entitlement to a government grant

An entity has a 31 March year end and on 20 March 20X1 there is an earthquake in the jurisdiction in which it operates. There is severe damage to the company's facilities. The government of that jurisdiction announces on 21 March that it will introduce assistance, but the exact nature and terms of such assistance are not communicated until 4 April 20X1. Hence, the criteria in IAS 20.7 cannot be met on 31 March 20X1. The announcement on 4 April 20X1 confirming the conditions related to the grant is a non-adjusting post balance sheet event.

If the facts and circumstances supporting the recognition of the government grant change and it is no longer 'reasonably assured' that the entity will retain the grant it has initially recognised, then the entity needs to derecognise any grant income and reverse any related asset or, to the extent the grant has already been received in cash, recognise a refund liability. This may be before it becomes 'more likely than not' that the entity may need to refund the grant (i.e., before the recognition threshold for a provision is met under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*).

When a grant is derecognised, consideration must be given as to whether there has been a change in facts and circumstances or whether there was an error in the initial application of the recognition criteria. In the case of the latter, please refer to IAS 8 guidance as discussed in Chapter 3 at section 4.6.

After an entity has recognised a government grant, any related contingent liability or contingent asset must be accounted for under IAS 37. *[IAS 20.11]*.

Illustration 3-3: Derecognition of a government grant

A pharmaceutical company recognised a government grant two years ago based on meeting future conditions on their performance. It has reassessed their future performance and no longer believes it is reasonable assured they will comply with the conditions attached to the government grant. This is due to a decline in performance that could not be foreseen when making the initial judgement on recognising the government grant. Any grant funding already received is required to be repaid.

The government grant the company was initially entitled to was CU500 to be recognised in the income statement on a straight-line basis over 5 years. Currently, the company has deferred income of CU300 and as CU250 had already been received in cash, the remaining CU250 is held as a receivable on the balance sheet.

On derecognition, the accounting entries would be;

Dr	Grant income (income statement)		CU200	
Dr	Deferred income (balance sheet)		CU300	
	Cr	Government grant receivable (balance sheet)		CU250
	Cr	Payable to Government (balance sheet)		CU250

Government grants are accounted for similarly regardless of whether they are received in cash or as a reduction of a liability to the government. *[IAS 20.9]*. When a grant is received in the form of a transfer of a non-monetary asset, the standard allows an alternative accounting treatment, which is detailed in section 3.2 below.

3.2 Non-monetary grants

A government grant in the form of a transfer of a non-monetary asset, such as land or other resources, which is intended for use by the entity, is usually recognised at the fair value of that asset. *[IAS 20.23]*. Fair value is defined in IFRS 13 and applies when another IFRS accounting standard requires or permits fair value measurement, including IAS 20. *[IFRS 13.5, IAS 20.45]*. "Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date". *[IAS 20.3, IFRS 13.9]*. The requirements of IFRS 13 are discussed in Chapter 15.

An alternative of recognising such assets, and the related grant, at a nominal amount is permitted, effectively leading to no recognition and a pure disclosure approach. *[IAS 20.23]*. This alternative is available even if the fair value of the asset differs materially from the nominal amount. Under IAS 8 an entity must select an accounting policy and apply it consistently to all non-monetary government grants. *[IAS 8.13]*. Despite IAS 20 permitting two approaches to measuring non-monetary grants, it is acknowledged that regulators in some jurisdictions may have a preference for one approach over the other.

3.3 Forgivable loans

A forgivable loan from government, the repayment of which will be waived under certain prescribed conditions, *[IAS 20.3]*, is to be treated as a government grant when there is reasonable assurance that the entity will meet the terms for forgiveness of the loan. *[IAS 20.10]*.

Illustration 3-4: Government grant by way of forgivable loan

An entity participates in a government-sponsored research and development programme under which it is entitled to receive a government grant of up to 50% of the costs incurred for a particular project. The government grant is interest-bearing and fully repayable based on a percentage ('royalty') of the sales revenue of any products developed. Although the repayment period is not limited, no repayment is required if there are no sales of the products.

The entity must account for this type of government grant as a forgivable loan, as follows:

- Initially recognise the cash received as a liability.
- Apply the principles underlying the effective interest rate method in subsequent periods, which would involve estimating the amount and timing of future cash flows.
- Review at each reporting date whether there is reasonable assurance that the entity will meet the terms for forgiveness of part, or all of the loan based on expected future royalty repayments. If this is the case, then IAS 20.10 would require derecognition of part or all of the liability initially recorded with a corresponding profit in the income statement.

  And

- If the entity subsequently revises its estimates of future sales upwards, it adjusts the amount of the liability and recognises a corresponding loss in the income statement for any amounts previously included in profit.

However, an arrangement only meets the definition of a forgivable loan if its terms provide for circumstances where repayment would be waived (i.e., forgiven), without any other form of settlement. In Illustration 3-4 above, the entity either repays some or all of the loan if the project generates any sales, or, if no sales are made, its liability is waived in full, with no further recourse to the government. In May 2016, the IFRS IC concluded that if any other consideration is required to be given in settlement of the obligation, then the arrangement is not a forgivable loan.

Frequently asked questions

Question 3-1: How does an entity account for cash received from a government to help finance a research and development project, when nothing is repayable in cash if the project is unsuccessful and instead the entity is required only to transfer to the government the rights to the research?

The IFRS IC was asked to clarify whether the cash received would be treated as a forgivable loan in the following specific circumstances:[2]

- The loan was repayable only if the entity decided to exploit and commercialise the results of the research phase of the project.
- Otherwise, the loan was not repayable in cash but instead the entity was required to transfer to the government the rights to the research.

The IFRS IC noted that, in this arrangement, the cash received did not meet the definition of a forgivable loan under IAS 20, because the government did not undertake to waive repayment of the loan but instead required settlement in cash or by the transfer of rights to the research. In other words, the entity could only avoid repayment by settling a non-financial obligation (to hand over the rights to the research). This requirement confirms the status of the cash receipt as a financial liability under IAS 32 *Financial Instruments: Presentation*. *[IAS 32.20(a)]*. The IFRS IC also noted that the financial liability must be measured under IFRS 9. Any difference between the cash receipt and the fair value of the liability would need to be accounted for under IAS 20 as discussed in section 3.4 below. The IFRS IC decided not to add this issue to its agenda on the basis that existing standards provide an adequate basis of accounting.[3]

Where an entity receives a loan to finance a research and development project and the loan will be forgiven if the project is not successful, then the existence of the forgivable loan has no bearing on assessing the project for capitalisation under the criteria in IAS 38 (see Chapter 18 at section 6.2). One of the criteria for capitalisation of development costs is that the entity must demonstrate that the intangible asset will generate probable economic benefits. *[IAS 38.57(d)]*. The existence of the forgivable loan does not mean that this requirement is always met. The criteria in IAS 38 must be assessed on their own merits.

3.4 Loans at lower than market rates of interest

IAS 20 requires government loans that have a below-market rate of interest to be recognised and measured in accordance with IFRS 9. *[IAS 20.10A, IFRS 9.5.1.1]*. The loans could be interest-free. The difference between the initial carrying value of the loan (its fair value) and the proceeds received is treated as a government grant. *[IAS 20.10A, IFRS 9.B5.1.1]*.

Illustration 3-5: Interest-free loan from a government agency

Company A secures an interest-free loan of CU1,000 from a local government agency to ensure that the company invests in new equipment at its manufacturing facility. The loan is repayable at the end of five years and carries no interest. Company A can draw down the loan on demonstrating that it has incurred qualifying expenditure on property, plant and equipment.

On initial recognition, the market rate of interest for a similar five-year loan for Company A is 10% per year. The initial fair value of the loan is the present value of the future payment of CU1,000, discounted using the market rate of interest for a similar loan of 10% for five years. This equates to CU621.

The value of the government incentive to Company A to invest in its factory is CU379, which is the difference between the total consideration received of CU1,000 and the loan's initial fair value of CU621. This difference is treated as a government grant.

Subsequently, interest will be imputed to the loan using the effective interest method, taking account of any transaction costs (see Chapter 45 at section 3.3.1). IAS 20 requires that the grant is recognised in profit or loss on a systematic basis that matches it with the related costs it is intended to compensate. *[IAS 20.12]*. The standard stresses that the entity must consider the conditions and obligations that have been, or must be, met when "identifying the costs for which the benefit of the loan is intended to compensate". *[IAS 20.10A]*. In this example, the benefit of the loan is to help fund the purchase of new equipment. Therefore, it would be appropriate to recognise the grant as the new equipment is depreciated, rather than as the interest on the loan is recognised. Recognition in the income statement of the benefit of loans at below-market interest rates is discussed further in section 3.6.2 below.

2 *IFRIC Update*, May 2016, available on the IFRS Foundation's website.

3 *IFRIC Update*, May 2016, available on the IFRS Foundation's website.

As well as subsidised lending to meet specific objectives such as investment in new equipment, loans made as part of government rescue plans are generally within the scope of IAS 20 if they are at a lower than market rate of interest. In 2009, PSA Peugeot Citroën received assistance from the European Investment Bank as described in Practical example 3-1 below.

Practical example 3-1: PSA Peugeot Citroën (2009) France

Half-Year Financial Report [extract]

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS
Six months ended June 30, 2009 [extract]

NOTE 17 - CURRENT AND NON-CURRENT FINANCIAL LIABILITIES MANUFACTURING AND SALES COMPANIES [extract]

17.2. REFINANCING TRANSACTIONS [extract]

- EIB loan

In April 2009, Peugeot Citroën Automobiles S.A. obtained a €400 million 4-year bullet loan from the European Investment Bank (EIB). Interest on the loan is based on the 3-month Euribor plus 179 bps. At June 30, 2009 the government bonds (OATs) given by Peugeot S.A. as collateral for all EIB loans to Group companies had a market value of €160 million. In addition, 4,695,000 Faurecia shares held by Peugeot S.A. were pledged to the EIB as security for the loans. The interest rate risk on the new EIB loan has not been specifically hedged.

This new loan is at a reduced rate of interest. The difference between the market rate of interest for an equivalent loan at the inception date and the rate granted by the EIB has been recognised as a government grant in accordance with IAS 20. The grant was originally valued at €38 million and was recorded as a deduction from the capitalized development costs financed by the loan. It is being amortised on a straight-line basis over the life of the underlying projects. The loan is measured at amortised cost, in the amount of €362 million at June 30, 2009. The effective interest rate is estimated at 5.90%.

Governments sometimes provide assistance in arrangements that are similar in substance to loans by allowing entities to retain sums that they collect on behalf of the government (e.g., value added taxes) until a future event, as in the following Illustration:

Illustration 3-6: Entity allowed to retain amounts owed to government

The local government of an underdeveloped region is trying to stimulate investment in fixed assets by allowing local companies to delay payment of the value added tax (VAT) on their sales. An entity participating in this scheme is entitled to retain an amount up to 40% of its investment in fixed assets. The retained VAT must be paid to the local government after 5 years and does not bear interest.

The fact that amounts retained by the entity are required to be repaid after 5 years makes this arrangement similar in nature to an interest-free loan. Accordingly, the entity would determine a value for the government assistance by comparing the amounts retained to the fair value of a 5-year loan at market rates of interest, as illustrated in Illustration 3-5 in section 3.4 above. In determining an appropriate basis for recognising the benefit of the grant in profit or loss, the entity must consider the conditions and obligations that have been, or must be, met when "identifying the costs for which the benefit of the loan is intended to compensate". *[IAS 20.10A]*.

In Illustration 3-6 above, because the grant is intended to stimulate investment in fixed assets, it would be appropriate to recognise the grant in income in line with depreciation of the relevant assets. The judgement involved in matching the benefit to costs is discussed in section 3.6.1 below.

3.5 Government guarantees

Governments sometimes provide support to an entity indirectly in the form of guarantees to lenders to the entity.

For example, a government may offer to guarantee loans taken out by entities that meet certain conditions. The government does not charge the lender a fee for this guarantee and consequently with the credit enhancement provided by the guarantee, the lender is able to reduce the interest rate charged to the borrower.

How we see it

IAS 20 cites guarantees as an example of government assistance that cannot reasonably have a value placed on them and hence are excluded from the definition of government grants. Nevertheless, where it can be demonstrated that a fair value can be determined for the guarantee, and the guarantee is not integral to the loan then it could be accounted for separately as a government grant.

This determination will depend on the facts and circumstances of the guarantee. Assessing whether the guarantee is integral to the loan is a matter of judgement (see Chapter 47 at section 5.8.1.A). This may include consideration as to whether the loan together with the guarantee is capable of being transferred.

If it is determined that grant accounting is appropriate, then the approach for below-market rate loans would apply (see sections 3.4 above and 3.6.2 below). In this case, the fair value of the loan reflects the present value of cash flows discounted using the market rate as if no guarantee were in place. The difference between the proceeds received and the fair value of the loan is accounted for as a government grant. If it is determined that the guarantee is government assistance, then the nature of that government assistance must be disclosed. *[IAS 20.39(b)]*.

3.6 Recognition in the income statement

IAS 20 notes that: *[IAS 20.12]*

Extract from IAS 20	
12	**Government grants shall be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate.**

Grants must not be credited directly to equity. *[IAS 20.15]*. Income recognition on a receipts basis, which is not in accordance with the accruals accounting assumption, is only acceptable if there is no basis for allocating a grant to periods other than the one in which it is received. *[IAS 20.16]*.

IAS 20 rejects a 'capital approach', under which a grant is recognised outside profit or loss (typically credited directly to equity), *[IAS 20.13]*, in favour of the 'income approach', under which grants are taken to income over one or more periods, because:

(a) Government grants are receipts from a source other than shareholders. As such, they are not credited directly to equity but must be recognised in profit or loss in appropriate periods.

(b) Government grants are rarely gratuitous. An entity earns them through compliance with their conditions and meeting the envisaged obligations. They must therefore be recognised in profit or loss over the periods in which the entity recognises the associated costs which the grant is intended to compensate.

(c) As income and other taxes are expenses, it is logical to deal also with government grants, which are an extension of fiscal policies, in profit or loss. *[IAS 20.15]*.

IAS 20 envisages that in most cases, the periods over which an entity recognises the costs or expenses related to the government grant are readily ascertainable and thus grants in recognition of specific expenses are recognised as income in the same period as the relevant expense. *[IAS 20.17]*.

Grants related to depreciable assets are recognised as income over the periods in which, and in proportion to, depreciation on those assets is charged. *[IAS 20.17]*. Grants related to non-depreciable assets may also require the fulfilment of certain obligations, in which case they would be recognised as income over the periods in which the costs of meeting the obligations are incurred. For example, a grant of land may be conditional upon the erection of a building on the site, and it may be appropriate to recognise it as income over the life of the building. *[IAS 20.18]*.

IAS 20 acknowledges that grants may be received as part of a package of financial or fiscal aids to which a number of conditions are attached. In such cases, the standard indicates that care is needed in identifying the conditions giving rise to the costs and expenses which determine the periods over which the grant will be recognised as income. It may also be appropriate to allocate part of the grant on one basis and part on another. *[IAS 20.19]*.

Where a grant relates to expenses or losses already incurred or becomes receivable for the purpose of giving immediate financial support to the entity with no future related costs, the grant must be recognised in income when it becomes receivable, and the entity must disclose its effects to ensure that these are clearly understood. *[IAS 20.20, IAS 20.21, IAS 20.22]*. The reference to 'expenses or losses already incurred' relates to expenses already recognised in the income statement. Where an entity has already incurred costs but they have been capitalised, then the grant received will be recognised in profit or loss as the depreciation expense on the asset is recognised. *[IAS 20.17]*.

Many of the problems in accounting for government grants relate to that of interpreting the requirement to match the grant with the related costs, particularly because of the international context in which IAS 20 is written. It does not address specific questions that relate to particular types of grants that are available in individual countries.

3.6.1 Achieving the most appropriate matching

The requirement to match the grant against the costs that it is intended to compensate can be difficult to apply in practice, because grants are sometimes given for a particular kind of expenditure that forms a component of a larger project. For example, in trying to determine an appropriate accounting policy for government assistance that is in the form of a grant against training costs incurred as part of a larger project, an entity might consider recognition in income in one of the following ways:

(a) Matching against direct training costs

Or

(b) Matching rateably against total project costs

How we see it

Determining a reasonable approach is dependent on the specific facts and circumstances, including not only the terms of the arrangement but also other facts that might highlight the purpose of the grant, including those relating to the context in which the grant was offered, the conditions attached to it and the consequences of failing to meet those conditions.

Recognition of a grant in income when received in cash is unlikely to be an appropriate method because it is not obviously linked to the recognition of the related expenditure and would be acceptable only in the rare circumstances where no basis exists for allocating a grant to periods other than the one in which it is received.

In some jurisdictions, grants are taxed as income on receipt; consequently, this is often the argument advanced for taking grants to income when received in cash. However, it is clear that the treatment of an item for tax purposes does not necessarily determine its treatment for accounting purposes, and recognition in the income statement on receipt may result in an unacceptable departure from the principle that government grants must be matched with the costs that they are intended to compensate. *[IAS 20.16]*. The recognition of a grant in the income statement in a different period from that in which it is taxed, gives rise to a temporary difference that must be accounted for in accordance with IAS 12 (see Chapter 29). The Illustration below illustrates that the determination of a systematic basis for recognition under the standard is not always straightforward.

Illustration 3-7: Grant associated with investment property

The government provides a grant to an entity that owns an investment property on the condition that it is let for social housing for 10 years. The grant is intended to compensate the entity for the lower rent it will receive when the property is let as social housing at below-market rates. That means that future rental income will be lower over the period of the lease which, at the same time, reduces the fair value of the investment property. The property cost CU1,000 and its fair value with the condition that it must be let for social housing is CU900, while the fair value of the property without that condition is CU1,000. The grant is for CU100, and the useful life of the property is 20 years.

If the entity accounts for the investment property under the cost model in IAS 40, then it could be argued that the government grant must be recognised on a straight-line basis (or another systematic basis) over the 10-year term of the lease to offset the lower than market rental income as social housing.

Alternatively, if the entity applies the fair value model in IAS 40.33, the cost being compensated is effectively the present value of the foregone future rentals (which affects the fair value change recognised). In that case, it is more appropriate to recognise the benefit of the government grant immediately, to match the reduction in the fair value of the investment property which, in this example is CU100.

How we see it

In the face of the issues described above of attributing a grant to related costs, entities will have to make their own determination as to how the matching principle must be applied in light of the specific facts and circumstances of the case. The only overriding considerations are that the determination must be consistently applied to similar grants and the policy adopted in respect of both grants related to assets and grants related to income, if material, must be adequately disclosed along with any significant judgements relevant to the application of IAS 20.

3.6.2 Loans at lower than market rates of interest

As discussed in section 3.4 above, IAS 20 requires that the difference between the initial fair value of a government loan that has a below-market rate of interest and the proceeds received is treated as a government grant. *[IAS 20.10A]*.

The issue that then arises is how to recognise the grant in profit or loss. As noted in section 3.6 above, IAS 20 requires that the grant is recognised in profit or loss on a systematic basis that matches it with the related costs it is intended to compensate, *[IAS 20.12]*, i.e., the emphasis in IAS 20 is on matching the benefit of a grant with the related costs as they are recognised in the income statement, rather than on the recognition of liquidity or cash flows.

The assessment of an appropriate method of allocation requires the entity to identify the costs intended to be compensated by the grant and is driven by a careful analysis of the facts and circumstances. The final determination as to which treatment is appropriate must reflect not only the terms of the arrangement but also other facts that might highlight the purpose of the loan, e.g.:

- Where it is determined that the grant is a grant related to an asset, as in Illustration 3-5 in section 3.4 above, recognition as the asset is depreciated would be appropriate.
- Where the grant is a grant related to income and is intended to compensate for a specific expense, then recognition at the same time as that expense is recognised in profit or loss would be appropriate. *[IAS 20.17]*. This could include immediate recognition for expenses or losses that had already been incurred. *[IAS 20.20]*. Where the grant is intended to compensate for the cost of funding, then recognition on the same basis as the interest is charged (i.e., over the term of the loan) would be appropriate. This is shown in the following Illustration.

Illustration 3-8: Below-market interest rate loan from the government

Company A secures a low interest loan of CU1,000 from the government as part of its support measures for the coronavirus pandemic. The loan is repayable at the end of five years and carries an interest rate of 5%, demonstrably below the market rate. There are no conditions attached regarding the expenditure that the loan must be used for. Also, the grant benefit of the below-market rate loan cannot be attributed to any specific costs, past or future, neither based on the terms of the arrangement nor on other facts and circumstances, other than the cost of funding. The purpose of the grant is to provide the entity with immediate liquidity support by allowing it to borrow more money than it could have based on the market rate.

On initial recognition, the market rate of interest for a similar five-year loan is 10% per year. The initial fair value of the loan is the present value of the future payments for the loan, discounted using the market rate of interest for a similar loan of 10% for five years. This equates to CU811.

The value of the government incentive to Company A is CU189 being the difference between the total consideration received of CU1,000 and the loan's initial fair value of CU811. This difference is treated as a government grant.

In this Illustration, the grant is compensating Company A for the higher market rate of interest that would otherwise have been charged as an expense on the loan. Company A recognises the grant benefit on the same basis as the interest is charged, over the term of the loan, thereby matching the benefit with the interest cost.

3.6.3 The period to be benefited by the grant

IAS 20 cautions that care is needed in identifying the conditions giving rise to the costs and expenses which determine the periods over which the grant will be earned. *[IAS 20.19]*. The qualifying conditions that must be satisfied are not necessarily conclusive evidence of the period to be benefited by the grant. For example, certain grants may become repayable if assets cease to be used for a qualifying purpose within a certain period; notwithstanding this condition, the grant may need to be recognised over the whole life of the asset, not over the qualifying period.

3.6.4 Separating grants into components

The grant received may relate to a package of activities, the components of which have different costs and conditions. In such cases, it is common that the components for which the grant is given are not specifically identified or quantified. It might be appropriate to treat these different components on different bases rather than accounting for the entire grant in one way, *[IAS 20.19]*, however, this will not always be practicable. For example, a grant may be given on the basis that an entity makes approved capital expenditure in a particular area and employs a specified number of local people for an agreed period of time. In general, the most straightforward way of recognising such a grant is by linking it to long-term assets where this is a possible interpretation, particularly where the receipt of the grant depends on the cost of acquisition of long-term assets. However, this approach can only be taken if there is no clear indication to the contrary.

How we see it

The assessment of an appropriate method of allocation requires the entity to identify the costs intended to be compensated by the grant and is driven by a careful analysis of the facts and circumstances. The final determination as to which treatment is appropriate must reflect not only the terms of the arrangement but also other facts that might highlight the purpose of the loan.

Allocation of a grant between the components will often involve judgement and entities may place more emphasis on some features than on others. In these cases, and where the effect is material, the financial statements must explicitly state what judgement has been made when applying the standard and disclose the corresponding financial effect.

3.7 Repayment of government grants

A government grant that becomes repayable after recognition must be accounted for as a revision of an accounting estimate. An entity must carefully assess the existence of a 'reasonable assurance' required to account for the grant initially so that if the grant subsequently becomes repayable, this is not the correction of a prior period error but the consequence of a change in circumstances or new information. *[IAS 8.34]*.

Repayment of a grant related to income must be charged first against the related unamortised deferred credit and any excess must be recognised as an expense immediately. *[IAS 20.32]*.

Repayment of a grant related to an asset must be recognised by increasing the carrying amount of the related asset or reducing the related unamortised deferred credit. The cumulative additional depreciation that would have been recognised to date as an expense in the absence of the grant must be charged immediately to profit or loss. *[IAS 20.32]*.

IAS 20 emphasises that the circumstances giving rise to the repayment of a grant related to an asset may require that consideration be given to the possible impairment of the asset. *[IAS 20.33]*.

3.8 Government assistance

Extract from IAS 20	
34	Excluded from the definition of government grants in paragraph 3 are certain forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

[IAS 20.34].

In the period since 1984, when IAS 20 first became effective, *[IAS 20.41]*, the use of fair values in financial reporting and the range of techniques used to determine reliable measures of fair value have increased. IFRS 13, issued in 2011, defines fair value, provides a principles-based framework for measuring fair value under IFRS accounting standards and requires information about those fair value measurements to be disclosed. *[IFRS 13.1]*. IFRS 13 provides guidance for selecting appropriate valuation techniques and therefore one might now expect the occurrence of government assistance that cannot reasonably have a value placed on it to be a relatively rare occurrence (see Chapter 15).

IAS 20 cites a government procurement policy as an example of assistance that cannot be distinguished from the normal trading transactions of the entity. In this case, the "existence of the benefit might be unquestioned but any attempt to segregate the trading activities from government assistance could well be arbitrary". *[IAS 20.35]*. The standard therefore requires disclosure of significant government assistance. *[IAS 20.36, IAS 20.39(b)]*.

The following Illustration describes two different forms of government assistance:

Illustration 3-9: Government assistance

(a) Assistance in the form of priority bidding status

A government specifies that entities below a certain size are to be given priority in bidding for a particular type of government contract by mandating a minimum number of such entities to obtain bidding status. Although the entities will benefit from the quota, the value cannot be identified, and the effects of the assistance cannot be segregated from the trading activities of the qualifying entities.

(b) Assistance in the form of credit facilities at market rates

Three governments that between themselves own just over 50% of the shares in an airline participate in granting it a revolving credit facility at a market rate of interest. This is not a government grant as it is on terms that a private market participant might have accepted but it is government assistance as the benefit cannot be distinguished from normal trading activities of the airline.

IAS 20 notes that: *[IAS 20.38]*

Extract from IAS 20

38 In this Standard, government assistance does not include the provision of infrastructure by improvement to the general transport and communication network and the supply of improved facilities such as irrigation or water reticulation which is available on an ongoing indeterminate basis for the benefit of an entire local community.

3.9 Particular issues arising when grants related to assets are accounted for as deferred income

When grants related to assets are accounted for as deferred income, any unamortised balance carried in the statement of financial position needs to be included in the accounting treatment of an impairment loss, a gain on disposal or a reassessment of the useful of the asset to which it relates so that the impact on profit or loss is the same as if the grant had been deducted from the initial carrying amount of the related asset.

3.9.1 Impairment testing of assets that qualified for government grants

When an asset is tested for impairment under IAS 36 *Impairment of Assets*, the value of any government grants received in relation to those assets is taken into account regardless of whether the entity elected to deduct the grants in arriving at the carrying amount of the related assets or decided to set up the grant as deferred income.

Where grants have been deducted from the initial carrying amount of the related assets, no further adjustment is required before commencing the impairment test. However, when grants relating to assets are classified as deferred income, the unamortised balance carried in the statement of financial position must be deducted from the carrying amount of the assets or cash generating unit (CGU) being tested.

Illustration 3-10: Impairment test of an asset that qualified for a government grant

An entity, which is operating in a development area, purchased a machine for CU1,000 to use for the production of goods. The investment in the machine is eligible for a government grant amounting to 50% of the purchase price. The machine is measured according to the cost model in IAS 16 *Property, Plant and Equipment*.

In accordance with IAS 20.24 and 26, the entity presented the grant, which it received in cash, as deferred income in the statement of financial position. The entity subsequently recognised this deferred income as income on a straight-line basis over the useful life of the machine.

The entity has to perform an impairment test of the asset. What impact does the grant have on this test?

The entity deducts the grant recognised as deferred income that relates to the machine from the carrying amount of the asset for an impairment test for that asset.

If the entity cannot test the asset for impairment individually and the impairment test is carried out at a CGU level, the grant is deducted from the carrying amount of the CGU.

If the impairment test requires the carrying value of the asset or related CGU to be reduced (because it exceeds the recoverable amount determined under IAS 36), the amount of the impairment is deducted from the carrying amount of the asset. However, an entity must not adjust the balance presented as deferred income, which continues to be recognised as income over the useful life of the asset. This is illustrated as follows:

Illustration 3-11: The effect of impairment of asset on the related government grant

On 1 January 20X1, an entity purchased a machine costing CU1,000 to use for the production of goods. The investment in the machine is eligible for a government grant amounting to 50% of the purchase price. The machine has a useful economic life of 10 years, and the entity determines that the benefit of the grant will be amortised over the useful life of the asset. However, due to adverse trading conditions, at the end of 20X1 it is determined that the carrying value of the asset (net of grant) is not recoverable, and is fully impaired

Immediately before the impairment, the respective carrying values are:

- Asset CU900 (cost of CU1,000 less depreciation to date of CU100)
- Grant CU450 (after amounts released to income statement to date of CU50)

Applying the principles noted in Illustration 3-10 above, if the asset, net of the grant, is fully impaired that means an impairment loss of CU450 (CU900-CU450) arises and is charged to the income statement. Immediately after this impairment, the carrying values are as follows:

- Asset CU450 (after impairment of CU450)
- Grant CU450

The grant continues to be recognised as income over the useful life of the asset.

Likewise, any future reversal of the impairment would not affect the carrying value of the grant.

When the asset that is tested for impairment has been financed partly or fully by forgivable loans, the recognition of an impairment loss would generally be a trigger for the reassessment of whether there is reasonable assurance that the entity will meet the terms for forgiveness of part or all the related forgivable loan (see section 3.3 above).

The requirements of IAS 36 are discussed in Chapter 21.

3.9.2 Disposal of assets that qualified for government grants

Where grants have been deducted from the initial carrying amount of the related assets, the gain on disposal is based on the carrying amount of the assets and no further adjustment is needed.

Where an asset is disposed of and the grant related to the asset is classified as deferred income, any remaining deferred income at the time of disposal must be recognised immediately in the income statement. It would also be necessary to assess whether the disposal of such an asset triggers any payment obligations to the government, such as full or partial repayment of the grant or sharing of the gain on disposal, if applicable. These obligations may give rise to the recognition of a liability.

3.9.3 Changes to the useful life of assets that qualified for government grants

Where the useful life of an asset has changed then in respect of depreciation of that asset, the change is accounted for as a change in an accounting estimate in accordance with IAS 8. *[IAS 16.51, IAS 8.36]*.

Where grants have been deducted from the initial carrying amount of the related assets, no further adjustment is needed to reflect the change in estimate prospectively over the remaining useful life of the assets.

Where a grant related to the asset is classified as deferred income, the change to the release of any remaining deferred income to the income statement is also reflected prospectively over the new remaining useful life of the associated asset.

4 Presentation of grants

4.1 Presentation of grants related to assets in the statement of financial position

Grants that are related to assets (i.e., those whose primary condition is that an entity qualifying for them must purchase, construct or otherwise acquire long-term assets) must be presented in the statement of financial position either: *[IAS 20.24]*

(a) By setting up the grant as deferred income, which is recognised as income on a systematic basis over the useful life of the asset *[IAS 20.26]*

Or

(b) By deducting the grant in arriving at the carrying amount of the asset, in which case the grant is recognised in profit or loss as a reduction of depreciation *[IAS 20.27]*

IAS 20 regards both these methods of presenting grants in financial statements as acceptable alternatives. *[IAS 20.25]*. The presentation approach must be applied consistently to all similar grants and appropriately disclosed.

Greencore Group plc adopted the former treatment, as shown below:

Practical example 4-1: Greencore Group plc (2021) United Kingdom

Annual Report and Financial Statements 2021 [extract]

Notes to the Group Financial Statements [extract]

1. Group statement of accounting policies [extract]

Government grants

Government grants for the acquisition of assets are recognised at their fair value when there is reasonable assurance that the grant will be received and any conditions attached to them have been fulfilled. The grant is held on the Statement of Financial Position as a deferred credit and released to the Group Income Statement over the periods necessary to match the related depreciation charges, or other expenses of the asset, as they are incurred.

...

If an entity chooses to set up the grant as deferred income, which is then recognised as income on a systematic basis over the useful life of the asset, IAS 20 is not explicit about where in the income statement this must be presented.

How we see it

Where a grant related to an asset is recognised as deferred income, we believe that when it is subsequently recognised in profit or loss, there is an accounting policy choice as to whether it is recognised gross or deducted from the depreciation expense.

Under the 'gross' accounting policy, the income statement presentation reflects the balance sheet treatment. However, the 'net' approach is also an acceptable accounting policy as this is analogous to the accounting policy choice available under IAS 20.29 (see section 4.2 below). IAS 1 *Presentation of Financial Statements*[4] also suggests offsetting may be appropriate where it 'reflects the substance of the transaction' *[IAS 1.33],* which will be subject to some degree of judgement.

4 IFRS 18 *Presentation and Disclosure in Financial Statements,* which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted) was issued by the IASB in April 2024. See Chapter 4 for further details on the new concepts and requirements of IFRS 18.

An example of a company adopting a policy of deducting grants related to assets from the cost of the assets is shown below:

Practical example 4-2:	Akzo Nobel N.V. (2023)	The Netherlands

AkzoNobel Report 2023 [extract]
FINANCIAL INFORMATION [extract]
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]
Note 1 SUMMARY OF MATERIAL ACCOUNTING POLICIES [extract]

Government grants

Government grants related to costs are deducted from the relevant costs to be compensated in the same period. Government grants to compensate for the cost of an asset are deducted from the cost of the related asset. Emission rights granted by the government are recorded at cost. A provision is recorded if the actual emission is higher than the emission rights granted.

4.2 Presentation of grants related to income in the statement of profit or loss

Grants related to income must be presented either as:

(a) A credit in the income statement, either separately or under a general heading such as 'other income'
Or

(b) A deduction in reporting the related expense *[IAS 20.29]*

The standard points out that supporters of method (a) above consider it inappropriate to present income and expense items on a net basis and that "separation of the grant from the expense facilitates comparison with other expenses not affected by a grant". *[IAS 20.30]*. Furthermore, method (a) is consistent with the general prohibition of offsetting in IAS 1 *Presentation of Financial Statements*. *[IAS 1.32, IAS 1.33]*. However, supporters of method (b) above would argue that "the expenses might well not have been incurred by the entity if the grant had not been available and presentation of the expense without offsetting the grant may therefore be misleading". *[IAS 20.30]*. The standard regards both methods as acceptable for the presentation of grants related to income. *[IAS 20.31]*. When offsetting is permitted by another standard, the general prohibition in IAS 1 does not apply. *[IAS 1.32]*. In any case, IAS 20 considers that disclosure of the grant is necessary when material for a proper understanding of the financial statements. Furthermore, disclosure of the effect of grants on any item of income or expense, which must be disclosed separately, is usually appropriate. *[IAS 20.31]*.

As illustrated below, Anheuser-Busch InBev NV/SA has adopted a policy of presenting grants within other operating income, which is shown separately on the face of the income statement as a component of profit from operations, rather than as a deduction from the related expense.

Practical example 4-3:	Anheuser-Busch InBev NV/SA (2023)	Belgium

2023 Annual Report [extract]
Financial report [extract]
Consolidated financial statements [extract]
Notes to the consolidated financial statements [extract]
3. Summary of significant accounting policies [extract]
(W) INCOME RECOGNITION [extract]

Government grants

A government grant is recognized in the statement of financial position initially as deferred income when there is reasonable assurance that it will be received and that the company will comply with the conditions attached to it. Grants that compensate the company for expenses incurred are recognized as other operating income on a systematic basis in the same periods in which the expenses are incurred. Grants that compensate the company for the acquisition of an asset are presented by deducting them from the acquisition cost of the related asset.

Refer to Practical example 4-2 in section 4.1 above for an example of a company presenting the grant as a deduction from the related expense in the income statement.

Frequently asked questions

Question 4-1: Assuming an entity elects not to deduct the government grant from the related expense, can an entity present government grants related to income as revenue?

When grants related to income are not deducted from the related expense, IAS 20 is not prescriptive, stating that such grants are presented "... **either** separately, **or** under a general heading such as 'Other income'". *[IAS 20.29]*.

A question, therefore, arises as to whether it may be appropriate to present income from grants as revenue on the face of the income statement either within one revenue line item with appropriate disaggregation in the notes to the financial statements or shown as a separate line item on the face of the income statement (i.e., Revenue from grants) with inclusion in a revenue subtotal.

How we see it

IFRS 15 defines revenue as income arising in the course of an entity's ordinary activities. Determining whether a government grant is income arising in the course of an entity's ordinary activities is a matter of judgement after considering all the facts and circumstances relevant to an entity. Facts to consider relevant to this judgement include consideration of the business model of the entity as well as the frequency and purpose of grants received.

Accordingly, some grants may be presented as revenue while others, that are determined not to arise in the course of an entity's ordinary activities, cannot be presented as revenue.

However, any grant revenue recognised that is outside the scope of IFRS 15 will need to be presented either separately from revenue from contracts with customers within the income statement or disclosed separately within the notes. This is because entities are required to present in the statement of comprehensive income, or disclose within the notes, the amount of revenue recognised from contracts with customers separately from other sources of revenue.

This view is consistent with the Basis for Conclusions on IFRS 15, which says that an entity can present interest income as revenue only when interest income represents income from an entity's ordinary activities (discussed in Chapter 28 at section 5.5.5). *[IFRS 15.BC247]*.

It is important to distinguish between those transactions which arise in the course of an entity's ordinary activities, and therefore may be presented as revenue, and transactions that are incidental to the main revenue-generating activities, but do not generate revenue themselves.

The presentation approach must be applied consistently to all similar grants and appropriately disclosed. Grants that have the same characteristics must follow the same presentational approach on a consistent basis.

Illustration 4-1: Presentation of grants with different characteristics

Company A has been receiving government grants to fund research activities for a number of years that it presents as 'other operating income'. In its current financial year, it has also received government support to compensate for the salaries of furloughed employees due to the coronavirus pandemic. Company A judges the R&D credits and the furlough grant to have different characteristics. It continues to present the grants to fund research activities separately in other operating income and recognises the furlough grant as a deduction from employment costs.

4.3 Statement of cash flows

The receipt of grants can cause major movements in the cash flows of an entity.

However, neither IAS 20 nor IAS 7 *Statement of Cash Flows* (see Chapter 36 at section 4.4.15) provide unambiguous guidance on where in the statement of cash flows to present the cash inflows from the receipt of government grants.

The IFRS IC discussed the presentation of cash flows for several fact patterns including government grants related to assets in July 2012.[5] The issue was further discussed in March 2013. The IFRS IC observed that the primary principle behind the classification of cash flows in IAS 7 is that cash flows are classified on the basis of the nature of the activity in a manner that is most appropriate to the business of the entity in accordance with IAS 7.11 and with the definitions of operating, investing and financing activities in IAS 7.6. In the course of the discussions held, staff initially suggested that grants were providing a source of financing to the entity, and consequently cash received would be part of the entity's financing activities. In a later meeting, however, it reached a different conclusion that cash received from a government grant is presented as an operating cash flow instead, on the basis that although cash inflows from a grant provide the entity with financing for the designated asset/activity, a grant does not represent a borrowing activity because there is no expectation that the resource will be returned to the provider of finance; or that the provider of finance will be appropriately compensated. Eventually, the IFRS IC concluded that clarifying the application of the primary classification principle in IAS 7 was a matter too broad for it to address and discontinued its work.[6]

Consequently, until and unless the IASB addresses this issue as part of its upcoming project on the cash flow statement, there is likely to be diversity in practice for the presentation of all grants in the statement of cash flows, whether related to assets or to income. Cash flows received from grants could be considered to be financing by nature because they provide a source of financing to the entity. Alternatively, cash flows received from grants (or only those from grants related to income) could be presented as operating cash flows by default since they do not seem to meet the definition of financing activities and cash flows received from grants related to assets could be presented as investing cash flows as they relate to an investing activity. Further discussion on cash flow classification can be found in Chapter 36 at section 4.

How we see it

Selecting the most appropriate presentation will be a matter of judgement. Once adopted, the presentation principles must be applied consistently and clear disclosure of the principles and the impact thereof on the cash flow statement must be provided in accordance with IAS 1.

IAS 20 does makes clear, however, that cash flows from government grants must be disclosed as separate items in the cash flow statement, even as regards grants related to assets, when such grants are deducted from the related assets for the purpose of presentation in the statement of financial position. *[IAS 20.28]*.

Lastly, cash flows from refundable advances must be presented as financing cash flows, whereas their transformation into a grant, if and when the entity meets the conditions for forgiveness of the loan, is a non-cash transaction.

5 *IFRIC Update*, July 2012, available on the IFRS Foundation's website.

6 *IFRIC Update*, March 2013, available on the IFRS Foundation's website.

5 Government grants related to biological assets in the scope of IAS 41

A different accounting treatment to that prescribed in IAS 20 is required if a government grant relates to a biological asset measured at its fair value less costs to sell, in accordance with IAS 41, or a government grant requires an entity not to engage in specified agricultural activity. *[IAS 41.38]*. In this context, the term 'biological asset' excludes bearer plants as defined in IAS 41 (see section 1.1 above). *[IAS 41.1(a), IAS 41.5]*. Government grants involving biological assets are only accounted for under IAS 20 if the biological asset is "measured at its cost less any accumulated depreciation and any accumulated impairment losses" (see Chapter 38 at section 3.3). *[IAS 41.37, IAS 41.38]*. For government grants relating to biological assets measured at fair value less costs to sell, the requirements of IAS 41 apply as discussed below.

An unconditional government grant related to a biological asset measured at its fair value less costs to sell is recognised in profit or loss when, and only when, the grant becomes receivable. *[IAS 41.34]*. An entity is therefore not permitted under IAS 41 to deduct a government grant from the carrying amount of the related asset. The IASB determined that any adjustment to the carrying value of the asset would be inconsistent with a fair value model and would give rise to no difference in the treatment of unconditional and conditional government grants, with both effectively recognised in income immediately. *[IAS 41.B66]*.

A conditional government grant related to a biological asset measured at its fair value less costs to sell is recognised only when the conditions attaching to the grant are met. *[IAS 41.35]*. IAS 41 permits an entity to recognise a government grant as income only to the extent that it (i) has met the terms and conditions of the grant and (ii) has no obligation to return the grant. *[IAS 41.36]*. This could be later than the point of recognition in IAS 20, where reasonable assurance that these criteria will be met is sufficient. *[IAS 20.7]*. The following Illustration, which is taken from IAS 41, illustrates how an entity applies these requirements. *[IAS 41.36]*.

Illustration 5-1: Grant relating to biological assets carried at fair value

Entity A receives a government grant under terms that require it to farm in a particular location for five years. The entire government grant must be returned if it farms for less than five years. In this case the government grant is not recognised as income until the five years have passed.

Entity B receives a government grant on a similar basis, except the terms of the grant allow part of it to be retained based on the passage of time. Entity B recognises that part of the government grant as income as time passes.

6 Disclosures

IAS 20 requires, whenever material, that entities must disclose the following information regarding government grants:

(a) The accounting policy, including the methods of presentation adopted in the statement of financial position, the statement of profit or loss and the cash flow statement

(b) A description of the nature and extent of the grants recognised in the financial statements and an indication of other forms of government assistance from which the entity has directly benefited

And

(c) Unfulfilled conditions or other contingencies attaching to government assistance that has been recognised *[IAS 20.39]*

The Practical examples below illustrate how companies typically satisfy the disclosure requirements of IAS 20. It should be noted that disclosures concerning the nature and conditions of government grants are sometimes relatively minimal, possibly because the amounts involved are immaterial. Marks and Spencer Group plc disclose both government grants received and the effect of other government assistance.

Practical example 6-1: Marks and Spencer Group plc (2021) United Kingdom

Annual Report & Financial Statements & Notice of Annual General Meeting 2021 [extract]

NOTES TO THE FINANCIAL STATEMENTS [extract]

1 ACCOUNTING POLICIES [extract]

Government grants

Government grants are recognised where there is reasonable assurance that the grants will be received and that the Group will comply with the conditions attached to them.

Government grants that compensate the Group for expenses incurred are recognised in profit or loss, as a deduction against the related expense, over the periods necessary to match them with the related costs.

Government grant income is disclosed in note 30.

30 GOVERNMENT SUPPORT

During the year, the Group has received support from governments in connection with its response to the Covid-19 pandemic. This support included furlough and job retention scheme reliefs, tax payment deferral schemes and business rates relief.

The Group has recognised government grant income of £131.5m in relation to furlough programmes, such as the Coronavirus Job Retention Scheme (CJRS) in the UK, and its equivalents in other countries. The salary expense relating to those colleagues on furlough during the period was £181.8m.

The Group also benefited from the business rates holiday for the retail, hospitality and leisure sector of £174.6m.

There are no unfulfilled conditions or contingencies attached to these grants.

Additional examples of accounting policies for government grants can be found in Practical examples 4-1 and 4-2 in section 4.1 above and Practical example 4-3 in section 4.2 above.

In Practical example 6-2 below, Stagecoach Group plc also provides an indication of other forms of government assistance from which the entity has directly benefited, *[IAS 20.39(b)]*, in this case in the form of additional support from government bodies and local authorities to whom the Group provides concessionary travel and other tendered transport services.

Practical example 6-2: Stagecoach Group plc (2021) **United Kingdom**

Annual Report and Financial Statements 2021 [extract]

Notes to the consolidated financial statements [extract]

Note 3 Operating costs and other operating income [extract]

COVID-19 related grants receivable reflects the amounts receivable in respect of government grants provided to organisations in light of the ongoing COVID-19 situation. The amounts reflect grants receivable in respect of the year ended 1 May 2021 under the Coronavirus Job Retention Scheme ("CJRS"), the COVID-19 Bus Services Support Grant ("CBSSG") scheme, the COVID-19 Support Grant ("CSG") scheme for bus services in Scotland, the Bus Emergency Scheme ("BES") in Wales and the Light Rail Revenue Grant ("LRRRG") scheme.

Under the CJRS, grant income may be claimed in respect of certain costs to the Group of furloughed employees. The CJRS income included above reflects the costs incurred on or prior to 1 May 2021 that are eligible to be included in CJRS grant claims to the extent the Group considers there to be reasonable certainty that the grant will be received.

Under the CBSSG, CSG and BES schemes, grant income may be claimed by operators of certain bus services to close the shortfall of revenue earned by them during the period affected by COVID–19 and the costs incurred by them in that period. The estimation of the grant income involves significant uncertainty, as explained in note 1(e)(ii) to these consolidated financial statements. The amount of income recognised in the year ended 1 May 2021 reflects the amount in respect of which the Group considers there to be reasonable certainty that: (a) the Group will comply with the conditions attaching to the grant and (b) the grant will be received and retained by the Group, taking account of the potential adjustments to grant payments as a result of any reconciliation process.

In addition to the COVID–19 related grants receivable shown above, some government bodies have agreed to continue certain levels of payments of concessionary revenue, tender revenue and Bus Service Operators Grant ("BSOG") to help support the continuing operation of bus services. The payment rates of these items during the period affected by COVID-19 are higher than they would ordinarily be for the relevant levels of patronage, mileage and fuel consumption. Consistent with previous years, all amounts of concessionary revenue and tender revenue are reported within revenue and an analysis of revenue for the year ended 1 May 2021 is provided in note 2(a) to these consolidated financial statements. Also consistent with previous years, all amounts of BSOG receivable, essentially rebates of fuel duty, are included net within materials and consumables costs shown above.

Had the average rate of concessionary revenue per journey for the year ended 1 May 2021 as a whole been consistent with the rate for the period from 28 April 2019 to 29 February 2020, the concessionary revenue for the year would have been £89.1m, £153.9m lower than £243.0m reported in note 2(a) (2020: £234.3m, £22.3m lower than £256.6m reported in note 2(a)). While not all concessionary revenue is ordinarily determined on a "per journey" basis, that illustrates the extent to which concessionary payments were maintained notwithstanding the COVID-19 related reductions in journey numbers.

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Appendix C - Defined terms

Extract from IFRS accounting standards - Definitions	
bearer plant	A *bearer plant* is a living plant that: (a) is used in the production or supply of agricultural produce; (b) is expected to bear produce for more than one period; and (c) has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales. *[IAS 41.5]*.
biological asset	A *biological asset* is a living animal or plant. *[IAS 41.5]*.
costs to sell	*Costs to sell* are the incremental costs directly attributable to the disposal of an asset, excluding finance costs and income taxes. *[IAS 41.5]*.
government	*Government* refers to government, government agencies and similar bodies whether local, national or international. *[IAS 20.3]*.
government assistance	*Government assistance* is action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria. Government assistance for the purpose of this Standard does not include benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints on competitors. *[IAS 20.3]*.
government grants	*Government grants* are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.[2] *[IAS 20.3]*.
grants related to assets	*Grants related to assets* are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held. *[IAS 20.3]*.
grants related to income	*Grants related to income* are government grants other than those related to assets. *[IAS 20.3]*.
forgivable loans	*Forgivable loans* are loans which the lender undertakes to waive repayment of under certain prescribed conditions. *[IAS 20.3]*.
fair value	*Fair value* is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13 Fair Value Measurement.) *[IAS 20.3]*.

2 See also SIC-10 *Government Assistance-No Specific Relation to Operating Activities*.

Chapter 26 Service concession arrangements

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Overview

In some countries, governments have introduced contractual service arrangements to attract private sector participation in the development, financing, operation and maintenance of public service infrastructure. IFRIC 12 *Service Concession Arrangements* was developed to provide guidance on the accounting by private sector operators for public-to-private service concession arrangements. The interpretation applies to public-to-private service concession arrangements (SCAs) in which the public sector grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at which price, and the grantor controls- through ownership, beneficial entitlement or otherwise- any significant residual interest in the infrastructure at the end of the term of the arrangement. It does not specify the accounting by grantors.

Infrastructure within the scope of IFRIC 12 is not recognised as property, plant and equipment of the operator as the operator does not have the right to control the use of the infrastructure. Instead, the operator acts as service provider, and recognises revenue in accordance with IFRS 15 *Revenue from Contracts with Customers* for the services it performs. The nature of the consideration receivable determines its subsequent accounting treatment.

This chapter addresses the scope of IFRIC 12, and the accounting for service concession arrangements within the scope of IFRIC 12. It also covers disclosures required by SIC-29 *Service Concession Arrangements: Disclosures*. Revenue recognition in accordance with IFRS 15 is addressed in Chapter 28.

What you need to know

- IFRIC 12 applies to public-to-private service concession arrangements in which:
  - The public sector grantor controls or regulates:
    - What services the operator must provide with the infrastructure
    - To whom it must provide them

    And
    - At what price

    And
  - The grantor controls any significant residual interest in the infrastructure at the end of the term of the arrangement.
- IFRIC 12 does not specify the accounting by grantors.
- The assessment of whether an arrangement is a service concession in scope of IFRIC 12, or an outsourcing arrangement, could give rise to differences in accounting for the private sector entity.
  - It is important to consider whether the infrastructure is being used by the operator to provide services for the benefit of the public, rather than to the grantor for its own benefit.
- Infrastructure within the scope of IFRIC 12 is not recognised as property, plant and equipment of the operator. Instead, the operator recognises a financial asset, an intangible asset, or both, as consideration for construction or upgrade services provided.
- IFRIC 12 requires the operator to account for construction or upgrade services, and operation services, in accordance with IFRS 15.
- Under the financial asset model, total revenue recognised over the concession term will be the same as the total cash inflows under the contract. Total revenue recognised under the intangible asset model will also include the fair value of the intangible asset, and so will be higher by that amount.
- Disclosure requirements for service concession arrangements are set out in SIC-29.

1 Introduction

Service concession arrangements have been developed as a mechanism for governments to procure public services using private capital and management expertise. The rights and obligations of the public sector body procuring the services and the private sector entity providing the services are set out in a contract, the terms of which can be complex depending upon the nature of the SCA. The most common forms of arrangement are as follows:

- **'Build-operate-transfer'** SCA - where a private sector entity takes responsibility for building and operating infrastructure assets such as roads, bridges, railways, hospitals, prisons, power stations and schools, in consideration for a long-term contract from the public sector body giving the entity the right to charge for services to the public using that infrastructure.
- **'Rehabilitate-operate-transfer'** SCA - where the private sector entity restores or improves an existing facility or public service up to an agreed standard and continues to maintain and operate the related infrastructure for a contracted period. This type of arrangement includes a range of projects from the refurbishment of social housing and street lighting to major civil engineering projects to restore a city's underground rail system.
- **'Operate-only'** SCA - where a private sector entity becomes responsible for the operational management and maintenance of an existing infrastructure asset that is used to provide services to the public. This last variant, together with the development of similar arrangements between private sector bodies, has at times obscured the boundary between service concessions and outsourcing arrangements (see section 2.2.1 below).

The accounting challenge is to reflect the substance of these arrangements fairly in the financial statements of both of the contracting parties, because the various transactions between the parties to a SCA range across a number of accounting standards and interpretations, including:

- Accounting for the rights of the parties over the infrastructure assets (IAS 16 *Property, Plant and Equipment*, and IFRS 16 *Leases*)
- Construction or refurbishment of the infrastructure assets (IFRS 15)
- Accounting for the various obligations under the contract during the operations period of the concession (IFRS 15 and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*)
- Recognition and measurement of the amounts payable or receivable under the arrangement (IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, IAS 23 *Borrowing Costs*, IAS 32 *Financial Instruments: Presentation*, IAS 37, IAS 38 *Intangible Assets* and IFRS 9 *Financial Instruments*)

This makes it difficult to develop a coherent accounting model that deals with all the features of service concessions simultaneously, and from the position of both the private sector (i.e., the 'operator') and public sector (i.e., the 'grantor'). Moreover, prior to the issue of IFRIC 12, entrenched national positions had developed and differing accounting treatments had been widely adopted in various jurisdictions, with or without a basis in specific local accounting standards. Also, some jurisdictions accepted more than one accounting treatment for broadly similar arrangements, some of which are influenced by a taxation basis that has been agreed with the jurisdictional taxation authorities. All this resulted in considerable diversity in the accounting by IFRS reporters of seemingly similar arrangements.

In 2001, SIC-29 was issued. This did not attempt to address the accounting issues but considered the information that must be disclosed in the notes to the financial statements of an 'operator' and 'grantor' under a service concession arrangement. *[SIC-29.4]*. Its requirements are described further in section 7 below.

IFRIC 12 addresses the accounting issues from the perspective of the operator and was approved by the IASB in November 2006. The fact that the Interpretation took more than three years to develop indicates the complexity of the issues and the difficulty that the IFRS IC encountered in fitting a solution into the existing accounting framework.

IFRIC 12 is not a converged standard and there are differences of methodology between the IFRS accounting standards and US GAAP guidance on this topic that are not discussed in this chapter.

In January 2021, the Board published the Exposure Draft *Regulatory Assets and Regulatory Liabilities*.[1] It proposes an accounting model to supplement the information that an entity already provides by applying IFRS accounting standards in accounting for the effects of regulatory agreements that determine a regulated rate to be applied in contracts with customers. It gives a service concession arrangement as an example of a regulatory agreement.[2] The interaction between these proposals relating to rate-regulated activities and the requirements of IFRIC 12 are discussed in section 2.2.2 below.

1.1 The IFRS IC's approach to accounting for service concessions

The IFRS IC views the primary accounting determination for the operator as being whether control over the infrastructure assets rests with the operator or whether any new or existing assets under the concession arrangement are controlled by the grantor. *[IFRIC 12.BC11]*.

The IFRS IC decided that arrangements where control does not rest with the grantor, and the asset is either derecognised by the grantor or is an asset constructed for the concession that the grantor never controls, can be dealt with adequately by other accounting standards or interpretations. *[IFRIC 12.BC12, IFRIC 12.BC13]*. The interrelationship with other accounting standards is discussed further in section 2.2 below.

Infrastructure assets controlled by the grantor are the subject of IFRIC 12. This applies whether the assets are constructed or acquired by the operator for the concession, that become those of the grantor because it controls them, or existing assets that remain under the grantor's control and to which the operator is granted access. *[IFRIC 12.7]*.

'Control' is therefore a central concept in IFRIC 12. Control is not determined by attributing risks and benefits to identify the 'owner' of the infrastructure. Instead, IFRIC 12 regards control in terms of the operator's ability (or lack thereof) to decide how to use the asset during the concession term and how it will be deployed thereafter. Its definition and consequences are discussed further in section 3 below.

Thus, an operator will account for any infrastructure that is under the control of the grantor using IFRIC 12. In doing so, the IFRS IC establishes the following principles for accounting by the operator of a concession falling within its scope:

- The infrastructure is not recognised as property, plant and equipment by the operator. *[IFRIC 12.11]*.
- The operator recognises revenue from construction services when assets are built or upgraded during the concession term. *[IFRIC 12.14]*.
- A financial asset or an intangible asset is recognised as consideration for these construction services, depending upon the way in which the operator is paid for services under the contract. *[IFRIC 12.15]*.
- However, both types of consideration are classified as a contract asset during the construction or upgrade period in accordance with IFRS 15. *[IFRIC 12.19]*.
- Revenue and costs for the provision of operating services are recognised over the term of the concession arrangement. *[IFRIC 12.20]*.

The requirement to recognise an asset as consideration for construction services gives rise to three service concession models- the 'financial asset' model, the 'intangible asset' model and a hybrid model. These are considered further in section 4 below. However, under all models the operator is required to recognise a contract asset during the construction or upgrade period in accordance with IFRS 15. The recognition of revenue and costs in the operations phase is discussed in section 5 below.

1 Exposure Draft ED/2021/1: *Regulatory Assets and Regulatory Liabilities*, IASB, January 2021. Available on the IFRS Foundation's website.

2 Exposure Draft ED/2021/1: *Regulatory Assets and Regulatory Liabilities*, IASB, January 2021, para. 7-8. Available on the IFRS Foundation's website.

1.2 Terms used in this chapter

The following terms are used in this chapter with the meanings specified:

Term	Definition
Grantor	A public sector body (including a governmental body, or a private sector entity to which responsibility for a public service has been devolved) that grants the service arrangement. *[IFRIC 12.3]*.
Operator	A private sector entity that is contractually obliged to construct and/or upgrade, operate and maintain infrastructure used to provide services to the public on behalf of the public sector entity. The operator is responsible for at least some of the management of the infrastructure and related services and does not merely act as an agent on behalf of the grantor. *[IFRIC 12.2, IFRIC 12.3]*.
Service concession arrangement	A contract that obliges the operator to construct and/or upgrade, operate and maintain infrastructure used to provide the services to the public on behalf of the grantor. The contract sets the initial prices to be levied by the operator and regulates price revisions over the period of the service arrangement. *[IFRIC 12.3]*.
Infrastructure	Assets used in the provision of services to the public. Examples include roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and telecommunications networks. *[IFRIC 12.1]*. Infrastructure can be constructed or acquired by the operator for the purpose of the service arrangement; or can be existing assets to which the grantor gives the operator access for the purpose of the service arrangement. *[IFRIC 12.7]*.
Control criteria	(a) The grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price. And (b) The grantor controls any significant residual interest in the infrastructure at the end of the term of the arrangement, through ownership, beneficial entitlement or otherwise. *[IFRIC 12.5]*.
Residual interest in the infrastructure	The estimated current value of the infrastructure as if it were already of the age and in the condition expected at the end of the period of the arrangement. *[IFRIC 12.AG4]*.
Government	Refers to government, government agencies and similar bodies whether local, national, or international. *[IAS 20.3]*.

2 Scope of IFRIC 12

The scope of IFRIC 12 is specific and relatively narrow. *[IFRIC 12.5]*.

Extract from IFRIC 12

5 This Interpretation applies to public-to-private service concession arrangements if:

(a) the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price; and

(b) the grantor controls - through ownership, beneficial entitlement or otherwise - any significant residual interest in the infrastructure at the end of the term of the arrangement.

Infrastructure used in a service concession for its entire useful life is deemed to meet the second condition above (grantor control of significant residual interest) because there is no significant residual interest. *[IFRIC 12.6]*.

The IFRS IC also decided to restrict its guidance to the accounting by operators in public-to-private service concession arrangements. *[IFRIC 12.4]*. Accordingly, the Interpretation does not specify the accounting by grantors. *[IFRIC 12.9]*.

The IFRS IC acknowledged that these restrictions would exclude many arrangements that are found in practice for private sector participation in the provision of public services. However, it concluded that the above conditions were likely to be met in most of the public-to-private service concession arrangements for which guidance had been sought and that other accounting standards apply when these conditions are not a feature of the arrangement. *[IFRIC 12.BC11, IFRIC 12.BC13]*. The accounting standards that might apply for arrangements outside the scope of IFRIC 12 are set out in section 2.2 below.

2.1 Public service nature of the obligation

Initially, as described in the exposure draft D12,[3] the interpretation was intended to apply only to arrangements that involved a 'public service obligation', i.e., a contractual obligation for the operator to keep the infrastructure available for public use.

Having agreed that "...the concept of a public service obligation was not in itself robust enough to form the basis for the scope...",[4] the IFRS IC did not retain this condition. This is understandable, since different governments will have a range of political or ideological views of what activities should be provided by the state and the definition of a 'public service obligation' may vary across jurisdictions and, sometimes, over time within the same jurisdiction.

As a result, the reference to "...the public service nature of the obligation undertaken by the operator..." now only appears as a common feature of a service concession in the background section of the interpretation, without defining what is meant by the term. *[IFRIC 12.3]*. Instead, the IFRS IC refers to examples of service concession arrangements. IFRIC 12 identifies roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and telecommunications networks as examples of infrastructure used for public services. *[IFRIC 12.1]*. SIC-29 refers to water treatment and supply facilities, motorways, car parks, tunnels, bridges, airports and telecommunications networks. *[SIC-29.1]*. It also states that a service concession arrangement generally involves the grantor conveying to the concession operator the right to provide services that give the public access to major economic and social facilities for the period of the concession. *[SIC-29.2(a)]*.

It is at least clear that it is not necessary for the operator to have direct involvement with the public as evidenced by the example in the Application Guidance of the interpretation of a hospital used by the grantor to treat public patients. *[IFRIC 12.AG7]*.

2.2 Arrangements that are not in the scope of IFRIC 12

The IFRS IC acknowledged that in practice there are arrangements between the public sector and the private sector that will not fall in the scope of IFRIC 12. However, it was satisfied that the Interpretation would apply to most of the public-to-private service concession arrangements for which guidance had been sought. Nevertheless, the IFRS IC did consider a range of typical arrangements and decided that it could provide references to the accounting standards that apply to those that fall outside the scope of IFRIC 12 without giving any guidance as to their application. *[IFRIC 12.BC13]*.

3 Exposure Draft D12 *Service Concession Arrangements - Determining the Accounting Model*.

4 *IFRIC Update*, September 2005, available on the IFRS Foundation's website.

These references are presented in Information note 2 to IFRIC 12 which shows a range of arrangements between the public and private sectors. The IFRS IC's view is that IFRIC 12 is interpreting IFRS accounting standards for the transactions in the middle of this range, where the application of accounting standards was previously unclear. These are described in Information note 2 below as 'Rehabilitate-operate-transfer' and 'Build-operate-transfer' arrangements. The Information note also demonstrates how other accounting standards, namely IFRS 16, IFRS 15 and IAS 16, apply to arrangements that do not meet the control criteria of a public-to-private service concession as defined in the Interpretation.

Extract from IFRIC 12

Information note 2

References to IFRSs that apply to typical types of public-to-private arrangements

This note accompanies, but is not part of, IFRIC 12.

The table sets out the typical types of arrangements for private sector participation in the provision of public sector services and provides references to IFRSs that apply to those arrangements. The list of arrangements types is not exhaustive. The purpose of the table is to highlight the continuum of arrangements. It is not the IFRIC's intention to convey the impression that bright lines exist between the accounting requirements for public-to-private arrangements.

Category	Lessee	Service Provider			Owner	
Typical arrangement types	Lease (eg Operator leases assets from grantor)	Service and/or maintenance contract (specific tasks eg debt collection)	Rehabilitate-operate-transfer	Build-operate-transfer	Build-own-operate	100% Divestment/ Privatisation/ Corporation
Asset ownership	Grantor				Operator	
Capital investment	Grantor		Operator			
Demand risk	Shared	Grantor	Operator and/or Grantor		Operator	
Typical duration	8-20 years	1-5 years	25-30 years			Indefinite (or may be limited by licence)
Residual interest	Grantor				Operator	
Relevant IFRSs	IFRS 16	IFRS 15	IFRIC 12		IAS 16	

[IFRIC 12.IG Information note 2]

2.2.1 Outsourcing arrangements

Service concessions are not the only contractual arrangements between public sector bodies and private sector providers of services. Public sector bodies lease buildings or other property, plant and equipment from private sector entities for their own use. The private sector entity might also be engaged to construct the buildings or other property before it is occupied by the public sector body. The public sector also engages independent subcontractors to perform procurement services or to outsource the operation of its internal activities and functions.

It is important to consider whether the infrastructure is being used by the operator to provide services for the benefit of the public (such as in the case of a water treatment facility, for example), rather than to the grantor for its own benefit.

SIC-29 identifies examples of activities that are not service concession arrangements, citing an entity outsourcing the operation of its internal services, such as employee cafeteria, building maintenance, and accounting or information technology functions. *[SIC-29.1]*.

The IFRS IC noted in September 2005 that it would not expect an information technology outsourcing arrangement for a government department to be dealt with under IFRIC 12 because the infrastructure is not available for the public to use.[5]

The assessment of whether an arrangement is a service concession within scope of IFRIC 12 or an outsourcing arrangement could give rise to differences in accounting for the private sector entity. Treating an arrangement as an outsourcing arrangement could result in the private sector entity recognising property, plant and equipment in its financial statements in respect of the assets subject to the arrangement. This would be the case, if the arrangement were accounted for as the provision of goods and services under IFRS 15. When the private sector entity is considered to be the lessor, given the length of typical service concession arrangements, it is likely that a finance lease receivable would be recognised under IFRS 16. *[IFRS 16.63, IFRS 16.67]*. Although for an arrangement accounted for under IFRIC 12, the private sector entity (operator) would in this case normally recognise a financial asset, an important distinction is that in an IFRIC 12 service concession, the private sector entity would recognise revenue in the period during which any infrastructure asset was being constructed. *[IFRIC 12.14]*. A lessor would record an IAS 16 asset under construction and only recognise a gain or loss on derecognition of the constructed asset at lease commencement if the terms of the lease required that asset to be derecognised.

2.2.2 Rate-regulated activities

In many countries, the provision of utilities (e.g., water, natural gas or electricity) to consumers is regulated by a government agency (regulator). Regulations differ between countries but often regulators operate a cost-plus system under which a utility provider is allowed to make a fixed return on investment. When there is a rate-adjustment mechanism to adjust the future price, a utility is allowed to charge its customers for variances between estimated and actual inputs to the rate calculation. Hence, this adjustment creates timing differences as the future price for services may be influenced by past cost levels and investment levels. For some time, the Board has been working on its rate-regulated activities project to address the accounting and disclosure of rate-regulated activities. Currently, IFRS 14 *Regulatory Deferral Accounts*, an interim standard on the accounting for regulatory deferral accounts, applies for first-time adopters of IFRS accounting standards who conduct rate-regulated activities (as defined in that standard) and recognised amounts that qualify as regulatory deferral account balances in their financial statements under their previous GAAP. *[IFRS 14.5]*. This standard does not apply to other IFRS reporters and in some jurisdictions (e.g., Europe) it has not been endorsed in local regulations.

In January 2021, the Board published the Exposure Draft *Regulatory Assets and Regulatory Liabilities*. Under its proposals, when an entity has an enforceable right, created by a regulatory agreement, to add an amount in determining the regulated rate to be charged to customers in future periods, it must recognise this as regulatory income together with a related regulatory asset. Conversely, a regulatory expense and a related regulatory liability must be recognised when an entity has an enforceable present obligation, created by a regulatory agreement, to deduct an amount in determining the regulated rate to be charged to customers in future periods.[6] The Exposure Draft gives a service concession arrangement as an example of a regulatory agreement.[7]

The Exposure Draft states "…some arrangements within the scope of IFRIC 12 may create regulatory assets or regulatory liabilities within the scope of this [draft] Standard. An entity shall account for those regulatory assets or regulatory liabilities separately from the assets and liabilities within the scope of IFRIC 12".[8] Most respondents who commented on the proposed guidance agreed that service concession arrangements can create regulatory assets and regulatory liabilities, but many respondents felt that the guidance proposed in the Exposure Draft was insufficient and suggested that the Board provide detailed guidance and illustrative examples on how an entity would account for regulatory assets and regulatory

5 *IFRIC Update*, September 2005, available on the IFRS Foundation's website.

6 Exposure Draft ED/2021/1: *Regulatory Assets and Regulatory Liabilities*, IASB, January 2021, para. 16. Available on the IFRS Foundation's website.

7 Exposure Draft ED/2021/1: *Regulatory Assets and Regulatory Liabilities*, IASB, January 2021, para. 8. Available on the IFRS Foundation's website.

8 Exposure Draft ED/2021/1: *Regulatory Assets and Regulatory Liabilities*, IASB, January 2021, para. B47. Available on the IFRS Foundation's website.

liabilities in all three financial reporting models in IFRIC 12- the financial asset model, the intangible asset model, and the hybrid model.[9]

As drafted, the statement of the Exposure Draft that an entity "…shall account for those regulatory assets or regulatory liabilities separately from the assets and liabilities within the scope of IFRIC 12"[10] indicates that any new accounting standard would not apply to assets and liabilities currently recognised under IFRIC 12 and IFRS 15. However, it could require new regulatory assets and regulatory liabilities to be recognised when and to the extent the regulated rates for the services provided by the operator of the infrastructure to customers in one period are set by reference to services provided in a different period.[11]

On this basis, it would appear that the proposals included in the Exposure Draft would not significantly change the accounting for the construction phase of a service concession arrangement. IFRIC 12 requires revenue for construction or upgrade services to be recognised in accordance with IFRS 15 *[IFRIC 12.14]*, and the rights to receive consideration to be recognised as a financial asset, intangible asset, or both, depending on the terms of the arrangement. *[IFRIC 12.15, IFRIC 12.18]*. Under both the financial asset and intangible asset models, we believe that the grantor will be identified as the customer for any construction or upgrade services (see section 4.1.1.A below). The pricing arrangements for construction services provided to the grantor is governed by a contractual agreement between the grantor (as customer) and the operator and is therefore wholly within the scope IFRS 15. In addition, we would not anticipate the proposals to significantly impact the accounting by an operator during the operational phase of a service concession under the financial asset model in IFRIC 12. This is because the Exposure Draft applies to regulatory assets and liabilities created by a regulatory agreement.[12] A regulatory agreement is defined as a set of enforceable rights and obligations that determine a regulated rate to be applied in contracts with customers.[13] Under the financial asset model, where the grantor is the customer for both construction and operation services, the price charged by the operator to the grantor is controlled by a contractual arrangement between the operator and grantor (as customer), rather than by a separate regulatory agreement. Therefore, the arrangement between operator and grantor is wholly within the scope of IFRS 15. In contrast, under the intangible asset model or hybrid model, we believe that the customer for operational services may be the individual user of those services rather than the grantor (see section 4.1.1.A below). While the terms under which the operator provides services to a user of the infrastructure would be a customer contract in the scope of IFRS 15, the price charged by the operator to an individual user may be impacted by a separate regulatory agreement between the operator and the grantor (acting in its capacity as a regulator) that could give rise to regulatory assets or regulatory liabilities, depending on the terms of the arrangement.

At the time of writing, the IASB has finalised redeliberating the proposals in the Exposure Draft, with the expectation of an IFRS accounting standard during the second half of 2025.[14] At its September 2022 meeting, the IASB tentatively decided to clarify in the standard its interaction with IFRIC 12 by stating that an entity would apply IFRIC 12 first and then apply the requirements of the standard to any remaining rights and obligations to determine if the entity has regulatory assets or regulatory liabilities. It also tentatively decided to include examples to illustrate that interaction.[15]

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9 IASB Staff Paper 9H: Project: *Rate-Regulated Activities*, Paper topic: *Feedback summary-interaction with other IFRS Standards*, IASB meeting, October 2021, paras. 13 and 14. Available on the IFRS Foundation's website.

10 Exposure Draft ED/2021/1: *Regulatory Assets and Regulatory Liabilities*, IASB, January 2021, para. B47. Available on the IFRS Foundation's website.

11 Exposure Draft ED/2021/1: *Regulatory Assets and Regulatory Liabilities*, IASB, January 2021, para. 16. Available on the IFRS Foundation's website.

12 Exposure Draft ED/2021/1: *Regulatory Assets and Regulatory Liabilities*, IASB, January 2021, paras. 3 to 5. Available on the IFRS Foundation's website.

13 Exposure Draft ED/2021/1: *Regulatory Assets and Regulatory Liabilities*, IASB, January 2021, para. 7. Available on the IFRS Foundation's website.

14 *IFRS Foundation work plan*, IFRS Foundation website (accessed 28 August 2024).

15 *IASB Update*, September 2022, available on the IFRS Foundation's website.

How we see it

The possible effects of interactions between IFRIC 12 and any finalised accounting standard on regulatory assets and regulatory liabilities will need to be further assessed when it is issued, including in light of any specific guidance and examples developed by the IASB. However, these proposals seem more likely to affect the accounting for activities in the operational phase of a service concession arrangement accounted under the intangible asset model, where the customer is the user of the services rather than the grantor. We do not anticipate that the Exposure Draft would significantly change the accounting during the construction phase of a service concession arrangement, or during the operational phase of a service concession arrangement accounted for using the financial asset model in IFRIC 12.

The rate-regulated activities project is discussed further in Chapter 27 at section 5.4 and in Chapter 28 at section 2.6.4.

2.3 Interaction of IFRS 16 and IFRIC 12

IFRS 16 clearly excludes from its scope service concession arrangements falling within scope of IFRIC 12. *[IFRS 16.3(c)]*.

IFRS 16 defines an arrangement as containing a lease "…if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration". *[IFRS 16.9]*. A right to control the use of an identified asset is then described in terms of the right to direct the use of the asset. *[IFRS 16.B9]*. Since IFRS 16 clearly applies a control model, like IFRIC 12, any arrangement that meets the control criteria in IFRIC 12.5 cannot meet the definition of a lease in IFRS 16, *[IFRS 16.BC69]*, as a conclusion that the grantor controls or regulates what services the operator must provide with the infrastructure, to whom, and at what price, *[IFRIC 12.5]*, is not compatible with the assertion that the private sector entity has a leasehold interest in the same assets under IFRS 16. The control criteria in IFRIC 12 are discussed in section 3 below.

In light of this, the IASB had considered whether it was necessary to explicitly exclude from the scope of IFRS 16 service concession arrangements within the scope of IFRIC 12. However, stakeholders informed the IASB that including a scope exclusion for service concession arrangements in IFRS 16 would provide clarity in this respect. *[IFRS 16.BC69]*.

2.4 Private-to-private arrangements

While the IFRS IC expects IFRIC 12 to be applied primarily to public-to-private arrangements, its application to private-to-private arrangements is neither required nor prohibited. The Basis for Conclusions notes that application by analogy could be appropriate under the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* if the arrangement met the control criteria quoted in section 2 above. *[IFRIC 12.BC14]*. Accordingly, the application of IFRIC 12 to other arrangements would be regarded as an accounting policy choice, rather than a treatment that could be determined on a case-by-case basis. However, this choice would not be possible if it was determined that the arrangement falls within the scope of other accounting standards, such as IFRS 15 and IFRS 16. In practice, it is not common to see IFRIC 12 applied to private-to-private arrangements.

2.5 Accounting by grantors

The Interpretation applies only to accounting by the operator, not the grantor. *[IFRIC 12.4, IFRIC 12.9]*. Grantor accounting was determined not to be a priority for the IFRS IC, who noted that grantors are government bodies that do not necessarily apply IFRS accounting standards. *[IFRIC 12.BC15]*. IPSAS 32 *Service Concession Arrangements: Grantor,* issued by the International Public Sector Accounting Standards Board (IPSASB), addresses the grantor's accounting in such arrangements. Its approach is consistent with that used for the operator's accounting in IFRIC 12, in that an infrastructure asset is recognised by the grantor, together with an obligation comprising either a financial liability to the operator or, where an unconditional obligation to pay cash to the operator is not a feature of the arrangement, a deferred revenue balance.[16] This chapter does not address accounting by grantors.

16 IPSAS 32, *Service Concession Arrangements: Grantor*, International Public Sector Accounting Standards Board, October 2011.

3 The control model

A contractual arrangement that is within the scope of IFRIC 12 includes both of the following features, commonly referred to as the 'control criteria':

(a) The grantor controls or regulates the services that the operator must provide using the infrastructure, to whom it must provide them, and at what price.

And

(b) The grantor controls any significant residual interest in the infrastructure at the end of the concession term through ownership, beneficial entitlement or otherwise. *[IFRIC 12.5]*.

The IFRS IC considers that, taken together, these conditions identify when the infrastructure is controlled by the grantor for the whole of its economic life, *[IFRIC 12.AG6]*, in which case an operator is only managing the infrastructure on the grantor's behalf. Crucially, it has concluded from this that an infrastructure asset controlled by the grantor cannot be the property, plant and equipment of the operator. *[IFRIC 12.11, IFRIC 12.BC21, IFRIC 12.BC22]*. Control must be distinguished from management. If the grantor retains both the degree of control described in (a) above and any significant residual interest in the infrastructure, the operator is only managing the infrastructure on the grantor's behalf- even though, in many cases, it may have wide managerial discretion. *[IFRIC 12.AG5]*.

3.1 Regulation of services

The control or regulation of services does not have to be governed by contract as it could include control via an industry regulator. Control also extends to circumstances in which the grantor buys all the output as well as those in which it is bought by other users.

The grantor and relevant related parties must be considered together. If the grantor is a public sector entity, the public sector as a whole, together with any independent regulators acting in the public interest, are to be regarded as related to the grantor. *[IFRIC 12.AG2]*. 'Price' can mean the amount at which the grantor buys the service or the amount that the operator charges members of the public or a combination of both.

This means that many regulated public utilities (water, sewage, electricity supply etc.) will fall within (a) in section 3 above. Other arrangements that fall within (a) include public health facilities that are free to users and subsidised transport facilities (some rail, toll roads and bridges) that are partly paid by public sector grant and partly by passenger fares. Of course, all of these will only be within scope of IFRIC 12 if there is also a contract between grantor and operator for the arrangement and any significant residual interest is also 'controlled' by the grantor under (b) above.

The IFRS IC stresses that the grantor does not need to have complete control of the price. It is sufficient for the price to be regulated, which could be by way of a capping mechanism (regulated utilities are usually free to charge lower prices). Other 'caps' may not be so apparent. A contract may give the operator freedom to set its prices, but any excess is clawed back by the grantor, e.g., through setting a maximum return on an agreed investment in the infrastructure. In such a case, the operator's return is capped, and the price element of the control test is substantively met. *[IFRIC 12.AG3]*.

Care must be taken to look to the substance of the agreements, so a cap that only applies in remote circumstances will be ignored. *[IFRIC 12.AG3]*.

A requirement in the agreement for the grantor to review or approve prices would also generally be sufficient to determine that the grantor controls the price. It would not be appropriate to assume that such approvals are insubstantial or 'rubber stamps' that could be disregarded by the operator.[17] See section 2.2.2 above for discussion on how the proposals in the Exposure Draft *Regulatory Assets and Regulatory Liabilities* published in January 2021 may interact with IFRIC 12.

17 *IFRIC Update,* July 2009, available on the IFRS Foundation's website.

3.1.1 Partial regulation of services

Some arrangements only allow the grantor to control prices for part of the life of the infrastructure. For example, an operator may construct clinical facilities that are used by a government health care provider (the grantor) for a five-year contract term (i.e., for a period less than the remaining useful life of the infrastructure). At the end of the term, the health care provider may request (but not require) the operator to extend the contract by renegotiation. If it does not do so, the operator can run the facilities for private health care. Although the prices are controlled for the first five years, this arrangement is unlikely to meet the control condition in (a) in section 3 above.

Alternatively, the contract might allow regulation of the prices of some but not all the services provided with the infrastructure. Judgement is required in determining whether arrangements involving partially regulated assets fall within the scope of IFRIC 12 (see section 3.4 below).

Where arrangements involving partially regulated assets do not fall within the scope of IFRIC 12, the operator would need to assess how other accounting standards, namely IFRS 16, IFRS 15 and IAS 16 apply to the arrangement. See section 2.2 above for further discussion of arrangements that are not in scope of IFRIC 12.

3.2 Control of the residual interest

In order for an arrangement to be within scope of IFRIC 12, the grantor must control not only the services provided with the infrastructure but also any significant residual interest in the infrastructure at the end of the concession term through ownership, beneficial entitlement or otherwise. *[IFRIC 12.5(b)]*. For this to be the case, the grantor's control over any significant residual interest should restrict the operator's ability to sell or pledge the infrastructure. *[IFRIC 12.AG4]*. IFRIC 12 provides only this limited guidance on assessing whether the grantor controls any significant residual interest in the infrastructure. It may be relevant also to consider that IFRS 15 states that "…Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining economic benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways…". *[IFRS 15.33].* As discussed below, control over the residual interest does not require the infrastructure to be returned to the grantor. It is sufficient that the grantor controls how access to the infrastructure is awarded after the concession term.

The control approach requires consideration of the infrastructure as a whole, thereby avoiding the piecemeal accounting for the different components of the infrastructure as required by IAS 16. If the operator has to replace part of an item of infrastructure during the life of the concession, e.g., the top layer of a road or the roof of a building, the item of infrastructure is to be considered as a whole, so that condition (b) will be met for the whole of the infrastructure, including the part that is replaced, if the grantor has the residual interest in the final replacement of that part. *[IFRIC 12.AG6]*.

The Interpretation does not expand on what is regarded as 'significant'. Some infrastructure assets such as toll roads and bridges generate cash flows directly and it may be possible to use estimated future cash flows to calculate the significance of the residual value, whether or not the grantor will charge tolls after reversion of the asset. It may not be possible to base the assessment of 'significance' on the cash flows received by the operator on handing back the asset to the grantor as these may be nominal amounts; indeed, the grantor may pay nothing. The remaining useful life of the asset when it reverts may give a good indication, e.g., if a hospital is handed back to the public sector with a remaining useful life of twenty years, this residual interest is likely to be significant.

There are a number of features that indicate whether the grantor controls the residual interest. There are usually several contractual alternatives: the operator is granted a second concession term, a new operator is allowed to acquire the assets or the grantor acquires the assets and brings the arrangement 'in house'. The grantor still controls the residual as it will determine which of these alternatives applies and the option exercise price (if it or a new operator acquires the infrastructure) is irrelevant.

In some arrangements, the grantor only has an option to reacquire the asset at the end of the concession term. The operator cannot control the infrastructure until the grantor decides what to do with the option. An option at fair value at the date of exercise may by itself be enough to give the grantor control over the residual under IFRIC 12 if it is sufficient to restrict the operator's ability to sell or pledge the infrastructure. This is a clear difference between a 'risks and rewards' and a 'control' model as under the former, the operator would be seen as keeping the risks and rewards of ownership if another party had the right to acquire the asset at fair value.

Illustration 3-1: Residual arrangements

A gas transmission system is being operated under a concession arrangement with the State Gas Authority. At the end of the term, the grantor will either acquire the infrastructure assets at their net book value, determined on the basis of the contract, or it may decide to grant a new SCA on the basis of a competitive tender, which will exclude the current operator. If the grantor elects to do the latter, the operator will be entitled to the lower of the following two amounts:

(a) The net book value of the infrastructure, determined on the basis of the contract

And

(b) The proceeds of a new competitive bidding process to acquire a new contract

Although the operator cannot enter the competitive tender, it also has the right to enter into a new concession term but, in order to do so, it must match the best tender offer made. It has to pay to the grantor the excess of the best offer (b) above the amount in (a); should the tender offer be lower than (a), it will receive an equivalent refund.

In this arrangement, the grantor will control the residual. It can choose to take over the activities of the concession itself or it can allow potential operators, including the incumbent, to bid for a second term. The price that might be received by the operator, or paid by the grantor, is not relevant.

What if the arrangement is for the whole life of the infrastructure? Assets in service concession arrangements may revert to the grantor at the end of the concession term but they may not have much, if any, remaining useful life. Many modern buildings, for example, only have a useful life of thirty years or so and this is a common concession term. Consequently, infrastructure used in a service concession arrangement for its entire useful life ('whole of life infrastructure') is included within the scope of IFRIC 12 if the grantor controls or regulates the services that the operator must provide using the infrastructure, to whom it must provide them, and at what price. *[IFRIC 12.6]*.

The IFRS IC noted that one reason for including the 'significant residual interest' requirement was to differentiate between privatised, but still regulated, industries and service concession arrangements, thereby seeming to confirm that it had not intended regulated industries to be in scope.[18] The IFRS IC considers that privatised regulated industries are generally out of scope, because they are divestitures or privatisations where it is more appropriate to treat the infrastructure as the property, plant and equipment of the operator. This is indicated in the table included as Information note 2 to IFRIC 12 (reproduced in section 2.2 above). It is usually the case in a privatisation that the infrastructure only reverts to the grantor in the event of a major breach of the conditions of the regulatory framework as otherwise the right of the operator to provide the regulated services may roll over indefinitely into a new term. In other cases, it may require legislative change to bring the assets back into the control of the public sector. This means that the grantor does not control the residual interest in the property as required by IFRIC 12.

ENGIE SA discloses that some of its concessions are not considered to be within scope of IFRIC 12 as the grantor has no rights over the infrastructure at the end of the contract. These assets (for gas distribution) are likely to have an economic life significantly in excess of the contract term.

18 *IFRIC Update*, September 2005, available on the IFRS Foundation's website.

Practical example 3-1: ENGIE SA (2023) France

2023 MANAGEMENT REPORT AND ANNUAL CONSOLIDATED FINANCIAL STATEMENTS [extract]
03 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]
NOTE 13 FIXED ASSETS [extract]
13.2 Intangible assets [extract]
Accounting standards [extract]

Intangible rights arising on concession contracts

IFRIC 12 – *Service Concession Arrangements* deals with the treatment to be applied by the concession operator in respect of certain concession arrangements.

For a concession arrangement to fall within the scope of IFRIC 12, usage of the infrastructure must be controlled by the concession grantor. This requirement is satisfied when the following two conditions are met:

- the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price; and
- the grantor controls any residual interest in the infrastructure at the end of the term of the arrangement, for example it retains the right to take back the infrastructure at the end of the concession.

The intangible asset model according to paragraph 17 of IFRIC 12 applies if the operator receives a right (a license) to charge the users, or the grantor, depending on the use made of the public service. There is no unconditional right to receive cash, as the amounts depend on the extent to which the public uses the service.

Concession infrastructures that do not meet the requirements of IFRIC 12 are presented as property, plant and equipment. This is the case of gas distribution infrastructures in France. The related assets are recognized in accordance with IAS 16, given that GRDF operates its network under long-term concession arrangements, most of which are mandatorily renewed upon expiration pursuant to French law No. 46-628 of April 8, 1946.

3.3 Assets within scope

Extract from IFRIC 12

7 This Interpretation applies to both:

(a) infrastructure that the operator constructs or acquires from a third party for the purpose of the service arrangement; and

(b) existing infrastructure to which the grantor gives the operator access for the purpose of the service arrangement.

[IFRIC 12.7].

How we see it

Generally, 'infrastructure' is interpreted broadly, and it is accepted that 'the infrastructure' used to provide services can include moveable assets.

Although IFRIC 12 uses the word 'infrastructure' and includes examples traditionally regarded as such, including roads, bridges, hospitals, and airports, *[IFRIC 12.1]*, the Interpretation is based on the definition of an asset under IFRS accounting standards. "An asset is a present economic resource controlled by the entity as a result of past events" *[CF 4.3]* and is therefore considered to apply to all assets, including items such as buses or railway rolling stock that are made available by the grantor to the operator of the public service.

It is usually relatively straightforward to apply (a) above to infrastructure that the operator constructs or acquires from a third party for the purpose of the concession. The accounting for service concession arrangements in which infrastructure is leased from a party other than the grantor is discussed in section 3.3.1 below.

However, there are some issues of interpretation relating to infrastructure to which the grantor has given access to the operator for the purpose of the SCA. 'Existing infrastructure' under (b) above could include other arrangements in the form of leases from the grantor over assets. As part of a SCA, in addition to receiving payments for the construction and/or operation of the infrastructure, an operator may make payments to a grantor, e.g., in respect of the land on which a facility is to be built. These issues are discussed in section 3.3.2 below.

A third group of assets comprises property, plant and equipment previously held by the operator and then used in connection with the provision of services under the SCA. The IFRS IC's view is that accounting for these types of assets is already covered by existing IFRS accounting standards, principally IAS 16, and therefore, it does not specify how the operator accounts for its previously existing assets that now form part of the infrastructure. *[IFRIC 12.8]*. The treatment of existing assets is discussed further in section 3.3.3 below.

3.3.1 Accounting for service concession arrangements for which the infrastructure is leased from a party other than the grantor

As noted in section 3.3 above, assets within the scope of IFRIC 12 include infrastructure that the operator constructs or acquires from a third party for the purpose of the service arrangement and existing infrastructure to which the grantor gives the operator access for the purpose of the service arrangement. *[IFRIC 12.7]*. In some cases, an operator may enter into an arrangement with the grantor to provide a public service using infrastructure that is leased. For example, an operator may lease trains in order to provide rail transportation services to the public. The accounting for arrangements in which infrastructure is leased from the grantor are addressed in section 3.3.2 below. Where the lessor and grantor are controlled by the same governmental body and are related parties, lease payments made by the operator to the lessor are, in substance, payments made to a grantor in a service concession arrangement[19] which are covered in section 3.3.2 below.

In September 2016, the IFRS IC considered this issue.

19 IASB Staff Paper 06, Project: *IFRIC 12* Service Concession Arrangements, Paper topic: *Service concession arrangements with leased infrastructure*, IFRS IC Meeting, March 2016, p.11. Available on the IFRS Foundation's website.

Frequently asked questions

Question 3-1: How does an operator account for a service concession arrangement in which the infrastructure is leased from a third party?
Is the arrangement (including the leased infrastructure) in scope of IFRIC 12?
If so, how does the operator account for any assets and liabilities arising from the arrangement with the lessor?

The IFRS IC was asked these questions in respect of an arrangement where infrastructure is leased from a third party lessor, unrelated to the grantor, and the operator is not required to provide any construction or upgrade services with respect to the infrastructure. In the fact pattern discussed, the operator is contractually required to pay the lessor for the lease of the infrastructure, and has an unconditional contractual right to receive cash from the grantor to reimburse those payments. The grantor provides the lessor with a guarantee of the lease payments to be made during the lease terms and of any residual value at the end of the lease term. The IFRS IC observed that:

(a) Assessing whether an arrangement (including the leased infrastructure) is in scope of IFRIC 12 requires consideration of all facts and circumstances, in particular whether the control conditions in IFRIC 12.5 are met (see section 3 above), and whether the infrastructure falls within one of the groups of assets set out in IFRIC 12.7 as in scope of IFRIC 12 (see section 3.3 above). However, an operator is not required to provide construction or upgrade services with respect to the infrastructure for the arrangement to be in scope of IFRIC 12.

(b) If the arrangement is in scope of IFRIC 12, then it is the grantor, not the operator, that controls the right to use the infrastructure. Accordingly, the operator assesses whether it has the obligation to make payments to the lessor for the lease, or whether the grantor has this obligation.

  (i) If the grantor has the obligation to make payments to the lessor, the operator is collecting cash from the grantor that it remits to the lessor on behalf of the grantor.

  (ii) If the operator has the obligation to make payments to the lessor as part of the service concession arrangement, the operator recognises a liability for this obligation when it is committed to the service concession arrangement and the infrastructure is made available by the lessor. At the time the operator recognises the liability, it also recognises a financial asset because the operator has a contractual right to receive cash from the grantor to reimburse those payments. The operator offsets the liability to make payments to the lessor against the corresponding receivable from the grantor only when the criteria for offsetting a financial asset and financial liability in IAS 32 are met.[20] The offsetting criteria in IAS 32 are discussed in Chapter 50 at section 7.4.1.

In contrast to the fact pattern discussed by the IFRS IC, if the operator is contractually required to pay the lessor for the lease of the infrastructure, but does not have an unconditional contractual right to receive cash from the grantor to reimburse those payments, then in effect it is paying the lease payments on behalf of the grantor. Therefore, the operator recognises a liability for this obligation and treats this obligation either as an additional cost of the concession right asset under the intangible asset model or as a reduction to the overall consideration the financial asset model applies (see section 3.3.2 below).

3.3.2 Periodic payments to the grantor for the right to use assets

Assets within the scope of IFRIC 12 include infrastructure that the operator constructs or acquires from a third party for the purpose of the service arrangement and existing infrastructure to which the grantor gives the operator access for the purpose of the service arrangement. *[IFRIC 12.7]*. IFRIC 12 contains no explicit guidance regarding periodic payments made to the grantor in connection with the right to use assets. The issue is whether these costs are treated as lease costs in accordance with IFRS 16, treated as executory in nature with costs expensed as incurred or otherwise recognised as a liability. If they are considered to be within scope of IFRIC 12, what are the accounting consequences? Are they part of the overall consideration paid by the grantor or recognised as an asset and, if an asset, did they form part of the 'concession asset' at the start of the concession, with an obligation to make the related payments?

20 *IFRIC Update*, September 2016, available on the IFRS Foundation's website.

This has been discussed by the IFRS IC in the context of a question about payments to the grantor in general (see section 4.7 below). The IFRS IC decided in March 2016 that the treatment of variable payments for asset purchases, including payments that vary in relation to future activity by the purchaser, was too broad an issue for it to address, and consequently decided not to add the issue to its agenda.[21]

For fixed payments made by the operator to the grantor, the IFRS IC observed in July 2016 that IFRIC 12 would apply, unless:

(a) They are payments for the right to a good or service that is separate from the service concession arrangement, which are accounted for under other applicable IFRS accounting standards.

Or

(b) They are payments for the right to use an asset that is separate from the infrastructure within the scope of IFRIC 12, in which case the operator assesses whether the arrangement contains a lease. If the arrangement contains a lease, the operator accounts for those payments by applying IFRS 16.[22]

This approach is consistent with the requirements in IFRS 15 to determine whether consideration payable to a customer gives rise to goods or services distinct from the customer contract (see Chapter 28 at section 5.7). *[IFRS 15.70, IFRS 15.71]*. Payments that are part of the overall concession agreement but do not fall within these two exceptions will be accounted for as part of the SCA. In this case, the accounting treatment will depend on whether the SCA falls within the financial asset model, the intangible asset model or is a hybrid. If the financial asset model applies, payments to the grantor would be treated as reductions to the overall consideration received and therefore be offset against the financial asset receivable under the SCA. In contrast, under the intangible asset model the payments to the grantor are recognised as a liability that increases the cost of the concession right asset. If the hybrid model applies, then the entity assesses the extent to which the concession payment represents an adjustment to the overall consideration receivable or whether it is consideration for the intangible asset element. This is discussed further in section 4.7 below.

3.3.3 Previously held assets used for the concession

IFRIC 12 does not apply to infrastructure held and recognised as property, plant and equipment by the operator before entering into the SCA. If such assets of the operator become part of the infrastructure in the SCA, the operator applies the derecognition requirements of IAS 16 to determine whether it derecognises those previously held assets. *[IFRIC 12.8]*. The IFRS IC's view is that accounting for assets is already covered by existing accounting standards, principally IAS 16, and therefore, it is not necessary to specify how the operator accounts for its previously existing assets that now form part of the infrastructure. *[IFRIC 12.BC16, IFRIC 12.BC18]*.

How we see it

The implication of the guidance above is that losing control of a previously held asset by contractually giving control of its use to the grantor would give rise to a disposal of the asset under IAS 16.

The existing asset would be derecognised and any consideration on the disposal established in accordance with the requirements for determining the transaction price in IFRS 15. *[IAS 16.72]*. This means that the total consideration received under the contract would be allocated between an amount receivable for construction and upgrade services and an amount to reflect the transfer of the existing asset to the control of the grantor. What was previously recorded by the operator as property, plant and equipment would be replaced by an element of either an intangible asset or a financial asset, depending on the accounting model determined to be appropriate to the particular SCA (see section 4.1.2 below). Gains and losses must be calculated as the difference between any net disposal proceeds and the carrying value of the item of property, plant and equipment, *[IAS 16.71]*, and recognised in profit or loss. Derecognition of assets within scope of IAS 16 in general is discussed in Chapter 19 at section 7.

The operator may use some of its existing assets for the purpose of the concession without transferring control to the grantor. Unless the contract transfers the residual interest in these pre-existing assets to the grantor (and thereby both of the control criteria laid out in section 3 above are met), these assets are out of scope of IFRIC 12. If an infrastructure asset is itself out of scope, the SCA might include, for example, extensions to that asset, upgrades to it and a contractual period of using the infrastructure asset to provide services. In this case, the total consideration payable under the concession will be allocated between the extension, upgrade and operating services within scope of IFRIC 12. Accordingly, construction revenue would be recognised at the time of the extension or upgrade work, with an additional financial asset or intangible asset recognised as appropriate.

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21 *IFRIC Update*, March 2016, available on the IFRS Foundation's website.

22 *IFRIC Update*, July 2016, available on the IFRS Foundation's website.

3.4 Partially regulated assets

IFRIC 12 notes that it is not uncommon for the use of infrastructure to be partly regulated and partly unregulated. *[IFRIC 12.AG7]*.

Extract from IFRIC 12

AG7 Sometimes the use of infrastructure is partly regulated in the manner described in paragraph 5(a) and partly unregulated. However, these arrangements take a variety of forms:

(a) any infrastructure that is physically separable and capable of being operated independently and meets the definition of a cash-generating unit as defined in IAS 36 shall be analysed separately if it is used wholly for unregulated purposes. For example, this might apply to a private wing of a hospital, where the remainder of the hospital is used by the grantor to treat public patients.

(b) when purely ancillary activities (such as a hospital shop) are unregulated, the control tests shall be applied as if those services did not exist, because in cases in which the grantor controls the services in the manner described in paragraph 5, the existence of ancillary activities does not detract from the grantor's control of the infrastructure.

In both cases set out in IFRIC 12.AG7, the grantor may have given to the operator a right to use the unregulated asset in question. This right may be in substance a lease from the grantor to the operator; if so, this is to be accounted for in accordance with IFRS 16. *[IFRIC 12.AG8]*. Determining whether the right is, in substance, a lease would involve using the principles in IFRS 16 (see Chapter 24 at section 3.1). The interaction of IFRIC 12 and IFRS 16 is discussed in section 2.3 above.

The Interpretation gives no further guidance on how an entity might interpret the term 'purely ancillary' in evaluating whether an unregulated activity is ignored for the purposes of determining if the control criteria are met or considered to detract from the grantor's control of the asset. The hospital shop is clearly insignificant by virtue of its size relative to the whole hospital, the proportion of cash flows attributable to it and the fact that the existence of a shop has no direct impact on the function of the infrastructure in the provision of regulated services. However, it is not clear at what point a secondary activity would become or cease to be 'purely ancillary'. This will be a matter of judgement, as demonstrated in Illustration 3-2 below.

Illustration 3-2: Partially regulated assets - Airport

Entity A has been contracted by the government department of transport to construct a regional airport and operate it for a period of 25 years.

Entity A will have the right to charge airlines using the airport fees for 'aeronautical services' provided by Entity A, such as landing fees, passenger fees, terminal fees and fees for gate and ground services. These aeronautical services and fees will be subject to regulation by the department of transport. Entity A expects 55% of its income from the airport over the contract period to come from aeronautical fees and expects the remainder of its income over the term of the contract to arise from unregulated non-aeronautical activities within the airport, such as rent for concessions, retail and parking.

Whilst some of the areas of the airport used to provide concession, retail and parking services are physically separable, Entity A concludes that they do not meet the definition of a cash-generating unit as defined in IAS 36 *Impairment of Assets* *[IFRIC 12.AG7(a)]* because the cash inflows from these areas are not largely independent of the cash inflows from other parts of the airport infrastructure, because the users of those services are also passengers of the airlines to whom Entity A provides aeronautical services. *[IAS 36.6]*.

As the use of the airport infrastructure is partially regulated and partially unregulated, Entity A will need to apply judgement to assess whether the non-aeronautical activities are purely ancillary.

Entity A could base this judgement on a qualitative assessment. Entity A could take the view that, although the non-aeronautical services are outside the primary purpose of the airport infrastructure, they are important to managing the flow of passengers through the airport, and do not significantly impact the function of the infrastructure in the provision of the regulated aeronautical services. Entity A could therefore conclude that the non-aeronautical services are purely ancillary and apply the control test in paragraph 5(a) of IFRIC 12 as if those services did not exist. *[IFRIC 12.AG7(b)]*.

Alternatively, Entity A could base its judgement on a quantitative assessment, comparing total estimated revenues from regulated services over the life of the arrangement to estimated revenues from unregulated services. Under this approach, Entity A could conclude that the unregulated non-aeronautical services are not ancillary as the proportion of cash flows attributable to those services is not clearly insignificant. Entity A could conclude that the extent of unregulated services provided using the airport infrastructure is such that that the grantor is not considered to control the infrastructure.

Regardless of which approach is used or the emphasis placed by the entity on qualitative or quantitative factors, there may be judgement involved in making the determination of whether non-aeronautical services are ancillary. Entity A must apply a consistent approach and determine its judgements consistently to all similar contractual arrangements.

In addition, there are many concession agreements that include unregulated services that are neither purely ancillary nor delivered by using a physically separable portion of the total infrastructure, a situation not addressed by IFRIC 12.AG7. For example, a grantor may control prices charged to children, pensioners and the unemployed who use a sports facility, but the amounts charged to other adults are not controlled. The same facility is being used by all, regardless of the amount that they pay. Alternatively, price regulation could apply only to services provided at certain times of the day rather than to different classes of user.

Illustration 3-3: Partially regulated assets - Rail transportation

Entity B has been contracted by the government department of transport to build and operate a regional rail network for 10 years.

Entity B will operate the trains across the regional network, employ the required staff, and manage the railway stations and depots across the regional network. The department of transport will specify the level of train services to be provided, set certain specifications of trains to be used, and establish overall performance targets. Train fares charged by Entity B to rail passengers will consist of regulated fares (for peak-time rail tickets), and unregulated fares (for off-peak time rail tickets). Entity B expects 60% of rail fare revenue over the term of the contract to come from regulated fares, and 40% from unregulated fares.

The same rail infrastructure will be used to provide both peak-time and off-peak services. Entity B will therefore need to apply judgement in assessing the control criteria in paragraph 5(a) of IFRIC 12 ('The grantor controls or regulates the services that the operator must provide using the infrastructure, to whom it must provide them, and at what price'). *[IFRIC 12.5(a)]*.

In this case, Entity B could base its judgement on a quantitative assessment, comparing total estimated revenues from regulated fares over the life of the arrangement to estimated revenues from unregulated fares. As Entity B expects 40% of its revenue over the term of the contract to come from unregulated fares, Entity B could conclude that although the department of transport may control the services that the operator must provide with the rail infrastructure, they do not control the price given that a significant portion of non-regulated rail fare revenue is expected to be generated by Entity B. In this case, the arrangement is not in scope of IFRIC 12. Entity B could reach a different conclusion if the proportion of non-regulated rail fare income was expected to be clearly insignificant.

In practice, there may be judgement involved in making the determination of whether enough of the service or process for the service is unregulated in order to demonstrate that the grantor is not considered to control the infrastructure. Whilst we do not believe that there are any clear cut-off points or bright lines in making this judgement, entities must apply a consistent approach and determine its judgements consistently to all similar contractual arrangements.

How we see it

When a concession agreement includes unregulated services that are neither purely ancillary, nor delivered by using a physically separable portion of the total infrastructure, it will be a matter of judgement whether enough of the service is unregulated in order to demonstrate that the grantor is not considered to control the asset, which would lead to the arrangement as a whole falling out of the scope of IFRIC 12. We would expect entities to apply these judgements consistently to similar arrangements.

The assessment of whether enough of the service is unregulated in order to demonstrate that the grantor is not considered to control the asset will be made at the beginning of the contract and will not be revisited unless errors were made in the original assessment, i.e., it will not be revisited simply because there are significantly more or fewer unregulated users than originally anticipated. In practice, partial price regulation is often a reason for an arrangement to fall outside the scope of IFRIC 12.

However, if it transpires that there are significantly fewer unregulated users than anticipated then it is likely that the contract will be renegotiated. This is because of the public service obligation, which means that the grantor will want the service to continue to be provided to the public albeit under new terms. Whilst IFRIC 12 does not address changes to concession arrangements, it would be necessary to look to the requirements of other standards that IFRIC 12 interprets (such as IFRS 15, IFRS 9 and IAS 38) in order to determine the impact on the accounting for the concession, including the impact on any assets and liabilities recognised in respect of the concession. Similar considerations apply where there is a change in regulation that impacts whether the grantor controls or regulates the services that the operator must provide using the infrastructure, to whom it must provide them, and at what price, and/or whether grantor controls any significant residual interest in the infrastructure at the end of the concession term.

4 Accounting by the concession operator: the financial asset and intangible asset models

The IFRS IC's accounting framework for public-to-private arrangements is summarised in the following diagram from Information note 1 in IFRIC 12.

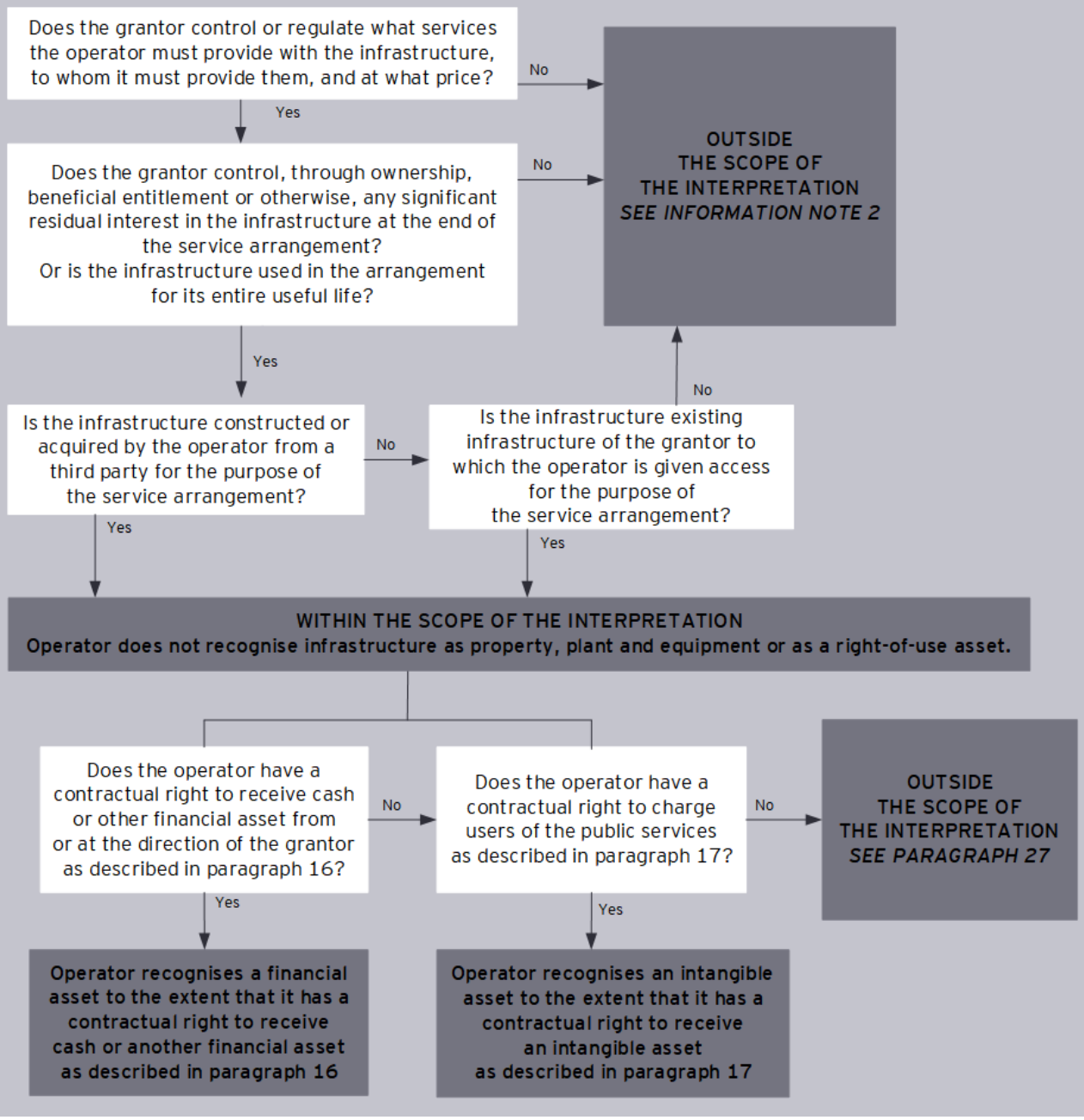
Extract from IFRIC 12

Information note 1

Accounting framework for public-to-private service arrangements

This note accompanies, but is not part of, IFRIC 12.

The diagram below summarises the accounting for service arrangements established by IFRIC 12.



[IFRIC 12.IG Information note 1].

The two accounting models in IFRIC 12 apply several decisions of principle:

- The control model applies as described in section 3 above, which means that the operator will not recognise infrastructure assets as its property, plant and equipment. *[IFRIC 12.11]*.

  And

- The operator is providing 'construction services' and not, for example, constructing an item of property, plant and equipment for sale. Construction services are to be accounted for separately from 'operation services' in the operations phase of the contract. *[IFRIC 12.14, IFRIC 12.20, IFRIC 12.BC31]*.

There is a third important point of principle: although the nature of the consideration determines the subsequent accounting (as discussed in section 4.1.2 below), both types of consideration give rise to a contract asset during the construction or upgrade period. *[IFRIC 12.19]*. The point at which the consideration is subsequently classified as a receivable or intangible asset is discussed in sections 4.2 and 4.3 below, respectively.

4.1 Consideration for services provided and the determination of the appropriate model

Most service concession agreements are for both construction (or upgrade) services and operations services. Operators almost always negotiate a single contract with the grantor and, although the Interpretation does not refer to this, this will usually include a single payment mechanism throughout the concession term, sometimes called a 'unitary payment'. The operator is unlikely to be remunerated separately for its different activities. The payment mechanism often falls into one or other of the following models:

Illustration 4-1: Payment mechanisms for service concessions

(a) A hospital where the payment is based on the availability of the whole hospital

The unitary payment is based on the full provision of an overall accommodation requirement which is divided into different units, such as hospital wards, consulting rooms, operating theatres, common parts and reception. Availability is defined in terms of being usable and accessible and, includes some associated core services such as heating, power and cleaning services. There is a payment deduction for failure to provide an available unit according to a contractual scale. There are no separate payment streams for any of the non-core services but substandard performance can result in payment deductions.

P = (F × I) - (D + E)

P = unitary payment per day

F = price per day for overall accommodation requirement

I = Indexation increase based on the retail prices index

D = deductions for unavailability

E = performance deductions

b) A prison where payment is made based on the number of occupied places

The unitary payment is based on the number of occupied places. Occupied means not only that a prisoner is allocated a physical space but the associated core services and minimum requirements must be met in relation to services such as heating, mail delivery and food. No payment is made for unoccupied places. There are no separate payment streams for any of the non-core services (i.e., not associated with the definition of an occupied place) but deductions from the unitary payment can be made for substandard performance of these services.

The unitary payment is based on the following formula:

P = (F × I) - Z

P = unitary payment per place

F = Fixed amount per occupied place per day

I = Indexation increase based on the retail prices index

Z = Performance deductions

The payments for both models are not immediately separable between amounts attributable to the construction or other services.

The operator acts as a service provider. It constructs or upgrades infrastructure used to provide a public service and operates and maintains that infrastructure for a specified period of time. *[IFRIC 12.12]*. IFRIC 12 clarifies that the operator recognises and measures revenue in accordance with IFRS 15 for the services it performs. *[IFRIC 12.13]*. This requires the operator to allocate the consideration receivable to each performance obligation in proportion to their relative stand-alone selling prices. The exercise to separate the consideration receivable for the distinct services (i.e., construction, upgrade or operating services) provided by the operator is explained in section 4.1.1 below. The nature of the consideration determines the accounting model, *[IFRIC 12.13]*, as described in section 4.1.2 below.

Payments often start only when the infrastructure asset has been completed and accepted as suitable for purpose by the grantor. Operators usually seek payment during the construction phase but whether or not they receive any is inevitably a result of negotiation between the parties. Payments that are received are normally for services provided and not directly to meet construction costs; any amounts received will be allocated to the relevant service activity as described below.

4.1.1 Allocating the consideration

The Interpretation argues that the separate services within a service concession arrangement, i.e., 'construction services', 'upgrade services' or 'operations services', must be disaggregated "…because each separate phase or element has its own distinct skills, requirements and risks…". *[IFRIC 12.BC31]*.

The allocation of revenue for the provision of these separate services is determined in accordance with IFRS 15. *[IFRIC 12.14, IFRIC 12.20]*. This involves identifying who is the customer(s) of the service concession arrangement (see section 4.1.1.A below), identifying the performance obligations under the contract with the customer (see section 4.1.1.B below), determining the transaction price under the contract(s) (see section 4.1.1.C below), and allocating that transaction price to the performance obligations in the contract (see section 4.1.1.D below).

4.1.1.A Identifying the contract(s) with a customer

The first step in allocating consideration in accordance with IFRS 15 is to identify the contract with the customer. Under IFRS 15, a contract is defined as an agreement between two parties that creates enforceable rights and obligations. *[IFRS 15 Appendix A]*. Whether the customer in a service concession arrangement is the grantor and/or the user of the infrastructure will depend on the terms and conditions of the service concession arrangement. Because the grantor of the concession retains control over the infrastructure asset, *[IFRIC 12.5]*, it is likely that the grantor will be identified as the customer for any construction or upgrade services.

Because of the public service nature of the obligation undertaken by the operator, the operating services are provided to the public. This suggests that the public may be the customer for the operating services. A customer is defined in IFRS 15 as a party that has contracted with an entity to obtain goods or services that are an output of an entity's ordinary activities in exchange for consideration. *[IFRS 15 Appendix A]*. IFRS 15 does not require the existence of a written contract; a contract may be oral or implied, although it must be legally enforceable. *[IFRS 15.10]*.

How we see it

We believe that the users of the infrastructure may be identified as the customers for the operation services where:

- A written or implied contract exists between the operator and users of the infrastructure
- The operator receives consideration from those users of the infrastructure

  And
- The operator is collecting that consideration as principal (rather than as agent for the grantor)

Identification of the contract with the customer under IFRS 15 is discussed in Chapter 28 at section 3.

4.1.1.B Identifying the performance obligations in the contract

Most service concession agreements are for both construction (or upgrade) services and operations services. Many service concessions also require the operator to perform some level of maintenance of the infrastructure asset over the term of the service concession arrangement. IFRS 15 provides guidance on the types of items that may be goods or services promised in the contract. Examples given by the standard include performing a contractually agreed-upon task (or tasks) for a customer, and providing a service of standing ready to provide goods or services. *[IFRS 15.26]*.

A promised good or service is a performance obligation if it is either:

(a) A good or service that is distinct

  Or

(b) A series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer *[IFRS 15.22]*

In order to be distinct, a promised good or service must be:

(a) Capable of being distinct- i.e., provide a benefit to the customer either on its own or together with other resources that are readily available to the customer

And

(b) Distinct within the context of the contract- i.e., the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract *[IFRS 15.27]*

If a promised good or service is not distinct, IFRS 15 requires that the entity must combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct. *[IFRS 15.30]*.

How we see it

Where an operator has identified only one contract with the grantor, the operator would typically identify, at least, construction services, upgrade services and operation services as separate performance obligations. Whether the operator has identified a contract with the users of the infrastructure as the customer for the operating services will impact the identification of performance obligations within the contract(s) with customers.

It could be argued that because major maintenance enhances an asset that the grantor owns, then it is providing a benefit to the grantor. In addition, contractual terms often require an operator to repay an element advanced by the grantor for maintenance services if the operator does not incur contracted levels of maintenance spend. This may also support the argument that maintenance is a separate performance obligation. In practice, there is likely to be some judgement involved in determining whether maintenance is a separate performance obligation, based on how it is defined in the contractual arrangement. To the extent that the contract requires the operator to provide major maintenance, similar in nature to an upgrade, that enhances the infrastructure asset, maintenance could be a separate performance obligation. However, minor maintenance necessary to preserve the infrastructure in a condition required for the operator to operate the infrastructure safely and to return it to the grantor in a certain condition at the end of the arrangement could be argued as not transferring a distinct good or service to the grantor. In other cases, it may be less clear whether a contractual obligation represents a performance obligation under IFRS 15 or an obligation that is accounted for under IAS 37. For example, a water supply operator may be contractually required to replace all lead pipes for environmental and health reasons; similarly, a gas supply operator may be required to replace all cast-iron pipes for safety reasons.

As discussed at section 6 below, some respondents to the post-implementation review of IFRS 15 raised questions related to the interaction between IFRS 15 and IFRIC 12 on accounting for contractual obligations to maintain or restore infrastructure. This is because, while paragraph 21 of IFRIC 12 requires such contractual obligations to be recognised and measured in accordance with IAS 37, the Illustrative Examples to IFRIC 12 show the obligation to maintain or restore infrastructure as a distinct performance obligation applying IFRS 15 in Example 1 ('financial asset model' example), and a provision applying IAS 37 in Example 2 ('intangible asset model' example), with the reasons for the different approaches not explained in IFRIC 12.[23] However, the IASB decided to classify the matter as low priority, and will consider applying IFRS 15 with IFRIC 12 in the next agenda consultation, including accounting for contractual obligations to maintain or restore service concession infrastructure.[24]

Significant judgement may be needed to determine whether major maintenance is a separate performance obligation and consideration must be given to the disclosure requirements in paragraph 122 of IAS 1 *Presentation of Financial Statements*. See Chapter 3 at section 5.1.1.A.

In practice, operators may often sub-contract some or all the construction activities under a service concession arrangement. In such cases, the operator applies the guidance in IFRS 15 to determine whether it is acting as principal or agent for the provision of construction services. This determination will impact whether the operator's performance obligation under the contract is to provide construction services, or to arrange for another party to provide construction services. Principal versus agent considerations under IFRS 15 are discussed in Chapter 28 at section 4.4.

23 IASB Staff Paper 6E: Project: *Post-implementation Review of IFRS 15*, Paper topic: *Applying IFRS 15 with other IFRS Accounting Standards*, IASB meeting, April 2024. Available on the IFRS Foundation's website.

24 *IFRS - IASB Update July 2024*. Available on the IFRS Foundation's website.

4.1.1.C Determining the transaction price under the contract

Transaction price is defined in IFRS 15 as the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. *[IFRS 15.47]*.

The determination of transaction price must take into account any elements of variable consideration. It is often the case within service concession arrangements that the operator will be required to pay penalties if its performance under the contract does not meet specified standards. The element of revenue that is subject to such penalties would be considered a form of variable consideration under IFRS 15. *[IFRS 15.51]*. IFRS 15 requires that, if the consideration promised in a contract includes a variable amount, an entity must estimate the amount of consideration to which they will be entitled. *[IFRS 15.50]*. IFRS 15 requires that variable consideration must be estimated using either an expected value or most likely amount basis, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled. *[IFRS 15.53]*. The assessment of which approach is most appropriate will depend upon the facts and circumstances of the service concession arrangement and the penalty regime. In practice, it may be that the expected value approach better predicts the amount of consideration to which the operator expects to be entitled in many service concession arrangements. Estimates of variable consideration are then included in the transaction price only to the extent that it is highly probable that a significant reversal of revenue will not occur when the uncertainty associated with the variable consideration is subsequently resolved. *[IFRS 15.56]*.

Payments often start under a service concession arrangement only when the infrastructure asset has been completed and accepted as suitable for purpose by the grantor. In these cases, the delay between the timing of payments from the grantor compared to the provision of construction services by the operator may require a significant financing component to be taken into account in determining the transaction price. However, where the reason for the difference between the cash selling price of the construction services and the promised consideration arises for reasons other than the provision of finance, and the difference between those amounts is proportional to the reason given for the difference, the contract does not contain a significant financing component. *[IFRS 15.62]*. This may be the case where the form of the consideration for the construction services necessitates a delay between the provision of the services and the receipt of the consideration, such as where the operator receives an intangible asset in return for construction services.

When it is determined that the contract contains a significant financing component, the amount of promised consideration is discounted at a rate that the operator would use if it were to enter into a separate financing transaction with the grantor at contract inception. The discount rate reflects the credit characteristics of the grantor, as well as any collateral or security provided, including assets transferred in the contract, *[IFRS 15.64]*, i.e., the discount rate is a rate specific to the contract. IFRS 15 also notes that the discount rate could be derived by discounting the contractual cash flows to a cash selling price for the promised good or service. *[IFRS 15.64]*. In Illustrative Example 1 to IFRIC 12 (which is reproduced in Illustration 4-2 in section 4.2 below), the implied interest rate in the contract is assumed to be the rate that would be reflected in a financing transaction between the operator and the grantor, although this may not always be the case in a service concession arrangement.

How we see it

In determining the discount rate to be used when a service concession contract contains a significant financing component, we believe that IFRS 15 requires primacy to be given to the rate that the operator would use if it were to enter into a separate financing transaction with the grantor at contract inception. Whilst the rate implicit in the contract may be used in determining that rate, the use of the rate implicit in the contract may not always be consistent with the objective of IFRS 15.64. However, because most operators in a service concession are not in the business of entering into free-standing financing arrangements with grantors, they may find it difficult to identify an appropriate rate, and judgement may be required.

When determining the discount rate to use, the factors that the operator might take into account include, but are not limited to:

- The expected duration and repayment pattern of the service payments, noting that SCA payments may extend significantly longer than the duration of government bonds
- The credit profile of the government entity
- Borrowing rates that may be offered by the central treasury function of the government
- Credit risks specific to the terms of the SCA, including security or guarantees provided by the government, whether express or implied by statute or legislation, and to the extent it impacts the rate that would be negotiated between the parties

Determination of the discount rate when an entity concludes that a financing component is significant to a customer contract is discussed in Chapter 28 at section 5.5.3.

The effect of financing is excluded from the transaction price prior to the allocation of the transaction price to the performance obligations in the contract.

IFRS 15 is clear that an entity does not update the interest rate for changes in circumstances or market interest rates after contract inception. *[IFRS 15.64]*. However, the standard does not discuss situations in which expectations change after contract inception regarding the timing difference between the receipt of consideration and the transfer of goods and services to the customer (e.g., a change in the timing of delivery). If an entity has accounted for a significant financing component at contract inception and the expected timing of the transfer of goods or services then changes, it may be important to understand the reason for the expectation change. This is discussed further in Chapter 28 at section 5.5.3.

Where consideration for construction services comprises or includes a license to charge end users of the concession infrastructure, the license will be non-cash consideration. IFRS 15 requires non-cash consideration to be included in the transaction price, measured at fair value. *[IFRS 15.66]*. If the fair value of the non-cash consideration cannot be reasonably estimated, the non-cash consideration is measured indirectly by reference to the stand-alone selling price of the goods or services promised to the customer. *[IFRS 15.67]*. In practice, it may often be the case that the fair value of the licence received from the grantor to charge users cannot be estimated reasonably and will therefore be measured indirectly by reference to the stand-alone selling price of the construction services provided by the operator in exchange for the license. This is consistent with the approach shown in Illustrative Example 2 and Illustrative Example 3 to IFRIC 12. *[IFRIC 12.IE14, IFRIC 12.IE24]*.

Determination of the transaction price under IFRS 15 is discussed in Chapter 28 at section 5.

An operator may also be contractually required to make payments to the grantor. These may take the form of payments for the right of access to infrastructure or other assets, for the construction of assets or additional fees for the right to operate the concession. If the SCA falls within the financial asset model, the payments made may reduce the consideration received from the grantor. This is considered further in section 4.7 below.

4.1.1.D Allocating the transaction price to the performance obligations in the contract

IFRS 15 generally requires the transaction price to be allocated to each performance obligation in proportion to their relative stand-alone selling prices. *[IFRS 15.74]*.

If stand-alone selling prices are not readily observable, they must be estimated, considering all information that is reasonably available to the entity. *[IFRS 15.78]*. The operator may choose to estimate stand-alone selling prices using an expected cost-plus margin approach, *[IFRS 15.79]*, although other approaches are permitted.

How we see it

Although most service concessions apply a single payment mechanism, it is often straightforward in practice to identify the underlying cash flows that relate to different activities within the arrangement. This may be based on the original contract negotiations or because the contract contains terms allowing for subsequent price adjustments by 'market testing' or 'benchmarking'. However, the cash flows may not reflect the stand-alone prices of the underlying services so care will have to be taken. There may be practical problems when it comes to apportioning the total contract consideration between the elements of the contract and the allocation will be a matter of judgement.

Allocation of the transaction price to performance obligations under IFRS 15 is discussed in Chapter 28 at section 6.

4.1.2 Determining the accounting model after the construction phase

IFRIC 12 states that the operator may receive a financial asset or an intangible asset as consideration for its construction services and the asset that it receives determines the subsequent treatment. *[IFRIC 12.15, IFRIC 12.19]*. The nature of the consideration given by the grantor to the operator must be determined by reference to the contract terms and, when it exists, relevant contract law. However, the Interpretation is clear that both types of consideration give rise to a contract asset during the construction or upgrade period. *[IFRIC 12.19]*.

The IFRS IC decided that the boundary between the financial and the intangible asset models is based on the operator's unconditional contractual right to receive cash from, or at the direction of, the grantor. *[IFRIC 12.16]*. The grantor does not need to pay the cash to the operator directly. Fees or tolls received from users are viewed as essentially no more than collections on behalf of the grantor if they are part of an overall arrangement under which the grantor bears ultimate responsibility. If the grantor pays but the amounts are wholly based on usage of the infrastructure and there is no minimum guaranteed payment, the entity has no unconditional contractual right to receive cash, as the amounts receivable are contingent on the extent to which the public uses the service. In this case, the intangible asset model will apply.

The operator will recognise a financial asset to the extent that it has a contractual right to receive cash or other financial assets from the grantor for the construction services, where the grantor has little, if any, discretion to avoid payment. This is usually because the agreement is legally enforceable. *[IFRIC 12.16]*. The recognition of a financial asset is not affected by the fact that the operator's contractual right to receive cash may be contingent on performance standards, as in the example of a unitary charge for a hospital in Illustration 4-1 in section 4.1 above. The IFRS IC points out that this is no different from other circumstances and other financial assets where the payment for goods and services depends on the subsequent performance of the asset. *[IFRIC 12.BC44]*.

The operator will recognise an intangible asset to the extent that it receives a licence to charge users of the public service. *[IFRIC 12.17]*.

Sometimes it is necessary to 'bifurcate' the operator's right to cash flows for construction services into a financial asset and an intangible asset and account separately for each component of the operator's consideration. This, the IFRS IC argues, is because the operator is paid for its services partly by a financial asset and partly by an intangible asset. *[IFRIC 12.18]*.

The analysis between the different models can be seen in the following table:

	Arrangement	Applicable model
1	Operator receives fixed payments from grantor	Financial asset
2	Operator receives payments from grantor which vary with demand	Intangible asset
3	Operator receives payments from users which vary with demand, and from grantor for any difference with guaranteed amounts	Financial asset or bifurcated (part financial, part intangible)
4	Operator receives payments from users which vary with demand until it achieves specified return	Intangible asset
5	Operator receives payment from users which vary with demand - no grantor guarantees	Intangible asset

Of the two arrangements in Illustration 4-1 above, the hospital is an example of (1) above: the payments are contractually fixed if all obligations and services are provided. The prison, as described in Illustration 4-1 above, would fall within (2) and be accounted for as an intangible asset. However, the prison operator might be paid on a different basis, e.g., it might be paid for 1,000 'available places' and receive this as long as heating and food were capable of being provided. In this case, it would be no different to the hospital and be a financial asset. There are, of course, many potential variations and a combination of fixed and variable demand could lead to bifurcation.

Common examples of arrangements that fall within (3) above are transport concessions where the operator collects revenue from users but is entitled to an agreed return on capital invested in the infrastructure. The fees or tolls up to this amount are considered to be collections on behalf of the grantor. There will be a financial asset to the extent of the guaranteed return. There may also be an intangible asset if the value of the financial asset is less than the fair value of the construction services.

However, arrangements of the type in (4) above remain to be treated as intangible assets even if the overall risk to the operator of not obtaining a specified result is very low.

How we see it

An arrangement that effectively caps revenue collected from users once an agreed level of return is reached, is not a contractual right to cash but a right to collect revenues from users and it is not relevant that the risk is low or that the operator will, in effect, get a fixed return.

The extent to which demand risk is borne by the operator does not determine whether the operator should recognise a financial asset or an intangible asset. This is because IAS 32 defines financial assets solely by reference to the existence of a contractual right to receive cash, not by reference to the likelihood of future cash flows. *[IAS 32.11]*. While it is true that to the extent the financial asset model is used, demand risk is borne by the grantor, there are instances where the intangible asset model must be applied in the absence of a contractual right to receive cash from, or at the direction of, the grantor, even though the demand risk borne by the operator is substantially eliminated.

The following are examples of arrangements that will be accounted for using the intangible asset model:

(a) A municipality grants the operator a contract to construct a waste treatment plant and treat all its waste collections for which it will be paid per unit processed. The arrangement does not provide for any guaranteed volume of waste to be provided by the grantor and treated by the operator (so it does not contain a take-or-pay arrangement) or any form of guarantee by the grantor. Historically, however, the annual volume of waste has never been less than 40,000 tonnes and the average annual volume over the last 20 years has been 75,000 tonnes. Although the operator has a contractual right to receive cash for all waste treated, there is no guarantee that any waste will be treated, and therefore no contractual right to receive cash.

(b) An operator enters into a toll bridge concession. The operator is permitted to collect revenues from users or the grantor until it achieves a 6% return on its agreed infrastructure spend, at which point the arrangement comes to an end.

In commercial terms, the toll bridge concession may be virtually identical to a transaction that falls within (3) above, e.g., where the users pay tolls but the grantor guarantees a minimum 6% return. The crucial difference is the grantor's guarantee. The arrangement with the guarantee, which will contain a financial asset, is likely to leave more of the rewards of ownership with the operator than the intangible arrangement in (b) as the operator will be entitled to benefits in excess of the 6% return. This demonstrates that the distinction between the financial asset and intangible asset models is linked less to the transfer of commercial risk, but more to the existence (or not) of an unconditional contractual right to cash flows.

If the terms of the arrangement in (a) above contained a clause whereby the municipality must either provide, or pay for, a minimum guaranteed volume of waste to be treated by the operator (i.e., the arrangement contained a take-or-pay element), there would be a financial asset to the extent of the guaranteed minimum to be provided or paid for. There may also be an intangible asset if the value of the financial asset is less than the fair value of the construction services.

There are jurisdictions where public-to-private contract laws or the concession arrangements themselves allow an operator to ask the grantor for a revision of the tariffs for the public service when the operator's actual return is below initial expectations. Although this feature in the concession arrangement is included to reduce the operator's risk, it only gives the operator a right to re-negotiate and the outcome of that is not certain. As a result, the operator does not have an unconditional right to receive cash and, therefore, the existence of these features would not allow the operator to apply the financial asset model.

Many payment mechanisms include deductions for substandard performance of services. These do not affect the analysis of the contract as a financial asset or intangible asset and are discussed further below.

4.2 The financial asset model

Under the financial asset model, which applies if the entity has an unconditional contractual right to receive cash or another financial asset, *[IFRIC 12.16]*, the service element that relates to the construction of the infrastructure asset ('construction services') is accounted for in accordance with IFRS 15. *[IFRIC 12.14]*. For the avoidance of doubt, an asset is not recognised for the discounted present value of all amounts payable by the grantor under the service concession arrangement. The entity recognises an asset for construction services performed up to the reporting date; subsequently it may recognise an asset on the same basis for upgrade services; the carrying value of the asset does not include future services yet to be performed or maintenance services that are accounted for as expenses. The consideration received by the operator for other services is addressed in section 5 below.

IFRIC 12 requires the consideration due to the operator to be classified as a contract asset rather than a receivable during the construction activity. *[IFRIC 12.19]*. IFRS 15 requires that a receivable is recognised only when the operator has an unconditional right to receive consideration. This is the case only if nothing other than the passage of time is required before payment of the consideration is due. *[IFRS 15.108]*. The right to consideration would not be unconditional if the operator must first satisfy another performance obligation in the contract before it is entitled to payment from the customer.

How we see it

We believe that the operator recognises a receivable in scope of IFRS 9 only when, and to the extent that, payment is not conditional on future delivery of operation services.

Due to the nature of contractual penalties imposed in service concession arrangements, in practice, the amount due to the operator in exchange for construction services may sometimes only unwind from a contract asset to a receivable over the period in which the other performance obligations in the contract are satisfied by the operator, rather than at the point when construction activity is completed. However, depending on the nature of contractual penalties, judgement may be required to identify the point at which the operator has an unconditional right to receive consideration and would therefore recognise a receivable.

IFRS 15 does not require entities to use the terms 'contract asset' or 'contract liability', but entities must disclose sufficient information so that users of the financial statements can clearly distinguish between unconditional rights to consideration (receivables) and conditional rights to receive consideration (contract assets). *[IFRS 15.109]*. See Chapter 28 at section 10.1.1 for further discussion on the distinction between contract assets and receivables.

Once the operator has an unconditional right to receive consideration, we believe that different approaches may be acceptable regarding measurement of the receivable at initial recognition.

On initial recognition, IFRS 9 generally requires a financial asset to be measured at its fair value (plus transaction costs, for a financial asset not at fair value through profit or loss). *[IFRS 9.5.1.1]*. See Chapter 15 for further discussion of fair value measurement. IFRS 15 requires any difference between the initial measurement of a financial asset in accordance with IFRS 9 and the corresponding amount of revenue recognised under IFRS 15 to be presented as an expense. *[IFRS 15.108]*. Applying this approach, movements in market interest rates between the date of commencement of construction services and the point at which the receivable is initially recognised that impact the fair value of the financial asset would result in the operator recognising an expense on initial recognition of the financial asset.

An alternative approach is based on the view that when an operator enters into a service concession contract accounted for under the financial asset model, it agrees to provide extended payments terms to the grantor for the construction services it provides. All terms and conditions are negotiated between the parties at the time of entering into the contract. The contract asset recognised during the construction phase is therefore a right to consideration at those pre-specified terms and conditions, subject to performance risk. The receivable recognised subsequently is based on the same terms and conditions and is a continuation of the contract asset (without any performance risk). A firm commitment to provide credit under pre-specified terms and conditions is a 'loan commitment' as defined in IFRS 9. *[IFRS 9.BCZ2.2]*. Under IFRS 9, specific requirements apply to loan commitments. Financial assets recognised following a draw down on a loan commitment are generally treated as a continuation of the related commitments instead of as a new financial instrument. *[IFRS 9.BCZ2.3, IFRS 9.B5.5.47]*. See Chapter 45 at section 3.7 for further discussion on assets arising from loan commitments. Accordingly:

- When a receivable is recognised after a contract asset for the same right to consideration (but subject to performance risk) has been recognised, the resulting receivable is treated as a continuation of the contract asset considering the terms and conditions contracted at inception of the contract, rather than as a new financial asset.

  And

- The entity does not measure the receivable at its fair value at the date of initial recognition and does not recognise changes in fair value of the contract asset that result from changes in market interest rates or credit spreads between the inception date of the customer contract and the initial recognition of the receivable. *[IFRS 9.BCZ2.3]*

Applying this approach, the operator would not recognise an expense on initial recognition of the financial asset as a result of any movements in market interest rates between the date of commencement of construction services and the point at which the receivable is initially recognised. Assets and liabilities arising from loan commitments are discussed in Chapter 45 at section 3.7.

How we see it

Once the operator has an unconditional right to receive consideration, we believe that different approaches may be acceptable regarding measurement of the receivable at initial recognition.

If the receivable is recognised at fair value, any movements in market interest rates between the date of commencement of construction services and the point at which the receivable is initially recognised that impact the fair value of the financial asset would result in the operator recognising an expense on initial recognition of the financial asset.

If the receivable is instead treated as a continuation of the contract asset, the operator would not recognise an expense on initial recognition of the financial asset as a result of any movements in market interest rates between the date of commencement of construction services and the point at which the receivable is initially recognised.

We would expect entities to apply either approach consistently to similar arrangements.

As required by IFRS 9, the receivable would subsequently be recognised at amortised cost, at fair value through other comprehensive income, or at fair value through profit or loss, depending upon how it is classified under IFRS 9. *[IFRIC 12.24]*. Measurement at amortised cost requires the receivable to be held in a business model whose objective is to hold financial assets in order to collect contractual cash flows, and requires that those contractual cash flows represent solely payments of principal and interest. *[IFRS 9.4.1.2]*. Any features that introduce a more than *de minimis* exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement would mean that the receivable would not be measured at amortised cost. *[IFRS 9.B4.1.7A, IFRS 9.B4.1.18]*. If the amount due from the grantor is measured at amortised cost or fair value through other comprehensive income, interest income will be recognised, calculated using the effective interest method. *[IFRIC 12.25]*. Classification of financial assets under IFRS 9 is discussed in Chapter 44 at section 1.

The financial asset recognised by the operator will be subject to the impairment requirements of IFRS 9. IFRS 15 also requires that contract assets are assessed for impairment in accordance with IFRS 9. *[IFRS 15.107]*. The impairment requirements of IFRS 9 are discussed in Chapter 47.

Borrowing costs incurred by the operator during the construction phase cannot be capitalised under the financial asset model. *[IFRIC 12.22]*.

Illustration 4-2 below is based on Illustrative Example 1 in IFRIC 12 and illustrates how the financial asset model may be applied. It must, however, be noted that this example deals with only one of many possible types of arrangements seen in practice and is based on an uncomplicated fact pattern. It is important that entities understand and assess all the facts and circumstances of their own service concession arrangements in order to determine the appropriate accounting.

In the Illustration below, the operator recognises a receivable once construction services are complete. As discussed above, IFRS 15 requires that a receivable is recognised only when the operator has an unconditional right to receive consideration, which will be the case only when nothing other than the passage of time is required before payment of the consideration is due. *[IFRS 15.108]*. The Illustration below contains an unstated assumption that this is the case at completion of construction services. However, this may not always be the case in practice.

Illustration 4-2: The Financial Asset Model

Table 1 Concession terms

The terms of the arrangement require an operator to construct a road- completing construction within two years- and maintain and operate the road to a specified standard for eight years (i.e., years 3-10). The terms of the concession also require the operator to resurface the road at the end of year 8. At the end of year 10, the arrangement will end. Assume that the operator identified three performance obligations for construction services, operation services and road resurfacing. The operator estimates that the costs it will incur to fulfil its obligations will be:

	Year	CU
Construction services (per year)	1-2	500
Operation services (per year)	3-10	10
Road resurfacing	8	100

The terms of the concession require the grantor to pay the operator CU200 per year in years 3-10 for making the road available to the public.

For the purpose of this Illustration, it is assumed that all cash flows take place at the end of the year.

Table 2 Contract revenue

The operator recognises contract revenue in accordance with IFRS 15. Revenue- the amount of consideration to which the operator expects to be entitled from the grantor for the services provided- is recognised when (or as) the performance obligations are satisfied.

The total consideration (CU200 in each of years 3-8) is allocated to the performance obligations based on the relative stand-alone selling prices of the construction services, operating services and road resurfacing, taking into the significant financing component, as follows:

	Transaction price allocation (including effect of the significant financing component)
	CU
Construction services (a)	1,050
Operation services (b)	96
Road resurfacing services (c)	110
Total	**1,256**
Implied interest rate (d)	6.18% per year

(a) The operator estimates the relative stand-alone selling price by reference to the forecast cost plus 5%.
(b) The operator estimates the relative stand-alone selling price by reference to the forecast cost plus 20%.
(c) The operator estimates the relative stand-alone selling price by reference to the forecast cost plus 10%.
(d) The implied interest rate is assumed to be the rate that would be reflected in a financing transaction between the operator and the grantor.

Financial asset

During the first two years, the entity recognises a contract asset and accounts for the significant financing component in the arrangement in accordance with IFRS 15. Once the construction is complete, the amounts due from the grantor are accounted for in accordance with IFRS 9 as receivables.

Table 3 Measurement of contract asset/receivable

	CU
Amount due for construction in year 1	525
Contract asset at end of year 1*	**525**
Effective interest in year 2 on contract asset at the end of year 1 (6.18% × CU525)	32
Amount due for construction in year 2	525
Receivable at end of year 2	**1,082**
Effective interest in year 3 on receivable at the end of year 2 (6.18% × CU1,082)	67
Amount due for operation in year 3 (CU10 × (1 + 20%))	12
Cash receipts in year 3	(200)
Receivable at end of year 3	**961**

* No effective interest arises in year 1 because the cash flows are assumed to take place at the end of the year.

Overview of cash flows, statement of comprehensive income and statement of financial position

For the purposes of this example, it is assumed that the operator finances the arrangement wholly with debt and retained profits. It pays interest at 6.7% per year on outstanding debt. If the cash flows and fair values remain the same as those forecast, the operator's cash flows, statement of comprehensive income and statement of financial position over the duration of the arrangement will be as follows.

Table 4 Cash flows (CU)

Year	1	2	3	4	5	6	7	8	9	10	Total
Receipts	-	-	200	200	200	200	200	200	200	200	1,600
Contract costs (a)	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(110)	(10)	(10)	(1,180)
Borrowing costs (b)	-	(34)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(342)
Net inflow/ (outflow)	**(500)**	**(534)**	**121**	**129**	**137**	**147**	**157**	**67**	**171**	**183**	**78**

(a) Table 1
(b) Debt at start of year (table 6) × 6.7%

Table 5 Statement of comprehensive income (CU)

Year	1	2	3	4	5	6	7	8	9	10	Total
Revenue	525	525	12	12	12	12	12	122	12	12	1,256
Contract costs	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(110)	(10)	(10)	(1,180)
Finance income (a)	-	32	67	59	51	43	34	25	22	11	344
Borrowing costs (b)	-	(34)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(342)
Net profit	**25**	**23**	**-**	**-**	**-**	**2**	**3**	**14**	**5**	**6**	**78**

(a) Amount due from grantor at start of year (table 6) × 6.18%
(b) Cash/(debt) (table 6) × 6.7%

Table 6 Statement of financial position (CU)

End of year	1	2	3	4	5	6	7	8	9	10
Amount due from grantor (a)	525	1,082	961	832	695	550	396	343	177	-
Cash/(debt) (b)	(500)	(1,034)	(913)	(784)	(647)	(500)	(343)	(276)	(105)	78
Net assets	**25**	**48**	**48**	**48**	**48**	**50**	**53**	**67**	**72**	**78**

(a) Amount due from grantor at start of year, plus revenue and finance income earned in year (table 5), less receipts in year (table 4).
(b) Debt at start of year plus net cash flows in year (table 4).

4.3 The intangible asset model

If the financial asset model does not apply (i.e., there is no unconditional contractual right to cash or other financial assets), the operator's consideration for its construction services will be an intangible asset. *[IFRIC 12.15]*. As with the financial asset model, the operator cannot have an item of property, plant and equipment because the physical infrastructure is controlled by the grantor (see section 3 above). *[IFRIC 12.11]*. Therefore, the IFRS IC has concluded that the right of an operator to charge users of the public service, for example, the right to collect tolls from a road or a bridge, meets the definition of an intangible asset, that is accounted for in accordance with IAS 38. It is, in effect, a licence 'bought' in exchange for construction services. *[IFRIC 12.17]*.

Consideration is classified as a contract asset during the construction or upgrade period, *[IFRIC 12.19]*, and revenue for construction or upgrade services will be recorded in accordance with IFRS 15. *[IFRIC 12.14]*.

Under the intangible asset model, borrowing costs must be capitalised during the period of construction. *[IFRIC 12.22]*. However, as noted above, IFRIC 12 requires consideration to be classified as a contract asset, rather than an intangible asset, during the construction period. *[IFRIC 12.19]*. In March 2019, the IFRS IC issued an agenda decision relating to the capitalisation of borrowing costs on a constructed good for which revenue was recognised over time. In that agenda decision, the IFRS IC noted that, in the particular fact pattern considered, a contract asset is not a qualifying asset as the intended use of the contract asset is not a use for which it necessarily takes a substantial period of time to get ready.[25] IAS 23 requires capitalisation of borrowing costs that are directly attributable to the acquisition, construction or production of an asset that necessarily takes a substantial period of time to get ready for is intended use or sale. *[IAS 23.8, IAS 23.5]*. Some may argue that there is a tension between the requirement in IFRIC 12 to capitalise interest during the construction phase under the intangible asset model and this agenda decision.

How we see it

We believe that the March 2019 agenda decision discussed above does not override the requirement in IFRIC 12.22 that, under the intangible asset model, borrowing costs must be capitalised during the period of construction.

25 *IFRIC Update*, March 2019, available on the IFRS Foundation's website.

Whilst IFRIC 12 requires consideration to be classified as a contract asset during the construction or upgrade period, Illustrative Example 2 to IFRIC 12 (which is reproduced in Illustration 4-3 below and Illustration 5-2 in section 5.2 below) shows that the contract asset is presented as an intangible asset during the construction phase. *[IFRIC 12.IE15]*.

It is argued that an inevitable consequence of applying the intangible asset model is that there must be an exchange transaction in which the operator receives the intangible right in exchange for its construction services. *[IFRIC 12.BC32]*. As this is an exchange of dissimilar assets, revenue must be recognised in accordance with IFRS 15, which requires the recognition of revenue based on the fair value of the assets received, unless the fair value of the assets received cannot be reasonably estimated. *[IFRIC 12.BC33, IFRS 15.66, IFRS 15.67]*. This means that the operator must establish the fair value of either the intangible asset it receives or the stand-alone selling price of the construction services. *[IFRS 15.67]*.

Under IAS 38, amortisation of an intangible asset begins when the asset is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. *[IAS 38.97]*.

How we see it

We believe that amortisation of the intangible asset recognised by the operator in exchange for construction services would likely commence once construction is complete, and the operator can begin using the licence received in exchange for construction services in order to generate revenues.

In the following Illustration, based on Illustrative Example 2 in IFRIC 12, the operator determines the fair value of the intangible asset indirectly by reference to the stand-alone selling price of the construction services delivered. As with Illustration 4-2 above, it must be noted that this relatively simple example deals with only one of many possible types of arrangements seen in practice and it is important that entities understand and assess the facts and circumstances of their own service concession arrangements in order to determine the appropriate accounting.

Illustration 4-3: The Intangible Asset Model - recording the construction asset

Arrangement terms

The terms of a service arrangement require an operator to construct a road- completing construction within two years- and maintain and operate the road to a specified standard for eight years (i.e., years 3-10). The terms of the arrangement also require the operator to resurface the road when the original surface has deteriorated below a specified condition. The operator estimates that it will have to undertake the resurfacing at the end of year 8. At the end of year 10, the service arrangement will end. The operator estimates that the costs it will incur to fulfil its obligations will be:

Table 1 Contract costs

	Year	CU
Construction services (per year)	1-2	500
Operation services (per year)	3-10	10
Road resurfacing	8	100

The terms of the arrangement allow the operator to collect tolls from drivers using the road. The operator forecasts that vehicle numbers will remain constant over the duration of the contract and that it will receive tolls of CU200 in each of years 3-10.

For the purpose of this Illustration, it is assumed that all cash flows take place at the end of the year.

Intangible asset

The operator provides construction services to the grantor in exchange for an intangible asset, i.e., a right to collect tolls from road users in years 3-10. In accordance with IFRS 15, the operator measures this non-cash consideration at fair value. In this case the operator determines the fair value indirectly by reference to the stand-alone selling price of the construction services delivered.

During the construction phase of the arrangement the operator's contract asset (representing its accumulating right to be paid for providing construction services) is presented as an intangible asset (licence to charge users of the infrastructure). The operator estimates the stand-alone selling price of the construction services to be equal to the forecast construction costs plus 5% margin, which the operator concludes is consistent with the rate a market participant would require as compensation for providing the construction services and for assuming the risk associated with the construction costs. The operator also capitalises borrowing costs during the construction phase as required by IAS 23, at an estimated rate of 6.7%:

Table 2 Initial measurement of intangible asset

	CU
Construction services in year 1 (CU500 × (1 + 5%))	525
Capitalisation of borrowing costs	34
Construction services in year 2 (CU500 × (1 + 5%))	525
Intangible asset at end of year 2	1,084

The intangible asset is amortised over the period in which it is expected to be available for use by the operator, i.e., years 3-10. In this case, the directors determine that it is appropriate to amortise using a straight-line method. The annual amortisation charge is therefore CU1,084 divided by 8 years, i.e., CU135 per year.

Construction costs and revenue

The operator accounts for the construction services in accordance with IFRS 15. It measures revenue at the fair value of the non-cash consideration received or receivable. Thus, in each of years 1 and 2 it recognises in its income statement construction costs of CU500, construction revenue of CU525 (cost plus 5%) and, hence, construction profit of CU25.

Toll revenue

The road users pay for the public services at the same time as they receive them, i.e., when they use the road. The operator therefore recognises toll revenue when it collects the tolls.

The accounting for the operations phase of this example service concession arrangement is discussed in Illustration 5-2 in section 5.2 below.

4.3.1 Amortisation of the intangible asset

The intangible asset will subsequently be accounted for in accordance with IAS 38, *[IFRIC 12.26]*, and the amount at which it is measured initially, i.e., after the exchange transaction, is its cost. *[IAS 38.45]*. It will be amortised on a systematic basis over its useful life, using a method that reflects "...the pattern in which the asset's future economic benefits are expected to be consumed by the entity...". *[IAS 38.97]*. This means that the methods permitted by IAS 38 are available (straight line, diminishing balance or units-of-production). *[IAS 38.98]*. The requirements of IAS 38 are discussed in detail in Chapter 18. Interest methods of amortisation are forbidden. *[IFRIC 12.BC65]*.

The IFRS IC expressly considered units-of-production methods to be appropriate in some circumstances; in March 2006, it was noted in the *IFRIC Update* that the Basis for Conclusions to Exposure Draft D14 *Service Concession Arrangements - The Intangible Asset Model* would be redrafted to avoid the impression that these methods were not allowed.[26] There were still concerns that a units-of-production method could result in lower amortisation in the early years of the asset's operation so IAS 38 itself was amended to remove a statement discouraging methods that might have such a result.[27] This clarifies that there is no prohibition when the method is the most appropriate, whatever the resulting profile of amortisation.

Units-of-production methods are typically considered in the context of toll roads and bridges. Obviously, the method might apply if there is a right to charge a specified number of users. It might also be applied using the estimated number of users, e.g., the number of vehicles that might use a particular road during the concession term, as a basis.

The remaining issue regarding amortisation methods has been whether they could be based on revenue generated by the asset; this depends on the meaning of 'consumption of economic benefits' in the context of intangible assets with finite lives. IAS 38 includes a rebuttable presumption that a method of amortisation based on the revenue expected to be generated from an activity that includes the use of an intangible asset is not appropriate. This is because this method typically reflects factors that are not directly linked to the consumption of the economic benefits embodied in the asset. *[IAS 38.98A]*. See Chapter 18 at section 9.2.2.

Illustration 4-4 below demonstrates the potentially distorting effects for a SCA of basing amortisation on revenue.

26 *IFRIC Update*, March 2006, available on the IFRS Foundation's website.

27 IAS 38 (2007), *Intangible Assets*, IASB, 2007 Bound Volume, para. 98 stated that "there is rarely, if ever, persuasive evidence to support an amortisation method for intangible assets with finite useful lives that results in a lower amount of accumulated amortisation than under the straight-line method." This was removed by Improvements to IFRSs, May 2008.

However, the Board did acknowledge certain 'limited circumstances' that would give rise to an exception to this presumption. Revenue generated can be used to amortise an intangible asset when: *[IAS 38.98A]*

- The rights embodied in that intangible asset are expressed as a measure of revenue

  Or

- It can be demonstrated that revenue and the consumption of economic benefits are 'highly correlated'

The Board did not define what is meant by 'highly correlated', but it describes situations where the asset is 'expressed as a measure of revenue'. A 'highly correlated' outcome would only be achieved where a revenue-based method of amortisation is expected to give a similar answer to one of the other methods permitted by IAS 38. For example, if revenue is earned evenly over the expected life of the asset, the pattern of amortisation would be similar to a straight-line basis.

How we see it

In situations where unit prices are fixed and all production is sold, a revenue-based pattern of amortisation would replicate the use of the units-of-production method. However, when unit prices are not fixed, a revenue-based pattern of amortisation would not provide a similar answer and its use would therefore be inappropriate.

The following Illustration shows how a revenue-based method of amortisation diverges from the units-of-production method when the price per unit is not fixed.

Illustration 4-4: Output-based versus revenue-based amortisation when prices change

Entity Z enters into a twenty-five year SCA over a toll bridge. It recognises an intangible asset of CU20 million and expects the bridge to be used at its full capacity of 100,000 vehicles per year. Tolls will commence at CU10 per vehicle and, under the terms of the SCA, it is allowed to raise prices by 10% every five years. On this basis, the profile of amortisation on a units-of-production method (UoP) and on a revenue-based method would be as follows:

	Units	Charge UoP basis	Revenue	Charge Revenue basis
		CU	CU	CU
Years 1-5	500,000	4,000,000	5,000,000	3,276,000
Years 6-10	500,000	4,000,000	5,500,000	3,604,000
Years 11-15	500,000	4,000,000	6,050,000	3,964,000
Years 16-20	500,000	4,000,000	6,655,000	4,360,000
Years 21-25	500,000	4,000,000	7,320,500	4,796,000
Total	**2,500,000**	**20,000,000**	**30,525,500**	**20,000,000**

Despite an expected constant level of consumption of the asset in the Illustration above, the revenue-based method results in amortisation being delayed until the later periods of the asset's use. This distortion is caused by the increase in price rather than any factor related to the use of the intangible asset.

The Board permits revenue-based amortisation to be used when revenue is "...the predominant limiting factor that is inherent in an intangible asset...". *[IAS 38.98C]*. In other words, revenue determines the useful life of the asset, rather than, for example, a number of years or the number of units produced.

The IASB provided two examples of this circumstance in which revenue earned can be regarded as a measure of consumption of an intangible asset: *[IAS 38.98C]*

(a) A contract may allow the extraction of gold from a mine until total cumulative revenue from the sale of gold reaches CU2 billion.

  Or

(b) The right to operate a toll road could be based on a fixed total amount of revenue generated, based on cumulative tolls that have been charged.

An example of (b) is a SCA, described in section 4.1.2 above, in which an operator enters into a toll bridge concession under which it is permitted to collect revenues from users or the grantor until it achieves a 6% return on its agreed infrastructure spend, at which point the arrangement comes to an end. As explained in section 4.1.2 above, this will be accounted for as an intangible asset because the operator may never achieve the revenue target. In this case, the operator could calculate amortisation based on cumulative revenue as a percentage of total revenue.

The choice of amortisation method is a matter of judgement. In the following extract from its accounting policies, ENGIE SA indicates that it amortises its intangible assets mainly on a straight-line basis.

Practical example 4-1: ENGIE SA (2023) France

2023 MANAGEMENT REPORT AND ANNUAL CONSOLIDATED FINANCIAL STATEMENTS [extract]
03 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]
NOTE 13 FIXED ASSETS [extract]
13.2 Intangible assets [extract]
Accounting standards [extract]

Amortization

Intangible assets are amortized on the basis of the expected pattern of consumption of the estimated future economic benefits embodied in the asset. Amortization is calculated mainly on a straight-line basis over the following useful lives:

	Useful life	
Main depreciation periods (years)	**Minimum**	**Maximum**
Concession rights	10	30
Customer portfolio	3	20
Other intangible assets	1	50

Intangible assets with an indefinite useful life are not amortized but are tested for impairment annually.

4.3.2 Impairment testing during the construction phase

As noted in section 4.3 above, IFRS 15 requires the operator to classify the consideration given by the grantor as a contract asset during the construction phase. *[IFRIC 12.19]*. Contract assets are subject to the impairment requirements of IFRS 9. *[IFRS 15.107]*.

How we see it

Operators may need to apply judgement in determining how to test the contract asset for impairment, given that the contract asset is expected to be realised in the form of an intangible asset, rather than as a receivable or cash. This will include consideration of whether and how they can use the value of the underlying asset to which they are entitled as a proxy for cash flows in order to determine expected credit losses on the contract asset.

The impairment requirements of IFRS 9 are discussed in Chapter 47, and impairment of non-cash consideration contract assets is discussed in Chapter 28 at section 10.1.3.

4.4 Revenue recognition implications of the two models

Extract from IFRIC 12

12 Under the terms of contractual arrangements within the scope of this Interpretation, the operator acts as a service provider. The operator constructs or upgrades infrastructure (construction or upgrade services) used to provide a public service and operates and maintains that infrastructure (operation services) for a specified period of time.

[IFRIC 12.12].

IFRIC 12 requires the operator to recognise and measure revenue in accordance with IFRS 15 for the services it performs. *[IFRIC 12.13]*.

While the nature of the consideration (i.e., a financial asset, an intangible asset, or a mixture of the two) determines how revenue is recognised during the operating phase, *[IFRIC 12.13]*, under both models, the revenue that is recognised by the operator for the construction or upgrade services is the same and equals the fair value of these construction services.

There is nonetheless a major difference in the way in which revenue is measured under the two models during the operating phase of the arrangement. Under the financial asset model, total revenue over the concession term will be the same as the total cash inflows under the contract. By contrast, the fair value of the intangible asset is recognised as revenue under the intangible asset model, so total revenue measured using this model will be higher by this amount. The consequences of the two models can be demonstrated by the following simple example:

Illustration 4-5: Revenue under the financial asset and intangible models

An operator builds a road at a cost of CU100. The construction profit is CU10 and total cash inflows over the life of the concession are CU200. Assume that there is no significant financing component in the arrangement.

Under the financial asset model, the operator will recognise construction revenue of CU110 and a receivable of CU110. Of the future cash inflows of CU200, CU110 will be treated as repaying the receivable, with the remaining CU90 being recognised as revenue over the life of the concession. Total revenue will be CU200.

Under the intangible asset model, the operator will recognise construction revenue of CU110, an intangible asset of CU110, and a construction profit of CU10. Over the life of the concession, the intangible asset of CU110 would be amortised against revenues (which in this case would be from users) of CU200. The net position is the same as in the financial asset case, but total revenues will be CU310 rather than CU200.

It is fair to say that this proved highly controversial. In fact, the September 2004 *IFRIC Update* stated that "…The majority of the IFRIC strongly disliked this outcome…".[28] However, the IFRS IC maintained that this is the appropriate application of accounting standards to the arrangements and is consistent with the treatment generally accorded to barter transactions, *[IFRIC 12.BC35]*, although, of course, there are no other sectors where barter transactions are fundamental to the arrangement.

4.5 'Bifurcation' - single arrangements that contain both financial and intangible assets

The IFRS IC concluded that it may be necessary in certain circumstances to divide the operator's right to cash flows into a financial asset and an intangible asset. *[IFRIC 12.18]*. The March 2006 *IFRIC Update* reported that "…With this change, the proposed amendment would better reflect the economic reality of concession arrangements: to the extent that the operator is remunerated for its construction services by obtaining a contractual right to receive cash from, or at the direction of, the grantor, the operator would recognise a financial asset and, to the extent that the operator receives only a licence to charge users, it would recognise an intangible asset…".[29]

The Basis for Conclusions on IFRIC 12 explains more of the reasoning and potential impact. In some arrangements, both parties to the contract share the risk (demand risk) that the cash flows generated by the project will not be sufficient to recover the operator's capital investment. A common mechanism for achieving this is where the grantor pays partly by a financial asset (i.e., the grantor will pay cash for the services provided) but gives the operator the right to charge for services (i.e., the operator has an intangible asset). The operator's infrastructure asset is to be split into a financial asset component for any guaranteed amount of cash and an intangible asset for the remainder. *[IFRIC 12.18, IFRIC 12.BC53]*.

This is common in transport concessions, e.g., a rail system paid for partly by grantor subsidy and partly by the payment of fares. This gives rise to difficult matters of judgement. It may not be clear how much of the arrangement is a financial asset and, therefore, where to draw the boundary between the two assets.

The following Illustration, based on Illustrative Example 3 in IFRIC 12, illustrates how an entity may account for a service concession arrangement under the bifurcated model. As with Illustration 4-2 and Illustration 4-3 above, it must be noted that this example deals with only one of many possible types of arrangements seen in practice and it is important that entities understand and assess the facts and circumstances of their own service concession arrangements in order to determine the appropriate accounting. In the Illustration below, the operator recognises a receivable and an intangible asset once construction services are complete. As discussed in section 4.2 above, IFRS 15 requires that a receivable is recognised only when the operator has an unconditional right to receive consideration, which will be the case only when nothing other than the passage of time is required before payment of the consideration is due. *[IFRS 15.108]*. We therefore assume that the example below contains an unstated assumption that this is the case at completion of construction services. However, this may not always be the situation in practice.

28 *IFRIC Update*, September 2004, available on the IFRS Foundation's website.

29 *IFRIC Update*, March 2006, available on the IFRS Foundation's website.

Illustration 4-6: The bifurcated model

Arrangement terms

The terms of a service arrangement require an operator to construct a road- completing construction within two years- and maintain and operate the road to a specified standard for eight years (i.e., years 3-10). The terms of the arrangement also require the operator to resurface the road when the original surface has deteriorated below a specified condition. The operator estimates that it will have to undertake the resurfacing at the end of the year 8. At the end of year 10, the service arrangement will end. The operator estimates that the costs it will incur to fulfil its obligations will be:

Table 1 Contract costs

	Year	CU
Construction services (per year)	1-2	500
Operation services (per year)	3-10	10
Road resurfacing	8	100

The operator estimates the consideration in respect of construction services to be CU1,050 by reference to the stand-alone selling price of those services, which it estimates at forecast cost plus 5%. The terms of the arrangement allow the operator to collect tolls from drivers using the road. In addition, the grantor guarantees the operator a minimum amount of CU700 and interest at a specified rate of 6.18% to reflect the timing of cash receipts. The operator forecasts that vehicle numbers will remain constant over the duration of the contract and that it will receive tolls of CU200 in each of years 3 to 10. All cash flows occur at the end of the year.

Dividing the arrangement

The contractual right to receive cash from the grantor for the services and the right to charge users for the public services are regarded as two separate assets under IFRS accounting standards. Therefore, in this arrangement it is necessary to divide the operator's contract asset during the construction phase into two components- a financial asset component based on the guaranteed amount and an intangible asset for the remainder. When the construction services are complete, the two components of the contract asset would be classified and measured as a financial asset and an intangible asset accordingly.

Table 2 Dividing the operator's consideration

Year	Total	Financial asset		Intangible asset
Construction services in year 1	525	350		175
Construction services in year 2	525	350		175
Total construction services	1,050	700		350
	100%	*67%*	*(a)*	*33%*
Finance income, at specified rate of 6.18% (see table 3)	22	22		-
Borrowing costs capitalised (interest paid in years 1 and 2 × 33%) (see table 7)	11	-		11
Total fair value of the operator's consideration	**1,083**	**722**		**361**

(a) Amount guaranteed by the grantor as a proportion of the construction services.

Financial asset

During the first two years, the entity recognises a contract asset and accounts for the significant financing component in the arrangement in accordance with IFRS 15. Once the construction is complete, the amount due from, or at the direction of, the grantor in exchange for the construction services is accounted for in accordance with IFRS 9 as a receivable. The example assumes that there has been no change in market interest rates during the construction phase of the arrangement.

Table 3 Measurement of the contract asset/receivable

	CU
Construction services in year 1 allocated to the contract asset	350
Contract asset at end of year 1	**350**
Construction services in year 2 allocated to the contract asset	350
Interest in year 2 on contract asset at end of year 1 (6.18% × CU350)	22
Receivable at end of year 2	**722**
Interest in year 3 on receivable at end of year 2 (6.18% × CU722)	45
Cash receipts in year 3 (see table 5)	(117)
Receivable at end of year 3	**650**

Intangible asset

In accordance with IAS 38, the operator recognises the intangible asset at cost, i.e., the fair value of the consideration received or receivable. During the construction phase of the arrangement, the portion of the operator's contract asset that represents its accumulating right to be paid amounts in excess of the guaranteed amount for providing construction services is presented as a right to receive a licence to charge users of the infrastructure. The operator estimates the stand-alone selling price of the construction services as equal to the forecast construction costs plus 5%, which the operator concludes is consistent with the rate that a market participant would require as compensation for providing the construction services and for assuming the risk associated with the construction costs. It is also assumed that, in accordance with IAS 23, the operator capitalises the borrowing costs, estimated at 6.7%, during the construction phase.

Table 4 Initial measurement of the intangible asset

	CU
Construction services in year 1	175
Borrowing costs (interest paid in years 1 and 2 × 33%) (see table 7)	11
Construction services in year 2	175
Intangible asset at the end of year 2	**361**

In accordance with IAS 38, the intangible asset is amortised over the period in which it is expected to be available for use by the operator, i.e., years 3-10. The depreciable amount of the intangible asset (CU361 including borrowing costs) is allocated using a straight-line method. The annual amortisation charge is therefore CU361 divided by 8 years, i.e., CU45 per year.

Revenue and costs

The operator provides construction services to the grantor in exchange for a financial asset and an intangible asset. Under both the financial asset model and intangible asset model, the operator accounts for the construction services in accordance with IFRS 15. Thus, in each of years 1 and 2 it recognises in profit or loss construction costs of CU500 and construction revenue of CU525.

Toll revenue

The road users pay for the public services at the same time as they receive them, i.e., when they use the road. Under the terms of this arrangement the cash flows are allocated to the financial asset and intangible asset in proportion, so the operator allocates the receipts from tolls between repayment of the financial asset and revenue earned from the intangible asset.

Table 5 Allocation of toll receipts

Year	CU
Guaranteed receipt from grantor	700
Finance income (see table 8)	237
Total	**937**
Cash allocated to realisation of the financial asset per year (CU937 ÷ 8 years)	117
Receipts attributable to intangible asset (CU200 × 8 years - CU937)	663
Annual receipt from intangible asset (CU663 ÷ 8 years)	83

Resurfacing obligations

The operator's resurfacing obligation arises as a consequence of use of the road during the operation phase. It is recognised and measured in accordance with IAS 37, i.e., at the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. It is assumed that the terms of the operator's contractual obligation are such that the best estimate of the expenditure required to settle the obligation at any date is proportionate to the number of vehicles that have used the road by that date and increases by CU17 each year. The operator discounts the provision to its present value in accordance with IAS 37. The charge recognised each period in profit or loss is:

Table 6 Resurfacing obligation (CU)

Year	3	4	5	6	7	8	Total
Obligation arising in year (CU17 discounted at 6%)	12	13	14	15	16	17	87
Increase in earlier years' provision arising from passage of time	0	1	1	2	4	5	13
Total expense recognised in profit or loss	**12**	**14**	**15**	**17**	**20**	**22**	**100**

Overview of cash flows, statement of comprehensive income and statement of financial position

For the purposes of this example, it is assumed that the operator finances the arrangement wholly with debt and retained profits. It pays interest at 6.7% per year on outstanding debt. If the cash flows are fair values remain the same as those forecast, the operator's cash flows, statement of comprehensive income and statement of financial position over the duration of the arrangement will be as follows:

Table 7 Cash flows (CU)

Year	1	2	3	4	5	6	7	8	9	10	Total
Receipts	-	-	200	200	200	200	200	200	200	200	1,600
Contract costs (a)	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(110)	(10)	(10)	(1,180)
Borrowing costs (b)	-	(34)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(342)
Net inflow/ (outflow)	**(500)**	**(534)**	**121**	**129**	**137**	**147**	**157**	**67**	**171**	**183**	**78**

(a) Table 1
(b) Debt at start of year (table 9) × 6.7%

Table 8 Statement of comprehensive income (CU)

Year	1	2	3	4	5	6	7	8	9	10	Total
Revenue on construction	525	525	-	-	-	-	-	-	-	-	1,050
Revenue allocated to operation services	-	-	83	83	83	83	83	83	83	83	663
Finance income (a)	-	22	45	40	35	30	25	19	13	7	237
Amortisation	-	-	(45)	(45)	(45)	(45)	(45)	(45)	(45)	(46)	(361)
Resurfacing expense	-	-	(12)	(14)	(15)	(17)	(20)	(22)	-	-	(100)
Construction costs	(500)	(500)	-	-	-	-	-	-	-	-	(1,000)
Other contract costs (b)	-	-	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(80)
Borrowing costs (c) (table 7)	-	(23)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(331)
Net profit	**25**	**24**	**(8)**	**(7)**	**(5)**	**(2)**	**-**	**2**	**22**	**27**	**78**

(a) Interest on receivable
(b) Table 1
(c) In year 2, borrowing costs are stated net of amount capitalised in the intangible (see table 4).

Table 9 Statement of financial position (CU)

End of year	1	2	3	4	5	6	7	8	9	10
Receivable (a)	350	722	650	573	491	404	312	214	110	-
Intangible asset (a)	175	361	316	271	226	181	136	91	46	-
Cash/(debt) (b)	(500)	(1,034)	(913)	(784)	(647)	(500)	(343)	(276)	(105)	78
Resurfacing obligation	-	-	(12)	(26)	(41)	(58)	(78)	-	-	-
Net assets	**25**	**49**	**41**	**34**	**29**	**27**	**27**	**29**	**51**	**78**

(a) Asset is a contract asset in years 1 and 2 until construction is completed
(b) Debt at start of year plus net cash flow in year (table 7)

The example above shows the operator's contractual obligation to resurface the road being recognised and measured in accordance with IAS 37. The accounting for maintenance costs during the operations phase is discussed in section 5.2 below.

4.6 Accounting for residual interests

Unless the infrastructure in a service concession arrangement is used for the whole of its useful life (within scope of IFRIC 12 - see section 3.2 above), there will be a residual interest at the end of the contract that will be controlled by the grantor. The way in which the grantor controls the residual interest will affect the way in which the operator accounts for it. If the operator has an unconditional contractual right to cash (or another financial asset) for the residual interest in the infrastructure, this right will be a financial asset. This is unaffected by the basis on which the consideration is calculated.

There are many different arrangements over residual interests in the infrastructure at the end of the concession term. The grantor may control the residual via:

(a) An obligation to purchase the infrastructure from the operator regardless of the pricing terms (fair value, net book value, a notional amount or zero)

(b) Other rights, e.g., deciding who will operate the residual interests at the end of the initial service concession arrangement either by granting the operator a new term or selecting a new party to take on the assets, regardless of whether payments are made by the grantor or by the new operator at the direction of the grantor

Or

(c) The grantor has an option to acquire the assets on similar bases to (a) but if this is not exercised then the operator may retain them

The implications of grantor options and control of the residual interest are discussed in section 3.2 above.

If the terminal arrangements fall within (a) above the operator will have an unconditional contractual right to cash (unless the infrastructure must be returned for no consideration). It will recognise a financial asset, initially at fair value, which will then be accounted for according to the relevant classification under IFRS 9 (see section 4.2 above). If the financial asset is measured at amortised cost or fair value through other comprehensive income under IFRS 9, then interest will be calculated using the effective interest method. At the end of the contract the financial asset in respect of the residual interest will be stated at the operator's best estimate of the amount receivable.

Where the grantor has a right to put in place other arrangements, as in (b) above, the operator would only have an unconditional right to cash (i.e., a financial asset) after the grantor terminates the operator's involvement in the concession (by letting the contract lapse or by selecting a new party to take on the assets) if such termination will result in a payment to the operator. To the extent that the grantor can avoid any obligation to pay cash by allowing the concession term to continue, the operator has an intangible asset. In this scenario, the operator has a right to receive economic benefits either in the form of cash or continuing use of the infrastructure at the end of the concession. The existence of such extension rights would have to be considered when determining the term of the concession arrangement.

If the arrangement is of the type described in (c), then the operator's residual interest is not a financial asset. Nor does it have a residual interest in the underlying property, plant and equipment because this is an arrangement within the scope of IFRIC 12 and the entity cannot recognise the underlying assets, in whole or in part. *[IFRIC 12.11]*. The only option is to recognise an intangible asset.

How we see it

The operator must account for its residual interests as a financial asset or an intangible asset based on the contractual rights, whatever model is being applied to its construction services. This is similar to the explicit requirements for upgrade services set out in IFRIC 12.15 and described in section 5.1 below

As described in section 5.1 below, IFRIC 12 recognises that entities account for upgrade services in accordance with IFRS accounting standards, meaning that revenue must be recognised on the basis of the contract terms related to the provision of those upgrade services regardless of what determinations were made in relation to the construction services, including the accounting model applied. *[IFRIC 12.14]*. We believe that the same principle applies to the operator's accounting for its residual interest. The result is that an entity that has recognised an intangible asset for the major part of its construction services might have to recognise a financial asset for the residual interests - or *vice versa* if its construction services have been accounted for as a financial asset. This treatment is a variation of the bifurcation described in section 4.5 above except that the financial asset relates only to the residual interest in the infrastructure rather than to a portion of the consideration receivable for the infrastructure as a whole. The residual rights will be taken into account in calculating the revenue receivable under the contract.

As the termination arrangements can be complex, care will have to be taken to ensure that the effects are fully analysed.

Illustration 4-7: Contractual rights to cash in termination arrangements

The facts of the SCA are as in Illustration 3-1 above. At the end of the term, the grantor will either pay for the infrastructure assets at their net book value, determined on the basis of the contract, or it may decide to grant a new SCA on the basis of a competitive tender, which will exclude the current operator. If the grantor elects to do the latter, the operator will be entitled to the lower of the following two amounts:

(a) The net book value of the infrastructure, determined on the basis of the contract

And

(b) The proceeds of a new competitive bidding process to acquire a new contract

Although the operator cannot enter the competitive tender, it also has the right to enter into a new concession term but in order to do so, it must match the best tender offer made. It has to pay to the grantor the excess of the best offer (b) above the amount in (a); should the tender offer be lower than (a), it will receive an equivalent refund.

In this arrangement, the operator has a contractual right to cash that is recognised as a financial asset. It has a right to receive the lower of (a) and (b). It may choose to use its right to cash to settle part or all of the price of a new concession agreement but this does not affect the fact that it has a right to cash. The financial asset will be initially measured at its fair value, and subsequently at fair value through profit or loss because the contractual cash flows of the financial asset do not represent solely payments of principal and interest. *[IFRS 9.4.1.2]*. Classification of financial assets under IFRS 9 is discussed in Chapter 44 at section 1.

The example above also illustrates that calculating the fair value of the contractual right to cash may be complex as it must take account of a number of different estimates, including the net book value of the infrastructure at the end of the contract, as well as the options available to the parties to the contract.

4.7 Accounting for contractual payments to be made by an operator to a grantor

Many arrangements require an entity to make payments to the grantor during the course of the SCA. These payments take two main forms:

(a) Payments related to the use of tangible assets, including:
   (i) Payments to the grantor or third parties for making assets available (such as trains and buses) in order to provide the services required by the concession contract
   (ii) Payments to a third party for the construction and making available of assets (such as rolling stock) that pass to the grantor at the end of the concession term
   (iii) Payments to the grantor for making available land on which the infrastructure assets are constructed or situated

   Or

(b) Fees payable to the grantor for the right to operate the concession, which can be described as concession fees, development fees or access charges

It is possible that some of these payments could be for the right to use assets controlled by the operator itself or the concession payment could relate to a distinct good or service that is separate from the concession arrangement.

In July 2016, the IFRS IC was asked to consider how such payments are accounted for, as follows:

Frequently asked questions

Question 4-1: How does an operator account for payments it makes to a grantor in a service concession arrangement within the scope of IFRIC 12?

The IFRS IC observed the following in circumstances other than those in which the operator is collecting amounts (for example, sales taxes) on behalf of, and remitting them to, the grantor:

(a) If payments made by an operator to a grantor are for a right to a good or service that is separate from the service concession arrangement, the operator accounts for those payments by applying the applicable IFRS accounting standards.

(b) If payments are for the right to use an asset that is separate from the infrastructure within the scope of IFRIC 12, the operator assesses whether the arrangement contains a lease. If the arrangement contains a lease, the operator accounts for those payments by applying IFRS 16.

(c) If payments are neither for the right to a separate good or service nor a separate right to use an asset that is a lease, then accounting for those payments should depend on whether the SCA falls within the financial asset model, the intangible asset model or is a hybrid. This means that the payments will be reflected in the carrying value of the appropriate concession asset, as follows:

  (i) If the SCA is accounted for under the financial asset model, then the concession payment is a reduction to of the transaction price, applying the requirements in IFRS 15.70 to 72 (as illustrated in section 4.7.2 below).

  (ii) If the intangible asset model applies, then the concession payment is part of the cost of acquiring the intangible asset recognised for the right to charge users of the service.

  (iii) If the operator has both a right to charge users of the public service and a contractual right to receive cash from the grantor, then the entity assesses the extent to which the concession payment represents an adjustment to the overall consideration receivable or whether it is consideration for the intangible asset element.[30]

The application guidance in AG7 and AG8 of IFRIC 12 may be relevant to an operator in assessing whether an asset is separate from the infrastructure within scope of IFRIC 12. This application guidance is considered in section 3.4 above, in the context of partially regulated assets.

The recommended treatment under the financial asset model is predicated on the fact that the operator has a contractual right to receive cash from the grantor and that payments between the parties are all part of this single relationship, however described. In this regard, payments to the grantor will include amounts paid to a related private sector entity to which responsibility for the service has been devolved. *[IFRIC 12.3]*.

Under the IFRS IC's approach for the intangible asset model, payments to the grantor that are not for a right to a good or service that is separate from the SCA, and are not an embedded lease, represent consideration for the concession, i.e., part of the cost of the intangible asset recognised.

4.7.1 Accounting for variable payments in a service concession

Some contracted payments, particularly concession fees, vary with a measure of usage of the concession asset or with another feature of the arrangement. Whilst the IFRS IC was able to reach a consensus on the treatment of concession fees that do not depend on future activity, as noted in section 4.7 above, it has found the issue of variable payments more challenging.

The topic of variable payments for an asset purchase was discussed by the IFRS IC between 2011 and 2016, and an agenda decision was published in March 2016. The IFRS IC's discussions considered both the accounting at the date of purchasing the asset and subsequently, and distinguished between those variable payments that depend on the purchaser's future activity and those that do not. The IFRS IC determined that the issue was too broad for it to address within the confines of existing standards and recommended that the IASB address the accounting for variable payments comprehensively. In May 2016, the IASB tentatively agreed that this issue would be included in the research pipeline between 2017 and 2021. At the time of writing this is not listed as an active research project on the IASB's work plan.

30 *IFRIC Update*, July 2016, available on the IFRS Foundation's website.

How we see it

In light of the discussions held by the IFRS IC; and in the absence of clear guidance in the final agenda decision, entities will need to develop and apply an accounting policy in respect of whether and when the obligation to make contingent payments should be recognised as a liability. In doing so, entities will need to apply the hierarchy in IAS 8. The policy selected should result in information that is relevant and reliable in the particular circumstances and must be consistently applied to similar transactions. Different payments may have different types of variability. Therefore, it might be appropriate for an entity to have different policies for dissimilar transactions.

If information about the selected accounting policy is expected to be material to users of the financial statements, that accounting policy information should be disclosed.

The IFRS IC's deliberations on the treatment of variable payments for the separate acquisition of intangible assets is also discussed in Chapter 18 at section 4.5. Operators in a service concession often treat contingent payments that vary in relation to future activity as executory and expense them as incurred.

4.7.2 Accounting for contractual payments under the financial asset model

If the financial asset model applies then the IFRS IC agreed that unless the contractual payments relate to the right to use assets controlled by the operator itself or relate to a distinct good or service that is distinct from the service concession arrangement, the contractual payment is accounted for as a reduction in the overall consideration received, i.e., it is an adjustment to the fair value of the consideration given by the grantor[31] (see section 4.7 above). Another way of expressing this is that payments from the grantor reduce the financial asset while payments to the grantor increase that asset; both will also affect the amount of interest accrued on the outstanding balance. This applies whether the payment is for the right of access to an asset or described as a concession fee.

Illustration 4-8: Contractual payments made to a grantor under the financial asset model

Entity A enters into a 10 year concession agreement requiring it to construct a school and be responsible for operations services (including maintenance, utilities, cleaning and catering). After a 2 year construction period, the entity will receive CU300 per year during years 3-10, to operate the asset, after which the concession will cease. The entity must pay CU30 per year for the use of the land on which the school is built. Entity A concludes that the land use charge does not relate to a distinct good or service that is distinct from the service concession itself and does not give the entity a right to use an asset that is separate from the infrastructure.

The entity's estimated contract costs and contractual payments are as follows:

		Annual charge	Total
	Year	CU	CU
Construction services	1-2	500	1,000
Operation services	3-10	100	800
Land use charge	1-10	30	300
Total cash paid	**1-10**		**2,100**

The operating cash flows under the contract are as follows:

Year	1	2	3	4	5	6	7	8	9	10
	CU	CU	CU	CU	CU	CU	CU	CU	CU	CU
Concession consideration	-	-	300	300	300	300	300	300	300	300
Construction and operation costs	(500)	(500)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)
Land use charge	(30)	(30)	(30)	(30)	(30)	(30)	(30)	(30)	(30)	(30)
Net cash flows	**(530)**	**(530)**	**170**	**170**	**170**	**170**	**170**	**170**	**170**	**170**

31 *IFRIC Update*, July 2016, available on the IFRS Foundation's website.

The entity recognises revenue in accordance with IFRS 15 and estimates that the stand-alone selling price of its services and total revenue from those services is as follows:

	Estimated stand-alone selling price			Total
				CU
Construction	Forecast cost	+	5%	1,050
Operation and maintenance	Forecast cost	+	15%	920
Total revenue				1,970
Lending rate to grantor	2.25% per year			

Under the financial asset model, the land use charge is treated as an adjustment to the transaction price and is not treated as an expense. Accordingly, the gross concession profit is calculated as follows:

Year	1	2	3	4	5	6	7	8	9	10	Total
	CU	CU	CU	CU	CU	CU	CU	CU	CU	CU	CU
Concession revenue*	525	525	115	115	115	115	115	115	115	115	1,970
Construction costs	(500)	(500)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(1,800)
Finance income	6	19	24	21	18	15	12	8	5	3	130
Concession profit*	**31**	**44**	**39**	**36**	**33**	**30**	**27**	**23**	**20**	**18**	**300**

* Concession revenue comprises revenue from construction and operation and maintenance services, less the land use charge.

** Concession profit totals CU300, which represents the total consideration received for services (CU2,400), less the land use charge of CU300, and construction costs of CU1,800. In the income statement this is analysed as:

	CU
Concession revenue	1,970
Construction costs	(1,800)
Finance income	130
Total	300

The contract asset/financial asset is computed as follows, applying an effective interest rate of 2.25%.

Year	1	2	3	4	5	6	7	8	9	10
	CU	CU	CU	CU	CU	CU	CU	CU	CU	CU
Opening balance	0	561	1,135	1,004	870	733	592	449	302	152
Additions	525	525	115	115	115	115	115	115	115	115
Net cash	30	30	(270)	(270)	(270)	(270)	(270)	(270)	(270)	(270)
Finance income*	6	19	24	21	18	15	12	8	5	3
Closing balance	**561**	**1,135**	**1,004**	**870**	**733**	**592**	**449**	**302**	**152**	**-**

* Finance income is calculated on the average debtor balance outstanding and assumes that the same interest rate is applied to both the contract asset and receivable.

4.7.3 Accounting for contractual payments under the intangible asset model

Under the intangible asset model, concession payments would be treated in accordance with IAS 38 as part of the consideration for the intangible asset.

While lease-type costs and land use charges can be part of any concession arrangement, concession fees (however called) are much more commonly a feature of arrangements which follow the intangible asset model. This is unsurprising as they are in substance payments made by the operator for the right to charge users of the concession infrastructure.

The IFRS IC have noted that unless the contractual payments relate to the right to use assets controlled by the operator itself or relate to a distinct good or service that is distinct from the service concession arrangement, the concession payment represents additional consideration for the concession right (i.e., part of the cost of the intangible asset recognised) - see section 4.7 above.

4.8 Contract acquisition and mobilisation costs

Given the scale of many service concession arrangements, operators often incur significant bid costs, pre-contract costs and mobilisation costs.

IFRS 15 specifies the accounting treatment for costs that an entity incurs to obtain and fulfil a contract to provide goods or services to customers, if those costs are not within the scope of another IFRS accounting standard. *[IFRS 15.8]*.

4.8.1 Costs to obtain a contract

IFRS 15 requires that incremental costs of obtaining a contract with a customer are recognised as an asset if the entity expects to recover them, either directly (i.e., reimbursement under the contract), or indirectly (i.e., through the margin inherent under the contract). *[IFRS 15.91]*. Incremental costs of obtaining a contract are those that the entity would not have incurred if the contract had not been obtained, such as sales commission. *[IFRS 15.92]*. Costs incurred to obtain a contract that are not incremental costs must be expensed as incurred, unless they are explicitly chargeable to the customer regardless of whether the contract is obtained. *[IFRS 15.93]*. Many of the costs that an operator incurs in bidding for a service concession contract, such as the fixed salaries of employees involved in drafting the tender document, and legal due diligence fees, may not meet the definition of incremental costs under IFRS 15 and therefore must be expensed as incurred, even if the operator expects to be successful in bidding for the service concession and expects to be able to indirectly recover those costs through the margin in the service concession contract over the term of the arrangement.

In determining the appropriate accounting treatment for costs to obtain a service concession that are not explicitly chargeable regardless of obtaining the contract, the key judgements are made in the following order:

- Are the costs within the scope of another IFRS accounting standard? If so, apply that standard.
- Are the costs incremental (i.e., would not have occurred if the contract had not been obtained)? Costs that are not incremental are expensed.
- Are the incremental costs expected to be recovered? To the extent that incremental costs are not expected to be recoverable, they are expensed as incurred.

Costs to obtain a contract with a customer are discussed in Chapter 28 at section 9.3.1.

4.8.2 Pre-contract costs

Pre-contract costs incurred by the operator of a service concession may include costs incurred in designing financial models and planning infrastructure improvements for tender purposes, costs incurred in undertaking site surveys, and similar expenses. Such costs will often result in no future economic benefit for the operator unless the contract is obtained. As discussed in Chapter 28 in section 9.3.2, pre-contract costs that are incurred in anticipation of a specific contract are first be evaluated for capitalisation under other accounting standards (e.g., IAS 2 *Inventories*, IAS 16, or IAS 38). Costs not addressed under other IFRS accounting standards are capitalised under IFRS 15 only if they meet all of the following criteria of a cost incurred to fulfil a contract:

(a) The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (e.g., costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved).

(b) The costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future.

And

(c) The costs are expected to be recovered. *[IFRS 15.95]*.

The need to consider first the requirement of other relevant IFRS accounting standards is significant, for example, where another standard requires costs of a similar nature to be expensed. As noted in section 4.8.3 below, these requirements are not overridden on the basis that the costs were incurred in the context of a service concession arrangement.

Criteria (b) and (c) above are to ensure that only those costs that meet the definition of an asset are recognised as such. *[IFRS 15.BC308]*. In the context of service concessions, costs for pre-designing a bespoke piece of equipment or infrastructure for the concession (e.g., a tramway or a depot for electrical buses) are an example of such costs.

4.8.3 Mobilisation costs

An operator may also incur significant mobilisation costs in moving personnel, equipment and supplies as it takes on the service concession. These costs are incurred to ensure that the entity is able to fulfil its promise to the customer in a contract, rather than transferring a good or service to the customer. That is, they do not represent a promised good or service in its own right. The assessment of whether mobilisation costs can be capitalised will depend on the specific facts and circumstances and may require significant judgement. Entities need to ensure that the costs to be capitalised are within the scope of IFRS 15; and meet all of the criteria of a cost incurred to fulfil a contract set out in section 4.8.2 above.

Particular care must be taken where costs of a similar nature to those being considered in the service concession arrangement fall under the scope of another IFRS accounting standard. For example, IAS 38 cites training costs, expenditure on advertising and promotional activities, and expenditure on start-up activities not themselves qualifying for inclusion in the cost of property, plant and equipment in accordance with IAS 16 as examples of expenditure that is recognised as an expense when it is incurred. *[IAS 38.69]*. In March 2020, the IFRS IC considered a question about the interaction of the above requirements in relation to staff training to deliver outsourced services for a customer. The IFRS IC concluded that, in the fact pattern described in the request, the entity recognises the training costs to fulfil the contract with the customer as an expense when incurred. The IFRS IC noted that the entity's ability to charge to the customer the costs of training does not affect that conclusion.[32]

Mobilisation costs are discussed in Chapter 28 at section 9.3.2.

4.8.3.A Mobilisation costs are excluded from input measures of contract progress

Where an operator determines that a performance obligation is satisfied over time, IFRS 15 requires selection of a revenue recognition method to measure progress. *[IFRS 15.39]*. If the operator selects a method based on costs incurred, they must exclude from their measure of progress those costs that do not depict the entity's performance in transferring a good or service to the customer. *[IFRS 15.B19]*. An example may be costs incurred in mobilisation activities that do not transfer a good or service to the grantor and from which the grantor receives little or no benefit. Measurement of revenue recognised over time is discussed in Chapter 28 at section 7.1.4.

4.9 Onerous performance obligations within a contract

As discussed in section 4.1.1.D above, IFRS 15 generally requires the transaction price in a contract with a customer to be allocated to each performance obligation in proportion to their relative stand-alone selling prices. *[IFRS 15.74]*. This allocation is done at contract inception and is generally not updated unless there is a change to the transaction price after contract inception. If an operator were to incur unexpected costs during the construction phase of a service concession arrangement and could not pass those additional costs on to the grantor, the operator may expect to incur a loss on the construction services performance obligation, whilst still expecting to make a profit on the operation services performance obligation. IFRIC 12 requires operators to account for construction, upgrade and operation services in accordance with IFRS 15. *[IFRIC 12.14, IFRIC 12.20]*. As IFRS 15 contains no specific requirements to address contracts with customers that have become onerous, IAS 37 applies to such contracts. *[IAS 37.5(g)]*.

How we see it

Since the definition of an onerous contract in IAS 37 refers only to a contract, the unit of account to determine whether an onerous contract exists is the contract itself, rather than the performance obligations identified in accordance with IFRS 15. As a result, the operator would not recognise an onerous contract provision unless the entire remaining contract was onerous.

Contracts with customers that are, or have become, onerous are discussed further in Chapter 27 at section 6.2.2.

32 *IFRIC Update*, March 2020, available on the IFRS Foundation's website.

5 Revenue and expenditure during the operations phase of the concession agreement

So far, we have described the recognition and measurement of the infrastructure asset in the accounts of the operator under the two models. A significant issue in practice is that service concession arrangements are composite transactions. They usually have a long duration (twenty-five to thirty years is not uncommon) during which time the operator has a variety of obligations. These may be in connection with the infrastructure asset itself and include:

- Enhancement of the infrastructure or construction of new infrastructure
- Infrastructure components that must be replaced in their entirety
- Infrastructure subject to major cyclical repairs
- Regular repairs and maintenance

In addition, many service concession arrangements involve the provision of services. In the case of a hospital, for example, this could include utilities (such as water and electricity) and a wide range of 'soft' services such as cleaning, laundry, meals, portering, security and grounds maintenance, amongst others. All of these might be paid for as a single unitary charge that would probably be adjusted according to performance as in Illustration 4-1 above. The accounting models for service concessions must be able to deal with all of these issues.

IFRIC 12 identifies two principal revenue-generating activities in a service concession arrangement, construction or upgrade services and operation services, requiring that both are accounted for in accordance with IFRS 15. *[IFRIC 12.14, IFRIC 12.20]*. The Interpretation also states that, during the construction phase, both accounting models (intangible asset and financial asset) give rise to a contract asset in accordance with IFRS 15. *[IFRIC 12.19]*. The point at which the consideration is subsequently classified as a receivable, or an intangible asset, is discussed in sections 4.2 and 4.3 above, respectively. Whilst the Interpretation includes examples to illustrate how these requirements might be applied to a relatively simple set of facts and circumstances, it does not set out any special treatments in relation to how IFRS 15 is applied for an SCA. Any questions about how IFRS 15 is applied in accounting for revenue from construction, upgrade or operation services or for the contract assets and liabilities arising during the construction phase of an SCA will be answered by reference to that standard (see Chapter 28), rather than to IFRIC 12.

5.1 Additional construction and upgrade services

The concession may include obligations to construct new infrastructure (construction services) or to enhance either new or existing infrastructure to a condition better than at the start of the concession (upgrade services). IFRIC 12 does not deal in detail with the treatment to be adopted other than to say that revenue and costs relating to construction or upgrade services are recognised in accordance with IFRS 15. *[IFRIC 12.14]*. This means that all construction or upgrade services are accounted for in accordance with the appropriate model, regardless of when they take place. Contractual obligations to maintain or restore infrastructure may also include an upgrade element. *[IFRIC 12.21]*.

Upgrade or construction services are separate performance obligations. This means that the contract has to require the particular service to be carried out at a specified time. This is not the same as a general requirement to maintain the asset in a specified condition.

It would be unusual for a toll road concession, for example, to require resurfacing to take place according to a predetermined schedule as road surfaces degrade with usage (based on both the number of vehicles and weight per axle) as well as weather conditions. However, the contract might require a new bridge or access road after a specified period of time and either of these would be separate upgrade services.

Upgrade services must be recognised in accordance with IFRS 15. *[IFRIC 12.14]*. IFRS 15 is discussed in Chapter 28.

The entity must determine the consideration receivable for the upgrade services. This may be part of the allocation at inception of the contract, as shown in Illustration 4-2 above where part of the contract revenue is attributed to road resurfacing, or the contract may specify a separate payment when the upgrade is performed. In either case, the entity would allocate the transaction price for the arrangement as a whole to each of the performance obligations in proportion to their stand-alone selling prices in accordance with IFRS 15. *[IFRIC 12.14]*. The entity would recognise revenue for the upgrade service only as the obligation to provide those services is fulfilled.

5.1.1 Subsequent construction or upgrade services that are part of the initial intangible asset

In some circumstances, the 'enhancement' spend is a component of the original intangible asset and is recognised as part of the exchange transaction to secure the right to charge users described in section 4.3 above. An example of this is the construction of an additional water treatment facility for an existing water distribution network to which the operator is given immediate access to charge users for water supply.

Assuming that the intangible asset model is the relevant one, the intangible asset received in exchange for such construction or upgrade services is recognised in accordance with the general principles applicable to contracts for the exchange of goods or services. *[IFRIC 12.BC66]*. Therefore, service concession contracts are not recognised to the extent that they remain executory, which is generally the case when they are signed. *[IFRIC 12.BC68]*. The contract is no longer executory if:

- The operator has started to fulfil its contractual obligations by constructing the infrastructure concerned or enhancing an existing infrastructure before being entitled to derive benefits from its right to charge for the public service.

  Or

- The operator starts deriving benefits from its right to charge for the public service before fulfilling its obligations (e.g., when the contract provides for a new item to be constructed some time ahead in the concession period).

Therefore, if the operator starts charging users before the upgrade services are performed, the carrying amount of the intangible asset includes the fair value of the upgrade services, which is recognised as a contract liability.

5.1.2 Subsequent construction services that are additional to the initial intangible asset

An operator may be contractually required to add to the infrastructure to which it is given a licence and from this generate additional revenues. For example, it is common in developing countries that the operator of a water distribution network incurs an obligation to extend the distribution network. The operator will obtain revenues from newly connected users under its right to charge for the services.

Revenues generated by the licence to operate the new infrastructure will be determined under the terms of the original licence granted to the operator. However, the operator cannot start charging users of the extension to the distribution network until it has completed constructing the extension. Any obligation to extend the network is not recognised whilst it remains executory and is not an additional component of the cost of the original intangible asset. Instead, the completion of the extension will create a new intangible asset (representing the right to charge users of the extended network), giving rise to new construction revenues and recognised using the same principles as the original as described in section 4.3 above.

5.2 Accounting for the operations phase

Both the financial and intangible asset models apply the same accounting in the operations phase of the SCA. According to the September 2006 *IFRIC Update*, "...the nature of the asset recognised by the operator as consideration for providing construction services (a financial asset or an intangible asset) does not determine the accounting for the operation phase of the arrangement...".[33]

Revenue and costs for the operation services will be recognised in accordance with IFRS 15. *[IFRIC 12.20]*. This means that most operating costs are likely to be executory and will be accounted for as incurred. Contractual obligations, including obligations to maintain, replace or restore infrastructure to a specified level of serviceability during its operation or to a specified condition at the end of the concession, are to be recognised and measured in accordance with IAS 37, *[IFRIC 12.21]*, as shown in Illustration 5-1 below, when such obligations do not include any upgrade element (which is treated as an additional construction service, see section 5.1 above).

33 *IFRIC Update*, September 2006, available on the IFRS Foundation's website.

How we see it

Distinguishing between executory maintenance expenditure and contractual obligations is not always straightforward. In such circumstances, judgement is required in deciding whether expenditure on renewals is an obligation requiring recognition or an executory contract.

A concession arrangement may provide for a specified total amount of expenditure to be incurred by the operator throughout the contract. Sometimes, the contract provides for mechanisms whereby at the end of the contract, any shortfall in the agreed amount is paid in cash to the grantor by the operator. Particularly in the case of older contracts, it is common for the maintenance and repair obligation to be expressed in very general terms such as keeping the infrastructure in 'good working condition' or 'state of the art' working condition. The obligation may include the requirement that the asset be handed over with a certain number of years' useful life remaining.

Local regulations or laws also change over time. Some operators are obliged to report annually to the grantor on the level of maintenance and renewal expenditure incurred during the year and on a cumulative basis from inception of the contract. Sometimes, the operator must report on expected expenditures over some future period of time (e.g., over the next 12 months or two years) as well. In these situations, more often than not, the grantor compares the cumulative expenditure at any point in time with either the operator's prior estimates of expenditures or with the level of expenditure that had been anticipated at the outset of the arrangement and was factored into the level of usage charges.

Illustration 5-1: Executory and contractual obligations to maintain and restore the infrastructure

The operator under a water supply service concession is required as part of the overall contractual arrangement to replace four water pumps as soon as their performance drops below certain quality levels. The operator expects this to be the case after 15 years of service. The expected cost of replacing the pumps is CU1,000. The operator's best estimate is that the service potential of the pumps is consumed evenly over time and provision for the costs is made on this basis from inception of the service concession arrangement until the date of expected replacement. The provision is measured at the net present value of the amounts expected to be paid, using the operator's discount rate of 5%. The amount provided in the first year can be calculated as CU33.67. Assuming no changes to estimates, in 15 years CU1,000 would have been provided and would be utilised in replacing the pumps. The provision would be adjusted on a cumulative basis to take account of changes in estimates to the cost of replacement pumps, the manner in which they are wearing out or changes to the operator's discount rate.

The IFRS IC has also provided an example in Illustrative Example 2, the intangible asset model, of how operational expenditure might be accounted for in accordance with IAS 37. Although this Illustration is in the context of an intangible asset, IAS 37 can apply to maintenance and other obligations whichever model applies. Major maintenance, in this case, the requirement to resurface the road, will be recognised as the best estimate of the expenditure required to settle the present obligation at the reporting date and it is suggested that this might arise "...as a consequence of use of the road..." *[IFRIC 12.IE19]*, therefore increasing in measurable annual increments. *[IFRIC 12.IE20]*. The basis for accounting for such obligations is discussed further in Chapter 27.

Illustration 5-2: The Intangible Asset Model - recording the operations phase

The terms of the arrangement are the same as in Illustration 4-3 above. The contract costs and initial measurement of the intangible asset are set out in Table 1 and Table 2 in that example.

Resurfacing obligations

The operator's resurfacing obligation arises as a consequence of use of the road during the operating phase. It is recognised and measured in accordance with IAS 37, i.e., at the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

For the purpose of this Illustration, it is assumed that the terms of the operator's contractual obligation are such that the best estimate of the expenditure required to settle the obligation at any date is proportional to the number of vehicles that have used the road by that date and increases by CU17 (discounted to a current value) each year. The operator discounts the provision to its present value in accordance with IAS 37. The income statement charge each period is:

Table 3 Resurfacing obligation

Year	3	4	5	6	7	8	Total
	CU	CU	CU	CU	CU	CU	CU
Obligation arising in year (CU17 discounted at 6%)	12	13	14	15	16	17	87
Increase in earlier years' provision arising from passage of time	-	1	1	2	4	5	13
Total expense recognised in income statement	**12**	**14**	**15**	**17**	**20**	**22**	**100**

Overview of cash flows, income statement and statement of financial position

For the purpose of this Illustration, it is assumed that the operator finances the arrangement wholly with debt and retained profits. It pays interest at 6.7% a year on outstanding debt. If the cash flows and fair values remain the same as those forecast, the operator's cash flows, income statement and statement of financial position over the duration of the arrangement will be:

Table 4 Cash flows

Year	1	2	3	4	5	6	7	8	9	10	Total
	CU	CU	CU	CU	CU	CU	CU	CU	CU	CU	CU
Receipts	-	-	200	200	200	200	200	200	200	200	1,600
Contract costs	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(110)	(10)	(10)	(1,180)
Borrowing costs†	-	(34)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(342)
Net inflow/ (outflow)	**(500)**	**(534)**	**121**	**129**	**137**	**147**	**157**	**67**	**171**	**183**	**78**

† Debt at start of year (table 6) × 6.7%

Table 5 Income statement

Year	1	2	3	4	5	6	7	8	9	10	Total
	CU	CU	CU	CU	CU	CU	CU	CU	CU	CU	CU
Revenue	525	525	200	200	200	200	200	200	200	200	2,650
Amortisation	-	-	(135)	(135)	(136)	(136)	(136)	(136)	(135)	(135)	(1,084)
Resurfacing expense	-	-	(12)	(14)	(15)	(17)	(20)	(22)	-	-	(100)
Other operating costs†	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(1,080)
Borrowing costs* (table 4)	-	-	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(308)
Net profits	**25**	**25**	**(26)**	**(20)**	**(14)**	**(6)**	**1**	**9**	**36**	**48**	**78**

* Borrowing costs are capitalised during the construction phase

† Table 1

Table 6 Statement of financial position

End of Year	1	2	3	4	5	6	7	8	9	10
	CU	CU	CU	CU	CU	CU	CU	CU	CU	CU
Intangible asset	525	1,084	949	814	678	542	406	270	135	-
Cash/(debt)*	(500)	(1,034)	(913)	(784)	(647)	(500)	(343)	(276)	(105)	78
Resurfacing obligation	-	-	(12)	(26)	(41)	(58)	(78)	-	-	-
Net assets	25	50	24	4	(10)	(16)	(15)	(6)	30	78

* Debt at start of year plus net cash flow in year (table 4)

To make this Illustration as clear as possible, it has been assumed that the arrangement period is only ten years and that the operator's annual receipts are constant over the period. In practice, arrangement periods may be much longer and annual revenue may increase with time. In such circumstances, the changes in net profit from year to year could be greater.

In the following Practical example, VINCI explains how provisions are recognised for contractual obligations to maintain the condition of concession assets.

Practical example 5-1: VINCI (2023) **France**

Consolidated financial statements at 31 December 2023 [extract]

Notes to the consolidated financial statements [extract]

H. Other balance sheet items and business-related commitments [extract]

19. Working capital requirement and current provisions [extract]

19.3 Breakdown of current provisions [extract]

...

Provisions are taken for contractual obligations to maintain the condition of concession assets. They concern the motorway concession companies and cover the expense of major repairs of roads, bridges, tunnels and hydraulic infrastructure. They also include expenses to be incurred by airport concession companies (repairs to runways, traffic lanes and other paved surfaces) and are calculated on the basis of maintenance plans spanning several years, which are updated annually. These expenses are reassessed on the basis of appropriate indices (mainly the TP01, TP02 and TP09 indices in France). Provisions are also taken whenever signs of defects are encountered on certain infrastructure.

...

At 31 December 2023, contractual obligations to maintain the condition of concession assets mainly comprised €600 million for the ASF group (€534 million at 31 December 2022), €279 million for Cofiroute (€264 million at 31 December 2022), and €393 million for VINCI Airports (€333 million at 31 December 2022) including €148 million for ANA (€125 million at 31 December 2022) and €119 million for OMA (€94 million at 31 December 2022).

...

5.3 Items provided to the operator by the grantor

Following the basic principles underlying the accounting treatment under both models, infrastructure items to which the operator is given access by the grantor for the purpose of the service concession are not recognised as its property, plant and equipment. *[IFRIC 12.27]*. This is because they remain under the control of the grantor.

There is a different treatment for assets that are given to the operator as part of the consideration for the concession that can be kept or dealt with as the operator wishes. These assets are not to be treated as government grants as defined in IAS 20. Instead, an operator accounts for these assets as part of the transaction price and in accordance with IFRS 15. *[IFRIC 12.27]*. See Chapter 28 at section 5.

What this means is that an operator that has, for example, been given a licence or similar arrangement over a piece of land on which a hospital is to be built does not recognise the land as an asset. If, on the other hand, the operator has been given a piece of surplus land on which it can build private housing for sale, it will recognise an asset. The consideration, which is the fair value of that land, will be aggregated with the remainder of the consideration for the transaction and accounted for according to the model being used.

6 Further examples illustrating the application of IFRIC 12 and interactions with IFRS 15 and IFRS 9

IFRIC 12 was not significantly amended upon issue of IFRS 15 and IFRS 9 and the Illustrative Examples to IFRIC 12 were largely unchanged. However, it must be noted that the Illustrative Examples in IFRIC 12 are intended simply to demonstrate the principal features of the financial asset and intangible asset models. In doing so, they reflect some aspects of service concession arrangements that are commonly seen in practice, but the examples are not intended to be exhaustive.

In June 2022, a post-implementation review of IFRS 15 was added to the IASB agenda. In June 2023, the IASB issued its request for stakeholder feedback to inform its post-implementation review of IFRS 15.[34] Although the post-implementation review did not ask stakeholders about the interaction between IFRS 15 and IFRIC 12 (as outreach indicated that IFRIC 12 affects a relatively narrow population of entities and relatively little feedback was received on its interaction with IFRS 15[35]), a few respondents to the post-implementation review did provide comments relating to the application of IFRS 15 with IFRIC 12. The most common matter raised related to IFRIC 12 requirements on accounting for contractual obligations to maintain or restore infrastructure. Whilst there was some acknowledgement that the clarity and suitability of the requirements in IFRIC 12 on applying IAS 37 to account for obligations to maintain or restore service concession infrastructure could be improved,[36] the issue was decided to be low priority. The IASB also decided to consider the application of IFRS 15 with IFRIC 12, including accounting for contractual obligations to maintain or restore service concession infrastructure, in the next agenda consultation.[37] The post-implementation review of IFRS 15 is discussed further in Chapter 28 at section 1.4.

How we see it

It is important that entities understand and assess the facts and circumstances of their own arrangements in order to determine whether their service concession accounting is supported under the 5-step model within IFRS 15 and the requirements of IFRS 9 as appropriate.

In the Illustrations below, we have considered the fact patterns set out in Illustrative Examples 1 and 2 from IFRIC 12 (which are reproduced in Illustration 4-2 in section 4.2 above, Illustration 4-3 in section 4.3 above and Illustration 5-2 in section 5.2 above), in the context of the 5-step model in IFRS 15, and suggested how the accounting for the same basic fact pattern may be impacted by certain changes to the terms within the concession arrangement, the operator's assessment of those terms, and the introduction of other facts and circumstances.

Illustration 6-1: Financial asset model - Receivable recognised once construction is complete

Arrangement terms

The terms of the arrangement are the same as in Illustration 4-2 in section 4.2 above.

The operator's annual receipts do not vary over the concession period, cash flows and fair values remain the same as forecast, no contract modifications occur over the concession period, and there is no change to the timing of delivery from that anticipated at contract inception. In addition, for the purposes of this example, we assume that the operator may be subject to penalties for substandard performance, with any penalties being deducted from the CU200 per annum to which the operator is entitled in years 3 to 10 of the arrangement. However, in this case, the operator has not deducted any potential penalties when determining the transaction price under the contract on the basis that it is highly probable that significant penalties will not be incurred (see Step 3 below- Determining the transaction price).

Any changes in these assumptions or facts and circumstances would need to be assessed by reference to the requirements of IFRIC 12 and IFRS 15 and could result in a change to the accounting discussed below.

34 Request for Information: Post-implementation Review IFRS 15 *Revenue from Contracts with Customers*, June 2023. Available on the IFRS Foundation's website.

35 IASB Staff Paper 6E: Project: *Post-implementation Review of IFRS 15*, Paper topic: *Analysis of outreach feedback - Interaction with other IFRS Accounting Standards*, IASB meeting, March 2023, paras. 47, 48 and 49. Available on the IFRS Foundation's website.

36 IASB Staff Paper 6E: Project: *Post-implementation Review of IFRS 15*, Paper topic: *Applying IFRS 15 with other IFRS Accounting Standards*, IASB meeting, April 2024. Available on the IFRS Foundation's website.

37 IFRS - IASB Update July 2024. Available on the IFRS Foundation's website.

Step 1 - Identify the contract with the customer

Under IFRS 15, a contract is defined as an agreement between two parties that creates enforceable rights and obligations. *[IFRS 15 Appendix A]*.

Because the public-sector grantor of the concession retains control over the infrastructure asset, construction and upgrade (resurfacing) services are provided to the grantor. The grantor pays cash consideration to the operator in exchange for those services. The grantor is the only party with which the operator has a contract.

Because of the public service nature of the obligation undertaken by the operator, the operating services (operation of the road) are provided to the public. However, a customer is defined in IFRS 15 as a party that has contracted with an entity to obtain goods or services that are an output of an entity's ordinary activities in exchange for consideration. *[IFRS 15 Appendix A]*. Under the terms of the arrangement, the operator does not collect any tolls so the end user of the road is not passing consideration to the operator and therefore is not considered a customer. The grantor is therefore considered to be the only customer of the operator in this arrangement.

Identification of the contract(s) with the customer under IFRS 15 is discussed in Chapter 28 at section 3.

Step 2 - Identify the performance obligations in the contract

Illustration 4-2 in section 4.2 above identifies construction services, operation services and road resurfacing as performance obligations within the contract with the grantor.

IFRS 15 provides guidance on the types of items that may be goods or services promised in the contract. Examples given by the standard include performing a contractually agreed-upon task (or tasks) for a customer, and providing a service of standing ready to provide goods or services. *[IFRS 15.26]*. This introduces the possibility that maintenance may also be a performance obligation within the contract with the grantor.

A promised good or service is a performance obligation if it is either:

(a) A good or service that is distinct

Or

(b) A series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer *[IFRS 15.22]*

In order to be distinct, a promised good or service must be:

(a) Capable of being distinct- i.e., provide a benefit to the customer either on its own or together with other resources that are readily available to the customer

And

(b) Distinct within the context of the contract- i.e., the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract *[IFRS 15.27]*

If a promised good or service is not distinct, IFRS 15 requires that the entity combines those goods or services with other promised goods or services until it identifies a bundle of goods or services that is distinct. *[IFRS 15.30]*.

It could be argued that because major maintenance enhances an asset that the grantor owns, then it is providing a benefit to the grantor. In addition, contractual terms often require an operator to repay an element advanced by the grantor for maintenance services if the operator does not incur contracted levels of maintenance spend. This may also support the argument that maintenance is a separate performance obligation. In practice, there is likely to be some judgement involved in determining whether maintenance is a separate performance obligation, based on how it is defined in the contractual arrangement. To the extent that the contract requires the operator to provide major maintenance, similar in nature to an upgrade, that enhances the infrastructure asset, maintenance could be a separate performance obligation. However, minor maintenance necessary to preserve the road in a condition required for the operator to operate the road safely and to return the road to the grantor in a certain condition at the end of the arrangement could be argued as not transferring a distinct good or service to the grantor.

Maintenance has not been identified as a separate performance obligation in Illustration 4-2 in section 4.2 above. This may be on the basis that the operator is required to return the road to the grantor in a specified condition at the end of the concession arrangement. IFRIC 12 requires contractual obligations to maintain infrastructure to a specified level of serviceability or to return infrastructure to the grantor in a specified condition at the end of the service concession arrangement to be recognised and measured in accordance with IAS 37. *[IFRIC 12.21]*. This treatment is akin to that required for assurance-type warranties under IFRS 15. An assurance-type warranty provides the customer with assurance that the product complies with agreed-upon specifications and is not a separate performance obligation. *[IFRS 15.B30]*. IFRS 15 requires the estimated cost of satisfying assurance warranty obligations to be accrued in accordance with the requirements in IAS 37. *[IFRS 15.B30]*. In many arrangements other than service concessions, the 8 year term of the maintenance promise would likely indicate that treatment as an assurance-type warranty may not be appropriate. However, common warranty practices within the industry and the entity's business practices relating to warranties must be considered when identifying assurance-type warranties under IFRS 15. The accounting for warranties under IFRS 15 is discussed in Chapter 28 at section 9.1.

Alternatively, it may be, that in Illustration 4-2 in section 4.2 above, maintenance is considered to be a promised service that is not distinct in the context of the contract, as the operator would not be able to fulfil its promise to operate the road without maintaining the road in a safe condition. As such, maintenance may have been bundled with operation services into a single performance obligation.

Identification of performance obligations in a contract under IFRS 15 is discussed in Chapter 28 at section 4.

Step 3 - Determine the transaction price

Transaction price is defined in IFRS 15 as "...the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties...". *[IFRS 15.47]*.

The determination of transaction price must also take into account any elements of variable consideration. The element of revenue that is subject to penalties would be considered a form of variable consideration under IFRS 15. *[IFRS 15.51]*. IFRS 15 requires that, if the consideration promised in a contract includes a variable amount, an entity must estimate the amount of consideration to which they will be entitled. *[IFRS 15.50]*. Estimates of variable consideration are then included in the transaction price only to the extent that it is highly probable that a significant reversal of revenue will not occur when the uncertainty associated with the variable consideration is subsequently resolved. *[IFRS 15.56]*. As noted in the arrangement terms section above, for the purposes of this example we assume that the operator is subject to penalties for substandard performance, with any penalties being deducted from the CU200 per annum to which the operator is entitled in years 3 to 10 of the service concession arrangement. IFRS 15 requires that variable consideration must be estimated using either an expected value or most likely amount basis, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled. *[IFRS 15.53]*. The assessment of which approach is most appropriate will depend upon the facts and circumstances of the service concession arrangement and the penalty regime. In practice, it may be that the expected value approach better predicts the amount of consideration to which the operator expects to be entitled in many service concession arrangements. In this example, the operator concludes that the most-likely amount is the most appropriate approach due to the nature of the penalties. Based on their previous experience in the sector, the operator concludes that they are most likely to receive the full amount of CU200 per annum (i.e., CU1600 in total, and not incur any penalties) and that it is highly probable that they will not incur significant penalties. The operator concludes that if they include the full CU200 per annum in the transaction price for the contract, it is highly probable that a significant revenue reversal will not occur when the uncertainty is resolved. The operator therefore does not deduct any potential penalties when determining the transaction price under the contract. The assessment of the impact of penalties on the IFRS 15 transaction price will depend on facts and circumstances. Whilst an experienced concession operator may be able to meet the requirements for not constraining revenue in some concessions, this will not hold true in all cases, for example if they were to enter into a concession involving an infrastructure asset with which they had little experience.

The difference between the timing of payments from the grantor compared to the provision of construction services by the operator is likely to require a significant financing component to be taken into account in determining the transaction price. The gross amount of consideration is discounted at a rate that the operator would use if it were to enter into a separate financing transaction with the grantor at contract inception. The discount rate reflects the credit characteristics of the grantor, as well as any collateral or security provided, including assets transferred in the contract, *[IFRS 15.64]*, i.e., the discount rate is a rate specific to the contract. IFRS 15 also notes that an entity may be able to determine that rate by identifying the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer. *[IFRS 15.64]*. In Illustration 4-2 in section 4.2 above, the implied interest rate in the contract is assumed to be the rate that would be reflected in a financing transaction between the operator and the grantor, although this may not always be the case in a service concession arrangement.

How we see it

In determining the discount rate to be used when a service concession contract contains a significant financing component, we believe that IFRS 15 requires primacy to be given to the rate that the operator would use if it were to enter into a separate financing transaction with the grantor at contract inception. Whilst the rate implicit in the contract may be used in determining that rate, the use of the rate implicit in the contract may not always be consistent with the objective of IFRS 15.64. However, because most operators in service concessions are not in the business of entering into free-standing financing arrangements with grantors, they may find it difficult to identify an appropriate rate, and judgement may be required.

The effect of financing is excluded from the transaction price prior to the allocation of transaction price to performance obligations.

Based on the arrangement terms in this example, the total amount of consideration to which the operator expects to be entitled in exchange for transferring promised construction, operating, maintenance and upgrade services to the grantor is CU200 per year for 8 years, i.e., CU1600. The financing component is CU344, based on a rate of 6.18% per year. This gives a net transaction price of CU1256 (being CU1600 - CU344). This is consistent with the transaction price in Illustration 4-2 in section 4.2 above.

Step 4 - Allocate the transaction price to the performance obligations in the contract

IFRS 15 generally requires the transaction price to be allocated to each performance obligation in proportion to their relative stand-alone selling prices. *[IFRS 15.74]*.

If stand-alone selling prices are not readily observable, they must be estimated, considering all information that is reasonably available to the entity. *[IFRS 15.78]*. The operator may choose to estimate stand-alone selling prices using an expected cost plus margin approach, *[IFRS 15.79]*, although other approaches are permitted. Illustration 4-2 in section 4.2 above shows the operator estimating stand-alone selling prices for each performance obligation using an expected cost plus margin approach.

In Illustration 4-2 in section 4.2 above, the transaction price allocated to each performance obligation is equal to the estimated stand-alone selling price for each distinct service (i.e., construction, operations, upgrade), and as such, there is no discount in the contract to allocate between the performance obligations.

Allocation of the transaction price to performance obligations under IFRS 15 is discussed in Chapter 28 at section 6.

Step 5 - Recognise revenue when (or as) the entity satisfies a performance obligation

IFRS 15 requires that revenue is recognised when an identified performance obligation is satisfied, by transferring a promised good or service to a customer, i.e., when the customer obtains control. *[IFRS 15.31]*. Performance obligations will be satisfied either over time or at a point in time. *[IFRS 15.32]*.

In Illustration 4-2 in section 4.2 above, revenue is recognised over time for construction, resurfacing and operating services. As discussed at Step 2 above, maintenance is assumed not to be a separate performance obligation within this example and therefore no revenue is recognised in respect of maintenance.

One of the criteria in IFRS 15 for recognising revenue over time is that an entity's performance creates or enhances an asset that the customer controls. *[IFRS 15.35(b)]*. In order to be in scope of IFRIC 12, the grantor to a service concession arrangement must control the infrastructure asset, including any significant residual interest. It therefore appears reasonable to conclude that this criteria for recognising revenue over time is met for construction and resurfacing services because they create and then enhance the grantor's asset.

In some circumstances, an entity may be unable to reasonably measure the outcome of the construction performance obligation. They may be able to determine that a loss will not be incurred, but may not be able to reasonably estimate the amount of profit. Until the entity can reasonably measure the outcome, IFRS 15 requires the entity to recognise revenue, but only up to the amount of costs incurred. *[IFRS 15.45]*. This could result in an operator recognising no margin on construction services until they are able to reasonably estimate the amount of profit.

An alternative criterion in IFRS 15 for recognising revenue over time is that the customer simultaneously receives and consumes the benefit as the entity performs. *[IFRS 15.35(a)]*. i.e., a performance obligation is satisfied over time if an entity determines that another entity would not need to substantially re-perform the work that the entity has completed to date if that other entity were to fulfil the remaining performance obligation to the customer. *[IFRS 15.B4]*. It would seem reasonable to conclude that this criterion is met for operating services in Illustrative Illustration 4-2 in section 4.2 above.

Progress over time may be measured using an input method to recognise revenue on the basis of the operator's inputs to the satisfaction of the performance obligation (e.g., costs incurred or time elapsed) relative to the total expected efforts to the satisfaction of that performance obligation. *[IFRS 15.B18]*. Other methods are also permitted, although the entity must determine the best method that faithfully depicts the entity's performance.

In Illustration 4-2 in section 4.2 above, construction revenue appears to be recognised over time by reference to costs incurred relative to total expected costs required to satisfy the construction services performance obligation. Revenue from operation services is also recognised using an input method. In Illustration 4-2 above, operating costs are incurred evenly over the operating phase of the service concession arrangement and so the recognition pattern shown in the example may have been derived using either a time elapsed input method or by reference to costs incurred relative to total expected costs required to satisfy the performance obligation. Entities do not have a free choice in determining how to measure progress over time. IFRS 15 requires that, in measuring progress over time, an entity must select a revenue recognition method that faithfully depicts its performance in satisfying the performance obligation. Although upgrade revenue appears to meet the criteria to be recognised over time as it enhances an asset owned and controlled by the grantor, all upgrade services occur in year 8 and hence the revenue allocated to this performance obligation is all recognised in year 8.

With regards the recognition of finance income, IFRIC 12 requires consideration given by the grantor to be classified as a contract asset during the construction activity. *[IFRIC 12.19]*. The operator would recognise a receivable, rather than a contract asset, only once the operator has an unconditional right to receive consideration from the customer. The operator's right to consideration is unconditional only if nothing other than the passage of time is required before payment of that consideration is due. *[IFRS 15.108]*. The right to consideration would not be unconditional if the operator must first satisfy another performance obligation in the contract before it is entitled to payment from the customer.

In this example, the operator receives payment of CU200 per annum in years 3 to 10 of the service concession arrangement, i.e., once construction is complete and the operator starts providing operating services. As noted in the arrangement terms section above, for the purposes of this example we assume that the operator is subject to penalties for substandard performance, with any penalties being deducted from the CU200 per annum to which the operator is entitled in years 3 to 10 of the service concession arrangement. Although the amounts the operator will receive may be reduced by penalties in the event of substandard performance, or failure to meet specified quality or efficiency requirements, for the purposes of this example, we assume that the operator determines that even in the event that the maximum penalties possible under the contract were incurred, the total consideration to which they would be entitled in years 3 to 10 would exceed the amount recognised as revenue for satisfying the construction performance obligation. Because the operator will receive payment for their construction services regardless of whether they deliver the other performance obligations within the contract, the operator therefore concludes that they have an unconditional right to consideration from the grantor for construction services as soon as construction activity is complete. The operator therefore recognises a receivable in respect of the construction performance obligation once construction is complete. This is consistent with the treatment in Illustration 4-2 in section 4.2 above.

Until a receivable is recognised, the operator accounts for the significant financing component in the arrangement in accordance with IFRS 15. Under IFRS 15 a significant financing component would be recorded if the consideration was paid more than a year after construction is complete, which is the case in Illustration 4-2 above, and this example, as noted at step 3 above. Illustration 4-2 does not identify any significant financing component in respect of upgrade services delivered in year 8. Based on the entity's chosen approach to allocating the consideration receivable under the arrangement to the various performance obligations, at contract inception, the entity may expect the period between delivery of the upgrade services and the date on which payment will be received to be one year or less. *[IFRS 15.63]*.

Once a receivable is recognised, the amounts due from the grantor are accounted for in accordance with IFRS 9. As discussed in section 4.2 above, we believe that different approaches may be acceptable regarding measurement of the receivable at initial recognition. In this example, the value of the receivable at initial recognition is equal to the carrying value of the contract asset at completion of construction, and interest is recognised on the financial asset at 6.18%. This is consistent with Illustration 4-2 in section 4.2 above.

How we see it

Once the operator has an unconditional right to receive consideration, we believe that different approaches may be acceptable regarding measurement of the receivable at initial recognition.

If the receivable is recognised at fair value, any movements in market interest rates between the date of commencement of construction services and the point at which the receivable is initially recognised that impact the fair value of the financial asset would result in the operator recognising an expense on initial recognition of the financial asset.

If the receivable is instead treated as a continuation of the contract asset, the operator would not recognise an expense on initial recognition of the financial asset as a result of any movements in market interest rates between the date of commencement of construction services and the point at which the receivable is initially recognised.

We would expect entities to apply either approach consistently to similar arrangements.

IFRS 9 requires the receivable to be subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss, depending on the operator's business model for managing the receivable, and the contractual cash flow characteristics of the receivable. We assume for the purpose of this example that the operator has a business model whose objective is to collect the contractual cash flows of the receivable. As noted above, the operator has determined that recoverability of the receivable recognised for construction services is not dependent upon their future performance of the service concession arrangement. The operator has not identified any other features that would cause the receivable to fail the SPPI test (that confirms that the cash flows are 'solely payments of principal and interest on the principal amount outstanding'). Therefore, the receivable is subsequently measured at amortised cost. This is consistent with Illustration 4-2 in section 4.2 above. Subsequent measurement of financial assets under IFRS 9 is discussed in Chapter 46.

Under the arrangement terms in this example, as set out above, the overview of the operator's statement of cash flows, statement of comprehensive income and statement of financial position will be consistent with those in Illustrative Example 1 to IFRIC 12, which are shown in Illustration 4-2 in section 4.2 above. Although the operator in this arrangement may be subject to penalties for substandard performance, the contractual terms of the penalties do not impact the accounting in the operator's primary statements, for reasons explained above.

Both the contract asset recognised during the construction phase, and the receivable recognised once construction is complete will be subject to the impairment requirements of IFRS 9. *[IFRS 15.107]*. Impairment of financial assets under IFRS 9 is discussed in Chapter 47.

Illustration 6-2: Financial Asset Model - Contract asset relating to construction services unwinds to a receivable over the period in which the other performance obligations in the contract are satisfied

Arrangement terms

The terms of the arrangement are the same as in Illustration 6-1 above, except that in this example we assume that in the event of total non-performance by the operator of operating, maintenance and upgrade services, the penalties incurred in years 3 to 10 of the arrangement could be up to CU200 per annum. Therefore, if the operator were to incur maximum penalties, the total amount the operator would receive in years 3 to 10 would be nil. This will result in changes to the income statement and statement of financial position of the operator compared to those shown in the previous examples.

As discussed in section 4.1.2 above, the recognition of a financial asset is not affected by the fact that the operator's contractual right to receive cash may be contingent on performance standards. Therefore, the fact that penalties incurred for underperformance in this Illustration could reduce the amount received by the operator to nil, does not preclude the arrangement from being accounted for under the financial asset model. The IFRS IC points out that this is no different from other circumstances and other financial assets where the payment for goods and services depends on the subsequent performance of the asset. *[IFRIC 12.BC44]*.

Any changes in these assumptions or facts and circumstances would need to be assessed by reference to the requirements of IFRIC 12 and IFRS 15 and could result in a change to the accounting discussed below.

Initial recognition of the receivable

IFRIC 12 requires consideration due from the grantor to be classified as a contract asset during the construction activity. *[IFRIC 12.19]*. The operator would recognise a receivable, rather than a contract asset, only once the operator has an unconditional right to receive consideration from the customer. The operator's right to consideration is unconditional only if nothing other than the passage of time is required before payment of that consideration is due. *[IFRS 15.108]*. The right to consideration would not be unconditional if the operator must first satisfy another performance obligation in the contract before it is entitled to payment from the customer.

In this example, the operator is entitled to payment of CU200 per annum in each of years 3 to 10, i.e., once construction is complete and the operator starts providing operating services. However, this amount may be reduced by penalties in the event of substandard performance by the operator, or failure to meet specified quality or efficiency requirements. In the event of total non-performance by the operator of operating, maintenance and upgrade services, the penalties would be CU200 per annum, such that the total amount the operator would receive in years 3-10 would be nil. Although the operator does not expect to incur a significant amount of penalties, the operator does not have an unconditional right to consideration once construction is complete because it is not only the passage of time that is required before payment of consideration for construction services is due. Instead, the operator must provide other services, and to a satisfactory standard, in order to receive payment for the construction services. Because the operator must first satisfy another performance obligation in the contract before it is entitled to receive consideration for the construction services, the operator continues to recognise a contract asset even after construction is complete. Each year, as the operator satisfies the operations and maintenance performance obligation, CU200 of the operator's right to consideration becomes unconditional (i.e., nothing other than the passage of time is required before payment of the CU200 becomes due). The amount due for construction services therefore unwinds from a contract asset to a receivable over the period in which the other performance obligations in the contact are satisfied by the operator.

How we see it

Due to the nature of contractual penalties imposed in service concession arrangements, in practice, the amount due to the operator in exchange for construction services may sometimes only unwind from a contract asset to a receivable over the period in which the other performance obligations in the contract are satisfied by the operator. However, depending on the nature of the contractual penalties, judgement may be required to identify the point at which the operator has an unconditional right to receive consideration and would therefore recognise a receivable.

Once a receivable is recognised, the amounts due from the grantor are accounted for in accordance with IFRS 9. As discussed in section 4.2 above, we believe that different approaches may be acceptable regarding measurement of the receivable at initial recognition.

The operator continues to accrue interest on the remaining portion of the contract asset in accordance with IFRS 15 at the original interest rate of 6.18%. Whilst it is possible that market interest rates may have moved since construction services were provided by the operator, IFRS 15 requires that an entity does not update the discount rate (used to discount promised consideration) for changes in circumstances or interest rates after contract inception. *[IFRS 15.64]*.

Both the contract asset and the receivable will be subject to the impairment requirements of IFRS 9. *[IFRS 15.107]*.

The operator's statement of comprehensive income and statement of financial position will be as follows. The operator's statement of cash flows will be the same as that shown in Illustration 4-2 in section 4.2 above.

Statement of comprehensive income (CU)

Year	1	2	3	4	5	6	7	8	9	10	**Total**
Revenue (a)	525	525	12	12	12	12	12	122	12	12	1,256
Contract costs (a)	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(110)	(10)	(10)	(1,180)
Finance income (b)	-	32	67	59	51	43	34	25	22	11	344
Borrowing costs (a)	-	(34)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(342)
Net profit	**25**	**23**	**-**	**-**	**-**	**2**	**3**	**14**	**5**	**6**	**78**

(a) Revenue, contract costs and borrowing costs are the same as in Illustrative Example 1 to IFRIC 12, as shown in Illustration 4-2 in section 4.2 above.

(b) Finance income on the contract asset continued to be recognised at a rate of 6.18%, determined in accordance with IFRS 15 at inception of the contract.

Statement of financial position (CU)

End of year	1	2	3	4	5	6	7	8	9	10
Amount due from grantor (a)	-	-	-	-	-	-	-	-	-	-
Contract asset	525	1,082	961	832	695	550	396	343	177	-
Cash/(debt) (b)	(500)	(1,034)	(913)	(784)	(647)	(500)	(343)	(276)	(105)	78
Net assets	**25**	**48**	**48**	**48**	**48**	**50**	**53**	**67**	**72**	**78**

(a) Contract asset at the start of year, plus revenue and finance income earned in year (statement of comprehensive income), less receipts of CU200 in years 3-10.

(b) Cash/debt and statement of cash flows are the same as in Illustrative Example 1 to IFRIC 12, as shown in Illustration 4-2 in section 4.2 above.

Illustration 6-3: Intangible Asset Model

Arrangement terms

The terms of the arrangement are the same as in Illustration 4-3 in section 4.3 above and Illustration 5-2 in section 5.2 above. Illustration 4-3 and Illustration 5-2 are based on Illustrative Example 2 in IFRIC 12 and assume that that the operator's annual receipts are constant over the concession period, that cash flows and fair values remain the same as forecast, that no contract modifications occur over the concession period, and that there is no change to the timing of delivery from that anticipated at contract inception. Any changes in these assumptions or facts and circumstances would need to be assessed by reference to the requirements of IFRIC 12 and IFRS 15 and could result in a change to the accounting illustrated in Illustration 4-3 and Illustration 5-2 above.

Step 1 - Identify the contract(s) with a customer

Under IFRS 15, a contract is defined as an agreement between two parties that creates enforceable rights and obligations. *[IFRS 15 Appendix A]*. A customer is defined in IFRS 15 as a party that has contracted with an entity to obtain goods or services that are an output of an entity's ordinary activities in exchange for consideration. *[IFRS 15 Appendix A]*.

Because the public sector grantor of the concession retains control over the infrastructure asset, construction and upgrade (resurfacing) services are provided to the grantor. The grantor pays consideration, in the form of an intangible asset, to the operator in exchange for those services.

Because of the public service nature of the obligation undertaken by the operator, the operating services are provided to the public users the road. There could be a written contract between the operator and each road user, if, for example, the road user takes a ticket from the toll booth on entering the road. Even in the absence of a written contract, the public users of the road transfer consideration to the operator in exchange for using the road, and therefore could be considered to have an implied contract with the operator. IFRS 15 does not require the existence of a written contract; a contract may be oral or implied, although it must be legally enforceable. *[IFRS 15.10]*. The specified good or service in the contract between the operator and the road user is the provision of access to the toll road. Access is physically controlled by the operator through the operating services that they provide.

Illustration 4-3 and Illustration 5-2 above reflect two contractual customer relationships within the arrangement, being (1) a contract with the grantor for the provision of construction services to build toll road; and (2) many contracts with individual public road users to provide access to the toll road by way of a service fulfilled by the operator, and reflect the operator acting as principal in both contractual customer relationships.

Identification of the contract(s) with the customer under IFRS 15 is discussed in Chapter 28 at section 3.

Step 2 - Identify the performance obligations in the contract

In Illustration 4-3 and Illustration 5-2 above, the operator recognises revenue in respect of the following performance obligations:

- Contract with the grantor- a distinct performance obligation, being construction services

  And

- Many contracts with road users- a distinct performance obligation for operation services

The contract with the grantor requires the operator to resurface the road when the original surface has deteriorated below a specified condition. Resurfacing is not identified as a separate performance obligation. Because the resurfacing is required when the original surface has deteriorated below a specific condition, rather than being required at a specified point in time, the operator treats this as a contractual obligation to maintain or restore the infrastructure, with the contractual obligation to restore the road recognised and measured in accordance with IAS 37. *[IFRIC 12.21]*. This is similar to the treatment required for assurance-type warranties under IFRS 15. An assurance-type warranty is a warranty that provides the customer (the public users of the road in this example) with assurance that the product complies with agreed-upon specifications and is not a separate performance obligation. *[IFRS 15.B30]*.

Identification of performance obligations in a contract under IFRS 15 is discussed in Chapter 28 at section 4.

Step 3 - Determine the transaction price

The consideration in the contract with the grantor is the amount that the operator expects to be entitled to in exchange for construction services. The consideration is a right to charge toll road users, i.e., non-cash consideration which would be measured at fair value, unless the entity cannot reasonably estimate the fair value of the non-cash consideration, in which case it is measured indirectly by reference to the stand-alone selling price of the promised goods or services. *[IFRS 15.66, IFRS 15.67]*. In Illustration 4-3 and Illustration 5-2 above, the fair value of the intangible asset has been measured indirectly by reference to the stand-alone selling price of the promised construction services.

Illustration 4-3 and Illustration 5-2 above do not identify a significant financing component related to the provision of construction services by the operator, despite the timing difference between the operator providing construction services in years 1 and 2, and delivery of the intangible asset once construction is complete at the end of year 2. This may be because the operator has concluded that the reason for the difference between the cash selling price of the construction services and the promised consideration arises for reasons other than the provision of finance, and the difference between those amounts is proportional to the reason for the difference. *[IFRS 15.62]*. The operator may have reached this conclusion because the promised consideration in this example is an intangible asset, representing a right to charge users of the toll road, and that right cannot be exercised until the toll road is constructed. Therefore, in this example, the nature of the consideration necessitates a delay between provision of the construction services by the operator, and receipt of the promised consideration, being the intangible asset.

The operator will receive cash consideration from each toll road user in exchange for operating services. The total amount of consideration for operating services will vary depending upon how many vehicles use the toll road. However, as each contract is with a separate road user (customer), it would seem appropriate to consider each contract in isolation. The transaction price for each contract is the cash toll paid by each road user.

Determination of the transaction price under IFRS 15 is discussed in Chapter 28 at section 5.

Step 4 - Allocate the transaction price to the performance obligations in the contract

IFRS 15 generally requires the transaction price to be allocated to each performance obligation in proportion to their relative stand-alone selling prices. *[IFRS 15.74]*. If stand-alone selling prices are not readily observable, they must be estimated, considering all information that is reasonably available to the entity. *[IFRS 15.78]*. The operator may choose to estimate stand-alone selling prices using an expected cost-plus margin approach, *[IFRS 15.79]*, although other approaches are permitted.

As discussed at Step 2 above, there is only one distinct performance obligation in the contract with the grantor, being construction services. The transaction price is therefore allocated to construction services. Similarly, each contract with individual road users has one distinct performance obligation, being the provision of operating services.

Allocation of the transaction price to performance obligations under IFRS 15 is discussed in Chapter 28 at section 6.

Step 5 - Recognise revenue when (or as) the entity satisfies a performance obligation

Illustration 4-3 and Illustration 5-2 above show revenue being recognised over time for construction and operating services.

One criterion within IFRS 15 for recognising revenue over time is that an entity's performance creates or enhances an asset that the customer controls. *[IFRS 15.35(b)]*. To be in scope of IFRIC 12, the grantor to a service concession arrangement must control the infrastructure asset, including any significant residual interest. It therefore appears reasonable to conclude that this criteria for recognising revenue over time is met for construction services. Progress over time may be measured using an input method to recognise revenue based on the operator's inputs to the satisfaction of the performance obligation (e.g., costs incurred or time elapsed) relative to the total expected efforts to the satisfaction of that performance obligation. *[IFRS 15.B18]*. Other methods are also permitted, although the entity must determine the best method that faithfully depicts the entity's performance. In Illustration 4-3 and Illustration 5-2 above, construction revenue appears to be recognised over time by reference to costs incurred relative to total expected costs required to satisfy the construction services performance obligation.

An alternative criterion in IFRS 15 for recognising revenue over time is that the customer simultaneously receives and consumes the benefit as the entity performs. *[IFRS 15.35(a)]*. Each road-user simultaneously receives and consumes the benefits provided by the operator as the operator provides the road operating services and therefore the operator recognises revenue over time. However, given the short time period over which the operator provides road operating services to each road user in this fact pattern (i.e., the duration of the time it takes the road user to travel the length of the toll road), the operator recognises toll revenue when it collects the tolls.

Under the arrangement terms in this example, as set out above, the overview of the operator's statement of cash flows, statement of comprehensive income and statement of financial position will be consistent with those in Illustrative Example 2 to IFRIC 12, which are shown in Illustration 4-3 in section 4.3 above and Illustration 5-2 in section 5.2 above.

Satisfaction of performance obligations under IFRS 15 is discussed in Chapter 28 at section 7.

Classification as contract asset or intangible asset, and impairment testing

IFRIC 12 requires that, during the construction or upgrade period, consideration is classified as a contract asset by the operator. *[IFRIC 12.19]*.

Whilst IFRIC 12 requires consideration to be classified as a contract asset during the construction or upgrade period, Illustrative Example 2 to IFRIC 12 shows that the contract asset may still be presented as an intangible asset during the construction phase. *[IFRIC 12.IE15]*.

Under IAS 38, amortisation of an intangible asset begins when the asset is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. This would likely be the case once construction of the road is complete and the operator can begin using their right to operate the road to generate revenue.

As noted above, IFRIC 12 requires that during the construction or upgrade period, consideration is classified as a contract asset by the operator. Contract assets are subject to the impairment requirements of IFRS 9. *[IFRS 15.107]*. Operators may need to apply judgement in determining how to test the contract asset for impairment, given that the contract asset is expected to be realised in the form of an intangible asset, rather than as a receivable or cash. Operators may consider whether and how they can use the value of the underlying intangible asset to which they are entitled as a proxy for cash flows in order to determine expected credit losses on the contract asset.

Capitalisation of borrowing costs

Under the intangible asset model, borrowing costs must be capitalised during the period of construction. *[IFRIC 12.22]*. However, as noted above IFRIC 12 requires consideration to be classified as a contract asset, rather than an intangible asset, during the construction period. *[IFRIC 12.19]*. In March 2019, the IFRS IC issued an agenda decision relating to the capitalisation of borrowing costs on a constructed good for which revenue was recognised over time. In that agenda decision, the IFRS IC noted that, in the particular fact pattern considered, a contract asset is not a qualifying asset as the intended use of the contract asset is not a use for which it necessarily takes a substantial period of time to get ready. IAS 23 requires capitalisation of borrowing costs that are directly attributable to the acquisition, construction or production of an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. *[IAS 23.8, IAS 23.5]*. Some may argue that there is a tension between the requirement in IFRIC 12 to capitalise interest during the construction phase under the intangible asset model and this agenda decision.

How we see it

We believe that the March 2019 agenda decision noted above does not override the requirement in IFRIC 12.22 that, under the intangible asset model, borrowing costs must be capitalised during the period of construction.

7 Disclosure requirements: SIC-29

IFRIC 12 has no specific disclosure requirements, although the disclosure requirements of the various applicable accounting standards (such as IFRS 9, IFRS 7 *Financial Instruments: Disclosures, [IFRIC 12.23]*, IFRS 15, and IAS 38) will have to be applied as appropriate. SIC-29, which pre-dates IFRIC 12 by several years, includes additional disclosure requirements. *[IFRIC 12.10]*. It is important to note that the scope of SIC-29 is not defined in terms of IFRIC 12 and is potentially broader in scope than IFRIC 12. It applies to a type of transaction that is described although not really defined and which does not depend on the control criteria described in section 3 above. It also applies to both sides of the transaction, whereas IFRIC 12 applies only to the operator under the concession agreement.

SIC-29 describes service concessions as arrangements in which an entity (the operator) provides services on behalf of another entity (the grantor, which may be a public or private sector entity, including a governmental body) that give the public access to major economic and social facilities. The examples of service concession arrangements given by SIC-29 include water treatment and supply facilities, motorways, car parks, tunnels, bridges, airports and telecommunications networks. *[SIC-29.1]*.

SIC-29 states that the common characteristic of all service concession arrangements is that the operator both receives a right and incurs an obligation to provide public services. *[SIC-29.3]*. It excludes from its scope an entity outsourcing the operation of its internal services (e.g., employee cafeteria, building maintenance, and accounting or information technology functions). *[SIC-29.1]*.

How we see it

Some of the arrangements that do not include the construction of a major capital asset, as discussed above, may not be caught by the disclosure requirements of the SIC, although there is no hard-and-fast dividing line between service concessions and outsourcing arrangements. For example, a contract between a government department and an operator to maintain the existing computer system, including replacement of hardware and software as appropriate, may be outside the scope of SIC-29 if it is concluded that the government department has outsourced the operation of its internal services to the operator for its own benefit.

However, arrangements where an entity provides services on behalf of another entity that give the public access to major economic and social facilities will be in scope of the disclosure requirements of SIC-29 even if they do not meet the control criteria in IFRIC 12.5.

SIC-29 summarises the rights and obligations as follows:

For the period of the concession, the operator has received from the grantor:

(a) The right to provide services that give the public access to major economic and social facilities

And

(b) In some cases, the right to use specified tangible assets, intangible assets, and/or financial assets

In exchange for the operator:

(a) Committing to provide the services according to certain terms and conditions during the concession period

And

(b) When applicable, committing to return at the end of the concession period the rights received at the beginning of the concession period and/or acquired during the concession period *[SIC-29.2]*

SIC-29 requires disclosure in addition to that required by other accounting standards that may cover part of the transaction, such as IAS 16 (see Chapter 19), IFRS 16 (see Chapter 24) and IAS 38 (see Chapter 18). *[SIC-29.5]*. The disclosure requirements are set out below:

Extract from SIC-29

6 All aspects of a service concession arrangement shall be considered in determining the appropriate disclosures in the notes. An operator and a grantor shall disclose the following in each period:

(a) a description of the arrangement;

(b) significant terms of the arrangement that may affect the amount, timing and certainty of future cash flows (eg the period of the concession, re-pricing dates and the basis upon which re-pricing or re-negotiation is determined);

(c) the nature and extent (eg quantity, time period or amount as appropriate) of:

(i) rights to use specified assets;

(ii) obligations to provide or rights to expect provision of services;

(iii) obligations to acquire or build items of property, plant and equipment;

(iv) obligations to deliver or rights to receive specified assets at the end of the concession period;

(v) renewal and termination options; and

(vi) other rights and obligations (eg major overhauls);

(d) changes in the arrangement occurring during the period; and

(e) how the service arrangement has been classified.

6A An operator shall disclose the amount of revenue and profits or losses recognised in the period on exchanging construction services for a financial asset or an intangible asset.

[SIC-29.6, SIC-29.6A].

The disclosures required in SIC-29.6 above are provided individually for each service concession arrangement or in aggregate for each class of service concession arrangements. A class is a grouping of service concession arrangements involving services of a similar nature (e.g., toll collections, telecommunications and water treatment services). *[SIC-29.7]*.

VINCI has made aggregate disclosures for the principal terms of its arrangements. The following extract is part of the disclosures that address concession arrangements.

Practical example 7-1: VINCI (2023) France

Consolidated financial statements at 31 December 2023 [extract]

Notes to the consolidated financial statements [extract]

F. Concessions: PPP contracts, concession contracts and other infrastructure [extract]

12. Details of the main contracts in Concessions [extract]

Details of the main contracts in the Concessions business are set out by business line in the table below.

	Country	End of contract	Accounting model	Consolidation method
VINCI Autoroutes (1)				
ASF group				
ASF 2,730 km of toll motorways	France	2036	Intangible asset	FC
Escota 471 km of toll motorways	France	2032	Intangible asset	FC
...				
VINCI Airports (2)				
Société Concessionnaire Aéroports du Grand Ouest Nantes Atlantique and Saint-Nazaire Montoir airports	France	(3)	Intangible asset	FC
Aéroports de Lyon Lyon-Saint Exupéry and Lyon-Bron airports	France	2047	Intangible asset	FC
ANA group 10 airports	Portugal	2063	Intangible asset	FC
Belfast International airport	United Kingdom	2993	Intangible asset	FC
...				

(1) Remuneration is based on the pricing law as defined in the concession contract, and price increases must be validated by the grantor.

(2) Remuneration comes from both users and from airlines. Airport fees are generally regulated.

(3) The concession contract was terminated on 24 October 2019 on the grounds of public interest. The termination is due to take effect no later than the signing date of the new concession contract.

...

FC: Full consolidation; EM: Equity method.

	Country	End of contract	Accounting model	Consolidation method
VINCI Highways				
Vía Sumapaz (ex Vía 40 Express) Toll motorway connecting Bogotá and Girardot (141 km including construction of a third lane over 65 km)	Colombia	2046	Intangible asset	FC
Gefyra Toll bridge between Rio and Antirrio	Greece	2039	Intangible asset	FC
Lima Expresa Línea Amarilla: 25 km toll expressway in Lima	Peru	2049	Intangible asset	FC
Strait Crossing Development Inc. Confederation Bridge connecting the Canadian provinces of Prince Edward Island and New Brunswick	Canada	2032	Intangible asset	FC
A4 Hörselberg A-Modell 45 km	Germany	2037	Intangible asset	EM

...

Certain contracts may benefit from investment grants from the grantor. This relates mainly to contracts under the financial asset model, but also certain contracts with traffic level risk (Arcour (A19), LISEA and Consortium Stade de France).

As a general rule, when the contracts end, the concession infrastructure is returned to the grantor for no consideration. In the event that the contract is terminated or the asset under concession is bought out early by the grantor, compensation is payable to the concession holders. Its amount is determined in accordance with contractual or statutory provisions.

15. Off-balance sheet commitments in Concessions [extract]

15.1 Companies controlled by the Group

Contractual investment and renewal obligations

(in € millions)	31/12/2023	31/12/2022
Aerodom	1,036	-
ASF group	963	1,039
OMA (Grupo Aeroportuario del Centro Norte – Mexico)	342	488
Cobra IS	321	143
Cofiroute	279	370
ANA group (Portugal)	269	199
Vía Sumapaz (ex Vía 40 Express)	239	-
Concessionária dos Aeroportos da Amazônia	153	176
Cabo Verde Airports	114	-
VINCI Highways (Entrevias in Brazil)	-	286
Other	241	221
Total	**3,958**	**2,922**

Contractual investment obligations of motorway concession companies consist mainly of undertakings made under concession contracts, multi-year master contracts as part of the 2015 motorway stimulus plan and the motorway investment plan approved in 2018. VINCI Autoroutes' investment undertakings amounted to €1,242 million at 31 December 2023 (€1,409 million at 31 December 2022). The decrease in these undertakings during the period was due to progress with works.

...

The above amounts do not include obligations relating to maintenance expenditure on infrastructure under concession, in respect of which specific provisions based on maintenance plans are set aside (see Note H.19.3, "Breakdown of current provisions").

In addition to the disclosures required by SIC-29, the disclosure requirements of IFRS 15 will need to be considered. See Chapter 28 at section 10. VINCI also disclosed the revenue and profit earned from its concession arrangements. The following Practical example discloses revenue from concessions as a component of revenue by business line. The Practical example is not intended to illustrate the disclosures requirements of IFRS 15.

Practical example 7-2: VINCI (2023) **France**

Consolidated financial statements at 31 December 2023 [extract]

Notes to the consolidated financial statements [extract]

C. Financial indicators by business line and geographical area [extract]

1. Segment information by business line [extract]

1.2 Information relating to the Concessions business [extract]

2023

	Concessions			
(in € millions)	VINCI Autoroutes	VINCI Airports	VINCI Highways, VINCI Railways, VINCI Stadium and other	Total
Income statement				
Revenue(*)	**6,324**	**3,947**	**661**	**10,932**
Concession subsidiaries' works revenue	559	278	73	910
Total revenue	6,883	4,225	734	11,842
Operating income from ordinary activities	**3,362**	**1,889**	**122**	**5,373**
% of revenue	*53.2%*	*47.9%*	*18.5%*	*49.2%*
Recurring operating income	**3,342**	**1,937**	**177**	**5,456**
Operating income	**3,342**	**1,928**	**198**	**5,468**

...

(*) Excluding concession subsidiaries' revenue derived from works carried out by non-Group companies.

...

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Chapter 27 Provisions, contingent liabilities and contingent assets

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Overview

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* prescribes the recognition criteria and measurement bases to be applied to provisions, contingent liabilities and contingent assets. IAS 37 also prescribes the disclosures required in the notes to financial statements to enable users to understand the nature, timing and amount of provisions, contingent liabilities and contingent assets.

IAS 37 requires a provision to be recognised when an entity has a present obligation (legal or constructive) as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate can be made of the obligation. The amount required to be recognised as a provision is the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. Provisions are not recognised for executory contracts, except where the contract is onerous.

Contingent liabilities and contingent assets are not recognised. Instead, IAS 37 requires contingent liabilities to be disclosed, unless the possibility of any outflow is remote, and disclosure of contingent assets where an inflow of economic benefits is probable.

This chapter addresses the accounting for, and disclosure of, provisions, contingent liabilities and contingent assets in scope of IAS 37. It also covers IFRIC Interpretations related to the application of IAS 37. It does not address the accounting for provisions, contingent liabilities and contingent assets covered by another IFRS accounting standard. When another IFRS accounting standard deals with a specific type of provision, contingent liability or contingent asset, an entity applies that standard instead of IAS 37. For example, some types of provisions are addressed in standards on income taxes (see Chapter 29), leases (see Chapter 24), employee benefits (see Chapter 31), insurance contacts and other contracts within the scope of IFRS 17 *Insurance Contracts* (see Chapter 51), contingent consideration of an acquirer in a business combination (see Chapter 10) or revenue from contracts with customers (see Chapter 28).

What you need to know

- A provision is recognised if, and only if, an entity has a present obligation (legal or constructive) as a result of a past event, it is probable that an outflow of economic resources embodying economic benefits will be required to settle the obligation, and a reliable estimate can be made of the obligation.
- The amount recognised as a provision is required to be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. Where the effect of the time value of money is material, the amount of a provision is the present value of the expenditures expected to be required to settle the obligation.
- IAS 37 prohibits the recognition of provisions for future operating losses, repairs and maintenance of owned assets, and staff training costs.
- Contingent liabilities and contingent assets are not recognised.
- IAS 37 requires contingent liabilities to be disclosed unless the possibility of any outflow in settlement is remote.
- Contingent assets are disclosed if an inflow of economic benefits is probable.
- Disclosures of provisions, contingent liabilities and contingent assets must be sufficient to enable users to understand their nature, timing and amount.

1 Introduction

1.1 Background

IAS 37 applies to all provisions, contingent liabilities and contingent assets, except those relating to executory contracts that are not onerous and those provisions covered by another IFRS accounting standard. *[IAS 37.1]*.

For some time, the IASB has considered amending IAS 37 and an exposure draft was issued in June 2005. Subsequent deliberation, including round-table meetings held with constituents to discuss their views, resulted in the Board revising its proposals and issuing a second exposure draft in January 2010. However, IAS 37 was not revised. Instead, in 2010, the Board suspended the project to allow it to focus on higher priority projects, and pending completion of its project to revise the *Conceptual Framework for Financial Reporting (Conceptual Framework)*. The IASB again began discussions on a *Provisions, Contingent Liabilities and Contingent Assets* research project in 2015. Whilst stakeholders have told the Board that IAS 37 generally works well in practice, problems have been identified with some aspects of the standard. It is often difficult to determine whether an entity has a liability if an entity has an obligation that has arisen from its past actions but is also dependent on a future action of the entity. Some stakeholders have argued that the principles underlying IFRIC 21 *Levies*, an interpretation of IAS 37, are inconsistent with other requirements in IAS 37, and have argued that IFRIC 21 results in information that is not useful to investors. In addition, the measurement requirements in IAS 37 for provisions are not clear on which costs are included as part of 'the expenditure required to settle' an obligation, and do not specify whether the rate used to discount provisions should reflect the risk that the entity may fail to fulfil its liability (i.e., the entity's own credit risk). This leads to diversity in practice in the measurement of provisions. The Board is currently developing proposals for three targeted improvements to IAS 37. This would involve aligning the definition of a liability and requirements for identifying liabilities with the *Conceptual Framework*. At the time of writing, resulting amendments are expected to replace IFRIC 21 with new application requirements for levies. The IASB has also indicated an intention to add new examples to the Guidance on implementing IAS 37 to illustrate the application of the requirements, and to update the explanations for some of the existing examples, without changing those conclusions.[1] In addition, the IASB is developing proposals to clarify which costs to include in the measurement of a provision, and whether the rate at which an entity discounts a provision should reflect the entity's own credit risk. At the time of writing, discussions are ongoing, with an Exposure Draft expected in the last quarter of 2024.[2]

FASB differences

Differences between IFRS accounting standards and US GAAP guidance on this topic are not addressed in this chapter as the accounting standards are not converged.

1.2 Interpretations related to the application of IAS 37

The IFRS IC has issued a number of pronouncements relating to the application of IAS 37 (although one of them was subsequently withdrawn).

1.2.1 IFRIC 1

IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* provides guidance on how to account for the effect of changes in the measurement of existing provisions for obligations to dismantle, remove or restore items of property, plant and equipment. This is discussed in section 6.3.1 below.

1.2.2 IFRIC 3

Another issue considered by the IFRS IC was how to account for a 'cap and trade' emission rights scheme. In December 2004, the IFRS IC issued IFRIC 3 *Emission Rights*, but this was later withdrawn in June 2005. This interpretation, *inter alia*, required that as emissions are made, a liability was to be recognised for the obligation to deliver allowances equal to the emissions that had been made by the entity. Such a liability was a provision within the scope of IAS 37 and was to be measured at the present market value of the number of allowances required to cover emissions made up to the end of the reporting period. Accounting for liabilities associated with emissions trading schemes is discussed in section 6.5 below.

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1 *IASB Update, April 2024*, available on the IFRS Foundation's website.

2 *IFRS Foundation work plan*, IFRS Foundation website (accessed September 2024).

1.2.3 IFRIC 5

IFRIC 5 *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds* deals with the accounting by an entity when it participates in a 'decommissioning fund', the purpose of which is to segregate assets to fund some or all of the costs of its decommissioning or environmental liabilities for which it has to make a provision under IAS 37. This is discussed in section 6.3.3 below.

1.2.4 IFRIC 6

IFRIC 6 *Liabilities arising from Participating in a Specific Market - Waste Electrical and Electronic Equipment* provides guidance on the accounting for liabilities for waste management costs. This clarifies when certain producers of electrical goods will need to recognise a liability for the cost of waste management relating to the decommissioning of waste electrical and electronic equipment (historical waste) supplied to private households. This is discussed in section 6.7 below.

1.2.5 IFRIC 21

IFRIC 21 addresses the recognition of a liability to pay a levy imposed by government if that liability is within the scope of IAS 37. It also addresses the accounting for a liability to pay a levy whose timing and amount is certain (see section 6.8 below).

Although they are not interpretations of the standard as such, the IAS 37 guidance on non-financial liabilities is also referred to in IFRIC 12 *Service Concession Arrangements* (see Chapter 26); and IFRIC 14 *IAS 19 - The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* (see Chapter 31).

1.3 Terms used in this chapter

The following terms are used in this chapter with the meanings specified in the respective IFRS accounting standard:

Extract from IAS 37

3 Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. This Standard does not apply to executory contracts unless they are onerous.

Definitions

10 **The following terms are used in this Standard with the meanings specified:**

A *provision* is a liability of uncertain timing or amount.

A *liability* is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.[1]

An *obligating event* is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

A *legal obligation* is an obligation that derives from:

(a) a contract (through its explicit or implicit terms);

(b) legislation; or

(c) other operation of law.

A *constructive obligation* is an obligation that derives from an entity's actions where:

(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

(b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

A *contingent liability* is:

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

(b) a present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) the amount of the obligation cannot be measured with sufficient reliability.

A *contingent asset* is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

An *onerous contract* is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

A *restructuring* is a programme that is planned and controlled by management, and materially changes either:

(a) the scope of a business undertaken by an entity; or

(b) the manner in which that business is conducted.

1 The definition of a liability in this Standard was not revised following the revision of the definition of a liability in the *Conceptual Framework for Financial Reporting* issued in 2018.

[IAS 37.3, IAS 37.10].

Extract from IFRIC 21

4 For the purposes of this Interpretation, a levy is an outflow of resources embodying economic benefits that is imposed by governments on entities in accordance with legislation (ie laws and/or regulations), other than:

(a) those outflows of resources that are within the scope of other Standards (such as income taxes that are within the scope of IAS 12 *Income Taxes*); and

(b) fines or other penalties that are imposed for breaches of the legislation.

'Government' refers to government, government agencies and similar bodies whether local, national or international.

[IFRIC 21.4].

As noted in section 1.1 above, the IASB is developing proposals for three targeted improvements to IAS 37. One of the proposed improvements would involve aligning the definition of a liability in IAS 37 and the requirements for identifying liabilities with the *Conceptual Framework*. The *Conceptual Framework* defines a liability as a present obligation of the entity to transfer an economic resource as a result of past events, *[CF 4.26]*, and requires that for a liability to exist, three criteria must be satisfied:

(a) The entity has an obligation

(b) The obligation is to transfer an economic resource

And

(c) The obligation is a present obligation that exists as a result of past events *[CF 4.27]*

2 Objective and scope of IAS 37

2.1 Objective

Extract from IAS 37

Objective

The objective of this Standard is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to enable users to understand their nature, timing and amount.

[IAS 37 Objective].

2.2 Scope of IAS 37

Extract from IAS 37

1 This Standard shall be applied by all entities in accounting for provisions, contingent liabilities and contingent assets, except:

(a) those resulting from executory contracts, except where the contract is onerous; and

(b) [deleted]

(c) those covered by another Standard.

[IAS 37.1].

The following table lists the specific types of transaction or circumstances referred to in the standard that might give rise to a provision, contingent liability or contingent asset. In some cases, the transaction is identified in IAS 37 only to prohibit recognition of any liability, such as for future operating losses and repairs and maintenance of owned assets (see section 5 below). This chapter does not address those items identified below as falling outside the scope of the standard.

Types of transaction or circumstances referred to	In scope	Out of scope	Covered by
Restructuring costs	Yes		
Environmental penalties or clean-up costs	Yes		
Decommissioning costs	Yes		
Product warranties/refunds	Yes		
Legal claims	Yes		
Reimbursement rights	Yes		
Insurance recoveries	Yes		
Future operating costs (training, relocation, etc.)	Yes		
Future operating losses	Yes		
Onerous contracts (including onerous contracts under IFRS 15)	Yes		
Repairs and maintenance costs	Yes		
Provisions for depreciation, impairment or doubtful debts		Yes	IAS 16 / IAS 38 / IAS 36 / IFRS 9
Executory contracts (unless onerous)		Yes	
Income taxes		Yes	IAS 12
Leases (other than leases becoming onerous before commencement date, short-term leases, and leases of low-value assets)		Yes	IFRS 16

Types of transaction or circumstances referred to	In scope	Out of scope	Covered by
Employee benefits		Yes	IAS 19
Insurance contracts issued		Yes	IFRS 17
Contingent liabilities acquired in a business combination		Yes	IFRS 3
Contingent consideration of an acquirer in a business combination		Yes	IFRS 3
Financial instruments and financial guarantees within the scope of IFRS 9		Yes	IFRS 9
Trade payables		Yes	IFRS 9
Accruals		Yes	

2.2.1 Items outside the scope of IAS 37

2.2.1.A Executory contracts, except where the contract is onerous

The standard uses the term executory contracts to mean "...contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent...". *[IAS 37.3]*. This means that contracts such as supplier purchase contracts and capital commitments, which would otherwise fall within the scope of the standard, are exempt.

This exemption prevents the statement of financial position from being grossed up for all manner of commitments that an entity has entered into, and in respect of which it is debatable whether (or at what point) such contracts give rise to items that meet the definition of a liability or an asset. In particular, the need for this exemption arises because the liability framework on which this standard is based includes the concept of a constructive obligation (see section 3.1.1 below) which, when applied to executory contracts would otherwise give rise to an inordinate number of contingent promises requiring recognition or disclosure.

An executory contract will still require recognition as a provision if the contract becomes onerous. *[IAS 37.3]*. Onerous contracts are dealt with in section 6.2 below.

2.2.1.B Items covered by another IFRS accounting standard

Where another IFRS accounting standard deals with a specific type of provision, contingent liability or contingent asset, it must be applied instead of IAS 37. Examples given in the standard are:

- Income taxes (dealt with in IAS 12 *Income Taxes* - see Chapter 29).
- Leases (dealt with in IFRS 16 *Leases* - see Chapter 24). However, IAS 37 applies to any lease that becomes onerous before the commencement date of the lease, as defined in IFRS 16. IAS 37 also applies to onerous short-term leases and onerous leases of low value assets that are accounted for under IFRS 16.6. *[IAS 37.5(c)]*.
- Employee benefits (dealt with in IAS 19 *Employee Benefits* - see Chapter 31).
- Insurance and other contracts in scope of IFRS 17 (see Chapter 51).
- Contingent consideration of an acquirer in a business combination (dealt with in IFRS 3 *Business Combinations* - see Chapter 10).
- Revenue from contracts with customers (dealt with in IFRS 15 *Revenue from Contracts with Customers* - see Chapter 28). However, as IFRS 15 contains no specific requirements to address contracts with customers that are, or have become, onerous, IAS 37 applies to such cases. *[IAS 37.5(g)]*.

Contingent consideration of an acquirer in a business combination is excluded from the scope of IAS 37. See Chapter 10 at section 7.1.

As noted above, the scope of IAS 37 excludes income taxes that fall in the scope of IAS 12. The IFRS IC confirmed in July 2014 that the recognition of tax-related contingent liabilities and contingent assets are assessed using the guidance in IAS 12 rather than IAS 37.[3] In addition, IFRIC 23 *Uncertainty over Income Tax Treatments* clarifies how to apply the recognition and measurement requirements in IAS 12 when there is uncertainty over tax treatments. *[IFRIC 23.4]*. IAS 37 remains relevant to the disclosure of tax-related contingent liabilities and contingent assets. *[IAS 12.88]*. However, as discussed in section 6.8.1 below, IAS 37 in general and IFRIC 21 in particular, apply to taxes or levies outside the scope of IAS 12. As regards interest and penalties imposed by taxation authorities, the position is unclear. Neither IAS 12 nor IFRIC 23 contain a specific reference to interest and penalties, the IFRS IC decided not to add a project on interest and penalties to its agenda.[4] However, notwithstanding their decision to exclude interest and penalties from the scope of IFRIC 23 and their decision not to add a project on interest and penalties to its agenda, the IFRS IC observed that if an entity determines that amounts payable or receivable for interest and penalties are income taxes, then the entity applies IAS 12 to those amounts. If an entity does not apply IAS 12 to interest and penalties, then it applies IAS 37 to those amounts. Uncertain tax treatments are discussed further in Chapter 29 at section 9. The circumstances in which interest and penalties might fall within the scope of IAS 12 are considered in Chapter 29 at section 4.4. Levies imposed by governments are examined in section 6.8 below.

Whilst IAS 37 contains no reference to it, IFRS 3 is clear that the requirements in IAS 37 do not apply in determining which contingent liabilities to recognise as of the acquisition date (see section 4.10 below and Chapter 10 at section 5.6.1). *[IFRS 3.23]*.

In addition, the standard does not apply to financial instruments (including guarantees) that are within the scope of IFRS 9 *Financial Instruments*. *[IAS 37.2]*. This means that guarantees of third-party borrowings (including those of subsidiaries, associates and joint arrangements) are not covered by IAS 37. See Chapter 41 at section 2.4.

The standard applies to provisions for restructurings, including discontinued operations. However, it emphasises that when a restructuring meets the definition of a discontinued operation under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, additional disclosures may be required under that standard (see Chapter 5 at section 3). *[IAS 37.9]*.

As noted above, IAS 37 applies to contracts in scope of IFRS 15 that are, or have become, onerous. *[IAS 37.5(g)]*. IFRS 15 adds that IAS 37 applies to other obligations under a contract with a customer that do not give rise to a performance obligation. For example, a law that requires an entity to pay compensation if its products cause harm or damage does not give rise to a performance obligation and IAS 37 would apply. Similarly, an entity would account for customer indemnities arising from claims of patent, copyright, trademark or other infringement in relation to its products in accordance with IAS 37. *[IFRS 15.B33]*. Furthermore, whilst an entity would apply IFRS 15 to separately purchased warranties, if a customer does not have the option to purchase a warranty separately, an entity would consider IAS 37 (see section 6.10 below), unless the promised warranty, or a part of the promised warranty, provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications. *[IFRS 15.B30]*.

The standard defines a provision as "…a liability of uncertain timing or amount". *[IAS 37.10]*. Thus, it only deals with provisions that are shown as liabilities in a statement of financial position. The term 'provision' is also used widely in the context of items such as depreciation, impairment of assets and doubtful debts. Such 'provisions' are not addressed in IAS 37, since these are adjustments to the carrying amounts of assets. *[IAS 37.7]*.

2.2.2 Provisions compared to other liabilities

IAS 37 states that the feature distinguishing provisions from other liabilities, such as trade payables and accruals, is the existence of "…uncertainty about the timing or amount of the future expenditure required in settlement…". *[IAS 37.11]*. The standard compares provisions to:

(a) Trade payables - liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier.

(b) Accruals - liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees (for example, amounts relating to accrued vacation pay). Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions.

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3 *IFRIC Update*, July 2014, p.7. Available on the IFRS Foundation's website.

4 *IFRIC Update*, September 2017, available on the IFRS Foundation's website.

IAS 37 also notes that accruals are often reported as part of trade and other payables whereas provisions are reported separately. *[IAS 37.11]*.

For trade payables and their associated accruals, there is little uncertainty regarding either the amount of the obligation (which would be determined by the contracted price for the goods and services being provided) or of the timing of settlement (which would normally occur within an agreed period following transfer of the goods and services in question and the issue of an invoice). In practice, however, contracts can be more complex and give rise to a wide range of possible outcomes in terms of the amount or timing of payment. In these circumstances, the difference between provisions and other liabilities is less obvious and judgement may be required to determine where the requirement to make an estimate of an obligation indicates a level of uncertainty about timing or amount that is more indicative of a provision. Such judgements, if significant to the amounts recognised in the financial statements, would merit disclosure (see Chapter 3 at section 5.1.1.A). *[IAS 1.122]*.

Some liabilities may initially be classified as provisions due to uncertainty regarding the timing or amount of payment. Subsequently, after negotiation with a counterparty or a decision by a court of law, the exact amount and timing of settlement may be agreed. As the entity now has an obligation to pay a fixed sum at an agreed point in time, the liability no longer meets the definition of a provision and instead is a financial liability in scope of IFRS 9.

One reason why the distinction between provisions and other liabilities matters is that provisions are subject to narrative disclosure requirements regarding the nature of the obligation and the uncertainties over timing and amount; and to quantitative disclosures of movements arising from their use, remeasurement or release that do not apply to other payables (see section 7.1 below). In fact, although questions of recognition and measurement are important, transparency of disclosure is also a very significant matter in relation to accounting for provisions and ensuring that their effect is properly understood by users of the financial statements.

2.2.3 Distinction between provisions and contingent liabilities

There is an area of overlap between provisions and contingent liabilities. Although contingent liabilities are clearly not as likely to give rise to outflows, similar judgements are made in assessing the nature of the uncertainties, the need for disclosures and ultimately the recognition of a liability in the financial statements. The standard notes that in a general sense, all provisions are contingent because they are uncertain in timing or amount. However, in IAS 37 the term 'contingent' is used for liabilities and assets that are not recognised because their existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the entity's control. In addition, the term 'contingent liability' is used for liabilities that do not meet the recognition criteria for provisions. *[IAS 37.12]*.

Accordingly, the standard distinguishes between:

(a) Provisions - which are recognised as liabilities (assuming that a reliable estimate can be made) because they are present obligations and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations.

(b) Contingent liabilities - which are not recognised as liabilities because they are either:

  (i) Possible obligations, as it has yet to be confirmed whether the entity has a present obligation that could lead to an outflow of resources embodying economic benefits.

  Or

  (ii) Present obligations that do not meet the recognition criteria in the standard because either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a sufficiently reliable estimate of the amount of the obligation cannot be made. *[IAS 37.13]*.

3 Recognition

3.1 Determining when a provision must be recognised

Extract from IAS 37

14 A *provision* shall be recognised when:

(a) an entity has a present obligation (legal or constructive) as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision shall be recognised.

[IAS 37.14].

Each of these three conditions is discussed separately below.

3.1.1 'An entity has a present obligation (legal or constructive) as a result of a past event'

The standard defines both legal and constructive obligations. The definition of a legal obligation is fairly straightforward and uncontroversial; it refers to an obligation that derives from a contract (through its explicit or implicit terms), legislation or other operation of law. *[IAS 37.10]*.

The definition of a constructive obligation, on the other hand, may give rise to more problems of interpretation. A constructive obligation is defined as "…an obligation that derives from an entity's actions where:

(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

(b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities." *[IAS 37.10]*.

The following Illustration, based on the examples in IAS 37, shows how a constructive obligation is created.

Illustration 3-1: Recognising a provision because of a constructive obligation

Scenario 1: Environmental policy - contaminated land

An entity in the oil industry operates in a country with no environmental legislation. However, it has a widely published environmental policy in which it undertakes to clean up all contamination that it causes and it has a record of honouring this published policy. During the period, the entity causes contamination to some land in this country.

In these circumstances, the contamination of the land gives rise to a constructive obligation because the entity (through its published policy and record of honouring it) has created a valid expectation on the part of those affected by it that the entity will clean up the site. *[IAS 37.IE Example 2B]*.

Scenario 2: Refunds policy - product returns

A retail store has a generally known policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so.

In these circumstances, the sale of its products gives rise to a constructive obligation because the entity (through its reputation for providing refunds) has created a valid expectation on the part of customers that a refund will be given if they are dissatisfied with their purchase. *[IAS 37.IE Example 4]*.

Scenario 2 above addresses refunds policy for product returns. As noted in section 6.12 below, the accounting treatment of refunds impinges into the area of revenue recognition. Other than contracts with customers that are, or have become onerous, contracts in scope of IFRS 15 are outside the scope of IAS 37.

The examples in Illustration 3-1 above demonstrate that the essence of a constructive obligation is the creation of a valid expectation that the entity is irrevocably committed to accepting and discharging its responsibilities.

The standard states that in almost all cases it will be clear whether a past event has given rise to a present obligation. However, it acknowledges that there will be some rare cases, such as a lawsuit against an entity, where this will not be so because the occurrence of certain events or the consequences of those events are disputed. *[IAS 37.16]*. When it is not clear whether there is a present obligation, a 'more likely than not' evaluation (taking into account all available evidence) is deemed to be sufficient to require recognition of a provision at the end of the reporting period. *[IAS 37.15]*.

The evidence to be considered includes, for example, the opinion of experts together with any additional evidence provided by events after the reporting period. If, on the basis of such evidence, it is concluded that a present obligation is 'more likely than not' to exist at the end of the reporting period, a provision will be required (assuming that the other recognition criteria are met). *[IAS 37.16]*. This is an apparent relaxation of the standard's first criterion for the recognition of a provision as set out in section 3.1 above, which requires there to be a definite obligation, not just a probable one. It also confuses slightly the question of the existence of an obligation with the probability criterion, which strictly speaking relates to whether it is more likely than not that there will be an outflow of resources (see section 3.1.2 below). However, this interpretation is confirmed in IAS 10 *Events after the Reporting Period*, which includes "…the settlement after the reporting period of a court case that confirms that the entity had a present obligation at the end of the reporting period…" as an example of an adjusting event. *[IAS 10.9]*.

The second half of this condition uses the phrase 'as a result of a past event'. This is based on the concept of an obligating event, which the standard defines as "…an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation". *[IAS 37.10]*. The standard says that this will be the case only:

(a) Where the settlement of the obligation can be enforced by law
Or
(b) In the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation *[IAS 37.17]*

This concept of obligating event is used in the standard when discussing specific examples of recognition, which we consider further in section 6 below. However, it is worth mentioning here that this concept, like that of a constructive obligation, is open to interpretation and requires the exercise of judgement, as the obligating event is not always easy to identify.

The standard emphasises that the financial statements deal with the financial position of an entity at the end of its reporting period, not its possible position in the future. Accordingly, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities to be recognised are those that exist at the end of the reporting period. *[IAS 37.18]*. It is not always easy to distinguish between the current state at the reporting date and the entity's future possible position, especially where IAS 37 requires an assessment to be made based on the probability of obligations and expectations as to their outcome. However, when considering these questions, it is important to ensure that provisions are not recognised for liabilities that arise from events after the reporting period (see Chapter 34 at section 2).

Illustration 3-2: No provision without a past obligating event

The government introduces a number of changes to the income tax system. As a result of these changes, an entity in the financial services sector will need to retrain a large proportion of its administrative and sales staff in order to ensure continued compliance with financial services regulation. At the end of the reporting period, no training has taken place.

In these circumstances, no event has taken place at the reporting date to create an obligation. Only once the training has taken place, will there be a present obligation as a result of a past event. *[IAS 37.IE Example 7]*.

IAS 37 prohibits certain provisions that might otherwise qualify to be recognised by stating that "It is only those obligations arising from past events existing independently of an entity's future actions (ie the future conduct of its business) that are recognised as provisions…". *[IAS 37.19]*. In contrast to situations where the entity's past conduct has created an obligation to incur expenditure (such as to rectify environmental damage already caused), a commercial or legal requirement to incur expenditure in order to operate in a particular way in the future, will not of itself justify the recognition of a provision. It argues that because the entity can avoid the expenditure by its future actions, for example, by changing its method of operation, there is no present obligation for the future expenditure. *[IAS 37.19]*.

Illustration 3-3: Obligations must exist independently of an entity's future actions

Under legislation passed in 20X1, an entity is required to fit smoke filters in its factories by 30 June 20X3. The entity has not fitted the smoke filters.

At 31 December 20X2, the end of the reporting period, no event has taken place to create an obligation. Only once the smoke filters are fitted or the legislation takes effect, will there be a present obligation as a result of a past event, either for the cost of fitting smoke filters or for fines under the legislation.

At 31 December 20X3, there is still no obligating event to justify provision for the cost of fitting the smoke filters required under the legislation because the filters have not been fitted. However, an obligation may exist as at the reporting date to pay fines or penalties under the legislation because the entity is operating its factory in a non-compliant way. However, a provision would only be recognised for the best estimate of any fines and penalties if, as at 31 December 20X3, it is determined to be more likely than not that such fines and penalties will be imposed. *[IAS 37.IE Example 6]*.

The standard expects strict application of the requirement that, to qualify for recognition, an obligation must exist independently of an entity's future actions. Even if a failure to incur certain costs would result in a legal requirement to discontinue an entity's operations, no provision can be recognised. As discussed in section 5.2 below, IAS 37 considers the example of an airline required by law to overhaul its aircraft once every three years. It concludes that no provision is recognised because the entity can avoid the requirement to perform the overhaul, for example, by replacing the aircraft before the three-year period has expired. *[IAS 37.IE Example 11B]*.

Significantly, however, such considerations do not apply in the case of obligations to dismantle or remove an asset at the end of its useful life, where an obligation is recognised despite the entity's ability to dispose of the asset before its useful life has expired. Such costs are required to be included by IAS 16 *Property, Plant and Equipment* as part of the measurement of an asset's initial cost. *[IAS 16.16]*. Decommissioning provisions are discussed in section 6.3 below. Accordingly, the determination of whether an obligation exists independently of an entity's future actions can be a matter of judgement that depends on the particular facts and circumstances of the case.

There is no requirement for an entity to know to whom an obligation is owed. The obligation may be to the public at large. It follows that the obligation could be to one party, but the amount ultimately payable will be to another party. For example, in the case of a constructive obligation for an environmental clean-up, the obligation is to the public, but the liability will be settled by making payment to the contractors engaged to carry out the clean-up. However, the principle is that there must be another party for the obligation to exist. It follows from this that a management or board decision will not give rise to a constructive obligation unless it is communicated in sufficient detail to those affected by it before the end of the reporting period. *[IAS 37.20]*. The most significant application of this requirement relates to restructuring provisions, which is discussed further in section 6.1 below.

The standard discusses the possibility that an event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law or an act by the entity (such as a sufficiently specific public statement) which gives rise to a constructive obligation. *[IAS 37.21]*. Changes in the law will be relatively straightforward to identify. The only issue that arises will be to determine exactly when that change in the law is recognised. IAS 37 states that an obligation arises only when the legislation is virtually certain to be enacted as drafted and suggests that in many cases, this will not be until it is enacted. *[IAS 37.22]*.

The more subjective area is the possibility that an act by the entity will give rise to a constructive obligation. The example given is of an entity publicly accepting responsibility for rectification of previous environmental damage in a way that creates a constructive obligation. *[IAS 37.21]*. This seems to introduce a certain amount of flexibility to management when reporting results. By bringing forward or delaying a public announcement of a commitment that management had always intended to honour, it can affect the reporting period in which a provision is recognised. Nevertheless, the existence of a public announcement provides a more transparent basis for recognising a provision than, for example, a decision made behind the closed doors of a boardroom.

3.1.2 'It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation'

This requirement has been included as a result of the standard's attempt to incorporate contingent liabilities within the definition of provisions. This is discussed in section 3.2 below.

It is important to note that even if an entity will incur expenditure to settle an obligation, it will not suffer a net outflow of resources if it receives resources of equal value in exchange for that expenditure. That is, it must be probable that a net outflow of resources embodying economic benefits will be required to settle the obligation for a provision to be recognised.

The meaning of probable in these circumstances is that the outflow of resources is more likely than not to occur; that is, it has a probability of occurring that is greater than 50%. *[IAS 37.23]*. The standard also makes it clear that where there are a number of similar obligations, the probability that an outflow will occur is based on the class of obligations as a whole. This is because in the case of certain obligations such as warranties, the possibility of an outflow for an individual item may be small (likely to be much less than 50%) whereas the possibility of at least some outflow of resources for the population as a whole will be much greater (almost certainly greater than 50%). *[IAS 37.24]*. With regard to the measurement of a provision arising from a number of similar obligations, the standard refers to the calculation of an 'expected value', whereby the obligation is estimated by weighting all the possible outcomes by their associated probabilities. *[IAS 37.39]*. Where the obligation being measured relates to a single item, the standard suggests that the best estimate of the liability may be the individual most likely outcome. *[IAS 37.40]*. For the purposes of recognition, a determination that it is more likely than not that any outflow of resources will be required is sufficient. The measurement of provisions is discussed in section 4 below.

3.1.3 'A reliable estimate can be made of the amount of the obligation'

The standard takes the view that a sufficiently reliable estimate can almost always be made for a provision where an entity can determine a range of possible outcomes. Hence, the standard contends that it will only be in extremely rare cases that a range of possible outcomes cannot be determined and therefore no sufficiently reliable estimate of the obligation can be made. *[IAS 37.25]*. In these extremely rare circumstances, no liability is recognised. Instead, the liability must be disclosed as a contingent liability (see disclosure requirements in section 7.2 below). *[IAS 37.26]*. Whether such a situation is as rare as the standard asserts is open to question, especially for entities trying to determine estimates relating to potential obligations that arise from litigation and other legal claims (see section 6.11 below).

In the Practical example below, Alcon Inc. explains that it does not recognise provisions for potential damage awards for legal claims if the payment cannot be reliably estimated.

Practical example 3-1: Alcon Inc. (2023) **Switzerland**

2023 Annual Report [extract]
Part III [extract]
ITEM 18. FINANCIAL STATEMENTS [extract]
CONSOLIDATED FINANCIAL STATEMENTS OF ALCON INC. [extract]
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS OF ALCON INC. [extract]
18. Provisions and other non-current liabilities [extract]

Provisions for litigation and other legal matters

Alcon has established provisions for certain litigation and other legal matters, where a potential cash outflow is probable and a reliable estimate can be made of the amount of the outflow. These provisions represent the current best estimate of the total financial effect for these matters. Potential cash outflows reflected in a provision may be fully or partially offset by insurance in certain circumstances.

Alcon has not established provisions for potential damage awards for certain additional legal claims if Alcon currently believes that a payment is either not probable or cannot be reliably estimated. A number of other legal matters are in such early stages or the issues presented are such that Alcon has not made any provisions since it cannot currently estimate either a potential outcome or the amount of any potential losses. For these reasons, among others, Alcon generally is unable to make a reliable estimate of possible loss with respect to such cases. It is therefore not practicable to provide information about the potential financial impact of those cases.

There might also be cases for which Alcon was able to make a reliable estimate of the possible loss or the range of possible loss, but Alcon believes that publication of such information on a case-by-case basis would prejudice Alcon's position in ongoing legal proceedings or in any related settlement discussions. Accordingly, in such cases, information would be disclosed with respect to the nature of the contingency, but no disclosure is provided as to an estimate of the possible loss or range of possible loss.

Note 25 contains additional information on contingencies.

3.2 Contingencies

IAS 37 says that contingent liabilities and contingent assets are not recognised, but only disclosed. *[IAS 37.27, IAS 37.28, IAS 37.31, IAS 37.34]*.

Contingent liabilities that are recognised separately as part of allocating the cost of a business combination are covered by the requirements of IFRS 3. *[IFRS 3.23]*. Such liabilities continue to be measured after the business combination at the higher of:

(a) The amount that would be recognised in accordance with IAS 37

(b) The amount initially recognised less, if appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15 *[IFRS 3.56]*

The requirements in respect of contingent liabilities identified in a business combination are discussed in Chapter 10 at section 5.6.1.

3.2.1 Contingent liabilities

Extract from IAS 37

10 The following terms are used in this Standard with the meanings specified:

...

A *contingent liability* is:

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

(b) a present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) the amount of the obligation cannot be measured with sufficient reliability.

...

[IAS 37.10].

At first glance, this definition is not easy to understand because a natural meaning of 'contingent' would include any event whose outcome depends on future circumstances. The meaning is perhaps clearer when considering the definition of a liability and the criteria for recognising a provision in the standard. A possible obligation whose existence is yet to be confirmed does not meet the definition of a liability; and a present obligation in respect of which an outflow of resources is not probable, or which cannot be measured reliably does not qualify for recognition. *[IAS 37.14]*. On that basis a contingent liability under IAS 37 means one of the following:

(a) An obligation that is estimated to be less than 50+% likely to exist (i.e., it does not meet the definition of a liability). Where it is more likely than not that a present obligation exists at the end of the reporting period, a provision is recognised. *[IAS 37.16(a)]*. Where it is more likely than not that no present obligation exists, a contingent liability is disclosed (unless the possibility is remote). *[IAS 37.16(b)]*.

(b) A present obligation that has a less than 50+% chance of requiring an outflow of economic benefits (i.e., it meets the definition of a liability but does not meet the recognition criteria). Where it is not probable that there will be an outflow of resources, an entity discloses a contingent liability (unless the possibility is remote). *[IAS 37.23]*.

Or

(c) A present obligation for which a sufficiently reliable estimate cannot be made (i.e., it meets the definition of a liability but does not meet the recognition criteria). In these rare circumstances, a liability cannot be recognised and it is disclosed as a contingent liability. *[IAS 37.26]*.

The term 'possible' is not defined, but literally it could mean any probability greater than 0% and less than 100%. However, the standard effectively divides this range into four components, namely 'remote', 'possible but not probable', 'probable' and 'virtually certain'. The standard requires a provision to be recognised if "...it is more likely than not that a present obligation exists at the end of the reporting period...". *[IAS 37.16(a)]*. Therefore, IAS 37 distinguishes between a 'probable' obligation (which is more likely than not to exist and, therefore requires recognition as a provision) and a 'possible' obligation (for which either the existence of a present obligation is yet to be confirmed or where the probability of an outflow of resources is 50% or less). *[IAS 37.13]*. Section A of the Implementation Guidance to IAS 37, in summarising the main requirements of the standard, uses the phrase "...a possible obligation ... that may, but probably will not, require an outflow of resources". Accordingly, the definition restricts contingent liabilities to those where either the existence of the liability or the transfer of economic benefits arising is less than 50+% probable (or where the obligation cannot be measured at all, but as noted in section 3.1.3 above, this would be relatively rare).

The standard requires that contingent liabilities are assessed continually to determine whether circumstances have changed, in particular whether an outflow of resources embodying economic benefits has become probable. Where this becomes the case, then provision is made in the period in which the change in probability occurs (except in the rare circumstances where no reliable estimate can be made). *[IAS 37.30]*. Other changes in circumstances might require disclosure of a previously remote obligation on the grounds that an outflow of resources has become possible (but not probable). The impact of changes in circumstances on the recognition of provisions is shown in Illustration 3-4 below, and the Practical example 3-2 below, from Shell plc:

Illustration 3-4: When the likelihood of an outflow of benefits becomes probable

After a wedding in 20X2, ten people died, possibly as a result of food poisoning from products sold by the entity. Legal proceedings are started seeking damages from the entity. The entity disputes any liability and, up to the date on which its financial statements for the year ended 31 December 20X2 are authorised for issue, its lawyers have advised that is probable that the entity will not be found liable. However, when the entity prepares its financial statements for the year ended 31 December 20X3, its lawyers advise that, owing to developments in the case, it is probable that the entity will be found liable.

At 31 December 20X2, no provision is recognised and the matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote. On the basis of the evidence available when the financial statements were approved, there is no obligation as a result of a past event.

At 31 December 20X3, a provision is recognised for the best estimate of the amount required to settle the obligation. The fact that an outflow of economic benefits is now believed to be probable means that there is a present obligation. *[IAS 37.IE Example 10]*.

Practical example 3-2: Shell plc (2022) United Kingdom

Annual Report and Accounts [extract]
Financial Statements and Supplements [extract]
Consolidated Financial Statements [extract]
Notes to the Consolidated Financial Statements [extract]
31 - Legal proceedings and other contingencies [extract]

Decommissioning and restoration of manufacturing facilities
Prior to 2020, in line with industry practice, Shell's policy had been not to recognise decommissioning and restoration provisions associated with manufacturing facilities in Oil Products and Chemicals. This was on the basis that these assets were considered to have indefinite lives and, therefore, that it was considered remote that an outflow of economic benefits would be required.

In 2020, the changed macroeconomic fundamentals were considered, together with Shell's plans to rationalise the Group's manufacturing portfolio. It was also reconsidered whether it remained appropriate not to recognise decommissioning and restoration provisions for manufacturing facilities.

It was concluded that the assumption of indefinite lives for manufacturing facilities was no longer appropriate, and the need for either recognition of decommissioning and restoration provisions or contingent liability disclosure was reviewed. In 2020, provisions had been recognised for certain shorter-lived manufacturing facilities, but for the remaining longer-lived facilities, where decommissioning would generally be more than 50 years away, it was concluded that, while there is a present obligation that has arisen from past events, the amount of the obligation cannot be measured with sufficient reliability. This conclusion was reached on the basis that the settlement dates are indeterminate; and that other estimates, such as extremely long-term discount rates for which there is no observable measure, are not reliable. Consequently, a decommissioning and restoration obligation exists that cannot be recognised or quantified and that is disclosed as a contingent liability.

3.2.2 Contingent assets

A contingent asset is defined in a more intuitive way. It is "…a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity". *[IAS 37.10]*. In this case, the word 'possible' is not confined to a level of probability of 50% or less, which may further increase the confusion over the different meaning of the term in the definition of contingent liabilities. *[IAS 37.32]*.

Extract from IAS 37

32 Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the entity. An example is a claim that an entity is pursuing through legal processes, where the outcome is uncertain.

[IAS 37.32].

The standard states that contingent assets are not recognised, as this could give rise to recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is no longer regarded as contingent and recognition is appropriate. *[IAS 37.33]*.

Virtual certainty is not defined in the standard, but it is certainly a much higher hurdle than 'probable' and indeed more challenging than the term 'highly probable', defined in IFRS 5 as "Significantly more likely than probable". *[IFRS 5 Appendix A]*. We think it reasonable that virtual certainty is interpreted as being as close to 100% as to make any remaining uncertainty insignificant. What this means in practice requires each case to be decided on its merits and any judgement must be made in the knowledge that, in any event, it is rarely possible to accurately assess the probability of the outcome of a particular event.

The standard requires disclosure of the contingent asset when the inflow of economic benefits is probable. *[IAS 37.34]*. For the purposes of the standard 'probable' means that the event is more likely than not to occur; that is, it has a probability greater than 50%. *[IAS 37.23]*. The disclosure requirements are detailed in section 7.3 below.

As with contingent liabilities, any contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the period in which the change occurs. If a previously unlikely inflow becomes probable, then the contingent asset must be disclosed. *[IAS 37.35]*.

The requirement to recognise the effect of changing circumstances in the period in which the change occurs extends to the analysis of information available after the end of the reporting period and before the date of approval of the financial statements. In our view, such information would not give rise to an adjusting event after the reporting period. In contrast to contingent liabilities (in respect of which IAS 10 includes as a specific example of an adjusting event "...the settlement after the reporting period of a court case that confirms that the entity had a present obligation at the end of the reporting period..." *[IAS 10.9]*), no adjustment is made to reflect the subsequent settlement of a legal claim in favour of the entity. In this instance, the period in which the change occurs is subsequent to the reporting period. There is also no suggestion that the example in IAS 10 is referring to anything but liabilities. An asset could only be recognised if, at the end of the reporting period, the entity could show that it was virtually certain that its claim would succeed.

How we see it

In contrast to contingent liabilities, information available after the end of the reporting period and before the date of approval of the financial statements would not give rise to an adjusting event after the reporting period for contingent assets. No adjustment is made to reflect the subsequent settlement of a legal claim in favour of the entity. An asset could only be recognised if, at the end of the reporting period, the entity could show that it was virtually certain that its claim would succeed.

3.2.2.A Obligations contingent on the successful recovery of a contingent asset

Entities may sometimes be required to pay contingent fees to a third-party dependent upon the successful recovery of a contingent asset. For example, the payment of fees to a legal advisor in a contract agreed on a 'no win, no fee' basis will depend upon the successful outcome of a legal claim.

How we see it

Where entities are required to pay contingent fees to a third party, dependent upon the successful recovery of a contingent asset, the obligation for the success fee arises from an executory contract that must be evaluated separately from the legal claim. The liability for the success fee would therefore only be recognised by the entity upon winning the claim.

IAS 37 uses the term executory contracts to mean "...contracts under which neither party has performed any of its obligations, or both parties have partially performed their obligations to an equal extent...". *[IAS 37.3]*. When a contract for services is wholly contingent on recovering a contingent asset, no service requiring payment is deemed to be provided until or unless the matter is resolved successfully. Unless the contract also required payment to be made in the event of failure, the amount of work put in by the lawyer to prepare a case and argue for recovery of the contingent asset is irrelevant to the existence of a liability to pay fees.

If the entity has deemed it appropriate to recognise an asset in respect of the claim, it would be appropriate to take account of any such fees in the measurement of that asset (in determining the net amount recoverable); but no accrual is made for the legal fees themselves unless a successful outcome is confirmed.

This analysis is specific to a no win-no fee arrangement related to a contingent asset and may not be appropriate in other circumstances.

3.2.3 How probability determines whether to recognise or disclose

The following matrix summarises the treatment of contingencies under IAS 37:

Likelihood of outcome	Accounting treatment: contingent liability	Accounting treatment: contingent asset
Virtually certain	Recognise	Recognise
Probable	Recognise	Disclose
Possible but not probable	Disclose	No disclosure permitted
Remote	No disclosure required	No disclosure permitted

The standard does not put a numerical measure of probability on either 'virtually certain' or 'remote'. In our view, the use of such measures would downgrade a process requiring the exercise of judgement into a mechanical exercise. It is difficult to imagine circumstances when an entity could reliably determine an obligation to be, for example, 92%, 95% or 99% likely, let alone be able to compare those probabilities objectively.

How we see it

In our view, it is reasonable to regard 'virtually certain' as describing a likelihood that is as close to 100% as to make any remaining uncertainty insignificant; to see 'remote' as meaning a likelihood of an outflow of resources that is not significant; and for significance to be a matter for judgement and determined according to the merits of each case.

3.3 Recognising an asset when recognising a provision

In most cases, the recognition of a provision results in an immediate expense in profit or loss. Nevertheless, in some cases it will be appropriate to recognise an asset. These issues are not discussed in IAS 37, which neither prohibits nor requires capitalisation of the costs recognised when a provision is made. It states that other IFRS accounting standards specify whether expenditures are treated as assets or expenses. *[IAS 37.8]*.

Whilst the main body of IAS 37 is silent on the matter, the standard contains an example which concludes that an asset is recognised when a decommissioning provision is established. This example is replicated in the Illustration below.

Illustration 3-5: When the recognition of a provision gives rise to an asset

An entity operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. 90% of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, with 10% expected to arise through the extraction of oil. At the end of the reporting period, the rig has been constructed but no oil has been extracted.

A provision is recognised in respect of the probable costs relating to the removal of the rig and restoring damage caused by building it. This is because the construction of the rig, combined with the requirement under the licence to remove the rig and restore the seabed, creates an obligating event as at the end of the reporting period. These costs are included as part of the cost of the oil rig.

However, there is no obligation to rectify any damage that will be caused by the future extraction of oil. *[IAS 37.IE Example 3]*.

This conclusion is supported by IAS 16, which requires the cost of an item of property, plant and equipment to include the initial estimate of the costs of dismantling and removing an asset and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period. *[IAS 16.16(c), IAS 16.18]*. The treatment of decommissioning costs is discussed further in section 6.3 below.

4 Measurement

Except in the case of an onerous contract, the amount required to be recognised as a provision is the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. *[IAS 37.36].* In the case of an onerous contract, the amount required to be recognised as a provision is not based on an estimate of an expected outcome. Instead, the provision reflects the lower of the costs of fulfilling the contract and any compensation or penalties from a failure to fulfil it *[IAS 37.68]*, regardless of what the entity expects to do. Onerous contracts are discussed in section 6.2 below.

4.1 Best estimate of provision

Extract from IAS 37	
36	**The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.**

[IAS 37.36].

IAS 37 requires the amount to be recognised as a provision to be determined before tax, as the tax consequences of the provision, and changes to it, are dealt with under IAS 12. *[IAS 37.41]*.

The standard equates this 'best estimate' with the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. *[IAS 37.37]*. It is interesting that a hypothetical transaction of this kind is proposed as the conceptual basis of the measurement required, rather than putting the main emphasis upon the actual expenditure that is expected to be incurred in the future.

The standard does acknowledge that it would often be impossible or prohibitively expensive to settle or transfer the obligation at the end of the reporting period. However, it goes on to state that "…the estimate of the amount that an entity would rationally pay to settle or transfer the obligation gives the best estimate of the expenditure required to settle the present obligation at the end of the reporting period". *[IAS 37.37]*.

During the Provisions research project (see section 1.1 above), stakeholders noted that the measurement objective in IAS 37 is not precise and, in practice, is interpreted in different ways.[5] Paragraph 36 of IAS 37 requires an entity to measure a provision at the best estimate of the expenditure required to settle the obligation, implying a 'fulfilment value' measurement basis. However, IAS 37.37 states that the best estimate is the amount that the entity would rationally pay to transfer the obligation to a third party at the reporting date, suggesting a 'transfer value' measurement basis. *[IAS 37.36, IAS 37.37]*. The assumptions that an entity makes regarding derecognition of the liability could influence how the entity determines the best estimate of the expenditure required to settle the obligation. In practice, there are several ways in which an IAS 37 obligation could be derecognised. For example:

(a) The obligation is settled by the entity performing the obligation itself (for example, the entity uses its own personnel to clean up a site to satisfy an environmental clean-up obligation)

(b) The entity employs a third party to perform the work required to settle the obligation (for example, the entity hires a third-party company to clean up the site)

(c) The entity transfers the obligation to a third party (for example, another entity takes on the obligation to clean up the site, the entity pays the transferee, and is relieved of the obligation)

Or

(d) The obligation is cash settled by negotiation with the party to whom the obligation is owed (for example, the entity negotiates a cash settlement with the local municipality in order to be relieved of the obligation)

5 IASB Staff Paper 22: Project: *Provisions*, Paper topic: *Education Session - scope of possible project to amend IAS 37*, IASB Meeting, May 2019. Available on the IFRS Foundation's website.

In January 2020, the IASB decided that clarification of the measurement objective of IAS 37 would not be included in the scope of the current project to amend aspects of IAS 37.[6] In our view, any of the assumptions above are acceptable bases for measurement provided that they appropriately reflect the facts and circumstances of the situation. If an entity exercises significant judgement in determining the most appropriate approach, consideration must be given to the disclosure requirements in paragraph 122 of IAS 1 *Presentation of Financial Statements*.[7] See Chapter 3 at section 5.1.1.A.

How we see it

The assumptions that an entity makes regarding how an IAS 37 obligation will be derecognised could influence how the entity determines the best estimate of the expenditure required to settle the obligation. We believe that this is acceptable, provided that the measurement basis appropriately reflects the facts and circumstances of the situation.

The estimates of outcome and financial effect are determined by the judgement of the entity's management, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The evidence considered will include any additional evidence provided by events after the reporting period. *[IAS 37.38]*. The standard suggests that there are various ways of dealing with the uncertainties surrounding the amount to be recognised as a provision. It mentions three, an expected value (or probability-weighted) method; the mid-point of the range of possible outcomes; and an estimate of the individual most likely outcome. An expected value approach would be appropriate when a large population of items is being measured, such as warranty costs. This is a statistical computation which weights the cost of all the various possible outcomes according to their probabilities, as shown in the following Illustration based on the example in IAS 37. *[IAS 37.39]*.

Illustration 4-1: Calculation of expected value

An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent within the first six months after purchase. If minor defects were detected in all products sold, repair costs of CU1 million would result. If major defects were detected in all products sold, repair costs of CU4 million would result. The entity's past experience and future expectations indicate that, for the coming year, 75% of the goods sold will have no defects, 20% of the goods sold will have minor defects and 5% of the goods sold will have major defects. In accordance with IAS 37.24 (see section 3.1.2 above) an entity assesses the probability of a transfer for the warranty obligations as a whole.

The expected value of the cost of repairs is:

(75% of nil) + (20% of CU1m) + (5% of CU4m) = CU400,000.

In a situation where there is a continuous range of possible outcomes and each point in that range is as likely as any other, IAS 37 requires that the mid-point of the range is used. *[IAS 37.39]*. This is not a particularly helpful way of setting out the requirement, as it does not make it clear what the principle is meant to be. The mid-point in this case represents the median as well as the expected value. The latter may have been what was intended, but the median could be equally well justified on the basis that it is 50% probable that at least this amount will be payable, while anything in excess of that constitutes a possible but not a probable liability, that would be disclosed rather than accrued. Interestingly, US GAAP has a different approach to this issue in relation to contingencies. FASB ASC Topic 450 *Contingencies* states that where a contingent loss could fall within a range of amounts then, if there is a best estimate within the range, that amount is required to be accrued, with the remainder noted as a contingent liability. However, if there is no best estimate then the lowest figure within the range is accrued, with the remainder up to the maximum potential loss noted as a contingent liability.[8]

Where the obligation being measured relates to a single item, the standard suggests that the best estimate of the liability may be the individual most likely outcome. However, even in such a case, it notes that consideration must be given to other possible outcomes and where these are predominantly higher or mainly lower than the most likely outcome, the resultant 'best estimate' will be a higher or lower amount than the individual most likely outcome. To illustrate this, the standard gives an example of an entity that has to rectify a fault in a major plant that it has constructed for a customer. The most likely outcome is that the repair will succeed at the first attempt. However, a provision is made for a larger amount if there is a significant chance that further attempts will be necessary. *[IAS 37.40]*.

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6 *IASB Update*, January 2020, available on the IFRS Foundation's website.

7 IFRS 18 *Presentation and Disclosure in Financial Statements*, which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted) was issued by the IASB in April 2024. See Chapter 4 for further details on the new concepts and requirements of IFRS 18.

8 FASB ASC Topic 450, *Contingencies*, para. 450-20-30-1 and para. 450-20-50-3.

As noted in section 1.1 above, in January 2020, the IASB decided to add to its work plan a project to amend aspects of IAS 37. The scope of this project includes three targeted improvements to the standard, one of which is to clarify which costs are included in the measurement of a provision.[9]

4.2 Dealing with risk and uncertainty in measuring a provision

It is clear from the definition of a provision as a liability of uncertain timing or amount that entities will have to deal with risk and uncertainty in estimating an appropriate measure of the obligation at the end of the reporting period. It is therefore interesting to consider how the measurement rules detailed in IAS 37 help entities achieve a faithful representation of the obligation in these circumstances. A faithful representation requires estimates that are neutral, that is, without bias. *[CF 2.13, CF 2.15]*. The *Conceptual Framework* notes that neutrality is supported by the exercise of prudence, i.e., the exercise of caution when making judgements under conditions of uncertainty. However, it warns that the exercise of prudence does not allow for the understatement of assets or income or the overstatement of liabilities or expenses. Such misstatements can lead to the overstatement or understatement of income or expenses in future periods. *[CF 2.16]*. The *Conceptual Framework* notes also that the exercise of prudence does not imply a need for asymmetry. *[CF 2.17]*.

The standard does not refer to neutrality as such; however, it does discuss the concept of risk and the need for exercising caution and care in making judgements under conditions of uncertainty. It states that "The risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision". *[IAS 37.42]*. It refers to risk as being variability of outcome and suggests that a risk adjustment may increase the amount at which a liability is measured. *[IAS 37.43]*. Whilst the standard provides an example of a case in which the best estimate of an obligation might have to be larger than the individual most likely outcome, *[IAS 37.40]*, it gives no indication of how this increment should be determined. It warns that caution is needed in making judgements under conditions of uncertainty, so that expenses or liabilities are not understated. However, it says that uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. Accordingly, care is needed to avoid duplicating adjustments for risk and uncertainty, for example, by estimating the costs of a particularly adverse outcome and then overestimating its probability. *[IAS 37.43]*. Any uncertainties surrounding the amount of the expenditure are to be disclosed (see section 7.1 below). *[IAS 37.44]*.

The overall result of all this is somewhat confusing. Whilst a best estimate based solely on the expected value approach or the mid-point of a range addresses the uncertainties relating to there being a variety of possible outcomes, it does not fully reflect risk, because the actual outcome could still be higher or lower than the estimate. Therefore, the discussion on risk suggests that an additional adjustment is required. However, apart from indicating that the result may be to increase the recognised liability and pointing out the need to avoid duplicating the effect of risk in estimates of cash flows and probability, *[IAS 37.43]*, it is not clear quite how this might be achieved. This leaves a certain amount of scope for variation in the estimation of provisions and is further complicated when the concept of risk is combined with considerations relating to the time value of money (see section 4.3.2 below).

4.3 Discounting the estimated cash flows to a present value

Extract from IAS 37

	Present value
45	**Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.**
46	Because of the time value of money, provisions relating to cash outflows that arise soon after the reporting period are more onerous than those where cash outflows of the same amount arise later. Provisions are therefore discounted, where the effect is material.
47	**The discount rate (or rates) shall be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) shall not reflect risks for which future cash flow estimates have been adjusted.**

[IAS 37.45, IAS 37.46, IAS 37.47]

9 *IASB Update*, January 2020, available on the IFRS Foundation's website.

The main types of provision where the impact of discounting will be significant are those relating to decommissioning and other environmental restoration liabilities. IFRIC 1 addresses some of the issues relating to the use of discounting (in the context of provisions for obligations to dismantle, remove or restore items of property, plant and equipment, referred to as 'decommissioning, restoration and similar liabilities') which are discussed in section 6.3.1 below.

Higher interest rates seen in some jurisdictions in recent years could lead to more provisions becoming subject to discounting, as the effect of the time value of money is more likely to be material.

4.3.1 Real versus nominal rate

IAS 37 does not indicate whether the discount rate should be a real discount rate or a nominal discount rate (although a real discount rate is referred to in Example 2 in Appendix D to IAS 37 which illustrates the narrative disclosure for decommissioning costs). The discount rate to be used depends on whether:

(a) The future cash flows are expressed in current prices; in which case a real discount rate (which excludes the effects of general inflation) is used.

Or

(b) The future cash flows are expressed in expected future prices, in which case a nominal discount rate (which includes a return to cover expected inflation) is used.

Either alternative is acceptable, and these methods would produce the same figure for the initial present value of the provision. However, the effect of the unwinding of the discount could be different in each case (see section 4.3.5 below).

4.3.2 Adjusting for risk and using a government bond rate

IAS 37 also requires that risk is taken into account in the calculation of a provision, but gives little guidance as to how this should be done. Where discounting is concerned, it merely says that the discount rate must not reflect risks for which the future cash flow estimates have been adjusted. *[IAS 37.47]*. One could use a discount rate that reflects the risk associated with the liability (a risk-adjusted rate). The following Illustration shows how an entity might calculate such a risk adjusted rate.

Illustration 4-2: Calculation of a risk-adjusted rate

A company has a provision for which the expected value of the cash outflow in three years' time is CU250, and the risk-free rate (i.e., the nominal rate unadjusted for risk) is 5%. However, the possible outcomes lie within a range between CU200 and CU300. As the company is risk averse, management would settle instead for a certain payment of CU270 in three years' time rather than be exposed to the risk of the actual outcome being as high as CU300. The effect of risk in calculating the present value can be expressed as either:

(a) Discounting the risk-adjusted cash flow of CU270 at the risk-free (unadjusted) rate of 5%, giving a present value of CU233.

Or

(b) Discounting the expected cash flow (which is unadjusted for risk) of CU250 at a risk-adjusted rate that will give the present value of CU233, i.e., a rate of 2.35%.

As can be seen from this Illustration, the risk-adjusted discount rate is a lower rate than the unadjusted (risk-free) discount rate. This may seem counter-intuitive initially, because the experience of most borrowers is that banks and other lenders will charge a higher rate of interest on loans that are assessed to be higher risk to the lender. However, in the case of a provision, a risk premium is being suffered to eliminate the possibility of the actual cost being higher (thereby capping a liability), whereas in the case of a loan receivable, a premium is required to compensate the lender for taking on the risk of not recovering its full value (setting a floor for the value of the lender's financial asset). In both cases, the actual cash flows incurred by the paying entity are higher to reflect a premium for risk. In other words, the discount rate for an asset is increased to reflect the risk of recovering less and the discount rate for a liability is reduced to reflect the risk of paying more.

A problem with changing the discount rate to account for risk is that this adjusted rate is a theoretical rate, as it is unlikely that there would be a market assessment of the risks specific to the liability alone. *[IAS 37.47]*. However, the lower discount rate in the above example is consistent with the premise that a risk-adjusted liability is higher than a liability without accounting for the risk that the actual settlement amount is different to the estimate. *[IAS 37.43]*. It is also difficult to see how a risk-adjusted rate could be obtained in practice. In the above example, it was obtained only by reverse-engineering; it was already known that the net present value of a risk-adjusted liability was CU233, so the risk-adjusted rate was just the discount rate applied to unadjusted cash flow of CU250 to give that result.

IAS 37 offers an alternative approach - instead of using a risk-adjusted discount rate, the estimated future cash flows themselves can be adjusted for risk. *[IAS 37.47]*. This does of course present the problem of how to adjust the cash flows for risk (see section 4.2 above). However, this may be easier than attempting to risk-adjust the discount rate.

For the purposes of discounting post-employment benefit obligations, IAS 19 requires the discount rate to be determined by reference to market yields at the end of the reporting period on high quality corporate bonds (although in countries where there is no deep market in such bonds, the market yields on government bonds are required to be used). *[IAS 19.83]*. Although IAS 19 indicates that this discount rate reflects the time value of money (but not the actuarial or investment risk), *[IAS 19.84]*, we do not believe it is appropriate to use the yield on a high-quality corporate bond for determining a risk-free rate to be used in discounting provisions under IAS 37. Where an entity is using a risk-free discount rate for the purposes of calculating a provision under IAS 37, we believe that rate must be based on a government bond rate with a similar currency and remaining term as the provision.

How we see it

Even as government bond rates have become more volatile in recent years, in most countries a government bond remains the most suitable of all the observable measures of the time value of money in a particular country. It follows that because a risk-adjusted rate is always lower than the risk-free rate, an entity cannot justify the discounting of a provision at a rate that is higher than a government bond rate with a similar currency and term to the provision.

Where government bond rates are negative or, more likely, result in a negative discount rate once adjusted for risk, we believe that it is not appropriate to apply a floor of zero to the discount rate as this would result in an understatement of the liability.

Whichever method of reflecting risk is adopted, IAS 37 emphasises that care must be taken that the effect of risk is not double-counted by inclusion in both the cash flows and the discount rate. *[IAS 37.47]*.

In recent years, government bond rates have been more volatile as markets have changed rates to reflect (among other factors) heightened perceptions of sovereign debt risk. Several years ago, it was not uncommon for government debt to offer negative yields. It is now much less common. The question has therefore arisen whether government bond rates, at least in certain jurisdictions, should continue to be regarded as the default measure of a risk-free discount rate. Whilst the current volatility in rates has highlighted the fact that no debt (even government debt) is totally risk free, the challenge is to find a more reliable measure as an alternative. Any adjustment to the government bond rate to 'remove' the estimate of sovereign debt risk is conceptually flawed, as it is not possible to isolate one component of risk from all the other variables that influence the setting of an interest rate. Another approach might be to apply some form of average bond rate over a period of 3, 6 or 12 months to mitigate the volatility inherent in applying the spot rate at the period end. However, this is clearly inappropriate given the requirements in IAS 37 to determine the best estimate of an obligation by reference to the expenditure required to settle it at the end of the reporting period, *[IAS 37.36]*, and to determine the discount rate on the basis of current market assessments of the time value of money. *[IAS 37.47]*.

With 'risk' being a measure of potential variability in returns, it remains the case that in most countries a government bond will be subject to the lowest level of variability in that jurisdiction. As such, in most countries, it remains the most suitable of all the observable measures of the time value of money in a particular country. Several years ago, it was not uncommon for government debt to offer negative yields. Whilst this is now much less common, where government bond rates are negative or, more likely, result in a negative discount rate once adjusted for risk, we believe that it is not appropriate to apply a floor of zero to the discount rate as this would result in an understatement of the liability. As discussed above, and in section 4.3.1 above, IAS 37 offers various approaches to determining an appropriate discount rate. It could be the case that one or more of the allowed approaches result in a negative discount rate whereas the application of an alternative permitted approach would not. In order to avoid some of the presentational difficulties associated with a negative discount rate, entities faced with a negative real discount rate before risk adjustment could consider the alternative approach of discounting expected future cash flows expressed in future prices, at a nominal discount rate (see section 4.3.1 above), if the nominal rate is not negative. Similarly, entities that are faced with a negative risk-adjusted discount rate only because of risk adjustment (i.e., where risk free rates themselves are not negative) could adopt the alternative approach of adjusting the estimated future cash flows to reflect the risks associated with the liability, rather than risk-adjusting the discount rate.

A difficulty that can arise in certain countries is finding a government bond with a similar term to the provision, for example, when measuring a decommissioning provision expected to be settled in 30 years in a country where there are no government bonds with a term exceeding 10 years. In such cases, the government bond rate might be adjusted and the techniques adopted by actuaries for measuring retirement obligations with long maturities, which involve extrapolating current market rates along a yield curve, *[IAS 19.86]*, might be considered. The difficulties of finding an appropriate discount rate in the context of retirement benefit obligations are discussed in Chapter 31 at section 7.6.1.

4.3.3 Own credit risk

IAS 37 does not address whether an entity's own credit risk is a risk specific to a liability when determining a risk-adjusted discount rate. In March 2011, the IFRS IC decided not to take onto its agenda a request for interpretation of the phrase 'the risks specific to the liability' and whether this means that an entity's own credit risk is required to be excluded from any adjustments made to the discount rate used to measure liabilities. In doing so, the IFRS IC acknowledged that IAS 37 is not explicit on the question of own credit risk; but understood that the predominant practice was to exclude it for the reason that credit risk is generally viewed as a risk of the entity rather than a risk specific to the liability.[10]

How we see it

Whether own credit risk is considered a risk specific to a liability could depend, at least in part, on the way in which an entity measures a provision (i.e., how an entity determines the best estimate of the expenditure required to settle the obligation).

As discussed in section 4.1 above, the measurement objective in IAS 37 is not precise, and the term 'best estimate' can be interpreted in different ways. For example, an entity could determine the best estimate by assuming that the obligation will be cash settled by negotiation with the party to whom the obligation is owed. In this case, own credit risk could be considered relevant if the party to whom the obligation is owed would be willing to negotiate a lower settlement amount if the entity risks defaulting in the future. If an entity has exercised significant judgement in determining the best estimate of the expenditure required to settle an obligation, and whether own credit risk is taken into account, consideration must be given to the disclosure requirements in IAS 1.122. See Chapter 3 at section 5.1.1.A.

As noted in section 1.1 above, in January 2020, the IASB decided to add to its work plan a project to amend aspects of IAS 37. The scope of this project includes three targeted improvements to the standard, one of which is to specify whether the rate at which an entity discounts a provision should reflect the entity's own credit risk.[11]

4.3.4 Pre-tax discount rate

Since IAS 37 requires provisions to be measured before tax, it follows that cash flows shall be discounted at a pre-tax discount rate. *[IAS 37.47]*. No further explanation of this is given in the standard.

This is probably because, in reality, the use of a pre-tax discount rate will be most common. Supposing, for example, that the risk-free rate of return is being used, then the discount rate used will be a government bond rate. This rate will be obtained gross. Thus, the idea of trying to determine a pre-tax rate (for example, by obtaining a required post-tax rate of return and adjusting it for the tax consequences of different cash flows) will seldom be relevant.

The calculation is shown in the following Illustration.

Illustration 4-3: Use of discounting and tax effect

It is estimated that the settlement of an environmental provision will give rise to a gross cash outflow of CU500,000 in three years' time. The gross interest rate on a government bond maturing in three years' time is 6%. The tax rate is 30%.

The net present value of the provision is CU419,810 (CU500,000 × 1 ÷ $(1.06)^3$). Hence, a provision of CU419,810 is be booked in the statement of financial position. A corresponding deferred tax asset of CU125,943 (30% of CU419,810) would be set up if it met the criteria for recognition in IAS 12 (see Chapter 29 at section 7.5).

10 *IFRIC Update*, March 2011, p.4. Available on the IFRS Foundation's website.

11 *IASB Update*, January 2020, available on the IFRS Foundation's website.

4.3.5 Unwinding of the discount

Extract from IAS 37

60 Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognised as borrowing cost.

[IAS 37.60].

The extract above is the only guidance that the standard gives on the unwinding of the discount. IFRIC 1 in relation to provisions for decommissioning, restoration and similar liabilities requires that the periodic unwinding of the discount is recognised in profit or loss as a finance cost as it occurs. The IFRS IC concluded that the unwinding of the discount is not a borrowing cost for the purposes of IAS 23 *Borrowing Costs* and thus, cannot be capitalised under that standard. *[IFRIC 1.8]*. It noted that IAS 23 addresses funds borrowed specifically for the purpose of obtaining a particular asset and agreed that a decommissioning liability does not fall within this description since it does not reflect funds borrowed. Accordingly, the IFRS IC concluded that the unwinding of the discount is not a borrowing cost as defined in IAS 23. *[IFRIC 1.BC26]*.

However, there is no discussion of the impact that the original selection of discount rate can have on its unwinding, that is, the selection of real versus nominal rates, and risk-free versus risk-adjusted rates and the fact that these different discount rates will unwind differently. This is best illustrated by way of an example.

Illustration 4-4: Effect on future profits of choosing a real or nominal discount rate

A provision is required to be set up for an expected cash outflow of CU100,000 (estimated at current prices), payable in three years' time. The appropriate nominal discount rate is 7.5%, and inflation is estimated at 5%. If the provision is discounted using the nominal rate, the expected cash outflow has to reflect future prices. Accordingly, if prices increase at the rate of inflation, the cash outflow will be CU115,762 (CU100,000 × 1.05^3). The net present value of CU115,762, discounted at 7.5%, is CU93,184 (CU115,762 × 1 ÷ $(1.075)^3$). If all assumptions remain valid throughout the three-year period, the movement in the provision would be as follows:

	Undiscounted cash flows	Provision
	CU	CU
Year 0	115,762	93,184
Unwinding of discount (CU93,184 × 0.075)		6,989
Revision to estimate		-
Year 1	115,762	100,173
Unwinding of discount (CU100,173 × 0.075)		7,513
Revision to estimate		-
Year 2	115,762	107,686
Unwinding of discount (CU107,686 × 0.075)		8,076
Revision to estimate		-
Year 3	115,762	115,762

If the provision is calculated based on the expected cash outflow of CU100,000 (estimated at current prices), then it needs to be discounted using a real discount rate. This may be thought to be 2.5%, being the difference between the nominal rate of 7.5% and the inflation rate of 5%. However, it is more accurately calculated as 2.381%, being (1.075 ÷ 1.05) - 1. Accordingly, the net present value of CU100,000, discounted at 2.381%, is CU93,184 (CU100,000 × 1 ÷ $(1.02381)^3$), the same as the calculation using future prices discounted at the nominal rate.

If all assumptions remain valid throughout the three-year period, the movement in the provision comprises both the unwinding of the discount and the increase in the level of current prices used to determine the estimate of cost, as follows:

	Undiscounted cash flows	Provision
	CU	CU
Year 0	100,000	93,184
Unwinding of discount (CU93,184 × 0.02381)		2,219
Revision to estimate (CU100,000 × 0.05)	5,000	4,770
Year 1	105,000	100,173
Unwinding of discount (CU100,173 × 0.02381)		2,385
Revision to estimate (CU105,000 × 0.05)	5,250	5,128
Year 2	110,250	107,686
Unwinding of discount (CU107,686 × 0.02381)		2,564
Revision to estimate (CU110,250 × 0.05)	5,512	5,512
Year 3	115,762	115,762

Although the total expense in each year is the same under either method, what will be different is the allocation of the change in provision between operating costs (assuming the original provision was treated as an operating expense) and finance charges. It can be seen from the second table in the above example that using the real discount rate will give rise to a much lower finance charge each year. However, this does not lead to a lower provision in the statement of financial position at the end of each year. Provisions have to be revised annually to reflect the current best estimate of the obligation. *[IAS 37.59]*. Thus, the provision in the above example at the end of each year needs to be adjusted to reflect current prices at that time (and any other adjustments that arise from changes in the estimate of the provision), as well as being adjusted for the unwinding of the discount. For example, the revised provision at the end of Year 1 is CU100,173, being CU105,000 discounted for two years at 2.381%. After allowing for the unwinding of the discount, this required an additional provision of CU4,770. Alternatively, entities could take the view that the amount included as a borrowing cost is based on the nominal discount rate. The basis for this argument is that IAS 37 requires the increase in a provision due to the passage of time to be recognised as a borrowing cost *[IAS 37.60]* and inflation, which is reflected in the nominal rate but not the real rate, must be treated as part of the time value of money.

A more significant difference will arise where the recognition of the original provision is included as part of the cost of property, plant or equipment, rather than as an expense, such as when a decommissioning provision is recognised. In that case, using a real discount rate will result initially in a lower charge to the income statement, since under IFRIC 1 any revision to the estimate of the provision is not taken to the income statement but is treated as an adjustment to the carrying value of the related asset, which is then depreciated prospectively over the remaining life of the asset (see section 6.3.1 below).

How we see it

As shown in Illustration 4-4 above, whether a provision is discounted at a real or nominal rate can impact the allocation of the year-on-year change in provision between operating costs (assuming the original provision was treated as an operating expense) and finance charges. Alternatively, entities could take the view that the amount included as a finance cost is based on the nominal discount rate. The basis for this argument is that IAS 37 requires the increase in a provision due to the passage of time to be recognised as a borrowing cost and inflation - which is reflected in the nominal rate, but not the real rate - must be treated as part of the time value of money.

A similar issue arises with the option of using the risk-free or the risk-adjusted discount rate. However, this is a more complex problem, because it is not clear what to do with the risk-adjustment built into the provision. This is shown in the following Illustration.

Illustration 4-5: Effect on future profits of choosing a risk-free or risk-adjusted rate

A company is required to make a provision for which the estimated value of the cash outflow in three years' time is CU150, when the risk-free rate (i.e., the rate unadjusted for risk) is 5%. However, the possible outcomes from which the expected value has been determined lie within a range between CU100 and CU200. The reporting entity is risk averse and would settle instead for a certain payment of, say, CU160 in three years' time rather than be exposed to the risk of the actual outcome being as high as CU200. The measurement options to account for risk can be expressed as either:

(a) Discounting the risk-adjusted cash flow of CU160 at the risk-free (unadjusted) rate of 5%, giving a present value of CU138.

Or

(b) Discounting the expected cash flow (which is unadjusted for risk) of CU150 at a risk-adjusted rate that will give the present value of CU138, i.e., a rate of 2.8%.

If no changes in estimate were made to the provision during the three-year period, alternative (a) will unwind to give an overall finance charge of CU22 and a final provision of CU160. Alternative (b) will unwind to give an overall finance charge of CU12 and a final provision of CU150.

In this Illustration, the unwinding of different discount rates gives rise to different provisions. The difference of CU10 (CU22 - CU12) relates to the risk adjustment that has been made to the provision. However, as the actual date of settlement comes closer, the estimates of the range of possible outcomes (and accordingly the expected value of the outflow) and the premium the entity would accept for certainty would need to be re-estimated. As such, the effect of any initial difference related to the decision to apply a risk-free or risk-adjusted rate will be lost in the other estimation adjustments that would be made over time.

In circumstances where a provision has been discounted using a negative discount rate (see section 4.3.2 above), entities will need to give some consideration to how the unwinding of the discount is presented in the statement of comprehensive income. The presentation of income and expense resulting from negative interest has been discussed by the IFRS IC in the context of financial instruments. Whilst that topic was not taken on to the IFRS IC's agenda, it was noted in the agenda decision that the expense arising on a financial asset because of a negative interest rate should not be presented as interest revenue, but in an appropriate expense classification.[12] Whilst negative interest rates on financial liabilities were not explicitly addressed in the agenda decision, the IFRS IC noted during discussions that an inflow of economic benefits arising from a liability cannot be characterised as revenue.[13] In our view, similar considerations are appropriate to the presentation of the unwinding of the discount on a provision that has been discounted using a negative nominal discount rate.

How we see it

In our view, the IFRS IC agenda decision on the presentation of income and expense resulting from negative interest (see discussion above) is relevant when considering how to present unwinding of the discount on a provision that has been discounted using a negative discount rate in the statement of comprehensive income.

4.3.6 The effect of changes in interest rates on the discount rate applied

The standard requires the discount rate to reflect current market assessments of the time value of money. *[IAS 37.47]*. This means that where interest rates change, the provision must be recalculated on the basis of revised interest rates (see Illustration 4-6 below).

Any revision in the interest rate will give rise to an adjustment to the carrying value of the provision in addition to the unwinding of the previously estimated discount. The standard requires these movements to be disclosed in the notes to the financial statements (see section 7.1 below). *[IAS 37.84(e)]*. However, the standard does not explicitly say how the effect of changes in interest rates should be classified in the income statement. We believe that this element is required to be treated separately from the effect of the passage of time, with only the charge for unwinding of the discount being classified as a finance cost. Any adjustment to the provision as a result of revising the discount rate is a change in accounting estimate, as defined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (see Chapter 3 at

12 *IFRIC Update*, January 2015, available on the IFRS Foundation's website.

13 IASB Staff Paper 4: Project: *IAS 39* Financial Instruments: Recognition and Measurement, Paper topic: *Negative interest rates: implication for presentation in the statement of comprehensive income*, IFRS IC Meeting, January 2015, p.6. Available on the IFRS Foundation's website.

section 4.5). Accordingly, it must be reflected in the line item of the income statement to which the expense establishing the provision was originally taken and not as a component of the finance cost. Indeed, this is the approach required by IFRIC 1 in relation to provisions for decommissioning, restoration and similar liabilities in relation to assets measured using the cost model (see section 6.3.1 below). However, in that case the original provision gives rise to an asset rather than an expense, so any subsequent adjustment is not included in profit or loss, *[IAS 8.36]*, but added to or deducted from the cost of the asset to which it relates. *[IFRIC 1.5]*. The adjusted depreciable amount of the asset is then depreciated prospectively over its remaining useful life. *[IFRIC 1.7]*. Nevertheless, the effect is distinguished from the unwinding of the discount.

In addition, the standard gives no specific guidance on how or when this adjustment should be made. For example, it is unclear whether the new discount rate must be applied during the year or just at the year-end, and whether the rate must be applied to the new estimate of the provision or the old estimate. IFRIC 1 implies that the finance cost is adjusted prospectively from the date on which the liability is remeasured. Example 1 to IFRIC 1 states that if the change in the liability had resulted from a change in discount rate, instead of a change in the estimated cash flows, the change would still have been reflected in the carrying value of the related asset, but next year's finance cost would have reflected the new discount rate. *[IFRIC 1.IE5]*. This conclusion is consistent with the requirement in IAS 37 for the value of a provision to reflect the best estimate of the expenditure required to settle the obligation as at the end of the reporting period, *[IAS 37.36]*, as shown in the following Illustration.

Illustration 4-6: Accounting for the effect of changes in the discount rate

A provision is required to be set up for an expected cash outflow of CU100,000 (estimated at current prices), payable in three years' time. The appropriate nominal discount rate is 7.5%, and inflation is estimated at 5%. At future prices the cash outflow will be CU115,762 (CU100,000 × 1.053). The net present value of CU115,762, discounted at 7.5%, is CU93,184 (CU115,762 × 1 ÷ 1.0753).

At the end of Year 2, all assumptions remain valid, except it is determined that a current market assessment of the time value of money and the risks specific to the liability would require a decrease in the discount rate to 6.5%. Accordingly, at the end of Year 2, the revised net present value of CU115,762, discounted at 6.5%, is CU108,697 (CU115,762 ÷ 1.065).

The movement in the provision would be reflected as follows:

	Undiscounted cash flows	Provision
	CU	CU
Year 0	115,762	93,184
Unwinding of discount (CU93,184 × 0.075)		6,989
Revision to estimate		-
Year 1	115,762	100,173
Unwinding of discount (CU100,173 × 0.075)		7,513
	115,762	107,686
Revision to estimate (CU108,697 - CU107,686)		1,011
Year 2	115,762	108,697
Unwinding of discount (CU108,697 × 0.065)		7,065
Revision to estimate		-
Year 3	115,762	115,762

In Year 2, the finance charge is based on the previous estimate of the discount rate and the revision to the estimate of the provision would be charged to the same line item in the income statement that was used to establish the provision of CU93,184 at the start of Year 1.

Where market rates of interest are more volatile, entities could decide to reassess the applicable discount rate for a provision during an annual reporting period. Equally, it would be appropriate to revise this assessment as at the end of any interim reporting period during the financial year to the extent that the impact is material.

4.4 Anticipating future events that may affect the estimate of cash flows

Extract from IAS 37	
48	**Future events that may affect the amount required to settle an obligation shall be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.**

[IAS 37.48].

Future events such as advances in technology and changes in legislation could impact the amount required to settle an obligation.

The requirement for objective evidence means that it is not appropriate to reduce the best estimate of future cash flows simply by assuming that a completely new technology will be developed before the liability is required to be settled. There will need to be sufficient objective evidence that such future developments are likely. For example, an entity may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology. The amount recognised has to reflect a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus, it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. *[IAS 37.49]*.

Similarly, if new legislation is to be anticipated, there will need to be evidence both of what the legislation will demand and whether it is virtually certain to be enacted and implemented. In many cases, sufficient objective evidence will not exist until the new legislation is enacted. *[IAS 37.50]*.

These requirements are most likely to impact provisions for liabilities that will be settled some distance in the future, such as decommissioning costs (see section 6.3 below).

4.5 Provisions that will be settled in a currency other than the entity's functional currency

Entities may sometimes expect to settle an obligation in a currency other than their functional currency. In such cases, the provision would be measured in the currency in which settlement is expected and then discounted using a discount rate appropriate for that currency. This approach is consistent with that required by IAS 36 *Impairment of Assets* for foreign currency cash flows in value in use calculations. *[IAS 36.54]*. The present value would be translated into functional currency at the spot exchange rate at the date at which the provision is recognised. *[IAS 21.21]*. If the provision is considered to be a monetary liability, i.e., it is expected to be paid in a fixed or determinable number of units of currency, *[IAS 21.8]*, it would thereafter be retranslated at the spot exchange rate at each reporting date. *[IAS 21.23]*. In most cases, exchange differences arising on provisions will be taken to profit or loss in the period in which they arise, in accordance with the general rule for monetary items in IAS 21 *The Effects of Changes in Foreign Exchange Rates*. *[IAS 21.28]*.

Exchange differences arising on decommissioning provisions recognised under IAS 37 and capitalised as part of the cost of an asset under IAS 16 are considered in Chapter 39 at section 10.2.

4.6 Reimbursements, insurance and other recoveries from third parties

In some circumstances, an entity is able to look to a third party to reimburse part of the costs required to settle a provision or to pay the amounts directly to a third party. Examples are insurance contracts, indemnity clauses and suppliers' warranties. *[IAS 37.55]*. A reimbursement asset is recognised only when it is virtually certain to be received if the entity settles the obligation. The asset cannot be greater than the amount of the provision. No 'netting off' is allowed in the statement of financial position, with any asset classified separately from any provision. *[IAS 37.53]*. However, the expense relating to a provision can be shown in the income statement net of reimbursement. *[IAS 37.54]*. This means that if an entity has insurance cover in relation to a specific potential obligation, this is treated as a reimbursement right under IAS 37. It is not appropriate to record no provision (where the recognition criteria in the standard are met) on the basis that the entity's net exposure is expected to be zero.

The main area of concern with these requirements is whether the 'virtually certain' criterion that needs to be applied to the corresponding asset might mean that some reimbursements will not be capable of recognition at all. For items such as insurance contracts, this may not be an issue, as entities will probably be able to confirm the existence of cover for the obligation in question and accordingly be able to demonstrate that a recovery on an insurance contract is virtually certain if the entity is required to settle the obligation. Of course, it may be more difficult in complex situations for an entity to confirm it has cover against any loss. For other types of reimbursement, it may be more difficult to establish that recovery is virtually certain.

Except when an obligation is determined to be joint and several (see section 4.7 below), any form of net presentation in the statement of financial position is prohibited. This is because the entity would remain liable for the whole cost if the third party failed to pay for any reason, for example, as a result of the third party's insolvency. In such situations, the provision must be made gross and any reimbursement must be treated as a separate asset (but only when it is virtually certain that the reimbursement will be received if the entity settles the obligation). *[IAS 37.56]*.

If the entity has no liability in the event that the third party cannot pay, then these costs are excluded from the estimate of the provision altogether because, by its very nature, there is no liability. *[IAS 37.57]*.

In contrast, where an entity is assessing an onerous contract, it is common for entities to apply what looks like a net approach. However, because an onerous contract provision relates to the excess of the unavoidable costs over the expected economic benefits, *[IAS 37.68]*, there is no corresponding asset to be recognised. This is discussed further in section 6.2 below.

4.7 Joint and several liability

It is interesting to contrast the approach of IAS 37 to reimbursements with the case where an entity is jointly and severally liable for an obligation. Joint and several liability arises when a number of entities are liable for a single obligation (for example, to damages), both individually and collectively. The holder of the obligation in these circumstances can collect the entire amount from any single member of the group or from any and all of the members in various amounts until the liability is settled in full. Even when the members have an agreement between themselves as to how the total obligation should be divided, each member remains liable to make good any deficiency on the part of the others. This situation is different from proportionate liability, where individual members of a group might be required to bear a percentage of the total liability, but without any obligation to make good any shortfall by another member. Joint and several liability can be established in a contract, by a court judgement or under legislation.

An entity that is jointly and severally liable recognises only its own share of the obligation, based on the amount it is probable that the entity will pay. The remainder that is expected to be met by other parties is treated only as a contingent liability. *[IAS 37.29, IAS 37.58]*.

The fact that the other third parties in this situation have a direct (albeit shared) obligation for the past event itself, rather than only a contractual relationship with the entity, is enough of a difference in circumstances to allow a form of net determination of the amount to recognise. Arguably, the economic position is no different, because the entity is exposed to further loss in the event that the third parties are unable or unwilling to pay. However, IAS 37 does not treat joint and several liability in the same way as reimbursement, which would have required a liability to be set up for the whole amount with a corresponding asset recognised for the amount expected to be met by other parties.

4.8 Provisions are not reduced for gains on disposal of related assets

Extract from IAS 37	
51	**Gains from the expected disposal of assets shall not be taken into account in measuring a provision.**

Gains from the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. *[IAS 37.51, IAS 37.52]*. Such gains are instead recognised at the time specified by the standard dealing with the assets concerned. *[IAS 37.52]*. This is likely to be of particular relevance in relation to restructuring provisions (see section 6.1.4 below). However, it may also apply in other situations. Practical example 6-1 in section 6.3 below illustrates an example of a company excluding gains from the expected disposal of assets in determining its provision for decommissioning costs.

4.9 Changes and uses of provisions

After recognition, a provision will be re-estimated, used and released over the period up to the eventual determination of a settlement amount for the obligation. Once the exact amount and timing of settlement are agreed, for example, through negotiation with a counterparty or a decision of a court of law, the entity has an obligation to pay a fixed sum at an agreed point in time. The liability no longer meets the definition of a provision and instead is a financial liability in scope of IFRS 9.

Until determination of a settlement amount, IAS 37 requires that provisions are reviewed at the end of each reporting period and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision must be reversed. *[IAS 37.59]*. Where discounting is applied, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognised as a borrowing cost. *[IAS 37.60]*. As discussed in section 4.3.5 above, the periodic unwinding of the discount is recognised as a finance cost in the income statement, and it is not a borrowing cost capable of being capitalised under IAS 23. *[IFRIC 1.8]*.

The standard does not allow provisions to be redesignated or otherwise used for expenditures for which the provision was not originally recognised. *[IAS 37.61]*. In such circumstances, a new provision is created and the amount no longer needed is reversed, as to do otherwise would conceal the impact of two different events. *[IAS 37.62]*. This means that the questionable practice of charging costs against a provision that was set up for a different purpose is specifically prohibited.

4.10 Changes in contingent liabilities recognised in a business combination

In a business combination, the usual requirements of IAS 37 do not apply and the acquirer recognises a liability at the acquisition date for those contingent liabilities of the acquiree that represent a present obligation arising as a result of a past event and in respect of which the fair value can be measured reliably. *[IFRS 3.23]*. After initial recognition, and until the liability is settled, cancelled or expires, the acquirer measures the contingent liability recognised in a business combination at the higher of:

(a) The amount that would be recognised in accordance with IAS 37

(b) The amount initially recognised less, if appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15 *[IFRS 3.56]*

This requirement does not apply to contracts accounted for in accordance with IFRS 9. See Chapter 10 at section 5.6.1.B.

This requirement prevents the immediate release to post acquisition profit of any contingency recognised in a business combination.

5 Cases in which no provision can be recognised

IAS 37 sets out three particular cases in which the recognition of a provision is prohibited. They are: future operating losses, repairs and maintenance of owned assets and staff training costs. The IFRS IC has also considered repeated requests relating to obligations arising on entities operating in a rate-regulated environment. The IFRS IC concluded that there is no justification for the recognition of a special regulatory liability, although IFRS 14 *Regulatory Deferral Accounts* provides some relief for first-time adopters of IFRS accounting standards who have recognised regulatory deferral account balances under their previous GAAP (see section 5.4 below). The common theme in these cases is that the potential obligation does not exist independently of an entity's future actions. In other words, the entity is able to change the future conduct of its business in a way that avoids the future expenditure. Only those obligations that exist independently of an entity's future actions are recognised as provisions. *[IAS 37.19]*. This principle is also relevant to determining the timing of recognition of a provision, whereby no liability is recognised until the obligation cannot otherwise be avoided by the entity. Examples include those arising from participation in a particular market under IFRIC 6 (see section 6.7 below) and an obligation for levies imposed by government under IFRIC 21 (see section 6.8 below).

5.1 Future operating losses

Extract from IAS 37

63 Provisions shall not be recognised for future operating losses.

[IAS 37.63]

Future operating losses do not meet the definition of a liability and the general recognition criteria of the standard. *[IAS 37.64]*. In particular, there is no present obligation as a result of a past event. Such costs must be left to be recognised as they occur in the future in the same way as future profits.

However, it would be wrong to assume that this requirement has effectively prevented the effect of future operating losses from being anticipated, because they are sometimes recognised as a result of requirements in another IFRS accounting standard, either in the measurement of an asset of the entity or to prevent inappropriate recognition of revenue. For example:

- Under IAS 2 *Inventories,* inventories are written down to the extent that they will not be recovered from future revenues, rather than leaving the non-recovery to show up as future operating losses (see Chapter 23 at section 3.3).
- Under IAS 36, impairment is assessed on the basis of the present value of future operating cash flows, meaning that the effect of not only future operating losses but also sub-standard operating profits will be recognised (see Chapter 21). IAS 37 specifically makes reference to the fact that an expectation of future operating losses is an indication that certain assets may be impaired. *[IAS 37.65]*.

This is therefore a rather more complex issue than IAS 37 acknowledges. Indeed, IAS 37 itself must navigate closely the dividing line between the general prohibition of the recognition of future losses and the recognition of contractual or constructive obligations that are expected to give rise to losses in future periods.

5.2 Repairs and maintenance of owned assets

Repairs and maintenance provisions in respect of owned assets are generally prohibited under IAS 37. Under the standard, the following principles apply:

(a) Provisions are recognised only for obligations existing independently of the entity's future actions (i.e., the future conduct of its business) and in cases where an entity can avoid future expenditure by its future actions, for example, by changing its method of operation, it has no present obligation. *[IAS 37.19]*.

(b) Financial statements deal with an entity's position at the end of the reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. *[IAS 37.18]*.

(c) For an event to be an obligating event, the entity must have no realistic alternative to settling the obligation created by the event. *[IAS 37.17]*.

These principles are applied strictly in the case of an obligation to incur repairs and maintenance costs in the future, even when this expenditure is substantial, distinct from what may be regarded as routine maintenance and essential to the continuing operations of the entity, such as a major refit or refurbishment of the asset. This is illustrated by two examples in an appendix to the standard.

Illustration 5-1: Prohibition on maintenance provisions relating to owned assets

Scenario 1: Re-lining costs of a furnace

An entity operates a furnace, the lining of which needs to be replaced every five years for technical reasons. At the end of the reporting period, the lining has been in use for three years. In these circumstances, a provision for the cost of replacing the lining is not recognised because, at the end of the reporting period, no obligation to replace the lining exists independently of the entity's future actions. Even the intention to incur the expenditure depends upon the entity deciding to continue operating the furnace or to replace the lining. Instead of a provision being recognised, the initial cost of the lining is treated as a significant part of the furnace asset and depreciated over a period of five years. *[IAS 16.43]*. The re-lining costs are then capitalised when incurred and depreciated over the next five years. *[IAS 37.IE Example 11A]*.

Scenario 2: Overhaul costs of an aircraft

An airline is required by law to overhaul its aircraft once every three years. Even with the legal requirement to perform the overhaul, there is no obligating event until the three-year period has elapsed. As with Scenario 1, no obligation exists independently of the entity's future actions. The entity could avoid the cost of the overhaul by selling the aircraft before the three-year period has elapsed. Instead of a provision being recognised, the overhaul cost is identified as a separate part of the aircraft asset under IAS 16 and is depreciated over three years. *[IAS 37.IE Example 11B]*.

Entities might try to argue that a repairs and maintenance provision should be recognised on the basis that there is a clear intention to incur the expenditure at the appointed time and that this means it is more likely than not, as at the end of the reporting period, that an outflow of resources will occur. However, the application of the three principles noted above, particularly that an entity must not provide for future operating costs, make an entity's intentions irrelevant. In the example above, recognition was not allowed because the entity could do all manner of things to avoid the obligation, including selling the asset, however unlikely that might be in the context of the entity's business or in terms of the relative cost of replacement as compared to repair. The existence of a legal requirement, probably resulting in the aircraft being grounded, was still not enough. This detachment from intention or even commercial reality, regarded by some as extreme, is also exhibited in the IFRS IC's approach to the recognition of levies imposed by government under IFRIC 21 (see section 6.8 below).

The effect of the prohibition on setting up provisions for repairs obviously has an impact on presentation in the statement of financial position. It may not always, however, have as much impact on the statement of comprehensive income. This is because it is stated in the examples that depreciation would be adjusted to take account of the repairs. For example, in the case of the furnace lining, the lining is depreciated over five years in advance of its expected repair. Similarly, in the case of the aircraft overhaul, the example in the standard states that an amount equivalent to the expected maintenance costs is depreciated over three years. The result of this is that the depreciation charge recognised in profit or loss over the life of the component of the asset requiring regular repair may be equivalent to that which would previously have arisen from the combination of depreciation and a provision for repair. This is the way IAS 16 requires entities to account for significant parts of an item of property, plant and equipment which have different useful lives (see Chapter 19 at section 5.2). *[IAS 16.44, IAS 16.45]*.

5.3 Staff training costs

In the normal course of business, it is unlikely that provisions for staff training costs would be permissible, because it would normally contravene the general prohibition in the standard on the recognition of provisions for future operating costs. *[IAS 37.18]*. In the context of a restructuring, IAS 37 identifies staff retraining as an ineligible cost because it relates to the future conduct of the business. *[IAS 37.81]*. Illustration 3-2 in section 3.1.1 above reproduces an example in the standard where the government introduces changes to the income tax system, such that an entity in the financial services sector needs to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. The standard argues that there is no present obligation until the actual training has taken place and so no provision is recognised. We also note that in many cases the need to incur training costs is not only future operating expenditure but also fails the 'existing independently of an entity's future actions' criterion, *[IAS 37.19]*, in that the cost could be avoided by the entity, for example, if it withdrew from that market or hired new staff who were already appropriately qualified.

This example again illustrates how important it is to properly understand the nature of any potential 'constructive obligation' or 'obligating event' and to determine separately its financial effect in relation to past transactions and events on the one hand and in relation to the future operation of the business on the other. Otherwise, it can be easy to mistakenly argue that a provision is required, such as for training costs to ensure that staff comply with new legal requirements, on the basis that the entity has a constructive obligation to ensure staff are appropriately skilled to adequately meet the needs of its customers. However, the obligation, constructive or not, declared or not, relates to the entity's future conduct, is a future cost of operation and is therefore ineligible for recognition under the standard until the training takes place.

5.4 Rate-regulated activities

In many countries, the provision of utilities (e.g., water, natural gas or electricity) to consumers is regulated by the national government. Regulations differ between countries but often regulators operate a cost-plus system under which a utility provider is allowed to make a fixed return on investment. Under certain national GAAPs, an entity could account for the effects of regulation by recognising a 'regulatory asset' that reflects the increase in future prices approved by the regulator or a 'regulatory liability' that reflects a requirement from the regulator to reduce tariffs or improve services so as to return the benefit of earlier excess profits to customers. This issue has for a long time been a matter of significant interest as entities in those countries adopt IFRS accounting standards, because the recognition of these regulatory assets and liabilities is prohibited under IFRS accounting standards. Just as the ability to charge higher prices for goods services to be rendered in the future does not meet the definition of an intangible asset in IAS 38 *Intangible Assets* (see Chapter 18 at section 11.1), the requirement to charge a lower price for the delivery of goods and services in the future does not meet the definition of a past obligating event, or a liability, in IAS 37.

A liability is defined in IAS 37 as "...a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits". *[IAS 37.10]*. The return to customers of amounts mandated by a regulator depends on future events including:

- Future rendering of services
- Future volumes of output (generally consisting of utilities such as water or electricity) consumed by users
- The continuation of regulation

Similar considerations apply to actions that a regulator may require entities to complete in the future, such as an obligation to invest in equipment to improve efficiency. Other than decommissioning obligations (see section 6.3 below), such items do not meet the definition of a liability because there needs to be a present obligation at the end of the reporting period before a liability can be recognised.

Whilst the requirements of IAS 37 and the *Conceptual Framework* are clear in this respect, their perceived inflexibility in this regard has been identified as a significant barrier that prevents the entities affected by it from adopting IFRS accounting standards as a whole.[14] In 2012, the IASB decided on a two-tier approach to address this.[15] As a result, in January 2014, the IASB issued IFRS 14, an interim standard on the accounting for regulatory deferral accounts that would apply for first-time adopters of IFRS accounting standards until the completion of a more comprehensive project. *[IFRS 14.BC10]*. IFRS 14 became effective for annual periods beginning on or after 1 January 2016. *[IFRS 14.C1]*.

Extract from IFRS 14

5 An entity is permitted to apply the requirements of this Standard in its *first IFRS financial statements* if and only if it:

(a) conducts *rate-regulated activities*; and

(b) recognised amounts that qualify as regulatory deferral account balances in its financial statements in accordance with its previous GAAP.

The standard can be applied in only very limited circumstances. *[IFRS 14.5]*. In addition, a first-time adopter meeting the criteria in IFRS 14.5 is permitted, but not required, to apply IFRS 14 in its first IFRS financial statements. An entity shall not change its accounting policies in order to start to recognise regulatory deferral account balances. *[IFRS 14.13]*.

14 Exposure Draft ED/2013/5: *Regulatory Deferral Accounts*, IASB, April 2013, para. BC15. Available on the IFRS Foundation's website.

15 *IASB Update*, September 2012; and *IASB Update*, December 2012, available on the IFRS Foundation's website.

Entities can apply IFRS 14 after first-time adoption if, and only if, they had elected to apply the standard in their first IFRS financial statements and had recognised regulatory deferral account balances in those financial statements. *[IFRS 14.6]*. Therefore, the scope for applying this standard does not extend to existing IFRS reporters; nor to first-time adopters whose previous GAAP did not allow for the recognition of regulatory assets and liabilities; nor even to first-time adopters whose previous GAAP allowed such recognition but the entity chose not to do so.

The requirements of first-time adoption of IFRS accounting standards are discussed further in Chapter 6.

As regards its comprehensive standard-setting project, in January 2021, the Board published the Exposure Draft *Regulatory Assets and Regulatory Liabilities*.

The Exposure Draft sets out proposals for the recognition, measurement, presentation and disclosure of regulatory assets, regulatory liabilities, regulatory income and regulatory expense. It uses the term 'total allowed compensation' for the full amount of compensation for goods or services supplied that a regulatory agreement entitles a company to charge customers through regulated rates, in either the period when the company supplies those goods or services or in a different period. Under the proposals, when an entity has an enforceable right to add an amount in determining the regulated rate in future periods, because part of the total allowed compensation for goods and services already supplied will be included in revenue in the future, it must recognise this as a regulatory asset. Conversely, a regulatory liability must be recognised when an entity has an enforceable present obligation to deduct an amount in determining the regulated rate in future periods because the revenue already recognised includes an amount that will be part of the total allowed compensation for goods and services to be supplied in the future. In addition, the Exposure Draft provides guidance if an entity is uncertain about whether a regulatory asset or regulatory liability exists, by stating that an entity would recognise that regulatory asset or regulatory liability if it is 'more likely than not' that it exists.

The Exposure Draft proposes that an entity would measure regulatory assets and regulatory liabilities at historical cost, modified by using updated estimates of future cash flows. An entity would implement that measurement basis by applying a cash flow-based measurement technique. That technique would involve estimating future cash flows from a regulatory asset or liability, including future cash flows arising from regulatory interest. The cash flows to be used in this estimate are those that result from adding amounts to, or deducting amounts from, a regulated rate when the entity has an enforceable, present right or obligation at the reporting date. Entities will need to determine whether they or the customer bear any risk arising from uncertainty in the cash flows. Customers will bear the risk if the entity is able to pass on the effects of this uncertainty to the customers. In predicting this uncertainty, the 'most likely amounts' and 'expected value' methods are proposed as appropriate alternative methods. The future cash flows are required to be discounted at the regulatory interest rate, unless the regulatory interest rate for a regulatory asset is insufficient. The Exposure Draft includes additional guidance to determine whether that rate is sufficient and what discount rate to use if it is insufficient. For a regulatory liability, an entity must always use the regulatory interest rate as the discount rate. When the interest rate in a regulatory agreement varies throughout the life of the agreement, at initial recognition, the Exposure Draft requires an entity to "...translate those uneven regulatory interest rates into a single discount rate that it shall use throughout the life of the regulatory asset or regulatory liability...".[16]

In terms of presentation, the Exposure Draft proposes that an entity presents all regulatory income or regulatory expense as a separate line item immediately below revenue. In the balance sheet, the Exposure Draft proposes the presentation of line items for regulatory assets and regulatory liabilities. Where appropriate, these lines are required be further bifurcated as current or non-current.[17] The Exposure Draft also sets out a disclosure objective, and certain disclosures that are required to be provided in order to meet that objective.

The comment period for the Exposure Draft closed on 30 July 2021. At the time of writing, the IASB is redeliberating proposals in the Exposure Draft, with an accounting standard expected to be issued in 2025.[18] When issued, the accounting standard would replace IFRS 14.

16 Exposure Draft ED/2021/1: *Regulatory Assets and Regulatory Liabilities*, IASB, January 2021, paragraph 54. Available on the IFRS Foundation's website.

17 Exposure Draft ED/2021/1: *Regulatory Assets and Regulatory Liabilities*, IASB, January 2021, paragraphs 67 and 70. Available on the IFRS Foundation's website.

18 *IFRS Foundation work plan*, IFRS Foundation website (accessed September 2024).

6 Specific examples of provisions and contingencies

IAS 37 expands on its general recognition and measurement requirements by including more specific requirements for particular situations, i.e., future restructuring costs and onerous contracts. This section discusses those situations, looks at other examples, including those addressed in an appendix to the standard and other areas where the IFRS IC has considered how the principles of IAS 37 are required to be applied.

6.1 Restructuring provisions

IAS 37 allows entities to recognise restructuring provisions, but it has specific rules on the nature of obligations and the types of cost that are eligible for inclusion in such provisions, as discussed below. These rules ensure that entities recognise only obligations that exist independently of their future actions, *[IAS 37.19]*, and that provisions are not made for future operating costs and losses. *[IAS 37.63]*.

6.1.1 Definition

IAS 37 defines a restructuring as follows: *[IAS 37.10, IAS 37.70]*

Extract from IAS 37

10 The following terms are used in this Standard with the meanings specified:

...

A *restructuring* is a programme that is planned and controlled by management, and materially changes either:

(a) the scope of a business undertaken by an entity; or

(b) the manner in which that business is conducted.

70 The following are examples of events that may fall under the definition of restructuring:

(a) sale or termination of a line of business;

(b) the closure of business locations in a country or region or the relocation of business activities from one country or region to another;

(c) changes in management structure, for example, eliminating a layer of management; and

(d) fundamental reorganisations that have a material effect on the nature and focus of the entity's operations.

[IAS 37.10, IAS 37.70].

This definition is very wide and whilst it may be relatively straightforward to establish whether an operation has been sold, closed or relocated, the determination of whether an organisational change is fundamental, material or just part of a process of continuous improvement is a subjective judgement. Whilst organisational change is a perennial feature in most business sectors, entities could be tempted to classify all kinds of operating costs as restructuring costs and thereby invite the user of the financial statements to perceive them in a different light from the 'normal' costs of operating in a dynamic business environment. Even though the requirements in IAS 37 prevent such costs being recognised too early, the standard still leaves the question of classification open to judgement. As such, there can be a tension between the permitted recognition of expected restructuring costs, subject to meeting the criteria set out in section 6.1.2 below, and the general prohibition in IAS 37 against provision for future operating losses, which is discussed in section 5.1 above.

IAS 37 emphasises that when a restructuring meets the definition of a discontinued operation under IFRS 5, additional disclosures may be required under that standard (see Chapter 5 at section 3). *[IAS 37.9]*.

6.1.2 Recognition of a restructuring provision

IAS 37 requires that restructuring costs are recognised only when the general recognition criteria in the standard are met, i.e., there is a present obligation (legal or constructive) as a result of a past event, in respect of which a reliable estimate can be made of the probable cost. *[IAS 37.71]*. The standard's specific requirements for the recognition of a provision for restructuring costs seek to define the circumstances that give rise to a constructive obligation and thereby restrict the recognition of a provision to cases when an entity:

(a) Has a detailed formal plan for the restructuring identifying at least:
    (i) The business or part of a business concerned
    (ii) The principal locations affected
    (iii) The location, function, and approximate number of employees who will be compensated for terminating their services
    (iv) The expenditures that will be undertaken
    (v) When the plan will be implemented

(b) Has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it *[IAS 37.72]*

The standard gives examples of the entity's actions that would provide evidence that the entity has started to implement a plan, quoting the dismantling of plant or selling of assets, or the public announcement of the main features of the plan. However, it also emphasises that the public announcement of a detailed plan to restructure will not automatically create an obligation; the important principle is that the announcement is made in such a way and in sufficient detail to give rise to valid expectations in other parties such as customers, suppliers and employees that the restructuring will be carried out. *[IAS 37.73]*.

The standard also suggests that for an announced plan to give rise to a constructive obligation, its implementation needs to be planned to begin as soon as possible and to be completed in a timeframe that makes significant changes to the plan unlikely. Any extended period before commencement of implementation, or if the restructuring will take an unreasonably long time, will mean that recognition of a provision is premature, because the entity is still likely to have a chance of changing the plan. *[IAS 37.74]*.

In summary, these conditions require the plan to be detailed and specific, to have gone beyond the directors' powers of recall and to be put into operation without delay or significant alteration.

The criteria set out above for the recognition of provisions mean that a board decision, if it is the only relevant event arising before the end of the reporting period, is not sufficient. This message is reinforced specifically in the standard, the argument being made that a constructive obligation is not created by a management decision. There will only be a constructive obligation where the entity has, before the end of the reporting period:

(a) Started to implement the restructuring plan
    Or
(b) Announced the main features of the restructuring plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will carry out the restructuring *[IAS 37.75]*

If the restructuring is not started or announced in detail until after the end of the reporting period, no provision is recognised. Instead, the entity discloses a non-adjusting event after the reporting period. *[IAS 37.75, IAS 10.22(e)]*.

The following Illustrations, based on examples in IAS 37, show how a constructive obligation for a restructuring may or may not be created.

Illustration 6-1: The effect of timing of the creation of a constructive obligation on the recognition of a restructuring provision

Scenario 1: Closure of a division - no implementation before end of the reporting period

On 12 December 20X2, the board of Entity A decided to close down a division. No announcement was made before the end of the reporting period (31 December 20X2) and no other steps were taken to implement the decision before that date.

In these circumstances, no provision is recognised because management's actions are insufficient to create a constructive obligation before the end of the reporting period. *[IAS 37.IE Example 5A]*.

Scenario 2: Closure of a division - communication/implementation before end of the reporting period

In another case, the board of Entity B decides on 12 December 20X2 to close down one of its manufacturing divisions. On 20 December 20X2 a detailed plan for closure was agreed by the board; letters were sent to customers warning them to seek an alternative source of supply and redundancy notices were sent to the staff of the division.

The communication of management's decision to customers and employees on 20 December 20X2 creates a valid expectation that the division will be closed, thereby giving rise to a constructive obligation from that date. Accordingly, a provision is recognised at 31 December 20X2 for the best estimate of the costs of closing the division. *[IAS 37.IE Example 5B]*.

The standard acknowledges that there will be circumstances where a board decision could trigger recognition, but not on its own. Only if earlier events, such as negotiations with employee representatives for termination payments or with purchasers for the sale of an operation, have been concluded subject only to board approval would the decision of the board create an obligation. In such circumstances, it is reasoned that when board approval has been obtained and communicated to the other parties, the entity is committed to restructure, assuming all other conditions are met. *[IAS 37.76]*.

There is also discussion in the standard of the situation that may arise in some countries where, for example, employee representatives may sit on the board, so that a board decision effectively communicates the decision to them, which may result in a constructive obligation to restructure. *[IAS 37.77]*.

In practice, it can be very difficult to determine whether it is appropriate to recognise a provision for the future costs of a restructuring programme. The determination of whether an organisational change is fundamental, material or just part of a process of continuous improvement is a subjective judgement. Once it has been established that the activities in question constitute a restructuring rather than an ongoing operating cost, it can be difficult to determine whether management's actions before the reporting date have been sufficient to have raised a valid expectation in those affected. *[IAS 37.72]*. Even if a trigger point is easily identifiable, such as the date of an appropriately detailed public announcement, it might not necessarily commit management to the whole restructuring, but only to specific items of expenditure such as redundancy costs. When the announcement is less clear, referring for example to consultations, negotiations or voluntary arrangements, particularly with employees, judgement is required. Furthermore, taken on its own, the 'valid expectation' test is at least as open to manipulation as one based on the timing of a board decision. Entities anxious to accelerate or postpone recognition of a liability could do so by advancing or deferring an event that signals such a commitment, such as a public announcement, without any change to the substance of their position.

In these situations, it is important to consider all the related facts and circumstances and not to 'home in' on a single recognition criterion. The objective of the analysis is to determine whether there is a past obligating event at the reporting date. The guidance in the standard about restructuring, referring as it does to constructive obligations and valid expectations is ultimately aimed at properly applying the principle in IAS 37 that only those obligations arising from past events and existing independently of an entity's future actions are recognised as provisions. *[IAS 37.19]*. In essence, a restructuring provision qualifies for recognition if, as at the reporting date, it relates to a detailed plan of action from which management cannot realistically withdraw.

In many cases, a restructuring plan may involve the payment of termination benefits to employees. Termination benefits are employee benefits payable as a result of either:

(a) An entity's decision to terminate an employee's employment before the normal retirement date.

Or

(b) An employee's decision to accept an offer of benefits in exchange for the termination of employment. *[IAS 19.8]*.

Termination benefits are in scope of IAS 19. An entity should recognise termination benefits as a liability and an expense at the earlier of the following dates:

(a) When it can no longer withdraw the offer of those benefits (discussed in Chapter 31 at section 14.2).

And

(b) When it recognises costs for a restructuring that is within the scope of IAS 37 and involves the payment of termination benefits. *[IAS 19.165]*.

6.1.3 Recognition of obligations arising from the sale of an operation

IAS 37 has some further specific rules governing when to recognise an obligation arising on the sale of an operation, stating that no obligation arises for the sale of an operation until the entity is committed to the sale, i.e., there is a binding sale agreement. *[IAS 37.78]*. Thus, a provision cannot be made for a loss on sale unless there is a binding sale agreement by the end of the reporting period. The standard says that this applies even when an entity has taken a decision to sell an operation and announced that decision publicly, it cannot be committed to the sale until a purchaser has been identified and there is a binding sale agreement. Until there is such an agreement, the entity will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms. *[IAS 37.79]*.

Even in cases where it is part of a larger restructuring that qualifies for recognition under IAS 37, an obligation arising from the sale is not recognised until there is a binding sale agreement. Instead, the assets of the operation must be reviewed for impairment under IAS 36. This could therefore mean that an expense is recorded in the income statement; it is just that the expense gives rise to a reduction of the carrying amount of assets rather than the recognition of a liability. The standard also recognises that where a sale is only part of a restructuring, the entity could be committed to the other parts of restructuring before a binding sale agreement is in place. *[IAS 37.79]*. Hence, the costs of the restructuring will be recognised over different reporting periods.

6.1.4 Costs that can (and cannot) be included in a restructuring provision

Having met the specific tests in the standard for the recognition of a restructuring provision at the end of the reporting period, IAS 37 imposes further criteria to restrict the types of cost that can be provided for. Presumably, these additional restrictions are intended to ensure that the entity does not contravene the general prohibition in IAS 37 against provision for future operating losses. *[IAS 37.63]*.

Extract from IAS 37

80 A restructuring provision shall include only the direct expenditures arising from the restructuring, which are those that are both:

(a) necessarily entailed by the restructuring; and

(b) not associated with the ongoing activities of the entity.

81 A restructuring provision does not include such costs as:

(a) retraining or relocating continuing staff;

(b) marketing; or

(c) investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the end of the reporting period. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

[IAS 37.80, IAS 37.81].

Illustration 6-2: Distinguishing restructuring costs from ongoing expenses

On 15 November 20X2, management announced its intention to close down its operation in the North of the country and relocate to a new site in the South, primarily to be closer to its key customers. Before the end of the reporting period (31 December 20X2), the principal elements of the plan were agreed with employee representatives, a lease signed for a building at the new location, and a decision was made to market the existing facility for sale; all on the basis that production would start at the new location on 31 March 20X3 and the existing site would be vacated on 30 April 20X3. Production would cease at the existing site on 28 February 20X3 to allow plant and equipment to be relocated. Inventory levels would be increased up to that date so that customers could be supplied with goods sent from the Northern facility until 31 March.

Whilst the majority of the 600 existing staff was expected to take redundancy on 28 February 20X3, 50 had agreed to accept the entity's offer of relocation, including an incentive of CU3,000 each towards relocation costs. Of those employees taking redundancy, 20 had agreed to continue to work for the entity until 30 June 20X3, to dismantle plant and equipment at the Northern site; install it at the new facility in the South; and train new staff on its operation. A bonus of CU4,500 per employee would be payable if they remained until 30 June. A further 60 had agreed to stay with the entity until 31 March 20X3, to ensure that inventory was sent out to customers before the new site was operational, of which 10 would remain until 30 April 20X3 to complete the decommissioning of the Northern facility. These employees would also receive a bonus for staying until the promised date.

The announcement of management's decision on 15 November 20X2 and the fact that the key elements of the plan were understood by employees and customers of the Northern site before the end of the reporting period give rise to a constructive obligation that requires a provision to be recognised at 31 December 20X2 for the best estimate of the costs of the reorganisation.

However, only those direct costs of the restructuring not associated with ongoing activities can be included in the provision. For example, as follows:

Type of expense	Direct cost of restructuring	Associated with ongoing activities
Redundancy payments to 550 staff	•	
Payroll costs to 28 February 20X3 (all 600 staff)		•
Relocation incentive of CU3,000 per employee (50 staff)		•
Payroll costs - to 31 March 20X3 (60 staff dispatching goods)		•
Payroll costs - March to June 20X3 (20 staff relocating plant) Note 1	•	•
Payroll costs - April 20X3 (10 staff decommissioning site)	•	
Costs of dismantling plant and equipment Note 1	•	•
Cost of transporting PP&E and inventory to the new site		•
Costs of recruiting and training staff for the Southern site		•
Rent of new site to 31 March 20X3 (pre-production)		•
Cost of invoices, forms and stationery showing new address		•

Note 1:
Costs relating to dismantling plant and equipment that is no longer intended for use in the business could be regarded as a direct cost of restructuring. However, costs relating to the dismantling and installation of equipment at the new site and training staff to operate it are costs associated with ongoing operations and, therefore, ineligible for inclusion in the restructuring provision.

The entity will need to consider whether the existing facility meets the criteria in IFRS 5 to be classified as a non-current asset held for sale. On the basis that management had decided to market the facility for sale, but had not yet actively begun to do so, it is unlikely that the criteria in IFRS 5 would be met as at 31 December 20X2. Classification of non-current assets held for sale is discussed in Chapter 5 at section 2.

This example shows that individual classes of expenditure must be disaggregated into components that distinguish those elements associated with ongoing activities. Even if expenditure would not have been incurred without the restructuring activity, its association with ongoing activities means that it is ineligible for inclusion in a provision. IAS 37 requires the cost to be both necessarily entailed by the restructuring and not associated with the ongoing activities of the entity. *[IAS 37.80]*.

For that reason, whilst the cost of making employees redundant is an eligible restructuring cost, any incremental amounts paid to retain staff to ensure a smooth transition of operations from one location to another are not eligible because they are incurred to facilitate ongoing activities. IAS 19 requires these to be treated as short-term employee benefits to the extent that they are expected to be settled within 12 months after the end of the reporting period.[19] Similarly, whilst the costs of dismantling plant and equipment intended to be scrapped is an eligible restructuring cost, the costs of dismantling plant and equipment intended to be relocated and installed at the new site is ineligible, because it is associated with ongoing activities.

A further rule in IAS 37 is that the provision must not include identifiable future operating losses up to the date of the restructuring, unless they relate to an onerous contract. *[IAS 37.82]*. This means that even if the operation being reorganised is loss-making, its ongoing costs are not provided for. This is consistent with the general prohibition against the recognition of provisions for future operating losses. *[IAS 37.63]*.

The general requirement in the standard that gains from the expected disposal of assets cannot be taken into account in the measurement of provisions, *[IAS 37.51]*, is also relevant to the measurement of restructuring provisions, even if the sale of the asset is envisaged as part of the restructuring. *[IAS 37.83]*. Whilst the expected disposal proceeds from asset sales might have been a significant element of the economic case for a restructuring, the income from disposal is not anticipated just because it is part of a restructuring plan.

19 IAS 19 *Employee Benefits*, Example illustrating paras. 159-170.

6.2 Onerous contracts

Although future operating losses in general cannot be provided for, IAS 37 requires that "If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision". *[IAS 37.66]*.

The standard notes that many contracts (for example, some routine purchase orders) can be cancelled without paying compensation to the other party, and therefore there is no obligation. However, other contracts establish both rights and obligations for each of the contracting parties. Where events make such a contract onerous, the contract falls within the scope of the standard and a liability exists which is recognised. Executory contracts that are not onerous fall outside the scope of the standard. *[IAS 37.67]*.

IAS 37 defines an onerous contract as "...a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it". *[IAS 37.10]*. This requires that the contract is onerous to the point of being directly loss-making, not simply uneconomic by reference to current prices. For example, a change to more environmentally friendly materials or processes because of increased stakeholder interest in climate change could mean that contracts previously expected to be profitable are now expected to be loss making.

IAS 37 considers that "...The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it". *[IAS 37.68]*. This evaluation does not require an intention by the entity to fulfil or to exit the contract. It does not even require there to be specific terms in the contract that apply in the event of its termination or breach. Its purpose is to recognise only the unavoidable costs to the entity, which in the absence of specific clauses in the contract relating to termination or breach could include an estimation of the cost of ceasing to honour the contract and having the other party go to court for compensation for the resultant breach.

There has historically been some diversity in practice in how entities determine the unavoidable costs of fulfilling their obligations under a contract. In May 2020, the IASB issued *Onerous Contracts - Cost of Fulfilling a Contract (Amendments to* IAS 37*)* that clarified that "The cost of fulfilling a contract comprises the costs that relate directly to the contract. Costs that relate directly to a contract consist of both:

(a) the incremental costs of fulfilling that contract - for example, direct labour and materials; and

(b) an allocation of other costs that relate directly to fulfilling contracts - for example, an allocation of the depreciation charge for an item of property, plant and equipment used in fulfilling that contract among others." *[IAS 37.68A]*.

Whilst the amendment to IAS 37 was intended to clarify how to determine the unavoidable costs of fulfilling obligations under a contract, judgement will be required in determining which costs are directly related to contract activities. The Board noted in the Basis for Conclusions to the amendment that several IFRS accounting standards, such as IAS 2, specify the costs to include in measuring a non-monetary asset. Although the detailed requirements differ, they all require an entity to include both the incremental costs of purchasing or constructing the asset, and an allocation of other directly related or directly attributable costs, such as production overheads. The Board concluded that, in assessing whether a contract to deliver goods is onerous, the way in which an entity determines the cost of fulfilling the contract should be broadly consistent with the way it measures the costs of the goods when it holds them. *[IAS 37.BC7]*. Therefore, entities could look to other IFRS accounting standards, such as IAS 2 (see Chapter 23 at section 3.1), IAS 16 (see Chapter 19 at section 4.1), and IAS 38 (see Chapter 18 at section 4.2) when considering which costs are included or excluded when assessing whether an onerous contract provision is recognised. In addition, we believe that the guidance in IFRS 15 on costs to fulfil a contract will be relevant (see Chapter 28 at section 9.3.2). All of these IFRS accounting standards specify that entities exclude 'general overhead' or 'administrative' costs when measuring the cost of an asset, although with some exceptions:

(a) Under IFRS 15, general and administrative costs that are explicitly chargeable to customers could be costs to fulfil a contract that the entity recognises as an asset, subject to meeting certain criteria *[IFRS 15.98]* (see Chapter 28 at section 9.3.2).

(b) Under IAS 2, administrative overheads that contribute to bringing inventories to their present condition and location are included in the cost of inventories *[IAS 2.16(c)]* (see Chapter 23 at section 3.1.3.B).

(c) Under IAS 38, selling, administrative and other general overheads expenditure that can be directly attributed to preparing an internally generated intangible asset for use are included in the cost of the intangible asset *[IAS 38.67(a)]* (see Chapter 18 at section 6.3.2).

Therefore, whilst we believe that general overhead or administrative costs typically would not relate directly to fulfilling contracts, judgement can sometimes be required in making this assessment. In addition, whilst IAS 2 refers to indirect costs of production being included in the cost of inventories, the examples the standard gives of such costs include depreciation and maintenance of factory buildings, and the cost of factory management and administration. *[IAS 2.12]*. These are similar to the depreciation and contract management and supervision costs that IFRS 15 gives as examples of costs that relate directly to a contract. *[IFRS 15.97]*. Therefore, an entity could determine that such costs do relate directly to fulfilling contracts for the sale of inventory when assessing whether an onerous contract provision is recognised.

Whilst the clarification regarding costs to fulfil a contract is part of IAS 37's recognition requirements for onerous contracts, rather than its measurement requirements, entities could reasonably decide that the same costs are also used to measure any onerous contract provision recognised.[20] As noted in section 1.1 above, in January 2020, the IASB decided to add to its work plan a project to amend aspects of IAS 37. The scope of this project includes three targeted improvements to the standard, one of which is to clarify which costs are included in the measurement of a provision.[21]

As noted above, IAS 37 defines an onerous contract as "...a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it". *[IAS 37.10]*. There is also some diversity in practice in how entities determine the economic benefits expected to be received under a contract. In particular, whether the 'economic benefit expected to be received' should be interpreted narrowly (to include only the economic benefits to which the entity becomes directly entitled under the contract) or more broadly (to include other expected indirect benefits, such as access to future profitable contracts). However, in January 2020, the Board decided not to address this matter as part the planned targeted improvements to IAS 37.[22]

There is a subtle yet important distinction between making a provision in respect of the unavoidable costs under a contract (reflecting the least net cost of what the entity has to do) compared to making an estimate of the cost of what the entity intends to do. The first is an obligation, which merits the recognition as a provision, whereas the second is a choice of the entity, which fails the recognition criteria because it does not exist independently of the entity's future actions, *[IAS 37.19]*, and is therefore akin to a future operating loss.

Illustration 6-3: Onerous supply contract

Entity P negotiated a contract in 20X9 for the supply of components when availability in the market was scarce. It agreed to purchase 100,000 units per annum for 5 years commencing 1 January 20X0 at a price of CU20 per unit. Since then, new suppliers have entered the market and the typical price of a component is now CU5 per unit. Whilst its activities are still profitable (Entity P makes a margin of CU6 per unit of finished product sold) changes to the entity's own business means that it will not use all of the components it is contracted to purchase. As at 31 December 20X2, Entity P expects to use 150,000 units in future and has 55,000 units in inventory. The contract requires 200,000 units to be purchased before the agreement expires in 20X4. If the entity terminates the contract before 20X4, compensation of CU1 million per year is payable to the supplier. Each finished product contains one unit of the component.

Therefore, the entity expects to achieve a margin of CU900,000 (150,000 × CU6) on the units it will produce and sell; but will make a loss of CU15 (CU20 - CU5) per unit on each of the 105,000 components (55,000 + 200,000 - 150,000) it is left with at the end of 20X2 and now expects to sell in the components market.

In considering the extent to which the contract is onerous, Entity P does not concentrate solely on the net cost of the excess units of CU1,575,000 (105,000 × CU15) that it is contracted to purchase but which are expected to be left unsold. Instead, the entity must consider all of the related benefits of the contract, which includes the profits earned as a result of having a secure source of supply of components. Therefore, the supply contract is onerous (directly loss making) only to the extent of the costs not covered by related revenues, justifying a provision of CU675,000 (CU1,575,000 - CU900,000).

IAS 37 requires that an impairment loss that has occurred on assets 'used in fulfilling' the contract be recognised before establishing a provision for the onerous contract. *[IAS 37.69]*.

20 IASB Staff Paper 22A: Project: *Provisions,* Paper topic: *Research summary*, IASB meeting, January 2020, para. 3.20; and Exposure Draft ED/2018/2: *Onerous Contracts-Cost of Fulfilling a Contract: Proposed amendments to IAS 37*, IASB, December 2018, paragraph BC14. Available on the IFRS Foundation's website.

21 *IASB Update*, January 2020, available on the IFRS Foundation's website.

22 *IASB Update*, January 2020; and IASB Staff Paper 22: Project: *Provisions*, Paper topic: *Project proposal*, IASB meeting, January 2020, para. 12. Available on the IFRS Foundation's website.

6.2.1 Onerous leases

As discussed in section 2.2.1.B above, IAS 37 specifically applies to leases only in limited circumstances. IAS 37 specifically applies only to:

- Leases that become onerous before the commencement date of the lease
- Short-term leases (as defined in IFRS 16) and leases for which the underlying asset is of low value that are accounted for in accordance with IFRS 16.6 and that have become onerous *[IAS 37.5(c)]*

The IASB noted in the Basis for Conclusions to IFRS 16 that it "…decided not to specify any particular requirements in IFRS 16 for onerous contracts. The IASB made this decision because: (a) for leases that have already commenced, no requirements are necessary. After the commencement date, an entity will appropriately reflect an onerous lease contract by applying the requirements of IFRS 16. For example, a lessee will determine and recognise any impairment of right-of-use assets applying IAS 36 *Impairment of Assets*…" *[IFRS 16.BC72]*. However, this raises the question how an entity should account for onerous variable lease payments that are not included in the measurement of right-of-use assets or lease liabilities under IFRS 16 (including variable payments related to non-lease components that have not been separated from the lease components, in accordance with IFRS 16.15). It is not immediately obvious whether such onerous variable lease payments fall within the scope of IFRS 16 (and IAS 36), or IAS 37.

As discussed in Chapter 21 at section 7.1.9.A, we believe that contractual variable lease payments that are not included in the lease liability (such as those that are not based on an index or rate and are not in substance fixed) need to be reflected in cash flow forecasts used for value-in-use calculations for impairment testing purposes. In many cases, leased assets will be tested for impairment at a cash-generating-unit (CGU) level rather than at an individual asset level, as many leased assets are used as an input to the operating activities of an entity rather than generating largely independent cash flows. IAS 36 sets out requirements for the allocation of an impairment loss to assets within a CGU and requires that the allocation of the impairment loss does not reduce the carrying amount of an individual asset within the CGU below the highest of its fair value less costs of disposal, or value-in-use (if these can be established), or zero (see Chapter 21 at section 11.2). It is therefore logically possible, after all assets and goodwill are either written off or down to their fair value less costs of disposal or value-in-use, for the carrying amount of a CGU to be higher than the computed recoverable amount. IAS 36 requires that a liability is recognised for any remaining amount of an impairment loss for a CGU only if that is required by another IFRS accounting standard. *[IAS 36.108]*.

A question therefore arises as to whether, in such situations, an onerous lease provision should be recognised under the requirements of IAS 37, for any variable lease payments not included in the measurement of any right-of-use assets that are part of the CGU. A similar question arises for a right-of-use asset tested for impairment at the asset level rather than as part of a CGU. The answers will depend upon the interpretation of the scope exemption in IAS 37.5.

One view is that IAS 37.5 does not explicitly state that provisions for onerous leases are outside the scope of IAS 37, it merely provides examples of cases where other IFRS accounting standards address provisions, including IFRS 16. The general requirements of IFRS 16 are applied to the extent that there is a right-of-use asset and liability recognised and measured in accordance with the requirements of that standard. Any other lease payments not included in the measurement of the lease liability or right-of-use asset, such as variable lease payments that do not depend on an index or rate and are not in substance fixed, are in scope of the requirements of IAS 37 on onerous contracts. An onerous lease provision would be recognised for onerous variable lease payments that are not included in the measurement of right-of-use assets or lease liabilities under IFRS 16.

An alternative view is that the scope exemption in IAS 37.5 applies to all leases and lease payments other than the specific exceptions set out in IAS 37.5(c). An onerous lease provision would not be recognised for onerous variable lease payments not included in the measurement of right-of-use assets or lease liabilities under IFRS 16.

How we see it

Whether entities recognise onerous lease provisions for variable lease payments not included in the measurement of right-of-use assets recognised under IFRS 16 will depend upon their interpretation of the scope exemption in IAS 37.5. Where this has a material impact on entities financial statements, we would expect to see the entities interpretation disclosed as part of their material accounting policies as required by IAS 1.117.

In any case, where a lease contract contains non-lease components that have been accounted for separately from the lease components in accordance with IFRS 16.12, these non-lease components are in scope of IAS 37. This is because IFRS 16 specifies that once lease and non-lease components are elected not to be combined, a lessee accounts for non-lease components applying other applicable IFRS accounting standards. *[IFRS 16.15, IFRS 16.16]*.

In practice, entering into a lease contract may sometimes require a lessee to pay costs related to the leased property to third parties, other than the lessor, over the lease term. For example, a lessee, as legal occupier of the property, may be required by law to pay a quarterly levy to the government. Such levies are statutory obligations, which fall in scope of IFRIC 21, *[IFRIC 21.4]*, and are not part of the consideration for the lease contract. IFRIC 21 notes that the obligating event that gives rise to a liability to pay a levy is the activity that triggers the payment of the levy, as identified by the legislation. *[IFRIC 21.8].* Applying the requirements of IFRIC 21, the lessee recognises the levy when the event that triggers the payment of the levy occurs, which would be on a quarterly basis over the period in which the lessee remains legal occupier in this case. In the event that the lessee vacates the property during the lease term, it would not be appropriate for the lessee to recognise an onerous contract provision in respect of levies payable over the remaining term of the lease. The signing of the lease contract is necessary, but not sufficient, to create a present obligation in respect of business rates for the remaining lease term. IFRIC 21 is discussed in section 6.8 below.

A lease could also require a lessee to incur other costs payable to third parties, which are not statutory obligations. For example, a lease may require a lessee to ensure that a leased property is adequately insured throughout the term of the lease. If the lessee vacates the leased property during the lease term, entering into a lease contract that requires the lessee to ensure that the property is adequately insured for the remainder of the lease term would be a 'past obligating event' that would require the recognition of an onerous contract provision by the lessee in respect of property insurance costs. *[IAS 37.14]*. If, however, the lease does not include such an obligation but the lessee simply chooses to continue insuring the property throughout the lease term, there is no 'past obligating event' in respect of insurance costs. In that case, no onerous contract provision would be recognised for the insurance cost, and the cost would instead be treated as a future operating cost to be expensed as incurred.

6.2.2 Contracts with customers that are, or have become, onerous

As IFRS 15 contains no specific requirements to address contracts with customers that are, or have become, onerous, IAS 37 applies to such contracts. *[IAS 37.5(g)]*. In assessing whether a contract is onerous, an entity is required to compare the unavoidable costs of meeting the obligations under the contract to the economic benefits expected to be received under it. The unavoidable costs under the contract are the lower of the cost of fulfilling the contract and any compensation or penalties arising from failure to fulfil the contract. *[IAS 37.68]*. As discussed in section 6.2 above, in May 2020, the IASB issued an amendment to IAS 37 that clarifies that the costs of fulfilling a contract comprise the costs that relate directly to the contract, rather than only the incremental costs of the contract.[23]

One question that may arise, is how an entity should account for an onerous contract with a customer when the contract includes several 'over time' performance obligations that are satisfied consecutively. Since the requirements for onerous contracts are outside the scope of IFRS 15, an entity's accounting for onerous contracts does not affect the accounting for its revenue from contracts with customers in accordance with IFRS 15.

How we see it

To account for an onerous contract with a customer when the contract includes several 'over time' performance obligations that are satisfied consecutively, we believe that an entity must use an 'overlay' approach, which consists of two steps:

(a) Apply the requirements of IFRS 15 to measure progress in satisfying each performance obligation, and account for the related costs when incurred in accordance with the applicable standards.

(b) At the end of each reporting period, apply IAS 37 to determine if the remaining contract as a whole is onerous. If the entity concludes that the remaining contract as a whole is onerous, it recognises a provision only to the extent that the amount of the remaining unavoidable costs under the contract exceed the remaining economic benefits to be received under it.

23 *Onerous Contracts-Cost of Fulfilling a Contract: Amendments to IAS 37*, IASB, May 2020.

This approach is shown in Illustration 6-4 below.

Illustration 6-4: Onerous contract with several 'over time' performance obligations that are satisfied consecutively

Entity A enters into a contract that consists of two distinct performance obligations, which are satisfied consecutively. Revenue is recognised over time for both performance obligations. Entity A expects to satisfy the first performance obligation (PO1) during Years 1-4 and the second performance obligation (PO2) in Years 5-6. Entity A measures progress towards the satisfaction of both performance obligations based on costs incurred compared to the total expected costs (i.e., it applies an input method under IFRS 15).

If Entity A terminates the contract, a penalty of CU100,000 is payable.

The expected revenues and costs at the inception of the contract and the updated expectations at the beginning of Year 2 are as follows:

	At contract inception		Update in Year 2		
PO1	*Expected costs*	*Expected revenue*	*Expected costs*	*Expected revenue*	*Expected progress*
Year 1	24,000	30,000	24,000	30,000	25%
Year 2	24,000	30,000	24,000	30,000	25%
Year 3	24,000	30,000	24,000	30,000	25%
Year 4	24,000	30,000	24,000	30,000	25%
Total PO1	**96,000**	**120,000**	**96,000**	**120,000**	
PO2					
Year 5	10,000	15,000	32,000	15,000	50%
Year 6	10,000	15,000	32,000	15,000	50%
Total PO2	**20,000**	**30,000**	**64,000**	**30,000**	
Total contract	**116,000**	**150,000**	**160,000**	**150,000**	
Gross profit (loss)		34,000		(10,000)	

At contract inception, Entity A expects a positive margin for both performance obligations. At the beginning of Year 2, its estimates of the cost to fulfil the second performance obligation are increased by CU44,000. Therefore, Entity A now expects to incur a loss of CU34,000 for the second performance obligation, resulting in a negative margin for the entire contract of CU10,000.

The contract as a whole is only onerous to the extent that the remaining costs to be incurred exceed the remaining benefits to be recognised. This is not the CU34,000 loss relating to the second performance obligation, because at the beginning of Year 2, Entity A has yet to recognise profits of CU18,000 for the completion of the first performance obligation. As a result, the net cost of fulfilling the contract at Year 2 is CU16,000. This cost is less than the termination penalty of CU100,000 and therefore, applying the 'overlay' approach explained above, Entity A recognises a provision under IAS 37 of CU16,000 in Year 2.

In Years 2 to 4, as the first performance obligation is being completed, the provision increases to reflect the higher net cost of satisfying the remaining performance obligations in the contract. As at the end of Year 4, only the revenues and costs relating to the second performance obligation remain, such that the provision now stands at CU34,000 and is utilised in Years 5 and 6 as the related losses are incurred.

The table below illustrates the effect of this accounting treatment (assuming that the actual outcome of the contract is the same as the updated estimates). This example ignores the time value of money for simplicity reasons.

			Provision		
	Costs	*Revenue*	*Additions/ Utilisations*	*Balance*	*Profit or loss for the period*
Year 1	24,000	30,000	-	-	6,000
Year 2 (change in estimated total costs)	-	-	16,000	16,000	(16,000)
Year 2	24,000	30,000	6,000	22,000	-
Year 3	24,000	30,000	6,000	28,000	-
Year 4	24,000	30,000	6,000	34,000	-
Year 5	32,000	15,000	(17,000)	17,000	-
Year 6	32,000	15,000	(17,000)	-	-
Total	160,000	150,000	-	-	(10,000)

The effect of an onerous contract provision, or a change in the provision, is recognised as an expense in profit or loss and not as an adjustment to revenue.

As provisions for onerous contracts with customers are in the scope of IAS 37, they are classified as provisions in the balance sheet and disclosed in accordance with IAS 37 (see section 7.1 below). Onerous contract provisions are outside the scope of IFRS 15 and are not included within contract liabilities.

Since the definition of an onerous contract in IAS 37 refers only to a contract, the unit of account to determine whether an onerous contract exists is the contract itself, rather than the performance obligations identified in accordance with IFRS 15. *[IAS 37.10]*. As a result, the entity must consider the entire remaining contract, including remaining revenue to be recognised for unsatisfied, or partially unsatisfied, performance obligations and the remaining costs to fulfil those performance obligations.

As discussed in section 6.2 above, there is diversity in practice in how entities determine the economic benefits expected to be received under a contract for the purposes of assessing whether a contract is onerous. Where a contract with a customer contains an element of variable consideration, it is likely that judgement will be required in assessing the economic benefits expected to be received under a contract. This may particularly be the case where an entity is required to constrain the estimate of variable consideration to be included in the transaction price for revenue recognition purposes under IFRS 15. Variable consideration under IFRS 15 is discussed further in Chapter 28 at section 5.2.

6.3 Decommissioning provisions

Decommissioning costs arise when an entity is required to dismantle or remove an asset at the end of its useful life and to restore the site on which it has been located, for example, when an oil rig or nuclear power station reaches the end of its economic life.

Rather than allowing an entity to build up a provision for the required costs over the life of the facility, IAS 37 requires that the liability is recognised as soon as the obligation arises. This is because the construction of the asset (and the environmental damage caused by it) creates the past obligating event requiring restoration in the future. *[IAS 37.IE Example 3]*.

The accounting for decommissioning costs is dealt with in IAS 37 by way of an example relating to an oil rig in an offshore oilfield (see Illustration 3-5 in section 3.3 above). A provision is recognised at the time of constructing the oil rig in relation to the eventual costs that relate to its removal and the restoration of damage caused by building it. Additional provisions are recognised over the life of the oil field to reflect the need to reverse damage caused during the extraction of oil. *[IAS 37.IE Example 3]*. The total decommissioning cost is estimated, discounted to its present value and it is this amount which forms the initial provision. This 'initial estimate of the costs of dismantling and removing the item and restoring the site' is added to the corresponding asset's cost. *[IAS 16.16]*. Thereafter, the asset is depreciated over its useful life, while the discounted provision is progressively unwound, with the unwinding charge shown as a finance cost, as discussed in section 4.3.5 above.

The effect of discounting on the statement of comprehensive income is to split the cost of the eventual decommissioning into two components: an expense based on the present value of the expected future cash outflows; and a finance element representing the unwinding of the discount. The overall effect is to produce a rising pattern of cost over the life of the facility, often with much of the total cost of the decommissioning classified as a finance cost.

AngloGold Ashanti plc's accounting policies and provisions note in respect of decommissioning obligations and restoration obligations are shown in the following Practical example.

Practical example 6-1: AngloGold Ashanti plc (2023) **United Kingdom**

Annual Report 2023 [extract]

Annual financial statements [extract]

Group financial statements [extract]

Group Notes to the financial statements [extract]

23 ENVIRONMENTAL REHABILITATION AND OTHER PROVISIONS [extract]

US dollar millions	Provision for decommissioning	Provision for restoration	Provision for silicosis	Other provisions [2]	Total
Balance at 1 January 2023	162	416	35	64	677
Changes in estimates - recognised in profit or loss [1]	–	48	(6)	28	70
Change in estimates - capitalised [1]	4	–	–	–	4
Reclassifications	–	–	(2)	2	–
Utilised during the year	–	(28)	(11)	(21)	(60)
Unwinding of provision	6	17	2	1	26
Translation	1	(1)	(1)	–	(1)
Balance at 31 December 2023	173	452	17	74	716
Current	1	46	1	32	80
Non-current	172	406	16	42	636

...

[1] *The change in estimates relating to the provision for decommissioning and restoration is attributable to shifts in discount rates from global economic assumption changes, alterations in mine plans affecting cash flows, updates in design for closure of tailings storage facilities and in revised methodology following requests from the environmental regulatory authorities. These provisions are expected to unwind beyond the end of the life-of-mine.*

[2] *Other provisions comprise claims filed by former employees in respect of loss of employment, work-related accident injuries and diseases, governmental fiscal claims relating to levies, surcharges and environmental legal disputes, a shareholder claim related to stamp duties and an onerous provision in Yatela. These liabilities are expected to be settled over the next five-year period.*

...

Environmental obligations [extract]

Accounting policies

Environmental expenditure

The Group has long term remediation obligations comprising decommissioning and restoration liabilities relating to its past operations which are based on the Group's environmental management plans, in compliance with current environmental and regulatory requirements. Provisions for non-recurring remediation costs are made when there is a present obligation, it is probable that expenditure on remediation work will be required and the cost can be estimated within a reasonable range of possible outcomes. The costs are based on currently available facts, technology expected to be available at the time of the clean-up, laws and regulations presently or virtually certain to be enacted and prior experience in remediation of contaminated sites.

Decommissioning costs

The provision for decommissioning represents the cost that will arise from dismantling and removing an asset and restoring the site on which it is located. The obligation is incurred at the time the asset is put in place or as a consequence of using the asset for purposes other than to produce inventories. Accordingly, a provision and a decommissioning asset is recognised and included within mine infrastructure.

Decommissioning costs are provided at the present value of the expenditures expected to settle the obligation, using estimated cash flows based on current prices. The unwinding of the decommissioning obligation is included in the income statement as finance costs. Estimated future costs of decommissioning obligations are reviewed regularly and adjusted as appropriate for new circumstances or changes in law or technology. Changes in estimates are capitalised or reversed against the relevant asset. Estimates are discounted at a pre-tax rate that reflects current market assessments of the time value of money.

Gains or losses from the expected disposal of assets are not taken into account when determining the provision.

Restoration costs

The provision for restoration represents the cost of restoring site damage as a result of operating the asset to produce inventories. Changes in the provision are recorded in the income statement as a cost of production.

Restoration costs are estimated at the present value of the expenditures expected to settle the obligation, using estimated cash flows based on current prices and adjusted for risks specific to the liability. The estimates are discounted at a pre-tax rate that reflects current market assessments of the time value of money.

...

In the past, some entities may not have recognised provisions for the decommissioning costs of assets such as coal, or oil and gas plants, because they were considered to have indefinite useful lives. Climate-related risks, and any associated legislation, may require this judgement to be reconsidered and new decommissioning provisions recognised, or new contingent liabilities disclosed, as seen in Practical example 3-2 from Shell plc, in section 3.2.1 above.

6.3.1 Changes in estimated decommissioning costs (IFRIC 1)

IAS 37 requires provisions to be revised annually to reflect the current best estimate of the provision. *[IAS 37.59]*. However, the standard gives no guidance on accounting for changes in the decommissioning provision. Similarly, IAS 16 is unclear about the extent to which an item's carrying amount should be affected by changes in the estimated amount of dismantling and site restoration costs that occur after the estimate made upon initial measurement. This was addressed by the IASB with the publication of IFRIC 1. *[IFRIC 1.1]*.

IFRIC 1 applies to any decommissioning, restoration or similar liability that has been both included as part of the cost of an asset measured in accordance with IAS 16 or as part of the cost of a right-of-use asset in accordance with IFRS 16 and recognised as a liability in accordance with IAS 37. *[IFRIC 1.2]*. It addresses how the effect of the following events that change the measurement of an existing decommissioning, restoration or similar liability is accounted for:

(a) A change in the estimated outflow of resources embodying economic benefits (e.g., cash flows) required to settle the obligation

(b) A change in the current market-based discount rate (this includes changes in the time value of money and the risks specific to the liability)

(c) An increase that reflects the passage of time (also referred to as the unwinding of the discount) *[IFRIC 1.3]*

IFRIC 1 requires that (c) above, the periodic unwinding of the discount, is recognised in profit or loss as a finance cost as it occurs. *[IFRIC 1.8]*. The IFRS IC concluded that the unwinding of the discount is not a borrowing cost as defined in IAS 23, and thus cannot be capitalised under that standard. *[IFRIC 1.BC26, IFRIC 1.BC27]*.

For a change caused by (a) or (b) above, however, the adjustment is taken to the income statement only in specific circumstances. Any revision to the provision (other than to reflect the passage of time) is first recognised in the carrying value of the related asset or in other comprehensive income, depending on whether the asset is measured at cost or using the revaluation model. *[IFRIC 1.4, IFRIC 1.5, IFRIC 1.6, IFRIC 1.7]*.

If the related asset is measured using the cost model, the change in the liability is added to or deducted from the cost of the asset to which it relates. Where the change gives rise to an addition to cost, the entity must consider the need to test the new carrying value for impairment. This is particularly relevant for assets approaching the end of their useful life, as their remaining economic benefits are often small compared to the potential changes in the related decommissioning liability. Reductions over and above the remaining carrying value of the asset are recognised immediately in profit or loss. *[IFRIC 1.5]*. The adjusted depreciable amount of the asset is then depreciated prospectively over its remaining useful life. *[IFRIC 1.7]*. IFRIC 1 includes the following illustrative example.

Illustration 6-5: Changes in decommissioning costs - related asset measured at cost

An entity has a nuclear power plant and a related decommissioning liability. The nuclear power plant started operating on 1 January 20W3. The plant has a useful life of 40 years. Its initial cost was CU120,000,000; this included an amount for decommissioning costs of CU10,000,000, which represented CU70,400,000 in estimated cash flows payable in 40 years discounted at a risk-adjusted rate of 5%. The entity's financial year ends on 31 December.

On 31 December 20X2, the plant is 10 years old. Accumulated depreciation is CU30,000,000. Because of the unwinding of discount over the 10 years, the decommissioning liability has grown from CU10,000,000 to CU16,300,000.

On 31 December 20X2, the discount rate has not changed. However, the entity estimates that, as a result of technological advances, the net present value of the expected cash flows has decreased by CU8,000,000. Accordingly, the entity reduces the decommissioning liability from CU16,300,000 to CU8,300,000 and reduces the carrying amount of the asset by the same amount.

Following this adjustment, the carrying amount of the asset is CU82,000,000 (CU120,000,000 - CU8,000,000 - CU30,000,000), which will be depreciated over the remaining 30 years of the asset's life to give a depreciation expense for 20X2 of CU2,733,333 (CU82,000,000 ÷ 30). The next year's finance cost for the unwinding of the discount will be CU415,000 (CU8,300,000 × 5%). *[IFRIC 1.IE1, IFRIC 1.IE2, IFRIC 1.IE3, IFRIC 1.IE4]*.

In illustrating the requirements of the Interpretation, the example in IFRIC 1 reduces the carrying value of the whole asset (comprising its construction cost and decommissioning cost) by the reduction in the present value of the decommissioning provision. The solution set out in the Illustration does not treat the decommissioning element as a separate component of the asset. Had this been the case, the component would have had accumulated depreciation as at 31 December 20X2 of CU2,500,000 (CU10,000,000 × 10/40), giving a carrying amount of CU7,500,000 at that date and a gain of CU500,000 when reduced by the decrease in the provision of CU8,000,000. Accordingly, we believe that the example in IFRIC 1 indicates that it would not be appropriate to recognise any gain until the carrying value of the whole asset is extinguished.

If the related asset is measured using the revaluation model, changes in the liability alter the revaluation surplus or deficit previously recognised for that asset. Decreases in the provision are recognised in other comprehensive income and increase the value of the revaluation surplus in respect of the asset, except that:

(a) A decrease in the provision is required to be recognised in profit or loss to the extent that it reverses a previous revaluation deficit on that asset that was recognised in profit or loss

(b) If a decrease in the provision exceeds the carrying amount of the asset that would have been recognised under the cost model, the excess is required to be recognised in profit or loss *[IFRIC 1.6]*

Increases in the provision are recognised in profit or loss, except that they must be recognised in other comprehensive income, and reduce the revaluation surplus, to the extent of any credit balance existing in the revaluation surplus in respect of that asset. Changes in the provision might also indicate the need for the asset (and therefore all assets in the same class) to be revalued. *[IFRIC 1.6]*.

The Illustration below, based on the examples in IFRIC 1 address this alternative.

Illustration 6-6: Changes in decommissioning costs - related asset carried at revaluation amount

Assume that the entity in Illustration 6-5 above instead adopts the revaluation model in IAS 16, and its policy is to eliminate accumulated depreciation at the revaluation date against the gross carrying amount of the asset.

The entity first revalues the asset as at 31 December 20W5 when the nuclear power plant is 3 years old. The valuation of CU115,000,000 comprises a gross valuation of CU126,600,000 and an allowance of CU11,600,000 for decommissioning costs, which represents no change to the original estimate, after the unwinding of three years' discount. The amounts included in the statement of financial position at 31 December 20W5 and the related revaluation reserve movements are therefore:

	Net book value	Valuation	Revaluation reserve
	CU'000	CU'000	CU'000
Cost or valuation	120,000	126,600	6,600
Accumulated depreciation (3/40)	(9,000)	-	9,000
Carrying amount of asset	111,000	126,600	15,600
Original provision	10,000		
Unwinding of discount (3 years @ 5%)	1,600		
	11,600	11,600	
Carrying amount less provision	99,400	115,000	15,600

The depreciation expense for 20W6 is therefore CU3,420,000 (CU126,600,000 ÷ 37) and the discount expense for 20W5 is CU580,000 (5% of CU11,600,000). On 31 December 20W6, the decommissioning liability (before any adjustment) is CU12,180,000 and the discount rate has not changed. However, on that date, the entity estimates that, as a result of technological advances, the present value of the decommissioning liability has decreased by CU5,000,000. Accordingly, the entity adjusts the decommissioning liability to CU7,180,000. To determine the extent to which any of the change to the provision is recognised in profit or loss, the entity has to keep a record of revaluations previously recognised in profit or loss; the carrying amount of the asset that would have been recognised under the cost model; and the previous revaluation surplus relating to that asset. *[IFRIC 1.6]*. In this example, the whole of the adjustment is taken to revaluation surplus, because it does not exceed the carrying amount that would have been recognised for the asset under the cost model of CU103,000 (see below). *[IFRIC 1.IE6, IFRIC 1.IE7, IFRIC 1.IE8, IFRIC 1.IE9, IFRIC 1.IE10]*.

In addition, the entity decides that a full valuation of the asset is needed at 31 December 20W6, in order to ensure that the carrying amount does not differ materially from fair value. Suppose that the asset is now valued at CU107,000,000, which is net of an allowance of CU7,180,000 for the reduced decommissioning obligation. The valuation of the asset for financial reporting purposes, before deducting this allowance, is therefore CU114,180,000. The effect on the revaluation reserve of the revision to the estimate of the decommissioning provision and the new valuation can be illustrated in the table below. *[IFRIC 1.IE11, IFRIC 1.IE12]*.

	Cost model	Revaluation	Revaluation reserve
	CU'000	CU'000	CU'000
Carrying amount as at 31 December 20W5	111,000	126,600	15,600
Depreciation charge for 20W6	(3,000)	(3,420)	
Carrying amount as at 31 December 20W6	108,000	123,180	
Revision to estimate of provision	(5,000)		
Revaluation adjustment in 20W6		(9,000)	(9,000)
	103,000	114,180	
Provision as at 31 December 20W5	11,600	11,600	
Unwinding of discount @ 5%	580	580	
Revision to estimate	(5,000)	(5,000)	5,000
Provision as at 31 December 20W6	7,180	7,180	
Carrying amount less provision	95,820	107,000	11,600

As indicated in section 4.3.6 above, IAS 37 is unclear whether a new discount rate should be applied during the year or just at the year-end, and whether the rate should be applied to the new estimate of the provision or the old estimate. Although IFRIC 1 requires that changes in the provision resulting from a change in the discount rate is added to, or deducted from, the cost of the related asset in the current period, it does not deal specifically with these points. However, Example 1 in the illustrative examples to IFRIC 1 indicates that a change in discount rate would be accounted for in the same way as other changes affecting the estimate of a provision for decommissioning, restoration and similar liabilities. That is, it is reflected as a change in the liability at the time the revised estimate is made and the new estimate is discounted at the revised discount rate from that point on. *[IFRIC 1.IE5]*.

When accounting for revalued assets to which decommissioning liabilities attach, the illustrative example in IFRIC 1 states that it is important to understand the basis of the valuation obtained. For example:

(a) If an asset is valued on a discounted cash flow basis, some valuers may value the asset without deducting any allowance for decommissioning costs (a 'gross' valuation), whereas others may value the asset after deducting an allowance for decommissioning costs (a 'net' valuation), because an entity acquiring the asset will generally also assume the decommissioning obligation. For financial reporting purposes, the decommissioning obligation is recognised as a separate liability, and is not deducted from the asset. Accordingly, if the asset is valued on a net basis, it is necessary to adjust the valuation obtained by adding back the allowance for the liability, so that the liability is not counted twice. This is the case in Illustration 6-6 above.

(b) If an asset is valued on a depreciated replacement cost basis, the valuation obtained may not include an amount for the decommissioning component of the asset. If it does not, an appropriate amount will need to be added to the valuation to reflect the depreciated replacement cost of that component. *[IFRIC 1.IE7]*.

6.3.2 Changes in legislation after construction of the asset

The scope of IFRIC 1 is set out in terms of any existing decommissioning, restoration or similar liability that is both recognised as part of the cost of the asset under IAS 16 or as part of the cost of a right-of-use asset in accordance with IFRS 16; and recognised as a liability in accordance with IAS 37. *[IFRIC 1.2]*. The Interpretation does not address the treatment of obligations arising after the asset has been constructed, for example, as a result of changes in legislation. *[IFRIC 1.BC23]*. Nevertheless, in our opinion the cost of the related asset is be measured in accordance with the principles set out in IFRIC 1 regardless of whether the obligation exists at the time of constructing the asset or arises later in its life.

As discussed in Chapter 19 at section 3.3, IAS 16 makes no distinction in principle between the initial costs of acquiring an asset and any subsequent expenditure upon it. In both cases, any and all expenditure has to meet the recognition rules, and be expensed in profit or loss if it does not. IAS 16 states that the cost of an item of property, plant and equipment includes "…the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period." *[IAS 16.16(c)]*. For example, the introduction

of new legislation to require the clean-up of sites that cease to be used as gasoline filling stations would give rise to the recognition of a decommissioning provision and, to the extent that the clean-up obligation arose as a result of the construction of the filling stations, an increase in the carrying value of the properties. Similarly, IFRS 16 states that the cost of a right-of-use asset includes "…an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories. The lessee incurs the obligation for those costs either at the commencement date or as a consequence of having used the underlying asset during a particular period." *[IFRS 16.24(d)]*.

Both IAS 16 and IFRS 16 require an entity to apply IAS 2 to the costs of obligations for dismantling, removing and restoring the site on which an item is located that are incurred during a particular period as a consequence of having used the item to produce inventories during that period. *[IAS 16.18, IFRS 16.25]*. For example, the cost of restoring the site of a quarry would be reflected as part of the cost of the aggregate extracted from it, and not added to the carrying value of the site. Accordingly, if an entity previously had no obligation to restore the site and new legislation was introduced after 25% of the site had been excavated and 80% of that output had been sold, then 80% of the new estimate of the restoration cost would be expensed; 20% added to the cost of inventory; and none added to the carrying value of the site.

When changes in legislation give rise to a new decommissioning, restoration or similar liability that is added to the carrying amount of the related asset, it would be appropriate to perform an impairment review in accordance with IAS 36 (see Chapter 21).

6.3.3 Funds established to meet an obligation (IFRIC 5)

Some entities may participate in a decommissioning, restoration or environmental rehabilitation fund, the purpose of which is to segregate assets to fund some or all of the costs of decommissioning for which the entity has to make a provision under IAS 37. IFRIC 5 was issued to address this issue, referring to decommissioning to mean not only the dismantling of plant and equipment but also the costs of undertaking environmental rehabilitation, such as rectifying pollution of water or restoring mined land. *[IFRIC 5.1]*.

Contributions to these funds may be voluntary or required by regulation or law, and the funds may have one of the following common structures:

- Funds that are established by a single contributor to fund its own decommissioning obligations, whether for a particular site, or for a number of geographically dispersed sites.
- Funds that are established with multiple contributors to fund their individual or joint decommissioning obligations, where contributors are entitled to reimbursement for decommissioning expenses to the extent of their fund contributions plus any actual earnings on those contributions less their share of the costs of administering the fund. Contributors may have an obligation to make potential additional contributions, for example, in the event of the bankruptcy of another contributor.
- Funds that are established with multiple contributors to fund their individual or joint decommissioning obligations when the required level of contributions is based on the current activity of a contributor, but the benefit obtained by that contributor is based on its past activity. In such cases there is a potential mismatch in the amount of contributions made by a contributor (based on current activity) and the value realisable from the fund (based on past activity). *[IFRIC 5.2]*.

Such funds generally have the following features:

- The fund is separately administered by independent trustees.
- Entities (contributors) make contributions to the fund, which are invested in a range of assets that may include both debt and equity investments, and are available to help pay the contributors' decommissioning costs. The trustees determine how contributions are invested, within the constraints set by the fund's governing documents and any applicable legislation or other regulations.
- The contributors retain the obligation to pay decommissioning costs. However, contributors are able to obtain reimbursement of decommissioning costs from the fund up to the lower of the decommissioning costs incurred and the entity's share of assets of the fund.
- The contributors may have restricted or no access to any surplus of assets of the fund over those used to meet eligible decommissioning costs. *[IFRIC 5.3]*.

IFRIC 5 applies to accounting in the financial statements of a contributor for interests arising from decommissioning funds that have both the following features:

- The assets are administered separately (either by being held in a separate legal entity or as segregated assets within another entity).
- A contributor's right to access the assets is restricted. *[IFRIC 5.4]*.

A residual interest in a fund that extends beyond a right to reimbursement, such as a contractual right to distributions once all the decommissioning has been completed or on winding up the fund, may be an equity instrument within the scope of IFRS 9, and is not within the scope of IFRIC 5. *[IFRIC 5.5]*.

The issues addressed by IFRIC 5 are:

(a) How should a contributor account for its interest in a fund?

(b) When a contributor has an obligation to make additional contributions, for example, in the event of the bankruptcy of another contributor, how should that obligation be accounted for? *[IFRIC 5.6]*

6.3.3.A Accounting for an interest in a fund

IFRIC 5 requires the contributor to recognise its obligations to pay decommissioning costs as a liability and recognise its interest in the fund separately, unless the contributor is not liable to pay decommissioning costs even if the fund fails to pay. *[IFRIC 5.7]*.

The contributor determines whether it has control, joint control or significant influence over the fund by reference to IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements* and IAS 28 *Investments in Associates and Joint Ventures*. If the contributor determines that it has such control, joint control or significant influence, it is required to account for its interest in the fund in accordance with those standards (see Chapters 7, 13 and 12 respectively). *[IFRIC 5.8]*.

Otherwise, the contributor must recognise the right to receive reimbursement from the fund as a reimbursement in accordance with IAS 37 (see section 4.6 above). This reimbursement is measured at the lower of:

- The amount of the decommissioning obligation recognised
- The contributor's share of the fair value of the net assets of the fund attributable to contributors *[IFRIC 5.9]*

This 'asset cap' means that the asset recognised in respect of the reimbursement rights can never exceed the recognised liability. Accordingly, rights to receive reimbursement to meet decommissioning liabilities that have yet to be recognised as a provision are not recognised. *[IFRIC 5.BC14]*. Although many respondents expressed concern about this asset cap and argued that rights to benefit in excess of this amount give rise to an additional asset, separate from the reimbursement asset, the IFRS IC, despite having sympathy with the concerns, concluded that to recognise such an asset would be inconsistent with the requirement in IAS 37 that the amount recognised for the reimbursement should not exceed the amount of the provision. *[IFRIC 5.BC19, IFRIC 5.BC20]*.

Changes in the carrying value of the right to receive reimbursement other than contributions to and payments from the fund are required to be recognised in profit or loss in the period in which these changes occur. *[IFRIC 5.9]*.

The effect of this requirement is that the amount recognised in the statement of comprehensive income relating to the reimbursement bears no relation to the expense recognised in respect of the provision, particularly for decommissioning liabilities where most changes in the measurement of the provision are not taken to the profit or loss immediately, but are recognised prospectively over the remaining useful life of the related asset (see section 6.3.1 above).

One company that has been affected by the 'asset cap' is Fortum Oyj as shown below. In this Practical example, the company observes that because IFRS accounting standards do not allow the asset to exceed the amount of the provision, *[IFRIC 5.9, IFRIC 5.BC19, IFRIC 5.BC20]*, it recognises a reimbursement asset in its statement of financial position that is lower than its actual share of the fund.

Practical example 6-2: Fortum Oyj (2023) **Finland**

Financials 2023 [extract]
FINANCIAL STATEMENTS [extract]
Consolidated financial statements [extract]
Notes to the consolidated financial statements [extract]
28 Nuclear-related assets and liabilities [extract]

ACCOUNTING POLICIES

Fortum owns Loviisa nuclear power plant in Finland. In Fortum's consolidated balance sheet, Share in the State Nuclear Waste Management Fund and the Nuclear provisions relate to Loviisa nuclear power plant. Fortum's share in the State Nuclear Waste Management Fund is accounted for according to IFRIC 5, Rights to interests arising from decommissioning, restoration and environmental rehabilitation funds which states that the fund assets are measured at the lower of fair value or the value of the related liabilities since Fortum does not have control or joint control over the State Nuclear Waste Management Fund. The Nuclear Waste Management Fund is managed by governmental authorities. The related provisions are the provision for decommissioning and the provision for disposal of spent fuel.

...

Fortum's actual share of the State Nuclear Waste Management Fund, related to Loviisa nuclear power plant, is higher than the carrying value of the Fund on the balance sheet. The legal nuclear liability should, according to the Finnish Nuclear Energy Act, be fully covered by payments and guarantees to the State Nuclear Waste Management Fund. The legal liability is not discounted while the provisions are, and since the future cash flow is spread over a very long time horison, the difference between the legal liability and the provisions are material.

...

28.1 Nuclear-related assets and liabilities for consolidated nuclear power plants

EUR million	2023	2022
Carrying values on the balance sheet		
BS Nuclear provisions	1,058	966
BS Fortum's share in the State Nuclear Waste Management Fund	1,058	966
Fortum's share of the fair value of the net assets in the State Nuclear Waste Management Fund	1,197	1,148
Share of fund not recognised on the balance sheet	139	182

Nuclear provision and fund accounted according to IFRS

Nuclear provisions include the provision for decommissioning and the provision for disposal of spent fuel. The carrying value of the nuclear provisions, calculated according to IAS 37, increased by EUR 92 million compared to 31 December 2022, totalling EUR 1,058 million at 31 December 2023. The change is mainly due to the Loviisa lifetime extension and updates in Posiva's project budget.

Fortum's share of the State Nuclear Waste Management Fund is from an IFRS perspective overfunded by EUR 139 million, since Fortum's share of the Fund on 31 December 2023 was EUR 1,197 million and the carrying value on the balance sheet was EUR 1,058 million. The Fund on Fortum's balance sheet can at maximum be equal to the amount of the provisions according to IFRS. As long as the Fund is overfunded from an IFRS perspective, the other financial items - net, is adjusted positively if the provisions increase more than the Fund, and negatively if the provision decreases below the actual value of the fund.

Legal liability for Loviisa nuclear power plant

The legal liability on 31 December 2023, decided by the Ministry of Economic Affairs and Employment in December 2023, was EUR 1,253 million.

The legal liability is based on a cost estimate, which is updated every year; and a technical plan, which is updated every three years. The legal liability is determined by assuming that the decommissioning would start at the beginning of the year following the assessment year and discounting is not applied in determining the amount.

Fortum's share in the Finnish Nuclear Waste Management Fund

According to Nuclear Energy Act, Fortum is obligated to contribute funds in full to the State Nuclear Waste Management Fund to cover the legal liability. Fortum contributes funds to the Finnish State Nuclear Waste Management Fund based on the yearly funding obligation target decided by the governmental authorities in connection with the decision of size of the legal liability. The current funding obligation target decided in December 2023 is EUR 1,253 million.

...

6.3.3.B Accounting for obligations to make additional contributions

IFRIC 5 requires that when a contributor has an obligation to make potential additional contributions, for example, in the event of the bankruptcy of another contributor or if the value of the investments held by the fund decreases to an extent that they are insufficient to fulfil the fund's reimbursement obligations, this obligation is a contingent liability that is within the scope of IAS 37. The contributor shall recognise a liability only if it is probable that additional contributions will be made. *[IFRIC 5.10]*.

6.3.3.C Gross presentation of interest in the fund and the decommissioning liability

IFRIC 5 requires the contributor to a fund to recognise its obligations to pay decommissioning costs as a liability and recognise its interest in the fund separately, unless the contributor is not liable to pay decommissioning costs even if the fund fails to pay. *[IFRIC 5.7]*. Accordingly, in most cases it would not be appropriate to offset the decommissioning liability and the interest in the fund.

The IFRS IC reached this conclusion because IAS 37 requires an entity that remains liable for expenditure to recognise a provision even where reimbursement is available and to recognise a separate reimbursement asset only when the entity is virtually certain that it will be received when the obligation is settled. *[IFRIC 5.BC7]*. The IFRS IC also noted that the conditions in IAS 32 *Financial Instruments: Presentation* for offsetting a financial asset and a financial liability would rarely be met because of the absence of a legal right of set off and the likelihood that settlement will not be net or simultaneous. *[IAS 32.42]*. Arguments that the existence of a fund allows derecognition of the liability by analogy to IAS 39 *Financial Instruments: Recognition and Measurement*;[24] or a net presentation similar to a pension fund, were also rejected. *[IFRIC 5.BC8]*.

6.3.3.D Disclosure of interests arising from decommissioning, restoration and environmental rehabilitation funds

IFRIC 5 requires the following disclosures:

- A contributor must disclose the nature of its interest in a fund and any restrictions on access to the assets in the fund. *[IFRIC 5.11]*.
- When a contributor has an obligation to make potential additional contributions that is not recognised as a liability (see section 6.3.3.B above), it is required to provide the contingent liability disclosures required by IAS 37 (see section 7.2 below). *[IFRIC 5.12]*.
- When a contributor accounts for its right to receive reimbursement from the fund as a reimbursement right under IAS 37 in accordance with IFRIC 5.9 (see section 6.3.3.A above), it must disclose the amount of the expected reimbursement and the amount of any asset that has been recognised for that expected reimbursement. *[IFRIC 5.13]*.

6.3.4 Interaction of leases with asset retirement obligations

An entity may sometimes use, or expect to use, a leased asset to carry out decommissioning or remediation work for which it has recognised a decommissioning, remediation or asset retirement provision. For example, at the end of life of an oil field, an entity may use a leased ship or rig to undertake the plugging and abandonment of oil wells. The entity may have included the estimated cost of plugging and abandonment of the wells in the decommissioning provision set up at the commencement of oil production. If an entity uses leased assets to carry out decommissioning or remediation work for which it recognised a decommissioning, remediation, or asset retirement provision, the question arises as to whether, at lease commencement, the entity's recognition of a lease liability for the leased assets in accordance with IFRS 16 results in derecognition of the asset retirement obligation recognised in the balance sheet. Given that, prior to the commencement of any asset retirement obligation related activities, the entity still has an obligation to rehabilitate under IAS 37, it cannot derecognise the asset retirement obligation. Instead, it now has a separate lease liability for the financing of the lease of the asset. Accordingly, acquiring the right-of-use asset does not result in the derecognition of the asset retirement obligation liability, rather it would be the activity undertaken or output of the asset which would ultimately settle the asset retirement obligation. This is discussed further in Chapter 39 at section 17.7.

24 IFRS 9 replaced IAS 39, effective for annual periods beginning on or after 1 January 2018. IFRS 9 applies to items that were previously within the scope of IAS 39.

How we see it

The recognition, at lease commencement, of an IFRS 16 lease liability for assets leased in order to fulfil an entity's asset retirement obligation, does not result in derecognition of the asset retirement obligation recognised in the balance sheet.

6.4 Environmental provisions - general guidance in IAS 37

The standard illustrates its recognition requirements in two examples relating to environmental provisions. The first deals with the situation where it is virtually certain that legislation will be enacted which will require the clean-up of land already contaminated. In these circumstances, the virtual certainty of new legislation being enacted means that the entity has a present legal obligation as a result of the past event (contamination of the land), requiring a provision to be recognised. *[IAS 37.IE Example 2A]*. However, in its discussion about what constitutes an obligating event, the standard notes that "…Differences in circumstances surrounding enactment make it impossible to specify a single event that would make the enactment of a law virtually certain. In many cases, it will be impossible to be virtually certain of the enactment of a law until it is enacted." *[IAS 37.22]*. The second example deals with a similar situation, except that the entity is not expected to be legally required to clean it up. Nevertheless, the entity has a widely publicised environmental policy undertaking to clean up all contamination that it causes, and has a record of honouring this policy. In these circumstances, a provision is still required because the entity has created a valid expectation that it will clean up the land, meaning that the entity has a present constructive obligation as a result of past contamination. *[IAS 37.IE Example 2B]*. It is therefore clear that where an entity causes environmental damage and has a present legal or constructive obligation to make it good; it is probable that an outflow of resources will be required to settle the obligation; and a reliable estimate can be made of the amount, a provision will be required. *[IAS 37.14]*.

One company making provision for environmental costs is Koninklijke Philips N.V., which describes some of the uncertainties relating to its measurement in the Practical example below.

Practical example 6-3: Koninklijke Philips N.V. (2022) — Netherlands

Annual Report 2022 [extract]
Group financial statements [extract]
Notes to the Consolidated financial statements [extract]
19 Provisions [extract]

Environmental provisions

The environmental provisions include accrued costs recorded with respect to environmental remediation in various countries. In the United States, subsidiaries of the company have been named as potentially responsible parties in state and federal proceedings for the clean-up of certain sites.

Provisions for environmental remediation can change significantly due to the emergence of additional information regarding the extent or nature of the contamination, the need to utilize alternative technologies, actions by regulatory authorities as well as changes in judgments and discount rates.

Approximately EUR 73 million of the long-term provision is expected to be utilized after one to five years, with the remainder after five years. For more details on the environmental remediation refer to Contingencies, starting on page 204.

Philips Group
Environmental provisions in millions of EUR

	2021	2022
Balance as of January 1	183	124
Additions	18	15
Utilizations	(15)	(17)
Releases	(64)	(2)
Changes in discount rate	(10)	(27)
Accretion	3	4
Translation differences and other	9	7
Balance as of December 31	**124**	**104**

The additions and the releases of the provisions originate from additional insights in relation to factors like the estimated cost of remediation, changes in regulatory requirements and efficiencies in completion of various site work phases.

Based on the progressive insight with respect to site remediation experience, technological progress and risk-based clean-up strategies, the estimated remaining duration of remediation activities for environmental liabilities for infinite environmental sites was revised in 2021 from 60 years to 30 years. The resulting release was EUR 55 million of which EUR 33 million is recorded in continuing operations and EUR 22 million in discontinued operations.

If the expenditure relating to an environmental obligation is not expected to be incurred for some time, a significant effect of the standard is its requirement that provisions are discounted, which can have a material impact.

6.5 Liabilities associated with emissions trading schemes

A number of countries around the world either have, or are developing, schemes to encourage reduced emissions of pollutants, in particular of greenhouse gases. These schemes comprise tradable emissions allowances or permits, an example of which is a 'cap and trade' model whereby participants are allocated emission rights or allowances equal to a cap (i.e., a maximum level of allowable emissions) and are permitted to trade those allowances. A cap and trade emission rights scheme typically has the following features:[25]

- An entity participating in the scheme (participant) is set a target to reduce its emissions to a specified level (the cap). The participant is issued allowances equal in number to its cap by a government or government agency. Allowances may be issued free of charge, or participants may pay the government for them.
- The scheme operates for defined compliance periods.
- Participants are free to buy and sell allowances.
- If at the end of the compliance period a participant's actual emissions exceeded its emission rights, the participant will incur a penalty.
- In some schemes emission rights may be carried forward to future periods.
- The scheme may provide for brokers - who are not themselves participants - to buy and sell emission rights.

In response to diversity in the accounting for cap and trade emission rights schemes, the IFRS IC added this matter to its agenda. Accordingly, in December 2004 the IASB issued IFRIC 3 to address the accounting for emission allowances that arise from cap and trade emission rights schemes.

25 IFRIC 3, *Emission Rights*, IASB, December 2004, para. 6.

IFRIC 3 took the view that a cap and trade scheme did not give rise to a net asset or liability, but that it gave rise to various items that were to be accounted for separately:[26]

(a) *An asset for allowances held* - Allowances, whether allocated by government or purchased, were to be regarded as intangible assets and accounted for under IAS 38. Allowances issued for less than fair value were to be measured initially at their fair value.[27]

(b) *A government grant* - When allowances are issued for less than fair value, the difference between the amount paid and fair value was a government grant that was required to be accounted for under IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. Initially the grant was to be recognised as deferred income in the statement of financial position and subsequently recognised as income on a systematic basis over the compliance period for which the allowances were issued, regardless of whether the allowances were held or sold.[28]

(c) *A liability for the obligation to deliver allowances equal to emissions that have been made* - As emissions are made, a liability was to be recognised as a provision that falls within the scope of IAS 37. The liability was to be measured at the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. This would usually be the present market price of the number of allowances required to cover emissions made up to the end of the reporting period.[29]

However, the Interpretation met with significant resistance because application of IFRIC 3 would result in a number of accounting mismatches:[30]

- A measurement mismatch between the assets and liabilities recognised in accordance with IFRIC 3
- A mismatch in the location in which the gains and losses on those assets are reported
- A possible timing mismatch because allowances would be recognised when they are obtained - typically at the start of the year - whereas the emission liability would be recognised during the year as it is incurred

Consequently, the IASB decided in June 2005 to withdraw IFRIC 3 despite the fact that it considered it to be "...an appropriate interpretation of existing IFRSs".[31] The IASB activated its project on emission trading schemes in December 2007, but work was suspended in November 2010. In May 2012, IASB members gave their unanimous support to giving priority to restarting research on emission trading schemes.[32] In February 2015, the project was renamed from 'Emission trading schemes' to 'Pollutant pricing mechanisms'. This change was to reflect a decision by the Board in January 2015 to broaden the scope of the project to consider a variety of schemes that use emission allowances and other financial tools to manage the emission of pollutants. The Board also decided in January 2015 that they would take a 'fresh start' approach to the project rather than starting from the tentative decisions made in the previous project.[33] In April 2022, the IASB decided to include the project on Pollutant pricing mechanisms on a reserve list of projects that would be added to the work plan only if additional capacity becomes available.[34]

In the meantime, entities can either:

(a) Apply IFRIC 3, which despite having been withdrawn, is considered to be an appropriate interpretation of existing IFRS accounting standards.

Or

(b) Develop its own accounting policy for cap and trade schemes based on the hierarchy of authoritative guidance in IAS 8.

A more detailed discussion of the issues and methods applied in practice is covered in Chapter 18 at section 11.2.

26 IFRIC 3.5.

27 IFRIC 3.6.

28 IFRIC 3.7.

29 IFRIC 3.8.

30 *IASB Update*, June 2005, p.1. Available on the IFRS Foundation's website.

31 *IASB Update*, June 2005, p.1. Available on the IFRS Foundation's website.

32 *IASB Update*, May 2012, p.8. Available on the IFRS Foundation's website.

33 *IASB Update*, January 2015, p.9. Available on the IFRS Foundation's website.

34 *IASB Update*, April 2022, available on the IFRS Foundation's website.

6.6 Green certificates compared to emissions trading schemes

Some countries have launched schemes to promote the production of power from renewable sources based on green certificates - also known as renewable energy certificates (RECs), green tags, or tradable renewable certificates.

In a green certificates system, a producer of electricity from renewable sources is granted certificates by the government based on the power output (kWh) of green electricity produced. These certificates may be used in the current and future compliance periods as defined by the particular scheme. The certificates can be sold separately. Generally, the cost to produce green electricity is higher than the cost of producing an equivalent amount of electricity generated from non-renewable sources, although this is not always the case. Distributors of electricity sell green electricity at the same price as other electricity.

In a typical green certificates scheme, distributors of electricity to consumers (businesses, households etc.) are required to remit a number of green certificates based on the kWh of electricity sold on an annual basis. Distributors must therefore purchase green certificates in the market (such certificates having been sold by producers). If a distribution company does not have the number of required certificates, it is required to pay a penalty to the environmental agency. Once the penalty is paid, the entity is discharged of its obligations to remit certificates.

It is this requirement to remit certificates that creates a market in and gives value to green certificates (the value depends on many variables but primarily on the required number of certificates that have to be delivered relative to the amount of power that is produced from renewable sources, and the level of penalty payable if the required number of certificates are not remitted).

There are similarities between green certificates and emission rights. However, green certificates are granted to generators of cleaner energy as an incentive for 'good' production achieved, irrespective of whether or not there is a subsequent sale of that cleaner energy to an end consumer. For a distributor of energy, a green certificate gives a similar 'right to pollute' as an emission right except that a distributor of energy under a green certificate regime must acquire the certificates from the market (i.e., they are not granted to the distributor by the government). As with emission rights, the topic of green certificates cuts across a number of different areas of accounting, not just provisions. A more detailed discussion of the issues and methods applied in practice is covered in Chapter 18 at section 11.3.

6.7 EU Directive on 'Waste Electrical and Electronic Equipment' (IFRIC 6)

This Directive regulates the collection, treatment, recovery and environmentally sound disposal of waste electrical or electronic equipment (WE&EE).[35] It applies to entities involved in the manufacture and resale of electrical or electronic equipment, including entities (both European and Non-European) that import such equipment into the EU. As member states in the EU began to implement this directive into their national laws, it gave rise to questions about when the liability for the decommissioning of WE&EE should be recognised. The Directive distinguishes between 'new' and 'historical' waste and between waste from private households and waste from sources other than private households. New waste relates to products sold after 13 August 2005. All household equipment sold before that date is deemed to give rise to historical waste for the purposes of the Directive. *[IFRIC 6.3]*.

The Directive states that the cost of waste management for historical household equipment should be borne by producers of that type of equipment that are in the market during a period to be specified in the applicable legislation of each Member State (the measurement period). The Directive states that each Member State shall establish a mechanism to have producers contribute to costs proportionately "…e.g. in proportion to their respective share of the market by type of equipment." *[IFRIC 6.4]*.

The IFRS IC was asked to determine in the context of the decommissioning of WE&EE what constitutes the obligating event in accordance with IAS 37.14(a) (discussed in section 3.1.1 above) for the recognition of a provision for waste management costs:

- The manufacture or sale of the historical household equipment?
- Participation in the market during the measurement period?
- The incurrence of costs in the performance of waste management activities? *[IFRIC 6.8]*

35 Directive 2002/96/EC of the European Parliament and of the Council of 27 January 2003 on waste electrical and electronic equipment; and Directive 2003/108/EC of the European Parliament and of the Council of 8 December 2003 amending Directive 2002/96/EC on waste electrical and electronic equipment.

IFRIC 6 was issued in September 2005 and provides guidance on the recognition, in the financial statements of producers, of liabilities for waste management under the EU Directive on WE&EE in respect of sales of historical household equipment. *[IFRIC 6.6]*. The interpretation addresses neither new waste nor historical waste from sources other than private households. The IFRS IC considers that the liability for such waste management is adequately covered in IAS 37. However, if, in national legislation, new waste from private households is treated in a similar manner to historical waste from private households, the principles of IFRIC 6 are to apply by reference to the hierarchy set out in IAS 8 (see Chapter 3 at section 4.3). The IAS 8 hierarchy is also stated to be relevant for other regulations that impose obligations in a way that is similar to the cost attribution model specified in the EU Directive. *[IFRIC 6.7]*.

Extract from IFRIC 6

Consensus

9 Participation in the market during the measurement period is the obligating event in accordance with paragraph 14(a) of IAS 37. As a consequence, a liability for waste management costs for historical household equipment does not arise as the products are manufactured or sold. Because the obligation for historical household equipment is linked to participation in the market during the measurement period, rather than to production or sale of the items to be disposed of, there is no obligation unless and until a market share exists during the measurement period. The timing of the obligating event may also be independent of the particular period in which the activities to perform the waste management are undertaken and the related costs incurred.

[IFRIC 6.9]

The following Illustration, which is based on an example within the accompanying Basis for Conclusions on IFRIC 6, illustrates its requirements.

Illustration 6-7: Illustration of IFRIC 6 requirements

An entity selling electrical equipment in 20X0 has a market share of 4% for that calendar year. It subsequently discontinues operations and is thus no longer in the market when the waste management costs for its products are allocated to those entities with market share in 20X2. With a market share of 0% in 20X2, the entity's obligation is zero. However, if another entity enters the market for electronic products in 20X2 and achieves a market share of 3% in that period, then that entity's obligation for the costs of waste management from earlier periods will be 3% of the total costs of waste management allocated to 20X2, even though the entity was not in the market in those earlier periods and has not produced any of the products for which waste management costs are allocated to 20X2. *[IFRIC 6.BC5]*.

The IFRS IC concluded that the effect of the cost attribution model specified in the Directive is that the making of sales during the measurement period is the 'past event' that requires recognition of a provision under IAS 37 over the measurement period. Aggregate sales for the period determine the entity's obligation for a proportion of the costs of waste management allocated to that period. The measurement period is independent of the period when the cost allocation is notified to market participants. *[IFRIC 6.BC6]*.

Some constituents asked the IFRS IC to consider the effect of the following possible national legislation: the waste management costs for which a producer is responsible because of its participation in the market during a specified period (for example 20X2) are not based on the market share of the producer during that period but on the producer's participation in the market during a previous period (for example 20X1). The IFRS IC noted that this affects only the measurement of the liability and that the obligating event is still participation in the market during 20X2. *[IFRIC 6.BC7]*.

IFRIC 6 notes that terms used in the interpretation such as 'market share' and 'measurement period' may be defined very differently in the applicable legislation of individual Member States. For example, the length of the measurement period might be a year or only one month. Similarly, the measurement of market share and the formulae for computing the obligation may differ in the various national legislations. However, all of these examples affect only the measurement of the liability, which is not within the scope of the interpretation. *[IFRIC 6.5]*.

6.8 Levies imposed by governments

When governments or other public authorities impose levies on entities in relation to their activities, as opposed to income taxes and fines or other penalties, it is not always clear when the liability to pay a levy arises and a provision should be recognised. In May 2013, the IFRS IC issued IFRIC 21 to address this question. *[IFRIC 21.2, IFRIC 21.7]*. The Interpretation does not address the accounting for the costs arising out of an obligation to pay a levy, for example, to determine whether an asset or expense should be recorded. Other IFRS accounting standards are required to be applied in this regard. *[IFRIC 21.3]*.

The Interpretation requires that, for levies within its scope, an entity recognises a liability only when the activity that triggers payment, as identified by the relevant legislation, occurs. *[IFRIC 21.8]*.

As noted in section 1.1 above, the IASB is developing proposals for three targeted improvements to IAS 37. One of the proposed improvements would involve aligning the definition of a liability in IAS 37 and the requirements for identifying liabilities with the Conceptual Framework. Any resulting amendments are expected to replace IFRIC 21 with new application requirements for levies.[36] At the time of writing, discussions are ongoing, with an Exposure Draft expected in the last quarter of 2024.[37]

6.8.1 Scope of IFRIC 21

A levy is defined as follows: *[IFRIC 21.4]*

Extract from IFRIC 21

4 For the purposes of this Interpretation, a levy is an outflow of resources embodying economic benefits that is imposed by governments on entities in accordance with legislation (ie laws and/or regulations), other than:

(a) those outflows of resources that are within the scope of other Standards (such as income taxes that are within the scope of IAS 12 *Income Taxes*); and

(b) fines or other penalties that are imposed for breaches of the legislation.

'Government' refers to government, government agencies and similar bodies whether local, national or international.

In addition to income taxes (see Chapter 29) and fines, the Interpretation does not apply to contractual arrangements with government in which the entity acquires an asset (see Chapters 18 and 19) or receives services; and it is not required to be applied to liabilities that arise from emission trading schemes (see section 6.5 above). *[IFRIC 21.5, IFRIC 21.6]*. Although IFRIC 21 does not apply to income taxes in scope of IAS 12, the IFRS IC concluded that any taxes not within the scope of other IFRS accounting standards (such as IAS 12) are within the scope of IAS 37. Therefore, such taxes would be within the scope of IFRIC 21. *[IFRIC 21.BC4]*.

IFRIC 21 was developed to address concerns over the timing of recognition for government-imposed levies in which the obligation to pay depended upon participation in a particular market on a specified date. However, the definition of levy in IFRIC 21 has resulted in the scope of the interpretation being broader than entities might have expected. The term 'levy' may not be widely used across jurisdictions, and may be referred to as a charge, duty or a tax, for example. However, it is not the terminology, but the nature of the payment, which must be considered when determining if it is in the scope of IFRIC 21.

Entities must consider all payments imposed by governments pursuant to legislation to determine whether they are in scope of IFRIC 21. The interpretation provides a broad definition of government, including municipal, provincial, state, federal or international governments or government agencies or organisations controlled or administered by government. *[IFRIC 21.4]*.

IFRIC 21 clarifies that both levies that give rise to a liability under IAS 37, and levies whose timing or amounts are certain are within scope of the interpretation. *[IFRIC 21.2]*. Therefore, the scope of IFRIC 21 is broader than IAS 37. For example, a non-refundable fixed fee imposed by government payable at a specific date could be a levy within the scope of IFRIC 21.

36 IASB Update, April 2024, available on the IFRS Foundation's website

37 *IFRS Foundation work plan*, IFRS Foundation website (accessed September 2024).

In some cases, payments may pass through one or more non-governmental bodies or entities before being received by the government. In our view, IFRIC 21 does not distinguish between recipients of the payment; the key factor is whether the payment is required by law. Therefore, as long as the payments are required by law, they are generally considered to be imposed by the government. *[IFRIC 21.4]*.

How we see it

IFRIC 21 does not distinguish between recipients of the payment; the key factor is whether the payment is required by law. As long as the payments are required by law, they are generally considered to be imposed by the government.

Some of the legislation relating to payments imposed by governments can be complex, so entities must carefully analyse the facts and circumstances to determine whether a payment falls within the scope of IFRIC 21. However, where entities are making payments for any of the following items, it is necessary to assess for any potential IFRIC 21 impacts:

- Taxes other than income taxes, e.g., property tax, land tax and capital-based tax
- Certain fees, concessions, contributions or royalty fees imposed on industries which are regulated by government, e.g., telecommunications, mining, airline, banking, insurance, dairy produce and energy and natural resources
- Transaction taxes based on activity in a specified market, e.g., banking and insurance

6.8.2 Recognition and measurement of levy liabilities

For levies within the scope of the Interpretation, the activity that creates the obligation under the relevant legislation to pay the levy is the obligating event for recognition purposes. *[IFRIC 21.8]*. In many cases this activity is related to the entity's participation in a relevant market at a specific date or dates. The Interpretation states that neither a constructive nor a present obligation arises as a result of being economically compelled to continue operating; or from any implication of continuing operations in the future arising from the use of the going concern assumption in the preparation of financial statements. *[IFRIC 21.9, IFRIC 21.10]*.

When a levy is payable progressively, for example, as the entity generates revenues, the entity recognises a liability over a period of time on that basis. This is because the obligating event is the activity that generates revenues. *[IFRIC 21.11]*. If an obligation to pay a levy is triggered in full as soon as a minimum threshold is reached, such as when the entity commences generating sales or achieves a certain level of revenue, the liability is recognised in full on the first day that the entity reaches that threshold. *[IFRIC 21.12]*. If an entity pays over amounts to government before it is determined that an obligation to pay that levy exists, it recognises an asset. *[IFRIC 21.14]*.

Illustration 6-8: A levy is triggered in full as soon as the entity generates revenues

An entity with a calendar year end generates revenues in a specific market in 20X1. The amount of the levy is determined by reference to revenues generated by the entity in the market in 20X0 although the levy is only payable when revenues are generated in 20X1. The entity generated revenues in the market in 20X0 and starts to generate revenues in the market in 20X1 on 3 January 20X1.

In this example, the liability is recognised in full on 3 January 20X1 because the obligating event, as identified by the legislation, is the first generation of revenues in 20X1. The generation of revenues in 20X0 is necessary, but not sufficient, to create a present obligation to pay a levy. Before 3 January 20X1, the entity has no obligation. In other words, the activity that triggers the payment of the levy as identified by the legislation is the first generation of revenues at a point in time in 20X1. The generation of revenues in 20X0 is not the activity that triggers the payment of the levy. The amount of revenues generated in 20X0 only affects the measurement of the liability. *[IFRIC 21.IE1 Example 2]*.

The table below summarises the illustrative examples that accompany IFRIC 21, which provide guidelines on how to account for the timing of the recognition for the various types of levies: *[IFRIC 21.IE1]*

Illustrative examples	Obligating event	Recognition of liability
Levy triggered progressively as revenue is generated in a specified period.	Generation of revenue in the specified period.	Recognise progressively. A liability must be recognised progressively because, at any point in time during the specified period, the entity has a present obligation to pay a levy on revenues generated to date.
Levy triggered in full as soon as revenue is generated in one period, based on revenues from a previous period.	First generation of revenue in subsequent period.	Full recognition at that point in time. Where an entity generates revenue in one period, which serves as the basis for measuring the amount of the levy, the entity does not become liable for the levy, and therefore cannot recognise a liability, until it first starts generating revenue in the subsequent period.
Levy triggered in full if the entity operates as a bank at the end of the annual reporting period.	Operating as a bank at the end of the reporting period.	Full recognition at the end of the annual reporting period. Before the end of the annual reporting period, the entity has no present obligation to pay a levy, even if it is economically compelled to continue operating as a bank in the future. The liability is recognised only at the end of the annual reporting period.
Levy triggered if revenues are above a minimum specified threshold (e.g., when a certain level of revenue has been achieved)	Reaching the specified minimum threshold.	Recognise an amount consistent with the obligation at that point of time. A liability is recognised only at the point that the specified minimum threshold is reached. For example, a levy is triggered when an entity generates revenues above specified thresholds: 0% for the first CU50 million and 2% above CU50 million. In this example, no liability is accrued until the entity's revenues reach the revenue threshold of CU50 million.

As set out in the table above, when a levy is triggered progressively, for example, as the entity generates revenues, the entity recognises a liability over the period of time on that basis. Some examples of progressive-type levies are set out below.

Illustration 6-9: Recognising a liability for levies that are triggered progressively

Scenario 1: Minimums

The legislation prescribes that no levy is triggered until revenues reach a certain threshold. There is a 0% tax rate on revenues until they reach CU50 million, with a payment of 2% of revenues in excess of that amount.

For an entity that earns CU49 million as at 30 June 20X1, CU51 million as at 31 July 20X1 and CU100 million as at 31 December 20X1, the following liabilities are recognised:

- 30 June 20X1 - No provision is recognised
- 31 July 20X1 - CU20,000 provision is recognised (2% × CU1 million)

  And
- 31 December 20X1 - CU1 million provision is recognised (2% × CU50 million)

Scenario 2: Progressive tax rates

The legislation prescribes that the tax rate is escalating. There is a 2% tax rate on the first CU50 million in revenues and 3% for revenues in excess of CU50 million.

For an entity that earns CU49 million as at 30 June 20X1, CU51 million as at 31 July 20X1 and CU100 million as at 31 December 20X1, the following liabilities are recognised:

- 30 June 20X1 - CU980,000 provision is recognised (2% × CU49 million)
- 31 July 20X1 - CU1,030,000 provision is recognised ((2% × CU50 million) + (3% × CU1 million))

And

- 31 December 20X1 - CU2.5 million provision is recognised ((2% × CU50 million) + (3% × CU50 million))

Scenario 3: Specified formula

The legislation prescribes that the levy is calculated based on a specified formula that does not match the actual activity for the period. A calendar year-end entity has to pay a monthly levy based on 0.1% of a 12-month rolling average of gross profit.

Under the legislation, the 12-month period which the rolling average of the gross profit would be based on relates to the preceding 12 months, for example:

Date	Preceding 12 months	12 month rolling average (CU)	Liability to be recognised (CU)
30 June 20X1	1 July 20X0 - 30 June 20X1	50 million	50,000
31 July 20X1	1 August 20X0 - 31 July 20X1	60 million	60,000
31 December 20X1	1 January 20X1 - 31 December 20X1	40 million	40,000

When the legislation provides that a levy is triggered by an entity operating in a market only at the end of its annual reporting period, no liability is recognised until the last day of the annual reporting period. No amount is recognised before that date in anticipation of the entity still operating in the market. Accordingly, a provision would not be permitted to be recognised in interim financial statements if the obligating event occurs only at the end of the annual reporting period. *[IFRIC 21.IE1 Example 3]*. The accounting treatment in interim reports is discussed in Chapter 37 at section 9.7.5.

6.8.3 Recognition of an asset or expense when a levy is recorded

IFRIC 21 only provides guidance on when to recognise a liability, which is the credit side of the journal entry. The interpretation specifically states that it does not address whether the debit side of the journal entry is an asset or an expense, *[IFRIC 21.3]*, except in the case of prepaid levies. *[IFRIC 21.14]*.

Prepayments may be fairly common in arrangements in which the legislation requires entities to pay levies in advance and where the obligating events for these levies are progressive. For example, property taxes that are paid in advance at a specified date (e.g., 1 January) for an obligating event that relates to future periods (e.g., 1 January to 31 December). In such instances, the entity would recognise the prepaid levy as an asset. *[IFRIC 21.14]*. In this scenario, the prepaid levy would then be amortised over the period.

Aside from prepaid levies, there are also instances when the assessment of expensing the liability or recognising a corresponding asset requires the application of other IFRS accounting standards, such as IAS 2, IAS 16 or IAS 38. Given that levies are imposed by government and arise from non-exchange transactions, there would not typically be a clear linkage to future economic benefits. Consequentially, if the incurrence of the liability does not give rise to an identifiable future economic benefit to the entity, the recognition of an asset would be inappropriate as the definition of an asset would not be met. In such cases, the debit side would therefore be to an expense account.

In the case where asset recognition is appropriate under other IFRS accounting standards, levies are generally not expected to give rise to a stand-alone asset in its own right, given that payments for the acquisition of goods or services are scoped out of IFRIC 21. *[IFRIC 21.5]*. However, a levy may form part of the acquisition costs of some other asset, provided it meets the asset recognition criteria in other IFRS accounting standards. For example, an entity may be required to pay an import duty to the government under legislation for any large cargo trucks purchased from overseas. The entity uses the large cargo trucks as part of their operations to transport their goods to customers locally and therefore capitalises the trucks as part of property, plant and equipment under IAS 16. The import duty that is payable under the legislation could give rise to an IFRIC 21 levy, which would also be capitalised as part of the cost of the asset. *[IAS 16.16(a)]*.

6.8.4 Payments relating to taxes other than income tax

As discussed in section 6.8.1 above, IFRIC 21 does not apply to income taxes in scope of IAS 12. However, the IFRS IC concluded that any taxes not within the scope of other IFRS accounting standards (such as IAS 12) are within the scope of IAS 37. Therefore, such taxes would be within the scope of IFRIC 21. *[IFRIC 21.BC4]*.

In 2018, the IFRS IC began discussing a fact pattern where an entity is in dispute with a tax authority in respect of a tax other than income tax. The entity determines that it is probable that it does not have an obligation for the disputed amount and consequently, it does not recognise a liability applying IAS 37. The entity nonetheless pays the disputed amount to the tax authority, either voluntarily or because it is required to do so. The entity has no right to a refund of the amount before resolution of the dispute. Upon resolution, either the tax authority returns the payment to the entity (if the outcome of the dispute is favourable to the entity) or the payment is used to settle the tax liability (if the outcome of the dispute is unfavourable to the entity).

In January 2019, the IFRS IC observed that the payment made by the entity gives rise to an asset as defined in both the *Conceptual Framework for Financial Reporting* issued in March 2018, and the definition in the previous *Conceptual Framework* that was in place when many existing IFRS accounting standards were developed. The tax deposit gives the entity a right to receive future economic benefits, either in the form of a cash refund or by using the payment to settle the tax liability. The nature of the tax deposit, either voluntary or required, does not affect the conclusion that there is an asset. The right is not a contingent asset as defined in IAS 37 because it is an asset, and not a possible asset, of the entity. The entity therefore recognises an asset when it makes the payment to the tax authority.[38]

6.9 Dilapidation and other provisions relating to leased assets

As discussed in section 5.2 above, it is not appropriate to recognise provisions that relate to repairs and maintenance of owned assets. However, the position can be different in the case of obligations relating to assets held under leases. Nevertheless, the same principles under IAS 37 apply:

(a) Provisions are recognised only for obligations existing independently of the entity's future actions (i.e., the future conduct of its business) and in cases where an entity can avoid future expenditure by its future actions, for example, by changing its method of operation, it has no present obligation. *[IAS 37.19]*.

(b) Financial statements deal with an entity's position at the end of the reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. *[IAS 37.18]*.

(c) For an event to be an obligating event, the entity must have no realistic alternative to settling the obligation created by the event. *[IAS 37.17]*.

Leases often contain clauses which specify that the lessee will incur periodic charges for maintenance, make good dilapidations or other damage occurring during the rental period or return the asset to the configuration that existed as at inception of the lease. These contractual provisions may restrict the entity's ability to change its future conduct to avoid the expenditure. For example, the entity might not be able to transfer the asset in its existing condition. Alternatively, the entity could return the asset to avoid the risk of incurring costs relating to any future damage, but would have to make a payment in relation of dilapidations incurred to date. Therefore, the contractual obligations in a lease could create an environment in which a present obligation could exist as at the reporting date from which the entity cannot realistically withdraw.

Under principle (b) above, any provision must reflect only the conditions as at the reporting date. This means that a provision for specific damage done to the leased asset would merit recognition, as the event giving rise to the obligation under the lease has certainly occurred. For example, if an entity has erected partitioning or internal walls in a leasehold property and under the lease these must be removed at the end of the term, then provision is made for this cost (on a discounted basis, if material) at the time of putting up the partitioning or the walls. In this case, an equivalent asset would be recognised and depreciated over the term of the lease. This is similar to a decommissioning provision discussed in section 6.3 above. Another example would be where an airline company leases aircraft, and upon delivery of the aircraft has made changes to the interior fittings and layout, but under the leasing arrangements must return the asset to the configuration that existed as at inception of the lease.

38 *IFRIC Update*, January 2019, available on the IFRS Foundation's website.

What is less clear is whether a more general provision can be built up over time for maintenance charges and dilapidation costs in relation to a leased asset. It might be argued that in this case, the event giving rise to the obligation under the lease is simply the passage of time, and so a provision can be built up over time. However, in our view the phrase 'the event giving rise to the obligation under the lease' indicates that a more specific event must occur; there has to be specific evidence of dilapidation etc. before any provision can be made. That is, it cannot be assumed that the condition of a leased asset has deteriorated simply because time has passed. However, in practice, it will often be the case that dilapidations do occur over time, in which case a dilapidations provision would be recognised as those dilapidations occur over the lease term. Illustration 5-1 in section 5.2 above dealt with an owned aircraft that by law needs overhauling every three years, but no provision could be recognised for such costs. Instead, IAS 37 suggests that an amount equivalent to the expected maintenance costs is treated as a separate part of the asset and depreciated over three years. Airworthiness requirements for the airline industry are the same irrespective of whether the aircraft is owned or leased. So, if an airline company leases the aircraft, should a provision be made for the overhaul costs? The answer will depend on the terms of the lease.

How we see it

Leases often contain clauses which specify that the lessee is required to make good dilapidations or other damage occurring during the rental period or return the asset to the configuration that existed as at inception of the lease. However, there must be specific evidence of dilapidation before any provision can be made. It cannot be assumed that the condition of a leased asset has deteriorated simply because time has passed.

For a lessee, the accounting for contractual overhaul obligations will require careful consideration. IFRS 16 requires the depreciation requirements of IAS 16 to be applied in the subsequent measurement of a right-of-use asset. *[IFRS 16.31]*. Under the depreciation requirements of IAS 16, each part of an asset with a cost that is significant in relation to the total cost of the item must be depreciated separately. *[IAS 16.44, IAS 16.45]*. The application of this 'component approach' to the right-of-use asset could imply an approach similar to that suggested in Illustration 5-1 in section 5.2 above for owned assets. Determining an appropriate accounting policy for how the application of component accounting for the right-of-use asset would interact with the recognition of provisions for regulatory overhauls under IAS 37 requires judgement.

The fact that a provision for repairs can be made at all for leased assets might appear inconsistent with the case where the asset is owned by the entity. In that case, as discussed in section 5.2 above, no provision for repairs could be made. There is, however, a difference between the two situations. Where the entity owns the asset, it has the choice of selling it rather than repairing it, and so the obligation is not independent of the entity's future actions. However, in the case of an entity leasing the asset, it can have a contractual obligation to repair any damage from which it cannot walk away.

6.10 Warranty provisions

Warranty provisions are specifically addressed in one of the examples appended to IAS 37. However, as noted in section 2.2.1.B above, an entity would apply IFRS 15 to separately purchased warranties and to those warranties determined to provide the customer with a service in addition to the assurance that the product complies with agreed-upon specifications. Only if a customer does not have the option to purchase a warranty separately and the warranty is determined only to provide assurance that the product complies with agreed-upon specifications would an entity consider IAS 37. *[IFRS 15.B30]*. The requirements for warranties falling within the scope of IFRS 15 are considered further in Chapter 28 at section 9.1.

The following Illustration shows how warranty costs are addressed if IAS 37 applies.

Illustration 6-10: Recognition of a provision for warranty costs

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale, the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (i.e., more likely than not) that there will be some claims under the warranties.

In these circumstances the obligating event is the sale of the product with a warranty, which gives rise to a legal obligation. Because it is more likely than not that there will be an outflow of resources for some claims under the warranties as a whole, a provision is recognised for the best estimate of the costs of making good under the warranty for those products sold before the end of the reporting period. *[IAS 37.IE Example 1]*.

The assessment of the probability of an outflow of resources is made across the population as a whole, and not using each potential claim as the unit of account. *[IAS 37.24]*. On past experience, it is probable that there will be some claims under the warranties, so a provision is recognised.

The assessment over the class of obligations as a whole makes it more likely that a provision will be recognised, because the probability criterion is considered in terms of whether at least one item in the population will give rise to a payment. Recognition then becomes a matter of reliable measurement and entities calculate an expected value of the estimated warranty costs. IAS 37 discusses this method of 'expected value' and illustrates how it is calculated in an example of a warranty provision. *[IAS 37.39]*. See Illustration 4-1 in section 4.1 above.

An example of a company that makes a warranty provision is AB Volvo as shown below:

Practical example 6-4: AB Volvo (2023) **Sweden**

VOLVO GROUP ANNUAL REPORT 2023 [extract]
Financial statements [extract]
Notes to the financial statements [extract]
21 Other provision [extract]
ACCOUNTING POLICY [extract]

Provisions for product warranty
Provisions for product warranty are recognized as cost of sales and include contractual warranty and campaign warranty. Provisions for contractual warranty are recognized when the products are sold. Provision for campaigns in connection with specific quality problems are recognized when the campaign is decided.

SOURCE OF ESTIMATION UNCERTAINTY AND CRITICAL JUDGMENTS [extract]

Provisions for product warranty
Warranty provisions are estimated with consideration of historical statistics with regard to known changes in warranty claims, warranty periods, the average time-lag between faults occurring until claims are received by the company and anticipated changes in quality indexes. The actual outcome of product warranties may deviate from the expected outcome and materially affect the warranty costs and provisions in future periods. Refunds from suppliers, that decrease the Volvo Group's warranty costs, are recognized to the extent these are considered to be certain.

...

21:1

	Carrying value, Dec 31, 2022	Provisions	Reversals	Utilizations	Acquired and divested operations[2]	Exchange rate changes	Other reclassifications[2]	**Carrying value, Dec 31, 2023**	Of which due within 12 months	Of which due after 12 months
Provisions for product warranty[1]	16,841	11,427	−1,963	−8,729	−32	−407	194	17,331	8,575	8,756

...

1 Including a provision for emission control component. For more information see below.

2 » Read more in Note 3 Acquisitions and divestments of operations, for a description of acquired and divested operations as well as assets and liabilities held for sale.

...

The Volvo Group has detected that an emissions control component used in certain markets and models, may degrade more quickly than expected, affecting the vehicles emission performance negatively. The Volvo Group made a provision of SEK 7 billion impacting the operating income in 2018, relating to the estimated costs to address the issue. The negative cash flow effect started in 2019 and will continue in the coming years. As of year-end 2023, approximately half of the initial provision had been utilized. The Volvo Group will continuously assess the size of the provision as the matter develops.

...

6.11 Litigation and other legal claims

IAS 37 includes an example of a court case in its appendix to illustrate how its principles distinguish between a contingent liability and a provision in such situations. See Illustration 3-4 in section 3.2.1 above. However, the assessment of the particular case in the example is clear-cut. In most situations, assessing the need to provide for legal claims is one of the most difficult tasks in the field of provisioning. This is due mainly to the inherent uncertainty in the judicial process itself, which may be very long and drawn out. Furthermore, this is an area where either provision or disclosure might risk prejudicing the outcome of the case, because they give an insight into the entity's own view on the strength of its defence that can assist the claimant.

In principle, whether a provision is recognised will depend on whether the three conditions for recognising a provision are met, i.e.,

(a) There is a present obligation as a result of a past event

(b) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation

And

(c) A reliable estimate can be made of the amount of the obligation *[IAS 37.14]*

In situations such as these, a past event is deemed to give rise to a present obligation if, taking account of all available evidence (including, for example, the opinion of experts), it is more likely than not that a present obligation exists at the end of the reporting period. *[IAS 37.15]*. The evidence to be considered includes any additional evidence occurring after the end of the reporting period. Accordingly, if on the basis of the evidence it is concluded that a present obligation is more likely than not to exist, a provision will be required, assuming the other conditions are met. *[IAS 37.16]*.

Condition (b) will be met if the transfer of economic benefits is more likely than not to occur, that is, it has a probability greater than 50%. In making this assessment, it is likely that any expert advice received would need to be considered.

As far as condition (c) is concerned, the standard takes the view that a reasonable estimate can generally be made and it is only in extremely rare cases that this will not be the case. *[IAS 37.25]*.

Clearly, whether an entity is required to make provision for the costs of settling a case or to meet any award given by a court will depend on a reasoned assessment of the particular circumstances, based on appropriate legal advice.

Whilst litigation can arise in respect of many areas of business activities, lawsuits linked to climate-related matters may become more common as the focus on climate change by governments, other organisations and the public increases. The outcome of these lawsuits will often be uncertain. This is discussed in the disclosure below by Shell plc.

Practical example 6-5: Shell plc (2023) **United Kingdom**

Annual Report and Accounts [extract]
Financial Statements and Supplements [extract]
Consolidated Financial Statements [extract]
Notes to the Consolidated Financial Statements [extract]
31. Legal proceedings and other contingencies [extract]

Climate change litigation
In the USA, energy companies (including Shell), industry associations, and others have been named in several matters alleging responsibility for the impacts of climate change due to the use of fossil fuels. These matters assert a number of different theories of liability for a wide variety of harms, including but not limited to, impacts to public and private infrastructure, natural resources, and public health and services. As of December 31, 2023, 24 lawsuits naming Shell as a defendant were pending, three claims were filed but not yet served, and one petition to preserve testimony was pending.

In the Netherlands, in a case against Shell brought by a group of environmental non-governmental organisations (eNGOs) and individual claimants, the Court found that while Shell is not currently acting unlawfully, Shell must reduce the aggregate annual volume of CO_2 emissions of Shell operations and energy-carrying products sold across Scopes 1, 2 and 3 by 45% (net) by the end of 2030 relative to its 2019 emissions levels (the "Dutch Court Order"). For Scopes 2 and 3, this is a significant best-efforts obligation. Shell appealed that ruling and a hearing is scheduled to take place before the Dutch Court of Appeal of The Hague in April 2024.

Management believes the outcome of these matters should be resolved in a manner favourable to Shell, but there remains a high degree of uncertainty regarding the ultimate outcome of these lawsuits, as well as their potential effect on future operations, earnings, cash flows and Shell's financial condition.

6.12 Refunds policy

Illustration 3-1 in section 3.1.1 above reflects an example given in the appendix of IAS 37 of a retail store that has a policy of refunding goods returned by dissatisfied customers. There is no legal obligation to do so, but the company's policy of making refunds is generally known. The example argues that the conduct of the store has created a valid expectation on the part of its customers that it will refund purchases. The obligating event is the original sale of the item, and the probability of some economic outflow is greater than 50%, as there will nearly always be some customers demanding refunds. Hence, a provision is required, *[IAS 37.IE Example 4]*, presumably calculated on the 'expected value' basis.

This example is straightforward when the store has a very specific and highly publicised policy on refunds. However, some stores' policies on refunds might not be so clear cut. A store may offer refunds under certain conditions, but not widely publicise its policy. In these circumstances, there might be doubt as to whether the store has created a valid expectation on the part of its customers that it will honour all requests for a refund.

As with warranty costs (discussed in section 6.10 above), the accounting treatment of refunds impinges into the area of revenue recognition. Under IFRS 15, an entity recognises the amount of expected returns as a refund liability, representing its obligation to return the customer's consideration. *[IFRS 15.55]*. As noted in section 2.2.1.B above, other than contracts with customers that are, or have become onerous, contracts in scope of IFRS 15 are outside the scope of IAS 37. *[IAS 37.5(g)]*.

6.13 Self-insurance

Another situation where entities sometimes make provisions is self-insurance which arises when an entity decides not to take out external insurance in respect of a certain category of risk because it would be uneconomic to do so. The same position may arise when a group insures its risks with a captive insurance subsidiary, the effects of which have to be eliminated on consolidation. In fact, the term 'self-insurance' is potentially misleading, since it really means that the entity is not insured at all and will settle claims from third parties from its own resources in the event that it is found to be liable. Accordingly, the recognition criteria in IAS 37 must be applied, with a provision being justified only if there is a present obligation as a result of a past event; if it is probable that an outflow of resources will occur; and a reliable estimate can be determined. *[IAS 37.14]*.

Therefore, losses are recognised based on their actual incidence and any provisions that appear in the statement of financial position must reflect only the amounts expected to be paid in respect of those incidents that have occurred by the end of the reporting period.

In certain circumstances, a provision will often be needed not simply for known incidents, but also for those which insurance companies call IBNR - Incurred But Not Reported - representing an estimate of claims that have occurred at the end of the reporting period but which have not yet been notified to the reporting entity. It is less likely to be appropriate when assessing a small number of distinct claims, but could be needed when estimating the amount of a provision for a larger population of claims with common characteristics. We believe that it is appropriate that provision for such expected claims is made to the extent that such items can be measured reliably.

6.14 Obligations to make donations to non-profit organisations

When an entity promises to make donations to a non-profit organisation it can be difficult to determine whether a past obligating event exists that requires a provision to be recognised or whether it is appropriate instead to account for the gift as payments are made.

Illustration 6-11: Accounting for donations to non-profit organisations

An entity decides to enter into an arrangement to 'donate' CU1m in cash to a university. A number of different options are available for the arrangement and the entity's management want to determine whether the terms of these options make any difference to the timing, measurement or presentation of the CU1m expenditure, as follows:

Option 1:

The entity enters into an unenforceable contract to contribute CU1m for general purposes. The benefits to the entity are deemed only to relate to its reputation as a 'good corporate citizen'; the entity does not receive any consideration or significant benefit from the university in return for the donation.

Option 2:

As per Option 1 except the entity publishes a press release in relation to the donation and announcing that payment is to be made in equal instalments of CU200,000 over 5 years.

Option 3:

As per Option 2, except that the contract is legally enforceable in the event that the entity does not pay all the instalments under the contract.

Option 4:

As per Option 2, except that the entity is only required to make the donation if the university raises CU4m from other sources.

Option 5:

As per Option 2, except that the contract is legally enforceable and the funds will be used for research and development activities specified by the entity. The entity will retain proprietary rights over the results of the research.

The following principles are relevant in determining when a promise to make a donation is recognised as an obligation:

- To the extent that there is an enforceable contract, the donor is required to recognise an expense and a liability upon entry into that contract.
- Where the agreement is not enforceable, the donor recognises an expense and a liability when a constructive obligation arises. The timing of recognition depends on whether the donation is conditional, whether it is probable that those conditions are substantially met and whether a past event has occurred.
- If the donor expects to receive benefits commensurate with the value of the donation, the arrangement is treated as an exchange transaction. Such transactions are, in some cases, executory contracts and could also give rise to the recognition of an asset rather than an expense.

In cases where the 'donation' is made under an enforceable contract, a present obligation is created when the entity enters into that contract. When payment is required in cash, the signing of an enforceable contract gives rise to a financial liability, *[IAS 32.11]*, which is measured initially at fair value. *[IFRS 9.5.1.1]*.

Where there is no legal obligation to make the payments, a liability is recognised when a constructive obligation arises. It is a matter of judgement whether and when a constructive obligation exists. In many unenforceable contracts, a signed contract would not, in itself, be sufficient to create a constructive obligation. Hence, in the absence of other facts and circumstances that would create a constructive obligation, the donor would recognise the expenditure when the cash or other assets are transferred.

By contrast, an exchange transaction is a reciprocal transfer in which each party receives and sacrifices approximately equal value. Assets and liabilities are not recognised until each party performs their obligations under the arrangement.

Applying these principles to the options listed in Illustration 6-11 above:

- In Option 1, the contract is unenforceable, there is no announcement or conditions preceding payment and there is no exchange of benefits. Accordingly, an expense would be recognised only when the entity transfers cash to the university.
- For Option 2, it could be appropriate for the entity to conclude that the entity's announcement of the donation to be paid by instalments indicates that there is a constructive obligation because the entity has a created a valid expectation that it will make all of the payments promised. Alternatively, it could determine that once the first instalment is paid, the entity has created a valid expectation that it will make the remaining payments. This is a matter of judgement. In this case, the entity would recognise an expense and a liability, measured at the net present value of the 5 instalments of CU200,000, at the point when it is determined that a constructive obligation exists.

- Option 3 involves an enforceable contract with no exchange of benefits. Therefore, a liability and an expense are recognised on signing the enforceable contract, measured at the fair value of the 5 instalments of CU200,000.
- Under Option 4, the contract is unenforceable and the donation is subject to a condition. In these circumstances, whether there is a constructive obligation to make the donation is a matter of judgement. Management might conclude that no constructive obligation exists until it is probable that the condition is met (which might not be until the additional funds have been collected). Only then would a liability and expense be recognised, measured at the net present value of the CU1m promised.
- Option 5 involves an enforceable contract which could give rise to a liability when the contract is signed. However, there is an exchange of benefits relating to the research and development activities performed on behalf of the entity. Whether these benefits have a value of at least the present value of the 5 instalments of CU200,000 is a matter of judgement. If it is determined that this is an exchange transaction that is not onerous, the entity could regard the signing of the contract as executory and could apply the criteria in IAS 38 to determine whether an asset or expense would be recognised for the related research and development costs as incurred (see Chapter 18 at section 6.2).

Where the arrangement gives rise to an exchange transaction rather than a donation, the expenditure incurred by the donor is recorded in accordance with the relevant IFRS accounting standard.

6.15 Settlement payments

A similar issue to that discussed in section 6.14 above arises when an entity promises to make a settlement payment in cases where an entity believes that there is no present legal obligation. For example, an entity dismisses an employee for behaving in a manner which breaches their employment contract. The entity determines that it has no present legal obligation under the terms of the employment contract or employment law, but promises to make a settlement payment to the former employee in order to avoid future possible lawsuits and unfavourable publicity. It can be difficult to determine whether a past obligating event exists that requires a provision to be recognised before payment to the employee is made.

Where there is no legal obligation to make the payments, a liability is recognised when a constructive obligation arises. It is a matter of judgement whether and when a constructive obligation exists. A binding agreement to make a payment to the former employee could give rise to a legal obligation. In the absence of facts and circumstances that would create a constructive or legal obligation prior to settlement, the entity would recognise the settlement as an expense when the cash is transferred.

6.16 Negative low emission vehicle credits

In 2021, the IFRS IC received a request asking whether particular government measures to encourage reductions in vehicle carbon emissions give rise to obligations that meet the definition of a liability. In the fact pattern discussed:

- Entities that produce or import passenger vehicles for sale in a specified market receive positive credits if, in a calendar year, they have produced or imported vehicles whose average fuel emissions are lower than a government target.
- Entities that have, in a calendar year, produced or imported vehicles whose average fuel emissions are higher than the target receive negative credits.
- The measures require an entity that receives negative credits for one year to eliminate these negative credits by obtaining and surrendering positive credits. The entity can obtain positive credits either by purchasing them from another entity or by generating them itself in the next year (by producing or importing more low-emission vehicles).
- If the entity fails to eliminate its negative credits, the government can impose sanctions on the entity. These sanctions would not require payment of fines or penalties, or any other outflow of resources embodying economic benefits, but could deny the entity opportunities in the future, for example, by restricting the entity's access to the market.

The IFRS IC observed that, in determining whether it has a liability, the entity described in the request would consider:

(a) Whether settling an obligation to eliminate negative credits would result in an outflow of resources embodying economic benefits.

(b) Which event creates a present obligation to eliminate negative credits.

And

(c) Whether the entity has no realistic alternative to settling the obligation.

The IFRS IC concluded that:[39]

- An entity can settle an obligation to eliminate negative credits either by purchasing credits from another entity or by generating positive credits itself next year. The IFRS IC concluded that either method of settling the obligation would result in an outflow of resources embodying economic benefits. These resources are the positive credits the entity would surrender to eliminate the negative balance. The entity could otherwise have used self-generated positive credits for other purposes - for example, to sell to other entities with negative credits.
- In the fact pattern described in the request, the activity that triggers a requirement to eliminate negative credits is the production or import of vehicles with average fuel emissions higher than the government target. If, in a calendar year, an entity has produced or imported vehicles with average fuel emissions higher than the government target, an obligation (a) has arisen from past events; (b) exists independently of the entity's future actions. The entity's future actions will determine only the means by which the entity settles its present obligation - whether it purchases positive credits from another entity or generates positive credits itself by producing or importing more low-emission vehicles.

  The IFRS IC observed also that a present obligation could arise at any date within a calendar year, on the basis of the entity's production or import activities to that date, not only at the end of the calendar year.
- The measures described in the request could give rise to a legal obligation, as (a) obligations that arise under the measures derive from an operation of law; and (b) the sanctions the government can impose under the measures would be the mechanism by which settlement may be enforceable by law. The IFRS IC observed that an entity would have a legal obligation that is enforceable by law if accepting the possible sanctions for non-settlement is not a realistic alternative for that entity. Determining whether accepting sanctions is a realistic alternative requires judgement and will depend on the nature of the sanctions and the entity's specific circumstances.
- If an entity determines has no legal obligation to eliminate its negative credits, it would need to consider whether it has a constructive obligation to do so. It would have a constructive obligation if it has both (a) in a calendar year, produced or imported vehicles with average fuel emissions higher than the government target; and (b) taken an action that creates valid expectations in other parties that it will eliminate the resulting negative credits - for example, made a sufficiently specific current statement that it will do so.

The IFRS IC observed that, having identified an obligation arising from the government measures set out in the request, an entity would apply other requirements in IAS 37 to determine how to measure the liability. The IFRS IC did not discuss those other requirements.

6.17 Net zero commitments

In recent years, many entities have declared that they intend to reduce and / or offset their greenhouse gas emissions with the aim of achieving net zero emissions. Disclosed net-zero commitments might merely establish the intent to reduce greenhouse gas emissions without specifying how the entity expects to achieve its goals. However, others might provide details of their short- or medium-term plans. The financial reporting consequences of such net zero commitments will vary depending on the nature of the declarations. Entities will need to assess whether they have a legal or constructive obligation that requires recognition of a provision. Under IAS 37, only those obligations arising from past events that exist independently of an entity's future actions can be recognised as a provision. *[IAS 37.19]*.

39 *IFRIC Update*, June 2022, available on the IFRS Foundation's website.

In November 2023, the IFRS IC discussed a submission related to climate-related (net-zero) commitments made by an entity. An agenda decision was subsequently published in March 2024.[40] The IFRIC IC discussed in detail the IAS 37 requirements with regards to the existence of constructive obligations. As discussed at section 3.1.1 above, a constructive obligation is an obligation that derives from an entity's actions where:

(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities

And

(b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities *[IAS 37.10]*

IAS 37 states that an obligation always involves another party to whom the obligation is owed, but that it is not necessary to know the identity of that party - the obligation may be to the public at large. *[IAS 37.20]*. The IFRS IC observed that a constructive obligation to reduce or offset greenhouse gas emissions, if one exists, would be owed to all people adversely affected by the emissions so would extend to the public at large.

The IFRS IC noted that determining whether the entity has created a valid expectation will depend on the facts of the commitment and the circumstances surrounding it. Therefore, management needs to apply judgement to reach a conclusion. If those facts or circumstances change over time, the conclusion could do so as well. The IFRS IC discussed several factors, which are not exhaustive, that entities should consider in their analysis, such as:

(a) What language is used in the statement? If statements describe the actions the entity 'will take', 'is committed to taking' or 'pledges to take', they are more likely to indicate that the entity will fulfil the commitment than statements that describe the entity's 'ambitions', 'targets' or 'aspirations'.

(b) What is the specificity and status of plans supporting the statement? Statements are more likely to raise a valid expectation that the entity will achieve its target to reduce its greenhouse gas emissions if they are supported by formally-approved plans detailing, for example:

  (i) The nature and timing of the actions the entity will take to achieve the reductions

  (ii) Milestones the entity has committed to achieve on the path to longer term goals

  (iii) How management will measure progress towards the milestones and longer-term goals (for example, the metrics an entity will use).

(c) What is the expected timing of the actions required to fulfil the commitment? Plans for short- and medium-term actions are less likely to be changed than those for longer-term actions.

(d) Is there publicly available evidence of progress to date? Evidence that the entity has achieved milestones it committed to in previous statements may enhance expectations that it will achieve milestones and longer-term goals it commits to in its current statement. Conversely, evidence that an entity has failed to achieve previous milestones may reduce those expectations.[41]

If the entity's statement has not created a constructive obligation, the entity does not recognise a provision. If the entity's statement has created a constructive obligation, consideration must then be given to whether that obligation satisfies the criteria for recognising a provision. IAS 37 requires an entity to recognise a provision when the following criteria are met:

(a) The entity has a present obligation (legal or constructive) as a result of a past event

(b) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation

And

(c) A reliable estimate can be made of the obligation *[IAS 37.14]*

In considering criterion (a), the IFRS IC observed that, "…just as the enactment of a law is not sufficient to give an entity a present legal obligation, the publication of a policy or statement is not sufficient to give an entity a present constructive obligation-an entity has a present legal or constructive obligation only when the event to which the law, policy or statement applies has occurred. For example, as illustrated in Illustrative Example 2B accompanying IAS 37, an entity with a widely published policy of cleaning up land it contaminates incurs a present obligation only when it contaminates land-publishing the policy is necessary but not sufficient to give the entity a present obligation."[42]

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40 *IFRIC Update*, March 2024, available on the IFRS Foundation's website.

41 IFRS IC Staff Paper 2, Project: Climate-related Commitments (IAS 37), Topic: Initial Consideration, November 2023. Available on the IFRS Foundation's website.

42 *IFRIC Update*, March 2024, available on the IFRS Foundation's website.

The IFRS IC noted that IAS 37 requires that provisions are not recognised for costs that need to be incurred to operate in the future *[IAS 37.18]*, and it is only those obligations arising from past events that exist independently of an entity's future actions (i.e., the future conduct of its business) that are recognised as provisions. *[IAS 37.19]*.

In the context of climate-related (net-zero) commitments:

- When the entity publishes a climate-related (net-zero) commitment that requires future action (e.g., modifying its manufacturing methods, purchasing and retiring carbon credits in the future), the related costs need to be incurred to operate in the future. The obligations to incur those costs do not exist independently of the entity's future actions. Accordingly, there is no present obligation for those costs when the entity publishes its commitment.
- An entity will have a present obligation for the modifications to its manufacturing methods once it has to pay for resources it purchases to modify its methods - for example, to pay for new plant or equipment or for renewable energy - but only when it receives those resources. Similarly, in the case of a commitment to offset greenhouse gas emissions, the entity will have a present obligation only when the entity emits the gases it has committed to offset.

In considering criterion (b), whether a constructive obligation satisfies the probable outflows criterion depends on the nature of the actions required to settle it. Even if an entity will incur expenditure to settle an obligation, it will not suffer a net outflow of resources if it receives resources of equal value in exchange for that expenditure. For example, an entity may expect to incur expenditure on low-emission plant and equipment in order to modify its manufacturing methods to meet net zero commitments. In that case, the entity will receive resources (plant and equipment) of equal value in exchange for the cash outflow, and no net outflow of resources embodying economic benefits will be required to settle the obligation.

A contractual commitment to purchase low-emission plant and equipment would usually be in scope of IAS 16 rather than IAS 37 and would require disclosure. *[IAS 16.74(c)]*. Executory contracts, such as contractual commitments for the acquisition of plant and equipment, are within the scope of IAS 37 only if they are onerous. *[IAS 37.3]*. Executory contracts are dealt with in section 2.2.1.A above.

Where an entity has a constructive obligation to offset greenhouse gas emissions, settling the constructive obligation will require an outflow of resources embodying economic benefits, as the entity will be required to buy and retire carbon credits without receiving any resources embodying economic benefits in exchange.

In considering criterion (c), it is relevant to note that IAS 37 states that 'except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision'. *[IAS 37.25]*. The IFRS IC observed that it is likely that the entity would be able to make a reliable estimate of the amount of a constructive obligation that satisfies the other recognition criteria.

If a provision is recognised, the IFRS IC observed that the corresponding amount is recognised as an expense, rather than as an asset, unless it gives rise to, or forms part of the cost of, an item that qualifies for recognition as an asset in accordance with an IFRS accounting standard.

Illustration 6-12 below, which is based on an example discussed by the IASB as part of its Provisions - Targeted Improvements project,[43] is consistent with the conclusions of the IFRS IC included in the agenda decision published in March 2024.

Illustration 6-12: Recognising a provision for a net zero commitment

In March 20X0, a manufacturer publicly announces its commitment to becoming 'net zero' by 20X5. It announces it will:

(a) Immediately start to change the way it manufactures its products with the aim of gradually reducing its greenhouse gas emissions, so they are no more than 40% of their current level by 20X5; and

(b) In 20X5 and thereafter, offset the remaining emissions by paying the forestry commissions of the countries in which it manufactures to plant trees

Present obligation as a result of a past event

The manufacturer's public announcement indicates to the public that it has accepted a responsibility to eliminate or offset its greenhouse gas emissions from 20X5 onwards. This announcement is judged to create a constructive obligation for the manufacturer if it creates a valid expectation among members of the public that it will discharge this responsibility. Whether the announcement creates such an expectation is a matter of judgement, determined by management taking into account the facts and circumstances.

An announcement that fulfils the criteria for creating a constructive obligation is not sufficient in itself to recognise a provision. A present constructive obligation arises only when the manufacturer has taken actions that will require it to transfer an economic resource - that is, when it has emitted greenhouse gases it has committed to offset. It then has an obligation to pay for the amount of tree planting required to offset the past emissions. The manufacturer's commitment to change aspects of the way in which it manufacturers its goods is not an obligation to transfer an economic resource.

Conclusion - The manufacturer recognises a provision as a result of its net zero commitment:

(a) When it has emitted the greenhouse gases it has committed to offset; and

(b) If at that time, management judges that its announcement has given rise to a constructive obligation to meet the net zero commitments.

The manufacturer would recognise a provision for the best estimate of the amounts payable to forestry commission in respect of past emissions.

Since an entity's specific plans are key to appropriately accounting for net-zero commitments, entities will need to provide sufficient disclosure to allow users of financial statements to understand the nature of their net-zero commitments and the impact on the financial statements, together with any key estimates and critical judgements required to be disclosed by IAS 1. *[IAS 1.122, IAS 1.125]*. Furthermore, entities should be careful to ensure that clear language is used in describing their aspirations, targets and intended actions in response to the climate change challenge. Without clear disclosure, a reader may have difficulty understanding the extent to which the entity can realistically withdraw from a course of action described in its transition plan.

How we see it

Climate-related matters potentially have a significant impact on the recognition and measurement of provisions, and the need for disclosure of contingent liabilities. However, under IAS 37, only those obligations arising from past events that exist independently of an entity's future actions shall be recognised as a provision.

Given the significant uncertainties involved in assessing the extent and impact of climate change, entities need to ensure that sufficient information is disclosed to allow users of financial statements to understand those uncertainties, how planned climate transition has been taken into account in the measurement of a provision or disclosure of a contingent liability, and the assumptions and judgements made by management in recognising and measuring provisions.

In a note to its 2023 financial statements, Vale S.A. discloses that it assessed its decarbonization goals and, considering the IAS 37 recognition criteria, concluded that no provision should be recognised.

43 *IASB Staff paper 22 (Appendix B):* Project: Provisions, Paper topic: Liability definition and 'present obligation' recognition criterion, IASB Meeting, April 2023. Available on the IFRS Foundation's website.

Practical example 6-6: Vale S.A. (2023) **Brazil**

Financial Statements [extract]
Notes to the Financial Statements [extract]
2. Basis of preparation of financial statements [extract]
f) Financial information related to sustainability [extract]
Decarbonization plan [extract]

...

Additionally, Vale has assessed its decarbonization goals considering the criteria for provision in accordance with IAS 37 – Provisions, Contingent Liabilities, and Contingent Assets and it did not record any provision since these commitments are not deemed a legal nor constructive obligation.

Regardless of whether an entity's commitment to reduce or offset its greenhouse gas emissions results in the recognition of a provision, the actions an entity plans to take to fulfil its commitment could also affect the amount at which it measures other assets and liabilities and the information it discloses about them. For example, they can impact the remaining useful lives of existing plant and equipment (see Chapter 19 at section 5.4.5), assumptions used in impairment testing (see Chapter 21 at section 7.1.11), and assessments of expected credit losses (see Chapter 47 at section 7.9).

The recognition and measurement of liabilities related to obligations to make good emissions already made under emissions trading schemes are discussed in Section 6.5 above, and further in Chapter 18 at section 11.2.

7 Disclosure requirements

A significant distinction between the accounting treatment of provisions and other liabilities, such as trade payables and accruals, is the level of disclosure required.

7.1 Provisions

For each class of provision an entity is required to provide a reconciliation of the carrying amount of the provision at the beginning and end of the period showing:

(a) Additional provisions made in the period, including increases to existing provisions

(b) Amounts used, i.e., incurred and charged against the provision, during the period

(c) Unused amounts reversed during the period

(d) The increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate

Comparative information is not required. *[IAS 37.84]*.

It is not clear whether disclosure (d) allows a single amount to be provided for the sum of the unwinding of the discount and any change in the provision resulting from a reassessment of the discount rate to be used or it requires these amounts to be given separately. However, given our view (discussed in section 4.3.6 above) that only the charge for unwinding of the discount is classified as a finance cost, with any further charge or credit that arises if discount rates have changed being recorded in the same line item that was used to establish the provision, it would make sense to disclose these items separately. It is also interesting that there is no specific requirement in the standard to disclose the discount rate used, especially where the effect of using a different discount rate could be material, such as in the measurement of a decommissioning provision. However, entities must remember that IAS 1 requires disclosure of information about major sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. *[IAS 1.125]*.

How we see it

We believe that the increase during the period in the discounted amount of a provision arising from the passage of time must be disclosed separately from the effect of any change in the discount rate on the provision.

One of the important disclosures which is reinforced here is the requirement to disclose the release of provisions found to be unnecessary. This disclosure, along with the requirement in the standard that provisions must be used only for the purpose for which the provision was originally recognised, *[IAS 37.61]*, is designed to prevent entities from concealing expenditure by charging it against a provision that was set up for another purpose.

In addition, for each class of provision an entity is required to disclose the following:

(a) A brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits.

(b) An indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity is required to disclose the major assumptions made concerning future events, as addressed in IAS 37.48 (discussed in section 4.4 above). This refers to future developments in technology and legislation and is of particular relevance to environmental liabilities.

(c) The amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement. *[IAS 37.85]*.

Section D of the implementation guidance to the standard provides examples of suitable disclosures in relation to warranties and decommissioning costs.

Most of the above disclosures are illustrated in the Practical example below, which includes the disclosure of provisions determined in accordance with IAS 37, contingent consideration provisions which would be determined in accordance with IFRS 3, and employee provisions (included within Other provisions) which would be determined in accordance with IAS 19.

Practical example 7-1: Roche Holding Ltd (2023) **Switzerland**

Finance Report 2023 [extract]

Roche Group Consolidated Financial Statements [extract]

Notes to the Roche Group Consolidated Financial Statements [extract]

20. Provisions and contingent liabilities [extract]

Provisions: movements in recognised liabilities in millions of CHF

	Legal provisions	Environmental provisions	Restructuring provisions	Contingent consideration provisions	Other provisions	Total
Year ended 31 December 2022						
At 1 January 2022	372	447	1,427	141	1,581	3,968
Additional provisions created	33	12	149	2	868	1,064
Unused amounts reversed	(67)	(1)	(221)	(41)	(215)	(545)
Utilised	(23)	(51)	(488)	0	(490)	(1,052)
Discount unwind, including effects from discount rate changes [4]	0	(20)	(7)	(1)	1	(27)
Business combinations						
– Acquired companies	0	0	0	0	0	0
– Deferred consideration	–	–	–	–	0	0
– Contingent consideration	–	–	–	0	–	0
Asset acquisitions	0	0	0	–	0	0
Currency translation effects	1	(13)	(16)	2	(23)	(49)
At 31 December 2022	**316**	**374**	**844**	**103**	**1,722**	**3,359**
Current	307	88	419	38	1,396	2,248
Non-current	9	286	425	65	326	1,111
At 31 December 2022	**316**	**374**	**844**	**103**	**1,722**	**3,359**
Year ended 31 December 2023						
At 1 January 2023	316	374	844	103	1,722	3,359
Additional provisions created	45	61	450	0	877	1,433
Unused amounts reversed	(171)	(8)	(86)	(10)	(579)	(854)
Utilised	(48)	(53)	(337)	0	(614)	(1,052)
Discount unwind, including effects from discount rate changes [4]	0	10	3	6	0	19
Business combinations						
– Acquired companies	0	0	0	0	0	0
– Deferred consideration	–	–	–	–	0	0
– Contingent consideration	–	–	–	0	–	0
Asset acquisitions	0	0	0	–	0	0
Currency translation effects	(16)	(23)	(23)	(4)	(96)	(162)
At 31 December 2023	**126**	**361**	**851**	**95**	**1,310**	**2,743**
Current	120	77	468	35	984	1,684
Non-current	6	284	383	60	326	1,059
At 31 December 2023	**126**	**361**	**851**	**95**	**1,310**	**2,743**
Expected outflow of resources						
Within one year	120	77	468	35	984	1,684
Between one and two years	2	103	234	12	113	464
Between two and three years	1	75	92	26	47	241
More than three years	3	106	57	22	166	354
At 31 December 2023	**126**	**361**	**851**	**95**	**1,310**	**2,743**

...

Legal provisions

Legal provisions relate to a number of separate legal matters, including claims arising from trade, in various Group companies. By their nature the amounts and timings of any outflows are difficult to predict.

As part of the regular review of litigation matters, management has reassessed the provisions recorded for certain litigation matters. Based on the development of the various litigations, notably the Meso case, some of the provisions previously held were released which resulted in an income of CHF 171 million in 2023. In addition, a fine of CHF 59 million imposed by the French Competition Authority on the Avastin/Lucentis investigation in 2020 was reimbursed following a court decision. These were the major elements in the expenses for legal cases in 2023, which show a net income of CHF 182 million reported in other operating income (expense) (2022: net income of CHF 25 million). Details of the major legal cases outstanding are disclosed below.

Environmental provisions

Provisions for environmental matters relate to various separate environmental issues in a number of countries. By their nature the amounts and timings of any outflows are difficult to predict. At 31 December 2023 significant provisions were discounted by between 3% and 5% (2022: between 4% and 5%) where the time value of money was material. The significant provisions relate to the estimated remediation costs for the manufacturing site at Clarecastle, Ireland, which was shut down in the meantime, and to the US site in Nutley, New Jersey, which was divested in September 2016. In 2023 environmental provisions decreased by CHF 13 million, mainly due to utilisations and currency translation effects and partially offset by an increase in provisions. The net environmental expenses reported in other operating income (expense) in 2023 were CHF 60 million (2022: net expenses of CHF 3 million) and included an increase of provisions of CHF 61 million mainly for the Clarecastle site following a reassessment of the expected costs of the environmental remediation.

The Group's procedures on environmental protection are included in the Annual Report on pages 78 to 83. These include the actions taken by the Group with regard to climate change, notably the Group's commitment to reduce greenhouse gas emissions.

Restructuring provisions

These arise from planned programmes that materially change the scope of business undertaken by the Group or the manner in which business is conducted. Such provisions include only the costs necessarily entailed by the restructuring which are not associated with the recurring activities of the Group. The timings of these cash outflows are reasonably certain. Significant non-current provisions are discounted using an average discount rate of 1.4% (2022: 2.1%).

In the Pharmaceuticals Division the significant provisions relate to various business transformation initiatives, including the site development plans at the Basel/Kaiseraugst site and the resourcing flexibility plans, as well as to the redesign and the strategic realignment of its manufacturing network mainly in the US. In the Diagnostics Division the significant provisions are associated with manufacturing and supply chain optimisations, research and development productivity initiatives and business transformations measures. Additionally, provisions were also recorded for a cross-divisional transformation programme to simplify the systems landscape and reduce process complexity. Further details are given in Note 7.

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Other provisions

Other provisions relate to the items shown in the table below. With the exception of employee provisions, the timing of cash outflows is by its nature uncertain.

Other provisions in millions of CHF

	2023	2022	2021
Sales returns[3]	481	588	514
Employee provisions	406	366	384
Other items	423	768	683
Total other provisions	**1,310**	**1,722**	**1,581**

The standard states that in determining which provisions may be aggregated to form a class, it is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfil the requirements of (a) and (b) above. An example is given of warranties: it is suggested that, while it may be appropriate to treat warranties of different products as a single class of provision, it would not be appropriate to aggregate normal warranties with amounts that are subject to legal proceedings. *[IAS 37.87]*.

For entities disclosing restructuring costs, this requirement could result in material components of the costs being disclosed separately. However, materiality will be an important consideration in judging how much analysis is required.

As noted above, IAS 37 requires entities to disclose an indication of the uncertainties about the amount or timing of outflows. *[IAS 37.85]*. Illustrative example 7-1 below reproduces an example proposed in Exposure Draft - *Climate-related and Other Uncertainties in the Financial Statements - Proposed illustrative examples*[44], and illustrates how the Board proposes an entity might disclose this information even if the carrying amount of the associated provision is immaterial.

Illustration 7-1: Disclosures about decommissioning and restoration provisions (IAS 37)

Background

The entity is a petrochemicals manufacturer and has plant decommissioning and site restoration obligations for its petrochemical facilities. The entity assumes that it will continue to maintain and operate the facilities for an extremely long time. Consequently, the costs required to settle the obligations will be incurred so far into the future that, when discounted to their present value, their effect on the carrying amount of the provision is immaterial. However, the costs to settle the obligations will be high and there is an increasing risk that the entity might be required to close some of its petrochemical facilities earlier than it expects because of efforts to transition to a lower-carbon economy.

Application

Paragraph 85 of IAS 37 requires an entity to disclose information for each class of provision. Although the carrying amount of the entity's plant decommissioning and site restoration provision is immaterial, the entity concludes that information about the related obligations is material. The entity reaches this conclusion after considering, among other factors, the environment in which it operates, the risk that it might be required to settle the obligations earlier than expected and the size of the outflows that will be required to settle them.

Applying paragraph 85 of IAS 37, the entity discloses information about its plant decommissioning and site restoration provision, including:

(a) a brief description of the nature of its plant decommissioning and site restoration obligations and the expected timing of the outflows of economic benefits required to settle them.

(b) an indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, the entity also discloses the major assumptions made concerning future events. These assumptions could include assumptions about the future use of each of the entity's main petrochemical facilities-for example, when the facility is expected to be closed

Given the inherent uncertainty related to provisions, entities may also need to perform, and disclose, a sensitivity analysis of the impact of possible scenarios. In its 2023 financial statements, Equinor ASA provided a sensitivity analysis regarding its asset retirement obligation by quantifying the financial statement impact if it were to perform removals five years earlier then currently scheduled.

44 Exposure Draft - Climate-related and Other Uncertainties in the Financial Statements - Proposed illustrative examples, IASB, July 2024, Example 7. Available on the IFRS Foundation's website.

Practical example 7-2: Equinor ASA (2023) **Norway**

2023 Integrated Annual Report [extract]
Financial statements [extract]
4.1 Consolidated financial statements [extract]
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]
Note 3. Climate change and energy transition [extract]
Effects on estimation uncertainty [extract]

Timing of Asset Retirement Obligations (ARO)
As mentioned above, there are currently no assets triggered for earlier cessation as a result of Equinor's ambition to become a net-zero company by 2050. However, if the business cases of Equinor's producing oil and gas assets should change materially, this could affect the timing of cessation of the assets. A shorter production period will increase the carrying value of the liability. To illustrate, performing removal five years earlier than currently scheduled would increase the liability by around USD 1.2 billion before tax (around USD 1 billion in 2022). See note 23 Provisions and other liabilities for more information regarding Equinor's ARO, including expected timing of cash outflows of recognised asset retirement obligations. The most significant cash outflows are expected within the year 2043.

As indicated in section 6.1.1 above, IAS 37 emphasises that when a restructuring meets the definition of a discontinued operation under IFRS 5, additional disclosures may be required under that standard (see Chapter 5 at section 3). *[IAS 37.9]*.

7.2 Contingent liabilities

Unless the possibility of any outflow in settlement is remote, IAS 37 requires the disclosure for each class of contingent liability at the end of the reporting period to include a brief description of the nature of the contingent liability, and where practicable:

(a) An estimate of its financial effect, measured in accordance with IAS 37.36 to 52 (discussed in section 4 above)
(b) An indication of the uncertainties relating to the amount or timing of any outflow
(c) The possibility of any reimbursement *[IAS 37.86]*

Where any of the information above is not disclosed because it is not practicable to do so, that fact must be stated. *[IAS 37.91]*.

The guidance given in the standard on determining which provisions may be aggregated to form a class referred to in section 7.1 above also applies to contingent liabilities.

A further point noted in the standard is that where a provision and a contingent liability arise from the same circumstances, an entity must ensure that the link between the provision and the contingent liability is clear. *[IAS 37.88]*. This situation may occur, for instance, when an entity stratifies a population of known and potential claimants between different classes of obligation, and accounts for each class separately. For example, an entity's actions may have resulted in environmental damage. The entity identifies the geographical area over which that damage is likely to have occurred and recognises a provision based on its 'best estimate' of value of claims it expects to be submitted from residents in that geographical area. In addition, there is a chance (albeit possible rather than probable) that the pollution is found to have had an effect beyond the geographical area established by the entity. As noted in section 3.2.1 above, the latter, 'possible but not probable' obligation meets the definition of a contingent liability for which disclosure is required.

Another example of when a provision and a contingent liability may arise from the same circumstance would be where an entity is jointly and severally liable for an obligation. As noted in section 4.7 above, in these circumstances the part of the obligation that is expected to be met by other parties is treated as a contingent liability.

It is not absolutely clear what is meant by 'financial effect' in (a) above. Is it the potential amount of the loss or is it the *expected* amount of the loss? The cross-reference to the measurement principles in IAS 37.36 to 52 might imply the latter, but in any event, disclosure of the potential amount is likely to be relevant in explaining the uncertainties in (b) above.

7.3 Contingent assets

IAS 37 requires disclosure of contingent assets where an inflow of economic benefits is probable. The disclosures required are:

(a) A brief description of the nature of the contingent assets at the end of the reporting period

(b) Where practicable, an estimate of their financial effect, measured using the principles set out for provisions in IAS 37.36 to 52 *[IAS 37.89]*

Where any of the information above is not disclosed because it is not practicable to do so, that fact must be stated. *[IAS 37.91]*. The standard also notes that the disclosure must avoid giving misleading indications of the likelihood of income arising. *[IAS 37.90]*.

One problem that arises with IAS 37 is that it requires the disclosure of an estimate of the potential financial effect for contingent assets to be measured in accordance with the measurement principles in the standard. Unfortunately, the measurement principles in the standard are all set out in terms of the settlement of obligations, and these principles cannot readily be applied to the measurement of contingent assets. Hence, judgement will have to be used as to how rigorously these principles are required to be applied.

7.4 Reduced disclosure when information is seriously prejudicial

IAS 37 contains an exemption from disclosure of information in the following circumstances. It says that "In extremely rare cases, disclosure of some or all of the information required by paragraphs 84-89 can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset…" *[IAS 37.92]*.

In such circumstances, the information need not be disclosed. However, disclosure will still need to be made of the general nature of the dispute, together with the fact that, and the reason why, the required information has not been disclosed. *[IAS 37.92]*.

The following Illustration, based on an example from the implementation guidance to the Standard, provides an example of the disclosures required where some of the information required by the standard is not given because it is expected to prejudice seriously the position of the entity.

Illustration 7-2: Reduced disclosure when information is seriously prejudicial

An entity is involved in a dispute with a competitor, who is alleging that the entity has infringed patents and is seeking damages of CU100 million. The entity recognises a provision for its best estimate of the obligation, but discloses none of the information required by IAS 37.84 and 85. The following information is disclosed:

Litigation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed patents and is seeking damages of CU100 million. The information usually required by IAS 37 is not disclosed on the grounds that it can be expected to prejudice seriously the outcome of the litigation. The directors are of the opinion that the claim can be successfully resisted by the company. *[IAS 37.IE D Example 3]*.

As it can be seen in the above example, an entity applying the 'seriously prejudicial' exemption is still required to describe the general nature of the dispute, resulting in a level of disclosure that many entities might find uncomfortable in the circumstances.

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Appendix B - Defined terms

Extract from IFRS accounting standards - Definitions	
constructive obligation	A *constructive obligation* is an obligation that derives from an entity's actions where: (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities. *[IAS 37.10]*.
contingent asset	A *contingent asset* is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. *[IAS 37.10]*.
contingent liability	A *contingent liability* is: (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or (b) a present obligation that arises from past events but is not recognised because: (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or (ii) the amount of the obligation cannot be measured with sufficient reliability. *[IAS 37.10]*.
executory contracts	Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. This Standard does not apply to executory contracts unless they are onerous. *[IAS 37.3]*
Government	'Government' refers to government, government agencies and similar bodies whether local, national or international. *[IFRIC 21.4]*
legal obligation	A *legal obligation* is an obligation that derives from: (a) a contract (through its explicit or implicit terms); (b) legislation; or (c) other operation of law. *[IAS 37.10]*.
levy	For the purposes of this Interpretation, a levy is an outflow of resources embodying economic benefits that is imposed by governments on entities in accordance with legislation (ie laws and/or regulations), other than: (a) those outflows of resources that are within the scope of other Standards (such as income taxes that are within the scope of IAS 12 *Income Taxes*); and (b) fines or other penalties that are imposed for breaches of the legislation. *[IFRIC 21.4]*.
liability	A *liability* is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.[1] *[IAS 37.10]*.
obligating event	An *obligating event* is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation. *[IAS 37.10]*.

onerous contract	An *onerous contract* is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. *[IAS 37.10]*.
provision	A *provision* is a liability of uncertain timing or amount. *[IAS 37.10]*.
restructuring	A *restructuring* is a programme that is planned and controlled by management, and materially changes either: (a) the scope of a business undertaken by an entity; or (b) the manner in which that business is conducted. *[IAS 37.10]*.

1 The definition of a liability in this Standard was not revised following the revision of the definition of a liability in the *Conceptual Framework for Financial Reporting* issued in 2018.

Chapter 28 Revenue

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Overview

Revenue is, arguably, one of most important indicators of an entity's performance. It may be perceived as an indicator of the desirability of an entity's products and services, and the growth or decline over time of a business. However, revenue does not represent all income for an entity. As discussed in section 1.1 below, revenue is a subset of income, it is derived from the ordinary activities of an entity and may be referred to by a variety of different names, including sales, fees, interest, dividends, royalties and rent.

Identifying what is revenue and specifying how and when to measure and report it is critical to any accounting framework. IFRS 15 *Revenue from Contracts with Customers* (IFRS 15 or the standard) provides accounting requirements for all revenue arising from contracts with customers to provide goods or services (unless the contracts are in the scope of other IFRS accounting standards). Within IFRS accounting standards, several other standards deal with the recognition of revenue, for example, IFRS 16 *Leases* covers lease revenue and IFRS 9 *Financial Instruments* covers dividends and interest, which would represent revenue if they are part of an entity's ordinary activities.

This chapter primarily covers IFRS 15. As discussed further in section 1.1 below, IFRS 15 only covers a subset of revenue - specifically, revenue that arises from a contract when the counterparty to that contract is a customer (as defined, see section 2.3 below) and the contract is not specifically excluded from the standard (e.g., lease contracts within the scope of IFRS 16 or financial instruments within the scope of IFRS 9, see section 2.1 below for a complete list of scope exclusions).

Other revenue items that are not within the scope of IFRS 15 but arise in the course of the ordinary activities of an entity, as well as the disposal of non-financial assets that are not part of the ordinary activities of the entity, for which IFRS 15's requirements are relevant, are addressed in section 2.6 below.

IFRS 15 includes detailed application guidance. The International Accounting Standards Board (IASB or the Board) also published more than 60 illustrative examples that accompany IFRS 15. We list these examples in Appendix D to this chapter and provide references to where certain examples are included in this chapter. The standard, which is largely converged with the revenue guidance in US GAAP, also specifies the accounting for costs an entity incurs to obtain and fulfil a contract to provide goods or services to customers (see section 9.3 below) and provides a model for the measurement and recognition of gains and losses on the sale of certain non-financial assets, such as property, plant or equipment (see section 2.6.3 below).

Entities often find application of the standard to be a significant undertaking. This is because the standard requires entities to make many judgements and estimates, which affect their financial statements, business processes and internal controls over financial reporting. The complexity of the standard has also led to further standard setting and regulatory discussion, which continues to contribute to the overall understanding on how the standard should be applied.

While entities are now more familiar with its requirements, the application of IFRS 15 continues to be challenging for them when business practices and models evolve (e.g., increasing the use of online retail and platform services, changing to 'greener' practices, etc.) and operating environments change, raising new implementation questions. Entities may also have to consider the effect on their business of economic, social and political developments, both local and international. For example, in times of economic volatility, areas that may have been affected for revenue contracts include, but are not limited to, variable consideration, contract modifications and terminations, collectability and any extended payment terms (including whether they affect collectability assessments, estimates of variable consideration, subsequent impairment under IFRS 9 or impairment of contract cost assets), customer incentives and changes to selling prices and onerous contracts. See our publication, *Applying IFRS: Accounting considerations for geopolitical events and uncertainty*, which provides considerations for entities on the possible accounting effects of the geopolitical events and uncertainty.[1] Even if changes to the accounting for revenue contracts are not necessary, entities need to consider whether additional disclosure is required.

1 Available on ey.com/IFRS.

Following the issuance of their revenue standards, the IASB and the US Financial Accounting Standards Board (FASB) (collectively, the Boards) created the Joint Transition Resource Group for Revenue Recognition (TRG) to help them determine whether more application guidance was needed. The members of the TRG included financial statement preparers, auditors and other users from a variety of industries and countries, as well as public and private entities. The TRG members' views are not authoritative, but entities should consider them as they apply the standards. In its July 2016 public statement, the European Securities and Markets Authority (ESMA) encouraged issuers to consider the TRG discussions when implementing IFRS 15.[2] Furthermore, the former Chief Accountant of the US Securities and Exchange Commission (SEC) encouraged SEC registrants, including foreign private issuers (that may report under IFRS accounting standards), to consult with his office if they are considering applying the standard in a manner that differs from the discussions in which the members of the TRG reached general agreement.[3]

We have incorporated our summaries of topics on which the members of the TRG generally agreed throughout this chapter (also see the listing of all TRG discussions and where they are discussed in this chapter in Appendix E). Unless otherwise specified, these summaries represent the discussions of the joint TRG. Where possible, we indicate if members of the IASB or its staff commented on the FASB TRG discussions. In addition, this chapter highlights relevant discussions by the IFRS IC. See Appendix F for a summary listing.

In July 2024, the IASB finalised its decisions in the post-implementation review (PIR) of the standard, which included evaluating its effectiveness and identifying areas for improvement.[4] Following initial outreach and research, the IASB published a Request for Information in June 2023, with a 120-day comment period ending in October 2023. The IASB discussed the feedback received to the Request for Information from January to July 2024, and ultimately concluded that, overall, the requirements in IFRS 15 are working as intended and, therefore, decided not to add any new projects to its standard-setting agenda. See section 1.4 below for a more detailed description of the PIR.

This chapter discusses the IASB's standard (including all amendments) and highlights significant differences from the FASB's standard, Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*; a summary of significant differences is included in Appendix G.[5]

What you need to know

- IFRS 15 provides a single source of revenue requirements for all entities in all industries.
- IFRS 15 applies to revenue from contracts with customers, unless explicitly excluded from the scope (e.g., leasing contracts, financial instruments).
- IFRS 15 is principles-based and includes detailed application guidance. The lack of bright lines in some cases requires the use of judgement.
- While entities are more familiar with its requirements, application of IFRS 15 continues to be challenging for entities as business practices evolve and operating environments change.
- IFRS 15 also specifies the accounting treatment for certain items other than revenue, such as certain costs associated with obtaining and fulfilling a contract and the sale of certain non-financial assets.

2 Public Statement: *Issues for consideration in implementing IFRS 15: Revenue from Contracts with Customers*, ESMA, issued 20 July 2016, available on ESMA's website.

3 Speech, *Remarks before the 2016 Baruch College Financial Reporting Conference*, by Wesley R. Bricker, Deputy Chief Accountant, 5 May 2016. Available on the SEC's website.

4 News: *IASB completes technical decisions on three projects*, IASB, issued 23 July 2024, available on the IFRS Foundation's website.

5 Throughout this chapter, when we refer to the FASB's standard, we mean ASC 606 (including all amendments), unless otherwise noted.

1 Introduction

1.1 The distinction between income, revenue and gains

Income is defined in IFRS 15 as "increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity, other than those relating to contributions from equity participants". *[IFRS 15 Appendix A]*. The *Conceptual Framework for Financial Reporting* similarly defines income. *[CF 4.68]*.

This definition encompasses both 'revenue' and 'gains'. IFRS 15 defines revenue as income that arises in the course of the ordinary activities of an entity. *[IFRS 15 Appendix A]*. As discussed in the Overview above, according to the IASB's 2010 *Conceptual Framework for Financial Reporting* (which applied when IFRS 15 was issued), it can include sales, fees, interest, dividends, royalties and rent. *[CF(2010) 4.29]*. Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity. Gains include, for example, those arising on the disposal of non-current assets. The definition of income also includes unrealised gains; for example, those arising on the revaluation of marketable securities and those resulting from increases in the carrying amount of long-term assets. *[CF(2010) 4.31]*. The 2018 *Conceptual Framework for Financial Reporting* no longer contains a discussion about revenue and gains and losses. However, the definition of revenue in IFRS 15 remains unchanged. At the time the 2018 Conceptual Framework was issued, the Board noted it did not expect the removal of that discussion to cause any changes in practice. *[CF BC4.96]*.

The rules on offsetting in IAS 1 *Presentation of Financial Statements* distinguish between revenue and gains.[6] That standard states that an entity undertakes, in the course of its ordinary activities, other transactions that do not generate revenue but are incidental to the main revenue-generating activities. When this presentation reflects the substance of the transaction or other event, the results of such transactions are presented by netting any income with related expenses arising on the same transaction. For example, gains and losses on the disposal of non-current assets, including investments and operating assets, are reported by deducting from the proceeds on disposal the carrying amount of the asset and related selling expenses. *[IAS 1.34]*. IAS 16 *Property, Plant and Equipment* has a general rule that 'gains shall not be classified as revenue'. *[IAS 16.68]*. The only exception to this rule is where an entity routinely sells property, plant and equipment that it has held for rental to others, which is discussed further in section 2.6.3.A below.

1.2 IFRS 15 - Overview of the standard

The revenue standard provides accounting requirements for all revenue arising from contracts with customers. They affect all entities that enter into contracts to provide goods or services to their customers, unless the contracts are in the scope of other IFRS accounting standards, such as that for leases. The standard also specifies the accounting for costs an entity incurs to obtain and fulfil a contract to provide goods or services to customers (see section 9.3 below) and provides a model for the measurement and recognition of gains and losses on the sale of certain non-financial assets, such as property, plant or equipment (see section 2.6.3 below).

IFRS 15 became effective for annual reporting periods beginning on or after 1 January 2018. Early adoption was permitted, provided that fact was disclosed. *[IFRS 15.C1]*.

IFRS 15 required retrospective application. However, it allowed either a 'full retrospective' adoption (in which the standard was applied retrospectively to all of the periods presented in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*[7]) or a 'modified retrospective' adoption (in which the standard was applied retrospectively to only the most current period presented in the financial statements). Under both transition methods, the IASB granted transition practical expedients to provide relief.

Depending on the manner in which an entity elected to transition to IFRS 15, it may not have needed to apply the standard to contracts if they had completed performance before the date of initial application or the beginning of the earliest period presented (depending on the practical expedient and the transition method), even if they had not yet received the consideration and that consideration was still subject to variability. Applying a completed contract practical expedient might also have affected an entity's revenue recognition in subsequent reporting periods. That is, if an entity applied a practical expedient for completed contracts, it continued to apply its legacy revenue policy to its completed contracts, instead of IFRS 15. In some cases, even though an entity had fully transferred its identified goods or services, there may still be revenue to recognise in accordance with its legacy revenue policy in reporting periods after adoption of IFRS 15.

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6 IFRS 18 *Presentation and Disclosure in Financial Statements*, which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted) was issued by the IASB in April 2024. See Chapter 4 for further details on the new concepts and requirements of IFRS 18.

7 The consequential amendments resulting from IFRS 18, once effective, change the title of IAS 8 to '*Basis of Preparation of Financial Statements*' to better reflect the amended content of IAS 8. See Chapter 4 for more details.

While we address the significant differences between the IASB's final standard and the FASB's final standard in Appendix G and highlight some differences throughout this chapter, the primary purpose of this chapter is to describe the IASB's standard, including all amendments to date, and focus on the effects for preparers applying IFRS accounting standards.[8] As such, we generally refer to the 'standard' in the singular in this chapter.

1.3 Core principle of IFRS 15

The standard describes the principles an entity must apply to measure and recognise revenue and the related cash flows. *[IFRS 15.1]*. The core principle is that an entity recognises revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to a customer. *[IFRS 15.2]*.

The principles in IFRS 15 are applied using the following five steps:

1. Identify the contract(s) with a customer (see section 3 below)
2. Identify the performance obligations in the contract (see section 4 below)
3. Determine the transaction price (see section 5 below)
4. Allocate the transaction price to the performance obligations in the contract (see section 6 below)
5. Recognise revenue when (or as) the entity satisfies a performance obligation (see section 7 below)

Entities need to exercise judgement when considering the terms of the contract(s) and all of the facts and circumstances, including implied contract terms. Entities also have to apply the requirements of the standard consistently to contracts with similar characteristics and in similar circumstances. *[IFRS 15.3]*.

1.4 The Post-implementation Review of IFRS 15

In the second half of 2022, the IASB began its post-implementation review (PIR) of IFRS 15. Following initial outreach activities by the IASB staff, a Request for Information was published in June 2023 with a 120-day comment period ending on 27 October 2023.[9] In the Request for Information, the IASB included questions on a multitude of topics, including: the standard's overall objective; convergence with US GAAP; specific requirements in the standard, including determining when to recognise revenue, determining the transaction price, and identifying performance obligations in a contract; and the interaction with other IFRS accounting standards and disclosure requirements. The Board also included some narrower questions on specific topics, including consideration payable to a customer, the presentation of negative revenue, over-time revenue recognition and principal versus agent considerations.

The Board did, however, omit several key topics from the Request for Information, perhaps most notably contracts with customers to sell an asset by selling an equity interest in a separate single-asset entity that holds that asset (commonly referred to as a 'corporate wrapper', see Question 2-12 in section 2.5 below). The IASB explained that this issue had been identified as a low priority in the Third Agenda Consultation[10] and that, in order to solve this issue, the interaction between several different IFRS accounting standards, including IFRS 15, IFRS 10 *Consolidated Financial Statements* and IAS 12 *Income Taxes*, would need to be addressed, which would require significant resources.

The IASB discussed the feedback to the Request for Information from January to July 2024, and the Board's discussions also included a review of academic literature and a joint FASB-IASB education meeting in June 2024, where the Boards discussed and compared the PIR processes of their respective revenue standards. In general, the IASB's view on the feedback received throughout the PIR process was that the requirements of the standard generally are working as intended.

The Board identified several matters it assessed to be of low priority and will therefore be considered in the next agenda consultation.[11] These matters include assessing whether an entity is a principal or an agent, consideration payable to a customer and applying IFRS 15 with IFRIC 12 *Service Concession Arrangements*. The Board also confirmed its previous decision to not consider the issue of corporate wrappers in the PIR of IFRS 15, to gather evidence on the assessment of whether a transfer of an asset is a sale in a sale and leaseback transaction in the PIR of IFRS 16 and to take no action on any other matters identified during the PIR of IFRS 15. In July 2024, the Board finalised its decisions in the PIR.[12] At the time of writing, the project summary and feedback statement for the PIR had not yet been published.

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8 For more information on the effect of the new revenue standard for US GAAP preparers, refer to our *Financial Reporting Developments: Revenue from contracts with customers (ASC 606)*, available on *EY Accounting Link*.

9 *Request for Information: Post-implementation Review of IFRS 15* Revenue from Contracts with Customers, IASB, June 2023.

10 *Feedback Statement: Third Agenda Consultation*, IASB, July 2022.

11 IASB Update, July 2024. Available on the IFRS Foundation's website.

12 News: *IASB completes technical decisions on three projects,* IASB, issued 23 July 2024, available on the IFRS Foundation's website.

2 Scope

2.1 Scope of IFRS 15

IFRS 15 applies to all entities and all contracts with customers to provide goods or services in the ordinary course of business, except for the following contracts, which are specifically excluded: *[IFRS 15.5]*

- Lease contracts within the scope of IFRS 16
- Insurance contracts within the scope of IFRS 17 *Insurance Contracts*, except when an entity elects to apply IFRS 15 to certain service contracts in accordance with IFRS 17.8
- Financial instruments and other contractual rights or obligations within the scope of IFRS 9, IFRS 10, IFRS 11 *Joint Arrangements*, IAS 27 *Separate Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures*
- Non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers

Arrangements must meet the criteria set out in IFRS 15.9, which are discussed in section 3.1 below, to be accounted for as a revenue contract under the standard.

For certain arrangements, entities have to evaluate their relationship with the counterparty to the contract in order to determine whether a vendor-customer relationship exists. Some collaboration arrangements, for example, are more akin to a partnership, while others have a vendor-customer relationship. Only transactions that are determined to be with a customer are within the scope of IFRS 15. *[IFRS 15.6]*. The definition of a customer is discussed in section 2.3 below. See section 2.4 below for a discussion on collaborative arrangements.

The interaction between IFRS 15 and other IFRS accounting standards can be challenging and might require significant judgement. Such interactions with IFRS 15 include when:

- An entity needs to apply other IFRS accounting standards' requirements to assets and liabilities arising from a revenue contract (e.g., applying certain requirements in IFRS 9 to contract assets, determining an entity's right to consideration becomes unconditional (i.e., a receivable) such that IFRS 9 applies to that asset instead of IFRS 15, see section 10.1 below for further discussion).
- Other IFRS accounting standards refer to guidance in IFRS 15 (e.g., the accounting for disposals of certain non-financial assets - as discussed in section 2.6.3 below, applying requirements in IFRS 15 to service concession arrangements that are within the scope of IFRIC 12 - see Chapter 26).
- Two or more contracts need to be assessed together to determine the appropriate IFRS accounting standard(s) to apply (e.g., sales with repurchase agreements (see section 7.3 below), sale and leaseback arrangements within the scope of IFRS 16) or the legal form of the arrangement is not consistent with the substance. When developing IFRS 16, the IASB noted that constituents had questions about how to distinguish between a lease and a sale or purchase when legal title to the underlying asset is not transferred. *[IFRS 16.BC79]*. If an arrangement does not meet the definition of a lease because the 'lessor' has a substantive right to substitute the underlying asset throughout the period of use and, hence, is out of scope of IFRS 16 (see Chapter 24 at section 2.2), that entity might be providing a service within the scope of IFRS 15. The IASB decided not to provide guidance in this area and noted that the accounting for such leases would be similar to the sale or purchase of the respective asset and that the accounting also depends on the substance of the transaction and not its legal form. *[IFRS 16.BC138, IFRS 16.BC139]*. Refer to Chapter 24 for more information on IFRS 16.
- A contract falls within the scope of more than one IFRS accounting standard (e.g., lease with a non-lease revenue component, a contract that includes the issuance of a financial instrument and a revenue component within the scope of IFRS 15). When entities enter into transactions that are partially within the scope of IFRS 15 and partially within the scope of other IFRS accounting standards, IFRS 15 requires an entity to apply any separation and/or measurement requirements in the other IFRS accounting standard first, before applying the requirements in IFRS 15. *[IFRS 15.7]*. See section 2.5 below for further discussion.

As noted above, IFRS 17 could include in its scope certain contracts, particularly fixed-fee service contracts, which are contracts in which the level of service depends on an uncertain event, and certain warranties. Entities that enter into these contracts and might need to apply IFRS 17 are not limited to insurance companies; other financial institutions (e.g., banks), as well as other entities, such as manufacturers, also might be affected.

Fixed-fee service contracts can include roadside assistance programmes and maintenance contracts in which the service provider agrees to repair specified equipment after a malfunction for a fixed fee. IFRS 17 indicates that these are insurance contracts and, therefore, that standard would apply. However, if their primary purpose is the provision of services for a fixed fee, IFRS 17 permits entities the choice of applying IFRS 15 instead of IFRS 17 to such contracts if, and only if, all of the following conditions are met:

- The entity does not reflect an assessment of the risk associated with an individual customer in setting the price of the contract with that customer.
- The contract compensates the customer by providing services, rather than by making cash payments to the customer.

  And
- The insurance risk transferred by the contract arises primarily from the customer's use of services rather than from uncertainty over the cost of those services. *[IFRS 17.8]*.

The entity might make that choice on a contract-by-contract basis, but the choice for each contract is irrevocable. IFRS 17 became effective for annual periods beginning on or after 1 January 2023. See Chapter 51 at section 2.3.2 for further discussion.

Many entities issue warranties together with, and/or related to, goods or services provided to a customer. While IFRS 15 provides application guidance that applies to warranties, some might be within the scope of IFRS 17. Determining whether IFRS 15 or IFRS 17 applies might require significant judgement. This is discussed further in section 9.1 below. If IFRS 17 applies to a warranty within a contract with a customer, the requirements in IFRS 15.7 will need to be considered to determine how to allocate the contract consideration between the two standards. See section 2.5 below for further discussion.

2.1.1 Non-monetary exchanges

IFRS 15 does not apply to non-monetary exchanges between entities in the same line of business to facilitate sales to (potential) customers. For example, the standard does not apply to a contract between two oil companies that swap oil to fulfil demand from their respective customers in different locations on a timely basis and to reduce transportation costs. This scope exclusion applies even though the party exchanging goods or services with the entity might meet the definition of a customer on the basis that it has contracted with the entity to obtain an output of the entity's ordinary activities. As discussed in the Basis for Conclusions, this type of scenario might be common in industries with homogeneous products. *[IFRS 15.BC58]*. Not all non-monetary exchanges between entities are outside the scope of IFRS 15 and the standard does provide requirements for contracts involving non-cash consideration in exchange for goods or services (see section 5.6 below on non-cash consideration and section 5.6.2 below on barter transactions). Therefore, determining whether an exchange is to facilitate a sale to a customer could require judgement. Judgement might also be needed to determine whether entities are in the same line of business.

The following Illustration shows some of these considerations:

Illustration 2-1: Non-monetary exchange outside the scope of IFRS 15

An automobile dealer exchanges new model automobiles with another dealer to obtain the colour ordered by a customer. This non-monetary exchange is intended to facilitate a sale to a customer who is not a party to the exchange. In addition, it involves the exchange of inventory that both dealers hold for sale, as part of their ordinary activities, and the automobile dealers are in the same line of business. Accordingly, this transaction is outside the scope of IFRS 15.

Illustration 2-2: Non-monetary exchange in the scope of IFRS 15

An office supply retailer provides office equipment and supplies to an automobile dealer in exchange for an automobile. The automobile dealer will use the office equipment and supplies in its financing department. The new equipment is an upgrade from the automobile dealer's old equipment and will allow the automobile dealer to reduce administrative expenses. The office supply retailer will use the car received in its repair department, allowing the department to reduce response times and meet service level commitments. Although the exchange involves inventory held for sale by each entity, the transaction is not an exchange of a product held for sale in the ordinary course of business for a product to be sold in the same line of business to facilitate sales to customers. Accordingly, this transaction is within the scope of IFRS 15 for each entity.

2.2 Other scope considerations

Certain arrangements executed by entities include repurchase provisions, either as a component of a sales contract or as a separate contract that relates to the same or similar goods in the original agreement. The form of the repurchase agreement and whether the customer obtains control of the asset will determine whether the agreement is within the scope of the standard. See section 7.3 below for a discussion on repurchase agreements.

IFRS 15 also specifies the accounting for certain costs, such as the incremental costs of obtaining a contract and the costs of fulfilling a contract. However, the standard is clear that these requirements only apply if there are no other applicable requirements in IFRS accounting standards for those costs. *[IFRS 15.8]*. See section 9.3 below for further discussion on the requirements relating to contract costs in the standard.

Certain requirements in IFRS 15 are also relevant for the recognition and measurement of a gain or loss on the disposal of a non-financial asset not in the ordinary course of business (see section 2.6.3 below and see section 2.3 below for further discussion on determining whether a transaction is part of an entity's ordinary activities).

Entities sometimes enter into transactions with suppliers that result in the entity receiving consideration from a supplier (or from other parties that sell the goods or services to the supplier). In these situations, entities need to apply judgement to determine whether they need to account for the consideration received as revenue in accordance with the relevant standard (e.g., IFRS 15, IFRS 16 or IFRS 9), a reimbursement of a cost incurred on behalf of a supplier, or a reduction of costs of goods or services acquired. For further discussion on this topic, refer to our publication *Applying IFRS: Accounting for Payments from Suppliers*.[13]

2.3 Definition of a customer

The standard defines a customer as "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration". *[IFRS 15 Appendix A]*. IFRS 15 does not define the term 'ordinary activities' because it was derived from the definitions of revenue in the respective conceptual frameworks of the IASB and the FASB in effect when the standards were developed. In particular, the description of revenue in the IASB's *Conceptual Framework for Financial Reporting* at that time referred specifically to the 'ordinary activities' of an entity - *[CF(2010) 4.29]* - and the definition of revenue in the FASB's (now superseded) Statement of Financial Accounting Concepts No. 6, which referred to the notion of an entity's 'ongoing major or central operations'.[14] In many transactions, a customer is easily identifiable. However, in transactions involving multiple parties, it might be less clear which counterparties are customers of the entity. For some arrangements, multiple parties could all be considered customers of the entity, while in other arrangements only some of the parties involved are considered customers.

During times of geopolitical and economic uncertainty, governments might grant wide-ranging assistance, particularly if there are restrictions on business activities. Identifying whether there is vendor-customer relationship might be challenging if the counterparty in an arrangement is the government or a similar body. To determine the appropriate IFRS accounting standard to apply, an entity needs to consider all relevant facts and circumstances to understand whether there is an exchange transaction arising from a vendor-customer relationship (to which IFRS 15 applies) or if, for example, the entity is receiving government assistance or a grant (as defined in IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*). Factors to consider would include, but not be limited to, whether the government (or similar body) is providing assistance to the entity or to its customer (e.g., by paying the entity on a customer's behalf), and whether the government (or similar body) is providing assistance in their capacity as the government (or similar body) or as the entity's customer. An entity with an existing vendor-customer relationship with a government or similar body also needs to evaluate whether any additional assistance is a modification of a customer contract under IFRS 15. See section 3.4 below for contract modifications.

13 Available on ey.com/IFRS.

14 US GAAP, *Statement of Financial Accounting Concepts (CON) No. 6* (2021), paragraph 78. In December 2021, the FASB superseded CON 6 with CON 8 which defines revenue as "inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities." However, the definition of revenue in ASC 606 did not change.

The Illustration below shows how the party considered to be the customer might differ, depending on the specific facts and circumstances:

Illustration 2-3: Identification of a customer

An entity provides internet-based advertising services to companies. As part of those services, the entity purchases banner-space on various websites from a selection of publishers. For certain contracts, the entity provides a sophisticated service of matching the ad placement with the pre-identified criteria of the advertising party (i.e., the customer). In addition, the entity pre-purchases the banner-space from the publishers before it finds advertisers for that space. Assume that the entity appropriately concludes it is acting as the principal in these contracts (see section 4.4 below for further discussion on principal versus agent considerations). Accordingly, the entity identifies that its customer is the advertiser to whom it is providing services.

In other contracts, the entity simply matches advertisers with the publishers in its portfolio, but the entity does not provide any sophisticated ad-targeting services or purchase the advertising space from the publishers before it finds advertisers for that space. Assume that the entity appropriately concludes it is acting as the agent in these contracts. Accordingly, the entity identifies that its customer is the publisher to whom it is providing services.

In addition, the identification of the performance obligations in a contract (discussed further in section 4 below) can have a significant effect on the determination of which party is the entity's customer. Also see the discussion of the identification of an entity's customer when applying the application guidance on consideration paid or payable to a customer in section 5.7 below.

2.4 Collaborative arrangements

Entities often enter into collaborative arrangements to, for example, jointly develop and commercialise intellectual property such as a drug candidate in the life sciences industry or a motion picture in the entertainment industry. In such arrangements, a counterparty might not always be a 'customer' of the entity. Instead, the counterparty might be a collaborator or partner that shares in the risks and benefits of developing a product to be marketed. *[IFRS 15.6]*. This is common in the pharmaceutical, biotechnology, oil and gas, and health care industries. However, depending on the facts and circumstances, these arrangements might also contain a vendor-customer relationship component. Such contracts could still be within the scope of IFRS 15, at least partially, if the collaborator or partner meets the definition of a customer for some, or all, aspects of the arrangement. If the collaborator or partner is not a customer, the transaction is not within the scope of IFRS 15. An example of transactions between collaborators or partners not being within the scope of IFRS 15 was discussed by the IFRS IC in March 2019; it related to the output to which an entity is entitled from a joint operation, but which the entity has not yet received and sold to its customers (see Question 2-12 in section 2.5 below).

The IASB decided not to provide additional application guidance for determining whether certain revenue-generating collaborative arrangements are within the scope of IFRS 15. In the Basis for Conclusions, the IASB explained that it would not be possible to provide application guidance that applies to all collaborative arrangements. *[IFRS 15.BC54]*. Therefore, the parties to such arrangements need to consider all facts and circumstances to determine whether a vendor-customer relationship exists that is subject to the standard.

However, the IASB did determine that, in some circumstances, it might be appropriate for an entity to apply the principles in IFRS 15 to collaborations or partnerships (e.g., when there are no applicable or more relevant requirements that could be applied). *[IFRS 15.BC56]*.

How we see it

Identifying the customer can be difficult, especially when multiple parties are involved in a transaction. This evaluation might require significant judgement and IFRS 15 does not provide many factors to consider.

Furthermore, transactions among partners in collaboration arrangements are not within the scope of IFRS 15. Therefore, entities need to use judgement to determine whether transactions are between partners acting in their capacity as collaborators or reflect a vendor-customer relationship.

2.5 Interaction with other IFRS accounting standards

The standard provides requirements for arrangements partially within the scope of IFRS 15 and partially within the scope of other IFRS accounting standards that apply to contracts with customers, as follows: *[IFRS 15.7]*

Extract from IFRS 15

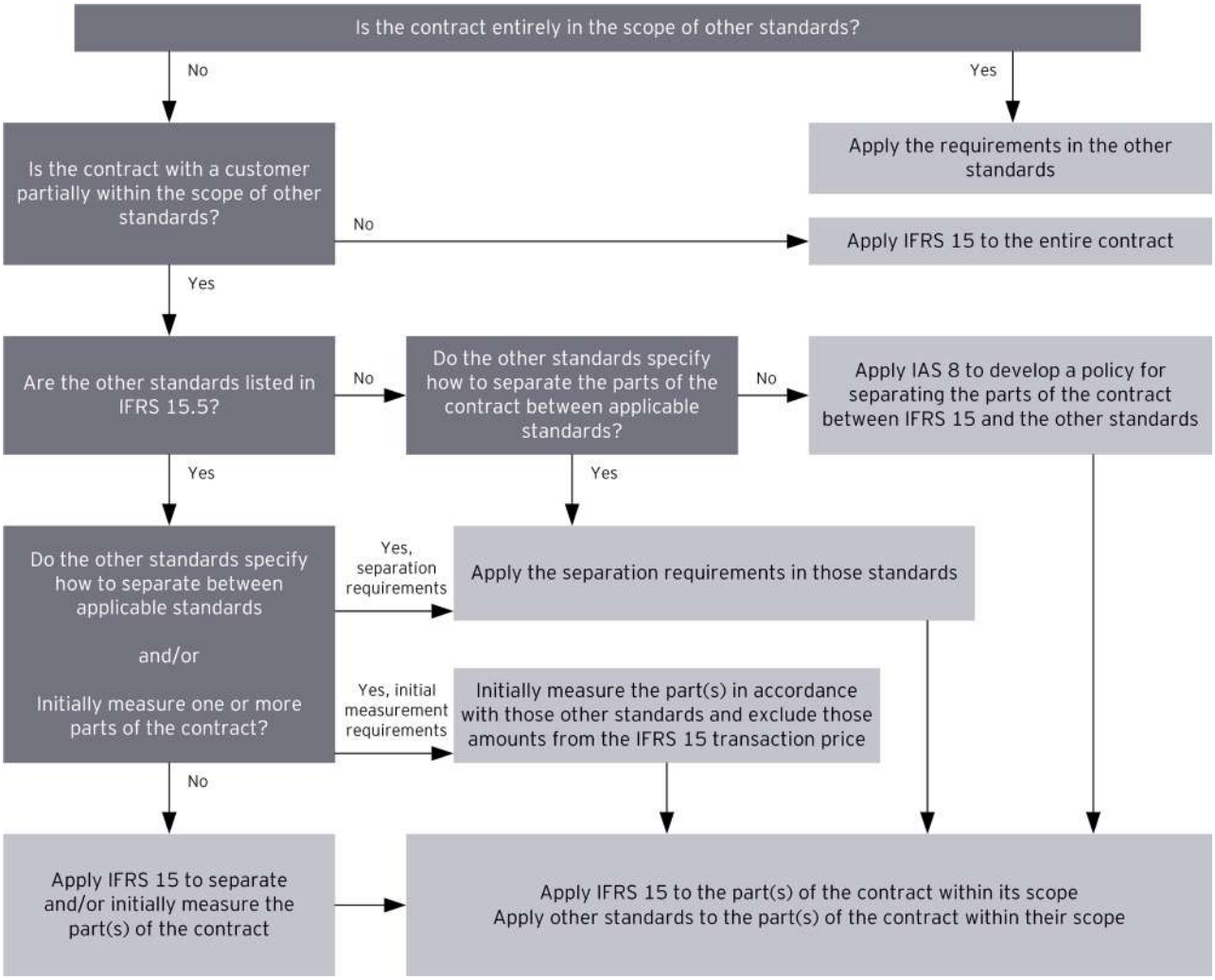
7 A contract with a customer may be partially within the scope of this Standard and partially within the scope of other Standards listed in paragraph 5.

(a) If the other Standards specify how to separate and/or initially measure one or more parts of the contract, then an entity shall first apply the separation and/or measurement requirements in those Standards. An entity shall exclude from the transaction price the amount of the part (or parts) of the contract that are initially measured in accordance with other Standards and shall apply paragraphs 73-86 to allocate the amount of the transaction price that remains (if any) to each performance obligation within the scope of this Standard and to any other parts of the contract identified by paragraph 7(b).

(b) If the other Standards do not specify how to separate and/or initially measure one or more parts of the contract, then the entity shall apply this Standard to separate and/or initially measure the part (or parts) of the contract.

The requirements in IFRS 15.7 are only applicable to contracts that are partially within the scope of IFRS 15 and partially within the scope of any of the other IFRS accounting standards that are listed in IFRS 15.5. That is, the scope of IFRS 15.7 is narrow and not applicable to all contracts that might be partially within the scope of IFRS 15. *[IFRS 15.5, IFRS 15.7]*. Figure 2-1 below illustrates these requirements.

Figure 2-1: Interactions with other IFRS accounting standards



Consider the following example:

Illustration 2-4: Transactions that might be in the scope of multiple IFRS accounting standards

A bank, Company A, offers credit cards to consumers. The credit cards provide lending facilities that allow cardholders to make purchases on deferred payment terms. Cardholders pay an annual fee to obtain a credit card, and in return are entitled to ancillary services, such as concierge services. In addition, Company A provides guarantees to cardholders in respect of goods or services purchased using the credit card.

Company A must consider whether this contract is entirely, or partially, within the scope of one, or multiple, other IFRS accounting standards before it assesses whether IFRS 15 applies. For example, the guarantee provided to cardholders might give rise to an insurance contract that needs to be accounted for by applying IFRS 17 (see Chapter 51 at section 2.3.1.D). Furthermore, Company A must determine whether the fees and other features of the credit card arrangement are within the scope of IFRS 9 (see Chapter 41 at section 2.3.4). Only any remaining components of the arrangement that are not in scope of any other IFRS accounting standards are accounted for by applying IFRS 15 (see Question 2-4 below), if in scope of that standard.

If a component of the arrangement is covered by another IFRS accounting standard that is listed in IFRS 15.5 (for example, IFRS 9 or IFRS 17 in Illustration 2-4 above) and that other IFRS accounting standard specifies how to separate and/or initially measure that component, an entity needs to first apply that standard. The Board noted in the Basis for Conclusions that, "the more specific Standard would take precedence in accounting for a part of a contract …". *[IFRS 15.BC66]*. An entity then applies IFRS 15 to the remaining components of the arrangement. Some examples of where separation and/or initial measurement are addressed in other IFRS accounting standards include the following:

- IFRS 9 generally requires that a financial instrument be recognised at fair value at initial recognition. For contracts that include the issuance of a financial instrument and revenue components within the scope of IFRS 15 and the financial instrument is required to be initially recognised at fair value, the fair value of the financial instrument is first measured and the remainder of the estimated contract consideration is allocated among the other components in the contract that are accounted for in accordance with IFRS 15.
- A contract might contain a lease coupled with an agreement to sell other goods or services (e.g., subject to IFRS 15). IFRS 16 requires that a lessor accounts separately for the lease component (in accordance with IFRS 16) and any non-lease components (in accordance with other IFRS accounting standards) and provides application guidance on separating the components of such a contract. *[IFRS 16.12, IFRS 16.B32, IFRS 16.B33]*. A lessor allocates the consideration in a contract that contains a lease component and one or more additional lease or non-lease components by applying the requirements in IFRS 15 for allocating the transaction price to performance obligations and changes in the transaction price after contract inception (see section 6 below). *[IFRS 16.17]*. Care might be needed in such an allocation if the lease term (under IFRS 16) and the contract duration (under IFRS 15) differ. Refer to Chapter 24 for more information on IFRS 16.

Conversely, if a component of the arrangement is covered by another IFRS accounting standard listed in IFRS 15.5, but that standard does not specify how to separate and/or initially measure that component, the entity needs to apply IFRS 15 to separate and/or initially measure each component. For example, specific requirements do not exist for the separation and measurement of the different parts of an arrangement when an entity sells a business and also enters into a long-term supply agreement with the other party. See section 6.6 below for further discussion on the effect on the allocation of arrangement consideration when an arrangement includes both revenue and non-revenue components.

As noted above, if a contract includes a component that is covered by another IFRS accounting standard or interpretation that is not listed in IFRS 15.5, the requirements of IFRS 15.7 do not apply. For example, an IFRS 15 contract with a customer might also include the disposal of property, plant and equipment (within the scope of IAS 16) or an intangible asset (within the scope of IAS 38 *Intangible Assets*). Another example might be an IFRS 15 contract with a customer that includes a government grant that falls within the scope of IAS 20. Since the requirements of IFRS 15.7 do not apply, if the other IFRS accounting standard or interpretation does not specify how to separate the components between standards or interpretations, an entity would need to apply the requirements in IAS 8 to develop an accounting policy to determine how to separate the parts of the contract between IFRS 15 and the other standard or interpretation. When developing its policy, an entity must, in accordance with IAS 8.11, refer to, and consider the applicability of requirements in IFRS accounting standards that deal with similar and related issues. *[IAS 8.11]*.

Frequently asked questions

Question 2-1: Before applying the financial instruments standards, are deferred-payment transactions that are part of Sharia-compliant instruments and transactions within the scope of the revenue standard?

(TRG meeting 26 January 2015 - Agenda paper no. 17)

Islamic financial institutions (IFIs) enter into Sharia-compliant instruments and transactions that do not result in IFIs earning interest on loans. Instead, these transactions involve purchases and sales of real assets (e.g., vehicles) on which IFIs can earn a premium to compensate them for deferred payment terms. Typically, an IFI makes a cash purchase of the underlying asset, takes legal possession, even if only for a short time, and immediately sells the asset on deferred payment terms. The financial instruments created by these transactions are within the scope of the financial instruments' standards.

At the January 2015 TRG meeting, the IASB TRG members discussed whether (before applying the financial instruments standards) deferred-payment transactions that are part of Sharia-compliant instruments and transactions are within the scope of IFRS 15. The IASB TRG members generally agreed that Sharia-compliant instruments and transactions might be outside the scope of the standard. However, the analysis depends on the specific facts and circumstances. This might require significant judgement as contracts often differ within and between jurisdictions. The FASB TRG members did not discuss this issue.

Question 2-2: Are certain fee-generating activities of financial institutions in the scope of the revenue standard (i.e., servicing and sub-servicing financial assets, providing financial guarantees and providing deposit-related services)?

(FASB TRG meeting 18 April 2016 - Agenda paper no. 52)

The FASB TRG members generally agreed that the standard provides a framework for determining whether certain contracts are in the scope of the FASB's standard, ASC 606, or other standards. While this was not specifically discussed by the IASB TRG, preparers that apply IFRS accounting standards might find the FASB TRG's discussions helpful in assessing whether certain contracts are within the scope of IFRS 15 or other standards.

As discussed above, under both IFRS accounting standards and US GAAP, the revenue standard's scope includes all contracts with customers to provide goods or services in the ordinary course of business, except for contracts with customers that are within the scope of certain other requirements that are listed as scope exclusions. If another accounting standard specifies the accounting for the consideration (e.g., a fee) received in the arrangement, the consideration is outside the scope of the revenue standard. If other standards do not specify the accounting for the consideration and there is a separate good or service provided, the consideration is in (or at least partially in) the scope of the revenue standard.

In considering this issue under US GAAP, the FASB staff applied the above framework in the TRG agenda paper to arrangements to service financial assets, provide financial guarantees and provide deposit-related services.

The FASB TRG members generally agreed that income from servicing financial assets (e.g., loans) is not within the scope of ASC 606. An asset servicer performs various services, such as communication with the borrower and payment collection, in exchange for a fee. The FASB TRG members generally agreed that an entity would look to ASC 860, *Transfers and Servicing*, to determine the appropriate accounting for these fees. This is because ASC 606 contains a scope exception for contracts that fall under ASC 860, which provides requirements on the recognition of the fees (despite not providing explicit requirements on revenue accounting).

The FASB TRG members generally agreed that fees from providing financial guarantees are not within the scope of ASC 606. A financial institution might receive a fee for providing a guarantee of a loan. These types of financial guarantees are generally within the scope of ASC 460, *Guarantees* or ASC 815, *Derivatives and Hedging*. The FASB TRG members generally agreed that an entity would look to ASC 460 or ASC 815 to determine the appropriate accounting for these fees. This is because ASC 606 contains a scope exception for contracts that fall within those topics, which provide principles an entity can follow to determine the appropriate accounting to reflect the financial guarantor's release from risk (and credit to earnings).

The FASB TRG members also generally agreed that fees from deposit-related services are within the scope of ASC 606. In contrast to the conclusions above for servicing income and financial guarantees, the guidance in ASC 405, *Liabilities*, that financial institutions apply to determine the appropriate liability accounting for customer deposits, does not provide a model for recognising fees related to customer deposits (e.g., ATM fees, account maintenance or dormancy fees). Accordingly, the FASB TRG members generally agreed that deposit fees and charges are within the scope of ASC 606, even though ASC 405 is listed as a scope exception in ASC 606, because of the lack of guidance on the accounting for these fees in ASC 405.

Question 2-3: Are contracts in which the consideration is in the form of incentive-based capital allocations within the scope of IFRS 15?

As discussed above, IFRS 15's scope includes all contracts with customers to provide goods or services in the ordinary course of business, except for contracts with customers that are within the scope of certain other requirements that are listed as scope exclusions. When a contract with a customer includes consideration in the form of incentive-based capital allocations, judgement might be needed to determine whether some (or all) of the contract is within the scope of another IFRS accounting standard (e.g., IFRS 9) or IFRS 15.

If the contract includes an embedded derivative, some (or all) of the consideration might be within the scope of IFRS 9 (see Chapter 42 at section 4.2.5). Assuming it is not an embedded derivative, if fund managers are entitled to incentive-based capital allocations in a contract with a customer in exchange for services that are within the scope of IFRS 15, the fees will be within the scope of IFRS 15 - that is, IFRS 15 applies irrespective of whether the consideration is cash or non-cash. *[IFRS 15.5, IFRS 15.6, IFRS 15.IE Example 25, IFRS 15.IE129-IE133].* If the incentive-based capital allocation is paid for another reason (e.g., part of distributions to equity investors), the fees will not be within the scope of IFRS 15, and other IFRS accounting standards would apply.

Question 2-4: Are credit card fees in the scope of the revenue standard?

(TRG meeting 13 July 2015 - Agenda paper no. 36)

A bank that issues credit cards can have various income streams (e.g., annual fees) from a cardholder under various credit card arrangements. Some of these fees might entitle cardholders to ancillary services (e.g., concierge services, airport lounge access). The card issuer might also provide rewards to cardholders based on their purchases. At the July 2015 TRG meeting, the TRG members discussed a question raised by US GAAP stakeholders regarding whether such fees and programmes are within the scope of the revenue standard, particularly when a good or service is provided to a cardholder.

While this question was only raised by US GAAP stakeholders, the IASB TRG members generally agreed that a preparer that applies IFRS accounting standards first needs to determine whether the credit card fees are within the scope of IFRS 9. IFRS 9 requires that any fees that are an integral part of the effective interest rate for a financial instrument be treated as an adjustment to the effective interest rate. Conversely, any fees that are not an integral part of the effective interest rate of the financial instrument are generally accounted for under IFRS 15.

The FASB TRG members generally agreed that credit card fees that are accounted for under ASC 310, *Receivables* are not in the scope of ASC 606. This includes annual fees that might entitle cardholders to ancillary services. The FASB TRG members noted that this conclusion is consistent with legacy US GAAP requirements for credit card fees. However, the observer from the US SEC noted that the nature of the arrangement must truly be that of a credit card lending arrangement in order to be in the scope of ASC 310. As such, entities need to continue evaluating their arrangements as new programmes develop. Credit card fees could, therefore, be treated differently under IFRS accounting standards and US GAAP.

Question 2-5: Are rewards programmes linked to financial instruments (e.g., credit cards) in the scope of the revenue standard?

(TRG meeting 13 July 2015 - Agenda paper no. 36)

Loyalty programmes might be linked to credit card arrangements or fixed-odds wagering contracts that are in the scope of IFRS 9. In those scenarios, the question is whether the loyalty programmes fall within the scope of IFRS 15.

The FASB TRG members discussed whether cardholder rewards programmes are within the scope of ASC 606. They generally agreed that if all consideration (i.e., credit card fees discussed in Question 2-4 above) related to the rewards programme is determined to be within the scope of ASC 310, the rewards programme is not in the scope of ASC 606. However, this determination has to be made based on the facts and circumstances due to the wide variety of credit card reward programmes offered.

While the IASB TRG members did not discuss this issue because the question was only raised in relation to US GAAP, as noted above, credit card reward programmes can vary significantly, for example, some include cash-back rewards, others involve the use of loyalty points. Similarly, some entities that offer fixed-odds wagering contracts to customers have established customer loyalty programmes, where customers earn loyalty points on their gambling activities, for example as a fixed percentage of the amounts spent by a customer. Such loyalty points, with a fixed expiry period, can typically be redeemed for on-site goods or services, such as food, beverages or hotel accommodation.

To determine the applicable IFRS accounting standard(s), entities need to carefully assess the nature of the promise to cardholders. This evaluation would consider contractual obligations to cardholders as well as any implied promises to provide incentives.

If an entity determines that such programmes are within the scope of IFRS 15, depending on the programme, the requirements for consideration payable to customers (which includes a customer's customer) and/or the application guidance for customer options for additional goods or services may be relevant.

Question 2-6: Are fixed-odds wagering contracts within the scope of the revenue standard?

In fixed-odds wagering contracts, the payout for wagers placed on gambling activities (e.g., table games, slot machines, sports betting) is known at the time the wager is placed. Under IFRS accounting standards, consistent with a July 2007 IFRS IC agenda decision, wagers that meet the definition of a derivative are within the scope of IFRS 9. Those that do not meet the definition of a derivative are within the scope of IFRS 15.

FASB differences

Under US GAAP, fixed-odds wagering arrangements are within the scope of ASC 606.

Question 2-7: Are pre-production activities in the scope of the revenue standard?

Manufacturing and production entities in various industries might perform activities and incur costs before they produce goods. In some arrangements (including long-term supply arrangements), entities perform upfront engineering and design activities and/or incur costs related to set-up activities to create new technology or adapt existing technology according to the needs of the customer. These pre-production activities are often a prerequisite to delivering any units under a production contract.

Entities need to evaluate whether the pre-production activities are promises in a contract with a customer (and potentially performance obligations) under IFRS 15. When making this evaluation, entities need to determine whether the activities transfer a good or service to a customer. Refer to Question 4-1 in section 4.1.1 below for further discussion on determining whether pre-production activities are promised goods or services under IFRS 15. If an entity determines that these activities are promised goods or services, it will apply the requirements in IFRS 15 to those goods or services. Also see Question 4-1 in section 4.1.1 below and Questions 9-18 and 9-19 in section 9.3.2 below for a discussion of scope and accounting considerations for costs related to pre-production activities and pre-contract or set-up activities, respectively.

Question 2-8: Are sales of by-products or scrap materials in the scope of the revenue standard?

Consider an example in which a consumer products entity sells by-products or accumulated scrap materials that are produced as a result of its manufacturing process. In determining whether the sale of by-products or scrap materials to third parties is in the scope of IFRS 15, an entity first determines whether the sale of such items is an output of the entity's ordinary activities. This is because IFRS 15 defines revenue as "income arising in the course of an entity's ordinary activities". *[IFRS 15 Appendix A]*. If an entity determines the sale of such items represents revenue from a contract with a customer, it would generally recognise the sale under IFRS 15.

If an entity determines that such sales are not in the course of its ordinary activities, the entity would recognise those sales separately from revenue from contracts with customers because they represent sales to non-customers.

How we see it

We do not believe that it would be appropriate for an entity to recognise the sale of by-products or scrap materials as a reduction of cost of goods sold. This is because recognising the sale of by-products or scrap materials as a reduction of cost of goods sold might inappropriately reflect the cost of raw materials used in manufacturing the main product. However, this interpretation would not apply if other IFRS accounting standards allow for recognition as a reduction of costs.

IAS 2 *Inventories* requires that the costs of conversion of the main product and the by-product be allocated between the products on a rational and consistent basis. *[IAS 2.14]*. However, IAS 2 mentions that most by-products, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

In our view, the language in IAS 2 only relates to the allocation of the costs of conversion between the main product and by-product and does not allow the proceeds from the sale of by-products to be presented as a reduction of cost of goods sold.

Question 2-9: Are the sales of prepaid gift cards within the scope of IFRS 15?

Entities might sell prepaid gift cards in their normal course of business in exchange for cash. The prepaid gift cards typically provide the customer with the right to redeem those cards in the future for goods or services of the entity and/or third parties. For any unused balance of the prepaid gift cards, entities need to recognise a liability that will be released upon redemption of that unused balance. However, the features of each prepaid gift card might vary and the nature of the liability depends on the assessment of these features. Entities might need to use judgement in order to determine whether the prepaid gift card is within the scope of IFRS 15 or another IFRS accounting standard.

Prepaid gift cards that give rise to financial liabilities are within the scope of IFRS 9 (see Chapter 41). If a prepaid gift card does not give rise to a financial liability, it is likely to be within the scope of IFRS 15. For further guidance on applying IFRS 15 to prepaid gift cards within its scope, refer to section 7.9 below.

An example of a prepaid gift card that is within the scope of IFRS 9 was discussed by the IFRS IC at its March 2016 meeting. The issue related to the accounting treatment of any unused balance on a prepaid card issued by an entity in exchange for cash as well as the classification of the relevant liability that arises. The discussion was limited to prepaid cards that have the specific features described in the request to the IFRS IC. In particular, the prepaid card:[15]

a. Has no expiry date and no back-end fees. That is, any unspent balance does not reduce unless it is spent by the cardholder

b. Is non-refundable, non-redeemable and non-exchangeable for cash

c. Can be redeemed only for goods or services to a specified monetary amount

And

d. Can be redeemed only at specified third-party merchants (the range of merchants accepting the specific card could vary depending on the card programme) and, upon redemption, the entity delivers cash to the merchant(s)

The IFRS IC observed that when an entity issues a prepaid card with the above features, it is contractually obliged to deliver cash to the merchants on behalf of the cardholder. Although this obligation is conditional upon the cardholder redeeming the card by purchasing goods or services, the entity's right to avoid delivering cash to settle this contractual obligation is not unconditional. On this basis, the IFRS IC concluded that the entity's liability for such a prepaid card meets the definition of a financial liability and would fall within the scope of IFRS 9 and IAS 32 *Financial Instruments: Presentation*. Entities might need to apply judgement to determine which IFRS accounting standard applies depending upon the specific facts and circumstances for scenarios other than the one discussed by the IFRS IC in its March 2016 meeting. The IFRS IC also noted in its agenda decision that its discussion on this issue did not include customer loyalty programmes.

Question 2-10: How does a utility entity determine whether a contract that includes a non-refundable upfront fee received for establishing a connection to a network (i.e., a connection fee) is within the scope of IFRS 15?

See response to Question 5-34 in section 5.8 below.

Question 2-11: Does an entity apply IFRS 10 or IFRS 15 to the sale of a corporate wrapper to a customer?

As part of their ordinary activities, entities might enter into contracts with customers to sell an asset by selling their equity interest in a separate entity (commonly referred to as a 'corporate wrapper' or 'single-asset entity') holding that asset (e.g., real estate), rather than by selling the asset itself. Entities might sell assets via a sale of equity interest in a corporate wrapper for tax or legal reasons or because of local regulation or business practice. Facts and circumstances might differ, for example, in relation to:

- When the corporate wrapper is created and the asset transferred into it
- When the entity enters into a contract with a customer
- If the asset is constructed by the entity, when construction starts
- When the equity interest in the corporate wrapper is legally transferred to the customer

In addition, a corporate wrapper could include only one asset (plus a related deferred tax asset or liability) or one or more other assets or liabilities, such as a financing liability.

15 *IFRIC Update*, March 2016, available on the IFRS Foundation's website.

Whether an entity needs to apply IFRS 10 or IFRS 15 to the sale of a corporate wrapper to a customer depends on facts and circumstances and might require significant judgement, including consideration of the following:

- IFRS 10 requires an entity that controls one or more entities (i.e., the parent) to present consolidated financial statements, with some limited exceptions, and sets out the requirements to determine whether, as an investor, it controls (and, therefore, must consolidate) an investee. A parent consolidates an entity that it controls (i.e., the subsidiary) from the date on which it first obtains control. It ceases consolidating that subsidiary on the date on which it loses control. *[IFRS 10.2, IFRS 10.4-4B, IFRS 10.20, IFRS 10 Appendix A]*. IFRS 10 also specifies how a parent accounts for the full or partial sale of a subsidiary. *[IFRS 10.25]*. See Chapters 7 and 8 for further discussion.[16]
- IFRS 15 excludes from its scope "… financial instruments and other contractual rights or obligations within the scope of … IFRS 10" (see section 2.1 above). *[IFRS 15.5(c)]*.

In practice, some entities apply IFRS 15 to all such contracts with customers because the transactions are part of the entity's ordinary activities and they believe doing so would better reflect the 'substance' of each transaction (e.g., the entity is 'in substance' selling the asset and not the equity interest; the structure is for legal, tax or risk reasons and they believe it does not affect the recognition of revenue).[17]

Judgement might also be needed in determining whether an investor controls the corporate wrapper. For example, the (selling) entity might act as an agent (in accordance with IFRS 10) in relation to the corporate wrapper based on the terms and conditions in the customer contract. IFRS 10 would not apply to the sale, if the entity does not control the corporate wrapper prior to sale.

In June 2019, the IFRS IC discussed a request about the accounting for a transaction in which an entity, as part of its ordinary activities, enters into a contract with a customer to sell real estate by selling its equity interest in a subsidiary. The entity established the subsidiary some time before it enters into the contract with the customer; the subsidiary has one asset (real estate inventory) and a related tax asset or liability. The entity has applied IFRS 10 in consolidating the subsidiary before it loses control of the subsidiary as a result of the transaction with the customer. The IFRS IC discussed this issue, but did not issue an agenda decision on this matter. Instead, the issue was referred to the IASB.

In October 2019, the IASB directed its staff to research the feasibility of narrow-scope standard setting. In June 2020, the IASB discussed a possible narrow-scope amendment that would have required an entity to apply IFRS 15, instead of IFRS 10, to sales of subsidiaries where all of the following apply:

- The entity contracts with a customer for goods or services that are the output of its ordinary activities in exchange for consideration
- The subsidiary contains only inventory and any related income tax asset or liability
- The entity retains no interest in the inventory transferred to the customer

The Board decided against proposing this amendment.[18]

During the discussions held by both the IFRS IC and the IASB, a number of members of the IFRS IC and the Board considered that, absent an amendment, IFRS 10 (rather than IFRS 15) would apply to the transaction considered. During the June 2020 discussion, some Board members thought there was merit in a narrow-scope amendment. However, concerns were raised about potential unintended consequences of proposing a narrow-scope amendment without a more comprehensive discussion. Any narrow-scope amendment would affect the scope of both IFRS 10 and IFRS 15 and, as such, Board members wanted to learn more from stakeholders about the need for, and the consequences of, such a project.[19] However, these considerations were not noted in the relevant IFRIC Update or IASB Update that were issued as summaries of the meetings. This matter was being considered as part of phase 2 of the post-implementation review (PIR) of IFRS 10. In June 2022, the Board assessed this matter as a low priority based on input received in the Third Agenda Consultation and concluded this topic could be explored if identified as a priority in the next agenda consultation. In the Request for Information for the PIR of IFRS 15 published in June 2023, the Board also explained that it decided against including the issue in the PIR, as any comprehensive solution would require significant resources and amendments to

16 IFRS 10.25-26 apply if a parent loses control of a subsidiary. IFRS 10.23-24 apply if a parent's ownership interest in a subsidiary changes without the parent losing control of that subsidiary.

17 IASB Staff Paper 6: IFRS IC Agenda Paper 6, Project: *Sale of a single asset entity containing real estate (IFRS 10)*, Paper topic: *Initial Consideration,* IFRS IC meeting, June 2019, paragraphs 15-16. Available on the IFRS Foundation's website.

18 *IASB Update*, June 2020; and IASB Staff Paper 12A: Project: *Maintenance and Consistent Application,* Paper topic: *Sale of a Subsidiary to a Customer*, IASB Meeting, June 2020. Available on the IFRS Foundation's website.

19 Project summary: *Sale of a Subsidiary to a customer*, IFRS Foundation's website, accessed on 8 August 2022.

several different IFRS accounting standards.[20] The Board confirmed, during its discussion of responses to the Request for Information for the PIR, that it would defer this issue to the next agenda consultation.[21] See Chapter 8 at sections 3.2.1 and 7.5 for further discussion.[22]

How we see it

Even though the deliberation process on this question has been completed, there might continue to be some diversity in practice. However, in the meantime, entities might need to consider the discussions on this matter as they determine the appropriate standard to apply to transactions with customers involving the loss of control of a single asset entity.

It is noted that the applicable IFRS accounting standard (i.e., IFRS 10 or IFRS 15) is not just a matter of presentation. That is, it might also affect, for example, the timing of recognition (i.e., point in time versus over time and, if point in time, the specific point in time) and the measurement of consideration (e.g., IFRS 10 does not constrain variable consideration). Furthermore, IFRS 10 provides specific requirements for the derecognition of all assets and liabilities of the former subsidiary on loss of control, which would not apply if the contract with the customer is within the scope of IFRS 15.

FASB differences

Under US GAAP, the sale of a corporate wrapper to a customer generally will be in the scope of ASC 606. However, the sale of a corporate wrapper to a counterparty that is not a customer might be in the scope of ASC 610-20, *Other Income - Gains and Losses from Derecognition of Nonfinancial Assets*, which applies to the recognition of gains or losses on transfers of non-financial assets and in-substance non-financial assets, including transfers of these assets when included in a consolidated subsidiary, that are not businesses, to counterparties that are not customers.

Question 2-12: Can a joint operator under IFRS 11 recognise as revenue under IFRS 15 amounts to which it is entitled as a joint operator that have not yet been sold to customers?

No. Revenue recognised in accordance with IFRS 15 must reflect an entity's performance in transferring a good or service to a customer.

Under IFRS 11, a joint operator is required to account for revenue relating to its interest in the joint operation (as defined in IFRS 11; see Chapter 13) by applying the IFRS accounting standards that are applicable to the particular revenue. *[IFRS 11.21]*. Therefore, while contracts with joint operators are excluded from the scope of IFRS 15, if revenue relating to an interest in a joint operation under IFRS 11 arises from a contract with a customer, it is recognised in accordance with IFRS 15.

As discussed in section 2.1 above, IFRS 15 applies only to contracts with customers. In addition, IFRS 11 requires a joint operator to recognise "its revenue from the sale of its share of the output arising from the joint operation". *[IFRS 11.20(c)]*. Therefore, revenue recognised by a joint operator must depict the output it has received from the joint operation and sold to customers, rather than the production of output or entitlement to output, as shown in Illustration 2-5 below.

This is consistent with the conclusion reached by the IFRS IC in March 2019. The IFRS IC discussed this issue using the following Illustration:[23]

Illustration 2-5: Interaction between IFRS 11 and IFRS 15 in recognising revenue relating to an interest in a joint operation

Operators A and B establish an unincorporated joint operation (JO) that they expect will produce output over a 2-year period. According to the joint operating agreement, each operator is entitled to receive 50% of the output arising from the JO's activities and obliged to pay for 50% of the production costs incurred. For operational reasons, the output received by each joint operator and transferred to its customers in any one reporting period is different from the output to which it is entitled. Any difference between the operators' entitlement and the output received will be settled through future deliveries of output arising from the JO, not in cash.

20 Request for Information: *Post-implementation Review of IFRS 15* Revenue from Contracts with Customers, IASB, June 2023; Spotlight 9.4 - IFRS 10 Consolidated Financial Statements, page 29.

21 *IASB Update*, April 2024; and *IASB Update*, July 2024. Both are available on the IFRS Foundation's website.

22 Project Report and Feedback Statement, *Post-implementation Review: IFRS 10* Consolidated Financial Statements, *IFRS 11* Joint Arrangements, *IFRS 12* Disclosure of Interests in Other Entities, IASB, June 2022. Available on the IFRS Foundation's website.

23 *IFRIC Update*, March 2019; and IASB Staff Paper 2: Project: *Output received by a joint operator (IFRS 11),* Paper topic: *Initial Consideration*, IFRS IC meeting, November 2018. Available on the IFRS Foundation's website.

Output from the JO's activities was CU100 in year 1 and CU150 in year 2. In Years 1 and 2, both operators paid for 50% of the production costs incurred.

	Operator A	Operator B
Year 1		
Entitlement to output	CU50	CU50
Output received and transferred to customers	(CU48)	(CU52)
Asset/(liability)	CU2	(CU2)
Year 2		
Entitlement to output	CU75	CU75
Output received and transferred to customers	(CU77)	(CU73)
	-	-

Operators A and B consider whether to recognise as revenue in each period: the entitlement to the output produced from the joint operation's activities; or the output that was received and transferred to its customers.

In this fact pattern, the IFRS IC concluded that, in accordance with IFRS 15, each joint operator recognises revenue to depict only the transfer of output to its customers in each reporting period. As such, if Operators A and B are entitled to output, but that output has not been received and sold to customers, they do not recognise revenue.

Therefore, Operator A recognises revenue from contracts with customers of CU48 in Year 1 and CU77 in Year 2. Similarly, Operator B recognises revenue from contracts with customers of CU52 in Year 1 and CU73 in Year 2.

Question 2-13: Are equity instruments issued by an entity to a customer in connection with a revenue arrangement within the scope of the revenue standard?

Whether or not an entity needs to apply IFRS 15 to a transaction in which equity instruments (e.g., shares) are issued to a customer in connection with a revenue arrangement depends on the substance and purpose of the transaction.

Many entities make payments to their customers. In some cases, the consideration paid or payable represents purchases by the entity of goods or services offered by the customer that satisfy a business need of the entity. In other cases, the consideration paid or payable represents incentives given by the entity to entice the customer to purchase, or continue purchasing, its goods or services.

According to IFRS 15.7, a contract with a customer may be partially within the scope of IFRS 15 and partially within the scope of other IFRS accounting standards. IFRS 15 does not specify whether equity instruments issued by an entity to a customer are a type of consideration paid or payable to customer. Nor does IFRS 2 *Share-based Payment* specifically address such transactions.

How we see it

Depending on the facts and circumstances, several standards (or a combination of standards) might be applicable (e.g., IFRS 2, IFRS 15, IAS 32). To determine the substance of the transaction and which standard(s) apply, entities will need to consider all relevant facts and circumstances, including the purpose of the transaction. Such determinations might require significant judgement.

FASB differences

Under US GAAP, equity instruments granted to customers in conjunction with the sale of goods or services (e.g., shares, options) are within the scope of the requirements for consideration payable to customers.[24]

24 ASU 2018-07 *Compensation - Stock Compensation (718): Improvements to Nonemployee Share-Based Payment accounting*.

2.6 Other income and other revenue

As income and revenue are defined broadly, not all income-generating transactions are in the scope of IFRS 15. As discussed in section 2.1 above, an entity applies IFRS 15 only to a contract in which the counterparty to the contract meets the definition of a customer (unless the contract is specifically excluded from the scope of IFRS 15 (see section 2.1 above for a list of scope exclusions)).

Below, we highlight some other items of income that are not within the scope of IFRS 15 and note whether they are covered by another IFRS accounting standard. Some of these items of income might represent other revenue (i.e., non-IFRS 15 revenue) if they are part of the entity's ordinary activities. For a further discussion of whether income outside the scope of IFRS 15 can be presented as revenue, please see Question 10-7 in section 10.2 below.

2.6.1 Income and distributable profits

In general, IFRS accounting standards do not address the issue of the distribution of profit. Whether or not revenue and gains recognised in accordance with IFRS accounting standards are distributable to shareholders of an entity will depend entirely on the national laws and regulations with which the entity needs to comply. Thus, income reported in accordance with IFRS accounting standards does not necessarily imply that such income would either be realised or distributable under a reporting entity's applicable national legislation.

2.6.2 Interest and dividends

Entities (e.g., financial institutions) might earn interest or dividends in the course of their ordinary activities and, therefore, present these transactions as revenue. The relevant recognition and measurement requirements are included in IFRS 9. These transactions are recognised, as follows:

- Interest: calculated by using the effective interest method *[IFRS 9 Appendix A, IFRS 9.5.4.1, IFRS 9.B5.4.1-B5.4.7]* as discussed in Chapter 46 at section 3.
- Dividends: when the shareholder's right to receive payment is established, it is probable that the economic benefits associated with the dividend will flow to the entity and the amount of the dividend can be measured reliably. *[IFRS 9.5.7.1A]*. See Chapter 46 at section 2.

2.6.3 Disposal of non-financial assets not in the ordinary course of business

When an entity disposes of an asset that is within the scope of IAS 16, IAS 38 or IAS 40 *Investment Property*, and that disposal is not part of the entity's ordinary activities, the transaction is within the scope of those standards, not IFRS 15. However, IAS 16, IAS 38 and IAS 40 require entities to use certain of the requirements of IFRS 15 when recognising and measuring gains or losses arising from the sale or disposal of non-financial assets.

IAS 16, IAS 38 and IAS 40 require that the gain or loss arising from the disposal of a non-financial asset be included in profit or loss when the item is derecognised, unless IFRS 16 requires otherwise on a sale and leaseback. IAS 16 and IAS 38 specifically prohibit classification of any such gain as revenue. *[IAS 16.68, IAS 38.113, IAS 40.69]*. This was reiterated by the IFRS IC in June 2020 in relation to the presentation of player transfer payments resulting from the sale of an intangible asset within the scope of IAS 38.[25] However, IAS 16 mentions an exception in the case of entities that are in the business of renting and subsequently selling the same assets (discussed in section 2.6.3.A below). *[IAS 16.68A, IAS 16.BC35C]*. IFRS 16 applies to disposal via a sale and leaseback. *[IAS 16.69, IAS 38.114, IAS 40.67]*.

The gain or loss on disposal of a non-financial asset is the difference between the net disposal proceeds, if any, and the carrying amount of the item. *[IAS 16.71, IAS 38.113, IAS 40.69]*. Under IAS 16 or IAS 38, if an entity applies the revaluation model for measurement after initial recognition, any revaluation surplus relating to the asset disposed of is transferred within equity to retained earnings when the asset is derecognised and not reflected in profit or loss. *[IAS 16.41, IAS 38.87]*.

25 *IFRIC Update*, June 2020, available on the IFRS Foundation's website.

As noted above, IAS 16, IAS 38 and IAS 40 provide a consistent model for the measurement and recognition of gains or losses on the sale or disposal of non-financial assets to non-customers (i.e., not in the ordinary course of business) by referring to the requirements in IFRS 15. For sales of non-financial assets to non-customers, IAS 16, IAS 38 and IAS 40 require entities to:

- Determine the date of disposal (and, therefore, derecognition of the asset) using the requirements in IFRS 15 for determining when a performance obligation is satisfied (i.e., Step 5 requirements, see section 7 below). *[IAS 16.69, IAS 38.114, IAS 40.67]*.
- Measure the consideration that is included in the calculation of the gain or loss on disposal in accordance with the requirements for determining the transaction price (i.e., Step 3 requirements, see section 5 below). Any subsequent changes to the estimate of the consideration (e.g., updates of variable consideration estimates, including reassessment of the constraint) are recognised in accordance with the requirements for changes in the transaction price. *[IAS 16.72, IAS 38.116, IAS 40.70]*. For example, if variable consideration is constrained at the time of disposal, it would not be recognised in profit or loss until it is no longer constrained, which could be in a subsequent period.

IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* provides additional requirements for assets that meet that standard's criteria to be classified as held for sale. These requirements include measurement provisions, which might affect the measurement of the amount of the subsequent gain or loss on disposal. These are discussed in Chapter 5 at section 2.2.

IFRS 10 specifies how a parent accounts for the full or partial disposal of a subsidiary (see Chapter 8 for further discussion).[26] The accounting treatment might, therefore, differ depending on whether a non-financial asset is sold on its own (in which case, IAS 16, IAS 38 or IAS 40 would apply) or included within a full or partial disposal of a subsidiary (in which case, IFRS 10 would apply). Where there is a retained interest in a former subsidiary, other IFRS accounting standards (such as IAS 28, IFRS 11 or IFRS 9) might also apply in accounting for the transaction.

Similar considerations might apply to disposals of non-financial assets held in a corporate wrapper that are in the ordinary course of business, since IFRS 15 excludes transactions within the scope of IFRS 10. See Question 2-11 in section 2.5 above for further discussion.

FASB differences

ASC 610-20 provides guidance under US GAAP on how to account for any gain or loss resulting from the sale of non-financial assets or in-substance non-financial assets that are not an output of an entity's ordinary activities and are not a business. ASC 610-20 requires entities to apply certain recognition and measurement principles of ASC 606. Sales or transfers of businesses or subsidiaries that do not contain solely non-financial assets and in-substance non-financial assets to non-customers are accounted for using the deconsolidation guidance in ASC 810, *Consolidation*.

2.6.3.A Sale of assets held for rental

In general, IAS 16 prohibits the classification of gains arising from the derecognition of property, plant and equipment as revenue. *[IAS 16.68A]*. However, for entities that are in the business of renting and subsequently selling the same asset, the IASB has agreed that the presentation of revenue, rather than a net gain or loss on the sale of the assets, would better reflect the ordinary activities of such entities. *[IAS 16.BC35C]*. See Chapter 19 at section 7.2 for further discussion.

Therefore, where an entity, in the course of its ordinary activities, routinely sells items of property, plant and equipment, that it has held for rental, to others, it is required to transfer the assets to inventories at their carrying amount when they cease to be rented and become held for sale. The proceeds from the sale of such assets are recognised as revenue in accordance with IFRS 15 on a gross basis. IFRS 5 does not apply when assets that are held for sale in the ordinary course of business are transferred to inventories. *[IAS 16.68A]*.

IAS 7 *Statement of Cash Flows* requires presentation within operating activities of cash payments to manufacture or acquire such assets and cash receipts from rents and sales of such assets. *[IAS 7.14]*. The requirements of IAS 7 are discussed further in Chapter 36.

26 IFRS 10.25-26 apply if a parent loses control of a subsidiary. IFRS 10.23-24 apply if a parent's ownership interest in a subsidiary changes without the parent losing control of that subsidiary.

2.6.4 Regulatory assets and regulatory liabilities

In many countries, the provision of utilities (e.g., water, natural gas or electricity) to consumers is regulated by a government agency (regulator). The objective of this rate regulation is to ensure "quality, quantity and availability of supply", as well as "stability, predictability and affordability of pricing" for "goods or services that governments consider essential for a reasonable quality of life for their citizens and for which there are significant barriers to effective competition for supply".[27] Regulations differ between countries, but regulators might operate a cost-plus system under which a utility is allowed to make a fixed return on investment. When there is a rate-adjustment mechanism to adjust the future price, a utility is allowed to charge its customers for variances between estimated and actual inputs to the rate calculation. Hence, this adjustment creates timing differences as the future price might be influenced by past cost levels and investment levels.

Under some national GAAPs (including US GAAP), accounting practices have been developed that allow an entity to account for the effects of regulation by recognising a 'regulatory liability' or 'regulatory asset' that reflects the decrease in future prices required by the regulator to compensate for an excessive return on investment, and *vice versa* where an increase would be permitted.

In September 2012, the Board decided to restart its rate-regulated activities project and issued a discussion paper in September 2014 aiming to develop an accounting model so that investors can compare the effects of rate regulation on the financial position, performance and cash flows of any entity with significant rate-regulated revenue.[28] As an interim measure, the IASB issued IFRS 14 *Regulatory Deferral Accounts* to help entities that currently recognise rate-regulated assets and liabilities under their national GAAP to adopt IFRS accounting standards. IFRS 14 permits a first-time adopter of IFRS accounting standards to continue to use its previous accounting policies for rate-regulated assets and liabilities, with specific disclosure requirements (see Chapter 6 for discussion on first-time adoption).

The Board is currently undertaking a standard-setting project to develop a new accounting model to provide users of financial statements with useful information about an entity's rights and obligations arising from a defined rate regulation that are not captured by existing requirements in IFRS accounting standards. On 28 January 2021, the Board issued the exposure draft *Regulatory Assets and Regulatory Liabilities*. The exposure draft set out proposals for the recognition, measurement, presentation and disclosure of regulatory assets, regulatory liabilities, regulatory income and regulatory expense.

Under the exposure draft, an entity would continue to apply existing IFRS accounting standards, including IFRS 15, without modification (i.e., customer contracts perspective). The proposed requirements would then be applied to provide information about the effects of the timing differences between when a transaction or event takes place and when the effects of that transaction or event are reflected in the rate (i.e., total allowed compensation perspective). The rights and obligations reflecting these timing differences that are incremental to those reported using existing IFRS accounting standards (e.g., IFRS 15) would then be recognised in the statement of financial position as a regulatory asset or regulatory liability.[29]

The Board completed its redeliberations of the proposals in response to the feedback it received on the exposure draft in July 2024.[30] At the time of writing, the Board was expected to issue a new IFRS accounting standard, which will replace IFRS 14, in the second half of 2025 with an effective date of 1 January 2029.[31] Until the new standard is issued and becomes effective, regulatory assets and liabilities are not eligible for recognition under IFRS accounting standards, unless the entity is a first-time adopter that can apply IFRS 14. For further details see Chapter 18 at section 11.1, Chapter 26 at section 2.2.2, and Chapter 27 at section 5.4.

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27 IASB Staff Paper 9A: Project: *Rate-regulated Activities*, Paper topic: *Background and summary of decisions to date*, IASB Meeting, July 2018, paragraph 5. Available on the IFRS Foundation's website.

28 Discussion Paper DP/2014/2: *Reporting the Financial Effects of Rate Regulation*, IASB, September 2014. Available on the IFRS Foundation's website.

29 Exposure Draft ED/2021/1: *Regulatory Assets and Regulatory Liabilities*, IASB, January 2021. Available on the IFRS Foundation's website.

30 *IASB Update*, July 2024, available on the IFRS Foundation's website.

31 *IFRS Foundation work plan*, IFRS Foundation website (accessed 30 July 2024).

3 IFRS 15 - Identify the contract with the customer

To apply the five-step model in IFRS 15, an entity must first identify the contract, or contracts, to provide goods or services to customers.

A contract must create enforceable rights and obligations to fall within the scope of the model in the standard. Such contracts might be written, oral or implied by an entity's customary business practices. For example, if an entity has an established practice of starting performance based on oral agreements with its customers, it might determine that such oral agreements meet the definition of a contract. *[IFRS 15.10]*.

As a result, an entity might need to account for a contract as soon as performance begins, rather than delay revenue recognition until the arrangement is documented in a signed contract. Certain arrangements might require a written contract to comply with laws or regulations in a particular jurisdiction. These requirements must be considered when determining whether a contract exists.

In the Basis for Conclusions, the Board acknowledged that entities need to look at the relevant legal framework to determine whether the contract is enforceable because factors that determine enforceability might differ among jurisdictions. *[IFRS 15.BC32]*. The Board also clarified that, while the contract must be legally enforceable to be within the scope of the model in the standard, all of the promises do not have to be enforceable to be considered performance obligations (see section 4.1 below). That is, a performance obligation can be based on the customer's valid expectations (e.g., due to the entity's business practice of providing an additional good or service that is not specified in the contract). In addition, the standard clarifies that some contracts have no fixed duration and can be terminated or modified by either party at any time. Other contracts automatically renew on a specified periodic basis. Entities are required to apply IFRS 15 to the contractual period in which the parties have present enforceable rights and obligations. *[IFRS 15.11]*. Contract enforceability and termination clauses are discussed in section 3.2 below.

Illustration 3-1: Oral contract

IT Support Co. provides online technology support for customers remotely via the internet. For a fixed fee, IT Support Co. will scan a customer's personal computer (PC) for viruses, optimise the PC's performance and solve any connectivity problems. When a customer calls to obtain the scan services, IT Support Co. describes the services it can provide and states the price for those services. When the customer agrees to the terms stated by the representative, payment is made over the telephone. IT Support Co. then gives the customer the information it needs to obtain the scan services (e.g., an access code for the website). It provides the services when the customer connects to the internet and logs onto the entity's website (which might be that day or a future date).

In this example, IT Support Co. and its customer are entering into an oral agreement, which is legally enforceable in this jurisdiction, for IT Support Co. to repair the customer's PC and for the customer to provide consideration by transmitting a valid credit card number and authorisation over the telephone. The required criteria for a contract with a customer (discussed further in section 3.1 below) are all met. As such, this agreement is within the scope of the model in the standard at the time of the telephone conversation, even if the entity has not yet performed the scanning services.

3.1 Attributes of a contract

To help entities determine whether (and when) their arrangements with customers are contracts within the scope of the model in the standard, the Board identified certain attributes that must be present, as follows: *[IFRS 15.9]*

- The parties have approved the contract and are committed to perform their respective obligations
- Each party's rights regarding the goods or services to be transferred can be identified
- Payment terms can be identified
- The contract has commercial substance
- It is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer

The Board noted in the Basis for Conclusions that it added the criteria because when some, or all, of the criteria are not met, it is questionable whether the arrangement contains enforceable rights and obligations. *[IFRS 15.BC33]*.These criteria are assessed at the inception of the arrangement. If the criteria are met at that time, an entity does not reassess these criteria unless there is an indication of a significant change in facts and circumstances. *[IFRS 15.13]*. For example, as noted in IFRS 15.13, if the customer's ability to pay significantly deteriorates, an entity would have to reassess whether it is probable that the entity will collect the consideration to which it is entitled in exchange for transferring the remaining goods or services under the contract. The updated assessment is prospective in nature and would not change the conclusions associated with goods or services already transferred. That is, an entity would not reverse any receivables, revenue or contract assets already recognised under the contract. *[IFRS 15.BC34]*.

If the criteria are not met (and until the criteria are met), the arrangement is not considered a revenue contract under the standard and the requirements discussed in section 3.5 below must be applied.

Example 4 in the standard provides an example of a significant change in facts and circumstances that results in the reassessment of the contract criteria in IFRS 15.9. *[IFRS 15.IE Example 4, IFRS 15.IE14-IE17]*.

Frequently asked questions

Question 3-1: Does a master supply arrangement (MSA) create enforceable rights and obligations to be considered a contract within the scope of the model in IFRS 15?

An entity might use an MSA to govern the overall terms and conditions of a business arrangement between itself and a customer (e.g., scope of services, pricing, payment terms, warranties and other rights and obligations). Typically, when an entity and a customer enter into an MSA, purchases are subsequently made by the customer by issuing a non-cancellable purchase order or an approved online authorisation that explicitly references the MSA and specifies the products, services and quantities to be delivered.

In such cases, the MSA is unlikely to create enforceable rights and obligations, which are needed to be considered a contract within the scope of the model in IFRS 15. This is because, while the MSA might specify the pricing or payment terms, it usually does not specify the specific goods or services, or quantities thereof, to be transferred. Therefore, each party's rights and obligations regarding the goods or services to be transferred are not identifiable. It is likely that the MSA and the customer order, taken together, would constitute a contract under IFRS 15. As such, entities need to evaluate both the MSA and the subsequent customer order(s) together to determine whether and when the criteria in IFRS 15.9 are met. *[IFRS 15.9]*.

If an MSA includes an enforceable clause requiring the customer to purchase a minimum quantity of goods or services, the MSA alone might constitute a contract under the standard because enforceable rights and obligations exist for this minimum amount of goods or services.

Question 3-2: How would an entity determine whether a contract exists within the scope of the model during a free trial period?

Free trial periods are common in certain subscription arrangements (e.g., magazines, streaming services). A customer might receive a number of 'free' months of goods or services at the inception of an arrangement; before the paid subscription begins; or as a bonus period at the beginning or end of a paid subscription period.

How we see it

Under IFRS 15, revenue is not recognised until an entity determines that a contract within the scope of the model exists. Once an entity determines that an IFRS 15 contract exists, it is required to identify the promises in the contract. Therefore, if the entity has transferred goods or services prior to the existence of an IFRS 15 contract, we believe that the free goods or services provided during the trial period would generally be accounted for as marketing incentives.

Consider an example in which an entity has a marketing programme to provide a three-month free trial period of its services to prospective customers. The entity's customers are not required to pay for the services provided during the free trial period and the entity is under no obligation to provide the services under the marketing programme. If a customer enters into a contract with the entity at the end of the free trial period that obliges the entity to provide services in the future (e.g., signing up for a subsequent 12-month period) and obliges the customer to pay for the services, the services provided as part of the marketing programme might not be promises that are part of an enforceable contract with the customer.

However, if an entity, as part of a negotiation with a prospective customer, agrees to provide three free months of services if the customer agrees to pay for 12 months of services (effectively providing the customer a discount on 15 months), the entity would identify the free months as promises in the contract because the contract requires it to provide them.

The above interpretation applies if the customer is not required to pay any consideration for the additional goods or services during the trial period (i.e., they are free). If the customer is required to pay consideration in exchange for the goods or services received during the trial period (even if it is only a nominal amount), a different accounting conclusion could be reached. Entities need to apply judgement to evaluate whether a contract exists that falls within the scope of the model in the standard.

Question 3-3: Do entities need to consider side agreements when determining whether a contract exists within the scope of the model?

All terms and conditions that create or negate enforceable rights and obligations must be considered when determining whether a contract exists under the standard. Understanding the entire contract, including any side agreements or other amendments, is critical to this determination.

Side agreements are amendments to a contract that can be either undocumented or documented separately from the main contract. The potential for side agreements is greater for complex or material transactions or when complex arrangements or relationships exist between an entity and its customers. Side agreements might be communicated in many forms (e.g., oral agreements, email, letters or contract amendments) and could be entered into for a variety of reasons.

Side agreements might provide an incentive for a customer to enter into a contract near the end of a financial reporting period or to enter into a contract that it would not enter into in the normal course of business. Side agreements might entice a customer to accept delivery of goods or services earlier than required or could provide the customer with rights in excess of those customarily provided by the entity. For example, a side agreement might extend contractual payment terms; expand contractually stated rights; provide a right of return; or commit the entity to provide future products or functionality not contained in the contract or to assist resellers in selling a product. Therefore, if the provisions in a side agreement differ from those in the main contract, an entity assesses whether the side agreement creates new rights and obligations or changes existing rights and obligations. See sections 3.3 and 3.4 below, respectively, for further discussion of the standard's requirements on combining contracts and contract modifications.

3.1.1 Parties have approved the contract and are committed to perform their respective obligations

Before applying the model in IFRS 15, the parties must have approved the contract. As indicated in the Basis for Conclusions, the Board included this criterion because a contract might not be legally enforceable without the approval of both parties. Furthermore, the Board decided that the form of the contract (i.e., oral, written or implied) is not determinative in assessing whether the parties have approved the contract. Instead, an entity must consider all relevant facts and circumstances when assessing whether the parties intend to be bound by the terms and conditions of the contract. In some cases, the parties to an oral or implied contract might have the intent to fulfil their respective obligations. However, in other cases, a written contract might be required before an entity can conclude that the parties have approved the arrangement. *[IFRS 15.10, IFRS 15.BC35]*.

In addition to approving the contract, the entity must be able to conclude that both parties are committed to perform their respective obligations. *[IFRS 15.9(a)]*. That is, the entity must be committed to providing the promised goods or services. In addition, the customer must be committed to purchasing those promised goods or services. In the Basis for Conclusions, the Board clarified that an entity and a customer do not always have to be committed to fulfilling all of their respective rights and obligations for a contract to meet this requirement. *[IFRS 15.BC36]*. The Board cited, as an example, a supply agreement between two parties that includes stated minimums. The customer does not always buy the required minimum quantity and the entity does not always enforce its right to require the customer to purchase the minimum quantity. In this situation, the Board stated that it might still be possible for the entity to determine that there is sufficient evidence to demonstrate that the parties are substantially committed to the contract. This criterion does not address a customer's intent and ability to pay the consideration (i.e., collectability). Collectability is a separate criterion and is discussed in section 3.1.5 below.

Termination clauses are also an important consideration when determining whether both parties are committed to perform under a contract and, consequently, whether a contract within the scope of the model in IFRS 15 exists. See section 3.2 below for further discussion of termination clauses and how they affect contract duration.

3.1.2 Each party's rights regarding the goods or services to be transferred can be identified

This criterion is relatively straightforward. If the goods or services to be provided in the arrangement cannot be identified, it is not possible to conclude that an entity has a contract within the scope of the model in IFRS 15. The Board indicated that if the promised goods or services cannot be identified, the entity cannot assess whether those goods or services have been transferred because the entity would be unable to assess each party's rights with respect to those goods or services. *[IFRS 15.BC37]*.

3.1.3 Payment terms can be identified

Identifying the payment terms does not require that the transaction price be fixed or stated in the contract with the customer. As long as there is an enforceable right to payment (i.e., enforceability as a matter of law) and the contract contains sufficient information to enable the entity to estimate the transaction price (see further discussion in section 5 below), the contract would qualify for accounting under the standard (assuming the remaining criteria set out in IFRS 15.9, discussed in section 3.1 above, have been met).

3.1.4 Commercial substance

The Board included a criterion that requires arrangements to have commercial substance (i.e., the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract) to prevent entities from artificially inflating revenue. *[IFRS 15.BC40]*. The model in IFRS 15 does not apply if an arrangement does not have commercial substance. Historically, some entities in high-growth industries allegedly engaged in transactions in which goods or services were transferred back and forth between the same entities in an attempt to show higher transaction volume and gross revenue (sometimes known as 'round-tripping'). This is also a risk in arrangements that involve non-cash consideration (e.g., barter transactions).

Determining whether a contract has commercial substance for the purposes of IFRS 15 could require significant judgement. In all situations, the entity must be able to demonstrate a substantive business purpose exists, considering the nature and structure of its transactions.

IFRS 15 does not contain requirements specific to advertising barter transactions. Entities need to carefully consider the commercial substance criterion when evaluating these types of transactions (see section 5.6.2 below for further discussion on barter transactions).

3.1.5 Collectability

Under IFRS 15, collectability refers to the customer's ability and intent to pay the amount of consideration to which the entity will be entitled in exchange for the goods or services that will be transferred to the customer. An entity needs to assess a customer's ability to pay based on the customer's financial capacity and its intention to pay considering all relevant facts and circumstances, including past experiences with that customer or customer class. *[IFRS 15.BC45]*.

In the Basis for Conclusions, the Board noted that the purpose of the criteria in IFRS 15.9 is to require an entity to assess whether a contract is valid and represents a genuine transaction. The collectability criterion (i.e., determining whether the customer has the ability and the intention to pay the promised consideration) is a key part of that assessment. In addition, the Board noted that, in general, entities only enter into contracts in which it is probable that the entity will collect the amount to which it will be entitled. *[IFRS 15.BC43]*. That is, in most instances, an entity would not enter into a contract with a customer if there was significant credit risk associated with that customer without also having adequate economic protection to ensure that it would collect the consideration. The IASB expects that only a small number of arrangements might fail to meet the collectability criterion. *[IFRS 15.BC46E]*.

IFRS 15.9(e) requires an entity to evaluate at contract inception whether it is *probable* that it will *collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to a customer*. An entity is also required to reassess collectability after contract inception, when significant facts and circumstances change (see Question 3-5 in section 3.1.5.B below for further discussion). We discuss each of the italicised concepts below:

- *Probable* - For purposes of this analysis, the meaning of the term 'probable' is consistent with the existing definition in IFRS accounting standards, i.e., "more likely than not". *[IFRS 5 Appendix A]*. If it is not probable that the entity will collect amounts to which it is entitled, the model in IFRS 15 is not applied to the contract until the concerns about collectability have been resolved. However, other requirements in IFRS 15 apply to such arrangements (see section 3.5 below for further discussion).
- *Consideration to which it will be entitled in exchange for the goods or services that will be transferred to a customer* - The amount of consideration that is assessed for collectability is the amount to which the entity will be entitled. That is, the amount of consideration assessed for collectability is often the transaction price, but it could be a lesser amount in certain circumstances, as discussed further below.

  It is important to note that the transaction price might be less than the stated contract price for the goods or services in the contract. Entities need to determine the transaction price in Step 3 of the model (as discussed in section 5 below) before assessing the collectability of that amount. The contract price and transaction price most often will differ because of variable consideration (e.g., rebates, discounts, or explicit or implicit price concessions) that reduces the amount of consideration stated in the contract. For example, the transaction price for the items expected to be transferred might be less than the stated contract price for those items if an entity concludes that it has offered, or is willing to accept, a price concession on products sold to a customer. See section 5.2.1.A below for further discussion on price concessions.

An entity deducts from the contract price any variable consideration that would reduce the amount of consideration to which it expects to be entitled (e.g., an estimated price concession) at contract inception in order to derive the transaction price for those items. The collectability assessment is then performed on the determined transaction price.

IFRS 15.9(e) specifies that an entity assesses only the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer (rather than the total amount promised for all goods or services in the contract). *[IFRS 15.9(e)]*. In the Basis for Conclusions, the Board noted that, if the customer were to fail to perform as promised and the entity were able to stop transferring additional goods or services to the customer in response, the entity would not consider the likelihood of payment for those goods or services that would not be transferred in its assessment of collectability. *[IFRS 15.BC46]*.

In the Basis for Conclusions, the Board also noted that the assessment of collectability criteria requires an entity to consider how the entity's contractual rights to the consideration relate to its performance obligations. That assessment considers the business practices available to the entity to manage its exposure to credit risk throughout the contract (e.g., through advance payments or the right to stop transferring additional goods or services). *[IFRS 15.BC46C]*.

In addition to the IFRS 15 collectability assessment, an entity has to assess any contract assets or trade receivables arising from an IFRS 15 contract under the expected credit loss model in IFRS 9 (for further discussion see section 10.1 below and Chapter 47).

How we see it

At contract inception, significant judgement is required to determine when an expected partial payment indicates that: (i) there is an implied price concession in the contract that affects the determination of the transaction price and the amount assessed for collectability under IFRS 15; (ii) there is an expected credit loss (accounted for as an impairment loss under IFRS 9); or (iii) the arrangement lacks sufficient substance to be considered a contract under the standard. See section 5.2.1.A below for further discussion on implicit price concessions.

FASB differences

ASC 606 also uses the term 'probable' for the collectability assessment. However, 'probable' under US GAAP is a higher threshold than under IFRS accounting standards.[32]

The FASB's standard includes additional guidance to clarify the intention of the collectability assessment. However, the IASB stated in the Basis for Conclusions on IFRS 15 that it does not expect differences in outcomes under IFRS and US GAAP in relation to the evaluation of the collectability criterion. *[IFRS 15.BC46E]*.

3.1.5.A Variable consideration versus credit risk

In the Basis for Conclusions on IFRS 15, the IASB acknowledged that in some cases, it might be difficult to determine whether the entity has implicitly offered a price concession (i.e., variable consideration) or whether the entity has chosen to accept the risk of default by the customer of the contractually agreed-upon consideration (i.e., impairment losses under IFRS 9). *[IFRS 15.BC194]*. The Board did not develop detailed guidance for distinguishing between price concessions (recognised as variable consideration through revenue) and an expected credit loss to be accounted for as an impairment loss under IFRS 9 (i.e., outside of revenue). Therefore, an entity needs to consider all relevant facts and circumstances when analysing situations in which, at contract inception, it is willing to accept a lower price than the amount stated in the contract. In section 5.2.1.A below, we discuss certain factors that might suggest the entity has implicitly offered a price concession to the customer.

After the entity has determined the amount to assess for collectability under IFRS 15.9(e), it also has to apply the requirements in IFRS 9 to account for any expected credit losses for the receivable (or contract asset) that is recorded (i.e., after consideration of any variable consideration, such as an implicit price concession). Also, it presents any resulting impairment loss as an expense under IFRS 9 (i.e., not as a reduction of the transaction price).

32 For US GAAP, the term 'probable' is defined in the master glossary of the US Accounting Standards Codification as "The future event or events are likely to occur".

Example 2 (included in section 5.2.1.A below), Example 3 and Example 23 (included in section 5.2.3 below) from the standard illustrate situations where the transaction price that is evaluated for collectability is not the amount stated in the contract. In contrast, the TRG discussed an example (included in Question 3-4 in section 3.1.5.B below) in which an entity, at contract inception, believes it is probable that its customers will pay amounts owed and the transaction price (i.e., revenue recorded) equals the contract price, even though, on a portfolio basis, 2% is not expected to be collected.

3.1.5.B Example of assessing the collectability criterion

The standard provides the following example of how an entity would assess the collectability criterion:
[IFRS 15.IE Example 1, IFRS 15.IE3-IE6]

Extract from IFRS 15

Example 1-Collectability of the consideration

An entity, a real estate developer, enters into a contract with a customer for the sale of a building for CU1 million[1]. The customer intends to open a restaurant in the building. The building is located in an area where new restaurants face high levels of competition and the customer has little experience in the restaurant industry.

The customer pays a non-refundable deposit of CU50,000 at inception of the contract and enters into a long-term financing agreement with the entity for the remaining 95 per cent of the promised consideration. The financing arrangement is provided on a non-recourse basis, which means that if the customer defaults, the entity can repossess the building, but cannot seek further compensation from the customer, even if the collateral does not cover the full value of the amount owed. The entity's cost of the building is CU600,000. The customer obtains control of the building at contract inception.

In assessing whether the contract meets the criteria in paragraph 9 of IFRS 15, the entity concludes that the criterion in paragraph 9(e) of IFRS 15 is not met because it is not probable that the entity will collect the consideration to which it is entitled in exchange for the transfer of the building. In reaching this conclusion, the entity observes that the customer's ability and intention to pay may be in doubt because of the following factors:

(a) the customer intends to repay the loan (which has a significant balance) primarily from income derived from its restaurant business (which is a business facing significant risks because of high competition in the industry and the customer's limited experience);

(b) the customer lacks other income or assets that could be used to repay the loan; and

(c) the customer's liability under the loan is limited because the loan is non-recourse.

Because the criteria in paragraph 9 of IFRS 15 are not met, the entity applies paragraphs 15-16 of IFRS 15 to determine the accounting for the non-refundable deposit of CU50,000. The entity observes that none of the events described in paragraph 15 have occurred-that is, the entity has not received substantially all of the consideration and it has not terminated the contract. Consequently, in accordance with paragraph 16, the entity accounts for the non-refundable CU50,000 payment as a deposit liability. The entity continues to account for the initial deposit, as well as any future payments of principal and interest, as a deposit liability, until such time that the entity concludes that the criteria in paragraph 9 are met (ie the entity is able to conclude that it is probable that the entity will collect the consideration) or one of the events in paragraph 15 has occurred. The entity continues to assess the contract in accordance with paragraph 14 to determine whether the criteria in paragraph 9 are subsequently met or whether the events in paragraph 15 of IFRS 15 have occurred.

1 In these examples monetary amounts are denominated in 'currency units' (CU).

Frequently asked questions

Question 3-4: How would an entity assess collectability for a portfolio of contracts?

(TRG meeting 26 January 2015 - Agenda paper no. 13)

The TRG members generally agreed that if an entity has determined it is probable that a customer will pay amounts owed under a contract, but the entity has historical experience that it will not collect consideration from some of the customers within a portfolio of contracts (see section 3.3.1 below), it would be appropriate for the entity to record revenue for the contract in full and separately evaluate the corresponding contract asset or receivable for impairment. That is, the entity would not conclude the arrangement contains an implicit price concession and would not reduce revenue for the uncollectable amounts. See section 5.2.1.A below for a discussion of evaluating whether an entity has offered an implicit price concession.

If an entity determines that collection is probable, that does not mean that the risk of an expected credit loss is zero. Entities still need to apply IFRS 9 to estimate the expected credit losses on contract assets or receivables resulting from the application of IFRS 15.

Consider the following Illustration based on the example included in the TRG agenda paper:

Illustration 3-2: Assessing collectability for a portfolio of contracts

An entity has a large volume of similar customer contracts for which it invoices its customers in arrears, on a monthly basis. Before accepting a customer, the entity performs procedures designed to determine if it is probable that the customer will pay the amounts owed. It does not accept customers if it is not probable that the customer will pay the amounts owed. Because these procedures are only designed to determine whether collection is probable (and, thus, not a certainty), the entity anticipates that it will have some customers that will not pay all of the amounts owed. While the entity collects the entire amount due from the vast majority of its customers, on average, the entity's historical evidence (which is representative of its expectations for the future) indicates that the entity will only collect 98% of the amounts invoiced.

In this case, the entity would recognise revenue for the full amount due. That is, when the entity satisfies the performance obligations in the contracts, it would recognise revenue of 100% of the amount due and a corresponding receivable for the same amount representing its unconditional right to the full consideration. It would then recognise an impairment loss in accordance with IFRS 9 for 2% of the amount due (i.e., the amount the entity does not expect to collect).

In this example, the entity concludes that collectability is probable for each customer based on procedures it performed prior to accepting each customer and on its historical experience with this customer class, while also accepting that there is some credit risk inherent with this customer class. Furthermore, the entity concludes that any amounts not collected do not represent implied price concessions. Instead, they are due to credit risk that is present in a limited number of customer contracts.

Some of the TRG members cautioned that the analysis to determine whether to recognise an impairment loss for a contract in the same period in which revenue is recognised (instead of reducing revenue for an anticipated price concession) will require judgement. Refer to Chapter 47 at section 10.1 for further information on estimating the expected credit loss on receivables and contract assets recognised as a result of the application of IFRS 15.

Question 3-5: When would an entity reassess collectability?

(TRG meeting 26 January 2015 - Agenda paper no. 13)

As discussed in section 3.1.5 above, IFRS 15.13 requires an entity to reassess whether it is probable that it will collect the consideration to which it will be entitled when significant facts and circumstances change. Example 4 in IFRS 15 illustrates a situation in which a customer's financial condition declines and its current access to credit and available cash on hand is limited. In this case, the entity does not reassess the collectability criterion. However, in a subsequent year, the customer's financial condition further declines after losing access to credit and its major customers. Example 4 in IFRS 15 illustrates that this subsequent change in the customer's financial condition is so significant that a reassessment of the criteria for identifying a contract is required, resulting in the collectability criterion not being met. *[IFRS 15.IE Example 4, IFRS 15.IE14-IE17]*. As noted in the TRG agenda paper, this example illustrates that it was not the Board's intent to require an entity to reassess collectability when changes occur that are relatively minor in nature (i.e., those that do not call into question the validity of the contract). The TRG members generally agreed that entities need to exercise judgement to determine whether changes in the facts and circumstances are significant enough to indicate that a contract no longer exists under the standard.[33]

Example 4 in the standard also notes that the entity accounts for any impairment of the existing receivable in accordance with IFRS 9 (see Chapter 47). *[IFRS 15.IE17]*.

33 TRG Agenda paper no. 25, *January 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 30 March 2015.

3.2 Contract enforceability and termination clauses

An entity has to determine the duration of the contract (i.e., the stated contractual term or a shorter period) before applying certain aspects of the revenue model (e.g., identifying performance obligations, determining the transaction price). The contract duration under IFRS 15 is the period in which parties to the contract have present enforceable rights and obligations. An entity cannot assume that there are present enforceable rights and obligations for the entire term stated in the contract and it is likely that an entity will have to consider enforceable rights and obligations in individual contracts, as described in the standard: *[IFRS 15.11]*

Extract from IFRS 15

11	Some contracts with customers may have no fixed duration and can be terminated or modified by either party at any time. Other contracts may automatically renew on a periodic basis that is specified in the contract. An entity shall apply this Standard to the duration of the contract (ie the contractual period) in which the parties to the contract have present enforceable rights and obligations.

The period in which enforceable rights and obligations exist might be affected by termination provisions in the contract. Significant judgement is required to determine the effect of termination provisions on the contract duration. Entities need to review the overall contractual arrangements, including any master service arrangements, wind-down provisions and business practices to identify terms or conditions that might affect the enforceable rights and obligations in their contracts.

Under the standard, this determination is critical because the contract duration to which the standard is applied might affect the number of performance obligations identified and the determination of the transaction price. It might also affect the amounts disclosed in some of the required disclosures. See Questions 3-6 to 3-8 in this section below for further discussion on how termination provisions might affect the contract duration.

If each party has the unilateral right to terminate a 'wholly unperformed' contract (as defined in IFRS 15.12) without compensating the counterparty, IFRS 15 states that, for purposes of the standard, a contract does not exist and its accounting and disclosure requirements would not apply. This is because the contracts would not affect an entity's financial position or performance until either party performs. Any arrangement in which the entity has not provided any of the contracted goods or services and has not received or is not entitled to receive any of the contracted consideration is considered to be a 'wholly unperformed' contract. *[IFRS 15.12]*.

The requirements for 'wholly unperformed' contracts do not apply if the parties to the contract have to compensate the other party if either of them exercises their right to terminate the contract and the termination payment is considered substantive, and all facts and circumstances related to the contract need to be considered.

Because the contract duration is determined on the basis of the period over which the parties to the contract have present enforceable rights and obligations, certain economic factors (e.g., economic compulsion) are not considered in this assessment because they do not create or modify the present enforceable rights and obligations of either party in the contract.

For example, consider a long-term contract between an entity and a customer that permits the customer to terminate the contract at any time without paying a substantive termination penalty. The entity believes that it is virtually certain that the customer will not terminate the contract because the customer's business relies on a good or service that only the entity can provide. However, when determining the duration of the contract, the entity would not consider the perceived economic compulsion on the customer's part because it does not create or modify any present enforceable rights and obligations. As a result, the contract would have a shorter duration than the stated term because the terminating party is not required to compensate the other party.

Similarly, if there are no contractual penalties (e.g., termination fees, monetary penalties for not meeting contractual minimums), the contract duration does not extend beyond the period in which both parties have present enforceable rights and obligations even when a customer is expected to be economically compelled to exercise an option for additional goods and services (e.g., the customer would forgo a substantial discount on the optional purchases if it were to cancel the contract). Rather, the discount on optional purchases is assessed to determine whether it conveys a material right. See Question 4-19 in section 4.6 below for further discussion.

How we see it

Under IFRS 15, entities are required to account for contracts with longer stated terms as month-to-month (or possibly a shorter duration) contracts if the parties can terminate the contract without penalty. When determining a contract's duration, entities need to carefully evaluate the contractual terms (including any substantive termination provisions) and the present enforceable rights and obligations of both parties. Certain economic factors (e.g., economic compulsion) are not relevant because they do not create or modify present enforceable rights and obligations of either party.

Frequently asked questions

Question 3-6: How do termination clauses and termination payments affect the duration of a contract (i.e., the contractual period)?

(TRG meeting 31 October 2014 - Agenda paper no. 10)

Entities need to carefully evaluate termination clauses and any related termination payments to determine how they affect contract duration (i.e., the period in which there are enforceable rights and obligations).

The TRG members generally agreed that enforceable rights and obligations exist throughout the term in which each party has the unilateral enforceable right to terminate the contract by compensating the other party. For example, if a contract includes a substantive termination payment, the duration of the contract would equal the period through which a termination penalty would be due. This could be the stated contractual term or a shorter duration if the termination penalty does not extend to the end of the contract. However, the TRG members observed that the determination of whether a termination penalty is substantive, and what constitutes enforceable rights and obligations under a contract, requires judgement and consideration of the facts and circumstances. The TRG agenda paper also noted that, if an entity concludes that the duration of the contract is less than the stated term because of a termination clause, any termination penalty needs to be included in the transaction price. If the termination penalty is variable, the requirements for variable consideration, including the constraint (see section 5.2.3 below), apply.

The TRG members also agreed that if a contract with a stated contractual term can be terminated by either party at any time for no consideration, the contract duration ends when control of the goods or services that have already been provided transfers to the customer (e.g., a month-to-month service contract), regardless of the contract's stated contractual term. In this case, entities also need to consider whether a contract includes a notification or cancellation period (e.g., the contract can be terminated with 90 days' notice) that would cause the contract duration to extend beyond the date when control of the goods or services that have already been provided were transferred to the customer. If such a period exists, the contract duration would be shorter than the stated contractual term, but would extend beyond the date when control of the goods or services that have already been provided were transferred to the customer. Consider the following Illustrations that show how termination provisions affect the duration of a contract:

Illustration 3-3: Determining the duration of the contract

Entity A enters into a four-year service contract with a customer. The customer is required to pay a non-refundable annual fee of CU100,000, which is the stand-alone selling price for each year of service.

To determine the duration of the contract in each of the scenarios below, the entity considers these facts and whether the contract provides cancellation rights and termination penalties.

Scenario A

Assume no cancellation rights are provided to either party. In this case, the enforceable rights and obligations exist for the entire stated contractual term and the contract duration is four years.

Scenario B

Assume the contract provides the customer with a right to cancel the contract at the end of each year without cause, but with a termination penalty. The penalty decreases annually throughout the contract term at the end of each year. The following illustrates the payments under the contract:

	Year 1	Year 2	Year 3	Year 4
Annual fee (CU)	100,000	100,000	100,000	100,000
Termination penalty (CU)	225,000	150,000	75,000	-

If Entity A determines that the penalty is substantive in each period, enforceable rights and obligations exist for the stated contractual term of four years.

Scenario C

Assume the contract provides the customer with a right to cancel at the end of each year, with no termination penalty.

In this case, Entity A determines that the contract duration is one year, with options to renew for each of the following three years because the customer can choose whether to receive the service during those years. That is, Entity A determines that enforceable rights and obligations do not exist throughout the entire stated contractual term because there is no substantive termination penalty. The options to renew are not material rights because they are offered at the stand-alone selling price of CU100,000.

Illustration 3-4: Duration of a contract without a termination penalty

Entity A enters into a three-year contract with a customer to provide maintenance services. Entity A begins providing the services immediately. Consideration is payable in equal monthly instalments and each party has the unilateral right to terminate the contract without compensating the other party if it provides 30 days' notice.

While the stated contractual term is three years, Entity A's rights and obligations are enforceable only for 30 days. Therefore, under IFRS 15, the contract is accounted for as a one-month contract with a renewal option for additional months of maintenance services. This is because the customer or Entity A could cancel the agreement with 30 days' notice without paying a substantive termination payment.

Entity A also needs to evaluate the accounting for the renewal option(s) to determine whether it is a material right (see section 4.6 below).

Question 3-7: How would an entity evaluate the contract term when only the customer has the right to cancel the contract without cause and how do termination penalties affect this analysis?

(TRG meeting 9 November 2015 - Agenda paper no. 48)

Enforceable rights and obligations exist throughout the term in which each party has the unilateral enforceable right to terminate the contract by compensating the other party. The TRG members did not view a customer-only right to terminate sufficient to warrant a different conclusion than one in which both parties have the right to terminate, as discussed in Question 3-6 above.

The TRG members generally agreed that a substantive termination penalty payable by a customer to the entity is evidence of enforceable rights and obligations of both parties throughout the period covered by the termination penalty. For example, consider a four-year service contract in which the customer has the right to cancel without cause at the end of each year, but for which the customer would incur a termination penalty that decreases each year and is determined to be substantive. TRG members generally agreed that the arrangement would be treated as a four-year contract. Refer to Illustration 3-3, Scenario B in Question 3-6 above.

The TRG members also discussed situations in which a contractual penalty for not meeting contractual minimums would result in including optional goods or services in the accounting for the original contract (see Question 4-21 in section 4.6 below).

The TRG members observed that the determination of whether a termination penalty is substantive, and what constitutes enforceable rights and obligations under a contract, requires judgement and consideration of the facts and circumstances. In addition, it is possible that payments that effectively act as a termination penalty and create or negate enforceable rights and obligations might not be labelled as such in a contract. The TRG agenda paper included an illustration in which an entity sells equipment and consumables. The equipment is sold at a discount, but the customer is required to repay some or all of the discount if it does not purchase a minimum number of consumables. The TRG paper concludes that the penalty (i.e., repaying the upfront discount) is substantive and is evidence of enforceable rights and obligations up to the minimum quantity. This example is discussed further in Question 4-21 of section 4.6 below.

If enforceable rights and obligations do not exist throughout the entire term stated in the contract, the TRG members generally agreed that customer cancellation rights would be treated as customer options. Examples include when there are no (or non-substantive) contractual penalties that compensate the entity upon cancellation and when the customer has the unilateral right to terminate the contract for reasons other than cause or contingent events outside the customer's control. In the Basis for Conclusions, the Board noted that a cancellation option or termination right can be similar to a renewal option. *[IFRS 15.BC391]*. An entity would need to determine whether a cancellation option indicates that the customer has a material right that would need to be accounted for as a performance obligation (e.g., there is a discount for goods or services provided during the cancellable period that provides the customer with a material right) (see section 4.6 below for further discussion on customer options and the determination of whether an option represents a material right).

Question 3-8: If an entity has a past practice of not enforcing termination payments, does this affect the duration of the contract (i.e., the contractual period)?

(TRG meeting 31 October 2014 - Agenda paper no. 10)

A TRG agenda paper for the October 2014 TRG meeting noted that the evaluation of the termination payment in determining the duration of a contract depends on whether the law (which might vary by jurisdiction) considers past practice as limiting the parties' enforceable rights and obligations. An entity's past practice of allowing customers to terminate the contract early without enforcing collection of the termination payment only affects the contract duration in cases in which the parties' legally enforceable rights and obligations are limited because of the lack of enforcement by the entity. If that past practice does not change the parties' legally enforceable rights and obligations, the contract duration equals the period throughout which a substantive termination penalty would be due (which could be the stated contractual term or a shorter duration if the termination penalty did not extend to the end of the contract).

Question 3-9: How would an entity account for a partial termination of a contract (e.g., a change in the contract term from three years to two years prior to the beginning of year two)?

How we see it

We believe an entity accounts for the partial termination of a contract as a contract modification (see section 3.4 below) because it results in a change in the scope of the contract.

IFRS 15 states that "a contract modification exists when the parties to a contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract". *[IFRS 15.18]*. A partial termination of a contract results in a change to the enforceable rights and obligations in the existing contract (also see Question 3-20 in section 3.4.2.C below regarding contract modifications that decrease the scope of a contract). This conclusion is consistent with TRG agenda paper no. 48, which states, "a substantive termination penalty is evidence of enforceable rights and obligations throughout the contract term. The termination penalty is ignored until the contract is terminated at which point it is accounted for as a modification".[34]

Consider the following Illustration:

Illustration 3-5: Partial termination of a contract

An entity enters into a contract with a customer to provide monthly maintenance services for three years at a fixed price of CU500 per month (i.e., total consideration of CU18,000). The contract includes a termination clause that allows the customer to cancel the third year of the contract by paying a termination penalty of CU1,000 (which is considered substantive for the purpose of this example). That is, the entity determines the contract duration is three years. However, at the end of the first year, the customer decides to cancel the third year of the contract and pays the CU1,000 termination penalty specified in the contract.

In this example, the modification is not accounted for as a separate contract because it does not result in the addition of distinct goods or services (see section 3.4.2 below). Since the remaining services are distinct, the entity applies the requirements in IFRS 15.21(a) and accounts for the modification prospectively. The remaining consideration of CU7,000 (CU6,000 per year under the original contract for the second year, plus the CU1,000 payment upon modification) is recognised over the remaining revised contract period of one year. That is, the entity recognises the CU1,000 termination penalty over the remaining performance period.

In contrast, if the entity determined that the termination penalty was not substantive, the contract duration would be two years (not the three-year stated term). As discussed in Question 3-6 above, because the entity concluded that the contract duration was less than the stated term due to a termination clause, the termination penalty would need to be included in the transaction price at contract inception. The penalty would effectively result in an adjusted price per month of CU542 for two years (i.e., total consideration of CU13,000 ÷ 24 months). Determining whether a termination penalty is substantive will require judgement and consideration of the facts and circumstances.

34 TRG Agenda paper no. 48, *Customer options for additional goods and services*, dated 9 November 2015, paragraph 47a.

Question 3-10: How is consideration that was received from a customer, but not yet recognised as revenue, accounted for when the contract is cancelled?

When a contract is cancelled (by either the customer or the entity), it is a contract modification that reduces the scope of the contract. As discussed in Question 3-9 above and Question 3-20 in section 3.4.2.C below, such a modification would not be accounted for as a separate contract because it does not result in the addition of distinct goods or services. Rather, the accounting will depend on whether there are any remaining goods and services to be provided after the cancellation and, if so, whether they are distinct from the goods and services already provided as discussed in section 3.4 below. That is, if a contract is cancelled but there are remaining goods and services to be provided, the entity applies the standard's contract modification requirements.

If there are no remaining goods and services to be provided after the cancellation, the accounting depends on whether the consideration is refundable or non-refundable. To determine whether consideration is refundable or non-refundable, entities might need to consider termination penalties, legal requirements for refund, customary business practices of providing refunds or statements made to customers that create a constructive or legal obligation to provide a refund.

If the consideration received from the customer is refundable and there are no remaining goods and services to be provided after the cancellation, the entity has a refund liability. This might require the entity to reclassify any existing contract liability to refund liability. In some cases, the entity might ask the customer to waive their right to a refund of the consideration in exchange for vouchers, for example, and/or discounts on future goods or services. The accounting for such offers (including the accounting for the liability) depends on the specific facts and circumstances and could require judgement.

How we see it

If the consideration received from the customer is non-refundable and there are no remaining goods and services to be provided after the cancellation, we believe that the entity can recognise revenue for the consideration received when the contract is cancelled, and the related contract liability would also be derecognised.

This accounting treatment is similar to the application guidance for breakage (e.g., for gift cards, see section 7.9 below) and the recognition of revenue for arrangements that fail the IFRS 15 contract criteria in accordance with IFRS 15.15 (see section 3.5 below). In both of those situations, IFRS 15 provides guidance that permits an entity to derecognise a liability and recognise revenue, provided the relevant criteria are met, when: the entity expects the customer will not exercise its contractual rights (for breakage); *[IFRS 15.B46]* or the contract is effectively completed or cancelled (for contracts that do not meet the contract criteria in IFRS 15.9). *[IFRS 15.15, IFRS 15.BC48]*.

In some cases, an entity might be entitled to termination fees in the event of cancellation. The accounting for termination fees is discussed in Question 3-9 above.

Question 3-11: How does an entity account for services provided during a period after contract expiration in which enforceable rights and obligations do not exist until the contract is renewed?

How we see it

If an entity continues to provide services to a customer during a period when a contract does not exist because a previous contract has expired and the contract has not yet been renewed, we believe that the entity would need to recognise revenue for providing those services on a cumulative catch-up basis at the time the contract is renewed (i.e., when enforceable rights and obligations exist between the entity and its customer).

As discussed in section 3.1 above, determining whether an enforceable contract exists under the model might require judgement and an evaluation of the relevant legal framework.

This approach to record revenue on a cumulative catch-up basis reflects the performance obligations that are partially satisfied at the time enforceable rights and obligations exist and is consistent with the overall principle of the standard that requires revenue to be recognised when (or as) an entity transfers control of goods or services to a customer under an enforceable contract. This conclusion is also consistent with the discussion in Question 7-20 in section 7.1.4.E below on the accounting for goods or services provided to a customer before the contract establishment date.

Consider the following Illustration:

Illustration 3-6: Services provided during a period after contract expiration

Entity A enters into a non-cancellable one-year contract with a customer on 1 January 20X1 to provide web-hosting services that are transferred to the customer over time. The total consideration of CU1,200 is payable upfront and is non-refundable. After the expiration of the contract, at its discretion, Entity A continues to provide web-hosting services to the customer for a limited time to allow the customer to contemplate renewing the contract. If the customer renews the contract, the pricing would include the web-hosting services provided during the period between the original contract expiration and the contract renewal.

The customer agrees to renew the contract on 1 February 20X2. Entity A agrees to provide web-hosting services from 1 January 20X2 to 31 December 20X2 for total consideration of CU1,200, which is payable on the renewal date. Entity A determines that enforceable rights and obligations exist on 1 February 20X2 and recognises revenue on a cumulative catch-up basis to reflect the entity's transfer of control of the web-hosting services for one month (i.e., January 20X2). Accordingly, Entity A recognises CU100 on 1 February 20X2 for the web-hosting services provided to the customer before the renewal date. The remaining consideration of CU1,100 is recognised from 1 February 20X2 to 31 December 20X2 as the entity performs.

An entity might receive consideration from the customer for the goods or services transferred before the existence of an enforceable contract. If so, the entity would need to follow the requirements in IFRS 15.14-16 (discussed in section 3.5 below). This requires that when an arrangement does not meet the criteria to be a contract under the standard, an entity would recognise the non-refundable consideration received as revenue only if one of the two events has occurred (e.g., the entity has no remaining obligations to transfer goods or services to the customer and all, or substantially all, of the consideration promised by the customer has been received by the entity and is non-refundable).

3.3 Combining contracts

In most cases, entities apply the model to individual contracts with a customer. However, the standard requires entities to combine contracts entered into at, or near, the same time with the same customer (or related parties of the customer as defined in IAS 24 *Related Party Disclosures*) if they meet one or more of the following criteria: *[IFRS 15.17, IFRS 15.BC74]*

- The contracts are negotiated together with a single commercial objective
- The consideration to be paid for one contract is dependent on the price or performance of another contract
- The goods or services promised in the contracts are a single performance obligation (see section 4 below)

In the Basis for Conclusions, the Board explained that it included the requirements on combining contracts in the standard because, in some cases, the amount and timing of revenue might differ depending on whether an entity accounts for contracts as a single contract or separately. *[IFRS 15.BC71]*.

Entities need to apply judgement to determine whether contracts are entered into at or near the same time because the standard does not provide a bright line for making this assessment. In the Basis for Conclusions, the Board noted that the longer the period between entering into different contracts, the more likely it is that the economic circumstances affecting the negotiations of those contracts will have changed. *[IFRS 15.BC75]*.

Negotiating multiple contracts at the same time is not sufficient evidence to demonstrate that the contracts represent a single arrangement for accounting purposes. In the Basis for Conclusions, the Board noted that there are pricing interdependencies between two or more contracts when either of the first two criteria (i.e., the contracts are negotiated with a single commercial objective or the price in one contract depends on the price or performance of the other contract) are met, so the amount of consideration allocated to the performance obligations in each contract might not faithfully depict the value of the goods or services transferred to the customer if those contracts were not combined.

The Board also explained that it decided to include the third criterion (i.e., the goods or services in the contracts are a single performance obligation) to avoid any structuring opportunities that would effectively allow entities to bypass the requirements for identifying performance obligations. *[IFRS 15.BC73]*. That is, an entity cannot avoid determining whether multiple promises made to a customer at, or near, the same time need to be bundled into one or more performance obligations in accordance with Step 2 of the model (see section 4 below) solely by including the promises in separate contracts.

3.3.1 Portfolio approach practical expedient

Under the standard, the five-step model is applied to individual contracts with customers, unless the contract combination requirements discussed in section 3.3 above are met. However, the IASB recognised that there might be situations in which it could be more practical for an entity to group contracts for revenue recognition purposes, rather than attempt to account for each contract separately. Specifically, the standard includes the following practical expedient: *[IFRS 15.4]*

Extract from IFRS 15

4	This Standard specifies the accounting for an individual contract with a customer. However, as a practical expedient, an entity may apply this Standard to a portfolio of contracts (or *performance obligations*) with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this Standard to the portfolio would not differ materially from applying this Standard to the individual contracts (or performance obligations) within that portfolio. When accounting for a portfolio, an entity shall use estimates and assumptions that reflect the size and composition of the portfolio.

In order to use the portfolio approach, an entity must reasonably expect that the accounting result will not be materially different from the result of applying the standard to the individual contracts. However, in the Basis for Conclusions, the Board noted that it does not intend for an entity to quantitatively evaluate every possible outcome when concluding that the portfolio approach is not materially different. Instead, they indicated that an entity would be able to take a reasonable approach to determine portfolios that are representative of its types of customers and that an entity needs to use judgement in selecting the size and composition of those portfolios. *[IFRS 15.BC69]*.

How we see it

Application of the portfolio approach will likely vary based on the facts and circumstances of each entity. An entity can choose to apply the portfolio approach to only certain aspects of the model (e.g., determining the transaction price in Step 3).

Frequently asked questions

Question 3-12: How would an entity assess collectability for a portfolio of contracts?

(TRG meeting 26 January 2015 - Agenda paper no. 13)

See response to Question 3-4 in section 3.1.5.B above.

3.4 Contract modifications

Parties to an arrangement frequently agree to modify the scope or price (or both) of their contract. If that happens, an entity must determine whether the modification is accounted for as a new contract or as part of the existing contract. Generally, it is clear when a contract modification has taken place, but in some circumstances, that determination is more difficult. To assist entities when making this determination, the standard states the following: *[IFRS 15.18, IFRS 15.19]*

Extract from IFRS 15

18 A contract modification is a change in the scope or price (or both) of a contract that is approved by the parties to the contract. In some industries and jurisdictions, a contract modification may be described as a change order, a variation or an amendment. A contract modification exists when the parties to a contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract. A contract modification could be approved in writing, by oral agreement or implied by customary business practices. If the parties to the contract have not approved a contract modification, an entity shall continue to apply this Standard to the existing contract until the contract modification is approved.

19 A contract modification may exist even though the parties to the contract have a dispute about the scope or price (or both) of the modification or the parties have approved a change in the scope of the contract but have not yet determined the corresponding change in price. In determining whether the rights and obligations that are created or changed by a modification are enforceable, an entity shall consider all relevant facts and circumstances including the terms of the contract and other evidence. If the parties to a contract have approved a change in the scope of the contract but have not yet determined the corresponding change in price, an entity shall estimate the change to the transaction price arising from the modification in accordance with paragraphs 50-54 on estimating variable consideration and paragraphs 56-58 on constraining estimates of variable consideration.

The extract above illustrates that the Board intended these requirements to apply more broadly than only to finalised modifications. That is, IFRS 15 indicates that an entity might have to account for a contract modification prior to the parties reaching final agreement on changes in scope or pricing (or both). Instead of focusing on the finalisation of a modification, IFRS 15 focuses on the enforceability of the changes to the rights and obligations in the contract. Once an entity determines the revised rights and obligations are enforceable, it accounts for the contract modification. Contract terminations (either partial or full) are also considered a form of contract modification under IFRS 15.

The standard provides the following example to illustrate the accounting for an unapproved modification: *[IFRS 15.IE Example 9, IFRS 15.IE42-IE43]*

Extract from IFRS 15

Example 9-Unapproved change in scope and price

An entity enters into a contract with a customer to construct a building on customer-owned land. The contract states that the customer will provide the entity with access to the land within 30 days of contract inception. However, the entity was not provided access until 120 days after contract inception because of storm damage to the site that occurred after contract inception. The contract specifically identifies any delay (including *force majeure*) in the entity's access to customer-owned land as an event that entitles the entity to compensation that is equal to actual costs incurred as a direct result of the delay. The entity is able to demonstrate that the specific direct costs were incurred as a result of the delay in accordance with the terms of the contract and prepares a claim. The customer initially disagreed with the entity's claim.

The entity assesses the legal basis of the claim and determines, on the basis of the underlying contractual terms, that it has enforceable rights. Consequently, it accounts for the claim as a contract modification in accordance with paragraphs 18-21 of IFRS 15. The modification does not result in any additional goods and services being provided to the customer. In addition, all of the remaining goods and services after the modification are not distinct and form part of a single performance obligation. Consequently, the entity accounts for the modification in accordance with paragraph 21(b) of IFRS 15 by updating the transaction price and the measure of progress towards complete satisfaction of the performance obligation. The entity considers the constraint on estimates of variable consideration in paragraphs 56-58 of IFRS 15 when estimating the transaction price.

Once an entity has determined that a contract has been modified, the entity determines the appropriate accounting treatment for the modification. Certain modifications are treated as separate stand-alone contracts (discussed in section 3.4.1 below), while others are combined with the original contract (discussed in section 3.4.2 below) and accounted for in that manner. In addition, an entity accounts for some modifications on a prospective basis and others on a cumulative catch-up basis. The Board explained that it developed different approaches to account for different types of modifications with an overall objective of faithfully depicting an entity's rights and obligations in each modified contract. *[IFRS 15.BC76]*.

The standard includes the following requirements for determining the appropriate accounting treatment: *[IFRS 15.20, IFRS 15.21]*

Extract from IFRS 15

20 An entity shall account for a contract modification as a separate contract if both of the following conditions are present:

(a) the scope of the contract increases because of the addition of promised goods or services that are distinct (in accordance with paragraphs 26-30); and

(b) the price of the contract increases by an amount of consideration that reflects the entity's stand-alone selling prices of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract. For example, an entity may adjust the stand-alone selling price of an additional good or service for a discount that the customer receives, because it is not necessary for the entity to incur the selling-related costs that it would incur when selling a similar good or service to a new customer.

21 If a contract modification is not accounted for as a separate contract in accordance with paragraph 20, an entity shall account for the promised goods or services not yet transferred at the date of the contract modification (ie the remaining promised goods or services) in whichever of the following ways is applicable:

(a) An entity shall account for the contract modification as if it were a termination of the existing contract and the creation of a new contract, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification. The amount of consideration to be allocated to the remaining performance obligations (or to the remaining distinct goods or services in a single performance obligation identified in accordance with paragraph 22(b)) is the sum of:

(i) the consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognised as revenue; and

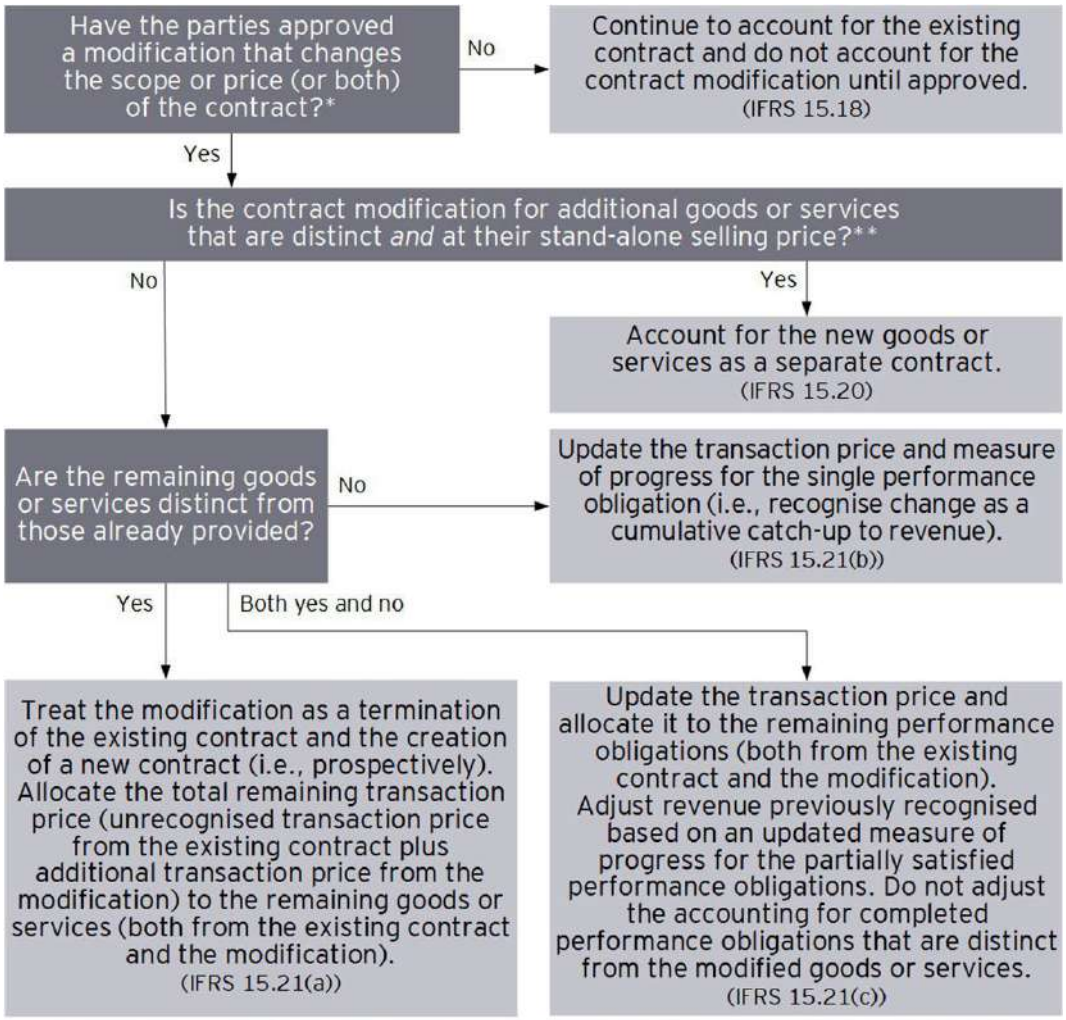
(ii) the consideration promised as part of the contract modification.

(b) An entity shall account for the contract modification as if it were a part of the existing contract if the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification. The effect that the contract modification has on the transaction price, and on the entity's measure of progress towards complete satisfaction of the performance obligation, is recognised as an adjustment to revenue (either as an increase in or a reduction of revenue) at the date of the contract modification (ie the adjustment to revenue is made on a cumulative catch-up basis).

(c) If the remaining goods or services are a combination of items (a) and (b), then the entity shall account for the effects of the modification on the unsatisfied (including partially unsatisfied) performance obligations in the modified contract in a manner that is consistent with the objectives of this paragraph.

The following flow chart illustrates these requirements:

Figure 3-1: Contract modifications



* Under IFRS 15, a contract modification can be approved in writing, by oral agreement or implied by customary business practices. IFRS 15.19 states that an entity may have to account for a contract modification prior to the parties reaching final agreement on changes in scope or pricing (or both), provided the rights and obligations that are created or changed by a modification are enforceable.

** In accordance with IFRS 15.20, an entity may make appropriate adjustments to the stand-alone selling price to reflect the circumstances of the contract and still meet the criteria to account for the modification as a separate contract.

When determining how to account for a contract modification, an entity must consider whether any additional goods or services are distinct, often giving careful consideration to whether those goods or services are distinct within the context of the modified contract (see section 4.2.1 below for further discussion on evaluating whether goods or services are distinct). That is, although a contract modification might add a new good or service that would be distinct in a stand-alone transaction, that new good or service might not be distinct when considered in the context of the contract, as modified. For example, in a building renovation project, a customer might request a contract modification to add a new room. The construction firm might commonly sell the construction of an added room on a stand-alone basis, which would indicate that the service is capable of being distinct. However, when that service is added to an existing contract and the entity has already determined that the entire project is a single performance obligation, the added goods or services would normally be combined with the existing bundle of goods or services.

In contrast to the construction example (for which the addition of otherwise distinct goods or services are combined with the existing single performance obligation and accounted for in that manner), a contract modification that adds distinct goods or services to a single performance obligation that comprise a series of distinct goods or services (see section 4.2.2 below) is accounted for either as a separate contract or as the termination of the old contract and the creation of a new contract (i.e., prospectively). In the Basis for Conclusions, the Board explained that it clarified the accounting for modifications that affect a single performance obligation that is made up of a series of distinct goods or services (e.g., repetitive service contracts) to address some stakeholders' concerns that an entity otherwise would have been required to account for these modifications on a cumulative catch-up basis. *[IFRS 15.BC79]*.

In addition to determining whether any additional goods or services are distinct, an entity also needs to determine whether the additional goods or services are added at the stand-alone selling price that exists at the contract modification date. As stated in IFRS 15.20, an entity might make appropriate adjustments to the stand-alone selling price to reflect the circumstances of the contract and still meet the criteria to account for the modification as a separate contract. See further discussion in section 3.4.1 below.

Furthermore, as illustrated in Example 5, Case B (see section 3.4.2.A below), a contract modification might include compensation to a customer for performance issues (e.g., poor service by the entity, defects present in transferred goods). An entity might need to account for the compensation to the customer as a change in the transaction price (see section 6.5 below) separate from other modifications to the contract.

Frequently asked questions

Question 3-13: When would an entity evaluate a contract under the contract modification requirements?

An entity typically enters into a separate contract with a customer to provide additional goods or services. Stakeholders had questioned whether a new contract with an existing customer needs to be evaluated under the contract modification requirements.

A new contract with an existing customer needs to be evaluated under the contract modification requirements if the new contract results in a change in the scope or price of the original contract. IFRS 15.18 states that "a contract modification exists when the parties to a contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract". *[IFRS 15.18]*. Therefore, an entity needs to evaluate whether a new contract with an existing customer represents a legally enforceable change in scope or price (or both) to an existing contract. A legally enforceable change in scope or price to an existing contract could also be accomplished by terminating the existing contract and entering into a new contract with the same customer. In those situations, entities also need to consider the contract modification requirements in IFRS 15.

In some cases, the determination of whether a new contract with an existing customer creates new or changes existing enforceable rights and obligations is straightforward because the new contract does not contemplate goods or services in the existing contract, including the pricing of those goods or services. Purchases of additional goods or services under a separate contract that do not modify the scope or price of an existing contract do not need to be evaluated under the contract modification requirements. Rather, they are accounted for as new (separate) contract.

How we see it

In other cases, the determination of whether a new contract is a modification of an existing contract requires judgement. In such circumstances, we believe an entity needs to consider the specific facts and circumstances surrounding the new contract in order to determine whether it represents a contract modification, which could include considering factors such as those included in the contract combination requirements discussed below.

The factors in the contract combination requirements (see section 3.3 above) include:

- Whether the contracts were negotiated as a package with a single commercial objective (this might be the case in situations where the existing contract contemplates future modifications)
- Whether the amount of consideration to be paid in one contract depends on the price or performance of the other contract
- Whether the goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation

If the pricing in the new contract is dependent on the original contract, or if the terms of the new contract are in some other way negotiated based on the original contract, it is likely that the new contract needs to be evaluated under the contract modification requirements.

Question 3-14: When an arrangement that has already been determined to meet the standard's contract criteria is modified, would an entity need to reassess whether that arrangement still meets the criteria to be considered a contract within the scope of the five-step model and/or the stand-alone selling prices of the underlying goods and services?

How we see it

Whether an entity needs to make these reassessments depends on the nature of the modification. For a contract modification that is accounted for by updating the transaction price and measure of progress for the single performance obligation in the modified contract (in accordance with IFRS 15.21(b) - see section 3.4.2.B below), an entity will need to apply judgement to determine whether to reassess the contract and determine whether it still meets the criteria to be considered a contract in the scope of the model. However, if a contract is modified, we believe that might indicate that "a significant change in facts and circumstances" has occurred (see section 3.1 above) and that the entity should reassess the criteria in IFRS 15.9 for the modified contract.

Any reassessment is prospective in nature and would not change the conclusions associated with goods or services already transferred. That is, an entity would not reverse any receivables, revenue or contract assets already recognised under the contract because of the reassessment of the contract criteria in IFRS 15.9. However, due to the contract modification accounting, the entity might need to adjust contract assets or cumulative revenue recognised in the period of the contract modification, but it would not update the stand-alone selling prices of the goods and services underlying the existing, modified contract.

For a contract modification that is accounted for as a separate contract (in accordance with IFRS 15.20 - see section 3.4.1 below), an entity needs to assess whether that separate contract meets the criteria to be considered a contract within the scope of the model in the standard. If the separate contract meets the criteria to be considered a separate contract, the entity applies the requirements in IFRS 15 to account for the separate contract, including assessing the stand-alone selling price of the underlying goods and services as at the separate contract's inception date (i.e., the modification date). The accounting for the original contract would not be affected. That is, an entity would not need to reassess whether the original contract still meets the criteria to be considered a contract with the scope of the model in the standard, and the stand-alone selling prices of the underlying goods and services in the original contract would also not be updated.

For a modification that is accounted for as a termination of the old contract and the creation of a new contract (in accordance with IFRS 15.21(a) - see section 3.4.2.A below), an entity needs to assess whether the new contract meets the criteria to be considered a contract within the scope of the model. If the new contract meets the criteria to be considered a contract, the entity applies the requirements in IFRS 15 to account for the new contract, including assessing the stand-alone selling price of the remaining underlying goods and services as at the new contract's inception date (i.e., the modification date).

For a modification that is accounted for as a combination of a modification of the existing contract and the creation of a new contract (in accordance with IFRS 15.21(c) - see section 3.4.2.C below), many of the considerations noted above are also relevant. Entities needs to apply judgement to appropriately reassess the related contracts and stand-alone selling prices for these types of modifications.

For further discussion on updating stand-alone selling prices, refer to section 6.1.3 below.

Question 3-15: How would an entity distinguish between a contract modification and a change in the estimated transaction price due to variable consideration after contract inception?

An entity might need to apply judgement to determine whether a change in the transaction price is the result of either:

- A contract modification (due to a change in the parties' enforceable rights and obligations after contract inception)

  Or

- New information obtained about variable consideration that existed (and was estimated) at contract inception

While a contract modification might result in a change in the transaction price, not all changes in the transaction price are due to contract modifications. An entity needs to carefully evaluate the facts and circumstances related to the change in the transaction price to assess whether it creates new or changes existing enforceable rights and obligations or is a change in the estimate of variable consideration. For example, a decision by both parties to reduce the amount of goods or services promised in the contract would generally represent a contract modification.

Conversely, a change in transaction price due to an update of the estimate of variable consideration does not create new or change existing enforceable rights and obligations. When a contract with a customer includes variable consideration (see section 5.2 below), the entity is generally required to estimate, at contract inception and throughout the contract term, the amount of consideration to which it will be entitled in exchange for transferring promised goods or services.

Changes to the transaction price that are related to a change in estimates of variable consideration (because they result in the resolution of variability that existed at contract inception), are allocated to the performance obligations in the contract on the same basis as at contract inception (see section 6.5 below). *[IFRS 15.88, IFRS 15.89]*. In contrast, changes in the transaction price that are related to a contract modification are accounted for in accordance with the contract modification requirements (as described above in IFRS 15.18-21).

Question 3-16: How would an entity distinguish between a contract modification and a marketing offer when an entity provides customer incentives?

An entity might provide incentives to customers to encourage demand. Customer incentives might include free goods or services, options for additional goods and services at a discount (e.g., additional loyalty points, prospective coupons or discounts) or cash payments to customers. The accounting for these incentives will depend on the facts and circumstances of the offer. An offer to a current customer that creates new enforceable rights and obligations or changes the enforceable rights and obligations of the parties to an existing contract is accounted for as a contract modification. In some cases, an offer might not result in a contract modification and would be accounted for as a marketing offer (i.e., an expense).

How we see it

Entities need to carefully consider the terms and conditions of any customer incentive to determine whether the offer needs to be accounted for as a contract modification or a marketing offer, including consideration of the above circumstances.

In addition, as discussed in Question 3-13 above, we believe that the accounting principles for determining when contracts have to be combined under IFRS 15.17 will be helpful when determining whether an offer of free goods or services to an existing customer is a contract modification.

An offer that is the result of negotiations with a specific customer or group of customers might indicate the addition of new enforceable rights and obligations to an existing contract or changes to existing enforceable rights and obligations. However, the following circumstances might indicate that the entity has made a marketing offer:

- The same offer is available to both existing customers and counterparties that do not meet the definition of a customer
- The offer is available to a broad group of (or all) current customers and is not the result of negotiations with individual customers
- The entity has the right to rescind the offer

For any payments to customers, entities will need to consider the requirements for consideration paid or payable to a customer (see section 5.7 below). Such payments would be accounted for as a reduction of the transaction price (and, therefore, revenue) unless the payment to the customer is in exchange for a distinct good or service that the customer transfers to the entity.

Question 3-17: How would an entity account for the exercise of a material right? That is, would an entity account for it as: a contract modification, a continuation of the existing contract or variable consideration?

(TRG meeting 30 March 2015 - Agenda paper no. 32)

See response to Question 4-27 in section 4.6 below.

Question 3-18: How do entities account for modifications and other changes to licences of intellectual property?

See response to Question 8-1 in section 8.1.4 below.

3.4.1 Contract modification represents a separate contract

Certain contract modifications are treated as separate, new contracts. *[IFRS 15.20]*. For these modifications, the accounting for the original contract is not affected by the modification and the revenue recognised to date on the original contract is not adjusted. Furthermore, any performance obligations remaining under the original contract continue to be accounted for under the original contract. The accounting for this type of modification reflects the fact that there is no economic difference between a separate contract for additional goods or services and a modified contract for those same items, provided the two criteria required for this type of modification are met.

The first criterion that must be met for a modification to be treated as a separate contract is that the additional promised goods or services in the modification must be distinct from the promised goods or services in the original contract. This assessment is done in accordance with IFRS 15's general requirements for determining whether promised goods or services are distinct (see section 4.2.1 below). Only modifications that add distinct goods or services to the arrangement can be treated as separate contracts. Arrangements that reduce the amount of promised goods or services or change the scope of the original promised goods or services cannot, by their very nature, be considered separate contracts. Instead, they are modifications of the original contract (see section 3.4.2 below). *[IFRS 15.20(a)]*.

The second criterion is that the amount of consideration expected for the added promised goods or services must reflect the stand-alone selling prices of those promised goods or services at the contract modification date. However, when determining the stand-alone selling price, entities have some flexibility to adjust the stand-alone selling price, depending on the facts and circumstances. For example, an entity might give an existing customer a discount on additional goods because the entity would not incur selling-related costs that it would typically incur for new customers. In this example, the entity might determine that the additional transaction consideration meets the criterion, even though the discounted price is less than the stand-alone selling price of that good or service for a new customer. In another example, an entity might conclude that, with the additional purchases, the customer qualifies for a volume-based discount (see Questions 4-23 and 4-24 in section 4.6 below on volume discounts). *[IFRS 15.20(b)]*.

The following Illustration shows considerations for determining whether the amount of consideration expected for the additional goods and services reflects the stand-alone selling price:

Illustration 3-7: Determining whether the amount of consideration reflects the stand-alone selling price of additional goods or services

Entity E agrees to construct a manufacturing facility on a customer's land for CU10 million. During construction, the customer determines that a separate storage facility is needed at the location. The parties agree to modify the contract to include the construction of the storage facility, which is to be completed within three months of completing the manufacturing facility, for a total price of CU11 million (i.e., when the contract is modified, an additional CU1 million is added to the consideration Entity E will receive). Assume that Entity E determines that the construction of the separate storage facility is distinct (i.e., a performance obligation) and that it transfers control of each facility over time. Entity E must determine whether the CU1 million represents the stand-alone selling price of the separate storage facility.

Scenario A

Entity E determines that CU1.1 million is the stand-alone selling price at the contract modification date for the construction of a similar facility. However, much of the equipment and labour force necessary to complete construction of the storage facility is already onsite and available for use by Entity E. Thus, Entity E concludes that the additional CU1 million reflects the stand-alone selling price at contract modification, adjusted for the circumstances of the contract.

Scenario B

Entity E determines that CU1.5 million is the stand-alone selling price at the contract modification date for the construction of a similar facility. While Entity E can attribute some of the discount to its ability to use equipment and labour that are already onsite, the price reduction was primarily driven by other factors (e.g., a desire to maintain the customer relationship). Therefore, the additional CU1 million does not reflect the stand-alone selling price at contract modification.

In situations with highly variable pricing, determining whether the additional consideration in a modified contract reflects the stand-alone selling price for the additional goods or services might not be straightforward. Entities need to apply judgement when making this assessment. Evaluating whether the price in the modified contract is within a range of prices for which the goods or services are typically sold to similar customers might be an acceptable approach.

The following example illustrates a contract modification that represents a separate contract: *[IFRS 15.IE Example 5 Case A, IFRS 15.IE19-IE21]*

Extract from IFRS 15

Example 5-Modification of a contract for goods

An entity promises to sell 120 products to a customer for CU12,000 (CU100 per product). The products are transferred to the customer over a six-month period. The entity transfers control of each product at a point in time. After the entity has transferred control of 60 products to the customer, the contract is modified to require the delivery of an additional 30 products (a total of 150 identical products) to the customer. The additional 30 products were not included in the initial contract.

Case A-Additional products for a price that reflects the stand-alone selling price

When the contract is modified, the price of the contract modification for the additional 30 products is an additional CU2,850 or CU95 per product. The pricing for the additional products reflects the stand-alone selling price of the products at the time of the contract modification and the additional products are distinct (in accordance with paragraph 27 of IFRS 15) from the original products.

In accordance with paragraph 20 of IFRS 15, the contract modification for the additional 30 products is, in effect, a new and separate contract for future products that does not affect the accounting for the existing contract. The entity recognises revenue of CU100 per product for the 120 products in the original contract and CU95 per product for the 30 products in the new contract.

3.4.2 Contract modification is not a separate contract

If one or both of the criteria discussed in section 3.4.1 above are not met (i.e., distinct goods or services are not added or the distinct goods or services are not priced at their stand-alone selling price), the contract modifications are accounted for as changes to the original contract and not as separate contracts. This includes contract modifications that modify or remove previously agreed-upon goods or services or reduce the price of the contract. An entity accounts for the effects of these modifications differently, depending on which of the three scenarios described in IFRS 15.21 (see the extract in section 3.4 above), and discussed in sections 3.4.2.A-3.4.2.C below, most closely aligns with the facts and circumstances of the modification. *[IFRS 15.21]*.

3.4.2.A Modification is a termination of the existing contract and the creation of a new contract

If the remaining goods or services after the contract modification are distinct from the goods or services transferred on, or before, the contract modification (but the distinct goods or services added in the modification were not added at their stand-alone selling prices at the date of the contract modification), the entity accounts for the modification as if it were a termination of the old contract and the creation of a new contract. *[IFRS 15.21(a)]*.

For these modifications, the revenue recognised to date on the original contract (i.e., the amount associated with the completed performance obligations) is not adjusted. Instead, the remaining portion of the original contract and the modification are accounted for, together, on a prospective basis by allocating the remaining consideration (i.e., the unrecognised transaction price from the existing contract plus the additional transaction price from the modification) to the remaining performance obligations (or to the remaining distinct goods or services in a single performance obligation identified as a series, see section 4.2.2 below), including those added in the modification. *[IFRS 15.21(a)]*.

Example 7 in the standard illustrates the accounting for a contract modification of a services contract that is determined to be a series of distinct goods or services (see section 4.2.2 below) and meets the criteria in IFRS 15.21(a) to be accounted for as a termination of the existing contract and the creation of a new contract. As the performance obligation is a series, the services provided after the contract modification are distinct from those provided before the contract modification. *[IFRS 15.IE Example 7, IFRS 15.IE33-IE36]*.

The following example from the standard also illustrates a modification that is treated as a termination of an existing contract and the creation of a new contract: *[IFRS 15.IE Example 5 Case B, IFRS 15.IE19, IFRS 15.IE22-IE24]*

Extract from IFRS 15

Example 5-Modification of a contract for goods

An entity promises to sell 120 products to a customer for CU12,000 (CU100 per product). The products are transferred to the customer over a six-month period. The entity transfers control of each product at a point in time. After the entity has transferred control of 60 products to the customer, the contract is modified to require the delivery of an additional 30 products (a total of 150 identical products) to the customer. The additional 30 products were not included in the initial contract.

...

Case B-Additional products for a price that does not reflect the stand-alone selling price

During the process of negotiating the purchase of an additional 30 products, the parties initially agree on a price of CU80 per product. However, the customer discovers that the initial 60 products transferred to the customer contained minor defects that were unique to those delivered products. The entity promises a partial credit of CU15 per product to compensate the customer for the poor quality of those products. The entity and the customer agree to incorporate the credit of CU900 (CU15 credit × 60 products) into the price that the entity charges for the additional 30 products. Consequently, the contract modification specifies that the price of the additional 30 products is CU1,500 or CU50 per product. That price comprises the agreed-upon price for the additional 30 products of CU2,400, or CU80 per product, less the credit of CU900.

At the time of modification, the entity recognises the CU900 as a reduction of the transaction price and, therefore, as a reduction of revenue for the initial 60 products transferred. In accounting for the sale of the additional 30 products, the entity determines that the negotiated price of CU80 per product does not reflect the stand-alone selling price of the additional products. Consequently, the contract modification does not meet the conditions in paragraph 20 of IFRS 15 to be accounted for as a separate contract. Because the remaining products to be delivered are distinct from those already transferred, the entity applies the requirements in paragraph 21(a) of IFRS 15 and accounts for the modification as a termination of the original contract and the creation of a new contract.

Consequently, the amount recognised as revenue for each of the remaining products is a blended price of CU93.33 {[(CU100 × 60 products not yet transferred under the original contract) + (CU80 × 30 products to be transferred under the contract modification)] ÷ 90 remaining products}.

In Example 5, Case B, in the extract above, the entity attributed a portion of the discount provided on the additional products to the previously delivered products because they contained defects. This is because the compensation provided to the customer for the previously delivered products is a discount on those products, which results in variable consideration (i.e., a price concession) for them. The new discount on the previously delivered products was recognised as a reduction of the transaction price (and, therefore, revenue) on the date of the modification. Changes in the transaction price after contract inception are accounted for in accordance with IFRS 15.88-90 (see section 6.5 below).

In similar situations, it might not be clear from the change in the contract terms whether an entity has offered a price concession on previously transferred goods or services to compensate the customer for performance issues related to those items (that would be accounted for as a reduction of the transaction price) or has offered a discount on future goods or services (that would be included in the accounting for the contract modification). An entity needs to apply judgement when performance issues exist for previously transferred goods or services to determine whether to account for any compensation to the customer as a change in the transaction price for those previously transferred goods or services.

3.4.2.B Modification is part of the existing contract

The remaining goods or services to be provided after the contract modification might not be distinct from those goods or services already provided and, therefore, form part of a single performance obligation that is partially satisfied at the date of modification. *[IFRS 15.21(b)]*.

If this is the case, the entity accounts for the contract modification as if it were part of the original contract. This would be the case regardless of whether the additional goods or services were added at their stand-alone selling prices at the contract modification date. The entity adjusts revenue previously recognised (either up or down) to reflect the effect that the contract modification has on the transaction price and update the measure of progress (i.e., the revenue adjustment is made on a cumulative catch-up basis). This scenario is illustrated, as follows: *[IFRS 15.IE Example 8, IFRS 15.IE37-IE41]*

Extract from IFRS 15

Example 8-Modification resulting in a cumulative catch-up adjustment to revenue

An entity, a construction company, enters into a contract to construct a commercial building for a customer on customer-owned land for promised consideration of CU1 million and a bonus of CU200,000 if the building is completed within 24 months. The entity accounts for the promised bundle of goods and services as a single performance obligation satisfied over time in accordance with paragraph 35(b) of IFRS 15 because the customer controls the building during construction.

At the inception of the contract, the entity expects the following:

	CU
Transaction price	1,000,000
Expected costs	700,000
Expected profit (30%)	300,000

At contract inception, the entity excludes the CU200,000 bonus from the transaction price because it cannot conclude that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur. Completion of the building is highly susceptible to factors outside the entity's influence, including weather and regulatory approvals. In addition, the entity has limited experience with similar types of contracts.

The entity determines that the input measure, on the basis of costs incurred, provides an appropriate measure of progress towards complete satisfaction of the performance obligation. By the end of the first year, the entity has satisfied 60 per cent of its performance obligation on the basis of costs incurred to date (CU420,000) relative to total expected costs (CU700,000). The entity reassesses the variable consideration and concludes that the amount is still constrained in accordance with paragraphs 56-58 of IFRS 15. Consequently, the cumulative revenue and costs recognised for the first year are as follows:

	CU
Revenue	600,000
Costs	420,000
Gross profit	180,000

In the first quarter of the second year, the parties to the contract agree to modify the contract by changing the floor plan of the building. As a result, the fixed consideration and expected costs increase by CU150,000 and CU120,000, respectively. Total potential consideration after the modification is CU1,350,000 (CU1,150,000 fixed consideration + CU200,000 completion bonus). In addition, the allowable time for achieving the CU200,000 bonus is extended by 6 months to 30 months from the original contract inception date. At the date of the modification, on the basis of its experience and the remaining work to be performed, which is primarily inside the building and not subject to weather conditions, the entity concludes that it is highly probable that including the bonus in the transaction price will not result in a significant reversal in the amount of cumulative revenue recognised in accordance with paragraph 56 of IFRS 15 and includes the CU200,000 in the transaction price. In assessing the contract modification, the entity evaluates paragraph 27(b) of IFRS 15 and concludes (on the basis of the factors in paragraph 29 of IFRS 15) that the remaining goods and services to be provided using the modified contract are not distinct from the goods and services transferred on or before the date of contract modification; that is, the contract remains a single performance obligation.

Consequently, the entity accounts for the contract modification as if it were part of the original contract (in accordance with paragraph 21(b) of IFRS 15). The entity updates its measure of progress and estimates that it has satisfied 51.2 per cent of its performance obligation (CU420,000 actual costs incurred ÷ CU820,000 total expected costs). The entity recognises additional revenue of CU91,200 [(51.2 per cent complete × CU1,350,000 modified transaction price) - CU600,000 revenue recognised to date] at the date of the modification as a cumulative catch-up adjustment.

3.4.2.C Modification is part of the existing contract and the creation of a new contract

A change in a contract might also be treated as a combination of the two: a modification of the existing contract and the creation of a new contract. This would be the case when some, but not all, of the goods or services added in the modification are distinct from those already provided as at the date of the modification. In this case, an entity would not adjust the accounting treatment for completed performance obligations that are distinct from the modified goods or services. However, the entity would adjust revenue previously recognised (either up or down) to reflect the effect of the contract modification on the estimated transaction price allocated to performance obligations that are not distinct from the modified portion of the contract and would update the measure of progress. *[IFRS 15.21(c)]*.

Frequently asked questions

Question 3-19: How would an entity account for a partial termination of a contract (e.g., a change in the contract term from three years to two years prior to the beginning of year two)?

See response to Question 3-9 in section 3.2 above.

Question 3-20: How would an entity account for a contract modification that decreases the scope of a contract?

A modification that decreases the scope of a contract is not accounted for as a separate contract because it does not result in the addition of distinct goods or services (see section 3.4.2 above). The accounting will depend on whether the remaining goods and services to be provided after the contract modification are distinct from the goods and services already provided. If the remaining goods and services are distinct (including goods or services that are part of a single performance obligation that is a series of distinct goods or services), the contract modification is accounted for as a termination of the old contract and the creation of a new contract (i.e., prospectively). If the remaining goods and services are not distinct, the contract modification is accounted for as if it were part of the original contract (i.e., cumulative catch-up). See Question 3-9 in section 3.2 above regarding a partial termination of a contract.

How we see it

To modify a contract, a customer might agree to pay a fee to terminate, or decrease the scope of, some of the rights and obligations included in the original contract (e.g., a termination fee, one-time payment, lump-sum payment). We believe that such a fee is additional consideration that needs to be included in the modified transaction price and allocated to the remaining goods and services to be provided to the customer.

Consider the following Illustration:

Illustration 3-8: Contract modification that decreases the scope of the promised goods or services in a contract

Entity X enters into a non-cancellable contract with a customer to provide information technology (IT) outsourcing services continuously for a three-year period. Entity X determines that the arrangement contains a single performance obligation comprising a series of distinct services that is transferred to the customer over time. Entity X bills the customer a fixed price of CU500 per month (i.e., the total consideration is CU500 x 36 months = CU18,000).

At the end of the second year, Entity X and the customer modify the contract to remove certain discrete services from the overall outsourcing service. As part of the modification, the customer agrees to pay a contract modification fee of CU500 and reduce the monthly payments to CU400 per month.

The services provided after the contract modification are distinct from those provided before the contract modification. This is because the performance obligation is a series of distinct services. Accordingly, Entity X applies the requirements in IFRS 15.21(a) and accounts for the modification prospectively. The remaining consideration of CU5,300 (CU400 x 12 months = CU4,800 for the services to be provided in the third year, plus the CU500 payment upon modification) is recognised over the remaining contract period of one year. That is, Entity X recognises the CU500 contract modification fee over the remaining performance period.

Question 3-21: How would an entity account for a 'blend-and-extend' contract modification?

A 'blend-and-extend' contract modification typically is one in which an entity, in exchange for a customer extending the term of the contract (and, therefore, purchasing additional units of a good or service), agrees to decrease the price per unit for all units to be provided (i.e., the new units, as well as the remaining units on the existing contract), resulting in a new blended price per unit. These types of contracts often occur in the power and utilities industry when market prices for the good or service decline after contract inception.

These arrangements are subject to the contract modification requirements in IFRS 15. Since these arrangements typically include the addition of distinct goods or services, the next step is for entities to evaluate whether the additional distinct goods or services are added at their stand-alone selling price in order to determine the accounting for the contract modification (i.e., as a separate contract or as a termination of the existing contract and the creation of a new contract).

When making this evaluation, stakeholders have questioned whether an entity needs to compare the blended contractual cash selling price or the overall contract price increase to the stand-alone selling price of the additional promised goods or services.

How we see it

We believe that entities need to establish an approach based on the facts and circumstances of their modifications and apply that approach consistently to similar fact patterns.

Consider the following Illustration:

Illustration 3-9: Blend-and-extend contract modification

Entity N enters into a four-year non-cancellable contract with Customer A to provide 100,000 widgets per year at a fixed price of CU10 per widget. Each widget is a distinct good transferred at a point in time.

At the end of the second year, Entity N and Customer A modify the contract to extend the term of the contract by another two years (i.e., Entity N will continue to provide 100,000 widgets in years 5 and 6). The stand-alone selling price of the widget has declined and is now CU8 per widget. As part of the modification, Entity N agrees to reduce the price to a blended rate of CU9 per widget (based on CU10 in years 3 and 4 and CU8 in years 5 and 6) in exchange for Customer A extending the contract term.

Entity N determines that each widget provided after the modification date is distinct from the widgets provided before the modification date.

Approach A - Compare the overall contract price increase to the stand-alone selling price of the additional promised goods or services

Since the price of the contract increases by an amount of consideration that reflects the stand-alone selling prices of the additional widgets (i.e., CU8 per widget in years 5 and 6), Entity N determines that the contract modification is accounted for as a separate contract in accordance with IFRS 15.20. Entity N will continue to recognise revenue of CU10 per widget for the remaining period in the initial contract (i.e., years 3 and 4) and recognise revenue of CU8 per widget in years 5 and 6.

Approach B - Compare the blended contractual cash selling price to the stand-alone selling price of the additional promised goods or services

Since the blended price of CU9 per widget does not reflect the stand-alone selling price of widgets at the modification date (i.e., CU8 per widget), Entity N applies the requirements in IFRS 15.21(a) and accounts for the modification as if it were a termination of the original contract and the creation of a new contract. Total consideration of CU3,600,000 (100,000 x CU10 x 2 years = CU2,000,000 for the widgets to be provided the years 3 and 4, plus CU1,600,000 (100,000 x CU8 x 2 years) for the widgets to be provided in years 5 and 6) is allocated to each of the remaining widgets to be provided (400,000 widgets). Entity N will recognise revenue for each widget at a blended rate of CU9 per widget (CU3,600,000 ÷ 400,000 widgets).

The accounting will be different in contract modifications where an entity determines that the remaining goods or services to be provided after the modification date are not distinct from those goods or services provided before the modification date.

There is no presumption that such contract modifications contain a financing component that would be required to be accounted for separately. That is, the mere act of blending the rate in connection with a contract extension in which the customer pays more cash consideration for the same amount of goods or services at the beginning of the contract than the end of the contract does not automatically create a financing. However, each contract's facts and circumstances would need to be evaluated to determine whether a significant financing component exists (see section 5.5 below for further discussion on significant financing components).

Question 3-22: How would an entity account for a contract asset that exists when a contract is modified if the modification is treated as the termination of an existing contract and the creation of a new contract? (FASB TRG meeting 18 April 2016 - Agenda paper no. 51)

See response to Question 10-5 in section 10.1.5 below.

3.5 Arrangements that do not meet the definition of a contract under the standard

If an arrangement does not meet the criteria to be considered a contract under the standard, it must be accounted for as follows: *[IFRS 15.15, IFRS 15.16]*

Extract from IFRS 15

15 When a contract with a customer does not meet the criteria in paragraph 9 and an entity receives consideration from the customer, the entity shall recognise the consideration received as revenue only when either of the following events has occurred:

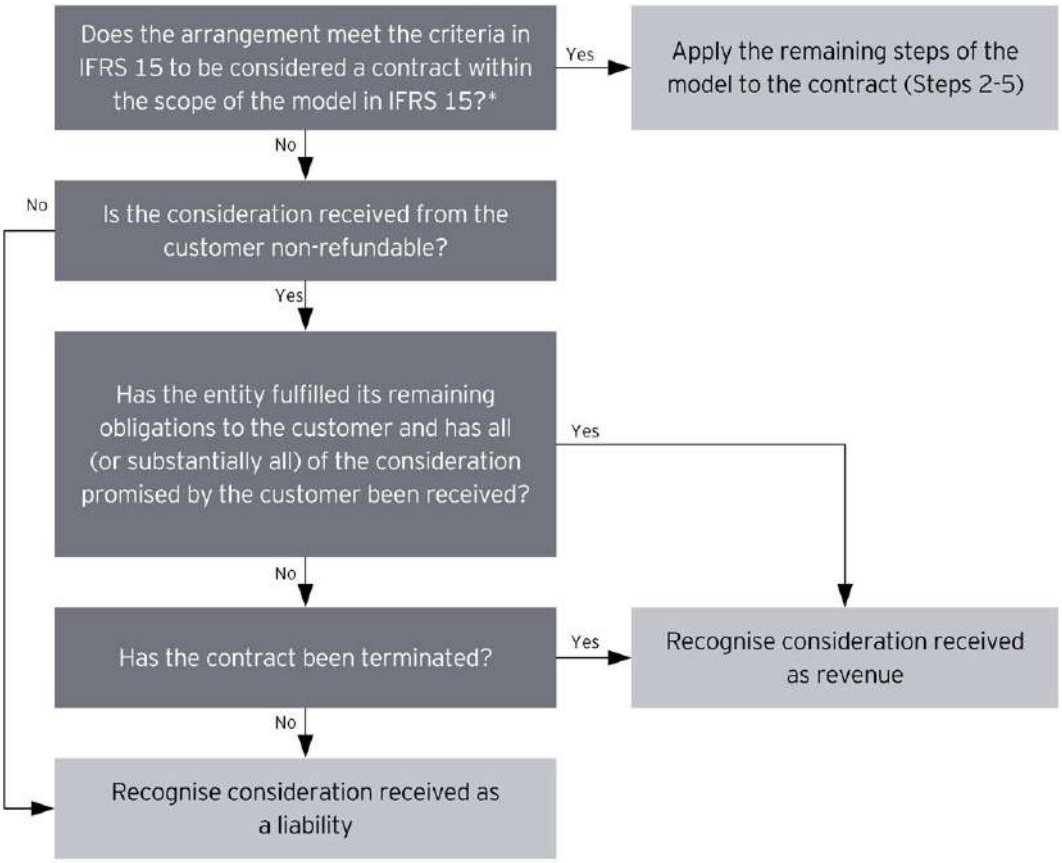
(a) the entity has no remaining obligations to transfer goods or services to the customer and all, or substantially all, of the consideration promised by the customer has been received by the entity and is non-refundable; or

(b) the contract has been terminated and the consideration received from the customer is non-refundable.

16 An entity shall recognise the consideration received from a customer as a liability until one of the events in paragraph 15 occurs or until the criteria in paragraph 9 are subsequently met (see paragraph 14). Depending on the facts and circumstances relating to the contract, the liability recognised represents the entity's obligation to either transfer goods or services in the future or refund the consideration received. In either case, the liability shall be measured at the amount of consideration received from the customer.

The following flow chart illustrates this requirement:

Figure 3-2: Arrangements that do not meet the definition of a contract under the standard



* Entities need to continue to assess the criteria throughout the term of the arrangement to determine whether they are subsequently met.

If a contract does not initially meet the criteria in IFRS 15.9 (as discussed in section 3.1 above), an entity continues to assess the criteria throughout the term of the arrangement to determine whether they are subsequently met. Once the criteria are met, the model in the standard applies, rather than the requirements discussed below. *[IFRS 15.14]*. If an entity determines that the criteria in IFRS 15.9 are subsequently met, revenue is recognised on a cumulative catch-up basis as at the date when a contract exists within the scope of the model (i.e., at the 'contract establishment date', reflecting the performance obligations that are partially, or fully, satisfied at that date). This accounting is consistent with the discussion in TRG agenda paper no. 33, which states that the cumulative catch-up method "best satisfies the core principle" in IFRS 15.2.[35] See Question 7-20 in section 7.1.4.E below for further discussion.

If an arrangement does not meet the criteria in IFRS 15.9 (and until the criteria are met), an entity only recognises non-refundable consideration received as revenue when one of the events outlined above has occurred (i.e., full performance and all (or substantially all) consideration received or the contract has been terminated) or the arrangement subsequently meets the criteria in IFRS 15.9.

Until one of these events happens, any consideration received from the customer is initially accounted for as a liability (not revenue) and the liability is measured at the amount of consideration received from the customer.

In the Basis for Conclusions, the Board indicated that it intended this accounting to be "similar to the 'deposit method' that was previously included in US GAAP and that was applied when there was no consummation of a sale". *[IFRS 15.BC48]*. As noted in the Basis for Conclusions, the Board decided to include the requirements in IFRS 15.14-16 to prevent entities from seeking alternative guidance or improperly analogising to the five-step revenue recognition model in IFRS 15 in circumstances in which an executed contract does not meet the criteria in IFRS 15.9. *[IFRS 15.BC47]*.

FASB differences

Under the FASB's standard, when the arrangement does not meet the criteria to be accounted for as a revenue contract under the standard, an entity can also recognise revenue (at the amount of the non-refundable consideration received) when the entity has transferred control of the goods or services and has stopped transferring (and has no obligation to transfer) additional goods or services. IFRS 15 does not include a similar requirement.

Frequently asked questions

Question 3-23: When is a contract considered terminated for purposes of applying IFRS 15.15(b)?

Determining whether a contract is terminated might require significant judgement.

In the Basis for Conclusions on IFRS 15, "the IASB noted that contracts often specify that an entity has the right to terminate the contract in the event of non-payment by the customer and that this would not generally affect the entity's rights to recover any amounts owed by the customer. The IASB also noted that an entity's decision to stop pursuing collection would not typically affect the entity's rights and the customer's obligations under the contract with respect to the consideration owed by the customer. On this basis, … the existing requirements in IFRS 15 are sufficient for an entity to conclude … that a contract is terminated when it stops providing goods or services to the customer." *[IFRS 15.BC46H]*.

35 TRG Agenda paper no. 33, *Partial Satisfaction of Performance Obligations Prior to Identifying the Contract*, dated 30 March 2015.

4 IFRS 15 - Identify the performance obligations in the contract

To apply the standard, an entity is required to identify the promised goods or services within the contract and determine which of those goods or services are separate performance obligations. As noted in the Basis for Conclusions, the Board developed the notion of a 'performance obligation' to assist entities with appropriately identifying the unit of account for the purposes of applying the standard. *[IFRS 15.BC85]*. Because the standard requires entities to allocate the transaction price to performance obligations, identifying the correct unit of account is fundamental to recognising revenue on a basis that faithfully depicts the entity's performance in transferring the promised goods or services to the customer.

The standard provides the following requirements with respect to identifying the performance obligations in a contract: *[IFRS 15.22, IFRS 15.23]*

Extract from IFRS 15

22 **At contract inception, an entity shall assess the goods or services promised in a contract with a customer and shall identify as a performance obligation each promise to transfer to the customer either:**

(a) a good or service (or a bundle of goods or services) that is distinct; or

(b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer (see paragraph 23).

23 A series of distinct goods or services has the same pattern of transfer to the customer if both of the following criteria are met:

(a) each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria in paragraph 35 to be a performance obligation satisfied over time; and

(b) in accordance with paragraphs 39-40, the same method would be used to measure the entity's progress towards complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

4.1 Identifying the promised goods or services in the contract

As a first step in identifying the performance obligation(s) in the contract, the standard requires an entity to identify, at contract inception, the promised goods or services in the contract. The standard provides guidance on the types of items that could be goods or services promised in the contract, as follows: *[IFRS 15.24, IFRS 15.25, IFRS 15.26]*

Extract from IFRS 15

24 A contract with a customer generally explicitly states the goods or services that an entity promises to transfer to a customer. However, the performance obligations identified in a contract with a customer may not be limited to the goods or services that are explicitly stated in that contract. This is because a contract with a customer may also include promises that are implied by an entity's customary business practices, published policies or specific statements if, at the time of entering into the contract, those promises create a valid expectation of the customer that the entity will transfer a good or service to the customer.

25 Performance obligations do not include activities that an entity must undertake to fulfil a contract unless those activities transfer a good or service to a customer. For example, a services provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed. Therefore, those setup activities are not a performance obligation.

26 Depending on the contract, promised goods or services may include, but are not limited to, the following:

(a) sale of goods produced by an entity (for example, inventory of a manufacturer);

(b) resale of goods purchased by an entity (for example, merchandise of a retailer);

(c) resale of rights to goods or services purchased by an entity (for example, a ticket resold by an entity acting as a principal, as described in paragraphs B34-B38);

(d) performing a contractually agreed-upon task (or tasks) for a customer;

(e) providing a service of standing ready to provide goods or services (for example, unspecified updates to software that are provided on a when-and-if-available basis) or of making goods or services available for a customer to use as and when the customer decides;

(f) providing a service of arranging for another party to transfer goods or services to a customer (for example, acting as an agent of another party, as described in paragraphs B34-B38);

(g) granting rights to goods or services to be provided in the future that a customer can resell or provide to its customer (for example, an entity selling a product to a retailer promises to transfer an additional good or service to an individual who purchases the product from the retailer);

(h) constructing, manufacturing or developing an asset on behalf of a customer;

(i) granting licences (see paragraphs B52-B63B); and

(j) granting options to purchase additional goods or services (when those options provide a customer with a material right, as described in paragraphs B39-B43).

In order for an entity to identify the promised goods or services in a contract, IFRS 15 indicates that an entity considers whether there is a valid expectation on the part of the customer that the entity will provide a good or service. *[IFRS 15.24]*. If the customer has a valid expectation that it will receive certain goods or services, it is likely that the customer would view those promises as part of the negotiated exchange. This expectation is most commonly created from an entity's explicit promise in a contract to transfer a good(s) or service(s) to the customer.

However, in other cases, promises to provide goods or services might be implied by the entity's customary business practices or standard industry norms (i.e., outside of the written contract). As discussed in section 3 above, the Board clarified that, while the contract must be legally enforceable to be within the scope of the revenue model, not all of the promises (explicit or implicit) have to be legally enforceable to be considered when determining the entity's performance obligations. *[IFRS 15.BC32, IFRS 15.BC87]*. That is, a performance obligation can be based on a customer's valid expectations (e.g., due to the entity's business practice of providing an additional good or service that is not specified in the contract).

Promised goods or services might include items such as 'free' handsets provided by telecommunication entities, 'free' maintenance provided by automotive manufacturers and customer loyalty points awarded by supermarkets, airlines and hotels. *[IFRS 15.BC88]*. When the IASB sought comments on the draft standard, some respondents suggested that these types of promised goods or services would be excluded from the scope and accounted for as marketing expenses or incidental obligations, even though the promises would meet the definition of a performance obligation. The Board concluded that, while an entity might not consider those goods or services to be the 'main' items that the customer contracts to receive, they are goods or services for which the customer pays and to which the entity allocates consideration for the purpose of recognising revenue. *[IFRS 15.BC89]*.

IFRS 15 states that promised goods or services do *not* include activities that an entity must undertake to fulfil a contract unless those activities transfer control of a good or service to a customer. *[IFRS 15.25]*. For example, internal administrative activities that an entity must perform to satisfy its obligation to deliver the promised goods or services, but do not transfer control of a good or service to a customer, would not be promised goods or services. The IFRS IC reiterated this point during its January 2019 meeting (see below for further discussion).

How we see it

An entity might have to apply judgement when determining whether an activity it will perform is a promised good or service that will be transferred to a customer. The following questions could be relevant for an entity to consider when making this judgement:

- Is the activity identified as a good or service to be provided in the contractual arrangement with the customer? Activities that are not specifically identified could relate to an internal process of the entity, but they could also relate to implicit promises to the customer.
- Does the activity relate to the entity establishing processes and procedures or training its employees, so that it can render the contracted goods or services to the customer (e.g., set-up activities)?
- Is the activity administrative in nature (e.g., tasks performed to determine whether to accept or reject a customer, establishing the customer's account, invoicing the customer)?
- Is the customer aware of when the activity will be performed?

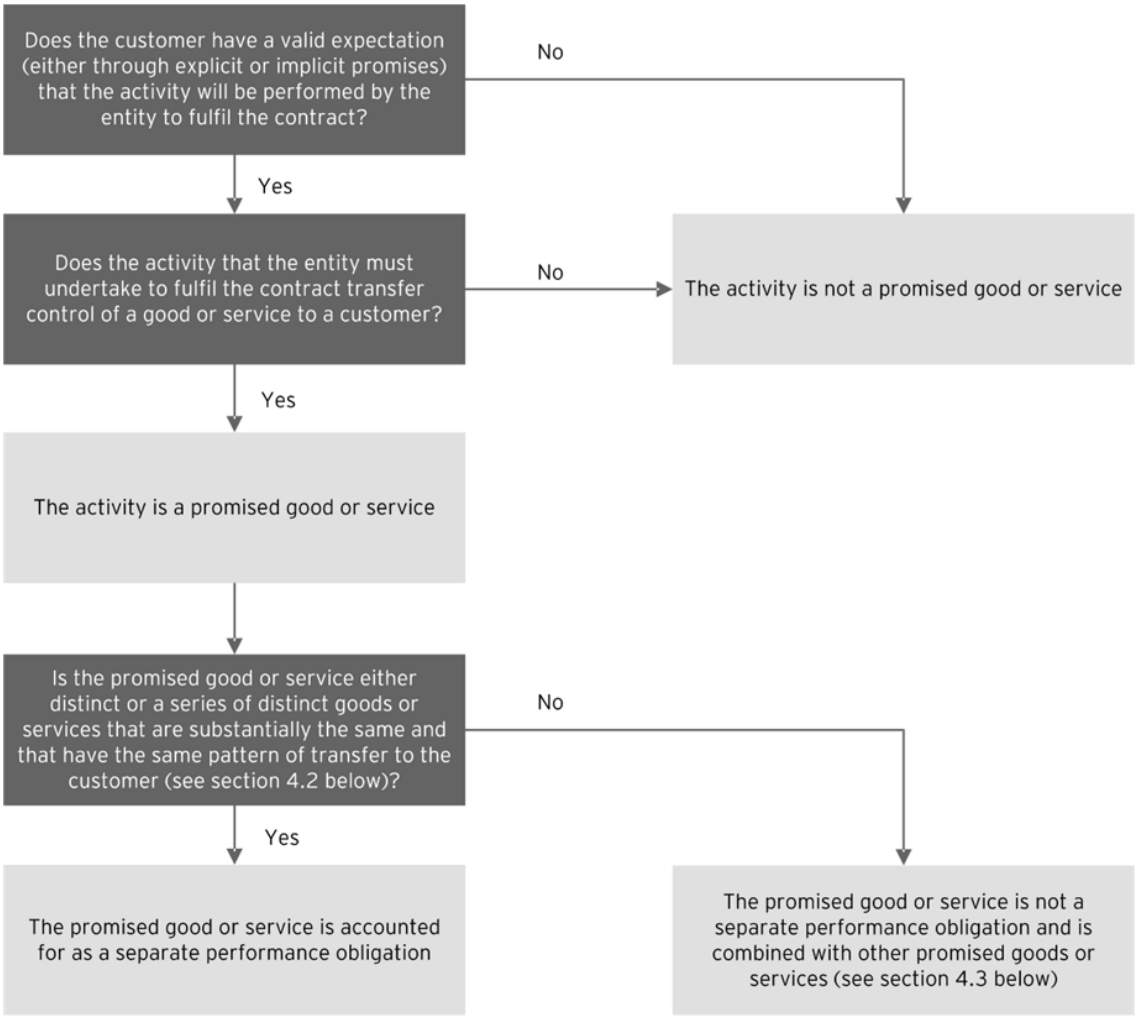
IFRS 15.26 provides examples of promised goods or services that may be included in a contract with a customer, such as a good produced by an entity or a contractually agreed-upon task (or service) performed for a customer. IFRS 15.26(e) describes a stand-ready obligation as a promised service that consists of standing ready to provide goods or services or making goods or services available for a customer to use as and when it decides to use it. *[IFRS 15.26(e)]*. That is, a stand-ready obligation is the promise that the customer has access to a good or service, rather than a promise to transfer the underlying good or service itself. Stand-ready obligations are common in the software industry (e.g., unspecified updates to software on a when-and-if-available basis) and might be present in other industries. See Questions 4-2 and 4-3 below for further discussion on stand-ready obligations.

IFRS 15.26(g) notes that a promise to a customer may include granting rights to goods or services to be provided in the future that the customer can resell or provide to its own customers. *[IFRS 15.26(g)]*. Such a right might represent promises to the customer if it existed at the time that the parties agreed to the contract. As noted in the Basis for Conclusions, the Board thought it was important to clarify that a performance obligation might exist for a promise to provide a good or service in the future (e.g., when an entity makes a promise to provide goods or services to its customer's customer). *[IFRS 15.BC92]*. These types of promises exist in distribution networks in various industries and are common in the automotive industry.

After identifying the promised goods or services in the contract, an entity then determines which of these promised goods or services (or bundle of goods or services) represent separate performance obligations.

The following flowchart illustrates the guidance an entity uses to assess whether the activities it will perform are promised goods or services and whether they are accounted for as performance obligations under Step 2 of the five-step model in IFRS 15:

Figure 4-1: Identifying the performance obligation(s) in the contract



The standard includes the following example to illustrate how an entity would identify the promised goods or services in a contract (including both explicit and implicit promises). The example also evaluates whether the identified promises are performance obligations, which we discuss in section 4.2 below. *[IFRS 15.IE Example 12 Case A, IFRS 15.IE59-IE65A]*. The IFRS IC also discussed the assessment of whether there is an implicit promise in a contract as part of a principal versus agent assessment during its April 2022 meeting. See Illustration 4-18 in section 4.4.2 below for further details.

Extract from IFRS 15

Example 12-Explicit and implicit promises in a contract

An entity, a manufacturer, sells a product to a distributor (ie its customer) who will then resell it to an end customer.

Case A-Explicit promise of service

In the contract with the distributor, the entity promises to provide maintenance services for no additional consideration (ie 'free') to any party (ie the end customer) that purchases the product from the distributor. The entity outsources the performance of the maintenance services to the distributor and pays the distributor an agreed-upon amount for providing those services on the entity's behalf. If the end customer does not use the maintenance services, the entity is not obliged to pay the distributor.

The contract with the customer includes two promised goods or services - (a) the product and (b) the maintenance services. The promise of maintenance services is a promise to transfer goods or services in the future and is part of the negotiated exchange between the entity and the distributor. The entity assesses whether each good or service is distinct in accordance with paragraph 27 of IFRS 15. The entity determines that both the product and the maintenance services meet the criterion in paragraph 27(a) of IFRS 15. The entity regularly sells the product on a stand-alone basis, which indicates that the customer can benefit from the product on its own. The customer can benefit from the maintenance services together with a resource the customer already has obtained from the entity (ie the product).

The entity further determines that its promises to transfer the product and to provide the maintenance services are separately identifiable (in accordance with paragraph 27(b) of IFRS 15) on the basis of the principle and the factors in paragraph 29 of IFRS 15. The product and the maintenance services are not inputs to a combined item in the contract. The entity is not providing a significant integration service because the presence of the product and the services together in this contract do not result in any additional or combined functionality. In addition, neither the product nor the services modify or customise the other. Lastly, the product and the maintenance services are not highly interdependent or highly interrelated because the entity would be able to fulfil each of the promises in the contract independently of its efforts to fulfil the other (ie the entity would be able to transfer the product even if the customer declined maintenance services and would be able to provide maintenance services in relation to products sold previously through other distributors). The entity also observes, in applying the principle in paragraph 29 of IFRS 15, that the entity's promise to provide maintenance is not necessary for the product to continue to provide significant benefit to the customer. Consequently, the entity allocates a portion of the transaction price to each of the two performance obligations (ie the product and the maintenance services) in the contract.

Case B-Implicit promise of service

The entity has historically provided maintenance services for no additional consideration (ie 'free') to end customers that purchase the entity's product from the distributor. The entity does not explicitly promise maintenance services during negotiations with the distributor and the final contract between the entity and the distributor does not specify terms or conditions for those services.

However, on the basis of its customary business practice, the entity determines at contract inception that it has made an implicit promise to provide maintenance services as part of the negotiated exchange with the distributor. That is, the entity's past practices of providing these services create valid expectations of the entity's customers (ie the distributor and end customers) in accordance with paragraph 24 of IFRS 15. Consequently, the entity assesses whether the promise of maintenance services is a performance obligation. For the same reasons as in Case A, the entity determines that the product and maintenance services are separate performance obligations.

Case C-Services are not a promised service

In the contract with the distributor, the entity does not promise to provide any maintenance services. In addition, the entity typically does not provide maintenance services and, therefore, the entity's customary business practices, published policies and specific statements at the time of entering into the contract have not created an implicit promise to provide goods or services to its customers. The entity transfers control of the product to the distributor and, therefore, the contract is completed. However, before the sale to the end customer, the entity makes an offer to provide maintenance services to any party that purchases the product from the distributor for no additional promised consideration.

The promise of maintenance is not included in the contract between the entity and the distributor at contract inception. That is, in accordance with paragraph 24 of IFRS 15, the entity does not explicitly or implicitly promise to provide maintenance services to the distributor or the end customers. Consequently, the entity does not identify the promise to provide maintenance services as a performance obligation. Instead, the obligation to provide maintenance services is accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Although the maintenance services are not a promised service in the current contract, in future contracts with customers the entity would assess whether it has created a business practice resulting in an implied promise to provide maintenance services.

4.1.1 Identifying the promised goods or services in the contract: January 2019 IFRS IC discussion

In 2018, the IFRS IC received a request regarding the recognition of revenue by a stock exchange that provides listing services to customers. The request asked whether the stock exchange is providing an admission service that is distinct from an ongoing listing service. At its January 2019 meeting, the IFRS IC concluded that the principles and requirements in IFRS 15 provide sufficient guidance for an entity to assess the promised goods and services in a contract with a customer. Consequently, the IFRS IC decided not to add this matter to its agenda. *[IFRS 15.BC87]*.[36]

In considering this request, the IFRS IC noted that the main question relates to the assessment of the promised goods or services in the contract, rather than the assessment of whether the admission and the listing service are 'distinct' based on IFRS 15.27-30. In their agenda decision, the IFRS IC highlighted that:

- Before identifying its performance obligations, an entity needs to identify the goods and services promised in the contract. *[IFRS 15.24]*.[37]
- Performing various tasks (e.g., set-up activities) that do not transfer a good or service to a customer is not a performance obligation - a performance obligation does not include activities that an entity must undertake to fulfil a contract, unless those activities transfer a good or service to a customer. *[IFRS 15.25]*.[38]
- If a non-refundable upfront fee relates to an activity that is undertaken at or near contract inception to fulfil the contract but does not result in transfer of a promised good or service to a customer (i.e., the activities only represent tasks to set up a contract), the fee is an advance payment for future goods or services. *[IFRS 15.B49]*.[39]

The IFRS IC discussed what the promised goods and services are in the contract using the following Illustration.[40]

36 *IFRIC Update*, January 2019, available on the IFRS Foundation's website.

37 *IFRIC Update*, January 2019, available on the IFRS Foundation's website.

38 *IFRIC Update*, January 2019, available on the IFRS Foundation's website.

39 *IFRIC Update*, January 2019, available on the IFRS Foundation's website.

40 IASB Staff Paper 3: Project: *Assessment of promised goods or services (IFRS 15)*, Paper topic: *Agenda decision to finalise*, IFRS IC meeting, January 2019; and IASB Staff Paper 2: *IFRS 15* Revenue from Contracts with Customers-*Assessment of promised goods or services*, Paper topic: *Initial Consideration*, IFRS IC meeting, September 2018; and *IFRIC Update*, January 2019, available on the IFRS Foundation's website.

Illustration 4-1: Identification of promised good or service in a contract by a stock exchange that provides listing service to a customer

A stock exchange entity provides its customers with access to the capital markets by admitting them for listing in the stock exchange. The entity charges its customers a non-refundable upfront admission fee and an ongoing listing fee. The non-refundable upfront fee relates to various activities that are undertaken by the entity at or near contract inception to enable admission to the exchange, including:

- Performing due diligence for new applications
- Reviewing the customer's listing application forms, including determining whether the application should be accepted
- Issuing tickers and reference numbers for the new security
- Processing of the listing on, and admission to, the exchange
- Publishing the security on the order book
- Issuing the dealing notice on the applicable admission date

Once the customer has been admitted, the entity provides ongoing market access and maintains the listing. The listing service transferred to the customer is the same on initial listing and on all subsequent days for which the customer remains listed.

As part of identifying the goods and services promised to the customer in the contract, the stock exchange considers whether the above activities undertaken at or near contract inception transfer a service to the customer as the activities are performed. This assessment depends on the facts and circumstances of the contract.

In this fact pattern, the IFRS IC concluded that, while the activities undertaken at or near contract inception are required to fulfil the contract with the customer (which promises to provide the customer with the service of being listed on the exchange), it is likely that the stock exchange would conclude that the activities do not transfer separate services to the customer as they are performed. Accordingly, they are not promised goods or services to be identified under Step 2 of the model.

How we see it

Entities might need to use judgement to identify promised goods or services in a contract. For example, some 'free' goods or services that might seem like marketing incentives have to be evaluated under the standard to determine whether they represent promised goods or services in a contract. In addition, the standard makes it clear that certain activities are not promised goods or services, such as activities that an entity must perform to satisfy its obligation to deliver the promised goods or services (e.g., internal administrative activities).

The Board noted in the Basis for Conclusions that it intentionally "decided not to exempt an entity from accounting for performance obligations that the entity might regard as being perfunctory or inconsequential.[41] Instead, an entity should assess whether those performance obligations are immaterial to its financial statements". *[IFRS 15.BC90]*.

In January 2015, the TRG members noted that entities cannot disregard items that they deem to be perfunctory or inconsequential and need to consider whether 'free' goods or services represent promises to a customer. For example, telecommunications entities might have to allocate consideration to the 'free' handsets that they provide. Likewise, automobile manufacturers might have to allocate consideration to 'free' maintenance that might have been considered a marketing incentive in the past. However, entities would consider materiality in determining whether items are promised goods or services. *[IFRS 15.BC88]*.[42]

FASB differences

The FASB's standard allows entities to disregard promises that are deemed to be immaterial in the context of a contract. IFRS 15 does not include explicit language to indicate an entity can disregard promised goods or services that are immaterial in the context of the contract. Nonetheless, entities applying IFRS 15 would consider materiality in determining the promises in the contract.

The FASB's standard also allows entities to elect to account for shipping and handling activities performed after the control of a good has been transferred to the customer as a fulfilment cost (i.e., an expense). IFRS 15 does not.

41 "The FASB subsequently decided to amend Topic 606 to state that an entity is not required to assess whether promised goods or services are performance obligations if they are immaterial within the context of the contract with the customer. The IASB's considerations for deciding not to make similar amendments to IFRS 15 are explained in paragraphs BC116A-BC116E."

42 TRG Agenda paper no. 25, *January 2015 Meeting - Summary of Issues Discussed and Next Steps,* dated 30 March 2015.

Frequently asked questions

Question 4-1: How would an entity assess whether pre-production activities are a promised good or service?

(TRG meeting 9 November 2015 - Agenda paper no. 46)

Manufacturing and production entities in various industries might perform activities and incur costs before they produce goods. Some arrangements (including long-term supply arrangements) require an entity to incur upfront costs, such as non-recurring engineering and design costs or costs related to set-up activities, to create new technology or adapt existing technology to the needs of the customer.

These pre-production activities are often a prerequisite to delivering any units under a production contract. For example, a manufacturer might incur costs to perform certain services related to the design and development of products it will sell under long-term supply arrangements. It might also incur costs to design and develop moulds, dies and other tools that will be used to produce those products. A contract might require the customer to reimburse the manufacturer for these costs. Alternatively, reimbursement might be implicitly guaranteed as part of the price of the product or by other means.

At the meeting in November 2015, the TRG members generally agreed that the determination of whether pre-production activities are a promised good or service or fulfilment activities requires judgement and consideration of the facts and circumstances. When assessing whether pre-production activities are promises in a contract with a customer (and potentially performance obligations under IFRS 15), entities need to determine whether the activities transfer a good or service to a customer. If an entity determines that these activities are promised goods or services, it applies the requirements in IFRS 15 to those goods or services. Also see Questions 9-15 and 9-16 in section 9.3.2 below for a discussion of how an entity accounts for costs related to pre-production activities and pre-contract or set-up activities, respectively.

The TRG members generally agreed that, if an entity is having difficulty determining whether a pre-production activity is a promised good or service in a contract, the entity needs to consider whether control of that good or service transfers to the customer. For example, if an entity is performing engineering and development services as part of developing a new product for a customer and the customer will own the resulting intellectual property (e.g., patents), it is likely that the entity would conclude that it is transferring control of the intellectual property and that the engineering and development activities are a promised good or service in the contract.

The TRG members noted that assessing whether control transfers in such arrangements might be challenging. In some arrangements, legal title of the good or service created from the pre-production activity is transferred to the customer. However, the TRG members generally agreed that an entity has to consider all indicators of control transfer under IFRS 15 and that the transfer of legal title is not a presumptive indicator.

The IASB staff noted in the TRG agenda paper that, when an entity is determining whether control transfers to a customer in such arrangements, one of the three over-time revenue recognition criteria may be applicable to pre-production activities. That criterion is whether the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs. *[IFRS 15.35(a)]*. As further discussed in section 7.1.1 below, IFRS 15.B3 notes that if an entity cannot readily identify whether this criterion is met, it considers whether another entity would need to re-perform the work the entity had completed to date if that other entity were required to fulfil the remaining performance obligation. *[IFRS 15.B3]*.

For example, assume an entity is performing engineering and development as part of developing a new product for a customer. If the entity provided the customer with periodic progress reports in a level of detail that would not require the customer to contract with another entity to re-perform the work, or if the entity were required to provide the customer with the design information completed to date in the case of a termination, it is likely that the entity would conclude that control of that service transfers to the customer as the entity performs.

If a pre-production activity is determined to be a promised good or service, an entity allocates a portion of the transaction price to that good or service (as a single performance obligation or as part of a combined performance obligation that includes the pre-production activities along with other goods or services). If the pre-production activities are included in a performance obligation satisfied over time, they are considered when measuring progress toward satisfaction of that performance obligation (see section 7.1.4 below).

If a pre-production activity does not result in the transfer of control of a good or service to a customer, an entity considers other requirements that might be applicable (e.g., IAS 16, IAS 38, IFRS 15.95-98 on costs to fulfil a contract with a customer).

Question 4-2: What is the nature of the promise in a 'typical' stand-ready obligation?

(TRG meeting 26 January 2015 - Agenda paper no. 16)

At the January 2015 TRG meeting, the TRG members discussed numerous examples of stand-ready obligations and generally agreed that the nature of the promise in a stand-ready obligation is the promise that the customer will have access to a good or service, not the delivery of the underlying good or service. The standard describes a stand-ready obligation as a promised service that consists of standing ready to provide goods or services or making goods or services available for a customer to use as and when it decides to do so.

The TRG agenda paper included the following types of promises to a customer that could be considered stand-ready obligations, depending on the facts and circumstances:

- Obligations for which the delivery of the good, service or intellectual property is within the control of the entity, but is still being developed (e.g., a software entity's promise to transfer unspecified software upgrades at its discretion)
- Obligations for which the delivery of the underlying good or service is outside the control of the entity and the customer (e.g., an entity's promise to remove snow from an airport runway in exchange for a fixed fee for the year)
- Obligations for which the delivery of the underlying good or service is within the control of the customer (e.g., an entity's promise to provide periodic maintenance on a when-and-if needed basis on a customer's equipment after a pre-established amount of usage by the customer)
- Obligations to make a good or service available to a customer continuously (e.g., a gym membership that provides unlimited access to a customer for a specified period of time)

An entity needs to carefully evaluate the facts and circumstances of its contracts to appropriately identify whether the nature of a promise to a customer is the delivery of the underlying good(s) or service(s) or the service of standing ready to provide goods or services. Entities also have to consider other promises in a contract that includes a stand-ready obligation to appropriately identify the performance obligations in the contract. The TRG members generally agreed that all contracts with a stand-ready element do not necessarily include a single performance obligation (refer to Question 4-3 below).[43]

Refer to Question 4-13 in section 4.2.2 below for a discussion on whether stand-ready obligations are generally considered to be a series of distinct goods or services.

Stand-ready obligations are common in the software industry and might be present in other industries. For example, a software entity's promise to provide an unspecified number of software updates on a when-and-if-available basis typically represents a stand-ready obligation. In contrast, a promise to provide certain specified software updates would generally not be a stand-ready obligation.

Furthermore, an arrangement that requires the customer to make additional purchasing decisions (e.g., through the submission of a purchase order) is generally not a stand-ready obligation. This is because the entity is not obligated to fulfil the purchase order until it is submitted. Therefore, the nature of the promise to the customer is the delivery of the underlying goods or service and not a promise to stand ready to provide goods or services.

For details of the TRG members' discussion on measuring progress toward satisfaction for a stand-ready obligation that is satisfied over time, see Question 7-14 in section 7.1.4.E below.

Question 4-3: Do all contracts with a stand-ready element include a single performance obligation that is satisfied over time?

(TRG meeting 9 November 2015 - Agenda paper no. 48)

The TRG members generally agreed that the stand-ready element in a contract does not always represent a single performance obligation satisfied over time. This conclusion is consistent with the discussion in Question 4-2 above that, when identifying the nature of a promise to a customer, an entity might determine that a stand-ready element exists, but it is not the promised good or service for revenue recognition purposes. Instead, the underlying goods or services are the goods or services promised to the customer and accounted for by the entity.

43 TRG Agenda paper no. 48, *Customer options for additional goods and services*, dated 9 November 2015.

Consider the following Illustration based on the example in the TRG agenda paper:

Illustration 4-2: Determining the nature of the promise in a contract with a stand-ready element

An entity is required to stand ready to produce a part for a customer under an MSA. The customer is not obligated to purchase any parts (i.e., there is no minimum guaranteed volume). However, it is highly likely the customer will purchase parts because the part is required to manufacture the customer's product and it is not practical for the customer to buy parts from multiple suppliers. The TRG members generally agreed that the nature of the promise in this example is the delivery of the parts, rather than a service of standing ready. When the customer submits a purchase order under the master supply arrangement, it is contracting for a specific number of distinct goods and the purchase order creates new performance obligations for the entity. However, if the entity determined that the nature of the promise is a service of standing ready, the contract would be accounted for as a single performance obligation satisfied over time. In that situation, the entity might be required to estimate the number of purchases to be made throughout the contract term (i.e., make an estimate of variable consideration and apply the constraint on variable consideration) and continually update the transaction price and its allocation among the transferred goods or services.

The TRG agenda paper also noted that, in this example, the entity is not obligated to transfer any parts until the customer submits a purchase order (i.e., the customer makes a separate purchasing decision). This contrasts with a stand-ready obligation, which requires the entity to make a promised service available to the customer and does not require the customer to make any additional purchasing decisions.

See Question 4-20 in section 4.6 below for further discussion on determining whether a contract involving variable quantities of goods or services is accounted for as variable consideration (i.e., if the nature of the promise is to transfer one overall service to the customer, such as a stand-ready obligation) or a contract containing customer options (i.e., if the nature of the promise is to transfer the underlying distinct goods or services).

Question 4-4: How would an entity evaluate whether an exclusivity provision in a contract with customer represents a promised good or service?

How we see it

We generally believe that an exclusivity provision does not represent a promised good or service.

Contracts with customers involving the sale of products or services might contain exclusivity clauses whereby the entity agrees that it will not provide the products or services to others or will do so only on a limited basis. Such provisions could restrict the distribution of the products or services in certain geographical areas and/or prohibit the sale of the products or services to a customer's competitors. For example, an entity that provides advertising on its website might agree to run a banner advertisement for one customer for a specified period of time and exclude advertisements for similar products or services from the advertiser's competitors.

In the Basis for Conclusions on IFRS 15, the IASB discussed exclusivity in relation to licences of intellectual property and concluded that exclusivity is a restriction that represents an attribute of a licence, rather than the nature of the underlying intellectual property or the entity's promise in granting the licence. That is, exclusivity provisions define the scope of the customer's rights to intellectual property and would not be accounted for separately (see section 8.1.3 below for further discussion). *[IFRS 15.BC412(b)]*.

As explained above, we believe that the same principles would apply when evaluating exclusivity provisions in contracts that do not contain a licence of intellectual property. That is, exclusivity is an attribute of the promise to the customer, rather than a separate promised good or service. This is because exclusivity does not change the nature of the entity's performance to provide the underlying goods or services to the customer.

Any upfront payment received from a customer related to an exclusivity provision would need to be evaluated to determine whether it represents a material right (see further discussion in section 5.8 below). Conversely, an entity might make a payment to a customer for being the customer's exclusive provider for certain goods or services. Any payment made by the entity to the customer would need to be evaluated in accordance with the requirements for consideration paid or payable to a customer (see further discussion in section 5.7 below).

Question 4-5: Does a guarantee to defend or maintain a patent represent a promised good or service?

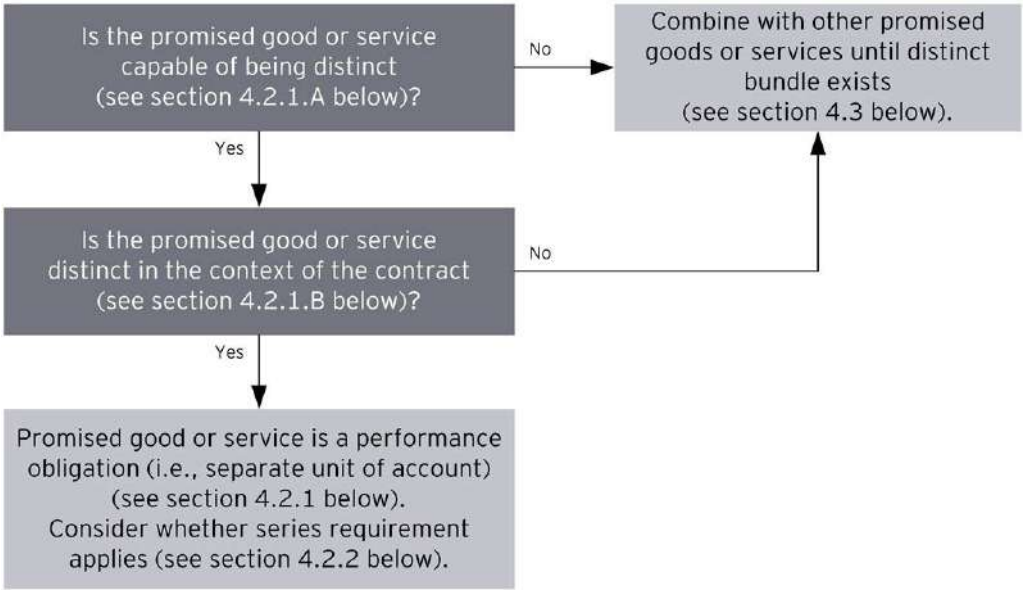
A guarantee to defend or maintain a patent does not represent a promised good or service. This is consistent with IFRS 15.B62(b) (discussed in section 8.1.4 below). *[IFRS 15.B62(b)]*.

4.2 Determining when promises are performance obligations

After identifying the promised goods or services within a contract, an entity determines which of those goods or services will be treated as separate performance obligations. That is, the entity identifies the individual units of account. Promised goods or services represent separate performance obligations if the goods or services are distinct (by themselves, or as part of a bundle of goods or services) (see section 4.2.1 below) or if the goods or services are part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer (see section 4.2.2 below).

If a promised good or service is not distinct, an entity is required to combine that good or service with other promised goods or services until it identifies a bundle of goods or services that, together, is distinct. *[IFRS 15.30]*. An entity is required to account for all the goods or services promised in a contract as a single performance obligation if the entire bundle of promised goods or services is the only performance obligation identified. See section 4.3 below for further discussion. The following flow chart illustrates these requirements:

Figure 4-2: Determining when promises are performance obligations



A single performance obligation could include a licence of intellectual property and other promised goods or services. IFRS 15 identifies two examples of licences of intellectual property that are not distinct from other promised goods or services in a contract: (1) a licence that is a component of a tangible good and that is integral to the functionality of the tangible good; and (2) a licence that the customer can benefit from only in conjunction with a related service (e.g., an online hosting service that enables a customer to access the content provided by the licence of intellectual property). *[IFRS 15.B54]*. See section 8.1.2 below for further discussion on these two examples.

The standard also specifies that the following items are performance obligations:

- Customer options for additional goods or services that provide material rights to customers (see section 4.6 below) *[IFRS 15.B39-B43]*
- Service-type warranties (see in section 9.1 below) *[IFRS 15.B28-B33]*

Entities do not apply the general model to determine whether these goods or services are performance obligations because the Board deemed them to be performance obligations if they are identified as promises in a contract.

The Board noted that an entity is not precluded from accounting for distinct goods or services that are delivered concurrently and have the same pattern of transfer, as a single performance obligation, if the outcome would be the same as accounting for the goods and services as individual performance obligations. *[IFRS 15.BC116]*.

4.2.1 Determination of 'distinct'

IFRS 15 outlines a two-step process for determining whether a promised good or service (or a bundle of goods or services) is distinct: *[IFRS 15.27]*

- Consideration at the level of the individual good or service of whether the customer can benefit from the good or service on its own or with other readily available resources (i.e., the good or service is capable of being distinct)
- Consideration of whether the good or service is separately identifiable from other promises in the contract (i.e., the promise to transfer the good or service is distinct within the context of the contract)

Both of these criteria must be met to conclude that the good or service is distinct. If these criteria are met, the individual good or service must be accounted for as a separate unit of account (i.e., a performance obligation).

The Board concluded that both steps are important in determining whether a promised good or service is accounted for separately. The first criterion (i.e., capable of being distinct) establishes the minimum characteristics for a good or service to be accounted for separately. However, even if the individual goods or services promised in a contract are capable of being distinct, it might not be appropriate to account for each of them separately because doing so would not result in a faithful depiction of the entity's performance in that contract or appropriately represent the nature of an entity's promise to the customer. *[IFRS 15.BC102]*. Therefore, an entity also needs to consider the interrelationship of those goods or services to apply the second criterion (i.e., distinct within the context of the contract) and determine the performance obligations within a contract.

The IFRS IC received a request about the identification of performance obligations in a contract for the sale of a real estate unit that includes the transfer of land, which is discussed in section 4.2.1.G below.

4.2.1.A Capable of being distinct

The first criterion requires that a promised good or service must be capable of being distinct by providing a benefit to the customer either on its own or together with other resources that are readily available to the customer.

The standard provides the following requirements on how to determine whether a promised good or service is capable of being distinct: *[IFRS 15.28]*

Extract from IFRS 15	
28	A customer can benefit from a good or service in accordance with paragraph 27(a) if the good or service could be used, consumed, sold for an amount that is greater than scrap value or otherwise held in a way that generates economic benefits. For some goods or services, a customer may be able to benefit from a good or service on its own. For other goods or services, a customer may be able to benefit from the good or service only in conjunction with other readily available resources. A readily available resource is a good or service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained from the entity (including goods or services that the entity will have already transferred to the customer under the contract) or from other transactions or events. Various factors may provide evidence that the customer can benefit from a good or service either on its own or in conjunction with other readily available resources. For example, the fact that the entity regularly sells a good or service separately would indicate that a customer can benefit from the good or service on its own or with other readily available resources.

Determining whether a good or service is capable of being distinct is straightforward in many situations. For example, if an entity regularly sells a good or service separately, this fact would demonstrate that the good or service provides benefit to a customer on its own or with other readily available resources.

The evaluation might require more judgement in other situations, particularly when the good or service can only provide benefit to the customer with readily available resources provided by other entities. These are resources that meet either of the following conditions:

- They are sold separately by the entity (or another entity).
- The customer has already obtained them from the entity (including goods or services that the entity has already transferred to the customer under the contract) or from other transactions or events.

As noted in the Basis for Conclusions, the assessment of whether the customer can benefit from the goods or services (either on its own or with other readily available resources) is based on the characteristics of the goods or services themselves, instead of how the customer might use the goods or services. *[IFRS 15.BC100]*. Consistent with this notion, an entity disregards any contractual limitations that might prevent the customer from obtaining readily available resources from a party other than the entity when making this assessment (as illustrated in Example 11, Case D, extracted in full in section 4.2.3 below). The IFRS IC also reiterated this point during its March 2018 meeting (see section 4.2.1.G below for further discussion). *[IFRS 15.IE Example 11 Case D, IFRS 15.IE58E-IE58F]*.

In the Basis for Conclusions, the Board explained that it did not require that a delivered item have 'value to the customer on a stand-alone basis' for an entity to account for that item separately. The Board said it wanted to avoid implying that an entity must assess a customer's intended use for a promised good or service when it is identifying performance obligations because it observed that it would be difficult, if not impossible, for an entity to know a customer's intent. *[IFRS 15.BC101]*.

4.2.1.B Distinct within the context of the contract

Once an entity has determined whether a promised good or service is capable of being distinct based on the individual characteristics of the promise, the entity considers the second criterion of whether the good or service is separately identifiable from other promises in the contract (i.e., whether the promise to transfer the good or service is distinct within the context of the contract).

The standard provides the following requirements for making this determination: *[IFRS 15.29]*

Extract from IFRS 15

29 In assessing whether an entity's promises to transfer goods or services to the customer are separately identifiable in accordance with paragraph 27(b), the objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each of those goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate that two or more promises to transfer goods or services to a customer are not separately identifiable include, but are not limited to, the following:

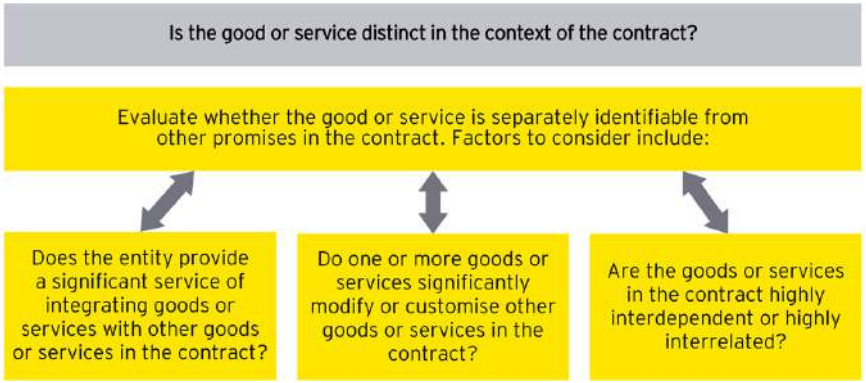
(a) the entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer. A combined output or outputs might include more than one phase, element or unit.

(b) one or more of the goods or services significantly modifies or customises, or are significantly modified or customised by, one or more of the other goods or services promised in the contract.

(c) the goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfil its promise by transferring each of the goods or services independently.

The following figure depicts the above requirements:

Figure 4-3: Distinct in the context of the contract



4.2.1.C Distinct within the context of the contract: separately identifiable principle

To determine whether promised goods or services are separately identifiable (i.e., whether a promise to transfer a good or service is distinct within the context of the contract), an entity needs to evaluate whether its promise is to transfer each good or service individually or a combined item (or items) that comprises the individual goods or services promised in the contract. Therefore, an entity would evaluate whether the promised goods or services in the contract are outputs or they are inputs to a combined item (or items). In the Basis for Conclusions, the Board noted that, in many cases, a combined item (or items) is more than (or substantially different from) the sum of the underlying promised goods or services. *[IFRS 15.BC116J]*.

The evaluation of whether an entity's promise is separately identifiable considers the relationship between the various goods or services in the context of the process to fulfil the contract. Therefore, an entity considers the level of integration, interrelation or interdependence among the promises to transfer goods or services. In the Basis for Conclusions, the Board observed that, rather than considering whether one item, by its nature, depends on the other (i.e., whether two items have a functional relationship), an entity evaluates whether there is a transformative relationship between the two or more items in the process of fulfilling the contract. *[IFRS 15.BC116K]*. The point was also reiterated by the IFRS IC during its March 2018 meeting (see the discussion in section 4.2.1.G below).

The Board also emphasised that the separately identifiable principle is applied within the context of the bundle of promised goods or services in the contract. It is not within the context of each individual promised good or service. That is, the separately identifiable principle is intended to identify when an entity's performance in transferring a bundle of goods or services in a contract is fulfilling a single promise to a customer. Therefore, to apply the 'separately identifiable' principle, an entity evaluates whether two or more promised goods or services significantly affect each other in the contract (and are, therefore, highly interdependent or highly interrelated). *[IFRS 15.BC116L]*.

As an example of this evaluation, the IASB discussed in the Basis for Conclusions a typical construction contract that involves transferring to the customer many goods or services that are capable of being distinct (e.g., various building materials, labour, project management services). In this example, the IASB concluded that identifying all of the individual goods or services as separate performance obligations would be impractical and would not faithfully represent the nature of the entity's promise to the customer. That is, the entity would recognise revenue when the materials and other inputs to the construction process are provided rather than when it performs (and uses those inputs) in the construction of the item the customer has contracted to receive (e.g., a building, a house). As such, when determining whether a promised good or service is distinct, an entity not only determines whether the good or service is capable of being distinct but also whether the promise to transfer the good or service is distinct within the context of the contract. *[IFRS 15.BC102]*.

IFRS 15 includes three factors (discussed individually in sections 4.2.1.D - 4.2.1.F below) that are intended to help entities identify when the promises in a bundle of promised goods or services are not separately identifiable and, therefore, need to be combined into a single performance obligation. *[IFRS 15.29]*. In the Basis for Conclusions, the IASB noted that these three factors are not an exhaustive list and that not all of the factors need to exist in order to conclude that the entity's promises to transfer goods or services are not separately identifiable. As emphasised by the IFRS IC during its March 2018 meeting (see the discussion in section 4.2.1.G below), the three factors also are not intended to be criteria that are evaluated independently of the separately identifiable principle. Given the wide variety of arrangements that are within the scope of IFRS 15, the Board expects that there are some instances in which the factors are less relevant to the evaluation of the separately identifiable principle. *[IFRS 15.BC116N]*. Entities might need to apply significant judgement to evaluate whether a promised good or service is separately identifiable. The evaluation requires a thorough understanding of the facts and circumstances present in each contract. An entity would consider the following questions, which summarise what is discussed in the Basis for Conclusions: *[IFRS 15.BC116J, IFRS 15.BC116K, IFRS 15.BC116L]*

- Is the combined item greater than, or substantively different from, the sum of the promised goods or services?
- Is an entity, in substance, fulfilling a single promise to the customer?
- Is the risk an entity assumes to fulfil its obligation to transfer a promised good or service inseparable from the risk relating to the transfer of the other promised goods or services in the bundle?
- Do two or more promised goods or services each significantly affect the other?
- Does each promised good or service significantly affect the other promised good or service's utility to the customer?

In a speech, a member of staff from the US SEC focused on considerations for determining whether a promise to transfer a good or service to a customer is separately identifiable from other promises in the contract, which could require significant judgement, as noted above. The SEC staff member emphasised the importance of supporting a registrant's conclusions by providing a well-reasoned analysis of the guidance in the revenue standard, rather than just referring to the manner in which the goods and services are sold to customers. The SEC staff member stated that the SEC staff are not persuaded that promises are combined into a single performance obligation simply because they are provided as part of a 'solution'. Instead, they expect registrants to provide a robust assessment of the requirements in the revenue standard to support an assertion that the promises to transfer goods are not separately identifiable.

To illustrate this, the SEC staff member described a consultation with the Office of the Chief Accountant (OCA) in which the staff did not object to a registrant's conclusion that software and software updates represent a combined performance obligation. The registrant was able to demonstrate that the software updates were integral to maintaining the utility of the software. That is, without the software updates, the customer's ability to benefit from the software would be significantly limited over the contract term. Based on this point and other facts and circumstances, the registrant was able to demonstrate that the combined output was greater than, or substantively different from, the individual promises of the software and software updates.[44]

4.2.1.D Distinct within the context of the contract: significant integration service

The first factor (included in IFRS 15.29(a)) is the presence of a significant integration service. *[IFRS 15.29(a)]*. The IASB determined that, when an entity provides a significant service of integrating a good or service with other goods or services in a contract, the bundle of integrated goods or services represents a combined output or outputs. In other words, when an entity provides a significant integration service, the risk of transferring individual goods or services is inseparable from the bundle of integrated goods or services because a substantial part of an entity's promise to the customer is to make sure the individual goods or services are incorporated into the combined output or outputs. *[IFRS 15.BC107]*. When evaluating this factor, entities need to consider whether they are providing a significant integration service that effectively *transforms* the individual promised goods or services (the inputs) into a combined output(s), as discussed in Example 11, Case E (included in section 4.2.3 below). When more than one party is involved in providing goods or services to a customer, entities would refer to Example 46. *[IFRS 15.IE Example 11 Case E, IFRS 15.IE58G-IE58K, IFRS 15.IE Example 46, IFRS 15.IE234-IE238]*. This is consistent with the notion discussed above that a combined item (or items) would be greater than (or substantially different from) the sum of the underlying promised goods or services.

This factor applies even if there is more than one output. Furthermore, as described in the standard, a combined output or outputs might include more than one phase, element or unit.

In the Basis for Conclusions, the IASB noted that this factor might be relevant in many construction contracts in which a contractor provides an integration (or contract management) service to manage and coordinate the various construction tasks and to assume the risks associated with the integration of those tasks. An integration service provided by the contractor often includes coordinating the activities performed by any subcontractors and making sure the quality of the work performed is in compliance with contract specifications and that the individual goods or services are appropriately integrated into the combined item that the customer has contracted to receive. *[IFRS 15.BC107]*. This type of construction contract and the analysis of whether it contains a significant integration service is illustrated in Example 10, Case A (included in section 4.2.3 below), *[IFRS 15.IE Example 10 Case A, IFRS 15.IE45-IE48]*, and in Illustration 4-3 below. In addition, when more than one party (e.g., a subcontractor) is involved in providing goods or services to a customer, the standard requires the entity to determine whether it is a principal or an agent in these transactions (see section 4.4).

Illustration 4-3: Significant integration service

Contractor Q, a construction firm, enters into a contract with a customer to design and construct a concert hall. The project has two phases, design and construction and the contract provides separate compensation for each phase.

For purposes of this example, assume that the individual goods and services provided in each phase are capable of being distinct. Contractor Q must then determine whether each of the individual goods and services in each phase are distinct in the context of the contract. Contractor Q provides a significant service of: (1) integrating the various design services to produce project plans in the design phase; and (2) integrating the various materials and construction services to build the concert hall in the construction phase. Contractor Q then evaluates whether the aggregated goods and services in the design phase (i.e., project plans) and aggregated goods and services in the construction phase (i.e., concert hall) are distinct in the context of the contract and, therefore, are two performance obligations or whether together they represent a single performance obligation.

44 Speech, *Remarks before the 2019 AICPA Conference on Current SEC and PCAOB Developments*, by Susan M. Mercier, Professional Accounting Fellow, SEC Office of the Chief Accountant, 9 December 2019. Available on the SEC's website.

In this Illustration, the design and construction of a concert hall is necessary to satisfy Contractor Q's contract with the customer. Given the complex nature of the project, assume Contractor Q will be required to frequently alter the design of the concert hall during construction and to continually assess the propriety of the materials to be used. These changes might cause Contractor Q to rework the construction of the concert hall. Contractor Q determines it is providing a significant service of integrating goods and services into the combined output for which the customer has contracted (i.e., a completed concert hall). Contractor Q concludes that the design services and construction services are not distinct in the context of the contract and instead are combined and accounted for as one performance obligation.

The Board observed that this factor could apply to other industries as well. *[IFRS 15.BC108]*. In a speech, a member of the US SEC staff described a consultation with the OCA in which an entity concluded that it was providing a significant integration service that transformed equipment (e.g., cameras, sensors) and monitoring services into a combined output (i.e., a 'smart' security solution) that provided its customers with an overall service offering that was greater than the customer could receive from each individual promise. In this consultation, OCA did not object to the entity's conclusion that its promises comprised a single performance obligation.[45]

4.2.1.E Distinct within the context of the contract: significant modification or customisation

The second factor in IFRS 15.29(b) is the presence of significant modification or customisation. *[IFRS 15.29(b)]*. In the Basis for Conclusions, the IASB explained that in some industries, the notion of inseparable risks is more clearly illustrated by assessing whether one good or service significantly modifies or customises another. This is because if a good or service modifies or customises another good or service in a contract, each good or service is being assembled together (as an input) to produce a combined output. *[IFRS 15.BC109]*.

In the Basis for Conclusions on IFRS 15, the Board provided an example which the following Illustration is based on: *[IFRS 15.BC110]*

Illustration 4-4: Significant customisation service

Assume that an entity promises to provide a customer with software that it will significantly customise to make the software function with the customer's existing infrastructure. Based on its facts and circumstances, the entity determines that it is providing the customer with a fully integrated system and that the customisation service requires it to significantly modify the software in such a way that the risks of providing it and the customisation service are inseparable (i.e., the software and customisation service are not separately identifiable).

The *significance* of modification or customisation services can affect an entity's conclusion about the number of identified performance obligations for similar fact patterns. Consider Example 11, Case A, and Example 11, Case B, in the standard (included in section 4.2.3 below). In Case A, each of the promised goods or services are determined to be distinct because the installation services being provided to the customer do not significantly modify the software. In Case B, two of the promised goods or services are combined into one performance obligation because one promise (the installation) significantly customises another promise (the software). *[IFRS 15.IE Example 11 Case A-Case B, IFRS 15.IE49-IE58]*.

4.2.1.F Distinct within the context of the contract: highly interdependent or highly interrelated

The third factor in IFRS 15.29(c) is whether the promised goods or services are highly interdependent or highly interrelated. *[IFRS 15.29(c)]*. This is often the most difficult distinct factor for entities to assess. Promised goods or services are highly interdependent or highly interrelated if each of the promised goods or services is significantly affected by one or more of the other goods or services in the contract. As discussed above, the Board clarified that an entity would evaluate how two or more promised goods or services affect each other and not just evaluate whether one item, by its nature, depends on the other. That is, an entity needs to evaluate whether there is a *significant two-way dependency* or transformative relationship between the promised goods or services to determine whether the promises are highly interdependent or highly interrelated. Determining whether a two-way dependency is significant such that the promises are highly interdependent or highly interrelated with each other is a judgement that requires careful consideration.

45 Speech, *Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments*, by Sheri L. York, Professional Accounting Fellow, SEC Office of the Chief Accountant, 10 December 2018. Available on the SEC's website.

In the Basis for Conclusions on IFRS 15, the Board provided an example, which the following Illustration is based on. *[IFRS 15.BC112]*.

Illustration 4-5: Highly interdependent and highly interrelated

An entity promises to design an experimental new product for a customer and to manufacture ten prototype units of that product. Because the product and manufacturing process is unproven, the entity is required to continue to revise the design of the product during the construction and test of the prototypes and make any necessary modifications to in-progress or completed prototypes. The entity expects that most, or all, of the units to be produced will require some rework because of design changes made during the production process. That is, the customer is not likely to be able to choose whether to purchase only the design service or the manufacturing service without one significantly affecting the other. The entity determines that the design and manufacturing promises are highly interdependent on, and highly interrelated with, the other promises in the contract. Consequently, although each promise might provide a benefit on its own, the promises are not separately identifiable within the context of the contract.

Conversely, if the design was similar to that of a previous product and/or the entity did not expect to have to rework the prototypes due to design changes, the entity might determine that the two promises are not highly interdependent or highly interrelated and might conclude the contract contains multiple performance obligations.

Goods or services might not be separately identifiable if they are so highly interdependent on, or highly interrelated with, other goods or services under the contract. This might occur when the customer's decision not to purchase one promised good or service would significantly affect the other promised goods or services. In other words, the promised goods or services are so highly interrelated or highly interdependent with each other that the entity could not fulfil an individual promise independently from the other promises in the contract.

One aspect on which this evaluation should focus is the specific utility that can only be delivered through the combination of the goods or services. That is, it is important to establish that the utility each good or service can provide on its own is significantly less than the utility of the combined goods or services. Often, gaining sufficient understanding of the specific utility of the individual goods or services, as well as the combined offering, might involve discussion with employees from various departments (e.g., engineering, sales), in addition to those in the accounting and finance departments. An entity also needs to consider how its products and services are described in publicly available information (e.g., the entity's website, investor relations reports, financial statement filings). Those descriptions might indicate which functionalities are critical to the overall offering and influence customer expectations and whether those functionalities significantly affect the utility of other goods or services in the contract. Overall, the specific facts and circumstances of each offering and contract have to be carefully considered.

The concept regarding an entity's ability to separately fulfil a promise to a customer is highlighted in Example 11, Case E, (included in section 4.2.3 below) in the standard. This example includes a contract for the sale of equipment and specialised consumables to be used with the equipment. In this example, the entity determines that the equipment and consumables are not highly interdependent or highly interrelated because the two promises do not significantly affect each other. As part of its analysis, the entity concludes that it would be able to fulfil each of its promises in the contract independently of the other promises.

4.2.1.G Distinct within the context of the contract: March 2018 IFRS IC discussion

In 2017, the IFRS IC received a request regarding the identification of performance obligations in a contract for the sale of a real estate unit that includes the transfer of land. The request also asked about the timing of revenue recognition for each performance obligation (either over-time or at a point in time), which is discussed in Question 7-11 in section 7.1.3.B below. At its March 2018 meeting, the IFRS IC concluded that the principles and requirements in IFRS 15 provide sufficient guidance for an entity to recognise revenue in a contract for the sale of a real estate unit that includes the transfer of land. Consequently, the IFRS IC decided not to add this matter to its agenda.[46]

46 *IFRIC Update*, March 2018, available on the IFRS Foundation's website.

In considering this request, the IFRS IC noted that the assessment of the distinct criteria requires judgement. Furthermore:

- The assessment of the first criterion is based on the characteristics of the goods or services themselves. Accordingly, an entity disregards any contractual limitations that might preclude the customer from obtaining readily available resources from a source other than the entity (see section 4.2.1.A above). *[IFRS 15.BC100]*.
- The objective underlying the second criterion is to determine the nature of the promise within the context of the contract. That is, whether the entity has promised to transfer either the promised goods or services individually or a combined item to which those goods or services are inputs. IFRS 15 also includes some factors that indicate that two or more promises to transfer goods or services are not separately identifiable. *[IFRS 15.29]*. However, these factors are not intended to be criteria that an entity evaluates independently of the 'separately identifiable' principle because, in some instances, one or more of the factors might be less relevant to the evaluation of that principle (see section 4.2.1.C above). *[IFRS 15.BC116N]*.

  In the Basis for Conclusion, the Board indicated that the separately identifiable concept is influenced by the idea of separable risks. That is, whether the risk assumed to fulfil the obligation to transfer one of the promised goods or services to the customer is separable from the risk relating to the transfer of the other promised goods or services. Evaluating whether an entity's promise is separately identifiable considers the interrelationship between the goods or services within the contract in the context of the process to fulfil the contract. Accordingly, an entity considers the level of integration, interrelation or interdependence among the promises in the contract to transfer goods or services. An entity evaluates whether, in the process of fulfilling the contract, there is a transformative relationship between the promises, rather than considering whether one item, by its nature, depends upon another (i.e., whether the promises have a functional relationship). *[IFRS 15.BC105, IFRS 15.BC116J, IFRS 15.BC116K]*. That is, the conclusion about whether the promised goods or services are separately identifiable hinges on whether there is a *significant two-way dependency* between the items. Determining whether a two-way dependency is significant such that the promises are separately identifiable is a judgement that requires careful consideration (this is discussed further in section 4.2.1.F above).

The following Illustration is based on the example from the IFRS IC agenda paper used by the IFRS IC when it discussed the identification of performance obligations in its March 2018 meeting:[47]

Illustration 4-6: Identification of performance obligations in a contract for the sale of a real estate unit that includes the transfer of land

Entity A enters into a non-cancellable contract with a customer for the sale of a real estate unit that involves the transfer of a plot of land and a building that Entity A constructs on that land. The land represents all of the area on which the building will be constructed and the contract is for the entire building.

At contract inception, Entity A transfers the legal title of the land and the customer pays the price specified in the contract for it. The transfer of legal title to the customer cannot be revoked, regardless of what happens during the construction of the building. Throughout the construction period, the customer makes milestone payments that do not necessarily correspond to the amount of work completed to date.

The design and specification of the building were agreed between the counterparties before the contract was signed. However, during the construction of the building, the customer can request changes to the design and specification that are priced by Entity A based on a methodology specified in the contract. If the customer decides to proceed with the proposed changes, Entity A can reject them only for a limited number of reasons (e.g., when the change would breach planning permission). Entity A can only request changes if not doing so would lead to an unreasonable increase in costs or delay construction. However, the customer must approve those changes.

Entity A first assesses whether the land and the building are each capable of being distinct in accordance with IFRS 15.27(a). Entity A determines that the customer could benefit from the land on its own or together with other resources readily available to it (e.g., by hiring another developer to construct a building on the land). Also, Entity A determines that the customer could benefit from the construction of the building on its own or together with other resources readily available to it (e.g., by obtaining the construction services from Entity A or another developer without transferring the land). Therefore, Entity A concludes that the land and the building are each capable of being distinct.

47 IASB Staff Paper 2D: Project: *Revenue recognition in a real estate contract that includes the transfer of land (IFRS 15), IFRS IC Meeting*, Paper topic: *Agenda decision to finalise,* March 2018; and *IFRIC Update*, March 2018. Available on the IFRS Foundation's website.

The criterion in paragraph 27(b) is then assessed by Entity A in order to determine whether the land and the building are distinct in the context of the contract. In making this assessment, Entity A considers the factors in IFRS 15.29, including the following:

a. Whether it provides a significant service of integrating the land and the building into a combined output. Entity A analyses the transformative relationship between the transfer of the land and the construction of the building in the process of fulfilling the contract. As part of this analysis, it considers whether its performance in constructing the building would be different if it did not also transfer the land and *vice versa*. Despite the functional relationship between the land and the building (because the building cannot exist without the land on which its foundations will be built), the risks assumed by Entity A in transferring the land might, or might not, be separable from those assumed in constructing the building.

b. Whether the land and the building are highly interdependent or highly interrelated. Entity A determines whether its promise to transfer the land could be fulfilled if it did not also construct the building and *vice versa*.

The IFRS IC concluded that the two promises would be separately identifiable if Entity A concluded that "(a) its performance in constructing the building would be the same regardless of whether it also transferred the land; and (b) it would be able to fulfil its promise to construct the building even if it did not also transfer the land, and would be able to fulfil its promise to transfer the land even if it did not also construct the building."[48]

4.2.1.H Distinct within the context of the contract: examples

The IASB included a number of examples in the standard that illustrate the application of the requirements for identifying performance obligations. The examples include analysis of how an entity might determine whether the promises to transfer goods or services are distinct within the context of the contract. Refer to section 4.2.3 below for full extracts of several of these examples.

How we see it

The assessment of whether a good or service is distinct must consider the specific contract with a customer. That is, an entity cannot assume that a particular good or service is distinct (or not distinct) in all instances. The manner in which promised goods or services are bundled within a contract can affect the conclusion of whether a good or service is distinct. As a result, entities might account the same goods or services differently, depending on how those goods or services are bundled within a contract.

Frequently asked questions

Question 4-6: How does an entity determine whether 'connected' hardware sold with cloud services represent one or more performance obligations?

To identify performance obligations in contracts containing connected hardware and cloud services, entities must determine whether the hardware and cloud services are each capable of being distinct and whether they are distinct within the context of the contract (as discussed in section 4.2.1 above). An increasing number of connected hardware devices are now available (e.g., security cameras, home equipment). In contracts where a customer purchases hardware, the hardware might require the installation of an app or the purchase of a cloud service subscription in order to be used. Alternatively, the hardware might provide additional functionalities when paired with the cloud service.

In evaluating the distinct criteria, entities need to consider: whether the hardware can be used without the cloud service; how the hardware and cloud service affect each other (e.g., whether the cloud service enables the hardware to 'learn' or perform its intended function better over time); whether there are additional functionalities that result from using the hardware with the cloud service; and other details of how the hardware and cloud services function and are sold.

48 *IFRIC Update*, March 2018, available on the IFRS Foundation's website.

Consider the following Illustration where an entity concludes that the connected hardware and cloud services are separately identifiable:

Illustration 4-7: Hardware sold with cloud services

Entity L enters into a contract with a customer to provide a smart home security camera bundled with cloud services, which enable the customer to view live images from the camera in an app on internet-connected devices (e.g., tablets, phones). Entity L also provides the cloud services to customers who purchase the camera through secondary markets.

Entity L concludes that the customer can benefit from each of the goods and services either on its own or together with other goods or services that are readily available. That is, each good or service is capable of being distinct under IFRS 15.27(a).

The camera is capable of being distinct because the customer can benefit from it together with the cloud services, which are a readily available resource since they can be obtained separately. Furthermore, the customer can benefit from the camera because it can be resold through secondary markets for more than scrap value.

The cloud services are capable of being distinct because the customer can benefit from them together with the camera transferred at the outset of the contract or the customer can purchase the camera separately through the secondary markets and obtain the cloud services from the entity.

Entity L then considers the factors in IFRS 15.29 and determines that the promise to transfer each good and service is distinct within the context of the contract. In reaching this conclusion, the entity notes that it does not provide a significant service of integrating the cloud services with the camera into a combined output, and the cloud services and the camera do not significantly modify or customise one another.

Entity L also determines that the camera and the cloud services are not highly interdependent or highly interrelated because it can fulfil its promise to transfer the cloud services independently from its promise to provide the camera (i.e., since customers can purchase the camera in secondary markets).

The cloud services provide only the basic functionality of connecting the camera to a personal device using Wi-Fi (instead of a traditional electrical cable). Therefore, the utility the customer can derive from the camera and the cloud services (when transferred together) is not greater than, or substantially different from, the utility the customer would receive if the camera and cloud services had been transferred separately.

As a result, Entity L identifies two performance obligations: the camera and the cloud services.

Entities will need to evaluate the specific features and functionality of the cloud services in arrangements that include connected hardware devices. Evaluating whether hardware and cloud services are separate performance obligations in arrangements for connected devices might be complex and require significant judgement when the cloud service has sophisticated features or functionality that the device cannot do independently. In these cases, there might be a high degree of interdependency between the hardware and the cloud service or a significant integration service might be present.

How we see it

To conclude that hardware and a cloud service are a single performance obligation, entities will need to demonstrate that the functionality of both the hardware and the service is significantly elevated when they are used together. Many technology entities have concluded that they have separate performance obligations because the hardware and the cloud service do not significantly affect each other and because the hardware can be sold separately from the cloud service.

Question 4-7: How would entities determine whether implementation services are distinct?

Entities will need to assess their implementation services and consider all relevant facts and circumstances to determine whether they are separate performance obligations (i.e., they are capable of being distinct and are distinct within the context of a contract, as discussed in section 4.2.1 above).

Entities might include promises to provide implementation services to customers as part of their product or service contracts (i.e., the implementation activities have been determined to transfer a service to the customer, as discussed in section 4.1 above). For example, these services might include training of customer personnel and data conversion.

When assessing whether implementation services are capable of being distinct, an entity first considers whether the customer can benefit from those services on their own. There is strong evidence to suggest that implementation services are capable of being distinct if third party vendors offer (or are capable of offering) implementation services for the entity's products or services, or if the customer could perform these services on its own. This evidence would demonstrate that the implementation services provide benefit to the customer on their own (i.e., apart from the other promised products or services purchased from the entity).

If an entity concludes that the customer is not able to benefit from the implementation services on their own, the entity considers whether the customer can benefit from the services together with other readily available resources. Readily available resources include the other promised products or services from the contract if they are sold separately by the entity or if they are transferred to the customer before the implementation services. An entity disregards any contractual limitations that prevent the customer from obtaining readily available resources from a party other than the entity when making this assessment. That is, contractually restricting a customer from using another vendor to perform the installation services would not preclude an entity from determining that the implementation services are capable of being distinct.

In assessing whether the implementation services are distinct within the context of the contract, an entity needs to consider whether: the implementation services modify or customise the other promised products or services; the entity is providing a significant service of integrating the promised products or services with the implementation services into one combined output; or the entity would be able to fulfil its promise to transfer the other promised products or services in the contract independently from its promise to provide the implementation services (i.e., whether the implementation services are highly interdependent or interrelated with the other products or services). This evaluation might require judgement and is based on the facts and circumstances of the entity's contracts.

The following Illustrations depict implementation services that are distinct and are not distinct, respectively:

Illustration 4-8: Implementation services are distinct

Technology entity P enters into an arrangement with a customer to perform implementation services and to provide software as a service (SaaS) for a three-year period. The entity sells the SaaS and implementation services separately. The implementation services include changing the layout of the main dashboard for each type of user (e.g., marketing, finance) and do not alter the source code of the underlying software or add any new functionality. The implementation service is routinely performed by third parties and does not significantly modify or customise the SaaS.

Technology entity P evaluates the promised goods and services to determine which promises would be accounted for as separate performance obligations.

Technology entity P concludes that the implementation services are capable of being distinct because they can be used with the SaaS, a readily available resource, and because they can be purchased from third parties. Furthermore, the implementation services are distinct within the context of the contract for the following reasons: they are routine; they do not significantly modify or customise the SaaS; they are not integrated with the SaaS into a combined output; and they are not highly interdependent or interrelated with the SaaS since the entity can fulfil its promise to transfer the SaaS independently from its promise to provide the implementation services.

Based on this assessment, Technology entity P identifies two performance obligations: the SaaS and the implementation services.

Illustration 4-9: Implementation services are not distinct

Consider the same promised goods or services as in Illustration 4-8 above, except that the nature of the implementation services is to set up data feeds and interfaces with third-party applications and to connect the customer's SaaS account to Technology entity P's infrastructure.

Technology entity P does not sell the SaaS without the implementation services, and the customer cannot use the SaaS until the implementation services are complete, which might be up to nine months after entering into a contract. The implementation services cannot be provided by other entities because they require access to Technology entity P's systems.

Technology entity P evaluates the promised goods and services to determine which promises would be accounted for as separate performance obligations. The SaaS is capable of being distinct because it can be used together with the implementation services that are provided at the outset of the contract. However, the implementation services are not capable of being distinct because: they are not sold separately by the Technology entity P; they cannot be provided by a third party; and they do not provide benefit to the customer without SaaS (which is not a readily available resource).

Based on this assessment, Technology entity P identifies one performance obligation: the implemented SaaS (comprised of the SaaS and implementation services).

Question 4-8: Does a licence to a content library include more than one performance obligation?

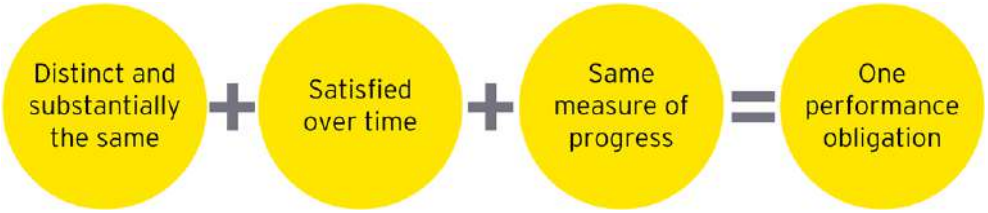
See response to Question 8-4 in section 8.1.4 below.

4.2.2 Series of distinct goods or services that are substantially the same and have the same pattern of transfer

As discussed above, IFRS 15.22(b) defines, as a second type of performance obligation, a promise to transfer to the customer a series of distinct goods or services that are substantially the same and that have the same pattern of transfer, if both of the following criteria from IFRS 15.23 are met: *[IFRS 15.22(b), IFRS 15.23]*

- Each distinct good or service in the series that the entity promises to transfer represents a performance obligation that would be satisfied over time, in accordance with IFRS 15.35 (see below and section 7.1 below), if it were accounted for separately.
- The entity would measure its progress toward satisfaction of the performance obligation using the same measure of progress for each distinct good or service in the series (see section 7.1.4 below).

Figure 4-4: The series requirement criteria



If a series of distinct goods or services meets the criteria in IFRS 15.22(b) and IFRS 15.23 (i.e., the series requirement), an entity is required to treat that series as a single performance obligation (i.e., it is not optional). The Board incorporated this requirement to simplify the model and promote consistent identification of performance obligations in cases when an entity provides the same good or service over a period of time. *[IFRS 15.BC113]*. In the Basis for Conclusions, the Board provided three examples of repetitive services (i.e., cleaning, transaction processing and delivering electricity) that meet the series requirement. *[IFRS 15.BC114]*. Without the series requirement, the Board noted that applying the revenue model might present operational challenges because an entity would have to identify multiple distinct goods or services, allocate the transaction price to each distinct good or service on a stand-alone selling price basis and then recognise revenue when those performance obligations are satisfied. The IASB determined that this would not be cost effective. Instead, an entity identifies a single performance obligation and allocates the transaction price to that performance obligation. It will then recognise revenue by applying a single measure of progress to that performance obligation. *[IFRS 15.BC114]*.

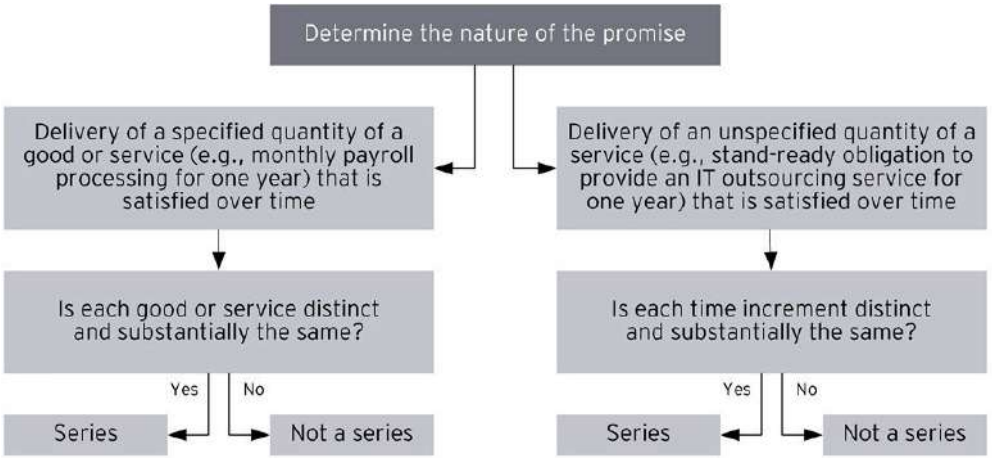
Distinct goods and services that are "substantially the same"

For distinct goods or services to be accounted for as a series, one of the criteria is that they must be substantially the same. This is often the most difficult criterion for entities to assess. In addition, the TRG members generally agreed that when determining whether distinct goods or services are substantially the same, entities need to first determine the nature of their promise. This is because a series could consist of either specified quantities of the underlying good or service delivered (e.g., each unit of a good) or distinct time increments (e.g., an hourly service), depending on the nature of the promise. That is, if the nature of the promise is to deliver a specified quantity of service (e.g., monthly payroll services over a defined contract period), the evaluation considers whether each service is distinct and substantially the same. In contrast, if the nature of the entity's promise is to stand ready or provide a single service for a period of time (i.e., because there is an unspecified quantity to be delivered), the evaluation considers whether each time increment (e.g., hour, day), rather than the underlying activities, is distinct and substantially the same.[49]

49 TRG Agenda paper no. 39, *Application of the Series Provision and Allocation of Variable Consideration*, dated 13 July 2015.

The following flow chart illustrates how the determination of the nature of the promise might affect whether the series requirement applies:

Figure 4-5: The series requirement: determining the nature of the promise



It is important to highlight that even if the underlying activities an entity performs to satisfy a promise vary significantly throughout the day and from day to day, that fact, by itself, does not mean the distinct goods or services are not substantially the same. Consider an example where the nature of the promise is to provide a daily hotel management service (i.e., an obligation to provide an unspecified quantity of a service for 20 years). Therefore, the entity evaluates whether each time increment is distinct and substantially the same. The service is comprised of activities that might vary each day (e.g., cleaning services, reservation services or property maintenance). However, the entity determines that the daily hotel management services are substantially the same because the nature of the entity's promise is the same each day and the entity is providing the same overall management service each day. Furthermore, each day of service is distinct because the management services provided on any day during the 20-year contract period are not dependent on, or interrelated with, the management services provided on any other day during the period. See Question 4-11 below for further discussion on determining the nature of an entity's promise and evaluating the 'substantially the same' criterion.

Satisfied over time

A July 2015 TRG agenda paper explained that, when considering the nature of the entity's promise and the applicability of the series requirement (including whether a good or service is distinct), it could be helpful to consider which over-time criterion in IFRS 15.35 was met (i.e., why the entity concluded that the performance obligation is satisfied over time).[50] As discussed further in section 7.1 below, a performance obligation is satisfied over time if one of three criteria are met. For example, if a performance obligation is satisfied over time because the customer simultaneously receives and consumes the benefits provided as the entity performs (i.e., the first over-time criterion in IFRS 15.35(a)), that might indicate that each increment of service is capable of being distinct. If that is the case, the entity would need to evaluate whether each increment of service is separately identifiable (and substantially the same). If a performance obligation is satisfied over time based on the other two criteria in IFRS 15.35 (i.e., (1) the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or (2) the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date), the nature of that promise might be to deliver a single specified good or service (e.g., a contract to construct a single piece of equipment), which would not be considered a series because the individual goods or services within that performance obligation are not distinct.

50 TRG Agenda paper no. 39, *Application of the Series Provision and Allocation of Variable Consideration*, dated 13 July 2015.

An entity's determination of whether a performance obligation is a single performance obligation comprising a series of distinct goods or services or a single performance obligation comprising goods or services that are not distinct from one another affects the accounting in the following areas: (1) allocation of variable consideration (see section 6.3 below); (2) contract modifications (see section 3.4 above); and (3) changes in transaction price (see section 6.5 below). As the IASB discussed in the Basis for Conclusions, an entity considers the underlying distinct goods or services in the contract, rather than the single performance obligation identified under the series requirement, when applying the requirements for these three areas of the model. *[IFRS 15.BC115]*.

The following Illustration, based on the example included in a March 2015 TRG agenda paper, shows how the allocation of variable consideration might differ for a single performance obligation identified under the series requirement and a single performance obligation comprising non-distinct goods and/or services:[51]

Illustration 4-10: Allocation of variable consideration for a series versus a single performance obligation comprising non-distinct goods and/or services

Consider a five-year service contract that includes payment terms of a fixed annual fee plus a performance bonus upon completion of a milestone at the end of year two. If the entire service period is determined to be a single performance obligation comprising a series of distinct services, the entity might be able to conclude that the variable consideration (i.e., the bonus amount) is allocated directly to its efforts to perform the distinct services up to the date that the milestone is achieved (e.g., the underlying distinct services in years one and two). This could result in the entity recognising the entire bonus amount at the end of year two (when it is highly probable that a significant revenue reversal will not occur). See Question 4-10 below for several examples of services for which it would be reasonable to conclude that they meet the series requirement.

In contrast, if the entity determines that the entire service period is a single performance obligation that is comprised of non-distinct services, the bonus would be included in the transaction price (subject to the constraint on variable consideration see section 5.2.3 below) and recognised based on the measure of progress determined for the entire service period. For example, assume the bonus becomes part of the transaction price at the end of year two (when it is highly probable that a significant revenue reversal will not occur). In that case, a portion of the bonus would be recognised at that the end of year two based on performance completed to date and a portion would be recognised as the remainder of the performance obligation is satisfied. As a result, the bonus amount would be recognised as revenue through to the end of the five-year service period.

How we see it

We believe that entities might need to apply significant judgement when determining whether a promised good or service in a contract with a customer meets the criteria to be accounted for as a series of distinct goods or services. As illustrated in Question 4-10 below, promised goods or services that meet the series criteria are not limited to a particular industry and can encompass a wide array of promised goods or services.

Frequently asked questions

Question 4-9: In order to apply the series requirement, must the goods or services be consecutively transferred?

(TRG meeting 30 March 2015 - Agenda paper no. 27)

The TRG members generally agreed that a series of distinct goods or services need not be consecutively transferred. That is, the series requirement must be applied even when there is a gap or an overlap in an entity's transfer of goods or services, provided that the criteria in IFRS 15.23 are met. The IASB TRG members also noted that entities might need to carefully consider whether the series requirement applies, depending on the length of the gap between an entity's transfer of goods or services.

Stakeholders had asked this question because the Basis for Conclusions uses the term 'consecutively' when it discusses the series requirement. *[IFRS 15.BC113, IFRS 15.BC116]*. However, the TRG agenda paper concluded that the Board's discussion was not meant to imply that the series requirement only applies to circumstances in which the entity provides the same good or service consecutively over a period of time.

51 TRG Agenda paper no. 27, *Series of Distinct Goods or Services*, dated 30 March 2015.

Consider the following Illustration based on the example from the TRG agenda paper:

Illustration 4-11: A series in which the goods or services need not be consecutively transferred

An entity has a contract with a customer to provide a manufacturing service for the production of 24,000 units of a product over a two-year period. The units produced under the service arrangement are distinct, substantially the same and manufactured in accordance with the customer's specifications.

The entity determines that the service is satisfied over time (see section 7.1 below) because the performance of the service does not create an asset with an alternative use to the entity (since the units are manufactured in accordance with the customer's specifications). Furthermore, if the contract were to be cancelled, the entity would have an enforceable right to payment for performance completed to date (cost plus a reasonable profit margin). Therefore, the criteria for the series requirement in IFRS 15.23 have been met.

The conclusion in the TRG agenda paper was not influenced by whether the entity would perform the service evenly over the two-year period (e.g., produce 1,000 units per month). That is, the entity could produce 2,000 units in some months and none in others, but this would not be a determining factor in concluding whether the contract met the criteria to be accounted for as a series.

Question 4-10: In order to apply the series requirement, does the accounting result need to be the same as if the underlying distinct goods or services were accounted for as separate performance obligations?

(TRG meeting 30 March 2015 - Agenda paper no. 27)

The TRG members generally agreed that the accounting result does not need to be the same. Furthermore, an entity is not required to prove that the result would be the same as if the goods or services were accounted for as separate performance obligations.[52]

Consider the following Illustration based on the example from the TRG agenda paper to illustrate this point:

Illustration 4-12: A series for which the accounting result would be different if not treated as a series

An entity contracts with a customer to perform a manufacturing service that results in the production of 10 widgets. The manufacturing service will be performed over a three-year period. The contract price is CU100 million and the stand-alone selling price for each widget is CU10 million.

Total expected costs are CU80 million. The service the entity will provide to the customer in producing each widget is substantially the same. However, the design is new, so the entity expects a decline in production costs over time. Production of the first five units is expected to cost CU9 million per widget. The costs to produce the other five widgets are expected to be CU7 million per widget.

For purposes of this example, the entity determines that each service that it will provide to produce one of the 10 widgets is distinct and meets the criteria to be satisfied over time, and that the same cost-based measure of progress would be used (i.e., the series requirement criteria in IFRS 15.23 are met). The following table demonstrates the difference in accounting between concluding that the series requirement applies and concluding that the contract is for 10 separate performance obligations:

(in CU millions)	Total contract	Series requirement (one performance obligation)		10 separate performance obligations	
		Units 1-5	Units 6-10	Units 1-5	Units 6-10
Revenue	100	56	44	50	50
Cost	(80)	(45)	(35)	(45)	(35)
Margin	**20**	**11**	**9**	**5**	**15**

Although CU20 million in margin is recognised for the contract under both scenarios, there is a difference in the timing of revenue recognition (and margin) because more revenue is recognised in relation to the service to produce the first five widgets (and less in relation to its service to produce the final five widgets) when the series is accounted for as a single performance obligation using a single measure of progress towards complete satisfaction.

Also see Question 9-17 below on how the effect of learning curve costs are addressed in IFRS 15.

52 TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015.

Question 4-11: In order to apply the series requirement, how does an entity consider whether a performance obligation consists of distinct goods or services that are 'substantially the same'?

(TRG meeting 13 July 2015 - Agenda paper no. 39)

As discussed above, the TRG members generally agreed that the TRG paper, which primarily focused on the application of the series requirement to service contracts, will help entities understand how to determine whether a performance obligation consists of distinct goods or services that are 'substantially the same' under IFRS 15.

The TRG agenda paper noted that, when making the evaluation of whether goods or services are distinct and substantially the same, an entity first needs to determine the nature of the entity's promise in providing services to the customer. That is, if the nature of the promise is to deliver a specified quantity of service (e.g., monthly payroll services over a defined contract period), the evaluation considers whether each specified quantity of the underlying service is distinct and substantially the same. In contrast, if the nature of the entity's promise is to stand ready or provide a single service for a period of time (i.e., because there is an unspecified quantity to be delivered), the evaluation would consider whether each time increment (e.g., hour, day), rather than the underlying activities, is distinct and substantially the same. The TRG agenda paper noted that the Board intended that a series could consist of either specified quantities of the underlying good or service delivered (e.g., each unit of a good) or distinct time increments (e.g., an hourly service), depending on the nature of the promise.

As discussed in section 4.2.2 above, it is important to highlight that the underlying activities an entity performs to satisfy a performance obligation could vary significantly throughout a day and from day to day. However, the TRG agenda paper noted that this is not determinative in the assessment of whether a performance obligation consists of goods or services that are distinct and substantially the same. Consider an example where the nature of the promise is to provide a daily hotel management service (i.e., an obligation to provide an unspecified quantity of a service for 20 years). Therefore, the entity evaluates whether each time increment is distinct and substantially the same. The hotel management service comprises various activities that might vary each day (e.g., cleaning services, reservation services, property maintenance). However, the entity determines that the daily hotel management services are substantially the same because the nature of the entity's promise is the same each day and the entity is providing the same overall management service each day. Furthermore, each day of service is distinct because the management services provided on any day during the 20-year contract period are not dependent on, or interrelated with, the management services provided on any other day during the period.

The TRG agenda paper included several examples of promised goods or services that might meet the series requirement and the analysis that supports that conclusion. The evaluation of the nature of the promise for each example is consistent with Example 13 of IFRS 15 (extracted in full in section 7.1.1 below), *[IFRS 15.IE Example 13, IFRS 15.IE67-IE68]*, on monthly payroll processing.

Below we have summarised some of the examples and analysis in the TRG agenda paper.

Illustration 4-13: IT outsourcing - series provision is met

A vendor and customer execute a 10-year IT outsourcing arrangement in which the vendor continuously delivers the outsourced activities over the contract term (e.g., it provides server capacity, manages the customer's software portfolio, runs an IT help desk). The total monthly invoice is calculated based on different units consumed for the respective activities. The vendor concludes that the customer simultaneously receives and consumes the benefits provided by its services as it performs (meeting the over-time recognition criterion in IFRS 15.35(a)).

The vendor first considers the nature of its promise to the customer. Because the vendor has promised to provide an unspecified quantity of activities, rather than a defined number of services, the TRG agenda paper noted that the vendor could reasonably conclude that the nature of the promise is an obligation to stand ready to provide the integrated outsourcing service each day. If the nature of the promise is the overall IT outsourcing service, each day of service could be considered distinct because the customer can benefit from each day of service on its own and each day is separately identifiable. The TRG agenda paper also noted that the vendor could reasonably conclude that each day of service is substantially the same. That is, even if the individual activities that comprise the performance obligation vary from day to day, the nature of the overall promise is the same from day to day. Accordingly, it would be reasonable for an entity to conclude that this contract meets the series requirement.

Illustration 4-14: Transaction processing - series provision is met

A vendor enters into a 10-year contract with a customer to provide continuous access to its system and to process all transactions on behalf of the customer. The customer is obliged to use the vendor's system, but the ultimate quantity of transactions is unknown. The vendor concludes that the customer simultaneously receives and consumes the benefits as it performs (meeting the over-time recognition criterion in IFRS 15.35(a)).

If the vendor concludes that the nature of its promise is to provide continuous access to its system, rather than process a particular quantity of transactions, it might conclude that there is a single performance obligation to stand ready to process as many transactions as the customer requires. If that is the case, the TRG agenda paper noted that it would be reasonable to conclude that there are multiple distinct time increments of the service. Each day of access to the service provided to the customer could be considered substantially the same since the customer is deriving a consistent benefit from the access each day, even if a different number of transactions are processed each day.

If the vendor concludes that the nature of the promise is the processing of each transaction (i.e., a specified quantity of transactions), the TRG agenda paper noted that each transaction processed could be considered substantially the same even if there are multiple types of transactions that generate different payments. Furthermore, the TRG agenda paper noted that each transaction processed could be a distinct service because the customer could benefit from each transaction on its own and each transaction could be separately identifiable. Accordingly, it would be reasonable for an entity to conclude that this contract meets the series requirement.

Illustration 4-15: Hotel management - series provision is met

A hotel manager (HM) enters into a 20-year contract to manage properties on behalf of a customer. HM receives monthly consideration of 1% of the monthly rental revenue, as well as reimbursement of labour costs incurred to perform the service and an annual incentive payment. HM concludes that the customer simultaneously receives and consumes the benefits of its services as it performs (meeting the over-time recognition criterion in IFRS 15.35(a)).

HM considers the nature of its promise to the customer. If the nature of its promise is the overall management service (because the underlying activities are not distinct from each other), the TRG agenda paper noted that each day of service could be considered distinct because the customer can benefit from each day of service on its own and each day of service is separately identifiable.

Assuming the nature of the promise is the overall management service (i.e., an unspecified quantity of service), the TRG agenda paper noted that the service performed each day could be considered distinct and substantially the same. This is because, even if the individual activities that comprise the performance obligation vary significantly throughout the day and from day to day, the nature of the overall promise to provide the management service is the same from day to day. Accordingly, it would be reasonable for an entity to conclude that this contract meets the series requirement.

The following is another Illustration of promised goods and services that might meet the series requirement and the analysis that supports that conclusion:

Illustration 4-16: Determining whether promised goods and services represent a series - series provision is met

A SaaS provider enters into a three-year contract with Customer X to provide access to its SaaS basic customer relationship management (CRM) application for CU300,000. The contract also includes professional services that will personalise the user's interface based on the user's role. These services are sold separately from the CRM application and can be provided by third party vendors. The customer can benefit from the CRM application without the professional services, which do not significantly customise or modify the CRM application.

The SaaS provider determines that the CRM application and professional services are distinct (i.e., the CRM application and the professional services should not be combined into a single performance obligation). The two services are each capable of being distinct because Customer X can benefit from them on their own. The services are distinct within the context of the contract because they are not highly interdependent or interrelated and each service does not significantly modify or customise the other.

The SaaS provider first determines that the nature of the CRM application promise is to provide continuous access to its CRM application for the three-year period (i.e., an unspecified quantity of service). Although the activities that Customer X might be able to perform via the CRM application might vary from day to day, the overall promise is to provide continuous access to the CRM application to Customer X for a period of three years.

The SaaS provider determines that access to the CRM application represents a series of distinct services that are substantially the same and have the same pattern of transfer to Customer X. Each day of service is capable of being distinct because Customer X benefits each day from access to the CRM application. Each day is distinct within the context of the contract because there are no significant integration services, each day does not modify or customise another day and each day is not highly interdependent or interrelated. Each day of service is substantially the same because Customer X derives a consistent benefit from the access to the CRM application and has the same pattern of transfer over the term of the contract. Each distinct service represents a performance obligation that is satisfied over time and has the same measure of progress (e.g., time-elapsed). Therefore, the criteria to account for access to the CRM application as a series of distinct services (i.e., a single performance obligation) are met.

The SaaS provider also considers whether the professional services meet the criteria to be accounted for as a series. As part of this assessment, the entity considers whether each day of the professional services is distinct from the other days or whether the nature of the promise for the professional services is for a combined output from all of the days. The entity also considers the complexity of the professional services and whether the activity of each day builds on one another or if each day is substantially the same. This analysis requires judgement and is based on the facts and circumstances of the professional services performed.

Question 4-12: Can an entity choose whether to apply the series requirement?

As discussed above, if a series of distinct goods or services meets the criteria in IFRS 15.22(b) and 23, an entity is required to treat that series as a single performance obligation (i.e., it is not an optional requirement). *[IFRS 15.22(b), IFRS 15.23]*.

Question 4-13: Do all stand-ready obligations meet the criteria to be accounted for as a series?

How we see it

We generally believe that stand-ready obligations (i.e., when the nature of the entity's promise is to provide an unspecified quantity of a service over time) will meet the criteria and, therefore, need to be accounted for as a series of distinct goods or services.

As discussed in Questions 4-2 and 4-3 in section 4.1.1 above, entities might need to apply judgement to determine whether the nature of a promise to a customer is the service of standing ready to provide goods or services (i.e., a stand-ready obligation) or the delivery of the underlying goods or services (i.e., not a stand-ready obligation).

4.2.3 Examples of identifying performance obligations

The standard includes several examples that illustrate the application of the requirements for identifying performance obligations. The examples explain the judgements made to determine whether the promises to transfer goods or services are capable of being distinct and distinct within the context of the contract. We have extracted these examples in full below.

The following example illustrates contracts with promised goods or services that, while capable of being distinct, are not distinct within the context of the contract because of a significant integration service that combines the inputs (the underlying goods or services) into a combined output: *[IFRS 15.IE Example 10, IFRS 15.IE45-IE48C]*

Extract from IFRS 15

Example 10-Goods and services are not distinct

Case A-Significant integration service

An entity, a contractor, enters into a contract to build a hospital for a customer. The entity is responsible for the overall management of the project and identifies various promised goods and services, including engineering, site clearance, foundation, procurement, construction of the structure, piping and wiring, installation of equipment and finishing.

The promised goods and services are capable of being distinct in accordance with paragraph 27(a) of IFRS 15. That is, the customer can benefit from the goods and services either on their own or together with other readily available resources. This is evidenced by the fact that the entity, or competitors of the entity, regularly sells many of these goods and services separately to other customers. In addition, the customer could generate economic benefit from the individual goods and services by using, consuming, selling or holding those goods or services.

However, the promises to transfer the goods and services are not separately identifiable in accordance with paragraph 27(b) of IFRS 15 (on the basis of the factors in paragraph 29 of IFRS 15). This is evidenced by the fact that the entity provides a significant service of integrating the goods and services (the inputs) into the hospital (the combined output) for which the customer has contracted.

Because both criteria in paragraph 27 of IFRS 15 are not met, the goods and services are not distinct. The entity accounts for all of the goods and services in the contract as a single performance obligation.

Case B-Significant integration service

An entity enters into a contract with a customer that will result in the delivery of multiple units of a highly complex, specialised device. The terms of the contract require the entity to establish a manufacturing process in order to produce the contracted units. The specifications are unique to the customer, based on a custom design that is owned by the customer and that were developed under the terms of a separate contract that is not part of the current negotiated exchange. The entity is responsible for the overall management of the contract, which requires the performance and integration of various activities including procurement of materials, identifying and managing subcontractors, and performing manufacturing, assembly and testing.

The entity assesses the promises in the contract and determines that each of the promised devices is capable of being distinct in accordance with paragraph 27(a) of IFRS 15 because the customer can benefit from each device on its own. This is because each unit can function independently of the other units.

The entity observes that the nature of its promise is to establish and provide a service of producing the full complement of devices for which the customer has contracted in accordance with the customer's specifications. The entity considers that it is responsible for overall management of the contract and for providing a significant service of integrating various goods and services (the inputs) into its overall service and the resulting devices (the combined output) and, therefore, the devices and the various promised goods and services inherent in producing those devices are not separately identifiable in accordance with paragraph 27(b) and paragraph 29 of IFRS 15. In this case, the manufacturing process provided by the entity is specific to its contract with the customer. In addition, the nature of the entity's performance and, in particular, the significant integration service of the various activities means that a change in one of the entity's activities to produce the devices has a significant effect on the other activities required to produce the highly complex, specialised devices such that the entity's activities are highly interdependent and highly interrelated. Because the criterion in paragraph 27(b) of IFRS 15 is not met, the goods and services that will be provided by the entity are not separately identifiable and, therefore, are not distinct. The entity accounts for all of the goods and services promised in the contract as a single performance obligation.

The determination of whether a 'significant integration service' exists within a contract, as illustrated in Case A and Case B above, requires significant judgement and is heavily dependent on the unique facts and circumstances for each individual contract with a customer.

The following example illustrates how the significance of installation services can affect an entity's conclusion about the number of identified performance obligations for similar fact patterns. In Case A, each of the promised goods and services are determined to be distinct. In Case B, two of the promised goods and services are combined into a single performance obligation because one promise (the installation) significantly customises another promise (the software). *[IFRS 15.IE Example 11 Case A-Case B, IFRS 15.IE49-IE58]*.

Extract from IFRS 15

Example 11-Determining whether goods or services are distinct

Case A-Distinct goods or services

An entity, a software developer, enters into a contract with a customer to transfer a software licence, perform an installation service and provide unspecified software updates and technical support (online and telephone) for a two-year period. The entity sells the licence, installation service and technical support separately. The installation service includes changing the web screen for each type of user (for example, marketing, inventory management and information technology). The installation service is routinely performed by other entities and does not significantly modify the software. The software remains functional without the updates and the technical support.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 27 of IFRS 15. The entity observes that the software is delivered before the other goods and services and remains functional without the updates and the technical support. The customer can benefit from the updates together with the software licence transferred at the start of the contract. Thus, the entity concludes that the customer can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available and the criterion in paragraph 27(a) of IFRS 15 is met.

The entity also considers the principle and the factors in paragraph 29 of IFRS 15 and determines that the promise to transfer each good and service to the customer is separately identifiable from each of the other promises (thus the criterion in paragraph 27(b) of IFRS 15 is met). In reaching this determination, the entity considers that, although it integrates the software into the customer's system, the installation services do not significantly affect the customer's ability to use and benefit from the software licence because the installation services are routine and can be obtained from alternative providers. The software updates do not significantly affect the customer's ability to use and benefit from the software licence during the licence period. The entity further observes that none of the promised goods or services significantly modify or customise one another, nor is the entity providing a significant service of integrating the software and the services into a combined output. Lastly, the entity concludes that the software and the services do not significantly affect each other and, therefore, are not highly interdependent or highly interrelated, because the entity would be able to fulfil its promise to transfer the initial software licence independently from its promise to subsequently provide the installation service, software updates or technical support.

On the basis of this assessment, the entity identifies four performance obligations in the contract for the following goods or services:

(a) the software licence;

(b) an installation service;

(c) software updates; and

(d) technical support.

The entity applies paragraphs 31-38 of IFRS 15 to determine whether each of the performance obligations for the installation service, software updates and technical support are satisfied at a point in time or over time. The entity also assesses the nature of the entity's promise to transfer the software licence in accordance with paragraph B58 of IFRS 15 (see Example 54 in paragraphs IE276-IE277).

Case B-Significant customisation

The promised goods and services are the same as in Case A, except that the contract specifies that, as part of the installation service, the software is to be substantially customised to add significant new functionality to enable the software to interface with other customised software applications used by the customer. The customised installation service can be provided by other entities.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 27 of IFRS 15. The entity first assesses whether the criterion in paragraph 27(a) has been met. For the same reasons as in Case A, the entity determines that the software licence, installation, software updates and technical support each meet that criterion. The entity next assesses whether the criterion in paragraph 27(b) has been met by evaluating the principle and the factors in paragraph 29 of IFRS 15. The entity observes that the terms of the contract result in a promise to provide a significant service of integrating the licenced software into the existing software system by performing a customised installation service as specified in the contract. In other words, the entity is using the licence and the customised installation service as inputs to produce the combined output (ie a functional and integrated software system) specified in the contract (see paragraph 29(a) of IFRS 15). The software is significantly modified and customised by the service (see paragraph 29(b) of IFRS 15). Consequently, the entity determines that the promise to transfer the licence is not separately identifiable from the customised installation service and, therefore, the criterion in paragraph 27(b) of IFRS 15 is not met. Thus, the software licence and the customised installation service are not distinct.

On the basis of the same analysis as in Case A, the entity concludes that the software updates and technical support are distinct from the other promises in the contract.

On the basis of this assessment, the entity identifies three performance obligations in the contract for the following goods or services:

(a) software customisation (which comprises the licence for the software and the customised installation service);

(b) software updates; and

(c) technical support.

The entity applies paragraphs 31-38 of IFRS 15 to determine whether each performance obligation is satisfied at a point in time or over time.

The following example illustrates contracts that include multiple promised goods or services, all of which are determined to be distinct. The examples highlight the importance of considering both the separately identifiable principle and the underlying factors in IFRS 15.29.

Case C illustrates a contract that includes the sale of equipment and installation services. The equipment can be operated without any customisation or modification. The installation is not complex and can be performed by other entities. The entity determines that the two promises in the contract are distinct.

Case D illustrates that certain types of contractual restrictions, including those that require a customer to only use the entity's services, would not affect the evaluation of whether a promised good or service is distinct.

Case E illustrates a contract that includes the sale of equipment and specialised consumables to be used with the equipment. Even though the consumables can only be produced by the entity, they are sold separately. The entity determines that the two promises in the contract are distinct and the example walks through the analysis for determining whether the promises are capable of being distinct and distinct in the context of the contract. As part of this analysis, the entity concludes that the equipment and consumables are not highly interrelated nor highly interdependent because the two promises do not significantly affect each other. That is, the entity would be able to fulfil each of its promises in the contract independently of the other promises. *[IFRS 15.IE Example 11 Case C-Case E, IFRS 15.IE58A-IE58K]*.

Extract from IFRS 15

Example 11-Determining whether goods or services are distinct

...

Case C-Promises are separately identifiable (installation)

An entity contracts with a customer to sell a piece of equipment and installation services. The equipment is operational without any customisation or modification. The installation required is not complex and is capable of being performed by several alternative service providers.

The entity identifies two promised goods and services in the contract: (a) equipment and (b) installation. The entity assesses the criteria in paragraph 27 of IFRS 15 to determine whether each promised good or service is distinct. The entity determines that the equipment and the installation each meet the criterion in paragraph 27(a) of IFRS 15. The customer can benefit from the equipment on its own, by using it or reselling it for an amount greater than scrap value, or together with other readily available resources (for example, installation services available from alternative providers). The customer also can benefit from the installation services together with other resources that the customer will already have obtained from the entity (ie the equipment).

The entity further determines that its promises to transfer the equipment and to provide the installation services are each separately identifiable (in accordance with paragraph 27(b) of IFRS 15). The entity considers the principle and the factors in paragraph 29 of IFRS 15 in determining that the equipment and the installation services are not inputs to a combined item in this contract. In this case, each of the factors in paragraph 29 of IFRS 15 contributes to, but is not individually determinative of, the conclusion that the equipment and the installation services are separately identifiable as follows:

(a) The entity is not providing a significant integration service. That is, the entity has promised to deliver the equipment and then install it; the entity would be able to fulfil its promise to transfer the equipment separately from its promise to subsequently install it. The entity has not promised to combine the equipment and the installation services in a way that would transform them into a combined output.

(b) The entity's installation services will not significantly customise or significantly modify the equipment.

(c) Although the customer can benefit from the installation services only after it has obtained control of the equipment, the installation services do not significantly affect the equipment because the entity would be able to fulfil its promise to transfer the equipment independently of its promise to provide the installation services. Because the equipment and the installation services do not each significantly affect the other, they are not highly interdependent or highly interrelated.

On the basis of this assessment, the entity identifies two performance obligations in the contract for the following goods or services:

(i) the equipment; and

(ii) installation services.

The entity applies paragraphs 31-38 of IFRS 15 to determine whether each performance obligation is satisfied at a point in time or over time.

Case D-Promises are separately identifiable (contractual restrictions)

Assume the same facts as in Case C, except that the customer is contractually required to use the entity's installation services.

The contractual requirement to use the entity's installation services does not change the evaluation of whether the promised goods and services are distinct in this case. This is because the contractual requirement to use the entity's installation services does not change the characteristics of the goods or services themselves, nor does it change the entity's promises to the customer. Although the customer is required to use the entity's installation services, the equipment and the installation services are capable of being distinct (ie they each meet the criterion in paragraph 27(a) of IFRS 15) and the entity's promises to provide the equipment and to provide the installation services are each separately identifiable, ie they each meet the criterion in paragraph 27(b) of IFRS 15. The entity's analysis in this regard is consistent with that in Case C.

Case E-Promises are separately identifiable (consumables)

An entity enters into a contract with a customer to provide a piece of off-the-shelf equipment (ie the equipment is operational without any significant customisation or modification) and to provide specialised consumables for use in the equipment at predetermined intervals over the next three years. The consumables are produced only by the entity, but are sold separately by the entity.

The entity determines that the customer can benefit from the equipment together with the readily available consumables. The consumables are readily available in accordance with paragraph 28 of IFRS 15, because they are regularly sold separately by the entity (ie through refill orders to customers that previously purchased the equipment). The customer can benefit from the consumables that will be delivered under the contract together with the delivered equipment that is transferred to the customer initially under the contract. Therefore, the equipment and the consumables are each capable of being distinct in accordance with paragraph 27(a) of IFRS 15.

The entity determines that its promises to transfer the equipment and to provide consumables over a three-year period are each separately identifiable in accordance with paragraph 27(b) of IFRS 15. In determining that the equipment and the consumables are not inputs to a combined item in this contract, the entity considers that it is not providing a significant integration service that transforms the equipment and consumables into a combined output. In addition, neither the equipment nor the consumables are significantly customised or modified by the other. Lastly, the entity concludes that the equipment and the consumables are not highly interdependent or highly interrelated because they do not significantly affect each other. Although the customer can benefit from the consumables in this contract only after it has obtained control of the equipment (ie the consumables would have no use without the equipment) and the consumables are required for the equipment to function, the equipment and the consumables do not each significantly affect the other. This is because the entity would be able to fulfil each of its promises in the contract independently of the other. That is, the entity would be able to fulfil its promise to transfer the equipment even if the customer did not purchase any consumables and would be able to fulfil its promise to provide the consumables, even if the customer acquired the equipment separately.

On the basis of this assessment, the entity identifies two performance obligations in the contract for the following goods or services:

(a) the equipment; and

(b) the consumables.

The entity applies paragraphs 31-38 of IFRS 15 to determine whether each performance obligation is satisfied at a point in time or over time.

4.3 Promised goods or services that are not distinct

If a promised good or service does not meet the criteria to be considered distinct, an entity is required to combine that good or service with other promised goods or services until the entity identifies a bundle of goods or services that, together, is distinct. This could result in an entity combining a good or service that is not considered distinct with another good or service that, on its own, would meet the criteria to be considered distinct (see section 4.2.1 above). *[IFRS 15.30]*.

The standard provides two examples of contracts with promised goods or services that, while capable of being distinct, are not distinct in the context of the contract because of a significant integration service that combines the inputs (the underlying goods or services) into a combined output. Full extracts of these examples (Example 10, Case A, and Example 10, Case B) are included in section 4.2.3 above. *[IFRS 15.IE Example 10, IFRS 15.IE45-IE48C]*.

4.4 Principal versus agent considerations

When more than one party is involved in providing goods or services to a customer, the standard requires an entity to determine whether it is a principal or an agent in these transactions by evaluating the nature of its promise to the customer. For example, an entity that issues loyalty points to its customers that are redeemable for another entity's goods or services needs to assess whether it is a principal or an agent in relation to the redemption of the points.

An entity is a principal (and, therefore, records revenue on a gross basis) if it controls a promised good or service before transferring that good or service to the customer. *[IFRS 15.B35]*. An entity is an agent (and, therefore, records as revenue the net amount that it retains for its agency services) if its role is to arrange for another entity to provide the goods or services. *[IFRS 15.B36]*.

In the Basis for Conclusions, the Board explained that in order for an entity to conclude that it is providing the good or service to the customer, it must first control that good or service. That is, the entity cannot provide the good or service to a customer if the entity does not first control it. If an entity controls the good or service, the entity is a principal in the transaction. If an entity does not control the good or service before it is transferred to the customer, the entity is an agent in the transaction. *[IFRS 15.BC385D]*.

In the Basis for Conclusions, the Board noted that an entity that itself manufactures a good or performs a service is always a principal if it transfers control of that good or service to another party. There is no need for such an entity to evaluate the principal versus agent application guidance because it transfers control of or provides its own good or service directly to its customer without the involvement of another party. For example, if an entity transfers control of a good to an intermediary that is a principal in providing that good to an end-consumer, the entity records revenue as a principal in the sale of the good to its customer (the intermediary). *[IFRS 15.BC385E]*.

An entity applies judgement in making its overall assessment of whether it is a principal or agent. Therefore, appropriate disclosures are important, in particular: (a) significant judgements in accordance with paragraph 122 of IAS 1; and (b) information required by IFRS 15, including information about its performance obligations and the judgements made in applying the standard that significantly affect the determination of the amount and timing of revenue recognised. The IFRS IC reiterated this point in its April 2022 meeting (see section 4.4.2 below for more on this IFRS IC discussion).[53]

How we see it

Entities need to carefully evaluate whether they are acting as a principal or as an agent. As a reminder, the application guidance in IFRS 15 focuses on control of the specified goods or services as the overarching principle for entities to consider in determining whether they are acting as a principal or an agent. That is, an entity first evaluates whether it controls the specified good or service before reviewing the standard's principal indicators. As discussed above, appropriate disclosure in accordance with IAS 1 and IFRS 15 will be required.

As part of understanding the relationships between the parties involved in the transaction, it might be helpful to understand the flow of consideration between the parties. However, whether the entity receives consideration from one or more parties involved in the transaction on a gross or net basis is not determinative in the principal versus agent analysis.

53 *IFRIC Update*, April 2022, available on the IFRS Foundation's website.

IFRS 15 states the overall principle for the principal versus agent evaluation, as follows: *[IFRS 15.B34, IFRS 15.B34A, IFRS 15.B35]*

Extract from IFRS 15

B34 When another party is involved in providing goods or services to a customer, the entity shall determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (ie the entity is a principal) or to arrange for those goods or services to be provided by the other party (ie the entity is an agent). An entity determines whether it is a principal or an agent for each specified good or service promised to the customer. A specified good or service is a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer (see paragraphs 27-30). If a contract with a customer includes more than one specified good or service, an entity could be a principal for some specified goods or services and an agent for others.

B34A To determine the nature of its promise (as described in paragraph B34), the entity shall:

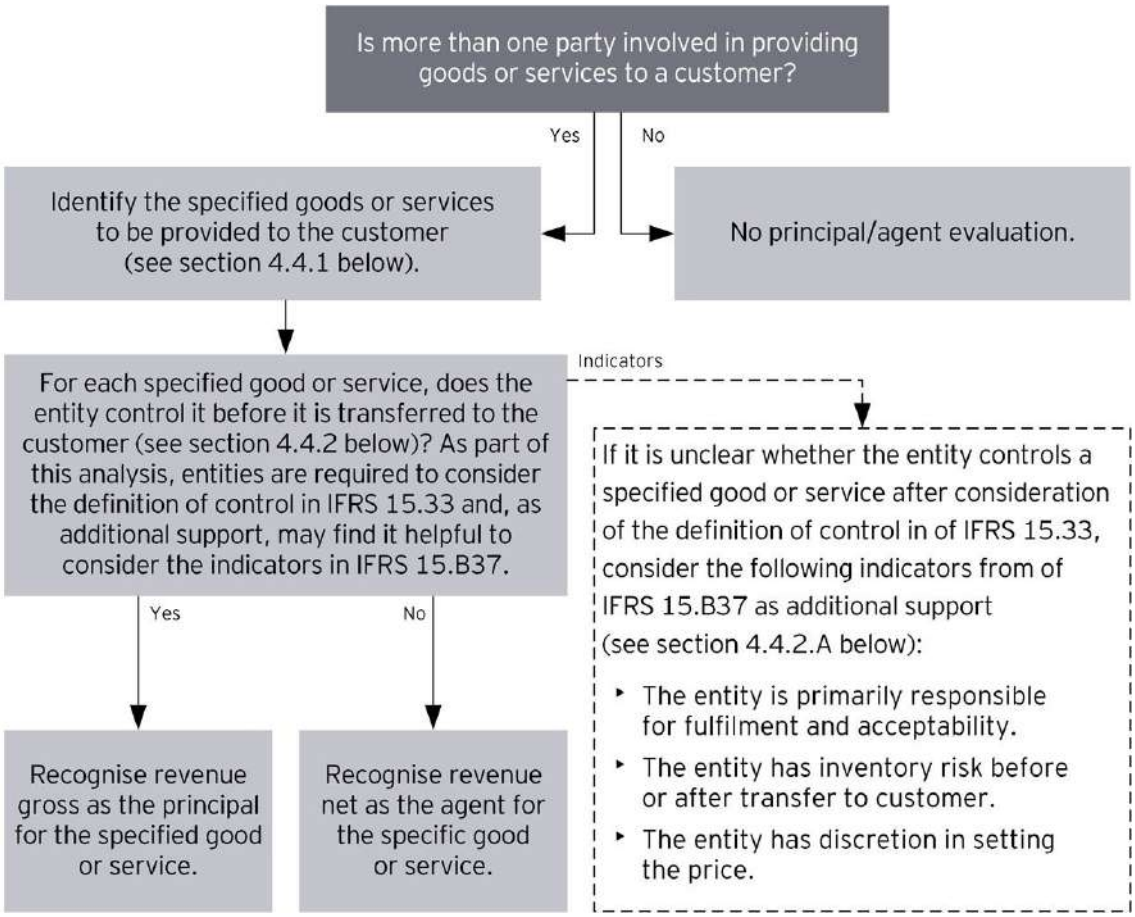
(a) identify the specified goods or services to be provided to the customer (which, for example, could be a right to a good or service to be provided by another party (see paragraph 26)); and

(b) assess whether it controls (as described in paragraph 33) each specified good or service before that good or service is transferred to the customer.

B35 An entity is a principal if it controls the specified good or service before that good or service is transferred to a customer. However, an entity does not necessarily control a specified good if the entity obtains legal title to that good only momentarily before legal title is transferred to a customer. An entity that is a principal may satisfy its performance obligation to provide the specified good or service itself or it may engage another party (for example, a subcontractor) to satisfy some or all of the performance obligation on its behalf.

The following flow chart illustrates the process for performing a principal versus agent evaluation:

Figure 4-6: Principal versus agent evaluation



How we see it

The principal versus agent application guidance applies regardless of the type of transaction under evaluation or the industry in which the entity operates. Entities that: (a) do not stock inventory and might employ independent warehouses or fulfilment houses to drop-ship merchandise to customers on their behalf; or (b) offer services to be provided by an independent service provider (e.g., travel agents, magazine subscription brokers and retailers that sell goods through catalogues or that sell goods on consignment) might need to apply significant judgement when applying this application guidance.

Frequently asked questions

Question 4-14: Can an entity make an accounting policy choice to report revenue from contracts with customers on a gross or net basis?

The principal versus agent assessment is not something about which an entity can make a policy choice. Entities must carefully consider the facts and circumstances of each contract to determine the appropriate accounting.

4.4.1 Identifying the specified good or service

In accordance with IFRS 15.B34A, an entity must first identify the specified good or service (or unit of account for the principal versus agent evaluation) to be provided to the customer in order to determine the nature of its promise (i.e., whether it is to provide the specified goods or services to the end-consumer as a principal or to arrange for those goods or services to be provided by another party as an agent). *[IFRS 15.B34A]*. A specified good or service is defined as "a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer". *[IFRS 15.B34]*. That is, specified goods or services are the distinct goods or services (or a distinct bundle of goods or services) identified using the requirements in IFRS 15.27-29 (see section 4.2 above) that are transferred to the end-consumer. Because the specified goods or services are determined from the perspective of the end-consumer, they will not always be the same as the entity's performance obligation - particularly when the entity is an agent.

The IASB noted in the Basis for Conclusions that, while the definition of specified goods or services is similar to that of a performance obligation, it created this new term because using 'performance obligation' would have been confusing in agency relationships. *[IFRS 15.BC385B]*. That is, because an agent's performance obligation is to arrange for goods or services to be provided by another party, providing the specified goods or services to the end-consumer is not the agent's performance obligation. For example, consider Example 45 in the standard, in which an entity operates a website that enables users to purchase goods from a range of suppliers who then deliver the goods directly to the users. In this example, the entity concludes that the specified goods to be provided to the users of the website (i.e., the end-consumer) are the goods provided by the suppliers, and no other goods or services are promised to the end-consumer by the entity. The entity further concludes that it does not control the specified goods before they are transferred to the end-consumer, and it is an agent in the transaction. Its performance obligation is to arrange for the provision of goods to the end-consumer by the supplier (i.e., not the provision of the specified goods themselves).

As discussed above, a specified good or service might be a distinct good or service or a distinct bundle of goods or services. In the Basis for Conclusions, the Board noted that if individual goods or services are not distinct from one another, they might be inputs to a combined item and each good or service might represent only a part of a single promise to the customer. For example, in a contract in which goods or services provided by another party are inputs to a combined item (or items), the entity would assess whether it controls the combined item (or items) before that item (or items) is transferred to the customer. *[IFRS 15.BC385Q]*. If yes, in determining whether it is a principal or an agent, an entity evaluates that single promise to the customer, rather than the individual inputs that make up that promise. However, in order to conclude that it controls the combined item(s), IFRS 15.B35A(c) (further discussed in section 4.4.2 below) notes that it is likely an entity will need to conclude it performs a significant service of integrating the individual goods or services because it also controls the underlying inputs before integration.

Appropriately identifying the specified good or service to be provided is a critical step in determining whether an entity is a principal or an agent in a transaction. In many situations, especially those involving tangible goods, identifying the specified good or service is relatively straightforward. For example, if an entity is reselling laptop computers, the specified good that is transferred to the customer is a laptop computer.

However, the assessment might require significant judgement in other situations, such as those involving intangible goods or services. In accordance with IFRS 15.B34A(a), the specified good or service might be the underlying good or service a customer ultimately wants to obtain (e.g., a flight, a meal) or a right to

obtain that good or service (e.g., in the form of a ticket or voucher). In the Basis for Conclusions, the Board noted that when the specified good or service is a right to a good or service that will be provided by another party, the entity would determine whether its performance obligation is a promise to provide that right (and it is, therefore, a principal) or whether it is arranging for the other party to provide that right (and it is, therefore, an agent). The fact that the entity does not provide the underlying goods or services itself is not determinative. *[IFRS 15.BC385O]*. As well as considering the goods or services explicitly promised in the contract, an entity also needs to consider any implicit promises (see section 4.1 above and Illustration 4-18 in section 4.4.2 below for further discussion), which might require judgement. *[IFRS 15.24]*.

The Board acknowledged that it might be difficult in some cases to determine whether the specified good or service is the underlying good or service or a right to obtain that good or service. Therefore, it provided examples in the standard. Example 47 (extracted in full in section 4.4.4 below) involves an airline ticket reseller. In this example, the entity pre-purchases airline tickets that it will later sell to customers. While the customer ultimately wants airline travel, the conclusion in Example 47 is that the specified good or service is the right to fly on a specified flight (in the form of a ticket) and not the underlying flight itself. The entity itself does not fly the plane and it cannot change the service (e.g., change the flight time or destination). However, the entity obtained the ticket prior to identifying a specific customer to purchase the ticket. As a result, the entity holds an asset (in the form of a ticket) that represents a right to fly. The entity could, therefore, transfer that right to a customer (as depicted in the example) or decide to use the right itself. *[IFRS 15.IE Example 47, IFRS 15.IE239-IE243]*.

Example 46A (extracted in full in section 4.4.4 below) involves an office maintenance service provider. In this example, the entity concludes that the specified good or service is the underlying office maintenance service (rather than a right to that service). While the entity obtained the contract with the customer prior to engaging a third party to perform the requested services, the right to the subcontractor's services never transfers to the customer. Instead, the entity retains the right to direct the service provider. That is, the entity can direct the right to use the subcontractor's services as it chooses (e.g., to fulfil the customer contract, to fulfil another customer contract, to service its own facilities). Furthermore, the customer in Example 46A is indifferent as to who carries out the office maintenance services. *[IFRS 15.IE Example 46A, IFRS 15.IE238A-IE238G]*. This is not the case in Example 47, in which the customer wants the ticket reseller to sell one of its tickets on a specific flight.

If a contract with a customer includes more than one specified good or service, IFRS 15 clarifies that an entity might be a principal for some specified goods or services and an agent for others. *[IFRS 15.B34]*. Example 48A in IFRS 15 provides an illustration of this. *[IFRS 15.IE Example 48A, IFRS 15.IE248A-IE248F]*. Also consider the following Illustration:

Illustration 4-17: Entity is both a principal and an agent

A software reseller sells software licences bundled with post-contract support (PCS) and other IT solutions to end-users. The reseller has entered into contracts with several software manufacturers that provide the reseller with the right to sell licences to the software with PCS to end-users during non-cancellable periods of time in exchange for fixed fees per licence sold. The reseller can set the prices it charges end-users, but is contractually required to pay the software manufacturer the fixed fee, regardless of the price paid by end-users. The software reseller does not have a commitment to make a minimum number of purchases from the software manufacturer and does not make purchases in advance.

The software reseller is responsible for identifying which software will address the customer's needs (including the feasibility of integrating it with the customer's existing technology environment), ordering the software from the manufacturer, assisting customers if they encounter issues downloading the software (all software is provided electronically) and with other basic technical support. The software reseller is also responsible for providing refunds or remedies to the customer if the software product is not suitable for the customer's needs. The software manufacturer provides higher levels of technical support and provides PCS directly to the customer.

As part of its principal-versus-agent evaluation for these contracts, the software reseller determines that the software licence and PCS are separate specified goods or services.

When assessing control for the software licence, the reseller concludes that it controls the software licence before the licence is provided to the end-user. This is because the reseller has the right to direct the software manufacturer to provide the software to the end-user on the reseller's behalf, including the right to redirect the software to another end user (consistent with the requirements in IFRS 15.B35A(b), which are discussed in section 4.4.2 below). As part of this assessment, the software reseller also considers the three indicators of control in the standard and makes the following determinations that support its overall control evaluation:

- The software reseller is responsible for fulfilling the promise to the customer and the entity takes responsibility for much of the purchasing process, as described above.
- There is no inventory risk associated with the software provided electronically.
- The software reseller has discretion to establish prices.

Conversely, the reseller concludes that it does not control the PCS before it is provided to the end-user because the software manufacturer creates the updates that it delivers electronically to end-users of the software directly through the internet and all but the most basic level of technical support will be provided by the software manufacturer. As part of this assessment, the software reseller also considers the three indicators of control in the standard and makes the following determinations that support its overall control evaluation:

- The software manufacturer is responsible for fulfilling the promise to the customer because, in this example, it provides the updates directly to the end-users.
- There is no inventory risk associated with the PCS provided electronically.
- The software reseller has discretion to establish prices.

The software reseller believes that the first of the indicators is the most relevant to consider in this assessment and that it supports its overall control assessment. Therefore, the software reseller concludes that it is the principal for the software licence, but is an agent for the PCS, because it does not control the PCS before it is transferred to the end-user.

How we see it

As discussed above, appropriately identifying the specified good or service to be provided to the customer is a critical step in identifying whether the nature of an entity's promise is to act as a principal or an agent. Entities need to carefully examine their contract terms and might need to apply significant judgement to determine whether the specified good or service is the underlying good or service or a right to obtain that good or service.

4.4.2 Control of the specified good or service

In accordance with IFRS 15.B34A, the second step in determining the nature of the entity's promise (i.e., whether it is to provide the specified goods or services or to arrange for those goods or services to be provided by another party) is for the entity to determine whether the entity controls the specified good or service before it is transferred to the customer. An entity cannot provide the specified good or service to a customer (and, therefore, be a principal) unless it controls that good or service prior to its transfer. That is, as the Board noted in the Basis for Conclusions, control is the determining factor when assessing whether an entity is a principal or an agent. *[IFRS 15.BC385S]*.

In assessing whether an entity controls the specified good or service prior to transfer to the customer, IFRS 15.B34A(b) requires the entity to consider the definition of control that is included in Step 5 of the model, in accordance with IFRS 15.33 (discussed further in section 7 below). *[IFRS 15.B34A(b), IFRS 15.33]*.

Extract from IFRS 15

33 Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services). Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by:

(a) using the asset to produce goods or provide services (including public services);

(b) using the asset to enhance the value of other assets;

(c) using the asset to settle liabilities or reduce expenses;

(d) selling or exchanging the asset;

(e) pledging the asset to secure a loan; and

(f) holding the asset.

How we see it

When evaluating the definition of control in IFRS 15.33, we believe it could be helpful for entities to consider the indicators in IFRS 15.38 (see section 7.2 below) that the IASB included to help determine the point in time when a customer obtains control of a particular good or service (e.g., legal title, physical possession, risks and rewards of ownership).

If, after evaluating the requirement in IFRS 15.33, an entity concludes that it controls the specified good or service before it is transferred to the customer, the entity is a principal in the transaction. If the entity does not control that good or service before transfer to the customer, it is an agent.

The control principle is often easier to apply to tangible goods than to intangible goods or services because intangible goods or services generally exist only at the moment they are delivered. Therefore, the standard includes application guidance on how the control principle applies to certain types of arrangements (including service transactions) by explaining what a principal controls before the specified good or service is transferred to the customer: *[IFRS 15.B35A]*

Extract from IFRS 15

B35A When another party is involved in providing goods or services to a customer, an entity that is a principal obtains control of any one of the following:

(a) a good or another asset from the other party that it then transfers to the customer.

(b) a right to a service to be performed by the other party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf.

(c) a good or service from the other party that it then combines with other goods or services in providing the specified good or service to the customer. For example, if an entity provides a significant service of integrating goods or services (see paragraph 29(a)) provided by another party into the specified good or service for which the customer has contracted, the entity controls the specified good or service before that good or service is transferred to the customer. This is because the entity first obtains control of the inputs to the specified good or service (which includes goods or services from other parties) and directs their use to create the combined output that is the specified good or service.

In the Basis for Conclusions, the Board observed that an entity can control a service to be provided by another party when it controls the right to the specified service that will be provided to the customer. *[IFRS 15.BC385U]*. Generally, the entity then either transfers the right (in the form of an asset, such as a ticket) to its customer, in accordance with IFRS 15.B35A(a) (as in Example 47 involving the airline ticket reseller discussed in section 4.4.1 above) or uses its right to direct the other party to provide the specified service to the customer on the entity's behalf, in accordance with IFRS 15.B35A(b) (as in Example 46A involving the office maintenance services discussed in section 4.4.1 above).

The condition described in IFRS 15.B35A(a) includes contracts in which an entity transfers to the customer a right to a future service to be provided by another party. If the specified good or service is a right to a good or service to be provided by another party, the entity evaluates whether it controls the right to the goods or services before that right is transferred to the customer (rather than whether it controls the underlying goods or services). In the Basis for Conclusions, the Board noted that, in assessing such rights, it is often relevant to assess whether the right is created only when it is obtained by the customer or whether the right exists before the customer obtains it. If the right does not exist before the customer obtains it, an entity would not be able to control right before it is transferred to the customer. *[IFRS 15.BC385O]*.

The standard includes two examples to illustrate this point. In Example 47 (discussed above in section 4.4.1 above and extracted in full in section 4.4.4 below), which involves an airline ticket reseller, the specified good or service is determined to be the right to fly on a specified flight (in the form of a ticket). One of the determining factors for the principal-agent evaluation in this example is that the entity pre-purchases the airline tickets before a specific customer is identified. Accordingly, the right existed prior to a customer obtaining it. The example concludes that the entity controls the right before it is transferred to the customer (and is, therefore, a principal). *[IFRS 15.IE Example 47, IFRS 15.IE239-IE243]*.

In Example 48 (extracted in full in section 4.4.4 below), an entity sells vouchers that entitle customers to future meals at specified restaurants selected by the customer. The specified good or service is determined to be the right to a meal (in the form of a voucher). One of the determining factors for the principal-agent evaluation is that the entity does not control the voucher (the right to a meal) at any time. It does not pre-purchase or commit itself to purchase the vouchers from the restaurants before they are sold to a customer. Instead, the entity waits to purchase the voucher until a customer requests a voucher for a particular restaurant. In addition, vouchers are created only at the time that they are transferred to a customer and do not exist before that transfer. Accordingly, the right does not exist before the customer obtains it. Therefore, the entity does not at any time have the ability to direct the use of the vouchers or obtain substantially all of the remaining benefits from the vouchers before they are transferred to customers. The example concludes that the entity does not control the right before it is transferred to the customer (and is, therefore, an agent). *[IFRS 15.IE Example 48, IFRS 15.IE244-IE248]*.

In the Basis for Conclusions, the IASB acknowledged that determining whether an entity is a principal or an agent may be more difficult when evaluating whether a contract falls under IFRS 15.B35A(b). That is, it might be difficult to determine whether an entity has the ability to direct another party to provide the service on its behalf (and is, therefore, a principal) or is only arranging for the other party to provide the service (and is, therefore, an agent). As depicted in Example 46A (as discussed in section 4.4.1 above and extracted in full in section 4.4.4 below), an entity could control the right to the specified service and be a principal by entering into a contract with the subcontractor in which the entity defines the scope of service to be performed by the subcontractor on its behalf. This situation is equivalent to the entity fulfilling the contract using its own resources. Furthermore, the entity remains responsible for the satisfactory provision of the specified service in accordance with the contract with the customer. In contrast, when the specified service is provided by another party and the entity does not have the ability to direct those services, the entity typically is an agent because the entity is facilitating, rather than controlling the rights to, the service. *[IFRS 15.BC385V, IFRS 15.IE Example 46A, IFRS 15.IE238A-IE238G]*.

In a speech, a member of the US SEC staff described a consultation regarding a registrant that had performed some of the specified services for its customer but had fully relied on another service provider for others, due to certain regulatory restrictions. The SEC staff member noted that it was critical to evaluate whether the entity could control the specified services before transferring them to the customer. In this case, the registrant was able to demonstrate that it had the contractual ability to control the other service provider by determining when the service provider delivered the services because the service provider could not contractually deny services to the customer, even though the service provider had discretion in how it fulfilled its obligations. The registrant concluded, and the SEC staff did not object, that the registrant was the principal in the arrangement, based on this analysis and an analysis of the other relevant indicators of control (e.g., the registrant was responsible for handling most customer concerns that arose from the services provided by the other service provider).[54]

In accordance with IFRS 15.B35A(c), if an entity provides a significant service of integrating two or more goods or services into a combined item that is the specified good or service the customer contracted to receive, the entity controls that specified good or service before it is transferred to the customer. This is because the entity first obtains control of the inputs to the specified good or service (which can include goods or services from other parties) and directs their use to create the combined item that is the specified good or service. The inputs would be a fulfilment cost to the entity. However, as noted by the Board in the Basis for Conclusions, if a third party provides the significant integration service, the entity's customer for its good or services (which would be inputs to the specified good or service) is likely to be the third party. *[IFRS 15.BC385R]*.

In a speech, a member of the SEC staff discussed consultations in which entities have concluded that they are a principal primarily because they integrate goods or services from a third party with their own goods or services and sell the combined good or service to the end-consumer. The SEC staff member said that, when an entity assesses whether it controls the combined good or service before transfer to the end-consumer, it is helpful to determine the nature and significance of the integration service and to evaluate whether the entity first controls the inputs to the combined good or service. That is, it might be unclear how an entity could conclude that it is a principal if the integration service is not significant or it does not control the inputs to the combined good or service.[55]

While IFRS 15.B35A provides helpful guidance, significant judgement may still be needed to determine whether the entity controls the specified good or service before it is transferred to the customer. In 2021, the IFRS IC received a request regarding the determination of whether a reseller of software licences is a principal or agent. At its April 2022 meeting, the IFRS IC concluded that the principles and requirements in IFRS 15 provide an adequate basis for a reseller to determine this in the submitted fact pattern. Consequently, the IFRS IC decided not to add a standard-setting project to the work plan.

In considering this request, the IFRS IC noted that the assessment of control requires an entity to consider specific facts and circumstances, including the terms and conditions of the contracts between each of the parties involved. If it is unclear whether the entity controls the specified good or service, the entity would consider the indicators in IFRS 15.B37 to assess whether it obtains control. The IFRS IC noted that part of applying judgement in the principal versus agent assessment involves "considering the relevance of the indicators to the assessment of control and the degree to which they provide evidence of control".[56]

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54 Speech, *Remarks before the 2019 AICPA Conference on Current SEC and PCAOB Developments*, by Lauren K. Alexander, Professional Accounting Fellow, SEC Office of the Chief Accountant, 9 December 2019. Available on the SEC's website.

55 Remarks by Jonathan Wiggins, Senior Associate Chief Accountant, SEC Office of the Chief Accountant, 6 December 2021. Refer to our publication, *2021 AICPA & CIMA Conference on Current SEC and PCAOB Developments - Compendium of significant accounting and reporting issues*, on *Accounting Link*.

56 *IFRIC Update*, April 2022, available on the IFRS Foundation's website.

The following Illustration is based on the example from the IFRS IC agenda paper used by the IFRS IC when it discussed whether a reseller of software licences is a principal or agent in its April 2022 meeting:[57]

Illustration 4-18: Determination of whether a reseller of software licences is a principal or agent

A reseller of standard software licences has a distribution agreement with a software manufacturer to sell licences to customers. The reseller has discretion in pricing the software licences. The reseller provides pre-sales advice to each customer to identify the type and number of the licences that meet the customer's needs.

If the customer decides not to buy software licences, the reseller and the customer do not enter into an agreement, and the customer does not pay anything.

If the customer decides to buy the software licences, the reseller negotiates the selling price with the customer, places an order with the software manufacturer (and pays the manufacturer) and invoices the customer. The software licences are issued in the customer's name via a software portal with an activation key. If the pre-sale advice is incorrect, the customer might not accept the licences. However, the reseller cannot return unaccepted licences to the software manufacturer or sell them to another customer.

Identify the specified goods or services in the contract

The IFRS IC observed that the pre-sales advice the reseller provides is not an implicit promise in the contract. Since the reseller has already provided the advice at the time of entering into the contract with the customer, there is no further advice to be provided by the reseller after the contract inception. Therefore, the specified goods in the contract are the standard software licences as described in IFRS 15.B34A(a).

Assess whether the entity controls the specified good before it is transferred to the customer

The reseller assesses whether it obtains control of the standard software licences from the software manufacturer before they are transferred to the customer. After applying IFRS 15.B35-B35A, if it is unclear, the reseller considers the indicators in IFRS 15.B37. The IFRS IC observed that:

- The software manufacturer is responsible for fulfilling the promise to provide the licences to the customer (IFRS 15.B37(a)), for example, the software's functionality, issuing and activating the licences.
- The reseller is responsible for fulfilling the promise to provide the licences to the customer (IFRS 15.B37(a)), for example, engaging with the customer before and after the software licences are provided to the customer and taking unaccepted licences.
- The reseller has no inventory risk before the licences are provided to the customer but then has inventory risk until the customer accepts the licences (IFRS 15.B37(b)).
- The reseller has discretion in establishing the price for the software licences (IFRS 15.B37(c)), which might be less relevant if, for example, the market has limited flexibility in establishing the price.

The reseller would apply judgement in making its overall assessment, including considering the relevance of the indicators to the assessment of control and the degree to which they provide evidence of control.

57 *IFRIC Update*, April 2022, available on the IFRS Foundation's website.

4.4.2.A Principal indicators

After considering the application guidance discussed above, it still might not be clear whether an entity controls the specified good or service. Therefore, the standard provides three indicators of when an entity controls the specified good or service (and is, therefore, a principal): *[IFRS 15.B37]*

Extract from IFRS 15

B37 Indicators that an entity controls the specified good or service before it is transferred to the customer (and is therefore a principal (see paragraph B35)) include, but are not limited to, the following:

(a) the entity is primarily responsible for fulfilling the promise to provide the specified good or service. This typically includes responsibility for the acceptability of the specified good or service (for example, primary responsibility for the good or service meeting customer specifications). If the entity is primarily responsible for fulfilling the promise to provide the specified good or service, this may indicate that the other party involved in providing the specified good or service is acting on the entity's behalf.

(b) the entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (for example, if the customer has a right of return). For example, if the entity obtains, or commits itself to obtain, the specified good or service before obtaining a contract with a customer, that may indicate that the entity has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service before it is transferred to the customer.

(c) the entity has discretion in establishing the price for the specified good or service. Establishing the price that the customer pays for the specified good or service may indicate that the entity has the ability to direct the use of that good or service and obtain substantially all of the remaining benefits. However, an agent can have discretion in establishing prices in some cases. For example, an agent may have some flexibility in setting prices in order to generate additional revenue from its service of arranging for goods or services to be provided by other parties to customers.

The principal indicators above are meant to support an entity's assessment of control, not to replace it. Each indicator explains how it supports the assessment of control. As emphasised in the Basis for Conclusions, the indicators do not override the assessment of control, are not meant to be viewed in isolation and do not constitute a separate or additional evaluation. Furthermore, they are not a checklist of criteria to be met or factors to be considered in all scenarios. IFRS 15.B37A notes that considering one or more of the indicators will often be helpful and, depending on the facts and circumstances, individual indicators will be more or less relevant or persuasive to the assessment of control. *[IFRS 15.B37A, IFRS 15.BC385H]*. The IFRS IC reiterated this point in its April 2022 discussions (see section 4.4.2 above for further discussion). If an entity reaches different conclusions about whether it controls the specified good or service by applying the standard's definition of control versus the principal indicators, the entity re-evaluates its assessment, considering the facts and circumstances of its contract. This is because an entity's conclusions about control and the principal indicators need to align.

4.4.2.B Principal indicators: primarily responsible for fulfilling the promise

The first indicator that an entity is a principal, in IFRS 15.B37(a), is that the entity is primarily responsible for fulfilling the promise to provide the specified good or service to the customer, which typically includes responsibility for the acceptability of the specified good or service.

How we see it

We believe that one of the reasons that the indicator in IFRS 15.B37(a) supports the assessment of control of the specified good or service is because an entity generally controls a specified good or service that it is responsible for transferring control to a customer.

The terms of the contract and representations (written or otherwise) made by an entity during marketing generally provide evidence of which party is responsible for fulfilling the promise to provide the specified good or service and for the acceptability of that good or service.

It is possible that one entity might not be solely responsible for both providing the specified good or service and for the acceptability of that same good or service. For example, a reseller might sell goods or services that are provided to the customer by a supplier. However, if the customer is dissatisfied with the goods or services it receives, the reseller might be solely responsible for providing a remedy to the customer. The reseller might promote such a role during the marketing process or might agree to such a role as claims arise in order to maintain its relationship with its customer. In this situation, both the reseller and the supplier possess characteristics of this indicator. Therefore, it is likely that other indicators will need to be considered to determine which entity is the principal. However, if the reseller is responsible for providing a remedy to a dissatisfied customer but can then pursue a claim against the supplier to recoup any remedies it provides, that might indicate that the reseller is not ultimately responsible for the acceptability of the specified good or service.

4.4.2.C Principal indicators: inventory risk

The second indicator that an entity is a principal, in IFRS 15.B37(b), is that the entity has inventory risk (before the specified good or service is transferred to the customer or upon customer return). Inventory risk is the risk normally taken by an entity that acquires inventory in the hope of reselling it at a profit. Inventory risk exists if a reseller obtains (or commits to obtain) the specified good or service before it is ordered by a customer. Inventory risk also exists if a customer has a right of return and the reseller will take back the specified good or service if the customer exercises that right.

This indicator supports the assessment of control of the specified good or service because when an entity obtains (or commits to obtain) the specified good or service before it has contracted with a customer, it is likely that the entity has the ability to direct the use of and obtain substantially all of the remaining benefits from the good or service. For example, inventory risk can exist in a customer arrangement involving the provision of services if an entity is obliged to compensate the individual service provider(s) for work performed, regardless of whether the customer accepts that work. However, this indicator often does not apply to intangible goods or services.

Factors might exist that mitigate a reseller's inventory risk. For example, a reseller's inventory risk might be significantly reduced or eliminated if it has the right to return to the supplier goods it cannot sell or goods that are returned by customers. Another example is if a reseller receives inventory price protection from the supplier. In these cases, the inventory risk indicator might be less relevant or persuasive to the assessment of control.

4.4.2.D Principal indicators: pricing discretion

The third principal indicator, in IFRS 15.B37(c), is that the entity has discretion in establishing the price of the specified good or service. Reasonable latitude, within economic constraints, to establish the price with a customer for the product or service might indicate that the entity has the ability to direct the use of that good or service and obtain substantially all of the remaining benefits (i.e., the entity controls the specified good or service). However, because an agent might also have discretion in establishing the price of the specified good or service, the facts and circumstances of the transaction need to be carefully evaluated.

In a speech, a US SEC staff member described a consultation involving a registrant that produces and sells a commodity, which it might source from its own production, a related party's production or from a third party. For sales sourced from the related party, the registrant took possession and legal title of the product and had the right to redirect the product to other customers during shipment. The price of the commodity generally was determined based on the market price at delivery, and payment was made by the end-consumer to the registrant. The registrant then remitted the payment, less a fixed percentage fee, to the related-party producer. The registrant evaluated the indicators of control and concluded it was an agent because it did not receive substantially all the benefits of the sale due to the fixed percentage commission. The staff objected to this conclusion based on the facts presented. That is, a fixed commission structure alone does not provide conclusive evidence that an entity does not control the specified good or service.[58]

58 Speech, *Remarks before the 2020 AICPA Conference on Current SEC and PCAOB Developments*, by Jillian Pearce, Professional Accounting Fellow, SEC Office of the Chief Accountant, 7 December 2020. Available on the SEC's website.

4.4.2.E Principal indicators: examples

Illustration 4-19 below, which is similar to Example 45 in the standard, shows how an entity might conclude that it is an agent:

Illustration 4-19: Entity is an agent

An entity operates a website that provides a marketplace for customers to purchase goods from a variety of suppliers who deliver the goods directly to the customers. The entity's website facilitates customer payments to suppliers at prices that are set by the suppliers. The entity requires payment from customers before orders are processed and all orders are non-refundable. The entity has no further obligations to the customers after arranging for the products to be provided to them; the entity is not responsible for the acceptability of goods provided to customers.

First, the entity evaluates the specified goods and concludes that there are no other goods or services provided to the customer except for those provided directly by the suppliers. Next, the entity considers whether it controls the specified goods before they are transferred to the customers. Since the entity does not at any time have the ability to direct the use of the goods transferred to the customers, the entity concludes that it does not control the specified goods before they are transferred. As part of this assessment, the entity considers the three indicators of control in the standard and makes the following determinations that support its overall control evaluation:

- The suppliers are responsible for fulfilling the promise to the customer and the entity does not take responsibility for the acceptability of the goods
- The entity does not have inventory risk because it does not obtain the goods at any time
- The entity does not have discretion to establish prices because they are set by the suppliers

The entity concludes that it is an agent for the goods sold through its website because the nature of its performance obligation is to arrange for goods to be provided to the customers.

In contrast, consider the following Illustration of an entity that concludes it is acting as a principal:

Illustration 4-20: Entity is a principal

An entity operates a website that provides a marketplace for customers to purchase digital content. The entity has entered into contracts with suppliers that provide it with the right to sell the digital content during a non-cancellable period of time in exchange for a fixed fee per unit of content. The entity can set the price for the content to be sold to customers on its website. The entity is contractually required to pay the supplier a fixed price or rate for any digital content it sells to its customers and that price or rate is unaffected by the price paid by the end-consumers. The entity is responsible for assisting customers if they encounter issues downloading the content or with the user experience, and customers do not interact with the suppliers.

The entity first evaluates the specified goods and concludes that the digital content is the only specified good or service. Next, the entity considers whether it controls the digital content before it is transferred to the customer. The entity concludes that it controls the specified goods before they are transferred because it has entered into a non-cancellable distribution agreement that permits the entity to sell the digital content to its customers. This conclusion differs from the entity's conclusion in Illustration 4-19 above because that entity provided a platform to connect suppliers to customers and did not have the ability to sell the suppliers' goods. As part of this assessment, the entity also considers the three indicators of control in the standard and makes the following determinations that support its overall control evaluation:

- The entity is responsible for fulfilling the promise to the customer and the entity takes responsibility for the acceptability of the digital content
- There is no inventory risk associated with digital content
- The entity has discretion to establish prices

The entity concludes that it is a principal for the digital content sold through its website because it controls the content before it is transferred to the customer.

4.4.3 Recognising revenue as principal or agent

The determination of whether the entity is acting as a principal or an agent affects the amount of revenue the entity recognises. When the entity is the principal in the arrangement, the revenue recognised is the gross amount to which the entity expects to be entitled. *[IFRS 15.B35B]*. When the entity is the agent, the revenue recognised is the net amount that the entity is entitled to retain in return for its services as the agent. The entity's fee or commission might be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party. *[IFRS 15.B36]*.

After an entity determines whether it is the principal or the agent and the amount of gross or net revenue that would be recognised, the entity recognises revenue when or as it satisfies its performance obligation. An entity satisfies its performance obligation by transferring control of the specified good or service underlying the performance obligation, either at a point in time or over time (as discussed in section 7 below). That is, a principal would recognise revenue when (or as) it transfers the specified good or service to the customer. An agent would recognise revenue when its performance obligation to arrange for the specified good or service is complete.

In the Basis for Conclusions, the Board noted that, in some contracts in which the entity is the agent, control of specified goods or services promised by the agent might transfer before the customer receives related goods or services from the principal. For example, an entity might satisfy its promise to provide customers with loyalty points when those points are transferred to the customer if:

- The entity's promise is to provide loyalty points to customers when the customer purchases goods or services from the entity.
- The points entitle the customers to future discounted purchases with a third party (i.e., the points represent a material right to a future discount).
- The entity determines that it is an agent (i.e., its promise is to arrange for the customers to be provided with points) and the entity does not control those points (i.e., the specified good or service) before they are transferred to the customer.

In contrast, if the points entitle the customers to future goods or services to be provided by the entity, the entity might conclude it is not an agent. This is because the entity's promise is to provide those future goods or services and, therefore, the entity controls both the points and the future goods or services before they are transferred to the customer. In these cases, the entity's performance obligation might only be satisfied when the future goods or services are provided.

In other cases, the points might entitle customers to choose between future goods or services provided by either the entity or a third party. For example, many airlines allow loyalty programme members to redeem loyalty points for goods or services provided by a partner (e.g., travel on another airline, hotel accommodation). In this situation, the nature of the entity's performance obligation might not be known until the customer makes its choice. That is, until the customer has chosen the goods or services to be provided (and, therefore, whether the entity or the third party will provide those goods or services), the entity is obliged to stand ready to deliver goods or services. Therefore, the entity might not satisfy its performance obligation until it either delivers the goods or services or is no longer obliged to stand ready. If the customer subsequently chooses to receive the goods or services from a third party, the entity would need to consider whether it was acting as an agent and would, therefore, only recognise revenue for a fee or commission that it received for arranging the ultimate transaction between the customer and the third party. *[IFRS 15.BC383, IFRS 15.BC384, IFRS 15.BC385]*.

How we see it

The above discussion illustrates that control of specified goods or services promised by an agent might transfer before the customer receives related goods or services from the principal. An entity needs to assess each loyalty programme in accordance with the principles of the principal versus agent application guidance to determine if revenue would be reported on a gross or net basis.

In addition, if an entity that was initially the principal in a transaction transfers to another entity its obligation to provide the specified goods or services to the customer, the standard says that, in such a transfer, the entity shall not continue to recognise revenue as a principal. Instead, after the transfer of its obligation, the entity must evaluate whether it is acting as an agent and would recognise as revenue the net amount of consideration that the entity retains in accordance with IFRS 15.B36: *[IFRS 15.B38]*

Extract from IFRS 15	
B38	If another entity assumes the entity's performance obligations and contractual rights in the contract so that the entity is no longer obliged to satisfy the performance obligation to transfer the specified good or service to the customer (ie the entity is no longer acting as the principal), the entity shall not recognise revenue for that performance obligation. Instead, the entity shall evaluate whether to recognise revenue for satisfying a performance obligation to obtain a contract for the other party (ie whether the entity is acting as an agent).

4.4.4 Examples of principal versus agent considerations

The standard includes six examples to illustrate the principal versus agent application guidance discussed above. We have extracted four of them below.

The standard includes the following example of when the specified good or service (see section 4.4.1 above) is the underlying service, rather than the right to obtain that service. The entity in this example is determined to be a principal: *[IFRS 15.IE Example 46A, IFRS 15.IE238A-IE238G]*

Extract from IFRS 15

Example 46A-Promise to provide goods or services (entity is a principal)

An entity enters into a contract with a customer to provide office maintenance services. The entity and the customer define and agree on the scope of the services and negotiate the price. The entity is responsible for ensuring that the services are performed in accordance with the terms and conditions in the contract. The entity invoices the customer for the agreed-upon price on a monthly basis with 10-day payment terms.

The entity regularly engages third-party service providers to provide office maintenance services to its customers. When the entity obtains a contract from a customer, the entity enters into a contract with one of those service providers, directing the service provider to perform office maintenance services for the customer. The payment terms in the contracts with the service providers are generally aligned with the payment terms in the entity's contracts with customers. However, the entity is obliged to pay the service provider even if the customer fails to pay.

To determine whether the entity is a principal or an agent, the entity identifies the specified good or service to be provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer.

The entity observes that the specified services to be provided to the customer are the office maintenance services for which the customer contracted, and that no other goods or services are promised to the customer. While the entity obtains a right to office maintenance services from the service provider after entering into the contract with the customer, that right is not transferred to the customer. That is, the entity retains the ability to direct the use of, and obtain substantially all the remaining benefits from, that right. For example, the entity can decide whether to direct the service provider to provide the office maintenance services for that customer, or for another customer, or at its own facilities. The customer does not have a right to direct the service provider to perform services that the entity has not agreed to provide. Therefore, the right to office maintenance services obtained by the entity from the service provider is not the specified good or service in its contract with the customer.

The entity concludes that it controls the specified services before they are provided to the customer. The entity obtains control of a right to office maintenance services after entering into the contract with the customer but before those services are provided to the customer. The terms of the entity's contract with the service provider give the entity the ability to direct the service provider to provide the specified services on the entity's behalf (see paragraph B35A(b)). In addition, the entity concludes that the following indicators in paragraph B37 of IFRS 15 provide further evidence that the entity controls the office maintenance services before they are provided to the customer:

(a) the entity is primarily responsible for fulfilling the promise to provide office maintenance services. Although the entity has hired a service provider to perform the services promised to the customer, it is the entity itself that is responsible for ensuring that the services are performed and are acceptable to the customer (ie the entity is responsible for fulfilment of the promise in the contract, regardless of whether the entity performs the services itself or engages a third-party service provider to perform the services).

(b) the entity has discretion in setting the price for the services to the customer.

The entity observes that it does not commit itself to obtain the services from the service provider before obtaining the contract with the customer. Thus, the entity has mitigated inventory risk with respect to the office maintenance services. Nonetheless, the entity concludes that it controls the office maintenance services before they are provided to the customer on the basis of the evidence in paragraph IE238E.

Thus, the entity is a principal in the transaction and recognises revenue in the amount of consideration to which it is entitled from the customer in exchange for the office maintenance services.

The standard also includes the following example of when the specified good or service is the right to obtain a service and not the underlying service itself. The entity in this example is determined to be a principal:
[IFRS 15.IE Example 47, IFRS 15.IE239-IE243]

Extract from IFRS 15

Example 47-Promise to provide goods or services (entity is a principal)

An entity negotiates with major airlines to purchase tickets at reduced rates compared with the price of tickets sold directly by the airlines to the public. The entity agrees to buy a specific number of tickets and must pay for those tickets regardless of whether it is able to resell them. The reduced rate paid by the entity for each ticket purchased is negotiated and agreed in advance.

The entity determines the prices at which the airline tickets will be sold to its customers. The entity sells the tickets and collects the consideration from customers when the tickets are purchased.

The entity also assists the customers in resolving complaints with the service provided by the airlines. However, each airline is responsible for fulfilling obligations associated with the ticket, including remedies to a customer for dissatisfaction with the service.

To determine whether the entity's performance obligation is to provide the specified goods or services itself (ie the entity is a principal) or to arrange for those goods or services to be provided by another party (ie the entity is an agent), the entity identifies the specified good or service to be provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer.

The entity concludes that, with each ticket that it commits itself to purchase from the airline, it obtains control of a right to fly on a specified flight (in the form of a ticket) that the entity then transfers to one of its customers (see paragraph B35A(a)). Consequently, the entity determines that the specified good or service to be provided to its customer is that right (to a seat on a specific flight) that the entity controls. The entity observes that no other goods or services are promised to the customer.

The entity controls the right to each flight before it transfers that specified right to one of its customers because the entity has the ability to direct the use of that right by deciding whether to use the ticket to fulfil a contract with a customer and, if so, which contract it will fulfil. The entity also has the ability to obtain the remaining benefits from that right by either reselling the ticket and obtaining all of the proceeds from the sale or, alternatively, using the ticket itself.

The indicators in paragraphs B37(b)-(c) of IFRS 15 also provide relevant evidence that the entity controls each specified right (ticket) before it is transferred to the customer. The entity has inventory risk with respect to the ticket because the entity committed itself to obtain the ticket from the airline before obtaining a contract with a customer to purchase the ticket. This is because the entity is obliged to pay the airline for that right regardless of whether it is able to obtain a customer to resell the ticket to or whether it can obtain a favourable price for the ticket. The entity also establishes the price that the customer will pay for the specified ticket.

Thus, the entity concludes that it is a principal in the transactions with customers. The entity recognises revenue in the gross amount of consideration to which it is entitled in exchange for the tickets transferred to the customers.

In the following example, the entity also determines that the specified good or service is the right to obtain a service and not the underlying service itself. However, the entity in this example is determined to be an agent. *[IFRS 15.IE Example 48, IFRS 15.IE244-IE248]*.

Extract from IFRS 15

Example 48-Arranging for the provision of goods or services (entity is an agent)

An entity sells vouchers that entitle customers to future meals at specified restaurants. The sales price of the voucher provides the customer with a significant discount when compared with the normal selling prices of the meals (for example, a customer pays CU100 for a voucher that entitles the customer to a meal at a restaurant that would otherwise cost CU200). The entity does not purchase or commit itself to purchase vouchers in advance of the sale of a voucher to a customer; instead, it purchases vouchers only as they are requested by the customers. The entity sells the vouchers through its website and the vouchers are non-refundable.

The entity and the restaurants jointly determine the prices at which the vouchers will be sold to customers. Under the terms of its contracts with the restaurants, the entity is entitled to 30 per cent of the voucher price when it sells the voucher.

The entity also assists the customers in resolving complaints about the meals and has a buyer satisfaction programme. However, the restaurant is responsible for fulfilling obligations associated with the voucher, including remedies to a customer for dissatisfaction with the service.

To determine whether the entity is a principal or an agent, the entity identifies the specified good or service to be provided to the customer and assesses whether it controls the specified good or service before that good or service is transferred to the customer.

A customer obtains a voucher for the restaurant that it selects. The entity does not engage the restaurants to provide meals to customers on the entity's behalf as described in the indicator in paragraph B37(a) of IFRS 15. Therefore, the entity observes that the specified good or service to be provided to the customer is the right to a meal (in the form of a voucher) at a specified restaurant or restaurants, which the customer purchases and then can use itself or transfer to another person. The entity also observes that no other goods or services (other than the vouchers) are promised to the customers.

The entity concludes that it does not control the voucher (right to a meal) at any time. In reaching this conclusion, the entity principally considers the following:

(a) the vouchers are created only at the time that they are transferred to the customers and, thus, do not exist before that transfer. Therefore, the entity does not at any time have the ability to direct the use of the vouchers, or obtain substantially all of the remaining benefits from the vouchers, before they are transferred to customers.

(b) the entity neither purchases, nor commits itself to purchase, vouchers before they are sold to customers. The entity also has no responsibility to accept any returned vouchers. Therefore, the entity does not have inventory risk with respect to the vouchers as described in the indicator in paragraph B37(b) of IFRS 15.

Thus, the entity concludes that it is an agent with respect to the vouchers. The entity recognises revenue in the net amount of consideration to which the entity will be entitled in exchange for arranging for the restaurants to provide vouchers to customers for the restaurants' meals, which is the 30 per cent commission it is entitled to upon the sale of each voucher.

IFRS 15.34 clarifies that an entity might be a principal for some specified goods or services in a contract and an agent for others. The standard includes the Example 48A to illustrate a contract in which an entity is determined to be both principal and agent. *[IFRS 15.IE Example 48A, IFRS 15.IE248A-IE248F]*.

Frequently asked questions

Question 4-15: How would an entity determine whether it is a principal or an agent in a transaction for a specified good for which it only takes title momentarily or never has physical possession?

An entity's determination of whether it is a principal or an agent in a transaction for a specified good for which it only takes title momentarily or never has physical possession requires significant judgement and careful consideration of the facts and circumstances. Entities might enter into contracts with third-party vendors (the vendors) to provide goods or services to be sold through their sales channels to their customers. In these arrangements, the entity might take legal title to the good only momentarily before the good is transferred to the customer, such as in scan-based trading or 'flash title' contracts (e.g., vendor is responsible for stocking, rotating and otherwise managing the product until the final point of sale). Alternatively, the entity might never take physical possession or legal title to the good (e.g., 'drop shipment arrangements' when goods are shipped directly from a vendor to the customer). In these situations, the entity needs to carefully evaluate whether it obtains control of the specified good and, therefore, is the principal in the transaction with the end-consumer.

How we see it

When evaluating the control principle and the principal indicators provided in the standard, we believe some questions an entity might consider when making this judgement could include the questions listed below.

- Does the entity take title to the goods at any point in the order-to-delivery process? If not, why?
- Is the vendor the party that the customer will hold responsible for the acceptability of the product (e.g., handling of complaints and returns)? If so, why?
- Does the entity have a return-to-vendor agreement with the vendor or have a history of returning goods to the vendor after a customer returns the good(s)? If so, why?
- Does the vendor have discretion in establishing the price for the goods (e.g., setting the floor or ceiling)? If so, why?
- Is the vendor responsible for the risk of loss or damage (e.g., shrinkage) while the goods are in the entity's store? If so, why?
- Does the vendor have the contractual right to take back the goods delivered to the entity and, if so, has the vendor exercised that right in situations other than when the goods were at the end of their useful lives?
- Can the entity move goods between their stores or relocate goods within their stores without first obtaining permission from the vendor? If not, why?
- Does the entity have any further obligation to the customer after remitting the customer's order to the vendor? If not, why?
- Once a customer order is placed, can the entity direct the product to another entity or prevent the product from being transferred to the customer? If not, why?

A US SEC staff member said in a speech that the application of the principal-versus-agent application guidance can be especially challenging when an entity never obtains physical possession of a good. While noting that the staff has seen these types of fact patterns with conclusions of both principal and agent, the staff member further discussed certain facts and circumstances of a registrant consultation in which the SEC staff did not object to a principal determination in a transaction in which certain specialised goods were shipped directly to the end-consumer by the vendor (not the registrant). In reaching this conclusion, the SEC staff member reiterated that the determination requires consideration of the definition of control in the standard, which often includes consideration of the indicators in IFRS 15.B37. However, inventory risk is only one of those indicators and it is possible that physical possession will not coincide with control of a specified good.[59] This conclusion is consistent with Example 46 in the standard in which an entity is deemed to be the principal even though the supplier delivers the specified good or service (i.e., a piece of specialised equipment) directly to the customer.

59 Speech, *Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments*, by Sheri L. York, Professional Accounting Fellow, SEC Office of the Chief Accountant, 10 December 2018. Available on the SEC's website.

In another speech, an SEC staff member shared observations from a consultation involving a registrant that operated a platform that facilitated an advertiser's purchase of digital advertising space from a publisher. The registrant concluded that it was an agent in the transaction, despite the fact that it obtained momentary title of the digital advertising space, because the registrant was unable to direct the use of the potential advertising space to an ad other than the advertiser's predetermined ad. The registrant further evaluated the indicators of control and determined that it was not primarily responsible for fulfilment and did not have inventory risk. The staff did not object to the registrant's conclusion that it was an agent in the transaction.[60]

Understanding the business purpose and rationale for the contractual terms between the vendor and the entity might help the entity assess whether it controls the specified goods prior to the transfer to the end-consumer and is, therefore, the principal in the sale to the end-consumer.

Question 4-16: How would entities determine the presentation of amounts billed to customers (e.g., shipping and handling, expenses or cost reimbursements and taxes) under the standards (i.e., as revenue or as a reduction of costs)?

(TRG meeting 18 July 2014 - Agenda paper no. 2)

The TRG members generally agreed that the standard is clear that any amounts not collected on behalf of third parties would be included in the transaction price (i.e., revenue). As discussed in section 5 below, IFRS 15.47 says that "the transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes)". Therefore, if the amounts were earned by the entity in fulfilling its performance obligations, the amounts are included in the transaction price and recorded as revenue.

Shipping and handling

The appropriate presentation of amounts billed to customers for shipping and handling activities would depend on whether they entity is a principal or an agent in the shipping arrangement (see Question 10-8 in section 10.3 below for further discussion on presentation of shipping and handling costs incurred by the entity).

Expense or cost reimbursements

Many service providers routinely incur incidental expenses, commonly referred to as 'out-of-pocket' expenses, in the course of conducting their normal operations. Those expenses often include, but are not limited to, airfare, other travel-related costs (such as car rentals and hotel accommodation) and telecommunications charges. The entity (i.e., the service provider) and the customer might agree that the customer will reimburse the entity for the actual amount of such expenses incurred. Alternatively, the parties might negotiate a single fixed fee that is intended to compensate the service provider for both professional services rendered and out-of-pocket expenses incurred.

Out-of-pocket expenses are often costs incurred by an entity in fulfilling its performance obligation(s) (i.e., the out-of-pocket expenses are fulfilment costs) and do not transfer a good or service to the customer. In these situations, reimbursement for such costs generally is included in the entity's estimate of the transaction price and recognised as revenue when (or as) the performance obligation(s) is (are) satisfied, even if the entity is reimbursed at 'cost' (i.e., at zero margin). Alternatively, if an entity concludes that the costs *do* transfer a good or service to the customer, it considers the principal-versus-agent application guidance when determining whether reimbursement amounts received from its customer need to be recorded on a gross or net basis.

In some cases, it might be appropriate to include the reimbursement in the transaction price and recognise that amount as revenue when the applicable expense is incurred. That is, an entity might not have to estimate out-of-pocket expenses in its determination of the transaction price at contract inception. This was discussed in a US Private Company Council meeting under US GAAP. The FASB staff observed in the related staff paper the following situations in which this would be the case:[61]

- The entity is an agent as it relates to the specified good or service identified (see section 4.4 above). That is, in cases in which the entity is an agent and the reimbursement is equal to the cost, the net effect on revenue would be zero and, therefore, no estimation would be required.
- The variable consideration is constrained (see section 5.2.3 below). That is, if a portion of the transaction price related to reimbursements of out-of-pocket expenses is constrained, an entity would not include an estimate in the transaction price for that amount until it becomes highly probable that a significant revenue reversal will not occur, which might be when the underlying out-of-pocket expenses are incurred in some cases. For example, an entity might not be able to make reliable estimates of expenses and the related reimbursements that will not be subject to a significant revenue reversal due to a lack of historical evidence.

- The variable consideration relates specifically to a performance obligation or a distinct good or service in a series and the entity meets the variable consideration exception (see section 6.3 below).
- The entity qualifies to apply the 'right to invoice' practical expedient (see section 7.1.4.B below).
- The entity applies a 'costs incurred' measure of progress when recognising revenue for over-time performance obligations (see section 7.1.4 below). That is, if an entity selects a 'costs incurred' method, the timing of the costs being incurred and the revenue recognition associated with those costs would align.

Taxes or other assessments

Several of the TRG members noted that this would require entities to evaluate taxes collected in all jurisdictions in which they operate to determine whether a tax is levied on the entity or the customer. TRG members generally agreed that an entity would apply the principal versus agent application guidance when it is not clear whether the amounts are collected on behalf of third parties. This could result in amounts billed to a customer being recorded as an offset to costs incurred (i.e., on a net basis). See section 5.1 below for further discussion on consideration for sales (and other similar) taxes.

Question 4-17: How does an entity allocate the transaction price in a contract with multiple performance obligations in which the entity acts as both a principal and an agent?

See response to Question 6-9 in section 6.2 below.

FASB differences

Under US GAAP, an entity that is the principal is not permitted to estimate its gross transaction price when it is unable to determine the ultimate price charged to the customer by an intermediary and the uncertainty related to the transaction price is not ultimately expected to be resolved.[62] The IASB did not specifically consider how the transaction price requirements would be applied in these situations (i.e., when an entity that is a principal does not know and expects not to know the price charged to its customer by an agent), but concluded in the Basis for Conclusions that an entity that is a principal would generally be able to apply judgement and determine the consideration to which it is entitled using all information available to it. *[IFRS 15.BC385Z]*.

4.5 Consignment arrangements

The standard provides specific application guidance for a promise to deliver goods on a consignment basis to other parties. See section 7.4 below.

4.6 Customer options for additional goods or services

Many sales contracts give customers the option to acquire additional goods or services. These additional goods or services might be priced at a discount or might even be free of charge. Options to acquire additional goods or services at a discount can come in many forms, including sales incentives, volume-tiered pricing structures, customer award credits (e.g., frequent flyer points) or contract renewal options (e.g., waiver of certain fees, reduced future rates). *[IFRS 15.B39]*. See the Questions that follow this section, which discuss many of these different types of customer options.

When an entity grants a customer the option to acquire additional goods or services, that option is only a separate performance obligation if it provides a material right to the customer that the customer would not receive without entering into the contract (e.g., a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). Refer to Question 4-22 below for further discussion on the evaluation of class of customer. If the option provides a material right to the customer, the customer has, in effect, paid in advance for future goods or services. As such, the entity recognises revenue when those future goods or services are transferred or when the option expires. *[IFRS 15.40]*. In the Basis for Conclusions, the IASB indicated that the purpose of this requirement is to identify and account for options that customers are paying for (often implicitly) as part of the current transaction. *[IFRS 15.BC386]*.

60 Speech, *Remarks before the 2020 AICPA Conference on Current SEC and PCAOB Developments*, by Geoff Griffin, Professional Accounting Fellow, SEC Office of the Chief Accountant, 7 December 2020. Available on the SEC's website.

61 FASB staff Private Company Council Memo, *Reimbursement of Out-of-Pocket Expenses,* dated 26 June 2018. Refer to the FASB's website.

62 FASB ASU 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations* (March 2016), paragraph BC38.

The Board did not provide any bright lines as to what constitutes a 'material' right. However, the standard requires that an option to purchase additional goods or services at their stand-alone selling prices does not provide a material right and, instead, is a marketing offer. This is the case even if the customer has obtained the option only as a result of entering into a previous contract. However, an option to purchase additional goods or services in the future at the current stand-alone selling price could be a material right if prices are highly likely to significantly increase. This could also be the case if a renewal option at the current stand-alone selling price is offered for an extended period of time and the stand-alone selling price for the product is highly likely to significantly increase, depending on the facts and circumstances of the contract. This is because the customer is being offered a discount on future goods or services compared to what others will have to pay in the future as a result of entering into the previous contract. The standard states that this is the case even if the option can only be exercised because the customer entered into the earlier transaction. An entity that has made a marketing offer accounts for it in accordance with IFRS 15 only when the customer exercises the option to purchase the additional goods or services. *[IFRS 15.B41]*.

How we see it

Significant judgement might be required to determine whether a customer option represents a material right. This determination is important because it affects the accounting and disclosures for the contract at inception and throughout the life of the contract.

The standard includes the following example to illustrate the determination of whether an option represents a material right (see section 6.1.5 below for a discussion of the measurement of options that are separate performance obligations): *[IFRS 15.IE Example 49, IFRS 15.IE250-IE253]*

Extract from IFRS 15

Example 49-Option that provides the customer with a material right (discount voucher)

An entity enters into a contract for the sale of Product A for CU100. As part of the contract, the entity gives the customer a 40 per cent discount voucher for any future purchases up to CU100 in the next 30 days. The entity intends to offer a 10 per cent discount on all sales during the next 30 days as part of a seasonal promotion. The 10 per cent discount cannot be used in addition to the 40 per cent discount voucher.

Because all customers will receive a 10 per cent discount on purchases during the next 30 days, the only discount that provides the customer with a material right is the discount that is incremental to that 10 per cent (ie the additional 30 per cent discount). The entity accounts for the promise to provide the incremental discount as a performance obligation in the contract for the sale of Product A.

To estimate the stand-alone selling price of the discount voucher in accordance with paragraph B42 of IFRS 15, the entity estimates an 80 per cent likelihood that a customer will redeem the voucher and that a customer will, on average, purchase CU50 of additional products. Consequently, the entity's estimated stand-alone selling price of the discount voucher is CU12 (CU50 average purchase price of additional products × 30 per cent incremental discount × 80 per cent likelihood of exercising the option). The stand-alone selling prices of Product A and the discount voucher and the resulting allocation of the CU100 transaction price are as follows:

Performance obligations	Stand-alone selling price	
	CU	
Product A	100	
Discount voucher	12	
Total	112	

	Allocated transaction price	
Product A	89	(CU100 ÷ CU112 × CU100)
Discount voucher	11	(CU12 ÷ CU112 × CU100)
Total	100	

The entity allocates CU89 to Product A and recognises revenue for Product A when control transfers. The entity allocates CU11 to the discount voucher and recognises revenue for the voucher when the customer redeems it for goods or services or when it expires.

Evaluating whether an option provides a material right might be more complex when the stand-alone selling price of the good or service is highly variable, as illustrated below:

Illustration 4-21: Evaluating a customer option when the stand-alone selling price is highly variable

A technology entity enters into a contract with a customer for a perpetual licence of a software, with one year of post-contract support (PCS). The contract also includes an option to purchase additional licences of the software at 40% off the list price.

The entity does not sell the software separately, but it sells PCS separately in the form of renewals that are consistently priced at 20% of the net licence fee. Assume that the technology entity uses the residual method to estimate the stand-alone selling price of the perpetual licence for the software (see section 6.1.2 below). Also assume that the price the technology entity charges for the bundle of the perpetual licence and PCS is highly variable. That is because the price the technology entity charges to customers in the same class and same market as the customer who have not made prior purchases ranges from the list price to a discounted price of up to 70% off the list price for the bundle. Assume that the entity has appropriately stratified its contracts/customers to evaluate the range of discounts and has a sufficient amount of transactions to support that this is the range of discounts it offers.

Since the 40% discount the technology entity offered to the customer is within the range of discounts it typically offers to customers in the same class as the customer, the technology entity concludes that this option does not represent a material right.

While the customer option is determined not to be a material right in this example, that might not always be the case. An entity would need to evaluate all customer options, even those for which the price of the good or service that is subject to the option is highly variable and for which the residual approach was used.

Frequently asked questions

Question 4-18: Would entities consider only the current transaction or would they consider past and future transactions with the same customer when determining whether an option for additional goods or services provides the customer with a material right?

(TRG meeting 31 October 2014 - Agenda paper no. 6)

The TRG members generally agreed that entities would consider all relevant transactions with a customer (i.e., current, past and future transactions), including those that provide accumulating incentives, such as loyalty programmes, when determining whether an option represents a material right. That is, the evaluation is not solely performed in relation to the current transaction.[63]

Question 4-19: Is the material right evaluation solely a quantitative evaluation or does the evaluation also consider qualitative factors?

(TRG meeting 31 October 2014 - Agenda paper no. 6)

The TRG members generally agreed that the evaluation considers both quantitative and qualitative factors that would be known to the entity (e.g., what a new customer would pay for the same service, the availability and pricing of competitors' service alternatives, whether the average customer life indicates that the fee provides an incentive for customers to remain beyond the stated contract term, whether the right accumulates). This is because a customer's perspective on what constitutes a 'material right' might consider qualitative factors. This is consistent with the notion that when identifying promised goods or services in Step 2, an entity considers reasonable expectations of the customer that the entity will transfer a good or service to it.[64]

Question 4-20: How would an entity distinguish between a contract that contains an option to purchase additional goods or services and a contract that includes variable consideration (see section 5.2 below) based on a variable quantity (e.g., a usage-based fee)?

(TRG meeting 9 November 2015 - Agenda paper no. 48)

Entities have found it challenging to distinguish between a contract that includes customer options to purchase additional goods or services and one that includes variable consideration based on a variable quantity (e.g., a usage-based fee). This is because, under both types of contracts, the ultimate quantity of goods or services to be transferred to the customer is often unknown at contact inception. The TRG members generally agreed that this determination requires judgement and consideration of the facts and circumstances. They also generally agreed that the TRG agenda paper on this question provides a framework that helps entities to make this determination.

63 TRG Agenda paper no. 6, *Customer options for additional goods and services and non-refundable upfront fees*, dated 31 October 2014, and TRG Agenda paper no. 11, *October 2014 Meeting - Summary of Issues Discussed and Next Steps*, dated 26 January 2015.

64 TRG Agenda paper no. 6, *Customer options for additional goods and services and non-refundable upfront fees*, dated 31 October 2014, and TRG Agenda paper no. 11, *October 2014 Meeting - Summary of Issues Discussed and Next Steps*, dated 26 January 2015.

This determination is important because it affects the accounting for the contract at inception and throughout the life of the contract, as well as disclosures. If an entity concludes that a customer option for additional goods or services provides a material right, the option itself is deemed to be a performance obligation in the contract, but the underlying goods or services are not accounted for until the option is exercised (as discussed below in Question 4-21 below). As a result, the entity is required to allocate a portion of the transaction price to the material right at contract inception and to recognise that revenue when or as the option is exercised or the option expires. If an entity, instead, concludes that an option for additional goods or services is not a material right, there is no accounting for the option and no accounting for the underlying optional goods or services until those subsequent purchases occur.
However, if the contract includes variable consideration (rather than a customer option), an entity has to estimate at contract inception the variable consideration expected over the life of the contract and update that estimate each reporting period (subject to the constraint on variable consideration) (see section 5.2 below). There are also more disclosures required for variable consideration (e.g., the requirement to disclose the remaining transaction price for unsatisfied performance obligations) (see section 10.5.1.C below) than for options that are not determined to be material rights.
The TRG agenda paper explained that the first step (in determining whether a contract involving variable quantities of goods or services are accounted for as a contract containing customer options or variable consideration) is for the entity to determine the nature of its promise in providing goods or services to the customer and the rights and obligations of each party.
In a contract in which the variable quantity of goods or services results in variable consideration, the nature of the entity's promise is to transfer to the customer an overall service. In providing this overall service, an entity might perform individual tasks or activities. At contract inception, the entity is presently obliged by the terms and conditions of the contract to transfer all promised goods or services provided under the contract and the customer is obliged to pay for those promised goods or services. This is because the customer entered into a contract that obliges the entity to transfer those goods or services. The customer's subsequent actions to utilise the service affect the measurement of revenue (in the form of variable consideration), but do not oblige the entity to provide additional distinct goods or services beyond those promised in the contract.
For example, consider a contract between a transaction processor and a customer in which the processor will process all of the customer's transactions in exchange for a fee paid for each transaction processed. The ultimate quantity of transactions that will be processed is not known. The nature of the entity's promise is to provide the customer with continuous access to the processing platform so that submitted transactions are processed. By entering into the contract, the customer has made a purchasing decision that obliges the entity to provide continuous access to the transaction processing platform. The consideration paid by the customer results from events (i.e., additional transactions being submitted for processing to the processor) that occur after (or as) the entity transfers the payment processing service. The customer's actions do not oblige the processor to provide additional distinct goods or services because the processor is already obliged (starting at contract inception) to process all transactions submitted to it.
Another example described in the TRG agenda paper of contracts that might include variable consideration was related to certain IT outsourcing contracts. Under this type of contract (similar to the transaction processing contract, discussed above), the entity provides continuous delivery of a service over the contract term and the amount of service provided is variable.

Illustration 4-22: Variable consideration (IT outsourcing arrangement)

An entity enters into a 10-year IT outsourcing arrangement with a customer in which it provides continuous delivery of outsourced activities over the contract term. The entity provides server capacity, manages the customer's software portfolio and runs an IT help desk. The total monthly invoice is calculated based on the units consumed for each activity. For example, the billings might be based on millions of instructions per second of computing power, the number of software applications used or the number of employees supported. The price per unit differs for each type of activity.

At contract inception, it is unknown how many outsourced activities the entity will perform for the customer throughout the life of the contract. The question that arises is whether the customer makes optional purchases when it sends activities to the entity to be performed or whether its use of the service affects the measurement of revenue (in the form of variable consideration).

The conclusion in the TRG agenda paper was that it is likely that this contract contains variable consideration because of the nature of the entity's promise. The customer is paying for the entity to stand ready to perform in an outsourcing capacity on any given day. The customer does not make a separate purchasing decision each time it sends a unit for processing. Instead, the customer made its purchasing decision when it entered into the outsourcing contract with the entity. Therefore, the customer's actions to use the service also do not oblige the entity to provide any additional distinct goods or services.

In contrast, when an entity provides a customer option, the nature of its promise is to provide the quantity of goods or services specified in the contract, if any, and a right for the customer to choose the amount of additional distinct goods or services the customer will purchase. That is, the entity is not obliged to provide any additional distinct goods or services until the customer exercises the option. The customer has a contractual right that allows it to choose the amount of additional distinct goods or services to purchase, but the customer has to make a separate purchasing decision to obtain those additional distinct goods or services. Prior to the customer's exercise of that right, the entity is not obliged to provide (nor does it have a right to consideration for transferring) those goods or services.

Since an option that is a marketing offer is considered a new contract if it is exercised, the IASB staff noted in the TRG agenda paper that an analogy to the contract modification requirements in IFRS 15.20-21 (see section 3.4 above) could be helpful when an entity is distinguishing between optional purchases and variable consideration. For a modification to be considered a separate contract, one of the criteria is that the modification results in the addition of promised goods or services that are distinct. Similarly, the IASB staff noted that the exercise of a customer option would typically result in the addition of promised goods or services that are distinct.

The TRG agenda paper included an example, which the following Illustration is based on, of a contract that includes a customer option (rather than variable consideration).

Illustration 4-23: Customer option that is not a material right

Entity B enters into a contract to provide 100 widgets to Customer Y in return for consideration of CU10 per widget. Each widget is a distinct good transferred at a point in time. The contract also gives Customer Y the right to purchase additional widgets at the stand-alone selling price of CU10 per widget. Therefore, the quantity that might be purchased by Customer Y is variable.

The conclusion in the TRG agenda paper was that, while the quantity of widgets that might be purchased is variable, the transaction price for the existing contract is fixed at CU1,000 [100 widgets x CU10 per widget].

That is, the transaction price only includes the consideration for the 100 widgets specified in the contract and the customer's decision to purchase additional widgets is an option. While Entity B might be required to deliver additional widgets in the future, Entity B is not legally obligated to provide the additional widgets until Customer Y exercises the option. In this example, the option is accounted for as a separate contract because there is no material right, since the pricing of the option is at the stand-alone selling price of the widgets.

Contrast the above Illustration with another contract that includes a customer option that is determined to be a material right:

Illustration 4-24: Customer option that is a material right

Entity B enters into a contract to provide 100 widgets to Customer Y at CU10 per widget (which is the widget's stand-alone selling price at contract inception). Each widget is a distinct good transferred at a point in time. The contract also gives Customer Y the right to purchase additional widgets at CU9 per widget. Therefore, the quantity that might be purchased by Customer Y is variable.

While the quantity of widgets that might be purchased is variable, the transaction price for the existing contract is fixed at CU1,000 [100 widgets x CU10 per widget]. That is, the transaction price only includes the consideration for the 100 widgets specified in the contract, and the customer's decision to purchase additional widgets is an option. While Entity B might be required to deliver additional widgets in the future, Entity B is not legally obligated to provide the additional widgets until Customer Y exercises the option.

Entity B determines that Customer Y obtained a discount on future widgets because CU9 per widget is lower than the stand-alone selling price of each widget at contract inception (i.e., CU10 per widget), as well as being lower than the expected stand-alone selling price at renewal. In this example, the option is accounted for as a material right.

The TRG agenda paper also included an example, which the following Illustration is based on, of a contract in which the variable quantity of goods or services includes a customer option:

Illustration 4-25: Customer option

A supplier enters into a five-year master supply arrangement in which the supplier is obliged to produce and sell parts to a customer at the customer's request. That is, the supplier is not obliged to transfer any parts until the customer submits a purchase order. In addition, the customer is not obliged to purchase any parts; however, it is highly likely it will do so because the part is required to manufacture the customer's product and it is not practical to obtain parts from multiple suppliers. Each part is determined to be a distinct good that transfers to the customer at a point in time.

The conclusion in the TRG agenda paper was that the nature of the promise in this example is the delivery of parts (and not a service of standing ready to produce and sell parts). That is, the contract provides the customer with a right to choose the quantity of additional distinct goods (i.e., it provides a customer option), rather than a right to use the services for which control to the customer has (or is currently being) transferred (such as in the transaction processor example above). Similarly, the supplier is not obliged to transfer any parts until the customer submits the purchase order (another important factor in distinguishing a customer option from variable consideration). In contrast, in certain other fact patterns, the supplier is obliged to make the promised services available to the customer without any additional decisions made by the customer.

The TRG agenda paper contrasted this example with other contracts that might include a stand-ready obligation (e.g., a customer's use of a health club). When the customer submits a purchase order under the master supply arrangement, it is contracting for a specific number of distinct goods, which creates new performance obligations for the supplier. In contrast, a customer using services in a health club is using services that the health club is already obliged to provide under the present contract. That is, there are no new obligations arising from the customer's usage.

The TRG agenda paper also included an example, which the following Illustration is based on, of a contract in which the variable quantity of goods or services results in variable consideration:

Illustration 4-26: Variable consideration (variable quantities of goods or services)

Entity A enters into a contract to provide equipment to Customer X. The equipment is a single performance obligation transferred at a point in time. Entity A charges Customer X based on its usage of the equipment at a fixed rate per unit of consumption. The contract has no minimum payment guarantees. Customer X is not contractually obliged to use the equipment. However, Entity A is contractually obliged to transfer the equipment to Customer X.

The conclusion in the TRG agenda paper was that the usage of the equipment by Customer X is a variable quantity that affects the amount of consideration owed to Entity A. It does not affect Entity A's performance obligation, which is to transfer the piece of equipment. That is, Entity A has performed by transferring the distinct good. Customer X's actions, which result in payment to Entity A, occur after the equipment has been transferred and do not require Entity A to provide additional goods or services.

Question 4-21: When, if ever, would an entity consider the goods or services underlying a customer option as a separate performance obligation?

(TRG meeting 9 November 2015 - Agenda paper no. 48)

The TRG members generally agreed that an entity does not need to identify the additional goods or services underlying the option as promised goods or services (or performance obligations) if there are no contractual penalties (e.g., termination fees, monetary penalties for not meeting contractual minimums), even if it believes that it is virtually certain that a customer will exercise its option for additional goods or services. Only the option is assessed to determine whether it represents a material right (and accounted for as a performance obligation). As a result, any consideration that would be received in return for optional goods or services is not included in the transaction price at contract inception. The TRG agenda paper included an example, which the following Illustration is based on, of a contract in which it is virtually certain that a customer will exercise its option for additional goods or services:

Illustration 4-27: Customer option with no contractual penalties

An entity sells equipment and consumables, both of which are determined to be distinct goods that are recognised at a point in time. The stand-alone selling price of the equipment and each consumable is CU10,000 and CU100, respectively. The equipment costs CU8,000 and each consumable costs CU60. The entity sells the equipment for CU6,000 (i.e., at a 40% discount on its stand-alone selling price) with a customer option to purchase each consumable for CU100 (i.e., equal to its stand-alone selling price). There are no contractual minimums, but the entity estimates the customer will purchase 200 parts over the next two years. This is an exclusive contract in which the customer cannot purchase the consumables from any other vendors during the contract term.

TRG members generally agreed that the consumables underlying each option would not be considered part of the contract. Furthermore, the option does not represent a material right because it is priced at the stand-alone selling price for the consumable. This is the case even though the customer is compelled to exercise its option for the consumables because the equipment cannot function without the consumables and the contract includes an exclusivity clause that requires the customer to acquire the consumables only from the entity. Accordingly, the transaction price is CU6,000 and it is entirely attributable to the equipment. This would result in a loss for the entity of CU2,000 when it transfers control of the equipment to the customer.

However, contractual minimums might represent fixed consideration in a contract, even if the contract also contains optional purchases. For example, an MSA might set minimum purchase quantities that the entity is obliged to provide, but any quantities above the minimum might require the customer to make a separate purchasing decision (i.e., exercise a customer option). If contractual penalties exist (e.g., termination fees, monetary penalties assessed) for not meeting contractual minimums, it might be appropriate to include some or all of the goods or services underlying customer options as part of the contract at inception. This is because the penalty effectively creates a minimum purchase obligation for the goods or services that would be purchased if the penalty were enforced.

Illustration 4-28: Customer option with contractual penalties

Consider the same facts as in Illustration 4-27 above, except that the customer will incur a penalty if it does not purchase at least 200 consumables. That is, the customer will be required to repay some or all of the CU4,000 discount provided on the equipment. Per the contract terms, the penalty decreases as each consumable is purchased at a rate of CU20 per consumable.

The conclusion in the TRG agenda paper was that the penalty is substantive and it effectively creates a minimum purchase obligation. As a result, the entity concludes that the minimum number of consumables required to avoid the penalty would be evidence of enforceable rights and obligations. The entity would then calculate the transaction price as CU26,000 [(200 consumables x CU100/consumable) + CU6,000 (the selling price of the equipment)]. Furthermore, the conclusion in the TRG agenda paper was that, if the customer failed to purchase 200 consumables, the entity accounts for the resulting penalty as a contract modification.

Question 4-22: How does an entity consider the class of customer when evaluating whether a customer option is a material right?

(FASB TRG meeting 18 April 2016 - Agenda paper no. 54)

The FASB TRG members generally agreed that an entity considers 'class of customer' when determining whether a customer option to acquire additional goods or services represents a material right. When making this evaluation, they agreed that an entity first determines whether the customer option exists independently of the existing contract. That is, would the entity offer the same pricing to a similar customer independent of a prior contract with the entity? If the pricing is independent, the option is considered a marketing offer and there is no material right. The FASB TRG members also generally agreed that it is likely that the determination will require an entity to exercise significant judgement and consider all facts and circumstances. In addition, a volume rebate or discount that is provided prospectively to all customers within a class of customers might also provide a material right. Refer to Question 4-23 below for additional discussion.

As discussed above, IFRS 15.B40 states that when an entity grants a customer the option to acquire additional goods or services, that option is a separate performance obligation if it provides a material right that the customer would not receive without entering into the contract (e.g., a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that region or market). *[IFRS 15.B40]*. Furthermore, IFRS 15.B41 states that an option to purchase additional goods or services at their stand-alone selling prices does not provide a material right and instead is a marketing offer. *[IFRS 15.B41]*. The FASB staff noted in the TRG agenda paper that these requirements are intended to make clear that a customer option to acquire additional goods or services would not give rise to a material right if a customer could execute a separate contract to obtain the goods or services at the same price. That is, customer options that would exist independently of an existing contract with a customer do not constitute performance obligations in that existing contract. The TRG agenda paper provided several examples of the FASB staff's views on this topic, including one that the following Illustration is based on:

Illustration 4-29: Class of customer evaluation

Retailer owns and operates several electronic stores and currently provides customers who purchase a 50-inch television with a coupon for 50% off the purchase of a stereo system. The coupon must be redeemed at one of Retailer's stores and is valid for one year. Retailer has never offered a discount of this magnitude to a customer that does not purchase a television (or another item of similar value).

Customer A purchases a 50-inch television from Retailer. At the time of purchase, Customer A receives a coupon for 50% off a stereo system. In evaluating whether the 50% discount provided to Customer A exists independently of its existing contract to purchase a television, Retailer needs to compare the discount offered to Customer A (50%) with the discount typically offered to other customers independent of a prior contract (purchase) with Retailer. For customers that do not purchase a 50-inch television, the only promotion Retailer is running on the stereo system is offering a 5% off coupon to all customers walking into the store. It would not be appropriate for Retailer to compare the discount offered to Customer A with a discount offered to another customer that also purchased a 50-inch television. This is because the objective of the requirements in IFRS 15.B40-B41 is to determine whether a customer option exists independently of an existing contract with a customer.

Retailer determines that the discount offered to Customer A is not comparable to the discount typically offered to customers without a prior contract (purchase). Rather, Customer A is receiving an incremental discount that it would not have received had it not entered into a contract to purchase a 50-inch television. The incremental discount provided to Customer A represents a material right.

Question 4-23: Are volume rebates and/or discounts on goods or services accounted for as variable consideration or as customer options to acquire additional goods or services at a discount?

How we see it

We believe the appropriate accounting for volume rebates and/or discounts depends on whether the rebate or discount programme is applied retrospectively (variable consideration) or prospectively (a customer option).

Generally, if a volume rebate or discount is applied prospectively, we believe the rebate or discount would be accounted for as a customer option (not variable consideration). This is because the consideration for the goods or services in the present contract is not contingent upon or affected by any future purchases. Rather, the discounts available from the rebate programme affect the price of future purchases. Entities need to evaluate whether the volume rebate or discount provides the customer with an option to purchase goods or services in the future at a discount that represents a material right (and is, therefore, accounted for as a performance obligation) (see Question 4-24 below). In addition, a volume rebate or discount that is provided prospectively to all customers within a class of customer might also provide a material right. The fact that other customers receive the same volume rebate or discount is not relevant to the assessment if those customers similarly must first make purchases at a higher price in order to receive a right to discount on purchases in the future. That is, consistent with the guidance in Question 4-24 below, an entity does not compare discounts given to other customers who receive a similar volume-based discount. Rather, the entity must evaluate whether the option exists independently of an existing contract with the customer.

However, we believe a volume rebate or discount that is applied retrospectively is accounted for as variable consideration (see section 5.2 below). This is because the final price of each good or service sold depends upon the customer's total purchases that are subject to the rebate programme. That is, the consideration is contingent upon the occurrence or non-occurrence of future events. This view is consistent with Example 24 in the standard (which is extracted in full in section 5.2.1 below). *[IFRS 15.IE Example 24, IFRS 15.IE124-IE128]*.

Entities should keep in mind that they need to evaluate whether contract terms, other than those specific to the rebate or discount programme, create variable consideration that needs to be separately evaluated (e.g., if the goods subject to the rebate programme are also sold with a right of return).

Question 4-24: How does an entity consider whether prospective volume discounts determined to be customer options are material rights?

(FASB TRG meeting 18 April 2016 - Agenda paper no. 54)

The FASB TRG members generally agreed that in making this evaluation, similar to the discussion in Question 4-22 and Question 4-23 above, an entity would first evaluate whether the option exists independently of the existing contract. That is, would the entity offer the same pricing to a similar high-volume customer independent of a prior contract with the entity? If yes, it indicates that the volume discount is not a material right, as it is not incremental to the discount typically offered to a similar high-volume customer. If the entity typically charges a higher price to a similar customer, it might indicate that the volume discount is a material right as the discount is incremental.

The TRG agenda paper included an example, which the following Illustration is based on:

Illustration 4-30: Volume discounts

Entity enters into a long-term master supply arrangement with Customer A to provide an unspecified volume of non-customised parts. The price of the parts in subsequent years is dependent upon Customer A's purchases in the current year. That is, Entity charges Customer A CU1.00 per part in year one and if Customer A purchases more than 100,000 parts, the year two price will be CU0.90 per part.

When determining whether the contract between Entity and Customer A includes a material right, Entity first evaluates whether the option provided to Customer A exists independently of the existing contract. To do this, Entity compares the discount offered to Customer A with the discount typically offered to a similar high-volume customer that receives a discount independent of a prior contract with Entity. Such a similar customer could be Customer B who places a single order with Entity for 105,000 parts. Comparing the price offered to Customer A in year two with offers to other customers that also receive pricing that is contingent on prior purchases would not help Entity determine whether Customer A would have been offered the year two price had it not entered into the original contract.

Volume discounts or tiered pricing can make an entity's assessment of whether a customer option to purchase additional goods or services is a material right more complex. It is likely that this assessment will require significant judgement, as illustrated below:

Illustration 4-31: Evaluating a customer option with volume discounts

Semi-conductor Entity S sells microchips for use in cell phones. The entity executes a contract with a customer to sell one million units of microchip M for CU0.50 each (or CU500,000). The contract provides the right for the customer to purchase an additional 200,000 microchips for CU0.40 each.

The entity concludes that it has provided the customer with an option to purchase the additional microchips since the entity is not obligated to provide the additional goods until the customer makes a purchasing decision. Furthermore, the volume discount is applied prospectively and does not affect the transaction price in the original contract.

Scenario A

For microchip M, Semi-conductor Entity S provides volume discounts as part of its standard pricing practices and typically prices the first one million microchips at CU0.50 each, the second million at CU0.40 each and any additional amounts at CU0.35 each.

Semi-conductor Entity S considers whether the option provides the customer with a material right. To make this evaluation, the entity compares the discount offered in this option with the discount it typically offers to a similar high-volume customer that receives a discount without having had a prior contract. In other words, the entity compares the pricing in this contract to the pricing it typically offers to customers that purchase between one million and two million units of microchip M without having made any prior purchases.

The entity has sold, and continues to sell, the same volume of microchip M at the same price to other customers in the same class of customer who have not made prior purchases (i.e., similar customers pay CU0.50 each for the first one million microchips and CU0.40 each for the second million). That is, the price offered to the customer in the option exists independently of the existing contract. Therefore, Semi-conductor Entity S concludes that it has not provided the customer with a material right.

Scenario B

For microchip M, Semi-conductor Entity S provides volume discounts as part of its standard pricing practices and typically prices the first three million microchips at CU0.50 each and any additional amounts at CU0.30 each.

Semi-conductor Entity S considers whether the option provides the customer with a material right. To make this evaluation, the entity compares the discount offered in this option with the discount it typically offers to a similar high-volume customer that receives a discount without having had a prior contract.

For similar high-volume customers of the same customer class who have not made prior purchases, the entity typically does not provide this pricing (e.g., similar customers would pay CU0.50 per microchip for all of the 1.2 million microchips). Therefore, the entity concludes that it has provided the customer with a material right.

Question 4-25: How would an entity consider whether a renewal option is a material right?

An entity assesses whether a renewal option represents a material right in the same manner as other customer options discussed above. That is, an entity would determine whether the customer renewal option would be offered at the same price to a similar class of customer, independent of a prior contract with the entity. Customer renewal options might be explicitly included in the original contract or, as discussed in section 5.8 below, the existence of a non-refundable upfront fee might indicate that the contract includes a renewal option for future goods or services (e.g., if the customer renews the contract without the payment of an additional upfront fee).

As discussed above in this section, IFRS 15.B41 specifies that if a customer has the option to purchase additional goods or services (e.g., by exercising a renewal option) at a price that would reflect the stand-alone selling prices of those goods or services, the renewal option would not provide a material right and, instead, is a marketing offer. *[IFRS 15.B41]*. Determining the stand-alone selling price of a renewal option might require significant judgement. For example, a renewal option offered at the current stand-alone selling price might or might not be determined to be a material right. That is, if the pricing for the goods and services are expected to remain stable, it would be appropriate for a renewal option offered at a current stand-alone selling price to be considered a marketing offer. In contrast, a renewal option at the current stand-alone selling price could be a material right if, for example, prices are highly likely to significantly increase or the renewal option is offered for an extended period of time.

Example 51 from the standard describes the accounting for a renewal option that is a material right. That example also includes guidance on how to allocate a portion of the transaction price to the material right, which is further discussed in section 6.1.5 below. *[IFRS 15.IE Example 51, IFRS 15.IE257-IE266]*.

Question 4-26: How would an entity consider whether a loyalty or reward programme is a material right?

Entities frequently offer loyalty or reward programmes under which customers accumulate points that they can redeem for 'free' or discounted products or services. Under IFRS 15.B40, an entity typically concludes that such a loyalty or reward programme provides a material right to customers that they would not receive without entering into a contract. This is because the customer effectively pays in advance for the right to obtain a future good or service (e.g., travel, upgrades, products) or a discount on that good or service.

This is also consistent with the discussion of the TRG members, as noted in Questions 4-15 and 4-16 above, that entities need to consider all relevant transactions with a customer (i.e., current, past and future transactions) and both quantitative and qualitative factors, including those that provide accumulating incentives, when determining whether an option represents a material right. Example 52 in the standard (extracted in full in section 7.9 below) illustrates the accounting for a loyalty programme. *[IFRS 15.IE Example 52, IFRS 15.IE267-IE270]*.

Question 4-27: How would an entity account for the exercise of a material right? That is, would an entity account for it as: a contract modification, a continuation of the existing contract or variable consideration?

(TRG meeting 30 March 2015 - Agenda paper no. 32)

The TRG members generally agreed that it is reasonable for an entity to account for the exercise of a material right as either a contract modification or as a continuation of the existing contract (i.e., a change in the transaction price). TRG members also generally agreed that it is not appropriate to account for the exercise of a material right as variable consideration.

Under the approach that treats the exercise of a material right as a continuation of the existing contract (i.e., because the customer decided to purchase additional goods or services contemplated in the original contract), an entity would update the transaction price of the contract to include any consideration to which the entity expects to be entitled as a result of the exercise, in accordance with the requirements for changes in the transaction price included in IFRS 15.87-90 (see section 6.5 below).

Under these requirements, changes in the total transaction price are generally allocated to the separate performance obligations on the same basis as the initial allocation. However, IFRS 15.89 requires an entity to allocate a change in the transaction price entirely to one or more, but not all, performance obligations if the criteria of IFRS 15.85 are met. *[IFRS 15.89]*. These criteria (discussed further in section 6.3 below) are that the additional consideration specifically relates to the entity's efforts to satisfy the performance obligation(s) and that allocating the additional consideration entirely to one or more, but not all, performance obligation(s) is consistent with the standard's allocation objective (see section 6 below). The additional consideration received for the exercise of the option is likely to meet the criteria to be allocated directly to the performance obligation(s) underlying the material right. Revenue would be recognised when (or as) the performance obligation(s) is (are) satisfied. *[IFRS 15.85]*.

The TRG agenda paper included an example, which the following Illustration is based on:

Illustration 4-32: Exercise of a material right under the requirements for changes in the transaction price

Entity enters into a contract with Customer to provide two years of Service A for CU100 and includes an option for Customer to purchase two years of Service B for CU300. The stand-alone selling prices of Services A and B are CU100 and CU400, respectively. Entity concludes that the option represents a material right and its estimate of the stand-alone selling price of the option is CU33. Entity allocates the CU100 transaction price to each performance obligation as follows:

	Transaction price	Stand-alone selling price	%	Allocation
Service A		CU100	75%	CU75
Option		CU33	25%	CU25
Totals	**CU100**	**CU133**	**100%**	**CU100**

Upon executing the contract, Customer pays CU100 and Entity begins transferring Service A to Customer. The consideration of CU75 that is allocated to Service A is recognised over the two-year service period. The consideration of CU25 that is allocated to the option is deferred until Service B is transferred to the customer or the option expires.

Six months after executing the contract, Customer exercises the option to purchase two years of Service B for CU300. Following the requirements for changes in the transaction price, the consideration of CU300 related to Service B is added to the amount previously allocated to the option to purchase Service B (i.e., CU300 + CU25 = CU325). This is recognised as revenue over the two-year period in which Service B is transferred. Entity is able to allocate the additional consideration received for the exercise of the option to Service B because it specifically relates to Entity's efforts to satisfy the performance obligation and the allocation in this manner is consistent with the standard's allocation objective.

Under the second approach, which treats the exercise of a material right as a contract modification (i.e., because there is a change in the scope and/or price of a contract), an entity follows the contract modification requirements in IFRS 15.18-21 (see section 3.4 above).

Since more than one approach would be acceptable, the TRG members generally agreed that an entity needs to consider which approach is most appropriate, based on the facts and circumstances, and consistently apply that approach to similar contracts.[65]

65 TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015.

Question 4-28: Is an entity required to evaluate whether a customer option that provides a material right includes a significant financing component? If so, how would entities perform this evaluation?

(TRG meeting 30 March 2015 - Agenda paper no. 32)

The TRG members generally agreed that an entity has to evaluate whether a material right includes a significant financing component (see section 5.5 below) in the same way that it evaluates any other performance obligation. This evaluation requires judgement and consideration of the facts and circumstances.[66]

On this question, the TRG agenda paper discussed a factor that might be determinative in this evaluation. IFRS 15.62(a) indicates that if a customer provides advance payment for a good or service, but the customer can choose when the good or service is transferred, no significant financing component exists. *[IFRS 15.62(a)]*. As a result, if the customer can choose when to exercise the option, it is unlikely that there will be a significant financing component.

Question 4-29: How would revenue be recognised for customer options for additional goods or services that represent a material right but do not have an expiration date (i.e., can an entity recognise breakage for these options)?

Stakeholders asked this question because IFRS 15.B40 states that an entity recognises revenue allocated to options that are material rights when the future goods or services resulting from the option are transferred or when the option expires. *[IFRS 15.B40]*. However, in some cases, options might be perpetual and not have an expiration date. For example, loyalty points likely provide a material right to a customer and, sometimes, these points do not expire.

How we see it

We believe an entity might apply the requirements in IFRS 15 on customers' unexercised rights (or breakage), which are discussed in section 7.9 below (i.e., IFRS 15.B44-B47) to customer options that represent a material right but do not have an expiry date. That is, we believe it is appropriate for revenue allocated to a customer option that does not expire to be recognised at the earlier of when the future goods or services, resulting from the option, are transferred or, if the goods or services are not transferred, when the likelihood of the customer exercising the option becomes remote.

66 TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015.

4.7 Sale of products with a right of return

An entity might provide its customers with a right to return a transferred product. A right of return might be contractual, an implicit right that exists due to the entity's customary business practice or a combination of both (e.g., an entity has a stated return period, but generally accepts returns over a longer period). A customer exercising its right to return a product might receive a full or partial refund, a credit that can be applied to amounts owed, a different product in exchange or any combination of these items. *[IFRS 15.B20]*.

Offering a right of return in a sales agreement obliges the selling entity to stand ready to accept any returned product. IFRS 15.B22 states that such an obligation does not represent a performance obligation. *[IFRS 15.B22]*. Instead, the Board concluded that an entity makes an uncertain number of sales when it provides goods with a return right. That is, until the right of return expires, the entity is not certain how many sales will fail. Therefore, the Board concluded that an entity does not recognise revenue for sales that are expected to fail as a result of the customer exercising its right to return the goods. *[IFRS 15.BC364]*. Instead, the potential for customer returns needs to be considered when an entity estimates the transaction price because potential returns are a component of variable consideration. This concept is discussed further in section 5.4 below.

IFRS 15.B26 clarifies that exchanges by customers of one product for another of the same type, quality, condition and price (e.g., one colour or size for another) are not considered returns for the purposes of applying the standard. *[IFRS 15.B26]*. Furthermore, contracts in which a customer might return a defective product in exchange for a functioning product need to be evaluated in accordance with the requirements on warranties included in IFRS 15. *[IFRS 15.B27]*. See further discussion on warranties in section 9.1 below.

5 IFRS 15 - Determine the transaction price

When (or as) an entity satisfies a performance obligation, it recognises revenue at the amount of the transaction price (which excludes constrained estimates of variable consideration - see section 5.2.3 below) that is allocated to that performance obligation. *[IFRS 15.46]*.

The standard provides the following requirements for determining the transaction price: *[IFRS 15.47, IFRS 15.48, IFRS 15.49]*

Extract from IFRS 15

47 **An entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.**

48 The nature, timing and amount of consideration promised by a customer affect the estimate of the transaction price. When determining the transaction price, an entity shall consider the effects of all of the following:

(a) variable consideration (see paragraphs 50-55 and 59);

(b) constraining estimates of variable consideration (see paragraphs 56-58);

(c) the existence of a significant financing component in the contract (see paragraphs 60-65);

(d) non-cash consideration (see paragraphs 66-69); and

(e) consideration payable to a customer (see paragraphs 70-72).

49 For the purpose of determining the transaction price, an entity shall assume that the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be cancelled, renewed or modified.

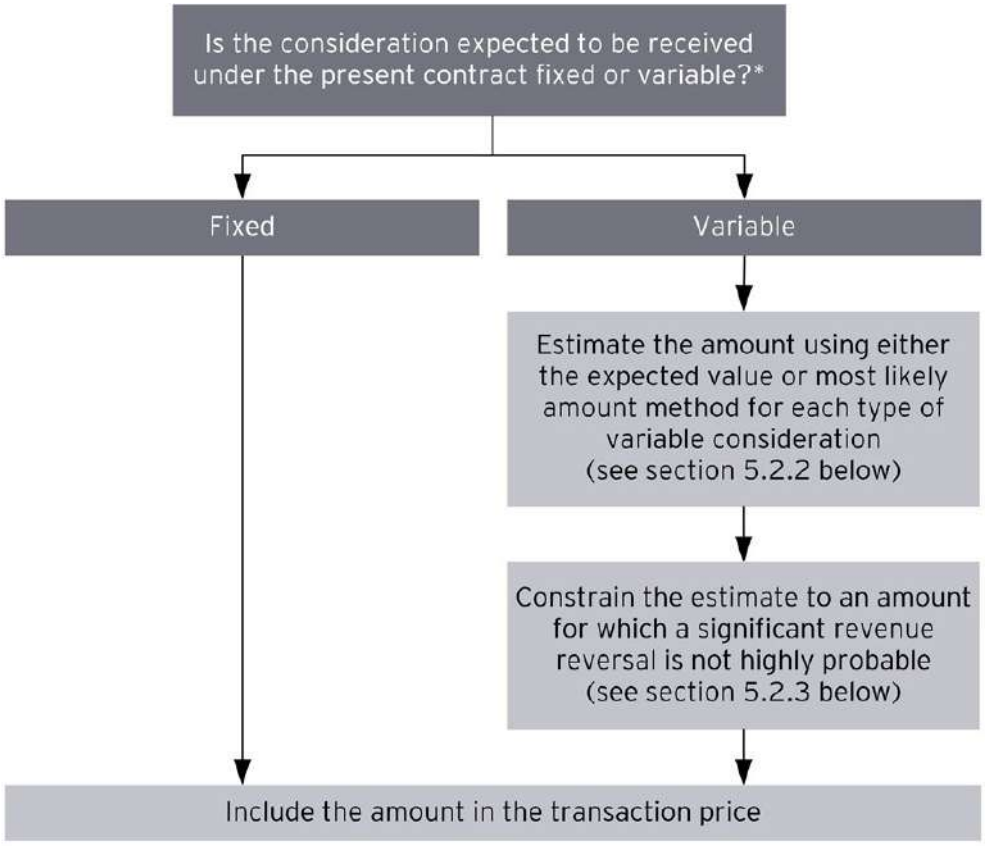
The transaction price is based on the amount to which the entity expects to be 'entitled'. This is meant to reflect the amount to which the entity has rights under the present contract (see section 3.2 above on contract enforceability and termination clauses). That is, the transaction price does not include estimates of consideration resulting from future change orders for additional goods or services. The amount to which the entity expects to be entitled also excludes amounts collected on behalf of another party, such as sales taxes. As noted in the Basis for Conclusions, the Board decided that the transaction price would not include the effects of the customer's credit risk, unless the contract includes a significant financing component (see section 5.5 below). *[IFRS 15.BC185]*.

The IASB also clarified in the Basis for Conclusions that entities might have rights under the present contract to amounts that are to be paid by parties other than the customer and, if so, these amounts would be included in the transaction price. For example, in the healthcare industry, an entity might be entitled under the present contract to payments from the patient, insurance companies and/or government organisations. If that is the case, the total amount to which the entity expects to be entitled needs to be included in the transaction price, regardless of the source. *[IFRS 15.BC187]*.

Determining the transaction price is an important step in applying IFRS 15 because this amount is allocated to the identified performance obligations and is recognised as revenue when (or as) those performance obligations are satisfied. In many cases, the transaction price is readily determinable because the entity receives payment when it transfers promised goods or services and the price is fixed (e.g., a restaurant's sale of food with a no refund policy). Determining the transaction price is more challenging when the consideration is variable, when payment is received at a time that differs from when the entity provides the promised goods or services or when payment is in a form other than cash. Consideration paid or payable by the entity to the customer might also affect the determination of the transaction price.

Figure 5-1 illustrates how an entity would determine the transaction price if the consideration to be received is fixed or variable:

Figure 5-1: Fixed versus variable consideration



* Consideration expected to be received under the contract can be variable even when the stated price in the contract is fixed. This is because the entity may be entitled to consideration only upon the occurrence or non-occurrence of a future event (see section 5.2.1 below).

Frequently asked questions

Question 5-1: How would entities determine the presentation of amounts billed to customers (e.g., shipping and handling, expenses or cost reimbursements and taxes under the revenue standards (i.e., as revenue or as a reduction of costs)?

(TRG meeting 18 July 2014 - Agenda paper no. 2)

See response to Question 4-16 in section 4.4.4 above.

5.1 Presentation of sales (and other similar) taxes

Various types of taxes based on the production, use, consumption or sale of goods and services are common in many jurisdictions (e.g., taxes levied on tobacco, alcohol, gasoline, sugar). Sales and excise taxes are those levied by taxing authorities on the sales of goods or services. Although various names are used for these taxes, sales taxes generally refer to taxes levied on the purchasers of the goods or services and excise taxes refer to those levied on the sellers of goods or services. Significant variations exist in how these taxes are calculated and administered and the regulations might differ significantly from one country to another. In some cases, these taxes are collected by an entity from a customer on behalf of the tax authorities while, in other cases, the entity is directly liable for the tax obligation.

The standard includes a general principle that an entity determines the transaction price exclusive of amounts collected on behalf of third parties (e.g., some sales taxes). Following the issuance of the standard, some stakeholders informed the Board's staff that there could be multiple interpretations regarding whether certain items that are billed to customers need to be presented as revenue or as a reduction of costs. Examples of such amounts include shipping and handling fees, reimbursements of out-of-pocket expenses and taxes or other assessments collected and remitted to government authorities.

At the July 2014 TRG meeting, the TRG members generally agreed that the standard is clear that any amounts that are not collected on behalf of third parties would be included in the transaction price (i.e., revenue). That is, if the amounts were earned by the entity in fulfilling its performance obligations, the amounts are included in the transaction price and recorded as revenue.

Several TRG members noted that this would require entities to evaluate taxes collected in all jurisdictions in which they operate to determine whether a tax is levied on the entity or the customer. That is, whether the entity is liable for the tax (regardless of whether it can pass that cost onto its customers) or the customer is liable, and the entity would be collecting the tax on behalf of the tax authority. Assume an entity sets the price for a good at CU99, which includes an amount equivalent to the sales tax of CU9:

- If the tax is levied on the entity (i.e., the entity is liable for the tax), the CU9 charged to the customer is because the entity is able to increase its prices to cover the sales tax (its own cost). Therefore, CU9 is actually part of the transaction price that the entity earns from the customer in exchange for fulfilling its performance obligation(s). That is, CU99 is the transaction price (i.e., revenue) and the entity would recognise an expense of CU9 when it is liable for the tax.
- If the tax is levied on the customer (i.e., the entity is collecting the tax on behalf of the tax authority), the transaction price would be CU90. This is because the sales tax of CU9 is being collected by the entity on behalf of the tax authority. Furthermore, the entity would not incur any costs in respect of the tax, since it is the customer who is liable, rather than the entity.

The TRG members also indicated that an entity would apply the principal versus agent application guidance (see section 4.4 above) when it is not clear whether the amounts are collected on behalf of third parties. This could result in amounts billed to a customer being recorded net of costs incurred (i.e., on a net basis).[67] Because sales or similar taxes are an obligation to a tax authority, rather than a good or service promised to a customer, the principal versus agent application guidance is applied by analogy and judgement might, therefore, be needed.

Determining whether an entity is a principal (i.e., directly liable for the tax obligation) or an agent (i.e., collecting the tax on behalf of the tax authority) in relation to such taxes will depend on the specific facts and circumstances, including the intention and underlying characteristics of the tax in the particular jurisdiction. The basis on which the tax is calculated might be informative (e.g., the sales price, units sold or consumed, units produced, imported or exported). However, the measurement point will not, in and of itself, determine the economic nature of the tax. Tax authorities might simply utilise a basis that is at a convenient point in the process and is easy to verify.

The July 2014 TRG paper included indicators identified by stakeholders, noting that one or more might indicate that the entity is the principal in relation to taxes and other assessments remitted to governmental authorities:[68]

- *The entity is primarily responsible for fulfilling the tax obligation* - The TRG paper gives the example of a tax imposed upon telecommunication entities in the US based upon their revenues. In relation to that particular tax, the TRG paper noted that the entities "are responsible for that assessment regardless of whether they choose to seek full or partial reimbursement of that assessment through billings to their customers." This example is contrasted with some in other jurisdictions where "the customer may be responsible for payment of sales (…) taxes even though the jurisdiction may require the entity to collect the tax from the customer and remit the entire amount to the jurisdiction." In that context, the TRG paper noted that the customer might be responsible for remitting the tax to the appropriate authority if the entity does not collect the tax.
- *The entity has latitude with respect to the amount charged to the customer* - If the entity is able to make its own decision about whether and how it recovers the tax from its customers, it might be the principal. For example, the TRG paper noted that, "entities that are required to collect sales tax from customers are required to do so at the amount owed to the jurisdiction and remit that amount to the jurisdiction", while other entities "make their own decision about whether and how they recover the costs" from their customers.
- *The amount retained by the entity is not fixed* - If the entity is required to remit what it collects from the customer and its retention is fixed (at zero), it might indicate it is an agent. Conversely, the entity might be a principal if its margins on the tax are not fixed and the selling price represents a business decision about the price that customers are willing to pay for the goods or services.
- *The entity has credit risk* - The TRG paper noted that an entity would have credit risk if it "is solely responsible for payment of the full tax or other assessment amount, regardless of whether it collects any amounts it has billed to its customers".

67 TRG Agenda paper no. 5, *July 2014 Meeting - Summary of Issues Discussed and Next Steps*, originally dated 31 October 2014, reissued 18 March 2015.

68 TRG Agenda paper no. 2, *Gross versus Net Revenue: Amounts Billed to Customers*, dated 18 July 2014.

In addition to the above indicators, the TRG paper noted that, while it might vary depending on the nature of the sales (or similar) tax, some stakeholders thought it might not be clear "whether those amounts represent consideration to which the entity expects to be entitled *in exchange for transferring promised goods or services to a customer*". That is, the amount billed to the customer in respect of the tax might not relate to the entity's performance in satisfying a performance obligation. The TRG paper notes that this "may be evident in circumstances when the price of the good or service varies among jurisdictions by the statutorily mandated tax … For example, when a good is sold over the internet, a sales tax amount is added (or not added) at time of checkout based on where the customer resides. In addition, in some jurisdictions, certain types of entities might not be required to pay sales tax for certain products, while other types of entities are required to pay sales tax for the same products." Since the price variation in those examples is entirely attributable to the tax (not to any incremental performance), one might conclude that the tax amount should not be part of the transaction price (i.e., excluded from revenue).[69]

FASB differences

The FASB's standard allows an entity to make an accounting policy election to present revenue net of certain types of taxes (including sales, use, value-added and some excise taxes) with a requirement for preparers to disclose the policy. The IASB decided not to include a similar accounting policy election in IFRS 15. *[IFRS 15.BC188D]*.

5.2 Variable consideration

The transaction price reflects an entity's expectations about the consideration to which it will be entitled to receive from the customer. The standard provides the following requirements for determining whether consideration is variable and, if so, how it would be treated under the model: *[IFRS 15.50, IFRS 15.51, IFRS 15.52]*

Extract from IFRS 15

50 If the consideration promised in a contract includes a variable amount, an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer.

51 An amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items. The promised consideration can also vary if an entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event. For example, an amount of consideration would be variable if either a product was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone.

52 The variability relating to the consideration promised by a customer may be explicitly stated in the contract. In addition to the terms of the contract, the promised consideration is variable if either of the following circumstances exists:

(a) the customer has a valid expectation arising from an entity's customary business practices, published policies or specific statements that the entity will accept an amount of consideration that is less than the price stated in the contract. That is, it is expected that the entity will offer a price concession. Depending on the jurisdiction, industry or customer this offer may be referred to as a discount, rebate, refund or credit.

(b) other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer.

These concepts are discussed in more detail below.

5.2.1 Forms of variable consideration

IFRS 15.51 describes 'variable consideration' broadly to include discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses (e.g., meeting specified performance conditions where there is uncertainty about the outcome) and penalties. *[IFRS 15.51]*. Variable consideration can result from explicit terms in a contract to which the parties to the contract agreed or can be implied by an entity's past business practices or intentions under the contract. It is important for entities to appropriately identify the different instances of variable consideration included in a contract because the second step of estimating variable consideration requires entities to apply a constraint (as discussed further in section 5.2.3 below) to all variable consideration.

69 TRG Agenda paper no. 2, Gross versus Net Revenue: Amounts Billed to Customers, dated 18 July 2014.

The Board noted in the Basis for Conclusions that consideration can be variable even when the stated price in the contract is fixed. This is because the entity might be entitled to consideration only upon the occurrence or non-occurrence of a future event. *[IFRS 15.BC191]*. For example, IFRS 15's description of variable consideration includes amounts resulting from variability due to customer refunds or returns. As a result, a contract to provide a customer with 100 widgets at a fixed price per widget would be considered to include a variable component if the customer has the right to return the widgets (see section 5.4 below).

In many transactions, entities have variable consideration as a result of rebates and/or discounts on the price of products or services they provide to customers once the customers meet specific volume thresholds. The standard contains the following example relating to volume discounts: *[IFRS 15.IE Example 24, IFRS 15.IE124-IE128]*

Extract from IFRS 15

Example 24-Volume discount incentive

An entity enters into a contract with a customer on 1 January 20X8 to sell Product A for CU100 per unit. If the customer purchases more than 1,000 units of Product A in a calendar year, the contract specifies that the price per unit is retrospectively reduced to CU90 per unit. Consequently, the consideration in the contract is variable.

For the first quarter ended 31 March 20X8, the entity sells 75 units of Product A to the customer. The entity estimates that the customer's purchases will not exceed the 1,000-unit threshold required for the volume discount in the calendar year.

The entity considers the requirements in paragraphs 56-58 of IFRS 15 on constraining estimates of variable consideration, including the factors in paragraph 57 of IFRS 15. The entity determines that it has significant experience with this product and with the purchasing pattern of the entity. Thus, the entity concludes that it is highly probable that a significant reversal in the cumulative amount of revenue recognised (ie CU100 per unit) will not occur when the uncertainty is resolved (ie when the total amount of purchases is known). Consequently, the entity recognises revenue of CU7,500 (75 units × CU100 per unit) for the quarter ended 31 March 20X8.

In May 20X8, the entity's customer acquires another company and in the second quarter ended 30 June 20X8 the entity sells an additional 500 units of Product A to the customer. In the light of the new fact, the entity estimates that the customer's purchases will exceed the 1,000-unit threshold for the calendar year and therefore it will be required to retrospectively reduce the price per unit to CU90.

Consequently, the entity recognises revenue of CU44,250 for the quarter ended 30 June 20X8. That amount is calculated from CU45,000 for the sale of 500 units (500 units × CU90 per unit) less the change in transaction price of CU750 (75 units × CU10 price reduction) for the reduction of revenue relating to units sold for the quarter ended 31 March 20X8 (see paragraphs 87 and 88 of IFRS 15).

How we see it

IFRS 15 requires entities to disclose how they estimate variable consideration when determining the transaction price in contracts with customers, including the following:

- Significant payment terms (including whether the consideration is variable and whether the estimate is typically constrained, rights of return, etc.)
- Significant judgements used in determining the transaction price, including information about methods, inputs and assumptions used to estimate variable consideration and assess whether the estimate is constrained

As a result, entities might need to explain the different forms of variable consideration included in their contracts with customers. Entities, therefore, need to carefully consider and identify all forms of variable consideration when they determine the transaction price for their customer contracts and review their disclosures to verify that they meet the disclosure requirements in IFRS 15.119, 123 and 126 (see section 10.5 below for further discussion of disclosure requirements).

Frequently asked questions

Question 5-2: Are volume rebates and/or discounts on goods or services accounted for as variable consideration or as customer options to acquire additional goods or services at a discount?

See response to Question 4-23 in section 4.6 above.

Question 5-3: How would an entity distinguish between a contract that contains an option to purchase additional goods or services and a contract that includes variable consideration based on a variable quantity (e.g., a usage-based fee)?

(TRG Meeting 9 November 2015 - Agenda paper no. 48)

See response to Question 4-20 in section 4.6 above.

Question 5-4: Are liquidated damages, penalties or compensation from other similar clauses accounted for as variable consideration or as warranties under the standard?

How we see it

Most liquidated damages, penalties and similar payments are accounted for as variable consideration. However, in limited situations, we believe that amounts that are based on the actual performance of a delivered good or service could be considered similar to warranty payments (e.g., in situations in which an entity pays the customer's direct costs to remedy a defect).

Some contracts provide for liquidated damages, penalties or other damages if an entity fails to deliver future goods or services or if the goods or services fail to meet certain specifications. IFRS 15.51 includes 'penalties' as an example of variable consideration and describes how promised consideration in a contract can be variable if the right to receive the consideration is contingent on the occurrence or non-occurrence of a future event (e.g., the contract specifies that an entity pays a penalty if it fails to perform according to the agreed upon terms). *[IFRS 15.51]*.

Penalties and other clauses that are considered similar to warranty provisions would be accounted for as:

(a) Consideration paid or payable to a customer (which might be variable consideration, see section 5.7 below)

Or

(b) An assurance-type or service-type warranty (see section 9.1 below on warranties)

Cash fines or penalties paid to a customer would generally be accounted for under the requirements on consideration payable to a customer. However, we believe there might be situations in which it is appropriate to account for cash payments to a customer as an assurance-type warranty (e.g., an entity's direct reimbursement to the customer for costs paid by the customer to a third party for repair of a product).

Example 20 in the standard illustrates a performance penalty that is a form of variable consideration. *[IFRS 15.IE Example 20, IFRS 15.IE102-IE104]*.

In 2019, the IFRS IC received a request asking whether an airline accounts for its obligation to compensate customers for delayed or cancelled flights as variable consideration or, separate from the contract, by applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

When the issue was discussed at the September 2019 meeting, the IFRS IC observed that the compensation for delays or cancellations gives rise to variable consideration because it:

- Relates directly to the entity's fulfilment of its performance obligation (i.e., failure to perform as promised triggers the compensation payment)

  And

- Does not represent compensation for harm or damage caused by the entity's products (and, therefore, IFRS 15.B33 does not apply)

The IFRS IC also observed that the compensation payment was similar to penalties for delayed transfer of an asset, which also gives rise to variable consideration, as is illustrated in Example 20 of the standard.[70]

70 *IFRIC Update*, September 2019, available on the IFRS Foundation's website.

Question 5-5: If a contract includes an undefined quantity of outputs, but the contractual rate per unit is fixed, is the consideration variable?

(TRG meeting 13 July 2015 - Agenda paper no. 39)

The TRG members generally agreed that if a contract includes an unknown quantity of tasks, throughout the contract period, for which the entity has enforceable rights and obligations (i.e., the unknown quantity of tasks is not an option to purchase additional goods or services, as described in Question 4-20 in section 4.6 above) and the consideration received is contingent upon the quantity completed, the total transaction price would be variable. This is because the contract has a range of possible transaction prices and the ultimate consideration depends on the occurrence or non-occurrence of a future event (e.g., customer usage), even though the rate per unit is fixed.

The TRG agenda paper on this topic noted that an entity would need to consider contractual minimums (or other clauses) that would make some or all of the consideration fixed.

Question 5-6: If a contract is denominated in a currency other than that of the entity's functional currency, would changes in the contract price due to exchange rate fluctuations be accounted for as variable consideration?

Changes to the contract price due to exchange rate fluctuations are a consequence of entering into a contract that is denominated in a foreign currency.

How we see it

The variability resulting from changes in foreign exchange rates relates to the form of the consideration (i.e., it is in a currency other than the entity's functional currency), rather than as a result of a contractual term like a discount or rebate or one that depends on the occurrence or non-occurrence of a future event, as described in IFRS 15.51. As such, we believe that it would not be considered variable consideration when determining the transaction price.

Such variability might, instead, need to be accounted for in accordance with IFRS 9 if it is a separable embedded derivative. Otherwise, an entity would account for this variability in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

IFRIC 22 *Foreign Currency Transactions and Advance Consideration* specifies that when consideration denominated in a foreign currency is recognised in advance of the associated revenue, the appropriate application of IAS 21 is to measure the revenue using the exchange rate at the date the advanced receipt is recognised, normally the payment date (see Chapter 16). *[IFRIC 22.8]*.

Question 5-7: How would an entity account for price protection or price matching clauses included in a contract with a customer?

How we see it

Consideration subject to price protection or price matching clauses that require an entity to refund a portion of the consideration to the customer in certain situations must be accounted for as variable consideration under IFRS 15. That is, we believe that, if an entity is required to retrospectively apply lower prices to previous purchases made by a customer (or has a past business practice of doing so, even if the contractual terms would only require prospective application), the consideration would be accounted for as variable consideration.

Examples include contracts between an entity and a customer that provide, either as a matter of formal agreement or due to an entity's business practices, that the entity will refund or provide a credit equal to a portion of the original purchase price towards future purchases if the entity subsequently reduces its price for a previously delivered product and the customer still has inventory of that product on hand. An entity might also offer to match a competitor's price and provide a refund of the difference if the customer finds the same product offered by one of the entity's competitors for a lower price during a specified period of time following the sale.

Contracts with customers also might contain 'most favoured nation' or 'most favoured customer' clauses under which the entity guarantees that the price of any products sold to the customer after contract inception will be the lowest price the entity offers to any other customer. How consideration from such contracts would be accounted for under IFRS 15 depends on the terms of the clause (i.e., whether the price protection is offered prospectively or retrospectively).

How we see it

We believe that clauses that require an entity to prospectively provide a customer with its best prices on any purchases of products after the execution of a contract have no effect on the revenue recognised for goods or services already transferred to the customer (i.e., the consideration would not be accounted for as variable consideration).

However, if an entity is required to retrospectively apply lower prices to previous purchases made by a customer (or has a past business practice of doing so even if the written contractual terms would only require prospective application), we believe the contract includes a form of price protection and the consideration subject to this provision would be accounted for as variable consideration, as discussed above.

We note that these clauses might be present in arrangements with governmental agencies. For example, an entity might be required to monitor discounts given to comparable customers during the contract period and to refund the difference between what was paid by the government and the price granted to comparable commercial customers.

Question 5-8: Do early payment (or prompt payment) discounts represent a form of variable consideration?

Contracts with customers might include a discount for early payment (or 'prompt payment' discount) under which the customer can pay less than an invoice's stated amount if the payment is made within a certain period of time. For example, a customer might receive a 2% discount if the payment is made within 15 days of receipt (if payment is otherwise due within 45 days of receipt).

How we see it

Because the amount of consideration to be received by the entity would vary depending on whether the customer takes advantage of the discount, we believe the transaction price is variable.

Question 5-9: How does an entity account for a dispute related to a contract accounted for in accordance with IFRS 15 that might result in consideration received or receivable from a customer?

A dispute related to a contract accounted for in accordance with IFRS 15 may result in consideration received or receivable from a customer. Disputes might involve third-party arbitration or litigation proceedings, or they might not (e.g., a resolution negotiated only between the entity and the customer).

For settlements (or potential settlements) received or receivable from a customer, an entity needs to apply judgement to determine the appropriate accounting based on a thorough analysis of facts and circumstances. For example, if the entity receives (or expects to receive) consideration from its customer as part of a settlement related to a contract accounted for in accordance with IFRS 15, the payment may represent variable consideration to which the entity is entitled based on its performance under that contract. The requirements for estimating and constraining variable consideration in IFRS 15 would apply.

An entity will also need to determine whether the settlement with the customer represents a contract modification, (see section 3.4 above, including Question 3-13). This would be the case if the settlement results in a change in the scope and/or price of a contract that either creates new or changes existing enforceable rights and obligations of the parties. Judgement may also be required to distinguish between a contract modification and a change in the estimated transaction price due to variable consideration, as discussed in Question 3-15 in section 3.4 above.

If a dispute arises, but the payment or anticipated payment was not contemplated in the original contract and the settlement does not yet represent a contract modification, the requirements for contingent assets in IAS 37 (see Chapter 27) might apply until there is a contract modification under IFRS 15.

For settlements (or potential settlements) from litigation or disputes that result in consideration paid or payable to a customer, please see response to Question 5-32 in section 5.7.2 below.

5.2.1.A Implicit price concessions

For some contracts, the stated price has easily identifiable variable components. However, for other contracts, the consideration might be variable because the facts and circumstances indicate that the entity might accept a lower price than the amount stated in the contract (i.e., it expects to provide an implicit price concession). *[IFRS 15.52(b)]*. This could be a result of the customer having a valid expectation that the entity will reduce its price based on the entity's customary business practices, published policies or statements made by the entity.

An implicit price concession could also result from other facts and circumstances indicating that the entity intended to offer a price concession to the customer when it entered into the contract. For example, an entity might accept a lower price than the amount stated in the contract to develop or enhance a customer relationship or because the incremental cost of providing the service to the customer is not significant and the consideration it expects to collect provides a sufficient margin.

An entity deducts from its contract price any estimated price concessions to derive the transaction price at contract inception (i.e., the amount the entity expects to be entitled in exchange for the goods or services that will be transferred to the customer). The IFRS 15 collectability assessment is then performed on the transaction price (see section 3.1.5 above). An entity also has to assess any contract assets or trade receivables arising from an IFRS 15 contract under the expected credit loss model in IFRS 9 (see Chapter 47).

The standard provides the following example of when an implicit price concession exists and, as a result, the transaction price is not the amount stated in the contract: *[IFRS 15.IE Example 2, IFRS 15.IE7-IE9]*

Extract from IFRS 15

Example 2–Consideration is not the stated price – implicit price concession

An entity sells 1,000 units of a prescription drug to a customer for promised consideration of CU1 million. This is the entity's first sale to a customer in a new region, which is experiencing significant economic difficulty. Thus, the entity expects that it will not be able to collect from the customer the full amount of the promised consideration. Despite the possibility of not collecting the full amount, the entity expects the region's economy to recover over the next two to three years and determines that a relationship with the customer could help it to forge relationships with other potential customers in the region.

When assessing whether the criterion in paragraph 9(e) of IFRS 15 is met, the entity also considers paragraphs 47 and 52(b) of IFRS 15. Based on the assessment of the facts and circumstances, the entity determines that it expects to provide a price concession and accept a lower amount of consideration from the customer. Accordingly, the entity concludes that the transaction price is not CU1 million and, therefore, the promised consideration is variable. The entity estimates the variable consideration and determines that it expects to be entitled to CU400,000.

The entity considers the customer's ability and intention to pay the consideration and concludes that even though the region is experiencing economic difficulty, it is probable that it will collect CU400,000 from the customer. Consequently, the entity concludes that the criterion in paragraph 9(e) of IFRS 15 is met based on an estimate of variable consideration of CU400,000. In addition, on the basis of an evaluation of the contract terms and other facts and circumstances, the entity concludes that the other criteria in paragraph 9 of IFRS 15 are also met. Consequently, the entity accounts for the contract with the customer in accordance with the requirements in IFRS 15.

Examples 3 and 23 from the standard (see section 5.2.3 below) also illustrate situations where an implicit price concession exists at contract inception and, therefore, the transaction price evaluated for collectability is not the amount stated in the contract due to implicit price concessions that exist at contract inception.

Variable consideration might also result from extended payment terms in a contract and any resulting uncertainty about whether the entity will be willing to accept a lower payment amount in the future. That is, an entity has to evaluate whether the extended payment terms represent an implied price concession because the entity does not intend to collect all amounts due in future periods. Offering extended payment terms might also indicate that the contract includes a significant financing component (see section 5.5 below).

5.2.1.B Variable consideration versus credit risk

As discussed in section 3.1.5 above, entities need to determine at contract inception whether they expect to collect a lower amount of consideration than the amount stated in the contract. In the Basis for Conclusions, the IASB acknowledged that, in some cases, it might be difficult to determine whether the entity has implicitly offered a price concession (i.e., variable consideration) or whether the entity has chosen to accept the risk of the customer defaulting on the contractually agreed consideration (i.e., impairment losses under IFRS 9, see Chapter 47). *[IFRS 15.BC194]*. The Board did not develop detailed application guidance to assist in distinguishing between price concessions (recognised as variable consideration, within revenue) and an expected credit loss to be accounted for as an impairment loss under IFRS 9 (i.e., outside of revenue). Therefore, entities need to consider all relevant facts and circumstances when analysing situations in which an entity is willing to accept a lower price than the amount stated in the contract.

How we see it

We believe the following factors might suggest that the entity has implicitly offered a price concession to the customer:

- The entity has an established business practice that indicates it is willing to accept consideration less than its contractually stated prices. For example, an entity routinely accepts reduced payments on services for which it earns high margins, indicating that it is willing to accept an amount of consideration that is less than the contract price.
- The entity has a history of not enforcing its contractual rights to promised consideration in similar contracts under similar circumstances such that customers expect the entity to offer price concessions. For example, the customer has a valid expectation that the entity is willing to accept a lower amount of consideration than the contractually stated price based on its past experience with the entity.
- The entity is willing to enter into a contract with a customer even though facts and circumstances indicate that the customer intends to pay an amount of consideration that is less than the contractually stated price. For example, the entity willingly enters into a contract expecting that it will receive less than the stated contract price, implicitly reducing the transaction price to the expected lesser consideration.

Appropriately distinguishing between price concessions (i.e., reductions of revenue) and customer credit risk (i.e., impairment loss) for collectability concerns, that were known at contract inception, is also important because it affects whether a valid contract exists (see section 3.1.5 above). If an entity determines at contract inception that a contract includes a price concession (i.e., variable consideration), the estimated amount of the concession is reflected in the transaction price (i.e., as a reduction of the stated contract price). As illustrated in Example 2 in IFRS 15 in the extract in section 5.2.1.A above (and also in Examples 3 and 23 in IFRS 15, see section 5.2.3 below), entities might estimate a transaction price that is significantly lower than the stated invoice or contractual amount, but still consider the difference between those amounts to be variable consideration (e.g., a price concession), rather than a collectability issue that would result in expected credit losses.

After the entity has determined the amount to assess for collectability under IFRS 15.9(e), it also has to apply the requirements in IFRS 9 to account for any expected credit losses for the receivable (or contract asset) that is recorded (i.e., after consideration of any variable consideration, such as an implicit price concession). Also, it presents any resulting impairment loss as an expense under IFRS 9 (i.e., not as a reduction of the transaction price). This is illustrated in an example from a January 2015 TRG agenda paper included in Question 3-4 in section 3.1.5.B above.[71]

71 TRG Agenda paper no. 13, *Collectibility*, dated 26 January 2015.

After contract inception, entities need to update both their estimate of variable consideration under IFRS 15 (see section 5.2.4 below) and their assessment of expected credit losses under IFRS 9, respectively, at the end of each reporting period. When the amount an entity expects to collect changes after contract inception, the entity might need to exercise significant judgement to determine whether that change is due to: (1) a change in estimate of the variable consideration identified at contract inception (and, therefore, would be accounted for as a change in the transaction price, as discussed in section 6.5 below); or (2) an identifiable credit event (e.g., a known or expected decline in a customer's operations, a known or expected bankruptcy filing or other financial reorganisation or the request for a concession on payment terms due to economic reasons) that would trigger a credit loss to be accounted for as an impairment loss under IFRS 9 (i.e., outside revenue). It is likely that this determination will require entities to establish policies to differentiate between price concessions and customer credit events, both at contract inception and as facts and circumstances change over the life of the contract. Such assessments could, for example, be needed during a pandemic or following a natural disaster because customers' ability and intent to pay might be affected and/or entities might be more willing to accept partial payment or extended payment terms. Importantly, if the parties need to change the terms of contracts with existing customers as a result, entities need to determine whether there is a contract modification (see section 3.4 above).

When making this evaluation, the entity needs to consider the facts and circumstances that led to its change in expectation about the amount it expects to collect. For example, if an entity that had contemplated an implicit price concession at contract inception decides to increase the amount of the concession it is willing to provide to further enhance the relationship with its customer, it might conclude that this is variable consideration. Therefore, it would be a reduction of the transaction price, i.e., revenue. In contrast, if the entity determines it will collect less consideration than it originally estimated due to its customer filing for bankruptcy, it is likely the entity would conclude that this is an impairment loss to be accounted for outside of IFRS 15 (i.e., there would be no adjustment to revenue).

An entity might also need to make the following assessments when evaluating changes in expectations about the amount it expects to collect after contract inception:

- Reassess collectability of the remaining contract consideration if the entity concludes that the change in expectation is due to a significant change in facts and circumstances (see Question 3-5 in section 3.1.5.B above).
- Consider whether the change in expectation is due to a contract modification. A contract modification is defined in IFRS 15 as "a change in the scope or price (or both) of a contract that is approved by the parties to the contract". *[IFRS 15.18]*. See section 3.4 above for further discussion on contract modifications.
- Consider whether the change in expectation indicates that the entity needs to assess related capitalised costs to obtain or fulfil a contract for impairment (see section 9.3 below).

How we see it

Determining, at contract inception, whether an entity has implicitly offered a price concession (i.e., variable consideration) or whether it has accepted the risk that a customer might default on the contractually agreed-upon consideration (i.e., impairment losses) might require significant judgement. The entity needs to consider its specific facts and circumstances, including its customary business practices and any other indicators about whether it intended at contract inception to offer a price concession to the customer.

Entities might also need to apply judgement when determining whether a change in the amount it expects to collect after contract inception is due to a change in an estimate of variable consideration (and, therefore, needs to be accounted for as change in transaction price) or due to a change in estimated credit losses that would be accounted for as impairment loss.

5.2.2 Estimating variable consideration

If a contract with a customer includes variable consideration, IFRS 15.50 (see section 5.2 above) states that "an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer". Entities are generally required to estimate variable consideration at contract inception and at the end of each reporting period (see section 5.2.4 below for reassessment requirements). In Question 5-10 below, we discuss limited situations in which the estimation of variable consideration might not be required.

Variable consideration generally needs to be estimated, instead of waiting for the variable consideration to be received or known with a high degree of certainty (e.g., upon receipt of a report from a customer detailing the amount of revenue due to the entity). For example, it would not be acceptable for entities that sell their products through distributors or resellers to wait until the end-sale has occurred if the only uncertainty is the variability in the pricing. This is because IFRS 15 requires an entity to estimate the variable consideration (the end-sales price in our example) based on the information available, taking into consideration the effect of the constraint on variable consideration (see section 5.2.3 below), unless one of the limited situations discussed in Question 5-10 occurs.

An entity is required to estimate variable consideration using either the 'expected value' or the 'most likely amount' method, as described in the standard: *[IFRS 15.53, IFRS 15.54]*

Extract from IFRS 15

53 An entity shall estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

(a) The expected value-the expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.

(b) The most likely amount-the most likely amount is the single most likely amount in a range of possible consideration amounts (ie the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

54 An entity shall apply one method consistently throughout the contract when estimating the effect of an uncertainty on an amount of variable consideration to which the entity will be entitled. In addition, an entity shall consider all the information (historical, current and forecast) that is reasonably available to the entity and shall identify a reasonable number of possible consideration amounts. The information that an entity uses to estimate the amount of variable consideration would typically be similar to the information that the entity's management uses during the bid-and-proposal process and in establishing prices for promised goods or services.

An entity is required to choose between the expected value method and the most likely amount method based on which method better predicts the amount of consideration to which it will be entitled. That is, the method selected is not meant to be a 'free choice'. Rather, an entity must select the method that is best suited, based on the specific facts and circumstances of the contract. *[IFRS 15.53]*.

An entity applies the selected method consistently to each type of variable consideration throughout the contract term and updates the estimated variable consideration at the end of each reporting period. Once it selects a method, an entity is required to apply that method consistently for similar types of variable consideration in similar types of contracts. In the Basis for Conclusions, the Board noted that a contract might contain different types of variable consideration. *[IFRS 15.BC202]*. As such, it might be appropriate for an entity to use different methods (i.e., expected value or most likely amount) for estimating different types of variable consideration within a single contract. This is illustrated in Example 21 in the standard. *[IFRS 15.IE Example 21, IFRS 15.IE105-IE108]*.

Entities determine the expected value of variable consideration using the sum of probability-weighted amounts in a range of possible amounts under the contract. To do this, an entity identifies the possible outcomes of a contract and the probabilities of those outcomes. The Board indicated in the Basis for Conclusions that the expected value method is likely to better predict expected consideration when an entity has a large number of contracts with similar characteristics. *[IFRS 15.BC200]*. This method might also better predict consideration when an entity has a single contract with a large number of possible outcomes. The IASB clarified that an entity preparing an expected value calculation is not required to consider all possible outcomes, even if the entity has extensive data and can identify many possible outcomes. Instead, the IASB noted in the Basis for Conclusions that, in many cases, a limited number of discrete outcomes and probabilities can provide a reasonable estimate of the expected value. *[IFRS 15.BC201]*.

Illustration 5-1: Estimating the transaction price using the expected value method

Entity A enters into contracts with customers to construct commercial buildings. The contracts include similar terms and conditions and contain a fixed fee plus variable consideration for a performance bonus related to the timing of Entity A's completion of the construction. Based on Entity A's historical experience, the expected bonus amounts and associated probabilities for achieving each bonus are, as follows:

Bonus amount	Probability of outcome
CU0	25%
CU100,000	50%
CU150,000	25%

Entity A determines that using the expected value method would better predict the amount of consideration to which it will be entitled because it has a large number of contracts that have characteristics that are similar to the new contract. Under the expected value method, Entity A estimates variable consideration of CU87,500, as follows:

Bonus amount (a)	Probability of outcome (b)	Expected value amount (a × b)
CU0	25%	CU0
CU100,000	50%	CU50,000
CU150,000	25%	CU37,500
	Total	**CU87,500**

Entity A needs to consider the effect of applying the constraint on variable consideration (see section 5.2.3 below).

Entities determine the most likely amount of variable consideration using the single most likely amount in a range of possible consideration amounts. The Board indicated in the Basis for Conclusions that the most likely amount method might be the better predictor when the entity expects to be entitled to one of two possible amounts. *[IFRS 15.BC200]*. For example, a contract in which an entity is entitled to receive all or none of a specified performance bonus, but not a portion of that bonus.

Illustration 5-2: Estimating the transaction price using the most likely amount

Entity A enters into a six-month advertising campaign agreement (CU500,000 fixed fee) that also includes a potential CU100,000 performance bonus linked to certain goals. Entity A estimates that it is 90% likely to receive the entire performance bonus and 10% likely to receive none of the bonus.

Because of the binary nature of the outcome (i.e., the entity will either receive the performance bonus or not receive it), Entity A determines that the most likely amount method is the better predictor of the amount to which it expects to be entitled. Because it is 90% probable that Entity A will receive the CU100,000 performance bonus, Entity A estimates the most likely amount it will receive is CU600,000 (i.e., CU500,000 fixed fee plus the entire CU100,000 bonus).

However, Entity A also needs to consider the effect of applying the constraint on variable consideration (see section 5.2.3 below) and determine whether it is highly probable that a significant reversal will not occur if it includes the entire CU100,000 performance bonus in the transaction price.

The standard requires that when applying either of these methods, an entity considers all information (historical, current and forecast) that is reasonably available to the entity. Some stakeholders questioned whether an entity would be applying the portfolio approach practical expedient in IFRS 15.4 (see section 3.3.1 above) when considering evidence from other, similar contracts to develop an estimate of variable consideration using an expected value method. The TRG members discussed this question and generally agreed that an entity would not be applying the portfolio approach practical expedient if it used a portfolio of data from its historical experience with similar customers and/or contracts. The TRG members noted that an entity could choose to apply the portfolio approach practical expedient, but would not be required to do so.[72] Use of this practical expedient requires an entity to assert that it does not expect the use of the expedient to differ materially from applying the standard to an individual contract. The TRG agenda paper noted that using a portfolio of data is not equivalent to using the portfolio approach practical expedient, so entities that use the expected value method to estimate variable consideration would not be required to assert that the outcome from the portfolio is not expected to materially differ from an assessment of individual contracts.

72 TRG Agenda paper no. 38, *Portfolio Practical Expedient and Application of Variable Consideration Constraint*, dated 13 July 2015.

Frequently asked questions

Question 5-10: Are there any situations in which an entity would not have to estimate variable consideration at contract inception under IFRS 15?

An entity would not have to estimate variable consideration at the inception of a contract in the following situations:

- **Variable consideration allocation exception** - When the terms of a variable payment relate to an entity's efforts to satisfy a specific part of a contract (i.e., one or more, but not all, performance obligations or distinct goods or services promised in a series) and allocating the consideration to this specific part is consistent with the overall allocation objectives of the standard, IFRS 15 requires variable consideration to be allocated entirely to that specific part of a contract. As a result, variable consideration would not be estimated for the purpose of recognising revenue. For example, an entity that provides a series of distinct hotel management services and receives a variable fee based on a fixed percentage of rental revenue would need to allocate the percentage of monthly rental revenue entirely to the period in which the consideration is earned if the criteria to use this allocation exception are met. See section 6.3 below for further discussion of the variable consideration allocation exception.
- **The 'right to invoice' practical expedient** - When an entity recognises revenue over time, the right to invoice practical expedient allows it to recognise revenue as invoiced if the entity's right to payment is for an amount that corresponds directly with the value to the customer of the entity's performance to date. For example, an entity would not be required to estimate the variable consideration for a three-year service contract under which it has a right to invoice the customer a fixed amount for each hour of service rendered, provided that fixed amount reflects the value to the customer. See section 7.1.4.B below for further discussion of the right to invoice practical expedient.
- **Recognition constraint for sales-based and usage-based royalties related to licences of intellectual property** - The standard provides explicit application guidance for recognising consideration from sales-based and usage-based royalties provided in exchange for licences of intellectual property. The standard states that an entity recognises sales-based and usage-based royalties as revenue at the later of when: (1) the subsequent sales or usage occurs; or (2) the performance obligation to which some, or all, of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied). In many cases, using this application guidance results in the same pattern of revenue recognition as fully constraining the estimate of variable consideration associated with the future royalty stream. However, in cases where an entity is required to allocate sales-based or usage-based royalties to separate performance obligations in a contract, it might need to include expected royalties in its estimate of the stand-alone selling price of one or more of the performance obligations. See section 8.5 below for further discussion about sales-based and usage-based royalties related to licences of intellectual property.

5.2.3 Constraining estimates of variable consideration

Before an entity can include any amount of variable consideration in the transaction price, it must consider whether the amount of variable consideration is required to be constrained. The Board explained in the Basis for Conclusions that it created this constraint on variable consideration to address concerns raised by many constituents that the standard could otherwise require recognition of revenue before there was sufficient certainty that the amounts recognised would faithfully depict the consideration to which an entity expects to be entitled in exchange for the goods or services transferred to a customer. *[IFRS 15.BC203]*.

The IASB explained in the Basis for Conclusions that it did not intend to eliminate the use of estimates from the revenue recognition standard. Instead, it wanted to make sure the estimates are robust and result in useful information. *[IFRS 15.BC204]*. Following this objective, the Board concluded that it was appropriate to include estimates of variable consideration in revenue only when an entity has a 'high degree of confidence' that revenue will not be reversed in a subsequent reporting period.

Therefore, as the following extract from the standard states, the constraint is aimed at preventing the over-recognition of revenue (i.e., the standard focuses on potential significant reversals of revenue): *[IFRS 15.56, IFRS 15.57]*

Extract from IFRS 15

56 An entity shall include in the transaction price some or all of an amount of variable consideration estimated in accordance with paragraph 53 only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

57 In assessing whether it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur once the uncertainty related to the variable consideration is subsequently resolved, an entity shall consider both the likelihood and the magnitude of the revenue reversal. Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, any of the following:

(a) the amount of consideration is highly susceptible to factors outside the entity's influence. Those factors may include volatility in a market, the judgement or actions of third parties, weather conditions and a high risk of obsolescence of the promised good or service.

(b) the uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

(c) the entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.

(d) the entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

(e) the contract has a large number and broad range of possible consideration amounts.

The standard has a different model "for consideration in the form of a sales-based or usage-based royalty that is promised in exchange for a licence of intellectual property". *[IFRS 15.58]*. See section 8.5 below for further discussion about sales-based and usage-based royalties related to licences of intellectual property.

To include variable consideration in the estimated transaction price, the entity has to conclude that it is 'highly probable' that a significant revenue reversal will not occur in future periods once the uncertainty related to the variable consideration is resolved. For the purpose of this analysis, the meaning of the term 'highly probable' is consistent with the existing definition in IFRS accounting standards, i.e., "significantly more likely than probable".[73]

FASB differences

ASC 606 uses the term 'probable' as the confidence threshold for applying the constraint, rather than 'highly probable', which is defined as "the future event or events are likely to occur".[74] However, the meaning of 'probable' under US GAAP is intended to be the same as 'highly probable' under IFRS accounting standards. *[IFRS 15.BC211]*.

Furthermore, the IASB noted that an entity's analysis to determine whether its estimate of variable consideration must be constrained is largely qualitative. *[IFRS 15.BC212]*. That is, an entity needs to use judgement to evaluate whether it has met the objective of the constraint (i.e., it is highly probable that a significant revenue reversal will not occur in future periods) considering the factors provided in the standard that increase the probability of a significant revenue reversal (discussed further below). In addition, conclusions about amounts that could result in a significant revenue reversal might change as an entity satisfies a performance obligation.

An entity needs to consider both the likelihood and magnitude of a revenue reversal to apply the constraint:

- *Likelihood* - assessing the likelihood of a future reversal of revenue requires significant judgement. Entities want to ensure they adequately document the basis for their conclusions. The presence of any one of the indicators cited in the extract above does not necessarily mean that a reversal will occur if the variable consideration is included in the transaction price. The standard includes 'factors', rather than 'criteria', to signal that the list of items to consider is not a checklist for which all items need to be met. In addition, the factors provided are not meant to be an all-inclusive list and entities might need to consider additional factors that are relevant to their facts and circumstances.

73 As defined in IFRS 5, Appendix A.

74 Master glossary of the US Accounting Standards Codification.

- *Magnitude* - when assessing the probability of a significant revenue reversal, an entity is also required to assess the magnitude of that reversal. The constraint is based on the probability of a reversal of an amount that is 'significant' relative to the cumulative revenue recognised for the contract. When assessing the significance of the potential revenue reversal, the cumulative revenue recognised at the date of the potential reversal includes both fixed and variable consideration and includes revenue recognised from the entire contract, not just the transaction price allocated to a single performance obligation.

An entity must carefully evaluate the factors that could increase the likelihood or the magnitude of a revenue reversal, including those listed in IFRS 15.57: *[IFRS 15.57]*

- The amount of consideration is highly susceptible to factors outside the entity's influence (e.g., volatility in a market, judgement or actions of third parties, weather conditions, high risk of obsolescence of the promised good or service).
- The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.
- The entity's experience (or other evidence) of similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.
- The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.
- The contract has a large number and broad range of possible consideration amounts.

Illustration 5-3: Evaluating the factors that could increase the likelihood or magnitude of a significant revenue reversal

Assume that an insurance broker receives 'trailing commissions' of CU100 every time a consumer signs up for a new insurance policy and CU50 whenever one of those consumers renews a policy.

In this fact pattern, the broker has a large pool of historical data about customer renewal patterns, given its significant experience with similar contracts. The broker considers the above factors and notes that the amount of consideration is highly susceptible to factors outside its influence and the uncertainty could remain over several years. However, it also has significant experience with similar types of contracts and its experience has predictive value.

As a result, even though the amount of consideration the entity will be entitled to is uncertain and depends on the actions of third parties (i.e., customer renewals), it is likely that the entity can estimate a minimum amount of variable consideration for which it is highly probable that a significant reversal of cumulative revenue will not occur. Assuming the broker's performance is complete upon initial signing of a contract, the broker would recognise the initial CU100 fee plus the minimum amount related to future renewals that is not constrained.

There are some types of variable consideration that are frequently included in contracts that have significant uncertainties. It is likely to be more difficult for an entity to assert it is highly probable that these types of estimated amounts will not be subsequently reversed. Examples of the types of variable consideration include, but are not limited to, the following:

- Payments contingent on regulatory approval (e.g., regulatory approval of a new drug)
- Long-term commodity supply arrangements that are settled based on market prices at the future delivery date
- Contingency fees based on litigation or regulatory outcomes (e.g., fees based on the positive outcome of litigation or the settlement of claims with government agencies)

When an entity determines that it cannot meet the highly probable threshold if it includes all of the variable consideration in the transaction price, the amount of variable consideration that must be included in the transaction price is limited to the amount that would not result in a significant revenue reversal. That is, the estimate of variable consideration is reduced until it reaches an amount that can be included in the transaction price that, if subsequently reversed when the uncertainty associated with the variable consideration is resolved, would not result in a significant reversal of cumulative revenue recognised. When there is significant uncertainty about the ultimate pricing of a contract, entities must not default to constraining the estimate of variable consideration to zero. During the post-implementation review of IFRS 15, a non-authoritative IASB staff paper noted that, while the constraint includes a downward bias, the intention behind the constraint was not to limit the amount of variable consideration included in the transaction price to nil.[75]

75 IASB Agenda paper 6A, *Determining the transaction price*, dated March 2024, available on the IFRS Foundation's website.

The standard includes an example in which the application of the constraint limits the amount of variable consideration included in the transaction price and one in which it does not: *[IFRS 15.IE Example 23, IFRS 15.IE116-IE123]*

Extract from IFRS 15

Example 23-Price concessions

An entity enters into a contract with a customer, a distributor, on 1 December 20X7. The entity transfers 1,000 products at contract inception for a price stated in the contract of CU100 per product (total consideration is CU100,000). Payment from the customer is due when the customer sells the products to the end customers. The entity's customer generally sells the products within 90 days of obtaining them. Control of the products transfers to the customer on 1 December 20X7.

On the basis of its past practices and to maintain its relationship with the customer, the entity anticipates granting a price concession to its customer because this will enable the customer to discount the product and thereby move the product through the distribution chain. Consequently, the consideration in the contract is variable.

Case A-Estimate of variable consideration is not constrained

The entity has significant experience selling this and similar products. The observable data indicate that historically the entity grants a price concession of approximately 20 per cent of the sales price for these products. Current market information suggests that a 20 per cent reduction in price will be sufficient to move the products through the distribution chain. The entity has not granted a price concession significantly greater than 20 per cent in many years.

To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 53(a) of IFRS 15) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates the transaction price to be CU80,000 (CU80 × 1,000 products).

The entity also considers the requirements in paragraphs 56-58 of IFRS 15 on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration of CU80,000 can be included in the transaction price. The entity considers the factors in paragraph 57 of IFRS 15 and determines that it has significant previous experience with this product and current market information that supports its estimate. In addition, despite some uncertainty resulting from factors outside its influence, based on its current market estimates, the entity expects the price to be resolved within a short time frame. Thus, the entity concludes that it is highly probable that a significant reversal in the cumulative amount of revenue recognised (ie CU80,000) will not occur when the uncertainty is resolved (ie when the total amount of price concessions is determined). Consequently, the entity recognises CU80,000 as revenue when the products are transferred on 1 December 20X7.

Case B-Estimate of variable consideration is constrained

The entity has experience selling similar products. However, the entity's products have a high risk of obsolescence and the entity is experiencing high volatility in the pricing of its products. The observable data indicate that historically the entity grants a broad range of price concessions ranging from 20-60 per cent of the sales price for similar products. Current market information also suggests that a 15-50 per cent reduction in price may be necessary to move the products through the distribution chain.

To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 53(a) of IFRS 15) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates that a discount of 40 per cent will be provided and, therefore, the estimate of the variable consideration is CU60,000 (CU60 × 1,000 products).

The entity also considers the requirements in paragraphs 56-58 of IFRS 15 on constraining estimates of variable consideration to determine whether some or all of the estimated amount of variable consideration of CU60,000 can be included in the transaction price. The entity considers the factors in paragraph 57 of IFRS 15 and observes that the amount of consideration is highly susceptible to factors outside the entity's influence (ie risk of obsolescence) and it is likely that the entity may be required to provide a broad range of price concessions to move the products through the distribution chain. Consequently, the entity cannot include its estimate of CU60,000 (ie a discount of 40 per cent) in the transaction price because it cannot conclude that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur. Although the entity's historical price concessions have ranged from 20-60 per cent, market information currently suggests that a price concession of 15-50 per cent will be necessary. The entity's actual results have been consistent with then-current market information in previous, similar transactions. Consequently, the entity concludes that it is highly probable that a significant reversal in the cumulative amount of revenue recognised will not occur if the entity includes CU50,000 in the transaction price (CU100 sales price and a 50 per cent price concession) and therefore, recognises revenue at that amount. Therefore, the entity recognises revenue of CU50,000 when the products are transferred and reassesses the estimates of the transaction price at each reporting date until the uncertainty is resolved in accordance with paragraph 59 of IFRS 15.

In some situations, it is appropriate for an entity to include in the transaction price an estimate of variable consideration that is not a possible outcome of an individual contract. The TRG discussed this topic using an example from the TRG agenda paper, which the following Illustration is based on:[76]

Illustration 5-4: Estimating variable consideration using the expected value method

Entity A develops websites for customers. The contracts include similar terms and conditions and contain a fixed fee, plus variable consideration for a performance bonus related to the timing of Entity A completing the website. Based on Entity A's historical experience, the bonus amounts and associated probabilities for achieving each bonus are, as follows:

Bonus amount	Probability of outcome
-	15%
CU50	40%
CU100	45%

Entity A determines that using the expected value method would better predict the amount of consideration to which it will be entitled than using the most likely amount method because it has a large number of contracts that have characteristics that are similar to the new contract.

Under the expected value method, Entity A estimates variable consideration of CU65,000 [(0 x 15%) + (50,000 x 40%) + (100,000 × 45%)]. Entity A must then consider the effect of applying the constraint on variable consideration. To do this, Entity A considers the factors that could increase the likelihood of a revenue reversal in IFRS 15.57 and concludes that it has relevant historical experience with similar types of contracts and that the amount of consideration is not highly susceptible to factors outside of its influence.

In determining whether the entity would include CU50,000 or CU65,000 in the transaction price, the TRG members generally agreed that when an entity has concluded that the expected value approach is the appropriate method to estimate variable consideration, the constraint is also applied based on the expected value method. That is, the entity is not required to switch from an expected value method to a most likely amount for purposes of applying the constraint. As a result, if an entity applies the expected value method for a particular contract, the estimated transaction price might not be a possible outcome in an individual contract. Therefore, the entity could conclude that, in this example, CU65,000 is the appropriate estimate of variable consideration to include in the transaction price. It is important to note that in this example, the entity had concluded that none of the factors in IFRS 15.57 or any other factors indicate a likelihood of a significant revenue reversal.

When an entity uses the expected value method and determines that the estimated amount of variable consideration is not a possible outcome in the individual contract, the entity must still consider the constraint on variable consideration. Depending on the facts and circumstances of each contract, an entity might need to constrain its estimate of variable consideration, even though it has used an expected value method, if the factors in IFRS 15.57 indicate a likelihood of a significant revenue reversal. However, using the expected value method and considering probability-weighted amounts sometimes achieve the objective of the constraint on variable consideration. When an entity estimates the transaction price using the expected value method, the entity reduces the probability of a revenue reversal because the estimate does not include all of the potential consideration due to the probability weighting of the outcomes. In some cases, the entity does not need to constrain the estimate of variable consideration if the factors in IFRS 15.57 do not indicate a likelihood of a significant revenue reversal.

Example 25 in the standard illustrates a situation in which a qualitative analysis of the factors in IFRS 15.57 indicates that it is not highly probable that a significant reversal would not occur if an entity includes a performance-based incentive fee in the transaction price of an investment management contract. *[IFRS 15.IE Example 25, IFRS 15.IE129-IE133]*.

See section 6 below for a discussion of allocating the transaction price.

76 TRG Agenda paper no. 38, *Portfolio Practical Expedient and Application of Variable Consideration Constraint*, dated 13 July 2015.

Frequently asked questions

Question 5-11: Is the constraint on variable consideration applied at the contract or performance obligation level?

(TRG meeting 26 January 2015 - Agenda paper no. 14)

The TRG members generally agreed that the constraint would be applied at the contract level and not at the performance obligation level. That is, the significance assessment of the potential revenue reversal would consider the total transaction price of the contract (and not the portion of transaction price allocated to a performance obligation).

Question 5-12: Would an entity be required to follow a two-step approach to estimate variable consideration (i.e., first estimate the variable consideration and then apply the constraint to that estimate)?

The Board noted in the Basis for Conclusions that an entity is not required to strictly follow a two-step process (i.e., first estimate the variable consideration and then apply the constraint to that estimate) if its internal processes incorporate the principles of both steps in a single step. *[IFRS 15.BC215]*. For example, if an entity already had a single process to estimate expected returns when calculating revenue from the sale of goods in a manner consistent with the objectives of applying the constraint, the entity would not need to estimate the transaction price and then separately apply the constraint.

A TRG agenda paper also noted that applying the expected value method, which requires an entity to consider probability-weighted amounts, might sometimes achieve the objective of the constraint on variable consideration.[77] That is, in developing its estimate of the transaction price in accordance with the expected value method, an entity reduces the probability of a revenue reversal and might not need to further constrain its estimate of variable consideration. However, to meet the objective of the constraint, the entity's estimated transaction price would need to incorporate its expectations of the possible consideration amounts (e.g., products not expected to be returned) at a level at which it is highly probable that including the estimate of variable consideration in the transaction price would not result in a significant revenue reversal (e.g., such that it is highly probable that additional returns above the estimated amount would not result in a significant reversal).

Question 5-13: How does an entity apply the constraint on variable consideration to milestone payments?

An entity might need to apply significant judgement to determine whether and, if so, how much of a milestone payment is constrained. Assuming the payment is not subject to the sales-based or usage-based royalty recognition constraint (see section 8.5 below), a milestone payment is a form of variable consideration that needs to be estimated and included in the transaction price, subject to the variable consideration constraint.

Milestone payments are often binary (i.e., the entity will either achieve the target or desired outcome and become entitled to the milestone payment or not). In these situations, entities generally conclude that the most likely amount method is the better predictor of the amount to which it expects to be entitled. The entity will then consider the constraint on variable consideration to determine whether it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainties related to the milestone payments have been resolved. When assessing the significance of the potential revenue reversal of a future milestone payment, the cumulative revenue recognised at the date of the potential reversal would include any fixed consideration in addition to the variable consideration for the entire contract.

How we see it

Applying the constraint to milestone payments often requires significant judgement, especially when uncertainty exists about the underlying activities necessary to meet the target or desired outcome that entitle the entity to the milestone payment. Entities need to analyse the facts and circumstances of each milestone payment and consider all information (historical, current and forecast) that is reasonably available to them to assess whether the revenue needs to be constrained. In addition, there could be external factors that affect an entity's assessment of the contract and the probability of entitlement to milestone payments. For example, we expect entities to conclude in many instances that milestone payments contingent on regulatory approval (e.g., regulatory approval of a new drug) are constrained, preventing them from recognising these payments until the uncertainty associated with the payments is resolved.

77 TRG Agenda paper no. 38, *Portfolio Practical Expedient and Application of Variable Consideration Constraint*, dated 13 July 2015.

Consider the following Illustration:

Illustration 5-5: Milestone payments

Biotech enters into an arrangement with Pharma under which Biotech provides a licence to a product candidate that is starting phase II clinical studies and performs research and development services for a specified period of time. Assume that these two promises are determined to be distinct. Biotech receives an upfront payment upon execution of the arrangement and is entitled to receive milestone payments upon: (1) enrolment of a specified number of patients in a phase II clinical study; (2) completion of phase III clinical studies, (3) regulatory approval in the US; and (4) regulatory approval in the European Union.

Under the standard, Biotech includes in the transaction price the upfront payment and its estimate of the milestone payments it expects to receive. The amount of consideration that Biotech can include in the transaction price is limited to amounts for which it is highly probable that a significant reversal of cumulative revenues recognised under the contract will not occur in future periods.

The milestone for patient enrolment only has two possible outcomes (e.g., Biotech enrols or does not enrol the specified number of patients). Therefore, Biotech determines that the most likely amount method is the better predictor of the milestone payment. It then determines that it can include the amount associated with the enrolment milestone in the transaction price because it is highly probable that doing so will not result in a significant revenue reversal, based on: its prior experience with enrolling participants in similar studies; clinical trial results on the product candidate to date; and the significance of the milestone payment compared to the cumulative revenues expected to be recognised under the contract at the time of the enrolment milestone.

Due to the significant uncertainty associated with the other future events that would result in milestone payments, however, Biotech initially determines that it cannot include these amounts in the transaction price (i.e., the other milestone payments are fully constrained at contract inception). At the end of each reporting period, Biotech updates its assessment of whether the milestone payments are constrained by considering both the likelihood and magnitude of a potential revenue reversal.

The evaluation of the constraint considers the probability of reversal (i.e., not achieving the target or desired outcome) and whether any such reversal would be significant in relation to cumulative revenue recognised to date on the total contract. There are many variables that need to be factored into this assessment. Thus, entities need to carefully evaluate each milestone to determine when it is appropriate to include the milestone in the transaction price.

For example, an entity might consider the variable consideration constraint and conclude that the milestone payment is not constrained at contract inception because including the milestone payment in the transaction price would not result in a significant reversal of cumulative revenue in the event that the milestone requirements are not achieved (i.e., the entity is not entitled to the consideration). This would be the case when an entity expects to recognise a significant amount of the contract revenue early in the life of the contract and the milestone payment amount is not significant in relation to the cumulative revenue that will be recognised by the time the uncertainties related to the milestone have been resolved.

As discussed in section 5.2.4 below, an entity is required to update its estimate of variable consideration (including any amounts that are constrained) at the end of each reporting period to reflect its revised expectations of the amount of consideration to which it expects to be entitled. For example, an entity might initially conclude that a milestone payment is constrained and, therefore, exclude it from the transaction price. However, in a later reporting period, when reassessing the amount of variable consideration that must be included in the transaction price, the entity might conclude a milestone payment is no longer constrained even though the target or desired outcome has not been achieved. That is, based on new information, an entity might conclude that it expects to achieve the target or desired outcome and, therefore, concludes that it is now highly probable that a significant revenue reversal will not occur.

5.2.4 Reassessment of variable consideration

When a contract includes variable consideration, an entity needs to update its estimate of the transaction price throughout the term of the contract to depict conditions that exist at the end of each reporting period. This involves updating the estimate of the variable consideration (including any amounts that are constrained) to reflect an entity's revised expectations about the amount of consideration to which it expects to be entitled, considering uncertainties that are resolved or new information that is gained about remaining uncertainties. The entity accounts for changes in the transaction price in accordance with IFRS 15.87-90. *[IFRS 15.59]*. As discussed in section 5.2.3 above, conclusions about amounts that could result in a significant revenue reversal might change as an entity satisfies a performance obligation. See section 6.5 below for a discussion of allocating changes in the transaction price after contract inception.

The IASB noted in the Basis for Conclusions that, in some cases, an estimate of variable consideration made at the end of an accounting period could be affected by information that arises after the end of the reporting period, but before the release of the financial statements. The Board decided not to include guidance in IFRS 15 on accounting in these situations, because it noted that the accounting for subsequent events is already addressed in IAS 10 *Events after the Reporting Period* (see Chapter 34). *[IFRS 15.BC228]*.

Frequently asked questions

Question 5-14: How would an entity distinguish between a contract modification and a change in the estimated transaction price due to variable consideration after contract inception?

See response to Question 3-15 in section 3.4 above.

5.3 Refund liabilities

An entity might receive consideration that it will need to refund to the customer in the future because the consideration is not an amount to which the entity ultimately will be entitled under the contract. If an entity expects to refund some or all of that consideration, the amounts received (or receivable) need to be recorded as refund liabilities.

A refund liability is measured "at the amount of consideration received (or receivable) for which the entity does not expect to be entitled (i.e., amounts not included in the transaction price)". An entity is required to update its estimates of refund liabilities (and the corresponding change in the transaction price) at the end of each reporting period. The standard also notes that, if a refund liability relates to a sale with a right of return, an entity applies the specific application guidance for sales with a right of return. *[IFRS 15.55]*.

While the most common form of refund liabilities is related to sales with a right of return (see section 5.4 below), the refund liability requirements also apply when an entity expects that it will need to refund consideration received due to poor customer satisfaction with a service provided (i.e., there was no good delivered or returned) and/or if an entity expects to have to provide retrospective price reductions to a customer (e.g., if a customer reaches a certain threshold of purchases, the unit price is retrospectively adjusted).

Frequently asked questions

Question 5-15: Is a refund liability a contract liability (and, thus, subject to the presentation and disclosure requirements of a contract liability)?

See response to Question 10-4 in section 10.1.5 below.

5.4 Rights of return

The standard notes that, in some contracts, an entity might transfer control of a product to a customer but grant the customer a right of return. In return, the customer might receive a full or partial refund of any consideration paid; a credit that can be applied against amounts owed, or that will be owed, to the entity; another product in exchange; or any combination thereof. *[IFRS 15.B20]*. As discussed in section 4.7 above, the standard states that a right of return does not represent a separate performance obligation. *[IFRS 15.B22]*. Instead, a right of return affects the transaction price and the amount of revenue an entity can recognise for satisfied performance obligations. In other words, rights of return create variability in the transaction price.

Under IFRS 15, rights of return do not include exchanges by customers of one product for another of the same type, quality, condition and price (e.g., one colour or size for another). *[IFRS 15.B26]*. Nor do rights of return include situations where a customer might return a defective product in exchange for a functioning product; these are, instead, evaluated in accordance with the application guidance on warranties (see section 9.1 below).

The standard provides the following application guidance to determine how rights of return would be treated: *[IFRS 15.B21]*

Extract from IFRS 15

B21 To account for the transfer of products with a right of return (and for some services that are provided subject to a refund), an entity shall recognise all of the following:

(a) revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (therefore, revenue would not be recognised for the products expected to be returned);

(b) a refund liability; and

(c) an asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.

Under the standard, an entity estimates the transaction price and applies the constraint to the estimated transaction price to determine the amount of consideration to which the entity expects to be entitled. In doing so, it considers the products expected to be returned in order to determine the amount to which the entity expects to be entitled (excluding consideration for the products expected to be returned). The entity recognises revenue based on the amount to which it expects to be entitled through to the end of the return period (considering expected product returns). An entity does not recognise the portion of the revenue subject to the constraint until the amount is no longer constrained, which could be at the end of the return period. The entity recognises the amount received or receivable that is expected to be returned as a refund liability, representing its obligation to return the customer's consideration (see section 5.3 above). Subsequently, at the end of each reporting period, the entity updates its assessment of amounts for which it expects to be entitled. *[IFRS 15.B23]*.

As part of updating its estimate, an entity must update its assessment of expected returns and the related refund liabilities. *[IFRS 15.B24]*. This remeasurement is performed at the end of each reporting period and reflects any changes in assumptions about expected returns. Any adjustments made to the estimate result in a corresponding adjustment to amounts recognised as revenue for the satisfied performance obligations (e.g., if the entity expected the number of returns to be lower than originally estimated, it would have to increase the amount of revenue recognised and decrease the refund liability). *[IFRS 15.B23, IFRS 15.B24]*.

Finally, when customers exercise their rights of return, the entity might receive the returned product in a saleable or repairable condition. Under the standard, at the time of the initial sale (i.e., when recognition of revenue is deferred due to the anticipated return), the entity recognises a return asset (and adjusts the cost of goods sold) for its right to recover the goods returned by the customer. *[IFRS 15.B21]*. The entity initially measures this asset at the former carrying amount of the inventory, less any expected costs to recover the goods, including any potential decreases in the value of the returned goods. The consideration of potential decreases in value of the returned products is important because the returned products might not be in the same condition they were in when they were sold (e.g., due to damage or use) and this helps to ensure that the value of the return asset is not impaired.

The following table provides a summary of what an entity initially recognises in relation to a right of return in accordance with the requirements in IFRS 15 (also see Example 22 from the standard below).

Figure 5-2: Rights of return

Revenue	The amount to which the entity expects to be entitled through to the end of the return period (considering expected product returns)
Cost of sales	The carrying amount of goods transferred, less the return asset
Refund liability	The amount received or receivable that is expected to be returned
Return asset	The former carrying amount of the inventory the entity expects to recover (i.e., goods expected to be returned by the customer), less any expected costs to recover the goods, including potential decreases in the value of the returned goods

Along with remeasuring the refund liability at the end of each reporting period (as discussed above), the entity updates the measurement of the asset recorded for any revisions to its expected level of returns, as well as any additional potential decreases in the value of the returned products. *[IFRS 15.B25]*. Because the standard includes specific remeasurement requirements for the return asset, an entity applies those requirements, rather than other impairment models (e.g., inventory). The standard also requires the refund liability to be presented separately from the corresponding asset (i.e., on a gross basis, rather than a net basis). *[IFRS 15.B25]*.

How we see it

While the standard does not explicitly state this, we believe that the return asset would generally be presented separately from inventory.

The standard provides the following example of rights of return: *[IFRS 15.IE Example 22, IFRS 15.IE110-IE115]*

Extract from IFRS 15

Example 22-Right of return

An entity enters into 100 contracts with customers. Each contract includes the sale of one product for CU100 (100 total products × CU100 = CU10,000 total consideration). Cash is received when control of a product transfers. The entity's customary business practice is to allow a customer to return any unused product within 30 days and receive a full refund. The entity's cost of each product is CU60.

The entity applies the requirements in IFRS 15 to the portfolio of 100 contracts because it reasonably expects that, in accordance with paragraph 4, the effects on the financial statements from applying these requirements to the portfolio would not differ materially from applying the requirements to the individual contracts within the portfolio.

Because the contract allows a customer to return the products, the consideration received from the customer is variable. To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 53(a) of IFRS 15) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates that 97 products will not be returned.

The entity also considers the requirements in paragraphs 56-58 of IFRS 15 on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration of CU9,700 (CU100 × 97 products not expected to be returned) can be included in the transaction price. The entity considers the factors in paragraph 57 of IFRS 15 and determines that although the returns are outside the entity's influence, it has significant experience in estimating returns for this product and customer class. In addition, the uncertainty will be resolved within a short time frame (ie the 30-day return period). Thus, the entity concludes that it is highly probable that a significant reversal in the cumulative amount of revenue recognised (ie CU9,700) will not occur as the uncertainty is resolved (ie over the return period).

The entity estimates that the costs of recovering the products will be immaterial and expects that the returned products can be resold at a profit.

Upon transfer of control of the 100 products, the entity does not recognise revenue for the three products that it expects to be returned. Consequently, in accordance with paragraphs 55 and B21 of IFRS 15, the entity recognises the following:

(a) revenue of CU9,700 (CU100 × 97 products not expected to be returned);

(b) a refund liability of CU300 (CU100 refund × 3 products expected to be returned); and

(c) an asset of CU180 (CU60 × 3 products for its right to recover products from customers on settling the refund liability).

In ASC 606, the same example includes the following journal entries to illustrate how the entity would account for the contract in Example 22 in accordance with the US GAAP equivalents of IFRS 15.55 and B21 when the product is transferred to the customer.[78] These entries would also apply to entities applying IFRS 15:

Dr	Cash		CU10,000[(a)]	
	Cr	Revenue		CU9,700[(b)]
	Cr	Refund liability		CU300[(c)]
Dr	Cost of sales		CU5,820[(d)]	
Dr	Asset		CU180[(e)]	
	Cr	Inventory		CU6,000[(f)]

(a) (CU100 × 100 products transferred).

(b) (CU100 × 97 products not expected to be returned)

(c) (CU100 refund × 3 products expected to be returned)

(d) (CU60 × 97 products not expected to be returned)

(e) (CU60 × 3 products for its right to recover products from customers on settling the refund liability)

(f) (CU60 × 100 products)

78 ASC 606-10-55-207.

Frequently asked questions

Question 5-16: Is an entity applying the portfolio approach practical expedient when accounting for rights of return?

(TRG meeting 13 July 2015 - Agenda paper no. 38)

An entity can, but would not be required to, apply the portfolio approach practical expedient to estimate variable consideration for expected returns using the expected value method. Similar to the discussion in section 5.2.2 above on estimating variable consideration, the TRG agenda paper noted that an entity can consider evidence from other, similar contracts to develop an estimate of variable consideration using the expected value method without applying the portfolio approach practical expedient. In order to estimate variable consideration in a contract, an entity frequently makes judgements considering its historical experience with other, similar contracts. Considering historical experience does not necessarily mean the entity is applying the portfolio approach practical expedient.

This question arises, in part, because Example 22 from the standard (in the extract above) states that the entity is using the portfolio approach practical expedient in IFRS 15.4 to calculate its estimate of returns. Use of this practical expedient requires an entity to assert that it does not expect the use of the expedient to differ materially from applying the standard to an individual contract.

We expect that entities often use the expected value method to estimate variable consideration related to returns because doing so would likely better predict the amount of consideration to which the entities will be entitled. This is despite the fact that there are two potential outcomes for each contract from the variability of product returns: the product either will be returned or will not be returned. That is, the revenue for each contract ultimately either will be 100% or will be 0% of the total contract value (assuming returns create the only variability in the contract). However, entities might conclude that the expected value is the appropriate method for estimating variable consideration because they have a large number of contracts with similar characteristics. The TRG agenda paper noted that using a portfolio of data is not equivalent to using the portfolio approach practical expedient, so entities that use the expected value method to estimate variable consideration for returns would not be required to assert that the outcome from the portfolio is not expected to materially differ from an assessment of individual contracts.

Question 5-17: How does an entity account for restocking fees for goods that are expected to be returned?

(TRG meeting 13 July 2015 - Agenda paper no. 35)

Entities sometimes charge customers a 'restocking fee' when a product is returned. This fee might be levied by entities to compensate them for the costs of repackaging, shipping and/or reselling the item at a lower price to another customer. Stakeholders had raised questions about how to account for restocking fees and related costs.

The TRG members generally agreed that restocking fees for goods that are expected to be returned would be included in the estimate of the transaction price at contract inception and recorded as revenue when (or as) control of the good transfers. That is, selling a product subject to a restocking fee if it is returned is not different from providing a partial return right and must be accounted for similarly.

Consider the following Illustration based on an example in the TRG agenda paper:

Illustration 5-6: Restocking fees

Entity A enters into a contract with a customer to sell 10 widgets for CU100 each. The customer has the right to return the widgets, but, if it does so, it will be charged a 10% restocking fee (or CU10 per returned widget). The entity estimates that 10% of all widgets that are sold will be returned. Upon transfer of control of the 10 widgets, the entity will recognise revenue of CU910 [(9 widgets not expected to be returned x CU100 selling price) + (1 widget expected to be returned x CU10 restocking fee)]. A refund liability of CU90 will also be recorded [1 widget expected to be returned x (CU100 selling price - CU10 restocking fee)].

Question 5-18: How does an entity account for restocking costs related to expected returns (e.g., shipping or repackaging costs)?

(TRG meeting 13 July 2015 - Agenda paper no. 35)

The TRG members generally agreed that restocking costs (e.g., shipping and repackaging costs) would be recorded as a reduction of the amount of the return asset when (or as) control of the good is transferred to the customer. This accounting treatment is consistent with the requirement in IFRS 15.B25 that the return asset be initially measured at the former carrying amount of the inventory, less any expected costs to recover the goods (e.g., restocking costs). *[IFRS 15.B25]*.

Question 5-19: How can an entity evaluate a conditional call option to repurchase an asset?

See response to Question 7-23 in section 7.3.1 below.

Question 5-20: Does an entity account for a customer's return of a defective item in exchange for compensation (i.e., not for a replacement item) as a right of return or an assurance-type warranty?

See response to Question 9-3 in section 9.1.1 below.

5.5 Significant financing component

For some transactions, the receipt of the consideration does not match the timing of the transfer of goods or services to the customer (e.g., the consideration is prepaid or is paid after the services are provided). When the customer pays in arrears, the entity is effectively providing financing to the customer. Conversely, when the customer pays in advance, the entity has effectively received financing from the customer.

IFRS 15 states the following in relation to a significant financing component in a contract: *[IFRS 15.60-64]*

Extract from IFRS 15

60 In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.

61 The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognise revenue at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer (ie the cash selling price). An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including both of the following:

(a) the difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services; and

(b) the combined effect of both of the following:

(i) the expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services; and

(ii) the prevailing interest rates in the relevant market.

62 Notwithstanding the assessment in paragraph 61, a contract with a customer would not have a significant financing component if any of the following factors exist:

(a) the customer paid for the goods or services in advance and the timing of the transfer of those goods or services is at the discretion of the customer.

(b) a substantial amount of the consideration promised by the customer is variable and the amount or timing of that consideration varies on the basis of the occurrence or non-occurrence of a future event that is not substantially within the control of the customer or the entity (for example, if the consideration is a sales-based royalty).

(c) the difference between the promised consideration and the cash selling price of the good or service (as described in paragraph 61) arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference. For example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract.

63 As a practical expedient, an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.

64 To meet the objective in paragraph 61 when adjusting the promised amount of consideration for a significant financing component, an entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. That rate would reflect the credit characteristics of the party receiving financing in the contract, as well as any collateral or security provided by the customer or the entity, including assets transferred in the contract. An entity may be able to determine that rate by identifying the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer. After contract inception, an entity shall not update the discount rate for changes in interest rates or other circumstances (such as a change in the assessment of the customer's credit risk).

The Board explained in the Basis for Conclusions that, conceptually, a contract that includes a financing component is comprised of two transactions - one for the sale of goods and/or services and one for the financing. *[IFRS 15.BC229]*. Accordingly, the Board decided to require entities to adjust the amount of promised consideration for the effects of financing only if the timing of payments specified in the contract provides the customer or the entity with a significant benefit of financing. The IASB's objective in requiring entities to adjust the promised amount of consideration for the effects of a significant financing component is for entities to recognise as revenue the 'cash selling price' of the underlying goods or services at the time of transfer. *[IFRS 15.BC230]*.

5.5.1 Practical expedient

As a practical expedient, an entity is not required to adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less. The Board added this practical expedient to the standard because it simplifies the application of this aspect of IFRS 15 and because the effect of accounting for a significant financing component (or of not doing so) should be limited in financing arrangements with a duration of less than 12 months. *[IFRS 15.BC236]*. If an entity uses this practical expedient, it applies the expedient consistently to similar contracts in similar circumstances. *[IFRS 15.BC235]*.

It is important to note that if the period between when the entity transfers a promised good or service to a customer and the customer pays for that good or service is more than one year and the financing component is deemed to be significant, the entity must account for the entire financing component. That is, an entity cannot exclude the first 12 months of the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service from the calculation of the potential adjustment to the transaction price. An entity also cannot exclude the first 12 months in its determination of whether the financing component of a contract is significant.

Entities might need to apply judgement to determine whether the practical expedient applies to some contracts. For example, the standard does not specify whether entities must assess the period between payment and performance at the contract level or at the performance obligation level. In addition, the TRG discussed how an entity would consider whether the practical expedient applies to contracts with a single payment stream for multiple performance obligations. See Question 5-24 in section 5.5.4 below.

5.5.2 Existence of a significant financing component

Absent the use of the practical expedient, to determine whether a significant financing component exists, an entity needs to consider all relevant facts and circumstances, including:

(a) The difference between the cash selling price and the amount of promised consideration for the promised goods or services.

And

(b) The combined effect of the expected length of time between the transfer of the goods or services and the receipt of consideration and the prevailing market interest rates. The Board acknowledged that a difference in the timing between the transfer of and payment for goods or services is not determinative, but the combined effect of timing and the prevailing interest rates may provide a strong indication that an entity is providing or receiving a significant benefit of financing. *[IFRS 15.BC232]*.

Even if conditions in a contract would otherwise indicate that a significant financing component exists, the standard includes several situations that the Board has determined do not provide the customer or the entity with a significant benefit of financing. These situations, as described in IFRS 15.62, include the following: *[IFRS 15.62]*

- The customer has paid for the goods or services in advance and the timing of the transfer of those goods or services is at the discretion of the customer. In these situations (e.g., prepaid phone cards, customer loyalty programmes), the Board noted in the Basis for Conclusions that the payment terms are not related to a financing arrangement between the parties and the costs of requiring an entity to account for a significant financing component would outweigh the benefits because an entity would need to continually estimate when the goods or services will transfer to the customer. *[IFRS 15.BC233]*.
- A substantial amount of the consideration promised by the customer is variable and is based on factors outside the control of the customer or entity. In these situations, the Board noted in the Basis for Conclusions that the primary purpose of the timing or terms of payment might be to allow for the resolution of uncertainties that relate to the consideration, rather than to provide the customer or the entity with the significant benefit of financing. In addition, the terms or timing of payment in these situations might be to provide the parties with assurance of the value of the goods or services (e.g., an arrangement for which consideration is in the form of a sales-based royalty). *[IFRS 15.BC233]*.
- The difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of financing to either the customer or the entity (e.g., a payment is made in advance or in arrears in accordance with the typical payment terms of the industry or jurisdiction) and the difference between those amounts is proportional to the reason for the difference. In certain situations, the Board determined the purpose of the payment terms might be to provide the customer with assurance that the entity will complete its obligations under the contract, rather than to provide financing to the customer or the entity. Examples include a customer withholding a portion of the consideration until the contract is complete (illustrated in Example 27, included in section 5.5.4 below) or a milestone is reached, or an entity requiring a customer to pay a portion of the consideration upfront in order to secure a future supply of goods or services. See Question 5-20 in section 5.5.4 below for further discussion.

5.5.2.A Advance payments

As explained in the Basis for Conclusions, the Board decided not to provide an overall exemption from accounting for the effects of a significant financing component arising from advance payments. This is because ignoring the effects of advance payments could skew the amount and timing of revenue recognised if the advance payment is significant and the purpose of the payment is to provide the entity with financing. *[IFRS 15.BC238]*. For example, an entity might require a customer to make advance payments to avoid obtaining the financing from a third party. If the entity obtained third-party financing, it would likely charge the customer additional amounts to cover the finance costs incurred. The Board decided that an entity's revenue should be consistent regardless of whether it receives the significant financing benefit from a customer or from a third party because, in either scenario, the entity's performance is the same.

How we see it

In order to conclude that an advance payment does not represent a significant financing component, we believe that an entity needs to support why the advance payment does not provide a significant financing benefit and describe its substantive business purpose.[79] As a result, it is important that entities analyse all of the relevant facts and circumstances.

In a 2018 speech, a member of the US SEC staff discussed a consultation with the Office of the Chief Accountant (OCA) in which a registrant concluded that a contract with a large upfront payment did not have a significant financing component because: (1) the upfront payment was made for reasons other than to provide a significant financing benefit; and (2) the difference between the upfront payment and what the customer would have paid, had the payments been made over the term of the arrangement, was proportional to the reason identified for the difference. The SEC staff member noted that, like other consultations that OCA has evaluated in relation to the revenue standard, the evaluation was based on the facts and circumstances. In this fact pattern, the staff did not object to the registrant's conclusion that the contract did not have a significant financing component based on the nature of the transaction and the purpose of the upfront payment.[80]

79 Consistent with the discussions within TRG Agenda paper no. 30, *Significant Financing Components*, dated 30 March 2015.

80 Speech, *Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments*, by Sarah N. Esquivel, Associate Chief Accountant, SEC Office of the Chief Accountant, 10 December 2018. Available on the SEC's website.

Example 29 (included in section 5.5.4 below) illustrates an entity's determination that a customer's advance payment represents a significant financing component. Example 30 (included in section 5.5.4 below) illustrates an entity's determination that a customer's advance payment does not represent a significant financing component.

5.5.2.B Assessment of significance

The assessment of significance is made at the individual contract level. As noted in the Basis for Conclusions, the Board decided that it would be an undue burden to require an entity to account for a financing component if the effects of the financing component are not significant to the individual contract, but the combined effects of the financing components for a portfolio of similar contracts were material to the entity as a whole. *[IFRS 15.BC234]*.

5.5.3 Determination of the discount rate

When an entity concludes that a financing component is significant to a contract, in accordance with IFRS 15.64, it determines the transaction price by applying a discount rate to the amount of promised consideration. *[IFRS 15.64]*. As stated above, the objective of requiring entities to adjust the promised consideration for the effects of a significant financing component is for the revenue recognised to approximate an amount that reflects the cash selling price that a customer would have paid for the promised goods or services. However, to achieve this objective, the entity does not need to estimate that cash selling price. Rather, the entity determines an interest rate and applies it to the amount of the promised consideration.

The entity uses the same interest rate that it would use if it were to enter into a separate financing transaction with the customer at contract inception. The interest rate needs to reflect the credit characteristics of the borrower in the contract, which could be either the entity or the customer (depending on who receives the financing). Using the risk-free rate or a rate explicitly stated in the contract that does not correspond with a separate financing rate would not be acceptable. *[IFRS 15.BC239]*. Example 28, Case B (included in section 5.5.4 below) illustrates a contractual discount rate that does not reflect the rate in a separate financing transaction. *[IFRS 15.IE Example 28, IFRS 15.IE143-IE147]*. Furthermore, using a contract's implicit interest rate (i.e., the interest rate that would make alternative payment options economically equivalent) would also not be acceptable if that rate does not reflect the rate in a separate financing transaction (as illustrated in Example 29, included in section 5.5.4 below). *[IFRS 15.IE Example 29, IFRS 15.IE148-IE151]*.

How we see it

While not explicitly stated in the standard, we believe an entity would consider the expected term of the financing when determining the interest rate in light of current market conditions at contract inception.

IFRS 15.64 is clear that an entity does not update the interest rate for changes in circumstances or market interest rates after contract inception. The Board noted that "an entity should not update the discount rate for a change in circumstances because an entity should reflect in the measurement of the transaction price only the discount rate that is determined at contract inception." It also observed that it would be "impractical for an entity to update the transaction price for changes in the assessment of the discount rate". *[IFRS 15.BC243]*.

However, the standard does not discuss situations in which expectations change after contract inception regarding the timing difference between the receipt of consideration and the transfer of goods and services to the customer (e.g., a change in the timing of delivery).

How we see it

As discussed above in section 5.5.1 above, the standard includes a practical expedient in IFRS 15.63 that allows an entity to not identify a significant financing component when it expects at contract inception that the period between transfer to, and payment from, the customer will be less than one year. To the extent this period of time extends beyond one year (due to events unknown at contract inception), we believe an entity would not be required to reconsider the use of this expedient because the guidance does not contemplate updating this assessment after contract inception.

If an entity has accounted for a significant financing component at contract inception and the expected timing of the transfer of goods or services then changes, it is important to understand the reason for the expectation change. For example, if the expected delivery date was revised as a consequence of the customer exercising its contractual right to change that date (i.e., it was at the discretion of the customer), it is likely that the entity previously concluded there was no significant financing component, as discussed above. *[IFRS 15.62(a)]*. If the change to the delivery date was part of a larger contract modification that changed the scope and/or price of the contract, the entity would need to apply the contract modification requirements (see section 3.4 above for further discussion on accounting for contract modifications). If the change to the delivery date was at the entity's discretion or was due to circumstances that were not foreseen at contract inception, the standard does not specify how an entity would account for that change and an entity needs to use judgement to determine the appropriate accounting treatment.

How we see it

The standard requires that the interest rate be a rate similar to one that the entity would have used in a separate financing transaction with the customer. Because most entities are not in the business of entering into free-standing financing arrangements with their customers, they might find it difficult to identify an appropriate rate. However, most entities perform some level of credit analysis before financing purchases for a customer, so they likely have some information about the customer's credit risk. For entities that have different pricing for products depending on the time of payment (e.g., cash discounts), the standard indicates that the appropriate interest rate, in some cases, could be determined by identifying the rate that discounts the nominal amount of the promised consideration to the cash selling price of the good or service.

It is likely that entities will have to exercise significant judgement to determine whether a significant financing component exists when there is more than one year between the transfer of goods or services and the receipt of contract consideration. Entities need to consider sufficiently documenting their analyses to support their conclusions.

5.5.4 Examples of significant financing components

The standard includes several examples to illustrate these concepts. Example 26 illustrates a contract that contains a significant financing component because the cash selling price at contract inception differs from the promised amount of consideration payable after delivery and there are no other factors present that would indicate that this difference arises for reasons other than financing. In this example, the implicit interest rate in the contract is determined to be commensurate with the rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. *[IFRS 15.IE Example 26, IFRS 15.IE135-IE140]*.

Extract from IFRS 15

Example 26-Significant financing component and right of return

An entity sells a product to a customer for CU121 that is payable 24 months after delivery. The customer obtains control of the product at contract inception. The contract permits the customer to return the product within 90 days. The product is new and the entity has no relevant historical evidence of product returns or other available market evidence.

The cash selling price of the product is CU100, which represents the amount that the customer would pay upon delivery for the same product sold under otherwise identical terms and conditions as at contract inception. The entity's cost of the product is CU80.

The entity does not recognise revenue when control of the product transfers to the customer. This is because the existence of the right of return and the lack of relevant historical evidence means that the entity cannot conclude that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur in accordance with paragraphs 56-58 of IFRS 15. Consequently, revenue is recognised after three months when the right of return lapses.

The contract includes a significant financing component, in accordance with paragraphs 60-62 of IFRS 15. This is evident from the difference between the amount of promised consideration of CU121 and the cash selling price of CU100 at the date that the goods are transferred to the customer.

The contract includes an implicit interest rate of 10 per cent (ie the interest rate that over 24 months discounts the promised consideration of CU121 to the cash selling price of CU100). The entity evaluates the rate and concludes that it is commensurate with the rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. The following journal entries illustrate how the entity accounts for this contract in accordance with paragraphs B20-B27 of IFRS 15.

(a) When the product is transferred to the customer, in accordance with paragraph B21 of IFRS 15:

Asset for right to recover product to be returned	CU80[(a)]	
Inventory		CU80

(a) This example does not consider expected costs to recover the asset.

(b) During the three-month right of return period, no interest is recognised in accordance with paragraph 65 of IFRS 15 because no contract asset or receivable has been recognised.

(c) When the right of return lapses (the product is not returned):

Receivable	CU100[(a)]	
Revenue		CU100
Cost of sales	CU80	
Asset for product to be returned		CU80

(a) The receivable recognised would be measured in accordance with IFRS 9. This example assumes there is no material difference between the fair value of the receivable at contract inception and the fair value of the receivable when it is recognised at the time the right of return lapses. In addition, this example does not consider the impairment accounting for the receivable.

Until the entity receives the cash payment from the customer, interest revenue would be recognised in accordance with IFRS 9. In determining the effective interest rate in accordance with IFRS 9, the entity would consider the remaining contractual term.

Example 26 also illustrates the requirement in IFRS 15.65, which provides that interest income or interest expense is recognised only to the extent that a contract asset (or receivable) or a contract liability is recognised in accounting for a contract with a customer. See further discussion in section 5.5.5 below.

In Example 27, the difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of financing. In this example, the customer withholds a portion of each payment until the contract is complete in order to protect itself from the entity failing to complete its obligations under the contract, as follows: *[IFRS 15.IE Example 27, IFRS 15.IE141-IE142]*

Extract from IFRS 15

Example 27-Withheld payments on a long-term contract

An entity enters into a contract for the construction of a building that includes scheduled milestone payments for the performance by the entity throughout the contract term of three years. The performance obligation will be satisfied over time and the milestone payments are scheduled to coincide with the entity's expected performance. The contract provides that a specified percentage of each milestone payment is to be withheld (ie retained) by the customer throughout the arrangement and paid to the entity only when the building is complete.

The entity concludes that the contract does not include a significant financing component. The milestone payments coincide with the entity's performance and the contract requires amounts to be retained for reasons other than the provision of finance in accordance with paragraph 62(c) of IFRS 15. The withholding of a specified percentage of each milestone payment is intended to protect the customer from the contractor failing to adequately complete its obligations under the contract.

Example 28 illustrates two situations. In one, a contractual discount rate reflects the rate in a separate financing transaction. In the other, it does not. *[IFRS 15.IE Example 28, IFRS 15.IE143-IE147]*.

Extract from IFRS 15

Example 28-Determining the discount rate

An entity enters into a contract with a customer to sell equipment. Control of the equipment transfers to the customer when the contract is signed. The price stated in the contract is CU1 million plus a five per cent contractual rate of interest, payable in 60 monthly instalments of CU18,871.

Case A-Contractual discount rate reflects the rate in a separate financing transaction

In evaluating the discount rate in the contract that contains a significant financing component, the entity observes that the five per cent contractual rate of interest reflects the rate that would be used in a separate financing transaction between the entity and its customer at contract inception (ie the contractual rate of interest of five per cent reflects the credit characteristics of the customer).

The market terms of the financing mean that the cash selling price of the equipment is CU1 million. This amount is recognised as revenue and as a loan receivable when control of the equipment transfers to the customer. The entity accounts for the receivable in accordance with IFRS 9.

Case B-Contractual discount rate does not reflect the rate in a separate financing transaction

In evaluating the discount rate in the contract that contains a significant financing component, the entity observes that the five per cent contractual rate of interest is significantly lower than the 12 per cent interest rate that would be used in a separate financing transaction between the entity and its customer at contract inception (ie the contractual rate of interest of five per cent does not reflect the credit characteristics of the customer). This suggests that the cash selling price is less than CU1 million.

In accordance with paragraph 64 of IFRS 15, the entity determines the transaction price by adjusting the promised amount of consideration to reflect the contractual payments using the 12 per cent interest rate that reflects the credit characteristics of the customer. Consequently, the entity determines that the transaction price is CU848,357 (60 monthly payments of CU18,871 discounted at 12 per cent). The entity recognises revenue and a loan receivable for that amount. The entity accounts for the loan receivable in accordance with IFRS 9.

Example 29 illustrates a contract with an advance payment from the customer that the entity concludes represents a significant benefit of financing. It also illustrates a situation in which the implicit interest rate does not reflect the interest rate that would be used in a separate financing transaction between the entity and its customer at contract inception, as follows: *[IFRS 15.IE Example 29, IFRS 15.IE148-IE151]*

Extract from IFRS 15

Example 29-Advance payment and assessment of discount rate

An entity enters into a contract with a customer to sell an asset. Control of the asset will transfer to the customer in two years (ie the performance obligation will be satisfied at a point in time). The contract includes two alternative payment options: payment of CU5,000 in two years when the customer obtains control of the asset or payment of CU4,000 when the contract is signed. The customer elects to pay CU4,000 when the contract is signed.

The entity concludes that the contract contains a significant financing component because of the length of time between when the customer pays for the asset and when the entity transfers the asset to the customer, as well as the prevailing interest rates in the market.

The interest rate implicit in the transaction is 11.8 per cent, which is the interest rate necessary to make the two alternative payment options economically equivalent. However, the entity determines that, in accordance with paragraph 64 of IFRS 15, the rate that should be used in adjusting the promised consideration is six per cent, which is the entity's incremental borrowing rate.

The following journal entries illustrate how the entity would account for the significant financing component:

(a) recognise a contract liability for the CU4,000 payment received at contract inception:

Cash	CU4,000	
Contract liability		CU4,000

(b) during the two years from contract inception until the transfer of the asset, the entity adjusts the promised amount of consideration (in accordance with paragraph 65 of IFRS 15) and accretes the contract liability by recognising interest on CU4,000 at six per cent for two years:

Interest expense	CU494[(a)]	
Contract liability		CU494

(a) CU494 = CU4,000 contract liability × (6 per cent interest per year for two years).

(c) recognise revenue for the transfer of the asset:

Contract liability	CU4,494	
Revenue		CU4,494

In Example 30, involving a contract with an advance payment from the customer, the entity determines that a significant financing component does not exist because the difference between the amount of promised consideration and the cash selling price of the good or service arises for reasons other than the provision of financing, as follows: *[IFRS 15.IE Example 30, IFRS 15.IE152-IE154]*

Extract from IFRS 15

Example 30-Advance payment

An entity, a technology product manufacturer, enters into a contract with a customer to provide global telephone technology support and repair coverage for three years along with its technology product. The customer purchases this support service at the time of buying the product. Consideration for the service is an additional CU300. Customers electing to buy this service must pay for it upfront (ie a monthly payment option is not available).

To determine whether there is a significant financing component in the contract, the entity considers the nature of the service being offered and the purpose of the payment terms. The entity charges a single upfront amount, not with the primary purpose of obtaining financing from the customer but, instead, to maximise profitability, taking into consideration the risks associated with providing the service. Specifically, if customers could pay monthly, they would be less likely to renew and the population of customers that continue to use the support service in the later years may become smaller and less diverse over time (ie customers that choose to renew historically are those that make greater use of the service, thereby increasing the entity's costs). In addition, customers tend to use services more if they pay monthly rather than making an upfront payment. Finally, the entity would incur higher administration costs such as the costs related to administering renewals and collection of monthly payments.

In assessing the requirements in paragraph 62(c) of IFRS 15, the entity determines that the payment terms were structured primarily for reasons other than the provision of finance to the entity. The entity charges a single upfront amount for the services because other payment terms (such as a monthly payment plan) would affect the nature of the risks assumed by the entity to provide the service and may make it uneconomical to provide the service. As a result of its analysis, the entity concludes that there is not a significant financing component.

Frequently asked questions

Question 5-21: The standard states that a significant financing component does not exist if the difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of finance. How broadly would this factor be applied?

(TRG meeting 30 March 2015 - Agenda paper no. 30)

According to IFRS 15, a significant financing component does not exist if the difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of finance. *[IFRS 15.62(c)]*. The TRG members discussed how broadly this factor would be applied.

The TRG members generally agreed that there is likely significant judgement involved in determining whether either party is providing financing or the payment terms are for another reason. The TRG members also generally agreed that the Board did not seem to intend to create a presumption that a significant financing component exists if the cash selling price differs from the promised consideration (or there is a long period of time between transfer of the goods and payment).

The TRG agenda paper noted that, although IFRS 15.61 states that the measurement objective for a significant financing component is to recognise revenue for the goods or services at an amount that reflects the cash selling price, this measurement objective is only followed when an entity has already determined that a significant financing component exists. *[IFRS 15.61]*. The fact that there is a difference in the promised consideration and the cash selling price is not a principle for determining whether a significant financing component actually exists. It is only one factor to consider.

Many TRG members noted that it requires significant judgement in some circumstances to determine whether a transaction includes a significant financing component.[81] The TRG members also acknowledged that when entities consider whether the difference between the promised consideration and cash selling price is for a reason other than financing, they must consider whether the difference between those amounts is proportional to the reason for the difference, as contemplated in IFRS 15.62(c).

Question 5-22: If the promised consideration is equal to the cash selling price, does a financing component exist?

(TRG meeting 30 March 2015 - Agenda paper no. 30)

The TRG members generally agreed that even if the list price, cash selling price and promised consideration of a good or service are all equal, an entity must not automatically assume that a significant financing component does not exist. This would be a factor to consider, but it would not be determinative.[82]

As discussed above in Question 5-21, while IFRS 15.61 states that the measurement objective for a significant financing component is to recognise revenue for the goods or services at an amount that reflects the cash selling price, this measurement objective is only followed when an entity has already determined that a significant financing component exists. The fact that there is no difference between the promised consideration and the cash selling price is not determinative in the evaluation of whether a significant financing component actually exists. It is a factor to consider, but it is not the only factor and is not determinative. As discussed above, an entity needs to consider all facts and circumstances in this evaluation.

The TRG agenda paper noted that the list price might not always equal the cash selling price (i.e., the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer, as defined in IFRS 15.61). For example, if a customer offers to pay cash upfront when the entity is offering 'free' financing to customers, the customer that offers the upfront payment might be able to pay less than the list price. Determining a 'cash selling price' might require judgement and the fact that an entity provides 'interest-free financing' does not necessarily mean that the cash selling price is the same as the price another customer would pay over time. Entities would have to consider the cash selling price in comparison to the promised consideration in making the evaluation based on the overall facts and circumstances of the arrangement.

81 TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015.

82 TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015.

This notion is consistent with IFRS 15.77 on allocating the transaction price to performance obligations based on stand-alone selling prices (see section 6.1 below), which indicates that a contractually stated price or a list price for a good or service may be (but is not presumed to be) the stand-alone selling price of that good or service. The TRG agenda paper noted that it might be possible for a financing component to exist, but that it might not be significant. As discussed above in this section, entities need to apply judgement in determining whether the financing component is significant.

Question 5-23: Does the standard preclude accounting for financing components that are not significant?

(TRG meeting 30 March 2015 - Agenda paper no. 30)

The TRG members generally agreed that the standard does not preclude an entity from deciding to account for a financing component that is not significant. For example, an entity might have a portfolio of contracts in which there is a mix of significant and insignificant financing components. An entity could choose to account for all of the financing components as if they were significant in order to avoid having to apply different accounting methods to each.

An entity electing to apply the requirements for significant financing components to an insignificant financing component would need to be consistent in its application to all similar contracts with similar circumstances.[83]

Question 5-24: How do entities consider whether the significant financing component practical expedient applies to contracts with a single payment stream for multiple performance obligations?

(TRG meeting 30 March 2015 - Agenda paper no. 30)

The standard includes a practical expedient that allows an entity not to assess a contract for a significant financing component if the period between the customer's payment and the entity's transfer of the goods or services is one year or less. *[IFRS 15.63]*. The TRG members generally agreed that entities either apply an approach of allocating any consideration received:

(1) To the earliest good or service delivered

Or

(2) Proportionately between the goods or services depending on the facts and circumstances

The TRG agenda paper on this topic provided an example of a telecommunications entity that enters into a two-year contract to provide a device at contract inception and related data services over 24 months in exchange for 24 equal monthly instalments.[84] Under approach (1) above, an entity would be allowed to apply the practical expedient because the period between transfer of the good or service and customer payment would be less than one year for both the device and the related services. This is because, in the example provided, the device would be 'paid off' after five months. Under approach (2) above, an entity would not be able to apply the practical expedient because the device would be deemed to be paid off over the full 24 months (i.e., greater than one year).

Approach (2) above would be appropriate in circumstances similar to the example in the TRG agenda paper, when the cash payment is not directly tied to the earliest good or service delivered in a contract. Approach (1) would be appropriate when the cash payment is directly tied to the earliest good or service delivered in a contract. However, the TRG members noted it might be difficult to tie a cash payment directly to a good or service because cash is fungible. Accordingly, judgement is required based on the facts and circumstances.[85]

Question 5-25: If a significant financing component exists in a contract, how does an entity calculate the adjustment to revenue?

(TRG meeting 30 March 2015 - Agenda paper no. 30)

The TRG members generally agreed that the standard does not contain requirements for how to calculate the adjustment to the transaction price due to a significant financing component. A financing component is recognised as interest expense (when the customer pays in advance) or interest income (when the customer pays in arrears). Entities need to consider requirements outside IFRS 15 to determine the appropriate accounting treatment (i.e., IFRS 9).[86]

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83 TRG Agenda paper no. 30, *Significant Financing Components*, dated 30 March 2015 and TRG Agenda paper no. 34, March 2015 Meeting - Summary of Issues Discussed and Next Steps, dated 13 July 2015.

84 TRG Agenda paper no. 30, *Significant Financing Components,* dated 30 March 2015.

85 TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015.

86 TRG Agenda paper no. 30, *Significant Financing Components*, dated 30 March 2015 and TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015.

Question 5-26: How does an entity allocate a significant financing component when there are multiple performance obligations in a contract?

(TRG meeting 30 March 2015 - Agenda paper no. 30)

The standard is clear that, when determining the transaction price in Step 3 of the model, the effect of financing is excluded from the transaction price prior to the allocation of the transaction price to performance obligations (which occurs in Step 4). However, stakeholders had questioned whether an adjustment for a significant financing component could ever be attributed to only one or some of the performance obligations in the contract, rather than to all of the performance obligations in the contract. This is because the standard only includes examples in which there is a single performance obligation.

The TRG members generally agreed that it might be reasonable for an entity to attribute a significant financing component to one or more, but not all, of the performance obligations in the contract. In doing so, the entity would analogise to the exceptions for allocating variable consideration and/or discounts to one or more (but not all) performance obligations, if specified criteria are met (see sections 6.3 and 6.4 below, respectively).[87] However, attribution of a financing component to one (or some) of the performance obligations requires the use of judgement, especially because cash is fungible.

Question 5-27: Is an entity required to evaluate whether a customer option that provides a material right includes a significant financing component? If so, how would entities perform this evaluation?

(TRG meeting 30 March 2015 - Agenda paper no. 32)

See response to Question 4-21 in section 4.6 above.

Question 5-28: Can an entity consider an interest expense arising from a customer contract with a significant financing component as borrowing costs eligible for capitalisation?

IAS 23 *Borrowing Costs* requires borrowing costs to be capitalised if they are directly attributable to the acquisition, construction or production of a qualifying asset (whether or not the funds have been borrowed specifically for that purpose) (see Chapter 22). *[IAS 23.8]*. IAS 23 and IFRS 15 do not specifically address whether interest expense arising from a customer contract with a significant financing component can be considered as borrowing costs eligible for capitalisation.

According to IAS 23, borrowing costs are "interest and other costs that an entity incurs in connection with the borrowing of funds". *[IAS 23.5]*. Interest expense arising from customer contracts with a significant financing component might qualify as borrowing costs eligible for capitalisation if they are directly attributable to the acquisition, construction or production of a qualifying asset.

For most revenue transactions, it is likely that entities would be considering inventory when determining whether there is a qualifying asset. According to IAS 23, inventory can be a qualifying asset, but "... inventories that are manufactured, or otherwise produced, over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired are not qualifying assets". *[IAS 23.7]*. Significant judgement might be needed to determine whether inventories take a substantial period of time to manufacture or produce before being ready for their intended use or sale. However, it might be helpful for an entity to consider how it satisfies its performance obligations as part of this determination. In particular, it is important to note that, if a performance obligation is satisfied over time, by definition, the customer obtains control of the good or service (and the entity derecognises any related inventory) as the entity performs. As discussed in Question 7-17 in section 7.1.4.E below, its performance would not result in the creation of a material asset in the entity's accounts (e.g., work in progress).

It is also important to note that capitalisation of borrowing costs is not required by IAS 23 for inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis even if they meet the definition of a qualifying asset. *[IAS 23.4(b)]*.

In late 2018, the IFRS IC received a request about the capitalisation of borrowing costs in relation to assets being developed for sale for which revenue is recognised over time as control transfers to the customer as the asset is constructed.

87 TRG Agenda paper no. 30, *Significant Financing Components*, dated 30 March 2015 and TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015.

At its March 2019 meeting, the IFRS IC noted that, when applying IAS 23 an entity assesses whether there is a qualifying asset (i.e., an asset that necessarily takes a substantial period of time to get ready for its intended use or sale). The request referred to real estate units, which might take a substantial period of time to construct. However, the IFRS IC concluded that:

- *For any sold units:* there is no qualifying asset. When any of the criteria in IFRS 15.35 are met (and revenue is recognised over time), control transfers to the customer as the entity performs. Therefore, the entity holds no inventory. Instead, it recognises a receivable or contract asset for its right to receive consideration in exchange for its performance to date. IAS 23 explicitly states that receivables are not a qualifying asset. *[IAS 23.7]*. Like receivables, the intended use of a contract assets is to collect cash (or another asset), which is not a use for which it necessarily takes a substantial period of time to get ready. Therefore, the IFRS IC observed that contract assets are also not qualifying assets.
- *For any unsold units:* any inventory (work-in-progress) for unsold units under construction is not a qualifying asset if: (i) the entity intends to sell the part-completed units as soon as it finds suitable customers - this is because the units are already ready for sale in their part-completed state; and (ii) control of the part-completed units transfers to the customer on signing the contract (which is the case if revenue is recognised over time).[88]

5.5.5 Financial statement presentation of financing component

As discussed above, when a significant financing component exists in a contract, the transaction price is adjusted so that the amount recognised as revenue is the 'cash selling price' of the underlying goods or services at the time of transfer. Essentially, a contract with a customer that has a significant financing component would be separated into a revenue component (for the notional cash selling price) and a loan component (for the effect of the deferred or advance payment terms). *[IFRS 15.BC244]*. Consequently, the accounting for accounts receivable arising from a contract that has a significant financing component should be comparable to the accounting for a loan with the same features. *[IFRS 15.BC244]*.

The amount allocated to the significant financing component would have to be presented separately from revenue recognised from contracts with customers. The financing component is recognised as interest expense (when the customer pays in advance) or interest income (when the customer pays in arrears). The interest income or expense is recognised over the financing period using the effective interest method described in IFRS 9. The standard notes that interest is only recognised to the extent that a contract asset, contract liability or receivable is recognised in accordance with IFRS 15. *[IFRS 15.65]*. For entities that apply IFRS 18 *Presentation and Disclosure in Financial Statements* early, IFRS 18 clarifies that interest expenses on contract liabilities with significant financing components must be classified in the financing category in the statement of profit or loss. This is required regardless of whether the entity has a specified main business activity of providing financing to customers. See Chapter 4 for further detail on the new concepts and classification requirements in IFRS 18. *[IFRS 18.61, IFRS 18.65(b)(i), IFRS 18.B53(b), IFRS 18.B54(b)]*.

As discussed in section 10.1 below, a contract asset (or receivable) or contract liability is generated (and presented on the balance sheet) when either party to a contract performs, depending on the relationship between the entity's performance and the customer's payment. Example 26 in the standard (see section 5.5.4 above) illustrates a situation in which an entity transfers control of a good to a customer, but the customer is not required to pay for the good until two years after delivery. The contract includes a significant financing component. Furthermore, the customer has the right to return the good for 90 days. The product is new and the entity does not have historical evidence of returns activity. Therefore, the entity is not able to recognise revenue (or a contract asset or receivable) upon delivery because it cannot assert that it is highly probable that a significant revenue reversal will not occur (i.e., it cannot assert that it is highly probable that the product will not be returned). Accordingly, during the 90-day return period, the entity also cannot record interest income. However, as depicted in the example, once the return period lapses, the entity can record revenue and a receivable, as well as begin to recognise interest income.

The IASB noted in the Basis for Conclusions that the requirement in IFRS 15.65 does not preclude an entity from presenting interest income as revenue when interest income represents income from an entity's ordinary activities, which might be the case for banks and other entities with similar types of operations. *[IFRS 15.BC247]*.

88 *IFRIC Update*, March 2019, available on the IFRS Foundation's website.

Although there are two components within the contract when there is a significant financing component (i.e., the revenue component and the significant financing component), it is only in the case of deferred payment terms that there are two cash flow components. In that case, the revenue component cash flows are classified as cash flows from operating activities, and the cash flows related to the significant financing component are classified consistent with the entity's choice to present cash flows from interest received in accordance with IAS 7.33 (i.e., as cash flows from operating or investing activities). If the customer pays in advance, the sum of the cash amount and the accrued interest represent revenue, and thus there is only one cash flow component. Accordingly, the cash received is classified as cash flows from operating activities. See Chapter 36 at section 7.3 for further discussion. For entities that apply IFRS 18 and the consequential amendments to IAS 7 early, the amendments to IAS 7 clarify that interest received must be classified as cash flows from investing activities. However, entities that have a specified main business activity (see Chapter 4) must instead classify interest received by reference to how interest income is classified in the statement of profit or loss. *[IAS 7(2027).34A(b), IAS 7(2027).34B]*.

Impairment losses on receivables, with or without a significant financing component, are presented in line with the requirements of IAS 1 (or IFRS 18 if applied early) and disclosed in accordance with IFRS 7 *Financial Instruments: Disclosures*. However, IFRS 15 makes it clear that such amounts are disclosed separately from impairment losses from other contracts. *[IFRS 15.113(b)]*.

How we see it

We believe entities might need to expend additional effort to track impairment losses on assets arising from contracts that are within the scope of IFRS 15 separately from impairment losses on assets arising from other contracts. Entities need to ensure that they have the appropriate systems, internal controls, policies and procedures in place to collect and separately present this information.

5.6 Non-cash consideration

Customer consideration might be in the form of goods, services or other non-cash consideration (e.g., property, plant and equipment, a financial instrument). When an entity (i.e., the seller or vendor) receives, or expects to receive, non-cash consideration, the fair value of the non-cash consideration is included in the transaction price. *[IFRS 15.66]*.

It is likely that an entity will apply the requirements of IFRS 13 *Fair Value Measurement* or IFRS 2 when measuring the fair value of any non-cash consideration. If an entity cannot reasonably estimate the fair value of non-cash consideration, it measures the non-cash consideration indirectly by reference to the stand-alone selling price of the promised goods or services. *[IFRS 15.67]*. Significant judgement and consideration of specific facts and circumstances might be required in such situations (e.g., advertising barter transactions, see section 5.6.2 below for further discussion on barter transactions).

For contracts with both non-cash consideration and cash consideration, an entity needs to measure the fair value of the non-cash consideration and it looks to other requirements within IFRS 15 to account for the cash consideration. For example, for a contract in which an entity receives non-cash consideration and a sales-based royalty, the entity would measure the fair value of the non-cash consideration and refer to the requirements within the standard for the sales-based royalties.

The fair value of non-cash consideration might change both because of the form of consideration (e.g., a change in the price of a share an entity is entitled to receive from a customer) and for reasons other than the form of consideration (e.g., a change in the exercise price of a share option because of the entity's performance). Under IFRS 15, if an entity's entitlement to non-cash consideration promised by a customer is variable for reasons other than the form of consideration (i.e., there is uncertainty as to whether the entity receives the non-cash consideration if a future event occurs or does not occur), the entity considers the constraint on variable consideration. *[IFRS 15.68]*.

In some transactions, a customer contributes goods or services, such as equipment or labour, to facilitate the fulfilment of the contract. If the entity obtains control of the contributed goods or services, it would consider them non-cash consideration and account for that consideration as described above. *[IFRS 15.69]*. Assessing whether the entity obtains control of the contributed goods or services by the customer might require judgement.

The Board also noted that any assets recognised as a result of non-cash consideration are accounted for in accordance with other relevant IFRS accounting standards (e.g., IAS 16). *[IFRS 15.BC253]*.

The standard provides the following example of a transaction for which non-cash consideration is received in exchange for services provided: *[IFRS 15.IE Example 31, IFRS 15.IE156-IE158]*

Extract from IFRS 15

Example 31-Entitlement to non-cash consideration

An entity enters into a contract with a customer to provide a weekly service for one year. The contract is signed on 1 January 20X1 and work begins immediately. The entity concludes that the service is a single performance obligation in accordance with paragraph 22(b) of IFRS 15. This is because the entity is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress-that is, a time-based measure of progress).

In exchange for the service, the customer promises 100 shares of its common stock per week of service (a total of 5,200 shares for the contract). The terms in the contract require that the shares must be paid upon the successful completion of each week of service.

The entity measures its progress towards complete satisfaction of the performance obligation as each week of service is complete. To determine the transaction price (and the amount of revenue to be recognised), the entity measures the fair value of 100 shares that are received upon completion of each weekly service. The entity does not reflect any subsequent changes in the fair value of the shares received (or receivable) in revenue.

5.6.1 Non-cash consideration application considerations

Stakeholders raised questions about the date to use when measuring the fair value of non-cash consideration for inclusion within the transaction price. In addition, constituents noted that the variability of non-cash consideration could arise both from its form (e.g., shares) and for other reasons (e.g., performance factors that affect the amount of consideration to which the entity will be entitled). Consequently, they questioned how the constraint on variable consideration would be applied in such circumstances.

At the January 2015 TRG meeting, the TRG members discussed these questions and agreed that, while the standard requires non-cash consideration (e.g., shares, advertising provided as consideration from a customer) to be measured at fair value, it is unclear when that fair value must be measured (i.e., the measurement date). The TRG members discussed three measurement date options:

- Contract inception
- When the non-cash consideration is received (or receivable)

  Or
- At the earlier of (i) when the non-cash consideration is received (or is receivable) and (ii) when (or as) the related performance obligation is satisfied

Consider Example 31 in the standard (included in section 5.6 above). Under the first view, the entity would measure fair value of all of the 5,200 shares on 1 January 20X1 (i.e., contract inception). Under the second view (which is illustrated in Example 31), it would measure the fair value of 100 shares at the end of each week, since this is when each week's shares are received (or receivable). Under the third view, the entity would measure the fair value of the weekly 100 shares over the course of each week. This is because the entity satisfies its performance obligation over time each week and this is earlier than when the non-cash consideration is received (or receivable), which is at the end of the week. As noted in Example 31, the entity does not reflect any subsequent changes in fair value in revenue. *[IFRS 15.IE158]*.

Each view received support from some TRG members.[89] Since IFRS 15 does not specify the measurement date, an entity needs to use its judgement to determine the most appropriate measurement date when measuring the fair value of non-cash consideration. However, in accordance with IFRS 15.126, information about the methods, inputs and assumptions used to measure non-cash consideration needs to be disclosed. *[IFRS 15.126, IFRS 15.BC254E]*.

Whichever method is selected, the objective is to choose a single measurement date. That is, the fact that IFRS 15 does not specify the measurement date does not change the requirement in the standard not to update the fair value measurement if the reason for the change is solely because of its form (i.e., because it is non-cash). *[IFRS 15.68]*.

89 TRG Agenda paper no. 15, *Noncash consideration*, dated 26 January 2015, and TRG Agenda paper no. 25, *January 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 30 March 2015.

IFRS 15 requires that the constraint on variable consideration be applied to non-cash consideration only if the variability is due to factors other than the form of consideration (i.e., variability arising for reasons other than changes in the price of the non-cash consideration). The constraint does not apply if the non-cash consideration varies because of its form (e.g., listed shares for which the share price changes). However, the standard does not address how the constraint would be applied when the non-cash consideration is variable due to both its form and other reasons. While some of the TRG members said the standard could be interpreted to require an entity to split the consideration based on the source of the variability, other TRG members highlighted that this approach would be overly complex and would not provide useful information.

FASB differences

The FASB's standard specifies that the fair value of non-cash consideration needs to be measured at contract inception when determining the transaction price. Any subsequent changes in the fair value of the non-cash consideration due to its form (e.g., changes in share price) are not included in the transaction price and would be recognised, if required, as a gain or loss in accordance with other accounting standards, but would not be recognised as revenue from contracts with customers. The use of a measurement date other than contract inception would not be precluded under IFRS accounting standards. *[IFRS 15.BC254E]*.

The FASB's standard also specifies that when the variability of non-cash consideration is due to both the form of the consideration and for other reasons, the constraint on variable consideration would apply only to the variability for reasons other than its form. While IFRS 15 does not have a similar requirement, the IASB decided to constrain variability in the estimate of the fair value of the non-cash consideration if that variability relates to changes in the fair value for reasons other than the form of the consideration. In practice, it might be difficult to distinguish between variability in the fair value due to the form of the consideration and other reasons, in which case applying the variable consideration constraint to the whole estimate of the non-cash consideration might be more practical. *[IFRS 15.BC252]*.

5.6.2 Barter transactions

An entity might enter into barter transactions to provide goods or services in exchange for receiving similar or dissimilar goods or services from its customers. In some cases, barter transactions include cash consideration in addition to the non-cash consideration. IFRS 15 does not contain specific requirements for barter transactions. Therefore, significant judgement and consideration of the specific facts and circumstances will be needed when accounting for such transactions.

Aspects of the standard that will be particularly important to consider include, but are not limited to:

- *Understanding whether the transaction is within the scope of the standard* - barter transactions involve non-monetary exchanges. Therefore, an entity first needs to determine whether the barter transaction involves a non-monetary exchange between entities in the same line of business to facilitate sales to (potential) customers. If it does, it is excluded from the scope of IFRS 15 (see section 2.1.1 above). For barter transactions not subject to this scope exclusion (i.e., they are within the scope of IFRS 15), an entity needs to understand whether there is vendor-customer relationship with the counterparty and whether the transaction is in the ordinary course of its business. This is because IFRS 15 only applies to contracts that provide goods or services to customers in the ordinary course of business (see sections 2.1 and 2.3 above).
- *Determining whether the transaction has commercial substance (such that the contract meets the criteria to be considered a contract under the five-step model in* IFRS 15*)* - exchanging goods or services in a barter transaction might lack commercial substance. An entity needs to determine whether the risk, timing or amount of an entity's future cash flows change as a result of the barter transaction (see section 3.1.4 above).
- *Identifying the promised goods or services to be transferred to the customer* - barter transactions might involve the exchange of a good or service, but not necessarily the transfer of its control. An entity needs to understand whether the customer will obtain control of a good or service (see section 7 below). That is, whether there is a promised good or service in the contract (see section 4.1 above).
- *Determining whether the entity will obtain control of any non-cash consideration* - barter transactions involve the exchange of non-cash items. Only non-cash items for which the entity obtains control from the customer would be non-cash consideration for purposes of applying the standard (as noted above in this section).

- *Determining the fair value of any non-cash consideration received from the customer (see section 5.6 above)* - in order to recognise revenue in the barter transaction, the non-cash consideration obtained from a customer needs to be measured either: (a) directly, at its fair value if it can be reasonably estimated; or (b) indirectly, by reference to the stand-alone selling price of the promised good or service transferred to the customer if the fair value of the non-cash consideration cannot be reasonably estimated. IFRS 15 does not permit an entity to avoid recognising revenue if the fair value cannot be estimated reliably. Therefore, if the transaction is within the scope of IFRS 15, revenue must be recognised.

5.7 Consideration paid or payable to a customer

Many entities make payments to their customers. In some cases, the consideration paid or payable represents purchases by the entity of goods or services offered by the customer that satisfy a business need of the entity. In other cases, the consideration paid or payable represents incentives given by the entity to entice the customer to purchase, or continue purchasing, its goods or services.

The standard provides the following requirements for consideration paid or payable to a customer: *[IFRS 15.70, IFRS 15.71, IFRS 15.72]*

Extract from IFRS 15

Consideration payable to a customer

70 Consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer). Consideration payable to a customer also includes credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer). An entity shall account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service (as described in paragraphs 26-30) that the customer transfers to the entity. If the consideration payable to a customer includes a variable amount, an entity shall estimate the transaction price (including assessing whether the estimate of variable consideration is constrained) in accordance with paragraphs 50-58.

71 If consideration payable to a customer is a payment for a distinct good or service from the customer, then an entity shall account for the purchase of the good or service in the same way that it accounts for other purchases from suppliers. If the amount of consideration payable to the customer exceeds the fair value of the distinct good or service that the entity receives from the customer, then the entity shall account for such an excess as a reduction of the transaction price. If the entity cannot reasonably estimate the fair value of the good or service received from the customer, it shall account for all of the consideration payable to the customer as a reduction of the transaction price.

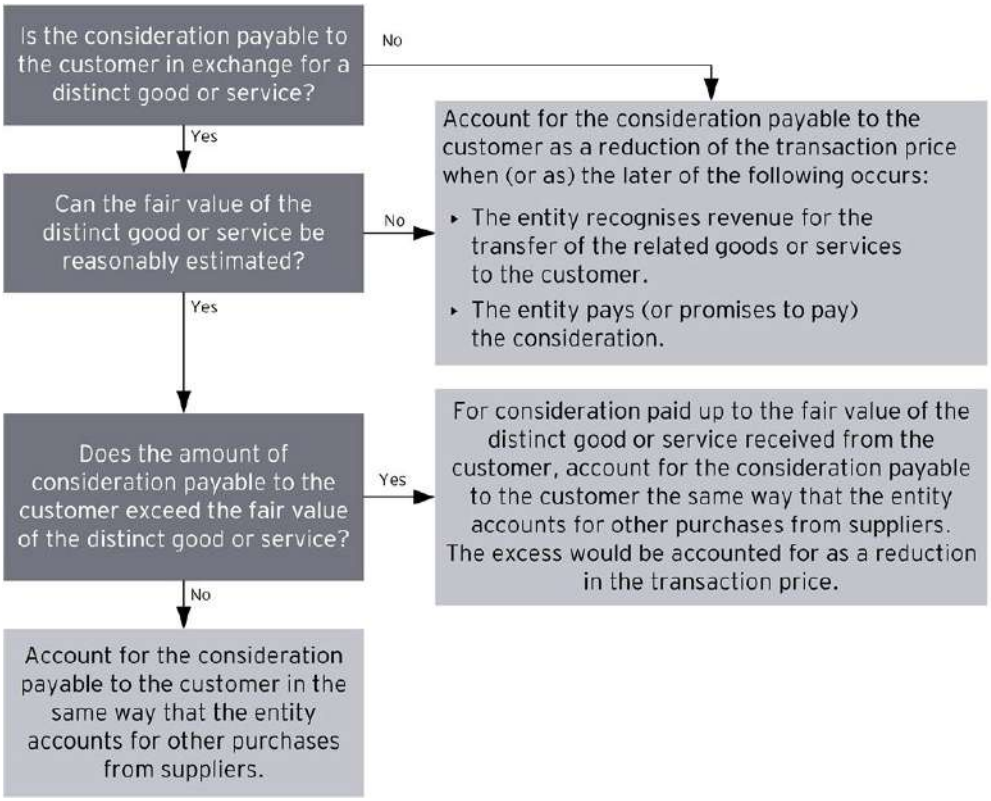
72 Accordingly, if consideration payable to a customer is accounted for as a reduction of the transaction price, an entity shall recognise the reduction of revenue when (or as) the later of either of the following events occurs:

(a) the entity recognises revenue for the transfer of the related goods or services to the customer; and

(b) the entity pays or promises to pay the consideration (even if the payment is conditional on a future event). That promise might be implied by the entity's customary business practices.

Figure 5-3 below illustrates these requirements.

Figure 5-3: Consideration payable to a customer



The standard indicates that an entity accounts for the consideration payable to a customer, regardless of whether the purchaser receiving the consideration is a direct or indirect customer of the entity. This includes consideration to any purchasers of the entity's products at any point along the distribution chain. This would include entities that make payments to the customers of resellers or distributors that purchase directly from the entity (e.g., manufacturers of breakfast cereals might offer coupons to end-consumers, even though their direct customers are the grocery stores that sell to end-consumers). The requirements in IFRS 15 apply to entities that derive revenue from sales of services, as well as entities that derive revenue from sales of goods.

The requirements for consideration payable to a customer may also be helpful for entities receiving such consideration from vendors to consider in the absence of other, specific guidance. For further discussion of this topic, refer to our publication *Applying IFRS: Accounting for Payments from Suppliers*.[90]

Frequently asked questions

Question 5-29: Who is considered to be an entity's customer when applying the requirements for consideration payable to a customer?

(TRG meetings 30 March 2015 - Agenda paper no. 28; and 13 July 2015 - Agenda paper no. 37)

The TRG members generally agreed that the requirements for consideration payable to a customer apply to all payments made to entities/customers in the distribution chain for that contract. However, they agreed that there could also be situations in which the requirements would apply to payments made to any customer of an entity's customer outside the distribution chain if both parties are considered the entity's customers. For example, in an arrangement with a principal, an agent and an end-consumer, an agent might conclude that its only customer is the principal or it might conclude that it has two customers - the principal and the end-consumer. Regardless of this assessment, an agent's payment to a principal's end-consumer that was contractually required based on an agreement between the entity (agent) and the principal would represent consideration payable to a customer. Absent similar contract provisions that clearly indicate when an amount is consideration payable, the TRG members agreed that agents need to evaluate their facts and circumstances to determine whether payments made to an end-consumer would be considered a reduction of revenue or a marketing expense.[91]

90 Available on www.ey.com/IFRS.

91 TRG Agenda paper no. 28, *Consideration Payable to a Customer*, dated 30 March 2015, TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015, and TRG Agenda paper no. 37, *Consideration Payable to a Customer*, dated 13 July 2015.

Question 5-30: How does an entity that acts as an agent account for incentive payments made to end-consumers that are not the entity's customers and are outside the distribution chain?

An entity might make incentive payments to an end-consumer that is not the entity's direct customer and is not identified as an indirect customer (e.g., the end-consumer does not purchase the entity's goods or services at any point along the distribution chain). Incentive payments of this nature might be common in arrangements in which an entity acts as an agent to facilitate the sale of its customer's (i.e., the principal's) goods or services to an end-consumer (e.g., incentive payments offered by platform entities). The entity will need to apply significant judgement to determine: (1) whether the end-consumer is a customer (see section 2.3 above); and (2) the appropriate accounting treatment for incentive payments made to an end-consumer that is not identified as a customer (e.g., whether to account for the payment as a reduction of revenue or as a marketing expense).

The entity first has to consider whether the payment to the end-consumer is in exchange for a distinct good or service acquired from the end-consumer at fair value. If it is, the entity must account for the payment in the same way it accounts for other purchases from suppliers. *[IFRS 15.71]*. If the incentive payment is not in exchange for a distinct good or service, the entity will need to apply significant judgement to determine whether the payment results in a reduction to revenue.

In a speech, a member of the US SEC staff noted that, when determining whether incentive payments need to be recorded as a reduction of revenue, it is important to consider whether the entity has a contractual or an implied obligation to provide incentives to the end-consumer on the seller's behalf. The SEC staff member noted that this includes assessing whether an entity is, in substance, providing a price concession to the seller. For example, a company would consider whether "the seller would have a valid expectation that the company would provide incentives to the end user".[92]

An entity's customer might have a valid expectation that the payment will be made to the end-consumer based on reasonably available information about the entity's incentive programme, including written or oral communications (e.g., advertisements, press releases, published policies, customer reporting) and any customary business practices of the entity. Entities will need to carefully consider their facts and circumstances to determine whether a valid expectation exists.

Similar to a contractually required obligation, an implied obligation to a customer to provide incentive payments to an end-consumer is accounted for as consideration payable to a customer and results in a reduction to the transaction price if the payment to the end-consumer is not in exchange for a distinct good or service.

In certain arrangements, an entity might make a payment to an end-consumer in exchange for a distinct good or service and the payment exceeds the fair value of that good or service. The entity will need to apply significant judgement in these arrangements to determine whether the excess payment represents an implied obligation to its customer. If the entity determines the excess payment is an implied obligation to the customer, then the excess payment must result in a reduction to the transaction price. *[IFRS 15.71]*.

Given the judgement involved with such arrangements, an entity needs to consider the disclosure requirements in IFRS 15.123 and IFRS 15.126 (see section 10.5.2 below).

92 Speech by Jonathan Wiggins, Senior Associate Chief Accountant, SEC Office of the Chief Accountant, 6 December 2021. Refer to our publication: *2021 AICPA & CIMA Conference on Current SEC and PCAOB Developments*.

5.7.1 Forms of consideration paid or payable to a customer

Consideration paid or payable to customers commonly takes the form of discounts and coupons, among others. Furthermore, the promise to pay the consideration might be implied by the entity's customary business practice, as stated in IFRS 15.72. *[IFRS 15.72]*.

Since consideration paid or payable to a customer can take many different forms, entities have to carefully evaluate each transaction to determine the appropriate treatment of such amounts (i.e., as payment for a distinct good or service, a reduction of the transaction price or a combination of both, as illustrated in Figure 5-3 in section 5.7 above). Some common examples of consideration paid to customers are given below:

- **Slotting fees** - Manufacturers of consumer products commonly pay retailers fees to have their goods displayed prominently on store shelves. Generally, such fees do not provide a distinct good or service to the manufacturer and are treated as a reduction of the transaction price.
- **Co-operative advertising arrangements** - In some arrangements, an entity agrees to reimburse a reseller for a portion of costs incurred by the reseller to advertise the entity's products. The determination of whether the payment from the vendor is in exchange for a distinct good or service at fair value depends on a careful analysis of the facts and circumstances of the contract.
- **Price protection** - An entity might agree to reimburse a retailer up to a specified amount for shortfalls in the sales price received by the retailer for the entity's products over a specified period of time. Normally such fees do not provide a distinct good or service to the manufacturer and are treated as a reduction of the transaction price (see Question 5-7 in section 5.2.1 above).
- **Coupons and rebates** - An indirect customer of an entity might receive a refund of a portion of the purchase price of the product or service acquired by returning a form to the retailer or the entity. Generally, such fees do not provide a distinct good or service to the manufacturer and are treated as a reduction of the transaction price.
- **'Pay-to-play' arrangements** - In some arrangements, an entity pays an upfront fee to the customer prior to, or in conjunction with, entering into a contract. In most cases, these payments are not associated with any distinct good or service to be received from the customer and are treated as a reduction of the transaction price.
- **Purchase of goods or services** - Entities often enter into supplier-vendor arrangements with their customers in which the customers provide them with a distinct good or service. For example, a software entity buys its office supplies from one of its software customers. In such situations, the entity has to carefully determine whether the payment made to the customer is solely for the goods or services received or whether part of the payment is actually a reduction of the transaction price for the goods or services the entity is transferring to the customer.

Frequently asked questions

Question 5-31: Which payments to a customer are within the scope of the requirements for consideration payable to a customer?

(TRG meetings 30 March 2015 - Agenda paper no. 28; and 13 July 2015 - Agenda paper no. 37)

The TRG members generally agreed that an entity does not need to separately analyse each payment to a customer if it is apparent that the payment is for a distinct good or service acquired in the normal course of business at a market price. However, if the business purpose of a payment to a customer is unclear or the goods or services are acquired in a manner that is inconsistent with market terms that other entities would receive when purchasing the customer's good or services, the payment needs to be evaluated under these requirements.[93]

In the Basis for Conclusions, the IASB noted that the amount of consideration received from a customer for goods or services and the amount of any consideration paid to that customer for goods or services could be linked even if they are separate events. *[IFRS 15.BC257]*.

Question 5-32: Do litigation settlements payable by an entity to its customer represent consideration payable to a customer?

An entity might be sued (for example, as a result of anti-competition investigations related to the price of the goods or services) by a current or previous customer in relation to goods or services that have already been transferred (or partially transferred) to a customer. If the entity is ordered to pay compensation to the customer, the entity needs to consider the accounting for the payment and the corresponding effects on the entity's statement of profit or loss. However, not all disputes with customers result in third-party arbitration or litigation proceeding. For example, an entity might agree to transfer consideration to a customer because of a resolution negotiated only between the entity and the customer.

Entities need to carefully consider all relevant facts and circumstances to determine the appropriate accounting, including whether compensation paid represents consideration payable to a customer. Factors to consider include whether the litigation is related to a revenue contract and whether the contract related to the litigation was previously completed, which might require judgement to determine.

If a litigation settlement is related to a revenue contract and that contract is not completed, IFRS 15 would apply unless it is covered by an assurance type warranty accounted for in accordance with IAS 37 (see section 9.1.3 below).

If a litigation settlement is related to a revenue contract and that contract is completed, an entity might conclude it is appropriate to apply IAS 37 to account for any (contingent) liability because there is no longer a contract or a customer relationship. If the entity reaches that conclusion, the compensation to the customer charged by the court's decision would not be part of the price that the parties agreed for the completed contract, nor related to any future contracts with that customer. However, an entity that applies IAS 37 might determine that it only applies to the recognition and measurement of any provision and not to the impact on profit or loss, and that, instead, it would apply IFRS 15 to determine the classification in profit or loss, in accordance with the requirements for consideration payable to a customer. This is because IAS 37 states that "Other Standards specify whether expenditures are treated as assets or as expenses. These issues are not addressed in this Standard". *[IAS 37.8]*.

However, an entity might conclude that only IFRS 15 applies because IAS 37 excludes from its scope any provision, contingent liability or contingent asset addressed by IFRS 15, except for onerous contracts, *[IAS 37.5(g)]*, and IFRS 15 provides specific requirements for consideration payable to a customer. Although there is no longer a contract or customer relationship, the litigation is directly attributable to a previously completed customer contract, and an entity might thus conclude it is reasonable, considering the scope exemption in IAS 37, to apply IFRS 15.

If an entity applies IFRS 15, it might need to apply the requirements for contract modifications. This is because, as a result of the court's decision, the entity has an enforceable obligation to pay the customer and an (implicit or explicit) agreement between the entity and customer leads to a reduction of the total consideration in the original contract. *[IFRS 15.10, IFRS 15.18]*. If the court finds in favour of the customer, but the amount to pay is not finalised, the consideration payable to the customer would be variable, *[IFRS 15.19, IFRS 15.50]*, and the entity would need to apply the variable consideration requirements (including the constraint).

93 TRG Agenda paper no. 28, *Consideration Payable to a Customer*, dated 30 March 2015, TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015, and TRG Agenda paper no. 37, *Consideration Payable to a Customer*, dated 13 July 2015.

How we see it

If the revenue contract related to the litigation is not yet completed, an entity needs to apply IFRS 15 to account for the litigation settlement as consideration payable to a customer, unless it is covered by an assurance-type warranty that is accounted for under IAS 37.

If the revenue contract related to the litigation was previously completed, we believe an entity needs to apply judgement, based on the specific facts and circumstances, to determine whether to either apply IAS 37 or IFRS 15 to account for any (contingent) liability, and apply the judgement consistently to similar transactions. Even if IAS 37 is applied to the liability for litigation settlements, an entity might conclude that, because it is a payment to a customer, the requirements for consideration payable to a customer apply when determining the classification in profit or loss, which might result in a reduction of revenue.

For settlements of litigation or disputes that result in consideration received or receivable from a customer, please see response to Question 5-9 in section 5.2.1 above.

FASB differences

Under US GAAP, equity instruments granted to customers in conjunction with selling goods or services (e.g., shares, options) are within the scope of the requirements for consideration payable to customers.[94] Entities are also required to measure and classify share-based payment awards (both equity-classified and liability-classified) granted to a customer in a revenue arrangement and are not in exchange for a distinct good or service in accordance with ASC 718, *Compensation - Stock Compensation*.[95]

IFRS 15 does not include similar requirements. For further discussion, see Question 2-13 in section 2.5 above.

5.7.2 Classification and measurement of consideration paid or payable to a customer

To determine the appropriate accounting treatment (and as illustrated in Figure 5-3 in section 5.7 above), an entity must first determine whether the consideration paid or payable to a customer is a payment for a distinct good or service. If it is not in exchange for a distinct good or service, an entity accounts for consideration payable to a customer as a reduction in the transaction price. This is because IFRS 15.70 states that "an entity shall account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment is for a distinct good or service" (see section 5.7 above). *[IFRS 15.70]*. That is, for a payment by the entity to a customer to be treated as something other than a reduction of the transaction price, the good or service provided by the customer must be distinct (as discussed in section 4.2.1 above).

If it is in exchange for a distinct good or service at fair value, an entity accounts for consideration payable to a customer in the same way it accounts for other purchases from suppliers. However, as noted in IFRS 15.71, if the payment to the customer is in excess of the fair value of the distinct good or service received, the entity must account for such excess as a reduction of the transaction price. In the event that the entity cannot reasonably estimate the fair value of the good or service received from the customer, it will need to account for all of the consideration payable to the customer as a reduction in the transaction price. *[IFRS 15.71]*.

Illustration 5-7: Consideration paid to a customer in exchange for a distinct good or service

Entity A enters into a contract to sell goods to Customer B in the ordinary course of business in exchange for cash consideration. Separately, Entity A enters into an agreement to purchase market research from Customer B related to the launch of a new product in exchange for cash consideration. The two contracts were not negotiated in contemplation of one another.

Entity A elects to purchase the market research, rather than internally developing such knowledge because of Customer's B expertise in this area. Entity A could purchase similar services from a non-customer.

94 ASU 2018-07, *Compensation - Stock Compensation (718): Improvements to Nonemployee Share-Based Payment accounting*.

95 ASU 2019-08, *Compensation - Stock Compensation (Topic 718) and Revenue from Contracts with Customers (Topic 606): Codification Improvements - Share-Based Consideration Payable to a Customer*.

Based on an evaluation of the circumstances, the cash consideration paid to the customer is in return for Customer B providing distinct services to Entity A. To reach this conclusion, Entity A considers the requirements in IFRS 15.27-30 and concludes that the market research services are capable of being distinct, as well as separately identifiable (or distinct within the context of the contract), from Entity A's sale of its goods to Customer B.

Entity A determines that market research is capable of being distinct from the sale of its goods to Customer B because the market research could be purchased from a non-customer. Therefore, Entity A is able to demonstrate that the market research can provide benefits on its own or with other readily available resources.

Entity A determines that the market research is distinct within the context of the contract because of the following:

- Customer B is not providing a significant service of integrating the market research with the purchases of Entity A's goods because the promises to Entity A are not a combined output of integrated goods or services.
- The market research provided by Customer B does not modify or customise the purchases of Entity A's goods. The market research and the purchases of goods are not being assembled together to produce a combined output.
- The market research is not highly interrelated or interdependent with the sale of Entity A's goods because the market research is not needed for Customer B to purchase the goods. That is, there is no significant two-way dependency between the promises.

Entity A accounts for the cash consideration paid to Customer B in the same way that it accounts for other purchases from suppliers, provided that the cash consideration paid does not exceed the fair value of the distinct services received from Customer B. If the amount of cash consideration paid by Entity A exceeds the fair value of the distinct services, that excess amount would be characterised as a reduction of the transaction price of the goods sold to Customer B in Entity A's income statement.

In many cases, determining the amount of consideration payable to a customer (e.g., cash amounts an entity pays to a customer) will be straightforward. However, if the consideration paid or payable to a customer includes a variable amount, IFRS 15.70 notes that an entity would estimate the amount using the variable consideration requirements in IFRS 15.50-58 (see section 5.2 above). *[IFRS 15.70]*.

5.7.3 Timing of recognition of consideration paid or payable to a customer

If the consideration paid or payable to a customer is accounted for as a reduction of the transaction price, IFRS 15.72 states that this reduction of the transaction price (and, ultimately, revenue) is recognised at the later of when: (1) the entity recognises revenue for the transfer of the related promised goods or services to the customer; or (2) the entity pays or promises to pay the consideration (even if the payment is conditional on a future event) (see section 5.7 above). *[IFRS 15.72]*. For example, if goods subject to a discount through a coupon are already delivered to the retailers, the discount would be recognised when the coupons are issued. However, if a coupon is issued that can be used on a new line of products that have not yet been sold to retailers, the discount would be recognised upon sale of the products to a retailer. IFRS 15.82(b) also notes that the promise to pay the consideration might be implied by an entity's customary business practices. *[IFRS 15.82(b)]*.

Certain sales incentives, such as mail-in rebates and manufacturer coupons, entitle a customer to receive a reduction in the price of goods or services by submitting a form or claim for a refund of a specified amount of the price charged to the customer at the point of sale. An entity must recognise a liability for those sales incentives at the later of: (a) when it recognises revenue on the goods or services; or (b) the date at which the sales incentive was offered. The amount of liability will be based on the estimated amount of discounts or refunds that will be claimed by customers, similar to how the entity would estimate variable consideration (see section 5.2.2 above).

Even if the sales incentives would result in a loss on the sale of the product or service, an entity would also recognise a liability for those sales incentives at the later of: (a) when it recognises revenue on the goods or services; or (b) the date at which the sales incentive was offered. That is, an entity would not recognise the loss before either date. However, an entity would need to consider whether the offer indicates that the net realisable value of inventories is lower than cost, which will require write-down of inventories to net realisable value. *[IAS 2.9, IAS 2.28]*.

To determine the appropriate timing of recognition of consideration payable to a customer, entities also need to consider the requirements for variable consideration. That is, the standard's description of variable consideration is broad and includes amounts such as coupons or other forms of credits that can be applied to the amounts owed to an entity by the customer (see section 5.2.1 above). IFRS 15 requires that all potential variable consideration be considered and reflected in the transaction price at contract inception and reassessed as the entity performs. In other words, if an entity has a history of providing this type of consideration to its customers, the requirements on estimating variable consideration would require that such amounts be considered at contract inception, even if the entity has not yet provided or explicitly promised this consideration to the customer.

The TRG discussed the potential inconsistency that arises between the requirements on consideration payable to a customer and variable consideration because the requirements specific to consideration payable to a customer indicate that such amounts are not recognised as a reduction of revenue until the *later* of when:[96]

- The related sales are recognised

  Or

- The entity promises to provide such consideration

A literal read of these requirements seems to suggest that an entity need not anticipate offering these types of programmes, even if it has a history of doing so, and would only recognise the effect of these programmes at the later of when the entity transfers the promised goods or services or makes a promise to pay the customer. The TRG members generally agreed that if an entity has historically provided or intends to provide this type of consideration to customers, the requirements on estimating variable consideration (i.e., IFRS 15.50-52) would require the entity to consider such amounts at contract inception when the transaction price is estimated, even if the entity has not yet provided or promised to provide this consideration to the customer.[97] If the consideration paid or payable to a customer includes variable consideration (e.g., in the form of a discount or refund for goods or services provided), an entity would use either the expected value method or most likely amount method to estimate the amount to which the entity expects to be entitled and apply the constraint to the estimate (see section 5.2.3 above for further discussion) to determine the effect of the variable consideration payable to the customer.

How we see it

There was general agreement by the TRG members that entities need to consider the requirements for variable consideration to determine the appropriate timing of recognition of consideration payable to a customer. Therefore, significant judgement might be needed to determine the appropriate timing of recognition.

The standard includes the following example of consideration paid to a customer: *[IFRS 15.IE Example 32, IFRS 15.IE160-IE162]*

Extract from IFRS 15

Example 32-Consideration payable to a customer

An entity that manufactures consumer goods enters into a one-year contract to sell goods to a customer that is a large global chain of retail stores. The customer commits to buy at least CU15 million of products during the year. The contract also requires the entity to make a non-refundable payment of CU1.5 million to the customer at the inception of the contract. The CU1.5 million payment will compensate the customer for the changes it needs to make to its shelving to accommodate the entity's products.

The entity considers the requirements in paragraphs 70-72 of IFRS 15 and concludes that the payment to the customer is not in exchange for a distinct good or service that transfers to the entity. This is because the entity does not obtain control of any rights to the customer's shelves. Consequently, the entity determines that, in accordance with paragraph 70 of IFRS 15, the CU1.5 million payment is a reduction of the transaction price.

The entity applies the requirements in paragraph 72 of IFRS 15 and concludes that the consideration payable is accounted for as a reduction in the transaction price when the entity recognises revenue for the transfer of the goods. Consequently, as the entity transfers goods to the customer, the entity reduces the transaction price for each good by 10 per cent (CU1.5 million ÷ CU15 million). Therefore, in the first month in which the entity transfers goods to the customer, the entity recognises revenue of CU1.8 million (CU2.0 million invoiced amount less CU0.2 million of consideration payable to the customer).

96 TRG Agenda paper no. 37, *Consideration Payable to a Customer*, dated 13 July 2015.

97 TRG Agenda paper no. 44, *July 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 9 November 2015.

Frequently asked questions

Question 5-33: How does an entity account for upfront payments to a customer or a potential customer?
(FASB TRG meeting 7 November 2016 - Agenda paper no. 59)

While the requirements for consideration payable to a customer clearly apply to payments to customers under current contracts, stakeholders have raised questions about how to account for upfront payments to potential customers and payments that relate to both current and anticipated contracts.

The FASB TRG members discussed two views. Under View A, an entity would recognise an asset for the upfront payment and reduce revenue as the related goods or services (or as the expected related goods or services) are transferred to the customer. As a result, the payment might be recognised in profit or loss over a period that is longer than the contract term. Entities would determine the amortisation period based on facts and circumstances and would assess the asset for recoverability using the principles in asset impairment models in other standards. Under View B, entities would reduce revenue in the current contract by the amount of the payment. If there is no current contract, entities would immediately recognise the payment in profit or loss. The FASB TRG members generally agreed that an entity needs to apply the view that best reflects the substance and economics of the payment to the customer; it would not be an accounting policy choice. Entities would evaluate the nature of the payment, the rights and obligations under the contract and whether the payment meets the definition of an asset. The FASB TRG members also noted that an entity's decision on which view is appropriate might be a significant judgement in the determination of the transaction price that would require disclosure under the revenue standard.[98]

How we see it

We believe an entity has to carefully evaluate all facts and circumstances of payments made to customers to determine the appropriate accounting treatment. However, if an entity expects to generate future revenue associated with the payment, we believe an entity generally applies View A (assuming any asset recorded is recoverable). If no revenue is expected as a result of the payment, View B might be appropriate.

If an entity recognises an asset for consideration paid to a customer (because the payment made to the customer will be recognised as a reduction from revenue in future periods when (or as) goods or services are transferred to the customer), a question arises about the nature of that asset. This is relevant because it would determine, among other things, which impairment requirements apply to the asset. This is discussed further in section 5.7.4 below.

Question 5-34: How does an entity present 'negative revenue' resulting from consideration paid or payable to a customer that exceeds the amount to which the entity expects to be entitled?

In certain arrangements, consideration paid or payable to a customer could exceed the consideration to which the entity expects to be entitled in exchange for transferring promised goods or services in a contract with a customer. In these situations, recognition of payments to the customer as a reduction of revenue could result in 'negative revenue'. IFRS 15 does not specifically address how entities would present negative revenue.

Stakeholders had asked the TRG whether an entity would reclassify negative revenue resulting from consideration paid or payable to a customer to expense and, if so, in what circumstances. The TRG did not discuss this question in detail and no additional application guidance was provided.

As discussed above, IFRS 15.70 states that an entity shall account for consideration payable to a customer as a reduction of the transaction price (and, therefore, of revenue), unless the payment to the customer is in exchange for a distinct good or service that the customer transfers to the entity.

How we see it

Therefore, we believe it is appropriate for an entity to present payments to a customer in excess of the transaction price that are not in exchange for a distinct good or service within revenue.

However, we believe it may also be acceptable, in limited circumstances, to reclassify negative revenue to expense in an entity's income statement. For example, if an entity demonstrates that characterisation of consideration payable to a customer as a reduction of revenue results in negative revenue for a specific customer on a cumulative basis (i.e., since the inception of the overall relationship between the entity and the customer), then the amount of the cumulative shortfall may be recharacterised as an expense.

98 FASB TRG Agenda paper no. 60, *November 2016 Meeting - Summary of Issues Discussed and Next Steps*, dated 31 January 2017.

In determining whether cumulative negative revenue exists for a specific customer, revenues from all transactions with that customer recognised by all entities within the consolidated group that includes the entity paying the consideration to the customer should be considered (i.e., revenues recognised from sales to the customer from all of the consolidated entities needs to be considered). Therefore, an entity that considers reclassifying negative revenue to expense must carefully evaluate all of its historical contractual arrangements with the customer before reclassifying any cumulative shortfall in revenue to expense. In addition, when making this evaluation, we believe an entity needs to incorporate revenue from any current or anticipated contracts with the customer to transfer goods or services in the future.

To provide users with sufficient information about its revenue transactions, entities need to consider the disclosure requirements in IFRS 15.123 and IFRS 15.126 (see section 10.5.2 below).

The question of whether negative revenue can be reclassified to expense in the income statement was originally raised the context of a submission to the IFRS IC in September 2019.[99] More recently, in a paper prepared in connection with the post-implementation review of IFRS 15, the IASB staff recognised that "there is evidence to suggest that the requirements in IFRS 15 are insufficient for entities to consistently account for incentives paid by an agent to an end customer and for 'negative' revenue."[100] However, the Board decided against adding this issue to its standard-setting agenda and instead tentatively decided to consider it in the next agenda consultation.[101]

5.7.4 Impairment of consideration paid to a customer recognised as an asset

If an entity has recognised an asset for consideration paid to a customer (because the payment made to the customer will be recognised as a reduction from revenue in future periods when (or as) goods or services are transferred to the customer, see section 5.7.3 above), it will need to consider the nature of that asset to determine which impairment requirements apply. Specifically, whether the asset is subject to the impairment requirements in IFRS 9 (see section 10.1.3 below) or the impairment requirements in IAS 36 *Impairment of Assets* (see Chapter 21).

Consideration paid to a customer recognised as an asset arises from a contract that is within the scope of IFRS 15. However, it is not a 'contract asset' as defined in IFRS 15 (see Appendix C and section 10.1.1 below) because it does not represent a conditional right to consideration in exchange for goods or services that it has transferred to a customer. In substance, consideration paid to a customer recognised as an asset is similar to a prepayment.

If the payment to the customer is refundable, the IFRS 9 impairment requirements would apply. Otherwise, the asset would be within the scope of IAS 36 for impairment purposes (see Chapter 21 at section 1.3). Judgement might be needed to assess impairment. For example, under IAS 36, an entity might need to test the asset for impairment as part of a cash-generating unit. When assessing indicators and/or testing for impairment, which goods or services are related to the deferred consideration payable to a customer and whether the customer is committed or only expected to purchase them might also be important.

5.8 Non-refundable upfront fees

In certain circumstances, entities receive payments from customers before they provide the contracted service or deliver a good. Upfront fees generally relate to the initiation, activation or set up of a good to be used or a service to be provided in the future. Upfront fees might also be paid to grant access to, or provide, a right to use a facility, product or service. In many cases, the upfront amounts paid by the customer are non-refundable. Examples include fees paid for membership to a health club or buying club and activation fees for phone, cable or internet services. *[IFRS 15.B48]*.

Entities must evaluate whether a non-refundable upfront fee relates to the transfer of a promised good or service. If it does, the entity is required to determine whether to account for the promised good or service as a separate performance obligation (see section 4 above). *[IFRS 15.B49, IFRS 15.B50]*. In addition, Question 4-7 in section 4.2.1.H above discusses how entities would determine whether implementation services are distinct.

99 *IFRIC Update*, September 2019, available on the IFRS Foundation's website.

100 IASB Agenda paper 6A, *Determining the transaction price*, dated March 2024, available on the IFRS Foundation's website.

101 *IASB update*, April 2024, available on the IFRS Foundation's website.

The standard notes that, even though a non-refundable upfront fee relates to an activity that the entity is required to undertake at or near contract inception in order to fulfil the contract, in many cases, that activity does not result in the transfer of a promised good or service to the customer. *[IFRS 15.B49]*. Instead, in many situations, an upfront fee represents an advance payment for future goods or services.

The existence of a non-refundable upfront fee might indicate that the contract includes a renewal option for future goods or services at a reduced price (if the customer renews the agreement without the payment of an additional upfront fee). In such circumstances, an entity would need to assess whether the option is a material right (i.e., another performance obligation in the contract) (see section 4.6 above). *[IFRS 15.B49]*. If the entity concludes that the non-refundable upfront fee does not provide a material right, the fee would be part of the consideration allocable to the goods or services in the contract and would be recognised when (or as) the good or service to which the consideration was allocated is transferred to the customer. If an entity concludes that the non-refundable upfront fee provides a material right, the amount of the fee allocated to the material right would be recognised over the period of benefit of the fee, which might be the estimated customer life.

The following Illustration depicts the allocation of a non-refundable upfront fee determined to be a material right:

Illustration 5-8: Non-refundable upfront fees

A customer signs a one-year contract with a health club and is required to pay both a non-refundable initiation fee of CU150 and an annual membership fee in monthly instalments of CU40. At the end of each year, the customer can renew the contract for an additional year without paying an additional initiation fee. The customer is then required to pay an annual membership fee in monthly instalments of CU40 for each renewal period. The club's activity of registering the customer does not transfer any service to the customer and, therefore, is not a performance obligation. By not requiring the customer to pay the upfront membership fee again upon renewal, the club is effectively providing a discounted renewal rate to the customer.

The club determines that the renewal option is a material right because it provides a renewal option at a lower price than the range of prices typically charged for new customers. Therefore, it is a separate performance obligation. Based on its experience, the club determines that its customers, on average, renew their annual memberships twice before terminating their relationship with the club. As a result, the club determines that the option provides the customer with the right to two annual renewals at a discounted price. In this scenario, the club would allocate the total transaction consideration of CU630 (CU150 upfront membership fee + CU480 (CU40 x 12 months)) to the identified performance obligations (monthly services for the one-year contract and renewal option) based on the relative stand-alone selling price method. In accordance with IFRS 15.B40, the amount allocated to the renewal option would be recognised when, or as, the future goods or services are transferred (e.g., years two and three of the services if the renewal option is fully exercised) or when the renewal option expires.

Alternatively, the club could value the option by 'looking through' to the optional goods or services using the practical alternative provided in IFRS 15.B42 (see section 6.1.5 below). In that case, the club would determine that the total hypothetical transaction price (for purposes of allocating the transaction price to the option) is the sum of the upfront fee plus three years of service fees (i.e., CU150 + CU1,440) and would allocate that amount to all of the services expected to be delivered or 36 months of membership (or CU44.17 per month). Therefore, the total consideration in the contract of CU630 would be allocated to the 12 months of service (CU530 (CU44.17 x 12 months)) with the remaining amount being allocated to the renewal option (CU100 (CU630 - CU530)). Assuming the renewal option is exercised for year 2 and year 3, the amount allocated to the renewal option (CU100) would be recognised as revenue over each renewal period. One acceptable approach would be to reduce the initial CU100 deferred revenue balance for the material right by CU4.17 each month (CU100 ÷ 24 months remaining), assuming that the estimated renewal period of two years remains unchanged.

See section 4.6 above and section 6.1.5 below for a more detailed discussion of the treatment of options (including the practical alternative allowed under IFRS 15.B42) and sections 6.1 and 6.2 below for a discussion of estimating stand-alone selling prices and allocating consideration using the relative stand-alone selling price method.

The standard notes that, in some cases, an entity might charge a non-refundable fee in part as compensation for costs incurred in setting up a contract (or other administrative tasks). If those set-up activities do not satisfy a performance obligation, the entity is required to disregard them (and the related costs) when measuring progress (see section 7.1.4 below). This is because the costs of set-up activities do not depict the transfer of services to the customer. In addition, the entity is required to assess whether costs incurred in setting up a contract are costs incurred to fulfil a contract that meet the requirements for capitalisation in IFRS 15 (see section 9.3.2 below). *[IFRS 15.B51]*.

Frequently asked questions

Question 5-35: Over what period would an entity recognise a non-refundable upfront fee (e.g., fees paid for membership to a club, activation fees for phone, cable or internet services) that does not relate to the transfer of a good or service?

(TRG meeting 30 March 2015 - Agenda paper no. 32)

The TRG members generally agreed that the period over which a non-refundable upfront fee is recognised depends on whether the fee provides the customer with a material right with respect to future contract renewals (see section 4.6 above).[102] For example, assume that an entity charges a one-time activation fee of CU50 to provide CU100 of services to a customer on a month-to-month basis. If the entity concludes that the activation fee provides a material right, the fee would be recognised over the service period during which the customer is expected to benefit from not having to pay an activation fee upon renewal of the service. That period might be the estimated customer life in some situations. If the entity concludes that the activation fee does not provide a material right, the fee would be recognised over the contract duration (i.e., one month).

Question 5-36: How does a utility entity determine whether a contract that includes a non-refundable upfront fee received for establishing a connection to a network (i.e., a connection fee) is within the scope of IFRS 15?

Utility entities are often responsible for constructing infrastructure (e.g., a pipe) that will physically connect a building to its network (i.e., connection) and for providing ongoing services (e.g., delivery of electricity, gas, water). In exchange, a utility entity generally charges the customer a non-refundable upfront connection fee and a separate fee for the ongoing services. Furthermore, the connection fee and/or the fee for ongoing services are often subject to rate regulation established through a formal regulatory framework that affects the rates that a utility entity is allowed to charge to its customers.

Utility entities first need to assess whether some or all of the contract is within the scope of another IFRS accounting standard (e.g., IFRS 16, IAS 16). If the contract is partially within the scope of IFRS 15, the entity would need to separate the non-revenue components, in accordance with IFRS 15.7, and account for the remainder within the scope of IFRS 15 (see section 2.5 above for further discussion).

To be within the scope of IFRS 15, a vendor-customer relationship needs to exist.

How we see it

Provided such goods or services are an output of the ordinary activities of the entity, we believe a vendor-customer relationship would exist (and the contract would be wholly, or partially, within the scope of the standard) if:

- The ongoing service is part of the contract or part of an associated contract for ongoing services that is combined with the contract to establish the connection if the combined contract criteria in IFRS 15.17 are met. In a rate-regulated environment, the contract to transfer ongoing services to a customer (e.g., delivery of energy) might be implied as the customer has no alternative other than purchasing the good or service from the entity that is responsible for creating the connection.

  Or

- The customer obtains control of the infrastructure asset (e.g., a pipe) or the connection.

Question 5-37: What factors might be relevant when a utility entity applies the application guidance to non-refundable upfront fees for establishing a connection to a network?

As discussed in Question 5-36 above, utility entities are often responsible for constructing infrastructure (e.g., a pipe) that will physically connect a building to its network (i.e., connection) and might receive a non-refundable upfront connection fee in exchange. Applying the non-refundable upfront fee application guidance in such contracts often requires significant judgement and depends on the facts and circumstances. For example, if more than one party is involved, the utility entity needs to consider the principal versus agent application guidance (see section 4.4 above) in addition to the non-refundable upfront fee application guidance.

102 TRG Agenda paper no. 32, *Accounting for a Customer's Exercise of a Material Right*, dated 30 March 2015 and TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015.

The non-refundable upfront fee application guidance requires an entity to determine if the upfront fee is related to a distinct good or service. *[IFRS 15.B49, IFRS 15.B50]*.

How we see it

Determining whether the connection to the network is a distinct good or service depends on the facts and circumstances and might require significant judgement.

As part of this assessment:

- A utility entity needs to determine whether the connection is a promised good or service in the contract. It considers explicit promises in the contract and implied promises that create a valid expectation of the customer that it will transfer control of the connection to the customer. *[IFRS 15.24, IFRS 15.25, IFRS 15.B51]*. This is likely to require significant judgement if the infrastructure asset remains an asset of the utility entity.
- If the connection is a promised good or service, a utility entity needs to determine whether the promise is distinct. In particular, the assessment of whether the connection is distinct in the context of the contract is highly judgemental and must consider the specific contract with the customer, including all relevant facts and circumstances. Entities must not assume that a particular type of good or service is distinct (or not distinct) in all instances. The manner in which the promised goods and services have been bundled within a contract, if any, will affect the entity's assessment. *[IFRS 15.27]*.

  As part of assessing whether the promise is distinct within the context of the contract, a utility entity considers the three factors described in IFRS 15.29 (see section 4.2.1.B above), as follows: *[IFRS 15.29]*
  - Factor (a): The utility entity needs to understand the promise(s) it has made to its customers and whether it integrates them to satisfy its promise(s). For example, if it promised its customer the ongoing supply of services, it might also bear the risk for distribution of these services (including ensuring continued connection). Therefore, it might be providing a significant service of integrating promised goods or services to provide a combined output.
  - Factor (b): This factor is unlikely to be relevant in the assessment of whether connection is distinct within the context of the contract because the ongoing service and the connection are unlikely to modify or customise each other.
  - Factor (c): The utility entity has to determine whether the connection is highly interdependent and highly interrelated with the ongoing service (e.g., supply of electricity). For example, whether there is more than just a functional relationship (i.e., one item, by its nature, depends on the other) because the utility entity cannot provide ongoing services (its main output, e.g., electricity, gas, water) without the connection and the customer cannot benefit from the connection without the ongoing services (i.e., is there two-way dependency?).

If the utility entity concludes that connection is not a distinct good or service, the non-refundable upfront fee is advanced payment for future goods or services and is recognised as revenue when (or as) the future goods or services are provided. As discussed above, in such situations, an entity must determine whether the non-refundable upfront fee represents an option to renew the contract at a lower price and must assesses whether the option to renew represents a material right. *[IFRS 15.B49, IFRS 15.B40, IFRS 15.BC391]*.

How we see it

Significant judgement might be needed to determine whether the customer has a material right. However, the fact that the customer remains connected to the network and does not to pay the connection fee again while in the same property, for example, might indicate that a material right exists.

If the renewal option represents a material right, the period over which the upfront fee is recognised is longer than the initial contract duration. *[IFRS 15.B49]*. It is likely that significant judgement will be needed to determine the appropriate period over which to recognise the upfront fee in such circumstances (see Question 5-35 above).

Question 5-38: How is consideration that was received from a customer, but not yet recognised as revenue, accounted for when the contract is cancelled?

See response to Question 3-10 in section 3.2 above.

5.9 Changes in the transaction price

Changes in the transaction price can occur for various reasons, including "the resolution of uncertain events or other changes in circumstances that change the amount of consideration to which an entity expects to be entitled in exchange for the promised goods or services". *[IFRS 15.87]*. See section 6.5 below for additional requirements on accounting for a change in transaction price.

6 IFRS 15 - Allocate the transaction price to the performance obligations

Once the separate performance obligations are identified and the transaction price has been determined, the standard generally requires an entity to allocate the transaction price to the performance obligations in proportion to their stand-alone selling prices (i.e., on a relative stand-alone selling price basis). The Board noted in the Basis for Conclusions that, in most cases, an allocation based on stand-alone selling prices will faithfully depict the different margins that might apply to promised goods or services. *[IFRS 15.BC266]*.

The standard's objective for the allocation of the transaction price to the performance obligations identified in a contract is as follows: *[IFRS 15.73]*

Extract from IFRS 15

73 **The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.**

When allocating on a relative stand-alone selling price basis, any discount within the contract is generally allocated proportionately to all of the performance obligations in the contract.

However, as discussed further in sections 6.3 and 6.4 below, there are some exceptions. For example, an entity could allocate variable consideration to a single performance obligation in some situations (see section 6.3 below). IFRS 15 also contemplates the allocation of any discount in a contract only to certain performance obligations, if specified criteria are met (see section 6.4 below). *[IFRS 15.74]*. An entity would not apply the allocation requirements if the contract has only one performance obligation (except for a single performance obligation that is made up of a series of distinct goods or services and includes variable consideration). *[IFRS 15.75]*.

6.1 Determining stand-alone selling prices

To allocate the transaction price on a relative stand-alone selling price basis, an entity must first determine the stand-alone selling price of the distinct good or service (which might represent a bundle of goods or services) underlying each performance obligation. *[IFRS 15.76]*. Under the standard, this is the price at which an entity would sell a distinct good or service on a stand-alone (or separate) basis at contract inception. If multiple non-distinct goods or services are bundled to form a single performance obligation, the stand-alone selling price is determined at the price the entity would sell the bundle separately to the customer. This amount is not always the sum of the prices at which the entity would sell the individual goods or services that make up the bundle. *[IFRS 15.77]*.

IFRS 15 indicates the observable price of a good or service sold separately (in similar circumstances and to similar customers) provides the best evidence of stand-alone selling price. *[IFRS 15.77]*. A contractually stated or list price for a good or service could be (but cannot be presumed to be) the stand-alone selling price of that good or service. However, in many situations, stand-alone selling prices are not readily observable. In those cases, the entity is required to estimate the stand-alone selling price by considering all relevant information (including market conditions, entity-specific factors, and information about the customer or class of customer) that is reasonably available to the entity. In doing so, an entity is required to maximise the use of observable inputs and apply estimation methods consistently in similar circumstances. The standard includes the following requirements on estimating stand-alone selling prices: *[IFRS 15.78, IFRS 15.79, IFRS 15.80]*

Extract from IFRS 15

78 If a stand-alone selling price is not directly observable, an entity shall estimate the stand-alone selling price at an amount that would result in the allocation of the transaction price meeting the allocation objective in paragraph 73. When estimating a stand-alone selling price, an entity shall consider all information (including market conditions, entity-specific factors and information about the customer or class of customer) that is reasonably available to the entity. In doing so, an entity shall maximise the use of observable inputs and apply estimation methods consistently in similar circumstances.

79 Suitable methods for estimating the stand-alone selling price of a good or service include, but are not limited to, the following:

(a) Adjusted market assessment approach-an entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. That approach might also include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.

(b) Expected cost plus a margin approach-an entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.

(c) Residual approach-an entity may estimate the stand-alone selling price by reference to the total transaction price less the sum of the observable stand-alone selling prices of other goods or services promised in the contract. However, an entity may use a residual approach to estimate, in accordance with paragraph 78, the stand-alone selling price of a good or service only if one of the following criteria is met:

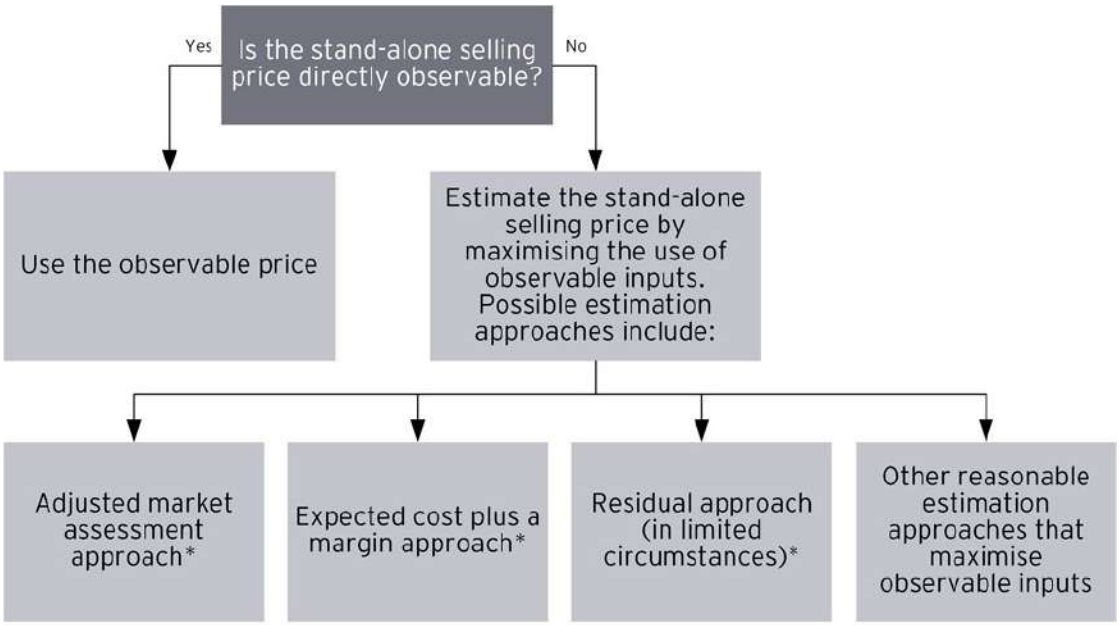
(i) the entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (ie the selling price is highly variable because a representative stand-alone selling price is not discernible from past transactions or other observable evidence); or

(ii) the entity has not yet established a price for that good or service and the good or service has not previously been sold on a stand-alone basis (ie the selling price is uncertain).

80 A combination of methods may need to be used to estimate the stand-alone selling prices of the goods or services promised in the contract if two or more of those goods or services have highly variable or uncertain stand-alone selling prices. For example, an entity may use a residual approach to estimate the aggregate stand-alone selling price for those promised goods or services with highly variable or uncertain stand-alone selling prices and then use another method to estimate the stand-alone selling prices of the individual goods or services relative to that estimated aggregate stand-alone selling price determined by the residual approach. When an entity uses a combination of methods to estimate the stand-alone selling price of each promised good or service in the contract, the entity shall evaluate whether allocating the transaction price at those estimated stand-alone selling prices would be consistent with the allocation objective in paragraph 73 and the requirements for estimating stand-alone selling prices in paragraph 78.

The following flow chart illustrates how an entity determines the stand-alone selling price of a good or service, which might include estimation:

Figure 6-1: Determining the stand-alone selling price of a good or service



* See section 6.1.2 below for further discussion of these estimation approaches, including when it might be appropriate to use a combination of approaches.

Stand-alone selling prices are determined at contract inception and are not updated to reflect changes between contract inception and when performance is complete. *[IFRS 15.88]*. For example, assume an entity determines the stand-alone selling price for a promised good using the expected cost plus a margin approach and, before it can finish manufacturing and deliver that good, the underlying cost of the materials doubles. In such a situation, the entity would not revise its stand-alone selling price used for this contract. However, for future contracts involving the same good, the entity would need to determine whether the change in circumstances (i.e., the significant increase in the cost to produce the good) warrants a revision of the stand-alone selling price. If so, the entity would use that revised price for allocations in future contracts (see section 6.1.3 below).

Similarly, when a modification is treated as part of the existing contract (see section 3.4.2.B above), stand-alone selling prices are also not updated to reflect changes in a transaction price. However, new estimates of stand-alone selling prices are used if the modification creates a new or separate contract, as in the following situations:

- If the modification is treated as a termination of the existing contract and the creation of a new contract (see section 3.4.2.A above), the entity would update its estimate of the stand-alone selling price at the time of the modification. This would include the portion of an IFRS 15.21(c) modification (see section 3.4.2.C above) that is treated as the creation of a new contract.
- If the modification is treated as a separate contract (see section 3.4.1 above), the accounting for the original contact would not be affected (and the stand-alone selling prices of the goods or services would not be updated), but the stand-alone selling prices of the distinct goods or services in the separate contract would have to be determined at the time of the modification.

Refer to section 3.4 above for further details about the accounting for contract modifications.

6.1.1 Factors to consider when estimating the stand-alone selling price

To estimate the stand-alone selling price (if not readily observable), an entity can consider the stated prices in the contract. However, the standard says an entity cannot presume that a contractually stated price, or a list price, for a good or service is the stand-alone selling price. *[IFRS 15.77]*. In estimating a stand-alone selling price, an "entity shall consider all information (including market conditions, entity-specific factors and information about the customer or class of customer) that is reasonably available to the entity". *[IFRS 15.78, IFRS 15.BC269]*. An entity also needs to maximise the use of observable inputs in its estimate. This is a very broad requirement for which an entity needs to consider a variety of data sources.

The following list, which is not all-inclusive, provides examples of market conditions to consider:

- Potential limits on the selling price of the product
- Competitor pricing for a similar or identical product
- Market awareness and perception of the product
- Current market trends that are likely to affect the pricing (e.g., supply and demand for the good or service, competition)
- The entity's market share and position (e.g., the entity's ability to dictate pricing)
- Effects of the geographic area on pricing
- Effects of customisation on pricing
- Expected life of the product, including whether significant technological advances are expected in the market in the near future

Examples of entity-specific factors include:

- Profit objectives and internal cost structure
- Pricing practices and pricing objectives (including desired gross profit margin)
- Effects of customisation on pricing
- Pricing practices used to establish pricing of bundled products
- Effects of a proposed transaction on pricing (e.g., the size of the deal, the characteristics of the targeted customer)
- Expected life of the product, including whether significant entity-specific technological advances are expected in the near future

Examples of information about the customer, or class of customer, include:

- Type of customer
- Geographic region
- Distribution channel

An entity must also consider its customary business practices when determining the stand-alone selling price. To document its estimated stand-alone selling price, an entity ought to consider describing the information that it has considered (e.g., the factors listed above), especially if there is limited observable data or none at all.

6.1.2 Possible estimation approaches

IFRS 15.79 discusses three estimation approaches: (1) the adjusted market assessment approach; (2) the expected cost plus a margin approach; and (3) the residual approach. *[IFRS 15.79]*. All of these are discussed further below. When applying IFRS 15, an entity might need to use a different estimation approach for each of the distinct goods or services underlying the performance obligations in a contract. In addition, an entity might need to use a combination of approaches to estimate the stand-alone selling prices of goods or services promised in a contract, if two or more of those goods or services have highly variable or uncertain stand-alone selling prices.

Furthermore, these are not the only estimation approaches permitted. IFRS 15 allows any reasonable estimation approach, as long as it is consistent with the notion of a stand-alone selling price, maximises the use of observable inputs and is applied on a consistent basis for similar goods or services and customers. *[IFRS 15.80]*.

In some cases, an entity will have sufficient observable data to determine the stand-alone selling price. For example, an entity might have sufficient stand-alone sales of a particular good or service that provide persuasive evidence of the stand-alone selling price of that particular good or service. In such situations, no estimation would be necessary. *[IFRS 15.77]*.

In many instances, an entity will not have sufficient stand-alone sales data to determine the stand-alone selling price based solely on those sales. In those instances, it must maximise the use of whatever observable inputs it has available in order to make its estimate. That is, an entity would not disregard any observable inputs when estimating the stand-alone selling price of a good or service. *[IFRS 15.78]*. An entity needs to consider all factors contemplated in negotiating the contract with the customer and the entity's normal pricing practices factoring in the most objective and reliable information that is available. Accordingly, entities need to have robust practices and processes in place regarding the pricing of goods or services and developing estimates of stand-alone selling prices.

The standard includes the following estimation approaches: *[IFRS 15.79]*

- **Adjusted market assessment approach** - this approach focuses on the amount that the entity believes a participant in the market in which it sells goods or services is willing to pay for a good or service. For example, an entity might refer to competitors' prices for similar goods or services and adjust those prices, as necessary, to reflect the entity's costs and margins. When using the adjusted market assessment approach, an entity considers market conditions, such as those listed in section 6.1.1 above. Applying this approach is likely to be easiest when an entity has sold the good or service for a period of time (such that it has data about customer demand) or a competitor offers similar goods or services that the entity can use as a basis for its analysis. Applying this approach will be difficult when an entity is selling an entirely new good or service because it might be difficult to anticipate market demand. In these situations, entities might want to use the market assessment approach, with adjustments, as necessary, to reflect the entity's costs and margins, in combination with other approaches to maximise the use of observable inputs (e.g., using competitors' pricing, adjusted based on the market assessment approach in combination with an entity's planned internal pricing strategies if the performance obligation has never been sold separately).
- **Expected cost plus margin approach** - this approach focuses more on internal factors (e.g., the entity's cost basis), but has an external component as well. That is, the margin included in this approach must reflect the margin the market would be willing to pay, not just the entity's desired margin. The margin might have to be adjusted for differences in products, geographies, customers and other factors. The expected cost plus margin approach could be useful in many situations, especially when the performance obligation has a determinable direct fulfilment cost (e.g., the performance obligation is a tangible product or an hourly service). However, this approach will be less helpful when there are no clearly identifiable direct fulfilment costs or the amount of those costs is unknown (e.g., when the performance obligation is a new software licence or specified upgrade rights).
- **Residual approach** - this approach allows an entity to estimate the stand-alone selling price of a promised good or service as the difference between the total transaction price and the observable (i.e., not estimated) stand-alone selling prices of other promised goods or services in the contract, provided that one of the following two criteria are met: *[IFRS 15.79(c)]*
  - At or near the same time, the same good or service is sold by the entity to different customers at a wide range of prices (i.e., the representative stand-alone selling price cannot be determined from past transactions or other observable evidence as it is highly variable)
  - The good or service has not yet been sold on a stand-alone basis and a price for that good or service has not previously been established by the entity (i.e., the selling price is uncertain)

We expect the use of the residual approach will be limited because the standard indicates that it can only be used for contracts with multiple promised goods or services when: (1) the selling price of one or more of the promised goods or services is unknown because one of the two criteria above are met; and (2) the remaining promised goods or services (of which there needs to be at least one) in the contract have observable (i.e., not estimated) stand-alone selling prices. That is, the residual approach cannot be used if the selling price for all the goods or services in the contract are unknown. However, allowing entities to use a residual technique provides relief to entities that rarely, or never, sell goods or services on a stand-alone basis, such as entities that sell intellectual property only with physical goods or services.

The Board noted in the Basis for Conclusions that the use of the residual approach cannot result in a stand-alone selling price of zero if the good or service is distinct. *[IFRS 15.BC273]*. This is because a good or service must have value on a stand-alone basis to be distinct. The Board also stated that, if use of the residual approach results in very little, or no, consideration being allocated to a good or service or a bundle of goods or services, an entity has to re-evaluate whether the use of the residual approach is appropriate.

An example of an appropriate use of the residual approach would be an entity that frequently sells software, professional services and maintenance, bundled together, at prices that vary widely. However, the entity also sells the professional services and maintenance individually at relatively stable, observable prices. The Board indicated that in such situation it would be appropriate to estimate the stand-alone selling price for the software as the difference between the total transaction price and the observable selling prices of the professional services and maintenance. See Example 34, Cases B and C, from IFRS 15 (included in section 6.4 below) for examples of when the residual approach is or is not appropriate.

The Board clarified in the Basis for Conclusions that an entity could also use the residual approach if there are two or more goods or services in the contract with highly variable or uncertain stand-alone selling prices, provided that the other promised goods or services in the contract (of which there needs to be at least one) have observable stand-alone selling prices. The Board observed that, in such an instance, an entity might need to use a combination of techniques to estimate the stand-alone selling prices. *[IFRS 15.BC272]*. For example, an entity could apply the residual approach to estimate the aggregate of the stand-alone selling prices for all of the promised goods or services with highly variable or uncertain stand-alone selling prices, but then use another approach (e.g., adjusted market assessment, expected cost plus margin) to estimate the stand-alone selling prices of each of those promised goods or services with highly variable or uncertain stand-alone selling prices.

Illustration 6-1: Estimating the stand-alone selling price using the residual approach

Entity X enters into a contract with a customer to sell equipment, professional services and maintenance as a bundled package for CU20,000. The professional services and maintenance have observable prices from Entity X's historical sales. The equipment is a new product for Entity X for which it has limited historical sales and no established price. Entity X has not historically sold any similar equipment, and Entity X's cost of the equipment is CU6,000.

Scenario A

Entity X frequently sells professional services and maintenance separately for observable prices of CU7,000 and CU5,000, respectively.

If Entity X determines that there is no other relevant observable data to determine the stand-alone selling price of the equipment, it could use the residual approach. This approach results in a stand-alone selling price for the equipment of CU8,000 (CU20,000 - CU7,000 - CU5,000).

Scenario B

Entity X frequently sells professional services and maintenance separately for observable prices of CU14,000 and CU5,500, respectively.

The residual approach would result in a stand-alone selling price for the equipment of CU500 (CU20,000 - CU14,000 - CU5,500). It might not be appropriate to use the approach in this situation because the result allocates very little consideration to the equipment.

The standard includes the following example in which two estimation approaches are used to estimate stand-alone selling prices of two different goods in a contract: *[IFRS 15.IE Example 33, IFRS 15.IE164-IE166]*

Extract from IFRS 15

Example 33-Allocation methodology

An entity enters into a contract with a customer to sell Products A, B and C in exchange for CU100. The entity will satisfy the performance obligations for each of the products at different points in time. The entity regularly sells Product A separately and therefore the stand-alone selling price is directly observable. The stand-alone selling prices of Products B and C are not directly observable.

Because the stand-alone selling prices for Products B and C are not directly observable, the entity must estimate them. To estimate the stand-alone selling prices, the entity uses the adjusted market assessment approach for Product B and the expected cost plus a margin approach for Product C. In making those estimates, the entity maximises the use of observable inputs (in accordance with paragraph 78 of IFRS 15). The entity estimates the stand-alone selling prices as follows:

Product	Stand-alone selling price	Method
	CU	
Product A	50	Directly observable (see paragraph 77 of IFRS 15)
Product B	25	Adjusted market assessment approach (see paragraph 79(a) of IFRS 15)
Product C	75	Expected cost plus a margin approach (see paragraph 79(b) of IFRS 15)
Total	150	

The customer receives a discount for purchasing the bundle of goods because the sum of the stand-alone selling prices (CU150) exceeds the promised consideration (CU100). The entity considers whether it has observable evidence about the performance obligation to which the entire discount belongs (in accordance with paragraph 82 of IFRS 15) and concludes that it does not. Consequently, in accordance with paragraphs 76 and 81 of IFRS 15, the discount is allocated proportionately across Products A, B and C. The discount, and therefore the transaction price, is allocated as follows:

Product	Allocated transaction price	
	CU	
Product A	33	(CU50 ÷ CU150 × CU100)
Product B	17	(CU25 ÷ CU150 × CU100)
Product C	50	(CU75 ÷ CU150 × CU100)
Total	100	

Given the flexibility provided by the standard to estimate stand-alone selling prices, it is both appropriate and necessary for entities to tailor the approach(es) used to their specific facts and circumstances. However, regardless of whether the entity uses a single approach or a combination of approaches, it must evaluate whether the resulting allocation of the transaction price is consistent with the overall allocation objective in IFRS 15.73 and the requirements for estimating stand-alone selling prices discussed above. *[IFRS 15.80]*.

In accordance with IFRS 15, an entity must make a reasonable estimate of the stand-alone selling price for the distinct good or service underlying each performance obligation if an observable selling price is not readily available.

How we see it

We believe entities generally have sufficient information to develop a reasonable estimate, even in instances in which limited information is available.

Entities need robust processes to estimate stand-alone selling prices. If those estimates have limited underlying observable data, it is important for entities to be able to demonstrate the reasonableness of the calculations they make in estimating stand-alone selling prices.

6.1.3 Updating estimated stand-alone selling prices

As discussed in section 6.1 above, stand-alone selling prices are determined at contract inception and are not updated to reflect changes between contract inception and when performance is complete. Similarly, when a modification is treated as part of the existing contract (see section 3.4.2.B above), stand-alone selling prices are also not updated to reflect changes in a transaction price. However, new estimates of stand-alone selling prices are used if the modification creates a new or separate contract, as in the following situations:

- If the modification is treated as a termination of the existing contract and the creation of a new contract (see section 3.4.2.A above), the entity would update its estimate of the stand-alone selling price at the time of the modification. This would include the portion of an IFRS 15.21(c) modification (see section 3.4.2.C above) that is treated as the creation of a new contract.
- If the modification is treated as a separate contract (see section 3.4.1 above), the accounting for the original contract would not be affected (and the stand-alone selling prices of the goods and services would not be updated), but the stand-alone selling prices of the distinct goods or services in the separate contract would have to be determined at the time of the modification.

Refer to section 3.4 above for further details about the accounting for contract modifications.

Furthermore, an entity needs to update its estimates of stand-alone selling prices for future transactions to reflect changes in circumstances. IFRS 15 does not specifically address how frequently estimated stand-alone selling prices for new contracts must be updated. Instead, it indicates that an entity must make this estimate for each distinct good or service underlying each performance obligation in each contract with a customer, which suggests that an entity needs to constantly update its estimates of stand-alone selling prices for each new contract.

In practice, we expect that entities will be able to consider their own facts and circumstances in order to determine how frequently they will need to update their stand-alone selling price estimates for new contracts. If, for example, the information used to estimate the stand-alone selling price for similar transactions has not changed, an entity might determine at inception of the new contract that it is still reasonable to use the previously determined stand-alone selling price.

However, in order for the changes in circumstances to be reflected in the estimate in a timely manner, we expect that an entity would formally update the estimate on a regular basis (e.g., monthly, quarterly, semi-annually). The frequency of updates needs to be based on the facts and circumstances of the distinct good or service underlying each performance obligation for which the estimate is made. An entity uses current information each time it develops or updates its estimate. While the estimates might be updated, the approach used to estimate stand-alone selling price does not change (i.e., an entity must use a consistent approach), unless facts and circumstances change. *[IFRS 15.78]*.

6.1.4 Additional considerations for determining the stand-alone selling price

While not explicitly stated in IFRS 15, a single good or service could have more than one stand-alone selling price. That is, the entity might be willing to sell goods or services at different prices to different customers. Furthermore, an entity might use different prices in different geographies or in markets where it uses different methods to distribute its products (e.g., it might use a distributor or reseller, rather than selling directly to the end-consumer) or for other reasons (e.g., different cost structures or strategies in different markets). Accordingly, an entity might need to stratify its analysis to determine its stand-alone selling price for each class of customer, geography and/or market, as applicable.

Frequently asked questions

Question 6-1: When estimating the stand-alone selling price, does an entity have to consider its historical pricing for the sale of the good or service involved?

Historical pricing is likely to be an important input as it often reflects both market conditions and entity-specific factors and can provide supporting evidence about the reasonableness of management's estimate. For example, if management determines, based on its pricing policies and competition in the market, that the stand-alone selling price of its good or service is X, historical transactions within a reasonable range of X would provide supporting evidence for management's estimate. However, if historical pricing was only 50% of X, this would indicate that historical pricing is no longer relevant due to changes in the market, for example, or that management's estimate is flawed.

Depending on the facts and circumstances, an entity might conclude that other factors such as internal pricing policies are more relevant to its determination of a stand-alone selling price. When historical pricing has been established using the entity's normal pricing policies and procedures, it is more likely that this information will be relevant in the estimation.

How we see it

We believe that an entity has to consider its historical pricing in all circumstances, but it is not necessarily determinative. If the entity has sold the product separately or has information on competitors' pricing for a similar product, it is likely that the entity would find historical data relevant to its estimate of stand-alone selling prices, among other factors. In addition, we believe it might be appropriate for entities to stratify stand-alone selling prices based on: the type or size of customer; the amount of product or services purchased; the distribution channel; the geographic location; or other factors.

Question 6-2: When using an expected cost plus margin approach to estimate a stand-alone selling price, how would an entity determine an appropriate margin?

When an entity elects to use the expected cost plus margin approach, it is important for the entity to use an appropriate margin.

How we see it

Determining an appropriate margin might require the use of significant judgement and involve the consideration of many market conditions and entity-specific factors, discussed in section 6.1.1 above.

It would not be appropriate, for example, to determine that the entity's estimate of stand-alone selling price is equivalent to cost plus a 30% margin if a review of market conditions demonstrates that customers are only willing to pay the equivalent of cost plus a 12% margin for a comparable product. Similarly, it would be inappropriate to determine that cost plus a specified margin represents the stand-alone selling price if competitors are selling a comparable product at twice the determined estimate. Furthermore, the determined margin might have to be adjusted for differences in products, geographic locations, customers and other factors.

Question 6-3: When estimating the stand-alone selling price of a good or service, can an entity estimate a range of prices or does it have to identify a point estimate?

Entities might use a range of prices to help estimate the stand-alone selling price of a good or service.

How we see it

We believe it is reasonable for an entity to use such a range for the purpose of assessing whether a stand-alone selling price (i.e., a single price) that the entity intends to use is reasonably within that range. That is, we do not believe that an entity is required to determine a point estimate for each estimated stand-alone selling price if a range is a more practical means of estimating the stand-alone selling price for a good or service.

The objective of the standard is to allocate the transaction price to each performance obligation in "an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer". *[IFRS 15.73]*. While the standard does not address ranges of estimates, using a range of prices would not be inconsistent with the objective of the standard. The only requirements in the standard are that an entity maximise its use of observable inputs and apply the estimation approaches consistently. Therefore, the use of a range would also be consistent with these principles.

Practices we have observed include an entity establishing that a large portion of the stand-alone selling prices falls within a narrow range (e.g., by reference to historical pricing).

How we see it

We believe the use of a narrow range is acceptable for determining estimates of stand-alone selling prices under the standard because it is consistent with the standard's principle that an entity must maximise its use of observable inputs. While the use of a range would be appropriate for estimating the stand-alone selling price, we believe that some approaches to identifying this range do not meet the requirements of IFRS 15.

It would not be appropriate, for example, for an entity to determine a range by estimating a single price point for the stand-alone selling price and then adding an arbitrary range on either side of that point estimate, nor would it be appropriate to take the historical prices and expand the range around the midpoint until a significant portion of the historical transactions fall within that band. The wider the range necessary to capture a high proportion of historical transactions, the less relevant it is in terms of providing a useful data point for estimating stand-alone selling prices.

Management's analysis of market conditions and entity-specific factors could support it in determining the best estimate of the stand-alone selling price. The historical pricing data from transactions, while not necessarily determinative, could be used as supporting evidence for management's conclusion. This is because it is consistent with the standard's principle that an entity must maximise its use of observable inputs. However, management would need to analyse the transactions that fall outside the range to determine whether they have similar characteristics and, therefore, need to be evaluated as a separate class of transactions with a different estimated selling price.

If the entity has established a reasonable range for the estimated stand-alone selling prices and the stated contractual price falls within that range, it would be appropriate to use the stated contractual price as the stand-alone selling price in the allocation calculation. However, if the stated contractual price for the good or service falls outside of the range, the stand-alone selling price needs to be adjusted to a point within the established range in order to allocate the transaction price on a relative stand-alone selling price basis. In these situations, the entity would need to determine which point in the range is most appropriate to use (e.g., the midpoint of the range or the outer limit nearest to the stated contractual price) when performing the allocation calculation.

Illustration 6-2: Allocating transaction price when there is a range of stand-alone selling prices

Entity X sells a product to Customer Y, along with a distinct service. Entity X sells the product on a stand-alone basis for prices that range from CU7,500 to CU8,500, and the service is sold on a stand-alone basis for CU4,000.

Scenario A

Assume the stated contract prices for the product and the service are CU8,000 and CU2,000, respectively, for a total transaction price of CU10,000.

The contract price for the product falls within the range that Entity X determined for the stand-alone selling price. Therefore, Entity X could use the stated contract price for the product as the stand-alone selling price when allocating the transaction price. The total stand-alone selling prices of the product and service would be CU12,000 (CU8,000 for the product and CU4,000 for the service). This calculation is illustrated, as follows:

	Stand-alone selling price		Allocated transaction price
	CU		CU
Product	8,000	(8,000 ÷ 12,000 × 10,000)	6,667
Service	4,000	(4,000 ÷ 12,000 × 10,000)	3,333
Total	**12,000**		**10,000**

Scenario B

Assume the stated contract prices for the product and the service are CU6,500 and CU2,000, respectively, for a total transaction price of CU8,500. Entity X has a policy that it will use the outer limit nearest to the stated contractual price when performing the allocation calculation.

In this scenario, the contract price for the product is not within the range of stand-alone selling prices. Therefore, Entity X would need to determine a price within the range to use as the stand-alone selling price of the product. Consistent with its policy, Entity X uses the outer limit closest to the contractual price, or CU7,500. Therefore, in this scenario, the total of the stand-alone selling prices is CU11,500 (CU7,500 for the product and CU4,000 for the service). The calculation is illustrated as follows:

	Stand-alone selling price		Allocated transaction price
	CU		CU
Product	7,500	(7,500 ÷ 11,500 × 8,500)	5,543
Service	4,000	(4,000 ÷ 11,500 × 8,500)	2,957
Total	**11,500**		**8,500**

Question 6-4: How does an entity evaluate a contract where the total transaction price exceeds the sum of the stand-alone selling prices?

If the total transaction price exceeds the sum of the stand-alone selling prices, it indicates that the customer is paying a premium for bundling the goods or services in the contract. This situation is likely to be rare because most customers expect to receive a discount for purchasing a bundle of goods or services. If a premium exists after determining the stand-alone selling prices of each good or service, the entity needs to evaluate whether it properly identified both the estimated stand-alone selling prices (i.e., are they too low?) and the number of performance obligations in the contract.

How we see it

If the entity determines that a premium does exist after this evaluation, we believe the entity would need to allocate the premium in a manner consistent with the standard's allocation objective, which would typically be on a relative stand-alone selling price basis.

Question 6-5: Can an entity use the residual method to estimate stand-alone selling prices if none of the distinct goods or services in the contract have an observable price?

As noted in section 6.1.2 above, IFRS 15.79(c) requires that an estimate determined using the residual approach equal "... the total transaction price less the sum of the observable stand-alone selling prices of other goods or services promised in the contract." Therefore, the residual method cannot be applied if none of the distinct goods or services in the contract have an observable stand-alone selling price.

Question 6-6: Can an entity use the stated contract price as the stand-alone selling price of a good or service?

As noted in section 6.1 above, IFRS 15.77 states that "A contractually stated price or a list price for a good or service may be (but shall not be presumed to be) the stand-alone selling price of that good or service." Therefore, an entity cannot assume that the contract price is the stand-alone selling price. However, the stated contract or list price might be a data point in determining the stand-alone selling price.

6.1.5 Measurement of options that are separate performance obligations

An entity that determines that a customer option for additional goods or services is a separate performance obligation (because the option provides the customer with a material right, as discussed in section 4.6 above) needs to determine the stand-alone selling price of the option. *[IFRS 15.B42]*.

If the option's stand-alone selling price is not directly observable, the entity needs to estimate it. In doing so, IFRS 15.B42 requires an entity to take into consideration any discount the customer would receive in a stand-alone transaction and the likelihood that the customer would exercise the option. *[IFRS 15.B42]*.

Generally, option pricing models consider both the intrinsic value of the option (i.e., the value of the option if it were exercised today) and its time value (e.g., the option might be more or less valuable based on the amount of time until its expiration date and/or the volatility of the price of the underlying good or service). However, an entity is only required to measure the intrinsic value of the option when estimating the stand-alone selling price of the option. In the Basis for Conclusions, the Board noted that the benefits of valuing the time value component of an option would not justify the cost of doing so. *[IFRS 15.BC390]*. Example 49 in the standard (included in section 4.6 above) illustrates the measurement of an option determined to be a material right under IFRS 15.B42. The following Illustration also explains this concept:

Illustration 6-3: Estimating the stand-alone selling price of options that are separate performance obligations

Publisher A sells a physical textbook for CU10 and offers the customer an option to purchase the digital version of the publication at 50% off the retail price of CU8. The typical discount for digital versions is 15%. Therefore, Publisher A concludes that this discount exceeds the typical discount offered to customers and that it provides the customer with a material right.

To estimate the stand-alone selling price of the option, Publisher A estimates there is a 50% likelihood that a customer will redeem the discount option. Therefore, Publisher A's estimated stand-alone selling price of the discount option is CU1.40 (CU8 digital price x 35% incremental discount x 50% likelihood of exercising the option).

Publisher A allocates CU1.23 (CU10 x [CU1.40 ÷ (CU1.40 + CU10)]) of the transaction price to the discount option and recognises revenue for the option when the customer exercises its right for the digital version or when the option expires. Publisher A allocates CU8.77 (CU10 - CU1.23) to the physical book and recognises revenue for the physical book when it transfers control of the book to the customer.

IFRS 15.B43 provides an alternative to estimating the stand-alone selling price of an option. This practical alternative applies when the additional goods or services are both: (1) similar to the original goods or services in the contract (i.e., the entity continues to provide what it was already providing); *[IFRS 15.BC394]* and (2) provided in accordance with the terms of the original contract. The standard indicates that this practical alternative generally applies to options for contract renewals (i.e., the renewal option approach). *[IFRS 15.B43]*.

The Basis for Conclusions states that customer loyalty points and discount vouchers typically do not meet the criteria for use of this practical alternative. This is because customer loyalty points and discount vouchers are redeemable for goods or services that might differ in nature from those offered in the original contract and the terms of the original contract do not restrict the pricing of the additional goods or services. For example, if an airline offers flights to customers in exchange for points from its frequent flyer programme, the airline is not restricted because it can subsequently determine the number of points that are required to be redeemed for any particular flight. *[IFRS 15.BC394, IFRS 15.BC395]*.

Under the practical alternative, a portion of the transaction price is allocated to the option (i.e., the material right that is a performance obligation) by reference to the total goods or services expected to be provided to the customer (including expected renewals) and the corresponding expected consideration. That is, the total amount of consideration expected to be received from the customer (including consideration from expected renewals) is allocated to the total goods or services expected to be provided to the customer, including those from the expected contract renewals. The amount allocated to the goods or services that the entity is required to transfer to the customer under the contract (i.e., excluding the optional goods or services that will be transferred if the customer exercises the renewal option(s)) is then subtracted from the total amount of consideration received (or that will be received) for transferring those goods or services. The difference is the amount that is allocated to the option at contract inception. An entity using this alternative needs to apply the constraint on variable consideration (as discussed in section 5.2.3 above) to the estimated consideration for the optional goods or services prior to performing the allocation (see Scenario B in Illustration 6-4 below). *[IFRS 15.B43]*. Example 51 in IFRS 15 also illustrates the use of the allocation alternative in IFRS 15.B43. *[IFRS 15.IE Example 51, IFRS 15.IE257-IE266]*.

It is important to note that the calculation of total expected consideration (i.e., the hypothetical transaction price), including consideration related to expected renewals, is only performed for the purpose of allocating a portion of the hypothetical transaction price to the option at contract inception. It does not change the enforceable rights or obligations in the contract, nor does it affect the actual transaction price for the goods or services that the entity is presently obliged to transfer to the customer (which would not include expected renewals). Accordingly, the entity would not include any remaining hypothetical transaction price in its disclosure of remaining performance obligations (see section 10.5.1.C below). In this respect, the practical alternative is consistent with the conclusion in Question 4-21 in section 4.6 above. That is, even if an entity thinks that it is almost certain that a customer will exercise an option to buy additional goods or services, an entity does not include the additional goods or services underlying the option as promised goods or services (or performance obligations), unless there are substantive contractual penalties.

Subsequent to contract inception, if the actual number of contract renewals is different from an entity's initial expectations, the entity updates the hypothetical transaction price and allocation. However, as discussed in section 6.1 above, the estimate of the stand-alone selling price at contract inception is not updated. See Scenario B in Illustration 6-4 below for an example of how an entity could update its practical alternative calculation based on a change in expectations.

The following Illustration shows the two possible approaches for measuring options included in a contract:

Illustration 6-4: Measuring an option

A machinery maintenance contract provider offers a promotion to new customers who pay full price for the first year of maintenance coverage that grants them an option to renew the services for up to two years at a discount. The entity regularly sells maintenance coverage for CU750 per year. With the promotion, the customer can renew the one-year maintenance at the end of each year for CU600. The entity concludes that the ability to renew is a material right because the customer would receive a discount that exceeds any discount available to other customers. The entity also determines that no directly observable stand-alone selling price exists for the option to renew at a discount.

Scenario A - Estimate the stand-alone selling price of the option directly (IFRS 15.B42)

Since the entity has no directly observable evidence of the stand-alone selling price for the renewal option, it estimates the stand-alone selling price of an option for a CU150 discount on the renewal of service in years two and three. When developing its estimate, the entity considers factors such as the likelihood that the option will be exercised and the price of comparable discounted offers. For example, the entity might consider the selling price of an offer for a discounted price of similar services found on a 'deal of the day' website.

The option will then be included in the relative stand-alone selling price allocation. In this example, there are two performance obligations: one-year of maintenance services; and an option for discounted renewals. The consideration of CU750 is allocated between these two performance obligations based on their relative stand-alone selling prices.

Example 49 in the standard (included in section 4.6 above) illustrates the estimation of the stand-alone selling price of an option determined to be a material right under IFRS 15.B42.

Scenario B - Practical alternative to estimating the stand-alone selling price of the option using the renewal option approach (IFRS 15.B43)

If the entity chooses to use the renewal option approach, it allocates the transaction price to the option for maintenance services by reference to the maintenance services expected to be provided (including expected renewals) and the corresponding expected consideration. Since there is a discount offered on renewal of the maintenance service, this calculation will result in less revenue being allocated to the first year of the maintenance service when compared to the amount of consideration received for the first year of service (i.e., an amount less than CU750). The difference between the consideration received (or that will be received) for the first year of maintenance service (i.e., CU750) and the revenue allocated to the first year of maintenance service (i.e., an amount less than CU750) will represent the amount allocated to the option using the renewal option approach.

Assume the entity obtained 100 new customers under the promotion. Based on its experience, the entity anticipates approximately 50% attrition annually, after giving consideration to the anticipated effect that the CU150 discount will have on attrition. The entity considers the constraint on variable consideration and concludes that it is highly probable that a significant revenue reversal will not occur. Therefore, the entity concludes that, for this portfolio of contracts, it will ultimately sell 175 contracts, each contract providing one-year of maintenance services (i.e., 100 customers in the first year, 50 customers in the second year and 25 customers in the third year).

Therefore, the total consideration the entity expects to receive is CU120,000 [(100 x CU750) + (50 x CU600) + (25 x CU600)] (i.e., the hypothetical transaction price). Assuming the stand-alone selling price for each maintenance contract period is the same, the entity allocates CU685.71 (CU120,000 ÷ 175) to each maintenance contract sold.

During the first year, the entity will recognise revenue of CU68,571 (100 one-year maintenance service contracts sold x the allocated price of CU685.71 per maintenance service contract). Consequently, at contract inception, the entity would allocate CU6,429 to the option to renew (CU75,000 cash received - CU68,571 revenue to be recognised in the first year).

If the actual renewals in years two and three differ from expectations, the entity would have to update the hypothetical transaction price and allocation accordingly. However, beyond stating, as discussed in section 6.1 above, that the estimate of the stand-alone selling prices at contract inception would not be updated, the standard is not explicit about how the entity would update the hypothetical transaction price and allocation. Below is an Illustration of how an entity could update its practical alternative calculation based on a change in expectations.

For example, assume that the entity experiences less attrition than expected (e.g., 40% attrition annually, instead of 50%). Therefore, the entity's revised estimate is that it will ultimately sell 196 one-year maintenance services (100 + 60 renewals after year one + 36 renewals after year two). Accordingly, the total consideration that the entity expects to receive is CU132,600 [(100 x CU750) + (60 x CU600) + (36 x CU600)] (i.e., the updated hypothetical transaction price). The entity would not update its estimates of the stand-alone selling prices (which were assumed to be the same for each maintenance period). As such, the entity allocates CU676.53 (CU132,600 ÷ 196) to each maintenance period. The entity would reduce the amount of revenue it recognises in year one by CU918 (CU68,571 - (100 x CU676.53)) because the amount allocated to the option would have been higher at contract inception.

See Illustration 5-8 in section 5.8 above for another example of applying the practical alternative when the contract includes a non-refundable upfront fee that is deemed to be a material right.

Frequently asked questions

Question 6-7: Could the form of an option (e.g., a gift card versus a coupon) affect how an option's stand-alone selling price is estimated?

How we see it

We believe that the form of an option would not affect how the stand-alone selling price is estimated.

Consider, for example, a retailer that gives customers who spend more than CU100 during a specified period a CU15 discount on a future purchase in the form of a coupon or a gift card that expires two weeks from the sale date. If the retailer determines that this type of offer represents a material right (see section 4.6 above), it will need to allocate a portion of the transaction price to the option on a relative stand-alone selling price basis.

As discussed in section 6.1 above, the standard requires that an entity first look to any directly observable stand-alone selling price. This requires the retailer to consider the nature of the underlying transaction. In this example, while a customer can purchase a CU15 gift card for its face value, that transaction is not the same in substance as a transaction in which the customer is given a CU15 gift card or coupon in connection with purchasing another good or service. As such, the retailer could conclude that there is no directly observable stand-alone selling price for a 'free' gift card or coupon obtained in connection with the purchase of another good or service. It would then need to estimate the stand-alone selling price in accordance with IFRS 15.B42.

The estimated stand-alone selling price of an option given in the form of a gift card or a coupon would be the same because both estimates would reflect the likelihood that the option will be exercised (i.e., breakage, as discussed in section 7.9 below).

Question 6-8: Can an entity use the practical alternative when some, but not all, of the goods or services in the original contract are subject to a renewal option?

How we see it

In certain instances, we believe it might be appropriate to apply the practical alternative even if not all of the goods or services in the original contract are subject to a renewal option, provided that at least one of the goods or services in the original contract is subject to the renewal terms included in the original contract.

Consider a contract to sell hardware and a service-type warranty where the customer has the option to renew only the warranty. Furthermore, assume that the renewal option is determined to be a material right. If the terms of any future warranty renewals are consistent with the terms provided in the original contract, we believe it would be reasonable to use the practical alternative when allocating the transaction price of the contract.

6.2 Applying the relative stand-alone selling price method

Once an entity has determined the stand-alone selling price for the separate goods or services in a contract, the entity allocates the transaction price to those performance obligations. The standard requires an entity to use the relative stand-alone selling price method to allocate the transaction price, except in the two specific circumstances (variable consideration and discounts), which are described in sections 6.3 and 6.4 below.

Under the relative stand-alone selling price method, the transaction price is allocated to each performance obligation based on the proportion of the stand-alone selling price of each performance obligation to the sum of the stand-alone selling prices of all of the performance obligations in the contract, as described in Illustration 6-5 below: *[IFRS 15.76]*

Illustration 6-5: Relative stand-alone selling price allocation

Manufacturing Co. entered into a contract with a customer to sell a machine for CU100,000. The total contract price included installation of the machine and a two-year extended warranty. Assume that Manufacturing Co. determined there were three performance obligations and the stand-alone selling prices of those performance obligations were as follows: machine - CU75,000, installation services - CU14,000 and extended warranty - CU20,000.

The aggregate of the stand-alone selling prices (CU109,000) exceeds the total transaction price of CU100,000, indicating there is a discount inherent in the contract. That discount must be allocated to each of the individual performance obligations based on the relative stand-alone selling price of each performance obligation. Therefore, the amount of the CU100,000 transaction price is allocated to each performance obligation as follows:

Machine - CU68,807 (CU100,000 x (CU75,000 ÷ CU109,000))

Installation - CU12,844 (CU100,000 x (CU14,000 ÷ CU109,000))

Warranty - CU18,349 (CU100,000 x (CU20,000 ÷ CU109,000))

The entity would recognise as revenue the amount allocated to each performance obligation when (or as) each performance obligation is satisfied.

Frequently asked questions

Question 6-9: How does an entity allocate the transaction price in a contract with multiple performance obligations in which the entity acts as both a principal and an agent?

(TRG meeting 18 July 2014 - Agenda paper no. 1)

The standard does not illustrate the allocation of the transaction price for a contract with multiple performance obligations in which the entity acts as both a principal and an agent (see section 4.4 above for a discussion of principal versus agent considerations). Below we illustrate two acceptable ways to perform the allocation for this type of contract that are consistent with the standard's objective for allocating the transaction price. Entities need to evaluate the facts and circumstances of their contracts to make sure that the allocation involving multiple performance obligations in which an entity acts as both a principal and an agent meets the allocation objective in IFRS 15.73.

Illustration 6-6: Allocation when an entity is both a principal and an agent in a contract

Entity X sells two distinct products (i.e., Product A and Product B) to Customer Y, along with a distinct service for an aggregate contract price of CU800. Entity X is the principal for the sale of Product A and Product B, but is an agent for the sale of the service.

The stand-alone selling price of each good and service in the contract is, as follows:

Contract	Stand-alone selling price
	CU
Product A	500
Product B	300
Service	200
Total	**1,000**

Entity X earns a 20% commission from the third-party service provider based on the stand-alone selling price of the service. That is, Entity X earns CU40 of commission (i.e., CU200 x 20%) and remits the remaining CU160 to the third-party service provider.

Method A - Entity X determines that it has provided a single discount of CU200 (i.e., sum of stand-alone selling prices of CU1,000 less the contract price of CU800) on the bundle of goods and services sold to Customer Y in the contract (i.e., Products A and B and the service provided by the third party). Assume that the criteria for allocating the discount to one or more, but not all, performance obligations in accordance with IFRS 15.82 are not met - see section 6.4 below.

In order to allocate the discount to all of the goods and services in the contract, Entity X considers the performance obligation for the agency service as part of the contract with Customer Y for purposes of allocating the transaction price. Entity X determines the stand-alone selling prices of Products A and B and the agency service and allocates the transaction price of CU640 (i.e., CU800 contract price less CU160 to be remitted to the third-party service provider) for Products A and B and the service on a relative stand-alone selling price basis. This method is illustrated, as follows:

Contract	Stand-alone selling price		Allocated transaction price
	CU		CU
Product A	500	(500 ÷ 840 × 640)	381
Product B	300	(300 ÷ 840 × 640)	229
Service	40	(40 ÷ 840 × 640)	30
Total	**840**		**640**

Method B - Entity X determines that it has provided a discount of CU200 on Products A and B since it is the principal for the transfer of those goods to Customer Y. Entity X believes the third-party service provider is a separate customer for its agency services and the commission Entity X expects to be entitled to receive for the agency service is not part of the transaction price in the contract with Customer Y. Entity X allocates a transaction price of CU600 (i.e., CU800 contract price less CU200 stand-alone selling price of service) to Product A and B on a relative stand-alone selling price basis. This method is illustrated, as follows:

Contract 1	Stand-alone selling price		Allocated transaction price
	CU		CU
Product A	500	(500 ÷ 800 × 600)	375
Product B	300	(300 ÷ 800 × 600)	225
Total	**800**		**600**

The entity would recognise CU40 separately for its earned commission on the service contract when the performance obligation for the agency service has been satisfied.

In either method, the same amount of revenue is ultimately recognised (i.e., CU640). However, the timing of revenue recognition would be different if the products and agency service are transferred to the customer at different times.

Question 6-10: How does an entity allocate the transaction price in a contract with optional purchases using the relative stand-alone selling price method?

(TRG meeting 9 November 2015 - Agenda paper no. 48)

TRG members generally agreed that, if there are no contractual penalties, the entity would not identify the additional goods and services underlying the option as performance obligations at contract inception. Therefore, the consideration that would be received for the optional goods or services is not included in the transaction price at contract inception (refer to Question 4-21 in section 4.6 above for additional details). The option needs to be assessed to determine whether it represents a material right that would be accounted for as a performance obligation. If the entity concludes the option is a material right, a portion of the consideration is allocated to that option using the relative stand-alone selling price method. Consider the following Illustration based on an example from the TRG agenda paper:

Illustration 6-7: Allocation using the relative stand-alone selling price method

An entity sells equipment and consumables, both of which are determined to be distinct goods that generate revenue that is recognised at a point in time. The stand-alone selling prices of the equipment and each consumable are CU10,000 and CU100, respectively.

The entity enters into a contract to sell the equipment for CU10,000 and gives the customer the option to purchase each consumable for CU80 (the entity concludes the 20% discount on consumables is material). The equipment cost the entity CU8,000, and each consumable costs the entity CU60. The customer is not required to purchase any consumables, however, the option to purchase consumables represents a material right. The entity estimates that 200 consumables would be purchased, and the stand-alone selling price of the material right is CU4,000.

The transaction price of CU10,000 for the sale of the equipment (prior to the purchase of any consumables) is allocated to the performance obligations on a relative stand-alone selling price basis. This method is illustrated, as follows:

	Stand-alone selling price		Allocated transaction price
	CU		CU
Equipment	10,000	(10,000 ÷ 14,000 × 10,000)	7,143
Material right	4,000	(4,000 ÷ 14,000 × 10,000)	2,857
Total	**14,000**		**10,000**

The allocated transaction price would be recognised as each performance obligation is satisfied (refer to section 7 below). The entity would recognise a loss on the sale of the equipment, and recognition of some of the transaction price would be deferred until the option to purchase the consumables has been exercised and control of the consumables is transferred.

Question 6-11: How does an entity allocate a significant financing component when there are multiple performance obligations in a contract?

(TRG meeting 30 March 2015 - Agenda paper no. 30)

See response to Question 5-26 in section 5.5.4.

6.3 Allocating variable consideration

The relative stand-alone selling price method is the default method for allocating the transaction price. However, the Board noted in the Basis for Conclusions on IFRS 15 that this method might not always result in a faithful depiction of the amount of consideration to which an entity expects to be entitled from the customer. *[IFRS 15.BC280]*. Therefore, the standard provides two exceptions to the relative selling price method of allocating the transaction price.

The first relates to the allocation of variable consideration (see section 6.4 below for the second exception on the allocation of a discount). This exception requires variable consideration to be allocated entirely to a specific part of a contract, such as one or more (but not all) performance obligations in the contract (e.g., a bonus might be contingent on an entity transferring a promised good or service within a specified period of time) or one or more (but not all) distinct goods or services promised in a series of distinct goods or services that form part of a single performance obligation (see section 4.2.2 above). For example, the consideration promised for the second year of a two-year cleaning contract will increase on the basis of movements in a specified inflation index. This exception will be applied to a single performance obligation, a combination of performance obligations or distinct goods or services that make up part of a performance obligation depending on the facts and circumstances of each contract. *[IFRS 15.84]*.

Two criteria must be met to apply this exception, as follows: *[IFRS 15.85, IFRS 15.86]*

Extract from IFRS 15

85 An entity shall allocate a variable amount (and subsequent changes to that amount) entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation in accordance with paragraph 22(b) if both of the following criteria are met:

(a) the terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service); and

(b) allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective in paragraph 73 when considering all of the performance obligations and payment terms in the contract.

86 The allocation requirements in paragraphs 73-83 shall be applied to allocate the remaining amount of the transaction price that does not meet the criteria in paragraph 85.

While the language in IFRS 15.85 in the extract above implies that this exception is limited to allocating variable consideration to a single performance obligation or a single distinct good or service within a series, IFRS 15.84 indicates that the variable consideration can be allocated to 'one or more, but not all', performance obligations or distinct goods or services within a series. We understand it was not the Board's intent to limit this exception to a single performance obligation or a single distinct good or service within a series, even though the standard uses a singular construction for the remainder of the discussion and does not repeat 'one or more, but not all'.

The Board noted in the Basis for Conclusions that this exception is necessary because allocating contingent amounts to all performance obligations in a contract might not reflect the economics of a transaction in all cases. *[IFRS 15.BC284]*. Allocating variable consideration entirely to a distinct good or service would be appropriate when the result is that the amount allocated to that particular good or service is reasonable relative to all other performance obligations and payment terms in the contract. Subsequent changes in variable consideration must be allocated in a consistent manner. It is important to note that allocating variable consideration to one or more, but not all, performance obligations or distinct goods or services in a series is a requirement, not a policy choice. If the above criteria in IFRS 15.85 are met, the entity must allocate the variable consideration to the related performance obligation(s) or distinct goods or services in a series. Entities might need to exercise significant judgement to determine whether they meet the requirements to allocate variable consideration to specific performance obligations or distinct goods or services within a series. *[IFRS 15.85]*.

Firstly, entities need to determine whether they meet the first criterion in IFRS 15.85, which requires that the terms of a variable payment relate specifically to either: 1) an entity's efforts to satisfy a performance obligation (or to transfer a distinct good or service that is part of a series); or 2) a specific outcome from satisfying the performance obligation (or transferring the distinct good or service).

In performing this assessment, an entity needs to consider the nature of its promise and how the performance obligation has been defined. In addition, the entity needs to clearly understand the variable payment terms and how they align with the entity's promise. This includes evaluating any clawbacks or other potential adjustments to the variable payment. For example, an entity might conclude that the nature of its promise in a contract is to provide hotel management services (including management of the hotel employees, accounting services, training, and procurement, etc.) that comprise a series of distinct services (i.e., daily hotel management). For providing this service, the entity receives a variable fee based on a percentage of occupancy rates. It is likely that the entity would determine that it meets the first criterion to allocate the daily variable fee to the distinct service performed that day because the uncertainty related to the consideration is resolved on a daily basis as the entity satisfies its obligation to perform daily hotel management services. This is because the variable payments specifically relate to transferring the distinct service that is part of a series of distinct goods or services (i.e., the daily management service). The fact that the payments do not directly correlate with each of the underlying activities performed each day does not affect this assessment. Refer to section 4 above for further discussion on identifying the nature of the goods or services promised in a contract, including whether they meet the series requirement.

In contrast, consider an entity that has a contract to sell equipment and maintenance services for that equipment. The maintenance services have been determined to be a series of distinct services because the customer benefits from the entity standing ready to perform in case the equipment breaks down. The consideration for the maintenance services is based on usage of the equipment and is, therefore, variable. In this example, the payment terms do not align with the nature of the entity's promise. This is because the payment terms are usage-based, but the nature of the entity's promise is to stand ready each day to perform any maintenance that is needed, regardless of how much the customer uses the equipment. Since the entity does not meet the criteria to apply the allocation exception, it must estimate the variable consideration at contract inception and over the life of the contract, including consideration of the constraint. The entity would then recognise revenue based on its selected measure of progress (see section 7.1.4 below).

After assessment of the first criterion, entities need to determine whether they meet the second criterion in IFRS 15.85; to confirm that allocating the consideration in this manner is consistent with the overall allocation objective of the standard in IFRS 15.73. That is, an entity must allocate to each performance obligation (or distinct good or service in a series) the portion of the transaction price that reflects the amount of consideration the entity expects to be entitled to in exchange for transferring those goods or services to the customer.

The TRG discussed four types of contracts with different variable payment terms that are accounted for as a series of distinct goods or services (see section 4.2.2 above) and for which an entity might reasonably conclude that the allocation objective has been met (and the variable consideration could be allocated to each distinct period of service, such as day, month or year), which are detailed below:[103]

- Declining prices - The TRG agenda paper included an IT outsourcing contract in which the events that trigger the variable consideration are the same throughout the contract, but the per unit price declines over the life of the contract. The allocation objective could be met if the pricing is based on market terms (e.g., if the contract contains a benchmarking clause) or the changes in price are substantive and linked to changes in an entity's cost to fulfil the obligation or value provided to the customer.
- Consistent fixed prices - The TRG agenda paper included a transaction processing contract with an unknown quantity of transactions, but a fixed contractual rate per transaction. The allocation objective could be met if the fees are priced consistently throughout the contract and the rates charged are consistent with the entity's standard pricing practices with similar customers.
- Consistent variable fees, cost reimbursements and incentive fees - The TRG agenda paper included a hotel management contract in which monthly consideration is based on a percentage of monthly rental revenue, reimbursement of labour costs and an annual incentive payment. The allocation objective could be met for each payment stream as follows. The base monthly fees could meet the allocation objective if the consistent measure throughout the contract period (e.g., 1% of monthly rental revenue) reflects the value to the customer. The cost reimbursements could meet the allocation objective if they are commensurate with an entity's efforts to fulfil the promise each day. The annual incentive fee could also meet the allocation objective if it reflects the value delivered to the customer for the annual period and is reasonable compared with incentive fees that could be earned in other periods.

103 TRG Agenda paper no. 39, *Application of the Series Provision and Allocation of Variable Consideration*, dated 13 July 2015.

- Sales-based and usage-based royalty for licences of intellectual property - The TRG agenda paper included a franchise agreement in which franchisor will receive a sales-based royalty of 5% in addition to a fixed fee. The allocation objective could be met if the consistent formula throughout the licence period reasonably reflects the value to the customer of its access to the franchisor's intellectual property (e.g., reflected by the sales that have been generated by the customer).

Beyond these four types of contracts discussed by the TRG, entities might also need to use judgement to determine whether contracts with usage-based variable consideration provisions meet the variable consideration allocation exception criteria, as discussed in sections 6.3.1 and 6.3.2 below.

6.3.1 Variable fee arrangements based on usage

Consideration for some service contracts is based entirely on customer usage, and an entity has a stand-ready obligation to perform, regardless of how often the customer uses the service. Therefore, the usage-based fees are variable consideration.

It is important to note that, while these usage-based transactions might be economically similar to licensing arrangements that include sales-based or usage-based royalties, the accounting would be different. As described in section 8.5 below, sales-based and usage-based royalties on licences of intellectual property are subject to the royalty recognition constraint and that requirement must be applied to the overall royalty stream when the sole or predominant item to which the royalty relates is a licence of intellectual property. Entities cannot analogise to the royalty recognition constraint for other situations.

If the usage-based fees relate specifically to the entity's effort to satisfy the performance obligation to provide services (or to a specific outcome from satisfying the performance obligation) and allocating the variable consideration to each distinct day is consistent with the allocation objective, the variable consideration allocation exception is met and the consideration is allocated to the period in which the usage occurred. If the usage-based fees do not relate to an entity's effort to satisfy the performance obligation (or to a specific outcome from satisfying the performance obligation) or if the allocation of the usage-based fees is not consistent with the allocation exception, the allocation exception is not met. For example, the allocation exception would not be met if the fees decline over the contract term as an incentive for the customer to achieve certain volume thresholds if, as discussed in section 6.3 above, such pricing is not based on market terms or not linked to changes in the entity's cost to fulfil the obligation or value provided to the customer. In this situation, the variable consideration is estimated at contract inception and it is to be recognised over the contract duration based on a selected measure of progress. These estimates of variable consideration must be updated at the end of each reporting period and are subject to the constraint on variable consideration. See section 5.2 above for further discussion on estimating variable consideration.

Consider the following Illustration of a contract with variable usage-based fees calculated daily that is likely to meet the variable consideration allocation exception:

Illustration 6-8: Variable fee service arrangement based on usage

Provider C enters into a contract for cloud storage in which a customer agrees to pay daily fees based on the amount of storage space it uses (i.e., a fixed daily rate of CU0.025 per gigabyte of storage is multiplied by the number of gigabytes used). Provider C invoices the customer at the end of each month. Assume that the entity has appropriately concluded that the nature of the entity's performance obligation is to stand ready to provide any amount of storage space the customer needs at any time during the contract term and the consideration in the contract is variable based on the number of gigabytes of storage used (and, therefore, each gigabyte used is not an optional purchase - refer to Question 4-20 in section 4.6 above).

Provider C determines that the service provided to the customer in this contract meets the criteria to be accounted for as a series of distinct goods or services (see section 4.2.2 above). This is because the performance obligation to stand ready to provide any amount of storage space represents a series of distinct services that are substantially the same and have the same pattern of transfer to the customer.

Provider C then considers whether the variable consideration allocation exception would apply to the daily usage-based fees. Provider C determines that it meets the first criterion to allocate the daily variable fee to the distinct service performed that day because the uncertainty related to the consideration is resolved on a daily basis as the entity satisfies its obligation to provide cloud storage. This is because the variable payments specifically relate to transferring the distinct service (i.e., access to any amount of cloud storage that the customer chooses to use each day).

Provider C concludes that allocating the variable payments to each day is consistent with the allocation objective because the fixed-rate-per-gigabyte fees reflect the value to the customer based on the amount of storage the customer uses each day. Furthermore, the rates charged are consistent with Provider C's standard pricing practices.

Therefore, Provider C determines that it needs to apply the variable consideration allocation exception and recognises each day's fee for the day in which it occurs. That is, if the customer uses 250 gigabytes of storage the first day and 300 gigabytes the second, Provider C will recognise CU6.25 and CU7.50 of revenue for the respective days.

6.3.2 Fixed-fee arrangements with overages

Some service contracts have fixed fees (including any minimum amounts guaranteed) but also require customers to pay overage fees when they exceed certain thresholds based on usage. When an entity's performance obligation is to stand ready to perform, regardless of customer usage, the overage fee is considered variable consideration that the entity needs to estimate at contract inception, unless the variable consideration allocation exception is met.

How we see it

We believe that, for an entity to apply the variable consideration allocation exception by allocating overage fees to a particular period (e.g., day, month, year), the entity would have to conclude that the overage fees relate to its performance during that particular period.

Consider the following Illustration of a contract with fixed fees and annual overages:

Illustration 6-9: Fixed-fee service arrangement with overages

Entity X enters into a three-year contract with a customer to provide access to its SaaS application, which allows the customer to process transactions, among other functions. The customer agrees to pay an annual fee of CU100,000, plus overage fees at a rate of CU0.10 per transaction for transactions processed through the application during the year that exceed one million (i.e., overage fees are only paid if the customer processes more than one million transactions during the year).

Assume that Entity X has determined that the nature of its performance obligation is to provide continuous access to the SaaS application, regardless of the number of transactions processed. Entity X determines that the CU100,000 annual fee is fixed consideration and all additional consideration received as overage fees is variable consideration.

Also assume that Entity X has determined that the fixed component of the consideration needs to be recognised rateably over the contract term because the service is provided to the customer on a consistent basis (i.e., the performance obligation is satisfied evenly over the period). Entity X will then need to determine whether the variable consideration allocation exception applies to the overage fees, which are calculated based on annual usage.

Evaluating the allocation exception for distinct daily periods

We believe that, for the entity to apply the variable consideration allocation exception by allocating overage fees to a particular day, the entity would have to conclude that the overage fees relate to its performance on that particular day. Therefore, Entity X concludes that it cannot apply the variable consideration allocation exception to the daily reporting periods for the overage fees because those payments do not relate to its efforts to satisfy the performance obligation to provide continuous access to the platform. That is, the nature of the performance obligation is a series of daily stand-ready obligations that are satisfied evenly over time, and the overage fees are additional consideration for satisfying that performance obligation over the course of each year.

Since the overage fees are only incurred after the annual minimum is reached, recognising revenue when the fees are incurred would result in more revenue recognised for the periods after the minimum is reached (i.e., backloading the revenue recognition), which is inconsistent with the allocation objective in IFRS 15.73. Therefore, the criteria for using the variable consideration allocation exception would not be met for each day of service, and Entity X would not recognise revenue for the overages on the days when the fees are incurred. However, we believe that if the overages in this example were calculated based on a short period of usage (e.g., daily or monthly (instead of annually)), Entity X might be able to demonstrate that it meets the criteria to apply the variable consideration allocation exception. This is because of the relatively short period of time between Entity X's performance and when it is entitled to the variable consideration such that Entity X could reasonably conclude that the allocation objective in IFRS 15.73 has been met.

Evaluating the allocation exception for annual periods

Since Entity X earns overage fees over a period of time that is less than the contract term (i.e., a three-year contract where overage fees are accrued and reset on an annual basis), Entity X would evaluate whether the overages need to be allocated to the period in which the overage fees are earned (e.g., to the annual period in which overages accrue).

To do so, Entity X evaluates whether it meets the criteria to apply the variable consideration allocation exception to the overage fees earned in each annual period in the three-year contract. Entity X might conclude that it needs to apply the variable consideration allocation exception to the overage fees earned in annual periods, which would require the entity to allocate the annual overage fees to each respective year (since the overages can be attributed to a single year). Therefore, Entity X will need to estimate overage fees only for each annual period (also considering the variable consideration constraint, as discussed in section 5.2 above), rather than for the full three-year period at contract inception (which would be required if the variable consideration allocation exception was not met for any period). This would result in recognition of revenue from the overage fees only in the annual period to which the overages relate and not over the entire contract term.

For example, if the entity estimated that the overage fees for the first year would be CU20,000, it would recognise this amount rateably over the year (i.e., CU5,000 in each quarter), in addition to the fixed consideration that is also recognised rateably. The estimates of variable consideration must be updated at the end of each reporting period, as discussed in section 5.2.4 above.

6.3.3 Example of allocating variable consideration

The standard provides the following example to illustrate when an entity is or is not able to allocate variable consideration to a specific part of a contract. Note that the example focuses on licences of intellectual property, which are discussed in section 8 below: *[IFRS 15.IE Example 35, IFRS 15.IE178-IE187]*

Extract from IFRS 15

Example 35-Allocation of variable consideration

An entity enters into a contract with a customer for two intellectual property licences (Licences X and Y), which the entity determines to represent two performance obligations each satisfied at a point in time. The stand-alone selling prices of Licences X and Y are CU800 and CU1,000, respectively.

Case A-Variable consideration allocated entirely to one performance obligation

The price stated in the contract for Licence X is a fixed amount of CU800 and for Licence Y the consideration is three per cent of the customer's future sales of products that use Licence Y. For purposes of allocation, the entity estimates its sales-based royalties (ie the variable consideration) to be CU1,000, in accordance with paragraph 53 of IFRS 15.

To allocate the transaction price, the entity considers the criteria in paragraph 85 of IFRS 15 and concludes that the variable consideration (ie the sales-based royalties) should be allocated entirely to Licence Y. The entity concludes that the criteria in paragraph 85 of IFRS 15 are met for the following reasons:

(a) the variable payment relates specifically to an outcome from the performance obligation to transfer Licence Y (ie the customer's subsequent sales of products that use Licence Y).

(b) allocating the expected royalty amounts of CU1,000 entirely to Licence Y is consistent with the allocation objective in paragraph 73 of IFRS 15. This is because the entity's estimate of the amount of sales-based royalties (CU1,000) approximates the stand-alone selling price of Licence Y and the fixed amount of CU800 approximates the stand-alone selling price of Licence X. The entity allocates CU800 to Licence X in accordance with paragraph 86 of IFRS 15. This is because, based on an assessment of the facts and circumstances relating to both licences, allocating to Licence Y some of the fixed consideration in addition to all of the variable consideration would not meet the allocation objective in paragraph 73 of IFRS 15.

The entity transfers Licence Y at inception of the contract and transfers Licence X one month later. Upon the transfer of Licence Y, the entity does not recognise revenue because the consideration allocated to Licence Y is in the form of a sales-based royalty. Therefore, in accordance with paragraph B63 of IFRS 15, the entity recognises revenue for the sales-based royalty when those subsequent sales occur.

When Licence X is transferred, the entity recognises as revenue the CU800 allocated to Licence X.

Case B-Variable consideration allocated on the basis of stand-alone selling prices

The price stated in the contract for Licence X is a fixed amount of CU300 and for Licence Y the consideration is five per cent of the customer's future sales of products that use Licence Y. The entity's estimate of the sales-based royalties (ie the variable consideration) is CU1,500 in accordance with paragraph 53 of IFRS 15.

To allocate the transaction price, the entity applies the criteria in paragraph 85 of IFRS 15 to determine whether to allocate the variable consideration (ie the sales-based royalties) entirely to Licence Y. In applying the criteria, the entity concludes that even though the variable payments relate specifically to an outcome from the performance obligation to transfer Licence Y (ie the customer's subsequent sales of products that use Licence Y), allocating the variable consideration entirely to Licence Y would be inconsistent with the principle for allocating the transaction price. Allocating CU300 to Licence X and CU1,500 to Licence Y does not reflect a reasonable allocation of the transaction price on the basis of the stand-alone selling prices of Licences X and Y of CU800 and CU1,000, respectively. Consequently, the entity applies the general allocation requirements in paragraphs 76-80 of IFRS 15.

The entity allocates the transaction price of CU300 to Licences X and Y on the basis of relative stand-alone selling prices of CU800 and CU1,000, respectively. The entity also allocates the consideration related to the sales-based royalty on a relative stand-alone selling price basis. However, in accordance with paragraph B63 of IFRS 15, when an entity licenses intellectual property in which the consideration is in the form of a sales-based royalty, the entity cannot recognise revenue until the later of the following events: the subsequent sales occur or the performance obligation is satisfied (or partially satisfied).

Licence Y is transferred to the customer at the inception of the contract and Licence X is transferred three months later. When Licence Y is transferred, the entity recognises as revenue the CU167 (CU1,000 ÷ CU1,800 × CU300) allocated to Licence Y. When Licence X is transferred, the entity recognises as revenue the CU133 (CU800 ÷ CU1,800 × CU300) allocated to Licence X.

In the first month, the royalty due from the customer's first month of sales is CU200. Consequently, in accordance with paragraph B63 of IFRS 15, the entity recognises as revenue the CU111 (CU1,000 ÷ CU1,800 × CU200) allocated to Licence Y (which has been transferred to the customer and is therefore a satisfied performance obligation). The entity recognises a contract liability for the CU89 (CU800 ÷ CU1,800 × CU200) allocated to Licence X. This is because although the subsequent sale by the entity's customer has occurred, the performance obligation to which the royalty has been allocated has not been satisfied.

Frequently asked questions

Question 6-12: In order to meet the criteria to allocate variable consideration entirely to a specific part of a contract, must the allocation be made on a relative stand-alone selling price basis?

(TRG meeting 13 July 2015 - Agenda paper no. 39)

The members of the TRG generally agreed that a relative stand-alone selling price allocation is not required to meet the allocation objective when it relates to the allocation of variable consideration to a specific part of a contract (e.g., a distinct good or service in a series). That is, the guidance would not require the same amount (absolute value) of variable consideration to be allocated to each distinct service that is substantially the same. The Basis for Conclusions notes that stand-alone selling price is the default method for meeting the allocation objective, but other methods could be used in certain instances (e.g., in allocating variable consideration). *[IFRS 15.BC279, IFRS 15.BC280]*.

While the standard does not state what other allocation methods could be used beyond the relative stand-alone selling price basis, the members of the TRG generally agreed that an entity would apply reasonable judgement to determine whether the allocation results in a reasonable outcome (and, therefore, meets the allocation objective in the standard), as discussed in section 6.3 above.

6.4 Allocating a discount

The second exception to the relative stand-alone selling price allocation (see section 6.3 above for the first exception) relates to discounts inherent in contracts. When an entity sells a bundle of goods or services, the selling price of the bundle is often less than the sum of the stand-alone selling prices of the individual elements. Under the relative stand-alone selling price allocation method, this discount would be allocated proportionately to all performance obligations. *[IFRS 15.81]*. However, if an entity determines that a discount is not related to all of the promised goods or services in the contract, the entity must allocate the contract's entire discount only to the goods or services to which it relates, if all of the following criteria are met: *[IFRS 15.82]*

Extract from IFRS 15

82 An entity shall allocate a discount entirely to one or more, but not all, performance obligations in the contract if all of the following criteria are met:

(a) the entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a stand-alone basis;

(b) the entity also regularly sells on a stand-alone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the stand-alone selling prices of the goods or services in each bundle; and

(c) the discount attributable to each bundle of goods or services described in paragraph 82(b) is substantially the same as the discount in the contract and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.

An entity makes this determination when the price of certain goods or services is largely independent of other goods or services in the contract. In these situations, an entity is able to effectively 'carve out' an individual performance obligation, or some of the performance obligations in the contract, and allocate the contract's entire discount to one or more, but not all, performance obligations provided the above criteria are met. However, an entity cannot use this exception to allocate only a portion of the discount to one or more, but not all, performance obligations in the contract.

The Board noted in the Basis for Conclusions that the requirements in IFRS 15.82 generally apply to contracts that include at least three performance obligations. While the standard contemplates that it might be possible for an entity to allocate the entire discount to as few as one performance obligation, the Board noted that such situations are expected to be rare. *[IFRS 15.BC283]*. Instead, the Board believes it is more likely that an entity will be able to demonstrate that a discount relates to two or more performance obligations. This is because an entity is likely to have observable information that the stand-alone selling price of a group of promised goods or services is lower than the price of those items when sold separately. It could be more difficult for an entity to have sufficient evidence to demonstrate that a discount is associated with a single performance obligation. When an entity applies a discount to one or more performance obligations in accordance with the above criteria, the standard states that the discount is allocated first before using the residual approach to estimate the stand-alone selling price of a good or service (see section 6.1.2 above). *[IFRS 15.83]*.

The standard includes the following example to illustrate this exception and when the use of the residual approach (discussed in section 6.1.2 above) for estimating stand-alone selling prices is or is not appropriate: *[IFRS 15.IE Example 34, IFRS 15.IE167-IE177]*

Extract from IFRS 15

Example 34-Allocating a discount

An entity regularly sells Products A, B and C individually, thereby establishing the following stand-alone selling prices:

Product	Stand-alone selling price
	CU
Product A	40
Product B	55
Product C	45
Total	140

In addition, the entity regularly sells Products B and C together for CU60.

Case A-Allocating a discount to one or more performance obligations

The entity enters into a contract with a customer to sell Products A, B and C in exchange for CU100. The entity will satisfy the performance obligations for each of the products at different points in time.

The contract includes a discount of CU40 on the overall transaction, which would be allocated proportionately to all three performance obligations when allocating the transaction price using the relative stand-alone selling price method (in accordance with paragraph 81 of IFRS 15). However, because the entity regularly sells Products B and C together for CU60 and Product A for CU40, it has evidence that the entire discount should be allocated to the promises to transfer Products B and C in accordance with paragraph 82 of IFRS 15.

If the entity transfers control of Products B and C at the same point in time, then the entity could, as a practical matter, account for the transfer of those products as a single performance obligation. That is, the entity could allocate CU60 of the transaction price to the single performance obligation and recognise revenue of CU60 when Products B and C simultaneously transfer to the customer.

If the contract requires the entity to transfer control of Products B and C at different points in time, then the allocated amount of CU60 is individually allocated to the promises to transfer Product B (stand-alone selling price of CU55) and Product C (stand-alone selling price of CU45) as follows:

Product	Allocated transaction price	
	CU	
Product B	33	(CU55 ÷ CU100 total stand-alone selling price × CU60)
Product C	27	(CU45 ÷ CU100 total stand-alone selling price × CU60)
Total	60	

Case B-Residual approach is appropriate

The entity enters into a contract with a customer to sell Products A, B and C as described in Case A. The contract also includes a promise to transfer Product D. Total consideration in the contract is CU130. The stand-alone selling price for Product D is highly variable (see paragraph 79(c) of IFRS 15) because the entity sells Product D to different customers for a broad range of amounts (CU15-CU45). Consequently, the entity decides to estimate the stand-alone selling price of Product D using the residual approach.

Before estimating the stand-alone selling price of Product D using the residual approach, the entity determines whether any discount should be allocated to the other performance obligations in the contract in accordance with paragraphs 82 and 83 of IFRS 15.

As in Case A, because the entity regularly sells Products B and C together for CU60 and Product A for CU40, it has observable evidence that CU100 should be allocated to those three products and a CU40 discount should be allocated to the promises to transfer Products B and C in accordance with paragraph 82 of IFRS 15. Using the residual approach, the entity estimates the stand-alone selling price of Product D to be CU30 as follows:

Product	Stand-alone selling price	Method
	CU	
Product A	40	Directly observable (see paragraph 77 of IFRS 15)
Products B and C	60	Directly observable with discount (see paragraph 82 of IFRS 15)
Product D	30	Residual approach (see paragraph 79(c) of IFRS 15)
Total	130	

The entity observes that the resulting CU30 allocated to Product D is within the range of its observable selling prices (CU15-CU45). Therefore, the resulting allocation (see above table) is consistent with the allocation objective in paragraph 73 of IFRS 15 and the requirements in paragraph 78 of IFRS 15.

Case C-Residual approach is inappropriate

The same facts as in Case B apply to Case C except the transaction price is CU105 instead of CU130. Consequently, the application of the residual approach would result in a stand-alone selling price of CU5 for Product D (CU105 transaction price less CU100 allocated to Products A, B and C). The entity concludes that CU5 would not faithfully depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying its performance obligation to transfer Product D, because CU5 does not approximate the stand-alone selling price of Product D, which ranges from CU15-CU45.

Consequently, the entity reviews its observable data, including sales and margin reports, to estimate the stand-alone selling price of Product D using another suitable method. The entity allocates the transaction price of CU105 to Products A, B, C and D using the relative stand-alone selling prices of those products in accordance with paragraphs 73-80 of IFRS 15.

How we see it

The exception allowing allocation of a discount to some, but not all, performance obligations within a contract gives entities the ability to better reflect the economics of the transaction in certain circumstances. However, the criteria that must be met to demonstrate that a discount is associated with only some of the performance obligations in the contract is likely to limit the number of transactions that are eligible for this exception.

Frequently asked questions

Question 6-13: If a discount also meets the definition of variable consideration (because it is variable in amount and/or contingent on a future event), which allocation exception would an entity apply?

(TRG meeting 30 March 2015 - Agenda paper no. 31)

TRG members generally agreed that an entity will first determine whether a variable discount meets the variable consideration exception (see section 6.3 above). *[IFRS 15.86]*. If it does not, the entity then considers whether it meets the discount exception (see section 6.4 above). In reaching that conclusion, the TRG agenda paper noted that IFRS 15.86 establishes a hierarchy for allocating variable consideration that requires an entity to identify variable consideration and then determine whether it must allocate variable consideration to one or some, but not all, performance obligations (or distinct goods or services that comprise a single performance obligation) based on the exception for allocating variable consideration. The entity would consider the requirements for allocating a discount only if the discount is not variable consideration (i.e., the amount of the discount is fixed and not contingent on future events) or the entity does not meet the criteria to allocate variable consideration to a specific part of the contract.[104]

6.5 Changes in transaction price after contract inception

The standard requires entities to determine the transaction price at contract inception. However, there could be changes to the transaction price after contract inception. For example, as discussed in section 5.2.4 above, when a contract includes variable consideration, entities need to update their estimate of the transaction price at the end of each reporting period to reflect any changes in circumstances. Changes in the transaction price can also occur due to contract modifications (see section 3.4 above).

As stated in IFRS 15.88-89, changes in the total transaction price are generally allocated to the performance obligations on the same basis as the initial allocation, whether they are allocated based on the relative stand-alone selling price (i.e., using the same proportionate share of the total) or to individual performance obligations under the allocation exceptions discussed in section 6.3 and section 6.4 above. Amounts allocated to a satisfied performance obligation must be recognised as revenue, or a reduction in revenue, in the period that the transaction price changes.

As discussed in section 6.1 and section 6.1.3 above, stand-alone selling prices are not updated after contract inception, unless the contract has been modified and the contract modification is accounted for as a new or separate contract. Furthermore, any amounts allocated to satisfied (or partially satisfied) performance obligations must be recognised in revenue in the period in which the transaction price changes (i.e., on a cumulative catch-up basis). This could result in either an increase or decrease to revenue in relation to a satisfied performance obligation or to cumulative revenue recognised for a partially satisfied over time performance obligation (see section 7.1 below). *[IFRS 15.88, IFRS 15.89]*.

104 TRG Agenda paper no. 31, *Allocation of the Transaction Price for Discounts and Variable Consideration*, dated 30 March 2015 and TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015.

The following Illustration explains this concept for a partially satisfied over-time performance obligation:

Illustration 6-10: Change in transaction price after contract inception

Entity A, a construction company, enters into a contract with a customer on 1 January 20X1 to build three specific amenities at a community centre, a swimming pool, playground and a parking lot, for CU3,000,000. Entity A will earn a bonus of CU250,000 if it completes the swimming pool by 1 May 20X1.

At contract inception, Entity A concludes that the swimming pool, playground and parking lot are each distinct and, therefore, represent separate performance obligations. Entity A also concludes that the CU250,000 bonus needs to be allocated entirely to the swimming pool because the criteria in IFRS 15.85 for the variable consideration allocation are met. However, Entity A does not expect it will be entitled to the CU250,000 bonus related to the completion of the swimming pool by 1 May 20X1 due to factors outside of Entity A's control, including inclement winter weather and the swimming pool supplier's backlog. Therefore, Entity A uses the most likely amount method to estimate variable consideration and does not include the bonus in the transaction price.

As at 1 January 20X1, Entity A allocates the transaction price to the performance obligations on a relative stand-alone selling price basis, as follows:

Performance obligations	Allocation of the transaction price
Swimming pool	CU2,000,000
Playground	CU750,000
Parking lot	CU250,000
Total	**CU3,000,000**

Entity A concludes that each of the performance obligations are satisfied over time because they meet the criteria in IFRS 15.35 (refer to section 7.1 below for further discussion on evaluating whether performance obligations are satisfied over time). Due to the nature of Entity A's business, it determines that an input method based on costs incurred is an appropriate measure of progress over time.

As at 31 March 20X1, Entity A determines that it has incurred 60% of the total expected costs to complete each of its performance obligations. Therefore, Entity A recognises CU1,800,000 (CU3,000,000 × 60%) as revenue.

In addition, as at 31 March 20X1, Entity A reassesses its estimate of variable consideration in the contract (including the constraint) and believes it will be able to complete the swimming pool by 1 May 20X1, because the significant uncertainties related to the weather and the supplier have been resolved. Entity A updates its transaction price to include the CU250,000 bonus related to the swimming pool in accordance with IFRS 15.59. Therefore, Entity A updates the transaction price as at 31 March 20X1, as follows:

Performance obligations	Allocation of the transaction price
Swimming pool	CU2,250,000
Playground	CU750,000
Parking lot	CU250,000
Total	**CU3,250,000**

Due to the change in the transaction price related to the swimming pool performance obligation, Entity A recognises CU150,000 (CU250,000 × 60%) as revenue on a cumulative catch-up basis as at 31 March 20X1.

If the change in the transaction price is due to a contract modification, the contract modification requirements in IFRS 15.18-21 must be followed (see section 3.4 above for a discussion on contract modifications). *[IFRS 15.90]*. See Question 3-15 in section 3.4 for further discussion on how an entity would distinguish between a contract modification and a change in the estimated transaction price due to variable consideration after contract inception. In addition, when contracts include variable consideration, it is possible that changes in the transaction price that arise after a modification are (or are not) related to performance obligations that existed before the modification. For changes in the transaction price arising after a contract modification that is not treated as a separate contract, an entity must apply one of the two approaches: *[IFRS 15.90]*

- If the change in transaction price is attributable to an amount of variable consideration promised before the modification and the modification was considered a termination of the existing contract and the creation of a new contract, the entity allocates the change in transaction price to the performance obligations that existed before the modification.
- In all other cases, the change in the transaction price is allocated to the performance obligations in the modified contract (i.e., the performance obligations that were unsatisfied and partially unsatisfied immediately after the modification).

The first approach is applicable to a change in transaction price that occurs after a contract modification that is accounted for in accordance with IFRS 15.21(a) (i.e., as a termination of the existing contract and the creation of a new contract) and the change in the transaction price is attributable to variable consideration promised before the modification. For example, an estimate of variable consideration in the initial contract might have changed or might no longer be constrained. *[IFRS 15.21(a), IFRS 15.90(a)]*. In this scenario, the Board decided that an entity has to allocate the corresponding change in the transaction price to the performance obligations identified in the contract before the modification (e.g., the original contract), including performance obligations that were satisfied prior to the modification. *[IFRS 15.BC83]*. That is, it would not be appropriate for an entity to allocate the corresponding change in the transaction price to the performance obligations that are in the modified contract if the promised variable consideration (and the resolution of the associated uncertainty) were not affected by the contract modification.

The second approach (i.e., IFRS 15.90(b)) is applicable in all other cases when a modification is not treated as a separate contract (e.g., when the change in the transaction price is not attributable to variable consideration promised before the modification). *[IFRS 15.90(b)]*. Under this approach, the change in the transaction price is allocated to the performance obligation(s) in the modified contract (i.e., the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification). Example 6 in IFRS 15 illustrates the accounting for a change in transaction price that occurs after a contract modification. *[IFRS 15.IE Example 6, IFRS 15.IE25-IE32]*.

The IASB noted in the Basis for Conclusions on IFRS 15 that in some cases, an estimate of variable consideration made at the end of a reporting period could be affected by information that arises after the end of the reporting period, but before the release of the financial statements. The Board decided not to include guidance in IFRS 15 to address this circumstance because an entity would follow the accounting requirements for subsequent events in IAS 10 (see Chapter 34). *[IFRS 15.BC228]*.

Frequently asked questions

Question 6-14: How would an entity distinguish between a contract modification and a change in the estimated transaction price due to variable consideration after contract inception?

See response to Question 3-15 in section 3.4 above.

6.6 Allocation of transaction price to components outside the scope of IFRS 15

Revenue arrangements might include some components that are not within the scope of IFRS 15. As discussed in section 2.5 above, the standard indicates that in such situations, an entity must first apply the other standards if those standards address separation and/or measurement. *[IFRS 15.7]*.

For example, some standards require certain components, such as financial liabilities, to be accounted for at fair value. As a result, when a revenue contract includes that type of component, the fair value of that component must be separated from the total transaction price. The remaining transaction price is then allocated to the remaining performance obligations.

The following Illustration explains this concept:

Illustration 6-11: Arrangements with components outside the scope of the standard

Retailer sells products to customers and often bundles them with prepaid gift cards when the customer buys multiple units of its products. The prepaid gift cards are non-refundable, non-redeemable and non-exchangeable for cash and do not have an expiry date or back-end fees. That is, any remaining balance on the prepaid gift cards does not reduce, unless it is spent by the customer. Customers can redeem prepaid gift cards only at third-party merchants specified by Retailer (i.e., the prepaid gift card cannot be redeemed at the Retailer) in exchange for goods or services up to a specified monetary amount. When a customer uses the prepaid gift cards at a merchant(s) to purchase goods or services, Retailer delivers cash to the merchant(s).

Customer X enters into a contract to purchase 100 units of a product and a prepaid gift card for total consideration of CU1,000. Because it bought 100 units, Retailer gives Customer X a discount on the bundle. The stand-alone selling price of the product and the fair value of the prepaid gift card are CU950 and CU200, respectively.

Retailer determines that it has a contractual obligation to deliver cash to specified merchants on behalf of the prepaid gift card owner (Customer X) and that this obligation is conditional upon Customer X using the prepaid gift card to purchase goods or services. Also, Retailer does not have an unconditional right to avoid delivering cash to settle this contractual obligation. Therefore, Retailer concludes that the liability for the prepaid gift card meets the definition of a financial liability and applies the requirements in IFRS 9 to account for it. In accordance with IFRS 15.7, because IFRS 9 provides measurement requirements for initial recognition (i.e., requires that financial liabilities within its scope be initially recognised at fair value), Retailer excludes from the IFRS 15 transaction price the fair value of the prepaid gift card. Retailer allocates the remaining transaction price to the products purchased. The allocation of the total transaction price is, as follows:

	stand-alone selling price and fair value	% Allocated discount	Allocated discount	Arrangement consideration allocation
Products (100 units)	CU950	100%	CU150	C800
Prepaid gift card	CU200	0%	-	CU200
	CU1,1150		**CU150**	**CU1,000**

For components that must be recognised at fair value at inception, any subsequent remeasurement would be pursuant to other IFRS accounting standards (e.g., IFRS 9). That is, subsequent adjustments to the fair value of those components have no effect on the amount of the transaction price previously allocated to any performance obligations included within the contract or on revenue recognised.

7 IFRS 15 - Satisfaction of performance obligations

Under IFRS 15, an entity only recognises revenue when it satisfies an identified performance obligation by transferring a promised good or service to a customer. A good or service is considered to be transferred when the customer obtains control. *[IFRS 15.31]*.

IFRS 15 states that "Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset." *[IFRS 15.33]*. Control also means the ability to prevent others from directing the use of, and receiving the benefit from, a good or service. The Board noted that both goods and services are assets that a customer acquires (even if many services are not recognised as an asset because those services are simultaneously received and consumed by the customer). *[IFRS 15.BC118]*. The IASB explained the key terms in the definition of control in the Basis for Conclusions, which are, as follows: *[IFRS 15.BC120]*

- *Ability* - a customer must have the present right to direct the use of, and obtain substantially all of the remaining benefits from, an asset for an entity to recognise revenue. For example, in a contract that requires a manufacturer to produce an asset for a customer, it might be clear that the customer will ultimately have the right to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, the entity does not recognise revenue until the customer has actually obtained that right (which, depending on the contract, might occur during production or afterwards).
- *Direct the use o*f - a customer's ability to direct the use of an asset refers to the customer's right to deploy or to allow another entity to deploy that asset in its activities or to restrict another entity from deploying that asset.
- *Obtain the benefits from* - the customer must have the ability to obtain substantially all of the remaining benefits from an asset for the customer to obtain control of it. Conceptually, the benefits from a good or service are potential cash flows (either an increase in cash inflows or a decrease in cash outflows). IFRS 15.33 indicates that a customer can obtain the benefits directly or indirectly in many ways, such as: using the asset to produce goods or services (including public services); using the asset to enhance the value of other assets; using the asset to settle a liability or reduce an expense; selling or exchanging the asset; pledging the asset to secure a loan; or holding the asset. *[IFRS 15.33]*.

Under IFRS 15, the transfer of control to the customer represents the transfer of the rights with regard to the good or service. The customer's ability to receive the benefit from the good or service is represented by its right to substantially all of the cash inflows, or the reduction of the cash outflows, generated by the goods or services. *[IFRS 15.33]*. Upon transfer of control, the customer has sole possession of the right to use the good or service for the remainder of its economic life or to consume the good or service in its own operations.

The IASB explained in the Basis for Conclusions that control must be assessed primarily from the customer's perspective. While a seller often surrenders control at the same time the customer obtains control, the Board required the assessment of control to be from the customer's perspective to minimise the risk of an entity recognising revenue from activities that do not coincide with the transfer of goods or services to the customer. *[IFRS 15.BC121]*.

The standard indicates that an entity must determine, at contract inception, whether it will transfer control of a promised good or service over time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. *[IFRS 15.32]*. These concepts are explored further in the following sections.

7.1 Performance obligations satisfied over time

Frequently, entities transfer the promised goods or services to the customer over time. While the determination of whether goods or services are transferred over time is straightforward in some contracts (e.g., many service contracts), it is more difficult in other contracts.

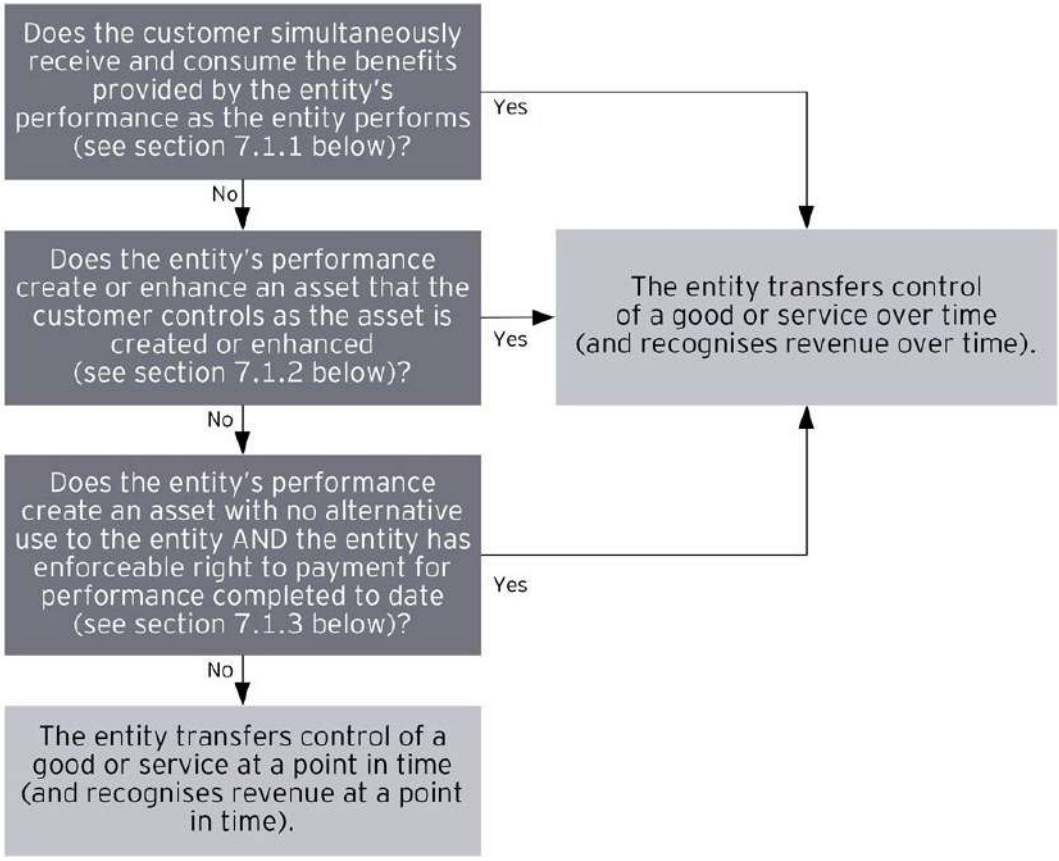
To help entities determine whether control transfers over time (rather than at a point in time), the standard states that an entity transfers control of a good or service over time (and, therefore, satisfies a performance obligation and recognises revenue over time) if one of the following criteria is met: *[IFRS 15.35, IFRS 15.B2]*

- As the entity performs, the customer simultaneously receives and consumes the benefits provided by the entity's performance (see section 7.1.1 below).
- The entity's performance creates or enhances an asset (e.g., work in progress) that the customer controls as the asset is created or enhanced (see section 7.1.2 below).
- The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date (see section 7.1.3 below).

Examples of each of the criteria above are included in the following sections. If an entity is unable to demonstrate that control transfers over time, the presumption is that control transfers at a point in time (see section 7.2 below). *[IFRS 15.32]*.

The following flow chart illustrates how to evaluate whether control transfers over time:

Figure 7-1: Evaluating whether control transfers over time



How we see it

Determining when performance obligations are satisfied requires judgement. IFRS 15.119(a) requires an entity to disclose when it typically satisfies its performance obligations (e.g., upon shipment, as services are delivered). See section 10.5.1.C below for more information. IFRS 15.123(a) requires entities to disclose significant judgements made in determining the timing of satisfaction of performance obligations and IFRS 15.124 requires entities to disclose the method used to recognise revenue (e.g., a description of the input or output method used and how that method is applied) and why the method selected provides a faithful depiction of the transfer of goods or services. See section 10.5.2 below for more information on these disclosure requirements. Entities are required to review their disclosures to verify that they not only meet the specific requirements of IFRS 15.119(a), 123(a) and 124, but they also meet the overall disclosure objective in IFRS 15.110 (See section 10.4 below).

Frequently asked questions

Question 7-1: Can an entity elect to recognise revenue at a point in time under IFRS 15?

Entities cannot elect to recognise revenue at a point in time. Rather, entities have to analyse their contracts to determine the appropriate timing and pattern of recognition while considering the specific criteria and requirements of IFRS 15. As discussed above, for each performance obligation identified in the contract, an entity is required to consider at contract inception whether it satisfies the performance obligation over time (i.e., whether it meets one of the three criteria for over-time recognition in IFRS 15.35) or at a point in time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. That is, there is no exception in IFRS 15 that would allow entities to elect point-in-time recognition for contracts, including those with a short duration (e.g., a year or less).

Question 7-2: Do all contracts with a stand-ready element include a single performance obligation that is satisfied over time?

(TRG meeting 9 November 2015 - Agenda paper no. 48)

See response to Question 4-3 in section 4.1.1 above.

7.1.1 Customer simultaneously receives and consumes benefits as the entity performs

As the Board explained in the Basis for Conclusions, in many service contracts the entity's performance creates an asset, momentarily, because that asset is simultaneously received and consumed by the customer. In these cases, the customer obtains control of the entity's output as the entity performs. Therefore, the performance obligation is satisfied over time. *[IFRS 15.BC125]*. While this criterion most often applies to service contracts, the TRG discussed instances in which commodity contracts (e.g., electricity, natural gas, heating oil) could be recognised over time. These situations could arise if the facts and circumstances of the contract indicate that the customer will simultaneously receive and consume the benefits (e.g., a continuous supply contract to meet immediate demands).[105] Refer to Question 7-3 below for further information.

There might be contracts in which it is unclear whether the customer simultaneously receives and consumes the benefit of the entity's performance over time. To assist entities, IFRS 15 provides the following application guidance: *[IFRS 15.B3, IFRS 15.B4]*

Extract from IFRS 15

Simultaneous receipt and consumption of the benefits of the entity's performance (paragraph 35(a))

B3 For some types of performance obligations, the assessment of whether a customer receives the benefits of an entity's performance as the entity performs and simultaneously consumes those benefits as they are received will be straightforward. Examples include routine or recurring services (such as a cleaning service) in which the receipt and simultaneous consumption by the customer of the benefits of the entity's performance can be readily identified.

B4 For other types of performance obligations, an entity may not be able to readily identify whether a customer simultaneously receives and consumes the benefits from the entity's performance as the entity performs. In those circumstances, a performance obligation is satisfied over time if an entity determines that another entity would not need to substantially re-perform the work that the entity has completed to date if that other entity were to fulfil the remaining performance obligation to the customer. In determining whether another entity would not need to substantially re-perform the work the entity has completed to date, an entity shall make both of the following assumptions:

(a) disregard potential contractual restrictions or practical limitations that otherwise would prevent the entity from transferring the remaining performance obligation to another entity; and

(b) presume that another entity fulfilling the remainder of the performance obligation would not have the benefit of any asset that is presently controlled by the entity and that would remain controlled by the entity if the performance obligation were to transfer to another entity.

The IASB added this application guidance because the notion of 'benefit' can be subjective. As discussed in the Basis for Conclusions, the Board provided an example of a freight logistics contract. Assume that the entity has agreed to transport goods from Vancouver to New York City. Some stakeholders had suggested that the customer receives no benefit from the entity's performance until the goods are delivered to, in this case, New York City. However, the Board said that the customer benefits as the entity performs. This is because, if the goods were only delivered part of the way (e.g., to Chicago), another entity would not need to substantially re-perform the entity's performance to date. The Board observed that in these cases, the assessment of whether another entity would need to substantially re-perform the entity's performance to date is an objective way to assess whether the customer receives benefit from the entity's performance as it occurs. *[IFRS 15.BC126]*.

In assessing whether a customer simultaneously receives and consumes the benefits provided by an entity's performance, all relevant facts and circumstances need to be considered. This includes considering the inherent characteristics of the good or service, the contract terms and information about how the good or service is transferred or delivered. However, as noted in IFRS 15.B4(a), an entity disregards any contractual or practical restrictions when it assesses this criterion. In the Basis for Conclusions, the IASB explained that the assessment of whether control of the goods or services has transferred to the customer is performed by making a hypothetical assessment of what another entity would need to do if it were to take over the remaining performance. Therefore, actual practical or contractual restrictions would have no bearing on the assessment of whether the entity had already transferred control of the goods or services provided to date. *[IFRS 15.BC127]*.

105 TRG Agenda paper no. 43, *Determining When Control of a Commodity Transfers*, dated 13 July 2015.

The standard provides the following example that illustrates a customer simultaneously receiving and consuming the benefits as the entity performs in relation to a series of distinct payroll processing services: *[IFRS 15.IE Example 13, IFRS 15.IE67-IE68]*

Extract from IFRS 15

Example 13-Customer simultaneously receives and consumes the benefits

An entity enters into a contract to provide monthly payroll processing services to a customer for one year.

The promised payroll processing services are accounted for as a single performance obligation in accordance with paragraph 22(b) of IFRS 15. The performance obligation is satisfied over time in accordance with paragraph 35(a) of IFRS 15 because the customer simultaneously receives and consumes the benefits of the entity's performance in processing each payroll transaction as and when each transaction is processed. The fact that another entity would not need to re-perform payroll processing services for the service that the entity has provided to date also demonstrates that the customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs. (The entity disregards any practical limitations on transferring the remaining performance obligation, including setup activities that would need to be undertaken by another entity.) The entity recognises revenue over time by measuring its progress towards complete satisfaction of that performance obligation in accordance with paragraphs 39-45 and B14-B19 of IFRS 15.

The IASB clarified, in the Basis for Conclusions, that an entity does not evaluate this criterion (to determine whether a performance obligation is satisfied over time) if the entity's performance creates an asset that the customer does not consume immediately as the asset is received. The IFRS IC reiterated this point at its meeting in March 2018, in relation to a contract for the sale of a real estate unit (see Question 7-11 in section 7.1.3.B below for further discussion).[106] Instead, an entity assesses that performance obligation using the criteria discussed in sections 7.1.2 and 7.1.3 below.

For some service contracts, the entity's performance will not satisfy its obligation over time because the customer does not consume the benefit of the entity's performance until the entity's performance is complete. The standard provides an example (Example 14) of an entity providing consulting services that will take the form of a professional opinion upon the completion of the services. In this situation, an entity cannot conclude that the services are transferred over time based on this criterion. Instead, the entity must consider the remaining two criteria in IFRS 15.35 (see sections 7.1.2 and 7.1.3 and Example 14, extracted in full in section 7.1.3.B below). *[IFRS 15.IE Example 14, IFRS 15.IE69-IE72]*.

Frequently asked questions

Question 7-3: What factors does an entity consider when evaluating whether a customer simultaneously receives and consumes the benefits of a commodity (e.g., electricity, natural gas or heating oil) as the entity performs?

(TRG meeting 13 July 2015 - Agenda paper no. 43)

The TRG members generally agreed that an entity would consider all known facts and circumstances when evaluating whether a customer simultaneously receives and consumes the benefits of a commodity. These might include the inherent characteristics of the commodity (e.g., whether the commodity can be stored), contract terms (e.g., a continuous supply contract to meet immediate demands) and information about infrastructure or other delivery mechanisms.

As such, revenue related to the sale of a commodity might or might not be recognised over time, depending on whether the facts and circumstances of the contract indicate that the customer simultaneously receives and consumes the benefits. This evaluation could require the use of significant judgement.

Whether a commodity meets this criterion and is transferred over time is important in determining whether the sale of a commodity meets the criteria to apply the series requirement (see section 4.2.2 above). This, in turn, affects how an entity allocates variable consideration and applies the requirements for contract modifications and changes in the transaction price.

106 *IFRIC Update*, March 2018, available on the IFRS Foundation's website.

7.1.2 Customer controls the asset as it is created or enhanced

The second criterion to determine whether control of a good or service is transferred over time requires entities to evaluate whether the customer controls the asset as it is being created or enhanced. An entity applies the requirements for control in IFRS 15.31-34 and IFRS 15.38. *[IFRS 15.B5]*.

For the purpose of this determination, the definition of 'control' is the same as previously discussed (i.e., the ability to direct the use of and obtain substantially all of the remaining benefits from the asset). The IASB explained in the Basis for Conclusions that this criterion addresses situations in which the customer clearly controls any work in progress arising from the entity's performance. It also noted that the second over-time criterion acknowledges that, in effect, the entity has agreed to sell its rights to the asset (i.e., work in progress) as the entity performs (i.e., a continuous sale). The Board provided an example in which the entity has entered into a construction contract to build on the customer's land, stating that any work in progress arising from the entity's performance is generally controlled by the customer. *[IFRS 15.BC129, IFRS 15.BC130]*. IFRS IC also reiterated the overall intent of the criterion and referred to this example from the Basis for Conclusions during its March 2018 meeting (see Question 7-11 in section 7.1.3.B below).[107] In addition, some construction contracts might also contain clauses indicating that the customer owns any work in progress as the contracted item is being built. Furthermore, the asset being created or enhanced can be either tangible or intangible. *[IFRS 15.B5]*.

Frequently asked questions

Question 7-4: How does an entity evaluate a customer's right to sell (or pledge) a right to obtain an asset when determining whether the customer controls the asset as it is created or enhanced under IFRS 15.35(b)?

How we see it

We believe that an entity needs to assess control of the asset that the entity's performance creates or enhances, rather than any contractual rights to obtain the completed asset in the future.

As an example, and as discussed by the IFRS IC (see Question 7-11 in section 7.1.3.B below), in a contract for the sale of real estate that the entity constructs, the asset created is the real estate itself and not the customer's right to obtain the completed real estate in the future. That is, an entity would evaluate whether the customer controls the partially constructed real estate as it is being constructed to determine whether the criterion IFRS 15.35(b) is met. The customer's right to sell (or pledge) a right to obtain a completed asset in the future is not evidence that the customer controls the asset itself as it is being created or enhanced.[108]

7.1.3 Asset with no alternative use and right to payment

In some cases, it might be unclear whether the asset that an entity creates or enhances is controlled by the customer when considering the first two criteria (discussed in sections 7.1.1 and 7.1.2 above) for evaluating whether control transfers over time. Therefore, the Board added a third criterion, which requires revenue to be recognised over time if both of the following two requirements are met: *[IFRS 15.35(c)]*

- The entity's performance does not create an asset with alternative use to the entity (see section 7.1.3.A below).
- The entity has an enforceable right to payment for performance completed to date (see section 7.1.3.B below).

107 *IFRIC Update*, March 2018, available on the IFRS Foundation's website.

108 *IFRIC Update*, March 2018, available on the IFRS Foundation's website.

7.1.3.A No alternative use

The IASB explained in the Basis for Conclusions that it had developed the notion of 'alternative use' to prevent over time revenue recognition when the entity's performance does not transfer control of the goods or services to the customer over time. When the entity's performance creates an asset with an alternative use to the entity (e.g., standard inventory items), the entity can readily direct the asset to another customer. In those cases, the entity (not the customer) controls the asset as it is created because the customer does not have the ability to direct the use of the asset or restrict the entity from directing that asset to another customer. The standard includes the following requirements for 'alternative use': *[IFRS 15.36, IFRS 15.B6, IFRS 15.B7, IFRS 15.B8]*

Extract from IFRS 15

36 An asset created by an entity's performance does not have an alternative use to an entity if the entity is either restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset or limited practically from readily directing the asset in its completed state for another use. The assessment of whether an asset has an alternative use to the entity is made at contract inception. After contract inception, an entity shall not update the assessment of the alternative use of an asset unless the parties to the contract approve a contract modification that substantively changes the performance obligation. Paragraphs B6-B8 provide guidance for assessing whether an asset has an alternative use to an entity.

Entity's performance does not create an asset with an alternative use (paragraph 35(c))

B6 In assessing whether an asset has an alternative use to an entity in accordance with paragraph 36, an entity shall consider the effects of contractual restrictions and practical limitations on the entity's ability to readily direct that asset for another use, such as selling it to a different customer. The possibility of the contract with the customer being terminated is not a relevant consideration in assessing whether the entity would be able to readily direct the asset for another use.

B7 A contractual restriction on an entity's ability to direct an asset for another use must be substantive for the asset not to have an alternative use to the entity. A contractual restriction is substantive if a customer could enforce its rights to the promised asset if the entity sought to direct the asset for another use. In contrast, a contractual restriction is not substantive if, for example, an asset is largely interchangeable with other assets that the entity could transfer to another customer without breaching the contract and without incurring significant costs that otherwise would not have been incurred in relation to that contract.

B8 A practical limitation on an entity's ability to direct an asset for another use exists if an entity would incur significant economic losses to direct the asset for another use. A significant economic loss could arise because the entity either would incur significant costs to rework the asset or would only be able to sell the asset at a significant loss. For example, an entity may be practically limited from redirecting assets that either have design specifications that are unique to a customer or are located in remote areas.

In making the assessment of whether a good or service has alternative use, an entity must consider any substantive contractual restrictions. A contractual restriction is substantive if a customer could enforce its rights to the promised asset if the entity sought to direct the asset for another use. Contractual restrictions that are not substantive, such as protective rights for the customer, are not considered. The Board explained in the Basis for Conclusions that a protective right typically gives an entity the practical ability to physically substitute or redirect the asset without the customer's knowledge or objection to the change. For example, a contract might specify that an entity cannot transfer a good to another customer because the customer has legal title to the good. Such a contractual term would not be substantive if the entity could physically substitute that good for another and could redirect the original good to another customer for little cost. In that case, the contractual restriction would merely be a protective right and would not indicate that control of the asset has transferred to the customer. *[IFRS 15.BC138]*.

An entity also needs to consider any practical limitations on directing the asset for another use. In making this determination, the Board clarified that an entity considers the characteristics of the asset that ultimately will be transferred to the customer and assesses whether the asset in its completed state could be redirected without a significant cost of rework. The Board provided an example of manufacturing contracts in which the basic design of the asset is the same across all contracts, but substantial customisation is made to the asset. As a result, redirecting the finished asset would require significant rework and the asset would not have an alternative use because the entity would incur significant economic losses to direct the asset for another use. *[IFRS 15.BC138]*.

Considering the level of customisation of an asset could help entities assess whether an asset has an alternative use. The IASB noted in the Basis for Conclusions that, when an entity is creating an asset that is highly customised for a particular customer, it is less likely that the entity could use that asset for any other purpose. *[IFRS 15.BC135]*. That is, it is likely that the entity would need to incur significant rework costs to redirect the asset to another customer or sell the asset at a significantly reduced price. As a result, the asset would not have an alternative use to the entity and the customer could be regarded as receiving the benefit of the entity's performance as the entity performs (i.e., having control of the asset), provided that the entity also has an enforceable right to payment (discussed below). However, the Board clarified that the level of customisation is a factor to consider, but it would not be a determinative factor. For example, in some real estate contracts, the asset could be standardised (i.e., not highly customised), but it still might not have an alternative use to the entity because of substantive contractual restrictions that preclude the entity from readily directing the asset to another customer. *[IFRS 15.BC137]*.

The standard provides the following example to illustrate an evaluation of practical limitations on directing an asset for another use: *[IFRS 15.IE Example 15, IFRS 15.IE73-IE76]*

Extract from IFRS 15

Example 15-Asset has no alternative use to the entity

An entity enters into a contract with a customer, a government agency, to build a specialised satellite. The entity builds satellites for various customers, such as governments and commercial entities. The design and construction of each satellite differ substantially, on the basis of each customer's needs and the type of technology that is incorporated into the satellite.

At contract inception, the entity assesses whether its performance obligation to build the satellite is a performance obligation satisfied over time in accordance with paragraph 35 of IFRS 15.

As part of that assessment, the entity considers whether the satellite in its completed state will have an alternative use to the entity. Although the contract does not preclude the entity from directing the completed satellite to another customer, the entity would incur significant costs to rework the design and function of the satellite to direct that asset to another customer. Consequently, the asset has no alternative use to the entity (see paragraphs 35(c), 36 and B6-B8 of IFRS 15) because the customer-specific design of the satellite limits the entity's practical ability to readily direct the satellite to another customer.

For the entity's performance obligation to be satisfied over time when building the satellite, paragraph 35(c) of IFRS 15 also requires the entity to have an enforceable right to payment for performance completed to date. This condition is not illustrated in this example.

Requiring an entity to assess contractual restrictions when evaluating this criterion might seem to contradict the requirements in IFRS 15.B4 to ignore contractual and practical restrictions when evaluating whether another entity would need to substantially reperform the work the entity has completed to date (see section 7.1.1 above). The Board explained that this difference is appropriate because each criterion provides a different method for assessing when control transfers and the criteria were designed to apply to different situations. *[IFRS 15.BC139]*.

After contract inception, an entity does not update its assessment of whether an asset has an alternative use for any subsequent changes in facts and circumstances, unless the parties approve a contract modification that substantively changes the performance obligation. *[IFRS 15.36]*. The IASB also decided that an entity's lack of an alternative use for an asset does not, by itself, mean that the customer effectively controls the asset. The entity would also need to determine that it has an enforceable right to payment for performance to date, as discussed below. *[IFRS 15.BC141]*.

Frequently asked questions

Question 7-5: Does an entity consider the completed asset or the work in progress when assessing whether its performance creates an asset with no alternative use under IFRS 15.35(c)? (FASB TRG meeting 7 November 2016 - Agenda paper no. 56)

The FASB TRG members generally agreed that when an entity evaluates whether its performance creates an asset with no alternative use, it considers whether it could sell the completed asset to another customer without incurring a significant economic loss (i.e., whether it could sell the raw materials or work in progress to another customer is not relevant). This conclusion is supported by the Board's comment in the Basis for Conclusions "that an entity should consider the characteristics of the asset that will ultimately be transferred to the customer". *[IFRS 15.BC136]*.[109]

However, as discussed above and in accordance with IFRS 15.36, if the entity is contractually restricted or has a practical limitation on its ability to direct the asset for another use, the asset would not have an alternative use, regardless of the characteristics of the completed asset. A contractual restriction is substantive if a customer could enforce its rights to the promised asset if the entity sought to direct the asset for another use. A practical limitation exists if an entity would incur a significant economic loss to direct the asset for another use.

The FASB TRG agenda paper included an example, which the following Illustration is based on:

Illustration 7-1: No alternative use

An entity enters into a contract with a customer to build customised equipment. The customisation of the equipment occurs when the manufacturing process is approximately 75% complete. That is, for approximately the first 75% of the manufacturing process, the in-process asset could be redirected to fulfil another customer's equipment order (assuming no contractual restrictions). However, the equipment cannot be sold in its completed state to another customer without incurring a significant economic loss. The design specifications of the equipment are unique to the customer and the entity would only be able to sell the completed equipment at a significant economic loss.

The entity would evaluate, at contract inception, whether there is any contractual restriction or practical limitation on its ability to readily direct the asset (in its completed state) for another use. Because the entity cannot sell the completed equipment to another customer without incurring a significant economic loss, the entity has a practical limitation on its ability to direct the equipment in its completed state and, therefore, the asset does not have an alternative use. However, before concluding that revenue would be recognised over time, an entity must evaluate whether it has an enforceable right to payment.

7.1.3.B Enforceable right to payment for performance completed to date

To evaluate whether it has an enforceable right to payment for performance completed to date, the entity is required to consider the terms of the contract and any laws or regulations that relate to it. *[IFRS 15.37, IFRS 15.B12]*. The standard states that the right to payment for performance completed to date need not be for a fixed amount. However, at any time during the contract term, an entity must be entitled to an amount that at least compensates the entity for performance completed to date (as defined in IFRS 15.B9, see extract below), even if the contract is terminated by the customer (or another party) for reasons other than the entity's failure to perform as promised. *[IFRS 15.37, IFRS 15.B9]*. The IASB concluded that a customer's obligation to pay for the entity's performance is an indicator that the customer has obtained benefit from the entity's performance. *[IFRS 15.BC142]*.

109 FASB TRG Agenda paper no. 60, November 2016 Meeting - Summary of Issues Discussed and Next Steps, dated 31 January 2017.

The standard states the following about an entity's right to payment for performance completed to date: *[IFRS 15.B9, IFRS 15.B10, IFRS 15.B11, IFRS 15.B12]*

Extract from IFRS 15

B9 In accordance with paragraph 37, an entity has a right to payment for performance completed to date if the entity would be entitled to an amount that at least compensates the entity for its performance completed to date in the event that the customer or another party terminates the contract for reasons other than the entity's failure to perform as promised. An amount that would compensate an entity for performance completed to date would be an amount that approximates the selling price of the goods or services transferred to date (for example, recovery of the costs incurred by an entity in satisfying the performance obligation plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract were to be terminated. Compensation for a reasonable profit margin need not equal the profit margin expected if the contract was fulfilled as promised, but an entity should be entitled to compensation for either of the following amounts:

(a) a proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination by the customer (or another party); or

(b) a reasonable return on the entity's cost of capital for similar contracts (or the entity's typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts.

B10 An entity's right to payment for performance completed to date need not be a present unconditional right to payment. In many cases, an entity will have an unconditional right to payment only at an agreed-upon milestone or upon complete satisfaction of the performance obligation. In assessing whether it has a right to payment for performance completed to date, an entity shall consider whether it would have an enforceable right to demand or retain payment for performance completed to date if the contract were to be terminated before completion for reasons other than the entity's failure to perform as promised.

B11 In some contracts, a customer may have a right to terminate the contract only at specified times during the life of the contract or the customer might not have any right to terminate the contract. If a customer acts to terminate a contract without having the right to terminate the contract at that time (including when a customer fails to perform its obligations as promised), the contract (or other laws) might entitle the entity to continue to transfer to the customer the goods or services promised in the contract and require the customer to pay the consideration promised in exchange for those goods or services. In those circumstances, an entity has a right to payment for performance completed to date because the entity has a right to continue to perform its obligations in accordance with the contract and to require the customer to perform its obligations (which include paying the promised consideration).

B12 In assessing the existence and enforceability of a right to payment for performance completed to date, an entity shall consider the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms. This would include an assessment of whether:

(a) legislation, administrative practice or legal precedent confers upon the entity a right to payment for performance to date even though that right is not specified in the contract with the customer;

(b) relevant legal precedent indicates that similar rights to payment for performance completed to date in similar contracts have no binding legal effect; or

(c) an entity's customary business practices of choosing not to enforce a right to payment has resulted in the right being rendered unenforceable in that legal environment. However, notwithstanding that an entity may choose to waive its right to payment in similar contracts, an entity would continue to have a right to payment to date if, in the contract with the customer, its right to payment for performance to date remains enforceable.

The IASB described in the Basis for Conclusions how the factors of 'no alternative use' and the 'right to payment' relate to the assessment of control. Since an entity is constructing an asset with no alternative use to the entity, the entity is effectively creating an asset at the direction of the customer. That asset would have little or no value to the entity if the customer were to terminate the contract. As a result, the entity will seek economic protection from the risk of customer termination by requiring the customer to pay for the entity's performance to date in the event of customer termination. The customer's obligation to pay for the entity's performance to date (or the inability to avoid paying for that performance) suggests that the customer has obtained the benefits from the entity's performance. *[IFRS 15.BC142]*.

The enforceable right to payment criterion has two components that an entity must assess:

- The amount that the customer would be required to pay

  And

- What it means to have the enforceable right to payment

The Board provided additional application guidance on how to evaluate each of these components.

Firstly, the Board explained in the Basis for Conclusions that the focus of the analysis is on the amount to which the entity would be entitled upon termination. *[IFRS 15.BC144]*. This amount is not the amount the entity would settle for in a negotiation and it does not need to reflect the full contract margin that the entity would earn if the contract were completed. The Board clarified in IFRS 15.B9 that a 'reasonable profit margin' would either be a proportion of the entity's expected profit margin that reasonably reflects the entity's performance to date or a reasonable return on the entity's cost of capital. In addition, the standard clarifies, in IFRS 15.B13, that including a payment schedule in a contract does not, in and of itself, indicate that the entity has the right to payment for performance completed to date. This is because, in some cases, the contract might specify that the consideration received from the customer is refundable for reasons other than the entity failing to perform as promised in the contract. The entity must examine information that might contradict the payment schedule and might represent the entity's actual right to payment for performance completed to date. As highlighted in Example 16 from the standard (included below), payments from a customer must approximate the selling price of the goods or services transferred to date to be considered a right to payment for performance to date. A fixed payment schedule might not meet this requirement. *[IFRS 15.B13]*.

Secondly, the IASB added application guidance in IFRS 15.B12 to help an entity assess the existence and enforceability of a right to payment. In making this assessment, entities need to consider any laws, legislation or legal precedent that could supplement or override the contractual terms. Furthermore, the standard indicates that an entity might have an enforceable right to payment even when the customer terminates the contract without having the right to terminate. This would be the case if the contract (or other law) entitles the entity to continue to transfer the goods or services promised in the contract and require the customer to pay the consideration promised for those goods or services (often referred to as 'specific performance'). *[IFRS 15.BC145]*. The standard also states that even when an entity chooses to waive its right to payment in other similar contracts, an entity would continue to have a right to payment for the contract if, in the contract, its right to payment for performance to date remains enforceable.

The standard provides the following example to illustrate the concepts described in section 7.1.3 above. Example 14 depicts an entity providing consulting services that will take the form of a professional opinion upon the completion of the services. In this example, the entity's performance obligation meets the no alternative use and right to payment criterion of IFRS 15.35(c), as follows: *[IFRS 15.IE Example 14, IFRS 15.IE69-IE72]*

Extract from IFRS 15

Example 14-Assessing alternative use and right to payment

An entity enters into a contract with a customer to provide a consulting service that results in the entity providing a professional opinion to the customer. The professional opinion relates to facts and circumstances that are specific to the customer. If the customer were to terminate the consulting contract for reasons other than the entity's failure to perform as promised, the contract requires the customer to compensate the entity for its costs incurred plus a 15 per cent margin. The 15 per cent margin approximates the profit margin that the entity earns from similar contracts.

The entity considers the criterion in paragraph 35(a) of IFRS 15 and the requirements in paragraphs B3 and B4 of IFRS 15 to determine whether the customer simultaneously receives and consumes the benefits of the entity's performance. If the entity were to be unable to satisfy its obligation and the customer hired another consulting firm to provide the opinion, the other consulting firm would need to substantially re-perform the work that the entity had completed to date, because the other consulting firm would not have the benefit of any work in progress performed by the entity. The nature of the professional opinion is such that the customer will receive the benefits of the entity's performance only when the customer receives the professional opinion. Consequently, the entity concludes that the criterion in paragraph 35(a) of IFRS 15 is not met.

However, the entity's performance obligation meets the criterion in paragraph 35(c) of IFRS 15 and is a performance obligation satisfied over time because of both of the following factors:

(a) in accordance with paragraphs 36 and B6-B8 of IFRS 15, the development of the professional opinion does not create an asset with alternative use to the entity because the professional opinion relates to facts and circumstances that are specific to the customer. Therefore, there is a practical limitation on the entity's ability to readily direct the asset to another customer.

(b) in accordance with paragraphs 37 and B9-B13 of IFRS 15, the entity has an enforceable right to payment for its performance completed to date for its costs plus a reasonable margin, which approximates the profit margin in other contracts.

Consequently, the entity recognises revenue over time by measuring the progress towards complete satisfaction of the performance obligation in accordance with paragraphs 39-45 and B14-B19 of IFRS 15.

Example 16 below illustrates a contract in which the fixed payment schedule is not expected to correspond, at all times throughout the contract, to the amount that would be necessary to compensate the entity for performance completed to date. Accordingly, the entity concludes that it does not have an enforceable right to payment for performance completed to date as follows: *[IFRS 15.IE Example 16, IFRS 15.IE77-IE80]*

Extract from IFRS 15

Example 16-Enforceable right to payment for performance completed to date

An entity enters into a contract with a customer to build an item of equipment. The payment schedule in the contract specifies that the customer must make an advance payment at contract inception of 10 per cent of the contract price, regular payments throughout the construction period (amounting to 50 per cent of the contract price) and a final payment of 40 per cent of the contract price after construction is completed and the equipment has passed the prescribed performance tests. The payments are non-refundable unless the entity fails to perform as promised. If the customer terminates the contract, the entity is entitled only to retain any progress payments received from the customer. The entity has no further rights to compensation from the customer.

At contract inception, the entity assesses whether its performance obligation to build the equipment is a performance obligation satisfied over time in accordance with paragraph 35 of IFRS 15.

As part of that assessment, the entity considers whether it has an enforceable right to payment for performance completed to date in accordance with paragraphs 35(c), 37 and B9-B13 of IFRS 15 if the customer were to terminate the contract for reasons other than the entity's failure to perform as promised. Even though the payments made by the customer are non-refundable, the cumulative amount of those payments is not expected, at all times throughout the contract, to at least correspond to the amount that would be necessary to compensate the entity for performance completed to date. This is because at various times during construction the cumulative amount of consideration paid by the customer might be less than the selling price of the partially completed item of equipment at that time. Consequently, the entity does not have a right to payment for performance completed to date.

Because the entity does not have a right to payment for performance completed to date, the entity's performance obligation is not satisfied over time in accordance with paragraph 35(c) of IFRS 15. Accordingly, the entity does not need to assess whether the equipment would have an alternative use to the entity. The entity also concludes that it does not meet the criteria in paragraph 35(a) or (b) of IFRS 15 and thus, the entity accounts for the construction of the equipment as a performance obligation satisfied at a point in time in accordance with paragraph 38 of IFRS 15.

Example 17 below contrasts similar situations and illustrates when revenue would be recognised over time (see section 7.1 above) versus at a point in time (see section 7.2 below). Specifically, this example illustrates the evaluation of the 'no alternative use' and 'right to payment for performance to date' concepts, as follows. *[IFRS 15.IE Example 17, IFRS 15.IE81-IE90]*.

Extract from IFRS 15

Example 17-Assessing whether a performance obligation is satisfied at a point in time or over time

An entity is developing a multi-unit residential complex. A customer enters into a binding sales contract with the entity for a specified unit that is under construction. Each unit has a similar floor plan and is of a similar size, but other attributes of the units are different (for example, the location of the unit within the complex).

Case A-Entity does not have an enforceable right to payment for performance completed to date

The customer pays a deposit upon entering into the contract and the deposit is refundable only if the entity fails to complete construction of the unit in accordance with the contract. The remainder of the contract price is payable on completion of the contract when the customer obtains physical possession of the unit. If the customer defaults on the contract before completion of the unit, the entity only has the right to retain the deposit.

At contract inception, the entity applies paragraph 35(c) of IFRS 15 to determine whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time. The entity determines that it does not have an enforceable right to payment for performance completed to date because, until construction of the unit is complete, the entity only has a right to the deposit paid by the customer.

Because the entity does not have a right to payment for work completed to date, the entity's performance obligation is not a performance obligation satisfied over time in accordance with paragraph 35(c) of IFRS 15. Instead, the entity accounts for the sale of the unit as a performance obligation satisfied at a point in time in accordance with paragraph 38 of IFRS 15.

Case B-Entity has an enforceable right to payment for performance completed to date

The customer pays a non-refundable deposit upon entering into the contract and will make progress payments during construction of the unit. The contract has substantive terms that preclude the entity from being able to direct the unit to another customer. In addition, the customer does not have the right to terminate the contract unless the entity fails to perform as promised. If the customer defaults on its obligations by failing to make the promised progress payments as and when they are due, the entity would have a right to all of the consideration promised in the contract if it completes the construction of the unit. The courts have previously upheld similar rights that entitle developers to require the customer to perform, subject to the entity meeting its obligations under the contract.

At contract inception, the entity applies paragraph 35(c) of IFRS 15 to determine whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time. The entity determines that the asset (unit) created by the entity's performance does not have an alternative use to the entity because the contract precludes the entity from transferring the specified unit to another customer. The entity does not consider the possibility of a contract termination in assessing whether the entity is able to direct the asset to another customer.

The entity also has a right to payment for performance completed to date in accordance with paragraphs 37 and B9-B13 of IFRS 15. This is because if the customer were to default on its obligations, the entity would have an enforceable right to all of the consideration promised under the contract if it continues to perform as promised.

Therefore, the terms of the contract and the practices in the legal jurisdiction indicate that there is a right to payment for performance completed to date. Consequently, the criteria in paragraph 35(c) of IFRS 15 are met and the entity has a performance obligation that it satisfies over time. To recognise revenue for that performance obligation satisfied over time, the entity measures its progress towards complete satisfaction of its performance obligation in accordance with paragraphs 39-45 and B14-B19 of IFRS 15.

In the construction of a multi-unit residential complex, the entity may have many contracts with individual customers for the construction of individual units within the complex. The entity would account for each contract separately. However, depending on the nature of the construction, the entity's performance in undertaking the initial construction works (ie the foundation and the basic structure), as well as the construction of common areas, may need to be reflected when measuring its progress towards complete satisfaction of its performance obligations in each contract.

Case C-Entity has an enforceable right to payment for performance completed to date

The same facts as in Case B apply to Case C, except that in the event of a default by the customer, either the entity can require the customer to perform as required under the contract or the entity can cancel the contract in exchange for the asset under construction and an entitlement to a penalty of a proportion of the contract price.

Notwithstanding that the entity could cancel the contract (in which case the customer's obligation to the entity would be limited to transferring control of the partially completed asset to the entity and paying the penalty prescribed), the entity has a right to payment for performance completed to date because the entity could also choose to enforce its rights to full payment under the contract. The fact that the entity may choose to cancel the contract in the event the customer defaults on its obligations would not affect that assessment (see paragraph B11 of IFRS 15), provided that the entity's rights to require the customer to continue to perform as required under the contract (ie pay the promised consideration) are enforceable.

Frequently asked questions

Question 7-6: How does an entity determine whether it has an enforceable right to payment under IFRS 15.35(c)? (FASB TRG meeting 7 November 2016 - Agenda paper no. 56)

The FASB TRG members generally agreed that entities need to evaluate the contractual provisions to determine whether the right to payment compensates the entity for performance completed to date. For example, a contract might not explicitly provide an entity with an enforceable right to payment for anything other than finished goods. However, if the termination provisions in the contract allow for a notice period (e.g., 60 days) that would provide sufficient time for an entity to move all work in progress to the finished goods stage, it is likely that an entity would conclude that the contract provides for an enforceable right to payment for performance completed to date. In addition, an entity considers any legislation or legal precedent that could supplement or override any contractual terms.

The FASB TRG also discussed the linkage amongst right to payment, measure of progress and the timing of the customisation of a good. For example, the FASB TRG noted an entity might not always have an enforceable right to payment at contract inception, such as when an entity is producing standard goods (i.e., inventory) that might be customised for a customer towards the end of the production process. The FASB TRG members generally agreed that an entity would need to consider whether it has an enforceable right to payment related to its performance completed to date. If the entity's performance obligation is to customise its standard goods for a customer, the FASB TRG members generally agreed that an entity would evaluate whether it has an enforceable right to payment at the point that the entity begins to satisfy the performance obligation to customise the goods for the customer. That is, because the right to payment is for performance completed to date, an entity's performance needs to coincide with how it defines the nature of its performance obligation and its measure of progress toward satisfaction of that performance obligation.

Question 7-7: To have an enforceable right to payment for performance completed to date, does an entity need to have a present unconditional right to payment?

In the Basis for Conclusions, the IASB clarified that the contractual payment terms in a contract might not always align with an entity's enforceable rights to payment for performance completed to date. As a result, an entity does not need to have a present unconditional right to payment. Instead, it must have an enforceable right to demand and/or retain payment for performance completed to date upon customer termination without cause. To illustrate this point, the Board included an example of a consulting contract that requires an entity to provide a report at the end of the project. In return, the entity earns a fixed amount, which is due and payable to the entity when it delivers the report. Assume that the entity is performing under the contract and that the contract (or the law) requires the customer to compensate the entity for its performance completed to date. In that situation, the entity would have an enforceable right to payment for performance completed to date, even though an unconditional right to the fixed amount only exists at the time the report is provided to the customer. This is because the entity has a right to demand and retain payment for performance completed to date. *[IFRS 15.BC145]*.

Question 7-8: Does an entity have a right to payment for performance completed to date if the entity receives a non-refundable upfront payment that represents the full transaction price?

The Board explained in the Basis for Conclusions that such a payment would represent an entity's right to payment for performance completed to date provided that the entity's right to retain and not refund the payment is enforceable upon termination by the customer. This is because a full upfront payment would at least compensate an entity for the work completed to date throughout the contract. *[IFRS 15.BC146]*. If the non-refundable upfront payment does not represent the full transaction price, an entity will have to apply judgement to determine whether the upfront payment provides the entity with a right to payment for performance completed to date in the event of a contract termination.

Question 7-9: Can an entity conclude it has an enforceable right to payment for performance completed to date when a contract is priced at a loss?

The specific facts and circumstances of the contract must be considered to determine whether an entity has an enforceable right to payment for performance completed to date when a contract is priced at a loss. As discussed above, the standard states that, if a contract is terminated for reasons other than the entity's failure to perform as promised, the entity must be entitled to an amount that at least compensates it for its performance to date. Furthermore, IFRS 15.B9 states that "An amount that would compensate an entity for performance completed to date would be an amount that approximates the selling price of the goods or services transferred to date (for example, recovery of the costs incurred by an entity in satisfying the performance obligation plus a reasonable profit margin)." Accordingly, stakeholders had asked whether an entity could have an enforceable right to payment for performance completed to date if the contract was priced at a loss.

How we see it

We believe that the example in IFRS 15.B9 of cost recovery plus a reasonable profit margin does not preclude an entity from having an enforceable right to payment even if the contract is priced at a loss. Rather, we believe an entity needs to evaluate whether it has an enforceable right to receive an amount that approximates the selling price of the goods or services for performance completed to date in the event the customer terminates the contract.

Consider the following Illustration based on an example from the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide, Revenue Recognition:[110]

Illustration 7-2: Determination of enforceable right to payment for a contract priced at a loss

Customer X requests bids for the design of a highly customised system. The customer expects to award subsequent contracts for systems over the next 10 years to the entity that wins the design contract. Contractor A is aware of the competition and knows that in order to win the design contract it must bid the contract at a loss. That is, Contractor A is willing to bid the design contract at a loss due to the significant value in future expected orders.

Contractor A wins the contract with a value of CU100 and estimated costs to complete of CU130. Contractor A has determined that the contract contains a single performance obligation and that its performance does not create an asset with an alternative use. The contract is non-cancellable, however, the contract terms stipulate that if the customer terminates the contract, Contractor A would be entitled to payment for work completed to date. The payment amount would be equal to a proportional amount of the price of the contract based upon the performance of work done to date. For example, if at the termination date Contractor A was 50% complete (i.e., incurred CU65 of costs), it would be entitled to a CU50 payment from Customer X (i.e., 50% of CU100 contract value).

In this example, we believe Contractor A has an enforceable right to payment for performance completed to date. This is in accordance with IFRS 15.35(c) because Contractor A is entitled to an amount that approximates the selling price of the good or service for performance completed to date in the event the customer terminates the contract.

Refer to section 9.2 below regarding accounting for anticipated losses on contracts.

Question 7-10: Can an entity have an enforceable right to payment for performance completed to date if it is not entitled to a reasonable profit margin on standard inventory materials that were purchased but not yet used in completing the performance obligation?

It is possible for an entity to have an enforceable right to payment for performance completed to date if it is not entitled to a reasonable profit margin on standard inventory materials that were purchased, but not yet used in completing the performance obligation. Consider an example in which an entity agrees to construct a specialised asset for a customer that has no alternative use to the entity. The construction of this asset requires the use of standard inventory materials that could be used interchangeably on other projects of the entity until they are integrated into the production of the customer's asset. The contract with the customer entitles the entity to reimbursement of costs incurred plus a reasonable profit margin if the contract is terminated. However, the contract specifically excludes reimbursement of standard inventory purchases before they are integrated into the customer's asset. As previously discussed, the standard states that, at any time during the contract, an entity must be entitled to an amount that compensates the entity for performance completed to date (as defined in IFRS 15.B9) if the contract is terminated for reasons other than the entity's failure to perform. However, in this example, the standard inventory materials have not yet been used in fulfilling the performance obligation, so the entity does not need to have an enforceable right to payment in relation to these materials. The entity could also repurpose the materials for use in other contracts with customers.

The entity will still need to evaluate whether it has an enforceable right to payment for performance completed to date once the standard inventory materials are used in fulfilling the performance obligation. *[IFRS 15.B9]*.

Question 7-11: What does an entity consider when assessing the over-time criteria for the sale of a real estate unit?

The IFRS IC received three requests regarding the assessment of the over-time criteria in relation to contracts for the sale of a real estate unit. At its March 2018 meeting, the IFRS IC concluded that the principles and requirements in IFRS 15 provide an adequate basis for an entity to determine whether to recognise revenue over time, or at a point in time, including whether it has an enforceable right to payment for performance completed to date for a contract for the sale of a real estate unit. Consequently, the IFRS IC decided not to add these matters to its agenda.[111]

110 See AICPA guide, *Revenue Recognition*, Chapter 3, *Aerospace and Defense Entities*, paragraphs 3.5.18 - 3.5.23.

111 *IFRIC Update*, March 2018, available on the IFRS Foundation's website.

After considering these requests, the IFRS IC decided that the agenda decisions should discuss the requirements of IFRS 15, as well as how the requirements apply to the fact patterns within the requests. The agenda decisions included the following reminders:

- An entity accounts for contracts within the scope of IFRS 15 only when all the criteria in IFRS 15.9 are met (which includes the collectability criterion).
- Before considering the over-time criteria, an entity is required to apply IFRS 15.22-30 to identify whether each promise to transfer a good or service to the customer is a performance obligation (see section 4.2 above for further discussion).
- An entity assesses the over-time criteria in IFRS 15.35 at contract inception. IFRS 15.35 specifies that an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if any of the three criteria is met. If an entity does not satisfy a performance obligation over time, it satisfies the performance obligation at a point in time.

The agenda decisions also noted the following in relation to the over-time criteria.

Criterion (a)

According to IFRS 15.35(a), an entity recognises revenue over time if the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs. This criterion is not applicable in a contract for the sale of a real estate unit that the entity constructs because the real estate unit created by the entity's performance is not consumed immediately.

Criterion (b)

IFRS 15.35(b) specifies that an entity recognises revenue over time if the customer controls the asset that an entity's performance creates or enhances as the asset is created or enhanced. Control refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. The Board included this criterion to "address situations in which an entity's performance creates or enhances an asset that a customer *clearly* controls as the asset is created or enhanced". *[IFRS 15.BC129]*. Therefore, all relevant facts and circumstances need to be considered by an entity when assessing whether there is evidence that the customer clearly controls the asset that is being created or enhanced (e.g., the part-constructed real estate unit) as it is created or enhanced. None of the facts and circumstances is determinative.

The IFRS IC observed that "in a contract for the sale of real estate that the entity constructs, the asset created is the real estate itself. It is not, for example, the right to obtain the real estate in the future. The right to sell or pledge a right to obtain real estate in the future is not evidence of control of the real estate itself".[112] That is, it is important to apply the requirements for control to the asset that the entity's performance creates or enhances (see Question 7-4 in section 7.1.2 above).

Criterion (c)

The Board developed this third criterion because, in some cases, it might not be clear whether the asset that is created or enhanced is controlled by the customer. IFRS 15.35(c) requires an entity to determine whether: (a) the asset created by an entity's performance does not have an alternative use to the entity; and (b) the entity has an enforceable right to payment for performance completed to date. However, the underlying objective of this criterion is still to determine whether the entity is transferring control of goods or services to the customer as it is creating the asset for that customer. The agenda decisions reiterate that:

- The asset being created does not have an alternative use to the entity if the entity is restricted contractually from readily directing the asset for another use during the asset's creation or if it is limited practically from readily directing the asset in the completed state for another use. *[IFRS 15.36]*.[113]
- The entity has an enforceable right to payment if it is entitled to an amount that at least compensates it for performance completed to date were the contract to be terminated by the customer for reasons other than the entity's failure to perform as promised. *[IFRS 15.37]*.[114] The entity must be entitled to this amount at all times throughout the duration of the contract and this amount must at least approximate the selling price of the goods or services transferred to date. That is, it is not meant to refer to compensation for only the entity's potential loss of profit were the

112 *IFRIC Update*, March 2018, available on the IFRS Foundation's website.

113 *IFRIC Update*, March 2018, available on the IFRS Foundation's website.

114 *IFRIC Update*, March 2018, available on the IFRS Foundation's website.

contract to be terminated. The IFRS IC observed that "it is the payment the entity is entitled to receive under the contract with the customer relating to performance under that contract that is relevant in determining whether the entity has an enforceable right to payment for performance completed to date". As discussed in Question 7-12 below, the IFRS IC also observed that an entity does not consider consideration it might receive upon resale of the asset if the original customer were to terminate the contract.[115]

In determining whether it has an enforceable right to payment, an entity considers the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms. While an entity does not need to undertake an exhaustive search for evidence, it is not appropriate for an entity to ignore evidence of relevant legal precedent that is available to it or to anticipate evidence that might become available in the future. The IFRS IC also observed that "the assessment … is focused on the existence of the right and its enforceability. The likelihood that the entity would exercise the right is not relevant to this assessment. Similarly, if a customer has the right to terminate the contract, the likelihood that the customer would terminate the contract is not relevant to this assessment".[116]

Question 7-12: Does an entity contemplate consideration it might receive from the potential resale of the asset to determine whether an enforceable right to payment for performance completed to date exists?

How we see it

We believe that only the payment the entity is entitled to receive relating to performance under the current customer contract is relevant in determining whether the entity has an enforceable right to payment for performance completed to date.

As an example, and as discussed by the IFRS IC (see Question 7-11 above), an entity would not look to potential consideration it might receive upon resale of the asset if the original customer were to terminate the contract. This is because the resale of an asset typically represents a separate contract with a different customer and, therefore, is not relevant to determining the existence and enforceability of a right to payment with the existing customer.

Consider the following Illustration based on an example discussed by the IFRS IC:[117]

Illustration 7-3: Determining whether an enforceable right to payment exists when cancellation by a customer obliges an entity to resell the asset

Entity X, a construction company, enters into a contract with a customer to sell a real estate unit in a residential multi-unit complex before the entity constructs the unit. The entity determines that it has a single performance obligation to construct and deliver the real estate unit. The customer pays 10% of the purchase price at contract inception and the remainder after construction is complete. The entity retains legal title to the real estate unit (and any land attributed to it) until the customer has paid the purchase price after construction is complete.

Under the contract, the customer has the right to cancel the contract at any time before construction is complete. However, if it does, the entity is legally required to make reasonable efforts to resell the real estate unit to a third party. If the entity finds a new buyer, a new contract is executed and the original contract is not novated to the third party. If the resale price in the contract with the third party is less than the original purchase price (plus selling costs), the customer is legally obliged to pay the difference to the entity.

The entity concludes that the over-time criteria in IFRS 15.35(a) and (b) are not met. In considering the over-time criterion in IFRS 15.35(c), the entity determines that its performance does not create an asset with an alternative use to the entity. It, therefore, considers whether it has an enforceable right to payment.

The IFRS IC observed that, when determining whether an entity has an enforceable right to payment, an entity considers the payment to which it is entitled under the existing contract with the customer, which relates to its performance under that contract. It does not consider the consideration it would receive from a third party in a potential resale contract. Such consideration relates to that resale contract and is not payment for performance under the existing contract with the customer.

115 *IFRIC Update*, March 2018, available on the IFRS Foundation's website.

116 *IFRIC Update*, March 2018, available on the IFRS Foundation's website.

117 *IFRIC Update*, March 2018, available on the IFRS Foundation's website.

Since Entity X cannot consider the resale contract, the only future payment to which it has rights under the existing contract with the customer is for the difference between the resale price of the unit, if any, and its original purchase price (plus selling costs). That payment, together with the deposit received, does not (at all times throughout the duration of the contract) entitle the entity to an amount that at least approximates the selling price of the part-constructed real estate unit (i.e., it does not compensate for performance completed to date). Therefore, Entity X does not have an enforceable right to payment for performance completed to date. The IFRS IC concluded that none of the over-time criteria are met and the entity would recognise revenue at a point in time in accordance with IFRS 15.38.

7.1.4 Measuring progress

When an entity has determined that a performance obligation is satisfied over time, the standard requires the entity to select a single revenue recognition method for the relevant performance obligation that faithfully depicts the entity's performance in transferring control of the goods or services. An entity applies the method selected consistently to similar performance obligations. In addition, at the end of each reporting period, an entity is required to remeasure its progress toward completion of the performance obligation. *[IFRS 15.40]*. The standard provides the following requirements to meet this objective: *[IFRS 15.41, IFRS 15.42, IFRS 15.43]*

Extract from IFRS 15[118]

Methods for measuring progress

41 Appropriate methods of measuring progress include output methods and input methods. Paragraphs B14-B19 provide guidance for using output methods and input methods to measure an entity's progress towards complete satisfaction of a performance obligation. In determining the appropriate method for measuring progress, an entity shall consider the nature of the good or service that the entity promised to transfer to the customer.

42 When applying a method for measuring progress, an entity shall exclude from the measure of progress any goods or services for which the entity does not transfer control to a customer. Conversely, an entity shall include in the measure of progress any goods or services for which the entity does transfer control to a customer when satisfying that performance obligation.

43 As circumstances change over time, an entity shall update its measure of progress to reflect any changes in the outcome of the performance obligation. Such changes to an entity's measure of progress shall be accounted for as a change in accounting estimate in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

While the standard (i.e., IFRS 15.40) requires an entity to remeasure its progress towards satisfaction of an over-time performance obligation at the end of each reporting period related to the measure of progress selected, it does not permit a change in method. A performance obligation is accounted for using the method the entity selects (i.e., either the specific input or output method it has chosen) from inception until the performance obligation has been fully satisfied. It would not be appropriate for an entity to start recognising revenue based on an input measure and later switch to an output measure (or to switch from one input method to a different input method). Furthermore, the standard requires that the selected method be applied to similar contracts in similar circumstances. It also requires that a single method of measuring progress be used for each performance obligation. *[IFRS 15.40]*. The Board noted that applying more than one method to measure performance would effectively override the guidance on identifying performance obligations. *[IFRS 15.BC161]*.

When measuring progress of an over-time performance obligation, IFRS 15.42 requires an entity to exclude any goods or services for which the entity does not transfer control to a customer. Conversely, an entity must include in the measure of progress any goods or services for which the entity does transfer control to a customer when satisfying that performance obligation.

118 The consequential amendments resulting from IFRS 18, once effective, changes the title of IAS 8 to '*Basis of Preparation of Financial Statements*' to better reflect the amended content of IAS 8. See Chapter 4 for more details on IFRS 18.

IFRS 15.43 notes that changes in circumstances over time might require an entity to update its measure of progress to reflect any changes in the outcome of the performance obligation. For example, an entity might determine that total expected costs are greater than its original expectation. If the entity was using an input method based on costs incurred, it would need to update its measure-of-progress calculation with this new information.

Changes to an entity's measure of progress are accounted for in accordance with the requirements in IAS 8 for changes in accounting estimates. IAS 8 requires a change in accounting estimate to be accounted for prospectively, i.e., by adjusting the carrying amount of an asset, liability or item of equity in the statement of financial position; and recognising the change by including it "in profit or loss in: (1) the period of the change, if the change affects that period only; or (2) the period of the change and future periods, if the change affects both". *[IAS 8.5, IAS 8.36, IAS 8.37]*. IAS 8 is clear that a change in accounting estimate, by its nature, does not relate to prior periods and is not the correction of an error. *[IAS 8.34]*. The disclosure requirements in IAS 8 related to changes in accounting estimates are also applicable (See Chapter 3 at section 4.5).

If an entity does not have a reasonable basis to measure its progress, revenue cannot be recognised until progress can be reasonably measured in accordance with IFRS 15.44. *[IFRS 15.44]*. However, if an entity can determine that a loss will not be incurred, the standard requires the entity to recognise revenue up to the amount of the costs incurred. *[IFRS 15.45]*. The IASB explained that an entity would need to stop using this method once it is able to reasonably measure its progress towards satisfaction of the performance obligation. *[IFRS 15.BC180]*. A cumulative catch-up adjustment would be recognised in the period in which the entity is able to reasonably measure its progress.

Finally, stakeholders had asked whether an entity's inability to measure progress would mean that costs incurred would also be deferred. The Board clarified that costs cannot be deferred in these situations, unless they meet the criteria for capitalisation under IFRS 15.95 (see section 9.3.2 below). *[IFRS 15.BC179]*.

The standard provides two methods for recognising revenue on contracts involving the transfer of goods or services over time: input methods and output methods. *[IFRS 15.41, IFRS 15.B14]*. The standard contains the following application guidance on these methods: *[IFRS 15.B15, IFRS 15.B16, IFRS 15.B17, IFRS 15.B18]*

Extract from IFRS 15

B15	Output methods recognise revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract. Output methods include methods such as surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed and units produced or units delivered. When an entity evaluates whether to apply an output method to measure its progress, the entity shall consider whether the output selected would faithfully depict the entity's performance towards complete satisfaction of the performance obligation. An output method would not provide a faithful depiction of the entity's performance if the output selected would fail to measure some of the goods or services for which control has transferred to the customer. For example, output methods based on units produced or units delivered would not faithfully depict an entity's performance in satisfying a performance obligation if, at the end of the reporting period, the entity's performance has produced work in progress or finished goods controlled by the customer that are not included in the measurement of the output.
B16	As a practical expedient, if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date (for example, a service contract in which an entity bills a fixed amount for each hour of service provided), the entity may recognise revenue in the amount to which the entity has a right to invoice.
B17	The disadvantages of output methods are that the outputs used to measure progress may not be directly observable and the information required to apply them may not be available to an entity without undue cost. Therefore, an input method may be necessary.
B18	Input methods recognise revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation (for example, resources consumed, labour hours expended, costs incurred, time elapsed or machine hours used) relative to the total expected inputs to the satisfaction of that performance obligation. If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for the entity to recognise revenue on a straight-line basis.

In determining the best method for measuring progress that faithfully depicts an entity's performance, an entity needs to consider both the nature of the promised goods or services and the nature of the entity's performance. *[IFRS 15.41]*. In other words, an entity's selection of a method to measure its performance needs to be consistent with the nature of its promise to the customer and what the entity has agreed to transfer to the customer. To illustrate this concept, the Basis for Conclusions cites, as an example, a contract for health club services. *[IFRS 15.BC160]*. Regardless of when, or how frequently, the customer uses the health club, the entity's obligation to stand ready for the contractual period does not change. Furthermore, the customer is required to pay the fee regardless of whether the customer uses the health club. As a result, the entity would need to select a measure of progress based on its service of standing ready to make the health club available. Example 18 in the standard (see section 7.1.4.E below) illustrates how a health club might select this measure of progress. *[IFRS 15.IE Example 18, IFRS 15.IE92-IE94]*.

An entity is required to recognise as revenue the amount of the transaction price it allocates to each performance obligation in a contract when or as it transfers the promised goods or services to customers, regardless of whether the consideration is paid upfront or the entity has a conditional or unconditional right to receive the consideration in the future. An entity that has not yet received the consideration to which it is entitled for transferring promised goods or services recognises a corresponding receivable if its right to payment is unconditional or a contract asset if its right to payment is conditional (see section 10.1 below for further discussion). This requirement, which applies to both revenue recognised over time and at a point in time, does not limit the arrangement consideration otherwise allocable to a satisfied performance obligation to the amount that is not contingent on future performance. See section 6 above for further discussion of allocating the transaction price to the performance obligations.

7.1.4.A Output methods

While there is no preferable measure of progress, the IASB stated in the Basis for Conclusions that, conceptually, an output measure is the most faithful depiction of an entity's performance. This is because it directly measures the value of the goods or services transferred to the customer. *[IFRS 15.BC164]*. However, the Board discussed two output methods that might not be appropriate in many instances if the entity's performance obligation is satisfied over time: units of delivery and units of production. *[IFRS 15.BC165]*.

Units-of-delivery or units-of-production methods might not result in the best depiction of an entity's performance over time if there is material work in progress at the end of the reporting period. In these cases, the IASB observed that using a units-of-delivery or units-of-production method would distort the entity's performance because it would not recognise revenue for the customer-controlled assets that are created before delivery or before construction is complete. This is because, when an entity determines control transfers to the customer over time, it has concluded that the customer controls any resulting asset as it is created. Therefore, the entity must recognise revenue related to those goods or services for which control has transferred. The IASB also stated, in the Basis for Conclusions, that a units-of-delivery or units-of-production method might not be appropriate if the contract provides both design and production services because each item produced "may not transfer an equal amount of value to the customer". *[IFRS 15.BC166]*. That is, it is likely that the items produced earlier have a higher value than those that are produced later.

It is important to note that 'value to the customer' in IFRS 15.B15 refers to an objective method of measuring the entity's performance in the contract. This is not intended to be assessed by reference to the market prices, stand-alone selling prices or the value a customer perceives to be embodied in the goods or services. *[IFRS 15.BC163]*. The TRG agenda paper noted that this concept of value is different from the concept of value an entity uses to determine whether it can use the 'right to invoice' practical expedient, as discussed below. When an entity determines whether items individually transfer an equal amount of value to the customer (i.e., when applying IFRS 15.B15), the evaluation related to how much, or what proportion, of the goods or services (i.e., quantities) have been delivered (but not the price). For example, for the purpose of applying IFRS 15.B15, an entity might consider the amount of goods or services transferred to date in proportion to the total expected goods or services to be transferred when measuring progress. However, if this measure of progress results in material work in progress at the end of the reporting period, it would not be appropriate, as discussed above.[119] See the discussion in section 7.1.4.B below regarding the evaluation of 'value to the customer' in the context of evaluating the 'right to invoice' practical expedient in IFRS 15.B16.

119 TRG Agenda paper no. 40, *Practical Expedient for Measuring Progress toward Complete Satisfaction of a Performance Obligation*, dated 13 July 2015.

7.1.4.B Output methods: practical expedient for measuring progress towards satisfaction of a performance obligation

The IASB provided a practical expedient in IFRS 15.B16 for an entity that is using an output method to measure progress towards completion of a performance obligation that is satisfied over time. The practical expedient only applies if an entity can demonstrate that the invoiced amount corresponds directly with the value to the customer of the entity's performance completed to date. In that situation, the practical expedient allows an entity to recognise revenue in the amount for which it has the right to invoice (i.e., the 'right to invoice' practical expedient). An entity might be able to use this practical expedient for a service contract in which an entity bills a fixed amount for each hour of service provided.

A TRG agenda paper noted that IFRS 15.B16 is intended as an expedient to some aspects of Step 3, Step 4 and Step 5 in the standard. Because this practical expedient allows an entity to recognise revenue on the basis of invoicing, revenue is recognised by multiplying the price (assigned to the goods or services delivered) by the measure of progress (i.e., the quantities or units transferred). Therefore, an entity effectively bypasses the steps in the model for determining the transaction price, allocating that transaction price to the performance obligations and determining when to recognise revenue. However, it does not permit an entity to bypass the requirements for identifying the performance obligations in the contract and evaluating whether the performance obligation is satisfied over time, which is a requirement to use this expedient.[120]

To apply the practical expedient, an entity must also be able to assert that the right to consideration from a customer corresponds directly with the value to the customer of the entity's performance to date. When determining whether the amount that has been invoiced to the customer corresponds directly with the value to the customer of an entity's performance completed to date, the entity could evaluate the amount that has been invoiced in comparison to market prices, stand-alone selling prices or another reasonable measure of value to the customer. See Question 7-18 in section 7.1.4.E below for the TRG discussion on evaluating value to the customer in contracts with changing rates.

Furthermore, the TRG members also noted in their discussion of the TRG agenda paper that an entity would have to evaluate all significant upfront payments or retrospective adjustments (e.g., accumulating rebates) in order to determine whether the amount the entity has a right to invoice for each good or service corresponds directly to the value to the customer of the entity's performance completed to date. That is, if an upfront payment or retrospective adjustment significantly shifts payment for value to the customer to the front or back-end of a contract, it might be difficult for an entity to conclude that the amount invoiced corresponds directly with the value provided to the customer for goods or services.[121]

The TRG agenda paper also stated that the presence of an agreed-upon customer payment schedule does not mean that the amount an entity has the right to invoice corresponds directly with the value to the customer of the entity's performance completed to date. In addition, the TRG agenda paper stated that the existence of specified contract minimums (or volume discounts) would not always preclude the application of the practical expedient, provided that these clauses are deemed non-substantive (e.g., the entity expects to receive amounts in excess of the specified minimums).[122]

7.1.4.C Input methods

Input methods recognise revenue based on an entity's efforts or inputs towards satisfying a performance obligation relative to the total expected efforts or inputs to satisfy the performance obligation. Examples of input methods mentioned in the standard include costs incurred, time elapsed, resources consumed, or labour hours expended. An entity is required to select a single measure of progress for each performance obligation that depicts the entity's performance in transferring control of the goods or services promised to a customer. If an entity's efforts or inputs are used evenly throughout the entity's performance period, a time-based measure that results in a straight-line recognition of revenue might be appropriate. However, there might be a disconnect between an entity's inputs (e.g., cost of non-distinct goods included in a single performance obligation satisfied over time) and the depiction of an entity's performance to date. The standard includes specific application guidance on adjustments to the measure of progress that might be necessary in those situations. See below for additional discussion.

120 TRG Agenda paper no. 40, *Practical Expedient for Measuring Progress toward Complete Satisfaction of a Performance Obligation*, dated 13 July 2015.

121 TRG Agenda paper no. 40, *Practical Expedient for Measuring Progress toward Complete Satisfaction of a Performance Obligation*, dated 13 July 2015.

122 TRG Agenda paper no. 44, *July 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 9 November 2015.

Regardless of which method an entity selects, it excludes from its measure of progress any goods or services for which control has not transferred to the customer. Likewise, if an entity uses an input method based on costs incurred, it excludes from its measure of progress those costs that do not reflect its performance in transferring a good or service to the customer (e.g., borrowing costs incurred, which it incurs to fund its activities, rather than to fulfil a performance obligation). *[IFRS 15.42, IFRS 15.B19(a)]*.

7.1.4.D Input methods: adjustments to the measure of progress based on an input method

If an entity applies an input method that uses costs incurred to measure its progress towards completion (e.g., cost to cost), the cost incurred might not always be proportionate to the entity's progress in satisfying the performance obligation. To address this shortcoming of input methods, the standard provides the following guidance: *[IFRS 15.B19]*

Extract from IFRS 15

B19 A shortcoming of input methods is that there may not be a direct relationship between an entity's inputs and the transfer of control of goods or services to a customer. Therefore, an entity shall exclude from an input method the effects of any inputs that, in accordance with the objective of measuring progress in paragraph 39, do not depict the entity's performance in transferring control of goods or services to the customer. For instance, when using a cost-based input method, an adjustment to the measure of progress may be required in the following circumstances:

(a) When a cost incurred does not contribute to an entity's progress in satisfying the performance obligation. For example, an entity would not recognise revenue on the basis of costs incurred that are attributable to significant inefficiencies in the entity's performance that were not reflected in the price of the contract (for example, the costs of unexpected amounts of wasted materials, labour or other resources that were incurred to satisfy the performance obligation).

(b) When a cost incurred is not proportionate to the entity's progress in satisfying the performance obligation. In those circumstances, the best depiction of the entity's performance may be to adjust the input method to recognise revenue only to the extent of that cost incurred. For example, a faithful depiction of an entity's performance might be to recognise revenue at an amount equal to the cost of a good used to satisfy a performance obligation if the entity expects at contract inception that all of the following conditions would be met:

(i) the good is not distinct;

(ii) the customer is expected to obtain control of the good significantly before receiving services related to the good;

(iii) the cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation; and

(iv) the entity procures the good from a third party and is not significantly involved in designing and manufacturing the good (but the entity is acting as a principal in accordance with paragraphs B34-B38).

In a combined performance obligation comprised of non-distinct goods or services, the customer might obtain control of some of the goods before the entity provides the services related to those goods. This could be the case when goods are delivered to a customer site, but the entity has not yet integrated the goods into the overall project (e.g., the materials are 'uninstalled'). The Board concluded that, if an entity were using a percentage-of-completion method based on costs incurred to measure its progress (i.e., cost-to-cost), the measure of progress might be inappropriately affected by the delivery of these goods and that a pure application of such a measure of progress would result in overstated revenue. *[IFRS 15.BC171]*.

IFRS 15.B19 indicates that, in such circumstances (e.g., when control of the individual goods has transferred to the customer, but the integration service has not yet occurred), the best depiction of the entity's performance might be to recognise revenue at an amount equal to the cost of the goods used to satisfy the performance obligation (i.e., a zero margin). This is because the costs incurred are not proportionate to an entity's progress in satisfying the performance obligation. It is also important to note that determining when control of the individual goods (that are part of a performance obligation) have transferred to the customer requires judgement.

The Board noted that the adjustment to the cost-to-cost measure of progress for uninstalled materials is generally intended to apply to a subset of construction-type goods that have a significant cost relative to the contract and for which the entity is effectively providing a simple procurement service to the customer. *[IFRS 15.BC172]*. By applying the adjustment to recognise revenue at an amount equal to the cost of uninstalled materials, an entity is recognising a margin similar to the one the entity would have recognised if the customer had supplied the materials. The IASB clarified that the outcome of recognising no margin for uninstalled materials is necessary to adjust the cost-to-cost calculation to faithfully depict an entity's performance. *[IFRS 15.BC174]*.

In addition, situations might arise in which not all of the costs incurred contribute to the entity's progress in completing the performance obligation. IFRS 15 requires that, under an input method, an entity exclude these types of costs (e.g., costs related to significant inefficiencies, wasted materials, required rework) from the measure of progress, unless such costs were reflected in the price of the contract. *[IFRS 15.B19(a)]*.

How we see it

As discussed above and in paragraph 172 of the Basis for Conclusions on IFRS 15, the IASB generally intended the application guidance to apply to a subset of construction-type goods that have a significant cost relative to the contract and for which the entity is effectively providing a simple procurement service to the customer. This was confirmed in a speech by a member of the US SEC staff who noted that they would be sceptical of broad application of the uninstalled materials application guidance.[123]

The standard includes the following example, illustrating how uninstalled materials are considered in measuring progress towards complete satisfaction of a performance obligation: *[IFRS 15.IE Example 19, IFRS 15.IE95-IE100]*

Extract from IFRS 15

Example 19-Uninstalled materials

In November 20X2, an entity contracts with a customer to refurbish a 3-storey building and install new elevators for total consideration of CU5 million. The promised refurbishment service, including the installation of elevators, is a single performance obligation satisfied over time. Total expected costs are CU4 million, including CU1.5 million for the elevators. The entity determines that it acts as a principal in accordance with paragraphs B34-B38 of IFRS 15, because it obtains control of the elevators before they are transferred to the customer.

A summary of the transaction price and expected costs is as follows:

	CU
Transaction price	5,000,000
Expected costs	
Elevators	1,500,000
Other costs	2,500,000
Total expected costs	4,000,000

The entity uses an input method based on costs incurred to measure its progress towards complete satisfaction of the performance obligation. The entity assesses whether the costs incurred to procure the elevators are proportionate to the entity's progress in satisfying the performance obligation, in accordance with paragraph B19 of IFRS 15. The customer obtains control of the elevators when they are delivered to the site in December 20X2, although the elevators will not be installed until June 20X3. The costs to procure the elevators (CU1.5 million) are significant relative to the total expected costs to completely satisfy the performance obligation (CU4 million). The entity is not involved in designing or manufacturing the elevators.

The entity concludes that including the costs to procure the elevators in the measure of progress would overstate the extent of the entity's performance. Consequently, in accordance with paragraph B19 of IFRS 15, the entity adjusts its measure of progress to exclude the costs to procure the elevators from the measure of costs incurred and from the transaction price. The entity recognises revenue for the transfer of the elevators in an amount equal to the costs to procure the elevators (ie at a zero margin).

123 Speech by Sylvia Alicea, Professional Accounting Fellow, SEC Office of the Chief Accountant, 8 May 2017, SEC.gov.

As of 31 December 20X2 the entity observes that:

(a) other costs incurred (excluding elevators) are CU500,000; and

(b) performance is 20 per cent complete (ie CU500,000 ÷ CU2,500,000).

Consequently, at 31 December 20X2, the entity recognises the following:

	CU	
Revenue	2,200,000	(a)
Cost of goods sold	2,000,000	(b)
Profit	200,000	

(a) Revenue recognised is calculated as (20 per cent × CU3,500,000) + CU1,500,000. (CU3,500,000 is CU5,000,000 transaction price - CU1,500,000 costs of elevators.)

(b) Cost of goods sold is CU500,000 of costs incurred + CU1,500,000 costs of elevators.

How we see it

When costs for uninstalled materials are excluded from the measure of progress and those materials are subsequently installed, an entity will need to apply significant judgement, based on its assessment of which treatment best depicts its performance in the contract, to determine whether the costs are: (a) included in the measure of progress upon installation; or (b) excluded from the measure of progress for the duration of the contract. These approaches are described below.

Approach (a) - once the materials have been installed, the costs for those materials are included in the measure of progress

IFRS 15.B19(b) can be read to apply only while materials are uninstalled. Once installed, it no longer applies to the materials and the entity reverts to the general requirements for measuring progress over time. The Basis for Conclusions indicates that recognising the profit margin for the performance obligation as a whole before the goods are installed could result in overstated revenue, and that IFRS 15.B19(b) applies to uninstalled materials and that it is only those materials that are not yet installed that attract a zero margin. *[IFRS 15.BC171, IFRS 15.BC172, IFRS 15.BC174]*. Furthermore, Example 19 of IFRS 15 (see extract above) illustrates the accounting for materials before they are installed (at the point in time that control of those materials has passed to the customer) and not after being installed.

When the profit margin applicable to the procured item(s) differs significantly from the profit margin attributable to other goods and services to be provided in accordance with the contract, the application of the profit margin for the performance obligation as a whole might overstate the amount of revenue and profit that is attributed to the procured item(s). Entities will need to consider whether the outcome of applying this approach is consistent with the underlying principle in IFRS 15.39, that the amount of revenue recognised depict its performance, as it satisfies its performance obligation.

If this approach is used, an entity needs to ensure it does not use a profit margin that differs from the profit margin for the performance obligation as a whole. That is, it does not attribute different profit margins to each component within a single performance obligation. This would effectively treat each component as a separate performance obligation when they are not distinct (and, therefore, inappropriately bypass the requirements for identifying performance obligations). *[IFRS 15.BC171]*.

Approach (b) - the costs for uninstalled materials are excluded from the measure of progress for the duration of the contract

IFRS 15.B19(b) does not distinguish goods that have been installed from those that have not yet been installed and the adjustments to the measure of progress in Example 19 of IFRS 15 can be read to apply for the duration of the contract. *[IFRS 15.IE98]*. As discussed above, IFRS 15.B19(b) is generally intended to apply to a subset of construction-type goods that have a significant cost relative to the contract and for which the entity is effectively providing a simple procurement service to the customer or if the customer had supplied the materials themselves. *[IFRS 15.BC172]*.

Approach (b) shifts the margin from uninstalled materials to the other components within the single performance obligation, which is recognised as the related costs are incurred (and included in the measure of progress). Entities might need to consider whether this reflects their performance if they typically charge a margin for procurement of similar materials.

7.1.4.E Examples of measures of progress

The following Illustration shows some possible considerations when determining an appropriate measure of progress:

Illustration 7-4: Choosing the measure of progress

A ship-building entity enters into a contract to build 15 vessels for a customer over a three-year period. The contract includes both design and production services. The entity has not built a vessel of this type in the past. In addition, the entity expects that the first vessels might take longer to produce than the last vessels because, as the entity gains experience building the vessels, it expects to be able to construct the vessels more efficiently.

Assume that the entity has determined that the design and production services represent a single performance obligation. In this situation, it is likely that the entity would not choose a 'units-of-delivery' method as a measure of progress because that method would not accurately capture the level of performance. That is, such a method would not reflect the entity's efforts during the design phase of the contract because no revenue would be recognised until a vessel was shipped. In such situations, an entity would likely determine that an input method is more appropriate, such as a percentage of completion method based on costs incurred.

The standard also includes the following example on selecting an appropriate measure of progress towards satisfaction of a performance obligation: *[IFRS 15.IE Example 18, IFRS 15.IE92-IE94]*

Extract from IFRS 15

Example 18-Measuring progress when making goods or services available

An entity, an owner and manager of health clubs, enters into a contract with a customer for one year of access to any of its health clubs. The customer has unlimited use of the health clubs and promises to pay CU100 per month.

The entity determines that its promise to the customer is to provide a service of making the health clubs available for the customer to use as and when the customer wishes. This is because the extent to which the customer uses the health clubs does not affect the amount of the remaining goods and services to which the customer is entitled. The entity concludes that the customer simultaneously receives and consumes the benefits of the entity's performance as it performs by making the health clubs available. Consequently, the entity's performance obligation is satisfied over time in accordance with paragraph 35(a) of IFRS 15.

The entity also determines that the customer benefits from the entity's service of making the health clubs available evenly throughout the year. (That is, the customer benefits from having the health clubs available, regardless of whether the customer uses it or not.) Consequently, the entity concludes that the best measure of progress towards complete satisfaction of the performance obligation over time is a time-based measure and it recognises revenue on a straight-line basis throughout the year at CU100 per month.

Frequently asked questions

Question 7-13 How are the effects of learning curve costs addressed in IFRS 15?

See response to Question 9-17 in section 9.3.2 below.

Question 7-14: How would an entity measure progress towards satisfaction of a stand-ready obligation that is satisfied over time?

(TRG meeting 26 January 2015 - Agenda paper no. 16)

The TRG members generally agreed that an entity cannot default to a straight-line revenue attribution model. However, they also generally agreed that if an entity expects the customer to receive and consume the benefits of its promise throughout the contract period, a time-based measure of progress (e.g., straight-line) would be appropriate. The TRG agenda paper noted that this is generally the case for unspecified upgrade rights, help-desk support contracts and cable or satellite television contracts. In contrast, the TRG members generally agreed that rateable recognition might not be appropriate if the benefits are not spread evenly over the contract period (e.g., an annual snow removal contract that provides most benefits in winter).

As discussed in Question 4-13 in section 4.2.2 above, we generally believe that a stand-ready obligation that is satisfied over time will meet the criteria to be accounted for as a series of distinct goods and services. Similar to the discussion above, while it is not appropriate to default to a straight-line revenue attribution model for a series, straight-line revenue recognition might be reasonable in many cases. Management needs to select the measure of progress that faithfully depicts the entity's performance in transferring the goods or services promised in a series.

Question 7-15: Can multiple measures of progress be used to depict an entity's performance in transferring a performance obligation comprised of two or more goods and/or services that is satisfied over time (i.e., a combined performance obligation)?[124]

(TRG meeting 13 July 2015 - Agenda paper no. 41)

The TRG members agreed that when an entity has determined that a combined performance obligation is satisfied over time, the entity has to select a single measure of progress that faithfully depicts the entity's performance in transferring the goods or services. For example, using different measures of progress for different non-distinct goods or services in the combined performance obligation would be inappropriate because doing so ignores the unit of account that has been identified under the standard (i.e., the single combined performance obligation). Furthermore, it would also be inappropriate because the entity would recognise revenue in a way that overrides the separation and allocation requirements in the standard. *[IFRS 15.BC161]*.

The TRG agenda paper noted that a single method of measuring progress cannot be broadly interpreted to mean an entity might apply multiple measures of progress as long as all measures used are either output or input measures.

Question 7-16: How would an entity determine the appropriate single measure of progress for a combined performance obligation that is satisfied over time?

(TRG meeting 13 July 2015 - Agenda paper no. 41)

The TRG members acknowledged that it might be difficult to appropriately determine a single measure of progress when the entity transfers goods or services that make up the combined performance obligation over different points of time and/or the entity would otherwise use a different measure of progress (e.g., a time-based method versus a labour-based input method) if each promise was a separate performance obligation.

Such a determination requires significant judgement, but the TRG members generally agreed that the measure of progress selected is not meant to be a 'free choice'. Entities need to consider the nature of the overall promise for the combined performance obligation in determining the measure of progress to use. For example, entities must not default to a 'final deliverable' methodology, such that all revenue would be recognised over the performance period of the last promised good or service. Rather, an entity is required to select the single measure of progress that most faithfully depicts the entity's performance in satisfying its combined performance obligation.

124 Under Step 2 of the model (see section 4 above), a single performance obligation might contain multiple non-distinct goods or services and/or distinct goods or services that were required to be combined with non-distinct goods or services in order to identify a distinct bundle. This bundled performance obligation is referred to as a 'combined performance obligation' for the purpose of this discussion.

Some of the TRG members observed that an entity would need to consider the reasons why goods or services were bundled into a combined performance obligation in order to determine the appropriate pattern of revenue recognition. For example, if a good or service was combined with other goods or services because it was not capable of being distinct, that might indicate that it does not provide value or use to the customer on its own. As such, the entity would not contemplate the transfer of that good or service when determining the pattern of revenue recognition for the combined performance obligation.

The TRG members also generally agreed that, if an appropriately selected single measure of progress does not faithfully depict the economics of the arrangement, the entity needs to challenge whether the performance obligation was correctly combined (i.e., there might be more than one performance obligation).

Consider the following Illustration based on an example included in the TRG paper:

Illustration 7-5: Combined licence and installation service performance obligation

An entity promises to provide a software licence and installation services that will substantially customise the software to add significant new functionality that enables the software to interface with other customised applications used by the customer.

The entity concludes that the software and services are not separately identifiable from the customised installation service, and the criterion in IFRS 15.27(b) is not met (see section 4.2.1 above). Therefore, the software licence and installation service are combined into a single performance obligation and the entity concludes that the combined performance obligation is satisfied over time. If the licence was distinct, it would be considered a right-to-use licence and revenue would be recognised at a point in time.

The entity further determines that the nature of its overall promise is to develop the customised software over time. Accordingly, the entity determines that it needs to use a measure of progress that depicts the performance of completing the customised software solution. Therefore, all of the revenue for this contract would be recognised over the period that the customisation services are performed.

Question 7-17: Can control of a good or service underlying a performance obligation satisfied over time be transferred at discrete points in time? (FASB TRG meeting 18 April 2016 - Agenda paper no. 53)

The FASB TRG members generally agreed that, if a performance obligation meets the criteria for revenue to be recognised over time (rather than at a point in time), control of the underlying good or service is not transferred at discrete points in time. Because control transfers as an entity performs, an entity's performance (as reflected using an appropriate measure of progress) must not result in the creation of a material asset in the entity's accounts (e.g., work in progress).

Stakeholders had queried whether control of a good or service underlying a performance obligation that is satisfied over time can be transferred at discrete points in time because the standard highlights several output methods, including 'milestones reached', as potentially acceptable methods for measuring progress towards satisfaction of an over-time performance obligation. The FASB TRG members generally agreed that an entity could use an output method only if that measure of progress correlates to the entity's performance to date.

At the May 2016 IASB meeting, the IASB staff indicated support for the conclusions reached in the TRG agenda paper on this issue, noting that it provides some clarity about when to use milestones reached as a measure of progress. Furthermore, the members of the IASB who observed the FASB TRG meeting indicated that the FASB TRG discussion on the topic was helpful.

Question 7-18: Can an entity use the 'right to invoice' practical expedient for a contract that includes rates that change over the contractual term?

(TRG meeting 13 July 2015 - Agenda paper no. 40)

The TRG members generally agreed that determining whether an entity can apply the 'right to invoice' practical expedient requires judgement. They also generally agreed that it is possible for entities to meet the requirements for the practical expedient in contracts with changing rates, provided that the changes in rates correspond directly to changes in value to the customer. That is, a contract does not need to have a fixed price per unit for the duration of a contract to qualify for the practical expedient. Examples of contracts that might qualify include an IT outsourcing arrangement with rates that decrease over the contract term as the level of effort to the customer decreases or a multi-year electricity contract that contemplates the forward market price of electricity. However, the US SEC staff observer also noted that entities need to have strong evidence that variable prices reflect the value to the customer to recognise variable amounts of revenue for similar goods or services.

Question 7-19: If an entity does not meet the criteria to use the 'right to invoice' practical expedient, can it still use the disclosure practical expedient regarding the amount of transaction price allocated to remaining performance obligations?

(TRG meeting 13 July 2015 - Agenda paper no. 40)

See response to Question 10-11 in section 10.5.1.C below.

Question 7-20: If an entity begins activities on a specifically anticipated contract either: (1) before it agrees to the contract with the customer; or (2) before the arrangement meets the criteria to be considered a contract under the standard, how would revenue for those activities be recognised at the date a contract exists?

(TRG meeting 30 March 2015 - Agenda paper no. 33)

The TRG members generally agreed that if the goods or services that ultimately will be transferred meet the criteria to be recognised over time, revenue would be recognised on a cumulative catch-up basis at the 'contract establishment date', reflecting the performance obligation(s) that are partially or fully satisfied at that time. The TRG agenda paper noted that the cumulative catch-up method is considered to be consistent with the overall principle of the standard that revenue is recognised when (or as) an entity transfers control of goods or services to a customer.

When recording revenue on a cumulative catch-up basis in these circumstances, an entity needs to consider the requirements in Step 5 of the model to determine the goods or services that the customer controls. This determines what portion of costs incurred before the contract establishment date would be included in any measure of progress used to calculate the cumulative catch-up adjustment. If, for example, costs incurred prior to the contract establishment date relate to uninstalled materials or any goods or services that the customer does not control, the inclusion of those costs in determining how much revenue to recognise might not be appropriate (see section 7.1.4.D above for further discussion on uninstalled materials).

Question 7-21: How do entities consider costs subject to volatility caused by factors such as foreign exchange rates and commodity prices in a measure of progress if an entity applies an input method based on costs incurred?

Entities might enter into contracts for which they will incur costs that are subject to volatility caused by market factors such as foreign exchange rates, inflation and commodity prices, either directly or indirectly (e.g., when suppliers pass on such costs to the entity). That volatility in prices might be passed along to the customer in some cases but not in others.

The underlying premise of an input method based on costs incurred (e.g., cost-to-cost) for measuring progress is that the costs incurred are proportionate to an entity's progress as the entity performs. That is, an entity must include costs that contribute to its performance and exclude those costs that do not. *[IFRS 15.42, IFRS 15.B19]*.

Under IFRS 15, an entity needs to ensure that the measure of progress appropriately reflects the entity's performance in transferring control of the promised good or service to the customer, which could require judgement. Exchange rates and commodity prices are subject to changes in market activity and often drive a degree of mismatch between expected costs and market prices. In some cases, the entity might conclude that the use of an input method based on costs incurred is not appropriate if the costs it will incur will be subject to significant market volatility.

If the entity concludes the cost contributes to performance, but the volatility of the market price or exchange rate does not, it will need to appropriately reflect that in an input method based on costs incurred to measure progress, which will require judgement.

Entities might need to consider whether the determination of an exchange rate or commodity price applied on an input method based on costs incurred requires significant judgement or is a source of estimation uncertainty. If so, disclosure would be required in accordance with IAS 1.

Question 7-22: How does an entity account for fulfilment costs incurred prior to the contract establishment date that are outside the scope of another standard (e.g., IAS 2)?

(TRG meeting 30 March 2015 - Agenda paper no. 33)

See response to Question 9-16 in section 9.3.2 below.

7.2 Control transferred at a point in time

For performance obligations in which control is not transferred over time, control is transferred as at a point in time. *[IFRS 15.38]*. In many situations, the determination of *when* that point in time occurs is relatively straightforward. However, in other circumstances, this determination is more complex.

To help entities determine the point in time when a customer obtains control of a particular good or service, the Board provided the following requirements: *[IFRS 15.38]*

Extract from IFRS 15

Performance obligations satisfied at a point in time

38 If a performance obligation is not satisfied over time in accordance with paragraphs 35-37, an entity satisfies the performance obligation at a point in time. To determine the point in time at which a customer obtains control of a promised asset and the entity satisfies a performance obligation, the entity shall consider the requirements for control in paragraphs 31-34. In addition, an entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

(a) The entity has a present right to payment for the asset-if a customer is presently obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.

(b) The customer has legal title to the asset-legal title may indicate which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.

(c) The entity has transferred physical possession of the asset-the customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls. Paragraphs B64-B76, B77-B78 and B79-B82 provide guidance on accounting for repurchase agreements, consignment arrangements and bill-and-hold arrangements, respectively.

(d) The customer has the significant risks and rewards of ownership of the asset-the transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity shall exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.

(e) The customer has accepted the asset-the customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. To evaluate the effect of a contractual customer acceptance clause on when control of an asset is transferred, an entity shall consider the guidance in paragraphs B83-B86.

None of the indicators above are meant to individually determine whether the customer has gained control of the good or service. For example, while shipping terms might provide information about when legal title to a good transfers to the customer, they are not determinative when evaluating the point in time at which the customer obtains control of the promised asset. See Question 7-23 in section 7.2.5 below for further discussion on shipping terms. An entity must consider all relevant facts and circumstances to determine whether control has transferred. The IASB also made it clear that the indicators are not meant to be a checklist. Furthermore, not all of them must be present for an entity to determine that the customer has gained control. Rather, the indicators are factors that are often present when a customer has obtained control of an asset and the list is meant to help entities apply the principle of control. *[IFRS 15.BC155]*.

IFRS 15.38 also states that indicators of control transfer are not limited to those listed above. For example, channel stuffing is a practice that entities sometimes use to increase sales by inducing distributors or resellers to buy substantially more goods than can be promptly resold. To induce the distributors to make such purchases, an entity might offer deep discounts that it would have to evaluate as variable consideration in estimating the transaction price (see section 5.2 above). Channel stuffing also might be accompanied by side agreements with the distributors that provide a right of return for unsold goods that is in excess of the normal sales return privileges offered by the entity. Significant increases in, or excess levels of, inventory in a distribution channel due to channel stuffing might affect or preclude the ability to conclude that control of such goods has transferred.

How we see it

Entities need to carefully consider the expanded rights of returns offered to customers in connection with channel stuffing in order to determine whether they prevent the entity from recognising revenue at the time of the sales transaction.

If an entity uses channel stuffing practices, it needs to consider whether disclosure in its financial statements is required when it expects these practices to materially affect future operating results.

If, for example, an entity sold excess levels into a certain distribution channel at, or near, the end of a reporting period, it is likely that those sales volumes would not be sustainable in future periods. That is, sales into that channel might, in fact, slow down in future periods as the excess inventory takes longer to entirely sell through the channel. In such a case, the entity needs to consider whether disclosure of the effect of the channel stuffing practice on its current and future earnings is required, if material.

In determining when control transfers, it is important that the entity consider the good or service it is transferring, not the right to obtain that good or service in the future. In its March 2018 meeting, the IFRS IC noted that the right to sell (or pledge) a right to obtain an asset (e.g., real estate) in the future is not evidence of control of the asset itself (see Question 7-4 in section 7.1.2 above and Question 7-11 in section 7.1.3.B above for further discussion).[125]

We discuss the indicators in IFRS 15.38 that an entity considers when determining when it transfers control of the promised good or service to the customer in more detail in sections 7.2.1 - 7.2.4 below.

7.2.1 Present right to payment for the asset

As noted in the Basis for Conclusions, the IASB considered, but rejected specifying a right to payment as an overarching criterion for determining when revenue would be recognised. Therefore, while the date at which the entity has a right to payment for the asset might be an indicator of the date the customer obtained control of the asset, it does not always indicate that the customer has obtained control of the asset. *[IFRS 15.BC148]*. For example, in some contracts, a customer is required to make a non-refundable upfront payment but receives no goods or services in return at that time.

7.2.2 Legal title and physical possession

The term 'title' is often associated with a legal definition denoting the ownership of an asset or legally recognised rights that preclude others' claim to the asset. Accordingly, the transfer of title often indicates that control of an asset has been transferred. Determination of which party has title to an asset does not always depend on which party has physical possession of the asset, but without contractual terms to the contrary, title generally passes to the customer at the time of the physical transfer. For example, in a retail store transaction, there is often no clear documentation of the transfer of title. However, it is generally understood that the title to a product is transferred at the time it is purchased by the customer.

While the retail store transaction is relatively straightforward, determining when title has transferred might be more complicated in other arrangements. Transactions that involve the shipment of products might have varying shipping terms and could involve third-party shipping agents. In such cases, a clear understanding of the seller's practices and the contractual terms is required in order to make an assessment of when title transfers. As indicated in IFRS 15.38(b), legal title and/or physical possession might be an indicator of which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. See Question 7-23 in section 7.2.5 below for further discussion on how shipping terms affect when an entity has transferred control of a good to a customer.

125 *IFRIC Update*, March 2018, available on the IFRS Foundation's website.

7.2.3 Risks and rewards of ownership

Although the Board included the risks and rewards of ownership as one factor to consider when evaluating whether control of an asset has transferred, it emphasised, in the Basis for Conclusions, that this factor does not change the principle of determining the transfer of goods or services on the basis of control. *[IFRS 15.BC154]*. The concept of the risks and rewards of ownership is based on how the seller and the customer share both the potential gain (the reward) and the potential loss (risk) associated with owning an asset. Rewards of ownership include the following:

- Rights to all appreciation in value of the asset
- Unrestricted usage of the asset
- Ability to modify the asset
- Ability to transfer or sell the asset
- Ability to grant a security interest in the asset

Conversely, the risks of ownership include the following:

- Absorbing all of the declines in market value
- Incurring losses due to theft or damage of the asset
- Incurring losses due to changes in the business environment (e.g., obsolescence, excess inventory, effect of retail pricing environment)

However, as noted in IFRS 15.38(d), an entity does not consider risks that give rise to a separate performance obligation when evaluating whether the entity has the risks of ownership of an asset. For example, an entity does not consider warranty services that represent a separate performance obligation when evaluating whether it retains the risks of ownership of the asset sold to the customer.

7.2.4 Customer acceptance

When determining whether the customer has obtained control of the goods or services, an entity must consider any customer acceptance clauses that require the customer to approve the goods or services before it is obliged to pay for them. If a customer does not accept the goods or services, the entity might not be entitled to consideration, might be required to take remedial action or be required to take back the delivered good. *[IFRS 15.38(e), IFRS 15.B83]*.

The standard provides the following application guidance regarding how to evaluate customer acceptance provisions: *[IFRS 15.B84, IFRS 15.B85, IFRS 15.B86]*

Extract from IFRS 15	
B84	If an entity can objectively determine that control of a good or service has been transferred to the customer in accordance with the agreed-upon specifications in the contract, then customer acceptance is a formality that would not affect the entity's determination of when the customer has obtained control of the good or service. For example, if the customer acceptance clause is based on meeting specified size and weight characteristics, an entity would be able to determine whether those criteria have been met before receiving confirmation of the customer's acceptance. The entity's experience with contracts for similar goods or services may provide evidence that a good or service provided to the customer is in accordance with the agreed-upon specifications in the contract. If revenue is recognised before customer acceptance, the entity still must consider whether there are any remaining performance obligations (for example, installation of equipment) and evaluate whether to account for them separately.
B85	However, if an entity cannot objectively determine that the good or service provided to the customer is in accordance with the agreed-upon specifications in the contract, then the entity would not be able to conclude that the customer has obtained control until the entity receives the customer's acceptance. That is because in that circumstance the entity cannot determine that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service.
B86	If an entity delivers products to a customer for trial or evaluation purposes and the customer is not committed to pay any consideration until the trial period lapses, control of the product is not transferred to the customer until either the customer accepts the product or the trial period lapses.

Some acceptance provisions might be straightforward, giving a customer the ability to accept or reject the transferred products based on objective criteria specified in the contract (e.g., the goods function at a specified speed). Other acceptance clauses might be subjective or appear in parts of the contract that do not typically address acceptance matters, such as warranty provisions or indemnification clauses.

Professional judgement might be required to determine the effect on revenue recognition of the latter types of acceptance clauses.

Acceptance criteria that an entity cannot objectively evaluate against the agreed-upon specifications in the contract preclude an entity from concluding that a customer has obtained control of a good or service until formal customer sign-off is obtained or the acceptance provisions lapse. However, the entity would consider its experience with other contracts for similar goods or services because that experience might provide evidence about whether the entity is able to objectively determine that a good or service provided to the customer is in accordance with the agreed-upon specifications in the contract.

How we see it

We believe one or more of the following would represent circumstances in which the entity might not be able to objectively evaluate the acceptance criteria:

- The acceptance provisions are unusual or 'non-standard'. Indicators of 'non-standard' acceptance terms are:
  - The duration of the acceptance period is longer than in contracts for similar goods or services.
  - The majority of the entity's contracts lack similar acceptance terms.
  - The contract contains explicit customer-specified requirements that must be met prior to acceptance.
- The contract contains a requirement for explicit notification of acceptance (not just deemed acceptance). Explicit notification requirements might indicate that the criteria with which the customer is assessing compliance are not objective. In addition, such explicit notification clauses might limit the time period within which the customer can reject transferred products and might require the customer to provide, in writing, the reasons for the rejection of the products by the end of a specified period. When such clauses exist, acceptance can be deemed to have occurred at the end of the specified time period if notification of rejection has not been received from the customer, as long as the customer has not indicated it will reject the products.

In determining whether compliance with the criteria for acceptance can be objectively assessed (and acceptance is only a formality), the following is considered:

- Whether the acceptance terms are standard in arrangements entered into by the entity.
- Whether the acceptance is based on the transferred product performing to standard, published, specifications, and the entity can demonstrate that it has an established history of objectively determining that the product functions in accordance with those specifications.

As discussed above, customer acceptance would not be deemed a formality if the acceptance terms are unusual or non-standard. If a contract contains acceptance provisions that are based on customer-specified criteria, it might be difficult for the entity to objectively assess compliance with the criteria and the entity might not be able to recognise revenue prior to obtaining evidence of customer acceptance. However, determining that the acceptance criteria have been met (and, therefore, acceptance is merely a formality) might be appropriate if the entity can demonstrate that its product meets all of the customer's acceptance specifications by replicating, before shipment, those conditions under which the customer intends to use the product.

If it is reasonable to expect that the product's performance (once it has been installed and is operating at the customer's facility) will be different from the performance when it was tested prior to shipment, this acceptance provision will not have been met. The entity, therefore, would not be able to conclude that the customer has obtained control until customer acceptance occurs. Factors indicating that specifications cannot be tested effectively prior to shipment include:

- The customer has unique equipment, software or environmental conditions that can reasonably be expected to make performance in that customer's environment different from testing performed by the entity. If the contract includes customer acceptance criteria or specifications that cannot be effectively tested before delivery or installation at the customer's site, revenue recognition would be deferred until it can be demonstrated that the criteria are met.
- The products that are transferred are highly complex.
- The entity has a limited history of testing products prior to control transferring to the customer or a limited history of having customers accept products that it has previously tested.

Determining when a customer obtains control of an asset in a contract with customer-specified acceptance criteria requires the use of professional judgement and depends on the weight of the evidence in the particular circumstances. The conclusion could change based on an analysis of an individual factor, such as the complexity of the equipment, the nature of the interface with the customer's environment, the extent of the entity's experience with this type of transaction or a particular clause in the agreement. An entity might need to discuss the situation with knowledgeable project managers or engineers in making such an assessment.

In addition, each contract containing customer-specified acceptance criteria might require a separate compliance assessment of whether the acceptance provisions have been met prior to confirmation of the customer's acceptance. That is, since different customers might specify different acceptance criteria, an entity might not be able to make one compliance assessment that applies to all contracts because of the variations in contractual terms and customer environments.

Even if a contract includes a standard acceptance clause, if the clause relates to a new product or one that has only been sold on a limited basis previously, an entity might be required to initially defer revenue recognition for the product until it establishes a history of successfully obtaining acceptance.

IFRS 15.B86 states that, if an entity delivers products to a customer for trial or evaluation purposes and the customer is not committed to pay any consideration until the trial period lapses, control of the product is not transferred to the customer until either the customer accepts the product or the trial period lapses. See further discussion of 'free' trial periods in Question 3-2 in section 3.1 above, including when such arrangements might meet the criteria to be considered a contract within the scope of the model in IFRS 15.

7.2.5 Example of control transferring at a point in time

The following Illustration shows the application of the indicators of the transfer of control in IFRS 15.38 to a performance obligation that is satisfied at a point in time:

Illustration 7-6: Applying the indicators of the transfer of control to a performance obligation satisfied at a point in time

BCB Liquors (BCB) uses a distribution network to sell its product to end-consumers. Upon receipt of the product, a distributor receives legal title to the goods and is required to pay BCB for the product. In this example, BCB has determined its relationship with the distributor is not a consignment agreement (see section 7.4 below). Rather, the distributor is BCB's customer.

BCB determines that its performance obligation for the sale of product to the distributor is satisfied at a point in time. BCB considers the indicators of the transfer of control and concludes that control transfers to the distributor when the product is delivered to the distributor. At this point in time, BCB has a present right to payment and the distributor has legal title and physical possession of the product, as well as the risks and rewards of ownership. BCB concludes customer acceptance is a formality as BCB can objectively determine that the goods meet the agreed-upon specifications before shipment to the distributor.

Alternatively, if BCB sold the product to the distributor on consignment or determined that the end-consumer was its customer, the distributor was not obligated to pay for the product until it was sold to the end-consumer and BCB had the ability to require the return of any unsold product or the distributor had an unlimited amount of time to return any unsold products, then BCB might have concluded that control of the product would not transfer until it is sold to the end-consumer. Therefore, BCB would not recognise revenue until the product was sold to the end-consumer.

An entity is required to recognise as revenue the amount of the transaction price it allocates to each performance obligation in a contract when or as it transfers the promised goods or services to customers, regardless of whether the consideration is paid upfront or the entity has a conditional or unconditional right to receive the consideration in the future. An entity that has not yet received the consideration to which it is entitled for transferring promised goods or services recognises a corresponding receivable if its right to payment is unconditional or a contract asset if its right to payment is conditional (see section 10.1 below for further discussion). This requirement, which applies to both revenue recognised over time and at a point in time, does not limit the arrangement consideration allocable to satisfied performance obligation to the amount that is not contingent on future performance. See section 6 above for further discussion of allocating the transaction price to the performance obligations.

Frequently asked questions

Question 7-23: How do shipping terms affect when an entity has transferred control of a good to a customer?

Under the standard, an entity recognises revenue only when it satisfies an identified performance obligation by transferring a promised good or service to a customer. While shipping terms might provide information about when legal title to a good transfers to the customer, they are not determinative when evaluating the point in time at which the customer obtains control of the promised asset. Entities must consider all relevant facts and circumstances to determine whether control has transferred. *[IFRS 15.38]*.

As an example, when the shipping terms are free on board (FOB), entities need to carefully consider whether the customer or the entity has the ability to control the goods during the shipment period. Furthermore, if the entity has the legal or constructive obligation to replace goods that are lost or damaged in transit, it needs to evaluate whether that obligation influences the customer's ability to direct the use, and obtain substantially all of the remaining benefits from, the goods. A selling entity's historical practices also need to be considered when evaluating whether control of a good has transferred to a customer because the entity's practices might override the contractual terms of the arrangement.

Contractually specified shipping terms might vary depending on factors such as the mode of transport (e.g., by sea, inland waterway, road, air) and whether the goods are shipped locally or internationally. A selling entity might utilise International Commerce Terms (Incoterms®) to clarify when delivery occurs. Incoterms® are a series of pre-defined commercial terms published by the International Chamber of Commerce (ICC) relating to international commercial law. For example, 'EXW' or 'Ex Works' in Incoterms® 2020 means that the selling entity 'delivers' when it places the goods at the disposal of the customer, either at the seller's premises or at another named location (e.g., a factory, warehouse). The selling entity is not required to load the goods on any collecting vehicle, nor does it need to clear the goods for export (if applicable, see further discussion on Ex Works in section 7.5 below). The Incoterm FOB means "the seller delivers the goods on board the vessel nominated by the buyer at the named port of shipment or procures the goods already so delivered. The risk of loss of or damage to the goods passes when the goods are on board the vessel, and the buyer bears all costs from that moment onwards".[126]

7.3 Repurchase agreements

Some agreements include repurchase provisions, either as part of a sales contract or as a separate contract that relates to the goods in the original agreement or similar goods. These provisions affect how an entity applies the requirements on control to affected transactions. That is, when evaluating whether a customer obtains control of an asset, an entity needs to consider any agreement to repurchase the asset. *[IFRS 15.34]*.

The standard clarifies the types of arrangements that qualify as repurchase agreements: *[IFRS 15.B64, IFRS 15.B65]*

Extract from IFRS 15

B64 A repurchase agreement is a contract in which an entity sells an asset and also promises or has the option (either in the same contract or in another contract) to repurchase the asset. The repurchased asset may be the asset that was originally sold to the customer, an asset that is substantially the same as that asset, or another asset of which the asset that was originally sold is a component.

B65 Repurchase agreements generally come in three forms:

(a) an entity's obligation to repurchase the asset (a forward);

(b) an entity's right to repurchase the asset (a call option); and

(c) an entity's obligation to repurchase the asset at the customer's request (a put option).

For an obligation or right to purchase an asset to be accounted for as a repurchase agreement under IFRS 15, it needs to exist at contract inception, either as a part of the same contract or in another contract. The IASB clarified that an entity's subsequent decision to repurchase an asset (after transferring control of that asset to a customer) without reference to any pre-existing contractual right would not be accounted for as a repurchase agreement under the standard. That is, the customer is not obliged to resell that good to the entity as a result of the initial contract. Therefore, any subsequent decision to repurchase the asset does not affect the customer's ability to control the asset upon initial transfer. However, in cases in which an entity decides to repurchase a good after transferring control of the good to a customer, the Board

126 See the ICC website for further information.

observed that the entity needs to carefully consider whether the customer obtained control in the initial transaction. Furthermore, it might need to consider the application guidance on principal versus agent considerations (see section 4.4 above). *[IFRS 15.BC423]*.

7.3.1 Forward or call option held by the entity

When an entity has the obligation or right to repurchase an asset (i.e., a forward or a call option), the standard indicates that the customer has not obtained control of the asset. The standard provides the following application guidance: *[IFRS 15.B66, IFRS 15.B67]*

Extract from IFRS 15

B66 If an entity has an obligation or a right to repurchase the asset (a forward or a call option), a customer does not obtain control of the asset because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset even though the customer may have physical possession of the asset. Consequently, the entity shall account for the contract as either of the following:

(a) a lease in accordance with IFRS 16 *Leases* if the entity can or must repurchase the asset for an amount that is less than the original selling price of the asset, unless the contract is part of a sale and leaseback transaction. If the contract is part of a sale and leaseback transaction, the entity shall continue to recognise the asset and shall recognise a financial liability for any consideration received from the customer. The entity shall account for the financial liability in accordance with IFRS 9; or

(b) a financing arrangement in accordance with paragraph B68 if the entity can or must repurchase the asset for an amount that is equal to or more than the original selling price of the asset.

B67 When comparing the repurchase price with the selling price, an entity shall consider the time value of money.

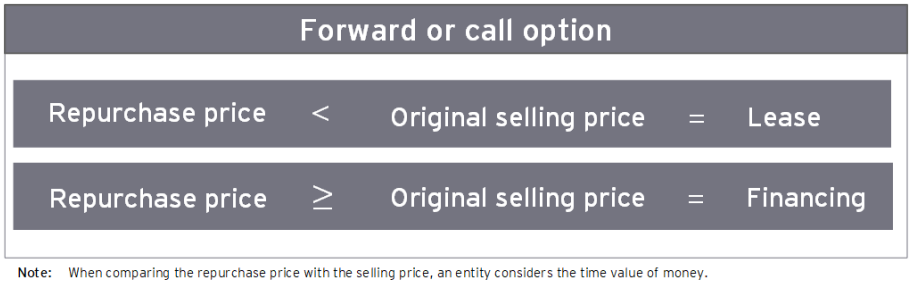
The application guidance in the extract above requires that an entity account for a transaction including a forward or a call option based on the relationship between the repurchase price and the original selling price, regardless of whether the option will be exercised. The standard indicates that if the entity has the right or obligation to repurchase the asset at a price less than the original selling price (taking into consideration the effects of the time value of money), the entity would account for the transaction as a lease in accordance with IFRS 16, unless the contract is part of a sale and leaseback transaction. For additional information on lease accounting under IFRS 16, see Chapter 24. If the entity has the right or obligation to repurchase the asset at a price equal to or greater than the original selling price (considering the effects of the time value of money) or if the contract is part of a sale and leaseback transaction, the entity would account for the contract as a financing arrangement in accordance with IFRS 15. *[IFRS 15.B68]*.

How we see it

It is important to remember that the effect of the time value of money must be considered when comparing the repurchase price to the original selling price of the asset. This evaluation can influence the determination of whether the repurchase agreement represents a lease or financing arrangement.

The following figure depicts this application guidance for transactions that are not sale and leaseback transactions:

Figure 7-2: Forward or call options



Under the standard, a transaction in which a seller has an option to repurchase the product is treated as a lease or a financing arrangement (i.e., not a sale). This is because the customer does not have control of the product and is constrained in its ability to direct the use of and obtain substantially all of the remaining benefits from the good. The Board noted in the Basis for Conclusions that entities would not need to consider the likelihood that a call option will be exercised in determining the accounting for the repurchase provision. However, the Board also stated that non-substantive call options are ignored and would not affect when a customer obtains control of an asset. *[IFRS 15.BC427]*. See Question 7-24 below for how an entity might consider conditional call options and an example of a conditional call option that might qualify to be treated as a sale.

In the Basis for Conclusions, the Board also observed that, "Theoretically, a customer is not constrained in its ability to direct the use of and obtain substantially all of the benefits from, the asset if an entity agrees to repurchase, at the prevailing market price, an asset from the customer that is substantially the same and is readily available in the marketplace." *[IFRS 15.BC425]*. For example, an entity might transfer control of a commodity to a customer together with a forward or call option to repurchase that commodity (or one that is substantially the same). If (1) the repurchase price in the forward or call option is at the prevailing market price at the repurchase date, (2) the commodity to be repurchased is substantially the same, and (3) the commodity to be repurchased under the forward or call option is readily available (e.g., by being traded in an active commodity market), then the customer might not be constrained in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset as discussed in IFRS 15.B66.

How we see it

To conclude that the customer obtains control in such an arrangement would require the use of significant judgement, and such a conclusion might not be appropriate in situations that do not meet the narrow fact pattern discussed above.

If a transaction is considered a financing arrangement under the IFRS 15, in accordance with IFRS 15.B68, the selling entity continues to recognise the asset. In addition, it records a financial liability for the consideration received from the customer. The difference between the consideration received from the customer and the consideration subsequently paid to the customer (upon repurchasing the asset) represents the interest and holding costs (as applicable) that are recognised over the term of the financing arrangement. If the option lapses unexercised, the entity derecognises the liability and recognises revenue at that time. *[IFRS 15.B68, IFRS 15.B69]*.

Also note that IFRS 15.B66(a) specifies that, if the contract is part of a sale and leaseback transaction, the entity continues to recognise the asset. Furthermore, the entity recognises a financial liability for any consideration received from the customer to which IFRS 9 would apply.

How we see it

Since the IASB has embedded lease guidance in IFRS 15, it is important for entities to understand the interaction between the lease and revenue standards.

The standard provides the following example of a call option: *[IFRS 15.IE Example 62 Case A, IFRS 15.IE315-IE318]*

Extract from IFRS 15

Example 62-Repurchase agreements

An entity enters into a contract with a customer for the sale of a tangible asset on 1 January 20X7 for CU1 million.

Case A-Call option: financing

The contract includes a call option that gives the entity the right to repurchase the asset for CU1.1 million on or before 31 December 20X7.

Control of the asset does not transfer to the customer on 1 January 20X7 because the entity has a right to repurchase the asset and therefore the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Consequently, in accordance with paragraph B66(b) of IFRS 15, the entity accounts for the transaction as a financing arrangement, because the exercise price is more than the original selling price. In accordance with paragraph B68 of IFRS 15, the entity does not derecognise the asset and instead recognises the cash received as a financial liability. The entity also recognises interest expense for the difference between the exercise price (CU1.1 million) and the cash received (CU1 million), which increases the liability.

On 31 December 20X7, the option lapses unexercised; therefore, the entity derecognises the liability and recognises revenue of CU1.1 million.

Frequently asked questions

Question 7-24: How can an entity evaluate a conditional call option to repurchase an asset?

The standard does not specifically address conditional call options.

How we see it

We believe entities need to consider the following when evaluating conditional call options to repurchase an asset.

- If the entity controls the outcome of the condition that causes the call option to become active, then the presence of the call option indicates that control has not transferred because the customer is limited in its ability to direct the use of and obtain substantially all of the remaining benefits from the asset. That is, the entity would be required to treat the contract as a lease or a financing arrangement as required by IFRS 15.B66.
- If the entity does not control the condition that causes the call option to become active, then it would be acceptable for the entity to apply judgement to determine whether the call option limits the customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. For example, if neither the entity nor the customer controls the outcome of the contingency, the entity could evaluate the nature of the contingency, together with the likelihood of the contingency becoming active, to determine whether it limits the customer's ability to obtain control of the asset. This could be the case for certain types of product recalls. See also Question 9-3 in section 9.1.1 below for how an entity would account for a customer's return of a defective item in exchange for compensation (i.e., not for a replacement item).
- If the customer controls the outcome of the contingency, then the conditional call option might not prevent the customer from obtaining control of the asset if the customer can direct the use of, and obtain substantially all the remaining benefits from, the asset. The application guidance in IFRS 15.B70-B76 (see section 7.3.2 below) might be helpful for an entity to consider when determining whether the customer obtains control of the asset when it controls the outcome of the contingency.
- In the case of perishable products, an entity's conditional right to remove and replace expired goods does not necessarily constrain the customer's ability to direct the use of and obtain substantially all of the remaining benefits from the products. That is, the entity is not able to remove and replace the products until they expire. Furthermore, the customer has control of the products over their entire useful life. Consequently, it might be reasonable for an entity to conclude that control of the initial product does transfer to the customer in this situation and that an entity could consider this right to be a form of a right of return (see section 5.4 above).

7.3.2 Put option held by the customer

IFRS 15 indicates that if the customer has the ability to require an entity to repurchase an asset (i.e., a put option) at a price lower than its original selling price, the entity considers, at contract inception, whether the customer has a significant economic incentive to exercise that right. *[IFRS 15.B70]*. That is, this determination influences whether the customer truly has control over the asset received.

The determination of whether an entity has a significant economic incentive to exercise its right determines whether the arrangement is treated as a lease or a sale with the right of return (discussed in section 5.4 above). An entity must consider all relevant facts and circumstances to determine whether a customer has a significant economic incentive to exercise its right, including the relationship between the repurchase price to the expected market value (taking into consideration the effects of the time value of money) of the asset at the date of repurchase and the amount of time until the right expires. *[IFRS 15.B71, IFRS 15.B75]*. The standard notes that if the repurchase price is expected to significantly exceed the market value of the asset, the customer might have a significant economic incentive to exercise the put option. Since the standard provides limited guidance on determining whether a significant economic incentive exists, judgement might be required to make this determination:

- If a customer has a significant economic incentive to exercise its right, the customer is expected to ultimately return the asset. The entity accounts for the agreement as a lease because the customer is effectively paying the entity for the right to use the asset for a period of time. However, one exception to this would be if the contract is part of a sale and leaseback, in which case, the contract would be accounted for as a financing arrangement (financing arrangements are discussed in section 7.3.1 above). *[IFRS 15.B73]*. If the contract is part of a sale and leaseback transaction, the entity continues to recognise the asset. Furthermore, the entity recognises a financial liability for any consideration received from the customer to which IFRS 9 would apply.
- If a customer does not have a significant economic incentive to exercise its right, the entity accounts for the agreement in a manner similar to a sale of a product with a right of return. *[IFRS 15.B72]*.

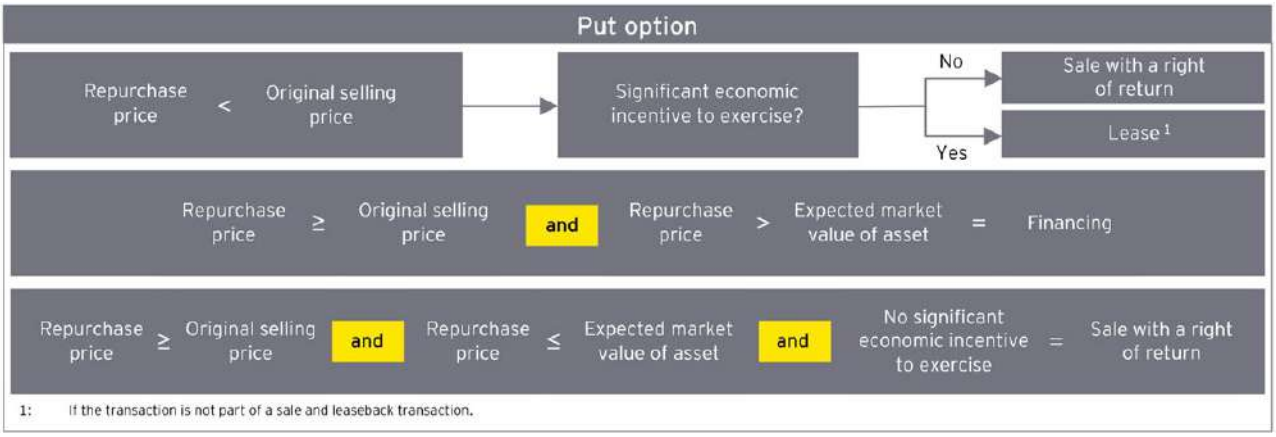
The repurchase price of an asset that is equal to or greater than the original selling price, but less than or equal to the expected market value of the asset, must also be accounted for as a sale of a product with a right of return, if the customer does not have a significant economic incentive to exercise its right. *[IFRS 15.B74]*. See section 5.4 above for a discussion on sales with a right of return.

If the customer has the ability to require an entity to repurchase the asset at a price equal to, or more than, the original selling price and the repurchase price is more than the expected market value of the asset, the contract is in effect a financing arrangement.

If the option lapses unexercised, an entity derecognises the liability and recognises revenue. *[IFRS 15.B76]*.

The following figure depicts this application guidance:

Figure 7-3: Put options held by the customer



1 If the transaction is not part of a sale and leaseback transaction.

The standard provides the following example of a put option: *[IFRS 15.IE Example 62 Case B, IFRS 15.IE315, IFRS 15.IE319-IE321]*

Extract from IFRS 15

Example 62-Repurchase agreements

An entity enters into a contract with a customer for the sale of a tangible asset on 1 January 20X7 for CU1 million.

...

Case B-Put option: lease

Instead of having a call option, the contract includes a put option that obliges the entity to repurchase the asset at the customer's request for CU900,000 on or before 31 December 20X7. The market value is expected to be CU750,000 on 31 December 20X7.

At the inception of the contract, the entity assesses whether the customer has a significant economic incentive to exercise the put option, to determine the accounting for the transfer of the asset (see paragraphs B70-B76 of IFRS 15). The entity concludes that the customer has a significant economic incentive to exercise the put option because the repurchase price significantly exceeds the expected market value of the asset at the date of repurchase. The entity determines there are no other relevant factors to consider when assessing whether the customer has a significant economic incentive to exercise the put option. Consequently, the entity concludes that control of the asset does not transfer to the customer, because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

In accordance with paragraphs B70-B71 of IFRS 15, the entity accounts for the transaction as a lease in accordance with IFRS 16 *Leases*.

7.3.3 Sales with residual value guarantees

An entity that sells equipment might use a sales incentive programme under which it guarantees that the customer will receive a minimum resale amount when it disposes of the equipment (i.e., a residual value guarantee). If the customer holds a put option and has a significant economic incentive to exercise, the customer is effectively restricted in its ability to consume, modify or sell the asset. In contrast, when the entity guarantees that the customer will receive a minimum amount of sales proceeds, the customer is not constrained in its ability to direct the use of, and obtain substantially all of the benefits from, the asset. Accordingly, the Board decided that it was not necessary to expand the application guidance on repurchase agreements to consider guaranteed amounts of resale. *[IFRS 15.BC427]*.

Therefore, it is important for an entity to review all its contracts and make sure that the residual value guarantee is not accomplished through a repurchase provision, such as a put within the contract (e.g., the customer has the right to require the entity to repurchase equipment two years after the date of purchase at 85% of the original purchase price). If a put option is present, the entity would have to use the application guidance in the standard discussed in section 7.3.2 above to determine whether the existence of the put option precludes the customer from obtaining control of the acquired item. In such circumstances, the entity would determine whether the customer has a significant economic incentive to exercise the put. If the entity concludes that there is no significant economic incentive, the transaction would be accounted for as a sale with a right of return. Alternatively, if the entity concludes there is a significant economic incentive for the customer to exercise its right, the transaction would be accounted for as a lease, unless the contract is part of a sale and leaseback transaction as noted in IFRS 15.B66 (see section 7.3.1 above).

However, assume the transaction includes a residual value guarantee in which no put option is present. If the entity guarantees that it will compensate the customer (or 'make whole') on a qualifying future sale if the customer receives less than 85% of the initial sale price, the application guidance on repurchase agreements in IFRS 15 would not apply. That is because the entity is not repurchasing the asset.

In such situations, judgement is needed to determine the appropriate accounting treatment, which will depend on the specific facts and circumstances. In some cases, an entity might need to consider the requirements of other IFRS accounting standards to appropriately account for the residual value guarantee. In other situations, IFRS 15 might apply to the entire transaction. If IFRS 15 applies, an entity would need to assess whether the guarantee affects control of the asset transferring, which will depend on the promise to the customer. In some cases, it might not affect the transfer of control. In the Basis for Conclusions, the Board noted that "when the entity guarantees that the customer will receive a minimum amount of sales proceeds, the customer is not constrained in its ability to direct the use of, and obtain substantially all of the benefits from, the asset." *[IFRS 15.BC431]*. However, while a residual value guarantee might not affect the transfer of control, an entity would need to consider whether it affects the transaction price (see section 5 above). While the economics of a repurchase agreement and a residual value guarantee might be similar, the accounting could be quite different.

7.4 Consignment arrangements

Entities frequently deliver inventory on a consignment basis to other parties (e.g., distributor, dealer). A consignment sale is one in which physical delivery of a product to a counterparty has occurred, but the counterparty is not required to pay until the product is either resold to an end-consumer or used by the counterparty. Under such arrangements, the seller (or consignor) retains the legal title to the merchandise and the counterparty (or consignee) acts as a selling agent. The consignee earns a commission on the products that have been sold and periodically remits the cash from those sales, net of the commission it has earned, to the consignor. In addition, consigned products that are not sold or used generally can be returned to the consignor. By shipping on a consignment basis, consignors are able to better market products by moving them closer to the end-consumer. However, they do so without selling the goods to the intermediary (consignee). *[IFRS 15.B77]*.

The standard provides the following application guidance for determining whether an arrangement is a consignment arrangement: *[IFRS 15.B78]*

Extract from IFRS 15

B78 Indicators that an arrangement is a consignment arrangement include, but are not limited to, the following:

(a) the product is controlled by the entity until a specified event occurs, such as the sale of the product to a customer of the dealer or until a specified period expires;

(b) the entity is able to require the return of the product or transfer the product to a third party (such as another dealer); and

(c) the dealer does not have an unconditional obligation to pay for the product (although it might be required to pay a deposit).

Entities entering into a consignment arrangement need to determine the nature of the performance obligation (i.e., whether the obligation is to transfer the product to the consignee or to transfer the product to the end-consumer). This determination would be based on whether control of the product passes to the consignee. Typically, a consignor does not relinquish control of the consigned product until the product is sold to the end-consumer or, in some cases, when a specified period expires. Consignees commonly do not have any obligation to pay for the product, other than to pay the consignor the agreed-upon portion of the sale price once the consignee sells the product to a third party. As a result, for consignment arrangements, revenue generally would not be recognised when the products are delivered to the consignee because control has not transferred (i.e., the performance obligation to deliver goods to the end-consumer has not yet been satisfied). *[IFRS 15.B77]*.

While some transactions are clearly identified as consignment arrangements, there are other less transparent transactions, in which the seller has retained control of the goods, despite no longer having physical possession. Such arrangements might include the shipment of products to distributors that are not required (either explicitly or implicitly), or do not have the wherewithal, to pay for the product until it is sold to the end-consumer.

Judgement is necessary in assessing whether the substance of a transaction is a consignment arrangement. The identification of such arrangements often requires a careful analysis of the facts and circumstances of the transaction, as well as an understanding of the rights and obligations of the parties and the seller's customary business practices in such arrangements. *[IFRS 15.B78]*. While not required by IFRS 15 or IAS 2, we would encourage entities to separately disclose the amount of their consigned inventory, if material.

7.5 Bill-and-hold arrangements

In some sales transactions, the selling entity fulfils its obligations and bills the customer for the work performed, but does not ship the goods until a later date. These transactions, often called bill-and-hold transactions, are usually designed this way at the request of the purchaser for a number of reasons, including a lack of storage capacity or an inability to use the goods until a later date. Whereas in a consignment sale (discussed in section 7.4 above), physical delivery has occurred, but control of the goods has not transferred to the customer, the opposite might be true in a bill-and-hold transaction.

The standard provides the following application guidance with respect to these arrangements: *[IFRS 15.B79, IFRS 15.B80, IFRS 15.B81, IFRS 15.B82]*

Extract from IFRS 15

Bill-and-hold arrangements

B79 A bill-and-hold arrangement is a contract under which an entity bills a customer for a product but the entity retains physical possession of the product until it is transferred to the customer at a point in time in the future. For example, a customer may request an entity to enter into such a contract because of the customer's lack of available space for the product or because of delays in the customer's production schedules.

B80 An entity shall determine when it has satisfied its performance obligation to transfer a product by evaluating when a customer obtains control of that product (see paragraph 38). For some contracts, control is transferred either when the product is delivered to the customer's site or when the product is shipped, depending on the terms of the contract (including delivery and shipping terms). However, for some contracts, a customer may obtain control of a product even though that product remains in an entity's physical possession. In that case, the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the product even though it has decided not to exercise its right to take physical possession of that product. Consequently, the entity does not control the product. Instead, the entity provides custodial services to the customer over the customer's asset.

B81 In addition to applying the requirements in paragraph 38, for a customer to have obtained control of a product in a bill-and-hold arrangement, all of the following criteria must be met:

(a) the reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement);

(b) the product must be identified separately as belonging to the customer;

(c) the product currently must be ready for physical transfer to the customer; and

(d) the entity cannot have the ability to use the product or to direct it to another customer.

B82 If an entity recognises revenue for the sale of a product on a bill-and-hold basis, the entity shall consider whether it has remaining performance obligations (for example, for custodial services) in accordance with paragraphs 22-30 to which the entity shall allocate a portion of the transaction price in accordance with paragraphs 73-86.

When evaluating whether revenue recognition is appropriate for a bill-and-hold transaction, an entity must evaluate the application guidance in both IFRS 15.38 (to determine whether control has been transferred to the customer - see section 7.2 above) and IFRS 15.B81 (to determine whether all four bill-and-hold criteria are met). That is, in addition to IFRS 15.38, the criteria that must be met for bill-and-hold transactions are:

- *The reason for the bill-and-hold arrangement must be substantive (e.g., the customer has requested the arrangement).* A bill-and-hold transaction initiated by the selling entity typically indicates that a bill-and-hold arrangement is not substantive. Generally, a customer requests such an arrangement and the selling entity would need to evaluate the reasons for the request to determine whether the customer has a substantive business purpose. Judgement is required when assessing this criterion. For example, a customer with an established buying history that places an order in excess of its normal volume and requests that the entity retains the product needs to be evaluated carefully because the request might not appear to have a substantive business purpose.
- *The product must be identified separately as belonging to the customer*. Even if the entity's inventory is homogenous, the customer's product must be segregated from the entity's ongoing fulfilment operations.
- *The product currently must be ready for physical transfer to the customer*. In any revenue transactions recognised at a point in time, revenue is recognised when an entity has satisfied its performance obligation to transfer control of the product to the customer. If an entity has remaining costs or effort to develop, manufacture or refine the product, the entity might not have satisfied its performance obligation. This criterion does not include the actual costs to deliver a product, which would be normal and customary in most revenue transactions, or if the entity identifies a separate performance obligation for custodial services, as discussed below.
- *The entity cannot have the ability to use the product or to direct it to another customer*. If the entity has the ability to freely substitute goods to fill other orders, control of the goods has not passed to the buyer. That is, the entity has retained the right to use the customer's product in a manner that best suits the entity.

If an entity concludes that it can recognise revenue for a bill-and-hold transaction, IFRS 15.B82 states that the entity needs to further consider whether it is also providing custodial services for the customer that would be identified as a separate performance obligation in the contract. Entities need to carefully evaluate their bill-and-hold arrangements and apply judgement to determine the performance obligations in the arrangements (e.g., products, custodial services) and assess when control transfers to the customer.

As discussed in Question 7-23 in section 7.2.5 above, certain entities might use Ex Works from Incoterms® 2020 in contracts with customers. Under an Ex Works arrangement, the entity's responsibility is to make ordered goods available to the customer at the entity's premises or another named location. The customer is responsible for arranging, and paying for, shipment of the goods to the desired location and bears all of the risks related to them once they are made available.

How we see it

We believe that all Ex Works arrangements need to be evaluated using the bill-and-hold criteria discussed above to determine whether revenue recognition is appropriate prior to shipment.

The standard provides the following example to illustrate the application guidance on bill-and-hold arrangements: *[IFRS 15.IE Example 63, IFRS 15.IE323-IE327]*

Extract from IFRS 15

Example 63-Bill-and-hold arrangement

An entity enters into a contract with a customer on 1 January 20X8 for the sale of a machine and spare parts. The manufacturing lead time for the machine and spare parts is two years.

Upon completion of manufacturing, the entity demonstrates that the machine and spare parts meet the agreed-upon specifications in the contract. The promises to transfer the machine and spare parts are distinct and result in two performance obligations that each will be satisfied at a point in time. On 31 December 20X9, the customer pays for the machine and spare parts, but only takes physical possession of the machine. Although the customer inspects and accepts the spare parts, the customer requests that the spare parts be stored at the entity's warehouse because of its close proximity to the customer's factory. The customer has legal title to the spare parts and the parts can be identified as belonging to the customer.

Furthermore, the entity stores the spare parts in a separate section of its warehouse and the parts are ready for immediate shipment at the customer's request. The entity expects to hold the spare parts for two to four years and the entity does not have the ability to use the spare parts or direct them to another customer.

The entity identifies the promise to provide custodial services as a performance obligation because it is a service provided to the customer and it is distinct from the machine and spare parts. Consequently, the entity accounts for three performance obligations in the contract (the promises to provide the machine, the spare parts and the custodial services). The transaction price is allocated to the three performance obligations and revenue is recognised when (or as) control transfers to the customer.

Control of the machine transfers to the customer on 31 December 20X9 when the customer takes physical possession. The entity assesses the indicators in paragraph 38 of IFRS 15 to determine the point in time at which control of the spare parts transfers to the customer, noting that the entity has received payment, the customer has legal title to the spare parts and the customer has inspected and accepted the spare parts. In addition, the entity concludes that all of the criteria in paragraph B81 of IFRS 15 are met, which is necessary for the entity to recognise revenue in a bill-and-hold arrangement. The entity recognises revenue for the spare parts on 31 December 20X9 when control transfers to the customer.

The performance obligation to provide custodial services is satisfied over time as the services are provided. The entity considers whether the payment terms include a significant financing component in accordance with paragraphs 60-65 of IFRS 15.

7.6 Recognising revenue for licences of intellectual property

IFRS 15 provides application guidance for recognising revenue from licences of intellectual property that differs in some respects from the general requirements for other promised goods or services. We discuss licensing in detail in section 8 below.

7.7 Recognising revenue when a right of return exists

As discussed in section 4.7 above, a right of return does not represent a separate performance obligation. Instead, the existence of a right of return affects the transaction price and the entity must determine whether the customer will return the transferred product.

Under IFRS 15, as discussed in section 5 above, an entity estimates the transaction price and applies the constraint to the estimated transaction price. In doing so, it considers the products expected to be returned in order to determine the amount to which the entity expects to be entitled (excluding consideration for the products expected to be returned). The entity recognises revenue based on the amounts to which the entity expects to be entitled through to the end of the return period (considering expected product returns). An entity does not recognise the portion of the revenue that is subject to the constraint until the amount is no longer constrained, which could be at the end of the return period or earlier if the entity's expectations about the products expected to be returned change prior to the end of the return period. The entity recognises the amount received or receivable that is expected to be returned as a refund liability, representing its obligation to return the customer's consideration. An entity also updates its estimates at the end of each reporting period. See sections 4.7 and 5.4 above for further discussion on this topic.

7.8 Recognising revenue for customer options for additional goods or services

As discussed in section 4.6 above, when an entity grants a customer the option to acquire additional goods or services, that option is a separate performance obligation if it provides a material right to the customer that the customer would not receive without entering into the contract (e.g., a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). If the option provides a material right to the customer, the customer has, in effect, paid the entity in advance for future goods or services. IFRS 15 requires the entity to allocate a portion of the transaction price to the material right at contract inception (see section 6.1.5 above). The revenue allocated to the material right is recognised when (or as) the option is exercised (and the underlying future goods or services are transferred) or when the option expires.

In contrast, if a customer option is not deemed to be a material right and is instead a marketing offer, the entity does not account for the option and waits to account for the underlying goods or services until those subsequent purchases occur.

Frequently asked questions

Question 7-25: How would an entity account for the exercise of a material right? That is, would an entity account for it as: a contract modification, a continuation of the existing contract or variable consideration?

(TRG meeting 30 March 2015 - Agenda paper no. 32)

See response to Question 4-27 in section 4.6 above.

7.9 Breakage and prepayments for future goods or services

In certain industries, an entity collects non-refundable payments from its customers for goods or services that the customer has a right to receive in the future. However, a customer might ultimately leave that right unexercised (often referred to as 'breakage'). *[IFRS 15.B45]*. Retailers, for example, frequently sell gift cards that might not be partially redeemed or completely redeemed and airlines sometimes sell non-refundable tickets to passengers who allow the tickets to expire unused.

Under IFRS 15.B44, when an entity receives consideration that is attributable to a customer's unexercised rights, the entity recognises a contract liability equal to the full amount prepaid by the customer for the performance obligation to transfer, or to stand ready to transfer, goods or services in the future. *[IFRS 15.B44]*. As discussed further below, an entity derecognises that contract liability (and recognises revenue) when it transfers those goods or services and, therefore, satisfies its performance obligation. The Board noted that this application guidance requires the same pattern of revenue recognition as the requirements for customer options (see section 6.1.5 above). *[IFRS 15.BC398]*.

However, since entities might not be required by customers to fully satisfy their performance obligations, IFRS 15.B46 requires that when an entity expects to be entitled to a breakage amount, the expected breakage would be recognised as revenue in proportion to the pattern of rights exercised by the customer. If an entity does not expect to be entitled to a breakage amount, it would not recognise any breakage amounts as revenue until the likelihood of the customer exercising its right becomes remote. *[IFRS 15.B46, IFRS 15.BC398]*.

When estimating any breakage amount, an entity has to consider the constraint on variable consideration, as discussed in section 5.2.3 above. *[IFRS 15.B46]*. That is, if it is highly probable that a significant revenue reversal would occur for any estimated breakage amounts, an entity would not recognise those amounts until the breakage amounts are no longer constrained.

Entities cannot recognise estimated breakage as revenue immediately upon receipt of prepayment from the customer. The Board noted that it rejected such an approach because the entity has not performed under the contract. That is, recognising revenue would not be a faithful depiction of the entity's performance and would understate its obligation to stand ready to provide future goods or services. *[IFRS 15.BC400]*. This would be the case even if an entity has historical evidence to support the view that no further performance will be required for some portion of the customer contract(s).

Furthermore, in accordance with IFRS 15.B47, regardless of whether an entity can demonstrate the ability to reliably estimate breakage, entities would not estimate or recognise any amounts attributable to a customer's unexercised rights in income (e.g., an unused gift card balance) if the amounts are required to be remitted to another party (e.g., the government). Such an amount is recognised as a liability (not as revenue). *[IFRS 15.B47]*. The liability would not be derecognised until the derecognition requirements in IFRS 9 are met, generally when cash is remitted to the other party.

Consider the following Illustration which shows how an entity would apply the above application guidance to the sale of a gift card that is within the scope of IFRS 15 (see Question 2-9 in section 2.5 above for further discussion):

Illustration 7-7: Accounting for the sale of a gift card

Entity A sells a CU500 non-refundable gift card that can be redeemed at any of its retail locations. Any unused balance is not subject to laws that require from the entity to remit the payment to another party. When the gift card is sold, Entity A recognises a contract liability of CU500 (i.e., the full amount that was prepaid by the customer). No breakage is recognised as revenue upon sale of the gift card.

Scenario A - Entity expects to be entitled to a breakage amount

Based on historical redemption rates, Entity A expects 90% of the gift card (or CU450) to be redeemed. That is, Entity A expects breakage of 10% (or CU50). Upon its first use, the customer redeems CU225 of the gift card. That is, 50% of the expected redemption has occurred (i.e., CU225 redemption ÷ CU450 total expected redemption). Upon this redemption, Entity A recognises revenue and reduces the contract liability by CU250. This is equal to CU225 for the transfer of goods or services purchased by the customer, as well as breakage of CU25 (50% redemption × CU50 breakage estimate) that is recognised in proportion to the exercise of the customer's rights. Similar accounting would occur for future redemptions.

Scenario B - Entity does not expect to be entitled to a breakage amount

Based on historical redemption experiences that customers fully redeem similar gift cards (or possibly the lack of historical experience due to a new gift card programme that means Entity A is unable to estimate the redemption rates), Entity A does not expect to be entitled to a breakage amount. Upon its first use of the gift card, the customer redeems CU225. Entity A recognises revenue and reduces the contract liability by the same amount as the redemption (or CU225). That is, no additional amounts are recognised for breakage. Similar accounting would occur for future redemptions.

If no further redemptions occur, Entity A recognises the remaining gift card balance (or CU275) as revenue (and reduces the contract liability by the same amount) when the likelihood of the customer exercising its remaining rights becomes remote.

As discussed above, the application guidance on breakage requires that an entity recognise a contract liability for the full amount of the prepayment. It would then recognise breakage on that contract liability proportionate to the pattern of rights exercised by the customer. If the prepayment element (e.g., the sale of a gift card, loyalty points) is part of a multiple-element arrangement, an entity needs to allocate the transaction price between the identified performance obligations. As a result, the deferred revenue associated with this element would be less than the 'prepaid' amount received for the unsatisfied performance obligations.

The following example depicts the sale of goods with loyalty points. In this example, the amount allocated to the points (i.e., the 'prepaid' element) is less than the stand-alone selling price of those points because of the allocation of the transaction price among the two performance obligations. *[IFRS 15.IE Example 52, IFRS 15.IE267-IE270]*.

Extract from IFRS 15

Example 52-Customer loyalty programme

An entity has a customer loyalty programme that rewards a customer with one customer loyalty point for every CU10 of purchases. Each point is redeemable for a CU1 discount on any future purchases of the entity's products. During a reporting period, customers purchase products for CU100,000 and earn 10,000 points that are redeemable for future purchases. The consideration is fixed and the stand-alone selling price of the purchased products is CU100,000. The entity expects 9,500 points to be redeemed. The entity estimates a stand-alone selling price of CU0.95 per point (totalling CU9,500) on the basis of the likelihood of redemption in accordance with paragraph B42 of IFRS 15.

The points provide a material right to customers that they would not receive without entering into a contract. Consequently, the entity concludes that the promise to provide points to the customer is a performance obligation. The entity allocates the transaction price (CU100,000) to the product and the points on a relative stand-alone selling price basis as follows:

	CU	
Product	91,324	[CU100,000 × (CU100,000 stand-alone selling price ÷ CU109,500)]
Points	8,676	[CU100,000 × (CU9,500 stand-alone selling price ÷ CU109,500)]

At the end of the first reporting period, 4,500 points have been redeemed and the entity continues to expect 9,500 points to be redeemed in total. The entity recognises revenue for the loyalty points of CU4,110 [(4,500 points ÷ 9,500 points) × CU8,676] and recognises a contract liability of CU4,566 (CU8,676- CU4,110) for the unredeemed points at the end of the first reporting period.

At the end of the second reporting period, 8,500 points have been redeemed cumulatively. The entity updates its estimate of the points that will be redeemed and now expects that 9,700 points will be redeemed. The entity recognises revenue for the loyalty points of CU3,493 {[(8,500 total points redeemed ÷ 9,700 total points expected to be redeemed) × CU8,676 initial allocation] - CU4,110 recognised in the first reporting period}. The contract liability balance is CU1,073 (CU8,676 initial allocation - CU7,603 of cumulative revenue recognised).

As depicted in Example 52 above (i.e., IFRS 15.IE269-IE270), entities need to routinely refine and evaluate estimates of breakage. An entity can elect to apply the portfolio approach practical expedient (see section 3.3.1 above) to estimate breakage. Similar to the discussion in Question 5-16 in section 5.4 above, an entity can consider evidence from similar contracts to develop an estimate without applying the portfolio approach practical expedient. That is, considering historical experience does not necessarily mean the entity is applying the portfolio approach practical expedient.

Frequently asked questions

Question 7-26: Are customers' unexercised rights (i.e., breakage) a form of variable consideration?

How we see it

Although the breakage application guidance in IFRS 15.B46 specifically refers to the constraint on variable consideration, we do not believe breakage is a form of variable consideration (see section 5.2 above).

This is because it does not affect the transaction price. Breakage is a recognition concept (Step 5) that could affect the timing of revenue recognition. It is not a measurement concept (Step 3). For example, the transaction price for a sale of a CU20 gift card is fixed at CU20 regardless of the expected breakage amount. The expected breakage, however, could affect the timing of revenue recognition because an entity is required under IFRS 15.B46 to "recognise the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer" if it expects to be entitled to a breakage amount. *[IFRS 15.B46]*.

Question 7-27: How would revenue be recognised for customer options for additional goods or services that represent a material right, but do not have an expiration date (i.e., can an entity recognise breakage for these options)?

See response to Question 4-29 in section 4.6 above.

8 IFRS 15 - Licences of intellectual property

IFRS 15 provides application guidance for recognising revenue from licences of intellectual property that differs in some respects from the requirements for other promised goods or services. Given that licences include a wide array of features and economic characteristics, the Board decided that an entity needs to evaluate the nature of its promise to grant a licence of intellectual property in order to determine whether the promise is satisfied (and revenue is recognised) over time or at a point in time. A licence provides either: *[IFRS 15.B56]*

- A right to access the entity's intellectual property throughout the licence period, which results in revenue that is recognised over time

  Or

- A right to use the entity's intellectual property as it exists at the point in time in which the licence is granted, which results in revenue that is recognised at a point in time

The standard states that licences of intellectual property establish a customer's rights to the intellectual property of an entity and may include licences for any of the following: software and technology, media and entertainment (e.g., motion pictures and music), franchises, patents, trademarks and copyrights. *[IFRS 15.B52]*.

The application guidance provided on licences of intellectual property is only applicable to licences that are distinct. When the licence is the only promised item (either explicitly or implicitly) in the contract, the application guidance is clearly applicable to that licence. The assessment as to whether the contract includes a distinct licence of intellectual property will be straightforward for many contracts. However, if there are multiple promises in a contract, entities might have to more carefully evaluate the nature of the rights conveyed.

Licences of intellectual property are frequently included in multiple-element arrangements with promises for additional goods or services that could be explicit or implicit. In these situations, an entity first applies the requirements of Step 2 of the model to determine whether the licence of intellectual property is distinct, as discussed in section 4 above and section 8.1 below.

For most licences that are not distinct, an entity would follow the general requirements in Step 5 of the model to account for the recognition of revenue for the performance obligation that includes the licence (i.e., the requirements in IFRS 15.31-38 to determine whether the performance obligation transfers over time or at a point in time, as discussed in sections 7.1 and 7.2 above). Furthermore, the IASB noted in the Basis for Conclusions that there may be some situations in which, even though the licence is not distinct from the good or service transferred with the licence, the licence is the primary or dominant component (i.e., the predominant item) of the combined performance obligation. *[IFRS 15.BC407]*. In such situations, the IASB indicated that the application guidance for licences still applies. The Board provided no application guidance or bright lines for determining when a licence is the primary or dominant component. However, the IASB referred to an example in the Basis for Conclusions to illustrate this concept further. *[IFRS 15.BC414X]*. See section 8.2.1 below for further discussion. The determination of whether a licence is the predominant component will be obvious in some cases, but not in others. Therefore, entities might need to exercise significant judgement and consider both qualitative and quantitative factors.

In 2020, the IFRS IC received a request regarding the customer's accounting for configuration and customisation costs in a cloud computing arrangement. The IFRS IC concluded that the principles and requirements in IFRS accounting standards provide sufficient guidance and, consequently, decided not to add this matter to its agenda. In situations where the customer does not recognise an intangible asset in relation to configuration or customisation of the application software, a customer needs to determine which goods or services must be accounted for separately. IAS 38 does not include guidance on identifying separate goods or services that the customer receives. Therefore, the IFRS IC noted that, in developing a policy in accordance with IAS 8, the customer might look to the requirements in IFRS 15 for guidance on identifying the promised goods or services in a contract with a customer.[127] See Chapter 18 at section 11.7.5.B for further discussion of the IFRS IC's agenda decision and considerations for customers when looking to IFRS 15 for guidance to account for such transactions.

127 *IFRIC Update*, March 2021, Addendum, available on the IFRS Foundation's website.

8.1 Identifying performance obligations in a licensing arrangement

Contracts for licences of intellectual property frequently include explicit or implicit promises for additional goods or services (e.g., equipment, when-and-if available upgrades, maintenance and installation). Consistent with Step 2 of the general model (see section 4 above), entities need to apply the requirements on identifying performance obligations in IFRS 15.22-30 when a contract with a customer includes a licence of intellectual property and other promised goods or services in order to appropriately determine whether the licence of intellectual property and the other promises are distinct (i.e., are separate performance obligations).

In respect of identifying performance obligations in a licensing arrangement, the standard states that "In addition to a promise to grant a licence (or licences) to a customer, an entity may also promise to transfer other goods or services to the customer. Those promises may be explicitly stated in the contract or implied by an entity's customary business practices, published policies or specific statements (see paragraph 24). As with other types of contracts, when a contract with a customer includes a promise to grant a licence (or licences) in addition to other promised goods or services, an entity applies paragraphs 22-30 to identify each of the performance obligations in the contract". *[IFRS 15.B53]*.

As discussed in section 4.2 above, the standard outlines a two-step process for determining whether a promised good or service (including a licence of intellectual property) is distinct and, therefore, is a performance obligation, as follows:

(a) Consideration of the individual good or service (i.e., whether the good or service is capable of being distinct)

And

(b) Consideration of whether the good or service is separately identifiable from other promises in the contract (i.e., whether the promise to transfer the good or service is distinct in the context of the contract)

To conclude that a good or service is distinct, an entity needs to determine that the good or service is both capable of being distinct and distinct in the context of the contract. These requirements need to be applied to determine whether a promise to grant a licence of intellectual property is distinct from other promised goods or services in the contract. Therefore, entities are required to assess whether the customer can benefit from a licence of intellectual property on its own or together with readily available resources (i.e., whether it is capable of being distinct) and whether the entity's promise to transfer a licence of intellectual property is separately identifiable from other promises in the contract (i.e., whether it is distinct in the context of the contract). The assessment of whether a licence of intellectual property is distinct needs to be based on the facts and circumstances of each contract.

8.1.1 Licences of intellectual property that are distinct

Licences are frequently capable of being distinct (i.e., the first criteria of a distinct good or service) as a customer can often obtain at least some benefit from the licence of intellectual property on its own or with other readily available resources. Consider Example 11, Case A, from the standard (extracted in full in section 4.2.3 above), which includes a contract for a software licence that is transferred along with installation services, technical support and unspecified software updates. The installation service is routinely performed by other entities and does not significantly modify the software. The software licence is delivered before the other goods or services and remains functional without the updates and technical support. The entity concludes that the customer can benefit from each of the goods or services either on their own or together with other goods or services that are readily available. That is, each good or service, including the software licence, is capable of being distinct under IFRS 15.27. *[IFRS 15.IE Example 11 Case A, IFRS 15.IE49-IE53]*.

If an entity determines that a licence of intellectual property and other promised goods or services are capable of being distinct, the second step in the evaluation is to determine whether they are distinct in the context of the contract. As part of this evaluation, an entity considers the indicators for whether the goods or services are not separately identifiable, including whether:

(a) The entity provides a significant service of integrating the licence and other goods or services into a combined output or outputs

(b) The licence and other goods or services significantly modify or customise each other

Or

(c) The licence and other goods or services are highly interdependent or highly interrelated, such that the entity would not be able to fulfil its promise to transfer the licence independently of fulfilling its promise to transfer the other goods or services to the customer

Continuing with Example 11, Case A, which is discussed above, the entity considers the separately identifiable principle and factors in IFRS 15.29 and determines that the promise to transfer each good and service, including the software licence, is separately identifiable. In reaching this determination, the entity considers that the installation services are routine and can be obtained from other providers. In addition, the entity considers that, although it integrates the software into the customer's system, the software updates do not significantly affect the customer's ability to use and benefit from the software licence during the licence period. Therefore, neither the installation services nor the software updates significantly affect the customer's ability to use and benefit from the software licence. The entity further observes that none of the promised goods or services significantly modify or customise one another and the entity is not providing a significant service of integrating the software and services into one combined output. Lastly, the software and the services are not deemed to be highly interdependent or highly interrelated because the entity would be able to fulfil its promise to transfer the initial software licence independent from its promise to subsequently provide the installation service, software updates and the technical support. *[IFRS 15.IE Example 11 Case A, IFRS 15.IE49-IE53]*.

The following example from the standard also illustrates a contract for which a licence of intellectual property is determined to be distinct from other promised goods or services: *[IFRS 15.IE Example 56 Case B, IFRS 15.IE281, IFRS 15.IE285-IE288]*

Extract from IFRS 15

Example 56-Identifying a distinct licence

An entity, a pharmaceutical company, licenses to a customer its patent rights to an approved drug compound for 10 years and also promises to manufacture the drug for the customer. The drug is a mature product; therefore the entity will not undertake any activities to support the drug, which is consistent with its customary business practices.

Case B-Licence is distinct

In this case, the manufacturing process used to produce the drug is not unique or specialised and several other entities can also manufacture the drug for the customer.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct, and it concludes that the criteria in paragraph 27 of IFRS 15 are met for each of the licence and the manufacturing service. The entity concludes that the criterion in paragraph 27(a) of IFRS 15 is met because the customer can benefit from the licence together with readily available resources other than the entity's manufacturing service (because there are other entities that can provide the manufacturing service), and can benefit from the manufacturing service together with the licence transferred to the customer at the start of the contract.

The entity also concludes that its promises to grant the licence and to provide the manufacturing service are separately identifiable (ie the criterion in paragraph 27(b) of IFRS 15 is met). The entity concludes that the licence and the manufacturing service are not inputs to a combined item in this contract on the basis of the principle and the factors in paragraph 29 of IFRS 15. In reaching this conclusion, the entity considers that the customer could separately purchase the licence without significantly affecting its ability to benefit from the licence. Neither the licence, nor the manufacturing service, is significantly modified or customised by the other and the entity is not providing a significant service of integrating those items into a combined output. The entity further considers that the licence and the manufacturing service are not highly interdependent or highly interrelated because the entity would be able to fulfil its promise to transfer the licence independently of fulfilling its promise to subsequently manufacture the drug for the customer. Similarly, the entity would be able to manufacture the drug for the customer even if the customer had previously obtained the licence and initially utilised a different manufacturer. Thus, although the manufacturing service necessarily depends on the licence in this contract (ie the entity would not provide the manufacturing service without the customer having obtained the licence), the licence and the manufacturing service do not significantly affect each other. Consequently, the entity concludes that its promises to grant the licence and to provide the manufacturing service are distinct and that there are two performance obligations:

(a) licence of patent rights; and

(b) manufacturing service.

The entity assesses, in accordance with paragraph B58 of IFRS 15, the nature of the entity's promise to grant the licence. The drug is a mature product (ie it has been approved, is currently being manufactured and has been sold commercially for the last several years). For these types of mature products, the entity's customary business practices are not to undertake any activities to support the drug. The drug compound has significant stand-alone functionality (ie its ability to produce a drug that treats a disease or condition). Consequently, the customer obtains a substantial portion of the benefits of the drug compound from that functionality, rather than from the entity's ongoing activities. The entity concludes that the criteria in paragraph B58 of IFRS 15 are not met because the contract does not require, and the customer does not reasonably expect, the entity to undertake activities that significantly affect the intellectual property to which the customer has rights. In its assessment of the criteria in paragraph B58 of IFRS 15, the entity does not take into consideration the separate performance obligation of promising to provide a manufacturing service. Consequently, the nature of the entity's promise in transferring the licence is to provide a right to use the entity's intellectual property in the form and the functionality with which it exists at the point in time that it is granted to the customer. Consequently, the entity accounts for the licence as a performance obligation satisfied at a point in time.

The entity applies paragraphs 31-38 of IFRS 15 to determine whether the manufacturing service is a performance obligation satisfied at a point in time or over time.

8.1.2 Licences of intellectual property that are not distinct

The licences of intellectual property included in the examples in section 8.1.1 above were determined to be distinct because they met the two criteria of IFRS 15.27. In other situations, a licence of intellectual property might not be distinct from other promised goods or services in a contract, either because it is not capable of being distinct and/or it is not separately identifiable.

IFRS 15.B54 requires that a licence that is not distinct from other promised goods or services in a contract be combined into a single performance obligation. It also identifies two examples of licences of intellectual property that are not distinct from other goods or services, as follows: *[IFRS 15.B54]*

- A licence that is a component of, and integral to the functionality of, a tangible good
- A licence that the customer can benefit from, but only in conjunction with a related service (e.g., as a result of the entity granting a licence, the customer has access to an online service provided by the entity)

In both examples, a customer only benefits from the combined output of the licence of intellectual property and the related good or service. Therefore, the licence is not distinct and would be combined with those other promised goods or services in the contract.

The standard includes other examples of licences of intellectual property that are not distinct, which are combined with other promised goods or services because the customer can only benefit from the licence in conjunction with a related service (as described in IFRS 15.B54(b)). For example, Example 55 and Example 56, Case A (the latter extracted in full in section 8.2.1 below) illustrate contracts that include licences of intellectual property that are not distinct from other goods or services promised to the customer. *[IFRS 15.IE Example 55, IFRS 15.IE278 -IE280, IFRS 15.IE Example 56 Case A, IFRS 15.IE281-IE284]*.

When an entity is required to bundle a licence of intellectual property with other promised goods or services in a contract, it often needs to consider the licensing application guidance to help determine the nature of its promise to the customer when the licence is the predominant item in the combined performance obligation. See section 8.2.1 below for further discussion on applying the licensing application guidance to such performance obligations.

8.1.3 Contractual restrictions

Some licences contain substantive contractual restrictions on how the customer can employ a licence. The standard explicitly states that restrictions of time, geography or use do not affect the licensor's determination of whether the promise to transfer a licence is satisfied over time or at a point in time, as follows: *[IFRS 15.B62(a)]*

Extract from IFRS 15

B62 An entity shall disregard the following factors when determining whether a licence provides a right to access the entity's intellectual property or a right to use the entity's intellectual property:

(a) Restrictions of time, geographical region or use-those restrictions define the attributes of the promised licence, rather than define whether the entity satisfies its performance obligation at a point in time or over time.

(b) ...

While stakeholders acknowledged that IFRS 15.B62 is clear that restrictions of time, geographical region or use do not affect the licensor's determination about whether the promise to transfer a licence is satisfied over time or at a point in time, some stakeholders thought that the standard was unclear about whether particular types of contractual restrictions would affect the identification of the promised goods or services in the contract. For example, an arrangement might grant a customer a licence to a well-known television programme or movie for a period of time (e.g., three years), but the customer might be restricted in how often it can show that licensed content to only once per year during each of those three years. In this instance, stakeholders thought that it was unclear whether contractual restrictions affect the entity's identification of its promises in the contract (i.e., do the airing restrictions affect whether the entity has granted one licence or three licences?). *[IFRS 15.BC414O]*.

In considering this issue further, the IASB explained that contracts that include a promise to grant a licence to a customer require an assessment of the promises in the contract using the criteria for identifying performance obligations, as is the case with other contracts. *[IFRS 15.BC405, IFRS 15.BC406]*. This assessment is done before applying the criteria to determine the nature of an entity's promise in granting a licence. *[IFRS 15.BC414P]*.

In the Basis for Conclusions, the IASB further explained that they considered Example 59 in the standard (see extract in section 8.3.2 below) in the context of this issue. The entity concludes that its only performance obligation is to grant the customer a right to use the music recording. *[IFRS 15.IE Example 59, IFRS 15.IE303-IE306]*. When, where and how the right can be used is defined by the attributes of time (i.e., two years), geographical scope (i.e., Country A) and permitted use (i.e., in commercials). If, instead, the entity had granted the customer rights to use the recording for two different time periods in two geographical locations, for example, years X1-X3 in Country A and years X2-X4 in Country B, the entity would need to use the criteria for identifying performance obligations in IFRS 15.27-30 to determine whether the contract included one licence that covers both countries or separate licences for each country. *[IFRS 15.BC414Q]*.

Consequently, the entity considers all of the contractual terms to determine whether the promised rights result in the transfer to the customer of one or more licences. In making this determination, judgement is needed to distinguish between contractual provisions that create promises to transfer rights to use the entity's intellectual property from contractual provisions that establish when, where and how those rights may be used. Therefore, in the Board's view, the clarifications made to the requirements on identifying performance obligations in IFRS 15.22-30 provide sufficient guidance to entities. *[IFRS 15.BC414P]*.

How we see it

We believe a critical part of the evaluation of contractual restrictions is whether the lifting of a restriction at a future date requires an entity to *grant additional rights* to the customer at that future date in order to fulfil its promises under the contract. The presence of a requirement to grant additional rights to the customer indicates that there could be multiple performance obligations that need to be accounted for under Step 2 of the model.

Entities might need to use significant judgement to distinguish between a single promised licence with multiple attributes and a licence that contains multiple promises to the customer that could be separate performance obligations.

FASB differences

ASC 606 requires that entities distinguish between contractual provisions that define the attributes of a single promised licence (e.g., restrictions of time, geography or use) and contractual provisions that require them to transfer additional goods or services to customers (e.g., additional rights to use or access intellectual property). Contractual provisions that are attributes of a promised licence define the scope of a customer's rights to intellectual property and do not affect whether a performance obligation is satisfied at a point in time or over time. Nor do they affect the number of performance obligations in the contract. IFRS 15 does not include similar requirements. *[IFRS 15.BC414P]*.

8.1.4 Guarantees to defend or maintain a patent

IFRS 15 states that a guarantee to defend or maintain a patent does not represent a performance obligation in a licensing contract. Furthermore, this type of guarantee does not affect the licensor's determination as to whether the licence provides a right to access intellectual property (satisfied over time) or a right to use intellectual property (satisfied at a point in time).

The requirements for guarantees to defend or maintain a patent are included in the following extract from the standard: *[IFRS 15.B62(b)]*

Extract from IFRS 15

B62 An entity shall disregard the following factors when determining whether a licence provides a right to access the entity's intellectual property or a right to use the entity's intellectual property:

(a) ...

(b) Guarantees provided by the entity that it has a valid patent to intellectual property and that it will defend that patent from unauthorised use - a promise to defend a patent right is not a performance obligation because the act of defending a patent protects the value of the entity's intellectual property assets and provides assurance to the customer that the licence transferred meets the specifications of the licence promised in the contract.

It is not unusual for intellectual property arrangements to include a clause that requires a licensor to defend and maintain related patents. While patent defence and maintenance is a continuing obligation, it is an obligation to ensure the licensee can continue to use the intellectual property as intended, and, as discussed above, is not a promised good or service under IFRS 15 that has to be evaluated under Step 2. However, if there are questions regarding the validity of a patent at the time a licence arrangement is entered into, licensors need to consider whether that component of the arrangement meets the attributes to be considered a contract within the scope of the model (see section 3.1 above).

Furthermore, as discussed above, because such a provision is to ensure that the licensee can continue to use the intellectual property as intended, it is similar to an assurance-type warranty discussed in section 9.1 below (i.e., a warranty that promises the customer that the delivered product is as specified in the contract). Assurance-type warranties are not within the scope of IFRS 15 and, as stated in IFRS 15.B30, would be accounted for in accordance with the requirements for product warranties in IAS 37.

Frequently asked questions

Question 8-1: How do entities account for modifications and other changes to licences of intellectual property?

A licence provides a customer with a right to use or a right to access the intellectual property of an entity. The terms of each licence of intellectual property are defined by the contract, which establishes the customer's rights (e.g., period of time, area of use). Parties to a licensing arrangement might agree to renew (or extend) the terms and conditions of an existing licence (refer to section 8.4 below for further discussion on the accounting for licence renewals).

However, parties to a licensing arrangement might agree to extend the licence term, but the extension is not solely a renewal of the terms and conditions of a licence (i.e., the parties could add goods or services, change the pricing, or do both). The standard does not explicitly address the accounting for these types of licence changes.

How we see it

The following are two approaches that entities have applied in practice that we believe would be acceptable. The approaches described below assume a right-to-use licence. Approach A is based on the use and benefit requirement in IFRS 15.B61 (discussed in section 8.3.3 below) and approach B is based on the contract modification requirements in IFRS 15.18-21 (discussed in section 3.4 above).[128]

While we believe both approaches are acceptable, an entity must make a policy choice to select one approach and apply it consistently to similar transactions. We believe other approaches could also be acceptable, depending on the facts and circumstances.

128 These approaches are consistent with the alternatives described in the FASB staff's memo, *Issue Summary No. 1*, when the FASB's Emerging Issues Task Force (EITF) considered the accounting for contract modifications of licenses of intellectual property. For further details about these alternatives, refer to *Issue 1: Accounting for contract modifications under which the contract term for existing rights is extended, while also adding rights* in the staff's memo, available on the FASB's website. The FASB will consider this issue as part of the post-implementation review process of ASC 606.

Approach A

New rights granted in a licensing arrangement (i.e., an extension for existing rights and the granting of additional rights) do not constitute a contract modification but, instead, create a new contract. Under this approach, because the performance related to the existing right-to-use licence was completed at the beginning of the original licence period (when the customer was able to use and benefit from the licence), any changes to the terms or pricing (or both) of the licence cannot modify or revoke the existing licence.

Instead, new rights granted in the licensing arrangement would be accounted for using the licensing application guidance (i.e., the use and benefit requirement in IFRS 15.B61 that is discussed in section 8.3.3 below). As a result, revenue related to the renewal or extension of the existing licence would be recognised when (or as) that performance obligation is satisfied, which might not be until the beginning of the renewal or extension period (see section 8.4 below) or some other date.

Approach B

The contract modification requirements in IFRS 15.18-21 (discussed in section 3.4 above) are applied to the licence extension. Under this approach, the accounting for the renewed licence follows the form of the contract modification.

How we see it

We believe that when a contract that only includes a licence of intellectual property is modified, the additional and/or modified licence of intellectual property is distinct from the existing licence because the new and/or modified rights will always differ from those conveyed by the existing licence.

The standard contains requirements on accounting for contract modification and it requires that a modification in which the additional promised goods or services are distinct be accounted for on a prospective basis, as follows:

- The modification is accounted for as a separate contract if the additional consideration from the modification reflects the new licence's stand-alone selling price in accordance with IFRS 15.20(b). *[IFRS 15.20(b)]*.
- If the additional consideration does not reflect the stand-alone selling price of the new licence, the modification is accounted for in accordance with IFRS 15.21(a). *[IFRS 15.21(a)]*.

If the modification is determined to be a separate contract in accordance with IFRS 15.20(b), the existing contract is not considered terminated. As a result, any revenue allocated to a performance obligation created at the modification date for the renewal or extension of a licence would be recognised when (or as) that performance obligation is satisfied, which might not occur until the beginning of the renewal or extension period (consistent with Approach A above).

If the modification is determined to be a termination of the existing contract and the creation of a new contract in accordance with IFRS 15.21(a), any revenue recognised to date under the original contract would not be adjusted. At the date of the modification, the remaining unrecognised transaction price from the existing contract (if any) and the additional transaction price from the new contract are allocated to the remaining performance obligation(s) in the new contract. Any revenue allocated to a performance obligation created at the modification date for the renewal or extension of a licence would be recognised when (or as) that performance obligation is satisfied, which might occur as early as the modification date (if the customer can use and benefit from the licences) because the existing contract (including the existing licence) would be considered terminated.

Example

The following Illustration shows the application of each of the approaches discussed above:

Illustration 8-1: Additional rights under a right-to-use licence granted to a licensee

Entity A enters into a contract on 1 January 20X0 with Customer B to transfer a right-to-use licence of software. The licence provides 100 seats (i.e., a right-to-use licence for 100 users to access the software) of Product C for a two-year term for CU200,000. The consideration is paid annually in two equal instalments (i.e., CU100,000 is due 30 January 20X0 and the remaining CU100,000 is due on 30 January 20X1). The price reflects the stand-alone selling price of Product C.

On 1 January 20X1, Entity A and Customer B agree to add more seats to the licence. The existing licence is terminated, and the customer is granted a new licence for 150 seats for a two-year term for CU276,000, which represents the second CU100,000 payment from the original contract plus an additional CU176,000. That is, Customer B receives an 8% discount per seat on the original price because of the added volume.

Entity A determines that the additional seats are distinct from the existing seats and the additional seats are not priced at their stand-alone selling prices because the price has decreased by 8%.

Since it is a right-to-use licence under IFRS 15, Entity A needs to evaluate when Customer B can use and benefit from the new software licence because that determines the point before which control cannot transfer (and Entity A cannot recognise revenue) related to the new software licence. Entity A also needs to evaluate ongoing services, such as post-contract customer support, which could change the allocation of consideration to the performance obligations and, therefore, the timing of revenue recognition.

To illustrate the different approaches that would be acceptable, the analysis below focuses only on the creation of the new licence itself:

Approach A

Entity A determines that the new licence is: (1) the addition of 50 new seats for a two-year term (from 1 January 20X1 through to 31 December 20X2); (2) a one-year renewal of the original 100 seats (from 1 January 20X2 through to 31 December 20X2); and (3) an 8% reduction from the original price for each of the 100 original seats for the second year (from 1 January 20X1 through to 31 December 20X1).

Entity A allocates the additional consideration of CU176,000 between the 50 new seats and the renewal of the original 100 seats. The consideration allocated to the new seats is recognised on 1 January 20X1, which is the date when Customer B can use and benefit from the new seats (and assuming control has transferred at the beginning of licence period). Entity A would then need to determine when it has satisfied its performance obligation for the renewal (which cannot be before Customer B can use and benefit from the renewed licence) to determine when to recognise the consideration allocated to the renewal. Entity A might, for example, determine that this is at the time of the new licence is granted (1 January 20X1), not before the beginning of the licence renewal period (1 January 20X2) or some other date.

Approach B

Entity A determines that a contract modification has occurred in accordance with IFRS 15.21(a), whereby a new licence for 150 seats for a two-year term has been granted and the original licence has been terminated as at 1 January 20X1 when the additional, distinct seats were added to the contract. Entity A concludes that Customer B can use the software and benefit from the modified licence immediately because the customer is not renewing a licence with the same terms and conditions as the original contract due to the addition of 50 new seats and change in pricing. It also determines control has transferred to Customer B at the same date. As a result, Entity A recognises the entire CU176,000 on 1 January 20X1.

Question 8-2: How do entities account for an option to revoke licensing rights?

Certain licensing arrangements include, either at inception or as a result of a modification, an option that allows the customer to revoke licensing rights in the future. For example, a contract for an on-premise software licence might include an option that allows the customer to migrate the on-premise software to a SaaS arrangement (i.e., the on-premise licence is revoked).

The standard does not provide guidance on how to account for an option that allows a customer to revoke rights to a licence of intellectual property. We believe there are two alternatives, if the option is determined not to be a material right, that entities could apply to account for the option:[129]

- We believe it would be acceptable for an entity to account for the option as a right of return (refer to section 4.7 above for further details about the accounting for rights of return).
- We believe it also would be acceptable for an entity to account for the conversion prospectively when it occurs applying the contract modification requirements (refer to section 3.4 above for further details about the accounting for contract modifications).

However, if the option is determined to be a material right, refer to section 4.6 above for further details about the accounting for material rights.

How we see it

We believe entities must select one of the two alternatives above to account for the revocation of a licence and apply it consistently to similar transactions.

129 These alternatives are consistent with the alternatives described in the FASB staff's memo, *Issue Summary No. 1*, when the EITF considered this issue. For further details about these alternatives, refer to *Issue 2: Accounting for the revocation of licensing rights (including conversion of term software licences to SaaS arrangements)* in the staff's memo, available on the FASB's website. The FASB will consider the issue as part of the post-implementation review process of ASC 606.

Question 8-3: How does an entity account for contracts that grant both permission for past use of intellectual property and a licence to use the intellectual property in the future?

An entity might enter into a contract with a customer that grants the right to use intellectual property and the customer also agrees to pay consideration for past use of that intellectual property. Such an agreement could be partially a settlement for the use of the intellectual property in the past without the entity's permission.

In such circumstances, it would require judgement to determine what aspects of the contract are within the scope of IFRS 15. This would include consideration of whether, and to what extent, the counterparty is acting as a customer as defined in the standard (see section 2.3 above).

If the contract is only partially within the scope of IFRS 15, an entity would need to use judgement when applying the requirements in IFRS 15.7 (see section 2.5 above) to separate the consideration between the revenue in exchange for the licence, any amount received for the past use and any other components. *[IFRS 15.7]*.

If, or to the extent, the contract is outside the scope of IFRS 15, an entity considers whether the income is arising in the course of the entity's ordinary activities in order to determine whether presentation as (other) revenue is appropriate (see Question 10-7 in section 10.2 below).

Question 8-4: Does a licence to a content library include more than one performance obligation?

Whether a contract that includes the transfer of one or more licences of intellectual property to a content library includes more than one performance obligation depends on facts and circumstances, and requires an entity to apply significant judgement. For example, an entity might enter into a licensing arrangement that provides the customer with a right to use all of the entity's existing content at contract inception, together with a right to use unspecified future updates to the content library (e.g., a licence for a film producer's completed titles and any titles produced in the future, a licence for an existing music library and any songs added or removed in the future). Typically, the contractual licence fee is not adjusted if the licensor does not obtain or create new content to provide to the licensee over the term of the contract.

In these arrangements, the licensor needs to evaluate the promised goods or services in the contract to determine the number of performance obligations (e.g., whether the licence for the existing content library provided at inception of the arrangement is distinct from other promises in the contract, including the obligation to provide updates to the content library on a when-and-if-available basis). That is, entities need to consider whether each individual good or service is both capable of being distinct and distinct in the context of the contract.

The licence for the existing content library is considered distinct from the other promised goods or services in the contract if it is separately identifiable from them. That might be the case if the licensor does not provide a significant service of integrating the existing content library with other promised goods or services in the contract (e.g., unspecified future updates to the content library), the promise goods or services do not significantly modify or customise each other, or the existing content library is not highly interdependent or interrelated with the other promised goods or services.

In many cases, a licensing arrangement that provides the customer with a right to use all of the entity's existing content at contract inception, together with a right to use unspecified future updates to the content library will generally be both capable of being distinct and distinct within the context of the contract (i.e., separately identifiable). Therefore, these promises are generally two separate performance obligations.

When an entity determines that there is more than one performance obligation (e.g., one for the licence to the content library provided at the inception of the arrangement, and another for the obligation to provide updates to the content library in the future, when and if available), the licensor will need to allocate the transaction price to the separate performance obligations on a relative stand-alone selling price basis.[130]

130 Licences of content library arrangements are typically provided in exchange for fixed consideration and/or variable consideration in the form of a sales-based or usage-based royalty. This paragraph assumes the transaction price does not include any other form of variable consideration that could be subject to the variable consideration allocation exception in IFRS 15.84.

8.2 Determining the nature of the entity's promise in granting a licence

Entities need to evaluate the nature of a promise to grant a licence of intellectual property in order to determine whether the promise is satisfied (and revenue is recognised) over time or at a point in time.

In order to help entities in determining whether a licence provides a customer with a right to access or a right to use the intellectual property (which is important when determining the period of performance and, therefore, the timing of revenue recognition - see section 8.3 below), the Board provided the following application guidance: *[IFRS 15.B58, IFRS 15.B59, IFRS 15.B59A]*

Extract from IFRS 15

B58 The nature of an entity's promise in granting a licence is a promise to provide a right to access the entity's intellectual property if all of the following criteria are met:

(a) the contract requires, or the customer reasonably expects, that the entity will undertake activities that significantly affect the intellectual property to which the customer has rights (see paragraphs B59 and B59A);

(b) the rights granted by the licence directly expose the customer to any positive or negative effects of the entity's activities identified in paragraph B58(a); and

(c) those activities do not result in the transfer of a good or a service to the customer as those activities occur (see paragraph 25).

B59 Factors that may indicate that a customer could reasonably expect that an entity will undertake activities that significantly affect the intellectual property include the entity's customary business practices, published policies or specific statements. Although not determinative, the existence of a shared economic interest (for example, a sales-based royalty) between the entity and the customer related to the intellectual property to which the customer has rights may also indicate that the customer could reasonably expect that the entity will undertake such activities.

B59A An entity's activities significantly affect the intellectual property to which the customer has rights when either:

(a) those activities are expected to significantly change the form (for example, the design or content) or the functionality (for example, the ability to perform a function or task) of the intellectual property; or

(b) the ability of the customer to obtain benefit from the intellectual property is substantially derived from, or dependent upon, those activities. For example, the benefit from a brand is often derived from, or dependent upon, the entity's ongoing activities that support or maintain the value of the intellectual property.

Accordingly, if the intellectual property to which the customer has rights has significant stand-alone functionality, a substantial portion of the benefit of that intellectual property is derived from that functionality. Consequently, the ability of the customer to obtain benefit from that intellectual property would not be significantly affected by the entity's activities unless those activities significantly change its form or functionality. Types of intellectual property that often have significant stand-alone functionality include software, biological compounds or drug formulas, and completed media content (for example, films, television shows and music recordings).

In providing this application guidance, the Board decided to focus on the characteristics of a licence that provides a right to access the entity's intellectual property. If the licensed intellectual property does not have those characteristics, it provides a right to use the entity's intellectual property, by default. This analysis is focused on situations in which the underlying intellectual property is subject to change over the licence period.

The key determinants of whether the nature of an entity's promise is a right to access the entity's intellectual property are whether: (1) the entity is required to undertake activities that affect the licensed intellectual property (or the customer has a reasonable expectation that the entity will do so); and (2) the customer is exposed to positive or negative effects resulting from those changes.

It is important to note that when an entity is making this assessment, it excludes the effect of any other performance obligations in the contract. For example, if an entity enters into a contract to licence software and provide access to any future upgrades to that software during the licence period, the entity first determines whether the licence and the promise to provide future updates are separate performance obligations. If they are separate, when the entity considers whether it has a contractual (explicit or implicit) obligation to undertake activities to change the software during the licence period, it excludes any changes and activities associated with the performance obligation to provide future upgrades.

While the activities considered in this assessment do not include those that are a performance obligation, these activities can be part of an entity's ongoing ordinary activities and customary business practices (i.e., they do not have to be activities the entity is undertaking specifically as a result of the contract with the customer). In addition, the IASB noted in the Basis for Conclusions that the existence of a shared economic interest between the parties (e.g., sales-based or usage-based royalties) could be an indicator that the customer has a reasonable expectation that the entity will undertake such activities. *[IFRS 15.BC413]*.

After an entity has identified the activities for this assessment, it must determine if those activities significantly affect the intellectual property to which the customer has rights. The standard clarifies that such activities significantly affect the intellectual property if they: *[IFRS 15.B59A]*

- Significantly change the form (e.g., design or content) or functionality (e.g., the ability to perform a function or task) of the intellectual property

  Or

- Affect the ability of the customer to obtain benefit from the intellectual property (e.g., the benefit from a brand is often derived from, or dependent upon, the entity's ongoing activities that support or maintain the value of the intellectual property)

If the intellectual property has significant stand-alone functionality, the standard clarifies that the customer derives a substantial portion of the benefit of that intellectual property from that functionality. As such, "the ability of the customer to obtain benefit from that intellectual property would not be significantly affected by the entity's activities unless those activities significantly change its form or functionality." Therefore, if the intellectual property has significant stand-alone functionality, revenue is recognised at a point in time. Examples of types of intellectual property that often have significant stand-alone functionality that are mentioned in the standard include software, biological compounds or drug formulas, and completed media content. *[IFRS 15.B59A]*.

The IASB has not defined the term 'significant stand-alone functionality', but has made clarifications to the examples in the standard to illustrate when the intellectual property to which the customer has rights might have significant stand-alone functionality. In some cases, it will be clear when intellectual property has significant stand-alone functionality. If there is no significant stand-alone functionality, the benefit to the customer might be substantially derived from the value of the intellectual property and the entity's activities to support or maintain that value. The IASB noted, however, that an entity may need to apply judgement to determine whether the intellectual property to which the customer has rights has significant stand-alone functionality. *[IFRS 15.BC414I]*.

How we see it

It is important for entities that provide licences of intellectual property to their customers to appropriately identify the performance obligations as part of Step 2 of the model because those conclusions will directly affect their evaluation of whether the entity's activities significantly change the form or functionality of the intellectual property or affect the ability of the customer to obtain benefit from the intellectual property.

FASB differences

Unlike IFRS 15, ASC 606 requires entities to classify intellectual property in one of two categories to determine the nature of the entity's promise in granting a licence:

(a) Functional: This intellectual property has significant stand-alone functionality (e.g., many types of software, completed media content such as films, television shows and music). Revenue for these licences is generally recognised at a point in time.

(b) Symbolic: This intellectual property does not have significant stand-alone functionality (e.g., brands, team and trade names, character images). Revenue from these licences is recognised over time.

The IASB and FASB agreed that their approaches will generally result in consistent answers, but the Boards acknowledged that different outcomes may arise due to the different approaches when entities licence brand names that no longer have any related ongoing activities (e.g., the licence to the brand name of a defunct sports team, such as the Brooklyn Dodgers). *[IFRS 15.BC414K, IFRS 15.BC414N]*.

8.2.1 Applying the licensing application guidance to a single (bundled) performance obligation that includes a licence of intellectual property

If a licence is not distinct, entities are required to follow the requirements in IFRS 15.31-38 to determine whether the performance obligation is satisfied over time or at a point in time (i.e., the general requirements in Step 5 of the model, as discussed in sections 7.1 and 7.2 above). *[IFRS 15.B55]*.

IFRS 15 does not explicitly state that an entity needs to consider the nature of its promise in granting a licence when applying the general revenue recognition model to performance obligations that are comprised of both a licence (that is not distinct) and other goods or services. However, the Board clarified in the Basis for Conclusions that to the extent that an entity is required to combine a licence with other promised goods or services in a single performance obligation and the licence is the primary or dominant component (i.e., the predominant item) of that performance obligation, the entity needs to consider the licensing application guidance to help determine the nature of its promise to the customer. *[IFRS 15.BC407]*.

If the licence is the predominant item of a single performance obligation, entities need to consider the licensing application guidance when:

(a) Determining whether the performance obligation is satisfied over time or at a point in time

And

(b) Selecting an appropriate method for measuring progress of that performance obligation if it is satisfied over time

Considering the nature of an entity's promise in granting a licence that is part of a single combined performance obligation is not a separate step or evaluation in the revenue model. Rather, it is part of the overall requirements in Step 5 of the model to determine whether that single performance obligation is satisfied over time or at a point in time and the appropriate measure of progress toward the satisfaction, if it is satisfied over time.

The Board did not provide application guidance or bright lines for determining when a licence is the primary or dominant (i.e., the predominant) component. However, the IASB explained in the Basis for Conclusions that, in some instances, not considering the nature of the entity's promise in granting a licence that is combined with other promised goods or services in a single performance obligation would result in accounting that does not best reflect the entity's performance. For example, consider a situation where an entity grants a 10-year licence that is not distinct from a one-year service arrangement. The IASB noted that a distinct licence that provides access to an entity's intellectual property over a 10-year period could not be considered completely satisfied before the end of the access period. The IASB observed in that example that it is, therefore, inappropriate to conclude that a single performance obligation that includes that licence is satisfied over the one-year period of the service arrangement. *[IFRS 15.BC414X]*.

The standard includes examples that illustrate how an entity applies the licensing application guidance to help determine the nature of a performance obligation that includes a licence of intellectual property and other promised goods or services.

In Example 56, Case A (extracted below), an entity licences the patent rights for an approved drug compound to its customer and also promises to manufacture the drug for the customer. The entity considers that no other entity can perform the manufacturing service because of the highly specialised nature of the manufacturing process. Therefore, the licence cannot be purchased separately from the manufacturing service and the customer cannot benefit from the licence on its own or with other readily available resources (i.e., the licence and the manufacturing service are not capable of being distinct).

Accordingly, the entity's promises to grant the licence and to manufacture the drug are accounted for as a single performance obligation, as follows: *[IFRS 15.IE Example 56 Case A, IFRS 15.IE281-IE284]*

Extract from IFRS 15

Example 56-Identifying a distinct licence

An entity, a pharmaceutical company, licenses to a customer its patent rights to an approved drug compound for 10 years and also promises to manufacture the drug for the customer. The drug is a mature product; therefore the entity will not undertake any activities to support the drug, which is consistent with its customary business practices.

Case A-Licence is not distinct

In this case, no other entity can manufacture this drug because of the highly specialised nature of the manufacturing process. As a result, the licence cannot be purchased separately from the manufacturing services.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 27 of IFRS 15. The entity determines that the customer cannot benefit from the licence without the manufacturing service; therefore, the criterion in paragraph 27(a) of IFRS 15 is not met. Consequently, the licence and the manufacturing service are not distinct and the entity accounts for the licence and the manufacturing service as a single performance obligation.

The entity applies paragraphs 31-38 of IFRS 15 to determine whether the performance obligation (ie the bundle of the licence and the manufacturing services) is a performance obligation satisfied at a point in time or over time.

The example in the extract above (Example 56, Case A) illustrates the importance of applying the licensing application guidance when determining the nature of an entity's promise in granting a licence that is combined into a single performance obligation with other promised goods or services. This is because the conclusion of whether a non-distinct licence provides the customer with a right to use intellectual property or a right to access intellectual property might have a significant effect on the timing of revenue recognition for the single combined performance obligation. In Example 56, Case A, the entity needs to determine the nature of its promise in granting the licence within the single performance obligation (comprising the licence and the manufacturing service) to appropriately apply the general principle of recognising revenue when (or as) it satisfies its performance obligation to the customer. If the licence in this example provided a right to use the entity's intellectual property that on its own would be recognised at the point in time in which control of the licence is transferred to the customer, it is likely that the combined performance obligation would only be fully satisfied when the manufacturing service is complete. In contrast, if the licence provided a right to access the entity's intellectual property, the combined performance obligation would not be fully satisfied until the end of the 10-year licence period, which could extend the period of revenue recognition beyond the date when the manufacturing service is complete.

FASB differences

ASC 606 explicitly states that an entity considers the nature of its promise in granting a licence when applying the general revenue recognition model to a single performance obligation that includes a licence and other goods or services (i.e., when applying the general requirements, consistent with those in IFRS 15.31-45, to assess whether the performance obligations are satisfied at a point in time or over time). IFRS 15 does not explicitly state this. *[IFRS 15.BC414Y]*.

8.3 Transfer of control of licensed intellectual property

When determining whether a licence of intellectual property transfers to a customer (and revenue is recognised) over time or at a point in time, the standard states that an entity provides a customer with either:

- A right to access the entity's intellectual property throughout the licence period for which revenue is recognised over the licence period

  Or

- A right to use the entity's intellectual property as it exists at the point in time the licence is granted for which revenue is recognised at the point in time the customer can first use and benefit from the licensed intellectual property

The standard provides the following application guidance on the timing of revenue recognition for right-to-access and right-to-use licences: *[IFRS 15.B60, IFRS 15.B61]*

Extract from IFRS 15

B60 If the criteria in paragraph B58 are met, an entity shall account for the promise to grant a licence as a performance obligation satisfied over time because the customer will simultaneously receive and consume the benefit from the entity's performance of providing access to its intellectual property as the performance occurs (see paragraph 35(a)). An entity shall apply paragraphs 39-45 to select an appropriate method to measure its progress towards complete satisfaction of that performance obligation to provide access.

B61 If the criteria in paragraph B58 are not met, the nature of an entity's promise is to provide a right to use the entity's intellectual property as that intellectual property exists (in terms of form and functionality) at the point in time at which the licence is granted to the customer. This means that the customer can direct the use of, and obtain substantially all of the remaining benefits from, the licence at the point in time at which the licence transfers. An entity shall account for the promise to provide a right to use the entity's intellectual property as a performance obligation satisfied at a point in time. An entity shall apply paragraph 38 to determine the point in time at which the licence transfers to the customer. However, revenue cannot be recognised for a licence that provides a right to use the entity's intellectual property before the beginning of the period during which the customer is able to use and benefit from the licence. For example, if a software licence period begins before an entity provides (or otherwise makes available) to the customer a code that enables the customer to immediately use the software, the entity would not recognise revenue before that code has been provided (or otherwise made available).

8.3.1 Right to access

The Board concluded that a licence that provides an entity with the right to access intellectual property is satisfied over time "because the customer simultaneously receives and consumes the benefit from the entity's performance as the performance occurs", including the related activities undertaken by entity. *[IFRS 15.B60, IFRS 15.BC414]*. This conclusion is based on the determination that when a licence is subject to change (and the customer is exposed to the positive or negative effects of that change), the customer is not able to fully gain control over the licence of intellectual property at any given point in time, but rather gains control over the licence period. Entities need to apply the general Step 5 requirements in IFRS 15.39-45 to determine the appropriate method to measure progress (see section 7.1.4 above) in addition to IFRS 15.B61 (i.e., the use and benefit requirement, which is discussed in section 8.3.3 below).

In performing this analysis, an entity would not default to a straight-line revenue attribution model. However, the customer often receives and consumes the benefits of a right-to-access licence evenly over the contract period and, therefore, a time-based measure of progress that results in a straight-line recognition of revenue would be appropriate.

The standard includes the following example of a right-to-access licence: *[IFRS 15.IE Example 58, IFRS 15.IE297-IE302]*

Extract from IFRS 15

Example 58-Access to intellectual property

An entity, a creator of comic strips, licenses the use of the images and names of its comic strip characters in three of its comic strips to a customer for a four-year term. There are main characters involved in each of the comic strips. However, newly created characters appear regularly and the images of the characters evolve over time. The customer, an operator of cruise ships, can use the entity's characters in various ways, such as in shows or parades, within reasonable guidelines. The contract requires the customer to use the latest images of the characters.

In exchange for granting the licence, the entity receives a fixed payment of CU1 million in each year of the four-year term.

In accordance with paragraph 27 of IFRS 15, the entity assesses the goods and services promised to the customer to determine which goods and services are distinct. The entity concludes that it has no other performance obligations other than the promise to grant a licence. That is, the additional activities associated with the licence do not directly transfer a good or service to the customer because they are part of the entity's promise to grant a licence.

The entity assesses the nature of the entity's promise to transfer the licence in accordance with paragraph B58 of IFRS 15. In assessing the criteria the entity considers the following:

(a) the customer reasonably expects (arising from the entity's customary business practices) that the entity will undertake activities that will significantly affect the intellectual property to which the customer has rights (ie the characters). This is because the entity's activities (ie development of the characters) change the form of the intellectual property to which the customer has rights. In addition, the ability of the customer to obtain benefit from the intellectual property to which the customer has rights is substantially derived from, or dependent upon, the entity's ongoing activities (ie the publishing of the comic strip).

(b) the rights granted by the licence directly expose the customer to any positive or negative effects of the entity's activities because the contract requires the customer to use the latest characters.

(c) even though the customer may benefit from those activities through the rights granted by the licence, they do not transfer a good or service to the customer as those activities occur.

Consequently, the entity concludes that the criteria in paragraph B58 of IFRS 15 are met and that the nature of the entity's promise to transfer the licence is to provide the customer with access to the entity's intellectual property as it exists throughout the licence period. Consequently, the entity accounts for the promised licence as a performance obligation satisfied over time (ie the criterion in paragraph 35(a) of IFRS 15 is met).

The entity applies paragraphs 39-45 of IFRS 15 to identify the method that best depicts its performance in the licence. Because the contract provides the customer with unlimited use of the licensed characters for a fixed term, the entity determines that a time-based method would be the most appropriate measure of progress towards complete satisfaction of the performance obligation.

Frequently asked questions

Question 8-5: Is a licence that provides a right to access intellectual property a series of distinct goods or services that would be accounted for as a single performance obligation?

Step 2 of the model requires an entity to identify the performance obligations in a contract. This includes determining whether multiple distinct goods or services would be accounted for as a single performance obligation under the series requirement (see section 4.2.2 above). It is likely that many licences that provide a right to access intellectual property are a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer (e.g., a series of distinct periods of access to intellectual property, such as monthly access or quarterly access).

A TRG agenda paper included an example of a licence that provides a right to access intellectual property that is accounted for as a series of distinct goods or services.[131] In the example, a franchisor grants a licence of intellectual property to a franchisee allowing the franchisee to use its trade name and sell its product for a period of 10 years. As discussed in Question 4-11 in section 4.2.2 above, if the nature of an entity's promise is to provide a single service for a period of time, the evaluation of whether goods or services are distinct and substantially the same considers whether each time increment of access to the intellectual property (e.g., hour, day) is distinct and substantially the same. In this example, the nature of the franchisor's promise is to provide a right to access the intellectual property throughout the licence period. Each time increment is distinct because the customer benefits from the right to access each day on its own (i.e., each time increment is capable of being distinct). In addition, each day is separately identifiable (i.e., each time increment is distinct in the context of the contract) because: there is no integration service provided between the days of access provided; no day modifies or customises another; and the days of access are not highly interdependent or highly interrelated. In addition, each distinct daily service is substantially the same because the customer receives access to the intellectual property each day.

If a licence meets the criteria to be accounted for as a series of distinct goods or services, an entity needs to consider whether any variable consideration in the contract (e.g., royalties, milestone payments) must be allocated to the distinct periods of access, if certain allocation criteria are met. See section 6.3 above for a discussion of the variable consideration allocation exception and section 8.5 below for a discussion of the accounting for sales-based or usage-based royalties.

131 TRG Agenda paper no. 39, *Application of the Series Provision and Allocation of Variable Consideration*, dated 13 July 2015.

8.3.2 Right to use

In contrast, when the licence represents a right to use the intellectual property as it exists at a specific point in time, the customer gains control over that intellectual property at the beginning of the period for which it has the right to use the intellectual property. *[IFRS 15.B61]*. This timing might differ from when the licence was granted. For example, an entity could provide a customer with the right to use intellectual property but indicate that right to use does not start until 30 days after the agreement is finalised. For the purpose of determining when control transfers for the right-to-use licence, the Board was clear that the assessment is from the customer's perspective (i.e., when the customer can use the licensed intellectual property), rather than the entity's perspective (i.e., when the entity transfers the licence). Entities need to apply the general Step 5 requirements in IFRS 15.38 to determine the point in time that control of the licence transfers to the customer (see section 7.2 above) in addition to IFRS 15.B61 (i.e., the use and benefit requirement, which is discussed below in section 8.3.3 below).

The standard includes the following example of a right-to-use licence: *[IFRS 15.IE Example 59, IFRS 15.IE303-IE306]*

Extract from IFRS 15

Example 59-Right to use intellectual property

An entity, a music record label, licenses to a customer a 1975 recording of a classical symphony by a noted orchestra. The customer, a consumer products company, has the right to use the recorded symphony in all commercials, including television, radio and online advertisements for two years in Country A. In exchange for providing the licence, the entity receives fixed consideration of CU10,000 per month. The contract does not include any other goods or services to be provided by the entity. The contract is non-cancellable.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 27 of IFRS 15. The entity concludes that its only performance obligation is to grant the licence. The entity determines that the term of the licence (two years), its geographical scope (the customer's right to use the recording only in Country A), and the defined permitted use for the recording (in commercials) are all attributes of the promised licence in the contract.

In accordance with paragraph B58 of IFRS 15, the entity assesses the nature of the entity's promise to grant the licence. The entity does not have any contractual or implied obligations to change the licensed recording. The licensed recording has significant stand-alone functionality (ie the ability to be played) and, therefore, the ability of the customer to obtain the benefits of the recording is not substantially derived from the entity's ongoing activities. The entity therefore determines that the contract does not require, and the customer does not reasonably expect, the entity to undertake activities that significantly affect the licensed recording (ie the criterion in paragraph B58(a) is not met). Consequently, the entity concludes that the nature of its promise in transferring the licence is to provide the customer with a right to use the entity's intellectual property as it exists at the point in time that it is granted. Therefore, the promise to grant the licence is a performance obligation satisfied at a point in time. The entity recognises all of the revenue at the point in time when the customer can direct the use of, and obtain substantially all of the remaining benefits from, the licensed intellectual property.

Because of the length of time between the entity's performance (at the beginning of the period) and the customer's monthly payments over two years (which are non-cancellable), the entity considers the requirements in paragraphs 60-65 of IFRS 15 to determine whether a significant financing component exists.

8.3.3 Use and benefit requirement

IFRS 15 states that revenue from a right-to-use licence cannot be recognised before the beginning of the period during which "the customer is able to use and benefit from the licence". *[IFRS 15.B61]*. The IASB explained in the Basis for Conclusions that if the customer cannot use and benefit from the licensed intellectual property then, by definition, it does not control the licence. *[IFRS 15.BC414]*. See section 8.4 below for discussion on licence renewals.

Consider an example where an entity provides a customer with a right to use its software, but the customer requires a code before the software will function, which the entity will not provide until 30 days after the agreement is finalised. In this example, it is likely that the entity would conclude that control of the licence does not transfer until 30 days after the agreement is finalised because that is when the customer has the right to use and can benefit from the software.

8.4 Licence renewals

As discussed in section 8.3.3 above, IFRS 15 states that revenue cannot be recognised for a licence that provides a right to use the entity's intellectual property before the beginning of the period during which the customer is able to use and benefit from the licence. *[IFRS 15.B61]*. Some stakeholders questioned whether IFRS 15.B61 applies to the renewal of an existing licence or whether the entity could recognise revenue for the renewal when the parties agree to the renewal. Therefore, the TRG discussed the application of IFRS 15.B61 within the context of renewals or extensions of existing licences. *[IFRS 15.BC414S]*. The discussion at the TRG indicated that this is an area in which judgement is needed and, therefore, this topic was further discussed by the IASB.[132]

The IASB decided that a clarification about the application of the contract modification requirements specifically for renewals of licensing arrangements was not necessary. The Board noted that, although some diversity might arise, IFRS 15 provides an extensive framework for applying judgement (see Question 8-1 in section 8.1.4 above for further discussion on modifications of licences).

Therefore, when an entity and a customer enter into a contract to renew (or extend the period of) an existing licence, the entity needs to evaluate whether the renewal or extension has to be treated as a new licence or as a modification of the existing contract. A modification would be accounted for in accordance with the contract modifications requirements in IFRS 15.18-21 (see section 3.4 above). *[IFRS 15.BC414T]*.

FASB differences

Under ASC 606, revenue related to the renewal of a licence of intellectual property would not be recognised earlier than the beginning of the renewal period. IFRS 15 does not include a similar requirement. *[IFRS 15.BC414U]*.

Frequently asked questions

Question 8-6: How do entities account for modifications and other changes to licences of intellectual property?

See response to Question 8-1 in section 8.1.4 above.

Question 8-7: How do entities account for an option to revoke licensing rights?

See response to Question 8-2 in section 8.1.4 above.

8.5 Sales-based or usage-based royalties on licences of intellectual property

The standard provides application guidance on the recognition of revenue for sales-based or usage-based royalties on licences of intellectual property, which differs from the requirements that apply to other revenue from licences. IFRS 15 requires that royalties received in exchange for licences of intellectual property are recognised at the later of when: *[IFRS 15.B63]*

(a) The subsequent sale or usage occurs

And

(b) The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated is satisfied (or partially satisfied)

That is, an entity recognises the royalties as revenue for such arrangements when (or as) the customer's subsequent sales or usage occurs, unless that pattern of recognition accelerates revenue recognition ahead of the entity's satisfaction of the performance obligation to which the royalty solely or partially relates, based on an appropriate measure of progress (see section 7.1.4 above). *[IFRS 15.BC421I]*.

The Board explained in the Basis for Conclusions that for a licence of intellectual property for which the consideration is based on the *customer's* subsequent sales or usage, an entity does not recognise any revenue for the variable amounts until the uncertainty is resolved (i.e., when a customer's subsequent sales or usage occurs). *[IFRS 15.BC219]*.

132 TRG Agenda paper no. 45, *Licences - Specific Application Issues About Restrictions and Renewals*, dated 9 November 2015.

The IASB also explained in the Basis for Conclusions that the application guidance in IFRS 15.B63-B63B addresses the *recognition* of sales-based or usage-based royalties received in exchange for a licence of intellectual property, rather than when such amounts are included in the transaction price of the contract. *[IFRS 15.BC421I]*. As a result, this exception is a recognition constraint and the constraint on variable consideration (see section 5.2.3 above) does not apply.

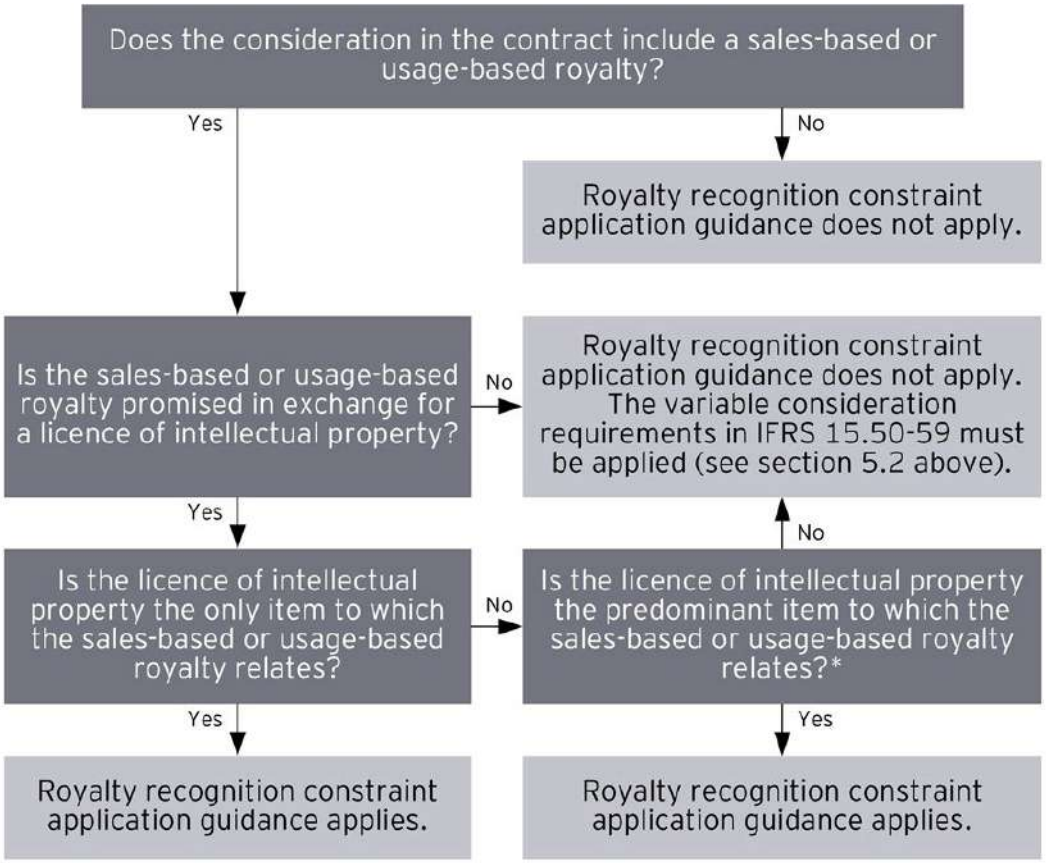
While the variable consideration constraint does not apply, the other requirements for variable consideration still apply (see section 5.2.2 above). However, as mentioned in Question 5-10 in section 5.2.2 above, this might be one of the situations where an entity would not need to estimate variable consideration at contract inception. This is because, in many cases, using this application guidance will result in the same pattern of revenue recognition as fully constraining the estimate of variable consideration associated with the future royalty stream (also see section 8.5.1 below for more information about recognition of royalties for a licence that provides a right to access the entity's intellectual property). However, in cases where an entity is required to allocate sales-based or usage-based royalties to separate performance obligations in a contract, it would need to include expected royalties in its estimate of the stand-alone selling price of one or more of the performance obligations. The Board explained that it added the royalty recognition constraint because both users and preparers of financial statements indicated that it would not be useful for entities to recognise a minimum amount of revenue for sales-based or usage-based royalties received in exchange for licences of intellectual property (following the requirements in the general model on estimating the transaction price). This is because that approach would inevitably require the entity to report significant adjustments to the amount of revenue recognised throughout the life of the contract as a result of changes in circumstances that are not related to the entity's performance. The Board observed that this would not result in relevant information, especially for contracts in which the sales-based or usage-based royalties are paid over a long period of time. *[IFRS 15.BC415]*.

In some contracts, a sales-based or usage-based royalty might be related to both a licence of intellectual property and another good or service that is, or is not, be distinct. IFRS 15.B63A requires that the royalty recognition constraint be applied to the overall royalty stream when the sole or predominant item to which the royalty relates is a licence of intellectual property (including when no single licence of intellectual property is the predominant item to which the royalty relates, but the royalty predominantly relates to two or more licences of intellectual property in the contract). *[IFRS 15.B63A, IFRS 15.BC421G]*. That is, this application guidance is applicable to all licences of intellectual property, regardless of whether they have been determined to be distinct. The standard does not provide a bright line for determining the 'predominant' item in a contract that includes a licence of intellectual property. The Board acknowledged in the Basis for Conclusions that significant judgement is required to determine when a licence is the predominant item to which a royalty relates. However, the judgement for determining whether a licence is the predominant item is likely to be less than the judgement needed to apply the general requirements for variable consideration to such contracts. *[IFRS 15.BC421E]*. See Question 8-18 in section 8.5.1 below for further discussion.

It is important to note that the application guidance in IFRS 15.B63-B63B applies only to licences of intellectual property for which some or all of the consideration is in the form of a sales-based or usage-based royalty. The Board said in the Basis for Conclusions that the royalty recognition constraint was structured to apply only to a particular type of transaction (i.e., a licence of intellectual property). Therefore, other transactions that might be economically similar would be accounted for differently. *[IFRS 15.BC416]*. That is, entities cannot analogise to the royalty recognition constraint for other types of transactions. For example, it cannot be applied if consideration in a contract is in the form of a sales-based or usage-based royalty, but there is either: (a) no licence of intellectual property; or (b) the licence of intellectual property to which the sales-based or usage-based royalty relates is not the predominant item in the contract (e.g., the sale of a tangible good that includes a significant amount of intellectual property). When the royalty recognition constraint cannot be applied, an entity follows the requirements in the general model on estimating variable consideration and applying the constraint on variable consideration (see section 5.2 above). In some cases, it will not be obvious whether the arrangement is an in-substance sale of intellectual property (i.e., a promise that is in the form of a licence, but, in substance, has the characteristics of a sale) or a licence of intellectual property. In such instances, entities would have to exercise judgement to determine whether the control over the underlying intellectual property has been transferred from the entity to the customer and therefore, has been sold.

The following flow chart illustrates an entity's evaluation when determining whether the royalty recognition constraint must be applied to a royalty stream:

Figure 8-1: Determining whether the royalty recognition constraint applies to a royalty stream



* This includes situations in which no single licence is the predominant item to which the sales-based or usage-based royalty relates, but the sales-based or usage-based royalty predominantly relates to two or more licences in the contract.

The standard provides the following example of a contract that includes two performance obligations, including a licence that provides a right to use the entity's intellectual property and consideration in the form of sales-based royalties. In the example, the licence is determined to be the predominant item to which the royalty relates: *[IFRS 15.IE Example 60, IFRS 15.IE307-IE308]*

Extract from IFRS 15

Example 60-Sales-based royalty for a licence of intellectual property

An entity, a movie distribution company, licenses Movie XYZ to a customer. The customer, an operator of cinemas, has the right to show the movie in its cinemas for six weeks. Additionally, the entity has agreed to (a) provide memorabilia from the filming to the customer for display at the customer's cinemas before the beginning of the six-week screening period; and (b) sponsor radio advertisements for Movie XYZ on popular radio stations in the customer's geographical area throughout the six-week screening period. In exchange for providing the licence and the additional promotional goods and services, the entity will receive a portion of the operator's ticket sales for Movie XYZ (ie variable consideration in the form of a sales-based royalty).

The entity concludes that the licence to show Movie XYZ is the predominant item to which the sales-based royalty relates because the entity has a reasonable expectation that the customer would ascribe significantly more value to the licence than to the related promotional goods or services. The entity recognises revenue from the sales-based royalty, the only consideration to which the entity is entitled under the contract, wholly in accordance with paragraph B63. If the licence, the memorabilia and the advertising activities are separate performance obligations, the entity would allocate the sales-based royalty to each performance obligation.

As illustrated in the extract above (Example 60), IFRS 15.B63B states that, when the criteria for applying the royalty recognition constraint are applied, the royalty stream must be accounted for entirely under the royalty recognition constraint. *[IFRS 15.B63B]*. That is, an entity would not split a single royalty and apply the royalty recognition constraint to a portion of the sales-based royalty and the general constraint requirements for variable consideration (see section 5.2.3 above) to the remainder. The Board indicated in the Basis for Conclusions that it would be more complex to account for part of a royalty under the royalty recognition constraint and another part under the general requirements for variable consideration and that doing so would not provide any additional useful information to users of financial statements. This is because splitting a royalty would result in an entity recognising an amount at contract inception that would reflect neither the amount to which the entity expects to be entitled, based on its performance, nor the amount to which the entity has become legally entitled during the period. *[IFRS 15.BC421J]*.

Regardless of whether an entity applies the royalty recognition constraint or the general requirements for variable consideration, it is still required to allocate sales-based or usage-based royalties to separate performance obligations in a contract (as noted in Example 60 above) in a manner consistent with the allocation objective in IFRS 15.73. In order to perform such an allocation, an entity would need to include expected royalties in its estimate of the stand-alone selling price of one or more of the performance obligations. Example 35 from the standard (extracted in full in section 6.3.3 above) also illustrates the allocation of the transaction price (including sales-based or usage-based royalties) to the performance obligations in the contract. *[IFRS 15.IE Example 35, IFRS 15.IE178, IFRS 15.IE187]*.

8.5.1 Recognition of royalties for a licence that provides a right to access intellectual property

The IASB explained in the Basis for Conclusions that the royalty recognition constraint is intended to align the recognition of sales or usage-based royalties with the standard's key principle that revenue is recognised when (or as) an entity satisfies a performance obligation. As discussed in section 8.5 above, IFRS 15 requires that royalties received in exchange for licences of intellectual property are recognised at the later of when: (1) the subsequent sales or usage occurs; and (2) the performance obligation to which the sales-based or usage-based royalties relate has been satisfied (or partially satisfied). That is, an entity recognises the royalties as revenue when (or as) the customer's subsequent sales or usage occurs, unless that pattern of recognition accelerates revenue recognition ahead of the entity's satisfaction of the performance obligation to which the royalty solely or partially relates, based on an appropriate measure of progress (see section 7.1.4 above). *[IFRS 15.BC421I]*.

Consider the following Illustration, based on an example provided by the FASB, that is an example of when revenue recognition would be inappropriately accelerated ahead of an entity's performance, if revenue was recognised under IFRS 15.B63(a) for a right-to-access licence:[133]

Illustration 8-2: Licensing contract with a declining royalty rate

A contract provides a customer with the right to access an entity's intellectual property and the entity receives royalties of 8% on total sales up to CU1 million, 4% on the next CU3 million in sales and 2% on all sales above CU4 million. The declining royalty rate does not reflect changing value to the customer.

In this example, the FASB noted that recognising royalties as they are due (i.e., according to the contractual formula) would not be aligned with the principle of recognising revenue only when (or as) an entity satisfies a performance obligation because the right to access the intellectual property is provided evenly over the licence term while the declining royalty rate does not reflect the value to the customer. However, the FASB stated that the existence of a declining royalty rate in a contract does not always mean that recognising revenue for sales-based or usage-based royalties as the customer's underlying sales or usage occur is inappropriate. In fact, it would be appropriate if the declining royalty rate reflects the changing value to the customer.

The above example notwithstanding, for many contracts with licences that provide a right to access an entity's intellectual property, applying the royalty recognition constraint results in an entity recognising revenue from sales-based or usage-based royalties when (or as) the customer's underlying sales or usage occurs in accordance with IFRS 15.B63(a). An output-based measure of progress that is the same as, or similar to, the application of the practical expedient in IFRS 15.B16 (i.e., when the right to consideration corresponds directly with the value to the customer of the entity's performance to date) is appropriate because the entity's right to consideration (i.e., the sales-based or usage-based royalties earned) often corresponds directly with the value to the customer of the entity's performance completed to date. The practical expedient in IFRS 15.B16 is discussed further in section 7.1.4 above.

133 ASU 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*, April 2016, paragraph BC71.

In addition, an output-based measure could also be appropriate for a licence that provides a right to access intellectual property in which the consideration is in the form of a fixed fee and royalties. The following example from the standard illustrates this: *[IFRS 15.IE Example 61, IFRS 15.IE309-IE313]*

Extract from IFRS 15

Example 61–Access to intellectual property

An entity, a well-known sports team, licenses the use of its name and logo to a customer. The customer, an apparel designer, has the right to use the sports team's name and logo on items including t-shirts, caps, mugs and towels for one year. In exchange for providing the licence, the entity will receive fixed consideration of CU2 million and a royalty of five per cent of the sales price of any items using the team name or logo. The customer expects that the entity will continue to play games and provide a competitive team.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 27 of IFRS 15. The entity concludes that its only performance obligation is to transfer the licence. The additional activities associated with the licence (ie continuing to play games and provide a competitive team) do not directly transfer a good or service to the customer because they are part of the entity's promise to grant the licence.

The entity assesses the nature of the entity's promise to transfer the licence in accordance with paragraph B58 of IFRS 15. In assessing the criteria the entity considers the following:

(a) the entity concludes that the customer would reasonably expect that the entity will undertake activities that will significantly affect the intellectual property (ie the team name and logo) to which the customer has rights. This is on the basis of the entity's customary business practice to undertake activities that support and maintain the value of the name and logo such as continuing to play and providing a competitive team. The entity determines that the ability of the customer to obtain benefit from the name and logo is substantially derived from, or dependent upon, the expected activities of the entity. In addition, the entity observes that because some of its consideration is dependent on the success of the customer (through the sales-based royalty), the entity has a shared economic interest with the customer, which indicates that the customer will expect the entity to undertake those activities to maximise earnings.

(b) the entity observes that the rights granted by the licence (ie the use of the team's name and logo) directly expose the customer to any positive or negative effects of the entity's activities.

(c) the entity also observes that even though the customer may benefit from the activities through the rights granted by the licence, they do not transfer a good or service to the customer as those activities occur.

The entity concludes that the criteria in paragraph B58 of IFRS 15 are met and the nature of the entity's promise to grant the licence is to provide the customer with access to the entity's intellectual property as it exists throughout the licence period. Consequently, the entity accounts for the promised licence as a performance obligation satisfied over time (ie the criterion in paragraph 35(a) of IFRS 15 is met).

The entity then applies paragraphs 39-45 of IFRS 15 to determine a measure of progress that will depict the entity's performance. For the consideration that is in the form of a sales-based royalty, paragraph B63 of IFRS 15 applies because the sales-based royalty relates solely to the licence, which is the only performance obligation in the contract. The entity concludes that recognition of the CU2 million fixed consideration as revenue rateably over time plus recognition of the royalty as revenue as and when the customer's sales of items using the team name or logo occur reasonably depicts the entity's progress towards complete satisfaction of the licence performance obligation.

In Example 61 above, the fixed consideration of CU2 million is an explicit term in the contract with the customer. In some contracts, fixed consideration is implied, such as when a guaranteed minimum amount of royalties is part of the transaction price.

In addition, as discussed in Question 8-5 in section 8.3.1 above, many licences that provide a right to access intellectual property constitute a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer (e.g., a series of distinct periods of access to intellectual property, such as monthly access or quarterly access). In cases where the criteria for a performance obligation to be accounted for as a series of distinct goods or services have been met, an entity needs to consider whether any variable consideration in the contract (e.g., sales-based or usage-based royalties) must be allocated directly to the distinct periods of access, if the criteria for the variable consideration allocation exception are met (see section 6.3 above). The allocation of sales-based or usage-based royalties in this manner generally results in the recognition of royalties as revenue when (or as) the customer's underlying sales or usage occurs.

An entity might need to apply significant judgement to determine the appropriate pattern of revenue recognition for royalties received on a licence that provides a right to access intellectual property.

Frequently asked questions

Question 8-8: Can the recognition constraint for sales-based or usage-based royalties be applied to royalties that are paid in consideration for sales of intellectual property (rather than just licences of intellectual property)?

As noted in the Basis for Conclusions, the Board discussed but decided not to expand the scope of the royalty recognition constraint to include sales of intellectual property. The Board also stated that the royalty recognition constraint is intended to apply only to limited circumstances (i.e., those circumstances involving licences of intellectual property) and, therefore, entities cannot apply it by analogy to other types of transactions. *[IFRS 15.BC421, IFRS 15.BC421F]*.

Question 8-9: If a contract for a licence of intellectual property includes payments with fixed amounts (e.g., milestone payments) that are determined by reference to sales-based or usage-based thresholds, would the royalty recognition constraint need to be applied?

How we see it

We generally believe the royalty recognition constraint would apply to fixed amounts of variable consideration (i.e., fixed amounts of consideration that are contingent on the occurrence of a future event), such as milestone payments, provided the amounts are determined by reference to sales-based or usage-based thresholds. This is the case even if those payments are not referred to as 'royalties' under the terms of the contract. However, entities need to apply judgement and carefully evaluate the facts and circumstances of their contracts for licences of intellectual property to determine whether these types of payments need to be accounted for using the royalty recognition constraint.

Consider the following Illustration:

Illustration 8-3: Application of the royalty recognition constraint to a milestone payment

An entity enters into a contract to grant a customer a right to use the entity's intellectual property. The contract contains payment terms that include a CU10 million milestone payment that is payable to the entity once the customer has achieved sales of CU100 million associated with the licence.

The entity determines that the milestone payment is based on the customer's subsequent sales and represents variable consideration because it is contingent on the customer's sales reaching CU100 million. The entity accounts for the CU10 million milestone payment in accordance with the royalty recognition constraint and only recognises revenue for the milestone payment once the customer's sales reach CU100 million.

Question 8-10: If a contract for a licence of intellectual property includes a milestone payment based on the first commercial sale, would the royalty recognition constraint apply?

How we see it

We generally believe it would be acceptable for an entity to apply the royalty recognition constraint to a milestone payment that is contingent on the customer's first commercial sale of a product using the entity's intellectual property. This is because the milestone payment is linked to a sales-based or usage-based threshold (i.e., the milestone payment is based on the customer's sales).

Consider the following Illustration:

Illustration 8-4: Application of the royalty recognition constraint to a milestone payment based on the first commercial sale

An entity enters into a contract to grant a customer a right to use the entity's intellectual property. The contract contains payment terms that include a CU10 million milestone payment that is payable to the entity upon the customer's first commercial sale of a product that uses the entity's intellectual property.

The entity determines that the milestone payment is based on the customer's subsequent sales and represents variable consideration because it is contingent on the customer's first commercial sale. It accounts for the CU10 million milestone payment in accordance with the royalty recognition constraint and only recognises revenue for the milestone payment upon the customer's first commercial sale.

In contrast, if a milestone payment is contingent on metrics that are not determined by reference to sales-based or usage-based thresholds and that are substantive (e.g., regulatory approval), the royalty recognition constraint must not be applied (i.e., the milestone payment is not based on the customer's sales). Rather, the general variable consideration requirements need to be applied.

As discussed in Question 5-12 in section 5.2.3 above, we expect entities to conclude, in many instances, that milestone payments contingent on regulatory approval (e.g., regulatory approval of a new drug) are constrained, preventing them from recognising these payments until the uncertainty associated with the payments is resolved.

Question 8-11: Does the application of the royalty recognition constraint preclude the requirement to adhere to the allocation objective in IFRS 15.73?

If an entity applies the royalty recognition constraint, it still needs to adhere to the allocation objective in IFRS 15.73 if the contract contains multiple performance obligations. It is clear from paragraphs IFRS 15.BC421A and BC421G that allocation of sales-based or usage-based royalties to two or more different performance obligations was contemplated by the Board. This is also consistent with Example 60, which clarifies sales-based or usage-based royalties need to be allocated to each performance obligation. *[IFRS 15.IE Example 60, IFRS 15.IE308]*. Therefore, regardless of whether an entity applies the royalty recognition constraint or the general constraint on variable consideration, it is still required to allocate sales-based or usage-based royalties to separate performance obligations in a contract in a manner consistent with the allocation objective in IFRS 15.73. To perform such an allocation, an entity might need to include expected royalties in its estimate of the stand-alone selling price of one or more of the performance obligations.

Question 8-12: Can an entity recognise revenue for sales-based or usage-based royalties for licences of intellectual property on a lag if actual sales or usage data is not available at the end of a reporting period?

The standard requires that sales-based or usage-based royalties promised in exchange for licences of intellectual property be recognised as revenue at the later of when: (1) the subsequent sales or usage occurs and (2) the performance obligation to which the sales-based or usage-based royalties relate has been satisfied (or partially satisfied). *[IFRS 15.B63]*.

How we see it

After the conditions in the royalty recognition constraint application guidance have been met (i.e., the underlying sales or usage has occurred and the performance obligation to which the royalties relate has been satisfied (or partially satisfied)), we believe that licensors without actual sales or usage data from the licensee need to make an estimate of royalties earned in the current reporting period.

Question 8-13: How does a minimum guarantee affect the recognition of sales-based or usage-based royalties promised in exchange for a licence of intellectual property that is satisfied at a point in time?

(FASB TRG meeting 7 November 2016 - Agenda paper no. 58)

The FASB TRG members generally agreed that a minimum guaranteed amount of sales based or usage-based royalties promised in exchange for a licence of intellectual property that is satisfied at a point in time (IFRS accounting standards: right-to-use licence; US GAAP: licence of functional intellectual property) would need to be recognised as revenue at the point in time that the entity transfers control of the licence to the customer (see section 8.3.2 above). Any royalties above the fixed minimum would be recognised in accordance with the royalty recognition constraint (i.e., at the later of when the sale or usage occurs or when the entity satisfies the performance obligation to which some or all of the royalty has been allocated).[134]

134 FASB TRG Agenda paper no. 60, *November 2016 Meeting - Summary of Issues Discussed and Next Steps*, dated 31 January 2017.

Question 8-14: How does a minimum guarantee affect the recognition of sales-based or usage-based royalties promised in exchange for a licence of intellectual property that is satisfied over time?

(FASB TRG meeting 7 November 2016 - Agenda paper no. 58)

The FASB TRG members generally agreed that various recognition approaches could be acceptable for minimum guarantees promised in exchange for licences of intellectual property that are satisfied over time (IFRS accounting standards: right-to-access licences; US GAAP: licences of symbolic intellectual property, see section 8.3.1 above). This is because, as the FASB staff noted in the TRG agenda paper, this question is asking what is an appropriate measure of progress for such contracts and the standard permits reasonable judgement when selecting a measure of progress. Because the standard does not prescribe a single approach that must be applied in all circumstances in which a sales-based or usage-based royalty is promised in exchange for a licence of intellectual property and the contract includes a minimum guaranteed amount, an entity needs to consider the nature of its arrangements and make sure that the measure of progress it selects does not override the core principle of the standard that "an entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services". *[IFRS 15.2]*. An entity would need to disclose the accounting policy it selects because it is likely that this would affect the timing of revenue recognised.

The agenda paper describes two approaches. Under one approach, an entity would estimate the total consideration (i.e., the fixed minimum and the variable consideration from future royalties) and apply an appropriate measure of progress to recognise revenue as the entity satisfies the performance obligation, subject to the royalty recognition constraint. Alternatively, under the other approach, an entity could apply a measure of progress to the fixed consideration and begin recognising the variable component after exceeding the fixed amount on a cumulative basis.

The first approach can be applied in two different ways, as follows:

- View A: If an entity expects royalties to exceed the minimum guarantee, the entity might determine that an output-based measure is an appropriate measure of progress and apply the right-to-invoice practical expedient (i.e., IFRS 15.B16, see section 7.1.4.B above) because the royalties due for each period correlate directly with the value to the customer of the entity's performance each period. As a result of applying the practical expedient for recognising revenue, the entity would not need to estimate the expected royalties beyond determining whether it expects, at contract inception, that the royalties will exceed the minimum guarantee. However, the entity would be required to update that assessment at the end of each reporting period. It is important to note that this view is likely to be appropriate if the entity expects cumulative royalties to exceed the minimum guarantee.
- View B: An entity estimates the transaction price for the performance obligation (including both fixed and variable consideration) and recognises revenue using an appropriate measure of progress, subject to the royalty recognition constraint. If an entity does not expect cumulative royalties to exceed the minimum guarantee, the measure of progress is applied to the minimum guarantee since the transaction price will at least equal the fixed amount.

The second approach can be summarised, as follows:

- View C: An entity recognises the minimum guarantee (i.e., the fixed consideration) using an appropriate measure of progress and recognises royalties only when cumulative royalties exceed the minimum guarantee.

The FASB staff noted in the TRG agenda paper that, in order for an entity to apply View C, the over-time licence would have to be considered a series of distinct goods or services (i.e., a series of distinct time periods) and the variable consideration (i.e., the royalties in excess of the minimum guarantee) would have to be allocated to the distinct time periods to which they relate.

To illustrate the application of these views, the following Illustration has been adapted from an example included in the FASB TRG agenda paper:

Illustration 8-5: Accounting for a licence of intellectual property that is satisfied over time in exchange for a minimum guarantee and sales-based royalty

An entity enters into a five-year arrangement to licence a trademark. The trademark is determined to be a licence of intellectual property that is satisfied over time (IFRS accounting standards: right-to-access licence; US GAAP: licence of symbolic intellectual property). The licence requires the customer to pay a sales-based royalty of 5% of its gross sales associated with the trademark. However, the contract includes a guarantee that the entity will receive a minimum of CU5 million for the entire five-year period.

The customer's actual gross sales associated with the trademark and the related royalties each year are, as follows (this information is not known at the beginning of the contract):

Year 1 - CU15 million (royalties equal CU750,000)

Year 2 - CU30 million (royalties equal CU1.5 million)

Year 3 - CU40 million (royalties equal CU2 million)

Year 4 - CU20 million (royalties equal CU1 million)

Year 5 - CU60 million (royalties equal CU3 million)

Total royalties equal CU8.25 million.

View A: The entity expects total royalties to exceed the minimum guarantee. The entity determines that an output-based measure is an appropriate measure of progress and applies the right-to-invoice practical expedient because the royalties due for each period correlate directly with the value to the customer of the entity's performance for each period. The entity recognises revenue from the sales-based royalty when the customer's subsequent sales occur.

(in 000s)	Year 1	Year 2	Year 3	Year 4	Year 5
Royalties received	750	1,500	2,000	1,000	3,000
Annual revenue	750	1,500	2,000	1,000	3,000
Cumulative revenue	**750**	**2,250**	**4,250**	**5,250**	**8,250**

View B: The entity estimates the transaction price (including fixed and variable consideration) for the contract. The entity determines that time elapsed is an appropriate measure of progress and recognises revenue rateably over the five-year term of the contract, subject to the royalty recognition constraint (i.e., cumulative revenue recognised cannot exceed the cumulative royalties received once the minimum guarantee has been met).

(in 000s)	Year 1	Year 2	Year 3	Year 4	Year 5
Royalties received	750	1,500	2,000	1,000	3,000
Royalties (cumulative)	**750**	**2,250**	**4,250**	**5,250**	**8,250**
Fixed + Variable (rateable)[a]	1,650	1,650	1,650	1,650	1,650
Annual revenue	1,650	1,650	1,650	300	3,000
Cumulative revenue	**1,650**	**3,300**	**4,950**	**5,250**[b]	**8,250**

a. Assuming the entity's estimated transaction price (including both fixed and variable consideration) is CU8.25 million, the annual revenue that could be recognised is CU1.65 million (CU8.25 million divided by five years, being contract term).

b. In Year 4, the cumulative revenue using a time-elapsed measure of progress of CU6.6 million (CU4.95 million plus CU1.65 million) exceeds the cumulative royalties received (CU5.25 million). As such, the total cumulative revenue recognised through to the end of Year 4 is constrained to the total cumulative royalties received of CU5.25 million.

View C: The entity recognises the minimum guarantee (i.e., the fixed consideration) using an appropriate measure of progress and recognises royalties only when cumulative royalties exceed the minimum guarantee. The entity determines that time elapsed is an appropriate measure of progress.

The entity applies the royalty recognition constraint to the sales-based royalties that are in excess of the minimum guarantee (i.e., recognise the royalties as revenue when the minimum guarantee is exceeded on a cumulative basis). The variable consideration (royalties in excess of the minimum guarantee) is allocated to the distinct periods using the variable consideration allocation exception (see section 6.3 above). *[IFRS 15.85]*.

As previously discussed, the FASB staff noted in the TRG agenda paper that, in order for an entity to apply View C, the over-time licence would have to be considered a series of distinct goods or services (i.e., a series of distinct time periods) and the variable consideration (i.e., the royalties that are in excess of the minimum guarantee) would have to be allocated to the distinct time periods to which they relate.

(in 000s)	Year 1	Year 2	Year 3	Year 4	Year 5
Royalties received	750	1,500	2,000	1,000	3,000
Royalties (cumulative)	**750**	**2,250**	**4,250**	**5,250**	**8,250**
Fixed (rateable)[a]	1,000	1,000	1,000	1,000	1,000
Annual revenue	1,000	1,000	1,000	1,250[b]	4,000[c]
Cumulative revenue	**1,000**	**2,000**	**3,000**	**4,250**	**8,250**

a. Because the minimum guarantee is CU5 million over the contract term, the annual revenue (excluding royalties that are in excess of the minimum guarantee) is CU1 million (CU5 million divided by five years, being the contract term).

b. In Year 4, the cumulative royalties received (CU5.25 million) exceed the total minimum guarantee (CU5 million) by CU250,000. As such, the annual revenue recognised in Year 4 is CU1.25 million (CU1 million annual revenue plus CU250,000 of royalties in excess of the minimum guarantee).

c. In Year 5, the annual revenue recognised (CU4 million) is calculated as the CU1 million annual revenue plus the royalties for that year (CU3 million) since the royalties exceeded the minimum guarantee in Year 4.

The FASB staff noted in the TRG agenda paper that other measures of progress, in addition to those set out above, could be acceptable because the standard permits entities to use judgement in selecting an appropriate measure of progress and that judgement is not limited to the views in the TRG agenda paper. However, the staff emphasised that it would not be acceptable for entities to apply any measure of progress in any circumstance. For example, the FASB staff noted it would not be acceptable to apply multiple measures of progress to a single performance obligation, such as one measure for fixed consideration and a different one for variable consideration. The staff also thought it would not be appropriate for an entity to apply the breakage model in IFRS 15.B46 (see section 7.9 above) because it is likely that a customer would not have an unexercised right in a licence arrangement if the entity were providing the customer with access to its intellectual property over the entire term of the arrangement. *[IFRS 15.B46]*. Another approach that would not be appropriate, according to the FASB staff, is one that ignores the royalty recognition constraint application guidance in IFRS 15.B63, which requires revenue to be recognised at the later of when: (1) the subsequent sale or usage occurs; or (2) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated is satisfied (in whole or in part) (discussed in section 8.5 above). *[IFRS 15.B63]*.

Question 8-15: Can entities apply the royalty recognition constraint for sales-based or usage-based royalties if they do not own the intellectual property or control the intellectual property as a principal in the arrangement?

How we see it

We generally believe entities can apply the royalty recognition constraint if their revenue is based on a sales-based or usage-based royalty from a licence of intellectual property, but they do not own or control the intellectual property as a principal in the arrangement.

It is important to note that this view applies only to licences of intellectual property for which some or all of the consideration received by both the licensor and the agent is in the form of a sales-based or usage-based royalty. Entities cannot analogise to this view for other situations.

Entities need to disclose their use of the royalty recognition constraint because it is likely to affect the amount and timing of revenue recognised.

Consider the following Illustration:

Illustration 8-6: Application of the royalty recognition constraint as an agent

University U has intellectual property for its logo. Company Z, acting as an agent for University U, identifies an apparel company looking to licence University U's logo to put it on merchandise. University U is paid a royalty based on sales and usage of its intellectual property (the logo) by the licensee (the apparel company). Company Z receives a portion of the royalty earned by University U. Company Z does not control the intellectual property at any point during the arrangement and its ability to receive consideration from University U depends on the licensing of University U's intellectual property. We believe that application of the royalty recognition constraint would be appropriate in this example because the royalties earned by University U and, in effect, the amount Company Z expects to be entitled to receive, are directly tied to the usage of the intellectual property.

Question 8-16: Can entities recognise sales-based or usage-based royalties before the sale or usage of the intellectual property occurs if they have historical information that is highly predictive of future royalty amounts?

In accordance with IFRS 15.B63-B63B, revenue from a sales-based or usage-based royalty promised in exchange for a licence of intellectual property is recognised at the later of when: (1) the subsequent sale or usage occurs; or (2) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (in whole or in part).

How we see it

Revenue recognition cannot be accelerated even if an entity has historical information that is highly predictive of future royalty amounts. That is, the use of the royalty recognition constraint is not optional.

Question 8-17: Must an entity apply the royalty recognition constraint when the royalty is calculated on a financial metric that is not solely based on sales or usage?

How we see it

In certain circumstances, we believe the royalty recognition constraint can be applied when the royalty is calculated on a financial metric that is not solely based on sales or usage.

We believe that a metric such as gross profit (commonly defined as sales less cost of goods sold) is largely attributable to sales. Judgement will be required to determine whether the royalty recognition constraint needs to be applied if the royalty is based on a different financial metric that is not solely based on sales or usage.

A licensor, for example, might be entitled to a fee based on a fixed percentage of gross profit generated by the licensee for the entire term of the contract. If the royalty is calculated using gross profit, the royalty recognition constraint might be applied.

Question 8-18: Does the royalty recognition constraint apply if the licence of intellectual property is not distinct from other goods or services in the contract?

If the licence of intellectual property is not distinct from other goods or services in the contract, the royalty recognition constraint applies only if the licence is the predominant item to which the royalty relates. As discussed in section 8.5 above, IFRS 15.B63A requires that the royalty recognition constraint be applied to the overall royalty stream when the sole or predominant item to which the royalty relates is a licence of intellectual property. For example, the licence of intellectual property may be the predominant item to which the royalty relates when the entity has a reasonable expectation that the customer would ascribe significantly more value to the licence than to the other goods or services to which the royalty relates. The royalty recognition constraint would also apply when there is no single licence of intellectual property is the predominant item to which the royalty relates, but the royalty predominantly relates to two or more licences of intellectual property in the contract. *[IFRS 15.BC421G]*.

The Board noted in the Basis for Conclusions that applying the royalty recognition constraint only when the royalty solely relates to a licence that is a separate performance obligation would have excessively restricted its application. Furthermore, it noted that applying the royalty recognition constraint to those royalty arrangements in which the licence is the predominant feature to which the royalty relates provides more useful information to users that are likely to view those arrangements as licensing arrangements. *[IFRS 15.BC421D]*.

The standard does not provide a bright line for determining the 'predominant' item in a contract that includes a licence of intellectual property. The Board acknowledged in the Basis for Conclusions that significant judgement is required to determine when a licence is the predominant item to which a royalty relates. However, the judgement for determining whether a licence is the predominant item is likely to be less than the judgement needed to apply the general requirements for variable consideration to such contracts. *[IFRS 15.BC421E]*.

Question 8-19: Can an entity recognise revenue at an expected average rate when a licence of intellectual property has royalty rates that increase over time?

As discussed in section 8.5 above, IFRS 15.B63 requires that sales-based or usage-based royalties received in exchange for licences of intellectual property be recognised at the later of when: (1) the subsequent sale or usage occurs; or (2) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated is satisfied (wholly or partially). That is, an entity recognises the royalties as revenue when (or as) the customer's subsequent sales or usage occurs, unless that recognition pattern accelerates revenue recognition ahead of the entity's satisfaction of the performance obligation to which the royalty solely (or partially) relates based on an appropriate measure of progress.

In contrast to the declining royalty rate scenario discussed by the FASB in the Basis for Conclusions to its revenue standard, and discussed above,[135] we would not expect an increasing royalty rate to cause revenue to be recognised ahead of an entity's performance if an entity's recognises revenue as the related sales or usage occurs at the contractual rate in place at the time. However, if an entity were to use an output measure based on an average expected royalty rate over the full contract term, it would be accelerating revenue recognition ahead of the related sales or usage, which would be counter to the principle of the royalty recognition constraint. In this case, it would be inappropriate to recognise revenue using an output measure based on an average expected royalty rate over the full contract term.

Question 8-20: How would an entity distinguish between a contract that contains an option to purchase additional licences and a contract in which additional licence usage may be subject to the royalty recognition constraint?

(TRG meeting 9 November 2015 - Agenda paper no. 45)

A technology entity might, for example, provide the customer with the option to purchase or use additional copies of software in exchange for additional consideration, and the customer may have the ability to replicate the software or download additional copies without further assistance from the technology entity. Questions have been raised about whether this type of option is an option to acquire additional software rights (i.e., an option for additional goods, as discussed in section 4.6 above) or whether the extra copies represent additional usage of the software licence and, therefore, whether the additional usage gives rise to a sales-based or usage-based royalty that is likely to be subject to the royalty recognition constraint.

The TRG generally agreed that the entity has to exercise judgement to determine whether the contract is for a single licence or for multiple licences. In doing so, the entity considers whether the additional copies are distinct goods or services. Additional licences are typically distinct because the customer can benefit from the additional licence on its own, providing it does not modify, customise or have an interdependency with existing licences. The TRG members also generally agreed that, while the customer may be able to replicate the software or download additional copies without the assistance of the technology entity, the entity might still be required to grant additional rights to the customer for the use of the additional copies of software.

An entity has provided a customer with an option if the customer can decide to purchase additional distinct copies of the software, and the entity is required to transfer those additional rights to the customer. See section 4.6 above for further discussion of the accounting for customer options for additional goods and services, including how to evaluate whether the option represents a material right. Conversely, if the contract requires the customer to pay usage-based fees to compensate the vendor for the rights to use the software that have already been transferred, these fees are treated as variable consideration (see section 5.2 above). This conclusion is consistent with the discussion in Question 4-19 in section 4.6 above. However, when the software licence is the sole or predominant item to which the usage-based fees relate, in accordance with IFRS 15.B63A, the fees are accounted for as sales-based and usage-based royalties (as discussed in section 8.5 above) rather than the general variable consideration requirements.

135 ASU 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*, April 2016, paragraph BC71.

9 IFRS 15 - Other measurement and recognition topics

9.1 Warranties

Warranties are commonly included in arrangements to sell goods or services. They might be explicitly included in the contractual arrangement with a customer or might be required by law or regulation. In addition, an entity might have established an implicit policy of providing warranty services to maintain a desired level of satisfaction among its customers. Whether explicit or implicit, warranties extend an entity's obligations beyond the transfer of control of the good or service to the customer, requiring it to stand ready to perform under the warranty over the life of the warranty obligation.

Warranties will normally meet the definition of an insurance contract, which is a contract in which "one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder". *[IFRS 17 Appendix A]*. Therefore, before assessing warranties under IFRS 15, an entity needs to consider whether the warranty might be within the scope of IFRS 17 (also see Chapter 51 at section 2.3.1.A). To make this assessment, entities need to consider whether the scope exception in IFRS 17 applies for "warranties provided by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer". *[IFRS 17.7(a)]*.

How we see it

For some entities this assessment will be straightforward. For other entities, we believe judgement might be needed to determine whether the scope exception applies, and the following three consideration are relevant:

- What is considered a manufacturer, dealer or retailer? Even though these terms are not defined, we believe these terms are to be understood broadly, which also appears to have been the IASB's intention as described in the Basis for Conclusions on IFRS 17 (also see Question 3-1 in Chapter 51 at section 3.1). *[IFRS 17.BC89]*. That is, use of these terms is not meant to be restrictive. Therefore, an entity can use its judgement to determine whether it broadly can be considered a manufacturer, dealer or retailer (e.g., a service provider might conclude it can apply the scope exception).
- How close does the connection to the sale of goods need to be? For example, it is likely that a warranty sold separately at or near the time that the goods or services are provided would be considered 'in connection', but what if the warranty is separately sold at a later date? In making the assessment about the IFRS 17 scope exclusion, we believe that time is generally a relevant, but not necessarily determinative, consideration. Furthermore, the guidance in IFRS 15 on contract combinations and contract modifications could be relevant for this assessment (see section 3-3 and section 3-4 above, respectively).
- What if there is more than one party involved in providing the goods or services and the warranty? Assume, for example, that a manufacturer's customer is a retailer for specific goods (i.e., the retailer is the principal for goods sold to end-consumers (see section 4.4 above for further discussion on principal versus agent assessments), but it provides warranties to the end-consumers (i.e., the retailer's customers) for which the retailer is an agent. In such a situation, an entity needs to assess whether it is the principal or an agent. If it is an agent, then it might conclude the scope exception in IFRS 17.7 does not apply because an agent's customer is the principal in the transaction (not the end-customer). However, judgement would be needed based on the specific facts and circumstances.

For further discussion on the requirements of IFRS 17, see Chapter 51.

The price of a warranty might be included in the overall purchase price or listed separately as an optional product. If the warranty is not separately purchased and it is within the scope of IFRS 17, the contract consideration will need to be allocated between the standards in accordance with IFRS 15.7 - see sections 2.5 and 6.6 above for further discussion.

For warranties within the scope of IFRS 15, while the standard notes that the nature of a warranty can vary significantly across industries and contracts, it identifies two types of warranties: *[IFRS 15.B28]*

- Warranties that promise the customer that the delivered product is as specified in the contract (called 'assurance-type warranties')
- Warranties that provide a service to the customer in addition to assurance that the delivered product is as specified in the contract (called 'service-type warranties')

9.1.1 Determining whether a warranty is an assurance-type or service-type warranty

If the customer has the option to purchase the warranty separately or if the warranty provides a service to the customer, beyond ensuring that the product complies with agreed-upon specifications, IFRS 15.B29 states that the entity is providing a service-type warranty. *[IFRS 15.B29]*. Otherwise, it is an assurance-type warranty, which provides the customer with assurance that the product complies with agreed-upon specifications. *[IFRS 15.B30]*. In some cases, it might be difficult to determine whether a warranty provides a customer with a service in addition to the assurance that the delivered product is as specified in the contract. To help entities make that assessment, the standard provides the following application guidance: *[IFRS 15.B31, IFRS 15.B33]*

Extract from IFRS 15

B31 In assessing whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, an entity shall consider factors such as:

(a) Whether the warranty is required by law-if the entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation because such requirements typically exist to protect customers from the risk of purchasing defective products.

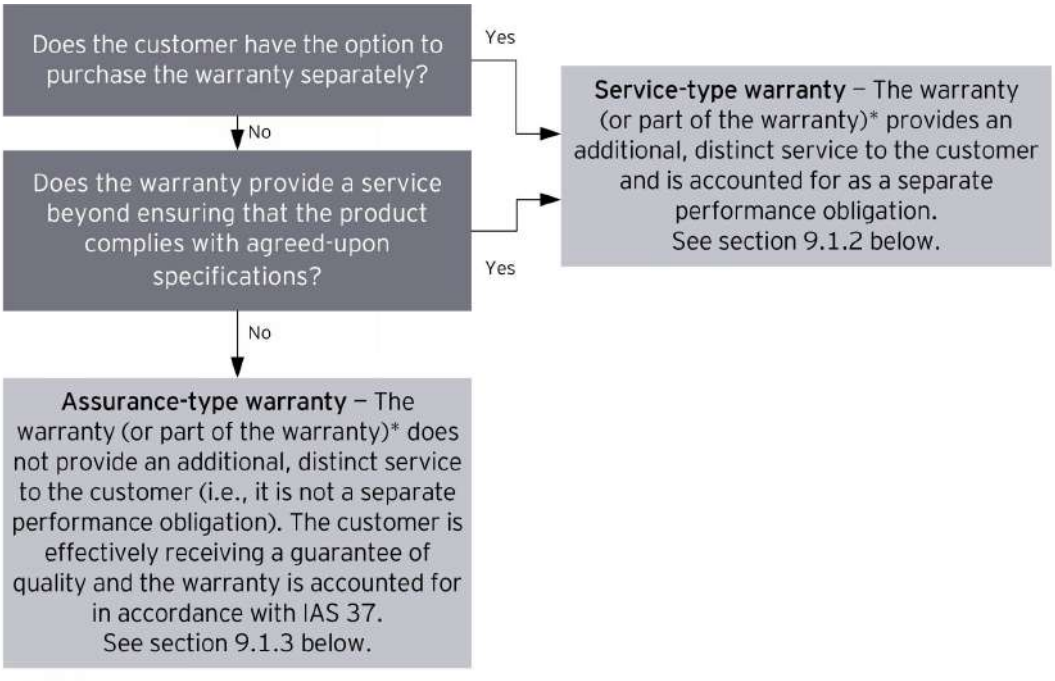
(b) The length of the warranty coverage period-the longer the coverage period, the more likely it is that the promised warranty is a performance obligation because it is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications.

(c) The nature of the tasks that the entity promises to perform-if it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (for example, a return shipping service for a defective product), then those tasks likely do not give rise to a performance obligation.

B33 A law that requires an entity to pay compensation if its products cause harm or damage does not give rise to a performance obligation. For example, a manufacturer might sell products in a jurisdiction in which the law holds the manufacturer liable for any damages (for example, to personal property) that might be caused by a consumer using a product for its intended purpose. Similarly, an entity's promise to indemnify the customer for liabilities and damages arising from claims of patent, copyright, trademark or other infringement by the entity's products does not give rise to a performance obligation. The entity shall account for such obligations in accordance with IAS 37.

The following flow chart illustrates these requirements:

Figure 9-1: Determining whether a warranty is an assurance-type or service-type warranty



* Some contracts may include both assurance-type and service-type warranties. See section 9.1.4 below for further discussion.

How we see it

Entities might need to exercise significant judgement when determining whether a warranty is an assurance-type or service-type warranty. An entity's evaluation might be affected by several factors, including common warranty practices within its industry and the entity's business practices related to warranties. For example, consider an automotive manufacturer that provides a five-year warranty on a luxury vehicle and a three-year warranty on a standard vehicle. The manufacturer might conclude that the longer warranty period is not an additional service because it believes the materials used to construct the luxury vehicle are of a higher quality and that latent defects would take longer to appear. In contrast, the manufacturer might also consider the length of the warranty period and the nature of the services provided under the warranty and conclude that the five-year warranty period, or some portion of it, is an additional service that needs to be accounted for as a service-type warranty. The standard excludes assurance-type warranties, which are accounted for in accordance with IAS 37.

As a reminder (and as discussed in section 2.5 above), elements of a contract with a customer might be in the scope of other standards and not within the scope of IFRS 15. Certain entities, particularly those that act as an agent in a revenue transaction and provide quality assurance or similar promises to a customer's customer, will need to consider whether such promises are in the scope of other standards (e.g., IFRS 17, IFRS 9) before applying the warranty application guidance in IFRS 15.

Frequently asked questions

Question 9-1: How does an entity evaluate whether a product warranty is a service-type warranty (i.e., a performance obligation) when it is not separately priced?

(TRG meeting 30 March 2015 - Agenda paper no. 29)

TRG members generally agreed that the evaluation of whether a warranty provides a service (in addition to the assurance that the product complies with agreed specifications) requires judgement and depends on the facts and circumstances. There is no bright line in the standard on what constitutes a service-type warranty, beyond it being separately priced.

However, IFRS 15.B31 includes three factors that need to be considered in each evaluation: (1) whether the warranty is required by law; (2) the length of the warranty coverage; and (3) the nature of the tasks that the entity promises to perform. Consider the following Illustration, based on an example from the TRG agenda paper, which shows the factors an entity considers in assessing whether a product warranty is a service-type warranty:

Illustration 9-1: Consideration of service-type warranty factors

A luggage company provides a life-time warranty to repair broken or damaged baggage free of charge.

The luggage company evaluates the three factors in IFRS 15.B31 and determines that the warranty is a performance obligation in addition to the assurance that the product complies with agreed-upon specifications because: (1) there is no law that requires the luggage company to make a promise for the lifetime of the product; (2) the length of the warranty is for the life of the baggage; and (3) the tasks include both repairs to baggage that does not meet the promised specifications and repairs for broken or damaged baggage.

Furthermore, the TRG agenda paper emphasised that entities need to evaluate each type of warranty offered to determine the appropriate accounting treatment.[136]

Question 9-2: How would an entity account for a customary business practice of providing repairs provided outside the stated contractual warranty period?

An entity must consider all facts and circumstances, including the factors in IFRS 15.B31 (e.g., the nature of the services provided, the length of the implied warranty period) to determine whether a customary business practice of providing repairs outside the stated contractual warranty period needs to be accounted for as an implied assurance-type or service-type warranty. For example, an equipment manufacturer might give its customers a standard product warranty that provides assurance that the product complies with agreed-upon specifications for one year from the date of purchase. However, the entity might also provide an implied warranty by frequently repairing products for free after the one-year standard warranty period has ended. See section 4.1 above for a discussion of implied promises in a contract with a customer.

136 TRG Agenda paper no. 29, *Warranties*, dated 30 March 2015 and TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015.

If the entity determines that the repairs made during the implied warranty period generally involve defects that existed when the product was sold and the repairs occur shortly after the assurance warranty period, it is likely that the entity would conclude that the repairs are covered by an assurance-type warranty. That is, the term of the assurance-type warranty might be longer than that stated in the contract. However, all facts need to be considered to reach a conclusion.

If the entity determines that the repairs made during the implied warranty period are covered by a service-type warranty (because the entity is providing a service to the customer beyond fixing defects that existed at the time of sale), it also needs to consider whether the term of the service-type warranty is longer than that stated in the contract.

Question 9-3: Does an entity account for a customer's return of a defective item in exchange for compensation (i.e., not for a replacement item) as a right of return or an assurance-type warranty?

How we see it

We believe that an entity that is the principal in the transaction must account for a customer's right to return a defective item in return for cash (instead of a replacement item) under the right of return application guidance in IFRS 15.B20-B27, rather than as an assurance-type warranty.

The Basis for Conclusions states that "… the boards decided that an entity should recognise an assurance-type warranty as a separate liability to replace or repair a defective product". *[IFRS 15.BC376]*. This description of an assurance-type warranty does not include defective products that are returned for a refund. It only contemplates defective products that are replaced or repaired. See section 5.4 above for a discussion of rights of return.

If an entity provides customers with an option to receive either a cash refund or a replacement product, the entity is required to estimate which options customers will choose and account for each option accordingly. That is, the entity needs to estimate the expected returns in exchange for cash as part of its accounting for estimated returns and account for the expected returns in exchange for a replacement product under the warranty application guidance.

However, there might be limited circumstances in which the cash paid to a customer for a defective item would need to be accounted for in accordance with the warranty application guidance, instead of as a right of return. For example, an entity might pay cash to a customer as reimbursement for third-party costs incurred to repair a defective item. In this case, the cash payment to the customer was incurred to fulfil the entity's warranty obligation. This assessment requires judgement and depends on the facts and circumstances.

Similarly, entities will need to apply judgement in determining the appropriate treatment for product recalls (also see Question 7-24 in section 7.3.1 above).

Question 9-4: Are liquidated damages, penalties or compensation from other similar clauses accounted for as variable consideration or as warranties under the standard?

See response to Question 5-4 in section 5.2.1 above.

9.1.2 Service-type warranties

The Board determined that a service-type warranty represents a distinct service and is a separate performance obligation. *[IFRS 15.BC371]*. Therefore, using the relative stand-alone selling price of the warranty, an entity allocates a portion of the transaction price to the service-type warranty (see section 6 above, also see section 6.1 above for a discussion on determining stand-alone selling prices, which might not be equal to the contractually stated price). The entity then recognises the allocated revenue over the period in which the service-type warranty service is provided. *[IFRS 15.B29, IFRS 15.B32]*. This is because it is likely that the customer receives and consumes the benefits of the warranty as the entity performs (i.e., it is likely that the warranty performance obligation is satisfied over time in accordance with IFRS 15.35(a), see section 7.1.1 above).

Judgement might be required to determine the appropriate pattern of revenue recognition associated with service-type warranties. For example, an entity might determine that it provides the warranty service continuously over the warranty period (i.e., the performance obligation is an obligation to 'stand ready to perform' during the stated warranty period). An entity that makes this determination is likely to recognise revenue rateably over the warranty period. An entity might also conclude that a different pattern of recognition is appropriate based on data it has collected about when it provides such services. For example, an entity might recognise little or no revenue in the first year of a three-year service-type warranty if its historical data indicates that it only provides warranty services in the second and third years of the warranty period.

The AICPA Audit and Accounting Guide, *Revenue Recognition*, provides non-authoritative guidance on how to determine the appropriate pattern of recognition for service-type warranties. The guidance says that, if an entity determines that it is standing ready to provide protection against damage, loss or malfunction of a product caused by various risks for the specified coverage period (i.e., provides assurance of use for the covered product for the coverage period that would include some level of involvement with the repair or replacement), it recognises revenue over the coverage period.

If an entity determines that it has promised to repair, arrange to repair or replace the product, it recognises revenue over the period in which it is expected to repair or replace the product. The period could extend beyond the coverage period if services to repair or replace the product are expected to be provided after the coverage period ends.

For example, a claim might be filed at the end of a one-year period, but it is fulfilled after the coverage period ends. While the activities in both instances might be similar, the nature of the promise to the customer determines the period of recognition.[137] Section 7.1.4 above describes considerations for determining the appropriate pattern of revenue recognition, including those for stand-ready obligations. If payment for the service-type warranty is received upfront, an entity must also evaluate whether a significant financing component exists (see section 5.5 above).

In some instances, entities that sell service-type warranties will buy insurance to protect themselves against the potential costs of performing under such warranties. Although the anticipated insurance proceeds might offset any costs that the entity might incur, immediate revenue recognition for the price of the service-type warranty is not appropriate. The entity has not been relieved of its obligation to perform under the terms of the warranty contract and, therefore, a liability still exists. Accordingly, the warranty obligation and any proceeds related to the insurance coverage need to be accounted for separately (unless the insurer has legally assumed the warranty obligation and the customer has acknowledged that fact).

As discussed in section 6.1 above, stand-alone selling prices are determined at contract inception and are not updated to reflect changes in the period between contract inception and when performance is complete (unless the contract has been modified and the contract modification is accounted for as a new or separate contract - see section 6.1.3 above). Accordingly, an entity generally would not change the amount of transaction price it originally allocated to the service-type warranty at contract inception. This would be the case even if, for example, an entity discovers two months after a product is shipped that the cost of a part acquired from a third-party manufacturer has tripled and that, as a result, it will cost the entity significantly more to replace that part if a warranty claim is made. However, for future contracts involving the same warranty, the entity would need to determine whether to revise the stand-alone selling price because of the increase in the costs to satisfy the warranty and, if so, use that revised price for future allocations (see section 6.1.3 above).

9.1.3 Assurance-type warranties

The Board concluded that assurance-type warranties do not provide an additional good or service to the customer (i.e., they are not separate performance obligations). By providing this type of warranty, the selling entity has effectively provided a guarantee of quality. In accordance with IFRS 15.B30, these types of warranties are accounted for as warranty obligations and the estimated cost of satisfying them is accrued in accordance with the requirements in IAS 37. *[IFRS 15.BC376]*. Once recorded, the warranty liability is assessed on an ongoing basis in accordance with IAS 37 (see Chapter 27).

An entity recognises revenue for sales of goods or services, including assurance-type warranties, when control of the goods or services is transferred to the customer, assuming that the arrangement meets the criteria to be considered a contract under IFRS 15 (see section 3.1 above).

Assurance-type warranties are accounted for outside of the scope of IFRS 15. Therefore, if an entity elects to use a costs incurred measure of progress for over time revenue recognition of the related good or service, the costs of satisfying an assurance-type warranty are excluded (i.e., excluded from both the numerator and the denominator in the measure of progress calculation - see section 7.1.4 above for further discussion on measuring progress over time).

137 See AICPA guide, *Revenue Recognition*, Chapter 1, *General Accounting Considerations*, paragraphs 1.63 - 1.75.

9.1.4 Contracts that contain both assurance and service-type warranties

If an entity provides both an assurance-type and service-type warranty within a contract and the entity cannot reasonably account for them separately, the warranties are accounted for as a single performance obligation (i.e., revenue would be allocated to the combined warranty and recognised over the period the warranty services are provided). *[IFRS 15.B32].* The Board noted that this accounting would ensure the entity does not overstate the recognition of revenue at the time the product is transferred to the customer. *[IFRS 15.BC376].*

When an assurance-type warranty and a service-type warranty are both present in a contract with a customer and can reasonably account for them separately, an entity is required to accrue for the expected costs associated with the assurance-type warranty and defer the revenue for the service-type warranty, as illustrated below:

Illustration 9-2: Service-type and assurance-type warranties

An entity manufactures and sells computers that include an assurance-type warranty for the first 90 days. The entity offers an optional 'extended coverage' plan under which it will repair or replace any defective part for three years from the expiration of the assurance-type warranty. Since the optional 'extended coverage' plan is sold separately, the entity determines that the three years of extended coverage represent a separate performance obligation (i.e., a service-type warranty).

The total transaction price for the sale of a computer and the extended warranty is CU3,600. The entity determines that the stand-alone selling prices of the computer and the extended warranty are CU3,200 and CU400, respectively. The inventory value of the computer is CU1,440. Furthermore, the entity estimates that, based on its experience, it will incur CU200 in costs to repair defects that arise within the 90-day coverage period for the assurance-type warranty. As a result, the entity will record the following entries:

Dr	Cash/Trade receivables		CU3,600	
Dr	Warranty expense		CU200	
	Cr	Accrued warranty costs (assurance-type warranty)		CU200
	Cr	Contract liability (service-type warranty)		CU400
	Cr	Revenue		CU3,200

To record revenue and liabilities related to warranties.

Dr		Cost of goods sold	CU1,440	
	Cr	Inventory		CU1,440

To relieve inventory and recognise cost of goods sold.

The entity derecognises the accrued warranty liability associated with the assurance-type warranty as actual warranty costs are incurred during the first 90 days after the customer receives the computer. The entity recognises the contract liability associated with the service-type warranty as revenue during the contract warranty period and recognises the costs associated with providing the service-type warranty as they are incurred. The entity would need to be able to determine whether the repair costs incurred are applied against the warranty reserve it had already established for claims that occur during the first 90 days or recognised as an expense as incurred.

Accounting for both assurance-type warranties and service-type warranties in the same transaction can be complex. Entities might need to develop processes to match individual warranty claims with the specific warranty plans so that claims can be analysed for the appropriate accounting treatment. This individual assessment of warranty claims is necessary because the assurance-type warranty costs will have been accrued previously, while the service-type warranty costs are expenses that need to be recognised in the period in which they are incurred, as illustrated below:

Illustration 9-3: Service-type and assurance-type warranty costs

Assume the same facts as in Illustration 9-2 above, but assume the entity has sold 500 computers during the year. In January of the following year, CU10,000 of warranty claims are submitted by customers. The entity analyses each claim and identifies the specific computer sale to which the claims relate. The entity needs to do this in order to determine eligibility under the warranty plans and the appropriate accounting treatment.

The entity determines that a portion of the claims, costing CU2,500 for repair and replacement parts, are covered by the assurance-type warranty plan. As shown in Illustration 9-2 above, the expected cost of each assurance-type warranty was accrued at the time of the sale. The entity records the following entry to derecognise a portion of the warranty liability:

Dr	Accrued warranty costs (assurance-type warranty)		CU2,500	
	Cr	Cash		CU2,500

To derecognise the assurance-type warranty liability as the costs are incurred.

The entity also determines that a portion of the claims, costing CU7,000 for repair and replacement parts, are eligible under the 'extended coverage' plan (i.e., the service-type warranty). The entity records the following entry to recognise the costs associated with the service-type warranty:

Dr	Warranty expense		CU7,000	
	Cr	Cash		CU7,000

To record the costs of the service-type warranty as the costs are incurred.

The entity also determines that CU500 of the claims are not eligible under either warranty plan. This is because the claims relate to incidents that occurred after the 90-day coverage period for the assurance-type warranty and the customers in those transactions did not purchase the extended warranty coverage. The entity rejects these customer claims.

9.2 Onerous contracts

Entities are required to use the requirements in IAS 37 to identify and measure onerous revenue contracts. *[IFRS 15.BC296]*. IAS 37 requires the following in respect of onerous contracts: *[IAS 37.66-69]*

Extract from IAS 37

Onerous contracts

66 **If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision.**

67 Many contracts (for example, some routine purchase orders) can be cancelled without paying compensation to the other party, and therefore there is no obligation. Other contracts establish both rights and obligations for each of the contracting parties. Where events make such a contract onerous, the contract falls within the scope of this Standard and a liability exists which is recognised. Executory contracts that are not onerous fall outside the scope of this Standard.

68 This Standard defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.

68A The cost of fulfilling a contract comprises the costs that relate directly to the contract. Costs that relate directly to a contract consist of both:

(a) the incremental costs of fulfilling that contract-for example, direct labour and materials; and

(b) an allocation of other costs that relate directly to fulfilling contracts-for example, an allocation of the depreciation charge for an item of property, plant and equipment used in fulfilling that contract among others.

69 Before a separate provision for an onerous contract is established, an entity recognises any impairment loss that has occurred on assets used in fulfilling the contract (see IAS 36).

The requirements in IAS 37 on onerous contracts are discussed generally in Chapter 27 at section 6.2 and for contracts with customers specifically in Chapter 27 at section 6.2.2.

If an entity determines a contract is onerous under IAS 37, the provision for the onerous contract will reflect the lower of the penalty for terminating the contract or the present value of the net cost of fulfilling the contract. Contracts need to be reviewed to determine whether there are any special terms that might relieve an entity of its obligations (e.g., *force majeure*). Contracts that can be cancelled without paying compensation to the other party do not become onerous as there is no obligation.

Frequently asked questions

Question 9-5: How does an entity account for an onerous contract with a customer when the contract includes more than one performance obligation that is satisfied over time consecutively?

How we see it

Since the requirements for onerous contracts are outside the scope of IFRS 15, an entity's accounting for onerous contracts does not affect the accounting for its revenue from contracts with customers in accordance with IFRS 15.

Therefore, we believe that entities must use an 'overlay' approach, which consists of two steps:

1. Apply the requirements of IFRS 15 to measure progress in satisfying each performance obligation over time and account for the related costs when incurred in accordance with the applicable standards.
2. At the end of each reporting period, apply IAS 37 to determine if the remaining contract as a whole is onerous (i.e., considering whether the revenue still to be recognised is less than the costs yet to be incurred). If an entity concludes that the remaining contract is onerous, it recognises a provision to the extent that the amount of the unavoidable costs under the contract exceed the economic benefits to be received under it.

The effect of the provision is recognised as an expense, not as an adjustment to revenue. A change in the provision is recognised in profit or loss in accordance with IAS 37.59. *[IAS 37.59]*.

Since the definition of an onerous contract in IAS 37.10 refers only to a contract, the unit of account to determine whether an onerous contract exists is the contract itself, rather than the performance obligations identified in accordance with IFRS 15. *[IAS 37.10, IFRS 15.BC295]*. As a result, the entity must consider the entire remaining contract, including remaining revenue to be recognised for unsatisfied, or partially unsatisfied, performance obligations and the remaining costs to fulfil those performance obligations.

FASB differences

While requirements exist for some industries or for certain types of transactions, there is no general authoritative standard in US GAAP for when to recognise losses on onerous contracts and, if a loss is to be recognised, how to measure the loss. Accordingly, there is diversity in practice when such contracts are not within the scope of specific authoritative standards.

ASC 605-35, *Revenue Recognition - Provision for Losses on Construction-Type and Production-Type Contracts*, applies to situations in which an entity is expected to incur a loss on a contract within its scope and specifies that the assessment is performed at either the contract level or at the performance obligation level as an accounting policy election.

As the FASB's requirements on onerous contracts are not the same as those in IAS 37, the accounting treatment in this area is not converged.

9.3 Contract costs

IFRS 15 specifies the accounting treatment for costs an entity incurs to obtain and fulfil a contract to provide goods or services to customers as discussed below. An entity only applies those requirements to costs incurred that relate to a contract with a customer that is within the scope of IFRS 15 (see section 2 above). *[IFRS 15.8]*.

It is important to note that IFRS 15 provides guidance on certain costs relating to contracts with customers in the scope of IFRS 15 (i.e., the incremental costs of obtaining a contract and costs incurred to fulfil a contract). However, it does not provide comprehensive cost guidance and must only be applied if the costs are not in the scope of other IFRS accounting standards. That is, if other IFRS accounting standards precludes the recognition of an asset for a particular cost, an asset cannot be recognised under IFRS 15. If the costs are not in the scope of other IFRS accounting standards, an entity would then evaluate whether the costs meet the criteria for capitalisation under IFRS 15. *[IFRS 15.8, IFRS 15.BC307]*.

When an entity recognises capitalised contract costs under IFRS 15, any such assets must be presented separately from contract assets and contract liabilities (see section 10.1 below) in the statement of financial position or disclosed separately in the notes to the financial statements. Furthermore, entities must consider the requirements in IAS 1 (or IFRS 18,[138] if adopted early) on classification of current assets when determining whether their contract cost assets are presented as current or non-current. See section 10.1.2 below for a discussion on classification as current or non-current.

9.3.1 Costs to obtain a contract

Before applying the cost requirements in IFRS 15, entities need to consider the scoping provisions of the standard. If a payment is made to a customer, an entity first needs to consider whether the requirements on consideration payable to a customer under IFRS 15 apply to the costs (see section 5.7 above for a discussion on accounting for consideration paid or payable to a customer). *[IFRS 15.BC255, IFRS 15.BC256]*.

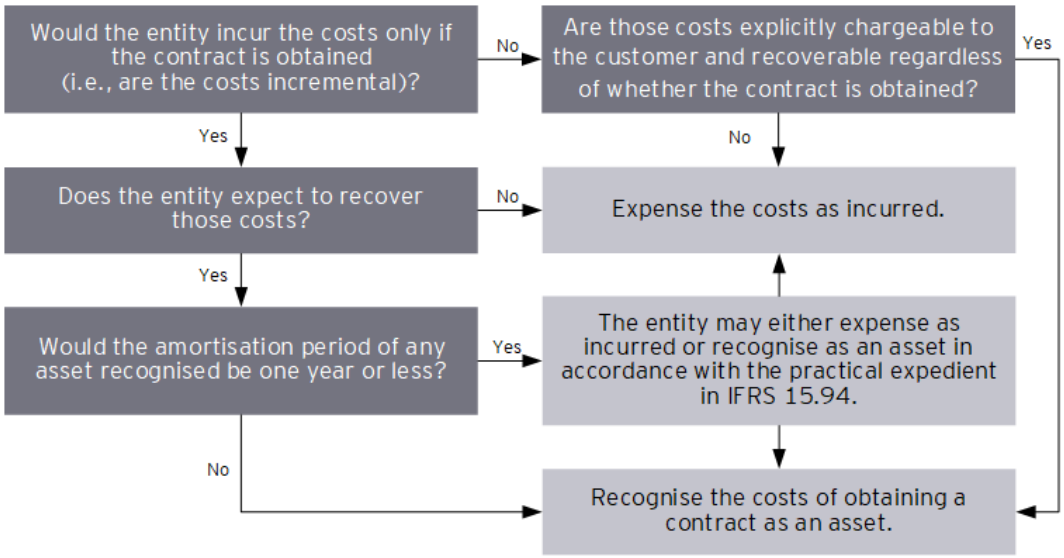
For costs that are within the scope of the cost requirements in IFRS 15, the standard requires that incremental costs of obtaining a contract with a customer are recognised as an asset if the entity expects to recover them. *[IFRS 15.91, IFRS 15.92, IFRS 15.93]*. An entity can expect to recover contract acquisition costs through direct recovery (i.e., reimbursement under the contract) or indirect recovery (i.e., through the margin inherent in the contract). Incremental costs are those that an entity would not have incurred if the contract had not been obtained. *[IFRS 15.92]*.

To determine whether a cost is recoverable, an entity needs to include the future cash inflows and outflows associated with the contract renewal or extension periods if the period of benefit of the costs under assessment is expected to extend beyond the present contract (see section 9.3.3 below for further discussion on the period of benefit). Furthermore, when determining the amount it expects to receive as part of the recoverability assessment, an entity would not apply the requirements on constraining estimates of variable consideration. That is, if an entity were required to reduce the estimated transaction price because of the constraint on variable consideration, it would use the unconstrained transaction price to evaluate recoverability of the contract acquisition costs. The unconstrained transaction price also needs to be adjusted to reflect the customer's credit risk. This recoverability assessment for the costs to obtain a contract is similar to the impairment assessment discussed in section 9.3.4 below.

Costs incurred to obtain a contract that are not incremental costs must be expensed as incurred, unless they are explicitly chargeable to the customer (regardless of whether the contract is obtained).

The following flow chart illustrates the requirements in IFRS 15:

Figure 9-2: Costs to obtain a contract



138 IFRS 18 supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted). See Chapter 4 for further details on the requirements of IFRS 18.

In a FASB TRG agenda paper, the FASB staff suggested that, to determine whether a cost is incremental, an entity considers whether it would incur the cost if the customer (or the entity) decides, just as the parties are about to sign the contract, that it will not enter into the contract. If the costs would have been incurred even if the contract is not executed, the costs are not incremental to obtaining that contract. The FASB staff also noted that the objective of this requirement is not to allocate costs that are associated in some manner with an entity's marketing and sales activity, but only to identify those costs that an entity would not have incurred if the contract had not been obtained. For example, salaries and benefits of sales employees that are incurred regardless of whether a contract is obtained are not incremental costs.[139]

Consider the following Illustration based on an example from the FASB TRG agenda paper:[140]

Illustration 9-4: Fixed employee salaries

An entity pays an employee an annual salary of CU100,000. The employee's salary is based on the number of contracts he or she signed for the prior year, as well as the number of contracts the employee is expected to sign for the current year. The employee's current year salary will not change if the number of contracts the employee actually signs differs from the projected number. However, any difference would affect the employee's salary in the following year.

FASB TRG members generally agreed that no portion of the employee's salary will be capitalised because it is not an incremental cost of obtaining a contract. The employee's salary would have been incurred regardless of the number of contracts the employee has actually signed during the current year.

The standard cites sales commissions as a type of an incremental cost that might require capitalisation under the standard. For example, commissions that are related to sales from contracts signed during the period might represent incremental costs that would require capitalisation. The standard does not explicitly address considerations for different types of commission programmes. Therefore, entities have to exercise judgement to determine whether sales commissions are incremental costs and, if so, the point in time when the costs would be capitalised. However, the FASB TRG members generally agreed that an employee's title or level in the organisation or how directly involved the employee is in obtaining the contract, are not factors in assessing whether a sales commission is incremental.[141] Consider the following Illustration based on an example from a FASB TRG paper:[142]

Illustration 9-5: Commissions paid to different levels of employees

An entity's salesperson receives a 10% sales commission on each contract that he or she obtains. In addition, the following employees of the entity receive sales commissions on each signed contract negotiated by the salesperson: 5% to the manager and 3% to the regional manager.

FASB TRG members generally agreed that all of the commissions are incremental because the commissions would not have been incurred if the contract had not been obtained. IFRS 15 does not distinguish between commissions paid to the employee(s) based on the function or the title of the employee(s) that receives a commission. It is the entity that decides which employee(s) are entitled to a commission as a result of obtaining a contract.

How we see it

We believe that commissions that are paid to a third party in relation to sales from contracts that were signed during the period might also represent incremental costs that would require capitalisation. That is, commissions paid to third parties must be evaluated in the same manner as commissions paid to employees in order to determine whether they are required to be capitalised.

In addition, entities need to carefully evaluate all compensation plans, not just sales commission plans, to determine whether any plans contain incremental costs that need to be capitalised. For example, payments under a compensation 'bonus' plan might be solely tied to contracts that are obtained. Such costs would be capitalised if they are incremental costs of obtaining a contract, irrespective of the title of the plan.

139 FASB TRG Agenda paper no. 57, *Capitalization and Amortization of Incremental Costs of Obtaining a Contract*, dated 7 November 2016.

140 FASB TRG Agenda paper no. 57, *Capitalization and Amortization of Incremental Costs of Obtaining a Contract*, dated 7 November 2016.

141 FASB TRG Agenda paper no. 60, *November 2016 Meeting - Summary of Issues Discussed and Next Steps*, dated 31 January 2017.

142 FASB TRG Agenda paper no. 57, *Capitalization and Amortization of Incremental Costs of Obtaining a Contract*, dated 7 November 2016.

Illustration 9-6: Commissions paid to a pool of funds

Assume that an entity has a compensation plan for support personnel in its sales department. As a group, the employees are entitled to a pool of funds calculated based on 2% of all new contracts signed during the monthly period. Once the amount of the pool is known, the amount paid to each individual employee is determined based on each employee's rating.

While the amount paid to each employee is discretionary (based on each employee's rating), the total amount of the pool is considered an incremental cost to obtain a contract because the entity owes that amount to the employees (as a group) simply because a contract was signed.

The TRG members discussed the underlying principle for capitalising costs under the standard and generally agreed that entities first need to refer to the applicable liability standard (e.g., IAS 37, IFRS 9) to determine when they are required to accrue for certain costs. Entities then use the requirements in IFRS 15 to determine whether the related costs need to be capitalised. TRG members acknowledged that certain aspects of the cost requirements require entities to apply significant judgement in analysing the facts and circumstances and determining the appropriate accounting treatment.[143]

In addition, the IASB staff observed in a TRG agenda paper that incremental costs of obtaining a contract are not limited to initial incremental costs. Commissions recognised subsequent to contract inception (e.g., commissions paid on modifications, commissions subject to contingent events or clawback) because they did not meet the recognition criteria for liabilities at contract inception would still be considered for capitalisation as costs to obtain the contract when the liability is recognised. This would include costs related to contract renewals because, as mentioned in the TRG agenda paper, a renewal is a contract and there is nothing in the requirements for costs to obtain a contract that suggests a different treatment for contracts that are renewals of existing contracts. That is, the only difference between the two costs would be the timing of recognition based on when a liability has been incurred.[144] See Question 9-8 below for additional discussion of capitalising commissions paid on contract modifications.

Unlike many commissions, some incentive payments, such as bonuses and other compensation that are based on quantitative or qualitative metrics that are not related to contracts obtained (e.g., profitability, earnings per share (EPS), performance evaluations) are unlikely to meet the criteria for capitalisation, because they are not incremental to obtaining a contract. However, a legal contingency cost might be an incremental cost of obtaining a contract, for example, when a lawyer is entitled to be paid only upon the successful completion of a negotiation. Determining which costs must be capitalised under the standard might require judgement and it is possible that some contract acquisition costs are determined to be incremental and others are not. Consider the following Illustration based on an example from a FASB TRG agenda paper:[145]

Illustration 9-7: Incremental and non-incremental costs for the same contract

An entity pays a 5% sales commission to its employees when they obtain contracts with customers. An employee begins negotiating a contract with a prospective customer and the entity incurs CU5,000 in legal and travel costs in the process of trying to obtain the contract. The customer ultimately enters into a CU500,000 contract and, as a result, the employee receives a sales commission of CU25,000.

The FASB TRG members generally agreed that the entity will only capitalise the commission paid to the employee of CU25,000. This cost is the only one that is incremental to obtaining the contract. While the entity incurs other costs that are necessary to facilitate a sale (e.g., legal, travel), those costs would have been incurred even if the contract had not been obtained.

143 TRG agenda paper no. 23, *Incremental costs of obtaining a contract*, dated 26 January 2015.

144 TRG agenda paper no. 23, *Incremental costs of obtaining a contract*, dated 26 January 2015.

145 FASB TRG Agenda paper no. 57, *Capitalization and Amortization of Incremental Costs of Obtaining a Contract*, dated 7 November 2016.

The standard provides the following example regarding incremental costs of obtaining a contract:
[IFRS 15.IE Example 36, IFRS 15.IE189-IE191]

Extract from IFRS 15

Example 36-Incremental costs of obtaining a contract

An entity, a provider of consulting services, wins a competitive bid to provide consulting services to a new customer. The entity incurred the following costs to obtain the contract:

	CU
External legal fees for due diligence	15,000
Travel costs to deliver proposal	25,000
Commissions to sales employees	10,000
Total costs incurred	50,000

In accordance with paragraph 91 of IFRS 15, the entity recognises an asset for the CU10,000 incremental costs of obtaining the contract arising from the commissions to sales employees because the entity expects to recover those costs through future fees for the consulting services. The entity also pays discretionary annual bonuses to sales supervisors based on annual sales targets, overall profitability of the entity and individual performance evaluations. In accordance with paragraph 91 of IFRS 15, the entity does not recognise an asset for the bonuses paid to sales supervisors because the bonuses are not incremental to obtaining a contract. The amounts are discretionary and are based on other factors, including the profitability of the entity and the individuals' performance. The bonuses are not directly attributable to identifiable contracts.

The entity observes that the external legal fees and travel costs would have been incurred regardless of whether the contract was obtained. Therefore, in accordance with paragraph 93 of IFRS 15, those costs are recognised as expenses when incurred, unless they are within the scope of another Standard, in which case, the relevant provisions of that Standard apply.

As a practical expedient, the standard permits an entity to immediately expense contract acquisition costs when the asset that would have resulted from capitalising such costs would have been amortised within one year or less. *[IFRS 15.94]*. It is important to note that the amortisation period for incremental costs is not always the initial contract term (see further discussion on this in Question 9-13 below). Also see section 9.3.3 below for discussion of the amortisation of capitalised contract costs.

Frequently asked questions

Question 9-6: Does the timing of commission payments affect whether they are incremental costs?

(FASB TRG meeting 7 November 2016 - Agenda paper no. 57)

FASB TRG members generally agreed that the timing of commission payments does not affect whether the costs would have been incurred if the contract had not been obtained. However, there could be additional factors or contingencies that would need to be considered in different commission plans that could affect the determination of whether all (or a portion) of a cost is incremental.[146] Consider the following Illustration based on an example from a FASB TRG agenda paper:

Illustration 9-8: Timing of commission payments

An entity pays an employee a 4% sales commission on a CU50,000 signed contract with a customer. For cash flow management purposes, the entity pays the employee half of the commission (i.e., 2% of the total contract value) upon completion of the sale and the remainder in six months' time. The employee is entitled to receive the unpaid commission even if he or she is no longer employed by the entity when payment is due.

FASB TRG members generally agreed that the entity would capitalise the entire commission in this example (the timing of which would coincide with the recognition of the related liability). That is, the entity would not just capitalise the portion it paid immediately and expense the rest.

In this fact pattern, only the passage of time is required for the entity to pay the second half of the commission. For example, in some commission plans, the employee will only be entitled to the second half of the commission payment if the employee is still employed by the entity when the commission is due. For such plans, an entity needs to carefully evaluate whether the requirement to remain employed in order to receive the commission (i.e., the service vesting condition) is substantive.

How we see it

We believe that the second half of the commission payment would not be incremental if the service condition is substantive because other conditions are necessary, beyond simply obtaining the contract, for the entity to incur the cost.

If the entity's payment of a commission is only 'contingent' on a customer paying the amount due in the obtained contract, we do not believe this would influence the determination of whether the commission is an incremental cost, provided the contract meets the Step 1 criteria to be accounted for as a contract under the five-step model (see section 3.1 above). However, if there is an extended payment term (i.e., there is a significant amount of time between contract signing and the date in which the contract consideration is due), the entity needs to consider whether there is a service condition or other contingency, as discussed above.

Question 9-7: Would commission payments subject to a threshold be considered incremental costs?

(FASB TRG meeting 7 November 2016 - Agenda paper no. 57)

FASB TRG members generally agreed that basing a commission on a pool of contracts, rather than paying a set percentage for each contract, would not affect the determination of whether the commissions would have been incurred if the entity did not obtain the contracts with those customers.[147]

146 FASB TRG Agenda paper no. 60, *November 2016 Meeting - Summary of Issues Discussed and Next Steps*, dated 31 January 2017.

147 FASB TRG Agenda paper no. 60, *November 2016 Meeting - Summary of Issues Discussed and Next Steps*, dated 31 January 2017.

Consider the following example in a TRG agenda paper:

Illustration 9-9: Commission payments subject to a threshold

An entity has a commission programme that increases the amount of commission a salesperson receives based on how many contracts the salesperson has obtained during an annual period, as follows:

0-9 contracts	0% commission
10-19 contracts	2% of value of contracts 1-19
20+ contracts	5% of value of contracts 1-20+

FASB TRG members generally agreed that these costs are incremental costs of obtaining a contract with a customer. Therefore, the costs will be capitalised when the entity incurs a liability to pay these commissions. The costs are incremental because the entity will pay the commission under the programme terms as a result of entering into the contracts. See Question 9-25 in section 9.3.3 below for discussion about the period over which an entity would amortise a sales commission that is subject to a threshold and is considered an incremental cost of obtaining a contract.

Question 9-8: Would an entity capitalise commissions paid on contract modifications?

(TRG meeting 26 January 2015 - Agenda paper no. 23)

If commissions paid on contract modifications are incremental (i.e., they would not have been incurred if there had not been a modification) and recoverable, an entity would capitalise them. Contract modifications are accounted for in one of three ways: (1) as a separate contract; (2) as a termination of the existing contract and the creation of a new contract; or (3) as part of the existing contract (see section 3.4 above for further requirements on contract modifications). In all three cases, commissions paid on contract modifications are incremental costs of obtaining a contract and must be capitalised if they are recoverable. In the first two cases, a separate or new contract is created, so the costs of obtaining that contract would be incremental.

The TRG agenda paper said that commissions paid on the modification of a contract that is accounted for as part of the existing contract are incremental costs even though they are not initial incremental costs. Also see Question 9-11 below for further discussion of accounting for capitalised commissions upon a modification of the contract that is treated as the termination of an existing contract and the creation of a new contract.

Question 9-9: Would fringe benefits on commission payments be included in the capitalised amounts?

(TRG meeting 26 January 2015 - Agenda paper no. 23)

Fringe benefits must be capitalised as part of the incremental cost of obtaining a contract if the additional costs are based on the amount of commissions paid and the commissions qualify as costs to obtain a contract. However, if the costs of fringe benefits would have been incurred regardless of whether the contract had been obtained (e.g., health insurance premiums), the fringe benefits must not be capitalised. That is, an entity cannot allocate fringe benefits to the commission and, therefore, capitalise a portion of the costs of benefits it would provide regardless of whether the commission was paid.

Question 9-10: Must an entity apply the practical expedient to expense contract acquisition costs to all of its qualifying contracts across the entity or can it apply the practical expedient to individual contracts?

How we see it

We believe the practical expedient to expense contract acquisition costs (that would, otherwise, be amortised over a period of one year or less) must be applied consistently to contracts with similar characteristics and in similar circumstances.

Question 9-11: How would an entity account for capitalised commissions upon a modification of the contract that is treated as the termination of an existing contract and the creation of a new contract?

How we see it

We believe an asset recognised for incremental costs to obtain a contract that exists when the related contract is modified must be carried forward into the new contract, if the modification is treated as the termination of an existing contract and the creation of a new contract and the goods or services to which the original contract cost asset relates are part of the new contract.

This is because the contract cost asset relates to goods or services that have not yet been transferred and the accounting for the modification is prospective. This conclusion is similar to the one reached by FASB TRG members in relation to the accounting for contract assets upon a contract modification, as discussed in Question 10-5 in section 10.1.5 below.

The contract cost asset that remains on the entity's statement of financial position at the date of modification would continue to be evaluated for impairment in accordance with IFRS 15 (see section 9.3.4 below). In addition, an entity must determine an appropriate amortisation period for the contract cost asset (see section 9.3.3 below).

Question 9-12: Can an entity choose whether to capitalise incremental costs to obtain a contract that it expects to recover?

An entity cannot choose whether to capitalise incremental costs to obtain a contract that it expects to recover. As discussed above, an entity is required to capitalise incremental costs to obtain a contract if it expects to recover those costs. However, as a practical expedient, entities are allowed to recognise the incremental costs of obtaining a contract as an expense only if the asset that would have resulted from capitalising these costs would have been amortised in one year or less.

Question 9-13: Would an entity consider contract renewals when assessing whether the practical expedient applies?

Contract renewals are considered when assessing whether the practical expedient for incremental costs to obtain a contract applies. As discussed above, as a practical expedient, entities are allowed to recognise the incremental costs of obtaining a contract as an expense only if the asset that would have resulted from capitalising these costs would have been amortised in one year or less. That is, the ability to apply the practical expedient depends on the amortisation period rather than the initial contract term.

As discussed further in section 9.3.3 below, in order to determine the amortisation period for capitalised incremental costs to obtain a contract, an entity needs to consider whether the capitalised contract costs only relate to goods or services that will be transferred under the initial contract or whether the costs also relate to goods or services that will be transferred under a specific anticipated contract.

If an entity's past experience indicates that a renewal is likely, the entity needs to determine whether the renewal commission is commensurate with the initial commission; if not, the amortisation period for the initial commission would be longer than the initial term. If the amortisation period extends beyond one year due to expected contract renewals, the practical expedient would not be available to the entity.

Question 9-14: If a contract contains more than one performance obligation, can an entity apply the practical expedient?

Whether the practical expedient for incremental costs to obtain a contract will apply when a contract contains more than one performance obligation will depend on the specific facts and circumstances. Entities are allowed to recognise the incremental costs of obtaining a contract as an expense only if the asset resulting from capitalising these costs would have been amortised in one year or less. As discussed further in Question 9-24 in section 9.3.3 below, we believe an entity can attribute capitalised contract costs to individual performance obligations in a contract, but it is not required to do so. That is, an entity can use multiple approaches to determine the amortisation period provided that the asset recognised is amortised on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates.

Reasonable approaches could include:

- Amortising a single capitalised contract cost using one measure of performance considering all of the performance obligations in the contract
- Allocating the capitalised costs to all performance obligations in the contract on a relative basis and determining an appropriate amortisation period for each performance obligation

  Or
- Allocating specific capitalised contracts costs to individual performance obligations in the contract (but not all) when the costs relate specifically to certain goods or services (but not all) in the contract

Regardless of the approach used to determine the appropriate amortisation period for a capitalised contract cost related to a contract containing multiple performance obligations, all of the amortisation periods related to the contract would have to be one year or less for an entity to apply the practical expedient. If any amortisation period related to the contract extends beyond one year, the entity cannot apply the practical expedient.

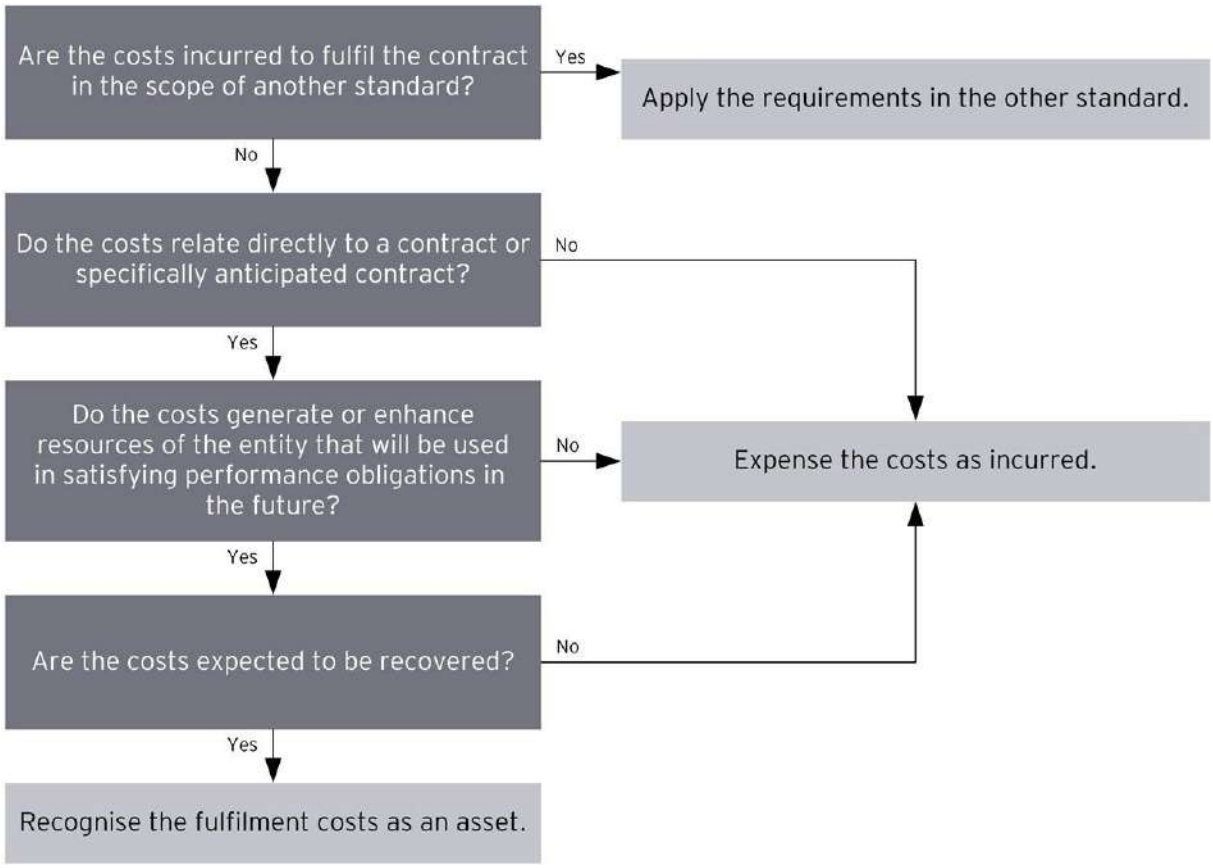
9.3.2 Costs to fulfil a contract

The standard divides contract fulfilment costs into two categories: (1) costs that give rise to an asset; and (2) costs that are expensed as incurred. When determining the appropriate accounting treatment for such costs, IFRS 15 makes it clear that any other applicable standards (e.g., IAS 2, IAS 16 and IAS 38) are considered first. That is, if costs incurred in fulfilling a contract are within the scope of another standard, an entity accounts for those costs in accordance with those other standards. *[IFRS 15.95, IFRS 15.96]*. If those other standards preclude capitalisation of a particular cost, then an asset cannot be recognised under IFRS 15. *[IFRS 15.BC307]*. If the costs incurred to fulfil a contract are not within the scope of another standard, an entity capitalises such costs only if they meet all of the following criteria: *[IFRS 15.95]*

- The costs directly relate to a contract or to a specifically identifiable anticipated contract (e.g., costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved).
- The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.
- The costs are expected to be recovered.

If all of the criteria are met, an entity is required to capitalise the costs. The following flow chart illustrates these requirements:

Figure 9-3: Costs to fulfil a contract



Standards that might be applicable to costs to fulfil a contract with a customer include, but are not limited to, the following:

- Inventory costs within the scope of IAS 2
- Costs related to the acquisition of an intangible asset within the scope of IAS 38
- Costs attributable to the acquisition or construction of property, plant and equipment within the scope of IAS 16 or an investment property within the scope of IAS 40
- Costs related to biological assets or agricultural produce within the scope of IAS 41 *Agriculture* or bearer plants within the scope of IAS 16

Example 37 in the standard (included below) illustrates some costs that are accounted for under other standards.

The IFRS IC received a request about the recognition of training costs incurred to fulfil a contract with a customer in relation to an entity that supplies outsourced services and incurs costs to train its employees so that they understand the customer's equipment and processes. In March 2020, the IFRS IC concluded that, before assessing the criteria in IFRS 15.95, an entity first considers whether the training costs incurred to fulfil the contract are within the scope of another IFRS accounting standard. In relation to the request, since IAS 38 explicitly includes expenditure on training within its scope, the entity would apply the IAS 38 requirements and not IFRS 15. IAS 38 requires an entity to expense training costs as incurred and states that "an entity usually has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training for these items to meet the definition of an intangible asset". *[IAS 38.15, IAS 38.68, IAS 38.69]*. The IFRS IC noted that the Basis for Conclusions on IFRS 15 states that "if the other Standards preclude the recognition of any asset arising from a particular cost, an asset cannot then be recognised under IFRS 15". *[IFRS 15.BC307]*. Therefore, since IAS 38 requires those costs to be expensed as incurred, they cannot be capitalised under IFRS 15. The IFRS IC concluded that IFRS 15 and IAS 38 provide an adequate basis for an entity to determine its accounting for training costs incurred to fulfil a contract with a customer and decided not to add the matter to its agenda.[148]

When determining whether costs to fulfil a contract with a customer meet the criteria for capitalisation in IFRS 15.95, an entity must consider its specific facts and circumstances.

With regard to the first criterion, IFRS 15 states that costs can be capitalised even if the contract with the customer is not yet finalised. However, rather than allowing costs to be related to any potential future contract, the standard requires that the costs relate directly to a specifically anticipated contract.

The standard provides examples of costs that meet the first criterion for capitalisation (i.e., costs that relate directly to the contract or a specifically anticipated contract) as follows: *[IFRS 15.97]*

Extract from IFRS 15

97 Costs that relate directly to a contract (or a specific anticipated contract) include any of the following:

(a) direct labour (for example, salaries and wages of employees who provide the promised services directly to the customer);

(b) direct materials (for example, supplies used in providing the promised services to a customer);

(c) allocations of costs that relate directly to the contract or to contract activities (for example, costs of contract management and supervision, insurance and depreciation of tools, equipment and right-of-use assets used in fulfilling the contract);

(d) costs that are explicitly chargeable to the customer under the contract; and

(e) other costs that are incurred only because an entity entered into the contract (for example, payments to subcontractors).

Significant judgement might be required to determine whether costs meet the second criterion for capitalisation in IFRS 15.95(b) (i.e., the costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future). In the Basis for Conclusions, the IASB explained that the standard only results in the capitalisation of costs that meet the definition of an asset and precludes an entity from deferring costs merely to normalise profit margins throughout a contract (by allocating revenue and costs evenly over the contract term). *[IFRS 15.BC308]*.

For costs to meet the third criterion (i.e., the 'expected to be recovered' criterion in IFRS 15.95(c)), they need to be either explicitly reimbursable under the contract or reflected through the pricing on the contract and recoverable through margin. Determining whether the costs are expected to be recovered might be challenging and require significant judgement if some, or all, of the transaction price is contingent (e.g., success-based fees).

Similar to the discussion related to incremental costs to obtain a contract in section 9.3.1 above, an entity needs to include all future cash inflows and outflows associated with fulfilling the contract to determine whether costs to fulfil a contract are recoverable. Furthermore, when determining the amount it expects to receive as part of the recoverability assessment, an entity would not apply the requirements for constraining estimates of variable consideration. That is, if an entity were required to reduce the estimated transaction price because of the constraint on variable consideration, it would use the unconstrained transaction price to evaluate recoverability of the contract fulfilment costs. The unconstrained transaction price also needs to be adjusted to reflect the customer's credit risk. This recoverability assessment for the costs to fulfil a contract is similar to the impairment assessment discussed in section 9.3.4 below.

148 IASB Staff Paper 2: Project: *Training Costs to Fulfil a Contract (IFRS 15)*, Paper topic: *Initial Consideration*, IFRS IC meeting, September 2019; and *IFRIC Update*, March 2020. Available on the IFRS Foundation's website.

How we see it

As discussed above, entities must first determine whether costs incurred to fulfil a contract with a customer are in the scope of other standards before determining whether capitalisation is required under IFRS 15. As an example, an entity might determine that fulfilment costs related to a service contract are not in the scope of other standards (e.g., IAS 2), so it evaluates the requirements in IFRS 15 to determine whether the fulfilment costs need to be capitalised or expensed. The type of costs that might be capitalised under IFRS 15 for the service contract are similar to the types of costs that might be capitalised under IAS 2 for a contract to sell goods.

As noted in IFRS 15.97, costs that are evaluated for capitalisation include direct costs and allocable overhead-type costs. However, an entity will also need to consider the types of costs that must be expensed as incurred in accordance with IFRS 15.98, as discussed further below.

If the criteria in IFRS 15.95 are not met, the costs incurred in fulfilling a contract do not give rise to an asset and must be expensed as incurred. The standard provides some common examples of costs that must be expensed as incurred, as follows: *[IFRS 15.98]*

Extract from IFRS 15

98 An entity shall recognise the following costs as expenses when incurred:

(a) general and administrative costs (unless those costs are explicitly chargeable to the customer under the contract, in which case an entity shall evaluate those costs in accordance with paragraph 97);

(b) costs of wasted materials, labour or other resources to fulfil the contract that were not reflected in the price of the contract;

(c) costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (ie costs that relate to past performance); and

(d) costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations (or partially satisfied performance obligations).

IFRS 15.98(c) specifies that, if a performance obligation (or a portion of a performance obligation that is satisfied over time) has been satisfied, fulfilment costs related to that performance obligation (or portion thereof) can no longer be capitalised. This is true even if the associated revenue has not yet been recognised (e.g., the contract consideration is variable and has been fully or partially constrained). Once an entity has begun satisfying a performance obligation that is satisfied over time, it only capitalises fulfilment costs that relate to future performance. Accordingly, it might be challenging for an entity to capitalise costs that are related to a performance obligation that an entity has already started to satisfy. Similarly, IFRS 15.98(d) specifies that, if an entity is unable to determine whether certain costs relate to past or future performance and the costs are not eligible for capitalisation under other IFRS accounting standards, the costs are expensed as incurred.

The IFRS IC received a request about the recognition of costs incurred to fulfil a contract in relation to a performance obligation that is satisfied over time. In June 2019, the IFRS IC concluded that IFRS 15 provides an adequate basis for an entity to determine how to recognise the costs in the fact pattern provided and decided not to add the matter to its agenda.[149]

The IFRS IC discussed this issue using the following example.[150]

149 *IFRIC Update*, June 2019, available on the IFRS Foundation's website.

150 IASB Staff Paper 2: Project: *Costs to Fulfil a Contract (IFRS 15)*, Paper topic: *Initial Consideration*, IFRS IC meeting, March 2019; and *IFRIC Update*, June 2019. Available on the IFRS Foundation's website.

Illustration 9-10: Costs to fulfil a contract related to past performance

An entity enters into a contract with a customer to construct a building. It identifies a single performance obligation, being the promise to transfer the building to the customer, which it expects will take three years to complete. The entity satisfies this performance obligation (and recognises revenue) over time in accordance with IFRS 15.35(c) because its performance does not create an asset with alternative use and it has an enforceable right to payment (see section 7.1.3 above).

At the end of the reporting period, the entity has begun constructing the building and has incurred costs related to laying the foundation of the building.

The IFRS IC noted that the foundation costs relate to construction work done on the partly-constructed building, which has been transferred to the customer. Therefore, the costs relate to the entity's past performance in partially satisfying its performance obligation and in accordance with IFRS 15.98(c), must be expensed as incurred. That is, the costs do not meet the criteria to be recognised as an asset under IFRS 15.95.

The standard provides the following example that illustrates costs that are capitalised under other IFRS accounting standards, costs that meet the capitalisation criteria and costs that do not: *[IFRS 15.IE Example 37, IFRS 15.IE192-IE196]*

Extract from IFRS 15

Example 37-Costs that give rise to an asset

An entity enters into a service contract to manage a customer's information technology data centre for five years. The contract is renewable for subsequent one-year periods. The average customer term is seven years. The entity pays an employee a CU10,000 sales commission upon the customer signing the contract. Before providing the services, the entity designs and builds a technology platform for the entity's internal use that interfaces with the customer's systems. That platform is not transferred to the customer, but will be used to deliver services to the customer.

Incremental costs of obtaining a contract

In accordance with paragraph 91 of IFRS 15, the entity recognises an asset for the CU10,000 incremental costs of obtaining the contract for the sales commission because the entity expects to recover those costs through future fees for the services to be provided. The entity amortises the asset over seven years in accordance with paragraph 99 of IFRS 15, because the asset relates to the services transferred to the customer during the contract term of five years and the entity anticipates that the contract will be renewed for two subsequent one-year periods.

Costs to fulfil a contract

The initial costs incurred to set up the technology platform are as follows:

	CU
Design services	40,000
Hardware	120,000
Software	90,000
Migration and testing of data centre	100,000
Total costs	350,000

The initial setup costs relate primarily to activities to fulfil the contract but do not transfer goods or services to the customer. The entity accounts for the initial setup costs as follows:

(a) hardware costs-accounted for in accordance with IAS 16 *Property, Plant and Equipment*.

(b) software costs-accounted for in accordance with IAS 38 *Intangible Assets*.

(c) costs of the design, migration and testing of the data centre-assessed in accordance with paragraph 95 of IFRS 15 to determine whether an asset can be recognised for the costs to fulfil the contract. Any resulting asset would be amortised on a systematic basis over the seven-year period (ie the five-year contract term and two anticipated one-year renewal periods) that the entity expects to provide services related to the data centre.

In addition to the initial costs to set up the technology platform, the entity also assigns two employees who are primarily responsible for providing the service to the customer. Although the costs for these two employees are incurred as part of providing the service to the customer, the entity concludes that the costs do not generate or enhance resources of the entity (see paragraph 95(b) of IFRS 15). Therefore, the costs do not meet the criteria in paragraph 95 of IFRS 15 and cannot be recognised as an asset using IFRS 15. In accordance with paragraph 98, the entity recognises the payroll expense for these two employees when incurred.

Frequently asked questions

Question 9-15: Can an entity defer costs of a transferred good or service that would otherwise generate an upfront loss because variable consideration is fully or partially constrained?

An entity cannot defer the costs of a transferred good or service when the application of the constraint on variable consideration results in an upfront loss, even if the entity ultimately expects to recognise a profit on that good or service, unless other specific requirements allow or require a deferral of those costs. The criteria in IFRS 15 must be met to capitalise costs to fulfil a contract, including the criterion that the costs must generate or enhance resources of the entity that will be used in satisfying performance obligations in the future. An entity recognises such costs when control of a good or service transfers to the customer. As such, the cost of those sales would not generate or enhance resources of the entity used to satisfy future performance obligations.

Consider the following example:

Illustration 9-11: Recognise cost of sales when control is transferred

An entity sells goods with a cost of CU500,000 for consideration of CU600,000. The goods have a high risk of obsolescence, which might require the entity to provide price concessions in the future, resulting in variable consideration (see sections 5.2.1.A - 5.2.1.B above). The entity constrains the transaction price and concludes that it is highly probable that CU470,000 will not result in a significant revenue reversal, even though the entity reasonably expects the contract to ultimately be profitable. When control transfers, the entity recognises revenue of CU470,000 and costs of CU500,000. It would not capitalise the loss of CU30,000 because the loss does not generate or enhance resources of the entity that will be used in satisfying performance obligations in the future.

Question 9-16: How does an entity account for fulfilment costs incurred prior to the contract establishment date that are outside the scope of another standard (e.g., IAS 2)?

(TRG meeting 30 March 2015 - Agenda paper no. 33)

Entities sometimes begin activities on a specifically anticipated contract before the contract establishment date (e.g., before agreeing to the contract with the customer, before the contract satisfies the criteria to be accounted for under IFRS 15) that are not within the scope of another standard (e.g., IAS 2). The TRG members generally agreed that costs in respect of pre-contract establishment date activities that relate to a good or service that will transfer to the customer at or after the contract establishment date may be capitalised as costs to fulfil a specifically anticipated contract. However, the TRG members noted that such costs would still need to meet the criteria in IFRS 15.95 to be capitalised (e.g., they are expected to be recovered under the anticipated contract). Certain costs, such as general and administrative costs that are not explicitly chargeable to the customer under the contract, would not satisfy these criteria and would need to be expensed as incurred.

Subsequent to capitalisation, costs that relate to goods or services that are transferred to the customer at the contract establishment date would be expensed immediately. Any remaining capitalised contract costs would be amortised over the period that the related goods or services are transferred to the customer.[151]

For requirements on recognising revenue for a performance obligation satisfied over time when activities are completed before the contract establishment date, see Question 7-20 in section 7.1.4.E above.

Question 9-17: How are the effects of learning curve costs addressed in IFRS 15?

As discussed in the Basis for Conclusions on IFRS 15, "a 'learning curve' is the effect of efficiencies realised over time when an entity's costs of performing a task (or producing a unit) decline in relation to how many times the entity performs that task (or produces that unit)". *[IFRS 15.BC312]*.

Learning curve costs usually consist of materials, labour, overhead, rework or other costs that must be incurred to complete the contract (but do not include research and development costs). These types of efficiencies generally can be predicted at inception of an arrangement and are often considered in the pricing of a contract between an entity and a customer.

151 TRG Agenda paper no. 33, *Partial Satisfaction of Performance Obligations Prior to Identifying the Contract*, dated 30 March 2015 and TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015.

The IASB noted that in situations where learning curve costs are incurred in relation to a contract with a customer accounted for as a single performance obligation that is satisfied over time to deliver a specified number of units, IFRS 15 requires an entity to select a method of progress that depicts the transfer over time of the good or service to the customer (see section 7.1.4 above). *[IFRS 15.BC313]*. The IASB further noted that an entity would probably select a method (such as a costs incurred measure of progress) for these types of contracts, which would result in the entity recognising more revenue and expense at the beginning of the contract relative to the end. The IASB clarified that this would be appropriate as an entity would charge a higher price to a customer only purchasing one unit (rather than multiple units) in order to recover its learning curve costs.

Conversely, when learning curve costs are incurred for a performance obligation satisfied at a point in time (rather than over time), an entity needs to assess whether those costs are within the scope of another standard. The IASB noted that in situations in which an entity incurs cost to fulfil a contract without also satisfying a performance obligation over time, the entity is probably creating an asset that is within the scope of another standard (e.g., IAS 2). *[IFRS 15.BC315]*. For example, if within the scope of IAS 2, the costs of producing the components would accumulate as inventory in accordance with the requirements in IAS 2. The entity would then recognise revenue when control of the inventory transfers to the customer. In that situation, no learning curve costs would be capitalised under IFRS 15 as the costs would be in the scope of another standard.

How we see it

If the learning curve costs are not within the scope of another standard, we believe they generally will not be eligible for capitalisation under IFRS 15 (e.g., because the costs relate to past (and not future) performance).

Question 9-18: How does an entity account for pre-contract or setup costs?

Pre-contract costs are often incurred in anticipation of a contract and will result in no future benefit unless the contract is obtained. Examples include: (1) engineering, design or other activities performed on the basis of commitments, or other indications of interest, by a customer; (2) costs for production equipment and materials relating to specifically anticipated contracts (e.g., costs for the purchase of production equipment, materials or supplies); and (3) costs incurred to acquire or produce goods in excess of contractual requirements in anticipation of subsequent orders for the same item.

Pre-contract costs that are incurred in anticipation of a specific contract must first be evaluated for capitalisation under other standards (e.g., IAS 2, IAS 16, IAS 38). For example, pre-contract costs incurred to acquire or produce goods in excess of contractual requirements for an existing contract in anticipation of subsequent orders for the same item would likely be evaluated under IAS 2. Some other examples include costs incurred to move newly acquired equipment to its intended location, which could be required to be capitalised under IAS 16 (see Question 9-19 below), and employee training costs that are expensed in accordance with IAS 38.[152] Pre-contract costs incurred in anticipation of a specific contract that are not addressed under other standards are capitalised under IFRS 15 only if they meet all of the criteria of a cost incurred to fulfil a contract. Pre-contract costs that are not in the scope of other IFRS accounting standards and do not meet the criteria under IFRS 15 are expensed as incurred.

Question 9-19: Can mobilisation costs be capitalised as costs to fulfil a contract with a customer under IFRS 15?

Entities incur mobilisation costs when moving personnel, equipment and supplies to a project site either before, at or after inception of a contract with a customer. They are incurred in order to ensure that the entity is in a position to fulfil its promise(s) in a contract (or specifically anticipated contract) with a customer, rather than transferring a good or service to a customer (i.e., they are not a promised good or service).

How we see it

The assessment of whether mobilisation costs can be capitalised depends on the specific facts and circumstances and might require significant judgement. Entities need to ensure that the costs are: (1) within the scope of IFRS 15; and (2) meet all of the criteria in IFRS 15.95 to be capitalised. We believe the considerations listed below are relevant to this assessment.

Are the costs within the scope of IFRS 15?

If the asset being moved (e.g., equipment in the scope of IAS 16, inventory in the scope of IAS 2) is in the scope of another standard, an entity must determine whether the mobilisation costs are specifically addressed by the other standard; if so, the cost is outside the scope of IFRS 15.

If the mobilisation costs are not specifically addressed in another standard, or it is not clear whether these are within the scope of another standard, an entity further analyses whether the mobilisation costs are:

- Specific to the asset being moved or applicable to more than one customer under unrelated contracts; in the latter case it is likely that they would not be within the scope of IFRS 15. For example, moving an asset between different premises of the entity to better utilise the asset in preparation for future contracts with many customers.

  Or

- Specific to the contract with the customer, in which case, it would be within the scope of IFRS 15. For example, moving an asset to a remote location at the customer's request, which does not provide a benefit to the entity beyond ensuring it is in a position to fulfil its obligation(s) to the customer under the contract.

Do the costs meet the criteria in IFRS 15.95 to be capitalised?

As discussed above, IFRS 15 includes three criteria that must be met for costs to fulfil a contract within its scope can be capitalised:

(a) Entities might need to use judgement to determine if costs relate directly to a contract (or a specifically anticipated contract, see section 9.3.2 above), as required in IFRS 15.95(a). Indicators that a cost, by function rather than by nature, might be directly related include, but are not limited to, the following:

- The costs are explicitly or implicitly chargeable to the customer under the contract.
- The costs are incurred only because the entity entered into the contract.
- The contract explicitly or implicitly refers to mobilisation activities (e.g., that the entity must move equipment to a specific location).
- The location in which the entity must perform is explicitly or implicitly specified in the contract and the mobilisation costs are incurred in order for the entity to fulfil its promise(s) to the customer.

(b) Significant judgement might also be required to determine whether costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future as required by IFRS 15.95(b). This determination would include (but not be limited to) considering whether:

- The costs are incurred in order for the entity to be able to fulfil the contract

  And

- Location is implicitly or explicitly an attribute of the contract

  If a performance obligation (or a portion of a performance obligation that is satisfied over time) has been satisfied, fulfilment costs related to that performance obligation (or portion thereof) can no longer be capitalised (see section 9.3.2 above for further discussion).

(c) For costs to meet the 'expected to be recovered' criterion as required by IFRS 15.95(c), they need to be either explicitly reimbursable under the contract or reflected through the pricing on the contract and recoverable through margin.

Determining whether mobilisation costs are directly related to a contract might be more challenging when they are incurred between two contracts. That is, when the costs are related to returning an entity's personnel, equipment and/or supplies to their original location or to another project site. In those situations, an entity will need to determine to which contract the costs relate. It will also need to determine whether the costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future. This is important because costs related to past performance cannot be capitalised under IFRS 15.

152 IASB Staff Paper 2: Project: *Training Costs to Fulfil a Contract (IFRS 15)*, Paper topic: *Initial Consideration*, IFRS IC meeting, September 2019; and *IFRIC Update*, March 2020. Available on the IFRS Foundation's website.

Question 9-20: Can an entity defer losses incurred on a contract by capitalising related fulfilment costs when it is expected to generate future profits on the sale of optional goods or services (i.e., loss leader)?

Certain contracts are executed as part of a loss leader strategy in which a good is sold at a loss with an expectation that future sales contracts will result in higher sales and/or profits. In determining whether these anticipated contracts would be part of the accounting for the existing loss leader contract, entities need to refer to the definition of a contract in IFRS 15, which is based on enforceable rights and obligations in the existing contract (see section 3.1 above). While it might be probable that the customer will enter into a future contract or the customer might even be economically compelled, or compelled by regulation to do so, it would not be appropriate to account for an anticipated contract when there is an absence of enforceable rights and obligations.

In addition, if the fulfilment costs incurred during satisfying the initial contract are within the scope of other IFRS accounting standards (e.g., IAS 2), the entity must account for those costs under that relevant standard. Even if the costs are not within the scope of another IFRS accounting standard, the costs would relate to a satisfied or partially satisfied performance obligation (i.e., the original contract priced at a loss) and, therefore, must be expensed as incurred. IFRS 15 does not permit an entity to defer fulfilment costs or losses incurred based on the expectation of profits in a future contract.

Question 9-21: How does an entity account for costs associated with installation or implementation services?

Entities that provide installation or implementation services to customers incur costs to fulfil the services. To determine the appropriate accounting for these costs, entities first need to determine whether the costs are within the scope of another IFRS accounting standard (e.g., property, plant and equipment, intangibles). *[IFRS 15.96]*.

If they are not within the scope of another IFRS accounting standard, entities need to determine whether the installation or implementation service is a separate performance obligation that is satisfied over time (see section 4 above). If it is a performance obligation, then entities generally expense the costs associated with it as incurred because, as discussed in section 9.3.2 above, it might be challenging to conclude that the costs relate only to the entity's satisfaction of performance obligations in the future, which is required for capitalisation by IFRS 15.95(b). *[IFRS 15.95(b)]*.

If the installation or implementation service is not a separate performance obligation, an entity needs to evaluate whether it is required to capitalise the costs to fulfil the contract under the IFRS 15 requirements mentioned above. That is, costs incurred to fulfil a contract are required to be capitalised only if they meet all of the criteria for capitalisation in IFRS 15.95. *[IFRS 15.95]*.

The Illustrations below contrast an example of implementation services that are determined to be a separate performance obligation (and, therefore, are not capitalised as costs to fulfil a contract) with an example of implementation services that meet the criteria for capitalisation as costs to fulfil a contract under IFRS 15.

Illustration 9-12: Implementation services are not capitalised costs to fulfil a contract

Technology entity M enters into a three-year SaaS contract with a customer for CU4,000,000 for a subscription to an inventory management application beginning 1 June 20X3. The contract includes implementation services that will be performed at the beginning of the contract, starting on 1 June 20X3. The implementation services include data migration, creation of objects for the customer's products that will be inventoried, and customisation of the application's layout with the customer's logo and colour scheme. Several third-party service providers also sell implementation services for Technology entity M's application. Assume that the implementation services do not represent a significant integration service (i.e., the implementation services do not significantly modify or customise the SaaS) and the SaaS is fully functional without the implementation service. Under the contract, the customer receives access to the fully functional SaaS on 1 June 20X3.

Technology entity M determines that the costs incurred related to the implementation services are not within the scope of another IFRS accounting standard (e.g., property, plant and equipment, intangible assets).

Technology entity M then considers the implementation services and SaaS and determines that they are separate performance obligations that will be satisfied over time. This is because the implementation services and SaaS can be purchased separately. Technology entity M determines that it is able to fulfil its promise to transfer the SaaS separately from the implementation services, indicating that the two are not highly interdependent or interrelated. Therefore, Technology entity M determines that the costs incurred related to implementation services do not meet the criteria for capitalisation because they do not relate to the entity's satisfaction of performance obligations in the future (i.e., the costs are expensed as incurred in the process of performing the implementation services).

Illustration 9-13: Implementation services are capitalised costs to fulfil a contract

Technology entity N enters into a contract with a customer for CU2,000,000 for a one-year SaaS subscription to an enterprise software application beginning when the customer obtains access to the SaaS. The contract includes implementation services that will be performed at the beginning of the contract, starting on 1 January 20X5. The implementation services, which will take approximately two months to complete, must be performed in order for the customer to access the SaaS because the services involve the creation of customer-specific interfaces. Technology entity N does not sell the SaaS without these implementation services and no other vendors are able to perform the implementation services because they require the creation of code that will reside on Technology entity N's servers.

Technology entity N determines that the costs incurred related to the implementation services are not within the scope of another IFRS accounting standard (e.g., property, plant and equipment, intangible assets).

Technology entity N then determines that the implementation services are not capable of being distinct. This is because they cannot be purchased separately or provided by a third party and because the services do not provide benefit on their own or with other readily available resources (since the SaaS has not yet been provided and also cannot be sold separately). Therefore, the implementation services and SaaS subscription are a combined performance obligation.

Technology entity N also concludes that the combined performance obligation meets the requirements for recognition over time. It determines that revenue will be recognised over the contract term, beginning when the customer obtains access to the SaaS.

Therefore, Technology entity N considers whether the costs incurred related to the implementation services that will be provided at the outset of the contract (i.e., before the customer obtains access to the SaaS) meet the criteria to be capitalised as a cost to fulfil the contract, as follows:

- The costs relate specifically to the SaaS contract with this customer
- The costs generate a resource (i.e., the interfaces) that will be used in future performance (i.e., providing the SaaS, to the customer)
- The costs are expected to be recovered based on the margin included in the contract

As such, Technology entity N determines that the costs must be capitalised as a cost to fulfil as the implementation services are performed. The costs will then be amortised over the estimated period of benefit beginning when the customer gains access to the SaaS.

9.3.3 Amortisation of capitalised contract costs

Any capitalised contract costs are amortised, with the expense recognised on a systematic basis that is consistent with the entity's transfer of the related goods or services to the customer. *[IFRS 15.99]*.

IFRS 15.99 states that capitalised contract costs are amortised on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. When the timing of revenue recognition (e.g., at a point in time, over time) aligns with the transfer of the goods or services to the customer, the amortisation of the capitalised contract costs in a reporting period will correspond with the revenue recognition in that reporting period. However, the timing of revenue recognition might not always align with the transfer of the goods and services to the customer (e.g., when variable consideration is constrained at the time the related performance obligation is satisfied). When this occurs, the amortisation of the capitalised contract costs will not correspond with the revenue recognition in a reporting period.

For example, consider an entity that enters into a contract with a customer with two performance obligations: (a) a right-to-use licence; and (b) a related service for three years. Further assume that payment from the customer is based on the customer's usage of the intellectual property (i.e., a usage-based royalty). Revenue in respect of the licence of intellectual property would be recognised at a point in time (see section 8.3.2 above) and revenue in respect of the related service would be recognised over time. The transaction price allocated to the performance obligation for the licence of intellectual property cannot be recognised at the point in time when control of the licence transfers to the customer due to the royalty recognition constraint (see section 8.5 above). Accordingly, any capitalised contract costs that relate to the licence need to be fully amortised upon the transfer of control of that licence (i.e., at a point in time), regardless of when the related revenue will be recognised. Any capitalised contract costs that relate to the services need to be amortised over the period of time consistent with the transfer of control of the service.

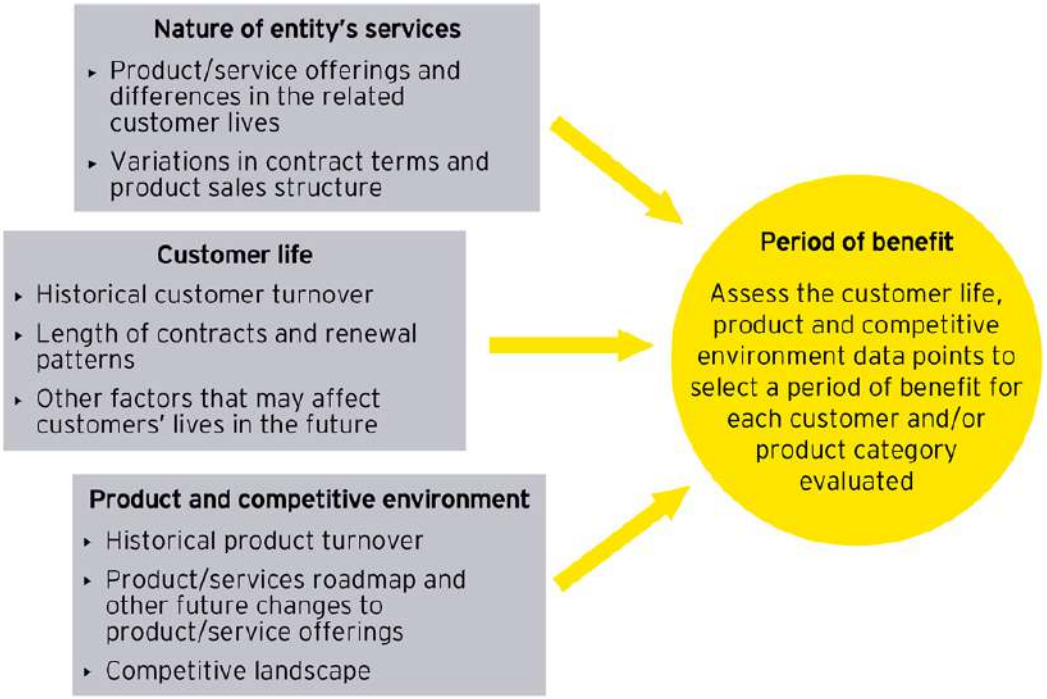
It is important to note that capitalised contract costs could relate to multiple goods or services (e.g., design costs to manufacture multiple distinct goods when design services are not a separate performance obligation) in a single contract. In such instances, the amortisation period could be the entire contract term. See Question 9-24 below for a discussion on how an entity might determine the appropriate amortisation period when capitalised contract costs relate to multiple performance obligations. The amortisation period could also extend beyond a single contract, if the capitalised contract costs relate to goods or services being transferred under multiple contracts or to a specifically anticipated contract (e.g., certain contract renewals). *[IFRS 15.99]*.

In these situations, the capitalised contract costs would be amortised over a period that is consistent with the transfer to the customer of the goods or services to which the asset relates. This can also be thought of as the expected period of benefit of the asset capitalised. The expected period of benefit might be the expected customer relationship period, but that is not always the case. To determine the appropriate amortisation period, an entity needs to evaluate the type of capitalised contract costs, what the costs relate to and other facts and circumstances of the specific arrangement. Furthermore, before including estimated renewals in the period of benefit, an entity needs to evaluate its history with renewals, to conclude that such an estimate is supportable.

How we see it

We believe the following factors might be relevant for the evaluation of the period of benefit.

Figure 9-4: Evaluation of the period of benefit



An entity updates the amortisation period when there is a significant change in the expected timing of transfer to the customer of the goods or services to which the asset relates (and accounts for such a change as a change in accounting estimate in accordance with IAS 8), as shown in the following Illustration: *[IFRS 15.100]*.

Illustration 9-14: Amortisation period

Entity A enters into a three-year contract with a new customer for transaction processing services. To fulfil the contract, Entity A incurred set-up costs of CU60,000, which it capitalised in accordance with IFRS 15.95-98 and will amortise over the term of the contract.

At the beginning of the third year, the customer renews the contract for an additional two years. Entity A will benefit from the initial set-up costs during the additional two-year period. Therefore, it changes the remaining amortisation period from one year to three years and adjusts the amortisation expense in the period of the change and future periods in accordance with the requirements in IAS 8 for changes in accounting estimates. The disclosure requirements of IAS 8 related to changes in accounting estimates are also applicable.

However, under IFRS 15, if Entity A had been in the position to anticipate the contract renewal at contract inception, Entity A would have amortised the set-up costs over the anticipated term of the contract including the expected renewal (i.e., five years).

Determining the amortisation period for incremental costs of obtaining a contract with a customer can be complicated, especially when contract renewals are expected and the commission rates are not constant throughout the entire life of the contract.

When evaluating whether the amortisation period for a sales commission extends beyond the original contract period, an entity would also evaluate whether an additional commission is paid for subsequent renewals. If so, it evaluates whether the renewal commission is considered 'commensurate' with the original commission. See Question 9-22 below for further discussion on whether a commission is commensurate. In the Basis for Conclusions, the IASB explained that amortising the asset over a longer period than the initial contract would not be appropriate if an entity pays a commission on a contract renewal that is commensurate with the commission paid on the initial contract. In that case, the costs of obtaining the initial contract do not relate to the subsequent contract. *[IFRS 15.BC309]*. An entity would also need to evaluate the appropriate amortisation period for any renewal commissions that are required to be capitalised under IFRS 15 in a similar manner. See Question 9-23 below for the FASB TRG's discussion of how an entity determines the amortisation period of an asset recognised for the incremental costs of obtaining a contract with a customer.

How we see it

Under IFRS 15, entities are required to evaluate whether the period of benefit is longer than the term of the initial contract. As discussed above, it is likely that an entity would be required to amortise the capitalised sales commission cost over a period longer than the initial contract, if a renewal commission is not paid or a renewal commission is paid that is not commensurate with the original commission. It is also important to note that the amortisation period affects whether the entity can apply the practical expedient allowing the incremental cost of obtaining a contract to be expensed immediately. That expedient requires that the asset resulting from the capitalisation of these costs be amortised in one year or less. It is not dependent on the initial contract term.

In determining the appropriate amortisation period or the period of benefit for capitalised contract costs, an entity considers its facts and circumstances and might use judgement similar to that used when estimating the amortisation period for intangible assets (e.g., a customer relationship intangible acquired in a business combination). This could include considering factors such as customer retention and how quickly the entity's products and services change.

It is important for entities to document the judgements they make when determining the appropriate amortisation period and disclose the same in their financial statements. IFRS 15 disclosure requirements (see section 10.5.3 below) include judgements made in determining the amounts of costs that are capitalised, the amortisation method chosen and other quantitative disclosures.

Frequently asked questions

Question 9-22: How does an entity determine whether a commission on a renewal contract is commensurate with the commission on the initial contract?

(FASB TRG meeting 7 November 2016 - Agenda paper no. 57)

FASB TRG members generally agreed that the commissions would have to be reasonably proportional to the contract values (e.g., 5% of both the initial and renewal contract values) to be considered commensurate. The FASB TRG members also generally agreed that it would not be reasonable for an entity to use a 'level of effort' analysis to determine whether a commission is commensurate. For example, a 6% commission on an initial contract and a 2% commission on a renewal would not be commensurate even if the declining commission rate corresponds to the level of effort required to obtain the contracts.[153]

As discussed above in this section, if the renewal commission is considered to be commensurate with the commission on the initial contract, it would not be appropriate to amortise any asset for the initial commission over a longer period than the initial contract. In contrast, it is likely that it would be appropriate to amortise the asset over a longer period than the initial contract if the commissions are not considered to be commensurate (such as in the example above with a 6% initial commission and 2% renewal commission). See Question 9-23 below for discussion of how an entity determines this longer amortisation period.

153 FASB TRG Agenda paper no. 60, *November 2016 Meeting - Summary of Issues Discussed and Next Steps*, dated 31 January 2017 and FASB TRG Agenda paper no. 57, *Capitalization and Amortization of Incremental Costs of Obtaining a Contract*, dated 7 November 2016.

Although the TRG did not discuss this, entities would also need to evaluate whether any expected subsequent renewal commissions are commensurate with prior renewal commissions to determine the appropriate amortisation period for any renewal commissions that are required to be capitalised under IFRS 15. Continuing the above example, assume the original three-year contract (for which a 6% commission is paid) and each subsequent renewal contract (for which a 2% renewal commission is paid) is for a one-year term. If the entity expects to renew the contract in years two through four and continue to pay a constant 2% commission upon each renewal, each renewal commission would be considered commensurate. As a result, it is likely that the appropriate amortisation period for each renewal required to be capitalised would be one year. See Question 9-26 below for discussion of when an entity would begin to amortise an asset recognised for the incremental cost of obtaining a renewal contract.

Question 9-23: How does an entity determine the amortisation period of an asset recognised for the incremental costs of obtaining a contract with a customer?

(FASB TRG meeting 7 November 2016 - Agenda paper no. 57 and TRG meeting 26 January 2015 - Agenda paper no. 23)

The FASB TRG members generally agreed that when an entity determines an amortisation period that is consistent with the transfer to the customer of the goods or services to which the asset relates, it must determine whether the capitalised contract costs relate only to goods or services that will be transferred under the initial contract, or whether the costs also relate to goods or services that will be transferred under a specifically anticipated contract. For example, if an entity only pays a commission based on the initial contract and does not expect the customer to renew the contract (e.g., based on its past experience or other relevant information), amortising the asset over the initial term would be appropriate.

However, if the entity's past experience indicates that the customer is likely to renew the contract, the amortisation period would be longer than the initial term if the renewal commission is not 'commensurate' with the initial commission. See Question 9-22 above for a discussion of commensurate.

The FASB TRG members generally agreed that an entity needs to evaluate its facts and circumstances to determine an appropriate amortisation period if it determines that the period extends beyond the initial contract term, because the commission on the renewal contract is not commensurate with the commission on the initial contract. An entity might reasonably conclude that its average customer life is the best estimate of the amortisation period that is consistent with the transfer of the goods or services to which the asset relates (e.g., if the good or service does not change over time, such as a health club membership). However, FASB TRG members generally agreed that this approach is not required and that entities must not use this as a default. The FASB TRG members noted that entities would use judgement that is similar to judgement used when estimating the amortisation period for intangible assets (e.g., a customer relationship intangible acquired in a business combination) and could consider factors such as customer loyalty and how quickly their products and services change.[154]

Consider a technology entity that capitalises a commission paid on the sale of software, which the entity estimates it will maintain and support for only the next five years, and the estimated customer life is seven years. In evaluating the period of benefit, the entity might reasonably conclude that the capitalised commission has to be amortised over the five-year life of the software to which the commission relates.

However, in a TRG agenda paper, the staff discussed two acceptable methods for amortising capitalised contract costs that relate to both the original contract and the renewals in cases in which the renewal commission is not commensurate with the initial commission:[155]

- The initial capitalised amount is amortised over the period of benefit that includes expected renewals, while amounts capitalised that relate to renewals are amortised over the renewal period.
- The portion of the initial capitalised amount that is commensurate is amortised over the original contract term and the additional amount that is not commensurate is amortised over the period of benefit that includes expected renewals. Capitalised amounts that relate to renewals are amortised over the renewal period.

Both methods are acceptable because they each meet the objective of amortising the costs on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. However, an entity needs to select one method and apply it consistently in similar circumstances. Other amortisation methods might also be acceptable if they are consistent with the pattern of transfer to the customer of the goods or services to which the asset relates.

154 FASB TRG Agenda paper no. 60, *November 2016 Meeting - Summary of Issues Discussed and Next Steps*, dated 31 January 2017 and FASB TRG Agenda paper no. 57, *Capitalization and Amortization of Incremental Costs of Obtaining a Contract*, dated 7 November 2016.

155 TRG Agenda paper no. 23, *Incremental costs of obtaining a contract*, dated 26 January 2015.

The following Illustration shows the two methods described in the TRG agenda paper:

Illustration 9-15: Methods for amortising capitalised contract costs

An entity has a commission plan that pays a 6% commission to a sales representative each time that sales representative obtains a new contract with a customer and a 2% commission each time that customer renews. Based on the entity's assessment of the requirements in IFRS 15 for contract costs, it has concluded that the commissions paid as part of this commission plan are incremental costs to obtain a contract that are required to be capitalised. Furthermore, the entity has determined that the 2% commission paid for renewals is not commensurate with the 6% commission paid for initial contracts and, therefore, the period of benefit for capitalised commissions extends beyond the initial contract term.

The entity performs an assessment of average customer life, technology turnover and competitive factors and concludes that the period of benefit for capitalised commissions is five years.

The entity executes a three-year service contract with a customer for CU600,000 and pays a 6% commission to the sales representative. At the end of the three-year term, the customer renews the contract for two more years for CU400,000 and the entity pays a 2% commission to the sales representative.

The following are two acceptable methods for amortising the capitalised contract costs related to the CU36,000 commission paid on the initial contract and the CU8,000 commission paid on the renewal:

Method 1

The CU36,000 commission related to the initial contract that was capitalised is amortised over the five-year period of benefit. When the contract is renewed, the CU8,000 commission related to the renewal that was capitalised is amortised over the two-year renewal period. The commission would be amortised, as follows:

CU	Year 1	Year 2	Year 3	Year 4	Year 5
Initial commission	7,200	7,200	7,200	7,200	7,200
Renewal commission	-	-	-	4,000	4,000
Total amortisation expense	**7,200**	**7,200**	**7,200**	**11,200**	**11,200**

Method 2

The CU36,000 commission related to the initial contract that was capitalised is separated into two components: CU12,000 that is commensurate with the commission paid on renewal (i.e., the amount of commission that the CU600,000 initial contract earns at the commensurate rate of 2%); and CU24,000 that is not commensurate. The entity amortises the CU12,000 component over the three-year initial contract term and the CU24,000 component over the five-year period of benefit. When the contract is renewed, the CU8,000 commission related to the renewal that was capitalised is amortised over the two-year renewal period. The commission would be amortised, as follows:

CU	Year 1	Year 2	Year 3	Year 4	Year 5
Initial commission (not commensurate)	4,800	4,800	4,800	4,800	4,800
Initial commission (commensurate)	4,000	4,000	4,000	-	-
Renewal commission	-	-	-	4,000	4,000
Total amortisation expense	**8,800**	**8,800**	**8,800**	**8,800**	**8,800**

Question 9-24: Can an entity attribute the capitalised contract costs to the individual performance obligations in the contract to determine the appropriate amortisation period?

(TRG meeting 26 January 2015 - Agenda paper no. 23)

How we see it

We believe an entity can attribute the capitalised contract costs to individual performance obligations in the contract to determine the appropriate amortisation period, but it is not required to do so.

IFRS 15.99 states that the asset recognised is amortised on a systematic basis "that is consistent with the transfer to the customer of the goods or services to which the asset relates". *[IFRS 15.99]*. The TRG agenda paper noted that an entity would meet this objective by allocating the capitalised contract costs to performance obligations on a relative basis (i.e., in proportion to the transaction price allocated to each performance obligation) to determine the period of amortisation.

Illustration 9-16: Allocation of capitalised contract costs

A technology entity executes a contract for CU600,000 for a perpetual software licence and one year of PCS. Based on the stand-alone selling prices, the entity allocates CU500,000 (83%) of the total transaction price to the licence and CU100,000 (17%) to the PCS. The entity pays a 4% commission to the sales representative and has determined that the commission is required to be capitalised under IFRS 15 because it is an incremental cost of obtaining the contract. The entity concludes that the CU24,000 sales commission needs to be allocated between the licence and the PCS and amortised over the expected period of benefit associated with each of those performance obligations. The entity allocates CU20,000 (83%) to the licence and CU4,000 (17%) to the PCS, consistent with the relative value of the performance obligations to the transaction price.

Other methods for allocating capitalised contract costs might be appropriate. For example, we believe an entity would also meet the objective by allocating specific capitalised contract costs to individual performance obligations when the costs relate specifically to certain goods or services.

An entity needs to have objective evidence to support a conclusion that a specified amount of the costs relates to a specific performance obligation and consistently apply any methods used for allocating capitalised contract costs to performance obligations.

In addition, as discussed in Question 9-23 above, an entity that attributes capitalised contract costs to individual performance obligations needs to consider whether the amortisation period for some or all of the performance obligations extends beyond the original contract (see discussion in this section above).

The TRG agenda paper also discussed another potentially acceptable amortisation pattern for capitalised contract costs. This pattern relates to multiple performance obligations that are satisfied over different periods that would not require allocation of the asset to individual performance obligations in the contract. That is, an entity might amortise a single capitalised contract cost using one measure of performance taking into consideration all of the performance obligations in the contract. The TRG paper noted that an entity that uses this method needs to select a measure that best reflects the 'use' of the asset as the goods and services are transferred to the customer. That is, the pattern of amortisation must meet the objective of IFRS 15.99 so that it is consistent with the transfer to the customer of the goods or services to which the asset relates.

Question 9-25: Over what period would an entity amortise a sales commission (that is only paid once a threshold is met) that is determined to be an incremental cost to obtain a contract?

(TRG meeting 26 January 2015 - Agenda paper no. 23)

The TRG agenda paper indicated that there are at least two alternatives that meet the objective of amortising the costs on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. However, either alternative must be applied consistently to similar circumstances. In the first alternative, an entity allocates the capitalised costs to all of the contracts that cumulatively result in the threshold being met and amortises the costs over the expected customer relationship period of each of those contracts. In the second alternative, an entity allocates the capitalised costs to the contract that results in the threshold being met and amortise the costs over the expected customer relationship period of that contract. The TRG agenda paper noted that the second alternative might result in a counterintuitive answer if the commission paid upon obtaining the contract that resulted in the threshold being met was large in relation to the transaction price for only that contract. While the first alternative might be easier to apply and result in a more intuitive answer than the second alternative in some situations, the TRG agenda paper noted that either approach is acceptable. The TRG agenda paper did not contemplate all possible alternatives, therefore, there could be other approaches that also are acceptable.

Consider the following example in the TRG agenda paper:

Illustration 9-17: Amortisation of capitalised commission payments subject to a threshold

An entity has a commission programme that increases the amount of commission a salesperson receives based on how many contracts the salesperson has obtained during an annual period. In this example, the first commission is paid when the first contract is signed. Subsequently, once a cumulative threshold number of contracts is reached, a commission is paid on that threshold contract as a fixed escalating amount, taking into account any commission already paid, as follows:

1 contract	CU3,000 commission
10 contracts	CU5,000 cumulative commission (including CU3,000 already paid)
15 contracts	CU10,000 cumulative commission (including CU5,000 already paid)

Assume 11 new contracts are signed by a specific employee in that period.

As discussed in Question 9-7 in section 9.3.1 above, FASB TRG members generally agreed that commission payments subject to a threshold are incremental costs of obtaining a contract with a customer and, therefore, the costs must be capitalised when the entity incurs a liability to pay these commissions.

In the first acceptable alternative, an entity estimates the total amount of commission that is expected to be paid for the period and capitalises an equal amount as each contract is signed. In this example, because the entity estimates that the employee will sign 11 new contracts during the period, it expects the total amount of commission to be paid will be CU5,000. The entity would capitalise CU455 when each contract is signed (i.e., CU5,000 cumulative commission divided by the 11 contracts). The capitalised amount would be amortised over the expected customer relationship period of each of those contracts. That is, the CU455 capitalised for the first contract would be amortised over the expected customer relationship period of the first contract and the CU455 capitalised for the second contract would be amortised over the expected customer relationship period of the second contract.

In the second acceptable alternative, an entity capitalises CU3,000 in commission costs upon signing the first contract. This amount would be amortised over the expected customer relationship period of that contract (i.e., the first contract). The entity would not capitalise any additional costs upon signing the second contract through to the ninth contract because the next commission 'tier' has not been met. Once the tenth contract is signed, the entity capitalises an additional CU2,000 in commission costs. This amount would be amortised over the expected customer relationship period for that contract (i.e., the tenth contract).

Question 9-26: When does an entity begin to amortise an asset recognised for the incremental cost of obtaining a renewal contract?

As discussed in Question 9-22 above, assets recognised for commensurate renewal commissions paid are amortised over the term of the contract renewal, with the expense recognised as the entity transfers the related goods or services to the customer.

How we see it

We believe that the amortisation of the renewal commission must not begin earlier than the beginning of the renewal period.

Consider the following Illustration:

Illustration 9-18: Amortisation of a capitalised contract costs

On 1 January 20X0, an entity enters into a three-year service contract with a customer that ends on 31 December 20X2. Upon the customer signing the contract, the entity pays a sales employee a CU50,000 sales commission for obtaining the contract. On 30 September 20X2, the entity negotiates a three-year renewal term that will begin on 1 January 20X3 and pays the sales employee a renewal commission that is commensurate with the initial sales commission paid. Since the entity does not begin to transfer services under the contract renewal until 1 January 20X3, the entity would not begin amortising the asset related to the renewal commission until 1 January 20X3.

Question 9-27: How are capitalised contract costs and their amortisation classified and presented in the statement of financial position and statement of profit or loss and other comprehensive income, respectively?

As discussed in sections 9.3.1 - 9.3.3 above, IFRS 15 requires incremental costs of obtaining a contract and certain costs to fulfil a contract to be recognised as an asset and that asset to be amortised on a systematic basis. IFRS 15.128 requires separate disclosure of closing balances and the amount of amortisation and impairment losses recognised during the period (see section 10.5.3 below). However, the standard is silent on the classification of that asset and the related amortisation.

Under legacy IFRS accounting standards, IAS 2 included the notion of work in progress (or 'inventory') of a service provider. However, references to service providers were consequentially removed from IAS 2 and replaced with the relevant requirements in IFRS 15. Furthermore, while these capitalised contract cost assets are intangible, in nature, IAS 38 specifically excludes from its scope intangible assets arising from contracts with customers that are recognised in accordance with IFRS 15. *[IAS 38.3(i)]*. In the absence of a standard that specifically deals with classification and presentation of contract costs, management would need to apply the requirements in IAS 8.10-12 to select an appropriate accounting policy (see Chapter 3 at section 4.3).

How we see it

In developing such an accounting policy, we believe that costs to obtain a contract and costs to fulfil a contract need to be considered separately for the purpose of classification and presentation in the financial statements, as described in the bullets below.

- Considering the nature of *costs to obtain a contract* and the lack of guidance in IFRS accounting standards, we believe an entity can choose to classify and present these costs as either:
  - A separate class of asset (similar in nature to work in progress or 'inventory') in the statement of financial position and its amortisation within cost of goods sold, changes in contract costs or similar

    Or
  - A separate class of intangible assets in the statement of financial position and its amortisation in the same line item as amortisation of intangible assets within the scope of IAS 38

  In all cases, an entity needs to consider the aggregation requirements of IAS 1 (or IFRS 18,[156] if adopted early) when determining whether the separate classes of assets must be presented together with other assets (see Chapter 3 at sections 3.1.5, 3.1.6, and 4.1.5).

  In addition, the entity needs to consider the requirements in IAS 7, in particular IAS 7.16(a), when determining the classification of cash flows arising from costs to obtain a contract (i.e., either as cash flow from operating activities or investing activities). *[IAS 7.16(a)]*.
- In contrast, the nature of *costs to fulfil a contract* is such that they directly impact the entity's performance under the contract. Therefore, costs to fulfil a contract are classified and presented as a separate class of asset in the statement of financial position and its amortisation within cost of goods sold, changes in contract costs or similar.

  We do not believe it would be appropriate to analogise to the requirements for intangible assets in IAS 38. Instead, such costs are consistent in nature to costs incurred in the process of production, as is contemplated in IAS 2. That is, in nature, they are consistent with work in progress, or 'inventory', of a service provider. Therefore, whether costs to fulfil a contract meet the criteria for capitalisation in IFRS 15.95 or are expensed as incurred, we believe that classification and presentation of such costs in the statement of profit or loss and other comprehensive income, and the classification and presentation of related cash flows in the statement of cash flows needs to be consistent.

Capitalised contract costs are subject to impairment assessments (see section 9.3.4 below). Impairment losses are recognised in profit or loss, but the standard is silent on where to classify and present such amounts within the primary financial statements.

How we see it

We believe it would be appropriate for the classification and presentation of any impairment losses to be consistent with the classification and presentation of the amortisation expense.

156 IFRS 18 supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted). See Chapter 4 for further details on the requirements of IFRS 18.

9.3.4 Impairment of capitalised contract costs

Capitalised contract costs must be tested for impairment. This is because the costs that give rise to an asset must be recoverable throughout the contract period (or period of benefit, if longer), to meet the criteria for capitalisation.

An impairment exists if the carrying amount of the asset exceeds the amount of consideration the entity expects to receive in exchange for providing the associated goods or services, less the remaining costs that relate directly to providing those goods or services. Impairment losses are recognised in profit or loss. *[IFRS 15.101]*. Refer to Question 9-27 in section 9.3.3 above for further discussion on classifying and presenting impairment losses within profit or loss.

TRG members generally agreed that an impairment test of capitalised contract costs must include future cash inflows and outflows associated with contract renewal or extension periods, if the period of benefit of the costs under assessment is expected to extend beyond the present contract.[157] In other words, an entity must consider the total period over which it expects to receive economic benefits relating to the asset, for the purpose of both determining the amortisation period and estimating cash flows to be used in the impairment test. The question was raised because of an inconsistency within IFRS 15. IFRS 15 indicates that costs capitalised under the standard could relate to goods or services to be transferred under 'a specific anticipated contract' (e.g., goods or services to be provided under contract renewals and/or extensions). *[IFRS 15.99]*. The standard also indicates that an impairment loss would be recognised when the carrying amount of the asset exceeds the remaining amount of consideration expected to be received (determined by using principles in IFRS 15 for determining the transaction price, see section 5 above). *[IFRS 15.101(a), IFRS 15.102]*. However, the requirements for measuring the transaction price in IFRS 15 indicate that an entity does not anticipate that the contract will be "cancelled, renewed or modified" when determining the transaction price. *[IFRS 15.49]*.

In some instances, excluding renewals or extensions would trigger an immediate impairment of a contract asset because the consideration an entity expects to receive would not include anticipated cash flows from contract extensions or renewal periods. However, the entity would have capitalised contract costs on the basis that they would be recovered over the contract extension or renewal periods. When an entity determines the amount it expects to receive (see section 5 above), it would not apply the requirements for constraining estimates of variable consideration. That is, if an entity were required to reduce the estimated transaction price because of the constraint on variable consideration, it would use the unconstrained transaction price for the impairment test. This would include any amounts expected to be received but not yet recognised because of the royalties recognition constraint (see section 8.5 above) or the 'right to invoice' practical expedient (see section 7.1.4.B above). While the amount expected to be received is unconstrained, it would still need to be adjusted to reflect the customer's credit risk before it is used in the impairment test. *[IFRS 15.102]*. However, before recognising an impairment loss on capitalised contract costs incurred to obtain or fulfil a contract, entities need to consider impairment losses recognised in accordance with other standards (e.g., IAS 36). After applying the impairment test to the capitalised contract costs, an entity includes the resulting carrying amounts in the carrying amount of a cash-generating unit for purposes of applying the requirements in IAS 36. *[IFRS 15.103]*.

Under IFRS accounting standards, IAS 36 permits the reversal of some or all of previous impairment losses on assets (other than goodwill) or cash-generating units if the estimates used to determine the assets' recoverable amount have changed. *[IAS 36.109-125]*. Consistent with IAS 36, IFRS 15 permits reversal of impairment losses when impairment conditions no longer exist or have improved. However, the increased carrying amount of the asset must not exceed the amount that would have been determined (net of amortisation) if no impairment loss had been recognised previously. *[IFRS 15.104]*.

157 TRG Agenda paper no. 4, *Impairment testing of capitalised contract costs*, dated 18 July 2014 and TRG Agenda paper no. 5, *July 2014 Meeting-Summary of Issues Discussed and Next Steps*, dated 31 October 2014.

FASB differences

Under US GAAP, the reversal of previous impairment losses is prohibited.

Frequently asked questions

Question 9-28: How often does an entity need to assess its capitalised contract costs for impairment under IFRS 15?

IFRS 15 does not explicitly state how often an entity needs to assess its capitalised contract costs for impairment.

How we see it

We believe an entity needs to assess whether there is any indication that its capitalised contract costs might be impaired at the end of each reporting period.

This is consistent with the requirement in IAS 36.9 to assess whether there are indicators that assets within the scope of that standard are impaired. For example, a pandemic or natural disaster might affect customers' ability and intent to pay, and/or entities might be more willing to accept partial payment or extend payment terms. Such collectability concerns might indicate that entities need to assess related capitalised costs to obtain or fulfil a contract for impairment.

10 IFRS 15 - Presentation and disclosure

IFRS 15 provides explicit presentation and disclosure requirements, which are more detailed than under legacy IFRS accounting standards and increase the volume of required disclosures that entities have to include in their interim and annual financial statements.

While not part of the requirements in IFRS 15, entities also need to disclosure material accounting policy information in accordance with IAS 1 (or IAS 8, if IFRS 18[158] is adopted early). *[IAS 1.117, IAS 8(2027).27A]*. It is likely that entities will conclude that accounting policy information about areas of IFRS 15 that are complex or require significant judgements are material. If so, entities will need to make entity-specific and tailored disclosures. *[IAS 1.117B-117C]*.

The extracts in this section illustrate possible formats entities might use to disclose information required by IFRS 15, using real-life examples from entities that have adopted the standard.

How we see it

As discussed more fully below, IFRS 15 requires extensive and detailed disclosures in entities' financial statements, particularly annual financial statements.

Entities might have to expend considerable effort when preparing the required disclosures for their interim and annual financial statements. For example, some entities operating in multiple segments with many different product lines might find it challenging to gather the data needed to provide the disclosures. Therefore, it is important for entities to have the appropriate systems, internal controls, policies and procedures in place to collect and disclose the required information.

FASB differences

For US GAAP preparers, the standard provides requirements on presentation and disclosure that apply to both public and non-public entities and provide some relief on disclosure requirements for non-public entities. IFRS 15 does not differentiate between public and non-public entities. Therefore, an entity that applies IFRS 15 must apply all of its requirements.[159]

10.1 Presentation requirements for contract assets and contract liabilities

The revenue model is based on the notion that a contract asset or contract liability is generated when either party to a contract performs, depending on the relationship between the entity's performance and the customer's payment. The standard requires that an entity present these contract assets or contract liabilities in the statement of financial position, as extracted below: *[IFRS 15.105, IFRS 15.106, IFRS 15.107, IFRS 15.108]*

Extract from IFRS 15

105	**When either party to a contract has performed, an entity shall present the contract in the statement of financial position as a contract asset or a contract liability, depending on the relationship between the entity's performance and the customer's payment. An entity shall present any unconditional rights to consideration separately as a receivable.**
106	If a customer pays consideration, or an entity has a right to an amount of consideration that is unconditional (ie a receivable), before the entity transfers a good or service to the customer, the entity shall present the contract as a contract liability when the payment is made or the payment is due (whichever is earlier). A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or an amount of consideration is due) from the customer.

158 IFRS 18 supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted). Once effective, the consequential amendments resulting from IFRS 18 will change the scope and title of IAS 8 due to certain sections previously included within IAS 1 being moved (mostly unchanged) to IAS 8. See Chapter 4 for further details on the requirements of IFRS 18.

159 IFRS 19 *Subsidiaries without Public Accountability: Disclosures* was issued by the IASB in May 2024 to simplify the preparation of financial statements by eligible subsidiaries. Eligible subsidiaries that elect to apply IFRS 19 are allowed to provide reduced disclosures while still applying the recognition, measurement and presentation requirements in other IFRS accounting standards. IFRS 19 is effective for annual reporting periods beginning on or after 1 January 2027, with earlier application permitted (subject to jurisdictional endorsement). See Chapter 4 at section 7 for further details on the requirements of IFRS 19.

107 If an entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due, the entity shall present the contract as a contract asset, excluding any amounts presented as a receivable. A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer. An entity shall assess a contract asset for impairment in accordance with IFRS 9. An impairment of a contract asset shall be measured, presented and disclosed on the same basis as a financial asset that is within the scope of IFRS 9 (see also paragraph 113(b)).

108 A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due. For example, an entity would recognise a receivable if it has a present right to payment even though that amount may be subject to refund in the future. An entity shall account for a receivable in accordance with IFRS 9. Upon initial recognition of a receivable from a contract with a customer, any difference between the measurement of the receivable in accordance with IFRS 9 and the corresponding amount of revenue recognised shall be presented as an expense (for example, as an impairment loss).

The standard does not explicitly require an entity to present contract assets or contract liabilities as separate line items in the statement of financial position. Therefore, entities need to consider the requirements in IAS 1 (see Chapter 3), or IFRS 18,[160] if adopted early (see Chapter 4), to determine whether to present them in separate line items. See Question 10-1 and Question 10-3 in section 10.1.5 below for further information on offsetting contract assets and contract liabilities. *[IFRS 15.BC130, IAS 1.55, IAS 1.57]*.

In the following Practical example, Bombardier Inc. presents these amounts separately using the terminology from the standard.

Practical example 10-1: Bombardier Inc. (2023) **Canada**

2023 Financial Report [extract]

CONSOLIDATED FINANCIAL STATEMENTS [extract]

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION [extract]

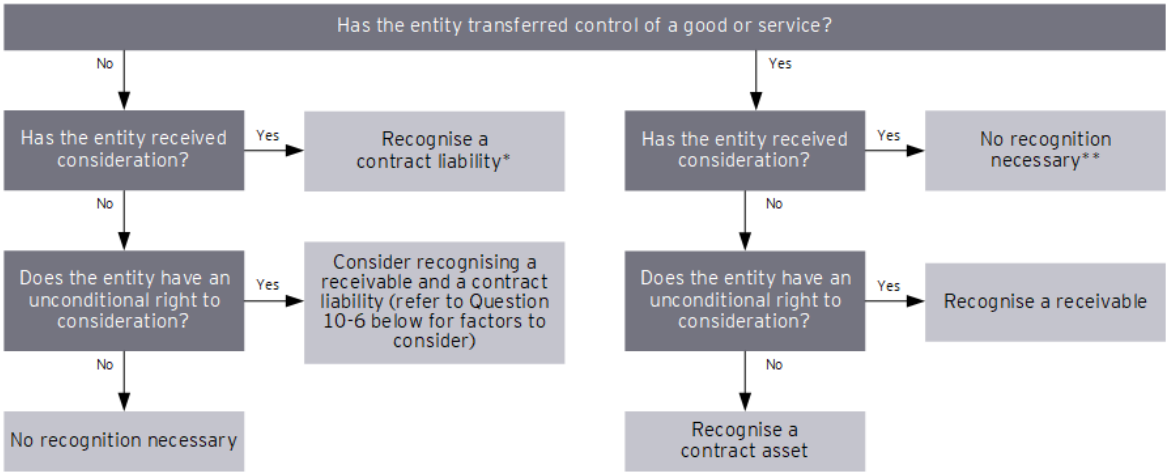
As at
(in millions of U.S. dollars)

	Notes	December 31 2023	December 31 2022
Assets			
Cash and cash equivalents	12	**$ 1,594**	$ 1,291
Trade and other receivables	13	**258**	252
Contract assets	14	**84**	67
Inventories	15	**3,768**	3,322
Other financial assets	17	**97**	472
Other assets	18	**133**	181
Current assets		**5,934**	5,585
...			
Liabilities			
Trade and other payables	22	**$ 1,820**	$ 1,286
Provisions	23	**78**	82
Contract liabilities	14	**3,455**	3,290
Other financial liabilities	24	**148**	345
Other liabilities	25	**437**	434
Current liabilities		**5,938**	5,437
...			

160 IFRS 18 supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted). IFRS 18 introduces new requirements for the aggregation and location of information in the financial statements based on the identified 'roles' of the primary financial statements and the notes, as well as guidance on providing informative labels. See Chapter 4 for further details on the requirements of IFRS 18.

The following flowchart illustrates how an entity determines whether to recognise a receivable, a contract asset or a contract liability on the balance sheet:

Figure 10-1: Recognition of a receivable, a contract asset or a contract liability



* If the customer can cancel the contract and receive a refund of the advance payment, an entity would consider recognising a refund liability (separate from contract liabilities – see Question 10-4 below).

** This assumes the consideration received is equal to the amount to which the entity is entitled for the good or service already transferred. If the consideration received is less than this amount, an entity may need to recognise a contract asset or a receivable for the difference. If the consideration received is more than this amount, an entity may need to recognise a contract liability or a refund liability.

When an entity satisfies a performance obligation by transferring a promised good or service, the entity has earned a right to consideration from the customer and, therefore, has a contract asset. When the customer performs first, for example, by prepaying its promised consideration, the entity has a contract liability. *[IFRS 15.106, IFRS 15.107]*.

An entity could also have recognised other assets related to contracts with a customer (e.g., the incremental costs of obtaining the contract and other costs incurred that meet the criteria for capitalisation). The standard requires that any such assets be presented separately from contract assets and contract liabilities in the statement of financial position or disclosed separately in the notes to the financial statements (assuming that they are material). *[IFRS 15.116(a)]*. These amounts are also assessed for impairment separately (see section 9.3.4 above).

10.1.1 Distinction between contract assets and receivables

Contract assets represent conditional or unconditional rights to consideration. The right is conditional, for example, when an entity must first satisfy another performance obligation in the contract before it is entitled to payment from the customer. If an entity has an unconditional right to receive consideration from the customer, the contract asset is accounted for as a receivable and presented separately from other contract assets. *[IFRS 15.105, IFRS 15.BC323, IFRS 15.BC324]*. A right is unconditional if nothing other than the passage of time is required before payment of that consideration is due. *[IFRS 15.108]*.

In the Basis for Conclusions on IFRS 15, the Board explains that in many cases an unconditional right to consideration (i.e., a receivable) arises when an entity satisfies a performance obligation, which could be before it invoices the customer (e.g., an unbilled receivable) if only the passage of time is required before payment of that consideration is due. It is also possible for an entity to have an unconditional right to consideration before it satisfies a performance obligation. *[IFRS 15.107, IFRS 15.BC325]*. In some industries, it is common for an entity to invoice its customers in advance of performance (and satisfaction of the performance obligation). For example, an entity that enters into a non-cancellable contract requiring payment a month before the entity provides the goods or services would recognise a receivable and a contract liability on the date the entity has an unconditional right to the consideration (see Question 10-6 in section 10.1.5 below for factors to consider when assessing whether an entity's right to consideration is considered unconditional). In this situation, revenue is not recognised until goods or services are transferred to the customer.

In December 2015, the IASB discussed application of IFRS 15 to contracts in which the entity has transferred control of a good to the customer at a point in time, but the consideration to which the entity is entitled is contingent upon a market price (e.g., a commodity price), which will be determined at a future date. The example assumed that there was no separable embedded derivative (i.e., the entire contract was within the scope of IFRS 15). In discussing this issue, the Board clarified the nature of conditions that might prevent recognition of a receivable. Specifically, the Board agreed that the variability arising solely from changes in the market price would not be a condition that prevents an entity to recognise a receivable. That is, since the entity has performed, "… nothing else (ie no future event) needs to happen before payment of

the consideration is due. The existence of a price in the future requires no event to occur and depends solely on the passage of time. Changes in the price of Commodity do not affect the entity's right to consideration, even though the amount that the entity receives is known only on the payment date. In other words, there is no uncertainty with regards to the entity's entitlement to the consideration. The entity's right to consideration is therefore unconditional as understood by IFRS 15…". Therefore, when the entity performs by transferring control of the good to the customer, it recognises a receivable in accordance with IFRS 9 (and is no longer subject to the requirements in IFRS 15 for the variable consideration constraint).[161]

In the Basis for Conclusions, the Board noted that making the distinction between a contract asset and a receivable is important because doing so provides users of financial statements with relevant information about the risks associated with the entity's rights in a contract. Although both are subject to credit risk, a contract asset is also subject to other risks (e.g., performance risk). *[IFRS 15.BC323]*.

Under the standard, entities are not required to use the terms 'contract asset' or 'contract liability', but must disclose sufficient information so that users of the financial statements can clearly distinguish between unconditional rights to consideration (receivables) and conditional rights to receive consideration (contract assets). *[IFRS 15.109]*.

The standard provides the following example of presentation of contract balances: *[IFRS 15.IE Example 38, IFRS 15.IE198-IE200]*

Extract from IFRS 15

Example 38-Contract liability and receivable

Case A-Cancellable contract

On 1 January 20X9, an entity enters into a cancellable contract to transfer a product to a customer on 31 March 20X9. The contract requires the customer to pay consideration of CU1,000 in advance on 31 January 20X9. The customer pays the consideration on 1 March 20X9. The entity transfers the product on 31 March 20X9. The following journal entries illustrate how the entity accounts for the contract:

(a) The entity receives cash of CU1,000 on 1 March 20X9 (cash is received in advance of performance):

Cash	CU1,000	
Contract liability		CU1,000

(b) The entity satisfies the performance obligation on 31 March 20X9:

Contract liability	CU1,000	
Revenue		CU1,000

Case B-Non-cancellable contract

The same facts as in Case A apply to Case B except that the contract is non-cancellable. The following journal entries illustrate how the entity accounts for the contract:

(a) The amount of consideration is due on 31 January 20X9 (which is when the entity recognises a receivable because it has an unconditional right to consideration):

Receivable	CU1,000	
Contract liability		CU1,000

(b) The entity receives the cash on 1 March 20X9:

Cash	CU1,000	
Receivable		CU1,000

(c) The entity satisfies the performance obligation on 31 March 20X9:

Contract liability	CU1,000	
Revenue		CU1,000

161 IASB Staff Paper 7H: Project: *Revenue from Contracts with Customers*, Paper topic: *Constraining estimates of variable consideration when the consideration varies based on a future market price*, IASB Meeting, December 2015; and *IASB Update*, December 2015. Available on the IFRS Foundation's website.

If the entity issued the invoice before 31 January 20X9 (the due date of the consideration), the entity would not present the receivable and the contract liability on a gross basis in the statement of financial position because the entity does not yet have a right to consideration that is unconditional.

The standard includes another example of presentation of contract balances that illustrates when an entity has satisfied a performance obligation, but does not have an unconditional right to payment and, therefore, recognises a contract asset: *[IFRS 15.IE Example 39, IFRS 15.IE201-IE204]*

Extract from IFRS 15

Example 39-Contract asset recognised for the entity's performance

On 1 January 20X8, an entity enters into a contract to transfer Products A and B to a customer in exchange for CU1,000. The contract requires Product A to be delivered first and states that payment for the delivery of Product A is conditional on the delivery of Product B. In other words, the consideration of CU1,000 is due only after the entity has transferred both Products A and B to the customer. Consequently, the entity does not have a right to consideration that is unconditional (a receivable) until both Products A and B are transferred to the customer.

The entity identifies the promises to transfer Products A and B as performance obligations and allocates CU400 to the performance obligation to transfer Product A and CU600 to the performance obligation to transfer Product B on the basis of their relative stand-alone selling prices. The entity recognises revenue for each respective performance obligation when control of the product transfers to the customer.

The entity satisfies the performance obligation to transfer Product A:

Contract asset		CU400	
	Revenue		CU400

The entity satisfies the performance obligation to transfer Product B and to recognise the unconditional right to consideration:

Receivable		CU1,000	
	Contract asset		CU400
	Revenue		CU600

Also consider the following Illustration, which shows an unbilled receivable (rather than a contract asset):

Illustration 10-1: Unbilled receivable

On 14 September 20X0, Entity L enters into a contract to sell 100 widgets to Customer F at CU10 per widget. All of the widgets are delivered to Customer F on 29 September 20X0. Entity L invoices Customer F on 12 October 20X0.

Entity L determines that revenue is recognised when control of the widgets transfers to Customer F on 29 September 20X0. Entity L records a corresponding receivable because only the passage of time is required before payment of that consideration is due. That is, Entity L has an unconditional right to consideration as at 29 September 20X0, even though Entity L has not yet issued an invoice. That is, even though the amount is 'unbilled', it is still considered a receivable, rather than a contract asset.

As noted in Question 5-6 in section 5.2.1 above, when an entity is entitled to receive consideration denominated in a foreign currency, it needs to apply IAS 21 and IFRIC 22 to appropriately translate a foreign denominated transaction on initial recognition. After initial recognition, receivables are retranslated using the spot exchange rate at each subsequent reporting date and on derecognition, with the exchange gains and losses being recognised in profit or loss. This is because receivables are monetary items as defined in IAS 21.8. *[IAS 21.8]*. Further analysis is needed for a contract asset to determine whether it is a monetary item that requires retranslation, or a non-monetary item that does not. Some (or all) of a contract asset will meet the definition of a monetary item to the extent the (conditional) right to consideration is to foreign denominated cash.[162] See Chapter 16 at section 5.3 for further discussion.

162 IASB Staff Paper 2: Project: *IAS 21 The Effects of Changes in Foreign Exchange Rates*, Paper topic: *Draft Interpretation-Foreign Currency Transactions and Advance Consideration*, IFRS IC meeting, March 2015, paragraph 38. Available on the IFRS Foundation's website.

10.1.2 Current versus non-current

Unless an entity presents its statement of financial position on a liquidity basis, it needs to present contract assets or contract liabilities as current or non-current in the statement of financial position. Since IFRS 15 does not address this classification, entities need to consider the requirements in IAS 1 (or IFRS 18,[163] if adopted early).

The distinction between current and non-current items depends on the length of the entity's operating cycle. IAS 1 states that the operating cycle of an entity is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. However, when the entity's normal operating cycle is not clearly identifiable, it is assumed to be 12 months. *[IAS 1.68, IAS 1.70, IFRS 18.B95, IFRS 18.B96]*. IAS 1 does not provide guidance on how to determine whether an entity's operating cycle is 'clearly identifiable'. For some entities, the time involved to produce goods or provide services might vary significantly from contracts with one customer to another. In such cases, it might be difficult to determine what is the normal operating cycle.

Therefore, entities need to consider all facts and circumstances and use judgement to determine whether it is appropriate to consider that the operating cycle is clearly identifiable, or whether to use the twelve-month default. *[IAS 1.68, IAS 1.70, IFRS 18.B95, IFRS 18.B96]*. This assessment is also relevant for other assets and liabilities arising from contracts with customers within the scope of IFRS 15 (e.g., capitalised contract costs to obtain and fulfil a contract).

Consequently, an entity assesses, based on the contract terms, facts and circumstances, whether a contract asset or contract liability is classified as current or non-current. It considers:

- For a contract asset: when payment is due (e.g., based on payment schedule agreed with client)
- For a contract liability: the timing of satisfaction of the performance obligation as a factor when applying the requirements of IAS 1 *[IAS 1.69, IFRS 18.101]*

This assessment might lead to a separation of the contract asset or contract liability into a current and a non-current portion.

In Practical example 10-2 below, Fédération Internationale de Football Association (FIFA) splits contract liabilities between current and non-current in its balance sheet and uses the terms from the standard.

Practical example 10-2: Fédération Internationale de Football Association (FIFA) (2023) **Switzerland**

ANNUAL REPORT 2023 [extract]
2023 FINANCIAL STATEMENTS [extract]
CONSOLIDATED FINANCIAL STATEMENTS ACCORDING TO IFRS [extract]
CONSOLIDATED BALANCE SHEET [extract]

in TUSD	Note	31 Dec 2023	31 Dec 2022
...			
Liabilities and reserves			
Payables	24	81,802	653,434
Contract liabilities	26	122,625	233,458
Accrued expenses and deferred income	25	769,733	1,305,740
Derivative financial liabilities	31	81,056	102,970
Lease liabilities	28	9,236	10,063
Current liabilities		**1,064,452**	**2,305,665**
Contract liabilities	26	340,294	31,677
Accrued expenses and deferred income	25	225,543	238,272
Post-employment benefit obligation	32	45,442	16,989
Provisions	27	58,551	54,960
Derivative financial liabilities	31	170	0
Lease liabilities	28	191,209	176,720
Non-current liabilities		**861,209**	**518,618**
Total liabilities		**1,925,661**	**2,824,283**

163 IFRS 18 supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted). See Chapter 4 for further details on the requirements of IFRS 18.

10.1.3 Impairment of contract assets

After initial recognition, contract assets, like receivables, are subject to impairment assessments in accordance with IFRS 9 (the impairment requirements are discussed in Chapter 47). *[IFRS 15.107]*. The Basis for Conclusions on IFRS 9 clarifies that contract assets are in scope of IFRS 9 impairment because the IASB considered "the exposure to credit risk on contract assets is similar to that of trade receivables". *[IFRS 9.BC5.154]*.

The expected credit loss model in IFRS 9 focuses on the difference between the contractual cash flows and expected cash flows. *[IFRS 9.B5.5.29]*. However, the right to receive non-cash consideration does not give rise to cash inflows. As such, judgement might be needed when the consideration to which the entity is entitled is non-cash. Since the entity does not yet hold the non-cash consideration, the impairment requirements in IAS 36, for example, do not directly apply.

How we see it

When applying the impairment requirements of IFRS 9 to the contract asset, an entity considers the likelihood of not receiving the non-cash consideration (i.e., non-performance risk). However, this would not consider any potential impairment in the underlying asset to which the entity is entitled. As such, an entity might need to consider the value of the underlying non-cash consideration to which it is entitled to use as a proxy for the cash inflows when applying the impairment requirements of IFRS 9.

As discussed in section 5.5.5 above, impairment losses on receivables are presented in line with the requirements of IAS 1 (or IFRS 18,[164] if adopted early) and the disclosure requirements in IFRS 7 apply. *[IFRS 7.35A(a)]*. In addition, as discussed in section 10.2 below, IFRS 15 requires that such amounts are disclosed separately from impairment losses from other contracts. *[IFRS 15.113(b)]*. These requirements also apply to impairment losses on contract assets.

10.1.4 Derecognition of contract assets

Contract assets will generally be derecognised when an entity's right to consideration becomes unconditional, and it is able to recognise a receivable in accordance with IFRS 9. *[IFRS 15.108]*. IFRS 15 does not provide any additional requirements on derecognising contract assets and only the impairment requirements in IFRS 9 apply to contract assets (as discussed in section 10.1.3 above). *[IFRS 15.107]*.

How we see it

In theory, entities could also apply the derecognition requirements in IFRS 9 by analogy to contract assets. However, in practice, we believe that it is very unlikely that many contract assets would meet the requirements for derecognition in IFRS 9, particularly if they are still conditional on the entity's future performance. See Chapter 48 for further discussion on the derecognition requirements of IFRS 9.

164 IFRS 18 supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted). See Chapter 4 for further details on the requirements of IFRS 18.

10.1.5 Initial measurement of receivables

IFRS 9 includes different initial measurement requirements for receivables arising from IFRS 15 contracts depending on whether there is a significant financing component.

- If there is a significant financing component, the receivable is initially measured at fair value. *[IFRS 9.5.1.1]*.
- If there is no significant financing component (or the entity has used the practical expedient in IFRS 15.63), the receivable is initially recognised at the transaction price, measured in accordance with IFRS 15. *[IFRS 9.5.1.3]*. The *Annual Improvements* issued by the Board in July 2024, once effective, amends IFRS 9.5.1.3 to replace the reference to "transaction price (as defined in IFRS 15)" with "the amount determined by applying IFRS 15". The use of the term 'transaction price' in relation to IFRS 15 was potentially confusing and so it will be removed by the amendment. The term will also be deleted from Appendix A of IFRS 9. This amendment is effective for annual periods beginning on or after 1 January 2026 and earlier application is permitted. *[IFRS 9(2026).5.1.3, IFRS 9(2026).BC5.10A-BC5.10B]*.

If upon initial measurement there is a difference between the measurement of the receivable under IFRS 9 and the corresponding amount of revenue, that difference is presented immediately in profit or loss (e.g., as an impairment loss). *[IFRS 15.108]*. See Chapter 45 for further discussion on recognition and initial measurement under IFRS 9.

If the initial measurement of a receivable is at fair value, there might be a number of reasons why differences from the IFRS 15 transaction price could arise (e.g., changes in the fair value of non-cash consideration not yet received, changes in market interest rates or inflation, etc.). This is the case when the difference is attributable to customer credit risk, rather than an implied price concession. Implied price concessions are deducted from the contract price to derive the transaction price, which is the amount recognised as revenue. Distinguishing between implied price concessions and expense due to customer credit risk requires judgement (see sections 5.2.1.A - 5.2.1.B above). Impairment losses resulting from contracts with customers are presented separately from other impairment losses (see section 10.5.1 below for further discussion). *[IFRS 15.113(b)]*.

Further analysis of the reason for such a difference might be needed if an entity has an unconditional right to payment (i.e., a receivable) even though that amount is subject to refund in the future. This could occur because, for example, a customer might be entitled to a retrospective volume rebate. Assume, for example, that an entity has invoiced a customer CU100 for the sale of goods, but expects to refund CU25 because the customer will meet the conditions for an agreed volume rebate. The entity recognises CU75 because it has constrained the consideration (in accordance with the variable consideration requirements, see section 5.2 above). However, it has an unconditional right to receive payment for the full invoice price of CU100. Therefore, the entity recognises a receivable of CU100 and the refund obligation of CU25 (on a gross basis), unless the offsetting requirements in IAS 32.42 are met (see Chapter 50 at section 7.4.1 on the requirements in IAS 32 for offsetting financial assets and financial liabilities). This is consistent with Example 40 in the standard. *[IFRS 15.IE Example 40, IFRS 15.IE205-IE208]*. Careful analysis of the facts will be important including expectations about when any conditions for refund will be met and when the entity has an unconditional right to payment.

Frequently asked questions

Question 10-1: How would an entity determine the presentation of contract assets and liabilities for contracts that contain multiple performance obligations?

(TRG meeting 31 October 2014 - Agenda paper no. 7)

TRG members generally agreed that contract assets and liabilities would be determined at the contract level and not at the performance obligation level. That is, an entity does not separately recognise an asset or liability for each performance obligation within a contract, but aggregates them into a single contract asset or liability.[165]

Under the standard, the amount and timing of revenue recognition is determined based on progress toward complete satisfaction of *each* performance obligation. Therefore, this question addresses whether an entity could have a contract asset and a contract liability for a single contract. An example is when the entity has satisfied (or partially satisfied) one performance obligation in a contract for which consideration is not yet due but has received a prepayment for another unsatisfied performance obligation in the contract. Members of the TRG generally agreed that the discussion in the Basis for Conclusions was clear that contract asset or contract liability positions are determined for each contract on a net basis. This is because the rights and obligations in a contract with a customer are interdependent - the right to receive consideration from a customer depends on the entity's performance and, similarly, the entity performs only as long as the customer continues to pay. The Board decided that those interdependencies are best reflected by accounting and presenting contract assets or liabilities on a net basis. *[IFRS 15.BC317]*.

Consider the following Illustration:

Illustration 10-2: Presentation of contract assets and liabilities

Entity A has a contract with Customer B to transfer a licence on 1 January 20X0 for the right to use Entity A's intellectual property in exchange for a CU200,000 milestone payment that is contingent upon Customer B achieving a specific outcome. The contract also includes a one-year service to be provided by Entity A for fixed consideration of CU100,000 that is paid upfront by Customer B at contract inception.

Assume Entity A concludes there are two performance obligations: one for the right to use licence of intellectual property that will be satisfied when the licence is delivered and one for the service that will be recognised over time using a time-elapsed measure of progress. On 1 January 20X0, the licence is delivered and the service commences.

Entity A determines that the milestone payment is variable consideration. Because of the binary nature of the outcome (i.e., the entity will either receive the milestone payment or not), Entity A determines that the most likely amount method (discussed in section 5.2.2 above) is the better predictor of the amount to which it expects to be entitled. Entity A believes it is 90% probable that it will receive the CU200,000 milestone payment. Therefore, using the most likely amount method, Entity A estimates that it will receive the full CU200,000. Entity A then allocates the total transaction price of CU300,000 (variable consideration of CU200,000 plus the fixed consideration of CU100,000) to the licence and the service based on their relative stand-alone selling prices (assume this arrangement does not meet the variable consideration allocation exception). Further assume that CU200,000 is allocated to the licence and CU100,000 is allocated to the service, i.e., the components were priced at their stand-alone selling price.

On 1 January 20X0, when Entity A satisfies the performance obligation related to the licence, it recognises revenue and a contract asset of CU200,000. A contract asset is recorded (rather than a receivable) because Entity A's right to the consideration is contingent upon something other than the passage of time (i.e., Customer B achieving a specific outcome). The performance obligation associated with the service results in the recognition of a contract liability of CU100,000 as at 1 January 20X0 because Entity A paid upfront for the service.

On 31 March 20X0, related to the contract with Customer B, Entity A has a contract asset of CU200,000 (because the condition to receive consideration for the licence still has not been met) and a contract liability of CU75,000 (because CU25,000 of revenue has been recognised for one quarter of service). For presentation purposes as at 31 March 20X0, Entity A nets the contract asset of CU200,000 and the contract liability of CU75,000, and presents a net contract asset of CU125,000.

165 TRG Agenda paper no. 7, *Presentation of a contract as a contract asset or a contract liability*, dated 31 October 2014 and TRG Agenda paper no. 11, *October 2014 Meeting - Summary of Issues Discussed and Next Steps*, dated 26 January 2015.

After determining the net contract asset or contract liability position for a contract, entities consider the requirements in IAS 1 (or IFRS 18,[166] if adopted early) on classification as current or non-current in the statement of financial position, unless an entity presents its statement of financial position on a liquidity basis (as discussed above in this section).

Question 10-2: How would an entity determine the presentation of two or more contracts that are required to be combined under the standard?

(TRG meeting 31 October 2014 - Agenda paper no. 7)

TRG members generally agreed that the contract asset or liability would be combined (i.e., presented net) for different contracts with the same customer (or a related party of the customer) if an entity is otherwise required to combine those contracts under the standard (see section 3.3 above for discussion of the criteria for combining contracts).[167] When two or more contracts are required to be combined under the standard, the rights and obligations in the individual contracts are interdependent. Therefore, as discussed in Question 10-1 above, this interdependency is best reflected by combining the individual contracts as if they were a single contract. However, TRG members acknowledged that this analysis might be operationally difficult for some entities because their systems might capture data at the performance obligation level in order to comply with the recognition and measurement aspects of the standard.

Question 10-3: When would an entity offset contract assets and liabilities against other statement of financial position items (e.g., accounts receivable)?

(TRG meeting 31 October 2014 - Agenda paper no. 7)

TRG members generally agreed that, because the standard does not provide requirements for offsetting, entities need to apply the requirements of other standards to determine whether offsetting is appropriate (e.g., IAS 1, IAS 32, IFRS 18).[168] For example, if an entity has recorded a contract asset (or a receivable) and a contract liability (or refund liability) from separate contracts with the same customer (that are not required to be combined under the standard), the entity needs to look to requirements outside IFRS 15 to determine whether offsetting is appropriate.

Question 10-4: Is a refund liability a contract liability (and, thus, subject to the presentation and disclosure requirements of a contract liability)?

How we see it

An entity needs to determine whether a refund liability is characterised as a contract liability based on the specific facts and circumstances of the arrangement. We believe the following are relevant considerations in making that determination.

We believe that a refund liability typically does not meet the definition of a contract liability. When an entity concludes that a refund liability is not a contract liability, it presents the refund liability separately from any contract liability (or asset) and the refund liability is not subject to the disclosure requirements in IFRS 15.116-118 discussed in section 10.5.1.B below.

When a customer pays consideration (or consideration is unconditionally due) and the entity has an obligation to transfer *goods or services* to the customer, the entity recognises a contract liability. When the entity expects to refund some or all of the *consideration* received (or receivable) from the customer, it recognises a refund liability. A refund liability generally does not represent an obligation to transfer goods or services in the future. Similar to receivables (which are considered a subset of contract assets), refund liabilities could be considered a subset of contract liabilities.

We believe refund liabilities are also similar to receivables in that they are extracted from the net contract position and presented separately (if material). This conclusion is consistent with the standard's specific requirement to present the corresponding asset for expected returns separately (see section 5.4 above).

If an entity concludes, based on its specific facts and circumstances, that a refund liability represents an obligation to transfer goods or services in the future, the refund liability is a contract liability subject to the disclosure requirements in IFRS 15.116-118. In addition, in that situation, the entity presents a single net contract liability or asset (i.e., including the refund liability) determined at the contract level, as discussed in Question 10-1 above.

166 IFRS 18 supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted). See Chapter 4 for further details on the requirements of IFRS 18.

167 TRG Agenda paper no. 7, *Presentation of a contract as a contract asset or a contract liability*, dated 31 October 2014 and TRG Agenda paper no. 11, *October 2014 Meeting - Summary of Issues Discussed and Next Steps,* dated 26 January 2015.

168 TRG Agenda paper no. 7, *Presentation of a contract as a contract asset or a contract liability*, dated 31 October 2014 and TRG Agenda paper no. 11, *October 2014 Meeting - Summary of Issues Discussed and Next Steps,* dated 26 January 2015.

Question 10-5: How would an entity account for a contract asset that exists when a contract is modified if the modification is treated as the termination of an existing contract and the creation of a new contract? (FASB TRG meeting 18 April 2016 - Agenda paper no. 51)

FASB TRG members generally agreed that a contract asset that exists when a contract is modified would be carried forward into the new contract if the modification is treated as the termination of an existing contract and the creation of a new contract (see section 3.4.1 above).

This question addresses this type of modification because the termination of the old contract could indicate that any remaining balances associated with the old contract must be written off.

FASB TRG members generally agreed that it is appropriate to carry forward the related contract asset in such modifications because the asset relates to a right to consideration for goods or services that have already been transferred and are distinct from those to be transferred in the future. As such, the revenue recognised to date is not reversed and the contract asset continues to be realised as amounts become due from the customer and are presented as a receivable. The contract asset that remains on the entity's statement of financial position at the date of modification continues to be subject to evaluation for impairment.

Consider the following example included in the TRG agenda paper:

Illustration 10-3: Accounting for an existing contract asset when the contract is modified

Vendor A enters into a contract to provide a good and one year of service. The transaction price is CU4,200. The good and service are separate performance obligations, and the service is considered a series of distinct goods or services (see section 4.2.2 above). The stand-alone selling price for the good is CU3,000 and the stand-alone selling price for the services is CU100 per month (CU1,200 for one year). Therefore, Vendor A allocates CU3,000 to the good and CU1,200 to the services. Customer B will pay 12 equal instalments of CU350. Vendor A will invoice Customer B at the end of each month.

At the beginning of the first month, the good is transferred to Customer B and the revenue allocated to that performance obligation (CU3,000) is recognised. Vendor A also recognises a contract asset for CU3,000 because payment of that CU3,000 is conditional upon Vendor A's performance of future services.

At the end of the first month, Vendor A recognises revenue of CU100 for progress toward complete satisfaction of the performance obligation related to the services (assuming the entity is using a time-based measure of progress). Vendor A also recognises accounts receivable of CU350 because that amount is not conditional. The contract asset, which had a balance of CU3,000 at the beginning of the month, would have a balance of CU2,750 at the end of the first month.

Vendor A continues to make similar entries for the first nine months of the contract. After nine months, CU3,900 of revenue has been recognised for the contract (CU900 of revenue for the services and CU3,000 for the good). Vendor A has a receivable for CU350 (assuming Customer B already paid the first eight instalments). In addition, Vendor A has a contract asset for CU750 (CU3,000 - (9 × (CU350 - CU100))).

At the end of nine months, the contract is modified to include one additional year of service. The fee for the last three months of the initial one-year contract is unchanged, but the agreed fee for the additional one year of services is CU50 per month, which is significantly below the stand-alone selling price of the services.

In addition, because the remaining services are a series of distinct services, Vendor A determines that the remaining services are distinct from the goods or services transferred prior to the modification. Therefore, the modification would be accounted for under IFRS 15.21(a) (i.e., as a termination of the existing contract and the creation of a new contract, as discussed in section 3.4.1 above).

At the modification date, Vendor A retains the existing contract asset of CU750 that relates to revenue previously recognised, but which has not been paid by the customer (and is not presented as a receivable). Vendor A also determines the total consideration to be allocated to the remaining performance obligations. The consideration promised by Customer B that was included in the transaction price, but not yet recognised as revenue under the original contract, is CU300 (equal to CU4,200 transaction price - CU3,900 already recognised as revenue). The additional consideration promised as part of the contract modification is CU600 (equal to 12 additional months × CU50 per month). Therefore, the total amount of consideration allocated to the remaining distinct services is CU900 (CU300 + CU600). Vendor A would allocate the CU900 to the remaining performance obligations and recognise revenue over the remaining modified contract duration. Subsequent to the contract modification, the contract asset would be evaluated and accounted for in the same manner as any other contract asset.

How we see it

While the FASB TRG members did not discuss this point, we believe a similar conclusion would be appropriate when accounting for an asset created under IFRS 15, such as capitalised commissions, which exists immediately before a contract modification that is treated as if it were a termination of the existing contract and creation of a new contract. Refer to Question 9-11 in section 9.3.1 above for further discussion.

Question 10-6: If an entity has not transferred a good or service, when does it have an unconditional right to payment?

The standard states in IFRS 15.108 that a receivable is an entity's right to consideration that is unconditional.

How we see it

In general, we believe it might be difficult to assert that the entity has an unconditional right to payment when it has not transferred a good or service.

However, an entity might enter into non-cancellable contracts that provide unconditional rights to payment from the customer for services that the entity has not yet completed providing or services it will provide in the near future (e.g., amounts invoiced in advance related to a service or maintenance arrangement).

When determining whether an entity is required to recognise accounts receivable and a corresponding contract liability, the contractual terms and specific facts and circumstances supporting the existence of an unconditional right to payment need to be evaluated, including the factors outlined below.

(a) Does the entity have a contractual (or legal) right to invoice and receive payment from the customer for services being provided currently (and not yet completed) or being provided in the near future (e.g., amounts invoiced in advance related to a service or maintenance arrangement)?

(b) Is the advance invoice consistent with the entity's normal invoicing terms?

(c) Will the entity commence performance within a relatively short time frame of the invoice date?

(d) Is there more than one year between the advance invoice and performance?

10.2 Presentation requirements for revenue from contracts with customers

The Board decided to require entities to separately present or disclose the amount of revenue related to contracts with customers, as follows: *[IFRS 15.113, IFRS 15.BC332]*

- IFRS 15.113(a) requires an entity to disclose (or present in the statement of comprehensive income) the amount of revenue recognised from contracts with customers under IFRS 15 separately from other sources of revenue. For example, a large equipment manufacturer that both sells and leases its equipment is required to present (or disclose) amounts from these transactions separately.
- IFRS 15.113(b) also requires an entity to disclose impairment losses from contracts with customers separately from other impairment losses if they are not presented in the statement of comprehensive income separately. As noted in the Basis for Conclusions, the Board felt that separately disclosing the impairment losses on contracts with customers provides the most relevant information to users of financial statements. *[IFRS 15.BC334]*.

In the following extract, Slater and Gordon Limited presents revenue from contracts with customers that are within the scope of IFRS 15, separately from other income, on the face of its consolidated statement of comprehensive income in its 2022 annual financial statements.

Practical example 10-3: Slater and Gordon Limited (2022) — **Australia**

Annual Report 2022 [extract]

Consolidated statement of profit or loss and other comprehensive income [extract]

For the year ended 30 June 2022 [extract]

	Note	30 June 2022 $'000	30 June 2021 $'000
Revenue			
Fee revenue		155,421	154,245
Net movement in work in progress		26,620	48,096
Revenue from contracts with customers	3	182,041	202,341
Other income		576	1,460
Total revenue and other income		182,617	203,801

In the following extract, A.P. Møller - Mærsk A/S presents a combined revenue number on the face of the consolidated income statement which includes revenue recognised from contracts with customers in accordance with IFRS 15 and other revenue (e.g., vessel-sharing and slot charter income, lease income and other income) in the same line item. It then presents customer contract revenues separately from other sources of revenue, in note 2.1.

Practical example 10-4: A.P. Møller - Mærsk A/S (2022) — **Denmark**

Annual Report 2022 [extract]
Consolidated financial statements [extract]
Consolidated income statement [extract]

Note		2022	2021
2.1	Revenue	81,529	61,787
2.2	Operating costs	44,882	37,748
	Other income	319	166
	Other costs	153	169
2.1	**Profit before depreciation, amortisation and impairment losses, etc. (EBITDA)**	**36,813**	**24,036**

Notes [extract]
2. Operating profit [extract]
Note 2.1 Segment information [extract]

	2022	2021
Revenue from contracts with customers	80,179	60,632
Revenue from other sources		
Vessel-sharing and slot charter income	1,229	1,060
Lease income	14	19
Others	107	76
Total revenue	**81,529**	**61,787**

Ferrovial, S.A. has applied a different approach by disclosing the amounts relating to contracts with customers in a narrative within the notes.

Practical example 10-5: Ferrovial, S.A. (2021) — **Spain**

Integrated Annual Report [extract]
Consolidated Financial Statements [extract]
F. NOTES TO THE CONSOLIDATED ANNUAL ACCOUNTS FOR 2021 [extract]
SECTION 2: PROFIT/(LOSS) FOR THE YEAR [extract]
NOTES ON PROFIT/(LOSS) FOR CONTINUING OPERATIONS [extract]
2.1. OPERATING INCOME [extract]

The detail of the Group's operating income at 31 December 2021 is as follows:

(Millions of euros)	2021	2020 (*)
Revenue	6,778	6,532
Other operating income	1	3
Total operating income	**6,779**	**6,534**

(*) Restated figures (Note 1.1.5)

The Group's revenue at 31 December 2021 relating to contracts with customers, as interpreted by IFRS 15, amounts to EUR 6,678 million (Note 4.4).

...

Unless required, or permitted, by another standard, IAS 1 (or IFRS 18,[169] if adopted early) does not permit offsetting of income and expenses within profit or loss or the statement of comprehensive income. *[IAS 1.32, IFRS 18.44]*.

After applying the requirements for determining the transaction price in IFRS 15, revenue recognised by an entity might include offsets, for example, for any trade discounts given and volume rebates paid by the entity to its customers. Similarly, in the ordinary course of business, an entity might undertake other transactions that do not generate revenue, but are incidental to the main revenue-generating activities. When this presentation reflects the substance of the transaction or other event, IAS 1 permits an entity to present "the results of such transactions … by netting any income with related expenses arising on the same transaction". *[IAS 1.34, IFRS 18.B27]*. An example given in IAS 1 is the presentation of gains and losses on the disposal of non-current assets by deducting from the amount of consideration on disposal the carrying amount of the asset and related selling expenses. *[IAS 1.34(a), IFRS 18.B27(a)]*.

Frequently asked questions

Question 10-7: Can income outside the scope of IFRS 15 be presented as revenue in the income statement?

How we see it

Entities need to consider the definition of revenue to determine whether income outside the scope of IFRS 15 can be presented as revenue in the income statement. We believe an entity needs to consider the discussion below as part of its determination.

IFRS 15 defines revenue as "Income arising in the course of an entity's ordinary activities", but the standard excludes some revenue contracts from its scope (e.g., leases). *[IFRS 15 Appendix A, IFRS 15.5]*. According to the 2010 *Conceptual Framework for Financial Reporting* (which applied when IFRS 15 was issued), revenue arises in the course of the ordinary activities of an entity and is referred to by a variety of different names including "sales, fees, interest, dividends, royalties and rent". *[CF(2010) 4.29]*. The 2018 *Conceptual Framework for Financial Reporting* (which became effective in 2020) no longer contains a discussion about revenue and gains and losses. However, the definition of revenue in IFRS 15 remains unchanged. The Board does not expect the removal of that discussion to cause any changes in practice. *[CF BC4.96]*.

While 'ordinary activities' is not defined, if the transaction involves the sale of an asset, the nature of the asset and the purpose for which it was held by the entity could be informative. For example, inventory accounted for under IAS 2 is, by definition, held for use in production or sale in the ordinary course of business. *[IAS 2.6]*. Therefore, the sale of that inventory is typically part of an entity's ordinary activities. Conversely, property, plant and equipment accounted for under IAS 16 is, by definition, held for use by the entity for more than one period. *[IAS 16.6]*. Likewise, IAS 38 excludes from its scope intangible assets held for sale in the ordinary course of business. *[IAS 38.3(a)]*. Therefore, their disposal is not typically part of an entity's ordinary activities and the difference between the net disposal proceeds and the carrying amount of the asset is not recognised as revenue under IFRS 15, but as a gain or loss on disposal. This was reiterated by the IFRS IC in June 2020, as is discussed in section 2.6.3 above.[170]

If an entity receives consideration in the course of its ordinary activities that is outside the scope of IFRS 15, it might present that income as revenue in the income statement. This view is consistent with the Basis for Conclusions on IFRS 15, which says that an entity can present interest income as revenue only when interest income represents income from an entity's ordinary activities (also discussed in section 5.5.5 above). *[IFRS 15.BC247]*. However, any revenue recognised that is outside the scope of IFRS 15 will need to be presented either separately from revenue from contracts with customers within the income statement or disclosed separately within the notes. This is because, as mentioned above, entities are required to present in the statement of comprehensive income, or disclose within the notes, the amount of revenue recognised from contracts with customers separately from other sources of revenue. *[IFRS 15.113(a), IFRS 15 Appendix A]*.

IFRS 15 does not explicitly require an entity to use the term 'revenue from contracts with customers'. Therefore, entities might use a different terminology in their financial statements to describe revenue arising from transactions that are within the scope of IFRS 15. However, entities need to ensure the terms used are not misleading and allow users to distinguish revenue from contracts with customers from other sources of revenue. *[IFRS 15.113(a)]*.

169 IFRS 18 supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted). See Chapter 4 for further details on the requirements of IFRS 18.

170 *IFRIC Update*, June 2020, available on the IFRS Foundation's website.

10.3 Other presentation considerations

The standard also includes presentation requirements for products expected to be returned and for those that contain a significant financing component. Refer to section 5.4 and section 5.5.5 above for presentation considerations related to rights of return and significant financing components, respectively. Also refer to Question 9-27 in section 9.3.3 above for classification and presentation considerations related to capitalised contract costs to obtain and fulfil a contract.

Frequently asked questions

Question 10-8: How are shipping and handling costs incurred in relation to a revenue contract presented in the income statement?

How an entity presents shipping and handling costs in the income statement will depend upon how it presents expenses in accordance with IAS 1 (or IFRS 18,[171] if adopted early), by nature (e.g., purchases of materials or transportation costs) or by function (e.g., cost of sales, costs of distribution or administrative activities). *[IAS 1.102, IAS 1.103]*. When an entity presents expenses by function, it also needs to disclose further analysis of expenses by their nature in accordance with IAS 1 (See Chapter 3 at section 3.2.3.B). *[IAS 1.104]*.

An entity might be involved with a variety of shipping and handling activities. Prior to a revenue contract, for example, an entity might transport inventory it has purchased to its warehouse or move it between warehouses. In such cases, the related costs will be within the scope of IAS 2 (discussed in Chapter 23). An entity might also incur shipping and handling costs not related to a promised good or service to the customer (e.g., distribution costs) that are outside the scope of IAS 2 and IFRS 15. An entity might need to apply judgement to distinguish such costs from those within the scope of IAS 2 or IFRS 15, and to determine where to present such costs.

Under IFRS 15, an entity needs to determine whether shipping and handling is a separate promised service to the customer or if they are activities to fulfil the promise to transfer the good (see section 4.1 above). Shipping and handling activities that are performed before the customer obtains control of the related good are activities to fulfil its promise to transfer control of the good. If shipping and handling activities are performed after a customer obtains control of the related good, shipping and handling is a promised service to that customer and an entity needs to determine whether it acts as a principal or an agent in providing those services.

If an entity determines that the shipping and handling activities are related to a promised good or service to the customer (either the promise to transfer control of the good or the promise to provide shipping and handling services) and the entity is the principal (rather than the agent), the costs are incurred to fulfil its promise to provide those services.

How we see it

If the entity determines that the shipping and handling activities are related either to the promise to transfer control of the good or the promise to provide shipping and handling services and the entity is the principal, we believe it is appropriate to present the related costs as cost of sales, changes in contract costs, or similar, because the costs would be incurred to fulfil a revenue obligation (i.e., fulfilment costs). In determining the presentation of shipping and handling costs, entities might also need to consider the views of local regulators.[172]

Entities need to consider whether disclosure of the amount of shipping and handling costs and the line items in the income statement that include them is required. *[IAS 1.17(c), IAS 1.104]*.

If the entity determines that shipping and handling is a separate promised service to the customer and it is acting as an agent in providing those services, the related revenue to be recognised for shipping and handling services would be net of the related costs. *[IFRS 15.47, IFRS 15.B34-B38]*.

171 IFRS 18 supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted). IFRS 18 introduces new requirements relating to the presentation of expenses classified in the operating category, while these expenses will still be presented by 'function' or by 'nature', it introduces additional disclosure requirements for entities choosing to present these items by function. See Chapter 4 for further details on the requirements of IFRS 18.

172 Foreign Private Issuers are encouraged to consider the views of the US SEC and the guidance in *EY's Financial Reporting Developments - Revenue from contracts with customers (ASC 606)*, section 4.1.2, Question 4-7.

Question 10-9: How are capitalised contract costs and their amortisation classified and presented in the statement of financial position and statement of profit or loss and other comprehensive income, respectively?

See response to Question 9-27 in section 9.3.3 above.

Question 10-10: How would entities determine the presentation of amounts billed to customers (e.g., shipping and handling, expenses or cost reimbursements and taxes) under the standards (i.e., as revenue or as a reduction of costs)?

(TRG meeting 18 July 2014 - Agenda paper no. 2)

See response to Question 4-16 in section 4.4.4 above.

10.4 Disclosure objective and general requirements

IFRS 15 requires a comprehensive and coherent set of revenue recognition disclosures. The IASB described the overall objective of the disclosures, consistent with other recent standards, as follows: *[IFRS 15.110]*

Extract from IFRS 15

110 The objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, an entity shall disclose qualitative and quantitative information about all of the following:

(a) its contracts with customers (see paragraphs 113-122);

(b) the significant judgements, and changes in the judgements, made in applying this Standard to those contracts (see paragraphs 123-126); and

(c) any assets recognised from the costs to obtain or fulfil a contract with a customer in accordance with paragraph 91 or 95 (see paragraphs 127-128).

Each of these disclosure requirements is discussed further below.

The standard requires that an entity consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. The level of aggregation or disaggregation of disclosures requires judgement. Entities are required to ensure that useful information is not obscured (by either the inclusion of a large amount of insignificant detail or the aggregation of items that have substantially different characteristics). *[IFRS 15.111]*. An entity does not need to disclose information in accordance with IFRS 15 if it discloses that information in accordance with another standard. *[IFRS 15.112]*.

As explained in the Basis for Conclusions, many preparers raised concerns that they would need to provide voluminous disclosures at a cost that might outweigh any potential benefits. *[IFRS 15.BC327, IFRS 15.BC331]*. As summarised above, the Board clarified the disclosure objective and indicated that the disclosures described in the standard are not meant to be a checklist of minimum requirements. That is, entities do not need to include disclosures that are not relevant or are not material to them. In addition, the Board decided to require qualitative disclosures instead of tabular reconciliations for certain disclosures.

How we see it

Entities need to review their disclosures in each reporting period to determine whether they have met the standard's disclosure objective to enable users to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. For example, some entities might make large payments to customers that do not represent payment for a distinct good or service and therefore reduce the transaction price and affect the amount and timing of revenue recognised. Although there are no specific requirements in the standard to disclose balances related to consideration paid or payable to a customer, an entity might need to disclose qualitative and/or quantitative information about those arrangements to meet the objective of the disclosure requirements in the standard if the amounts are material.

The disclosures are required for (and as at) each annual period for which a statement of comprehensive income and a statement of financial position are presented.

Certain interim revenue disclosures are also required for entities preparing interim financial statements (see section 10.6 below). When it issued IFRS 15, the IASB amended IAS 34 *Interim Financial Reporting* to require disclosure of disaggregated revenue information. However, none of the other annual disclosures are required for interim financial statements (see Chapter 37 for further discussion on interim financial reporting).

10.5 Specific disclosure requirements

The following Illustration depicts the disclosure requirements, which are discussed further below by category:

Figure 10-2: Specific disclosure requirements

Category	Sub-category/*type*	Required disclosure*
Contracts with customers	Contracts with customers (see section 10.5.1 below) *Quantitative*	If not presented separately in the statement of comprehensive income: ▸ The amount of revenue recognised from contracts with customers (i.e., IFRS 15) separately from other sources of revenue ▸ Any impairment losses from contract with customers separately from other impairment losses
	Disaggregation of revenue (see section 10.5.1.A below) *Quantitative and qualitative*	▸ Disaggregation of revenue from contracts with customers into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors ▸ Sufficient information to enable users of financial statements to understand the relationship between the disclosure of disaggregated revenue and revenue information that is disclosed for each reportable segment, if the entity applies IFRS 8 *Operating Segments*
	Contract balances (see section 10.5.1.B below) *Quantitative and qualitative*	▸ Opening and closing balances of receivables, contract assets and contract liabilities ▸ Revenue recognised in the reporting period that was included in the contract liability balance at the beginning of the period ▸ Explanation of how the timing of satisfaction of performance obligations relates to the typical timing of payment and the effect thereof on contract assets and liabilities ▸ Explanation of the significant changes in the contract asset and contract liability balances during the reporting period
	Performance obligations (see section 10.5.1.C below) *Quantitative and qualitative*	▸ Descriptive information about an entity's performance obligations (i.e., when typically satisfied, significant payment terms, nature of goods and services, obligations for returns, refunds, and other similar obligations, and types of warranties and related obligations) ▸ Revenue recognised in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods ▸ Aggregate amount of the transaction price allocated to performance obligations that are unsatisfied (or partially satisfied) as of the end of the reporting period and explanation of when the related revenue is expected to be recognised (subject to certain optional exemptions)

Category	Sub-category/*type*	Required disclosure*
Significant judgements (see section 10.5.2 below)	*Qualitative*	▸ Judgements (and changes in judgements) made in determining the timing of satisfaction of performance obligations, the transaction price and amounts allocated to performance obligations, including: ▸ For performance obligations satisfied over time, the method used to recognise revenue and why the method faithfully depicts the transfer of goods and services ▸ For performance obligations satisfied at a point in time, significant judgements made in evaluating when control transfers to a customer ▸ Methods, inputs and assumptions used to estimate variable consideration, adjust consideration for the effects of time value of money, measure non-cash consideration and apply the constraint ▸ Methods, inputs and assumptions used to estimate stand-alone selling prices and the use of any allocation exceptions ▸ Methods, inputs and assumptions used to measure obligations for returns, refunds and other similar obligations
Costs to obtain or fulfil a contract (see section 10.5.3 below)	*Quantitative and qualitative*	▸ Judgements made in determining the amount of costs to obtain or fulfil a contract ▸ Method used to determine amortisation for each reporting period ▸ Closing balances of capitalised contract costs ▸ Amount of amortisation and any impairment losses recognised in the period
Practical expedients (see section 10.5.4 below)	*Qualitative*	▸ Use of the following practical expedients: ▸ Practical expedient on the existence of a significant financing component ▸ Practical expedient on expensing incremental costs of obtaining a contract.

* As discussed in section 10.4 above, the IASB decided to include disclosure requirements in IFRS 15 to help an entity meet the standard's disclosure objective. However, these disclosures must not be viewed as a checklist of minimum requirements. Refer to section 10.6 below for information on interim disclosure requirements.

10.5.1 Contracts with customers

The majority of the standard's disclosures relate to an entity's contracts with customers. These disclosures include disaggregation of revenue, information about contract asset and liability balances and information about an entity's performance obligations.

10.5.1.A Disaggregation of revenue

Entities are required to disclose disaggregated revenue information to illustrate how the nature, amount, timing and uncertainty about revenue and cash flows are affected by economic factors. *[IFRS 15.114]*. This is the only revenue disclosure requirement that is required in both an entity's interim and annual financial statements.

As noted above, an entity is required to separately disclose any impairment losses recognised in accordance with IFRS 9 on receivables or contract assets arising from contracts with customers. However, IFRS 15 does not require entities to further disaggregate such losses for uncollectible amounts.

While the standard does not specify precisely how revenue needs to be disaggregated, the application guidance suggests categories for entities to consider. The application guidance indicates that the most appropriate categories for a particular entity depend on its facts and circumstances, but an entity needs to consider how it disaggregates revenue in other communications (e.g., press releases, information regularly reviewed by the chief operating decision maker) when determining which categories are most relevant and useful.

The standard includes the following application guidance on the required disaggregation of revenue disclosures: *[IFRS 15.B88, IFRS 15.B89]*

Extract from IFRS 15

B88 When selecting the type of category (or categories) to use to disaggregate revenue, an entity shall consider how information about the entity's revenue has been presented for other purposes, including all of the following:

(a) disclosures presented outside the financial statements (for example, in earnings releases, annual reports or investor presentations);

(b) information regularly reviewed by the chief operating decision maker for evaluating the financial performance of operating segments; and

(c) other information that is similar to the types of information identified in paragraph B88(a) and (b) and that is used by the entity or users of the entity's financial statements to evaluate the entity's financial performance or make resource allocation decisions.

B89 Examples of categories that might be appropriate include, but are not limited to, all of the following:

(a) type of good or service (for example, major product lines);

(b) geographical region (for example, country or region);

(c) market or type of customer (for example, government and non-government customers);

(d) type of contract (for example, fixed-price and time-and-materials contracts);

(e) contract duration (for example, short-term and long-term contracts);

(f) timing of transfer of goods or services (for example, revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred over time); and

(g) sales channels (for example, goods sold directly to consumers and goods sold through intermediaries).

As noted in the Basis for Conclusions, the Board decided not to prescribe a specific characteristic of revenue to be used as the basis for disaggregation because it intended for entities to make this determination based on entity-specific and/or industry-specific factors that are the most meaningful for their businesses. The Board acknowledged that an entity might need to use more than one type of category to disaggregate its revenue. *[IFRS 15.B87, IFRS 15.BC336]*.

We believe that, when determining categories for disaggregation of revenue, entities need to analyse specific risk factors for each of their revenue streams to determine the appropriate level of revenue disaggregation that will be beneficial to users of the financial statements. If certain risk factors could lead to changes in the nature, amount, timing and uncertainty of revenue recognition and cash flows, those factors will need to be considered as part of the evaluation. *[IFRS 15.B87, IFRS 15.B88]*. Different risk factors associated with each revenue streams might indicate when disaggregation is required.

IFRS 15.112 clarifies that an entity does not have to duplicate disclosures required by another standard. *[IFRS 15.112]*. For example, an entity that provides disaggregated revenue disclosures as part of its segment disclosures, in accordance with IFRS 8, does not need to separately provide disaggregated revenue disclosures if the segment-related disclosures are sufficient to illustrate how the nature, amount, timing and uncertainty about revenue and cash flows from contracts with customers are affected by economic factors and are presented on a basis consistent with IFRS accounting standards.

However, segment disclosures might not be sufficiently disaggregated to achieve the disclosure objectives of IFRS 15. The IASB noted in the Basis for Conclusions that segment disclosures on revenue might not always provide users of financial statements with enough information to help them understand the composition of revenue recognised in the period. *[IFRS 15.BC340]*. If an entity applies IFRS 8, it is required under IFRS 15.115 to explain the relationship between the disaggregated revenue information and revenue information that is disclosed for each reportable segment. *[IFRS 15.115]*. Users of the financial statements believe this information is critical to their ability to understand not only the composition of revenue, but also how revenue relates to other information provided in the segment disclosures. Entities can provide this information in a tabular or a narrative form.

How we see it

Regulators might review publicly provided information (e.g., investor presentations, press releases) in order to evaluate whether entities have met the objectives of this disclosure requirement. In accordance with IFRS 15.B88, an entity needs to consider how information about its revenue has been presented for other purposes, including information disclosed outside the financial statements, information regularly reviewed by the chief operating decision maker (e.g., chief executive officer or chief operating officer) and other similar information used by the entity or users of the financial statements to evaluate the entity's financial performance or to make resource allocation decisions.

As discussed above, to help determine the appropriate level of revenue disaggregation that is beneficial to users of the financial statements, entities would analyse specific risk factors for each revenue stream. Different risk factors for revenue streams might indicate when disaggregation is required.

It is important to note that IFRS 15 and IFRS 8 have different objectives. The objective of the segment reporting requirements in IFRS 8 is to enable users of the financial statements to evaluate the nature and financial effects of the business activities in which an entity engages and the economic environment in which it operates. *[IFRS 8.20]*. These disclosure requirements are largely based on how the chief operating decision maker allocates resources to the operating segments of the entity and assesses their performance. *[IFRS 8.5(b)]*. They also permit aggregation in certain situations. In contrast, IFRS 15 disclosure requirements focus on how the revenues and cash flows from contracts with customers are affected by economic factors and do not have similar aggregation criteria. As noted above, if an entity concludes that it is necessary to provide disaggregated revenue disclosures along with the segment disclosures required under IFRS 8, it is required under IFRS 15 to explain the relationship between the disclosures.

The Board provided an example of the disclosures for disaggregation of revenue, as follows: *[IFRS 15.IE Example 41, IFRS 15.IE210-IE211]*

Extract from IFRS 15

Example 41-Disaggregation of revenue-quantitative disclosure

An entity reports the following segments: consumer products, transportation and energy, in accordance with IFRS 8 *Operating Segments*. When the entity prepares its investor presentations, it disaggregates revenue into primary geographical markets, major product lines and timing of revenue recognition (ie goods transferred at a point in time or services transferred over time).

The entity determines that the categories used in the investor presentations can be used to meet the objective of the disaggregation disclosure requirement in paragraph 114 of IFRS 15, which is to disaggregate revenue from contracts with customers into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. The following table illustrates the disaggregation disclosure by primary geographical market, major product line and timing of revenue recognition, including a reconciliation of how the disaggregated revenue ties in with the consumer products, transportation and energy segments, in accordance with paragraph 115 of IFRS 15.

Segments	Consumer products	Transport	Energy	Total
	CU	CU	CU	CU
Primary geographical markets				
North America	990	2,250	5,250	8,490
Europe	300	750	1,000	2,050
Asia	700	260	-	960
	1,990	3,260	6,250	11,500
Major goods/service lines				
Office supplies	600	-	-	600
Appliances	990	-	-	990
Clothing	400	-	-	400
Motorcycles	-	500	-	500
Automobiles	-	2,760	-	2,760
Solar panels	-	-	1,000	1,000
Power plant	-	-	5,250	5,250
	1,990	3,260	6,250	11,500

Timing of revenue recognition				
Goods transferred at a point in time	1,990	3,260	1,000	6,250
Services transferred over time	-	-	5,250	5,250
	1,990	3,260	6,250	11,500

Since entities are encouraged to tailor their disclosure of disaggregated revenue, they are unlikely to follow a single approach.

Consistent with the approach illustrated in Example 41 from the standard above, some entities provide disaggregated revenue information within their segment reporting disclosure. As shown in Practical example 10-6 below, Capita plc discloses both revenue by major product line and segment revenue by contract type and geographical location in its segment note (Note 2.2.1). The disaggregation per geographical location has been provided in accordance with the requirements in IFRS 8.33(a). In the summary of significant accounting policies (Note 2), it specifically states that this approach is consistent with the objective of the IFRS 15 disclosure requirement and explains differences in the terminology used in previous financial statements.

Entities that are required to apply IFRS 8 might already provide adequate information that allows users to understand the composition of revenue. However, this information might be based on non-GAAP information (i.e., the revenue that is reported to the chief operating decision maker might be calculated on a basis that is not in accordance with IFRS 15). In such a situation, an entity might need to disclose additional information to meet the objective in IFRS 15.114.

Practical example 10-6: Capita plc (2023) **United Kingdom**

Annual Report and Accounts 2023 [extract]

Notes to the consolidated financial statements [extract]

Section 2: Results for the year [extract]

2.2 Revenue including segmental revenue [extract]

Contract types

The Group disaggregates revenue from contracts with customers by contract type, because management believe this best depicts how the nature, amount, timing, and uncertainty of the Group's revenue and cash flows are affected by economic factors. Categories are: long-term contractual – greater than two years; short-term contractual – less than two years; and transactional. The years being measured from the service commencement date.

...

2.2.1 Segmental revenue

The Group's operations are managed separately according to the nature of the services provided, with each segment representing a strategic business division offering a different package of client services across the markets the Group serves. Capita plc is a reconciling item and not an operating segment. A description of the service provision for each segment can be found in the strategic report on pages 14 to 21. Inter-segmental pricing is based on set criteria and is either charged on an arm's length basis or at cost.

The tables below present revenue for the Group's business segments as reported to the Chief Operating Decision Maker. The Group now comprises two divisions - Capita Public Service and Capita Experience - following the completion of the Group's exit of the non-core businesses in the Capita Portfolio division. Comparative information has been re-presented to reflect businesses exited during 2023, and accordingly the Capita Portfolio division is no longer disclosed as a division. Comparative information has also been re-presented to reflect the move of businesses between segments during 2023 to enable comparability.

Adjusted revenue, excluding results from businesses exited in both years (adjusting items), was £2,642.1m (2022: £2,609.0m), an increase of 1.3% (2022: increase 1.7%).

Year ended 31 December 2023	Notes	Capita Public Service £m	Capita Experience £m	Total adjusted £m	Adjusting items £m	Total reported £m
Continuing operations						
Long-term contractual		**1,206.6**	**875.9**	**2,082.5**	**21.5**	**2,104.0**
Short-term contractual		**195.9**	**288.4**	**484.3**	**19.1**	**503.4**
Transactional (point-in-time)		**56.1**	**19.2**	**75.3**	**131.9**	**207.2**
Total segment revenue		**1,458.6**	**1,183.5**	**2,642.1**	**172.5**	**2,814.6**
Trading revenue		**1,507.9**	**1,221.9**	**2,729.8**	**194.4**	**2,924.2**
Inter-segment revenue		**(49.3)**	**(38.4)**	**(87.7)**	**(21.9)**	**(109.6)**
Total adjusted segment revenue		**1,458.6**	**1,183.5**	**2,642.1**	**—**	**2,642.1**
Business exits – trading	2.8	**—**	**—**	**—**	**172.5**	**172.5**
Total segment revenue		**1,458.6**	**1,183.5**	**2,642.1**	**172.5**	**2,814.6**

Year ended 31 December 2022						
Continuing operations						
Long-term contractual		1,166.8	987.6	2,154.4	81.8	2,236.2
Short-term contractual		236.8	150.5	387.3	107.5	494.8
Transactional (point-in-time)		51.2	16.1	67.3	216.3	283.6
Total segment revenue		1,454.8	1,154.2	2,609.0	405.6	3,014.6
Trading revenue		1,497.0	1,194.4	2,691.4	490.0	3,181.4
Inter-segment revenue		(42.2)	(40.2)	(82.4)	(84.4)	(166.8)
Total adjusted segment revenue		1,454.8	1,154.2	2,609.0	—	2,609.0
Business exits – trading	2.8	—	—	—	405.6	405.6
Total segment revenue		1,454.8	1,154.2	2,609.0	405.6	3,014.6

Geographical location

The Group generates revenue largely in the UK and Europe. The table below presents revenue by geographical location.

	2023				2022			
	United Kingdom £m	**Europe £m**	**Other £m**	**Total £m**	United Kingdom £m	Europe £m	Other £m	Total £m
Revenue	**2,526.0**	**282.5**	**6.1**	**2,814.6**	2,731.2	270.8	12.6	3,014.6

In Practical example 10-7 below, Société nationale SNCF discloses disaggregated revenue by main types of services provided, by type of customer, and by timing of transfer of services in the revenue note (Note 3.2) of its 2022 annual financial statements. The disaggregated revenue table below includes a column for Société nationale SNCF's reportable segments and the amount of total revenue reconciles with the total revenue disclosed in the segment note. This is important because it helps users to understand the relationship between the disclosure of disaggregated revenue in the revenue note and the revenue information that is disclosed for each reportable segment in the segment note.

Practical example 10-7: Société nationale SNCF (2022) **France**

SNCF GROUP ANNUAL FINANCIAL REPORT [extract]

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]

3. PERFORMANCE FOR THE PERIOD [extract]

3.2 REVENUE [extract]

The SNCF Group derives revenue from providing services, at a point in time or continuously over a period of time, to private individuals and to public and private sector customers in the following main service lines:

In € millions	31/12/2022	31/12/2021	Change	Segment
Passenger transport revenue	7,251	4,342	2,909	TGV - Intercites
Freight transport revenue	11,723	9,433	2,290	Freight & Logistics business line
Other services ancillary to transport	3,541	2,855	686	TGV - Intercites, Freight & Logistics business line
Fees from Transport Organising Authorities (TOA) for regulated operations	15,065	14,115	951	Transilien, TER, Keolis
Rail network management fees	2,440	2,348	91	SNCF Réseau
Station management revenue	299	239	61	SNCF Gares & Connexions
Real estate rental revenue (excluding rent generated)	95	93	3	Freight & Logistics, TGV - Intercites, Corporate business line
Transport equipment leasing revenue	42	320	-279	Freight & Logistics, Transilien, TER, Keolis business line
Upkeep and maintenance services	172	284	-112	All segments
Other revenue	820	723	97	All segments
Revenue by main service line	**41,449**	**34,752**	**6,697**	
Public sector (public bodies)	17,718	16,643	1,075	
Private individuals	7,271	4,482	2,789	
Private sector companies	16,460	13,627	2,833	
Revenue by customer type	**41,449**	**34,752**	**6,697**	
Immediate or one-day transfer	9,779	7,137	2,642	
Point-in-time transfer over a period of less than one year (logistics, freight transport and compensation from OA)	31,295	27,384	3,911	
Services provided continuously over more than one year (real estate, some station management operations, etc.)	375	231	144	
Revenue by recognition rate	**41,449**	**34,752**	**6,697**	

In Practical example 10-8 below, Fédération Internationale de Football Association (FIFA) splits its disclosure of disaggregated revenue between the primary financial statements and the notes. In the statement of comprehensive income, FIFA presents revenue on a disaggregated basis, by the type of service. In the notes, FIFA further disaggregates each type of revenue into different categories, depending on the nature of the revenue. For example, in Note 1, FIFA disaggregates 'Revenue from television broadcasting rights' by geographical region, while presenting 'Revenue from marketing rights' by type of customer. Since FIFA does not need to comply with IFRS 8, it provides all disaggregation disclosures in accordance with IFRS 15.114 and the requirements in IFRS 15.115 do not apply.

Practical example 10-8: Fédération Internationale de Football Association (FIFA) (2023) — **Switzerland**

ANNUAL REPORT 2023 [extract]

2023 FINANCIAL STATEMENTS [extract]

CONSOLIDATED FINANCIAL STATEMENTS

ACCORDING TO IFRS [extract]

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME [extract]

in TUSD	Note	2023	2022
REVENUE			
Revenue from television broadcasting rights	1	267,220	2,958,352
Revenue from marketing rights	2	455,916	1,424,524
Revenue from licensing rights	3	181,177	270,397
Revenue from hospitality rights and ticket sales	4	80,157	929,016
Other revenue	5	126,814	62,072
Other income	6	58,365	124,852
Total revenue and other income		**1,169,649**	**5,769,213**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]

1 Revenue from television broadcasting rights [extract]

in TUSD	2023	2022
Europe	44,682	1,030,880
Asia and North Africa	63,824	875,120
South and Central America	54,300	351,526
North America and the Caribbean	60,409	518,965
Rest of the world	20,858	103,111
Total revenue from television broadcasting rights by region	**244,073**	**2,879,602**
Other broadcasting revenue	17,983	75,416
Other FIFA event revenue	5,164	3,334
Total revenue from television broadcasting rights	**267,220**	**2,958,352**

2 Revenue from marketing rights [extract]

in TUSD	2023	2022
FIFA Partners	245,712	762,568
FIFA World Cup Partners/FIFA Women's Football Partners	40,105	2,608
FIFA World Cup Sponsors/FIFA Women's World Cup Sponsors	121,428	534,527
FIFA Tournament Supporters	20,296	0
Other marketing revenues	28,375	0
FIFA Regional Supporters	0	122,028
FIFA National Supporters	0	2,793
Total revenue from marketing rights	**455,916**	**1,424,524**

10.5.1.B Contract balances

The Board noted in the Basis for Conclusions that users of the financial statements need to understand the relationship between the revenue recognised and changes in the overall balances of an entity's total contract assets and liabilities during a particular reporting period. *[IFRS 15.BC341]*. As a result, the Board included the following disclosure requirements for an entity's contract balances and changes in the balances: *[IFRS 15.116, IFRS 15.117, IFRS 15.118]*

Extract from IFRS 15

Contract balances

116 An entity shall disclose all of the following:

(a) the opening and closing balances of receivables, contract assets and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed;

(b) revenue recognised in the reporting period that was included in the contract liability balance at the beginning of the period; and

(c) revenue recognised in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price).

117 An entity shall explain how the timing of satisfaction of its performance obligations (see paragraph 119(a)) relates to the typical timing of payment (see paragraph 119(b)) and the effect that those factors have on the contract asset and the contract liability balances. The explanation provided may use qualitative information.

118 An entity shall provide an explanation of the significant changes in the contract asset and the contract liability balances during the reporting period. The explanation shall include qualitative and quantitative information. Examples of changes in the entity's balances of contract assets and contract liabilities include any of the following:

(a) changes due to business combinations;

(b) cumulative catch-up adjustments to revenue that affect the corresponding contract asset or contract liability, including adjustments arising from a change in the measure of progress, a change in an estimate of the transaction price (including any changes in the assessment of whether an estimate of variable consideration is constrained) or a contract modification;

(c) impairment of a contract asset;

(d) a change in the time frame for a right to consideration to become unconditional (ie for a contract asset to be reclassified to a receivable); and

(e) a change in the time frame for a performance obligation to be satisfied (ie for the recognition of revenue arising from a contract liability).

Entities are permitted to disclose information about contract balances, and changes therein, as they deem to be most appropriate, which would include a combination of tabular and narrative information. The IASB explained in the Basis for Conclusions that these disclosures are intended to provide financial statement users with information they requested on when contract assets are typically transferred to accounts receivable or collected as cash and when contract liabilities are recognised as revenue. *[IFRS 15.BC346]*.

In addition to the disclosures on contract balances and changes, the standard requires entities to disclose the amount of revenue recognised in the period that relates to amounts allocated to performance obligations that were satisfied (or partially satisfied) in previous periods (e.g., due to a change in transaction price or in estimates related to the constraint on revenue recognised). This disclosure requirement applies to sales-based and usage-based royalties received from a customer in exchange for a licence of intellectual property that are recognised as revenue in a reporting period, but relate to performance obligations satisfied (or partially satisfied) in previous periods (e.g., sales-based royalties recognised in the current period that are related to a right-to-use licence previously transferred to a customer). As noted in the Basis for Conclusions, the Board noted that this information is not required elsewhere in the financial statements and provides relevant information about the timing of revenue recognised that was not a result of performance in the current period. *[IFRS 15.BC347]*.

The Illustration below is an example of how an entity might fulfil these requirements:

Illustration 10-4: Contract asset and liability disclosures

Company A discloses receivables from contracts with customers separately in the statement of financial position. To comply with the other disclosure requirements for contract assets and liabilities, Company A includes the following information in the notes to the financial statements:

	20X2	20X1	20X0
Contract asset	CU1,500	CU2,250	CU1,800
Contract liability	CU(200)	CU(850)	CU(500)
Revenue recognised in the period from:			
Amounts included in contract liability at the beginning of the period	CU650	CU200	CU100
Performance obligations satisfied in previous periods	CU200	CU125	CU200

We receive payments from customers based on a billing schedule, as established in our contracts. Contract asset relates to our conditional right to consideration for our completed performance under the contract. Accounts receivable are recognised when the right to consideration becomes unconditional. Contract liability relates to payments received in advance of performance under the contract. Contract liabilities are recognised as revenue as (or when) we perform under the contract. In addition, contract asset decreased in 20X2 due to a contract asset impairment of CU400 relating to the early cancellation of a contract with a customer.

How we see it

IFRS 15.116(a) requires entities to separately disclose contract balances from contracts with customers. Therefore, it is necessary for entities that have material receivables from non-IFRS 15 contracts to separate these balances for disclosure purposes. For example, an entity might have accounts receivable relating to leasing contracts that would need to be disclosed separately from accounts receivable related to contracts with customers.

Entities need to make sure they have appropriate systems, policies and procedures and internal controls in place to collect and disclose the required information.

Before providing its disclosure of significant changes in contract balances, Airbus SE provides the accounting policies for its contract balances in Practical example 10-9 below. It then provides in a table the significant changes in the contract asset and the contract liability balances during the reporting period. The opening and closing balances are included in the primary financial statements.

Practical example 10-9: Airbus SE (2023) **Netherlands**

Airbus Annual Report 2023 [extract]
Financial Statements 2023 [extract]
2 Notes to the IFRS Consolidated Financial Statements [extract]
2.5 Operational Assets and Liabilities [extract]
22. Contract Assets and Contract Liabilities, Trade Receivables and Trade Liabilities [extract]

Contract assets represent the Company's right to consideration in exchange for goods or services that the Company has transferred to a customer when that right is conditioned by something other than the passage of time (*e.g.* revenue recognised from the application of the PoC method before the Company has a right to invoice).

Contract liabilities represent the Company's obligation to transfer goods or services to a customer for which the Company has received consideration, or for which an amount of consideration is due from the customer (*e.g.* advance payments received).

Net contract assets and contract liabilities are determined for each contract separately. For serial contracts, contract liabilities are presented in current contract liabilities, if revenues are expected within the next twelve months or material expenses for the manufacturing process have already occurred. For long-term production contracts (*e.g.* governmental contracts such as A400M, Tiger, NH90), contract liabilities are classified as current when the relating inventories or receivables are expected to be recognised within the normal operating cycle of the long-term contract.

Trade receivables arise when the Company provides goods or services directly to a customer with no intention of trading the receivable. Trade receivables include claims arising from revenue recognition that are not yet settled by the debtor. Trade receivables are initially recognised at their transaction prices and are subsequently measured at amortised cost less any allowances for impairment. Gains and losses are recognised in the Consolidated Income Statement when the receivables are derecognised and impaired.

Impairment and allowances of trade receivables and contract assets are measured at an amount equal to the life-time expected loss as described in "– Note 37: Financial Instruments".

Contract Assets, Contract Liabilities and Trade Receivables

Significant changes in contract assets and contract liabilities during the period are as follows:

	2023		2022	
(In € million)	**Contract assets**	**Contract liabilities**	Contract assets	Contract liabilities
Revenue recognised that was included in the contract liability balance at 1 January	-	(26,175)	-	(23,494)
Increases due to cash received, excluding amounts recognised as revenue [1]	-	29,198	-	26,797
Transfers from contract assets recognised at 1 January	(2,168)	-	(2,798)	-
Increase as a result of changes in the measure of progress	2,509	-	3,034	-

(1) Including final payments received from customers and others parties in anticipation.

As of 31 December 2023, trade receivables amounting to €227 million (2022: €301 million) will mature after more than one year.

ProSiebenSat.1 Media SE explains, in Practical example 10-10 below, the nature of its contract assets and contract liabilities. In Note 6, it discloses the opening and closing balances of contract assets and contract liabilities in a table. Below the table, it explains significant changes in the contract asset and contract liability balances during the reporting period using a narrative format. In the same note, ProSiebenSat.1 Media SE discloses revenue recognised that was included in the contract liability balance at the beginning of the period.

Practical example 10-10: ProSiebenSat.1 Media SE (2022) **Germany**

ANNUAL REPORT 2022 [extract]
Consolidated Financial Statements [extract]
NOTES TO THE CONSOLIDATED INCOME STATEMENT [extract]
6/Revenues [extract]

CONTRACT ASSETS AND LIABILITIES
in EUR m

	12/31/2022	12/31/2021
Contract assets	32	34
Contract liabilities	97	131

Contract assets, i.e. positive balances from contracts with customers, primarily relate to claims for consideration resulting from work completed under commissioned productions still to be invoiced as of the reporting date. These contract assets will be reclassified as trade receivables upon invoicing. Furthermore, the contract assets mainly include services already rendered but not yet billable in the Dating & Video segment.

In connection with the sale of the US production business of Red Arrow Studios, contract assets of EUR 17 million were disposed of in the third quarter of 2022.

Contract liabilities mainly relate to advance payments received for service productions, the sale of programming rights and media services not yet provided, as well as advance services from customers in the Dating & Video segment.

Of the contract liabilities existing as of January 1, 2022, EUR 93 million (previous year: EUR 96 million) were recognized as revenues in 2022. In addition, contract liabilities of EUR 15 million were deconsolidated as a result of the sale of the US production business of Red Arrow Studios in the third quarter of 2022.

As permitted by IFRS 15, no information is provided on the remaining performance obligations as of December 31, 2022 that have an expected original term of one year or less. Performance obligations with an expected original term beyond the period of more than one year after December 31, 2022 exist only to an immaterial extent.

Inventories of EUR 41 million (previous year: EUR 49 million) primarily comprise merchandise. Impairment losses on inventories amounting to EUR 7 million (previous year: EUR 10 million) were recognized in the financial year 2022. The Beauty & Lifestyle revenue category includes revenues from the sale of goods of EUR 291 million (previous year: EUR 354 million).

As shown in Practical example 10-11 below, ASML Holding N.V. included a roll-forward of contract assets and contract liabilities to disclose significant changes in the balances during the reporting period. Although such a roll-forward is not required under IFRS 15, it might be an effective way to provide the disclosures required by IFRS 15.118. The requirement of the standard to disclose the 'revenue recognised in the reporting period that was included in the contract liability balance at the beginning of the period' was incorporated in the roll-forward. In addition, ASML Holding N.V. also provided a narrative explanation of the significant changes in the net contract balances during the reporting period.

Practical example 10-11: ASML Holding N.V. (2021) **Netherlands**

Annual Report 2021 [extract]

Notes to the Consolidated Financial Statements [extract]

2. Revenue from contracts with customers [extract]

Contract assets and liabilities

The contract assets relate to our right to a consideration in exchange for goods or services delivered, when that right is conditional on something other than the passage of time. The contract assets are transferred to the receivables when the receivables become unconditional. The contract liabilities primarily relate to remaining performance obligations for which consideration has been received such as down payments received for systems to be delivered, as well as deferred revenue from system shipments, based on the allocation of the consideration to the related performance obligations in the contract. This deferred revenue mainly consists of extended and enhanced warranties, installation and free goods or services provided as part of a volume purchase agreement.

The majority of our customer contracts contain both asset and liability positions. At the end of each reporting period, these positions are netted on a contract basis and presented as either an asset or a liability in the Consolidated Statement of Financial Position. Consequently, a contract balance can change between periods from a net contract asset balance to a net contract liability balance in the balance sheet.

Significant changes in the contract assets and the contract liabilities balances during the periods are as follows.

Year ended December 31 (€, in millions)	2020		2021	
	Contract Assets	Contract Liabilities	Contract Assets	Contract Liabilities
Balance at beginning of the year	231.0	4,286.0	**119.2**	**5,594.1**
Transferred from contract assets to accounts receivables	(192.2)	—	**(268.2)**	**—**
Revenue recognized during the year ending in contract assets	83.4	—	**199.7**	**—**
Revenue recognized that was included in contract liabilities	—	(2,428.4)	**—**	**(3,767.0)**
Changes as a result of cumulative catch-up adjustments arising from changes in estimates	—	(41.9)	**—**	**39.7**
Remaining performance obligations for which considerations have been received, or for which we have an unconditional right to consideration	—	3,781.4	**—**	**9,180.2**
Transfer between contract assets and liabilities	(3.0)	(3.0)	**113.9**	**113.9**
Total	119.2	5,594.1	**164.6**	**11,160.9**

The increase in the net contract liability to €10,996.3 million as of December 31, 2021 compared to €5,474.9 million as of December 31, 2020 is mainly driven by the recognition of down payments for systems which will be shipped in the future. Cumulative catch-up adjustments recognized in our current year revenue are due to updated estimates for system volume, discounts and credits included in our volume purchase agreements.

10.5.1.C Performance obligations

To help users of financial statements analyse the nature, amount, timing and uncertainty about revenue and cash flows arising from contracts with customers, the Board decided to require disclosures about an entity's performance obligations. As noted in the Basis for Conclusions, while IAS 1.10(e) requires entities to disclose their accounting policies for recognising revenue, users of financial statements told the Board that many entities provided a 'boilerplate' description that did not explain how the policy related to the contracts they entered into with customers. *[IFRS 15.BC354]*. To address this criticism, IFRS 15 requires an entity to provide more descriptive information about its performance obligations.

An entity is also required to disclose information about remaining performance obligations and the amount of the transaction price allocated to such obligations, including an explanation of when it expects to recognise the amount(s) in its financial statements. Entities need to make sure they have appropriate systems, policies and procedures and internal controls in place to collect and disclose the required information.

Both quantitative and qualitative information are required as follows: *[IFRS 15.119, IFRS 15.120, IFRS 15.121, IFRS 15.122]*

Extract from IFRS 15

Performance obligations

119 An entity shall disclose information about its performance obligations in contracts with customers, including a description of all of the following:

(a) when the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered or upon completion of service), including when performance obligations are satisfied in a bill-and-hold arrangement;

(b) the significant payment terms (for example, when payment is typically due, whether the contract has a significant financing component, whether the consideration amount is variable and whether the estimate of variable consideration is typically constrained in accordance with paragraphs 56-58);

(c) the nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (ie if the entity is acting as an agent);

(d) obligations for returns, refunds and other similar obligations; and

(e) types of warranties and related obligations.

Transaction price allocated to the remaining performance obligations

120 An entity shall disclose the following information about its remaining performance obligations:

(a) the aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period; and

(b) an explanation of when the entity expects to recognise as revenue the amount disclosed in accordance with paragraph 120(a), which the entity shall disclose in either of the following ways:

(i) on a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations; or

(ii) by using qualitative information.

121 As a practical expedient, an entity need not disclose the information in paragraph 120 for a performance obligation if either of the following conditions is met:

(a) the performance obligation is part of a contract that has an original expected duration of one year or less; or

(b) the entity recognises revenue from the satisfaction of the performance obligation in accordance with paragraph B16.

122 An entity shall explain qualitatively whether it is applying the practical expedient in paragraph 121 and whether any consideration from contracts with customers is not included in the transaction price and, therefore, not included in the information disclosed in accordance with paragraph 120. For example, an estimate of the transaction price would not include any estimated amounts of variable consideration that are constrained (see paragraphs 56-58).

In Practical example 10-12 below, Spotify Technology S.A. highlighted in its revenue note that the disclosures of its performance obligations are included in its significant accounting policy disclosures. In its summary of significant accounting policies, Spotify Technology S.A. discloses information about its performance obligations for subscription and advertising services. It describes when it typically satisfies its performance obligations and the significant payment terms.

Practical example 10-12: Spotify Technology S.A. (2022) **Sweden**

FORM 20-F [extract]

Notes to the 2022 consolidated financial statements [extract]

4. Revenue recognition [extract]

Revenue from contracts with customers [extract]

(ii) Performance obligations

The Group discloses its policies for how it identifies, satisfies, and recognizes its performance obligations associated with its contracts with customers in Note 2.

2. Summary of significant accounting policies [extract]

(d) Revenue recognition

Premium revenue

The Group generates subscription revenue through the sale of the Premium Service in which customers can listen on-demand and offline. The Premium Service is sold directly to end users and through partners who are generally telecommunications companies that bundle the subscription with their own services or collect payment for the stand-alone subscriptions from their end customers. The Group satisfies its performance obligation, and revenue from these services is recognized, on a straight-line basis over the subscription period. Typically, the Premium Service is paid for monthly in advance.

Premium partner subscription revenue is based on a per-subscriber rate in a negotiated partner agreement. Under these arrangements, a premium partner may bundle the Premium Service with its existing product offerings or offer the Premium Service as an add-on. Payment is remitted to the Group through the premium partner. The Group assesses the facts and circumstances, including whether the partner is acting as a principal or agent, of all partner revenue arrangements and then recognizes revenues either gross or net. Premium partner services, whether recognized gross or net, have one material performance obligation, which is the delivery of the Premium Service.

Additionally, the Group bundles the Premium Service with other services and products. In bundle arrangements where the Group has multiple performance obligations, the transaction price is allocated to each performance obligation based on the relative stand-alone selling price. The Group generally determines stand-alone selling prices based on the prices charged to customers. For each performance obligation within the bundle, revenue is recognized either on a straight-line basis over the subscription period or at a point in time when control of the service or product is transferred to the customer.

Ad-Supported revenue

The Group's advertising revenue is generated primarily from the sale of display, audio, and video advertising delivered through advertising impressions across music and podcast content. The Group enters into arrangements with advertising agencies that purchase advertising on our platform on behalf of their clients. The Group also enters into arrangements directly with some large advertisers. These advertising arrangements are typically sold on a cost-per-thousand basis and are evidenced by an Insertion Order, a submission of order placements through a self-serve platform that includes the online acceptance of terms and conditions, or contracts that specify the terms of the arrangement such as the type of ad product, pricing, insertion dates, and number of impressions in a stated period. Revenue is recognized based on the number of impressions delivered.

Additionally, the Group generates Ad-Supported revenue through arrangements with certain advertising automated exchanges, internal self-serve, and advertising marketplace platforms to distribute advertising inventory for purchase on a cost-per-thousand basis. Revenue is recognized when impressions are delivered on the platform.

As part of its disclosure of information about its performance obligations, as presented in Practical example 10-13 below, Koninklijke Philips N.V. provides information about the nature of its goods and services (e.g., consumer type-products), the timing of satisfaction of their performance obligations and the significant payment terms. It also provides information about the existence of sales returns and assurance-type warranties.

Practical example 10-13: Koninklijke Philips N.V. (2022) **Netherlands**

Annual Report 2022 [extract]

10 Group financial statements [extract]

10.9 Notes to the Consolidated financial statements [extract]

6. Income from operations [extract]

Accounting policies [extract]

Revenue recognition

The company recognizes revenue when it transfers control over a good or service to a customer, in an amount that reflects the consideration (i.e., transaction price) to which the company expects to be entitled to in exchange for the good or service. The consideration expected by the company may include fixed and/or variable amounts which can be impacted by sales returns, trade discounts and volume rebates. The company adjusts the consideration for the time value of money if the period between the transfer of the promised goods or services to the customer and payment by the customer exceeds six months.

Transfer of control varies depending on the individual terms of the contract of sale. For consumer-type products in the segment Personal Health businesses, control is transferred when the product is shipped and delivered to the customer and title and risk have passed to the customer (depending on the delivery conditions) and acceptance of the product has been obtained.

Revenues from transactions relating to distinct goods or services are accounted for separately based on their relative stand-alone selling prices. The stand-alone selling price is the price that would be charged for the goods or service in a separate transaction under similar conditions to similar customers. The transaction price is determined (considering variable considerations) and allocated to performance obligations based on their relative stand-alone selling prices. These transactions mainly occur in the segments Diagnosis & Treatment businesses and Connected Care businesses and include arrangements that require subsequent installation and training activities to make distinct goods operable for the customer. As such, the related installation and training activities are part of equipment sales rather than separate performance obligations. Revenue is recognized when the performance obligation is satisfied, i.e., when the installation has been completed and the equipment is ready to be used by the customer in the way contractually agreed.

Variable consideration is included in the transaction price to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognized will not occur once associated uncertainties are resolved. Such assessment is performed on each reporting date to check whether it is constrained. For products for which a right of return exists during a defined period, revenue recognition is determined based on the historical pattern of actual returns, or in cases where such information is not available, revenue recognition is postponed until the return period has lapsed. Return policies are typically based on customary return arrangements in local markets. A provision is recognized for assurance-type product warranty at the time of revenue recognition and reflects the estimated costs of replacement and free-of-charge services that will be incurred by the company with respect to the products sold. For certain products, the customer has the option to purchase the warranty separately, which is considered a separate performance obligation on top of the assurance-type product warranty. For such warranties which provide distinct service, revenue recognition occurs on a straight-line basis over the extended warranty contract period.

In the case of loss under a sales agreement, the loss is recognized immediately.

Sale of goods
Revenues are recognized at a point in time when control of the goods passes to the buyer, based on the allocation of the transaction price to the performance obligation.

Revenue from services
Revenues are recognized over time as the company transfers control of the services to the customer which is demonstrated by the customer simultaneously receiving and consuming the benefits provided by the company. The amount of revenues is measured by reference to the progress made towards complete satisfaction of the performance obligation, which in general is evenly over time. Service revenue related to repair and maintenance activities for goods sold is recognized ratably over the service period or as services are rendered.

Income from royalties
Royalty income from brand license arrangements and from intellectual property rights, such as technology licenses or patents, is recognized on an accrual basis in accordance with the substance of the relevant agreement.

Shipping and handling
Expenses incurred for shipping and handling are mainly recorded as cost of sales. When shipping and handling are part of a project and billed to the customer, then the related expenses are recorded as cost of sales. Shipping and handling related to sales to third parties are partly recorded as selling expenses. When shipping and handling billed to customers are considered a distinct and separate performance obligation, the fees are recognized as revenue and costs included in cost of sales.

In its 2021 annual financial statements, ASML Holding N.V. provides a table that includes information about its performance obligations as shown in Practical example 10-14 below. The first column details the various performance obligations. The second column provides information about the nature and satisfaction of these performance obligations and details of payment terms.

Practical example 10-14: ASML Holding N.V. (2021) — Netherlands

Annual Report 2021 [extract]

Notes to the Consolidated Financial Statements [extract]

2. Revenue from contracts with customers [extract]

Accounting Policy- [extract]

Goods or services	Nature, timing of satisfying the performance obligations, and significant payment terms
New systems (established technologies)	New systems sales include i-line, KrF, ArF, ArFi and EUV related systems, along with the related factory options ordered with the base system, as well as metrology and inspection systems. Prior to shipment, the majority of our systems undergo a Factory Acceptance Test (FAT) in our cleanroom facilities, effectively replicating the operating conditions that will be present on the customer's site, in order to verify whether the system meets its standard specifications and any additional technical and performance criteria agreed with the customer. A system is shipped only after all contractual specifications are met or discrepancies from agreed upon specifications are waived and customer sign-off is received for delivery. Each system's performance is re-tested through a Site Acceptance Test (SAT) after installation at the customer site. We have never failed to successfully complete installation of a system at a customer's premises; therefore, acceptance at FAT is considered to be proven for established technologies with a history of successful customer acceptances at SAT (equal or better than FAT). New system sales do not meet the requirements for over time revenue recognition because our customers do not simultaneously receive and consume the benefits provided by our performance, or control the asset throughout any stage of our production process, as well as the systems are considered to have alternative use. Transfer of control of a system undergoing a FAT, and recognition of revenue related to this system, will occur upon delivery of the system. Transfer of control of a system not undergoing a FAT, and recognition of revenue related to this system, will occur upon customer acceptance of the system at SAT after installation is complete.
Used systems	We have no repurchase commitments in our general sales terms and conditions, however we occasionally repurchase systems that we previously manufactured and sold, in order to refurbish and resell the system to a different customer. This repurchase decision is mainly driven by market demand expressed by other customers. Transfer of control of a used system, and recognition of revenue, follow the same logic as for our "New systems (established technologies)".
Field upgrades and options (system enhancements)	Field upgrades and options mainly relate to goods and services that are delivered for systems already installed in the customer factories. Certain upgrades require significant installation efforts, enhancing an asset the customer controls, therefore resulting in transfer of control over the period of installation, measured using the cost incurred method which is estimated using labor hours, as this best depicts the satisfaction of our obligation in transferring control. For the options and other upgrades for which the customer receives and consumes the benefit at the moment of delivery, the transfer of control and recognition of revenue will occur upon delivery. As long as we are not able to make a reliable estimate of the total efforts needed to complete the upgrade, we only recognize revenue to cover costs incurred. Margin will be realized at the earlier of us being able to make a reliable estimate or completion of the upgrade.
New product introduction	We sell new products and services, which are evolutions of our existing technologies. If installation is determined not to be a separate performance or if there is not a sufficient established history of acceptance on FAT, the product is determined to be a "new product introduction". New product introductions are typically newly developed options to be used within our systems. Transfer of control and revenue recognition for new product introductions occurs after successful installation and customer acceptance at SAT. Once there is an established history of successful installation and customer acceptance, revenue will be recognized consistent with other systems and goods after transfer of control.
Installation	Installation is provided within the selling price of a system. Installation is considered to be distinct as it does not significantly modify the system being purchased and the customer or a third party could be capable of performing the installation themselves, if desired. Transfer of control takes place over the period of installation from delivery through SAT, measured on a straight-line basis, as our performance is satisfied evenly over this period of time.

Goods or services	Nature, timing of satisfying the performance obligations, and significant payment terms
Warranties	We provide standard warranty coverage on our systems for 12 months, providing labor and non-consumable parts necessary to repair our systems during these warranty periods. These standard warranties cannot be purchased and do not provide a service in addition to the general assurance the system will perform as promised. As a result, no revenue is allocated to these standard warranties. Both the extended and enhanced warranties on our systems are accounted for as a separate performance obligation, with transfer of control taking place over the warranty period, measured on a straight-line basis, as this is a stand-ready obligation.
Time-based licenses and related service	Time-based licenses relate to software licenses and the related service which are sold for a period of time. The licenses and the related service are not considered to be individually distinct as the support services are integral to the customer's ability to continue to use the software license in the rapidly changing technological environment. The transfer of control takes place over the license term, measured on a straight-line basis, as our performance is satisfied evenly over this period of time. Payments are made in installments throughout the license term.
Application projects	Application projects are node transition and consulting projects which at times may be provided as free service within a volume purchase agreement. Measuring satisfaction of this performance obligation is performed through an input method based on the labor hours expended relative to the estimated total labor hours as this best depicts the transfer of control of these kind of services.
Service contracts	Service contracts are entered into with our customers to support our systems used in their ongoing operations during the systems lifecycle, typically in the form of full-service agreements, limited manpower agreements, other labor agreements, parts availability or parts usage agreements. These services are typically for a specified period of time. Control transfers over this period of time, measured on a straight-line basis, as these are stand-ready obligations, with an exception for the labor hour pool service contracts for which we recognize revenue in line with invoicing, using the practical expedient in EU-IFRS 15.B16. Invoicing is typically performed monthly or quarterly throughout the service period.
Billable parts and labor	Billable labor represents maintenance services to our systems installed in the customer's factories while in operation, through purchase orders from our customer. Control over these services is transferred to the customer upon receipt of customer sign-off. Billable parts represent spare parts including optical components relating to our systems installed in the customer's factories while in operation, through purchase orders from our customer. Billable parts can be: • Sold as direct spare parts, for which control transfers upon delivery; or • Sold as part of maintenance services, where control transfers upon receipt of customer sign-off.
Field projects (relocations)	Field projects represent mainly relocation services. Measuring satisfaction of this performance obligation is performed through an input method based on the labor hours expended relative to the estimated total labor hours as this best depicts the transfer of control of our service.
OnPulse Maintenance	OnPulse maintenance services are provided over a specified period of time on our light source systems. Payment is determined by the amount of pulses counted from each light source system, which is variable. Invoicing is monthly based on the pulses counted. Revenue is recognized in line with invoicing using the practical expedient in EU-IFRS 15.B16.

During the development of the standard, many users of financial statements commented that information about the amount and timing of revenue that an entity expects to recognise from its existing contracts would be useful in their analyses of revenue, especially for long-term contracts with significant unrecognised revenue. *[IFRS 15.BC348, IFRS 15.BC349]*. In addition, the Board observed that a number of entities often voluntarily disclose such 'backlog' information. However, this information is typically presented outside the financial statements and might not be comparable across entities because there is no common definition of backlog.

As summarised in the Basis for Conclusions, the Board's intention in including the disclosure requirements in IFRS 15.120 is to "provide users of an entity's financial statements with additional information about the following:

"(a) the amount and expected timing of revenue to be recognised from the remaining `performance obligations in existing contracts.

"(b) trends relating to the amount and expected timing of revenue to be recognised from the remaining performance obligations in existing contracts.

"(c) risks associated with expected future revenue (for example, some observe that revenue is more uncertain if an entity does not expect to satisfy a performance obligation until a much later date); and

"(d) the effect of changes in judgements or circumstances on an entity's revenue." *[IFRS 15.BC350]*.

This disclosure can be provided on either a quantitative basis (e.g., amounts to be recognised in given time bands, such as between one and two years and between two and three years) or by disclosing a mix of quantitative and qualitative information. In addition, this disclosure would only include amounts related to performance obligations in the current contract. For example, expected contract renewals that have not been executed and do not represent material rights are not performance obligations in the current contract. As such, an entity does not disclose amounts related to such renewals. However, if an entity concludes that expected contract renewals represents a material right to acquire goods or services in the future (and, therefore, was a separate performance obligation - see section 4.6 above), the entity includes in its disclosure the consideration attributable to the material right for the options that have not yet been exercised (i.e., the unsatisfied performance obligation(s)).

Also consider the following Illustration:

Illustration 10-5: Transaction price allocated to remaining performance obligations in an MSA with a minimum purchase requirement

An entity sells equipment and consumables under a two-year MSA. Both the equipment and the consumables are determined to be distinct performance obligations that are recognised at a point in time. The stand-alone selling price of the equipment and each consumable is CU10,000 and CU100, respectively. The equipment costs CU8,000 and each consumable costs CU60. The entity sells the equipment for CU6,000 (a 40% discount from the stand-alone selling price) with a customer option to purchase each consumable for CU100 (equal to its stand-alone selling price). The customer will incur a penalty if it does not purchase at least 200 consumables over the next two years. The entity concludes that the penalty is substantive and it creates a minimum purchase commitment. The option to purchase the consumables does not represent a material right because it is priced at the stand-alone selling price for the consumable.

As at the entity's reporting date, the customer has purchased 80 consumables during the first six months of the two-year contract. While the entity expects to sell quantities in excess of the remaining 120 units that are subject to the minimum purchase commitment, it only includes the transaction price for the remaining 120 committed consumables in the disclosure of the transaction price allocated to remaining performance obligations. This is because the MSA only commits the parties to the purchase and sale of these minimum units. The entity does not include the transaction price for any expected units in excess of the required minimum because the additional optional purchases are not within the enforceable rights and obligations of the current contract with the customer.

The disclosure of the transaction price allocated to the remaining performance obligations does not include consideration that has been excluded from the transaction price (e.g., amounts subject to termination without penalty). However, the standard requires entities to disclose qualitatively whether any consideration is not included in the transaction price and, therefore, is not included in the disclosure of the remaining performance obligations (e.g., variable consideration amounts that are constrained and, therefore, excluded from the transaction price).

Bombardier Inc. uses time bands to disclose information about remaining performance obligations. In Practical example 10-15, it also explicitly discloses that constrained variable consideration is excluded from the amounts disclosed. This is a helpful reminder for users of financial statements and it indicates amounts recognised in future periods might be higher than those included in the table.

Practical example 10-15: Bombardier Inc. (2023) **Canada**

2023 Financial Report [extract]

CONSOLIDATED FINANCIAL STATEMENTS [extract]

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]

16. BACKLOG

The following table presents the aggregate amount of the revenues expected to be realized in the future from partially or fully unsatisfied performance obligations as we perform under contracts at delivery or recognized over time. The amounts disclosed below represent the value of firm orders only. Such orders may be subject to future modifications that might impact the amount and/or timing of revenue recognition. The amounts disclosed below do not include unexercised options or letters of intent.

Revenues from continuing operations expected to be recognized in:

(In billions of $)	December 31, 2023	December 31, 2022
Less than 24 months	$ 10.0	$ 10.5
Thereafter	4.2	4.3
Total	$ 14.2	$ 14.8

In contrast to the previous extract, SAP SE uses a non-tabular approach when disclosing information about remaining performance obligations. Practical example 10-16 below illustrates this. SAP SE provides information about its remaining performance obligations to provide 'software support or cloud subscriptions and support'.

Practical example 10-16: SAP SE (2022) **Germany**

SAP Integrated Report 2022 [extract]
Consolidated Financial Statements IFRS [extract]
Notes [extract]
Section A - Customers [extract]
(A.1) Revenue [extract]

Remaining Performance Obligations

Amounts of a customer contract's transaction price that are allocated to the remaining performance obligations represent contracted revenue that has not yet been recognized. They include amounts recognized as contract liabilities and amounts that are contracted but not yet due.

The transaction price allocated to performance obligations that were unsatisfied or partially unsatisfied as at December 31, 2022, was €48.9 billion (December 31, 2021: €39.9 billion). The transaction price thereof allocated to cloud performance obligations that were unsatisfied or partially unsatisfied as at December 31, 2022, was €34.2 billion (December 31, 2021: €25.3 billion). The remaining amount mostly comprises obligations to provide software support services. The vast majority of software support contracts are contracts in the renewal phase that typically have a one-year contract term, while cloud subscription contracts typically are multiple-year contracts. The portion of remaining performance obligations related to services consists of non-cancelable revenue from contracts for projects with a predefined output.

Overall, about half of the remaining performance obligations is expected to be recognized over the next 12 months following the respective balance sheet date. This estimate is based on our best judgment, as it, for example, needs to consider estimates of possible future contract modifications or customers' deployment of the solutions. The amount of transaction price allocated to the remaining performance obligations, and changes in this amount over time, are impacted by, among others:

- Currency fluctuations
- The contract period of our cloud and software support contracts remaining at the balance sheet date and thus by the timing of contract renewals

Optional exemptions

The Board also provided a practical expedient under which an entity need not disclose the amount of the remaining performance obligations for contracts with an original expected duration of one year or less or those that meet the requirements of the right to invoice practical expedient in IFRS 15.B16. *[IFRS 15.121]*. As explained in section 7.1.4.B above, the right to invoice practical expedient permits an entity that is recognising revenue over time to recognise revenue as invoiced if the entity's right to payment is an amount that corresponds directly with the value to the customer of the entity's performance to date. For example, an entity is not required to make the disclosure for a three-year service contract under which it has a right to invoice the customer a fixed amount for each hour of service provided. If an entity uses this disclosure practical expedient, it is required to qualitatively disclose that fact. *[IFRS 15.122]*.

FASB differences

ASC 606 contains optional exemptions that are consistent with the optional practical expedients included in IFRS 15.121. However, ASC 606 includes additional optional exemptions (that IFRS 15 does not) to allow entities not to make quantitative disclosures about remaining performance obligations in certain cases and require entities that use any of the new or existing optional exemptions to expand their qualitative disclosures.

The standard provides the following examples of the required disclosures on remaining performance obligations: *[IFRS 15.IE Example 42, IFRS 15.IE212-IE219]*

Extract from IFRS 15

Example 42-Disclosure of the transaction price allocated to the remaining performance obligations

On 30 June 20X7, an entity enters into three contracts (Contracts A, B and C) with separate customers to provide services. Each contract has a two-year non-cancellable term. The entity considers the requirements in paragraphs 120-122 of IFRS 15 in determining the information in each contract to be included in the disclosure of the transaction price allocated to the remaining performance obligations at 31 December 20X7.

Contract A

Cleaning services are to be provided over the next two years typically at least once per month. For services provided, the customer pays an hourly rate of CU25.

Because the entity bills a fixed amount for each hour of service provided, the entity has a right to invoice the customer in the amount that corresponds directly with the value of the entity's performance completed to date in accordance with paragraph B16 of IFRS 15. Consequently, no disclosure is necessary if the entity elects to apply the practical expedient in paragraph 121(b) of IFRS 15.

Contract B

Cleaning services and lawn maintenance services are to be provided as and when needed with a maximum of four visits per month over the next two years. The customer pays a fixed price of CU400 per month for both services. The entity measures its progress towards complete satisfaction of the performance obligation using a time-based measure.

The entity discloses the amount of the transaction price that has not yet been recognised as revenue in a table with quantitative time bands that illustrates when the entity expects to recognise the amount as revenue. The information for Contract B included in the overall disclosure is, as follows:

	20X8	20X9	Total
	CU	CU	CU
Revenue expected to be recognised on this contract as of 31 December 20X7	4,800[(a)]	2,400[(b)]	7,200

(a) CU4,800 = CU400 × 12 months.

(b) CU2,400 = CU400 × 6 months.

Contract C

Cleaning services are to be provided as and when needed over the next two years. The customer pays fixed consideration of CU100 per month plus a one-time variable consideration payment ranging from CU0-CU1,000 corresponding to a one-time regulatory review and certification of the customer's facility (ie a performance bonus). The entity estimates that it will be entitled to CU750 of the variable consideration. On the basis of the entity's assessment of the factors in paragraph 57 of IFRS 15, the entity includes its estimate of CU750 of variable consideration in the transaction price because it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur. The entity measures its progress towards complete satisfaction of the performance obligation using a time-based measure.

The entity discloses the amount of the transaction price that has not yet been recognised as revenue in a table with quantitative time bands that illustrates when the entity expects to recognise the amount as revenue. The entity also includes a qualitative discussion about any significant variable consideration that is not included in the disclosure. The information for Contract C included in the overall disclosure is as follows:

	20X8	20X9	Total
	CU	CU	CU
Revenue expected to be recognised on this contract as of 31 December 20X7	1,575[(a)]	788[(b)]	2,363

(a) Transaction price = CU3,150 (CU100 × 24 months + CU750 variable consideration) recognised evenly over 24 months at CU1,575 per year.

(b) CU1,575 ÷ 2 = CU788 (ie for 6 months of the year).

In addition, in accordance with paragraph 122 of IFRS 15, the entity discloses qualitatively that part of the performance bonus has been excluded from the disclosure because it was not included in the transaction price. That part of the performance bonus was excluded from the transaction price in accordance with the requirements for constraining estimates of variable consideration.

The standard also provides an example of how an entity could make the disclosure required by IFRS 15.120(b) using qualitative information (instead of quantitatively, using time bands), as follows: *[IFRS 15.IE Example 43, IFRS 15.IE220-IE221]*

Extract from IFRS 15

Example 43-Disclosure of the transaction price allocated to the remaining performance obligations-qualitative disclosure

On 1 January 20X2, an entity enters into a contract with a customer to construct a commercial building for fixed consideration of CU10 million. The construction of the building is a single performance obligation that the entity satisfies over time. As of 31 December 20X2, the entity has recognised CU3.2 million of revenue. The entity estimates that construction will be completed in 20X3, but it is possible that the project will be completed in the first half of 20X4.

At 31 December 20X2, the entity discloses the amount of the transaction price that has not yet been recognised as revenue in its disclosure of the transaction price allocated to the remaining performance obligations. The entity also discloses an explanation of when the entity expects to recognise that amount as revenue. The explanation can be disclosed either on a quantitative basis using time bands that are most appropriate for the duration of the remaining performance obligation or by providing a qualitative explanation. Because the entity is uncertain about the timing of revenue recognition, the entity discloses this information qualitatively as follows:

> 'As of 31 December 20X2, the aggregate amount of the transaction price allocated to the remaining performance obligation is CU6.8 million and the entity will recognise this revenue as the building is completed, which is expected to occur over the next 12-18 months.'

Frequently asked questions

Question 10-11: If an entity does not meet the criteria to use the 'right to invoice' practical expedient, can it still use the disclosure practical expedient regarding the amount of transaction price allocated to remaining performance obligations?

(TRG meeting 13 July 2015 - Agenda paper no. 40)

Members of the TRG generally agreed that the standard is clear that an entity can only use the practical expedient to avoid disclosing the amount of the transaction price allocated to remaining performance obligations for contracts: (a) with an original expected duration of less than one year; or (b) that qualify for the 'right to invoice' practical expedient. *[IFRS 15.121]*. If a contract does not meet either of these criteria, an entity must disclose the information about remaining performance obligations that is required by IFRS 15.120. *[IFRS 15.120]*. However, under these requirements, an entity is able to qualitatively describe any consideration that is not included in the transaction price (e.g., any estimated amount of variable consideration that is constrained).

Stakeholders had questioned whether an entity can still use this disclosure practical expedient if it determines that it has not met the criteria to use the right to invoice practical expedient (e.g., because there is a substantive contractual minimum payment or a volume discount).

10.5.2 Significant judgements

The standard specifically requires disclosure of significant accounting estimates and judgements (and changes in those judgements) made in determining the transaction price, allocating the transaction price to performance obligations and determining when performance obligations are satisfied. *[IFRS 15.123]*.

IFRS accounting standards have general requirements requiring disclosures about significant accounting estimates and judgements made by an entity. Because of the importance placed on revenue by users of financial statements, as noted in the Basis for Conclusions on IFRS 15, the Board decided to require specific disclosures about the estimates used and the judgements made in determining the amount and timing of revenue recognition. *[IFRS 15.BC355]*. These requirements exceed those in the general requirements for significant judgements and accounting estimates required by IAS 1 (or IAS 8, if IFRS 18[173] is adopted early) and are discussed in more detail below. *[IAS 1.122-133, IAS 8(2027).27G-27I, IAS 8(2027).31A-31I]*.

173 IFRS 18 supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted). Once effective, the consequential amendments resulting from IFRS 18 will change the scope and title of IAS 8 due to certain sections previously included within IAS 1 being moved (mostly unchanged) to IAS 8. See Chapter 4 for further details on the requirements of IFRS 18.

10.5.2.A Determining the timing of satisfaction of performance obligations

IFRS 15 requires entities to provide disclosures about the significant judgements made in determining the timing of satisfaction of performance obligations. The disclosure requirements for performance obligations that are satisfied over time differ from those satisfied at a point in time, but the objective is similar - to disclose the judgements made in determining the timing of revenue recognition. Entities must disclose the following information: *[IFRS 15.124, IFRS 15.125]*

Extract from IFRS 15

Determining the timing of satisfaction of performance obligations

124 For performance obligations that an entity satisfies over time, an entity shall disclose both of the following:

(a) the methods used to recognise revenue (for example, a description of the output methods or input methods used and how those methods are applied); and

(b) an explanation of why the methods used provide a faithful depiction of the transfer of goods or services.

125 For performance obligations satisfied at a point in time, an entity shall disclose the significant judgements made in evaluating when a customer obtains control of promised goods or services.

When an entity has determined that a performance obligation is satisfied over time, IFRS 15 requires the entity to select a single revenue recognition method for each performance obligation that best depicts the entity's performance in transferring the goods or services. Entities must disclose the method used to recognise revenue.

For example, assume an entity enters into a contract to refurbish a multi-level building for a customer and the work is expected to take two years. The entity concludes that the promised refurbishment service is a single performance obligation satisfied over time and it decides to measure progress using a percentage of completion method, based on the costs incurred. The entity discloses the method used, how it has been applied to the contract and why the method selected provides a faithful depiction of the transfer of goods or services.

When an entity has determined that a performance obligation is satisfied at a point in time, the standard requires the entity to disclose the significant judgements made in evaluating when the customer obtains control of the promised goods or services. For example, an entity needs to consider the indicators of the transfer of control listed in IFRS 15.38 to determine when control transfers and disclose the significant judgements made in reaching that conclusion.

In Practical example 10-14 in section 10.5.1.C above, ASML Holding N.V. describes the methods used to recognise its revenue over time and explains the relationship between the methods and the different types of services it provides. Koninklijke Philips N.V. recognises revenue at a point in time in relation its consumer type-products sales. In Practical example 10-13 in section 10.5.1.C above Koninklijke Philips N.V. provides a description of when control transfers to the customer for these sales.

In Practical example 10-17 below, SAP SE provides disclosure of the significant judgement involved in determining the satisfaction of its performance obligations. It explains how it determines whether its software offerings provide customers with a right to use or a right to access its intellectual property. It also describes the judgement involved in identifying the appropriate method to measure the progress of its performance obligations satisfied over time.

Practical example 10-17: SAP SE (2022) **Germany**

SAP Integrated Report 2022 [extract]
Consolidated Financial Statements IFRS [extract]
Notes [extract]
Section A - Customers [extract]
(A.1) Revenue [extract]
Accounting for Revenue from Contracts with Customers [extract]

Recognition of Revenue

Cloud revenue is recognized over time as the services are performed. For cloud business models where we grant rights to continuously access and use one or more cloud offerings for a certain term, revenue is recognized based on time elapsed and thus ratably over this term. For cloud business models provisioned on a consumption basis where a customer commits to a fixed value of spend on cloud services throughout the contract term, but with the discretion to call off cloud services during the contract term, we recognize revenue based on consumption as it best reflects our measure towards satisfaction of that performance obligation. In limited scenarios where the transaction price is entirely variable and determined by the customer's consumption, we recognize revenue based on usage in the period in which it was earned.

Software license revenue is recognized at a point in time or over time depending on whether we deliver standard software, customer-specific software, or software subscription contracts that combine the delivery of software and the obligation to deliver, in the future, unspecified software products:

- Licenses for our standard on-premise software products are typically delivered by providing the customer with access to download the software. We recognize revenue for these on-premise licenses at the point in time when we grant the license rights to the customer and the customer has access to and thus control over the software. In judging whether our on-premise software offerings grant customers a right to use, rather than a right to access, our intellectual property, we have considered the usefulness of our software without subsequent updates to it.
- Typically, our customer-specific on-premise software development agreements:
  - Represent software developed for specific needs of individual customers and therefore do not have any use for us
  - Provide us with an enforceable right to payment for performance completed to date

  For such development agreements, we recognize revenue over time as the software development progresses. Judgment is required in identifying an appropriate method to measure the progress toward complete satisfaction of such performance obligations. We typically measure progress of our development agreements based on the direct costs incurred to date in developing the software as a percentage of the total reasonably estimated direct costs to fully complete the development work (percentage-of-completion method). This method of measuring progress faithfully depicts the transfer of the development services to the customer, as substantially all of these costs are cost of the staff or third parties performing the development work. In estimating the total cost to fully complete the development work, we consider our history with similar projects.
- For agreements that combine the delivery of software and the obligation to deliver, in the future, unspecific software products, we recognize revenue at a point in time for licenses that are made immediately accessible to the customer. We recognize revenue ratably over the term of the software subscription contract for the unspecified software products, as our performance obligation is to stand ready to deliver such products on a when-and-if-available basis.

Software support revenue is typically recognized based on time elapsed and thus ratably over the term of the support arrangement. Under our standardized support services, our performance obligation is to stand ready to provide technical product support and unspecified updates, upgrades, and enhancements on a when-and-if-available basis. Our customers simultaneously receive and consume the benefits of these support services as we perform.

Service revenue is typically recognized over time. Where we stand ready to provide the service (such as access to learning content), we recognize revenue based on time elapsed and thus ratably over the service period. Consumption-based services (such as separately identifiable consulting services and premium support services and classroom training services) are recognized over time as the services are utilized, typically following the percentage-of-completion method or ratably. When using the percentage-of-completion method, we typically measure the progress toward complete satisfaction of the performance obligation in the same way and with the same reasoning and judgment as we do for customer-specific on-premise software development agreements. We apply judgment in determining whether a service qualifies as a stand-ready service or as a consumption-based service.

Revenue for combined performance obligations is recognized over the longest period of all promises in the combined performance obligation.

Judgment is also required to determine whether revenue is to be recognized at a point in time or over time. For performance obligations satisfied over time, we need to measure progress using the method that best reflects SAP's performance. When using cost incurred as a measure of progress for recognizing revenue over time, we apply judgment in estimating the total cost to satisfy the performance obligation.

All of the judgments and estimates mentioned above can significantly impact the timing and amount of revenue to be recognized.

10.5.2.B Determining the transaction price and the amounts allocated to performance obligations

Entities often exercise significant judgement when estimating the transaction prices of their contracts, especially when those estimates involve variable consideration.

Furthermore, significant judgement might be required when allocating the transaction price, including estimating stand-alone selling prices; for example, it is likely that entities will need to exercise judgement when determining whether a customer option gives rise to a material right (see section 4.6 above) and in estimating the stand-alone selling price for those material rights.

Given the importance placed on revenue by financial statement users, the standard requires entities to disclose qualitative information about the methods, inputs and assumptions used in their annual financial statements, as follows: *[IFRS 15.126, IFRS 15.BC355]*

Extract from IFRS 15

Determining the transaction price and the amounts allocated to performance obligations

126 An entity shall disclose information about the methods, inputs and assumptions used for all of the following:

(a) determining the transaction price, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money and measuring non-cash consideration;

(b) assessing whether an estimate of variable consideration is constrained;

(c) allocating the transaction price, including estimating stand-alone selling prices of promised goods or services and allocating discounts and variable consideration to a specific part of the contract (if applicable); and

(d) measuring obligations for returns, refunds and other similar obligations.

How we see it

Entities with diverse contracts need to ensure they have the processes and procedures in place to capture all of the different methods, inputs and assumptions used in determining the transaction price and allocating it to performance obligations.

In Practical example 10-13 in section 10.5.1.C above, Koninklijke Philips N.V. explains the need to estimate variable consideration in relation to returns.

Since fee arrangements often include contingencies (e.g., 'No Win-No Fee' arrangements), Slater and Gordon Limited estimated variable consideration when determining the transaction price as presented in Practical example 10-18 below. Therefore, it discloses information about the method (i.e., most likely amount approach), inputs and assumptions (i.e., management's assessment and the probability of success of each case). Furthermore, Slater and Gordon Limited discloses information about the assessment of whether a significant financing component exists. The entity concludes that contracts generally comprise only one performance obligation. As such, Slater and Gordon Limited does not disclose information about the allocation of the transaction price.

Practical example 10-18: Slater and Gordon Limited (2022) **Australia**

Annual Report 2022 [extract]

Notes to the consolidated financial statements [extract]

For the Year Ended 30 June 2022 [extract]

Note 3: Revenue from Contracts with Customers [extract]

3.1 Accounting Policies [extract]

Provision of Legal Services – Litigation and Emerging Services

The Group earns revenue from the provision of general legal services, including project litigation. Revenue for general legal services is recognised over time in the accounting period when services are rendered. Revenue recognised is carried as 'Work in progress' until the matter is finalised and a client invoice is raised.

Fee arrangements from general legal services include NWNF arrangements, contingency fee arrangements, fixed fee arrangements, and partially or fully funded litigation.

NWNF arrangements: Revenue is estimated using a most likely amount approach on a contract by contract basis. Management makes a detailed assessment of the amount of revenue expected to be received and the probability of success of each case. Variable consideration is included in revenue only to the extent that it is highly probable that a significant reversal will not occur.

Contingency fee arrangements: During the period, one of the Group's Project Litigation cases converted from a NWNF arrangement to a Group Cost Order ("GCO") which operates on the basis of contingency fee arrangements. The *Justice Legislation Miscellaneous Amendments Act 2000*, effective on 1 July 2020, amended the Victorian Supreme Court Act 1956 to enable contingency fee arrangements. A contingency fee arrangement entitles the Group to receive a percentage share of the damages awarded to the plaintiffs. As with existing NWNF arrangements, the revenue will only be recognised if it is it is highly probable that a significant reversal will not occur.

Partially or fully funded litigation: The Group enters into arrangements with third party funders to provide a portion of the fees on a matter over time as services are performed. In such arrangements, the funded portion of fees, referred to as time and materials, is billed regularly over time and is not contingent on the successful outcome of the litigation. The remaining portion of fees is variable consideration which is conditional on the successful resolution of the litigation. The variable consideration is included in revenue as services are performed only to the extent that it is highly probable that the amount will not be subject to significant reversal when the uncertainty is resolved.

Fixed fee arrangements: Revenue is recognised based on the stage of completion tracked on a contract by contract basis using a milestone-based approach, similar to Personal Injury Law Claims as explained above.

As in the case of personal injury claims, estimates of revenues, costs or extent of progress toward completion are revised if circumstances change. Any resulting increases or decreases in estimated revenues or costs are reflected in profit or loss in the period in which the circumstances that give rise to the revision become known by management.

The Group has determined that no significant financing component exists in respect of all its revenue streams. This is because:

- a substantial amount of the consideration promised by the client is variable subject to the occurrence or non-occurrence of a future event that is not substantially within the control of the client or the Group; and
- for fixed and funded fee arrangements, the period between when the entity transfers a promised good or service to a client and when the client pays for that good or service is expected to be one year or less.

A receivable in relation to the Group's services is recognised when a bill has been invoiced, as this is the point in time that the consideration is unconditional because only the passage of time is required before the payment is due. When an invoice is raised, the amount receivable is transferred from 'Work in progress' to 'Accounts receivable'.

Contract Costs

Applying the practical expedient in paragraph 94 of AASB 15 *Revenue from Contracts with Customers*, the Group recognises the incremental costs of obtaining contracts as an expense when incurred.

10.5.3 Assets recognised from the costs to obtain or fulfil a contract

As discussed in section 9.3 above, the standard specifies the accounting for costs an entity incurs to obtain and fulfil a contract to provide goods or services to customers. IFRS 15 requires entities to disclose information about the assets recognised to help users understand the types of costs recognised as assets and how those assets are subsequently amortised or impaired. These disclosure requirements are as follows: *[IFRS 15.127, IFRS 15.128]*

Extract from IFRS 15

Assets recognised from the costs to obtain or fulfil a contract with a customer

127 An entity shall describe both of the following:

(a) the judgements made in determining the amount of the costs incurred to obtain or fulfil a contract with a customer (in accordance with paragraph 91 or 95); and

(b) the method it uses to determine the amortisation for each reporting period.

128 An entity shall disclose all of the following:

(a) the closing balances of assets recognised from the costs incurred to obtain or fulfil a contract with a customer (in accordance with paragraph 91 or 95), by main category of asset (for example, costs to obtain contracts with customers, pre-contract costs and setup costs); and

(b) the amount of amortisation and any impairment losses recognised in the reporting period.

Entities are required to disclose the judgements made in determining the amount of costs that were incurred to obtain or fulfil contracts with customers that meet the criteria for capitalisation, as well as the method the entity uses to amortise the assets recognised. For example, for costs to obtain a contract, an entity that capitalises commission costs upon the signing of each contract needs to describe the judgements used to determine the commission costs that qualified as costs incurred to obtain a contract with a customer, as well as the determination of the amortisation period.

In addition, entities are required to disclose closing balances of assets recognised for costs to obtain or fulfil contracts with customers, as well as any amortisation or impairment losses recognised during the reporting period.

In Practical example 10-19 below, Capita plc discloses its accounting policy on assets recognised from costs to fulfil and costs to obtain a contract in Note 3 on 'Operating assets and liabilities' in its 2021 annual financial statements. This is followed by a description of how it determines the amortisation period and assesses the assets for impairment. In the same Note, Capita plc provides quantitative disclosures of 'contract fulfilment assets', separately disclosing the closing balance, the amount that was utilised (i.e., amortisation expense) and the amount of impairment losses for each reporting period.

Practical example 10-19: Capita plc (2023) **United Kingdom**

Annual Report and Accounts 2023 [extract]

Notes to the consolidated financial statements [extract]

Section 3: Operating assets and liabilities [extract]

3.1 Working Capital [extract]

3.1.3 Contract fulfilment assets (non-current) [extract]

AP Accounting policies

The Group regularly incurs costs to deliver its outsourcing services in a more efficient way (often referred to as 'transformation' costs). These costs may include process mapping and design, system development, project management, hardware (generally within the scope of the Group's accounting policy for property, plant and equipment), software licence costs (generally within the scope of the Group's accounting policy for intangible assets), recruitment costs and training.

Contract fulfilment costs are divided into: (i) costs that give rise to an asset; and (ii) costs that are expensed as incurred.

When determining the appropriate accounting treatment for such costs, the Group firstly considers any other applicable standards. If those other standards preclude capitalisation of a particular cost, then an asset is not recognised under IFRS 15 *Revenue from Contracts with Customers*.

If other standards are not applicable to contract fulfilment costs, the Group applies the following criteria which, if met, result in capitalisation of costs that: (i) directly relate to a contract or to a specifically identifiable anticipated contract; (ii) generate or enhance resources that will be used in satisfying (or in continuing to satisfy) performance obligations in the future; and (iii) are expected to be recovered.

The Group has determined that, where the relevant specific criteria are met, the costs for (i) process mapping and design; (ii) system development; and (iii) project management; are likely to qualify to be capitalised as contract fulfilment assets.

The incremental costs of obtaining a contract with a customer are recognised as a contract fulfilment asset if the Group expects to recover them. The Group incurs costs such as bid costs, legal fees to draft a contract and sales commissions when it enters into a new contract.

The Group has determined that the following costs may be capitalised as contract fulfilment assets: (i) legal fees to draft a contract after the Group has been selected as preferred supplier; and (ii) sales commissions directly related to winning a specific contract.

Costs incurred prior to selection as preferred supplier are not capitalised but expensed when incurred.

Utilisation: The utilisation charge is included within cost of sales. The Group utilises non-current contract fulfilment assets over the expected contract period on a systematic basis that mirrors the pattern in which the Group transfers control of the service to the customer.

Derecognition: A non-current contract fulfilment asset is derecognised either when it is disposed of or when no further economic benefits are expected to flow from its use or disposal.

Impairment: At each balance sheet date, the Group determines whether or not the non-current contract fulfilment assets are impaired by comparing the carrying amount of the asset with the remaining amount of consideration that the Group expects to receive less the costs that relate to providing services under the relevant contract. In determining the estimated amount of consideration, the Group uses the same principles as it does to determine the contract transaction price, except that any constraints used to reduce the transaction price are removed for the impairment test.

J Significant accounting judgements

Judgement is applied by the Group when determining what costs qualify to be capitalised, in particular when considering whether these costs are incremental and when considering if costs generate or enhance resources to be used to satisfy future performance obligations and whether costs are expected to be recoverable. For example, the Group considers which type of sales commissions are incremental to the cost of obtaining specific contracts and the point in time when the costs will be capitalised. See note 2.1 for further information.

Movements in non-current contract fulfilment assets were as follows[1]:

	2023 £m	2022 £m
At 1 January	**263.0**	286.7
Impact of change in accounting standards – amendments to IAS 37[2]	**—**	(2.4)
At 1 January 2022 on adoption of IAS 37	**263.0**	284.3
Additions	**79.5**	67.1
Transfer to disposal group assets held for sale[3]	**(0.9)**	—
Disposal of businesses	**—**	(2.8)
Impairment - included in adjusted profit	**(3.3)**	(3.8)
Impairment - included in business exits	**(0.1)**	—
Derecognition - included in adjusted profit	**(4.1)**	(0.4)
Derecognition - included in business exits	**(8.2)**	—
Utilisation - included in adjusted profit	**(68.4)**	(79.3)
Utilisation - included in business exits	**(0.4)**	(2.2)
Exchange movement	**(0.1)**	0.1
At 31 December	**257.0**	263.0

1. Refer to note 3.1.1 for current contract fulfilment assets.
2. The Group initially applied the amendments to IAS 37 at 1 January 2022 and the cumulative effect of applying the amendments was recognised as an opening balance adjustment to retained earnings.
3. Transfers to disposal group assets held for sale in the year ended 31 December 2023 includes £0.9m that was transferred at 30 June 2023 and subsequently sold during the second half of the year.

Impairment: In 2023, the Group recognised an impairment of £3.4m (2022: £3.8m) in cost of sales, of which, £nil (2022: £0.5m) relates to contract fulfilment assets added during the year.

Derecognition: In 2023, £12.3m (2022: £0.4m) was derecognised, primarily in relation to a contract in Capita Public Service following the termination of a customer contract and the Group having no further use for the assets (£8.2m). Subsequently the Group decided to exit the business this contract was within and therefore the derecognition of the contract fulfilment asset has been included within business exits (refer to note 2.8). In 2022 the derecognition related to a contract in Capita Experience where the scope of services changed due to termination of contracts and the Group had no further use for the assets.

Frequently asked questions

Question 10-12: How are capitalised contract costs and their amortisation classified and presented in the statement of financial position and statement of profit or loss and other comprehensive income, respectively?

See response to Question 9-27 in section 9.3.3 above.

10.5.4 Practical expedients

The standard allows entities to use several practical expedients. IFRS 15.129 requires entities to disclose their use of two practical expedients: (a) the practical expedient in IFRS 15.63 associated with the determination of whether a significant financing component exists (see section 5.5 above); and (b) the expedient in IFRS 15.94 for recognising an immediate expense for certain incremental costs of obtaining a contract with a customer (see section 9.3.1 above). *[IFRS 15.129]*.

In addition, entities are required to disclose the use of the disclosure practical expedient in IFRS 15.121 (which permits an entity not to disclose information about remaining performance obligations if one of the conditions in the paragraph are met, see section 10.5.1.C above). IFRS 15 provides other practical expedients. Entities need to carefully consider the disclosure requirements of any other practical expedients it uses.

In Practical example 10-10 in section 10.5.1.B above, ProSiebenSat.1 Media SE discloses that it elected to use the practical expedient in IFRS 15.121(a) in relation to the remaining performance obligation disclosure requirement. Slater and Gordon Limited discloses its application of IFRS 15.94 relating to incremental costs of obtaining a contract in Practical example 10-18 in section 10.5.2.B above. In Practical example 10-14 in section 10.5.1.C above, ASML Holding N.V. discloses that it uses the 'right to invoice' practical expedient in IFRS 15.B16 for its performance obligations relating to 'Service contracts' and 'OnPulse maintenance'.

10.6 Disclosures in interim financial statements

IAS 34 requires disclosure of disaggregated revenue information, consistent with the requirement included in IFRS 15 for annual financial statements. *[IAS 34.16A(l)]*. See section 10.5.1.A above for further discussion on this disclosure requirement.

Although none of the other annual IFRS 15 disclosure requirements apply to condensed interim financial statements, entities need to comply with the general requirements in IAS 34. For example, an entity is required to include sufficient information to explain events and transactions that are significant to an understanding of the changes in the entity's financial position and performance since the end of the last annual reporting period. *[IAS 34.15]*. Information disclosed in relation to those events and transactions must update the relevant information presented in the most recent annual financial report. IAS 34 includes a non-exhaustive list of events and transactions for which disclosure would be required if they are significant, and which includes recognition of impairment losses on assets arising from contracts with customers, or reversals of such impairment losses. *[IAS 34.15B]*.

FASB differences

The FASB requires all quantitative disclosures about revenue required for annual financial statements to also be disclosed in interim financial statements.

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Appendix C - Defined terms

Extract from IFRS 15

Appendix A
Defined terms

This appendix is an integral part of the Standard.

contract	An agreement between two or more parties that creates enforceable rights and obligations.
contract asset	An entity's right to consideration in exchange for goods or services that the entity has transferred to a **customer** when that right is conditioned on something other than the passage of time (for example, the entity's future performance).
contract liability	An entity's obligation to transfer goods or services to a **customer** for which the entity has received consideration (or the amount is due) from the customer.
customer	A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.
income	Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity, other than those relating to contributions from equity participants.
performance obligation	A promise in a **contract** with a **customer** to transfer to the customer either: (a) A good or service (or a bundle of goods or services) that is distinct; or (b) A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.
revenue	**Income** arising in the course of an entity's ordinary activities.
stand-alone selling price (of a good or service)	The price at which an entity would sell a promised good or service separately to a **customer**.
transaction price (for a contract with a customer)	The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a **customer**, excluding amounts collected on behalf of third parties.

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Example 31	Entitlement to non-cash consideration	Section 5.6
Consideration payable to a customer		
Example 32	Consideration payable to a customer	Section 5.7.3

Allocating the transaction price to performance obligations		
Example 33	Allocation methodology	Section 6.1.2
Example 34	Allocating a discount	
	Case A-Allocating a discount to one or more performance obligations	Section 6.4
	Case B-Residual approach is appropriate	Section 6.4
	Case C-Residual approach is inappropriate	Section 6.4
Example 35	Allocation of variable consideration	
	Case A-Variable consideration allocated entirely to one performance obligation	Section 6.3.3
	Case B-Variable consideration allocated on the basis of stand-alone selling prices	Section 6.3.3
Contract costs		
Example 36	Incremental costs of obtaining a contract	Section 9.3.1
Example 37	Costs that give rise to an asset	Section 9.3.2
Presentation		
Example 38	Contract liability and receivable	
	Case A-Cancellable contract	Section 10.1.1
	Case B-Non-cancellable contract	Section 10.1.1
Example 39	Contract asset recognised for the entity's performance	Section 10.1.1
Example 40	Receivable recognised for entity's performance	Not Included
Disclosure		
Example 41	Disaggregation of revenue - quantitative disclosure	Section 10.5.1.A
Example 42	Disclosure of the transaction price allocated to the remaining performance obligations	Section 10.5.1.C
Example 43	Disclosure of the transaction price allocated to the remaining performance obligations - qualitative disclosure	Section 10.5.1.C
Warranties		
Example 44	Warranties	Not Included
Principal versus agent considerations		
Example 45	Arranging for the provision of goods or services (entity is an agent)	Not Included
Example 46	Promise to provide goods or services (entity is a principal)	Not Included
Example 46A	Promise to provide goods or services (entity is a principal)	Section 4.4.4
Example 47	Promise to provide goods or services (entity is a principal)	Section 4.4.4
Example 48	Arranging for the provision of goods or services (entity is an agent)	Section 4.4.4
Example 48A	Entity is a principal and an agent in the same contract	Not Included

Customer options for additional goods or services		
Example 49	Option that provides the customer with a material right (discount voucher)	Section 4.6
Example 50	Option that does not provide the customer with a material right (additional goods or services)	Not Included
Example 51	Option that provides the customer with a material right (renewal option)	Not Included
Example 52	Customer loyalty programme	Section 7.9
Non-refundable upfront fees		
Example 53	Non-refundable upfront fee	Not Included
Licensing		
Example 54	Right to use intellectual property	Not Included
Example 55	Licence of intellectual property	Not Included
Example 56	Identifying a distinct licence	
	Case A-Licence is not distinct	Section 8.2.1
	Case B-Licence is distinct	Section 8.1.1
Example 57	Franchise rights	Not Included
Example 58	Access to intellectual property	Section 8.3.1
Example 59	Right to use intellectual property	Section 8.3.2
Example 60	Access to intellectual property	Section 8.5
Example 61	Access to intellectual property	Section 8.5.1
Repurchase arrangements		
Example 62	Repurchase agreements	
	Case A-Call option: financing	Section 7.3.1
	Case B-Put option: lease	Section 7.3.2
Bill-and-hold arrangements		
Example 63	Bill-and-hold arrangement	Section 7.5

Appendix E - TRG discussions and references in this chapter

This appendix includes topics discussed by the TRG and where they are discussed within this chapter.

The FASB staff has compiled publicly available TRG memos and other educational resources previously issued on the implementation of the US GAAP revenue standard, ASC 606, into a document called Revenue Recognition Implementation Q&As (FASB staff Q&As).[174] The staff's objective in compiling this material, which is organised by subject matter (e.g., step of the revenue model), was to make the available educational resources easier to navigate and not to issue any new application guidance.

Date of TRG meeting	Agenda paper no.	Topic discussed	Section
18 July 2014	1	Gross versus net revenue	TRG discussions led to amendments to IFRS 15 that are discussed in sections 4.4 & 6.2
	2	Gross versus net revenue: amounts billed to customers	Section 4.4.4
	3	Sales-based and usage-based royalties in contracts with licences and goods or services other than licences	TRG discussions led to amendments to IFRS 15 that are discussed in section 8.5
	4	Impairment testing of capitalised contract costs	Section 9.3.4
31 October 2014	5	July 2014 meeting - summary of issues discussed and next steps	Section 9.3.4
	6	Customer options for additional goods and services and non-refundable upfront fees	Section 4.6
	7	Presentation of a contract as a contract asset or a contract liability	Section 10.1.5
	8	Determining the nature of a licence of intellectual property	TRG discussions led to amendments to IFRS 15 that are discussed in section 8
	9	Distinct in the context of the contract	TRG discussions led to amendments to IFRS 15 that are discussed in sections 4.2.1.B - 4.2.1.H
	10	Contract enforceability and termination clauses	Section 3.2

174 Available on the *FASB's website.*

Date of TRG meeting	Agenda paper no.	Topic discussed	Section
	11	October 2014 meeting - summary of issues discussed and next steps	Not applicable
	12	Identifying promised goods or services	TRG discussions led to amendments to IFRS 15 that are discussed in section 4.1
	13	Collectability	Sections 3.1.5.B & 5.2.1.B
	14	Variable consideration	Section 5.2.3
	15	Non-cash consideration	Section 5.6.1
	16	Stand-ready obligations	Sections 4.1.1, 7.1.4.E
	17	Islamic finance transactions	Section 2.5
	18	Material right	Questions in this paper were brought forward to agenda paper no. 32 for TRG discussion
	19	Consideration payable to a customer	Questions in this paper were brought forward to agenda paper no. 28 for TRG discussion
	20	Significant financing component	Questions in this paper were brought forward to agenda paper no. 30 for TRG discussion
	21	Licences research update	No TRG discussion - update only
	22	Performance obligations research update	No TRG discussion - update only
	23	Costs to obtain a contract	Sections 9.3.1 & 9.3.3
26 January 2015	24	Contract modifications prior to the date of initial application	Not included
	25	January 2015 meeting - summary of issues discussed and next steps	Sections 3.1.5.B & 4.1.1
	26	Contributions	Not included
	27	Series of distinct goods or services	Section 4.2.2
	28	Consideration payable to a customer	Sections 5.7 & 5.7.1
	29	Warranties	Section 9.1.1
	30	Significant financing component	Sections 5.5.2.A & 5.5.4
	31	Variable discounts	Section 6.4
	32	Exercise of material right	Sections 4.6 & 5.8
30 March 2015	33	Partially satisfied performance obligations	Sections 3.5, 7.1.4.E & 9.3.2

Date of TRG meeting	Agenda paper no.	Topic discussed	Section
	34	March 2015 meeting - summary of issues discussed and next steps	Not applicable
	35	Accounting for restocking fees and related costs	Section 5.4
	36	Credit cards	Section 2.5
	37	Consideration payable to a customer	Sections 5.7, 5.7.1 & 5.7.3
	38	Portfolio practical expedient and application of variable consideration constraint	Sections 5.2.2, 5.2.3 & 5.4
	39	Application of the series provision and allocation of variable consideration	Sections 4.2.2, 5.2.1, 6.3 & 8.3.1
	40	Practical expedient for measuring progress toward complete satisfaction of a performance obligation	Sections 7.1.4.A, 7.1.4.B, 7.1.4.E & 10.5.1.C
	41	Measuring progress when multiple goods or services are included in a single performance obligation	Section 7.1.4.E
	42	Completed contracts at transition	Not included
13 July 2015	43	Determining when control of a commodity transfers	Section 7.1.1
	44	July 2015 meeting - summary of issues discussed and next steps	Section 5.7.3 & 7.1.4.B
	45	Licences - specific application issues about restrictions and renewals	TRG discussions led to amendments to IFRS 15 that are discussed in sections 8.1.3, 8.4 & 8.5.1
	46	Pre-production activities	Section 4.1.1
	47	Whether fixed odds wagering contracts are included or excluded from the scope of the new standard	Not included
	48	Customer options for additional goods and services	Sections 3.2, 4.1.1, 4.6 & 6.2
9 November 2015	49	November 2015 meeting - summary of issues discussed and next steps	Not applicable
	50	Scoping considerations for incentive-based capital allocations	Not included
	51	Contract asset treatment in contract modifications	Section 10.1.5
	52	Scoping considerations for financial institutions	Section 2.5
	53	Evaluating how control transfers over time	Section 7.1.4.E
	54	Class of customer	Section 4.6
18 April 2016 *(FASB TRG meeting only)*	55	April 2016 Meeting - Summary of Issues Discussed and Next Steps	Not applicable

Date of TRG meeting	Agenda paper no.	Topic discussed	Section
	56	Over Time Revenue Recognition	Sections 7.1.3.A & 7.1.3.B
	57	Capitalization and Amortization of Incremental Costs of Obtaining a Contract	Sections 9.3.1 & 9.3.3
	58	Sales-Based or Usage-Based Royalty with Minimum Guarantee	Section 8.5.1
	59	Payments to Customers	Section 5.7.3
7 November 2016	60	November 2016 Meeting - Summary of Issues Discussed and Next Steps	Not applicable

Appendix F - IFRS IC discussions and references in this chapter

This appendix includes topics discussed by the IFRS IC that are discussed within this chapter. Applicable IFRS accounting standards referenced exclude any standards that were superseded at the time of writing.

Topic discussed (and applicable IFRS accounting standards)	Date(s) discussed by IFRS IC	Agenda paper no.	Status at the time of writing	IFRIC Update	Section
Principal versus Agent: Software reseller (IFRS 15)	30 November-1 December 2021 20 April 2022	2 2	Final agenda decision	April 2022	Sections 4.1 and 4.4.2
Configuration or Customisation Costs in a Cloud Computing Arrangement (IAS 38)	1-2 December 2020 16 March 2021 27 April 2021 approved by the IASB	5 2 12A	Final agenda decision	March 2021 (Addendum)	Section 8
Presentation of Player Transfer Payments (IAS 38)	26 November 2019 16 June 2020	6 5	Final agenda decision	June 2020	Section 2.6.3 and Question 10-7 in section 10.2
Sale of a Single Asset Entity Containing Real Estate (IFRS 10 and IFRS 15)/ Sale of a Subsidiary to a Customer	11-12 June 2019 IASB discussion 23-25 June	6 12A	Issue considered as part of the post-implementation review of IFRS 10. The IASB assessed this matter as a low priority and agreed to explore further if identified as a priority in the next agenda consultation.	June 2019 *IASB Update* June 2020	Question 2-11 in section 2.5
Training Costs to Fulfil a Contract (IFRS 15)	17 September 2019 3 March 2020	2 5	Final agenda decision	March 2020	Section 9.3.2 and Question 9-18 in section 9.3.2
Compensation for Delays or Cancellations (IFRS 15)	17 September 2019 11-12 June 2019	6 8	Final agenda decision	September 2019	Question 5-4 in section 5.2.1 and Question 5-33 in section 5.7.3
Costs to Fulfil a Contract (IFRS 15)	11-12 June 2019 5-6 March 2019	10 2	Final agenda decision	June 2019	Section 9.3.2
Sale of Output by a Joint Operator (IFRS 11 and IFRS 15)	5-6 March 2019 27 November 2018	8 2	Final agenda decision	March 2019	Question 2-12 in section 2.5
	5-6 March 2019	3		March 2019	

Topic discussed (and applicable IFRS accounting standards)	Date(s) discussed by IFRS IC	Agenda paper no.	Status at the time of writing	IFRIC Update	Section
Over time transfer of constructed good (IAS 23 and IFRS 15)	27 November 2018	4	Final agenda decision		Question 5-28 in section 5.5.4
Assessment of promised goods or services (IFRS 15)	16 January 2019 11-12 September 2018	3 2	Final agenda decision	January 2019	Section 4.1.1
Revenue recognition in a real estate contract (IFRS 15)	13 March 2018 12 September 2017	2C 2	Final agenda decision	March 2018	Question 7-3 in section 7.1.2, Question 7-10 in section 7.1.3.B and section 7.2
Revenue recognition in a real estate contract that includes the transfer of land (IFRS 15)	13 March 2018 20 November 2017	2D 2A	Final agenda decision	March 2018	Section 4.2.1.G and Question 7-10 in section 7.1.3.B
Right to payment for performance completed to date (IFRS 15)	13 March 2018 20 November 2017	2E 2B	Final agenda decision	March 2018	Questions 7-10 and 7-11 in section 7.1.3.B
Classification of liability for a prepaid card in the issuer's financial statements (IAS 32 and IFRS 9)	22 March 2016 12 January 2016 8-9 September 2015 27 January 2015 11 November 2014	4 5 4 6 13	Final agenda decision	March 2016	Question 2-9 in section 2.5
Gaming transactions (IAS 32)	12 July 2007 3-4 May 2007	7B 11(i)	Final agenda decision	July 2007	Question 2-6 in section 2.5

Appendix G - Summary of significant differences from US GAAP

Below are significant differences between IFRS accounting standards and US GAAP related to revenue recognition under IFRS 15. This list is not exhaustive.

	IFRS	US GAAP
Fixed-odds wagering contracts (section 2.5, Question 2-6)	Fixed-odds wagering contracts that meet the definition of a derivative are within the scope of IFRS 9; otherwise, they are within the scope of IFRS 15.	Fixed-odds wagering arrangements are within the scope of ASC 606.
Sale of a corporate wrapper (section 2.5, Question 2-11)	Whether an entity needs to apply IFRS 10 or IFRS 15 to the sale of a corporate wrapper to a customer depends on facts and circumstances and might require significant judgement.	The sale of a corporate wrapper to a customer generally will be in the scope of ASC 606. ASC 810, *Consolidation* indicates that its deconsolidation and derecognition guidance does not apply to a loss of control of a subsidiary that is a business if that transaction is within the scope of ASC 606. Loss of control of a subsidiary that is not a business is equally excluded from the scope of ASC 810 if the substance of the transaction is within the scope of another standard (e.g., ASC 606, ASC 610-20, *Other Income - Gains and Losses from Derecognition of Nonfinancial Assets*). However, the sale of a corporate wrapper to a counterparty that is not a customer might be in the scope of ASC 610-20.
Consideration paid or payable to a customer - equity instruments (section 2.5, Question 2-13 and section 5.7)	IFRS 15 does not specify whether equity instruments issued by an entity to a customer are a type of consideration paid or payable to a customer, nor does the standard address the accounting for the initial and subsequent measurement of equity instruments granted to customers in a revenue arrangement. IFRS 2 also does not specifically address such transactions. Depending on the facts and circumstances, several IFRS accounting standards (or a combination of IFRS accounting standards) might be applicable (e.g., IFRS 2, IFRS 15, IAS 32).	Equity instruments granted to a customer in conjunction with selling goods or services (e.g., shares, options) are a form of consideration paid or payable to a customer and accounted for under ASC 606. Entities are required to measure such equity awards in accordance with ASC 718. That is, an entity must measure the equity instrument using the grant-date fair value for both equity- and liability-classified share-based payment awards. ASC 606 also includes guidance on how to measure variability of share-based payment awards granted to a customer in conjunction with selling goods or services.

	IFRS	US GAAP
Disposals of non-financial assets not in the ordinary course of business (section 2.6.3)	IAS 16, IAS 38 and IAS 40 require entities to use certain of the requirements of IFRS 15 when recognising and measuring gains or losses arising from the sale or disposal of non-financial assets when it is not in the ordinary course of business. Changes in a parent's ownership interest in a subsidiary (including loss of control through sale or disposal) are generally accounted for under IFRS 10. Unlike US GAAP, IFRS accounting standards do not contain specific requirements regarding the sale of in-substance non-financial assets	ASC 610-20 provides guidance on how to account for any gain or loss resulting from the sale of non-financial assets or in-substance non-financial assets that are not an output of an entity's ordinary activities and are not a business. This includes the sale of intangible assets and property, plant and equipment, including real estate, as well as materials and supplies. ASC 610-20 requires entities to apply certain recognition and measurement principles of ASC 606. Thus, under US GAAP, the accounting for a contract that includes the sale of a non-financial asset to a non-customer will generally be consistent with a contract to sell a non-financial asset to a customer, except for financial statement presentation and disclosure. Sales or transfers of businesses or subsidiaries that do not contain solely non-financial assets and in-substance non-financial assets to non-customers are accounted for using the deconsolidation guidance in ASC 810.
Collectability threshold (section 3.1.5)	An entity must assess whether it is *probable* that it will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. For purposes of this analysis, the term 'probable' is defined as "more likely than not", consistent with its definition elsewhere in IFRS accounting standards. IFRS 15 does not include the additional guidance on the intention of the collectability assessment that is in ASC 606. However, the IASB stated that it does not expect differences in outcomes under IFRS accounting standards and US GAAP in relation to the evaluation of the collectability criterion. *[IFRS 15.BC46E]*.	An entity must assess whether it is *probable* that it will collect *substantially all* of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. For purposes of this analysis, the term 'probable' is defined as "the future event or events are likely to occur", consistent with its definition elsewhere in US GAAP. ASC 606 also includes additional guidance to clarify the intention of the collectability assessment.

	IFRS	US GAAP
Arrangements that do not meet the definition of a contract (section 3.5)	When an arrangement does not meet (and continues not to meet) the criteria to be a contract under the five-step model in IFRS 15, the entity is required to recognise non-refundable consideration received as revenue only when one of the following two events has occurred: ▸ The entity has fully performed and substantially all of the consideration has been received. ▸ The contract has been terminated. Until one of these events happens, any consideration received from the customer is initially accounted for as a liability (not revenue), and the liability is measured at the amount of consideration received from the customer. However, the IASB noted that contracts often specify that an entity has a right to terminate the contract in the event of non-payment. Furthermore, such clauses would not generally affect the entity's legal rights to recover any amounts due. Therefore, the IASB concluded that the requirements in IFRS 15 would allow an entity to conclude that a contract is terminated when it stops providing goods or services to the customer. *[IFRS 15.BC46H]*.	When an arrangement does not meet (and continues not to meet) the criteria to be a contract under the five-step model in ASC 606, the entity is required to recognise non-refundable consideration received as revenue only when one of the following three events has occurred: ▸ The entity has fully performed and substantially all of the consideration has been received. ▸ The contract has been terminated. ▸ The entity has transferred control of the goods or services and has stopped transferring (and has no obligation under the contract to transfer) additional goods or services to the customer, if applicable. Until one of these events happens, any consideration received from the customer is initially accounted for as a liability (not revenue), and the liability is measured at the amount of consideration received from the customer.
Promises that are immaterial in the context of the contract (section 4.1.1)	IFRS 15 does not include explicit language to indicate that an entity can disregard promised goods or services that are immaterial in the context of the contract. However, the IASB noted that it did not intend for entities to identify every possible promised good or services in a contract and that entities need to consider materiality and the overall objective of IFRS 15 when assessing promised goods or services and identifying performance obligations. *[IFRS 15.BC116D]*.	ASC 606 permits entities to disregard items that are immaterial at the contract level and does not require that the items be aggregated and assessed for materiality at the entity level. However, ASC 606 also emphasises that entities still need to evaluate whether customer options for additional goods or services are material rights to be accounted for in accordance with the related requirements.

	IFRS	US GAAP
Shipping and handling activities (section 4.1.1)	The IASB has not permitted a policy choice in IFRS 15 similar to that in US GAAP. The IASB noted that IFRS 15.22 requires an entity to assess the goods or services promised in a contract with a customer in order to identify performance obligations. Such a policy choice would override that requirement. Furthermore, a policy choice is applicable to all entities and it is possible that entities with significant shipping operations might make different policy choices. Therefore, it could also reduce comparability between entities, including those within the same industry. *[IFRS 15.BC116U]*.	ASC 606 allows entities to elect to account for shipping and handling activities performed after the control of a good has been transferred to the customer as fulfilment activities, and not as a promised service to the customer. If revenue is recognized for the good prior to the shipping and handling activities occurring, then those related costs are accrued.
Estimation of gross transaction price by a principal (section 4.4.4)	The IASB did not specifically consider how the transaction price requirements would be applied when an entity that is a principal does not know, and expects not to know, the price charged to its customer by an agent. However, the IASB noted that an entity that is a principal would generally be able to apply judgement and determine the consideration to which it is entitled using all information available to it. *[IFRS 15.BC385Z]*.	An entity that is a principal cannot estimate its gross transaction price when it does not know (or expects not to know) the price charged to its customer for its goods and services by an intermediary.
Presentation of sales (and other similar) taxes (section 5.1)	The IASB decided not to include a accounting policy election in IFRS 15 similar to that in US GAAP. The IASB noted that the requirements of IFRS 15 are consistent with legacy requirements in IFRS accounting standards. *[IFRS 15.BC188D]*.	An entity can make an accounting policy election to present revenue net of certain types of taxes (including sales, use, value-added and some excise taxes) with a requirement for preparers to disclose the policy. As a result, entities that make this election do not need to evaluate taxes that they collect (e.g., sales, use, value-added, some excise taxes) in all jurisdictions in which they operate in order to determine whether a tax is levied on the entity or the customer.
Confidence threshold for the constraint on variable consideration (section 5.2.3)	IFRS 15 uses the term 'highly probable', which is defined as "significantly more likely than probable". However, the meaning of 'probable' under US GAAP is intended to be the same as 'highly probable' under IFRS accounting standards. *[IFRS 15.BC211]*.	ASC 606 uses the term 'probable' as the confidence threshold for applying the constraint, which is defined as "the future event or events are likely to occur" in the master glossary of the US Accounting Standards Codification.

	IFRS	US GAAP
Non-cash consideration - measurement date (section 5.6.1)	IFRS 15 does not specify the measurement date for non-cash consideration. The IASB observed that this issue has important interactions with other IFRS accounting standards (including IFRS 2 and IAS 21) and there was a concern about the risk of unintended consequences. Therefore, the Board decided that, if needed, these issues would be considered more comprehensively in a separate project. *[IFRS 15.BC254C]*. Furthermore, the use of a measurement date other than contract inception would not be precluded under IFRS 15. *[IFRS 15.BC254E]*.	An entity is required to measure the estimated fair value of non-cash consideration at contract inception.
Non-cash consideration - types of variability (section 5.6.1)	IFRS 15 does not address how the constraint is applied when the non-cash consideration is variable due to both its form and other reasons. The IASB noted that, in practice, it might be difficult to distinguish between variability in the fair value due to the form of the consideration and other reasons, in which case applying the variable consideration constraint to the whole estimate of the non-cash consideration might be more practical. *[IFRS 15.BC252]*. However, for reasons similar to those on the measurement date for non-cash consideration, the IASB decided not to have a similar requirement to that of the FASB's standard. *[IFRS 15.BC254H]*.	When the variability of non-cash consideration is due to both the form (e.g., changes in share price) of the consideration and for other reasons (e.g., a change in the exercise price of a share option because of the entity's performance), the constraint on variable consideration applies only to the variability for reasons other than its form.

	IFRS	US GAAP
Licences of intellectual property - contractual restrictions (section 8.1.3)	IFRS 15 includes language on contractual restrictions that differs from the language in US GAAP. It does explicitly state that restrictions of time, geography or use do not affect the licensor's determination of whether the promise to transfer a licence is satisfied over time or at a point in time. IFRS 15 is less specific than US GAAP about whether particular types of contractual restrictions would affect the identification of promised goods or services in the contract. The IASB decided not to clarify the requirements for identifying performance obligations in a contract containing one or more licences since it had clarified the general requirements for identifying performance obligations. *[IFRS 15.BC414P]*. The IASB noted that, consistent with ASC 606, an entity needs to apply the requirements in Step 2 of the general model on identifying performance obligations when distinguishing between contractual provisions that create promises to transfer additional rights from those that are merely attributes of a licence that establish when, where and how the right might be used. *[IFRS 15.BC414P]*. Under both IFRS 15 and ASC 606, an entity might need to apply significant judgement to distinguish between a single promised licence with multiple attributes and a licence that contains multiple promises to the customer that might be separate performance obligations.	ASC 606 requires that entities distinguish between contractual provisions that define the attributes of a single promised licence (e.g., restrictions of time, geography or use) and contractual provisions that require them to transfer additional goods or services to customers (e.g., additional rights to use or access intellectual property). Contractual provisions that are attributes of a promised licence define the scope of a customer's rights to intellectual property and do not affect whether a performance obligation is satisfied at a point in time or over time. Nor do they affect the number of performance obligations in the contract.

	IFRS	US GAAP
Licences of intellectual property - determining the nature of an entity's promise (section 8.2)	IFRS 15 does not require an entity to classify licences as either functional or symbolic. IFRS 15 requires three criteria to be met to recognise the revenue related to the licence over time. If the licence does not meet those criteria, the related revenue is recorded at a point in time. The IASB and FASB agreed that their approaches will generally result in consistent answers, but they acknowledged that different outcomes might arise due to the different approaches when entities licence brand names that no longer have any related ongoing activities (e.g., the licence to the brand name of a defunct sports team, such as the Brooklyn Dodgers). Under the FASB's approach, a licence of a brand name would be classified as symbolic intellectual property and revenue would be recognised over time, regardless of whether there are any related ongoing activities. Under the IASB's approach, revenue is recognised at a point in time if there are no ongoing activities that significantly affect the intellectual property. *[IFRS 15.BC414K, IFRS 15.BC414N]*.	ASC 606 requires entities to classify intellectual property in one of two categories to determine the nature of the entity's promise in granting a licence: *(a) Functional:* This intellectual property has significant stand-alone functionality (e.g., many types of software, completed media content such as films, television shows and music). Revenue for these licences is generally recognised at the point in time when the intellectual property is made available for the customer's use and benefit if the functionality is not expected to change substantively as a result of the licensor's ongoing activities that do not transfer another good or service to the customer. *(b) Symbolic:* This intellectual property does not have significant stand-alone functionality (e.g., brands, team and trade names, character images). The utility of symbolic intellectual property is derived from the licensor's ongoing or past activities (e.g., activities that support the value of character images licensed from an animated film) that does not transfer a promised good or service to a customer. Revenue from these licences is recognised over time as the performance obligation is satisfied (e.g., over the licence period).
Licences of intellectual property - applying the guidance to bundled performance obligations (section 8.2.1)	IFRS 15 does not explicitly state that an entity needs to consider the licences guidance to help determine the nature of its promise to the customer when a licence is bundled with other goods or services. However, the IASB clarified that an entity need to consider the nature of its promise in granting the licence if the licence is the primary or dominant component (i.e., the predominant item) of a single performance obligation.	ASC 606 explicitly states that an entity considers the nature of its promise in granting a licence when applying the general revenue recognition model to a single performance obligation that includes a licence and other goods or services (i.e., when applying the general requirements, consistent with those in IFRS 15.31-45, to assess whether the performance obligations are satisfied at a point in time or over time). Consequently, when the licence is not the predominant item in a single performance obligation, this might result in a US GAAP preparer considering the nature of its promise in granting a licence in a greater number of circumstances than a preparer applying IFRS accounting standards. *[IFRS 15.BC414Y]*.

	IFRS	US GAAP
Licences of intellectual property - renewals (section 8.4)	IFRS 15 does not include similar requirements to US GAAP for renewals. When an entity and a customer enter into a contract to renew (or extend the period of) an existing licence, the entity needs to evaluate whether the renewal or extension would be treated as a new contract or as a modification of the existing contract. Entities that report under IFRS accounting standards might recognise revenue for contract renewals or extensions earlier than entities that report under US GAAP. *[IFRS 15.BC414U]*.	Under ASC 606, revenue related to the renewal of a licence of intellectual property might not be recognised earlier than the beginning of the renewal period. This is the case even if the entity provides a copy of the intellectual property in advance or the customer has a copy of the intellectual property from another transaction. The FASB also provided an additional example to illustrate this point.
Onerous contracts (section 9.2)	IAS 37 applies to onerous revenue contracts. Since the definition of an onerous contract in IAS 37 only refers to a contract, the unit of account to determine whether an onerous contract exists is the contract itself, rather the performance obligations determined in accordance with IFRS 15. As the FASB's requirements on onerous contracts are not the same as those in IAS 37, the accounting treatment in this area is not converged.	While requirements exist for some industries or for certain types of transactions, there is no general authoritative standard in US GAAP for when to recognise losses on onerous contracts and, if a loss is to be recognised, how to measure the loss. Accordingly, there is diversity in practice when such contracts are not within the scope of specific authoritative standards. ASC 605-35, *Revenue Recognition - Provision for Losses on Construction-Type and Production-Type Contracts*, applies to situations in which an entity is expected to incur a loss on a contract within its scope and specifies that the assessment in ASC 605-35 is performed at either the contract level or at the performance obligation level as an accounting policy election.
Reversal of impairment losses (section 9.3.4)	IFRS 15 permits the reversal of some or all of previous impairment losses when impairment conditions no longer exist or have improved. However, the increased carrying value of the asset must not exceed the amount that would have been determined (net of amortisation) if no impairment had been recognised previously.	The reversal of previous impairment losses is prohibited.

	IFRS	US GAAP
Disclosure requirements for public and non-public entities (section 10)	IFRS 15 does not differentiate between public and non-public entities. Therefore, an entity that applies IFRS 15 must apply all of its requirements.	ASC 606 provides requirements on presentation and disclosure that apply to both public and non-public entities and provide some relief on disclosure requirements for non-public entities. The FASB's standard defines a public entity as one of the following: (i) A public business entity, as defined (ii) A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed or quoted on an exchange or an over-the-counter market (iii) An employee benefit plan that files or furnishes financial statements with the SEC An entity that does not meet any of the criteria above is considered a non-public entity for purposes of the FASB's standard.
Disclosure of the transaction price related to remaining performance obligations (section 10.5.1.C)	IFRS 15 does have some optional exemptions to this disclosure requirement that are consistent with ASC 606 (discussed in section 10.5.1.C), but they do not include the two optional exemptions (or the related disclosures) discussed in the US GAAP column.	ASC 606 contains optional exemptions that are consistent with the optional practical expedients included in IFRS 15.121. However, ASC 606 includes additional optional exemptions (that IFRS 15 does not) to allow entities not to make quantitative disclosures about remaining performance obligations when variable consideration in the contract is: ▸ Due to a sales-based or usage-based royalty promised in exchange for a licence of intellectual property ▸ Allocated entirely to a wholly unsatisfied performance obligation or a wholly unsatisfied promise to transfer a distinct good or service that forms part of a series An entity that elects to use any of the optional exemptions to this disclosure requirement must disclose, among other things, the nature of the performance obligations, the remaining duration of the contract and a description of the variable consideration (e.g., the nature of the variability, how that variability will be resolved) that has been excluded from the information disclosed.
Interim disclosures (section 10.6)	The IASB requires only disaggregated revenue information to be disclosed for interim financial statements.	The FASB requires the quantitative disclosures about revenue required for annual financial statements to also be disclosed in interim financial statements.

Chapter 29 Income taxes

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Overview

This chapter discusses the requirements of IAS 12 *Income Taxes*. IAS 12 applies to taxes that are "based on taxable profits". *[IAS 12.2]*.

The standard, and this chapter, does not address the accounting for other taxes and levies such as sales taxes, payroll taxes, duties and other taxes related to specific items of revenue or expenditure. These non-income taxes often fall within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and in particular IFRIC 21 *Levies* (see Chapter 27) and in some cases by reference to the accounting standard most closely related to the item subject to the non-income tax, such as IFRS 15 *Revenue from Contracts with Customers* in the case of sales taxes (see Chapter 28) and IAS 19 *Employee Benefits* in the case of payroll taxes (see Chapter 31).

The requirements of IFRS accounting standards for accounting for income taxes in interim financial statements are discussed in Chapter 37 at section 9.5.

What you need to know

The overall requirements of IAS 12 can be summarised as follows:

- Determine whether a tax is an 'income tax' (see section 4 below).
- Recognise income tax due or receivable in respect of the current and prior periods (current tax), measured using enacted or substantively enacted legislation (see section 5 below), and having regard to any uncertain tax treatments (see section 9 below).
- Determine whether there are temporary differences between the carrying amount of assets and liabilities and their tax bases (see section 6 below), having regard to the expected manner of recovery of assets or settlement of liabilities (see section 8 below).
- Determine whether there are unused tax losses or investment tax credits (see section 7 below).
- Determine whether IAS 12 prohibits or restricts recognition of deferred tax on any deductible temporary differences or unused tax losses or investment tax credits (see section 7 below).
- Recognise deferred tax on all temporary differences, unused tax losses or investment tax credits not subject to such a prohibition or restriction (see section 7 below), measured using enacted or substantively enacted legislation (see section 8 below), and having regard to:
  - The expected manner of recovery of assets and settlement of liabilities (see section 8 below).

    And
  - Any uncertain tax treatments (see section 9 below).
- Allocate any income tax charge or credit for the period to profit or loss, other comprehensive income or equity as appropriate (see section 10 below).
- Present income tax in the financial statements as required by IAS 12 (see section 13 below).
- Disclose information required by IAS 12 (see section 14 below).

1 Introduction

1.1 The nature of taxation

Taxation has certain characteristics which set it apart from other business expenses and which might justify a different treatment, in particular, tax payments are not:

- Typically made in exchange for goods or services specific to the business (as opposed to access to generally available national infrastructure assets and services).
- An optional expense for the business.

1.2 Allocation between periods

The most significant accounting question which arises in relation to taxation is how to allocate tax expense between accounting periods. The recognition of transactions in the financial statements in a particular period is governed by the application of IFRS accounting standards. However, the timing of the recognition of transactions for the purposes of measuring taxable profit is governed by the application of tax law, which sometimes prescribes a treatment different from that used in the financial statements. The generally accepted view is that it is necessary for the financial statements to seek some reconciliation between these different treatments.

Accordingly, IAS 12 requires an entity to recognise, at each reporting date, the tax consequences expected to arise in future periods in respect of the recovery of its assets and settlement of its liabilities recognised at that date. Broadly speaking, those tax consequences that are legal assets or liabilities at the reporting date are referred to as current tax. The other consequences, which are expected to become, or form part of, legal assets or liabilities in a future period, are referred to as deferred tax.

This is explained in Illustration 1-1 below, which considers the treatment of tax deductions received against the cost of property, plant and equipment (PP&E), and in the further discussion in sections 1.2.1 and 1.2.2 below.

Illustration 1-1: PP&E attracting tax deductions in advance of accounting depreciation

An item of equipment is purchased on 1 January 20X3 for CU50,000 and is estimated to have a useful life of five years, at the end of which it will be scrapped. The estimated residual amount is zero and this estimate does not change over the life of the equipment. The depreciation charge will therefore be CU10,000 per year for five years.

The entity is tax-resident in a jurisdiction where the corporate tax rate is 30%. No tax deductions are given for depreciation charged in the financial statements. Instead, the cost of the asset may be deducted from taxes payable in the year that the asset is purchased. The entity's profit before tax, after deducting the depreciation charge, for each of the five years ended 31 December 20X3 to 31 December 20X7 is CU100,000. All components of pre-tax profit, other than the accounting depreciation, are taxable or tax-deductible.

The entity's tax computations for each year would show the following (all figures in currency units):

	20X3	20X4	20X5	20X6	20X7
Accounting profit	100,000	100,000	100,000	100,000	100,000
Accounting depreciation	10,000	10,000	10,000	10,000	10,000
Tax depreciation	(50,000)	-	-	-	-
Taxable profit	60,000	110,000	110,000	110,000	110,000
Tax payable @ 30%	18,000	33,000	33,000	33,000	33,000

1.2.1 Deferred tax not recognised ('flow through')

If the entity in Illustration 1-1 above were to account only for the tax legally due in respect of each year ('current tax'), it would report the amounts in the table below in profit or loss. Accounting for current tax only is generally known as the 'flow through' method.

CUs	20X3	20X4	20X5	20X6	20X7	Total
Profit before tax	100,000	100,000	100,000	100,000	100,000	500,000
Current tax	18,000	33,000	33,000	33,000	33,000	150,000
Profit after tax	82,000	67,000	67,000	67,000	67,000	350,000
Effective tax rate (%)	18	33	33	33	33	30

The 'effective tax rate' in the last row of the table above is the ratio, expressed as a percentage, of the profit before tax to the charge for tax in the financial statements. As can be seen from the table above, over the full five-year life of the asset, the entity pays tax at the statutory rate of 30% on its total profits of CU500,000, but with considerable variation in the effective rate in individual accounting periods.

The generally held view is that simply to account for the tax legally payable as above is distortive, and that the tax must therefore be allocated between periods. Under IAS 12 this allocation is achieved by means of deferred taxation (see section 1.2.2 below).

However, the flow-through method attracts the support of a number of commentators. They argue that the tax authorities impose a single annual tax assessment on the entity based on its profits as determined for tax purposes, not on accounting profits. That assessment is the entity's only liability to tax for that period, and any tax to be assessed in future years is not a present obligation and therefore not a liability as defined in the IASB's *Conceptual Framework for Financial Reporting*. Supporters of flow-through acknowledge the distortive effect of transactions such as that in Illustration 1-1 above, but argue that this is better remedied by disclosure than by creating what they see as an 'imaginary' liability for deferred tax.

1.2.2 Accounting for deferred tax (the temporary difference approach)

The approach required by IAS 12 is known as the temporary difference approach, which focuses on the difference between the carrying amount of an asset or liability in the financial statements and the amount attributed to it for tax purposes, known as its 'tax base' (see section 6.1 below).

In Illustration 1-1 above, the carrying value of the PP&E in the financial statements at the end of each reporting period is:

CUs	20X3	20X4	20X5	20X6	20X7
PP&E	40,000	30,000	20,000	10,000	-

If the tax authority were to prepare financial statements based on tax law rather than IFRS accounting standards, it would record PP&E of nil at the end of each period, since the full cost of CU50,000 was written off in 20X3 for tax purposes. There is therefore a difference, at the end of 20X3, of CU40,000 between the carrying amount of CU40,000 of the asset in the financial statements and its tax base of nil. This difference is referred to as a 'temporary' difference because, by the end of 20X7, the carrying value of the PP&E in the financial statements and its tax base are both nil, so that there is no longer a difference between them.

As discussed in more detail later in this Chapter, IAS 12 requires an entity to recognise a liability for deferred tax on the temporary difference arising on the asset (at 30%), as follows:

CUs	20X3	20X4	20X5	20X6	20X7
Net book value	40,000	30,000	20,000	10,000	-
Tax base	-	-	-	-	-
Temporary difference	40,000	30,000	20,000	10,000	-
Deferred tax @ 30%	12,000	9,000	6,000	3,000	-
Movement in deferred tax in period	12,000	(3,000)	(3,000)	(3,000)	(3,000)

IAS 12 argues that, taking the position as at 31 December 20X3 as an example, the carrying amount of the PP&E of CU40,000 implicitly assumes that the asset will ultimately be recovered or realised by a cash inflow of at least CU40,000. Any tax that will be paid on that inflow represents a present liability. In this case, the entity pays tax at 30% and will be unable to make any deduction in respect of the asset for tax purposes in a future period. It will therefore pay tax of CU12,000 (30% of (CU40,000 - nil)) as the asset is realised. This tax is as much a liability as the PP&E is an asset, since it would be inconsistent for the financial statements simultaneously to represent that the asset will be recovered at CU40,000 while ignoring the tax consequences of doing so. *[IAS 12.16]*.

The deferred tax liability is recognised in the statement of financial position and any movement in the deferred tax liability during the period is recognised as deferred tax income or expense in profit or loss, with the following impact:

CUs	20X3	20X4	20X5	20X6	20X7	Total
Profit before tax	100,000	100,000	100,000	100,000	100,000	500,000
Current tax	18,000	33,000	33,000	33,000	33,000	150,000
Deferred tax	12,000	(3,000)	(3,000)	(3,000)	(3,000)	-
Total tax	30,000	30,000	30,000	30,000	30,000	150,000
Profit after tax	70,000	70,000	70,000	70,000	70,000	350,000
Effective tax rate (%)	30	30	30	30	30	30

It can be seen that in this example the effect of accounting for deferred tax is to present an effective tax rate of 30% in profit or loss for each period. This might not be the result in all cases where IAS 12 is applied, but it is the outcome in this example because the asset is fully deductible for tax purposes and is fully depreciated over its useful life for accounting purposes. The only difference between the tax treatment and the accounting treatment is the timing of the deduction being recognised.

In fact, earlier methods of accounting for income tax, which explicitly focused on tax income and expense ('income statement/timing difference approaches') rather than tax assets and liabilities ('balance sheet/temporary difference approaches'), remain common in national GAAPs and a focus on understanding and managing an entity's effective tax rate is still an objective of many preparers and users.

1.3 The development of IAS 12

The current version of IAS 12 was published in October 1996 and has been amended by a number of subsequent pronouncements.

In July 2000, the SIC issued an interpretation of IAS 12, SIC-25 *Income Taxes - Changes in the Tax Status of an Entity or its Shareholders* (see section 10.9 below).

In March 2009, the IASB issued an exposure draft (ED/2009/2 *Income Tax*) of a standard to replace IAS 12. This was poorly received by stakeholders and the project was halted. Nevertheless, the IASB continues to consider possible limited changes to IAS 12 with the aim of improving it or clarifying its existing requirements.

In December 2010, the IASB issued an amendment to IAS 12 *Deferred Tax: Recovery of Underlying Assets*. The amendment addressed the measurement of deferred tax associated with non-depreciable revalued property, plant and equipment and investment properties accounted for at fair value (see sections 8.4.6 and 8.4.7 below). *Recognition of Deferred Tax Assets for Unrealised Losses (Amendments to* IAS 12*)* was issued in January 2016 in relation to the recognition of deferred tax assets for unrealised losses, for example on debt securities measured at fair value and related clarifications to the guidance on determining future taxable profits (see section 7.5.5 below).

In June 2017, the IFRS IC issued IFRIC 23 *Uncertainty over Income Tax Treatments,* on the recognition and measurement of uncertain tax treatments. *Annual Improvements to IFRS Standards 2015-2017 Cycle*, issued in December 2017, clarified that the income tax consequences of distributions relating to equity instruments must always be allocated to profit or loss, other comprehensive income or equity according to where the entity originally recognised the past transactions or events that generated distributable profits, and not only in situations where differential tax rates apply to distributed or undistributed earnings. This required adjustment by those entities that previously allocated the related income tax to equity on the basis that it was linked more directly to the distribution to owners. The treatment of uncertain tax positions is discussed in section 9 below, with the allocation of tax on equity distributions set out in section 10.3.5 below.

In May 2021, the IASB issued *Deferred Tax related to Assets and Liabilities arising from a Single Transaction (Amendments to* IAS 12*)*, to reduce diversity in the way that entities account for deferred tax on transactions and events, such as leases and decommissioning obligations, that lead to the initial recognition of both an asset and a liability. These amendments are discussed in section 7.3.1 below.

In May 2023, the IASB issued *International Tax Reform-Pillar Two Model Rules - Amendments to IAS 12,* to address concerns from stakeholders regarding the implications for income tax accounting resulting from the jurisdictional implementation of the Pillar Two model rules published by the Organisation for Economic Co-operation and Development/G20 Inclusive Framework on Base Erosion and Profit Shifting. The Amendments introduce a mandatory exception to recognising and disclosing information about deferred tax assets and liabilities related to Pillar Two income taxes, that is applicable with immediate effect. In addition, the Amendments introduce certain disclosure requirements for affected entities to help users of the financial statements better understand an entity's exposure to Pillar Two income taxes arising from that legislation, particularly in the period between legislation being (substantive) enacted and the date from which the tax first applies to the entity. These amendments are discussed in section 4.6.2 below.

2 Objective of IAS 12

Extract from IAS 12

Objective

The objective of this Standard is to prescribe the accounting treatment for income taxes. The principal issue in accounting for income taxes is how to account for the current and future tax consequences of:

(a) the future recovery (settlement) of the carrying amount of assets (liabilities) that are recognised in an entity's statement of financial position; and

(b) transactions and other events of the current period that are recognised in an entity's financial statements.

...

IAS 12 asserts that it is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. The standard requires an entity to consider whether it is probable that recovery or settlement of that carrying amount will make future tax payments larger (or smaller) than they would be if such recovery or settlement had no tax consequences. *[IAS 12 Objective]*. If it is probable that such a larger or smaller tax payment will arise, IAS 12 requires an entity, with certain limited exceptions, to recognise a deferred tax liability or deferred tax asset. *[IAS 12.10, IAS 12.16, IAS 12.25]*. This is often referred to as the 'temporary difference approach' and is discussed further in sections 3 to 9 and section 11 below.

IAS 12 also requires an entity to account for the tax consequences of transactions and other events in a manner consistent with the accounting treatment of the transactions and other events themselves. *[IAS 12 Objective]*. In other words:

- Tax effects of transactions and other events recognised in profit or loss are also recognised in profit or loss.
- Tax effects of transactions and other events recognised in other comprehensive income are also recognised in other comprehensive income.
- Tax effects of transactions and other events recognised directly in equity are also recognised directly in equity.
- Deferred tax assets and liabilities recognised in a business combination affect:
  - The amount of goodwill arising in that business combination.

    Or
  - The amount of the bargain purchase gain recognised.

This is discussed in more detail in sections 10 and 12 below.

The standard also deals with:

- The recognition of deferred tax assets arising from unused tax losses or unused tax credits (see section 7.5.6 below).
- The presentation of income taxes in financial statements (see section 13 below).
- The disclosure of information relating to income taxes (see section 14 below).

IAS 12 requires an entity to account for the tax consequences of recovering assets or settling liabilities at their carrying amount in the statement of financial position, not for the total tax expected to be paid (which will reflect the amount at which the asset or liability is actually settled, not its carrying amount at the reporting date).

IAS 12 may require an entity to recognise tax even on an accounting transaction that is not itself directly taxable, where the transaction gives rise to an asset (or liability) whose recovery (or settlement) will have tax consequences. For example, an entity might revalue a property. If (as is the case in many tax jurisdictions) no tax is payable on the revaluation, one might conclude that it has no tax effect. However, this is not the correct analysis under IAS 12, which focuses not on whether the revaluation itself is directly taxed, but rather on whether the profits out of which the increased carrying value of the property will be recovered will be subsequently taxed. This is discussed further in section 8.4 below.

3 Definitions

Income taxes include all domestic and foreign taxes which are based on taxable profits. Income taxes also include taxes, such as withholding taxes, which are payable by a subsidiary, associate or joint arrangement on distributions to the reporting entity. *[IAS 12.2]*.

IAS 12 uses the following terms with the meanings specified below. *[IAS 12.5]*.

Extract from IAS 12

5 The following terms are used in this Standard with the meanings specified:

Accounting profit is profit or loss for a period before deducting tax expense.

Taxable profit (tax loss) is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).

Tax expense (tax income) is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.

Current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

Deferred tax assets are the amounts of income taxes recoverable in future periods in respect of:

(a) deductible temporary differences;

(b) the carryforward of unused tax losses; and

(c) the carryforward of unused tax credits.

Temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base.

Temporary differences may be either:

(a) *taxable temporary differences*, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or

(b) *deductible temporary differences*, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

The *tax base* of an asset or liability is the amount attributed to that asset or liability for tax purposes.

IFRIC 23 uses the following terms in addition to those defined in IAS 12: *[IFRIC 23.3]*

Extract from IFRIC 23

3 In this Interpretation:

(a) 'tax treatments' refers to the treatments used by an entity or that it plans to use in its income tax filings.

(b) 'taxation authority' refers to the body or bodies that decide whether tax treatments are acceptable under tax law. This might include a court.

(c) an 'uncertain tax treatment' is a tax treatment for which there is uncertainty over whether the relevant taxation authority will accept the tax treatment under tax law. For example, an entity's decision not to submit any income tax filing in a tax jurisdiction, or not to include particular income in taxable profit, is an uncertain tax treatment if its acceptability is uncertain under tax law.

4 Scope

IAS 12 must be applied in accounting for income taxes. That includes:

- All domestic and foreign taxes which are based on taxable profits
- Taxes, such as withholding taxes, which are payable by a subsidiary, associate or joint arrangement on distributions to the reporting entity *[IAS 12.1, IAS 12.2]*

IAS 12 does not apply to accounting for government grants, which fall within the scope of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, or investment tax credits. However, it does deal with the accounting for any temporary differences that may arise from grants or investment tax credits. *[IAS 12.4]*.

A tax classified as an income tax is accounted for under IAS 12. Taxes other than income taxes are often accounted for under IAS 37 and, in particular, IFRIC 21 and in some cases by reference to the accounting standard most closely related to the item subject to such a non-income tax (such as IAS 19, in the case of payroll taxes, or IFRS 15 in the case of sales taxes). The classification of a tax as an income tax affects its accounting treatment in several key respects:

- *Deferred tax*

  IAS 12 requires an entity to account for deferred tax in respect of income taxes. IAS 37 has no equivalent requirement for other taxes, recognising only legal or constructive obligations.
- *Recognition and measurement*

  IAS 12 requires tax to be recognised and measured according to a relatively tightly-defined accounting model, based on legislation enacted or substantively enacted as at the end of the reporting period. IAS 37 requires a provision to be recognised only where it is more likely than not that an outflow of resources will occur as a result of a past obligating event and measured at the best estimate of the amount expected to be paid. In the case of uncertain tax treatments (discussed in section 9 below) an approach distinct from that in IAS 37 is required when IFRIC 23 is applied.
- *Presentation*

  IAS 1 *Presentation of Financial Statements* requires income tax assets, liabilities, income and expense to be presented in separate headings in profit or loss and the statement of financial position. There is no requirement for separate presentation of other taxes, but neither can they be included within the captions for 'income taxes'.
- *Disclosure*

  IAS 12 requires disclosures for income taxes significantly more detailed than those required by IAS 37 for other taxes.

4.1 What is an 'income tax'?

For the purposes of IAS 12, income tax includes all taxes based on 'taxable profits', which are in turn defined as profits 'upon which income taxes are payable'. *[IAS 12.5]*. Accordingly, it seems clear that those taxes that take as their starting point the reported net profit or loss of an entity are income taxes. However, several jurisdictions raise 'taxes' on sub-components of net profit. These include:

- Sales taxes
- Goods and services taxes
- Value added taxes
- Levies on the sale or extraction of minerals and other natural resources
- Taxes on certain goods as they reach a given state of production or are moved from one location to another
- Taxes on gross production margins

Taxes that are simply collected by the entity from a third party (such as a customer or employee) on behalf of a local or national government are generally not regarded as 'income taxes' for the purposes of IAS 12. This view is supported by the requirement of IFRS 15 that amounts which are collected from customers by the entity on behalf of third parties (for example, some sales taxes) do not form part of the entity's revenue, *[IFRS 15.47]*, (and, by implication, are not an expense of the entity either).

In cases where such taxes are a liability of the entity, they may often have some characteristics both of production or sales taxes (in that they are payable at a particular stage in the production or extraction process and may well be allowed as an expense in arriving at the tax on net profits) and of income taxes (in that they may be determined after deduction of certain allowable expenditure). This makes the classification of such taxes (as income taxes or not) difficult.

Frequently asked questions

Question 4-1: Which taxes are in the scope of IAS 12?

In March 2006, the IFRS IC considered whether to give guidance on which taxes are within the scope of IAS 12. The IFRS IC noted that the definition of 'income tax' in IAS 12 (i.e., taxes that are based on taxable profit) implies that:

- Not all taxes are within the scope of IAS 12

  But

- Because taxable profit is not the same as accounting profit, taxes do not need to be based on a figure that is exactly accounting profit to be within the scope of IAS 12

The latter point is also implied by the requirement in IAS 12 to disclose an explanation of the relationship between tax expense and accounting profit - see section 14.2 below. *[IAS 12.81(c)]*. The IFRS IC further noted that the term 'taxable profit' implies a notion of a net rather than gross amount, and that any taxes that are not in the scope of IAS 12 are in the scope of IAS 37 (see Chapter 27).

The IFRS IC drew attention to the variety of taxes that exist across the world and the need for judgement in determining whether some taxes are income taxes. The IFRS IC therefore believed that guidance beyond the observations noted above could not be developed in a reasonable period of time and decided not to take a project on this issue onto its agenda.[1] This decision was confirmed in May 2009, when the IFRS IC concluded that taxes based on tonnage transported or tonnage capacity or on notional income derived from tonnage capacity, being based on a gross amount, are not based on 'taxable profit' and, consequently, would not be considered income taxes in accordance with IAS 12.[2]

The IFRS IC's deliberations reinforce the difficulty of formulating a single view as to the treatment of taxes. The appropriate treatment will need to be addressed on a case-by-case basis depending on the particular terms of the tax concerned and the entity's own circumstances.

How we see it

Where a tax is levied on multiple components of net income, we believe it is more likely that the tax must be viewed as substantially a tax on income and therefore subject to IAS 12.

Even where such taxes are not income taxes, if they are deductible against current or future income taxes, they may nevertheless give rise to tax assets which do fall within the scope of IAS 12.

4.1.1 Levies

Several governments have introduced levies on certain types of entity, including those in the financial services sector. In many cases the levies are expressed as a percentage of a measure of revenue or net assets, or some component(s) of revenue or net assets, at a particular date. Such levies are not income taxes and must be accounted for in accordance with IAS 37 and IFRIC 21 (see Chapter 27 at section 6.8).

4.1.2 Hybrid taxes (including minimum taxes)

Some jurisdictions impose income taxes which are charged as a percentage of taxable profits in the normal way, but are subject to a requirement that a minimum amount of tax must be paid. This minimum may be an absolute amount or a proportion of one or more components of the statement of financial position - for example, total equity as reported in the financial statements, or total share capital and additional paid-in capital (share premium). Another form of arrangement is where the amount of tax payable is the higher of one measure (based on profits) and another (for example based on: revenues; net assets; on total debt and equity).

Such 'hybrid taxes' raise the issue of how they must be accounted for; in particular whether they fall in the scope of IAS 12 or another standard. This issue is discussed in section 4.5 below.

In other circumstances a tax may be levied on a measure based primarily on revenue but incorporating deductions for certain items, some of which might be described as "costs". In such situations the entity would need to assess whether the amount assessed for the tax is a measure of profit (and, therefore, in scope of IAS 12), or whether the tax is applied to a measure of adjusted revenue and is therefore a levy not in scope of IAS 12, as discussed in section 4.1 above.

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1 *IFRIC Update*, March 2006, available on the IFRS Foundation's website.

2 *IFRIC Update*, May 2009, available on the IFRS Foundation's website.

4.2 Withholding and similar taxes

4.2.1 Withholding taxes on distributions

As noted in section 4.1 above, IAS 12 also includes in its scope those taxes, such as withholding taxes, which are payable by a subsidiary, associate or joint arrangement on distributions to the reporting entity. *[IAS 12.2]*. This gives rise to further questions of interpretation.

The most basic issue is what is meant by a 'withholding tax'. This is discussed in sections 10.3.2 and 10.3.4 below.

A second issue is whether the scope of IAS 12 covers only taxes on distributions from a subsidiary, associate or joint arrangement, or whether it extends to tax on distributions from other entities in which the reporting entity has an investment. Such an investment is typically accounted for at fair value under IFRS 9 *Financial Instruments*.

The rationale for the treatment as income taxes of taxes payable by a subsidiary, associate or joint arrangement on distributions to the investor is discussed further in section 7.6 below. Essentially, the reason for considering withholding taxes within the scope of income tax accounting derives from the accounting treatment of the investments themselves. The accounting treatment for such investments - whether by full consolidation or the equity method - results in the investor recognising profit that may be taxed twice: once as it is earned by the investee entity concerned, and again as that entity distributes the profit as dividend to the investor. IAS 12 ensures that the financial statements reflect both tax consequences.

Some argue that this indicates a general principle that an entity must account for all the tax consequences of realising the income of an investee as that income is recognised. On this analysis withholding taxes suffered on any investment income must be treated as income taxes. Others argue that the reference in IAS 12 to distributions from 'a subsidiary, associate or joint arrangement' must be read restrictively, and that no wider general principle is implied. In addition, because the amount of the tax relates to a single component of the investor entity's income, it can be argued that (without the specific reference to a 'withholding tax') such amounts are not within the scope of IAS 12 because they are not 'based on taxable profits', *[IAS 12.2]*, (see section 4.1 above).

How we see it

We believe that judgement is required to decide whether a tax deducted from investment income at the source of the income is a withholding tax in the scope of IAS 12. As well as the considerations noted above, the decision requires consideration of all the relevant facts and circumstances of the jurisdiction that levies the tax, especially the national tax legislation and the design of the investor entity.

If it is determined that the tax withheld from investment income is a tax within the scope of IAS 12, any non-refundable portion of such withholding taxes is recognised as a tax expense in the statement of comprehensive income. In addition, the entity must apply all the provisions of IAS 12 for current and deferred taxes, including recognition, measurement, presentation and disclosure. An entity that determines that a withholding tax is in the scope of IAS 12 presents its related income as an amount gross of withholding taxes in the statement of comprehensive income.

Accordingly, an entity may determine that it must treat as income taxes the withholding taxes that could potentially be suffered on distributions from all investments, not just subsidiaries, associates and joint arrangements. Whether or not any tax liability is recognised will depend on an analysis of the facts and circumstances in each case, in particular whether the investment concerned is expected to be recovered through receipt of dividend income or through sale (see section 8.4 below).

4.2.2 Withholding taxes on royalty payments

Governments often require deduction of tax at source on payments other than dividends, particularly when such payments are made to entities outside the home country of the paying entity, for example in respect of royalties. As discussed at section 4.1 above, the determination of whether such withholding taxes are in scope of IAS 12 requires the entity to consider whether the taxes are based on a measure of taxable profits.

Illustration 4-1: Withholding taxes on royalty payments

Entity A is domiciled in Country X. Entity A develops and sells software licences to customers in the telecommunications industry. Entity A receives revenue in the form of royalties from licences. The royalties are determined as a fixed percentage of revenue. Entity A has a customer in Country Z from which it receives royalties. The royalties are paid by the customer net of withholding taxes determined as per regulations applicable in Country Z.

In Country Z, a tax is charged on entities that do not have a sufficient presence in Country Z to be required to register a business (branch) in Country Z and to be liable to pay local income tax.

Taxable profit for Entity A's income tax return in its home country (Country X) includes the gross amount of the royalty income (i.e., the amount invoiced by Entity A to the customer in Country Z). The withholding tax on royalties that is paid in Country Z is, however, deductible against income taxes payable in Country X.

How should Entity A account for the tax withheld by the customer in Country Z?

How we see it

In fact patterns similar to Illustration 4-1 above, the withholding tax is normally treated as a non-income tax outside the scope of IAS 12 as the tax is based on the royalty amount invoiced to the customer rather than based on taxable profits. However, in limited circumstances there may be a combination of other factors that are sufficiently distinctive to result in a judgement that such a withholding tax is an income tax within the scope of IAS 12, in a particular jurisdiction. Such factors may include, for example, the fact that Entity A receives a foreign tax credit for tax paid in Country Z that reduces its income tax liability in Country X and because the gross amount of royalty income is equal to the net profit earned by Entity A from this activity in Country Z.

Even if the withholding tax is determined not to be in scope of IAS 12, it might give rise to temporary differences in relation to Entity A's own tax return in its home jurisdiction, for example where the withholding tax incurred is not deductible until a later period. Such temporary differences would be in scope of IAS 12.

4.3 Investment tax credits

Investment tax credits are not defined in IAS 12, but for the purposes of the following discussion they are taken to comprise government assistance and incentives for specific kinds of business activity and investment delivered through the tax system. Investment tax credits can take different forms and be subject to different conditions. Sometimes a tax credit is given as a deductible expense in computing the entity's tax liability, and sometimes as a deduction from the entity's tax liability, rather than as a deductible expense. In some cases, the value of the credit is chargeable to income taxes and in others it is not.

Entitlement to receive investment tax credits can be determined in a variety of ways. Some investment tax credits may relate to direct investment in property, plant and equipment. Other entities may receive investment tax credits relating to research and development or other specific activities. Some credits may be realisable only through a reduction in current or future income taxes payable, while others may be settled directly in cash if the entity does not have sufficient income taxes payable to offset the credit within a certain period. Access to the credit may be limited according to total taxes paid (i.e., including taxes such as payroll and sales taxes remitted to government in addition to income taxes). There may be other conditions associated with receiving the investment tax credit, for example with respect to the conduct and continuing activities of the entity, and the credit may become repayable if ongoing conditions are not met.

As noted in section 4 above, IAS 12 states that it does not deal with the methods of accounting for government grants or investment tax credits although any temporary differences that arise from them are in the scope of the standard. *[IAS 12.4]*. At the same time, government assistance that is either provided in the form of benefits that are available in determining taxable profit or tax loss, or determined or limited according to an entity's income tax liability, is excluded from the scope of IAS 20. That standard lists income tax holidays, investment tax credits, accelerated depreciation allowances and reduced income tax rates as examples of such benefits. *[IAS 20.2]*. Accordingly, if government assistance is described as an investment tax credit, but it is neither determined nor limited by reference to an entity's liability to income taxes, it falls within the scope of IAS 20 and must therefore be accounted for as a government grant (see Chapter 25 at section 2.3.2).

The fact that both IAS 20 and IAS 12 use the term 'investment tax credits' to describe items excluded from their scope requires entities to carefully consider the nature of such incentives and the conditions attached to them to determine which standard the particular tax credit is excluded from and, therefore, whether they fall in the scope of IAS 12 or IAS 20.

How we see it

In our view, the determination of which standard to apply to a particular investment tax credit (IAS 12 or IAS 20) is a matter of judgement and all facts and circumstances relating to the specific incentive need to be considered in assessing the substance of the arrangement.

The following factors will often be relevant, but this list of factors must not be considered exhaustive, and entities may identify other factors which they consider to be more important than those listed below.

Feature of credit	Indicator of IAS 12 treatment	Indicator of IAS 20 treatment
Method of realisation	Only available as a reduction in income taxes payable (i.e., benefit is forfeited if there are insufficient income taxes payable). However, a lengthy period allowed for carrying forward unused credits may make this indicator less relevant.	Directly settled in cash where there are insufficient taxable profits to allow credit to be fully recovered, or available for set off against non-income taxes, such as payroll taxes, sales taxes or other amounts owed to government.
Number of non-tax conditions attached to the initial receipt of grant (e.g., minimum employment, ongoing use of purchased assets)	None or few	Many
Restrictions as to nature of expenditure required to receive the grant	Broad criteria encompassing many different types of qualifying expenditure	Highly specific
Tax treatment of grant income	Not taxable	Taxable

In group accounts, in which entities from several different jurisdictions may be consolidated, it may be desirable that all 'investment tax credits' must be consistently accounted for, either as an IAS 12 income tax or as a government grant under IAS 20. However, the judgement as to which standard applies is made by reference to the nature of each type of investment tax credit and the conditions attached to it. This may mean that the predominant practice among IFRS reporters in a particular jurisdiction for a specific type of investment tax credit has evolved differently from the consensus in another jurisdiction for what could appear to be a substantially similar credit. We believe that, in determining whether the arrangement is of a type that falls within the scope of IAS 12 or IAS 20, an entity considers the following factors in the order listed below:

- If there is a predominant local treatment among IFRS reporters for a specific investment tax credit as to whether that specific credit in the relevant tax jurisdiction falls within the scope of IAS 12 or IAS 20, this must take precedence.
- If there is no predominant local treatment among IFRS reporters, the group-wide approach to determining the standard that applies to such a credit must be applied.
- In the absence of a predominant local treatment by IFRS reporters or a group-wide approach to making the determination, the indicators listed in the table above must provide guidance.

This may mean that an entity operating in several territories adopts different accounting treatments for apparently similar arrangements in different countries, but it at least ensures a measure of comparability between different entities operating in the same tax jurisdiction. Similar considerations apply in determining the meaning of 'substantively enacted' legislation in different jurisdictions (see section 5.1 below).

How we see it

In our view this is not an accounting policy choice. Accordingly, an entity operating in several territories could be required to adopt different accounting treatments for apparently similar arrangements in different countries if predominant local practice among IFRS reporters for a specific type of investment tax credit has evolved differently from the consensus in another jurisdiction.

Where a tax credit is determined to be in the nature of an income tax, the incentive should be recognised as an asset and a reduction in current income tax (to the extent of the incentive that has already been used) as soon as the entity can demonstrate it complies with the substantive conditions of the tax credit and the tax credit thereby becomes allowable against the income tax base of the current or preceding year.

A deferred tax asset will be recognised for any unused tax credits (up to the amount of incentive to which the entity is already entitled) to the extent that the entity can demonstrate that it complies with the conditions of the tax credit as at the end of the reporting period and it is probable that future taxable profit will be available against which the unused tax credits can be utilised. *[IAS 12.34]*. For incentives related to the initial recognition of assets (i.e., not relating to items expensed for accounting purposes), an entity could either reflect the associated income tax effect immediately in profit or loss, or treat the tax credit as an adjustment to the tax base of the asset. If regarded as an adjustment to the tax base of the asset, the initial recognition exception would apply to prohibit recognition of the excess of the tax base over the accounting carrying value. The subsequent accounting would then be similar to the accounting followed for a super-deductible asset. The treatment of super-deductible assets is discussed further in section 7.2.6 below.

How we see it

In our view, it would be acceptable to adopt either of these approaches for incentives determined to be in the scope of IAS 12 and related to the initial recognition of assets, provided that it is applied consistently.

Even if investment tax credits are recorded which will be realised in future periods, the related deferred tax asset must not be discounted.

4.4 Interest and penalties

Many tax regimes require interest and/or penalties to be paid on late payments of tax. This raises the question of whether or not such penalties fall within the scope of IAS 12. The answer can have consequences not only for the presentation of interest and penalties in the income statement; but also for the timing of recognition and for the measurement of amounts recognised. If such penalties and interest fall within the scope of IAS 12, they are presented as part of tax expense and measured in accordance with the requirements of IAS 12. Further, IFRIC 23 on uncertain tax treatments would be relevant where uncertainty exists as to whether interest and penalties will be applied by the tax authorities (see section 9.1 below). If interest and penalties do not fall within the scope of IAS 12, they must be included in profit before tax, with recognition and measurement determined in accordance with another IFRS accounting standard, most likely to be IAS 37.

Some argue that penalties and interest have the characteristics of an income tax - they are paid to the tax authorities under specific tax legislation that has already been deemed to give rise to an IAS 12 income tax and therefore must be treated consistently. Others contend that penalties and interest are distinct from the main income tax liability, are not 'based on taxable profits' as required in IAS 12.2 and must not therefore form part of tax expense. Those who hold this view would point out, for example, that under IFRS accounting standards the unwinding of the interest on discounted items is generally accounted for separately from the discounted expense.

Frequently asked questions

Question 4-2: How do you determine whether interest and penalties related to income taxes are in the scope of IAS 12?

The IFRS IC considered this issue most recently in 2017, as a result of comments received from respondents regarding the scope of what is now IFRIC 23. Notwithstanding their decision to exclude a specific reference to interest and penalties in IFRIC 23 and their decision in September 2017 not to add a project on interest and penalties to its agenda, the Committee observed that:[3]

(a) The determination of whether IAS 12 or IAS 37 should be applied is not an accounting policy choice. Instead, if an entity determines that a particular amount payable or receivable for interest and penalties is an income tax, then the entity applies IAS 12 to that amount. If an entity does not apply IAS 12 to interest and penalties, then it applies IAS 37 to those amounts.

(b) Paragraph 79 of IAS 12 requires an entity to disclose the major components of tax expense (income); for each class of provision, IAS 37.84 and 85 require a reconciliation of the carrying amount at the beginning and end of the reporting period as well as various other pieces of information. Accordingly, regardless of whether an entity applies IAS 12 or IAS 37 when accounting for interest and penalties related to income taxes, the entity would disclose information about those interest and penalties if it is material.

3 *IFRIC Update*, September 2017, available on the IFRS Foundation's website.

(c) Paragraph 122 of IAS 1 requires disclosure of the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

The IFRS IC also observed that it had previously published agenda decisions discussing the scope of IAS 12 in March 2006 and May 2009 (as noted in section 4.1 above).

The IFRS IC did not give any specific guidance as to how one might decide whether interest and penalties should be regarded as an IAS 12 income tax.

How we see it

In our view, the judgement of whether IAS 12 or IAS 37 applies must be determined on a country-by-country and a tax-by-tax basis. The agenda decision is clear that this is not an accounting policy choice whereby an entity has 'free rein' to choose the standard that is applied. Instead, an entity must make a determination of the nature of the particular interest and penalties in question based on its understanding of the operation of the specific tax law and the way in which the charge or credit is calculated.

The following factors are relevant in determining whether an item is in scope of IAS 12, although we believe that no particular order must be applied and that no single factor is conclusive:

- Whether there is a predominant local consensus in evidence or specific guidance issued locally by regulators as to the nature of interest and penalties applied to a specific tax in the relevant tax jurisdiction, leading to a predominant practice of accounting for these as income tax or not. Where a treatment may not otherwise be clear, entities often refer to local practice in determining whether a tax is an income tax; whether legislation has been substantively enacted; and in the treatment of investment tax credits. Determining whether interest and penalties are part of income tax requires careful consideration of the local legislation and hence entities would usually defer to local consensus where it exists. Since the judgement depends on the circumstances of the tax laws in a particular country, it must be accepted that an international group could encounter different conclusions in relation to interest and penalties arising in different jurisdictions. In particular, we would normally not expect a conclusion based on local consensus to be reversed in a subsequent consolidation by an overseas parent.
- Whether the amounts are clearly identifiable as 'interest' or as 'penalty' making it more appropriate to not account for these as income tax. Does the tax legislation have specific rules and requirements that allow an entity to identify the amounts that are to be regarded as 'interest' and as 'penalties'? That is, if an entity pays a single lump sum to settle existing tax positions, it would only identify interest and penalty components to the extent that communications from the tax authorities and/or tax legislation allow the entity to identify such components. An entity would not bifurcate such a single payment to identify notional interest and penalty amounts as this would be too judgemental, but rather account for the whole as an income tax.
- The degree to which an entity believes it is certain that interest and penalties will be applied. A certain payment of interest for example may indicate it being a financing expense rather than an income tax. In some cases, an entity might decide to wait until a tax enquiry is concluded before settling an expected obligation. In others, the entity could be confident of recovering an overpayment of tax, with interest added to the expected refund. In these circumstances, it could be argued that interest and penalties result from an entity's conscious decision not to pay taxes due earlier or to secure the later receipt of interest. Hence, those interest and penalties might be regarded as not directly related to taxable income, but rather the result of the entity's financing decisions.
- Whether the amount is based on net taxable profit, indicating it is an income tax. As noted in section 4.1 above, IAS 12 only applies to income taxes, which are based on 'taxable profits'. However, in many jurisdictions income tax legislation contains elements that, when looked at in isolation, are not strictly based on a notion of taxable profits. Examples include tax exempt amounts, deductibility caps and super-deductions for certain eligible expenditure. As a practical matter it is normally not considered helpful or necessary to account for such elements as a separate unit of account, unless not doing so would significantly misrepresent the underlying substance of the arrangements.
- Whether the interest rate applied by the tax authorities reflects current market assessments of the time value of money, indicating it being a financing expense rather than income tax. If the applied rate clearly reflects the time value of money, it must be treated as interest. If the rate is largely punitive, the interest must be considered together with penalties. However, it would not be sensible to attempt to identify a notional time value component as this would be too judgemental.

Where the amounts involved are material, it will be appropriate for the entity to consider whether the judgements made and the amounts involved must be disclosed in accordance with the requirements of IAS 1.122 (see Chapter 3 at section 5.1.1.A).

4.5 Hybrid taxes (including minimum taxes)

The term 'hybrid taxes' is applied to arrangements in which:

(a) An entity's liability to tax is assessed on both a measure of its taxable profits and a non-profit measure

(b) The amount of tax to be paid in any period depends on the interaction between those two measures

Examples of non-profit measures would include amounts based on particular types of revenue; on components of the statement of financial position, such as total equity, net assets or net debt; or to a non-financial measure such as physical output. Tax authorities might require entities to use the alternative measures to determine a minimum amount of tax to be paid in any period. Hybrid taxes do not include arrangements where an entity can elect to operate within one of a number of alternative tax regimes, for example to choose to be assessed on the basis of its taxable profits, or to have its profits exempt from tax and instead be assessed according to a non-profit measure such as revenues, net assets or physical output. In this case there is no interaction between taxable profits and the non-profit measure in determining the actual tax to be paid in a given period.

Such 'hybrid taxes' (where the tax to be paid depends on the interaction of a profit and a non-profit measure) raise the issue of how they must be accounted for. Does IAS 12 apply simply because one of the measures referred to in the tax legislation is based on taxable profits, or must a determination be made based on an assessment of which measure is most likely to influence the actual amount of tax to be incurred by the entity? Alternatively, should the tax charge be bifurcated between the component based on profits and the component based on another measure, with the former accounted as an income tax and the other as a levy under IAS 37 and IFRIC 21? This section considers some of the different arrangements seen in practice.

4.5.1 Hybrid taxes - minimum based on a measure other than taxable profits

In the case of a minimum tax, the authorities impose income taxes which are charged as a percentage of taxable profits in the normal way, but subject to a requirement that a minimum amount of tax must be paid. This minimum may be an absolute amount.

One approach would be to account for the fixed minimum element as a non-income tax under IAS 37 and IFRIC 21, with any excess above the fixed minimum element treated as an income tax under IAS 12.

An alternative approach would be to consider the overall substance of the tax. If it is apparent that the overall intention of the legislation is to charge taxes based on net profit, but subject to a floor, the tax must be accounted for as an income tax in its entirety, even if the floor would not be an income tax if considered in isolation.

This second approach appears to have some advantages over the first. A determination that the tax, in its entirety, is either in scope of IAS 12 or not is consistent with the IFRS IC's agenda decision in relation to interest and penalties (see section 4.4 above). Having established the overall intention of the legislation, a consistent basis can be applied from period to period, for example to the identification of a tax rate for measuring deferred tax (should the entity have determined that IAS 12 must apply).

Under the first approach, an entity might have to account for current and deferred tax in periods where net profit results in a higher liability than the non-profit measure and apply a different basis when taxable profits give an assessment lower than the non-profit measure. Another practical disadvantage is that the effective rate of the element accounted for as income tax is unpredictable, as it will depend on the level of profit in future periods relative to the established minimum level of tax, as shown in the following Illustration.

Illustration 4-2: Minimum tax based on a specified amount - minimum treated as a levy

Entity A is required to pay tax at 30% on its taxable profit, but subject to a minimum tax of CU90,000 per year. No income tax relief is available for the minimum tax. If its taxable profits were less than or equal to CU300,000, it would pay the minimum tax of CU90,000. If taxable profits were CU1 million, it would pay total tax of CU300,000 (CU1,000,000 at 30%). If the entity's taxable profits were CU2,000,000 it would pay tax of CU600,000 (CU2,000,000 at 30%). Entity A applies the first approach above, treating the minimum amount as a levy under IAS 37 and IFRIC 21 and accounting for any excess as an income tax under IAS 12. On this basis, the effective rate of tax, for the purpose of measuring any deferred tax balances, would be derived as follows in each scenario:

Total tax charge	CU	CU	CU
Taxable profit before minimum tax	300,000	1,000,000	2,000,000
Total tax (@ 30% or CU90,000)	90,000	300,000	600,000
Minimum tax	90,000	90,000	90,000
Income tax (remainder)	-	210,000	510,000
Effective income tax rate			
Taxable profit before minimum tax	300,000	1,000,000	2,000,000
Minimum tax	90,000	90,000	90,000
Profit before income tax (A)	210,000	910,000	1,910,000
Income tax (B)	-	210,000	510,000
Profit after tax	210,000	700,000	1,400,000
Effective income tax rate (B/A)	n/a	23.1%	26.7%

In the circumstances illustrated above, in order to calculate deferred income taxes for the purposes of IAS 12, any future income tax rate would be subject to constant re-estimation, even if the 'headline' enacted rate had not changed.

How we see it

In our view, either of these two approaches can be adopted so long as it is applied consistently.

4.5.2 Tax is the higher of measures based on taxable profits and revenues

Another form of hybrid tax is where the amount of tax payable is the higher of one measure (based on profits) and another (for example based on: revenues; net assets; or total debt and equity).

Treating the tax on an 'all-or-nothing' basis, e.g., wholly as a non-income tax could be problematic, especially in situations where the basis giving rise to the amount of total tax payable changes from period to period.

Alternatively, an entity could determine either that the tax is primarily a non-income tax, with amounts in excess of that basis accounted under IAS 12; or that the tax is primarily an IAS 12 income tax, with any excess accounted as a non-income tax under IAS 37 and IFRIC 21. These two approaches are shown in Illustration 4-3 below.

Illustration 4-3: Tax is the higher of measures based on taxable profits or revenues

Entity B is required to pay tax at the higher of 40% on its taxable profit or 2% of its reported revenue. Income tax relief is not available for the revenue tax. The entity must therefore determine how much tax would be paid on each basis and incur the higher amount. The effective rate of income tax, for the purpose of measuring any deferred tax balances, would be derived as follows in the various scenarios below:

Total tax charge	CU	CU	CU	CU
Revenue (A)	20,000,000	20,000,000	20,000,000	20,000,000
Profit before tax (B)	500,000	900,000	1,200,000	2,400,000
Charge based on revenue (A @ 2%)	400,000	400,000	400,000	400,000
Charge based on profit (B @ 40%)	200,000	360,000	480,000	960,000
Tax charge under legislation	400,000	400,000	480,000	960,000

Approach 1 - Excess is IAS 12 tax				
Profit before revenue tax	500,000	900,000	1,200,000	2,400,000
Revenue tax	400,000	400,000	400,000	400,000
Profit before income tax (C)	100,000	500,000	800,000	2,000,000
Income tax (D)	-	-	80,000	560,000
Profit after tax	100,000	500,000	720,000	1,440,000
Effective income tax rate (D/C)	0%	0%	10%	28%
Approach 2 - Excess is revenue tax				
Profit before revenue tax	500,000	900,000	1,200,000	2,400,000
Revenue tax	200,000	40,000	-	-
Profit before income tax (E)	300,000	860,000	1,200,000	2,400,000
Income tax (F)	200,000	360,000	480,000	960,000
Profit after tax	100,000	500,000	720,000	1,040,000
Effective income tax rate (F/E)	66.7%	41.8%	40%	40%

In the Illustration above, when the excess is accounted as an IAS 12 income tax, the effective income tax rate varies once the minimum tax threshold is exceeded (see the last two columns under Approach 1 above). This variability requires the entity to reassess its estimate for measuring deferred taxes in the future even when the enacted rate of income tax is unchanged. When the excess is treated as a revenue tax, the effective rate of income tax varies initially and then stabilises at the enacted rate (40%) when the minimum tax threshold is exceeded. Until that point, the entity would have to consider the variability in the effective tax rate when measuring deferred taxes (see the first two columns under Approach 2 above).

How we see it

In our view, either of these approaches can be adopted so long as it is applied consistently.

4.5.3 Tax is based on revenues, unless a profit measure gives a lower result

As businesses have increasingly operated across international boundaries, national governments have sought to evolve their tax systems to ensure that the profit of a multinational group is taxed in the countries in which it creates value. The need for this development has become more urgent with the advent of the digital revolution, whereby companies can earn profits in a particular country without having any physical presence there.

As a result, individual governments are introducing taxes based primarily on measures of revenue earned in their jurisdiction by these entities. However, at the same time, governments do not wish to discourage local investment and innovation by businesses operating internationally or in the digital space, so they introduce reliefs and incentives. For example, the tax might be levied only on revenues above a certain threshold, or an entity might be permitted to elect to be taxed on its profits from that activity if it has a presence in the jurisdiction and it can show that a measure based on profits would give rise to a lower liability.

This is shown in the following Illustration.

Illustration 4-4: Tax based on revenues, unless a profit measure gives a lower result

A government introduces a tax on the revenues of certain digital businesses (DST). A charge of 2% is levied on the digital revenues earned from customers in that country above an annual threshold. Where the local revenues received in connection with digital services activities exceed the annual threshold, the entity must submit DST returns to the local tax authority and will have to pay DST. No tax is payable for revenues up to the annual threshold.

Because the entities subject to this tax often have little or no physical presence in the country in question, DST normally applies at the rate of 2% on local digital services revenues above the annual threshold. However, an entity can elect to calculate its tax liability using an alternative basis. The alternative basis gives rise to a lower DST liability for entities making a loss or operating at a low margin on their local digital services activity.

This election is voluntary, applies for one year, and entities must make or renew the election at the time they submit their tax return for the period they wish to calculate their DST liability using the alternative method. Under the alternative basis, the DST is calculated by reference to the operating margin of the local digital services activity at a rate of 80% of that margin. In cases where the local digital services activity is loss making and the alternative basis is being applied, no DST needs to be paid on revenues attributable to that activity, but at the same time no relief is given in respect of those losses. That is, the DST is set at zero for the current period, but no losses are carried forward or back into other accounting periods.

How should entities account for this tax?

How we see it

In these circumstances we believe that this type of arrangement must be treated wholly as a non-income tax outside the scope of IAS 12. In our view, it would not be appropriate to account for the tax as a non-income tax in those years when tax is paid on digital services revenues, and as an IAS 12 income tax when an election is taken to apply the alternative basis, using a measure of profit. It would also be inappropriate to try to bifurcate the tax between a component based on revenue and a component based on the alternative profit measure regardless of whether the election is taken. Such bifurcation is only effective where the tax liability is the higher of one measure or another, as discussed in section 4.5.2 above.

The nature of the arrangement in the Illustration above, in both design and operation, is a revenue-based tax that would fall outside the scope of IAS 12. The tax is designed to achieve a higher level of tax for entities that do not have a physical presence in the country in which revenues are generated; and in most cases it is this basis that will determine the amount of tax payable. The election to apply the alternative basis represents a relief for those particular entities with a low operating margin in the local jurisdiction (for example because they have a physical presence, employ staff or have other activities that would attract a liability to local taxes). In the Illustration above, only if the entity's operating margin were below 2.5% (2% ÷ 0.8) would the alternative basis give rise to a lower charge than the levy on revenue.

Governments are also co-operating internationally to establish ways to ensure that the profits of multinational groups are taxed appropriately. An example of such international co-operation and the accounting challenges it presents is discussed in section 4.6 below.

4.6 Global Anti-Base Erosion Rules

The Organisation for Economic Co-operation and Development (OECD)/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) addresses the tax challenges arising from the digitalisation of the global economy. To restore confidence in the international tax system and with the aim that profits are taxed where economic activities take place and value is created, the Inclusive Framework on BEPS proposes two "pillars":

- Pillar One applies to multinational enterprises (MNEs) with global turnover above EUR20 billion and profitability above 10% (i.e., profit before tax/revenue).
- Pillar Two applies to MNEs with revenue in excess of EUR750 million per their consolidated financial statements.

The Pillar Two Global anti-Base Erosion rules (GloBE Rules or Pillar Two Model Rules) represent the first substantial overhaul of the international tax rules in almost a century. The GloBE Rules introduce four new taxing mechanisms under which MNEs would pay a minimum level of tax (Minimum Tax):

- the Subject to Tax Rule is a tax treaty-based rule that generally proposes a Minimum Tax on certain cross-border intercompany transactions that otherwise are not subject to a minimum level of tax.
- the Income Inclusion Rule (IIR).
- the Under Taxed Payments Rule (UTPR).
- the Qualified Domestic Minimum Top-up Tax (QDMT).

The new taxing mechanisms can impose a Minimum Tax on the income arising in each jurisdiction in which an MNE operates. The IIR, UTPR and QDMT do so by imposing a Top-up Tax in a jurisdiction whenever the effective tax rate (ETR), determined on a jurisdictional basis under the GloBE Rules, is below a 15% minimum rate (Minimum Rate). The GloBE Rules set out the mechanics for determining which entity (or entities) in an MNE Group (i.e., a group in which the ultimate parent entity has, directly or indirectly, at least one foreign subsidiary or a permanent establishment) would apply the IIR, the UTPR, and/or the QDMT, and the portion of Minimum Tax that is charged to each relevant entity. While the framework for the GloBE Rules is global, the GloBE Rules would be implemented through legislation enacted in jurisdictions that adopt the rules.

The GloBE Rules raise a number of accounting questions. In particular, whether the Minimum Tax is an income tax in the scope of IAS 12 and, if so, when and how entities should account for the new taxes.

The GloBE Rules are complex and contain complicated terminology that is not discussed in detail in this publication. The OECD has published GloBE Model Rules, GloBE Model Rules Commentary, and GloBE Model Rules Examples, which can be found on their website.[4] In addition, the OECD has published a summary, fact sheets, frequently asked questions, and press releases that provide additional information on the GloBE Rules. EY has published an executive summary and discussion of GloBE Model Rules, Commentary and Examples, which provides helpful context and further explanation of the GloBE Rules.[5] There remain numerous areas of uncertainty in the application of the GloBE Rules that require additional interpretive guidance.

4.6.1 The GloBE Rules

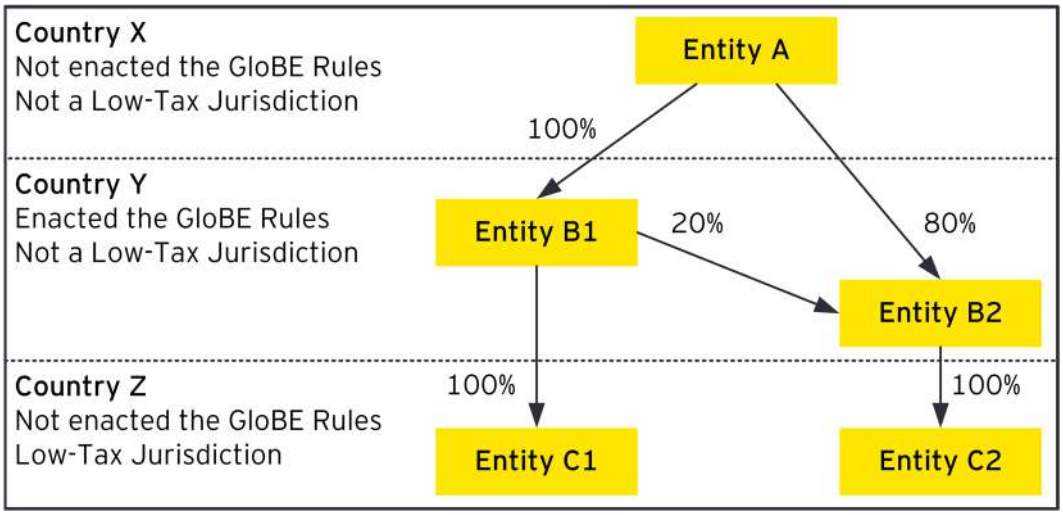
The OECD notes that "The GloBE Rules apply a system of Top-up Taxes - that is, an IIR and a UTPR - that brings the total amount of taxes paid on an MNE's Excess Profit in a jurisdiction up to the Minimum Rate. This Top-up Tax does not operate as a typical direct tax on income of an Entity. Rather it applies to the Excess Profits calculated on a jurisdictional basis and only applies to the extent those profits are subject to tax in a given year below the Minimum Rate. Rather than a typical direct tax on income, the tax imposed under the GloBE Rules is closer in design to an international alternative minimum tax, that uses standardised base and tax calculation mechanics to identify pools of low-taxed income within an MNE Group and imposes a co-ordinated tax charge that brings the Group's ETR on that income in each jurisdiction up to the Minimum Rate".[6]

4.6.1.A Five step process to apply the GloBE Rules

At the simplest level, the GloBE Rules impose a Top-up Tax that is calculated and applied at a jurisdictional level involving five steps: 1) identify MNE Groups in scope of the GloBE Rules; 2) determine GloBE income or loss for each constituent entity; 3) determine adjusted covered taxes; 4) compute GloBE ETR and Top-up Tax; and 5) determine the entities liable to pay taxes under the IIR, UTPR and/or QDMT. These elements are shown in Illustration 4-5 below.

Illustration 4-5: Application of GLoBE Rules

The diagram below sets out the holding structure and location of the members of the ABC Group and illustrates the application of GloBE Rules.



Entities A, B1 and B2 have a GloBE ETR above the 15% Minimum Rate, but Entity C1 and Entity C2 are located in a low-tax jurisdiction with a GloBE ETR below 15%. Only Country Y has enacted an IIR.

4 OECD website, www.oecd.org, (accessed on 30 September 2022).

5 Tax Alert, *OECD releases Commentary and illustrative examples on Pillar Two Model Rules*, EY Global, 21 March 2022.

6 OECD (2022), *Tax Challenges Arising from the Digitalisation of the Economy - Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)*, OECD, Paris, page 8.

Step 1: Identify MNE groups in scope of the GloBE Rules

Entity A, located in Country X, is the ultimate parent entity (UPE) of the consolidated group (ABC Group). ABC Group has determined it is an MNE Group in scope of the GloBE Rules. Accordingly, ABC Group has identified its constituent entities and their locations according to the diagram above. As Countries X and Z have not enacted GloBE Rules, any Top-up Taxes due by the entities located in those jurisdictions will be payable by entities in Country Y to Country Y (see Step 5).

Step 2: Determine GloBE income or loss for each constituent entity

ABC Group has determined GloBE income for each constituent entity in the MNE Group based on the group financial accounting net income of each constituent entity adjusted to the GloBE tax base. Only the results for C1 and C2 are given in this example, as they operate in a low-tax jurisdiction. Assume GloBE income is CU600 for C1 and CU1,800 for C2.

Step 3: Determine adjusted covered taxes

ABC Group has determined adjusted covered taxes for each constituent entity in the MNE Group based on group financial accounting tax expense/benefit adjusted to the GloBE covered taxes. Assume adjusted covered taxes are CU30 for Entity C1 and CU240 for Entity C2.

Step 4: Compute GloBE ETR and Top-up Tax

The GloBE ETR of the constituent entities located in Country Z is (CU30+CU240) ÷ (CU600+CU1,800) = 11.25% and thus, the Top-up Tax rate is 3.75% (i.e., minimum rate of 15% less GloBE ETR of 11.25%). The Excess Profit (amount of profit upon which the Top-up Tax is levied) is assumed to be equal to GloBE income, so the Top-up Tax is (CU600+CU1,800) × 3.75% = CU90. The example assumes the Group does not have any substance-based income exclusion (i.e., exclusion of a fixed return for substantive activities within a jurisdiction from the application of the GloBE Rules).

Step 5: Determine the entities liable for payment of the Top-up Tax

In applying the IIR, a parent entity pays its allocable share of the Top-up Tax with respect to a low-taxed constituent entity. The IIR operates on a top-down approach, starting with the UPE. If the UPE is not located in a jurisdiction that has enacted an IIR, the highest parent entity in the ownership chain that is located in a jurisdiction that has enacted an IIR pays its allocable share of the Top-up Tax. (Note: an exception to the top-down approach applies in split-ownership situations).

In this example, only Country Y has enacted an IIR and thus, the intermediate parent Entities B1 and B2 are required to pay any Top-up Taxes. Entity B1 is liable for 100% of any Top-up Tax attributable to its wholly-owned subsidiary C1 and 20% of the Top-up Tax for C2, as a result of its 20% indirect shareholding interest in C2. Entity B2 is liable for 100% of any Top-up Tax attributable to its wholly-owned subsidiary C2.

As Entity B2 is liable for 100% of any Top-up Tax of C2, Entity B1's allocable share (i.e., 20%) of C2's Top-up Tax due to its indirect interest in C2 via B2 would result in double-taxation. To avoid double taxation, Entity B1 reduces its Top-up Tax attributable to its indirect ownership in C2 that is paid by B2.

In summary, Entity B1 pays Top-up Tax of CU22.5, calculated as follows: Entity C1: CU22.5 (i.e., 3.75% × CU600), plus Entity C2: CU13.5 (20% of 3.75% × CU1,800), less CU13.5 paid by Entity B2. Entity B2 pays Top-up Tax of CU67.5, calculated as follows: Entity C2: CU67.5 (i.e., 3.75% × CU1,800).

The above simple example demonstrates the application of only an IIR. In practice, if a UTPR and QDMT are enacted with an IIR, an MNE Group would first calculate the Top-up Tax under QDMT, then apply the IIR to capture residual Top-up Tax not included in the QDMT, and finally apply the UTPR to capture residual Top-up Tax not included in the IIR.

4.6.2 International Tax Reform-Pillar Two Model Rules - Amendments to IAS 12

On 23 May 2023, the IASB issued *International Tax Reform-Pillar Two Model Rules - Amendments to IAS 12 (the Amendments)*. The Board amended the standard for the following reasons:

- Provide timely relief for affected entities.
- Avoid diverse interpretations of IAS 12 developing in practice.
- Improve the information provided to users of financial statements before and after Pillar Two legislation comes into effect.

The Amendments have introduced:

- A mandatory temporary exception to the accounting for deferred taxes arising from the jurisdictional implementation of the Pillar Two model rules. See sections 4.6.2.A and 4.6.2.B below.
- Disclosure requirements for affected entities to help users of the financial statements better understand an entity's exposure to Pillar Two income taxes arising from that legislation, particularly before its effective date. See sections 4.6.2.C and 4.6.2.B below.

4.6.2.A Mandatory temporary exception from recognition and disclosure of deferred taxes

The Amendments clarify that IAS 12 applies to income taxes arising from tax law enacted or substantively enacted to implement the Pillar Two Model Rules published by the OECD, including tax law that implements qualified domestic minimum top-up taxes. Such tax legislation, and the income taxes arising from it, are referred to as 'Pillar Two legislation' and 'Pillar Two income taxes', respectively.

The Amendments have introduced a mandatory exception in IAS 12 from recognising and disclosing deferred tax assets and liabilities related to Pillar Two income taxes. *[IAS 12.4A]*. The Board did not expand the scope of the temporary exception to include the measurement of deferred taxes recognised under domestic tax regimes. The Board concluded that an entity would not remeasure such deferred taxes to reflect Pillar Two income taxes it expects to pay when recovering or settling a related asset or liability because the temporary exception applies to deferred tax assets and liabilities related to such income taxes. *[IAS 12.BC104]*.

The Amendments note that the temporary exception provides entities with relief from accounting for deferred taxes in relation to this complex new tax legislation allowing stakeholders time to assess the implications. It also avoids entities developing diverse interpretations of IAS 12 that could result in inconsistent application of the standard. *[IAS 12.BC101]*.

The Board did not include a sunset date for the temporary exception, but will monitor the implementation of the Pillar Two Model rules to determine when to undertake further work. *[IAS 12.BC106]*.

4.6.2.B Pillar Two taxes and the scope of IAS 12

The Board did not provide further clarifications about when a Pillar Two top-up tax is considered to be an income tax in the scope of IAS 12, nor to require entities to treat all top-up taxes as if they were income taxes. *[IAS 12.BC103]*. An entity is, therefore, required to apply judgement in determining which top-up taxes it considers to be income taxes in the entity's circumstances.

The Board noted that stakeholders were generally of the view that Pillar Two top-up tax is an income tax and, therefore, within the scope of IAS 12 in the consolidated financial statements of the ultimate parent entity of a group subject to the Pillar Two model rules. However, stakeholders noted that this view does not necessarily apply in the financial statements of intermediate parents and subsidiaries of an MNE group that is subject to the Pillar Two model rules. For example, when those subsidiaries may need to pay top-up taxes under the UTPR mechanism in respect to a fellow subsidiary's profits and the top-up tax allocation is not necessarily in direct proportion to the intermediate parent's ownership interest in its investees.

How we see it

We believe that intermediate parents and subsidiaries of an MNE group need to apply judgement in determining whether or not in a particular situation a top-up tax meets the definition of an income tax in IAS 12 and disclose those judgements in accordance with IAS 1.

If an entity concludes that Pillar Two taxes are outside the scope of IAS 12, it needs to consider disclosing information, applying IAS 1, that is helpful to other users of the financial statements in understanding how such Pillar Two taxes have been accounted for.

4.6.2.C Disclosure of application of the exception

An entity is required to disclose that it has applied the exception to recognising and disclosing information about deferred tax assets and liabilities related to Pillar Two income taxes. *[IAS 12.88A]*.

4.6.2.D Disclosure of current tax

An entity is required to separately disclose its current tax expense (income) related to Pillar Two income taxes in the periods when the legislation is effective, as this helps users of financial statements understand the relative level of those taxes. *[IAS 12.88B]*.

4.6.2.E Disclosure in periods after (substantive) enactment but before the legislation is effective

The Amendments require, for periods in which Pillar Two legislation is (substantively) enacted but not yet effective, disclosure of known or reasonably estimable information that helps users of financial statements understand the entity's exposure arising from Pillar Two income taxes. *[IAS 12.88C]*. To comply with these requirements, an entity is required to disclose qualitative and quantitative information about its exposure to Pillar Two income taxes at the end of the reporting period. *[IAS 12.88D]*. For example, an entity could disclose the following information to meet these requirements:

- Qualitative information such as how an entity is affected by Pillar Two legislation and the main jurisdictions in which exposures to Pillar Two income taxes might exist.
- Quantitative information such as:
  - An indication of the proportion of an entity's profits that risks being subject to Pillar Two income taxes and the average effective tax rate applicable to those profits.
  - An indication of how the entity's overall effective tax rate would have changed if Pillar Two legislation had been effective.

The above information does not need to reflect all the specific requirements of the legislation and could be provided in the form of an indicative range. The IASB notes in the Basis for Conclusions '... that an entity would not have to disclose information about possible future transactions and other possible future events (forward-looking information) to meet this requirement. For example, an entity would not be required to forecast future profits, reflect mitigation actions it expects to take in future periods, or consider possible future changes in tax legislation.' *[IAS 12.BC112(b)]*. Further, to the extent information is not known or reasonably estimable, an entity is instead required to disclose a statement to that effect and information about its progress in assessing its exposure. *[IAS 12.88D]*.

Gradually, countries are enacting Pillar Two legislation with legislation in certain countries becoming effective in 2024 or 2025. An MNE group may find that it operates in some jurisdictions where Pillar Two legislation is both enacted and in effect, while in other jurisdictions Pillar Two legislation is (substantively) enacted but not yet in effect. In some cases (e.g., when the ultimate parent entity is already in scope of Pillar Two tax legislation), the (substantive) enactment of Pillar Two tax legislation in additional jurisdictions might shift the Pillar Two tax liability within the group, but not materially affect the group's overall exposure. However, in other cases, the (substantive) enactment of Pillar Two tax legislation in additional jurisdictions may bring more group entities within scope of Pillar Two and affect the group's overall exposure.

How we see it

The requirements of paragraph 88C of IAS 12 apply in periods when Pillar Two legislation is enacted or substantively enacted but not yet in effect. If an MNE group finds that it operates in some jurisdictions where Pillar Two legislation is both enacted and in effect, while in other jurisdictions, Pillar Two legislation is (substantively) enacted but not yet in effect, the disclosure of qualitative and quantitative information about an entity's exposure to Pillar Two income taxes will continue to apply. If the (substantive) enactment of Pillar Two tax legislation in additional jurisdictions brings more group entities within scope of Pillar Two and materially affects the group's overall exposure, the entity would need to disclose qualitative and quantitative information about its exposure to Pillar Two income taxes because of group entities operating in such additional jurisdictions.

4.6.2.F Transition and effective date

The mandatory temporary exception from the recognition and disclosure of information about deferred taxes and the requirement to disclose the application of that exception, applied immediately upon issuance and retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (see Chapter 3 at section 4.4). *[IAS 12.98M(a)]*.

The requirements to disclose separately the current tax expense related to Pillar Two income taxes and to provide additional information in periods in which Pillar Two legislation is enacted but is not yet effective for the reporting entity are required for annual reporting periods beginning on or after 1 January 2023. *[IAS 12.98M(b)]*.

Refer Chapter 37 at section 9.5.7 regarding disclosures in a set of interim financial statements for any period ending on or after 1 January 2024).

4.6.3 Other accounting considerations related to Pillar Two income taxes

4.6.3.A Accounting for Pillar Two income taxes before IAS 12 amendments are endorsed

Some jurisdictions have a process of formally adopting the accounting standards, interpretations and amendments issued by the IASB. In such jurisdictions the IAS 12 amendments will only take effect when endorsed by the respective local authority. Consequently, the amendments to IAS 12 may not be endorsed until after an MNE becomes subject to Pillar Two income taxes. Entities that need to prepare IFRS annual or interim financial statements before these amendments are endorsed in their jurisdiction, will therefore need to develop an accounting policy to provide relevant and reliable information to the users of their annual or interim financial statements.

Before the amendments were issued, IAS 12 did not offer specific guidance on accounting for Pillar Two income taxes. IAS 8 requires that, in the absence of an IFRS accounting standard that specifically applies to a transaction, other event or condition, an entity is required to use its judgement in developing and applying an accounting policy that results in information that is relevant and reliable (see Chapter 3 at section 4).

In the Basis for Conclusions, the IASB notes that stakeholders had said that it is unclear whether the Pillar Two model rules create additional temporary differences, whether to remeasure deferred taxes recognised under domestic tax regimes and which tax rate to use to measure deferred taxes. It was further noted that the tax rate that will apply to an entity's excess profit in future periods depends on a number of factors that are difficult, if not impossible, to forecast reliably. *[IAS 12.BC99(b)]*. As a result, the application of the requirements of IAS 12 to Pillar Two income taxes prior to the amendments is unclear.

How we see it

In our view it would be acceptable for an entity to apply judgement and conclude - in accordance with paragraphs 10 and 11 of IAS 8 - that not accounting for deferred taxes related to Pillar Two income taxes would result in the most relevant and reliable accounting policy.

Such an accounting policy results in an approach that is consistent with the mandatory temporary exception in the amendments to IAS 12 and would avoid otherwise unnecessary changes in accounting policies should the amendments be later endorsed.

While the above accounting policy choice is considered acceptable, it would not preclude an entity from developing an accounting policy that does result in the recognition of deferred taxes in respect of Pillar Two income taxes. However, it should be noted that, in that case, an entity will be required to change its accounting significantly once the IAS 12 amendments are endorsed, which will prescribe a mandatory temporary exception from accounting for deferred taxes in respect of Pillar Two income taxes.

4.6.3.B Substantive enactment

Under IAS 12, a new tax law impacts the financial statements when it is enacted or substantively enacted in a particular jurisdiction. The date a tax law is enacted or substantively enacted is key to the measurement of current and deferred tax assets and liabilities. *[IAS 12.46, IAS 12.47]*. In the case of Pillar Two taxes, MNEs need to monitor regulatory developments in respect of (substantive) enactment in all of the jurisdictions where they operate either through wholly- or partially-owned subsidiaries, joint ventures, flow-through entities or permanent establishments (such as branches). Different countries may (substantively) enact the Pillar Two tax rules on different dates and with variations to the GloBE Model Rules, potentially adding more complexity to the accounting. In this context, the discussion on substantive enactment of tax legislation in section 5.1 below is relevant to the assessment of the date from which Pillar Two legislation should apply in the financial statements.

4.7 Effectively tax-free entities

In several jurisdictions, certain classes of entity are exempt from income tax, and accordingly are not within the scope of IAS 12.

However, a more common, and more complex, situation is that tax legislation has the effect that certain classes of entities, whilst not formally designated as 'tax-free' in law, are nevertheless exempt from tax provided that they meet certain conditions that, in practice, they are almost certain to meet. A common example is that, in many jurisdictions, investment vehicles pay no tax, provided that they distribute all, or a minimum percentage, of their earnings to investors.

Accounting for the tax affairs of such entities raises a number of challenges, as discussed further in section 8.5.1 below.

5 Current tax

Current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period. *[IAS 12.5]*.

Current tax for current and prior periods must, to the extent unpaid, be recognised as a liability. If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess is recognised as an asset. *[IAS 12.12]*.

The benefit relating to a tax loss that can be carried back to recover current tax of a previous period must be recognised as an asset. When a tax loss is used to recover current tax of a previous period, an entity recognises the benefit as an asset in the period in which the tax loss occurs because it is probable that the benefit will flow to the entity and the benefit can be reliably measured. *[IAS 12.13, IAS 12.14]*.

Current tax must be measured at the amount expected to be paid to or recovered from the tax authorities by reference to tax rates and laws that have been enacted or substantively enacted by the end of the reporting period. *[IAS 12.46]*.

5.1 Enacted or substantively enacted tax legislation

Extract from IAS 12

46	**Current tax liabilities (assets) for the current and prior periods shall be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.**

IAS 12 requires current tax to be measured using tax rates or laws enacted 'or substantively enacted' at the end of the reporting period. *[IAS 12.46]*. The standard comments that, in some jurisdictions, announcements of tax rates (and tax laws) by the government have the substantive effect of actual enactment, which may follow the announcement by a period of several months. In these circumstances, current tax assets and liabilities are measured using the announced tax rate (and tax laws). *[IAS 12.48]*.

IAS 12 gives no guidance as to how this requirement is to be interpreted in different jurisdictions. In most jurisdictions, however, a consensus has emerged as to the meaning of 'substantive enactment' for that jurisdiction (see section 5.1.1 below). Nevertheless, apparently similar legislative processes in different jurisdictions may give rise to different treatments under IAS 12. For example, in most jurisdictions, tax legislation requires the formal approval of the head of state in order to become law. However, in some jurisdictions, the head of state has real executive power (and could potentially not approve the legislation), whereas in others the head of state has a more ceremonial role (and cannot practically fail to approve the legislation).

The general principle tends to be that in those jurisdictions where the head of state has executive power, legislation is not substantively enacted until actually approved by the head of state. Where, however, the head of state's powers are more ceremonial, substantive enactment is generally regarded as occurring at the stage of the legislative process where no further amendment is possible.

How we see it

Substantive enactment is a legal process rather than a concept for the purposes of applying the requirements in IAS 12. As such the substantive enactment of new tax legislation is specific to a jurisdiction, its legislative processes and traditions. The assessment for a particular new tax must be consistent with the assessment applied to other taxes in that jurisdiction. Accordingly, the determination of the stage of the legislative process that constitutes substantive enactment would not vary because of the complexity of the tax legislation in question. Further, although it might appear that the legislative process in one jurisdiction is similar to that of another, it is possible that the conclusion as to the stage of the process that constitutes substantive enactment is different.

5.1.1 Meaning of substantive enactment in various jurisdictions

The following table summarises the meaning of 'substantive enactment' in various jurisdictions as generally understood in those jurisdictions.[7]

Country	Point of substantive enactment
United Kingdom	A Finance Bill has been passed by the House of Commons (after the 'third reading') and is awaiting only passage through the House of Lords and Royal Assent. Alternatively, a resolution having statutory effect has been passed under the Provisional Collection of Taxes Act 1968.
Canada	If there is a majority government, substantive enactment generally occurs with respect to proposed amendments to the Federal Income Tax Act when detailed draft legislation has been tabled for first reading in Parliament. If there is a minority government, proposed amendments to the Federal Income Tax Act would not normally be considered to be substantively enacted until the proposals have passed the third reading in the House of Commons.
Australia	The Bill has passed through both Houses of Parliament (but before Royal Assent).
France	Signature of the legislation by the President.
Germany	The Bundestag and Bundesrat pass the legislation.
Japan	The Diet passes the legislation.
United States	The legislation is signed by the President or there is a successful override vote by both houses of Congress.
South Africa	Changes in tax rates not inextricably linked to other changes in tax law are substantively enacted when announced in the Minister of Finance's Budget statement. Other changes in tax rates and tax laws are substantively enacted when approved by Parliament and signed by the President.

5.1.2 Changes to tax rates and laws enacted before the reporting date

Current tax must be measured at the amount expected to be paid to or recovered from the tax authorities by reference to tax rates and laws that have been enacted, or substantively enacted, by the end of the reporting period. *[IAS 12.46]*. Accordingly, the effects of changes in tax rates and laws on current tax balances are required to be recognised in the period in which the legislation is substantively enacted. There is no relief from this requirement under IAS 12, even in circumstances when complex legislation is substantively enacted shortly before the end of an annual or interim reporting period. In cases where the effective date of any rate changes is not the first day of the entity's annual reporting period, current tax would be calculated by applying a blended rate to the taxable profits for the year.

Where complex legislation is enacted shortly before the end of the period, entities might encounter two distinct sources of uncertainty:

- Uncertainty about the requirements of the law, which may give rise to uncertain tax treatments as defined by IFRIC 23 and discussed in sections 5.2 and 9 below
- Uncertainties arising from incomplete information because entities may not have all the data required to process the effects of the changes in tax laws

It is not necessary for entities to have a complete understanding of every aspect of the new tax law to arrive at reasonable estimates, and provided that entities make every effort to obtain and take into account all the information they could reasonably be expected to obtain up to the date when the financial statements for the period are authorised for issue, subsequent changes to those estimates would not be regarded as a prior period error under IAS 8. *[IAS 8.5]*. We expect that only in rare circumstances would it not be possible to determine a reasonable estimate. However, these uncertainties may require additional disclosure in the financial statements. IAS 1 requires entities to disclose information about major sources of estimation uncertainty at the end of the reporting period that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year (see Chapter 3 at section 5.2.1). *[IAS 1.125, IAS 1.129]*.

7 Based on a summary in the *IASB Update*, February 2005. Available on the IFRS Foundation's website.

Whilst the effect of changes in tax laws enacted after the end of the reporting period are not taken into account (see section 5.1.3 below), information and events that occur between the end of the reporting period and the date when the financial statements are authorised for issue are adjusting events after the reporting period if they provide evidence of conditions that existed as at the reporting date. *[IAS 10.3]*. Updated tax calculations, collection of additional data, clarifications issued by the tax authorities and gaining more experience with the tax legislation before the authorisation of the financial statements must be treated as adjusting events if they pertain to the position at the balance sheet date. Events that are indicative of conditions that arose after the reporting period must be treated as non-adjusting events. Judgement needs to be applied in determining whether technical corrections and regulatory guidance issued after year-end are to be considered adjusting events.

Where the effect of changes in the applicable tax rates compared to the previous accounting period are material, an explanation of those effects is required to be provided in the notes to the financial statements (see section 14.1 below). *[IAS 12.81(d)]*.

5.1.3 Changes to tax rates and laws enacted after the reporting date

The requirement for substantive enactment by the end of the reporting period is quite clear in the literature. IAS 10 *Events after the Reporting Period* identifies the enactment or announcement of a change in tax rates and laws after the end of the reporting period as an example of a non-adjusting event. *[IAS 10.22(h)]*. For example, an entity with a reporting period ending on 31 December issuing its financial statements on 20 April the following year would measure its tax assets and liabilities by reference to tax rates and laws enacted or substantively enacted as at 31 December even if these had changed significantly before 20 April and even if those changes had retrospective effect. However, in these circumstances the entity would have to disclose the nature of those changes and provide an estimate of the financial effect of those changes if the impact is expected to be significant (see section 14.2 below). *[IAS 10.21]*.

5.2 Uncertain tax treatments

In recording the 'amount expected to be paid or recovered' as required by IAS 12, the entity will need to have regard to any uncertain tax treatments. 'Uncertain tax treatment' is defined as a tax treatment over which there is uncertainty concerning its acceptance under the law by the relevant taxation authority. For example, an entity's decision not to submit any tax filing in a particular tax jurisdiction or not to include specific income in taxable profit would be an uncertain tax treatment, if its acceptability is unclear under tax law. *[IFRIC 23.3]*. Entities might also have to address uncertainty in applying new tax legislation, especially when it is enacted shortly before the end of the reporting period, as discussed in section 5.1.2 above.

Accounting for uncertain tax treatments is a particularly challenging aspect of accounting for tax. The requirements of IFRIC 23 are discussed in section 9 below.

5.3 'Prior year adjustments' of previously presented tax balances and expense (income)

The determination of the tax liability for all but the most straightforward entities is a complex process. It may be several years after the end of a reporting period before the tax liability for that period is finally agreed with the tax authorities and settled. Therefore, the tax liability initially recorded at the end of the reporting period to which it relates is no more than a best estimate at that time, which will usually require revision in subsequent periods until the liability is finally settled.

Tax practitioners often refer to such revisions as 'prior year adjustments' and regard them as part of the overall tax charge or credit for the current reporting period whatever their nature. However, for financial reporting purposes, the normal provisions of IAS 8 (see Chapter 3) apply to tax balances and the related expense (income). Therefore, the nature of any revision to a previously stated tax balance must be considered to determine whether the revision represents:

- A correction of a material prior period error (in which case it must be accounted for retrospectively, with a restatement of comparative amounts and, where applicable, the opening balance of assets, liabilities and equity at the start of the earliest period presented). *[IAS 8.42]*.

  Or

- A refinement in the current period of an estimate made in a previous period (in which case it must be accounted for in the current period). *[IAS 8.36]*.

In some cases, the distinction is clear. If, for example, the entity used an incorrect substantively enacted tax rate (see section 5.1 above) to calculate the liability in a previous period, the correction of that rate would - subject to materiality - be a prior year adjustment. A more difficult area is the treatment of accounting changes to reflect the resolution of uncertain tax treatments (see section 5.2 above). These have in practice almost always been treated as measurement adjustments in the current period. However, a view could be taken that the eventual denial, or acceptance, by the tax authorities of a position taken by the taxpayer indicates that one or other party (or both) were previously misinterpreting the tax law. As with other aspects of accounting for uncertain tax treatments, this is an area where judgement may be required. IFRIC 23 suggests that entities would reassess judgements and estimates in response to a change in facts and circumstances, and that the financial effect would be recognised as a change in estimate under IAS 8, i.e., in the period of change (see section 9.5 below). *[IFRIC 23.13, IFRIC 23.14]*.

5.4 Discounting of current tax assets and liabilities

In some jurisdictions, entities are permitted to settle current tax liabilities on deferred terms. Similarly, refunds of current tax might be receivable more than 12 months after the reporting date. IAS 12 specifically prohibits discounting of deferred tax assets and liabilities. *[IAS 12.53]*. However, the standard is silent on the discounting of current tax assets and liabilities. In June 2004, the IFRS IC decided not to add this issue to its agenda, but expressed a general view that current taxes payable should be discounted when the effects are material. However, the IFRS IC also noted a potential conflict with the requirements of IAS 20, which at the time was intended to be withdrawn.[8]

How we see it

The lack of explicit guidance in the current version of IAS 12 has led to diversity in practice and it remains that entities are permitted, but not required, to discount current tax assets and liabilities. Accordingly, entities need to make an accounting policy choice and apply it consistently to all current taxes in all jurisdictions.

5.5 Intra-period allocation, presentation and disclosure

The allocation of current tax income and expense to components of total comprehensive income and equity is discussed in section 10 below. The presentation and disclosure of current tax income expense and assets and liabilities are discussed in sections 13 and 14 below.

8 *IFRIC Update*, June 2004, available on the IFRS Foundation's website.

6 Deferred tax - Tax bases and temporary differences

All deferred tax liabilities and many deferred tax assets represent the tax effects of temporary differences. Therefore, the first step in measuring deferred tax is to identify all temporary differences. The discussion below addresses only whether a temporary difference exists. It does not necessarily follow that deferred tax is recognised in respect of that difference, since there are a number of situations, discussed in section 7 below, in which IAS 12 prohibits the recognition of deferred tax on a temporary difference. *[IAS 12.5]*.

Extract from IAS 12

5 **The following terms are used in this Standard with the meanings specified:**

...

Temporary differences **are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base.**

Temporary differences may be either:

(a) ***taxable temporary differences*****, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or**

(b) ***deductible temporary differences*****, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.**

The *tax base* of an asset or liability is the amount attributed to that asset or liability for tax purposes.

In consolidated financial statements, temporary differences are determined by comparing the carrying amounts of an asset or liability in the consolidated financial statements with the appropriate tax base. The appropriate tax base is determined:

- In those jurisdictions in which a consolidated tax return is filed, by reference to that return.
- In other jurisdictions, by reference to the tax returns of each entity in the group. *[IAS 12.11]*.

As the definition of tax base is the one on which all the others relating to deferred tax ultimately depend, understanding it is key to a proper interpretation of IAS 12. A more detailed discussion follows in sections 6.1 and 6.2 below. However, the overall effect of IAS 12 can be summarised as follows:

A *taxable* temporary difference will arise when:

- *The carrying amount of an asset is higher than its tax base*

  For example, an item of PP&E is recorded in the financial statements at CU8,000, but has a tax base of only CU7,000. In future periods, tax will be paid on CU1,000 more profit than will be recognised in the financial statements (since CU1,000 of the remaining accounting depreciation is not tax-deductible).
- *The carrying amount of a liability is lower than its tax base*

  For example, a loan payable of CU100,000 is recorded in the financial statements at CU99,000, net of issue costs of CU1,000 which have already been allowed for tax purposes (so that the loan is regarded as having a tax base of CU100,000 - see section 6.2.1.B below). In future periods, tax will be paid on CU1,000 more profit than is recognised in the financial statements (since the CU1,000 issue costs will be charged to the income statement but not be eligible for further tax deductions).

Conversely, a *deductible* temporary difference will arise when:

- *The carrying amount of an asset is lower than its tax base*

  For example, an item of PP&E is recorded in the financial statements at CU7,000, but has a tax base of CU8,000. In future periods, tax will be paid on CU1,000 less profit than is recognised in the financial statements (since tax deductions will be claimed in respect of CU1,000 more depreciation than is charged to the income statement in those future periods).
- *The carrying amount of a liability is higher than its tax base*

  For example, the financial statements record a liability for unfunded pension costs of CU2 million. A tax deduction is available only as cash is paid to settle the liability (so that the liability is regarded as having a tax base of nil - see section 6.2.2.A below). In future periods, tax will be paid on CU2 million less profit than is recognised in the financial statements (since tax deductions will be claimed in respect of CU2 million more expense than is charged to the income statement in those future periods).

This may be summarised in the following table.

Asset/liability	Carrying amount higher or lower than tax base?	Nature of temporary difference	Resulting deferred tax (if recognised)
Asset	Higher	Taxable	Liability
Asset	Lower	Deductible	Asset
Liability	Higher	Deductible	Asset
Liability	Lower	Taxable	Liability

6.1 Tax base

6.1.1 Tax base of assets

The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount. *[IAS 12.7]*.

In some cases, the 'tax base' of an asset is relatively obvious. In the case of a tax-deductible item of PP&E, it is the tax-deductible amount of the asset at acquisition less tax depreciation already claimed (see Illustration 1-1 in section 1.2 above). Other items, however, require more careful analysis.

For example, an entity may have accrued interest receivable of CU1,000 that will be taxed only on receipt. When the asset is recovered, all the cash received is subject to tax. In other words, the amount deductible for tax on recovery of the asset, and therefore its tax base, is nil. Another way of arriving at the same conclusion might be to consider the amount at which the tax authority would recognise the receivable in notional financial statements for the entity prepared under tax law. At the end of the reporting period the receivable would not be recognised in such notional financial statements, since the interest has not yet been recognised for tax purposes.

Conversely, an entity may have a receivable of CU1,000 the recovery of which is not taxable. In this case, the tax base is CU1,000 on the rule above that, where realisation of an asset will not be taxable, the tax base of the asset is equal to its carrying amount. This applies irrespective of whether the asset concerned arises from:

- A transaction already recognised in total comprehensive income and already subject to tax on initial recognition (e.g., in most jurisdictions, a sale).
- A transaction already recognised in total comprehensive income and exempt from tax (e.g., tax-free dividend income).

  Or

- A transaction not affecting total comprehensive income at all (e.g., the principal of a loan receivable). *[IAS 12.7]*.

The effect of deeming the tax base of the CU1,000 receivable to be equal to its carrying amount will be that the temporary difference associated with it is nil, and that no deferred tax is recognised in respect of it. This is appropriate given that, in the first case, the debtor represents a sale that has already been taxed and, in the second and third cases, the debtors represent items that are outside the scope of tax.

6.1.2 Tax base of liabilities

The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. In the case of revenue which is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods. *[IAS 12.8]*.

As in the case of assets, the tax base of some items is relatively obvious. For example, an entity may have recognised a provision for environmental damage of CU5 million, which will be deductible for tax purposes only on payment. The liability has a tax base of nil. Its carrying amount is CU5 million, which is also the amount that will be deductible for tax purposes on settlement in future periods. The difference between these two (equal) amounts - the tax base - is nil. Another way of arriving at the same conclusion might be to consider the amount at which the tax authority would recognise the liability in notional financial statements for the entity prepared under tax law. At the end of the reporting period the liability would not be recognised in such notional financial statements, since the expense has not yet been recognised for tax purposes.

Likewise, if the entity records revenue of CU1,000 received in advance that was taxed on receipt, its tax base is nil. Under the definition above, the carrying amount is CU1,000, none of which is taxable in future periods. The tax base is the difference between the CU1,000 carrying amount and the amount not taxed in future periods (CU1,000) - i.e., nil.

Again, if we were to consider a notional statement of financial position of the entity drawn up by the tax authorities under tax law, this liability would not be included, since the relevant amount would, in the notional tax financial statements, have already been taken to income.

An entity may have a liability of (say) CU1,000 that will attract no tax deduction when it is settled. In this case, the tax base is CU1,000 (on the analogy with the rule in section 6.1.1 above that where, realisation of an asset will not be taxable, the tax base of the asset is equal to its carrying amount). This applies irrespective of whether the liability concerned arises from:

- A transaction already recognised in total comprehensive income and already subject to a tax deduction on initial recognition (e.g., in most jurisdictions, the cost of goods sold or accrued expenses).
- A transaction already recognised in total comprehensive income and outside the scope of tax (e.g., non tax-deductible fines and penalties).

  Or

- A transaction not affecting total comprehensive income at all (e.g., the principal of a loan payable). *[IAS 12.8]*.

This is appropriate given that, in the first case, the liability represents a cost that has already been deducted for tax purposes and, in the second and third cases, the liabilities represent items that are outside the scope of tax.

6.1.3 Assets and liabilities whose tax base is not immediately apparent

IAS 12 indicates that where the tax base of an asset or liability is not immediately apparent, it is helpful to consider the fundamental principle on which the standard is based: an entity must, with certain limited exceptions, recognise a deferred tax liability (asset) wherever recovery or settlement of the carrying amount of an asset or liability would make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences. *[IAS 12.10]*. In other words: provide for the tax that would be payable or receivable if the assets and liabilities in the statement of financial position were to be recovered or settled at book value.

The implication of this is that in the basic 'equation' of IAS 12, i.e.,

carrying amount - tax base = temporary difference,

the true unknown is not in fact the temporary difference (as implied by the definitions of tax base and temporary difference) but the tax base (as implied by IAS 12.10).

It will be apparent from the more detailed discussion in section 6.2 below that this clarification is particularly relevant to determining the tax bases of certain financial liabilities, which often do not fit the general 'formula' of carrying amount less amount deductible on settlement.

6.1.4 Tax base of items not recognised as assets or liabilities in financial statements

Certain items are not recognised as assets or liabilities in financial statements, but may nevertheless have a tax base. Examples may include:

- Research costs (which are required to be expensed immediately by IAS 38 *Intangible Assets* see Chapter 18)
- The cost of equity-settled share-based payment transactions (which under IFRS 2 *Share-based Payment* give rise to an increase in equity and not a liability - see Chapter 30)
- Goodwill deducted from equity under previous IFRS accounting standard or national GAAP

Where such items are tax-deductible, their tax base is the difference between their carrying amount (i.e., nil) and the amount deductible in future periods. *[IAS 12.9]*. This may seem somewhat contrary to the definition of tax base, in which it is inherent that, in order for an item to have a tax base, that item must be an asset or liability, whereas none of the items above was ever recognised as an asset.[9] The implicit argument is that all these items were initially (and very briefly) recognised as assets before being immediately written off in full.

9 In some cases, research and share-based payment costs may be included as part of the cost of other assets, such as inventories or PP&E.

Local tax legislation sometimes gives rise to liabilities that have a tax base but no carrying amount. For example, a subsidiary of the reporting entity may receive a tax deduction for a provision that has been recognised in the individual financial statements of that subsidiary prepared under local accounting principles. For the purposes of the entity's consolidated financial statements, however, the provision does not satisfy the recognition requirements of IAS 37. In such situations, we consider it appropriate to regard the tax deduction received as giving rise to a deferred tax liability in the consolidated financial statements (by virtue of there being a provision with a tax base but no carrying amount) in addition to the current tax income recorded for the subsidiary.

Similar situations may arise where local tax legislation permits deductions for certain expenditure determined according to tax legislation without reference to any financial statements. Again, in those cases where an equivalent amount of expenditure is likely to be recognised in the financial statements at a later date, we would regard it as appropriate to regard the tax deduction received as giving rise to a deferred tax liability in the consolidated financial statements.

6.1.5 Equity items with a tax base

The definition of 'tax base' refers to the tax base of an 'asset or liability'. This begs the question of whether IAS 12 regards equity items as having a tax base and therefore whether deferred tax can be recognised in respect of equity instruments (since deferred tax is the tax relating to temporary differences which, by definition, can only arise on items with a tax base - see above).

In February 2003, the IFRS IC considered this issue. It drew attention to the IASB's proposal at that time to amend the definition of 'tax base' so as to refer not only to assets and liabilities but also equity instruments as supporting the view that deferred tax must be recognised where appropriate on equity instruments. This was effectively the approach proposed in the exposure draft ED/2009/2 (see section 1.3 above) which, as noted in section 1.3 above, was withdrawn.[10]

An alternative analysis might be that equity items do not have a tax base, but that any tax effects of them are to be treated as items that are not recognised as assets or liabilities but nevertheless have a tax base (see section 6.1.4 above).

How we see it

Given the lack of explicit guidance in the current version of IAS 12, either analysis may be acceptable, provided that it is applied consistently. This is reflected in a number of the Illustrations in the remainder of this Chapter.

6.1.6 Items with more than one tax base

Some assets and liabilities have more than one tax base, depending on the manner in which they are realised or settled. These are discussed further in section 8.4 below.

6.1.7 Tax bases disclaimed or with no economic value

In some situations, an entity may choose not to claim an available deduction for an item as part of an overall tax planning strategy. In other cases, a deduction available as a matter of tax law may have no real economic effect - for example because the deduction will increase a pool of brought forward tax losses which the entity does not expect to recover in the foreseeable future.

How we see it

In our view, the fact that the entity chooses not to take advantage of a potential tax deduction, or that such a deduction would have no real economic effect in the foreseeable future, does not mean that the asset to which the deduction relates has no tax base. While such considerations will be relevant to determining whether a deductible temporary difference gives rise to a recoverable deferred tax asset (see section 7.5 below), the tax base of an asset is determined by reference to the amount attributed to the item by tax law.

10 Exposure draft *ED/2009/2*: *Income Tax*, IASB, March 2009, Appendix A, definition of 'tax basis'. Available on the IFRS Foundation's website.

6.2 Examples of temporary differences

The following are examples of taxable temporary differences, deductible temporary differences and items where the tax base and carrying value are the same so that there is no temporary difference. The examples are mostly based on those given in IAS 12, *[IAS 12.17, IAS 12.18, IAS 12.20, IAS 12.26, IAS 12.IE.A-C]*, but include several others that are encountered in practice. It will be seen that a number of categories of assets and liabilities may give rise to either taxable or deductible temporary differences.

A temporary difference will not always result in a deferred tax asset or liability being recorded under IAS 12, since the difference may be subject to other provisions of the standard restricting the recognition of deferred tax assets and liabilities, which are discussed in section 7 below. Moreover, even where deferred tax is recognised, it does not necessarily create tax income or expense, but may instead give rise to additional goodwill or bargain purchase gain in a business combination, or to a movement in equity.

6.2.1 Taxable temporary differences

6.2.1.A Transactions that affect profit or loss

- *Interest received in arrears*

  An entity with a financial year ending on 31 December 20X3 holds a medium-term cash deposit on which interest of CU10,000 is received annually on 31 March. The interest is taxed in the year of receipt. At 31 December 20X3, the entity recognises a receivable of CU7,000 in respect of interest accrued but not yet received. The receivable has a tax base of nil, since its recovery has tax consequences and no tax deductions are available in respect of it. The temporary difference associated with the receivable is CU7,000 (CU7,000 carrying amount less nil tax base).

- *Sale of goods taxed on a cash basis*

  An entity has recorded revenue from the sale of goods of CU40,000, together with a cost of the goods sold of CU35,000, since the goods have been delivered. However, the transaction is taxed in the following financial year when the cash from the sale is collected.

  The entity will have recognised a receivable of CU40,000 for the sale. The receivable has a tax base of nil, since its recovery has tax consequences and no tax deductions are available in respect of it. The temporary difference associated with the receivable is CU40,000 (CU40,000 carrying amount less nil tax base).

  There is also a deductible temporary difference of CU35,000 associated with the (now derecognised) inventory, which has a carrying amount of zero but a tax base of CU35,000 (since it will attract a tax deduction of CU35,000 when the sale is taxed) - see section 6.2.2.A below.

- *Depreciation of an asset accelerated for tax purposes*

  An entity has an item of PP&E whose cost is fully tax deductible, but with deductions being given over a period shorter than the period over which the asset is being depreciated under IAS 16 *Property, Plant and Equipment*. At the reporting date, the asset has been depreciated to CU500,000 for financial reporting purposes but to CU300,000 for tax purposes.

  Recovery of the PP&E has tax consequences since, although there is no deduction for accounting depreciation in the tax return, the PP&E is recovered through future taxable profits. There is a taxable temporary difference of CU200,000 between the carrying value of the asset (CU500,000) and its tax base (CU300,000).

- *Capitalised development costs already deducted for tax*

  An entity incurred development costs of CU1 million during the year ended 31 December 20X3. The costs were fully deductible for tax purposes in the tax return for that period, but were recognised as an intangible asset under IAS 38 in the financial statements. The amount carried forward at 31 December 20X3 is CU800,000.

  Recovery of the intangible asset through use has tax consequences since, although there is no deduction for accounting amortisation in the tax return, the asset is recovered through future profits which will be taxed. There is a taxable temporary difference of CU800,000 between the carrying value of the asset (CU800,000) and its tax base (nil). Although the expenditure to create the asset is tax-deductible in the current period, its tax base is the amount deductible in future periods, which is nil, since all deductions were made in the tax return for 20X3.

  A similar analysis would apply to prepaid expenses that have already been deducted on a cash basis in determining the taxable profit of the current or previous periods.

6.2.1.B Transactions that affect the statement of financial position

- *Non-deductible and partially deductible assets*

  An entity acquires a building for CU1 million. Any accounting depreciation of the building is not deductible for tax purposes, and no deduction will be available for tax purposes when the asset is sold or scrapped.

  Recovery of the building, whether in use or on sale, nevertheless has tax consequences since the building is recovered through future taxable profits of CU1 million. There is a taxable temporary difference of CU1 million between the carrying value of the asset (CU1 million) and its tax base of zero.

  A similar analysis applies to an asset which, when acquired, is deductible for tax purposes, but for an amount lower than its cost. The difference between the cost and the amount deductible for tax purposes is a taxable temporary difference.

- *Deductible loan transaction costs*

  A borrowing entity records a loan at CU9.5 million, being the proceeds received of CU10 million (which equal the amount due at maturity), less transaction costs of CU500,000, which are deducted for tax purposes in the period when the loan was first recognised. For loans carried at amortised cost, IFRS 9 requires the costs, together with interest and similar payments, to be accrued over the period to maturity using the effective interest method.

  Inception of the loan gives rise to a taxable temporary difference of CU500,000, being the difference between the carrying amount of the loan (CU9.5 million) and its tax base (CU10 million). This tax base does not conform to the general definition of the tax base of a liability - i.e., the carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods (see section 6.1.2 above).

  The easiest way to derive the correct tax base is to construct a notional statement of financial position prepared by the tax authorities according to tax law. This would show a liability for the full CU10 million (since the amortisation of the issue costs that has yet to occur in the financial statements has already occurred in the notional tax authority financial statements). This indicates that the tax base of the loan is CU10 million.

  A far simpler analysis for the purposes of IAS 12 might have been that the CU9.5 million carrying amount comprises a loan of CU10 million (with a tax base of CU10 million, giving rise to temporary difference of zero) offset by prepaid transaction costs of CU500,000 (with a tax base of zero, giving rise to a taxable temporary difference of CU500,000). However, this is inconsistent with the analysis in IFRS 9 that the issue costs are an integral part of the carrying value of the loan.

  The consequence of recognising a deferred tax liability in this case is that the tax deduction for the transaction costs is recognised in profit or loss, not on inception of the loan, but as the costs are recognised through the effective interest method in future periods.

- *Non-deductible loan transaction costs*

  As in the immediately preceding example, a borrowing entity records a loan at CU9.5 million, being the proceeds received of CU10 million (which equal the amount due at maturity), less transaction costs of CU500,000. In this case, however, the transaction costs are not deductible in determining the taxable profit of future, current or prior periods. For loans carried at amortised cost, IFRS 9 requires the costs to be accrued over the period to maturity using the effective interest method.

  Just as in the preceding example (and perhaps rather counter-intuitively, given that the costs are non-deductible) inception of the loan gives rise to a taxable temporary difference of CU500,000, being the difference between the carrying amount of the loan (CU9.5 million) and its tax base (CU10 million). This is because a notional statement of financial position prepared by the tax authorities according to tax law would show a liability for the full CU10 million, since the transaction costs would never have been recorded (as they never occurred for tax purposes).

- *Liability component of compound financial instrument*

  An entity issues a convertible bond for CU5 million which, in accordance with the requirements of IAS 32 *Financial Instruments: Presentation*, is analysed as comprising a liability component of CU4.6 million and a residual equity component of CU400,000. If the entity were to settle the liability for CU4.6 million it would be liable to tax on CU400,000 (CU5 million less CU4.6 million). Therefore, the tax base of the liability is CU5 million and there is a taxable temporary difference of CU400,000 between this and the carrying amount of the liability component. This is discussed further in section 7.2.7 below.

6.2.1.C Revaluations

- *Financial assets and property carried at valuation*

  An entity holds investments, accounted for at fair value through profit or loss, with a carrying amount of CU2 million and an original cost (and tax base) of CU1.3 million. There is a taxable temporary difference of CU700,000 associated with the investments, being the amount on which the entity would pay tax if the investments were realised at their carrying value.

  A similar analysis would apply to investment property or PP&E carried at a value that exceeds cost, where no equivalent adjustment is made for tax purposes.

6.2.1.D Tax re-basing

- *Withdrawal of tax depreciation for classes of PP&E*

  An entity holds buildings with a carrying amount of CU15 million and a tax base of CU12 million, giving rise to a taxable temporary difference of CU3 million. As part of a general fiscal reform package introduced by the government, future tax deductions for the buildings (their tax base) are reduced to CU1 million. This increases the taxable temporary difference by CU11 million to CU14 million.

6.2.1.E Business combinations and consolidation

- *Fair value adjustments*

  Where the carrying amount of an asset is increased to fair value in a business combination, but no equivalent adjustment is made for tax purposes, a taxable temporary difference arises just as on the revaluation of an asset (see section 6.2.1.C above).

- *Non-deductible or partially deductible goodwill*

  Where goodwill is not deductible, or only partially deductible, in determining taxable profit there will be a taxable temporary difference between the carrying amount of the goodwill and its tax base, similar to that arising on a non-deductible or partially deductible asset (see section 6.2.1.B above).

- *Intragroup transactions*

  Although intragroup transactions are eliminated in consolidated financial statements, they may give rise to temporary differences. An entity in a group (A) might sell inventory with a cost and tax base of CU1,000 to another group entity (B) for CU900, which becomes the cost and tax base to B. If the carrying value in the consolidated financial statements remains CU1,000 (i.e., the inventory is not actually impaired, notwithstanding the intragroup sale at a loss), a new taxable temporary difference of CU100 emerges in the consolidated financial statements between the carrying value of CU1,000 and the new tax base of CU900.

- *Undistributed earnings of group investments*

  A parent entity P holds an investment in subsidiary S. Retained earnings of CU1 million relating to S are included in the consolidated financial statements of P. S must pay a non-refundable withholding tax on any distribution of earnings to P. There is therefore a taxable temporary difference in the consolidated financial statements of CU1 million associated with the net assets representing the retained earnings, since their recovery (in the form of distribution to the parent) has tax consequences, with no offsetting tax deductions.

  Similar temporary differences may arise on the retained earnings of branches, associates and joint arrangements.

6.2.1.F Foreign currency differences

- *Translation of foreign subsidiary to presentation currency*

  A UK entity acquires the equity of a French entity, which therefore becomes its subsidiary, for €10 million. For UK tax purposes, the tax base of the investment is £8 million (the spot-rate equivalent of €10 million at the date of acquisition). The presentation currency of the UK entity's consolidated financial statements is sterling.

  Between the date of acquisition and the first reporting date, the French entity makes no gains or losses, such that its net assets and goodwill as included in the consolidated financial statements, expressed in euros, remain €10 million. However, the exchange rate has moved, so that the sterling equivalent of €10 million at the reporting date, included in the consolidated statement of financial position, is £9 million.

This gives rise to a £1 million taxable temporary difference between the £9 million carrying value of the investment and its £8 million tax base.

- ***Functional currency different from currency used to compute tax***

  On 1 January 20X3 an entity which, under IAS 21 *The Effects of Changes in Foreign Exchange Rates*, has determined its functional currency as Currency CU (see Chapter 16), purchases plant for CU1 million, which will be depreciated to its estimated residual value of zero over 10 years. The entity is taxed in the local currency LC, and is entitled to receive tax deductions for the depreciation charged in the financial statements. The exchange rate is CU1=LC2 at 1 January 20X3 (so that the cost of the asset for local tax purposes is LC2 million). The exchange rate at 31 December 20X3 is CU1=LC2.5.

  At 31 December 20X3 there is a taxable temporary difference of CU180,000, being the difference between the net book value of the plant of CU900,000 (cost CU1,000,000 less depreciation CU100,000) and its tax base of CU720,000 (cost LC2,000,000 less depreciation LC200,000 = LC1,800,000 translated at year end rate of CU1=LC2.5).

6.2.1.G Hyperinflation

A taxable temporary difference (similar to those in section 6.2.1.F above) arises when non-monetary assets are restated in terms of the measuring unit current at the end of the reporting period under IAS 29 *Financial Reporting in Hyperinflationary Economies* - but no equivalent adjustment is made for tax purposes.

6.2.2 Deductible temporary differences

6.2.2.A Transactions that affect profit of loss

- ***Expenses deductible for tax on cash basis***

  An entity records a liability of CU1 million for retirement benefit costs which are tax deductible only when paid. The tax base of the liability is zero, being its carrying amount (CU1 million) less the amount deductible for tax purposes when the liability is settled (also CU1 million). There is therefore a deductible temporary difference of CU1 million (CU1 million carrying amount less zero tax base) associated with the liability.

- ***Depreciation of an asset delayed for tax purposes***

  An entity has an item of PP&E that originally cost CU1 million. The cost is fully tax deductible, with deductions being given over a period longer than the period over which the asset is being depreciated under IAS 16. At the reporting date, the asset has been depreciated to CU300,000 for financial reporting purposes but to only CU500,000 for tax purposes.

  Recovery of the PP&E has tax consequences since, although there is no deduction for accounting depreciation in the tax return, the PP&E is recovered through future taxable profits of CU300,000. There is a deductible temporary difference of CU200,000 between the carrying value of the asset (CU300,000) and its tax base (CU500,000).

- ***Sale of goods taxed on a cash basis***

  An entity has recorded revenue from the sale of goods of CU40,000, together with a cost of the goods sold of CU35,000, since the goods have been delivered. However, the transaction is taxed in the following financial year when the cash from the sale is collected.

  There is a deductible temporary difference of CU35,000 associated with the (now derecognised) inventory, which has a carrying amount of zero but a tax base of CU35,000 (since it will attract a tax deduction of CU35,000 when the sale is taxed).

  There is also a taxable temporary difference of CU40,000 associated with the receivable (see section 6.2.1.A above).

- ***Write-down of asset not deductible for tax purposes until realised***

  An entity purchases inventory for CU1,000, which is also its tax base. The inventory is later written down to a net realisable value of CU800. However, no loss is recognised for tax purposes until the inventory is sold. There is a deductible temporary difference of CU200 between the CU800 carrying amount of the inventory and its CU1,000 tax base.

- ***Deferred income taxed on receipt***

  In the year ended 31 December 20X3, an entity received CU2 million, being 5 years' rent of an investment property received in advance. In the statement of financial position as at 31 December, CU1,800,000 is carried forward as deferred income. However, the whole CU2 million is taxed in the tax return for the period.

There is a deductible temporary difference of CU1,800,000 associated with the deferred income, being its carrying amount (CU1,800,000), less its tax base of zero, computed as the carrying amount (CU1,800,000) less the amount not taxable in future periods (also CU1,800,000 since the income has already been taxed).

- *Deferred non-taxable income*

  An entity receives a non-taxable government grant of CU1 million, of which CU700,000 is carried forward in the statement of financial position as at the period end.

  There is a deductible temporary difference of CU700,000 associated with the deferred income, being its carrying amount (CU700,000), less its tax base of zero, computed as the carrying amount (CU700,000) less the amount of income not taxable in future periods (also CU700,000 since the income is tax free). In this case, while there is a deductible temporary difference, no deferred tax asset would be recognised, as discussed in Illustration 7-6 in section 7.2.3 below. *[IAS 12.24, IAS 12.33]*.

6.2.2.B Transactions that affect the statement of financial position

- *Asset deductible for more than cost*

  An entity invests CU10 million in PP&E for which tax deductions of CU13 million may be claimed. There is a deductible temporary difference of CU3 million between the CU10 million carrying value of the PP&E and its tax base of CU13 million.

6.2.2.C Revaluations

- *Financial assets and property carried at valuation*

  An entity holds investments, accounted for at fair value through profit or loss, with a carrying amount of CU2 million and an original cost (and tax base) of CU2.5 million. There is a deductible temporary difference of CU500,000 associated with the investments, being the amount for which the entity would receive a tax deduction if the investments were realised at their carrying value.

  A similar analysis would apply to investment property or PP&E carried at a value below cost, where no equivalent adjustment is made for tax purposes.

6.2.2.D Tax re-basing

- *Indexation of assets for tax purposes*

  An entity acquires land for CU5 million, which is also its tax base at the date of purchase. A year later, as part of a general fiscal reform package introduced by the government, future tax deductions for the land (its tax base) are increased to CU6 million. This creates a deductible temporary difference of CU1 million in respect of the land.

6.2.2.E Business combinations and consolidation

- *Fair value adjustments*

  Where a liability is recognised at fair value in a business combination, but the liability is deductible for tax purposes only on settlement, a deductible temporary difference arises similar to that arising on the initial recognition of a liability for an expense deductible for tax on a cash basis (see section 6.2.2.A above).

- *Intragroup transactions*

  Although intragroup transactions are eliminated in consolidated financial statements, they may give rise to deductible temporary differences. An entity in a group (A) might sell inventory with a cost and tax base of CU1,000 to another group entity (B) for CU1,200, which becomes the cost and tax base to B. Since the carrying value in the consolidated financial statements remains CU1,000, a new deductible temporary difference of CU200 emerges in the consolidated financial statements between the carrying value of CU1,000 and the new tax base of CU1,200.

6.2.2.F Foreign currency differences

- *Translation of foreign subsidiary to presentation currency*

  A UK entity acquires the equity of a French entity, which therefore becomes its subsidiary, for €10 million. For UK tax purposes, the tax base of the investment is £8 million (the spot-rate equivalent of €10 million at the date of acquisition). The presentation currency of the UK entity's consolidated financial statements is sterling.

  Between the date of acquisition and the first reporting date, the French entity makes no gains or losses, such that its net assets and goodwill as included in the consolidated financial statements, expressed in euros, remain €10 million. However, the exchange rate has moved, so that the sterling equivalent of €10 million at the reporting date, included in the consolidated statement of financial position, is £7 million.

  This gives rise to a £1 million deductible temporary difference between the £7 million carrying value of the investment and its £8 million tax base.

- *Functional currency different from currency used to compute tax*

  On 1 January 20X3 an entity which, under IAS 21 has determined its functional currency as Currency CU (see Chapter 16), purchases plant for CU1 million, which will be depreciated to its estimated residual value of zero over 10 years. The entity is taxed in the local currency LC, and is entitled to receive tax deductions for the depreciation charged in the financial statements. The exchange rate is CU1=LC2 at 1 January 20X3 (so that the cost of the asset for local tax purposes is LC2 million). The exchange rate at 31 December 20X3 is CU1=LC1.8.

  At 31 December 20X3 there is a deductible temporary difference of CU100,000, being the difference between the net book value of the plant of CU900,000 (cost CU1,000,000 less depreciation CU100,000) and its tax base of CU1,000,000 (cost LC2,000,000 less depreciation LC200,000 = LC1,800,000 translated at year end rate of CU1=LC1.8).

6.2.3 Assets and liabilities with no temporary difference (because tax base equals carrying amount)

- *Liability for expense already deducted for tax*

  An entity accrues CU200,000 for electricity costs in the year ended 31 March 20X3. The expense is deductible for tax in that period. The temporary difference associated with the liability is zero. This is calculated as the carrying amount of CU200,000 less the tax base of CU200,000, being the carrying amount (CU200,000) less amount deductible for tax in future periods (zero).

- *Liability for expense never deductible for tax*

  An entity accrues CU400,000 for a fine for environmental pollution, which is not deductible for tax. The temporary difference associated with the liability is zero. This is calculated as the carrying amount of CU400,000 less the tax base of CU400,000, being the carrying amount (CU400,000) less amount deductible for tax in future periods (zero).

- *Loan repayable at carrying amount*

  An entity borrows CU2 million. This is the carrying amount of the loan on initial recognition, which is the same as the amount repayable on final maturity of the loan. The temporary difference associated with the liability is zero. This is calculated as the carrying amount of CU2 million less the tax base of CU2 million, being the carrying amount (CU2 million) less amount deductible for tax in future periods (zero).

- *Receivable for non-taxable income*

  In its separate financial statements, an entity records a receivable for a CU1 million dividend due from a subsidiary accounted for at cost. The dividend is not taxable. Accordingly, it gives rise to a temporary difference of zero, since the tax base of any asset, the recovery of the carrying amount of which is not taxable, is taken to be the same as its carrying amount.

7 Deferred tax - Recognition

7.1 The basic principles

7.1.1 Taxable temporary differences (deferred tax liabilities)

Extract from IAS 12

15 A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:

(a) the initial recognition of goodwill; or

(b) the initial recognition of an asset or liability in a transaction which:

(i) is not a business combination;

(ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss); and

(iii) at the time of the transaction, does not give rise to equal taxable and deductible temporary differences.

However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax liability shall be recognised in accordance with paragraph 39.

The above exceptions to the recognition principles do not apply to taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, which are subject to further detailed provisions of IAS 12 (see section 7.6 below). *[IAS 12.15]*.

Examples of taxable temporary differences are given in section 6.2.1 above.

7.1.2 Deductible temporary differences (deferred tax assets)

Extract from IAS 12

24 A deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:

(a) is not a business combination;

(b) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss); and

(c) at the time of the transaction, does not give rise to equal taxable and deductible temporary differences.

However, for deductible temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax asset shall be recognised in accordance with paragraph 44.

IAS 12 does not define 'probable' in this context. *[IAS 12.24]*. However, it is generally understood that, for example in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* and IAS 37, it must be taken to mean 'more likely than not'. *[IFRS 5 Appendix A, IAS 37.23]*. The exposure draft ED/2009/2 (see section 1.3 above) effectively clarified that this is the intended meaning.[11]

These exceptions to the recognition principles do not apply to deductible temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, which are subject to further detailed provisions of IAS 12 (see section 7.6 below).

As noted above, IAS 12 restricts the recognition of deferred tax assets to the extent that it is probable that taxable profit will be available against which the underlying deductible temporary differences can be utilised. *[IAS 12.24, IAS 12.27]*. This restriction is discussed in section 7.5 below.

Examples of deductible temporary differences are given in section 6.2.2 above.

11 Exposure draft ED/2009/2: *Income Tax*, IASB, March 2009, paras. 20 and 23. Available on the IFRS Foundation's website.

7.1.3 Interpretation issues

7.1.3.A Accounting profit

The provisions of IAS 12 summarised above refer to a transaction that affects 'accounting profit'. In this context 'accounting profit' means any item recognised in total comprehensive income, whether recognised in profit or loss or in other comprehensive income.

7.1.3.B Taxable profit 'at the time of the transaction'

The provisions of IAS 12 summarised above also refer to a transaction which affects taxable profit 'at the time of the transaction'. Strictly speaking, no transaction affects taxable profit 'at the time of the transaction', since the taxable profit is affected only when the relevant item is included (some time later) in the tax return for the period. It is clear, however, that the intended meaning is that the transaction that gives rise to the initial recognition of the relevant asset or liability affects the current tax liability for the accounting period in which the initial recognition occurs.

Suppose that, in the year ended 31 December 20X2, an entity received CU2 million, being 5 years' prepaid rent of an investment property. In the statement of financial position as at 31 December, CU1,800,000 is carried forward as deferred income. The whole CU2 million is taxed on receipt and will therefore be included in the tax return for 20X2, which is filed with the tax authorities in 20X3. For the purposes of IAS 12, the transaction is regarded as affecting taxable profit during 20X2 (since it affects the current tax for that period), even though the tax return for 20X2 is not filed with the tax authorities until 20X3. This gives rise to the recognition in the 20X2 financial statements, subject to the restrictions discussed in section 7.5 below, of a deferred tax asset based on a deductible temporary difference of CU1,800,000 (see section 6.2.2.A above).

7.2 The initial recognition exception

The exceptions (summarised in section 7.1 above) from recognising the deferred tax effects of certain temporary differences arising on the initial recognition of some assets and liabilities are generally referred to as the 'initial recognition exception' or 'initial recognition exemption', sometimes abbreviated to 'IRE'. 'Exception' is the more accurate description, since a reporting entity is required to apply it, rather than having the option to do so implicit in the term 'exemption'.

The initial recognition exception has its origins in the now superseded 'income statement' approaches to accounting for deferred tax. Under these approaches, deferred tax was not recognised on so-called 'permanent differences' - items of income or expense that appeared in either the financial statements or the tax return, but not in both. The majority of transactions to which the initial recognition exception applies would have been regarded as permanent differences under income statement approaches of accounting for deferred tax. For entities applying the temporary difference approach of IAS 12, the IRE avoids the need for entities to recognise an initial deferred tax liability or asset and adjust the carrying amount of the asset or liability by the same amount. The standard argues that such adjustments would make the financial statements less transparent. Therefore, IAS 12 does not allow an entity to recognise the resulting deferred tax liability or asset, either on initial recognition or subsequently. *[IAS 12.22(c)]*. It would also be inappropriate to recognise any adjustment as a gain or loss in profit or loss, given that the transaction itself has no effect on profit or loss.

The purpose of the initial recognition exception is most easily understood by considering the accounting consequences that would follow if it did not exist, as shown in Illustration 7-1 below.

Illustration 7-1: Rationale for initial recognition exception

An entity acquires an asset for CU1,000 which it intends to use for five years and then scrap (i.e., the residual value is nil). The tax rate is 40%. Depreciation of the asset is not deductible for tax purposes. On disposal, any capital gain would not be taxable and any capital loss would not be deductible.

Although the asset is non-deductible, its recovery has tax consequences, since it will be recovered out of taxable income of CU1,000 on which tax of CU400 will be paid. The tax base of the asset is therefore zero, and a temporary difference of CU1,000 arises on initial recognition of the asset.

Absent the initial recognition exception, the entity would recognise a deferred tax liability of CU400 on initial recognition of the asset, being the taxable temporary difference of CU1,000 multiplied by the tax rate of 40%. A debit entry would then be required to balance the credit for the liability.

One possibility might be to recognise tax expense of CU400 in the statement of total comprehensive income. This would be meaningless, since the entity has clearly not suffered a loss simply by purchasing a non-deductible asset in an arm's length transaction for a price that (economically) must reflect the asset's non-deductibility.

A second possibility would be to gross up the asset by CU400 to CU1,400. However, IAS 12 states that to make such adjustments to the carrying value of the asset would make the financial statements 'less transparent'. *[IAS 12.22(c)]*.

A third possibility would be to gross up the asset to the amount that would rationally have been paid for it, had it been fully tax-deductible, and recognise a corresponding amount of deferred tax. As the asset is non-deductible, the CU1,000 cost must theoretically represent the anticipated minimum *post*-tax return from the asset. In order to achieve a post-tax return of CU1,000, an entity paying tax at 40% needs to earn pre-tax profits of CU1,667 (CU1,000 ÷ [1 - 0.4]). Therefore, the cost of an equivalent fully-deductible asset would, all else being equal, be CU1,667. On this analysis, the entity would gross up the asset to CU1,667 and recognise deferred tax of CU667 (CU1,667 @ 40%).

The fourth possibility, which is what is actually required by IAS 12, is not to provide for deferred tax at all, where to do so would lead to one of the three outcomes above. However, in cases where provision for the deferred tax on a temporary difference arising on initial recognition of an asset or liability would not lead to one of the outcomes above, the initial recognition exception does not apply. This is the case in a business combination or a transaction affecting taxable profit or accounting profit (or both).

- *Business combination*

  In a business combination, the corresponding accounting entry for a deferred tax asset or liability forms part of the goodwill arising or the bargain purchase gain recognised. No deferred tax income or expense is recorded.

- *Transaction affecting taxable profit or accounting profit*

  In a transaction affecting taxable profit or accounting profit (or both), the corresponding accounting entry for a deferred tax asset or liability is recorded as deferred tax income or expense.

  This ensures that the entity recognises all future tax consequences of recovering the assets, or settling the liabilities, recognised in the transaction. The effect of this on the statement of total comprehensive income is broadly to recognise the tax effects of the various components of income and expenditure in the same period(s) in which those items are recognised for financial reporting purposes (as illustrated in section 1.2.2 above).

In short, the initial recognition exception may simply be seen as the least bad of the four theoretically possible options for dealing with 'day one' temporary differences.

7.2.1 Acquisition of tax losses

The initial recognition exception applies only to deferred tax relating to temporary differences. It does not apply to tax assets, such as purchased tax losses, that do not arise from deductible temporary differences. The definition of 'deferred tax assets' (see section 3 above) explicitly distinguishes between deductible temporary differences and unused losses and tax credits. *[IAS 12.5]*. There is therefore no restriction on the recognition of acquired tax losses other than the general criteria of IAS 12 for recognition of tax assets (see section 7.5 below).

Under the general principles of IAS 12, acquired tax losses are initially recognised at the amount paid, subsequently re-assessed for recoverability (see section 7.5.6 below) and remeasured accordingly (see section 8 below). Changes in the recognised amount of acquired tax losses are generally recognised in profit or loss as a tax expense (income), on the basis that, as acquired losses, they do not relate to any pre-tax transaction previously accounted for by the entity (see section 10 below). However, in some limited circumstances, changes to tax losses acquired as part of a business combination are required to be treated as an adjustment to goodwill (see section 12.1.2 below).

7.2.2 Initial recognition of goodwill

7.2.2.A Taxable temporary differences

In many jurisdictions, goodwill is not tax-deductible either as it is impaired or on ultimate disposal, such that it gives rise to a temporary difference equal to its carrying amount (representing its carrying amount less its tax base of zero).

It may well be that the shares in the acquired entity have a tax base equal to their cost so that, economically, an amount equal to the goodwill is deductible on disposal of those shares. However, accounting for the tax effects of the shares in an acquired subsidiary (or other significant group investment) is subject to separate provisions of IAS 12, which are discussed in section 7.6 below.

The initial recognition exception for taxable temporary differences on goodwill prevents the grossing-up of goodwill that would otherwise occur. Goodwill is a function of all the net assets of the acquired business, including deferred tax. If deferred tax is provided for on goodwill, the goodwill itself is increased, which means that the deferred tax on the goodwill is increased further, which means that the goodwill increases again, and so on. Equilibrium is reached when the amount of goodwill originally recorded is grossed up by the fraction 1 / (1 - *t*), where *t* is the entity's tax rate, expressed as a decimal fraction. For example, an entity that pays tax at 30% and recognises CU1,400 of goodwill before recognising deferred tax would (absent the initial recognition exception) increase the goodwill to CU2,000 and recognise a deferred tax liability of CU600 (which is 30% of the restated goodwill of CU2,000).

IAS 12 takes the view that this would not be appropriate, since goodwill is intended to be a residual arising after fair values have been determined for the assets and liabilities acquired in a business combination, and recognition of deferred tax liability would increase that goodwill. *[IAS 12.21]*. Subsequent reductions in a deferred tax liability that is unrecognised because it arises from the initial recognition of goodwill are also regarded as arising from the initial recognition of goodwill and are therefore not recognised. *[IAS 12.21A]*. This is shown in Illustration 7-7 in section 7.2.4.A below.

7.2.2.B Deductible temporary differences

Where the carrying amount of goodwill arising in a business combination is less than its tax base, a deductible temporary difference arises. In this case, IAS 12 requires a deferred tax asset to be recognised as part of the accounting for a business combination, to the extent that it is probable that taxable profit will be available against which the temporary difference could be utilised. *[IAS 12.32A]*. This contrasts with the prohibition against recognising a deferred tax liability on any taxable temporary difference on initial recognition of goodwill (see section 7.2.2.A above). Refer section 7.5 below for a more general discussion of the criteria in IAS 12 for assessing the recoverability of deferred tax assets.

IAS 12 gives no guidance on the method to be used in calculating the resulting deferred tax asset, which is not entirely straightforward, as demonstrated by the following Illustration.

Illustration 7-2: Deferred tax asset on initial recognition of goodwill

An entity that pays tax at 40% recognises, in the initial accounting for a business combination, goodwill of CU1,000 before recognising any related deferred tax asset. Tax deductions of CU1,250 are given for the goodwill over a 5-year period.

One approach would be to adopt an iterative method similar to that described in section 7.2.2.A above, whereby recognition of a deferred tax asset on goodwill leads to a reduction of the goodwill, which in turn will lead to a further increase in the deferred tax asset, and so on. Equilibrium is reached when the goodwill is adjusted to an amount equal to (*g* - *bt*) / (1 - *t*), where:

- *g* is the amount of goodwill originally recorded (before recognising a deferred tax asset)
- *b* is the tax base of the goodwill

  And
- *t* is the tax rate, expressed as a decimal fraction

Under this method, the entity would record goodwill of CU833 (being [CU1,000 - 0.4 × CU1,250] ÷ 0.6) and a deferred tax asset of CU167. This represents a deductible temporary difference of CU417 (comprising the tax base of CU1,250 less the adjusted carrying amount of CU833), multiplied by the tax rate of 40%. On any subsequent impairment or disposal of the goodwill, the entity would report an effective tax rate of 40% (the statutory rate), comprised of pre-tax expense of CU833 and tax income of CU333 (the real tax deduction of CU500 (CU1,250 @ 40%), less the write-off of the deferred tax asset of CU167).

An alternative approach might be to record a deferred tax asset based on the carrying amount of goodwill before calculating the deferred tax asset, and adjust the goodwill only once, rather than undertaking the iterative reduction in the goodwill described in the previous paragraph. In the Illustration above this would lead to the entity recording a deferred tax asset of CU100 (representing 40% of the deductible temporary difference of CU250 between the tax base of the goodwill of CU1,250 and its original carrying amount of CU1,000) and goodwill of CU900. On any subsequent impairment or disposal of the goodwill the entity would report an effective tax rate of 44% (higher than the statutory rate), comprised of pre-tax expense of CU900 and tax income of CU400 (the real tax deduction of CU500 (CU1,250 @ 40%), less the write-off of the deferred tax asset of CU100).

7.2.2.C Tax deductible goodwill

Where goodwill is tax-deductible, new temporary differences will arise after its initial recognition as a result of the interaction between tax deductions claimed and impairments (if any) of the goodwill in the financial statements. These temporary differences do not relate to the initial recognition of goodwill, and therefore deferred tax must be recognised on them, as demonstrated by Illustration 7-13 in section 7.2.4.C below. *[IAS 12.21B]*.

7.2.3 Initial recognition of other assets or liabilities

Where a temporary difference arises on initial recognition of an asset or liability, its treatment depends on the circumstances which give rise to the recognition of the asset or liability.

If the temporary difference arises as the result of a business combination, deferred tax is recognised on the temporary difference with a corresponding adjustment to goodwill or any bargain purchase gain.

If the temporary difference arises in a transaction that gives rise to an accounting or taxable profit or loss, deferred tax is recognised on the temporary difference, giving rise to deferred tax expense or deferred tax income.

If the temporary difference arises in any other circumstances (i.e., neither in a business combination nor in a transaction that gives rise to an accounting or taxable profit or loss) no deferred tax is recognised. *[IAS 12.22]*.

The application of the initial recognition exception to assets and liabilities is explained in Illustration 7-3 to Illustration 7-6 below.

Illustration 7-3: Non-deductible PP&E

An entity acquires a building for CU1 million. Any accounting depreciation of the building is not deductible for tax purposes, and no deduction will be available for tax purposes when the asset is sold or demolished.

Recovery of the building, whether in use or on sale, has tax consequences since the building is recovered through future taxable profits. There is a taxable temporary difference of CU1 million between the CU1 million carrying value of the asset and its tax base of zero.

Under the initial recognition exception, no deferred tax liability is provided for. The non-deductibility of the asset is reflected in an effective tax rate higher than the statutory rate (assuming that all other components of pre-tax profit are taxed at the statutory rate) as the asset is depreciated in future periods.

If the asset had been acquired as part of a business combination, the initial recognition exception would not have applied. Deferred tax would have been provided for, with a corresponding increase in goodwill. As the asset is depreciated, the reduction in the deferred tax liability is released to deferred tax in the income statement, as shown in Illustration 1-1 above. This results in an effective tax rate equal to the statutory rate (assuming that all other components of pre-tax profit are taxed at the statutory rate).

Illustration 7-4: Inception of loan with tax-deductible issue costs

A borrowing entity records a loan at CU9.5 million, being the proceeds received of CU10 million (which equal the amount due at maturity), less transaction costs of CU500,000, which are deducted for tax purposes in the period when the loan is first recognised. For financial reporting purposes, under IFRS 9 the costs, together with interest and similar payments, are accrued over the period to maturity using the effective interest method.

Inception of the loan gives rise to a taxable temporary difference of CU500,000, being the difference between the carrying amount of the loan (CU9.5 million) and its tax base (CU10 million). This analysis is explained in more detail in section 6.2.1.B above.

Initial recognition of the transaction costs gives rise to no accounting loss (because they are included in the carrying amount of the loan). However, there is a tax loss (since the costs are included in the tax return for the period of inception). Accordingly, the initial recognition exception does not apply, and a deferred tax liability is recognised on the taxable temporary difference of CU500,000.

Illustration 7-5: Inception of loan with non-deductible issue costs

A borrowing entity records a loan at CU9.5 million, being the proceeds received of CU10 million (which equal the amount due at maturity), less transaction costs of CU500,000, which are not deductible for tax purposes either in the period when the loan is first recognised or subsequently. For financial reporting purposes, under IFRS 9 the costs, together with interest and similar payments, are accrued over the period to maturity using the effective interest method.

Inception of the loan gives rise to a taxable temporary difference of CU500,000, being the difference between the carrying amount of the loan (CU9.5 million) and its tax base (CU10 million). This analysis is explained in more detail in section 6.2.1.B above.

Initial recognition of the transaction costs gives rise to no accounting loss (because they are included in the carrying amount of the loan) or tax loss (because in this case there is no deduction for the issue costs). Accordingly, the initial recognition exception applies and no deferred tax liability is recognised.

If the same loan (including the unamortised transaction costs) had been recognised as part of a larger business combination, the initial recognition exception would not have applied. Deferred tax would have been recognised on the taxable temporary difference of CU500,000, with a corresponding increase in goodwill (or decrease in any bargain purchase gain).

Illustration 7-6: Purchase of PP&E subject to tax-free government grant

An entity acquires an item of PP&E for CU1 million subject to a tax-free government grant of CU350,000. The asset is also fully-tax deductible (at CU1 million). IAS 20 permits the grant to be accounted for either as deferred income or by deduction from the cost of the asset. Whichever treatment is followed, a deductible temporary difference arises:

- If the grant is accounted for as deferred income, there is a deductible temporary difference between the liability of CU350,000 and its tax base of nil (carrying amount CU350,000 less amount not taxed in future periods, also CU350,000).
- If the grant is accounted for as a reduction in the cost of the PP&E, there is a deductible temporary difference between the carrying amount of the PP&E (CU650,000) and its tax base (CU1 million).

IAS 12 emphasises that the initial recognition exception applies, and a deferred tax asset must not be recognised. *[IAS 12.33]*.

7.2.4 Changes to temporary differences after initial recognition

The initial recognition exception applies only to temporary differences arising on initial recognition of an asset or liability. It does not apply to new temporary differences that arise on the same asset or liability after initial recognition. When the exception has been applied to the temporary difference arising on initial recognition of an asset or liability, and there is a different temporary difference associated with that asset or liability at a subsequent date, it is necessary to analyse the temporary difference at that date between:

- Any amount relating to the original temporary difference (on which no deferred tax is recognised)

  And

- The remainder, which has implicitly arisen after initial recognition of the asset or liability (on which deferred tax is recognised)

IAS 12 does not set out comprehensive guidance to be followed in making this analysis, but it does give a number of examples, from which the following general principles may be inferred:

- The new temporary difference is treated as part of the temporary difference arising on initial recognition to the extent that any change from the original temporary difference is due to:
  - The write-down (through depreciation, amortisation or impairment) of the original carrying amount of an asset with no corresponding change in the tax base (see section 7.2.4.A below).

    Or

  - The increase in the original carrying amount of a liability arising from the amortisation of any discount recognised at the time of initial recognition of that liability, with no corresponding change in the tax base (see section 7.2.4.A below).

- The new temporary difference is regarded as arising after initial recognition to the extent that any change from the original temporary difference is due to:
  - A change in the carrying value of the asset or liability, other than for the reasons set out above (see section 7.2.4.B below).

    Or
  - A change in the tax base due to items being recorded on the tax return (see section 7.2.4.C below).
- Where the change in the temporary difference results from a change in the tax base due to legislative change, IAS 12 provides no specific guidance, and more than one treatment may be possible (see section 7.2.4.D below).

7.2.4.A Depreciation, amortisation or impairment of initial carrying value

The following are examples of transactions where the initial temporary difference changes as the result of the amortisation of the original carrying amount, so that the adjusted temporary difference is regarded as part of the temporary difference arising on initial recognition, rather than a new difference.

Illustration 7-7: Impairment of non-deductible goodwill

Goodwill of CU10 million (not tax-deductible) arose on a business combination over ten years ago. In accordance with IAS 12 no deferred tax liability was recognised on the taxable temporary difference of CU10 million that arose on initial recognition of the goodwill. During the year ended 31 December 20X3, following an impairment test, the carrying amount of the goodwill is reduced to CU6 million.

No deferred tax is recognised on the new temporary difference of CU6 million, because it has the effect of decreasing the value of the previously unrecognised deferred tax liability relating to the initial recognition of the goodwill. *[IAS 12.21A]*.

Illustration 7-8: Depreciation of non-deductible PP&E

During the year ended 31 March 20X3 an entity acquires an item of PP&E for CU1 million which it intends to use for 20 years, with no anticipated residual value. No tax deductions are available for the asset. In accordance with IAS 12 no deferred tax liability was recognised on the taxable temporary difference of CU1 million that arises on initial recognition of the PP&E.

The entity's accounting policy is to charge a full year's depreciation in the year of purchase, so that the carrying amount of the asset at 31 March 20X3 is CU950,000. No deferred tax is recognised on the reduction to the temporary difference of CU50,000, because IAS 12 prohibits the recognition of subsequent changes in the unrecognised deferred tax liability that arose on the initial recognition of the PP&E as the asset is depreciated. *[IAS 12.22(c)]*.

Illustration 7-9: Amortisation of non-deductible loan issue costs

A borrowing entity records a loan at CU9.5 million, being the proceeds received of CU10 million (which equal the amount due at maturity), less transaction costs of CU500,000, which are not deductible for tax purposes either in the period when the loan is first recognised or subsequently. For financial reporting purposes, under IFRS 9 the costs, together with interest and similar payments, are accrued over the period to maturity using the effective interest method.

Inception of the loan gives rise to a taxable temporary difference of CU500,000, being the difference between the carrying amount of the loan (CU9.5 million) and its tax base (CU10 million). This analysis is explained in more detail in section 6.2.1.B above.

In accordance with IAS 12, no deferred tax liability was recognised on the taxable temporary difference of CU10 million that arose on initial recognition of the loan.

One year later, the carrying amount of the loan is CU9.7 million, comprising the proceeds received of CU10 million (which equal the amount due at maturity), less unamortised transaction costs of CU300,000. This gives rise to a current temporary difference of CU300,000. No deferred tax is recognised on the current temporary difference, because it is part of the temporary difference arising on the initial recognition of the loan.

7.2.4.B Change in carrying value due to revaluation

As shown in Illustration 7-3 in section 7.2.3 above, a temporary difference arises when a non tax-deductible asset is acquired. Where the asset is acquired separately (i.e., not as part of a larger business combination) in circumstances giving rise to neither an accounting nor a taxable profit or loss, no deferred tax liability is recognised for that temporary difference.

If such an asset is subsequently revalued, however, deferred tax is recognised on the new temporary difference arising as a result of the revaluation, since this does not arise on initial recognition of the asset, as shown in Illustration 7-10 and Illustration 7-11.

Illustration 7-10: Revaluation of non-deductible and non-depreciable asset

On 1 January 20X3 an entity paying tax at 30% acquires a non tax-deductible office building for CU1,000,000 in circumstances in which IAS 12 prohibits recognition of the deferred tax liability associated with the temporary difference of CU1,000,000.

Application of IAS 16 results in no depreciation being charged on the building.

On 1 January 20X3 the entity revalues the building to CU1,200,000. The temporary difference associated with the building is now CU1,200,000, only CU1,000,000 of which arose on initial recognition. Accordingly, the entity recognises a deferred tax liability based on the remaining temporary difference of CU200,000 giving deferred tax expense at 30% of CU60,000. This tax expense would be recognised in other comprehensive income (see section 10 below).

Illustration 7-11: Revaluation of non-deductible and depreciable asset

On 1 January 20X2 an entity paying tax at 30% acquires a non tax-deductible office building for CU100,000 in circumstances in which IAS 12 prohibits recognition of the deferred tax liability associated with the temporary difference of CU100,000. The building is depreciated over 10 years at CU10,000 per year to a residual value of zero. The entity's financial year ends on 31 December.

At 1 January 20X3, the carrying amount of the building is CU90,000, and it is revalued upwards by CU45,000 to its current market value of CU135,000. As there is no change to the estimated residual value of zero, or to the life of the building, this will be depreciated over the next 9 years at CU15,000 per year.

Following the revaluation, the temporary difference associated with the building is CU135,000. Of this amount, only CU90,000 arose on initial recognition, since CU10,000 of the original temporary difference of CU100,000 arising on initial recognition of the asset has been eliminated through depreciation of the asset (see section 7.2.4.A above). The carrying amount (which equals the temporary difference, since the tax base is zero) and depreciation during the year ended 31 December 20X3 and thereafter may then be analysed as follows:

Year	*Carrying amount*	*Tax base*	*Gross temporary difference*	*Unrecognised temporary difference*[1]	*Recognised temporary difference*	*Deferred tax liability*
	a	b	c (=a-b)	d	e (=c-d)	e @ 30%
0	100,000	-	100,000	100,000	-	-
1	90,000	-	90,000	90,000	-	-
Reval	135,000	-	135,000	90,000	45,000	13,500
2	120,000	-	120,000	80,000	40,000	12,000
3	105,000	-	105,000	70,000	35,000	10,500
4	90,000	-	90,000	60,000	30,000	9,000
5	75,000	-	75,000	50,000	25,000	7,500
6	60,000	-	60,000	40,000	20,000	6,000
7	45,000	-	45,000	30,000	15,000	4,500
8	30,000	-	30,000	20,000	10,000	3,000
9	15,000	-	15,000	10,000	5,000	1,500
10	-	-	-	-	-	-

[1] The depreciation is allocated *pro rata* to the cost element and revalued element of the total carrying amount.

On 1 January 20X4 the entity recognises a deferred tax liability based on the temporary difference of CU45,000 arising on the revaluation (i.e., after initial recognition) giving a deferred tax expense of CU13,500 (CU45,000 @ 30%), recognised in other comprehensive income (see section 10 below). This has the result that the effective tax rate shown in the financial statements for the revaluation is 30% (CU45,000 gain with deferred tax expense of CU13,500).

As can be seen from the table above, as at 31 December 20X4 (year 2), CU40,000 of the total temporary difference arose after initial recognition. The entity therefore provides for deferred tax of CU12,000 (CU40,000 @ 30%), and a deferred tax credit of CU1,500 (the reduction in the liability from CU13,500 to CU12,000) is recognised in profit or loss.

The deferred tax credit can be explained as the tax effect at 30% of the additional CU5,000 depreciation relating to the revalued element of the building (see table above).

7.2.4.C Change in tax base due to deductions in tax return

The following are examples of transactions where a new temporary difference emerges after initial recognition as the result of claiming tax deductions.

Illustration 7-12: Tax deduction for land

An entity that pays tax at 35% acquires land with a fair value of CU5 million. Tax deductions of CU100,000 per year may be claimed for the land for the next 30 years (i.e., the tax base of the land is CU3 million). In accordance with IAS 12, no deferred tax liability is recognised on the taxable temporary difference of CU2 million that arises on initial recognition of the land.

In the period in which the land is acquired, the entity claims the first CU100,000 annual tax deduction, and the original cost of the land is not depreciated or impaired. The taxable temporary difference at the end of the period is therefore CU2.1 million (cost CU5.0 million less tax base CU2.9 million). Of this, CU2 million arose on initial recognition and no deferred tax is recognised on this. However, the remaining CU100,000 of the gross temporary difference arose after initial recognition. Accordingly, the entity recognises a deferred tax liability of CU35,000 (CU100,000 @ 35%).

In subsequent years, the deferred tax liability is increased for the new temporary differences arising as a result of changes to the tax base as a result of claiming tax deductions, as illustrated in the following table:

Year	*Carrying amount*	*Tax base*	*Gross temporary difference*	*Unrecognised temporary difference*	*Recognised temporary difference*	*Deferred tax liability*
	a	b	c (=a-b)	d	e (=c-d)	e @ 35%
0	5,000,000	3,000,000	2,000,000	2,000,000	-	-
1	5,000,000	2,900,000	2,100,000	2,000,000	100,000	35,000
2	5,000,000	2,800,000	2,200,000	2,000,000	200,000	70,000
3	5,000,000	2,700,000	2,300,000	2,000,000	300,000	105,000
4	5,000,000	2,600,000	2,400,000	2,000,000	400,000	140,000
5	5,000,000	2,500,000	2,500,000	2,000,000	500,000	175,000

The analysis if the land had later been impaired would be rather more complicated. The general issue of the treatment of assets that are tax-deductible, but for less than their cost, is discussed in section 7.2.6 below.

Illustration 7-13: Tax-deductible goodwill

On 1 January 20X3 an entity with a tax rate of 35% acquires goodwill in a business combination with a cost of CU1 million, which is deductible for tax purposes at a rate of 20% per year, starting in the year of acquisition.

During 20X3 the entity claims the full 20% tax deduction and writes off CU120,000 of the goodwill as the result of an impairment test. Thus, at the end of 20X3 the goodwill has a carrying amount of CU880,000 and a tax base of CU800,000. This gives rise to a taxable temporary difference of CU80,000 that does not relate to the initial recognition of goodwill, and accordingly the entity recognises a deferred tax liability at 35% of CU28,000.

If, during 20X3, there had been no impairment of the goodwill, but the full tax deduction had nevertheless been claimed, at the end of the year the entity would have had goodwill with a carrying amount of CU1 million and a tax base of CU800,000. This would have given rise to a taxable temporary difference of CU200,000 that does not relate to the initial recognition of goodwill, and accordingly the entity would have recognised a deferred tax liability at 35% of CU70,000.

7.2.4.D Temporary difference altered by legislative change

Any change to the basis on which an item is treated for tax purposes alters the tax base of the item concerned. For example, if the government decides that an item of PP&E that was previously tax-deductible is no longer eligible for tax deductions, the tax base of the PP&E is reduced to zero. Under IAS 12, any change in tax base normally results in an immediate adjustment of any associated deferred tax asset or liability, and the recognition of a corresponding amount of deferred tax income or expense.

However, where such an adjustment to the tax base occurs in respect of an asset or liability for which no deferred tax has previously been recognised because of the initial recognition exception, the treatment required by IAS 12 is not entirely clear. The issue is demonstrated by Illustration 7-14 below.

Illustration 7-14: Asset non-deductible at date of acquisition later becomes deductible

At the beginning of the year ended 31 March 20X3, an entity acquired an item of PP&E for CU1 million which it intends to use for 20 years, with no anticipated residual value. No tax deductions were available for the asset. In accordance with IAS 12 no deferred tax liability was recognised on the taxable temporary difference of CU1 million that arose on initial recognition of the PP&E. Then standard rate of income tax is 20%.

During the year ended 31 March 20X4, the government announces that it will allow the cost of such assets to be deducted in arriving at taxable profit. The deductions will be allowed in equal annual instalments over a 10-year period. As at 31 March 20X4, the carrying amount of the asset and its tax base are both CU900,000. The carrying amount is the original cost of CU1 million less two years' depreciation at CU50,000 per year. The tax base is the original cost of CU1 million less one year's tax deduction at CU100,000 per year.

Prima facie, therefore, there is now no temporary difference associated with the asset, because its carrying amount and tax base are equal. However, the treatment applied in Illustration 7-12 and Illustration 7-13 above would lead to the conclusion that this net temporary difference of nil must be analysed into:

- An original taxable temporary difference of CU900,000 arising on initial recognition of the asset (being the CU1 million difference arising on initial recognition less the CU100,000 depreciation charged).
- A new deductible temporary difference of CU900,000 arising after initial recognition (representing the fact that, since initial recognition, the government increased the tax base by CU1 million which has been reduced to CU900,000 by the CU100,000 tax deduction claimed in the current period).

This approach would indicate that a deferred tax liability must not be recognised on the original taxable temporary difference (since this arose on initial recognition), but a deferred tax asset must be recognised on the new deductible temporary difference of CU900,000 identified above, subject to confirming that there are sufficient future taxable profits available against which those deductions are expected to be utilised. The effect is illustrated as follows:

End of Year	*Carrying amount*	*Tax base*	*Net temporary difference*	*Unrecognised temporary difference*	*Recognised temporary difference*	*Deferred tax liability/ (asset)*
	A	b	c (=a-b)	d	e (=c-d)	e @ 20%
Acquisition	1,000,000	-	1,000,000	1,000,000	-	-
20X3	950,000	-	950,000	950,000	-	-
20X4	900,000	900,000	-	900,000	(900,000)	(180,000)
20X5	850,000	800,000	50,000	850,000	(800,000)	(160,000)
20X6	800,000	700,000	100,000	800,000	(700,000)	(140,000)
20X7	750,000	600,000	150,000	750,000	(600,000)	(120,000)

An alternative approach would be that there is now no temporary difference as the granting of the tax base by the government simply eliminates a previously unrecognised temporary difference:

- The change in tax law does not give rise to a 'new' temporary difference as would be the case for a revaluation of the asset (which is accompanied by the recognition of a gain in the financial statements) or a claim for tax deductions (which attracts a reduction to the tax charge for the period). Instead, the effect of the change in legislation is to reduce the original taxable temporary difference that arose on initial recognition of the asset. Such a reduction in the original temporary difference would not be recognised under IAS 12. *[IAS 12.21A]*.
- To account for only the deferred tax asset is effectively recognising a gain on the elimination of an income tax liability that was never previously recognised.

As far as the income tax charge or credit in profit or loss is concerned, the difference between the two approaches is one of timing. Where the overall temporary difference of zero is 'bifurcated' into an amount arising on initial recognition and an amount arising later, the change in legislation reduces income tax expense and the effective tax rate in the year of change. In the case where the net temporary difference of zero is considered as a whole, the reduction in income tax expense and the effective tax rate is recognised prospectively over the remaining life of the asset as those tax deductions are realised.

How we see it

In our view, in the absence of specific guidance in the standard, either approach is acceptable, provided that it is applied consistently.

7.2.5 Intragroup transfers of assets with no change in tax base

In many tax jurisdictions the tax deductions for an asset are generally related to the cost of that asset to the legal entity that owns it. However, in some jurisdictions, where an asset is transferred between members of the same group within that jurisdiction, the tax base remains unchanged, irrespective of the consideration paid.

Therefore, where the consideration paid for an asset in such a case differs from its tax base, a temporary difference arises in the acquiring entity's separate financial statements on transfer of the asset. The initial recognition exception applies to any such temporary difference. A further complication can arise when the acquiring entity acquires an asset that is deductible for tax purposes, but for an amount different from its cost. The treatment of such assets in the context of the initial recognition exception is discussed more generally in section 7.2.6 below.

In the consolidated financial statements of any parent of the buying entity, however, there is no change to the amount of deferred tax recognised provided that the tax rate of the buying and selling entity is the same. Where the tax rate differs, the deferred tax will be remeasured using the buying entity's tax rate.

Where an asset is transferred between group entities and the tax base of the asset changes as a result of the transaction, there will be deferred tax income or expense in the consolidated financial statements. This is discussed further in section 8.7 below.

7.2.6 Partially deductible and super-deductible assets

In many tax jurisdictions the tax deductions for an asset are generally based on the cost of that asset to the legal entity that owns it. However, in some jurisdictions, certain categories of asset are deductible for tax but for an amount either less than the cost of the asset ('partially deductible') or more than the cost of the asset ('super-deductible').

IAS 12 provides no specific guidance on the treatment of partially deductible and super-deductible assets acquired in a transaction to which the initial recognition exception applies. The issues raised by such assets are shown in Illustration 7-15 and Illustration 7-16 below.

Illustration 7-15: Partially deductible asset

An entity acquires an asset with a cost of CU100,000 and a tax base of CU60,000 in a transaction where IAS 12 prohibits recognition of deferred tax on the taxable temporary difference of CU40,000 arising on initial recognition of the asset. The asset is depreciated to a residual value of zero over 10 years and qualifies for tax deductions of 20% per year over 5 years. The temporary differences associated with the asset over its life will therefore be as follows:

Year	*Carrying amount*	*Tax base*	*Temporary difference*
	CU	CU	CU
0	100,000	60,000	40,000
1	90,000	48,000	42,000
2	80,000	36,000	44,000
3	70,000	24,000	46,000
4	60,000	12,000	48,000
5	50,000	-	50,000
6	40,000	-	40,000
7	30,000	-	30,000
8	20,000	-	20,000
9	10,000	-	10,000
10	-	-	-

These differences are clearly a function both of:

- The CU40,000 temporary difference arising on initial recognition relating to the non-deductible element of the asset

  And

- The emergence of temporary differences arising from the claiming of tax deductions for the CU60,000 deductible element in advance of its depreciation

Whilst IAS 12 does not explicitly mandate the treatment to be followed here, the general requirement to distinguish between these elements of the gross temporary difference (see section 7.2.4 above) suggests the following approach.

On initial recognition, the entity pro-rates the total carrying amount of the asset into a 60% deductible element and a 40% non-deductible element. The taxable temporary difference on the non-deductible element is not recognised (under the initial recognition exception). The 60% deductible element has a tax base equal to its carrying amount, such that there is no temporary difference for the deductible element on initial recognition. In subsequent periods, the entity would provide for deferred tax only on the temporary difference that subsequently emerges between the 60% deductible element and its tax base. On this basis, the temporary differences would be calculated as follows:

Year	*Carrying amount*	*40% non- deductible element*	*60% deductible element*	*Tax base*	*Temporary difference*
	a	**b (40% of a)**	**c (60% of a)**	**d**	**c - d**
0	100,000	40,000	60,000	60,000	-
1	90,000	36,000	54,000	48,000	6,000
2	80,000	32,000	48,000	36,000	12,000
3	70,000	28,000	42,000	24,000	18,000
4	60,000	24,000	36,000	12,000	24,000
5	50,000	20,000	30,000	-	30,000
6	40,000	16,000	24,000	-	24,000
7	30,000	12,000	18,000	-	18,000
8	20,000	8,000	12,000	-	12,000
9	10,000	4,000	6,000	-	6,000
10	-	-	-	-	-

Assuming that the entity pays tax at 30%, the amounts recorded for this transaction during year 1 (assuming that there are sufficient other taxable profits to absorb the tax loss created) would be as follows:

	CU
Depreciation of asset	(10,000)
Current tax income[1]	3,600
Deferred tax charge[2]	(1,800)
Net tax credit	1,800
Post tax depreciation	(8,200)

1 CU100,000 [cost of asset] × 60% [deductible element] × 20% [tax depreciation rate] × 30% [tax rate]
2 CU6,000 [temporary difference] × 30% [tax rate] - brought forward balance [nil]

If this calculation is repeated for all 10 years, the following would be reported in the financial statements.

Year	*Depreciation*	*Current tax credit*	*Deferred tax (charge)/credit*	*Total tax credit*	*Effective tax rate*
	a	b	c	d (=b+c)	e (=d/a)
1	(10,000)	3,600	(1,800)	1,800	18%
2	(10,000)	3,600	(1,800)	1,800	18%
3	(10,000)	3,600	(1,800)	1,800	18%
4	(10,000)	3,600	(1,800)	1,800	18%
5	(10,000)	3,600	(1,800)	1,800	18%
6	(10,000)	-	1,800	1,800	18%
7	(10,000)	-	1,800	1,800	18%
8	(10,000)	-	1,800	1,800	18%
9	(10,000)	-	1,800	1,800	18%
10	(10,000)	-	1,800	1,800	18%

This methodology has the result that the effective tax rate in each period corresponds to the effective tax rate for the transaction as a whole - i.e., cost of CU100,000 attracting total tax deductions of CU18,000 (CU60,000 at 30%), an overall rate of 18%.

How we see it

Whilst we believe that the approach shown above results in an appropriate effective tax rate in each period, it cannot be said to be required by IAS 12 and other methodologies could well be appropriate, provided that they are applied consistently in similar circumstances.

Illustration 7-16: Super-deductible asset

The converse situation to that in Illustration 7-15 exists in some jurisdictions which seek to encourage certain types of investment by giving tax allowances for an amount in excess of the expenditure actually incurred. Suppose that an entity invests CU1,000,000 in PP&E with a tax base of CU1,200,000 in circumstances where IAS 12 prohibits recognition of deferred tax on the deductible temporary difference of CU200,000 arising on initial recognition of the asset. The asset is depreciated to a residual value of zero over 10 years and qualifies for five annual tax deductions of 20% of its deemed tax cost of CU1,200,000.

The approach adopted in Illustration 7-15 considered the deductible and non-deductible elements separately and recognised deferred tax on the temporary difference between the deductible element and its tax base. If a similar approach is applied, on initial recognition the entity would split the tax base of the asset into a 'cost' element and a 'super deduction' element, and recognise deferred tax on only the temporary difference between the 'cost' element of the tax base and its carrying amount. Based on the fact pattern above the temporary differences associated with the 'super-deductible' asset would arise as follows:

Year	*Carrying amount*	*Tax base*	*'Super deduction' element*	*Cost element*	*Temporary difference*
	a	b	c (=2/12 of b)	d (=10/12 of b)	a - d
0	1,000,000	1,200,000	200,000	1,000,000	-
1	900,000	960,000	160,000	800,000	100,000
2	800,000	720,000	120,000	600,000	200,000
3	700,000	480,000	80,000	400,000	300,000
4	600,000	240,000	40,000	200,000	400,000
5	500,000	-	-	-	500,000
6	400,000	-	-	-	400,000
7	300,000	-	-	-	300,000
8	200,000	-	-	-	200,000
9	100,000	-	-	-	100,000
10	-	-	-	-	-

Assuming that the entity pays tax at 30%, the amounts recognised for this transaction during year 1 (assuming that there are sufficient other taxable profits to absorb the tax loss created) are as follows:

	CU
Depreciation of asset	(100,000)
Current tax income[1]	72,000
Deferred tax charge[2]	(30,000)
Net tax credit	42,000
Profit after tax	(58,000)

1 CU1,200,000 [deemed tax cost of asset] × 20% [tax depreciation rate] × 30% [tax rate]
2 CU100,000 [temporary difference] × 30% [tax rate] - brought forward balance [nil]

If this calculation is repeated for all 10 years, the following would be recognised in the financial statements.

Year	*Depreciation*	*Current tax credit*	*Deferred tax (charge)/credit*	*Total tax credit*	*Effective tax rate*
	a	b	c	d (=b+c)	e (=d/a)
1	(100,000)	72,000	(30,000)	42,000	42%
2	(100,000)	72,000	(30,000)	42,000	42%
3	(100,000)	72,000	(30,000)	42,000	42%
4	(100,000)	72,000	(30,000)	42,000	42%
5	(100,000)	72,000	(30,000)	42,000	42%
6	(100,000)	-	30,000	30,000	30%
7	(100,000)	-	30,000	30,000	30%
8	(100,000)	-	30,000	30,000	30%
9	(100,000)	-	30,000	30,000	30%
10	(100,000)	-	30,000	30,000	30%

This accounting results in an effective 42% tax rate for this transaction being reported in years 1 to 5, and a rate of 30% in years 6 to 10, in contrast to the true effective rate of 36% for the transaction as a whole - i.e., cost of CU1,000,000 attracting total tax deductions of CU360,000 (CU1,200,000 at 30%). This is because, whilst in the case of a partially deductible asset as in Illustration 7-15 above there is an accounting mechanism (i.e., depreciation) for allocating the non-deductible cost on a straight-line basis, in the case of a super-deductible asset there is no ready mechanism for spreading the additional CU60,000 tax deductions on a straight-line basis.

In specific cases, the additional tax deductions might have sufficient characteristics of a government grant (e.g., if it were subject to conditions more onerous that those normally associated with tax deductions in the jurisdiction concerned) to allow application of the principles of IAS 20 which results in the allocation of the additional tax deductions over the life of the asset (see section 4.4 above). However, such circumstances are rare.

Again, as in Illustration 7-15 above, no single approach can be said to be required by IAS 12 and other methodologies could well be appropriate, provided that they are applied consistently in similar circumstances.

7.2.7 Initial recognition of compound financial instruments by the issuer

IAS 32 requires 'compound' financial instruments (those with both a liability feature and an equity feature, such as convertible bonds) to be accounted for by the issuer using so-called split accounting. This is discussed in more detail in Chapter 43 at section 6, but in essence an entity is required to split the proceeds of issue of such an instrument (say CU1 million) into a liability component, measured at its fair value based on real market rates for non-convertible debt rather than the nominal rate on the bond (say CU750,000), with the balance being treated as an equity component (in this case CU250,000).

Over the life of the instrument, the CU750,000 carrying value of the liability element will be accreted back up to CU1,000,000 (or such lower or higher sum as might be potentially repayable), so that the cumulative income statement interest charge will comprise:

(a) Any actual cash interest payments made (which are tax-deductible in most jurisdictions)

(b) The CU250,000 accretion of the liability from CU750,000 to CU1,000,000 (which is not tax-deductible in most jurisdictions)

Where such an instrument is issued, IAS 12 requires the treatment in Illustration 7-17 to be adopted. *[IAS 12.IE Example 4]*.

Illustration 7-17: Compound financial instrument

An entity issues a zero-coupon convertible loan of CU1,000,000 on 1 January 20X3 repayable at par on 1 January 20X6. In accordance with IAS 32, the entity assigns an initial carrying amount of CU750,000 to the liability component of the convertible loan and CU250,000 to the equity component. Subsequently, the entity recognises the imputed discount of CU250,000 as interest expense at the effective annual rate of 10% on the carrying amount of the liability component at the beginning of the year. The tax authorities do not allow the entity to claim any deduction for the imputed discount on the liability component of the convertible loan. The tax rate is 40%.

Temporary differences arise on the liability element as follows (all figures in CU thousands).

	1.1.20X3	31.12.20X3	31.12.20X4	31.12.20X5
Carrying value of liability component[1]	750	825	908	1,000
Tax base	1,000	1,000	1,000	1,000
Taxable temporary difference	250	175	92	-
Deferred tax liability @ 40%	100	70	37	-

[1] Balance carried forward at end of previous period plus 10% accretion of notional interest less repayments.

The deferred tax arising at 1 January 20X3 is deducted from equity. Subsequent reductions in the deferred tax balance are recognised in the income statement, resulting in an effective tax rate of 40%. For example, in 20X3, the entity will accrete notional interest of CU75,000 (closing loan liability CU825,000 less opening balance CU750,000) with deferred tax income of CU30,000 (closing deferred tax liability CU70,000 less opening liability CU100,000).

This treatment causes some confusion in practice because it appears to contravene the prohibition on recognition of deferred tax on temporary differences arising on the initial recognition of assets and liabilities (other than in a business combination) that do not give rise to accounting or taxable profit or loss. *[IAS 12.15(b)]*. IAS 12 states that this temporary difference does not arise on initial recognition of a liability but as a result of the initial recognition of the equity component as a result of the requirement in IAS 32 to separate the instrument between its equity and liability components. *[IAS 12.23]*.

7.2.8 Acquisition of subsidiary that does not constitute a business

Occasionally, an entity may acquire a subsidiary which is accounted for as the acquisition of an asset rather than as a business combination. This will most often be the case where the subsidiary concerned is a 'single asset entity' holding a single item of property, plant and equipment which is not considered to constitute a business. The question then arises as to whether any deferred tax must be recognised for the property in the financial statements of the acquiring entity.

The IFRS IC considered this issue in March 2017 and determined that no deferred tax must be recognised, as follows:

Frequently asked questions

Question 7-1: How, in its consolidated financial statements, does an entity account for a transaction in which it acquires all the shares of another entity that has an investment property as its only asset?

The IFRS IC considered this issue in March 2017. In the fact pattern submitted, the acquiree had measured its investment property at fair value and recognised a deferred tax liability for the excess over cost (tax base). The amount paid for the shares was less than the fair value of the investment property because of the associated deferred tax liability. It was determined that the transaction does not meet the definition of a business combination in IFRS 3 because the acquired entity is not a business. The acquiring entity applies the fair value model in IAS 40 *Investment Property*.

The submitter asked whether the requirements in IAS 12.15(b) permit the acquiring entity to recognise a deferred tax liability on initial recognition of the transaction. If this is not the case, the submitter asked the Committee to consider whether the requirements in IAS 12.15(b) should be amended so that, in these circumstances, the acquiring entity would not recognise a gain on measuring the investment property at fair value immediately after initial recognition of the transaction.

The IFRS IC noted that:[12]

(a) Because the transaction is not a business combination, IFRS 3.2(b) requires the acquiring entity, in its consolidated financial statements, to allocate the purchase price to the assets acquired and liabilities assumed.

(b) Paragraph 15(b) of IAS 12 says that an entity does not recognise a deferred tax liability for taxable temporary differences that arise from the initial recognition of an asset or liability in a transaction that is not a business combination and that, at the time of the transaction, affects neither accounting profit or loss nor taxable profit (tax loss).

Accordingly, on acquisition, the acquiring entity recognises only the investment property and not a deferred tax liability in its consolidated financial statements. *[IAS 12.15(b)]*. The acquiring entity therefore allocates the entire purchase price to the investment property. *[IFRS 3.2(b)]*.

The conclusion of the IFRS IC, that when an asset is acquired in such circumstances, the initial recognition exception applies, can be demonstrated by the following Illustration.

Illustration 7-18: Acquired subsidiary accounted for as asset purchase

An entity (P) acquires all the shares of a subsidiary (S), whose only asset is an investment property, for CU9 million. The transaction is accounted for as the acquisition of a property rather than as a business combination. The tax base of the property is CU4.5 million and its carrying value (fair value) in the financial statements of S (under IFRS accounting standards) is CU12 million. The taxable temporary difference of CU7.5 million in the financial records of S arose after the initial recognition by S of the property, and accordingly a deferred tax liability of CU3 million has been recognised by S at its tax rate of 40%.

The question then arises as to whether any deferred tax should be recognised for the property in the financial statements of P.

Having determined that the acquisition does not constitute a business combination, the purchase price of CU9 million is allocated to the assets acquired and liabilities assumed. *[IFRS 3.2(b)]*. The initial recognition exception applies to the difference between the cost of the property in the financial statements of P of CU9 million and its tax base of CU4.5 million, in exactly the same way as if the property had been legally acquired as a separate asset rather than through acquisition of the shares of S. *[IAS 12.15(b)]*. Therefore, no deferred tax is recognised by P in respect of the property at the time of its acquisition. At this point, P has an unrecognised taxable temporary difference of CU4.5 million (CU9 million less CU4.5 million).

If P applies the fair value model in IAS 40, the investment property is subsequently remeasured at its fair value of CU12 million. This creates a new temporary difference in P of CU3 million (CU12 million less CU9 million), in respect of which a taxable temporary difference of CU1.2 million is recognised in profit and loss (CU3 million @ 40%).

7.2.9 Acquisition of an investment in a subsidiary, associate, branch or joint arrangement

The initial recognition exception does not apply to temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, which are subject to further detailed provisions of IAS 12 (see section 7.6 below). *[IAS 12.15, IAS 12.24]*.

7.3 Transactions involving the initial recognition of an asset and liability

As noted in section 7.2 above, the initial recognition exception is essentially a pragmatic remedy to avoid accounting problems that would arise without it, particularly in transactions where one asset is exchanged for another (such as the acquisition of PP&E for cash).

However, experience has shown that the exception creates new difficulties of its own. For example, there was no guidance on how entities must account for the tax effects of transactions involving the initial recognition of an equal and opposite asset and liability which subsequently unwind on different bases. Examples of such transactions include:

- Recording a liability for decommissioning costs, for which the corresponding debit entry is an increase in PP&E.
- The commencement of a lease by a lessee, which involves the recording of an asset and a corresponding liability.

12 *IFRIC Update*, March 2017, available on the IFRS Foundation's website.

In the absence of any guidance, three alternative approaches had developed in practice:

(i) Apply the initial recognition exception. Recognise nothing in respect of temporary differences arising at the time the asset and liability are first recognised. No deferred tax arises for any changes in those initial temporary differences.

(ii) Recognise deferred tax on initial recognition and consider the asset and the liability separately. The entity recognises a deferred tax liability for any taxable temporary differences related to the asset component and a deferred tax asset for any deductible temporary differences related to the liability component. On initial recognition, the taxable temporary difference and the deductible temporary differences are equal and offset to zero. Deferred tax is recognised on subsequent changes to the taxable and deductible temporary differences.

Or

(iii) Recognise deferred tax on initial recognition but consider the asset and the liability as in substance linked to each other. Consider any temporary differences on a net basis and recognise deferred tax on that net amount. In this approach, the non-deductible asset and the tax-deductible liability are regarded as being economically the same as a tax-deductible asset that is acquired on deferred terms (where the repayment of the loan does not normally give rise to tax). On this basis, the net carrying value of the asset and liability is zero on initial recognition, as is the tax base. There is therefore no temporary difference and the initial recognition exception does not apply. Deferred tax is recognised on subsequent temporary differences that arise when the net asset or liability changes from zero.

In June 2018, the IFRS IC acknowledged the three approaches that were applied in the circumstances noted above and decided to recommend that the Board should develop a narrow-scope amendment to IAS 12.[13] The amendments to IAS 12 were issued in May 2021 and are discussed in section 7.3.1 below.

7.3.1 Deferred Tax related to Assets and Liabilities arising from a Single Transaction - Amendments to IAS 12

On 7 May 2021, the IASB issued *Deferred Tax related to Assets and Liabilities arising from a Single Transaction - Amendments to* IAS 12 (the Amendments). The Board amended the standard to reduce diversity in the way that entities account for deferred tax on transactions and events, such as leases and decommissioning obligations, that lead to the initial recognition of both an asset and a liability.

The Amendments narrow the scope of the initial recognition exception under IAS 12 so that it no longer applies to transactions that give rise to equal taxable and deductible temporary differences. *[IAS 12.BC71]*. The Amendments also clarify that where payments that settle a liability are deductible for tax purposes, it is a matter of judgement (having considered the applicable tax law) whether such deductions are attributable for tax purposes to the liability recognised in the financial statements (and interest expense) or to the related asset component (and interest expense). *[IAS 12.BC75]*. This judgement is important in determining whether any temporary differences exist on initial recognition of the asset and liability.

The Amendments were effective to annual reporting periods beginning on or after 1 January 2023, with earlier application permitted. *[IAS 12.98J]*. Entities had to apply the Amendments to transactions that occurred on or after the beginning of the earliest comparative period presented *[IAS 12.98J]*. In addition, at the beginning of the earliest comparative period presented, it had to recognise a deferred tax asset (subject to deferred tax asset recognition criteria in IAS 12) and a deferred tax liability for all deductible and taxable temporary differences as required by paragraph 98L of IAS 12 and recognise the cumulative effect of initially applying the Amendments as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at that date. *[IAS 12.98L]*.

The transitional provisions also apply to first-time adopters at the date of their transition to IFRS accounting standards. *[IFRS 1.B14]*.

How we see it

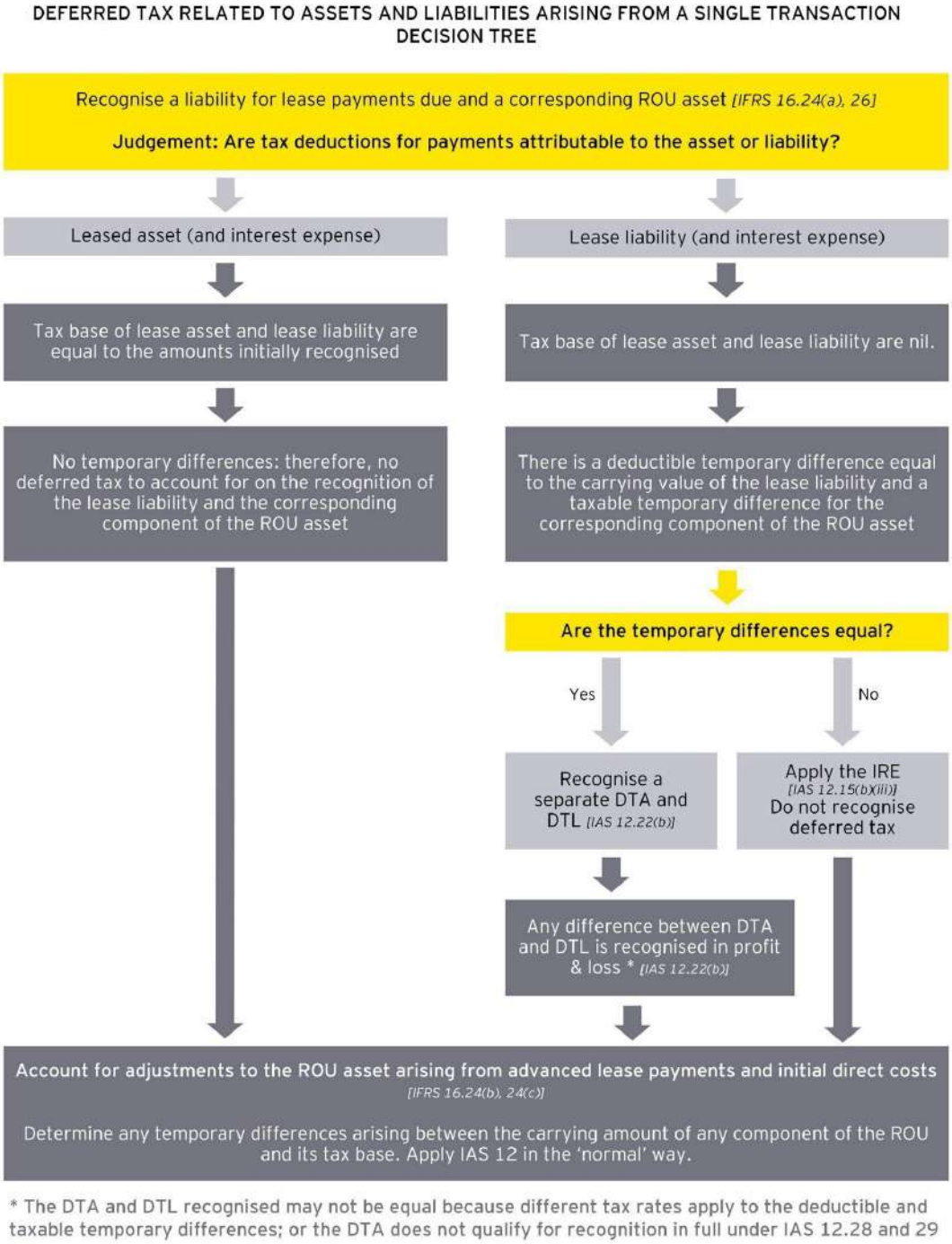
The Amendments could, in some cases, lead to the recognition of unequal amounts of deferred tax assets and liabilities, despite the gross deductible and taxable temporary differences being equal. In such cases, an entity would need to account for the difference between the deferred tax asset and liability in profit or loss.

For simplicity, the basis for the Amendments is explained using leases as an example. This explanation applies equally to similar transactions and events, such as decommissioning obligations. *[IAS 12.BC73]*.

13 *IFRIC Update*, June 2018, available on the IFRS Foundation's website.

The following diagram illustrates the process applied in the Amendments for determining the tax consequences of a transaction that gives rise to the recognition of both an asset and a liability.

Figure 7-1: Deferred tax related to assets and liabilities arising from a single transaction decision tree



7.3.1.A Determining the tax base of assets and liabilities

An entity that applies IFRS 16 *Leases* recognises a right-of-use asset (lease asset) and a lease liability at the commencement date of a lease. On initial recognition, the entity needs to assess the tax base of the lease asset and liability by identifying the amounts attributable to them for tax purposes. In a jurisdiction where an entity receives tax deductions when it makes lease payments, it applies judgement in determining whether those tax deductions are attributable to:

- The lease asset (and interest expense) because the deductions relate to the expenses (i.e., depreciation and interest expense) arising from the lease

  Or
- The lease liability (and interest expense) because the deductions relate to the repayment of the lease liability and interest expense *[IAS 12.BC74]*

If the tax deductions are attributed to the lease asset, the tax bases of the lease asset and lease liability equal their carrying amounts, and no temporary differences arise on initial recognition. However, if the tax deductions are attributed to the lease liability, the tax bases of the lease asset and lease liability are nil, giving rise to taxable and deductible temporary differences in respect of the asset and the liability, respectively. *[IAS 12.BC76]*. If those gross temporary differences are equal, the Amendments require that a deferred tax liability and a deferred tax asset are recognised. *[IAS 12.22A]*.

The Board decided not to provide application guidance to help entities assess whether tax deductions are attributable to the lease asset or lease liability as the costs of doing so would outweigh the benefits. The Board was satisfied that the Amendments will result in entities recognising deferred tax for temporary differences that arise on leases (either on initial recognition or subsequently) regardless of whether tax deductions were attributed to the asset or liability. An entity will need to make a judgement, having considered the applicable tax law, whether tax deductions relate to the lease asset or lease liability. *[IAS 12.BC89]*.

In the absence of guidance from the IASB, some preparers and users may find it difficult to determine that tax deductions made available at the time when lease payments or decommissioning costs are incurred can be allocated to anything other than the liability component of the transaction. Others will be keen to justify allocation of the tax deductions to the asset, so as to determine that there are no temporary differences on initial recognition of the asset and liability.

In the absence of explicit guidance, practice will no doubt develop. In considering applicable tax law, entities might refer to implementation guidance issued to tax inspectors and other officers in interpreting the nature of the deductions provided. In some jurisdictions, a predominant local determination may evolve for a particular tax deduction. Others might look to other indicators; for example, whether tax deductions for decommissioning costs can be carried back to the same period(s) as those in which the asset is consumed. Some of these considerations are shown in Illustration 7-19 below.

How we see it

Despite any difficulty that entities might find in determining whether the deductions relate to the consumption of the related asset, rather than to the settlement of the lease or decommissioning liability, the Board has concluded that this judgement is required to be made, having considered the applicable tax law *[IAS 12.BC75]* and that, as such, it is not an accounting policy choice.

All of the factors noted above will be relevant in making that determination.

7.3.1.B Changes to the initial recognition exception

As noted in section 7.3 above, before the Amendments were issued, views differed on whether (and to what extent) the IRE applied to transactions and events, such as leases, that lead to the recognition of an asset and a liability. To address this problem, the IASB decided to narrow the scope of the recognition exception so that it does not apply to transactions that, on initial recognition, give rise to equal taxable and deductible temporary differences. *[IAS 12.BC80]*.

Only if the recognition of a lease asset and lease liability (or decommissioning liability and decommissioning asset component) give rise to taxable and deductible temporary differences that are not equal, would the IRE be applied. *[IAS 12.15(b)(iii)]*.

The Amendments do not change the fact that the initial recognition exception applies only to temporary differences arising on initial recognition of an asset or liability. It does not apply to new temporary differences that arise on the same asset or liability after initial recognition. When the exception has been applied to the temporary difference arising on initial recognition of an asset or liability, and there is a different temporary difference associated with that asset or liability at a subsequent date, it is necessary to analyse the temporary difference at that date between:

- Any amount relating to the original temporary difference (on which no deferred tax is recognised) *[IAS 12.22(c)]*

  And

- The remainder, which has implicitly arisen after initial recognition of the asset or liability (on which deferred tax is recognised)

Illustration 7-19 below applies the requirements of the Amendments. A key judgement required is the determination of whether the tax relief provided when decommissioning payments are made is attributable to the liability or to the decommissioning component of the asset is a matter of judgement. *[IAS 12.BC75]*.

Illustration 7-19: Asset and liability giving rise to equal temporary differences on initial recognition - applying the Amendments to IAS 12

On 1 January 20X3 an entity paying tax at 40% recognises a provision for the clean-up costs of a mine that will require expenditure of CU10 million at the end of 20X7. A tax deduction for the expenditure will be given when it is incurred (i.e., as a reduction in the current tax liability for 20X7).

In accordance with IAS 37, this provision is discounted (at a rate of 6%) to CU7.5m, giving rise to the following accounting entry (see Chapter 27 at section 6.3):

			CU m	CU m
Dr	PP&E		7.5	
	Cr	Provision for clean-up costs		7.5

Under local tax legislation, no deductions are available for depreciation of the decommissioning component of the PP&E asset. However, payments made for decommissioning expenses are deductible for tax and capable of being carried forward or carried back against taxable profits.

Scenario 1: The entity determines that the tax deductions are attributable to the related asset

In this scenario, the entity determines that the tax deduction for decommissioning expenses is attributable to the asset recognised alongside the decommissioning liability and the payment of interest. The entity considers a number of factors in making this judgement, perhaps with emphasis that while the timing of obtaining tax relief is linked to the date on which the decommissioning expenses are incurred, deductions can be carried back in a manner that allows the deductions to be applied against the taxable profits generated as the asset is consumed.

In this scenario, the tax base of the decommissioning component added to the carrying value of PP&E is equal to its carrying amount, since the CU7.5 million carrying value of the asset is regarded as fully deductible for tax purposes. The tax base of the provision is also CU7.5 million (carrying amount of CU7.5 million, less the amount determined to be deductible in future periods, in this case nil). Although deductions of CU10 million are expected to be received in 20X7 when the decommissioning costs are incurred, the tax base is determined by reference to the carrying amount of the asset of CU7.5 million and to the interest expense to be recognised on the liability of CU2.5 million.

On this basis, there are no temporary differences to recognise on 1 January 20X3. In subsequent years, the entity recognises depreciation of CU1.5 million (CU7.5m ÷ 5) and interest on the decommissioning liability, which in 20X3 is CU0.45 million (CU7.5m × 6%). Given that the decommissioning expense of CU10 million is fully tax-deductible, the entity expects to be entitled to a CU4 million reduction in its current tax liability when the obligation for decommissioning costs is settled.

This would result in the following amounts being included in subsequent income statements (all figures in CU millions):

	20X3	20X4	20X5	20X6	20X7	Total
Depreciation	1.50	1.50	1.50	1.50	1.50	7.50
Finance costs	0.45	0.47	0.50	0.53	0.55	2.50
Cost before tax	1.95	1.97	2.00	2.03	2.05	10.00
Current tax (income)					(4.00)	(4.00)
Deferred tax (income)/charge[1]	(0.78)	(0.79)	(0.80)	(0.81)	3.18	-
Cost after tax	1.17	1.18	1.20	1.22	1.23	6.00
Effective tax rate	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%

1 In 20X3, the depreciation of CU1.50 creates a deductible temporary difference in relation to the asset (as its carrying value of CU6 million is less than its tax base of CU7.5 million) and in relation to the accrued interest there is a deductible temporary difference of CU0.45 million because its tax base is nil (carrying amount of CU0.45 million, less the amount deductible in future periods, also CU0.45 million). This results in a deferred tax asset CU0.78 million (CU1.95 million @ 40%) - similarly for 20X4-20X6. The charge in 20X7 represents the release of the remaining net deferred tax asset (equal to cumulative income statement credits in 20X3-20X6).

Scenario 2: The entity determines that the tax deductions are attributable to the liability

In this scenario, the entity determines that the tax deduction for decommissioning expenses is attributable to the settlement of the decommissioning liability and the payment of interest. The entity considers a number of factors in making this judgement, perhaps with emphasis that the timing of obtaining tax relief is linked to the date on which the decommissioning expenses are incurred, which coincides with the settlement of the liability recognised under IAS 37.

In this case, the tax base of the decommissioning component added to the carrying value of PP&E is nil, since no deductions have been attributed to the asset and the CU7.5 million carrying value of the asset is recovered through future taxable profits. The tax base of the provision is also nil (carrying amount of CU7.5 million, less the tax deductions attributed for future periods, also CU7.5 million). Although deductions of CU10 million are expected to be received in 20X7 when the decommissioning costs are incurred, the tax base is determined by reference to the consequences of the liability being settled at its carrying amount of CU7.5 million, with CU2.5 million attributed to the future interest expense.

There is therefore a taxable temporary difference of CU7.5 million associated with the decommissioning component of the PP&E asset and a deductible temporary difference of the same amount associated with the provision.

Having first confirmed that the deductible temporary difference is recoverable, it would, on initial recognition of the provision and the addition to PP&E, establish a deferred tax asset of CU3 million in respect of the provision (CU7.5m @ 40%) and an equal liability in respect of the decommissioning component of PP&E. This would result in the following amounts being included in subsequent income statements (all figures in CU millions):

	20X3	20X4	20X5	20X6	20X7	Total
Depreciation	1.50	1.50	1.50	1.50	1.50	7.50
Finance costs	0.45	0.47	0.50	0.53	0.55	2.50
Cost before tax	1.95	1.97	2.00	2.03	2.05	10.00
Current tax (income)					(4.00)	(4.00)
Deferred tax (income)/charge[1]	(0.78)	(0.79)	(0.80)	(0.81)	3.18	-
Cost after tax	1.17	1.18	1.20	1.22	1.23	6.00
Effective tax rate	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%

1 In 20X3, the sum of the reduction in deferred tax liability in respect of the decommissioning component of PP&E CU0.6m (CU1.5 million @ 40%) and increase in deferred tax asset in respect of provision CU0.18 million (CU0.45 million @ 40%) - similarly for 20X4-20X6. The charge in 20X7 represents the release of the remaining net deferred tax asset (equal to cumulative income statement credits in 20X3-20X6).

In the statement of financial position, the related assets and liabilities would be recognised as follows:

	20X3	20X4	20X5	20X6	20X7
PP&E - decommissioning asset	6.00	4.50	3.00	1.50	-
Decommissioning liability	(7.95)	(8.42)	(8.92)	(9.45)	-
Net decommissioning liability	(1.95)	(3.92)	(5.92)	(7.95)	-
Deferred tax asset	3.18	3.37	3.57	3.78	-
Deferred tax liability	(2.40)	(1.80)	(1.20)	(0.60)	-
Current tax recoverable					4.00

How we see it

Under the Amendments, on initial recognition of a right-of-use asset and lease liability (or a decommissioning liability and related asset component), temporary differences would either:

- Not arise, because the tax deductions are determined by the entity to relate to the right-of-use asset or decommissioning asset

  Or

- Be equal and offsetting (that is, the resulting taxable and deductible temporary differences would be of the same amount), because the tax deductions are determined by the entity to relate to the liability

7.3.1.C When the deferred tax asset and deferred tax liability are not equal

The Amendments require entities to recognise a separate deferred tax asset (DTA) and deferred tax liability (DTL) when the temporary differences arising on the initial recognition of an asset and liability are equal. Nevertheless, it is possible that resulting DTAs and DTLs are not equal, for example. because:

- An entity may recognise a deferred tax liability, but is unable to recognise an equal and offsetting deferred tax asset if it is unable to benefit from the tax deductions

  Or

- Different tax rates may apply to the taxable and deductible temporary differences

In the above scenarios, which the Board expects to occur infrequently, an entity would need to account for the difference between the deferred tax asset and liability in profit or loss. *[IAS 12.BC86, IAS 12.BC87, IAS 12.BC88]*.

7.3.1.D Advance lease payments and initial direct costs

Having initially measured a lease liability at the present value of the lease payments not yet made at the commencement date and recognised a related component of the lease asset, entities will adjust the measurement of the lease asset for any advance lease payments or initial direct costs incurred. The Board notes that these adjustments could result in additional taxable temporary differences associated with the lease asset, to which an entity would apply the relevant requirements in IAS 12. In response to requests to do so, the Board included the following example to illustrate the accounting for deferred tax on advance lease payments and initial direct costs. *[IAS 12.BC91, IAS 12.IE Example 8]*.

Extract from IAS 12 - Illustrative Examples

Example 8 - Leases

Lease

An entity (Lessee) enters into a five-year lease of a building. The annual lease payments are CU100 payable at the end of each year. Before the commencement date of the lease, Lessee makes a lease payment of CU15 (advance lease payment) and pays initial direct costs of CU5. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate is 5% per year.

At the commencement date, applying IFRS 16 *Leases*, Lessee recognises a lease liability of CU435 (measured at the present value of the five lease payments of CU100, discounted at the interest rate of 5% per year). Lessee measures the right-of-use asset (lease asset) at CU455, comprising the initial measurement of the lease liability (CU435), the advance lease payment (CU15) and the initial direct costs (CU5).

Tax law

The tax law allows tax deductions for lease payments (including those made before the commencement date) and initial direct costs when an entity makes those payments. Economic benefits that will flow to Lessee when it recovers the carrying amount of the lease asset will be taxable.

A tax rate of 20% is expected to apply to the period(s) when Lessee will recover the carrying amount of the lease asset and will settle the lease liability.

After considering the applicable tax law, Lessee concludes that the tax deductions it will receive for lease payments relate to the repayment of the lease liability.[2]

Deferred tax on the advance lease payment and initial direct costs

Lessee recognises the advance lease payment (CU15) and initial direct costs (CU5) as components of the lease asset's cost. The tax base of these components is nil because Lessee already received tax deductions for the advance lease payment and initial direct costs when it made those payments. The difference between the tax base (nil) and the carrying amount of each component results in taxable temporary differences of CU15 (related to the advance lease payment) and CU5 (related to the initial direct costs).

The exemption from recognising a deferred tax liability in paragraph 15 does not apply because the temporary differences arise from transactions that, at the time of the transactions, affect Lessee's taxable profit (that is, the tax deductions Lessee received when it made the advance lease payment and paid initial direct costs reduced its taxable profit). Accordingly, Lessee recognises a deferred tax liability of CU3 (CU15 × 20%) and CU1 (CU5 × 20%) for the taxable temporary differences related to the advance lease payment and initial direct costs, respectively.

Deferred tax on the lease liability and related component of the lease asset's cost

At the commencement date, the tax base of the lease liability is nil because Lessee will receive tax deductions equal to the carrying amount of the lease liability (CU435). The tax base of the related component of the lease asset's cost is also nil because Lessee will receive no tax deductions from recovering the carrying amount of that component of the lease asset's cost (CU435).

The differences between the carrying amounts of the lease liability and the related component of the lease asset's cost (CU435) and their tax bases of nil result in the following temporary differences at the commencement date:

(a) a taxable temporary difference of CU435 associated with the lease asset; and

(b) a deductible temporary difference of CU435 associated with the lease liability.

The exemption from recognising a deferred tax asset and liability in paragraphs 15 and 24 does not apply because the transaction gives rise to equal taxable and deductible temporary differences. Lessee concludes that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised. Accordingly, Lessee recognises a deferred tax asset and a deferred tax liability, each of CU87 (CU435 × 20%), for the deductible and taxable temporary differences.

Summary of recognised deferred tax

The table below summarises the deferred tax that Lessee recognises on initial recognition of the lease (including the advance lease payment and initial direct costs):

	Carrying amount	Tax base	Deductible / (taxable) temporary difference	Deferred tax asset / (liability)
Lease asset				
- advance lease payment	15	-	(15)	(3)
- initial direct costs	5	-	(5)	(1)
- the amount of the initial measurement of the lease liability	435	-	(435)	(87)
Lease liability	435	-	435	87

Applying paragraph 22(b) of IAS 12, Lessee recognises deferred tax assets and liabilities as illustrated in this example and recognises the resulting deferred tax income or expense in profit or loss.

2. Depending on the applicable tax law, an entity might alternatively conclude that the tax deductions it will receive for lease payments relate to the lease asset, in which case temporary differences would not arise on initial recognition of the lease liability and the related component of the lease asset's cost. Accordingly, the entity would not recognise deferred tax on initial recognition but would do so if and when temporary differences arise after initial recognition.

7.4 Assets carried at fair value or revalued amount

IAS 12 notes that certain IFRS accounting standards permit or require assets to be carried at fair value or to be revalued. These include: *[IAS 12.20]*

- IAS 16 *Property, Plant and Equipment*
- IAS 38 *Intangible Assets*
- IAS 40 *Investment Property*
- IFRS 9 *Financial Instruments*
- IFRS 16 *Leases*

In many jurisdictions, the revaluation or restatement of an asset does not affect taxable profit in the period of the revaluation or restatement. Nevertheless, the future recovery of the carrying amount will result in a taxable flow of economic benefits to the entity and the amount that will be deductible for tax purposes (i.e., the original tax base) will differ from the amount of those economic benefits.

The difference between the carrying amount of a revalued asset and its tax base is a temporary difference and gives rise to a deferred tax liability or asset. IAS 12 clarifies that this is the case even if:

- The entity does not intend to dispose of the asset. In such cases, the revalued carrying amount of the asset will be recovered through use and this will generate taxable income which exceeds the depreciation that will be allowable for tax purposes in future periods.
- Tax on capital gains is deferred if the proceeds of the disposal of the asset are invested in similar assets. In such cases, the tax will ultimately become payable on sale or use of the similar assets. *[IAS 12.20]*. A discussion of the accounting for deferred taxable gains can be found in section 7.8 below.

In some jurisdictions, the revaluation or other restatement of an asset to fair value affects taxable profit (tax loss) for the current period. In such cases, the tax base of the asset may be raised by an amount equivalent to the revaluation gain, so that no temporary difference arises.

7.5 Restrictions on recognition of deferred tax assets

There is an essential difference between deferred tax liabilities and deferred tax assets. An entity's deferred tax liabilities will crystallise if the entity recovers its existing net assets at their carrying amount. However, in order to realise its net deferred tax assets in full, an entity must earn profits in excess of those represented by the carrying amount of its net assets in order to generate sufficient taxable profits against which the deductions represented by deferred tax assets can be offset. Accordingly, IAS 12 restricts the recognition of deferred tax assets to the extent that it is probable that taxable profit will be available against which the underlying deductible temporary differences can be utilised. *[IAS 12.27]*.

7.5.1 Restrictions imposed by relevant tax laws

When an entity assesses whether a deductible temporary difference is capable of being utilised, it must consider whether tax law restricts the sources of taxable profits against which deductions for this type of temporary difference are permitted. If tax law imposes no such restrictions, an entity can assess a deductible temporary difference in combination with all its other deductible temporary differences. However, if tax law restricts the utilisation of losses to deduction against a specific type of income, the recovery of a deductible temporary difference is assessed in combination only with other deductible temporary differences of the appropriate type. *[IAS 12.27A]*.

7.5.2 Sources of 'probable' taxable profit - taxable temporary differences

Before considering forecasts of future taxable profits, an entity must look to the deferred tax liabilities it has already recognised at the reporting date as a source of probable taxable profits that would allow any deductible temporary differences to be utilised. IAS 12 states that it is 'probable' that there will be sufficient taxable profit if a deductible temporary difference can be offset against a taxable temporary difference (deferred tax liability) relating to the same tax authority and the same taxable entity which will reverse in the same period as the asset, or in a period into which a loss arising from the asset may be carried back or forward. In such circumstances, a deferred tax asset is recognised. *[IAS 12.28]*.

There is no need at this stage to estimate the future taxable profits of the entity. If there are sufficient taxable temporary differences to justify the recognition of a deferred tax asset for deductible temporary differences, then the asset is recognised. The only condition to apply, as noted in section 7.5.1 above, is that any deferred tax liability used as the basis for recognising a deferred tax asset represents a future tax liability against which the deductible temporary difference can actually be offset under the relevant tax law. *[IAS 12.27A]*. For example, in a tax jurisdiction where revenue and capital items are treated separately for tax purposes, a deferred tax asset representing a capital loss cannot be recognised by reference to a deferred tax liability relating to tax allowances received on PP&E in advance of the related depreciation expense.

7.5.3 Sources of 'probable' taxable profit - estimates of future taxable profits

Estimates of future taxable profits are only required to justify the recoverability of those deductible temporary differences in excess of the amounts already 'matched' against deferred tax liabilities recognised at the reporting date in the manner described in section 7.5.2 above. *[IAS 12.29]*. When this is the case, the following requirements apply:

Extract from IAS 12

29 When there are insufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, the deferred tax asset is recognised to the extent that:

(a) it is probable that the entity will have sufficient taxable profit relating to the same taxation authority and the same taxable entity in the same period as the reversal of the deductible temporary difference (or in the periods into which a tax loss arising from the deferred tax asset can be carried back or forward). In evaluating whether it will have sufficient taxable profit in future periods, an entity:

(i) compares the deductible temporary differences with future taxable profit that excludes tax deductions resulting from the reversal of those deductible temporary differences. This comparison shows the extent to which the future taxable profit is sufficient for the entity to deduct the amounts resulting from the reversal of those deductible temporary differences; and

(ii) ignores taxable amounts arising from deductible temporary differences that are expected to originate in future periods, because the deferred tax asset arising from these deductible temporary differences will itself require future taxable profit in order to be utilised; or

(b) tax planning opportunities are available to the entity that will create taxable profit in appropriate periods.

Where an entity has a history of recent losses it must also consider the guidance in IAS 12 for recognition of such losses (see section 7.5.6 below). *[IAS 12.31]*.

7.5.3.A Ignore the origination of new future deductible temporary differences

In assessing the availability of future taxable profits, an entity must ignore taxable amounts arising from deductible temporary differences expected to originate in future periods. This is because those new deductible differences will themselves require future taxable profit in order to be utilised. *[IAS 12.29(a)(ii)]*.

For example, suppose that in 20X3 an entity charges CU100 to profit or loss for which a tax deduction is not available until 20X4, when the amount is settled. However, in 20X4 a further CU100 is expected to be charged to profit or loss, for which a deduction will be available in 20X5, and so on for the foreseeable future. This will have the effect that, in 20X3, the entity will pay tax on the CU100 for which no deduction is made on the 20X3 tax return. In the tax return for 20X4, there will be a deduction for that CU100, but this will be offset by the add-back in the same tax return for the equivalent CU100 charged for accounting purposes in 20X4. If this cycle of 'CU100 deduction less CU100 add-back' is expected to be perpetuated in each tax return for the foreseeable future, there is never any real recovery of the tax paid on the CU100 in 20X3 and, in the absence of any other taxable profits, no deferred tax asset would be recognised.

7.5.3.B Ignore the reversal of existing deductible temporary differences

In 2016, the IASB added text to the standard to clarify that the estimate of probable future taxable profit must exclude the tax deductions resulting from the reversal of the deductible temporary differences that are themselves being assessed for recognition as an asset. *[IAS 12.29(a)(i)]*. This amendment was made following the IASB's deliberations on the recognition of deferred tax assets for unrealised losses, as discussed in section 7.5.5 below. The effect of the amendment is to clarify that the measure of taxable profit used for assessing the utilisation of deductible temporary differences is different from the taxable profit on which income taxes are payable. *[IAS 12.BC56]*.

The former is calculated before any allowances or deductions arising from the reversal of deductible temporary differences. The latter is the amount determined after the application of all applicable tax laws that gives rise to an entity's liability to pay income tax. *[IAS 12.5]*.

7.5.3.C Include the effect of (substantively) enacted changes to future tax rates and laws

As explained in section 8.1 below, deferred tax is measured by reference to the tax rates and laws, as enacted or substantively enacted by the end of the reporting period. *[IAS 12.47]*. Changes enacted after the end of the reporting period are ignored for measurement purposes and the effect is disclosed as a non-adjusting event. *[IAS 10.22(h)]*. However, in cases where changes have been (substantively) enacted before the end of the reporting period but are not effective until a later date, deferred tax would be calculated by applying the new rates and laws to the deductible and taxable temporary differences that are expected to reverse after that later effective date. *[IAS 12.47]*. Illustration 7-20 below shows how estimates of future taxable profits must also reflect any future changes to tax rates and laws that have been enacted by the end of the reporting period.

Illustration 7-20: Including the effect of enacted changes to future tax rates and laws

At the end of 20X3, Entity A has deductible temporary differences in excess of its taxable temporary differences of CU200,000. Entity A expects to generate annual profits of CU30,000 per year for the foreseeable future, after deducting costs of CU10,000 per annum which are currently not deductible for tax purposes. However, in December 20X3, legislation is enacted to the effect that these costs will be deductible from 20X5 onwards.

As a result, Entity A estimates future taxable profits of CU40,000 in 20X3 and 20X4 and revises its estimate of taxable profits from 20X5 onwards to CU30,000.

7.5.4 Tax planning opportunities and the recognition of deferred tax assets

'Tax planning opportunities' are actions that the entity would take in order to create or increase taxable income in a particular period before the expiry of a tax loss or tax credit carryforward. IAS 12 notes that, in some jurisdictions, taxable profit may be created or increased by:

- Electing to have interest income taxed on either a received or receivable basis
- Deferring the claim for certain deductions from taxable profit
- Selling, and perhaps leasing back, assets that have appreciated but for which the tax base has not been adjusted to reflect such appreciation
- Selling an asset that generates non-taxable income (such as, in some jurisdictions, a government bond) in order to purchase another investment that generates taxable income

Where tax planning opportunities advance taxable profit from a later period to an earlier period, the utilisation of a tax loss or tax credit carryforward still depends on the existence of future taxable profit from sources other than future originating temporary differences. *[IAS 12.30]*.

The requirement to have regard to future tax planning opportunities applies only to the measurement of deferred tax assets. It does not apply to the measurement of deferred tax liabilities. Thus, for example, it would not be open to an entity subject to tax at 30% to argue that it must provide for deferred tax liabilities at some lower rate on the grounds that it intends to invest in assets attracting investment tax credits that will allow it to pay tax at that lower rate (see section 8.4.1 below).

IAS 12 describes tax planning opportunities as actions that the entity 'would' take - not those it 'could' take. In other words, they are restricted to future courses of action that the entity would actually undertake to realise such a deferred tax asset, and do not include actions that are theoretically possible but practically implausible, such as the sale of an asset essential to the ongoing operations of the entity. Only if such actions are both capable of being taken as at the end of the reporting period and are intended to be taken by the entity before the related tax loss or credit expires can it be said that the resulting tax planning would give rise to a 'probable' future taxable profit.

Implementation of a tax planning opportunity may well entail significant direct costs or the loss of other tax benefits or both. Accordingly, any deferred tax asset recognised on the basis of a tax planning opportunity must be reduced by any cost of implementing that opportunity (measured, where applicable, on an after-tax basis).

How we see it

The requirement to have regard to future tax planning opportunities applies only to the measurement of deferred tax assets.

IAS 12 describes tax planning opportunities as actions that the entity 'would' take - not those it 'could' take, i.e., both capable of being taken as at the end of the reporting period and are intended to be taken by the entity.

Moreover, IAS 12 regards tax planning opportunities as a component of future net taxable profits. Thus, where a tax planning opportunity exists, but the entity is expected to remain loss-making (such that the opportunity effectively will simply reduce future tax losses), we believe that such an opportunity does not generally form the basis for recognising a deferred tax asset, except to the extent that it will create net future taxable profits (see also section 7.5.6 below).

7.5.4.A Changes in tax laws not yet enacted and future circumstances are not anticipated

Paragraph 29 of IAS 12 separates the consideration of probable future taxable profits *[IAS 12.29(a)]* from the assessment of whether tax planning opportunities are available to the entity. *[IAS 12.29(b)]*. Accordingly, the evaluation of whether tax planning opportunities are available is made as at the end of the reporting period rather than in contemplation of future possible events outside the entity's control. In this context, the general principle applies that deferred taxes are determined on the basis of tax rates and laws that are (substantively) enacted as at the end of the reporting period. *[IAS 12.47]*. Therefore, an entity must not take into consideration any tax planning that relies on the effect of an actual or probable change in tax law becoming (substantively) enacted after the end of the reporting period. However, it would be appropriate to consider a tax planning opportunity that cannot be implemented until the effective date of a future change to a rate or regulation that has been enacted as at the end of the reporting period.

Similarly, in assessing which tax planning opportunities 'are available', the entity can only consider its circumstances as they exist at the end of the reporting period, including the result of actions within the entity's control as at that date. For example, when an entity is contemplating the acquisition of a business and, as a result of the business combination, the probability of realising a pre-acquisition deferred tax asset of the acquirer is expected to change, IAS 12 requires that any change in the deferred tax asset is recognised in the period of the business combination. *[IAS 12.67]*. The change in probability must not be anticipated, because the forecast profits of the target acquiree are not available to the acquirer until the business combination is completed. This is also discussed in section 12.1.2.A below. Conversely, the sale of assets already held by the entity (or even the acquisition of assets freely available in the market) to achieve a tax advantage is an example of a tax planning opportunity that could be taken into account, because the action is in the entity's control as at the end of the reporting period. *[IAS 12.30]*.

7.5.5 Unrealised losses on debt securities measured at fair value

In January 2016, the IASB issued *Recognition of Deferred Tax Assets for Unrealised Losses (Amendments to* IAS 12*)*. These amendments concluded deliberations started by the IFRS IC in May 2010 on the recognition of deferred tax assets for unrealised losses, for example on debt instruments measured at fair value. *[IAS 12.BC1A]*.

The IFRS IC had been asked to provide guidance on how an entity determines whether to recognise a deferred tax asset under IAS 12 in the following circumstances: *[IAS 12.BC37]*

(a) The entity has a debt instrument measured at fair value under IAS 39 *Financial Instruments: Recognition and Measurement* and changes in market interest rates result in a decrease in the fair value of the debt instrument below its cost.

(b) It is probable that the issuer of the debt instrument will make all the contractual payments.

(c) The tax base of the debt instrument is its cost.

(d) Tax law does not allow a loss to be deducted on a debt instrument until the loss is realised for tax purposes.

(e) The entity has the ability and intention to hold the debt instrument until the unrealised loss reverses (which may be at its maturity).

(f) Tax law distinguishes between capital gains and losses and ordinary income tax losses. While capital losses can only be offset against capital gains, ordinary losses can be offset against both capital gains and ordinary income.

(g) The entity has insufficient taxable temporary differences and no other probable taxable profits against which the entity can utilise those deductible temporary differences.

The IFRS IC had identified diversity in practice because of uncertainty about the application of some of the principles in IAS 12, in particular in relation to the following:

(a) The existence of a deductible temporary difference, when there are no tax consequences to the recovery of the principal on maturity; the holder of the debt instrument expects to hold it to maturity; and it is probable that the issuer will pay all the contractual cash flows. *[IAS 12.BC38, IAS 12.BC39]*.

(b) Whether it is appropriate for an entity to determine deductible temporary differences and taxable temporary differences on the basis of the asset's carrying amount when at the same time it assumes that the asset is recovered for more than its carrying amount for the purposes of estimating probable future taxable profit against which deductible temporary differences are assessed for utilisation. This question is relevant when taxable profit from other sources is insufficient for the utilisation of the deductible temporary differences arising when the asset is measured at fair value. *[IAS 12.BC38, IAS 12.BC47]*.

(c) Whether the estimate of probable future taxable profit must include or exclude the effects of reversing the deductible temporary differences that are being assessed for recognition as an asset. *[IAS 12.BC38, IAS 12.BC55]*.

(d) The basis for assessing the recoverability of deductible temporary differences, i.e., for each deductible temporary difference separately, or in combination with other deductible temporary differences. This question is relevant, for example, when tax law distinguishes capital gains and losses from other taxable gains and losses and capital losses can only be offset against capital gains. *[IAS 12.BC38, IAS 12.BC57]*.

Whilst the amendments to IAS 12 were framed around the above example of a fixed-rate debt instrument measured at fair value, the Board noted that the principle on which the amendments are based is not limited to any specific type or class of assets. *[IAS 12.BC52]*. However, as noted in section 7.5.5.B below, the IASB acknowledged the concerns raised by respondents that the amendments could be applied too broadly and highlighted the need for particular caution where assets are measured at fair value. In response to that concern, the Board noted that entities will need to have sufficient evidence on which to base their estimate of probable future taxable profit, including when that estimate involves the recovery of an asset for more than its carrying amount. *[IAS 12.BC53]*.

7.5.5.A The existence of a deductible temporary difference

Because, in the case of many debt instruments, the collection of the principal on maturity does not give rise to any liability for tax, some believed that the collection of the principal is a non-taxable event. Consequently, proponents of this view argued that a deductible temporary difference cannot exist when an entity asserts that the contractual payments will be received, because any difference between the debt instrument's carrying amount and its higher tax base results from a loss that the entity expects never to realise for tax purposes. *[IAS 12.BC40]*.

The IASB rejected this argument. IAS 12 already states that a deductible temporary difference arises if the tax base of an asset exceeds its carrying amount. *[IAS 12.20, IAS 12.26(d)]*. The calculation of a temporary difference is based on the premise that the carrying amount of the asset will be recovered. *[IAS 12.5, IAS 12.BC42]*. The calculation of the temporary difference is not affected by possible future changes in the carrying amount of the asset. The Board considered that the economic benefit embodied in the related deferred tax asset results from the ability of the holder of the debt instrument to achieve future taxable gains in the amount of the deductible temporary difference without paying tax on those gains. This is the case where a previous impairment reverses, such that the entity recovers the original principal on the debt instrument. *[IAS 12.BC44]*. Accordingly, the amendments added an example after IAS 12.26 to illustrate how a deductible temporary difference exists under IAS 12.26(d).

Illustration 7-21: Deductible temporary difference when the asset is valued below cost

At the beginning of Year 1, Entity A purchases for CU1,000 a debt instrument with a nominal value of CU1,000 payable at the end of Year 5 and with an interest rate of 2% payable at the end of each year. The effective interest rate is determined to be 2% and the debt instrument is measured at fair value.

At the end of year 2, market interest rates have increased to 5%, causing the fair value of the debt instrument to decrease to CU918. It is probable that Entity A will collect all the contractual cash flows if it continues to hold the debt instrument.

Any gains or losses on the debt instrument are taxable or deductible only when realised. Gains or losses arising on the sale or maturity of the instrument are calculated for tax purposes as the difference between the amount collected and the original cost of the debt instrument. Accordingly, the tax base of the debt instrument is its original cost.

The Illustration concludes that the difference between the carrying amount of the debt instrument of CU918 and its tax base of CU1,000 gives rise to a deductible temporary difference of CU82 at the end of Year 2, *[IAS 12.20, IAS 12.26(d)]*, irrespective of whether Entity A expects to recover the carrying amount of the debt instrument by sale or by use, i.e., by holding it and collecting contractual cash flows, or a combination of both. Whether the asset is realised on sale or on maturity (i.e., through use), Entity A will obtain a tax deduction equivalent to the tax base of CU1,000 in determining any resultant taxable profit.

7.5.5.B Recovering an asset for more than its carrying amount

The Board concluded that the estimate of probable future taxable profit may include the recovery of some of an entity's assets for more than their carrying amount, but only if there is sufficient evidence that it is probable that the entity will achieve this. In the case of a fixed-rate debt instrument measured at fair value, recovery for more than the carrying amount is probable if the entity expects to collect the contractual cash flows. *[IAS 12.29A]*.

The determination of temporary differences and the estimation of probable future taxable profit are two separate steps, and the IASB concluded that the carrying amount of an asset is relevant only to determining the temporary differences. *[IAS 12.BC49]*. Indeed, the Board identified scenarios where an inappropriate outcome can arise if the possibility of realising a profit in excess of the carrying amount were limited. For example, a profitable manufacturing company relies on a business model that involves the sale of inventories and the recovery of property, plant and equipment for amounts exceeding their cost. Therefore, where such assets are recorded using the cost model, it may be inconsistent to assume that the entity will only recover these assets for their carrying amount. *[IAS 12.BC50]*. Nevertheless, in response to concerns raised by respondents that the amendment could be applied inappropriately, the Board acknowledged the need for caution where assets are measured at fair value. The risk of arbitrary estimates of future taxable profit is reduced where entities rely on evidence, such as the existence of contractual cash flows and an expectation of their recovery. *[IAS 12.BC53]*. For example, it would not be appropriate to assume recovery greater than an asset's carrying amount at fair value on the basis of an arbitrary assertion that fair value will inevitably recover in line with a longer-term improvement in the related market for the asset in question.

7.5.5.C Excluding the reversal of existing deductible temporary differences

During its deliberations, the IFRS IC observed uncertainty about how entities should calculate the measure of taxable profit that is used for assessing the amounts available for the future utilisation of deductible temporary differences. In particular, there seemed to be diversity of opinion relating to whether entities must include or exclude deductions that will arise when those deductible temporary differences reverse. *[IAS 12.BC55]*. As discussed above in section 7.5.3.B, the IASB concluded that the estimate of future taxable profit used to assess whether deductions can be utilised is not the same as 'taxable profit' (which is the amount determined after the application of all applicable tax laws that gives rise to an entity's liability to pay income tax). *[IAS 12.5]*.

Therefore, entities must exclude the effect of deductions arising from the reversal of the deductible temporary differences being assessed for recoverability, or they would be counted twice. *[IAS 12.29(a)(i), IAS 12.BC56]*.

7.5.5.D The basis for assessing the recoverability of deductible temporary differences

As noted in section 7.5 above, IAS 12 restricts the recognition of deferred tax assets to the extent that it is probable that taxable profit will be available against which the underlying deductible temporary differences can be utilised. *[IAS 12.27]*.

The Board noted that this is a matter for tax law; that IAS 12 defines taxable profit by reference to the application of the rules determined by tax authorities; and that no deferred tax is recognised if the reversal of the temporary difference will not lead to tax deductions. *[IAS 12.BC58]*. Therefore, the assessment of whether a deductible temporary difference can be utilised considers on a combined basis all deductible temporary differences relating to the same taxation authority and same taxable entity that are treated in a similar way under tax law. However, if tax law offsets specific types of losses against particular categories of income (for example when tax law allows capital losses to be deducted only against capital gains) such temporary differences are segregated according to their treatment under the relevant tax law. *[IAS 12.BC59]*.

IAS 12 was amended to clarify that entities making the assessment of the availability of taxable profits against which a deductible temporary difference can be utilised must do so in combination with all other deductible temporary differences, unless tax law restricts the sources of taxable profits against which that deductible temporary difference can be utilised. Where restrictions exist, the assessment is made together only with deductible temporary differences recoverable from the same sources. *[IAS 12.27A]*.

The amendments to IAS 12 add an example to show how these requirements are applied to debt instruments measured at fair value, on which Illustration 7-22 below is based. *[IAS 12.IE Example 7]*.

Illustration 7-22: Debt instruments measured at fair value

At 31 December 20X3 an entity holds a portfolio of three debt instruments, which are measured at fair value through other comprehensive income:

Debt instrument (All amounts in CU)	Cost	Fair value	Contractual interest rate
Debt instrument A	2,000,000	1,942,857	2.00%
Debt instrument B	750,000	778,571	9.00%
Debt instrument C	2,000,000	1,961,905	3.00%

All the debt instruments were acquired for their nominal value. All three debt instruments mature on 31 December 20X4, on which date repayment of the nominal value is due. Interest is paid at the end of each year. When the instruments were acquired, the contractually fixed interest rates were equal to the relevant market rates. However, at 31 December 20X3 the market interest rate is 5%, resulting in the fair value of instruments A and C to be below their cost and the fair value of instrument B to be above its cost. It is probable that the entity would receive all the contractual cash flows if it continues to hold the debt instruments.

The entity expects to hold instruments A and B to maturity, collecting the cash flows as they fall due, and to sell instrument C in early 20X4 for its fair value of CU1,961,905.

The tax base of the debt instruments is cost, which is deductible either on maturity when the principal is paid or against any sale proceeds when the instruments are sold. Tax law specifies that gains (losses) on the debt instruments are taxable (deductible) only when realised. Tax law distinguishes ordinary gains and losses from capital gains and losses. Ordinary losses can be offset against both ordinary gains and capital gains. Capital losses can only be offset against capital gains. Capital losses can be carried forward for 5 years and ordinary losses can be carried forward for 20 years.

Ordinary gains are taxed at 30% and capital gains are taxed at 10%.

Tax law classifies interest income from the debt instruments as 'ordinary' and gains and losses arising on the sale of the debt instruments as 'capital'. Losses that arise if the issuer of the debt instrument fails to pay the principal on maturity are classified as ordinary by tax law.

In addition to the above, there are other taxable temporary differences of CU50,000 and deductible temporary differences of CU430,000 which are expected to reverse in ordinary taxable profit in 20X4.

In summary, the following temporary differences are identified at 31 December 20X3:

Temporary differences (All amounts in CU)	Carrying amount	Tax base	Taxable temporary differences	Deductible temporary differences
Debt instrument A	1,942,857	2,000,000		57,143
Debt instrument B	778,571	750,000	28,571	
Debt instrument C	1,961,905	2,000,000		38,095
Other sources (not specified)			50,000	430,000
Total temporary differences			78,571	525.238
Expected to reverse in ordinary gains or losses			78,571	487,143
Expected to reverse as capital losses				38,095

The entity expects to report an ordinary tax loss of CU200,000 for the year ending 31 December 20X4. The deductible temporary difference on instrument C is classified as a capital loss because it is expected to be realised by sale. There are no other capital gains against which the entity could utilise capital losses in the current or future periods. What is the entity's deferred tax asset or liability as at 31 December 20X3?

The entity assesses the availability of probable future taxable profits in two steps:

- Step 1: Determine the availability of taxable temporary differences at the reporting date. *[IAS 12.28]*.
- Step 2: Determine the availability of probable future taxable profits. *[IAS 12.29]*.

Step 1: Determine the availability of taxable temporary differences at the reporting date

All of the taxable temporary differences are expected to reverse in ordinary gains or losses and must therefore be compared to the deductible temporary differences of CU487,143 that are capable of being utilised against ordinary gains. Accordingly, a deferred tax asset of CU78,571 is justified at this stage, with CU408,572 (487,143 - 78,571) of deductible temporary differences remaining to be utilised against ordinary gains or losses.

Step 2: Determine the availability of probable future taxable profits

The fact pattern states that the entity expects to report an ordinary tax loss of CU200,000 for 20X4. As noted in section 7.5.5.C above, this figure is the amount determined after the application of all applicable tax laws that gives rise to an entity's liability to pay income tax. In order to calculate the available profits against which the deductible temporary differences can be utilised, the effect of deductions arising from the reversal of the deductible temporary differences must be excluded. This gives a probable future taxable profit of CU208,572, as follows:

Excluding the reversal of existing temporary differences	Amount CU
Expected tax loss reported for 20X4	(200,000)
Reversal of taxable temporary differences (ordinary gains and losses)	(78,571)
Reversal of deductible temporary differences (ordinary gains and losses)	487,143
Probable taxable profit for 20X4 excluding the effect of reversals	208,572

Accordingly, the entity recognises a deferred tax asset in respect of deductible temporary differences of CU287,143, comprising CU78,571 justified by reference to taxable temporary differences existing at the reporting date and CU208,572 expected to be utilised against probable taxable profits in 20X4. All of these deductible temporary differences are expected to reverse in ordinary gains or losses, for which the applicable tax rate is 30%.

Therefore, at 31 December 20X3, the entity reports a deferred tax liability of CU23,571, a deferred tax asset of CU86,143 and unrecognised deductible temporary differences of CU238,095, as follows:

Temporary differences (All amounts in CU)	Amount	Tax rate	Deferred tax liability	Deferred tax asset
Taxable temporary differences	78,571	30%	23,571	
Total deductible temporary differences	525.238			
Less: eligible for recognition	(287,143)	30%		86,143
Unrecognised	238,095			

The unrecognised deductible temporary differences comprise CU38,095 expected to reverse in capital gains and losses and CU200,000 (487,143 - 287,143) expected to reverse in ordinary gains and losses.

7.5.6 Unused tax losses and unused tax credits

A deferred tax asset must be recognised for the carryforward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised. *[IAS 12.34]*.

The criteria for recognition are essentially the same as those for deductible temporary differences, as set out in sections 7.5.1 to 7.5.4 above, in particular that it is 'probable' that there will be sufficient taxable profit against which a deductible temporary difference can be utilised when there are sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity which are expected to reverse in the same period as the asset, or in a period into which a loss arising from the asset may be carried back or forward. *[IAS 12.28]*.

However, IAS 12 emphasises that the existence of unused tax losses is strong evidence that taxable profits (other than those represented by deferred tax liabilities) may not be available. Therefore, an entity with a history of recent losses recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that: *[IAS 12.35]*

- It has sufficient taxable temporary differences

  Or

- There is other convincing evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity

Frequently asked questions

Question 7-2: How does an entity justify the recognition of deferred tax assets on the basis of taxable temporary differences as at the reporting date, when it expects to incur tax losses in the future?

In May 2014, the IFRS IC confirmed that the consideration of available reversing taxable temporary differences is made independently of the assessment of an entity's expectations of future tax losses. Accordingly, a deferred tax asset is recognised for the carryforward of unused tax losses to the extent of the existing taxable temporary differences, of an appropriate type, that reverse in an appropriate period. The reversal of those taxable temporary differences enables the utilisation of the unused tax losses and justifies the recognition of deferred tax assets. Consequently, future tax losses are not considered.[14]

In addition to the question noted above, the IFRS IC was asked to clarify how the guidance in IAS 12 is applied when tax laws limit the extent to which tax losses brought forward can be recovered against future taxable profits. In the tax systems considered for this issue, the amount of tax losses brought forward that can be recovered in each tax year is limited to a specified percentage of the taxable profits of that year.

In these circumstances, the IFRS IC noted that the amount of deferred tax assets recognised from unused tax losses as a result of suitable existing taxable temporary differences should be restricted as specified by the tax law. This is because when the suitable taxable temporary differences reverse, the amount of tax losses that can be utilised by that reversal is reduced as specified by the tax law. Also, the IFRS IC noted that in this case future tax losses are not considered.

Consequently, the availability of future taxable profits is only required to be considered if the unused tax losses exceed the amount of suitable existing taxable temporary differences (after taking into account any restrictions).[15]

The IFRS IC also confirmed in May 2014 that an additional deferred tax asset is recognised only to the extent that the requirements in IAS 12.36 are met, as follows:[16] *[IAS 12.36]*

Extract from IAS 12

36 An entity considers the following criteria in assessing the probability that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised:

(a) whether the entity has sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, which will result in taxable amounts against which the unused tax losses or unused tax credits can be utilised before they expire;

(b) whether it is probable that the entity will have taxable profits before the unused tax losses or unused tax credits expire;

(c) whether the unused tax losses result from identifiable causes which are unlikely to recur; and

(d) whether tax planning opportunities (see paragraph 30) are available to the entity that will create taxable profit in the period in which the unused tax losses or unused tax credits can be utilised.

To the extent that it is not probable that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised, the deferred tax asset is not recognised.

Additional disclosures are required when an entity recognises a deferred tax asset on the assumption that there will be future taxable profits available in excess of the amount of existing taxable temporary differences, and the entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates (see section 14.3 below). *[IAS 12.35]*.

Some have suggested that the IASB should set time limits on the foresight period used. We consider that such generalised guidance would be inappropriate, particularly in the context of an international standard, which must address the great variety of tax systems that exist worldwide, and which impose a wide range of restrictions on the carryforward of tax losses or tax credits. In any event, it may well be the case that a deferred tax asset recoverable in twenty years from profits from a currently existing long-term supply contract with a creditworthy customer may be more robust than one recoverable in one year from expected future trading by a start-up company.

14 *IFRIC Update*, May 2014, available on the IFRS Foundation's website.

15 *IFRIC Update*, May 2014, available on the IFRS Foundation's website.

16 *IFRIC Update*, May 2014, available on the IFRS Foundation's website.

7.5.6.A Where taxable temporary differences were recognised outside profit or loss

As noted above, where an entity has a history of recent losses, or even where it expects to continue to incur trading losses in the future, it still recognises a deferred tax asset for the carryforward of unused tax losses or tax credits to the extent that it has sufficient taxable temporary differences against which those tax losses and tax credits can be utilised. *[IAS 12.35]*. This will be the case for taxable temporary differences that relate to the same taxation authority and the same taxable entity, and which are expected to reverse in the same period as the asset, or in a period into which a loss arising from the asset may be carried back or forward. *[IAS 12.28]*.

It is irrelevant whether the taxable temporary differences were recognised in profit or loss, other comprehensive income or directly in equity, provided that offset is not restricted under local tax law. For example, a taxable temporary difference arises when assets are carried at fair value. *[IAS 12.20]*. For debt instruments classified as fair value through other comprehensive income and for property, plant and equipment the related taxable temporary difference is recognised in other comprehensive income together with the revaluation gain or loss. Deferred tax is also recorded outside profit and loss when the initial carrying value of a compound financial instrument is split between its liability and equity components, and a related taxable temporary difference is recognised in equity (see section 7.2.7 above).

If local tax laws do not restrict the tax losses and tax credits to be utilised against the reversal of those taxable temporary differences, then a deferred tax asset is recognised. The deferred tax asset is recognised through profit or loss, except in those circumstances where the losses are related to transactions that were originally recognised outside profit or loss. *[IAS 12.61A]*. Illustration 10-7 in section 10.5 below demonstrates the recognition of a deferred tax asset in profit or loss on the basis of a deferred tax liability accounted for outside profit or loss.

7.5.7 Reassessment of deferred tax assets

An entity must review its deferred tax assets, both recognised and unrecognised, at each reporting date.

7.5.7.A Previously recognised assets

An entity must reduce the carrying amount of a deferred tax asset to the extent that it is no longer probable that sufficient taxable profit will be available to enable the asset to be recovered. Any such reduction must be reversed if it subsequently becomes probable that sufficient taxable profit will be available. *[IAS 12.56]*.

7.5.7.B Previously unrecognised assets

An entity recognises a previously unrecognised deferred tax asset to the extent that it has become probable that sufficient taxable profit will be available to enable the asset to be recovered. For example, an improvement in trading conditions may make it more probable that the entity will be able to generate sufficient taxable profit in the future for the deferred tax asset to meet the recognition criteria. Special considerations apply when an entity re-appraises deferred tax assets of an acquired business at the date of the business combination or subsequently (see section 12.1.2 below). *[IAS 12.37]*.

7.5.8 Effect of disposals on recoverability of tax losses

In consolidated financial statements, the disposal of a subsidiary may lead to the derecognition of a deferred tax asset in respect of tax losses because either:

- The entity disposed of had incurred those tax losses itself

  Or

- The entity disposed of was the source of probable future taxable profits against which the tax losses of another member of the group could be offset, allowing the group to recognise a deferred tax asset

It is clear that, once the disposal has been completed, those tax losses will no longer appear in the disposing entity's statement of financial position. What is less clear is whether those tax losses must be derecognised before the disposal itself is accounted for and, if so, when. IAS 12 does not give any explicit guidance on this point, beyond the general requirement to recognise tax losses only to the extent that their recoverability is probable (see section 7.5 above).

How we see it

In our view, three broad circumstances need to be considered:

- The entity has recognised a deferred tax asset in respect of tax losses of the subsidiary to be disposed of, the recoverability of which is dependent on future profits of that subsidiary (see section 7.5.8.A below).
- The entity has recognised a deferred tax asset in respect of tax losses of a subsidiary that is to remain in the group, the recoverability of which is dependent on future profits of the subsidiary to be disposed of (see section 7.5.8.B below).
- The entity has recognised a deferred tax asset in respect of tax losses of the subsidiary to be disposed of, the recoverability of which is dependent on future profits of one or more entities that are to remain in the group (see section 7.5.8.C below).

7.5.8.A Tax losses of a subsidiary disposed of recoverable against profits of that subsidiary

In this situation, we believe that the deferred tax asset for the losses must remain recognised until the point of disposal, provided that the expected proceeds of the disposal are expected at least to be equal to the total consolidated net assets of the entity to be disposed of, including the deferred tax asset. Whilst the group will no longer recover the tax losses through a reduction in its future tax liabilities, it will effectively recover their value through the disposal. Moreover, it would be expected that the disposal price would reflect the availability of usable tax losses in the disposed of entity, albeit that any price paid would reflect the fair value of such tax losses, rather than the undiscounted value required to be recorded by IAS 12 (see section 8.6 below).

7.5.8.B Tax losses of a retained entity recoverable against profits of a subsidiary disposed of

In this case, we believe that IAS 12 requires the deferred tax asset to be derecognised once the disposal of the profitable subsidiary is probable (effectively meaning that the recoverability of losses by the retained entity is no longer probable). This derecognition threshold may be reached before the subsidiary to be disposed of is classified as held for sale under IFRS 5 (see Chapter 5). This is because the threshold for derecognising the deferred tax asset under IAS 12 (i.e., that the sale of the subsidiary is probable) is lower than the threshold for accounting for the net assets of the subsidiary under IFRS 5 (i.e., that the subsidiary is ready for sale, and the sale is highly probable).

7.5.8.C Tax losses of a subsidiary disposed of recoverable against profits of a retained entity

In this situation, we believe that more than one analysis is possible. One view would be that - as in section 7.5.8.A above - a deferred tax asset for the losses must remain recognised until the point of disposal, provided that the expected proceeds of the disposal are at least equal to the total consolidated net assets of the entity to be disposed of, including the deferred tax asset. Another view would be that the asset must be derecognised. In contrast to the situation in section 7.5.8.A above, it is not the case that the losses are of any benefit to the acquiring entity since they are recognised by virtue of the expected profits of other entities in the group which are not being sold. Rather, as in section 7.5.8.B above, the likely separation of the subsidiary from the profits available in one or more retained entities means that the utilisation of those losses by the retained subsidiary is no longer probable. A third view would be that it is necessary to determine whether or not the losses would be of value to the acquirer. If so, they must continue to be recognised to the extent that they are being recovered by the disposing entity through the sales proceeds (as in section 7.5.8.A above). If not, they must be derecognised on the grounds that they will not be recovered either through a reduction in future taxable profits of the disposing entity, or through sale (as in section 7.5.8.B above).

7.6 'Outside' temporary differences relating to subsidiaries, branches, associates and joint arrangements

Investments in subsidiaries, branches and associates or interests in joint arrangements can give rise to two types of temporary difference:

- Differences between the tax base of the investment or interest and its carrying amount. 'Tax base' refers to the amount that will be deductible for tax purposes against any taxable benefits arising when the carrying value of the asset is recovered. *[IAS 12.7]*. The tax base will be determined by the rules set in the relevant tax jurisdiction. It may be the original cost of the equity held in that investment or interest or its current fair value or even an historic amount excluding unremitted earnings. That will be determined by the local tax laws. 'Carrying amount' in this context means:
  - In separate financial statements, the carrying amount of the relevant investment or interest.
  - In financial statements other than separate financial statements, the carrying amount of the net assets (including goodwill) relating to the relevant investment or interest, whether accounted for by consolidation or equity accounting.

  These differences are generally referred to in practice as 'outside' temporary differences, and normally arise in the tax jurisdiction of the entity that holds the equity in the investment or interest. Accordingly, in general they directly affect the taxable profit of the investor entity.
- In financial statements other than separate financial statements, differences between the tax bases of the individual assets and liabilities of the investment or interest and the carrying amounts of those assets and liabilities (as included in those financial statements through consolidation or equity accounting).

  These differences are generally referred to in practice as 'inside' temporary differences. They normally arise in the tax jurisdiction of the investment or interest and affect the taxable profit of the investee entity.

This section is concerned with 'outside' temporary differences, the most common source of which is the undistributed profits of the investee entities, where distribution to the investor would trigger a tax liability. 'Outside' temporary differences may also arise from a change in the carrying value of an investment due to exchange movements, provisions, or revaluations; or from a change in the tax base of the investee in the jurisdiction of the investor.

The reversal of most 'inside' temporary differences is essentially inevitable as assets are recovered or liabilities settled at their carrying amount in the normal course of business. However, an entity may be able to postpone the reversal of some or all of its 'outside' differences more or less permanently. For example, if a distribution of the retained profits of a subsidiary would be subject to withholding tax, the parent may effectively be able to avoid such a tax by making the subsidiary reinvest all its profits into the business. IAS 12 recognises this essential difference in the nature of 'outside' and 'inside' temporary differences by setting different criteria for the recognition of 'outside' temporary differences.

As noted in section 7.2.9 above, the initial recognition exception does not apply to temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements. *[IAS 12.15, IAS 12.24]*. The provisions of IAS 12 applicable to these temporary differences are set out in sections 7.6.2 and 7.6.3 below.

7.6.1 Calculation of 'outside' temporary differences

As noted above, 'outside' temporary differences arise in both consolidated and separate financial statements and may well be different, due to the different bases used to account for subsidiaries, branches and associates or interests in joint arrangements in consolidated and separate financial statements. *[IAS 12.38]*. This is shown in Illustration 7-23 below.

Illustration 7-23: Temporary differences associated with subsidiaries, branches, associates and joint arrangements

On 1 January 20X3 entity H acquired 100% of the shares of entity S, whose functional currency is different from that of H, for CU600m. The tax rate in H's tax jurisdiction is 30% and the tax rate in S's tax jurisdiction is 40%.

The fair value of the identifiable assets and liabilities (excluding deferred tax assets and liabilities) of S acquired by H is set out in the following table, together with their tax base in S's tax jurisdiction and the resulting temporary differences (all figures in CU millions).

	Fair value	Tax base	(Taxable)/ Deductible temporary difference
PP&E	270	155	(115)
Accounts receivable	210	210	-
Inventory	174	124	(50)
Retirement benefit obligations	(30)	-	30
Accounts payable	(120)	(120)	-
Fair value of net assets acquired excluding deferred tax	504	369	(135)
Deferred tax (135 @ 40%)	(54)		
Fair value of identifiable assets acquired and liabilities assumed	450		
Goodwill (balancing figure)	150		
Carrying amount	600		

No deferred tax is recognised on the goodwill, in accordance with the requirements of IAS 12 as discussed in section 7.2.2.A above.

At the date of combination, the tax base, in H's tax jurisdiction, of H's investment in S is CU600 million. Therefore, in H's jurisdiction, no temporary difference is associated with the investment, either in the consolidated financial statements of H (where the investment is represented by net assets and goodwill of CU600 million), or in its separate financial statements, if prepared (where the investment is shown as an investment at cost of CU600 million).

During 20X3:

- S makes a profit after tax, as reported in H's consolidated financial statements, of CU150 million, of which CU80 million is paid as a dividend (after deduction of withholding tax) before 31 December 20X3, leaving a net retained profit of CU70 million.
- In accordance with IAS 21, H's consolidated financial statements record a loss of CU15 million on retranslation to the closing exchange rate of S's opening net assets and profit for the period.
- In accordance with IAS 36 *Impairment of Assets*, H's consolidated financial statements record an impairment loss of CU10 million in respect of goodwill.

Thus, in H's consolidated financial statements the carrying value of its investment in S is CU645 million, comprising:

	CU m
Carrying amount at 1.1.20X3	600
Retained profit	70
Exchange loss	(15)
Impairment of goodwill	(10)
Carrying amount at 31.12.20X3	645

7.6.1.A Consolidated financial statements

Assuming that the tax base in H's jurisdiction remains CU600 million, there is a taxable temporary difference of CU45 million (carrying amount CU645m less tax base CU600m) associated with S in H's consolidated financial statements. Whether or not any deferred tax is required to be provided for on this difference is determined in accordance with the principles discussed in section 7.6.2 below. Any tax provided for would be allocated to profit or loss, other comprehensive income or equity in accordance with the general provisions of IAS 12 (see section 10 below). In this case, the foreign exchange loss, as a presentational rather than a functional exchange difference, would be recognised in other comprehensive income (see Chapter 16 at section 6.1), as would any associated tax effect. The other items, and their associated effects, would be recognised in profit or loss.

Irrespective of whether provision is made for deferred tax, H would be required to make disclosures in respect of this difference (see section 14.2.2 below).

7.6.1.B Separate financial statements of investor

The amount of any temporary difference in H's separate financial statements would depend on the accounting policy adopted in those statements. IAS 27 *Separate Financial Statements* allows entities the choice of accounting for investments in group companies at either cost (less impairment), using the equity method or at fair value - see Chapter 9 at section 2. Suppose that, notwithstanding the impairment of goodwill required to be recognised in the consolidated financial statements, the investment in S taken as a whole is not impaired, and indeed its fair value at 31 December 20X3 is CU660 million.

If, in its separate financial statements, H accounts for its investment at cost of CU600 million, there would be no temporary difference associated with S in H's separate financial statements, since the carrying amount and tax base of S would both be CU600 million.

If, however, in its separate financial statements, H accounts for its investment at its fair value of CU660 million, there would be a taxable temporary difference of CU60 million (carrying amount CU660m less tax base CU600m) associated with S in H's separate financial statements. Whether or not any deferred tax is required to be provided for on this difference is determined in accordance with the principles discussed in section 7.6.2 and in section 7.6.3 below. Any tax provided for would be allocated to profit or loss, other comprehensive income or equity of the investor in accordance with the general provisions of IAS 12 (see section 10 below). Irrespective of whether provision is made for deferred tax, H would be required to make disclosures in respect of this difference (see section 14.2.2 below).

IAS 27 also allows entities to use the equity method as described in IAS 28 *Investments in Associates and Joint Ventures* to account for investments in subsidiaries, joint ventures and associates in their separate financial statements. *[IAS 27.10(c)]*. Where the equity method is used, dividends from those investments are to be recognised as a reduction from the carrying value of the investment. *[IAS 27.12]*.

For taxation, the same principles apply as those discussed above. Any difference between the carrying value of the entity's interest in its subsidiaries, joint ventures and associates, in this case determined using the equity method, and the tax base in the investor's jurisdiction gives rise to a temporary difference. Whether or not any deferred tax is required to be recognised on this difference is determined in accordance with the principles discussed in section 7.6.2 below. Any tax provided for would be allocated to profit or loss, other comprehensive income or equity of the investor in accordance with the general provisions of IAS 12 (see section 10 below). This tax must not be offset against the carrying value of the investors' interest in its equity-accounted investee, since this is the investor's tax provision, not the investee's.

7.6.2 Taxable temporary differences

Extract from IAS 12

39 **An entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, except to the extent that both of the following conditions are satisfied:**

(a) the parent, investor, joint venturer or joint operator is able to control the timing of the reversal of the temporary difference; and

(b) it is probable that the temporary difference will not reverse in the foreseeable future.

[IAS 12.39].

How we see it

IAS 12 does not define the meaning of 'probable' in this context. However, we consider that, as in other IFRS accounting standards, it must be taken to mean 'more likely than not' (see section 7.1.2 above).

IAS 12 also does not elaborate on the meaning of 'foreseeable'. In our view, the period used will be a matter of judgement in individual circumstances and not limited by the setting of any arbitrary period.

What this means in practice is best illustrated by reference to its application to the retained earnings of subsidiaries, branches and joint arrangements on the one hand, and those of associates on the other.

In the case of a subsidiary or a branch, the parent is able to control when and whether the retained earnings are distributed. Therefore, no provision need be made for the tax consequences of distribution of profits that the parent has determined will not be distributed in the foreseeable future. *[IAS 12.40]*. In the case of a joint arrangement, provided that the joint venturer or joint operator can control the distribution policy, for example because any decision requires the consent of all or a group of the parties, similar considerations apply. *[IAS 12.43]*.

In the case of an associate, however, the investor cannot usually control the distribution policy. Therefore, provision must be made for the tax consequences of the distribution of the retained earnings of an associate, except to the extent that there is a shareholders' agreement that those earnings will not be distributed. *[IAS 12.42]*.

Some might consider this a counter-intuitive result. In reality, it is extremely unusual for any entity (other than one set up for a specific project) to pursue a policy of full distribution. To the extent that it occurs at all, it is much more likely in a wholly-owned subsidiary than in an associate; and yet IAS 12 seems to treat full distribution by associates as the norm and that by subsidiaries as the exception. Moreover, it seems to ignore the fact that equity accounting was developed as a regulatory response to the perceived ability of investors in associates to exert some degree of control over the amount and timing of dividends from them. However, the 'default' position in IAS 12 is that a deferred tax liability is recognised for *all* taxable temporary differences associated with investments in subsidiaries, branches and associates and interests in joint arrangements, with the exception applying only if the entity *both* controls the timing of reversal *and* it is probable that there will be no such reversal in the foreseeable future. *[IAS 12.39]*.

In some jurisdictions, some or all of the temporary differences associated with such investments in subsidiaries, branches and associates or interests in joint arrangements are taxed on disposal of that investment or interest. Clearly, where the entity is contemplating such a disposal, it would no longer be able to assert that it is probable that the relevant temporary difference will not reverse in the foreseeable future.

The measurement of any deferred tax liability recognised is discussed in section 8.4.9 below.

7.6.3 Deductible temporary differences

Extract from IAS 12

44 An entity shall recognise a deferred tax asset for all deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint arrangements, to the extent that, and only to the extent that, it is probable that:

(a) the temporary difference will reverse in the foreseeable future; and

(b) taxable profit will be available against which the temporary difference can be utilised.

IAS 12 does not define the meaning of 'probable' in this context. *[IAS 12.44]*. However, we consider that, as in other IFRS accounting standards, it must be taken to mean 'more likely than not' (see section 7.1.2 above).

The guidance discussed in section 7.5 above is used to determine whether or not a deferred tax asset can be recognised for such deductible temporary differences. *[IAS 12.45]*.

Any analysis of whether a deductible temporary difference gives rise to an asset must presumably make the same distinction between controlled and non-controlled entities as is required when assessing whether a taxable temporary difference gives rise to a liability (see section 7.6.2 above). This may mean, in practical terms, that it is never possible to recognise a deferred tax asset in respect of a non-controlled investment (such as an associate), unless either the investee entity is committed to a course of action that would realise the asset or, where the asset can be realised by disposal, that it is probable that the reporting entity will undertake such a disposal.

The measurement of any deferred tax asset recognised is discussed in section 8.4.9 below.

7.6.4 Foreseeable future - anticipated intragroup dividends

Under IAS 10, a dividend may be recognised as a liability of the paying entity and revenue of the receiving entity only if it has been declared by the paying entity before the end of the reporting period. *[IAS 10.12]*. This raises the question of when a reporting entity must account for the tax consequences of a dividend expected to be paid by a subsidiary or other investee out of its retained profits as at the reporting date.

7.6.4.A Consolidated financial statements of receiving entity

IAS 12 requires an investor to make provision for the taxes payable on the retained profits of its subsidiaries, branches, associates, and interests in joint arrangements as at each reporting date based on the best evidence available to it at the reporting date, subject only to the exception discussed in section 7.6.2 above. *[IAS 12.39]*. For example, if in preparing its financial statements for 31 December 20X3, an entity believes that, in order to meet the dividend expectations of its shareholders in 20X4 and 20X5, it will have to cause the retained earnings of certain overseas subsidiaries (as included in the group accounts at 31 December 20X3) to be distributed, the group must provide for any tax consequences of such distributions in its consolidated financial statements for the period ended 31 December 20X3. In these circumstances, the entity would be unable to assert that it is probable that the temporary difference associated with the retained earnings of these subsidiaries will not reverse in the foreseeable future. *[IAS 12.39(b)]*. Similarly, if the ability of the entity to settle financial liabilities as at the reporting date depends on the future receipt of dividends from other entities in the group, it must recognise the tax consequences of making those distributions in its consolidated financial statements for the current period.

It is not relevant that such dividends have not yet been recognised in the separate financial statements of the relevant members of the group. Indeed, such intragroup dividends will never be recognised in the group financial statements, as they will be eliminated on consolidation. IAS 12 requires recognition of the tax consequences of temporary differences as at the end of the reporting period, in this case the taxes ultimately payable on recovering the net assets of the group as at 31 December 20X3. However, for this reason it would not be appropriate to recognise any liability for the tax anticipated to be paid out of an intragroup dividend in a future period that is likely to be covered by profits generated in future periods, since such profits do not form part of the carrying amount of the net assets of the group as at 31 December 20X3.

This requirement was confirmed by the IFRS IC in June 2020, when it considered a question about how an entity, in its consolidated financial statements, accounts for deferred tax related to its investment in a subsidiary.[17] See section 8.4.9 below.

7.6.4.B Separate financial statements of paying entity

Irrespective of whether a provision is made in the consolidated financial statements for the tax effects of an expected future intragroup dividend of the retained earnings of a subsidiary, the paying subsidiary would not recognise a liability for the tax effects of any distribution in its individual or separate financial statements until the liability to pay the dividend was recognised in those individual or separate financial statements. IAS 12 requires current and deferred taxes to be measured using the rate applicable to undistributed profits until a liability to pay a dividend is recognised, as discussed in section 8.5 below. *[IAS 12.52A, IAS 12.57A]*.

7.6.5 Unpaid intragroup interest, royalties, management charges, etc.

It is common for groups of companies to access the earnings of subsidiaries not only through distribution by way of dividend, but also by levying charges on subsidiaries such as interest, royalties or general management charges for central corporate services. In practice, such charges are often not settled but left outstanding on the intercompany account between the subsidiary and the parent. In some jurisdictions, such income is taxed only on receipt.

This has led some to argue that, where settlement of such balances is within the control of the reporting entity, and it can be demonstrated that there is no foreseeable intention or need to settle outstanding amounts, such balances are economically equivalent to unremitted earnings, so that there is no need to provide for the tax consequences of settlement.

In February 2003, the IFRS IC considered the issue and indicated that it believes that the exemption from provision for deferred taxes on 'outside' temporary differences arising from subsidiaries, branches, associates and interests in joint arrangements is intended to address the temporary differences arising from the undistributed earnings of such entities. The exception does not apply to the 'inside' temporary differences that exist between the carrying amount and the tax base of individual assets and liabilities within the subsidiary, branch, associate or interest in a joint arrangement. Accordingly, the IFRS IC concluded that a deferred tax liability must be provided for the tax consequences of settling unpaid intragroup charges.[18]

17 *IFRIC Update*, June 2020, available on the IFRS Foundation's website.

18 *IFRIC Update*, February 2003, available on the IFRS Foundation's website.

7.7 'Tax-transparent' ('flow-through') entities

In many tax jurisdictions certain entities are not taxed in their own right. Instead, the income of such entities is taxed in the hands of their owners as if it were income of the owners. An example might be a partnership which does not itself pay tax, but whose partners each pay tax on their share of the partnership's profits. Such entities are sometimes referred to as 'tax-transparent' or 'flow-through' entities.

The tax status of such an entity is of no particular relevance to the accounting treatment, in the investor's financial statements, of the current tax on the income of the entity. An investor in such an entity will determine whether the entity is a subsidiary, associate, joint arrangement, branch or a financial asset investment and account for it accordingly. The investor then accounts for its own current tax payable as it arises under the relevant tax legislation.

The investor will also determine whether the basis on which the investment has been accounted for (e.g., through consolidation or equity accounting) has led to the recognition of assets or liabilities which give rise to temporary differences and recognise deferred tax on these in the normal way.

Finally, the investor will also determine whether there are 'outside' temporary differences associated with the investment as a whole and account for these as above. However, in situations where the income from the investment is, under tax law, automatically regarded as income of the investor (for example, regardless of whether such income is distributed or not), there would be no 'outside' temporary differences associated with undistributed profits. As such, the criteria in IAS 12.39 that allow non-recognition of certain taxable temporary differences would not apply (see section 7.6.2 above). *[IAS 12.39]*.

Illustration 7-24 and Illustration 7-25 show the accounting treatment for, respectively, a consolidated and an equity-accounted tax-transparent entity.

Illustration 7-24: Tax-transparent entity (consolidated)

An entity (A) acquires 60% of a tax-transparent partnership (P) for CU100 million in a transaction accounted for as a business combination. The aggregate fair value of the identifiable net assets of the partnership is CU80 million and their tax base is CU60m. A is directly liable to tax at 25% on 60% of the taxable profits of the partnership, in computing which it is entitled to offset 60% of the tax base of the assets. A elects to measure the non-controlling interest at its proportionate share of the net assets of the partnership.

The accounting entry to record the business combination is:

			CU m	CU m
Dr	Net assets		80	
Dr	Goodwill (balancing figure)		55	
	Cr	Consideration paid		100
	Cr	Deferred tax*		3
	Cr	Non-controlling interest†		32

* *In recovering the carrying value of the net assets (CU80m), A will pay tax on 60% of CU20m (CU80m - CU60m) = CU12m at 25% = CU3m.*

† *40% of CU80m.*

By contrast, if the partnership were a tax-paying entity, the accounting entry would be:

			CU m	CU m
Dr	Net assets		80	
Dr	Goodwill (balancing figure)		55	
	Cr	Consideration paid		100
	Cr	Deferred tax*		5
	Cr	Non-controlling interest†		30

* *In recovering the carrying value of the net assets (CU80m), P will pay tax on CU20m (CU80m - CU60m) at 25% = CU5m.*

† *40% of CU75m (net assets excluding deferred tax CU80m less deferred tax (as above) CU5m).*

Illustration 7-25: Tax-transparent entity (equity-accounted)

The facts are the same as in Illustration 7-24 above, except that, due to an agreement between A and the other partners, P is a jointly-controlled entity, rather than a subsidiary, of A, which accounts for P using the equity method. In this case it is less clear how to account for the deferred tax liability, which, it must be remembered, is not a liability of P, but of A and therefore does not form part of the net assets and goodwill underlying A's investment in P.

Analysis 1

One analysis might be that the deferred tax relates to a temporary difference arising on the initial recognition of the investment in P in a transaction that gives rise to no accounting or taxable profit, and therefore is not recognised under the initial recognition exception (see section 7.2.3 above). On this view, the initial accounting entry is simply:

			CU m	CU m
Dr	Investment in P		100	
	Cr	Consideration		100

Analysis 2

Another analysis might be that the true cost of the investment in P comprises both the consideration paid to the vendor and the assumption by A of the deferred tax liability associated with its share of the underlying assets (other than goodwill) of the investment. On this view the initial accounting entry is:

			CU m	CU m
Dr	Investment in P		103	
	Cr	Deferred tax (see Illustration 7-24 above)		3
	Cr	Consideration		100

This second method has the merit that it results in the same implied underlying goodwill as arises on full consolidation in Illustration 7-24 above: CU103m - CU48m [60% of CU80m] = CU55m. However, it does raise the issue of an apparent 'day one' impairment, as discussed in more detail in section 12.3 below.

How we see it

In our view, either analysis is acceptable so long as it is applied consistently.

Any income tax relating to a tax-transparent entity accounted for using equity accounting forms part of the investor's tax charge. It is therefore included in the income tax line in profit or loss and not shown as part of the investor's share of the results of the tax-transparent entity.

7.8 Deferred taxable gains

Some tax regimes mitigate the tax impact of significant asset disposals by allowing some or all of the tax liability on such transactions to be deferred, usually subject to conditions, such as a requirement to reinvest the proceeds from the sale of the asset disposed of in a similar 'replacement' asset. The postponement of tax payments achieved in this way may either be for a fixed period (e.g., the liability must be paid in any event no later than ten years after the original disposal) or for an indefinite period (e.g., the liability crystallises when, and only when, the 'replacement' asset is subsequently disposed of).

As noted in section 7.4 above, IAS 12 makes it clear that the ability to postpone payment of the tax liability arising on disposal of an asset - even for a considerable period - does not extinguish the liability. In many cases, the effect of such deferral provisions in tax legislation is to reduce the tax base of the 'replacement' asset. This will increase any taxable temporary difference, or reduce any deductible temporary difference, associated with the asset.

8 Deferred tax - Measurement

8.1 Legislation at the end of the reporting period

Deferred tax must be measured by reference to the tax rates and laws, as enacted or substantively enacted by the end of the reporting period: *[IAS 12.47, IAS 12.49]*

Extract from IAS 12	
47	**Deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.**

IAS 12 comments that, in some jurisdictions, announcements of tax rates (and tax laws) by the government have the substantive effect of actual enactment, which may follow the announcement by a period of several months. In these circumstances, deferred tax assets and liabilities are measured using the announced tax rate (and tax laws). *[IAS 12.48]*.

However, IAS 12 gives no guidance as to how this requirement is to be interpreted in different jurisdictions. The determination of the stage of the legislative process that constitutes substantive enactment, as discussed in section 5.1 above in relation to current tax, also applies to the measurement of deferred tax assets and liabilities.

Some examples of the interpretation of 'substantive enactment' in particular jurisdictions are given in section 5.1.1 above.

8.1.1 Changes to tax rates and laws enacted before the reporting date

Deferred tax must be measured by reference to the tax rates and laws, as enacted or substantively enacted by the end of the reporting period. *[IAS 12.47]*. This requirement for substantive enactment is clear. Changes that have not been enacted by the end of the reporting period are ignored, but changes that are enacted before the reporting date must be applied, even in circumstances when complex legislation is substantively enacted shortly before the end of an annual or interim reporting period.

In cases where the effective date of any enacted changes is after the end of the reporting period, deferred tax must still be calculated by applying the new rates and laws to the deductible and taxable temporary differences that are expected to reverse in those later periods. *[IAS 12.47]*. When the effective date of any rate changes is not the first day of the entity's annual reporting period, deferred tax would be calculated by applying a blended rate to the taxable profits for each year.

In implementing any amendment to enacted tax rates and laws there will be matters to consider that are specific to the actual changes being made to the tax legislation. However, the following principles from IAS 12 and other standards are relevant in all cases where new tax legislation has been enacted before the end of the reporting period.

8.1.1.A Managing uncertainty in determining the effect of new tax legislation

Where complex legislation is enacted, especially if enactment is shortly before the end of the reporting period, entities might encounter two distinct sources of uncertainty:

- Uncertainty about the requirements of the new law, which may give rise to uncertain tax treatments as defined by IFRIC 23 and discussed in sections 8.2 and 9 below
- Incomplete information because entities may not have all the data required to process the effects of the changes in tax laws

It is not necessary for entities to have a complete understanding of every aspect of the new tax law to arrive at reasonable estimates, and provided that entities make every effort to obtain and take into account all the information they could reasonably be expected to obtain up to the date when the financial statements for the period are authorised for issue, subsequent changes to those estimates would not be regarded as a prior period error under IAS 8. *[IAS 8.5]*. Only in rare circumstances would it not be possible to determine a reasonable estimate. However, these uncertainties may require additional disclosure in the financial statements. IAS 1 requires entities to disclose information about major sources of estimation uncertainty at the end of the reporting period that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year (see Chapter 3 at section 5.2.1). *[IAS 1.125, IAS 1.129]*.

Whilst the effect of changes in tax laws enacted after the end of the reporting period are not taken into account (see section 8.1.2 below), information and events that occur between the end of the reporting period and the date when the financial statements are authorised for issue are adjusting events after the reporting period if they provide evidence of conditions that existed as at the reporting date. *[IAS 10.3]*. Updated tax calculations, collection of additional data, clarifications issued by the tax authorities and gaining more experience with the previously enacted tax legislation before the authorisation of the financial statements must be treated as adjusting events if they pertain to the position at the balance sheet date. Events that are indicative of conditions that arose after the reporting period must be treated as non-adjusting events. Judgement needs to be applied in determining whether technical corrections and regulatory guidance issued after year-end pertain to the position as at the balance sheet date.

Where the effect of changes in the applicable tax rates compared to the previous accounting period are material, an explanation of those effects is required to be provided in the notes to the financial statements (see section 14.1 below). *[IAS 12.81(d)]*.

8.1.1.B Backward tracing of changes in deferred taxation

IAS 12 requires tax relating to items not accounted for in profit or loss, whether in the same period or a different period, to be recognised:

(a) In other comprehensive income if it relates to an item accounted for in other comprehensive income

Or

(b) Directly in equity if it relates to an item accounted for directly in equity *[IAS 12.61A]*

If current and deferred taxes change as a result of new tax legislation, IAS 12 requires the impact to be attributed to the items in profit or loss, other comprehensive income and equity that gave rise to the tax in the first place. The requirement to have regard to the previous history of a transaction in accounting for its tax effects is commonly referred to as 'backward tracing' and is discussed in section 10 below. The backward tracing requirements also apply to any subsequent changes in accounting estimates.

8.1.1.C Disclosures relating to changes in enacted tax rates and laws

In addition to the disclosures noted in section 8.1.1.A above concerning major sources of estimation uncertainty at the end of the reporting period, the following disclosures are required by IAS 12 (see section 14 below):

- The amount of deferred tax expense (or income) relating to changes in tax rates or the imposition of new taxes. *[IAS 12.80(d)]*.
- An explanation of changes in the applicable tax rate(s) compared to the previous accounting period. *[IAS 12.81(d)]*.
- Information about tax-related contingent liabilities and contingent assets in accordance with the requirements of IAS 37 (see section 9.6 below and Chapter 27 at section 7). *[IAS 12.88]*.

8.1.2 Changes to tax rates and laws enacted after the reporting date

The requirement for substantive enactment as at the end of the reporting period is clear. IAS 10 identifies the enactment or announcement of a change in tax rates and laws after the end of the reporting period as an example of a non-adjusting event. *[IAS 10.22(h)]*. For example, an entity with a reporting period ending on 31 December issuing its financial statements on 20 April the following year would measure its tax assets and liabilities by reference to tax rates and laws enacted or substantively enacted as at 31 December even if these had changed significantly before 20 April and even if those changes have retrospective effect. However, in these circumstances the entity would have to disclose the nature of those changes and provide an estimate of the financial effect of those changes if the impact is expected to be significant (see section 14.2 below). *[IAS 10.21]*.

8.2 Uncertain tax treatments

'Uncertain tax treatment' is defined as a tax treatment over which there is uncertainty concerning its acceptance under the law by the relevant taxation authority. For example, an entity's decision not to submit any tax filing in a particular tax jurisdiction or not to include specific income in taxable profit would be an uncertain tax treatment, if its acceptability is unclear under tax law. *[IFRIC 23.3]*.

Accounting for uncertain tax treatments is a particularly challenging aspect of accounting for tax. The requirements of IFRIC 23, which was issued in June 2017, are mandatory for annual reporting periods beginning on or after 1 January 2019 and are discussed in section 9 below.

8.3 'Prior year adjustments' of previously presented tax balances and expense (income)

This is discussed in the context of current tax in section 5.3 above. The comments there apply equally to adjustments to deferred tax balances and expense (income). Accordingly, for accounting purposes, the normal provisions of IAS 8 apply, which require an entity to determine whether the revision represents a correction of a material prior period error or a refinement in the current period of an earlier estimate.

8.4 Expected manner of recovery of assets or settlement of liabilities

Deferred tax must be measured by reference to the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of the asset or liability to which it relates. *[IAS 12.51]*.

8.4.1 Tax planning strategies to reduce liabilities are not anticipated

As discussed in section 7.5.4 above, IAS 12 allows tax planning strategies to be taken into account in determining whether a deductible temporary difference as at the reporting date can be recognised as a deferred tax asset, provided that the entity will create taxable profit in appropriate periods. *[IAS 12.29(b)]*. This raises the question of the extent to which tax planning strategies may be taken into account more generally in applying IAS 12.

For example, some jurisdictions may offer incentives in the form of a significantly reduced tax rate for entities that undertake particular activities, or invest in particular plant, property and equipment, or create a certain level of employment.

Some have argued that, where an entity has the ability and intention to undertake transactions in the future that will lead to it being taxed at a lower rate, it may take this into account in measuring deferred tax liabilities relating to temporary differences that exist at the reporting date and will reverse in future periods when the lower rate is expected to apply.

How we see it

We believe that it is not appropriate to anticipate the effect of tax planning strategies in the measurement of deferred tax liabilities. IAS 12 only allows entities to consider tax planning opportunities available to the entity that will create taxable profits in appropriate periods for the purpose of determining whether deferred tax assets qualify for recognition. However, entities are not permitted to take into account future tax planning opportunities in relation to the measurement of deferred tax liabilities as at the reporting date, nor are entities allowed to anticipate future tax deductions that are expected to become available. Such opportunities do not impact on the measurement of deferred tax until the entity has undertaken them, or is at least irrevocably committed to doing so.

8.4.2 Carrying amount

IAS 12 requires an entity to account for the tax consequences of recovering an asset or settling a liability at its carrying amount, and not, for example, the tax that might arise on a disposal at the current estimated fair value of the asset. This is illustrated by the example below.

Illustration 8-1: Measurement of deferred tax based on carrying amount of asset

During 20X3 an entity, which has an accounting date of 31 December and pays tax at 40%, purchased a business and assigned CU3 million of the purchase consideration to goodwill. The goodwill originally had a tax base of CU3 million, deductible only on disposal of the goodwill. Thus there was no temporary difference on initial recognition of the goodwill (and, even if there had been, no deferred tax would have been recognised under the initial recognition exception - see section 7.2.2 above). During 20X4 the entity disposed of another business giving rise to a taxable gain of CU500,000. The tax law of the relevant jurisdiction allowed the gain to be deferred by deducting it from the tax base of the goodwill, which therefore became CU2.5 million.

How we see it

Since IFRS accounting standards prohibits the amortisation of goodwill, but instead requires it to be measured at cost less impairment, in our view IAS 12 effectively requires any deferred tax to be measured at the amount that would arise if the goodwill were sold at its carrying amount.

At the end of 20X4, the goodwill was still carried at CU3 million. The decrease in the tax base during the period through deferral of the taxable gain gave rise to a taxable temporary difference of CU500,000 (CU3 million carrying amount less CU2.5 million tax base), which, since it arose after the initial recognition of the goodwill (see section 7.2.4 above), gave rise to the recognition of a deferred tax liability of CU200,000 (CU500,000 @ 40%).

During 20X5, the acquired business suffered a severe downturn in trading, such that the goodwill of CU3 million was written off in its entirety. This gave rise to a deductible temporary difference of CU2.5 million (carrying amount of zero less CU2.5 million tax base). The deferred tax liability of CU200,000 recognised at the end of 20X4 was released. However, no deferred tax asset was recognised since it did not meet the criteria in IAS 12 for recognition of deferred tax assets, since there was no expectation of suitable taxable profits sufficient to enable recovery of the asset (see section 7.5 above).

During 20X6, a new trading opportunity arises in the acquired business, with the result that, at the end of 20X6, the value of the goodwill of that business is once more CU3 million. However, in accordance with IAS 36, which prohibits the reinstatement of previously impaired goodwill (see Chapter 21 at section 8.2.4), no accounting adjustment is made to the carrying value of goodwill.

If the goodwill were disposed of for its current fair value of CU3 million, tax of CU200,000 would arise. However, the entity recognises no deferred tax liability at the end of 20X6, since IAS 12 requires the entity to recognise the tax (if any) that would arise on disposal of the goodwill for its carrying amount of zero. If the asset were sold for zero, a tax loss of CU2.5 million would arise but, in accordance with the general provisions of IAS 12 discussed in section 7.5 above, a deferred tax asset could be recognised in respect of this deductible temporary difference only if there were an expectation of suitable taxable profits sufficient to enable that tax loss to be utilised.

This may mean that any deferred tax asset or liability recognised under IAS 12 will reflect the expected manner of recovery or settlement, but not the expected amount of recovery or settlement, where this differs from the current carrying amount.

8.4.3 Assets and liabilities with more than one tax base

Assets which are treated differently for tax purposes depending on whether their value is recovered through use or sale are commonly referred to as 'dual-based assets'. *[IAS 12.51A].*

Extract from IAS 12

51A In some jurisdictions, the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of:

(a) the tax rate applicable when the entity recovers (settles) the carrying amount of the asset (liability); and

(b) the tax base of the asset (liability).

In such cases, an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement.

...

The basic requirements of IAS 12 for dual-based assets can be illustrated with an example.

Illustration 8-2: Calculation of deferred tax depending on method of realisation of asset

A building, which is fully tax-deductible, originally cost CU1 million. At the end of the reporting period it is carried at CU1,750,000, but tax allowances of CU400,000 have been claimed in respect of it. If the building were sold the tax base of the building would be CU1.5 million due to inflation-linked increases in its tax base.

Any gain on sale (calculated as sale proceeds less tax base of CU1.5 million) would be taxed at 40%. If the asset is consumed in the business, its depreciation will be charged to profits that are taxed at 30%.

If the intention is to retain the asset in the business, its carrying amount will be recovered out of future income of CU1.75 million, on which tax of CU345,000 will be paid, calculated as:

	CU000
Gross income (carrying amount of asset)	1,750
Future tax allowances for asset (CU1m less CU400,000 claimed to date)	(600)
	1,150
Tax at 30%	345

If, however, the intention is to sell the asset without further use, the required deferred tax liability is only CU100,000 calculated as:

	CU000
Sales proceeds (carrying amount of asset)	1,750
Tax base	(1,500)
	250
Tax at 40%	100

8.4.4 Determining the expected manner of recovery of assets

Illustration 8-2 above, like the various similar examples in IAS 12, assumes that an asset will either be used in the business or sold. In practice, however, many assets are acquired, used for part of their life and then sold before the end of that period. This is particularly the case with long-lived assets such as property. We set out below the approach which we believe must be adopted in assessing the manner of recovery of:

- Depreciable PP&E, investment properties and intangible assets (see section 8.4.5 below)
- Non-depreciable PP&E, investment properties and intangible assets (see sections 8.4.6 and 8.4.7 below)
- Other assets and liabilities (see section 8.4.8 below)

8.4.5 Depreciable PP&E and intangible assets

Depreciable PP&E and investment properties are accounted for in accordance with IAS 16. Amortisable intangibles are accounted for in accordance with IAS 38. IAS 16 and IAS 38, which are discussed in detail in Chapters 18 and 19, require the carrying amount of a depreciable asset to be separated into a 'residual value' and a 'depreciable amount'.

'Residual value' is defined as:

> "... the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and condition expected at the end of its useful life".

And 'depreciable amount' as:

> "... the cost of an asset, or other amount substituted for cost, less its residual value". *[IAS 16.6, IAS 38.8]*.

It is inherent in the definitions of residual value and depreciable amount that, in determining residual value, an entity is effectively asserting that it expects to recover the depreciable amount of an asset through use and its residual value through sale. If the entity does not expect to sell an asset, but to use and scrap it, then the residual value (i.e., the amount that would be obtained from sale) must be nil.

How we see it

Accordingly, we believe that, in determining the expected manner of recovery of a depreciable asset for the purposes of IAS 12, an entity must assume that, in the case of an asset accounted for under IAS 16 or IAS 38, it will recover the residual value of the asset through sale and the depreciable amount through use. This view is reinforced by the Basis for Conclusions on IAS 12 which notes that "recognition of depreciation implies that the carrying amount of a depreciable asset is expected to be recovered through use to the extent of its depreciable amount, and through sale at its residual value".

Such an analysis is also consistent with the requirement of IAS 8 to account for similar transactions consistently (see Chapter 3 at section 4.1.4). This suggests that consistent assumptions must be used in determining both the residual value of an asset for the purposes of IAS 16 and IAS 38 and the expected manner of its recovery for the purposes of IAS 12.

The effect of this treatment is demonstrated as follows:

Illustration 8-3: Dual-based asset

As part of a business combination an entity purchases an opencast mine to which there is assigned a fair value of CU10 million. The tax system of the jurisdiction where the mine is located provides that, if the site is sold (with or without the minerals *in situ*), CU9 million will be allowed as a deduction in calculating the taxable profit on sale. The profit on sale of the land is taxed as a capital item. If the mine is exploited through excavation and sale of the minerals, no tax deduction is available.

The entity intends fully to exploit the mine and then to sell the site for retail development. Given the costs that any developer will need to incur in preparing the excavated site for development, the ultimate sales proceeds are expected to be CU6 million. Thus, for the purposes of IAS 16, the quarry is treated as having a depreciable amount of CU4 million and a residual value of CU6 million.

On the analysis above, there is a taxable temporary difference of CU4 million associated with the depreciable amount of the asset (carrying amount of CU4 million less tax base in use of nil), and a deductible temporary difference of CU3 million associated with the residual value (carrying amount of CU6 million less tax base on disposal of CU9 million).

The entity will therefore provide for a deferred tax liability on the taxable temporary difference. The extent to which a deferred tax asset is recognised in respect of the deductible temporary difference will depend on whether it is probable that taxable profits will be available against which that deductible temporary difference can be utilised (see section 7.5 above). In some tax regimes, capital profits and losses are treated more or less separately from revenue profits and losses to a greater or lesser degree, so that it may be difficult to recognise such an asset due to a lack of suitable taxable profits.

This has not been the only interpretation of IAS 12 adopted in practice and there has been diversity as a result. However, in response to a request for guidance on this matter, the IFRS IC issued an agenda decision in April 2020 that supports the above analysis, as follows:[19]

Frequently asked questions

Question 8-1: How do you determine the tax base of an asset under IAS 12, when for tax purposes no deductions are available through use; but its cost is fully deductible when sold?

The IFRS IC was asked to consider an example in which an entity acquires an intangible asset with a finite useful life (a licence) as part of a business combination. The entity intends to recover the carrying amount of the licence through use, and the expected residual value of the licence at expiry is nil. Under the applicable tax law, two tax regimes are prescribed: an income tax regime and a capital gains tax regime. Any tax arising under each regime is not permitted to be offset in determining taxable profit. Tax paid under both regimes meets the definition of income taxes in IAS 12. Recovering the licence's carrying amount has both of the following tax consequences:

- Under the income tax regime - the entity pays income tax on the economic benefits it receives from recovering the licence's carrying amount through use, but receives no tax deductions in respect of amortisation of the licence (taxable economic benefits from use).
- Under the capital gains tax regime - the entity receives a tax deduction when the licence expires that is equal to its initial carrying value (capital gain deduction). The capital gain deduction cannot be used to offset the taxable economic benefits from use in determining taxable profits.

In reaching its conclusion, the IFRS IC cited the fundamental principle on which IAS 12 is based, that "an entity shall, with certain limited exceptions, recognise a deferred tax liability (asset) whenever recovery or settlement of the carrying amount of an asset or liability would make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences". *[IAS 12.10]*. The IFRS IC determined that the entity should separately identify the temporary differences in a manner that reflects the distinct tax consequences under the two tax regimes of recovering the asset's carrying amount, by comparing:

(a) The portion of the asset's carrying amount that will be recovered under one tax regime

To

(b) The tax deductions the entity will receive under that same tax regime (which are reflected in the asset's tax base)

19 *IFRIC Update*, April 2020, available on the IFRS Foundation's website.

In the fact pattern described in the request, the IFRS IC concluded that the entity identifies both:

(a) A taxable temporary difference under the income tax regime, reflecting the fact that it will receive no tax deductions as it recovers the asset through use

And

(b) A deductible temporary difference under the capital gains tax regime, representing the deduction received upon expiry of the licence

The entity should then apply the requirements in IAS 12 considering the applicable tax law in recognising and measuring deferred tax for the identified temporary differences.

On this basis, the IFRS IC concluded that the principles and requirements in IAS 12 provide an adequate basis for an entity to recognise and measure deferred tax in the fact pattern described in the request and consequently decided not to add the matter to its standard-setting agenda.[20]

8.4.6 Non-depreciable PP&E and intangible assets

During 2009 and 2010 the IASB received representations from various entities and bodies that it was often difficult and subjective to determine the manner of recovery of certain categories of asset for the purposes of IAS 12. This was particularly the case for investment properties accounted for at fair value under IAS 40 which are often traded opportunistically, without a specific business plan, but yield rental income until disposed of. In many jurisdictions rental income is taxed at the standard rate, while gains on asset sales are tax-free or taxed at a significantly lower rate. The principal difficulty was that the then extant guidance (SIC-21 *Income Taxes - Recovery of Revalued Non-Depreciable Assets*) effectively required entities to determine what the residual amount of the asset would be if it were depreciated under IAS 16 rather than accounted for at fair value, which many regarded as resulting in nonsensical tax effect accounting.

To deal with these concerns, in December 2010 the IASB amended IAS 12 so as to give more specific guidance on determining the expected manner of recovery for non-depreciable assets measured using the revaluation model in IAS 16 (see section 8.4.6.A below) and for investment properties measured using the fair value model in IAS 40 (see section 8.4.7 below). As noted in section 8.4.6.B below, an indefinite-life intangible asset (that is not amortised because its useful economic life cannot be reliably determined) is not the same as a non-depreciable asset to which this amendment would apply.

8.4.6.A PP&E accounted for using the revaluation model

IAS 16 allows property, plant and equipment (PP&E) to be accounted for using a revaluation model under which PP&E is regularly revalued to fair value (see Chapter 19 at section 6). IAS 12 clarifies that where a non-depreciable asset is revalued, any deferred tax on the revaluation must be calculated by reference to the tax consequences that would arise if the asset were sold at book value irrespective of the basis on which the carrying amount of the asset is measured. *[IAS 12.51B]*. The rationale for this treatment is that, in accounting terms, the asset is never recovered through use, as it is not depreciable. *[IAS 12.BC6]*.

IAS 12 clarifies that these requirements are subject to the general restrictions on the recognition of deferred tax assets (see section 7.5 above). *[IAS 12.51E]*.

An issue not explicitly addressed in IAS 12 is whether the term 'non-depreciable' asset refers to an asset that is not currently being depreciated or to one that does not have a limited useful life. This is explored further in the discussion of non-amortised intangible assets immediately below.

8.4.6.B Non-amortised or indefinite-life intangible assets

Under IAS 38 an intangible asset with an indefinite life is not subject to amortisation.

The analysis in sections 8.4.5 and 8.4.6.A above would appear to lead to the conclusion that, where an intangible asset is not amortised, any deferred tax related to that asset must be measured on an 'on sale' basis. IAS 12 requires tax to be provided for based on the manner in which the entity expects to recover the 'carrying amount' of its assets. In this case it could be argued that if the asset is not amortised under IAS 38, the financial statements are asserting that the carrying amount is not recovered through use.

20 *IFRIC Update*, April 2020, available on the IFRS Foundation's website.

However, an alternative analysis would be that the fact that an intangible asset is not being amortised does not necessarily indicate that the expected manner of recovery is by sale or through use. The determination of an indefinite life under IAS 38 means that there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity. *[IAS 38.88]*. This could still indicate an expectation of recovery through use.

Frequently asked questions

Question 8-2: How do you determine the expected manner of recovery for an intangible asset that is not being amortised because it has an indefinite useful life?

This question was considered by the IFRS IC, which issued an agenda decision in November 2016, as follows:[21]

The requirements in IAS 12.51B do not apply to indefinite-life intangible assets. An indefinite-life intangible asset is not a non-depreciable asset as envisaged by IAS 12.51B. This is because a non-depreciable asset has an unlimited (or infinite) life. IAS 38 is clear that the term 'indefinite' does not mean 'infinite'. *[IAS 38.91]*.

- The reason for not amortising an indefinite-life intangible asset is not because there is no consumption of the future economic benefits embodied in the asset. When the IASB amended IAS 38 in 2004, it observed that an indefinite-life intangible asset is not amortised because there is no foreseeable limit on the period during which the entity expects to consume the future economic benefits embodied in the asset and, hence, amortisation over an arbitrarily determined maximum period would not be representationally faithful. *[IAS 38.BC74]*.
- The fact that an entity does not amortise an indefinite-life intangible asset does not necessarily mean that its carrying amount will be recovered only through sale and not through use. An entity recovers the carrying amount of an asset in the form of economic benefits that flow to the entity in future periods, which could be through use or sale of the asset.
- Accordingly, an entity should determine its expected manner of recovery of the carrying value of the indefinite-life intangible asset in accordance with the principle and requirements in IAS 12.51 and 51A (as discussed in section 8.4.3 above) and reflect the tax consequences that follow from that expected manner of recovery.

Whilst the agenda decision required entities to review cases where they have previously applied IAS 12.51B to indefinite-life intangible assets, it does not imply a presumption that the carrying amount of an indefinite-life intangible asset is always recovered through use (or for that matter through sale). The agenda decision emphasises that entities must apply the principle and requirements in IAS 12.51 and 51A that the tax consequences follow the expected manner of recovery of the asset.

How we see it

As noted above, this is a judgement made by reference to the entity's specific circumstances including its business model. Therefore, it remains possible that an entity could determine recovery through sale by applying the requirements of IAS 12.51 and 51A. However, such a conclusion would require an entity to be able to demonstrate that the facts and circumstances, including the entity's business model, support a realistic expectation that the specific intangible asset would be disposed of before any material recovery of its carrying amount had occurred through use.

It is possible that an entity applies the principle and requirements in IAS 12.51 and 51A and determines that, in its opinion, a portion of the indefinite-life intangible asset is expected to be recovered through use and another component is expected to be recovered through sale. In this case, the entity must challenge its original conclusion that the asset has an indefinite-life, in particular, that 'there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity'. *[IAS 38.88]*.

Another question that often arises in the context of expected manner of recovery of an indefinite-life intangible asset is whether an entity must have a formal plan to sell the asset in order to determine an expected recovery through sale. Unlike other Standards (such as IFRS 5), IAS 12 does not require there to be a formal plan to sell the asset. Accordingly, judgement is required in deciding whether recovery is through sale if there are no immediate plans to sell the asset.

21 *IFRIC Update*, July 2016, available on the IFRS Foundation's website.

An impairment of an indefinite-life intangible asset or non-depreciable asset previously determined to be recovered through sale does not automatically change the expected manner of recovery of the asset. The recoverable amount under IAS 36 is defined as the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use regardless of the intent of management, whereas the expected manner of recovery will take management intent into account. Accordingly, an impairment charge can arise simply because of a change in the entity's estimate of the asset's recoverable amount. If an indefinite-life intangible asset is impaired, it is appropriate to challenge the validity of the entity's original determination that the asset life was indefinite. If it is determined that the asset is now depreciable, there is a change in the expected manner of recovery of at least the depreciable portion of the asset under IAS 12.51. When an entity starts to amortise the indefinite-life intangible asset, the asset ceases to be an indefinite life intangible asset, and the change is accounted as a change in estimate under IAS 8. *[IAS 38.109]*.

8.4.7 Investment properties

IAS 40 allows investment properties to be accounted for at fair value (see Chapter 20 at section 6). IAS 12 requires any deferred tax asset or liability associated with such a property to be measured using a rebuttable presumption that the carrying amount of the investment property will be recovered through sale. *[IAS 12.51C]*. The same rebuttable presumption is used when measuring any deferred tax asset or liability associated with an investment property acquired in a business combination if the entity intends to adopt the fair value model in accounting for the property subsequently. *[IAS 12.51D]*.

The presumption is rebutted if the investment property is depreciable and the entity's business model is to consume substantially all the economic benefits embodied in the investment property over time, rather than through sale. The IFRS IC has clarified that the presumption can be rebutted in other circumstances, provided that sufficient evidence is available to support that rebuttal. However, the IFRS IC neither gave any indication of, nor placed any restriction on, what those other circumstances might be.[22] If the presumption is rebutted, the entity applies the normal requirements of IAS 12 for determining the manner of recovery of assets (see sections 8.4.1 to 8.4.5 above). *[IAS 12.51C]*.

IAS 12 clarifies that these requirements are subject to the general restrictions on the recognition of deferred tax assets (see section 7.5 above). *[IAS 12.51E]*.

8.4.8 Other assets and liabilities

In a number of areas of accounting IFRS accounting standards effectively requires a transaction to be accounted for in accordance with an assumption as to the ultimate settlement of that transaction that may not reflect the entity's expectation of the actual outcome.

For example, if the entity enters into a share-based payment transaction with an employee that gives the employee the right to require settlement in either shares or cash, IFRS 2 requires the transaction to be accounted for on the assumption that it will be settled in cash, however unlikely this may be. IAS 19 may assert that an entity has a surplus on a defined benefit pension scheme on an accounting basis, when in reality it has a deficit on a funding basis. Similarly, if an entity issues a convertible bond that can also be settled in cash at the holder's option, IAS 32 requires the bond to be accounted for on the assumption that it will be repaid, however probable it is that the holders will actually elect for conversion. It may well be that such transactions have different tax consequences depending on the expected manner of settlement, as shown in Illustration 8-4 below.

Illustration 8-4: Convertible bond deductible if settled

An entity issues a convertible bond for CU1 million. After three years, the holders can elect to receive CU1.2 million or 100,000 shares of the entity. If the bond were settled in cash, the entity would receive a tax deduction for the CU200,000 difference between its original issue proceeds and the amount payable on redemption. If the bond is converted, no tax deduction is available.

Under IAS 32, the bond would be accreted from CU1 million to CU1.2 million over the three-year issue period. The tax base remains at CU1 million throughout, so that a deductible temporary difference of CU200,000 emerges over the issue period. It is assumed that the deferred tax asset relating to this difference would meet the recognition criteria in IAS 12 (see section 7.5 above).

For various reasons, it is extremely unlikely that the bond will be redeemed in cash.

22 *IFRIC Update*, November 2011, available on the IFRS Foundation's website.

Illustration 8-4 raises the issue of whether any deferred tax asset must be recognised in respect of the CU200,000 temporary difference.

One view would be that no deferred tax asset must be recognised on the basis that there is no real expectation that the transaction will be settled in cash, thus allowing the entity to claim a tax deduction. The contrary view would be that the underlying rationale of IAS 12 is that, in order for the financial statements to be internally consistent, the tax effects of recognised assets and liabilities must also be recognised (see section 2 above). Accordingly, a deferred tax asset must be recognised.

How we see it

In the absence of guidance in the standard, the exercise of judgement is required, based on the particular facts and circumstances.

8.4.9 'Outside' temporary differences relating to subsidiaries, branches, associates and joint arrangements

In this section, an 'outside' temporary difference means a difference between the tax base in the jurisdiction of the investor of an investment in a subsidiary, associate or branch or an interest in a joint arrangement and carrying amount of that investment or interest (or the net assets and goodwill relating to it) included in the financial statements. Such differences, and the special recognition criteria applied to them by IAS 12, are discussed in more detail in section 7.6 above.

Where deferred tax is required to be recognised on such a temporary difference (see sections 7.6.2 to 7.6.4 above), the question arises as to how it should be measured. Broadly speaking, investors can realise an investment in one of two ways - either indirectly (by remittance of retained earnings or capital) or directly (through sale of the investment to a third party or by receiving residual assets upon liquidation of the associate). In many jurisdictions, the two means of realisation have very different tax consequences.

Having determined that a temporary difference must be recognised, the entity must apply the general rule (discussed in more detail above) that, where there is more than one method of recovering an investment, the entity must measure any associated deferred tax asset or liability by reference to the tax consequences associated with the expected manner of recovery of the investment. *[IAS 12.51A]*. In other words, to the extent that the investment is expected to be realised through sale, the deferred tax is measured according to the tax rules applicable on sale, but to the extent that the temporary difference is expected to reverse through a distribution of earnings or capital, the deferred tax is measured according to the tax rules applicable on distribution. In its decision in March 2015 not to take a question on this matter to its agenda, the IFRS IC confirmed this view. Accordingly, if one part of the temporary difference is expected to be received as dividends, and another part is expected to be recovered upon sale or liquidation (for example, an investor has a plan to sell the investment later and expects to receive dividends until the sale of the investment), different tax rates would be applied to the parts of the temporary difference in order to be consistent with the expected manner of recovery.[23]

Where the expected manner of recovery is through distribution, IAS 12 requires this to be reflected in the measurement of any related deferred tax assets and liabilities. *[IAS 12.51A]*. This includes proper consideration of the requirements of the standard where the rate at which tax is paid depends on whether profits are distributed or retained (see section 8.5 below). This was confirmed in June 2020, when the IFRS IC considered the following case where an entity and its subsidiary operate in a jurisdiction where profits are taxable only when distributed (i.e., the income tax rate applicable to undistributed profits is nil).

23 *IFRIC Update*, March 2015, available on the IFRS Foundation's website.

Frequently asked questions

Question 8-3: When an investee operates in a jurisdiction where profits are only taxed when distributed, how does its investor determine whether to recognise deferred tax related to its investment in a subsidiary and, if it does, on what basis is it measured?

In June 2020, the IFRS IC issued an agenda decision in response to a question based on the following fact pattern:[24]

Entity A has determined that the undistributed profits of its subsidiary give rise to a taxable temporary difference associated with the entity's investment in the subsidiary and that it cannot rely on the recognition exemption in IAS 12.39 because it expects the subsidiary to distribute its profits (which are available for distribution) in the foreseeable future.

Both Entity A and its subsidiary operate in a jurisdiction in which:

(a) Profits are taxable only when distributed, i.e., the income tax rate applicable to undistributed profits is nil (undistributed tax rate).

(b) A 20% tax rate applies to profit distributions (distributed tax rate). However, profit distributions made by the entity are not taxable to the extent that the subsidiary has already been taxed on that profit, i.e., profit distributions are taxed only once.

The IFRS IC was asked whether Entity A recognises a deferred tax liability for the taxable temporary difference associated with its investment in the subsidiary.

The IFRS IC concluded that, in the fact pattern described, Entity A should recognise the deferred tax liability related to its investment in the subsidiary and measure it using the distributed tax rate of 20%. In making this determination, the Committee observed that:

- There is a taxable temporary difference associated with the entity's investment in the subsidiary. The entity has also determined that the recognition exception in IAS 12.39 does not apply because it is probable that the temporary difference will reverse in the foreseeable future when the subsidiary distributes its undistributed profits. *[IAS 12.39]*.
- Paragraph 51 of IAS 12 requires an entity to reflect, in the measurement of deferred tax assets and deferred tax liabilities, "the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities". *[IAS 12.51]*.
- The entity expects to recover the carrying amount of its investment in the subsidiary through distributions of profits by the subsidiary, which would be taxed at the distributed tax rate.
- It is not appropriate to use the undistributed rate in IAS 12.57A to measure the deferred tax liability, because that paragraph applies only in the context of dividends payable by the reporting entity. Further, IAS 12.52A does not apply to the measurement of a current or deferred tax asset or liability that itself reflects the tax consequences of a distribution of profits.
- The IFRS IC concluded that the principles and requirements in IAS 12 provide an adequate basis for an entity to account for deferred tax in the fact pattern described in the request and consequently decided not to add the matter to its standard-setting agenda.

How we see it

In other cases, there may be tax consequences for more than one entity in the group when a distribution is made. For example, the paying company may suffer a withholding tax on the dividend paid and the receiving company may suffer income tax on the dividend received. In such cases, provision must be made for the cumulative effect of all tax consequences.

As discussed further in section 10.3.3 below, a withholding tax on an intragroup dividend is not accounted for in the consolidated financial statements as a withholding tax (i.e., within equity), but as a tax expense in profit or loss, since the group is not making a distribution but transferring assets from a group entity to a parent of that entity.

24 *IFRIC Update*, June 2020, available on the IFRS Foundation's website.

8.4.10 'Single asset' entities

In many jurisdictions it is common for certain assets (particularly properties) to be bought and sold by transferring ownership of a separate legal entity formed to hold the asset (a 'single asset' entity) rather than the asset itself.

A 'single asset' entity may be formed for a number of reasons. For example, the insertion of a 'single asset' entity between the 'real' owner and the property may limit the 'real' owner's liability for obligations arising from ownership of the property. It may also provide shelter from tax liabilities arising on disposal of the property since, in many jurisdictions, the sale of shares is taxed at a lower rate than the sale of property.

Frequently asked questions

Question 8-4: When determining the expected manner of recovery of an asset for the purposes of IAS 12, can an entity have regard to the fact that an asset held by a 'single asset' entity can be disposed of by selling the shares of the entity rather than the asset itself?

The IFRS IC has discussed this matter on a number of occasions since September 2011. In May 2012, the IFRS IC noted the following significant diversity in practice:

- Some preparers recognise deferred tax on both the asset within, and the shares of, the 'single asset' entity.
- Some preparers recognise tax on the shares only.
- Some preparers provide deferred tax on the difference between the asset within the entity and the tax base of its shares, using the tax rate applicable to a disposal of the shares.

The IFRS IC noted that IAS 12 requires the parent to recognise deferred tax on both the asset within, and the shares of, the 'single asset' entity, if tax law considers the asset and the shares as two separate assets and if no specific exemptions in IAS 12 apply. At that time, the IFRS IC asked its staff to undertake more research with the possible outcome of an amendment to IAS 12 addressing this specific type of transaction. Such an amendment would, in the Committee's view, be beyond the scope of the Annual Improvements project.

Following further deliberations, the IFRS IC decided in July 2014 not to take the issue onto its agenda but instead to recommend to the IASB that it should analyse and assess the concerns raised about the current requirements in IAS 12 in its research project on Income Taxes. In issuing its agenda decision, the Committee noted that:

a) Paragraph 11 of IAS 12 requires the entity to determine temporary differences in the consolidated financial statements by comparing the carrying amounts of assets and liabilities in the consolidated financial statements with the appropriate tax base. In the case of an asset or a liability of a subsidiary that files separate tax returns, this is the amount that will be taxable or deductible on the recovery (settlement) of the asset (liability) in the tax returns of the subsidiary.

b) The requirement in IAS 12.11 is complemented by the requirement in IAS 12.38 to determine the temporary difference related to the shares held by the parent in the subsidiary by comparing the parent's share of the net assets of the subsidiary in the consolidated financial statements, including the carrying amount of goodwill, with the tax base of the shares for purposes of the parent's tax returns.

The IFRS IC also noted that these paragraphs require a parent to recognise both the deferred tax related to the asset inside and the deferred tax related to the shares, if:

a) Tax law attributes separate tax bases to the asset inside and to the shares

b) In the case of deferred tax assets, the related deductible temporary differences can be utilised as specified in IAS 12.24 to 31

And

c) No specific exceptions in IAS 12 apply

Accordingly, in determining the expected manner of recovery of an asset for the purposes of IAS 12, the entity should have regard to both the asset itself and the shares (subject to the exemption relating to investments in subsidiaries in IAS 12.39 (see section 7.6.2 above)).

8.4.11 Change in expected manner of recovery of an asset or settlement of a liability

A change in the expected manner of recovery of an asset or settlement of a liability must be dealt with as an item of deferred tax income or expense for the period in which the change of expectation occurs, and recognised in profit or loss or in other comprehensive income or movements in equity for that period as appropriate (see section 10 below).

This may have the effect, in certain situations, that some tax consequences of a disposal transaction are recognised before the transaction itself. For example, an entity might own an item of PP&E which has previously been held for use but which the entity now expects to sell.

How we see it

In our view, any deferred tax relating to that item of PP&E must be measured on a 'sale' rather than a 'use' basis from the point when the entity's expected manner of recovery changes, even though the disposal itself, and any related current tax, will not be accounted for until the disposal occurs.

As noted in section 7.5.8 above, which discusses the effect of disposals on the recoverability of tax losses, the change in measurement will be required even if the asset does not yet meet the criteria for being classified as held for sale in IFRS 5 (see Chapter 5 at section 2.1.2). This is because those criteria set a higher hurdle for reclassification ('highly probable') than the requirement in IAS 12 to use the entity's expected manner of recovery of an asset. The extent to which deferred tax assets and liabilities are classified within a disposal group under IFRS 5 is discussed in Chapter 5 at section 2.1.1.A.

8.5 Different tax rates applicable to retained and distributed profits

In some jurisdictions, the rate at which tax is paid depends on whether profits are distributed or retained. In other jurisdictions, distribution may lead to an additional liability to tax, or a refund of tax already paid. IAS 12 requires current and deferred taxes to be measured using the rate applicable to undistributed profits. *[IAS 12.52A]*. Only when an entity recognises a liability to pay a dividend should the tax consequences of that dividend also be recognised, as shown in Illustration 8-5 below. *[IAS 12.57A]*.

Illustration 8-5: Different tax rates applicable to retained and distributed profits

An entity operates in a jurisdiction where income taxes are payable at a higher rate on undistributed profits (50%) with an amount being refundable when profits are distributed. The tax rate on distributed profits is 35%. At the end of the reporting period, 31 December 20X3, the entity does not recognise a liability for dividends proposed or declared after the end of the reporting period. As a result, no dividends are recognised in the year 20X3. Taxable income for 20X3 is CU100,000. Net taxable temporary differences have increased during the year ended 31 December 20X3 by CU40,000.

The entity recognises a current tax liability and a current income tax expense of CU50,000 (CU100,000 taxable profit @ 50%). No asset is recognised for the amount potentially recoverable as a result of future dividends. The entity also recognises a deferred tax liability and deferred tax expense of CU20,000 (CU40,000 @ 50%) representing the income taxes that the entity will pay when it recovers or settles the carrying amounts of its assets and liabilities based on the tax rate applicable to undistributed profits.

Subsequently, on 15 March 20X4 the entity declares, and recognises as a liability, dividends of CU10,000 from previous operating profits. At that point, the entity recognises the recovery of income taxes of CU1,500 (CU10,000 @ [50% - 35%]), representing the refund of tax due in respect of the dividends recognised as a liability, as a current tax asset and as a reduction of current income tax expense for the year ended 31 December 20X4.

As discussed in section 10.3.5 below, the tax benefit of CU1,500 in the Illustration above will be recognised in profit or loss.

8.5.1 Effectively tax-free entities

In a number of jurisdictions certain types of entity, such as investment vehicles, are generally exempt from corporate income tax provided that they fulfil certain criteria, which generally include a requirement to distribute all, or a minimum percentage, of their annual income as a dividend to investors. This raises the question of how such entities should measure income taxes.

One view would be that, under the basic principle set out above, such an entity has a liability to tax at the undistributed rate until the dividend for a year becomes a liability. The liability for a dividend for an accounting period usually arises after the end of that period (as in Illustration 8-5 above). Under this analysis, therefore, such an entity would be required, at each period end, to record a liability for current tax at the standard corporate rate. That liability would be released in full when the dividend is recognised as a liability in the following period. This would mean that, on an ongoing basis, the income statement would show a current tax charge or credit comprising:

- A charge for a full liability for the current period
- A credit for the reversal of the corresponding liability for the prior period

In addition, deferred tax would be recognised at the standard tax rate on all temporary differences.

A second view would be that the provisions of IAS 12 regarding different tax rates for distributed and undistributed tax rates are intended to apply where the only significant factor determining the differential tax rate is the retention or distribution of profit. By contrast, the tax status of an investment fund often depends on many more factors than whether or not profits are distributed, including restrictions on its activities and the nature of its investments. On this view, the analysis would be that such an entity can choose to operate within one of two tax regimes (a 'full tax' regime or a 'no tax' regime), rather than that it operates in a single tax regime with a dual tax rate depending on whether profits are retained or distributed. In these circumstances, it would be appropriate to infer a tax-free status for the entity until such time as it was evident that it no longer meets the conditions for retaining that status.

The IASB previously appeared to regard IAS 12 as favouring the first analysis, while accepting that the resulting accounting treatment - a cycle of raising full tax provisions and then reversing them - does not reflect economic reality. Accordingly, the exposure draft ED/2009/2 proposed that the measurement of tax assets and liabilities must include the effect of expected future distributions, based on the entity's past practices and expectations of future distributions.[25] Following the withdrawal of the exposure draft, the IASB intended to consider this issue further. However, no formal decision has been taken, nor proposals issued for comment.

8.5.2 Withholding tax or distribution tax?

In practice, it is sometimes difficult to determine whether a particular transaction should be accounted for under the provisions of IAS 12 relating to different tax rates for distributed and undistributed profits, or in accordance with the provisions of the standard relating to withholding taxes.

The classification can significantly affect tax expense because IAS 12 requires a withholding tax to be accounted for as a deduction from equity, whereas a higher tax rate for distributed profits is usually accounted for as a charge to profit or loss.

This issue is discussed further in section 10.3 below.

8.6 Discounting

IAS 12 prohibits discounting of deferred tax. *[IAS 12.53, IAS 12.54]*.

Extract from IAS 12	
53	**Deferred tax assets and liabilities shall not be discounted.**
54	The reliable determination of deferred tax assets and liabilities on a discounted basis requires detailed scheduling of the timing of the reversal of each temporary difference. In many cases such scheduling is impracticable or highly complex. Therefore, it is inappropriate to require discounting of deferred tax assets and liabilities. To permit, but not to require, discounting would result in deferred tax assets and liabilities which would not be comparable between entities. Therefore, this Standard does not require or permit the discounting of deferred tax assets and liabilities.

Moreover, IAS 12 notes that when deferred tax is recognised in relation to an item that is itself discounted (such as a liability for post-employment benefits or a lease liability), the deferred tax, being based on the carrying amount of that item, is also effectively discounted. *[IAS 12.55]*.

8.7 Unrealised intragroup profits and losses in consolidated financial statements

As noted in sections 6.2.1 and 6.2.2 above, an unrealised intragroup profit or loss eliminated on consolidation will give rise to a temporary difference where the profit or loss arises on a transaction that alters the tax base of the item(s) subject to the transaction. Such an alteration in the tax base creates a temporary difference because there is no corresponding change in the carrying amount of the assets or liabilities in the consolidated financial statements, due to the intragroup eliminations.

25 Exposure draft *ED/2009/2*: *Income Tax*, IASB, March 2009, paras. 27(d), B31-B32. Available on the IFRS Foundation's website.

IAS 12 does not specifically address the measurement of such items. However, IAS 12 generally requires an entity, in measuring deferred tax, to have regard to the expected manner of recovery or settlement of the tax. It would be consistent with this requirement to measure deferred tax on temporary differences arising from intragroup transfers at the tax rates and laws applicable to the 'transferee' company rather than those applicable to the 'transferor' company, since the 'transferee' company will be taxed when the asset or liability subject to the transfer is realised or sold.

There are some jurisdictions where the tax history of an asset or liability subject to an intragroup transfer remains with the 'transferor' company. In such cases, the general principles of IAS 12 must be used to determine whether any deferred tax should be measured at the tax rate of the 'transferor' or the 'transferee' company in the consolidated financial statements.

The effect of the treatment required by IAS 12 is that tax income or expense may be recognised on transactions eliminated on consolidation, as demonstrated by Illustration 8-6 and Illustration 8-7.

Illustration 8-6: Elimination of intragroup profit (1)

H, an entity taxed at 30%, has a subsidiary S, which is taxed at 34%. On 15 December 20X3 S sells inventory with a cost of CU100,000 to H for CU120,000, giving rise to a taxable profit of CU20,000 and current tax at 34% of CU6,800. In the consolidated financial statements of H group for the year ended 31 December 20X3, the profit made by S on the sale to H would be eliminated. However, whilst the carrying value of the inventory in the consolidated balance sheet is unchanged at CU100,000, its tax base in H is now CU120,000.

Under IAS 12, a deferred tax asset would be recognised in the consolidated financial statements on the unrealised profit of CU20,000, based on H's 30% tax rate, i.e., CU6,000. The additional CU800 tax actually paid by S would be recognised in profit or loss for the period ended 31 December 20X3, the accounting entry being:

Dr	Current tax (profit or loss)		CU6,800	
	Cr	Current tax (statement of financial position)		CU6,800
Dr	Deferred tax (statement of financial position)		CU6,000	
	Cr	Deferred tax (profit or loss)		CU6,000

The net CU800 tax charge to profit or loss (current tax charge CU6,800 less deferred tax credit CU6,000) reflects the fact that, by transferring the inventory from one tax jurisdiction to another with a lower tax rate, the group has effectively denied itself a tax deduction of CU800 (i.e., CU20,000 at the tax rate differential of 4%) for the inventory that would have been available had the inventory been sold by S, rather than H, to the ultimate third party customer.

Illustration 8-7: Elimination of intragroup profit (2)

H, an entity taxed at 34%, has a subsidiary S, which is taxed at 30%. On 15 December 20X3 S sells inventory with a cost of CU100,000 to H for CU120,000, giving rise to a taxable profit of CU20,000 and current tax at 30% of CU6,000. In the consolidated financial statements of H group for the year ended 31 December 20X3, the profit made by S on the sale to H would be eliminated. However, whilst the carrying value of the inventory in the consolidated balance sheet is unchanged at CU100,000, its tax base in H is now CU120,000.

In this case, the consolidated financial statements would record current tax paid by S of CU6,000 and a deferred tax asset measured at H's effective tax rate of 34% of CU6,800, giving rise to the following entry:

Dr	Current tax (profit or loss)		CU6,000	
	Cr	Current tax (statement of financial position)		CU6,000
Dr	Deferred tax (statement of financial position)		CU6,800	
	Cr	Deferred tax (profit or loss)		CU6,800

In this case there is a net CU800 tax credit to profit or loss (current tax charge CU6,000 less deferred tax credit CU6,800). This reflects the fact that, by transferring the inventory from one tax jurisdiction to another with a higher tax rate, the group has put itself in the position of being able to claim a tax deduction for the inventory of CU800 (i.e., CU20,000 at the tax rate differential of 4%) in excess of that which would have been available had the inventory been sold by S, rather than H, to the ultimate third party customer.

8.7.1 Intragroup transfers of goodwill and intangible assets

It is common in some jurisdictions to sell goodwill and intangible assets from one entity in a group to another in the same group, very often in order to either increase tax deductions on an already recognised asset or to obtain deductions for a previously unrecognised asset. This raises the issue of how the tax effects of such transactions should be accounted for in the financial statements both of the individual entities concerned and in the consolidated financial statements, as demonstrated by Illustration 8-8 below.

Illustration 8-8: Intragroup transfer of goodwill

A parent company P has two subsidiaries - A, which was acquired some years ago and B, which was acquired during the period ended 31 December 20X2 at a cost of CU10 million. For the purposes of this discussion, it is assumed that B had negligible identifiable assets and liabilities. Accordingly, P recorded goodwill of CU10 million in its consolidated financial statements.

During 20X3, B sells its business to A for its then current fair value of CU12.5 million. As the goodwill inherent in B's business was internally generated, it was not recognised in the financial statements of B. Hence, the entire consideration of CU12.5 million represents a profit to B, which is subject to current tax at 20% (i.e., CU2.5 million). However, as a result of this transaction, A will be entitled to claim tax deductions (again at 20%) for its newly-acquired goodwill of CU12.5 million. The deductions will be received in ten equal annual instalments from 20X3 to 20Y0. For the purposes of this discussion, it is assumed that A will have sufficient suitable taxable profits to be able to recover these deductions in full.

8.7.1.A Individual financial statements of buyer

The buyer (A) accounts for the acquisition of B's business using acquisition accounting. As the business still has negligible identifiable assets and liabilities, this gives rise to goodwill of CU12.5 million within A's own financial statements. A has acquired an asset for CU12.5 million with a tax base of the same amount. There is therefore no temporary difference (and thus no deferred tax) to be accounted for in the financial statements of A.

8.7.1.B Individual financial statements of seller

As described above, the individual financial statements of the seller (B) reflect a profit of CU12.5 million and current tax of CU2.5 million.

8.7.1.C Consolidated financial statements

In the consolidated financial statements of P, the sale of the business from B to A will be eliminated on consolidation. However, the CU2.5 million current tax suffered by B will be reflected in the consolidated financial statements, since this is a transaction with a third party (the tax authority), not an intragroup transaction. The question is what, if any, deferred tax arises as the result of this transaction.

Analysis 1

One analysis would be that the tax base of the consolidated goodwill has effectively been increased from nil to CU12.5 million. Compared to its carrying amount of CU10 million, this creates a deductible temporary difference of CU2.5 million on which a deferred tax asset at 20% (CU500,000) may be recognised. It could also be argued that there is an analogy here with the general treatment of deferred tax on intragroup profits and losses eliminated on consolidation (see Illustration 8-6 and Illustration 8-7 above).

Under this analysis, the consolidated income statement would show a net tax charge of CU2.0 million (CU2.5 million current tax expense arising in B, less CU0.5 million deferred tax income arising on consolidation). However, this is arguably inconsistent with the fact that the entity is not in an overall tax-paying position (since it has incurred a current tax loss of CU2.5 million, but expects to receive tax deductions of the same amount over the next ten years). Clearly, there is an economic loss since the entity has effectively made an interest free loan equal to the current tax paid to the tax authority, but this is not relevant, since tax is not measured on a discounted basis under IAS 12 (see section 8.6 above).

Analysis 2

An alternative analysis might therefore be to argue that the goodwill reflected in the consolidated statement of financial position still has no tax base. Rather, the tax base attaches to the goodwill recognised in the separate financial statements of A, which is eliminated on consolidation, and therefore has no carrying amount in the consolidated financial statements. Thus, applying the general principle shown in Illustration 8-6 and Illustration 8-7 above, there is a deductible temporary difference of CU12.5 million, being the difference between the carrying value of the goodwill (zero in the consolidated statement of financial position) and its tax base (CU12.5 million). Alternatively, as noted in section 6.1.4 above, certain items may have a tax base, but no carrying amount, and thus give rise to deferred tax.

This analysis would allow recognition of a deferred tax asset of CU2.5 million on a temporary difference of CU12.5 million, subject to the recognition criteria for deferred tax assets. This would result in a net tax charge of nil (CU2.5 million current tax expense arising in B less CU2.5 million deferred tax income arising on consolidation).

How we see it

In our view, there are arguments for either analysis above and entities need to take a view on their accounting policy for such transactions and apply it consistently.

8.7.1.D When the tax base of goodwill is retained by the transferor entity

In May 2014, the IFRS IC considered another example involving the internal reorganisation of a previously acquired business, as set out below.[26]

Frequently asked questions

Question 8-5: How does a group account in its consolidated financial statements for an intragroup transfer of goodwill when the tax base is retained by the transferor entity?

A parent company, H, recognised goodwill that had resulted from the acquisition of a group of assets (Business C) that meets the definition of a business in IFRS 3 *Business Combinations*. Entity H subsequently recorded a deferred tax liability relating to goodwill deducted for tax purposes. Against this background, Entity H effects an internal reorganisation in which:

- Entity H set up a new wholly-owned subsidiary (Subsidiary A).
- Entity H transfers Business C, including the related (accounting) goodwill to Subsidiary A.
- For tax purposes, however, the (tax) goodwill is retained by Entity H and not transferred to Subsidiary A.

How should Entity H calculate deferred tax following this internal reorganisation transaction in its consolidated financial statements in accordance with IAS 12?

The IFRS IC noted that when entities in the same consolidated group file separate tax returns, separate temporary differences will arise in those entities. Consequently, when an entity prepares its consolidated financial statements, deferred tax balances would be determined separately for those temporary differences, using the applicable tax rates for each entity's tax jurisdiction. *[IAS 12.11]*. The IFRS IC also noted that when calculating the deferred tax amount for the consolidated financial statements:

(a) The amount used as the carrying amount by the 'receiving' entity (in this case, Subsidiary A that receives the (accounting) goodwill) for an asset or a liability is the amount recognised in the consolidated financial statements.

(b) The assessment of whether an asset or a liability is being recognised for the first time for the purpose of applying the initial recognition exception (see section 7.2 above) is made from the perspective of the consolidated financial statements.

The IFRS IC noted that transferring the goodwill to Subsidiary A would not meet the initial recognition exception in the consolidated financial statements. *[IAS 12.15, IAS 12.24]*. Consequently, deferred tax would be recognised in the consolidated financial statements for any temporary differences arising in each separate entity by using the applicable tax rates for each entity's tax jurisdiction (subject to meeting the recoverability criteria for recognising deferred tax assets described in section 7.5 above).

To the extent that there is a temporary difference between the carrying amount of the investment in Subsidiary A and the tax base of the investment (a so-called 'outside basis difference') in the consolidated financial statements, deferred tax for such a temporary difference would also be recognised subject to the limitations and exceptions discussed in sections 7.6.2 and 7.6.3 above.

The IFRS IC also noted that transferring assets between the entities in the consolidated group would affect the consolidated financial statements in terms of recognition, measurement and presentation of deferred tax, if the transfer affects the tax base of assets or liabilities, or the tax rate applicable to the recovery or settlement of those assets or liabilities. Such a transfer could also affect:

(a) The recoverability of any related deductible temporary differences and thereby affect the recognition of deferred tax assets

And

(b) The extent to which deferred tax assets and liabilities of different entities in the group are offset in the consolidated financial statements

26 *IFRIC Update*, May 2014, available on the IFRS Foundation's website.

9 Uncertain tax treatments

The terms 'uncertain tax treatment' or 'uncertain tax position' refer to an item, the tax treatment of which is either unclear or is a matter of unresolved dispute between the reporting entity and the relevant tax authority. Uncertain tax treatments generally occur where there is an uncertainty as to the meaning of the law, or to the applicability of the law to a particular transaction, or both. For example, the tax legislation may allow the deduction of research and development expenditure, but there may be disagreement as to whether a specific item of expenditure falls within the definition of eligible research and development costs in the legislation. In some cases, it may not be clear how tax law applies to a particular transaction, if at all. In other situations, a tax return might have been submitted to the tax authorities, who are yet to opine on the treatment of certain transactions, or may even have indicated that they disagree with the entity's interpretation of tax law.

Estimating the outcome of an uncertain tax treatment is often one of the most complex and subjective areas in accounting for tax. However, IAS 12 does not specifically address the measurement of uncertain tax treatments, which are therefore implicitly subject to the general requirement of the standard to measure current tax and deferred tax at the amount expected to be paid or recovered, *[IAS 12.46, IAS 12.47]*, (see section 5 above).

Uncertain liabilities are generally accounted for under IAS 37 and historically entities have been drawn to this standard for guidance. However, IAS 37 does not apply to income taxes (see Chapter 27 at section 2.2.1.B). *[IAS 37.5]*. In 2014, the IFRS IC was asked to consider the interaction between IAS 12 and IAS 37 in the situation where entities are required to make advance payments on account to the tax authorities before an uncertain tax treatment is resolved (see section 9.7 below). The IFRS IC concluded that IAS 12, not IAS 37, provides the relevant guidance on the recognition of current tax, in particular that probability of recovery (rather than virtual certainty) was the threshold for recognition of an asset for the advance payment.[27] It then embarked on a project to give guidance on the recognition and measurement of income tax assets and liabilities in circumstances where there is uncertainty, in particular in relation to how probability and detection risk should be reflected.[28]

In June 2017, the IFRS IC issued IFRIC 23 that has been effective since annual reporting periods beginning on or after 1 January 2019. *[IFRIC 23.B1]*. On initial application, entities could either apply the Interpretation with full retrospective effect, in accordance with IAS 8, provided that this was possible without the use of hindsight, or by an adjustment to the opening balance of equity at the beginning of the first annual reporting period of application and without restating comparative information. *[IFRIC 23.B2]*.

9.1 Scope of IFRIC 23 and definitions used

The Interpretation clarifies how to apply the recognition and measurement requirements of IAS 12 when there is uncertainty over income tax treatments. Those requirements must be applied after determining the relevant taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates for the entity. *[IFRIC 23.4]*.

The following issues are addressed by the Interpretation: *[IFRIC 23.5]*

a) Whether an entity must consider uncertain tax treatments separately
b) The assumptions an entity must make about the examination of tax treatments by taxation authorities
c) How an entity must determine taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates
d) How an entity must consider changes in facts and circumstances

The Interpretation applies only to income taxes within the scope of IAS 12 and therefore does not apply to levies and other taxes not within the scope of that Standard. *[IFRIC 23.BC6]*. Despite a request from a number of respondents to the Draft Interpretation to do so, IFRIC 23 does not include requirements relating to interest and penalties associated with uncertain tax treatments. Instead, the IFRS IC noted that an entity may or may not regard a particular amount for interest and penalties as an income tax within the scope of IAS 12 and apply the Interpretation only to those determined to be in scope. *[IFRIC 23.BC8, IFRIC 23.BC9]*. In September 2017, the IFRS IC decided not to add a project on interest and penalties to its agenda, but nevertheless observed that the determination of whether interest and penalties are within the scope of IAS 12 is a judgement and not an accounting policy choice for entities.[29] We discuss in section 4.4 above the attributes that might be relevant to determining whether interest and penalties fall within the scope of IAS 12. The Interpretation uses the following terms in addition to those defined in IAS 12. *[IFRIC 23.3]*.

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27 *IFRIC Update*, July 2014, available on the IFRS Foundation's website.

28 *IFRIC Update*, July 2014, available on the IFRS Foundation's website.

29 *IFRIC Update*, September 2017, available on the IFRS Foundation's website.

Extract from IFRIC 23

3 In this Interpretation:

(a) 'tax treatments' refers to the treatments used by an entity or that it plans to use in its income tax filings.

(b) 'taxation authority' refers to the body or bodies that decide whether tax treatments are acceptable under tax law. This might include a court.

(c) an 'uncertain tax treatment' is a tax treatment for which there is uncertainty over whether the relevant taxation authority will accept the tax treatment under tax law. For example, an entity's decision not to submit any income tax filing in a tax jurisdiction, or not to include particular income in taxable profit, is an uncertain tax treatment if its acceptability is uncertain under tax law.

In determining 'uncertainty', the entity only needs to consider whether a particular tax treatment is probable, rather than highly likely or certain, to be accepted by the taxation authorities. As explained in section 9.4 below, if the entity determines it is probable that a tax treatment will be accepted, then it must measure its income taxes on that basis. Only if the entity believes the likelihood of acceptance is not probable, would there be an uncertain tax treatment to be addressed by IFRIC 23.

9.1.1 Business combinations

The IFRS IC considered whether the Interpretation should address the accounting for tax assets and liabilities acquired or assumed in a business combination when there is uncertainty over income tax treatments. It noted that IFRS 3 applies to all assets acquired and liabilities assumed in a business combination and concluded that on this basis the Interpretation should not explicitly address tax assets and liabilities acquired or assumed in a business combination. *[IFRIC 23.BC23]*.

Nonetheless, IFRS 3 requires an entity to account for deferred tax assets and liabilities that arise as part of a business combination by applying IAS 12. *[IFRS 3.24]*. Accordingly, the Interpretation applies to such assets and liabilities when there is uncertainty over income tax treatments that affect deferred tax. *[IFRIC 23.BC24]*.

How we see it

IFRS 3 suggests that current tax must be measured at fair value, which differs from the subsequent measurement required by IFRIC 23. Entities must consider whether the application of IFRS 3 fair value requirements to current tax assets and liabilities (which may result in possible Day 2 gains and losses) takes precedence over the requirements of IFRIC 23 for the measurement of current tax assets and liabilities. We believe either approach is acceptable, provided that it is applied consistently (see also Chapter 10 at section 5.6.2).

9.2 Whether to consider uncertain tax treatments separately (unit of account)

A key input to any estimation process is to determine the unit of account for uncertain tax treatments. In practice this might be an entire tax computation, individual uncertain treatments, or a group of related uncertain treatments (e.g., all positions in a particular tax jurisdiction, or all positions of a similar nature or relating to the same interpretation of tax legislation).

The Interpretation requires that entities determine whether to consider tax uncertainties separately or grouped together on the basis of which approach provides a better prediction of the resolution of the uncertainty. For example, if the entity prepares and supports tax treatments as a group or if the entity expects the taxation authority to assess items collectively during a tax examination, it would be appropriate to consider those uncertain tax treatments together. *[IFRIC 23.6]*. This implies that material tax uncertainties would be considered separately if there was no such inter-dependency as to the expected outcome.

9.3 Assumptions about the examination of tax treatments ('detection risk')

'Detection risk' is a term commonly used to refer to the likelihood that the taxation authority examines the amounts reported to it by the entity. The IFRS IC concluded that in cases where the taxation authority has a right to examine amounts reported to it, the entity must assume that it will do so; and that when it performs those examinations, the taxation authority will have full knowledge of all related information. *[IFRIC 23.8]*.

The IFRS IC noted that this position is consistent with the requirement in IAS 12.46 and 47 to measure the amount of a tax liability or asset based on the tax laws that have been enacted or substantively enacted at the reporting date. *[IFRIC 23.BC11]*. The IFRS IC also rejected a suggestion by a few respondents to the Draft Interpretation that the consideration of probability of examination must be taken into account and would be particularly important if there was no time limit on the right of the taxation authority to examine income tax filings. It determined that no exception would be appropriate and noted that the threshold for reflecting the effects of uncertainty is whether it is probable that the taxation authority will accept an uncertain tax treatment and not based on whether the taxation authority will examine a tax treatment. *[IFRIC 23.12, IFRIC 23.BC13]*. Indeed, in many jurisdictions, the tax law imposes a legal obligation on an entity operating in that jurisdiction to disclose its full liability to tax, or to assess its own liability to tax, and to make all relevant information available to the taxation authorities. In such a tax jurisdiction it might be difficult, as a matter of corporate governance, for an entity to argue that it can calculate its tax liability on the basis that the taxation authority will not become aware of information regarding a particular treatment which the entity has a legal obligation to disclose to that authority.

9.4 Determining the effect of an uncertain tax treatment or group of tax treatments

A variety of methodologies had been applied in the past for determining the effect of uncertain tax treatments on estimates of taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates. These included a weighted average probability of outcomes, the most likely single outcome and an 'all or nothing approach' (i.e., no liability is recognised for an uncertain tax treatment with a probability of occurrence below the selected recognition threshold and a full liability for a position with a probability of occurrence above the threshold). IFRIC 23 established the following requirements. *[IFRIC 23.9, IFRIC 23.10, IFRIC 23.11]*.

Extract from IFRIC 23

9	An entity shall consider whether it is probable that a taxation authority will accept an uncertain tax treatment.
10	If an entity concludes it is probable that the taxation authority will accept an uncertain tax treatment, the entity shall determine the taxable profit (tax loss), tax bases, unused tax losses, unused tax credits or tax rates consistently with the tax treatment used or planned to be used in its income tax filings.
11	If an entity concludes it is not probable that the taxation authority will accept an uncertain tax treatment, the entity shall reflect the effect of uncertainty in determining the related taxable profit (tax loss), tax bases, unused tax losses, unused tax credits or tax rates. An entity shall reflect the effect of uncertainty for each uncertain tax treatment by using either of the following methods, depending on which method the entity expects to better predict the resolution of the uncertainty: (a) the most likely amount - the single most likely amount in a range of possible outcomes. The most likely amount may better predict the resolution of the uncertainty if the possible outcomes are binary or are concentrated on one value. (b) the expected value - the sum of the probability-weighted amounts in a range of possible outcomes. The expected value may better predict the resolution of the uncertainty if there is a range of possible outcomes that are neither binary nor concentrated on one value.

How we see it

The Interpretation does not define probable, but this is generally referred to in other IFRS accounting standards as meaning more likely than not (see section 7.1.2 above).

If the entity concludes that it is probable that the taxation authority will accept the tax treatment used or planned to be used in its tax filings, the entity determines its tax position on that basis. This is consistent with the requirement that current tax is measured at the amount expected to be paid or recovered from the taxation authorities, and that deferred tax is measured using the rates and tax laws expected to apply when the related asset is realised or liability is settled. This means that all likelihoods beyond the probable threshold are treated in the same way. That is, any likelihood of acceptance by the taxation authority beyond 50% is treated in the same way as 100% likelihood of acceptance. Therefore, it is not necessary to distinguish between outcomes that are probable, highly likely or virtually certain.

If the entity concludes that acceptance of the uncertain tax treatment by the taxation authorities is not probable, it must apply one of the following two methods for reflecting the effect of uncertainty in its estimate of the amount it expects to pay or recover from the tax authorities: *[IFRIC 23.11]*

(a) The most likely amount - the single most likely amount in a range of possible outcomes

Or

(b) The expected value - the sum of the probability-weighted amounts in a range of possible outcomes

The entity is required to use the method that it expects to better predict the resolution of the uncertainty. The Interpretation suggests that the most likely amount may be a better method if the outcomes are binary (for example where an item might be deductible or disallowed for tax purposes) or are concentrated on one value (that is clearly more likely than the alternative outcomes). The expected value method may be more appropriate if possible outcomes are widely dispersed with low individual probabilities (where a number of individual but related uncertainties have been combined into a single unit of account). *[IFRIC 23.11]*.

The Interpretation includes two examples to illustrate how an entity might apply its requirements for hypothetical situations and based on the limited facts presented, as follows:

- When multiple tax treatments are considered together and when the expected value is used to reflect the effect of uncertainty *[IFRIC 23.IE Example 1]* (Illustration 9-1 below).
- When current and deferred tax is recognised and measured based on the most likely amount for a tax base that reflects the effect of uncertainty *[IFRIC 23.IE Example 2]* (Illustration 9-2 below).

In both of these examples, the entities have assumed that the taxation authority will examine the amounts reported to it and have full knowledge of all related information, as discussed in section 9.3 above. *[IFRIC 23.IE1]*.

Illustration 9-1: Multiple treatments, expected value method

Entity A's tax filing included a number of deductions related to transfer pricing. The taxation authority in its jurisdiction may challenge those tax treatments. Entity A notes that the taxation authority's decision on one transfer pricing matter would affect, or be affected by, the other transfer pricing matters. Entity A determines that the tax treatments must be considered together, because this better predicts the resolution of the uncertainty. At the end of the reporting period, Entity A concludes, on the basis of an evaluation of all available evidence, that it is not probable that the taxation authority will accept all of the tax treatments.

Entity A estimates the probabilities of what would be added to its taxable profits (in currency units), as follows:

	Estimated additional amount	Probability	Expected value
Outcome 1	-	5%	-
Outcome 2	200	5%	10
Outcome 3	400	20%	80
Outcome 4	600	20%	120
Outcome 5	800	30%	240
Outcome 6	1,000	20%	200
		100%	650

Outcome 5 is the most likely outcome, with a probability of 30%. However, entity A observes that the possible outcomes are neither binary nor concentrated in one value. Entity A therefore concludes that the expected value (CU650) better predicts the resolution of the uncertainty. Accordingly, Entity A adds CU650 to its estimate of the taxable profit, in addition to the amount reported in its tax filing.

Illustration 9-2: Treatment relates to deferred tax asset, most likely amount is applied

Entity B acquired a separately identifiable intangible asset for CU100 that has an indefinite life and is, therefore, not amortised in accordance with IAS 38. Tax law specifies that the full amount of the intangible asset is deductible for tax purposes, but the timing of deductibility (i.e., period of amortisation under the tax law) is uncertain. Entity B has no similar intangible assets and it therefore decides that this tax treatment must be considered separately.

Entity B deducted CU100 (the cost of the intangible asset) in calculating its taxable profit for Year 1 in its income tax filing. At the end of Year 1, Entity B concludes, on the basis of an evaluation of all available evidence (e.g., information about disputes for other entities' similar transactions), that it is not probable that this tax treatment will be accepted. Entity B estimates that the most likely deduction that the tax authority will accept for Year 1 is CU10, and that the most likely amount better predicts the resolution of the tax uncertainty. Accordingly, at the end of Year 1, Entity B recognises and measures a deferred tax liability based on the amount of the temporary difference between the carrying amount of the intangible asset in its financial statements and the most likely amount of the tax base (i.e., the difference between CU100 and CU90).

Entity B also concludes that it must make similar judgements in estimating the most likely amount for its current tax for Year 1, because this uncertain tax treatment also affects the taxable profit. Entity B recognises and measures its current tax liability, based on the taxable profit that includes CU90, in addition to the amount in its tax filing. (This is because Entity B deducted CU100 from taxable income for Year 1, whereas the most likely amount is now estimated to be CU10. Entity B concluded that it is not probable that the tax treatment used in its filing will be accepted.)

Where the uncertain tax treatment affects both current tax and deferred tax, an entity is required to make estimates and judgements on a consistent basis. *[IFRIC 23.12]*.

9.5 Consideration of changes in facts and circumstances

An entity is required to reassess its judgements about the acceptability of tax treatments or its estimates of the effect of uncertainty, or both, if facts and circumstances change or if new information becomes available. *[IFRIC 23.13]*. In such a situation, the entity reflects the effect as a change in accounting estimate, applying the requirements of IAS 8 to its measure of the taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates. Where circumstances change or new information becomes available after the end of the reporting period, the entity must apply the guidance in IAS 10 to determine whether the change is an adjusting or non-adjusting event. *[IFRIC 23.14]*.

The Application Guidance in Appendix A to the Interpretation provides some examples of changes that can result in the reassessment of judgements or estimates previously made by the entity. *[IFRIC 23.A2]*.

(a) The results of examinations or actions taken by a taxation authority. For example:
    (i) Agreement or disagreement by the taxation authority with the tax treatment or a similar tax treatment used by the entity
    (ii) Information that the taxation authority has agreed or disagreed with a similar tax treatment used by another entity
    (iii) Information about the amount received or paid to settle a similar tax treatment
(b) Changes in rules established by the taxation authority
(c) The expiry of a taxation authority's right to examine or re-examine a tax treatment

An uncertain tax treatment is resolved when the treatment is accepted or rejected by the taxation authorities. The Interpretation does not discuss the manner of acceptance (i.e., implicit or explicit) of an uncertain tax treatment by the taxation authorities. In practice, a taxation authority might accept a tax return without commenting explicitly on any particular treatment in it. Alternatively, it might raise some questions in an examination of a tax return. Unless such clearance is provided explicitly, it is not always clear if a taxation authority has accepted an uncertain tax treatment.

An entity may consider the following to determine whether a taxation authority has implicitly or explicitly accepted an uncertain tax treatment:

- The tax treatment is explicitly mentioned in a report issued by the taxation authorities following an examination.
- The treatment was specifically discussed with the taxation authorities (e.g., during an on-site examination) and the taxation authorities verbally agreed with the approach.

  Or
- The treatment was specifically highlighted in the income tax filings, but not subsequently queried by the taxation authorities in their examination.

The Application Guidance goes on to say that the absence of agreement or disagreement by a taxation authority with a tax treatment, in isolation, is unlikely to constitute a change in facts and circumstances or new information that affects the judgements and estimates required by the Interpretation. *[IFRIC 23.A3]*. In such situations, an entity has to consider other available facts and circumstances before concluding that a reassessment of the judgements and estimates is required.

9.5.1 The expiry of a taxation authority's right to examine or re-examine a tax treatment

As noted above, the expiry of a taxation authority's right to examine or re-examine a tax treatment is one example of a change in facts and circumstances cited in the guidance to IFRIC 23. Where this right expires between the end of the reporting period and the date when the financial statements are authorised for issue, the entity must apply the guidance in IAS 10 to determine whether the change is an adjusting or non-adjusting event. *[IFRIC 23.14]*.

IAS 10 defines adjusting events as "those that provide evidence of conditions that existed at the end of the reporting period". Non-adjusting events are "those that are indicative of conditions that arose after the reporting period". *[IAS 10.3]*.

If the right of the tax authority to examine or re-examine a tax treatment does not expire until a date falling after the end of the reporting period, it is clearly indicative of conditions that arose after the reporting period and would therefore be regarded as a non-adjusting event. In addition, because the Interpretation requires an entity to reflect the effect of a change in facts and circumstances or of new information as a change in accounting estimate applying IAS 8, *[IFRIC 23.14]*, the effect of such a change would be recognised prospectively in the period of the change, with no restatement of any estimates made as at the end of the (previous) reporting period. *[IAS 8.36]*.

9.6 Disclosures relating to uncertain tax treatments

IFRIC 23 does not propose any new disclosures. Instead, the Application Guidance requires entities to consider whether the following existing disclosure requirements are relevant in these circumstances:

- To disclose judgements made in the process of applying the entity's accounting policies in accordance with IAS 1.122 (see Chapter 3 at section 5.1.1.A). *[IFRIC 23.A4(a)]*. Such judgements might include the decision to consider uncertain tax treatments separately or together (see section 9.2 above); the determination as to whether acceptance by the taxation authorities is probable; or the decision to apply the 'most likely amount' or 'expected value' method to reflect uncertainty (see section 9.4 above).
- To disclose information about the assumptions and estimates made in determining taxable profit or loss, tax bases, unused tax losses, unused tax credits and tax rates in accordance with IAS 1.125 to 129 regarding the sources of significant estimation uncertainty (see Chapter 3 at section 5.2.1). *[IFRIC 23.A4(b)]*.

As discussed in section 9.4 above, if an entity determines that it is probable that a taxation authority will accept the tax treatment used or planned to be used in its tax filings, it determines its tax position on that basis. *[IFRIC 23.10]*. Nevertheless, the entity must still consider whether to disclose the potential effect of the uncertainty as a tax-related contingency applying IAS 12.88. *[IFRIC 23.A5]*.

As noted above, uncertain tax treatments generally relate to the estimate of the entity's liability for current tax. Any amount recognised for an uncertain current tax treatment must therefore normally be classified as current tax, and presented (or disclosed) as current or non-current in accordance with the general requirements of IAS 1 (see Chapter 3 at section 3.1.1).

However, there are circumstances where an uncertain tax treatment affects the tax base of an asset or liability and therefore relates to deferred tax, as shown in Illustration 9-2 in section 9.4 above. For example, there might be doubt as to the amount of tax depreciation that can be deducted in respect of a particular asset, which in turn would lead to doubt as to the tax base of the asset. There may sometimes be an equal and opposite uncertainty relating to current and deferred tax. For example, there might be uncertainty as to whether a particular item of income is taxable, but - if it is - any tax payable will be reduced to zero by a loss carried forward from a prior period. As discussed in section 13.1.1.C below, it is not appropriate to offset current and deferred tax items.

9.7 Presentation of liabilities or assets for uncertain tax treatments

Neither IAS 12 nor IFRIC 23 contain requirements on the presentation of uncertain tax liabilities or assets in the statement of financial position. Before the Interpretation was issued, there was diversity in practice between entities that presented uncertain tax liabilities as current (or deferred) tax liabilities and those that included these balances within another line item such as provisions.

Frequently asked questions

Question 9-1: Is an entity required to present uncertain tax liabilities as current (or deferred) tax liabilities or, instead, can such liabilities be presented within another line item such as provisions?

In response to a request for clarification on this matter, the IFRS IC issued an agenda decision in September 2019 that, applying IAS 1, an entity is required to present uncertain tax liabilities as current tax liabilities *[IAS 1.54(n)]* or deferred tax liabilities *[IAS 1.54(o)]* and that uncertain tax assets are presented as current tax assets *[IAS 1.54(n)]* or deferred tax assets. *[IAS 1.54(o)]*.

This conclusion had been reached based on the following considerations:

- When there is uncertainty over income tax treatments, IFRIC 23 requires an entity to "recognise and measure its current or deferred tax asset or liability applying the requirements in IAS 12 based on taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates determined applying this Interpretation". *[IFRIC 23.4]*.
- Current tax is defined as the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period; and deferred tax liabilities (or assets) are defined as the amounts of income taxes payable (recoverable) in future periods in respect of taxable (deductible) temporary differences and, in the case of deferred tax assets, the carryforward of unused tax losses and credits. *[IAS 12.5]*.
- Because no specific requirements are set out in IAS 12 or IFRIC 23, the presentation requirements in IAS 1 apply, which "lists items that are sufficiently different in nature or function to warrant separate presentation in the statement of financial position". *[IAS 1.57]*. This list includes line items for "liabilities and assets for current tax, as defined in IAS 12" and for "deferred tax liabilities and deferred tax assets, as defined in IAS 12". *[IAS 1.54]*. In addition, IAS 1 requires an entity to "present separately items of a dissimilar nature or function unless they are immaterial". *[IAS 1.29]*.

On this basis, the IFRS IC proposed not to add the matter to its standard-setting agenda.

9.8 Recognition of an asset for payments on account

Extract from IAS 12

12	**Current tax for current and prior periods shall, to the extent unpaid, be recognised as a liability. If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognised as an asset.**

In some jurisdictions, entities are required to make payments to the tax authorities before an uncertain tax treatment is resolved. *[IAS 12.12]*. If an entity considers its liability to be lower than the assessment made by the tax authorities, it would record an asset for a payment in excess of its estimated liability for current tax, but recovery of that excess would be contingent upon the successful resolution of the uncertainty.

In these circumstances, some had argued that the 'virtually certain' threshold in IAS 37 must be applied before allowing recognition of such a 'contingent' asset. *[IAS 37.35]*. Others argued that the requirement in IAS 12 to measure current tax assets at the amount expected to be recovered from the tax authorities requires only a 'probable' assessment of recovery to be sufficient for recognising an asset. *[IAS 12.46]*. As a result, there had been diversity in the approach used to determine whether an asset should be recognised for the amount potentially recoverable from the tax authority.

Frequently asked questions

Question 9-2: Can an asset be recognised for the amount paid to settle a tax assessment arising from a tax examination when the entity is still challenging the charge and expects, but is not certain, to recover some, or all, of the amount paid?

In 2014, the IFRS IC considered this question and noted that:

a) Paragraph 12 of IAS 12 provides guidance on the recognition of current tax assets and current tax liabilities. In particular, it states that:
   i) Current tax for current and prior periods shall, to the extent unpaid, be recognised as a liability
   And
   ii) If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognised as an asset *[IAS 12.12]*

b) In the specific fact pattern described in the submission, an asset is recognised if the amount of cash paid (which is a certain amount) exceeds the amount of tax expected to be due (which is an uncertain amount)

c) The timing of payment should not affect the amount of current tax expense recognised

The IFRS IC acknowledged that the reference to IAS 37 in IAS 12.88 in respect of tax-related contingent liabilities and contingent assets may have been understood by some to mean that IAS 37 applied to the recognition of such items. However, the IFRS IC noted that this paragraph provides guidance only on disclosures required for such items. Accordingly, the IFRS IC determined that IAS 12, not IAS 37, provides the relevant guidance on recognition.[30]

It was this determination in 2014 that led to the development of IFRIC 23. *[IFRIC 23.BC4]*.

In January 2019, the Committee confirmed a similar conclusion regarding the recoverability of payments relating to uncertain tax treatments that are outside the scope of IAS 12 (i.e., payments on account for taxes other than income tax). It concluded that, on making the payment, the entity has the right to receive future economic benefits either in the form of a cash refund or by using the payment to settle the tax liability. As such, an asset exists as defined in the Conceptual Framework, as opposed to a contingent asset as defined in IAS 37, and it is recognised when the payment is made to the tax authority.[31] This agenda decision is discussed in Chapter 27 at section 6.8.4.

30 *IFRIC Update*, July 2014, available on the IFRS Foundation's website.

31 *IFRIC Update*, January 2019, available on the IFRS Foundation's website.

10 Allocation of tax charge or credit

Current and deferred tax is normally recognised as income or an expense in the profit or loss for the period, except to the extent that it arises from:

- An item that has been recognised directly outside profit or loss, whether in the same period or in a different period (see sections 10.1 to 10.7 below). *[IAS 12.57, IAS 12.58, IAS 12.61A]*.
- Certain share-based payment transactions (see section 10.8 below). *[IAS 12.68A, IAS 12.68C]*.

  Or
- A business combination (see section 12 below). *[IAS 12.66]*.

Extract from IAS 12

58 Current and deferred tax shall be recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from:

(a) a transaction or event which is recognised, in the same or a different period, outside profit or loss, either in other comprehensive income or directly in equity (see paragraphs 61A-65); or

(b) a business combination (other than the acquisition by an investment entity, as defined in IFRS 10 *Consolidated Financial Statements*, of a subsidiary that is required to be measured at fair value through profit or loss) (see paragraphs 66-68).

61A Current tax and deferred tax shall be recognised outside profit or loss if the tax relates to items that are recognised, in the same or a different period, outside profit or loss. Therefore, current tax and deferred tax that relates to items that are recognised, in the same or a different period:

(a) in other comprehensive income, shall be recognised in other comprehensive income (see paragraph 62).

(b) directly in equity, shall be recognised directly in equity (see paragraph 62A).

Where a deferred tax asset or liability is remeasured subsequent to its initial recognition, the change must be accounted for in profit or loss, unless it relates to an item originally recognised outside profit or loss, in which case the change must also be accounted for outside profit or loss. Such remeasurement might result from:

- A change in tax law.
- A reassessment of the recoverability of deferred tax assets (see section 7.5 above).

  Or
- A change in the expected manner of recovery of an asset or settlement of a liability (see section 8.4.11 above). *[IAS 12.60]*.

Whilst IAS 12 as drafted refers only to remeasurement of 'deferred' tax, it seems clear that these principles must also be applied to any remeasurement of current tax.

Any current tax or deferred tax on items recognised outside profit or loss, whether in the same period or a different period, is also recognised directly outside profit or loss. Such items include:

- Revaluations of property, plant and equipment under IAS 16 (see section 10.1 below).
- Retrospective restatements or retrospective applications arising from corrections of errors and changes in accounting policy under IAS 8 (see section 10.2 below).
- Exchange differences arising on translation of the financial statements of a foreign operation under IAS 21 (see section 7.6 above).
- Amounts taken to equity on initial recognition of a compound financial instrument by its issuer (so-called 'split accounting') under IAS 32 (see section 7.2.7 above). *[IAS 12.61A, IAS 12.62, IAS 12.62A]*.

IAS 12 acknowledges that, in exceptional circumstances, it may be difficult to determine the amount of tax that relates to items recognised in other comprehensive income and/or equity. In these cases, an entity may use a reasonable *pro rata* method, or another method that achieves a more appropriate allocation in the circumstances. IAS 12 gives the following examples of situations where such an approach may be appropriate:

- There are graduated rates of income tax and it is impossible to determine the rate at which a specific component of taxable profit (tax loss) has been taxed.
- A change in the tax rate or other tax rules affects a deferred tax asset or liability relating (in whole or in part) to an item that was previously recognised outside profit or loss.

  Or
- An entity determines that a deferred tax asset must be recognised, or must no longer be recognised in full, and the deferred tax asset relates (in whole or in part) to an item that was previously recognised outside profit or loss. *[IAS 12.63]*.

IAS 12 requires tax relating to items not accounted for in profit or loss, whether in the same period or a different period, to be recognised:

- In other comprehensive income, if it relates to an item accounted for in other comprehensive income.
- Directly in equity, if it relates to an item accounted for directly in equity. *[IAS 12.61A]*.

This requirement to have regard to the previous history of a transaction in accounting for its tax effects is commonly referred to as 'backward tracing' (see section 8.1.1.B above).

10.1 Revalued and rebased assets

Where an entity depreciates a revalued item of PP&E, it may choose to transfer the depreciation in excess of the amount that would have arisen on a historical cost basis from revaluation surplus to retained earnings. In such cases, the relevant portion of any deferred tax liability recognised on the revaluation must also be transferred to retained earnings. A similar treatment must be adopted by an entity which has a policy of transferring revaluation gains to retained earnings on disposal of a previously revalued asset. *[IAS 12.64]*.

When an asset is revalued for tax purposes and that revaluation is related to an accounting revaluation of an earlier period, or to one that is expected to be carried out in a future period, the tax effects of both the asset revaluation and the adjustment of the tax base are credited or charged to equity in the periods in which they occur.

However, if the revaluation for tax purposes is not related to an accounting revaluation of an earlier period, or to one that is expected to be carried out in a future period, the tax effects of the adjustment of the tax base are recognised in profit or loss. *[IAS 12.65]*. For example, when tax law gives additional deductions to reflect the indexation of assets for tax purposes (see section 6.2.2.D above) the tax base of the asset changes without any corresponding change to the asset's carrying amount in the financial statements. Because the carrying amount has not changed, there is no gain or loss in relation to indexation in profit and loss or in other comprehensive income. Accordingly, the effect of the change in tax base is recorded in profit or loss. *[IAS 12.65]*.

10.1.1 Non-monetary assets or liabilities with a tax base determined in a different currency

Another example arises when the tax base of a non-monetary asset or liability is determined in a different currency to the entity's functional currency for accounting purposes. This can be the case in oil and gas producing entities that have a functional currency of US dollars but operate (and are accountable for income taxes) in various local jurisdictions under different currencies (see Chapter 39 at section 9.1).

IAS 12 notes that in this situation the entity measures its non-monetary asset or liability using its functional currency as at the date of initial recognition, as required by IAS 21. However, if the tax base of its non-monetary assets and liabilities is determined in a different currency, changes in the exchange rate will give rise to temporary differences that result in a recognised deferred tax liability or deferred tax asset (if recoverable). Because this retranslation has no effect on carrying values recognised in the financial statements, there is no corresponding gain or loss against which the tax can be allocated. As a result, the movement in deferred tax is recorded in profit or loss. *[IAS 12.41]*.

Frequently asked questions

Question 10-1: When the tax bases of an entity's non-monetary assets are determined in a currency that is different from its functional currency, where must deferred tax be recognised?

The IFRS IC issued an agenda decision relating to this question in January 2016 which determined that:[32]

- When the tax base of a non-monetary asset or liability is determined in a currency that is different from the functional currency, temporary differences arise resulting in a deferred tax asset or liability. *[IAS 12.41]*.
- Such deferred tax does not arise from a transaction or event that is recognised outside profit or loss and is therefore charged or credited to profit or loss in accordance with IAS 12.58.
- Such a deferred tax charge or credit would be presented with other deferred taxes, instead of with foreign exchange gains or losses, in the statement of profit or loss.
- Paragraph 79 of IAS 12 requires the disclosure of the major components of tax expense (income). When changes in the exchange rate are the cause of a major component of the deferred tax charge or credit, an explanation of this in accordance with IAS 12.79 would help explain the tax expense (income) to the users of the financial statements.

In the light of requirements in the existing IFRS accounting standards, the IFRS IC determined that neither an Interpretation nor an amendment to a Standard was necessary.

10.2 Retrospective restatements or applications

IAS 8 requires retrospective restatements or retrospective applications arising from corrections of errors and changes in accounting policy to be accounted for by adjusting the amounts presented in the financial statements of comparative periods and restating the opening balances of assets, liabilities and equity for the earliest prior period presented as if the new accounting policy had always been applied. *[IAS 8.23]*. IFRS 1 *First-time Adoption of International Financial Reporting Standards* - requires first-time adopters to recognise the adjustments resulting from the application of IFRS accounting standards to the opening IFRS statement of financial position directly in retained earnings (or, if appropriate, another category of equity), on the basis that those adjustments 'arise from events and transactions before the date of transition to IFRS'. *[IFRS 1.11]*.

Because IAS 12 requires tax relating to an item that has been recognised outside profit or loss to be treated in the same way, any tax effect of a retrospective restatement or retrospective application on the opening comparative statement of financial position is dealt with as an adjustment to equity also. *[IAS 12.58]*. The standard identifies the adjustment to the opening balance of retained earnings under IAS 8 as an example where IFRS accounting standards requires or permits particular items to be charged or credited directly to equity. *[IAS 12.62A(a)]*.

However, the fact that IAS 12 states that tax arising in a different period, but relating to a transaction or event arising outside profit or loss must also be recognised in other comprehensive income or equity (as applicable) is taken by some to mean that any subsequent remeasurement of tax originally recognised in equity as part of a prior year adjustment must be accounted for in equity also.

How we see it

In our view, such an assertion fails to reflect the true nature of retrospective application, which as noted above is defined in IAS 8 as the application of a new accounting policy 'to transactions, other events and conditions as if that policy had always been applied' (our emphasis), and under IFRS 1 'arise from events and transactions before the date of transition to IFRS'. This is demonstrated by Illustration 10-1 below.

32 *IFRIC Update*, January 2016, available on the IFRS Foundation's website.

Illustration 10-1: Remeasurement of deferred tax liability recognised as the result of retrospective application

Entity A applied IAS 19 when it first became effective and recognised a pension asset of CU3 million and a corresponding deferred tax liability, which was accounted for as a prior year adjustment in retained earnings under IAS 8. At that time, the effective tax rate applicable to Entity A was 40%, resulting in a deferred tax liability of CU1,200,000.

Entity B's date of transition to IFRS was 1 January 20X4. As a result of the adoption of IAS 37, its first IFRS financial statements (prepared for the year ended 31 December 20X5) showed an additional liability for environmental rectification costs of CU5 million as an adjustment to opening reserves, together with an associated deferred tax asset at 40% of CU2 million.

The pension asset in Entity A and the environmental liability in Entity B do not change substantially over the following accounting periods, but during the year ended 31 December 20X3 the tax rate falls to 30%. This requires Entity A to remeasure to CU900,000 its deferred tax liability relating to the pension asset, giving rise to a tax benefit of CU300,000. For Entity B, the deferred tax asset is remeasured to CU1.5 million, giving rise to a tax expense of CU500,000. Should this expense be recognised in profit or loss for the period or in equity?

When the carrying amount of deferred tax assets and liabilities change because of a change in tax rates, the resulting deferred tax is recorded in profit or loss, 'except to the extent that it relates to items previously recognised outside profit or loss'. *[IAS 12.60]*. Paragraph 61A of IAS 12 also requires an entity to recognise in other comprehensive income or directly in equity the tax effect of items that are recognised, in the same or a different period, outside profit or loss. If read in isolation, IAS 12 could be construed as requiring the amounts arising on the remeasurement of deferred tax in the Illustration above to be accounted for in equity, as being a remeasurement of amounts originally recognised in equity. However, as discussed above, this interpretation fails to reflect the true nature of what is meant by retrospective restatement.

IAS 8 defines retrospective application as the application of a new accounting policy 'to transactions, other events or conditions as if that policy had always been applied' and the treatment required by IFRS 1 is based on the fact that an entity is restating amounts that arise from events and transactions before the date of transition to IFRS. Accordingly, if the item that gave rise to the deferred tax would have been recognised in profit or loss in the normal course of events had the new accounting policies (or IFRS) always been applied, the effect of subsequent re-measurement is also recognised in profit or loss. In the fact patterns for both entities A and B in Illustration 10-1 above, the changes in the tax rate relating to the pension asset and the environmental liability are recognised in profit or loss.

Where the retrospective restatement giving rise to a deferred tax asset or liability directly in equity represented the cumulative total of amounts that would have been recognised ordinarily in other comprehensive income or directly in equity in previous periods if the new accounting policy had always been applied (e.g., deferred tax relating to the revaluation of property, plant, or equipment), any subsequent re-measurement of the deferred tax is also accounted for in the same manner, i.e., in other comprehensive income or directly in equity.

10.3 Dividends and transaction costs of equity instruments

10.3.1 Dividend subject to differential tax rate

In some jurisdictions, the rate at which tax is paid depends on whether profits are distributed or retained. In other jurisdictions, distribution may lead to an additional liability to tax, or a refund of tax already paid. IAS 12 requires current and deferred taxes to be measured using the rate applicable to undistributed profits until a liability to pay a dividend is recognised, at which point the tax consequences of that dividend must also be recognised. This is discussed further in section 8.5 above.

Where taxes are remeasured on recognition of a liability to pay a dividend, the difference must normally be recognised in profit or loss rather than directly in equity, even though the dividend itself is recognised directly in equity under IFRS accounting standards. IAS 12 takes the view that any additional (or lower) tax liability relates to the original profit now being distributed rather than to the distribution itself. Where, however, the dividend is paid out of profit arising from a transaction that was originally recognised in other comprehensive income or equity, the adjustment to the tax liability must also be recognised in other comprehensive income or equity. *[IAS 12.57A]*.

10.3.2 Dividend subject to withholding tax

Where dividends are paid by the reporting entity subject to withholding tax, the withholding tax must be included as part of the dividend charged to equity. *[IAS 12.65A]*.

It is noteworthy that there may be little economic difference, from the paying entity's perspective, between a requirement to pay a 5% 'withholding tax' on all dividends and a requirement to pay an additional 5% 'income tax' on distributed profit. Yet, the accounting treatment varies significantly depending on the analysis. If the tax is considered a withholding tax, it is treated as a deduction from equity in all circumstances. If, however, it is considered as an additional income tax, it will generally be treated as a charge to profit or loss (see section 10.3.1 above). This distinction therefore relies on a clear definition of withholding tax, which IAS 12 unfortunately does not provide.

IAS 12 describes a withholding tax as a "portion of the dividends [paid] to taxation authorities on behalf of shareholders". *[IAS 12.65A]*. However, it is not clear whether the determination of whether the tax is being paid 'on behalf of shareholders' is made by reference to the characterisation of the tax:

- In the paying entity's tax jurisdiction - in which case, there is the problem noted above that one jurisdiction's 'additional distribution tax' may be economically identical to another jurisdiction's 'withholding tax'.

  Or

- In the receiving entity's tax jurisdiction - in which case there would be the problem that the tax on a dividend paid to one shareholder is a 'withholding tax' (because credit is given for it on the shareholder's tax return) but the tax on a dividend paid to another shareholder at the same time is not (because no credit is given for it on that shareholder's tax return).

This distinction is also relevant in accounting for dividend income that has been subject to withholding tax, as discussed in section 10.3.4 below.

10.3.3 Intragroup dividend subject to withholding tax

Where irrecoverable withholding tax is suffered on intragroup dividends, the withholding tax does not relate to an item recognised in equity in the consolidated financial statements (since the intragroup dividend to which it relates has been eliminated in those financial statements). The tax must therefore be accounted for in profit or loss for the period.

10.3.4 Incoming dividends

IAS 12 does not directly address the treatment of incoming dividends on which tax has been levied (i.e., whether they should be shown at the amount received, or gross of withholding tax together with a corresponding tax charge). As discussed in section 4.2 above, we believe that judgement is required to determine whether a tax deducted from investment income at the source of the income is a withholding tax in the scope of IAS 12.

As well as the considerations discussed in section 4.2 above, it is noted in section 10.3.2 above that an entity paying dividends that are subject to withholding tax would record the gross value of the distribution in equity, on the basis that the withholding tax is regarded as an amount paid to the tax authorities 'on behalf of shareholders'. *[IAS 12.65A]*. If it is determined from the point of view of the recipient of the dividend that a particular withholding tax is an income tax in the scope of IAS 12, it would therefore be consistent with this treatment for the recipient to show dividends (and other income subject to withholding taxes) gross of withholding taxes and to recognise any non-refundable portion of such withholding taxes as a tax expense in the statement of comprehensive income.

Some jurisdictions also give tax deductions for the 'underlying' tax suffered on dividends received. This is based on the concept that the dividend has been paid out of profits already subject to tax, so that to tax the full amount received again would amount to a punitive double taxation of the underlying profits.

How we see it

In our view, any underlying tax which would form part of the tax charge, not the dividend, of the paying company is not directly paid on behalf of the shareholder, and accordingly, incoming dividends must not be grossed up for underlying tax.

10.3.5 Tax benefits of distributions and transaction costs of equity instruments

IAS 32 as originally issued required distributions to shareholders and transaction costs of equity instruments to be accounted for in equity net of any related income tax benefit (see Chapter 43 at section 8.2). However, as discussed below, the 'default' allocation for income tax on equity distributions is now to profit or loss, with the tax consequences of transaction costs relating to equity instruments still being taken to equity, provided that the related costs are also recognised in equity.

Annual Improvements to IFRSs 2009-2011 Cycle, issued in May 2012, amended IAS 32 so as to remove the reference to income tax benefit. This means that all tax effects of equity transactions are allocated in accordance with the general principles of IAS 12. Unfortunately, IAS 12 was not entirely clear as to how the tax effects of certain equity transactions must be dealt with, as demonstrated by Illustration 10-2 below.

Illustration 10-2: Tax deductible distribution on equity instrument

An entity paying tax at 25% has issued CU25 million 4% preference shares at par value that are treated as equity instruments for accounting purposes (because coupon payments are subject to an equity dividend blocker and are therefore discretionary). The preference shares are treated as debt for tax purposes (i.e., all coupon payments are deductible in determining taxable profit). The entity makes a payment of CU1 million and is able to claim a tax deduction of CU250,000. There are no restrictions on the recoverability of that deduction for tax purposes.

Some would have allocated the tax deduction to equity on the basis that it relates to the coupon payment, which was accounted for in equity. Others would have considered the distribution as being sourced from an accumulation of retained earnings originally accounted for in profit or loss and, therefore, have allocated the tax deduction for the dividend payment in profit or loss. The cause of this divergence was IAS 12.52B, which stated the following:

"In the circumstances described in IAS 12.52A, the income tax consequences of dividends are recognised when a liability to pay the dividend is recognised. The income tax consequences of dividends are more directly linked to past transactions or events than to distributions to owners. Therefore, the income tax consequences of dividends are recognised in profit or loss for the period as required by IAS 12.58 except to the extent that the income tax consequences of dividends arise from the circumstances described in IAS 12.58(a) and (b)." *[IAS 12(2018).52A]*.

Those who believed that the tax deduction must be accounted for in equity argued that IAS 12.52B only applies 'in the circumstances described in paragraph 52A' and the example does not include differential tax rates for retained and distributed profits. Those who argued that the tax deduction must be credited to profit or loss considered that the reference in IAS 12.52A to taxes 'payable at a higher or lower rate', must be interpreted as including a higher or lower effective rate, as well as a higher or lower headline rate.

The IFRS IC observed that the circumstances to which the requirements in IAS 12.52B apply were unclear and decided that a limited amendment to IAS 12 was required to clarify that the requirements in IAS 12.52B apply to all payments on financial instruments classified as equity that are distributions of profits, and are not limited to the circumstances described in IAS 12.52A.[33]

In December 2017, the IASB published *Annual Improvements to IFRS Standards - 2015-2017 Cycle*, which moves the text in IAS 12.52B to IAS 12.57A, thereby relating it more closely to the general requirements for the allocation of tax set out in section 10 above, and removes any reference to the specific circumstances when there are different tax rates for distributed and undistributed profits. Accordingly, the tax benefits of equity distributions will be recognised in profit or loss, unless it can be demonstrated that the profits being distributed were previously generated in transactions recognised in other comprehensive income or equity. These amendments are mandatory for annual periods beginning on or after 1 January 2019. When an entity first applies these amendments, it applies them to the income tax consequences of dividends recognised on or after the beginning of the earliest comparative period. *[IAS 12.98I]*.

The Board concluded that entities would have sufficient information to apply the amendments in this way, which will enhance comparability of reporting periods. *[IAS 12.BC70]*.

33 *IFRIC Update*, March 2016, available on the IFRS Foundation's website.

10.3.5.A Tax benefits of payments on equity instruments

In its Basis for Conclusions, the Board noted that the amendments must not be interpreted to mean that an entity recognises in profit or loss the income tax consequences of all payments on financial instruments classified as equity. Rather, an entity would exercise judgement in determining whether payments on such instruments are distributions of profits (i.e., dividends). If they are, then the requirements in IAS 12.57A apply. If they are not, then the requirements of IAS 12.61A apply to the income tax consequences of those payments, meaning the related tax is recognised in equity. *[IAS 12.BC67]*.

The Board considered and rejected the suggestion that it should provide guidance on how to determine if payments on financial instruments classified as equity are distributions of profits on the basis that:

(a) Any attempt by the Board to define or describe distributions of profits could affect other IFRS accounting standards and IFRIC Interpretations, and risks unintended consequences.

(b) The amendments do not change what is and is not a distribution of profits. They simply clarify that the requirements in IAS 12.57A apply to all income tax consequences of dividends.

Nevertheless, the Board concluded that finalising the amendments without adding specific guidance would eliminate the potential for inconsistent accounting that resulted from the ambiguity of the scope of the requirements that had existed previously. *[IAS 12.BC69]*. In our opinion, guidance will be needed ultimately on how to determine which payments on financial instruments classified as equity would not be regarded as distributions of profits.

How we see it

Whilst some payments in relation to equity instruments, such as the issue costs of equity shares, can clearly be regarded as a transaction cost rather than a distribution of profits, entities will have to exercise judgement in determining the appropriate treatment of other items. In making such a judgement, the legal and regulatory requirements in the entity's jurisdiction would also be relevant, for example if those local requirements stipulate whether a particular payment is, in law, a distribution.

10.4 Gains and losses reclassified ('recycled') to profit or loss

Several IFRS accounting standards (notably IAS 21 and IFRS 9) require certain gains and losses that have been accounted for outside profit or loss to be reclassified ('recycled') to profit or loss at a later date when the assets or liabilities to which they relate are realised or settled. Whilst IAS 12 requires any tax consequences of the original recognition of the gains or losses outside profit or loss also to be accounted for outside profit or loss, it is silent on the treatment to be adopted when the gains or losses are reclassified.

How we see it

In our view, any tax consequences of reclassified gains or losses originally recognised outside profit or loss must also be reclassified through profit or loss in the same period as the gains or losses to which they relate. Indeed, such reclassification is often an automatic consequence of the reversal of previously recognised deferred tax income or expense and its 're-recognition' as current tax income or expense, as shown in Illustration 10-3.

Illustration 10-3: Tax on reclassified ('recycled') items

An entity has an annual reporting period ending 30 September. On 1 January 20X3 an entity purchases for CU2,000 a debt security that it classifies under IFRS 9 as fair value through other comprehensive income ('FVOCI') with recycling. At 30 September 20X3 it restates the security to its fair value of CU2,400, which was also its fair value on 1 May 20X4. On 1 July 20X4 it disposes of the investment for CU2,100.

The entity's tax rate for the year ending 30 September 20X3 is 40% and for 20X4 35%. The change of rate was made in legislation enacted (without previous substantive enactment) on 1 May 20X4. The entity is subject to tax on disposal of the investment (based on disposal proceeds less cost) in the period of disposal.

The accounting entries for this transaction would be as follows:

1 January 20X3

Dr	Debt security		CU2,000	
	Cr	Cash		CU2,000

30 September 20X3				
Dr	Debt security (CU2,400 - CU2,000)		CU400	
	Cr	Deferred tax (statement of financial position) (CU400 @ 40%)		CU160
	Cr	Other comprehensive income ('OCI')		CU240
Recognition of increase in value of asset, and related deferred tax				
1 May 20X4				
Dr	Deferred tax (statement of financial position) (CU400 @ (35% - 40%))		CU20	
	Cr	OCI		CU20
Remeasurement of deferred tax (no change in the fair value of the debt security since 30 September 20X3)				
1 July 20X4				
Dr	OCI (revaluation of CU300 less deferred tax of CU105)		CU195	
Dr	Deferred tax (statement of financial position)		CU105	
	Cr	Debt security		CU300
Recognition of decrease in value of asset, and related deferred tax				
Dr	Cash		CU2,100	
Dr	OCI (reclassification of CU100 (before tax) to income statement)		CU100	
	Cr	Debt security		CU2,100
	Cr	Profit on disposal of debt security (cash CU2,100 less original cost CU2,000)		CU100
Dr	Deferred tax (statement of financial position)		CU35	
	Cr	Deferred tax income (OCI)		CU35
Dr	Current tax (profit or loss)		CU35	
	Cr	Current tax (statement of financial position) (35% of CU100 pre-tax profit)		CU35
To record the sale of the debt security and related taxation				

10.4.1 Debt instrument measured at fair value through OCI under IFRS 9

IFRS 9 requires an entity to recognise a loss allowance for expected credit losses (ECLs) on financial assets that are debt instruments measured at fair value through other comprehensive income (FVOCI). *[IFRS 9.5.5.1]*.

Under the general approach, at each reporting date, an entity recognises a loss allowance based on either 12-month expected credit losses or lifetime expected credit losses, depending on whether there has been a significant increase in credit risk on the financial instrument since initial recognition. *[IFRS 9.5.5.3, IFRS 9.5.5.5]*.

The standard states that these expected credit losses do not reduce the carrying amount of the financial assets in the statement of financial position, which remains at fair value. Instead, an amount equal to the allowance that would arise if the asset was measured at amortised cost is recognised in other comprehensive income as the 'accumulated impairment amount'. *[IFRS 9.4.1.2A, IFRS 9.5.5.2, IFRS 9 Appendix A]*.

The accounting treatment (ignoring the accounting for any tax) and journal entries for debt instruments measured at FVOCI are illustrated in Chapter 47 at section 9.1 by the following Illustration, based on Illustrative Example 3 in the Implementation Guidance for the standard. *[IFRS 9.IE Example 13, IFRS 9.IE78-IE81]*.

Illustration 10-4: Debt instrument measured at fair value through other comprehensive income

An entity purchases a debt instrument with a fair value of CU1,000 on 15 December 20X3 and measures the debt instrument at fair value through other comprehensive income (FVOCI). The instrument has an interest rate of 5% over the contractual term of 10 years and has a 5% effective interest rate. At initial recognition the entity determines that the asset is not purchased or originated credit-impaired.

Dr	Financial asset - FVOCI		CU1,000	
	Cr	Cash		CU1,000

To recognise the debt instrument measured at its fair value

On 31 December 20X3 (the reporting date), the fair value of the debt instrument has decreased to CU950 as a result of changes in market interest rates. The entity determines that there has not been a significant increase in credit risk since initial recognition and that ECLs must be measured at an amount equal to 12-month expected credit losses, which amounts to CU30. For simplicity, journal entries for the receipt of interest revenue are not provided.

Dr	Impairment loss (profit or loss)		CU30	
Dr	Other comprehensive income[(a)]		CU20	
	Cr	Financial asset - FVOCI		CU50

To recognise 12-month expected credit losses and other fair value changes on the debt instrument

(a) The cumulative loss in other comprehensive income at the reporting date was CU20. That amount consists of the total fair value change of CU50 (i.e., CU1,000 - CU950) offset by the change in the accumulated impairment amount representing 12-month ECLs that was recognised (CU30).

On 1 January 20X4, the entity decides to sell the debt instrument for CU950, which is its fair value at that date.

Dr	Cash		CU950	
	Cr	Financial asset - FVOCI		CU950
Dr	Loss (profit or loss)		CU20	
	Cr	Other comprehensive income		CU20

To derecognise the fair value through other comprehensive income asset and recycle amounts accumulated in other comprehensive income to profit or loss, i.e., CU20.

As noted in Chapter 47 at section 9.1, this means that in contrast to financial assets measured at amortised cost, there is no separate allowance for credit losses but, instead, impairment gains or losses are accounted for as an adjustment of the revaluation reserve accumulated in other comprehensive income, with a corresponding charge to profit or loss (which is then reflected in retained earnings).

Assume that, for tax purposes, current tax does not arise until the asset is recovered. In Illustration 10-4 above, the asset revaluation creates a temporary difference as the carrying value is now different to its original cost (being its tax base). The asset revaluation is first accounted for in OCI, therefore, the related tax is recorded in OCI. *[IAS 12.61A]*.

As regards the recognition of the ECLs, and as noted above, there is no further change to the carrying value of the asset. Impairment gains or losses are accounted for as an adjustment of the revaluation reserve accumulated in other comprehensive income, with a corresponding charge to profit or loss. Under the general principal in IAS 12, the entity would transfer the related deferred tax out of OCI and into profit or loss in respect of the ECLs reallocated out of OCI. A similar transfer would be made in respect of any earlier revaluation entries that are recycled to profit or loss on derecognition of the debt instrument. *[IAS 12.61A]*. Accordingly, if the applicable rate of tax is 20%, the tax-effected journals in Illustration 10-4 above would be as follows:

Illustration 10-5: Debt instrument measured at fair value through other comprehensive income - tax effect

When the entity recognises the reduction in fair value of the instrument from CU1,000 to CU950 and the 12-month ECLs:

Dr	Deferred tax asset (statement of financial position)[(a)]	CU10		
	Cr	Profit or loss - deferred tax		CU6
	Cr	Other comprehensive income - deferred tax		CU4

(a) The deferred tax asset arising from the deductible temporary difference on revaluation is CU10 (CU50 @ 20%), with related deferred tax credits in profit or loss and OCI at a rate of 20% applied to the amounts recognised in each of those statements of CU30 and CU20 respectively.

On 1 January 20X4, the entity decides to sell the debt instrument for CU950, which is its fair value at that date. The tax rate on a disposal is also 20% in this example. The related tax journals are as follows:

Dr	Profit or loss - deferred tax	CU6		
Dr	Other comprehensive income - deferred tax	CU4		
Dr	Current tax liability (statement of financial position)	CU10		
	Cr	Deferred tax asset (statement of financial position)		CU10
	Cr	Profit or loss - current tax		CU10

Being the reversal of the deductible temporary differences on disposal of the debt instrument and the recognition of current tax deduction on the taxable loss on sale.

10.4.2 Recognition of expected credit losses with no change in fair value

Consider an example where there has been no change to the asset's fair value since its acquisition, but an expected credit loss has been determined. Current tax is charged on realisation of the asset only.

As discussed above, the ECLs are accounted for as an adjustment (credit) to the revaluation reserve accumulated in other comprehensive income, with a corresponding charge to profit or loss. However, in this case, there is no change to the carrying amount of the asset. *Prima facie*, therefore, there is no temporary difference associated with the asset. However, the treatment discussed in section 7.2.4.D above would support a conclusion that this temporary difference of nil must in fact be analysed into:

- A deductible temporary difference arising on the ECLs that affect accounting profit
- A taxable temporary difference of an equal amount arising on the amount reflected in OCI, which is effectively an upward revaluation to restore the asset back to its fair value

This analysis indicates it would be appropriate to recognise a deferred tax asset for amounts recognised for ECLs in profit or loss *[IAS 12.58]* and to recognise the tax effect of the 'item that is recognised outside profit or loss' (i.e., the credit to OCI) in other comprehensive income. *[IAS 12.61A]*.

This approach is applied in Illustration 10-6 below:

Illustration 10-6: Tax effect of expected credit losses with no change in fair value

An entity purchases a debt instrument with a fair value of CU1,000 and measures the debt instrument at fair value through other comprehensive income (FVOCI). The instrument has an interest rate of 5% over the contractual term of 10 years, and has a 5% effective interest rate. At initial recognition the entity determines that the asset is not purchased or originated credit-impaired. Current tax is charged or credited on realisation of the asset, at an enacted rate of 20%.

Dr	Financial asset - FVOCI	CU1,000		
	Cr	Cash		CU1,000

To recognise the debt instrument measured at its initial fair value

The entity determines that expected credit losses (ECLs) must be measured at an amount equal to 12-month expected credit losses, which amounts to CU30. However, the fair value of the debt instrument is still CU1,000.

Dr	Impairment loss (profit or loss)		CU30	
	Cr	Other comprehensive income		CU30
Dr	Financial asset - FVOCI[1]		Nil	

To recognise 12-month expected credit losses on the debt instrument and (in OCI) its increase in fair value.

[1] The decrease in the carrying value of the financial asset by CU30 on account of ECLs is offset in the balance sheet by the CU30 increase in the fair value of the financial asset.

The entity determines that IAS 12.58 and 61A require the tax effect of amounts recognised in profit and loss to be recognised in profit or loss and for the tax effect of amounts recognised in other comprehensive income to be recorded in the same place.

Dr	Other comprehensive income - deferred tax		CU6	
	Cr	Profit or loss - deferred tax		CU6
Dr	Deferred tax asset (statement of financial position)		Nil	

The entity in Illustration 10-6 above could have determined that the recognition of the expected credit loss does not generate a temporary difference because neither the carrying amount nor the tax base of the asset has changed. However, this determination can have unwanted consequences as the debt instrument is later revalued and realised, in particular with respect to variability in the effective tax rate reported in both profit or loss and in other comprehensive income.

10.5 Gain/loss in profit or loss and loss/gain outside profit or loss offset for tax purposes

It often happens that a gain or loss accounted for in profit or loss can be offset for tax purposes against a gain or loss accounted for in other comprehensive income (or an increase or decrease in equity). This raises the question of how the tax effects of such transactions should be accounted for, as demonstrated by Illustration 10-7 below.

Illustration 10-7: Loss in other comprehensive income and gain in profit or loss offset for tax purposes

During the year ended 31 December 20X3, an entity that pays tax at 35% makes a taxable profit of CU50,000 comprising:

- CU80,000 trading profit less finance costs accounted for in profit or loss

  And

- CU30,000 foreign exchange losses accounted for in other comprehensive income ('OCI')

Should the total tax liability of CU17,500 (35% of CU50,000) be presented as either:

(a) A charge of CU17,500 in profit or loss?

Or

(b) A charge of CU28,000 (35% of CU80,000) in profit or loss and a credit of CU10,500 (35% of CU30,000) in OCI?

How we see it

In our view, (b) is the appropriate treatment, since the amount accounted for in OCI represents the difference between the tax that would have been paid absent the exchange loss accounted for in OCI and the amount actually payable. This indicates that this is the amount that, in the words of IAS 12.61A, 'relates to' items that are recognised outside profit or loss.

Similar issues may arise where a transaction accounted for outside profit or loss generates a suitable taxable profit that allows recognition of a previously unrecognised tax asset relating to a transaction previously accounted for in profit or loss, as demonstrated by Illustration 10-8 below.

Illustration 10-8: Recognition of deferred tax asset in profit or loss on the basis of tax liability accounted for outside profit or loss

An entity that pays tax at 30% has brought forward unrecognised deferred tax assets (with an indefinite life) totalling CU1 million, relating to trading losses accounted for in profit or loss in prior periods. On 1 January 20X3 it invests CU100,000 in government bonds, which it holds until they are redeemed for the same amount on maturity on 31 December 20X6. For tax purposes, any gain made by the entity on disposal of the bonds can be offset against the brought forward tax losses. The tax base of the bonds remains CU100,000 at all times.

The entity elects to account for the bonds as fair value through other comprehensive income and therefore carries them at fair value in the statement of financial position and amortised cost information is presented in profit or loss (see Chapter 46 at section 2.3). Over the period to maturity the fair value of the bonds at the end of each reporting period (31 December) is as follows:

	Fair value	Amortised cost	Movement in OCI
	CU000	CU000	CU000
20X3	111	101	10
20X4	117	102	15
20X5	122	102	20
20X6	100	100	-

Under IFRS 9 the movements in fair value in excess of the amounts recognised in profit or loss (excluding any amounts received in cash, e.g., the coupon on a bond) would be accounted for in other comprehensive income ('OCI') - see Chapter 46 at section 2.3. Taken in isolation, the valuation gains recorded in OCI in 20X3 to 20X5 would give rise to a deferred tax liability (at 30%) of CU3,000 (20X3), CU4,500 (20X4) and CU6,000 (20X5). However, these liabilities arise from taxable temporary differences that can be offset against the losses brought forward (see section 7.5 above), and accordingly, the (equal and opposite) deferred tax liability and deferred tax asset are offset in the statement of financial position (see section 13.1.1 below). This raises the question as to whether there should be either:

(a) No tax charge or credit in either profit or loss or OCI in any of the periods affected

Or

(b) In each period, a deferred tax charge in OCI (in respect of the taxable temporary difference arising from valuation gains on the bonds) and deferred tax income in profit or loss (representing the recognition of the previously unrecognised deferred tax asset)

How we see it

In our view, the treatment in (b) above must be followed.

The fact that no deferred tax is presented in the statement of financial position arises from the offset of a deferred tax asset and deferred tax liability - it does not imply that there is no deferred tax. Moreover, although the recognition of the deferred tax asset is possible only as the result of the recognition of a deferred tax liability arising from a transaction accounted for in OCI, the asset itself relates to a trading loss previously accounted for in profit or loss. Accordingly, the deferred tax credit arising from the recognition of the asset is properly accounted for in profit or loss.

10.6 Discontinued operations

IAS 12 does not explicitly address the allocation of income tax charges and credits between continuing and discontinued operations. However, that some allocation is required is implicit in the requirement of IFRS 5.33(b)(ii) to disclose how much of the single figure post-tax profit or loss of discontinued operations disclosed in the statement of comprehensive income is comprised of 'the related income tax expense' (see Chapter 5). *[IFRS 5.33(b)(ii)]*.

How we see it

In our view, the provisions of IAS 12 for the allocation of tax income and expense between profit or loss, other comprehensive income and equity also form a basis for allocating tax income and expense between continuing and discontinued operations, as demonstrated by Illustration 10-9 to Illustration 10-11 below.

Illustration 10-9: Profit in continuing operations and loss in discontinued operations offset for tax purposes

Entity A, which pays tax at 25%, has identified an operation as discontinued for the purposes of IFRS 5. During the period the discontinued operation incurred a loss of CU2 million and the continuing operations made a profit of CU10 million. The net CU8 million profit is fully taxable in the period, and there is no deferred tax income or expense.

How we see it

In our view, the tax expense must be allocated between continuing and discontinued operations. The tax allocated to the discontinued operation represents the difference between the tax that would have been paid absent the loss accounted for in discontinued operations and the amount actually payable.

Accordingly, the tax expense is allocated as follows:

		CU m	CU m
Dr	Current tax expense (continuing operations)[1]	2.5	
Cr	Current tax income (discontinued operation)[2]		0.5
Cr	Current tax liability[3]		2.0

1 Continuing operations profit CU10m @ 25% = CU2.5m
2 Discontinued operations loss CU2m @ 25% = CU0.5m.
3 Net taxable profit CU8m @ 25% = CU2.0m

Illustration 10-10: Taxable profit on disposal of discontinued operation reduced by previously unrecognised tax losses

Entity B disposes of a discontinued operation during the current accounting period. The disposal gives rise to a charge to tax of CU4 million. However, this is reduced to zero by offset against brought forward tax losses, which relate to the continuing operations of the entity, and for which no deferred tax asset has previously been recognised.

How we see it

In our view, even though there is no overall tax expense, amounts must be allocated between continued and discontinued operations.

		CU m	CU m
Dr	Current tax expense (discontinued operation)	4.0	
Cr	Current tax income (continuing operations)		4.0

This allocation reflects that fact that, although the transaction that allows recognition of the brought forward tax losses is accounted for as a discontinued operation, the losses themselves arose from continuing operations. This is essentially the same analysis as is used in Illustration 10-8 above (where a deferred tax liability recognised in other comprehensive income gives rise to an equal deferred tax asset recognised in profit or loss).

Illustration 10-11: Taxable profit on disposal of discontinued operation reduced by previously recognised tax losses

Entity B disposes of a discontinued operation during the current accounting period. The disposal gives rise to a charge to tax of CU4 million. However, this is reduced to zero by offset against brought forward tax losses, which relate to the entity's continuing operations, and for which a deferred tax asset has previously been recognised.

How we see it

In our view, even though there is no overall tax expense, amounts must be allocated between continued and discontinued operations.

			CU m	CU m
Dr	Current tax expense (discontinued operation)		4.0	
Dr	Deferred tax expense (continuing operations)		4.0	
	Cr	Current tax income (continuing operations)		4.0
	Cr	Deferred tax asset (statement of financial position)		4.0

This allocation reflects that fact that, although the transaction that allows realisation of the brought forward tax losses is accounted for as a discontinued operation, the losses themselves arose from continuing operations. This is essentially the same analysis as is used in Illustration 10-10 above.

10.7 Defined benefit pension plans

IAS 19 requires an entity, in accounting for a defined benefit post-employment benefit plan, to recognise actuarial gains and losses relating to the plan in full in other comprehensive income ('OCI'). At the same time, a calculated current (and, where applicable, past) service cost and net interest on the net defined benefit liability or asset are recognised in profit or loss - see Chapter 31 at section 10.

In many jurisdictions, tax deductions for post-employment benefits are given on the basis of cash contributions paid to the plan fund (or benefits paid when a plan is unfunded).

This significant difference between the way in which defined plans are treated for tax and financial reporting purposes can make the allocation of tax deductions for them between profit or loss and OCI somewhat arbitrary, as shown in Illustration 10-12 below.

Illustration 10-12: Tax deductions for defined benefit pension plans

At 1 January 20X3 an entity that pays tax at 40% has a fully-funded defined benefit pension scheme. During the year ended 31 December 20X3 it records a total cost of CU1 million, of which CU800,000 is allocated to profit or loss and CU200,000 to other comprehensive income ('OCI'). In January 20X4 it makes a funding payment of CU400,000, a tax deduction for which is received through the current tax charge for the year ended 31 December 20X4.

Assuming that the entity is able to recognise a deferred tax asset for the entire CU1 million charged in 20X3, it will record the following entry for income taxes in 20X3.

Dr	Deferred tax asset (CU1,000,000 @ 40%)		CU400,000	
	Cr	Deferred tax income (profit or loss) (CU800,000 @ 40%)		CU320,000
	Cr	Deferred tax income (OCI) (CU200,000 @ 40%)		CU80,000

When the funding payment is made in January 20X4, the accounting deficit on the fund is reduced by CU400,000. This gives rise to deferred tax expense of CU160,000 (CU400,000 @ 40%), as some of the deferred tax asset as at 31 December 20X3 is released, and current tax income of CU160,000 is recorded. The difficulty is how to allocate this movement in the deferred tax asset between profit or loss and OCI, as it is ultimately a matter of arbitrary allocation as to whether the funding payment is regarded as making good (for example):

- CU400,000 of the CU800,000 deficit previously accounted for in profit or loss.
- The whole of the CU200,000 of the deficit previously accounted for in OCI and CU200,000 of the CU800,000 deficit previously accounted for in profit or loss.

  Or
- A *pro rata* share of those parts of the total deficit accounted for in profit or loss and OCI.

In the Illustration above, the split is of relatively minor significance, since the entity was able to recognise 100% of the potential deferred tax asset associated with the pension liability. This means that, as the scheme is funded, there will be an equal and opposite amount of current tax income and deferred tax expense. The only real issue is therefore one of presentation, namely whether the gross items comprising this net nil charge are disclosed within the tax charge in profit or loss or in OCI.

In other cases, however, there might be an amount of net tax income or expense that needs to be allocated. Suppose that, as above, the entity recorded a pension cost of CU1 million in 20X3 but determined that the related deferred tax asset did not meet the criteria for recognition under IAS 12. In 20X4, the entity determines that an asset of CU50,000 can be recognised in view of the funding payments and taxable profits anticipated in 20X4 and later years. This results in a total tax credit of CU210,000 (CU160,000 current tax, CU50,000 deferred tax) in 20X4, raising the question of whether it should be allocated to profit or loss, to OCI, or allocated on a *pro rata* basis. This question might also arise if, as the result of newly enacted tax rates, the existing deferred tax balance were required to be remeasured.

How we see it

In our view, these are instances of the exceptional circumstances envisaged by IAS 12 when a strict allocation of tax between profit or loss and OCI is not possible (see section 10 above). Accordingly, a reasonable method of allocation may be used, provided that it is applied on a consistent basis.

One approach might be to compare the funding payments made to the scheme in the previous few years with the charges made to profit or loss under IAS 19 in those periods. If, for example, it is found that the payments were equal to or greater than the charges to profit or loss, it might reasonably be concluded that the funding payments have 'covered' the charge recognised in profit or loss, so that any surplus or deficit on the statement of financial position is broadly represented by items that have been accounted for in OCI.

However, a surplus may also arise from funding the scheme to an amount greater than the liability recognised under IAS 19 (for example under a minimum funding requirement imposed by local legislation or agreed with the pension fund trustees). In this case, the asset does not result from previously recognised income but from a reduction in another asset (i.e., cash). The entity must assess the expected manner of recovery of any asset implied by the accounting treatment of the surplus - i.e., whether it has been recognised on the basis that it will be 'consumed' (resulting in an accounting expense) or refunded to the entity in due course. The accounting treatment of refunds is discussed further in Chapter 31, and in section 10.7.1 below.

The entity will account for the tax consequences of the expected manner of recovery implied by the accounting treatment. Where it is concluded that the asset will be 'consumed' (resulting in accounting expense), the entity will need to determine whether such an expense is likely to be recognised in profit or loss or in OCI in a future period.

10.7.1 Tax on refund of pension surplus

In some jurisdictions, a pension fund may be permitted or required to make a refund to the sponsoring employee of any surplus in the fund not required to settle the known or anticipated liabilities of the fund. It may be that such a refund is subject to tax. IFRIC 14 IAS 19 *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* - requires any asset recorded in respect of such a refund to be shown net of any tax other than an income tax (see Chapter 31). In determining whether such a tax is an income tax of the entity, the general principles in section 4.1 above must be applied. Relevant factors may include:

- Whether tax is levied on the pension fund or the sponsoring entity
- Whether tax is levied on the gross amount of the refund in all cases, or has regard to the sponsoring entity's other taxable income, or the amount of tax deductions received by the sponsoring entity in respect of contributions to the fund

10.8 Share-based payment transactions

The accounting treatment of share-based payment transactions, some knowledge of which is required to understand the discussion below, is dealt with in Chapter 30.

In many tax jurisdictions, an entity receives a tax deduction in respect of remuneration paid in shares, share options or other equity instruments of the entity. The amount of any tax deduction may differ from the related remuneration expense, and may arise in a later accounting period. For example, in some jurisdictions, an entity may recognise an expense for employee services in accordance with IFRS 2 (based on the fair value of the award at the date of grant), but not receive a tax deduction until the share options are exercised (based on the intrinsic value of the award at the date of exercise).

As noted in section 6.1.4 above, IAS 12 effectively considers the cumulative expense associated with share-based payment transactions as an asset that has been fully expensed in the financial statements in advance of being recognised for tax purposes, thus giving rise to a deductible temporary difference. *[IAS 12.68A, IAS 12.68B]*.

If the tax deduction available in future periods is not known at the end of the period, it must be estimated based on information available at the end of the period. For example, if the tax deduction will be dependent upon the entity's share price at a future date, the measurement of the deductible temporary difference must be based on the entity's share price at the end of the period. *[IAS 12.68B]*.

10.8.1 Allocation of tax deduction between profit or loss and equity

Where the amount of any tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, the current or deferred tax associated with the excess must be recognised directly in equity. *[IAS 12.68C]*. This treatment is demonstrated by Illustration 10-13 below.

Illustration 10-13: Tax deductions for share-based payment transactions - allocation to profit or loss and equity

At the start of year 1, an entity with a tax rate of 40% grants options, which vest at the end of year 3 and are exercised at the end of year 5. Tax deductions are received at the date of exercise of the options, based on their intrinsic value at the date of exercise. Details of the expense recognised for employee services received and consumed in each accounting period, the number of options expected to vest by the entity at each year-end during the vesting period and outstanding after the end of the vesting period, and the intrinsic value of the options at each year-end, are as follows:

Year	IFRS 2 *expense for period*	*Cumulative* IFRS 2 *expense*	*Number of options*	*Intrinsic value per option*	*Total intrinsic value*
	CU	CU		CU	CU
1	188,000	188,000	50,000	5	250,000
2	185,000	373,000	45,000	8	360,000
3	190,000	563,000	40,000	13	520,000
4		563,000	40,000	17	680,000
5		563,000	40,000	20	800,000

The tax base of, and the temporary difference and deferred tax asset associated with, the employee services is calculated as follows. Since the book value of the employee services is in all cases zero, the temporary difference associated with the services is at all times equal to their tax base as set out below.

Year	*Intrinsic value (see table above)*	*Expired portion of vesting period*[1]	*Tax base (and temporary difference)*	*Tax asset*[2]	*Tax income*[3]
	CU		CU	CU	CU
	a	b	c = a × b	c @ 40%	
1	250,000	1/3	83,333	33,333	33,333
2	360,000	2/3	240,000	96,000	62,667
3	520,000	3/3	520,000	208,000	112,000
4	680,000	3/3	680,000	272,000	64,000
5	800,000	3/3	800,000	320,000	48,000

1 The expired portion of the vesting period is consistent with that used to calculate the cumulative charge employee costs under IFRS 2 (see Chapter 30).

2 Deferred tax asset in years 1 to 4 and current tax asset in year 5.

3 Year-on-year increase in asset.

By comparing the 'Cumulative IFRS 2 expense' column in the first table with the 'Tax base (and temporary difference)' column in the second table it can be seen that in years 1 to 3 the expected tax deduction is lower than the cumulative expense charged, and is therefore dealt with entirely in profit or loss. However in years 4 and 5 the expected (and in year 5 the actual) tax deduction is higher than the cumulative expense charged. The tax relating to the cumulative expense charged is dealt with in profit or loss, and the tax relating to the excess of the tax-deductible amount over the amount charged in profit or loss is dealt with in equity as follows:

Year 1				
Dr	Deferred tax (statement of financial position)		CU33,333	
	Cr	Deferred tax (profit or loss)		CU33,333
Year 2				
Dr	Deferred tax (statement of financial position)		CU62,667	
	Cr	Deferred tax (profit or loss)		CU62,667
Year 3				
Dr	Deferred tax (statement of financial position)		CU112,000	
	Cr	Deferred tax (profit or loss)		CU112,000
Year 4				
Dr	Deferred tax (statement of financial position)		CU64,000	
	Cr	Deferred tax (profit or loss)[1]		CU17,200
	Cr	Equity		CU46,800
Year 5				
Dr	Deferred tax (profit or loss)		CU225,200	
Dr	Deferred tax (equity)		CU46,800	
	Cr	Deferred tax (statement of financial position)		CU272,000
Dr	Current tax (statement of financial position)		CU320,000	
	Cr	Current tax (profit or loss)[2]		CU225,200
	Cr	Current tax (equity)		CU94,800

1 Cumulative tax credit to profit or loss restricted to 40% of cumulative expense of CU563,000 = CU225,200. Amount credited in years 1 to 3 is CU(33,333 + 62,667 + 112,000) = CU208,000. Therefore, the amount recognised in profit or loss is CU(225,200 - 208,000) = CU17,200.

2 Current tax credit in profit or loss is restricted to CU225,200 as explained in note 1 above. The CU48,000 net increase in total cumulative tax income since year 4 (CU320,000 - CU272,000) is dealt with entirely in equity (current tax income CU94,800 less deferred tax charge CU46,800).

Illustration 10-13 above is based on Example 5 in the illustrative examples accompanying IAS 12 (as inserted by IFRS 2). However, the example included in IAS 12 states that the cumulative tax income is based on the number of options 'outstanding' at each period end. This would be inconsistent with the methodology in IFRS 2 (see Chapter 30), which requires the share-based payment expense during the vesting period to be based on the number of options expected to vest (as that term is defined in IFRS 2), not the total number of options outstanding, at the period end. It would only be once the vesting period is complete that the number of options outstanding becomes relevant. We assume that this is simply a drafting slip by the IASB.

IAS 12 asserts that the allocation of the tax deduction between profit or loss and equity shown in Illustration 10-13 is appropriate on the basis that the fact that the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense 'indicates that the tax deduction relates not only to remuneration expense but also to an equity item'. *[IAS 12.68C]*.

10.8.2 Determining the tax base

IAS 12 does not specify exactly how the tax base of a share-based payment transaction is to be determined. However, Example 5 in the illustrative examples accompanying IAS 12 (the substance of which is reproduced in section 10.8.1 above) calculates the tax base as:

- The amount that would be deductible for tax if the event triggering deduction occurred at the end of the reporting period; multiplied by
- The expired portion of the vesting period at the end of the reporting period

IFRS 2 treats certain share-based payment awards as, in effect, a parcel of a number of discrete awards, each with a different vesting period. This may be the case where an award is subject to graded vesting, has been modified, or has separate equity and liability components (see Chapter 30). In order to determine the tax base for such an award, it is necessary to consider separately the part, or parts, of the award with the same vesting period, as shown in Illustration 10-14 below.

Illustration 10-14: Tax deductions for share-based payment transactions - 'multi-element' awards

An entity awards 550 free shares to an employee, with no conditions other than continuous service. 100 shares vest after one year, 150 shares after two years and 300 shares after three years. Any shares received at the end of years 1 and 2 have vested unconditionally.

At the date the award is granted, the fair value of a share delivered in one year's time is CU3.00; in two years' time CU2.80; and in three years' time CU2.50.

Under IFRS 2, the analysis is that the employee has simultaneously received an award of 100 shares vesting over one year, an award of 150 shares vesting over two years and an award of 300 shares vesting over 3 years (see Chapter 30 at section 6.2.2). This would be accounted for as follows (assuming that the award was expected to vest in full at each reporting date and did actually vest in full - see Chapter 30):

Year	*Calculation of cumulative expense*	*Cumulative expense (CU)*	*Expense for period (CU)*
1	(100 shares × CU3.00) + (150 shares × CU2.80 × 1/2) + (300 shares × CU2.50 × 1/3)	760	760
2	(100 shares × CU3.00) + (150 shares × CU2.80 × 2/2) + (300 shares × CU2.50 × 2/3)	1,220	460
3	(100 shares × CU3.00) + (150 shares × CU2.80 × 2/2) + (300 shares × CU2.50 × 3/3)	1,470	250

The entity receives a tax deduction at 30% for the awards based on the fair value of the shares delivered. The fair value of a share at the end of years 1, 2 and 3 is, respectively, CU3.60, CU2.00 and CU6.00.

At the end of year 1, a current tax deduction of CU108 (100 shares × CU3.60 @ 30%) is receivable in respect of the 100 shares that vest. The tax base of the shares expected to vest in years 2 and 3 is calculated by reference to the year-end share price of CU3.60 as:

- In respect of the 150 shares expected to vest at the end of year 2, CU270 (150 shares × CU3.60 × 1/2). This will give rise to a deferred tax asset of CU81 (CU270 @ 30%)
- In respect of the 300 shares expected to vest at the end of year 3, CU360 (300 shares × CU3.60 × 1/3). This will give rise to a deferred tax asset of CU108 (CU360 @ 30%)

The total deferred tax asset at the end of year is therefore CU189 (CU81 + CU108).

At the end of year 2, a current tax deduction of CU90 is receivable in respect of the 150 shares that vest (150 shares × CU2.00 @ 30%). The tax base of the shares expected to vest in year 3 is calculated by reference to the year-end share price of CU2.00 as CU400 (300 shares × CU2.00 × 2/3). This gives rise to a deferred tax asset of CU120 (CU400 @ 30%).

At the end of year 3, a current tax deduction of CU540 (300 shares × CU6.00 @ 30%) is receivable in respect of the 300 shares that vest.

When an award has multiple elements that vest at different times, the question arises as to whether the unit of account for applying the 'cap' on recognition of the tax benefit in profit or loss is the award as a whole or each element separately accounted for.

How we see it

In our view, the determination needs to be made for each element of the award separately. This is similar to our analysis in section 10.8.3 below (multiple awards outstanding) and section 10.8.4 below (awards for which a tax deduction is received on exercise which are exercised at different times).

Based on the information above, the total current and deferred tax income or expense (i.e., before allocation to profit or loss and equity) at the ends of years 1 to 3 would be as follows, assuming in each case that there is no restriction on the recognition of tax assets (see section 7.5 above).

Year	*Current tax asset and income*	*Deferred tax asset*	*Deferred tax income/(expense)*
	CU	**CU**	**CU**
1	108	189	189
2	90	120	(69)
3	540	-	(120)

The required accounting entries for income taxes are as follows:

Year 1

Dr	Current tax (statement of financial position)		CU108	
	Cr	Current tax (profit or loss)		CU90
	Cr	Current tax (equity)[1]		CU18
Dr	Deferred tax (statement of financial position)		CU189	
	Cr	Deferred tax (profit or loss)[2] (CU63 + CU75 - see below)		CU138
	Cr	Deferred tax (equity)[2] (CU18 + CU33 - see below)		CU51

1 The current tax deduction relates to the 100 shares vesting in year 1, for which the charge to profit or loss is CU300 (100 shares × CU3.00). The tax deduction accounted for in profit or loss is therefore restricted to 30% of CU300 = CU90. The balance of CU18 is credited to equity and relates to the CU0.60 difference between the grant date fair value of a 'Year 1' share at grant (CU3.00) and at vesting (CU3.60) - 100 shares × CU0.60 = CU60 @ 30% = CU18.

2 The total deferred tax income of CU189 represents:

- CU81 (see above) in respect of the 150 shares expected to vest in year 2, for which the charge to profit or loss is CU210 (150 shares × CU2.80 × 1/2). The tax deduction accounted for in profit or loss is restricted to 30% of CU210 = CU63, with the balance of CU18 credited to equity.

  And

- CU108 (see above) in respect of the 300 shares expected to vest in year 3, for which the expected charge to profit or loss is CU250 (300 shares × CU2.50 × 1/3). The tax deduction accounted for in profit or loss is therefore restricted to 30% of CU250 = CU75, with the balance of CU33 credited to equity.

Year 2

Dr	Current tax (statement of financial position)		CU90	
	Cr	Current tax (profit or loss)[3]		CU90
Dr	Deferred tax (profit or loss)[4]		CU18	
Dr	Deferred tax (equity)[4]		CU51	
	Cr	Deferred tax (statement of financial position)[4]		CU69

3 The current tax deduction relates to the 150 shares vesting in year 2, for which the cumulative charge to profit or loss is CU420 (150 shares × CU2.80). The cumulative tax deduction accounted for in profit or loss would therefore be restricted to 30% of CU420 = CU126. The entire amount of current tax deduction received (CU90) is therefore credited to profit or loss.

4 At the end of year 2, the deferred tax relates to the 300 shares expected to vest at the end of year 3, which has been measured based on the year end share price of CU2.00. This is lower than the share price on which the IFRS 2 charge has been based. Therefore, there is no requirement to allocate any deferred tax to equity, and the balance of deferred tax in equity is reduced to nil. The balance of the total CU69 movement in the deferred tax balance is allocated to profit or loss.

The net tax credit in profit or loss in year 2 of CU72 (current tax credit CU90, less deferred tax charge CU18) can be seen as representing:

Credit relating to IFRS 2 expense recognised in the period[5]	105
Charge relating to remeasurement of prior year deferred tax[6]	(33)
Total	72

5 In this case the tax credit recognised in profit or loss is not the 'expected' credit of CU138 (IFRS 2 charge of CU460 @ 30%). This is because the current tax deduction for the shares vesting in year 2 and the deferred tax deduction for the shares expected to vest in year 3 are based on the year-end share price of CU2.00, which is lower than the share values used to calculate the IFRS 2 charge (CU2.80 and CU2.50). During the year, an IFRS 2 expense has been recognised for 75 'whole share equivalents' in respect of the shares vesting in year 2 (150 shares × 1/2) and 100 'whole share equivalents' in respect of the shares expected to vest in year 3 (300 shares × 1/3), a total of 175 'whole share equivalents'. Accordingly, the credit for the year is CU105 (175 × CU2.00 × 30%).

6 In year 1 the deferred tax credit (based on the year 1 year-end share price of CU3.60) recognised in profit of loss in respect of the shares expected to vest in years 2 and 3 was CU138. If this had been based on the year 2 year-end share price of CU2.00 this would have been only CU105. [150 × 1/2 × CU2.00] + [300 × 1/3 × CU2.00] = CU350 × 30% = CU105. CU138 - CU105 = CU33.

Year 3

Dr	Current tax (statement of financial position)		CU540	
	Cr	Current tax (profit or loss)		CU225
	Cr	Current tax (equity)[7]		CU315
Dr	Deferred tax (profit or loss)		CU120	
	Cr	Deferred tax (statement of financial position)[8]		CU120

7 The current tax deduction relates to the 300 shares vesting in year 1, for which the cumulative charge to profit or loss is CU750 (300 shares × CU2.50). The tax deduction accounted for in profit or loss is therefore restricted to 30% of CU750 = CU225.

8 The deferred tax asset, all of which was - on a cumulative basis - recognised in profit or loss, is derecognised in profit or loss.

The net tax credit in profit or loss in year 3 of CU105 (current tax credit CU225, less deferred tax charge CU120) can be seen as representing:

Credit relating to IFRS 2 expense recognised in the period[9]	75
Credit relating to remeasurement of prior year deferred tax[10]	30
Total	105

9 CU250 @ 30%.

10 The opening balance deferred tax asset of CU120 is based on the year 2 share price of CU2.00. If this had been based on the year 3 share price of CU6.00 it would have been CU360. However, the amount recognised in profit or loss would have been restricted to CU150 - 30% of the cumulative expense at the end of year 2 of CU500 (300 shares × CU2.50 × 2/3). CU150 - CU120 = CU30.

10.8.3 Allocation when more than one award is outstanding

As noted above, IAS 12 requires that, "where the amount of any tax deduction … exceeds the amount of the related cumulative remuneration expense, the current or deferred tax associated with the excess must be recognised directly in equity". Some have therefore argued that, as drafted, IAS 12 requires the cumulative expense for all outstanding share schemes to be compared in aggregate with the aggregate tax deduction for all share schemes. Others argue that the comparison must be made for each scheme separately. The effect of each treatment is shown in Illustration 10-15 below.

Illustration 10-15: Tax deductions for share-based payment transactions - more than one award

An entity that pays tax at 30% has two outstanding share schemes, Scheme A and Scheme B. The entity receives tax deductions for share-based payment transactions based on their intrinsic value at the date of exercise.

At the end of the reporting period, the cumulative expense charged for each scheme is CU1 million. Scheme A has a negative intrinsic value at the end of the reporting period and is not expected to recover its value to the extent that employees will exercise their options. Accordingly, no deferred tax asset is recognised for Scheme A. Scheme B has an intrinsic value of CU1.5 million. The entity will therefore record a deferred tax asset of CU450,000 (30% of CU1.5 million), subject to the recognition criteria for deferred tax assets being satisfied.

Those who argue that comparison of share-based payment expense to tax deduction must be made on an aggregated basis would conclude that, because the cumulative potential tax deduction of CU1.5 million (which relates only to Scheme B) is lower than the cumulative aggregate expense for both Scheme A and Scheme B (CU2 million), the deferred tax income must be recognised entirely in profit or loss.

However, those who argue that comparison of share-based payment expense to tax deduction must be made on a discrete basis for each scheme would conclude that, because the cumulative tax deduction for Scheme B (CU1.5 million) is higher than the cumulative aggregate expense for Scheme B (CU1 million), only CU300,000 of the deferred tax income (30% of CU1 million) must be recognised in profit or loss, with the remaining CU150,000 recognised in equity.

How we see it

In our view, the comparison must be made on a discrete scheme-by-scheme basis. As noted in section 10.8.2 above, it is clear from IAS 12 and the Basis for Conclusions to IFRS 2 that the IASB's intention was to exclude from profit or loss any tax deduction that is effectively given for the growth in fair value of an award that accrues after grant date. This can be determined only on an award-by-award basis. Moreover, IAS 12 requires the amount of any tax deduction to be accounted for in equity when it 'exceeds the amount of the related cumulative remuneration expense' (emphasis added). In Illustration 10-15 above, the tax deduction on Scheme B cannot, in our view, be said to be 'related' to the remuneration expense for Scheme A. Accordingly, the expense relating to Scheme A is not relevant for determining the amount of tax income relating to Scheme B that is required to be accounted for in equity.

It may also be that what is regarded as a single scheme may need to be further sub-divided for the purposes of the comparison for reasons such as the following:

- Where the same award is made to regular employees and also to top management, the fair value of the options granted to each population may nevertheless be different for the purposes of IFRS 2 given different exercise behaviours (see Chapter 30 at section 8.5.2.A)
- An award is made to employees which attracts tax deductions in more than one tax jurisdiction Or
- An award is made in the same tax jurisdiction to employees in different entities, not all of which are able to recognise a deferred tax asset

10.8.4 Staggered exercise of awards

The example in IAS 12, the substance of which is included in Illustration 10-13 in section 10.8.1 above, addresses a situation in which all vested awards are exercised simultaneously. In practice, however, vested awards are often exercised at different dates.

Once an award under a given scheme has vested, and different awards in that scheme are exercised at different times, the question arises as to whether the 'cap' on recognition of the tax benefit in profit or loss must be calculated by reference to the cumulative expense recognised in respect of the total number of awards vested, or in respect only of as yet unexercised vested awards.

How we see it

In our view, where a tax deduction is received on exercise, the calculation must be undertaken by reference to the cumulative expense recognised for outstanding unexercised options. This is demonstrated by Illustration 10-16 below.

Illustration 10-16: Tax deductions for share-based payment transactions - staggered exercise of award

At the start of year 1, an entity with a tax rate of 40% grants 20 options each to 5 employees. The options have a fair value of CU5 and vest at the end of year 2. The options vest in full. 25 are exercised at the end of year 3 and 75 at the end of year 6. The entity is able to support the view that any deferred tax asset arising before exercise will be recoverable, and may therefore be recognised in full.

Tax deductions are given in the year of exercise, based on the intrinsic value of the options at the date of exercise. The intrinsic value of options at the end of each reporting period is as follows:

Year	*Intrinsic value per option*
	CU
1	3
2	8
3	8
4	1
5	7
6	6

On the basis of the information above:

- There would be an IFRS 2 charge of CU250 in years 1 and 2 (20 options × 5 employees × CU5 × 1/2 (portion of vesting period)
- Current and deferred tax assets must be recognised at the end of each period as follows:

Current tax

Year	*Number of options exercised*	*Intrinsic value per option*	*Total intrinsic value*	*Tax effect at 40%*
		CU	CU	CU
3	25	8	200	80
6	75	6	450	180

Deferred tax

Year	*Number of options outstanding*	*Temporary difference per option*	*Total temporary difference*	*Tax effect at 40%*
		CU	CU	CU
1	100	1.5[1]	150	60
2	100	8	800	320
3	75	8	600	240
4	75	1	75	30
5	75	7	525	210
6	-	6	-	-

1 Intrinsic value CU3 × 1/2 (expired portion of vesting period).

The required accounting entries for income taxes are as follows:

Year 1

Dr	Deferred tax (statement of financial position)	CU60		
	Cr Deferred tax (profit or loss)[1]		CU60	

Year 2

Dr	Deferred tax (statement of financial position)[2]	CU260		
	Cr Deferred tax (profit or loss)[3]		CU140	
	Cr Deferred tax (equity)		CU120	

Year 3				
Dr	Deferred tax (profit or loss)[4]		CU50	
Dr	Deferred tax (equity)		CU30	
	Cr	Deferred tax (statement of financial position)[5]		CU80
Dr	Current tax (statement of financial position)[6]		CU80	
	Cr	Current tax (profit or loss)[4]		CU50
	Cr	Current tax (equity)		CU30
Year 4				
Dr	Deferred tax (profit or loss)[7]		CU120	
Dr	Deferred tax (equity)		CU90	
	Cr	Deferred tax (statement of financial position)[8]		CU210
Year 5				
Dr	Deferred tax (statement of financial position)[9]		CU180	
	Cr	Deferred tax (profit or loss)[10]		CU120
	Cr	Deferred tax (equity)		CU60
Year 6				
Dr	Deferred tax (profit or loss)[11]		CU150	
Dr	Deferred tax (equity)		CU60	
	Cr	Deferred tax (statement of financial position)		CU210
Dr	Current tax (statement of financial position)[12]		CU180	
	Cr	Current tax (profit or loss)[13]		CU150
	Cr	Current tax (equity)		CU30

1 The cumulative tax income is based on expected deductions of CU150, which is less than the cumulative IFRS 2 charge of CU250 (see above)

2 Year 2 year-end balance of CU320 (see table above), less CU60 recognised at end of year 1 = CU140

3 Cumulative deferred tax recognised in profit or loss must not exceed 40% × CU500 (cumulative IFRS 2 charge) = CU200. This limits the credit for year 2 to CU200 less the CU60 credited in year 1 = CU140

4 Reversal of deferred tax income previously recognised in profit or loss for the 25 options exercised: 25 × CU5 [IFRS 2 charge per option] × 40% = CU50. This also represents the limit on the amount of current tax deduction that can be recognised in profit or loss

5 Year 3 year-end balance of CU240 (see table above), less CU320 recognised at end of year 2 = CU80.

6 25 options × CU8 intrinsic value × 40% = CU80

In years 4 to 6, the amount of tax recognised in profit or loss is restricted by the cumulative IFRS 2 expense of CU375 for the 75 options left outstanding (75 options × CU5).

7 Cumulative (maximum) tax deduction already recognised in profit or loss is CU375 @ 40% = CU150. This needs to be reduced to CU30 (year end deferred tax balance), giving rise to a charge of CU150 - CU30 = CU120. This can be seen as representing the fact that, at the start of the period a cumulative potential tax deduction of CU5 per award had been recognised in profit or loss. At the end of the period it is expected that deductions of only CU1 per award will be available. Therefore, there is a loss to be recognised in profit or loss of 75 awards × (CU5 - CU1) × 40% = CU120

8 Year 4 year-end balance of CU30 (see table above), less CU240 recognised at end of year 3 = CU(210)

9 Year 5 year-end balance of CU210 (see table above), less CU30 recognised at end of year 4 = CU180

10 Cumulative maximum tax deduction that can be recognised in profit or loss is CU150 (see note 7). CU30 cumulative deduction is brought forward, so that credit for period is limited to CU150 - CU30 = CU120

11 Reversal of deferred tax previously recognised. The amount previously taken to profit or loss was limited to CU150 (see notes 7 and 9)

12 75 options × CU6 × 40% = CU180

13 Deduction restricted to CU375 [IFRS 2 charge] × 40% = CU150

It will be noted that the cumulative effect of the above entries in profit or loss is as follows (tax income in brackets):

Year	*Deferred tax*	*Current tax*	*Total*
	CU	CU	CU
1	(60)		(60)
2	(140)		(140)
3	50	(50)	-
4	120		120
5	(120)		(120)
6	150	(150)	-
		Total	(200)

The cumulative effect of the above entries in equity is as follows (tax income in brackets):

Year	*Deferred tax*	*Current tax*	*Total*
	CU	CU	CU
1			-
2	(120)		(120)
3	30	(30)	-
4	90		90
5	(60)		(60)
6	60	(30)	30
		Total	(60)

The overall effect is to take credit in profit or loss for the lower of total tax deductions actually received of CU260 (CU80 in year 3 and CU180 in year 6) and the tax deductions on the IFRS 2 expense of CU200 (40% of CU500). The excess tax deductions of CU60 are recognised in equity.

10.8.5 Replacement awards in a business combination

IFRS 3 contains some detailed provisions on the treatment of share-based payment awards issued by an acquirer to replace awards made by the acquired entity before the business combination occurred. These are discussed in Chapter 30 at section 11.

IFRS 3 amended IAS 12 to include an illustrative example for the treatment of tax deductions on such replacement awards, the substance of which is reproduced as Illustration 10-17 below. *[IAS 12.IE Example 6]*.

Illustration 10-17: Deferred tax on replacement share-based awards in a business combination

On 1 January 20X3 Entity A acquired Entity B. A paid cash consideration of CU400 million to the former owners of B. At the acquisition date B had outstanding fully-vested employee share options with a fair value of CU100 million. As part of the business combination B's outstanding share options are replaced by fully vested share options of A (replacement awards) with a market-based measure of CU100 million and an intrinsic value of CU80 million. In accordance with IFRS 3, the replacement awards are part of the consideration transferred for B (see Chapter 30 at section 11).

A tax deduction will be given only when the options are exercised, based on the intrinsic value of the options at that date. A's tax rate is 40%.

A recognises a deferred tax asset of CU32 million (intrinsic value of CU80m × 40%) on the replacement awards at the acquisition date (see section 10.8.1 above). IAS 12 does not indicate the calculation if only part of the fair value of the award were regarded as part of the consideration transferred. However, it would be consistent with the general approach indicated in section 10.8.2 above to calculate the tax base of the award by adjusting the intrinsic value by the ratio of the expired vesting period at acquisition to the total vesting period of the award (as determined for the purposes of IFRS 3 see Chapter 30 at section 11).

A measures the identifiable net assets obtained in the business combination (excluding deferred tax assets and liabilities) at CU450 million, with a combined tax base of CU300 million, giving rise to a taxable temporary difference at the acquisition date of CU150 million, on which deferred tax at 40% of CU60 million is recognised. Goodwill is calculated as follows:

	CU m
Cash consideration	400
Replacement options	100
Total consideration	500
Identifiable net assets (excluding deferred tax)	(450)
Deferred tax asset	(32)
Deferred tax liability	60
Goodwill	78

Reductions in the carrying amount of goodwill are not deductible for tax purposes. In accordance with the initial recognition exception in IAS 12 (see section 7.2 above), A recognises no deferred tax liability for the taxable temporary difference associated with the goodwill recognised in the business combination. The accounting entry for the business combination is therefore as follows:

			CU m	CU m
Dr	Goodwill		78	
Dr	Identifiable net assets		450	
Dr	Deferred tax asset		32	
	Cr	Cash		400
	Cr	Equity		100
	Cr	Deferred tax liability		60

On 31 December 20X3 the intrinsic value of the replacement awards is CU120 million, in respect of which A recognises a deferred tax asset of CU48 million (CU120 million at 40%). This gives rise to deferred tax income of CU16 million (CU48 million recognised at 31 December 20X3 less CU32 million arising on acquisition). IAS 12 notes, somewhat redundantly, that this amount is credited to 'deferred tax income', but with no indication as to whether the amount must be recognised in profit or loss or in equity.

How we see it

In our view, the general principles of IAS 12 regarding tax deductions on share-based payment transactions suggest that the entire amount is recognised in equity. This is because the replacement awards are equity-settled and because they were fully-vested as at the acquisition date and as a result the consolidated financial statements of A have never recognised any expense for the award in profit or loss (since it is attributed fully to the consideration transferred). Therefore, none of the tax deductions can be recognised in profit or loss either.

10.8.5.A Implications if the replacement awards are cash-settled

Illustration 10-18 below demonstrates the implications where the replacement awards in a business combination are cash-settled.

Illustration 10-18: Deferred tax on replacement share-based awards in a business combination

If the replacement awards in Illustration 10-17 above were cash-settled, the accounting as at the acquisition date would be the same as above, except only that the fair value of the replacement award of CU100 is recognised as a liability rather than as a credit to equity.

			CU m	CU m
Dr	Goodwill		78	
Dr	Identifiable net assets		450	
Dr	Deferred tax asset		32	
	Cr	Cash		400
	Cr	Liability - cash-settled awards		100
	Cr	Deferred tax liability		60

In the case of a cash-settled replacement award, the liability is remeasured for changes to its fair value up to the settlement date. As all changes in the liability related to a cash-settled share-based payment transaction are recognised in profit or loss for the period (see Chapter 30 at section 9.3.1), the related movement in the deferred tax asset (of CU16 million in Illustration 10-17 above) is also recognised in profit or loss. *[IAS 12.58]*.

10.8.6 Share-based payment transactions subject to transitional provisions of IFRS 1 and IFRS 2

IFRS 1 and IFRS 2 provide, respectively, first-time adopters and existing IFRS preparers with some transitional exemptions from accounting for share-based payment transactions. The accounting treatment of the tax effects of transactions to which these exemptions have been applied is discussed in Chapter 6 at section 7.3.2. Whilst that discussion specifically addresses the tax effects of transactions subject to the exemption for first-time adopters of IFRS accounting standards, it is equally applicable to the tax effects of transactions subject to the exemptions in IFRS 2 for existing IFRS preparers.

10.9 Change in tax status of entity or shareholders

Sometimes there is a change in an entity's tax assets and liabilities as a result of a change in the tax status of the entity itself or that of its shareholders. SIC-25 clarifies that the effect of such a change must be recognised in profit or loss for the period except to the extent that it involves a remeasurement of tax originally accounted for in other comprehensive income or in equity, in which case the change must also be dealt with in, respectively, other comprehensive income or equity. *[SIC-25.4]*.

SIC-25 does not specifically address when the effect of a change in tax status must be recognised except to state that a change in tax status is included in the profit or loss 'for the period'. The effect of change in tax status is recognised when such a change is effective, and the entity has complied with all the criteria imposed by the legislation. However, in situations where an entity has complied with all the criteria for a change in tax status earlier than its effective date and as such the timing of the change is under the control of the entity or otherwise determined, the entity might need to assess whether it is appropriate to recognise the effect of such change in tax status prior to the effective date.

How we see it

In our view, where an entity has complied with all the substantive criteria required by the legislation as at the end of the reporting period and the change in tax status is wholly under the control of the entity or otherwise merely a matter of the passage of time, it would be appropriate to recognise the effect of change in tax status prior to the effective date when the substantive criteria is met.

10.10 Previous revaluation of PP&E treated as deemed cost on transition to IFRS

IFRS 1 requires full retrospective application of standards effective at the end of a first-time adopter's first IFRS reporting period, unless a specific exemption is provided therein. *[IFRS 1.7]*. In some cases, IFRS 1 allows an entity, on transition to IFRS accounting standards, to treat the carrying amount of property, plant, and equipment (PP&E) revalued under its pre-transition GAAP as a deemed cost for the purposes of IFRS accounting standards (see Chapter 6 at section 5.4).

Where an asset is carried at deemed cost on transition to IFRS accounting standards, but the tax base of the asset remains at original cost (or an amount based on original cost), the pre-transition revaluation will give rise to a temporary difference (often, a taxable temporary difference) associated with the asset. While the deemed cost provisions in IFRS 1 establish an appropriate measurement base for the carrying amount of previously revalued assets in the financial statements at the date of transition, they have no impact on whether a temporary difference exists. IFRS 1 does not provide an exemption from applying IAS 12, which requires deferred tax to be recognised on any such temporary difference at transition.

If, after transition, the deferred tax is required to be remeasured (e.g., because of a change in tax rate, or a re-basing of the asset for tax purposes), and the asset concerned was revalued outside profit or loss under pre-transition GAAP, the question arises as to whether the resulting deferred tax income or expense should be recognised in, or outside, profit or loss. A literal interpretation of IAS 12 would require changes relating to the past revaluation of the PP&E to be reflected in other comprehensive income, because that is where such an earlier revaluation would have been recorded under IFRS accounting standards (see section 10.2 above). However, where an entity elects to apply the cost model of IAS 16, the subsequent accounting treatment of the asset is the same, regardless of whether the 'deemed cost' of the asset on transition to IFRS was an earlier valuation, a revaluation as at the date of transition or original cost less depreciation and impairment up to that date. In all cases, subsequent depreciation and impairments are charged to profit or loss. In these circumstances, it could be argued that the deemed cost exemption on transition requires the asset to be treated in all respects as if its original cost had been the carrying value as at the transition date. In this way, any backward tracing of deferred tax in relation to past revaluations of an asset carried at 'deemed cost' must also be ignored and the effect of subsequent measurement must also be recognised in profit or loss.

How we see it

In our view, either approach is acceptable provided that it is applied consistently.

10.11 Disposal of an interest in a subsidiary that does not result in a loss of control

Under IFRS 10 *Consolidated Financial Statements* - a decrease in a parent's ownership interest in a subsidiary that does not result in a loss of control is accounted for in the consolidated financial statements as an equity transaction, i.e., a transaction with owners in their capacity as owners. *[IFRS 10.23]*. In these circumstances, the carrying amounts of the controlling and non-controlling interests are adjusted to reflect the changes in their relative interests in the subsidiary. "The entity shall recognise directly in equity any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received, and attribute it to the owners of the parent." *[IFRS 10.B96]*. In other words, no changes in a subsidiary's assets (including goodwill) and liabilities are recognised in a transaction in which a parent increases or decreases its ownership interest in a subsidiary that it already controls. *[IFRS 10.BCZ173]*. Increases or decreases in the ownership interest in a subsidiary do not result in the recognition of a gain or loss. Accounting for disposals of interests that do not result in a loss of control is discussed in Chapter 8 at section 4.

As the transaction is accounted for as an equity transaction, which does not affect profit or loss in the consolidated financial statements, one might assume that the full amount of any tax effect must also be recognised in equity. *[IAS 12.58(a)]*. However, this is not the case to the extent that any adjustment to non-controlling interests relates to the post acquisition profit of the subsidiary, which was previously recognised in the consolidated income statement, as shown in Illustration 10-19 below.

Illustration 10-19: Tax effect of a disposal of an interest in a subsidiary that does not result in a loss of control

A parent owns 100% of the equity shares of a subsidiary and presents the investment at a cost of CU1,000,000 in its separate financial statements. At the end of the reporting period, the subsidiary's post acquisition profit and net asset value recognised in the parent's consolidated financial statements are CU500,000 and CU1,500,000 respectively. Previously, the parent had not recognised deferred taxation, as it considered it probable that the temporary difference would not reverse in the foreseeable future. The parent disposes of a 20% interest in the subsidiary for a cash consideration of CU1,400,000 (the 'Transaction').

It is assumed that the tax base of the investment in the subsidiary is the same as its original cost of CU1,000,000. The taxable gain is calculated on the same basis as the gain recognised in the separate financial statements and the applicable tax rate is 25%.

The parent recognises a gain of CU1,200,000 (i.e., CU1,400,000 - [CU1,000,000 × 20%]) in its separate financial statements and is liable for a current tax of CU300,000 (i.e., CU1,200,000 × 25%).

The Transaction does not result in the parent losing control of the subsidiary and it is accounted for in equity in the consolidated financial statements of the parent. The parent recognises non-controlling interests of CU300,000 (i.e., CU1,500,000 × 20%) and credits equity for CU1,100,000, being the difference between the consideration of CU1,400,000 and the non-controlling interests of CU300,000, in the consolidated financial statements of the parent.

What are the current and deferred tax effects in the consolidated financial statements if:

(a) The transaction, although expected, is not completed until after the end of the reporting period?

Or

(b) The transaction is completed at the end of the reporting period?

If the transaction is not completed until after the end of the reporting period, no current tax is recognised. However, as the parent intends to recover 20% of its investment in the subsidiary through sale, it must recognise a deferred tax liability in the consolidated financial statements for the temporary difference associated with its investment in the subsidiary that is expected to reverse in the foreseeable future. *[IAS 12.39]*. Its carrying value in the consolidated financial statements is CU1,500,000 and its tax base is CU1,000,000. Accordingly, deferred tax of CU25,000 (i.e., [CU1,500,000 - CU1,000,000] × 20% × 25%) must be recognised in profit or loss in the consolidated financial statements. This deferred tax would reverse through profit or loss upon disposal, because it relates to the post acquisition profit recognised in an earlier period. *[IAS 12.58]*.

If the transaction is completed at the end of the reporting period, the consolidated financial statements would include a current tax charge of CU300,000 on the taxable gain on sale recorded by the subsidiary. Whilst the transaction is recorded in equity in the consolidated financial statements, because there is no loss of control, only CU1,100,000 out of the total taxable gain of CU1,200,000 was taken to non-controlling interests in equity. *[IAS 12.58(a)]*. CU275,000 (i.e., CU1,100,000 × 25%) of the current tax charge relates to the amount that is recognised directly in equity (CU1,100,000) and is, therefore, recognised directly in equity. *[IAS 12.61A(b)]*. The remaining CU25,000 (i.e., [CU1,500,000 - CU1,000,000] × 20% × 25%) is recognised as a current tax expense in profit or loss in the consolidated financial statements, as it does not relate to an amount directly recognised in equity, but to the crystallisation of part of the outside basis temporary difference arising from the post-acquisition profits of the subsidiary.

11 Consolidated tax returns and offset of taxable profits and losses within groups

In some jurisdictions, one member of a group of companies may file a single tax return on behalf of all, or some, members of the group. Sometimes this is a mandatory requirement for a parent entity and its eligible subsidiaries operating in the same tax jurisdiction; and sometimes adoption is elective. In other jurisdictions, it is possible for one member of a group to transfer its tax losses to one or more other members of the group in order to reduce their tax liabilities. In some groups a company whose tax liability is reduced by such an arrangement may be required to make a payment to the member of the group that pays tax on its behalf, or transfers losses to it, as the case may be. In other groups no such charge is made.

Such transactions raise the question of the appropriate accounting treatment in the separate financial statements of the group entities involved - in particular, whether the company benefiting from such an arrangement must reflect income (or more likely a capital contribution) from another member of the group equal to the tax expense mitigated as a result of the arrangement.

Some argue that the effects of such transactions must be reflected in the separate financial statements of the entities involved, as is required by some national standards (e.g., those of the US and Australia). Others argue that, except to the extent that a management charge is actually made (see section 11.1 below), there is no need to reflect such transactions in the separate financial statements of the entities involved. Those that take this view point out that it is inconsistent to require companies to show a capital contribution for tax losses ceded to them without charge, unless all other intragroup transactions are also restated on arm's-length terms - which would be somewhat radical. Moreover, IAS 24 *Related Party Disclosures* merely requires disclosure of the actual terms of such transactions, not that they be remeasured, either for financial reporting or disclosure purposes, on the same basis as a similar notional arm's length transaction (see Chapter 35).

How we see it

IAS 12 is silent on the issue and, in our view, no single approach can be said to either be prohibited or required. Accordingly, a properly considered approach may be adopted, provided that it is applied on a consistent basis and the related judgements are disclosed where their impact is believed to be material. In arriving at an appropriate judgement, the discussion in sections 4.1 and 4.4 above is relevant in considering whether entities must apply IAS 12 or another standard (such as IAS 37). Any judgement must be based on the particular facts and circumstances relating to the legislation giving rise to tax-consolidation, the nature of the obligations and rights of entities in the group and local company law. As noted in section 4.4 above, where there is a predominant local consensus in evidence or specific guidance issued by regulators in the relevant tax jurisdiction, then we believe that the entity must apply this consensus or guidance.

11.1 Examples of accounting by entities in a tax-consolidated group

In a typical tax-consolidation arrangement, a single consolidated annual tax return is prepared for the tax-consolidated group as a whole. Transactions between the entities in the tax-consolidated group are eliminated, and therefore ignored for tax purposes. A single legal entity in the group (usually the parent) is primarily liable for the current income tax liabilities of that group. Each entity in the group would be jointly and severally liable for the current income tax liability of the group if the parent entity defaults. There might also be a legally binding agreement between the entities in the group which establishes how tax assets and liabilities are allocated within the group.

As noted above, IAS 12 is silent on the issue and there is diversity in practice where these arrangements exist. Some entities apply IAS 37 principles to the recognition, measurement and allocation of current tax assets and liabilities to individual entities in the group, on the basis that tax is determined on the basis of the taxable profits of the group as a whole and not on the profits of the individual entities themselves. In that case current tax assets and liabilities are allocated on the basis of each entity's legal or constructive obligations to the tax authorities (for example, where joint and several liability is determined to exist) or to other entities in the tax-consolidated group (including where formal agreements are implemented for the funding and sharing or tax liabilities and assets). Deferred tax is not accounted for in separate financial statements in these circumstances. Other entities apply the recognition and measurement principles of IAS 12 on the basis that tax is still determined on the basis of the taxable profits of each entity in the group on the obligations of each entity to the tax authorities. When IAS 12 is deemed to apply, entities will account for both current and deferred tax in their separate financial statements. Various approaches may be acceptable under IFRS accounting standards for the determination of how current and deferred tax is allocated between entities in the tax-consolidated group. In Australia, where entities apply a standard virtually identical to IAS 12 in separate financial statements, three alternative approaches are suggested as examples of acceptable allocation methods:[34]

- A 'stand-alone taxpayer' approach for each entity, as if it continued to be a taxable entity in its own right.
- A 'separate taxpayer within group' approach for each entity, on the basis that the entity is subject to tax as part of the tax-consolidated group. This method requires adjustments for transactions and events occurring within the tax-consolidated group that do not give rise to a tax consequence for the group or that have a different tax consequence at the level of the group.
- A 'group allocation' approach, under which the income tax amounts for the tax-consolidated group are allocated among each entity in the group.

Nevertheless, there may be other methods that are also appropriate.

11.2 Payments for intragroup transfer of tax losses

Where one member of a group transfers tax losses to another member of the group, the entity whose tax liability is reduced may be required, as matter of group policy, to pay an amount of compensation to the member of the group that transfers the losses to it. Such payments are known by different terms in different jurisdictions, but are referred to in the discussion below as 'tax loss payments'.

Tax loss payments are generally made in an amount equal to the tax saved by the paying company. In some cases, however, payment may be made in an amount equal to the nominal amount of the tax loss, which will be greater than the amount of tax saved. This raises the question of how such payments must be accounted for.

The first issue is whether such payments must be recognised:

- In total comprehensive income

  Or

- As a distribution (in the case of a payment from a subsidiary to a parent) or a capital contribution (in the case of a payment from a parent to a subsidiary)

The second issue is, to the extent that the payments are accounted for in total comprehensive income, whether they must be classified as:

- Income tax allocated between profit or loss, other comprehensive income or equity (see section 10 above). The argument for this treatment is that the payments made or received are amounts that would otherwise be paid to or received from (or offset against an amount paid to) a tax authority.

  Or

- Operating income or expense in profit or loss (on the grounds that, as a matter of fact, the payments are not made to or received from any tax authority).

34 Urgent Issues Group Interpretation 1052 - Tax Consolidation Accounting, AASB, as amended June 2010.

How we see it

IAS 12 is silent on these issues. However, there is a long-standing practice in many jurisdictions that such payments are treated as if they were income taxes. We believe that this practice is appropriate to the extent that the intragroup payment is for an amount up to the amount of tax that would otherwise have been paid by the paying company. Where a tax loss payment is made in excess of this amount, we consider that it is more appropriate to account for the excess not as an income tax but as either:

- A distribution or capital contribution (as applicable)

  Or

- Operating income or expense (as applicable)

In considering the applicable treatment, the legal and regulatory requirements in the entity's jurisdiction would also be relevant, for example if those local requirements stipulate whether the excess payment is, in law, a distribution. The chosen treatment must be applied consistently.

11.3 Recognition of deferred tax assets where tax losses are transferred in a group

The ability of one member of a group to transfer its tax losses to another member of the group that expects to have taxable profits against which those losses can be utilised is an example of a tax planning opportunity 'that will create taxable profit in appropriate periods'. *[IAS 12.29(b)]*. Accordingly, it would be appropriate to recognise in the entity's consolidated financial statements a deferred tax asset in respect of unused tax losses and unused tax credits that are expected to be utilised in this way. *[IAS 12.29]*.

In the separate financial statements of the member of the group that holds the unused losses and tax credits, it would only be appropriate to recognise an asset to the extent that this entity expects to benefit itself from any transfer. Such benefits might be in the form of payment for losses as discussed in section 11.1 above, or as a result of taxable profits otherwise created in the surrendering entity as a result of the transfer. If the surrendering entity is not expected to receive any benefit in relation to the unused losses and tax credits given up, then an asset must not be recognised in the separate financial statements of that entity.

12 Business combinations

Additional deferred tax arises on business combinations as a result of items such as:

- The application of IAS 12 to the assets and liabilities of the acquired business in the consolidated financial statements, when it has not been applied in the separate financial statements of that business.
- Where the acquired entity already applies IAS 12 in its own financial statements, the recognition in the fair value exercise of deferred tax in respect of assets and liabilities of the acquired entity where no deferred tax is provided in those financial statements. This may be the case where a temporary difference arose on initial recognition of an asset or liability in the acquired entity's own financial statements. Deferred tax would then be recognised in the acquirer's consolidated financial statements, because, in those statements, the difference arises on initial recognition in a business combination (see section 7.2 above).
- Adjustments made to measure the assets and liabilities of the acquired business fair value, with consequential changes in the temporary differences associated with those assets and liabilities.

Any deferred tax assets or liabilities on temporary differences that arise on a business combination affect the amount of goodwill or bargain purchase gain. *[IAS 12.66]*. Illustration 7-23 in section 7.6.1 above demonstrates the application of this principle.

12.1 Measurement and recognition of deferred tax in a business combination

IFRS 3 generally requires assets acquired and liabilities assumed in a business combination to be:

- Recognised only to the extent that they were assets or liabilities of the acquired entity at the date of acquisition. *[IFRS 3.10]*.

  And

- Measured at fair value. *[IFRS 3.18]*.

These provisions of IFRS 3 are discussed in more detail in Chapter 10 at section 5. As exceptions to this general principle, IFRS 3 requires an acquirer to:

- Recognise and measure a deferred tax asset or liability arising from the assets acquired and liabilities assumed in a business combination "in accordance with IAS 12". *[IFRS 3.24]*.

  And

- Account for the potential tax effects of temporary differences and carryforwards of an acquiree that exist at the acquisition date or arise as a result of the acquisition "in accordance with IAS 12". *[IFRS 3.25]*.

There are essentially two reasons underlying these exceptions. The first is that IAS 12 does not purport to measure future tax at fair value, but at an amount based on a prescribed model that takes no account of the time value of money. Secondly, and more subtly, IAS 12 requires a number of questions of both recognition and measurement to be resolved by reference to management's plans and expectations - in particular, the expected manner of recovery of assets (see section 8.4 above) or the likelihood of recovering deferred tax assets (see section 7.5 above). The expectations and plans of the acquirer may well differ from those of the acquired entity. For example, the acquired entity might have assessed, for the purposes of IAS 12, that an asset would be recovered through use, whereas the acquirer assesses it as recoverable through sale. The exceptions made by IFRS 3 allow the deferred tax recognised in a business combination to reflect the expectations of the acquirer rather than those of the acquiree.

Areas that give rise to particular difficulties of interpretation are:

- Determining the manner of recovery of assets and settlement of liabilities at the date of the business combination (see section 12.1.1 below)
- Deferred tax assets (see section 12.1.2 below)

12.1.1 Determining the manner of recovery of assets and settlement of liabilities

As discussed in section 8.4 above, IAS 12 requires deferred tax to be measured at an amount that reflects the tax consequences that would follow from the manner in which the entity expects to recover its assets or settle its liabilities. The expected manner of recovery or settlement may affect both the tax base of an asset or liability and the tax rate to be applied to any temporary difference arising.

How we see it

As further noted above, the acquirer's assessment of the manner of recovery for the purposes of IAS 12 may well differ from that of the acquired entity. For example, the acquired entity might have intended to recover an asset through use, whereas the acquirer intends to sell it. In such a case, in our view, the requirement of IFRS 3 to recognise and measure deferred tax in accordance with IAS 12 has the effect that the expectations of the acquirer are used to determine the tax base of an item and the measurement of any deferred tax associated with the item.

12.1.1.A Changes in tax base consequent on the business combination

In some jurisdictions, a business combination may provide the opportunity to revise the tax base of an asset to an amount equal to the fair value assigned to it in accounting for the business combination. Most significantly, this may include the ability to create a tax base for an intangible asset or goodwill which may have had no tax base at all for the acquiree.

In some cases, the increase (as it generally is) in tax base may be more or less automatic. In others, the taxpayer may be required to make a formal claim or election for the increase to the tax authority. Sometimes further restructuring may be required - for example, it may be necessary for the business of the acquired entity to be transferred to another entity in the acquirer's group in the same tax jurisdiction.

An increase in a tax base that requires action by the relevant entity after the acquisition (such as making a claim or election or undertaking a restructuring) occurs after the business combination. However, some hold the view that the ability to increase a tax base following a business combination is a benefit that is taken into account by an informed buyer in negotiating the purchase price. Accordingly, it is argued, the increase is most appropriately reflected by adjusting the tax base of assets acquired as at the date of the business combination as if the increase had occurred at that date. This reduces any deferred tax liability and, therefore, reduces any goodwill (or increases any 'bargain purchase' gain).

Those who support this view note that, if the increase in tax base is accounted for only when it legally occurs in the post-combination period, the net effect is to increase goodwill and reduce post-combination tax expense when in reality the entity may have done little more than fill in a form. It might also be difficult to sustain the higher carrying amount of goodwill arising from this treatment.

How we see it

We believe that it is generally appropriate to anticipate an increase to a tax base that legally occurs following a business combination in accounting for the business combination where the increase:

- Is automatic or requires only a notification to the tax authority
- Requires an application to the tax authority that is not normally refused for transactions of a comparable nature

  Or
- Is contingent on some post-acquisition restructuring, where this can be done without substantial difficulty

Conversely, we believe that it would not generally be appropriate to account for an increase in a tax base until it occurs where the increase:

- Relies on 'bespoke' tax planning that may be challenged by the tax authority
- Requires an application to the tax authority that in practice is frequently and successfully challenged for transactions of a comparable nature

  Or
- Is contingent on some post-acquisition restructuring, where this will involve a substantial process, such as obtaining approval from regulators, unions, pension fund trustees etc.

12.1.2 Deferred tax assets arising on a business combination

12.1.2.A Assets of the acquirer

Extract from IAS 12	
67	As a result of a business combination, the probability of realising a pre-acquisition deferred tax asset of the acquirer could change. An acquirer may consider it probable that it will recover its own deferred tax asset that was not recognised before the business combination. For example, the acquirer may be able to utilise the benefit of its unused tax losses against the future taxable profit of the acquiree. Alternatively, as a result of the business combination it might no longer be probable that future taxable profit will allow the deferred tax asset to be recovered. In such cases, the acquirer recognises a change in the deferred tax asset in the period of the business combination, but does not include it as part of the accounting for the business combination. Therefore, the acquirer does not take it into account in measuring the goodwill or bargain purchase gain it recognises in the business combination.

Therefore, when the acquiring entity is able to recognise a previously unrecognised tax asset of its own (e.g., unused tax losses), the recognition of the asset is accounted for as income in the period of the business combination, and not as part of the accounting for the business combination. Accordingly, the acquirer does not take it into account in measuring the goodwill or bargain purchase gain it recognises in the business combination. *[IAS 12.67]*.

As noted in section 7.5.4 above, the change in probability is not anticipated, i.e., an acquirer does not recognise the effect (positive or negative) relating to a target entity being acquired until the period in which the business combination is accounted for.

12.1.2.B Assets of the acquiree

It may be the case that deferred tax assets of an acquired entity do not meet the recognition criteria of IAS 12 from the perspective of the acquired entity, but do meet the criteria from the perspective of the acquirer. In such cases, the general principles of IAS 12 require the acquirer's perspective to be applied as at the date of the business combination. Accordingly, a deferred tax asset would be recognised, with a corresponding reduction in goodwill. *[IAS 12.66]*.

The potential benefit of the acquiree's income tax loss carryforwards or other deferred tax assets may not satisfy the criteria for separate recognition when a business combination is initially accounted for but may be realised subsequently. Any changes in recognised deferred tax assets of an acquired entity are accounted for as follows:

- Acquired deferred tax benefits recognised within the measurement period (see Chapter 10 at section 5.6.2) that result from new information about facts and circumstances that existed at the acquisition date are applied to reduce the carrying amount of any goodwill related to that acquisition. If the carrying amount of that goodwill is zero, any remaining deferred tax benefits are recognised in profit or loss.
- All other acquired deferred tax benefits realised are recognised in profit or loss (or outside profit or loss if IAS 12 so requires - see section 10 above). *[IAS 12.68]*.

12.1.3 Deferred tax liabilities of acquired entity

IAS 12 contains no specific provisions regarding the recognition of a deferred tax liability of an acquired entity after the date of the original combination. The recognition of such liabilities must therefore be accounted for in accordance with the normal rules of IAS 12 (i.e., in the period in which the liability arises), unless either:

- The recognition of the liability occurs within the provisional measurement period for the business combination and reflects new information about facts and circumstances that existed at the acquisition date, in which case the acquisition date value of the liability is retrospectively adjusted - see Chapter 10 at section 12

  Or

- The failure to recognise the liability at the time of the combination was an error, in which case the provisions of IAS 8 must be applied - see Chapter 3 at section 4.6

12.1.4 Tax deductible goodwill of the acquiree

An entity acquired in a business combination may have recognised goodwill, arising from its own previous business combinations, that is deductible for tax purposes. A question that arises is, how does the new acquirer reflect the tax consequences of such tax-deductible goodwill upon acquisition and subsequently in its consolidated financial statements? The deferred tax accounting of the tax-deductible goodwill ('old goodwill') depends on its relationship with the goodwill recognised by the acquirer upon acquisition ('new goodwill'). The considerations involved in assessing the extent of any relationship between the old and the new goodwill are described in section 12.1.4.A below. The Illustrations below describe two approaches to reflect tax consequences of the tax-deductible goodwill that is based on establishing relationship between the two.

Illustration 12-1: No relationship is established - a DTA is recognised for the old goodwill

Entity A, operating in country A, has two business units (A1 and A2) that are also cash generating units. Entity A acquired Subsidiary A2 on 1 January 20X4 for CU1,000, when subsidiary A2 had separable net assets with a fair value of CU700. Entity A recognised goodwill amounting to CU300 that is entirely attributable to A2. This goodwill is tax deductible over a period of 20 years. Entity A has never recognised an impairment loss on the goodwill to date. As at 31 December 20Y3, this goodwill has a carrying value of CU300 and a tax base of CU150. Accordingly, Entity A carried a deferred tax liability of CU30 (300-150 @20%) on its balance sheet.

On 1 January 20Y4, Entity X, operating in country X, acquires Entity A for a total consideration of CU2,500. The acquisition is treated as a business combination under IFRS 3. The fair value of the separable net assets of Entity A was CU1,600 (excluding the value of the future tax deductions on previously recognised goodwill). The resulting goodwill of CU900 is not tax deductible. However, Entity A is still entitled to claim tax deductions on its previously recognised goodwill and expects to have sufficient taxable profits available (either from existing deferred tax liabilities or future taxable profits) to utilise those deductions in future periods.

For the purpose of the Illustration, any taxable or deductible temporary differences arising on fair value adjustments in relation to the separable net assets acquired have been ignored. The tax rate assumed is 20% in both countries.

Management of Entity X have concluded that there is no relationship between the old and the new goodwill. The consequence of this conclusion is that the tax base of the new goodwill is zero because the new goodwill has arisen independently of the old goodwill. The carrying value of the new goodwill upon acquisition is CU900. This results in a taxable temporary difference of CU900. However, Entity X would not recognise the deferred tax liability of CU180 because it must apply the initial recognition exception in paragraph 15 of IAS 12.

Although the tax base of new goodwill is zero, there exists a tax base of CU150 related to the old goodwill, that does not have a corresponding carrying value in the consolidated balance sheet of Entity X. This tax base arises from the fact Entity A is entitled to the benefit of future tax deductions in relation to its previously recognised goodwill. Having determined that there are sufficient probable taxable profits available, Entity X recognises a deferred tax asset amounting to CU30 as part of its acquisition accounting and as a result the carrying value of the new goodwill is reduced to CU870. Under paragraph 24 of IAS 12, there is no initial recognition exception for such deductible temporary difference.

In the subsequent years, Entity X will continue to benefit from the tax deduction in Country A. Accordingly, when the current tax deduction of CU15 is claimed each year, a deferred tax expense of CU3 will be recognised by crediting the deferred tax asset. The deferred tax expense will offset the current tax credit from claiming the deduction. At the end of the remaining 10 years, the deferred tax asset of CU30 recognised upon acquisition will unwind to zero.

Illustration 12-2: A relationship is established - No deferred tax asset or liability is recognised

The facts are the same as in Illustration 12-1 above. However, in this scenario the management of Entity X have concluded that there is a relationship between the old and the new goodwill. The consequence of this conclusion is that the tax base of the new goodwill is CU150. The carrying value of the new goodwill upon acquisition is CU900, resulting in a taxable temporary difference of CU750. However, Entity X would not recognise a deferred tax liability of CU150 because it must apply the initial recognition exception in paragraph 15 of IAS 12.

In the subsequent years, Entity X will continue to benefit from the tax deduction in Country A. Accordingly, when the tax deduction of CU15 is claimed each year, a taxable temporary difference arises. Entity X will recognise a deferred tax expense of CU3 and a deferred tax liability of CU3. The deferred tax expense will offset the current tax credit from claiming the deduction. At the end of the remaining 10 years, Entity X will have accreted a deferred tax liability of CU30 that will reverse upon impairment and/or disposal of the CGUs comprising of associated goodwill.

How we see it

Establishing a relationship between the new goodwill and any old goodwill involves the exercise of judgement. In our view, it would be acceptable to adopt either of the approaches illustrated above provided that it is applied consistently in similar facts and circumstances. A key consideration in accounting for the tax consequences of tax-deductible goodwill is the extent to which there is any relationship between the old and the new goodwill and therefore the answer may not be binary.

Whether a relationship is established or not, the impact on the income statement after the business combination is the same. However, goodwill from the acquisition will be lower to the extent that no relationship is established (by virtue of the DTA recognised in relation to the acquiree's old goodwill). Both goodwill and any deferred tax asset are subject to impairment testing in accordance with the requirements in IAS 36 and IAS 12 respectively.

12.1.4.A A Establishing the extent of any relationship between the old and the new goodwill

As noted above, establishing a relationship between new goodwill in a business combination and any old goodwill involves the exercise of judgement. Goodwill represents the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised. Considering the new goodwill is a residual asset, a key consideration, as stated above, in accounting for tax consequences of tax-deductible goodwill is, whether there is any relationship between the old and the new goodwill. Entities would need to consider all relevant factors before concluding whether the old and new goodwill are related. Such relevant factors could include, but are not limited, to:

- The timing of the acquisitions creating the old and the new goodwill. If the previous acquisition is recent, it might appear that the new goodwill arose from similar factors as the old goodwill. As the length of the period between the two transactions increases, the factors giving rise to the new goodwill could become different.
- The extent of any differences between the first and second acquirer's expectations regarding the likely synergies from integrating the business that had generated the old goodwill.
- The extent to which the previously acquired business is intact. A greater degree of reorganisation and integration of the previously acquired business with that of its first parent might suggest a weaker relationship between the old goodwill and new goodwill.
- The difference in the value of old and new goodwill could give an indication of their relationship. A large difference between the old and the new goodwill could imply the two are arising from different factors, hence they are unrelated.
- Allocation of goodwill between different CGUs of the consolidated group may provide an indication of relationship. Allocating the new goodwill arising from the second acquisition to a CGU that includes business acquired in the first acquisition might suggest a stronger relationship between the old goodwill and new goodwill.

12.2 Tax deductions for replacement share-based payment awards in a business combination

IFRS 3 contains some guidance on the treatment of tax deductions for share-based payment transactions made by an acquirer as a replacement for awards made by the acquired entity before the business combination. This is discussed in more detail in section 10.8.5 above.

12.3 Apparent immediate impairment of goodwill created by deferred tax

The requirement of IAS 12 to recognise deferred tax on all temporary differences arising on net assets acquired in a business combination leads to the creation of goodwill which, on a literal reading of IAS 36 may then be required to be immediately impaired, as shown in Illustration 12-3 below.

Illustration 12-3: Apparent 'day one' impairment arising from recognition of deferred tax in a business combination

Entity A, which is taxed at 40%, acquires Entity B for CU100m in a transaction that is a business combination. The fair values and tax bases of the identifiable net assets of Entity B are as follows:

	Fair value CU m	*Tax base* CU m
Brand name	60	-
Other net assets	20	15

This will give rise to the following consolidation journal:

			CU m	CU m
Dr	Goodwill (balance)		46	
Dr	Brand name		60	
Dr	Other net assets		20	
	Cr	Deferred tax[1]		26
	Cr	Cost of investment		100

1 40% of (CU[60m + 20m] - CU15m)

The fair value of the consolidated assets of the subsidiary (excluding deferred tax) and goodwill is now CU126m, but the cost of the subsidiary is only CU100m. Clearly CU26m of the goodwill arises solely from the recognition of deferred tax. However, IAS 36.50 explicitly requires tax to be excluded from the estimate of future cash flows used to calculate any impairment. This raises the question of whether there must be an immediate impairment write-down of the assets to CU100m. In our view, this is unlikely to have been the intention of IAS 36 (see the further discussion in Chapter 21 at section 8.3.1).

12.4 Tax deductions for acquisition costs

Under IFRS 3 transaction costs are required to be expensed. However, in a number of jurisdictions, transaction costs are regarded as forming part of the cost of the investment for tax purposes, with the effect that a tax deduction for them is given only when the investment is subsequently sold or otherwise disposed of, rather than at the time that the costs are charged to profit or loss.

In such jurisdictions, there will be a deductible 'outside' temporary difference (see section 7.6 above) between the carrying value of the net assets and goodwill of the acquired entity in the consolidated financial statements (which will exclude transaction costs) and tax base of the investment in the entity (which will include transaction costs). Whether or not a deferred tax asset is recognised in respect of such a deductible temporary difference will be determined in accordance with the general provisions of IAS 12 for deductible temporary differences (see section 7.6.3 above).

In the separate financial statements of the acquirer, there may be no temporary difference where the transaction costs are, under IAS 27, included in the cost of the investment.

12.5 Temporary differences arising from the acquisition of a group of assets that is not a business

Although the acquisition of an asset or a group of assets that do not constitute a business is not within the scope of IFRS 3, in such cases the acquirer has to identify and recognise the individual identifiable assets acquired (including intangible assets) and liabilities assumed. The cost of the group is allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase. These transactions or events do not give rise to goodwill. *[IFRS 3.2(b)]*. Temporary differences may therefore arise because the new carrying value of each acquired asset and liability could be changed without any equivalent adjustment for tax purposes.

However, in these circumstances the acquirer cannot account for any deferred tax assets or deferred tax liabilities, resulting from temporary differences identified. Since the acquisition does not constitute a business combination, the initial recognition exception applies as discussed in section 7.2 above. Indeed, the application of the IRE would mean that no deferred tax is recognised by an acquiring entity, either on initial recognition or subsequently, for any temporary differences related to the 'tax history' of the related assets and liabilities (i.e., in relation to differences between their carrying values before their transfer and their tax base). Furthermore, an entity does not recognise subsequent changes in the unrecognised deferred tax liability or asset as the asset is depreciated. *[IAS 12.22(c)]*.

The requirements of IFRS 3 in relation to the acquisition of an asset or a group of assets that does not constitute a business is discussed in Chapter 10 at section 2.2.2.

13 Presentation

13.1 Statement of financial position

Tax assets and liabilities must be shown separately from other assets and liabilities and current tax must be shown separately from deferred tax on the face of the statement of financial position. Where an entity presents current and non-current assets and liabilities separately, deferred tax must not be shown as part of current assets or liabilities. *[IAS 1.54, IAS 1.56]*. The extent to which deferred tax assets and liabilities are classified within a disposal group under IFRS 5 is discussed in Chapter 5 at section 2.1.1.A.

13.1.1 Offset

13.1.1.A Current tax

Current tax assets and liabilities must be offset if, and only if, the entity:

- Has a legally enforceable right to set off the recognised amounts.

  And

- Intends either to settle them net or simultaneously. *[IAS 12.71]*.

These requirements are based on the offset criteria in IAS 32 for financial instruments. The phrase 'if and only if' means that offset is required if both the above conditions are met, but prohibited if they are not both met. Accordingly, while entities in many jurisdictions have a right to offset current tax assets and liabilities, and the tax authority permits the entity to make or receive a single net payment, IAS 12 permits offset in financial statements only where there is a positive intention for simultaneous net settlement. *[IAS 12.72]*.

The offset requirements in IAS 12 also have the effect that, in consolidated financial statements, a current tax asset of one member of the group is offset against a current tax liability of another, if and only if the two group members have a legally enforceable right to make or receive a single net payment and a positive intention to recover the asset or settle the liability simultaneously. *[IAS 12.73]*.

13.1.1.B Deferred tax

Deferred tax assets and liabilities must be offset if, and only if:

- The entity has a legally enforceable right to set off current tax assets against current liabilities

  And

- The deferred tax assets and liabilities concerned relate to income taxes raised by the same taxation authority on either:
  - The same taxable entity.

    Or
  - Different taxable entities which intend, in each future period in which significant amounts of deferred tax are expected to be settled or recovered, to settle their current tax assets and liabilities either on a net basis or simultaneously. *[IAS 12.74]*.

The phrase 'if and only if' means that offset is required if both the above conditions are met, but prohibited if they are not both met.

The position is that where in a particular jurisdiction current tax assets and current tax liabilities relating to future periods will be offset under the requirements set out in section 13.1.1.A above, deferred tax assets and liabilities relating to that jurisdiction and those periods must also be offset.

This requirement was adopted in order to avoid the need for detailed scheduling of the reversal of temporary differences that would otherwise have been necessary to determine whether taxable temporary differences and deductible temporary differences would reverse in the same periods (and therefore be eligible for offset in their own right). *[IAS 12.75]*.

However, IAS 12 notes that, in rare circumstances, an entity may have a legally enforceable right of set-off, and an intention to settle net, for some periods but not for others. In such circumstances, detailed scheduling may be required to establish reliably whether the deferred tax liability of one taxable entity in the group will result in increased tax payments in the same period in which a deferred tax asset of a second taxable entity in the group will result in decreased payments by that second taxable entity. *[IAS 12.76]*.

13.1.1.C No offset of current and deferred tax

IAS 12 contains no provisions allowing or requiring the offset of current tax and deferred tax. Also, as noted in section 13.1 above, IAS 1 requires tax assets and liabilities to be shown separately from other assets and liabilities and current tax to be shown separately from deferred tax on the face of the statement of financial position. *[IAS 1.54(n), IAS 1.54(o)]*.

How we see it

Accordingly, in our view, current and deferred tax may not be offset against each other and must always be presented gross.

13.2 Statement of comprehensive income

The tax expense (or income) related to profit or loss from ordinary activities must be presented as a component of profit or loss in the statement of comprehensive income. *[IAS 12.77]*.

The IFRS IC noted in July 2012 that the line item of 'tax expense' that is required by IAS 1.82(d) (see Chapter 3 at section 3.2.2) is intended to require an entity to present taxes that meet the definition of income taxes under IAS 12. The IFRS IC also noted that it is the basis of calculation determined by the relevant tax rules that determines whether a tax meets the definition of an income tax and consequently its presentation as a tax expense in the statement of comprehensive income. Accordingly, it is not appropriate to include in the line item for 'tax expense' charges or credits related to taxes that do not meet the definition of an income tax in IAS 12.[35]

The results of discontinued operations must be presented on a post-tax basis. *[IFRS 5.33]*. This is discussed further in Chapter 5 at section 3.2.

The results of equity-accounted entities must be presented on a post-tax basis. *[IAS 1.IG6]*. Any income tax relating to a 'tax-transparent' equity-accounted entity (see section 7.7 above) forms part of the investor's tax charge. It is therefore included in the income tax line in profit or loss and not shown as part of the investor's share of the results of the tax-transparent entity. Similarly, any deferred tax recognised in respect of temporary differences arising from differences between the carrying value of the entity's interest in its equity-accounted entities and its tax base forms part of the investor's tax charge. It must not be offset against the carrying value of the investors' interest in its equity-accounted investees,

Entities are required to disclose the amount of income tax relating to each item of other comprehensive income, including reclassification adjustments, either in the statement of profit or loss and other comprehensive income or in the notes. *[IAS 1.90]*. Components of other comprehensive income may be presented either:

- Net of related tax effects.

  Or

- Before related tax effects with one amount shown for the total income tax effects relating to the items that might be reclassified subsequently to profit and loss and another amount shown for the total income tax effects relating to those items that will not be subsequently reclassified to profit and loss. *[IAS 1.91]*.

IAS 12 notes that, whilst IAS 21 requires certain exchange differences to be recognised within income or expense, it does not specify where exactly in the statement of comprehensive income they must be presented. Accordingly, exchange differences relating to deferred tax assets and liabilities may be classified as deferred tax expense (or income), if that presentation is considered to be the most useful to users of the financial statements. *[IAS 12.78]*. IAS 12 makes no reference to the treatment of exchange differences on current tax assets and liabilities but, presumably, the same considerations apply.

However, the treatment of exchange differences related to both deferred tax assets and liabilities and current tax assets and liabilities has been clarified in IFRS 18 *Presentation and Disclosure in Financial Statements*, issued by the IASB in April 2024 that supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted).

35 *IFRIC Update*, July 2012, available on the IFRS Foundation's website.

IFRS 18 has introduced a separate category called 'The income taxes category'. Paragraph 67 of IFRS 18 requires an entity to classify in the income taxes category tax expense or tax income that is included in the statement of profit or loss applying IAS 12 including related foreign exchange differences, if any. *[IFRS 18.67]*. Accordingly, applying IFRS 18, an entity must classify exchange differences related to both deferred tax assets and liabilities and current tax assets and liabilities in the income taxes category of the profit and loss statement. Paragraph 78 of IAS 12 is consequentially amended upon the issuance of IFRS 18 to refer to, and require entities to apply, paragraph 67 of IFRS 18. See Chapter 4 for further guidance regarding the requirements in IFRS 18.

13.3 Statement of cash flows

Cash flows arising from taxes on income are separately disclosed and classified as cash flows from operating activities, unless they can be specifically identified with financing and investing activities. *[IAS 7.35]*.

IAS 7 *Statement of Cash Flows* notes that, whilst it is relatively easy to identify the expense relating to investing or financing activities, the related tax cash flows are often impracticable to identify. Therefore, taxes paid are usually classified as cash flows from operating activities. However, when it is practicable to identify the tax cash flow with an individual transaction that gives rise to cash flows that are classified as investing or financing activities, the tax cash flow is classified as an investing or financing activity as appropriate. When tax cash flows are allocated over more than one class of activity, the total amount of taxes paid is disclosed. *[IAS 7.36]*.

14 Disclosure

IAS 12 imposes extensive disclosure requirements as follows.

14.1 Components of tax expense

The major components of tax expense (or income) must be disclosed separately. *[IAS 12.79, IAS 12.80]*.

Extract from IAS 12

80 Components of tax expense (income) may include:

(a) current tax expense (income);

(b) any adjustments recognised in the period for current tax of prior periods;

(c) the amount of deferred tax expense (income) relating to the origination and reversal of temporary differences;

(d) the amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes;

(e) the amount of the benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce current tax expense;

(f) the amount of the benefit from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce deferred tax expense;

(g) deferred tax expense arising from the write-down, or reversal of a previous write-down, of a deferred tax asset in accordance with paragraph 56; and

(h) the amount of tax expense (income) relating to those changes in accounting policies and errors that are included in profit or loss in accordance with IAS 8, because they cannot be accounted for retrospectively.

14.2 Other disclosures

The following must also be disclosed separately: *[IAS 12.81]*

(a) The aggregate current and deferred tax relating to items that are charged or credited to equity.

(b) The amount of income tax relating to each component of other comprehensive income.

The analysis in (b) can be provided either in the statement of profit or loss and other comprehensive income or in the notes. *[IAS 1.90]*.

(c) An explanation of the relationship between tax expense (or income) and accounting profit in either or both of the following forms:

(i) A numerical reconciliation between tax expense (or income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed.

Or

(ii) A numerical reconciliation between the average effective tax rate (i.e., tax expense (or income) divided by accounting profit), *[IAS 12.86]*, and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed.

This requirement is discussed further in section 14.2.1 below.

(d) An explanation of changes in the applicable tax rate(s) compared to the previous accounting period.

(e) The amount (and expiry date, if any) of deductible temporary differences, unused tax losses, and unused tax credits for which no deferred tax asset is recognised in the statement of financial position.

(f) The aggregate amount of temporary differences associated with investments in subsidiaries, branches and associates and interests in joint arrangements, for which deferred tax liabilities have not been recognised.

This is discussed further in section 14.2.2 below.

(g) In respect of each type of temporary difference, and in respect of each type of unused tax losses and unused tax credits:

(i) The amount of the deferred tax assets and liabilities recognised in the statement of financial position for each period presented.

And

(ii) The amount of the deferred tax income or expense recognised in profit or loss, if this is not apparent from the changes in the amounts recognised in the statement of financial position.

The analysis in (ii) will be required, for example, by any entity with acquisitions and disposals, or deferred tax accounted for in other comprehensive income or equity, since this will have the effect that the year-on-year movement in the statement of financial position is not solely due to items recognised in profit or loss.

(h) In respect of discontinued operations, the tax expense relating to:

(i) The gain or loss on discontinuance.

And

(ii) The profit or loss from the ordinary activities of the discontinued operation for the period, together with the corresponding amounts for each prior period presented.

(i) The amount of income tax consequences of dividends to shareholders of the entity that were proposed or declared before the financial statements were authorised for issue, but are not recognised as a liability in the financial statements.

Further disclosures are required in respect of the tax consequences of distributing retained earnings, which are discussed in section 14.4 below.

(j) If a business combination in which the entity is the acquirer causes a change in the amount of a pre-acquisition deferred tax asset of the entity (see section 12.1.2 above), the amount of that change.

(k) If the deferred tax benefits acquired in a business combination are not recognised at the acquisition date, but are recognised after the acquisition date (see section 12.1.2 above), a description of the event or change in circumstances that caused the deferred tax benefits to be recognised.

The requirement at (e) and (f) above is to disclose the amount of the relevant temporary differences that have not been recognised (i.e., gross) whereas at (g) and (i) above, the requirement is to disclose the tax amount.

Tax-related contingent liabilities and contingent assets (such as those arising from unresolved disputes with taxation authorities) are disclosed in accordance with IAS 37 (see section 9.6 above and Chapter 27 at section 7). *[IAS 12.88]*.

Significant effects of changes in tax rates or tax laws enacted or announced after the reporting period on current and deferred tax assets and liabilities are disclosed in accordance with IAS 10 (see Chapter 34 at section 2). *[IAS 12.88]*.

14.2.1 Tax (or tax rate) reconciliation

IAS 12 explains that the purpose of the tax reconciliation required by (c) above is to enable users of financial statements to understand whether the relationship between tax expense (or income) and accounting profit is unusual and to understand the significant factors that could affect that relationship in the future. The relationship may be affected by the effects of such factors as:

- Revenue and expenses that are outside the scope of taxation.
- Tax losses.
- Foreign tax rates. *[IAS 12.84]*.

Accordingly, in explaining the relationship between tax expense (or income) and accounting profit, an entity must use an applicable tax rate that provides the most meaningful information to the users of its financial statements.

Often, the most meaningful rate is the domestic rate of tax in the country in which the entity is domiciled. In this case, the tax rate applied for national taxes must be aggregated with the rates applied for any local taxes which are computed on a substantially similar level of taxable profit (tax loss). However, for an entity operating in several jurisdictions, it may be more meaningful to aggregate separate reconciliations prepared using the domestic rate in each individual jurisdiction. *[IAS 12.85]*. Where this latter approach is adopted, the entity may need to discuss the effect of significant changes in either tax rates, or the mix of profits earned in different jurisdictions, in order to satisfy the requirement of IAS 12 to explain changes in the applicable tax rate(s) compared to the previous accounting period - see item (d) in section 14.2 above.

Illustration 14-1 demonstrates how the selection of the applicable tax rate affects the presentation of the numerical reconciliation.

Illustration 14-1: Alternative presentations of tax reconciliation

In 20X3 an entity has accounting profit of CU3,000m (20X2: CU2,500m) comprising CU1,500m (20X2: CU2,000m) in its own jurisdiction (country A) and CU1,500m (20X2: CU500m) in country B. The tax rate is 30% in country A and 20% in country B. In country B, expenses of CU200m (20X2: CU100m) are not deductible for tax purposes. There are no other differences between accounting profit and profit that is subject to current tax, or on which deferred tax has been provided for under IAS 12.

Thus, the accounting tax charge in the financial statements for each period will be as follows:

	20X3	20X2
	CU m	CU m
Country A		
CU1,500m/CU2,000m @ 30%	450	600
Country B		
CU(1,500 + 200)m/CU(500 + 100)m @ 20%	340	120
Total tax charge	790	720

Reconciliation based on A's domestic tax rate

If the entity presents a tax reconciliation based on its own (i.e., country A's) domestic tax rate, the following presentation would be adopted.

	20X3	20X2
	CU m	CU m
Accounting profit	3,000	2,500
Tax at domestic rate of 30%	900	750
Effect of:		
Expenses not deductible for tax purposes[1]	60	30
Overseas tax rates[2]	(170)	(60)
Tax expense	790	720

1 CU200m/CU100m @ 30%
2 B's taxable profit CU1,700m/CU600m @ (20% - 30%)

Reconciliation based on each jurisdiction's tax rate

If the entity presents a tax reconciliation based on each jurisdiction's domestic tax rate, the following presentation would be adopted.

	20X3	20X2
	CU m	CU m
Accounting profit	3,000	2,500
Tax at domestic rates applicable to individual group entities[1]	750	700
Effect of:		
Expenses not deductible for tax purposes[2]	40	20
Tax expense	790	720

1 20X3: A = CU450m [CU1,500m @ 30%], B = CU300m [CU1,500m @ 20%], total CU750m
20X2: A = CU600m [CU2,000m @ 30%], B = CU100m [CU500m @ 20%], total CU700m
2 CU200m/CU100m @ 20%

14.2.2 Temporary differences relating to subsidiaries, associates, branches and joint arrangements

IAS 12 requires an entity to disclose the gross temporary differences associated with subsidiaries, associates, branches and joint arrangements for which a deferred tax liability is not recognised, as opposed to the unrecognised deferred tax on those temporary differences - see (f) under 14.2 above.

IAS 12 clarifies that this approach is adopted because it would often be impracticable to compute the amount of unrecognised deferred tax. Nevertheless, where practicable, entities are encouraged to disclose the amounts of the unrecognised deferred tax liabilities because financial statement users may find such information useful. *[IAS 12.87]*.

14.3 Reason for recognition of particular tax assets

Separate disclosure is required of the amount of any deferred tax asset that is recognised, and the nature of the evidence supporting its recognition, when:

(a) Utilisation of the deferred tax asset is dependent on future profits in excess of those arising from the reversal of deferred tax liabilities.

And

(b) The entity has suffered a loss in the current or preceding period in the tax jurisdiction to which the asset relates. *[IAS 12.82]*.

In effect these disclosures are required when the entity has rebutted the presumption inherent in the recognition rules of IAS 12 that tax assets will not normally be recognised in these circumstances (see section 7.5 above).

14.4 Dividends

As discussed in section 8.5 above, where there are different tax consequences for an entity depending on whether profits are retained or distributed, tax must be measured at the rates applicable to retained profits except to the extent that there is a liability to pay dividends at the end of the reporting period, where the rate applicable to distributed profits must be used.

Where such differential tax rates apply, the entity must disclose the nature of the potential income tax consequences that would arise from a payment of dividends to shareholders. It must quantify the amount of potential income tax consequences that is practicably determinable and disclose whether there are any potential income tax consequences that are not practicably determinable. *[IAS 12.82A]*. This will include disclosure of the important features of the income tax systems and the factors that will affect the amount of the potential income tax consequences of dividends. *[IAS 12.87A]*.

The reason for this rather complicated requirement is that, as IAS 12 acknowledges, it can often be very difficult to quantify the tax consequences of a full distribution of profits (e.g., where there are a large number of overseas subsidiaries). *[IAS 12.87B]*. Moreover, IAS 12 concedes that there is a tension between, on the one hand, the exemption from disclosing the deferred tax associated with temporary differences associated with subsidiaries and other investments (see section 14.2.2 above) and, on the other hand, this requirement to disclose the tax effect of distributing undistributed profits. *[IAS 12.87C]*.

However, to the extent that any liability can be quantified, it must be disclosed. This may mean that consolidated financial statements will disclose the potential tax effect of distributing the earnings of some, but not all, subsidiaries, associates, branches and joint arrangements.

IAS 12 emphasises that, in an entity's separate financial statements, this requirement applies only to the undistributed earnings of the entity itself and not those of any of its subsidiaries, associates, branches and joint arrangements. *[IAS 12.87B]*.

14.5 International tax reform-Pillar Two model rules

See sections 4.6.2.C, 4.6.2.D and 4.6.2.E above for the disclosure requirements related to Pillar Two Income Taxes introduced by the amendments to IAS 12 in May 2023.

14.6 Examples of disclosures

14.6.1 Components of tax expense and reconciliation of the tax charge

In Practical example 14-1 below, Shell plc sets out the components of the tax expense and provides a reconciliation of the tax charge in the income statement. *[IAS 12.79, IAS 12.80, IAS 12.81(c)]*.

Practical example 14-1: Shell plc (2023) — United Kingdom

Annual Report and Accounts [extract]
Financial Statements and Supplements [extract]
Consolidated Financial Statements [extract]
Notes to the Consolidated Financial Statements [extract]
22. Taxation [extract]

Taxation charge

			$ million
	2023	2022	2021
Current tax:			
Charge in respect of current period	13,066	16,383	7,254
Adjustments in respect of prior periods	(422)	(947)	(719)
Total	12,644	15,436	6,535
Deferred tax:			
Relating to the origination and reversal of temporary differences, tax losses and credits	(305)	5,196	2,971
Relating to changes in tax rates and legislation	242	785	10
Adjustments in respect of prior periods	410	524	(317)
Total	347	6,505	2,664
Total taxation charge	12,991	21,941	9,199

Adjustments in respect of prior periods relate to events in the current period and reflect the effects of changes in rules, facts or other factors compared with those used in establishing the current tax position or deferred tax balance in prior periods.

Adjustments in respect of changes in tax rates and legislation in 2022 principally relate to the introduction of the UK Energy Profits Levy Act 2022 (EPL) on July 14, 2022.

On December 20, 2021, the OECD/G20 Inclusive Framework on BEPS released the Pillar Two Model Rules aimed to address the tax challenges of the digitalisation of the economy. The Pillar Two rules are designed to ensure large multinational enterprises (meeting certain conditions) pay a minimum level of tax on the income arising in each jurisdiction where they operate. On June 20, 2023, the UK substantively enacted Pillar Two. Shell has established a Group-wide Pillar Two Project, with oversight from senior executives, to prepare and implement these new tax rules.

Shell has applied the exception, as set out in the amendments to IAS 12, to recognising and disclosing information about deferred tax assets and liabilities related to Pillar Two income taxes. The adoption of Pillar Two by the jurisdictions in which Shell operates is not expected to have a significant impact (see also Note 2).

Reconciliation of applicable tax charge at statutory tax rates to taxation charge

			$ million
	2023	2022	2021
Income before taxation	32,627	64,815	29,829
Less: share of profit of joint ventures and associates	(3,725)	(3,972)	(4,097)
Income before taxation and share of profit of joint ventures and associates	28,902	60,843	25,732
Applicable tax charge at standard statutory tax rates	11,921	22,170	10,097
Adjustments in respect of prior periods	(12)	(424)	(1,036)
Tax effects of:			
Expenses not deductible for tax purposes	1,225	849	893
Incentives for investment and development	(553)	(1,388)	(467)
Derecognition/(recognition) of deferred tax assets	243	(457)	(113)
Changes in tax rates and legislation	242	785	10
Income not subject to tax at standard statutory rates	(213)	234	90
Disposals	(113)	39	(328)
Exchange rate differences	89	(102)	53
Other reconciling items	162	235	–
Taxation charge	12,991	21,941	9,199
Weighted average of statutory tax rates [A]	41%	36%	39%
Effective tax rate based on income before taxation [B]	40%	34%	31%
Effective tax rate based on income before taxation excluding share of profit of joint ventures and associates [C]	45%	36%	36%

[A] The weighted average of statutory tax rates is calculated by dividing the applicable tax charge at standard statutory tax rates by Income before taxation and share of profit of joint ventures and associates.
[B] The effective tax rate based on income before taxation is calculated by dividing Taxation charge by Income before taxation.
[C] The effective tax rate based on income before taxation excluding share of profit of joint ventures and associates is calculated by dividing Taxation charge by Income before taxation and share of profit of joint ventures and associates.

...

14.6.2 Analysis of deferred tax assets and liabilities and movement in deferred taxes

In Practical example 14-2 below, Heineken Holding N.V. provides an analysis of deferred tax assets and liabilities recognised in the statement of financial position and a movement in deferred tax balances during the year. *[IAS 12.81(g)]*.

Practical example 14-2: Heineken Holding N.V. (2023) **Netherlands**

Annual Report 2023 [extract]
Financial Statements 2023 [extract]
Notes to the Consolidated Financial Statements [extract]
12. Tax [extract]
12.2 Deferred tax assets and liabilities [extract]

Recognised deferred tax assets and liabilities

Deferred tax assets and liabilities are attributable to the following items:

	Assets		Liabilities		Net	
In millions of €	**2023**	2022	**2023**	2022	**2023**	2022
Property, plant and equipment	162	149	(988)	(837)	(826)	(688)
Intangible assets	42	41	(2,166)	(2,052)	(2,124)	(2,011)
Investments	81	56	(7)	(5)	74	51
Inventories	63	67	(36)	(12)	27	55
Borrowings	399	314	(1)	(2)	398	312
Post-retirement obligations	209	203	(30)	(19)	179	184
Provisions	396	300	(9)	(13)	387	287
Other items	320	153	(210)	(211)	110	(58)
Tax losses carried forward	854	348	—	—	854	348
Tax assets/(liabilities)	**2,526**	1,631	**(3,447)**	(3,151)	**(921)**	(1,520)
Set-off of tax	(1,234)	(1,013)	1,234	1,013	—	—
Net tax assets/(liabilities)	**1,292**	618	**(2,213)**	(2,138)	**(921)**	(1,520)

In 2023, HEINEKEN approved a corporate restructuring plan to optimize the legal structure of Heineken Brazil, and part of the plan was executed in 2023. As a result of this restructuring, previously unrecognised deferred tax assets were recognised, amounting to €751 million. These assets mainly relate to tax losses carried forward. The measurement of these deferred tax assets takes into account the recent tax law changes in Brazil, effective from 2024, which are expected to lead to higher taxable profits in future years. Furthermore, a number of mergers are planned in future years resulting in a tax depreciable base, amounting to €403 million. No deferred tax asset was recorded for this tax depreciable base in 2023 awaiting the respective mergers. Reassessment will take place at the end of each reporting period.

Of the total net deferred tax assets of €1,292 million as at 31 December 2023 (2022: €618 million), €72 million (2022: €84 million) is recognised in respect of subsidiaries in various countries where there have been losses in the current or preceding period. Management's projections support the assumption that it is probable that the results of future operations will generate sufficient taxable income to utilise these deferred tax assets. This judgement is performed annually and based on budgets and business plans for the coming years, including planned commercial initiatives.

No deferred tax liability has been recognised in respect of undistributed earnings of subsidiaries, joint ventures and associates, with an impact of €743 million (2022: €573 million). This is because HEINEKEN is able to control the timing of the reversal of the temporary differences, and it is probable that such differences will not reverse in the foreseeable future.

Tax losses carried forward

HEINEKEN has tax losses carried forward of €4,011 million as at 31 December 2023 (2022: €3,802 million), out of which €294 million (2022: €389 million) expires in the following five years, €162 million (2022: €158 million) will expire after five years and €3,555 million (2022: €3,255 million) can be carried forward indefinitely. Deferred tax assets have not been recognised in respect of tax losses carried forward of €1,076 million (2022: €2,470 million) as it is not probable that taxable profit will be available to offset these losses. Out of this €1,076 million (2022: €2,470 million), €142 million (2022: €276 million) expires in the following five years, €13 million (2022: €37 million) will expire after five years and €921 million (2022: €2,157 million) can be carried forward indefinitely.

Movement in deferred tax balances during the year

In millions of €	1 January 2023	Hyperinflation restatement to 1 January 2023	Changes in consolidation	Hyperinflation adjustment	Effect of movements in foreign exchange	Recognised in income	Recognised in OCI/equity	Transfers	31 December 2023
Property, plant and equipment	(688)	(35)	(104)	(17)	46	(46)	(1)	19	(826)
Intangible assets	(2,011)	(2)	(227)	(1)	48	83	—	(14)	(2,124)
Investments	51	—	(3)	—	5	21	—	—	74
Inventories	54	(2)	(39)	(3)	1	15	—	1	27
Borrowings	312	—	—	—	93	(1)	—	(6)	398
Post-retirement obligations	184	—	(6)	—	(4)	(15)	20	—	179
Provisions	287	—	7	—	10	81	—	2	387
Other items	(57)	—	1	—	(12)	192	(11)	(3)	110
Tax losses carried forward	348	—	2	—	(24)	521	(1)	8	854
Net tax assets/(liabilities)	**(1,520)**	**(39)**	**(369)**	**(21)**	**163**	**851**	**7**	**7**	**(921)**

...

14.6.3 Tax-related contingent liabilities

In Practical example 14-3 below, Hochschild Mining PLC describes the general nature of its tax-related contingent liabilities relating to fiscal periods that are still open to review by the tax authorities and quantifies its estimate of the possible total exposure to tax assessments. *[IAS 12.88]*.

Practical example 14-3: Hochschild Mining PLC (2023) **United Kingdom**

Annual Report and Accounts 2023 [extract]

Financial Statements 2023 [extract]

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]

37 Contingencies [extract]

(a) Taxation

Fiscal periods remain open to review by the tax authorities for four years in Peru, five years in Argentina and Mexico, ten years in Brazil and three years in Chile, preceding the year of review. During this time the authorities have the right to raise additional tax assessments including penalties and interest. Under certain circumstances, reviews may cover longer periods.

Because a number of fiscal periods remain open to review by the tax authorities, coupled with the complexity of the Group and the transactions undertaken by it, there remains a risk that significant additional tax liabilities may arise. As at 31 December 2023, the Group had exposures totalling US$19,885,000 (2022: US$20,713,000).

When the Tax authority challenges the deductibility of certain expenses the Group reassesses the case internally and externally, with the support of a third party professional to determine the probability of success and, depending on the result, makes the decision whether or not to continue with the claim. Notwithstanding this risk, the Directors believe that management's interpretation of the relevant legislation and assessment of taxation is appropriate and that it is probable that the Group's tax and customs positions will be sustained in the event of a challenge by the tax authorities. Consequently, the Directors consider that no tax liability is required to be recognised in respect of these claims or risks.

14.6.4 Information regarding temporary differences for which no deferred taxes are recognised

The disclosures in Practical example 14-4 below include information about deductible temporary differences, unused tax losses and unused tax credits in respect of which no deferred tax asset has been recognised, together with details of the aggregate amount of temporary differences associated with its investments in subsidiaries and equity-accounted entities for which deferred tax liabilities have not been recognised. *[IAS 12.81(e), IAS 12.81(f)]*.

Practical example 14-4: BP p.l.c (2023) **United Kingdom**

bp Annual Report and Form 20-F 2023 [extract]
Financial Statements [extract]
Consolidated financial statements of the bp group [extract]
Notes on the financial statements [extract]
9. Taxation [extract]
Deferred Tax [extract]

...

A summary of temporary differences, unused tax credits and unused tax losses for which deferred tax has not been recognized is shown in the table below.

		$ billion
At 31 December	2023	2022
Unused US state tax losses[a]	2.1	2.1
Unused tax losses – other jurisdictions[b]	5.6	5.4
Unused tax credits	31.3	28.6
of which – arising in the UK[c]	27.3	24.6
– arising in the US[d]	4.0	4.0
Deductible temporary differences[e]	20.7	22.7
Taxable temporary differences associated with investments in subsidiaries and equity-accounted entities	0.7	0.7

[a] For 2023 the majority of these losses expire in the period 2024-2043 with applicable tax rates ranging from 3% to 9%.
[b] 2023 and 2022 mainly relate to the UK, Brazil and Canada. The majority of the unused tax losses have no fixed expiry date.
[c] The UK unused tax credits arise predominantly in overseas branches of UK entities based in jurisdictions with higher statutory corporate income tax rates than the UK. No deferred tax asset has been recognized on these tax credits as they are unlikely to have value in the future; UK taxes on these overseas branches are largely mitigated by double tax relief in respect of overseas tax. These tax credits have no fixed expiry date.
[d] The US unused tax credits predominantly comprise foreign tax credits. No deferred tax asset has been recognized on these tax credits as they are unlikely to have value in the future. For 2023 these tax credits expire in the period 2025-2033.
[e] 2023 and 2022 mainly comprise fixed asset temporary differences in overseas branches of UK entities. Substantially all of the temporary differences have no expiry date.

			$ million
Impact of previously unrecognized deferred tax or write-down of deferred tax assets on tax charge	2023	2022	2021
Current tax benefit relating to the utilization of previously unrecognized deferred tax assets	360	492	331
Deferred tax benefit arising from the reversal of a previous write-down of deferred tax assets	3	–	773
Deferred tax benefit relating to the recognition of previously unrecognized deferred tax assets	332	792	820
Deferred tax expense arising from the write-down of a previously recognized deferred tax asset	54	–	29

14.6.5 Evidence supporting recognition of deferred tax assets

In Practical example 14-5 below, Energean plc discloses the nature of the evidence supporting its recognition of deferred tax assets in excess of its taxable temporary differences, including where entities in the group have recently incurred losses. *[IAS 12.82]*.

Practical example 14-5: Energean plc (2023) **United Kingdom**

2023 Annual Report [extract]
Financial Statements [extract]
CONSOLIDATED FINANCIAL STATEMENTS [extract]
Notes to the Consolidated Financial Statements [extract]
14 Net deferred tax (liability)/asset [extract]

...

($'000)	2023	2022
Deferred tax liabilities	(122,785)	(56,114)
Deferred tax assets	217,504	242,226
	94,719	186,112

At 31 December 2023 the Group had gross unused tax losses of $907.4 million (as of 31 December 2022: $1,093.8 million) available to offset against future profits and other temporary differences. A deferred tax asset of $144.9 million (2022: $197.0 million) has been recognised on tax losses of $571.5 million, based on the forecasted profits. The Group did not recognise deferred tax on tax losses and other differences of total amount of $655.1 million.

In Greece, Italy and the UK, the net DTA for carried forward losses recognised in excess of the other net taxable temporary differences was $77.8 million, $19.6 million and $10.8 million (2022: $69.2 million, $33.4 million and $15.1 million) respectively. An additional DTA of $109.3 million (2022: $124.6 million) arose primarily in respect of deductible temporary differences related to property, plant and equipment, decommissioning provisions and accrued expenses, resulting in a total DTA of $217.5 million (2022: $242.2 million). During the period, Italy recognised a DTA of $19.6 million on tax losses of $81.6 million in accordance with its latest tax losses utilisation forecast.

Greek tax losses (Prinos area) can be carried forward without limitation up until the relevant concession agreement expires (by 2039), whereas the tax losses in Israel, Italy and the United Kingdom can be carried forward indefinitely. Based on the Prinos area forecasts (including the Epsilon development), the deferred tax asset is fully utilised by 2032. In Italy, deferred tax asset of $94.6 million recognised on decommissioning costs scheduled up to the year the Italian assets expect to enter into a declining phase assuming that there still be available profits from Cassiopea asset and other long-lived assets. Finally, in the UK, decommissioning losses is expected to be tax relieved up until 2028 in accordance with the latest taxable profits forecasts.

14.6.6 Impact of amendment to IAS 12 related to Pillar Two income taxes

In Practical example 14-6 below, BHP Group Limited discloses the adoption of the amendment to IAS 12 which introduced a mandatory exception to recognising and disclosing information about deferred tax assets and liabilities related to Pillar Two income taxes *[IAS 12.88A]*.

Practical example 14-6: BHP Group Limited (2024) **Australia**

Annual Report 2024 [extract]
Financial Statements [extract]
1 Consolidated Financial Statements [extract]
Notes to the Financial Statements [extract]
6. Income tax expense [extract]

International Tax Reform – Pillar Two Model Rules

The Organisation for Economic Co-operation and Development (OECD)/G20 Inclusive Framework on Base Erosion and Profit Shifting previously published the Pillar Two model rules designed to address the tax challenges arising from the digitalisation of the global economy, including the implementation of a global minimum tax. The Group has a presence in jurisdictions that have enacted or substantively enacted legislation in relation to the OECD/G20 BEPS Pillar Two model rules.

The enacted or substantively enacted rules apply to income years commencing on or after 1 January 2024 and, on this basis, there is no current tax impact for the income year ended 30 June 2024. The temporary exception to recognising and disclosing information about deferred tax assets and liabilities related to Pillar Two income taxes has been applied at 30 June 2024, pursuant to the amendments to IAS 12 issued on 23 May 2023 and 27 June 2023 by the IASB and AASB respectively.

The Group continues to monitor and evaluate the domestic implementation of the Pillar Two rules in the jurisdictions in which it operates. The Group's potential exposure to Pillar Two taxes, based on legislation that is enacted or substantively enacted, is not expected to be material.

14.7 Discontinued operations - interaction with IFRS 5

IFRS 5 requires the post-tax results of discontinued operations to be shown separately on the face of the statement of comprehensive income (and any separate income statement presenting the components of profit or loss). This may be done by giving the results of discontinued operations after those of continuing operations. This is discussed further in Chapter 5.

The definitions of income tax, tax expense and taxable profit in IAS 12 (see section 3 above) do not distinguish between the results of continuing and discontinued operations, or the tax on those results. Thus, as drafted, IAS 12 applies not only to the tax income or expense on continuing operations (i.e., the amount shown in the 'tax line' in the income statement) but also to any tax income or expense relating to the results of discontinued operations separately disclosed after those of continuing operations.

However, IFRS 5 clarifies that items accounted for under that standard are not subject to the disclosure requirements of other standards, other than:

- Specific disclosures in respect of non-current assets (or disposal groups) classified as held for sale or discontinued operations.

  Or

- Disclosures about the measurement of assets and liabilities within a disposal group that are not within the scope of the measurement requirements of IFRS 5, where such disclosures are not already provided in the other notes to the financial statements. *[IFRS 5.5B]*.

The extent to which deferred tax assets and liabilities are classified within a disposal group under IFRS 5 is discussed in Chapter 5 at section 2.1.1.A.

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Appendix C - Defined terms

Extract from IFRS accounting standards - Definitions	
accounting profit	Accounting profit is profit or loss for a period before deducting tax expense. *[IAS 12.5]*.
current tax	Current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period. *[IAS 12.5]*.
deferred tax assets	Deferred tax assets are the amounts of income taxes recoverable in future periods in respect of: (a) deductible temporary differences; (b) the carryforward of unused tax losses; and (c) the carryforward of unused tax credits. *[IAS 12.5]*.
deferred tax liabilities	Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences. *[IAS 12.5]*.
income taxes	For the purposes of this Standard, income taxes include all domestic and foreign taxes which are based on taxable profits. Income taxes also include taxes, such as withholding taxes, which are payable by a subsidiary, associate or joint arrangement on distributions to the reporting entity. *[IAS 12.2]*.
taxable profit (tax loss)	Taxable profit (tax loss) is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable). *[IAS 12.5]*.
taxation authority	In this interpretation: (a) ... (b) 'taxation authority' refers to the body or bodies that decide whether tax treatments are acceptable under tax law. This might include a court. (c) ... *[IFRIC 23.3]*.
tax base	The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes. *[IAS 12.5]*.
tax expense (tax income)	Tax expense (tax income) is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax. *[IAS 12.5]*.
tax treatments	In this interpretation: (a) 'tax treatments' refers to the treatments used by an entity or that it plans to use in its income tax filings. (b) ... *[IFRIC 23.3]*.
temporary differences	Temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. Temporary differences may be either: (a) taxable temporary differences, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or (b) deductible temporary differences, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled. *[IAS 12.5]*.

uncertain tax treatment	In this interpretation: (a) … (c) an 'uncertain tax treatment' is a tax treatment for which there is uncertainty over whether the relevant taxation authority will accept the tax treatment under tax law. For example, an entity's decision not to submit any income tax filing in a tax jurisdiction, or not to include particular income in taxable profit, is an uncertain tax treatment if its acceptability is uncertain under tax law. *[IFRIC 23.3]*.

Chapter 30 Share-based payment

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Overview

This chapter discusses the requirements of IFRS 2 *Share-based Payment* (IFRS 2 or the standard), that provides accounting requirements when an entity enters into a share-based payment transaction that includes an entity receiving goods or services from a supplier of those goods or services in a share-based payment arrangement or incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another group entity receives the goods or services. Where the supplier of the goods or services receives; cash or assets of an entity for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity, or equity instruments (including shares or share options) of the entity or another group entity, when vesting conditions are met, such an arrangement would be in scope of IFRS 2.

IFRS 2 is applied in accounting for all share-based payment transactions, whether or not an entity can identify specifically some or all of the goods or services received. Share-based payment transactions include equity-settled share-based payments, cash-settled share-based payments and those transactions where the entity or the supplier has a choice of settlement in cash or equity instruments.

The standard is also applied to share-based payment transactions where the transaction is settled by another group entity (or a shareholder), in such instances the standard applies to the recipient group entity of the goods or services and the group entity (or shareholder) settling the transaction.

The recognition rules in IFRS 2 are based on a so-called 'service date model'. In other words, IFRS 2 requires the goods or services received or acquired in a share-based payment transaction to be recognised when the goods are acquired or the services rendered. However, for awards to employees (or others providing similar services), the measurement rules require a share-based payment transaction to be measured at the date on which the transaction was entered into (grant date model), whereas a transaction with non-employees, is measured at the service date.

The point at which the cost is recognised for goods or services in a share-based payment arrangement depends on the concept of 'vesting'. A share-based payment arrangement vests when the counterparty's entitlement is no longer conditional on the satisfaction of any vesting conditions (service condition or performance condition). The cost is recognised during the vesting period, which is the period that all vesting conditions for the share-based payment arrangement are to be satisfied.

IFRS 2 contains detailed accounting requirements for vesting conditions and non-vesting conditions, in addition to accounting requirements for modification and cancellation of share-based payment transactions. The modification and cancellation accounting requirements equally apply to the replacement of awards in a business combination applying IFRS 3 *Business Combinations*.

IFRS 2 is in many respects a rules-based 'anti-avoidance' standard, which often requires an expense to be recorded for transactions that either have no ultimate value to the counterparty or to which, in some cases, the counterparty actually has no entitlement at all.

Most share-based payment transactions undertaken by entities are awards of shares and options as remuneration to employees, in particular senior management and directors. In a number of countries, shares and options now comprise the greatest element of the total remuneration package of senior personnel, a trend encouraged by the consensus that it is a matter of good corporate governance to promote significant long-term shareholdings by senior management, so as to align their economic interests with those of shareholders. For this reason, the main focus of this chapter is accounting for share-based payment transactions with employees. Other forms of employee benefits that are not share-based payment transactions would fall within the scope of IAS 19 *Employee Benefits*, as discussed in Chapter 31.

What you need to know

- An entity applies IFRS 2 when the entity receives goods or services in a share-based payment transaction that is settled by the entity itself, another group entity or shareholder.
- An entity settling a share-based payment transaction when another group entity receives the goods or services is in scope of IFRS 2.
- IFRS 2 applies whether or not an entity can identify specifically some or all of the goods or services received.
- Awards to employees and others providing similar services are measured using the 'grant date model', whereas services provided by others and goods acquired are measured using the 'service date model' for the share-based payment arrangement.
- The cost is recognised over the vesting period, which is the period that all vesting conditions are satisfied.
- Vesting conditions include service conditions or performance conditions. Share-based payment arrangements can also contain non-vesting conditions.
- IFRS 2 contains specific rules on accounting for modification and cancellation of share-based payment transactions.
- IFRS 2 in many respects is a rules-based 'anti-avoidance' standard, which often requires an expense to be recorded for transactions that either have no ultimate value to the counterparty or to which, in some cases, the counterparty actually has no entitlement at all.

1 Introduction

1.1 Background

Most share-based payment transactions undertaken by entities are awards of shares and options as remuneration to employees, in particular senior management and directors. In a number of countries, shares and options now comprise the greatest element of the total remuneration package of senior personnel, a trend encouraged by the consensus that it is a matter of good corporate governance to promote significant long-term shareholdings by senior management, so as to align their economic interests with those of shareholders.

One advantage of shares and options as remuneration is that they need not entail any cash cost to the entity. If an executive is entitled under a bonus scheme to a free share, the entity can satisfy this award simply by printing another share certificate, which the executive can sell, so that the cash cost of the award is effectively borne by shareholders rather than by the entity itself. However, this very advantage was the source of the controversy surrounding share-based remuneration.

Investors became increasingly concerned that share-based remuneration was resulting in a significant cost to them, through dilution of their existing shareholdings. As a result, there emerged an increasing consensus among investors that awards of shares and share options should be recognised as a cost in the financial statements.

The opposing view, held by most entities, was that the financial statements were simply reflecting the economic reality that such awards are ultimately a cost to other shareholders and not to the entity. Another powerful argument for those opposed to expensing options was to point out that some clearly successful companies, particularly in the new technology sector at that time, would never have shown a profit if they had been required to book an accounting expense for options.

1.2 Development of IFRS 2 and amendments to the standard

In November 2002, the IASB issued an exposure draft ED 2 *Share-based Payment* - proposing that share-based payments for goods and services should be expensed. The exposure draft proved highly controversial. Those who supported it in principle nevertheless had concerns about nearly every detail of the accounting treatment proposed, in particular the fact that it did not permit any 'truing up', i.e., reversing any expense previously charged for an award that never actually crystallises. More fundamentally, many questioned whether there yet existed a methodology sufficiently robust for valuing shares and share options subject to the restrictions and performance conditions typically associated with employee share awards. There also remained a significant minority who still questioned the whole principle of expensing options and other share awards.

Despite these comments, the IASB finalised its proposals with the publication of IFRS 2 *Share-based Payment* - on 19 February 2004, although some significant changes had been necessary to the prohibition on 'truing up' in the ED. In particular, IFRS 2 requires an expense to be recognised only for awards that vest (or are considered by IFRS 2 to vest), but (in the case of awards settled in shares) based on their fair value at the date of grant. Nevertheless, IFRS 2 remains contentious: for example, there is still only limited provision for 'truing up', with the result that significant costs can potentially be recognised for awards that ultimately have no value to their recipients, and give rise to no dilution of the interests of other shareholders. Some commentators continue to question whether existing option valuation models can produce a reliable valuation of employee share awards.

The IASB has issued the following amendments to the original version of IFRS 2:

- *Vesting Conditions and Cancellations*,[1] issued in January 2008 ('the January 2008 amendment'). *[IFRS 2.62]*.
- *Group Cash-settled Share-based Payment Transactions*,[2] issued in June 2009 ('the June 2009 amendment'). *[IFRS 2.63]*.
- *Improvements to IFRSs,* issued in April 2009 ('the April 2009 amendment'). This made a minor amendment to the scope of IFRS 2.
- *Annual Improvements to IFRSs 2010-2012 Cycle*, issued in December 2013, which made amendments to the definitions in Appendix A of IFRS 2 relating to vesting conditions.
- *Classification and Measurement of Share-based Payment Transactions,*[3] issued in June 2016 ('the June 2016 amendments'). *[IFRS 2.63D]*.

1 Amendment to International Financial Reporting Standards: IFRS 2 *Share-based Payment* - Vesting Conditions and Cancellations, IASB, January 2008 ('January 2008 amendment').

2 *Group Cash-settled Share-based Payment Transactions*, Amendments to IFRS 2, IASB, June 2009 ('June 2009 amendment').

3 *Classification and Measurement of Share-based Payment Transactions*, Amendments to IFRS 2, IASB, June 2016 ('June 2016 amendments').

There have also been two interpretations of IFRS 2 by the IFRS IC, IFRIC 8 *Scope of IFRS 2 and IFRIC 11 IFRS 2 Group and Treasury Share Transactions*, but these were incorporated into IFRS 2 as part of the June 2009 amendment and the separate interpretations withdrawn. *[IFRS 2.64]*.

Revision of, and amendments to, IFRS 3 in 2008 and 2010 respectively, led to consequential amendments to IFRS 2. The revised and amended IFRS 3 provides guidance on the replacement of share-based payment awards in a business combination (see section 11 below).

The revision of the *Conceptual Framework* in 2018 led to a minor consequential amendment to IFRS 2 as part of the *Amendments to References to the Conceptual Framework in IFRS Standards*.[4] The revision amended the footnote to the definition of an equity instrument in Appendix A (see section 1.4.1 below).

IFRS 2 is also supplemented by implementation guidance.

Some but not all differences between IFRS 2 and US GAAP guidance on this topic are mentioned in this chapter, as the accounting standards are not converged. Therefore, differences between IFRS 2 and US GAAP may exist that are not discussed in this chapter.

1.2.1 IFRS 2 research project

In May 2015, the IASB announced a research project into certain aspects of IFRS 2.[5] In November 2015, the IASB considered a staff report which observed that, on the basis of research and outreach performed, the complexity of applying IFRS 2 in practice has two main causes: the complexity of share-based payment arrangements themselves and use of the grant date fair value measurement model.[6] In May 2016, the IASB decided not to perform further research on this topic.[7]

The IASB published a summary of the research findings in October 2018, confirming that the main sources of complexity in accounting for share-based payments include: the variety and complexity of the terms and conditions of share-based payments and use of grant date fair value measurement. The project summary also comments on criticism of excessive disclosures in the standard.[8]

The IASB confirmed in the Project Summary, that the terms and conditions of share-based payments are varied and complex which contributes significantly to the complexity in accounting for transactions involving share-based payments. Subsequently, IFRS accounting standards cannot remove the complexity arising from the variety and complexity of terms and conditions of share-based payments.

In considering the complexity of the grant date fair value measurement model used for equity-settled share-based payments, the IASB confirmed in the Project Summary the application issues covered three areas:

- Difficulty in understanding why changes in share price do not affect the accounting for equity-settled share-based payments: the research found that the treatment is consistent with the accounting for other obligations that must be settled by issuing equity instruments in payment; and reflects the fact that the value of services received is unlikely to change after the grant date.
- Complexity in classifying conditions of share-based payments as vesting or non-vesting: the research found that reducing that complexity significantly would require fundamental changes that would negate the advantages of the grant-date fair value measurement model and could be inconsistent with the distinction made between liabilities and equity in accounting for other obligations that must be settled by issuing equity instruments in payment.
- The apparently counterintuitive results for some actions that change equity-settled share-based payments, for example continuing to recognise expense for cancelled share-based payments and not reversing expense for 'negative' modifications of share-based payments: the staff research confirmed that the Basis for Conclusions on IFRS 2 provides for the approach to these items.

In addressing the criticisms that IFRS 2 leads entities to disclose excessive information in their financial statements, the research findings reminded preparers that IAS 1 *Presentation of Financial Statements* - provides appropriate flexibility in how entities can disclose information about share-based payments. Therefore, entities need to exercise judgement in deciding which information is material and must be disclosed.

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4 *Amendments to References to the Conceptual Framework in IFRS Standards*, IASB, March 2018.

5 *IASB Update*, May 2015, available on the IFRS Foundation's website.

6 IASB Staff Paper 16: Project: I*FRS 2* Share-based Payment *research project*, Paper topic: *Report on research so far*, IASB Meeting, November 2015, available on the IFRS Foundation's website.

7 *IASB Update*, May 2016, available on the IFRS Foundation's website.

8 Project Summary, *Share-based payment-research on sources of accounting complexity*, IASB, 31 October 2018, available on the IFRS Foundation's website.

1.3 Scope of the chapter and referencing convention

This chapter generally discusses the requirements of IFRS 2 for accounting periods beginning on or after 1 January 2025 and reflects those amendments to the original version of IFRS 2, referred to in section 1.2 above. This amended version of IFRS 2 is referred to as 'IFRS 2' throughout the chapter.

1.4 Overall approach of IFRS 2

IFRS 2 is a complex standard, in part because its overall accounting approach is something of a hybrid. Essentially the total cost (i.e., measurement) of an award is calculated by determining whether the award is a liability or an equity instrument, using criteria somewhat different from those in IAS 32 *Financial Instruments: Presentation* (see section 1.4.1 below), but then applying the measurement principles generally applicable to liabilities or equity instruments under IAS 32 and IFRS 9 *Financial Instruments*. However, the periodic allocation (i.e., recognition) of the cost is determined using something closer to a straight-line accrual methodology, which would not generally be used for financial instruments. For convenience, throughout this chapter we refer to the recognition of a cost for share-based payments. In some cases, however, a share-based payment transaction may initially give rise to an asset (e.g., where employee costs are capitalised as part of the cost of PP&E or inventories).

This inevitably has the result that, depending on its legal form, a transaction of equal value to the recipient can result in several different potential charges in profit or loss for the entity, causing some to call into question the comparability of the information provided. Moreover, IFRS 2 is in many respects a rules-based 'anti-avoidance' standard, which often requires an expense to be recorded for transactions that either have no ultimate value to the counterparty or to which, in some cases, the counterparty actually has no entitlement at all.

IFRS 2 has an unusually long Basis for Conclusions - longer in fact than the standard and implementation guidance combined, highlighting some of the controversy in the development of the standard.

1.4.1 Classification differences between IFRS 2 and IAS 32/IFRS 9

As noted above, not only are there differences between the accounting treatment of liabilities or equity under IFRS 2 as compared with that under IAS 32 and IFRS 9, but the classification of a transaction as a liability or equity transaction under IFRS 2 may differ from that under IAS 32.

One of the most important differences between IAS 32 and IFRS 2 is that a transaction involving the delivery of equity instruments within the scope of IFRS 2 is always accounted for as an equity transaction, whereas a similar transaction within the scope of IAS 32 might well be classified as a liability if the number of shares to be delivered varies.

The IASB offers some (pragmatic rather than conceptual) explanation for these differences in the Basis for Conclusions on IFRS 2. First, it is argued that to apply IAS 32 to share option plans would mean that a variable share option plan (i.e., one where the number of shares varied according to performance) would give rise to a more volatile (and typically greater) cost than a fixed plan (i.e., one where the number of shares to be awarded is fixed from the start), even if the same number of shares was ultimately delivered under each plan, which would have 'undesirable consequences'. *[IFRS 2.BC109]*. Second, it is argued that this is just one of several inconsistencies between IAS 32 and IFRS 2 to be addressed as part of the IASB's review of the definitions of liabilities and equity in the *Conceptual Framework*. *[IFRS 2.BC110]*.

The revision of the *Conceptual Framework* in 2018 led to a minor consequential amendment to the footnote to the definition of an equity instrument in Appendix A to IFRS 2. It is the definition of a liability within the footnote that has been revised rather than the definition of an equity instrument. In paragraph BC384 of the Basis for Conclusions on IFRS 2, the Board notes that the 2018 *Conceptual Framework* did not address classification of financial instruments with characteristics of both liabilities and equity and that the consequential amendments did not amend the guidance on classification of financial instruments in IFRS 2. Therefore, it does not expect the amendment to the footnote in IFRS 2 to have a significant effect on the application of the standard.

The boundary between liabilities and equity were further explored by the IASB in its research project on *Financial Instruments with Characteristics of Equity*.[9] In November 2023, the IASB issued an Exposure Draft, *Financial Instruments with Characteristics of Equity - proposed amendments to IAS 32 Financial, Instruments: Presentation, IFRS 7: Financial Instruments: Disclosures, IAS 1 Presentation of Financial Statements*.[10] At the time of writing this chapter, the IASB are considering responses to the Exposure Draft (see Chapter 43 at section 12). Until there are any further amendments resulting from this or other projects, there will continue to be differences between the accounting and classification treatment of liabilities and equity under IFRS 2, compared with that under IAS 32 and IFRS 9.

9 Discussion Paper DP/2018/1, *Financial Instruments with Characteristics of Equity*, IASB, June 2018. Available on the IFRS Foundation's website.

10 Exposure Draft (IASB/ED/2023/5) *Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1*, IASB, November 2023. Available on the IFRS Foundation's website.

2 The objective and scope of IFRS 2

This section sets out the objective of IFRS 2 (see section 2.1 below) and then considers the scope of the standard in the following sub-sections:

- Definitions in IFRS 2 relevant to the scope of the standard (see section 2.2.1 below).
- Transactions and arrangements within the scope of IFRS 2 (see section 2.2.2 below) including arrangements within a group and with shareholders (see section 2.2.2.A below).
- Transactions outside the scope of IFRS 2 (see section 2.2.3 below).
- Application of the scope requirements to a number of situations frequently encountered in practice (see section 2.2.4 below).

Further details of the transactions and arrangements discussed are given at the start of each sub-section.

2.1 Objective

Extract from IFRS 2

Objective

1	The objective of this IFRS is to specify the financial reporting by an entity when it undertakes a share-based payment transaction. In particular, it requires an entity to reflect in its profit or loss and financial position the effects of share-based payment transactions, including expenses associated with transactions in which share options are granted to employees.

[IFRS 2.1].

2.2 Scope

2.2.1 Definitions

The following definitions are relevant to the scope of IFRS 2. *[IFRS 2 Appendix A]*.

Extract from IFRS 2

Appendix A IFRS 2
Defined terms

cash-settled share-based payment transaction	A **share-based payment transaction** in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services for amounts that are based on the price (or value) of **equity instruments** (including shares or **share options**) of the entity or another group entity.
equity instrument	A contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.[5]
equity instrument granted	The right (conditional or unconditional) to an **equity instrument** of the entity conferred by the entity on another party, under a **share-based payment arrangement**.
equity-settled share-based payment transaction	A **share-based payment transaction** in which the entity (a) receives goods or services as consideration for its own **equity instruments** (including shares or **share options**), or (b) receives goods or services but has no obligation to settle the transaction with the supplier.
share-based payment arrangement	An agreement between the entity (or another group[7] entity or any shareholder of any group entity) and another party (including an employee) that entitles the other party to receive (a) cash or other assets of the entity for amounts that are based on the price (or value) of **equity instruments** (including shares or **share options**) of the entity or another group entity, or (b) **equity instruments** (including shares or **share options**) of the entity or another group entity, provided the specified vesting conditions, if any, are met.
share-based payment transaction	A transaction in which the entity (a) receives goods or services from the supplier of those goods or services (including an employee) in a **share-based payment arrangement**, or (b) incurs an obligation to settle the transaction with the supplier in a **share-based payment arrangement** when another group entity receives those goods or services.
share option	A contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed or determinable price for a specified period of time.

5 The *Conceptual Framework for Financial Reporting* issued in 2018 defines a liability as a present obligation of the entity to transfer an economic resource as a result of past events.

7 A 'group' is defined in Appendix A of IFRS 10 *Consolidated Financial Statements* as 'a parent and its subsidiaries' from the perspective of the reporting entity's ultimate parent.

A *group entity* in the definitions above means any parent, subsidiary, or subsidiary of any parent, of the entity and is based on the definition of 'group' in Appendix A to IFRS 10 *Consolidated Financial Statements* - as 'a parent and its subsidiaries'. *[IFRS 2.63A, IFRS 2.BC22E]*.

It will be seen from these definitions that IFRS 2 applies not only to awards of shares and share options but also to awards of cash (or other assets) of a value equivalent to the value, or a movement in the value, of a particular number of shares. Such cash awards may arise in a number of situations. For example:

- An entity may wish to extend its share scheme to the employees of overseas subsidiaries in jurisdictions where it may be difficult, or even illegal, to trade in the entity's shares, or where delivering shares would not give the same tax benefits to employees as would apply in the parent's own jurisdiction.

  Or

- The entity may not wish to dilute existing shareholdings by significant share awards to employees.

In such cases, the employees may instead be offered cash equivalent to the value of the shares that they would otherwise have obtained.

2.2.2 Transactions within the scope of IFRS 2

Subject to the exceptions noted in section 2.2.3 below, IFRS 2 must be applied to all share-based payment transactions, including:

(a) Equity-settled share-based payment transactions (discussed in sections 4 to 8 below).

(b) Cash-settled share-based payment transactions (discussed in section 9 below).

(c) Transactions where either the entity or the supplier of goods or services can choose whether the transaction is to be equity-settled or cash-settled (discussed in section 10 below). *[IFRS 2.2]*.

Whilst the boundaries between these types of transactions are reasonably self-explanatory, there may be transactions - as discussed in more detail in sections 9 and 10 below - that an entity may intuitively regard as equity-settled which are in fact required to be treated as cash-settled under IFRS 2.

Although IFRS 2 was primarily a response to concerns over share-based remuneration, its scope is not restricted to transactions with employees. For example, if an external supplier of goods or services, including another group entity, is paid in shares or share options, or cash (or other assets) of equivalent value, IFRS 2 must be applied. Goods include:

- Inventories
- Consumables
- Property, plant and equipment
- Intangibles
- Other non-financial assets *[IFRS 2.5]*

It will be seen that 'goods' do not include financial assets, which raises some further issues (see section 2.2.3.F below).

The scope of IFRS 2 extends to:

- Group share schemes and certain transactions with shareholders (see section 2.2.2.A below).
- Transactions with employee benefit trusts and similar vehicles (see section 2.2.2.B below).
- Transactions where the identifiable consideration received appears to be less than the consideration given (see section 2.2.2.C below).
- 'All employee' share plans (see section 2.2.2.D below).
- Vested transactions (see section 2.2.2.E below).

2.2.2.A Group schemes and transactions with group shareholders: scope issues

The definitions of 'share-based payment arrangement' and 'share-based payment transaction' in section 2.2.1 above have the effect that the scope of IFRS 2 is not restricted to transactions where the reporting entity acquires goods or services in exchange for its own equity instruments (or cash or other assets based on the cost or value of those equity instruments). Within a group of companies, it is common for one member of the group (typically the parent) to have the obligation to settle a share-based payment transaction in which services are provided to another member of the group (typically a subsidiary). This transaction is within the scope of IFRS 2 for the entity receiving the services (even though it is not a direct party to the arrangement between its parent and its employee), the entity settling the transaction and the group as a whole.

Accordingly, IFRS 2 requires an entity to account for a transaction in which it either:

- Receives goods or services when another entity in the same group (or a shareholder of any group entity) has the obligation to settle the share-based payment transaction

  Or

- Has an obligation to settle a share-based payment transaction when another entity in the same group receives the goods or services

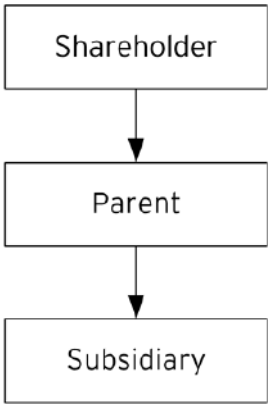
Unless the transaction is clearly for a purpose other than payment for goods or services supplied to the entity receiving them. *[IFRS 2.3A]*.

Moreover, the definitions of 'equity-settled share-based payment transaction' and 'cash-settled share-based payment transaction' have the effect that the analysis of the transaction as equity-settled or cash-settled (and its accounting treatment) may differ when viewed from the perspective of the entity receiving the goods or services, the entity settling the transaction and the group as a whole. *[IFRS 2.43A]*.

We consider below seven scenarios, based on the simple structure in Figure 2-1 below. These scenarios are by no means exhaustive, but cover the situations most commonly seen in practice.

The scenarios considered in this section do not consider recharge arrangements between group entities. The accounting treatment of group share schemes, including those with recharge arrangements, is discussed in more detail in section 12 below.

Figure 2-1: Scope of IFRS 2



The scenarios assume that:

- The shareholder is not a group entity.
- The subsidiary is directly owned by the parent company (see section 12.2.1 below in relation to intermediate parent companies).

Scenario	Who grants the award?	Which entity receives the goods or services?	Who settles the award?	On which entity's shares is the award based?	Award settled in shares or cash?
1	Parent	Subsidiary	Parent	Parent	Shares
2	Shareholder	Subsidiary	Shareholder	Parent	Shares
3	Subsidiary	Subsidiary	Subsidiary	Parent	Shares
4	Subsidiary	Subsidiary	Subsidiary	Subsidiary	Shares
5	Parent	Subsidiary	Parent	Subsidiary	Shares
6	Parent	Subsidiary	Parent	Parent	Cash
7	Shareholder	Subsidiary	Shareholder	Parent	Cash

Scenario 1

Parent awards equity shares in Parent to employees of Subsidiary in exchange for services to Subsidiary. Parent settles the award with the employees of Subsidiary. *[IFRS 2.43B, IFRS 2.43C, IFRS 2.B52(a), IFRS 2.B53, IFRS 2.B54]*.

Consolidated financial statements of Parent

Under the definition of 'share-based payment transaction', "the entity [i.e., the Parent group] … receives goods or services … in a share-based payment arrangement …". A share-based payment arrangement includes "an agreement between the entity … and another party (including an employee) that entitles the other party to receive … equity instruments … of the entity …".

The transaction is classified as an equity-settled transaction because it is settled in an equity instrument of the group.

Separate financial statements of Parent

Under the definition of 'share-based payment transaction', "the entity [i.e., the Parent as a single entity] … incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another group entity receives those goods or services".

The transaction is classified as an equity-settled transaction because it is settled in an equity instrument of Parent.

Subsidiary

Under the definition of 'share-based payment transaction', "the entity [i.e., Subsidiary] … receives goods or services … in a share-based payment arrangement …". A 'share-based payment arrangement' includes "an agreement between … another group entity [i.e., Parent] … and another party (including an employee) that entitles the other party to receive … equity instruments of … another group entity".

The transaction is classified as an equity-settled transaction because Subsidiary 'has no obligation to settle the transaction with the supplier'.

Even if Subsidiary is not a party to the agreement with its employees, it nevertheless records a cost for this transaction. In effect, the accounting treatment is representing that Subsidiary has received a capital contribution from Parent, which Subsidiary has then 'spent' on employee remuneration. This treatment is often referred to as 'push-down' accounting - the idea being that a transaction undertaken by one group entity (in this case, Parent) for the benefit of another group entity (in this case, Subsidiary) is 'pushed down' into the financial statements of the beneficiary entity.

Scenario 2

Shareholder awards equity shares in Parent to employees of Subsidiary in exchange for services to Subsidiary. Shareholder settles the award with the employees of Subsidiary. *[IFRS 2.B48(b)]*.

Consolidated financial statements of Parent

Under the definition of 'share-based payment transaction', "the entity [i.e., the Parent group] … receives goods or services … in a share-based payment arrangement". A 'share-based payment arrangement' includes "an agreement between … any shareholder … and another party (including an employee) that entitles the other party to receive … equity instruments (including shares or share options) of the entity…".

The transaction is classified as an equity-settled transaction, because the Parent group 'has no obligation to settle the transaction with the supplier'.

Separate financial statements of Parent

Scenario 2 is not within the scope of IFRS 2 for the separate financial statements of Parent, because Parent (as a separate entity) receives no goods or services, nor does it settle the transaction.

Subsidiary

Under the definition of 'share-based payment transaction', "the entity [i.e., Subsidiary] … receives goods or services … in a share-based payment arrangement". A 'share-based payment arrangement' includes "an agreement between … any shareholder of any group entity [i.e., Shareholder] … and another party (including an employee) that entitles the other party to receive equity instruments of … another group entity [i.e., Parent]".

The transaction is classified as an equity-settled transaction, because Subsidiary 'has no obligation to settle the transaction with the supplier'.

IFRS 2 does not explicitly address the accounting treatment for such a transaction within the financial statements of a shareholder that is not a group entity. *[IFRS 2.BC22G]*. We discuss in section 12.9 below the accounting treatment of such transactions in the financial statements of a shareholder that is an investor in a joint venture or associate.

Scenario 3

Subsidiary awards equity shares in Parent to employees of Subsidiary in exchange for services to Subsidiary. Subsidiary settles the award with the employees of Subsidiary. *[IFRS 2.43B, IFRS 2.B52(b), IFRS 2.B55]*.

Consolidated financial statements of Parent

Under the definition of 'share-based payment transaction', "the entity [i.e., the Parent group] … receives goods or services … in a share-based payment arrangement". A 'share-based payment arrangement' includes "an agreement between the entity … and another party (including an employee) that entitles the other party to receive … equity instruments (including shares or share options) of the entity".

The transaction is classified as an equity-settled transaction, because the Parent group 'receives goods or services as consideration for its own equity instruments (including shares or share options) …'.

Separate financial statements of Parent

Scenario 3 is not within the scope of IFRS 2 for the separate financial statements of Parent, because Parent (as a separate entity) receives no goods or services, nor does it settle the transaction.

Subsidiary

Under the definition of 'share-based payment transaction', "the entity [i.e., Subsidiary] … receives goods or services … in a share-based payment arrangement". A 'share-based payment arrangement' includes "an agreement between … [a] group entity [i.e., Subsidiary] … and another party (including an employee) that entitles the other party to receive equity instruments of … another group entity [i.e., Parent]".

The transaction is classified as a cash-settled transaction because Subsidiary has the obligation to settle the award with equity instruments issued by Parent - i.e., a financial asset in Subsidiary's separate financial statements - rather than with Subsidiary's own equity instruments.

However, for the approach in this Scenario to apply, it must be the case that Subsidiary grants the award as a principal rather than as agent for Parent and Subsidiary has the obligation to settle. If Subsidiary appears to be granting an award but is really doing so only on the instructions of Parent, as will generally be the case in certain jurisdictions, then the approach in Scenario 1 above is more likely to apply. This is discussed in more detail in section 12.2.5.B below.

Scenario 4

Subsidiary awards equity shares in Subsidiary to employees of Subsidiary in exchange for services to Subsidiary. Subsidiary settles the award with the employees of Subsidiary. *[IFRS 2.43B, IFRS 2.B49]*.

Consolidated financial statements of Parent

Under the definition of 'share-based payment transaction', "the entity [i.e., the Parent group] … receives goods or services … in a share-based payment arrangement". A share-based payment arrangement includes "an agreement between the entity … and another party (including an employee) that entitles the other party to receive … equity instruments … of the entity …".

The transaction is classified as an equity-settled transaction, because it is settled in an equity instrument of the group. In the consolidated financial statements of Parent, shares of Subsidiary not held by Parent are a non-controlling interest, classified as equity (see Chapter 8 at section 5).

Separate financial statements of Parent

Scenario 4 is not within the scope of IFRS 2 for the separate financial statements of Parent, because Parent (as a separate entity) receives no goods or services, nor does it settle the transaction.

Subsidiary

Under the definition of 'share-based payment transaction', "the entity [i.e., Subsidiary] … receives goods or services … in a share-based payment arrangement".

The transaction is classified as an equity-settled transaction, because it is settled in an equity instrument of Subsidiary.

Scenario 5

Parent awards equity shares in Subsidiary to employees of Subsidiary in exchange for services to Subsidiary. Parent settles the award with the employees of Subsidiary. *[IFRS 2.43B, IFRS 2.43C, IFRS 2.B50]*.

Consolidated financial statements of Parent

Under the definition of 'share-based payment transaction', "the entity [i.e., the Parent group] … receives goods or services … in a share-based payment arrangement". A share-based payment arrangement includes "an agreement between the entity … and another party (including an employee) that entitles the other party to receive … equity instruments of the entity …".

The transaction is classified as an equity-settled transaction, because it is settled in an equity instrument of the group. In the consolidated financial statements of Parent, shares of Subsidiary not held by Parent are a non-controlling interest, classified as equity (see Chapter 8 at section 5).

Separate financial statements of Parent

Under the definition of 'share-based payment transaction', "the entity [i.e., the Parent as a single entity] … incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another group entity [i.e., Subsidiary] receives those goods or services". The transaction is a share-based payment arrangement for Subsidiary (see below) and the consolidated financial statements of Parent (see above).

For Parent, the transaction is classified as a cash-settled transaction, because it is settled not in an equity instrument issued by Parent, but in an equity instrument issued by a subsidiary and held by Parent - i.e., a financial asset in Parent's separate financial statements.

Subsidiary

Under the definition of 'share-based payment transaction', "the entity [i.e., Subsidiary] … receives goods or services … in a share-based payment arrangement". A 'share-based payment arrangement' includes "an agreement between … another group entity [i.e., Parent] … and another party (including an employee) that entitles the other party to receive equity instruments of the entity…".

The transaction is classified as an equity-settled transaction, because Subsidiary 'has no obligation to settle the transaction with the supplier'.

Scenario 6

Parent awards cash based on the value of shares in Parent to employees of Subsidiary in exchange for services to Subsidiary. Parent settles the award with the employees of Subsidiary. *[IFRS 2.43C, IFRS 2.B56, IFRS 2.B57, IFRS 2.B58]*.

Consolidated financial statements of Parent

Under the definition of 'share-based payment transaction', "the entity [i.e., the Parent group] … receives goods or services … in a share-based payment arrangement". A 'share-based payment arrangement' includes "an agreement between the entity … and another party (including an employee) that entitles the other party to receive … cash … of the entity … based on the price (or value) of equity instruments … of the entity …".

The transaction is classified as a cash-settled transaction, because it is settled in cash of the group.

Separate financial statements of Parent

Under the definition of 'share-based payment transaction', "the entity [i.e., the Parent as a single entity] … incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another group entity [i.e., Subsidiary] receives those goods or services".

The transaction is classified as a cash-settled transaction, because it is settled in cash of Parent.

Subsidiary

IFRS 2 contains detailed guidance for the accounting treatment of such transactions by the employing subsidiary (see section 12 below), from which it may reasonably be inferred that the IASB intended them to be in the scope of IFRS 2 for the subsidiary.

However, this is strictly not the case when the drafting of IFRS 2 is examined closely. In order to be a share-based payment transaction (and therefore in the scope of IFRS 2) for the reporting entity, a transaction must also be a share-based payment arrangement. A share-based payment arrangement is defined as one in which the counterparty receives (our emphasis added):

- Equity of the entity *or any other group entity*

  Or
- Cash or other assets *of the entity*

As drafted, the definition has the effect that a transaction settled in equity is in the scope of IFRS 2 for a reporting entity, whether the equity used to settle is the entity's own equity or that of another group entity. Where a transaction is settled in cash, however, the definition has the effect that a transaction is in the scope of IFRS 2 for a reporting entity only when that entity's own cash (or other assets) is used in settlement, and not when another group entity settles the transaction.

How we see it

Given the guidance in IFRS 2, referred to above, on the accounting treatment for the reporting entity of transactions settled in cash by another group entity, we believe that the exclusion of such transactions from the definition of 'share-based payment arrangement' must be ignored. We see it as a drafting slip.

The transaction is classified as an equity-settled transaction by Subsidiary, because Subsidiary 'has no obligation to settle the transaction with the supplier'.

Scenario 7

Shareholder awards cash based on the value of shares in Parent to employees of Subsidiary in exchange for services to Subsidiary. Shareholder settles the award with the employees of Subsidiary.

For the reasons set out in Scenario 6 above, this transaction might also be seen as not strictly in the scope of IFRS 2 as drafted either for the consolidated or separate financial statements of Parent or for the individual financial statements of Subsidiary. As noted in Scenario 6 above, the definition of 'share-based payment arrangement' as drafted excludes any arrangement that is settled in cash by a party other than the reporting entity. Moreover, whilst IFRS 2 gives detailed guidance that effectively appears to 'over-ride' the definition in respect of a transaction settled by another group entity (see Scenario 6 above), there is no such over-riding guidance in respect of a transaction settled in cash by a non-group shareholder.

How we see it

Nevertheless, we believe that the transaction is required to be treated as within the scope of IFRS 2 for the consolidated financial statements of Parent and the individual financial statements of Subsidiary. One of the original objectives of the project that led to the issue of the June 2009 amendment to IFRS 2 was to address a concern that, as originally issued, IFRS 2 did not require an entity to account for a cash-settled share-based payment transaction settled by an external shareholder.

The transaction is not within the scope of IFRS 2 for the separate financial statements of Parent, because Parent (as a separate entity) receives no goods or services, nor does it settle the transaction.

In addition to the accounting treatment under IFRS 2, the group entities in this Scenario would need to consider the requirements of IAS 24 *Related Party Disclosures* - as any payments by a shareholder would potentially need to be disclosed (see Chapter 35).

2.2.2.B Transactions with employee benefit trusts and similar vehicles

In some jurisdictions, it is common for an entity to establish a trust to hold shares in the entity for the purpose of satisfying, or 'hedging' the cost of, share-based awards to employees. In such cases, it is often the trust, rather than any entity within the legal group, that actually makes share-based awards to employees.

A sponsoring employer (or its wider group) will need to assess whether it controls the trust in accordance with the requirements of IFRS 10 and therefore whether the trust is required to be consolidated (see section 12.3 below and Chapter 7).

Awards by employee benefit trusts and similar vehicles are within the scope of IFRS 2, irrespective of whether or not the trust is consolidated, since:

- Where the trust is consolidated, it is an award by a group entity.
- Where the trust is not consolidated, it is an award by a shareholder.

2.2.2.C Transactions where the identifiable consideration received appears to be less than the consideration given

A share-based payment transaction as defined (see section 2.2.1 above) involves the receipt of goods or services by the reporting entity or by another group entity. Nevertheless, IFRS 2 also applies to share-based payment transactions where no specifically identifiable goods or services have been (or will be) received. *[IFRS 2.2]*.

IFRS 2 asserts that, if the identifiable consideration received (if any) appears to be less than the fair value of consideration given, the implication is that, in addition to the identifiable goods and services acquired, the entity must also have received some unidentifiable consideration equal to the difference between the fair value of the share-based payment and the fair value of any identifiable consideration received. Accordingly, the cost of the unidentified consideration must be accounted for in accordance with IFRS 2. *[IFRS 2.13A]*.

For example, if an entity agrees to pay a supplier of services with a clearly identifiable market value of CU1,000 by issuing shares with a value of CU1,500, IFRS 2 requires the entity to recognise an expense of CU1,500. This is notwithstanding the normal requirement of IFRS 2 that an equity-settled share-based payment transaction with a non-employee be recognised at the fair value of the goods or services received (see sections 5.1 and 5.4 below).

This requirement was introduced by IFRIC 8 (since incorporated into IFRS 2). The reason for the change is alluded to in an illustrative example. *[IFRS 2.IG5D, IFRS 2.IG Example 1]*. As part of general economic reforms in South Africa, under arrangements generally referred to as black economic empowerment or 'BEE' (discussed further in section 15.5 below), various entities issued or transferred significant numbers of shares to bodies representing historically disadvantaged communities. Some took the view that these transactions did not fall within the scope of IFRS 2 as originally drafted because the entities concerned were not purchasing goods or services. Rather, BEE arrangements were simply meant to replicate a transfer of shares from one group of shareholders to another. Accordingly, it was argued, such transactions did not fall within the scope of IFRS 2, since it is intrinsic to the definition of a 'share-based payment transaction' (see section 2.2.1 above) that goods or services are received.

IFRS 2 rejects this argument. It effectively takes the view that, since the directors of an entity would not issue valuable consideration for nothing, something must have been received. *[IFRS 2.BC18C]*. IFRS 2 suggests that a transfer of equity under BEE and similar schemes is made 'as a means of enhancing [the entity's] image as a good corporate citizen'. *[IFRS 2.IG Example 1]*.

There seems little doubt that this aspect of IFRS 2 is in part an 'anti-avoidance' measure. As discussed in sections 4 to 8 below, the general measurement rule in IFRS 2 is that share-based payment transactions with employees are measured by reference to the fair value of the consideration given and those with non-employees by reference to the fair value of the consideration received. We argue in section 5.2.2 below that the requirement to measure transactions with employees by reference to the consideration given is essentially an anti-avoidance provision. It prevents entities from recognising a low cost for employee share options on the grounds that little incremental service is provided for them beyond that already provided for cash-based remuneration. The changes introduced by IFRIC 8 removed the potential for a similar abuse in accounting for transactions with non-employees.

Nevertheless, the IASB acknowledges that there may be rare circumstances in which a transaction may occur in which no goods or services are received by the entity. For example, a principal shareholder of an entity, for reasons of estate planning, may transfer shares to a relative. In the absence of indications that the relative has provided, or is expected to provide, goods or services to the entity in exchange for the shares, such a transfer would be outside the scope of IFRS 2. *[IFRS 2.BC18D]*.

See also the discussions in section 2.2.3.A below relating to transactions with shareholders in their capacity as such and in section 2.2.4.K below relating to dual pricing on a share issue.

2.2.2.D 'All employee' share plans

Many countries encourage wider share-ownership by allowing companies to award a limited number of free or discounted shares to employees without either the employee or the employer incurring tax liabilities which would apply if other benefits in kind to an equivalent value were given to employees. These share schemes are referred to in different jurisdictions by terms such as 'all-employee share plans', 'employee share purchase plans' and 'broad-based plans'.

Some national accounting standards exempt some such plans from their scope, to some extent as the result of local political pressures. Prior to issuing IFRS 2, the IASB received some strong representations that IFRS accounting standards should give a similar exemption, on the grounds that not to do so would discourage companies from continuing with such schemes. *[IFRS 2.BC10]*.

The IASB concluded that such an exemption would be wrong in principle and difficult to draft in practice. By way of concession, the Basis for Conclusions hints that if the IFRS 2 charge for such schemes is (as asserted by some of the proponents of an exemption) *de minimis*, then there would be no charge under IFRS 2 anyway, since, like all IFRS accounting standards, it applies only to material items. *[IFRS 2.BC8-17]*. However, our experience is that, in many cases, the charge is material.

2.2.2.E Vested transactions

Once a transaction accounted for under IFRS 2 has vested in the counterparty (see section 3 below), it does not necessarily cease to be in the scope of IFRS 2 just because the entity has received the goods or services required for the award to vest. This is made clear by the numerous provisions of IFRS 2 referring to the accounting treatment of vested awards.

Once equity shares have been unconditionally delivered or beneficially transferred to the counterparty (e.g., as the result of the vesting of an award of ordinary shares, or the exercise of a vested option over ordinary shares), the holder of those shares will often be in exactly the same position as any other holder of ordinary shares and the shares will generally be accounted for under IAS 32 and IFRS 9 rather than IFRS 2.

If, however, the holder of a share or vested option enjoys rights not applicable to all holders of that class of share, such as a right to put the share or the option to the entity for cash, or holds a special class of share with rights that do not apply to other classes of equity, the share or option might still remain in the scope of IFRS 2 as long as any such rights continue to apply. The same is true of modifications made after vesting which add such rights to a vested share or option or otherwise alter the life of the share-based payment transaction. The special terms or rights will often be linked to the holder's employment with the entity but could also apply to an arrangement with a non-employee.

The significance of this is that issued equity instruments and financial liabilities not within the scope of IFRS 2 would typically fall within the scope of IAS 32 and IFRS 9, which might require a significantly different accounting treatment from that required by IFRS 2. See, for example:

- The discussion in section 2.2.4.B below of the treatment in consolidated financial statements of an award with a right to put the share to the parent entity.
- The discussion in section 2.2.4.G below which highlights that a share option with a foreign currency strike price is accounted for as an equity instrument under IFRS 2, but as a liability under IAS 32 and IFRS 9.
- The discussion in section 10.1.6 below of the treatment of convertible instruments issued in exchange for goods and services and accounted for under IFRS 2 rather than under IAS 32 and IFRS 9.

How we see it

To summarise the above, an equity-settled share-based payment transaction will remain in scope of IFRS 2 until the equity instruments have been unconditionally delivered or beneficially transferred to the counterparty (e.g., as the result of the vesting of an award of ordinary shares, or the exercise of a vested option over ordinary shares), and the counterparty enjoys rights that are applicable to all holders of ordinary shares. However, if the counterparty holds a special class of share with rights that do not apply to other classes of equity, the shares might still remain in the scope of IFRS 2 as long as any such rights continue to apply.

The above discussion on the life of a share-based payment transaction focuses on shares or share options awarded, however, the life of a cash-settled share-based payment transaction is within the scope of IFRS 2 for its entire life, i.e., until settlement. *[IFRS 2.30]*.

2.2.3 Transactions not within the scope of IFRS 2

The following transactions are outside the scope of IFRS 2:

- Transactions with shareholders as a whole and with shareholders in their capacity as such (see section 2.2.3.A below).
- Transfers of assets in certain group restructuring arrangements (see section 2.2.3.B below).
- Business combinations (see section 2.2.3.C below).
- Combinations of businesses under common control and the contribution of a business to form a joint venture (see section 2.2.3.D below).
- Transactions in the scope of IAS 32 and IFRS 9 (see section 2.2.3.E below).

In addition, the scope exemptions in IFRS 2 combined with those in IAS 32 and IFRS 9 appear to have the effect that there is no specific guidance in IFRS accounting standards for accounting for certain types of investment when acquired in return for shares (see section 2.2.3.F below).

As noted in section 2.2.2.D above, there is no exemption from IFRS 2 for share schemes aimed mainly at lower- and middle-ranking employees, referred to in different jurisdictions by terms such as 'all-employee share schemes', 'employee share purchase plans' and 'broad-based plans'.

2.2.3.A Transactions with shareholders in their capacity as such

IFRS 2 does not apply to transactions with employees (and others) purely in their capacity as shareholders. For example, an employee may already hold shares in the entity as a result of previous share-based payment transactions. If the entity then raises funds through a rights issue, for example, whereby all shareholders (including the employee) can acquire additional shares for less than the current fair value of the shares, such a transaction is not a share-based payment transaction for the purposes of IFRS 2. *[IFRS 2.4]*.

2.2.3.B Transfer of assets in group restructuring arrangements

In some group restructuring arrangements, one entity will transfer a group of net assets, which does not meet the definition of a business, to another entity in return for shares. Careful consideration of the precise facts and circumstances is needed in order to determine whether, for the separate or individual financial statements of any entity affected by the transfer, such a transfer falls within the scope of IFRS 2.

How we see it

If the transfer is considered primarily to be a transfer of goods by their owner in return for payment in shares then, in our view, this is to be accounted for under IFRS 2. However, if the transaction is for another purpose and is driven by the group shareholder in its capacity as such, the transaction may be outside the scope of IFRS 2 (see section 2.2.3.A above).

Accounting for intra-group asset transfers in return for shares is considered further in Chapter 9 at section 4.4.1.

2.2.3.C Business combinations

IFRS 2 does not apply to share-based payments to acquire goods (such as inventories or property, plant and equipment) as part of a business combination to which IFRS 3 applies.

Transactions in which equity instruments are issued to acquire goods as part of the net assets in a business combination are outside the scope of IFRS 2 but equity instruments granted to the employees of the acquiree in their capacity as employees (e.g., in return for continued service following the business combination) are within its scope, as are the cancellation, replacement or modification of a share-based payment transaction as a result of the business combination or other equity restructuring (see sections 11 and 12.8 below). *[IFRS 2.5]*.

Thus, if a vendor of an acquired business remains as an employee of that business following the business combination and receives a share-based payment for transferring control of the entity and for remaining in continuing employment, it is necessary to determine how much of the share-based payment relates to the acquisition of control (which forms part of the cost of the combination, accounted for under IFRS 3) and how much relates to the provision of future services (which is a post-combination operating expense accounted for under IFRS 2). Guidance on this issue is given in IFRS 3 see Chapter 10 at section 11.2 - and there is discussion of related issues in section 2.2.4.B below.

2.2.3.D Common control transactions and formation of joint arrangements

IFRS 2 also does not apply to a combination of entities or businesses under common control (see Chapter 11), or the contribution of a business on the formation of a joint venture as defined by IFRS 11 *Joint Arrangements* (see Chapter 13). *[IFRS 2.5]*.

How we see it

However, contribution of non-financial assets (which do not constitute a business) to a joint venture in return for shares is within the scope of IFRS 2 for the joint venture and the assets must be accounted for at fair value in accordance with IFRS 2 (see section 2.2.2 above).

IFRS 2 does not directly address other types of transactions involving joint ventures or transactions involving associates, particularly arrangements relating to the employees of associates or joint ventures. These are discussed further in section 12.9 below.

2.2.3.E Transactions in the scope of IAS 32 and IFRS 9

IFRS 2 does not apply to transactions within the scope of IAS 32 and IFRS 9 (see Chapter 41). For example, if an entity enters into a share-based payment transaction to purchase a commodity surplus to its production requirements or with a view to short-term profit taking, the contract is treated as a financial instrument under IAS 32 and IFRS 9 rather than a share-based payment transaction under IFRS 2. *[IFRS 2.6]*.

Some practical examples of scope issues involving IFRS 2 and IAS 32/IFRS 9 are discussed in section 2.2.4 below.

2.2.3.F Transactions in financial assets outside the scope of IAS 32 and IFRS 9

As noted in section 2.2.2 above, IFRS 2 applies to share-based payment transactions involving goods or services, with 'goods' defined so as to exclude financial assets, presumably on the basis that these fall within IAS 32 and IFRS 9. However, investments in subsidiaries, associates and joint ventures in the separate financial statements of the investing entity are financial assets as defined in IAS 32 (and hence outside the scope of IFRS 2) but are outside the scope of IFRS 9 where the entity chooses to account for them at cost (see Chapter 9 at section 2.1 and Chapter 41 at section 2.1).

Moreover, IFRS accounting standards has no general requirements for accounting for the issue of equity instruments. Rather, consistent with the position taken by the *Conceptual Framework* that equity is a residual rather than an item 'in its own right', the amount of an equity instrument is normally measured by reference to the item (expense or asset) in consideration for which the equity is issued, as determined in accordance with IFRS accounting standards applicable to that other item.

This means that, when (as is commonly the case) an entity acquires an investment in a subsidiary, associate or joint venture in return for the issue of equity instruments, there is no explicit guidance in IFRS accounting standards as to the required accounting in the separate financial statements of the investor, and in particular as to how the 'cost' of such an item is to be determined. This is discussed further in Chapter 9 at section 2.1.1.A.

2.2.4 Some practical applications of the scope requirements

This section addresses the application of the scope requirements of IFRS 2 to a number of situations frequently encountered in practice:

- Remuneration in non-equity shares and arrangements with put rights over equity shares (see section 2.2.4.A below).
- The treatment in the consolidated accounts of the parent of an equity-settled award of a subsidiary with a put option against the parent (see section 2.2.4.B below).
- An increase in the counterparty's ownership interest with no change in the number of shares held (see section 2.2.4.C below).
- Awards for which the counterparty has paid 'fair value' (see section 2.2.4.D below).
- A cash bonus which depends on share price performance (see section 2.2.4.E below).
- Cash-settled awards based on an entity's 'enterprise value' or other formula (see section 2.2.4.F below).
- Awards with a foreign currency strike price (see section 2.2.4.G below).
- Holding own shares to satisfy or 'hedge' awards (see section 2.2.4.H below).
- Shares or warrants issued in connection with a loan or other financial liability (see section 2.2.4.I below).
- Options over puttable instruments classified as equity under the specific exception in IAS 32 in the absence of other equity instruments (see section 2.2.4.J below).
- Special discounts to certain categories of investor on a share issue (see section 2.2.4.K below).
- Acquisitions involving a listed shell entity (see section 2.2.4.L below).

The following aspects of the scope requirements are covered elsewhere in this chapter:

- Employment taxes on share-based payment transactions (see section 14 below).
- Instruments such as limited recourse loans and convertible bonds that sometimes fall within the scope of IFRS 2 rather than IAS 32/IFRS 9 because of the link both to the entity's equity instruments and to goods or services received in exchange. Convertible bonds are discussed in section 10.1.6 below and limited recourse loans in section 15.2 below.

2.2.4.A Remuneration in non-equity shares and arrangements with put rights over equity shares

A transaction is within the scope of IFRS 2 only where it involves the delivery of an equity instrument, or cash or other assets based on the price or value of an 'equity instrument', in return for goods or services (see section 2.2.1 above).

In some jurisdictions, there can be fiscal advantages in giving an employee, in lieu of a cash payment, a share that carries a right to a 'one-off' dividend, or is mandatorily redeemable, at an amount equivalent to the intended cash payment. Such a share would almost certainly be classified as a liability under IAS 32 (see Chapter 43). Payment in such a share would not fall in the scope of IFRS 2 since the consideration paid by the entity for services received is a financial liability rather than meeting the definition of an equity instrument (see the definitions in section 2.2.1 above).

How we see it

If the amount of remuneration delivered in this way were equivalent to the value of a particular number of equity instruments issued by the entity, then the transaction would be in scope of IFRS 2 as a cash-settled share-based payment transaction, since the entity would have incurred a liability (i.e., by issuing the redeemable shares) for an amount based on the price of its equity instruments.

Similarly, if an entity grants an award of equity instruments to an employee together with a put right whereby the employee can require the entity to purchase those shares for an amount based on their fair value, both elements of that transaction are in the scope of IFRS 2 as a single cash-settled transaction (see section 9 below). This is notwithstanding the fact that, under IAS 32, the share and the put right might well be analysed as a single synthetic instrument and classified as a liability with no equity component (see Chapter 43).

Differences in the classification of instruments between IFRS 2 and IAS 32 are discussed further in section 1.4.1 above.

Put options over instruments that are only classified as equity in limited circumstances (in accordance with IAS 32.16A-16B) are discussed in section 2.2.4.J below.

2.2.4.B Equity-settled award of subsidiary with put option against the parent - treatment in consolidated accounts of parent

It is sometimes the case that a subsidiary entity grants an award over its own equity instruments and, either on the same date or later, the parent entity separately grants the same counterparty a put option to sell the equity instruments of the subsidiary to the parent for a cash amount based on the fair value of the equity instruments. Accounting for such an arrangement in the separate financial statements of the subsidiary and the parent will be determined in accordance with the general principles of IFRS 2 (see section 2.2.2.A above). However, IFRS 2 does not explicitly address the accounting treatment of all such arrangements in the parent's consolidated financial statements.

How we see it

In our view, accounting for a put option to sell equity instruments in the subsidiary to the parent differs depending on whether the put option is granted during (including at grant date) or after the vesting period and whether it relates to ordinary shares or to share options. See the discussion that follows of the different accounting treatments.

If the put option is granted during the vesting period (whether at the same time as the grant of the equity instruments or later), the two transactions must be treated as linked and accounted for in the consolidated financial statements as a single cash-settled transaction from the date the put option is granted. This reflects the fact that this situation is similar in group terms to a modification of an award to add a cash-settlement alternative - see section 10.1.4 below.

If the put option is only granted once the equity instruments have vested, the accounting will depend on whether the equity instruments in the original share-based payment transaction are unexercised options or whether they are ordinary shares.

If they are unexercised options, the vested options remain within the scope of IFRS 2 until they are exercised (see section 2.2.2.E above) and, in this case, the put option is treated as a linked transaction. Its effect in group terms is to modify the original award from an equity- to a cash-settled transaction until final settlement date.

However, if the equity instruments are fully vested ordinary shares (whether free shares or shares from the exercise of options), rather than unexercised options, they are generally no longer within the scope of IFRS 2 as they are no different from any other ordinary shares issued by the subsidiary. In such cases, the parent entity will need to evaluate whether or not the grant of the put option, as a separate transaction which modifies the terms of certain of the subsidiary's equity instruments, falls within the scope of IFRS 2. For example, the addition of a condition that relates to one (non-controlling) shareholder of a subsidiary might indicate that it continues to be appropriate to account for the arrangement in accordance with the requirements of IFRS 2. By contrast, a modification to an entire class of ordinary shares would generally not be within the scope of IFRS 2.

A similar analysis is required in a situation where an individual sells a controlling interest in an entity for fair value and put and call options are granted over the individual's remaining non-controlling interest or over shares in the acquirer which have been given to the individual in return for the business acquired. To the extent that the exercise price of the call option depends on the fulfilment of a service condition in the period following the acquisition of the controlling interest, it is likely that the arrangement will fall within the scope of IFRS 2 with any payments contingent on future services recognised as compensation costs.

Put options over non-controlling interests that do not fall within the scope of IFRS 2 are addressed in Chapter 8 at section 6.2.

2.2.4.C Increase in ownership interest with no change in number of shares held

An arrangement typically found in entities with venture capital investors is one where an employee (often part of the key management) subscribes initially for, say, 1% of the entity's equity with the venture capitalist holding the other 99%. The employee's equity interest will subsequently increase by a variable amount depending on the extent to which certain targets are met. This is achieved not by issuing new shares but by cancelling some of the venture capitalist's shares.

How we see it

In our view, such an arrangement falls within the scope of IFRS 2 as the employee is rewarded with an increased equity stake in the entity if certain targets are achieved. The increased equity stake is consistent with the definition in Appendix A of IFRS 2 of an equity instrument as "a contract that evidences a residual interest …" notwithstanding the fact that no additional shares are issued.

In such arrangements, it is often asserted that the employee has subscribed for a share of the equity at fair value. However, the subscription price paid must represent a fair value using an IFRS 2 valuation basis in order for there to be no additional IFRS 2 expense to recognise (see section 2.2.4.D below).

2.2.4.D Awards for which the counterparty has paid 'fair value'

In certain situations, such as where a special class of share is issued, the counterparty might be asked to subscribe a certain amount for the share which is agreed as being its 'fair value' for taxation or other purposes.

How we see it

This does not mean that such arrangements fall entirely outside the scope of IFRS 2, either for measurement or disclosure purposes, if the arrangement, or a portion thereof, meets the definition of a share-based payment transaction. In many cases, the agreed 'fair value' will be lower than a fair value measured in accordance with IFRS 2 because it will reflect the impact of service and non-market vesting conditions which are excluded from an IFRS 2 fair value.

This is addressed in more detail in section 15.4.5 below.

2.2.4.E Cash bonus dependent on share price performance

An entity might agree to pay its employees a CU100 cash bonus if its share price remains at CU10 or more over a given period. Intuitively, this appears to be within the scope of IAS 19 rather than that of IFRS 2 because the employee is not being given cash of equivalent value to a particular number of shares. However, it could be argued that it does fall within the scope of IFRS 2 on the basis that the entity has incurred a liability, and the amount of that liability is 'based on' the share price (in accordance with the definition of a cash-settled share-based payment transaction) - it is nil if the share price is below CU10 and CU100 if the share price is CU10 or more.

How we see it

Either interpretation mentioned above is acceptable.

2.2.4.F Cash-settled awards based on an entity's 'enterprise value' or other formula

As noted in section 2.2.1 above, IFRS 2 includes within its scope transactions in which the entity acquires goods or services by incurring a liability "based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity". Employees of an unquoted entity may receive a cash award based on the value of the equity of that entity. Such awards are typically, but not exclusively, made by venture capital investors to the management of entities in which they have invested and which they aim to sell in the medium term. Further discussion of the accounting implications of awards made in connection with an exit event may be found in section 15.4 below.

More generally, where employees of an unquoted entity receive a cash award based on the value of the equity, there is no quoted share price and an 'enterprise value' has therefore to be calculated as a surrogate for it. This begs the question of whether such awards are within the scope of IFRS 2 (because they are based on the value of the entity's equity) or that of IAS 19.

How we see it

In order for an award to be within the scope of IFRS 2, any calculated 'enterprise value' must represent the fair value of the entity's equity. Where the calculation uses techniques recognised by IFRS 2 as yielding a fair value for equity instruments (as discussed in section 8 below), we believe that the award is considered to be within the scope of IFRS 2.

Appendix B of IFRS 2 notes that an unquoted entity may have calculated the value of its equity based on net assets or earnings (see section 8.5.3.B below). In our view, this is not intended to imply that it is always appropriate to do so, but simply to note that it could be appropriate in some cases.

Where, for example, the enterprise value is based on a constant formula, such as a fixed multiple of earnings before interest, tax, depreciation and amortisation ('EBITDA'), in our view it is unlikely that this will represent a good surrogate for the fair value of the equity on an ongoing basis, even if it did so at the inception of the transaction.

Possible scenarios in which an enterprise value based on EBITDA would not be a good surrogate for the fair value of the equity on an ongoing basis include one in which the fair value of the equity of an entity could be affected with no significant change in EBITDA, for example as a result of changes in interest rates and effective tax rates, or a significant impairment of assets. Alternatively, there might be a significant shift in the multiple of EBITDA equivalent to fair value, for example, if the entity were to create or acquire a significant item of intellectual property.

For an award by an individual entity, there is unlikely to be any significant difference in the cost ultimately recorded under IFRS 2 or IAS 19. However, the disclosure requirements of IFRS 2 are more onerous than those of IAS 19. In a group situation where the parent entity grants the award to the employees of a subsidiary, the two IFRS accounting standards could result in different levels of expense in the books of the subsidiary because IAS 19, unlike IFRS 2, does not require the employing subsidiary to recognise an expense for a transaction which it has no direct obligation to settle and for which the parent does not allocate the cost (see Chapter 31 at section 2.2.2).

The accounting treatment of awards based on the 'market price' of an unquoted subsidiary or business unit - where there is no actual market for the shares - raises similar issues about whether an equity value is being used, as discussed further in section 15.6 below.

2.2.4.G Awards with a foreign currency strike price

Many entities award their employees options with a foreign currency strike price. This will arise most commonly in a multinational group where employees of overseas subsidiaries are granted options on terms that they can pay the option strike price in their local currency. Such awards may also arise where an entity, which has a functional currency different from that of the country in which it operates (e.g., an oil company based in the United Kingdom with a functional currency of United States dollars), grants its UK-based employees options with a strike price in pounds sterling, which is a foreign currency from the perspective of the currency of the financial statements.

Under IAS 32, as currently interpreted, such an award could not be regarded as an equity instrument because the strike price to be tendered is not a fixed amount of the reporting entity's own currency (see Chapter 43 at section 5.2.3). However, under IFRS 2, as discussed in section 2.2.1 above, equity instruments include options, which are defined as the right to acquire shares for a 'fixed or determinable price'. Moreover, it is quite clear from the Basis for Conclusions on IFRS 2 that an award which ultimately results in an employee receiving equity is equity-settled under IFRS 2 whatever its status under IAS 32 might be (see section 1.4.1 above).

How we see it

In our view, an option over equity with a foreign currency strike price is an equity instrument if accounted for under IFRS 2.

The fair value of an option with a foreign currency strike price must be assessed at grant date and, where the award is treated as equity-settled, must not subsequently be revised for foreign exchange movements (on the basis that the equity instrument is a non-monetary item translated using the exchange rate at the date when the fair value was measured). This applies to the separate financial statements of a parent or subsidiary entity as well as to consolidated financial statements. Where the award is treated as cash-settled, however, the periodic reassessment through profit or loss of the fair value of the award required by IFRS 2 will also need to take into account any exchange difference arising from the requirements of IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

2.2.4.H Holding own shares to satisfy or 'hedge' awards

Entities often seek to hedge the cost of share-based payment transactions, most commonly by buying their own equity instruments in the market. For example, an entity could grant an employee options over 10,000 shares and buy 10,000 of its own shares into treasury at the date that the award is made. If the award is share-settled, the entity will deliver the shares to the counterparty. If it is cash-settled, it can sell the shares to raise the cash it is required to deliver to the counterparty. In either case, the cash cost of the award is capped at the market price of the shares at the date the award is made, less any amount paid by the employee on exercise. It could of course be argued that such an arrangement is not a true hedge at all. If the share price goes down so that the option is never exercised, the entity is left holding 10,000 of its own shares that cost more than they are now worth.

Whilst these strategies may cap the cash cost of share-based payment transactions that are eventually exercised, they will not have any effect on the charge to profit or loss required by IFRS 2 for such transactions. This is because purchases and sales of own shares are accounted for as movements in equity and are therefore never included in profit or loss (see section 4.1 below).

The illustrative examples of group share schemes in sections 12.4 and 12.5 below show the interaction of the accounting required for a holding of own shares and the requirements of IFRS 2.

2.2.4.I Shares or warrants issued in connection with a loan or other financial liability

As noted in section 2.2.3.E above, IFRS 2 does not apply to transactions within the scope of IAS 32 and IFRS 9. However, if shares or warrants are granted by a borrower to a lender as part of a loan or other financing arrangement, the measurement of those shares or warrants might fall within the scope of IFRS 2. The determination of the relevant standard is likely to require significant judgement based on the precise terms of individual transactions. If the shares or warrants are considered to be granted by the borrower in lieu of a cash fee for services provided by the lender then IFRS 2 is likely to be the appropriate standard, but if the shares or warrants are considered instead to be part of the overall return to the lender on the financing arrangement then IAS 32 and IFRS 9 are more likely to apply.

2.2.4.J Options over puttable instruments classified as equity under specific exception in IAS 32

Some entities, such as certain types of trusts, issue tradeable puttable instruments that are classified as equity instruments rather than as a financial liability because the entity has no other equity instruments. This classification is based on a specific exception in IAS 32 that makes it clear that such instruments are not equity instruments for the purposes of IFRS 2. *[IAS 32.16A, IAS 32.16B, IAS 32.96C]*. However, must options over such instruments granted to employees - and allowing them to obtain the instruments at a discount to the market price - be treated as cash-settled awards under IFRS 2 or are they outside the scope of IFRS 2 and within that of IAS 19?

The entity has no equity apart from the instruments classified as such under the narrow exception in IAS 32 and, in the absence of equity, the entity cannot logically issue equity instruments in satisfaction of an award to employees nor can it pay cash based on the price or value of its equity instruments.

How we see it

In our view, IAS 32.96C is required to be interpreted as meaning that, for the purposes of IFRS 2, awards of instruments applying the exception in IAS 32 are not share-based payments and the appropriate standard is IAS 19 rather than IFRS 2.

Those who take the view that such options could be cash-settled share-based payments seem to rely more on the general IAS 32 definition of equity than on the more specific requirements of IAS 32.96C (that "The instrument shall not be considered an equity instrument under other guidance, for example IFRS 2"). We believe that the more specific guidance takes precedence over the general definition.

2.2.4.K Special discounts to certain categories of investor on a share issue

In the context of a flotation or other equity fundraising, an entity might offer identical shares at different prices to institutional investors and to individual (retail) investors. Should the additional discount given to one class of investor be accounted for under IFRS 2 as representing unidentified goods or services received or receivable?

The IFRS IC was asked to clarify the accounting treatment in this area. The request submitted to the IFRS IC referred to the fact that the final retail price could differ from the institutional price because of:

- An unintentional difference arising from the book-building process.

  Or

- An intentional difference arising from a retail discount given by the issuer of the equity instruments as indicated in the prospectus.

For example, a discount to the institutional investor price might need to be offered to encourage retail investors to buy shares in order to meet the requirements of a particular stock exchange for an entity to have a minimum number of shareholders.

The IFRS IC considered whether the discount offered to retail investors in the above example involves the receipt of identifiable or unidentifiable goods or services from the retail shareholder group and, therefore, whether the discount is a share-based payment transaction within the scope of IFRS 2.

IFRS 2 was specifically amended for situations where the identifiable consideration received by the entity appears to be less than the fair value of the equity instruments granted (see section 2.2.2.C above). *[IFRS 2.2, IFRS 2.13A]*. The IFRS IC noted that the application of this guidance requires judgement and consideration of the specific facts and circumstances of each transaction.

In the circumstances underlying the submission to the IFRS IC, they observed that the entity issues shares at two different prices to two different groups of investors for the purpose of raising funds. Any difference in price between the two groups appears to relate to the existence of different markets - one accessible only to retail investors and the other accessible only to institutional investors - rather than to the receipt of additional goods or services. The only relationships involved are those between the investors and the investee entity and the investors are acting in their capacity as shareholders.

The IFRS IC therefore observed that the guidance in IFRS 2 is not applicable because there is no share-based payment transaction.

A distinction was drawn between the example above and a situation considered by the IFRS IC in 2013 (accounting for reverse acquisitions that do not constitute a business - see section 2.2.4.L below). In the latter situation, a stock exchange listing received by the accounting acquirer was considered to be a service received from the accounting acquiree and to represent the difference between the fair value of the equity instruments issued and the identifiable net assets acquired. Hence an IFRS 2 expense would be required in order to recognise this difference. In the situation relating to retail and institutional investors considered above, however, there is no service element and the difference in prices for the two different types of investor is due solely to an investor-investee relationship rather than to unidentifiable goods or services received from the investors.

At its July 2014 meeting the IFRS IC decided not to add this matter to its agenda on the basis that sufficient guidance exists without further interpretation or the need for an amendment to a standard.[11]

11 *IFRIC Update*, July 2014, available on the IFRS Foundation's website.

How we see it

An entity might voluntarily offer a discount to one class of investor, e.g., to an institution underwriting the share issue. In our view, this type of discount is likely to require an IFRS 2 expense to be recognised unless there is evidence that separate prices, and therefore different fair values, are required for each category of investor.

However, in some cases - such as the example above where an institution provides underwriting services - it might be possible to conclude that any additional cost under IFRS 2 is actually a cost of issuing the equity instruments and therefore is debited to equity rather than to profit or loss.

Similar considerations to those discussed in this section apply when, in advance of an IPO, a private company issues convertible instruments at a discount to their fair value in order both to attract key investors and to boost working capital. There is further discussion on convertible instruments in section 10.1.6 below.

2.2.4.L Acquisitions involving a listed shell entity

As noted above in section 2.2.3.C, IFRS 2 does not apply to share-based payments to acquire goods as part of a business combination to which IFRS 3 applies.

However, in 2013 the IFRS IC[12] has clarified that in a reverse acquisition involving an entity that does not constitute a business (i.e., an asset acquisition or the provision of a service), IFRS 2 rather than IFRS 3 is likely to apply. For example, a private operating entity may enter into a transaction to have itself 'acquired' by a listed shell (non-operating) entity, such as a special purpose acquisition company ('SPAC') as a means of obtaining a stock exchange listing.

The issue that was considered by the IFRS IC involved the former shareholders of a non-listed operating entity becoming the majority shareholders of the combined entity by exchanging their shares for new shares of a listed non-operating entity. The IFRS IC concluded that it is appropriate to apply the IFRS 3 guidance for reverse acquisitions by analogy, and the accounting acquirer is deemed to have issued shares to obtain control of the acquiree. The transaction is not a business combination, but a share-based payment transaction which should be accounted for in accordance with IFRS 2 (i.e., an asset acquisition or provision of service). The IFRS IC concluded that any difference in the fair value of the shares deemed to have been issued by the accounting acquirer and the fair value of the accounting acquiree's identifiable net assets represents a service received by the accounting acquirer for obtaining a stock exchange listing (see Chapter 10 at section 14.8). *[IFRS 2.8, IFRS 2.13A]*.

The IFRS IC considered another request in 2022,[13] on the accounting for warrants when acquiring a SPAC. The issue considered by the IFRIC IC in 2022 involved a private operating entity acquiring a SPAC by issuing new ordinary shares and warrants to the SPAC's founder shareholders and public investors in exchange for the SPAC's ordinary shares and the legal cancellation of the SPAC's warrants. The purpose of the acquisition is for the private operating entity to acquire the cash held by the SPAC (the SPAC has no assets other than cash) and the SPAC's listing on a stock exchange. This fact pattern is different to that discussed by the IFRS IC in 2013, as the operating entity (also referred to as the target) is identified as the acquirer for both accounting and legal purposes, whereas in the 2013 agenda decision the SPAC is identified as the legal acquirer and the operating entity as the accounting acquirer. The SPAC's founder shareholders and public investors are not SPAC employees nor will they provide services to the operating entity after the acquisition. In addition, the fair value of the instruments the operating entity issues to acquire the SPAC exceeds the fair value of the SPAC's identifiable net assets. The IFRS IC was asked to consider the accounting for the warrants at acquisition.

The IFRS IC concluded that, in applying IFRS 2, the operating entity receives a stock exchange listing service for which it has issued equity instruments as part of a share-based payment transaction, and it is measured as the difference between the fair value of the instruments issued to acquire the SPAC and the fair value of the identifiable net assets acquired. *[IFRS 2.2, IFRS 2.13A]*.

12 *IFRIC Update*, March 2013, available on the IFRS Foundation's website.

13 IFRIC Update, September 2022, available on the IFRS Foundation's website.

When assessing what are the individual identifiable net assets acquired, the IFRS IC observed that the operating entity acquires the cash held by the SPAC and also considers whether it assumes the SPAC warrants as part of the acquisition and, consequently, whether it assumes a liability if those warrants are classified as financial liabilities. In assessing whether it assumes the SPAC warrants as part of the acquisition, the operating entity considers the specific facts and circumstances of the transaction, including the terms and conditions of all agreements associated with the acquisition. For example, the operating entity considers the legal structure of the transaction and the terms and conditions of the SPAC warrants and the new warrants the entity issues.

Depending on the specific facts and circumstances, the operating entity might conclude that it assumes the SPAC warrants as part of the acquisition (in this case, the entity issues ordinary shares to acquire the SPAC, assumes the SPAC warrants as part of the acquisition and then issues new warrants to replace the SPAC warrants assumed). Alternatively, the operating entity might conclude that the facts and circumstances are such that it does not assume the SPAC warrants as part of the acquisition, and in this case, the operating entity issues both ordinary shares and new warrants to acquire the SPAC.

The IFRS IC observed that IAS 32 applies to all financial instruments, with some exceptions including financial instruments, contracts and obligations under share-based payment transactions to which IFRS 2 applies. In addition, IFRS 2 applies to 'share-based payment transactions in which an entity acquires or receives goods or services. Goods includes inventories, consumables, property, plant and equipment, intangible assets and other non-financial assets'. *[IFRS 2.5]*.

Therefore, the IFRS IC concluded that the operating entity applies IFRS 2 in the accounting for instruments issued to acquire the stock exchange listing service and IAS 32 in accounting for instruments issued to acquire cash and assume any liability related to the SPAC warrants given that these instruments were not issued to acquire goods or services and are not in the scope of IFRS 2.

To the extent it is determined that the operating entity assumes the SPAC warrants as part of the acquisition, the operating entity applies IAS 32 to determine whether the SPAC warrants assumed are financial liabilities or equity instruments, given that the SPAC's founder shareholders and public investors hold the SPAC warrants solely in their capacity as owners of the SPAC as they are not SPAC employees nor will they provide services to the combined entity after the acquisition (see Chapter 43 at section 4.10). The operating entity then applies IAS 32 and IFRS 9 Financial Instruments to account for the replacement of the SPAC warrants with new warrants. However, because the operating entity negotiated the replacement of the SPAC warrants as part of the SPAC acquisition, it determines whether it accounts for any of the new warrants it issues as part of that acquisition. No IFRS accounting standard specifically applies in making this determination. Therefore, the operating entity applies paragraphs 10-11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in developing and applying an accounting policy that results in information that is relevant and reliable.

To the extent that the operating entity does not assume the SPAC warrants as part of the acquisition (i.e., the entity issues both ordinary shares and new warrants to acquire cash and a stock exchange listing and does not assume the SPAC warrants), the operating entity determines to what extent it issued each type of instrument to acquire the cash and the stock exchange listing service. The issuance of shares and warrants in exchange for cash are accounted for under IAS 32 while those issued in exchange for the stock exchange listing service are accounted for under IFRS 2 as the acquisition of financial instruments falls outside the scope of a share-based payment transaction. No IFRS accounting standard specifically applies to this determination. Therefore, the operating entity applies paragraphs 10-11 of IAS 8 in developing and applying an accounting policy that results in information that is relevant and reliable. The IFRS IC observed that the operating entity could allocate the shares and new warrants to the acquisition of cash and the stock exchange listing service on the basis of the relative fair values of the instruments issued (i.e., in the same proportion as the fair value of each type of instrument to the total fair value of all issued instruments). For example, if 80% of the total fair value of the instruments issued comprises ordinary shares, the operating entity could conclude that 80% of the fair value of instruments issued to acquire cash also comprises ordinary shares. Other allocation methods could be used if they meet the requirements in paragraphs 10-11 of IAS 8. However, an accounting policy that results in the operating entity allocating all the new warrants issued to the acquisition of the stock exchange listing service solely to avoid the new warrants being classified as financial liabilities applying IAS 32 would not meet these requirements.

How we see it

To the extent that an operating entity issues both ordinary shares and new warrants to acquire cash and a stock exchange listing service and the new warrants are accounted for as part of the acquisition, the agenda decision concludes that the new warrants are allocated and accounted for in accordance with IAS 32 and IFRS 2, respectively. While this would not impact the measurement of the service listing expense, it would impact the subsequent accounting for these instruments post-acquisition. For example, warrants containing an obligation to deliver a variable number of shares would be accounted for as liability instruments in accordance with IAS 32 subject to fair value measurement subsequently, whereas such warrants could be equity instruments post-acquisition under IFRS 2. It is also observed that applying this allocation approach could present some practical challenges, such as tracking the exercise of warrants under different IFRS accounting standards post-acquisition.

In addition, the 2022 agenda decision identifies the operating entity (target) as both the legal and accounting acquirer, and replaces the SPAC as the entity listed on the stock exchange, we believe that the issue of whether the operating entity assumes the warrants is also relevant in other structures.

A target which is an accounting acquirer but not the legal acquirer in a SPAC acquisition (similar to the 2013 agenda decision fact pattern discussed above) is also required to apply IFRS 2 in accounting for the acquisition of goods or services (including a stock exchange listing) and IAS 32 in accounting for the acquisition/assumption of financial assets/liabilities included in the net assets of the SPAC.

The discussion above focuses on the scoping for the transaction, for further discussion on accounting considerations for SPAC transactions refer to our publication, Applying IFRS: Accounting for SPACs.

3 General recognition principles

The recognition rules in IFRS 2 are based on a so-called 'service date model'. In other words, IFRS 2 requires the goods or services received or acquired in a share-based payment transaction to be recognised when the goods are acquired or the services rendered. *[IFRS 2.7]*. For awards to employees (or others providing similar services), this contrasts with the measurement rules, which normally require a share-based payment transaction to be measured as at the date on which the transaction was entered into, which may be some time before or after the related services are received - see sections 4 to 7 below.

Where the goods or services received or acquired in exchange for a share-based payment transaction do not qualify for recognition as assets they are recognised as expenses. *[IFRS 2.8]*. The standard notes that typically services will not qualify as assets and must therefore be expensed immediately, whereas goods will generally be recognised initially as assets and expensed later as they are consumed. However, some payments for services may be capitalised (e.g., as part of the cost of PP&E, intangible assets or inventories) and some payments for goods may be expensed immediately (e.g., where they are for items included within development costs written off as incurred). *[IFRS 2.9]*.

The corresponding credit entry when goods are acquired or services are rendered is, in the case of an equity-settled transaction, an increase in equity and, in the case of a cash-settled transaction, a liability (or decrease in cash or other assets). *[IFRS 2.7]*.

The primary focus of the discussion in the remainder of this chapter is the application of these rules to transactions with employees. The accounting treatment of transactions with non-employees is addressed further in sections 5.1 and 5.4 below.

3.1 Vesting conditions

Under IFRS 2, the point at which a cost is recognised for goods or services depends on the concept of 'vesting'. The following definitions in Appendix A to IFRS 2 are relevant. *[IFRS 2 Appendix A]*.

Extract from IFRS 2

Appendix A IFRS 2
Defined terms

performance condition	A **vesting condition** that requires: (a) the counterparty to complete a specified period of service (ie a **service condition**); the service requirement can be explicit or implicit; and (b) specified performance target(s) to be met while the counterparty is rendering the service required in (a). The period of achieving the performance target(s): (a) shall not extend beyond the end of the service period; and (b) may start before the service period on the condition that the commencement date of the performance target is not substantially before the commencement of the service period. A performance target is defined by reference to: (a) the entity's own operations (or activities) or the operations or activities of another entity in the same group (ie a non-market condition); or (b) the price (or value) of the entity's **equity instruments** or the equity instruments of another entity in the same group (including shares and **share options**) (ie a **market condition**). A performance target might relate either to the performance of the entity as a whole or to some part of the entity (or part of the group), such as a division or an individual employee.
service condition	A **vesting condition** that requires the counterparty to complete a specified period of service during which services are provided to the entity. If the counterparty, regardless of the reason, ceases to provide service during the **vesting period**, it has failed to satisfy the condition. A service condition does not require a performance target to be met.
vest	To become an entitlement. Under a **share-based payment arrangement**, a counterparty's right to receive cash, other assets or **equity instruments** of the entity vests when the counterparty's entitlement is no longer conditional on the satisfaction of any **vesting conditions**.
vesting condition	A condition that determines whether the entity receives the services that entitle the counterparty to receive cash, other assets or **equity instruments** of the entity, under a **share-based payment arrangement**. A vesting condition is either a **service condition** or a **performance condition**.

An example of a service condition is one where an employee is granted a share option with a service requirement of remaining in employment with an entity for three years, the award vests three years after the date of grant if the employee is still employed by the entity at that date.

The definitions of 'vesting condition', 'service condition' and 'performance condition' reproduced above clarify the distinction between different types of conditions attached to a share-based payment.

The definition of a *market condition* is included in section 6.3 below.

In order for a condition to be a vesting condition - rather than a 'non-vesting' condition (see section 3.2 below) - there must be a service requirement and any additional performance target must relate to the entity or to some part of the entity or group, such as a division or an individual employee. Thus a condition that an award vests if, in three years' time, earnings per share has increased by 10% and the employee is still in employment, is a performance condition. If, however, the award becomes unconditional in three years' time if earnings per share has increased by 10%, irrespective of whether the employee is still in employment, that condition is not a performance condition but a non-vesting condition because there is no associated service requirement.

The different types of performance condition and the related accounting requirements are discussed more fully in section 6 below. The distinction between vesting and non-vesting conditions is discussed in section 3.2 below.

The accounting treatment in a situation where the counterparty fails to meet a service condition - a situation now explicitly covered by the definition of a service condition above - is considered in more detail in section 7.4.1.A below.

In addition to the general discussion throughout section 3, specific considerations relating to awards that vest on a flotation or change of control (or similar exit event) are addressed in section 15.4 below.

3.1.1 'Malus' clauses and clawback conditions

Whether as a result of an entity's own decision or in response to regulatory requirements, an increasing number of share-based payment awards include conditions in which the awards will only vest if there is no breach of any 'malus' clause on the part of the employee and/or the entity. Often these or other conditions are put in place to allow an entity to claw back awards from employees should any wrongdoing or underperformance be identified.

The impact of such clauses on the accounting treatment required by IFRS 2 depends on the precise terms of a particular arrangement. Aspects of arrangements that entities will need to consider include the following:

- Whether the terms are sufficiently clear at the inception of the arrangement that there can still be a grant in IFRS 2 terms (see section 5.3 below for further discussion of the requirements relating to grant date).
- Whether the malus clause relates only to the actions of the individual employee (so-called 'at fault' malus) and whether the relevant period for consideration of the condition is limited to the vesting period or extends over a longer period.
- Whether the malus clause relates only to the overall performance of the entity (so-called 'not at fault' malus) and, again, the applicable period during which the clause may be invoked.
- Whether the associated clawback arrangements are clear or depend on further decisions by the entity at the time the relevant 'malus' clause is invoked.

How we see it

It is likely to be the case that there will be a grant at inception provided the terms of the malus and clawback arrangements are sufficiently clear for there to be a shared understanding of the arrangements by both parties.

If the employee's ultimate entitlement to an award depends on an 'at fault' malus clause not being invoked, this is generally likely to be taken into account as part of any service vesting condition. If the condition extends beyond the usual vesting date of the award and the employee breaches the condition after the end of the vesting period, the vested awards will be treated as a cancellation under IFRS 2 (but there would be no impact on the expense already recognised for a vested award).

Depending on the precise terms, the assessment of a 'not at fault' malus clause is likely to require greater judgement. To the extent that the entity's overall performance formed part of the conditions on which the award would vest, it seems appropriate to treat the condition as part of a performance vesting condition. To the extent that a 'not at fault' malus clause could result in the clawback of an award after the end of the vesting period, there would need to be an assessment of how the identified fault or wrongdoing interacted with the position of the entity as previously determined at the end of the vesting period. The fault might relate solely to a situation that would have prevented the original vesting of the award (for example, a restatement of accounts relating to the vesting period) or it might be a more general condition relating to the ongoing performance of the entity subsequent to the vesting period. If the condition extended beyond the service period, the entity would need to consider whether the award may contain a non-vesting condition from inception (see section 3.2 below). However, given the nature of the condition, in our view if it was determined that a non-vesting condition existed, it would be unlikely that there would be a significant reduction, if any, in the fair value of the award as a consequence of the non-vesting condition.

How we see it

As noted above, an 'at fault' malus clause will likely be taken into account as part of the service vesting condition. A 'not at fault' malus clause requires greater judgement and consideration to whether it needs to be treated as part of the performance vesting condition, but if it extends beyond the service period, the entity would need to consider whether the award may contain a non-vesting condition from inception, and if it were determined to contain a non-vesting condition we believe it would not result in a significant reduction in the fair value of the award.

3.1.2 Vesting conditions based on an employee's performance rating

An entity may grant awards to employees that vest based on conditions that include the employee's performance rating. A performance rating would appear to meet the definition of a non-market performance condition in that it is a vesting condition that requires an employee to render service for a period of time and to achieve a specified performance rating while providing the service in employment of the entity (see section 3.1 above). Performance ratings can be influenced by the judgement of the individual(s) conducting an employee's evaluation, therefore, the question often arises whether the inherent subjectivity of a performance evaluation could delay the grant date for the award (see section 5.3 below). The impact of such condition on the accounting treatment required by IFRS 2 depends on the framework that is established by the entity to facilitate an employee's understanding of how their performance will be measured. A framework that clearly articulates criteria and includes more objective measures is more likely to result in a more predictive outcome and, thus likely a non-market performance condition. On the contrary, a framework that contains more subjective measures that provide less clarity and is less predictive of the outcome, would not. The following are aspects of the framework that should be considered in making the determination:

- Whether the criteria are sufficiently clear at the inception of the share-based payment arrangement such that there is a mutual understanding between the entity and the employee about how the performance rating will be measured.
- Whether the criteria relates only to the performance of the individual employee or the employee's performance relative to their peers, over the relevant measurement period.
- Whether the employee is able to predict the outcome under the related performance rating framework, given the set criteria.

In certain cases, the number of instruments underlying the award might vary depending on the employee's performance relative to the criteria in the framework. The entity will be required to estimate the potential outcome during the performance period and to recognise the cost for the number of instruments that the employee is expected to be entitled based on their performance rating (see section 6.2.4 below).

3.1.3 Environment Social and Governance ('ESG') related conditions

With the increase in focus by stakeholders of entities on ESG related matters, a growing number of share-based payment arrangements include conditions that require environmental, social and/or governance related targets to be met for the award to vest. An entity that grants such an award will need to assess if the ESG target is a vesting condition or non-vesting condition.

As noted in section 3 above, a vesting condition is either a service condition or performance condition, with the latter requiring the counterparty to complete a specified period of service and specified performance targets (such as a specified increase in the entity's profit over a specified period of time). A performance condition that is referenced to the entity's own operations (or activities) or the operations or activities of another entity in the same group, is a non-market vesting condition. A performance target might relate either to the performance of the entity as a whole or to some part of the entity (or part of the group), such as a division or an individual employee. IFRS 2 does not explicitly define a 'non-vesting condition' (see section 3.2.2 below), but uses the term to describe a condition that is neither a service condition nor a performance condition.

The identification of an ESG related target as a vesting condition is not always straightforward. One such area is conditions related to climate change. An entity may enter into a share-based payment arrangement with employees that vests on satisfying a service period and on achieving targets based on Scope 1, 2 and/or 3 GHG (greenhouse gas) emissions.[14] In general, Scope 1 emissions arise from sources that are owned or controlled by the entity, while Scope 2 emissions occur indirectly from the generation of purchased energy consumed by the entity. If the service condition requirements in the definition of a performance condition are met, both Scope 1 and Scope 2 emissions targets would meet the definition of performance vesting conditions as they both relate to the performance of the entity's own operations or activities. Scope 3 emissions are all indirect emissions (not included in scope 2) that occur in the value chain (upstream and downstream) of an entity. Fifteen reporting categories[15] exist for measuring an entity's Scope 3 emissions.

14 IFRS S2 Climate-related Disclosures, Appendix A Defined terms, available on the IFRS Foundation's website.

15 Greenhouse Gas Protocol, *Corporate Value Chain (Scope 3) Accounting and Reporting Standard,* available from the Greenhouse Gas Protocol website.

Determining whether a Scope 3 emissions target is a performance condition will require analysis of the conditions that has led to the emissions in determining if the definition of a performance condition is met or whether it represents a non-vesting condition. To meet the definition of a performance condition, the target is required to be referenced to the entity's own operations or activities. Whilst the service condition must not be for a period that is less than the period the Scope 3 target must be met, the following are some factors that could help in determining if the target is a performance condition:

- Whether an entity is able to influence if a target is met through its own actions. For example, when an entity grants a share-based payment award subject to a service condition and achieving a 20% reduction in Scope 3 Category 7 emissions (related to Employee Commuting emissions), as part of the entity's net zero commitment, and the entity has also put in place various policies to help meet the emission targets by providing employees hybrid working arrangements and incentives for carpooling. Another example may be an entity granting a share-based payment award subject to a service condition and achieving a 20% reduction in Scope 3 Category 1 emissions (related to Purchased Goods and Services emissions), as part of the entity's net zero commitment. The entity has introduced penalties into agreements with suppliers where suppliers have not met emission reduction targets agreed with the entity, has terminated some supplier agreements and entered into agreements with new suppliers in order to help meet the entity's emission targets.
- Whether the conditions are related to the entity's activities. For example, the target of achieving a 20% reduction in Scope 3 emissions in the examples in the previous bullet, is referenced to activities the entity is undertaking to meet its own target as part of its overall net zero commitment.

How we see it

Practice is evolving and there is always some judgement in determining if Scope 3 emission targets are performance conditions. However, in our view as long as the target is referenced to the entity's operations or activities, the achievement of a target does not need to be solely based on the actions of the entity to meet the definition of a performance condition. An example is when determining whether electric vehicle volume revenue target is met, such a target is also influenced by events outside an entity's direct control, such as consumer choice.

3.2 Non-vesting conditions (conditions that are neither service conditions nor performance conditions)

3.2.1 Background

Some share-based payment transactions, particularly those with employees, require the satisfaction of conditions that are neither service conditions nor performance conditions. For example, an employee might be given the right to 100 shares in three years' time, subject only to the employee not working in competition with the reporting entity during that time. An undertaking not to work for another entity does not 'determine whether the entity receives … services' - the employee could sit on a beach for three years and still be entitled to collect the award. Accordingly, such a condition is not regarded as a vesting condition for the purposes of IFRS 2, but is instead referred to as a 'non-vesting condition'. The accounting treatment of non-vesting conditions is discussed in detail in section 6.4 below.

IFRS 2 does not explicitly define a 'non-vesting condition' (see section 3.2.2 below), but uses the term to describe a condition that is neither a service condition nor a performance condition. Sometimes the condition will be wholly within the control of the counterparty and unconnected with the delivery of services, such as a requirement to save (see below). However, the identification of such conditions is not always straightforward.

The concept of a 'non-vesting condition', like much of IFRS 2 itself, had its origins as an anti-avoidance measure. It arose from a debate on how to account for employee share option schemes linked to a savings contract. In some jurisdictions, options are awarded to an employee on condition that the employee works for a fixed minimum period and, during that period, makes regular contributions to a savings account, which is then used to exercise the option. The employee is entitled to withdraw from the savings contract before vesting, in which case the right to the award lapses.

Entities applying IFRS 2 as originally issued almost invariably treated an employee's obligation to save as a vesting condition. If the employee stopped saving this was treated as a failure to meet a vesting condition and accounted for as a forfeiture, with the reversal of any expense so far recorded (see sections 6.1 and 6.2 below).

Some saw in this a scope for abuse of the general principle of IFRS 2 that, if a share-based payment transaction is cancelled, any amount not yet expensed for it is immediately recognised in full (see section 7.4 below). The concern was that, if such a plan were 'out of the money', the employer, rather than cancel the plan (and thereby trigger an acceleration of expense) would 'encourage' the employee to stop saving (and thereby create a reversal of any expense already charged).

The broad effect of the January 2008 amendment to IFRS 2 (see section 1.2 above) was to remove this perceived anomaly from the standard.

However, following the publication of the January 2008 amendment, it became apparent that the concept of the 'non-vesting' condition was not clear. This resulted in differing views on the appropriate classification of certain types of conditions depending on whether or not they were considered to be measures of the entity's performance or activities and hence performance vesting conditions.

The IFRS IC took a number of the above issues onto its agenda as part of a wider project on vesting and non-vesting conditions. Where the issues were not addressed through the IASB's *Annual Improvements to IFRSs 2010-2012 Cycle*, there is further discussion in section 3.4 below.

3.2.2 Defining a non-vesting condition

As noted in section 3.1 above, IFRS 2 defines a vesting condition as a condition that determines whether the entity receives the services that entitle the counterparty to receive payment in equity or cash. Performance conditions are those that require the counterparty to complete a specified period of service and specified performance targets to be met (such as a specified increase in the entity's profit over a specified period of time).

The Basis for Conclusions on IFRS 2 adds that the feature that distinguishes a performance condition from a non-vesting condition is that the former has an explicit or implicit service requirement and the latter does not. *[IFRS 2.BC171A]*.

In issuing its *Annual Improvements to IFRSs 2010-2012 Cycle* in December 2013 the IASB considered whether a definition of 'non-vesting condition' was needed. It decided that "the creation of a stand-alone definition … would not be the best alternative for providing clarity on this issue". *[IFRS 2.BC364]*. Instead, it sought to provide further clarification in the Basis for Conclusions on IFRS 2, as follows:

"…the Board observed that the concept of a non-vesting condition can be inferred from paragraphs BC170-BC184 of IFRS 2, which clarify the definition of vesting conditions. In accordance with this guidance it can be inferred that a non-vesting condition is any condition that does not determine whether the entity receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the entity under a share-based payment arrangement. In other words, a non-vesting condition is any condition that is not a vesting condition." *[IFRS 2.BC364]*.

Although it is stated that the Basis for Conclusions does not form part of IFRS 2, the IASB nonetheless appears to rely on users of the standard referring to the Basis for Conclusions in order to 'infer' the definition of a non-vesting condition.

A performance metric may be a non-vesting condition rather than a vesting condition in certain circumstances. For a condition to be a performance vesting condition, it is not sufficient for the condition to be specific to the performance of the entity. There must also be an explicit or implied service condition that extends to the end of the performance period. For example, a condition that requires the entity's profit before tax or its share price to reach a minimum level, but without any requirement for the employee to remain in employment throughout the performance period, is not a performance condition but a non-vesting condition.

Specific examples of non-vesting conditions given by IFRS 2 include:

- A requirement to make monthly savings during the vesting period.
- A requirement for a commodity index to reach a minimum level.
- Restrictions on the transfer of vested equity instruments.
- An agreement not to work for a competitor after the award has vested - a 'non-compete' agreement (see section 3.2.3 below). *[IFRS 2.BC171B, IFRS 2.IG24]*.

The IASB has also clarified in the Basis for Conclusions on IFRS 2 that a condition related to a share market index target (rather than to the specific performance of the entity's own shares) is a non-vesting condition because a share market index reflects not only the performance of an entity but also that of other entities outside the group. Even where an entity's share price makes up a substantial part of the share market index, the IASB confirmed that this would still be a non-vesting condition because it reflects the performance of other, non-group, entities. *[IFRS 2.BC353-BC358]*.

Thus, whilst conditions that are not related to the performance of the entity are always, by their nature, non-vesting conditions, conditions that relate to the performance of the entity may or may not be non-vesting conditions depending on whether there is also a requirement for the counterparty to render service.

As noted in section 3.1 above, the definition of a performance vesting condition was clarified and expanded in the IASB's *Annual Improvements*. The amended definition includes wording intended to clarify the extent to which the period of achieving the performance target(s) needs to coincide with the service period and states that this performance period:

(a) Shall not extend beyond the end of the service period.

And

(b) May start before the service period on the condition that the commencement date of the performance target is not substantially before the commencement of the service period.

During the process of finalising the amended definition, the IASB moved away from a requirement for the duration of the performance condition to fall wholly within the period of the related service requirement. In response to comments on the draft version of the *Annual Improvements*, the Board decided to make a late adjustment to clarify that the start of the performance period may be before the start of the service period, provided that the commencement date of the performance target is not substantially before the commencement of the service period. As stated in the definition above, however, the performance period may not extend beyond the end of the service period.

FASB differences

It is interesting to note that, in the US, the EITF also considered the question of non-coterminous service and performance conditions but, unlike the IASB, reached the conclusion that a performance target that affects the vesting of a share-based payment and that could be achieved after the requisite service period is a performance condition and does not need to be reflected in the fair value of the award at grant date.[16] This was on the premise that the original definition of a performance condition in ASC 718 *Compensation - Stock Compensation* - requires only a specified period of service. Before finalising the amendments to IFRS 2, the IASB specifically reconfirmed its own decision against the background of the US decision.[17] This is therefore an area of difference between IFRS accounting standards and US GAAP.

The late adjustment by the IASB goes some way towards removing an issue that is extremely common in practice, particularly with awards made to employees under a single scheme but at various times. The IASB gives the example of an earnings per share target as one of the areas in which respondents to the draft definitions observed that there could be a problem in practice, noting that the measure of earnings per share growth set as a performance target could often be that between the most recently published financial statements at grant date and those before the vesting date. *[IFRS 2.BC341]*. However, notwithstanding the amended definition, there clearly remains an element of judgement in the interpretation of 'substantially' as used in the definition.

There is further discussion of the accounting treatment of non-vesting conditions in section 6.4 below.

3.2.3 Non-compete agreements

In some jurisdictions it is relatively common to have a non-compete clause in share-based payment arrangements so that if the counterparty starts to work for a competitor within a specified timescale, i.e., he breaches the non-compete provision, he is required to return the shares (or an equivalent amount of cash) to the entity. Generally, a non-compete provision is relevant once an individual has ceased employment with the entity and so no future service is expected to be provided to the entity. However, the non-compete provision is often found in share-based payment awards entered into while the individual is still an employee of the entity and when there is no current intention for employment to cease. There are two divergent views on how such non-compete arrangements are required to be accounted for under IFRS 2.

The Basis for Conclusions on IFRS 2 states that "a share-based payment vests when the counterparty's entitlement to it is no longer conditional on future service or performance conditions. Therefore, conditions such as non-compete provisions and transfer restrictions, which apply after the counterparty has become entitled to the share-based payment, are not vesting conditions." *[IFRS 2.BC171B]*.

16 Accounting Standards Update 2014-12, FASB, *Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period (Topic 718).*

17 *IASB Update*, November 2013, available on the IFRS Foundation's website.

One view is that, under the current definitions in the standard, this means that all non-compete agreements must be treated as non-vesting conditions with the condition reflected in the grant date fair value. Another reading of IFRS 2.BC171B is that in some situations such arrangements meet the definition of a vesting condition and this allows any IFRS 2 expense to be reversed should the condition not be met. This view is explained further below. The lack of clarity in the standard as currently drafted means that there is diversity in practice.

Those who take the view that a non-compete arrangement is not always a non-vesting condition read IFRS 2.BC171B as distinguishing between non-compete clauses which apply after the counterparty has become entitled to an award (a non-vesting condition) and those that, by implication, apply before the counterparty has become entitled to an award (a vesting condition). Broadly, therefore, if an employee has been given shares at the start of a non-compete period he is entitled to them (a non-vesting condition), but if the shares are retained by the entity or held in escrow, the employee is not entitled to the shares until the end of the non-compete period (a vesting condition).

This view may be difficult to reconcile with IFRS 2 as currently drafted because:

- It requires the reference to 'entitlement' to an award to be read as including a contingent obligation to forfeit the share, which is not in accordance with the general approach of IFRS 2.

  And

- It requires the words 'which apply after the counterparty has become entitled to the share-based payment' to be read with an implied emphasis on the word 'after', so as to distinguish it from an implied (unstated) alternative scenario in which the conditions apply before the counterparty becomes entitled to the share-based payment. A more natural reading is to consider these words as describing all non-compete agreements and transfer restrictions.

How we see it

In summary, as noted above, there is diversity in practice on how non-compete agreements are treated. They are treated as non-vesting conditions or in some situations, as vesting conditions, with the latter view being more difficult to reconcile with the requirements of the standard as currently drafted.

The classification of a non-compete provision is a matter that had been referred to the IFRS IC and to the IASB (see section 3.4 below).

3.3 Vesting period

IFRS 2 defines the vesting period as follows: *[IFRS 2 Appendix A]*

Extract from IFRS 2

Appendix A
Defined terms

vesting period	The period during which all the specified **vesting conditions** of a **share-based payment arrangement** are to be satisfied.

The vesting period is not the same as the exercise period or the life of the option, as demonstrated by Illustration 3-1 below.

Illustration 3-1: Meaning of 'vesting period' - award with vesting conditions only

An employee is awarded options that can be exercised at any time between three and ten years from the date of the award, provided the employee remains in service for at least three years from the date of the award. For this award, the vesting period is three years; the exercise period is seven years; and the life of the option is ten years. However, as discussed further in section 8 below, for the purposes of calculating the fair value of the award under IFRS 2, the life of the award is taken as the period ending with the date on which the counterparty is most likely actually to exercise the option, which may be some time before the full ten year life expires.

It is also important to distinguish between vesting conditions and other restrictions on the exercise of options and/or trading in shares, as demonstrated by Illustration 3-2 below.

Illustration 3-2: Meaning of 'vesting period' - award with vesting and non-vesting conditions

An employee is awarded options that can be exercised at any time between five and ten years from the date of the award, provided the employee remains in service for at least three years from the date of the award. In this case, the vesting period remains three years as in Illustration 3-1 above, provided that the employee's entitlement to the award becomes absolute at the end of three years - in other words, the employee does not have to provide any services to the entity in years 4 and 5. The restriction on exercise of the award in the period after vesting is a non-vesting condition, which would be reflected in the original valuation of the award at the date of grant (see sections 4, 5 and 8 below).

The accounting implications of vesting conditions, non-vesting conditions and vesting periods for equity-settled transactions are discussed in sections 4 to 7 below and for cash-settled transactions in section 9 below.

3.4 Vesting and non-vesting conditions: issues referred to the IFRS IC and the IASB

In January 2010 the IFRS IC added to its agenda a request for clarification of the following:

- The basis on which vesting conditions, especially performance conditions, can be distinguished from non-vesting conditions, especially the distinction between a service condition, a performance condition and a non-vesting condition.
- The interaction of multiple conditions.

The amendments to IFRS 2 published in December 2013 as part of the IASB's *Annual Improvements to IFRSs 2010-2012 Cycle* were intended to address the first bullet point together with related application issues that had been raised with the IFRS IC (see sections 3.1 and 3.2 above).

In addition to considering matters subsequently addressed by the IASB in the *Annual Improvements*, the IFRS IC tentatively decided at its meetings in July and September 2010[18] that a non-compete provision should be presumed to be a 'contingent feature' - a term not defined in IFRS 2.[19]

The IFRS IC subsequently concluded that the classification of a non-compete provision and the question of how to account for the interaction of multiple vesting conditions should be referred to the IASB.[20] In September 2011 the IASB agreed that these issues should be considered as future agenda items.[21]

The IASB launched and concluded a research project into IFRS 2 (see section 1.2.1 above). The IASB decided in May 2016 not to perform further research and published a summary of the research findings in October 2018 - even though the issues continue to result in some diversity in practice (see also section 3.2.3 above and sections 6.3.6 to 6.3.7 below).[22]

18 *IFRIC Update*, July 2010; and *IFRIC Update*, September 2010, available on the IFRS Foundation's website.

19 'Contingent feature' is not a defined term in IFRS 2 but is used in the September 2011 IASB Meeting Staff Paper 7D (para. 49) to refer to a condition not currently defined in IFRS 2.

20 *IFRIC Update*, November 2010; and *IFRIC Update*, March 2011, available on the IFRS Foundation's website.

21 *IASB Update*, September 2011, available on the IFRS Foundation's website.

22 *IASB Update*, May 2016, available on the IFRS Foundation's website.

4 Equity-settled transactions - overview

4.1 Summary of accounting treatment

The detailed provisions of IFRS 2 are complex, but their key points can be summarised as follows:

(a) All equity-settled transactions are measured at fair value. However, transactions with employees are normally measured using a 'grant date model' (i.e., the transaction is recorded at the fair value of the equity instrument at the date when it is originally granted), whereas transactions with non-employees are normally measured using a 'service date model' (i.e., the transaction is recorded at the fair value of the goods or services received at the date they are received). As noted in section 3 above, all transactions, however measured, are recognised using a 'service date model' (see section 5 below).

(b) Where an award is made subject to future fulfilment of conditions, a 'market condition' (i.e., one related to the market price (or value) of the entity's equity instruments) or a 'non-vesting condition' (i.e., one that is neither a service condition nor a performance condition) is taken into account in determining the fair value of the award. However, the effect of conditions other than market and non-vesting conditions is ignored in determining the fair value of the award (see section 3 above and section 6 below).

(c) Where an award is made subject to future fulfilment of vesting conditions, its cost is recognised over the period during which the service condition is fulfilled (see section 3 above and section 6 below). The corresponding credit entry is recorded within equity (see section 4.2 below).

(d) Until an equity instrument has vested (i.e., the entitlement to it is no longer conditional on future service) any amounts recorded are in effect contingent and will be adjusted if more or fewer awards vest than were originally anticipated to do so. However, an equity instrument awarded subject to a market condition or a non-vesting condition is considered to vest irrespective of whether or not that market or non-vesting condition is fulfilled, provided that all other vesting conditions are satisfied (see section 6 below).

(e) No adjustments are made, either before or after vesting, to reflect the fact that an award has no value to the employee or other counterparty e.g., in the case of a share option, because the option exercise price is above the current market price of the share (see sections 6.1.1 and 6.1.3 below).

(f) If an equity instrument is cancelled, whether by the entity or the counterparty (see (g) below) before vesting, any amount remaining to be expensed is charged in full at that point (see section 7.4 below). If an equity instrument is modified before vesting (e.g., in the case of a share option, by changing the performance conditions or the exercise price), the financial statements must continue to show a cost for at least the fair value of the original instrument, as measured at the original grant date, together with any excess of the fair value of the modified instrument over that of the original instrument, as measured at the date of modification (see section 7.3 below).

(g) Where an award lapses during the vesting period due to a failure by the counterparty to satisfy a non-vesting condition within the counterparty's control, or a failure by the entity to satisfy a non-vesting condition within the entity's control, the lapse of the award is accounted for as if it were a cancellation (see (f) above and section 6.4.3 below).

(h) In determining the cost of an equity-settled transaction under IFRS 2, whether the entity satisfies its obligations under the transaction with a fresh issue of shares or by purchasing own shares in the financial markets is completely irrelevant to the charge in profit or loss, although there is clearly a difference in the cash flows. Where own shares are purchased, they are accounted for as treasury shares under IAS 32 (see section 2.2.4.H above and Chapter 43 at section 9). *[IFRS 2.BC330, IFRS 2.BC331, IFRS 2.BC332, IFRS 2.BC333]*.

The requirements summarised in (d) to (g) above can have the effect that IFRS 2 requires a cost to be recorded for an award that ultimately has no value to the counterparty, because the award either does not vest or vests but is not exercised. These rather counter-intuitive requirements of IFRS 2 are in part 'anti-abuse' provisions to prevent entities from applying a 'selective' grant date model, whereby awards that increase in value after grant date remain measured at grant date while awards that decrease in value are remeasured. This is discussed further in the detailed analysis in sections 5 to 7 below.

4.2 The credit entry

As noted at (c) in the summary in section 4.1 above, the basic accounting entry for an equity-settled share-based payment transaction is: debit profit or loss for the period (often classified as employee costs), credit equity (classified as a transaction with owners in their capacity as owners rather than as part of other comprehensive income).

IFRS 2 does not prescribe the component of equity to which the credit is required to be taken. The IASB presumably adopted this non-prescriptive approach so as to ensure there was no conflict between, on the one hand, the basic requirement of IFRS 2 that there is a credit in equity and, on the other, the legal requirements of various jurisdictions as to exactly how that credit is allocated within equity. Depending on the requirements of the particular jurisdiction, it might be appropriate to take the credit to retained earnings or to a separate component of equity or entities may be able to make a policy choice.

Occasionally there will be a credit to profit or loss (see for instance Illustration 6-7 in section 6.2.4 below) and a corresponding reduction in equity.

In some arrangements the share-based payment transaction will be settled in equity instruments of a subsidiary of the reporting entity. This is most commonly the case where the subsidiary is partly-owned with traded shares held by external shareholders. In the consolidated financial statements, the question arises as to whether the credit entry for such transactions is required to be presented as a non-controlling interest or as part of the equity attributable to the shareholders of the parent. This is discussed further in Chapter 8 at section 5.7.

5 Equity-settled transactions - cost of awards

5.1 Cost of awards - overview

The general measurement rule in IFRS 2 is that an entity must measure the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the fair value of the goods or services received cannot be estimated reliably, the entity must measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted. *[IFRS 2.10]*.

IFRS 2 defines 'Fair value' as: *[IFRS 2 Appendix A]*

Extract from IFRS 2

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fair value	The amount for which an asset could be exchanged, a liability settled, or an **equity instrument granted** could be exchanged, between knowledgeable, willing parties in an arm's length transaction.

IFRS 2 has its own specific rules in relation to determining the fair value of share-based payments which differ from the more general fair value measurement requirements in IFRS 13 *Fair Value Measurement* (see section 5.5 below). *[IFRS 2.6A]*.

On their own, the general measurement principles of IFRS 2 would suggest that the reporting entity must determine in each case whether the fair value of the equity instruments granted or that of the goods or services received is more reliably determinable. However, IFRS 2 goes on to clarify that:

- In the case of transactions with employees, the fair value of the equity instruments must be used (see section 5.2 below), except in those extremely rare cases where it is not possible to measure this fair value reliably, when the intrinsic value of the equity instruments may be used instead (see section 5.5 below).
- But in the case of transactions with non-employees, there is a rebuttable presumption that the fair value of the goods or services provided is more reliably determinable (see section 5.4 below).

Moreover, transactions with employees are measured at the date of grant (see section 5.2 below), whereas those with non-employees are measured at the date when goods or services are received (see section 5.4 below).

The overall position can be summarised by the following matrix.

Counterparty	Measurement basis	Measurement date	Recognition date
Employee	Fair value of equity instruments awarded	Grant date	Service date
Non-employee	Fair value of goods or services received	Service date	Service date

The Basis for Conclusions addresses the issue of why the accounting treatment for apparently identical transactions must, in effect, depend on the identity of the counterparty.

The main argument put forward to justify the approach adopted for transactions with employees is essentially that, once an award has been agreed, the value of the services provided pursuant to the transaction does not change significantly with the value of the award. *[IFRS 2.BC88-BC96]*. However, some might question this proposition, on the grounds that employees are more likely to work harder when the value of their options is rising than when it has sunk irretrievably.

As regards transactions with non-employees, the IASB offers two main arguments for the use of measurement at service date.

The first is that, if the counterparty is not firmly committed to delivering the goods or services, the counterparty would consider whether the fair value of the equity instruments at the delivery date is sufficient payment for the goods or services when deciding whether to deliver the goods or services. This suggests that there is a high correlation between the fair value of the equity instruments at the date the goods or services are received and the fair value of those goods or services. *[IFRS 2.BC126]*. This argument is clearly vulnerable to the challenge that it has no relevance where (as would more likely be the case) the counterparty is firmly committed to delivering the goods or services.

The second is that non-employees generally provide services over a short period commencing some time after grant date, whereas employees generally provide services over an extended period beginning on the grant date. This leads to a concern that transactions with non-employees could be entered into well in advance of the due date for delivery of goods or services. If an entity were able to measure the expense of such a transaction at the grant date fair value, the result, assuming that the entity's share price rises, would be to understate the cost of goods and services delivered. *[IFRS 2.BC126, IFRS 2.BC127]*.

The true reason for the IASB's approach may have been political as much as theoretical. One effect of a grant date measurement model is that, applied to a grant of share options that is eventually exercised, it 'freezes' the accounting cost at the (typically) lower fair value at the date of grant. This excludes from the post-grant financial statements the increased cost and volatility that would be associated with a model that constantly remeasured the award to fair value until exercise date. The IASB might well have perceived it as a marginally easier task to persuade the corporate sector of the merits of a 'lower cost, zero volatility' approach as opposed to a 'fair value at exercise date' model (such as is used for cash-settled awards - see section 9 below).

The price to be paid in accounting terms for the grant date model is that, when an award falls in value after grant date, it continues to be recognised at its higher grant date value. It is therefore quite possible that, during a period of general economic downturn, financial statements will show significant costs for options granted in previous years, but which are currently worthless. This could well lead to (in fact, sometimes groundless) accusations of rewarding management for failure.

5.2 Transactions with employees

These will comprise the great majority of transactions accounted for under IFRS 2, and include all remuneration in the form of shares, share options and any other form of reward settled in equity instruments of the entity or a member of its group.

5.2.1 Who is an 'employee'?

Given the difference between the accounting treatment of equity-settled transactions with employees and with non-employees, it is obviously important for IFRS 2 to define what is meant by employees. In fact, IFRS 2 strictly refers to 'employees and others providing similar services' who are defined as: *[IFRS 2.11, IFRS 2 Appendix A]*

Extract from IFRS 2

Appendix A
Defined terms

employees and others providing similar services	Individuals who render personal services to the entity and either (a) the individuals are regarded as employees for legal or tax purposes, (b) the individuals work for the entity under its direction in the same way as individuals who are regarded as employees for legal or tax purposes, or (c) the services rendered are similar to those rendered by employees. For example, the term encompasses all management personnel, ie those persons having authority and responsibility for planning, directing and controlling the activities of the entity, including non-executive directors.

The implication of (a) and (b) above is that it is not open to an entity to argue that an individual who is not an employee as a matter of law is therefore automatically a non-employee for the purposes of IFRS 2.

The implication of (b) and (c) above is that, where a third party provides services pursuant to a share-based payment transaction that could be provided by an employee (e.g., where an external IT consultant works alongside an in-house IT team), that third party is treated as an employee rather than a non-employee for the purposes of IFRS 2.

Conversely, however, where an entity engages a consultant to undertake work for which there is not an existing in-house function, the implication is that such an individual is not regarded as an employee.

How we see it

In our view, the reference in (c) to 'services … similar to those rendered by employees' is to services rendered by employees that the entity actually has, rather than to employees that the entity might have if it were to recruit them. Otherwise, the distinction in IFRS 2 between employees and non-employees would have no effect, since it would always be open to an entity to argue that it could employ someone to undertake any task instead of engaging a contractor.

Exceptionally there might be cases where the same individual is engaged in both capacities. For example, a director of the entity might also be a partner in a firm of lawyers and be engaged in that latter capacity to advise the entity on a particular issue. It might be more appropriate to regard payment for the legal services as made to a non-employee rather than to an employee.

Related questions of interpretation arise where an award is made to an employee of an associate or a joint venture (see section 12.9 below).

The effect of a change of status from employee to non-employee (or *vice versa*) is addressed in section 5.4.1 below.

5.2.2 Basis of measurement

As noted above, IFRS 2 requires equity-settled transactions with employees to be measured by reference to the fair value of the equity instruments granted at 'grant date' (see section 5.3 below). *[IFRS 2.11]*. IFRS 2 asserts that this approach is necessary because shares, share options and other equity instruments are typically only part of a larger remuneration package, such that it would not be practicable to determine the value of the work performed in consideration for the cash element of the total package, the benefit-in-kind element, the share option element and so on. *[IFRS 2.12]*.

In essence, this is really an anti-avoidance provision. The underlying concern is that, if an entity were able to value options by reference to the services provided for them, it might assert that the value of those services was zero, on the argument that its personnel are already so handsomely rewarded by the non-equity elements of their remuneration package (such as cash and health benefits), that no additional services are (or indeed could be) obtained by granting options.

5.3 Grant date

As noted above, IFRS 2 requires equity-settled transactions with employees to be accounted for at fair value at grant date. IFRS 2 defines grant date as follows: *[IFRS 2 Appendix A]*

Extract from IFRS 2

Appendix A
Defined terms

grant date	The date at which the entity and another party (including an employee) agree to a **share-based payment arrangement**, being when the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the counterparty the right to cash, other assets, or **equity instruments** of the entity, provided the specified **vesting conditions**, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained.

The determination of grant date is critical to the measurement of equity-settled share-based transactions with employees, since grant date is the date at which such transactions must be measured (see section 5.2.2 above).

In practice, it is not always clear when a mutual understanding of the award (and, therefore, grant date) has occurred. Issues of interpretation can arise as to:

- How precise the shared understanding of the terms of the award must be.
- Exactly what level of communication between the reporting entity and the counterparty is sufficient to ensure that there is the appropriate degree of agreement and 'shared understanding'.

As a consequence, the determination of the grant date is often difficult in practice. We discuss the following issues in more detail in the sections below:

- Basic determination of grant date (see section 5.3.1 below).
- The communication of awards to employees and the rendering of services in advance of grant date (see section 5.3.2 below).
- Awards where the exercise price or performance depends on a formula or on a future share price (see section 5.3.3 below).
- Awards where the exercise price is paid in shares (net settlement of award) (see section 5.3.4 below).
- An award of equity instruments to a fixed monetary value (see section 5.3.5 below).
- Awards over a fixed pool of shares (including 'last man standing' arrangements) (see section 5.3.6 below).
- Awards with multiple service and performance periods (see section 5.3.7 below).
- Awards subject to modification or discretionary re-assessment by the entity after the original grant date (see section 5.3.8 below).
- Mandatory or discretionary awards to 'good leavers' (see section 5.3.9 below).
- Shares issued by special purpose acquisition companies (see section 5.3.10 below).

The grant date for 'matching' awards (i.e., arrangements where an additional award of shares is granted to match an initial cash bonus or award of shares) is discussed in section 15.1 below.

5.3.1 Determination of grant date

IFRS 2 and the accompanying implementation guidance emphasise that a grant occurs only when all the conditions are understood and agreed by the parties to the arrangement and any required approval process has been completed. Thus, for example, if an entity makes an award 'in principle' to an employee of options whose terms are subject to review or approval by a remuneration committee or the shareholders, 'grant date' is the later date when the necessary formalities have been completed. *[IFRS 2 Appendix A, IFRS 2.IG1, IFRS 2.IG2, IFRS 2.IG3]*.

The implementation guidance to IFRS 2 emphasises that, "the word 'agree' is used in its usual sense, which means that there must be both an offer and an acceptance of that offer…". Therefore, there cannot be a grant unless an offer by one party has been accepted by the other party. The guidance notes that agreement will be explicit in some cases (e.g., if an agreement has to be signed), but in others it might be implicit, such as when an employee starts to deliver services for the award. *[IFRS 2.IG2]*.

The counterparty's agreement to an offer might be particularly difficult to determine when it is implicit rather than explicit. For example, if an award required both the rendering of service and a subscription payment (other than a minimal one) by the employee, it is likely that the employee's agreement, and hence the grant date of the award, would coincide with the payment date - provided this occurs shortly after the offer date. If, however, the employee had the choice at the offer date of deferring payment until a much later date and could therefore decide whether the entity's subsequent performance justified their payment, then it is more likely that grant date would be the date on which the services commenced.

How we see it

Determination of when the counterparty has agreed to an offer will often be an area of judgement that depends on the precise facts and circumstances of a particular situation.

The implementation guidance to IFRS 2 further notes that employees may begin rendering services in consideration for an award before it has been formally ratified. For example, a new employee might join the entity on 1 January and be granted options relating to performance for a period beginning on that date, but subject to formal approval by the remuneration committee at its next quarterly meeting on 15 March. In that case, the entity would typically begin expensing the award from 1 January based on a best estimate of its fair value, but would subsequently adjust that estimate so that the ultimate cost of the award was its actual fair value at 15 March. *[IFRS 2.IG4]*. This reference to formal approval could be construed as indicating that, in fact, IFRS 2 requires not merely that there is a mutual understanding of the award (which might well have been in existence since 1 January), but also that the entity has completed all processes necessary to make the award a legally binding agreement.

In practice, many situations are much less clear-cut than the examples given in the implementation guidance. For example, if a remuneration committee has discretion over some aspects of an award and whether it vests, does that mean that there is not a shared understanding until the vesting date? Similarly, does the counterparty need to have full quantification of every aspect of an award (performance targets, exercise price, etc.) or would an understanding of the formula for calculating performance or price be sufficient?

Some of these practical interpretation issues are considered further in the sections below.

5.3.2 Communication of awards to employees and services in advance of grant date

As discussed in section 5.3.1 above, the implementation guidance to IFRS 2 indicates that, in order for a grant to have been made, there must not merely be a mutual understanding of the terms - including the conditions attached to the award as discussed further in the sections that follow - but there must also be a legally enforceable arrangement. Thus, if an award requires board or shareholder approval for it to be legally binding on the reporting entity, for the purposes of IFRS 2 it has not been granted until such approval has been given, even if the terms of the award are fully understood at an earlier date. However, if services are effectively being rendered for an award from a date earlier than the grant date as defined in IFRS 2, the cost of the award is required to be recognised over a period starting with that earlier date. An estimate of the grant date fair value of the award is used (e.g., by estimating the fair value of the equity instruments at the end of the reporting period), for the purposes of recognising the services received during the period between service commencement date and grant date. *[IFRS 2.IG4]*.

How we see it

In some situations, the employee will have a valid expectation of an award, and the entity will have a corresponding obligation, based on an earlier commitment by the entity. However, it might be the case that not all of the precise terms and conditions have been finalised. In our view, provided it is possible to estimate the fair value of the arrangement, an estimated cost for services is to be recognised in advance of grant date in such cases as well as in those situations where formal approval does not take place until a later date.

In situations where the entity estimates at the reporting date the grant date fair value of an award for services received in advance of grant date, the estimate is revised at subsequent reporting periods until the date of grant has been established. Once grant date has been established the entity revises the earlier estimate so that the amounts recognised for services received in respect of the grant are ultimately based on the grant date fair value of the equity instruments awarded.

The implications of IFRS 2.IG4 requirements are demonstrated in Illustration 5-1 below for a situation where formal approval of an award is delayed. It is important, however, to retain a sense of proportion in considering the overall impact on the financial statements. For example, in cases where the share price is not particularly volatile, whether the grant date is, say, 1 January or 1 April may not make a great difference to the valuation of the award, particularly when set beside the range of acceptable valuations resulting from the use of estimates in the valuation model.

Illustration 5-1: Determination of grant date

Scenario 1

On 1 January an entity advises employees of the terms of a share award designed to reward performance over the following three years. The award is subject to board approval, which is given two months later on 1 March. Grant date is 1 March. However, the cost of the award would be recognised over the three year period beginning on 1 January, since the employees would have effectively been rendering service for the award from that date.

Scenario 2

On 1 January an entity's board resolves to implement a share scheme designed to reward performance over the following three years. The award is notified to employees two months later on 1 March. Grant date is again 1 March. *Prima facie*, in this case, the cost of the award would be recognised over the period of two years and ten months beginning on 1 March, since the employees could not be regarded as rendering service in January and February for an award of which they were not aware at that time.

However, if a similar award is made each year, and according to a similar timescale, there might be an argument that, during January and February of each year, the employees are rendering service for an award of which there is high expectation, and that the cost is therefore, as in Scenario 1, recognised over the full three year period. The broader issue of the accounting treatment for awards of which there is a high expectation is addressed in the discussion of matching share awards in section 15.1 below.

Scenario 3

On 1 January an entity advises employees of the terms of a share award designed to reward performance over the following three years. The award is subject to board approval, which is given two months later on 1 March. However, in giving such approval, the board makes some changes to the performance conditions as originally communicated to employees on 1 January. The revised terms of the award are communicated to employees a month later on 1 April. Grant date is 1 April. However, the cost of the award would be recognised over the three year period beginning on 1 January, since the employees would have effectively been rendering service for the award from that date.

Examples of situations where an employee might render service in advance of the IFRS 2 grant date because the precise conditions of an award are outstanding are considered in sections 5.3.3 to 5.3.7 and in sections 15.1 and 15.4.1 below.

5.3.3 Exercise price or performance target dependent on a formula or future share price

Some share plans define the exercise price not in absolute terms, but as a factor of the share price. For example, the price might be expressed as:

- A percentage of the share price at exercise date.

  Or

- A percentage of the lower of the share price at grant date and at exercise date.

The effect of this is that, although the actual exercise price is not known until the date of exercise, both the entity and the counterparty already have a shared understanding of how the price will be calculated and it is possible to estimate the outcome on an ongoing basis without the need for additional approval or inputs.

A similar approach might be applied in the setting of performance targets i.e., they are set by reference to a formula rather than in absolute terms and so do not require further input by the entity or its remuneration committee, for example.

In order for there to be a shared understanding and a grant date, the formula or method of determining the outcome needs to be sufficiently clear and objective to allow both the entity and the counterparty to make an estimate of the outcome of the award during the vesting period. Where there is subjectivity in determining the formula or method of determining the outcome there can be no shared understanding and a grant date (see scenario 2 in Illustration 5-2 in section 5.3.7 below).

How we see it

In our view, grant date is the date on which the terms and conditions (including the formula for calculating the exercise price or performance target) are determined sufficiently clearly and agreed by the entity and the counterparty, subject to the matters discussed in section 5.3.2 above.

5.3.4 Exercise price paid in shares (net settlement of award)

Some share awards allow the exercise price to be paid in shares. In practical terms, this means that the number of shares delivered to the counterparty will be the total 'gross' number of shares awarded less as many shares as have, at the date of exercise, a fair value equal to the exercise price.

How we see it

The above situation is analogous to that in section 5.3.3 above in that, whilst the absolute 'net' number of shares awarded will not be known until the date of exercise, the basis on which that 'net' number will be determined is established in advance. Accordingly, in our view, grant date is the date on which the terms and conditions (including the ability to surrender shares to a fair value equal to the exercise price) are determined and agreed by the entity and the counterparty, subject to the matters discussed in section 5.3.2 above.

Such a scheme could be analysed as a share-settled share appreciation right (whereby the employee receives shares to the value of the excess of the value of the shares given over the exercise price), which is treated as an equity-settled award under IFRS 2.

Awards settled in shares net of a cash amount to meet an employee's tax obligation are considered further in section 14.3 below.

5.3.5 Award of equity instruments to a fixed monetary value

Some entities may grant employees awards of shares to a fixed value. For example, an entity might award as many shares as are worth CU100,000, with the number of shares being calculated by reference to the share price as at the vesting date. The number of shares ultimately received will not be known until the vesting date. This begs the question of whether such an award can be regarded as having been granted until that date, on the argument that it is only then that the number of shares to be delivered - a key term of the award - is known, and therefore there cannot be a 'shared understanding' of the terms of the award until that later date.

How we see it

The above situation is analogous to those in sections 5.3.3 and 5.3.4 above. Although the absolute number of shares awarded will not be known until the vesting date, the basis on which that number will be determined is established in advance in a manner sufficiently clear and objective to allow an ongoing estimate by the entity and by the counterparty of the number of awards expected to vest. Accordingly, in our view, grant date is the date on which the terms and conditions are determined sufficiently clearly and agreed by the entity and the counterparty, subject to the matters discussed in section 5.3.2 above.

The measurement of such awards raises further issues of interpretation, which we discuss in section 8.10 below.

5.3.6 Awards over a fixed pool of shares (including 'last man standing' arrangements)

An award over a fixed pool of shares is sometimes granted to a small group of, typically senior, employees. Such awards might involve an initial allocation of shares to each individual but also provide for the redistribution of each employee's shares to the other participants should any individual leave employment before the end of the vesting period. This is often referred to as a 'last man standing' arrangement.

The accounting requirements of IFRS 2 for such an arrangement are unclear. In the absence of specific guidance, several interpretations are possible and we believe that an entity may make an accounting policy choice, provided that choice is applied consistently to all such arrangements.

The first approach is based on the view that the unit of account is all potential shares to be earned by the individual employee and that, from the outset, each employee has a full understanding of the terms and conditions of both the initial award and the reallocation arrangements. This means that there is a grant on day one with each individual's award being valued on the basis of:

- That employee's initial allocation of shares.
- Plus, an additional award with a non-vesting condition relating to the potential reallocation of other participants' shares.

Under this approach, the departure of an employee will be accounted for as a forfeiture and any cost reversed as the service condition will not have been met (see section 6.1.2 below), but the redistribution of that individual's shares to the other employees will have no accounting impact. This approach is likely to result in a total expense that is higher than the number of shares awarded multiplied by the grant date price per share.

The second approach, which we believe is consistent with US GAAP, also considers the individual employee's award to be the unit of account. Under this approach, there is an initial grant to all the employees and it is only these awards for which the fair value is measured at the date of the initial grant. Any subsequent reallocations of shares are to be accounted for as a forfeiture of the original award and a completely new grant to the remaining employees, measured at the new grant date. This approach accounts only for the specific number of shares that have been allocated to the individual employee as at the end of each reporting period. No account is taken in this approach of shares that might be allocated to the individual employee in the future due to another employee's forfeiture, even though the reallocation formula is known to the individual employees at the initial grant date.

A third view, which takes a pragmatic approach in the light of the issues arising from the two approaches outlined above, is to account for the award on the basis of the total pool of shares granted rather than treating the individual employee as the unit of account. In our view this approach is likely to be materially acceptable for many arrangements where the pool of shares relates to the same small number of participants from the outset. Under this approach, the fair value of the total pool of shares is measured at the grant date (day one) with the non-vesting condition effectively ignored for valuation purposes. Subsequent forfeitures and reallocations would have no effect on the accounting.

How we see it

To summarise, in the absence of specific guidance in IFRS 2, any one of the three approaches mentioned above provides an acceptable accounting policy so long as the choice is applied consistently to all arrangements.

There is a distinction between the 'last man standing' arrangement described above and a situation where an entity designates a fixed pool of shares to be used for awards to employees but where the allocation of leavers' shares is discretionary rather than pre-determined. In this situation, the valuation of the initial award would not take account of any potential future reallocations. If an employee left employment during the vesting period, that individual's award would be accounted for as a forfeiture and any reallocation of that individual's shares would be accounted for as a new grant with the fair value determined at the new grant date (i.e., a similar accounting treatment to that in approach two above).

A further type of award relating to a fixed pool of shares is one where an entity makes an award over a fixed number or percentage of its shares to a particular section of its workforce, the final allocation of the pool being made to those employed at the vesting date. In such an arrangement, some employees will typically join and leave the scheme during the original vesting period which will lead to changes in each employee's allocation of shares. Although employees are aware of the existence, and some of the terms, of the arrangement at the outset, the fact that there is no objective formula (see sections 5.3.3 to 5.3.5 above) for determining the number of shares that each individual will ultimately receive means that there is no grant under IFRS 2 until the date of final allocation. However, because the employees render service under the arrangement in advance of the grant date - either from day one or from a later joining date - the entity is required to estimate the fair value of the award to each individual from the date services commence and subsequently update it at each reporting period. The fair value estimated is expensed over the full service period of the award with a final truing up of the expense to the fair value of the award at the eventual grant date (see section 5.3.2 above).

This has the effect that, where an entity decides to set aside a bonus pool of a fixed amount of cash, say CU1 million, with the allocation to individual employees to be made at a later date, there is a known fixed cost of CU1 million. However, where an entity decides to set aside a bonus pool of a fixed number of shares, with the allocation to individual employees to be made at a later date, the final cost is not determined until the eventual grant date.

5.3.7 Awards with multiple service and performance periods

Entities frequently make awards that cover more than one reporting period, but with different performance conditions for each period, rather than a single cumulative target for the whole vesting period. In such cases, the grant date may depend on the precision with which the terms of the award are communicated to employees, as demonstrated by Illustration 5-2 below.

Illustration 5-2: Awards with multiple service and performance periods

Scenario 1

At the beginning of year 1, an entity enters into a share-based payment arrangement with an employee. The employee is informed that the maximum potential award is 40,000 shares, 10,000 of which will vest at the end of year 1, and 10,000 more at the end of each of years 2 to 4. Vesting of each of the four tranches of 10,000 shares is conditional on:

(a) The employee having been in continuous service until the end of each relevant year

And

(b) Revenue targets for each of those four years, as communicated to the employee at the beginning of year 1, having been attained

In this case, the terms of the award are clearly understood by both parties at the beginning of year 1, and this is therefore the grant date under IFRS 2 (subject to issues such as any requirement for later formal approval - see sections 5.3 to 5.3.2 above). The cost of the award would be recognised using a 'graded' vesting approach - see section 6.2.2 below.

Scenario 2

At the beginning of year 1, an entity enters into a share-based payment arrangement with an employee. The employee is informed that the maximum potential award is 40,000 shares, 10,000 of which will vest at the end of year 1, and 10,000 more at the end of each of years 2 to 4. Vesting of each of the four tranches of 10,000 shares is conditional on:

(a) The employee having been in continuous service until the end of each relevant year

And

(b) Budgeted revenue targets for each of those four years, to be communicated to the employee once management establish the budget at the beginning of each relevant year in respect of that year only, having been attained

In this case, in our view, at the beginning of year 1 there is a clear shared understanding only of the terms of the first tranche of 10,000 shares that will potentially vest at the end of year 1. There is no clear understanding of the terms of the tranches potentially vesting at the end of years 2 to 4 because their vesting depends on attaining budgeted revenue targets for those years which have not yet been set. The revenue targets remain subjective until management establish the budget for the relevant year and communicate the target to employees.

Accordingly, each of the four tranches of 10,000 shares has a separate grant date (and, therefore, a separate measurement date) - i.e., the beginning of each of years 1, 2, 3 and 4, and a vesting period of one year from the relevant grant date.

In this type of situation, the entity would also need to consider whether, in the absence of a grant date, the employee was nonetheless rendering services in advance of the grant date. However, if targets are unquantified and do not depend on a formula, for example, then it is likely to be difficult to estimate an expense in advance of the grant date (see section 5.3.2 above).

A variation on the above two scenarios which is seen quite frequently in practice is an award where the target is quantified for the first year and the targets for subsequent years depend on a formula-based increase in the year 1 target. The formula is set at the same time as the year 1 target.

Whether the accounting treatment for scenario 1 above or scenario 2 above is the more appropriate in such a situation is, in our view, a matter of judgement depending on the precise terms of the arrangement (see section 5.3.3 above).

How we see it

To summarise the above, where an award is made over more than one reporting period but with different performance conditions, rather than a single cumulative target, grant date will depend on the precision with which the terms of the award are communicated to employees. If the terms are clearly understood by both parties at the start of the award for all periods (i.e., scenario 1 above), grant date is established. If the performance conditions are set at a later date for subsequent periods, grant date is established when the terms are understood by both parties, which would result in different grant dates for each tranche (i.e., scenario 2 above). The entity would also need to consider whether, in the absence of a grant date, the employee was nonetheless rendering services in advance of the grant date.

5.3.8 Awards subject to modification by entity after original grant date

As noted in section 5.3.1 above, some employee share awards are drafted in terms that give the entity discretion to modify the detailed terms of the scheme after grant date. Some have questioned whether this effectively means that the date originally determined as the 'grant date' is not in fact the grant date as defined in IFRS 2, on the grounds that the entity's right to modify means that the terms are not in fact understood by both parties in advance.

How we see it

The above, in our view, is very often not an appropriate analysis. If it were, it could also mean that, in some jurisdictions, nearly all share-based awards to employees would be required to be measured at vesting date, which clearly was not the IASB's intention.

The assessment of whether or not an intervention by the entity after grant date constitutes a modification is often difficult. Some situations commonly encountered in practice are considered in the sections below. See also the discussion in section 3.1.1 above relating to the clawback of awards.

5.3.8.A Significant equity restructuring or transactions

Many schemes contain provisions designed to ensure that the value of awards is maintained following a major capital restructuring (such as a share split or share consolidation - see section 7.8 below) or a major transaction with shareholders as a whole (such as the insertion of a new holding company over an existing group (see section 12.8 below), a major share buyback or the payment of a special dividend). These provisions will either specify the adjustments to be made in a particular situation or, alternatively, may allow the entity to make such discretionary adjustments as it sees fit in order to maintain the value of awards. In some cases the exercise of such discretionary powers may be relatively mechanistic (e.g., the adjustment of the number of shares subject to options following a share split). In other cases, more subjectivity will be involved (e.g., in determining whether a particular dividend is a 'special' dividend for the purposes of the scheme).

In our view, where the scheme rules specify the adjustments to be made or where there is a legal requirement to make adjustments in order to remedy any dilution that would otherwise arise, the implementation of such adjustments would not result in the recognition of any incremental IFRS 2 fair value. This assumes that the adjustment would simply operate on an automatic basis to put the holders of awards back to the position that they would have been in had there not been a restructuring and hence there would be no difference in the fair value of the awards before and after the restructuring (or other specified event).

However, where there is no such explicit requirement in the scheme rules or under relevant legislation, we believe that there must be a presumption that the exercise of the entity's discretionary right to modify is a 'modification' as defined in IFRS 2. In such a situation, the fair values before and after the modification may differ and any incremental fair value is required to be expensed over the remaining vesting period (see section 7.3 below).

How we see it

In summary, as noted above, no incremental fair value would arise where the adjustment would simply operate on an automatic basis to put the holders of awards back to the position that they would have been in had there not been a restructuring, if the scheme rules or relevant legislation require an adjustment to remedy any dilution. Where there is no explicit requirement in the scheme rules or relevant legislation the exercise of the entity's discretionary right to modify is a 'modification' as defined in IFRS 2.

5.3.8.B Interpretation of general terms

More problematic might be the exercise of any discretion by the entity or its remuneration committee to interpret the more general terms of a scheme in deciding whether performance targets have been met and therefore whether, and to what extent, an award should vest. Suppose, for example, that an entity makes an award to its executives with a market condition based on total shareholder return (TSR) with a maximum payout if the entity is in the top quartile of a peer group of 100 entities (i.e., it is ranked between 1 and 25 in the peer group).

It might be that the entity is ranked 26 until shortly before the end of the performance period, at which point the entity ranked 25 suddenly announces that it is in financial difficulties and ceases trading shortly afterwards. This then means that the reporting entity moves up from 26 to 25 in the rankings. However, the entity might take the view that, in the circumstances, it could not be considered as having truly been ranked 25 in the peer group, so that a maximum payout is not justified.

In this case, the entity's intervention might be considered to be a modification. However, as the effect would be to reduce the fair value of the award, it would have no impact on the accounting treatment (see section 7.3.2 below).

If such an intervention were not regarded as a modification, then the results might be different depending on the nature of the award. Where an award is subject to a market condition, as here, or to a non-vesting condition, an expense might well have to be recognised in any event, if all the non-market vesting conditions (e.g., service) were satisfied - see sections 6.3 and 6.4 below.

However, suppose that the award had been based on a non-market performance condition, such as an EPS target, which was met, but only due to a gain of an unusual, non-recurring nature, such as the revaluation of PP&E for tax purposes, giving rise to a deferred tax credit. The remuneration committee concludes that this must be ignored, with the effect that the award does not vest. If this is regarded as the exercise of a pre-existing right to ensure that the award vests only if 'normal' EPS reaches a given level, then there has been no modification. On this analysis, the award has not vested, and any expense previously recognised would be reversed. If, however, the committee's intervention is regarded as a modification, it would have no impact on the accounting treatment in this particular case, as the effect would not be beneficial to the employee and so the modification would be ignored under the general requirements of IFRS 2 relating to modifications (see section 7.3.2 below).

5.3.8.C Discretion to make further awards

Some schemes may give the entity the power to increase an award in circumstances where the recipient is considered to have delivered exceptional performance, or some such similar wording.

How we see it

In our view, unless the criteria for judging such exceptional performance are so clear as to be, in effect, performance conditions under IFRS 2, the presumption is that any award made pursuant to such a clause is granted, and therefore measured, when it is made.

We note in section 15.1 below that there may be circumstances where an award described as 'discretionary' may not truly be so, since the entity has created an expectation amounting to an obligation to make the award. However, we believe that it would be somewhat contradictory to argue that such expectations had been created in the case of an award stated to be for (undefined) exceptional performance only.

5.3.9 'Good leaver' arrangements

In some jurisdictions it is common for awards to contain a so-called 'good leaver' clause. A 'good leaver' clause is one which makes provision for an employee who leaves employment before the end of the full vesting period of the award to receive some or all of the award on leaving (see section 5.3.9.A below).

In other cases, the original terms of an award will either make no reference to 'good leavers' or will not be sufficiently specific to allow the accounting treatment on cessation of employment to be an automatic outcome of the original terms of the scheme. In such cases, and in situations where awards are made to leavers on a fully discretionary basis, the approach required by IFRS 2 differs from that required where the original terms are clear about 'good leaver' classification and entitlement (see section 5.3.9.B below).

In some jurisdictions awards are structured in a way which allows the majority of participants, rather than just a few specified categories of 'good leaver', to retain all or part of an award if they leave employment during the vesting period (see section 5.3.9.C below).

We refer throughout this section on 'good leavers' to an employee leaving employment, but similar considerations apply when an individual automatically becomes entitled to an award before the end of the original vesting period due to other reasons specified in the terms of the agreement, e.g., attaining a certain age or achieving a specified length of service, even if the individual remains in employment after the relevant date. In these situations, the date of full entitlement is the date on which any services - and therefore expense recognition - cease for IFRS 2 purposes.

Arrangements for a good leaver to receive all, or part, of an award on leaving employment must be distinguished from a situation where an employee leaves with no award and where forfeiture accounting is likely to apply (see section 7.4.1.A below).

5.3.9.A Provision for 'good leavers' made in original terms of award

In some cases the types of persons who are 'good leavers' may be explicitly defined in the original terms of the arrangement (common examples being persons who die or reach normal retirement age before the end of the full vesting period, or who work for a business unit that is sold or closed during the vesting period). In other cases, the entity may have the discretion to determine on a case-by-case basis whether a person should be treated as a 'good leaver'.

In addition, some schemes may specify the entitlement of a 'good leaver' on leaving (e.g., that the leaver receive a portion of the award *pro rata* to the extent that the performance conditions have been met), whereas others leave the determination of the award to the entity at the time that the employee leaves.

Whichever situation applies, any expense relating to an award to a good leaver must be fully recognised by the leaving date because, at that point, the good leaver ceases to provide any services to the entity and any remaining conditions attached to the award will be treated as non-vesting rather than vesting conditions (see section 3.2 above).

How we see it

In our view, an award which vests before the end of the original vesting period due to the operation of a 'good leaver' clause is measured at the original grant date only where, under the rules of the scheme as understood by both parties at the original grant date, the award is made:

- To a person clearly identified as a 'good leaver'.

  And

- In an amount clearly quantified or quantifiable.

Where, as outlined above, the rules of the scheme make clear the categories of 'good leaver' and their entitlement, the entity must assess at grant date how many good leavers there are likely to be and to what extent the service period for these particular individuals is expected to be shorter than the full vesting period. The grant date fair value of the estimated awards to good leavers must be separately determined, where significant, and the expense relating to good leavers recognised over the expected reduced vesting period between grant date and leaving employment. In this situation the entity would re-estimate the number of good leavers and adjust the cumulative expense at each reporting date. This would be a change of estimate rather than a modification of the award as it would all be in accordance with the original terms and would require no discretionary decisions on the part of the entity. We would not generally expect an entity to have significant numbers of good leavers under such an arrangement.

It is important to draw a clear distinction between the IFRS 2 accounting on a straight-line basis over a reduced vesting period in the above case and that on a graded vesting basis in a situation of broader entitlement as outlined in section 5.3.9.C below.

5.3.9.B Discretionary awards to 'good leavers'

In section 5.3.9.A above we discuss awards where the arrangements for leavers are clear as at the original grant date of the award. However, where - as is more usually the case - the entity determines only at the time that the employee leaves either that the employee is a 'good leaver' or the amount of the award, grant date or modification date (see further below) must be taken as the later of the date on which such determination is made or the date on which the award is notified to the employee. This is because the employee had no clear understanding at the original grant date of an automatic entitlement to equity instruments other than through full vesting of the award at the end of the full service period.

How we see it

In our view, an entity is required to assess the appropriate accounting treatment for discretionary awards to 'good leavers' based on the particular facts and circumstances and the extent to which the discretionary award is linked to the original award.

A discretionary award at the time of leaving is considered to be either a modification of an original award in the employee's favour (for example, where vesting conditions are waived to allow an individual to keep an award) or the forfeiture of the original award and the granting of a completely new award on a discretionary basis (see sections 7.3 and 7.5 below).

In some cases, a good leaver will be allowed, on a discretionary basis, to keep existing awards that remain subject to performance conditions established at the original grant date. In this situation, any conditions that were previously treated as vesting conditions will become non-vesting conditions following the removal of the service requirement (see sections 3.1 and 3.2 above). This will be the case whether the discretionary arrangement is accounted for as the forfeiture of the old award plus a new grant or as a modification of the original award.

The non-vesting conditions will need to be reflected in the measurement of the fair value of the award as at the date of modification or new grant (although the non-vesting conditions alone will not result in any incremental fair value). Any fair value that is unrecognised as at the date of the good leaver ceasing employment will need to be expensed immediately as there is no further service period over which to recognise the expense.

There is further discussion of modifications in section 7.3 below and of replacement and *ex gratia* awards granted on termination of employment in section 7.5 below.

5.3.9.C Automatic full or *pro rata* entitlement on leaving employment

In some jurisdictions entities establish schemes where a significant number of the participants will potentially leave employment before the end of the full vesting period and will be allowed to keep a *pro rata* share of the award. This gives rise to a much broader category of employee than the small number of good leavers that one would generally expect under a scheme where 'good leaver' refers only to employees who die, retire or work for a business unit that is sold or closed (see section 5.3.9.A above).

The substance of an arrangement where significant numbers of employees are expected to leave with a *pro rata* entitlement is that the entire award to all participants vests on a graded basis over the vesting period as a whole. So, for example, an arrangement that gives employees 360 shares at the end of three years but, whether under the rules of the scheme or by precedent, allows the majority of leavers to take a *pro rata* share - based on the number of months that have elapsed - at their date of departure, must be treated as vesting at the rate of 10 shares per month for all employees. Such an arrangement is required to be accounted for using the graded vesting approach illustrated in section 6.2.2 below.

Some take the view that the situation outlined in the previous paragraph does not require graded vesting and that a straight-line approach may be taken because the award only vests *pro rata* if an employee leaves employment. Supporters of this view argue that the requirement to leave employment in order to receive the award before the end of the full vesting period is itself a substantive condition over and above the requirement to provide ongoing service. If an employee remains in employment the award only vests on completion of three years' service and there is no earlier entitlement on a *pro rata* basis.

How we see it

Although the straight-line approach has some appeal, in our view, it is difficult to reconcile to the standard and is not therefore an appropriate alternative accounting treatment to the graded vesting approach outlined above.

In other cases, rather than just a *pro rata* apportionment, any good leaver will be allowed to keep the entire award regardless of when they leave employment. If this is the case, and in substance there is no required minimum service period attached to the award, then the award is required to be treated as immediately vested in all employees and fully expensed at the grant date.

5.3.10 Special purpose acquisition companies ('SPACs')

IPOs and trade sales may be achieved through the medium of special purpose acquisition companies ('SPACs'). The detailed features of SPACs may vary, but common features tend to be:

- The SPAC is established by a small number of founders, typically with expertise in selecting attractive targets for flotation or sale. The founder shares contain a term to the effect that, if a target is eventually identified and floated or sold, the holders of the founder shares will receive a greater proportion of any proceeds than other shareholders at the time of flotation.
- At a later date, other (non-founder) shareholders invest. This is frequently achieved by an IPO of the SPAC. It is typically the case that, if a specific target is not identified and agreed by a required majority of non-founder shareholders, within a finite timescale, the other (non-founder) shareholders will have their funds returned.
- The SPAC seeks a target which is then approved (or not, as the case may be) by the required majority of non-founder shareholders.

The three stages outlined above have given rise to three interpretations as to the grant date for IFRS 2 purposes.

The first view is that there is no shared understanding until the specific target is identified and agreed (the third stage above). Holders of this view argue that the substance of the founder shareholders' interest is economically equivalent to an award of shares in any target finally approved. Therefore, until the target is finally approved, there is no clarity as to the nature and value of the award to the founder shareholders.

The second view is that a shared understanding occurs at the point at which the non-founder shareholders invest (i.e., the second stage above). Holders of this view argue that a share-based payment can only occur when there has been a transfer of value from the non-founder shareholders to the founder shareholders and this cannot occur until there are some non-founder shareholders in place. However, once those non-founder shareholders are in place, there is a shared understanding that - if a transaction is subsequently approved - there will be a benefit for founder shareholders.

The third view is that a shared understanding occurs on the issue of the founder shares (i.e., the first stage above). Holders of this view argue that at that point there is a shared understanding that there will be a benefit for founder shareholders if non-founder shareholders are subsequently introduced and a transaction is subsequently approved. The benefit for founder shareholders consists both in seeking further investors and in identifying a suitable target. The founder shareholders will be actively rendering service towards these goals from the outset.

The IFRS IC conducted some initial outreach research into how SPACs are treated in practice, but the question has not been formally discussed to date.

How we see it

Until such time as additional guidance is given, it seems that the diversity in practice outlined above will remain and entities must use judgement to determine an appropriate grant date based on the specific terms of the arrangement.

5.4 Transactions with non-employees

In accounting for equity-settled transactions with non-employees, the entity must adopt a rebuttable presumption that the value of the goods or services received provides the more reliable indication of the fair value of the transaction. The fair value to be used is that at the date on which the goods are obtained or the services rendered. *[IFRS 2.13]*. This implies that, where the goods or services are received on a number of dates over a period, the fair value at each date must be used, although in the case of a relatively short period there may be no great fluctuation in fair value.

If 'in rare cases' the presumption is rebutted, the entity may use as a surrogate measure the fair value of the equity instruments granted, but as at the date when the goods or services are received, not the original grant date. However, where the goods or services are received over a relatively short period where the share price does not change significantly, an average share price can be used in calculating the fair value of equity instruments granted. *[IFRS 2.13, IFRS 2.IG5, IFRS 2.IG6, IFRS 2.IG7]*.

FASB differences

This contrasts with US GAAP[23] which requires the fair value of goods or services received from non-employees to be measured at grant date of the equity-instruments to be received, rather than based on the fair value at the date the goods are obtained or services are rendered.

5.4.1 Effect of change of status from employee to non-employee (or *vice versa)*

IFRS 2 does not give specific guidance on how to account for an award when the status of the counterparty changes from employee to non-employee (or *vice versa*) but, in all other respects, the award remains unchanged. In our view, the accounting following the change of status will depend on the entity's assessment of whether or not the counterparty is performing the same or similar services before and after the change of status.

If it is concluded that the counterparty is providing the same or similar services before and after the change of status, the measurement approach remains unchanged.

23 FASB Accounting Standard Update 2018-07, *Improvements to Nonemployee Share-Based Payment Accounting (Topic 718)*.

However, if the services provided are substantially different, the accounting following the change of status will be determined by the counterparty's new status, as follows:

- For a change from non-employee to employee status, the expense for periods following the change must be measured as if the award had been granted at the date of change of status. This revised measurement only applies to the expense for the portion of the award that vests after the change of status and there is no effect on the expense recognised in prior periods.
- For a change from employee to non-employee status, the expense for periods following the change must be measured on the basis of the fair value of the counterparty's services as they are received - if this is reliably determinable. Otherwise, the fair value used is that of the equity instruments granted but measured at the date the services are received (see section 5.4 above). There is no effect on the expense recognised in prior periods.

If the status of the counterparty changes and the terms of the award are modified in order to allow the award to continue to vest, the modification and change of status must be assessed in accordance with the general principles in IFRS 2 relating to the modification of awards (see section 7.3 below).

How we see it

As noted above, the accounting depends on facts and circumstances and judgement thereof whether the counterparty is performing the same or similar services after the change in status as were being provided prior to the change in status. If same or similar services are being provided, there is no change in the measurement approach. If substantially different services are being provided, the measurement approach is determined based on the counterparty's new status.

5.5 Determining the fair value of equity instruments

As discussed in sections 5.2 and 5.4 above, IFRS 2 requires the following equity-settled transactions to be measured by reference to the fair value of the equity instruments issued rather than that of the goods or services received:

- All transactions with employees (except where it is impossible to determine fair value - see below).
- Transactions with non-employees where, in rare cases, the entity rebuts the presumption that the fair value of goods or services provided is more reliably measurable.

There will also be situations where the identifiable consideration received (if any) from non-employees appears to be less than the fair value of consideration given. In such cases, the cost of the unidentifiable goods or services received, if any, must be accounted for in accordance with IFRS 2 by determining the fair value of the equity instruments. This requirement is discussed in section 2.2.2.C above.

For all transactions measured by reference to the fair value of the equity instruments granted, IFRS 2 requires fair value to be measured at the 'measurement date' - i.e., grant date in the case of transactions with employees and service date in the case of transactions with non-employees. *[IFRS 2 Appendix A]*. Fair value must be based on market prices if available. *[IFRS 2.16]*. In the absence of market prices, a valuation technique must be used to estimate what the market price would have been on the measurement date in an arm's length transaction between informed and willing parties. The technique used is required to be a recognised technique and incorporate all factors that would be taken into account by knowledgeable and willing market participants. *[IFRS 2.17]*.

Appendix B to IFRS 2 contains more detailed guidance on valuation, which is discussed in section 8 below. *[IFRS 2.18]*. IFRS 2 also deals with those 'rare' cases where it is not possible to value equity instruments reliably, where an intrinsic value approach may be used. This is more likely to apply to awards of options than to awards of shares and is discussed further in section 8.8 below.

IFRS 2 rather confusingly states that the fair value of equity instruments granted must take into account the terms and conditions on which they were granted, but this requirement is said to be 'subject to the requirements of paragraphs 19-22'. *[IFRS 2.16]*. When those paragraphs are consulted, a somewhat different picture emerges, since they draw a distinction between:

- Non-vesting conditions (i.e., those that are neither service conditions nor performance conditions).
- Vesting conditions which are market conditions (i.e., those related to the entity's share price).
- Other vesting conditions (i.e., service and non-market performance conditions).

These are discussed in more detail in sections 6.2 to 6.4 and in section 8 below, but the essential difference is that, while non-vesting conditions and market conditions must be taken into account in any valuation, other vesting conditions must be ignored. *[IFRS 2.19, IFRS 2.20, IFRS 2.21, IFRS 2.21A]*. As we explain in the more detailed discussion later, these essentially arbitrary distinctions originated in part as anti-avoidance measures.

The 'fair value' of equity instruments under IFRS 2 therefore takes account of some, but not all, conditions attached to an award rather than being a 'true' fair value.

The approach to determining the fair value of share-based payments continues to be that specified in IFRS 2 and share-based payments fall outside the scope of IFRS 13 which applies more generally to the measurement of fair value under IFRS accounting standards (see Chapter 15). *[IFRS 2.6A]*.

5.5.1 Reload features

A 'reload feature' is a feature in a share option that provides for an automatic grant of additional share options (reload options) whenever the option holder exercises previously granted options using the entity's shares, rather than cash, to satisfy the exercise price. *[IFRS 2 Appendix A]*. IFRS 2 requires reload features to be ignored in the initial valuation of options that contain them. Instead any reload option must be treated as if it were a newly granted option when the reload conditions are satisfied. *[IFRS 2.22]*. This is discussed further in section 8.9 below.

6 Equity-settled transactions - allocation of expense

6.1 Overview

Equity-settled transactions, particularly those with employees, raise particular accounting problems since they are often subject to vesting conditions (see section 3.1 above) that can be satisfied only over an extended vesting period. This raises the issue of whether a share-based payment transaction is recognised:

- When the relevant equity instrument is first granted
- When it vests
- During the vesting period

  Or
- During the life of the option

An award of equity instruments that vests immediately is presumed, in the absence of evidence to the contrary, to relate to services that have already been rendered, and is therefore expensed in full at grant date. *[IFRS 2.14]*. This may lead to the immediate recognition of an expense for an award to which the employee may not be legally entitled for some time, as demonstrated in Illustration 6-1.

Illustration 6-1: Award with non-vesting condition only

An entity grants a director share options, exercisable after three years provided the director does not compete with the reporting entity for a period of at least three years. The 'non-compete' clause is considered to be a non-vesting condition (see sections 3.2 above and 6.4 below). As this is the only condition to which the award is subject, the award has no vesting conditions and therefore vests immediately. The fair value of the award at the date of grant, including the effect of the 'non-compete' clause, is determined to be CU150,000. Accordingly, the entity immediately recognises a cost of CU150,000.

This cost can never be reversed, even if the director goes to work for a competitor and loses the award. This is discussed more fully in section 3.2.3 above and in sections 6.1.2 and 6.4 below.

Where equity instruments are granted subject to vesting conditions (as in many cases they will be, particularly where payments to employees are concerned), IFRS 2 creates a presumption that they are a payment for services to be received in the future, during the 'vesting period', with the transaction being recognised during that period, as demonstrated in Illustration 6-2. *[IFRS 2.15]*.

Illustration 6-2: Award with service condition only

An entity grants a director share options on condition that the director remain in employment for three years. The requirement to remain in employment is a service condition, and therefore a vesting condition, which will take three years to fulfil. The fair value of the award at the date of grant, ignoring the effect of the vesting condition, is determined to be CU300,000. The entity will record a cost of CU100,000 a year in profit or loss for three years, with a corresponding increase in equity.

In practice, the calculations required by IFRS 2 are unlikely to be as simple as that in Illustration 6-2. In particular:

- The final number of awards that vest cannot be known until the vesting date (because employees may leave before the vesting date, or because relevant performance conditions may not be met).
- The length of the vesting period may not be known in advance (since vesting may depend on satisfaction of a performance condition with no, or a variable, time-limit on its attainment).

In order to deal with such issues, IFRS 2 requires a continuous re-estimation process as summarised in section 6.1.1 below.

6.1.1 The continuous estimation process of IFRS 2

The overall objective of IFRS 2 is that, at the end of the vesting period, the cumulative cost recognised in profit or loss (or, where applicable, included in the carrying amount of an asset), must represent the product of the following two items:

- The number of equity instruments that have vested, or would have vested, but for the failure to satisfy a market condition (see section 6.3 below) or a non-vesting condition (see section 6.4 below).
- The fair value (excluding the effect of any non-market vesting conditions, but including the effect of any market conditions or non-vesting conditions) of those equity instruments at the date of grant.

It is essential to appreciate that the 'grant date' measurement model in IFRS 2 seeks to capture the value of the contingent right to shares promised at grant date, to the extent that that promise becomes (or is deemed by IFRS 2 to become - see section 6.1.2 below) an entitlement of the counterparty, rather than the value of any shares finally delivered. Therefore, if an option vests, but is not exercised because it would not be in the counterparty's economic interest to do so, IFRS 2 still recognises a cost for the award.

In order to achieve this outcome, IFRS 2 requires the following process to be applied:

(a) At grant date, the fair value of the award (excluding the effect of any service and non-market performance conditions, but including the effect of any market conditions or non-vesting conditions) is determined.

(b) At each subsequent reporting date until vesting, the entity calculates a best estimate of the cumulative charge to profit or loss at that date, being the product of:
   (i) The grant date fair value of the award determined in (a) above.
   (ii) The current best estimate of the number of awards that will vest (see section 6.1.2 below).
   (iii) The expired portion of the vesting period.

(c) The charge (or credit) to profit or loss for the period is the cumulative amount calculated in (b) above less the amounts already charged in previous periods. There is a corresponding credit (or debit) to equity. *[IFRS 2.19, IFRS 2.20]*.

(d) Once the awards have vested, no further accounting adjustments are made to the cost of the award, except in respect of certain modifications to the award - see section 7 below.

(e) If a vested award is not exercised, an entity may (but need not) make a transfer between components of equity - see section 6.1.3 below.

The overall effect of this process is that a cost is recognised for every award that is granted, except when it is forfeited, as that term is defined in IFRS 2 (see section 6.1.2 below). *[IFRS 2.19]*.

6.1.2 Vesting and forfeiture

In normal English usage, and in many share scheme documents, an award is described as 'vested' when all the conditions needed to earn it have been met, and as 'forfeited' where it lapses before vesting because one or more of the conditions has not been met.

IFRS 2 uses the term 'forfeiture' in a much more restricted sense to mean an award that does not vest in IFRS 2 terms. This is a particularly complex aspect of IFRS 2, which is discussed in more detail in sections 6.2 to 6.4 below. Essentially:

- Where an award is subject only to vesting conditions other than market conditions, failure to satisfy any one of the conditions is treated as a forfeiture by IFRS 2.
- Where an award is subject to both:
  - Vesting conditions other than market conditions
  - Market conditions and/or non-vesting conditions

  Failure to satisfy any one of the vesting conditions other than market conditions is treated as a forfeiture by IFRS 2. Otherwise (i.e., where all the vesting conditions other than market conditions are satisfied), the award is deemed to vest by IFRS 2 even if the market conditions and/or non-vesting conditions have not been satisfied.
- Where an award is subject only to non-vesting conditions, it is always deemed to vest by IFRS 2.

Where an award has been modified (see section 7.3 below) so that different vesting conditions apply to the original and modified elements of an award, forfeiture will not apply to the original award if the service and non-market performance conditions attached to that element have been met. This will be the case even if the service and non-market performance conditions attached to the modified award have not been met and so the modified award is considered to have been forfeited (resulting in the reversal of any incremental expense relating to the modification). Illustrations 7-6 and 7-7 below demonstrate this point.

As a result of the interaction of the various types of conditions, the reference in the summary in section 6.1.1 above to the 'best estimate of the number of awards that will vest' really means the best estimate of the number of awards for which it is expected that all service and non-market vesting conditions will be met.

In practice, however, it is not always clear how that best estimate is to be determined, and in particular what future events may and may not be factored into the estimate. This is discussed further in sections 6.2 to 6.4 and in section 7.6 below.

6.1.3 Accounting after vesting

Once an equity-settled transaction has vested (or, in the case of a transaction subject to one or more market or non-vesting conditions, has been treated as vested under IFRS 2 - see section 6.1.2 above), no further accounting entries are made to reverse the cost already charged, even if the instruments that are the subject of the transaction are subsequently forfeited or, in the case of options, are not exercised. However, the entity may make a transfer between different components of equity. *[IFRS 2.23]*. For example, an entity's accounting policy might be to credit all amounts recorded for share-based transactions to a separate reserve such as 'Shares to be issued'. Where an award lapses after vesting, it would then be appropriate to transfer an amount equivalent to the cumulative cost for the lapsed award from 'Shares to be issued' to another component of equity.

This prohibition against 'truing up' (i.e., reversing the cost of vested awards that lapse) is controversial, since it has the effect that a cost is still recognised for options that are never exercised, typically because they are 'underwater' (i.e., the current share price is lower than the option exercise price), so that it is not in the holder's interest to exercise the option. Some commentators have observed that an accounting standard that can result in an accounting cost for non-dilutive options does not meet the needs of those shareholders whose concerns about dilution were the catalyst for the share-based payment project in the first place (see section 1.1 above).

The IASB counters such objections by pointing out that the treatment in IFRS 2 is perfectly consistent with that for other 'contingent' equity instruments, such as warrants, that ultimately result in no share ownership. Where an entity issues warrants for valuable consideration such as cash and those warrants lapse unexercised, the entity recognises no gain under IFRS accounting standards. *[IFRS 2.BC218-BC221]*.

6.2 Vesting conditions other than market conditions

6.2.1 Awards with service conditions and non-market vesting conditions

6.2.1.A Awards with service conditions

Most share-based payment transactions with employees are subject to explicit or implied service conditions. Illustrations 6-3 and 6-4 below demonstrate the application of the allocation principles discussed in section 6.1 above to awards subject only to service conditions. *[IFRS 2.IG11]*.

Illustration 6-3: Award with no change in the estimate of number of awards vesting

An entity grants 100 share options to each of its 500 employees. Vesting is conditional upon the employees working for the entity over the next three years. The entity estimates that the fair value of each share option is CU15. The entity's best estimate at each reporting date is that 100 (i.e., 20%) of the original 500 employees will leave during the three year period and therefore forfeit their rights to the share options.

If everything turns out exactly as expected, the entity will recognise the following amounts during the vesting period for services received as consideration for the share options.

Year	Calculation of cumulative expense	Cumulative expense (CU)	Expense for period‡ (CU)
1	50,000 options × 80%* × CU15 × 1/3†	200,000	200,000
2	50,000 options × 80% × CU15 × 2/3	400,000	200,000
3	50,000 options × 80% × CU15 × 3/3	600,000	200,000

* The entity expects 100 of its 500 employees to leave and therefore only 80% of the options to vest.

† The vesting period is 3 years, and 1 year of it has expired.

‡ In each case the expense for the period is the difference between the calculated cumulative expense at the beginning and end of the period.

Illustration 6-4: Award with re-estimation of number of awards vesting due to staff turnover

As in Illustration 6-3 above, an entity grants 100 share options to each of its 500 employees. Vesting is conditional upon the employee working for the entity over the next three years. The entity estimates that the fair value of each share option is CU15.

In this case, however, 20 employees leave during the first year, and the entity's best estimate at the end of year 1 is that a total of 75 (15%) of the original 500 employees will have left before the end of the vesting period. During the second year, a further 22 employees leave, and the entity revises its estimate of total employee departures over the vesting period from 15% to 12% (i.e., 60 of the original 500 employees). During the third year, a further 15 employees leave. Hence, a total of 57 employees (20 + 22 + 15) forfeit their rights to the share options during the three year period, and a total of 44,300 share options (443 employees × 100 options per employee) finally vest.

The entity will recognise the following amounts during the vesting period for services received as consideration for the share options.

Year	Calculation of cumulative expense	Cumulative expense (CU)	Expense for period (CU)
1	50,000 options × 85% × CU15 × 1/3	212,500	212,500
2	50,000 options × 88% × CU15 × 2/3	440,000	227,500
3	44,300 options × CU15 × 3/3	664,500	224,500

Note that in Illustration 6-4 above, the number of employees that leave during year 1 and year 2 is not directly relevant to the calculation of cumulative expense in those years, but would naturally be a factor taken into account by the entity in estimating the likely number of awards finally vesting.

6.2.1.B Non-market vesting conditions

It is common for entities to enter into share-based payment arrangements with employees subject to vesting conditions that include performance conditions (see section 3.1 above). A performance condition requires a specified period of service to be completed and the achievement of performance targets. Performance targets are either non-market vesting conditions (also referred to as 'non-market performance conditions'), further considered in this section of the chapter, or market conditions (see section 6.3 below). A performance target that is a non-market vesting condition is referenced to the entity's own operations (or activities) or the operations or activities of another entity in the same group. A performance target might relate either to the performance of the entity as a whole or to some part of the entity (or part of the group), such as a division or an individual employee.

Examples of non-market vesting conditions include achieving EPS, sales, profit or some Environmental, Social and Governance (ESG) targets. Examples of ESG targets include targets to reduce Scope 1, Scope 2 and possibly Scope 3 GHG emissions (see section 3.1.3 above), health and safety incidents of an entity or targets to increase employee engagement and workforce diversity.

IFRS 2 requires that an entity not take into account vesting conditions other than market conditions when estimating the fair value of equity instruments granted. Instead, vesting conditions, other than market conditions i.e., non-market vesting conditions, are taken into account by adjusting the number of equity instruments that are expected to vest. *[IFRS 2.19, IFRS 2.20]*.

In determining the expected number of equity instruments that are expected to vest as a result of a non-market vesting condition, the cumulative charge during the vesting period would be based on the best estimate of which outcome will occur, and the final cumulative charge would be based on the grant date fair value of the actual outcome. For example, if an employee was granted 100 share options which vest if the employee remains in service for three years and on achieving an EPS target, if that employee is still in service at the end of the three years, either 100 options will vest if the EPS target is met or zero options will vest if the EPS target is not met. During the vesting period the entity would need to make an assessment of the number of options that are expected to vest at each reporting date. If the entity assesses at the end of year one the probability that the EPS target would be met is 70% and the service condition will be met, the year one expense would be based on the full 100 options expected to vest at the end of year three, which represents the best estimate of the most likely outcome. In this example, the outcome is binary, the employee will receive either 100 or zero options based on the achievement or not of the EPS target and service condition, they will never receive 70% of the options. Assuming the entity recognised an expense for the award in year one and year two based on the entity's best estimate of the most likely outcome (i.e., the EPS and service condition are expected to be met), but then in year three the service condition is met but the EPS target is not, the entity would reverse in year three any previous expense recognised due to the failure to satisfy the non-market vesting condition.

See the Illustrations in sections 6.2.3 to 6.2.5 below that set out the accounting when determining the number of equity instruments expected to vest when an award includes a number of possible outcomes linked to non-market vesting conditions.

6.2.2 Equity instruments vesting in instalments ('graded' vesting)

An entity may make share-based payments that vest in instalments (sometimes referred to as 'graded' vesting). For example, an entity might grant an employee 600 options, 100 of which vest if the employee remains in service for one year, a further 200 after two years and the final 300 after three years. In today's more mobile labour markets, such awards are often favoured over awards which vest only on an 'all or nothing' basis after an extended period.

IFRS 2 requires such an award to be treated as three separate awards of 100, 200 and 300 options, because each instalment has a different vesting period and therefore, the fair value of each instalment will likely differ (e.g., the length of the vesting period may affect the likely timing of cash flows arising from the exercise of options in determining the fair value). *[IFRS 2.IG11]*. This may well have the effect that compared to the expense for an award with a single 'cliff' vesting, the expense for an award vesting in instalments will be for a different amount in total and require accelerated recognition of the expense in earlier periods, as demonstrated in Illustration 6-5 below.

Illustration 6-5: Award vesting in instalments ('graded' vesting)

An entity is considering the implementation of a scheme that awards 600 free shares to each of its employees, with no conditions other than continuous service. Two alternatives are being considered:

- All 600 shares vest in full only at the end of three years.
- 100 shares vest after one year, 200 shares after two years and 300 shares after three years. Any shares received at the end of years 1 and 2 would have vested unconditionally.

The fair value of a share delivered in one year's time is CU3; in two years' time CU2.80; and in three years' time CU2.50.

For an employee that remains with the entity for the full three year period, the first alternative would be accounted for as follows:

Year	Calculation of cumulative expense	Cumulative expense (CU)	Expense for period (CU)
1	600 shares × CU2.50 × 1/3	500	500
2	600 shares × CU2.50 × 2/3	1,000	500
3	600 shares × CU2.50 × 3/3	1,500	500

For the second alternative, the analysis is that the employee has simultaneously received an award of 100 shares vesting over one year, an award of 200 shares vesting over two years and an award of 300 shares vesting over 3 years. This would be accounted for as follows:

Year	Calculation of cumulative expense	Cumulative expense (CU)	Expense for period (CU)
1	[100 shares × CU3.00] + [200 shares × CU2.80 × 1/2] + [300 shares × CU2.50 × 1/3]	830	830
2	[100 shares × CU3.00] + [200 shares × CU2.80 × 2/2] + [300 shares × CU2.50 × 2/3]	1,360	530
3	[100 shares × CU3.00] + [200 shares × CU2.80 × 2/2] + [300 shares × CU2.50 × 3/3]	1,610	250

At first sight, such an approach seems to be taking account of vesting conditions other than market conditions in determining the fair value of an award, contrary to the basic principle of IFRS 2.19 (see section 6.1.1 above). However, it is not the vesting conditions that are being taken into account *per se*, but the fact that the varying vesting periods will give rise to different lives for the award (which are required to be taken into account - see sections 7.2 and 8 below).

Provided all conditions are clearly understood at the outset, the accounting treatment demonstrated in Illustration 6-5 above would apply even if the vesting of shares in each year also depended on a performance condition unique to that year (e.g., that profit in that year must reach a given minimum level), as opposed to a cumulative performance condition (e.g., that profit must have grown by a minimum amount by the end of year 1, 2 or 3). This is because all tranches of the arrangement have the same service commencement date and so for the awards that have a performance condition relating to year 2 or year 3 there is a service condition covering a longer period than the performance condition. In other words, an award that vests at the end of year 3 conditional on profitability in year 3 is also conditional on the employee providing service for three years from the date of grant in order to be eligible to receive the award. This is discussed further in section 5.3.7 above.

A variant of Illustration 6-5, is one where a share-based payment transaction vests with employees in instalments and the service period is not at least as long as the duration of the non-market performance condition, for example, a flotation or sale condition. The flotation or sale condition will be treated as a non-vesting condition and be incorporated into the determination of fair value (see section 3.2 above). In contrast, when the service condition is the same duration as the flotation and sale condition, that condition will be treated as a non-market performance condition, see Illustration 15-7 in section 15.4.3 below.

The accounting treatment demonstrated in Illustration 6-5 is the only treatment for graded vesting permitted under IFRS 2 whether an arrangement just has a service condition or whether it has both service and performance conditions.

FASB differences

This contrasts with US GAAP[24] which permits, for awards with graded vesting where vesting depends solely on a service condition, a policy choice between the approach illustrated above and a straight-line recognition method.

6.2.3 Transactions with variable vesting periods due to non-market vesting conditions

An award may be made with a vesting period of variable length. For example, an award might be contingent upon achievement of a particular performance target (such as achieving a given level of cumulative earnings) within a given period, but vesting immediately once the target has been reached. Alternatively, an award might be contingent on levels of earnings growth over a period, but with vesting occurring more quickly if growth is achieved more quickly. Also some plans provide for 're-testing', whereby an original target is set for achievement within a given vesting period, but if that target is not met, a new target and/or a different vesting period are substituted.

In such cases, the entity needs to estimate the length of the vesting period at grant date, based on the most likely outcome of the performance condition. Subsequently, it is necessary continuously to re-estimate not only the number of awards that will finally vest, but also the date of vesting, as shown by Illustration 6-6. *[IFRS 2.15(b), IFRS 2.IG12]*. This contrasts with the treatment of awards with market conditions and variable vesting periods, where the initial estimate of the vesting period is prohibited from being revised (see section 6.3.4 below).

Illustration 6-6: Award with non-market vesting condition and variable vesting period

At the beginning of year 1, the entity grants 100 shares each to 500 employees, conditional upon the employees remaining in the entity's employment during the vesting period. The shares will vest:

- At the end of year 1 if the entity's earnings increase by more than 18%.
- At the end of year 2 if the entity's earnings increase by more than an average of 13% per year over the two year period.

  Or
- At the end of year 3 if the entity's earnings increase by more than an average of 10% per year over the three year period.

The award is estimated to have a fair value of CU30 per share at grant date. It is expected that no dividends will be paid during the whole three year period.

24 FASB ASC 718 - *Compensation - Stock Compensation* (formerly FAS123(R), Share-Based Payment), FASB, December 2004.

By the end of the first year, the entity's earnings have increased by 14%, and 30 employees have left. The entity expects that earnings will continue to increase at a similar rate in year 2, and therefore expects that the shares will vest at the end of year 2. The entity expects, on the basis of a weighted average probability, that a further 30 employees will leave during year 2, and therefore expects that an award of 100 shares each will vest for 440 (500 - 30 - 30) employees at the end of year 2.

By the end of the second year, the entity's earnings have increased by only 10% and therefore the shares do not vest at the end of that year. 28 employees have left during the year. The entity expects that a further 25 employees will leave during year 3, and that the entity's earnings will increase by at least 6%, thereby achieving the average growth of 10% per year necessary for an award after 3 years, so that an award of 100 shares each will vest for 417 (500 - 30 - 28 - 25) employees at the end of year 3.

By the end of the third year, a further 23 employees have left and the entity's earnings have increased by 8%, resulting in an average increase of 10.67% per year. Therefore, 419 (500 - 30 - 28 - 23) employees receive 100 shares at the end of year 3.

The entity will recognise the following amounts during the vesting period for services received as consideration for the shares:

Year	Calculation of cumulative expense	Cumulative expense (CU)	Expense for period (CU)
1	440 employees × 100 shares × CU30 × 1/2*	660,000	660,000
2	417 employees × 100 shares × CU30 × 2/3*	834,000	174,000
3	419 employees × 100 shares × CU30	1,257,000	423,000

* The entity's best estimate at the end of year 1 is that it is one year through a two year vesting period and at the end of year 2 that it is two years through a three year vesting period.

It will be noted that in Illustration 6-6, which is based on IG Example 2 in the implementation guidance to IFRS 2, it is assumed that the entity will pay no dividends (to any shareholders) throughout the maximum possible three year vesting period. This has the effect that the fair value of the shares to be awarded is equivalent to their market value at the date of grant.

If dividends were expected to be paid during the vesting period, this would no longer be the case. Employees would be better off if they received shares after two years rather than three, since they would have a right to receive dividends from the end of year two. In practice, an entity is unlikely to suspend dividend payments in order to simplify the calculation of its share-based payment expense, and it is unfortunate that IG Example 2 is not more realistic. *[IFRS 2.IG Example 2]*.

One solution might be to use the approach in IG Example 4 in the implementation guidance to IFRS 2 (the substance of which is reproduced as Illustration 6-8 in section 6.2.5 below). That Example deals with an award whose exercise price is either CU40 or CU30, dependent upon various performance conditions. Because vesting conditions other than market conditions must be ignored in determining the value of an award, the approach is in effect to treat the award as the simultaneous grant of two awards, whose value, in that case, varies by reference to the different exercise prices. *[IFRS 2.IG Example 4]*.

The same principle could be applied to an award of shares that vests at different times according to the performance conditions, by determining different fair values for the shares (in this case depending on whether they vest after one, two or three years). The cumulative charge during the vesting period would be based on a best estimate of which outcome will occur, and the final cumulative charge would be based on the grant date fair value of the actual outcome (which will require some acceleration of expense if the actual vesting period is shorter than the previously estimated vesting period).

Such an approach appears to be taking account of non-market vesting conditions in determining the fair value of an award, contrary to the basic principle of IFRS 2.19 (see section 6.1.1 above). However, it is not the vesting conditions that are being taken into account *per se*, but the fact that the varying vesting periods will give rise to different lives for the award (which are required to be taken into account - see sections 7.2 and 8 below). That said, the impact of the time value of the different lives on the fair value of the award will, in many cases, be insignificant and it will therefore be a matter of judgement as to how precisely an entity switches from one fair value to another.

Economically speaking, the entity in Illustration 6-6 has made a single award, the true fair value of which must be a function of the weighted probabilities of the various outcomes occurring. However, under the accounting model for equity-settled awards in IFRS 2, the probability of achieving non-market performance conditions are not taken into account in valuing an award. If this is required to be ignored, the only approach open is to proceed as in Illustration 6-6 above and treat the arrangement as if it consisted of the simultaneous grant of three awards.

Some might object that this methodology is not relevant to the award in Illustration 6-6 above, since it is an award of shares rather than, in the case of Illustration 6-8 (see section 6.2.5 below), an award of options. However, an award of shares is no more than an award of options with an exercise price of zero. Moreover, the treatment outlined in the previous paragraph is broadly consistent with the rationale given by IFRS 2 for the treatment of an award vesting in instalments (see section 6.2.2 above).

In Illustration 6-6 above, the vesting period, although not known, is at least one of a finite number of known possibilities. The vesting period for some awards, however, may be more open-ended, such as is frequently the case for an award that vests on a trade sale or flotation of the business. Such awards are discussed further in section 15.4 below.

How we see it

In summary, as noted above, where an equity-settled award has a variable vesting period on achieving a non-market vesting condition, the cumulative charge during the vesting period would be based on a best estimate of which outcome will occur, and the final cumulative charge would be based on the grant date fair value of the actual outcome (which will require some acceleration of expense if the actual vesting period is shorter than the previously estimated vesting period).

6.2.4 Transactions with variable number of equity instruments awarded depending on non-market vesting conditions

More common than awards with a variable vesting period are those where the number of equity instruments awarded varies, typically increasing to reflect the margin by which a particular minimum target is exceeded. In accounting for such awards, the entity must continuously revise its estimate of the number of shares to be awarded, as demonstrated in Illustration 6-7 below (which is based on IG Example 3 in the implementation guidance to IFRS 2). *[IFRS 2.IG Example 3]*.

Illustration 6-7: Award with non-market vesting condition and variable number of equity instruments

At the beginning of year 1, an entity grants an option over a variable number of shares (see below), estimated to have a fair value at grant date of CU20 per share under option, to each of its 100 employees working in the sales department. The share options will vest at the end of year 3, provided that the employees remain in the entity's employment, and provided that the volume of sales of a particular product increases by at least an average of 5% per year. If the volume of sales of the product increases by an average of between 5% and 10% per year, each employee will be entitled to exercise 100 share options. If the volume of sales increases by an average of between 10% and 15% each year, each employee will be entitled to exercise 200 share options. If the volume of sales increases by an average of 15% or more, each employee will be entitled to exercise 300 share options.

By the end of the first year, seven employees have left and the entity expects that a total of 20 employees will leave by the end of year 3. Product sales have increased by 12% and the entity expects this rate of increase to continue over the next two years, so that 80 employees will be entitled to exercise 200 options each.

By the end of the second year, a further five employees have left. The entity now expects only three more employees to leave during year 3, and therefore expects a total of 15 employees to have left during the three year period. Product sales have increased by 18%, resulting in an average of 15% over the two years to date. The entity now expects that sales will average 15% or more over the three year period, so that 85 employees will be entitled to exercise 300 options each.

By the end of year 3, a further seven employees have left. Hence, 19 employees have left during the three year period, and 81 employees remain. However, due to trading conditions significantly poorer than expected, sales have increased by a 3 year average of only 12%, so that the 81 remaining employees are entitled to exercise only 200 share options.

The entity will recognise the following amounts during the vesting period for services received as consideration for the options.

Year	Calculation of cumulative expense	Cumulative expense (CU)	Expense for period (CU)
1	80 employees × 200 options × CU20 × 1/3	106,667	106,667
2	85 employees × 300 options × CU20 × 2/3	340,000	233,333
3	81 employees × 200 options × CU20	324,000	(16,000)

This Example reinforces the point that, under the methodology in IFRS 2, it is quite possible for an equity-settled transaction to give rise to a credit to profit or loss for a particular period during the period to vesting.

Other types of awards seen where variable number of equity instruments are awarded depending on non-market vesting conditions include an employee receiving awards dependent on an individual's performance rating, the higher the rating the more equity-instruments are awarded (see section 3.1.2 above). When the vesting of a share-based payment arrangement is based on an individual's performance rating, for there to be a grant date of such an award the framework for determining the performance rating outcome needs to be sufficiently clear and objective to allow both the entity and the employee to make an estimate of the outcome of the award during the vesting period (see section 5.3.3 above). Consistent with Illustration 6-7 above, the entity must continuously revise its estimate of the number of equity instruments to be awarded, provided a grant date has been established for the award. However, if the framework for determining the performance rating outcome is not sufficiently clear and objective, the grant date may not occur until a later date, but the entity would need to consider if services are effectively being rendered for an award from a date earlier than the grant date as defined in IFRS 2 and the cost of the award recognised over a period starting with that earlier date (see section 5.3.2 above).

6.2.5 Transactions with variable exercise price due to non-market vesting conditions

Another mechanism for delivering higher value to the recipient of a share award so as to reflect the margin by which a particular target is exceeded might be to vary the exercise price depending on performance. IFRS 2 requires such an award to be dealt with, in effect, as more than one award. The fair value of each award is determined, and the cost during the vesting period based on the best estimate of which award will actually vest, with the final cumulative charge being based on the actual outcome. *[IFRS 2.IG12, IFRS 2.IG Example 4]*.

This is demonstrated in Illustration 6-8 below.

Illustration 6-8: Award with non-market vesting condition and variable exercise price

An entity grants to a senior executive 10,000 share options, conditional upon the executive remaining in the entity's employment for three years. The exercise price is CU40. However, the exercise price drops to CU30 if the entity's earnings increase by at least an average of 10% per year over the three year period.

On grant date, the entity estimates that the fair value of the share options, with an exercise price of CU30, is CU16 per option. If the exercise price is CU40, the entity estimates that the share options have a fair value of CU12 per option. During year 1, the entity's earnings increased by 12%, and the entity expects that earnings will continue to increase at this rate over the next two years. The entity therefore expects that the earnings target will be achieved, and hence the share options will have an exercise price of CU30.

During year 2, the entity's earnings increased by 13%, and the entity continues to expect that the earnings target will be achieved. During year 3, the entity's earnings increased by only 3%, and therefore the earnings target was not achieved. The executive completes three years' service, and therefore satisfies the service condition. Because the earnings target was not achieved, the 10,000 vested share options have an exercise price of CU40.

The entity will recognise the following amounts during the vesting period for services received as consideration for the options.

Year	Calculation of cumulative expense	Cumulative expense (CU)	Expense for period (CU)
1	10,000 options × CU16 × 1/3	53,333	53,333
2	10,000 options × CU16 × 2/3	106,667	53,334
3	10,000 options × CU12	120,000	13,333

At first sight this may seem a rather surprising approach. In reality, is it not the case that the entity in Illustration 6-8 has made a single award, the fair value of which must lie between CU12 and CU16, as a function of the weighted probabilities of either outcome occurring? Economically speaking, this is indeed the case. However, under the accounting model for equity-settled share-based payments in IFRS 2, the probability of achieving non-market performance conditions are not taken into account in valuing an award. If this is required to be ignored, the only approach open is to proceed as above (see section 6.2.1.B above).

6.3 Market conditions

6.3.1 What is a 'market condition'?

The following definitions in Appendix A to IFRS 2 are relevant.

Extract from IFRS 2

Appendix A IFRS 2
Defined terms

intrinsic value	The difference between the **fair value** of the shares to which the counterparty has the (conditional or unconditional) right to subscribe or which it has the right to receive, and the price (if any) the counterparty is (or will be) required to pay for those shares. For example, a **share option** with an exercise price of CU15,[6] on a share with a fair value of CU20, has an intrinsic value of CU5.
market condition	A **performance condition** upon which the exercise price, vesting or exercisability of an **equity instrument** depends that is related to the market price (or value) of the entity's **equity instruments** (or the equity instruments of another entity in the same group), such as: (a) attaining a specified share price or a specified amount of **intrinsic value** of a **share option**; or (b) achieving a specified target that is based on the market price (or value) of the entity's **equity instruments** (or the equity instruments of another entity in the same group) relative to an index of market prices of **equity instruments** of other entities. A market condition requires the counterparty to complete a specified period of service (ie a **service condition**); the service requirement can be explicit or implicit.

6 In this appendix, monetary amounts are denominated in 'currency units (CU)'.

A market condition is a type of performance condition and the above definition must be read together with the definition of a performance condition (see section 3.1 above). If there is no service requirement, the condition will be a non-vesting condition rather than a performance condition (see section 3.2 above). *[IFRS 2 Appendix A]*.

A performance condition based on the share price and one based on the intrinsic value of the option are effectively the same, since the values of each will obviously move in parallel.

An example of a market condition is a condition based on total shareholder return (TSR). TSR is a measure of the increase or decrease in a given sum invested in an entity over a period on the assumption that all dividends received in the period had been used to purchase further shares in the entity. The market price of the entity's shares is an input to the calculation.

However, a condition linked to a purely internal financial performance measure such as profit or earnings per share is not a market condition. Such measures will affect the share price, but are not directly linked to it, and hence are not market conditions.

A condition linked to a general market index is a non-vesting condition rather than a market condition (see section 3.2 above and section 6.4 below). For example, suppose that an entity engaged in investment management and listed only in London grants options to an employee responsible for the Far East equities portfolio. The options have a condition linked to movements in a general index of shares of entities listed in Hong Kong, so as to compare the performance of the portfolio of investments for which the employee is responsible with that of the overall market in which they are traded. That condition would not be regarded as a market condition under IFRS 2, because even though it relates to the performance of a market, the reporting entity's own share price is not relevant to the satisfaction of the condition.

However, if the condition were that the entity's own share price had to outperform a general index of shares of entities listed in Hong Kong, that condition would be a market condition because the reporting entity's own share price is then relevant to the satisfaction of the condition.

6.3.2 Summary of accounting treatment

The key feature of the accounting treatment of an equity-settled transaction subject to a market condition is that the market condition is taken into account in valuing the award at the date of grant, but then subsequently ignored, so that an award is treated as vesting irrespective of whether the market condition is satisfied, provided that all service and non-market performance conditions are satisfied. *[IFRS 2.21, IFRS 2.IG13]*. This can have rather controversial consequences, as demonstrated by Illustration 6-9.

Illustration 6-9: Award with market condition

An entity grants an employee an option to buy a share on condition of remaining in employment for three years and the share price at the end of that period being at least CU7. At the end of the vesting period, the share price is CU6.80. The share price condition is factored into the initial valuation of the option, and the option is considered to vest provided that the employee remains for three years, irrespective of whether the share price does in fact reach CU7.

Therefore, IFRS 2 sometimes treats as vesting (and recognises a cost for) awards that do not actually vest in the natural sense of the word. See also Illustration 6-11 in section 6.3.4 below.

This treatment is clearly significantly different from that for transactions involving a non-market vesting condition, where no cost would be recognised where the conditions were not met. The Basis for Conclusions indicates that the IASB accepted this difference for two main reasons:

(a) It was consistent with the approach in the US standard FAS 123 *Accounting for Stock-Based Compensation*.

(b) In principle, the same approach should have been adopted for all performance conditions. However, whereas market conditions can be readily incorporated into the valuation of options, other conditions cannot. *[IFRS 2.BC183, IFRS 2.BC184]*.

The methodology prescribed by IFRS 2 for transactions with a vesting condition other than a market condition is therefore to determine the fair value of the option ignoring the condition and then to multiply that fair value by the estimated (and ultimately the actual) number of awards expected to vest based on the likelihood of that non-market vesting condition being met (see section 6.2 above). It is interesting to note, however, that the January 2008 amendment to IFRS 2 (see section 1.2 above) had the effect that certain conditions previously regarded as non-market vesting conditions (and therefore 'impossible' to incorporate in the determination of fair value) became non-vesting conditions (and therefore required to be incorporated in the determination of fair value).

One of the reasons for adoption of this approach under US GAAP (not referred to in the Basis for Conclusions on IFRS 2) was as an 'anti-avoidance' measure. The concern was that the introduction of certain market conditions could effectively allow for the reversal of the expense for 'underwater' options (i.e., those whose exercise price is higher than the share price such that it is not in the holder's interest to exercise the option) for which all significant vesting conditions had been satisfied, contrary to the general principle in US GAAP (and IFRS 2) that no revisions are to be made to the expense for an already vested option.

For example, when the share price is CU10 an entity could grant an employee an option, exercisable at CU10, provided that a certain sales target had been met within one year. If the target were achieved, IFRS 2 would require an expense to be recognised even if the share price at the end of the year were only CU8, so that the employee would not rationally exercise the option. If, however, the performance conditions were that (a) the sales target was achieved and (b) the share price was at least CU10.01, the effect would be (absent specific provision for market conditions) that the entity could reverse any expense for 'underwater' options.

It appears that it may be possible to soften the impact of IFRS 2's rules for market conditions relatively easily by introducing a non-market vesting condition closely correlated to the market condition. For instance, the option in Illustration 6-9 above could be modified so that exercise was dependent not only upon the CU7 target share price and continuous employment, but also on a target growth in earnings per share. Whilst there would not be a perfect correlation between earnings per share and the share price, it would be expected that they would move roughly in parallel, particularly if the entity has historically had a fairly consistent price/earnings ratio. Thus, if the share price target were not met, it would be highly likely that the earnings per share target would not be met either. This would allow the entity to show no cumulative cost for the option, since only one (i.e., not all) of the non-market related vesting conditions would have been met.

Similarly, entities in sectors where the share price is closely related to net asset value (e.g., property companies and investment trusts) could incorporate a net asset value target as a non-market performance condition that would be highly likely to be satisfied only if the market condition was satisfied (i.e., two separate conditions exist, one based on the market price/value of the shares and the other based on the net asset value).

The matrices below illustrate the interaction of market conditions and vesting conditions other than market conditions. Matrix 1 summarises the possible outcomes for an award with the following two vesting conditions:

- The employee remaining in service for three years ('service condition').
- The entity's total shareholder return ('TSR') relative to that of a peer group being in the top 10% of its peer group at the end of the period ('TSR target (market condition)').

Matrix 1

	Service condition met?	TSR target (market condition) met?	IFRS 2 expense?
1	Yes	Yes	Yes
2	Yes	No	Yes
3	No	Yes	No
4	No	No	No

It will be seen that, to all intents and purposes, the 'TSR target (market condition) met?' column is redundant, as this market condition is not relevant to whether or not the award is treated as vesting by IFRS 2. The effect of this is that the entity would recognise an expense for outcome 2, even though no awards truly vest.

Matrix 2 summarises the possible outcomes for an award with the same conditions as in Matrix 1, plus a requirement for earnings per share to grow by a general inflation index plus 10% over the period ('EPS target').

Matrix 2

	Service condition met?	TSR target (market condition) met?	EPS target (non-market vesting condition) met?	IFRS 2 expense?
1	Yes	Yes	Yes	Yes
2	Yes	No	Yes	Yes
3	Yes	Yes	No	No
4	Yes	No	No	No
5	No	Yes	Yes	No
6	No	No	Yes	No
7	No	Yes	No	No
8	No	No	No	No

Again, it will be seen that, to all intents and purposes, the 'TSR target (market condition) met?' column is redundant, as this market condition is not relevant to whether or not the award is treated as vesting by IFRS 2. The effect of this is that the entity would recognise an expense for outcome 2, even though no awards truly vest. However, no expense would be recognised for outcome 4, which is, except for the introduction of the EPS target, equivalent to outcome 2 in Matrix 1, for which an expense is recognised. This illustrates that the introduction of a non-market vesting condition closely related to a market condition may mitigate the impact of IFRS 2.

Examples of the application of the accounting treatment for transactions involving market conditions are given in sections 6.3.3 to 6.3.5 below.

6.3.3 Transactions with market conditions and known vesting periods

The accounting for such transactions is essentially the same as that for transactions without market conditions but with a known vesting period (including 'graded' vesting - see section 6.2.2 above), except that adjustments are made to reflect the changing probability of the achievement of the non-market vesting conditions only, as demonstrated by Illustration 6-10 below. *[IFRS 2.19, IFRS 2.20, IFRS 2.21, IFRS 2.IG13, IFRS 2.IG Example 5]*.

Illustration 6-10: Award with market condition and fixed vesting period

At the beginning of year 1, an entity grants to 100 employees 1,000 share options each, conditional upon the employees remaining in the entity's employment until the end of year 3. However, the share options cannot be exercised unless the share price has increased from CU50 at the beginning of year 1 to more than CU65 at the end of year 3.

If the share price is above CU65 at the end of year 3, the share options can be exercised at any time during the next seven years, i.e., by the end of year 10. The entity applies a binomial option pricing model (see section 8 below), which takes into account the possibility that the share price will exceed CU65 at the end of year 3 (and hence the share options vest and become exercisable) and the possibility that the share price will not exceed CU65 at the end of year 3 (and hence the options will be treated as having vested under IFRS 2 but will never be exercisable - as explained below). It estimates the fair value of the share options with this market condition to be CU24 per option.

IFRS 2 requires the entity to recognise the services received from a counterparty who satisfies all other vesting conditions (e.g., services received from an employee who remains in service for the specified service period), irrespective of whether that market condition is satisfied. It makes no difference whether the share price target is achieved, since the possibility that the share price target might not be achieved has already been taken into account when estimating the fair value of the share options at grant date. However, the options are subject to another condition (i.e., continuous employment) and the cost recognised is required to be adjusted to reflect the ongoing best estimate of employee retention.

By the end of the first year, seven employees have left and the entity expects that a total of 20 employees will leave by the end of year 3, so that 80 employees will have satisfied all conditions other than the market condition (i.e., continuous employment).

By the end of the second year, a further five employees have left. The entity now expects only three more employees will leave during year 3, and therefore expects that a total of 15 employees will have left during the three year period, so that 85 employees will have satisfied all conditions other than the market condition.

By the end of year 3, a further seven employees have left. Hence, 19 employees have left during the three year period, and 81 employees remain. However, the share price is only CU60, so that the options cannot be exercised. Nevertheless, as all conditions other than the market condition have been satisfied, a cumulative cost is recorded as if the options had fully vested in 81 employees.

The entity will recognise the following amounts during the vesting period for services received as consideration for the options (which in economic reality do not vest).

Year	Calculation of cumulative expense	Cumulative expense (CU)	Expense for period (CU)
1	80 employees × 1,000 options × CU24 × 1/3	640,000	640,000
2	85 employees × 1,000 options × CU24 × 2/3	1,360,000	720,000
3	81 employees × 1,000 options × CU24	1,944,000	584,000

6.3.4 Transactions with variable vesting periods due to market conditions

Where a transaction has a variable vesting period due to a market condition, a best estimate of the most likely vesting period will have been used in determining the fair value of the transaction at the date of grant. IFRS 2 requires the expense for that transaction to be recognised over an estimated expected vesting period consistent with the assumptions used in the valuation, without any subsequent revision. *[IFRS 2.15(b), IFRS 2.IG14]*.

This may mean, for example, that, if the actual vesting period for an employee share option award turns out to be longer than that anticipated for the purposes of the initial valuation, a cost is nevertheless recorded in respect of all employees who reach the end of the anticipated vesting period, even if they do not reach the end of the actual vesting period, as shown by Illustration 6-11 below, which is based on IG Example 6 in the implementation guidance in IFRS 2. *[IFRS 2.IG Example 6]*.

Illustration 6-11: Award with market condition and variable vesting period

At the beginning of year 1, an entity grants 10,000 share options with a ten year life to each of ten senior executives. The share options will vest and become exercisable immediately if and when the entity's share price increases from CU50 to CU70, provided that the executive remains in service until the share price target is achieved.

The entity applies a binomial option pricing model, which takes into account the possibility that the share price target will be achieved during the ten year life of the options, and the possibility that the target will not be achieved. The entity estimates that the fair value of the share options at grant date is CU25 per option. From the option pricing model, the entity determines that the most likely vesting period is five years. The entity also estimates that two executives will have left by the end of year 5, and therefore expects that 80,000 share options (10,000 share options × 8 executives) will vest at the end of year 5.

Throughout years 1 to 4, the entity continues to estimate that a total of two executives will leave by the end of year 5. However, in total three executives leave, one in each of years 3, 4 and 5. The share price target is achieved at the end of year 6. Another executive leaves during year 6, before the share price target is achieved.

Paragraph 15 of IFRS 2 requires the entity to recognise the services received over the expected vesting period, as estimated at grant date, and also requires the entity not to revise that estimate. Therefore, the entity recognises the services received from the executives over years 1-5. Hence, the transaction amount is ultimately based on 70,000 share options (10,000 share options × 7 executives who remain in service at the end of year 5). Although another executive left during year 6, no adjustment is made, because the executive had already completed the expected vesting period of 5 years.

The entity will recognise the following amounts during the initial expected five year vesting period for services received as consideration for the options.

Year	Calculation of cumulative expense	Cumulative expense (CU)	Expense for period (CU)
1	8 employees × 10,000 options × CU25 × 1/5	400,000	400,000
2	8 employees × 10,000 options × CU25 × 2/5	800,000	400,000
3	8 employees × 10,000 options × CU25 × 3/5	1,200,000	400,000
4	8 employees × 10,000 options × CU25 × 4/5	1,600,000	400,000
5	7 employees × 10,000 options × CU25	1,750,000	150,000

IFRS 2 does not specifically address the converse situation, namely where the award actually vests before the end of the anticipated vesting period.

How we see it

In our view, where the award vests before the end of the anticipated vesting period, any expense not yet recognised at the point of vesting is immediately accelerated. We consider that this treatment is most consistent with the overall requirement of IFRS 2 to recognise an expense for share-based payment transactions 'as the services are received'. It is difficult to regard any services being received for an award after it has vested.

Moreover, the prohibition in IFRS 2 on adjusting the vesting period as originally determined refers to 'the estimate of the expected vesting period'. In our view, the acceleration of vesting that we propose is not the revision of an estimated period, but the substitution of an estimate for a known vesting period.

Suppose in Illustration 6-11 above, the award had in fact vested at the end of year 4. We believe that the expense for such an award must be allocated as follows:

Year	Calculation of cumulative expense	Cumulative expense (CU)	Expense for period (CU)
1	8 employees × 10,000 options × CU25 × 1/5	400,000	400,000
2	8 employees × 10,000 options × CU25 × 2/5	800,000	400,000
3	8 employees × 10,000 options × CU25 × 3/5	1,200,000	400,000
4	8 employees × 10,000 options × CU25 × 4/4	2,000,000	800,000

6.3.5 Transactions with multiple outcomes depending on market conditions

In practice, it is very common for an award subject to market conditions to give varying levels of reward that increase depending on the extent to which a 'base line' market performance target has been met. Such an award is demonstrated in Illustration 6-12 below.

Illustration 6-12: Award with market conditions and multiple outcomes

At the beginning of year 1, the reporting entity grants an employee an award of shares that will vest on the third anniversary of grant if the employee is still in employment. The number of shares depends on the share price achieved at the end of the three-year period. The employee will receive:

- No shares if the share price is below CU10.00
- 100 shares if the share price is in the range CU10.00-CU14.99
- 150 shares if the share price is in the range CU15.00-CU19.99
- 180 shares if the share price is CU20.00 or above

In effect the entity has made three awards, which need to be valued as follows:

(a) 100 shares if the employee remains in service for three years and the share price is greater than CU10

(b) 50 (150 - 100) shares if the employee remains in service for three years and the share price is greater than CU15

And

(c) 30 (180 - 150) shares if the employee remains in service for three years and the share price is CU20.00 or more

Each award would be valued, ignoring the impact of the three-year service condition but taking account of the share price target. This would result in each tranche of the award being subject to an increasing level of discount to reflect the relative probability of the share price target for each tranche of the award being met. All three awards would then be expensed over the three-year service period, and forfeited only if the awards lapsed as a result of the employee leaving during that period.

It can be seen that the (perhaps somewhat counterintuitive) impact of this is that an equity-settled share-based payment where the number of shares increases in line with increases in the entity's share price may nevertheless have a fixed grant date value irrespective of the number of shares finally awarded.

6.3.6 Transactions with independent market conditions, non-market vesting conditions or non-vesting conditions

6.3.6.A Independent market and non-market vesting conditions

The discussion in section 6.3.2 above addressed the accounting treatment of awards with multiple conditions that must all be satisfied, i.e., a market condition and a non-market vesting condition. However, entities might also make awards with multiple conditions, only one of which need be satisfied, i.e., the awards vest on satisfaction of either a market condition *or* a non-market vesting condition. IFRS 2 provides no explicit guidance on the treatment of such awards, which is far from clear, as demonstrated by Illustration 6-13 below.

Illustration 6-13: Award with independent market conditions and non-market vesting conditions

An entity grants an employee 100 share options that vest after three years if the employee is still in employment and the entity achieves either:

- Cumulative total shareholder return (TSR) over three years of at least 15%.

  Or

- Cumulative profits over three years of at least CU200 million.

The fair value of the award, ignoring vesting conditions, is CU300,000. The fair value of the award, taking account of the TSR condition, but not the other conditions, is CU210,000.

In our view, the entity has, in effect, simultaneously issued two awards - call them 'A' and 'B' - which vest as follows:

A On achievement of three years' service plus minimum TSR.

And

B On achievement of three years' service plus minimum earnings growth.

If the conditions for both awards are simultaneously satisfied, one or other effectively lapses.

It is clear that award A, if issued separately, would require the entity to recognise an expense of CU210,000 if the employee were still in service at the end of the three year period. It therefore seems clear that, if the employee does remain in service, there must be a charge of CU210,000 irrespective of whether the award actually vests. It would be anomalous for the entity to avoid recording a charge that would have been recognised if the entity had made award A in isolation simply by packaging it with award B.

If in fact the award vested because the earnings condition, but not the market condition, had been satisfied, it would then be appropriate to recognise a total expense of CU300,000.

During the vesting period, we believe that the entity is required to make an assessment at each reporting date of the basis on which the award is expected to vest. It must assess whether, as at that date, the award is expected to vest by virtue of the earnings condition, but not the TSR condition, being satisfied. Assume (for example) that the entity assesses at the end of year 1 that the award is likely to vest by virtue of the TSR condition, and at the end of year 2 that it is likely to vest by virtue of the earnings condition, and that the award actually does not vest, but the employee remains in service. This would give rise to annual expense as follows:

Year	Calculation of cumulative expense	Cumulative expense (CU)	Expense for period (CU)
1	210,000 × 1/3	70,000	70,000
2	300,000 × 2/3	200,000	130,000
3	210,000 × 3/3	210,000	10,000

We believe that ongoing reassessment during the vesting period is most consistent with the general approach of IFRS 2 to awards with a number of possible outcomes (see section 10 below).

Of course, as for other awards, the accounting treatment would also require an assessment of whether or not the employee was actually going to remain in service.

A further question that arises is how the award must be accounted for if both conditions are satisfied. It would clearly be inappropriate to recognise an expense of CU510,000 (the sum of the separate fair values of the award) - this would be double-counting, because the employee receives only one package of 100 options. However, should the total expense be taken as CU210,000 or CU300,000? In our view, it is appropriate to recognise a cost of CU300,000 since the non-market vesting condition has been satisfied.

How we see it

As noted above, the entity has simultaneously issued two awards which vest on achievement of three years' service plus; minimum TSR or minimum earnings growth. If the conditions for both awards are simultaneously satisfied, one or other effectively lapses, we believe the higher of both expenses is recognised. We also believe that ongoing reassessment during the vesting period is most consistent with the general approach of IFRS 2 to awards with a number of possible outcomes.

Ultimately, this is an issue which only the IASB can solve, since it arises from the inconsistent treatment by IFRS 2 of awards with market conditions and those with non-market conditions. As noted in section 3.4 above, the IASB has concluded not to perform further research into IFRS 2.[25] Therefore we continue to believe that ongoing reassessment during the vesting period is most consistent with the general approach of IFRS 2 for awards with multiple possible outcomes.

6.3.6.B Independent market conditions and non-vesting conditions

Arrangements are also seen where a share-based payment transaction vests on the satisfaction of either a market condition or a non-vesting condition.

The fact that there are two alternative conditions on which the award might vest means that, unless the two conditions are perfectly correlated, the grant date fair value of such an award will be higher than that of an award where there is only one possible basis on which the award might vest. Irrespective of whether the market condition and/or the non-vesting conditions are met, the entity will recognise the grant date fair value provided all other service and non-market vesting conditions are met (i.e., the expense recognition is consistent with that of any award with market and/or non-vesting conditions).

25 Project Summary: *Share-based payment-research on sources of accounting complexity*, IASB, October 2018, available on the IFRS Foundation's website.

How we see it

In our view, an entity granting an award on the basis of a service condition (and any other non-market vesting conditions) plus either a market condition or a non-vesting condition is required to measure the fair value of the award at grant date taking into account the probability that either the market condition or the non-vesting condition will be met.

6.3.7 Transactions with hybrid or interdependent market conditions and non-market vesting conditions

Awards may sometimes have a performance condition which depends simultaneously on a market element and a non-market element, sometimes known as 'hybrid' conditions. Examples of such conditions include:

- A particular price-earnings (PE) ratio (calculated by reference to share price, a market condition, and earnings, a non-market vesting condition).
- A maximum level of discount of market capitalisation (a market condition) below net asset value (a non-market vesting condition).

Such awards are rather curious, in the sense that these ratios may remain fairly constant irrespective of the underlying performance of the entity, so that a performance condition based on them is arguably of limited motivational value.

How we see it

In our view, in contrast to our suggested treatment of awards with independent market and non-market vesting conditions discussed in section 6.3.6.A above, awards with interdependent market and non-market vesting conditions must be accounted for entirely as awards with market conditions. These awards contain at least one element that meets the definition of a market condition but which cannot be completely split from the non-market element for separate assessment. An indicator such as the PE ratio or discount of market capitalisation below net asset value, is a market condition as defined since it is "related to the market price … of the entity's equity instruments" (see section 6.3.1 above).

6.3.8 Awards with a condition linked to flotation price

Awards in an unlisted entity may be granted with a condition linked to the achievement of a specific price when the entity floats.

How we see it

On flotation there is a market and a market price for the entity's equity instruments and the achievement of a specific price on flotation would, in our view, be a market condition when accompanied by a corresponding service requirement (see section 15.4 below).

6.4 Non-vesting conditions

The accounting treatment for awards with non-vesting conditions has some similarities to that for awards with market conditions in that:

- The fair value of the award at grant date is reduced to reflect the impact of the condition.
- An expense is recognised for the award irrespective of whether the non-vesting condition is met, provided that all vesting conditions (other than market conditions) are met. *[IFRS 2.21A]*.

However, in some situations, the accounting for non-vesting conditions differs from that for market conditions as regards the timing of the recognition of expense if the non-vesting condition is not satisfied (see section 6.4.3 below).

6.4.1 Awards with no conditions other than non-vesting conditions

The effect of the treatment required by IFRS 2 is that any award that has only non-vesting conditions (e.g., an option award to an employee that may be exercised on a trade sale or IPO of the entity, irrespective of whether the employee is still in employment at that time) must be expensed in full at grant date. This is discussed further in section 3.2 above and in section 15.4 below, and demonstrated in Illustration 6-1 in section 6.1 above.

6.4.2 Awards with non-vesting conditions and variable vesting periods

IFRS 2 does not explicitly address the determination of the vesting period for an award with a non-vesting condition but a variable vesting period (e.g., an award which delivers 100 shares when the price of gold reaches a given level, but without limit as to when that level must be achieved, so long as the employee is still in employment when the target is reached).

How we see it

However, given the close similarity between the required treatment for awards with non-vesting conditions and that for awards with market conditions, we believe that entities must follow the guidance in the standard for awards with market conditions and variable vesting periods (see section 6.3.4 above).

6.4.3 Failure to meet non-vesting conditions

As noted above, the accounting for non-vesting conditions sometimes differs from that for market conditions as regards the timing of the recognition of expense if the non-vesting condition is not satisfied. The treatment depends on the nature of the non-vesting condition, as follows:

- If a non-vesting condition within the control of the counterparty (e.g., making monthly savings in an SAYE scheme or holding a specified number of shares in a matching share arrangement) is not satisfied during the vesting period, the failure to satisfy the condition is treated as a cancellation (see section 7.4 below), with immediate recognition of any expense for the award not previously recognised. *[IFRS 2.28A, IFRS 2.IG24, IFRS 2.IG Example 9A]*.
- If a non-vesting condition within the control of the entity (e.g., continuing to operate the scheme) is not satisfied during the vesting period, the failure to satisfy the condition is treated as a cancellation (see section 7.4 below), with immediate recognition of any expense for the award not previously recognised. *[IFRS 2.28A, IFRS 2.IG24]*. But, if a non-vesting condition within the control of neither the counterparty nor the entity (e.g., a financial market index reaching a minimum level) is not satisfied, there is no change to the accounting and the expense continues to be recognised over the vesting period, unless the award is otherwise treated as forfeited by IFRS 2. *[IFRS 2.BC237A, IFRS 2.IG24]*.

How we see it

The reference to the vesting period, when a non-vesting condition is not met that is not within the control of either party, would include any deemed vesting period calculated as described in section 6.4.2 above.

If an award is forfeited due to a failure to satisfy a non-vesting condition after the end of the vesting period (e.g., a requirement for an employee not to work for a competitor for a two year period after vesting), no adjustment is made to the expense previously recognised, consistent with the general provisions of IFRS 2 for accounting for awards in the post-vesting period (see section 6.1.3 above). This would be the case even if shares previously issued to the employee were required to be returned to the entity on forfeiture (see sections 3.1.1 and 3.2.3 above for further discussion of clawback arrangements and non-compete arrangements respectively).

7 Equity-settled transactions - modification, cancellation and settlement

7.1 Background

It is quite common for equity instruments to be modified or cancelled before or after vesting. Typically this is done where the conditions for an award have become so onerous as to be virtually unachievable, or (in the case of an option) where the share price has fallen so far below the exercise price of an option that it is unlikely that the option will ever be 'in the money' to the holder during its life. In such cases, an entity may take the view that the equity awards are so unattainable as to have little or no motivational effect, and accordingly replace them with less onerous alternatives. Conversely, and more rarely, an entity may make the terms of a share award more onerous (possibly because of shareholder concern that targets are insufficiently demanding). In addition, an entity may 'settle' an award, i.e., cancel it in return for cash or other consideration.

A target entity might modify existing share-based payment arrangements in the period leading up to a business combination. In this situation, it needs to be determined whether the guidance in IFRS 2 is applicable or whether the modification is being made for the benefit of the acquirer or the combined entity, in which case the guidance in IFRS 3 is likely to apply (see section 11.2 below).

IFRS 2 contains detailed provisions for modification, cancellation and settlement. Whilst these provisions (like the summary of them below) are framed in terms of share-based payment transactions with employees, they apply to transactions with parties other than employees that are measured by reference to the fair value of the equity instruments granted (see section 5.4 above). In that case, however, all references to 'grant date' must be taken as references to the date on which the third party supplied goods or rendered service. *[IFRS 2.26]*.

In the discussion below, any reference to a 'cancellation' is to any cancellation, whether instigated by the entity or the counterparty. As well as more obvious situations where an award is cancelled by either the entity or the counterparty, cancellations include:

- A failure by the entity to satisfy a non-vesting condition (see section 6.4.3 above) within the control of the entity.
- A failure by the counterparty to satisfy a non-vesting condition (see section 6.4.3 above) within the control of the counterparty. *[IFRS 2.28A, IFRS 2.IG24]*.

The discussion below is not relevant to cancellations and modifications of those equity-settled transactions that are (exceptionally) accounted for at intrinsic value (see section 8.8 below).

The basic principles of the rules for modification, cancellation and settlement, which are discussed in more detail in sections 7.3 and 7.4 below, can be summarised as follows:

- As a minimum, the entity must recognise the amount that would have been recognised for the award if it remained in place on its original terms. *[IFRS 2.27]*.
- If the value of an award to an employee is reduced (e.g., by reducing the number of equity instruments subject to the award or, in the case of an option, by increasing the exercise price), there is no reduction in the cost recognised in profit or loss. *[IFRS 2.27, IFRS 2.B42, IFRS 2.B44]*.
- However, where the effect of the modification, cancellation or settlement is to increase the value of the award to an employee (e.g., by increasing the number of equity instruments subject to the award or, in the case of an option, by reducing the exercise price), the incremental fair value must be recognised as a cost. The incremental fair value is the difference between the fair value of the original award and that of the modified award, both measured at the date of modification. *[IFRS 2.27, IFRS 2.B43]*.

It might be thought that, when an award has been modified, and certainly when it has been cancelled altogether, it no longer exists, and that it is therefore not appropriate to recognise any cost for it. However, such a view would be consistent with a vesting date measurement model rather than with the grant/service date measurement model of IFRS 2. Under the IFRS 2 model, the value of an award at grant date or service date cannot be changed by subsequent events.

Another reason given for the approach in IFRS 2 is that if entities were able not to recognise the cost of modified or cancelled options they would in effect be able to apply a selective form of 'truing up', whereby options that increased in value after grant would remain 'frozen' at their grant date valuation under the general principles of IFRS 2, whilst options that decreased in value could be modified or cancelled after grant date and credit taken for the fall in value. *[IFRS 2.BC222-237]*.

7.1.1 Determining the date of the modification

Determining the date of the modification is an important step in applying the rules for modification accounting. It is at that date that the entity must obtain a fair value not only for the modified award, but also for the original award updated to the date of modification, in order to determine any incremental fair value to be recognised. *[IFRS 2.27, IFRS 2.B43]*.

How should an entity determine the date of the modification?

IFRS 2 does not contain explicit guidance on determining the date of the modification, unlike determination of grant date. Grant date is defined as, "the date at which the entity and another party (including an employee) agree to a share-based payment arrangement, being when the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement… If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained." *[IFRS 2 Appendix A]*.

To determine the date of modification, we would expect an entity to first consider some of the existing principles in the standard on determining grant date. Not all these principles may be applicable in determining the date of the modification because grant date has already been established and the employees have either already provided or are currently providing services in return for the share-based payment award. The grant date principles that can be applied in establishing the date of modification include, there to be a shared understanding of the modified terms and conditions and the relevant approval for the modified award being obtained.

IG Examples 7, 9 and 12C of IFRS 2 refer to situations when the 'entity' modifies the award, for example, reprices share options, adds settlement alternatives or cancels and replaces awards. While these examples all refer to a 'modification date', there is no discussion on any principles used to determine this date. There may be instances where judgement is required in determining the date of the modification when other facts and circumstances indicate that the date of modification is different than the date employees are formally notified of a modification, especially when an entity has obtained relevant board approvals prior to employees being notified. Some of the factors to consider in addition to the grant date principles are as follows:

- A modification that is beneficial to employees approved by the board, for example removal of a non-market vesting condition or reducing the exercise price, where there is no subsequent further approval required (for example, by shareholders) and the communication to employees is shortly after that approval date, may indicate the date of the modification arises at the date of board approval. A factor that may further help to support the board approval date as the date of the modification is if there was some form of communication prior to the approval of a change in terms that created a valid expectation by the employees prior to the board approval that the award would be modified. Another factor to support the board approval date for the modification is that the communication to employees shortly after the board approval is considered an administrative task. If there was a substantive delay in communicating the amended award to employees, it is important to understand why there was such a delay and this could be a factor in determining that the date of the modification is when there is a shared understanding of the terms by both parties i.e., at the later date.
- Where an entity is permitted to amend certain terms and conditions of the original award that do not require approval by the employees, the date of modification is likely to be the date of board approval for the modified terms, provided the approval creates rights and obligations for both parties (the employee and entity). See discussion above in section 5.3.8, where an entity has discretion to modify the details of an award after grant date. If a modification requires the approval by employees or requires further services to be provided (for example, in a situation where the vesting period is extended), the date of modification is likely to be once a shared understanding of the terms has been reached.

The above are some of the factors to consider in addition to the grant date principles; there may be others and an entity will need to consider all facts and circumstances to establish the date of modification.

How we see it

There is no accounting policy choice to determine the date of modification, and we would expect an entity to first consider some of the principles in the standard on determining grant date, such as there being a shared understanding of the modified terms and conditions and the relevant approval for the modified award being obtained.

A mere intent by the entity's management to change the conditions of the award is not sufficient to determine a modification date as an intent would not create rights and obligations under the share-based payment arrangement. There is no basis in IFRS 2 for accounting for an anticipated future change to the terms of an award. The entity must account for those awards in issue at the reporting date (see section 7.6 below).

However, there could be instances where judgement is required in determining the date of the modification when other facts and circumstances indicate that the date of modification is different than the date employees are formally notified of a modification.

7.2 Valuation requirements when an award is modified, cancelled or settled

These provisions have the important practical consequence that, when an award is modified, cancelled or settled, the entity must obtain a fair value not only for the modified award, but also for the original award, updated to the date of modification. If the award had not been modified, there would have been no need to obtain a valuation for the original award after the date of grant.

Any modification of a performance condition clearly has an impact on the 'real' value of an award but it may have no direct effect on the value of the award for the purposes of IFRS 2. As discussed in sections 6.2 to 6.4 above, this is because market conditions and non-vesting conditions are taken into account in valuing an award whereas non-market vesting conditions are not. Accordingly, by implication, a change to a non-market performance condition will not necessarily affect the expense recognised for the award under IFRS 2.

For example, if an award is contingent upon sales of a given number of units and the number of units required to be sold is decreased, the 'real' value of the award is clearly increased. However, as the performance condition is a non-market vesting condition, and therefore not relevant to the original determination of the value of the award, there is no incremental fair value required to be accounted for by IFRS 2. If the change in the condition results in an increase in the estimated number of awards expected to vest, the change of estimate will however give rise to an accounting charge (see sections 6.1 to 6.4 above).

If an award is modified by changing the service period, the situation is more complex. A service condition does not of itself change the fair value of the award for the purposes of IFRS 2, but a change in service period may indirectly change the life of the award, which is relevant to its value (see section 8 below). Similar considerations apply where performance conditions are modified in such a way as to alter the anticipated vesting date.

The valuation requirements relating to cancelled and settled awards are considered further in section 7.4 below.

7.3 Modification

When an award is modified, the entity must as a minimum recognise the cost of the original award as if it had not been modified (i.e., at the original grant date fair value, spread over the original vesting period, and subject to the original vesting conditions). This applies unless the award does not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date. *[IFRS 2.27, IFRS 2.B42]*.

In addition, a further cost must be recognised for any modifications that increase the fair value of the award. This additional cost is spread over the period from the date of modification until the vesting date of the modified award, which might not be the same as that of the original award. Where a modification is made after the original vesting period has expired, and is subject to no further vesting conditions, any incremental fair value must be recognised immediately. *[IFRS 2.27, IFRS 2.B42, IFRS 2.B43]*.

Whether a modification increases or decreases the fair value of an award is determined as at the date of modification, as demonstrated by Illustration 7-1. *[IFRS 2.27, IFRS 2.B42, IFRS 2.B43, IFRS 2.B44]*.

Illustration 7-1: Does a modification increase or decrease the value of an award?

At the beginning of year 1, an entity granted two executives, A and B, a number of options worth CU100 each.

At the beginning of year 2, A's options are modified such that they have a fair value of CU85, their current fair value being CU80. This is treated as an increase in fair value of CU5 (even though the modified award is worth less than the original award when first granted). Therefore, an additional CU5 of expense would be recognised in respect of A's options.

At the beginning of year 3, B's options are modified such that they have a fair value of CU120, their current fair value being CU125. This is treated as a reduction in fair value of CU5 (even though the modified award is worth more than the original award when first granted). However, there is no change to the expense recognised for B's options as IFRS 2 requires the entity to recognise, as a minimum, the original grant date fair value of the options (i.e., CU100).

This treatment ensures that movements in the fair value of the original award are not reflected in the entity's profit or loss, consistent with the treatment of other equity instruments under IFRS accounting standards.

IFRS 2 provides further detailed guidance on this requirement as discussed below.

7.3.1 Modifications that increase the value of an award

7.3.1.A Increase in fair value of equity instruments granted

If the modification increases the fair value of the equity instruments granted, (e.g., by reducing the exercise price or changing the exercise period), the incremental fair value, measured at the date of modification, must be recognised over the period from the date of modification to the date of vesting for the modified instruments, as demonstrated in Illustration 7-2 below. *[IFRS 2.B43(a), IFRS 2.IG15, IFRS 2.IG Example 7]*.

Illustration 7-2: Award modified by repricing

At the beginning of year 1, an entity grants 100 share options to each of its 500 employees. Each grant is conditional upon the employee remaining in service over the next three years. The entity estimates that the fair value of each option is CU15.

By the end of year 1, the entity's share price has dropped, and the entity reprices its share options. The repriced share options vest at the end of year 3. The entity estimates that, at the date of repricing, the fair value of each of the original share options granted (i.e., before taking into account the repricing) is CU5 and that the fair value of each repriced share option is CU8.

40 employees leave during year 1. The entity estimates that a further 70 employees will leave during years 2 and 3, so that there will be 390 employees at the end of year 3 (500 - 40 - 70).

During year 2, a further 35 employees leave, and the entity estimates that a further 30 employees will leave during year 3, so that there will be 395 employees at the end of year 3 (500 - 40 - 35 - 30).

During year 3, 28 employees leave, and hence a total of 103 employees ceased employment during the original three year vesting period, so that, for the remaining 397 employees, the original share options vest at the end of year 3.

IFRS 2 requires the entity to recognise:

- The cost of the original award at grant date (CU15 per option) over a three year vesting period beginning at the start of year 1.
- Plus, the incremental fair value of the repriced options at repricing date (CU3 per option, being the CU8 fair value of each repriced option less the CU5 fair value of the original option) over a two year vesting period beginning at the date of repricing (end of year 1).

This would be calculated as follows:

Year	Calculation of cumulative expense		Cumulative expense (CU)	Expense for period (CU)
	Original award (a)	Modified award (b)	(a+b)	
1	390 employees × 100 options × CU15 × 1/3		195,000	195,000
2	395 employees × 100 options × CU15 × 2/3	395 employees × 100 options × CU3 × 1/2	454,250	259,250
3	397 employees × 100 options × CU15	397 employees × 100 options × CU3	714,600	260,350

In effect, IFRS 2 treats the original award and the incremental value of the modified award as if they were two separate awards.

A similar treatment to that in Illustration 7-2 above is adopted where the fair value of an award subject to a market condition has its value increased by the removal or mitigation of the market condition. *[IFRS 2.B43(a), IFRS 2.B43(c)]*. Where a vesting condition other than a market condition is changed, the treatment set out in section 7.3.1.C below is adopted. IFRS 2 does not specifically address the situation where the fair value of an award is increased by the removal or mitigation of a non-vesting condition.

How we see it

In our view, it seems appropriate to account for the increase in fair value by the removal or mitigation of a non-vesting condition in the same way as for a modification caused by the removal or mitigation of a market condition - i.e., as in Illustration 7-2 above.

7.3.1.B Increase in number of equity instruments granted

If the modification increases the number of equity instruments granted, the fair value of the additional instruments, measured at the date of modification, must be recognised over the period from the date of modification to the date of vesting for the modified instruments. If there is no further vesting period for the modified instruments, the incremental cost must be recognised immediately. *[IFRS 2.B43(b)]*.

7.3.1.C Removal or mitigation of non-market vesting conditions

Where a vesting condition, other than a market condition, is modified in a manner that is beneficial to the employee, the modified vesting condition is required to be taken into account when applying the general requirements of IFRS 2 as discussed in sections 6.1 to 6.4 above - in other words, the entity would continuously estimate the number of awards likely to vest and/or the vesting period. *[IFRS 2.B43(c)]*. This is consistent with the general principle of IFRS 2 that vesting conditions, other than market conditions, are not taken into account in the valuation of awards, but are reflected by recognising a cost for those instruments that ultimately vest on achievement of those conditions. See also the discussion in section 7.2 above.

IFRS 2 does not provide an example that addresses this point specifically, but we assume that the intended approach is as in Illustration 7-3 below. In this example, the entity modifies an award in a way that is beneficial to the employee even though the modification does not result in any incremental fair value. The effect of the modification is therefore recognised by basing the expense on the original grant date fair value of the awards and an assessment of the extent to which the modified vesting conditions will be met.

Illustration 7-3: Modification of non-market vesting condition in employee's favour

At the beginning of year 1, the entity grants 1,000 share options to each member of its sales team, with exercise conditional upon the employee remaining in the entity's employment for three years, and the team selling more than 50,000 units of a particular product over the three year period. The fair value of the share options is CU15 per option at the date of grant.

At the end of year 1, the entity estimates that a total of 48,000 units will be sold, and accordingly records no cost for the award in year 1.

During year 2, there is so severe a downturn in trading conditions that the entity believes that the sales target is too demanding to have any motivational effect, and reduces the target to 30,000 units, which it believes is achievable. It also expects 14 members of the sales team to remain in employment throughout the three year performance period. It therefore records an expense in year 2 of CU140,000 (CU15 × 14 employees × 1,000 options × 2/3). This cost is based on the originally assessed value of the award (i.e., CU15) since the performance condition was never factored into the original valuation, such that any change in performance condition likewise has no effect on the valuation and does not result in any incremental fair value.

By the end of year 3, the entity has sold 35,000 units, and the share options vest as the modified performance condition has been met. Twelve members of the sales team have remained in service for the three year period. The entity would therefore recognise a total cost of CU180,000 (12 employees × 1,000 options × CU15), giving an additional cost in year 3 of CU40,000 (total charge CU180,000, less CU140,000 charged in year 2).

How we see it

Where a vesting condition, other than a market condition, is modified in a manner that is beneficial to the employee, the modified vesting condition is taken into account when applying the general requirements of IFRS 2, and the entity would continuously estimate the number of awards likely to vest and/or the vesting period.

The difference between the accounting consequences for different methods of enhancing an award could cause confusion in some cases. For example, it may sometimes not be clear whether an award has been modified by increasing the number of equity instruments or by lowering the performance targets, as demonstrated in Illustration 7-4.

Illustration 7-4: Increase in number of equity instruments or modification of vesting conditions?

An entity grants a performance-related award which provides for different numbers of options to vest after 3 years, depending on different performance targets as follows:

Profit growth	Number of options
5%-10%	100
10%-15%	200
over 15%	300

During the vesting period, the entity concludes that the criteria are too demanding and modifies them as follows:

Profit growth	Number of options
5%-10%	200
over 10%	300

This raises the issue of whether the entity has changed:

(a) The performance conditions for the vesting of 200 or 300 options.

Or

(b) The number of equity instruments awarded for achieving growth of 5%-10% or growth of over 10%.

In our view, the reality is that the change is to the performance conditions for the vesting of 200 or 300 options, and must therefore be dealt with as in section 7.3.1.C, rather than in section 7.3.1.B, above. Suppose, however, that the conditions had been modified as follows:

Profit growth	Number of options
5%-10%	200
10%-15%	300
over 15%	400

In that case, there has clearly been an increase in the number of equity instruments subject to an award for a growth increase of over 15%, which would have to be accounted for as such (i.e., under section 7.3.1.B, rather than section 7.3.1.C, above). In such a case, it seems more appropriate also to deal with the changes to the lower bands as changes to the number of shares awarded rather than as changes to the performance conditions.

How we see it

The removal of the 'over 15%' performance condition is seen as a change in performance condition, whereas the increase in options for each profit growth target is seen an increase in the number of equity instruments granted.

7.3.2 Modifications that decrease the value of an award

This type of modification does not occur very often, as the effect would be somewhat demotivating and, in some cases, contrary to local labour regulations. However, there have been occasional examples of an award being made more onerous - usually in response to criticism by shareholders that the original terms were insufficiently demanding.

The general requirement of IFRS 2 (as outlined in section 7.3 above) is that, where an award is made more onerous (and therefore less valuable), the financial statements must still recognise the cost of the original award. This rule is in part an anti-avoidance measure since, without it, an entity could reverse the cost of an out-of-the-money award by modifying it so that it was unlikely to vest (for example, by adding unattainable non-market performance conditions) rather than cancelling the award and triggering an acceleration of expense as in section 7.1 above.

7.3.2.A Decrease in fair value of equity instruments granted

If the modification decreases the fair value of the equity instruments granted (e.g., by increasing the exercise price or reducing the exercise period), the decrease in value is effectively ignored and the entity continues to recognise a cost for services as if the awards had not been modified. *[IFRS 2.B44(a)]*. This approach also applies to reductions in the fair value of an award by the addition of a market condition or by making an existing market condition more onerous. *[IFRS 2.B44(a), IFRS 2.B44(c)]*.

How we see it

IFRS 2 notes the approach to apply to modifications of awards for market conditions that are not beneficial to employees (e.g., the decrease in fair value is effectively ignored) but has no specific guidance on how the above approach applies to non-vesting conditions. We assume that reductions in the fair value resulting from the addition or amendment of a non-vesting condition are similarly ignored.

Illustration 7-5 demonstrates the accounting for an award that is modified by replacing a non-market performance condition with a market condition:

Illustration 7-5: Award modified by replacing a non-market performance condition with a market condition

At the beginning of year 1, an entity grants 1,000 share options to each of its 10 employees, with exercise conditional upon the employee remaining in the entity's employment for three years, and an earnings per share (EPS) target (non-market performance condition) being met over the three-year period. The fair value of the share options is CU15 per option at the date of grant.

At the end of year 1, the entity estimates that all the employees will remain in service until the end of year 3 and that the EPS target will be met. It therefore records a cost of CU50,000 for the award in year 1 (CU15 × 10 employees × 1,000 options × 1/3).

During year 2, the entity reassesses the arrangement and replaces the EPS target with a share price target (market condition) that must be achieved by the end of year 3. At the date of modification, the fair value of the option with the market condition is CU12 and the fair value of the original option is CU17. Therefore, the fair value of the awards has decreased as a result of the modification but, under IFRS 2, this decrease is not accounted for and the entity must continue to use the original grant date fair value. An expense must be recognised based on this grant date fair value unless the award does not vest due to failure to meet a service or non-market performance condition specified at the original grant date. At the original grant date, the conditions were a service condition and a non-market performance condition. With the removal of the non-market performance condition, the only condition that has been in place since grant date is the service condition.

At the end of year 2 the entity estimates that nine employees will fulfil the service condition by the end of year 3. It therefore records a cumulative expense in year 2 of CU90,000 (CU15 × 9 employees × 1,000 options × 2/3) and an expense for the year of CU40,000 (CU90,000 - CU50,000).

At the end of year 3 the share price target has not been met but eight employees have met the service condition. The entity therefore recognises a cumulative expense of CU120,000 ((CU15 × 8 employees × 1,000 options) and an expense for the year of CU30,000 (CU120,000 - CU90,000).

It can be seen that the only expense reversal relates to those employees who have forfeited their options by failing to fulfil the employment condition. There is no reversal of expense for those employees who met the service condition but whose options did not vest (in real terms) because the market condition was not met. In IFRS 2 terms the options of those eight employees vested because all non-market conditions were met and so the entity has to recognise the grant date fair value for those awards. This is the case even though the original grant date fair value did not take account of the effect of the market condition (unlike an award with a market condition specified from grant date). This outcome is the result of the different treatment of market and non-market vesting conditions under IFRS 2 and the requirement to recognise an expense for an award with a market condition provided all other conditions have been met (see further discussion in section 6.3.2 above).

7.3.2.B Decrease in number of equity instruments granted

If the modification reduces the number of equity instruments granted, IFRS 2 requires the reduction to be treated as a cancellation of that portion of the award (see section 7.4 below). *[IFRS 2.B44(b)]*. Essentially this has the effect that any previously unrecognised cost of the cancelled instruments is immediately recognised in full, whereas the cost of an award whose value is reduced by other means continues to be spread in full over the remaining vesting period.

In situations where a decrease in the number of equity instruments is combined with other modifications so that the total fair value of the award remains the same or increases, it is unclear whether IFRS 2 requires an approach based on the value of the award as a whole or, as in the previous paragraph, one based on each equity instrument as the unit of account. This is considered further in section 7.3.4 below.

7.3.2.C Additional or more onerous non-market vesting conditions

Where a non-market vesting condition is modified in a manner that is not beneficial to the employee, again it is ignored and a cost recognised as if the original award had not been modified, as shown by Illustration 7-6 (which is based on IG Example 8 in the implementation guidance to IFRS 2). *[IFRS 2.B44(c), IFRS 2.IG15, IFRS 2.IG Example 8]*.

Illustration 7-6: Award modified by changing non-market performance conditions or service conditions

At the beginning of year 1, the entity grants 1,000 share options to each member of its sales team, conditional upon the employee remaining in the entity's employment for three years, and the team selling more than 50,000 units of a particular product over the three-year period. The fair value of the share options is CU15 per option at the date of grant. During year 2, the entity believes that the sales target is insufficiently demanding and increases it to 100,000 units. By the end of year 3, the entity has sold 55,000 units, and the modified share options are forfeited. Twelve members of the sales team have remained in service for the three-year period.

On the basis that the original target would have been met, and twelve employees would have been eligible for awards, the entity would recognise a total cost of CU180,000 (12 employees × 1,000 options × CU15) in accordance with the minimum cost requirements of IFRS 2.27. The cumulative cost in years 1 and 2 would, as in the Illustrations above, reflect the entity's best estimate of the original 50,000 unit sales target being achieved at the end of year 3. If, conversely, sales of only 49,000 units had been achieved, any cost booked for the award in years 1 and 2 would have been reversed in year 3, since the original target of 50,000 units would not have been met.

It is noted in IG Example 8 that the same accounting result would have occurred if the entity had increased the service requirement rather than modifying the performance target. Because such a modification would make it less likely that the options would vest, which would not be beneficial to the employees, the entity would take no account of the modified service condition when recognising the services received. Instead, it would recognise the services received from the twelve employees who remained in service for the original three-year vesting period. Other modifications to vesting periods are discussed below.

7.3.3 Modifications with altered vesting period

As noted in section 7.3.1 above, where an award is modified so that its value increases, IFRS 2 requires the entity to continue to recognise an expense for the grant date fair value of the unmodified award over its original vesting period, even where the vesting period of the modified award is longer. This appears to have the effect that an expense may need to be recognised for awards that do not actually vest, as demonstrated by Illustration 7-7 (which is based on Illustration 7-2 above).

Illustration 7-7: Award modified by reducing the exercise price and extending the vesting period

At the beginning of year 1, an entity grants 100 share options to each of its 500 employees, with vesting conditional upon the employee remaining in service over the next three years. The entity estimates that the fair value of each option is CU15.

By the end of year 1, the entity's share price has dropped, and the entity reprices its share options. The repriced share options vest at the end of year 4. The entity estimates that, at the date of repricing, the fair value of each of the original share options granted (i.e., before taking into account the repricing) is CU5 and that the fair value of each repriced share option is CU7.

40 employees leave during year 1. The entity estimates that a further 70 employees will leave during years 2 and 3, and a further 25 employees during year 4, such that there will be 390 employees at the end of year 3 (500 - 40 - 70) and 365 (500 - 40 - 70 - 25) at the end of year 4.

During year 2, a further 35 employees leave, and the entity estimates that a further 30 employees will leave during year 3 and 30 more in year 4, such that there will be 395 employees at the end of year 3 (500 - 40 - 35 - 30) and 365 (500 - 40 - 35 - 30 - 30) at the end of year 4.

During year 3, 28 employees leave, and hence a total of 103 employees ceased employment during the original three-year vesting period, so that, for the remaining 397 employees, the original share options would have vested at the end of year 3. The entity now estimates that only a further 20 employees will leave during year 4, leaving 377 at the end of year 4. In fact, 25 employees leave, so that 372 satisfy the criteria for the modified options at the end of year 4.

In our view IFRS 2 requires the entity to recognise:

- The cost of the original award at grant date (CU15 per option) over a three-year vesting period beginning at the start of year 1, based on the ongoing best estimate of, and ultimately the actual, number of employees at the end of the original three-year vesting period.
- The incremental fair value of the repriced options at repricing date (CU2 per option, being the CU7 fair value of each repriced option less the CU5 fair value of the original option) over a three-year vesting period beginning at the date of repricing (end of year one), but based on the ongoing best estimate of, and ultimately the actual, number of employees at the end of the modified four-year vesting period.

This would be calculated as follows:

Year	Calculation of cumulative expense		Cumulative expense (CU)	Expense for period (CU)
	Original award	Modified award		
1	390 employees × 100 options × CU15 × 1/3		195,000	195,000
2	395 employees × 100 options × CU15 × 2/3	365 employees × 100 options × CU2 × 1/3	419,333	224,333
3	397 employees × 100 options × CU15	377 employees × 100 options × CU2 × 2/3	645,767	226,434
4	397 employees × 100 options × CU15	372 employees × 100 options × CU2	669,900	24,133

How we see it

It may seem strange that a cost is being recognised for the original award in respect of the 25 employees who leave during year 4, who are never entitled to anything. However, in our view, this is consistent with:

- The overall requirement of IFRS 2 that the minimum cost of a modified award is the cost that would have been recognised if the award had not been modified.
- IG Example 8 in IFRS 2 (the substance of which is reproduced in Illustration 7-6 above) where an expense is clearly required to be recognised to the extent that the original performance conditions would have been met if the award had not been modified.

As noted in Illustrations 7-6 and 7-7 above, the rule in IFRS 2 requiring recognition of a minimum expense for a modified award (i.e., as if the original award had remained in place) applies irrespective of whether the effect of the modification is that an award becomes less valuable to the employee (as in Illustration 7-6) or more valuable to the employee (as in Illustration 7-7).

Where a modified vesting period is shorter than the original vesting period, a question arises on when all of the expense relating to both the original and modified elements of the award must be recognised.

How we see it

In our view, the expense is recognised by the end of the modified vesting period as no services will be rendered beyond that point. In this type of modification - as distinct from a change of estimate where there is a variable vesting period (see section 6.2.3 above) - we believe that an entity has an accounting policy choice between retrospective and prospective adjustment of the vesting period as at the modification date.

The overall expense recognised between grant date and vesting date will be the same in both cases, but there will be timing differences in the recognition of the expense, with retrospective accounting resulting in a higher expense as at the modification date itself.

7.3.4 Modifications that reduce the number of equity instruments granted but maintain or increase the value of an award ('value for value' exchanges and 'give and take' modifications)

As discussed in section 7.3.2.B above, cancellation accounting has to be applied to a reduction in the number of equity instruments when a modification reduces both the number of equity instruments granted and the total fair value of the award. *[IFRS 2.B44(b)]*. This approach is consistent with the fact that part of the award has been removed without compensation to the employee. However, a modification of this kind is rarely seen in practice because of the demotivating effect and, in some jurisdictions, a requirement to pay compensation to the counterparty. An entity is more likely to modify an award so that the overall fair value remains the same, or increases, even if the number of equity instruments is reduced. These types of modification, sometimes known as 'value for value' exchanges or 'give and take' modifications, are considered below.

Where an entity reduces the number of equity instruments but also makes other changes so that the total fair value of the modified award remains the same as, or exceeds, that of the original award as at the modification date, it is unclear whether the unit of account for accounting purposes must be an individual equity instrument or the award as a whole. Illustrations 7-8 and 7-9 below demonstrate the two situations and the two approaches.

Illustration 7-8: Modification where number of equity instruments is reduced but total fair value of award is unchanged

At the beginning of year 1, an entity granted an employee 200 share options with a grant date fair value of CU9 and a vesting period of three years. During years 1 and 2, the entity recognises a cumulative expense of CU1,200 (200 × CU9 × 2/3). At the end of year 2 the exercise price of the options is significantly higher than the market price and the options have a fair value of CU5 per option. On this date, the entity modifies the award and exchanges the 200 underwater options for 100 'at the money' options with a fair value of CU10 each. The total fair value of the new awards of CU1,000 (100 × CU10) equals the total fair value of the awards exchanged (200 × CU5), as measured at the modification date.

View 1 is that the unit of account is an individual option. Taking this approach, the decrease in the number of options from 200 to 100 will be accounted for as a cancellation with an acceleration at the modification date of any unexpensed element of the grant date fair value of 100 options (i.e., recognition of an additional amount of CU300 (100 × CU9 × 1/3)) The grant date fair value of the remaining 100 options continues to be recognised over the remainder of the vesting period together with their incremental fair value following the modification. Therefore, in year 3, there would be an expense of CU300 (for the remaining grant date fair value) plus CU500 (100 × (CU10 - CU5)) for the incremental fair value of 100 options. In total, therefore, an expense of CU2,300 is recognised.

View 2 is that the total number of options exchanged is the more appropriate unit of account. In this case, the cancellation of the original options and the grant of replacement options are accounted for as one modification. There would therefore be no acceleration of expense in respect of the reduction in the number of options from 200 to 100 and the grant date fair value of the original award would continue to be recognised over the vesting period. In this case, the total expense recognised would be CU1,800 (200 × CU9).

Illustration 7-9: Modification where number of equity instruments is reduced but total fair value of award is increased

At the beginning of year 1, an entity granted to its employees 1,000 share options with an exercise price equal to the market price of the shares at grant date. There is a two-year vesting period and the grant date fair value is CU10 per option. The entity's share price has declined significantly so that the share price is currently significantly less than the exercise price. At the end of year 1, the entity decides to reduce the exercise price of the options and, as part of the modification, it also reduces the number of options from 1,000 to 800. At the date of modification, the fair value of the original options is CU7 per option and that of the modified options CU11 per option.

View 1 is that the unit of account is an individual option. Taking this approach, the decrease in the number of options from 1,000 to 800 will be accounted for as a cancellation of 200 options with an acceleration at the modification date of any remaining grant date fair value relating to those 200 options. The total expense recognised in year 1 is CU6,000 ((800 × CU10 × ½) + (200 × CU10)). The grant date fair value of the remaining 800 options continues to be recognised over the remainder of the vesting period together with the incremental fair value of those options as measured at the modification date. In total the entity will recognise an expense of CU13,200 (original grant date fair value of CU10,000 (1,000 × CU10) plus incremental fair value of CU3,200 (800 × CU(11 - 7)).

View 2 is that the unit of account is the total number of options as there are linked modifications forming one package. In this case, the incremental fair value is calculated as the difference between the total fair value before and after the modification. In total the entity will recognise an expense of CU11,800 (original grant date fair value of CU10,000 (1,000 × CU10) plus incremental fair value on modification of CU1,800 ((800 × CU11) - (1,000 × CU7)).

In both Examples above, the first view is based on IFRS 2.B44(b) which states that "if the modification reduces the number of equity instruments granted to an employee, that reduction shall be accounted for as a cancellation of that portion of the grant, in accordance with the requirements of paragraph 28". This is perhaps further supported by IFRS 2.B43(a) which, in providing guidance on accounting for a modification that increases the fair value of an equity instrument, appears only to refer to individual equity instruments when it states that 'the incremental fair value granted' in a modification is "the difference between the fair value of the modified equity instrument and that of the original equity instrument, both estimated as at the date of modification". *[IFRS 2.B43, IFRS 2.B44]*.

The second view is based on the overriding requirement in IFRS 2.27 for the grant date fair value of the equity instruments to be recognised unless the awards do not vest due to a failure to meet a vesting condition (other than a market condition) that was specified at grant date. This requirement is applicable even if the award is modified after the grant date. The same paragraph also requires an entity to recognise the effect of modifications "that increase the total fair value of the share-based payment arrangement or are otherwise beneficial to the employee". This reference to 'total fair value' supports the view that the total award is the unit of account and is reiterated in IFRS 2.B42 and B44 which provide guidance, respectively, for situations where the total fair value decreases or increases as a consequence of the modification of an award. Supporters of view 2 further consider that, in contrast to the cancellation accounting approach that is required in the very specific case where part of the award is, in effect, settled for no consideration (see section 7.3.2.B above), a modification that reduces the number of equity instruments but maintains or increases the overall fair value of the award clearly provides the counterparty with a benefit. As a consequence, it is considered that no element of the grant date fair value is required to be accelerated as a cancellation expense. *[IFRS 2.27, IFRS 2.B42, IFRS 2.B44]*.

How we see it

Given the lack of clarity in IFRS 2, we believe that an entity could make an accounting policy choice as to whether it considers the unit of account to be an individual equity instrument or an award as a whole. However, once made, that accounting policy choice is applied consistently to all modifications that reduce the number of equity instruments but maintain or increase the overall fair value of an award. Whichever policy is chosen, the general requirements of IFRS 2 will still need to be applied in order to determine whether or not the amendments to the arrangement are such that it is appropriate to treat the changes as a modification (in IFRS 2 terms) rather than as a completely new award (see sections 7.4.2 and 7.4.4 below).

7.3.5 Modification of award from equity-settled to cash-settled (and *vice versa*)

Occasionally an award that was equity-settled when originally granted is modified so as to become cash-settled, or an originally cash-settled award is modified so as to become equity-settled. Such modifications are discussed in section 9.4 below.

7.4 Cancellation and settlement

Where an award is cancelled or settled (i.e., cancelled with some form of compensation), other than by forfeiture for failure to satisfy the vesting conditions:

(a) If the cancellation or settlement occurs during the vesting period, it is treated as an acceleration of vesting, and the entity recognises immediately the amount that would otherwise have been recognised for services received over the remainder of the vesting period.

(b) Where the entity pays compensation for a cancelled award:

  (i) Any compensation paid up to the fair value of the award at cancellation or settlement date (whether before or after vesting) is accounted for as a deduction from equity, as being equivalent to the redemption of an equity instrument.

  (ii) Any compensation paid in excess of the fair value of the award at cancellation or settlement date (whether before or after vesting) is accounted for as an expense in profit or loss.

  (iii) If the share-based payment arrangement includes liability components, the fair value of the liability is remeasured at the date of cancellation or settlement. Any payment made to settle the liability component is accounted for as an extinguishment of the liability.

(c) If the entity grants new equity instruments during the vesting period and, on the date that they are granted, identifies them as replacing the cancelled or settled instruments, the entity is required to account for the new equity instruments as if they were a modification of the cancelled or settled award. Otherwise, it accounts for the new instruments as an entirely new award. *[IFRS 2.28, IFRS 2.29]*.

The treatment of the cancelled or settled award in (a) above is similar, in its effect on profit or loss, to the result that would have occurred if:

- The fair value of the equity instruments issued had been recorded in full at grant date with a corresponding debit to a prepayment for 'services to be rendered'
- The prepayment were written off on a periodic basis until cancellation or settlement
- Any remaining prepayment at the date of cancellation or settlement were written off in full

It should be noted that the calculation of any additional expense in (b) above depends on the fair value of the award at the date of cancellation or settlement, not on the cumulative expense already charged. This has the important practical consequence that, when an entity pays compensation on cancellation or settlement of an award, it must obtain a fair value for the original award, updated to the date of cancellation or settlement. If the award had not been cancelled or settled, there would have been no need to obtain a valuation for the original award after the date of grant.

These requirements raise some further detailed issues of interpretation on a number of areas, as follows:

- The distinction between 'cancellation' and 'forfeiture' (see section 7.4.1 below)
- The distinction between 'cancellation' and 'modification' (see section 7.4.2 below)
- The calculation of the expense on cancellation (see section 7.4.3 below)
- Replacement awards (see sections 7.4.4 and 7.5 below)

7.4.1 Distinction between cancellation and forfeiture

The provisions of IFRS 2 summarised in section 7.4 above apply when an award of equity instruments is cancelled or settled "…other than a grant cancelled by forfeiture when the vesting conditions are not satisfied". *[IFRS 2.28]*. The significance of this is that the terms of many share-based awards provide that they are, or can be, 'cancelled', in a legal sense, on forfeiture. IFRS 2 is clarifying that, where an award is forfeited (within the meaning of that term in IFRS 2 see section 6.1.2 above), the entity must apply the accounting treatment for a forfeiture (i.e., reversal of expense previously recognised), even if the award is legally cancelled as a consequence of the forfeiture.

7.4.1.A Termination of employment by entity

Based on the guidance in IFRS 2.28 referred to in section 7.4.1 above, it might not always be immediately clear whether cancellation or forfeiture has occurred, particularly where options lapse as the result of a termination of employment by the entity. For example, an entity might grant options to an employee at the beginning of year 1 on condition of his remaining in employment until at least the end of year 3. During year 2, however, economic conditions require the entity to make a number of its personnel, including that employee, redundant, as a result of which his options lapse. Is this lapse a forfeiture or a cancellation for the purposes of IFRS 2?

The uncertainty arises because it could be argued either that the employee will be unable to deliver the services required in order for the options to vest (suggesting a forfeiture) or that the options lapse as a direct result of the employer's actions (suggesting a cancellation).

The IASB addressed this question by amending the definition of 'service condition' in IFRS 2 (see section 3.1 above). The definition includes the following guidance:

"… If the counterparty, regardless of the reason, ceases to provide service during the vesting period, it has failed to satisfy the condition. …" *[IFRS 2 Appendix A]*.

Therefore, IFRS 2 requires the failure to satisfy a service condition as the result of any termination of employment to be accounted for as a forfeiture rather than as a cancellation.

7.4.1.B Surrender of award by employee

It is sometimes the case that an employee, often a member of senior management, will decide - or be encouraged by the entity - to surrender awards during the vesting period. The question arises as to whether the surrendered awards are to be treated as a cancellation or forfeiture for accounting purposes. IFRS 2 allows forfeiture accounting, and the consequent reversal of any cumulative expense, only in situations where vesting conditions are not satisfied. A situation where the counterparty voluntarily surrenders an award, and therefore the opportunity to meet the vesting conditions, is a decision within the control of the counterparty rather than a failure to satisfy a vesting condition and must be accounted for as a cancellation rather than as a forfeiture.

How we see it

In its amendment of IFRS 2 (as discussed in section 7.4.1.A above), we do not believe that the IASB's intention was to allow an employee to 'fail' to meet a service condition by voluntarily surrendering an award. Such an action therefore continues to be treated as a cancellation rather than as a forfeiture.

7.4.2 Distinction between cancellation and modification

One general issue raised by IFRS 2 is where the boundary lies between 'modification' of an award in the entity's favour and outright cancellation of the award. As a matter of legal form, the difference is obvious. However, if an entity were to modify an award in such a way that there was no realistic chance of it ever vesting (for example, by introducing a requirement that the share price increase 1,000,000 times by vesting date), some might argue that this amounts to a *de facto* cancellation of the award. The significance of the distinction is that, whereas the cost of a 'modified' award continues to be recognised on a periodic basis over the vesting period (see section 7.3 above), the remaining cost of a cancelled award is recognised immediately.

7.4.3 Calculation of the expense on cancellation

The basic accounting treatment for a cancellation and settlement is demonstrated in Illustration 7-10 below.

Illustration 7-10: Cancellation and settlement - basic accounting treatment

At the start of year 1 an entity grants an executive 30,000 options on condition that she remain in employment for three years. Each option is determined to have a fair value of CU10.

At the end of year 1, the executive is still in employment and the entity charges an IFRS 2 expense of CU100,000 (30,000 × CU10 × 1/3). At the end of year 2, the executive is still in employment. However, the entity's share price has suffered a decline which the entity does not expect to have reversed by the end of year 3, such that the options, while still 'in the money' now have a fair value of only CU6. Moreover, the entity is under pressure from major shareholders to end option schemes with no performance criteria other than continuing employment.

Accordingly, the entity cancels the options at the end of year 2 and in compensation pays the executive CU6.50 per option cancelled, a total payment of CU195,000 (30,000 options × CU6.50).

IFRS 2 first requires the entity to record a cost as if the options had vested immediately. The total cumulative cost for the award must be CU300,000 (30,000 options × CU10). CU100,000 was recognised in year 1, so that an additional cost of CU200,000 is recognised.

As regards the compensation payment, the fair value of the awards cancelled is CU180,000 (30,000 options × CU6.00). Accordingly, CU180,000 of the payment is accounted for as a deduction from equity, with the remaining payment in excess of fair value, CU15,000, charged to profit or loss.

The net effect of this is that an award that ultimately results in a cash payment to the executive of only CU195,000 (i.e., CU6.50 per option) has resulted in a total charge to profit or loss of CU315,000 (i.e., CU10.50 per option, representing CU10 grant date fair value + CU6.50 compensation payment - CU6.00 cancellation date fair value).

Illustration 7-10 demonstrates the basic calculation of the cancellation 'charge' required by IFRS 2. In more complex situations, however, the amount of the 'charge' may not be so clear-cut, due to an ambiguity in the drafting of IFRS 2.28(a), which reads as follows:

> "the entity shall account for the cancellation or settlement as an acceleration of vesting, and shall therefore recognise immediately the amount that would otherwise have been recognised for services received over the remainder of the vesting period." *[IFRS 2.28(a)]*.

There is something of a contradiction within this requirement as demonstrated by Illustration 7-11.

Illustration 7-11: Cancellation and settlement - best estimate of cancellation expense

At the beginning of year 1, entity A granted 150 employees an award of free shares, with a grant date fair value of CU5, conditional upon continuous service and performance targets over a 3-year period from grant date. The number of shares awarded varies according to the extent to which targets (all non-market vesting conditions) have been met, and could result in each employee still in service at the end of year 3 receiving a minimum of 600, and a maximum of 1,000 shares.

Halfway through year 2 (i.e., 18 months after grant date), A is acquired by B, following which A cancels all of its share awards. At the time of the cancellation, 130 of the original 150 employees were still in employment. At that time, it was A's best estimate that, had the award run to its full term, 120 employees would have received 900 shares each. Accordingly, the cumulative expense recognised by A for the award as at the date of takeover would, under the normal estimation processes of IFRS 2 discussed in sections 6.1 to 6.4 above, be CU270,000 (900 shares × 120 employees × CU5 × 18/36).

How must A account for the cancellation of this award?

The opening phrase of IFRS 2.28(a) - "the entity shall account for the cancellation … as an acceleration of vesting" - suggests that A must recognise a cost for all 130 employees in service at the date of cancellation. However, the following phrase - "[the entity] shall therefore recognise immediately the amount that would otherwise have been recognised for services received over the remainder of the vesting period" - suggests that the charge must be based on only 120 employees, the best estimate, as at the date of cancellation of the number of employees in whom shares will finally vest.

How we see it

In our view, either reading of IFRS 2.28(a) is possible. Recognise the cancellation cost, either based on the employees in service at the date of cancellation or based on the best estimate of the number of employees at the date of cancellation to whom the shares would vest.

There is then the issue of the number of shares per employee that is required to be taken into account in the cancellation charge. Is this the 1,000 shares per employee (the maximum number that could vest) or 900 shares per employee (the number expected by the entity at the date of cancellation actually to vest)?

How we see it

In our view, it is unclear from the standard whether the intention was that the cancellation charge is to be based on the number of shares considered likely, as at the date of cancellation, to vest for each employee (900 shares in this example) or whether it be based on the maximum number of shares (1,000 shares in this example). Given the lack of clarity, in our view an entity has to make an accounting policy choice.

In extreme cases, the entity's best estimate, as at the date of cancellation, might be that no awards are likely to vest. In this situation, no cancellation expense would be recognised. However, there would need to be evidence that this was not just a rather convenient assessment made as at the date of cancellation. Typically, the previous accounting periods would also have reflected a cumulative IFRS 2 expense of zero on the assumption that the awards would never vest.

An effect of these requirements is that IFRS 2 creates an accounting arbitrage between an award that is 'out of the money' but not cancelled (the cost of which continues to be spread over the remaining period to vesting) and one which is formally cancelled (the cost of which is recognised immediately). Entities might well prefer to opt for cancellation so as to create a 'one-off' charge to earnings rather than continue to show, particularly during difficult trading periods, significant periodic costs for options that no longer have any real value. However, such early cancellation of an award precludes any chance of the cost of the award being reversed through forfeiture during, or at the end of, the vesting period if the original vesting conditions are not met.

7.4.4 Replacement awards

The required accounting treatment of replacement awards, whilst generally clear, nevertheless raises some issues of interpretation. Most of this sub-section addresses the replacement of unvested awards but the treatment of vested awards is addressed in section 7.4.4.C below.

As set out in section 7.4 above, a new award that meets the criteria in IFRS 2.28(c) to be treated as a replacement of a cancelled or settled award is accounted for as a modification of the original award and any incremental value arising from the granting of the replacement award is recognised over the vesting period of that replacement award. Where the criteria are not met, the new equity instruments are accounted for as a new grant (in addition to accounting for the cancellation or settlement of the original arrangement). The requirements are discussed in more detail below.

7.4.4.A Designation of award as replacement award

Whether or not an award is a 'replacement' award (and therefore recognised at only its incremental, rather than its full, fair value) is determined by whether or not the entity designates it as such on the date that it is granted. In other words, the accounting treatment effectively hinges on declared management intent, notwithstanding the IASB's systematic exclusion of management intent from many other areas of financial reporting. The Basis for Conclusions does not really explain the reason for this approach, which is also hard to reconcile with the fact that the value of an award is unaffected by whether, or when, the entity declares it to be a 'replacement' award for the purposes of IFRS 2. Presumably, the underlying reason is to prevent a retrospective, and possibly opportunistic, assertion that an award that has been in issue for some time is a replacement for an earlier award.

Entities need to ensure that designation occurs on grant date as defined by IFRS 2 (see section 5.3 above). For example, if an entity cancels an award on 15 March and notifies an employee in writing on the same day of its intention to ask the remuneration committee to grant replacement options at its meeting two months later, on 15 May, such notification (although formal and in writing) may not strictly meet IFRS 2's requirement for designation on grant date (i.e., 15 May).

How we see it

In our view, what is important is that the entity establishes a clear link between the cancellation of the old award and the granting of a replacement award even if there is later formal approval of the replacement award following the communication of its terms to the counterparty at the same time as the cancellation of the old award.

As drafted, IFRS 2 gives entities an apparently free choice to designate any newly granted awards as replacement awards. In our view, however, such designation cannot credibly be made unless there is evidence of some connection between the cancelled and replacement awards. This might be that the cancelled and replacement awards involve the same counterparties, or that the cancellation and replacement are part of the same arrangement.

7.4.4.B Incremental fair value of replacement award

Where an award is designated as a replacement award, any incremental fair value must be recognised over the vesting period of the replacement award. The incremental fair value is the difference between the fair value of the replacement award and the 'net fair value' of the cancelled or settled award, both measured at the date on which the replacement award is granted. The net fair value of the cancelled or settled award is the fair value of the award, immediately before cancellation, less any compensation payment that is accounted for as a deduction from equity. *[IFRS 2.28(c)]*. Thus the 'net fair value' of the original award can never be less than zero (since any compensation payment in excess of the fair value of the cancelled award would be accounted for in profit or loss, not in equity - see Illustration 7-10 in section 7.4.3 above).

There is some confusion within IFRS 2 as to whether a different accounting treatment is intended to result from, on the one hand, modifying an award and, on the other hand, cancelling it and replacing it with a new award on the same terms as the modified award. This is explored in the discussion of Illustration 7-12 below, which is based on the same fact pattern as Illustration 7-2 in section 7.3.1.A above.

Illustration 7-12: Replacement awards - is there an accounting arbitrage between accounting for a modification and accounting for cancellation and a new grant?

At the beginning of year 1, an entity grants 100 share options to each of its 500 employees. Each grant is conditional upon the employee remaining in service over the next three years. The entity estimates that the fair value of each option is CU15.

By the end of year 1, the entity's share price has dropped. The entity cancels the existing options and issues options which it identifies as replacement options, which also vest at the end of year 3. The entity estimates that, at the date of cancellation, the fair value of each of the original share options granted is CU5 and that the fair value of each replacement share option is CU8.

40 employees leave during year 1. The entity estimates that a further 70 employees will leave during years 2 and 3, so that there will be 390 employees at the end of year 3 (500 - 40 - 70).

During year 2, a further 35 employees leave, and the entity estimates that a further 30 employees will leave during year 3, so that there will be 395 employees at the end of year 3 (500 - 40 - 35 - 30).

During year 3, 28 employees leave, and hence a total of 103 employees ceased employment during the original three-year vesting period, so that, for the remaining 397 employees, the replacement share options vest at the end of year 3.

The intention of the IASB appears to have been that the arrangement should be accounted for in exactly the same way as the modification in Illustration 7-2 above, since the Basis for Conclusions on IFRS 2 notes:

> "...the Board saw no difference between a repricing of share options and a cancellation of share options followed by the granting of replacement share options at a lower exercise price, and therefore concluded that the accounting treatment should be the same." *[IFRS 2.BC233]*.

However, it is not clear that this intention is actually reflected in the drafting of IFRS 2.28 which reads as follows:

> "If a grant of equity instruments is cancelled or settled during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):
>
> "(a) the entity shall account for the cancellation or settlement as an acceleration of vesting, and shall therefore recognise immediately the amount that otherwise would have been recognised for services received over the remainder of the vesting period.
>
> "(b) any payment made to the employee on the cancellation or settlement of the grant shall be accounted for as the repurchase of an equity interest, i.e. as a deduction from equity, except to the extent that the payment exceeds the fair value of the equity instruments granted, measured at the repurchase date. Any such excess shall be recognised as an expense. …
>
> "(c) if new equity instruments are granted to the employee and, on the date when those new equity instruments are granted, the entity identifies the new equity instruments granted as replacement equity instruments for the cancelled equity instruments, the entity shall account for the granting of replacement equity instruments in the same way as a modification of the original grant of equity instruments, in accordance with paragraph 27 and the guidance in Appendix B…". *[IFRS 2.28]*.

As a matter of natural construction, paragraph (a) requires the cancellation of the existing award to be treated as an acceleration of vesting - explicitly and without qualification. In particular there is no rider to the effect that the requirement of paragraph (a) is to be read as 'subject to paragraph (c) below'.

Paragraph (c) requires any 'new equity instruments' granted to be accounted for in the same way as a modification of the original grant of equity instruments. It does not require this treatment for the cancellation of the original instruments, because this has already been addressed in paragraph (a).

Moreover, in order to construe paragraphs (a) and (c) in a manner consistent with the Basis for Conclusions on the standard, it would be necessary to read paragraph (c) as effectively superseding paragraph (a). However, for this to be a valid reading, it would also be necessary to read paragraph (b) as also superseding paragraph (a), and this would produce a manifestly incorrect result, namely that, if an award is cancelled and settled, there is no need ever to expense any part of the cancelled award not yet expensed at the date of cancellation.

The application of, firstly, the main text of IFRS 2 and, secondly, the Basis for Conclusions on IFRS 2 to the entity in Illustration 7-12 is set out below.

The main text in IFRS 2 appears to require the entity to recognise:

- The entire cost of the original options at the end of year 1 (since cancellation has the effect that they are treated as vesting at that date), based on the 390 employees expected at that date to be in employment at the end of the vesting period. This is not the only possible interpretation of the requirement of IFRS 2.28(a) - see below and the broader discussion in Illustration 7-11 in section 7.4.3 above.
- For the options replacing the 390 cancelled awards, the incremental fair value of the replacement options at repricing date (CU3 per option, being the CU8 fair value of each replacement option less the CU5 fair value of each cancelled option) over a two year vesting period beginning at the date of cancellation (end of year 1), based on the (at first estimated and then actual) number of employees at the end of year 3 (i.e., the final number could be less than the estimate of 390).
- For any additional replacement options (i.e., replacement options awarded in excess of the 390 × 100 options that were expected to vest at cancellation date), the full incremental fair value at repricing date (being the CU8 fair value of each replacement option) over a two-year vesting period beginning at the repricing date (end of year 1). The expense is based on the (at first estimated and then actual) number of employees in excess of 390 at the end of year 3.

This would be calculated as follows:

Year	Calculation of cumulative expense		Cumulative expense (CU)	Expense for period (CU)
	Original award	Replacement award		
1	390 employees × 100 options × CU15	-	585,000	585,000
2	390 employees × 100 options × CU15	390 employees × 100 options × CU3 × 1/2 5 employees × 100 options × CU8 × 1/2	645,500	60,500
3	390 employees × 100 options × CU15	390 employees × 100 options × CU3 7 employees × 100 options × CU8	707,600	62,100

By contrast, the accounting treatment implied by the Basis for Conclusions is as follows (see Illustration 7-2 above):

Year	Calculation of cumulative expense		Cumulative expense (CU)	Expense for period (CU)
	Original award (a)	Modified award (b)	(a+b)	
1	390 employees × 100 options × CU15 × 1/3	-	195,000	195,000
2	395 employees × 100 options × CU15 × 2/3	395 employees × 100 options × CU3 × 1/2	454,250	259,250
3	397 employees × 100 options × CU15	397 employees × 100 options × CU3	714,600	260,350

It will be seen that both the periodic allocation of expense and the total expense differ under each interpretation. This is because, under the first interpretation, the cost of the original award is accelerated at the end of year 1 for all 390 employees expected at that date to be in employment at the end of the vesting period, whereas under the second interpretation a cost is recognised for the 397 employees whose awards finally vest. The difference between the two total charges of CU7,000 (CU714,600 - CU707,600) represents 397 - 390 = 7 employees @ CU1,000 [100 options × CU10[CU15 + CU3 - CU8]] each = CU7,000.

How we see it

We believe that either interpretation is valid, and an entity adopts one or the other consistently as a matter of accounting policy.

In Illustration 7-12 above, we base the cancellation calculations on 390 employees (the number expected to be employed at the end of the vesting period as estimated at the cancellation date) rather than on 460 employees (the number in employment at the cancellation date). As discussed in Illustration 7-11 in section 7.4.3 above, either approach may be adopted but the selected approach must be applied consistently.

The illustrative examples above involve a relatively straightforward fact pattern where, as at the date of cancellation and replacement, there was an amount to accelerate in respect of the cancelled awards and an incremental fair value associated with the replacement awards. In other scenarios, the two accounting outcomes might result in greater divergence. For example, if the cancelled awards were expected never to vest, because performance conditions had become unachievable and this had been the conclusion for some time (see section 7.4.3 above), the cancelled awards might have a value of zero on a cancellation basis and the full value of the replacement awards would be recognised. If modification accounting were applied, however, the entity would have to recognise the grant date fair value of the cancelled awards plus any incremental value of the replacement awards over the fair value of the cancelled awards as at cancellation date. The latter approach might result in a significantly higher cost.

The discussion above relates to situations in which awards are cancelled and replaced for reasons other than expected, or actual, failure by the counterparty to meet a service condition. Changes to awards in contemplation, or as a consequence, of cessation of employment are considered in section 5.3.9.B above and in sections 7.5 and 7.6 below.

7.4.4.C Replacement of vested awards

The rules for replacement awards summarised in paragraph (c) in section 7.4 above apply "if a grant of equity instruments is cancelled or settled during the vesting period …". *[IFRS 2.28]*. However, if the original award has already vested when a replacement award is granted, there is no question of accelerating the cost of the cancelled award, as it has already been recognised in full during the vesting period. The issue is rather the treatment of the new award itself. IFRS 2 does not explicitly address this point but it appears that such a replacement award is treated in the same way as a completely new award. In other words, its full fair value is recognised immediately or, if there are any vesting conditions for the replacement award, over its vesting period.

By contrast, the rules for modification of awards discussed in section 7.3 above apply whether the award has vested or not. Paragraphs 26 and 27 of IFRS 2 (modifications) are not restricted to events 'during the vesting period' in contrast to paragraph 28 (cancellation and settlement, including replacement awards), which is restricted to events 'during the vesting period'. *[IFRS 2.26, IFRS 2.27, IFRS 2.28]*.

How we see it

This has the effect that the accounting cost of modifying an already vested award (i.e., the incremental fair value of the modified award) could, at first sight, appear to be lower than the cost of cancelling and replacing it, which requires the full fair value of the new award to be expensed. However, the full fair value of the new replacement award will be reduced by the fair value of the cancelled award that the employee has surrendered as part of the consideration for the new award. This analysis will, in many cases, produce an accounting outcome similar to that of the modification of an unvested award.

7.5 Replacement and *ex gratia* awards on termination of employment

When an employee's employment is terminated during the vesting period of an award of shares or options, the award will typically lapse in consequence, in other words applying IFRS 2 the award is 'forfeited' (see sections 6.1.2 and 7.4 above). It is common in such situations, particularly where the employee was part of the senior management, for the entity to make an alternative award, or to allow the employee to retain existing awards, as part of the package of benefits agreed with the employee on termination of employment.

Generally, such an award is an *ex gratia* award - in other words, it is a discretionary award to which the outgoing employee had no legal entitlement under the terms of the original award. However, a number of plan rules set out, in a 'good leaver' clause (see section 5.3.9 above), the terms on which any *ex gratia* award may be made, usually by applying a formula to determine, or limit, how much of the original award can be considered to have vested.

In many cases the award will be made on a fully vested basis, i.e., the employee has full entitlement without further conditions needing to be fulfilled. In other cases, however, an employee will be allowed to retain awards that remain subject to the fulfilment of the original conditions (other than future service). Whichever form the award takes, in IFRS 2 terms it will be treated as vesting at the date of termination of employment because any remaining conditions will be accounted for as non-vesting conditions in the absence of an explicit or implied service condition (see section 3.2 above).

As discussed in section 7.4.1.A above, IFRS 2 requires an entity to apply forfeiture (rather than cancellation) accounting to awards that lapse if an employee is unable to satisfy a service condition for any reason. In amending the standard to make clear that forfeiture accounting applied to the termination of employment, the IASB did not specifically address the accounting for any replacement or *ex gratia* awards on termination of employment.

If the original award is accounted for as a forfeiture and any previously recognised cost reversed in anticipation of the employee's expected departure, it perhaps follows that any replacement award will be treated as a completely new award and recognised and measured based on its own grant date. However, the standard is not clear and there might be situations where entities consider it more appropriate to apply modification accounting (recognising the original grant date fair value of the award that would otherwise be forfeited on its original terms (because the service condition would not be met) plus the incremental value of the modified terms).

How we see it

In the absence of clarity in IFRS 2, we believe that judgement will be required based on the specific facts and circumstances and the extent to which the changes to the arrangements are considered to be a waiver of existing conditions in connection with the cessation of employment rather than the introduction of a discretionary replacement arrangement on completely new terms.

The impact on the IFRS 2 charge where the changes to the arrangements are considered to be a waiver of existing conditions in connection with the cessation of employment rather than the introduction of a discretionary replacement arrangement on completely new terms, are set out in Illustration 7-13 below.

Illustration 7-13: Replacement award on termination of employment

At the beginning of year 1, an executive is granted the right to 10,000 free shares on condition of remaining in service until the end of year 3. The fair value of the award at grant date is CU2.00 per share.

At the end of year 2, the executive's employment is terminated and he therefore loses his right to any shares. However, as *ex gratia* (voluntary) compensation, the remuneration committee awards him 6,667 shares vesting immediately. As at the end of year 2 the share price was CU4.00, and the fair value of the original award was CU3.60 per share. (This is lower than the current share price because the holder of a share is entitled to receive any dividends paid during year 3 whereas the holder of an unvested right to a share is not - see section 8.5.4 below.)

This raises the question of how the *ex gratia* award of 6,667 shares must be accounted for. The factors to be considered in determining the grant date in such cases are discussed further in section 5.3.9 above. For the purposes of this Example, it is assumed that the replacement award is treated as having been granted, or the original award is treated as having been modified, at the end of year 2 rather than the terms being in place as at the beginning of year 1.

Where the lapse is treated as a forfeiture, the entity:

- Reverses the cost already booked for the award of CU13,333 (10,000 shares × CU2 × 2/3)
- Recognises the cost of the *ex gratia* award (at the fair value at that award's grant date) of CU26,668 (6,667 shares × CU4)

This results in a net charge on termination of CU13,335.

If the lapse is treated as a modification of the original award, the entity:

- Accelerates the cost not yet booked for the original award of CU6,667 (10,000 shares × CU2 = CU20,000, less CU13,333 already recognised - see above) as there is no future service period
- Treats the *ex gratia* award as a replacement award at incremental value. The fair value of the replacement award of CU26,668 (6,667 shares × CU4 - see above) is compared to the fair value of the original award of CU36,000 (10,000 shares × CU3.60). Since the fair value of the replacement award is less than that of the original award, there is no incremental cost required to be recorded under IFRS 2

This results in a net charge on termination of CU6,667.

Illustration 7-13 assumes that the entity treats the entire award as the unit of account. An entity that has instead made a policy choice to base its modification accounting on an individual share or option as the unit of account (see further discussion in section 7.3.4 above) will have a different accounting outcome.

7.6 Entity's plans for future modification or replacement of award - impact on estimation process at reporting date

As discussed in sections 6.1.1 and 6.1.2 above, IFRS 2 requires an entity to determine a cumulative IFRS 2 charge at each reporting date by reference to the 'best available estimate' of the number of awards that will vest (within the special meaning of that term in IFRS 2).

In addition to the normal difficulties inherent in any estimation process, it is not entirely clear which anticipated future events must be taken into account in the IFRS 2 estimation process and which must not, as demonstrated by Illustration 7-14 below.

Illustration 7-14: Estimation of number of awards expected to vest - treatment of anticipated future events

At the beginning of year 1, an entity granted an award of 1,000 shares to each of its 600 employees at a particular manufacturing unit. The award vests on completion of three years' service. As at the end of year 1, the entity firmly intends to close the unit, and terminate the employment of employees, as part of a rationalisation programme. This closure would occur part way through year 2. The entity has not, however, announced its intentions or taken any other steps so as to allow provision for the closure under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (see Chapter 27 at section 6.1).

Under the original terms of the award, the award would lapse on termination of employment. However, the entity intends to compensate employees made redundant by changing the terms of their award so as to allow full vesting on termination of employment.

What is the 'best estimate', as at the end of year 1, of the number of awards expected to vest? Specifically, must the entity:

(a) Ignore the intended closure altogether, on the grounds that there is no other recognition of it in the financial statements.

(b) Take account of the impact of the intended closure on vesting of the current award, but ignore the intended future change to the terms of the award to allow vesting.

Or

(c) Take account of both the intended closure and the intended change to the terms of the award?

In our view, there is no basis in IFRS 2 for accounting for an anticipated future change to the terms of an award. The entity must account for those awards in issue at the reporting date, not those that might be in issue in the future. Accordingly, we do not consider approach (c) above to be appropriate if any change to the issued awards was simply an intention.

Equally, we struggle to support approach (a) above. IFRS 2 requires the entity to use its 'best available estimate' and its best available estimate as at the end of year 1 must be that the unit will be closed, and the employees' employment terminated, in year 2. This view is supported by the fact that, unlike IAS 36 *Impairment of Assets* (see Chapter 21) and IAS 37 (see Chapter 27), IFRS 2 does not explicitly prohibit an entity from taking account of the consequences of reorganisations and similar transactions to which it is not yet committed.

Accordingly, we believe that approach (b) must be followed under IFRS 2.

The entity's best estimate at the end of year 1 must be that none of the awards currently in place will vest (because all the employees will be made redundant and so will not meet the service condition before the end of the vesting period). It therefore applies forfeiture accounting at the end of year 1 and reverses any cost previously recorded for the award.

When the terms of the award are changed (see section 7.1.1 above) in year 2 to allow full vesting on redundancy, the entity will either recognise the full cost of the new award (as all cost relating to the original award has been reversed) or will treat the revised arrangement as a modification of the original award that is beneficial to the employee. In effect, the modification approach is based on a view that the original award is not now going to lapse because it will be modified before employment ceases and the forfeiture crystallises. In our view, in the absence of clarity in IFRS 2, the entity is required to assess the more appropriate approach based on the particular facts and circumstances.

Either approach will have what many may see as the less than ideal result that the entity will recognise a credit in profit or loss in year 1 and an expense in year 2, even though there has been no change in management's best estimate of the overall outcome. This follows from the analysis, discussed above, that we do not believe that the entity can account in year 1 for the award on the basis of what its terms may be in year 2.

The best estimate is made as at each reporting date. A change in estimate made in a later period in response to subsequent events affects the accounting expense from that later period only (i.e., there is no restatement of earlier periods presented).

How we see it

In summary, as noted above, we believe there is no basis in IFRS 2 to account for an anticipated future change to the terms of an award. The entity must account for those awards in issue at the reporting date, not those that might be in issue in the future. The best estimate of the awards expected to vest at the end of the reporting date is based on the awards currently in place, in other words, at the end of year 1 none of the awards in place will vest. When the terms of the award are changed, it is then based on facts and circumstances, whether the change is accounted for as a new award or treat the revised arrangement as a modification of the original award.

7.7 Two awards running 'in parallel'

In some jurisdictions, it is not straightforward to cancel or modify an award. This may be because cancellation or modification triggers either a legal requirement for the entity to pay compensation to the holder, or adverse tax consequences for the holder. In such cases, where an award has become unattractive (for example, because it is 'out-of-the-money'), the entity may issue a second award rather than cancel or modify the original award. The second award cannot be designated as a replacement award, because the original award is still in place. The entity therefore has two awards running 'in parallel'.

However, a mechanism is then put in place to ensure that the employee can receive only one award. For instance, if the original award were 1,000 options, it might be replaced with a second award of 1,000 options, but on condition that, if options under one award are exercised, the number of options exercisable under the other award is correspondingly reduced, so that no more than 1,000 options can be exercised in total.

The accounting for such arrangements is discussed in Illustration 7-15 below.

Illustration 7-15: Two option awards running in parallel

At the beginning of year 1, an entity granted 1,000 A options to an employee, subject to non-market vesting conditions. The grant date fair value of an A option was CU50.

As at the beginning of year 2, the entity's share price is significantly below the exercise price of an A option, which now has a fair value of CU5. Without modifying or cancelling the A options, the entity awards the employee 1,000 new B options. The B options are subject to non-market vesting conditions different in nature from, and more onerous than, those applicable to the A options, but have a lower exercise price. The terms of the B options include a provision that for every A option that is exercised, the number of B options that can be exercised is reduced by one, and *vice versa*. The fair value of a B option at the beginning of year 2 is CU15.

Clearly, the employee will exercise whichever series of options, A or B, has the higher intrinsic value. There are four possible outcomes:

1. Neither the A options nor the B options vest.
2. Only the A options vest.
3. Only the B options vest.
4. Both the A options and B options vest and the employee must choose which to exercise. Rationally, the employee would exercise the B options as they have the lower exercise price.

How we see it

In our view, the B options are most appropriately accounted for as if they were a modification of the A options. In substance the A options have been modified by adding alternative non-market vesting conditions with a different option exercise price.

On the date of the substantive modification, the entity estimates the fair value of both the original and modified options and calculates the incremental fair value of the modification. As only one series of options can be exercised, we believe that the most appropriate treatment is to account for whichever award the entity believes, at each reporting date, is more likely to be exercised. This is analogous to the accounting treatment we suggest in Illustration 6-8 in section 6.2.5 above and in Illustration 6-13 in section 6.3.6 above.

If the entity believes that neither award will vest, any expense previously recorded would be reversed.

If the entity believes that only the A options will vest, it will recognise expense based on the grant date fair value of the A options (CU50 each).

If the entity believes that only the B options will vest, it will recognise expense based on:

(a) The grant date fair value of the A options (CU50 each) over the original vesting period of the A options.

Plus

(b) The incremental fair value of the B options, as at their grant date (CU10 each, being their CU15 fair value less the CU5 fair value of an A option), over the vesting period of the B options.

If the entity believes that both the A options and B options will vest, it follows the accounting treatment of outcome 3 above (i.e., vesting of the B options). This is because the employee will either choose the B options or, if the employee decides to choose the A options, the entity has to expense both the value of the A options and the incremental value of the B options because that incremental value relates to a vested award.

The entity revises the assessment at each reporting date and at the end of the vesting period when the actual outcome is known, so that the cumulative expense is based on the actual outcome.

Examples of other types of arrangements with multiple outcomes are illustrated in section 6.2.5 above and in sections 10.3 and 15.4 below.

7.8 Share splits and consolidations

It is common for an entity to divide its existing equity share capital into a larger number of shares (share splits) or to consolidate its existing share capital into a smaller number of shares (share consolidations). The impact of such splits and consolidations is not specifically addressed in IFRS 2, and a literal application of IFRS 2 could lead to some rather anomalous results.

Suppose that an employee has options over 100 shares in the reporting entity, with an exercise price of CU1. The entity undertakes a '1 for 2' share consolidation - i.e., the number of shares in issue is halved such that, all other things being equal, the value of one share in the entity after the consolidation is twice that of one share before the consolidation.

IFRS 2 is required to be applied to modifications to an award arising from equity restructurings. *[IFRS 2.BC24]*. In many cases, a share scheme will provide for automatic adjustment so that, following the consolidation, the employee holds options over only 50 shares with an exercise price of CU2. As discussed in section 5.3.8.A above, all things being equal, it would be expected that the modified award would have the same fair value as the original award and so there would be no incremental expense to be accounted for.

However, it may be that the scheme has no such provision for automatic adjustment, such that the employee still holds options over 100 shares. The clear economic effect is that the award has been modified, since its value has been doubled. It could be argued that, on a literal reading of IFRS 2, no modification has occurred, since the employee holds options over 100 shares at the same exercise price before and after the consolidation. The IFRS IC discussed this issue at its July and November 2006 meetings but decided not to take it onto its agenda because it "…was not a normal commercial occurrence and … unlikely to have widespread significance".[26] This decision was re-confirmed by the IFRS IC in March 2011.[27]

How we see it

In our view, whilst it seems appropriate to have regard to the substance of the transaction, and treat it as giving rise to a modification, it can be argued that IFRS 2 as drafted does not require such a treatment, particularly given the decision of the IFRS IC not to discuss the issue further. In the absence of clear guidance in the standard, the accounting policy adopted must be applied consistently.

Sometimes, the terms of an award give the entity discretion to make modifications at a future date in response to more complex changes to the share structure, such as those arising from bonus issues, share buybacks and rights issues where the effect on existing options may not be so clear-cut. These are discussed further in section 5.3.8.A above.

26 *IFRIC Update*, July 2006, available on the IFRS Foundation's website.

27 *IFRIC Update*, March 2011, available on the IFRS Foundation's website.

8 Equity-settled transactions - valuation

8.1 Introduction

The IASB provides some guidance on valuation in Appendix B to the standard, which we summarise and elaborate upon below. The guidance is framed in terms of awards to employees which are valued at grant date, but many of the general principles are equally applicable to awards to non-employees valued at service date. *[IFRS 2.B1]*.

As discussed in more detail in sections 4 to 7 above, IFRS 2 requires a 'modified grant-date' approach, under which the fair value of an equity award is estimated on the grant date without regard to the possibility that any service conditions or non-market performance conditions will not be met. Although the broad intention of IFRS 2 is to recognise the cost of the goods or services to be received, the IASB believes that, in the case of services from employees, the fair value of the equity instruments awarded is more readily determinable than the fair value of the services received.

As noted in section 5.1 above, IFRS 2 defines fair value as: *[IFRS 2 Appendix A]*

Extract from IFRS 2

Appendix A
Defined terms

fair value	The amount for which an asset could be exchanged, a liability settled, or an **equity instrument granted** could be exchanged, between knowledgeable, willing parties in an arm's length transaction.

IFRS 2 requires fair value to be based on the market price of the equity instruments, where available, or calculated using an option-pricing model. While fair value may be readily determinable for awards of shares, market quotations are not available for long-term, non-transferable share options because these instruments are not generally traded.

As discussed further in section 8.2.2 below, the fair value of an option at any point in time is made up of two basic components - intrinsic value and time value. Intrinsic value is the greater of (a) the market value of the underlying share less the exercise price of the option and (b) zero.

Time value reflects the potential of the option for future gain to the holder, given the length of time during which the option will be outstanding, and possible changes in the share price during that period. Because market price information is not normally available for an employee share option, the IASB believes that, in the absence of such information, the fair value of a share option awarded to an employee generally must be estimated using an option-pricing model. *[IFRS 2.BC130]*. This is discussed further in section 8.3 below.

The discussion below aims to provide guidance on the valuation of options and similar awards under IFRS 2; it is not intended to provide detailed instructions for constructing an option pricing model.

The approach to determining the fair value of share-based payments continues to be that specified in IFRS 2 as share-based payments fall outside the scope of IFRS 13 which applies more generally to the measurement of fair value under IFRS accounting standards (see Chapter 15). *[IFRS 2.6A]*.

8.2 Options

8.2.1 Call options - overview

Before considering the features of employee share options that make their valuation particularly difficult, a general overview of call options may be useful.

Call options give the holder the right, but not the obligation, to buy the underlying shares at a specified price (the 'exercise' or 'strike' price) on, or before, a specified date. Share-based payments take the form of call options over the underlying shares.

Options are often referred to as American or European. American options can be exercised at any time up to the expiry date, whereas European options can be exercised only on the expiry date itself.

The terms of employee options commonly have features of both American and European options, in that there is a period, generally two or three years, during which the option cannot be exercised (i.e., the vesting period). At the end of this period, if the options vest, they can be exercised at any time up until the expiry date. This type of option is known as a Window American option or Bermudan option.

A grant of shares is equivalent to an option with an exercise price of zero and will be exercised regardless of the share price on the vesting date. Throughout the discussion below, any reference to share options therefore includes, to the extent applicable, share grants or zero strike price options. There is further discussion of grants of free shares in section 8.7.1 below.

8.2.2 Call options - valuation

As noted in section 8.1 above, option value consists of intrinsic value and time value. For a call option, intrinsic value is the greater of:

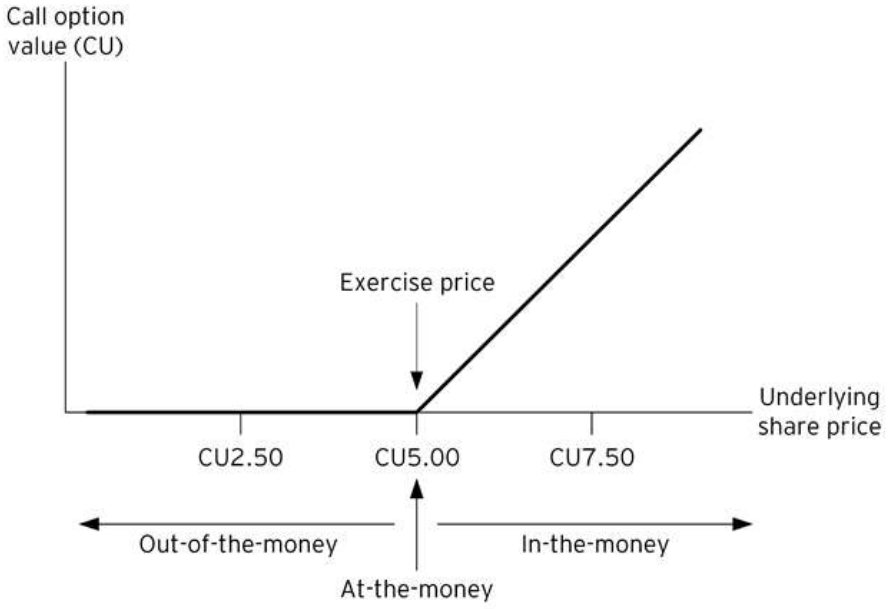
- The share price less the exercise price

  And

- Zero

Figure 8-1 below sets out the intrinsic value (or payoff) for a call option with an exercise price of CU5.00.

Figure 8-1: Intrinsic value of a call option



A call option is said to be 'in-the-money' when the share price is above the exercise price of the option and 'out-of-the-money' when the share price is less than the exercise price. An option is 'at-the-money' when the share price equals the exercise price of the option.

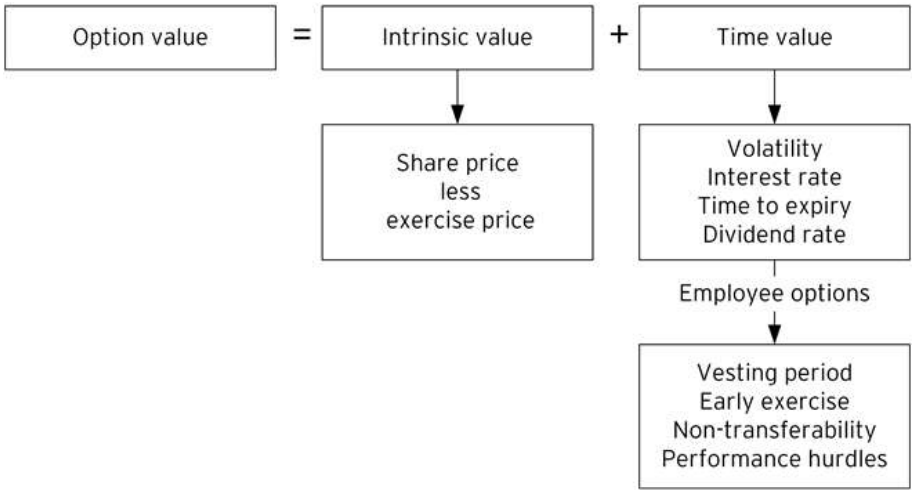
The time value of an option arises from the time remaining to expiry. As well as the share price and the exercise price, it is impacted by the volatility of the share price, time to expiry, dividend yield and the risk-free interest rate and the extent to which it is in- or out-of-the-money. For example, when the share price is significantly less than the exercise price, the option is said to be 'deeply' out-of-the-money. In this case, the fair value consists entirely of time value, which decreases the more the option is out-of-the-money.

The main inputs to the value of a simple option are:

- The exercise price of the option
- The term of the option
- The current market price of the underlying share
- The expected future volatility of the price of the underlying share
- The dividends expected to be paid on the shares during the life of the option (if any)
- The risk-free interest rate(s) for the expected term of the option

Their effect on each of the main components of the total value (intrinsic value and time value) is shown in Figure 8-2 below.

Figure 8-2: Determinants of the fair value of a call option



The effect of these inputs on the value of a call option can be summarised as follows:

If this variable increases,	the option value ...
Share price	Increases
Exercise price	Decreases
Volatility	Increases
Time to expiry	Usually increases*
Interest rate	Increases
Dividend yield/payout	Decreases

* In most cases the time value of an option is positive. Whilst an American option always has positive or zero time value, a European option may have a zero or negative time value when there is a high dividend yield and the option is considerably in-the-money. In this case, as the time to expiry increases, a European call option will reduce in value (negative time value) and an American call option will stay constant in value (zero time value).

The factors to be considered in estimating the determinants of an option value in the context of IFRS 2 are considered in more detail in section 8.5 below.

8.2.3 Factors specific to employee share options

In addition to the factors referred to in section 8.2.2 above, employee share options are also affected by a number of specific factors that can affect their true economic value. These factors, not all of which are taken into account for IFRS 2 valuation purposes (see sections 8.4 and 8.5 below), include the following:

- Non-transferability (see section 8.2.3.A below)
- Continued employment requirement (see section 8.2.3.B below)
- Vesting and non-vesting conditions (see section 8.2.3.C below)
- Periods during which holders cannot exercise their options - referred to in various jurisdictions as 'close', 'restricted' or 'blackout' periods (see section 8.2.3.D below)
- Limited ability to hedge option values (see section 8.2.3.E below)
- Dilution effects (see section 8.2.3.F below)

8.2.3.A Non-transferability

Holders of freely-traded share options (i.e., those outside a share-based payment transaction) can choose to 'sell' their options (typically by writing a call option on the same terms) rather than exercise them. By contrast, employee share options are generally non-transferable, leading to early (and sub-optimal) exercise of the option. This will lower the value of the options.

8.2.3.B Continued employment requirement

Holders of freely-traded share options can maintain their positions until they wish to exercise, regardless of other circumstances. In contrast, employee share options cannot normally be held once employment is terminated. If the options have not vested, they will be lost. If the options have vested, the employee will be forced to exercise the options immediately or within a short timescale, or forfeit them altogether, losing all time value. This will lower the value of the options.

8.2.3.C Vesting and non-vesting conditions

Holders of freely-traded share options have an unconditional right to exercise their options. In contrast, employee share options may have vesting and non-vesting conditions attached to them, which may not be met, reducing their value. This is discussed in more detail in section 8.4 below.

Although a non-market vesting condition reduces the 'true' fair value of an award, it does not directly affect its valuation for the purposes of IFRS 2 (see section 6.2 above). However, non-market vesting conditions may indirectly affect the value. For example, when an award vests on satisfaction of a particular target rather than at a specified time, its value may vary depending on the assessment of when that target will be met, since that may influence the expected life of the award, which is relevant to its fair value under IFRS 2 (see sections 6.2.3 and 8.2.2 above and section 8.5.1 below).

8.2.3.D Periods during which exercise is restricted

Holders of freely-traded American or Bermudan share options can exercise at any time during the exercisable window. In contrast, employees may be subject to 'blackout' periods in which they cannot exercise their options, for example to prevent insider trading. While this could conceivably make a significant impact if the shares were significantly mis-priced in the market, in an efficient market blackout periods will only marginally decrease the value.

8.2.3.E Limited ability to hedge option values

In the case of freely-traded share options, it is reasonable to justify the theoretical valuation on the basis that, for any other value, arbitrage opportunities could arise through hedging. In contrast, employee share options are usually awarded only in relatively small amounts, and the employees are usually subject to restrictions on share trading (especially short selling the shares, as would be required to hedge an option). When considered in combination with the non-transferability of the options (see section 8.2.3.A above), this means that exercising the options is the only way to remove exposure to fluctuations in value, which lowers the value of the options.

8.2.3.F Dilution effects

When third parties write traded share options, the writer delivers shares to the option holder when the options are exercised, so that the exercise of the traded share options has no dilutive effect. By contrast, if an entity writes share options to employees and, when those share options are exercised, issues new shares (or uses shares previously repurchased and held in treasury) to settle the awards, there is a dilutive effect as a result of the equity-settled awards. As the shares will be issued at the exercise price rather than the current market price at the date of exercise, this actual or potential dilution may reduce the share price, so that the option holder does not make as large a gain as would arise on the exercise of similar traded options which do not dilute the share price.

8.3 Selection of an option-pricing model

Extract from IFRS 2	
B4	For share options granted to employees, in many cases market prices are not available, because the options granted are subject to terms and conditions that do not apply to traded options. If traded options with similar terms and conditions do not exist, the fair value of the options granted shall be estimated by applying an option pricing model.

The entity must consider all factors that would be considered by knowledgeable, willing market participants in selecting a model. *[IFRS 2.B4, IFRS 2.B5]*.

The IASB decided that it was not necessary or appropriate to prescribe the precise formula or model to be used for option valuation. It notes that there is no particular option pricing model that is regarded as theoretically superior to the others, and there is the risk that any model specified might be superseded by improved methodologies in the future. *[IFRS 2.BC131]*.

The three most common option-pricing methodologies for valuing employee options are:

- The Black-Scholes-Merton formula (see section 8.3.1 below).
- The binomial model (see section 8.3.2 below).
- The Monte Carlo Simulation (see section 8.3.3 below).

It is important to understand all the terms and conditions of a share-based payment arrangement, as this will influence the choice of the most appropriate option pricing model.

IFRS 2 names the Black-Scholes-Merton formula and the binomial model as examples of acceptable models to use when estimating fair value, *[IFRS 2.BC152]*, while noting that there are certain circumstances in which the Black-Scholes-Merton formula may not be the most appropriate model (see section 8.3.1 below). Moreover, there may be instances where, due to the particular terms and conditions of the share-based payment arrangement, neither of these models is appropriate, and another methodology is more appropriate to achieving the intentions of IFRS 2. A model commonly used for valuing more complex awards is Monte Carlo Simulation (often combined with the Black-Scholes-Merton formula or the binomial model). This can deal with the complexities of a plan such as one with a market condition based on relative total shareholder return (TSR), which compares the return on a fixed sum invested in the entity to the return on the same amount invested in a peer group of entities.

8.3.1 The Black-Scholes-Merton formula

The Black-Scholes-Merton methodology is commonly used for assessing the value of a freely-traded put or call option and allows for the incorporation of static dividends on shares. The assumptions underlying the Black-Scholes-Merton formula are as follows:

- The option can be exercised only on the expiry date (i.e., it is a European option).
- There are no taxes or transaction costs and no margin requirements.
- The volatility of the underlying asset is constant and is defined as the standard deviation of the continuously compounded rates of return on the share over a specified period.
- The risk-free interest rate is constant over time.
- Short selling is permitted.
- There are no risk-free arbitrage opportunities.
- There are log normal returns (i.e., the continuously compounded rate of return is normally distributed).
- Security trading is continuous.

The main limitation of the Black-Scholes-Merton methodology is that it only calculates the option price at one point in time. It does not consider the steps along the way when there could be a possibility of early exercise of an American option (although as discussed in section 8.4 below this can be partially mitigated by using an assumed expected term as an input to the calculation).

The Black-Scholes-Merton formula is an example of a closed-form model, which is a valuation model that uses an equation to produce an estimated fair value. The formula is as shown in Figure 8-3 below.

Figure 8-3: The Black-Scholes-Merton formula

$$C = S_0 e^{-qT} N(d_1) - K e^{-rT} N(d_2)$$

Where:

$$d_1 = \frac{\ln(S_0/K) + (r - q + \sigma^2/2)T}{\sigma \sqrt{T}}$$

$d_2 = d_1 - \sigma\sqrt{T}$

C = price of a written call

S_0 = price of the underlying share

N = the cumulative probability distribution function for a standardised normal distribution

q = dividend yield (continuously compounded)

K = call option exercise price

r = the continuously compounded risk-free rate

σ = annualised volatility of the underlying share

T = time to expiry (in years)

Note: 'e' represents the mathematical constant, the base of the natural logarithm (2.718282...), and 'ln' is the natural logarithm of the indicated value

Whilst the Black-Scholes-Merton formula is complex, its application in practice is relatively easy. It can be programmed into a spreadsheet, and numerous programs and calculators exist that use it to calculate the fair value of an option. As a result, the formula is used widely by finance professionals to value a large variety of options. However, a number of the assumptions underlying the formula may be better suited to valuing short-term, exchange-traded share options rather than employee share options.

The attributes of employee share options that render the Black-Scholes-Merton formula less effective as a valuation technique include:

- *Long term to expiry*

  The formula assumes that volatility, interest rates and dividends are constant over the life of the option. While this may be appropriate when valuing short-term options, the assumption of constant values is less appropriate when valuing long-term options.

- *Non-transferability and early exercise*

  The formula assumes a fixed maturity/exercise date. While IFRS 2 provides for the use of an 'expected term' in place of the contractual life to reflect the possibility of early exercise resulting from the non-transferability of employee share options or other reasons (see section 8.5 below), this may not adequately describe early exercise behaviour.

- *Vesting conditions and non-vesting conditions*

  The formula does not take into account any market-based vesting conditions or non-vesting conditions.

- *Blackout periods*

  As the formula assumes exercise on a fixed date, and does not allow earlier exercise, it does not take into consideration any blackout periods (see section 8.2.3.D above).

In summary, application of the Black-Scholes-Merton formula is relatively simple, in part because many of the complicating factors associated with the valuation of employee share options cannot be incorporated into it directly and, therefore, must be derived outside of the formula (e.g., the input of an expected term).

IFRS 2 states that the Black-Scholes-Merton formula may not be appropriate for long-lived options which can be exercised before the end of their life and which are subject to variation in the various inputs to the model over the life of the option. However, IFRS 2 suggests that the Black-Scholes-Merton formula may give materially correct results for options with shorter lives and with a relatively short exercise period. *[IFRS 2.B5]*.

The development of appropriate assumptions for use in the Black-Scholes-Merton formula is discussed in section 8.5 below.

As noted above, the Black-Scholes-Merton formula is an example of a closed form model that is not generally appropriate for awards that include market conditions. However, in certain circumstances it may be possible to use closed form solutions other than the Black-Scholes-Merton formula to value options where, for example, the share price has to reach a specified level for the options to vest. These other solutions are beyond the scope of this chapter.

8.3.2 The binomial model

The binomial model is one of a subset of valuation models known as lattice models, which adopt a flexible, iterative approach to valuation that can capture the unique aspects of employee share options. A binomial model produces an estimated fair value based on the assumed changes in prices of a financial instrument over successive periods of time. In each time period, the model assumes that at least two price movements are possible. The lattice represents the evolution of the value of either a financial instrument or a market variable for the purpose of valuing a financial instrument.

The concepts that underpin lattice models and the Black-Scholes-Merton formula are the same, but the key difference between a lattice model and a closed-form model is that a lattice model is more flexible. The valuations obtained using the Black-Scholes-Merton formula and a lattice model will be very similar if the lattice model uses identical assumptions to the Black-Scholes-Merton calculation (e.g., constant volatility, constant dividend yields, constant risk-free rate, the same expected life). However, a lattice model can explicitly use dynamic assumptions regarding the term structure of volatility, dividend yields, and interest rates.

Further, a lattice model can incorporate assumptions about how the likelihood of early exercise of an employee share option may increase as the intrinsic value of that option increases, or how employees may have a high tendency to exercise options with significant intrinsic value shortly after vesting.

In addition, a lattice model can incorporate market conditions that may be part of the design of an option, such as a requirement that an option is only exercisable if the underlying share price reaches a certain level (sometimes referred to as 'target share price' awards). The Black-Scholes-Merton formula is not generally appropriate for awards that have a market-based performance condition because it cannot handle that additional complexity.

Most valuation specialists believe that lattice models, through their versatility, generally provide a more accurate estimate of the fair value of an employee share option with market conditions or with the possibility of early exercise than a value based on a closed-form Black-Scholes-Merton formula. As a general rule, the longer the term of the option and the higher the dividend yield, the larger the amount by which the binomial lattice model value may differ from the Black-Scholes-Merton formula value.

To implement the binomial model, a 'tree' is constructed the branches (or time steps) of which represent alternative future share price movements over the life of the option. In each time step over the life of the option, the share price has a certain probability of moving up or down by a certain percentage amount. It is important to emphasise the assumption, in these models, that the valuation occurs in a risk-neutral world, where investors are assumed to require no extra return on average for bearing risks and the expected return on all securities is the risk-free interest rate.

To demonstrate how the binomial model is used, Illustration 8-1 below constructs a simple binomial lattice model with a few time steps. The valuation assumptions and principles will not differ in essence from those in a Black-Scholes-Merton valuation except that the binomial lattice model will allow for early exercise of the option. The relevant difference between the two models is the specification of a very small number of time steps, for illustrative purposes, in the binomial lattice model (see also section 8.3.2.A below). We discuss below how the model can be augmented for a more complex set of assumptions.

Illustration 8-1: Binomial model

A share option is issued with an exercise price of CU10, being the share price on the grant date. This Example assumes a constant volatility (50%) and risk-free rate (5% continuously compounded) although, as discussed later, those static assumptions may not be appropriate when valuing a long-term share option. It is also assumed that: the grantor pays dividends with a yield of 2% (continuously compounded) on its shares; the term of the option is five years; and each branch of the tree represents a length of time of one year.

At t = 0 (the grant date), the model is started at the grant date share price (CU10 in this Example). At each node (the base of any price time step), two possible price changes (one increase and one decrease) are computed based on the volatility of the shares. The two new share prices are computed as follows:

The up-node price utilises the following formula:

$$u = e^{\sigma\sqrt{dt}} = e^{0.5*\sqrt{1}} = 1.6487$$

Where:
σ = annualised volatility of the underlying share
dt = period of time between nodes

The down-node is the inverse of the up-node:

$$d = \frac{1}{u} = \frac{1}{1.6487} = 0.6065$$

The probability of each upward and downward price movement occurring is calculated from:

- the probability of an upward movement in price:

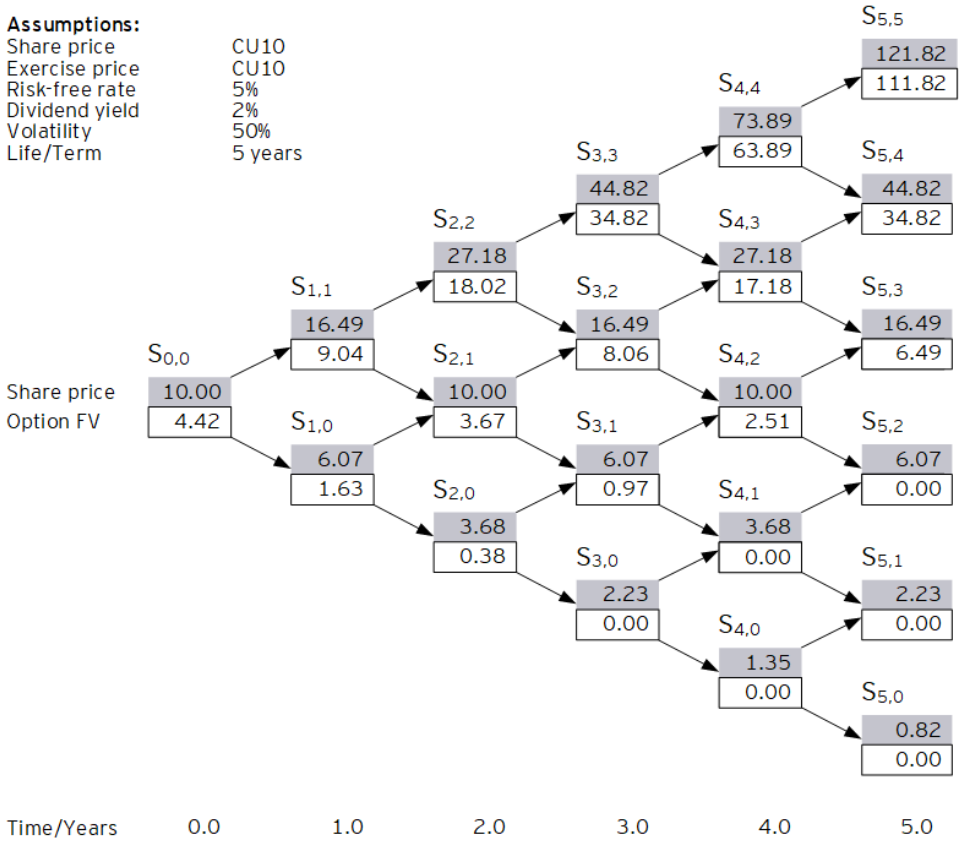
$$p = \frac{e^{(r-q)dt} - d}{u - d} = \frac{e^{(.05 - .02)*1} - 0.6065}{1.6487 - 0.6065} = 0.4068$$

Where:
e = represents the mathematical constant, the base of the natural logarithm (2.718282...)
r = continuously compounded risk-free rate
q = dividend yield (continuously compounded)
dt = period of time between nodes

- The probability of a downward movement in price:

$$= 1 - p = 1 - 0.4068 = 0.5932$$

Using the above price multiples, the price tree can then be constructed as shown diagrammatically below - each rising node is built by multiplying the previous price by 'u' and each falling node is similarly calculated by multiplying the previous price by 'd'.



To calculate the option value:

- The option payoffs at the final time node (time 5 above) must be calculated. This is the share price less the exercise price, or zero if the payoff is negative.
- Then the option values must be calculated at the previous time point (time 4 above). This is done by calculating the expected value of the option for the branch paths available to the particular node being valued discounted at the risk-free rate. For example, for $S_{4,4}$ in the chart above the option value is the probability of going to node $S_{5,5}$ multiplied by the option value at that node plus the probability of going to node $S_{5,4}$ multiplied by the option value at that node, all discounted at the risk-free rate):

  $$= e^{-r.dt}\{p.111.82 + (1 - p)34.82\} = 0.95\{0.4068 \times 111.82 + 0.5932 \times 34.82\} = 62.92$$

  This would be the value at node $S_{4,4}$ if the option were European and could not be exercised earlier. As the binomial model can allow for early exercise, the option value at node $S_{4,4}$ is the greater of the option value just calculated and the intrinsic value of the option which is calculated the same way as the end option payoff. In this case, as the intrinsic value is CU63.89 (CU73.89 - CU10.00), the node takes the value of CU63.89.
- The previous steps are then repeated throughout the entire lattice (i.e., for all nodes at time 4, then all nodes at time 3, etc.) until finally the option value is determined at time 0 - this being the binomial option value of CU4.42.
- Additionally, if there is a vesting period during which the options cannot be exercised, the model can be adjusted so as not to incorporate the early exercise condition stipulated in the previous point and allow for this only after the option has vested and has the ability to be exercised before expiry.

One of the advantages of a lattice model is its ability to depict a large number of possible future paths of share prices over the life of the option. In Illustration 8-1 above, the specification of an interval of 12 months between nodes provides an inappropriately narrow description of future price paths. The shorter the interval of time between each node, the more accurate will be the description of future share price movements.

Additions which can be made to a binomial model (or any type of lattice model) include the use of assumptions that are not fixed over the life of the option. Binomial trees may allow for conditions dependent on price and/or time, but in general do not support price-path dependent conditions and modifications to volatility. This may affect the structure of a tree making it difficult to recombine. In such cases, additional recombination techniques must be implemented, possibly with the use of a trinomial tree (i.e., one with three possible outcomes at each node).

For the first three assumptions above, the varying assumptions simply replace the value in the fixed assumption model. For instance, in Illustration 8-1 above r = 0.05; in a time-dependent version this could be 0.045 at time 1, 0.048 at time 2 and so on, depending on the length of time from the valuation date to the individual nodes.

However, for a more complicated addition such as assumed withdrawal rates, the equation:

$$= e^{-r.dt} \{p.111.82 + (1 - p)34.82\}$$

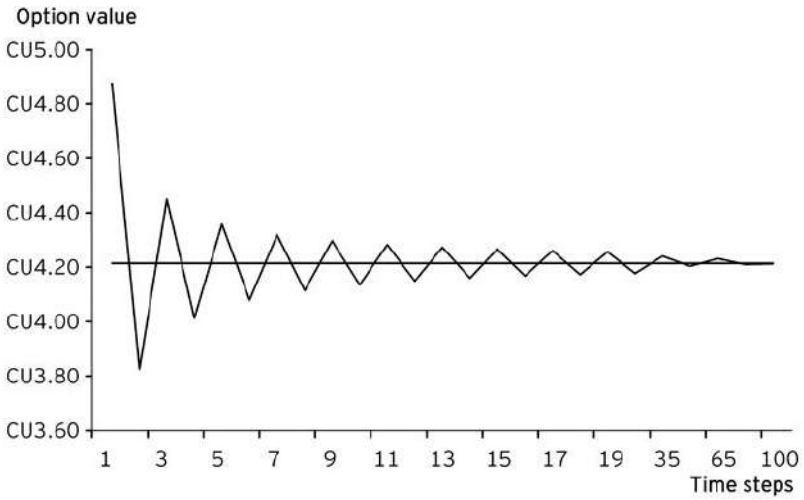
may be replaced with:

$$= (1 - g) \times e^{-r.dt} \{p.111.82 + (1 - p)34.82\} + g \times \max(\text{intrinsic value}, 0)$$

where 'g' is the rate of employee departure, on the assumption that, on departure, the option is either forfeited or exercised. As with the other time- and price-dependent assumptions, the rate of departure could also be made time- or price-dependent (i.e., the rate of departure could be assumed to increase as the share price increases, or increase as time passes, and so forth).

8.3.2.A Lattice models - number of time steps

When performing a lattice valuation, a decision must be taken as to how many time steps to use in the valuation (i.e., how much time passes between each node). Generally, the greater the number of time steps, the more accurate the final value. However, as more time steps are added, the incremental increase in accuracy declines. To illustrate the increases in accuracy, consider the diagram below, which values the option in Illustration 8-1 above as a European option. In this case, the binomial model has not been enhanced to allow for early exercise (i.e., the ability to exercise prior to expiry).



Whilst the binomial model is very flexible and can deal with much more complex assumptions than the Black-Scholes-Merton formula, there are certain complexities it cannot handle, which can best be accomplished by Monte Carlo Simulation - see section 8.3.3 below.

The development of appropriate assumptions for use in a binomial model is discussed in section 8.5 below.

In addition to the binomial model, other lattice models such as trinomial models or finite difference algorithms may be used. Discussion of these models is beyond the scope of this publication.

8.3.3 Monte Carlo Simulation

In order to value options with market-based performance targets where the market value of the entity's equity is an input to the determination of whether, or to what extent, an award has vested, the option methodology applied must be supplemented with techniques such as Monte Carlo Simulation.

A typical market condition is a TSR condition. TSR compares the return on a fixed sum invested in the entity to the return on the same amount invested in a peer group of entities. Typically, the entity is then ranked in the peer group and the number of share-based awards that vest depends on the ranking. For example, no award might vest for a low ranking, the full award might vest for a higher ranking, and a pro-rated level of award might vest for a median ranking.

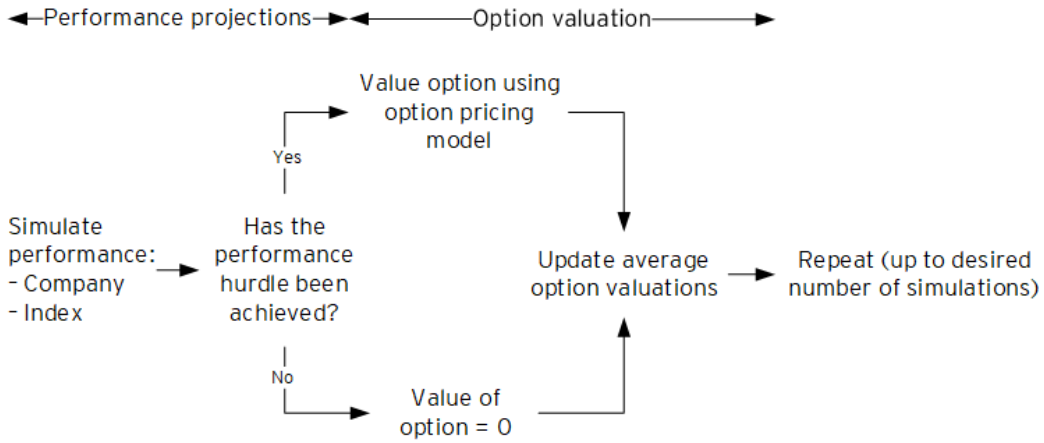
The following table gives an example of a possible vesting pattern for such a scheme, with a peer group of 100 entities.

Ranking in peer group	Percentage vesting
Below 50	0%
50	50%
51-74	50% plus an additional 2% for each increase of 1 in the ranking
75 or higher	100%

Figure 8-4 below summarises the Monte Carlo approach.

Other market conditions may have the form of share price targets, absolute share price growth or share price growth in excess of a pre-defined index growth. These types of market conditions are valued using techniques such as Monte Carlo simulation.

Figure 8-4: Monte Carlo Simulation approach for share-based payment transactions



The valuation could be performed using either:

- A binomial valuation or the Black-Scholes-Merton formula, dependent on the results of the Monte Carlo Simulation.

  Or

- The Monte Carlo Simulation on its own.

The framework for calculating future share prices uses essentially the same underlying assumptions as lie behind Black-Scholes-Merton and binomial models - namely a risk-neutral world and a log normal distribution of share prices.

For a given simulation, the risk-neutral returns of the entity and those of the peer group or index are projected until the performance target is achieved and the option vests. At this point, the option transforms into a 'vanilla' equity call option that may be valued using an option pricing model. This value is then discounted back to the grant date so as to give the value of the option for a single simulation.

When the performance target is not achieved and the option does not vest, a zero value is recorded. This process is repeated thousands or millions of times. The average option value obtained across all simulations provides an estimate of the value of the option, allowing for the impact of the performance target.

8.4 Adapting option-pricing models for share-based payment transactions

Since the option-pricing models discussed in section 8.3 above were developed to value freely-traded options, a number of adjustments are required in order to account for the restrictions usually attached to share-based payment transactions, particularly those with employees. The restrictions not accounted for in these models include:

- Non-transferability (see section 8.4.1 below).
- Vesting conditions, including performance targets, and non-vesting conditions that affect the value for the purposes of IFRS 2 (see section 8.4.2 below).

8.4.1 Non-transferability

As noted in section 8.2.3.A above, employee options and other share-based awards are almost invariably non-transferable, except (in some cases) to the employee's estate in the event of death in service. Non-transferability often results in an option being exercised early (i.e., before the end of its contractual life), as this is the only way for the employee to realise its value in cash. Therefore, by imposing the restriction of non-transferability, the entity may cause the effective life of the option to be shorter than its contractual life, resulting in a loss of time value to the holder. *[IFRS 2.BC153-169]*.

One aspect of time value is the value of the right to defer payment of the exercise price until the end of the option term. When the option is exercised early because of non-transferability, the entity receives the exercise price much earlier than it otherwise would. Therefore, as noted by IFRS 2, the effective time value granted by the entity to the option holder is less than that indicated by the contractual life of the option.

IFRS 2 requires the effect of early exercise as a result of non-transferability and other factors to be reflected either by modelling early exercise in a binomial or similar model or by using expected life rather than contractual life as an input into the option-pricing model. This is discussed further in section 8.5.1 below.

Reducing the time to expiry effectively reduces the value of the option. This is a simplified way of reducing the value of the employee stock option to reflect the fact that employees are unable to sell their vested options, rather than applying an arbitrary discount to take account of non-transferability.

8.4.2 Treatment of vesting and non-vesting conditions

Many share-based payment awards to employees have vesting and non-vesting conditions attached to them which must be satisfied before the award can be exercised. It must be remembered that a non-market vesting condition, while reducing the 'true' fair value of an award, does not directly affect its valuation for the purposes of IFRS 2 (see section 6.2 above). However, non-market vesting conditions may indirectly affect the value. For example, when an award vests on satisfaction of achieving a particular operational target rather than at a specified time, its value may vary depending on the assessment of when that target will be met, since that may influence the expected life of the award, which is relevant to its fair value under IFRS 2 (see sections 6.2.3 and 8.2.2 above and section 8.5 below).

8.4.2.A Market-based performance conditions and non-vesting conditions

As discussed in sections 6.3 and 6.4 above, IFRS 2 requires market-based vesting conditions and non-vesting conditions to be taken into account in estimating the fair value of the options granted. Moreover, the entity is required to recognise a cost for an award with a market condition or non-vesting condition if all the non-market vesting conditions attaching to the award are satisfied regardless of whether the market condition or non-vesting condition is satisfied. This means that a more sophisticated option pricing model may be required.

8.4.2.B Non-market vesting conditions

As discussed in section 6.2 above, IFRS 2 requires non-market vesting conditions to be ignored when estimating the fair value of share-based payment transactions. Instead, such vesting conditions are taken into account by adjusting the number of equity instruments included in the measurement of the transaction (by estimating the extent of forfeiture based on failure to vest) so that, ultimately, the amount recognised is based on the number of equity instruments that eventually vest.

8.5 Selecting appropriate assumptions for option-pricing models

IFRS 2 notes that, as discussed in section 8.2.2 above, option pricing models take into account, as a minimum:

- The exercise price of the option
- The life of the option (see sections 8.5.1 and 8.5.2 below)
- The current price of the underlying shares
- The expected volatility of the share price (see section 8.5.3 below)
- The dividends expected on the shares (if appropriate - see section 8.5.4 below)
- The risk-free interest rate for the life of the option (see section 8.5.5 below) *[IFRS 2.B6]*

Of these inputs, only the exercise price and the current share price of a listed entity are objectively determinable. The others are subjective, and their development will generally require significant analysis. The discussion below addresses the development of assumptions for use both in a Black-Scholes-Merton formula and in a lattice model.

IFRS 2 requires other factors that knowledgeable, willing market participants would consider in setting the price to be taken into account, except for those vesting conditions and reload features that are excluded from the measurement of fair value - see sections 5 and 6 above and section 8.9 below. Such factors include:

- Restrictions on exercise during the vesting period or during periods where trading by those with inside knowledge is prohibited by securities regulators.

  Or

- The possibility of the early exercise of options (see section 8.5.1 below). *[IFRS 2.B7, IFRS 2.B8, IFRS 2.B9]*.

However, the entity must not consider factors that are relevant only to an individual employee and not to the market as a whole (such as the effect of an award of options on the personal motivation of an individual). *[IFRS 2.B10]*.

The objective of estimating the expected volatility of, and dividends on, the underlying shares is to approximate the expectations that would be reflected in a current market or negotiated exchange price for the option. Similarly, when estimating the effects of early exercise of employee share options, the objective is to approximate the expectations about employees' exercise behaviour that would be developed by an outside party with access to detailed information at grant date. Where (as is likely) there is a range of reasonable expectations about future volatility, dividends and exercise behaviour, an expected value should be calculated, by weighting each amount within the range by its associated probability of occurrence. *[IFRS 2.B11, IFRS 2.B12]*.

Such expectations are often based on past data. In some cases, however, such historical information may not be relevant (e.g., where the business of the entity has changed significantly) or even available (e.g., where the entity is unlisted or newly listed). An entity should not base estimates of future volatility, dividends or exercise behaviour on historical data without considering the extent to which they are likely to be reasonably predictive of future experience. *[IFRS 2.B13, IFRS 2.B14, IFRS 2.B15]*.

8.5.1 Expected term of the option

IFRS 2 allows the estimation of the fair value of an employee share award to be based on its expected life, rather than its maximum term, as this is a reasonable means of reducing the value of the award to reflect its non-transferability.

Option value is not a linear function of option term. Rather, value increases at a decreasing rate as the term lengthens. For example, a two year option is worth less than twice as much as a one year option, if all other assumptions are equal. This means that to calculate a value for an award of options with widely different individual lives based on a single weighted average life is likely to overstate the value of the entire award. Accordingly, assumptions need to be made as to what exercise or termination behaviour an option holder will exhibit. Considerations include:

- Vesting period - the expected term of the option must be at least as long as its vesting period. The length of time employees hold options after they vest may vary inversely with the length of the vesting period.
- Past history of employee exercise and termination patterns for similar grants (adjusted for current expectations) - see section 8.5.2 below.
- Expected volatility of the underlying share - on average, employees tend to exercise options on shares with higher volatility earlier.

- Periods during which exercise may be precluded and related arrangements (e.g., agreements that allow for exercise to occur automatically during such periods if certain conditions are satisfied).
- Employee demographics (age, tenure, sex, position etc.).
- Time from vesting date - the likelihood of exercise typically increases as time passes.

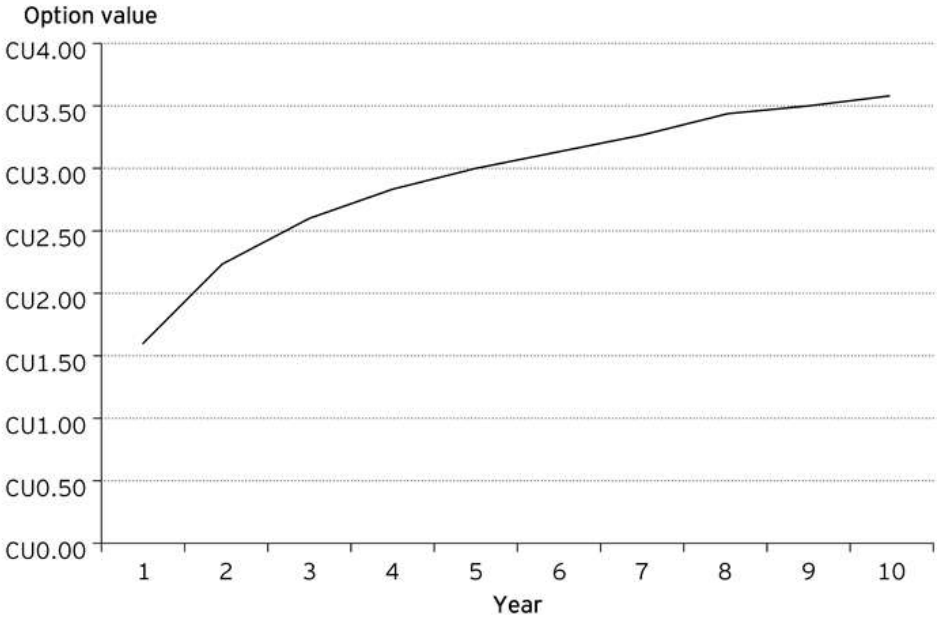
As discussed in section 8.4 above, IFRS 2 notes that the effect of early exercise can be reflected by either:

- Treating the expected, rather than the contractual, life of the option as an input to a pricing model, such as the Black-Scholes-Merton formula (see section 8.5.1.A below).
- Using contractual life as an input to a binomial or similar model. *[IFRS 2.B16, IFRS 2.B17]*.

8.5.1.A Expected term under the Black-Scholes-Merton formula

An estimate of expected term based on the types of inputs described above can be used in the Black-Scholes-Merton formula as well as a lattice model. However, the formula requires only a single expected term to be used. This is one of the reasons why the Black-Scholes-Merton formula may provide a higher valuation for the same options than a lattice model.

The difference in value that arises from using only a single expected term results, in part, from the convex shape of a typical option valuation curve, as illustrated below.



It is assumed, for the purposes of this Illustration, that an at-the-money option on a CU10 share with a 10-year contractual term is equally likely to be exercised at the end of each year beginning with year two. An average expected term of six years [(2+3+4+...10)/9] would be used in a Black-Scholes-Merton calculation giving a fair value of CU3.10 for the option. If, instead, nine separate valuations were performed, each with a different expected term corresponding to each of the possible terms (from two to ten years), the average of those valuations (also calculated using the Black-Scholes-Merton formula) would be CU2.9854. The latter amount is lower than CU3.10 because of the convex shape of the valuation curve, reflecting the fact that the value increases at a decreasing rate as the term lengthens. Therefore, the value of the share option with an average expected term of six years will exceed the value derived from averaging the separate valuations for each potential term.

In a lattice model, exercise can occur at any time based on the rules specified in the model regarding exercise behaviour. The lattice model can therefore be thought of as analogous to the calculation in the above example in which the fair value was calculated as the average of the valuations from periods two to ten. In contrast, the Black-Scholes-Merton valuation allows only a single expected term to be specified. Therefore, it is analogous to the valuation described in the above example based on a single average expected term of six years.

Therefore, even if the expected term derived from a lattice model were used as an input in the Black-Scholes-Merton formula (and all other inputs were identical), the two models would give different values.

To mitigate the impact of the convex shape of the valuation curve, an entity with a broad-based share option plan might consider stratifying annual awards into different employee groups for the purposes of estimating the expected option lives (see section 8.5.2 below).

Determining a single expected term can be quite challenging, particularly for an entity seeking to base its estimate on the periods for which previously granted options were outstanding, which would have been highly dependent on the circumstances during those periods. For example, if the entity's share price had increased significantly during the option period (as would be the case for share options granted by certain entities at the beginning of a bull market), it is likely that employees would have exercised options very soon after vesting. Alternatively, if options were granted at the end of a bull market and the share price declined significantly after the grant date, it is likely that the options would be exercised much later (if at all). These relationships would exist because, as discussed previously, the extent to which an option is in-the-money has a significant impact on exercise behaviour. Accordingly, deriving a single expected term in these situations involves considerable judgement.

8.5.2 Exercise and termination behaviour

IFRS 2 notes that employees often exercise options early for a number of reasons, most typically:

- Restrictions on transferability mean that this is the only way of realising the value of the option in cash.
- Aversion to the risk of not exercising 'in the money' options in the hope that they increase in value.
- In the case of leavers, a requirement to exercise, or forfeit, all vested options on or shortly after leaving (see section 8.5.2.B below).

Factors to consider in estimating early exercise include:

(a) The length of the vesting period, because the share option cannot be exercised until the end of the vesting period. Hence, determining the valuation implications of expected early exercise is based on the assumption that the options will vest.

(b) The average length of time similar options have remained outstanding in the past.

(c) The price of the underlying shares. Experience may indicate that employees tend to exercise options when the share price reaches a specified level above the exercise price.

(d) The employee's level within the organisation. For example, experience might indicate that higher-level employees tend to exercise options later than lower-level employees (see also section 8.5.2.A below).

(e) The expected volatility of the underlying shares. On average, employees might tend to exercise options on highly volatile shares earlier than on shares with low volatility. *[IFRS 2.B18]*.

In addition, the pattern of terminations of employment after vesting may be relevant (see section 8.5.2.B below).

How we see it

In our view, past exercise behaviour generally serves as the starting point for determining expected exercise behaviour. That behaviour must be analysed, correlated to the factors above, and extrapolated into the future. However, significant changes in the underlying share price or in other salient characteristics of the entity, changes in option plans, tax laws, share price volatility and termination patterns could indicate that past exercise behaviour is not indicative of expected exercise behaviour. The expected life may also be estimated indirectly, by using a modified option pricing model to compute an option value, an input to which is an assumption that the options will be expected to be exercised when a particular share price is reached.

Some entities, including recently listed entities, or entities for which all outstanding grants have been out-of-the-money for a long period, may simply not be able to observe any exercise behaviour or may not possess enough history to perform a reasonable analysis of past exercise behaviour.

How we see it

In these cases, in our view, entities could look to the exercise history of employees of similar entities to develop expectations of employee exercise behaviour. At present there is only limited publicly-available information about employee exercise patterns, but valuation professionals and human resource consultants may have access to relevant data, based on which they may have articulated specific exercise patterns. In such circumstances, considerable judgement is required in assessing the comparability and appropriateness of the historic data used (including whether the data is current).

In the absence of extensive information regarding exercise behaviour, another solution could be to use a midpoint assumption - i.e., selecting as the expected date of exercise the midpoint between the first available exercise date (the end of the vesting period) and the last available exercise date (the contracted expiry date). However, this must be undertaken only when the entity is satisfied that this does not lead to a material misstatement. It is also plausible to assume exercise at the earliest possible time or to undertake a reasonable analysis of past behaviour and set up the amount of intrinsic value which, when exceeded, will trigger exercise of the option.

8.5.2.A Grouping employees with homogeneous exercise behaviour

IFRS 2 emphasises that the estimated life of an option is critical to its valuation. Therefore, where options are granted to a group of employees, it will generally be necessary to ensure that either:

(a) All the employees are expected to exercise their options within a relatively narrow time-frame.

(b) If not, that the group is divided into sub-groups of employees who are expected to exercise their options within a similar relatively narrow time-frame.

IFRS 2 suggests that it may become apparent that middle and senior management tend to exercise options later than lower-level employees, either because they choose to do so, or because they are encouraged or compelled to do so as a result of required minimum levels of ownership of equity instruments (including options) among more senior employees. *[IFRS 2.B19, IFRS 2.B20, IFRS 2.B21]*.

8.5.2.B Post-vesting termination behaviour

Most employee share options provide that, if employment is terminated, the former employee typically has only a short period (e.g., 90 days from the date of termination of employment) in which to exercise any vested options, the contractual expiry of which would otherwise be some years away. Accordingly, an entity must look at its prior termination patterns, adjust those patterns for future expectations and incorporate those expected terminations into a lattice model as expected early exercises.

Patterns of employee turnover are not necessarily linear and may be a non-linear function of a variety of factors, such as:

- Employee demographics (age, sex, tenure, position, etc.)
- Path of share price - for example, if options are deeply out-of-the-money, they may have little retention value and more employees may leave than if the options were at- or in-the-money
- Economic conditions and other share prices

8.5.3 Expected volatility of share price

Expected volatility is a measure of the amount by which a price is expected to fluctuate during a period. Share price volatility has a powerful influence on the estimation of the fair value of an option, much of the value of which is derived from its potential for appreciation. The more volatile the share price, the more valuable the option. It is therefore essential that the choice of volatility assumption can be properly supported.

IFRS 2 notes that: *[IFRS 2.B22]*

Extract from IFRS 2	
B22	Expected volatility is a measure of the amount by which a price is expected to fluctuate during a period. The measure of volatility used in option pricing models is the annualised standard deviation of the continuously compounded rates of return on the share over a period of time. Volatility is typically expressed in annualised terms that are comparable regardless of the time period used in the calculation, for example, daily, weekly or monthly price observations.

The expected annualised volatility of a share is the range within which the continuously compounded annual rate of return is expected to fall approximately two-thirds of the time. For example, to say that a share with an expected continuously compounded rate of return of 12% has a volatility of 30% means that the probability that the rate of return on the share for one year will be between minus 18% (12% - 30%) and 42% (12% + 30%) is approximately two-thirds. If the share price is CU100 at the beginning of the year, and no dividends are paid, the year-end share price would be expected to be between CU83.53 (CU100 × $e^{-0.18}$) and CU152.20 (CU100 × $e^{0.42}$) approximately two-thirds of the time.

The rate of return (which may be positive or negative) on a share for a period measures how much a shareholder has benefited from dividends and appreciation (or depreciation) of the share price. *[IFRS 2.B23, IFRS 2.B24]*.

IFRS 2 gives examples of factors to consider in estimating expected volatility including the following: *[IFRS 2.B25]*

- *Implied volatility from traded share options*

  Implied volatility is the volatility derived by using an option pricing model with the traded option price (if available) as an input and solving for the volatility as the unknown on the entity's shares. It may also be derived from other traded instruments of the entity that include option features (such as convertible debt).

  Implied volatilities are often calculated by analysts and reflect market expectations for future volatility as well as imperfections in the assumptions in the valuation model. For this reason, the implied volatility of a share may be a better measure of prospective volatility than historical volatility (see below). However, traded options are usually short-term, ranging in general from one month to two years. If the expected lives are much longer than this, both the implied and historical volatilities will need to be considered.

- *Historical volatility*

  It may be relevant to consider the historical volatility of the share price over the most recent period that is generally commensurate with the expected term of the option (taking into account the remaining contractual life of the option and the effects of expected early exercise). However, this assumes that past share price behaviour is likely to be representative of future share price behaviour. Upon any restructuring of an entity, the question of whether or not past volatility will be likely to predict future volatility would need to be reassessed.

  The historical volatilities of similar entities may be relevant for newly listed entities, unlisted entities or entities that have undergone substantial restructuring (see sections 8.5.3.A to 8.5.3.C below).

- *The length of time the entity's shares have been publicly traded*

  A newly listed entity might have a high historical volatility, compared with similar entities that have been listed longer. Further guidance for newly listed entities is given in section 8.5.3.A below.

- *'Mean-reverting tendency'*

  This refers to the tendency of volatility to revert to its long-term average level, and other factors indicating that expected future volatility might differ from past volatility. For example, if an entity's share price was extraordinarily volatile for some identifiable period of time because of a failed takeover bid or a major restructuring, that period could be disregarded in computing historical average annual volatility. However, an entity must not exclude general economic factors such as the effect of an economic downturn on share price volatility.

- *Appropriate and regular intervals for price observations*

  The price observations should be consistent from period to period. For example, an entity might use the closing price for each week or the opening price for the week, but it should not use the closing price for some weeks and the opening price for other weeks. Also, the price observations should be expressed in the same currency as the exercise price.

How we see it

In our view, at least thirty observations are generally required to calculate a statistically valid standard deviation. Our experience has been that, in general, it is more appropriate to make such observations daily or weekly rather than monthly.

8.5.3.A Newly listed entities

As noted under 'Historical volatility' in section 8.5.3 above, an entity should consider the historical volatility of the share price over the most recent period that is generally commensurate with the expected option term. If a newly listed entity does not have sufficient information on historical volatility, it should compute historical volatility for the longest period for which trading activity is available. It could also consider the historical volatility of similar entities following a comparable period in their lives. *[IFRS 2.B26]*.

8.5.3.B Unlisted entities

An unlisted entity will have neither historical nor current market information to consider when estimating expected volatility. IFRS 2 suggests that, in some cases, an unlisted entity that regularly issues options or shares might have set up an internal market for its shares. The volatility of those share prices could be considered when estimating expected volatility. Alternatively, if the entity has based the value of its shares on the share prices of similar listed entities, the entity could consider the historical or implied volatility of the shares of those similar listed entities. *[IFRS 2.B27, IFRS 2.B28, IFRS 2.B29]*.

If the entity has not used a valuation methodology based on the share prices of similar listed entities, the entity could derive an estimate of expected volatility consistent with the valuation methodology used. For example, the entity might consider it appropriate to value its shares on a net asset or earnings basis if this approximates to the fair value of the equity instruments, in which case it could consider the expected volatility of those net asset values or earnings. *[IFRS 2.B30]*.

8.5.3.C Listed entities that have undergone significant restructuring

An issue not specifically addressed by IFRS 2 is the approach required in the case of an entity that has been listed for some time but which has recently undergone significant restructuring or refocusing of the business (e.g., as a result of acquisitions, disposals or refinancing). In such cases, it may well be appropriate to adopt the approach advocated for newly listed entities in section 8.5.3.A above.

8.5.3.D Expected volatility under the Black-Scholes-Merton formula

In calculating the fair value of a share option using the Black-Scholes-Merton formula, a single expected volatility assumption must be used. That amount is required to be based on the volatility expected over the expected term of the option. Frequently, expected volatility is based on observed historical share price volatility during the period of time equal to the expected term of the option and ending on the grant date. Implied volatilities (i.e., volatilities implied by actual option prices on the entity's shares observed in the market) also may be considered in determining the expected volatility assumption (see section 8.5.3 above).

When developing an expected volatility assumption, current and prior implied volatilities for publicly traded options and historical realised share volatilities must be considered for shares of the grantor and shares of other entities in the grantor's industry and comparable entities.

The volatility of a market index will not generally provide an appropriate input as the diversified nature of the index tends to produce a lower volatility figure than that applicable to individual shares.

8.5.3.E Expected volatility under lattice models

Expected volatility is more accurately taken into account by lattice models than by the Black-Scholes-Merton formula, because lattice models can accommodate dynamic assumptions regarding the term structure and path-dependence of volatility. For example, there is evidence that volatility during the life of an option depends on the term of the option and, in particular, that short-term options often exhibit higher volatility than similar options with longer terms. Additionally, volatility is path-dependent, in that it is often lower (higher) after an increase (decrease) in share price.

An entity that can observe sufficiently extensive trading of options over its shares may decide, when developing a term structure of expected volatility, to place greater weight on current implied volatilities than on historical observed and prior implied volatilities. It is likely that current implied volatilities are better indicators of the expectations of market participants about future volatility.

8.5.4 Expected dividends

The valuation of an award of options depends on whether or not the holder is entitled to dividends or dividend equivalents (whether in the form of cash payments or reductions in the exercise price) before the award is ultimately exercised. *[IFRS 2.B31, IFRS 2.B32, IFRS 2.B34]*. The accounting treatment of awards that entitle the holder to dividends before exercise is discussed further in section 15.3 below.

Dividends paid on the underlying share will impact the share option value - the higher the expected dividend yield (i.e., dividend per share ÷ share price), the lower the option value. Option holders generally do not have dividend rights until they actually exercise the options and become shareholders. All other things being equal, a share option for a share yielding a high dividend is less valuable than one for a share yielding a low dividend.

Where employees are entitled to dividends or dividend equivalents, the options granted should be valued as if no dividends will be paid on the underlying shares, so that the input for expected dividends (which would otherwise reduce the valuation of an option) is zero. Conversely, where employees are not entitled to dividends or dividend equivalents, the expected dividends should be included in the application of the pricing model. *[IFRS 2.B31, IFRS 2.B32, IFRS 2.B34]*.

While option pricing models generally call for an expected dividend yield, they may be modified to use an expected dividend amount rather than a yield. Where an entity uses expected payments rather than expected yields, it should consider its historical pattern of increases in dividends. For example, if an entity's policy has generally been to increase dividends, its estimated option value should not assume a fixed dividend amount throughout the life of the option unless there is evidence to support that assumption. *[IFRS 2.B35]*.

Determination of the expected dividends over the expected term of the option requires judgement. Generally, the expected dividend assumption should be based on current expectations about an entity's anticipated dividend policy. For example, an entity that has demonstrated a stable dividend yield in past years, and has indicated no foreseeable plans to change its dividend policy, may simply use its historical dividend yield to estimate the fair value of its options. If an entity has never paid a dividend, but has publicly announced that it will begin paying a dividend yielding 2% of the current share price, it is likely that an expected dividend yield of 2% would be assumed in estimating the fair value of its options.

Generally, assumptions about expected dividends should be based on publicly available information. Thus, an entity that does not pay dividends and has no plans to do so should assume an expected dividend yield of zero. However, an emerging entity with no history of paying dividends might expect to begin paying dividends during the expected lives of its employee share options. Such entities could use an average of their past dividend yield (zero) and the mean dividend yield of a comparable peer group of entities. *[IFRS 2.B36]*.

8.5.4.A Expected dividends under the Black-Scholes-Merton formula

Closed-form option-pricing models generally call for a single expected dividend yield as an input. That input must be determined based on the guidance in section 8.5.4 above.

8.5.4.B Expected dividends under the binomial model and other lattice models

Lattice models can be adapted to use an expected dividend amount rather than a dividend yield, and therefore can also take into account the impact of anticipated dividend changes. Such approaches might better reflect expected future dividends, since dividends do not always move in a fixed fashion with changes in the entity's share price. This may be a time- or price-dependent assumption, similar to those described in the discussion of the binomial model in section 8.3.2 above. Expected dividend estimates in a lattice model must be determined based on the general guidance above. Additionally, when the present value of dividends becomes significant in relation to the share price, standard lattice models may need to be amended.

8.5.5 Risk-free interest rate

Extract from IFRS 2	
B37	Typically, the risk-free interest rate is the implied yield currently available on zero-coupon government issues of the country in whose currency the exercise price is expressed, with a remaining term equal to the expected term of the option being valued (based on the option's remaining contractual life and taking into account the effects of expected early exercise). It may be necessary to use an appropriate substitute, if no such government issues exist or circumstances indicate that the implied yield on zero-coupon government issues is not representative of the risk-free interest rate (for example, in high inflation economies). Also, an appropriate substitute should be used if market participants would typically determine the risk-free interest rate by using that substitute, rather than the implied yield of zero-coupon government issues, when estimating the fair value of an option with a life equal to the expected term of the option being valued.

[IFRS 2.B37].

The risk-free interest rate will not have an impact on most free share grants unless the counterparty is not entitled to dividends during the vesting period and the fair value of the grant has been reduced by the present value of the dividends. Otherwise, grants of free shares have an exercise price of zero and therefore involve no cash outflow for the holder.

8.5.5.A Risk-free interest rate under the Black-Scholes-Merton formula

The Black-Scholes-Merton formula expressed in section 8.3.1 above uses a continuously compounded interest rate, which means that any interest rate calculated or obtained needs to be in this format. The continuously compounded interest rate is given by the formula:

continuously compounding rate = ln(1 + annual rate),

where ln represents a natural logarithm. For example, a 1.50% annual effective rate results in a continuously compounded rate of 1.49%:

1.49% = ln(1 + 0.0150)

8.5.5.B Risk-free interest rate under binomial and other lattice models

At each node in the lattice, the option values in the lattice must be discounted using an appropriate forward rate as determined by a yield curve constructed from the implied yield on zero-coupon government bond issues. In stable economies this will have minimal impact and it is therefore likely that a flat risk-free rate that is consistent with the expected life assumption will be a reasonable estimate for this input.

8.6 Capital structure effects and dilution

Typically, traded share options are written by third parties, not the entity issuing the shares that are the subject of the option. When these share options are exercised, the writer delivers to the option holder shares acquired from existing shareholders. Hence the exercise of traded share options has no dilutive effect. By contrast, when equity-settled share options written by the entity are exercised, new shares may be issued (either in form or in substance, if shares previously repurchased and held in treasury are used), giving rise to dilution. This actual or potential dilution may reduce the share price, so that the option holder does not make as large a gain on exercise as would be the case on exercising an otherwise similar traded option that does not dilute the share price. *[IFRS 2.B38, IFRS 2.B39]*.

Whether or not this has a significant effect on the value of the share options granted depends on various factors, such as the number of new shares that will be issued on exercise of the options compared with the number of shares already issued. Also, if the market already expects that the option grant will take place, the market may have already factored the potential dilution into the share price at the date of grant. However, the entity should consider whether the possible dilutive effect of the future exercise of the share options granted might have an impact on their estimated fair value at grant date. Option pricing models can be adapted to take into account this potential dilutive effect. *[IFRS 2.B40, IFRS 2.B41]*.

How we see it

In practice, in our view, it is unlikely that a listed entity would be required to make such an adjustment unless it makes a very large, unanticipated grant of share options. Indeed, even in that case, if the potential dilution is material and is not already incorporated into the share price, it would be expected that the announcement of the grant would cause the share price to decline by a material amount. Unlisted entities should consider whether the dilutive impact of a very large option grant is already incorporated into the estimated share price used in their option-pricing model. If that is not the case, some adjustment to the fair value may be appropriate.

8.7 Valuation of equity-settled awards other than options

As noted in section 8.1 above, the discussion in sections 8.3 to 8.5 above may well be relevant to share-based payments other than options. These include, but are not restricted to:

- Awards of shares (see section 8.7.1 below).
- Non-recourse loans (see section 8.7.2 below).
- Share appreciation rights (SARs) (see section 8.7.3 below).
- Performance rights (see section 8.7.4 below).

8.7.1 Shares

IFRS 2 requires shares granted to employees to be valued at their market price (where one exists) or an estimated market value (where the shares are not publicly traded), in either case adjusted to take into account the terms and conditions on which the shares were granted, other than those vesting conditions that IFRS 2 requires to be excluded in determining the grant date fair value (see section 6.2 above). *[IFRS 2.B2]*.

For example, the valuation must take into account restrictions on the employee's right:

- To receive dividends in the vesting period (see below).
- To transfer shares after vesting, but only to the extent that such restrictions would affect the price that a knowledgeable and willing market participant would pay for the shares. Where the shares are traded in a deep and liquid market, the effect may be negligible.

The valuation must not, however, take into account restrictions on transfer or other restrictions that exist during the vesting period and which stem from the existence of vesting conditions. *[IFRS 2.B3]*.

Whether dividends must be taken into account in measuring the fair value of shares depends on whether the counterparty is entitled to dividends or dividend equivalents (which might be paid in cash) during the vesting period. When the grant date fair value of shares granted to employees is estimated, no adjustment is required if the employees are entitled to receive dividends during the vesting period (as they are in no different a position in this respect than if they already held shares). However, where employees are not entitled to receive dividends during the vesting period, the valuation should be reduced by the present value of dividends expected to be paid during the vesting period. *[IFRS 2.B31, IFRS 2.B33, IFRS 2.B34]*. The basis on which expected dividends during the vesting period might be determined is discussed in the context of the impact of expected dividends on the fair value of share options in section 8.5.4 above.

The accounting treatment of awards which give the right to receive dividends or dividend equivalents during the vesting period is discussed further in section 15.3 below.

8.7.2 Non-recourse loans

Non-recourse loans are loans granted by an entity to the employee to allow the employee to buy shares, and are discussed in more detail in section 15.2 below. Generally, however, the loan is interest-free, with the dividends received on the purchased shares being used to repay the loan. The loan acts like an option, in that, at the point in time when the holder decides to sell the shares to repay the loan, if the shares are worth less than the loan, the remaining part of the loan is forgiven, with the effect that, just as in the case of an option, the holder bears no risk of ownership.

8.7.3 Share appreciation rights (SARs)

A share appreciation right (SAR) is a grant whereby the employee will become entitled either to shares or, more commonly, to a future cash payment based on the increase in the entity's share price from a specified level over a period of time (see further discussion in section 9 below on cash-settled awards). This essentially has the same payoff as a call option, except the award is generally cash- rather than equity-settled.

8.7.4 Performance rights

A performance right is the right to acquire further shares after vesting, upon certain criteria being met. These criteria may include certain performance conditions which can usually be modelled with either a Black-Scholes-Merton formula or a binomial lattice model or a Monte Carlo Simulation depending on the nature of the conditions attached to the rights. Such awards may be structured as matching share awards, as discussed in more detail in section 15.1 below.

8.8 Awards whose fair value cannot be measured reliably

IFRS 2 acknowledges that there may be rare cases where it is not possible to determine the fair value of equity instruments granted. In such cases, the entity is required to adopt a method of accounting based on the intrinsic value of the award (i.e., the price of the underlying share less the exercise price, if any, for the award). This is slightly puzzling in the sense that, for unlisted entities, a significant obstacle to determining a reliable fair value for equity instruments is the absence of a market share price, which is also a key input in determining intrinsic value. In fact, the intrinsic value model is arguably more onerous than the fair value model since, as discussed further in sections 8.8.1 and 8.8.2 below, it requires intrinsic value to be determined not just once, but at initial measurement date and each subsequent reporting date until exercise.

8.8.1 Intrinsic value method - the basic accounting treatment

Under the intrinsic value method:

(a) The entity measures the intrinsic value of the award at each reporting date between grant date and settlement (whether through exercise, forfeiture or lapse).

(b) At each reporting date during the vesting period the cumulative expense must be determined as the intrinsic value of the award at that date multiplied by the expired portion of the vesting period, with all changes in the cumulative expense recognised in profit or loss.

(c) Once options have vested, all changes in their intrinsic value until settlement must be recognised in profit or loss. *[IFRS 2.24(a)]*.

The cumulative expense during the vesting period, like that for awards measured at fair value, must always be based on the best estimate of the number of awards that will actually vest (see section 6 above). However, the distinction between market conditions, non-market vesting conditions and non-vesting conditions that would apply to equity-settled awards measured at fair value (see sections 6.1 to 6.4 above) does not apply in the case of awards measured at intrinsic value. *[IFRS 2.24(b)]*. In other words, where an award measured at intrinsic value is subject to a market condition or non-vesting condition that is not met, there is ultimately no accounting expense for that award. This is consistent with a model requiring constant remeasurement.

The cost of awards measured at intrinsic value is ultimately revised to reflect the number of awards that are actually exercised. However, during the vesting period the cost must be based on the number of awards estimated to vest and thereafter on the number of awards that have vested. In other words, any post-vesting forfeiture or lapse must not be anticipated, but must be accounted for as it occurs. *[IFRS 2.24(b)]*.

Illustration 8-2 is based on IG Example 10 in the implementation guidance to IFRS 2 and illustrates the intrinsic value method. *[IFRS 2.IG Example 10]*.

Illustration 8-2: Intrinsic value method

At the beginning of year 1, an entity grants 1,000 share options to 50 employees.

The share options will vest at the end of year 3, provided the employees remain in service until then. The options can be exercised at the end of year 4, and then at the end of each subsequent year up to and including year 10. The exercise price, and the entity's grant date share price, is CU60. At the date of grant, the entity concludes that it cannot estimate reliably the fair value of the share options granted.

At the end of year 1, the entity estimates that 10 of the employees will have left employment by the end of the vesting period and so 80% of the share options will vest. At the end of year 2, the entity revises the number of leavers to 7 and its estimate of the number of share options that it expects will vest to 86%.

During the vesting period, a total of 7 employees leave, so that 43,000 share options vest.

The intrinsic value of the options, and the number of share options exercised during years 4-10, are as follows:

Year	Share price at year end CU	Intrinsic value CU	Number exercised at year end
1	63	3	
2	65	5	
3	75	15	
4	88	28	6,000
5	100	40	8,000
6	90	30	5,000
7	96	36	9,000
8	105	45	8,000
9	108	48	5,000
10	115	55	2,000

The expense recognised under IFRS 2 will be as follows. In the period up to vesting the 'cumulative expense' methodology used in the Illustrations in sections 6.1 to 6.4 above can be adopted to derive the expense for each period:

Year	Calculation of cumulative expense	Cumulative expense (CU)	Expense for period (CU)
1	50,000 options × CU3 × 80% × 1/3	40,000	40,000
2	50,000 options × CU5 × 86% × 2/3	143,333	103,333
3	43,000 options × CU15	645,000	501,677

In years 4 to 10 it is more straightforward to calculate the expense directly. Since all options exercised during each year are exercised at the end of that year, the annual expense can be calculated as the change in intrinsic value during each year of the options outstanding at the start of the year.

Year		Expense for period (CU)
4	43,000 options × CU(28 - 15)	559,000
5	43,000 - 6,000 = 37,000 options × CU(40 - 28)	444,000
6	37,000 - 8,000 = 29,000 options × CU(30 - 40)	(290,000)
7	29,000 - 5,000 = 24,000 options × CU(36 - 30)	144,000
8	24,000 - 9,000 = 15,000 options × CU(45 - 36)	135,000
9	15,000 - 8,000 = 7,000 options × CU(48 - 45)	21,000
10	7,000 - 5,000 = 2,000 options × CU(55 - 48)	14,000

If, more realistically, the options had been exercisable, and were exercised, at other dates, it would have been necessary to record as an expense for those options the movement in intrinsic value from the start of the year until exercise date. For example, if the 6,000 options in year 4 had been exercised during the year when the intrinsic value was CU20, the expense for that period would have been CU511,000 comprising CU481,000 change in value for the options outstanding at the end of year [37,000 options × CU(28 - 15)] and CU30,000 change in value of options exercised during the period [6,000 options × CU(20 - 15)].

How we see it

Since the intrinsic value method will initially be applied at the date at which the entity obtains the goods or the counterparty renders service and continues to be applied at the end of each reporting period until the date of final settlement, in our view the entity would continue to apply this method of measurement throughout the life of such an award even if it becomes possible to measure the fair value of the award at some stage prior to its settlement.

8.8.2 Modification, cancellation and settlement

The methodology of the intrinsic value method has the effect that modification or cancellation is dealt with automatically, and the rules for modification and cancellation of awards measured at fair value (see section 7 above) therefore do not apply. *[IFRS 2.25]*.

Where an award accounted for at intrinsic value is settled in cash, the following provisions apply, which are broadly similar to the rules for settlement of awards accounted for at fair value.

If settlement occurs before vesting, the entity must treat this as an acceleration of vesting and "recognise immediately the amount that would otherwise have been recognised for services received over the remainder of the vesting period". *[IFRS 2.25(a)]*. The wording here is the same as that applicable to settlement of awards accounted for at fair value, which we discuss in more detail in section 7.4.3 above.

Any payment made on settlement must be deducted from equity, except to the extent that it is greater than the intrinsic value of the award at settlement date. Any such excess is accounted for as an expense. *[IFRS 2.25(b)]*.

8.9 Awards with reload features

Some share options contain a reload feature (see section 5.5.1 above). Reloads commonly provide that, where an exercise price is satisfied in shares of the issuing entity rather than cash, there is a new grant of at-the-money options over as many shares as are equal to the exercise price of the exercised option. For example, if there were 100 options with an exercise price of CU10, and the new share price was CU15, 67 options (CU1,000 ÷ CU15) would be re-issued.

Even though the reload feature (i.e., the possibility that additional options would be issued in the future) is a feature of the original option, and can be readily incorporated into the valuation of the original option using a lattice model, the IASB concluded that the fair value of a reload feature should not be incorporated into the estimate of the fair value of the award at grant date. As a result, subsequent grants of reload awards under the reload feature would be accounted for as new awards and measured on their respective grant dates. *[IFRS 2.BC188-BC192]*.

On the assumption that the exercise price of an award is at least the share price at grant date, the grant-date fair value of the reload award will generally be greater than the incremental value of the reload feature as at the date the original award was granted. This is because the reload award will only be granted if the original option is in-the-money and is exercised. As a result, the award would have increased in the period between the original grant date and the reload grant date, and the higher share price would be used to value the reload grant. However, from the perspective of the aggregate compensation cost, this result is mitigated by the fact that, as the value of the underlying share increases, fewer shares must be tendered to satisfy the exercise price requirement of the exercised option and, therefore, fewer reload options will be granted (as above when only 67 options are re-issued for the 100 originally issued).

If the reload feature were incorporated into the valuation of the original grant, then not only would a lower price be used, but the valuation would consider the possibility that the original option would never be exercised and, therefore, that the reload options would not be granted. Under the approach in IFRS 2, if the original award expires unexercised, no compensation cost results from the reload feature, so that the compensation cost is lower than would be the case if the value of the reload feature were incorporated into the measurement of the original award. Effectively, the approach in IFRS 2 incorporates subsequent share price changes into the valuation of a reload award.

8.10 Awards of equity instruments to a fixed monetary value

Entities may make an award of shares equivalent to a fixed monetary value (see section 5.3.5 above). This is commonly found as part of a matching share award where an employee may be offered the choice of receiving cash or shares of an equivalent value, or a multiple of that value (see section 15.1 below).

IFRS 2 does not address directly the valuation of such awards. Illustration 8-3 below demonstrates how such awards are valued:

Illustration 8-3: Award of shares to a fixed monetary value

At the beginning of year 1 the reporting entity grants:

- To Employee A an award of 1,000 shares subject to remaining in employment for three years.
- To Employee B CU10,000 subject to remaining in employment for three years, to be paid in as many shares as are (at the end of year 3) worth CU10,000.

Both awards vest, and the share price at the end of year 3 is CU10, so that both employees receive 1,000 shares.

The IFRS 2 charge for A's award is clearly 1000 × the fair value as at the beginning of year 1 of a share deliverable in three years' time. What is the charge for B's award?

How we see it

In our view, the fair value of the equity instruments granted for B's award would be the CU10,000 adjusted for the time value of money, as the value employee B will receive is fixed at CU10,000 and is independent of the share price. This amount, determined at grant date, would be recognised as an expense over the vesting period, which in this case is a three year service condition for employee B.

Although IFRS 2 does not directly address the valuation of awards of equity instruments equivalent to a fixed monetary value, IFRS 2 does require the grant date fair value of the equity instruments awarded to be recognised, which for a fixed monetary award would be the fixed monetary amount to be received adjusted for the time value of money.

9 Cash-settled transactions

Throughout the discussion in this section, 'cash' must be read as including 'other assets' in accordance with the definition of a cash-settled share-based payment in Appendix A to IFRS 2. *[IFRS 2 Appendix A]*.

Extract from IFRS 2

Appendix A IFRS 2
Defined terms

cash-settled share-based payment transaction	A **share-based payment transaction** in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services for amounts that are based on the price (or value) of **equity instruments** (including shares or **share options**) of the entity or another group entity.

9.1 Scope of requirements

Cash-settled share-based payment transactions include transactions such as:

- Share appreciation rights (SARs), where employees are entitled to a cash payment equivalent to the gain that would have arisen from a holding of a particular number of shares from the date of grant to the date of exercise.
- Phantom options, where employees are entitled to a cash payment equivalent to the gain that would have been made by exercising options at a notional price over a notional number of shares and then selling the shares at the date of exercise. *[IFRS 2.31]*.

However, IFRS 2 looks beyond the simple issue of whether an award entitles an employee to receive instruments that are in the form of shares or options to the terms of those instruments. For example, an award of shares or options over shares whose terms provide for their redemption either mandatorily according to their terms (e.g., on cessation of employment) or at the employee's option would be treated as a cash-settled, not an equity-settled, award under IFRS 2. *[IFRS 2.31]*. This is consistent with the fact that IAS 32 would regard a share with these terms as a financial liability rather than an equity instrument of the issuer (see Chapter 43 at section 4).

In some cases, the boundary between equity-settled and cash-settled schemes may appear somewhat blurred, so that further analysis may be required to determine whether a particular arrangement is equity-settled or cash-settled. Some examples of such arrangements are discussed in section 9.2 below.

9.2 What constitutes a cash-settled award?

There are a number of possible circumstances in which, on, or shortly after, settlement of an equity-settled award either:

- The entity incurs a cash outflow equivalent to that which would arise on cash-settlement (e.g., because it purchases shares in the market at fair value to deliver to counterparties).

  Or

- The counterparty receives a cash inflow equivalent to that which would arise on cash-settlement (e.g., because the shares are sold in the market for cash on behalf of the counterparty).

Such situations raise the question of whether such schemes are in fact truly equity-settled or cash-settled.

Examples of relatively common mechanisms for delivering the cash-equivalent of an equity-settled award to employees are discussed below. It emerges from the analysis below that, in reality, IFRS 2 is driven by questions of form rather than substance. To put it rather crudely, what matters is often not so much whether the entity has made a cash payment for the fair value of the award, but rather the name of the payee.

The significance of this is that the analysis affects the profit or loss charge for the award, as demonstrated by Illustration 9-1 below.

Illustration 9-1: Equity-settled award satisfied with market purchase of treasury shares

An entity awards an employee a free share with a fair value at grant date of CU5 which has a fair value of CU8 at vesting. At vesting the entity purchases a share in the market for CU8 for delivery to the employee. If the scheme were treated as cash-settled, there would be a charge to profit or loss of CU8 (the fair value at vesting date - see section 9.3 below). If it were treated as equity-settled (as required in this case by IFRS 2), profit or loss would show a charge of only CU5 (the fair value at grant date), with a further net charge of CU3 in equity, comprising the CU8 paid for the share accounted for as a treasury share (see Chapter 43 at section 9) less the CU5 credit to equity (being the credit entry corresponding to the CU5 charge to profit or loss - see section 4.2 above).

The analyses below all rely on a precise construction of the definition of a cash-settled share-based payment transaction, i.e., one "in which the entity acquires goods or services *by incurring a liability to transfer cash or other assets to the supplier of those goods or services* for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity" (emphasis added). *[IFRS 2 Appendix A]*. Thus, if the entity is not actually required - legally or constructively - to pay cash to the counterparty, there is no cash-settled transaction under IFRS 2, even though the arrangement may give rise to an external cash flow and, possibly, a liability under another standard.

9.2.1 Formal and informal arrangements for the entity to purchase illiquid shares or otherwise settle in cash (awards to be treated as cash-settled, including unlisted company schemes)

Some share-based payment awards, particularly when made by unlisted entities, might appear to be equity-settled in form but, in our view, may need to be accounted for as cash-settled awards under IFRS 2. This reflects either specific arrangements put in place by the entity (or a shareholder) for the employees to sell their shares or, more generally, the illiquid market in the shares which, in the absence of compelling evidence to the contrary, is likely to result in a cash payment by the entity to the counterparty at some stage. Such awards need to be carefully analysed, in the light of their particular facts and circumstances.

How we see it

Share-based payment awards, made by unlisted entities, may need to be accounted for as cash-settled awards under IFRS 2. Such awards need to be carefully analysed, in the light of their particular facts and circumstances.

This is similar to the assessment for awards where the agreement states that entities have a choice of settlement in equity or cash (see section 10.2.1.A below).

9.2.2 Market purchases of own equity used to satisfy awards

It is common for an entity to choose to settle equity-settled transactions using shares previously purchased in the market rather than by issuing new shares. This does not mean that the transaction is cash-settled, since there is no obligation to deliver cash to the counterparty. *[IFRS 2.B48, IFRS 2.B49]*.

The purchase of own shares is accounted for in accordance with the provisions of IAS 32 relating to treasury shares and other transactions over own equity (see Chapter 43 at section 9).

A question sometimes asked is whether the entity is required to recognise some form of liability to repurchase its own equity in situations where the entity has a stated policy of settling equity-settled transactions using previously purchased treasury shares.

How we see it

In our view, the normal provisions of IAS 32 would apply in these situations.

To illustrate this point, a public commitment to settle equity-settled transactions by purchasing treasury shares is no different in substance to a commitment to a share buyback programme. There would be no question under IAS 32 of recognising a liability to repurchase own equity on the basis merely of a declared intention. It is only when the entity enters into a forward contract or a call option with a third party that some accounting recognition of a future share purchase may be required.

9.2.3 Market purchases of own equity following equity-settlement of award

An entity might sometimes make a market purchase of its own shares shortly after issuing a similar number of shares in settlement of an equity-settled transaction. This raises the question of whether such a scheme would be considered as in substance cash-settled.

In our view, further enquiry into the detailed circumstances of the market purchase is required in order to determine the appropriate analysis under IFRS 2.

Broadly speaking, so long as there is no obligation (explicit or implicit) for the entity to settle in cash with the counterparty, such market purchase arrangements will not require a scheme to be treated as cash-settled under IFRS 2. This will be the case even where the entity, as a means of managing the dilutive impact on earnings per share of equity-settlement, routinely buys back shares broadly equivalent to the number issued in settlement.

However, in our view, there might be situations in which post-settlement market share purchases are indicative of an obligation to the counterparty, such that treatment as a cash-settled scheme would be appropriate.

For example, the shares might be quoted in a market which is not very deep, or in which the entity itself is a major participant. If the entity were to create an expectation by employees that any shares awarded can always be liquidated immediately, because the entity will ensure that there is sufficient depth in the market to do so, it could well be appropriate to account for such a scheme as cash-settled. The treatment of schemes in which the entity has a choice of settlement, but has created an expectation of cash-settlement, provides a relevant analogy (see section 10.2.1 below).

A more extreme example of such a situation would be where the entity has arranged for the shares delivered to the counterparty to be sold on the counterparty's behalf by a broker (see section 9.2.4 below), but has at the same time entered into a contract to purchase those shares from the broker. In that situation, in our view, the substance is that:

- The entity has created an expectation by the counterparty of a right to receive cash.
- The broker is no more than an agent paying that cash to the counterparty on behalf of the entity.

Accordingly, it would be appropriate to account for such an arrangement as a cash-settled award.

In a situation where the entity had pre-arranged to purchase some, but not all, the shares from the broker, in our view it would generally be appropriate to treat the award as cash-settled only to the extent of the shares subject to the purchase agreement.

How we see it

In summary, where an entity might sometimes make a market purchase of its own shares shortly after issuing a similar number of shares in settlement of an equity-settled transaction, detailed analysis is required to determine the appropriate classification of the share-based payment award.

If an entity were to create an expectation by employees that shares can be liquidated quickly by the entity ensuring there is depth in the market, our view is that it could be appropriate to account for the award as cash-settled.

Where the entity arranges a broker to purchase some or all shares from the counterparty on the counterparty's behalf and the entity then purchases those shares from the broker, it would be appropriate to account for the purchase arrangement of those shares as a cash-settled share-based payment transaction (see section 9.2.4 below).

9.2.4 Arrangements to sell employees' shares including 'broker settlement'

Many recipients of share awards, particularly employees in lower and middle ranking positions within an entity, do not wish to become long-term investors in the entity and prefer instead to realise any equity-settled awards in cash soon after receipt. In order to facilitate this, the entity may either sell the shares in the market on the employees' behalf or, more likely, arrange for a third-party broker to do so.

Such an arrangement (sometimes referred to as 'broker settlement') does not of itself create a cash-settled award, provided that the entity has not created any obligation to provide cash to the employees. If, however, the entity has either created an expectation among employees that it will step in to make good any lack of depth in the market, or has indeed itself contracted to repurchase the shares in question, that may well mean that analysis as a cash-settled scheme is more appropriate (see also section 9.2.3 above).

Broker settlement arrangements may raise a general concern that an entity may be masking what are really issues of shares to raise cash to pay its employees as sales of shares on behalf of employees. If an entity were simply to issue shares (or reissue treasury shares) for cash, and then use that cash to pay an employee's salary, the normal accounting treatment for such a transaction would be to credit equity with the proceeds of issue or reissue of shares, and to charge the payment to the employee to profit or loss.

By contrast, a sale of shares on behalf of an employee is undertaken by the entity as agent and does not give rise to an increase in equity and an expense, although an expense will be recognised for the award of shares under IFRS 2. However, the entity may enter into much the same transaction with a broker whether it is selling shares on its own behalf or on behalf of its employees. The challenge is therefore for the entity to be able to demonstrate the true economic nature of the transaction.

For this reason, some take the view that a sale of shares can be regarded as part of a broker settlement arrangement only if the shares are first legally registered in the name of the employee. Whilst we understand the concerns that lie behind this view, we nevertheless question whether legal registration is necessary to demonstrate the substance of a broker settlement arrangement. For example, suppose that 100 shares vest in each of 10 employees who all express a wish that the entity sell the shares on their behalf, and the entity then sells 1,000 treasury shares on behalf of the employees, but without first re-registering title to the shares to the employees. We do not believe that the entity is automatically precluded from regarding this as a broker settlement arrangement, particularly where the treasury shares are held not by the entity directly but through an employee benefit trust or similar vehicle (see section 12.3 below) that is permitted to hold or sell shares only for the benefit of employees.

By contrast, the entity might regularly purchase and sell treasury shares, but identify some of the sales as being undertaken on behalf of employees only after they have occurred. Such an arrangement, in our view, is more difficult to construe as a true broker-settlement arrangement.

Where shares are sold on behalf of an employee, they will typically attract transaction costs, such as brokerage fees or taxes. If such costs are borne by the entity, they must, in our view, be included within profit or loss as an additional component of employment costs, rather than deducted from equity as a cost of a transaction in own shares.

This highlights a commercial disadvantage of broker settlement arrangements. The entity may have to:

- Purchase shares in the market (incurring transaction costs) on behalf of an employee who does not want them and then sell them back into the market on the employee's behalf (incurring more transaction costs).

  Or

- Sell shares in the market (incurring transaction costs) on behalf of an employee who does not want them and then buy them back in the market on behalf of another employee who does want them (incurring more transaction costs).

In order to avoid this, entities may try to structure arrangements with their brokers involving back-to-back sale and purchase contracts, under which shares are never physically delivered, but the entity makes a cash payment to the broker in purported settlement of the purchase by the broker of shares on behalf of the entity and the broker passes it on to the employee in purported settlement of the sale of the shares by the broker on behalf of the employee.

In our view, such arrangements cannot be seen as equity-settled transactions with broker settlement, but must be regarded as cash-settled share-based payment transactions, using the broker as paying agent.

How we see it

In summary, to help facilitate the sale of shares awarded to employees, the entity may either sell the shares in the market on the employees' behalf or, more likely, arrange for a third party broker to do so. Such an arrangement (sometimes referred to as 'broker settlement') does not of itself create a cash-settled award, provided that the entity has not created any obligation to provide cash to the employees. Brokerage and taxes incurred on behalf of employees, in our view, must be recognised in profit or loss as an employee cost rather than deducted from equity as a cost of transaction in own shares.

However, a structured arrangement with an entity's broker involving back-to-back sale and purchase contracts, under which shares are never physically delivered, but the entity makes a cash payment to the broker in purported settlement of the purchase by the broker of shares on behalf of the entity and the broker passes it on to the employee in purported settlement of the sale of the shares by the broker on behalf of the employee; must be regarded as a cash-settled share-based payment transaction.

Related issues are raised by the 'drag along' and 'tag along' rights that are often a feature of awards designed to reward employees for a successful flotation or other exit event (see section 15.4.6 below).

9.3 Cash-settled transactions: required accounting

9.3.1 Basic accounting treatment

It is clear that the ultimate cost of a cash-settled transaction must be the actual cash paid to the counterparty, which will be the fair value at settlement date. Moreover, the cumulative cost recognised until settlement is clearly a liability, not a component of equity.

The liability is recognised and measured as follows:

- At each reporting date between grant and settlement the fair value of the award is determined in accordance with the specific requirements of IFRS 2.
- During the vesting period, the liability recognised at each reporting date is the IFRS 2 fair value of the award at that date multiplied by the expired portion of the vesting period.
- From the end of the vesting period until settlement, the liability recognised is the full fair value of the liability at the reporting date.

All changes in the liability are recognised in profit or loss for the period. *[IFRS 2.30-33D, IFRS 2.IG Example 12, IFRS 2.IG Example 12A]*.

When goods or services are acquired, an entity initially recognises a liability, when the entity obtains the goods or as the services are rendered, measured at the fair value of the liability. Thereafter, until the liability is settled, the entity is required to remeasure the fair value of the liability at the end of each reporting period and at the date of settlement, with any changes in fair value recognised in profit or loss for the period. *[IFRS 2.30, IFRS 2.IG18]* Where the cost of services received in a cash-settled transaction is recognised in the carrying amount of an asset (e.g., inventory) in the entity's statement of financial position, the carrying amount of the asset is not adjusted for changes in the fair value of the liability. *[IFRS 2.IG19]*.

The fair value of the liability must be determined, initially and at each reporting date until it is settled, by applying an option pricing model, taking into account the terms and conditions on which the cash-settled transaction was granted, and the extent to which the employees have rendered service to date. *[IFRS 2.33]*. Determination of fair value is subject to the requirements of IFRS 2.33A-33D, these paragraphs clarify the treatment of vesting and non-vesting conditions and are discussed further in section 9.3.2 below. *[IFRS 2.33]*.

This has the effect that, although the liability will ultimately be settled at its then intrinsic value, its measurement at reporting dates before settlement is based on its fair value. Before the initial publication of IFRS 2, a number of respondents to the IASB's earlier exposure draft suggested that, for reasons of consistency and simplicity of calculation, cash-settled transactions should be measured at intrinsic value throughout their entire life. The IASB, while accepting these merits of the intrinsic value approach, rejected it on the basis that, since it does not include a time value, it is not an adequate measure of either the liability or the cost of services consumed. *[IFRS 2.BC246-251]*.

As noted in section 5.5 above, the approach to determining the fair value of share-based payments continues to be that specified in IFRS 2 as share-based payments fall outside the scope of IFRS 13 which applies more generally to the measurement of fair value under IFRS accounting standards (see Chapter 15). *[IFRS 2.6A]*.

IFRS 2 uses the term 'share appreciation rights' when referring to measurement of the liability but makes clear that this must be read as including any cash-settled share-based payment transaction and therefore measured at fair value. *[IFRS 2.31]*.

To estimate the fair value of the liability an entity will use judgements and estimation assumptions, for example, selecting an option pricing model (i.e., measurement technique) and developing inputs in applying the option pricing model (i.e., applying the measurement technique). IAS 8, includes guidance that clarifies the distinction between changes in accounting estimates and changes in accounting policies. A change in an input or inputs (e.g., volatility assumption or measurement technique) are changes in accounting estimate unless they result from the correction of a prior period error (see Chapter 3 at section 4.5). *[IAS 8.IG Example 5]*.

9.3.2 Application of the accounting treatment

The treatment required by IFRS 2 for cash-settled transactions is demonstrated by Illustration 9-2 below and by Illustration 9-3 in section 9.3.2.C below. These examples are based, respectively, on IG Examples 12 and 12A in the implementation guidance accompanying IFRS 2. *[IFRS 2.IG Example 12, IFRS 2.IG Example 12A]*.

Illustration 9-2: Cash-settled transaction with service condition

An entity grants 100 cash-settled share appreciation rights (SARs) to each of its 500 employees, on condition that the employees remain in its employment for the next three years. The SARs can be exercised on the third, fourth and fifth anniversary of the grant date.

During year 1, 35 employees leave. The entity estimates that a further 60 will leave during years 2 and 3 (i.e., the award will vest in 405 employees).

During year 2, 40 employees leave and the entity estimates that a further 25 will leave during year 3 (i.e., the award will vest in 400 employees).

During year 3, 22 employees leave, so that the award vests in 403 employees. At the end of year 3, 150 employees exercise their SARs (leaving 253 employees still to exercise).

Another 140 employees exercise their SARs at the end of year 4, leaving 113 employees still to exercise, who do so at the end of year 5.

The entity estimates the fair value of the SARs at the end of each year in which a liability exists as shown below. The intrinsic values of the SARs at the date of exercise (which equal the cash paid out) at the end of years 3, 4 and 5 are also shown below.

Year	Fair value	Intrinsic value
	CU	CU
1	14.40	
2	15.50	
3	18.20	15.00
4	21.40	20.00
5		25.00

The entity will recognise the cost of this award as follows:

Year	Calculation of liability	Calculation of cash paid	Liability (CU)	Cash paid (CU)	Expense for period (CU)*
1	405 employees × 100 SARs × CU14.40 × 1/3		194,400	-	194,400
2	400 employees × 100 SARs × CU15.50 × 2/3		413,333	-	218,933
3	253 employees × 100 SARs × CU18.20	150 employees × 100 SARs × CU15.00	460,460	225,000	272,127
4	113 employees × 100 SARs × CU21.40	140 employees × 100 SARs × CU20.00	241,820	280,000	61,360
5	-	113 employees × 100 SARs × CU25.00	-	282,500	40,680

* Liability at end of period + cash paid in period - liability at start of period

The accounting treatment for cash-settled transactions is therefore (despite some similarities in the methodology) significantly different from that for equity-settled transactions. An important practical issue is that, for a cash-settled transaction, the entity must determine the fair value at each reporting date and not merely at grant date (and at the date of any subsequent modification or settlement) as would be the case for equity-settled transactions.

As Illustration 9-2 shows, it is not generally necessary, although arguably required by IFRS 2, to determine the fair value of a cash-settled transaction at grant date, at least to determine the expense under IFRS 2. However, for entities subject to IAS 33 *Earnings per Share,* the grant date fair value may be required in order to make the disclosures required by that standard - see Chapter 33 at section 6.4.2.

We discuss in more detail in sections 9.3.2.A to 9.3.2.E below the following aspects of the accounting treatment of cash-settled transactions:

- Determining the vesting period (see section 9.3.2.A below)
- Periodic allocation of cost (see section 9.3.2.B below)
- Treatment of non-market vesting conditions (see section 9.3.2.C below)
- Treatment of market conditions and non-vesting conditions (see section 9.3.2.D below)
- Treatment of modification, cancellation and settlement (see section 9.3.2.E below)

9.3.2.A Determining the vesting period

The rules for determining vesting periods are the same as those applicable to equity-settled transactions, as discussed in sections 6.1 to 6.4 above. Where an award vests immediately, IFRS 2 creates a presumption that, in the absence of evidence to the contrary, the award is in respect of services that have already been rendered, and must therefore be expensed in full at grant date. *[IFRS 2.32]*.

Where cash-settled awards are made subject to vesting conditions (as in many cases they will be, particularly where payments to employees are concerned), IFRS 2 creates a presumption that they are a payment for services to be received in the future, during the 'vesting period', with the transaction being recognised during that period, as demonstrated in Illustration 9-2 above. *[IFRS 2.32]*.

9.3.2.B Periodic allocation of cost

IFRS 2 states that the required treatment for cash-settled transactions is simply to measure the fair value of the liability at each reporting date, *[IFRS 2.30]*, which might suggest that the full fair value, and not just a time-apportioned part of it, must be recognised at each reporting date - as would be the case for any liability that is a financial instrument and measured at fair value under IFRS 9.

However, the standard goes on to clarify that the liability is to be measured at an amount that reflects 'the extent to which employees have rendered service to date', and the cost is to be recognised 'as the employees render service'. *[IFRS 2.32, IFRS 2.33]*. This, together with IG Examples 12-12A in IFRS 2 (the substance of which is reproduced as Illustrations 9-2 above and 9-3 below), indicates that a spreading approach is to be adopted.

For cash-settled awards vesting in instalments (sometimes referred to as 'graded' vesting), we believe that the requirements of the standard illustrated in IFRS 2.IG11, whereby each instalment is treated as a separate award, would be required to be followed similarly as to equity-settled awards (see section 6.2.2 above). This results in multiple separate awards having been granted with different vesting periods. As for all cash-settled share-based payment transactions the fair value for each instalment will be determined at each reporting date and at the date of settlement. On a cumulative basis, the amount ultimately recognised for goods or services received as consideration for the cash-settled awards will be equal to the cash that is paid. *[IFRS 2.32, IFRS 2.33, IFRS 2.33D]*.

How we see it

We believe, for cash-settled share-based payment transactions vesting in instalments, the requirement of the standard illustrated in IFRS 2.IG11 would be required to be followed with the associated cost recognised over the different vesting periods.

9.3.2.C Non-market vesting conditions

IFRS 2 clarifies how performance vesting conditions and non-vesting conditions must be treated in the measurement of cash-settled share-based payment transactions. In this section we consider non-market performance conditions; market conditions and non-vesting conditions are discussed in section 9.3.2.D below.

The standard makes clear that:

- Vesting conditions (other than market conditions) must not be taken into account in estimating the fair value of a cash-settled share-based payment. Instead, as for equity-settled share-based payment transactions, such conditions must be taken into account by adjusting the number of awards included in the measurement of the liability arising from the cash-settled share-based payment transaction.
- The amount recognised for the goods or services received during the vesting period must be based on the entity's best estimate of the number of awards expected to vest. This estimate must be revised, if necessary, if subsequent information indicates that the number of awards expected to vest differs from previous estimates. On the vesting date, the entity must revise the estimate to equal the number of awards that ultimately vested.
- On a cumulative basis, the amount ultimately recognised for goods or services received as consideration for the cash-settled share-based payment will be equal to the cash that is paid. *[IFRS 2.33A, IFRS 2.33B, IFRS 2.33D]*.

IG Example 12A of the implementation guidance accompanying IFRS 2 illustrates the accounting treatment of a cash-settled award with a non-market performance condition. *[IFRS 2.IG Example 12A]*. This example forms the basis of Illustration 9-3 below and supplements the Illustration of a service condition in IG Example 12 (broadly reproduced as Illustration 9-2 above).

Illustration 9-3: Cash-settled transaction with service condition and non-market performance condition

An entity grants 100 cash-settled share appreciation rights (SARs) to each of its 500 employees, on condition that the employees remain in its employment for the next three years and the entity reaches a revenue target (CU1 billion in sales) by the end of year 3. The entity expects all employees to remain in employment for the full three years.

At the end of year 1, the entity expects that the revenue target will not be achieved by the end of year 3. During year 2, the entity's revenue increased significantly and it is expected that the revenue will continue to grow. Consequently, at the end of year 2, the entity expects that the revenue target will be achieved by the end of year 3.

At the end of year 3, the revenue target is achieved and 150 employees exercise their SARs. Another 150 employees exercise their SARs at the end of year 4 and the remaining 200 exercise their SARs at the end of year 5.

Using an option pricing model, the entity estimates the fair value of the SARs, ignoring the revenue target performance condition and the employment service condition, at the end of each year until all of the cash-settled share-based payments are settled. At the end of year 3, all of the SARs vest. The following table shows the estimated fair value of the SARs at the end of each year and the intrinsic values of the SARs at the date of exercise (which equal the cash paid out).

Year	Fair value	Intrinsic value
	CU	CU
1	14.40	
2	15.50	
3	18.20	15.00
4	21.40	20.00
5	25.00	25.00

The entity will recognise a total expense and cash payment of CU1,025,000 as follows:

Year	Calculation of liability	Calculation of cash paid	Liability (CU)	Cash paid (CU)	Expense for period (CU)*
1	SARs are not expected to vest: no expense is recognised.		-	-	-
2	SARs are expected to vest: 500 employees × 100 SARs × CU15.50 × 2/3		516,667	-	516,667
3	((500 - 150) employees × 100 SARs × CU18.20 × 3/3) - 516,667	150 employees × 100 SARs × CU15.00	637,000	225,000	345,333
4	((350 - 150) employees × 100 SARs × CU21.40) - 637,000	150 employees × 100 SARs × CU20.00	428,000	300,000	91,000
5	((200 - 200) employees × 100 SARs × CU25.00) - 428,000	200 employees × 100 SARs × CU25.00	-	500,000	72,000

* Liability at end of period + cash paid in period - liability at start of period

9.3.2.D Market conditions and non-vesting conditions

IFRS 2 clarifies that market conditions and non-vesting conditions must be taken into account when estimating the fair value of a cash-settled share-based payment when it is initially measured and at each remeasurement date until settlement. *[IFRS 2.33C]*. There will be no ultimate cost for a cash-settled award where a market condition or non-vesting condition is not satisfied as any liability would be reversed. The cumulative amount recognised will be equal to the cash paid. *[IFRS 2.33D]*. This is different from the accounting model for equity-settled transactions with market conditions or non-vesting conditions, which can result in a cost being recognised for awards subject to a market or non-vesting condition that is not satisfied (see sections 6.3 and 6.4 above).

9.3.2.E Modification, cancellation and settlement

IFRS 2 includes guidance for modifications that change the classification of a share-based payment transaction from cash-settled to equity-settled (see section 9.4 below). Apart from this, IFRS 2 provides no specific guidance on modification, cancellation and settlement of cash-settled awards. However, as cash-settled awards are accounted for using a full fair value model no such guidance is needed. It is clear that:

- Where an award is modified, the liability recognised at and after the point of modification will be based on its new fair value, with the effect of any movement in the liability recognised immediately.
- Where an award is cancelled the liability will be derecognised, with a credit immediately recognised in profit or loss.
- Where an award is settled, the liability will be derecognised, and any gain or loss on settlement immediately recognised in profit or loss.

How we see it

As noted above, IFRS 2 provides no specific guidance on modification, cancellation and settlement of cash-settled awards. In our view, as cash-settled awards are accounted for using a full fair value model no such guidance is needed, the accounting set out above would apply.

9.4 Modification of award from equity-settled to cash-settled or from cash-settled to equity-settled

An entity will sometimes modify the terms of an award in order to change the manner of settlement. In other words, an award that at grant date was equity-settled is modified so as to become cash-settled, or *vice versa*.

IFRS 2 provides no explicit guidance for modifications that change an award from being equity-settled to being cash-settled. As part of the discussions relating to the June 2016 amended guidance for modifications from cash-settled to equity-settled, the IASB considered, but rejected, suggestions that additional examples be added to the implementation guidance to illustrate other types of modification, including equity-settled to cash-settled (see further discussion in section 9.4.1 below).

In order to develop the suggested accounting approaches discussed in section 9.4.1 below we have used the provisions of IFRS 2 in respect of:

- The modification of equity-settled awards during the vesting period (see section 7.3 above).
- The addition of a cash-settlement alternative to an equity-settled award after grant date, as illustrated by IG Example 9 in the implementation guidance to IFRS 2 (see section 10.1.4 below).
- The settlement of equity-settled awards in cash (see section 7.4 above).

As noted in section 10.2.3 below, the accounting in this section also applies where an entity with a choice of settlement in equity or cash switches between settlement methods.

9.4.1 Equity-settled award modified to cash-settled award

This section focuses on accounting for a change of settlement method rather than on the accounting treatment of other modifications to an equity-settled award that might be made at the same time as the change of settlement method (see section 7.3 above).

Drawing on the principles within the guidance referred to in section 9.4 above, we suggest that entities generally select one of the two approaches discussed below to account for the modification of an award from equity-settled to cash-settled during the vesting period. The first approach is based more closely on the IFRS 2 treatment for the modification of an equity-settled award (see section 7.3 above) and the second on that for the repurchase or settlement in cash of an equity instrument (see section 7.4 above).

Both approaches take into account IG Example 9 in the implementation guidance to IFRS 2 (see section 10.1.4 below) which shows the recognition of an expense when the cash-settlement alternative is remeasured in the period following modification, in addition to an expense for the full grant date fair value of the equity-settled arrangement. Although this Example reflects a choice of settlement by the counterparty, rather than the elimination of a method of settlement (as is the case in a modification from equity-settlement to cash-settlement), we believe that an analogy may be drawn between the two situations because the addition of a cash alternative for the counterparty effectively results in the award being treated as cash-settled from the date of modification.

The two approaches are discussed in more detail below and demonstrated in Illustration 9-4.

How we see it

In our view, when an equity-settled award is modified to a cash-settled award during the vesting period, in the absence of clear guidance in IFRS 2, either approach as set out in detail below is acceptable but the choice of approach must be applied consistently to all such modifications.

Both approaches require the recognition, as a minimum, of an IFRS 2 expense which comprises the following elements:

- The grant date fair value of the original equity-settled award (see section 7.3 above)
- Any incremental fair value arising from the modification of that award (see section 7.1 above)
- Any remeasurement of the liability between its fair value at the modification date and the amount finally settled (see section 10.1.4 below)

Over the vesting period as a whole, both approaches result in the same total IFRS 2 expense and the same liability/cash settlement amount. Under both approaches, the net overall difference between the expense and the cash settlement amount is an adjustment to equity. However, the timing of recognition of any incremental fair value arising on modification will differ under the two approaches, as explained below.

Approach 1

- At the date of modification, a liability is recognised based on the fair value of the cash-settled award as at that date and the extent to which the vesting period has expired.
- The entire corresponding debit is taken to equity. Any incremental fair value of the cash-settled award over that of the equity-settled award as at the modification date will be expensed over the period from the date of modification to the date of settlement of the cash-settled award (i.e., no expense is recognised at the date of modification).
- The total fair value of the cash-settled award is remeasured through profit or loss on an ongoing basis between the date of modification and the date of settlement.

As Approach 1 is based on the accounting treatment for a modification of an equity-settled award, no incremental fair value is recognised as an expense at the modification date. This means that, in cases where the fair value of the modified award is higher at the date of modification than that of the original award, the reduction in equity at the date of modification will be higher than the proportionate fair value at that date of the original equity-settled award. This situation reverses over the remainder of the vesting period when an expense (and corresponding credit to equity) will be recognised for the incremental fair value of the modified award. *[IFRS 2.27, IFRS 2.B42, IFRS 2.B43]*.

Approach 2

- As for Approach 1, at the date of modification a liability is recognised based on the fair value of the cash-settled award as at that date and the extent to which the vesting period has expired.
- Unlike Approach 1, the corresponding debit is taken to equity only to the extent of the fair value of the original equity-settled award as at the date of modification. Any incremental fair value of the cash-settled award over the equity-settled award as at the modification date is expensed immediately on modification to the extent that the vesting period has expired. The remainder of any incremental value is expensed over the period from the date of modification to the date of settlement.
- As for Approach 1, the total fair value of the cash-settled award is remeasured through profit or loss on an ongoing basis between the date of modification and the date of settlement.

Approach 2 is based on the accounting treatment for the repurchase of an equity instrument where a reduction in equity up to the fair value of the equity instrument is recognised as at the date of repurchase with any incremental fair value of the repurchase arrangement being treated as an expense. *[IFRS 2.28, IFRS 2.29]*. Whilst Approach 2 avoids the potential problem of an immediate reduction in equity in excess of the fair value of the equity-settled award, its settlement approach could be seen as diverging from the basic IFRS 2 treatment for the modification of an equity-settled award where none of the incremental fair value arising on a modification is expensed at the date of modification.

As noted at the start of this section, the two approaches outlined above are based on the specific principles referred to in section 9.4 above. In the absence of clear guidance in the standard, other interpretations of the appropriate expense and equity adjustment are also possible, although these will sometimes result in a higher expense through profit or loss than the two approaches above. For example, in relation to the cash-settled award, the approaches outlined above expense only the difference between the final settlement amount and the full fair value of the liability at the modification date, with the remainder adjusted through equity. An alternative view follows the accounting treatment for cash-settled awards which would lead to the recognition of an expense for the entire remeasurement of the liability from the amount recognised for a part-vested award at modification date to the amount finally settled.

As noted in section 9.4 above, the IASB decided that existing implementation guidance in IFRS 2 could be applied by analogy to other types of modification. As an example of this, it states that IG Example 9 illustrates a grant of shares to which a cash settlement alternative is subsequently added. *[IFRS 2.BC237K]*. The approach in IG Example 9 has been considered within our two suggested accounting approaches and is also discussed further in the context of Illustration 9-4 below.

Illustration 9-4: Modification of equity-settled award to cash-settled award

A Modified award with same fair value as original award

At the beginning of year 1 an entity granted an equity-settled award, with a fair value at that date of CU500, and vesting if the employee is still in service at the end of year 4. At the beginning of year 3, the award is modified so as to become cash-settled, but its terms are otherwise unchanged. The fair value at that date of both alternatives is CU150. The liability is actually settled for CU180 at the end of year 4.

	Approach 1			Approach 2		
	Expense	Equity	Liability	Expense	Equity	Liability
	CU	CU	CU	CU	CU	CU
Years 1-2	250	(250)	-	250	(250)	-
Modification date (beginning of year 3)	-	75	(75)	-	75	(75)
Years 3-4	280	(175)	(105)	280	(175)	(105)
Totals	530	(350)	(180)	530	(350)	(180)

During years 1 and 2 the entity recognises a cumulative expense of CU250, being the proportion of the grant date fair value of the equity-settled award of CU500 attributable to 2/4 of the vesting period.

At modification date (beginning of year 3), it is necessary to recognise a liability of CU75 (CU150 × 2/4 - see section 9.3.2 above). The full amount of this liability is recognised as a reduction in equity under both approaches as there is no difference between the fair value of the original and modified awards as at the modification date.

As the award is continuing, there is no acceleration at the modification date of the as yet unrecognised amount of the grant date fair value of the original award (CU250, being CU500 × 2/4), as would occur in an immediate settlement (see section 7.4 above).

During years 3 and 4 (the period from modification to settlement date), the entity recognises an increase of CU105 in the fair value of the liability (CU180 - CU75). During this period, it also recognises employee costs totalling CU280, being the remaining grant date fair value of CU250 (CU500 total less CU250 expensed prior to modification) plus the post-modification remeasurement of the liability of CU30 (CU180 - CU150). The balance of CU175 is credited to equity.

In total the entity recognises an expense of CU530, being the original grant date fair value of the equity-settled award of CU500 plus the post-modification remeasurement of the liability of CU30. This adjustment of CU30 is consistent with the approach taken in IG Example 9 in the implementation guidance to IFRS 2 (see section 10.1.4 and Illustration 10-2 below).

In Scenario A the modification date fair value is lower than the grant date fair value. Scenario E below considers a situation where the awards have the same fair value as at the date of modification, but this fair value is higher than the original grant date fair value of the equity-settled award.

B Modified award with greater fair value than original award

At the beginning of year 1 an entity granted an equity-settled award, with a fair value at that date of CU500, and vesting if the employee is still in service at the end of year 4. At the beginning of year 3, the award is modified so as to become cash-settled, with other modifications meaning that the new award has a higher fair value than the original award. At that date, the fair value of the original award is CU150, but that of the cash-settled replacement award is CU170. The liability is actually settled for CU200 at the end of year 4.

	Approach 1			Approach 2		
	Expense CU	Equity CU	Liability CU	Expense CU	Equity CU	Liability CU
Years 1-2	250	(250)	-	250	(250)	-
Modification date (beginning of year 3)	-	85	(85)	10	75	(85)
Years 3-4	300	(185)	(115)	290	(175)	(115)
Totals	550	(350)	(200)	550	(350)	(200)

During years 1 and 2 the entity recognises a cumulative expense of CU250, being the proportion of the grant date fair value of the equity-settled award of CU500 attributable to 2/4 of the vesting period.

At modification date (beginning of year 3), it is necessary to recognise a liability of CU85 (CU170 × 2/4 - see section 9.3.2 above). Under Approach 1 the difference between the fair value of the original equity-settled award and the modified award (CU20 in total) is not recognised immediately as an expense but is spread over the remainder of the vesting period (i.e., starting from the date of modification). The liability of CU85 is therefore recognised as a reduction in equity. Under Approach 2, the difference between the fair value of the original equity-settled award and the modified award is expensed immediately to the extent that the vesting period has already expired (CU20 × 2/4) with the remainder being expensed in the post-modification period.

As the award is continuing, there is no acceleration at the modification date of the as yet unrecognised amount of the grant date fair value of the original award (CU250, being CU500 × 2/4) as would occur in an immediate settlement (see section 7.4 above).

During years 3 and 4 (the period from modification to settlement date), the entity recognises an increase of CU115 in the fair value of the liability (CU200 - CU85). During this period, under Approach 1 it also recognises employee costs totalling CU300, being the remaining grant date fair value of CU250 (CU500 total less CU250 expensed prior to modification) plus the incremental modification fair value of CU20 (CU170 - CU150) plus the remeasurement of the liability of CU30 (CU200 - CU170) between modification date and settlement date. The balance of CU185 is credited to equity. For Approach 2, the expense and the credit to equity during this period are CU10 less than under Approach 1 because a proportionate amount of the incremental fair value was expensed immediately at the modification date.

In total the entity recognises an expense of CU550, being the original grant date fair value of the equity-settled award of CU500 plus the incremental fair value of CU20 arising on modification of the award plus the post-modification remeasurement of the liability of CU30. This remeasurement adjustment of CU30 is consistent with the approach taken in IG Example 9 in the implementation guidance to IFRS 2 (see section 10.1.4 and Illustration 10-2 below).

C Modified award with lower fair value than original award

At the beginning of year 1 an entity granted an equity-settled award, with a fair value at that date of CU500, and vesting if the employee is still in service at the end of year 4. At the beginning of year 3, the award is modified so as to become cash-settled, with other modifications meaning that the new award has a lower fair value than the original award. At that date, the fair value of the original award is CU150, but that of the cash-settled replacement award is CU130. The liability is actually settled for CU180 at the end of year 4.

	Approach 1			Approach 2		
	Expense CU	Equity CU	Liability CU	Expense CU	Equity CU	Liability CU
Years 1-2	250	(250)	-	250	(250)	-
Modification date (beginning of year 3)	-	65	(65)	-	65	(65)
Years 3-4	300	(185)	(115)	300	(185)	(115)
Totals	550	(370)	(180)	550	(370)	(180)

During years 1 and 2 the entity recognises a cumulative expense of CU250, being the proportion of the grant date fair value of the equity-settled award of CU500 attributable to 2/4 of the vesting period.

At modification date (beginning of year 3), it is necessary to recognise a liability of CU65 (CU130 × 2/4) (see section 9.3.2 above). The full amount of this liability is recognised as a reduction in equity under both approaches as the fair value of the modified award is lower than that of the original award. No gain is recognised for the reduction in fair value consistent with the general principle in IFRS 2 that the cost recognised for an equity-settled award must be at least the grant date fair value of the award.

As the award is continuing, there is no acceleration at the modification date of the as yet unrecognised amount of the grant date fair value of the original award (CU250, being CU500 × 2/4) as would occur in an immediate settlement (see section 7.4 above).

During years 3 and 4 (the period from modification to settlement date), the entity recognises an increase of CU115 in the fair value of the liability (CU180 - CU65). During this period, it also recognises employee costs totalling CU300, being the remaining grant date fair value of CU250 (CU500 total less CU250 expensed prior to modification) plus the remeasurement of the liability of CU50 (CU180 - CU130) between modification date and settlement date. The balance of CU185 is credited to equity.

In total the entity recognises an expense of CU550, being the original grant date fair value of the equity-settled award of CU500 plus the post-modification remeasurement of the liability of CU50. This adjustment of CU50 is consistent with the approach taken in IG Example 9 in the implementation guidance to IFRS 2 (see section 10.1.4 and Illustration 10-2 below).

Whilst the overall liability in Scenario C is the same as that in Scenario A above, the total expense and overall net credit to equity are higher even though the cash-settled award had a lower fair value at the modification date than that in Scenario A. This might appear illogical but is consistent with the approach in IG Example 9 and the requirement to recognise, as a minimum, the grant date fair value of the original equity-settled award together with any post-modification change in the fair value of the liability.

D Modified award with greater fair value than original award but settled for less than modification date fair value

At the beginning of year 1 an entity granted an equity-settled award, with a fair value at that date of CU500, and vesting if the employee is still in service at the end of year 4. At the beginning of year 3, the award is modified so as to become cash-settled, with other modifications meaning that the new award has a higher fair value than the original award. At that date, the fair value of the original award is CU150, but that of the cash-settled replacement award is CU170. The liability is actually settled for CU125 at the end of year 4.

	Approach 1			Approach 2		
	Expense CU	Equity CU	Liability CU	Expense CU	Equity CU	Liability CU
Years 1-2	250	(250)	-	250	(250)	-
Modification date (beginning of year 3)	-	85	(85)	10	75	(85)
Years 3-4	225	(185)	(40)	215	(175)	(40)
Totals	475	(350)	(125)	475	(350)	(125)

During years 1 and 2 the entity recognises a cumulative expense of CU250, being the proportion of the grant date fair value of the equity-settled award of CU500 attributable to 2/4 of the vesting period.

At modification date (beginning of year 3), it is necessary to recognise a liability of CU85 (CU170 × 2/4) (see section 9.3.2 above). Under Approach 1 the difference between the fair value of the original equity-settled award and the modified award (CU20 in total) is not recognised immediately as an expense but is spread over the remainder of the vesting period (i.e., starting from the date of modification). The liability of CU85 is therefore recognised as a reduction in equity. Under Approach 2, the difference between the fair value of the original equity-settled award and the modified award is expensed immediately to the extent that the vesting period has already expired (CU20 × 2/4) with the remainder being expensed in the post-modification period.

As the award is continuing, there is no acceleration at the modification date of the as yet unrecognised amount of the grant date fair value of the original award (CU250, being CU500 × 2/4) as would occur in an immediate settlement (see section 7.4 above).

During years 3 and 4 (the period from modification to settlement date), the entity recognises an increase of CU40 in the fair value of the liability (CU125 - CU85). During this period, under Approach 1 it also recognises employee costs totalling CU225, being the remaining grant date fair value of CU250 (CU500 total less CU250 expensed prior to modification) plus the incremental modification fair value of CU20 less a reduction of CU45 (CU170 - CU125) in the fair value of the liability since modification date. The balance of CU185 is credited to equity. For Approach 2, the expense and the credit to equity during this period are CU10 less than under Approach 1 because a proportionate amount of the incremental fair value was expensed immediately at the modification date.

In total the entity recognises an expense of CU475, being the original grant date fair value of the equity-settled award of CU500 plus the incremental fair value of CU20 arising on modification of the award less the post-modification remeasurement of the liability of CU45. This remeasurement adjustment of CU45 is consistent with the approach taken in IG Example 9 in the implementation guidance to IFRS 2 (see section 10.1.4 and Illustration 10-2 below).

E Modified award with same fair value as original award but where modification date fair value is higher than original grant date fair value

At the beginning of year 1 an entity granted an equity-settled award, with a fair value at that date of CU500, and vesting if the employee is still in service at the end of year 4. At the beginning of year 3, the award is modified so as to become cash-settled, but its terms are otherwise unchanged. The fair value of the award at that date on both an equity-settled basis and a cash-settled basis is CU800. The liability is actually settled for CU700 at the end of year 4.

	Approach 1			Approach 2		
	Expense	Equity	Liability	Expense	Equity	Liability
	CU	CU	CU	CU	CU	CU
Years 1-2	250	(250)	-	250	(250)	-
Modification date (beginning of year 3)	-	400	(400)	-	400	(400)
Years 3-4	300	-	(300)	300	-	(300)
Totals	550	150	(700)	550	150	(700)

During years 1 and 2 the entity recognises a cumulative expense of CU250, being the proportion of the grant date fair value of the equity-settled award of CU500 attributable to 2/4 of the vesting period.

At modification date (beginning of year 3), it is necessary to recognise a liability of CU400 (CU800 × 2/4 - see section 9.3.2 above). The full amount of this liability is recognised as a reduction in equity under both approaches as there is no difference between the fair value of the original and modified awards as at the modification date.

As the award is continuing, there is no acceleration at the modification date of the as yet unrecognised amount of the grant date fair value of the original award (CU250, being CU500 × 2/4), as would occur in an immediate settlement (see section 7.4 above).

During years 3 and 4 (the period from modification to settlement date), the entity recognises a net increase of CU300 in the fair value of the liability (CU700 - CU400). During this period it also recognises employee costs totalling CU300, being the remaining modification date fair value of the cash-settled award (CU800 × 2/4) plus the post-modification remeasurement of the liability of CU(100) (CU800 - CU700).

In total the entity recognises an expense of CU550. This expense reflects three components: firstly, half of the grant date fair value of the original equity-settled award and secondly, half of the modification date fair value of the cash-settled award. As the award had increased in value between grant date and modification date, the requirement of IFRS 2.27 to recognise, as a minimum, the original grant date fair value of the equity-settled award (CU250 for the portion of the vesting period prior to modification) has been met. The third component of the overall expense, in accordance with the requirements for cash-settled share-based payments, is the CU(100) remeasurement of the liability between modification and settlement. In our view, this is consistent with the approach taken in IG Example 9 in the implementation guidance to IFRS 2 (see section 10.1.4 and Illustration 10-2 below).

Some take the view that the approach in IG Example 9 would lead to a total expense of CU400 in the Illustration above, rather than CU550 (being the original grant date fair value of CU500 plus the remeasurement of the liability of CU(100) in the period following the modification). The difference of CU150 would be debited to equity in the two years following modification. In other words, in recognising an expense for the cash-settled award during the vesting period after the modification date, no account is taken of the fact that the fair value of the arrangement increased between the original grant date and the modification date.

IG Example 9 illustrates a situation where there is a decrease in the fair value between original grant date and modification date. As a result, that Example expenses the grant date fair value of the original equity-settled award (plus the remeasurement of the liability) in order to meet the minimum expense requirements of IFRS 2.27.

How we see it

In a situation such as that outlined in Scenario E above, it does not seem appropriate, in our view, to limit the post-modification expense for the cash-settled award to an amount based on the original grant date fair value of the equity-settled award (CU150) rather than applying cash-settled accounting to the element of the award for which services are delivered in years 3 and 4 and recognising a corresponding expense of CU300. Therefore, in our view, recognition of a total expense of CU550 as noted above is consistent with the approach taken in IG Example 9 in the implementation guidance to IFRS 2 (see section 10.1.4 below and Illustration 10-2 below).

9.4.2 Cash-settled award modified to equity-settled award

IFRS 2 provides guidance in situations where the terms and conditions of a cash-settled award are modified so that it becomes equity-settled. Appendix B to IFRS 2 states that if a cash-settled transaction is modified so that it becomes equity-settled, the transaction will be accounted for as such from the date of the modification and specifically:

- The equity-settled share-based payment transaction is measured by reference to the modification date fair value of the equity instruments granted at that date.
- The equity-settled share-based payment transaction is recognised in equity on the modification date to the extent to which goods or services have been received.
- The liability for the cash-settled share-based payment transaction as at the modification date is derecognised on that date.
- Any difference between the carrying amount of the liability derecognised and the amount recognised in equity on the modification date is recognised immediately in profit or loss. *[IFRS 2.B44A]*.

If the vesting period is extended or shortened as a result of the modification, the modified vesting period is reflected in applying the requirements above. The standard also clarifies that these requirements apply even if the modification takes place after the vesting period. *[IFRS 2.B44B]*.

The standard further clarifies that the above requirements apply if a cash-settled share-based payment is cancelled or settled (other than by forfeiture when vesting conditions are not satisfied) and equity instruments are designated as a replacement for the cancelled or settled share-based payment. In order to qualify as a replacement, the equity instruments must be designated as such on the grant date. *[IFRS 2.B44C]*.

The IASB notes in the Basis for Conclusions that the immediate recognition in profit or loss of any difference between the derecognised liability and the amount recognised in equity is consistent with how cash-settled share-based payments are measured in accordance with IFRS 2.30. It also observes that the approach is consistent with the requirements for the extinguishment of a financial liability (fully or partially by the issue of equity instruments) in IFRS 9 and in IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*. *[IFRS 2.BC237H]*.

IG Example 12C in the implementation guidance of IFRS 2 illustrates the above guidance and forms the basis of Illustration 9-5 below. *[IFRS 2.IG Example 12C]*.

Illustration 9-5: Modification of cash-settled award to equity-settled award

At the beginning of year 1 an entity grants 100 cash-settled share appreciation rights (SARs) to each of 100 employees on condition that they remain in the entity's service for four years.

At the end of year 1 each SAR has an estimated fair value of CU10 and at the end of year 2 CU12.

At the end of year 2 the entity cancels the SARs and, in their place, grants 100 share options to each employee on condition that each remains in service for the next two years, i.e., the original service period is unchanged. At the date of grant, the fair value of each share option is CU13.20. All of the employees are expected to meet the service condition.

In years 1 and 2 the entity recognises a cash-settled share-based payment expense of CU25,000 and CU35,000 respectively, based on the fair value of the SARs at each reporting date and the extent to which the vesting period has been completed. At the modification date, the requirements of paragraph B44A are applied as follows:

Modification date (end of year 2)

Dr	Liability	CU60,000	
Dr	Profit or loss	CU6,000	
	Cr Equity		CU66,000

The entity compares the fair value of the equity award, measured as at the date of modification, of CU66,000 (CU132,000 × 2/4) with the fair value of the liability for the cash-settled award of CU60,000 (CU120,000 × 2/4) at the same date. The difference of CU6,000 is recognised immediately in profit or loss.

The remainder of the equity-settled share-based payment, as measured at the modification date, is recognised in profit or loss during years 3 and 4 i.e., an expense of CU33,000 in each of the two years.

10 Transactions with equity and cash alternatives

It is common for share-based payment transactions (particularly those with employees) to provide either the entity or the counterparty with the choice of settling the transaction either in shares (or other equity instruments) or in cash (or other assets). The general principle of IFRS 2 is that a transaction with a cash alternative, or the components of that transaction, must be accounted for:

(a) As a cash-settled transaction if, and to the extent that, the entity has incurred a liability to settle in cash or other assets.

Or

(b) As an equity-settled transaction if, and to the extent that, no such liability has been incurred. *[IFRS 2.34]*.

More detailed guidance is provided as to how that general principle must be applied to transactions:

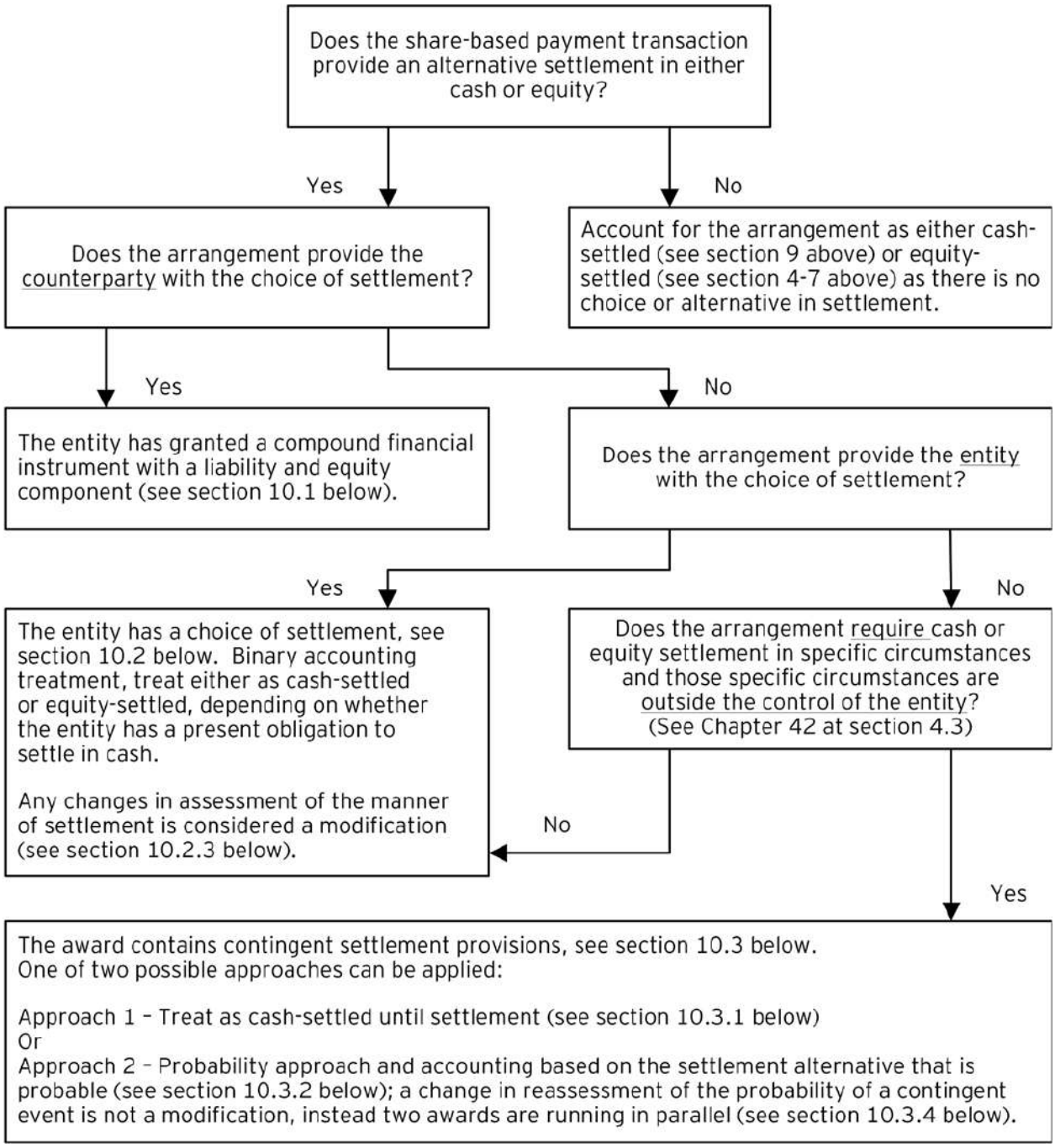
- Where the counterparty has choice of settlement (see section 10.1 below)
- Where the entity has choice of settlement (see section 10.2 below)

Some specific types of arrangement that include cash and equity alternatives, either as a matter of choice or depending on the outcome of certain events are covered elsewhere in this chapter, as outlined below.

A common type of arrangement seen in practice is the 'matching' award or deferred bonus arrangement where an employee is offered a share award or a cash alternative to 'match' a share award or a cash bonus earned during an initial period. This type of arrangement is addressed in section 15.1 below.

Rather than providing either the entity or the counterparty with a choice between settlement in equity or in cash, some transactions offer no choice but instead require an arrangement that will generally be equity-settled to be settled in cash in certain specific and limited circumstances (awards with contingent cash settlement). There will also be situations where there is contingent settlement in equity of an award that is otherwise cash-settled. These types of arrangement are considered in more detail in section 10.3 below.

The following flow chart illustrates how to navigate to the accounting in this section:



Some awards offer an equity alternative and a cash alternative where the cash alternative is not based on the price or value of the equity instruments. These arrangements are considered in section 10.4 below.

10.1 Transactions where the counterparty has choice of settlement in equity or in cash

Where the counterparty has the right to elect for settlement in either shares or cash, IFRS 2 regards the transaction as a compound transaction to which split accounting must be applied. The general principle is that the transaction must be analysed into a liability component (the counterparty's right to demand settlement in cash) and an equity component (the counterparty's right to demand settlement in shares). *[IFRS 2.35]*. Once split, the two components are accounted for separately. The methodology of split accounting required by IFRS 2 is somewhat different from that required by IAS 32 for issuers of other compound instruments (see Chapter 43 at section 6).

A practical issue is that, where a transaction gives the counterparty a choice of settlement, it will be necessary to establish a fair value for the liability component both at grant date and at each subsequent reporting date until settlement. By contrast, in the case of transactions that can be settled in cash only, a fair value is not generally required at grant date for IFRS 2 accounting purposes, but a fair value is required at each subsequent reporting date until settlement (see section 9 above). However, for entities subject to IAS 33, the grant date fair value is required in order to make the disclosures required by that standard - see Chapter 33 at section 6.4.2.

We consider in more detail in sections 10.1.1 to 10.1.3 below the accounting treatment required by IFRS 2 for transactions where the counterparty has a settlement choice. In addition, the following specific situations are discussed:

- The addition of a cash-settlement alternative after the grant date (see section 10.1.4 below)
- Arrangements where the counterparty is given a choice to cover more or less remote contingencies e.g., restrictions or limits on the issue of shares in a particular jurisdiction (see section 10.1.5 below)
- The issue of convertible bonds in return for goods or services (see section 10.1.6 below)

10.1.1 Transactions in which the fair value is measured directly

Transactions with non-employees are normally measured by reference to the fair value of goods and services supplied at service date (i.e., the date at which the goods or services are supplied) - see sections 4 and 5 above.

Accordingly, where an entity enters into such a transaction where the counterparty has choice of settlement, it determines the fair value of the liability component at service date. The equity component is the difference between the fair value (at service date) of the goods or services received and the fair value of the liability component. *[IFRS 2.35]*.

10.1.2 Transactions in which the fair value is measured indirectly - including transactions with employees

All other transactions, including those with employees, are measured by reference to the fair value of the instruments issued at 'measurement date', being grant date in the case of transactions with employees and service date in the case of transactions with non-employees - see sections 4.1 and 5.1 above. *[IFRS 2 Appendix A]*.

The fair value must take into account the terms and conditions on which the rights to cash or equity instruments were issued. *[IFRS 2.36]*. IFRS 2 does not elaborate further on this, but we assume that the IASB intends a reporting entity to apply:

- As regards the equity component of the transaction, the provisions of IFRS 2 relating to the impact of terms and conditions on the valuation of equity-settled transactions (see sections 4 to 6 above).
- As regards the liability component of the transaction, the provisions of IFRS 2 relating to the impact of terms and conditions on the valuation of cash-settled transactions (see section 9.3 above).

The entity must first measure the fair value of the liability component and then that of the equity component. The fair value of the equity component must be reduced to take into account the fact that the counterparty must forfeit the right to receive cash in order to receive shares. The sum of the two components is the fair value of the whole compound instrument. *[IFRS 2.37]*. IG Example 13 in IFRS 2 (the substance of which is reproduced as Illustration 10-1 below) suggests that this may be done by establishing the fair value of the equity alternative and subtracting from it the fair value of the liability component. This approach may be appropriate in a straightforward situation involving ordinary shares and cash, as illustrated in the Example in the implementation guidance, but will not necessarily be appropriate in more complex situations that include, for example, the likelihood of options being exercised.

How we see it

Where options are granted, the approach in IG Example 13, of subtracting the fair value of the liability component from the fair value of the equity alternative, will not necessarily be appropriate in more complex situations.

In many share-based payment transactions with a choice of settlement, the value to the counterparty of the share and cash alternatives is equal. The counterparty will have the choice between (say) 1,000 shares or the cash value of 1,000 shares. This will mean that the fair value of the liability component is equal to that of the transaction as a whole, so that the fair value of the equity component is zero. In other words, the transaction is accounted for as if it were a cash-settled transaction.

However, in some jurisdictions it is not uncommon, particularly in transactions with employees, for the equity-settlement alternative to have more value (as in Illustration 10-1 below). For example, an employee might be able to choose at vesting between the cash value of 1,000 shares immediately or 2,000 shares (often subject to further conditions such as a minimum holding period, or a further service period). In such cases the equity component will have an independent value. *[IFRS 2.37]*. Such schemes are discussed in more detail in Illustrations 15-4 and 15-5 in section 15.1 below.

10.1.3 Accounting treatment

10.1.3.A During vesting period

Having established a fair value for the liability and equity components as set out in sections 10.1.1 and 10.1.2 above, the entity accounts for the liability component according to the rules for cash-settled transactions (see section 9 above) and for the equity component according to the rules for equity-settled transactions (see sections 4 to 8 above). *[IFRS 2.38]*.

Illustration 10-1 below demonstrates the accounting treatment for a transaction with an employee (as summarised in section 10.1.2 above) where the equity component has a fair value independent of the liability component.

Illustration 10-1: Award with employee choice of settlement with different fair values for cash-settlement and equity-settlement

An entity grants to an employee an award with the right to choose settlement in either:

- 1,000 phantom shares, i.e., a right to a cash payment equal to the value of 1,000 shares.

  Or

- 1,200 shares.

Vesting is conditional upon the completion of three years' service. If the employee chooses the share alternative, the shares must be held for three years after vesting date.

At grant date, the entity estimates that the fair value of the share alternative, after taking into account the effects of the post-vesting transfer restrictions, is CU48 per share. The fair value of the cash alternative is estimated as:

	CU
Grant date	50
Year 1	52
Year 2	55
Year 3	60

The grant date fair value of the equity alternative is CU57,600 (1,200 shares × CU48). The grant date fair value of the cash alternative is CU50,000 (1,000 phantom shares × CU50). Therefore the fair value of the equity component excluding the right to receive cash is CU7,600 (CU57,600 - CU50,000). The entity recognises a cost based on the following amounts.

	Equity component			Liability component		
Year	Calculation of cumulative expense	Cumulative expense (CU)	Expense for year (CU)	Calculation of cumulative expense	Cumulative expense (CU)	Expense for year (CU)
1	CU7,600 × 1/3	2,533	2,533	1,000 phantoms × CU52 × 1/3	17,333	17,333
2	CU7,600 × 2/3	5,066	2,533	1,000 phantoms × CU55 × 2/3	36,667	19,334
3	CU7,600	7,600	2,534	1,000 phantoms × CU60	60,000	23,333

This generates the following accounting entries.

Year 1

Dr	Profit or loss (employment costs)		CU19,866	
	Cr	Liability		CU17,333
	Cr	Equity		CU2,533

Year 2				
Dr	Profit or loss (employment costs)		CU21,867	
	Cr	Liability		CU19,334
	Cr	Equity		CU2,533
Year 3				
Dr	Profit or loss (employment costs)		CU25,867	
	Cr	Liability		CU23,333
	Cr	Equity		CU2,534

The above Illustration is based on IG Example 13 in IFRS 2, in which the share price at each reporting date is treated as the fair value of the cash alternative. As discussed more fully in section 9 above, the fair value of a cash award is not necessarily exactly the same as the share price as it will depend on the terms and conditions of the award (see section 9.3.2 above). Accordingly, in adapting IG Example 13 as Illustration 10-1 above, we have deliberately described the numbers used in respect of the liability component as 'fair value' and not as the 'share price'. *[IFRS 2.IG Example 13]*.

Illustration 10-1 also ignores the fact that transactions of this type often have different vesting periods for the two settlement alternatives. For instance, the employee might have been offered:

(a) The cash equivalent of 1,000 shares in three years' time subject to performance conditions.

Or

(b) Subject to the performance criteria in (a) above being met over three years, 3,000 shares after a further two years' service.

IFRS 2 offers no guidance as to how such transactions are to be accounted for. Presumably, however, the equity component would be recognised over a five-year period and the liability component over a three year period. This is considered further in the discussion of 'matching' share awards in section 15.1 below.

How we see it

Where the equity component vesting period differs from the cash component vesting period in a share-based payment transaction, in our view, each component would be recognised over the vesting period specific to that component.

10.1.3.B Settlement

At the date of settlement, the liability component is restated to fair value through profit or loss. If the counterparty elects for settlement in equity, the restated liability is transferred to equity as consideration for the equity instruments issued. If the liability is settled in cash, the cash is obviously applied to reduce the liability. *[IFRS 2.39, IFRS 2.40]*. In other words, if the transaction in Illustration 10-1 above had been settled in shares the accounting entry would have been:

Dr	Liability*		CU60,000	
	Cr	Equity†		CU60,000

* There is no need to remeasure the liability in this case as it has already been stated at fair value at vesting date, which is the same as settlement date.

† The precise allocation of this amount within equity, and its impact on distributable reserves, will depend on a number of factors, including jurisdictional legal requirements, which are not discussed here.

If the transaction had been settled in cash the entry would simply have been:

Dr	Liability		CU60,000	
	Cr	Cash		CU60,000

If the transaction is settled in cash, any amount taken to equity during the vesting period (CU7,600 in Illustration 10-1 above) is not adjusted. However, the entity may transfer it from one component of equity to another (see section 4.2 above). *[IFRS 2.40]*.

10.1.4 Transactions with cash-settlement alternative for employee introduced after grant date

Such transactions are not specifically addressed in the main body of IFRS 2. However, IG Example 9 in the implementation guidance does address this issue, in the context of the rules for the modification of awards (discussed in sections 7.3 and 9.4 above). The substance of this example is reproduced as Illustration 10-2 below. *[IFRS 2.IG Example 9]*.

Illustration 10-2: Award with employee cash-settlement alternative introduced after grant

At the beginning of year 1, the entity grants 10,000 shares with a fair value of CU33 per share to a senior executive, conditional upon the completion of three years' service. By the end of year 2, the fair value of the award has dropped to CU25 per share. At that date, the entity adds a cash alternative to the grant, whereby the executive can choose whether to receive 10,000 shares or cash equal to the value of 10,000 shares on vesting date. The share price is CU22 on vesting. The implementation guidance to IFRS 2 proposes the following approach.

For the first two years, the entity would recognise an expense of CU110,000 per year, (representing 10,000 shares × CU33 × 1/3), giving rise to the cumulative accounting entry by the end of year 2:

Dr	Profit or loss (employee costs)	CU220,000	
	Cr Equity		CU220,000

The addition of a cash alternative at the end of year 2 constitutes a modification of the award, but does not increase the fair value of the award at the date of modification, which under either settlement alternative is CU250,000 (10,000 shares × CU25), excluding the effect of the non-market vesting condition as required by IFRS 2.

The fact that the employee now has the right to be paid in cash requires the 'split accounting' treatment set out in section 10.1.2 above. Because of the requirement, under the rules for modification of awards (see section 7.3 above), to recognise at least the grant date fair value of the original award, a minimum fair value of CU330,000 has to be recognised over the vesting period.

At the modification date, a liability of CU166,667 (representing 2/3 of the CU250,000 fair value of the liability component at modification date) is recognised as a transfer from equity to liabilities, the entry being:

Dr	Equity	CU166,667	
	Cr Liability		CU166,667

In year 3 an expense of CU110,000 is recognised as the final portion of the original grant date fair value. In addition to this, the liability is remeasured from its modification date value of CU250,000 (CU25 × 10,000 shares) to its settlement date value of CU220,000 (CU22 × 10,000 shares) resulting in a credit of CU30,000 to profit or loss. This results in the following accounting entry for the expense in year 3:

Dr	Profit or loss	CU80,000*	
	Cr Liability		CU53,333†
	Cr Equity		CU26,667‡

* ((10,000 shares × CU33 × 3/3) - (CU220,000 expensed to date)) less the remeasurement of CU30,000.

† Carried forward liability CU220,000 (10,000 shares × year 3 fair value CU22) less the brought forward liability CU166,667.

‡ Balancing figure.

The implementation guidance to IFRS 2 analyses the CU300,000 total expense over the three years as the grant date fair value of the award (CU330,000) less the movement in the fair value of the liability alternative (CU30,000, being the fair value of CU250,000 at the end of year 2 less the fair value of CU220,000 at vesting).

IG Example 9 only illustrates a situation where the grant date fair value of the equity-settled award exceeds the modification date fair value of both the equity and cash alternatives and the settlement date value of the cash alternative. In Illustration 9-4 in section 9.4.1 above we consider alternative scenarios, including one where the modification date fair value exceeds the grant date fair value.

10.1.5 'Backstop' cash settlement rights

Some schemes may provide cash settlement rights to the holder so as to cover more or less remote contingencies. For example, an employee whose nationality and/or country of permanent residence is different from the jurisdiction of the reporting entity may be offered the option of cash settlement in case unforeseen future events make the transfer of equity from the entity's jurisdiction, or the holding or trading of it in the employee's country, inconvenient or impossible.

If the terms of the award provide the employee with a general right of cash-settlement, IFRS 2 requires the award to be treated as cash-settled. This is the case even if the right of cash settlement is extremely unlikely to be exercised (e.g., because it would give rise to adverse tax consequences for the employee as compared with equity settlement). If, however, the right to cash-settlement is exercisable only in specific circumstances, a more detailed analysis may be required (see section 10.3 below).

10.1.6 Convertible bonds issued to acquire goods or services

In some jurisdictions entities issue convertible bonds to employees or other counterparties in exchange for goods or services. When this occurs, the bond will generally be accounted for under IFRS 2 rather than IAS 32 since it falls within the scope of IFRS 2 as a transaction "in which the entity receives or acquires goods or services and the terms of the arrangement provide either the entity or the supplier of those goods or services with a choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments" (see sections 2.2.1 and 2.2.2 above). *[IFRS 2.2(c)]*.

As noted in section 10.1 above, the methodology for splitting such an instrument into its liability and equity components under IFRS 2 differs from that under IAS 32. Moreover, under IAS 32 a convertible instrument is (broadly) recognised at fair value on the date of issue, whereas under IFRS 2 the fair value is accrued over time if the arrangement includes the rendering of services after the date of grant.

It is therefore possible that, if an entity has issued to employees convertible bonds that have also been issued in the market, the accounting treatment of the bonds issued to employees will differ significantly from that of the bonds issued in the market.

Where a convertible instrument is issued to an employee, the IFRS 2 expense will be based on the fair value of the instrument. However, if an entity issues a convertible instrument to a non-employee in return for an asset, for example a property, the entity will initially recognise a liability component at fair value and an equity component based on the difference between the fair value of the property and the fair value of the liability component. *[IFRS 2.35]*.

How we see it

Where an entity issues a convertible instrument to acquire property and the fair value of the property is lower than the fair value of the instrument as a whole then, in our view, the entity is required to recognise the shortfall in accordance with the requirements of IFRS 2 for unidentified goods or services. In the case of the acquisition of an asset, it is possible that this additional debit could be capitalised as part of the cost of the asset under IAS 16 *Property, Plant and Equipment* - but in other cases it would be expensed.

After the initial IFRS 2 accounting outlined above, the question arises as to whether the subsequent accounting for the convertible instrument must be in accordance with IFRS 2 or IFRS 9.

How we see it

In our view, the convertible instrument generally continues to be accounted for under IFRS 2 until shares or cash are delivered to the counterparty. However, if the vested convertible instrument were freely transferable or tradeable prior to conversion or settlement then a switch to IFRS 9 might be appropriate following transfer to a different counterparty (if considered practical to apply) - see also the discussion in section 2.2.2.E above.

10.2 Transactions where the entity has choice of settlement in equity or in cash

The accounting treatment for transactions where the entity has choice of settlement is quite different from transactions where the counterparty has choice of settlement, in that:

- Where the counterparty has choice of settlement, a liability component and an equity component are identified (see section 10.1 above).
- Where the entity has choice of settlement, the accounting treatment is binary - in other words the whole transaction is treated either as cash-settled or as equity-settled, depending on whether or not the entity has a present obligation to settle in cash, *[IFRS 2.41]*, determined according to the criteria discussed in section 10.2.1 below.

10.2.1 Transactions treated as cash-settled

IFRS 2 requires a transaction to be treated as a liability (and accounted for using the rules for cash-settled transactions discussed in section 9 above) if:

(a) The choice of settlement has no commercial substance (for example, because the entity is legally prohibited from issuing shares).

(b) The entity has a past practice or stated policy of settling in cash.

Or

(c) The entity generally settles in cash whenever the counterparty asks for cash settlement. *[IFRS 2.41, IFRS 2.42]*.

These criteria are fundamentally different from those in IAS 32 for derivatives over own shares (which is what cash-settled share-based payment transactions are) not within the scope of IFRS 2. IAS 32 rejects an approach based on past practice or intention and broadly requires all derivatives over own equity that could result in an exchange by the reporting entity of anything other than a fixed number of shares for a fixed amount of cash to be treated as giving rise to a financial instrument (see Chapter 43 at section 4).

An important practical effect of the IFRS 2 criteria is that some schemes that may appear at first sight to be equity-settled may in fact have to be treated as cash-settled. For example, if an entity has consistently adopted a policy of granting *ex gratia* cash compensation to all those deemed to be 'good' leavers (or all 'good' leavers of certain seniority) in respect of partially vested share options, such a scheme may well be treated as cash-settled for the purposes of IFRS 2 to the extent to which there are expected to be such 'good' leavers during the vesting period. 'Good leaver' arrangements are also discussed in section 5.3.9 above.

Another common example is that an entity may have a global share scheme with an entity option for cash settlement which it always exercises in respect of awards to employees in jurisdictions where it is difficult or illegal to hold shares in the parent. Such a scheme must be treated as a cash-settled scheme in respect of those jurisdictions. However, in our view, it would be appropriate to account for the scheme in other jurisdictions as equity-settled (provided of course that none of the criteria in (a) to (c) above applied in those jurisdictions).

How we see it

Where an entity has a global share scheme, classification of awards to employees must be based on whether the entity has a present obligation to settled in cash, which could be different for different jurisdictions, resulting in some of the awards accounted for as cash-settled and the remaining as equity-settled.

Where an entity has accounted for a transaction as cash-settled, IFRS 2 gives no specific guidance as to the accounting treatment on settlement, but it is clear from other provisions of IFRS 2 that the liability must be remeasured to fair value at settlement date and:

- If cash-settlement occurs, the cash paid is applied to reduce the liability.
- If equity-settlement occurs, the liability is transferred into equity (see section 10.1.3.B above).

10.2.1.A Entity choice has no substance due to economic or other compulsion for cash settlement (including unlisted entity awards with a presumption of cash settlement)

Some awards may nominally give the reporting entity the choice of settling in cash or equity, while in practice giving rise to an economic compulsion to settle only in cash. In addition to the examples mentioned in section 10.2.1 above, this will often be the case where an entity that is a subsidiary or owned by a small number of individuals, such as members of the same family, grants options to employees. In such cases there will normally be a very strong presumption that the entity will settle in cash in order to avoid diluting the existing owners' interests. Similarly, where the entity is not listed, there is little real benefit for an employee in receiving a share that cannot be realised except when another shareholder wishes to buy it or there is a change in ownership of the business as a whole.

How we see it

In our view, such schemes are generally most appropriately accounted for as cash-settled schemes from inception. In any event, once the scheme has been operating for a while, it is likely that there will be a past practice of cash settlement such that the scheme is required to be treated as a liability under the general provisions of IFRS 2 summarised above.

A similar conclusion is often reached even where the terms of the agreement do not appear to offer the entity a choice of settling the award in cash but it has established a constructive obligation or a past practice of so doing (see section 9.2.1 above).

10.2.2 Transactions treated as equity-settled

A transaction not meeting the criteria in section 10.2.1 above to be treated as cash-settled is required to be accounted for as an equity-settled transaction using the rules for such transactions discussed in sections 4 to 8 above. *[IFRS 2.43]*.

However, when the transaction is settled the following approach is adopted:

(a) If the entity chooses to settle in cash, the cash payment is accounted for as the repurchase of an equity interest, i.e., as a deduction from equity, except as noted in (c) below.

(b) If the entity chooses to settle by issuing equity instruments, no further accounting is required (other than a transfer from one component of equity to another, if necessary), except as noted in (c) below.

(c) If the entity chooses the settlement alternative with the higher fair value, as at the date of settlement, the entity recognises an additional expense for the excess value given, i.e., the difference between the cash paid and the fair value of the equity instruments that would otherwise have been issued, or the difference between the fair value of the equity instruments issued and the amount of cash that would otherwise have been paid, whichever is applicable. *[IFRS 2.43]*.

This is demonstrated in Illustrations 10-3 and 10-4 below.

Illustration 10-3: Settlement of transaction treated as equity-settled where fair value of cash settlement exceeds fair value of equity settlement

An entity has accounted for a share-based payment transaction where it has the choice of settlement as an equity-settled transaction, and has recognised a cumulative expense of CU1,000 based on the fair value at grant date.

At settlement date the fair value of the equity-settlement option is CU1,700 and that of the cash-settlement option CU2,000. If the entity settles in equity, no further accounting entry is required by IFRS 2. However, either at the entity's discretion or in compliance with local legal requirements, there may be a transfer within equity of the CU1,000 credited to equity during the vesting period.

If the entity settles in cash, the entity must recognise an additional expense of CU300, being the difference between the fair value of the equity-settlement option (CU1,700) and that of the cash-settlement option (CU2,000). The accounting entry is:

Dr	Profit or loss (employee costs)	CU300	
Dr	Equity	CU1,700	
	Cr Cash		CU2,000

Illustration 10-4: Settlement of transaction treated as equity-settled where fair value of equity settlement exceeds fair value of cash settlement

As in Illustration 10-3, an entity has accounted for a share-based payment transaction where it has the choice of settlement as an equity-settled transaction, and has recognised a cumulative expense of CU1,000 based on the fair value at grant date.

In this case, however, at settlement date the fair value of the equity-settlement option is CU2,000 and that of the cash-settlement option CU1,700. If the entity chooses to settle in equity, it must recognise an additional expense of CU300, being the difference between fair value of the equity-settlement option (CU2,000) and that of the cash-settlement option (CU1,700). The accounting entry is:

Dr	Profit or loss (employee costs)	CU300	
	Cr Equity		CU300

No further accounting entry is required by IFRS 2. However, either at the entity's discretion or in compliance with local legal requirements, there may be a transfer within equity of the CU1,300 credited during the vesting period and on settlement.

If the entity settles in cash, no extra expense is recognised, and the accounting entry is:

Dr	Equity	CU1,700	
	Cr Cash		CU1,700

It can be seen in this case that, if the transaction is settled in equity, an additional expense is recognised. If, however, the transaction had simply been an equity-settled transaction (i.e., with no cash alternative), there would have been no additional expense on settlement and the cumulative expense would have been only CU1,000 based on the fair value at grant date.

10.2.3 Change in entity's settlement policy or intention leading to change in classification of award after grant date

IFRS 2 does not specify whether a transaction where the entity has a choice of settlement in equity or cash has to be assessed as equity-settled or cash-settled only at the inception of the transaction or also at each reporting date until it is settled.

However, in describing the accounting treatment IFRS 2 states several times that the accounting depends on whether the entity '*has a present obligation* to settle in cash' (our emphasis added). In our view, this suggests that IFRS 2 intends the position to be reviewed at each reporting date and not just considered at the inception of the transaction.

IFRS 2 does not specify how to account for a change in classification resulting from a change in the entity's policy or intention. In our view, the most appropriate treatment is to account for such a change as if it were a modification of the manner of settlement of the award (see section 9.4 above). Where the entity is able to choose the manner of settlement, the substance of the situation is the same as a decision to modify the manner of settlement of an award which does not already give the entity a choice. These situations are distinct from those where the manner of settlement depends on the outcome of a contingent event outside the entity's control (see section 10.3 below).

How we see it

As noted above, where the entity is able to choose the manner of settlement, we believe an entity continuously reviews at each reporting date whether the entity 'has a present obligation to settle in cash'. Where there is a change in classification resulting from a change in the entity's policy or intention, the most appropriate treatment is to account for such a change as if it were a modification of the manner of settlement of the award (see section 9.4 above).

10.3 Awards requiring cash or equity settlement in specific circumstances (awards with contingent cash or contingent equity settlement)

This section is written with a focus on awards with contingent cash settlement. However, similar considerations will apply in a situation where it is the settlement in equity that depends on the outcome of circumstances outside the control of the entity or both the entity and the counterparty.

Rather than giving either the entity or the counterparty a general right to choose between equity- or cash-settlement, some awards require cash settlement in certain specific and limited circumstances but otherwise will be equity-settled. These arrangements are referred to by IAS 32 as contingent settlement provisions and are driven by the occurrence or non-occurrence of specific outcomes rather than by choice (see Chapter 43 at section 4.3). In the absence of specific guidance in IFRS 2, questions then arise as to whether such an award must be accounted for as equity-settled or cash-settled and whether this must be re-assessed on an ongoing basis during the vesting period. This is a subject that has been considered by both the IFRS IC and the IASB and their discussions are considered further in section 10.3.5 below.

In the sections below we consider:

- Two different approaches to the assessment of awards with contingent cash settlement (see sections 10.3.1 to 10.3.2 below).
- Awards that require cash settlement on a change of control (see section 10.3.3 below).
- The accounting treatment for changes in the manner of settlement where the award is contingent on future events (see sections 10.3.4 and 10.3.5 below).

How we see it

In our view, in the absence of specific guidance in IFRS 2, the two different approaches set out in sections 10.3.1 and 10.3.2 below could be applied to awards which offer no choice in settlement but instead require cash settlement in certain specific and limited circumstances (i.e., awards with contingent cash settlement).

Equally, similar considerations will apply to awards which offer no choice in settlement but instead require equity settlement in certain specific and limited circumstances (i.e., awards with contingent equity settlement).

10.3.1 Approach 1 - Treat as cash-settled if contingency is outside entity's control

One approach might be to observe that the underlying principle that determines whether an award is accounted for as equity-settled or cash-settled under IFRS 2 appears to be whether the reporting entity can unilaterally avoid cash-settlement (see sections 10.1 and 10.2 above). Under this approach, any award where the counterparty has a right to cash-settlement is always treated as a liability, irrespective of the probability of cash-settlement, since there is nothing that the entity could do to prevent cash-settlement. By contrast, an award where the choice of settlement rests with the entity is accounted for as a liability only where the entity's own actions have effectively put it in a position where it has no real choice but to settle in cash.

Applying this approach, it is first of all necessary to consider whether the event that requires cash-settlement is one over which the entity has control. If the event, however unlikely, is outside the entity's control, then under this approach the award should be treated as cash-settled. However, if the event is within the entity's control, the award should be treated as cash-settled only if the entity has a liability by reference to the criteria summarised in sections 10.1 and 10.2 above.

Whilst, in our view, this is an acceptable accounting approach, it does not seem entirely satisfactory. For example, in a number of jurisdictions, it is common for an equity-settled share-based payment award to contain a provision to the effect that, if the employee dies in service, the entity will pay to the employee's estate the fair value of the award in cash. The analysis above would lead to the conclusion that the award must be classified as cash-settled, on the basis that it is beyond the entity's control whether or not an employee dies in service. This seems a somewhat far-fetched conclusion, and is moreover inconsistent with the accounting treatment that the entity would apply to any other death-in-service benefit under IAS 19. IAS 19 would generally require the entity to recognise a liability for such a benefit based on an actuarial estimate (see Chapter 31 at section 3.6), rather than on a presumption that the entire workforce will die in service.

10.3.2 Approach 2 - Treat as cash-settled if contingency is outside entity's control and probable

It was presumably considerations such as those above that led the FASB to provide guidance for options or similar awards that are cash-settled in certain circumstances. ASC 718 states that a cash settlement feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control does not give rise to a liability until it becomes probable that that event will occur.[28]

In our view, an approach based on the probability of a contingent event that is outside the control of both the counterparty and the entity is also acceptable under IFRS accounting standards and is frequently applied in practice. The implied rationale (by reference to IFRS literature) is that:

- IFRS 2 clearly notes a number of inconsistencies between IFRS 2 and IAS 32 (see section 1.4.1 above) and so there is no requirement to follow IAS 32 in respect of contingent cash settlement arrangements.
- It is therefore appropriate to have regard to the principles of IAS 37 in determining whether an uncertain future event gives rise to a liability. IAS 37 requires a liability to be recognised only when it is probable (i.e., more likely than not) to occur (see Chapter 27).

The impact of Approach 1 and Approach 2 can be illustrated by reference to an award that requires cash-settlement in the event of a change of control of the entity (see section 10.3.3 below).

10.3.3 Application of Approach 1 and Approach 2 to awards requiring cash settlement on a change of control

It is not uncommon for the terms of an award to provide for compulsory cash-settlement by the entity if there is a change of control of the reporting entity. Such a provision ensures that there is no need for any separate negotiations to buy out all employee options, so as to avoid non-controlling interests arising in the acquired entity when equity-settled awards are settled after the change of control.

The question of whether or not a change of control is within the control of the entity is a matter that has been the subject of much discussion in the context of determining the classification of certain financial instruments by their issuer, and is considered more fully in Chapter 43 at section 4.3.

If the facts and circumstances of a particular case indicate that a change of control is within the entity's control, the conclusion under either Approach 1 or Approach 2 above would be that the award must be treated as cash-settled only if the entity has a liability by reference to the criteria summarised in section 10.2.1 above.

If, however, the change of control is not considered to be within the control of the reporting entity, the conclusion will vary depending on whether Approach 1 or Approach 2 is followed. Under Approach 1, an award requiring settlement in cash on a change of control outside the control of the entity would be treated as cash-settled, however unlikely the change of control may be. Under Approach 2 however, an award requiring settlement in cash on a change of control outside the control of the entity would be treated as cash-settled only if a change of control were probable.

A difficulty with Approach 2 is that it introduces rather bizarre inconsistencies in the accounting treatment for awards when the relative probability of their outcome is considered. As noted in section 10.1.5 above, an award that gives the counterparty an absolute right to cash-settlement is accounted for as a liability, however unlikely it is that the counterparty will exercise that right. Thus, under this approach, the entity could find itself in the situation where it treats:

- As a liability: an award with an unrestricted right to cash-settlement for the counterparty, where the probability of the counterparty exercising that right is less than 1%.
- But, as equity: an award that requires cash settlement in the event of a change of control which is assessed as having a 49% probability of occurring.

How we see it

In our view, an entity could adopt either of these accounting treatments (Approach 1 or Approach 2) as set out in sections 10.3.1 and 10.3.2 above, but must do so consistently and state its policy for accounting for such transactions if material having regard to the IASB's discussions in section 10.3.5 below.

28 ASC 718 - *Compensation - Stock Compensation* (formerly FAS123(R), Share-Based Payment), FASB, para. 718-10-25-11.

In selecting an accounting policy, an entity must however be aware of the IASB's discussions on whether an approach based on the 'probable' outcome be applied or whether an approach based on the accounting treatment for a compound instrument be used (see section 10.3.5 below).

There is further discussion in section 15.4 below of awards that vest or are exercisable on a flotation or change of control, including the question of whether a cash-settlement obligation rests with the entity itself or with other parties involved in the change of control (see section 15.4.6 below).

10.3.4 Accounting for change in manner of settlement where award is contingent on future events outside the control of the entity and the counterparty

When, under Approach 2 above, the manner of settlement of an award changes solely as a consequence of a re-assessment of the probability of a contingent event, there is neither settlement of the award nor modification of its original terms (see section 10.3.4.A below for discussion of awards that have also been modified). The terms of the award are such that there have been two potential outcomes, one equity-settled and one cash-settled, running in parallel since grant date. It is as if, in effect, the entity has simultaneously issued two awards, only one of which will vest.

At each reporting date the entity is required to assess which outcome is more likely and account for the award on an equity- or cash-settled basis accordingly.

How we see it

In our view, any adjustments arising from a switch between the cumulative amount for the cash-settled award and the cumulative amount for the equity-settled award is required to be taken to profit or loss in the current period. This is similar to the approach for an award with multiple independent vesting conditions (see section 6.3.6 above).

When applying an approach where the two outcomes have both been part of the arrangement from grant date, an entity measures the fair value of the equity-settled award only at the original grant date and there is no remeasurement of the equity-settled award on reassessment of the settlement method. As the cash-settled award would be remeasured on an ongoing basis, a switch in the manner of settlement during the period until the shares vest or the award is settled in cash could give rise to significant volatility in the cumulative expense. At the date of vesting or settlement, however, the cumulative expense will equate to either the grant date fair value of the equity-settled approach or the settlement value of the cash-settled approach depending on whether or not the contingent event has happened.

The situation discussed in this section (i.e., an arrangement with two potential outcomes from grant date because the manner of settlement is not within the control of either the entity or the counterparty) is not the same as an award where the manner of settlement is entirely within the entity's control. Where the entity has such control and therefore a choice of settlement, a change in the manner of settlement is treated as a modification with a potential catch-up adjustment through equity (see sections 9.4 and 10.2.3 above).

As noted in section 10.3.5 below, discussions by the IFRS IC indicated a preference for treating an award as equity-settled or cash-settled in its entirety, based on the probable outcome, rather than as a compound instrument, but subsequent discussions by the IASB were divided.

10.3.4.A Distinction between re-assessment of settlement method and modification of terms of award

Some awards include arrangements for contingent cash-settlement if an event outside the control of the entity and the counterparty, such as some forms of exit, has not happened within a certain timescale. During the initial period of such an arrangement there might be an expectation that the exit (or other event) will take place. In this case, the award would be treated as equity-settled using an approach based on the probability of this outcome, as outlined in section 10.3.4 above. However, if it is decided, close to the end of the period during which equity-settlement would apply, to modify the terms of the award so that this period is extended, the entity needs to re-assess the arrangement on both its original and modified terms.

It might therefore be the case that cash-settlement under the original terms of the award becomes the more likely outcome for a short time and that the entity has to switch the award from an equity-settled to a cash-settled basis in line with the guidance in section 10.3.4 above. If a modification is then made to extend the period during which the award can be equity-settled and hence the settlement in cash once again becomes less likely, the entity is required to then switch again to an equity-settled basis of accounting using modification accounting (see section 9.4.2 above).

10.3.5 Manner of settlement contingent on future events: discussions by the IASB and the IFRS IC

Following an earlier request to the IFRS IC for clarification on how share-based payment transactions must be classified and measured if the manner of settlement is contingent on either:

- A future event that is outside the control of both the entity and the counterparty

  Or

- A future event that is within the control of the counterparty

The IASB agreed that transactions in which the manner of settlement is contingent on future events should be considered together with other issues relating to IFRS 2 (see section 3.4 above).[29]

Prior to discussion by the IASB, the IFRS IC discussed the matter again in May 2013, noting that IFRS 2.34 requires an entity to account on a cash-settled basis if, and to the extent that, the entity has incurred a liability to settle in cash or other assets. However, it was further noted that IFRS 2 only provides guidance where the entity or the counterparty has a choice of settlement and not where the manner of settlement is contingent on a future event that is outside the control of both parties. The IFRS IC also observed that it was unclear which other guidance within IFRS accounting standards and the *Conceptual Framework* would provide the best analogy to this situation. It was concluded that there was significant diversity in practice.[30]

In September 2013, the IFRS IC noted that the results of additional outreach indicated that shared-based payment transactions in which the manner of settlement is contingent on a future event within the control of the counterparty (but not the entity) are not significantly widespread and so the IFRS IC decided not to add this element of the original submission to its agenda.[31]

The IFRS IC also returned to the question of accounting when the manner of settlement is contingent on a future event that is outside the control of both the entity and the counterparty. It was noted that such arrangements are settled either in cash or in equity instruments in their entirety and that neither party to the arrangement has control over the manner of settlement. Accordingly, the IFRS IC observed that the share-based payment should be classified as either equity-settled or cash-settled in its entirety depending on which outcome is probable.

The IFRS IC also discussed the accounting for a change in classification of the transaction arising from a change in the more likely settlement method. A majority of the IFRS IC thought that there should be a cumulative adjustment recorded at the time of the change of classification, in such a way that the cumulative cost would be the same as if the change of classification had occurred at the inception of the arrangement (see section 10.3.4 above). The IFRS IC decided to recommend that the IASB make a narrow-scope amendment to IFRS 2 based on the approach above.[32]

The IASB discussed these recommendations in February 2014. Some IASB members expressed concern over use of a 'probable' approach for deciding the classification of a share-based payment. They took the view that such share-based payment transactions were similar to those in which the counterparty has a choice of settlement method because the entity does not have the unconditional right to avoid delivering cash or other assets. Therefore, they considered that such arrangements should be accounted for, by analogy, in accordance with the compound instrument approach set out in IFRS 2.35-40, noting that this would also be consistent with the requirements for contingent settlement provisions in IAS 32.[33]

The topic was discussed again by the IASB in April 2014 when, notwithstanding the diversity in practice, the Board decided not to propose an amendment to IFRS 2 for this issue. Some IASB members were concerned that the suggested amendment would introduce a principle for distinguishing between a liability and equity in IFRS 2 that would be inconsistent with the requirements of IAS 32 and also noted that the definition of a liability was being discussed as part of the Conceptual Framework project (see Chapter 2).[34]

The IASB revised the *Conceptual Framework* in 2018 without addressing the above-mentioned issue; the boundary between liabilities and equity has been explored by the IASB in its research project on *Financial Instruments with Characteristics of Equity,* with an Exposure Draft issued in November 2023 (see section 1.4.1 above). Until such time as any revised guidance is issued, we expect Approach 1 or Approach 2, outlined in sections 10.3.1 and 10.3.2 above, to continue to be applied.

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29 *IASB Update*, September 2011, available on the IFRS Foundation's website.

30 *IFRIC Update*, May 2013, available on the IFRS Foundation's website.

31 *IFRIC Update*, September 2013, available on the IFRS Foundation's website.

32 *IFRIC Update*, September 2013, available on the IFRS Foundation's website.

33 *IASB Update*, February 2014, available on the IFRS Foundation's website.

34 *IASB Update*, April 2014, available on the IFRS Foundation's website.

10.4 Cash settlement alternative where cash sum is not based on share price or value

Some awards may provide a cash-settlement alternative that is not based on the share price. For example, an employee might be offered a choice between 500 shares or CU1,000,000 on the vesting of an award. Whilst an award of CU1,000,000, if considered in isolation, would obviously not be a share-based payment transaction, it nevertheless falls within the scope of IFRS 2, rather than - say - IAS 19, if it is offered as an alternative to a transaction that is within the scope of IFRS 2. The Basis for Conclusions on IFRS 2 states that the cash alternative may be fixed or variable and, if variable, may be determinable in a manner that is related, or unrelated, to the price of the entity's shares. *[IFRS 2.BC256]*.

11 Replacement share-based payment awards issued in a business combination

11.1 Background

It is frequently the case that an entity (A) acquires another (B) which, at the time of the business combination, has outstanding employee share options or other share-based awards. If no action were taken by A, employees of B would be entitled, once any vesting conditions had been satisfied, to shares in B. This is not a very satisfactory outcome for either party: A now has non-controlling (minority) shareholders in subsidiary B, which was previously wholly-owned, and the employees of B are the owners of unmarketable shares in an effectively wholly-owned subsidiary.

The obvious solution, adopted in the majority of cases, is for some mechanism to be put in place such that the employees of B end up holding shares in the new parent A. This can be achieved, for example, by:

- A granting options over its own shares to the employees of B in exchange for the surrender of the employees' options over the shares of B.

  Or

- Changing the terms of the options so that they are over a special class of shares in B which are mandatorily convertible into shares of A.

This raises the question of how such a substitution transaction is required to be accounted for in the consolidated financial statements of A (the treatment in the single entity financial statements of B is discussed in section 11.4 below).

IFRS 3 addresses the accounting treatment required in a business combination where an acquirer:

- Replaces acquiree awards on a mandatory basis (see section 11.2.1 below)
- Replaces acquiree awards on a voluntary basis, even if the acquiree awards would not expire as a consequence of the business combination (see section 11.2.2 below)
- Does not replace acquiree awards (see section 11.3 below)

Section 11 relates only to business combinations. Share-based payment arrangements in the context of group reorganisations are addressed in section 12.8 below.

11.2 Replacement awards in business combinations accounted for under IFRS 3

A more comprehensive discussion of the requirements of IFRS 3 may be found in Chapter 10.

IFRS 3 requires an acquirer to measure a liability or an equity instrument related to the replacement of an acquiree's share-based payment awards in accordance with IFRS 2, rather than in accordance with the general principles of IFRS 3. References to the 'fair value' of an award in the following discussion therefore mean the fair value determined under IFRS 2, for which IFRS 3 uses the term 'market-based measure'. The fair value measurement is to be made as at the acquisition date determined in accordance with IFRS 3. *[IFRS 3.30]*.

IFRS 3 notes that a transaction entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer or the combined entity, rather than that of the acquiree (or its former owners) before the combination, is likely to be a transaction separate from the business combination itself. This includes a transaction that remunerates employees or former owners of the acquiree for future services. *[IFRS 3.52]*. Target entities will therefore need to consider carefully whether any modifications to existing share-based payment arrangements in the period leading up to the business combination are straightforward modifications by the target entity for its own benefit or that of its owners at the time (and hence fully within the scope of IFRS 2) or whether the changes need to be assessed under the guidance in IFRS 3 because they are for the benefit of the acquirer or the combined entity. The indicators in IFRS 3.B50 are required to be used to determine when the modification must be measured and recognised. *[IFRS 3.B50]*.

The Application Guidance in Appendix B to IFRS 3 and the illustrative examples accompanying the standard explain how the general principle of paragraph 52 is to be applied to replacement share-based payment transactions. Essentially, however, IFRS 3 appears to view an exchange of share options or other share-based payment awards in conjunction with a business combination as a form of modification (see section 7.3 above). *[IFRS 3.B56]*.

11.2.1 Awards that the acquirer is 'obliged' to replace

Where the acquirer is 'obliged' to replace the acquiree awards (see below), either all or a portion of the fair value of the acquirer's replacement awards forms part of the consideration transferred in the business combination. *[IFRS 3.B56]*.

IFRS 3 regards the acquirer as 'obliged' to replace the acquiree awards if the acquiree or its employees have the ability to enforce replacement, for example if replacement is required by:

- The terms of the acquisition agreement.
- The terms of the acquiree's awards.

  Or
- Applicable laws or regulations. *[IFRS 3.B56]*.

The required treatment of replacement awards may be summarised as follows:

(a) At the date of acquisition, the fair values of the replacement award and the original award are determined in accordance with IFRS 2.

(b) The amount of the replacement award attributable to pre-combination service (and therefore included as part of the consideration transferred for the business) is determined by multiplying the fair value of the original award by the ratio of the vesting period completed, as at the date of the business combination, to the greater of:

- The total vesting period, as determined at the date of the business combination (being the period required to satisfy all vesting conditions, including conditions added to, or removed from, the original award by the replacement award).

  And
- The original vesting period.

(c) Any excess of the fair value of the replacement award over the amount determined in (b) above is recognised as a post-combination remuneration expense, in accordance with the normal principles of IFRS 2 (see sections 3 to 7 above). *[IFRS 3.B57, IFRS 3.B59]*.

The requirements summarised in (a) to (c) above have the effect that any excess of the fair value of the replacement award over the original award is recognised as a post-combination remuneration expense. The requirement in (b) above has the effect that, if the replacement award requires service in the period after the business combination, an IFRS 2 cost is recognised in the post-combination period, even if the acquiree award being replaced had fully vested at the date of acquisition. It also has the effect that if a replacement award requires no service in the post-combination period, but the acquiree award being replaced would have done so, a cost must be recognised in the post-combination period. *[IFRS 3.B59]*.

How we see it

There is no specific guidance in IFRS 3 on how and when to recognise the post-combination remuneration expense in the consolidated financial statements of the acquirer. In our view, the expense is recognised over the post-combination vesting period of the replacement award in accordance with the general principles of IFRS 2 (see sections 6.2 to 6.4 above).

The portions of the replacement award attributable to pre- and post-combination service calculated in (b) and (c) above are calculated, under the normal principles of IFRS 2, based on the best estimate of the number of awards expected to vest (or to be treated as vesting by IFRS 2). Rather than being treated as adjustments to the consideration for the business combination, any changes in estimates or forfeitures occurring after the acquisition date are reflected in remuneration cost for the period in which the changes occur in accordance with the normal principles of IFRS 2. Similarly, the effects of other post-acquisition events, such as modifications or the outcome of performance conditions, are accounted for in accordance with IFRS 2 as part of the determination of the remuneration expense for the period in which such events occur. *[IFRS 3.B60]*. The application of these requirements is discussed in more detail in section 11.2.3 below.

The requirements above to split an award into pre-combination and post-combination portions apply equally to equity-settled and cash-settled replacement awards. All changes after the acquisition date in the fair value of cash-settled replacements awards and their tax effects (recognised in accordance with IAS 12 *Income Taxes*) are recognised in the post-combination financial statements when the changes occur. *[IFRS 3.B61, IFRS 3.62]*.

How we see it

IFRS 3 does not specify where in the income statement any changes in the pre-combination element of a cash-settled award is to be reflected and, in the absence of clear guidance, an entity will need to consider whether this is remuneration expense or whether it is closer to a change in a liability for contingent consideration.

The treatment of the income tax effects of replacement share-based payment transactions in a business combination is discussed further in Chapter 29 at section 10.8.5.

11.2.1.A Illustrative examples of awards that the acquirer is 'obliged' to replace

IFRS 3 provides some examples in support of the written guidance summarised above, the substance of which is reproduced as Illustrations 11-1 to 11-4 below. *[IFRS 3.IE61-71]*. These deal with the following scenarios.

Is post-combination service required for the replacement award?	Has the acquiree award being replaced vested before the combination?	Example
Not required	Vested	11-1
Not required	Not vested	11-2
Required	Vested	11-3
Required	Not vested	11-4

In all the examples, it is assumed that the replacement award is equity-settled.

Illustration 11-1: Replacement award requiring no post-combination service replacing vested acquiree award

Entity A acquires Entity B and issues replacement awards with a fair value at the acquisition date of CU1.1 million for awards of Entity B with a fair value at the acquisition date of CU1.0 million. No post-combination services are required for the replacement awards and Entity B's employees had rendered all of the required service for the acquiree awards as of the acquisition date.

The amount attributable to pre-combination service, and therefore included in the consideration transferred in the business combination, is the fair value of Entity B's awards at the acquisition date (CU1.0 million). The amount attributable to post-combination service is CU0.1 million, the difference between the total value of the replacement awards (CU1.1 million) and the portion attributable to pre-combination service (CU1.0 million). Because no post-combination service is required for the replacement awards, Entity A immediately recognises CU0.1 million as remuneration cost in its post-combination financial statements.

Illustration 11-2: Replacement award requiring no post-combination service replacing unvested acquiree award

Entity A acquires Entity B and issues replacement awards with a fair value at the acquisition date of CU1.0 million for awards of Entity B also with a fair value at the acquisition date of CU1.0 million. When originally granted, the awards of Entity B had a vesting period of four years and, as of the acquisition date, the employees of Entity B had rendered two years' service. The replacement award vests in full immediately.

The portion of the fair value of the replacement awards attributable to pre-combination services is the fair value of the award of Entity B being replaced (CU1 million) multiplied by the ratio of the pre-combination vesting period (two years) to the greater of the total vesting period (now two years) and the original vesting period of Entity B's award (four years). Thus, CU0.5 million (CU1.0 million × 2/4 years) is attributable to pre-combination service and therefore included in the consideration transferred for the acquiree. The remaining CU0.5 million is attributable to post-combination service, but, because no post-combination service is required for the replacement award to vest, Entity A recognises the entire CU0.5 million immediately as remuneration cost in the post-combination financial statements.

Illustration 11-3: Replacement award requiring post-combination service replacing vested acquiree award

Entity A acquires Entity B and issues replacement awards with a fair value at the acquisition date of CU1.0 million for awards of Entity B also with a fair value at the acquisition date of CU1.0 million. The replacement awards require one year of post-combination service. The awards of Entity B being replaced had a vesting period of four years. As of the acquisition date, employees of Entity B holding unexercised vested awards had rendered a total of seven years of service since the grant date.

Even though the Entity B employees have already rendered all of the service for their original awards, Entity A attributes a portion of the replacement award to post-combination remuneration cost, because the replacement awards require one year of post-combination service. The total vesting period is five years - the vesting period for the original Entity B award completed before the acquisition date (four years) plus the vesting period for the replacement award (one year). The fact that the employees have rendered seven years of service in total in the pre-combination period is not relevant to the calculation because only four years of that service were necessary in order to earn the original award.

The portion attributable to pre-combination services equals the fair value of the award of Entity B being replaced (CU1 million) multiplied by the ratio of the pre-combination vesting period (four years) to the total vesting period (five years). Thus, CU0.8 million (CU1.0 million × 4/5 years) is attributed to the pre-combination vesting period and therefore included in the consideration transferred in the business combination. The remaining CU0.2 million is attributed to the post-combination vesting period and is recognised as remuneration cost in Entity A's post-combination financial statements in accordance with IFRS 2, over the remaining one-year vesting period.

Illustration 11-4: Replacement award requiring post-combination service replacing unvested acquiree award

Entity A acquires Entity B and issues replacement awards with a fair value at the acquisition date of CU1.0 million for awards of Entity B also with a fair value at the acquisition date of CU1.0 million. The replacement awards require one year of post-combination service. When originally granted, the awards of Entity B being replaced had a vesting period of four years and, as of the acquisition date, the employees had rendered two years' service.

The replacement awards require one year of post-combination service. Because employees have already rendered two years of service, the total vesting period is three years. The portion attributable to pre-combination services equals the fair value of the award of Entity B being replaced (CU1 million) multiplied by the ratio of the pre-combination vesting period (two years) to the greater of the total vesting period (three years) or the original vesting period of Entity B's award (four years). Thus, CU0.5 million (CU1.0 million × 2/4 years) is attributable to pre-combination service and therefore included in the consideration transferred for the acquiree. The remaining CU0.5 million is attributable to post-combination service and therefore recognised as remuneration cost in Entity A's post-combination financial statements, over the remaining one-year vesting period.

11.2.2 Acquiree awards that the acquirer is not 'obliged' to replace

IFRS 3 notes that, in some situations, acquiree awards may expire as a consequence of a business combination. In such a situation, the acquirer might decide to replace those awards even though it is not obliged to do so. It might also be the case that the acquirer decides voluntarily to replace awards that would not expire and which it is not otherwise obliged to replace.

Under IFRS 3 there is no difference in the basic approach to accounting for a replacement award that the acquirer is obliged to make and one that it makes on a voluntary basis (i.e., the approach is as set out in section 11.2.1 above). In other words, the accounting is based on the fair value of the replacement award at the date of acquisition, with an apportionment of that amount between the cost of acquisition and post-acquisition employment expense.

This approach would equally apply in a reverse acquisition by the accounting acquirer, absent any legal modification to the terms of the accounting acquiree's awards; it is as if the accounting acquiree's awards have been exchanged for a share-based payment award of the accounting acquirer. The fair value of accounting acquiree's share-based payment awards at the acquisition date is apportioned between the cost of the business combination and remuneration cost in the post-combination financial statements, i.e., the approach is as set out in section 11.2.1 above (see Chapter 10 at section 14.7). *[IFRS 2.5, IFRS 3.52(b)]*.

However, in situations where the acquiree awards would expire as a consequence of the business combination if they were not voluntarily replaced by the acquirer, none of the fair value of the replacement awards is treated as part of the consideration transferred for the business (and therefore included in the computation of goodwill), but the full amount is instead recognised as a remuneration cost in the post-combination financial statements. The IASB explains that this is because the new award by the acquirer can only be for future services to be provided by the employee as the acquirer has no obligation to the employee in respect of past services. *[IFRS 3.B56, IFRS 3.BC311B]*.

11.2.3 Accounting for changes in vesting assumptions after the acquisition date

Whilst the requirements outlined in section 11.2.1 above to reflect changes in assumptions relating to the post-acquisition portion of an award through post-combination remuneration appear consistent with the general principles of IFRS 2 and IFRS 3, the application of the requirements to the pre-combination portion is less straightforward.

Paragraph B60 of IFRS 3 appears to require all changes to both the pre- and post-combination portions of the award to be reflected in post-combination remuneration expense. *[IFRS 3.B60]*. This could lead to significant volatility in post-combination profit or loss as a consequence of forfeitures, or other changes in estimates, relating to awards accounted for as part of the consideration for the business combination.

A second approach relies on a combination of paragraphs B60 and B63(d). Whilst paragraph B60 is clear that no adjustment can be made to the purchase consideration, paragraph B63(d) refers to IFRS 2 providing "guidance on subsequent measurement and accounting for *the portion of replacement share-based payment awards … that is attributable to employees' future services*" (emphasis added). *[IFRS 3.B60, IFRS 3.B63(d)]*. Supporters of this view therefore argue that the remeasurement requirements of paragraph B60 apply only to the portion of the replacement award that is attributed to future service and that the award is required to be split into two parts:

- A pre-combination element that is treated as if it were vested at the acquisition date and then accounted for in the same way as other contingent consideration settled in equity.
- A post-combination portion that is treated as a new award and reflects only the employees' post-combination service.

A third approach is based on the guidance in IFRS 3.B59 which states that "the acquirer attributes any excess of the market-based measure of the replacement award over the market-based measure of the acquiree award to post-combination service and recognises that excess as remuneration cost in the post-combination financial statements". *[IFRS 3.B59]*. As for the second approach above, the pre-combination element is considered to be fixed and cannot be reversed. However, any subsequent changes in assumptions that give rise to an incremental expense over the amount recognised as pre-combination service must be recognised as part of the post-combination remuneration expense.

Whilst the second and third approaches above are more consistent with the general requirement under IFRS 2 that vested awards must not be adjusted, the first approach, based on paragraph B60, is arguably the most obvious reading of IFRS 3.

How we see it

In the absence of clear guidance in the standard, we believe that an entity could make an accounting policy choice between the three approaches noted above, but once chosen, the policy must be applied consistently.

The three approaches are demonstrated in Illustration 11-5 below.

Illustration 11-5: Accounting for post-acquisition changes in estimates relating to replacement awards

Entity A grants an award of 1,000 shares to each of two employees. The award will vest after three years provided the employees remain in service. At the end of year 2, Entity A is acquired by Entity B which replaces the award with one over its own shares but otherwise on the same terms. The fair value of each share at the date of acquisition is CU1. At this date, Entity B estimates that one of the two employees will leave employment before the end of the remaining one-year service period.

At the date of acquisition, Entity B recognises CU667 (1 employee × 1,000 shares × CU1 × 2/3) as part of the consideration for the business combination and expects to recognise a further CU333 as an expense through post-acquisition profit or loss (1 × 1,000 × CU1 × 1/3).

However, if the estimates made as at the date of the acquisition prove to be inaccurate and either both employees leave employment during year 3, or both remain in employment until the vesting date, there are three alternative approaches to the accounting as explained above:

- Approach 1 - all changes in estimates are reflected in post-acquisition profit or loss (drawing on IFRS 3.B60).
- Approach 2 - changes to the estimates that affect the amount recognised as part of the purchase consideration are not adjusted for and changes affecting the post-acquisition assumptions are adjusted through post-acquisition profit or loss (drawing on IFRS 3.B63(d)).
- Approach 3 - the amount attributable to pre-combination service, and treated as part of the business combination, is fixed and cannot be reversed. However, any changes in assumptions that give rise to an additional cumulative expense are reflected through post-acquisition profit or loss (drawing on IFRS 3.B59).

Using the fact pattern above, and assuming that both employees leave employment in the post-acquisition period, the three alternative approaches would give rise to the following entries in accounting for the forfeitures:

- Approach 1 - a credit of CU667 to post-acquisition profit or loss to reflect the reversal of the amount charged to the business combination. In addition to this, any additional expense that had been recognised in the post-acquisition period would be reversed.
- Approaches 2 and 3 - the reversal through post-acquisition profit or loss of any additional expense that had been recognised in the post-acquisition period.

If, instead, both employees remained in employment in the post-acquisition period and both awards vested, the three alternative approaches would give rise to the following entries:

- Approach 1 - an expense of CU1,333 through post-acquisition profit or loss to reflect the remaining CU333 fair value of the award to the employee who was expected to remain in service plus CU1,000 for the award to the employee who was not expected to remain in service.
- Approach 2 - an expense of CU666 (2 × CU333) through post-acquisition profit or loss for the remaining 1/3 of the acquisition date fair value of the two awards. There is no adjustment to the business combination or to post-acquisition profit or loss for the CU667 pre-acquisition element of the award that, as at the acquisition date, was not expected to vest.
- Approach 3 - an expense of CU1,333 through post-acquisition profit or loss to reflect the remaining CU333 fair value of the award to the employee who was expected to remain in service plus CU1,000 for the award to the employee who was not expected to remain in service.

11.3 Acquiree award not replaced by acquirer

It may occasionally happen that the acquirer does not replace awards of the acquiree at the time of the acquisition. This might be the case where, for example, the acquired subsidiary is only partly-owned and is itself listed.

IFRS 3 distinguishes between vested and unvested share-based payment transactions of the acquiree that are outstanding at the date of the business combination but which the acquirer chooses not to replace.

If vested, the outstanding acquiree share-based payment transactions are treated by the acquirer as part of the non-controlling interest in the acquiree and measured at their IFRS 2 fair value at the date of acquisition.

If unvested, the outstanding share-based payment transactions are fair valued in accordance with IFRS 2 as if the acquisition date were the grant date. The fair value must be allocated to the non-controlling interest in the acquiree on the basis of the ratio of the portion of the vesting period completed to the greater of:

- The total vesting period

  And

- The original vesting period of the share-based payment transactions

The balance is treated as a post-combination remuneration expense in accordance with the general principles of IFRS 2. *[IFRS 3.B62A, IFRS 3.B62B]*. Forfeitures in the post-combination period will need to be assessed in accordance with the approaches set out in section 11.2.3 above.

11.4 Financial statements of the acquired entity

The replacement of an award based on the acquiree's equity with one based on the acquirer's equity is, from the perspective of the acquired entity, a cancellation and replacement, to be accounted for in accordance with the general principles of IFRS 2 for such transactions (see section 7.4 above). However, in addition to considerations about whether this is accounted for as a separate cancellation and new grant or as a modification of the original terms, the acquiree needs to take into account its new status as a subsidiary of the acquirer.

If the acquirer is responsible for settling the award in its own equity with the acquiree's employees, the acquiree will continue to account for the award on an equity-settled basis. If, however, the acquiree is responsible for settling the award with shares of the acquirer, then the acquiree would have to switch from an equity-settled basis of accounting to a cash-settled basis of accounting (see sections 2.2.2.A and 9.4.1 above). *[IFRS 2.43B, IFRS 2.B52(b), IFRS 2.B55]*.

Even if the acquiree continues to account for the award on an equity-settled basis, the share-based payment expense recorded in the consolidated financial statements (based on fair value at the date of the business combination) will generally not be the same as that in the financial statements of the acquired entity (based on fair value at the date of original grant plus any incremental value granted at the date of acquisition, if modification accounting is applied). The exact timing of the recognition of the expense in the financial statements of the acquired entity after the date of cancellation and replacement will depend on its interpretation of the requirements of IFRS 2 for the cancellation and replacement of options (see Illustration 7-12 in section 7.4.4.B above).

12 Group share schemes

In this section we consider various aspects of share-based payment arrangements operated within a group and involving several legal entities. The focus of the section is on the accounting by the various parties involved and includes several comprehensive illustrative examples. The main areas covered are as follows:

- Typical features of a group share scheme (see section 12.1 below).
- A summary of the accounting treatment of group share schemes (see section 12.2 below).
- Employee benefit trusts ('EBTs') and similar vehicles (see section 12.3 below).
- An example of a group share scheme (based on an equity-settled award satisfied by a market purchase of shares) illustrating the accounting by the different entities involved (see section 12.4 below).
- An example of a group share scheme (based on an equity-settled award satisfied by a fresh issue of shares) illustrating the accounting by the different entities involved (see section 12.5 below).
- An example of a group cash-settled transaction where the award is settled by an entity other than the one receiving goods or services (see section 12.6 below).
- The accounting treatment when an employee transfers between group entities (see section 12.7 below).
- Group reorganisations (see section 12.8 below).

Whilst associates and joint arrangements accounted for as joint ventures do not meet the definition of group entities, there will sometimes be share-based payment arrangements that involve the investor or venturer and the employees of its associate or joint venture. These arrangements are discussed in section 12.9 below.

12.1 Typical features of a group share scheme

In this section we use the term 'share scheme' to encompass any transaction falling within the scope of IFRS 2, whether accounted for as equity-settled or cash-settled.

It is common practice for a group to operate a single share scheme covering several subsidiaries. Depending on the commercial needs of the entity, the scheme might cover all group entities, all group entities in a particular country or all employees of a particular grade throughout a number of subsidiaries.

The precise terms and structures of group share schemes are so varied that it is rare to find two completely identical arrangements. From an accounting perspective, however, group share schemes can generally be reduced to a basic prototype, as described below, which will serve as the basis of the discussion.

A group scheme typically involves transactions by several legal entities:

- The parent, over whose shares awards are granted.
- The subsidiary employing an employee who has been granted an award ('the employing subsidiary').
- The trust that administers the scheme. Such trusts are known by various names in different jurisdictions, but, for the sake of convenience, in this section we will use the term 'EBT' ('employee benefit trust') to cover all such vehicles by whatever name they are actually known. The accounting treatment of transactions with EBTs is discussed in section 12.3 below.

In practice, it might not always be a simple assessment to determine which entity is receiving an employee's services and which entity is responsible for settling the award. For example, the scheme may be directed by a group employee services entity or an individual might be a director of the parent as well as providing services to other operating entities within the group.

Where an employee services company is involved, it will be necessary to evaluate the precise group arrangements in order to decide whether that entity is, in substance, the employer or whether the entity or entities to which it makes a recharge for an individual's services must be treated as the employer(s). It will also often be the case that the services company is simply administering the arrangements on behalf of the parent entity.

How we see it

Where an individual provides services to more than one group entity, an assessment will need to be made as to which entity or entities are receiving the individual's services in return for the award (e.g., the employee service company or the entity or entities the service company makes a charge for an individual's services). This will depend on the precise facts and circumstances of a particular situation.

A share-based award is often granted to an employee by the parent, or a group employee services entity, which will in turn have an option exercisable against the EBT for the shares that it may be required to deliver to the employee. Less commonly, the trustees of the EBT make awards to the employees and enter into reciprocal arrangements with the parent.

If the parent takes the view that it will satisfy any awards using existing shares it will often seek to fix the cash cost of the award by arranging for the EBT to purchase in the market, on the day that the award is made, sufficient shares to satisfy all or part of the award. This purchase will be funded by external borrowings, a loan from the parent, a contribution from the employing subsidiary, or some combination. The cash received from the employee on exercise of the option can be used by the EBT to repay any borrowings.

If the parent takes the view that it will satisfy the options with a fresh issue of shares, these will be issued to the EBT, either:

(a) At the date on which the employee exercises his option (in which case the EBT will subscribe for the new shares using the cash received from the employee together with any non-refundable contribution made by the employing subsidiary - see below). Such arrangements are generally referred to as 'simultaneous funding'.

(b) At some earlier date (in which case the EBT will subscribe for the new shares using external borrowings, a loan from the parent or a contribution from the employing subsidiary, or some combination. The cash received from the employee on exercise of the option may then be used by the EBT to repay any borrowings). Such arrangements are generally referred to as 'pre-funding'.

Or

(c) Some shares will be issued before the exercise date as in (b) above, and the balance on the exercise date as in (a) above.

As noted in (a) above, the employing subsidiary often makes a non-refundable contribution to the EBT in connection with the scheme, so as to ensure that employing subsidiaries bear an appropriate share of the overall cost of a group-wide share scheme.

12.2 Accounting treatment of group share schemes - summary

12.2.1 Background

From a financial reporting perspective, it is generally necessary to consider the accounting treatment in:

- The group's consolidated financial statements
- The parent's separate financial statements
- The employing subsidiary's financial statements

We make the assumption throughout section 12 that the subsidiary is directly owned by the parent company. In practice, there will often be one or more intermediate holding companies between the ultimate parent and the subsidiary. The intermediate parent company generally will not be the entity granting the award, receiving the goods or services or responsible for settling the award. Therefore, under IFRS 2, we believe that there is no requirement for the intermediate company to account for the award in its separate or individual financial statements (although it might choose to recognise an increase in its investment in the subsidiary and a corresponding capital contribution from the ultimate parent in order for the transaction to be reflected throughout the chain of companies).

The accounting entries to be made in the various financial statements will broadly vary according to:

- Whether the award is satisfied using shares purchased in the market or a fresh issue of shares.
- Whether any charge is made to the employing subsidiary for the cost of awards to its employees.
- Whether an employee benefit trust (EBT) is involved. The accounting treatment of transactions undertaken with and by EBTs is discussed in more detail in section 12.3 below.
- The tax consequences of the award. However, for the purposes of the discussion and illustrative examples below, tax effects are ignored, since these will vary significantly by jurisdiction. A more general discussion of the tax effects of share-based payment transactions may be found in section 14 below and in Chapter 29 at section 10.8.

How we see it

As noted above, we believe there is no requirement under IFRS 2 for the intermediate company to account for the award in its separate or individual financial statements as it generally will not be the entity granting the award, receiving the goods or services or responsible for settling the award.

12.2.2 Scope of IFRS 2 for group share schemes

By virtue of the definition of 'share-based payment transaction' (see sections 2.2.1 and 2.2.2.A above), a group share-based payment transaction is in the scope of IFRS 2 for:

- The consolidated financial statements of the group (the accounting for which follows the general principles set out in sections 3 to 10 above).
- The separate or individual financial statements of the entity in the group that receives goods or services (see section 12.2.3 below).
- The separate or individual financial statements of the entity in the group (if different from that receiving the goods or services) that settles the transaction with the counterparty. This entity will typically, but not necessarily, be the parent (see section 12.2.4 below).

IFRS 2 provides further guidance on the application of its general principles to:

- Transactions settled in the equity of the entity, or in the equity of its parent (see section 12.2.5 below).
- Cash-settled transactions settled by a group entity other than the entity receiving the goods or services (see section 12.2.6 below).

In section 2.2.2.A above we consider seven scenarios commonly found in practice and outline the approach required by IFRS 2 in the consolidated and separate or individual financial statements of group entities depending on whether the award is settled in cash or shares and which entity grants the award, has the obligation to settle the award and receives the goods or services.

It is common practice in a group share scheme to require each participating entity in the group to pay a charge, either to the parent or to an EBT, in respect of the cost of awards made under the scheme to employees of that entity. This is generally done either as part of the group's cash-management strategy, or in order to obtain tax relief under applicable local legislation. The amount charged could in principle be at the discretion of the group, but is often based on either the fair value of the award at grant date or the fair value at vesting, in the case of an award of free shares, or exercise, in the case of an award of options.

IFRS 2 does not directly address the accounting treatment of such intragroup management charges and other recharge arrangements, which is discussed further in section 12.2.7 below. *[IFRS 2.B45, IFRS 2.B46]*.

Worked examples illustrating how these various principles translate into accounting entries are given in sections 12.4 to 12.6 below.

12.2.3 Entity receiving goods or services

The entity in a group receiving goods or services in a share-based payment transaction determines whether the transaction must be accounted for, in its separate or individual financial statements, as equity-settled or cash-settled. It does this by assessing the nature of the awards granted and its own rights and obligations. *[IFRS 2.43A]*.

The entity accounts for the transaction as equity-settled when either the awards granted are the entity's own equity instruments, or the entity has no obligation to settle the share-based payment transaction. Otherwise, the entity accounts for the transaction as cash-settled. Where the transaction is accounted for as equity-settled it is remeasured after grant date only to the extent permitted or required by IFRS 2 for equity-settled transactions generally, as discussed in sections 3 to 7 above. *[IFRS 2.43B]*.

IFRS 2 notes that a possible consequence of these requirements is that the amount recognised by the entity may differ from the amount recognised by the consolidated group or by another group entity settling the share-based payment transaction. *[IFRS 2.43A]*. This is discussed further in section 12.6 below.

The cost recognised by the entity receiving goods or services is always calculated according to the principles set out above, regardless of any intragroup recharging arrangement. *[IFRS 2.43D, IFRS 2.B45]*. The accounting for such arrangements is discussed in section 12.2.7 below.

12.2.4 Entity settling the transaction

A group entity which settles a share-based payment transaction in which another group entity receives goods or services accounts for the transaction as an equity-settled share-based payment transaction only if it is settled in the settling entity's own equity instruments. Otherwise, the transaction is accounted for as cash-settled. *[IFRS 2.43C]*.

IFRS 2 specifies only the credit entry - the classification of the transaction as equity- or cash-settled, and its measurement. IFRS 2 does not specify the debit entry, which is therefore subject to the general requirement of IFRS 2 that a share-based payment transaction must normally be treated as an expense, unless there is the basis for another treatment under other IFRS accounting standards (see section 3 above).

In our view, the settling entity is not always required to treat the transaction as an expense:

- Where the settling entity is a parent (direct or indirect) of the entity receiving the goods or services and is accounting for the transaction as equity-settled, it will generally account for the settlement under IAS 27 *Separate Financial Statements*, as an addition to the cost of its investment in the employing subsidiary (or of that holding company of the employing subsidiary which is the settling entity's directly-held subsidiary). *[IFRS 2.B45]*. It may then be necessary to review the carrying value of that investment to ensure that it is not impaired.
- Where the settling entity is a parent (direct or indirect) of the entity receiving the goods or services and is accounting for the transaction as cash-settled (whereas the subsidiary will be accounting for the transaction as equity-settled), in our view it has an accounting policy choice for the treatment of the remeasurement of the cash-settled liability. Either:
  - It accounts for the entire award as part of the contribution to the subsidiary and therefore as an addition to the cost of its investment in the employing subsidiary (or of that holding company of the employing subsidiary which is the settling entity's directly-held subsidiary).

    Or
  - After the initial capitalisation of the grant date fair value of the liability, it remeasures the liability through profit or loss.

  Whichever policy is chosen, it may then be necessary to review the carrying value of the investment to ensure that it is not impaired.
- In other cases (i.e., where the settling entity is a subsidiary (direct or indirect) or fellow subsidiary of the entity receiving the goods or services), the settlement is treated as a distribution, and charged it directly to equity. Whether or not such a settlement is a legal distribution is a matter of law in the jurisdiction concerned.

How we see it

As noted above, the debit entry depends on the classification of the award and which entity is settling the award in the group; parent or another entity. If the settling entity is the parent of the entity receiving the goods or services; in an equity-settled transaction - the debit is recognised as an addition to the cost of investment, in a cash-settled transaction - there is an accounting policy choice for the treatment of the remeasurement of the cash-settled liability.

If the settling entity is not the parent (i.e., direct or indirect subsidiary or fellow subsidiary, of the entity receiving the goods or services), the settlement is treated as a distribution, and charged directly to equity.

We adopt the approach of full capitalisation by the parent entity in the worked examples set out in sections 12.4 to 12.6 below.

12.2.5 Transactions settled in equity of the entity or its parent

12.2.5.A Awards settled in equity of subsidiary

Where a subsidiary grants an award to its employees and settles it in its own equity, the subsidiary accounts for the award as equity-settled.

The parent accounts for the award as equity-settled in its consolidated financial statements. In its separate financial statements, the parent is not required by IFRS 2 to account for the award. In both cases, the transaction may have implications for other aspects of the financial statements, since its settlement results in the partial disposal of the subsidiary (see Chapter 8).

Where the parent is responsible for settling the award, it accounts for the transaction as equity-settled in its consolidated financial statements. In its separate financial statements, however, it accounts for the award as cash-settled, since it is settled not in its own equity, but in the equity of the subsidiary. From the perspective of the parent's separate financial statements, the equity of a subsidiary is a financial asset. *[IFRS 2.B50]*.

12.2.5.B Awards settled in equity of the parent

Where the parent grants an award directly to the employees of a subsidiary and settles it in its own equity, the subsidiary accounts for the award as equity-settled, with a corresponding increase in equity as a contribution from the parent. *[IFRS 2.B53]*.

The parent accounts for the award as equity-settled in both its consolidated and separate financial statements. *[IFRS 2.B54]*.

Where a subsidiary grants an award of equity in its parent to its employees and settles the award itself, it accounts for the award as cash-settled, since it is settled not in its own equity, but in the equity of its parent. From the perspective of the subsidiary's separate or individual financial statements, the equity of the parent is a financial asset. *[IFRS 2.B55]*.

This requirement potentially represents something of a compliance burden. For the purposes of the parent's consolidated financial statements the fair value of the award needs to be calculated once, at grant date. For the purposes of the subsidiary's financial statements, however, IFRS 2 requires the award to be accounted for as cash-settled, with the fair value recalculated at each reporting date.

It is, however, important to note that IFRS 2 requires this accounting treatment only for a subsidiary that 'grants' such an award. *[IFRS 2.B52, IFRS 2.B53, IFRS 2.B55]*. In some jurisdictions it is normal for grants of share awards to be made by the parent, or an employee service company or EBT, rather than by the subsidiary, although the subsidiary may well make recommendations to the grantor of the award as to which of its employees should benefit.

In those cases, the fact that the subsidiary may communicate the award to the employee does not necessarily mean that the subsidiary itself has granted the award. It may simply be notifying the employee of an award granted by another group entity and which the other group company has the obligation to settle. In that case the subsidiary must apply the normal requirement of IFRS 2 to account for the award as equity-settled.

12.2.6 Cash-settled transactions not settled by the entity receiving goods or services

IFRS 2 considers arrangements in which the parent has an obligation to make cash payments to the employees of a subsidiary linked to the price of either:

- The subsidiary's equity instruments

  Or

- The parent's equity instruments

In both cases, the subsidiary has no obligation to settle the transaction and therefore accounts for the transaction as equity-settled, recognising a corresponding credit in equity as a contribution from its parent.

The subsidiary then subsequently remeasures the cost of the transaction only for any changes resulting from non-market vesting conditions not being met in accordance with the normal provisions of IFRS 2 discussed in sections 3 to 6 above. IFRS 2 points out that this will differ from the measurement of the transaction as cash-settled in the consolidated financial statements of the group. *[IFRS 2.B56, IFRS 2.B57]*.

In both cases, the parent has an obligation to settle the transaction in cash. Accordingly, the parent accounts for the transaction as cash-settled in both its consolidated and separate financial statements. *[IFRS 2.B58]*.

The requirement for the subsidiary to measure the transaction as equity-settled is somewhat controversial. The essential rationale for requiring the subsidiary to record the cost of a share-based payment transaction settled by its parent is to reflect that the subsidiary is effectively receiving a capital contribution from its parent.

The IASB specifically considered whether it would be more appropriate to measure that contribution by reference to the cash actually paid by the parent, but concluded that the approach adopted in IFRS 2 better reflects the perspective of the subsidiary as a separate reporting entity. An accounting treatment based on the cash paid by the parent would, in the IASB's view, reflect the perspective of the parent rather than that of the subsidiary. *[IFRS 2.BC268H-268K]*.

12.2.7 Intragroup recharges and management charges

As noted in section 12.2.3 above, the cost recognised by a subsidiary receiving goods or services in a share-based payment transaction among group entities is based on the principles in paragraph 43B regardless of intergroup recharge arrangements. *[IFRS 2.43D]*. In addition, as noted in section 12.2.2 above, IFRS 2 does not deal specifically with the accounting treatment of intragroup recharges and management charges that may be levied within the group on the subsidiary that receives goods or services, the consideration for which is equity instruments or cash provided by another group entity.

The timing of the recognition of intercompany recharges was considered by the IFRS IC in 2013 (see section 12.2.7.A below).

The accounting requirements of IFRS 2 for group share schemes derive from IFRIC 11 (now incorporated within IFRS 2 see section 1.2 above), which was based on an exposure draft (D17) published in 2005.

D17 proposed that any such payment made by a subsidiary is charged directly to equity, on the basis that it represents a return of the capital contribution recorded as the credit to equity required by IFRS 2 (see sections 12.2.3 and 12.2.6 above) up to the amount of that contribution, and a distribution thereafter.[35]

How we see it

In our view, whilst IFRS 2 as currently drafted does not explicitly require the accounting set out in D17 for the subsidiary, this is likely to be the more appropriate analysis for most cases where the amount of the recharge or management charge to a subsidiary is directly related to the value of the share-based payment transaction. Indeed, the only alternative, 'mechanically' speaking, would be to charge the relevant amount to profit or loss. This would result in a double charge (once for the IFRS 2 charge, and again for the management charge or recharge) which we consider not only less desirable for most entities, but also less appropriate in cases where the amounts are directly related.

In the Illustrations in sections 12.4 to 12.6 below, we apply the treatment originally proposed in D17 to any payments made by the subsidiary for participation in the group scheme.

Many intragroup recharge arrangements are based directly on the value of the underlying share-based payment - typically at grant date, vesting date or exercise date. In other cases, a more general management charge might be levied that reflects not just share-based payments but also a number of other arrangements or services provided to the subsidiary by the parent. Where there is a more general management charge of this kind, we believe that it is more appropriate for the subsidiary to recognise a double charge to profit or loss (once for the IFRS 2 charge, and again for the management charge) rather than debiting the management charge to equity as would be the case for a direct recharge.

IFRS 2 also does not address how the parent must account for a recharge or management charge received. In our view, to the extent that the receipt represents a return of a capital contribution made to the subsidiary, the parent may choose whether to credit:

- The carrying amount of its investment in the subsidiary

  Or

- Profit or loss (with a corresponding impairment review of the investment)

Even if part of the recharge received is credited to the carrying amount of the investment, any amount received in excess of the capital contribution previously debited to the investment in subsidiary must be accounted for as a distribution from the subsidiary and credited to the income statement of the parent. Where applicable, the Illustrations in sections 12.4 to 12.6 below show the entire amount as a credit to the income statement of the parent rather than part of the recharge being treated as a credit to the parent's investment in its subsidiary.

The treatment of a distribution from a subsidiary in the separate financial statements of a parent is more generally discussed in Chapter 9 at section 2.4.

How we see it

In the absence of guidance in IFRS 2 on accounting by the parent for a recharge or management charge received, in our view, to the extent that the receipt represents a return of a capital contribution made to the subsidiary, the parent could choose whether to credit the carrying amount of its investment in subsidiary (up to the capital contribution previously debited to the carrying amount of investment) with the excess recognised in profit or loss or the full receipt recognised in profit or loss.

35 D17 -IFRS 2 - Group and Treasury Share Transactions, IASB, 2005, para. IE5.

A further issue that arises in practice is the timing of recognition of the recharge by the parties to the arrangement. The treatment adopted might depend to some extent on the precise terms and whether there are contractual arrangements in place, but two approaches generally result in practice:

- To account for the recharge when it is actually levied or paid (which is consistent with accounting for a distribution).

  Or

- To accrue the recharge over the life of the award or the recharge agreement even if, as is commonly the case, the actual recharge is only made at vesting or exercise date.

An entity must choose the more appropriate treatment for its particular circumstances. The first approach is often the more appropriate in a group context where recharge arrangements might be rather informal and therefore not binding until such time as a payment is made. It is also consistent with the overall recognition of the arrangement through equity. The second approach, which is likely to be the more appropriate approach when a liability is considered to exist in advance of the payment date, is closer in some respects to the accounting treatment of a provision or financial liability but, unlike the requirements of IAS 37 or IFRS 9, reflects changes in the recognised amount through equity rather than profit or loss and builds up the recharge liability over the life of the award rather than recognising the liability in full when a present obligation has been identified.

Whichever accounting treatment is adopted, any adjustments to the amount to be recognised as a recharge, whether arising from a change in the IFRS 2 expense or other changes, must be recognised in the current period and previous periods must not be restated.

How we see it

In the absence of guidance in IFRS 2 on the timing of recognition of the recharge, in our view, an entity chooses the most appropriate treatment for its particular circumstances based on the guidance set out above, i.e., account for the charge when levied/paid or accrue the recharge over the life of the award.

Where applicable, the Illustrations in sections 12.4 to 12.6 below demonstrate the first of the two treatments outlined above and recognise the recharge only when it becomes payable at the date of exercise.

12.2.7.A Timing of recognition of intercompany recharges: discussion by the IFRS IC

In January 2013 the IFRS IC discussed whether a subsidiary's liability to pay to its parent the settlement value of share-based payments made by the parent to the subsidiary's employees should be recognised by the subsidiary from the grant date of the award or only at the date of settlement of the award.

While outreach conducted by the IFRS IC suggested that there is diversity in practice (as indicated in section 12.2.7 above), the IFRS IC concluded in May 2013 that the topic could not be restricted to recharges relating to share-based payments and therefore decided not to add this issue to its agenda.[36]

12.3 Employee benefit trusts ('EBTs') and similar arrangements

12.3.1 Background

For some time, entities have established trusts and similar arrangements for the benefit of employees. These are known by various names in different jurisdictions, but, for the sake of convenience, in this section we will use the term 'EBT' ('employee benefit trust') to cover all such vehicles by whatever name they are actually known.

The commercial purposes of using such vehicles vary from employer to employer, and from jurisdiction to jurisdiction, but may include the following:

- An EBT, in order to achieve its purpose, needs to hold shares that have either been issued to it by the entity or been bought by the EBT on the open market. In some jurisdictions, the direct holding of shares in an entity by the entity itself is unlawful.
- In the case of longer-term benefits the use of an EBT may 'ring fence' the assets set aside for the benefit of employees in case of the insolvency of the entity.
- The use of an EBT may be necessary in order to achieve a favourable tax treatment for the entity or the employees, or both.

36 *IFRIC Update*, May 2013, available on the IFRS Foundation's website.

The detailed features of an EBT will again vary from entity to entity, and from jurisdiction to jurisdiction, but typical features often include the following:

- The EBT provides a warehouse for the shares of the sponsoring entity, for example by acquiring and holding shares that are to be sold or transferred to employees in the future. The trustees may purchase the shares with finance provided by the sponsoring entity (by way of cash contributions or loans), or by a third-party bank loan, or by a combination of the two. Loans from the entity are usually interest-free. In other cases, the EBT may subscribe directly for shares issued by the sponsoring entity or acquire shares in the market.
- Where the EBT borrows from a third party, the sponsoring entity will usually guarantee the loan, i.e., it will be responsible for any shortfall if the EBT's assets are insufficient to meet its debt repayment obligations. The entity will also generally make regular contributions to the EBT to enable the EBT to meet its interest payments, i.e., to make good any shortfall between the dividend income of the EBT (if any) and the interest payable. As part of this arrangement the trustees may waive their right to dividends on the shares held by the EBT.
- Shares held by the EBT are distributed to employees through an employee share scheme. There are many different arrangements - these may include:
  - The purchase of shares by employees when exercising their share options under a share option scheme.
  - The purchase of shares by the trustees of an approved profit-sharing scheme for allocation to employees under the rules of the scheme.

    Or
  - The transfer of shares to employees under some other incentive scheme.
- The trustees of an EBT may have a legal duty to act at all times in accordance with the interests of the beneficiaries under the EBT. However, most EBTs (particularly those established as a means of remunerating employees) are specifically designed so as to serve the purposes of the sponsoring entity, and to ensure that there will be minimal risk of any conflict arising between the duties of the trustees and the interest of the entity.

12.3.2 Accounting for EBTs

Historically, transactions involving EBTs were accounted for according to their legal form. In other words, any cash gifted or lent to the EBT was simply treated as, respectively, an expense or a loan in the financial statements of the employing entity.

However, this treatment gradually came to be challenged, not least by some tax authorities who began to question whether it was appropriate to allow a corporate tax deduction for the 'expense' of putting money into an EBT which in some cases might remain in the EBT for some considerable time (or even be lent back to the entity) before being actually passed on to employees. Thus, the issue came onto the agenda of the national standard setters.

The accounting solution proposed by some national standard setters, such as those in the United States and the United Kingdom, was to require a reporting entity to account for an EBT as an extension of the entity. The basis for this treatment was essentially that, as noted in section 12.3.1 above, EBTs are specifically designed to serve the purposes of the sponsoring entity, and to ensure that there will be minimal risk of any conflict arising between the duties of the trustees and the interest of the entity, suggesting that they are under the *de facto* control of the entity.

Unlike the approach required by some national standard setters, IFRS accounting standards does not mandate the treatment of an EBT as an extension of the sponsoring entity in that entity's separate financial statements and the accounting treatment in the separate entity is therefore less clear under IFRS (see section 12.3.4 below). If an entity does not treat the EBT as an extension of itself in its own financial statements it will need to assess for its consolidated IFRS financial statements whether the EBT is required to be consolidated as a separate vehicle. This assessment will be based on the control criteria set out in IFRS 10, as discussed in more detail in Chapter 7. However, in summary, the entity will need to decide whether:

- It has power over the EBT.
- It has exposure, or rights, to variable returns from its involvement with the EBT.
- It has the ability to use its power over the EBT to affect the amount of the sponsoring entity's returns.

Paragraphs BC70 to BC74 of the Basis for Conclusions on IFRS 2 are clearly written on the assumption that the trust referred to in paragraph BC70 is being included in the financial statements of the reporting entity. This suggests that the IASB regards the consolidation of such vehicles as normal practice. *[IFRS 2.BC70-74]*.

In addition to a decision as to whether it is appropriate to consolidate an EBT, reporting entities also need to make an assessment as to the level within a group at which the EBT must be consolidated i.e., whether the EBT is controlled by a sponsoring entity at a sub-group level or whether just by the ultimate parent entity. In many cases, an EBT holding shares in the ultimate parent entity will be considered to be under the control of that entity but there will be exceptions in some group scenarios. The discussion below generally assumes that the reporting entity is the sponsoring entity of the EBT and consolidates an EBT holding the reporting entity's own shares.

Consolidation of an EBT will have the following broad consequences for the consolidated financial statements of the reporting entity:

- Until such time as the entity's own shares held by the EBT vest unconditionally in employees (e.g., as the result of the vesting of an award of ordinary shares, or the exercise of a vested option over ordinary shares):
  - Any consideration paid for the shares must be deducted in arriving at shareholders' equity in accordance with IAS 32 (see Chapter 43 at section 9).
  - The shares are required to be treated as if they were treasury shares when calculating earnings per share under IAS 33 (see Chapter 33 at section 3.2).
- Other assets and liabilities (including borrowings) of the EBT must be recognised as assets and liabilities in the consolidated financial statements of the sponsoring entity.
- No gain or loss is recognised in profit or loss on the purchase, sale, issue or cancellation of the entity's own shares, as required by IAS 32. Although not explicitly required by IFRS accounting standards, we suggest that entities show consideration paid or received for the purchase or sale of the entity's own shares in an EBT separately from other purchases and sales of the entity's own shares in the reconciliation of movements in shareholders' equity. This may be particularly relevant for entities in jurisdictions that distinguish between 'true' treasury shares (i.e., those legally held by the issuing entity) and those accounted for as such under IFRS (such as those held by an EBT).
- Any dividend income arising on own shares must be excluded in arriving at profit before tax and deducted from the aggregate of dividends paid and proposed. In our view, the deduction must be disclosed if material.
- Finance costs and any administration expenses must be charged as they accrue and not as funding payments are made to the EBT.

How we see it

As noted above, IFRS accounting standards does not mandate the treatment of an EBT as an extension of the sponsoring entity in the entity's financial statements and the accounting treatment in the separate entity is therefore less clear under IFRS accounting standards (see section 12.3.4 below). If an entity does not treat the EBT as an extension of itself in its own financial statements, it will need to assess for its consolidated IFRS financial statements whether the EBT is required to be consolidated as a separate vehicle. Whichever approach is used, it must be applied consistently.

The discussion above, and in the remainder of section 12, focuses on arrangements where the EBT holds unallocated shares of the reporting entity and/or shares that have been allocated to employees in connection with share awards but where the awards have not yet vested unconditionally. There will also be situations in practice in which an EBT reaches the stage where, or is designed so that, it only holds shares to which employees have full entitlement (i.e., the shares are fully vested). In this situation the shares are beneficially owned and controlled by the individual employees but might remain in trust for tax or other reasons in the period following vesting. Where an EBT does not hold any unvested shares and there are no other assets or liabilities in the EBT over which the entity continues to exercise control, there will be nothing left in the EBT to be consolidated.

12.3.3 Illustrative Examples - awards satisfied by shares purchased by, or issued to, an EBT

The following Illustrations assume that the EBT is consolidated in accordance with IFRS 10 and show the interaction of the requirements of IFRS 10 with those of IFRS 2. Illustration 12-1 demonstrates the treatment where an award is satisfied using shares previously purchased in the market. Illustration 12-2 demonstrates the treatment where freshly issued shares are used.

Illustration 12-1: Interaction of IFRS 10, IAS 32 and IFRS 2 (market purchase)

On 1 January in year 1, the EBT of ABC plc made a market purchase of 100,000 shares of ABC plc at CU2.50 per share. These were the only ABC shares held by the EBT at that date.

On 1 May in the same year, ABC granted executives options over between 300,000 and 500,000 shares at CU2.70 per share, which will vest at the end of year 1, the number vesting depending on various performance criteria. It is determined that the cost to be recognised in respect of this award under IFRS 2 is CU0.15 per share.

Four months later, on 1 September, the EBT made a further market purchase of 300,000 shares at CU2.65 per share.

At the end of year 1, options vested over 350,000 shares and were exercised immediately.

The accounting entries for the above transaction required by IFRS 10, IAS 32 and IFRS 2 in the consolidated financial statements of ABC would be as set out below. It should be noted that all these pronouncements require various entries to be recorded in 'equity'. Thus, some variation may be found in practice as to the precise characterisation of the reserves, depending on local legal requirements and other 'traditions' in national GAAP which are retained to the extent that they do not conflict with IFRS accounting standards.

1 January

Dr	Own shares (equity)		CU250,000	
	Cr	Cash		CU250,000

To record purchase of 100,000 CU1 shares at CU2.50/share

1 May - 31 December

Dr	Profit or loss		CU52,500	
	Cr	Equity†		CU52,500

To record cost of vested 350,000 options at CU0.15/option

1 September

Dr	Own shares (equity)		CU795,000	
	Cr	Cash		CU795,000

To record purchase of 300,000 CU1 shares at CU2.65/share

31 December

Dr	Cash		CU945,000	
	Cr	Equity†[1]		CU945,000

Receipt of proceeds on exercise of 350,000 options at CU2.70/share

Dr	Equity†		CU914,375	
	Cr	Own shares (equity)[2]		CU914,375

Release of shares from EBT to employees

1 This reflects the fact that the entity's resources have increased as a result of a transaction with an owner, which gives rise to no gain or loss and is therefore credited direct to equity.

2 It is necessary to transfer the cost of the shares 'reissued' by the EBT out of own shares, as the deduction for own shares would otherwise be overstated. The total cost of the pool of 400,000 shares immediately before vesting was CU1,045,000 (CU250,000 purchased on 1 January and CU795,000 purchased on 1 September), representing an average cost per share of CU2.6125. CU2.6125 × 350,000 shares = CU914,375.

† We recommend that, subject to any local legal restrictions, these amounts all be accounted for in the same component of equity.

Illustration 12-1 shows the importance of keeping the accounting treatment required by IAS 32 for the cost of the shares completely separate from that for the cost of the award required by IFRS 2. In cash terms, ABC has made a 'profit' of CU30,625, since it purchased 350,000 shares with a weighted average cost of CU914,375 and issued them to the executives for CU945,000. However, this 'profit' is accounted for entirely within equity, whereas a calculated IFRS 2 cost of CU52,500 is recognised in profit or loss.

Illustration 12-2: Interaction of IFRS 10, IAS 32 and IFRS 2 (fresh issue of shares)

On 1 January in year 1, the EBT of ABC plc subscribed for 100,000 CU1 shares of ABC plc at CU2.50 per share, paid for in cash provided by ABC by way of loan to the EBT. Under local law, these proceeds must be credited to the share capital account up to the par value of the shares issued, with any excess taken to a share premium account (additional paid-in capital). These were the only ABC shares held by the EBT at that date.

On 1 May in the same year, ABC granted executives options over between 300,000 and 500,000 shares at CU2.70 per share, which will vest at the end of year 1, the number vesting depending on various performance criteria. It is determined that the cost to be recognised in respect of this award is CU0.15 per share.

Four months later, on 1 September, the EBT subscribed for a further 300,000 shares at CU2.65 per share, again paid for in cash provided by ABC by way of loan to the EBT.

At the end of year 1, options vested over 350,000 shares and were exercised immediately.

The accounting entries for the above transaction required by IFRS 10, IAS 32 and IFRS 2 in the consolidated financial statements of ABC would be as set out below. It should be noted that all these pronouncements require various entries to be recorded in 'equity'. Thus, some variation may be found in practice as to the precise characterisation of the reserves, depending on local legal requirements and other 'traditions' in national GAAP which are retained to the extent that they do not conflict with IFRS accounting standards.

1 January

Dr	Equity[†1]		CU250,000	
	Cr	Share capital		CU100,000
	Cr	Share premium		CU150,000

To record issue of 100,000 CU1 shares to EBT at CU2.50/share

1 May - 31 December

Dr	Profit or loss		CU52,500	
	Cr	Equity[†]		CU52,500

To record cost of vested 350,000 options at CU0.15/option

1 September

Dr	Equity[†1]		CU795,000	
	Cr	Share capital		CU300,000
	Cr	Share premium		CU495,000

To record issue of 300,000 CU1 shares at CU2.65/share

31 December

Dr	Cash		CU945,000	
	Cr	Equity[2†]		CU945,000

Receipt of proceeds on exercise of 350,000 options at CU2.70/share

1 This entry is required to reconcile the requirement of local law to record an issue of shares with the fact that, in reality, there has been no increase in the resources of the reporting entity. All that has happened is that one member of the reporting group (the EBT) has transferred cash to another (the parent entity). In our view, this amount should not necessarily be accounted for within any 'Own shares reserve' in equity if such a reserve is generally restricted to shares acquired from third parties.

2 This reflects the fact that the entity's resources have increased as a result of a transaction with an owner, which gives rise to no gain or loss and is therefore credited direct to equity.

† We recommend that, subject to any local legal restrictions, these amounts all be accounted for in the same component of equity.

How we see it

As noted above, the debit to equity in note 1 on the issue of shares, must not be recognised within 'Own share reserve' in equity if such a reserve is restricted to shares acquired from third parties.

12.3.4 Separate financial statements of sponsoring entity

As noted in section 12.3.2 above, in contrast to some national GAAPs, where an EBT is treated as a direct extension of the parent or other sponsoring entity, such that the assets and liabilities of the EBT are included in both the separate financial statements of the sponsoring entity and the group consolidated financial statements, under IFRS accounting standards the accounting model is *prima facie* to treat the EBT as a separate group entity.

This means that the separate financial statements of the sponsoring entity must show transactions and balances with the EBT rather than the transactions, assets and liabilities of the EBT. This raises some accounting problems, for some of which IFRS accounting standards are not entirely clear, as demonstrated by Illustration 12-3 below. This has led the IFRS IC and others to discuss whether the 'separate entity' approach to accounting for EBTs is appropriate (see further discussion below).

Illustration 12-3: EBTs in separate financial statements of sponsoring entity

An entity lends its EBT CU1 million which the EBT uses to make a market purchase of 200,000 shares in the entity. In the separate financial statements of the EBT the shares will be shown as an asset. In the consolidated financial statements, the shares will be accounted for as treasury shares, by deduction from equity.

In the separate financial statements of the entity, on the basis that the EBT is a separate entity, like any other subsidiary, the normal accounting entry would be:

Dr	Loan to EBT		CU1,000,000	
	Cr	Cash		CU1,000,000

The obvious issue with this approach is that it is, in economic substance, treating the shares held by the EBT (represented by the loan to the EBT) as an asset of the entity, whereas, if they were held directly by the entity, they would have to be accounted for as treasury shares, by deduction from equity. If the share price falls such that the EBT has no means of repaying the full CU1,000,000, *prima facie* this gives rise to an impairment of the CU1,000,000 loan. Again, however, this seems in effect to be recognising a loss on own equity.

Suppose now that employees are granted options over the shares. The options have an exercise price of zero and a value under IFRS 2 of CU1,200,000. The entity will therefore book an expense of CU1,200,000 under IFRS 2. When the options are exercised, the shares are delivered to employees. At that point the CU1,000,000 loan to the EBT clearly becomes irrecoverable (as it has no assets), and must be impaired, with an expense recognised in profit or loss. However, to recognise an impairment of the loan as well as the CU1,200,000 IFRS 2 charge could result in a form of double counting, when the substance of the transaction is that the EBT delivers 200,000 shares as settlement for the loan.

How we see it

To avoid a form of double counting (i.e., loan impairment and IFRS 2 charge), some suggest that a solution to this problem is to say that the entity has effectively bought a gross-settled call option over its own shares from the EBT, whereby it can require the EBT to deliver 200,000 shares in return for a waiver of its CU1,000,000 loan.

The accounting for the settlement of the call over the shares is as for any other gross-settled purchased call option over own equity under IAS 32 see Chapter 43 at section 11.2.1, specifically Illustration 11-4 Purchased call option on own shares, example C Gross settlement.

Dr	Own shares (deduction from equity)		CU1,000,000	
	Cr	Loan to EBT		CU1,000,000

When the shares are delivered to employees (some milliseconds later), the entry is:

Dr	Other component of equity		CU1,000,000	
	Cr	Own shares (deduction from equity)		CU1,000,000

Depending on the particular facts and circumstances of the arrangement between the sponsoring entity and the EBT, other accounting treatments may also be appropriate.

At its meetings in May and July 2006, the IFRS IC discussed whether the EBT should be treated as an extension of the sponsoring entity, such as a branch, or as a separate entity. The IFRS IC decided to explore how specific transactions between the sponsor and the EBT should be treated in the sponsor's separate or individual financial statements and whether transactions between the EBT and the sponsor's employees should be attributed to the sponsor.

Interestingly, the IFRS IC fell short of dismissing the 'extension of the parent company' approach and has not since revisited this topic other than to re-confirm in March 2011 that it had not become aware of additional concerns or of diversity in practice and hence it did not think it necessary for this to be considered for the IASB's agenda.

How we see it

In our view, whilst any requirement to consolidate EBTs under IFRS 10 could be argued to give a clear steer towards treating the EBT as a separate entity, until there is any final clarification of this issue, it appears acceptable to treat an EBT as an extension of the sponsoring entity in that entity's separate financial statements. This treatment would result in outcomes essentially the same as those in Illustrations 12-1 and 12-2 above, while avoiding the issues highlighted in Illustration 12-3 above.

12.3.5 Financial statements of the EBT

The EBT may be required to prepare financial statements in accordance with requirements imposed by local law or by its own trust deed. The form and content of such financial statements are beyond the scope of this chapter.

12.4 Illustrative example of group share scheme - equity-settled award satisfied by market purchase of shares

The discussion in sections 12.4.1 to 12.4.3 below is based on Illustration 12-4 and addresses the accounting treatment for three distinct aspects of a group share scheme - a share-based payment arrangement involving group entities (see section 12.2 above), the use of an EBT (see section 12.3 above) and a group recharge arrangement (see section 12.2.7 above).

This illustrative example treats the recharge by the parent to the subsidiary as an income statement credit in the individual accounts of the parent and recognises the recharge when it is paid. In some situations, entities might consider it appropriate to apply alternative accounting treatments (see section 12.2.7 above).

Illustration 12-4: Group share scheme (market purchase of shares)

On 1 July 20X1 an employee of S Limited, a subsidiary of the H plc group, is awarded options under the H group share scheme over 3,000 shares in H plc at CU1.50 each, exercisable between 1 July 20X4 and 1 July 20X7, subject to a service condition and certain performance criteria being met in the three years ending 30 June 20X4.

H plc is the grantor of the award, and has the obligation to settle it. On 1 January 20X2, in connection with the award, the H plc group EBT purchases 3,000 shares at the then prevailing market price of CU2.00 each, funded by a loan from H plc. On exercise of the option, S Limited is required to pay the differential between the purchase price of the shares and the exercise price of the option (CU0.50 per share) to the EBT.

For the purposes of IFRS 2, the options are considered to have a fair value at grant date of CU1 per option. Throughout the vesting period of the option, H takes the view that the award will vest in full.

The option is exercised on 1 September 20X6, at which point the EBT uses the option proceeds, together with the payment by S Limited, to repay the loan from H plc.

H plc and its subsidiaries have a 31 December year end.

12.4.1 Consolidated financial statements

So far as the consolidated financial statements are concerned, the transactions to be accounted for are:

- The purchase of the shares by the EBT and their eventual transfer to the employee.
- The cost of the award.

Transactions between H plc or S Limited and the EBT are ignored since, in this illustrative example, the EBT is consolidated (see section 12.3 above). The accounting entries required are set out below. As in other examples in this chapter, where an entry is shown as being made to equity the precise allocation to a particular component of equity will be a matter for local legislation and, possibly, local accounting 'tradition', to the extent that this is not incompatible with IFRS accounting standards.

Y/e 31 December 20X1

Dr	Profit or loss (employee costs)*	CU500		
	Cr Equity			CU500

1 January 20X2

Dr	Own shares (equity)		CU6,000	
	Cr	Cash		CU6,000

Y/e 31 December 20X2

Dr	Profit or loss (employee costs)*		CU1,000	
	Cr	Equity		CU1,000

Y/e 31 December 20X3

Dr	Profit or loss (employee costs)*		CU1,000	
	Cr	Equity		CU1,000

Y/e 31 December 20X4

Dr	Profit or loss (employee costs)*		CU500	
	Cr	Equity		CU500

1 September 20X6

Dr	Cash (option proceeds)†		CU4,500	
Dr	Equity‡		CU1,500	
	Cr	Own shares (equity)**		CU6,000

* Total cost CU3,000 (3000 options × CU1) spread over 36 months. Charge for period to December 20X1 is 6/36 × CU3,000 = CU500, and so on. In practice, where options are granted to a group of individuals, or with variable performance criteria, the annual charge will be based on a continually revised cumulative charge (see further discussion in sections 6.1 to 6.4 above).

† 3,000 options at CU1.50 each.

‡ This reflects the fact that the overall effect of the transaction for the group *in cash terms* has been a 'loss' of CU1,500 (CU6,000 original cost of shares less CU4,500 option proceeds received). However, under IFRS accounting standards this is an equity transaction, not an expense.

** CU6,000 cost of own shares purchased on 1 January 20X2 now transferred to the employee. In practice, it is more likely that the appropriate amount to be transferred would be based on the weighted average price of shares held by the EBT at the date of exercise, as in Illustration 12-1 in section 12.3.3 above. In such a case there would be a corresponding adjustment to the debit to equity marked with ‡ above.

12.4.2 Parent

The accounting by the parent will depend on how the EBT is treated (i.e., whether it is accounted for as a separate entity or as an extension of the parent - see section 12.3 above for guidance). The parent must apply the accounting set out in the appropriate section below:

- EBT treated as separate entity (see section 12.4.2.A below).
- EBT treated as extension of parent (see section 12.4.2.B below).

We also discuss, in section 12.4.2.C below, the accounting implications if the parent, rather than - as in Illustration 12-4 - a subsidiary, is the employing entity.

12.4.2.A Accounting by parent where subsidiary is the employing entity and EBT is treated as separate entity

The parent accounts for the share-based payment transaction under IFRS 2 as an equity-settled transaction, since the parent settles the award by delivering its own equity instruments to the employees of the subsidiary (see section 12.2.4 above). However, as discussed in section 12.2.4 above, instead of recording a cost, as in its consolidated financial statements, the parent records an increase in the carrying value of its investment in subsidiary. It might then be necessary to consider whether the ever-increasing investment in subsidiary is supportable or is in fact impaired. As this is a matter to be determined in the light of specific facts and circumstances, it is not considered in this example. Any impairment charge would be recorded in profit or loss.

In addition to accounting for the share-based payment transaction, the parent records its transactions with the EBT and the purchase of shares.

This gives rise to the following entries:

Y/e 31 December 20X1

Dr	Investment in subsidiary*		CU500	
	Cr	Equity		CU500

1 January 20X2

Dr	Loan to EBT		CU6,000	
	Cr	Cash		CU6,000

Y/e 31 December 20X2

Dr	Investment in subsidiary*		CU1,000	
	Cr	Equity		CU1,000

Y/e 31 December 20X3

Dr	Investment in subsidiary*		CU1,000	
	Cr	Equity		CU1,000

Y/e 31 December 20X4

Dr	Investment in subsidiary*		CU500	
	Cr	Equity		CU500

1 September 20X6

Dr	Cash		CU6,000	
	Cr	Loan to EBT		CU6,000

* Total increase in investment CU3,000 (3000 shares × CU1 fair value of each option) recognised over 36 months. Increase during period to December 20X1 is 6/36 × CU3,000 = CU500, and so on. In practice, where options were granted to a group of individuals, or with variable performance criteria, the annual adjustment would be based on a continually revised cumulative adjustment (see further discussion in sections 6.1 to 6.4 above).

12.4.2.B Accounting by parent where subsidiary is the employing entity and EBT is treated as extension of the parent

The parent accounts for the share-based payment transaction under IFRS 2 as an equity-settled transaction, since the parent settles the award by delivering its own equity instruments to the employees of the subsidiary (see section 12.2.4 above). However, as discussed in section 12.2.4 above, instead of recording a cost, as in its consolidated financial statements, the parent records an increase in the carrying value of its investment in subsidiary. It might then be necessary to consider whether the ever-increasing investment in subsidiary is supportable or is in fact impaired. As this is a matter to be determined in the light of specific facts and circumstances, it is not considered in this example. Any impairment charge would be recorded in profit or loss.

In addition to accounting for the share-based payment transaction, the parent records the transactions of the EBT and the purchase of shares.

This gives rise to the following entries:

Y/e 31 December 20X1

Dr	Investment in subsidiary*		CU500	
	Cr	Equity		CU500

1 January 20X2

Dr	Own shares (equity)		CU6,000	
	Cr	Cash		CU6,000

Y/e 31 December 20X2

Dr	Investment in subsidiary*		CU1,000	
	Cr	Equity		CU1,000

Y/e 31 December 20X3

Dr	Investment in subsidiary*		CU1,000	
	Cr	Equity		CU1,000

Y/e 31 December 20X4

Dr	Investment in subsidiary*		CU500	
	Cr	Equity		CU500

1 September 20X6

Dr	Cash†		CU6,000	
Dr	Equity‡		CU1,500	
	Cr	Profit or loss§		CU1,500
	Cr	Own shares** (equity)		CU6,000

* Total increase in investment CU3,000 (3000 shares × CU1 fair value of each option) spread over 36 months. Increase during period to December 20X1 is 6/36 × CU3,000 = CU500, and so on. In practice, where options were granted to a group of individuals, or with variable performance criteria, the annual adjustment would be based on a continually revised cumulative adjustment (see further discussion in sections 6.1 to 6.4 above).

† CU4,500 option exercise proceeds from employee plus CU1,500 contribution from S Limited.

‡ This is essentially a balancing figure representing the fact that the entity is distributing own shares with an original cost of CU6,000, but has treated CU1,500 of the CU6,000 of the cash it has received as income (see § below) rather than as payment for the shares.

§ The CU1,500 contribution by the subsidiary to the EBT has been treated as a distribution from the subsidiary (see section 12.2.7 above) and recorded in profit or loss. It might then be necessary to consider whether, as a result of this payment, the investment in the subsidiary had become impaired (see Chapter 9 at section 2.4). As this is a matter to be determined in the light of specific facts and circumstances, it is not considered in this example. Any impairment charge would be recorded in profit or loss.

** CU6,000 cost of own shares purchased on 1 January 20X2 now transferred to employee. In practice, it is more likely that the appropriate amount to be transferred would be based on the weighted average price of shares held by the EBT at the date of exercise, as in Illustration 12-1 in section 12.3.3 above.

12.4.2.C Parent company as employing entity

If, in Illustration 12-4, the employing entity were the parent rather than the subsidiary, it would record an expense under IFRS 2. It would also normally waive CU1,500 of its CU6,000 loan to the EBT (i.e., the shortfall between the original loan and the CU4,500 option proceeds received from the employee).

If the EBT is treated as an extension of the parent, the accounting entries for the parent would be the same as those for the group, as set out in section 12.4.1 above.

If the EBT is treated as a separate entity, the accounting entries might be as follows:

Y/e 31 December 20X1

Dr	Profit or loss*		CU500	
	Cr	Equity		CU500

1 January 20X2

Dr	Loan to EBT		CU6,000	
	Cr	Cash		CU6,000

Y/e 31 December 20X2

Dr	Profit or loss*		CU1,000	
	Cr	Equity		CU1,000

Y/e 31 December 20X3

Dr	Profit or loss*		CU1,000	
	Cr	Equity		CU1,000

Y/e 31 December 20X4

Dr	Profit or loss*		CU500	
	Cr	Equity		CU500

1 September 20X6

Dr	Own shares (Equity)†		CU1,500	
Dr	Cash		CU4,500	
	Cr	Loan to EBT		CU6,000
Dr	Equity		CU1,500	
	Cr	Own shares (Equity)		CU1,500

* Total cost CU3,000 (3000 options × CU1) spread over 36 months. Charge for period to December 20X1 is 6/36 × CU3,000 = CU500, and so on. In practice, where options were granted to a group of individuals, or with variable performance criteria, the annual charge would be based on a continually revised cumulative charge (see further discussion in sections 6.1 to 6.4 above).

† This takes the approach of treating the parent as having a gross-settled purchased call option over its own equity (see Illustration 12-3 in section 12.3.4 above), under which it can acquire 3,000 own shares from the EBT for the consideration of the waiver of CU1,500 of the original CU6,000 loan. The CU4,500 cash inflow represents the CU4,500 option exercise proceeds received by the EBT from the employee, which is then used to pay the balance of the original CU6,000 loan.

12.4.3 Employing subsidiary

The employing subsidiary is required to account for the IFRS 2 expense and the contribution to the EBT on exercise of the award. This gives rise to the accounting entries set out below. The entries to reflect the IFRS 2 expense are required by IFRS 2 (see section 12.2.3 above). The contribution to the EBT is treated as a distribution (see section 12.2.7 above).

Y/e 31 December 20X1

Dr	Profit or loss*		CU500	
	Cr	Equity		CU500

Y/e 31 December 20X2

Dr	Profit or loss*		CU1,000	
	Cr	Equity		CU1,000

Y/e 31 December 20X3

Dr	Profit or loss*		CU1,000	
	Cr	Equity		CU1,000

Y/e 31 December 20X4

Dr	Profit or loss*		CU500	
	Cr	Equity		CU500

1 September 20X6

Dr	Equity†		CU1,500	
	Cr	Cash		CU1,500

* Total cost CU3,000 (3000 options × CU1) spread over 36 months. Charge for period to December 20X1 is 6/36 × CU3,000 = CU500, and so on. In practice, where options were granted to a group of individuals, or with variable performance criteria, the annual charge would be based on a continually revised cumulative charge (see further discussion in sections 6.1 to 6.4 above).

† This is treated as a reduction of whatever component of equity was credited with the CU3,000 quasi-contribution from the parent in the accounting entries above.

12.5 Illustrative example of group share scheme - equity-settled award satisfied by fresh issue of shares

Such schemes raise slightly different accounting issues. Again, these are most easily illustrated by way of an example. The discussion in sections 12.5.1 to 12.5.3 below is based on Illustration 12-5. As with Illustration 12-4 in section 12.4 above, this section addresses the accounting treatment for three distinct aspects of a group share scheme - a share-based payment arrangement involving group entities (see section 12.2 above), the use of an EBT (see section 12.3 above) and a group recharge arrangement (see section 12.2.7 above).

This illustrative example treats the recharge by the parent to the subsidiary as an income statement credit in the individual accounts of the parent and recognises the recharge when it is paid. In some situations, entities might consider it appropriate to apply alternative accounting treatments (see section 12.2.7 above).

Illustration 12-5: Group share scheme (fresh issue of shares)

On 1 July 20X1 an employee of S Limited, a subsidiary of the H plc group, is awarded options under the H group share scheme over 3,000 shares in H plc at CU1.50 each, exercisable between 1 July 20X4 and 1 July 20X7, subject to a service condition and certain performance criteria being met in the three years ending 30 June 20X4. The fair value of the options on 1 July 20X1 is CU1 each.

H plc grants the award and has the obligation to settle it.

When preparing accounts during the vesting period H plc and its subsidiaries assume that the award will vest in full. The options are finally exercised on 1 September 20X6, at which point H plc issues 3,000 new shares to the EBT at the then current market price of CU3.50 for CU10,500. The EBT funds the purchase using the CU4,500 option proceeds received from the employee together with CU6,000 contributed by S Limited, effectively representing the fair value of the options at exercise date (3,000 × [CU3.50 - CU1.50]).

H plc and its subsidiaries have a 31 December year end.

12.5.1 Consolidated financial statements

The consolidated financial statements need to deal with:

- The charge required by IFRS 2 in respect of the award.
- The issue of shares.

Transactions between H plc or S Limited and the EBT are ignored since, in this illustrative example, the EBT is consolidated (see section 12.3 above). The accounting entries required are set out below. As in other examples in this chapter, where an entry is shown as being made to equity, the precise allocation to a particular component of equity will be a matter for local legislation and, possibly, local accounting 'tradition', to the extent that this is not incompatible with IFRS accounting standards.

Y/e 31 December 20X1

Dr	Profit or loss*		CU500	
	Cr	Equity		CU500

Y/e 31 December 20X2

Dr	Profit or loss*		CU1,000	
	Cr	Equity		CU1,000

Y/e 31 December 20X3

Dr	Profit or loss*		CU1,000	
	Cr	Equity		CU1,000

Y/e 31 December 20X4

Dr	Profit or loss*		CU500	
	Cr	Equity		CU500

1 September 20X6

Dr	Cash		CU4,500	
	Cr	Equity†		CU4,500

* Total cost CU3,000 (3000 options × CU1) spread over 36 months. Charge for period to December 20X1 is 6/36 × CU3,000 = CU500, and so on. In practice, where options were granted to a group of individuals, or with variable performance criteria, the annual charge would be based on a continually revised cumulative charge (see further discussion in sections 6.1 to 6.4 above).

† From the point of view of the consolidated group, the issue of shares results in an increase in net assets of only CU4,500 (i.e., the exercise price received from the employee), since the CU6,000 contribution from the employing subsidiary to the EBT is an intragroup transaction. However, it may be that, in certain jurisdictions, the entity is required to increase its share capital and share premium (additional paid in capital) accounts by the CU10,500 legal consideration for the issue of shares. In that case, this entry would be expanded as below, which effectively treats the CU6,000 consideration provided from within the group as a bonus issue.

1 September 20X6

Dr	Cash		CU4,500	
Dr	Other equity		CU6,000	
	Cr	Share capital/premium		CU10,500

12.5.2 Parent

The accounting by the parent will depend on how the EBT is treated (i.e., whether it is accounted for as a separate entity or as an extension of the parent - see section 12.3 above for guidance). The parent must apply the accounting set out in the appropriate section below:

- EBT treated as separate entity (see section 12.5.2.A below).
- EBT treated as extension of parent (see section 12.5.2.B below).

We also discuss, in section 12.5.2.C below, the accounting implications if the parent, rather than - as in Illustration 12-5 - a subsidiary, is the employing entity.

12.5.2.A Accounting by parent where subsidiary is the employing entity and EBT is treated as separate entity

The parent accounts for the share-based payment transaction under IFRS 2 as an equity-settled transaction, since the parent settles the award by delivering its own equity instruments, via its EBT, to the employees of the subsidiary (see section 12.2.4 above). However, as discussed in section 12.2.4 above, instead of recording a cost, as in its consolidated financial statements, the parent records an increase in the carrying value of its investment in subsidiary. It might then be necessary to consider whether the ever-increasing investment in subsidiary is supportable or is in fact impaired. As this is a matter to be determined in the light of specific facts and circumstances, it is not considered in this example. Any impairment charge would be recorded in profit or loss.

In addition to accounting for the share-based payment transaction, the parent records its transactions with the EBT and the issue of shares.

Y/e 31 December 20X1

Dr	Investment in subsidiary*		CU500	
	Cr	Equity		CU500

Y/e 31 December 20X2

Dr	Investment in subsidiary*		CU1,000	
	Cr	Equity		CU1,000

Y/e 31 December 20X3

Dr	Investment in subsidiary*		CU1,000	
	Cr	Equity		CU1,000

Y/e 31 December 20X4

Dr	Investment in subsidiary*		CU500	
	Cr	Equity		CU500

1 September 20X6

Dr	Cash†		CU10,500	
	Cr	Share capital/premium		CU10,500

* Total increase in investment CU3,000 (3000 shares × CU1 fair value of each option), recognised over 36 months. Increase in period to December 20X1 is 6/36 × CU3,000 = CU500, and so on. In practice, where options were granted to a group of individuals, or with variable performance criteria, the annual adjustment would be based on a continually revised cumulative adjustment (see further discussion in sections 6.1 to 6.4 above).

† CU10,500 from EBT (which has received CU4,500 option exercise proceeds from employee plus CU6,000 contribution from the subsidiary).

12.5.2.B Accounting by parent where subsidiary is the employing entity and EBT is treated as extension of parent

The parent accounts for the share-based payment transaction under IFRS 2 as an equity-settled transaction, since the parent settles the award by delivering its own equity instruments, via its EBT, to the employees of the subsidiary (see section 12.2.4 above). However, as discussed in section 12.2.4 above, instead of recording a cost, as in its consolidated financial statements, the parent records an increase in the carrying value of its investment in subsidiary. It might then be necessary to consider whether the ever-increasing investment in subsidiary is supportable or is in fact impaired. As this is a matter to be determined in the light of specific facts and circumstances, it is not considered in this example. Any impairment charge would be recorded in profit or loss.

In addition to accounting for the share-based payment transaction, the parent records the transactions of the EBT and the issue of shares.

Y/e 31 December 20X1

Dr	Investment in subsidiary*		CU500	
	Cr	Equity		CU500

Y/e 31 December 20X2

Dr	Investment in subsidiary*		CU1,000	
	Cr	Equity		CU1,000

Y/e 31 December 20X3

Dr	Investment in subsidiary*		CU1,000	
	Cr	Equity		CU1,000

Y/e 31 December 20X4

Dr	Investment in subsidiary*		CU500	
	Cr	Equity		CU500

1 September 20X6

Dr	Cash†		CU10,500	
Dr	Equity‡		CU6,000	
	Cr	Profit or loss**		CU6,000
	Cr	Share capital/premium		CU10,500

* Total increase in investment CU3,000 (3000 shares × CU1 fair value of each option) spread over 36 months. Increase during period to December 20X1 is 6/36 × CU3,000 = CU500, and so on. In practice, where options were granted to a group of individuals, or with variable performance criteria, the annual adjustment would be based on a continually revised cumulative adjustment (see further discussion in sections 6.1 to 6.4 above).

† CU4,500 option exercise proceeds from employee plus CU6,000 contribution from the subsidiary.

‡ This assumes that local law requires the entity to record share capital and share premium (additional paid-in capital) of CU10,500, as in section 12.5.2.A above. However, IFRS accounting standards *prima facie* requires the CU6,000 cash received by the EBT from the subsidiary to be treated as income (see ** below) rather than as part of the proceeds of the issue of shares. In order, in effect, to reconcile these conflicting analyses, CU6,000 of the CU10,500 required by law to be capitalised as share capital and share premium has been treated as an appropriation out of other equity.

** The CU6,000 contribution by the subsidiary to the EBT has been treated as a distribution from the subsidiary (see section 12.2.7 above) and recorded in profit or loss. It might then be necessary to consider whether, as a result of this payment, the investment in the subsidiary had become impaired (see Chapter 9 at section 2.4). As this is a matter to be determined in the light of specific facts and circumstances, it is not considered in this Example. Any impairment charge would be recorded in profit or loss.

12.5.2.C Parent as employing entity

If, in Illustration 12-5, the employing entity were the parent rather than the subsidiary, it would clearly have to record an expense under IFRS 2. It would also have to fund the CU6,000 shortfall between the option exercise proceeds of CU4,500 and the CU10,500 issue proceeds of the shares.

If the EBT is treated as an extension of the parent, the accounting entries for the parent would be the same as those for the group, as set out in section 12.5.1 above.

How we see it

In our view, the treatment in section 12.5.1 above could also be appropriate where the EBT is treated as a separate entity and the parent is the employing entity.

The issue of shares requires the parent company to fund the EBT with CU6,000 which immediately returns it to the parent, along with the CU4,500 received from the employee, in exchange for an issue of shares. Whilst this 'circulation' of the CU6,000 might have some significance for legal purposes it is, economically speaking, a non-transaction that could be ignored for accounting purposes under IFRS accounting standards. It might, however, be relevant, under local law, to the amount of equity shown as share capital and share premium (additional paid-in capital), in which case the expanded entry in section 12.5.1 above would be appropriate.

Where, however, the EBT is treated as a separate entity, and the cash used to subscribe for the shares arises from a prior transaction, such as an earlier loan to the EBT, matters are more complicated. Suppose that, during the life of the award under discussion, the company were to advance CU50,000 to the EBT for general funding purposes. At that point it would clearly record the entry:

Dr	Loan to EBT		CU50,000	
	Cr	Cash		CU50,000

Suppose that, on exercise of the option, the EBT were to use some of that cash to fund the parent's 'top up' for the share issue. This effectively impairs the loan by CU6,000 and leaves a 'missing debit' indicated by '?' in the journal below:

Dr	Cash		CU10,500	
Dr	?		CU6,000	
	Cr	Loan to EBT		CU6,000
	Cr	Share capital/premium		CU10,500

This looks very much like an impairment loss on the loan required to be reported in profit or loss. On the other hand, it does not resemble a loss in any conventional sense. This suggests that another analysis may be possible.

Illustration 12-3 in section 12.3.4 above addresses the situation where an EBT is pre-funded to enable it to buy the reporting entity's own shares in the market, and those shares are finally delivered to the entity for distribution to employees. Illustration 12-3 suggests that this could be construed as the execution of a gross-settled purchased call option by the entity.

If that analogy is extended, the present situation could be construed as comprising a back-to-back: gross-settled purchased call option (whereby the entity can require the EBT to provide 3,000 shares in return for waiver of CU6,000 of its outstanding loan to the EBT), which triggers the exercise of; a gross-settled written call option (whereby the EBT can require the entity to issue 3,000 fresh shares for CU10,500 to the EBT, so that it can satisfy its obligations to the entity under the purchased call).

If these two call options are accounted for under IAS 32 (see Chapter 43 at section 11.2), the write-off of the loan to the EBT can be effectively charged to equity, as follows:

Dr	Cash		CU10,500	
	Cr	Share capital/premium		CU10,500
Exercise by EBT of written call				
Dr	Own shares (Equity)		CU6,000	
	Cr	Loan to EBT		CU6,000
Exercise by entity of purchased call				
Dr	Equity (other)		CU6,000	
	Cr	Own shares (Equity)		CU6,000
Exercise by EBT of written call				

How we see it

As noted above, the two call options accounted for together effectively result in the write-off of the loan to the EBT being recognised in equity.

12.5.3 Employing subsidiary

The employing subsidiary is required to account for the IFRS 2 expense and the contribution to the EBT on exercise of the award. This gives rise to the accounting entries set out below. The entries to reflect the IFRS 2 expense are required by IFRS 2 (see section 12.2.3 above). The contribution to the EBT is treated as a distribution (see section 12.2.7 above).

Y/e 31 December 20X1				
Dr	Profit or loss*		CU500	
	Cr	Equity		CU500
Y/e 31 December 20X2				
Dr	Profit or loss*		CU1,000	
	Cr	Equity		CU1,000
Y/e 31 December 20X3				
Dr	Profit or loss*		CU1,000	
	Cr	Equity		CU1,000
Y/e 31 December 20X4				
Dr	Profit or loss*		CU500	
	Cr	Equity		CU500
1 September 20X6				
Dr	Equity†		CU6,000	
	Cr	Cash		CU6,000

* Total cost CU3,000 (3000 options × CU1) spread over 36 months. Charge for period to December 20X1 6/36 × CU3,000 = CU500, and so on. In practice, where options were granted to a group of individuals, or with variable performance criteria, the annual charge would be based on a continually revised cumulative charge (see further discussion in sections 6.1 to 6.4 above).

† CU3,000 of this payment is treated as a reduction of whatever component of equity was credited with the CU3,000 quasi-contribution from the parent in the accounting entries above. The remaining CU3,000 would be treated as a distribution and charged to any appropriate component of equity.

12.6 Illustrative example - cash-settled transaction not settled by the entity receiving goods or services

The discussion in sections 12.6.1 to 12.6.3 below is based on Illustration 12-6.

Illustration 12-6: Cash-settled scheme not settled by receiving entity

On 1 July 20X1 an employee of S Limited, a subsidiary of the H plc group, is awarded a right, exercisable between 1 July 20X4 and 1 July 20X7, to receive cash equivalent to the value of 3,000 shares in H plc at the date on which the right is exercised. Exercise of the right is subject to a service condition and certain performance criteria being met in the three years ending 30 June 20X4. The cash will be paid to the employee not by S, but by H. Throughout the vesting period of the award, H and S take the view that it will vest in full.

The award does in fact vest, and the right is exercised on 1 September 20X6.

The fair value of the award (per share-equivalent) at various relevant dates is as follows:

Date	Fair value
	CU
1.7.20X1	1.50
31.12.20X1	1.80
31.12.20X2	2.70
31.12.20X3	2.40
31.12.20X4	2.90
31.12.20X5	3.30
1.9.20X6	3.50

If the award had been equity-settled (i.e., the employee had instead been granted a right to 3,000 free shares), the grant date fair value of the award would have been CU1.50 per share.

H plc and its subsidiaries have a 31 December year end.

12.6.1 Consolidated financial statements

The group has entered into a cash-settled transaction which is accounted for using the methodology discussed in section 9.3 above. This gives rise to the following accounting entries:

Y/e 31 December 20X1

Dr	Profit or loss*		CU900	
	Cr	Liability		CU900

Y/e 31 December 20X2

Dr	Profit or loss*		CU3,150	
	Cr	Liability		CU3,150

Y/e 31 December 20X3

Dr	Profit or loss*		CU1,950	
	Cr	Liability		CU1,950

Y/e 31 December 20X4

Dr	Profit or loss*		CU2,700	
	Cr	Liability		CU2,700

Y/e 31 December 20X5

Dr	Profit or loss*		CU1,200	
	Cr	Liability		CU1,200

Y/e 31 December 20X6

Dr	Profit or loss*		CU600	
	Cr	Liability		CU600

1 September 20X6

Dr	Liability		CU10,500	
	Cr	Cash		CU10,500

* Charge for period to 31 December 20X1 is 6/36 × 3000 × CU1.80 [reporting date fair value] = CU900. Charge for year ended 31 December 20X2 is 18/36 × 3000 × CU2.70 = CU4,050 less CU900 charged in 20X1 = CU3,150 and so on (refer to Illustration 9-2 in section 9.3.2 above). In practice, where options were granted to a group of individuals, or with variable performance criteria, the annual charge would be based on a continually revised cumulative charge (see further discussion in section 9 above).

12.6.2 Parent

The parent accounts for the share-based payment transaction under IFRS 2 as a cash-settled transaction, since the parent settles the award by delivering cash to the employees of the subsidiary (see section 12.2.4 above).

How we see it

As discussed in section 12.2.4 above, instead of recording a cost, consistent with the consolidated financial statements, the parent treats the debit entry (including, as a matter of accounting policy choice, any remeasurement of the liability) as an increase in the carrying value of its investment in subsidiary.

It might then be necessary to consider whether the ever-increasing investment in subsidiary is supportable or is in fact impaired. As this is a matter to be determined in the light of specific facts and circumstances, it is not considered in this example. Any impairment charge would be recorded in profit or loss.

This would result in the following accounting entries.

Y/e 31 December 20X1

Dr	Investment in subsidiary*		CU900	
	Cr	Liability		CU900

Y/e 31 December 20X2

Dr	Investment in subsidiary*		CU3,150	
	Cr	Liability		CU3,150

Y/e 31 December 20X3

Dr	Investment in subsidiary*		CU1,950	
	Cr	Liability		CU1,950

Y/e 31 December 20X4

Dr	Investment in subsidiary*		CU2,700	
	Cr	Liability		CU2,700

Y/e 31 December 20X5

Dr	Investment in subsidiary*		CU1,200	
	Cr	Liability		CU1,200

Y/e 31 December 20X6

Dr	Investment in subsidiary*		CU600	
	Cr	Liability		CU600

1 September 20X6

Dr	Liability		CU10,500	
	Cr	Cash		CU10,500

* Increase in investment to 31 December 20X1 is 6/36 × 3000 × CU1.80 [reporting date fair value] = CU900. Increase for year ended 31 December 20X2 is 18/36 × 3000 × CU2.70 = CU4,050 less CU900 charged in 20X1 = CU3,150 and so on (refer to Illustration 9-2 in section 9.3.2 above). In practice, where options were granted to a group of individuals, or with variable performance criteria, the annual charge would be based on a continually revised cumulative charge (see further discussion in section 9 above).

Where the parent entity was also the employing entity (and therefore receiving goods or services), it would apply the same accounting treatment in its separate financial statements as in its consolidated financial statements (see section 12.6.1 above).

12.6.3 Employing subsidiary

The employing subsidiary accounts for the transaction as equity-settled, since it receives services, but incurs no obligation to its employees (see sections 12.2.3 and 12.2.6 above). This gives rise to the following accounting entries.

Y/e 31 December 20X1

Dr	Profit or loss*		CU750	
	Cr	Equity		CU750

Y/e 31 December 20X2

Dr	Profit or loss*		CU1,500	
	Cr	Equity		CU1,500

Y/e 31 December 20X3

Dr	Profit or loss*		CU1,500	
	Cr	Equity		CU1,500

Y/e 31 December 20X4

Dr	Profit or loss*		CU750	
	Cr	Equity		CU750

* Charge for period to 31 December 20X1 is 6/36 × 3000 × CU1.50 [grant date fair value] = CU750, and so on. In practice, where options were granted to a group of individuals, or with variable performance criteria, the annual charge would be based on a continually revised cumulative charge (see further discussion in sections 6.1 to 6.4 above).

The effect of this treatment is that, while the group ultimately records a cost of CU10,500, the subsidiary records a cost of only CU4,500.

However, there may be cases where the subsidiary records a higher cost than the group. This would happen if, for example:

- The award vests, but the share price has fallen since grant date, so that the value of the award at vesting (as reflected in the consolidated financial statements) is lower than the value at grant (as reflected in the subsidiary's financial statements).

  Or

- The award does not actually vest because of a failure to meet a market condition and/or a non-vesting condition (so that the cost is nil in the consolidated financial statements) but is treated by IFRS 2 as vesting in the subsidiary's financial statements, because it is accounted for as equity-settled (see sections 6.3 and 6.4 above).

12.7 Employee transferring between group entities

It is not uncommon for an employee to be granted an equity-settled share-based payment award while in the employment of one subsidiary in the group, but to transfer to another subsidiary in the group before the award is vested, but with the entitlement to the award being unchanged.

In such cases, each subsidiary measures the services received from the employee by reference to the fair value of the equity instruments at the date those rights to equity instruments were originally granted, and the proportion of the vesting period served by the employee with each subsidiary. *[IFRS 2.B59]*. In other words, for an award with a three-year vesting period granted to an employee of subsidiary A, who transfers to subsidiary B at the end of year 2, subsidiary A will (cumulatively) record an expense of 2/3, and subsidiary B 1/3, of the fair value at grant date. However, any subsidiary required to account for the transaction as cash-settled in accordance with the general principles discussed in section 12.2 above accounts for its portion of the grant date fair value and also for any changes in the fair value of the award during the period of employment with that subsidiary. *[IFRS 2.B60]*.

After transferring between group entities, an employee may fail to satisfy a vesting condition other than a market condition, for example by leaving the employment of the group. In this situation each subsidiary adjusts the amount previously recognised in respect of the services received from the employee in accordance with the general principles of IFRS 2 (see sections 6.1 to 6.4 above). *[IFRS 2.B61]*. This imposes upon the original employing entity the rather curious burden of tracking the service record of its former employees, where the accounting impact is expected to be significant.

12.8 Group reorganisations

Following a group reorganisation, such as the insertion of a new parent entity above an existing group, share-based payment arrangements with employees are often amended or replaced so that they relate to the shares of the new parent. Group reorganisations of entities under common control are not within the scope of IFRS 3 and so the requirements set out in section 11 above are not directly applicable.

In some cases, the terms and conditions of a share-based payment arrangement will contain provisions relating to restructuring transactions (see section 5.3.8.A above) so that the application of any changes is not necessarily considered to be a modification in IFRS 2 terms. Where no such provision is made, the situation is less clear-cut.

How we see it

In our view, in the consolidated financial statements, such changes to share-based payments would generally be construed as a cancellation and replacement to which modification accounting could be applied (see section 7.4.4 above). However, in most cases, the changes made to the share-based payment awards following a group reorganisation are likely to be such that there is no incremental fair value arising from the cancellation and replacement, the intention being simply to replace like with like.

A subsidiary receiving the services of employees but with no obligation to settle the amended award would continue to apply equity-settled accounting in its own financial statements and, as for the consolidated financial statements, would strictly account for the changes as a cancellation and replacement of the original award. The accounting consequences would be more complicated if the subsidiary itself had an obligation to settle the award in the shares of its new parent, when previously it had had to settle in its own shares, as this would mean a change from equity-settled to cash-settled accounting (see section 9.4 above). However, we would expect this to be a rare occurrence in practice (see section 12.2.5.B above in relation to the grantor of an award in a situation involving parent and subsidiary entities).

The new parent entity becomes a party to the share-based payment arrangements for the first time and, assuming it has no employees of its own but is considered to have granted and to have the obligation to settle the awards, needs to account for the awards to the employees of its subsidiaries (see sections 12.2.4 and 12.2.5 above). The requirements of IFRS 2 in this situation are unclear and one could argue:

- Either that this is a new award by the parent and so must be valued as at the date of the new award.

  Or

- In accordance with the general principle that there is no overall change as a consequence of a reorganisation of entities under common control, that the parent must use the same (original grant date) fair value as the subsidiary.

How we see it

In our view, where a new parent entity becomes party to the share-based payment arrangement either approach, as set out above, is acceptable provided it is applied consistently.

12.9 Share-based payments to employees of joint ventures or associates

The majority of share-based payment transactions with employees involve payments to employees of the reporting entity or of another entity in the same group. Occasionally, however, share-based payments may be made to employees of significant investees of the reporting entity such as joint ventures or associates. For example, if one party to a joint venture is a quoted entity and the other not, it might be commercially appropriate for the quoted venturer to offer payments based on its quoted shares to employees of the joint venture, while the unquoted party contributes to the venture in other ways.

Such arrangements raise some questions of interpretation of IFRS 2, as demonstrated by Illustration 12-7 below. References to an associate in the Illustration and discussions below must be read as also referring to a joint venture.

Illustration 12-7: Share-based payment to employees of associate

At the beginning of year 1, an entity grants an award of free shares with a fair value at that date of CU600,000 to employees of its 40% associate. The shares vest over a three-year period. It is assumed throughout the vesting period of the award that it will vest in full, which is in fact the case.

12.9.1 Financial statements of the associate or joint venture

For the financial statements of the associate, the transaction does not strictly fall within the scope of IFRS 2. In order for a transaction to be in the scope of IFRS 2 for a reporting entity, it must be settled in the equity of the entity itself, or that of another member of the same group. A group comprises a parent and its subsidiaries (see Chapter 7 at section 2.2), and does not include associates.

How we see it

Where the investor grants an award of its own equity instruments to employees of its associate, we believe that it would be appropriate for the associate to account for the transaction as if it did fall within the scope of IFRS 2 by applying the 'GAAP hierarchy' in IAS 8 (see Chapter 3 at section 4.3). The investor has effectively made a capital contribution to the associate (in the form of the investor's own equity), no less than if it made a capital contribution in cash which was then used to pay employees of the associate.

If the investor in the associate had instead granted an award settled in the equity of the associate, the transaction would have been in the scope of IFRS 2 for the associate, as being the grant of an award over the equity of the reporting entity by a shareholder of that entity (see section 2.2.2.A above).

If the award is, or is treated as being, within the scope of IFRS 2 for the associate, the following entries are recorded:

Year 1

Dr	Employee costs[†]		CU200,000	
	Cr	Equity		CU200,000

Year 2

Dr	Employee costs		CU200,000	
	Cr	Equity		CU200,000

Year 3

Dr	Employee costs		CU200,000	
	Cr	Equity		CU200,000

[†] Grant date fair value of award CU600,000 × 1/3. The credit to equity represents a capital contribution from the investor.

12.9.2 Consolidated financial statements of the investor

The investor has entered into a share-based payment transaction since it has granted an award over its equity to third parties (the employees of the associates) in exchange for their services to a significant investee entity. However, employees of an associate are not employees of a group entity and are therefore not employees of the investor's group.

The issue for IFRS 2 purposes is, therefore, whether the award must be regarded as being made to persons providing similar services to employees (and therefore measured at grant date) or to persons other than employees or those providing similar services to employees (and therefore measured at service date) - see sections 5.2 to 5.4 above.

In our view, it is more appropriate to regard such awards as made to persons providing similar services to employees and therefore measured at grant date.

There are then, we believe, two possible approaches to the accounting. In our view, in the absence of clear guidance in the standard, an entity must choose the more appropriate approach based on the specific circumstances.

In any event, the investor's consolidated financial statements must show a credit to equity of CU200,000 a year over the vesting period. The accounting issue is the analysis of the corresponding debit.

It seems clear that the investor must as a minimum recognise an annual cost of CU80,000 (40% of CU200,000), as part of its 'one-line' share of the result of the associate. The issue then is whether it must account for the remaining CU120,000 as a further cost or as an increase in the cost of its investment in its associate.

The argument for treating the CU120,000 as an expense is that the associate will either have recorded nothing or, as set out in section 12.9.1 above, an entry that results in no net increase in the equity of the associate. Therefore, there has been no increase in the investor's share of the net assets of the associate, and there is no basis for the investor to record an increase in its investment. This is broadly the approach required under US GAAP (although US GAAP requires the associate itself to recognise the expense and a corresponding capital contribution applying the grant date measurement model of ASC 718).

It may be possible to conclude in some situations that the CU120,000 is an increase in the cost of the investment in associate. IAS 28 *Investments in Associates and Joint Ventures* - defines the equity method of accounting as (emphasis added):

> "a method of accounting whereby the investment is *initially recognised at cost and adjusted thereafter* for the post-acquisition change in the investor's share of the investee's net assets". *[IAS 28.3]*.

For example, there may be cases where another shareholder has made, or undertaken to make, contributions to the associate that are not reflected in its recognised net assets (such as an undertaking to provide knowhow or undertake mineral exploration).

Where an entity takes the view that the CU120,000 is an increase in the cost of its investment, it is essential to ensure that the resulting carrying value of the investment is sustainable. This may be the case if, for example:

- The fair value of the investment in the associate exceeds its carrying amount.

  Or

- The investor has agreed to enter into the transaction while another major shareholder has agreed to bear equivalent costs.

In other circumstances, the carrying amount of the investment may not be sustainable, and the investor may need to recognise an impairment of its investment in accordance with IAS 36 (see Chapter 21).

How we see it

In summary, as discussed above, the investor has entered into a share-based payment transaction. The measurement date of the award, in our view, is based on the grant date model, on the basis the award is made to 'persons providing similar services to employees'.

It is clear that the investor as a minimum, recognises 40% of the charge in its 'one-line' share of the result of the associate. There are two possible approaches in accounting for the additional expense (e.g., in Illustration 12-7, the additional 60% of the cost), either as an expense to profit or loss or an increase in the cost of its investment in the associate. An entity is required to choose the most appropriate approach based on the specific circumstances.

12.9.3 Separate financial statements of the investor

The discussion below assumes that the investor accounts for its investment in the associate at cost in its separate financial statements (see Chapter 9).

The issues here are much the same as in section 12.9.2 above. The investor has clearly entered into a share-based payment transaction since it has granted an award over its equity to third parties (the employees of the associates) in exchange for their services to a significant investee entity. As in section 12.9.2 above, we believe that this is most appropriately characterised as a transaction with persons providing similar services to employees and therefore measured at its grant date fair value.

In any event, the investor's separate financial statements must show a credit to equity of CU200,000 a year over the vesting period but, as in section 12.9.2 above, the analysis of the debit entry is more complex.

How we see it

In our view, the accounting considerations discussed in section 12.9.2 above, for the measurement date are much the same for the separate financial statements of the investor. In addition, the debit entry is more complex as discussed in section 12.9.2 above.

13 Disclosures

IFRS 2 requires three main groups of disclosures, explaining:

- The nature and extent of share-based payment arrangements (see section 13.1 below)
- The valuation of share-based payment arrangements (see section 13.2 below)
- The impact on the financial statements of share-based payment transactions (see section 13.3 below)

All of the disclosure requirements of IFRS 2 are subject to the overriding materiality considerations of IAS 1 (see Chapter 3 at section 4.1.5). However, depending on the identity of the counterparty and whether, for example, the individual is a member of key management, it will be necessary to assess whether an arrangement is material by nature even if it is immaterial in monetary terms.

In May 2024, the IASB issued IFRS 19 *Subsidiaries without Public Accountability: Disclosures*, which allows eligible entities to elect to apply IFRS 19's reduced disclosure requirements while still applying the recognition, measurement and presentation requirements in other IFRS accounting standards. The application of IFRS 19 is optional and becomes effective for reporting periods beginning on or after 1 January 2027, with early application permitted (see Chapter 4 at section 7). Therefore, if IFRS 19 is applied, an entity provides the reduced disclosures set out under the heading "*IFRS 2 Share-based Payment*" in IFRS 19.31-34 rather than those in IFRS 2. *[IFRS 19.31, IFRS 19.32, IFRS 19.33, IFRS 2.34]*

13.1 Nature and extent of share-based payment arrangements

IFRS 2 includes the following disclosure requirements to enable users of the financial statements to understand the nature and extent of share-based payment arrangements that existed during the period: *[IFRS 2.44, IFRS 2.45]*

Extract from IFRS 2	
44	**An entity shall disclose information that enables users of the financial statements to understand the nature and extent of share-based payment arrangements that existed during the period.**
45	To give effect to the principle in paragraph 44, the entity shall disclose at least the following: (a) a description of each type of share-based payment arrangement that existed at any time during the period, including the general terms and conditions of each arrangement, such as vesting requirements, the maximum term of options granted, and the method of settlement (eg whether in cash or equity). An entity with substantially similar types of share-based payment arrangements may aggregate this information, unless separate disclosure of each arrangement is necessary to satisfy the principle in paragraph 44.

(b) the number and weighted average exercise prices of share options for each of the following groups of options:
  (i) outstanding at the beginning of the period;
  (ii) granted during the period;
  (iii) forfeited during the period;
  (iv) exercised during the period;
  (v) expired during the period;
  (vi) outstanding at the end of the period; and
  (vii) exercisable at the end of the period.

(c) for share options exercised during the period, the weighted average share price at the date of exercise. If options were exercised on a regular basis throughout the period, the entity may instead disclose the weighted average share price during the period.

(d) for share options outstanding at the end of the period, the range of exercise prices and weighted average remaining contractual life. If the range of exercise prices is wide, the outstanding options shall be divided into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received upon exercise of those options.

How we see it

The reconciliation in (b) above, in our view, reflects all changes in the number of equity instruments outstanding. The reconciliation includes not just awards with a grant date during the period, but also includes subsequent additions to earlier grants e.g., options or shares added to the award in recognition of dividends declared during the period (where this is part of the original terms of the award), and changes to the number of equity instruments as a result of demergers, share splits or consolidations and other similar changes. In addition, as drafted, the requirements in (b) to (d) of IFRS 2.45 above appear to apply only to share options. However, since there is little distinction in IFRS 2 between the treatment of an option with a zero exercise price and the award of a free share, in our view the disclosures are not to be restricted to awards of options.

13.2 Valuation of share-based payment arrangements

IFRS 2 includes the following disclosure requirements to enable users of the financial statements to understand how fair value was determined during the period: *[IFRS 2.46, IFRS 2.47, IFRS 2.48, IFRS 2.49]*

Extract from IFRS 2

46 **An entity shall disclose information that enables users of the financial statements to understand how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined.**

47 If the entity has measured the fair value of goods or services received as consideration for equity instruments of the entity indirectly, by reference to the fair value of the equity instruments granted to give effect to the principle in paragraph 46, the entity shall disclose at least the following:

(a) for share options granted during the period, the weighted average fair value of those options at the measurement date and information on how that fair value was measured, including:
  (i) the option pricing model used and the inputs to that model, including the weighted average share price, exercise price, expected volatility, option life, expected dividends, the risk-free interest rate and any other inputs to the model, including the method used and the assumptions made to incorporate the effects of expected early exercise;
  (ii) how expected volatility was determined, including an explanation of the extent to which expected volatility was based on historical volatility; and
  (iii) whether and how any other features of the option grant were incorporated into the measurement of fair value, such as a market condition.

(b) for other equity instruments granted during the period (ie other than share options), the number and weighted average fair value of those equity instruments at the measurement date, and information on how that fair value was measured, including:

(i) if fair value was not measured on the basis of an observable market price, how it was determined;

(ii) whether and how expected dividends were incorporated into the measurement of fair value; and

(iii) whether and how any other features of the equity instruments granted were incorporated into the measurement of fair value.

(c) for share-based payment arrangements that were modified during the period:

(i) an explanation of those modifications;

(ii) the incremental fair value granted (as a result of those modifications); and

(iii) information on how the incremental fair value granted was measured, consistently with the requirements set out in (a) and (b) above, where applicable.

48 If the entity has measured directly the fair value of goods or services received during the period, the entity shall disclose how that fair value was determined, eg whether fair value was measured at a market price for those goods or services.

49 If the entity has rebutted the presumption in paragraph 13, it shall disclose that fact, and give an explanation of why the presumption was rebutted.

How we see it

As drafted, paragraph 46, and some of the detailed disclosures above in IFRS 2, appears to apply only to equity-settled transactions. However, it would be anomalous if detailed disclosures were required about the valuation of an award to be settled in shares, but not one to be settled in cash. In our view, therefore, the disclosures apply both to equity-settled and to cash-settled transactions.

These requirements can be seen to some extent as an anti-avoidance measure. It would not be surprising if the IASB had concerns that entities might seek to minimise the impact of IFRS 2 by using unduly pessimistic assumptions that result in a low fair value for share-based payment transactions, and the disclosures above seem designed to deter entities from doing so. However, these disclosures give information about other commercially sensitive matters. For example, (a)(i) above effectively requires disclosure of future dividend policy for a longer period than is generally covered by such forecasts. Entities may need to consider the impact on investors and analysts of dividend yield assumptions disclosed under IFRS 2.

How we see it

In our view, it is important for entities, in making these disclosures, to ensure that any assumptions disclosed, particularly those relating to future performance, are consistent with those used in other areas of financial reporting that rely on estimates of future events, such as the impairment of property, plant and equipment, intangible assets and goodwill, income taxes (recovery of deferred tax assets out of future profits) and pensions and other post-retirement benefits.

As discussed in section 5.4 above, IFRS 2 creates a rebuttable presumption that, for an equity-settled transaction with a counterparty other than an employee, the fair value of goods and services received provides the more reliable basis for assessing the fair value of the transaction. Where the entity has rebutted this presumption, the disclosure required by IFRS 2.49 must be provided.

13.3 Impact of share-based payment transactions on financial statements

IFRS 2 includes the following disclosure requirements to enable users of the financial statements to understand the impact of share-based payment transactions on the financial statements: *[IFRS 2.50, IFRS 2.51, IFRS 2.52]*

Extract from IFRS 2

50 **An entity shall disclose information that enables users of the financial statements to understand the effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position.**

51 To give effect to the principle in paragraph 50, the entity shall disclose at least the following:

(a) the total expense recognised for the period arising from share-based payment transactions in which the goods or services received did not qualify for recognition as assets and hence were recognised immediately as an expense, including separate disclosure of that portion of the total expense that arises from transactions accounted for as equity-settled share-based payment transactions;

(b) for liabilities arising from share-based payment transactions:

(i) the total carrying amount at the end of the period; and

(ii) the total intrinsic value at the end of the period of liabilities for which the counterparty's right to cash or other assets had vested by the end of the period (eg vested share appreciation rights).

52 If the information required to be disclosed by this Standard does not satisfy the principles in paragraphs 44, 46 and 50, the entity shall disclose such additional information as is necessary to satisfy them. For example, if an entity has classified any share-based payment transactions as equity-settled in accordance with paragraph 33F, the entity shall disclose an estimate of the amount that it expects to transfer to the tax authority to settle the employee's tax obligation when it is necessary to inform users about the future cash flow effects associated with the share-based payment arrangement.

The disclosures section of IFRS 2 has a final paragraph requiring an entity to disclose additional information about its share-based payments if the information requirements set out above and in sections 13.1 and 13.2 above are insufficient to meet the general disclosure principles of the standard. *[IFRS 2.52]*.

As an example of such additional disclosure, IFRS 2 says that if an entity has classified any share-based payment transactions as equity-settled when there is a net settlement feature for withholding tax obligations (see section 14.3.1 below), it must disclose the estimated future payment to the tax authority when it is necessary to inform users of the financial statements about the future cash flow effects of a share-based payment arrangement. *[IFRS 2.52]*.

13.4 Example of IFRS 2 disclosures

An example of many of the disclosures required by IFRS 2 may be found in the financial statements of Aviva plc for the year ended 31 December 2023.

Practical example 13-1: Aviva plc (2023) **United Kingdom**

Annual Report and Accounts 2023 [extract]

3. IFRS Financial Statements [extract]

Notes to the consolidated financial statements [extract]

33 - Group's share plans

This note describes various equity compensation plans operated by the Group, and shows how the Group values the options and awards of shares in the Company.

(a) Description of the plans

The Group maintains a number of active share option and award plans and schemes across all markets (the Group's share plans). All employees are eligible for share plans and the plans offered are as follows:

Plan	Description
(i) Savings-related options	These are options granted under the tax-advantaged Save As You Earn (SAYE) share option scheme in the UK and Irish revenue-approved SAYE share option scheme in Ireland. The SAYE allows eligible employees to acquire options over the Company's shares at a discount of up to 20% of their market value at the date of grant. Options are normally exercisable during the six month period following either the third or fifth anniversary of the start of the relevant savings contract. Seven year contracts were offered prior to 2012. Savings contracts are subject to the statutory savings limits of £500 per month in the UK and €500 per month in Ireland. A limit of £250 per month was applied to contracts in the UK prior to 2016.
(ii) Aviva long-term incentive plan awards	These awards have been made under the Aviva Long-Term Incentive Plan 2011 (LTIP), and are described in section (b) below and in the directors' remuneration report.
(iii) Aviva annual bonus plan awards	These awards have been made under the Aviva Annual Bonus Plan 2011 (ABP), and are described in section (b) below and in the directors' remuneration report.
(iv) Aviva recruitment and retention share plan awards	These are conditional awards granted under the Aviva Recruitment and Retention Share Award Plan (RRSAP) in relation to the recruitment or retention of senior managers excluding executive directors. The awards vest in tranches on various dates and vesting is conditional upon the participant being employed by the Group on the vesting date and not having served notice of resignation. Some awards can be subject to performance conditions. If a participant's employment is terminated due to resignation or dismissal, any tranche of the award which has vested within the 12 months prior to the termination date will be subject to clawback and any unvested tranches of the award will lapse in full.
(v) Aviva Investors deferred share award plan awards	These awards have been made under the Aviva Investors Deferred Share Award Plan (AI DSAP), where employees can choose to have the deferred element of their bonus deferred into awards over Aviva shares. The awards vest in three equal tranches on the second, third and fourth year following the year of grant.
(vi) Various all employee share plans	The Company maintains a number of active stock option and share award voluntary schemes: a) The global matching share plan b) Aviva Group employee share ownership scheme

No new Aviva plc ordinary shares will be issued to satisfy awards made under plans (iv), (v), (vi b).

(b) Outstanding options

The following table summarises information about options outstanding at 31 December:

	2023			2022		
Range of exercise prices	Outstanding options number	Weighted average remaining contractual life years	Weighted average exercise price pence	Outstanding options number	Weighted average remaining contractual life years	Weighted average exercise price pence
£2.20 - £3.16	**35,089,530**	**2.65**	**260.47**	32,596,283	2	227.63
£3.17 - £3.67	**9,043,614**	**2.40**	**333.38**	10,898,433	3	333.46
£3.68 - £4.19	**138,673**	**0.41**	**387.16**	470,831	1	393.31

(c) Movements in the year

A summary of the status of the option and share plans as at 31 December 2023 and 2022, and changes during the years ended on those dates, is shown below.

	2023			2022		
	Options number	Weighted average exercise price years	Awards number	Options number	Weighted average exercise price years	Awards number
Outstanding at 1 January	**43,965,547**	**255.64**	**40,030,981**	47,801,150	251.00	40,303,963
Granted during the year	**17,123,614**	**298.00**	**17,236,818**	6,369,795	336.00	18,158,925
Exercised during the year	**(13,599,458)**	**233.58**	**(16,024,769)**	(6,238,086)	298.73	(11,416,602)
Forfeited during the year	**(2,624,572)**	**301.08**	**(4,446,240)**	(2,801,326)	259.10	(7,015,305)
Cancelled during the year	**(299,957)**	**257.82**	**—**	(713,427)	238.30	—
Expired during the year	**(293,357)**	**305.61**	**—**	(452,559)	308.98	—
Outstanding at 31 December	**44,271,817**	**275.76**	**36,796,790**	43,965,547	255.64	40,030,981
Exercisable at 31 December	**6,917,910**	**222.99**	**—**	2,676,882	278.95	—

(d) Expense charged to the income statement

The total expense recognised for the year arising from equity compensation plans was as follows:

	2023 £m	2022 £m
Equity-settled expense	**(61)**	(58)

(e) Fair value of options and awards

The weighted average fair values of options and awards granted during the year, estimated by using the Binomial option pricing model and Monte Carlo Simulation model, were £0.86 and £3.75 (2022: £0.84 and £3.95) respectively.

(i) Share options

The fair value of the options was estimated on the date of grant, based on the following weighted average assumptions:

Weighted average assumption	2023	2022
Share price	**376p**	388p
Exercise price	**298p**	336p
Expected volatility	**32.13 %**	31.76%
Expected life	**4.11 years**	4.08 years
Expected dividend yield	**8.47 %**	6.44%
Risk-free interest rate	**4.41 %**	4.23%

The expected volatility used was based on the historical volatility of the share price over a period equivalent to the expected life of the option prior to its date of grant. The risk-free interest rate was based on the yields available on UK government bonds as at the date of grant. The bonds chosen were those with a similar remaining term to the expected life of the options. 13,599,458 options were exercised during the year (2022: 6,238,086).

(ii) Share awards

The fair value of the awards was estimated on the date of grant based on the following weighted average assumptions:

Weighted average assumption	2023	2022
Share price	**393p**	404p
Expected volatility[1]	**33 %**	33%
Expected volatility of comparator companies' share price[1]	**30 %**	35%
Correlation between Aviva and comparator competitors' share price[1]	**55 %**	51%
Expected life[1]	**3.00 years**	3.00 years
Expected dividend yield	**0.00 %**	0.00%
Risk-free interest rate[1]	**3.32 %**	1.49%

1. For awards with market-based performance conditions only

How we see it

Depending on the precise regulatory requirements of a particular jurisdiction, it might be possible to meet some of the IFRS 2 disclosure requirements by means of a cross-reference between the financial statements and other parts of an annual report published together with the financial statements, such as a management commentary or statutory remuneration report (as in the case of Aviva plc above). However, even where such an approach is permissible, care needs to be taken to ensure that any such cross-reference is clear and specific and that all of the relevant IFRS 2 requirements have been addressed as these requirements vary depending on when an award was granted. For example, detailed fair value information for an equity-settled award is generally required only in the year of grant (and as comparative information in the following period(s)), whereas the conditions attached to an award are required to be disclosed in every period in which that award is outstanding.

14 Taxes related to share-based payment transactions

14.1 Income tax deductions for the entity

In many jurisdictions entities are entitled to receive income tax deductions for share-based payment transactions. In many, if not most, cases the tax deduction is given for a cost different to that recorded under IFRS 2. For example, some jurisdictions give a tax deduction for the fair or intrinsic value of the award at the date of exercise; others may give a tax deduction for amounts charged to a subsidiary by its parent, or by a trust controlled by the parent, in respect of the cost of group awards to the employees of that subsidiary. In either case, both the amount and timing of the expense for tax purposes will be different from the amount and timing of the expense required by IFRS 2.

The particular issues raised by share-based payment transactions are addressed in IAS 12 and discussed further in Chapter 29 at section 10.8.

14.2 Employment taxes of the employer

It is frequently the case that an employing entity is required to pay employment taxes or social security contributions on share options and other share-based payment transactions with employees, just as if the employees had received cash remuneration. This raises the question of how such taxes must be accounted for.

14.2.1 Applicable standard

The choice of accounting method does not affect the total expense ultimately recognised (which must always be the tax actually paid), but rather its allocation to different accounting periods. IFRS accounting standards are unclear as to which standard must be applied in accounting for such employment taxes. Some consider that such taxes are most appropriately accounted for under IAS 37 (see section 14.2.1.A below), others favour IFRS 2 (see section 14.2.1.B below) or IAS 19 (see section 14.2.1.C below).

How we see it

A reporting entity therefore chooses what it considers an appropriate policy, either applying IAS 37, IFRS 2 or IAS 19, for employment taxes in its particular circumstances.

Such taxes do not fall within the scope of IFRS 9 since, like income taxes, they are not contractual liabilities (see Chapter 41 at section 1.2.1).

14.2.1.A IAS 37

Some consider that, for the reasons set out in sections 14.2.1.B and 14.2.1.C below, employment taxes of the employer do not fall within the scope of IFRS 2 or of IAS 19. Accordingly, since the amount ultimately payable is uncertain, the most appropriate standard to apply is IAS 37.

Where IAS 37 is applied, the entity will recognise a provision for the employment tax in accordance with IFRIC 21 *Levies,* which requires identification of the activity that triggers the payment, as identified by the legislation (see Chapter 27 at sections 3.1 and 6.8). However, there is some room for discussion as to what constitutes the activity that triggers the payment. Is it:

- The granting of the award
- The consumption of services received from employees
- The event (typically exercise) that gives rise to a real tax liability

  Or
- The vesting of the award

Entities applying IAS 37 need therefore to consider the appropriate treatment of employment taxes in light of IFRIC 21.

14.2.1.B IFRS 2

Some argue that, since the employment taxes are a payment of an amount of cash typically directly linked to the share price, they must be accounted for as a cash-settled share-based payment transaction under IFRS 2. This would require the taxes to be measured at each reporting date at fair value, multiplied by the expired vesting period of the award to which they relate (see section 9.3.1 above).

A difficulty with this analysis is that IFRS 2 defines a cash-settled share-based payment transaction as one in which the entity incurs a liability to the "supplier of … goods or services". The liability for such employment taxes is clearly due to the tax authorities, not to the supplier of goods and services (i.e., the employee). Some who support the application of IFRS 2 accept that IFRS 2 is not directly applicable but argue that it is nevertheless the most appropriate standard to apply under the 'GAAP hierarchy' in IAS 8 (see Chapter 3 at section 4.3). The objective of IFRS 2 (see section 2.1 above) states that the standard is intended to apply to "expenses associated with transactions in which share options are granted to employees". *[IFRS 2.1]*. However, the standard contains no explicit provisions relevant to this objective.

14.2.1.C IAS 19

Some argue that such payments are more appropriately accounted for under IAS 19 (see Chapter 31) especially when the taxes are social security contribution, as such contributions benefit the employee indirectly on retirement. Again, the difficulty is that IAS 19 defines employee benefits as "all forms of consideration given by an entity in exchange for service rendered by employees or for the termination of employment" *[IAS 19.8]* which would appear to rule out payments to the tax authority, but for the fact that IAS 19 refers to social security contributions as a component part of short-term employee benefits. *[IAS 19.9(a)]*. However, many share-based payment transactions would, if they were within the scope of IAS 19, be classified as long-term benefits. That brings the added complication that IAS 19 would require the employment taxes due on long-term benefits to be accounted for, like the benefits themselves, using the projected unit credit method, which seems an unduly complex approach in the circumstances.

In some situations, the entity may require employees to discharge any liability for employment taxes. The accounting issues raised by such arrangements are discussed in sections 14.2.2 and 14.3 below.

14.2.2 Recovery of employer's taxes from employees

As discussed in section 14.2 above, in some jurisdictions employers are required to pay employment taxes on share-based payment transactions. This detracts from one of the key attractions for an employer of a share-based payment transaction, namely that it entails no cash cost. This is particularly the case where the tax payable is based on the fair value of the award at vesting, meaning that the employer's liability is potentially unlimited.

Accordingly, employers liable to such taxes will sometimes make it a condition of receiving a share-based award that the employee bear all or some of the employer's cash cost of any related employment taxes. This may be done in a number of ways, including:

- Direct payment to the entity
- Authorising the entity to deduct the relevant amount from the employee's salary
- Surrendering as many shares to the entity as have a fair value equal to the tax liability

The accounting treatment of arrangements where the recovery of the employer's tax cost from the employee is made through surrendering of a number of shares with an equivalent value is similar to that discussed in section 14.3 below for the recovery of the employee's taxes.

Where the scheme requires direct cash reimbursement by employees of the cost of the employer's taxes, different considerations apply, as demonstrated by Illustration 14-1 below.

Illustration 14-1: Recovery of employment tax on share-based payment from employee

At the beginning of year 1, an entity granted an executive an award of free shares with a fair value of CU100,000 on condition that the executive remain in employment for three years. In the jurisdiction concerned, an employment tax at the rate of 12% is payable by the employer when the shares vest, based on their fair value at the date of vesting. As a condition of obtaining the shares on vesting, the executive is required to pay cash equal to the tax liability to the employer.

When the shares vest at the end of year 3, their fair value is CU300,000, on which employment taxes of CU36,000 are due. The executive pays this amount to the entity.

In our view, this arrangement can be construed in one of two ways, with somewhat different accounting outcomes:

- View 1: The executive's obligation to make whole the employer's tax liability means that this is, economically, not an award of free shares, but an option to acquire the shares for an exercise price equivalent to 12% of their market value at the date of exercise. The employer's tax liability is a separate transaction.

- View 2: The executive's obligation to make whole the employer's tax liability is accounted for as such, separately from the share-based payment transaction.

How we see it

In our view, either approach could be adopted, so long as it is applied consistently as a matter of accounting policy. View 1 treats the reimbursement as an exercise price and the employer's tax liability is a separate transaction. View 2 treats the reimbursement separately from the IFRS 2 charge. See below the accounting impact under both views.

The essential differences between View 1 and View 2, as illustrated below, are that:

- Under View 1 the reimbursement received from the employee is credited to equity, whereas under View 2 it is credited to profit or loss.

  And

- Under View 1, the IFRS 2 charge is lower than under View 2 reflecting the fact that under View 1 the award is construed as an option, not an award of free shares.

View 1 Reimbursement treated as exercise price

On this analysis, the award is construed as an option to acquire shares with an exercise price of 12% of the fair value, at vesting, of the shares. The grant date fair value of the award construed as an option is CU88,000. The entity would process the following accounting entries (on a cumulative basis).

Dr	Employee costs*		CU88,000	
	Cr	Equity		CU88,000
Dr	Employee costs†		CU36,000	
	Cr	Cash		CU36,000
Dr	Cash§		CU36,000	
	Cr	Equity		CU36,000

* IFRS 2 charge.

† Employment taxes (12% of CU300,000).

§ The receipt of cash from the employee to reimburse the tax is treated as the receipt of the exercise price for an option and credited to equity.

View 2 Reimbursement treated separately from the IFRS 2 *charge*

On this analysis, the award is construed as an award of free shares, with a grant date fair value of CU100,000. The reimbursement is accounted for as such, giving rise to a credit to profit or loss. The entity would process the following accounting entries (on a cumulative basis).

Dr	Employee costs*		CU100,000	
	Cr	Equity		CU100,000
Dr	Employee costs†		CU36,000	
	Cr	Cash		CU36,000
Dr	Cash§		CU36,000	
	Cr	Employee costs		CU36,000

* IFRS 2 charge.

† Employment taxes (12% of CU300,000).

§ The receipt of cash from the employee to reimburse the tax is treated as a reduction in employee costs.

It will be seen that View 1 results in a total employee expense of CU124,000, while View 2 results in a total employee expense of CU100,000.

14.2.3 Holding of own shares to 'hedge' employment tax liabilities

As noted in section 14.2 above, an award of shares or options to an employee may also give rise to an employment tax liability for the employer, often related to the fair value of the award when it vests or, in the case of an option, is exercised. Employers may hold their own shares in order to hedge this liability (in an economic sense, if not under the criteria in IFRS 9 - see section 2.2.4.H above), and later sell as many shares as are needed to raise proceeds equal to the tax liability.

These are two separate transactions. The purchase and sale of own shares are treasury share transactions accounted for in accordance with IAS 32 (see Chapter 43 at section 9). The accounting treatment of the employment tax liability is discussed in section 14.2.1 above.

14.3 Sale or surrender of shares by employee to meet employee's tax liability ('sell to cover' and 'net settlement')

In some jurisdictions, an award of shares or options to an employee gives rise to a personal tax liability for the employee, often related to the fair value of the award when it vests or, in the case of an option, is exercised. In order to meet this tax liability, employees may wish to sell or surrender as many shares as are needed to raise proceeds equal to the tax liability (sometimes described respectively as 'sell to cover' or 'net settlement').

This in itself does not, in our view, require the scheme to be considered as cash-settled, any more than if the employee wished to liquidate the shares in order to buy a car or undertake home improvements. However, if the manner in which the cash is passed to, or realised for, the employee gives rise to a legal or constructive obligation for the employer, then the scheme might well be cash-settled (see sections 9.2.2 to 9.2.4 above), to the extent of any such obligation.

In some jurisdictions where employees must pay income tax on share awards, the tax is initially collected from (and is a legal liability of) the employer, but with eventual recourse by the tax authorities to the employee for tax not collected from the employer. Such tax collection arrangements mean that even an equity-settled award results in a cash cost for the employer for the income tax.

In such a situation, the employer may require the employee, as a condition of taking delivery of any shares earned, to indemnify the entity against the tax liability, for example by:

- Direct payment to the entity.
- Authorising the entity to deduct the relevant amount from the employee's salary.
- Surrendering as many shares to the entity as have a fair value equal to the tax liability.

How we see it

If the entity requires the employee to surrender the relevant number of shares, in our view it is appropriate to treat the scheme as cash-settled to the extent of the indemnified amount, unless the criteria to account for the arrangement as equity-settled under the limited exception in IFRS 2 are met (see further below). This view relating to the general requirements of IFRS 2 was confirmed by the IASB in its discussions relating to the introduction of the exception into the standard.

IFRS 2 contains a limited exception to the general requirement to consider whether a net-settled arrangement needs to be split into equity-settled and cash-settled portions. An entity is required to account for net-settled arrangements meeting certain specified criteria as equity-settled in their entirety. However, the exception is narrow in scope and the requirement to assess whether an arrangement has an equity-settled element and a cash-settled element continues to be relevant in many cases. The exception is discussed and illustrated further in section 14.3.1 below.

The following Illustration shows the application of IFRS 2 to an arrangement where the exception does not apply and so the entity has to separate the transaction into two elements.

Illustration 14-2: Surrendering of vested shares by employee to indemnify liability of entity to pay employee's tax liability (net settlement where IFRS 2 exception does not apply)

An entity operates in a jurisdiction where the personal tax rate is 40%, and free shares are taxed at their fair value on vesting. The entity grants an award of 100 free shares with a grant date fair value of CU3 each. The fair value at vesting date is CU5, so that the employee's tax liability (required to be discharged in the first instance by the employer) is CU200 (40% of CU500). The award is to be satisfied using treasury shares with an original cost of CU2.50 per share. Tax law or regulation does not require the entity to withhold an amount for the employee's tax obligation (see Illustration 14-3 below for a demonstration of that situation).

The terms of the agreement between the entity and the employee specify that the employee must surrender the 40 shares needed to settle the tax liability. In our view the substance of the transaction is that, at grant date, the entity is making an award of only 60 shares (with a grant date fair value of CU3 each) and is bearing the cost of the employment tax itself. On this analysis, the entity will have recorded the following entries by the end of the vesting period:

Dr	Employee costs(based on 60 shares at grant date fair value)		CU180	
	Cr	Equity		CU180
Dr	Employee costs (based on 40% of vesting date value)		CU200	
	Cr	Employment tax liability		CU200

The award is then satisfied by delivery of 60 treasury shares (with a cost of CU2.50 each) to the employee:

Dr	Equity		CU150	
	Cr	Treasury shares		CU150

The entity might well then sell the 40 shares 'surrendered' by the employee in order to raise the cash to pay the tax, but this would be accounted for as an increase in equity on the reissue of treasury shares, not as income (see section 14.2.3 above).

If, instead of being required to surrender shares, the employee has a free choice as to how to indemnify the employer, the employer will have recorded the following entries by the end of the vesting period:

Dr	Employee costs(based on 100 shares at grant date fair value)		CU300	
	Cr	Equity		CU300
Dr	Receivable from employee (based on 40% of vesting date value)		CU200	
	Cr	Employment tax liability		CU200

The award is then satisfied by delivery of shares to the employee, and the employee indicates that he wishes to surrender 40 shares to discharge his obligation to the employer under the indemnity arrangement. The entity then receives 40 shares from the employee in settlement of the CU200 receivable from him.

In practice, this would almost certainly be effected as a net delivery of 60 shares, but in principle there are two transactions, a release of 100 treasury shares, with a cost of CU2.50 each, to the employee:

Dr	Equity		CU250	
	Cr	Treasury shares		CU250

and the re-acquisition of 40 of those shares at CU5 each from the employee:

Dr	Treasury shares		CU200	
	Cr	Receivable from employee		CU200

The entity then settles the tax liability:

Dr	Employment tax liability		CU200	
	Cr	Cash		CU200

Even in this case, however, some might take the view that the substance of the arrangement is that the employee has the right to put 40 shares to the employer, and accordingly 40% of the award must be accounted for as cash-settled, resulting in essentially the same accounting as when the employee is required to surrender 40 shares, as set out above. An entity must therefore make a careful assessment of the appropriate accounting treatment based on the terms of a particular arrangement.

14.3.1 Share-based payments with a net settlement feature for withholding tax obligations (net settlement where IFRS 2 exception applies)

IFRS 2 contains an exception for specific types of share-based payment transaction with a net settlement feature.

Extract from IFRS 2

33E Tax laws or regulations may oblige an entity to withhold an amount for an employee's tax obligation associated with a share-based payment and transfer that amount, normally in cash, to the tax authority on the employee's behalf. To fulfil this obligation, the terms of the share-based payment arrangement may permit or require the entity to withhold the number of equity instruments equal to the monetary value of the employee's tax obligation from the total number of equity instruments that otherwise would have been issued to the employee upon exercise (or vesting) of the share-based payment (ie the share-based payment arrangement has a 'net settlement feature').

33F As an exception to the requirements in paragraph 34, the transaction described in paragraph 33E shall be classified in its entirety as an equity-settled share-based payment transaction if it would have been so classified in the absence of the net settlement feature.

The exception was introduced as a result of discussions by the IFRS IC about the classification of a share-based payment transaction in which an entity withholds a specified portion of shares that would otherwise be issued to the counterparty at the date of exercise or vesting. The shares are withheld in return for the entity settling the counterparty's tax liability relating to the share-based payment. The question asked was whether the portion of the share-based payment that is withheld should be classified as cash-settled or equity-settled in a situation where, in the absence of the net settlement feature, the award would be treated in its entirety as equity-settled?

The exception to the usual requirements of the standard (which are set out in section 14.3 above) is narrow in scope and applies only in situations where there is a statutory withholding obligation. *[IFRS 2.33E]*.

If a transaction meeting the criteria in IFRS 2.33E, would have been classified entirely as equity-settled were it not for this net settlement feature, then the exception in IFRS 2 applies and the transaction is accounted for as equity-settled in its entirety (rather than being divided into an equity-settled portion and a cash-settled portion as discussed in section 14.3 above). *[IFRS 2.33F, IFRS 2.BC255G, IFRS 2.BC255H, IFRS 2.BC255I]*.

An entity applying the exception has to account for the withholding of shares to fund the payment to the tax authority as a deduction from equity (in accordance with IFRS 2.29). However, the deduction from equity may only be made up to the fair value at the net settlement date of the shares to be withheld. *[IFRS 2.33G]*. If the payment exceeds this fair value, the excess is expensed through profit or loss.

Where the entity withholds any equity instruments in excess of the employee's tax obligation associated with the share-based payment (i.e., the entity withholds an amount of shares that exceeds the monetary value of the employee's tax obligation), then the excess shares must be accounted for as a cash-settled share-based payment when this amount is paid in cash (or other assets) to the employee. *[IFRS 2.33H(b)]*. In other words, such shares are treated as a separate cash-settled share-based payment and fully recognised as an expense (rather than as a deduction from equity) as at the date of settlement.

To illustrate the application of the exception, the IASB has added an example to the implementation guidance accompanying IFRS 2. *[IFRS 2.IG Example 12B]*. The substance of this example is reproduced as Illustration 14-3 below.

An entity applying the exception will also need to consider whether additional disclosures are needed in respect of the future cash payment to the tax authorities (see section 13.3 above). *[IFRS 2.52]*.

The IASB notes in the Basis for Conclusions on IFRS 2 that the exception is designed to alleviate the operational difficulties, and any associated undue cost, encountered by entities when they are required, under the requirements of IFRS 2, to divide a share-based payment transaction into an equity-settled element and a cash-settled element (see section 14.3 above). *[IFRS 2.BC255J]*.

The IASB made it very clear during its discussions that the exception only addresses the narrow situation where the net settlement arrangement is designed to meet an entity's obligation under tax laws or regulations to withhold a certain amount to meet the counterparty's tax obligation associated with the share-based payment and transfer that amount in cash to the taxation authorities. This point has been incorporated into IFRS 2 as follows:

"The exception in paragraph 33F does not apply to:

(a) a share-based payment arrangement with a net settlement feature for which there is no obligation on the entity under tax laws or regulations to withhold an amount for an employee's tax obligation associated with that share-based payment …". *[IFRS 2.33H(a)]*.

Other types of arrangements that are very frequently seen in practice might appear similar in substance to the legal or regulatory obligation covered by the exception. For example, as discussed and illustrated in section 14.3 above, the terms of a share-based payment arrangement between an entity and an employee might require the employee to forfeit sufficient shares to meet the tax liability or the employee might have some choice over whether or not shares are withheld and/or directly sold in order to raise cash to settle the tax liability. However, unless the arrangements for net settlement are put in place to meet the entity's obligation under tax laws or regulations as described above, the exception will not apply. Therefore, careful analysis of such arrangements continues to be necessary to determine whether part of the award must be treated as cash-settled or whether the exception applies and the entire arrangement must therefore be treated as equity-settled.

Illustration 14-3: Share-based payment transactions with a net settlement feature for withholding tax obligations (application of IFRS 2 exception)

At the beginning of year 1 an entity grants an award of 100 shares to an employee. The award is conditional upon the completion of four years' service which the employee is expected to achieve.

The employee's tax obligation of 40% is based on the fair value of the shares at vesting date. Tax law in the entity's jurisdiction requires the entity to withhold an amount for an employee's tax obligation associated with a share-based payment and transfer that amount in cash to the tax authority on behalf of the employee.

The terms and conditions of the share-based payment arrangement require the entity to withhold shares from the settlement of the award to the employee in order to settle the employee's tax obligation. Accordingly, the entity settles the transaction on a net basis by withholding the number of shares with a fair value equal to the monetary value of the employee's tax obligation and issuing the remaining shares to the employee at the end of the vesting period.

The fair value at grant date is CU2 per share and at the end of year 4 is CU10 per share.

The fair value of the shares on the vesting date (end of year 4) is CU1,000 (100 × CU10) and therefore the employee's tax obligation is CU400 (100 × CU10 × 40%). Accordingly, on the vesting date, the entity issues 60 shares to the employee, withholds 40 shares from the employee and pays CU400 (the fair value of the shares withheld) in cash to the tax authority on the employee's behalf. In effect, it is as if the entity issued 100 vested shares to the employee and then repurchased 40 of them at fair value.

Accounting during the vesting period and on recognition and settlement of the tax obligation

Over the four-year vesting period, the entity recognises a cumulative IFRS 2 expense of CU200 (CU50 per annum) with a corresponding credit to equity. This is calculated as 100 shares × CU2 grant date fair value.

Dr	Employee costs		CU200	
	Cr	Equity		CU200

At the date of vesting the tax liability is recognised and subsequently paid:

Dr	Equity		CU400	
	Cr	Tax liability		CU400
Dr	Tax liability		CU400	
	Cr	Cash		CU400

The example in the implementation guidance also notes that the entity must consider disclosing at each reporting date an estimate of the expected tax payment (see section 13.3 above).

15 Other practical issues

We discuss below the following aspects of the practical application of IFRS 2:

- Matching share awards (including deferred bonuses delivered in shares) (see section 15.1 below)
- Loans to employees to purchase shares (limited recourse and full recourse loans) (see section 15.2 below)
- Awards entitled to dividends or dividend equivalents during the vesting period (see section 15.3 below)
- Awards vesting or exercisable on an exit event or change of control (flotation, trade sale etc.) (see section 15.4 below)
- Arrangements under South African black economic empowerment ('BEE') legislation and similar arrangements (see section 15.5 below)
- Shares used as a currency of payment (see section 15.6 below)

15.1 Matching share awards (including deferred bonuses delivered in shares)

As noted in the discussion in section 10.1.2 above, the rules in IFRS 2 for awards where there is a choice of equity- or cash-settlement do not fully address awards where the equity and cash alternatives may have significantly different fair values and vesting periods. In some jurisdictions, a popular type of scheme giving rise to such issues is a matching share award. This section will generally refer to matching share awards but arrangements to defer bonus payments for later settlement in shares (without a matching element) raise a number of similar issues.

Under a matching share award, the starting point is usually that an employee is awarded a bonus for a one-year performance period. At the end of that period, the employee may then be either required or permitted to take all or part of that bonus in shares rather than cash. To the extent that the employee takes shares rather than cash, the employing entity may then be required or permitted to make a 'matching' award of an equal number of shares (or a multiple or fraction of that number). The matching award will typically vest over a longer period.

How we see it

Whilst such schemes can appear superficially similar, the accounting analysis under IFRS 2 could vary significantly, according to whether:

- The employee has a choice, or is required, to take some of the 'base' bonus in shares and whether any such shares have to be retained by the employee in order for the matching shares to vest.

  And/Or
- The employer has a choice, or is required, to match any shares taken by the employee.

Illustrations 15-1 to 15-5 below set out an analysis of the five basic variants of such schemes, as summarised in the following matrix.

Employee's taking shares required or discretionary?	Employer's matching required or discretionary?	Example
Required	Required	15-1
Required	Discretionary	15-2
Discretionary	No provision for matching award	15-3
Discretionary	Required	15-4
Discretionary	Discretionary	15-5

A requirement for the employee to retain a base shareholding for the duration of the matching arrangement is a non-vesting condition and this is considered at the end of this section (following Illustration 15-5).

Illustration 15-1: Mandatory investment by employee of cash bonus into shares with mandatory matching award by employer

At the beginning of year 1 an employee is told that he is to participate in a bonus scheme which will pay CU1,000 if certain performance criteria are met by the end of year 1 and he remains in service. The bonus will be paid at the beginning of year 2. 50% will be paid in cash and the employee will be required to invest the remaining 50% in as many shares as are worth CU500 at the beginning of year 2. Thus, if the share price were CU2.50, the employee would receive CU500 cash and 200 shares. These shares are fully vested.

If this first award is achieved, the entity is required to award an equal number of additional shares ('matching shares') - in this Illustration 200 shares - conditional upon the employee remaining in service until the end of year 3. The award of any matching shares will be made at the beginning of year 2.

Annual bonus

The 50% of the bonus paid in cash is outside the scope of IFRS 2 and within that of IAS 19 (see Chapter 31). The 50% of the annual bonus settled in shares is an equity-settled share-based payment transaction within the scope of IFRS 2, since there is no discretion over the manner of settlement. The measurement date for this element of the bonus is 1 January in year 1 and the vesting period is year 1, since all vesting conditions have been met by the end of that year. Notwithstanding that the two legs of the award strictly fall within the scope of two different IFRS accounting standards, the practical effect will be to charge an expense over the course of year 1.

Matching shares

The terms of the award of 200 matching shares have the effect that the entity has committed, as at the beginning of year 1, to award shares with a value of CU500 as at the beginning of year 2, subject to satisfaction of:

- A performance condition relating to year 1
- A three-year service condition (years 1 to 3)

Those terms are understood by all parties at the beginning of year 1, which is therefore the measurement date. The fact that the matching award is not formally made until the beginning of year 2 is not relevant, since there has been a binding commitment to make the award, on terms understood both by the entity and the employee, since the beginning of year 1 (see section 5.3 above).

The vesting period is the three-year period to the end of year 3. As at the end of year 1 only one of the vesting conditions (i.e., the performance condition) has been met. The further vesting condition (i.e., the service condition) is not met until the end of year 3.

The discussion in section 8.10 above is relevant to the valuation of the equity elements of the award.

Illustration 15-2: Mandatory investment by employee of cash bonus into shares with discretionary matching award by employer

At the beginning of year 1 an employee is told that he is to participate in a bonus scheme which will pay CU1,000 if certain performance criteria are met by the end of year 1 and he remains in service. The bonus will be paid at the beginning of year 2. 50% will be paid in cash and the employee will be required to invest the remaining 50% in as many shares as are worth CU500 at the beginning of year 2. Thus, if the share price were CU2.50, the employee would receive CU500 cash and 200 shares. These shares are fully vested.

If this first award is achieved, the entity has the discretion, but not the obligation, to award an equal number of additional shares ('matching shares') - in this case 200 shares - conditional upon the employee remaining in service until the end of year 3. The award of any matching shares will be made at the beginning of year 2.

Annual bonus

The 50% of the bonus paid in cash is outside the scope of IFRS 2 and within that of IAS 19 (see Chapter 31). The 50% of the annual bonus settled in shares is an equity-settled share-based payment transaction within the scope of IFRS 2, since there is no discretion over the manner of settlement. The measurement date for this element of the bonus is 1 January in year 1 and the vesting period is year 1, since all vesting conditions have been met by the end of that year. Notwithstanding that the two legs of the award strictly fall within the scope of two different IFRS accounting standards, the practical effect will be to charge an expense over the course of year 1.

Matching shares

In our view, it is necessary to consider whether the entity's discretion is real or not, this being a matter for judgement in the light of individual facts and circumstances.

In some cases, the entity's discretion to make awards may have little real substance. For example, the awards may simply be documented as 'discretionary' for tax and other reasons. It may also be that the entity has consistently made matching awards to all eligible employees (or all members of a particular class of eligible employees), so that it has no realistic alternative but to make matching awards if it wants to maintain good staff relations. In such cases, it may be helpful to consider what the accounting for the 'matching' award would be if it were a pure cash award falling within the scope of IAS 19: *[IAS 19.21]*

Extract from IAS 19

21	An entity may have no legal obligation to pay a bonus. Nevertheless, in some cases, an entity has a practice of paying bonuses. In such cases, the entity has a constructive obligation because the entity has no realistic alternative but to pay the bonus. The measurement of the constructive obligation reflects the possibility that some employees may leave without receiving a bonus.

This is discussed further in Chapter 31 at section 12.3.

In making the determination of whether a constructive obligation would exist under IAS 19, it would be necessary to consider past data (e.g., the number of employees who have received matching awards having received the original award).

How we see it

If it is concluded that the entity does not have a constructive obligation to make a matching award, the accounting treatment would follow the legal form of the transaction. In this view, the grant date (and therefore measurement date) would be 1 January in year 2, and the vesting period the two years from the beginning of year 2 to the end of year 3.

If it is concluded that the entity does have a constructive obligation to make a matching award, the effect is that the matching award of shares is equivalent to the mandatory matching award in Illustration 15-1 above, and is therefore to be accounted for in the same way - i.e., the measurement date is 1 January in year 1 and the vesting period is the three year period to the end of year 3.

The discussion in section 8.10 above is relevant to the valuation of the matching equity award.

Illustration 15-3: Discretionary investment by employee of cash bonus into shares with no matching award

At the beginning of year 1 an employee is told that he is to participate in a bonus scheme which will pay CU1,000 if certain performance criteria are met by the end of year 1 and he remains in service. The bonus will be paid at the beginning of year 2. 50% will be paid in cash and the employee will be permitted, but not required, to invest the remaining 50% in as many shares as are worth CU500 at the beginning of year 2. Thus, if the share price were CU2.50, the employee could choose to receive either (a) CU1,000 or (b) CU500 cash and 200 shares. Any shares received are fully vested.

The 50% of the bonus automatically paid in cash is outside the scope of IFRS 2 and within that of IAS 19 (see Chapter 31).

The 50% of the bonus that may be invested in shares falls within the scope of IFRS 2 as a share-based payment transaction in which the terms of the arrangement provide the counterparty with the choice of settlement. This is the case even though the value of the alternative award is always CU500 and does not depend on the share price (see section 10.4 above).

The measurement date of the award is 1 January in year 1 and the vesting period is year 1. The methodology set out in IFRS 2 for awards where the counterparty has a choice of settlement would lead to recognition over the vesting period of a liability component of CU500 and an equity component of zero (see section 10.1.2 above). If in fact the employee took shares at vesting, the CU500 liability would be transferred to equity.

Illustration 15-4: Discretionary investment by employee of cash bonus into shares with mandatory matching award by employer

At the beginning of year 1 an employee is told that he is to participate in a bonus scheme which will pay CU1,000 if certain performance criteria are met by the end of year 1 and he remains in service. The bonus will be paid at the beginning of year 2. 50% will be paid in cash and the employee will be permitted, but not required, to invest the remaining 50% in as many shares as are worth CU500 at the beginning of year 2. Thus, if the share price were CU2.50, the employee could choose to receive either (a) CU1,000 or (b) CU500 cash and 200 shares.

If the employee elects to reinvest the bonus in shares, the shares are not fully vested unless the employee remains in service until the end of year 3. However, if the employee elects to receive 50% of the bonus in shares, the entity is required to award an equal number of additional shares ('matching shares'), in this case 200 shares, also conditional upon the employee remaining in service until the end of year 3. The award of any matching shares will be made at the beginning of year 2.

The 50% of the bonus automatically paid in cash is outside the scope of IFRS 2 and within that of IAS 19 (see Chapter 31).

The 50% of the bonus that may be invested in shares falls within the scope of IFRS 2 as a share-based payment transaction in which the terms of the arrangement provide the counterparty with the choice of settlement. This is the case even though the value of the alternative award is always CU500 and does not depend on the share price (see section 10.4 above).

The mandatory nature of the matching shares means that the award is a share-based payment transaction, entered into at the beginning of year 1 (and therefore measured as at that date), in which the terms of the arrangement provide the counterparty with a choice of settlement between:

- At the beginning of year 2: cash of CU500, subject to service and performance during year 1.

  Or

- At the end of year 3: shares with a value of CU1,000 as at the beginning of year 2, subject to:
  - (i) Performance in year 1.

    And
  - (ii) Service during years 1 to 3.

The equity component as calculated in accordance with IFRS 2 will have a value in excess of zero (see section 10.1.2 above). The measurement date of the equity component is the beginning of year 1. However, as discussed in section 10.1.3.A above, IFRS 2 does not specify how to deal with a transaction where the counterparty has the choice of equity- or cash-settlement but the liability and equity components have different vesting periods. In our view it is appropriate to recognise the liability and equity components independently over their different vesting periods, i.e., in this case:

- For the liability component (i.e., the fair value of the cash alternative), during year 1.
- For the equity component (i.e., the excess of the total fair value of the award over the fair value of the cash alternative), during the three-year period to the end of year 3.

Thus, at the end of year 1, the entity will have recorded an IFRS 2 expense together with a corresponding:

- Liability for the cost of the portion of the annual award that the employee may take in cash or equity (the liability component referred to above).
- Credit to equity, for one-third of the cost of the matching award (the equity component referred to above).

If the employee decides to take shares, the entity would simply transfer the amount recorded as a liability to equity and recognise the remaining cost of the matching shares over the following two years.

If, however, the employee elects to take cash, the position is more complicated. Clearly, the main accounting entry is to reduce the liability, with a corresponding reduction in cash, when the liability is settled. However, this raises the question of what is to be done with the one-third cost of the matching award already recognised in equity and the remaining, as yet unrecognised, two-thirds cost.

An election by the employee for cash at the end of year 1must be treated as a cancellation of the matching award, due to the employee's failure to fulfil a non-vesting condition (i.e., not taking the cash alternative) for the matching award - see sections 3.2 and 6.4 above. Therefore, the one-third cost that had already been expensed would not be reversed and the remaining two-thirds of the matching award not yet recognised would be recognised immediately, resulting in an expense for an award that does not actually crystallise.

How we see it

To summarise the above, in our view, it is appropriate to recognise the liability and equity components independently over their different vesting periods.

If the employee decides to take shares, the entity would simply transfer the amount recorded as a liability to equity and recognise the remaining cost of the matching shares over the remaining vesting period for the equity component.

If the employee elects to take the cash, this is treated as a cancellation of the matching award, due to failure to fulfil a non-vesting condition.

The analysis above assumes that the equity award either vests or is cancelled because the employee decides to take the cash award. An alternative outcome would be that the employee chooses the equity-settled award but then fails to meet the three-year service condition attached to that award. This would result in forfeiture of the equity-settled award and the reversal of any expense previously recognised for the equity component. However, this raises a question about the treatment of the amount for the cash component that was credited to equity when the employee chose the equity award rather than the cash award. In our view, there are two alternative approaches:

- The employee's decision to invest 50% of the bonus into the share award is similar to the employee making a non-refundable deposit for the shares and so it is appropriate to leave this amount in equity and not reverse it through profit or loss as part of the forfeiture accounting for the equity award.
- The reclassification of CU500 from liability to equity is part of the consideration for the forfeited equity instruments and relates to past service rendered in connection with the equity component of the award and so it is appropriate to reverse this amount through profit or loss as part of the forfeiture.

How we see it

As noted above, where an employee fails to meet the service condition attached to the equity-settled component of the award, this results in a forfeiture of that component. There are two alternative approaches in accounting for the cash component previously credited to equity at the date of forfeiture. Either approach noted above is acceptable but must be applied consistently.

Illustration 15-5: Discretionary investment by employee of cash bonus into shares with discretionary matching award by employer

At the beginning of year 1 an employee is told that he is to participate in a bonus scheme which will pay CU1,000 if certain performance criteria are met by the end of year 1 and he remains in service. The bonus will be paid at the beginning of year 2. 50% will be paid in cash and the employee will be permitted, but not required, to invest the remaining 50% in as many shares as are worth CU500 at the beginning of year 2. Thus, if the share price were CU2.50, the employee could choose to receive either (a) CU1,000 or (b) CU500 cash and 200 shares. Any shares received under this part of the arrangement are fully vested.

If the employee elects to receive shares, the entity has the discretion, but not the obligation, to award additional shares ('matching shares') - in this case 200 shares - conditional upon the employee remaining in service until the end of year 3. The award of any matching shares will be made at the beginning of year 2.

The 50% of the bonus automatically paid in cash is outside the scope of IFRS 2 and within that of IAS 19 (see Chapter 31).

The 50% of the bonus that may be invested in shares falls within the scope of IFRS 2 as a share-based payment transaction in which the terms of the arrangement provide the counterparty with the choice of settlement. This is the case even though the value of the alternative award is always CU500 and does not depend on the share price (see section 10.4 above).

How we see it

In our view, it is necessary, as discussed in Illustration 15-2 above, to consider whether the entity's discretion to make an award of matching shares is real or not, this being a matter for judgement in the light of individual facts and circumstances.

In addition, the accounting considerations relating to the employee choosing to take the cash or equity component discussed in Illustration 15-4 above are relevant to this Illustration 15-5, as discussed below.

If it is determined that the entity is effectively obliged to match any share award taken by the employee, then the award must be analysed as giving the employee the choice of settlement between:

- At the beginning of year 2: cash of CU500, subject to service and performance during year 1

  Or

- At the beginning of year 2 shares with a value of CU500 as at that date, subject to service and performance during year 1; and, at the end of year 3: the same number of shares again subject to (i) performance during year 1 and (ii) service during the three-year period to the end of year 3.

In this case the grant date (and therefore measurement date) of all the equity awards would be taken as the beginning of year 1. As regards the award due to vest at the beginning of year 2, this would be split into its equity and liability components, and in this case the equity component would have a value of zero (since the two components are essentially worth the same amount of CU500). Thus, the entity would accrue a liability during year 1. The matching share award would be expensed over the three-year period to the end of year 3.

Thus, at the end of year 1, the entity will have recorded an IFRS 2 expense together with a corresponding:

- Liability for the cost of the portion of the annual award that the employee may take in cash or equity (the liability component).

  And

- Credit to equity for one-third of the cost of the matching award (the equity component).

If the employee decides to take shares at the beginning of year 2, the entity would simply transfer the amount recorded as a liability to equity and recognise the remaining cost of the matching shares over the following two years.

If, however, the employee elects to take cash, the position is more complicated. Clearly, the main accounting entry is to reduce the liability, with a corresponding reduction in cash, when the liability is settled. However, this raises the question of what is to be done with the one-third cost of the matching award already recognised in equity and the remaining, as yet unrecognised, two-thirds cost.

As in Illustration 15-4 above, an election by the employee for cash at the end of year 1 must be treated as a cancellation of the matching award, due to the employee's failure to fulfil a non-vesting condition (i.e., not taking the cash alternative) for the matching award - see sections 3.2 and 6.4 above. Therefore, the one-third cost that had already been expensed would not be reversed and the remaining two-thirds of the matching award not yet recognised would be recognised immediately, resulting in an expense for an award that does not actually crystallise.

If it is concluded that the entity has genuine discretion to make a matching award, the analysis is somewhat different.

The portion of the annual award that may be taken in shares must be analysed as giving the employee the choice, at the beginning of year 2, between cash of CU500 and shares worth CU500 (the number of shares being determined by reference to the share price at that date). This would be split into its equity and liability components, and in this case the equity component would have a value of zero (since the two components are essentially worth the same). Thus, the entity would accrue a liability during year 1. If the employee elected to receive shares, this liability would be transferred to equity.

Any matching share award would be treated as being granted on, and measured as at, the beginning of year 2. The cost would be recognised over the two-year period from the beginning of year 2 to the end of year 3.

The discussion in section 8.10 above is relevant to the valuation of the matching equity award.

Illustration 15-4 above discusses the accounting treatment in a situation where the employee fails to meet the service condition.

If, as is often the case in practice, the employee had to retain his original holding of shares and complete a further period of service in order for the matching award to vest, the requirement to retain the original shares would be treated as a non-vesting condition and taken into account in the grant date fair value of the matching award (see section 6.4 above). Failure to meet this non-vesting condition, by disposing of the shares whilst remaining in employment during the matching period, would be treated as a cancellation of the matching award as holding the shares is a condition within the employee's control (see section 6.4.3 above).

15.2 Loans to employees to purchase shares (limited recourse and full recourse loans)

In some jurisdictions, share awards to employees are made by means of so-called 'limited recourse loan' schemes. The detailed terms of such schemes vary, but typical features include the following:

- The entity makes an interest-free loan to the employee which is immediately used to acquire shares to the value of the loan on behalf of the employee.
- The shares may be held by the entity, or a trust controlled by it (see section 12.3 above), until the loan is repaid.
- The employee is entitled to dividends, except that these are treated as paying off some of the outstanding loan.
- Within a given period (say, five years) the employee must either have paid off the outstanding balance of the loan, at which point the shares are delivered to the employee, or surrendered the shares. Surrender of the shares by the employee is treated as discharging any outstanding amount on the loan, irrespective of the value of the shares.

The effect of such an arrangement is equivalent to an option exercisable within five years with an exercise price per share equal to the share price at grant date less total dividends since grant date - a view reinforced by the IFRS IC.[37] There is no real loan at the initial stage. The entity has no right to receive cash or another financial asset, since the loan can be settled by the employee returning the (fixed) amount of equity 'purchased' at grant date.

Indeed, the only true cash flow in the entire transaction is any amount paid at the final stage if the employee chooses to acquire the shares at that point. The fact that the exercise price is a factor of the share price at grant date and dividends paid between grant date and the date of repayment of the 'loan' is simply an issue for the valuation of the option.

The arrangement is valued using an option-pricing model and the fair value is based on the employee's implicit right to buy the shares at a future date rather than being the share price at grant date (the face value of the loan).

The loan arrangement might have a defined period during which the employee must remain in service (five years in the Illustration above) and during which there might also be performance conditions to be met. Where this is the case, the IFRS 2 expense will be recognised by the entity over this period. However, where, as is frequently the case, such an award is subject to no future service or performance condition, i.e., the 'option' is, in effect, immediately exercisable by the employee should he choose to settle the 'loan', IFRS 2 requires the cost to be recognised in full at grant date (see section 6.1 above).

How we see it

As noted above, an arrangement with a limited recourse loan to the shares is equivalent to a share option provided to employees.

Where the limited recourse loan arrangement requires no future service or performance condition to be met by the employee, in effect, the 'option' is immediately exercisable, and the IFRS 2 expense is recognised in full at grant date. If the arrangement requires the employee to be in service that may include performance conditions to be met, the IFRS 2 expense is recognised over that period.

There are also some arrangements where the loan to the employee to acquire the shares is a full recourse loan (i.e., it cannot be discharged simply by surrendering the shares and there can be recourse to other assets of the employee). However, the amount repayable on the loan is reduced not only by dividends paid on the shares, but also by the achievement of performance targets, such as the achievement of a given level of earnings.

The appropriate analysis of such awards is more difficult, as they could be viewed in two ways:

- Either the employer has made a loan (which the employee has chosen to use to buy a share), accounted for under IFRS 9, and has then entered into a performance-related cash bonus arrangement with the employee, accounted for under IAS 19.

  Or

- The transaction is a share option where the exercise price varies according to the satisfaction of performance conditions and the amount of dividends on the shares, accounted for under IFRS 2.

37 *IFRIC Update*, November 2005, available on the IFRS Foundation's website.

The different analyses give rise to potentially significantly different expenses. This will particularly be the case where one of the conditions for mitigation of the amount repayable on the loan is linked to the price of the employer's equity. As this is a market condition, the effect of accounting for the arrangement under IFRS 2 may be that an expense is recognised in circumstances where no expense would be recognised under IAS 19.

Such awards need to be carefully analysed, in the light of their particular facts and circumstances, in order to determine the appropriate treatment. Factors that could suggest that IFRS 2 is the more relevant standard would, in our view, include:

- The employee can use the loan only to acquire shares.
- The employee cannot trade the shares until the loan is discharged.

  Or
- The entity has a practice of accepting (e.g., from leavers) surrender of the shares as full discharge for the amount outstanding on the loan and does not pursue any shortfall between the fair value of the shares and the amount owed by the employee. This would tend to indicate that, in substance, the loan is not truly full recourse.

How we see it

As noted above, a loan arrangement subject to full recourse requires careful analysis of the particular facts and circumstances to determine which is the appropriate standard to apply; IFRS 9 and IAS 19 or IFRS 2, considering the factors noted above.

15.3 Awards entitled to dividends or dividend equivalents during the vesting period

Some awards entitle the holder to receive dividends on unvested shares (or dividend equivalents on options) during the vesting period.

For example, in some jurisdictions, entities make awards of shares that are regarded as fully vested for the purposes of tax legislation (typically because the employee enjoys the full voting and dividend rights of the shares), but not for accounting purposes (typically because the shares are subject to forfeiture if a certain minimum service period is not achieved). In practice, the shares concerned are often held by an EBT until the potential forfeiture period has expired.

Another variant of such an award that is sometimes seen is where an entity grants an employee an option to acquire shares in the entity which can be exercised immediately. However, if the employee exercises the option but leaves within a certain minimum period from the grant date, he is required to sell back the share to the entity (typically either at the original exercise price, or the lower of that price or the market value of the share at the time of the buy-back - see also the discussions in section 15.4.5 below).

Such awards do not fully vest for the purposes of IFRS 2 until the potential forfeiture or buy-back period has expired. The cost of such awards must therefore be recognised over this period.

This raises the question of the accounting treatment of any dividends paid to employees during the vesting period, either as a charge to profit or loss as employee costs or a return on an equity instrument. Conceptually, it could be argued that such dividends cannot be dividends for financial reporting purposes since the equity instruments to which they relate are not yet regarded as issued for financial reporting purposes. One consequence of this, is that shares subject to such an award are excluded from the number of ordinary shares outstanding for the purposes of calculating EPS in accordance with IAS 33. These dividend entitlements would, however they are accounted for, constitute a reduction in earnings available to ordinary shareholders when applying IAS 33 (which is discussed in Chapter 33). As it is argued that equity instruments to which the dividends relate are not yet regarded as issued for financial reporting purposes, this would lead to the conclusion that dividends paid in the vesting period are required to be charged to profit or loss as an employment cost.

However, the charge to be made for the award under IFRS 2 will already take account of the fact that the recipient is entitled to receive dividends during the vesting period. If the recipient is not entitled to receive dividends during the vesting period a discount would be reflected in the fair value of the award; if the recipient is entitled to dividends, no such adjustment is made (see section 8.5.4 above). Thus, it could be argued that also to charge profit or loss with the dividends paid is a form of double counting. Moreover, whilst the relevant shares may not have been fully issued for financial reporting purposes, the basic IFRS 2 accounting does build up an amount in equity over the vesting period. It could therefore be argued that - conceptually, if not legally - any dividend paid relates not to an issued share, but rather to the equity instrument represented by the cumulative amount that has been recorded for the award as a credit to equity, and can therefore appropriately be shown as a deduction from equity.

The argument above is valid only to the extent that the credit to equity represents awards that are expected to vest. It cannot apply to dividends paid to employees whose awards are either known not to have vested or treated as expected not to vest when applying IFRS 2 (since there is no credit to equity for these awards).

How we see it

When employees are entitled to dividends paid during the vesting period and reflected in the fair value of the award, we believe that the most appropriate approach is to analyse the dividends paid so that, by the date of vesting, cumulative dividends paid on awards treated by IFRS 2 as vested are deducted from equity and those paid on awards treated by IFRS 2 as unvested are charged to profit or loss. The allocation for periods prior to vesting is to be based on a best estimate of the final outcome, as demonstrated by Illustration 15-6 below.

Illustration 15-6: Award with rights to receive (and retain) dividends during vesting period

An entity grants 100 free shares to each of its 500 employees. The shares are treated as fully vested for legal and tax purposes, so that the employees are eligible to receive any dividends paid. However, the shares will be forfeited if the employee leaves within three years of the award being made. Accordingly, for the purposes of IFRS 2, vesting is conditional upon the employee working for the entity over the next three years. The entity estimates that the fair value of each share (including the right to receive dividends during the IFRS 2 vesting period) is CU15. Employees are entitled to retain any dividend received even if the award does not vest.

20 employees leave during the first year, and the entity's best estimate at the end of year 1 is that 75 employees will have left before the end of the vesting period. During the second year, a further 22 employees leave, and the entity revises its estimate of total employee departures over the vesting period from 75 to 60. During the third year, a further 15 employees leave. Hence, a total of 57 employees (20 + 22 + 15) forfeit their rights to the shares during the three-year period, and a total of 44,300 shares (443 employees × 100 shares per employee) finally vest.

The entity pays dividends of CU1 per share in year 1, CU1.20 per share in year 2, and CU1.50 in year 3.

Under IFRS 2, the entity will recognise the following amounts during the vesting period for services received as consideration for the shares.

Year	Calculation of cumulative expense	Cumulative expense (CU)	Expense for period (CU)
1	100 shares × 425 employees × CU15 × 1/3	212,500	212,500
2	100 shares × 440 employees × CU15 × 2/3	440,000	227,500
3	100 shares × 443 × CU15 × 3/3	664,500	224,500

On the assumption that all employees who leave during a period do so on the last day of that period (and thus receive dividends paid in that period), in our view the dividends paid on the shares must be accounted for as follows:

Year 1

Dr	Profit or loss (employee costs)[1]	CU7,500	
Dr	Equity[1]	CU42,500	
Cr	Cash[2]		CU50,000

Year 2

Dr	Profit or loss (employee costs)[3]	CU3,300	
Dr	Equity[3]	CU54,300	
Cr	Cash[4]		CU57,600

Year 3

Dr	Profit or loss (employee costs)[5]	CU1,590	
Dr	Equity[5]	CU67,110	
Cr	Cash[6]		CU68,700

1 20 employees have left and a further 55 are anticipated to leave. Dividends paid to those employees (100 shares × 75 employees × CU1 = CU7,500) are therefore recognised as an expense. Dividends paid to other employees are recognised as a reduction in equity.

2 100 shares × 500 employees × CU1.

3 22 further employees have left and a further 18 are anticipated to leave. The cumulative expense for dividends paid to leavers and anticipated leavers must therefore be CU10,800 (100 shares × 20 employees × CU1 = CU2,000 for leavers in year 1 + 100 shares × 40 employees × [CU1 + CU1.20] for leavers and anticipated leavers in year 2 = CU8,800). CU7,500 was charged in year 1, so the charge for year 2 must be CU10,800 - CU7,500 = CU3,300. This could also have been calculated as charge for leavers and expected leavers in current year CU4,800 (100 shares × 40 [22 + 18] employees × CU1.20) less reversal of expense in year 1 for reduction in anticipated final number of leavers CU1,500 (100 shares × 15 [75 - 60] employees × CU1.00). Dividends paid to other employees are recognised as a reduction in equity.

4 100 shares × 480 employees in employment at start of year × CU1.20.

5 15 further employees have left. The cumulative expense for dividends paid to leavers must therefore be CU12,390 (CU2,000 for leavers in year 1 (see section 3 above) + 100 shares × 22 employees × [CU1 + CU1.20] = CU4,840 for leavers in year 2 + 100 shares × 15 employees × [CU1 + CU1.20 + CU1.50] = CU5,550 for leavers in year 3). A cumulative expense of CU10,800 (see section 3 above) was recognised by the end of year 2, so the charge for year 3 must be CU12,390 - CU10,800 = CU1,590. This could also have been calculated as charge for leavers in current year CU2,250 (100 shares × 15 employees × CU1.50) less reversal of expense in years 1 and 2 for reduction in final number of leavers as against estimate at end of year 2 CU660 (100 shares × 3 [60 - 57] employees × [CU1.00 + CU1.20]). Dividends paid to other employees are recognised as a reduction in equity.

6 100 shares × 458 employees in employment at start of year × CU1.50.

15.4 Awards vesting or exercisable on an exit event or change of control (flotation, trade sale etc.)

Entities frequently issue awards connected to a significant event such as a flotation, trade sale or other change of control of the business. It may be that an award that would otherwise be equity-settled automatically becomes cash-settled if such an event crystallises and the entity has no choice as to the method of settlement (as discussed in section 10.3 above).

However, it may also be the case that an award vests only on such an event, which raises various issues of interpretation, as discussed below.

The sections below must be read together with the more general discussions elsewhere in this chapter (as referred to in the narrative below) on topics such as grant date, vesting period, vesting and non-vesting conditions and classification as equity-settled or cash-settled. References to flotation are required to be read as also including other exit events.

15.4.1 Grant date

Sometimes such awards are structured so that they will vest on flotation or so that they will vest on flotation subject to further approval at that time. For awards in the first category, grant date as defined in IFRS 2 will be the date on which the award is first communicated to employees (subject to the normal requirements of IFRS 2 relating to a shared understanding, offer and acceptance, as discussed in section 5.3 above). For awards in the second category, grant date will be at or around the date of flotation, when the required further approval is given.

This means that the IFRS 2 cost of awards subject to final approval at flotation will generally be significantly higher than that of awards that do not require such approval. Moreover, as discussed further in section 5.3.2 above, it may well be the case that employees begin rendering service for such awards before grant date (e.g., from the date on which the entity communicates its intention to make the award in principle). In that case, the entity would need to make an initial estimate of the value of the award for the purpose of recognising an expense from the date services have been provided, and continually re-assess that value up until the actual IFRS 2 grant date. As with any award dependent on a non-market vesting condition, an expense would be recognised only to the extent that the award is considered likely to vest. The classification of a requirement to float as a non-market vesting condition is discussed further in section 15.4.3 below.

15.4.2 Vesting period

Many awards that vest on flotation have a time limit - in other words, the award lapses if flotation has not occurred on or before a given future date. In principle, as discussed in section 6.2.3 above, when an award has a variable vesting period due to a non-market performance condition, the reporting entity is required to make a best estimate of the likely vesting period at each reporting date and calculate the IFRS 2 expense on the basis of that best estimate, with the final cumulative charge based on the grant date fair value of the actual outcome. Such an approach appears to be taking account of a non-market performance condition in determining the fair value of an award where an award has a variable vesting period, contrary to the basic principle of paragraph 19 of IFRS 2. However, it is not the vesting conditions that are being taken into account per se, but the fact that the varying vesting periods will give rise to different lives for the award. That said, the impact of the time value of the different lives on the fair value of the award will, in many cases, be insignificant and it will therefore be a matter of judgement as to how precisely an entity switches from one fair value to another.

In practice, the likely timing of a future flotation is notoriously difficult to assess months, let alone years, in advance. In such cases, it would generally be acceptable simply to recognise the cost over the full potential vesting period until there is real clarity that a shorter period may be more appropriate. However, in making the assessment of the likelihood of vesting, it is important to take the company's circumstances into account. The likelihood of an exit event in the short- to medium-term is perhaps greater for a company owned by private equity investors seeking a return on their investment than for a long-established family-owned company considering a flotation.

It is worth noting that once an exit event becomes likely, the IFRS 2 expense will in some cases need to be recognised over a shorter vesting period than was originally envisaged as the probability of the exit event occurring will form the basis at the reporting date of the estimate of the number of awards expected to vest (see also the discussion in sections 6.2 and 7.6 above).

How we see it

To summarise the above, when an award has a variable vesting period due to a non-market performance condition, the reporting entity makes a best estimate of the likely vesting period at each reporting date and calculates the IFRS 2 charge on the basis of that best estimate, with the final cumulative expense based on the grant date fair value of the actual outcome. Judgement would need to be applied and it is important to take the company's circumstances into account, as the likelihood of an exit event in the short- to medium-term is perhaps greater for a company owned by private equity investors seeking a return on their investment than for a long-established family-owned company considering a flotation. In addition to determining the vesting period, judgement would also be needed to determine the likelihood of vesting. Once the exit event becomes likely, the IFRS 2 expense may need to be recognised over a shorter vesting period than was originally envisaged as the probability of the exit event occurring will form the basis at the reporting date of the estimate of the number of awards expected to vest.

FASB differences

The above contrasts with the US GAAP approach where, in practice, an exit event that is a change in control or an initial public offering is only recognised when it occurs. In a situation where a change in control or an initial public offering occurs shortly after the reporting date, it is therefore possible that the expense will need to be recognised in an earlier period under IFRS accounting standards than under US GAAP.

15.4.3 Is flotation or sale a vesting condition or a non-vesting condition?

There was debate in the past about whether a requirement for a flotation or sale to occur in order for an award to vest was a vesting condition or a non-vesting condition. The argument for it being a non-vesting condition was that flotation or sale may occur irrespective of the performance of the entity. The counter-argument was essentially that the price achieved on flotation or sale, which typically affects the ultimate value of the award (see section 15.4.4 below), reflects the performance of the entity and is therefore a non-market performance condition (provided there is an associated service condition - see further below).

As part of its wider project on vesting and non-vesting conditions, the IFRS IC reached a tentative decision in July 2010 that a condition requiring an initial public offering (IPO) or a change of control should be deemed to be a performance vesting condition rather than a non-vesting condition. This was subsequently reflected in general terms through the IASB's amendments to the definition of a performance condition in the *Annual Improvements to IFRSs 2010-2012 Cycle* (see sections 3.1 and 3.2 above). The amendments were intended, *inter alia*, to make clear that a requirement for flotation or sale (with an associated service condition) is a performance condition rather than a non-vesting condition on the basis that the flotation or sale condition is by reference to the entity's own operations.

How we see it

The amendments to IFRS 2 also made it clear that a performance target period cannot extend beyond the end of the associated service period in order for the definition of a performance vesting condition to be met (see section 3.2.2 above). Therefore, the flotation or sale condition will be treated as a non-vesting condition, rather than as a vesting condition, if the service period is not at least as long as the duration of the flotation or sale condition.

It is possible that in a share-based payment transaction a flotation or sale condition can be both a performance vesting condition and a non-vesting condition in an award that vests in instalments, 'graded vesting' (see section 6.2.2 above). Where the share-based payment transaction vests in instalments and the service period is not at least as long as the duration of the flotation or sale condition, that condition will be treated as a non-vesting condition (see section 3.2 above). In contrast, when the service condition is the same duration as the flotation and sale condition, that condition will be treated as non-market performance condition (see section 3.1 above), this is demonstrated in Illustration 15-7 below:

Illustration 15-7: Award vesting in instalments with a floatation or sale condition

An entity issues an award to employees at the beginning of year 1 with gradual vesting over five years. The award will vest 20% in each year of service over the five-year period. In addition to the service condition there is a flotation or sale condition that must be met at the end of year 5. As discussed in section 6.2.2 above, the award that vests in instalments will be treated as five different tranches because each tranche has a different vesting period with different fair values. The flotation or sale condition will be a non-vesting condition and factored in the grant date fair value of tranches 1 to 4 as the service period is not as long as the duration of the flotation or sale condition. However, for tranche 5, the service and performance conditions are for the same duration, therefore the flotation or sale condition will be treated as a non-market performance condition and not factored into the grant date fair value but factored into the number of awards that will vest for tranche 5.

The impact of treating the flotation or sale condition differently, results in an expense being recognised for the first four tranches regardless of the flotation or sale condition being met, so long as the service condition is met, as the likelihood of not meeting the flotation or sale condition is factored into the grant date fair value. In contrast for tranche 5 if the floatation or service condition is not met but the service condition is met, no expense will be recognised as the non-market performance condition has not been met.

The floatation or sale condition even though is deemed to relate to the entity's own operations and therefore generally classified as a performance condition, it will sometimes be concluded that fulfilment of the condition is outside the control of both the entity and the counterparty. The settlement of an award in equity or cash might depend on the outcome of the condition i.e., there might be either cash- or equity-settlement that is entirely contingent on the exit event. Such contingent arrangements are discussed in section 10.3 above.

15.4.4 Awards requiring achievement of a minimum price on flotation or sale

Some awards with a condition dependent on flotation (or another similar event) vest only if a minimum price per share is achieved. For example, an entity might grant all its employees share options, the vesting of which is conditional upon a flotation or sale of the shares at a price of at least CU5 per share within five years, and the employee still being in employment at the time of the flotation or sale.

Taken alone, the requirement for a flotation or sale to occur is a non-market performance condition (see further below and in section 15.4.3 above). However, if a minimum market price has to be achieved, the question arises as to whether, in addition to the service requirement, such an award comprises:

- A single market condition (i.e., float or sell within five years at a share price of at least CU5)

  Or

- Two conditions:
  - A market condition (share price at time of flotation or sale of at least CU5)

    And
  - A non-market performance condition (flotation or sale achieved within five years)

The significance of this is the issue discussed in section 6.3 above, namely that an expense must always be recognised for all awards with a market condition, if all the non-market vesting conditions are satisfied, even if the market condition is not. In either case, however, there is a market condition which needs to be factored into the valuation of the award.

If the view is that 'flotation or sale at CU5 within five years' is a single market condition, the entity will recognise an expense for the award for all employees still in service at the end of the five-year period, since the sole non-market vesting condition (i.e., service) will have been met. Note that this assumes that the full five-year period is considered the most likely vesting period at grant date (see sections 6.3.4 and 15.4.2 above).

If, on the other hand, the view is that 'flotation or sale within five years' and 'flotation or sale share price CU5' are two separate conditions, and no flotation or sale occurs, no expense will be recognised since the performance element of the non-market vesting condition (i.e., 'flotation or sale within five years') has not been satisfied. However, even on this second analysis, if a sale or flotation is achieved at a price less than CU5, an expense must be recognised, even though the award does not truly vest, since the non-market condition (i.e., 'flotation or sale within five years' with its associated service requirement) will have been met.

How we see it

In our view, the appropriate analysis in the example above is to regard 'flotation or sale within five years' and 'flotation or sale share price CU5' as two separate conditions.

The example above assumes that there is a service condition equal in duration to the other conditions attached to the award and hence the analysis above only considers vesting conditions. If the fact pattern were such that there was no service condition, or a service condition that was of a shorter duration than the other conditions, then those conditions would need to be treated as non-vesting conditions rather than as performance vesting conditions (see sections 3.1 and 3.2 above and Illustration 15-7 above).

15.4.5 Awards 'purchased for fair value'

As noted in section 2.2.4.D above, entities that are contemplating a flotation or trade sale may invite employees to subscribe for shares (often a special class of share) for a relatively nominal amount. In the event of a flotation or trade sale occurring, these shares may be sold or will be redeemable at a substantial premium. It is often argued that the initial subscription price paid represents the fair value of the share at the time, given the inherent high uncertainty as to whether a flotation or trade sale will in fact occur.

The premium paid on the shares in the event of a flotation or trade sale will typically be calculated in part by reference to the price achieved. The question therefore arises as to whether such arrangements fall within the scope of IFRS 2. It might be argued for example that, as the employee paid full fair value for the arrangement at issue, there has been no share-based payment and, accordingly, the instrument must be accounted for under IAS 32 and IFRS 9.

How we see it

In our view, in order to determine whether the arrangement, or a portion thereof, falls within the scope of IFRS 2, it is necessary to consider whether the arrangement has features that would not be expected in 'normal' equity transactions - in particular, a requirement for the holder of the shares to remain in employment until flotation or sale and/or individual buyback arrangements. If this is the case, regardless of the amount subscribed, the terms suggest that the shares are being awarded in connection with, and in return for, employee services and hence that the arrangement is within the scope of IFRS 2. This means that, even if the share-based payment transaction has no material fair value once the subscription price has been taken into account (and therefore gives rise to no IFRS 2 expense), it will be necessary to make the disclosures required by IFRS 2.

Moreover, even if the amount paid by the employees can be demonstrated to be fair value for tax or other purposes, that amount would not necessarily constitute fair value under IFRS 2. Specifically, a 'true' fair value would take into account non-market vesting conditions (such as a requirement for the employee to remain in employment until flotation or a trade sale occurs). However, a valuation for IFRS 2 purposes would not take such conditions into account (see sections 5.5 and 6.2.1.A above) and would therefore typically be higher than the 'true' fair value.

Where the arrangement relates to a special class of share rather than ordinary equity shares, the underlying shares might well be classified as a liability rather than as equity under IAS 32. However, if the redemption amount to be settled is linked to the flotation price of the 'real' equity, the arrangement will be a cash-settled share-based payment transaction under IFRS 2 (see section 2.2.4.A above).

It is common in such situations for the cost of satisfying any obligations to the special shareholders to be borne by shareholders rather than by the entity itself. This raises a number of further issues, which are discussed in section 2.2.2.A above and in section 15.4.6 below.

The approach outlined in this section, i.e., that there will generally be no IFRS 2 share-based payment transaction expense to recognise when the counterparty subscribes for a share at fair value, is the approach most commonly applied in practice by entities applying IFRS accounting standards. In this type of arrangement, the subscription price, or market value if lower, is often refundable to employees who leave employment before the shares vest.

How we see it

Where the subscription price, or market value if lower, is refundable to employees who leave employment before the shares vest, the amounts paid by the counterparty for the shares are generally classified as a liability by the entity until such time as the shares finally vest (at which point the cash paid will be treated as the proceeds of issuing shares).

FASB differences

The above, is not the only approach seen in practice. US GAAP, for example, requires in certain circumstances the recognition of an expense (representing the amount potentially at risk) in cases where an employee subscribes for a share at fair value but risks forfeiting some, or all, of the price paid for that share, together with any subsequent increases in value, should he fail to fulfil the service condition.

How we see it

In our view, in the absence of specific guidance, the recognition of such an expense when applying US GAAP for the amount risked by the employee is not a requirement based on IFRS 2 as currently drafted.

15.4.6 'Drag along' and 'tag along' rights

An award might be structured to allow management of an entity to acquire a special class of equity at fair value (as in section 15.4.5 above), but (in contrast to section 15.4.5 above) with no redemption right on an exit event. However, rights are given:

- To any buyer of the 'normal' equity also to buy the special shares (sometimes called a 'drag along' right).
- To a holder of the special shares to require any buyer of the 'normal' equity also to buy the special shares (sometimes called a 'tag along' right).

Such schemes are particularly found in entities where the 'normal' equity is held by a provider of venture capital, which will generally be looking for an exit in the medium term.

It may well be that, under the scheme, the entity itself is required to facilitate the operation of the drag along or tag along rights, which may involve the entity collecting the proceeds from the buyer and passing them on to the holder of the special shares.

This raises the issue of whether such an arrangement is equity-settled or cash-settled. The fact that, in certain circumstances, the entity is required to deliver cash to the holder of a share suggests that the arrangement is an award requiring cash settlement in specific circumstances, the treatment of which is discussed in section 10.3 above.

However, if the terms of the award are such that the entity is obliged to pass on cash to the holder of the share only if, and to the extent that, proceeds are received from an external buyer, in our view, the arrangement may be economically no different to the broker settlement arrangements typically entered into by listed entities, as discussed in section 9.2.4 above. This could allow the arrangement to be regarded as equity-settled because the entity's only involvement as a principal is in the initial delivery of shares to employees, provided that consideration is given to all the factors (discussed in section 9.2.4 above) that could suggest that the scheme is more appropriately regarded as cash-settled.

In making such an assessment, care needs to be taken to ensure that the precise facts of the arrangement are considered. For example, a transaction where the entity has some discretion over the amount of proceeds attributable to each class of shareholder might indicate that it is inappropriate to treat the entity simply as an agent in the cash payment arrangement. It might also be relevant to consider the extent to which, under relevant local law, the proceeds received can be 'ring fenced' so as not to be available to settle other liabilities of the entity.

It is also the case that arrangements that result in employees obtaining similar amounts of cash can be interpreted very differently under IFRS 2 depending on how the arrangement is structured and whether, for example:

- The entity is required to pay its employees cash on an exit (having perhaps held shares itself via a trust and those shares having been subject to 'drag along' rights).

  Or

- The employees themselves have held the right to equity shares on a restricted basis with vesting - and 'drag along' rights - taking effect on a change of control and the employees receiving cash for their shares.

How we see it

For 'drag along' and 'tag along' rights, if for example, there is no discretion over the amount of proceeds attributable to each class of shareholder and the entity is obliged to pass on cash received from the external buyer to the holder of the shares, in our view, the arrangement is economically no different to the broker settlement arrangements typically entered into by listed entities, as discussed in section 9.2.4 above. This could allow the arrangement to be regarded as equity-settled as the entity's only involvement as principal is in the initial delivery of the shares.

The appropriate accounting treatment in such cases requires a significant amount of judgement based on the precise facts and circumstances.

15.5 South African black economic empowerment ('BEE') and similar arrangements

15.5.1 Economic empowerment arrangements

As part of general economic reforms in many developing countries (such as South Africa), national governments have put in place policies to address socio-economic inequalities. These arrangements encourage the economic empowerment of historically disadvantaged individuals and communities through various ownership schemes. Beneficiaries of these economic empowerment schemes, i.e., economic empowerment partners, may range from individuals, communities or employees. As a result of having empowered certain individuals, the reporting entity is often able to claim 'economic empowerment credentials', thus allowing the reporting entity greater business opportunities. While local regulation may stipulate the ownership thresholds, the way this is to be achieved is generally not stipulated. Therefore, it is important to note that the design of schemes will differ from jurisdiction to jurisdiction, and many schemes will change over time. Each scheme is unique in terms of the contractual relationships that it creates.

Generally, the way to achieve these regulation thresholds is by transferring share ownership of the entity through share ownership vehicles to targeted beneficiaries. This section focuses specifically on Black Economic Empowerment (BEE) transactions as they have been applied in South Africa which involves the transfer of equity instruments, or interests in equity instruments, to historically disadvantaged individuals. However, the principles can equally be applied in other economic empowerment schemes with similar structures.

These arrangements have raised a number of practical issues of interpretation which led to the scope of IFRS 2 being extended to include transactions where the consideration received appears less than the consideration given, as discussed further in section 2.2.2.C above.

15.5.2 Receipt of goods or services

As noted in section 2.2.2.C above, the goods or services received from economic empowerment partners or entities controlled by them in return for the equity instruments may, or may not, be specifically identifiable. This is elaborated on in the guidance issued by the South African Institute of Chartered Accountants (SAICA).[38]

The SAICA guide reaches the consensus that IFRS 2 applies to the accounting for BEE transactions where the fair value of cash and other assets received is less than the fair value of equity instruments granted to the economic empowerment partner, i.e., to the BEE credentials.

38 *SAICA Financial Reporting Guide 2 - Accounting for Black Economic Empowerment (BEE) Transactions*, Accounting Practices Committee (APC) of SAICA, December 2012.

Some have sought to argue that, in the context of South African BEE credentials, these result in the recognition of an intangible asset rather than an expense. In order to be recognised as an asset, an entity must have control over the resource as a result of a past event. Paragraphs 13 and 16 of IAS 38 *Intangible Assets* indicate that control over an intangible asset may be evidenced in two ways:

- As legal rights that are enforceable by law

  Or

- As exchange transactions for the same or similar non-contractual customer relationships

In South African BEE transactions, a contract is usually entered into with an economic empowerment partner that may include a contractual lock-in period or a clause that only allows the transfer of such equity instruments to another economic empowerment partner, usually with the lock-in provision also transferred to the buyer. However, the contract does not provide the entity with legal rights that give it the power to obtain the future economic benefits arising from the economic empowerment transaction, nor the ability to restrict the access of others to those benefits. Therefore, economic empowerment credentials do not qualify for recognition of intangible assets and the difference between the fair value of the award and the consideration received is expensed.

How we see it

Economic empowerment credentials do not generally qualify for recognition of intangible assets and the difference between the fair value of the award and the consideration received is expensed.

This is consistent with guidance issued by SAICA in respect of South African BEE credentials. A similar thought process could be necessary in other jurisdictions where local standard setters have not opined on whether a recognisable intangible asset has been created, or not. Although these credentials could create competitive advantages for entities, they will often fail the recognition criteria of IAS 38. This is due to the absence of legal rights that give an entity power to obtain the future economic benefits arising from the economic empowerment transaction and an inability to restrict the access of others to those benefits i.e., an entity is typically unable to demonstrate control over the economic empowerment credentials.

15.5.3 The substance of equity instruments issued as part of the economic empowerment transactions

Economic empowerment deals are typically complex, and their specific structures and terms can vary considerably. All terms and conditions must be carefully analysed when determining the type of equity instruments granted and whether such instruments fall within the scope of IFRS 2.

However, in practice they do exhibit certain features with some regularity, as discussed below. Typically, economic empowerment arrangements have involved the transfer of equity instruments to:

- Empowerment companies controlled by economic empowerment qualifying individuals
- Economic empowerment qualifying employees of the reporting entity

  Or

- Beneficiaries in the economic empowerment qualifying communities in which the entity operates

The arrangements generally lock the parties in for a minimum specified period and if they want to withdraw, they are restricted to selling their interest only to others with similar qualifying economic empowerment credentials with the buyer's consent, usually with the lock-in provision also transferred to the buyer.

The premise of economic empowerment transactions is to transfer ordinary shares in an entity to the empowerment partner. The equity interest, together with the voting rights, allows for the empowerment partner to participate in the economic decisions made by the entity as would any other shareholder. However, the structure of the transaction and the rights attached of the shares need to be considered carefully to understand what risks and rewards the empowerment partner is exposed to.

Where the reporting entity facilitates the transaction and assists the economic empowerment partner by providing notional funding or non-recourse loans, these factors would need to be appropriately considered in the accounting for such schemes. Accordingly, where the financing provided by the entity to obtain the shares is non-recourse in nature, the arrangement is equivalent to a share option provided (see section 15.2 above) and it would be appropriate to account for it as such.

Another example of facilitating economic empowerment transactions involves the creation of a trust, with the economic empowerment partner holding beneficial rights in the trust, which in turn holds equity instruments of the reporting entity (or a member of its group). The awards made by the trust to the economic empowerment partner may be in the form of:

- The equity instruments originally transferred to the trust
- Units in the trust itself, usually with a value linked to the value of the equity instruments of the reporting entity originally transferred to the trust

  Or
- Payments made from the proceeds (dividends received, sale of equity instruments etc.) that the trust generates

The accounting issues arising from such schemes include:

- The nature of the trust and whether it meets the criteria for consolidation by the reporting entity. The consequence of the consolidation assessment is important when determining the impact of the transaction in the group accounts. For example, where the trust is not consolidated, the transfer of equity instruments to the trust crystallises an IFRS 2 charge on transfer, to the extent that the consideration paid is less than the fair value of shares issued. However, if the trust is consolidated, the receipt of equity instruments from the reporting entity to the trust is an intra-group transaction and therefore does not give rise to a charge under IFRS 2 in the group consolidated financial statements. The equity instruments held by the trust are instead treated as treasury shares in the group.
- Where the trust is an employee share trust, determining the nature of any distributions made to the employees, could be another issue that arises. For instance, where employees are entitled to receive equity shares in the entity (through the employee trust) or an amount derived from the value of the entity's share, IFRS 2 will be applicable. In other cases, where employees receive a *pro rata* payment based on the amount of cash available in the employee trust, the distribution needs to be analysed as to whether this constitutes a cash-settled share-based payment or a payment that could be within the scope of IAS 19. See section 5.3.6 above, for guidance on awards over a fixed pool of shares (including 'last man standing' arrangements) and section 12.3 above for the accounting of employee benefit trusts ('EBT's) and similar arrangements.
- Whether there is an impact on non-controlling interest. IFRS accounting standards does not provide specific guidance on the recognition and measurement of non-controlling interest arising from such transactions. How to account for non-controlling interest will be largely driven by the substance of the transaction and whether the economic empowerment partner (i.e., the non-controlling interest) has a 'present access to ownership benefits' as a result of a contractual arrangement (see Chapter 8).
- Whether any charge arises under IFRS 2 and, if so, the grant date and therefore, under a grant date model, the amount of the charge.
- Whether awards are equity-settled or cash-settled.

A third example of facilitating an economic empowerment transaction, which is often used when making equity awards to a community, is to make use of a trust as the operating vehicle and appoint trustees to make the awards. These schemes are similar to those above as it provides for a transfer of shares to the trust together with any associated financing. To this end, whether the trust meets the criteria for consolidation must also be considered. Typically, dividends received by the trust are first applied to servicing the financing and the residual is then awarded to the community by the trustees. Often these trusts are perpetual in nature and contain restrictions to prevent the disposal of any of the shares it holds in the entity. When considering the returns received by the community as the empowerment partner, it is clear that they participate in, or part of, the discretionary dividends paid by the entity to the trust. However, the restrictions placed on disposing the shares prevent any capital gain or loss exposure to the empowerment partner. In substance, this is similar to a discretionary annual community social investment being made by the entity to the community, together with the necessary voting rights being exercised by the trustees on behalf of the community. The substance of the transaction is such that the trust is entitled to a dividend stream in respect of the shares held in the trust. Careful consideration needs to be given to the rights of the empowerment parties, where the trust does not have the rights to dispose of the shares.

How we see it

Before one can apply IFRS 2, understanding the substance of the transaction is critical to assess the appropriate accounting thereof. This would involve an analysis of the rights and restrictions attached to the shares issued to the empowerment beneficiary, the funding provided and an analysis of the substance of the transaction in accounting for the arrangement by the entity. This could be different to the legal form that is employed by the entity to achieve its empowerment status.

15.6 Shares used as a currency of payment

Settlement of share-based payment arrangements can take many forms, and in some instances the market value of shares is used as currency to settle the share-based payment transaction. IFRS 2 contains little guidance on how to measure such arrangements. Awards of equity instruments to a fixed monetary value, as discussed above in section 8.10, is one example where the market value of the equity instrument at vesting date is used as a currency to settle an award to a fixed value. An award issued to employees of a subsidiary or business unit which is settled by reference to the fair value of shares in another group entity is another example where the market value of shares is used as a currency to settle the share-based payment transaction (see discussion below).

15.6.1 Awards assessed on the market value of a subsidiary or business unit and settled by reference to the fair value of shares in the parent entity

Some entities implement share-based remuneration schemes which aim to reward employees by reference to the 'market' value of the equity of the business unit for which they work as long as service conditions are met. This could arise where the Group considers the parent's share price to be a somewhat blunt instrument for measuring the performance of the employees of a particular subsidiary or business unit. Indeed, it is not difficult to imagine situations in which a particular subsidiary might perform well but the parent's share price might be dragged down by other factors, or conversely where the parent's share price might rise notwithstanding poor results for that subsidiary. The detail of such schemes varies, but they generally take the form as follows:

- At grant date, the employee is awarded a (real or notional) holding in the equity of the employing subsidiary, the market value of which is measured at grant date and the listed parent will convert the market value of those subsidiary shares at vesting date, into equal value of parent shares to settle the award (scenario 1).

  Or

- The employee is granted an award of as many shares of the listed parent as have a value, at a specified future date (often at, or shortly after, the end of the vesting period but sometimes at a later date), equal to the increase over the vesting period in the market value of the employee's (notional) holding in the equity of the employing subsidiary, otherwise known as share-settled share appreciation rights (akin to an option granted to the employee that is settled in the parent's shares) (scenario 2).

In the two scenarios above, the parent's shares are used as a currency to settle an arrangement with the subsidiary employees that is not dependent on the parent's share price. The share price of the parent's shares is used to determine the number of parent shares that will be issued on settlement. Put another away, the parent's share price (either at grant date or subsequently) does not affect the measurement of the award (see section 8.10 above).

After grant date, IFRS 2 requires remeasurement of an equity-settled share-based payment transaction only for changes in the service condition being met and other non-market vesting conditions. There is no remeasurement after grant date for market conditions and non-vesting conditions. Therefore, an important feature in accounting for the awards in the scenarios outlined above is to assess, whether the basis on which the subsidiary's equity is valued truly yields a market price (or value) to determine the type of performance conditions attached to the awards.

If the basis on which the subsidiary's equity is valued yields a 'market value', the awards in the two scenarios are considered as containing only a service condition, and those awards would not be considered as containing a non-market vesting condition or market condition (there is no specific target share price to be achieved). The awards are measured at grant date using valuation inputs related to the subsidiary's share price and are not remeasured. The fair value at vesting date is used as a conversion feature to determine the number of parent shares to be received as an exit mechanism, and the employee is receiving 'value for value'. The expense recognised is only adjusted for the failure to meet vesting conditions other than market conditions (e.g., service conditions).

If the 'market value' of the subsidiary is based on a constant formula (e.g., an EBITDA multiple), an assessment is required whether that formula provides a good surrogate for the market value of the subsidiary on an ongoing basis (see section 2.2.4.F above). If deemed not to provide a good surrogate for the market value, the awards outlined in the scenarios above could then be considered as containing a non-market vesting condition as the constant formula used by the subsidiary will result in variable number of shares that will vest based on the performance of that entity (see section 3.1 above). This would then result in an expense recognised that is revised at each reporting date consistent with the accounting for non-market vesting conditions. If the formula used to determine the number of parent's shares to be delivered can be determined sometime after the employee has satisfied the service vesting condition, then that formula driven condition would be treated as a non-vesting condition (see section 3.2 above). In contrast to the approach used to measure the non-market vesting condition, the non-vesting condition is taken into account in estimating the fair value of the award granted and not subsequently remeasured. The expense recognised is only adjusted for the failure to meet vesting conditions other than market conditions (e.g., service conditions).

How we see it

As noted above, where the parent's shares are used as a currency to settle a share-based payment arrangement with subsidiary employees based on the subsidiary equity instrument value in the scenarios above, the measurement of the award is not affected by the parent's share price. The arrangement is not dependent on the parent's share price.

However, an important feature in accounting for the awards in the scenarios outlined above is to assess whether the basis on which the subsidiary's equity is valued truly yields a market price (or value) to determine the type of performance conditions attached to the awards and whether the awards contain non-vesting conditions.

16 First-time adoption and transitional provisions

16.1 First-time adoption provisions

The requirements of IFRS 1 *First-time Adoption of International Financial Reporting Standards*, in relation to share-based payment arrangements are discussed in Chapter 6 at section 5.3. However, one provision may remain relevant for entities that have already adopted IFRS accounting standards and would no longer generally be considered 'first-time adopters'.

IFRS 1 does not require an entity to account for equity-settled transactions:

- Granted on or before 7 November 2002

  Or

- Granted after 7 November 2002 but vested before the later of the date of transition to IFRS accounting standards and 1 January 2005

However, where such an award is modified, cancelled or settled, the rules regarding modification, cancellation and settlement (see section 7 above) apply in full unless the modification occurred before the date of transition to IFRS accounting standards. *[IFRS 1.D2]*. The intention of this provision is to prevent an entity from avoiding the recognition of a cost for a new award by structuring it as a modification to an earlier award not in the scope of IFRS 2.

There is slight ambiguity on this point in the wording of IFRS 1, paragraph D2 of which refers only to the modification of such awards. However, paragraph D2 also requires an entity to apply 'paragraphs 26-29' of IFRS 2 to 'modified' awards.

How we see it

Paragraphs 26-29 of IFRS 2 deal not only with modification but also with cancellation and settlement, and indeed paragraphs 28 and 29 are not relevant to modification at all. This makes it clear, in our view, that the IASB intended IFRS 1 to be applied not only to the modification but also to the cancellation and settlement of such awards.

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Appendix B - Defined terms

Extract from IFRS 2

Appendix A
Defined terms

This appendix is an integral part of the IFRS.

cash-settled share-based payment transaction	A **share-based payment transaction** in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services for amounts that are based on the price (or value) of **equity instruments** (including shares or **share options**) of the entity or another group entity.
employees and others providing similar services	Individuals who render personal services to the entity and either (a) the individuals are regarded as employees for legal or tax purposes, (b) the individuals work for the entity under its direction in the same way as individuals who are regarded as employees for legal or tax purposes, or (c) the services rendered are similar to those rendered by employees. For example, the term encompasses all management personnel, ie those persons having authority and responsibility for planning, directing and controlling the activities of the entity, including non-executive directors.
equity instrument	A contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.[5]
equity instrument granted	The right (conditional or unconditional) to an **equity instrument** of the entity conferred by the entity on another party, under a **share-based payment arrangement**.
equity-settled share-based payment transaction	**A share-based payment transaction** in which the entity (a) receives goods or services as consideration for its own **equity instruments** (including shares or **share options**), or (b) receives goods or services but has no obligation to settle the transaction with the supplier.
fair value	The amount for which an asset could be exchanged, a liability settled, or an **equity instrument granted** could be exchanged, between knowledgeable, willing parties in an arm's length transaction.
grant date	The date at which the entity and another party (including an employee) agree to a **share-based payment arrangement**, being when the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the counterparty the right to cash, other assets, or **equity instruments** of the entity, provided the specified **vesting conditions**, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained.
intrinsic value	The difference between the **fair value** of the shares to which the counterparty has the (conditional or unconditional) right to subscribe or which it has the right to receive, and the price (if any) the counterparty is (or will be) required to pay for those shares. For example, a **share option** with an exercise price of CU15,[6] on a share with a fair value of CU20, has an intrinsic value of CU5.

market condition	A **performance condition** upon which the exercise price, vesting or exercisability of an **equity instrument** depends that is related to the market price (or value) of the entity's **equity instruments** (or the equity instruments of another entity in the same group), such as: (a) attaining a specified share price or a specified amount of **intrinsic value** of a **share option**; or (b) achieving a specified target that is based on the market price (or value) of the entity's **equity instruments** (or the equity instruments of another entity in the same group) relative to an index of market prices of **equity instruments** of other entities. A market condition requires the counterparty to complete a specified period of service (ie a **service condition**); the service requirement can be explicit or implicit.
measurement date	The date at which the **fair value** of the **equity instruments granted** is measured for the purposes of this IFRS. For transactions with **employees and others providing similar services**, the measurement date is **grant date**. For transactions with parties other than employees (and those providing similar services), the measurement date is the date the entity obtains the goods or the counterparty renders service.
performance condition	A **vesting condition** that requires: (a) the counterparty to complete a specified period of service (ie a **service condition**); the service requirement can be explicit or implicit; and (b) specified performance target(s) to be met while the counterparty is rendering the service required in (a). The period of achieving the performance target(s): (a) shall not extend beyond the end of the service period; and (b) may start before the service period on the condition that the commencement date of the performance target is not substantially before the commencement of the service period. A performance target is defined by reference to: (a) the entity's own operations (or activities) or the operations or activities of another entity in the same group (ie a non-market condition); or (b) the price (or value) of the entity's **equity instruments** or the equity instruments of another entity in the same group (including shares and **share options**) (ie a **market condition**). A performance target might relate either to the performance of the entity as a whole or to some part of the entity (or part of the group), such as a division or an individual employee.
reload feature	A feature that provides for an automatic grant of additional **share options** whenever the option holder exercises previously granted options using the entity's shares, rather than cash, to satisfy the exercise price.
reload option	A new **share option** granted when a share is used to satisfy the exercise price of a previous share option.
service condition	A **vesting condition** that requires the counterparty to complete a specified period of service during which services are provided to the entity. If the counterparty, regardless of the reason, ceases to provide service during the **vesting period**, it has failed to satisfy the condition. A service condition does not require a performance target to be met.

share-based payment arrangement	An agreement between the entity (or another group[7] entity or any shareholder of any group entity) and another party (including an employee) that entitles the other party to receive (a) cash or other assets of the entity for amounts that are based on the price (or value) of **equity instruments** (including shares or **share options**) of the entity or another group entity, or (b) **equity instruments** (including shares or **share options**) of the entity or another group entity, provided the specified **vesting conditions**, if any, are met.
share-based payment transaction	A transaction in which the entity (a) receives goods or services from the supplier of those goods or services (including an employee) in a **share-based payment arrangement**, or (b) incurs an obligation to settle the transaction with the supplier in a **share-based payment arrangement** when another group entity receives those goods or services.
share option	A contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed or determinable price for a specified period of time.
vest	To become an entitlement. Under a **share-based payment arrangement**, a counterparty's right to receive cash, other assets or **equity instruments** of the entity vests when the counterparty's entitlement is no longer conditional on the satisfaction of any **vesting conditions**.
vesting condition	A condition that determines whether the entity receives the services that entitle the counterparty to receive cash, other assets or **equity instruments** of the entity, under a **share-based payment arrangement**. A vesting condition is either a **service condition** or a **performance condition**.
vesting period	The period during which all the specified **vesting conditions** of a **share-based payment arrangement** are to be satisfied.

5 The *Conceptual Framework for Financial Reporting* issued in 2018 defines a liability as a present obligation of the entity to transfer an economic resource as a result of past events.

6 In this appendix, monetary amounts are denominated in 'currency units (CU)'.

7 A 'group' is defined in Appendix A of IFRS 10 *Consolidated Financial Statements* as 'a parent and its subsidiaries' from the perspective of the reporting entity's ultimate parent.

Chapter 31 Employee benefits

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Overview

Employee benefits typically form a very significant part of any entity's costs and can take many and varied forms. Accordingly, IFRS devotes considerable attention to them in two separate standards IFRS 2 *Share-based Payment* and IAS 19 *Employee Benefits*. IFRS 2 is discussed in Chapter 30. All other employee benefits are dealt with in IAS 19.

IAS 19 prescribes the accounting and disclosure for employee benefits, requiring a liability to be recognised as services are provided in exchange for employee benefits to be paid in the future and an expense when the entity consumes the economic benefit arising from these services. It addresses all forms of consideration (other than share-based payments) which are given by an employer in exchange for services rendered or on termination of employment. These include short-term employee benefits, long-term employee benefits, post-employment benefits and termination benefits.

Many issues raised in accounting for employee benefits can be straightforward, such as the allocation of wages paid to an accounting period and are generally dealt with by IAS 19 accordingly. In contrast, accounting for the costs of post-employment and other long-term benefits in the financial statements of employers presents a more difficult challenge. The amounts involved are large, the timescale is long, the estimation process is complex and involves many areas of uncertainty which have to be made the subject of assumptions. Furthermore, the complexities for an IFRS accounting standard are multiplied by the wide variety of arrangements found in different jurisdictions.

Although the standard does not prescribe a step-by-step approach, as seen in other standards, the following approach is recommended:

(1) Identify all employee benefits to ensure that none are overlooked and as a consequence remain unaccounted for.

(2) Employee benefits must then be classified into the different categories proposed by the standard, such as short-term benefits, other long-term benefits, termination benefits, defined contribution plans and defined benefit plans.

(3) All terms and conditions of the arrangement need to be considered, which could also include local laws and regulations or a constructive obligation beyond the formal terms of the plan.

(4) Internal control process will be needed to develop the estimates required and review the results of actuarial computations.

(5) Relevant disclosures will need to be determined, applying the materiality principle as appropriate.

What you need to know

- Classification of arrangements might require judgement and the classification could have a significant impact on the resultant accounting.
- The application of IAS 19 can be complicated and require significant estimates to be made annually or at interim reporting dates over many years. See section 7 below.
- Judgements might need to be made around various requirements of the standard, such as the date of modification or settlement of a plan.
- There can be significant assets or liabilities which need to be recognised on the statements of financial position from the recognition of defined benefit pension deficits or surpluses, and these might be very volatile.
- IFRIC 14 *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* might result in the restriction of surpluses or the recognition of additional liabilities. See section 8.2 below.
- Complexities arise due to the wide variety of arrangements and laws found in different jurisdictions.

1 Introduction

This chapter deals with IAS 19 as published in June 2011 and most recently amended in February 2018. The chapter also deals with IFRIC 14 which was published in July 2007 and subsequently amended in November 2009 to address prepayments of future minimum funding requirement contributions.

2 Objective and scope of IAS 19

2.1 Objective

IAS 19 sets out its objective as follows: *[IAS 19.1]*

Extract from IAS 19

Objective

1 The objective of this Standard is to prescribe the accounting and disclosure for employee benefits. The Standard requires an entity to recognise:

(a) a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and

(b) an expense when the entity consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

This provides the overarching principle of the standard. Driven by the focus on assets and liabilities in the IASB's *Conceptual Framework* (which is discussed in Chapter 2), it approaches the issues from the perspective of the statement of financial position of the entity. By accounting for the cost of providing employee benefits from the perspective of the employer, rather than from that of the employee, there are possible accounting consequences. For example, the timing of a settlement will be from the perspective of the employer.

2.2 Scope

The general scope of the standard is dealt with in section 2.2.1 below. The issue of employee benefits settled not by the employing entity but by a shareholder or other member of a group is discussed in section 2.2.2 below. As discussed in section 11.2 of Chapter 10, contingent payments to selling shareholders in a business combination may be accounted for as remuneration dependent on the nature of the arrangement. Where accounted for as remuneration they will fall under the scope of IAS 19 (or IFRS 2 if they represent a share-based payment transaction).

2.2.1 General scope requirements of IAS 19

As its name suggests, IAS 19 is not confined to pensions and other post-retirement benefits, but rather addresses all forms of consideration (apart from share-based payments which are dealt with by IFRS 2 and discussed in Chapter 30) given by an employer in exchange for service rendered by employees or for the termination of employment. *[IAS 19.2, IAS 19.8]*. In particular, in addition to post-retirement employee benefits it includes: *[IAS 19.5]*

(a) Short-term benefits, including wages and salaries, paid annual leave, bonuses, benefits in kind, etc. The accounting treatment of these is discussed in section 12 below.

(b) Other long-term benefits, such as long-service leave, long-term disability benefits, long-term bonuses, etc. These are to be accounted for in a similar, but not identical, way to post-retirement benefits by using actuarial techniques and are discussed in section 13 below.

And

(c) Termination benefits. These are to be provided for and expensed when the employer becomes committed to the redundancy plan, on a similar basis to that required by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* for provisions generally, and are discussed in section 14 below.

The standard addresses only the accounting by employers and excludes from its scope reporting by employee benefit plans themselves. These are dealt with in IAS 26 *Accounting and Reporting by Retirement Benefit Plans*. *[IAS 19.3]*. The specialist nature of these requirements puts them beyond the scope of this book.

The standard makes clear it applies widely and in particular to benefits:

(a) Provided to all employees (whether full-time, part-time, permanent, temporary or casual staff and specifically including directors and other management personnel). *[IAS 19.7]*.

(b) However settled, including payments in cash or goods or services, whether paid directly to employees, their spouses, children or other dependants or any other party (such as insurance companies). *[IAS 19.6]*.

And

(c) However provided, including:

(i) Under formal plans or other formal agreements between an entity and individual employees, groups of employees or their representatives.

(ii) Under legislative requirements, or through industry arrangements, whereby entities are required to contribute to national, state, industry or other multi-employer plans.

Or

(iii) By those informal practices that give rise to a constructive obligation, that is where the entity has no realistic alternative but to pay employee benefits. An example of a constructive obligation is where a change in the entity's informal practices would cause unacceptable damage to its relationship with employees. *[IAS 19.4]*.

The standard does not define the term 'employee'. However, it is clear from the reference in (a) above to 'full-time, part-time, permanent, casual or temporary' staff and specifically including directors and other management personnel that the term is intended to apply widely. In particular, it is not necessary for there to be a contract of employment in order for an individual to be considered an employee for IAS 19 purposes, other indicators must also be considered such as:

- The individual is considered an employee for tax purposes.
- Services must be performed by a particular individual who has no discretion to arrange for someone else to perform them.
- Services must be performed at a location specified by the entity.
- There is a large amount of oversight and direction by the entity.
- Necessary tools, equipment and materials are provided by the entity.
- Individuals are paid on a time basis, rather than a project/fixed price basis.

  And
- Individuals receive benefits of a nature typical for employees (e.g., paid holidays, paid sick leave, post-retirement benefits, or death and disability benefits).

How we see it

Although the standard does not define the term 'employee' we believe it applies to anyone who is in substance an employee which will be a matter of judgement in light of all the facts and circumstances.

Careful consideration is required to determine which standard applies in specific circumstances, and it is possible that a single arrangement could have elements of both an employee benefit and a share-based payment. An example of benefits which could be under the scope of either IAS 19 or IFRS 2 includes a cash bonus dependent on share performance (see Chapter 30 at section 2.2.4.E). Cash settled awards based on an entity's enterprise value would be under the scope of IAS 19 if the enterprise value used in the calculation did not represent the fair value of the entity's equity instruments (see Chapter 30 at section 2.2.4.F). Cash bonuses could also be within the scope of both IAS 19 and IFRS 2 if they require a mandatory investment of part of the bonus into shares (see Chapter 30 at section 15.1). The cash element paid would fall within the scope of IAS 19, whereas any bonus which results in a required or discretionary investment in shares would come under the scope of IFRS 2. Each element of a bonus would be under the scope of one of these standards, but not both standards.

2.2.2 Employee benefits settled by a shareholder or another group entity

In some circumstances, employee benefits could be settled by a party other than the entity to which services were rendered by employees. Examples would include a shareholder or another entity in a group of entities under common control.

Except for accounting for defined benefit plans under common control IAS 19 is silent on whether, and if so how, an entity receiving employee services in this way must account for them. IFRS 2, on the other hand, devotes quite some detail to this topic for employee services within its scope.

An entity could make reference to the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (discussed in Chapter 3 at section 4.3) when deciding on an accounting policy under IAS 19.

How we see it

Accordingly, in developing an accounting policy the provisions of IFRS 2 could be applied by analogy to transactions within the scope of IAS 19. That accounting policy should be applied consistently to similar transactions.

The relevant requirements of IFRS 2 are discussed in Chapter 30 at sections 2.2.2.A and 12.

3 Pensions and other post-employment benefits - Defined contribution and defined benefit plans

3.1 The distinction between defined contribution plans and defined benefit plans

IAS 19 draws an important distinction between defined contribution plans and defined benefit plans. The determination is made based on the economic substance of the plan as derived from its principal terms and conditions. *[IAS 19.27]*. The approach it takes is to define defined contribution plans, with the defined benefit plans being the default category. The relevant terms defined by the standard are as follows: *[IAS 19.8]*

Extract from IAS 19

8 **The following terms are used in this Standard with the meanings specified:**

...

Post-employment benefits **are employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment.**

Post-employment benefit plans **are formal or informal arrangements under which an entity provides post-employment benefits for one or more employees.**

Defined contribution plans **are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.**

Defined benefit plans **are post-employment benefit plans other than defined contribution plans.**

...

IAS 19 applies to all post-employment benefits (whether or not they involve the establishment of a separate entity to receive contributions and pay benefits) which include, for example, retirement benefits such as pensions, and post-employment life assurance or medical care. *[IAS 19.26]*. A less common benefit is the provision of services.

Under defined benefit plans the employer's obligation is not limited to the amount that it agrees to contribute to the fund. Rather, the employer is obliged (legally or constructively) to provide the agreed benefits to current and former employees. Examples of defined benefit schemes given by IAS 19 are: *[IAS 19.29]*

(a) Plans where the benefit formula is not linked solely to the amount of contributions and requires the entity to provide further contributions if assets are insufficient to meet the benefits in the plan formula.

(b) Guarantees, either directly or indirectly through a plan, of a specified return on contributions.

And

(c) Those informal practices that give rise to a constructive obligation, such as a history of increasing benefits for former employees to keep pace with inflation even where there is no legal obligation to do so.

The most significant difference between defined contribution and defined benefit plans is that, under defined benefit plans, some actuarial risk or investment risk (or both) falls, in substance, on the employer. This means that if actuarial or investment experience is worse than expected, the employer's obligation may be increased. *[IAS 19.30]*. Consequently, because the employer is in substance underwriting the actuarial and investment risks associated with the plan, the expense recognised for a defined benefit plan is not necessarily the amount of the contribution due for the period. *[IAS 19.56]*. Conversely, under defined contribution plans the benefits received by the employee are determined by the amount of contributions paid (either by the employer, the employee or both) to the benefit plan or insurance company, together with investment returns, and hence actuarial and investment risk fall in substance on the employee. *[IAS 19.28]*.

In 2019 the IFRS IC received a request concerning the classification of a post-employment benefit plan that is administered by a third party. The only relevant terms and conditions in the request were that:

- The entity has an obligation to pay fixed annual contributions into the plan. The entity has determined that it will have no legal or constructive obligation to pay further contributions into the plan if it does not hold sufficient assets to pay all employee benefits relating to employee service in current and prior periods.

  And

- The entity is entitled to a potential discount on its annual contributions if the ratio of plan assets to plan liabilities exceeds a set level.

The IFRS IC was asked to consider whether the existence of a right to a potential discount would result in classification as a defined benefit plan under IAS 19. The IFRS IC concluded that based on the fact pattern provided in the request the existence of a right to a potential discount would not in itself result in the classification as a defined benefit plan. However, they re-iterated the importance of assessing all the relevant terms and conditions of a plan, as well as any informal practices that might give rise to a constructive obligation, in the classification of a plan. The IFRS IC also concluded that the requirements of IAS 19 provide an adequate basis for an entity to determine the classification of a post-employment benefit plan as a defined contribution plan or a defined benefit plan and decided not to add this matter to its standard-setting agenda.[1]

The IFRS IC reached this conclusion through consideration of the definition of a defined contribution plan, which requires:

- Contributions to be fixed with no further legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits. *[IAS 19.8]*.
- That this does not exclude the upside potential where the cost to the entity could be less than expected. *[IAS 19.BC29]*.

  And
- The fact that in a defined contribution scheme the actuarial risk falls in substance on the employee. *[IAS 19.28, IAS 19.30]*.

The classification of plans such as those described in the fact pattern submitted will require careful consideration of all the facts and circumstances to determine whether actuarial risk has remained with the employer and a defined benefit classification is appropriate. An entity must also consider whether any significant judgements made in this determination must be disclosed in accordance with IAS 1 *Presentation of Financial Statements*. *[IAS 1.122]*.

3.2 Insured benefits

One factor that can complicate making the distinction between defined benefit and defined contribution plans is the use of external insurers. IAS 19 recognises that some employers could fund their post-employment benefit plans by paying insurance premiums and observes that the benefits insured need not have a direct or automatic relationship with the entity's obligation for employee benefits. However, it makes clear that post-employment benefit plans involving insurance contracts are subject to the same distinction between accounting and funding as other funded plans. *[IAS 19.47]*.

Where insurance premiums are paid to fund post-employment benefits, the employer must treat the plan as a defined contribution plan unless it has (either directly or indirectly through the plan) a legal or constructive obligation to:

(a) Pay the employee benefits directly when they fall due.

  Or

(b) Pay further amounts if the insurer does not pay all future employee benefits relating to employee service in the current and prior periods.

If the employer has retained such a legal or constructive obligation it must treat the plan as a defined benefit plan. *[IAS 19.46]*. In setting out how to apply defined benefit accounting, however, the standard refers to slightly different criteria to determine whether a legal or constructive obligation is retained. Rather than referring to 'either directly or indirectly through the plan', IAS 19.48 refers to "the entity (either directly, indirectly through the plan, *through the mechanism for setting future premiums or through a related party relationship with the insurer*) retains a legal or constructive obligation" (emphasis added). *[IAS 19.48]*.

How we see it

Our view is that the additional text "through the mechanism for setting future premiums or through a related party relationship with the insurer" in IAS 19.48 must be applied to IAS 19.46, further clarifying the situations in which insured benefits must be treated as defined benefit plans.

In cases where such obligations are retained by the employer, it recognises its rights under a 'qualifying insurance policy' as a plan asset and recognises other insurance policies as reimbursement rights. *[IAS 19.48]*. Plan assets are discussed in section 6 below.

1 *IFRIC Update*, June 2019, available on the IFRS Foundation's website.

By way of final clarification, the standard notes that where an insurance policy is in the name of a specified plan participant or a group of plan participants and the employer does not have any legal or constructive obligation to cover any loss on the policy, the employer has no obligation to pay benefits to the employees and the insurer has sole responsibility for paying the benefits. In that case, the payment of fixed premiums under such contracts is, in substance, the settlement of the employee benefit obligation, rather than an investment to meet the obligation. Consequently, the employer no longer has an asset or a liability. Accordingly, it must treat the payments as contributions to a defined contribution plan. *[IAS 19.49]*. The important point here is that employee entitlements will be of a defined benefit nature unless the employer has no obligation whatsoever to pay them were insurance to fail or otherwise be insufficient.

The analysis of insured plans given in the standard, which is described above, along with the definition of defined benefit and defined contribution plans seems comprehensive at first glance. However, there will be circumstances where the distinction might not be so apparent and careful analysis could be required. For example, it is possible that an employer buys insurance on a regular basis (say annually), retaining no further obligation in respect of the benefits insured, but has an obligation (legal or constructive) to keep doing so in the future. In such a scenario, the employer could be exposed to future actuarial variances reflected in a variable cost of purchasing the required insurance in future years (for example, due to changing mortality estimates by the insurer).

Another scenario would be where each year the employee earns an entitlement to a pension of (say) 2% of that year's salary (i.e., current as opposed to final) and the employer purchases each year an annuity contract to commence on the date of retirement.

In our view, the standard is not entirely clear as to the nature of such an arrangement.

On the one hand, it could be argued that it is a defined contribution plan because the definition of defined contribution plans is met when:

- 'Fixed' payments are paid to a separate fund.

  And

- The employer is not obliged to pay further amounts if the fund has insufficient assets to pay the benefits relating to employee service in the current and prior periods.

Further, as noted above the standard considers the payment of 'fixed' premiums to purchase insurance specific to an employee (or group thereof) with no retention of risk in respect of the insured benefits to be a defined contribution arrangement.

On the other hand, it could be argued that this is a defined benefit plan on the grounds that:

- The premiums of future years are not 'fixed' in any meaningful sense (certainly not in the same way as an intention simply to pay a one-off contribution of a given % of salary).
- The standard acknowledges that one factor that can mean insured arrangements are defined benefit in nature is when the employer retains an obligation indirectly through the mechanism for setting future premiums. *[IAS 19.48]*.

  And

- The standard observes that under defined benefit plans "… actuarial risk (that benefits will cost more than expected) and investment risk fall, in substance, on the entity. If actuarial or investment experience are worse than expected, the entity's obligation may be increased". *[IAS 19.30]*.

Much would seem to depend on just what 'fixed' means in such circumstances.

How we see it

Where an employer buys insurance to fund post-employment benefits on a regular basis (say annually) retaining no further obligation in respect of the benefits insured, but has an obligation (legal or constructive) to keep doing so in the future, the employer could be exposed to future actuarial variances reflected in a variable cost of purchasing the required insurance in future years.

Although not expressly addressed by the standard, in our view such arrangements will very likely be defined benefit in nature, albeit with regular (and perhaps only partial) settlement and, if so, must be accounted for as such. This is because the employer has retained actuarial risks by committing to pay whatever it takes in future years to secure the requisite insurance.

See section 3.1 above for further discussion on 'fixed' contributions. Naturally, for any schemes that are determined to be defined benefit plans, the next step would be to see whether the frequent settlement renders the output of the two accounting models materially the same. That would depend, *inter alia*, on the attribution of the benefit to years of service and the impact of an unwinding discount.

The wide variety of possible arrangements in practice mean that careful consideration of individual circumstances will be required to determine the true substance of such arrangements.

3.3 Multi-employer plans

3.3.1 Multi-employer plans other than plans sharing risks between entities under common control

3.3.1.A The treatment of multi-employer plans

Multi-employer plans, other than state plans (see section 3.4 below), under IAS 19 are defined contribution plans or defined benefit plans that:

(a) Pool assets contributed by various entities that are not under common control.

And

(b) Use those assets to provide benefits to employees of more than one entity, on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employs the employees. *[IAS 19.8]*.

Accordingly, they exclude group administration plans, which simply pool the assets of more than one employer, for investment purposes and the reduction of administrative and investment costs but keep the claims of different employers segregated for the sole benefit of their own employees. The standard observes that group administration plans pose no particular accounting problems because information is readily available to treat them in the same way as any other single employer plan and because they do not expose the participating employers to actuarial risks associated with the current and former employees of other entities. Accordingly, the standard requires group administration plans to be classified as defined contribution plans or defined benefit plans in accordance with the terms of the plan (including any constructive obligation that goes beyond the formal terms). *[IAS 19.38]*.

The standard gives a description of one example of a multi-employer scheme as follows:

(a) The plan is financed on a pay-as-you-go basis: contributions are set at a level that is expected to be sufficient to pay the benefits falling due in the same period; and future benefits earned during the current period will be paid out of future contributions.

And

(b) Employees' benefits are determined by the length of their service and the participating entities have no realistic means of withdrawing from the plan without paying a contribution for the benefits earned by employees up to the date of withdrawal. Such a plan creates actuarial risk for the entity: if the ultimate cost of benefits already earned at the end of the reporting period is more than expected, it will be necessary for the entity either to increase its contributions or persuade employees to accept a reduction in benefits. Therefore, such a plan is a defined benefit plan. *[IAS 19.35]*.

A multi-employer plan must be classified as either a defined contribution plan or a defined benefit plan in accordance with its terms in the normal way (see section 3.1 above). *[IAS 19.32]*. If a multi-employer plan is classified as a defined benefit plan, IAS 19 requires that the employer account for its proportionate share of the defined benefit obligation, plan assets and costs associated with the plan in the same way as for any other defined benefit plan (see sections 5 to 11 below). *[IAS 19.33, IAS 19.36]*.

The standard does, however, contain a practical exemption if insufficient information is available to use defined benefit accounting. This could be the case, for example, where:

(a) The entity does not have access to information about the plan that satisfies the requirements of the standard.

Or

(b) The plan exposes the participating entities to actuarial risks associated with the current and former employees of other entities, with the result that there is no consistent and reliable basis for allocating the obligation, plan assets and cost to individual entities participating in the plan. *[IAS 19.36]*.

In such circumstances, an entity must account for the plan as if it were a defined contribution plan and make the disclosures set out in section 15.2.4 below. *[IAS 19.34, IAS 19.36]*.

The standard notes that there may be a contractual agreement between the multi-employer plan and its participants that determines how the surplus in the plan will be distributed to the participants (or the deficit funded). In these circumstances, an entity participating in such a plan, and accounting for it as a defined contribution plan (as described above), must recognise the asset or liability arising from the contractual agreement and the resulting income or expense in profit or loss. *[IAS 19.37]*. The standard illustrates this with an example of an entity participating in a multi-employer defined benefit plan which it accounts for as a defined contribution plan because no IAS 19 valuations are prepared. A non-IAS 19 funding valuation shows a deficit of CU100 million in the plan. A contractual schedule of contributions has been agreed with the participating employers in the plan that will eliminate the deficit over the next five years. The entity's total contributions to eliminate the deficit under the contract are CU8 million. IAS 19 requires the entity to recognise immediately a liability for the contributions adjusted for the time value of money and an equal expense in profit or loss *[IAS 19.37 Example illustrating paragraph 37]*. The important point here is that the standard makes clear that 'defined contribution accounting' is not the same as cash accounting. Extra payments to make good a deficit must be provided for immediately when they are contracted for.

3.3.1.B What to do when 'sufficient information' becomes available

As discussed above, IAS 19 requires a multi-employer defined benefit plan to be treated for accounting purposes as a defined contribution plan when insufficient information is available to apply defined benefit accounting. The standard does not address the accounting treatment required when that situation changes because sufficient information becomes available in a period. Two possible approaches present themselves:

(a) An immediate charge/credit to profit or loss equal to the deficit/surplus.

Or

(b) An actuarial gain or loss recognised on other comprehensive income.

Arguments in favour of (a) would be that for accounting purposes the scheme was a defined contribution scheme. Accordingly, starting defined benefit accounting is akin to introducing a new scheme. The defined benefit obligation recognised is essentially a past service cost. In addition, as discussed in section 3.3.1.A above, the standard clarifies that while defined contribution accounting is being applied an asset or liability must be recognised where there is a contractual arrangement to share a surplus or fund a deficit. The receipt of full information could be considered to represent such an arrangement and hence require full recognition in the statement of financial position with an equivalent entry in profit or loss.

Arguments for (b) would be that the scheme has not changed and that defined contribution accounting was a proxy (and best available estimate) for what the defined benefit accounting should have been. Accordingly, any change to that estimate due to the emergence of new information is an actuarial variance which is recognised in other comprehensive income.

How we see it

Given the ambiguity of the standard either approach, detailed above, is acceptable in determining an accounting policy if applied consistently to similar facts and circumstances.

3.3.1.C Withdrawal from or winding up of a multi-employer scheme

IAS 19 requires the application of IAS 37 to determine when to recognise and how to measure a liability relating to the withdrawal from, or winding-up of, a multi-employer scheme. *[IAS 19.39]*.

3.3.2 Defined benefit plans sharing risks between entities under common control

IAS 19 provides that defined benefit plans that share risks between various entities under common control, for example a parent and its subsidiaries, are not multi-employer plans. *[IAS 19.40]*.

The test, described earlier, for allowing a defined benefit multi-employer plan to be accounted for as a defined contribution plan is that insufficient information is available. By completely excluding entities that are under common control from the definition of multi-employer plans the standard is essentially saying that for these employers, sufficient information is deemed always to be available - at least for the plan as a whole. The standard requires an entity participating in such a plan to obtain information about the plan as a whole measured in accordance with IAS 19 on the basis of assumptions that apply to the plan as a whole. *[IAS 19.41]*. Whilst a subsidiary might not be in a position to demand such information (any more than participants in schemes described in section 3.3.1.A above), the standard is essentially saying that the parent must make the information available if it wants the subsidiary to be able to comply with IAS 19.

The standard then goes on to specify the accounting treatment to be applied in the individual financial statements of the participating entities. The standard states: *[IAS 19.41]*

Extract from IAS 19

41 … If there is a contractual agreement or stated policy for charging to individual group entities the net defined benefit cost for the plan as a whole measured in accordance with this Standard, the entity shall, in its separate or individual financial statements, recognise the net defined benefit cost so charged. If there is no such agreement or policy, the net defined benefit cost shall be recognised in the separate or individual financial statements of the group entity that is legally the sponsoring employer for the plan. The other group entities shall, in their separate or individual financial statements, recognise a cost equal to their contribution payable for the period.

This seems to raise more questions than it answers. For example, it provides no clarity on what is meant by:

- The "net defined benefit cost … measured in accordance with this Standard" (IAS 19). In particular, are actuarial gains and losses part of this 'net cost'?
- An entity that "is legally the sponsoring employer for the plan". The pan-jurisdictional scope of IFRS makes such a determination particularly difficult. Furthermore, it suggests that there is only one such legal sponsor - which might not be the case in practice.

A further difficulty with these provisions of the standard is whether it is ever likely in practice that entities would be charged an amount based on the "defined benefit cost measured in accordance with this Standard" (IAS 19). Naturally, situations vary not just across, but also within, individual jurisdictions.

Some further insight as to the IASB's intentions can be found in the Basis for Conclusions to the standard. *[IAS 19.BC48, IAS 19.BC49]*.

Extract from IAS 19

BC48 The Board noted that, if there were a contractual agreement or stated policy on charging the net defined benefit cost to group entities, that agreement or policy would determine the cost for each entity. If there is no such contractual agreement or stated policy, the entity that is the sponsoring employer bears the risk relating to the plan by default. The Board therefore concluded that a group plan should be allocated to the individual entities within a group in accordance with any contractual agreement or stated policy. If there is no such agreement or policy, the net defined benefit cost is allocated to the sponsoring employer. The other group entities recognise a cost equal to any contribution collected by the sponsoring employer.

BC49 This approach has the advantages of (a) all group entities recognising the cost they have to bear for the defined benefit promise and (b) being simple to apply.

This analysis is particularly noteworthy in these respects:

(a) There is no mention of amounts charged being measured in accordance with IAS 19. Indeed, the third sentence refers to any such agreement or stated policy.

(b) The focus is not on 'amounts charged' but rather an 'allocation' of the scheme across entities.

(c) References are to a 'sponsoring employer' crucially not a legally sponsoring employer. The term is slightly clarified by the explanation that a sponsoring employer is one that by default bears the 'risks relating to the plan'.

And

(d) The discussion of employers other than the sponsoring employer is explicitly by reference to 'amounts collected'.

Given the ambiguities in the standard, for entities applying IFRS accounting standards at an individual company level, there could well be divergent treatments in practice.

The standard makes clear that, for each individual group entity, participation in such a plan is a related party transaction. Accordingly, the disclosures set out in section 15.2.5 below are required. *[IAS 19.42]*.

3.4 State plans

IAS 19 observes that state plans are established by legislation to cover all entities (or all entities in a particular category, for example a specific industry) and are operated by national or local government or by another body (for example an autonomous agency created specifically for this purpose) which is not subject to control or influence by the reporting entity. *[IAS 19.44]*. The standard requires that state plans be accounted for in the same way as for a multi-employer plan (see section 3.3.1 above). *[IAS 19.43]*. It goes on to note that it is characteristic of many state plans that:

- They are funded on a pay-as-you-go basis with contributions set at a level that is expected to be sufficient to pay the required benefits falling due in the same period.

  And

- Future benefits earned during the current period will be paid out of future contributions.

Nevertheless, in most state plans, the entity has no legal or constructive obligation to pay those future benefits: its only obligation is to pay the contributions as they fall due and if the entity ceases to employ members of the state plan, it will have no obligation to pay the benefits earned by its own employees in previous years. For this reason, the standard considers that state plans are normally defined contribution plans. However, in cases when a state plan is a defined benefit plan, IAS 19 requires it to be treated as such as a multi-employer plan. *[IAS 19.45]*.

Some plans established by an entity provide both compulsory benefits which substitute for benefits that would otherwise be covered under a state plan and additional voluntary benefits. IAS 19 clarifies that such plans are not state plans. *[IAS 19.44]*.

3.5 Plans that would be defined contribution plans but for the existence of a minimum return guarantee

It is common in some jurisdictions for the employer to make contributions to a defined contribution post-employment benefit plan and to guarantee a minimum level of return on the assets in which the contributions are invested. In other words, the employee enjoys upside risk on the investments but has some level of protection from downside risk.

The existence of such a guarantee means the arrangement fails to meet the definition of a defined contribution plan (see section 3.1 above) and accordingly is a defined benefit plan. Indeed, the standard is explicit, as it uses plans which guarantee a specified return on contributions as an example of a defined benefit arrangement. *[IAS 19.29(b)]*. The somewhat more difficult issue is how exactly to apply defined benefit accounting to such an arrangement, as this would require projecting forward future salary increases and investment returns and discounting these amounts at corporate bond rates. Although this approach is required by the standard, some consider it to be inappropriate in such circumstances. This issue was debated by the IFRS IC, which published a draft interpretation on 8 July 2004 entitled D9 - *Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions*. The approach taken in D9 was to distinguish two different types of benefits:

(a) A benefit of contributions or notional contributions plus a guarantee of a fixed return (in other words, benefits which can be estimated without having to make an estimate of future asset returns).

  And

(b) A benefit that depends on future asset returns.

For benefits under (a) above, it was proposed that the defined benefit methodology in IAS 19 be applied as normal. In summary, that meant:

- Calculating the benefit to be paid in the future by projecting forward the contributions or notional contributions at the guaranteed fixed rate of return.
- Allocating the benefit to periods of service.
- Discounting the benefits allocated to the current and prior periods at the rate specified in IAS 19 to arrive at the plan liability, current service cost and net interest.

  And

- Recognising any remeasurements in accordance with the entity's accounting policy (note that there is no longer an accounting policy choice under IAS 19 and remeasurements must be recorded in other comprehensive income).

For benefits covered by (b) above, it was proposed that the plan liability must be measured at the fair value, at the end of the reporting period, of the assets upon which the benefit is specified (whether plan assets or notional assets). No projection forward of the benefits would be made, and discounting of the benefit would not therefore be required.

D9 suggested that plans with a combination of a guaranteed fixed return and a benefit that depends on future asset returns must be accounted for by analysing the benefits into a fixed component and a variable component. The defined benefit asset or liability that would arise from the fixed component alone would be measured and recognised as described above. The defined benefit asset (or liability) that would arise from the variable component alone would then be calculated as described above and compared to the fixed component. An additional plan liability would be recognised to the extent that the asset (or liability) calculated for the variable component is smaller (or greater) than the asset (or liability) recognised in respect of the fixed component.

In August 2005, the IFRS IC however announced the withdrawal of D9, observing the following: "The staff found the fixed/variable and modified fixed/variable approaches inadequate to give a faithful representation of the entity's obligation for more complex benefit structures. They believed that some aspects of the fixed/variable approach in D9 were not fully consistent with IAS 19. … The staff … recommended that the correct treatment for D9 plans should be determined as part of an IASB project."

The IFRS IC was asked in 2012 whether the revisions to IAS 19 in 2011 affect the accounting for these types of employee benefits and concluded they do not.[2]

The IFRS IC re-opened its examination of the subject and spent some time considering the issue. In May 2014, it decided not to proceed with the issue, stating the following: "In the Interpretations Committee's view, developing accounting requirements for these plans would be better addressed by a broader consideration of accounting for employee benefits, potentially through the research agenda of the IASB. The Interpretations Committee acknowledged that reducing diversity in practice in the short term would be beneficial. However, because of the difficulties encountered in progressing the issues, the Interpretations Committee decided to remove the project from its agenda. The Interpretations Committee notes the importance of this issue because of the increasing use of these plans. Consequently, the Interpretations Committee would welcome progress on the IASB's research project on post-employment benefits".[3]

In February 2018, the Board announced a research project on pension benefits that depend on asset returns, however the IASB has currently discontinued any work with respect to IAS 19.

3.6 Death-in-service benefits

The provision of death-in-service benefits is a common part of employment packages (either as part of a defined benefit plan or on a standalone basis). We think it is regrettable that IAS 19 provides no guidance on how to account for such benefits, particularly as E54 (the exposure draft preceding an earlier version of IAS 19) devoted considerable attention to the issue.[4] The basis for conclusion to IAS 19 explains the removal of the guidance as follows: *[IAS 19.BC253]*

Extract from IAS 19

Other long-term employee benefits

Death-in-service benefits

BC253 E54 proposed guidance on cases where death-in-service benefits are not insured externally and are not provided through a post-employment benefit plan. IASC concluded that such cases will be rare. Accordingly, IASC deleted the guidance on death-in-service benefits.

This seems to miss the point - E54 also gave guidance on cases where the benefits are externally insured and where they are provided in conjunction with another post-employment benefit plan which entitles the member to either a death in service benefit or a post-employment benefit. In our view, the proposals in E54 had merit, and it is worth reproducing them here.

2 *IFRIC Update*, September 2012, available on the IFRS Foundation's website.

3 *IFRIC Update*, May 2014, available on the IFRS Foundation's website.

4 Exposure Draft, E54 *Employee Benefits*, IASC, October 1996, paras. 17-21.

"An enterprise should recognise the cost of death-in-service benefits … as follows:

(a) in the case of benefits insured or re-insured with third parties, in the period in respect of which the related insurance premiums are payable; and

(b) in the case of benefits not insured or re-insured with third parties, to the extent that deaths have occurred before the end of the reporting period.

"However, in the case of death-in-service benefits provided through a post-employment benefit plan, an enterprise should recognise the cost of those benefits by including their present value in the post-employment benefit obligation.

"If an enterprise re-insures a commitment to provide death-in-service benefits, it acquires a right (to receive payments if an employee dies in service) in exchange for an obligation to pay the premiums.

"Where an enterprise provides death-in-service benefits directly, rather than through a post-employment benefit plan, the enterprise has a future commitment to provide death-in-service coverage in exchange for employee service in those same future periods (in the same way that the enterprise has a future commitment to pay salaries if the employee renders service in those periods). That future commitment is not a present obligation and does not justify recognition of a liability. Therefore, an obligation arises only to the extent that a death has already occurred by the end of the reporting period.

"If death-in-service benefits are provided through a pension plan (or other post-employment plan) which also provides post-employment benefits to the same employee(s), the measurement of the obligation reflects both the probability of a reduction in future pension payments through death in service and the present value of the death-in-service benefits (see [E-54's discussion of mutual compatibility of actuarial assumptions]).

"Death-in-service benefits differ from post-employment life insurance because post-employment life insurance creates an obligation as the employee renders services in exchange for that benefit; an enterprise accounts for that obligation in accordance with [the requirements for defined benefit plans]. Life insurance benefits that are payable regardless of whether the employee remains in service comprise two components: a death-in-service benefit and a post-employment benefit. An enterprise accounts for the two components separately."

In particular, an appropriate approach could be that:

- Death-in-service benefits provided as part of a defined benefit post-employment plan are factored into the actuarial valuation. In this case any insurance cover must be accounted for in accordance with the normal rules of IAS 19 (see section 6 below). An important point here is that insurance policies for death-in-service benefits typically cover only one year, and hence will have a low or negligible fair value. As a result, it will not be the case that the insurance asset is equal and opposite to the defined benefit obligation.
- Other death-in-service benefits which are externally insured are accounted for by expensing the premiums as they become payable.

  And
- Other death-in-service benefits which are not externally insured are provided for as deaths in service occur.

The first bullet is particularly important. The measure of the post-employment benefit (like a pension) will be reduced to take account of expected deaths in service. Accordingly, it would be inappropriate to ignore the death in service payments that would be made. The question that arises is how exactly to include those expected payments. This raises the same issue as for long-term disability benefits (discussed in section 13.2.2 below), i.e., what to do with the debit entry. However, IAS 19 has no explicit special treatment for death-in-service benefits comparable to that for disability benefits. Given the absence of specific guidance, the requirement is to apply the projected unit credit method to death in service benefits. As the benefit is fully vested, an argument could be made that the expected benefit must be accrued fully (on a discounted basis). Another approach would be to build up the credit entry in the statement of financial position over the period to the expected date of death.

An alternative approach could be to view death-in-service benefits as being similar to disability benefits. Proponents of this view would argue that the recognition requirements for disability benefits (discussed in section 13.2.2 below) could also be applied to death-in-service.

In January 2008, the IFRS IC published its agenda decision explaining why it decided not to put death-in-service benefits onto its agenda.[5] In the view of the IFRS IC, "divergence in this area was unlikely to be significant. In addition, any further guidance that it could issue would be application guidance on the use of the Projected Unit Credit Method". The second reason seems more credible than the first.

As part of its analysis, the 'rejection notice' sets out some of the IFRS IC's views on the subject. It observes the following:

(a) In some situations, IAS 19 requires these benefits to be attributed to periods of service using the Projected Unit Credit Method.

(b) IAS 19 requires attribution of the cost of the benefits until the date when further service by the employee will lead to no material amount of further benefits under the plan, other than from further salary increases.

(c) The anticipated date of death would be the date at which no material amount of further benefit would arise from the plan.

And

(d) Using different mortality assumptions for a defined benefit pension plan and an associated death-in-service benefit would not comply with the requirement of IAS 19 to use actuarial assumptions that are mutually compatible.

Points (a) to (c) above support the analysis that a provision must be built up gradually from the commencement of employment to the expected date of death. They also suggest that making an analogy to the specific rules in the standard on disability might not be appropriate. In addition, point (c) is simply re-iterating a clear requirement of the standard. The above agenda decision of the IFRS IC is not as helpful as we would have liked. The use of the phrase 'in some situations' in point (a) above leaves uncertain just what those circumstances could be. In September 2007, the IFRS IC published a tentative agenda decision which said "If these benefits are provided as part of a defined benefit plan, IAS 19 requires them to be attributed to periods of service using the Projected Unit Credit Method".[6] At the following meeting the IFRS IC discussed the comment letters received which noted that it could be argued that such attribution would be required only if the benefits were dependent on the period of service. No decision was reached on the final wording of the rejection notice because "IFRIC … was unable to agree on wording for its agenda decision".[7]

How we see it

Given the lack of explicit guidance on death-in-service benefits in IAS 19 itself and given the IFRS IC's decision not to address the matter, it seems likely that practice will be mixed.

5 *IFRIC Update*, January 2008, available on the IFRS Foundation's website.

6 *IASB Update*, September 2007, available on the IFRS Foundation's website.

7 *IASB Update*, November 2007, available on the IFRS Foundation's website.

4 Defined contribution plans

4.1 General accounting requirements

Accounting for defined contribution plans (see section 3 above) is straightforward under IAS 19 because, as the standard observes, the reporting entity's obligation for each period is determined by the amounts to be contributed for that period. Consequently, no actuarial assumptions are required to be made to measure the obligation or the expense and there is no possibility of any actuarial gain or loss to the reporting entity. Moreover, the obligations are measured on an undiscounted basis, except where they are not expected to be settled wholly before twelve months after the end of the period in which the employees render the related service. *[IAS 19.50]*. Where discounting is required, the discount rate must be determined in the same way as for defined benefit plans, which is discussed in section 7.6 below. *[IAS 19.52]*. In general, though, it would seem unlikely for a defined contribution scheme to be structured with such a long delay between the employee service and the employer contribution.

IAS 19 requires that, when an employee has rendered service during a period, the employer must recognise the contribution payable to a defined contribution plan in exchange for that service:

(a) As a liability (accrued expense), after deducting any contribution already paid. If the contribution already paid exceeds the contribution due for service before the end of the reporting period, the excess must be recognised as an asset (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund.

And

(b) As an expense, unless another IFRS accounting standard requires or permits its capitalisation. *[IAS 19.51]*.

As discussed in section 3.3.1.A above, IAS 19 requires multi-employer defined benefit plans to be accounted for as defined contribution plans in certain circumstances. The standard makes clear that contractual arrangements to make contributions to fund a deficit must be fully provided for (on a discounted basis) even if they are to be paid over an extended period. *[IAS 19.37]*.

4.2 Defined contribution plans with vesting conditions

In February 2011, the IFRS IC received a request seeking clarification on the effect that vesting conditions have on the accounting for defined contribution plans. The IFRS IC was asked whether contributions to such plans must be recognised as an expense in the period for which they are paid or over the vesting period. In the examples given in the submission, the employee's failure to meet a vesting condition could result in the refund of contributions to, or reductions in future contributions by, the employer.

The IFRS IC decided not to add the issue to its agenda, noting that there is no significant diversity in practice in respect of the effect that vesting conditions have on the accounting for defined contribution post-employment benefit plans, nor does it expect significant diversity in practice to emerge in the future.

Explaining its decision, the IFRS IC observed that "each contribution to a defined contribution plan is to be recognised as an expense or recognised as a liability (accrued expense) over the period of service that obliges the employer to pay this contribution to the defined contribution plan. This period of service is distinguished from the period of service that entitles an employee to receive the benefit from the defined contribution plan (i.e., the vesting period), although both periods may be coincident in some circumstances. Refunds are recognised as an asset and as income when the entity/employer becomes entitled to the refunds, e.g., when the employee fails to meet the vesting condition".[8]

8 *IFRIC Update*, May 2011, available on the IFRS Foundation's website.

5 Defined benefit plans – General

The standard notes that accounting for defined benefit plans is complex because actuarial assumptions are required to measure both the obligation and the expense, and there is a possibility of actuarial gains and losses. Moreover, the obligations are measured on a discounted basis because they may be settled many years after the employees render the related service. *[IAS 19.55]*. Also, IAS 19 makes clear that it applies not just to unfunded obligations of employers but also to funded plans. The details of pension scheme arrangements vary widely from jurisdiction to jurisdiction and, indeed, within them. Frequently though, they involve some entity or fund, separate from the employer, to which contributions are made by the employer (and sometimes employees) and from which benefits are paid. Typically, the employer (through either legal or constructive obligations) essentially underwrites the fund in the event that the assets in the fund are insufficient to pay the required benefits. This is the key feature which means such an arrangement is a defined benefit plan (see section 3 above). *[IAS 19.56]*.

In addition to specifying accounting and disclosure requirements, IAS 19 summarises the steps necessary in accounting for a defined benefit plan, to be applied separately to each separate plan, as follows:

(a) Determining the deficit or surplus by:
   (i) Using an actuarial technique, the projected unit credit method, to make a reliable estimate of the ultimate cost to the entity of the benefit that employees have earned in return for their service in the current and prior periods. This requires an entity to determine how much benefit is attributable to the current and prior periods and to make estimates (actuarial assumptions) about demographic variables (such as employee turnover and mortality) and financial variables (such as future increases in salaries and medical costs) that will affect the cost of the benefit. See section 7.3 below. As noted in section 7.7 below, a valuation is required on an annual basis, or possibly more frequently where interim reports are prepared.
   (ii) Discounting that benefit in order to determine the present value of the defined benefit obligation and the current service cost. See section 7.6 below.

   And
   (iii) Deducting the fair value of any plan assets from the present value of the defined benefit obligation. See section 6.2 below.

(b) Determining the amount of the net defined benefit liability (asset) as the amount of the deficit or surplus determined in (a), adjusted for any effect of limiting a net defined benefit asset to the asset ceiling with sufficient regularity that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the end of the reporting period. See sections 6.2, 7.7 and 8.2 below.

(c) Determining amounts to be recognised in profit or loss:
   (i) Current service cost. See section 10.1 below.
   (ii) Any past service cost and gain or loss on settlement. See sections 10.2.1 and 10.2.3 below.
   (iii) Net interest on the net defined benefit liability (asset). See section 10.3 below.

   And

(d) Determining the remeasurements of the net defined benefit liability (asset), to be recognised in other comprehensive income, comprising:
   (i) Actuarial gains and losses. See section 10.4.1 below.
   (ii) Return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset). See section 10.4.2 below.

   And
   (iii) Any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset). See section 8.2 below. *[IAS 19.57]*.

Retirement benefits will often be very significant in the context of an employer's financial statements. Therefore, the standard encourages, but does not require involvement of a qualified actuary in the measurement of all material post-employment benefit obligations. *[IAS 19.59]*. However, the standard acknowledges that in some circumstances estimates, averages and computational shortcuts may provide a reliable approximation. *[IAS 19.60]*. These steps are discussed in further detail in the sections 7.5 and 7.6 below.

In addition, careful consideration of the disclosures will be required to ensure that the disclosure objective of the standard (see section 15.2 below) has been met.

6 Defined benefit plans - Plan assets

6.1 Definition of plan assets

IAS 19 provides the following definitions relating to plan assets: *[IAS 19.8, IAS 19.114]*

Extract from IAS 19

8 The following terms are used in this Standard with the meanings specified:

...

Plan assets comprise:

(a) assets held by a long-term employee benefit fund; and

(b) qualifying insurance policies.

Assets held by a long-term employee benefit fund are assets (other than non-transferable financial instruments issued by the reporting entity) that:

(a) are held by an entity (a fund) that is legally separate from the reporting entity and exists solely to pay or fund employee benefits; and

(b) are available to be used only to pay or fund employee benefits, are not available to the reporting entity's own creditors (even in bankruptcy), and cannot be returned to the reporting entity, unless either:

(i) the remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting entity; or

(ii) the assets are returned to the reporting entity to reimburse it for employee benefits already paid.

A *qualifying insurance policy* is an insurance policy[1] issued by an insurer that is not a related party (as defined in IAS 24 *Related Party Disclosures*) of the reporting entity, if the proceeds of the policy:

(a) can be used only to pay or fund employee benefits under a defined benefit plan; and

(b) are not available to the reporting entity's own creditors (even in bankruptcy) and cannot be paid to the reporting entity, unless either:

(i) the proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations; or

(ii) the proceeds are returned to the reporting entity to reimburse it for employee benefits already paid.

114 Plan assets exclude unpaid contributions due from the reporting entity to the fund, as well as any non-transferable financial instruments issued by the entity and held by the fund. Plan assets are reduced by any liabilities of the fund that do not relate to employee benefits, for example, trade and other payables and liabilities resulting from derivative financial instruments.

1 A qualifying insurance policy is not necessarily an insurance contract, as defined in IFRS 17 *Insurance Contracts*.

Whilst non-transferable financial instruments issued by the employer are excluded from the definition of plan assets, plans can, and do, own transferable instruments issued by the employer (such as listed shares and bonds) and these would qualify as plan assets.

A footnote to the definition indicates that a qualifying insurance policy is not necessarily an insurance contract as defined in IFRS 17 *Insurance Contracts* (see Chapter 51).

6.2 Measurement of plan assets

IAS 19 requires plan assets to be measured at their fair value, *[IAS 19.113]*, which is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date". *[IAS 19.8]*. This is the same definition as is used in IFRS 13 *Fair Value Measurement* (see Chapter 15). To comply with the requirements of paragraph 58 of the standard we would expect that the fair value of plan assets is measured at each reporting date, especially where fair values are volatile.

The fair value of any plan assets is deducted from the present value of the defined benefit obligation in determining the deficit or surplus - see section 8 below. *[IAS 19.113]*.

6.3 Qualifying insurance policies

Where plan assets include qualifying insurance policies that exactly match the amount and timing of some or all of the benefits payable under the plan, the fair value of those insurance policies is deemed to be the present value of the related obligations, subject to any reductions required if the amounts receivable under the insurance policies are not recoverable in full. *[IAS 19.115]*.

6.4 Reimbursement rights

Some employers could have in place arrangements to fund defined benefit obligations which do not meet the definition of qualifying insurance policies above but which do provide for another party to reimburse some or all of the expenditure required to settle a defined benefit obligation. In such a case, the expected receipts under the arrangement are not classified as plan assets under IAS 19 (and hence they are not presented as part of a net pension asset/liability - see section 8 below). Instead, the employer must recognise its right to reimbursement as a separate asset, but only when it is virtually certain that another party will reimburse some or all of the expenditure required to settle a defined benefit obligation. The asset must be measured at fair value and, in all other respects, it must be treated in the same way as a plan asset. In particular, changes in fair value are disaggregated and accounted for in the same way as plan assets - see section 10 below. In profit or loss, the expense relating to a defined benefit plan could be presented net of the amount recognised for a reimbursement. *[IAS 19.116, IAS 19.117, IAS 19.118]*.

As is the case for qualifying insurance policies, for reimbursement rights that exactly match the amount and timing of some or all of the benefits payable fair value is determined as the present value of the related obligation, subject to any reduction required if the reimbursement is not recoverable in full. *[IAS 19.119]*.

6.5 Contributions to defined benefit funds

Contributions to defined benefit plans under IAS 19 are a movement between line items in the statement of financial position - the reduction in cash for the employer being reflected by an increase in the plan assets. Perhaps because of this straightforward accounting, the standard provides no guidance on contributions, which it implicitly deals with as always being in the form of cash.

Although contributions are very commonly in cash, there is no reason why an employer could not contribute any other assets to a defined benefit plan and that raises the question of how to account for the disposal - particularly so, since from the point of transfer the assets will be measured at fair value under IAS 19.

How we see it

In our view, a transfer of a non-cash asset to a defined benefit plan must be treated as a disposal, with proceeds equal to the fair value of the asset.

That would give rise to gains and losses in profit or loss (unless the asset in question was already carried at fair value) and, for certain assets (such as debt instruments held at fair value through other comprehensive income), the reclassification into profit or loss of amounts previously recognised in other comprehensive income.

Where a company makes contributions to a post-employment benefit fund on behalf of its employees, those cash outflows are part of the compensation for employment services and would be classified as operating cash flows as they are derived from the principal-revenue-producing activities of the entity (see Chapter 36 at section 4.4.4).

6.6 Longevity swaps

A longevity swap transfers, from a pension scheme to an external party, the risk of members living longer (or shorter) than expected.

The IFRS IC was asked in August 2014 to clarify the measurement of longevity swaps held by an entity's defined benefit plan, and in particular discussed whether an entity must:

(a) Account for a longevity swap as a single instrument and measure its fair value as part of plan assets (discussed in section 6.2 above) with changes in fair value being recorded in other comprehensive income.

Or

(b) Split longevity swaps into two components.

The two components in (b) would be a 'fixed leg' and a 'variable leg'. As the variable leg exactly matches some or all of the defined benefit obligation it would represent a qualifying insurance policy and be measured at the present value of the related obligation (discussed in section 6.3 above). The fixed leg comprises a series of fixed payments to be made in return for the receipt of the variable leg receipts. In other words, a longevity swap could be considered to be economically equivalent to the purchase of qualifying insurance (commonly called a 'buy-in') but with the premium paid over a period of time rather than at inception.

The likely effect of disaggregating a longevity swap in this way would be to recognise a remeasurement loss at inception very similar to that for a buy-in. Conversely, considering the swap as a single instrument measured at fair value would likely have no initial effect as typically its fair value would be zero (that is, a premium neither received nor paid).

If the two legs were to be considered separately, an appropriate accounting policy would need to be applied to the fixed leg. Two possibilities were discussed by the IFRS IC as follows. The fixed leg would initially be measured at fair value with subsequent accounting either:

- If treated as part of plan assets, at fair value with interest reported in profit or loss and other changes being included in other comprehensive income (discussed in section 6.2 above).

  Or

- If treated as a financial liability, at amortised cost using the effective interest rate method with interest recognised in profit and loss and no other remeasurements.

The IFRS IC noted that when such transactions take place, the predominant practice is to account for a longevity swap as a single instrument and measure it at fair value as part of plan assets.

The IFRS IC decided not to add this issue to its agenda as it did not expect diversity to develop in the application of IAS 19.[9]

How we see it

Given that the IFRS IC decided not to add this to its agenda we believe that either of the accounting options detailed above would be acceptable. An entity should develop an accounting policy after consideration of these options and apply this consistently where there are similar facts and circumstances.

9 *IFRIC Update*, March 2015, available on the IFRS Foundation's website.

7 Defined benefit plans - Plan liabilities

7.1 Legal and constructive obligations

IAS 19 refers to the liabilities of defined benefit plans as the present value of defined benefit obligations, which it defines as "... the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods". *[IAS 19.8]*.

The obligations must include not only the benefits set out in the plan, but also any constructive obligations that arise from the employer's informal practices which go beyond the formal plan terms, and must where relevant include an estimate of expected future salary increases (taking into account inflation, seniority, promotion and other relevant factors, such as supply and demand in the employment market). *[IAS 19.61, IAS 19.87, IAS 19.88, IAS 19.89, IAS 19.90]*.

A constructive obligation exists where a change in the employer's informal practices would cause unacceptable damage to its relationship with employees and which therefore leaves the employer with no realistic alternative but to pay those employee benefits. *[IAS 19.61]*. As can be seen from the above it is very similar to the meaning of the term as used in IAS 37 where it is defined as follows: *[IAS 37.10]*

Extract from IAS 37

10 **The following terms are used in this Standard with the meanings specified:**

...

A *constructive obligation* is an obligation that derives from an entity's actions where:

(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

(b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

...

The standard refers to constructive obligations throughout and determining whether a constructive obligation exists will often require judgement and careful consideration of the facts and circumstances, including, but not limited to, any internal communication both from the employer as well as from employee representatives (e.g., trade unions within the company).

However, IAS 19 goes on to add a further nuance. The standard observes that it is usually difficult to cancel a retirement benefit plan (without payment) whilst still retaining staff, and in light of this it requires that reporting entities assume (in the absence of evidence to the contrary) any currently promised benefits will continue for the remaining working lives of employees. *[IAS 19.62]*. Absent any contrary evidence, such as the entity no longer being able to fund the plan, this observation appears reasonable.

An employer's obligations (legal or constructive) could also extend to making changes to benefits in the future. The standard requires all such effects to be built into the computation of the obligation and gives the following examples of what they might comprise:

(a) The entity has a history of increasing benefits, for example, to mitigate the effects of inflation, and no indication that this practice will change in the future.

(b) The entity is obliged, either by the formal terms of the plan (or a further constructive obligation) or by legislation to use any surplus in the plan for the benefit of plan participants.

Or

(c) Benefits vary in response to a performance target or other criteria. For example, the terms of the plan could state that it will pay reduced benefits or require additional contributions from employees if the plan assets are insufficient. The measurement of the obligation reflects the best estimate of the effect of target or other criteria. *[IAS 19.88]*. As noted in section 7.3 below, the IFRS IC has discussed how a performance target could affect the measurement of the defined benefit obligation.

By contrast, any other future changes in the obligation (i.e., where no legal or constructive obligation previously existed) will be reflected in future current service costs, future past service costs or both (discussed in section 10.1 below). *[IAS 19.89]*.

IAS 19 also deals with the situation where the level of defined benefits payable by a scheme varies with the level of state benefits. When this is the case a best estimate of any changes in state benefit must be factored into the actuarial computations only if they are enacted by the end of the reporting period or are predictable based on past history or other evidence. *[IAS 19.87, IAS 19.95]*.

Some defined benefit plans limit the contributions that an entity is required to pay. The ultimate cost of the benefits takes account of the effect of a limit on contributions. The effect of a limit on contributions is determined over the shorter of the estimated life of the entity and the estimated life of the plan. *[IAS 19.91]*.

It is sometimes the case where the plan rules include an automatic exit event, where the entity's involvement in the plan will cease, which cannot be unilaterally avoided by the entity. On occurrence of the exit event, the entity will extinguish its obligation under the plan by the payment of an agreed amount through giving up plan assets. We believe the consequences of this must be included within the calculation of the defined benefit obligation as the best estimate of the ultimate cost to the company, and that this should not be treated as a settlement. For example, an entity is a participant in a multi-employer scheme but will exit that scheme when its last member ceases to be active (such as through retirement) and the scheme is closed to new members, the calculation of the defined benefit obligation would include cash flows paid to members until the expected exit event plus any transfer of assets at the date of the exit event as required under the plan rules. This is similar to the situation discussed in section 10.2.3 below, where an agreement for a settlement is entered into prior to the year end, but the transaction completes post year end. Where the agreement is binding the impact would be reflected in the calculation of any loss on settlement recorded.

7.2 Contributions by employees and third parties

The standard notes that some defined benefit plans require employees or third parties to contribute to the cost of the plan. Contributions by employees reduce the cost of the benefits to the entity. The standard requires an entity to 'consider' whether third-party contributions reduce the cost of the benefits to the entity or are a reimbursement right (discussed in section 6.4 above). Contributions by employees or third parties are either set out in the formal terms of the plan (or arise from a constructive obligation that goes beyond those terms) or are discretionary. IAS 19 requires discretionary contributions by employees or third parties to be accounted for as a reduction in service cost when they are paid to the plan. *[IAS 19.92]*.

The standard draws a distinction between non-discretionary contributions from employees or third parties set out in the formal terms of the plan which are 'linked to service' and those which are not. Such contributions not dependent upon years of service reduce remeasurements of the net defined benefit liability (asset). An example given by the standard is if the contributions are required to reduce a deficit arising from losses on plan assets or actuarial losses. *[IAS 19.93]*.

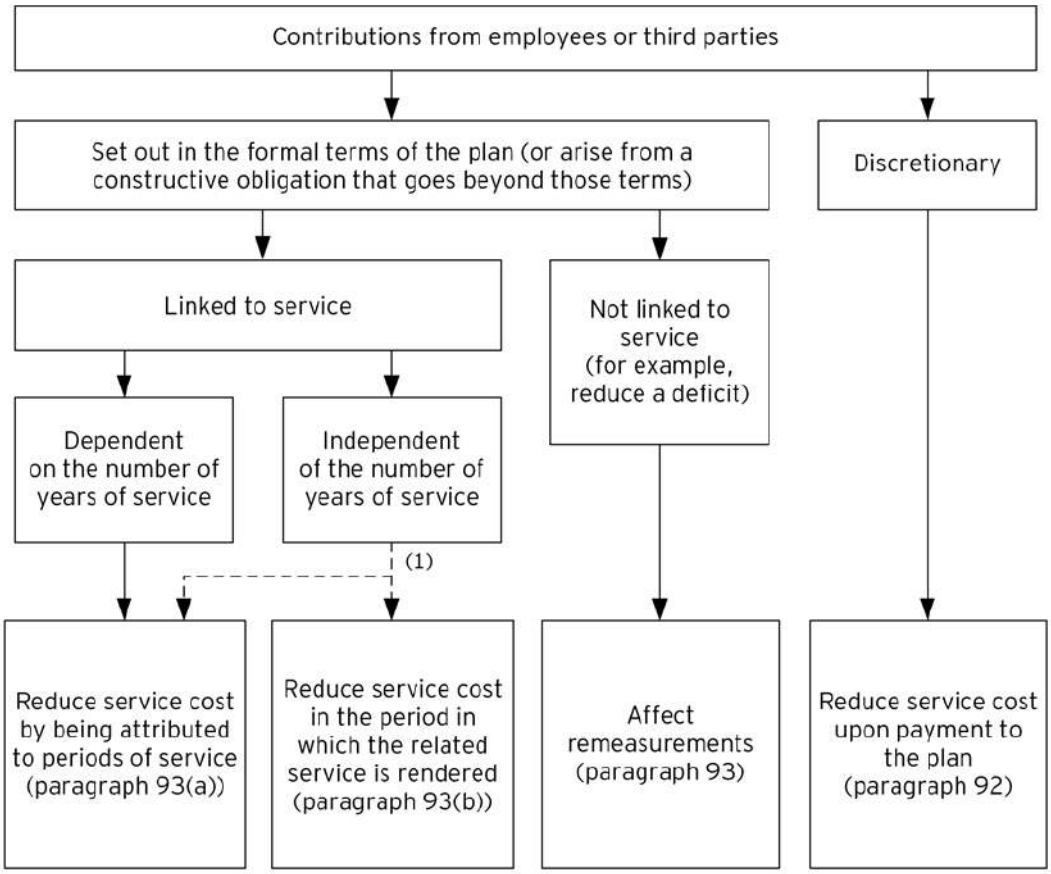
For contributions which are linked to service, the standard states that they reduce the service cost as follows:

- If the amount of the contributions is dependent on the number of years of service (e.g., contributions that increase with years of service), they must be attributed to periods of service using the same attribution method required for the gross benefit (i.e., either using the plan's contribution formula or on a straight-line basis - see section 7.4 below).

  Or

- If the amount of the contributions is independent of the number of years of service (e.g., contributions that are a fixed percentage of salary), they are permitted to be recognised as a reduction of the service cost in the period in which the related service is rendered. Examples of contributions that are independent of the number of years of service include those that are a fixed percentage of the employee's salary, a fixed amount throughout the service period or dependent on the employee's age. *[IAS 19.93]*.

Application guidance is given in Appendix A to the standard in the form of the following flow chart.



Regrettably, the standard does not explain the 'mechanics' of an attribution which is required where contributions are linked to service.

In particular, it is unclear how to treat employee contributions made over the service period. As shown in Illustration 7-2 in section 7.3 below, the projected unit credit method requires the net benefit to be expressed as a single net sum as at the date of retirement. Illustration 7-2 illustrates post-employment benefit payments being discounted to their present value as at the retirement date using the IAS 19 discount rate (discussed in section 7.6 below). On the same principle, therefore, employee contributions made over the period of employment would logically need to be inflated to be expressed in the 'time value' as at retirement. However, IAS 19 does not indicate what rate must be used for this purpose.

We note, in this regard, that when the IFRS IC discussed the matter in November 2012, it considered a Staff Paper which touched on the matter. The numerical examples appended to the paper expressed the 'future value' of in-service employee contributions as at the date of retirement using the IAS 19 discount rate.[10] The content of the third example in this Staff Paper is reflected in the Illustration set out below. This example pre-dates the amendments to IAS 19 in respect of employee contributions and therefore, it is assumed, that under the current standard the entity has made an accounting policy choice to attribute contributions to periods of service, even though contributions are independent of the number of years of service.

10 IASB Staff Paper 9B: Project: *Narrow scope amendments to IAS 19* Employee Benefits, Paper topic: *Measurement of the net DBO for post-employment benefit plans with employee contributions,* IASB meeting, February 2013, Appendix A. Available on the IFRS Foundation's website.

Illustration 7-1: Defined benefit plan with employee contributions, where the discount rate is higher than the salary growth rate

A lump sum benefit is payable on termination of service and equal to 1% of final salary for each year of service.

The salary in year 1 is CU10,000 and is assumed to increase at 7% (compound) each year. The discount rate used is 10% per year.

Employees are required to contribute 0.5% of salary each year, on the last day of the year.

Year	1	2	3	4	5	Total
	CU	CU	CU	CU	CU	CU
Salary	10,000	10,700	11,449	12,250	13,108	
Benefit attributed to:						
Prior years	-	131	262	393	524	
Current year (1% of final salary) (a)	131	131	131	131	131	
	131	**262**	**393**	**524**	**655**	
Gross benefit						
Opening obligation	-	90	197	325	476	
Interest at 10%	-	9	20	32	48	109
Current service cost	90	98	108	119	131	546
Closing obligation	**90**	**197**	**325**	**476**	**655**	

Year	1	2	3	4	5	Total
	CU	CU	CU	CU	CU	CU
Employee contributions						
Actual contributions	(50)	(54)	(57)	(61)	(66)	(288)
Projected total contributions ('gross') (b)	(73)	(71)	(69)	(67)	(66)	(346)
Attributed contributions ('gross') (c)	(69)	(69)	(69)	(69)	(70)	(346)
Attributed contributions ('discounted')						
Opening	-	(47)	(104)	(172)	(251)	
Interest at 10%	-	(5)	(11)	(17)	(25)	(58)
Negative benefit (d)	(47)	(52)	(57)	(62)	(70)	(288)
Closing	**(47)**	**(104)**	**(172)**	**(251)**	**(346)**	
Benefit including effect of contributions						
Opening obligation	-	93	202	330	480	
Interest at 10% (e)	-	9	20	32	48	109
Net current service cost - current service cost less negative benefit (f)	43	46	51	57	61	258
Actual contributions	50	54	57	61	66	288
Closing	**93**	**202**	**330**	**480**	**655**	
Net benefit (gross benefit minus projected total contribution) is attributed to each year using the discount rate						
Current service cost (f)	43	46	51	57	61	258

(a) Straight-lined (see section 7.4 below)

(b) Future-valued contributions (e.g., for Year 1, value of contribution paid at end of year 1 at end of year 5 using discount rate of 10% will be CU50 × 1.1^4 = CU73)

(c) Straight-lined to be on the same basis with the attributed benefit
(d) Present value of attributed contributions
(e) Includes rounding difference of (1) in Year 4
(f) Present value of gross benefit minus present value of projected total contributions

Journal entries (for Year 1)

Dr	Service cost		CU43	
	Cr	Defined benefit obligation		CU43
To recognise net service cost				
Dr	Plan asset		CU50	
	Cr	Defined benefit obligation		CU50
To reflect employee contributions				

The standard notes that changes in employee or third-party contributions dependent on number of years of service result in:

(a) Current and past service cost if the changes are not set out in the formal terms of the plan and do not arise from a constructive obligation.

Or

(b) Actuarial gains and losses if the changes in contributions are set out in the formal terms of the plan or arise from a constructive obligation. *[IAS 19.94]*.

7.3 Actuarial methodology

IAS 19 notes that the ultimate cost of a defined benefit plan may be influenced by many variables, such as final salaries, employee turnover and mortality, employee contributions and medical cost trends. The ultimate cost of the plan is uncertain and this uncertainty is likely to persist over a long period of time. In order to measure the present value of the post-employment benefit obligations and the related current service cost, it is necessary:

- To apply an actuarial valuation method.
- To attribute benefit to periods of service.

And

- To make actuarial assumptions. *[IAS 19.66]*.

These steps are discussed in the following sections.

Plan obligations are measured using the projected unit credit method, *[IAS 19.67]*, (sometimes known as the accrued benefit method pro-rated on service or as the benefit/years of service method). This method sees each period of service as giving rise to an additional unit of benefit entitlement and measures each unit separately to build up the final obligation. *[IAS 19.68]*. This actuarial method also determines the current service cost and any past service cost. *[IAS 19.67]*. IAS 19 provides a simple example of what this entails as follows: *[IAS 19.68]*

Illustration 7-2: The projected unit credit method

A lump sum benefit is payable on termination of service and equal to 1% of final salary for each year of service. The salary in year 1 is 10,000 and is assumed to increase at 7% (compound) each year. The discount rate used is 10% per year. The following table shows how the obligation builds up for an employee who is expected to leave at the end of year 5, assuming that there are no changes in actuarial assumptions. For simplicity, this example ignores the additional adjustment needed to reflect the probability that the employee may leave the entity at an earlier or later date.

Year	1	2	3	4	5
	CU	CU	CU	CU	CU
Benefit attributed to:					
▸ Prior years	-	131	262	393	524
▸ Current year (1% of final salary)	131	131	131	131	131
▸ **Current and prior years**	**131**	**262**	**393**	**524**	**655**

Opening obligation	-	**89**	**196**	**324**	**476**
Interest at 10%	-	9	20	33	48
Current service cost	89	98	108	119	131
Closing obligation	**89**	**196**	**324**	**476**	**655**

Notes:

- *The opening obligation is the present value of benefit attributed to prior years.*
- *The current service cost is the present value of benefit attributed to the current year.*
- *The closing obligation is the present value of benefit attributed to current and prior years.*

As can be seen in this simple example, the projected unit credit method produces a figure for current service cost and interest cost (and, although not illustrated here, would where appropriate produce a figure for past service cost). These cost components are discussed in section 10 below.

This example from the standard contains no underlying workings or proofs. The most useful would be as follows:

Final salary at year 5 (CU10,000 compounded at 7%)	$CU10,000 \times (1 + 0.07)^4 = CU13,100$
1% of final salary attributed to each year	CU131
Expected final benefit	5 years × 1% × CU131,000 = CU655
Current service cost, being present value of CU131 discounted at 10%: e.g.	
Year 1	$CU131 \times (1 + 0.1)^{-4} = CU89$
Year 2	$CU131 \times (1 + 0.1)^{-3} = CU98$
Closing obligation, being years served multiplied by present value of CU131: e.g.	
Year 3	$3 \text{ years} \times CU131 \times (1 + 0.1)^{-2} = CU324$

In January 2008, the IFRS IC published an agenda decision in response to a request to clarify the measurement of the defined benefit obligation when pension promises are based on achieving specific performance targets. These performance targets could relate to various forms of pension promises ranging from performance bonuses to more complex arrangements relating to additional sponsor contributions or years of deemed service. The IFRS IC noted that paragraph 73 of IAS 19 states that "Actuarial assumptions are the entity's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits" and therefore performance targets must be included within the determination of the benefit. The IFRS IC also noted that paragraph 67 of IAS 19 requires benefits to be attributed to periods of service according to the benefit formula, unless an employee's service in later years will lead to a materially high level of benefit than in earlier years. The effect of performance hurdles on attribution of benefits must also be considered. Given the requirements in IAS 19 the IFRS IC did not expect diversity in practice and decided not to add this to their agenda.[11] *[IAS 19.67, IAS 19.73].*

7.4 Attributing benefit to years of service

The projected unit credit method requires benefits to be attributed to the current period (in order to determine current service cost) and the current and prior periods (in order to determine the present value of defined benefit obligations).

IAS 19 requires benefits to be attributed to the periods in which the obligation to provide post-employment benefits arises. That is when employees render services in return for post-employment benefits which an entity expects to pay in future reporting periods. The standard takes the view that actuarial techniques allow an entity to measure that obligation with sufficient reliability to justify recognition of a liability. *[IAS 19.71]*.

11 *IFRIC Update*, January 2008, available on the IFRS Foundation's website.

The standard also explains that employee service gives rise to an obligation under a defined benefit plan even if the benefits are conditional on future employment (in other words they are not vested). *[IAS 19.70]*. Employee service before the vesting date is considered to give rise to a constructive obligation because, at each successive period end, the amount of future service that an employee will have to render before becoming entitled to the benefit is reduced. In measuring its defined benefit obligation, an entity must consider the probability that some employees might not satisfy any vesting requirements. Similarly, although certain post-employment benefits, such as post-employment medical benefits, become payable only if a specified event occurs when an employee is no longer employed, an obligation is considered to be created when the employee renders service that will provide entitlement to the benefit if the specified event occurs. The probability that the specified event will occur affects the measurement of the obligation but does not determine whether for accounting purposes the obligation exists. *[IAS 19.72]*.

In applying the projected unit credit method, IAS 19 normally requires benefits to be attributed to periods of service under the plan's 'benefit formula'. For example, in some schemes the benefit vests over time as service is provided, regardless of continued service in future periods. In these arrangements, an employee has some benefit vested whenever employment ceases, even if payment is made at a later date. Accordingly, the attribution of those benefits to periods of service is a straightforward matter and will match the period of employment (i.e., attribution commences on the hire date and ceases on the date that the participant leaves employment).

If, however, an employee's service in later years will lead to a materially higher level of benefit, the benefit must be attributed on a straight-line basis from:

(a) The date when service by the employee first leads to benefits under the plan.

Until

(b) The date when further service by the employee will lead to no material amount of further benefits under the plan, other than from further salary increases. *[IAS 19.70]*.

The requirements above apply the overarching principle of the standard, which is described as the 'objective' of IAS 19: *[IAS 19.1]*

Extract from IAS 19

Objective

1 The objective of this Standard is to prescribe the accounting and disclosure for employee benefits. The Standard requires an entity to recognise:

(a) a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and

(b) an expense when the entity consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

As an example, some schemes have what some refer to as 'cliff vesting' where there is a requirement to be in employment at a certain age or on the occurrence of a certain future event in order for any entitlement to vest. For an arrangement like this it is necessary to determine the period over which the benefits must be recognised. The requirement to accrue benefits until 'further service by the employee will lead to no material amount of further benefits' effectively means that attribution must continue until the vesting date. Indeed, it would not be appropriate to have full provision for a benefit which has not yet vested - attribution must continue until the benefit has vested as this is the point at which 'further service by the employee will lead to no material amount of further benefits'.

The standard considers that this requirement is necessary because the employee's service throughout the entire period will ultimately lead to benefit at that higher level. *[IAS 19.73]*.

Once the date until when benefits must be attributed is determined, the next step is to determine the point from which 'service by the employees first leads to benefits under the plan'.

This is a factual matter to be determined in light of all the facts and circumstances.

For example, a scheme could require the participant to be in service at a certain age and also to have rendered a certain number of years of service to the employer. In this situation, some judgement might be required in determining when the period of attribution begins. This is illustrated by Scenario 6 in Illustration 7-3 below where the benefit vests at the age of 55 provided 20 years' service have also been provided. The start of attribution is determined, in this example, by counting back 20 years from the vesting date.

IAS 19 illustrates the attribution of benefits to service periods with a number of worked examples as follows: *[IAS 19.71, IAS 19.72, IAS 19.73, IAS 19.74]*

Illustration 7-3: Attributing benefits to years of service

1) *A defined benefit plan provides a lump-sum benefit of CU100 payable on retirement for each year of service.*

   A benefit of CU100 is attributed to each year. The current service cost is the present value of CU100. The present value of the defined benefit obligation is the present value of CU100, multiplied by the number of years of service up to the end of the reporting period.

   If the benefit is payable immediately when the employee leaves the entity, the current service cost and the present value of the defined benefit obligation reflect the date at which the employee is expected to leave. Thus, because of the effect of discounting, they are less than the amounts that would be determined if the employee left at the end of the reporting period.

2) *A plan provides a monthly pension of 0.2% of final salary for each year of service. The pension is payable from the age of 65.*

   Benefit equal to the present value, at the expected retirement date, of a monthly pension of 0.2% of the estimated final salary payable from the expected retirement date until the expected date of death is attributed to each year of service. The current service cost is the present value of that benefit for the current year of service. The present value of the defined benefit obligation is the present value of monthly pension payments of 0.2% of final salary, multiplied by the number of years of service up to the end of the reporting period. The current service cost and the present value of the defined benefit obligation are discounted because pension payments begin at the age of 65.

3) *A plan pays a benefit of CU100 for each year of service. The benefits vest after ten years of service.*

   A benefit of CU100 is attributed to each year. In each of the first ten years, the current service cost and the present value of the obligation reflect the probability that the employee may not complete ten years of service.

4) *A plan pays a benefit of CU100 for each year of service, excluding service before the age of 25. The benefits vest immediately.*

   No benefit is attributed to service before the age of 25 because service before that date does not lead to benefits (conditional or unconditional). A benefit of CU100 is attributed to each subsequent year.

5) *A plan pays a lump-sum benefit of CU1,000 that vests after ten years of service. The plan provides no further benefit for subsequent service.*

   A benefit of CU100 (CU1,000 divided by ten) is attributed to each of the first ten years. The current service cost in each of the first ten years reflects the probability that the employee may not complete ten years of service. No benefit is attributed to subsequent years.

6) *A plan pays a lump-sum retirement benefit of CU2,000 to all employees who are still employed at the age of 55 after twenty years of service, or who are still employed at the age of 65, regardless of their length of service.*

   For employees who join before the age of 35, service first leads to benefits under the plan at the age of 35 (an employee could leave at the age of 30 and return at the age of 33, with no effect on the amount or timing of benefits). Those benefits are conditional on further service. Also, service beyond the age of 55 will lead to no material amount of further benefits. For these employees, the entity attributes benefit of CU100 (CU2,000 divided by twenty) to each year from the age of 35 to the age of 55.

   For employees who join between the ages of 35 and 45, service beyond twenty years will lead to no material amount of further benefits. For these employees, the entity attributes benefit of CU100 (CU2,000 divided by twenty) to each of the first twenty years.

   For an employee who joins at the age of 55, service beyond ten years will lead to no material amount of further benefits. For this employee, the entity attributes benefit of CU200 (CU2,000 divided by ten) to each of the first ten years.

   For all employees, the current service cost and the present value of the obligation reflect the probability that the employee may not complete the necessary period of service.

7) *A post-employment medical plan reimburses 40% of an employee's post-employment medical costs if the employee leaves after more than ten and less than twenty years of service and 50% of those costs if the employee leaves after twenty or more years of service.*

   Under the plan's benefit formula, the entity attributes 4% of the present value of the expected medical costs (40% divided by ten) to each of the first ten years and 1% (10% divided by ten) to each of the second ten years. The current service cost in each year reflects the probability that the employee may not complete the necessary period of service to earn part or all of the benefits. For employees expected to leave within ten years, no benefit is attributed.

8) *A post-employment medical plan reimburses 10% of an employee's post-employment medical costs if the employee leaves after more than ten and less than twenty years of service and 50% of those costs if the employee leaves after twenty or more years of service.*

Service in later years will lead to a materially higher level of benefit than in earlier years. Therefore, for employees expected to leave after twenty or more years, the entity attributes benefit on a straight-line basis (see section 7.3 above). Service beyond twenty years will lead to no material amount of further benefits. Therefore, the benefit attributed to each of the first twenty years is 2.5% of the present value of the expected medical costs (50% divided by twenty).

For employees expected to leave between ten and twenty years, the benefit attributed to each of the first ten years is 1% of the present value of the expected medical costs. For these employees, no benefit is attributed to service between the end of the tenth year and the estimated date of leaving.

For employees expected to leave within ten years, no benefit is attributed.

9) *Employees are entitled to a benefit of 3% of final salary for each year of service before the age of 55.*

Benefit of 3% of estimated final salary is attributed to each year up to the age of 55. This is the date when further service by the employee will lead to no material amount of further benefits under the plan. No benefit is attributed to service after that age.

The following points of note are brought out in the above:

- The scenarios in 3 and 5 are economically identical and are attributed to years of service accordingly. In each case benefits only vest after ten years, however an obligation is to be built up over that period rather than at the end.
- Scenario 6 above (example 2 in the standard) is the basis for an Agenda Decision by the IFRS IC (see below). As part of its deliberations, the IFRS IC considered and rejected an argument that the last part of that example was inconsistent with its first part. In the IFRS IC's view, the plan's benefit formula in the first part of the example (i.e., for employees who join before the age of 35) in effect specifies both: (i) the date when service by the employee first leads to benefits under the plan (when an employee reaches the age of 35); and (ii) the date when further service by the employee will lead to no material amount of further benefits under the plan (when an employee reaches the age of 55). Accordingly, this example concludes that the entity uses those dates when attributing benefit to periods of service for an employee who joins before the age of 35. The plan's benefit formula for the last part of the example specifies only that the retirement benefit is conditional on the employee being employed at the age of 65 (i.e., the date when further service by the employee will lead to no material amount of further benefits under the plan). However, it does not specify when service by the employee first leads to benefits under the plan. Although that benefit is provided at retirement, it is provided in exchange for services rendered before the age of 65. The IFRS IC concluded that, in the absence of the plan's benefit formula specifying when service by the employee first leads to benefits under the plan, the example concludes that the benefits are provided in exchange for services from the age of 55 (the entire period of service).[12]
- Scenario 8 illustrates that accruing a 10% benefit over a period of 20 years of service which jumps to 50% once 20 years have been completed is an example of service in later years leading to a materially higher level of benefit. Accordingly, the obligation is to be built-up on a straight-line basis over 20 years.
- Regarding scenario 9, the standard explains that where the amount of a benefit is a constant proportion of final salary for each year of service, future salary increases will affect the amount required to settle the obligation that exists for service before the end of the reporting period, but do not create an additional obligation. Therefore:

  (a) For the purpose of allocating benefits to years of service, salary increases are not considered to lead to further benefits, even though the amount of the benefits is dependent on final salary.

  And

  (b) The amount of benefit attributed to each period must be a constant proportion of the salary to which the benefit is linked. *[IAS 19.74]*.

12 *IFRIC Update*, December 2020, available on the IFRS Foundation's website.

In May 2021 the IFRS IC issued an Agenda Decision[13] following a request about the periods of service to which an entity attributes benefit for a particular defined benefit plan. In the particular fact pattern discussed:

- Employees are entitled to a retirement benefit only when they reach the age of 62 and are employed by the entity at that date.
- The amount of the benefit is one month of final salary for each year of service before the age of 62.
- The retirement benefit is capped at 16 years of service (the maximum amount of retirement benefit an employee would be entitled to is 16 months of final salary).

  And
- The retirement benefit is calculated using only the number of consequent years of employee service immediately before retirement.

The IFRS IC observed that each year of service between the ages of 46 and 62 leads to further benefits as service rendered in each of these years reduces the amount of future service that the employee will need to render before becoming entitled to the retirement benefit; and an employee will receive no material amount of further benefits from the age of 62 regardless of their age when joining the entity. Therefore, the entity attributes benefits only until the age of 62.

The IFRS IC concluded, for the benefit plan illustrated above, that the entity attributes retirement benefits to each year from the age of 46 to the age of 62 rather than from the hiring date, or from the date of employment until the age of 62 if employment commences after the age of 46.

In reaching its conclusion, the IFRS IC noted that IAS 19.70 specified the principle for attributing benefits to periods of service and IAS 19.71 to 74 of the standard include the requirements that specify how an entity must apply that principle. Paragraph 71 of IAS 19 requires an entity to attribute the benefit to periods in which the obligation to provide post-employment benefit arises. This paragraph also specifies that the obligation arises as the employees render services in return for post-employment benefits that an entity expects to pay in future reporting periods. Employee service before any vesting date gives rise to a constructive obligation, in accordance with IAS 19.72, as at the end of each successive reporting period the amount of future service that an employee will have to render before becoming entitled to the benefit is reduced. Paragraph 73 of IAS 19 specifies that an entity's obligation increases until the date when further service will lead to no material amount of further benefits under the plan.

When finalising its decision, the IFRS IC did not agree with some of the comments received that, in the fact pattern raised in the submission, it is also acceptable to start attributing benefits when the employee first provides service on the basis that although an employee joining at age 22 will need to provide service for 40 years (if the retirement age is 62) to earn the same level of benefits as an employee joining at 46, each year of service provided by that employee reduces the amount of future service that the employee will have to render before becoming entitled to the post-employment benefit. In the IFRS IC's view, its analysis and conclusions are consistent with Scenario 2 following IAS 19.73 (scenario 6 in Illustration 7-3 above), which illustrates an analogous fact pattern in the first part of the example (i.e., a retirement benefit payable to employees still employed at the age of 55 after 20 years of service). Scenario 2 is part of the standard, it does not accompany the standard. When specifying how an entity accounts for that analogous fact pattern, Scenario 2 does not permit or require the entity to attribute benefit over the entire period of employment for employees who join before the age of 35. On this basis, the IFRS IC concluded that reaching a different conclusion to that example would add or change the requirements in the standard.

The Agenda Decision addresses plans with the four characteristics listed above, regardless of the nature of the benefits (e.g., medical plans, retirement indemnities, or other benefits). Amongst these, the condition that benefits only cliff vest if the employee is still employed when reaching a certain age does not seem to be common, except in certain jurisdictions where this could be a general feature for many post-employment benefits plans (e.g., in France) or only for some of them.

13 *IFRIC Update*, April 2021, available on the IFRS Foundation's website.

7.5 Actuarial assumptions

The long timescales and numerous uncertainties involved in estimating obligations for post-employment benefits require many assumptions to be made when applying the projected unit credit method. These are termed 'actuarial assumptions' and comprise:

(a) Demographic assumptions about the future characteristics of current and former employees (and their dependants) who are eligible for benefits and deal with matters such as:
   (i) Mortality, both during and after employment.
   (ii) Rates of employee turnover, disability and early retirement.
   (iii) The proportion of plan members with dependants who will be eligible for benefits.
   (iv) The proportion of plan members who will select each form of payment option under the plan terms, (for example, a plan could offer participants a choice between a lump-sum cash payment, annuities and instalments over a defined period and these alternatives could have a significantly different impact on the measurement of the defined benefit obligation).

   And

   (v) Claim rates under medical plans.

   And

(b) Financial assumptions, dealing with items such as:
   (i) The discount rate.
   (ii) Future salary and benefit levels, excluding the cost of benefits that will be met by the employees.
   (iii) In the case of medical benefits, future medical costs, including claim handling costs, which the standard describes as costs that will be incurred in processing and resolving claims, including legal and adjuster's fees.

   And

   (iv) Taxes payable by the plan on contributions relating to service before the reporting date or on benefits resulting from that service. *[IAS 19.76]*.

The requirements of IAS 19 in this regard are set out below, with the exception of the discount rate which is discussed in section 7.6 below.

In periods of rising inflation this may have a significant impact on the measurement of the defined benefit obligation as this will often be linked to future salary increases, future benefit increases and future medical costs due to either contractual or constructive obligations (for example through a history of benefit payments to former employees being based on inflation even though there is no legal obligation to do so). Payment options selected by employees on retirement may also change where annuities are linked to fixed annual increases which become lower than expected inflation.

The standard requires that actuarial assumptions be unbiased (that is, neither imprudent nor excessively conservative), mutually compatible and represent the employer's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits. *[IAS 19.75, IAS 19.76, IAS 19.77]*. Actuarial assumptions are mutually compatible if they reflect the economic relationships between factors such as inflation, rates of salary increase and discount rates. For example, all assumptions which depend on a particular inflation level (such as assumptions about interest rates and salary and benefit increases) in any given future period must assume the same inflation level in that period. *[IAS 19.78]*.

The financial assumptions must be based on market expectations at the end of the reporting period, for the period over which the obligations are to be settled. *[IAS 19.80]*.

The standard requires that a defined benefit obligation be measured on a basis that reflects:

(a) The benefits set out in the terms of the plan (or resulting from any constructive obligation that goes beyond those terms) at the end of the reporting period.

(b) Any estimated future salary increases that affect the benefits payable.

(c) The effect of any limit on the employer's share of the cost of the future benefits.

   And

(d) Contributions from employees or third parties that reduce the ultimate cost to the entity of those benefits. *[IAS 19.87]*.

Regarding mortality, the standard requires assumptions to be a best estimate of the mortality of plan members both during and after employment. *[IAS 19.81]*. In particular, expected changes in mortality must be considered, for example by modifying standard mortality tables with estimates of mortality improvements. *[IAS 19.82]*.

Assumptions about medical costs must take account of inflation as well as specific changes in medical costs (including technological advances, changes in health care utilisation or delivery patterns, and changes in the health status of plan participants). *[IAS 19.96, IAS 19.97]*. The standard provides a quite detailed discussion of the factors that must be taken into account in making actuarial assumptions about medical costs, in particular:

(a) Measuring post-employment medical benefits requires assumptions about the level and frequency of future claims, and the cost of meeting them. An employer must make such estimates based on its own experience, supplemented where necessary by historical data from other sources (such as other entities, insurance companies and medical providers). *[IAS 19.97]*.

(b) The level and frequency of claims is particularly sensitive to the age, health status and sex of the claimants, and may also be sensitive to their geographical location. This means that any historical data used for estimating future claims need to be adjusted to the extent that the demographic mix of the plan participants differs from that of the population used as the basis for the historical data. Historical data must also be adjusted if there is reliable evidence that historical trends will not continue. *[IAS 19.98]*.

And

(c) Estimates of future medical costs must take account of any contributions that claimants are required to make based on the terms (whether formal or constructive) of the plan at the end of the reporting period. The treatment of contributions by employees and third parties is discussed in section 7.2 above.

Clearly, the application of actuarial techniques to compute plan obligations is a complex task, and it seems likely that few entities would seek to prepare valuations without the advice of qualified actuaries. However, IAS 19 only encourages, but does not require that an entity take actuarial advice. *[IAS 19.59]*.

However sophisticated actuarial projections could be, reality will (apart from the most simple scenarios) always diverge from assumptions. This means that when a surplus or deficit is estimated, it will almost certainly be different from the predicted value based on the last valuation. These differences are termed actuarial gains and losses. The standard observes that actuarial gains and losses result from increases or decreases in the present value of a defined benefit obligation because of changes in actuarial assumptions and experience adjustments (see section 10.4.1 below). Causes of actuarial gains and losses could include, for example:

(a) Unexpectedly high or low rates of employee turnover, early retirement or mortality or of increases in salaries, benefits (if the formal or constructive terms of a plan provide for inflationary benefit increases) or medical costs.

(b) Differences between the actual return on plan assets and amounts included as part of net interest in profit or loss.

(c) The effect of changes to assumptions concerning benefit payment options. Often an important example of this is the choice between an annuity and a lump sum payment as the various options are generally not actuarially equivalent (e.g., a lump sum payment will generally be less costly for the entity).

(d) The effect of changes in estimates of future employee turnover, early retirement or mortality or of increases in salaries, benefits (if the formal or constructive terms of a plan provide for inflationary benefit increases) or medical costs.

And

(e) The effect of changes in the discount rate. *[IAS 19.128, IAS 19.111]*.

Actuarial gains and losses are discussed further in section 10.4.1 below.

7.6 Discount rate

Due to the long timescales involved, post-employment benefit obligations are discounted. The whole obligation must be discounted, even if part of it is expected to be settled within twelve months of the end of the reporting period. *[IAS 19.69]*. The standard requires that the discount rate reflect the time value of money but not the actuarial or investment risk. Furthermore, the discount rate must not reflect the entity-specific credit risk borne by the entity's creditors, nor must it reflect the risk that future experience may differ from actuarial assumptions. *[IAS 19.84]*. The discount rate must reflect the estimated timing of benefit payments. For example, an appropriate rate could be quite different for a payment due in, say, ten years as opposed to one due in twenty. The standard observes that in practice, an acceptable answer can be obtained by applying a single weighted average discount rate that reflects the estimated timing and amount of benefit payments and the currency in which the benefits are to be paid. *[IAS 19.85]*. The standard does not preclude the use of a more granular approach in discounting cash flows at different periods along the yield curve. Nor does it preclude the use of different discount rates for different classes of participant in the interest of achieving a more precise measure of the defined benefit obligation than the computational shortcut which is allowed by the standard. An example of where discount rates could vary by class or participant is where there are both active and pensioner members, discount rates will vary by each of these classes purely as a result of their ages and the resultant timing of outflows associated to these classes. Whether it is acceptable to use the weighted average discount rate or a more granular approach is an entity's judgement which must be applied consistently. However, we would not expect an entity that elects to use the granular approach premised on it being a more precise measure to move back to the weighted average approach in subsequent periods.

The standard requires that actuarial assumptions, including discount rates be unbiased. *[IAS 19.83]*. A subpopulation of high quality corporate bonds (see section 7.6.1 below) used to derive a discount rate would only result in an unbiased assumption if the selection from the population of bonds was not skewed. For example, the exclusion of bonds from a population outside two standard deviations of the mean (both at the higher end and the lower end) would not result in an unbiased selection of the discount rate. However, if the entity were to exclude, say, bonds with the lowest 40% and the highest 10% yields, or bonds with a yield below the median, these methods would produce biased results.

IAS 19 also stipulates that the discount rate (and other financial assumptions) must be determined in nominal (stated) terms, unless estimates in real (inflation-adjusted) terms are more reliable, for example, in a hyperinflationary economy (see Chapter 17 for a discussion of IAS 29 *Financial Reporting in Hyperinflationary Economies*), or where the benefit is index-linked and there is a deep market in index-linked bonds of the same currency and term. *[IAS 19.79]*.

The basic part of this requirement - that a nominal rate be used - is consistent with the definition of the present value of a defined benefit obligation in that it must be " ... the present value ... of expected future payments required to settle the obligation ..." (see section 7.1 above). In other words, as the future cash flows are stated at the actual amounts expected to be paid, the rate used to discount them must reflect that and not be adjusted to remove the effects of expected inflation. In contrast, the reference to the use of index-linked bonds seems to allow taking account of inflation through the discount rate (which would require expressing cash flows in current prices). This approach seems to be in conflict with the definition of the obligation. However, in practice few index-linked corporate bonds exist (so it could be quite rare to have a deep market in them) and a more reliable approach could often be to take account of inflation via the projected cash flows.

The IFRS IC in July 2013 discussed whether the rate must be pre- or post-tax. It observed that the discount rate used to calculate a defined benefit obligation must be a pre-tax discount rate and decided not to add this issue to its agenda.[14]

Negative interest rates have been experienced in the past and at the time it was believed that these would be a temporary phenomenon, restricted to relatively short-term rates for certain government debt and deposits. This phenomenon has, however, not been short-lived with negative yields on government bonds seen in several countries and in some high quality corporate bonds. Discount rates are applied in various IFRS accounting standards. In the context of IAS 19 specifically, the standard does not contain a zero percent floor and negative discount rates should be used.

14 *IFRIC Update*, July 2013, available on the IFRS Foundation's website.

7.6.1 High quality corporate bonds

The rate used must be determined 'by reference to' the yield (at the end of the reporting period) on high quality corporate bonds of currency and term consistent with the liabilities. For currencies in which there is no deep market in such bonds, the yields on government bonds must be used instead (see section 7.6.2 below). *[IAS 19.83]*.

How we see it

IAS 19 does not explain what is meant by the term 'high quality'. In practice it is considered to mean either: bonds rated AA, bonds rated AA or higher by Standard and Poor's, or an equivalent rating from another rating agency, which in our view is consistent with the requirements of the standard.

The requirement that the rate be determined 'by reference to' high quality bond rates is an important one.

The standard gives an example of this in the context of the availability of bonds with sufficiently long maturities. It notes that in some cases, there may be no deep market in bonds with a sufficiently long maturity to match the estimated maturity of all the benefit payments. In such cases, the standard requires the use of current market rates of the appropriate term to discount shorter-term payments, and estimation of the rate for longer maturities by extrapolating current market rates along the yield curve. In practice extrapolation is appropriate when longer maturities result in too few observable bonds for the rates derived from these to be meaningful. It goes on to observe that the total present value of a defined benefit obligation is unlikely to be particularly sensitive to the discount rate applied to the portion of benefits that is payable beyond the final maturity of the available corporate or government bonds. *[IAS 19.86]*.

In November 2013, the IFRS IC was asked whether corporate bonds with a rating lower than 'AA' can be considered to be 'high quality corporate bonds' (HQCB).

The IFRS IC decided not to add the item to its agenda as issuing additional guidance or changing the requirements would be too broad for it to achieve in an efficient manner. The IFRS IC recommended that the IASB should address the issue as part of its research project on discount rates.[15] The IFRS IC reported this conclusion to the IASB at its December 2013 meeting. The IASB noted that no further work is currently planned on the issue of determining the discount rate for post-employment benefit obligations.[16]

The key observations of the IFRS IC were as follows:

- IAS 19 does not specify how to determine the market yields on HQCB, and in particular what grade of bonds must be designated as high quality.
- That 'high quality' as used in IAS 19 reflects an absolute concept of credit quality and not a concept of credit quality that is relative to a given population of corporate bonds, which would be the case, for example, if the paragraph used the term 'the highest quality'. Consequently, the concept of high quality must not change over time. Accordingly, a reduction in the number of HQCB must not result in a change to the concept of high quality. The IFRS IC does not expect that an entity's methods and techniques used for determining the discount rate so as to reflect the yields on HQCB will change significantly from period to period.
- IAS 19 already contains requirements if the market in HQCB is no longer deep or if the market remains deep overall, but there is an insufficient number of HQCB beyond a certain maturity.

  And
- Typically, the discount rate will be a significant actuarial assumption to be disclosed with sensitivity analyses under IAS 19.

As required by IAS 1 (see Chapter 3 at section 5.2.1), disclosure is required of the estimates that management has made in determining the carrying amounts of assets and liabilities and that have the most significant effect on the amounts recognised in the financial statements. Typically, the identification of the HQCB population used as a basis to determine the discount rate requires the use of estimates, which could often have a significant effect on the entity's financial statements.

In some countries ratings agencies could provide both a local rating and a global rating. As noted above the concept of 'high quality' is an absolute notion and therefore global ratings must be used to determine whether high quality corporate bonds exist in a currency.

15 *IFRIC Update*, November 2013, available on the IFRS Foundation's website.

16 *IASB Update*, December 2013, available on the IFRS Foundation's website.

7.6.2 No deep market

In currencies where there is no deep market in high quality corporate bonds, the market yields (at the end of the reporting period) on government bonds shall be used. *[IAS 19.83]*. This paragraph was amended by the Annual Improvements 2012-2014 Cycle replacing the reference to countries with a reference to currencies where there is no deep market in high quality corporate bonds. This amendment was issued to clarify, in particular, that for IAS 19 purposes the euro zone is considered in its entirety.

In June 2017, the IFRS IC considered a question on how an entity determines the rate to be used to discount post-employment benefit obligations in a country (in this case Ecuador) which has adopted another currency as its official or legal currency (in this case the US dollar). The entity's post-employment benefit obligation is denominated in US dollars. The submitter also confirmed that there was no deep market for high quality bonds denominated in US dollars in the country in which it operates (Ecuador).

The question asked by the submitter was whether in this situation the entity must consider the depth of the market in high quality corporate bonds denominated in US dollars in other markets or countries in which those bonds are issued. They also asked whether the entity can use market yields on bonds denominated in US dollars issued by the Ecuadorian government, or whether it is required to use market yields on bonds denominated in US dollars issued by a government in another market or country.

The IFRS IC observed that applying IAS 19.83 (see section 7.6.1 above) requires that:

- An entity with post-employment benefit obligations denominated in a particular currency assesses the depth of the market in high quality corporate bonds denominated in that currency, and does not limit this assessment to the market of country in which it operates.
- If there is a deep market in high quality corporate bonds denominated in that currency, the discount rate is determined by reference to market yields on high quality corporate bonds at the end of the reporting period.
- If there is no deep market in high quality corporate bonds in that currency, the entity determines the discount rate using market yields on government bonds denominated in that currency.

  And

- The entity applies judgement to determine the appropriate population of high quality corporate bonds or government bonds to reference when determining the discount rate. The currency and term of the bonds must be consistent with the currency and estimated term of the post-employment benefit obligations.

The IFRS IC noted that the discount rate does not reflect the expected return on plan assets; the Basis for Conclusions on IAS 19 confirms that the measurement of the obligation must be independent of the measurement of any plan assets held by the plan. *[IAS 19.BC130]*.

The IFRS IC also considered the interaction between the matters discussed above and the requirement that actuarial assumptions be mutually compatible (see section 7.5 above). *[IAS 19.75]*. The IFRS IC concluded that it is not possible to assess whether, and to what extent, a discount rate derived by applying the specific requirements of IAS 19 is compatible with other actuarial assumptions and that the specific requirements of IAS 19 must be applied when determining the discount rate.

The overall conclusion of the IFRS IC was that the requirements in IAS 19 provide an adequate basis for the determination of a discount rate in the circumstances described above. Consequently, the IFRS IC decided not to add this matter to its agenda.

7.7 Frequency of valuations

IAS 19 requires that the present value of defined benefit obligations, and the fair value of plan assets, must be determined frequently enough to ensure that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the end of the reporting period. *[IAS 19.58]*. An argument could be launched that, without a full valuation as at the end of the reporting period to compare with, it cannot be possible to know whether any less precise approach is materially different. However, it is reasonably clear that the intention of the standard is not necessarily to require full actuarial updates as at the reporting date. This is because the standard goes on to observe that for practical reasons a detailed valuation could be carried out before the end of the reporting period and that if such amounts determined before the end of the reporting period are used, they must be updated to take account of any material transactions or changes in circumstances up to the end of the reporting period. *[IAS 19.59]*. Much could depend on what is considered to be a 'material change', however it is expressly to include changes in market prices (hence requiring asset values to be those at the end of the reporting period) and interest rates, as well as financial actuarial assumptions. *[IAS 19.59, IAS 19.80]*.

In this regard, it is also worth noting the observation in the standard: *[IAS 19.60]*

Extract from IAS 19	
60	In some cases, estimates, averages and computational short cuts may provide a reliable approximation of the detailed computations illustrated in this Standard.

It must be remembered, though, that it is the amounts in the financial statements which must not differ materially from what they would be based on a valuation at the end of the reporting period. For funded schemes, the net surplus or deficit is usually the difference between two very large figures - plan assets and plan liabilities. Such a net item is inevitably highly sensitive, in percentage terms, to a given percentage change in the gross amounts.

In summary, a detailed valuation will be required on an annual basis, but not necessarily as at the end of the reporting period. However, a valuation undertaken other than as at the end of the reporting period will need to be updated as at the end of the reporting period to reflect at least changes in observable market data, such as asset values and discount rates. The need for updates in respect of other elements of the valuation will depend on individual circumstances.

As discussed in Chapter 37 at section 9.3.3, an updated valuation will be required for interim reporting as a result of the following:

- A significant change in the corporate bond rate used to discount the defined benefit obligation.
- Significant changes in the fair value of plan assets.
- Significant changes in actuarial assumptions, including those linked to economic factors such as inflation (which may in turn impact other actuarial assumptions such as the amount of lump sum benefits expected to be taken).
- One-off events such as a plan amendment, curtailment or the purchase of a qualifying insurance policy.

8 Defined benefit plans - Treatment of the plan surplus or deficit in the statement of financial position

8.1 Net defined benefit liability (asset)

IAS 19 defines the net defined benefit liability or asset as the deficit or surplus in the plan adjusted for any effect of the asset ceiling (see section 8.2 below).

The deficit or surplus is the present value of the defined benefit obligation (see section 7 above) less the fair value of the plan assets (if any) (see section 6 above).

The standard requires that the net defined benefit liability (asset) be recognised in the statement of financial position at each reporting period. *[IAS 19.63]*.

8.2 Restriction of assets to their recoverable amounts

The net defined benefit balance determined under IAS 19 could be an asset. The standard asserts that an asset may arise (that is, an asset measured on the basis of IAS 19) where a defined benefit plan has been 'over-funded' or when actuarial gains have arisen. The standard justifies the recognition of an asset in such cases because:

(a) The entity controls a resource, which is the ability to use the surplus to generate future benefits.

(b) That control is a result of past events (contributions paid by the entity and service rendered by the employee).

And

(c) Future economic benefits are available to the entity in the form of a reduction in future contributions or a cash refund, either directly to the entity or indirectly to another plan in deficit; the present value of those benefits is described as the asset ceiling. *[IAS 19.8, IAS 19.65]*.

In practice, pension plans tend to be funded on a significantly more prudent basis than would be the case if a surplus or deficit was measured in accordance with IAS 19. In particular, the discount rate used for funding purposes is typically lower than the rate required by the standard. For this reason, an IAS 19 valuation could produce a surplus, when for funding purposes there is a deficit. A surplus may also arise in economic conditions where discount rates are increased, and therefore the defined benefit obligation decreased, without a corresponding impact on the fair value of plan assets.

When there is an IAS 19 surplus in a defined benefit plan, the standard requires the net asset recognised to be restricted to the lower of the surplus in the plan and the asset ceiling discounted using the same discount rate used for determining the defined benefit obligation (see section 7.6 above). *[IAS 19.8, IAS 19.64, IFRIC 14.1]*.

Any adjustment required by the ceiling test is accounted for in other comprehensive income (see section 10.4 below).

This limitation has proved quite problematic in practice and as a result was considered by the IFRS IC, initially in the context of statutory minimum funding requirements (MFR). This resulted in the publication, in July 2007, of IFRIC 14. Whilst dealing with the interaction of the asset ceiling with MFR, IFRIC 14 also deals more generally with the restriction of an asset on recoverability grounds. *[IFRIC 14.1, IFRIC 14.2, IFRIC 14.3, IFRIC 14.6]*. Subsequently, IFRIC 14 was amended to deal with pre-paid MFR - see section 8.2.3 below.

The IFRS IC notes that MFR exist in many countries and normally stipulate a minimum amount or level of contribution that must be made to a plan over a given period. Therefore, a minimum funding requirement may limit an entity's ability to reduce future contributions. *[IFRIC 14.2]*.

In addition, the limit on the measurement of a defined benefit asset may cause a minimum funding requirement to be onerous. Normally, a requirement to make contributions to a plan would not affect the measurement of the defined benefit asset or liability. This is because the contributions, once paid, will become plan assets and so the additional net liability is nil. However, a minimum funding requirement may give rise to a liability if the required contributions will not be available to the entity once they have been paid. *[IFRIC 14.3]*.

The issues addressed by IFRIC 14 are: *[IFRIC 14.6]*

- When refunds or reductions in future contributions must be regarded as available in accordance with the definition of the asset ceiling (discussed in sections 8.2.1 and 8.2.2 below).
- How a minimum funding requirement might affect the availability of reductions in future contributions (discussed in section 8.2.3 below).

  And
- When a minimum funding requirement might give rise to a liability (discussed in section 8.2.4 below).

8.2.1 IFRIC Interpretation 14 - general requirements concerning the limit on a defined benefit asset

IFRIC 14 clarifies that economic benefits, in the form of refunds or reduced future contributions, are available if they can be realised by the entity at some point during the life of the plan or when the plan liabilities are settled. In particular, such economic benefits may be available even if they are not realisable immediately at the end of the reporting period. *[IFRIC 14.8]*.

Furthermore, the benefit available does not depend on how the entity intends to use the surplus. The entity must determine the maximum economic benefit that is available from refunds, reductions in future contributions or a combination of both. However, economic benefits must not be recognised from a combination of refunds and reductions in future contributions based on assumptions that are mutually exclusive. *[IFRIC 14.9]*. Perhaps unnecessarily, the interpretation requires the availability of a refund or a reduction in future contributions to be determined in accordance with the terms and conditions of the plan and any statutory requirements in the jurisdiction of the plan. *[IFRIC 14.7]*.

The interpretation observes that an unconditional right to a refund can exist whatever the funding level of a plan at the end of the reporting period. The interpretation further states that benefits are available as a refund only if the entity has an unconditional right to a refund:

(a) During the life of the plan, without assuming that the plan liabilities must be settled in order to obtain the refund.

Or

(b) Assuming the gradual settlement of the plan liabilities over time until all members have left the plan.

Or

(c) Assuming the full settlement of the plan liabilities in a single event (i.e., as a plan wind-up).

However, if the right to a refund of a surplus depends on the occurrence or non-occurrence of one or more uncertain future events not wholly within an entity's control, the entity does not have an unconditional right and must not recognise an asset. *[IFRIC 14.11, IFRIC 14.12]*.

The economic benefit available as a refund must be measured as the amount of the surplus at the end of the reporting period (being the fair value of the plan assets less the present value of the defined benefit obligation) that the entity has a right to receive as a refund, less any associated costs. For example, if a refund would be subject to a tax other than income tax of the reporting entity, it must be measured net of the tax. *[IFRIC 14.13]*. Tax on defined benefit pension plans is discussed further in Chapter 29 at section 10.7.

In measuring the amount of a refund available when the plan is wound up (point (c) above), the costs to the plan of settling the plan liabilities and making the refund must be included. For example, a deduction must be made for professional fees if these are paid by the plan rather than the entity, and the costs of any insurance premiums that may be required to secure the liability on wind-up. *[IFRIC 14.14]*.

It is usually the case that the trustees of a pension fund are independent of the entity. Trustees could have a variety of powers to influence a surplus in a plan. For example:

- Setting the investment strategy whereby assets with lower risk and lower return would erode a surplus over time; or the purchase of assets in the form of insurance policies matching all or some of the cash outflows of the plan.

  Or

- Full or partial settlement of liabilities; or the improvement of benefits under the plan.

IFRIC 14 makes it clear that for future benefit improvements made by the employer and actuarial gains and losses, the existence of an asset at the end of the reporting period is not affected by possible future changes to the amount of the surplus. If future events occur that change the amount of the surplus, their effects are recognised when they occur. *[IFRIC 14.BC10]*.

The interpretation is also clear that if the right to a refund of a surplus depends on the occurrence or non-occurrence of one or more uncertain future events that are not wholly within an entity's control, the entity does not have an unconditional right and must not recognise a surplus. *[IFRIC 14.11, IFRIC 14.12]*.

However, neither IAS 19 nor IFRIC 14 address the question of whether the entity's right to a refund of a surplus which depends on the occurrence or non-occurrence of uncertain future events means that no surplus should be recognised in any scenario where trustees have the power to 'spend' a surplus.

It is worth noting that in June 2018 the IASB published an exposure draft of proposed amendments to IAS 19 and IFRIC 14 which addressed whether other parties' (for example pension trustees) power to enhance benefits for plan members or wind up a plan affected the availability of a refund.

This exposure draft was issued as a response to two requests to the IFRS IC, suggesting that there is diversity in practice in this area. In the Basis for Conclusions on the exposure draft the IASB noted that IFRIC 14.BC10 had not specifically addressed the circumstances in which trustees have such unconditional powers. The exposure draft proposed that the amount of the surplus that the entity recognised as an asset on the basis of a future refund must not include amounts that other parties can use for other purposes that affect the benefits for plan members, for example by enhancing those benefits without the entity's consent. In February 2022, the IASB decided to remove this project from its work plan after concluding that the prospects for progress were limited.[17]

How we see it

Pending any change to the standard, we believe entities have an accounting policy choice, as to how unconditional rights by trustees to 'spend' any current surplus are taken into account in the recognition of any existing IAS 19 surplus, to be applied consistently to similar facts and circumstances, and disclosed where material.

If the amount of a refund is determined as the full amount or a proportion of the surplus, rather than a fixed amount, an entity should make no adjustment for the time value of money, even if the refund is realisable only at a future date. *[IFRIC 14.15]*.

8.2.2 Economic benefits available as reduced future contributions when there are no minimum funding requirements for future service

IFRIC 14 addresses separately cases where there are minimum funding requirements relating to benefits to be awarded in future periods in exchange for services to be rendered in those periods, and cases where there are no such funding requirements.

This section deals with the situation where there are no such funding requirements. The implications of future service minimum funding requirements are discussed in section 8.2.3 below.

IFRIC 14 requires that the economic benefit available by way of reduced future contributions be determined as the future service cost to the entity for each period over the shorter of the expected life of the plan and the expected life of the entity. The future service cost to the entity excludes amounts that will be borne by employees. *[IFRIC 14.16]*.

Future service costs should be determined using assumptions consistent with those used to determine the defined benefit obligation and with the situation that exists at the end of the reporting period as determined by IAS 19. Accordingly, no future changes to the benefits to be provided by a plan should be assumed until the plan is amended, and a stable workforce in the future should be assumed unless the entity makes a reduction in the number of employees covered by the plan. In the latter case, the assumption about the future workforce should include the reduction. The present value of the future service cost should be determined using the same discount rate as that used in the calculation of the defined benefit obligation (discount rates are discussed in section 7.6 above). *[IFRIC 14.17]*.

8.2.3 IFRIC Interpretation 14 - the effect of a minimum funding requirement on the economic benefit available as a reduction in future contributions

IFRIC 14 defines minimum funding requirements as "any requirements to fund a post-employment or other long-term defined benefit plan". *[IFRIC 14.5]*. This is clearly quite a wide definition encompassing more than just statutory regimes.

17 *IASB Update*, February 2022, available on the IFRS Foundation's website.

Some minimum funding arrangements require periodic reappraisal (for example, every three years). Should such an arrangement cover a longer period, all payments over this longer period constitute the minimum funding requirement, not just the three years until the next reappraisal. In its March 2015 meeting the IFRS IC, following a request for clarification, discussed whether an entity should assume that the minimum funding requirement for contributions to cover future services (see below) would continue over the estimated life of the pension plan. In its July 2015 agenda decision, the IFRS IC noted that the entity should assume a continuation of existing funding principles because:[18]

- For any factors not specified by the minimum funding basis (for example, the period to continue the plan is not specified by the existing funding principles), the assumptions for determining future service costs and those used to estimate the future minimum funding requirement contributions for future service must be consistent. This is because the Interpretation requires an entity to use assumptions that are consistent with those used to determine the defined benefit obligation and with the situation that exists at the end of the reporting period. *[IFRIC 14.17, IFRIC 14.21]*.
- The estimate should not include changes to the funding principles to determine contributions for future service, if such changes require future negotiations with pension trustees. *[IFRIC 14.21, IFRIC 14.BC30]*.

The Interpretation requires any minimum funding requirement at a given date to be analysed into contributions that are required to cover: *[IFRIC 14.18]*

(a) Any existing shortfall for past service on the minimum funding basis. These contributions do not affect future contributions for future service. However, they may give rise to a liability under IFRIC 14 (see section 8.2.4 below). *[IFRIC 14.19]*.

And

(b) Future service.

If there is a minimum funding requirement for contributions relating to future service, the economic benefit available as a reduction in future contributions is the sum of: *[IFRIC 14.20]*

(a) Any amount that reduces future minimum funding requirement contributions for future service because the entity made a pre-payment (that is, it paid the amount before being required to do so).

And

(b) The estimated future service cost in each period (as discussed in section 8.2.2 above) less the estimated minimum funding requirement contributions that would be required for future service in those periods if there were no pre-payment as described in (a).

The future minimum funding contributions required in respect of future service should be calculated:

- Taking into account the effect of any existing surplus on the minimum funding requirement basis but excluding the pre-payment discussed in (a) immediately above.
- Using assumptions consistent with the minimum funding requirement basis. For any factors not specified by the minimum funding requirement, the assumptions used should be consistent with those used to determine the defined benefit obligation and with the situation that exists at the end of the reporting period as determined by IAS 19.
- Including any changes expected as a result of the entity paying the minimum contributions when they are due.

  And
- Excluding the effect of expected changes in the terms and conditions of the minimum funding basis that are not substantively enacted or contractually agreed at the end of the reporting period. *[IFRIC 14.21]*.

If the future minimum funding contribution required in respect of future service exceeds the future IAS 19 service cost in any given period, the present value of that excess reduces the amount of the asset available as a reduction in future contributions. However, the amount of the asset available as a reduction in future contributions can never be less than zero. *[IFRIC 14.22]*.

The mechanics of the above requirements are illustrated in the following two examples based on the illustrative examples accompanying IFRIC 14. *[IFRIC 14.IE9-IE27]*. Illustration 8-1 also illustrates the requirement in certain circumstances to recognise an additional liability for future MFR payments in respect of past service (discussed in section 8.2.4 below).

18 *IFRIC Update*, July 2015, available on the IFRS Foundation's website.

Illustration 8-1: Deficit-clearing future minimum funding requirements when refunds are not available

An entity has a funding level on the minimum funding requirement basis (which is measured on a different basis from that required under IAS 19) of 95% in Plan C. Under the minimum funding requirements, the entity is required to pay contributions to increase the funding level to 100% over the next three years. The contributions are required to make good the deficit on the minimum funding requirement basis (shortfall) and to cover future service.

Plan C also has an IAS 19 surplus at the end of the reporting period of CU50m, which cannot be refunded to the entity under any circumstances. There are no unrecognised amounts.

The nominal amounts of the minimum funding contribution requirements in respect of the shortfall and the future IAS 19 service cost for the next three years are set out below.

	Total minimum funding contribution requirement	Minimum contributions required to make good the shortfall	Minimum contributions required to cover future accrual
Year	CU m	CU m	CU m
1	135	120	15
2	125	112	13
3	115	104	11

The entity's present obligation in respect of services already received includes the contributions required to make good the shortfall but does not include the minimum contributions required to cover future service.

The present value of the entity's obligation, assuming a discount rate of 6% per year, is approximately CU300m, calculated as follows:

$CU120m \div (1.06) + CU112m \div (1.06)^2 + CU104m \div (1.06)^3$

When these contributions are paid into the plan, the IAS 19 surplus (i.e., the fair value of assets less the present value of the defined benefit obligation) would, other things being equal, increase from CU50m to CU350m. However, the surplus is not refundable although an asset may be available as a future contribution reduction.

As noted above, the economic benefit available as a reduction in future contributions is the present value of:

- The future service cost in each year to the entity

  Less

- Any minimum funding contribution requirements in respect of the future accrual of benefits in that year

over the expected life of the plan.

The amounts available as a future contribution reduction are set out below.

	IAS 19 service cost	Minimum contributions required to cover future accrual	Amount available as contribution reduction
Year	CU m	CU m	CU m
1	13	15	(2)
2	13	13	0
3	13	11	2
4+	13	9	4

Assuming a discount rate of 6%, the economic benefit available as a future contribution reduction is therefore equal to:

$CU(2)m \div (1.06) + CU0m \div (1.06)^2 + CU2m \div (1.06)^3 + CU4m \div (1.06)^4 + CU4m \div (1.06)^5 + CU4m \div (1.06)^6 \ldots = CU56m.$

The asset available from future contribution reductions is accordingly limited to CU56m.

As discussed in section 8.2.4 below, IFRIC 14 requires the entity to recognise a liability to the extent that the additional contributions payable will not be fully available. Therefore, the effect of the asset ceiling is to reduce the defined benefit asset by CU294m (CU50m + CU300m - CU56m).

As discussed in section 10.4 below, the effect of the asset ceiling is part of remeasurements and the CU294m is recognised immediately in other comprehensive income and the entity recognises a net liability of CU244m. No other liability is recognised in respect of the obligation to make contributions to fund the minimum funding shortfall.

When the contributions of CU300m are paid into the plan, the net asset will become CU56m (CU300m - CU244m).

Illustration 8-2: Effect of a prepayment when a minimum funding requirement exceeds the expected future service charge

An entity is required to fund Plan D so that no deficit arises on the minimum funding basis. The entity is required to pay minimum funding requirement contributions to cover the service cost in each period determined on the minimum funding basis.

Plan D has an IAS 19 surplus of CU35 at the beginning of 20X7. This example assumes that the discount rate is 0%, and that the plan cannot refund the surplus to the entity under any circumstances but can use the surplus for reductions of future contributions.

The minimum contributions required to cover future service are CU15 for each of the next five years. The expected IAS 19 service cost is CU10 in each year.

The entity makes a prepayment of CU30 at the beginning of 20X7 in respect of years 20X7 and 20X8, increasing its surplus at the beginning of 20X7 to CU65. That prepayment reduces the future contributions it expects to make in the following two years, as follows:

		Minimum funding requirement contribution:	
	IAS 19 service cost	**Before pre-payment**	**After pre-payment**
Year	**CU**	**CU**	**CU**
20X7	10	15	0
20X8	10	15	0
20X9	10	15	15
20X0	10	15	15
20X1	10	15	15
Total	**50**	**75**	**45**

At the beginning of 20X7, the economic benefit available as a reduction in future contributions is the sum of:

- CU30, being the prepayment of the minimum funding requirement contributions.

  And

- Nil. The estimated minimum funding requirement contributions required for future service would be CU75 if there was no prepayment. Those contributions exceed the estimated future service cost (CU50); therefore, the entity cannot use any part of the surplus of CU35.

Assuming a discount rate of 0%, the present value of the economic benefit available as a reduction in future contributions is equal to CU30. Accordingly, the entity recognises an asset of CU30 (because this is lower than the IAS 19 surplus of CU65).

Two points worth noting in Illustration 8-2 above are as follows. The first is that, if IFRIC 14 did not allow the recognition of such prepayments, the full surplus of CU65 would have been written off. The second is that, in the fact pattern of the question, it is unnecessary to know that the surplus before the prepayment was CU35. This is because any surplus (other than the prepayment of MFR) would not be recognised because refunds are not available and future MFR exceeds future service costs.

8.2.4 IFRIC Interpretation 14 - when a minimum funding requirement may give rise to a liability

If there is an obligation under a minimum funding requirement to pay contributions to cover an existing shortfall on the minimum funding basis in respect of services already received, the entity should determine whether the contributions payable will be available as a refund or reduction in future contributions after they are paid into the plan. *[IFRIC 14.23]*. Recovery through reduced future contributions is discussed in sections 8.2.2 and 8.2.3 above.

If a surplus is recoverable by way of a refund (see section 8.2.1 above), a minimum funding requirement to cover a shortfall in respect of past services will neither restrict an IAS 19 asset nor trigger the recognition of a liability as it will be recoverable with any refund. IFRIC 14 illustrates this by way of an example upon which the following is based. *[IFRIC 14.IE1, IFRIC 14.IE2]*.

Illustration 8-3: Effect of the minimum funding requirement when there is an IAS 19 surplus and the minimum funding contributions payable are fully refundable to the entity

An entity has a funding level on the minimum funding requirement basis (which is measured on a different basis from that required under IAS 19) of 82% in Plan A. Under the minimum funding requirements, the entity is required to increase the funding level to 95% immediately. As a result, the entity has a statutory obligation at the end of the reporting period to contribute CU200m to Plan A immediately. The plan rules permit a full refund of any surplus to the entity at the end of the life of the plan. The year-end valuations for Plan A are set out below.

	CU m
Fair value of assets	1,200
Present value of defined benefit obligation under IAS 19	(1,100)
Surplus	**100**
Defined benefit asset (before consideration of the minimum funding requirement)	**100**

Payment of the contributions of CU200m will increase the IAS 19 surplus from CU100m to CU300m. Under the rules of the plan this amount will be fully refundable to the entity with no associated costs. Therefore, no liability is recognised for the obligation to pay the contributions and the net defined benefit asset will be recognised at CU100m.

To the extent that the contributions payable will not be available after they are paid into the plan, a liability should be recognised when the obligation arises. The liability should reduce the net defined benefit asset or increase the net defined benefit liability so that no gain or loss is expected to result from the effect of the asset ceiling when the contributions are paid. *[IFRIC 14.24]*.

IFRIC 14 illustrates this by way of an example upon which the following is based. *[IFRIC 14.IE3-8]*.

Illustration 8-4: Effect of a minimum funding requirement when there is an IAS 19 deficit and the minimum funding contributions payable would not be fully available

An entity has a funding level on the minimum funding requirement basis (which is measured on a different basis from that required under IAS 19) of 77% in Plan B. Under the minimum funding requirements, the entity is required to increase the funding level to 100% immediately. As a result, the entity has a statutory obligation at the end of the reporting period to pay additional contributions of CU300m to Plan B. The plan rules permit a maximum refund of 60% of the IAS 19 surplus to the entity and the entity is not permitted to reduce its contributions below a specified level which happens to equal the IAS 19 service cost. The year-end valuations for Plan B are set out below.

	CU m
Fair value of assets	1,000
Present value of defined benefit obligation under IAS 19	(1,100)
Deficit	**(100)**

The payment of CU300m would change the IAS 19 deficit of CU100m to a surplus of CU200m. Of this CU200m, 60% (CU120m) is refundable. Therefore, of the contributions of CU300m, CU100m eliminates the IAS 19 deficit and CU120m (60% of CU200m) is available as an economic benefit. The remaining CU80m (40% of CU200m) of the contributions paid is not available to the entity. As discussed above, IFRIC 14 requires the entity to recognise a liability to the extent that the additional contributions payable are not available to it. Accordingly, the net defined benefit liability is CU180m, comprising the deficit of CU100m plus the additional liability of CU80m with CU80m also being recognised in other comprehensive income. No other liability is recognised in respect of the statutory obligation to pay contributions of CU300m. When the contributions of CU300m are paid, the net asset will be CU120m. If the entity were required to achieve a 100% funding position at some point in the future, but not immediately, the present value of its contributions over this period would be used in the calculation above.

8.2.5 Pension funding payments contingent on future events within the control of the entity

As entities begin to consider moving away, in part at least, from deficit funding contributions which are fixed payments at fixed dates (which are clearly deficit clearing minimum funding requirements) to contributions contingent on future events, what constitutes a minimum funding requirement becomes more important, especially where it is concluded that an IAS 19 surplus is not recoverable. The definition of plan assets is discussed in section 6.1 above and minimum funding requirements are discussed in section 8.2.3 above. Where a surplus is not recoverable, under the asset ceiling:

- An instrument recognised as a plan asset would be written off.

  And

- An arrangement which, whilst not being a plan asset, is considered a minimum funding requirement, would be provided for under IFRIC 14.

However, an arrangement which is considered neither a plan asset nor a minimum funding requirement would not be accounted for until payments are made. An example of such a situation is a requirement to make a contribution to a plan at some multiple of any dividends paid within a specified period. Such a right to receive a contribution in these circumstances may or may not meet the definition of a plan asset depending on its precise terms (in particular, whether the right is a 'transferable' one).

In this situation, a funding payment only happens as a result of an action within the control of the entity. Accordingly, such an obligation on a stand-alone basis would not be considered a financial liability under IAS 32 *Financial Instruments: Presentation* (see Chapter 41 at section 1.1).

This leads to the key consideration of what accounting treatment to apply to a binding agreement requiring the making of payments to a plan only if the entity undertakes a separate transaction which is wholly within its control:

- If the corresponding entitlement of the plan does not meet the definition of a plan asset (for example, if it is non-transferable).

  And

- It is considered not to be a minimum funding requirement (as it is contingent on the actions of the entity).

Two possibilities present themselves, which would have quite different accounting consequences.

One view could be that these contingent contributions would meet the definition of a minimum funding requirement. IAS 19 is based on the best estimates of ultimate cashflows and it is unequivocal that cashflows used to calculate the defined benefit obligation include the effect of at least some actions which are within the control of the entity. Most obviously, both continued employment and pay increases are within the control of the employer and are estimated to determine the defined benefit obligation and service cost (see section 7.5 above). Therefore, if the defined benefit obligation reflects a best estimate of future actions within the control of the entity, an argument could be made that a similar approach could be taken to funding payments. If it is believed that contingent contributions meet the definition of a minimum funding requirement, any accounting consequences of them would be recognised at the inception of the agreement. Under this view the entity would need to make a best estimate of the amount and timing of any future contributions, and determine whether an additional liability arises under IFRIC 14 where these would not be recoverable (see section 8.2.4 above).

An alternative view that contingent funding is not a minimum funding requirement could be formed by analogy to IAS 32 or IAS 37. A cash payment which the entity could avoid would not generally be accounted for as a financial liability under IAS 32. It could be argued that it would therefore not be encompassed within the phrase 'any requirement to fund'. Under this analysis the definition of a plan asset (see section 6.1 above) becomes particularly important. A transferable instrument would be a plan asset, and would be written off under the asset ceiling mechanism if it is not considered recoverable under IFRIC 14. A non-transferable instrument would not meet the definition of a plan asset. If such an instrument was not considered a minimum funding requirement (because it could be avoided by the entity) it would not be accounted for until a payment were made.

If analogy were made to IAS 37, the presence of a constructive obligation could trigger recognition of a liability in respect of irrecoverable minimum funding payments at the moment it becomes probable that an outflow of resources will be required to settle the obligation and it can be estimated reliably.

How we see it

In developing an accounting policy an entity should consider the views above and apply judgement based on the individual facts and circumstances.

9 Defined benefit plans – Presentation of the net defined benefit liability (asset)

Neither IAS 19 nor IAS 1[19] specifies where in the statement of financial position a net asset or net liability in respect of a defined benefit plan should be presented, nor whether such balances should be shown separately on the face of the statement of financial position or only in the notes - this is left to the discretion of the reporting entity subject to the general requirements of IAS 1 discussed in Chapter 3 at section 3.1. If the format of the statement of financial position distinguishes current assets and liabilities from non-current ones, the question arises as to whether this split needs also to be made for pension balances. IAS 19 does not specify whether such a split should be made, on the grounds that it may sometimes be arbitrary. *[IAS 19.133, IAS 19.BC200]*.

Employers with more than one plan could find that some are in surplus while others are in deficit. IAS 19 contains offset criteria closely modelled on those in IAS 32. *[IAS 19.132]*. An asset relating to one plan could only be offset against a liability relating to another plan when there is a legally enforceable right to use a surplus in one plan to settle obligations under the other plan, and the employer intends to settle the obligations on a net basis or realise the surplus and settle the obligation simultaneously. *[IAS 19.131]*. It seems unlikely that these offset criteria would be met in practice.

19 IFRS 18 *Presentation and Disclosure in Financial Statements*, which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted) was issued by the IASB in April 2024, See Chapter 4 for further details on the new concepts and requirements of IFRS 18.

10 Defined benefit plans - Treatment in profit or loss and other comprehensive income

IAS 19 identifies three components of annual pension cost as follows:

(a) Service cost (see section 10.1 below)

(b) Net interest on the net defined benefit liability (asset) (see section 10.3 below)

And

(c) Remeasurements of the net defined benefit liability (see section 10.4 below) *[IAS 19.120]*

Of these, (a) and (b) are recognised in profit or loss and (c) is recognised in other comprehensive income. This is unless another standard requires or permits the costs to be included in the cost of an asset, for example IAS 2 *Inventories* and IAS 16 *Property, Plant and Equipment*. Where the post-employment benefit costs are included in the cost of an asset the appropriate proportion of all the above items must be included. *[IAS 19.121]*. There is no guidance in the standard as to what an 'appropriate' proportion of these items might be, although both IAS 2 (see Chapter 23 at section 3.1.2) and IAS 16 (see Chapter 19 at section 4.1.1) are clear that only those costs which are directly attributable to the asset qualify for capitalisation. It is not necessarily the case that the appropriate proportion will be the same for all of the components and judgement will be required in determining how much of each item can meaningfully be said to relate to the production of an asset.

Remeasurements recognised in other comprehensive income should not be reclassified to profit and loss in a subsequent period. The standard notes that those amounts may be transferred within equity. *[IAS 19.122]*.

The standard states that it does not specify how an entity should present service cost and net interest on the net defined benefit liability or asset. The presentation of these components in the profit and loss account are accounted for in accordance with IAS 1 (see Chapter 3 at section 3.2) and could either be included in one line or split between lines in the income statement according to its nature. *[IAS 19.134]*. For example, the net interest could be presented in the income statement along with other finance items. IFRS 18, once effective, will require that net interest on a defined benefit liability (or asset) be classified in the financing category in the income statement. *[IFRS 18.59(b), IFRS 18.B53]*. See Chapter 4 at section 3.3.3 for more details on the new requirements in IFRS 18.

10.1 Service cost

Service cost comprises:

(a) Current service cost - the increase in the present value of the defined benefit obligation resulting from employee service in the current period.

(b) Past service cost - the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or a curtailment (a significant reduction by the entity in the number of employees covered by a plan).

And

(c) Any gain or loss on settlement - the difference, at the date of settlement, between the present value of the defined benefit obligation being settled and the settlement price, including any plan assets transferred and any payments made directly by the entity in connection with the settlement. *[IAS 19.8, IAS 19.109]*. The gain or loss is recognised when the settlement occurs. *[IAS 19.110]*.

The current service cost should be determined using the projected unit credit method. *[IAS 19.67]*. The basic computation is illustrated in Illustration 7-2 in section 7.3 above.

There is no need to distinguish between past service cost resulting from a plan amendment, past service cost resulting from a curtailment and a gain or loss on settlement if these transactions occur together. In some cases, a plan amendment occurs before a settlement, such as when an entity changes the benefits under the plan and settles the amended benefits later. In those cases, an entity recognises past service cost before any gain or loss on settlement. *[IAS 19.8, IAS 19.100]*.

A settlement occurs together with a plan amendment and curtailment if a plan is terminated with the result that the obligation is settled and the plan ceases to exist. However, the termination of a plan is not a settlement if the plan is replaced by a new plan that offers benefits that are, in substance, the same. *[IAS 19.101]*.

10.2 Changes in a defined benefit plan

Accounting for past service costs (plan amendments or curtailments) and settlements are discussed in sections 10.2.1 and 10.2.3 below, respectively. The acquisition of a qualifying insurance policy not directly connected with a settlement is discussed in section 10.2.2 below. Each of these sections detail where any gain or loss arising is recorded which will either be in the profit and loss account or other comprehensive income.

In summary, when determining the effect of such a transaction, the net defined benefit liability (asset) should be remeasured using up to date values for plan assets and actuarial assumptions before and after the event to determine the effect of it. *[IAS 19.99]*.

Any past service cost or gain or loss on settlement should be recognised and measured without considering the effect of the asset ceiling (see section 8.2 above). The effect of the asset ceiling should then be determined after the plan amendment, curtailment or settlement with any change in that effect, excluding amounts included in net interest, recognised in other comprehensive income. *[IAS 19.101A]*.

Current service cost should ordinarily be determined using actuarial assumptions as at the start of the reporting period. However, as discussed in section 10.2.1 below, a plan amendment, curtailment or settlement during a reporting period will require remeasurement of the net defined benefit liability (asset). In such cases the current service cost for the remainder of the period, that is, after the plan amendment, curtailment or settlement, should be calculated using the actuarial assumptions used for the remeasurement. *[IAS 19.122A]*.

The point in time at which a plan amendment occurs will often be a matter of fact based on the legal entitlements of plan members. Judgement could be required, based on individual facts and circumstances, particularly if the benefits concerned constitute constructive, as opposed to legal, obligations (see section 7.1 above).

Sometimes benefit plans are amended in such a way as to allow members a choice, for a limited period, between two or more benefit arrangements. In such cases, a plan amendment occurs (and a positive or negative past service cost will be recognised) on the date at which the new arrangement comes into existence (legally or constructively) and not at the later date by which members are required to make their choice. This could mean that the initial accounting for the plan amendment will require estimates to be made of the choices which members will make. However, if it is known, at the time the relevant financial statements are prepared, what choices members have made (for example, because the 'window' for making selections closes before the financial statements are authorised for issue) this definitive data would remove the need for estimation. Any subsequent changes in estimates in the following years resulting from the confirmation process would be a change in estimate and recognised as a remeasurement gain or loss.

10.2.1 Past service cost

Past service cost is the change in the present value of the defined benefit obligation for employee service in prior periods resulting from a plan amendment or curtailment. *[IAS 19.8, IAS 19.102]*.

Past service costs should be recognised at the earlier of the date when:

(a) The plan amendment or curtailment occurs.

And

(b) The entity recognises related restructuring costs in accordance with IAS 37 (discussed in Chapter 27 at section 6.1). *[IAS 19.8, IAS 19.103]*.

A plan amendment occurs when an entity introduces, or withdraws, a defined benefit plan or changes the benefits payable under an existing defined benefit plan. *[IAS 19.8, IAS 19.104]*.

In November 2007, the IFRS IC discussed whether changes to a defined benefit plan as a result of government action must also be accounted for as a plan amendment. The IFRS IC noted that "the accounting for changes arising from government actions should be the same as for changes made by an employer." The IFRS IC also acknowledged that, "in some circumstances, it might be difficult to determine whether the change affects either actuarial assumptions or benefits payable and noted that judgement is required".[20]

A curtailment occurs when an entity significantly reduces the number of employees covered by a plan. A curtailment may arise from an isolated event, such as the closing of a plant, discontinuance of an operation or termination or suspension of a plan. *[IAS 19.8, IAS 19.105]*.

20 *IFRIC Update*, November 2007, available on the IFRS Foundation's website.

In determining whether a curtailment has occurred an entity should consider both quantitative factors (such as the reduction of the number of employees as a percentage of the total number of employees) and qualitative factors (such as whether a division has been closed). If a reduction in the number of employees is judged significant then a curtailment should be recognised. *[IAS 19.BC162]*.

The timing of the recognition of a plan amendment or curtailment which is not triggered by a restructuring will require judgement and depend on facts and circumstances, and their interaction with the constructive obligation requirements in the standard. *[IAS 19.BC158]*.

Past service cost may be either positive (when benefits are introduced or changed so that the present value of the defined benefit obligation increases) or negative (when benefits are withdrawn or changed so that the present value of the defined benefit obligation decreases). *[IAS 19.8, IAS 19.106]*.

Where an entity reduces benefits payable under an existing defined benefit plan and, at the same time, increases other benefits payable under the plan for the same employees, the entity treats the change as a single net change. *[IAS 19.8, IAS 19.107]*.

Past service cost excludes:

(a) The effect of differences between actual and previously assumed salary increases on the obligation to pay benefits for service in prior years (there is no past service cost because actuarial assumptions allow for projected salaries, accordingly the effect of any such difference is an actuarial gain or loss - see section 7.5 above).

(b) Under- and over-estimates of discretionary pension increases when an entity has a constructive obligation to grant such increases (there is no past service cost because actuarial assumptions allow for such increases, accordingly the effect of any such under- or over-estimate is an actuarial gain or loss - see section 7.5 above).

(c) Estimates of benefit improvements that result from actuarial gains or from the return on plan assets that have been recognised in the financial statements if the entity is obliged, by either the formal terms of a plan (or a constructive obligation that goes beyond those terms) or legislation, to use any surplus in the plan for the benefit of plan participants, even if the benefit increase has not yet been formally awarded (the resulting increase in the obligation is an actuarial loss and not past service cost, see section 7.5 above).

And

(d) The increase in vested benefits (that is, those not conditional on future employment) when, in the absence of new or improved benefits, employees complete vesting requirements (there is no past service cost because the estimated cost of benefits was recognised as current service cost as the service was rendered, accordingly the effect of any such increase is an actuarial gain or loss, see section 7.5 above). *[IAS 19.108]*.

10.2.2 Acquisition of a qualifying insurance policy

IAS 19 observes that an employer could acquire an insurance policy to fund some or all of the employee benefits relating to employee service in the current and prior periods. The acquisition of such a policy is not a settlement if the employer retains a legal or constructive obligation to pay further amounts if the insurer does not pay the employee benefits specified in the insurance policy (often referred to as a buy-in). *[IAS 19.112]*. However, the acquisition of an insurance policy will mean an entity has an asset which needs to be measured at fair value. As discussed in section 6.3 above, certain insurance policies are valued at an amount equal to the present value of the defined benefit obligation which they match. The cost of buying such a policy will typically greatly exceed its subsequent carrying amount. This loss is seen as an actuarial loss as it results from exchanging one plan asset for another, which is recognised in other comprehensive income, unless in substance the acquisition of the qualifying insurance policy is a settlement of the plan (see section 10.2.3 below).

10.2.3 Settlements

IAS 19 defines a settlement as a transaction that eliminates all further legal or constructive obligations for part or all of the benefits provided under a defined benefit plan, other than a payment of benefits to, or on behalf of, employees that is set out in the terms of the plan and included in the actuarial assumptions. *[IAS 19.8]*.

In other words, settlement occurs at the point of absolute risk extinguishment, for part or all of the employer obligations. The date on which absolute risk extinguishment occurs may require judgement and depend on facts and circumstances. The IFRS IC noted in their meeting in May 2008 that options covered by an existing plan, such as lump sum payments on retirement, are covered by actuarial assumptions and are not treated as settlements.[21]

21 *IFRIC Update*, May 2008, available on the IFRS Foundation's website.

For example, a one-off transfer of significant employer obligations under the plan to an insurance company through the purchase of an insurance policy (often referred to as a buy-out) is a settlement; a lump sum cash payment, under the terms of the plan, to plan participants in exchange for their rights to receive specified post-employment benefits is not. *[IAS 19.111]*.

The interaction between the asset ceiling and past service cost or a gain or loss on settlement is discussed further in section 10.2.1 above.

As noted in section 10.1 above the gain or loss on settlement forms part of the service cost and is recognised in profit or loss.

Any transactions in advance of the legal date of a settlement would also need to be considered. For example, an entity could enter into a binding commitment to settle a defined benefit obligation in the future with an insurance company, which as at the year-end date is beyond recall, but legally risk only transfers to the insurer after the year end. In this situation, the loss on settlement must be recognised at the point of commitment. However, the defined benefit obligation and related assets will remain on the statement of financial position until legal settlement occurs. As discussed in section 7.1 above an automatic exit event which is included within the plan rules and could not be avoided by the entity would also be taken into account as part of the measurement of the defined benefit obligation.

How we see it

The derecognition of a defined benefit obligation must only occur on absolute risk extinguishment. However an unavoidable commitment to do so may exist prior to that date, and that commitment and any resulting gain or loss will need to be accounted for.

The following extract from InterContinental Hotels Group PLC illustrates a buy-in which has occurred in one financial period, followed by a buy-out in the following financial period. As the policy was structured so as to enable the plan to move to a buy-out, and the intention was to proceed on that basis, the buy-in transaction was accounted for as a settlement with the loss arising recorded in the income statement.

Practical example 10-1: InterContinental Hotels Group PLC (2014) **United Kingdom**

Annual Report and Form 20-F 2014 [extract]

Notes to the Group Financial Statements [extract]

25. Retirement benefits

UK

Historically UK retirement and death in service benefits have been provided for eligible employees in the UK principally by the InterContinental Hotels UK Pension Plan, which has both defined benefit and defined contribution sections. The defined benefit section was subject to a buy-in transaction on 15 August 2013 whereby the assets of the plan were invested in a bulk purchase annuity policy with the insurer Rothesay Life under which the benefits payable to defined benefit members became fully insured. On 31 October 2014, the plan completed the move to a full buy-out of the defined benefit section, following which Rothesay Life has become fully and directly responsible for the pension obligations. On completion of the buy-out, the defined benefit assets (comprising the Rothesay Life insurance policy) and matching defined benefit liabilities were derecognised from the Group statement of financial position. The buy-out transaction

...

In respect of the defined benefit plans, the amounts recognised in the Group income statement, in administrative expenses, are:

	Pension plans											
	UK			US and other			Post-employment benefits			Total		
	2014 $m	2013 $m	2012 $m	2014 $m	2013 $m	2012 $m	2014 $m	2013 $m	2012 $m	2014 $m	2013 $m	2012 $m
Current service cost	–	2	5	1	1	1	–	–	–	1	3	6
Past service cost	–	–	–	–	1	–	–	–	–	–	1	–
Net interest expense	2	–	1	3	3	3	1	1	1	6	4	5
Administration costs	3	1	1	–	1	1	–	–	–	3	2	2
Operating profit before exceptional items	5	3	7	4	6	5	1	1	1	10	10	13
Exceptional items:												
Settlement cost	6	147	–	–	–	–	–	–	–	6	147	–
	11	150	7	4	6	5	1	1	1	16	157	13

settlement cost in 2013 resulted from the buy-in transaction described on the previous page and comprised a past service cost of n relating to additional benefits secured by the transaction, the $137m difference between the cost of the insurance policy and the ounting value of the liabilities secured and transaction costs of $5m. As the policy was structured to enable the plan to move to a -out and the intention was to proceed on that basis, the buy-in transaction was accounted for as a settlement with the loss arising orded in the income statement. The full buy-out was completed on 31 October 2014.

...

10.3 Net interest on the net defined benefit liability (asset)

Net interest on the net defined benefit liability (asset) is the change during the period in the net defined benefit liability (asset) that arises from the passage of time. *[IAS 19.8]*. It is determined by multiplying the net defined benefit liability (asset) by the discount rate (see section 7.6 above which also discusses the use of a more granular approach to determining the discount rate) taking into account any changes in the net defined benefit liability (asset) during the period resulting from contributions or benefit payments. *[IAS 19.123, IAS 19.123A]*.

Unless there are certain plan changes in the period, the discount rate used for the whole period is that determined at the start of the reporting period. However, if the net defined benefit liability (asset) is remeasured to determine a past service cost, or a gain or loss on settlement the net interest for the remainder of the reporting period is determined using: *[IAS 19.123A]*

(a) The net defined benefit liability (asset) reflecting the benefits offered after the plan amendment, curtailment or settlement.

And

(b) The discount rate used to remeasure the net defined benefit liability (asset).

Accounting for defined benefit schemes in interim financial statements is discussed in Chapter 37 at section 9.3.3.

As the net item in the statement of financial position is comprised of up to three separate components (the defined benefit obligation, plan assets and the asset ceiling), the net interest is made up of interest unwinding on each of these components. *[IAS 19.124]*. Although, computationally, the net interest is so composed, for the purposes of presentation in profit or loss it is a single net amount.

Interest on plan assets calculated as described above will not, other than by coincidence, be the same as the actual return on plan assets. The difference is a remeasurement recognised in other comprehensive income (see section 10.4.2 below). If the net plan liability (asset) is remeasured as a result of a plan amendment, curtailment or settlement the entity shall determine interest income for the remainder of the annual reporting period after the plan amendment, curtailment or settlement using the plan assets used to remeasure the net defined benefit liability (asset). In performing this calculation, the entity shall also take into account any changes in the plan assets held during the period resulting from contributions or benefit payments. *[IAS 19.125]*.

Similarly, the difference in the asset ceiling between the start and end of the period is unlikely to equal the interest on this component described above. An entity shall determine the effect of the asset ceiling at the start of the annual reporting period. However, if an entity remeasures the net defined benefit liability (asset) as a result of a plan amendment, curtailment or settlement, the entity shall determine interest on the effect of the asset ceiling for the remainder of the annual reporting period after the plan amendment, curtailment or settlement taking into account any change in the effect of the asset ceiling as discussed in section 10.2 above. The difference between the total change in the effect of the asset ceiling and the interest effect is accounted for as a remeasurement in other comprehensive income. *[IAS 19.126]*.

10.4 Remeasurements

Remeasurements of the net defined benefit liability (asset) comprise:

(a) Actuarial gains and losses

(b) The return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset)

And

(c) Any change in the effect of the asset ceiling (see section 8.2 above), excluding amounts included in net interest on the net defined benefit liability (asset) *[IAS 19.8, IAS 19.127]*

10.4.1 Actuarial gains and losses

Actuarial gains and losses are changes in the present value of the defined benefit obligation resulting from: experience adjustments (the effects of differences between the previous actuarial assumptions and what

has actually occurred); and the effects of changes in actuarial assumptions. *[IAS 19.8]*. These can result, for example, from:

(a) Unexpectedly high or low rates of: employee turnover, early retirement, mortality, increases in salaries or benefits, or medical costs (if the formal or constructive terms of the plan provide for inflationary benefits).

(b) The effect of changes to assumptions concerning benefit payment options.

(c) The effect of changes in estimates of future employee turnover, early retirement or mortality or of increases in salaries, benefits (if the formal or constructive terms of the plan provide for inflationary benefit increases) or medical costs.

And

(d) The effect of changes in the discount rate. *[IAS 19.128]*.

Actuarial gains and losses do not include changes in the present value of the defined benefit obligation because of the introduction, amendment, curtailment or settlement of the defined benefit plan, or changes to the benefits payable under the defined benefit plan. Such changes result in past service cost or gains or losses on settlement (see sections 10.2.1 and 10.2.3 above). *[IAS 19.129]*.

10.4.2 The return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset)

The return on plan assets is interest, dividends and other income derived from the plan assets, together with realised and unrealised gains on the assets, less:

- Any costs of managing plan assets.

  And

- Any tax payable by the plan itself, other than tax included in the actuarial assumptions used to measure the present value of the defined benefit obligation. *[IAS 19.8]*.

Other administration costs are not deducted from the return on plan assets, as discussed further in section 11 below. *[IAS 19.130]*.

11 Defined benefit plans - Costs of administering employee benefit plans

Some employee benefit plans incur costs as part of delivering employee benefits. The costs are generally more significant for post-retirement benefits such as pensions. Examples of costs include actuarial valuations, government levies, audits and the costs of managing any plan assets.

IAS 19 deals with some costs, as discussed below, but is silent on others.

The following costs are required to be factored into the measurement of the defined benefit obligation as part of the actuarial assumptions (see section 7.5 above):

- In the case of medical benefits, future medical costs, including claim handling costs (i.e., the costs that will be incurred in processing and resolving claims, including legal and adjuster's fees).

  And

- Taxes payable by the plan on contributions relating to service before the reporting date or on benefits resulting from that service. *[IAS 19.76(b)]*.

The following costs (and no others) are deducted from the return on plan assets (see section 10.4.2 above):

- The costs of managing the plan assets.

  And

- Any tax payable by the plan itself, other than tax included in the actuarial assumptions used to measure the defined benefit obligation. *[IAS 19.130]*.

As discussed in section 10.3 above, net interest on the net liability or asset is reported in the income statement. This is a wholly computed amount which is uninfluenced by actual asset returns; the difference between actual asset returns and the credit element of the net interest amount forms part of remeasurements reported in other comprehensive income.

So, although not expressed in these terms, costs of administering plan assets and the tax mentioned above are reported in other comprehensive income.

The standard is silent on the treatment of any other costs of administering employee benefit plans. However, the Basis for Conclusions on IAS 19 contains the following: "the Board decided that an entity should recognise administration costs when the administration services are provided. This practical expedient avoids the need to attribute costs between current and past service and future service". *[IAS 19.BC127]*. The Board may well have taken that decision, however it was not articulated in the practical expedient in the standard.

How we see it

In our view, recognising administration costs when the administration services are provided is an acceptable way to account for costs not dealt with in the standard. However other approaches could be acceptable, for example, in relation to closed schemes as discussed below. Once an accounting policy has been determined it must be applied consistently to similar facts and circumstances.

Entities need, in compliance with IAS 8, to develop an accounting policy in light of the standard not dealing with these costs. However, IAS 1 is clear that such costs would not be reported in other comprehensive income. *[IAS 1.88]*.

One alternative to simple accruals accounting as costs are incurred could be relevant to closed plans, where employees are no longer exchanging services for defined benefits. In this situation, it is clear that any and all future costs of administering the plan relate to past periods and no attribution is necessary. An entity with such an arrangement could select a policy of full provision of all costs of 'running-off' the plan (apart from those specifically dealt with by the standard) which should be applied consistently to similar facts and circumstances.

12 Short-term employee benefits

Short-term employee benefits are employee benefits (other than termination benefits) that are expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service. *[IAS 19.8]*.

The standard states that reclassification is not necessary if an entity's expectation of the timing of settlement changes temporarily. However, if the characteristics of the benefit change (such as a change from a non-accumulating benefit to an accumulating benefit) or if a change in expectations of the timing of settlement is not temporary, then the entity considers whether the benefit still meets the definition of short-term employee benefits. *[IAS 19.10]*.

They can include:

- Wages, salaries and social security contributions
- Paid annual leave and paid sick leave
- Profit-sharing and bonuses

  And
- Non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees *[IAS 19.9]*

12.1 General recognition criteria for short-term employee benefits

An entity should recognise the undiscounted amount of short-term benefits attributable to services that have been rendered in the period as an expense, unless another IFRS accounting standard requires or permits the benefits to be included in the cost of an asset. This could particularly be the case under IAS 2 (see Chapter 23 at section 3.1), IAS 16 (see Chapter 19 at section 4.1) and IAS 38 *Intangible Assets* (see Chapter 18 at section 6.3.2). Any difference between the amount of cost recognised and cash payments made should be treated as a liability or prepayment as appropriate. *[IAS 19.11]*. There are further requirements in respect of short-term paid absences and profit-sharing and bonus plans as detailed below. Cost is not defined in IAS 19 and therefore the accounting for such benefits could vary depending on any other standards involved in the recognition of the transaction.

12.2 Short-term paid absences

These include absences for vacation (holiday), sickness and short-term disability, maternity or paternity leave, jury service and military service. These can either be accumulating or non-accumulating absences. *[IAS 19.14]*. Accumulating absences are those that can be carried forward and used in future periods if the entitlement in the current period is not used in full. They can be either vesting entitlements (which entitle employees to a cash payment in lieu of absences not taken on leaving the entity) or non-vesting entitlements (where no cash compensation is payable). Non-accumulating absences are those where there is no entitlement to carry forward unused days. An obligation arises as employees render service that increases their entitlement to future paid absences. *[IAS 19.15]*.

12.2.1 Accumulating absences

The cost of accumulating paid absences should be recognised when employees render the service that increases their entitlement to future paid absences. No distinction should be made between the recognition of vesting and non-vesting entitlements (see section 12.2 above), on the basis that the liability arises as services are rendered in both cases. However, the measurement of non-vesting entitlements should take into account the possibility of employees leaving before receiving them. *[IAS 19.15]*.

The cost of accumulating paid absences should be measured as the additional amount that the entity expects to pay as a result of the unused entitlement that has accumulated at the end of the reporting period. *[IAS 19.16]*. In the case of unused paid sick leave, provision should be made only to the extent that it is expected that employees will use the sick leave in subsequent periods. The standard observes that in many cases, it may not be necessary to make detailed computations to estimate that there is no material obligation for unused paid absences. For example, IAS 19 considers it unlikely that a sick leave obligation will be material unless there is a formal or informal understanding that unused paid sick leave may be taken as paid vacation. *[IAS 19.17]*.

The standard provides an example to illustrate the requirements for accumulating paid absences upon which the following is based: *[IAS 19.17]*

Illustration 12-1: Accumulating paid absences

An entity has 100 employees, who are each entitled to five working days of paid sick leave for each year. Unused sick leave may be carried forward for one calendar year. Sick leave is taken first out of the current year's entitlement and then out of any balance brought forward from the previous year (a LIFO basis). At 31 December 20X9, the average unused entitlement is two days per employee. The entity expects, based on past experience which is expected to continue, that 92 employees will take no more than five days of paid sick leave in 20X0 and that the remaining eight employees will take an average of six and a half days each.

The entity expects that it will pay an additional 12 days of sick pay as a result of the unused entitlement that has accumulated at 31 December 20X9 (one and a half days each, for eight employees). Therefore, the entity recognises a liability equal to 12 days of sick pay.

12.2.2 Non-accumulating paid absences

The cost of non-accumulating absences should be recognised as and when they arise, on the basis that the entitlement is not directly linked to the service rendered by employees in the period. This is commonly the case for sick pay (to the extent that unused past entitlement cannot be carried forward), maternity or paternity leave, furlough periods and paid absences for jury service or military service. *[IAS 19.13(b), IAS 19.18]*.

12.3 Profit-sharing and bonus plans

An entity should recognise the expected cost of profit-sharing and bonus payments when and only when:

- The entity has a present legal or constructive obligation to make such payments as a result of past events.

  And

- A reliable estimate of the obligation can be made. *[IAS 19.19]*.

The above are discussed in turn in sections 12.3.1 and 12.3.2 below. Statutory profit-sharing arrangements based on taxable profit are discussed in section 12.3.3 below.

12.3.1 Present legal or constructive obligation

A present obligation exists when, and only when, the entity has no realistic alternative but to make the payments. *[IAS 19.19]*. IAS 19 clarifies that where a profit-sharing plan is subject to a loyalty period (i.e., a period during which employees must remain with the entity in order to receive their share), a constructive obligation is created as employees render service that increases the amount to be paid if they remain in service until the end of the specified period. However, the possibility of employees leaving during the loyalty period should be taken into account in measuring the cost of the plan. *[IAS 19.20]*. The standard illustrates the approach as follows:

Illustration 12-2: Profit sharing and bonus plans

A profit-sharing plan requires an entity to pay a specified proportion of its net profit for the year to employees who serve throughout the year. If no employees leave during the year, the total profit-sharing payments for the year will be 3% of profit. The entity estimates that staff turnover will reduce the payments to 2.5% of profit.

The entity recognises a liability and an expense of 2.5% of profit.

It is worth noting that in the scenario above, when an entity prepares its accounts for the year it will no longer be uncertain whether all eligible employees become entitled to the bonus, as that is determined at the year-end. That means the reduction in the accrual from 3% to 2.5% should be an observable fact, not an 'estimate'.

The standard also states that where an entity has a practice of paying bonuses it has a constructive obligation to pay a bonus, even though there could be no legal obligation for it to do so. Again, however, in measuring the cost, the possibility of employees leaving before receiving a bonus should be taken into account. *[IAS 19.21]*.

12.3.2 Reliable estimate of provision

A reliable estimate of a legal or constructive obligation under a profit-sharing or bonus plan can be made when and only when:

- The formal terms of the plan contain a formula for determining the amount of the benefit.
- The entity determines the amounts to be paid before the financial statements are authorised for issue.

  Or
- Past practice gives clear evidence of the amount of the entity's constructive obligation. *[IAS 19.22]*.

It is worth noting that the paragraph above from IAS 19 deals only with the measurement of the provision and not the point of recognition which is discussed in section 12.3.1 above.

IAS 19 states that an obligation under a profit-sharing or bonus plan must be accounted for as an expense and not a distribution of profit, since it results from employee service and not from a transaction with owners. *[IAS 19.23]*.

Where profit-sharing and bonus payments are not expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service, they should be accounted for as other long-term employee benefits (see section 13 below). *[IAS 19.24]*.

12.3.3 Statutory profit-sharing based on taxable profit

In November 2010, the IFRS IC was asked to clarify how to account for a particular statutory employee benefit whereby 10% of taxable profit is shared with employees. In particular, the request sought clarification as to whether analogy could be made to IAS 12 *Income Taxes* to account for temporary differences between accounting and taxable profit which would reverse in the future.

The IFRS IC thought that such an approach was not acceptable. It decided not to add the item to its agenda stating "The Committee noted that the statutory employee profit-sharing arrangement described in the request should be accounted for in accordance with IAS 19, and that IAS 19 provides sufficient guidance on amounts that should be recognised and measured, with the result that significantly divergent interpretations are not expected in practice. Consequently, the Committee decided not to add this issue to its agenda".[22]

22 *IFRIC Update*, November 2010, available on the IFRS Foundation's website.

13 Long-term employee benefits other than post-employment benefits

13.1 Meaning of other long-term employee benefits

These are all employee benefits other than post-employment benefits and termination benefits. *[IAS 19.8]*. They include the following if not expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees rendered the related service:

- Long-term paid absences such as long-service or sabbatical leave
- Jubilee or other long-service benefits
- Long-term disability benefits
- Profit-sharing and bonuses

  And
- Deferred remuneration *[IAS 19.153]*

13.2 Recognition and measurement

For such benefits IAS 19 requires a simplified version of the accounting treatment required in respect of defined benefit plans (which is discussed in detail in section 5 above). The amount recognised as a liability for other long-term employee benefits should be the net total, at the end of the reporting period, of the present value of the defined benefit obligation and the fair value of plan assets (if any) out of which the obligations are to be settled directly. The net total of the following amounts should be recognised in profit or loss, except to the extent that another IFRS accounting standard requires or permits their inclusion in the cost of an asset:

(a) Service cost

(b) Net interest on the net defined benefit liability (asset)

And

(c) Remeasurements of the net defined benefit liability (asset)

In other words, all assets, liabilities, income and expenditure relating to such benefits should be accounted for in the same way, and subject to the same restrictions on the recognition of assets and income, as those relating to a defined benefit pension plan (see sections 8.1 and 8.2 above), except that remeasurements are recognised in profit or loss. *[IAS 19.155, IAS 19.156]*.

The standard explains the use of this simplified approach by asserting that the measurement of other long-term employee benefits is not usually subject to the same degree of uncertainty as that of post-employment benefits. *[IAS 19.154]*.

An illustration of the methodology to calculate the defined benefit obligation, service and interest costs is given in Illustration 7-2 in section 7.3 above.

13.2.1 Attribution to years of service

Long-term employee benefit arrangements will typically have conditions attached to secure their vesting.

For example, employee bonuses are now commonly linked to vesting conditions which mean that they will not be settled wholly within 12 months after the period in which the employee renders the related service. In this case, the liability should be calculated using the projected unit credit method and spread on a straight-line basis over the full vesting period. For example, a bonus granted to an employee on 1 January 20X1 which is based on the employees' performance in 20X1 but is not payable until February 20X4 and is conditional on the employee remaining in service until 31 December 20X3 will have a vesting period from 1 January 20X1 to 31 December 20X3 and the liability will be spread on a straight line basis over this three year period.

The IFRS IC also received questions concerning early retirement bonuses where bonus payments are given in exchange for a 50% reduction in working hours which are conditional on the employee completing a required service period when employment is terminated. The IFRS IC concluded that as the bonus payments were conditional upon the completion of service over a specified period this indicated that the benefits were provided in exchange for that service and should be attributed over this period of service (and were not a termination benefit).[23]

23 *IFRIC Update*, November 2011, available on the IFRS Foundation's website.

It is not always clear how the attribution of long-term benefits to the years of service over which they are earned should be performed.

Consider an award made at the start of the year for a fixed cash payment. A third of the payment vests on each of the first, second and third anniversaries of the grant for employees still employed at each vesting date.

One interpretation would be that the 'benefit formula' attributes a third of the award to each year and that each of the three income statements will bear one third of the expense.

An alternative view is that there are three distinct awards with the same grant date, but with durations of one, two and three years. This pattern of vesting is sometimes described as 'graded vesting' and is discussed, in relation to share-based payments, in Chapter 30 at section 6.2.2 and illustrated in Illustration 6-5.

How we see it

In our view an entity has an accounting policy choice, as discussed above, to attributing long-term benefits to the years of service over which they are earned to be applied consistently to similar facts and circumstances.

13.2.2 Long-term disability benefit

Where long-term disability benefit depends on the length of service of the employee, an obligation arises as the employee renders service, which is measured according to the probability that payment will be required and the length of time for which payment is expected to be made. If, however, the level of benefit is the same for all disabled employees regardless of years of service, the expected cost is recognised only when an event causing disability occurs. *[IAS 19.157]*.

13.2.3 Long-term benefits contingent on a future event

It could be the case that a long-term benefit becomes payable only on the occurrence of an uncertain future event, for example an initial public offering of an entity's shares (IPO) or an exit event, financial KPI's such as revenue or non-financial KPI's such as the number of new customers or retail outlets opened in a period. Such events are binary in nature and would result in payment either to no employees with entitlements under the plan or to all such employees.

As discussed in section 13.2 above, the projected unit credit method is applied to long-term employee benefits, *[IAS 19.154]*, however the key question that arises is whether the accounting should reflect the single best estimate of the outcome; or, the expected value - that is, a weighted average of possible outcomes. Paragraph 72 of IAS 19 states that "the probability that the specified event will occur affects the measurement of the obligation, but does not determine whether the obligation exists". This sets out the requirement that probability affects measurement. The manner in which probability affects measurement is dealt with in IAS 19.76 which requires actuarial assumptions to be a best estimate of the ultimate cost of providing benefits. *[IAS 19.76]*.

How we see it

We believe that the best estimate of the outcome of an uncertain event must be used when accounting for long-term employee benefits where the outcome is binary.

Therefore, if the future event on which the long-term benefit is contingent is not probable the liability should be measured at nil. When the contingent event is or becomes probable (that is, more likely than not) the actuarial assumption used in applying the projected unit credit method should reflect the full benefits which would be payable upon the occurrence of the event. The result of revising the actuarial assumptions will result in a remeasurement gain or loss being recognised in profit and loss in the year of the change. For example consider a long-term employee benefit vesting over a five year period in which the liability was measured based on the projected unit credit method at the end of the first and second year as the contingent event was determined to be probable. If the contingent event becomes no longer probable during the third year, then the liability at the end of year three will be nil and the previous liability recognised in years one and two will be released to the profit and loss account. For example, consider a long-term benefit contingent on a future event such as an IPO, where an employee will receive a payment if (and only if) the employer entity becomes listed on a stock exchange within five years. In each of the first two years it was considered probable that the listing would take place in five years from the granting of the benefit and the benefit be paid on that date. Accordingly, the liability was measured using the projected unit credit method at the end of the first and second year with the discounted present value of 20% of the payment attributed to each year for service provided by the employee. If the listing becomes no longer probable during the third year, then the liability at the end of year three will be nil and the previous liability recognised in years one and two will be released to the profit and loss account.

14 Termination benefits

Termination benefits are employee benefits payable as a result of either:

- An entity's decision to terminate an employee's employment before the normal retirement date.

  Or

- An employee's decision to accept an offer of benefits in exchange for the termination of employment. *[IAS 19.8]*.

They are accounted for differently from other employee benefits because the event that gives rise to an obligation for them is the termination of employment rather than the rendering of service by the employee. *[IAS 19.159]*.

Termination benefits do not include employee benefits resulting from termination of employment at the request of the employee without an entity's offer, or as a result of mandatory retirement requirements, because those benefits are post-employment benefits. Some entities provide a lower level of benefit for termination of employment at the request of the employee (in substance, a post-employment benefit) than for termination of employment at the request of the entity. Only the difference between the benefit provided for termination of employment at the request of the employee and a higher benefit provided at the request of the entity is a termination benefit. *[IAS 19.160]*. Accordingly, employee benefits that are payable regardless of the reason for the employee's departure are accounted for as post-employment benefits. Any additional benefit payable as a result of termination at the request of the entity over the benefits payable as a result of termination at the request of the employee is accounted for as a termination benefit.

The form of the employee benefit does not determine whether it is provided in exchange for service or in exchange for termination of the employee's employment. Termination benefits are typically lump sum payments, but sometimes also include:

- Enhancement of post-employment benefits, either indirectly through an employee benefit plan or directly.

  And

- Salary until the end of a specified notice period if the employee renders no further service that provides economic benefits to the entity. *[IAS 19.161]*.

Indicators that an employee benefit is provided in exchange for services include the following:

- The benefit is conditional on future service being provided (including benefits that increase if further service is provided).

  And

- The benefit is provided in accordance with the terms of an employee benefit plan. *[IAS 19.162]*.

Some termination benefits are provided in accordance with the terms of an existing employee benefit plan. For example, they may be specified by statute, employment contract or union agreement, or may be implied as a result of the employer's past practice of providing similar benefits. As another example, if an entity makes an offer of benefits available for more than a short period, or there is more than a short period between the offer and the expected date of actual termination, an entity should consider whether it has established a new employee benefit plan and hence whether the benefits offered under that plan are termination benefits or post-employment benefits. Employee benefits provided in accordance with the terms of an employee benefit plan are termination benefits if they both result from an entity's decision to terminate an employee's employment and are not conditional on future service being provided. *[IAS 19.163]*. Benefits payable to incentivise employees to remain in service with the entity until the end of the termination period (referred to as stay bonuses) are not termination benefits because they are dependent on service being provided. These would be accounted for as either a short-term or long-term employee benefit as appropriate (see sections 12 and 13 above).

14.1 Statutory termination indemnities

Some employee benefits are provided regardless of the reason for the employee's departure. The payment of such benefits is certain (subject to any vesting or minimum service requirements) but the timing of their payment is uncertain. Although such benefits are described in some jurisdictions as termination indemnities or termination gratuities, they are post-employment benefits rather than termination benefits, and an entity accounts for them as post-employment benefits. *[IAS 19.164]*.

14.2 Recognition

An entity should recognise termination benefits as a liability and an expense at the earlier of the following dates:

- When it can no longer withdraw the offer of those benefits.

  And

- When it recognises costs for a restructuring that is within the scope of IAS 37 and involves the payment of termination benefits (discussed in Chapter 27 at section 6.1). *[IAS 19.165]*.

For termination benefits payable as a result of an employee's decision to accept an offer of benefits in exchange for the termination of employment, the time when an entity can no longer withdraw the offer of termination benefits is the earlier of:

- When the employee accepts the offer.

  And

- When a restriction (e.g., a legal, regulatory or contractual requirement or other restriction) on the entity's ability to withdraw the offer takes effect. This would be when the offer is made if the restriction existed at the time of the offer. *[IAS 19.166]*.

For termination benefits payable as a result of an entity's decision to terminate an employee's employment, the entity can no longer withdraw the offer when the entity has communicated to the affected employees a plan of termination meeting all of the following criteria:

- Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made.
- The plan identifies the number of employees whose employment is to be terminated, their job classifications or functions and their locations (but the plan need not identify each individual employee) and the expected completion date.

  And

- The plan establishes the termination benefits that employees will receive in sufficient detail that employees can determine the type and amount of benefits they will receive were their employment to be terminated. *[IAS 19.167]*.

The standard notes that when an entity recognises termination benefits, it may also have to account for a plan amendment or a curtailment of other employee benefits (discussed in section 10.2.1 above). *[IAS 19.168]*.

14.3 Measurement

IAS 19 requires that on initial recognition and subsequent remeasurement, termination benefits should be measured in accordance with the nature of the employee benefit. If the termination benefits are an enhancement to post-employment benefits, the entity applies the requirements for post-employment benefits. Otherwise:

- If the termination benefits are expected to be settled wholly before twelve months after the end of the annual reporting period in which the termination benefit is recognised, the requirements for short-term employee benefits should be applied (discussed in section 12 above).

  And

- If the termination benefits are not expected to be settled wholly before twelve months after the end of the annual reporting period, the requirements for other long-term employee benefits should be applied (discussed in section 13 above). *[IAS 19.169]*.

Because termination benefits are not provided in exchange for service, the standard notes that its rules relating to the attribution of the benefit to periods of service (discussed in section 7.4 above) are not relevant. *[IAS 19.170]*.

IAS 19 illustrates the accounting for termination benefits with an example.

Illustration 14-1: Termination benefits

Background

As a result of a recent acquisition, an entity plans to close a factory in ten months and, at that time, terminate the employment of all of the remaining employees at the factory. Because the entity needs the expertise of the employees at the factory to complete some contracts, it announces a plan of termination as follows.

Each employee who stays and renders service until the closure of the factory will receive on the termination date a cash payment of CU30,000. Employees leaving before closure of the factory will receive CU10,000.

There are 120 employees at the factory. At the time of announcing the plan, the entity expects 20 of them to leave before closure. Therefore, the total expected cash outflows under the plan are CU3,200,000 (i.e., 20 × CU10,000 + 100 × CU30,000). As required by the standard, the entity accounts for benefits provided in exchange for termination of employment as termination benefits and accounts for benefits provided in exchange for services as short-term employee benefits.

Termination benefits

The benefit provided in exchange for termination of employment is CU10,000. This is the amount that an entity would have to pay for terminating the employment regardless of whether the employees stay and render service until closure of the factory or they leave before closure. Even though the employees can leave before closure, the termination of all employees' employment is a result of the entity's decision to close the factory and terminate their employment (i.e., all employees will leave employment when the factory closes). Therefore the entity recognises a liability of CU1,200,000 (i.e., 120 × CU10,000) for the termination benefits provided in accordance with the employee benefit plan at the earlier of when the plan of termination is announced and when the entity recognises the restructuring costs associated with the closure of the factory.

Benefits provided in exchange for service

The incremental benefits that employees will receive if they provide services for the full ten-month period are in exchange for services provided over that period. The entity accounts for them as short-term employee benefits because the entity expects to settle them before twelve months after the end of the annual reporting period. In this example, discounting is not required, so an expense of CU200,000 (i.e., CU2,000,000 ÷ 10) is recognised in each month during the service period of ten months, with a corresponding increase in the carrying amount of the liability.

15 Disclosure requirements

In addition to the disclosures required by IAS 19, consideration should also be given to the disclosures required in IAS 1 to disclose:

- Significant accounting policies (especially where there is more than one acceptable policy).

  And

- Any significant judgements made by management in applying the accounting policies.

  As well as

- Significant sources of uncertainty. *[IAS 1.117, IAS 1.122, IAS 1.125].*

15.1 Defined contribution plans

IAS 19 requires the disclosure of the expense recognised for defined contribution plans. It also notes that IAS 24 *Related Party Disclosures* requires disclosure of the contributions in respect of key management personnel. *[IAS 19.53, IAS 19.54]*.

15.2 Defined benefit plans

The standard has a disclosure objective, as set out below, along with considerations in order to meet this objective. The result of this is likely to lead to extensive disclosures in relation to material defined benefit plans.

The standard requires an entity to disclose information that:

(a) Explains the characteristics of its defined benefit plans and risks associated with them.

(b) Identifies and explains the amounts in its financial statements arising from its defined benefit plans.

  And

(c) Describes how its defined benefit plans may affect the amount, timing and uncertainty of the entity's future cash flows. *[IAS 19.135]*.

To achieve the above, the standard sets out a long and detailed list of narrative and numerical disclosures that could be necessary in order for the entity to meet the objective in IAS 19.135 (considered further below).

An example of a disclosure that is not specifically listed in IAS 19, which may be required to meet the disclosure objective of the standard is the remeasurement gain or loss arising on the acquisition of a qualifying insurance policy (or buy-in arrangement) which has been recognised on other comprehensive income. The extract from RSA Insurance below gives an example of such disclosure.

Practical example 15-1: RSA Insurance Group Limited (2023) **United Kingdom**

Consolidated financial statements for the year ended 31 December 2023

Notes to the consolidated financial statements [extract]

29. Employee future Benefits [extract] [extract]

29.6 Purchase of annuity buy-in insurance contracts

On 27 February 2023 the Trustees of the Group's two major UK DB pension plans (the UK plans) entered into an agreement with PIC, a specialist insurer of defined benefit pension plans, to purchase buy-ins, as part of its de-risking strategy. The buy-in agreement transferred the remaining economic and demographic risks associated with these plans to PIC and removed the volatility in relation to these plans from the Group's Consolidated statement of financial position. The main risk that the Group retains is counterparty risk, with market risk on the assets that were remaining in the UK plans at the transaction date now largely removed as described below.

At the transaction date, the UK plans transferred the majority of their plan assets and an upfront contribution of £481m to PIC. Of the total buy-in premium of £6,307m, an amount of £550m was deferred and has now been largely re-paid through the sale of certain less liquid assets that were initially retained by the UK plans but were liquidated by the end of 2023. During 2023, the UK plans paid £457m of the deferred annuity premium. The Group has committed to the UK plans to fund any shortfall in the deferred annuity premium obligation resulting from the liquidation of the assets. In addition, the UK plans retained longevity swaps that were already in place. Refer to *Asset and longevity swaps* below for more details.

The buy-ins comprised various contracts which were considered in aggregate as one single contract because they form a structure designed to collectively match the exact amount and timing of all the benefits payable by the UK plans. The Group was not legally relieved of the primary responsibility for the obligation, and the benefit payments continue to be payable by the UK plans. The contracts provide the option to convert the buy-ins into individual policies which would transfer the UK plan assets and obligation to PIC (known as a buy-out). While this course of action may be considered in the future, a separate decision would be required, and certain significant conditions would need to be met before any buy-out could be executed. Consequently, the transaction was considered a buy-in as opposed to a buy-out under IAS 19. As a result, an initial actuarial loss of £727m net of tax was recognised in OCI during 2023. The fair value of annuity buy-in insurance contracts subsequently fluctuates based on changes in the value of the associated DB obligation.

The buy-in transaction was funded through the injection of share capital from the Group's immediate parent company, 2283485 Alberta Limited of £480m (note 20. Share capital).

...

The Board also noted that entities must comply with the general materiality requirements of IAS 1 (discussed in Chapter 3 at section 4.1.5), including the requirement to disclose additional information if necessary, and that the financial statements need not contain disclosures that are not material. *[IAS 19.BC209]*.

One of the Board's objectives in regard to disclosure was to ensure that financial statements provide relevant information that is not obscured by excessive detail. *[IAS 19.BC207]*.

These references to excessive detail and non-disclosure of immaterial items confirm that entities must apply judgement to determine the appropriate level of detail to be provided rather than giving everything set out in the standard.

To meet the objectives above, the standard requires consideration of all the following:

(a) The level of detail necessary to satisfy the disclosure requirements.

(b) How much emphasis to place on each of the various requirements.

(c) How much aggregation or disaggregation to undertake.

And

(d) Whether users of financial statements need additional information to evaluate the quantitative information disclosed. *[IAS 19.136]*.

If the disclosures provided in accordance with the requirements of IAS 19 and other IFRS accounting standards are insufficient to meet the objectives above, an entity should disclose additional information necessary to meet those objectives. For example, an entity may present an analysis of the present value of the defined benefit obligation that distinguishes the nature, characteristics and risks of the obligation. Such a disclosure could distinguish:

(a) Between amounts owing to active members, deferred members, and pensioners.

(b) Between vested benefits and accrued but not vested benefits.

And

(c) Between conditional benefits, amounts attributable to future salary increases and other benefits. *[IAS 19.137]*.

An assessment should be made as to whether all or some disclosures should be disaggregated to distinguish plans or groups of plans with materially different risks. For example, an entity may disaggregate disclosure about plans showing one or more of the following features:

(a) Different geographical locations

(b) Different characteristics such as flat salary pension plans, final salary pension plans or post-employment medical plans

(c) Different regulatory environments

(d) Different reporting segments

And

(e) Different funding arrangements (e.g., wholly unfunded, wholly funded or partly funded) *[IAS 19.138]*

15.2.1 Characteristics of defined benefit plans and risks associated with them

IAS 19 requires disclosure of:

(a) Information about the characteristics of its defined benefit plans, including:

(i) The nature of the benefits provided by the plan (e.g., final salary defined benefit plan or contribution-based plan with guarantee).

(ii) A description of the regulatory framework in which the plan operates, for example the level of any minimum funding requirements, and any effect of the regulatory framework on the plan, such as the asset ceiling.

And

(iii) A description of any other entity's responsibilities for the governance of the plan, for example responsibilities of trustees or of board members of the plan.

(b) A description of the risks to which the plan exposes the entity, focused on any unusual, entity-specific or plan-specific risks, and of any significant concentrations of risk. For example, if plan assets are invested primarily in one class of investments, e.g., property, the plan may expose the entity to a concentration of property market risk.

And

(c) A description of any plan amendments, curtailments and settlements. *[IAS 19.139]*.

15.2.2 Explanation of amounts in the financial statements

The disclosures should provide a reconciliation from the opening balance to the closing balance for each of the following, if applicable:

(a) The net defined benefit liability (asset), showing separate reconciliations for:

(i) Plan assets.

(ii) The present value of the defined benefit obligation.

And

(iii) The effect of the asset ceiling.

And

(b) Any reimbursement rights. If there are reimbursement rights a description of the relationship between them and the related obligation should be given. *[IAS 19.140]*.

Each reconciliation listed in (a) and (b) above should show each of the following, if applicable:

(a) Current service cost

(b) Interest income or expense (see section 10.3 above)

(c) Remeasurements of the net defined benefit liability (asset), showing separately:

(i) The return on plan assets, excluding amounts included in interest in (b) above

(ii) Actuarial gains and losses arising from changes in demographic assumptions

(iii) Actuarial gains and losses arising from changes in financial assumptions

And

(iv) Changes in the effect of limiting a net defined benefit asset to the asset ceiling, excluding amounts included in interest in (b). There should also be disclosure of how the maximum economic benefit available was determined, i.e., whether those benefits would be in the form of refunds, reductions in future contributions or a combination of both

(d) Past service cost and gains and losses arising from settlements. Past service cost and gains and losses arising from settlements need not be distinguished if they occur together (see section 10.2 above)

(e) The effect of changes in foreign exchange rates
(f) Contributions to the plan, showing separately those by the employer and by plan participants
(g) Payments from the plan, showing separately the amount paid in respect of any settlements
And
(h) The effects of business combinations and disposals *[IAS 19.141]*

The following extracts from Deutsche Bank Aktiengesellschaft and BT Group plc show how they have presented the above reconciliations (the former being a group with pension obligations in different countries). In each case the company has considered the requirements of IAS 19.136(a) to provide the level of detail necessary to satisfy the disclosure requirements.

Practical example 15-2: Deutsche Bank Aktiengesellschaft (2022) Germany

Annual Report 2022 [extract]

Additional notes [extract]

33. Employee Benefits [extract]

Post-employment Benefit Plans [extract]

Reconciliation in Movement of Liabilities and Assets – Impact on Financial Statements

in € m.	Germany	UK	U.S.	Other	2022 Total
Change in the present value of the defined benefit obligation:					
Balance, beginning of year	13,097	4,929	1,351	1,027	20,404
Defined benefit cost recognized in Profit & Loss					
Current service cost	164	18	10	38	230
Interest cost	142	88	39	20	289
Past service cost and gain or loss arising from settlements	17	2	0	0	19
Defined benefit cost recognized in Other Comprehensive Income					
Actuarial gain or loss arising from changes in financial assumptions	(3,055)	(1,966)	(196)	(183)	(5,400)
Actuarial gain or loss arising from changes in demographic assumptions	80	29	(5)	0	104
Actuarial gain or loss arising from experience	79	97	3	25	204
Cash flow and other changes					
Contributions by plan participants	1	0	0	16	17
Benefits paid	(485)	(131)	(92)	(67)	(775)
Payments in respect to settlements	0	0	0	0	0
Acquisitions/Divestitures	(2)	0	0	(2)	(4)
Exchange rate changes	0	(190)	92	9	(89)
Other	(0)	0	0	0	0
Balance, end of year	10,037	2,876	1,202	884	14,999
thereof:					
Unfunded	0	10	143	75	228
Funded	10,037	2,866	1,059	809	14,771
Change in fair value of plan assets:					
Balance, beginning of year	12,642	6,019	1,148	1,079	20,888
Defined benefit cost recognized in Profit & Loss					
Interest income	139	108	33	19	299
Defined benefit cost recognized in Other Comprehensive Income					
Return from plan assets less interest income	(1,594)	(1,982)	(184)	(130)	(3,890)
Cash flow and other changes					
Contributions by plan participants	1	0	0	16	17
Contributions by the employer[1]	(353)	0	0	28	(325)
Benefits paid[2]	(485)	(130)	(77)	(60)	(752)
Payments in respect to settlements	0	0	0	0	0
Acquisitions/Divestitures	1	0	0	(1)	0
Exchange rate changes	0	(243)	79	11	(153)
Other	0	0	0	0	0
Plan administration costs	0	(4)	(3)	0	(7)
Balance, end of year	10,351	3,768	996	962	16,077
Funded status, end of year	314	892	(206)	78	1,078
Change in irrecoverable surplus (asset ceiling)					
Balance, beginning of year	0	0	0	(90)	(90)
Interest cost	0	0	0	0	0
Changes in irrecoverable surplus	0	0	0	(12)	(12)
Exchange rate changes	0	0	0	(5)	(5)
Balance, end of year	0	0	0	(107)	(107)
Net asset (liability) recognized	314	892	(206)	(29)	971[3]
Fair value of reimbursement rights	0	0	0	3	3

[1] Net Amount includes re-imbursement of 2022 benefit payments and a forgiven benefit payment from 2021.
[2] For funded plans only.
[3] Thereof € 1,326 million recognized in Other assets and € 355 million in Other liabilities.

...

Practical example 15-3: BT Group plc (2022) **United Kingdom**

BT Group plc Annual Report 2022 [extract]

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]

20. Retirement benefit plans [extract]

Movements in defined benefit plan assets and liabilities

The table below shows the movements in the defined benefit plan assets and liabilities and shows where they are reflected in the financial statements.

	Assets £m	Liabilities £m	Deficit £m
At 31 March 2020	**53,471**	**(54,611)**	**(1,140)**
Service cost (including administration expenses and PPF levy)	(44)	(19)	(63)
Past service cost	–	(1)	(1)
Interest on pension deficit	1,281	(1,299)	(18)
Included in the group income statement			**(82)**
Return on plan assets above the amount included in the group income statement	1,766	–	1,766
Actuarial (loss) arising from changes in financial assumptions	–	(8,504)	(8,504)
Actuarial gain arising from changes in demographic assumptions	–	1,746	1,746
Actuarial gain arising from experience adjustments	–	136	136
Included in the group statement of comprehensive income			**(4,856)**
Regular contributions by employer	17	–	17
Deficit contributions by employer	955	–	955
Included in the group cash flow statement			**972**
Contributions by employees	1	(1)	–
Benefits paid	(2,822)	2,822	–
Other (e.g. foreign exchange)	(13)	23	10
Other movements			**10**
At 31 March 2021	**54,612**	**(59,708)**	**(5,096)**
Service cost (including administration expenses and PPF levy)	(47)	(20)	(67)
Past service credit	–	1	1
Interest on pension deficit	1,095	(1,188)	(93)
Included in the group income statement			**(159)**
Return on plan assets above the amount included in the group income statement	780	–	780
Actuarial gain arising from changes in financial assumptions	–	2,932	2,932
Actuarial gain arising from changes in demographic assumptions	–	804	804
Actuarial (loss) arising from experience adjustments[a]	–	(1,651)	(1,651)
Included in the group statement of comprehensive income			**2,865**
Regular contributions by employer	114	–	114
Deficit contributions by employer	1,121	–	1,121
Included in the group cash flow statement			**1,235**
Contributions by employees	1	(1)	–
Benefits paid	(2,748)	2,748	–
Other (e.g. foreign exchange)	9	3	12
Other movements			**12**
At 31 March 2022	**54,937**	**(56,080)**	**(1,143)**

a Primarily reflects the impact on the liabilities of actual inflation being higher than assumed at the prior reporting date. There has been a broadly equivalent benefit to inflation-linked assets from higher inflation.

...

Whenever the information is material, the fair value of the plan assets should be disaggregated into classes that distinguish the nature and risks of those assets, subdividing each class of plan asset into those that have a quoted market price in an active market (as defined in IFRS 13, see Chapter 15) and those that do not. For example, and considering the level of detail of disclosure, aggregation and emphasis discussed in section 15.2 above, an entity could distinguish between:

(a) Cash and cash equivalents

(b) Equity instruments (segregated by industry type, company size, geography etc.)

(c) Debt instruments (segregated by type of issuer, credit quality, geography etc.)

(d) Real estate (segregated by geography etc.)

(e) Derivatives (segregated by type of underlying risk in the contract, for example, interest rate contracts, foreign exchange contracts, equity contracts, credit contracts, longevity swaps etc.)

(f) Investment funds (segregated by type of fund)

(g) Asset-backed securities

And

(h) Structured debt *[IAS 19.142]*

The fair value of an entity's own transferable financial instruments held as plan assets, and the fair value of plan assets that are property occupied by, or other assets used by, the entity should be disclosed. *[IAS 19.143]*.

The following extracts from UBS Group AG and Deutsche Lufthansa Aktiengesellschaft illustrate how the plan assets could be disaggregated.

Practical example 15-4: UBS Group AG (2022) **Switzerland**

Annual Report 2022 [extract]

Notes to the UBS Group AG consolidated financial statements [extract]

Note 26 Post-employment benefit plans [extract]

a) Defined benefit plans [extract]

Fair value of plan assets [extract]

Composition and fair value of plan assets

Swiss pension plan

	31.12.22				31.12.21			
	Fair value			Plan asset allocation %	Fair value			Plan asset allocation %
USD m	Quoted in an active market	Other	Total		Quoted in an active market	Other	Total	
Cash and cash equivalents	326	0	326	1	187	0	187	1
Real estate / property								
Domestic	0	3,783	3,783	13	0	3,530	3,530	10
Foreign	0	919	919	3	0	580	580	2
Investment funds								
Equity								
Domestic	743	0	743	2	843	0	843	2
Foreign	4,964	2,171	7,134	24	6,213	2,652	8,865	26
Bonds[1]								
Domestic, AAA to BBB–	3,760	0	3,760	12	4,446	0	4,446	13
Foreign, AAA to BBB–	6,031	0	6,031	20	5,093	0	5,093	15
Foreign, below BBB–	1,062	0	1,062	4	1,314	0	1,314	4
Other	1,540	3,547	5,086	17	4,211	3,558	7,769	23
Other investments	624	651	1,275	4	668	682	1,349	4
Total fair value of plan assets	19,049	11,071	30,119	100	22,973	11,002	33,975	100

...

Practical example 15-5: Deutsche Lufthansa Aktiengesellschaft (2022) — Germany

ANNUAL REPORT 2022 [extract]

Notes to the consolidated financial statements [extract]

Notes to the consolidated statement of financial position [extract]

35 Pension provisions [extract]

T117 COMPOSITION OF PLAN ASSETS

	31 Dec 2022				31 Dec 2021			
	Listed price in an active market in €m	No listed price in an active market in €m	Total in €m	in %	Listed price in an active market in €m	No listed price in an active market in €m	Total in €m	in %
Equities			5,359	33.6			6,579	35.5
Europe	2,084	-			2,745	-		
Other	3,275	-			3,834	-		
Fixed-income securities			5,084	31.9			6,933	37.4
Government bonds	2,340	-			3,482	-		
Corporate bonds	2,744	-			3,451	-		
Share funds	166	-	166	1.0	173	-	173	0.9
Fixed-income funds	135	-	135	0.8	643	-	643	3.5
Mixed funds[1]	64	-	64	0.4	114	-	114	0.6
Money market investments	1,572	-	1,572	9.9	810	-	810	4.4
Property			1,476	9.2			1,348	7.3
Direct investments	-	11			-	9		
Indirect investments	1,034	431			957	382		
Insurance contracts	-	104	104	0.7	-	140	140	0.8
Bank balances	207	390	597	3.7	238	-	238	1.3
Other investments[2]	184	1,216	1,400	8.8	232	1,300	1,532	8.3
Total	**13,805**	**2,152**	**15,957**	**100.0**	**16,679**	**1,831**	**18,510**	**100.0**

[1] Mixed funds include equities and interest-bearing securities.
[2] Other investments include, in particular, alternative investments such as hedge funds, commodities and private equity funds.

An entity should disclose the significant actuarial assumptions used to determine the present value of the defined benefit obligation. Such disclosure should be in absolute terms (e.g., as an absolute percentage, and not just as a margin between different percentages and other variables). When an entity provides disclosures in total for a grouping of plans, it should provide such disclosures in the form of weighted averages or relatively narrow ranges. *[IAS 19.144]*.

The following disclosure from Deutsche Bank Aktiengesellschaft illustrates how the significant actuarial assumptions could be disclosed.

Practical example 15-6: Deutsche Bank Aktiengesellschaft (2022) **United Kingdom**

Annual Report 2022 [extract]
Additional Notes [extract]
Note 33: Employee Benefits [extract]
Post-employment Benefit Plans [extract]
Actuarial Methodology and Assumptions [extract]

The key actuarial assumptions applied in determining the defined benefit obligations at December 31 are presented below in the form of weighted averages.

	Dec 31, 2022				Dec 31, 2021			
	Germany	UK	U.S.[1]	Other	Germany	UK	U.S.[1]	Other
Discount rate (in %)	3.80%	4.77%	5.34%	3.99%	1.10%	1.86%	2.73%	1.92%
Rate of price inflation (in %)	2.62%	3.71%	2.20%	2.16%	2.19%	3.73%	2.30%	1.88%
Rate of nominal increase in future compensation levels (in %)	2.81%	3.71%	2.30%	3.14%	2.42%	4.23%	2.40%	2.69%
Rate of nominal increase for pensions in payment (in %)	2.97%	3.32%	2.20%	0.85%	2.10%	3.49%	2.30%	1.05%
Assumed life expectancy at age 65								
For a male aged 65 at measurement date	21.3	23.6	22.0	22.0	21.3	23.5	21.9	22.0
For a female aged 65 at measurement date	23.6	25.4	23.4	24.1	23.5	25.1	23.3	24.0
For a male aged 45 at measurement date	22.6	24.9	23.3	23.5	22.6	24.6	23.3	23.4
For a female aged 45 at measurement date	24.7	26.7	24.8	25.5	24.6	26.5	24.7	25.4
Mortality tables applied	Modified Richttafeln Heubeck 2018G	SAPS (S3) Light/ Very Light with CMI 2021 projections	PRI-2012 with MP-2021 projection	Country specific tables	Modified Richttafeln Heubeck 2018G	SAPS (S3) Light\ Very Light with CMI 2020 projections	PRI-2012 with MP-2021 projection	Country specific tables

[1] Cash balance interest crediting rate in line with the 30-year US government bond yield.

For the Group's most significant pension plans in the key countries, the discount rate used at each measurement date is set based on a high quality corporate bond yield curve, which is derived using a bond universe sourced from reputable third-party market data providers, and reflects the timing, amount and currency of the future expected benefit payments for the respective plan. In the second quarter 2022, a recalibration of the discount curve for defined benefit plans was applied to the Eurozone curve in order to better align to market data which resulted in a benefit recognized in Other Comprehensive Income of € 310 million.

The price inflation assumptions in the Eurozone and the United Kingdom are set with reference to market measures of inflation based on inflation swap rates in those markets at each measurement date. For other countries, the price inflation assumptions are typically based on long term forecasts by Consensus Economics Inc.

The assumptions for the increases in future compensation levels and for increases to pensions in payment are developed separately for each plan, where relevant. Each is set based on the price inflation assumption and reflecting the Group's reward structure or policies in each market, as well as relevant local statutory and plan-specific requirements.

Among other assumptions, mortality assumptions can be significant in measuring the Group's obligations under its defined benefit plans. These assumptions have been set in accordance with current best estimate in the respective countries. Future potential improvements in longevity have been considered and included where appropriate. Due to the long-term nature of mortality assumptions and lack of clarity over the longer term impacts of the pandemic on health outcomes, there has been no specific allowance for the impact of COVID-19 in any region, other than for recent experience which was captured as part of the annual valuation process.

...

15.2.3 Amount, timing and uncertainty of future cash flows

An entity should disclose:

(a) A sensitivity analysis for each significant actuarial assumption as of the end of the reporting period, showing how the defined benefit obligation would have been affected by changes in the relevant actuarial assumption that were reasonably possible at that date.

(b) The methods and assumptions used in preparing the sensitivity analyses required by (a) and the limitations of those methods.

And

(c) Changes from the previous period in the methods and assumptions used in preparing the sensitivity analyses, and the reasons for such changes. *[IAS 19.145]*.

In determining whether an actuarial assumption is significant an entity will need to make a judgement based on the impact of the assumption on the measurement of the defined benefit obligation and the possible range of assumptions. Whether an actuarial assumption is considered to be significant may also change over time due to external macro-economic factors such as inflation rates, and also as a result of changes to the membership composition of the scheme or as a result of a plan amendment.

The following disclosure from BAE Systems plc illustrates the disclosure of sensitivity analysis from changes in the actuarial assumptions as at 31 December 2022.

Practical example 15-7: BAE Systems plc (2022) — **United Kingdom**

Annual Report 2022 [extract]

Notes to the consolidated financial statements [extract]

Note 25: Post-employment benefits [extract]

IAS 19 accounting [extract]

Sensitivity analysis

The sensitivity information has been derived using scenario analysis from the actuarial assumptions as at 31 December 2022 and keeping all other assumptions as set out on page 271.

The pension schemes hold a number of unquoted pooled investment vehicles, which are investments in private markets. These are valued based on latest available valuation reports, and as noted on page 223, these valuations are subject to estimation uncertainty as their valuation techniques incorporate a number of assumptions, including those associated with the COVID-19 pandemic and the impact of climate change. Should these funds' actual valuations at 31 December 2022 be on average 2% different to those assumed, this would result in a £0.2bn (2021 £0.2bn) change in the valuation of the assets.

Financial assumptions

The estimated impact of changes in the discount rate and inflation assumptions on the defined benefit pension obligation, together with the estimated impact on scheme assets, is shown in the table below. The estimated impact on scheme assets takes into account the Group's risk management activities in respect of interest rate and inflation risk. The sensitivity analysis on the defined benefit obligation is measured on an IAS 19 accounting basis and, therefore, does not reflect the natural hedging in the discount rate used for funding valuation purposes.

	Decrease/(increase) in pension obligation[1] £bn	(Decrease)/increase in scheme assets[1] £bn
Discount rate:		
0.5 percentage point increase/decrease	1.4/(1.5)	(1.2)/1.4
1.0 percentage point increase/decrease	2.6/(3.2)	(2.3)/2.9
2.0 percentage point increase/decrease	4.7/(7.2)	(4.3)/6.6
3.0 percentage point increase/decrease	6.5/(12.4)	(5.9)/11.4

1. Before allocation to equity accounted investments and deduction of withholding tax.

	(Increase)/decrease in pension obligation[1] £bn	Increase/(decrease) in scheme assets[1] £bn
Inflation:		
0.1 percentage point increase/decrease	(0.2)/0.2	0.1/(0.1)
0.5 percentage point increase/decrease	(0.8)/0.8	0.7/(0.6)
1.0 percentage point increase/decrease	(1.5)/1.5	1.4/(1.1)

1. Before allocation to equity accounted investments and deduction of withholding tax.

Demographic assumptions

Changes in the life expectancy assumption, including the benefit of longevity swap arrangements (see longevity risk on page 270), would have the following effect on the total net IAS 19 surplus:

	(Decrease)/increase in net surplus[1] £bn
Life expectancy:	
One-year increase/decrease	(0.8)/0.7

1. Before allocation to equity accounted investments and deduction of withholding tax.

A description should be given of any asset-liability matching strategies used by the plan or the entity, including the use of annuities and other techniques, such as longevity swaps, to manage risk. *[IAS 19.146]*.

To provide an indication of the effect of the defined benefit plan on the entity's future cash flows, an entity should disclose:

(a) A description of any funding arrangements and funding policies that affect future contributions.

(b) The expected contributions to the plan for the next annual reporting period.

And

(c) Information about the maturity profile of the defined benefit obligation. This will include the weighted average duration of the defined benefit obligation and may include other information about the distribution of the timing of benefit payments, such as a maturity analysis of the benefit payments. *[IAS 19.147]*.

The following extract from Aviva plc illustrates the maturity profile of the defined benefit obligation.

Practical example 15-8: Aviva plc (2022) **United Kingdom**

Annual Report and accounts 2022 [extract]

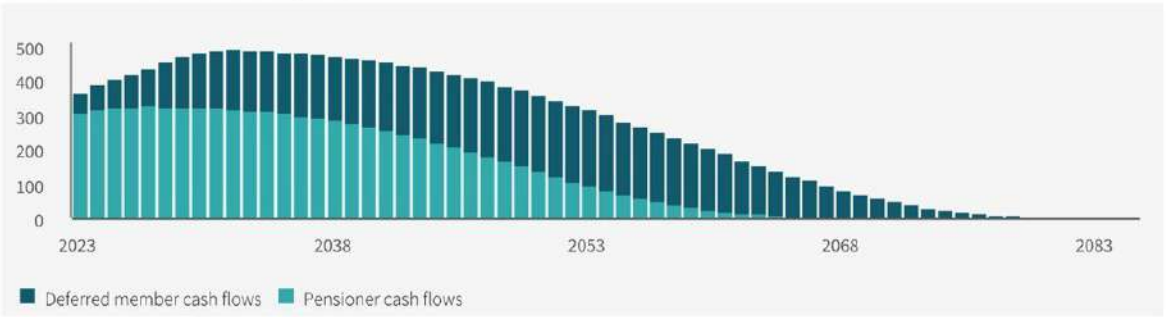
Notes to the consolidated financial statements [extract]

50. Pension obligations [extract]

Maturity profile of the defined benefit obligation

Due to the increase of the discount rate over the period, the average duration of the discounted liabilities has reduced in each scheme. The discounted scheme liabilities have an average duration of 13 years (2021: 17 years) in ASPS, 15 years (2021: 19 years) in FPPS, 14 years (2021: 18 years) in the RAC scheme, 15 years (2021: 19 years) in AISPF, 23 years (2021: 26 years) in FFPS and 9 years (2021: 11 years) in the Canadian scheme. The expected undiscounted benefits payable from the main UK defined benefit scheme, ASPS, is shown in the chart below:

Undiscounted benefit payments (£m)



And the following disclosure from Lloyds Banking Group plc illustrates how the group believes that risk is mitigated through the investment choices made by the trustees.

Practical example 15-9: Lloyds Banking Group plc (2022) **United Kingdom**

Lloyds Banking Group plc Annual Report and Accounts 2022 [extract]

Notes to the consolidated financial statements [extract]

Note 35: Retirement benefit obligations [extract]

(v) Amount, timing and uncertainty of future cash flows

Risk exposure of the defined benefit schemes

While the Group is not exposed to any unusual, entity-specific or scheme-specific risks in its defined benefit pension schemes, it is exposed to a number of significant risks, detailed below:

Inflation rate risk: The majority of the plans' benefit obligations are linked to inflation both in deferment and once in payment. Higher inflation will lead to higher liabilities although this will be materially offset by holdings of inflation-linked gilts and, in most cases, caps on the level of inflationary increases are in place to protect against extreme inflation.

Interest rate risk: The defined benefit obligation is determined using a discount rate derived from yields on AA-rated corporate bonds. A decrease in corporate bond yields will increase plan liabilities although this will be materially offset by an increase in the value of bond holdings and through the use of derivatives.

Longevity risk: The majority of the schemes' obligations are to provide benefits for the life of the members so increases in life expectancy will result in an increase in the plans' liabilities.

Investment risk: Scheme assets are invested in a diversified portfolio of debt securities, equities and other return-seeking assets. If the assets underperform the discount rate used to calculate the defined benefit obligation, it will reduce the surplus or increase the deficit. Volatility in asset values and the discount rate will lead to volatility in the net pension asset on the Group's balance sheet and in other comprehensive income. To a lesser extent this will also lead to volatility in the pension expense in the Group's income statement.

In addition, the schemes themselves are exposed to liquidity risk with the need to ensure that liquid assets held are sufficient to meet benefit payments as they fall due and there is sufficient collateral available to support their hedging activity.

The ultimate cost of the defined benefit obligations to the Group will depend upon actual future events rather than the assumptions made. The assumptions made are unlikely to be borne out in practice and as such the cost may be higher or lower than expected.

...

15.2.4 Multi-employer plans

If an entity participates in a multi-employer defined benefit plan, different disclosures are required depending upon how the arrangement is accounted for. These are discussed below.

15.2.4.A Plans accounted for as defined benefit plans

If an entity participates in a multi-employer defined benefit plan and accounts for it as such, it should make all the required disclosures discussed above. In addition, it should disclose:

(a) A description of the funding arrangements, including the method used to determine the entity's rate of contributions and any minimum funding requirements.

(b) A description of the extent to which the entity can be liable to the plan for other entities' obligations under the terms and conditions of the multi-employer plan.

(c) A description of any agreed allocation of a deficit or surplus on:

(i) Wind-up of the plan

Or

(ii) The entity's withdrawal from the plan *[IAS 19.148]*

15.2.4.B Plans accounted for as defined contribution plans

If an entity accounts for a multi-employer defined benefit plan as if it were a defined contribution plan, it should disclose the following, in addition to the information required by section 15.2.4.A above and instead of the disclosures normally required for defined benefits and discussed in sections 15.2 to 15.2.3 above:

(a) The fact that the plan is a defined benefit plan.

(b) The reason why sufficient information is not available to enable the entity to account for the plan as a defined benefit plan.

(c) The expected contributions to the plan for the next annual reporting period.

(d) Information about any deficit or surplus in the plan that may affect the amount of future contributions, including the basis used to determine that deficit or surplus and the implications, if any, for the entity.

And

(e) An indication of the level of participation of the entity in the plan compared with other participating entities. Examples of measures that might provide such an indication include the entity's proportion of the total contributions to the plan or the entity's proportion of the total number of active members, retired members, and former members entitled to benefits, if that information is available. *[IAS 19.148]*.

15.2.5 Defined benefit plans that share risks between entities under common control

If an entity participates in a defined benefit plan that shares risks between entities under common control, the entity should disclose:

(a) The contractual agreement or stated policy for charging the net defined benefit cost or the fact that there is no such policy.

And

(b) The policy for determining the contribution to be paid by the entity. *[IAS 19.149]*.

Further disclosures are required depending upon how the arrangement is accounted for. These are discussed below.

15.2.5.A Plans accounted for as defined benefit plans

If an entity participates in a defined benefit plan that shares risks between entities under common control and accounts for an allocation of the net defined benefit cost, it should also disclose all the information about the plan as a whole set out in sections 15.2 to 15.2.3 above. *[IAS 19.149]*.

15.2.5.B Plans accounted for as defined contribution plans

If an entity participates in a defined benefit plan that shares risks between entities under common control and accounts for the net contribution payable for the period, it should also disclose the information set out below. *[IAS 19.149]*.

The standard requires disclosure of information that: *[IAS 19.135]*

(a) Explains the characteristics of its defined benefit plans and risks associated with them.

(b) Identifies and explains the amounts in its financial statements arising from its defined benefit plans.

And

(c) Describes how its defined benefit plans may affect the amount, timing and uncertainty of the entity's future cash flows.

To meet the objectives above, the standard requires consideration of all the following:

(a) The level of detail necessary to satisfy the disclosure requirements.

(b) How much emphasis to place on each of the various requirements.

(c) How much aggregation or disaggregation to undertake.

And

(d) Whether users of financial statements need additional information to evaluate the quantitative information disclosed. *[IAS 19.136]*.

If the disclosures provided in accordance with the requirements in IAS 19 and other IFRS accounting standards are insufficient to meet the objectives above, an entity should disclose additional information necessary to meet those objectives. For example, an entity may present an analysis of the present value of the defined benefit obligation that distinguishes the nature, characteristics and risks of the obligation. Such a disclosure could distinguish:

(a) Between amounts owing to active members, deferred members, and pensioners.

(b) Between vested benefits and accrued but not vested benefits.

And

(c) Between conditional benefits, amounts attributable to future salary increases and other benefits. *[IAS 19.137]*.

IAS 19 requires disclosure of: *[IAS 19.139]*

(a) Information about the characteristics of its defined benefit plans, including:

  (i) The nature of the benefits provided by the plan (e.g., final salary defined benefit plan or contribution-based plan with guarantee).

  (ii) A description of the regulatory framework in which the plan operates, for example the level of any minimum funding requirements, and any effect of the regulatory framework on the plan, such as the asset ceiling.

  And

  (iii) A description of any other entity's responsibilities for the governance of the plan, for example responsibilities of trustees or of board members of the plan.

(b) A description of the risks to which the plan exposes the entity, focused on any unusual, entity-specific or plan-specific risks, and of any significant concentrations of risk. For example, if plan assets are invested primarily in one class of investments, e.g., property, the plan may expose the entity to a concentration of property market risk.

And

(c) A description of any plan amendments, curtailments and settlements.

The fair value of the plan assets should be disaggregated into classes that distinguish the nature and risks of those assets, subdividing each class of plan asset into those that have a quoted market price in an active market (as defined in IFRS 13, discussed in Chapter 15) and those that do not. For example, and considering the level of detail of disclosure, aggregation and emphasis discussed in section 15.2 above, an entity could distinguish between:

(a) Cash and cash equivalents

(b) Equity instruments (segregated by industry type, company size, geography etc.)

(c) Debt instruments (segregated by type of issuer, credit quality, geography etc.)

(d) Real estate (segregated by geography etc.)

(e) Derivatives (segregated by type of underlying risk in the contract, for example, interest rate contracts, foreign exchange contracts, equity contracts, credit contracts, longevity swaps etc.)

(f) Investment funds (segregated by type of fund)

(g) Asset-backed securities

And

(h) Structured debt *[IAS 19.142]*

The fair value of the entity's own transferable financial instruments held as plan assets, and the fair value of plan assets that are property occupied by, or other assets used by, the entity should be disclosed. *[IAS 19.143]*.

An entity should disclose the significant actuarial assumptions used to determine the present value of the defined benefit obligation. Such disclosure should be in absolute terms (e.g., as an absolute percentage, and not just as a margin between different percentages and other variables). When an entity provides disclosures in total for a grouping of plans, it shall provide such disclosures in the form of weighted averages or relatively narrow ranges.

To provide an indication of the effect of the defined benefit plan on the entity's future cash flows, an entity should disclose: *[IAS 19.147]*

(a) A description of any funding arrangements and funding policy that affect future contributions.

And

(b) The expected contributions to the plan for the next annual reporting period.

The information described above and in section 15.2.5.A above must be presented in the entity's own accounts. The rest of the information discussed in this section could be disclosed by cross-reference to disclosures in another group entity's financial statements if:

(a) That group entity's financial statements separately identify and disclose the information required about the plan.

And

(b) That group entity's financial statements are available to users of the financial statements on the same terms as the financial statements of the entity and at the same time as, or earlier than, the financial statements of the entity. *[IAS 19.150]*.

15.2.6 Disclosure requirements in other IFRS accounting standards

IFRIC 14 does not introduce any new disclosure requirements. However, it suggests that any restrictions on the current realisability of the surplus or a description of the basis used to determine the amount of the economic benefit available (see section 8.2 above), could require disclosure under the provisions in IAS 1 about key sources of estimation uncertainty. *[IFRIC 14.10]*. These requirements are discussed in Chapter 3 at section 5.2.1.

Where required by IAS 24 an entity discloses information about:

(a) Related party transactions with post-employment benefit plans

And

(b) Post-employment benefits for key management personnel *[IAS 19.151]*

Where required by IAS 37 an entity discloses information about contingent liabilities arising from post-employment benefit obligations. *[IAS 19.152]*.

15.3 Other employee benefits

IAS 19 has no specific disclosure requirements in respect of other types of employee benefits within its scope (i.e., short-term employee benefits, long-term employee benefits other than post-employment benefits and termination benefits) but contains reminders that:

- IAS 24 requires disclosure of employee benefits for key management personnel (see Chapter 35).

  And

- IAS 1 requires disclosure of employee benefits expense. *[IAS 19.25, IAS 19.158, IAS 19.171]*.

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Appendix B - Defined terms

Extract from IFRS accounting standards - Definitions	
actuarial gains and losses	*Actuarial gains and losses* are changes in the present value of the defined benefit obligation resulting from: (a) experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred); and (b) the effects of changes in actuarial assumptions. *[IAS 19.8]*.
asset ceiling	The *asset ceiling* is the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan. *[IAS 19.8]*.
assets held by a long-term employee benefit fund	*Assets held by a long-term employee benefit fund* are assets (other than non-transferable financial instruments issued by the reporting entity) that: (a) are held by an entity (a fund) that is legally separate from the reporting entity and exists solely to pay or fund employee benefits; and (b) are available to be used only to pay or fund employee benefits, are not available to the reporting entity's own creditors (even in bankruptcy), and cannot be returned to the reporting entity, unless either: (i) the remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting entity; or (ii) the assets are returned to the reporting entity to reimburse it for employee benefits already paid. *[IAS 19.8]*.
deficit or surplus	The *deficit or surplus* is: (a) the present value of the defined benefit obligation less (b) the fair value of plan assets (if any). *[IAS 19.8]*.
defined benefit plans	*Defined benefit plans* are post-employment benefit plans other than defined contribution plans. *[IAS 19.8]*.
defined contribution plans	*Defined contribution plans* are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods. *[IAS 19.8]*.
employee benefits	*Employee benefits* are all forms of consideration given by an entity in exchange for service rendered by employees or for the termination of employment. *[IAS 19.8]*.
fair value	*Fair value* is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13 *Fair Value Measurement*.) *[IAS 19.8]*.
multi-employer plans	*Multi-employer plans* are defined contribution plans (other than state plans) or defined benefit plans (other than state plans) that: (a) pool the assets contributed by various entities that are not under common control; and (b) use those assets to provide benefits to employees of more than one entity, on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employs the employees. *[IAS 19.8]*.

net defined benefit liability	The *net defined benefit liability* (asset) is the deficit or surplus, adjusted for any effect of limiting a net defined benefit asset to the asset ceiling. *[IAS 19.8]*.
net interest on the net defined benefit liability (asset)	*Net interest on the net defined benefit liability (asset)* is the change during the period in the net defined benefit liability (asset) that arises from the passage of time. *[IAS 19.8]*.
other long-term employee benefits	*Other long-term employee benefits* are all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits. *[IAS 19.8]*.
plan assets	*Plan assets* comprise: (a) assets held by a long-term employee benefit fund; and (b) qualifying insurance policies. *[IAS 19.8]*.
post-employment benefit plans	*Post-employment benefit plans* are formal or informal arrangements under which an entity provides post-employment benefits for one or more employees. *[IAS 19.8]*.
post-employment benefits	*Post-employment benefits* are employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment. *[IAS 19.8]*.
present value of a defined benefit obligation	The *present value of a defined benefit obligation* is the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods. *[IAS 19.8]*.
remeasurements of the net defined benefit liability (asset)	*Remeasurements of the net defined benefit liability (asset)* comprise: (a) actuarial gains and losses; (b) the return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset); and (c) any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset). *[IAS 19.8]*.
short-term employee benefits	*Short-term employee benefits* are employee benefits (other than termination benefits) that are expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service. *[IAS 19.8]*.
termination benefits	*Termination benefits* are employee benefits provided in exchange for the termination of an employee's employment as a result of either: (a) an entity's decision to terminate an employee's employment before the normal retirement date; or (b) an employee's decision to accept an offer of benefits in exchange for the termination of employment. *[IAS 19.8]*.
qualifying insurance policy	*A qualifying insurance policy* is an insurance policy[1] issued by an insurer that is not a related party (as defined in IAS 24 *Related Party Disclosures*) of the reporting entity, if the proceeds of the policy: (a) can be used only to pay or fund employee benefits under a defined benefit plan; and (b) are not available to the reporting entity's own creditors (even in bankruptcy) and cannot be paid to the reporting entity, unless either: (i) the proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations; or (ii) the proceeds are returned to the reporting entity to reimburse it for employee benefits already paid. *[IAS 19.8]*.

return on plan assets	The *return on plan assets* is interest, dividends and other income derived from the plan assets, together with realised and unrealised gains or losses on the plan assets, less: (a) any costs of managing plan assets; and (b) any tax payable by the plan itself, other than tax included in the actuarial assumptions used to measure the present value of the defined benefit obligation. *[IAS 19.8]*.
service cost	*Service cost* comprises: (a) *current service cost*, which is the increase in the present value of the defined benefit obligation resulting from employee service in the current period; (b) *past service cost*, which is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or a curtailment (a significant reduction by the entity in the number of employees covered by a plan); and (c) any gain or loss on settlement. *[IAS 19.8]*.
settlement	A *settlement* is a transaction that eliminates all further legal or constructive obligations for part or all of the benefits provided under a defined benefit plan, other than a payment of benefits to, or on behalf of, employees that is set out in the terms of the plan and included in the actuarial assumptions. *[IAS 19.8]*.

1 A qualifying insurance policy is not necessarily an insurance contract, as defined in IFRS 17 *Insurance Contracts*.

Chapter 32 Operating segments

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Overview

This chapter addresses the requirements for segment reporting under IFRS 8 *Operating segments*.

IFRS 8 is a disclosure standard. It specifies the way an entity must report information about its operating segments in its financial statements.

Segment reporting is required only for companies whose debt or equity instruments are traded in a public market, or that are in the process of filing financial statements or file financial statements with a securities regulator. Such segment reporting is based on an entity's internal reporting to the chief operating decision maker (sometimes referred to as 'CODM'). An entity is first required to determine its operating segments. If the qualitative criteria specified in IFRS 8 apply, these operating segments may be aggregated into larger segments. The entity would then apply the standard's quantitative criteria to determine the reportable segments.

IFRS 8 distinguishes between required disclosures that apply to the identified reportable segments and entity-wide disclosures. Segment disclosure requirements include general information on segments identified for reporting and quantitative information on reported segment profit or loss and the basis for measurement, as well as information about segment revenues, assets, liabilities and other material items with reconciliation to the corresponding amounts in the financial statements. Entity-wide disclosures apply to all entities, including those with a single operating segment, and cover certain information about products and services, geographical areas and major customers. The measures disclosed shall be consistent with entity's internal reporting.

Irrespective of whether an entity is in scope of IFRS 8 or not, its determination of operating segments is always relevant to the goodwill impairment test performed in line with IAS 36 *Impairment of Assets*, since an operating segment determined in accordance with IFRS 8 is the maximum level to which goodwill can be allocated for impairment testing purposes.

What you need to know

- Segment information is often key information to readers of an entity's IFRS financial statements.
- IFRS 8 adopts the management reporting approach to identifying and reporting operating segments.
- Determining reportable segments and related disclosures may require significant judgement.
- Segment amounts to be disclosed shall be the measures which are reported internally. They may differ from IFRS amounts reported elsewhere in the financial statements.
- An operating segment determined in accordance with IFRS 8 is the maximum level to which goodwill can be allocated for impairment testing purposes under IAS 36. IFRS 8 is therefore relevant also for entities which do not have to report segment information.

1 Introduction

1.1 Background

IFRS 8 was published in November 2006. The standard has been mandatory since 2009. *[IFRS 8.35]*.

In March 2021, in its request for information for the third agenda consultation, the IASB included Operating Segments as a potential project to be considered in its project planning.[1] Based on the feedback received on that agenda consultation, the IASB decided to put Operating Segments on the reserve list of projects for which capacity must be available to address it. If the IASB decides to proceed with the project, the management approach would not be reconsidered.[2]

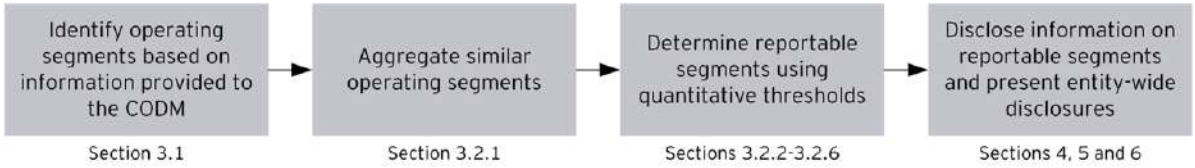
IFRS 8 and its US GAAP counterpart are not fully converged. Any differences between the IFRS and US GAAP guidance on this topic are not addressed in this chapter. For more information refer to EY's US GAAP/IFRS accounting differences identifier tool.[3] *[IFRS 8.BC60]*.

1.2 The basic approach of IFRS 8

IFRS 8 is a disclosure standard. It specifies the way an entity must report information about its operating segments in complete financial statements. Under IAS 34 *Interim Financial Reporting*, an entity must report selected information about its operating segments in condensed interim financial statements (see Chapter 37 at section 4.4).

The standard is based on so-called the management approach, i.e., the information provided regularly to the chief operating decision maker. The process of identifying operating segments for external reporting purposes begins with the information used by the entity's chief operating decision maker to assess performance and to make decisions about future allocations of resources. *[IFRS 8.5]*.

In determining the segments to report on and the disclosures required to be reported, IFRS 8 effectively requires an entity to follow the sequence of steps illustrated below:



There is no 'competitive harm' exemption in IFRS 8 from the requirement to disclose segment information, or components of such information, for example on the grounds of commercial sensitivity, confidentiality or being otherwise detrimental to the entity's competitive position. *[IFRS 8.BC43, IFRS 8.BC44, IFRS 8.BC45]*. (See section 5.8 below).

1.3 Interaction with IAS 36

The process for determining operating segments as described in section 3 below is important not only to entities applying IFRS 8 for external reporting purposes, but also to entities implementing the requirements of IAS 36 for testing goodwill for impairment. As such, the way that operating segments are defined and determined under IFRS 8 can affect the financial statements of entities to which the disclosure requirements in IFRS 8 do not apply, such as those without traded equity or debt. This is because IAS 36, applicable to all entities (i.e., whether in scope of IFRS 8 or not), states that goodwill cannot be allocated to a cash-generating unit or group of cash-generating units (CGUs) that is larger than an operating segment before aggregation (as determined in section 3.2.1 below). *[IAS 36.80(b)]*. See Chapter 21 at section 8.1.4.

1.4 Disclosures required by IFRS 15

IFRS 15 *Revenue from Contracts with Customers* requires entities to disclose disaggregated revenue information to illustrate how the nature, amount, timing and uncertainty about revenue and cash flows are affected by economic factors. *[IFRS 15.114]*. If an entity applies IFRS 8, it is also required to disclose 'sufficient information' to explain the relationship between the disaggregated revenue information and revenue information that is disclosed for each reportable segment. *[IFRS 15.115]*. IFRS 15 also acknowledges that information meeting its requirements might have already been provided under another standard, in which case it is not required to be duplicated. *[IFRS 15.112]*.

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1 Request for Information: *Third Agenda Consultation*, IASB, March 2021, pages 47-48. Available on the IFRS Foundation's website.

2 Feedback Statement: *Third Agenda Consultation*, IASB, July 2022, page 31. Available on the IFRS Foundation's website.

3 *US GAAP/IFRS accounting differences identifier tool*, EY, December 2024, available on ey.com.

Many entities may choose to combine the IFRS 15 disclosures of disaggregated revenue with their segment information in the notes to the financial statements. However, the segment disclosures required by IFRS 8 are made by reference to the information provided to the entity's chief operating decision maker and may not be sufficiently disaggregated to achieve the disclosure objectives of IFRS 15. In addition, the information used for segment reporting may be based on non-GAAP information rather than measured in accordance with IFRS 15. *[IFRS 15.BC340]*.

The requirements of IFRS 15 in this regard are discussed in Chapter 28 at section 10.5.1.

1.5 Terms used in IFRS 8

The following terms are used in IFRS 8 with the meanings specified:

Term	Meaning
Operating segment	Operating segment refers to a component of an entity (a) That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity). (b) Whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance. And (c) For which discrete financial information is available. *[IFRS 8.5, IFRS 8 Appendix A]*.
Chief operating decision maker (CODM)	CODM is described in the standard as a function of allocating resources to and assessing the performance of the operating segments of an entity. This is not necessarily a manager with a specific title, but can be an entity's chief executive officer, chief operating officer, a group of executive directors or others. *[IFRS 8.7]*.
Segment manager	The term "segment manager" refers to a function of being directly accountable to and maintaining regular contact with the chief operating decision maker to discuss operating activities, financial results, forecasts, or plans for the segment. *[IFRS 8.9]*.
Reportable segment	An operating segment or a group of two or more operating segments determined to be eligible for aggregation in accordance with IFRS 8.12; and which exceeds the quantitative thresholds in IFRS 8.13. *[IFRS 8.11]*.
Aggregation criteria	Two or more operating segments may be aggregated into a single operating segment if aggregation is consistent with the core principle of IFRS 8, they have similar economic characteristics, such as long-term average gross margins, and are similar in respect of the five qualitative characteristics set out in the standard. *[IFRS 8.12]*
Quantitative thresholds	Information about an operating segment that meets any of the following criteria: a) Its reported revenue, including both sales to external customers and intersegment sales or transfers, is 10% or more of combined revenue, internal and external, of all operating segments. (b) Its reported profit or loss is, in absolute terms, 10% or more of the greater of, in absolute amount: (i) The combined profit of all operating segments that did not report a loss And (ii) The combined reported loss of all operating segments that reported a loss Or (c) Its assets are 10% or more of the combined assets of all operating segments. *[IFRS 8.13]*.

1.6 Transitional provisions

There are no special arrangements for entities applying IFRS 8 for the first time, with the standard requiring comparative information to be restated. Only where the necessary information is both unavailable and incapable of being developed without excessive cost is an entity exempt from full restatement. *[IFRS 8.36]*. Accordingly, an entity must ensure that internal reporting systems can provide the information needed to meet the disclosure requirements of IFRS 8 for all periods presented in its financial statements.

2 Objective and scope of IFRS 8

2.1 Objective

Extract from IFRS 8

Core principle

1 **An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.**

The objective of IFRS 8 is expressed as a 'core principle'. *[IFRS 8.1]*. This core principle sets out the disclosure objective of the standard, which must be considered in making the judgements needed to determine the required disclosures under the standard, e.g., when aggregating operating segments or when dealing with a matrix organisation.

2.2 Scope of IFRS 8

Extract from IFRS 8

2 This IFRS shall apply to:

(a) the separate or individual financial statements of an entity:

(i) whose debt or equity instruments are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets), or

(ii) that files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and

(b) the consolidated financial statements of a group with a parent:

(i) whose debt or equity instruments are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets), or

(ii) that files, or is in the process of filing, the consolidated financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market.

[IFRS 8.2].

In the case of consolidated financial statements, the above test is applied to the parent entity alone. *[IFRS 8.2(b)]*. Therefore, IFRS 8 does not apply to a group headed by a parent that has no listed financial instruments, even if the group includes a subsidiary that has any of its equity or debt instruments traded in a public market. *[IFRS 8.BC23]*. The scope of IAS 33 *Earnings per Share* is similarly defined in this regard. *[IAS 33.2]*.

A subsidiary with publicly traded debt or equity instruments would be required to provide segment information under IFRS 8 in its own financial statements from its perspective as a reporting entity.

Entities without public accountability may apply IFRS 19 *Subsidiaries without public accountability: Disclosures*. IFRS 19 disclosures exclude IFRS 8. Therefore, if an entity that applies IFRS 19 elects to apply IFRS 8, that entity would be required to apply all the relevant disclosure requirement in that standard. See Chapter 4 at section 7 for further details on the requirements of IFRS 19.

2.2.1 The meaning of 'traded in a public market'

The standard describes a 'public market' as including a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets, *[IFRS 8.2]*, but does not define what would make some markets 'public' and others not.

How we see it

In our view, a market is 'public' when buyers and sellers (market participants) can transact with one another (directly; through agents; or in a secondary market) at a price determined in that market. A public market does not exist when the buyers and sellers can transact only with the entity itself (or an agent acting on its behalf). The requirement for an entity to list its securities on a stock exchange is not the sole factor determining whether the entity is in the scope of IFRS 8. Its securities must be traded in a public market meeting the criteria noted above.

Such 'public markets' would include exchange markets, dealer markets, brokered markets, and principal-to-principal markets as described in IFRS 13 *Fair Value Measurement* and listed in that standard as examples of markets in which fair value inputs might be observable (see Chapter 15 at section 15.1).

Illustration 2-1: The meaning of 'public market' in the context of a fund

Many investment funds are listed on a public stock exchange for informational purposes, in particular to facilitate the valuation of portfolios by investors or because it is a requirement for the fund to be listed on a public stock exchange to make it eligible for investment by entities that are required to invest only in listed securities. However, despite such a listing, subscriptions and redemptions are handled by a fund administrator or a transfer agent (acting on behalf of the fund) and no transactions are undertaken on the public stock exchange. In addition, the prices for those transactions are determined by the fund agreement, such as based on the fund's net asset value, rather than the price quoted on the public stock exchange and determined by supply and demand.

A 'public market' is a different and more restrictive term than the terms 'to the public' and 'public accountability'. In March 2010, the IFRS IC addressed an agenda request that asked to extend the scope of IFRS 8 to all entities that issue instruments 'to the public' (whether or not in a 'public market'). Although the IFRS IC did not interpret the term 'public market', they nevertheless made a clear distinction between the terms 'to the public' and 'public market', with the term 'to the public' being considered to have a broader scope. Therefore, even though a fund can issue instruments to the public (or redeem from the public), this does not result in the fund being subject to a public market unless market participants could freely transact with one another, at a price set by the market.

How we see it

In our view, considering the distinction made by IFRS IC between 'a public market' and 'to the public' discussed in the Illustration above, the debt or equity instruments of such entities are not traded in a public market and so the entity would not fall within the scope of IFRS 8. Nevertheless, regulators can mandate that funds provide segment information, or funds can voluntarily disclose segment information and not describe them as segment information under IFRS 8.

2.2.2 Consolidated financial statements presented with those of the parent

When both the consolidated financial statements and the parent's separate or individual financial statements are contained in the same financial report, segment information is only required in the consolidated financial statements. *[IFRS 8.4]*.

2.2.3 Entities providing segment information on a voluntary basis

Entities for which IFRS 8 is not mandatory might still want to provide information about their business activities, for example about sales by segment, without triggering the need to comply fully with the standard. The Board concluded that this would be acceptable, provided that such disclosure is not referred to as 'segment information'. *[IFRS 8.BC22]*. Consequently, entities giving information about segments on a voluntary basis cannot describe that information as 'segment information' unless it has been prepared in compliance with IFRS 8. *[IFRS 8.3]*.

3 Identifying a single set of operating segments

IFRS 8 adopts a 'bottom up' approach to determining the level of detail required for segment reporting in the notes to the financial statements. It requires the entity's revenue earning activities to be divided into operating segments (based on the same components used by management to run the business) and only allows that information to be aggregated for reporting purposes if specific criteria are met. This process can involve considerable judgement, as it may not always be immediately clear what components of an entity are operating segments for the purposes of the standard or which layer of the entity's organisational structure represents the level at which those activities are managed. This is particularly the case when management information is presented in a number of different ways (for example by product, by geographical market and by legal entity) or where management structures distinguish operational, strategic and oversight responsibilities.

Notwithstanding these difficulties, the requirement is to identify a single set of components as constituting the entity's operating segments. *[IFRS 8.8]*.

3.1 Definition of an operating segment

Extract from IFRS 8

Appendix A
Defined terms

This appendix is an integral part of the IFRS

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

[IFRS 8 Appendix A].

This definition in IFRS 8 means the determination of an entity's operating segments starts with the smallest components of the business for which information about profit is regularly reviewed by the entity's chief operating decision maker.

3.1.1 Revenue earning business activities

A significant feature of an operating segment is the potential for revenue generation rather than actually earning revenues in the reporting period.

Accordingly, a start-up operation can be treated as an operating segment while it has yet to earn revenues. *[IFRS 8.5]*.

However, not every part of an entity is necessarily an operating segment. For example, a corporate headquarters or a functional department (such as a centralised data processing centre) that either does not earn revenues or for which revenues are only incidental to the activities of the entity would not be an operating segment for the purposes of IFRS 8. Similarly, an entity's post-employment benefit plans would not be regarded as operating segments. *[IFRS 8.6]*.

3.1.2 'Chief operating decision maker' and 'segment manager'

Arguably the most important judgement made in implementing IFRS 8 relates to the identification of the entity's chief operating decision maker. The nature of what is ultimately disclosed in the financial statements about operating segments and the level of detail (or segmentation) required is directly related to the information regularly provided to the chief operating decision maker.

References in the standard to 'chief operating decision maker' are to the function of allocating resources and assessing performance of the operating segments and not to a manager with a specific title. Often the chief operating decision maker of an entity is its chief executive officer or chief operating officer (i.e., an individual), but the term could refer equally to a group of executive directors or others charged with that role. *[IFRS 8.7]*. The existence of a group of senior executives does not in itself result in the group being identified as a CODM if a single individual (for instance, the chief executive officer), based on the governance structure of the entity, was able to override the decisions taken by the group.

In Practical example 3-1 below, the Go-Ahead Group plc identifies its Group Chief Executive as the chief operating decision maker:

Practical example 3-1: The Go-Ahead Group plc (2022) **United Kingdom**

Annual report and Accounts [extract]

Notes to the consolidated financial statements [extract]

4. Segmental analysis [extract]

For management purposes, the Group is organised into four reportable segments: Regional Bus, London & International Bus, UK Rail, and International Rail. Operating segments are reported to the chief operating decision maker, considered to be the Group Chief Executive, on a periodic basis for the purposes of resource allocation and assessment of segmental performance. Segments are organised based on the long-term economic characteristics as well as the similar nature of the business activities and are reported as follows:

...

Frequently asked questions

Question 3-1: Could the CODM include non-executive persons?

The determination of chief operating decision maker will not be the same for all entities applying IFRS 8 and will depend upon the particular facts and circumstances applying to each entity, including the entity's governance structure. However, in stating that the term could apply to a group of executive directors or others, *[IFRS 8.7]*, the standard is clear that the function of CODM is an executive role. The IFRS IC confirmed this view in 2011. While it observed that in practice the functions of CODM are sometimes carried out by multiple persons and that all such persons involved in those activities would be part of the CODM group, the Committee noted that the CODM would not normally include non-executive directors.[4] For example, an entity may have a single board of executive and non-executive directors which reviews the performance of individual business units, makes decisions about the operating budgets for those businesses and reviews significant applications for investment. In that case, the full board could be identified as the chief operating decision maker. However, if the entity also has a subcommittee of executive directors or another grouping of key management personnel (sometimes referred to as an 'operational board'), this smaller group of executives would be identified as the chief operating decision maker.

Essentially, the chief operating decision maker is found at the most senior executive decision-making level of an organisation and as such must be distinguished from higher levels of management fulfilling primarily an oversight or approval role and who, to reflect their non-executive function, are provided information at a more aggregated level as a matter of course. For example, in some jurisdictions, supervisory bodies may be part of an entity's governance structure and be entrusted with significant oversight responsibilities. This role may give the supervisory body significant veto rights and rights of approval. However, that supervision will not typically represent the level of decision-making implicit in the notion of the CODM.

4 *IFRIC Update*, July 2011, available on the IFRS Foundation's website.

In Practical example 3-2 below, AstraZeneca PLC identifies the Senior Executive Team (SET) as the CODM:

Practical example 3-2: AstraZeneca PLC (2023) **United Kingdom**

Annual Report and Form 20-F Information 2023 [extract]
Financial Statements [extract]
Consolidated Statements [extract]
Notes to the Group Financial Statements [extract]
6 Segment information [extract]

2 The identification of the Chief Operating Decision Maker (CODM) and the nature and extent of the financial information reviewed by the CODM: The SET, established and chaired by the CEO, is the vehicle through which the CEO exercises the authority delegated to him from the Board for the management, development and performance of AstraZeneca as a whole. It is considered that the SET is AstraZeneca's Chief Operating Decision Making body (as defined by IFRS 8). The operation of the SET is principally driven by the management of the Commercial operations, R&D, manufacturing and supply and enabling functions. All significant operating decisions are undertaken by the SET. While members of the SET have responsibility for implementation of decisions in their respective areas, operating decision making is at SET level as a whole. Where necessary, these are implemented through cross-functional sub-committees that consider the Group-wide impact of a new decision. For example, product launch decisions would be initially considered by the SET and, on approval, passed to an appropriate sub team for implementation. The ability of the enterprise to develop, produce, deliver and commercialise a wide range of pharmaceutical products are central to the SET decision-making process.

In assessing performance, the SET reviews financial information on an integrated basis for the Group as a whole, substantially in the form of, and on the same basis as, the Group's IFRS Financial Statements. The high upfront cost of discovering and developing new products, coupled with the relatively insignificant and stable unit cost of production, means that there is not the clear link that exists in many manufacturing businesses between the revenue generated on an individual product sale and the associated cost and hence margin generated on a product. Consequently, the profitability of individual drugs or classes of drugs is not considered a key measure of performance for the business and is not monitored by the SET. The focus of additional financial information reviewed is at brand sales and Gross Margin level within specific geographies. Expenditure analysis is completed for the science units, operations and enabling functions; there is no allocation of these centrally managed Group costs to the individual product or brands. The bonus of SET members' continues to be derived from the Group scorecard outcome as discussed in our Directors' Remuneration Report.

Another important distinction to be made is between chief operating decision maker and the function of 'segment manager'. The segment manager is "directly accountable to and maintains regular contact with the chief operating decision maker to discuss operating activities, financial results, forecasts or plans for the segment. (...) The chief operating decision maker may also fulfil the role of segment manager for some operating segments. And a single segment manager may be responsible for more than one operating segment". *[IFRS 8.9]*. For example, if the CODM is a group of executives, members of that group may fulfil the role of segment manager for certain components of the entity.

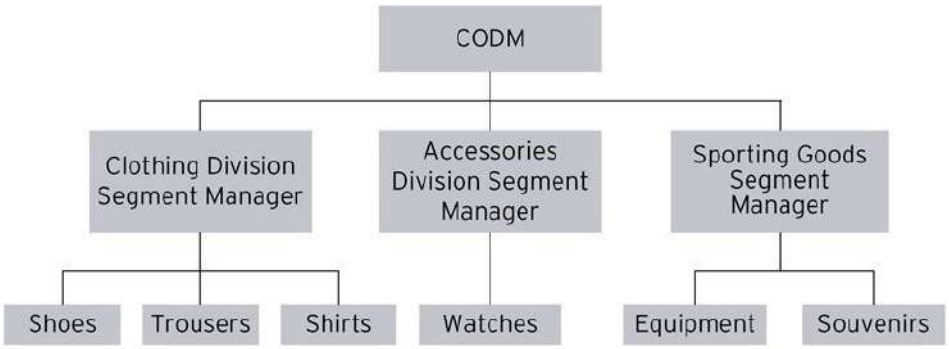
Considerations of how components of the entity are managed are relevant to the identification of an entity's operating segments and not to how they might be reported in the financial statements. Accordingly, separate operating segments which otherwise meet the definition in section 3.1 above are not aggregated into single reportable operating segments simply because they have a common segment manager. The standard is clear that such segments are only aggregated into reportable operating segments if they exhibit similar long-term economic characteristics and are similar in respect of the qualitative criteria set out in section 3.2.1 below. *[IFRS 8.12]*. In addition, because the oversight role of the CODM is separate from the operational role of the segment manager, it is possible that an entity could regard an investee accounted for by the equity method as an operating segment (see section 3.1.5 below).

How we see it

In our view, judgement is required in practice to determine whether the component(s) for which a segment manager is held responsible represents one or more operating segments. For example, if targets are set by the CODM for the entire area of one segment manager's responsibility and the remuneration of that segment manager is based on the achievement of those targets, on an aggregated basis, this could support a determination that the area of responsibility is one operating segment in the absence of other evidence indicating that the CODM reviews the results of these components separately. Equally, whilst IFRS 8 states that segment managers will generally exist, their existence is an important indicator for identifying operating segments, but not a necessary condition. The key determinant is based on the activity of the CODM with respect to the internally reported results of that component.

A common situation in practice is that detailed financial information is provided or available to the chief operating decision maker on a regular basis about various levels of management and operational activity within an entity. In these circumstances, the interplay between the three criteria embedded in the definition of an operating segment (see section 3.1 above) becomes very important, as the existence of more detailed internal reporting could otherwise lead to a determination that there are more operating segments. If the three criteria apply to more than one set of components of an entity, but there is only one set that has segment managers, generally the set of components with segment managers constitutes the operating segments. *[IFRS 8.8]*.

Illustration 3-1: Identifying operating segments - CODM and segment manager



The diagram above sets out the internal reporting structure of Entity A. Assume that six operating units (Shoes, Trousers, Shirts, Watches, Equipment and Souvenirs) are grouped into three divisions (Clothing, Accessories and Sporting Goods), each of which has a divisional manager who reports directly to the CODM. Even though the CODM receives discrete financial information for the six components, the company must assess how the CODM makes key operating decisions and at what level those decisions are made.

The company determines that operating decisions are made at the division level by the CODM. For example, marketing strategies are determined by the CODM for each division, and each divisional manager is responsible for deploying that strategy at the component level. Also, quarterly financial information is presented to the Board of directors and investors at the division level, which is consistent with the level at which the CODM makes decisions. In addition, the entity determines the following:

- Budgets and forecasts are prepared at the division level, and the CODM reviews budget-to-actual variances at that level on a monthly basis.
- The divisional managers are compensated in accordance with the company's bonus plan, which sets targets for each division.

In this case, the company concludes that while the CODM receives financial information for the components, performance is assessed and resources are allocated at the division level and therefore the three divisions are the operating segments.

Proper application of the requirements of IFRS 8 requires a clear understanding of what information is given to the chief operating decision maker and how the CODM uses that information, in conjunction with the segment managers. In the above example, the fact that the CODM receives detailed financial information about activities below the divisional level could raise doubts about the determination that the divisions represent the entity's operating segments, rather than the business units. In these circumstances, entities would be required to demonstrate that:

- The more detailed information is not used by the CODM to assess performance and allocate resources.
- Segment managers operate only at the divisional level and are not, in effect, managers for each of the business units in their division. As noted above, components otherwise meeting the characteristics of an operating segment under IFRS 8 are not combined simply because they share a segment manager.

It might be evident from the records of the discussions between segment managers and the CODM that results are monitored at divisional rather than at business unit level. It might equally be clear from the records of board meetings that more detailed information is not referred to by the CODM in its deliberations. However, there is evidence that when regulators and other enforcement agencies assess the quality of an entity's compliance with IFRS 8, they adopt the presumption that the CODM uses whatever detailed information is provided to him/her on a regular basis for decision-making and assessment purposes.

3.1.3 Availability of discrete financial information

As noted above, a component of an entity can only be regarded as an operating segment if discrete financial information is available about that component. *[IFRS 8.5(c)]*. This requirement relates solely to the existence of discrete information that allows the chief operating decision maker to make decisions about the allocation of resources and to assess the performance of that component.

Accordingly, a component of an entity is still regarded as an operating segment, if the only information available relates to the profitability of that component. Such information would be sufficient for the chief operating decision maker to review its operating results, assess performance and make decisions about resource allocation. *[IFRS 8.5(b)]*. Financial information does not become useless by the lack of, for example, a separate statement of financial position or a separate statement of cash flows for that component.

However, considering the requirement in IFRS 8 that the CODM for its assessment must review "operating profits", it would be unlikely that a component of an entity could be regarded as an operating segment solely because the chief operating decision maker receives information about revenue from that component. Without a measure of the component's operating results, it would be difficult to make meaningful assessments of the effect of allocating more or less resource to that activity. As such, information on revenue alone would have limited value in decision making. Therefore, the search for an entity's operating segments starts with the smallest components of the business for which a measure of profitability is provided to the entity's CODM. *[IFRS 8.5(b)]*.

3.1.4 When a single set of components is not immediately apparent

For many entities, the search for operating segments is concluded after applying the three criteria listed in section 3.1 above.

However, in cases where a single set of operating segments cannot be identified clearly by applying the above criteria (for example in an entity where its business activities are reported internally and assessed in a variety of ways), IFRS 8 states that other factors must be considered, including the nature of the business activities of each component, the existence of a manager responsible for it, and the information presented to the board of directors. *[IFRS 8.8]*. Therefore, if an entity's activities are reported internally in a number of different ways, each with their own set of business components as defined above, but there is only one set to which segment managers are assigned, then that will comprise the operating segments to report in the financial statements for IFRS 8 purposes. *[IFRS 8.9]*. For example, if an entity's board of directors manages its business using information on revenues and costs analysed both by product grouping as well as by geographical market, but the management structure operates only on geographical lines, then the financial statements would include segmental information on a geographical basis.

A single set of operating segments must be identified, even where two or more sets of components of an entity are managed in a matrix structure, for example, where financial information is available and performance is assessed and segment managers assigned not only on the basis of product and service lines worldwide, but also by geographical area irrespective of products and service lines. In that situation the choice of a single set of components is a matter of judgement, made by reference to the core principle of the standard as set out in section 2.1 above. *[IFRS 8.10]*.

3.1.5 An equity accounted investment can be an operating segment

The definition of an operating segment focuses on the review of its operating results by the entity's chief operating decision maker and the assessment of its performance and the allocation of resources to it by the CODM. *[IFRS 8.5(b)]*. This raises the question of whether the reporting entity needs to have control over the activities conducted in what otherwise would meet the definition of an operating segment, or whether it is sufficient that the CODM reviews its results and this review influences decisions about investment in those activities.

How we see it

In our view, when applying the above definition of an operating segment, control over the activities in which the entity is investing is not a requirement.

The core principle of IFRS 8 requires the disclosure of information relating to the business activities in which an entity engages and the economic environments in which it operates. No restriction is imposed according to the manner of that engagement, just the way in which the CODM makes decisions about allocating resources and assesses its performance.

For example, an equity method investee (i.e., associate or joint venture) could be considered an operating segment if it meets the criteria in IFRS 8. The CODM may regularly review the operating results and performance of an equity method investee for the purposes of making additional investments or advances, evaluating financial performance or evaluating whether to retain its investment. The CODM is not required to be responsible for making decisions at the investee operating level that affect the investee's operations and performance in order for it to be identified as an operating segment. Furthermore, the definition of an operating segment does not require that the revenue generating activities of the investee are included in the entity's revenue as reported in the IFRS financial statements. Segment performance could be measured by reference to the amounts included in the entity's IFRS financial statements or equally by reference to the financial information prepared by the investee itself. Any difference between the measures used by the CODM and the accounting treatment under IFRS would be reported as a reconciling item in the entity's disclosures under IFRS 8 (see section 5.6 below).

This view is consistent with the disclosure requirements of IFRS 8, which require the entity's share of the profits and losses of equity accounted associates and joint ventures and the amount of investment in equity accounted investees to be presented, if those amounts are included in the measures reviewed by the CODM of segment profit or loss and segment assets respectively (see sections 5.3 and 5.4 below). *[IFRS 8.23(g), IFRS 8.24(a)]*.

HOCHTIEF Aktiengesellschaft presents its significant equity-method investee Albertis Investment as a separate reportable segment:

Practical example 3-3: HOCHTIEF Aktiengesellschaft (2022) Germany

Group report 2022 [extract]

Notes to the Consolidated Financial Statements [extract]

HOCHTIEF's structure reflects the operating focus of the business as well as the Group's presence in key national and international regions and markets. Segmental reporting in the HOCHTIEF Group is based on the Group's divisional operations. The breakdown mirrors the Group's internal reporting systems.

The Group's reportable segments (divisions) are as follows:

HOCHTIEF Americas encompasses the construction management and construction activities of operational units in the USA and Canada;

...

HOCHTIEF Asia Pacific pools the construction, services, and PPP activities in the Asia-Pacific region and, among other things, includes the investment in Thiess, which was fully consolidated as a subsidiary until last December and has since been accounted for in the Consolidated Financial Statements using the equity method;

HOCHTIEF Europe brings together the core business in Europe as well as selected other regions and designs, develops, builds, operates, and manages real estate and infrastructure (PPP);

Abertis Investment comprises the investment in Spanish toll road operator Abertis Infraestructuras, S.A.

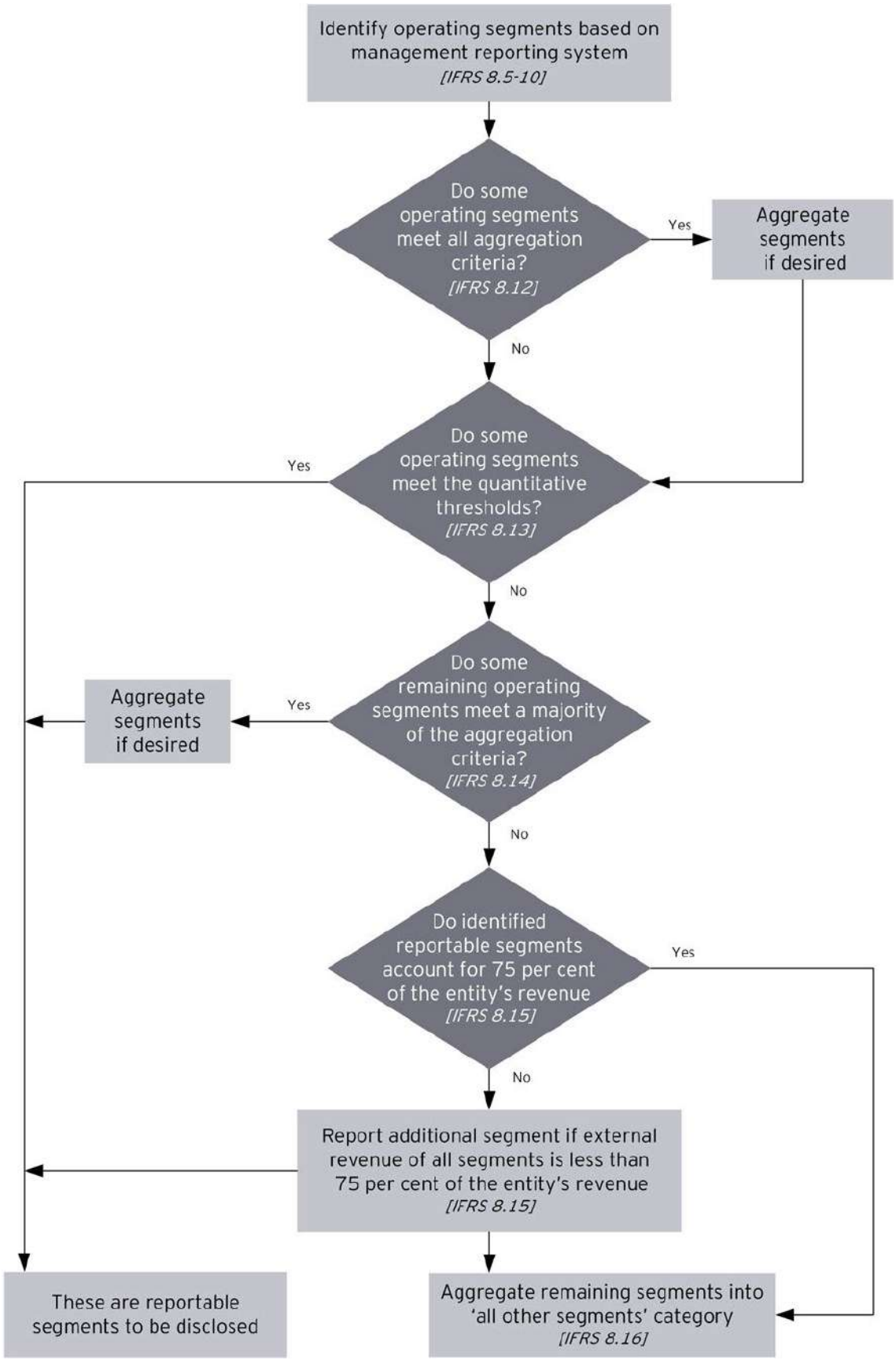
...

3.2 Identifying externally reportable segments

Having identified a single set of internal operating segments, the standard describes how reportable segments are determined. As a minimum, an entity must separately disclose information on reportable segments above a certain size (see section 3.2.2 below). In addition, a previously identified reportable segment continues to be disclosed separately in the current period if management judges it to be of continuing significance, even if it no longer satisfies the quantitative thresholds. *[IFRS 8.17]*.

Thereafter, an entity is only compelled to give information on other segments (either individually or in certain circumstances on a combined basis) if the unallocated element is too large (see section 3.2.4 below).

The implementation guidance to IFRS 8 includes a diagram illustrating how to apply the main provisions of the standard for identifying reportable segments, which is reproduced below:



As indicated in the implementation guidance, the diagram is a visual supplement to IFRS 8. It should not be interpreted as altering or adding to any requirements of IFRS 8 nor should it be regarded as a substitute for its requirements. *[IFRS 8.IG7]*.

IFRS 8 does not permit the omission of segment information when management believes that its disclosure is commercially sensitive or potentially detrimental to the entity's competitive position. If the criteria for separate disclosure described in sections 3.2.2 and 3.2.4 below are met, an entity is required to give information on that operating segment in the financial statements. The IASB considered both a general 'competitive harm' exemption and a 'comply or explain' basis for disclosure and rejected both. *[IFRS 8.BC43, IFRS 8.BC44, IFRS 8.BC45]*.

3.2.1 Aggregation criteria - aggregating internally reported operating segments into single reportable operating segments

Under IFRS 8, an entity is required both to determine its operating segments and report operating segment financial information in accordance with the management approach. However, reporting separate information about every operating segment that the CODM reviews separately may not enhance the financial statement user's understanding of the business, particularly when two or more of the operating segments are so similar that they 'can be expected to have the same future prospects.' *[IFRS 8.BC Appendix A 73]*.

Regardless of size, two or more of identified operating segments may be aggregated applying the following guidance: *[IFRS 8.12]*

Extract from IFRS 8

12 Operating segments often exhibit similar long-term financial performance if they have similar economic characteristics. For example, similar long-term average gross margins for two operating segments would be expected if their economic characteristics were similar. Two or more operating segments may be aggregated into a single operating segment if aggregation is consistent with the core principle of this IFRS, the segments have similar economic characteristics, and the segments are similar in each of the following respects:

(a) the nature of the products and services;

(b) the nature of the production processes;

(c) the type or class of customer for their products and services;

(d) the methods used to distribute their products or provide their services; and

(e) if applicable, the nature of the regulatory environment, for example, banking, insurance or public utilities.

At this stage in the process, only segments which are similar in *all* the above respects can be aggregated into single reportable segments, which can require judgement.

Each of the following criteria must be met for aggregation to be permitted:

- The aggregation is consistent with the core principle of IFRS 8.
- The operating segments have similar economic characteristics.
- The operating segments are similar in all of the five qualitative characteristics, including the nature of the products and services, the nature of the production processes, the type or class of customer for their products and services, the methods used to distribute their products or provide their services and, if applicable, the nature of the regulatory environment.

Reasonable judgement with a thorough understanding of the entity's specific facts and circumstances is required in applying these criteria.

Further aggregation can only be achieved for segments which do not merit separate disclosure by virtue of their size (see section 3.2.2 below).

The fact that certain operating segments have been selected by management as a separately reportable component of activities in the business would suggest that there are good commercial reasons why their performance is monitored separately by the CODM and, therefore, might usefully be reported separately to users of the financial statements. It is only when those components exhibit similar economic characteristics that their aggregation will not compromise the entity's ability to achieve the core principle of IFRS 8, to disclose information that is useful to users of its financial statements. *[IFRS 8.BC32]*.

How we see it

In our view, there is a certain presumption inherent in any standard on segment reporting that investors would prefer information on a more disaggregated basis. As a result, it may be questioned whether it is consistent with the objective and basic principles of IFRS 8 for a company to report just one reportable segment or a limited number of reportable segments, especially if such reportable segments are inconsistent with an entity's basic organisational structure. Companies that choose to aggregate operating segments must be prepared to explain why an operating segment is important enough to be individually reported to the CODM, but similar enough to other segments to be aggregated when reported to investors.

3.2.1.A Consistency with core principle

Aggregation must be consistent with the objective and basic principles of IFRS 8, which are to help users better understand the entity's performance and assess its prospects for future net cash flows. Aggregation is appropriate only when the operating segments are so similar that presenting the information separately would not significantly add to an investor's understanding of the future prospects of the company and its operating segments. Although the identification of operating segments is based on the management approach, the aggregation of operating segments should be viewed from the perspective of investors.

3.2.1.B Economic characteristics

Operating segments must have similar economic characteristics to be aggregated. While IFRS 8 includes long-term gross margin as an example of similar economic characteristics, if the CODM uses a different measure of profit or loss (e.g., EBITDA) to assess performance and allocate resources to each operating segment, that measure of profit or loss must also be considered when assessing whether operating segments possess similar economic characteristics. *[IFRS 8.12]*. In addition, if other economic measures are provided to the CODM, the similarities of those economic measures must also be considered. For example, if the CODM uses sales metrics, return on investment, or other standard industry measures, those metrics may also be relevant in determining economic similarity.

In assessing whether long-term average gross margins (or the appropriate measure of operating performance used by the CODM to assess performance and allocate resources, such as EBITDA) of operating segments are sufficiently similar, companies must look to past and present performance as indicators that segments are expected to again have the same future prospects. In other words, if operating segments do not currently have similar gross margins and sales trends but are expected to have similar long-term average gross margins and sales trends, it may be appropriate to aggregate the two operating segments (provided all other criteria are met). Conversely, if operating segments happen to have similar gross margins or sales trends in a given year but it is not expected that the similar gross margins or sales trends will continue in the future, the operating segments must not be aggregated for the current-year segment disclosures just because current economic measures happen to be similar. It follows that operating segments that have been profitable over the longer term must not be combined with segments that over the longer term have been consistently loss-making.

The following Illustration shows how the management of an entity has interpreted these requirements. However, any judgements to be made will be specific to the entity and the environment in which it operates and in different circumstances some of the characteristics considered will be relatively more or less relevant than others.

Illustration 3-2: Aggregating internally reported operating segments with similar characteristics into a single reportable operating segment

In the information presented to the executive directors, a single-product company has identified seven components of its business that are internally reported operating segments: Africa, Australia and Pacific, France, Germany, Italy, UK and Ireland, and USA. The company dominates its markets in Australia and Pacific and in Germany and consequently enjoys superior operating profits. Its other markets are fragmented, competition is greater and therefore historic and expected margins are lower. Can any segments be aggregated for external reporting purposes?

Management has considered each of the criteria set out in IFRS 8.12 to determine whether the economic characteristics of these separate operating segments are similar, including competitive and operating risks, currency risks and political conditions, as well as current performance and future trading prospects. In these circumstances, management decided that it would not combine operating segments with different underlying currency risks and regulatory environments. That left only France, Germany and Italy as candidates for combination, since they all operate within the Euro zone. However, Germany has not been included in a larger reportable segment because, whilst similar in all other ways, its long-term financial performance is not expected to be comparable to France and Italy, as evidenced by its superior operating profits. On this basis, management decided to aggregate only its operations in France and Italy for external segment reporting purposes.

As can be seen in the above Illustration, operating segments trading in clearly different economic environments (for example, with unrelated functional currencies) must not be aggregated for segment reporting purposes (unless they are so small as to fall within the 'all other segments' category discussed in section 3.2.4 below).

IFRS 8 does not define the term 'similar' and does not provide guidance about what is similar for aggregation purposes. As the above discussion indicates, the determination of whether two or more operating segments are similar requires judgement and is dependent on the individual facts and circumstances.

In a response to a submission in 2011, the IFRS IC had acknowledged that IFRS 8 could usefully include further guidance on the meaning of 'similar economic characteristics' and the criteria for identifying similar segments listed in (a) to (e) above.[5] In a move to improve the standard in this area, the IASB decided to enhance the disclosures on the aggregation of segments but not to add any further guidance at that time (see section 5.1.1 below). More recently, the IASB intended to include further examples of similar economic characteristics as result of its Post-implementation Review of IFRS 8. However, it decided not to amend IFRS 8.

3.2.1.C Qualitative characteristics

In assessing whether the aggregation criteria are met, it is important to note that the aggregation criteria are tests, not indicators, of similarity between operating segments. In addition to exhibiting similar economic characteristics, the operating segments must be similar in each (i.e., all) of the following areas for aggregation to be permitted:

(a) The nature of the products and services.

Similar products or services generally will have similar purposes or end uses. Thus, they may be subject to similar types and degrees of risk and similar opportunities for growth. We believe that it often will be appropriate to evaluate the similarity of products or services based on the range of activities of the organisation, as shown in the following Illustration:

Illustration 3-3: Aggregation - Similar products and services

When evaluating the similarity of products and services, a highly diversified company that manufactures a variety of consumer products, provides financial services and has a construction business may determine that all of its consumer products are similar. However, an entity that only sells consumer products might determine that not all of its consumer products are similar.

(b) The nature of the production processes.

A similar production process might be demonstrated by the sharing of common or interchangeable production facilities, equipment, labour force or service group and by using similar raw materials in the production process. Likewise, similarity in the nature and type of labour or amounts of capital required also may be indicative of a similar production process. The nature of the production process of two different products may be similar, even if the products do not function similarly. Consider the following Illustration:

Illustration 3-4: Aggregation - Similar production process

Assume that Life Co., a life sciences company manufactures various pharmaceutical products for commercial sale. These products include cold medicines and diet pills. Each product is manufactured through the same production process, even though the products have different applications. Both products consist of various chemical compounds that are mixed together in batches to create the end product. Both products undergo quality control testing in order to confirm the efficacy of the product. Both products also use the same manufacturing equipment for parts of the production process. Thus, Life Co. concludes that for the purposes of the segment aggregation criteria, the production processes are similar, despite the differences in the applications of the end products.

(c) The type or class of customer for their products and services.

Factors to consider in evaluating whether the type or class of customer are similar include: (1) the region or geography in which the products and services are marketed; (2) the methods used to market the products or services, including the use of a common or interchangeable sales force; and (3) the nature or type of customer including the industries in which the customers may operate. Entities must carefully consider whether this criterion has been met when the products or services of one operating segment are targeted to a different customer base or constitute a material revenue stream. Consider the following Illustration:

5 *IFRIC Update*, September 2011, available on the IFRS Foundation's website.

Illustration 3-5: Aggregation - Type and class of customer

Market Co., a diversified clothing manufacturer has two operating segments, Retail and Wholesale. Retail primarily markets its products to consumers through electronic and print advertising. In contrast, Wholesale principally markets its products through a network of sales representatives who call upon the distributors to purchase the products. In considering the type or class of customer, Market Co. concludes that the type and class of customer are not similar for the two operating segments based upon the distinction between retail and wholesale as well as the primary marketing methods for its products. As such, aggregation of the two operating segments would not be permitted.

(d) The methods used to distribute their products or provide their services.

The determination of whether two methods of distribution are similar will depend on the structure of a particular company. Consider the following Illustration:

Illustration 3-6: Aggregation - Retail outlets and internet distribution

Software Co., a software retailer, has two operating segments: Retail, which distributes its products through retail outlets, and Internet, which distributes its products through a website on the internet. In evaluating whether these operating segments can be aggregated, Software Co., might conclude that the methods to distribute its products are not similar because Retail and Internet distribute products through different distribution channels.

(e) If applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.

Entities that operate within certain industries may be subject to regulatory requirements that are promulgated by a government agency. Sometimes two operating segments may produce the same product through the same production process, but because of differences in the class of customer and the regulatory environment, the operating segments must not be aggregated. For example, it may not be appropriate for an entity to aggregate an operating segment that produces a product under government contracts together with an operating segment that produces the same product for commercial purposes.

Some entities are comprised of operating segments that operate within different regulatory environments. We believe that the nature of the regulatory environments in which two or more operating segments operate can be regarded as similar, even if the regulatory bodies are not the same.

3.2.2 Quantitative thresholds - operating segments which are reportable because of their size

IFRS 8 includes a number of quantitative measures for determining whether information on the identified operating segments must be reported separately. Accordingly, an operating segment (or combination of segments meeting the qualitative criteria for aggregation described in section 3.2.1 above) requires separate disclosure if it meets any of the following thresholds: *[IFRS 8.13]*

Extract from IFRS 8

13 An entity shall report separately information about an operating segment that meets any of the following quantitative thresholds:

(a) Its reported revenue, including both sales to external customers and intersegment sales or transfers, is 10 per cent or more of the combined revenue, internal and external, of all operating segments

(b) The absolute amount of its reported profit or loss is 10 per cent or more of the greater, in absolute terms, of (i) the combined reported profit of all operating segments that did not report a loss and (ii) the combined reported loss of all operating segments that reported a loss.

(c) Its assets are 10 per cent or more of the combined assets of all operating segments.

The definition of an operating segment includes a component of an entity earning revenues and incurring expenses relating to transactions with other components of the same entity, i.e., numbers in applying the quantitative criteria are prior to any consolidation. *[IFRS 8.5]*. Therefore, an entity would have to report separately information on an operating segment that exceeds the above criteria, even if that segment earns a majority of its revenues from transactions with other components of the same entity.

Illustration 3-7: Identifying reportable segments using the quantitative thresholds

	Unit 1 CU000	Unit 2 CU000	Unit 3 CU000	Unit 4 CU000	Unit 5 CU000	Unit 6 CU000	Unit 7 CU000	Unit 8 CU000	Unit 9 CU000	Total CU000
Revenue:										
External	34,000	3,000	15,000	30,000	35,000	35,000	77,500	55,500	25,000	310,000
Internal	35,000	34,000	12,500	2,200	-	1,500	7,800	2,300	-	95,300
Total	69,000	37,000	27,500	32,200	35,000	36,500	85,300	57,800	25,000	405,300
Profit/(loss)	21,500	24,500	(4,500)	2,300	10,000	7,500	3,500	35,000	(21,250)	78,550
Assets	12,250	77,800	25,000	24,000	40,000	7,730	145,000	55,000	4,300	391,080

Assuming that none of the operating segments (Units 1 through 9) are eligible for aggregation under the qualitative aggregation criteria set out in section 3.2.1 above, which units are required to be reported as operating segments in the entity's financial statements?

Applying the above quantitative thresholds, Units 1, 2, 5, 7, 8 and 9 must be identified as reportable segments, as follows:

- A unit whose internal and external revenue is 10% or more of the total revenue of all segments is a reportable segment. On this basis, Unit 1 (17%), Unit 7 (21%) and Unit 8 (14%) are reportable segments.
- A unit is a reportable segment if its profit or loss, in absolute terms, is 10% or more of the greater of the combined profits of all profitable segments or the combined losses of all segments in loss. The combined profit of all profitable segments is CU104.3m, which is greater than the total of CU25.75m for segments in loss. On this basis, Unit 1 (21%), Unit 2 (23%), Unit 8 (34%) and the loss-making Unit 9 (20%) are reportable segments.
- A unit is also a reportable segment if the measure of assets reported to the chief operating decision maker is 10% or more of the total reported measure of assets of all segments. On this test, Unit 5 (10%) joins the list of reportable segments, with Unit 2 (20%), Unit 7 (37%) and Unit 8 (14%) having been already identified under other criteria.

In Illustration 3-7 above, Units 1, 2, 5, 7, 8 and 9 are identified as reportable segments under IFRS 8 by virtue of their size. No further aggregation of large segments such as these would be possible unless all of the qualitative criteria set out in section 3.2.1 above are met.

Even if an internally reported operating segment falls below all of the quantitative thresholds, it may still be considered as reportable, and separately disclosed, if management believes information about the segment would be useful to users of the financial statements. *[IFRS 8.13]*.

How we see it

In our view, where information about segment assets is not disclosed under IFRS 8 because it is not provided regularly to the CODM, it would be appropriate to ignore criterion (c) above for determining the reportable segments.

3.2.3 Combining small operating segments into a larger reportable segment

Operating segments which individually fall below the size criteria may be combined with other small operating segments into a single larger reporting segment provided that:

(a) The operating segments being combined have similar economic characteristics

And

(b) They share a majority (rather than all) of the criteria listed in section 3.2.1 above *[IFRS 8.14]*

For the avoidance of doubt, if an entity proposes to combine a small operating segment with one that exceeds any of the quantitative thresholds, they must share all of the criteria described in section 3.2.1 above. The requirement that combining segments must demonstrate similar economic characteristics applies to combinations of both larger and smaller operating segments into reportable segments, without exception.

3.2.4 'All other segments'

At this stage, the entity has been divided into a single set of components based on the elements reported to the chief operating decision maker. Components have been combined where permitted by the standard and the entity has identified a number of individual operating segments or groups of operating segments that are required to be disclosed separately in the financial statements because each exceeds the quantitative thresholds for a reportable segment. The entity may then be left with a number of operating segments which have not been identified as being reportable, as well as other business activities that are not an operating segment or part of an operating segment.

Information about other business activities and operating segments that are not reportable must be combined and disclosed in a separate category for 'all other segments'. *[IFRS 8.16]*. However, this residual category cannot be too large. If total external revenue for the operating segments already reported separately is less than 75% of the entity's revenue, the entity must identify additional operating segments for external reporting until the 75% target is reached. In this situation, segments would have to be reported separately even if they fall below the quantitative thresholds described in section 3.2.2 above and are not otherwise regarded as being significant. *[IFRS 8.15]*.

There is no requirement to identify as a reportable segment the next largest internally reported operating segment. The choice of additional reporting segments is aimed simply to reach the 75% threshold, as illustrated below.

Illustration 3-8: Reaching the threshold of 75% of external revenue

In Illustration 3-7 above, Units 1, 2, 5, 7, 8 and 9 were identified as reportable segments. The total external revenue attributable to these reportable segments is CU230m. This is only 74.2% of total external revenues and less than the required 75% of total external revenue of CU310m.

The entity is, therefore, required to identify additional segments as reportable segments, even if they do not meet the quantitative thresholds in section 3.2.2 above. Entities that have numerous operating segments often will have latitude in selecting operating segments to meet the 75% test. In this case, Unit 3, with external revenue of CU15m (4.8%), Unit 4's external revenue of CU30m (9.7%) and Unit 6's external revenue of CU35m (11.3%) would each take the total above the required 75%. The entity can choose to present any of these as a reportable segment, leaving the others to be combined to form the item for 'all other segments'.

How we see it

In our view, the 'all other segments' category must be presented separately from other reconciling items. This raises the question whether headquarters, treasury and similar central functions (sometimes referred to as 'corporate items') must be included in 'all other segments' or in the reconciliation. In practice, the headquarters activities and its related accounting effects will not always be allocated to the operating segments for internal reporting purposes. The description of 'all other segments' refers to 'other business activities and operating segments'. It could be argued that central functions are not business activities, but support functions which must be part of the reconciliation. On the other hand, they could be regarded as incidental business activities. There is no guidance to suggest that either presentation is ruled out by the standard.

3.2.5 A 'practical limit' for the number of reported operating segments

IFRS 8 states that there may be a practical limit to the number of separately reportable segments beyond which segment information may become too detailed. Without prescribing such a limit, it suggests that an entity expecting to disclose more than 10 separate reportable segments must consider whether the practical limit has been reached. *[IFRS 8.19]*.

3.2.6 Restatement of segments reported in comparative periods

When the composition of reportable segments changes over time as a result of changes to an entity's internal reporting to the CODM, the prior period segment data that is presented for comparative purposes must be restated to reflect the newly reportable segment (see section 5.7.1 below). This also applies when an operating segment is identified for the first time as a reportable segment in accordance with the thresholds in section 3.2.2 above, regardless of whether it would have satisfied the quantitative thresholds in the prior period. *[IFRS 8.18]*.

Only if the necessary information is not available and the cost to develop it would be excessive, would prior periods not be restated. *[IFRS 8.18, IFRS 8.29]*.

4 Measurement

Extract from IFRS 8

25 The amount of each segment item reported shall be the measure reported to the chief operating decision maker for the purposes of making decisions about allocating resources to the segment and assessing its performance. Adjustments and eliminations made in preparing an entity's financial statements and allocations of revenues, expenses, and gains or losses shall be included in determining reported segment profit or loss only if they are included in the measure of the segment's profit or loss that is used by the chief operating decision maker. Similarly, only those assets and liabilities that are included in the measures of the segment's assets and segment's liabilities that are used by the chief operating decision maker shall be reported for that segment. If amounts are allocated to reported segment profit or loss, assets or liabilities, those amounts shall be allocated on a reasonable basis.

For an entity that does not present IFRS-compliant financial information to its chief operating decision maker, the measurement regime in IFRS 8 means that the amounts disclosed for segment revenue, profit or loss, and (when reported) assets or liabilities could be very different from those reported elsewhere in the financial statements. For example, management might include gains on sale of property, plant and equipment in its measure of segment revenue but not be permitted to do so in its financial statements. *[IAS 16.68]*.

There is no requirement in IFRS 8 for segment information to be prepared in conformity with the accounting policies used to present the financial statements of the consolidated group or entity. IFRS 8 requires amounts reported to be the same as the measures used by the chief operating decision maker for determining resource allocation and for assessing performance. *[IFRS 8.25]*. This requirement is interpreted strictly. For example, unless adjustments and eliminations made in preparing the financial statements are reflected in the information used by the chief operating decision maker, an entity is prohibited from restating reported segment profit or loss for those adjustments and eliminations. In addition, the standard prohibits any further allocation of revenues, expenses and gains and losses in determining segment profit or loss unless that measure is used by the chief operating decision maker. *[IFRS 8.25]*. IFRS 8 does not require symmetry between the revenues and expenses included in segment result and the assets and liabilities allocated to segments; it simply requires disclosure of the nature and effect of any asymmetrical allocations to reportable segments, for example when depreciation expense is reflected in segment profit or loss, but the related depreciable assets are not allocated to that segment. *[IFRS 8.27(f)]*. Only those assets and liabilities taken into account by the chief operating decision maker will be included in assets and liabilities reported for that segment. *[IFRS 8.25]*.

The amounts presented for segment revenue, profit or loss, assets and liabilities need bear no relationship to the amounts reported elsewhere in the financial statements, if the only measure of each that is used by the chief operating decision maker is not prepared in accordance with the entity's accounting policies or even under IFRS. *[IFRS 8.26]*. However, there is a constraint on this otherwise 'free-for-all', since in those cases where a number of measures of segment profit or loss, assets or liabilities are used by the chief operating decision maker, an entity is required to select for its segment disclosures the measurements that are most consistent with those used in preparing the financial statements. *[IFRS 8.26]*.

When multiple measures of profit or loss are used by the CODM in monitoring operating segments, when complying with this specific requirement, in some jurisdictions the regulator may interpret the provision of the standard as precluding the disclosure of more than one measure of profit or loss, in addition to the one most consistent with the measurements used in preparing the financial statements.

How we see it

In our view, a key judgement that can significantly affect the segment disclosures reported in the financial statements arises when an entity seeks to distinguish information used by the chief operating decision maker for determining resource allocation and for assessing performance from other information and supporting detail which is regularly provided. Whether, for example, it is appropriate to ignore IFRS-compliant measures provided to the chief operating decision maker on the basis that they are not used for determining resource allocation and for assessing performance depends on the facts and circumstances supporting that assertion. Nevertheless, it might be appropriate to apply a rebuttable presumption that management effort is not normally wasted in providing the chief operating decision maker with information that is not used.

5 Information to be disclosed about reportable segments

Extract from IFRS 8

20 An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

21 To give effect to the principle in paragraph 20, an entity shall disclose the following for each period for which a statement of comprehensive income is presented:

(a) general information as described in paragraph 22;

(b) information about reported segment profit or loss, including specified revenues and expenses included in reported segment profit or loss, segment assets, segment liabilities and the basis of measurement, as described in paragraphs 23-27; and

(c) reconciliations of the totals of segment revenues, reported segment profit or loss, segment assets, segment liabilities and other material segment items to corresponding entity amounts as described in paragraph 28.

Reconciliations of the amounts in the statement of financial position for reportable segments to the amounts in the entity's statement of financial position are required for each date at which a statement of financial position is presented. Information for prior periods shall be restated as described in paragraphs 29 and 30.

[IFRS 8.20, IFRS 8.21].

These requirements are addressed in more detail below and the information described therein must be given separately for each segment determined to be reportable using the process set out in section 3.2 above. *[IFRS 8.11]*.

As discussed in section 3.1.2 above, the identification of the chief operating decision maker can be a critical judgement in applying IFRS 8 because of its potential effect on what information is considered for disclosure. However, there is no explicit requirement in the standard to disclose the CODM. When in 2011, the IFRS IC and the IASB considered a request to amend the standard to require disclosure, they decided to defer this issue until the completion of the Post-implementation Review of IFRS 8 rather than through an interpretation or annual improvement.[6]

How we see it

In March 2017, the Board issued an ED which proposed that entities disclose the title and description of the role of the individual or group which is identified as the CODM. In our view, while the proposed disclosure requirement was not finally adopted, it would be good practice to disclose the individual or group identified as CODM (see Illustrations in section 3.1.2 above).

5.1 General information about reportable segments

The factors used to identify reportable segments must be described. This would include an explanation of the entity's basis of organisation, for example whether management has chosen to organise the entity by different products and services, by geographical area, by regulatory environment or by applying a combination of factors. *[IFRS 8.22(a)]*.

The description would also indicate whether and how operating segments have been aggregated (see section 5.1.1 below). The general information on reportable segments would include a description of the types of products and services from which each reportable segment derives its revenues. *[IFRS 8.22]*. The disclosures must also include a description of the sources of the revenue classified in the 'all other segments' category. *[IFRS 8.16]*.

In Practical example 5-1 below, Mercedes-Benz Group AG describes how its activities have been segmented into its principal business activities and specific product lines.

6 *IFRIC Update*, September 2011, available on the IFRS Foundation's website.

Practical example 5-1: Mercedes-Benz Group AG (2022) **Germany**

Annual report 2022 [extract]

Notes to the Consolidated Financial Statements [extract]

35. Segment reporting [extract]

Reported segments

The Group comprises the segments Mercedes-Benz Cars, Mercedes-Benz Vans and Mercedes-Benz Mobility.

...

The vehicle segments develop and manufacture premium and luxury passenger cars and vans. In addition to the Mercedes-Benz brand, the brand portfolio of the Mercedes-Benz Cars segment encompasses the brands Mercedes-AMG, Mercedes-Maybach and Mercedes-EQ. The Mercedes me brand provides access to the digital services of Mercedes-Benz Cars. At Mercedes-Benz Vans, the vans are sold under the Mercedes-Benz brand. Corresponding spare parts and accessories are also sold.

The Mercedes-Benz Mobility segment supports the sales of the Mercedes-Benz Group's vehicle brands worldwide. The product range mostly contains made-to-measure mobility and financial services. These services range from leasing and financing packages for end customers and dealers to insurance solutions, flexible subscription and rental models and fleet management services for business customers, with the latter primarily offered via the Athlon brand. Furthermore, Mercedes-Benz Mobility is active in the area of innovative mobility services.

5.1.1 Disclosure of how operating segments are aggregated

IFRS 8 requires disclosure of the judgements made by management in applying the aggregation criteria in the standard. This includes a brief description of the operating segments that have been aggregated in this way and the economic indicators that were considered in determining that the aggregated operating segments share similar economic characteristics. *[IFRS 8.22(aa)]*. The aggregation criteria are discussed in section 3.2.1 above.

In Practical example 5-2 below, Vodafone Group Plc describes the composition of its reportable segments. The narrative explains the basis for aggregating countries into those reportable segments.

Practical example 5-2: Vodafone Group Plc (2021) **United Kingdom**

Annual report 2021 [extract]

Notes to the consolidated financial statements [extract]

2. Revenue disaggregation and segmental analysis [extract]

Segmental analysis [extract]

With the exception of Vodacom, which is a legal entity encompassing South Africa and certain other smaller African markets, segment information is primarily provided on the basis of geographic areas, being the basis on which the Group manages its worldwide interests.

The operating segments for Germany, Italy, UK, Spain, and Vodacom are individually material for the Group and are each reporting segments for which certain financial information is provided. The aggregation of smaller operating segments into the Other Europe and Other Markets reporting segments reflects, in the opinion of management, the similar local market economic characteristics and regulatory environments for each of those operating segments as well as the similar products and services sold and comparable classes of customers. In the case of the Other Europe region this largely reflects membership or a close association with the European Union, while the Other Markets segment largely includes developing economies with less stable economic or regulatory environments. Common Functions is a separate reporting segment and comprises activities which are undertaken primarily in central Group entities that do not meet the criteria for aggregation with other reporting segments.

5.2 A measure of segment profit or loss, total assets and total liabilities

For each reportable segment, an entity is required to disclose a measure of profit or loss for each segment. An entity is also required to disclose a measure of total assets and total liabilities for each reportable segment, but only if such amounts are regularly provided to the chief operating decision maker. *[IFRS 8.23]*. This 'measure' means segment profit or loss and segment assets and liabilities as defined in the information used by the chief operating decision maker.

5.2.1 Other measures of segment performance

Entities typically use not only a measure of profit or loss, but also a combination of different financial and non-financial key performance indicators to assess performance of their operating segments and allocate resources to them. Examples include key measures based on capital invested like return on capital employed (ROCE), free cash flow or orders on hand. Since these are not measures of profit or loss, they would not need to be disclosed. However, the standard does not prohibit their disclosure.

Siemens Aktiengesellschaft includes measures of new orders and free cash flow in its segment information as shown in Practical example 5-3 below.

Practical example 5-3: Siemens Aktiengesellschaft (2022) **Germany**

Annual financial report 2022 [extract]

6. Notes to Consolidated Financial Statements [extract]

NOTE 29 Segment information [extract]

	Orders		Free cash flow	
	Fiscal year		Fiscal year	
(in millions of €)	2022	2021	2022	2021
Digital Industries	**25,283**	18,427	**4,090**	3,750
Smart Infrastructure	**20,798**	16,071	**2,203**	2,098
Mobility	**13,200**	12,696	**771**	898
Siemens Healthineers	**25,556**	20,320	**2,625**	3,101
Industrial Business	**84,837**	67,514	**9,689**	9,847
Siemens Financial Services	**662**	697	**985**	820
Portfolio Companies	**3,995**	3,516	**97**	354
Reconciliation to Consolidated Financial Statements	**(483)**	(353)	**(2,533)**	(2,642)
Siemens (continuing operations)	**89,010**	71,374	**8,238**	8,379

...

Orders

Orders are determined principally as estimated revenue of accepted purchase orders for which enforceable rights and obligations exist as well as subsequent order value changes and adjustments, excluding letters of intent. To determine orders, Siemens considers termination rights and customer's creditworthiness.

As of September 30, 2022, and 2021, order backlog totaled €102 billion and €85 billion (continuing operations); thereof Digital Industries €14 billion and €7 billion, Smart Infrastructure €15 billion and €11 billion, Mobility €36 billion and €36 billion and Siemens Healthineers €34 billion and €27 billion. In fiscal 2023, Siemens expects to convert approximately €45 billion of the September 30, 2022 order backlog into revenue; thereof at Digital Industries approximately €11 billion, Smart Infrastructure approximately €10 billion, Mobility approximately €10 billion and Siemens Healthineers approximately €12 billion.

Free cash flow definition

Free cash flow of the segments constitutes cash flows from operating activities less additions to intangible assets and property, plant and equipment. Except for SFS, it excludes financing interest, except for cases where interest on qualifying assets is capitalized or classified as contract costs; it also excludes income tax as well as certain other payments and proceeds. Free cash flow of SFS includes related financing interest payments and proceeds; income tax payments and proceeds of SFS are excluded. In individual cases, free cash flow of Mobility includes project-specific intercompany financing of long-term projects.

5.3 Disclosure of other elements of revenue, income and expense

The following items must also be disclosed about each reportable segment if the specified amounts are included in the measure of segment profit or loss reviewed by the chief operating decision maker or are otherwise regularly provided in respect of those segments to the chief operating decision maker (even if not included in that measure of segment profit or loss):

(a) Revenues from external customers

(b) Revenues from transactions with other operating segments of the same entity

(c) Interest revenue

(d) Interest expense

(e) Depreciation and amortisation

(f) Material items of income and expense disclosed in accordance with paragraph 97 of IAS 1 *Presentation of Financial Statements [paragraph IFRS 18.42]*

(g) The entity's interest in the profit or loss of associates and joint ventures accounted for by the equity method

(h) Income tax expense or income

And

(i) Material non-cash items other than depreciation and amortisation *[IFRS 8.23]*

Interest revenue must be reported separately from interest expense for each reportable segment unless a majority of the segment's revenues are from interest and the chief operating decision maker relies primarily on net interest revenue to assess the performance of the segment and make decisions on the allocation of resources to it. In that case, the entity can report net interest revenue or expense for the segment provided that it discloses it has done so. *[IFRS 8.23]*.

It can be seen that whilst IFRS 8 indicates the line items of income or expense or other information that might merit disclosure by segment, what an entity actually reports in its financial statements is determined by the line items used by the chief operating decision maker to define segment profit or loss and segment assets or liabilities, together with the other information otherwise regularly provided to the chief operating decision maker. *[IFRS 8.23, IFRS 8.24]*. This means that different entities (even those with very similar activities) will make different disclosures, depending on what information is provided to the chief operating decision maker. Indeed, what is disclosed by one entity for each of its reportable segments might vary because, for example, the result of one segment is determined after deducting interest whilst that of other segments is drawn before interest; or because the information provided to the chief operating decision maker about one segment includes equity-accounted associates but for other segments does not. As such the disclosures made by an entity are tailored according to exactly what appears in the information presented to the chief operating decision maker.

In July 2024, the IFRS IC published an agenda decision which discusses how an entity applies the requirements in paragraph 23 of IFRS 8 in making the assessment of which items of segment income and expense are material in the context of the financial statements as a whole and need to be disclosed in the segment reporting note.

The agenda decision addresses two main points:

- The IFRS IC said IFRS 8.23(a)-(i), which requires disclosure of specified segment amounts (e.g., revenues, interest, depreciation and amortization), applies to all amounts included in the measure of segment profit or loss that is reviewed by the chief operating decision maker (CODM). The IFRS IC observed that this is the case even for those amounts that make up the measure, which are themselves, not separately reviewed by, or provided to, the CODM.
- The agenda decision clarifies that IFRS 8.23(f), which requires the disclosure of material items of segment income and expense, applies to all material items of income or expense and not just unusual or non-recurring items. However, IFRS 8.23(f) does not require a complete statement of profit or loss by segment. The overarching concept of materiality in IAS 1 applies to IFRS 8. Therefore, an entity needs to assess whether the segment amount for an item of income or expense is material in its particular circumstances by considering qualitative and quantitative factors. Materiality is assessed in the context of the entity's financial statements as a whole and requires the use of judgement.[7]

Equinor ASA provides segment disclosures based on its internal management reporting, with reportable segments determined based on differences in the nature of their operations, products and services, as follows:

Practical example 5-4: Equinor ASA (2023) — Norway

Annual report on Form 20-F [extract]

Notes to the Consolidated financial statements [extract]

5 Segments [extract]

Segment information for the years ended 31 December 2023, 2022, and 2021 are presented below.

...

2023 (in USD million)	E&P Norway	E&P International	E&P USA	MMP	REN	Other	Eliminations	Total group
Revenues third party	230	993	277	105,242	20	85	0	106,848
Revenues and other income inter-segment	37,999	6,009	4,009	633	12	33	(48,695)	0
Net income/(loss) from equity accounted investments	0	28	0	12	(33)	(8)	0	(1)
Other income	111	1	32	23	18	142	0	327
Total revenues and other income	38,340	7,032	4,319	105,908	17	253	(48,695)	107,174
Purchases [net of inventory variation]	0	(70)	0	(95,769)	0	(1)	47,665	(48,175)
Operating, selling, general and administrative expenses	(3,759)	(2,176)	(1,178)	(4,916)	(462)	(201)	893	(11,800)
Depreciation and amortisation	(4,429)	(2,123)	(1,779)	(897)	(12)	(133)	0	(9,373)
Net impairment (losses)/reversals	(588)	(310)	290	(343)	(300)	(10)	0	(1,260)
Exploration expenses	(476)	(20)	(299)	0	0	0	0	(795)
Total operating expenses	(9,253)	(4,700)	(2,966)	(101,925)	(774)	(345)	48,558	(71,404)
Net operating income/(loss)	29,087	2,332	1,353	3,984	(757)	(92)	(137)	35,770

7 *IFRIC update*, July 2024, available on the IFRS Foundation's website.

5.4 Additional disclosures relating to segment assets

If any of the following items are either included in the measure of segment assets reviewed by the chief operating decision maker or otherwise regularly provided in respect of those segments (whether included in segment assets or not), an entity must also disclose for each segment:

(a) The investment in equity-accounted associates and joint ventures.

And

(b) Total expenditures for additions to non-current assets other than financial instruments, deferred tax assets, post-employment benefit assets and rights arising under insurance contracts. *[IFRS 8.24]*.

5.5 Explanation of the measurements used in segment reporting

As noted in section 4 above, instead of prescribing how an entity must calculate the amounts reported in its segmental disclosures, IFRS 8 requires an entity to explain how its measures of segment profit or loss, segment assets and segment liabilities have been determined. As a minimum, the following information is required:

(a) The basis of accounting for any transactions between reportable segments.

(b) If not apparent from the required reconciliations (see section 5.6 below), the nature of any differences between the measurement of total reported segment profit or loss and the entity's profit or loss before income taxes and discontinued operations.

(c) The nature of any differences between the measurements of total reported segment assets and the entity's assets, if not apparent from the required reconciliations.

(d) The nature of any differences between the measurements of total reported segment liabilities and the entity's liabilities, if not apparent from the required reconciliations.

(e) The nature of any changes from prior periods in the measurement methods used to determine segment profit or loss, including the financial effect, if any, of those changes.

And

(f) The nature and effect of any asymmetrical allocations to reportable segments, such as where depreciation is included in segment profit but the related property, plant and equipment is not included in segment assets. *[IFRS 8.27]*.

The kind of disclosures in (b), (c) and (d) above that are necessary for an understanding of the reported segment information could relate to the accounting policies used, including policies for the allocation of centrally incurred costs in arriving at segment profit or loss and for the allocation of jointly used assets and liabilities in determining segment assets and segment liabilities. *[IFRS 8.27]*. Other examples might include the use of previous local GAAP numbers, where internal reporting does not reflect the entity's move to IFRS, or the use of budgeted figures, for example when applying budgeted or constant foreign currency rates.

In Practical example 5-5 below, Mercedes-Benz Group AG confirms that segment information is prepared using the same accounting policies as the IFRS financial statements, describes how 'EBIT' is the measure of segment profit or loss and explains how segment assets and liabilities are determined.

Practical example 5-5:	Mercedes-Benz Group AG (2023)	Germany

Annual Report 2023 [extract]
Consolidated Financial Statements [extract]
Notes to the Consolidated Financial Statements [extract]
34. Segment reporting [extract]

...

Internal management and reporting structure

The internal management and reporting structure at the Mercedes-Benz Group is principally based on the accounting policies according to IFRS that are described in Note 1.

The measure of the Group's net profit or loss used by the Mercedes-Benz Group's management and reporting structure is referred to as "EBIT". EBIT comprises gross profit, selling and general administrative expenses, research and non-capitalized development costs, other operating income/expense, and the gains/losses on equity-method investments, as well as other financial income/expense.

...

Segment assets principally comprise all assets. The assets of the Mercedes-Benz Cars and Mercedes-Benz Vans segments exclude income tax assets, assets from defined benefit pension plans and other post-employment benefit plans, and certain financial instruments (including liquidity).

...

In its 2023 financial statements, HOCHTIEF Aktiengesellschaft provided an explanation of the basis of accounting for transactions between reportable segments.

Practical example 5-6:	HOCHTIEF Aktiengesellschaft (2023)	Germany

Group Report 2023 [extract]
COMBINED FINANCIAL AND SUSTAINABILITY REPORT [extract]
CONSOLIDATED FINANCIAL STATEMENTS AND NOTES [extract]
Notes to the Consolidated Financial Statements [extract]
35. Segment reporting [extract]

Explanatory notes to the segmental data

Intersegment sales represent revenue generated between divisions. They are transacted on an arm's length basis. External sales mainly comprise performance obligations recognized under the percentage of completion method in the mainstream construction business, construction management, and resource services. The sum of external sales and intersegment sales adds up to total sales for each division.

...

5.6 Reconciliations

Reconciliations are required of all the following:

(a) The total of revenue from reportable segments to the entity's revenue.

(b) The total profit or loss for reportable segments to the entity's profit or loss before income taxes and discontinued operations. Where items such as income taxes have been allocated to arrive at segment profit or loss, the reconciliation can be made to the entity's profit or loss after those items.

(c) If segment assets are reported (see section 5.2 above), the total of the reportable segments' assets to the entity's assets.

(d) If segment liabilities are reported (see section 5.2 above), the total of reportable segments' liabilities to the entity's liabilities.

And

(e) For every other material item of information the entity chooses to give in its segment information, the total of each item from all reportable segments to the corresponding amount for the entity. *[IFRS 8.28]*.

In each of the above reconciliations an entity must separately identify and describe all material reconciling items. For example, when reconciling segment profit or loss to the entity's profit or loss before income taxes and discontinued operations, each material adjustment arising from differences in accounting policies would have to be separately identified and described. *[IFRS 8.28]*. In addition, IFRS 8 requires information about the 'all other segments' category to be shown separately from other reconciling items. *[IFRS 8.16]*.

In its 2023 financial statements, National Australia Bank Limited evaluated the performance of operating segments on the basis of cash earnings. This post-tax measure of the profit or loss of reportable segments is reconciled to the consolidated financial statements as follows:

Practical example 5-7:	**National Australia Bank Limited (2023)**	**Australia**

Annual Report 2023 [extract]
Financial report [extract]
Notes to the financial statements [extract]
Financial performance [extract]
Overview [extract]

...

The Group evaluates performance on the basis of cash earnings as it better reflects what is considered to be the underlying performance of the Group. Cash earnings is a non-IFRS key financial performance measure used by the Group and the investment community.

Cash earnings is calculated by adjusting statutory net profit from continuing operations for certain non-cash earnings items. Non-cash earnings items are those items which are considered separately when assessing performance and analysing the underlying trends in the business. Cash earnings for the year ended 30 September 2023 has been adjusted for hedging and fair value volatility, amortisation of acquired intangible assets, and certain other items associated with acquisitions, disposals and business closures. Cash earnings does not purport to represent the cash flows, funding or liquidity position of the Group, nor any amount represented on a statement of cash flows.

...

Note 2 Segment information [extract]

	2023					
	Business and Private Banking $m	Personal Banking $m	Corporate and Institutional Banking[1] $m	New Zealand Banking[1] $m	Corporate Functions and Other[2] $m	Total Group $m
Reportable segment information						
Net interest income	7,270	4,329	2,361	2,616	231	16,807
Other income	976	567	1,593	536	175	3,847
Net operating income	8,246	4,896	3,954	3,152	406	20,654
Operating expenses	(2,931)	(2,561)	(1,452)	(1,105)	(974)	(9,023)
Underlying profit / (loss)	5,315	2,335	2,502	2,047	(568)	11,631
Credit impairment (charge) / write-back	(568)	(287)	(32)	(85)	170	(802)
Cash earnings / (loss) before tax and distributions	4,747	2,048	2,470	1,962	(398)	10,829
Income tax (expense) / benefit	(1,429)	(602)	(600)	(553)	91	(3,093)
Cash earnings / (loss) before non-controlling interests	3,318	1,446	1,870	1,409	(307)	7,736
Non-controlling interests	-	-	-	(5)	-	(5)
Cash earnings / (loss)	3,318	1,446	1,870	1,404	(307)	7,731
Hedging and fair value volatility	(2)	(6)	(95)	(8)	82	(29)
Other non-cash earnings items	(9)	(17)	-	-	(211)	(237)
Net profit / (loss) for the year from continuing operations	3,307	1,423	1,775	1,396	(436)	7,465
Net loss from discontinued operations attributable to owners of the Company	-	-	-	-	(51)	(51)
Net profit / (loss) attributable to owners of the Company	3,307	1,423	1,775	1,396	(487)	7,414
Reportable segment assets[3]	255,451	247,934	282,809	117,090	155,799	1,059,083

(1) For the year ended 30 September 2023, the New Zealand liquidity management portfolio of $18.3 billion of assets is reported within New Zealand Banking. Previously the assets and liabilities together with the related income was reported as part of Corporate and Institutional Banking. Comparative information has not been restated.
(2) Corporate Functions and Other includes eliminations.
(3) Reportable segment assets include inter-company balances which are eliminated within the Corporate Functions and Other segment.

...

5.7 Restatement of previously reported information

Entities may need to change their organisation to respond to their business needs. This may have an effect on the entity's segment reporting. IFRS 8 provides explicit guidance if such a change in the organisation changes the composition of its reportable segments. However, it does not explicitly address any changes that affect reportable segments, such as a change in segment measures. This is discussed further below.

5.7.1 Changes in organisation structure

When an entity changes its organisational structure in a manner that causes a change in the composition of its reportable segments, corresponding amounts for earlier periods must be restated unless the information is not available and the cost to develop it would be excessive. This requirement also applies to the presentation of segment information in respect of interim periods. *[IFRS 8.29]*.

The exemption from restatement on grounds of excessive cost is applied to each individual item of disclosure. *[IFRS 8.29]*. This means that an entity must restate its comparative information for all the items it can, even if this results in some comparative information not being presented or restated, such as inter-segment revenues. When the composition of reportable segments has changed, an entity must disclose whether the corresponding items of segment information have been restated. *[IFRS 8.29]*.

Where corresponding information is not restated to reflect the new composition of reportable segments, the segment information for the current period must be presented on both the old and the new bases of segmentation. Only if the necessary information were unavailable and the cost of developing it excessive, would an entity not have to show current information on the old basis of segmentation. *[IFRS 8.30]*.

How we see it

In our view, given the importance of comparable segment information in particular in years of changing segmentation, the 'excessive cost' criterion represents a high hurdle to overcome.

If an entity decides to change its organisational structure during the reporting period, this requirement applies equally to interim periods *[IFRS 8.29]* and the information presented at the reporting date is also restated to reflect the new basis of segmentation,

As illustrated by the following Practical example 5-8 Sanofi changed its segment structure from three segments to two segments and restated the prior year:

Practical example 5-8: Sanofi (2023) France

2023 FORM 20-F [extract]

PART III [extract]

Item 18. Financial Statements [extract]

2023 Consolidated financial statements [extract]

Notes to the Consolidated Financial Statements [extract]

D.35. Segment information [extract]

As indicated in Note B.26., Sanofi has two operating segments with effect from January 1, 2023: Biopharma and Consumer Healthcare.

In 2022, Sanofi reported three operating segments (Pharmaceuticals, Vaccines and Consumer Healthcare). The costs of the global support functions (Corporate Affairs, Finance, People & Culture, Legal, Ethics, Business Integrity & Global Security, Information Solutions & Technology, Sanofi Business Services, etc.), which are mainly managed centrally at group-wide level, were presented within the "Other" category.

In 2023, Sanofi reviewed the presentation of its segment information following adjustments to its internal reporting systems in order to reflect (i) progress on the "Play to Win" strategy leading to the creation of the standalone Consumer Healthcare Global Business Unit (GBU) which, in addition to integrated research, development and production functions now also has its own dedicated global support functions (including Finance, People & Culture, Legal, Ethics, Business Integrity & Global Security, Information Solutions & Technology, Global Business Services, etc.); and (ii) organizational changes to Sanofi's Manufacturing & Supply global function (previously known as Industrial Affairs).

Consequently, with effect from January 1, 2023, Sanofi reports two operating segments: Biopharma and Consumer Healthcare.

The Biopharma operating segment comprises commercial operations and research, development and production activities relating to the Specialty Care, General Medicines and Vaccines franchises, for all geographical territories. The segment's results include the costs of global support functions that are not within the managerial responsibility of the Consumer Healthcare GBU.

The Consumer Healthcare operating segment comprises commercial operations relating to Consumer Healthcare products, and research, development and production activities and global support functions (as listed above) dedicated to the segment, for all geographical territories. The Consumer Healthcare GBU segment's results reflect all incurred costs of global support functions attributable to its business.

The "Other" category comprises reconciling items, primarily but not limited to (i) gains and losses on centralized foreign exchange risk hedging transactions that cannot be allocated to the operating segments and (ii) gains and losses on retained commitments in respect of previously divested operations.

D.35.1.2. Business operating income [extract]

...

The table below shows Sanofi's segment results for the years ended December 31, 2023, December 31, 2022 and December 31, 2021:

	2023			
(€ million)	Biopharma	Consumer Healthcare	Other[a]	Total Sanofi
Net sales	**37,890**	**5,180**	**—**	**43,070**
Other revenues	3,322	52	—	3,374
Cost of sales	(12,282)	(1,933)	(1)	(14,216)
Research and development expenses	(6,509)	(219)	—	(6,728)
Selling and general expenses	(8,868)	(1,828)	4	(10,692)
Other operating income and expenses	(2,387)	181	(18)	(2,224)
Share of profit/(loss) from investments accounted for using the equity method	101	21	—	122
Net income attributable to non-controlling interests	(20)	(16)	—	(36)
Business operating income	**11,247**	**1,438**	**(15)**	**12,670**

(a) This caption reconciles segment financial information to total consolidated financial information.

	2022[a]			
(€ million)	Biopharma	Consumer Healthcare	Other[b]	Total Sanofi
Net sales	**37,812**	**5,185**	**—**	**42,997**
Other revenues	2,330	62	—	2,392
Cost of sales	(11,793)	(1,903)	4	(13,692)
Research and development expenses	(6,503)	(205)	2	(6,706)
Selling and general expenses	(8,736)	(1,761)	5	(10,492)
Other operating income and expenses	(1,679)	148	17	(1,514)
Share of profit/(loss) from investments accounted for using the equity method	76	12	—	88
Net income attributable to non-controlling interests	(17)	(16)	—	(33)
Business operating income	**11,490**	**1,522**	**28**	**13,040**

(a) 2022 figures have been adjusted to take account of the two new operating segments, Biopharma and Consumer Healthcare, effective from January 1, 2023.

(b) This caption reconciles segment financial information to total consolidated financial information.

...

Segment information may also change as a result of the disposal of an entire reportable segment or a component of it which qualifies under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* as a discontinued operation. The presentation of discontinued operations is governed by IFRS 5. The requirements of other standards do not apply to discontinued operations, unless they specify disclosures applicable to them. *[IFRS 5.5B]*.

In its 2022 annual report, the Mercedes-Benz Group AG disclosed that certain activities included in discontinued operations are not presented as part of segment reporting.

Practical example 5-9: Mercedes-Benz Group AG (2022) — Germany

Annual report 2022 [extract]

Notes to the Consolidated Financial Statements [extract]

35. Segment reporting [extract]

The segment information relates to continuing operations. The reported segment Daimler Trucks & Buses until spin-off and hive-down of the Daimler commercial vehicle business is included in the discontinued operations in 2021 and is therefore not part of the segment information presented.

...

How we see it

In our view, as a result of the provisions of IFRS 5 discussed above, since IFRS 8 does not refer to discontinued operations, entities are not required to include them in their segment disclosures. This would be the case even if the CODM continued to monitor the discontinued operation until disposal. Nevertheless, an entity would not be prohibited from disclosing such information if it wished, on the basis that the requirements of IFRS 8 relate to the measures reported to the CODM without any adjustments being made in preparing the entity's IFRS financial statements.

5.7.2 Changes in segment measures

As a result of a change in internal reporting, entities may change individual elements of their segment reporting.

When an entity changes any of its segment measures, including the definition of segment profit, or changes the allocation of income, expenses, assets or liabilities to segments, without a change to the composition of its reportable segments, the general principles of IAS 1 for changes in presentation or classification of items apply. Therefore, comparative information would be restated, unless this is impracticable. *[IAS 1.41]*.

In 2020, Vodafone Group Plc changed the segment information to reflect the adoption of IFRS 15 for purposes of internal decision making:

Practical example 5-10: Vodafone Group Plc (2020) **United Kingdom**

Annual report 2020 [extract]

Notes to the consolidated financial statements [extract]

2. Revenue disaggregation and segmental analysis [extract]

Segmental analysis [extract]

Segmental information used for internal decision making during the years ended 31 March 2018 and 2019 was on an IAS 18 (pre-IFRS 15) basis. In the year ended 31 March 2020 internal decisions were based upon IFRS 15 financial information and accordingly comparative information for the year ended 31 March 2019 was re-presented. Consequently, segmental information for the year ended 31 March 2018 is presented on an IAS 18 (pre-IFRS 15) basis and information for years ended 31 March 2020 and 2019 is presented on an IFRS 15 basis in accordance with the above revenue recognition policy. See note 32 "IAS 18 basis primary statements" for details of the IAS 18 revenue recognition policy.

The Group's measure of segment profit, adjusted EBITDA, excludes depreciation, amortisation, impairment loss, restructuring costs, loss on disposal of fixed assets, the Group's share of results in associates and joint ventures and other income and expense. A reconciliation of adjusted EBITDA to operating profit is shown below. For a reconciliation of operating profit to profit for the financial year, see the Consolidated income statement on page 141.

	2020 €m	2019 (re-presented)[1] €m	2018 €m
Adjusted EBITDA	**14,881**	**13,918**	**14,737**
Depreciation, amortisation and loss on disposal of fixed assets	(10,085)	(9,665)	(9,910)
Share of adjusted results in equity accounted associates and joint ventures[2]	(241)	(348)	389
Adjusted operating profit	**4,555**	**3,905**	**5,216**
Impairment losses	(1,685)	(3,525)	–
Restructuring costs[2]	(720)	(486)	(156)
Amortisation of acquired customer based and brand intangible assets[2]	(638)	(583)	(974)
Other income/(expense)[2]	2,257	(262)	213
Interest on lease liabilities	330	–	–
Operating profit/(loss)	**4,099**	**(951)**	**4,299**

Notes:

1 The results reflected in this table for the year ended 31 March 2019 were previously disclosed on an IAS 18 basis in the Annual Report for the year ended 31 March 2019 and have been re-presented in the table above on an IFRS 15 basis.

2 Share of results of equity accounted associates and joint ventures presented within the Consolidated income statement includes -€241m (2019: -€348 million, 2018 €389 million) included within Adjusted operating profit, -€25m (2019: -€26 million, 2018 -€9 million) included within Restructuring costs, -€215 million (2019: -€420 million, 2018 -€439 million) included within Amortisation of acquired customer based and brand intangible assets and -€2,024 million which is principally related to Vodafone Idea Limited (2019: -€114 million, 2018 €nil million) included within Other income/(expense).

In 2021, Sanofi made several changes to its segment measures and adjusted the prior period information :

Practical example 5-11: Sanofi (2021) **France**

Form 20-F 2021 [extract]

Part III [extract]

Notes to the Consolidated Financial Statements [extract]

D.35. Segment information [extract]

The costs of global support functions (External Affairs, Finance, Human Resources, Legal Affairs, Information Solutions & Technologies, Sanofi Business Services, etc.) are managed centrally at group-wide level. The costs of those functions are presented within the "Other" category. That category also includes other reconciling items such as retained commitments in respect of divested activities.

Following the Capital Markets Day held in February 2021, Sanofi changed the presentation of net sales within the General Medicines franchises and the Consumer Healthcare segment, and also reallocated certain expenses. In particular, IT costs relating to Sanofi's new digital organization – previously allocated to the Pharmaceuticals, Vaccines, and Consumer Healthcare segments – are now included within the "Other" segment. The 2020 segmental results presented below have been amended for comparative purposes in order to reflect those adjustments. Due to a lack of available data and the excessive complexity of the adjustments that would be required (especially to Sanofi's reporting tools), costs for 2019 have not been amended to reflect the changes arising from this new organization.

In accordance with IAS 8, Sanofi has treated the first-time application of the IFRIC agenda decisions on (i) the calculation of provisions for pensions and other post-employment benefits under IAS 19 and (ii) accounting for costs of configuring or customising a supplier's application software in a Software as a Service (SaaS) arrangement as retrospective changes in accounting policy. The impacts of those IFRIC agenda decisions are presented in Note A.2.1.

5.8 Disclosure of commercially sensitive information

The criteria for determining the externally reportable segments, as discussed in section 3.2 above, attempt to define which internally reported operating units can be combined, which must be reported separately and which are included in an unallocated reconciling item. The interaction between these criteria, in particular with the requirement that segments cannot be combined if they exhibit different long-term financial performance, leaves entities open to the risk of having to disclose information that management would be concerned about sharing with competitors, customers, suppliers or employees.

However, IFRS 8 does not permit the omission of segment information when management believes that its disclosure is commercially sensitive or potentially detrimental to the entity's competitive position. Indeed, IAS 1 requires an entity not only to present information in a manner that provides relevant, reliable, comparable and understandable information, but also to provide additional disclosures if compliance with an individual standard is insufficient to enable users to understand the entity's financial position and financial performance. *[IAS 1.17]*. The only justification for failing to meet these requirements is if disclosure would be so misleading that it would conflict with the objective of financial statements set out in the IASB's *Conceptual Framework*. *[IAS 1.19]*.

Given that the objective of IFRS 8 (see section 2.1 above) is to disclose information to help users of financial statements evaluate the nature and financial effects of the entity's business activities and the economic environments in which it operates, *[IFRS 8.1]*, the possibility discussed above would seem to be remote.

The IASB rejected similar concerns raised by respondents to the exposure draft preceding IFRS 8, noting that entities would be unlikely to suffer competitive harm from the required disclosures since most competitors have sources of detailed information about an entity other than its financial statements. *[IFRS 8.BC44]*. This concern was raised again by respondents to the post-implementation review. However, the IASB continues to reject such a limitation, because it would provide a means for broad-based non-compliance with the standard.[8]

8 Report and Feedback Statement: *Post-implementation Review: IFRS 8 Operating Segments*, IASB, July 2013, p.19. Available on the IFRS Foundation's website.

6 Entity-wide disclosures for all entities

In addition to disclosing segment information derived from the formats and measurements presented to the chief operating decision maker, IFRS 8 requires certain entity-wide disclosures about products and services, geographical areas, and major customers. The information described below is required even if the entity has only a single reportable segment but need not be repeated if already provided as part of the disclosures on reportable segments set out above. *[IFRS 8.31]*. The amounts reported about products and services and about geographical areas in these entity-wide disclosures are measured using the same accounting policies and estimates as the entity's financial statements (i.e., IFRS amounts). *[IFRS 8.32, IFRS 8.33]*. As such, the amounts disclosed in this part of the segment disclosures might well be different from the information already provided in other segment information, which might not be measured in accordance with IFRS accounting standards (see section 4 above).

Exemption from the requirements set out in sections 6.1 and 6.2 below is offered if the necessary information is unavailable and the cost to develop it would be excessive. If disclosure is not made on these grounds, that fact must be stated. *[IFRS 8.32, IFRS 8.33]*. Some respondents to exposure preceding IFRS 8 expressed concern that the basis of this exemption was inconsistent with the test of impracticability in IAS 1, which makes no allowance for the cost of compliance. *[IAS 1.7]*. However, the IASB did not see any merit in divergence from FASB ASC Topic 280 in this respect and therefore retained the exemption from disclosure if the necessary information were unavailable and the cost of developing it excessive. *[IFRS 8.BC46, IFRS 8.BC47]*.

This exemption is not available in respect of the disclosures about major customers set out in section 6.3 below.

6.1 Information about products and services

An entity must report revenues from external customers for each product and service or for each group of similar products and services, measuring revenues on the same basis as the entity's financial statements (unless the necessary information is not available and the cost to develop it would be excessive). *[IFRS 8.32]*.

In Practical example 6-1, L'Oréal SA discloses external revenues by business segments as follows:

Practical example 6-1: L'Oréal (2023) France

2023 UNIVERSAL REGISTRATION DOCUMENT [extract]
5 2023 Consolidated Financial Statements [extract]
5.6 Notes to the Consolidated Financial Statements [extract]
Note 3. Operating items - Segment information [extract]
3.1. Segment information [extract]
3.1.3. Sales by business segment [extract]

WEIGHT OF NET SALES BY BUSINESS SEGMENT OVER THE THREE PERIODS

€ millions	2023	Growth (%) Published data	Growth (%) Excluding exchange effect	2022	2021
Skincare	16,447.1	7.2%	12.5%	15,344.3	12,982.3
Make-up	8,123.7	5.0%	9.6%	7,738.8	6,626.8
Haircare	6,319.6	9.9%	15.0%	5,750.2	4,880.1
Hair colourants	3,425.6	1.9%	6.4%	3,361.6	3,016.1
Perfumes	5,171.3	13.7%	16.9%	4,546.2	3,511.8
Other	1,695.3	11.6%	20.0%	1,519.5	1,270.6
GROUP	**41,182.5**	**7.6%**	**12.6%**	**38,260.6**	**32,287.6**

6.2 Information about geographical areas

IFRS 8 requires disclosure of the following geographical information:

(a) Revenues from external customers, analysed between amounts attributed to the entity's country of domicile and the total of those attributed to all foreign countries.

And

(b) Non-current assets other than financial instruments, deferred tax assets, post-employment benefit assets and rights arising under insurance contracts, analysed between assets located in the entity's country of domicile and the total of those located in all foreign countries. *[IFRS 8.33]*.

How we see it

In our view, if revenues from external customers or assets attributed to an individual foreign country are material, separate disclosure of that country's revenues or assets is required. The standard does not indicate what might be regarded as 'material' but given the criteria for a reportable segment and a major customer for reporting purposes (see section 3.2.2 above and section 6.3 below respectively) it would seem appropriate to consider the need for separate disclosure in respect of a foreign country accounting for more than 10% of total external revenues or more than 10% of total non-current assets.

Disclosure of the above information would be required even if the entity's segment reporting is already based on geography and it is determined that individual operating segments include a number of countries. Thus, an entity may need to provide additional information on revenue or non-current assets by country that is not disclosed in the segment information used by the chief operating decision maker.

The basis on which revenues from external customers are attributed to individual countries must be disclosed. Revenues may be attributed to countries based on the location of customers or based on where the products or services are produced. An entity can elect to provide, in addition to the information required above, subtotals of geographical information about groups of countries. *[IFRS 8.33]*. In Practical example 6-2 below, BAE Systems plc provides this more detailed level of disclosure and goes on to reconcile the measure of total segment assets to the amounts shown on the statement of financial position, even though such a reconciliation is not required for this entity-wide disclosure.

Practical example 6-2: BAE Systems plc (2023) **United Kingdom**

Annual Report 2023 [extract]
Financial statements [extract]
Consolidated financial statements [extract]
Notes to the Consolidated financial statements [extract]

20. Geographical analysis of assets

Analysis of non-current assets by geographical location

Asset location	Note	2023 £m	2022 £m
UK		**4,877**	4,563
Rest of Europe		**2,065**	1,965
US		**10,167**	10,719
Kingdom of Saudi Arabia		**533**	586
Australia		**499**	518
Rest of Asia and Pacific		**8**	5
		18,149	18,356
Other investments	13	**84**	99
Other receivables	14	**418**	416
Post-employment benefit surpluses	24	**804**	1,297
Other financial assets	15	**227**	322
Deferred tax assets	16	**609**	338
Non-current assets		**20,291**	20,828

6.3 Information about major customers

IFRS 8 also requires an entity to give disclosures indicating the extent of its reliance on its major customers. If revenues from a single external customer account for 10% or more of the entity's total revenues, the entity must disclose:

(a) That fact

(b) The total amount of revenues from each such customer

And

(c) The identity of the reportable segment or segments reporting the revenues *[IFRS 8.34]*

Disclosure of the name of each major customer is not required, nor the amounts of revenue reported in each segment for that customer. *[IFRS 8.34]*. However, the disclosure must be provided if it relates only to one segment. Sanofi discloses such information in the Practical example below:

Practical example 6-3: Sanofi (2023) — France

2023 FORM 20-F [extract]
PART III [extract]
Item 18. Financial Statements [extract]
2023 Consolidated financial statements [extract]
Notes to the Consolidated Financial Statements [extract]
D.34. Disclosures about major customers and credit risk [extract]

...

Sales generated by Sanofi with its biggest customers, in particular certain wholesalers in the United States, represented 27% of net sales in 2023. The three largest customers respectively accounted for approximately 11%, 9% and 7% of Sanofi's net sales in 2023 (12%, 8% and 7% in 2022; 10%, 7% and 6% in 2021).

6.3.1 Customers known to be under common control

For the purposes of the above disclosures, a group of entities known to a reporting entity to be under common control are to be considered a single customer. *[IFRS 8.34]*.

However, judgement is required to assess whether a government (including government agencies and similar bodies whether local, national, or international) and entities known to the reporting entity to be under the control of that government are considered a single customer. The assessment of whether entities must be regarded as a single customer for these purposes must consider the extent of economic integration between those entities. *[IFRS 8.34]*. The standard does not include any further guidance on the factors relevant to determining the extent of economic integration.

BAE Systems plc identifies revenues from three principal governments.

Practical example 6-4: BAE Systems plc (2023) — United Kingdom

Annual Report 2023 [extract]
Financial statements [extract]
Consolidated financial statements [extract]
Notes to the Consolidated financial statements [extract]
2. Segmental analysis and revenue recognition [extract]

Revenue by major customer

Revenue from the Group's three principal customers, which individually represent over 10% of total revenue, is as follows:

	2023 £m	2022 £m
US Department of Defense	**7,518**	7,439
UK Ministry of Defence	**5,766**	4,721
Kingdom of Saudi Arabia Ministry of Defence and Aviation	**2,607**	2,425

Revenue from the UK Ministry of Defence and the US Department of Defense was generated by the five reporting segments, excluding HQ.
Revenue from the Kingdom of Saudi Arabia Ministry of Defence and Aviation was generated by the Air segment.

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Appendix C - Defined terms

Extract from IFRS 8

Appendix A
Defined terms

This appendix is an integral part of the IFRS

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

Chapter 33 Earnings per share

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Overview

This chapter deals with IAS 33 *Earnings per Share*. This accounting standard requires certain entities to disclose earnings per share figures in their financial statements. It also sets out how those figures are to be computed.

IAS 33 requires disclosure of both basic and diluted earnings per share. Where relevant, earnings per share is required separately for continuing operations, for discontinued operations and in total.

Basic and diluted earnings per share are intended to be measures of the interest each of the parent's ordinary shares has in the performance of the entity. Diluted earnings per share also gives effect to dilutive potential ordinary shares outstanding during the reporting period, for example convertible loans, convertible preference shares, share options and warrants, including those arising from share-based payment arrangements.

Earnings used in determining basic earnings per share are an entity's profit or loss attributable to ordinary equity holders. This can differ from an entity's profit or loss, for example, it will not include profit or loss attributable to non-controlling interests and certain adjustments will be necessary in respect of dividends and other payments in respect of preference shares classified as equity. Further adjustments may be required in the calculation of diluted earnings per share.

The standard also sets out requirements for the number of shares to be used in the calculation which will often be different for basic and for diluted earnings per share.

Entities may disclose earnings per share based on other components of comprehensive income, although the number of shares used must be the same as specified by IAS 33 and additional disclosures are required to explain the earnings figure used. Once IFRS 18 *Presentation and Disclosure in Financial Statements* is applied certain restrictions on the presentation of additional per share figures are introduced. In particular: any such amounts must be presented only in the notes; and, the numerator used must be either a line item in the primary statement or a management-defined performance measure.

What you need to know

- IAS 33 applies only to entities with publicly traded ordinary shares (or those in the process of becoming so) and to other entities choosing to present earnings per share.
- The standard sets out requirements for the number of shares to be used in each computation.
- Certain adjustments are required to earnings for the purposes of diluted earnings per share.
- IAS 33 requires disclosure of basic and diluted earnings per share.
- Certain changes come into force once IFRS 18 is applied. This is for periods beginning on or after 1 January 2027 with early adoption permitted.

1 Introduction

Earnings per share (EPS) is one of the most widely quoted statistics in financial analysis. It came into great prominence in the US during the late 1950s and early 1960s due to the widespread use of the price earnings ratio (PE) as a yardstick for investment decisions. As a result, standard setters in some jurisdictions (notably the US and the UK) have had rules on EPS for many years. However, it was not until 1997 that an international accounting standard on the subject was published.

IAS 33 was introduced for accounting periods beginning on or after 1 January 1998. In December 2003, as part of the improvements project, the IASB updated IAS 33 to provide more detailed guidance in some complex areas. There have been no substantive changes since. The requirements of IAS 33 are discussed in sections 2 to 7 below. The standard includes illustrative examples of particular issues and one comprehensive worked example. The illustrative examples are included where relevant in the text of the chapter, whilst the comprehensive worked example is included as an appendix.

1.1 Definitions

IAS 33 defines a number of its terms and these are dealt with in the text of this chapter where appropriate. One term which is particularly pervasive is 'fair value'. This term is defined and explained in IFRS 13 *Fair Value Measurement* and is discussed in Chapter 15. *[IAS 33.8]*. However, in the context of share-based payments the term fair value has the meaning used in IFRS 2 *Share-based Payment*. The relevance of share-based payment to EPS is discussed in section 6.4.5 below; IFRS 2 is discussed in Chapter 30. *[IAS 33.47A]*.

2 Objective and scope of IAS 33

2.1 Objective

IAS 33 sets out its objective as follows: *[IAS 33.1]*

Extract from IAS 33

Objective

1 The objective of this Standard is to prescribe principles for the determination and presentation of earnings per share, so as to improve performance comparisons between different entities in the same reporting period and between different reporting periods for the same entity. Even though earnings per share data have limitations because of the different accounting policies that may be used for determining 'earnings', a consistently determined denominator enhances financial reporting. The focus of this Standard is on the denominator of the earnings per share calculation.

The standard requires the computation of both basic and diluted EPS, explaining the objective of each as follows:

- The objective of basic earnings per share information is to provide a measure of the interests of each ordinary share of a parent entity in the performance of the entity over the reporting period. *[IAS 33.11]*.

  And

- The objective of diluted earnings per share is consistent with that of basic earnings per share - to provide a measure of the interest of each ordinary share in the performance of an entity - while giving effect to all dilutive potential ordinary shares outstanding during the period. *[IAS 33.32]*.

The underlying logic here is that EPS, including diluted EPS, is to be an historical performance measure. This impacts particularly on the reporting of diluted EPS, in steering it away from an alternative purpose: to warn of potential future dilution. Indeed, the tension between these differing objectives is evident in the standard. As discussed more fully in section 6.4.6 below, IAS 33 sets out a very restrictive regime for including certain potentially dilutive shares in the diluted EPS calculation. Yet diluted EPS is only to take account of those potential shares that would dilute earnings from continuing operations (see section 6.3.1 below) which seems to have more of a forward looking 'warning signal' flavour. Discontinued operations are discussed in Chapter 5.

2.2 Scope

IAS 33 applies to:

(a) The separate or individual financial statements of an entity:

(i) Whose ordinary shares or potential ordinary shares are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets)

Or

(ii) That files, or is in the process of filing, its financial statements with a securities commission or other regulatory information for the purpose of issuing ordinary shares in a public market

And

(b) The consolidated financial statements of a group with a parent:

(i) Whose ordinary shares or potential ordinary shares are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets)

Or

(ii) That files, or is in the process of filing, its financial statements with a securities commission or other regulatory information for the purpose of issuing ordinary shares in a public market *[IAS 33.2]*

IAS 33 also applies to any other entity that discloses earnings per share. *[IAS 33.3]*. Where both the parent's consolidated and separate financial statements are presented, the standard only requires consolidated earnings per share to be given. If the parent chooses to present EPS data based on its separate financial statements, the standard requires that the disclosures be restricted to the face of the parent-only statement of comprehensive income (or separate income statement) and not be included in the consolidated financial statements. *[IAS 33.4]*.

In January 2014, the IASB published IFRS 14 *Regulatory Deferral Accounts*. This standard allows a first-time adopter within its scope to continue to account for regulatory deferral account balances in its first IFRS financial statements in accordance with its previous GAAP when it adopts IFRS. The standard introduces limited changes to some previous GAAP accounting practices for regulatory deferral account balances, which are primarily related to the presentation of these accounts. For entities applying IFRS 14 certain additional EPS disclosures are required. This is discussed in Chapter 6 at section 5.22.6.B.

3 The basic EPS

IAS 33 requires the computation of basic EPS for the profit or loss (and, if presented, the profit or loss from continuing operations) attributable to ordinary equity holders. *[IAS 33.9]*. It defines, or rather describes, basic earnings per share in the following manner: *[IAS 33.10]*

Extract from IAS 33	
10	**Basic earnings per share shall be calculated by dividing profit or loss attributable to ordinary equity holders of the parent entity (the numerator) by the weighted average number of ordinary shares outstanding (the denominator) during the period.**

3.1 Earnings

The starting point for determining the earnings figure to be used in the basic EPS calculation (both for total earnings and, if appropriate, earnings from continuing operations) is the net profit or loss for the period attributable to ordinary equity holders of the parent entity. *[IAS 33.12]*. This will, in accordance with IAS 1 *Presentation of Financial Statements* (and, once IFRS 18 is applied, at the latest for periods beginning on or after 1 January 2027, in accordance with that standard) include all items of income and expense, including, dividends on preference shares classified as liabilities and tax and is stated after the deduction of non-controlling interests. *[IAS 33.13, IAS 33.A1]*. This is then adjusted for the after-tax amounts of preference dividends, differences arising on the settlement of preference shares, and other similar effects of preference shares classified as equity. *[IAS 33.12]*. These adjustments are discussed in section 5.2 below.

3.2 Number of shares

An ordinary share is defined as "an equity instrument that is subordinate to all other classes of equity instruments". *[IAS 33.5]*. Equity instrument has the same meaning as in IAS 32 *Financial Instruments: Presentation* that is "any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities". *[IAS 33.8, IAS 32.11]*. IAS 33 goes on to observe that ordinary shares participate in profit for the period only after other types of share such as preference shares have participated. *[IAS 33.6]*. The standard also clarifies that there may be more than one class of ordinary share and requires the computation and presentation of EPS for each class that has a different right to share in profit for the period. *[IAS 33.6, IAS 33.66]*. In practice, it is usually straightforward to determine which instruments are ordinary shares for EPS purposes. The treatment of different classes of shares is discussed in section 5.4 below.

The basic rule in IAS 33 is that all outstanding ordinary shares are brought into the basic EPS computation - time-weighted for changes in the period (changes in ordinary shares are discussed in section 4 below). *[IAS 33.19]*. There are three exceptions to this:

- Ordinary shares that are issued as partly paid are included in the weighted average as a fraction of a share based on their dividend participation relative to fully paid shares (so if although only partly paid, they ranked equally for dividends they would be included in full). *[IAS 33.A15]*.
- Treasury shares, which are presented in the financial statements as a deduction from equity, are not considered outstanding for EPS purposes for the period they are held in treasury. Although not stated explicitly in the standard itself, this requirement is clearly logical (as although the shares are still legally in issue, they are accounted for as if redeemed) and is illustrated in one of the examples appended to the standard (see Illustration 4-1 in section 4.1 below). *[IAS 33.IE2]*.

  And
- Shares that are contingently returnable (that is, subject to recall) are not treated as outstanding until they cease to be subject to recall, and hence are excluded from basic EPS until that time. *[IAS 33.24]*.

The standard contains some specific guidance on when newly issued ordinary shares are to be considered outstanding. In general, shares are to be included from the date consideration is receivable (considered by the standard generally to be the date of their issue), for example: *[IAS 33.21]*

- Shares issued in exchange for cash are included when cash is receivable
- Shares issued on the voluntary reinvestment of dividends on ordinary or preference shares are included when the dividends are reinvested
- Shares issued as a result of the conversion of a debt instrument to ordinary shares are included as of the date interest ceases accruing
- Shares issued in place of interest or principal on other financial instruments are included as of the date interest ceases accruing

- Shares issued in exchange for the settlement of a liability of the entity are included as of the settlement date
- Shares issued as consideration for the acquisition of an asset other than cash are included as of the date on which the acquisition is recognised
- Shares issued in exchange for the rendering of services to the entity are included as the services are rendered
- Shares that will be issued upon the conversion of a mandatorily convertible instrument are included in the calculation of basic earnings per share from the date the contract is entered into *[IAS 33.23]*

Most of these provisions are straightforward, however some are worthy of note.

Shares issued in exchange for services will be accounted for in accordance with IFRS 2, with a charge to income matched by a credit to equity. IAS 33 has some guidance on the inclusion of such potential shares in diluted EPS (see section 6.4.5 below); however, there is no further elaboration of the meaning of 'included as the services are rendered'. What seems to be implicit in the phrase is that the shares concerned vest unconditionally as services are rendered. On that basis, clearly it would be appropriate to include shares in basic EPS as entitlement to them vests, notwithstanding that the actual issue of shares may be at a different time. However, a very common form of share-based remuneration involves entitlement to shares vesting at the end of an extended period conditional on future events (typically continued employment and sometimes specific future performance). Such arrangements are clearly conditionally issuable shares and therefore, would be excluded from basic EPS until vesting. Indeed, when discussing employee share schemes in the context of diluted EPS the standard is explicit, as follows. *[IAS 33.48]*.

Extract from IAS 33

48 Employee share options with fixed or determinable terms and non-vested ordinary shares are treated as options in the calculation of diluted earnings per share, even though they may be contingent on vesting. They are treated as outstanding on the grant date. Performance-based employee share options are treated as contingently issuable shares because their issue is contingent upon satisfying specified conditions in addition to the passage of time.

Contingently issuable shares are discussed in section 6.4.6 below.

In respect of the final bullet point, the standard does not define what a mandatorily convertible instrument is. One view would be that the requirement to account for the shares in EPS from inception must mean it refers to instruments where the proceeds also are received at inception. On that basis, it would exclude a forward contract for the issue of shares which (as required by the first bullet above) would increase the denominator of basic EPS only from the time the cash is receivable. Similarly, in the reverse situation of a forward contract to redeem ordinary shares the shares would only be removed from basic EPS when the consideration becomes payable. Another view would be that all binding agreements to issue or redeem ordinary shares should be reflected in basic EPS when the entity becomes party to the arrangement. A further possible complexity is the question of whether or not a symmetrical treatment for the issue and redemption of shares should be applied for EPS purposes. Whilst that certainly seems logical, it is not beyond question in all circumstances particularly given the asymmetrical accounting treatment for certain derivatives over own shares required by IAS 32 (discussed in Chapter 43 at section 5).

More generally, the standard goes on to say the timing of inclusion is determined by the attaching terms and conditions, and also that due consideration must be given to the substance of any contract associated with the issue. *[IAS 33.21]*. Ordinary shares that are issuable on the satisfaction of certain conditions (contingently issuable shares) are to be included in the calculation of basic EPS only from the date when all necessary conditions have been satisfied; in effect when they are no longer contingent. *[IAS 33.24]*. This provision is interpreted strictly, as illustrated in Example 7 appended to the standard (see Illustration 6-7 in section 6.4.6.A below). In that example, earnings in a year, by meeting certain thresholds, would trigger the issue of shares. Because it is not certain that the condition is met until the last day of the year (when earnings become known with certainty) the new shares are excluded from basic EPS until the following year. Where shares will be issued at some future date (that is, solely after the passage of time) they are not considered contingently issuable by IAS 33, as the passage of time is a certainty. *[IAS 33.24]*. In principle, this would seem to mean that they should be included in basic EPS from the agreement date. However, careful consideration of the individual facts and circumstances would be necessary.

The calculation of the basic EPS is often simple but a number of complications can arise; these may be considered under the following two headings:

(a) Changes in ordinary shares outstanding

(b) Matters affecting the numerator

These are discussed in the next two sections.

4 Changes in outstanding ordinary shares

Changes in ordinary shares outstanding can occur under a variety of circumstances, the most common of which are dealt with below. Whenever such a change occurs during the accounting period, an adjustment is required to the number of shares in the EPS calculation for that period; furthermore, in certain situations the EPS for previous periods will also have to be recalculated.

4.1 Weighted average number of shares

Implicit in the methodology of IAS 33 is a perceived correlation between the capital of an entity (or rather the income-generating assets it reflects) and earnings. Accordingly, to compute EPS as a performance measure requires adjusting the number of shares in the denominator to reflect any variations in the period to the capital available to generate that period's earnings. The standard observes that using the weighted average number of ordinary shares outstanding during the period reflects the possibility that the amount of shareholders' capital varied during the period as a result of a larger or smaller number of shares being outstanding at any time. The weighted average number of ordinary shares outstanding during the period is the number of ordinary shares outstanding at the beginning of the period, adjusted by the number of ordinary shares bought back or issued during the period multiplied by a time-weighting factor. The time-weighting factor is the number of days that the shares are outstanding as a proportion of the total number of days in the period; IAS 33 notes that a reasonable approximation of the weighted average is adequate in many circumstances. *[IAS 33.20]*. Computation of a weighted average number of shares is shown in the following Illustration: *[IAS 33.IE2]*

Illustration 4-1: Calculation of weighted average number of shares

		Shares issued	Treasury shares*	Shares outstanding
1 January 20X2	Balance at beginning of year	2,000	300	1,700
31 May 20X2	Issue of new shares for cash	800	-	2,500
1 December 20X2	Purchase of treasury shares for cash	-	250	2,250
31 December 20X2	Balance at year end	2,800	550	2,250

Calculation of weighted average:

(1,700 × 5/12) + (2,500 × 6/12) + (2,250 × 1/12) = 2,146 shares

Or

(1,700 × 12/12) + (800 × 7/12) - (250 × 1/12) = 2,146 shares

* Treasury shares are equity instruments reacquired and held by the issuing entity itself or by its subsidiaries.

The use of a weighted average number of shares is necessary because the increase in the share capital would have affected earnings only for that portion of the year during which the issue proceeds were available to management for use in the business.

4.2 Purchase and redemption of own shares

An entity may, if it is authorised to do so by its constitution and it complies with any relevant legislation, purchase or otherwise redeem its own shares. Assuming this is done at fair value, then the earnings will be apportioned over the weighted average share capital in issue for the year. This was shown in Illustration 4-1 in section 4.1 above in relation to the purchase of treasury shares. If, on the other hand, the repurchase is at significantly more than market value, then IAS 33 requires adjustments to be made to EPS for periods before buy-back. This is discussed in section 4.3.5 below.

4.3 Changes in ordinary shares without corresponding changes in resources

IAS 33 requires the number of shares used in the calculation to be adjusted (for all periods presented) for any transaction (other than the conversion of potential ordinary shares) that changes the number of shares outstanding without a corresponding change in resources. *[IAS 33.26]*. This is also to apply when some, but not all, such changes have happened after the year-end but before the approval of the financial statements.

The standard gives the following as examples of changes in the number of ordinary shares without a corresponding change in resources:

(a) A capitalisation or bonus issue (sometimes referred to as a stock dividend)

(b) A bonus element in any other issue, for example a bonus element in a rights issue to existing shareholders

(c) A share split

(d) A reverse share split (share consolidation) *[IAS 33.27]*

Another example not mentioned by the standard would be any bonus element in a buy-back, such as a put warrant involving the repurchase of shares at significantly more than their fair value. The adjustments required to EPS for each of these is discussed below.

As noted above, IAS 33 requires retrospective adjustment for all such events that happen in the reporting period. However, it only requires restatement for those in (a), (c) and (d) if they happen after the year-end but before the financial statements are authorised for issue. *[IAS 33.64]*.

4.3.1 Capitalisation, bonus issue, share split and share consolidation

4.3.1.A Capitalisation, bonus issues and share splits

A capitalisation or bonus issue or share split has the effect of increasing the number of shares in issue without any inflow of resources, as further ordinary shares are issued to existing shareholders for no consideration. Consequently, no additional earnings will be expected to accrue as a result of the issue. The additional shares are treated as having been in issue for the whole period and also included in the EPS calculation of all earlier periods presented so as to give a comparable result. For example, on a two-for-one bonus issue, the number of ordinary shares outstanding before the issue is multiplied by three to obtain the new total number of ordinary shares, or by two to obtain the number of additional ordinary shares. *[IAS 33.28]*.

The EPS calculation involving a bonus issue is shown in the following Illustration. *[IAS 33.IE3]*.

Illustration 4-2: A bonus issue

Profit attributable to ordinary equity holders of the parent entity 20X1			CU180
Profit attributable to ordinary equity holders of the parent entity 20X2			CU600
Ordinary shares outstanding until 30 September 20X2			200
Bonus issue 1 October 20X2	2 ordinary shares for each ordinary share outstanding at 30 September 20X2		
	200 × 2	=	400
Basic earnings per share 20X2	$\frac{CU600}{(200 + 400)}$	=	CU1.00
Basic earnings per share 20X1	$\frac{CU180}{(200 + 400)}$	=	CU0.30

Because the bonus issue was without consideration, it is treated as if it had occurred before the beginning of 20X1, the earliest period presented.

4.3.1.B Stock dividends

Stock or scrip dividends refer to the case where an entity offers its shareholders the choice of receiving further fully paid up shares in the company as an alternative to receiving a cash dividend. It could be argued that the dividend foregone represents payment for the shares, usually at fair value, and hence no restatement is appropriate. Alternatively, the shares could be viewed as being, in substance, bonus issues which require the EPS for the earlier period to be adjusted. IAS 33 seems to suggest the latter view, as it notes that capitalisation or bonus issues are sometimes referred to as stock dividends. However, entities often refer to these arrangements as dividend reinvestment plans which suggests the acquisition of new shares for valuable consideration.

This distinction is a factual one. If an entity (say, through proposal and subsequent approval by shareholders) has a legal obligation to pay a dividend in cash or, at the shareholder's option, shares, then the cash payment avoided, if the stock dividend is taken up, is consideration for the shares. This may be equivalent to an issue at fair value or it may contain some bonus element requiring retrospective adjustment of EPS. In practice, the fair value of shares received as a stock dividend alternative may exceed the cash alternative; this is often referred to as an enhanced stock dividend. In these cases, IAS 33 requires a bonus element to be identified, and prior EPS figures restated accordingly. This is essentially the same as adjustments for the bonus element in a rights issue, discussed in section 4.3.3 below.

Furthermore, in this scenario, during the period between the obligation coming into existence and its settlement (in cash or shares) it could be argued to represent a written call option and hence potentially affect diluted EPS (see section 6.4.2.B below).

How we see it

Given that the standard is silent on this aspect of some stock dividends we do not believe that such an approach was intended. In any event, we generally do not believe the effect on diluted EPS would be significant.

Conversely, if the entity issues new shares instead of a dividend it would be a bonus issue requiring full retrospective adjustment to EPS.

4.3.1.C Share consolidations

Occasionally, entities will consolidate their equity share capital into a smaller number of shares. Such a consolidation generally reduces the number of shares outstanding without a corresponding outflow of resources, and this would require an adjustment to the denominator for periods before the consolidation. *[IAS 33.29]*.

4.3.2 Share consolidation with a special dividend

Share consolidations as discussed in section 4.3.1.C above normally do not involve any outflow of funds from the entity. However, entities may return surplus cash to their shareholders by paying special dividends accompanied by a share consolidation, the purpose of which is to maintain the value of each share following the payment of the dividend. This issue is specifically addressed by IAS 33. The normal rule of restating the outstanding number of shares for all periods for a share consolidation is not applied when the overall effect is a share repurchase at fair value because in such cases, the reduction of shares is the result of a corresponding reduction in resources. In such cases, the weighted average number of shares is adjusted for the consolidation from the date the special dividend is recognised. *[IAS 33.29]*.

4.3.3 Rights issue

A rights issue is a popular method through which entities are able to access the capital markets for further capital. Under the terms of such an issue, existing shareholders are given the opportunity to acquire further shares in the entity on a *pro rata* basis to their existing shareholdings.

The 'rights' shares will usually be offered either at the current market price or at a price below that. In the former case, the treatment of the issue for EPS purposes is as discussed in section 4.1 above. However, where the rights price is at a discount to market it is not quite as straightforward, since the issue is equivalent to a bonus issue (see section 4.3.1 above) combined with an issue at full market price. In such cases, IAS 33 requires an adjustment to the number of shares outstanding before the rights issue to reflect the bonus element inherent in it. *[IAS 33.26, IAS 33.27]*.

The bonus element of the rights issue available to all existing shareholders is given by the following adjustment factor, sometimes referred to as the bonus fraction: *[IAS 33.A2]*

$$\frac{\text{Fair value per share immediately before the exercise of rights}}{\text{Theoretical ex-rights fair value per share}}$$

The fair value per share immediately before the exercise of rights is the actual price at which the shares are quoted inclusive of the right to take up the future shares under the rights issue. Where the rights are to be traded separately from the shares the fair value used is the closing price on the last day on which the shares are traded inclusive of the right. *[IAS 33.A2]*.

The 'ex-rights fair value' is the theoretical price at which the shares would be expected to be quoted, other stock market factors apart, after the rights issue shares have been issued. It is calculated by adding the aggregate fair value of the shares immediately before the exercise of the rights to the proceeds from the exercise, and dividing by the number of shares outstanding after the exercise. *[IAS 33.A2]*. The EPS calculation involving a rights issue is shown in the following Illustration. *[IAS 33.IE4]*.

Illustration 4-3: Rights issue at less than full market price

		20X0	20X1	20X2
Profit attributable to ordinary equity holders of the parent entity		CU1,100	CU1,500	CU1,800
Shares outstanding before rights issue	500 shares			
Rights issue	One new share for each five outstanding shares (100 new shares total)			
	Exercise price: CU5.00			
	Date of rights issue: 1 January 20X1			
	Last date to exercise rights: 1 March 20X1			
Market price of one ordinary share immediately before exercise on 1 March 20X1	CU11.00			
Reporting date	31 December			

Calculation of theoretical ex-rights value per share

$$\frac{\text{Fair value of all outstanding shares before the exercise of rights} + \text{Total amount received from exercise of rights}}{\text{Number of shares outstanding before exercise} + \text{Number of shares issued in the exercise}} =$$

$$\frac{(\text{CU11.00} \times 500 \text{ shares}) + (\text{CU5.00} \times 100 \text{ shares})}{500 \text{ shares} + 100 \text{ shares}}$$

Theoretical ex-rights value per share = CU10.00

Calculation of adjustment factor

$$\frac{\text{Fair value per share before exercise of rights}}{\text{Theoretical ex-rights value per share}} = \frac{\text{CU11.00}}{\text{CU10.00}} = 1.10$$

Calculation of basic earnings per share

	20X0	20X1	20X2
20X0 basic EPS as originally reported:			
CU1,100 ÷ 500 shares =	CU2.20		
20X0 basic EPS restated for rights issue:			
CU1,100 ÷ (500 shares × 1.1) =	CU2.00		
20X1 basic EPS including effects of rights issue:			
$\frac{\text{CU1,500}}{(500 \times 1.1 \times 2/12) + (600 \times 10/12)} =$		CU2.54	
20X2 basic EPS:			
CU1,800 ÷ 600 shares =			CU3.00

Rather than multiplying the denominator by 11/10ths, the previous year's EPS (and any EPS disclosures in a historical summary) could alternatively be arrived at by multiplying the original EPS by 10/11ths.

During the period that the rights are outstanding they represent, strictly speaking, a written call option over the entity's shares which could have implications for diluted EPS (see section 6.4.2 below).

It is possible that shares could be issued as a result of open offers, placings and other offerings of equity shares not made to existing shareholders, at a discount to the market price. In such cases, it would be necessary to consider whether the issue contained a bonus element, or rather simply reflected differing views on the fair value of the shares. The latter is a more realistic alternative. Accordingly, the shares would be dealt with on a weighted average basis without calculating any bonus element when computing the EPS.

4.3.4 B share schemes

One method by which some entities have returned capital to shareholders is the so-called 'B share scheme'. These schemes involve issuing 'B shares' (usually undated preference shares with low or zero coupons) to existing shareholders, either as a bonus issue or via a share split, following which the ordinary shares are consolidated. The 'B shares' are then repurchased or redeemed for cash and cancelled. The overall effect is intended to be the same as a repurchase of ordinary shares at fair value, and accordingly no retrospective adjustment to EPS is necessary, assuming that the intention is achieved. *[IAS 33.29]*.

4.3.5 Put warrants priced above market value

As noted in section 4.3 above, an example of a change in the number of shares outstanding without a corresponding change in resources not mentioned by the standard would be any bonus element in a buy-back, such as a put warrant involving the repurchase of shares at significantly more than their fair value. The accounting requirements for such instruments are discussed in Chapter 43 at section 5.

IAS 33 does not give an illustrative calculation for a put warrant at significantly more than fair value, but it does for the more familiar rights issue (which are discussed in section 4.3.3 above). In a rights issue, new shares are issued at a discount to market value, whereas with put warrants shares are bought back at a premium to market value. In both cases, the remaining shares are viewed as being devalued for the purposes of comparing EPS over time. Applying the requirement to adjust EPS when there is a change in the number of shares without a corresponding change in resources would require that put warrants are treated as a reverse rights issue. This would mean calculating a similar 'adjustment factor', and applying it to the number of shares outstanding before the transaction. The difference in the calculation would be that the number of shares issued and the consideration received for them would be replaced by negative amounts representing the number of shares put back to the entity and the amount paid for them.

An illustration of what this might entail is as follows:

Illustration 4-4: Put warrants priced above market value

The following example takes the same scenario as Illustration 4-3 above (a rights issue), altered to illustrate a put warrant scheme. In that example the shares are issued at a discount of CU6.00 to the CU11.00 market price on a one for five basis two months into the year. Reversing this would give a put warrant to sell shares back to the company at a CU6 premium, again on a one for five basis. All other details have been left the same for comparability, although in reality the rising earnings following a rights issue may well become falling earnings after a buy-back. The calculation would then become:

Calculation of theoretical ex-warrant value per share

$$\frac{\text{Fair value of all outstanding shares before the exercise of warrants} - \text{Total amount paid on exercise of warrants}}{\text{Shares outstanding before exercise} - \text{Shares cancelled in the exercise}} =$$

$$\frac{(\text{CU11} \times 500) - (\text{CU17} \times 100)}{500 - 100} = \text{CU9.50}$$

Calculation of adjustment factor

$$\frac{\text{Fair value per share before exercise of warrants}}{\text{Theoretical ex-warrant value per share}} = \frac{\text{CU11}}{\text{CU9.5}} = 1.16$$

Calculation of basic earnings per share

	20X0	20X1	20X2
20X0 EPS as originally reported:			
CU1,100 ÷ 500 shares =	CU2.20		
20X0 EPS restated for warrants:			
CU1,100 ÷ (500 shares × 1.16) =	CU1.90		
20X1 EPS including effects of warrants:			
$\frac{\text{CU1,500}}{(500 \times 1.16 \times 2/12) + (400 \times 10/12)} =$		CU3.49	
20X2 basic EPS:			
CU1,800 ÷ 400 shares =			CU4.50

Whilst the above seems a sensible interpretation of the requirements, as the procedure is not specified in the standard there may be scope for other interpretations.

4.4 Options exercised during the year

Shares issued as a result of options being exercised are dealt with on a weighted average basis in the basic EPS. *[IAS 33.19]*. Furthermore, options that have been exercised during the year will also affect diluted EPS calculations. If the options in question would have had a diluting effect on the basic EPS had they been exercised at the beginning of the year, then they will be considered in the diluted EPS calculation as explained in section 6.4.2 below, but on a weighted average basis for the period up to the date of exercise. The exercise of options is a 'conversion of potential ordinary shares'. The standard excludes such conversions from the general requirement (see section 4.3 above) to adjust prior periods' EPS when a change in the number of shares happens without a corresponding change in resources. *[IAS 33.26]*.

4.5 Post balance sheet changes in capital

The EPS figure does not reflect any changes in the capital structure occurring after the reporting period, but before the financial statements are authorised for issue, which was effected for fair value. This is because any proceeds received from the issue were not available for use during the period. However, EPS for all periods presented is required to be adjusted for any bonus element in certain post year-end changes in the number of shares, as discussed in section 4.3 above. When this is done that fact must be disclosed. *[IAS 33.64]*.

4.6 Issue to acquire another business

4.6.1 Acquisitions

As a result of a share issue to acquire another business, funds or other assets will flow into the reporting entity and extra profits will be expected to be generated. When calculating EPS, it is assumed that the shares were issued on the acquisition date (even if the actual date of issue is later), since this will be the date from which the results of the newly acquired business are recognised. *[IAS 33.21(f), IAS 33.22]*.

4.6.2 Reverse acquisitions

Reverse acquisition is the term used to describe a business combination whereby the legal parent entity after the combination is in substance the acquired and not the acquiring entity (discussed in Chapter 10 at section 14). IAS 33 is silent on the subject; however, an appendix to IFRS 3 *Business Combinations* contains a discussion of the implications for EPS of such transactions. Following a reverse acquisition, the equity structure appearing in the consolidated financial statements will reflect the equity of the legal parent, including the equity instruments issued by it to effect the business combination. *[IFRS 3.B25]*.

For the purposes of calculating the weighted average number of ordinary shares outstanding during the period in which the reverse acquisition occurs:

(a) The number of ordinary shares outstanding from the beginning of that period to the acquisition date shall be computed on the basis of the weighted average number of ordinary shares of the legal acquiree (accounting acquirer) outstanding during the period multiplied by the exchange ratio established in the merger agreement.

(b) The number of ordinary shares outstanding from the acquisition date to the end of that period shall be the actual number of ordinary shares of the legal acquirer (the accounting acquiree) outstanding during that period. *[IFRS 3.B26]*.

The basic EPS disclosed for each comparative period before the acquisition date is calculated by dividing the profit or loss of the legal subsidiary attributable to ordinary shareholders in each of those periods by the legal acquiree's historical weighted average number of ordinary shares outstanding multiplied by the exchange ratio established in the acquisition agreement. *[IFRS 3.B27]*.

IFRS 3 presents an illustrative example of a reverse acquisition, including the EPS calculation, see Chapter 10 at section 14.5.

4.6.3 Establishment of a new parent undertaking

Where a new parent entity is established by means of a share for share exchange and its consolidated financial statements have been presented as a continuation of the existing group (discussed in Chapter 11 at section 4.2.1), the number of shares taken as being in issue for both the current and preceding periods would be the number of shares issued by the new parent entity. However, EPS calculations for previous periods in the new parent entity's financial statements would have to reflect any changes in the number of outstanding ordinary shares of the former parent entity that may have occurred in those periods, as shown in the Illustration below:

Illustration 4-5: Calculation of EPS where a new holding company is established

Entity A has been established as the newly formed parent entity of Entity B in a one for one share exchange on 30 June 20X2. At that date, Entity B has 1,000,000 CU1 ordinary shares in issue. Previously, on 30 June 20X1 Entity B had issued 200,000 CU1 ordinary shares for cash at full market price. Both entities have a 31 December year-end and the trading results of Entity B are as follows:

	20X2	20X1
	CU	CU
Profit for equity shareholders after taxation	500,000	300,000

The earnings per share calculation of Entity A is shown below:

		20X2				20X1
Number of equity shares			800,000	× 6/12	=	400,000
			1,000,000	× 6/12	=	500,000
		1,000,000				900,000
EPS	500,000 / 1,000,000	= CU0.50		300,000 / 900,000	=	CU0.33

If, in the above example, the share exchange did not take place on a one for one basis, but Entity A issued three shares for every one share held in Entity B, then the number of shares issued by Entity B in 20X1 would have to be apportioned accordingly, before carrying out the weighted average calculation. The earnings per share calculation would, therefore, have been as follows:

		20X2				20X1
Number of equity shares			2,400,000	× 6/12	=	1,200,000
			3,000,000	× 6/12	=	1,500,000
		3,000,000				2,700,000
EPS	500,000 / 3,000,000	= CU0.17		300,000 / 2,700,000	=	CU0.11

5 Matters affecting the numerator

5.1 Earnings

The earnings figure on which the basic EPS calculation is based is the consolidated net profit or loss for the year after: tax, non-controlling interests and after adjusting for returns to preference shareholders that are not already included in net profit (as will be the case for preference shares classified as liabilities under IAS 32).

5.2 Preference dividends

The adjustments to net profit attributable to ordinary shareholders in relation to returns to preference shareholders include:

- The after-tax amount of any preference dividends on non-cumulative preference shares declared in respect of the period. *[IAS 33.14(a)]*.
- The after-tax amount of the preference dividends for cumulative preference shares required for the period, whether or not the dividends have been declared. This does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods. *[IAS 33.14(b)]*.
- Any original issue discount or premium on increasing rate preference shares which is amortised to retained earnings using the effective interest method. Increasing rate preference shares are those that provide: a low initial dividend to compensate an entity for selling them at a discount; or an above-market dividend in later periods to compensate investors for purchasing them at a premium (see Illustration 5-1 below). *[IAS 33.15]*.
- The excess of the fair value of the consideration paid to shareholders over the carrying amount of the preference shares when the shares are repurchased under an entity's tender offer to the holders. As this represents a return to the holders of the shares (and a charge to retained earnings for the entity) it is deducted in calculating profit or loss attributable to ordinary equity holders of the parent entity. *[IAS 33.16]*.
- The excess of the fair value of the ordinary shares or other consideration paid over the fair value of the ordinary shares issuable under the original conversion terms when early conversion of convertible preference shares is induced through favourable changes to the original conversion terms or the payment of additional consideration. This is a return to the preference shareholders, and accordingly is deducted in calculating profit or loss attributable to ordinary equity holders of the parent entity. *[IAS 33.17]*.
- Any excess of the carrying amount of preference shares over the fair value of the consideration paid to settle them. This reflects a gain to the entity and is added in calculating profit or loss attributable to ordinary equity holders. *[IAS 33.18]*.

The computation of EPS involving increasing rate preference shares is shown in the following Illustration. *[IAS 33.IE1]*.

Illustration 5-1: Increasing rate preference shares

Entity D issued non-convertible, non-redeemable class A cumulative preference shares of CU100 par value on 1 January 20X2. The class A preference shares are entitled to a cumulative annual dividend of CU7 per share starting in 20X5. At the time of issue, the market rate dividend yield on the class A preference shares was 7% a year. Thus, Entity D could have expected to receive proceeds of approximately CU100 per class A preference share if the dividend rate of CU7 per share had been in effect at the date of issue.

In consideration of the dividend payment terms, however, the class A preference shares were issued at CU81.63 per share, i.e., at a discount of CU18.37 per share. The issue price can be calculated by taking the present value of CU100, discounted at 7% over a three-year period. Because the shares are classified as equity, the original issue discount is amortised to retained earnings using the effective interest method and treated as a preference dividend for earnings per share purposes. To calculate basic earnings per share, the following imputed dividend per class A preference share is deducted to determine the profit or loss attributable to ordinary equity holders of the parent entity:

Year paid	Carrying amount of class A preference shares 1 January	Imputed dividend[1]	Carrying amount of class A preference shares 31 December[2]	Dividend
	CU	CU	CU	CU
20X2	81.63	5.71	87.34	-
20X3	87.34	6.12	93.46	-
20X4	93.46	6.54	100.00	-
Thereafter:	100.00	7.00	107.00	(7.00)

1 At 7% of the carrying amount.
2 This is before dividend payment.

5.3 Retrospective adjustments

Where comparative figures have been restated (for example, to correct a material error or as a result of a change in accounting policy), earnings per share for all periods presented must also be restated. *[IAS 33.64]*.

5.4 Participating equity instruments and two class shares

As noted in section 3.2 above, IAS 33 envisages entities having more than one class of ordinary shares and requires the calculation and presentation of EPS for each such class. *[IAS 33.66]*. Although perhaps not exactly obvious from the definition, some instruments that have a right to participate in profits are viewed by the standard as ordinary shares. The standard observes that the equity of some entities includes:

(a) Instruments that participate in dividends with ordinary shares according to a predetermined formula (for example, two for one) with, at times, an upper limit on the extent of participation (for example, up to, but not beyond, a specified amount per share).

(b) A class of ordinary shares with a different dividend rate from that of another class of ordinary shares but without prior or senior rights. *[IAS 33.A13]*.

Whilst category (a) could encompass some participating preference shares (as shown in Illustration 5-2 below), not all participating preference shares would necessarily be treated as ordinary shares for EPS purposes. This is because the participation features of some instruments could mean that they are not subordinate to all other classes of equity instrument. The meaning of ordinary shares for EPS purposes is discussed in section 3.2 above.

To calculate basic (and diluted) earnings per share:

(a) Profit or loss attributable to ordinary equity holders of the parent entity is adjusted (a profit reduced and a loss increased) by the amount of dividends declared in the period for each class of shares and by the contractual amount of dividends (or interest on participating bonds) that must be paid for the period (for example, unpaid cumulative dividends).

(b) The remaining profit or loss is allocated to ordinary shares and participating equity instruments to the extent that each instrument shares in earnings as if all of the profit or loss for the period had been distributed. The total profit or loss allocated to each class of equity instrument is determined by adding together the amount allocated for dividends and the amount allocated for a participation feature.

And

(c) The total amount of profit or loss allocated to each class of equity instrument is divided by the number of outstanding instruments to which the earnings are allocated to determine the earnings per share for the instrument.

For the calculation of diluted earnings per share, all potential ordinary shares assumed to have been issued are included in outstanding ordinary shares. *[IAS 33.A14]*. This is discussed in section 6.4 below.

Participating equity instruments and two-class ordinary shares are shown with the following Illustration. *[IAS 33.IE11]*.

Illustration 5-2: Participating equity instruments and two-class ordinary shares

Profit attributable to equity holders of the parent entity	CU100,000
Ordinary shares outstanding	10,000
Non-convertible preference shares	6,000
Non-cumulative annual dividend on preference shares (before any dividend is paid on ordinary shares)	CU5.50 per share

After ordinary shares have been paid a dividend of CU2.10 per share, the preference shares participate in any additional dividends on a 20:80 ratio with ordinary shares (i.e., after preference and ordinary shares have been paid dividends of CU5.50 and CU2.10 per share, respectively, preference shares participate in any additional dividends at a rate of one-fourth of the amount paid to ordinary shares on a per-share basis).

Dividends on preference shares paid	CU33,000	(CU5.50 per share)
Dividends on ordinary shares paid	CU21,000	(CU2.10 per share)

Basic earnings per share is calculated as follows:

	CU	CU
Profit attributable to equity holders of the parent entity		100,000
Less dividends paid:		
Preference	33,000	
Ordinary	21,000	
		(54,000)
Undistributed earnings		46,000

Allocation of undistributed earnings:

Allocation per ordinary share = A

Allocation per preference share = B; B = 1/4 A

(A × 10,000) + (1/4 A × 6,000) = CU46,000

A = CU46,000 ÷ (10,000 + 1,500)

A = CU4.00

B = 1/4 A

B = CU1.00

Basic per share amounts:

	Preference shares	Ordinary shares
Distributed earnings	CU5.50	CU2.10
Undistributed earnings	CU1.00	CU4.00
Totals	CU6.50	CU6.10

N.B. This example does not illustrate the classification of the components of convertible financial instruments as liabilities and equity or the classification of related interest and dividends as expenses and equity as required by IAS 32.

5.4.1 Tax deductible dividends on participating equity instruments

In June 2017, the IFRS IC published an agenda decision in response to a request to clarify the treatment for EPS purposes of tax deductible dividends on participating equity instruments.[1]

The question asked of the IFRS IC was whether, in determining profit attributable to ordinary shareholders in the basic EPS calculation, an entity should reflect the tax benefit that would arise from the hypothetical distribution of profit to participating equity holders.

The IFRS IC concluded that, when calculating basic EPS in the fact pattern described in the submission, an entity adjusts profit or loss attributable to ordinary shareholders for the portion of any tax benefit attributable to those ordinary shareholders. This is because the tax benefit is a direct consequence of the hypothetical distribution of profit to the participating equity holders required by IAS 33 (see section 5.4 above). This accounting treatment is applied regardless of whether an entity would have recognised the tax benefit in equity or in profit or loss.

Because, in its view, the principles and requirements in IAS 33 provide an adequate basis to calculate basic EPS in this scenario, the IFRS IC decided not to add this matter to its standard-setting agenda. In publishing this decision, the IFRS IC indicated its decision to publish an illustrative example as educational material to accompany the agenda decision, although no indication of when it would do so was given.

1 *IFRIC Update*, June 2017, available on the IFRS Foundation's website.

5.5 Other bases

It is not uncommon for entities to supplement the EPS figures required by IAS 33 by voluntarily presenting additional amounts per share.

In 2024 the IASB published IFRS 18. This standard made consequential amendments to IAS 33 which will apply once IFRS 18 is applied. This will be for periods beginning on or after 1 January 2027 with early application allowed.

Section 5.5.1 deals with the requirements of IAS 33 before its amendment by IFRS 18; Section 5.5.2 deals with the requirements once IFRS 18 is applied.

5.5.1 The requirements of IAS 33 before its amendment by IFRS 18

For additional earnings per share amounts, the standard requires:

(a) That the denominator used be that required by IAS 33

(b) That basic and diluted amounts be disclosed with equal prominence and presented in the notes

(c) An indication of the basis on which the numerator is determined, including whether amounts per share are before or after tax

(d) If the numerator is not reported as a line item in the statement of comprehensive income or separate statement of profit or loss, a reconciliation to be provided between it and a line item that is reported in the statement of comprehensive income *[IAS 33.73, IAS 33.73A]*

In September 2007, the IASB indicated that it intended, as part of the annual improvements project, to modify IAS 33 to prohibit the presentation of alternative EPS figures on the face of the statement of comprehensive income. *[IAS 1.BC103]*. However, that project was ultimately finalised without addressing this issue. As a result, alternative EPS figures may be (and, in practice, are) presented on the face of the statement of comprehensive income (or separate income statement) as well as in the notes, provided that basic and diluted amounts are similarly disclosed with equal prominence. In 2024 IFRS 18 was published which made amendments to IAS 33 which are discussed at 5.5.2

The prevalence, within the European Union, of reporting alternative EPS measures on the face of the income statement was a matter considered by the European Securities and Markets Authority (ESMA). In April 2018, it published a report entitled *Enforcement and Regulatory Activities of Accounting Enforcers in 2017*.

The report includes (at paragraph 31) the following: "Around 16% of issuers disclosed, in addition to basic and diluted earnings per share, amounts per share using a reported component of the statement of comprehensive income other than required by IAS 33." The document goes on to observe that of these, 54% presented the information "in the notes rather than on the face of the statement".

From this we infer that, of the sample examined by ESMA, approximately half of entities disclosing alternative EPS presented the information on the face of the income statement.

5.5.2 The requirements of IAS 33 after its amendment by IFRS 18

As noted above, once IFRS 18 is applied (for periods beginning on or after 1 January 2027 with early adoption permitted) the revised provisions of IAS 33 will apply. These changes are concerned the voluntary presentation of per share data in addition to that required by IAS 33. Specifically, entities are restricted in what per share figures may be disclosed in the financial statements and also in the location of them, as follows. *[IAS 33(2027).73B, IAS 33(2027).73C]*.

IAS 33 permits entities to disclose in the notes additional amounts per share using a measure of performance as a numerator different from that required by the standard. However, any such numerator is only allowed to be the amount attributable to ordinary equity holders of the parent entity of either: a total or subtotal in the statement of profit or loss or statement of comprehensive income; or a management-defined performance measure as defined in IFRS 18.

The statement of profit or loss and the statement of comprehensive income are discussed in Chapter 4 at section 3. Management-defined performance measures are discussed in Chapter 4 at section 4.

If an entity discloses an additional amount per share, it is required to:

- disclose the additional basic and diluted amounts per share with equal prominence
- use in the calculation the weighted average number of ordinary shares determined in accordance with IAS 33
- disclose the additional amount per share only in the notes. That information cannot be presented in the primary financial statements.
- disclose the information required by IFRS 18 for the numerators that are management-defined performance measures (see Chapter 4 at section 4.2.1) *[IAS 33(2027).73C, IFRS 18.121, IFRS 18.122, IFRS 18.123, IFRS 18.124, IFRS 18.125]*

6 Diluted earnings per share

6.1 The need for diluted EPS

The presentation of basic EPS seeks to show a performance measure, by computing how much profit an entity has earned for each of the shares in issue for the period. Entities often enter into commitments to issue shares in the future which would result in a change in basic EPS. IAS 33 refers to such commitments as potential ordinary shares, which it defines as "a financial instrument or other contract that may entitle its holder to ordinary shares". *[IAS 33.5]*.

Examples of potential ordinary shares given by IAS 33 are:

(a) Financial liabilities or equity instruments, including preference shares, that are convertible into ordinary shares.

(b) Options and warrants (whether accounted for under IAS 32 or IFRS 2).

(c) Shares that would be issued upon the satisfaction of conditions resulting from contractual arrangements, such as the purchase of a business or other assets. *[IAS 33.7]*.

When potential shares are actually issued, the impact on basic EPS will be two-fold. First, the number of shares in issue will change; second, profits could be affected, for example by lower interest charges or the return made on cash inflows. Scenarios whereby such an adjustment to basic EPS is unfavourable are described by the standard as dilution, defined as "a reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions". *[IAS 33.5]*. This potential fall in EPS is quantified by computing diluted EPS, and as a result:

(a) Profit or loss attributable to equity holders is increased by the after-tax amount of dividends and interest recognised in the period in respect of the dilutive potential ordinary shares and is adjusted for any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares.

And

(b) The weighted average number of ordinary shares outstanding is increased by the weighted average number of additional ordinary shares that would have been outstanding assuming the conversion of all dilutive potential ordinary shares. *[IAS 33.32]*.

6.2 Calculation of diluted EPS

IAS 33 requires a diluted EPS figure to be calculated for the profit or loss attributable to ordinary equity holders of the parent and, if presented, profit or loss from continuing operations attributable to them. *[IAS 33.30]*. For these purposes, the profit or loss attributable to ordinary equity holders and the weighted average number of shares outstanding is adjusted for the effects of all potential ordinary shares. *[IAS 33.31]*. In calculating diluted EPS, the number of shares to be used is that used in calculating basic EPS, plus the weighted average number of shares that would be issued on the conversion of all the dilutive potential ordinary shares into ordinary shares. As is the case for outstanding shares in the basic EPS calculation, potential ordinary shares are to be weighted for the period they are outstanding. *[IAS 33.36, IAS 33.38]*. Accordingly, potential ordinary shares:

- Are deemed to have been converted into ordinary shares at the beginning of the period or, if not in existence at the beginning of the period, the date of their issue *[IAS 33.36]*
- Which are cancelled or allowed to lapse are included only for the period they are outstanding

  And
- Which convert into ordinary shares during the period are included up until the date of conversion (from which point they will be included in the basic EPS) *[IAS 33.38]*

The number of dilutive potential ordinary shares is to be determined independently for each period presented, and not subsequently revisited. In particular, prior periods' EPS are not restated for changes in assumptions about the conversion of potential shares into shares. IAS 33 also stresses that the number of dilutive potential ordinary shares included in the year-to-date period is not a weighted average of the dilutive potential ordinary shares included in each interim computation. *[IAS 33.37, IAS 33.65]*. This is illustrated in the comprehensive illustrative example accompanying IAS 33, the substance of which is reproduced in the appendix to this chapter.

6.2.1 Diluted earnings

The earnings figure is that used for basic EPS adjusted to reflect any changes that would arise if the potential shares outstanding in the period were actually issued. Adjustment is to be made for the post-tax effects of:

(a) Any dividends or other items related to dilutive potential ordinary shares deducted in arriving at the earnings figure used for basic EPS

(b) Any interest recognised in the period related to dilutive potential ordinary shares

(c) Any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares *[IAS 33.33]*

These adjustments will also include any amounts charged in accordance with the effective interest method prescribed by IFRS 9 *Financial Instruments* as a result of allocating transaction costs, premiums or discounts over the term of the instrument. *[IAS 33.34]*. Instruments with a choice of settlement method may also require adjustments to the numerator as discussed in section 6.2.2 below.

The standard notes that certain earnings adjustments directly attributable to the instrument could also affect other items of income or expense which will need to be taken into account. For example, the lower interest charge following conversion of convertible debt could lead to higher charges under profit sharing schemes. *[IAS 33.35]*.

No imputed earnings are taken into account in respect of the proceeds to be received on exercise of share options or warrants. The effect of such potential ordinary shares on the diluted EPS is reflected in the computation of the denominator. This is discussed in section 6.4.2 below.

6.2.2 Diluted number of shares

IAS 33 discusses a number of specific types of potential ordinary shares and how they are to be brought into the calculation; these are discussed in section 6.4 below.

More generally, the standard also discusses scenarios where the method of conversion or settlement of potential ordinary shares is at the discretion of one of the parties, as follows:

(a) The number of shares that would be issued on conversion must be determined from the terms of the potential ordinary shares. When more than one basis of conversion exists, the calculation assumes the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential ordinary shares. *[IAS 33.39]*.

(b) When an entity has issued a contract that may be settled in shares or cash at its option, it presumes that the contract will be settled in shares. The resulting potential ordinary shares would be included in diluted earnings per share if the effect is dilutive. *[IAS 33.58]*. When such a contract is presented for accounting purposes as an asset or a liability, or has an equity component and a liability component, the numerator is to be adjusted for any changes in profit or loss that would have resulted during the period if the contract had been classified wholly as an equity instrument. That adjustment is similar to the adjustments discussed in section 6.2.1 above. *[IAS 33.59]*.

And

(c) For contracts that may be settled in ordinary shares or cash at the holder's option, the more dilutive of cash settlement and share settlement is to be used in calculating diluted earnings per share. *[IAS 33.60]*.

An example of an instrument covered by (b) above is a debt instrument that, on maturity, gives the issuer the unrestricted right to settle the principal amount in cash or in its own ordinary shares (see Illustration 6-3 in section 6.4.1.A below). An example of an instrument covered by (c) is a written put option that gives the holder a choice of settling in ordinary shares or cash. *[IAS 33.61]*.

In our view, the requirements of the standard in (b) and (c) above relating to settlement options are somewhat confused. In particular, they seem to envisage a binary accounting model based on the strict legal form of settlement (cash or shares). However, IAS 32 sets out rules for three different settlement methods - net cash, net shares and gross physical settlement (discussed in Chapter 43 at section 5). One consequence of the above is that, if taken literally, the numerator is only required to be adjusted to remove items of income or expense arising from a liability when there is a choice of settlement method. However, mandatory net share settlement also gives rise to a liability and income/expense under IAS 32. In our view, any such income statement items need to be removed for diluted EPS purposes.

How we see it

Although not stated explicitly in IAS 33, in our view, the numerator for diluted EPS must be adjusted for any effect in income related to potential ordinary shares subject to mandatory net share settlement.

6.3 Dilutive potential ordinary shares

Only those potential shares whose issue would have a dilutive effect on EPS are brought into the calculation. Potential ordinary shares are 'antidilutive' when their conversion to ordinary shares would increase earnings per share or decrease loss per share. *[IAS 33.5, IAS 33.43]*. The calculation of diluted earnings per share must not assume conversion, exercise, or other issue of potential ordinary shares that would have an antidilutive effect on earnings per share. *[IAS 33.43]*. The standard gives detailed guidance for determining which potential shares are deemed to be dilutive, and hence brought into the diluted EPS calculation. This guidance covers the element of profit which needs to be diluted to trigger inclusion, and the sequence in which potential shares are tested to establish cumulative dilution. Each is discussed below.

6.3.1 Dilution judged by effect on profits from continuing operations

Potential ordinary shares are only to be treated as dilutive if their conversion to ordinary shares would decrease earnings per share or increase loss per share from continuing operations. The 'control number' that this focuses on is therefore the net result from continuing operations, which is the net profit or loss attributable to the parent entity, after deducting items relating to preference shares (see section 5.2 above) and after excluding items relating to discontinued operations. *[IAS 33.42]*. The same denominator is required to be used to compute diluted EPS from continuing operations and total diluted EPS. Determining which potential shares are to be included by reference to their impact on continuing EPS can produce some slightly curious results for total EPS. For example, it is possible to exclude instruments which would dilute basic EPS (but not continuing EPS), and include items which are antidilutive as regards total profit. This latter point is acknowledged by the standard as follows. *[IAS 33.A3]*.

Extract from IAS 33

Control number

A3 To illustrate the application of the control number notion described in paragraphs 42 and 43, assume that an entity has profit from continuing operations attributable to the parent entity of CU4,800, a loss from discontinued operations attributable to the parent entity of (CU7,200), a loss attributable to the parent entity of (CU2,400), and 2,000 ordinary shares and 400 potential ordinary shares outstanding. The entity's basic earnings per share is CU2.40 for continuing operations, (CU3.60) for discontinued operations and (CU1.20) for the loss. The 400 potential ordinary shares are included in the diluted earnings per share calculation because the resulting CU2.00 earnings per share for continuing operations is dilutive, assuming no profit or loss impact of those 400 potential ordinary shares. Because profit from continuing operations attributable to the parent entity is the control number, the entity also includes those 400 potential ordinary shares in the calculation of the other earnings per share amounts, even though the resulting earnings per share amounts are antidilutive to their comparable basic earnings per share amounts, ie the loss per share is less [(CU3.00) per share for the loss from discontinued operations and (CU1.00) per share for the loss].

6.3.2 Dilution judged by the cumulative impact of potential shares

Where an entity has a number of different potential ordinary shares, in deciding whether they are dilutive (and hence reflected in the calculation), each issue or series of potential ordinary shares is to be considered in sequence from the most to the least dilutive. Only those potential shares which produce a cumulative dilution are to be included. This means that some potential shares which would dilute basic EPS if viewed on their own may need to be excluded. This results in a diluted EPS showing the maximum overall dilution of basic EPS. The standard observes that options and warrants are generally included first as they do not affect the numerator in the diluted EPS calculation (but see the discussion in section 6.4.2 below). *[IAS 33.44]*. The way this is to be done is shown in the following Illustration. *[IAS 33.IE9]*.

Illustration 6-1: Calculation of weighted average number of shares: determining the order in which to include dilutive instruments

Earnings

	CU
Profit from continuing operations attributable to the parent entity	16,400,000
Less dividends on preference shares	(6,400,000)
Profit from continuing operations attributable to ordinary equity holders of the parent entity	10,000,000
Loss from discontinued operations attributable to the parent entity	(4,000,000)
Profit attributable to ordinary equity holders of the parent entity	6,000,000

Ordinary shares outstanding	2,000,000
Average market price of one ordinary share during year	CU75.00

Potential Ordinary Shares

Options	100,000 with exercise price of CU60
Convertible preference shares	800,000 shares with a par value of CU100 entitled to a cumulative dividend of CU8 per share. Each preference share is convertible to two ordinary shares.
5% convertible bonds	Nominal amount CU100,000,000. Each CU1,000 bond is convertible to 20 ordinary shares. There is no amortisation of premium or discount affecting the determination of interest expense.
Tax rate	40%

Increase in Earnings Attributable to Ordinary Equity Holders on Conversion of Potential Ordinary Shares

	Increase in earnings	Increase in number of ordinary shares	Earnings per incremental share
	CU		CU
Options			
Increase in earnings	Nil		
Incremental shares issued for no consideration			
100,000 × (CU75 - CU60) ÷ CU75 =		20,000	Nil
Convertible preference shares			
Increase in earnings			
CU800,000 × 100 × 0.08 =	6,400,000		
Incremental shares			
2 × 800,000 =		1,600,000	4.00
5% convertible bonds			
Increase in earnings			
CU100,000,000 × 0.05 × (1 - 0.40) =	3,000,000		
Incremental shares			
100,000 × 20 =		2,000,000	1.50

The order in which to include the dilutive instruments is therefore:

(1) Options

(2) 5% convertible bonds

(3) Convertible preference shares

Calculation of Diluted Earnings per Share

	Profit from continuing operations attributable to ordinary equity holders of the parent entity (control number)	Ordinary shares	Per share	
	CU		CU	
As reported	10,000,000	2,000,000	5.00	
Options	-	20,000		
	10,000,000	2,020,000	4.95	Dilutive
5% convertible bonds	3,000,000	2,000,000		
	13,000,000	4,020,000	3.23	Dilutive
Convertible preference shares	6,400,000	1,600,000		
	19,400,000	5,620,000	3.45	Antidilutive

Because diluted earnings per share is increased when taking the convertible preference shares into account (from CU3.23 to CU3.45), the convertible preference shares are antidilutive and are ignored in the calculation of diluted earnings per share. Therefore, diluted earnings per share for profit from continuing operations is CU3.23.

	Basic EPS		Diluted EPS	
	CU		CU	
Profit from continuing operations attributable to ordinary equity holders of the parent entity	5.00		3.23	
Loss from discontinued operations attributable to ordinary equity holders of the parent entity	(2.00)	(a)	(0.99)	(b)
Profit attributable to ordinary equity holders of the parent entity	3.00	(c)	2.24	(d)

(a) (CU4,000,000) ÷ 2,000,000 = (CU2.00)

(b) (CU4,000,000) ÷ 4,020,000 = (CU0.99)

(c) CU6,000,000 ÷ 2,000,000 = CU3.00

(d) (CU6,000,000 + CU3,000,000) ÷ 4,020,000 = CU2.24

This example does not illustrate the classification of the components of convertible financial instruments as liabilities and equity or the classification of related interest and dividends as expenses and equity as required by IAS 32.

6.4 Particular types of dilutive instruments

6.4.1 Convertible instruments

In order to secure a lower rate of interest, entities sometimes attach benefits to loan stock, debentures or preference shares in the form of conversion rights. These permit the holder to convert his holding in whole or part into equity capital. The right is normally exercisable between specified dates. The ultimate conversion of the instrument will have the following effects:

(a) There will be an increase in earnings by the amount of the interest (or items relating to preference shares) no longer payable. As interest is normally allowable for tax purposes, the effect on earnings may be net of a tax deduction relating to some or all of the items.

And

(b) The number of ordinary shares in issue will increase. The diluted EPS is calculated assuming that the instrument is converted into the maximum possible number of shares. *[IAS 33.49]*.

Convertible preference shares will be antidilutive whenever the amount of the dividend on such shares declared in or accumulated for the current period per ordinary share obtainable on conversion exceeds basic earnings per share. Similarly, convertible debt will be antidilutive whenever its interest (net of tax and other changes in income or expense) per ordinary share obtainable on conversion exceeds basic earnings per share. *[IAS 33.50]*.

6.4.1.A Convertible debt

The EPS calculation for convertible bonds is shown in the following Illustration: *[IAS 33.IE6]*

Illustration 6-2: Treatment of convertible bonds in diluted EPS calculations

Profit attributable to ordinary equity holders of the parent entity	CU1,004
Ordinary shares outstanding	1,000
Basic earnings per share	CU1.00
Convertible bonds	100
Each block of 10 bonds is convertible into three ordinary shares	
Interest expense for the current year relating to the liability component of the convertible bonds	CU10
Current and deferred tax relating to that interest expense	CU4

Note: the interest expense includes amortisation of the discount arising on initial recognition of the liability component (see IAS 32).

Adjusted profit attributable to ordinary equity holders of the parent entity	CU1,004 + CU10 - CU4 = CU1,010
Number of ordinary shares resulting from conversion of bonds	30
Number of ordinary shares used to calculate diluted earnings per share	1,000 + 30 = 1,030
Diluted earnings per share	CU1,010 ÷ 1,030 = CU0.98

This example does not illustrate the classification of the components of convertible financial instruments as liabilities and equity or the classification of related interest and dividends as expenses and equity as required by IAS 32.

As discussed in section 6.2.2 above, the standard also discusses the impact on diluted EPS of different settlement options. As discussed earlier, we believe this must be taken to mean that for diluted EPS purposes earnings are adjusted to remove any items that arose from an instrument being classified as an asset or liability rather than equity.

The standard illustrates settlement options with the following example. *[IAS 33.IE8]*.

Illustration 6-3: Convertible bonds settled in shares or cash at the issuer's option

An entity issues 2,000 convertible bonds at the beginning of Year 1. The bonds have a three-year term, and are issued at par with a face value of CU1,000 per bond, giving total proceeds of CU2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6%. Each bond is convertible at any time up to maturity into 250 common shares.

When the bonds are issued, the prevailing market interest rate for similar debt without a conversion option is 9%. At the issue date, the market price of one common share is CU3. Income tax is ignored.

Profit attributable to ordinary equity holders of the parent entity Year 1	CU1,000,000
Ordinary shares outstanding	1,200,000
Convertible bonds outstanding	2,000
Allocation of proceeds of the bond issue:	
Liability component	* CU1,848,122
Equity component	CU151,878
	CU2,000,000

The liability and equity components would be determined in accordance with IAS 32. These amounts are recognised as the initial carrying amounts of the liability and equity components. The amount assigned to the issuer conversion option equity element is an addition to equity and is not adjusted.

* This represents the present value of the principal and interest discounted at 9% - CU2,000,000 payable at the end of three years; CU120,000 payable annually in arrears for three years.

Basic earnings per share Year 1:

$$\frac{\text{CU1,000,000}}{\text{1,200,000}} = \text{CU0.83 per ordinary share}$$

Diluted earnings per share Year 1:

It is presumed that the issuer will be required to settle the contract by the issue of ordinary shares. The dilutive effect is therefore calculated in accordance with IAS 33.59.

$$\frac{\text{CU1,000,000} + \text{CU166,331}^{(a)}}{\text{1,200,000} + \text{500,000}^{(b)}} = \text{CU0.69 per ordinary share}$$

(a) Profit is adjusted for the accretion of CU166,331 (CU1,848,122 × 9%) of the liability because of the passage of time.

(b) 500,000 ordinary shares = 250 ordinary shares × 2,000 convertible bonds.

6.4.1.B Convertible preference shares

The rules for convertible preference shares are very similar to those detailed above in the case of convertible debt, i.e., dividends and other returns to preference shareholders are added back to earnings used for basic EPS and the maximum number of ordinary shares that could be issued on conversion are included in the calculation.

As discussed in section 5.2 above, one possible return to preference shareholders is a premium payable on redemption or induced early conversion in excess of the original terms. IAS 33 notes that the redemption or induced conversion of convertible preference shares may affect only a portion of the previously outstanding convertible preference shares. In such cases, the standard makes clear that any excess consideration is attributed to those shares that are redeemed or converted for the purpose of determining whether the remaining outstanding preference shares are dilutive. In other words, the shares redeemed or converted are considered separately from those shares that are not redeemed or converted. *[IAS 33.51]*.

6.4.1.C Participating equity instruments and two class shares with conversion rights

The treatment for basic EPS of participating equity instruments and two class shares is discussed in section 5.4 above. When discussing these instruments, the standard observes that when calculating diluted EPS:

- Conversion is assumed for those instruments that are convertible into ordinary shares if the effect is dilutive.
- For those that are not convertible into a class of ordinary shares, profit or loss for the period is allocated to the different classes of shares and participating equity instruments in accordance with their dividend rights or other rights to participate in undistributed earnings. *[IAS 33.A14]*.

What the standard seems to be hinting at here, without directly addressing, is how to present EPS for two or more classes of ordinary shares (say, class A and class B) when one class can convert into another (say, class B can convert into class A). In this scenario, the basic EPS for each class is calculated based on profit entitlement (see section 5.4 above). For diluted EPS it would be necessary to attribute to class A the profits attributed to class B in the basic EPS - if the overall effect were dilutive to class A, conversion is assumed.

6.4.2 Options, warrants and their equivalents

6.4.2.A The numerator

IAS 33 contains detailed guidance on the treatment for diluted EPS purposes of options, warrants and their equivalents which it defines as "financial instruments that give the holder the right to purchase ordinary shares". *[IAS 33.5]*. However, it was largely written before the significant developments in accounting for such instruments (IFRS 2 and IAS 32). As a result, individual facts and circumstances must be considered and judgement is required in some circumstances to address the dilutive effects on EPS.

IAS 33 clearly states that "Options and warrants … do not affect the numerator of the calculation" *[IAS 33.44]* and this text was added in 2003 as part of the improvements project, so clearly drafted against the back drop of the impending move to expensing share-based payments and also the (then) recent changes to IAS 32 regarding accounting for derivatives over an entity's own shares. As regards employee share options in particular, neither IAS 33 (as updated by IFRS 2) nor the worked example appended to it (see Illustration 6-6 in section 6.4.5 below) make reference to removing either some or all the charge when computing diluted EPS. However, this seems to sit somewhat awkwardly (particularly for options outside the scope of IFRS 2) with the general requirement for calculating diluted EPS that earnings be adjusted for the effects of "any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares". *[IAS 33.33]*. Furthermore, IAS 33 explicitly requires an adjustment to the numerator in some circumstances:

(a) As discussed in section 6.2.2 above, adjustment to the numerator may be required for a contract (which could include options and warrants) that may be settled in ordinary shares or cash at the entity's option when such a contract is presented for accounting purposes as an asset or a liability, or has an equity component and a liability component. In such a case, the standard requires that "the entity shall adjust the numerator for any changes in profit or loss that would have resulted during the period if the contract had been classified wholly as an equity instrument". For contracts that may be settled in ordinary shares or cash at the holder's option, "the more dilutive of cash settlement and share settlement shall be used in calculating diluted earnings per share". *[IAS 33.59, IAS 33.60]*.

(b) Where an option agreement requires or permits the tendering of debt in payment of the exercise price (and, if the holder could choose to pay cash, that tendering debt is more advantageous to him) the numerator must be adjusted for the after-tax amount of any such debt assumed to be tendered (see section 6.4.2.E below). *[IAS 33.A7]*.

(c) Where option proceeds are required to be applied to redeem debt or other instruments of the entity (see section 6.4.2.F below). *[IAS 33.A9]*.

For situations covered by (b) and (c) above the specific requirements of the standard for adjusting the numerator are to be followed. In other circumstances, the interaction of these complex and conflicting requirements with each other and with IFRS 2 and IAS 32 lead to the following requirements when computing the numerator for diluted EPS:

(a) For instruments accounted for under IAS 32:

  (i) For a contract classified wholly as an equity instrument, no adjustment to the numerator will be necessary.

  And

  (ii) For a contract not classified wholly as an equity instrument, the numerator is adjusted for any changes in profit or loss that would have resulted if it had been classified wholly as an equity instrument.

(b) For instruments accounted for under IFRS 2:

  (i) For those treated as equity-settled, no adjustment is made for the IFRS 2 charge.

  And

  (ii) For those treated as cash-settled, the numerator is adjusted for any changes in profit or loss that would have resulted if the instrument had been classified wholly as an equity instrument.

In respect of (b), part (i) is supported by the IASB's view regarding share-based payments as follows. *[IFRS 2.BC54, IFRS 2.BC55, IFRS 2.BC56, IFRS 2.BC57]*.

Extract from IFRS 2

'Earnings per share is "hit twice"'

BC54 Some argue that any cost arising from share-based payment transactions is already recognised in the dilution of earnings per share (EPS). If an expense were recognised in the income statement, EPS would be 'hit twice'.

BC55 However, the Board noted that this result is appropriate. For example, if the entity paid the employees in cash for their services and the cash was then returned to the entity, as consideration for the issue of share options, the effect on EPS would be the same as issuing those options direct to the employees.

BC56 The dual effect on EPS simply reflects the two economic events that have occurred: the entity has issued shares or share options, thereby increasing the number of shares included in the EPS calculation-although, in the case of options, only to the extent that the options are regarded as dilutive-and it has also consumed the resources it received for those options, thereby decreasing earnings. This is illustrated by the plant and machinery example mentioned in paragraphs BC42 and BC43. Issuing shares affects the number of shares in the EPS calculation, and the consumption (depreciation) of the asset affects earnings.

BC57 In summary, the Board concluded that the dual effect on diluted EPS is not double-counting the effects of a share or share option grant-the same effect is not counted twice. Rather, two different effects are each counted once.

As for part (ii) of (b) above, this is the explicit requirement of IAS 33 when the entity can choose cash or share settlement. It is also implicit in the requirement of the standard that for contracts that may be settled in ordinary shares or cash at the holder's option, the more dilutive of cash settlement and share settlement is to be used in calculating diluted earnings per share. This would also explain why IFRS 2 requires the computation of grant date fair values for cash-settled share-based payments when that information is not actually required for accounting purposes (see Chapter 30 at section 9.3.2).

6.4.2.B Written call options

Entities may issue options or warrants which give holders the right to subscribe for shares at fixed prices on specified future dates. If the options or warrants are exercised then:

(a) The number of shares in issue will be increased

(b) Funds will flow into the company and these will produce income

For calculating diluted EPS, IAS 33 requires the exercise of all dilutive options and warrants to be assumed. *[IAS 33.45]*. Options and warrants are considered dilutive when they would result in the issue of ordinary shares for less than the average market price of ordinary shares during the period. The amount of the dilution is taken to be the average market price of ordinary shares during the period minus the issue price. *[IAS 33.46]*.

Under IAS 33, the effects of such potential ordinary shares on the diluted EPS are reflected in the computation of the denominator using a method sometimes called the 'treasury stock method'.

For this purpose, the weighted average number of shares used in calculating the basic EPS is increased, but not by the full number of shares that would be issued on exercise of the instruments. To determine how many additional shares to include in the denominator, the assumed proceeds from these issues are to be treated as having been received in exchange for:

- A certain number of shares at their average market price for the period (i.e., no EPS impact)

  And
- The remainder for no consideration (i.e., full dilution) *[IAS 33.45, IAS 33.46]*

This means that the excess of the total number of potential shares over the number that could be issued at their average market price for the period out of the issue proceeds is included within the denominator; the calculation is illustrated as follows: *[IAS 33.IE5]*

Illustration 6-4: Effects of share options on diluted earnings per share

Profit attributable to ordinary equity holders of the parent entity for year	CU1,200,000
Weighted average number of ordinary shares outstanding during year	500,000 shares
Average market price of one ordinary share during year	CU20.00
Weighted average number of shares under option during year	100,000 shares
Exercise price for shares under option during year	CU15.00

Calculation of earnings per share

	Earnings	Shares	Per share
Profit attributable to ordinary equity holders of the parent entity for year	CU1,200,000		
Weighted average shares outstanding during year		500,000	
Basic earnings per share			CU2.40
Weighted average number of shares under option		100,000	
Weighted average number of shares that would have been issued at average market price: (100,000 × CU15.00) ÷ CU20.00	*	(75,000)	
Diluted earnings per share	CU1,200,000	525,000	CU2.29

* Earnings have not increased because the total number of shares has increased only by the number of shares (25,000) deemed to have been issued for no consideration.

The number of shares viewed as fairly priced (and hence neither dilutive nor antidilutive) for this purpose is calculated on the basis of the average price of the ordinary shares during the reporting period. *[IAS 33.46]*. The standard observes that, in theory, calculating an average share price for the period could include every market transaction in the shares. However, it notes that as a practical matter an average (weekly or monthly) will usually be adequate. *[IAS 33.A4]*. The individual prices to be used are generally the closing market price unless prices fluctuate widely, in which case the average of high and low prices may be more representative. Whatever method is adopted, it is required to be used consistently unless it ceases to yield a representative price. For example, closing prices may have been used consistently in a series of relatively stable periods then a change to high/low average could be appropriate when prices begin to fluctuate more widely. *[IAS 33.A5]*.

The shares would be deemed to have been issued at the beginning of the period or, if later, the date of issue of the warrants or options. Options which are exercised or lapse in the period are included for the portion of the period during which they were outstanding. *[IAS 33.36, IAS 33.38]*.

Although the standard seems to require that the fair value used be the average for the reporting period for all outstanding options or warrants, for instruments issued, lapsed or exercised during the period a credible case could be made for using an average price for that part of the reporting period that the instrument was outstanding. Indeed, this is supported by the comprehensive example included in the standard (see the appendix to this chapter), where in computing the number of warrants to be included in calculating the diluted EPS for the full year, the average price used was not that for the full year, but only for the period that the warrants were outstanding.

One practical problem with this requirement is that the average market price of ordinary shares for the reporting period may not be available. Examples would include an entity only listed for part of the period, or an unlisted entity giving voluntary disclosures. In such cases, estimates of the market price would need to be made.

6.4.2.C Written put options and forward purchase agreements

Contracts that require the entity to repurchase its own shares, such as written put options and forward purchase contracts, are to be reflected in the calculation of diluted earnings per share if the effect is dilutive. If these contracts are 'in the money' during the period (i.e., the exercise or settlement price is above the average market price for that period), IAS 33 requires the potential dilutive effect on EPS to be calculated as follows:

- It is assumed that at the beginning of the period sufficient ordinary shares are issued (at the average market price during the period) to raise proceeds to satisfy the contract.
- The proceeds from the issue are then assumed to be used to satisfy the contract (i.e., to buy back ordinary shares).

  And
- The incremental ordinary shares (the difference between the number of ordinary shares assumed issued and the number of ordinary shares received from satisfying the contract) is included in the calculation of diluted earnings per share. *[IAS 33.63]*.

The standard illustrates this methodology as follows: *[IAS 33.A10]*

Extract from IAS 33

Written put options

A10 To illustrate the application of paragraph 63, assume that an entity has outstanding 120 written put options on its ordinary shares with an exercise price of CU35. The average market price of its ordinary shares for the period is CU28. In calculating diluted earnings per share, the entity assumes that it issued 150 shares at CU28 per share at the beginning of the period to satisfy its put obligation of CU4,200. The difference between the 150 ordinary shares issued and the 120 ordinary shares received from satisfying the put option (30 incremental ordinary shares) is added to the denominator in calculating diluted earnings per share.

6.4.2.D Options over convertible instruments

Although not common, it is possible that an entity grants options or warrants to acquire not ordinary shares directly but other instruments convertible into them (such as convertible preference shares or debt). In this scenario, IAS 33 sets a dual test:

- Exercise is assumed whenever the average prices of both the convertible instrument and the ordinary shares obtainable upon conversion are above the exercise price of the options or warrants.

  But
- Exercise is not assumed unless conversion of similar outstanding convertible instruments, if any, is also assumed. *[IAS 33.A6]*.

6.4.2.E Settlement of option exercise price with debt or other instruments of the entity

The standard notes that options or warrants may permit or require the tendering of debt or other instruments of the entity (or its parent or a subsidiary) in payment of all or a portion of the exercise price. In the calculation of diluted earnings per share, those options or warrants have a dilutive effect if (a) the average market price of the related ordinary shares for the period exceeds the exercise price or (b) the selling price of the instrument to be tendered is below that at which the instrument may be tendered under the option or warrant agreement and the resulting discount establishes an effective exercise price below the market price of the ordinary shares obtainable upon exercise. In the calculation of diluted EPS, those options or warrants are assumed to be exercised and the debt or other instruments assumed to be tendered. If tendering cash is more advantageous to the option or warrant holder and the contract permits it, tendering of cash is assumed. Interest (net of tax) on any debt assumed to be tendered is added back as an adjustment to the numerator. *[IAS 33.A7]*.

Similar treatment is given to preference shares that have similar provisions or to other instruments that have conversion options that permit the investor to pay cash for a more favourable conversion rate. *[IAS 33.A8]*.

6.4.2.F Specified application of option proceeds

IAS 33 observes that the underlying terms of certain options or warrants may require the proceeds received from the exercise of those instruments to be applied to redeem debt or other instruments of the entity (or its parent or a subsidiary). In which case it requires that in "the calculation of diluted earnings per share, those options or warrants are assumed to be exercised and the proceeds applied to purchase the debt at its average market price rather than to purchase ordinary shares. However, the excess proceeds received from the assumed exercise over the amount used for the assumed purchase of debt are considered (i.e., assumed to be used to buy back ordinary shares) in the diluted earnings per share calculation. Interest (net of tax) on any debt assumed to be purchased is added back as an adjustment to the numerator." *[IAS 33.A9]*.

6.4.3 Purchased options and warrants

IAS 33 states that a holding by an entity of options over its own shares will always be antidilutive because:

- Put options would only be exercised if the exercise price were higher than the market price.

  And

- Call options would only be exercised if the exercise price were lower than the market price.

Accordingly, the standard requires that such instruments are not included in the calculation of diluted EPS. *[IAS 33.62]*.

However, depending upon the settlement mechanism and the share price at the beginning and end of the period, the option could have resulted in a gain being reported (see Chapter 43 at section 5). It is therefore possible that the removal of any such gain from the numerator could have a greater dilutive effect than the reduction in the denominator and hence render the option dilutive. In that circumstance, the option would be included in the diluted EPS calculation.

6.4.4 Partly paid shares

As noted in section 3.2 above, shares issued in partly paid form are to be included in the basic EPS as a fraction of a share, based on dividend participation. As regards diluted EPS they are to be treated, to the extent that they are not entitled to participate in dividends, as the equivalent of options or warrants. The unpaid balance is assumed to represent proceeds used to purchase ordinary shares. The number of shares included in diluted earnings per share is the difference between the number of shares subscribed and the number of shares assumed to be purchased. *[IAS 33.A16]*. The mechanics of this treatment are not further spelt out in the standard, but the phrase 'treated as a fraction of an ordinary share' is not repeated. Instead, it is 'the number of shares subscribed' which the standard says is to be compared to the number assumed purchased to measure dilution. However, 'the number of shares subscribed' is not defined. Whilst this could be read to mean that the remaining unpaid consideration is to be treated as the exercise price for options over all of the shares issued in partly paid form, we believe the better interpretation is that the unpaid capital be viewed as the exercise price for options over the proportion of the shares not reflected in the basic EPS. This would mean that if the average share price for the period were the same as the total issue price, then no dilution would be reported. Furthermore, an issue of partly paid shares, say 50% paid with 50% dividend entitlement is economically identical to an issue of half the quantity as fully paid (with full dividend entitlement) and a forward contract for the remaining half. In that scenario, the issued shares would be incorporated into the basic and diluted EPS in full from the date of issue. The forward contract would be included in diluted EPS calculation by comparing the contracted number of shares with the number of shares that could be bought out of proceeds based on the average share price for the period. These economically identical transactions should produce the same diluted EPS - that would be achieved by interpreting 'the number of shares subscribed' as the number economically subscribed, i.e., the proportion of part-paid shares not already included in basic EPS.

An illustration of what the calculation would look like is as follows:

Illustration 6-5: Partly paid shares

Capital structure

Issued share capital as at 31 December 20X1:

2,000,000 ordinary shares of CU0.10 each

Issued on 1 January 20X2:

500,000 part paid ordinary shares of CU0.10 each. Full consideration of CU0.50 per share (being fair value at 1 January 20X2) paid up 50% on issue. Dividend participation 50% until fully paid. New shares remain part paid at 31 December 20X2.

Average fair value of one ordinary share for the period CU0.60.

Trading results

Net profit attributable to ordinary shareholders for the year ended 31 December 20X2: CU100,000.

Computation of basic and diluted EPS

	Net profit attributable to ordinary shareholders	Ordinary shares	Per share
	CU	No.	
Fully paid shares		2,000,000	
Partly paid shares (1)		250,000	
Basic EPS	100,000	2,250,000	4.44 CU cents
Dilutive effect of partly paid shares (2)		41,667	
Diluted EPS	100,000	2,291,667	4.36 CU cents

(1) 50% dividend rights for 500,000 shares.

(2) Outstanding consideration of CU125,000 (500,000 × CU0.25), using fair value of CU0.60 this equates to 208,333 shares, hence the number of dilutive shares deemed issued for free is 41,667 (250,000 - 208,333).

The example assumes the fair value of the shares over the year is higher than the issue price, which explains why some extra shares are included in the diluted EPS. If the average fair value remained at the issue price of CU0.50 then no additional shares would be included for diluted EPS.

6.4.5 Share-based payments

Share options and other incentive schemes are a common feature of employee remuneration, and can come in many forms. For diluted EPS purposes, IAS 33 identifies two categories and specifies the diluted EPS treatment for each. The categories are:

(a) Performance-based employee share options

(b) Employee share options with fixed or determinable terms and non-vested ordinary shares *[IAS 33.48]*

Before moving on to the diluted EPS treatment, it is worth noting an issue that arises from the way IAS 33 phrases this categorisation and subsequent guidance.

How we see it

Although not clearly stated in the standard, we believe all schemes must be treated as either category (a) or category (b). Any arrangements where entitlement is subject to future performance would fall into category (a) with category (b) being the default for all other arrangements.

Schemes in the first category are to be treated as contingently issuable shares (see section 6.4.6 below) because their issue is contingent upon satisfying specified conditions in addition to the passage of time. *[IAS 33.48]*.

Those in the second category are to be treated as options (see section 6.4.2 above). They are regarded as outstanding from the grant date, even if they vest, and hence can be realised by the employees, at some later date. *[IAS 33.48]*. An example would be an unexpired loyalty period. This means that some shares may be included in diluted EPS which never, in fact, get issued to employees because they fail to remain with the company for this period. Furthermore, for share options and other share-based payment arrangements to which IFRS 2 applies, the proceeds figure to be used in calculating the dilution under such schemes will include the fair value (as determined in accordance with IFRS 2) of any goods or services to be supplied to the entity in the future under the arrangement. *[IAS 33.47A]*. An example illustrating the latter point is as follows: *[IAS 33.IE5A]*

Illustration 6-6: Determining the exercise price of employee share options	
Weighted average number of unvested share options per employee	1,000
Weighted average amount per employee to be recognised over the remainder of the vesting period for employee services to be rendered as consideration for the share options, determined in accordance with IFRS 2	CU1,200.00
Cash exercise price of unvested share options	CU15.00
Calculation of adjusted exercise price	
Fair value of services yet to be rendered per employee:	CU1,200.00
Fair value of services yet to be rendered per option: (CU1,200 ÷ 1,000)	CU1.20
Total exercise price of share options: (CU15.00 + CU1.20)	CU16.20

Whilst the standard requires that the additional deemed proceeds is the fair value of goods or services yet to be received, the example clarifies that it is the IFRS 2 expense yet to be charged to income.

What this requirement seeks to reflect is that for such options the issuer will receive not just the cash proceeds (if any) under the option when it is exercised but also valuable goods and services over its life. This will result in the dilutive effect of the options increasing over time as the deemed proceeds on exercise of the options reduces.

6.4.6 Contingently issuable shares

IAS 33 contains considerable detailed guidance, including a numerical worked example, on contingently issuable shares. Contingently issuable ordinary shares are defined as "ordinary shares issuable for little or no cash or other consideration upon satisfaction of specified conditions in a contingent share agreement." A contingent share agreement is defined by the standard as "an agreement to issue shares that is dependent on the satisfaction of specified conditions." *[IAS 33.5]*. The basic rule is that the number of contingently issuable shares to be included in the diluted EPS calculation is "based on the number of shares that would be issuable if the end of the period were the end of the contingency period". *[IAS 33.52]*. This requirement to look at the status of the contingency at the end of the reporting period, rather than to consider the most likely outcome, seems to have the overall result of reducing the amount of dilution disclosed.

The discussions in the standard cover three broad categories: earnings-based contingencies, share price-based contingencies, and other contingencies. These are discussed in turn below.

The number of shares contingently issuable may depend on future earnings and future prices of the ordinary shares. In such cases, the standard makes clear that the number of shares included in the diluted EPS calculation is based on both conditions (i.e., earnings to date and the current market price at the end of the reporting period). In other words, contingently issuable shares are not included in the diluted EPS calculation unless both conditions are met. *[IAS 33.55]*.

6.4.6.A Earnings-based contingencies

The standard discusses the scenario where shares would be issued contingent upon the attainment or maintenance of a specified amount of earnings for a period. In such a case the standard requires that: *[IAS 33.53]*

Extract from IAS 33	
53	… if that amount has been attained at the end of the reporting period but must be maintained beyond the end of the reporting period for an additional period, then the additional ordinary shares are treated as outstanding, if the effect is dilutive, when calculating diluted earnings per share. In that case, the calculation of diluted earnings per share is based on the number of ordinary shares that would be issued if the amount of earnings at the end of the reporting period were the amount of earnings at the end of the contingency period. …

As a result, earnings-based contingencies need to be viewed as an absolute cumulative hurdle which either is met or not met at the reporting date. Often, such contingencies may be contractually expressed in terms of annual performance over a number of years, say an average of CU1 million profit per year for three years. In such a scenario, 'the attainment or maintenance of a specified amount of earnings for a period' would mean generating a total of CU3 million of profits. If that is achieved by the end of a reporting period, the shares are outstanding for diluted EPS purposes and included in the computation if the effect is dilutive. It could, perhaps, be argued that the potential shares should be considered outstanding if profits of CU1 million were generated at the end of the first year. However, the requirement that the calculation be 'based on the number of ordinary shares that would be issued if the amount of earnings at the end of the reporting period were the amount of earnings at the end of the contingency period' means that the test must be: would shares be issued if the current earnings of CU1 million were all the profits earned by the end of the three-year contingency period? In this example, the answer is no, as that amount of earnings would fall short of averaging CU1 million per year. The standard then notes that, because earnings may change in a future period, the calculation of basic EPS does not include such contingently issuable shares until the end of the contingency period because not all necessary conditions have been satisfied. *[IAS 33.53]*.

An earnings-based contingency is shown in the following Illustration: *[IAS 33.IE7]*

Illustration 6-7: Contingently issuable shares

Ordinary shares outstanding during 20X2:	1,000,000 (there were no options, warrants or convertible instruments outstanding during the period)
An agreement related to a recent business combination provides for the issue of additional ordinary shares based on the following conditions:	5,000 additional ordinary shares for each new retail site opened during 20X2 1,000 additional ordinary shares for each CU1,000 of consolidated profit in excess of CU2,000,000 for the year ended 31 December 20X2
Retail sites opened during the year:	One on 1 May 20X2 One on 1 September 20X2
Consolidated year-to-date profit attributable to ordinary equity holders of the parent entity:	CU1,100,000 as of 31 March 20X2 CU2,300,000 as of 30 June 20X2 CU1,900,000 as of 30 September 20X2 (including a CU450,000 loss from a discontinued operation) CU2,900,000 as of 31 December 20X2

Basic earnings per share

	First quarter	Second quarter		Third quarter		Fourth quarter	Full year	
Numerator (CU)	1,100,000	1,200,000		(400,000)		1,000,000	2,900,000	
Denominator:								
Ordinary shares outstanding	1,000,000	1,000,000		1,000,000		1,000,000	1,000,000	
Retail site contingency	-	3,333	(a)	6,667	(b)	10,000	5,000	(c)
Earnings contingency	-	-		-		-	-	(d)
Total shares	1,000,000	1,003,333		1,006,667		1,010,000	1,005,000	
Basic earnings per share (CU)	1.10	1.20		(0.40)		0.99	2.89	

(a) 5,000 shares × 2/3
(b) 5,000 shares + (5,000 shares × 1/3)
(c) (5,000 shares × 8/12) + (5,000 shares × 4/12)
(d) The earnings contingency has no effect on basic earnings per share because it is not certain that the condition is satisfied until the end of the contingency period. The effect is negligible for the fourth-quarter and full-year calculations because it is not certain that the condition is met until the last day of the period.

Diluted earnings per share

	First quarter		Second quarter		Third quarter		Fourth quarter		Full year	
Numerator (CU)	1,100,000		1,200,000		(400,000)		1,000,000		2,900,000	
Denominator:										
Ordinary shares outstanding	1,000,000		1,000,000		1,000,000		1,000,000		1,000,000	
Retail site contingency	-		5,000		10,000		10,000		10,000	
Earnings contingency	-	(e)	300,000	(f)	-	(g)	900,000	(h)	900,000	(h)
Total shares	1,000,000		1,305,000		1,010,000		1,910,000		1,910,000	
Diluted earnings per share (CU)	1.10		0.92		(0.40)	(i)	0.52		1.52	

(e) Year-to-date profits do not exceed CU2,000,000 at 31 March 20X2. The Standard does not permit projecting future earnings levels and including the related contingent shares.

(f) [(CU2,300,000 - CU2,000,000) ÷ 1,000] × 1,000 shares = 300,000 shares.

(g) Year-to-date profit is less than CU2,000,000.

(h) [(CU2,900,000 - CU2,000,000) ÷ 1,000] × 1,000 shares = 900,000 shares.

(i) Because the loss during the third quarter is attributable to a loss from a discontinued operation, the antidilution rules do not apply. The control number (i.e., profit or loss from continuing operations attributable to the equity holders of the parent entity) is positive. Accordingly, the effect of potential ordinary shares is included in the calculation of diluted earnings per share.

This example from IAS 33 illustrates quarterly financial reporting. However, the principles are the same whether the reporting period is illustrated as three months or one year. The example does illustrate that the earnings target is a cumulative hurdle over the entire contingency period (four reporting periods in the example) rather than including potential shares based on the assumption that the level of quarterly profit would be maintained for the four quarters.

The standard only discusses earnings criteria based on absolute measures; in the example above a cumulative profit in excess of CU2,000,000. In our experience such criteria are rare. In practice, criteria are often phrased in terms of relative performance against an external benchmark. Examples would be earnings growth targets of inflation plus 2% or EPS growth being in the top quartile of a group of competitors. For contingencies such as these it is impossible to establish an absolute target in order to ask whether it is met at the period end. For example, consider the earnings contingency in IAS 33, discussed above, to achieve profits in excess of CU2,000,000 over four quarters. If this instead required the profits to be CU2,000,000 adjusted in line with inflation, it would be impossible to know how many shares would be issued if the cumulative profit at the end of the second quarter of CU2,300,000 were the amount of earnings at the end of the contingency period. Until the end of the year the absolute level of profit required would be unknown; it would be more or less than CU2,000,000 depending on the level of inflation or deflation over the period.

There would seem to be (at least) two different ways of interpreting the requirements of IAS 33 in such a scenario, each resulting in a different diluted EPS figure. One approach would be to consider such criteria as being based on 'a condition other than earnings or market price'. That would mean (as discussed in section 6.4.6.C below) that the number of shares brought into diluted EPS would be based on the status of the condition at the end of the reporting period. *[IAS 33.56]*. If the target was earnings for the year in excess of CU2,000,000 adjusted in line with inflation and at the end of the second quarter inflation had been 4%, then the target would become CU2,080,000 and hence 220,000 shares would be included for diluted EPS for the second quarter. An alternative approach would be to regard it as an earnings-based contingency and make an assumption as to future inflation over the contingency period. This would allow a cumulative hurdle to be calculated and compared with actual earnings to date. If at the end of the second quarter it was estimated that the annual inflation for the year was 5%, then the target would become CU2,100,000 and hence 200,000 shares would be included for diluted EPS for the second quarter. Given the lack of clarity in the standard, it seems likely that either of the above approaches may be selected in practice.

6.4.6.B Share price-based contingencies

The provisions here are more straightforward. In these cases, if the effect is dilutive, the calculation of diluted EPS is based on the number of shares that would be issued if the market price at the end of the reporting period were the market price at the end of the contingency period. If the condition is based on an average of market prices over a period of time that extends beyond the end of the reporting period, the average for the period of time that has lapsed is used. Again the standard explains that, because the market price may change in a future period, the calculation of basic earnings per share does not include such contingently issuable ordinary shares until the end of the contingency period because not all necessary conditions have been satisfied. *[IAS 33.54]*.

6.4.6.C Other contingencies

The requirement regarding contingencies not driven by earnings or share price is as follows: "assuming that the present status of the condition remains unchanged until the end of the contingency period, the contingently issuable ordinary shares are included in the calculation of diluted earnings per share according to the status at the end of the reporting period." *[IAS 33.56]*. The standard illustrates the 'other contingency' rules by the example of shares being issued depending upon the opening of a specified number of retail sites, and such a contingency is included in the numerical example in the standard (see Illustration 6-7 in section 6.4.6.A above). As is the case for earnings-based contingencies discussed above, it would seem that such conditions are always deemed to be expressed as a cumulative hurdle which may or may not be met by the end of the reporting period. Accordingly, the required treatment would be the same if the condition had been expressed in terms of achieving a certain average annual level of shop openings.

6.4.7 Potential ordinary shares of investees

A subsidiary, joint venture or associate may issue to parties other than the parent or investors with joint control of, or significant influence over the investee potential ordinary shares that are convertible into either ordinary shares of the subsidiary, joint venture or associate, or ordinary shares of the parent or investors with joint control of, or significant influence over the investee (the reporting entity). If these potential ordinary shares of the subsidiary, joint venture or associate have a dilutive effect on the basic EPS of the reporting entity, they are included in the calculation of diluted earnings per share. *[IAS 33.40]*.

The standard requires that such potential ordinary shares be included in the calculation of diluted EPS as follows:

(a) Instruments issued by a subsidiary, joint venture or associate that enable their holders to obtain ordinary shares of the subsidiary, joint venture or associate are to be included in calculating the diluted EPS data of the subsidiary, joint venture or associate. Those EPS are then included in the reporting entity's EPS calculations based on the reporting entity's holding of the instruments of the subsidiary, joint venture or associate.

(b) Instruments of a subsidiary, joint venture or associate that are convertible into the reporting entity's ordinary shares are to be considered among the potential ordinary shares of the reporting entity for the purpose of calculating diluted EPS. Similarly, options or warrants issued by a subsidiary, joint venture or associate to purchase ordinary shares of the reporting entity are considered among the potential ordinary shares of the reporting entity in the calculation of consolidated diluted EPS. *[IAS 33.A11]*.

For the purpose of determining the EPS effect of instruments issued by a reporting entity that are convertible into ordinary shares of a subsidiary, joint venture or associate, the standard requires that the instruments are assumed to be converted and the numerator (profit or loss attributable to ordinary equity holders of the parent entity) adjusted as necessary in accordance with the normal rules (see section 6.2.1 above). In addition to those adjustments, the numerator is adjusted for any change in the profit or loss recorded by the reporting entity (such as dividend income or equity method income) that is attributable to the increase in the number of ordinary shares of the subsidiary, joint venture or associate outstanding as a result of the assumed conversion. The denominator of the diluted EPS calculation is not affected because the number of ordinary shares of the reporting entity outstanding would not change upon assumed conversion. *[IAS 33.A12]*.

The computation under (a) above is shown in the following Illustration. *[IAS 33.IE10]*.

Illustration 6-8: Warrants issued by a subsidiary

Parent:

Profit attributable to ordinary equity holders of the parent entity	CU12,000 (excluding any earnings of, or dividends paid by, the subsidiary)
Ordinary shares outstanding	10,000
Instruments of subsidiary owned by the parent	800 ordinary shares 30 warrants exercisable to purchase ordinary shares of subsidiary 300 convertible preference shares

Subsidiary:

Profit	CU5,400
Ordinary shares outstanding	1,000
Warrants	150, exercisable to purchase ordinary shares of the subsidiary
Exercise price	CU10
Average market price of one ordinary share	CU20
Convertible preference shares	400, each convertible into one ordinary share
Dividends on preference shares	CU1 per share

No inter-company eliminations or adjustments were necessary except for dividends.

For the purposes of this Illustration, income taxes have been ignored.

Subsidiary's earnings per share

Basic EPS CU5.00 calculated: $\frac{CU5{,}400^{(a)} - CU400^{(b)}}{1{,}000^{(c)}}$

Diluted EPS CU3.66 calculated: $\frac{CU5{,}400^{(d)}}{1{,}000 + 75^{(e)} + 400^{(f)}}$

(a) Subsidiary's profit attributable to ordinary equity holders.
(b) Dividends paid by subsidiary on convertible preference shares.
(c) Subsidiary's ordinary shares outstanding.
(d) Subsidiary's profit attributable to ordinary equity holders (CU5,000) increased by CU400 preference dividends for the purpose of calculating diluted earnings per share.
(e) Incremental shares from warrants, calculated: [(CU20 - CU10) ÷ CU20] × 150.
(f) Subsidiary's ordinary shares assumed outstanding from conversion of convertible preference shares, calculated: 400 convertible preference shares × conversion factor of 1.

Consolidated earnings per share

Basic EPS CU1.63 calculated: $\frac{CU12{,}000^{(g)} - CU4{,}300^{(h)}}{10{,}000^{(i)}}$

Diluted EPS CU1.61 calculated: $\frac{CU12{,}000 + CU2{,}928^{(j)} + CU55^{(k)} + CU1{,}098^{(l)}}{10{,}000}$

(g) Parent's profit attributable to ordinary equity holders of the parent entity.
(h) Portion of subsidiary's profit to be included in consolidated basic earnings per share, calculated: (800 × CU5.00) + (300 × CU1.00)
(i) Parent's ordinary shares outstanding.
(j) Parent's proportionate interest in subsidiary's earnings attributable to ordinary shares, calculated: (800 ÷ 1,000) × (1,000 shares × CU3.66 per share)
(k) Parent's proportionate interest in subsidiary's earnings attributable to warrants, calculated: (30 ÷ 150) × (75 incremental shares × CU3.66 per share)
(l) Parent's proportionate interest in subsidiary's earnings attributable to convertible preference shares, calculated: (300 ÷ 400) × (400 shares from conversion × CU3.66 per share)

This example does not illustrate the classification of the components of convertible financial instruments as liabilities and equity or the classification of related interest and dividends as expenses and equity as required by IAS 32.

6.4.8 Contingently issuable potential ordinary shares

The standard requires contingently issuable potential ordinary shares (other than those covered by a contingent share agreement, such as contingently issuable convertible instruments) to be included in the diluted EPS calculation as follows:

(a) Determine whether the potential ordinary shares may be assumed to be issuable on the basis of the conditions specified for their issue in accordance with the provisions of the standard for contingent ordinary shares (see section 6.4.6 above).

(b) If on this basis, those potential ordinary shares are to be reflected in diluted EPS, determine their impact on the calculation of diluted earnings per share by following the provisions of the standard for that type of potential ordinary share.

However, exercise or conversion is not to be assumed for the purpose of calculating diluted earnings per share unless exercise or conversion of similar outstanding potential ordinary shares that are not contingently issuable is assumed. *[IAS 33.57]*.

7 Presentation, restatement and disclosure

7.1 Presentation

As discussed in Chapter 3 at section 3.2.1, IAS 1 requires (and at the latest for periods beginning on or after 1 January 2027, IFRS 18 requires - see chapter 4 at section 1.2) that all items of income and expense be presented either:

(a) In a single statement of profit or loss and comprehensive income

Or

(b) In two separate statements:

(i) A statement of profit or loss

And

(ii) A statement, beginning with profit or loss, presenting items of other comprehensive income *[IAS 1.10A]*

If the approach in (b) is followed, the separate statement of profit or loss must be displayed immediately before the statement of comprehensive income. *[IAS 1.10A]*.

If (a) is adopted, the EPS presentational requirements below apply to that single statement. If (b) is chosen, the requirements apply to the separate statement of profit or loss only and not the separate statement of comprehensive income. *[IAS 33.4A, IAS 33.67A, IAS 33.68A]*.

IAS 33 requires the presentation of basic and diluted EPS (with equal prominence and even if the amounts are negative - i.e., a loss per share) for each period for which a statement of comprehensive income (or separate income statement) is presented. *[IAS 33.66, IAS 33.69]*. This is required for the profit or loss attributable to ordinary equity holders for:

(a) Overall profit

(b) Profit or loss from continuing operations

And

(c) Profit or loss from discontinued operations, if any *[IAS 33.66, IAS 33.68]*

In the case of (a) and (b), separate figures are required for each class of ordinary shares with a different right to share in profits for the period. The figures for (a) and (b) must be displayed on the face of the statement. *[IAS 33.66]*. Those for (c) may be either on the face or in the notes. *[IAS 33.68]*. The standard states that if diluted EPS is given for at least one period it must be given for all periods presented. IAS 33 notes that if basic and diluted EPS are equal, dual presentation can be accomplished in one line in the statement. *[IAS 33.67]*.

Regarding (c), the wording of the standard is not very clear. In particular, if an entity has more than one discontinued operation it does not specify whether separate EPS disclosures are required for each or whether one aggregate figure is needed. The wording leans to the former, as it uses the singular - "An entity that reports a discontinued operation shall disclose the basic and diluted amounts per share for the discontinued operation …". However, IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* only requires the statement of comprehensive income (or separate income statement) to identify the total result from all discontinued operations. *[IFRS 5.33]*. The presentation of EPS data in addition to that required by IAS 33 is discussed in section 5.5 above.

7.2 Restatement

IAS 33 contains requirements to restate prior periods' EPS for events that change the number of shares outstanding without a corresponding change in resources. Additionally, it specifies circumstances when EPS is not to be restated.

Basic and diluted EPS for all periods presented is to be adjusted for:

- Events (other than the conversion of potential ordinary shares) which change the number of ordinary shares without a corresponding change in resources (discussed in section 4.3 above) *[IAS 33.26, IAS 33.64]*
- The effects of errors and adjustments resulting from changes in accounting policies accounted for retrospectively (see section 5.3 above) *[IAS 33.64]*
- The effects of group reorganisations that are accounted for as a pooling of interests (discussed in section 4.6 above)

No adjustment is to be made:

- To basic or diluted EPS when a share consolidation is combined with a special dividend where the overall commercial effect is that of a share repurchase at fair value (discussed in section 4.3.2 above) *[IAS 33.29]*
- To previously reported diluted EPS due to changes in the prices of ordinary shares which would have given a different dilutive effect for options and warrants *[IAS 33.47]*
- To prior period diluted EPS as a result of a contingency period coming to an end without the conditions attaching to contingently issuable shares being met *[IAS 33.52]*

  Or

- To prior period diluted EPS for changes in the assumptions used in the calculations or for the conversion of potential ordinary shares into ordinary shares *[IAS 33.65]*

7.3 Disclosure

IAS 33 requires disclosure of the following:

(a) The amounts used as the numerators in calculating basic and diluted EPS, and a reconciliation of those amounts to profit or loss attributable to the parent entity for the period. The reconciliation must include the individual effect of each class of instruments that affects EPS.

(b) The weighted average number of ordinary shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other. The reconciliation must include the individual effect of each class of instruments that affects EPS.

(c) Instruments (including contingently issuable shares) that could potentially dilute basic EPS in the future, but were not included in the calculation because they were antidilutive for the period(s) presented.

(d) A description of ordinary share transactions or potential ordinary share transactions (other than those accounted for in EPS for the year - see section 4.3 above - in which case that fact is to be stated), that occur after the end of the reporting period and that would have changed significantly the number of ordinary shares or potential ordinary shares outstanding at the end of the period if those transactions had occurred before the end of the reporting period. *[IAS 33.70]*.

Examples of transactions in (d) include:

(a) An issue of shares for cash

(b) An issue of shares when the proceeds are used to repay debt or preference shares outstanding at the end of the reporting period

(c) The redemption of ordinary shares outstanding

(d) The conversion or exercise of potential ordinary shares outstanding at the end of the reporting period into ordinary shares

(e) An issue of options, warrants, or convertible instruments

(f) The achievement of conditions that would result in the issue of contingently issuable shares

The standard observes that EPS amounts are not adjusted for such transactions occurring after the reporting period because such transactions do not affect the amount of capital used to produce profit or loss for the period. *[IAS 33.71]*. Changes in ordinary shares are discussed in section 4 above.

The standard observes that financial instruments and other contracts generating potential ordinary shares may incorporate terms and conditions that affect the measurement of basic and diluted earnings per share. These terms and conditions may determine whether any potential ordinary shares are dilutive and, if so, the effect on the weighted average number of shares outstanding and any consequent adjustments to profit or loss attributable to ordinary equity holders. The disclosure of the terms and conditions of such financial instruments and other contracts is encouraged by IAS 33, if not otherwise required by IFRS 7 *Financial Instruments: Disclosures* (discussed in Chapter 50). *[IAS 33.72]*.

Appendix A – Comprehensive illustrative example

Reproduced below is the comprehensive worked example in IAS 33 of the computation and presentation of EPS. *[IAS 33.IE12]*. It illustrates four quarters and then the full year, but the principles and calculations would be the same whatever the length of the periods considered.

Extract from IAS 33 Illustrative Examples

Example 12 Calculation and presentation of basic and diluted earnings per share (comprehensive example)[2]

This example illustrates the quarterly and annual calculations of basic and diluted earnings per share in the year 20X1 for Company A, which has a complex capital structure. The control number is profit or loss from continuing operations attributable to the parent entity. Other facts assumed are as follows:

Average market price of ordinary shares: The average market prices of ordinary shares for the calendar year 20X1 were as follows:

First quarter	CU49
Second quarter	CU60
Third quarter	CU67
Fourth quarter	CU67

The average market price of ordinary shares from 1 July to 1 September 20X1 was CU65.

Ordinary shares: The number of ordinary shares outstanding at the beginning of 20X1 was 5,000,000. On 1 March 20X1, 200,000 ordinary shares were issued for cash.

Convertible bonds: In the last quarter of 20X0, 5 per cent convertible bonds with a principal amount of CU12,000,000 due in 20 years were sold for cash at CU1,000 (par). Interest is payable twice a year, on 1 November and 1 May. Each CU1,000 bond is convertible into 40 ordinary shares. No bonds were converted in 20X0. The entire issue was converted on 1 April 20X1 because the issue was called by Company A.

Convertible preference shares: In the second quarter of 20X0, 800,000 convertible preference shares were issued for assets in a purchase transaction. The quarterly dividend on each convertible preference share is CU0.05, payable at the end of the quarter for shares outstanding at that date. Each share is convertible into one ordinary share. Holders of 600,000 convertible preference shares converted their preference shares into ordinary shares on 1 June 20X1.

Warrants: Warrants to buy 600,000 ordinary shares at CU55 per share for a period of five years were issued on 1 January 20X1. All outstanding warrants were exercised on 1 September 20X1.

Options: Options to buy 1,500,000 ordinary shares at CU75 per share for a period of 10 years were issued on 1 July 20X1. No options were exercised during 20X1 because the exercise price of the options exceeded the market price of the ordinary shares.

Tax rate: The tax rate was 40 per cent for 20X1.

20X1	*Profit (loss) from continuing operations attributable to the parent entity*[(a)]	*Profit (loss) attributable to the parent entity*
	CU	CU
First quarter	5,000,000	5,000,000
Second quarter	6,500,000	6,500,000
Third quarter	1,000,000	(1,000,000)[(b)]
Fourth quarter	(700,000)	(700,000)
Full year	11,800,000	9,800,000

(a) This is the control number (before adjusting for preference dividends).
(b) Company A had a CU2,000,000 loss (net of tax) from discontinued operations in the third quarter.

2 "This example does not illustrate the classification of the components of convertible financial instruments as liabilities and equity or the classification of related interest and dividends as expenses and equity as required by IAS 32."

First Quarter 20X1

Basic EPS calculation				**CU**
Profit from continuing operations attributable to the parent entity				5,000,000
Less: preference share dividends				(40,000)[a]
Profit attributable to ordinary equity holders of the parent entity				4,960,000

Dates	*Shares outstanding*	*Fraction of period*	*Weighted- average shares*
1 January–28 February	5,000,000	$^2/_3$	3,333,333
Issue of ordinary shares on 1 March			
1 March–31 March	200,000	$^1/_3$	1,733,333
Weighted-average shares	5,200,000		5,066,666
Basic EPS			***CU0.98***

Diluted EPS calculation			
Profit attributable to ordinary equity holders of the parent entity			CU4,960,000
Plus: profit impact of assumed conversions			
Preference share dividends	CU40,000	(a)	
Interest on 5% convertible bonds	CU90,000	(b)	
Effect of assumed conversions			CU130,000
Profit attributable to ordinary equity holders of the parent entity including assumed conversions			CU5,090,000
Weighted-average shares			5,066,666
Plus: incremental shares from assumed conversions			
Warrants	0	(c)	
Convertible preference shares	800,000		
5% convertible bonds	480,000		
Dilutive potential ordinary shares			1,280,000
Adjusted weighted-average shares			6,346,666
Diluted EPS			***CU0.80***

(a) 800,000 shares × CU0.05
(b) (CU12,000,000 × 5%) ÷ 4; less taxes at 40%
(c) The warrants were not assumed to be exercised because they were antidilutive in the period (CU55 [exercise price] > CU49 [average price]).

Second Quarter 20X1

Basic EPS calculation			**CU**
Profit from continuing operations attributable to the parent entity			6,500,000
Less: preference share dividends			(10,000)[(a)]
Profit attributable to ordinary equity holders of the parent entity			6,490,000

Dates	*Shares outstanding*	*Fraction of period*	*Weighted- average shares*
1 April	5,200,000		
Conversion of 5% bonds on 1 April	480,000		
1 April–31 May	5,680,000	$^2/_3$	3,786,666
Conversion of preference shares 1 June	600,000		
1 June–30 June	6,280,000	$^1/_3$	2,093,333
Weighted-average shares			5,880,000
Basic EPS			***CU1.10***

Diluted EPS calculation		
Profit attributable to ordinary equity holders of the parent entity		CU6,490,000
Plus: profit impact of assumed conversions		
Preference share dividends	CU10,000[(a)]	
Effect of assumed conversions		CU10,000
Profit attributable to ordinary equity holders of the parent entity including assumed conversions		CU6,500,000
Weighted-average shares		5,880,000
Plus: incremental shares from assumed conversions		
Warrants	50,000[(b)]	
Convertible preference shares	600,000[(c)]	
Dilutive potential ordinary shares		650,000
Adjusted weighted-average shares		6,530,000
Diluted EPS		***CU1.00***

(a) 200,000 shares × CU0.05

(b) CU55 × 600,000 = CU33,000,000; CU33,000,000 ÷ CU60 = 550,000; 600,000 - 550,000 = 50,000 shares OR [(CU60 – CU55) ÷ CU60] × 600,000 shares = 50,000 shares

(c) (800,000 shares × 2/3) + (200,000 shares × 1/3)

Third Quarter 20X1

Basic EPS calculation			**CU**
Profit from continuing operations attributable to the parent entity			1,000,000
Less: preference share dividends			(10,000)
Profit from continuing operations attributable to ordinary equity holders of the parent entity			990,000
Loss from discontinued operations attributable to the parent entity			(2,000,000)
Loss attributable to ordinary equity holders of the parent entity			(1,010,000)
Dates	*Shares outstanding*	*Fraction of period*	*Weighted- average shares*
1 July–31 August	6,280,000	$^{2}/_{3}$	4,186,666
Exercise of warrants on 1 September	600,000		
1 September–30 September	6,880,000	$^{1}/_{3}$	2,293,333
Weighted-average shares			6,480,000
Basic EPS			
Profit from continuing operations			***CU0.15***
Loss from discontinued operations			***(CU0.31)***
Loss			***(CU0.16)***
Diluted EPS calculation			
Profit from continuing operations attributable to ordinary equity holders of the parent entity			CU990,000
Plus: profit impact of assumed conversions			
Preference share dividends		CU10,000	
Effect of assumed conversions			CU10,000
Profit from continuing operations attributable to ordinary equity holders of the parent entity including assumed conversions			CU1,000,000
Loss from discontinued operations attributable to the parent entity			(CU2,000,000)
Loss attributable to ordinary equity holders of the parent entity including assumed conversions			(CU1,000,000)
Weighted-average shares			6,480,000
Plus: incremental shares from assumed conversions			
Warrants		61,538[(a)]	
Convertible preference shares		200,000	
Dilutive potential ordinary shares			261,538
Adjusted weighted-average shares			6,741,538
Diluted EPS			
Profit from continuing operations			***CU0.15***
Loss from discontinued operations			***(CU0.30)***
Loss			***(CU0.15)***

(a) [(CU65 − CU55) ÷ CU65] × 600,000 = 92,308 shares; 92,308 × 2/3 = 61,538 shares

Note: The incremental shares from assumed conversions are included in calculating the diluted per-share amounts for the loss from discontinued operations and loss even though they are antidilutive. This is because the control number (profit from continuing operations attributable to ordinary equity holders of the parent entity, adjusted for preference dividends) was positive (ie profit, rather than loss).

Fourth Quarter 20X1

Basic EPS calculation			**CU**
Loss from continuing operations attributable to the parent entity			(700,000)
Add: preference share dividends			(10,000)
Loss attributable to ordinary equity holders of the parent entity			(710,000)
Dates	*Shares outstanding*	*Fraction of period*	*Weighted- average shares*
1 October–31 December	6,880,000	$^{3}/_{3}$	6,880,000
Weighted-average shares			6,880,000
Basic and diluted EPS			
Loss attributable to ordinary equity holders of the parent entity			***(CU0.10)***

Note: The incremental shares from assumed conversions are not included in calculating the diluted per-share amounts because the control number (loss from continuing operations attributable to ordinary equity holders of the parent entity adjusted for preference dividends) was negative (ie a loss, rather than profit).

Full Year 20X1

Basic EPS calculation			**CU**
Profit from continuing operations attributable to the parent entity			11,800,000
Less: preference share dividends			(70,000)
Profit from continuing operations attributable to ordinary equity holders of the parent entity			11,730,000
Loss from discontinued operations attributable to the parent entity			(2,000,000)
Profit attributable to ordinary equity holders of the parent entity			9,730,000
Dates	*Shares outstanding*	*Fraction of period*	*Weighted- average shares*
1 January–28 February	5,000,000	$^{2}/_{12}$	833,333
Issue of ordinary shares on 1 March	200,000		
1 March–31 March	5,200,000	$^{1}/_{12}$	433,333
Conversion of 5% bonds on 1 April	480,000		
1 April–31 May	5,680,000	$^{2}/_{12}$	946,667
Conversion of preference shares on 1 June	600,000		
1 June–31 August	6,280,000	$^{3}/_{12}$	1,570,000
Exercise of warrants on 1 September	600,000		
1 September–31 December	6,880,000	$^{4}/_{12}$	2,293,333
Weighted-average shares			6,076,667
Basic EPS			
Profit from continuing operations			***CU1.93***
Loss from discontinued operations			***(CU0.33)***
Profit			***CU1.60***

Diluted EPS calculation		
Profit from continuing operations attributable to ordinary equity holders of the parent entity		CU11,730,000
Plus: profit impact of assumed conversions		
Preference share dividends	CU70,000	
Interest on 5% convertible bonds	CU90,000[(a)]	
Effect of assumed conversions		CU160,000
Profit from continuing operations attributable to ordinary equity holders of the parent entity including assumed conversions		CU11,890,000
Loss from discontinued operations attributable to the parent entity		(CU2,000,000)
Profit attributable to ordinary equity holders of the parent entity including assumed conversions		CU9,890,000
Weighted-average shares		6,076,667
Plus: incremental shares from assumed conversions		
Warrants	14,880[(b)]	
Convertible preference shares	450,000[(c)]	
5% convertible bonds	120,000[(d)]	
Dilutive potential ordinary shares		584,880
Adjusted weighted-average shares		6,661,547
Diluted EPS		
Profit from continuing operations		***CU1.78***
Loss from discontinued operations		***(CU0.30)***
Profit		***CU1.48***

(a) (CU12,000,000 × 5%) ÷ 4; less taxes at 40%.
(b) [(CU57.125* – CU55) ÷ CU57.125] × 600,000 = 22,320 shares; 22,320 × 8/12 = 14,880 shares*.
The average market price from 1 January 20X1 to 1 September 20X1.
(c) (800,000 shares × 5/12) + (200,000 shares × 7/12).
(d) 480,000 shares × 3/12.

The following illustrates how Company A might present its earnings per share data in its statement of comprehensive income. Note that the amounts per share for the loss from discontinued operations are not required to be presented in the statement of comprehensive income.

	For the year ended 20X1
	CU
Earnings per ordinary share	
Profit from continuing operations	1.93
Loss from discontinued operations	(0.33)
Profit	1.60
Diluted earnings per ordinary share	
Profit from continuing operations	1.78
Loss from discontinued operations	(0.30)
Profit	1.48

The following table includes the quarterly and annual earnings per share data for Company A. The purpose of this table is to illustrate that the sum of the four quarters' earnings per share data will not necessarily equal the annual earnings per share data. The Standard does not require disclosure of this information.

	First quarter	*Second quarter*	*Third quarter*	*Fourth quarter*	*Full year*
	CU	**CU**	**CU**	**CU**	**CU**
Basic EPS					
Profit (loss) from continuing operations	0.98	1.10	0.15	(0.10)	1.93
Loss from discontinued operations	-	-	(0.31)	-	(0.33)
Profit (loss)	0.98	1.10	(0.16)	(0.10)	1.60
Diluted EPS					
Profit (loss) from continuing operations	0.80	1.00	0.15	(0.10)	1.78
Loss from discontinued operations	-	-	(0.30)	-	(0.30)
Profit (loss)	0.80	1.00	(0.15)	(0.10)	1.48

The example above does not illustrate the classification of the components of convertible financial instruments as liabilities and equity or the classification of related interest and dividends as expenses and equity as required by IAS 32.

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Appendix C - Defined terms

Extract from IAS 33

5 The following terms are used in this Standard with the meanings specified:

Antidilution is an increase in earnings per share or a reduction in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

A *contingent share agreement* is an agreement to issue shares that is dependent on the satisfaction of specified conditions.

Contingently issuable ordinary shares are ordinary shares issuable for little or no cash or other consideration upon the satisfaction of specified conditions in a contingent share agreement.

Dilution is a reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

Options, warrants and their equivalents are financial instruments that give the holder the right to purchase ordinary shares.

An *ordinary share* is an equity instrument that is subordinate to all other classes of equity instruments.

A *potential ordinary share* is a financial instrument or other contract that may entitle its holder to ordinary shares.

Put options on ordinary shares are contracts that give the holder the right to sell ordinary shares at a specified price for a given period.

Chapter 34 Events after the reporting period

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Overview

IAS 10 *Events after the Reporting Period*[1] sets out the circumstances in which financial statements must be adjusted for events which have happened after the reporting period, the disclosures an entity must give about the date on which the financial statements were authorised for issue, and the required disclosures relating to events after the reporting period.

Events after the reporting period are those events, both favourable and non-favourable, which occur between the last day of the reporting period and the date on which the financial statements are authorised for issue. IAS 10 divides such events into two categories: adjusting and non-adjusting events. Adjusting events provide evidence of conditions which existed at the end of the reporting period and, consequently, an entity is required to adjust the amounts recognised in its financial statements to reflect those events. This may require the recognition of a previously unrecognised item. Conversely, no adjustment is made for non-adjusting events, though disclosure is required for such events, to the extent that the events are material to the financial statements. *[IAS 10.21]*.

IAS 10 does not permit an entity to prepare its financial statements on a going concern basis if events after the reporting period indicate that the going concern assumption is no longer appropriate.

What you need to know

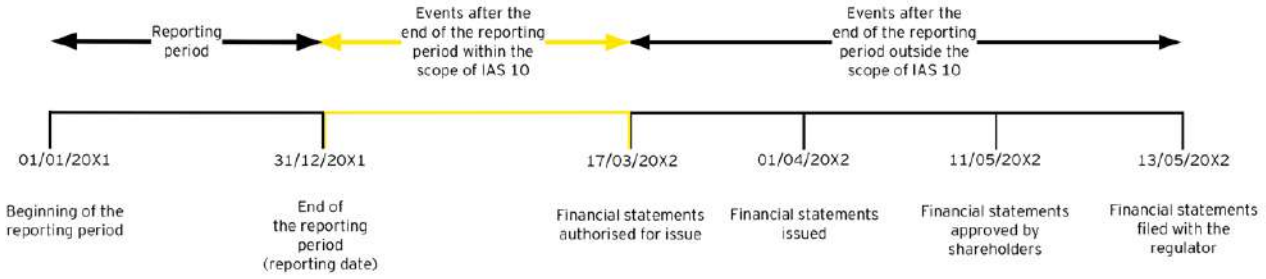
- IAS 10 identifies two types of events after the reporting period: adjusting and non-adjusting.
- Adjusting events are events which provide evidence of conditions which existed at the end of the reporting period; amounts recognised in financial statements are adjusted for such events.
- Non-adjusting events are indicative of conditions which arose after the reporting period, but before the financial statements were authorised for issue; amounts recognised in the financial statements are not adjusted for such events, but those events are required to be disclosed, to the extent material.
- When the going concern basis of accounting becomes inappropriate after the end of the reporting period, an entity is required to change its basis of accounting.

1 IFRS 18 *Presentation and Disclosure in Financial Statements*, which supersedes IAS 1 *Presentation of Financial Statements* for reporting periods beginning on or after 1 January 2027 (with earlier application permitted), was issued by the IASB in April 2024, which incorporates amendments to paragraphs 13 and 16 of IAS 10, which merely entails replacing references from IAS 1 to the appropriate updated IFRS 18 and IAS 8(2027) *Basis of Preparation of Financial Statements* references. An entity shall apply these amendments when it applies IFRS 18. See Chapter 4 for further details on the new concepts and requirements of IFRS 18. *[IAS 10(2027).13, IAS 10(2027).16, IAS 10(2027).23D]*.

1 Introduction

IAS 10 deals with accounting for, and disclosure of "those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue". *[IAS 10.2, IAS 10.3, IAS 10.7]*. This definition includes all events occurring between those dates *[IAS 10.7]*. The principal issue is determining which of these events are required to be reflected in the financial statements as adjustments, which are material enough to require additional disclosure, and which require neither adjustment nor disclosure.

The following timeline illustrates events after the end of the reporting period that are within the scope of IAS 10 for an entity with a 31 December year-end:



The financial statements of an entity present, among other things, its financial position at the end of the reporting period. Therefore, it is appropriate to adjust the financial statements for all events that offer greater clarity about conditions that existed at the end of the reporting period (reporting date), and which occur prior to the date the financial statements are authorised for issue. The standard, therefore, requires entities to adjust the amounts recognised in the financial statements for 'adjusting events', events that provide evidence of conditions that existed at the end of the reporting period. *[IAS 10.3(a), IAS 10.8]*. By the same reasoning an entity does not recognise in the financial statements those events that relate to conditions that arose after the reporting period ('non-adjusting events'). However, if non-adjusting events are material (that is, non-disclosure of the event could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements), certain disclosures are required. *[IAS 10.3(b), IAS 10.10, IAS 10.21, IAS 1.7, IFRS 18 Appendix A, IAS 8.5, IAS 8(2027).5]*.

One exception to the general rule for non-adjusting events is when the going concern basis becomes inappropriate. This is always treated as an adjusting event. *[IAS 10.1, IAS 10.14, IAS 10.15]*.

The requirements of IAS 10 and some practical issues resulting from these requirements are dealt with in section 2 and section 3 below, respectively.

Differences between the IFRS accounting standards and US GAAP guidance on this topic are not addressed in this chapter as the standards are not converged. Therefore, differences between IFRS accounting standards and US GAAP may exist that are not discussed in this chapter.

2 Requirements of IAS 10

2.1 Objective, scope and definitions

Extract from IAS 10

Objective

1 The objective of this Standard is to prescribe:

(a) when an entity should adjust its financial statements for events after the reporting period; and

(b) the disclosures that an entity should give about the date when the financial statements were authorised for issue and about events after the reporting period.

The Standard also requires that an entity should not prepare its financial statements on a going concern basis if events after the reporting period indicate that the going concern assumption is not appropriate.

The standard does not permit an entity to prepare its financial statements on a going concern basis if events after the reporting period indicate that the going concern assumption is not appropriate. *[IAS 10.1, IAS 10.14]*. This requirement is discussed further in section 2.2.2 below. The going concern basis is discussed in Chapter 3 at section 4.1.2.

IAS 10 defines events after the reporting period as "those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue". *[IAS 10.3]*. This definition includes events that provide additional evidence about conditions that existed at the end of the reporting period, as well as those that provide evidence of conditions that only existed after the end of the reporting period. The former are adjusting events, the latter are non-adjusting events. *[IAS 10.3]*. Adjusting and non-adjusting events are discussed further in section 2.1.2 and section 2.1.3 below, respectively.

2.1.1 Date when financial statements are authorised for issue

Given the definition above, the meaning of "the date when the financial statements are authorised for issue" is important. The standard observes that the process for authorising financial statements for issue varies depending upon the management structure, statutory requirements and procedures followed in preparing and finalising the financial statements. *[IAS 10.4]*.

The standard sets out two particular examples of different meanings of 'authorised for issue' as follows:

(a) An entity may be required to submit its financial statements to its shareholders for approval after the financial statements have been issued. In such cases, the financial statements are authorised for issue on the date of issue, not the date when shareholders approve them. *[IAS 10.5]*.

(b) The management of an entity may be required to issue its financial statements to a supervisory board (made up solely of non-executives) for approval. Such financial statements are authorised for issue when management authorises them for issue to the supervisory board. *[IAS 10.6]*.

These two meanings are shown in the following two Illustrations, which are based on the illustrative examples in IAS 10. *[IAS 10.5, IAS 10.6]*.

Illustration 2-1: Financial statements required to be approved by shareholders

The management of an entity completes draft financial statements for the year to 31 December 20X1 on 28 February 20X2. On 17 March 20X2, the board of directors reviews the financial statements and authorises them for issue. The entity announces its profit and certain other financial information on 18 March 20X2. The financial statements are made available to shareholders and others on 1 April 20X2. The shareholders approve the financial statements at their annual meeting on 11 May 20X2 and the approved financial statements are then filed with a regulatory body on 13 May 20X2.

The financial statements are authorised for issue on 17 March 20X2 (date of board authorisation for issue).

Illustration 2-2: Financial statements required to be approved by supervisory board

On 17 March 20X2, the management of an entity authorises for issue to its supervisory board financial statements for the year ended 31 December 20X1. The supervisory board consists solely of non-executives and may include representatives of employees and other outside interests. The supervisory board approves the financial statements on 25 March 20X2. The financial statements are made available to shareholders and others on 1 April 20X2. The shareholders approve the financial statements at their annual meeting on 11 May 20X2 and the financial statements are filed with a regulatory body on 13 May 20X2.

The financial statements are authorised for issue on 17 March 20X2 (date of management authorisation for issue to the supervisory board).

An uncommon, but possible, situation that can occur is that the financial statements are changed after they are authorised for issue to the supervisory board. The following Illustration demonstrates such a situation.

Illustration 2-3: Financial statements required to be approved by supervisory board - changes are made by supervisory board

This Illustration assumes the same facts as in Illustration 2-2 above, except that the supervisory board reviews the financial statements on 25 March 20X2 and proposes changes to certain note disclosures. The management of the entity incorporates the suggested changes and re-authorises those financial statements for issue to the supervisory board on 27 March 20X2. The supervisory board then approves the financial statements on 30 March 20X2.

The financial statements are authorised for issue on 27 March 20X2 (date of management re-authorisation for issue to the supervisory board). The financial statements were originally authorised for issue on 17 March 20X2 but have been amended and re-authorised on 27 March 20X2. This later date supersedes the original date.

As governance structures vary by jurisdiction, entities may be allowed to organise their procedures differently and adjust the financial reporting process accordingly.

An example of a company which is required to submit its financial statements to its shareholders for approval is Holcim Ltd, as illustrated in the following Practical example:

Practical example 2-1: Holcim Ltd (2023) Switzerland

2023 INTEGRATED ANNUAL REPORT [extract]

FINANCIAL INFORMATION [extract]

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]

21. Authorization of the financial statements for issuance

The consolidated financial statements were authorized for issuance by the Board of Directors of Holcim Ltd on 27 February 2024 and are subject to shareholder approval at the Annual General Meeting of shareholders scheduled for 8 May 2024.

As discussed above, an entity may be required to issue its financial statements to a supervisory board (made up solely of non-executives) for approval. The phrase 'made up solely of non-executives' is not defined by the standard, but it is clear from an illustrative example in the standard that it contemplates representatives of employees and other outside interests. The standard also seems to draw a distinction between those responsible for the executive management of an entity (and the preparation of its financial statements) and those in a position of high-level oversight (including reviewing and approving the financial statements). This situation seems to describe the typical two-tier board system seen in some jurisdictions. An example of a company with this structure is Bayer Aktiengesellschaft, as illustrated in the following Practical example.

Practical example 2-2:	Bayer Aktiengesellschaft (2023)	Germany

Annual Report 2023 [extract]

A/Combined Management Report [extract]

4. Corporate Governance Report [extract]

4.1 Declaration by Corporate Management Pursuant to Sections 289f and 315d of the German Commercial Code [extract]

Information on corporate governance practices

Bayer AG is subject to German stock corporation law and therefore has a dual governance system consisting of the Board of Management and the Supervisory Board, which manage the company based on a transparent strategy that is geared toward its long-term success and complies with applicable law and ethical standards.

...

Supervisory Board [extract]

Procedure and committees

The role of the Supervisory Board is to oversee and advise the Board of Management. The Supervisory Board is directly involved in decisions on matters of fundamental importance to the company, regularly conferring with the Board of Management on the company's strategic alignment and the implementation status of the business strategy. The Report of the Supervisory Board in this Annual Report provides details about the work of the Supervisory Board and its committees. In addition to the Presidial Committee and

...

Report of the Supervisory Board [extract]

Financial Statements and Audits [extract]

We have approved the financial statements of Bayer AG and the consolidated financial statements of the Bayer Group prepared by the Board of Management. The financial statements of Bayer AG are thus confirmed. We are in agreement with the Combined Management Report and, in particular, with the as-

...

2.1.1.A Impact of preliminary reporting

The Illustration below discusses the date of authorisation, in situations where the entity releases preliminary information, but not complete financial statements, before the date of the authorisation for issue.

Illustration 2-4:	Release of financial information before date of authorisation for issue

The management of an entity completes the primary financial statements for the year to 31 December 20X1 on 21 January 20X2, but has not yet completed the explanatory notes. On 26 January 20X2, the board of directors (which includes management and non-executives) reviews the primary financial statements and authorises them for public media release. The entity announces its profit and certain other financial information on 28 January 20X2. On 11 February 20X2, management issues the financial statements (with full explanatory notes) to the board of directors, which approves the financial statements for filing on 18 February 20X2. The entity files the financial statements with a regulatory body on 21 February 20X2.

The financial statements are authorised for issue on 18 February 20X2 (date the board of directors approves the financial statements for filing).

Illustration 2-4 shows that events after the reporting period include all events up to the date when the financial statements are authorised for issue, even if those events occur after the public announcement of profit or of other selected financial information. *[IAS 10.7]*. Accordingly, the information in the financial statements might differ from the equivalent information in a preliminary announcement.

2.1.1.B Re-issuing (dual dating) financial statements

IFRS accounting standards do not address whether and how an entity may amend its financial statements after they have been authorised for issue. Generally, such matters are dealt with in local laws or regulations.

If an entity re-issues financial statements (whether to correct an error or to include events that occurred after the financial statements were originally authorised for issue), there is a new date of authorisation for issue. The financial statements must then reflect, up to the new date of authorisation for issue:

- All adjusting events, by updating the amounts recognised in the financial statements
- Non-adjusting events, through additional disclosure

However, in certain circumstances, the re-issuing of previously issued financial statements is required by local regulators, particularly for inclusion in public offering and similar documents. In November 2012, the IFRS IC was asked to clarify the accounting implications of applying IAS 10 when previously issued financial statements are re-issued in connection with an offering document.[2]

In May 2013, the IFRS IC responded that:

- The scope of IAS 10 is the accounting for, and disclosure of, events after the reporting period and that the objective of this Standard is to prescribe both of the following:
  (a) When an entity should adjust its financial statements for events after the reporting period
  (b) The disclosures that an entity should give about the date when the financial statements were authorised for issue and about events after the reporting period
- Financial statements prepared in accordance with IAS 10 should reflect all adjusting and non-adjusting events up to the date that the financial statements were authorised for issue.
- IAS 10 does not address the presentation of re-issued financial statements in an offering document when the originally issued financial statements have not been withdrawn, but the re-issued financial statements are provided either as supplementary information or a re-presentation of the original financial statements in an offering document in accordance with regulatory requirements.

The IFRS IC decided not to add this issue to its agenda on the basis of the response above and because the issue arises in multiple jurisdictions, each with particular securities laws and regulations which may dictate the form for re-presentations of financial statements.[3]

Accordingly, depending on the particular regulatory requirements in a given jurisdiction, there may be variations in how re-issued financial statements are presented.

2.1.2 Adjusting events

Adjusting events are "those that provide evidence of conditions that existed at the end of the reporting period." *[IAS 10.3(a)]*.

Examples of adjusting events are as follows:

(a) The settlement after the reporting period of a court case that confirms that the entity had a present obligation at the end of the reporting period. In this situation, an entity adjusts any previously recognised provision related to this court case in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* or recognises a new provision. Mere disclosure of a contingent liability is not sufficient because the settlement provides additional evidence of conditions that existed at the end of the reporting period that would give rise to a provision in accordance with IAS 37 (see Chapter 27 at sections 3.1.1 and 3.2.1).

(b) The receipt of information after the reporting period indicating that an asset was impaired at the end of the reporting period, or that the amount of a previously recognised impairment loss for that asset needs to be adjusted. For example:
  (i) The bankruptcy of a customer that occurs after the reporting period usually confirms that the customer was credit-impaired at the end of the reporting period (this is discussed further in section 3.3 below).
  (ii) The sale of inventories after the reporting period may give evidence about their net realisable value at the end of the reporting period.

(c) The determination after the reporting period of the cost of assets purchased, or the proceeds from assets sold, before the end of the reporting period.

(d) The determination after the reporting period of the amount of profit-sharing or bonus payments, if the entity had a present legal or constructive obligation at the end of the reporting period to make such payments as a result of events before that date (see Chapter 31 at section 12.3).

(e) The discovery of fraud or errors that show that the financial statements are incorrect (see section 3.4 below). *[IAS 10.9]*.

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2 *IFRIC Update*, November 2012, available on the IFRS Foundation's website.

3 *IFRIC Update*, May 2013, available on the IFRS Foundation's website.

In addition, IFRIC 23 *Uncertainty over Income Tax Treatments* requires entities to apply IAS 10 to determine whether changes in facts and circumstances or new information after the reporting period gives rise to an adjusting or non-adjusting event for reassessing a judgement or estimate of an uncertain tax position. *[IFRIC 23.14, IFRIC 23(2027).14]*. An event would be considered adjusting if the change in facts and circumstances or new information after the reporting period provided evidence of conditions that existed at the end of the reporting period (see section 3.5 below).

Another standard which requires an adjustment for certain transactions after the reporting period is IAS 33 *Earnings per Share*. This standard requires an adjustment to earnings per share for certain share transactions after the reporting period (such as bonus issues, share splits or reverse share splits (share consolidations) as discussed in Chapter 33 at sections 4.3 and 4.5), even though the transactions themselves are non-adjusting events (see section 2.1.3 below). *[IAS 10.22(f)]*.

2.1.3 Non-adjusting events

The standard states that non-adjusting events are "those that are indicative of conditions that arose after the reporting period". *[IAS 10.3(b)]*.

Examples of non-adjusting events after the reporting period are as follows:

(a) A major business combination (IFRS 3 *Business Combinations* requires specific disclosures in such cases, see Chapter 10 at section 16.1.2) or disposing of a major subsidiary

(b) Announcing a plan to discontinue an operation

(c) Major purchases of assets, classification of assets as held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, other disposals of assets, or expropriation of major assets by government (see Chapter 5 at section 5.1 for certain disclosures that are required to be made)

(d) The destruction of a major production plant by a fire

(e) Announcing, or commencing the implementation of, a major restructuring (discussed in Chapter 27 at section 6.1.2)

(f) Major ordinary share transactions and potential ordinary share transactions (although as noted in section 2.1.2 above, some transactions in ordinary shares are adjusting events for the purposes of computing earnings per share)

(g) Abnormally large changes in asset prices or foreign exchange rates

(h) Changes in tax rates or the enactment or announcement of tax laws that significantly affect current and deferred tax assets and liabilities (discussed in Chapter 29 at sections 5.1.3 and 8.1.2)

(i) Entry into significant commitments or contingent liabilities, for example, by issuing significant guarantees

(j) Start of major litigation arising solely out of events that occurred after the reporting period

(k) A decline in fair value of investments

(l) A declaration of dividends to holders of equity instruments (as defined in IAS 32 *Financial Instruments: Presentation* discussed in Chapter 43 at section 4.1)

(m) A subsequent refinancing on a long-term basis of a liability classified as current

(n) A subsequent rectification of a breach of a long-term loan arrangement classified as current

(o) A subsequent granting by the lender of a period of grace to rectify a breach of a long-term loan arrangement classified as current

(p) A subsequent settlement of a liability classified as non-current

(q) A contingent asset becoming virtually certain after the end of the reporting period (discussed in Chapter 27 at section 3.2.2) *[IAS 10.11, IAS 10.12, IAS 10.13, IAS 10(2027).13, IAS 10.22, IAS 1.76, IFRS 18.B105, IAS 37.35]*

The reference in (a) and (c) above to asset disposals as examples of non-adjusting events is not quite the whole story as these may indicate an impairment of assets, which may be an adjusting event. Such events would be considered an impairment indicator, if they provide additional evidence of conditions which existed at the balance sheet date. In addition, (b) and (e) above regarding announcements of plans to discontinue an operation or to restructure a business, respectively, may also lead to an impairment charge (see Chapter 21 at section 5.1).

IFRS 5 makes it clear that the held for sale criteria must be met at the reporting date for a non-current asset (or disposal group) to be classified as held for sale in those financial statements. However, if those criteria are met after the reporting date but before the authorisation of the financial statements for issue, IFRS 5 requires certain additional disclosures (see Chapter 5 at sections 2.1.2 and 5.1). *[IFRS 5.12]*.

Information provided under (i) above, will be in addition to the disclosures required by other standards of commitments which exist at the reporting date. For example, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* require commitments for the acquisition of property, plant and equipment and intangible assets to be disclosed (see Chapter 19 at section 8.1 and Chapter 18 at section 10.1). *[IAS 16.74(c), IAS 38.122(e)]*. IFRS 16 *Leases* requires a lessee to disclose the amount of its lease commitments for short-term leases if the portfolio of short-term leases to which it is committed at the end of the reporting period is dissimilar to the portfolio of short-term leases for which current period short-term lease expense disclosure is provided (see Chapter 24 at section 5.8.2). *[IFRS 16.55]*.

For declines in fair value of investments, as in (k) above, the standard notes that such declines do not normally relate to the condition of the investments at the end of the reporting period, but reflects circumstances that arose subsequently. Therefore, in those circumstances, the amounts recognised in financial statements for the investments are not adjusted. Similarly, the standard states that an entity does not update the amounts disclosed for the investments as at the end of the reporting period, although it may need to give additional disclosure, if material, as discussed in section 2.3 below. *[IAS 10.11]*.

However, the assertion that a decline in fair value of investments does not normally relate to conditions at the end of the reporting period is similar wording to that used for bankruptcy and the sale of inventories (see section 2.1.2 above). Therefore, it requires an assessment of the circumstances in order to determine which conditions actually existed at the end of the reporting period - although this can be difficult in practice, particularly when fraud is involved (see section 3.4 below).

In addition to the examples of non-adjusting events in IAS 10, IFRIC 23 requires entities to apply IAS 10 to determine whether changes in facts and circumstances or new information after the reporting period gives rise to an adjusting or non-adjusting event when reassessing a judgement or estimate of an uncertain tax position. *[IFRIC 23.14, IFRIC 23(2027).14]*. An event is only considered non-adjusting if the change in facts and circumstances or new information after the reporting period is indicative of conditions that arose after the reporting period (see section 3.5 below).

The subsequent rectification of a breach in a long-term loan arrangement (n) is not an adjusting event and therefore, does not change the classification of the liability in the statement of financial position from current to non-current (see section 2.3.2 below). *[IAS 1.76(b), IFRS 18.B105(b)]*.

In January 2020, the IASB issued amendments to IAS 1 *Presentation of Financial Statements*[4], effective for annual reporting periods beginning on or after 1 January 2024, to specify the requirements for classifying liabilities as current or non-current. Paragraph 75A was added to clarify that the classification of a liability is not affected by the likelihood that the entity will exercise its right to defer settlement of the liability for at least twelve months after the reporting date *[IAS 1.75A, IFRS 18.B104]*. This applies even if settlement has occurred between the end of the reporting period and the date the financial statements are authorised for issue (see Chapter 3 at sections 3.1.4 and 3.1.4.A. Reflecting these amendments, the subsequent settlement of a liability classified as non-current (p) was also included in the list of events in paragraph 76 of IAS 1 that may require disclosure in accordance with IAS 10 *[IAS 1.76(d), IFRS 18.B105(d)]*. At the same time, the wording of the other examples of non-adjusting events was also amended to clarify that these events (see (m), (n) and (o) in the list above) refer to liabilities classified as current.

Another example of a non-adjusting event not mentioned by IAS 10 is where a contingent asset becomes virtually certain after the end of the reporting period. If the inflow of economic benefits from a contingent asset has become virtually certain, IAS 37 indicates that the asset and the related income must be recognised in the period in which the change occurs. The requirement to recognise the effect of changing circumstances in the period in which the change occurs extends to the analysis of information available after the end of the reporting period, but before the date when the financial statements are authorised for issue. In contrast to contingent liabilities, adjustments must not be made to reflect the subsequent settlement of a legal claim in favour of the entity, since the period in which the change occurs is after the end of the reporting period. An asset can only be recognised if, the entity can show that, at the end of the reporting period, it was virtually certain that its claim would succeed (see Chapter 27 at section 3.2.2). *[IAS 37.35]*.

4 IFRS 18 *Presentation and Disclosure in Financial Statements*, which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted) was issued by the IASB in April 2024. See Chapter 4 for further details on the new concepts and requirements of IFRS 18.

2.1.3.A Dividend declaration

Extract from IAS 10

Dividends

12 If an entity declares dividends to holders of equity instruments (as defined in IAS 32 Financial Instruments: Presentation) after the reporting period, the entity shall not recognise those dividends as a liability at the end of the reporting period.

13 If dividends are declared after the reporting period but before the financial statements are authorised for issue, the dividends are not recognised as a liability at the end of the reporting period because no obligation exists at that time. Such dividends are disclosed in the notes in accordance with IAS 1 Presentation of Financial Statements.

In respect of dividend declarations, as in (I) in section 2.1.3 above, dividends are only recognised as a liability if declared by the end of the reporting period. *[IAS 10.12, IAS 10.13, IAS 10(2027).13]*.

As a consequential amendment to IAS 10, the definition of 'declared' in this context was moved to IFRIC 17 *Distributions of Non-cash Assets to Owners*. IFRIC 17 did not change the principle regarding the appropriate timing for the recognition of dividends payable. *[IFRIC 17.BC18, IFRIC 17.BC19, IFRIC 17.BC20]*. It states that an entity recognises a liability to pay a dividend when the dividend is appropriately authorised and is no longer at the discretion of the entity, which is the date:

- When declaration of the dividend, e.g., by management or the board of directors, is approved by the relevant authority, e.g., the shareholders, if the jurisdiction requires such approval

  Or

- When the dividend is declared, e.g., by management or the board of directors, if the jurisdiction does not require further approval *[IFRIC 17.10]*.

How we see it

In many jurisdictions, the directors may keep discretion to cancel an interim dividend until such time as it is paid. In this case, the interim dividend is not declared (within the meaning described above), and is, therefore, not recognised until paid. Final dividends proposed by directors, in many jurisdictions, are only binding when approved by shareholders in general meeting or by the members passing a written resolution. Therefore, such a final dividend is only recognised as a liability when declared, i.e., approved by the shareholders at the annual general meeting or through the passing of a resolution by the members of an entity.

IAS 10 contains a reminder that an entity discloses dividends, both proposed and declared after the reporting period but before the financial statements are authorised for issue, in the notes to the financial statements in accordance with IAS 1 (see Chapter 3 at section 5.6). *[IAS 1.137, IFRS 18.132, IAS 10.13, IAS 10(2027).13]*.

Similar issues arise regarding the declaration of dividends by subsidiaries, associates and other equity investments. Although IAS 10 does not specifically address such items, IFRS 9 *Financial Instruments* requires a shareholder to recognise dividends when the shareholder's right to receive payment is established, it is probable that the economic benefits associated with the dividend will flow to the shareholder and the dividend can be measured reliably (see Chapter 46 at section 2.5). *[IFRS 9.5.7.1A]*.

Similarly, IAS 27 *Separate Financial Statements* also contains this general principle in recognising in an entity's separate financial statements those dividends received from subsidiaries, joint ventures or associates when its right to receive the dividend is established (see Chapter 9 at section 2.4.1). *[IAS 27.12]*.

Accordingly, a shareholder does not recognise such dividend income until the period in which the dividend is declared.

2.2 The treatment of adjusting events

2.2.1 Events requiring adjustment to the amounts recognised, or disclosures, in the financial statements

IAS 10 requires that the amounts recognised in the financial statements be adjusted to take account of an adjusting event. *[IAS 10.8]*.

The standard also notes that an entity may receive information after the reporting period about conditions existing at the end of the reporting period relating to disclosures made in the financial statements but not affecting the amounts recognised in them. *[IAS 10.20]*. In such cases, the standard requires the entity to update the disclosures that relate to those conditions for the new information. *[IAS 10.19]*.

For example, evidence may become available after the reporting period about a contingent liability that existed at the end of the reporting period. In addition to considering whether to recognise or change a provision under IAS 37, IAS 10 requires an entity to update its disclosures about the contingent liability for that evidence. *[IAS 10.20]*.

2.2.2 Events indicating that the going concern basis is not appropriate

If management determines after the reporting period (but before the financial statements are authorised for issue) either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so, the financial statements must not be prepared on a going concern basis. *[IAS 10.14]*.

Deterioration in operating results and financial position after the reporting period may indicate a need to consider whether the going concern assumption is still appropriate. If the going concern assumption is no longer appropriate, the standard states that the effect is so pervasive that it results in a fundamental change in the basis of accounting, rather than an adjustment to the amounts recognised within the original basis of accounting. *[IAS 10.15]*. As discussed in Chapter 3 at section 4.1.2.B, IFRS accounting standards contains no guidance on this 'fundamental change in the basis of accounting'. Accordingly, entities will need to consider carefully their individual circumstances to arrive at an appropriate basis.

The standard also contains a reminder of the specific disclosure requirements under IAS 1:

(a) When the financial statements are not prepared on a going concern basis, that fact must be disclosed, together with the basis on which the financial statements have been prepared and the reason why the entity is not regarded as a going concern.

(b) When management is aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, disclosure of those uncertainties must be made. *[IAS 10.16(a), IAS 10(2027).16(a), IAS 10.16(b), IAS 10(2027).16(b), IAS 1.25, IAS 8(2027).6K, IAS 1.26, IAS 8(2027).6L]*.

While IFRS accounting standards are generally written from the perspective that an entity is a going concern, they are also applicable when another basis of accounting is used to prepare financial statements. Various IFRS accounting standards acknowledge that financial statements may be prepared on either a going concern basis or an alternative basis of accounting. *[IAS 1.25, IAS 8(2027).6K, IAS 10.14, CF 3.9]*. Such IFRS accounting standards do not specifically exclude the application of IFRS accounting standards when an alternative basis of accounting is used. As a result, financial statements prepared on a 'non-going concern' basis of accounting may be described as complying with IFRS accounting standards as long as that other basis of preparation is sufficiently described. *[IAS 1.25, IAS 8(2027).6K]*. This is further discussed in Chapter 3 at section 4.1.2.B.

Regarding the requirement in (b) above, the events or conditions requiring disclosure may arise after the reporting period. *[IAS 10.16(b), IAS 10(2027).16(b)]*.

2.3 The treatment of non-adjusting events

IAS 10 prohibits the adjustment of amounts recognised in financial statements to reflect non-adjusting events. *[IAS 10.10]*. It indicates that if non-adjusting events are material, non-disclosure could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements. Accordingly, an entity must disclose the following for each material category of non-adjusting event:

(a) The nature of the event

(b) An estimate of its financial effect, or a statement that such an estimate cannot be made *[IAS 10.21]*

To illustrate how these requirements have been applied in practice, two Practical examples of disclosure for commonly occurring types of non-adjusting events are given below.

Practical example 2-3 below contains an example of the disclosures required for a business combination (example (a) in section 2.1.3 above). The requirement for the specific disclosures illustrated below is in IFRS 3.B66 (see Chapter 10 at section 16.1.2):

Practical example 2-3: Byggfakta Group Nordic HoldCo AB (publ) (2022) Sweden

Byggfakta Group Annual & Sustainability Report [extract]

Notes to the consolidated financial statements [extract]

NOTE 37 Significant events since the end of the financial year

On 3 April through its subsidiary BCI Central, Byggfakta Group acquired all shares in the American company Pantera Global Technology, Inc. (Pantera). Pantera's offering focuses on procurements in the commercial construction sector.

In 2022, Pantera had sales of approximately MUSD 1.8 with a strong EBITDA margin. Over 80% of the company's total revenue comprises subscription revenue.

On 13 February 2023, approximately 73% of the shares were acquired in the Norwegian company 4Cast Group AS. Through its subsidiaries Prognosesenteret AS in Norway and Prognoscentret AB in Sweden, 4Cast Group is the Nordic leader in market analysis and forecasting for the construction and civil engineering market, and will be consolidated into Byggfakta Group's operating segment, Construction solutions – Nordic.

4Cast Group AS has 48 employees and sales in 2022 of approximately MNOK 86 together with a healthy EBITDA margin. Approximately 70% of the company's total revenue comprises subscription revenue.

The company will be fully consolidated as binding put/call option agreements are in place for the acquisition of the remaining part of the company.

From the acquisition date until 31 December 2023, 4Cast Group is expected to contribute net sales amounting to MSEK 91.

If the acquisition of 4Cast Group had occurred at the start of 2023, the contribution to the Group's net sales would have been MSEK 109. The acquisition is expected to contribute MSEK 11 to Byggfakta Group's operating profit. If the acquisition had occurred at the start of 2023, the contribution to the Group's operating profit would have been MSEK 14.

The surplus values that arose in connection with the acquisition refer to customer relationships and brands. Customer relationships have an estimated useful life of ten years and are amortised over ten years.

Brands are estimated to have indefinite useful lives and are not amortised over time, since they are well established in the industry and business is expected to be conducted under these brands in the foreseeable future.

Goodwill is attributable to synergies and personnel. No part of goodwill will be tax deductible.

The preliminary operating profit for 2023 will include acquisition-related costs of MSEK 3 that will be included in other external expenses in the consolidated statement of comprehensive income and in operating activities in the cash-flow statement for 2023.

MSEK	Preliminary acquisition analysis
Intangible assets	174.9
Other current assets	31.4
Cash and cash equivalents	59.4
Deferred tax	−35.1
Other liabilities	−43.2
Net fair value of acquired assets and assumed liabilities	**187.4**
Goodwill	299.7
Total purchase consideration	**487.1**
Unpaid purchase consideration for the remainder of the company	−160.7
Acquisition-related costs	3.3
Cash and cash equivalents in acquired companies	−59.4
Net cash flow from acquisitions of Group companies	**270.3**

Practical example 2-4 below contains an example of the disclosure of major ordinary share transactions after the reporting period (example (f) in section 2.1.3 above):

Practical example 2-4: NP3 Fastigheter AB (publ) (2022) **Sweden**

Annual Report 2022 [extract]

Notes [extract]

Note 29 Significant events after the end of the financial year

In mid-February, a directed new share issue of 2,750,000 ordinary shares was carried out at a price of 230 SEK per share. This provided the company with 632.5 MSEK, which boosts the balance sheet and provides increased flexibility ahead of the loans falling due and provides an opportunity to make value-creating investments in existing properties and new production projects and to act on attractive acquisition opportunities. The new share issue was substantially oversubscribed and means that the number of shares in the company increases from 92,607,856 shares to 95,357,856 shares, distributed into 57,357,856 ordinary shares and 38,000,000 preference shares. The company's share capital increases from 324,127,496 SEK to 333,752,496 SEK. The new share issue results in dilution of 2.9 percent of the shares and 4.5 percent of the votes in relation to the total number of shares outstanding, or votes after the new share issue, respectively.

It is important to note that the list of examples of non-adjusting events in IAS 10, and summarised in section 2.1.3 above, is not an exhaustive one; IAS 10 requires disclosure of any material non-adjusting event. *[IAS 10.21]*.

2.3.1 Declaration to distribute non-cash assets to owners

When an entity declares a dividend to distribute a non-cash asset to owners after the end of a reporting period but before the financial statements are authorised for issue, IFRIC 17 requires an entity to disclose: *[IFRIC 17.17]*

(a) The nature of the asset to be distributed

(b) The carrying amount of the asset to be distributed as of the end of the reporting period

(c) The fair value of the asset to be distributed as of the end of the reporting period, if it is different from its carrying amount, and the following information about the method(s) used to measure that fair value:

  (i) The level of the fair value hierarchy within which the fair value measurement is categorised (Level 1, 2 or 3). *[IFRS 13.93(b)]*.

  (ii) For fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) and the inputs used in the fair value measurement. If there has been a change in valuation technique (e.g., changing from a market approach to an income approach or the use of an additional valuation technique), the entity must disclose that change and the reason(s) for making it. For fair value measurements categorised within Level 3 of the fair value hierarchy, quantitative information about the significant unobservable inputs used in the fair value measurement must be provided. An entity is not required to create quantitative information to comply with this disclosure requirement if quantitative unobservable inputs are not developed by the entity when measuring fair value (e.g., when an entity uses prices from prior transactions or third-party pricing information without adjustment). However, when providing this disclosure, the quantitative unobservable inputs that are significant to the fair value measurement and are reasonably available to the entity must not be ignored. *[IFRS 13.93(d)]*.

(iii) For fair value measurements categorised within Level 3 of the fair value hierarchy, a description of the valuation processes used by the entity (including, for example, how an entity decides its valuation policies and procedures and analyses changes in fair value measurements from period to period). *[IFRS 13.93(g)]*.

(iv) If the highest and best use of the non-financial asset differs from its current use, an entity must disclose that fact and why the non-financial asset is being used in a manner that differs from its highest and best use. *[IFRS 13.93(i)]*.

In the case of (c) above, any quantitative disclosures are required to be presented in a tabular format, unless another format is more appropriate. *[IFRS 13.99]*. Fair value measurement is further discussed in Chapter 15.

2.3.2 Breach of a long-term loan arrangement and its subsequent rectification

When an entity breaches a provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand, it classifies the liability as current in its statement of financial position (see Chapter 3 at sections 3.1.4 and 3.1.4.A). *[IAS 1.74, IFRS 18.B102]*. This may also give rise to going concern uncertainties (see section 2.2.2 above).

It is not uncommon that such covenant breaches are subsequently rectified; however, a subsequent rectification is not an adjusting event and therefore, does not change the classification of the liability in the statement of financial position from current to non-current.

IAS 1 requires disclosure of the following events if they occur between the end of the reporting period and the date the financial statements are authorised for issue:

- Refinancing on a long-term basis of a liability classified as current
- Rectification of a breach of a long-term loan arrangement classified as current
- The granting by the lender of a period of grace to rectify a breach of a long-term loan arrangement classified as current
- Settlement of a liability classified as non-current (see Chapter 3 at section 5.6) *[IAS 1.76, IFRS 18.B105]*

The amendments to IAS 1 issued in January 2020 effective for annual reporting periods beginning on or after 1 January 2024 included clarifications of the above list of subsequent events and added the 'settlement of a liability classified as non-current' to this list (see Chapter 3 at sections 3.1.4 and 5.6(b)).

2.4 Other disclosure requirements

The disclosures required in respect of non-adjusting events are discussed in section 2.3 above. As IAS 10 only requires consideration to be given to events that occur up to the date when the financial statements are authorised for issue, it is important for users to know that date, since the financial statements do not reflect events after that date. *[IAS 10.18]*. Accordingly, IAS 10 requires disclosure of the date the financial statements were authorised for issue. Furthermore, it requires disclosure of who authorised the financial statements for issue and, if the owners of the entity or others have the power to amend them after issue, disclosure of that fact. *[IAS 10.17]*. In practice, this information can be presented in a number of ways:

(a) On the face of a primary statement (for example, entities that are required to have the statement of financial position signed could include the information at that point)

(b) In the note dealing with other IAS 10 disclosures or another note (such as the summary of significant accounting policies)

(c) In a separate statement such as a statement of directors' responsibilities for the financial statements (that is, outside of the financial statements as permitted in certain jurisdictions)

How we see it

Strictly speaking, this information is required to be presented within the financial statements. So, if (c) above were chosen, either the whole statement of directors' responsibilities would need to be part of the financial statements or the information could be incorporated by way of a cross-reference.

In addition to the IAS 10 disclosure requirements, other standards may require disclosures to be provided about future events, for example, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*[5] requires disclosure of the expected impact of new standards that are issued but are not yet effective at the reporting date (see Chapter 3 at section 5.1.2.C). *[IAS 8.30, IAS 8.31]*.

5 The consequential amendments resulting from IFRS 18 *Presentation and Disclosure in Financial Statements*, once effective, changes the title of IAS 8 to '*Basis of Preparation of Financial Statements*' to better reflect the amended content of IAS 8. See Chapter 4 for further details on the requirements of IFRS 18.

3 Practical issues

The standard does address certain practical matters through examples of adjusting and non-adjusting events. For example, the standard asserts that the bankruptcy of a customer that occurs after the reporting period would usually be an adjusting event (see section 2.1.2 above). It also states that a decline in fair value of investments after the reporting period does not normally relate to conditions at the end of the reporting period and therefore, would be a non-adjusting event (see section 2.1.3 above). Judgement of the facts and circumstances is required to determine whether an event that occurs after the reporting period provides evidence about a condition that existed at the end of the reporting period, or whether the condition arose subsequent to the reporting period. The following sections address some commonly encountered practical issues.

3.1 Valuation of inventory

The sale of inventories after the reporting period is normally a good indicator of their net realisable value (NRV) at that date. IAS 10 states that such sales "may give evidence about their net realisable value at the end of the reporting period". *[IAS 10.9(b)(ii)]*. However, in some cases, NRV decreases because of conditions that did not exist at the end of the reporting period.

Therefore, it is important to determine why NRV decreased. Did it decrease because of circumstances that existed at the end of the reporting period, which subsequently became known, or did it decrease because of circumstances that arose after the end of the reporting period? A decrease in price is merely a response to changing conditions so it is important to assess the reasons for, and timing of, these changes.

Some examples of changing conditions are as follows:

(a) Price reductions caused by a sudden increase in cheap imports

Whilst it is arguable that the 'dumping' of cheap imports after the reporting period is a condition that arises subsequent to that date, it is more likely that this is a reaction to a condition that already existed such as overproduction in other parts of the world. Thus, it might be more appropriate in such a situation to adjust the value of inventories based on its subsequent NRV.

(b) Price reductions caused by increased competition

The reasons for price reductions and increased competition do not generally arise overnight but normally occur over a period. For example, a competitor may have built up a competitive advantage by investing in machinery that is more efficient. In these circumstances, it is appropriate for an entity to adjust the valuation of its inventories because this situation existed at the end of the reporting period.

(c) Price reductions caused by the introduction of an improved competitive product

It is unlikely that a competitor developed and introduced an improved product overnight. Therefore, it is appropriate to adjust the valuation of inventories held at the end of the reporting period to their NRV after that introduction because the entity's failure to maintain its competitive position in relation to product improvements existed at the end of the reporting period.

Price reductions after the reporting period caused by increased competition are generally evidence of conditions that existed at the end of the reporting period. For certain types of inventory, however, there may be clear evidence of a price at the end of the reporting period. If this is the case, it is inappropriate to adjust the NRV of that inventory to reflect a subsequent decline. An example is inventories for which there is a price on an active commodities market. In addition, inventory may be physically damaged or destroyed after the reporting period (e.g., by fire, flood, or other disaster). In these cases, the entity does not adjust the financial statements. However, the entity may be required to disclose the subsequent decline in NRV of the inventories if the impact is material (see section 2.3 above).

3.2 Over time measurement of progress

Events after the reporting period frequently give evidence about the profitability of contracts with customers, which are in progress at the end of the reporting period and where revenue is recognised over time.

IFRS 15 *Revenue from Contracts with Customers* requires an assessment to be made of the progress towards complete satisfaction of performance obligations satisfied over time (see Chapter 28 at section 7.1.4). *[IFRS 15.40]*. In such an assessment, consideration must be given to events that occur after the reporting period and a determination must be made as to whether they are adjusting or non-adjusting events for which the financial effect is included in the method used to measure progress over time.

3.3 Insolvency of a debtor and IFRS 9 expected credit losses

The insolvency of a debtor or inability to pay debts usually builds up over a period. IAS 10 states that the bankruptcy of a customer that occurs after the reporting period usually confirms that the customer was credit-impaired (Stage 3 under the IFRS 9 general approach - refer to Chapter 47 at section 3.1) at the end of the reporting period. *[IAS 10.9(b)(i)]*. If, however, there is evidence to show that the insolvency of the debtor resulted solely from an event occurring after the reporting period, then the event is a non-adjusting event. If the impact is material, the entity will be required to disclose the nature and effect of the debtor's default (see section 2.3 above).

Frequently asked questions

Question 3-1: Must an entity incorporate events and forecasts that occur between the reporting date and the date the financial statements are authorised for issue, when applying the impairment requirements of IFRS 9?

In April 2015, the IFRS Transition Resource Group for Impairment of Financial Instruments (ITG)[6] discussed whether, and if so how, to incorporate events and forecasts that occur between the reporting date and the date the financial statements are authorised for issue, when applying the impairment requirements of IFRS 9 at the reporting date. The ITG noted that if new information becomes available between the reporting date and the date of signing the financial statements, an entity needs to apply judgement, based on the specific facts and circumstances, to determine whether it is an adjusting or non-adjusting event in accordance with IAS 10. This is further discussed in Chapter 47 at section 5.9.4.

3.4 Discovery of fraud after the reporting period

The timing of when fraud is discovered will affect the accounting considerations. When fraud is discovered after the end of the reporting period, but before the financial statements have been authorised for issue, the discovery of fraud is often an adjusting event, i.e., an event that provides evidence of conditions that existed at the reporting date (see section 2.1.2 above). *[IAS 10.9]*. However, the discovery of fraud may also be a non-adjusting event. For example, for investments the discovery of fraud may affect the fair value of the assets subsequent to the discovery of the fraud, but not their fair values on the reporting date.

When fraud is discovered after the financial statements have been authorised for issue this may indicate prior period errors. Application of the IAS 8 definition of a 'prior period error' (see Chapter 3 at section 4.6) in the case of fraud requires the exercise of judgement. Facts and circumstances must be evaluated to determine if the discovery of the fraud resulted from a previous failure to use, or misuse of, reliable information, or from new information that was available at the time the financial statements were authorised for issue and was reasonably expected to have been obtained and taken into account in the preparation of the financial statements. *[IAS 8.5, IAS 8(2027).5]*.

3.5 Changes to estimates of uncertain tax treatments

IFRIC 23 addresses how to reflect uncertainty in accounting for income taxes. It requires an entity to reassess any judgement or estimate relating to an uncertain tax treatment if the facts and circumstances on which the judgement or estimate was based change, or as a result of new information that affects the judgement or estimate. In cases where the change in facts and circumstances or new information occurs after the reporting period, the interpretation requires an entity to apply IAS 10 to determine whether the change gives rise to an adjusting or non-adjusting event, as set out in sections 2.1.2 and 2.1.3 above. *[IFRIC 23.13, IFRIC 23.14, IFRIC 23(2027).14]*.

6 See Chapter 47 at section 1.4.

Examples of changes in facts and circumstances or new information that could result in the reassessment of a judgement or estimate required by IFRIC 23 include, but are not limited to, the following:

(a) Examinations or actions by a taxation authority. For example:
    (i) Agreement or disagreement by the taxation authority with the tax treatment or a similar tax treatment used by the entity
    (ii) Information that the taxation authority has agreed or disagreed with a similar tax treatment used by another entity
    (iii) Information about the amount received or paid to settle a similar tax treatment
(b) Changes in rules established by a taxation authority
(c) The expiry of a taxation authority's right to examine or re-examine a tax treatment *[IFRIC 23.A2]*

A change in rules established by a taxation authority after the reporting period constitutes a non-adjusting event (see section 2.1.3 above). *[IAS 10.22(h)]*. An entity must apply IAS 10 to determine whether any other change that occurs after a reporting period is an adjusting or non-adjusting event. The requirements of IFRIC 23 are further discussed in Chapter 29 at section 9.

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Appendix C - Defined terms

Extract from IAS 10

3 The following terms are used in this Standard with the meanings specified:

Events after the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue. Two types of events can be identified:

(a) those that provide evidence of conditions that existed at the end of the reporting period (*adjusting events after the reporting period*); and

(b) those that are indicative of conditions that arose after the reporting period (*non-adjusting events after the reporting period*).

Chapter 35 Related party disclosures

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Overview

This chapter addresses the requirements of IAS 24 *Related Party Disclosures*. IAS 24 defines related party relationships and transactions and sets out the relevant disclosure requirements. It is important to note that the standard does not address the accounting for such items; the transactions themselves are accounted for under the relevant IFRS accounting standard.

The aim of IAS 24 is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances, including commitments, with such parties. Related parties may enter into transactions and accept or demand terms which unrelated parties would not. It is hard to assess whether a transaction is at fair value between related parties, as it may never have been entered into, had it not been for the related party relationship. As a result, disclosure of any such relationships, transactions, outstanding balances and commitments is important for users of an entity's financial statements to make an assessment of its financial position and profit and loss, as well as the risks and opportunities to which that entity is exposed.

IAS 24 provides a wide-ranging definition of what constitutes a related party; a related party could be a person or an entity that is related to the entity preparing its financial statements (reporting entity) if the person or entity has control, joint control or significant influence over the reporting entity, or is a member of the reporting entity's key management personnel.

A related party transaction is defined in the standard as "a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged". *[IAS 24.9]*. Should an entity have related party transactions during the periods covered by the financial statements, it must disclose the nature of the related party relationship as well as information about those transactions and outstanding balances, including commitments, necessary for users to understand the potential effect of the relationship on the financial statements.

IAS 24 also requires an entity to disclose key management personnel compensation in total, using categories set out in the standard.

IAS 24 addresses related party disclosures for government-related entities; a reporting entity is exempt from the majority of disclosure requirements in the Standard, if the related party is:

- A government with control, joint control or significant influence over the reporting entity
- Another entity that is a related party because the same government has control, joint control or significant influence over both the reporting entities

However, if this exemption is applied, other disclosures are mandated.

What you need to know

- IAS 24 is a disclosure standard only. Transactions within its scope are accounted for under the relevant IFRS accounting standard.
- A related party is a person or entity which is related to the entity that is preparing its financial statements; IAS 24 provides a wide-ranging definition of what constitutes a related party.
- Information must be disclosed about transactions, outstanding balances and commitments.
- IAS 24 requires disclosure about key management personnel compensation.
- IAS 24 addresses related party disclosures for government-related entities.

1 Introduction

Relationships and transactions between related parties are a normal feature of commerce and business. Many entities carry on their business activities through subsidiaries, joint ventures, and associates and there are inevitably transactions between these parties. The investor, in these circumstances, has the ability to affect the financial and operating policies of the investee, through the presence of control, joint control or significant influence. *[IAS 24.5]*. It is also common for entities under common control, which are not a group for financial reporting purposes, to transact with each other. The disclosures considered necessary in such circumstances are addressed by IAS 24.

Differences may exist between the IFRS accounting standards and US GAAP guidance on this topic, but these are not addressed in this chapter as the standards are not converged.

1.1 The related party issue

The problems posed by related party relationships and transactions are described in IAS 24 as follows: *[IAS 24.6, IAS 24.7]*

Extract from IAS 24	
6	A related party relationship could have an effect on the profit or loss and financial position of an entity. Related parties may enter into transactions that unrelated parties would not. For example, an entity that sells goods to its parent at cost might not sell on those terms to another customer. Also, transactions between related parties may not be made at the same amounts as between unrelated parties.
7	The profit or loss and financial position of an entity may be affected by a related party relationship even if related party transactions do not occur. The mere existence of the relationship may be sufficient to affect the transactions of the entity with other parties. For example, a subsidiary may terminate relations with a trading partner on acquisition by the parent of a fellow subsidiary engaged in the same activity as the former trading partner. Alternatively, one party may refrain from acting because of the significant influence of another - for example, a subsidiary may be instructed by its parent not to engage in research and development.

1.2 Possible solutions

1.2.1 Disclosure of related party transactions

In response to the problem posed by related party transactions, IAS 24 requires disclosure of those transactions, rather than an adjustment to the financial statements. IAS 24 is purely a disclosure standard and does not establish any recognition or measurement requirements. Related party transactions are accounted for in accordance with the requirements of the IFRS accounting standard applicable to the transaction. The disclosures required by IAS 24 are in addition to those required by other IFRS accounting standards. For example, a loan to a related party will also be subject to the disclosure requirements of IFRS 7 *Financial Instruments: Disclosures*. This treatment of related party transactions and relationships using disclosure, rather than requiring adjustment, is in line with the requirements of local accounting standards in most jurisdictions.

The purpose of disclosing the information required by IAS 24 is to give users of financial statements knowledge about transactions (for example, whether they are at arm's length/fair value), outstanding balances, including commitments, and relationships with related parties that may affect their assessment of an entity's operations, including assessments of the risks and opportunities facing an entity. *[IAS 24.8]*.

1.2.2 Remeasurement of related party transactions at fair values

An alternative solution to the problems posed by related party relationships and transactions would be to adjust the financial statements by measuring related party transactions as if they occurred with an independent third party and recognise any such transactions at an arm's length price (i.e., fair value). However, although it may be possible to do this, it is often not possible to establish what would have been the terms of any non-arm's length transaction, had it been negotiated on an arm's length basis. This is because, normally, no comparable transactions may have taken place and, in any event, the transaction might never have taken place at all, if it had been negotiated at a different value. See Chapter 9 at section 4 for a discussion of common control transactions in individual or separate financial statements and Chapter 21 at section 12 for a discussion of considerations relating to impairment in group situations. As a result of the difficulties outlined above, IAS 24 does not propose the remeasurement of related party transactions at fair values, but only focusses on disclosures.

2 Objective and scope of IAS 24

2.1 Objective and scope

2.1.1 Objective

IAS 24 states that its objective is as follows: *[IAS 24.1]*

Extract from IAS 24

Objective

1 The objective of this Standard is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances, including commitments, with such parties.

Accordingly, IAS 24 requires disclosure of related party transactions and outstanding balances, including commitments, together with the names of any parties who control the reporting entity.

2.1.2 Scope

IAS 24 applies in:

(a) Identifying related party relationships and transactions

(b) Identifying outstanding balances, including commitments, between an entity and its related parties

(c) Identifying the circumstances in which disclosure of the items in (a) and (b) is required

And

(d) Determining the disclosures to be made about those items *[IAS 24.2]*

IAS 24 explicitly requires disclosure of related party relationships, transactions and outstanding balances, including commitments, in both the consolidated and separate financial statements of a parent or investors with joint control of, or significant influence over, an investee presented in accordance with IFRS 10 *Consolidated Financial Statements* or IAS 27 *Separate Financial Statements*. The standard also applies to individual financial statements. *[IAS 24.3]*.

All entities within a group that prepare their financial statements under IFRS accounting standards must disclose, in those financial statements, related party transactions and outstanding balances with other entities in the group. *[IAS 24.4]*. There are no disclosure exemptions for subsidiaries, or for parent companies that produce separate financial statements, even where, those separate financial statements are issued with the consolidated financial statements of the group of which they are a part. The IASB considers that the financial statements of an entity that is part of a consolidated group may include the effects of extensive intragroup transactions. Therefore, it concluded that the disclosures required by IAS 24 are essential to understanding the financial position and financial performance of such an entity and should be required for separate financial statements presented in accordance with IAS 27. *[IAS 24.BC16]*. The IASB also believes that disclosure of intragroup transactions is essential because external users of the financial statements need to be aware of the interrelationships between related parties, including the level of support provided by related parties, to assist in their economic decisions. *[IAS 24.BC17]*.

IAS 24 notes that "intragroup related party transactions and outstanding balances are eliminated in the preparation of consolidated financial statements of the group". *[IAS 24.4]*. This implies that disclosure of such transactions and balances is not required in the group's consolidated financial statements since, so far as those financial statements are concerned, such items do not exist. This would also apply to the parts of a transaction which have been eliminated when applying equity accounting. However, transactions and balances between an investment entity and those of its subsidiaries, which are held as part of an investment portfolio, are measured at fair value through profit or loss and are not consolidated in accordance with IFRS 10, should be disclosed in the consolidated financial statements. *[IAS 24.4]*.

Some jurisdictions may have local laws and regulations which require specific information to be disclosed about particular related party transactions. These local requirements should be seen as incremental to, and not a substitute for, the disclosure requirements of IAS 24.

3 Defining related parties and related party transactions

A related party is defined as "a person or entity that is related to the entity that is preparing its financial statements" (the 'reporting entity'). *[IAS 24.9]*. The definition of related parties is reciprocal. The use of the word 'party' means that the disclosure applies to both individuals and to entities. The factors considered in the identification of a related party are consistent, whether the controlling party is a person or an entity.

With regard to entities, IAS 24 defines related parties more widely than simply the members of a group (as defined in Appendix A of IFRS 10, i.e., a parent and its subsidiaries - see Chapter 7 at Appendix B). The definition includes joint ventures and associates of the parent, joint ventures and associates of a parent's subsidiary and subsidiaries of an associate or a joint venture.

IAS 24 contains a multi-part definition of 'related party' and the following are related parties of the reporting entity:

- Certain persons or a close member of that person's family (see section 3.1.1 below)
- Entities that are members of the same group (see section 3.1.2 below)
- Entities that are associates or joint ventures (see section 3.1.3 below)
- Entities that are joint ventures of the same third party (see section 3.1.4 below)
- Entities that are joint ventures of a third party and associates of the same third entity (see section 3.1.5 below)
- Post-employment benefit plans (see section 3.1.6 below)
- Entities under control or joint control of certain categories of persons or close members of such a person's family (see section 3.1.7 below)
- Entities under significant influence of certain categories of persons or close members of such a person's family (including a person who is a member of a key management personnel of the entity or of a parent of the entity) (see section 3.1.8 below)
- Entities, or any member of the group of which they are a part, that provide key management personnel services (see section 3.1.9 below)
- Government-related entities (see section 3.1.10 below)

The standard emphasises that attention should be directed to the substance of the relationship and not merely the legal form. *[IAS 24.10]*.

A related party transaction is a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged. *[IAS 24.9]*.

3.1 Identification of a related party and related party relationships

3.1.1 Persons or close members of a person's family that are related parties

Extract from IAS 24

9 The following terms are used in this Standard with the meanings specified:

A *related party* is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the 'reporting entity').

(a) A person or a close member of that person's family is related to a reporting entity if that person:

(i) has control or joint control of the reporting entity;

(ii) has significant influence over the reporting entity; or

(iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

(b) ...

Close members of the family of a person are those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity and include:

(a) that person's children and spouse or domestic partner;

(b) children of that person's spouse or domestic partner; and

(c) dependants of that person or that person's spouse or domestic partner.

...

[IAS 24.9].

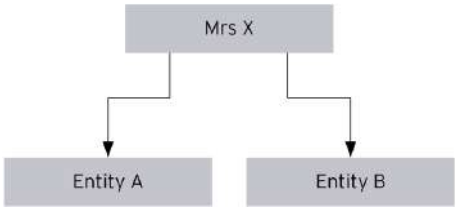
In May 2015, in response to a request to clarify the definition of a close member of the family of a person, the IFRS IC observed that the definition:

- Is expressed in a principle-based manner and involves the use of judgement to determine whether members of the family of a person (including that person's parents) are related parties or not
- Includes a list of family members that are always considered close members of the family of a person

The IFRS IC further noted that the list of family members that are always considered close members is non-exhaustive and does not preclude other family members from being considered as close members of the family of a person. Consequently, other family members, including parents or grandparents, could qualify as close members of the family depending on the assessment of specific facts and circumstances. The IFRS IC determined that neither an Interpretation nor an amendment to IAS 24 was necessary and therefore, decided not to add this item to its agenda.[1]

Relationships involving a person or close family members as investors are shown in the following two Illustrations, which are based on illustrative examples published by the IASB, which accompany, but are not part of IAS 24.

Illustration 3-1: Person as investor



Mrs X has an investment in Entity A and Entity B.

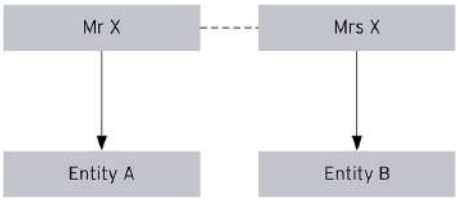
For Entity A's financial statements, if Mrs X controls or jointly controls Entity A, Entity B is related to Entity A when Mrs X has control, joint control or significant influence over Entity B or is a member of Entity B's key management personnel.

For Entity B's financial statements, if Mrs X controls or jointly controls Entity A, Entity A is related to Entity B when Mrs X has control, joint control or significant influence over Entity B, or is a member of Entity A's key management personnel.

However, if Mrs X has significant influence, but not control, over both Entity A and Entity B, Entities A and B are not related to each other.

If Mrs X is a member of the key management personnel of both Entity A and Entity B, Entities A and B are not, in the absence of any other indicator of a related party relationship, related to each other (see section 3.3 below).

Illustration 3-2: Close members of the family holding investments



Mr X is the spouse of Mrs X. Mr X has an investment in Entity A and Mrs X has an investment in Entity B.

For Entity A's financial statements, if Mr X controls or jointly controls Entity A, Entity B is related to Entity A when Mrs X has control, joint control or significant influence over Entity B, or is a member of Entity B's management personnel.

For Entity B's financial statements, if Mr X controls or jointly controls Entity A, Entity A is related to Entity B when Mrs X has control, joint control or significant influence over Entity B, or is a member of Entity A's key management personnel.

If Mr X has significant influence (but not control or joint control) over Entity A and Mrs X has significant influence (but not control or joint control) over Entity B, Entities A and B are not related to each other (see section 3.3 below).

If Mr X is a member of the key management personnel of Entity A and Mrs X is a member of the key management personnel of Entity B, Entities A and B are not, in the absence of any other indicator of a related party relationship, related to each other (see section 3.3 below).

1 *IFRIC Update*, May 2015, available on the IFRS Foundation's website.

3.1.1.A Control

The definition of 'control' in IAS 24 is a cross-reference to the definition in IFRS 10 - see Chapter 7 at Appendix B. IFRS 10 states that "an investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee". *[IFRS 10 Appendix A]*.

3.1.1.B Joint control

The definition of 'joint control' in IAS 24 is a cross-reference to the definition in IFRS 11 *Joint Arrangements*. IFRS 11 defines joint control as "the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control". *[IFRS 11 Appendix A]*.

In the definition of a related party, a joint venture includes subsidiaries of the joint venture. *[IAS 24.12]*. Therefore, for example, the subsidiary of a joint venture and the investor who has joint control are related to each other.

3.1.1.C Significant influence

The definition of 'significant influence' in IAS 24 is a cross-reference to the definition in IAS 28 *Investments in Associates and Joint Ventures*. IAS 28 defines significant influence as "the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies". *[IAS 28.3]*.

In the definition of a related party, an associate includes subsidiaries of the associate. Therefore, for example, the subsidiary of an associate and the investor who has significant influence over the associate are related to each other. *[IAS 24.12]*.

3.1.1.D Key management personnel

'Key management personnel' are those persons with authority and responsibility for planning, directing and controlling the activities of an entity, directly or indirectly, including any director (whether executive or otherwise) of that entity. *[IAS 24.9]*. A director of a reporting entity is automatically a member of key management personnel, even if they are not paid for their services by the reporting entity - thus, a director of a subsidiary is still a member of key management personnel of the subsidiary, even if their services are paid for by the parent.

A related party includes all key management personnel of a reporting entity and of a parent of the reporting entity. This means that all key management personnel of all parents (i.e., the immediate parent, any intermediate parent and the ultimate parent) of a reporting entity are related parties of the reporting entity. When the reporting entity's financial statements represent a group, key management personnel of subsidiaries might not be key management personnel of the group if those persons do not have the authority or responsibility for planning, directing and controlling the activities of the group.

Some entities may have more than one level of key management. For example, some entities may have a supervisory board, whose members have responsibilities similar to those of non-executive directors, as well as a board of directors that sets the overall operating strategy.

How we see it

In our view, all members of either board constitute key management personnel, as both levels of management have authority and responsibility for planning, directing and controlling the activities of the entity.

The definition of key management personnel is not restricted to directors. It also includes other individuals with authority and responsibility for planning, directing and controlling the activities of an entity. The main intention of the definition is presumably to ensure that key management personnel are identified because of the role the individual performs for the entity, rather than the job title attributed to the individual. Therefore, transactions with persons with responsibilities similar to those of directors, and the compensation paid to such persons, do not escape disclosure simply because they are not named as directors. For example, in some jurisdictions, a chief financial officer or a chief operating officer may not be directors but could meet the definition of key management personnel. Other examples of the type of persons who are not directors but may meet the definition of key management personnel include a divisional chief executive or a director of a major trading subsidiary of the entity, but not of the entity itself, who nevertheless does have the authority or responsibility for planning, directing and controlling the activities of the reporting entity. A reference to individuals who are not directors in a reporting entity's business review or management commentary might indicate that those persons are considered to be key management personnel.

Key management personnel are normally employees of the reporting entity (or of another entity in the same group). However, the definition does not restrict itself to employees. Therefore, seconded staff and persons engaged under management or outsourcing contracts may also have a level of authority or responsibility such that they are 'key management personnel'.

The definition of key management personnel refers to 'persons'. *[IAS 24.9]*. In IAS 24, a distinction is made between a 'person' (a human being) and an entity (a company with legal rights and obligations). *[IAS 24.9]*. In some jurisdictions, the term 'person' includes both a 'corporate person' (an artificial person, created by law, such as a corporation) and a 'natural person' (a human being). Additionally, in some jurisdictions, a corporate entity must by law have the authority and responsibility for planning, directing and controlling the activities of an investment fund for the benefit of the fund's investors in accordance with the fund's constitution and relevant statutes (i.e., the corporate entity is the body acting as key management personnel). Before the clarification in 2013, key management personnel were only referred to as persons and there was no acknowledgement that an entity could constitute key management personnel. To rectify this, IAS 24 now clarifies that if a reporting entity receives key management personnel services from another entity (described as a 'management entity') the disclosure requirements for key management personnel compensation (see section 3.1.9 below) do not apply to the compensation paid or payable by the management entity to the management entity's employees or directors. *[IAS 24.17A]*. In other words, it is not necessary to look through the management entity and disclose the compensation paid to the individuals performing the role on behalf of the management entity. Instead, amounts incurred for the service fee paid or payable by the reporting entity to the separate management entity for provision of key management personnel services are disclosed. *[IAS 24.18A]*. As a result of identifying the management entity as a related party of the reporting entity, other transactions with the management entity, such as loans, are also disclosed by the reporting entity.

3.1.2 Entities that are members of the same group

An entity is related to a reporting entity if: *[IAS 24.9]*

Extract from IAS 24

9 **The following terms are used in this Standard with the meanings specified:**

A *related party* is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the 'reporting entity').

(a) …

(b) An entity is related to a reporting entity if any of the following conditions applies:

(i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).

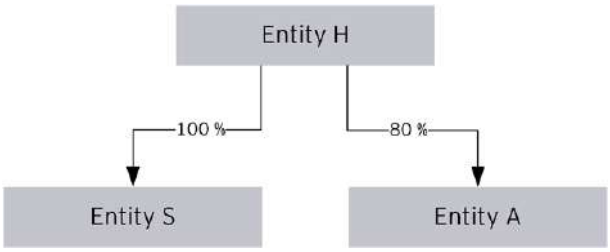
(ii) …

The terms group, parent and subsidiary are defined in IFRS accounting standards as follows:

- A group is "A parent and its subsidiaries."
- A parent is "An entity that controls one or more entities."
- A subsidiary is "An entity that is controlled by another entity." *[IFRS 10 Appendix A]*

Therefore, all entities controlled by the same ultimate parent are related parties. This would include entities where the reporting entity holds less than a majority of the voting rights, but which are subsidiaries as defined in IFRS 10. Conversely, a group would not include entities where the reporting entity holds a majority of the voting rights but which are not subsidiaries (for example, because the group does not have control), though these could be related parties of the reporting entity as they may fall into other categories of related party, such as associates.

Illustration 3-3: Entities that are members of the same group



Both Entity S and Entity A are subsidiaries of Entity H. Entities H, S and A are all related parties to each other as they are members of the same group.

Related party disclosures will be required in the financial statements of Entity S in respect of transactions with Entities H and A, in the financial statements of Entity A in respect of transactions with Entities H and S and in the separate financial statements of Entity H in respect of transactions with Entities S and A.

3.1.3 Entities that are associates or joint ventures

An entity is related to a reporting entity if: *[IAS 24.9]*

Extract from IAS 24

9 The following terms are used in this Standard with the meanings specified:

A related party is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the 'reporting entity').

(a) ...

(b) An entity is related to a reporting entity if any of the following conditions applies:

(i) ...

(ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).

(iii) ...

IAS 28 defines an associate as "an entity over which the investor has significant influence". *[IAS 28.3]*.

IFRS 11 defines a joint venture as "a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement" - see Chapter 13 at Appendix C. *[IFRS 11 Appendix A]*.

Any entity that a reporting entity determines is an associate under IAS 28 or a joint venture under IFRS 11 is a related party. All associates and joint ventures are related parties, whether they are accounted for under the equity method or by another method. For example, where the investment is accounted for at fair value through profit or loss under IFRS 9 *Financial Instruments* rather than under the equity method, such as investments in associates or joint ventures held by a venture capital organisation, mutual fund, unit trust or similar entity including unit-linked insurance funds, these are still related parties. Likewise, any reporting entity that is an associate or joint venture of another entity must treat that investor entity as a related party.

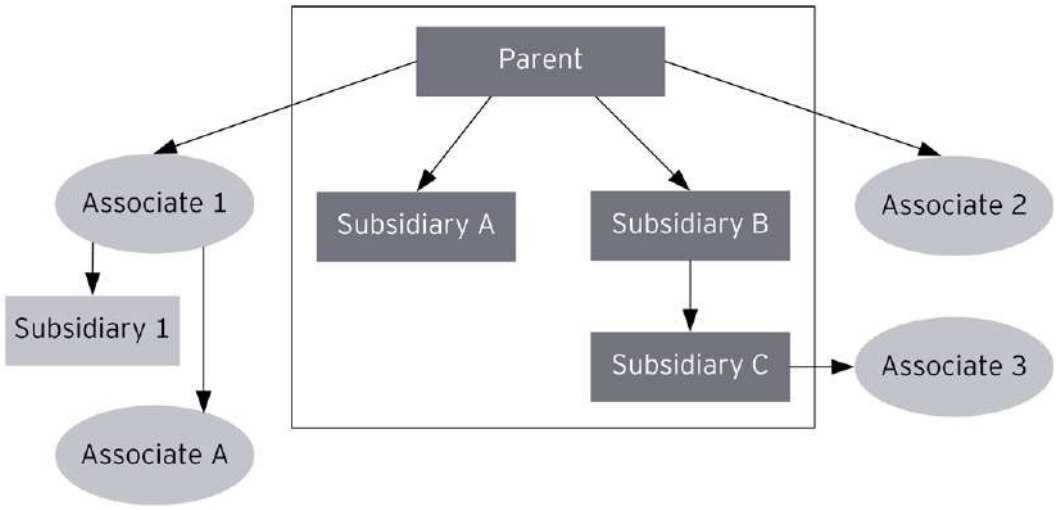
As noted above, in the definition of a related party, an associate includes subsidiaries of the associate and a joint venture includes subsidiaries of the joint venture. Therefore, for example, an associate's subsidiary and the investor that has significant influence over the associate are related to one another. *[IAS 24.12]*.

The definition also means that an associate of a reporting entity's parent is also a related party of the reporting entity.

However, the definition does not cause investors in a joint venture or an associate to be related to each other (see sections 3 above and 3.3 below). Investors in joint operations (as defined in IFRS 11 - see Chapter 13 at Appendix C) are also not related to each other. For the avoidance of doubt, two associates of the same third party are not related to one another (see section 3.1 above).

The application of these requirements is shown in Illustration 3-4 below, which is based on an illustrative example accompanying IAS 24. *[IAS 24.IE4].* The example mainly focuses on the application of the requirements to associate entities; for completeness all related parties are identified.

Illustration 3-4: Associates of the reporting entity's group that are related parties



In Parent's separate and consolidated financial statements:

Subsidiaries A, B, C and Associates 1 (including its subsidiary), 2 and 3 are related parties. Associate A is not a related party.

For Subsidiary A's financial statements:

Parent, Subsidiaries B and C and Associates 1 (including its subsidiary), 2 and 3 are related parties. Associate A is not a related party.

For Subsidiary B's consolidated or separate financial statements:

Parent, Subsidiaries A and C and Associates 1 (including its subsidiary), 2 and 3 are related parties. Associate A is not a related party.

For Subsidiary C's financial statements:

Parent, Subsidiaries A and B and Associates 1 (including its subsidiary), 2 and 3 are related parties. Associate A is not a related party.

For the financial statements of Associates 1 (consolidated or separate), 2 and 3:

Parent and Subsidiaries A, B and C are related parties. Associates 1, 2 and 3 are not related to each other.

In addition:

For the separate financial statements of Associate 1:

Subsidiary 1 and Associate A are also related and for *the consolidated financial statements of Associate 1*, Associate A is related.

For the financial statements of Subsidiary 1:

Associate 1, Associate A, Parent and Subsidiaries A, B and C are related parties. Associates 2 and 3 are not related parties. This is because there is neither control nor joint control in either leg of the indirect relationships between Associate 1 and Associates 2 and 3.

For the financial statements of Associate A:

Associate 1 and Subsidiary 1 are related. Parent, Subsidiaries A, B and C and Associates 2 and 3 are not related parties, as there are indirect relationships between these entities and no control exists in any leg of those indirect relationships, in respect of Associate A.

3.1.3.A Joint operations

IAS 24 defines 'joint ventures' of the reporting entity as related parties. The definition of a joint venture in IFRS 11 excludes joint operations, so that an investment in a joint operation is not a related party. The exclusion of joint operations in is line with the IASB view that joint operations are part of the reporting entity and therefore, a transaction with a joint operation is either a transaction by the reporting entity with itself or a transaction with the other joint operator which would not be a related party unless it otherwise met the related party definition in IAS 24 for some other reason (e.g., because it was an entity controlled by a member of key management personnel). *[IFRS 12.BC52]*.

3.1.4 Entities that are joint ventures of the same third party

An entity is related to a reporting entity if: *[IAS 24.9]*

Extract from IAS 24

9 The following terms are used in this Standard with the meanings specified:

A *related party* is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the 'reporting entity').

(a) ...

(b) An entity is related to a reporting entity if any of the following conditions applies:

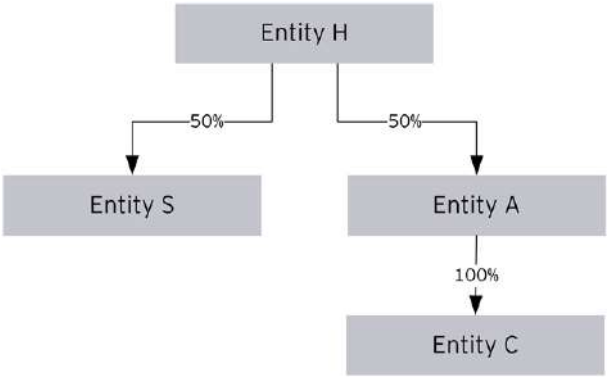
(i) ...

(iii) Both entities are joint ventures of the same third party.

(iv) ...

This is illustrated by the following:

Illustration 3-5: Entities that are joint ventures of the same third party



In this Illustration, Entities S and A are joint ventures of Entity H and are therefore related parties of one another. Entity C, as a subsidiary of Entity A, is also a related party of Entity H and Entity S.

If, however, Entities S and A were associates (rather than joint ventures) of the Entity H, then they would not be related parties, as there is no control in either leg of this indirect relationship (see section 3.2 below). The Basis for Conclusions to IAS 24 explains that a distinction was made between joint ventures and associates because the IASB considered that 'significant influence' was not as close a relationship as control or joint control. *[IAS 24.BC19(a)]*.

As noted above, in the definition of a related party, a joint venture includes subsidiaries of the joint venture. Therefore, a joint venture's subsidiary and the investor that has joint control over the joint venture are related parties of one another. *[IAS 24.12]*.

3.1.5 Entities that are joint ventures of a third party and associates of the same third entity

An entity is related to a reporting entity if: *[IAS 24.9]*

Extract from IAS 24

9 The following terms are used in this Standard with the meanings specified:

A related party is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the 'reporting entity').

(a) ...

(b) An entity is related to a reporting entity if any of the following conditions applies:

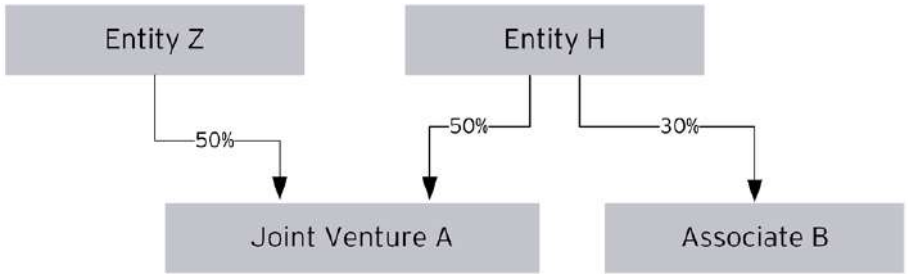
(i) ...

(iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.

(v) ...

This definition treats joint ventures in a similar manner to subsidiaries as shown in Illustration 3-3 above and therefore, an associate and a joint venture are related parties where they have an investor in common and that investor has control over the one and joint control over the other. This is because joint control exists in one leg of the indirect relationship between the investees. This is illustrated below:

Illustration 3-6: Entities that are joint ventures and associates of the same third entity



Joint Venture A is a joint venture of Entity H and Associate B is an associate of Entity H. Therefore, Joint Venture A and Associate B are related parties.

However, Entities Z and H are not related parties (see sections 3.2 and 3.3 below).

3.1.6 Post-employment benefit plans

An entity is related to a reporting entity if: *[IAS 24.9]*

Extract from IAS 24

9 The following terms are used in this Standard with the meanings specified:

A related party is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the 'reporting entity').

(a) ...

(b) An entity is related to a reporting entity if any of the following conditions applies:

(i) ...

(v) The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.

(vii) ...

The definition is quite wide-ranging and includes post-employment benefit plans of any entity related to the reporting entity. This includes, for example, post-employment benefit plans of an associate or joint venture of the reporting entity or a post-employment benefit plan of an associate of the reporting entity's parent.

The related party relationship would not extend to investment managers of the pension fund, provided that their acting for the fund was the only relationship. Any fees paid by the sponsoring employers (for example, to the investment manager) on behalf of the pension fund would be a related party transaction. 'Sponsoring employers' is not defined in IFRS accounting standards, but is generally taken to mean the entity which has a legal duty to ensure that funds are available in the pension fund when the payment of pensions falls due.

Sponsoring employers are also related parties of a post-employment benefit plan.

3.1.7 Entities under control or joint control of certain persons or close members of their family

An entity is related to a reporting entity if: *[IAS 24.9]*

Extract from IAS 24

9 The following terms are used in this Standard with the meanings specified:

A *related party* is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the 'reporting entity').

(a) A person or a close member of that person's family is related to a reporting entity if that person:

(i) has control or joint control of the reporting entity;

(ii) has significant influence over the reporting entity; or

(iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

(b) An entity is related to a reporting entity if any of the following conditions applies:

(i) ...

(vi) The entity is controlled or jointly controlled by a person identified in (a).

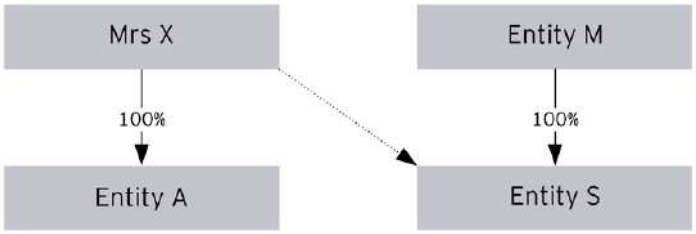
(vii) ...

This is intended to address situations in which an entity is controlled or jointly controlled by a person or close family member of that person and that person or close family member also controls, jointly controls, has significant influence over, or is a member of key management personnel of, the reporting entity or of a parent of the reporting entity. The situation whereby one company owns another is covered by Illustration 3-3 above.

This is illustrated below:

Illustration 3-7: Persons who control an entity and are a member of the key management personnel of another entity

Mrs X has a 100% investment in Entity A and is a member of the key management personnel of Entity S. Entity M has a 100% investment in Entity S.



For Entity S's financial statements, Entity A is related to Entity S because Mrs X controls Entity A and is a member of the key management personnel of Entity S.

For Entity S's financial statements, Entity A would also be related to Entity S if Mrs X is a member of the key management personnel of Entity M and not of Entity S.

This outcome would be the same if Mrs X had joint control over Entity A (if Mrs X only had significant influence over Entity A and not control or joint control then Entities A and S would not be related parties).

For Entity A's financial statements, Entity S is related to Entity A because Mrs X controls Entity A and is a member of Entity S's key management personnel. This outcome would be the same if Mrs X has joint control over Entity A and would also be the same if Mrs X is a member of the key management personnel of Entity M rather than Entity S (see section 3.1.8 below). Note that Entity M would also be a related party of Entity A in this instance.

For Entity M's consolidated financial statements, Entity A is a related party of the Group if Mrs X is a member of the key management personnel of the Group.

For Entity M's separate financial statements, Entity S is a related party. Further, Entity A will be a related party if Mrs X is a member of the key management personnel of Entity M.

3.1.8 Entities under significant influence of certain persons or close members of their family

An entity is related to a reporting entity if: *[IAS 24.9]*

Extract from IAS 24

9 The following terms are used in this Standard with the meanings specified:

A related party is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the 'reporting entity').

(a) A person or a close member of that person's family is related to a reporting entity if that person:

(i) has control or joint control of the reporting entity;

(ii) …

(b) An entity is related to a reporting entity if any of the following conditions applies:

(i) …

(vii) A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

(viii) …

This is the reciprocal of 3.1.7 and is illustrated in Illustration 3-7 above.

Entities that are significantly influenced by the same person or close member of that person's family or who simply share the same key management personnel are not related parties in the absence of any control or joint control by those persons (see section 3.3 below).

3.1.9 Entities, or any member of the group of which they are a part, that provide key management personnel services

An entity is related to a reporting entity if: *[IAS 24.9]*

Extract from IAS 24

9 The following terms are used in this Standard with the meanings specified:

A related party is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the 'reporting entity').

(a) …

(b) An entity is related to a reporting entity if any of the following conditions applies:

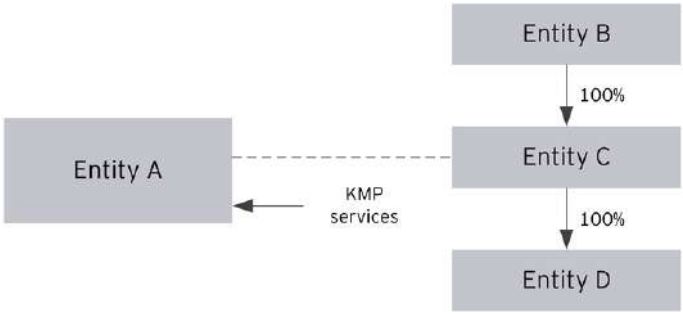
(i) …

(viii) The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.

…

This is intended to address situations in which an entity (described as a 'management entity'), or a member of its group, provides key management personnel services to the reporting entity (see sections 4.3 and 5.3 below) and is most commonly seen in the fund management sector. It applies to the provision of key management personnel services by the separate management entity. Staff acting for the management entity that are responsible for planning, directing and controlling the activities of the reporting entity are not considered to be key management personnel of the reporting entity. It is not necessary to look through the management entity to determine natural persons (see section 3.1.1.D above) as key management personnel. *[IAS 24.17A]*.

Illustration 3-8: Entities that provide key management personnel (KMP) services to a reporting entity



Entity C provides key management personnel services to Entity A. For Entity A's financial statements, Entities B, C and D are all related parties.

For the financial statements of Entities B, C and D, there is no related party relationship with Entity A. The related party relationship between the management entity and the reporting entity is not symmetrical. In the absence of any other indicator of a related party relationship, the reporting entity (Entity A) cannot affect the management entity's (Entity C's) activities, financial position or profit or loss.

3.1.10 Government-related entities

A 'government-related entity' is an entity that is controlled, jointly controlled or significantly influenced by a government. *[IAS 24.9]*.

'Government' in this context refers to government, government agencies and similar bodies whether local, national or international. *[IAS 24.9]*. This is the same as the definition used in IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* - see Chapter 25. The Board decided that it would not provide a more comprehensive definition or additional guidance on how to determine what is meant by 'government'. In the Board's view, a more detailed definition could not capture every conceivable government structure across every jurisdiction. In addition, judgement is required by a reporting entity when applying the definition because every jurisdiction has its own way of organising government-related activities. *[IAS 24.BC41]*. This implies that there may well be diversity in practice across different jurisdictions in defining what is meant by 'government'. For jurisdictions with multiple levels of government, judgement may be needed about whether parties controlled by different levels of government are related (for example, state versus federal), notwithstanding that both controlling parties are government bodies.

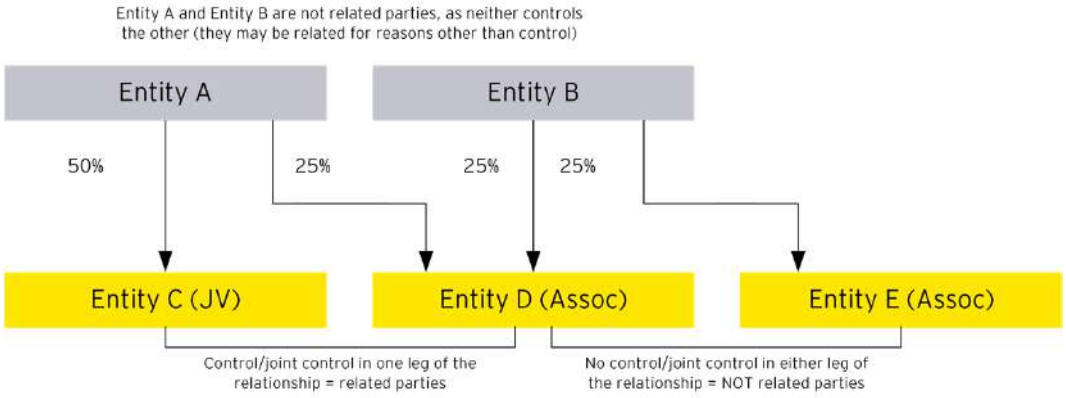
Where an entity is controlled, jointly controlled or significantly influenced by a government, then relationships, transactions and outstanding balances, including commitments, with that government are related party transactions. Similarly, transactions and outstanding balances, including commitments, with other entities controlled, jointly controlled or significantly influenced by that government are related party transactions. Related party transactions with government-related entities are subject to certain disclosure exemptions, with additional disclosure requirements depending on whether the transaction is individually significant or collectively significant and its consequent effect on the financial statements. *[IAS 24.26(bXi), IAS 24.26(bXii)]*. These are discussed in section 6 below.

3.2 Direct and indirect relationships

As indicated in previous paragraphs, IAS 24 contains a multi-part definition of 'related party' and therefore, the identification of all related parties in large groups can be complex. Moreover, IFRS 10 requires the continuous reassessment of control (see Chapter 7 at section 9) and for practical reasons, this may be difficult to execute in a timely manner. One possible way to address this complexity is to identify within a group direct and indirect relationships of the reporting entity. A direct relationship is where one entity has either control, joint control or significant influence over another entity (for example, a parent and a subsidiary), whereas an indirect relationship is where two entities may share a common investor, but neither entity has control, joint control or significant influence over the other entity (for example, two subsidiaries in a group).

For direct relationships, if control, joint control or significant influence is present, a related party relationship exists. *[IAS 24.9(b)(i), IAS 24.9(b)(ii), IAS 24.9(b)(iii), IAS 24.9(b)(iv)]*. However, for indirect relationships, control or joint control must exist in one leg of that indirect relationship for a related party relationship to exist. If only significant influence exists in both legs of the relationship, there is no related party relationship. Thus, two associates with a common investor are related to that investor, but not to each other. *[IAS 24.IE7]*. This is in contrast to a joint venture and an associate with a common investor, which will be related to each other as joint control exists in one leg of that indirect relationship. *[IAS 24.9(b)(iv)]*. Two investors with joint control over a joint venture are related to the joint venture, but not to each other. *[IAS 24.9(b)(ii), IAS 24.11(b)]*. This is because joint control exists with regard to their relationship with the joint venture, but there is no control relationship between the investors. The diagram below illustrates how the concept of control is applied in the context of IAS 24.

Illustration 3-9: The effect of the control concept in IAS 24 for direct and indirect relationships



3.3 Parties that are not related parties

Having included such a detailed definition of related parties, IAS 24 clarifies that the following are not related parties: *[IAS 24.11]*

Extract from IAS 24

11 In the context of this Standard, the following are not related parties:

(a) two entities simply because they have a director or other member of key management personnel in common or because a member of key management personnel of one entity has significant influence over the other entity.

(b) two joint venturers simply because they share joint control of a joint venture.

(c) (i) providers of finance,

(ii) trade unions,

(iii) public utilities, and

(iv) departments and agencies of a government that does not control, jointly control or significant influence the reporting entity,

simply by virtue of their normal dealings with an entity (even though they may affect the freedom of action of an entity or participate in its decision-making process).

(d) a customer, supplier, franchisor, distributor or general agent with whom an entity transacts a significant volume of business, simply by virtue of the resulting economic dependence.

The list above illustrates the application of the definition of 'related party' in IAS 24. Without the illustrations, there may be a risk of a perception that a related party relationship exists, for example where there is economic dependence on a single customer, but it is important to distinguish between control, as defined in IFRS 10 (see Chapter 7 at sections 3 and 7, respectively) and applied in IAS 24 and economic dependence, which is not relevant for an assessment of control.

These illustrations are relevant only for the precise situations described and there may be other reasons why a party in the list above is a related party. Consider the following examples:

- A water company that supplies the reporting entity is not a related party if the only link between the two is the supply of water. If, however, the water company is also an associate of the reporting entity, the exclusion does not apply; the two are related parties, and the transactions relating to the supply of water are disclosed if material.
- Two investors in the same entity are not related parties simply because one holds a controlling interest, and the other shareholder (not in the group) holds a non-controlling interest in a subsidiary of the group. Even if the investor holding the non-controlling interest exercises significant influence over the subsidiary, provided it is not otherwise related to the controlling investor, it is not normally a related party of the controlling investor. However, the non-controlling investor might have significant influence over the group if the subsidiary was significant to the group in which case the group, including the controlling investor and the non-controlling investor are related parties.
- Two entities are not related parties simply because they share common key management personnel. However, if the common member of key management personnel exerts control or joint control over one or more of the entities then they are related parties. See sections 3.1.7 and 3.1.8 above.
- An administrator, custodian, broker and fund manager of the same fund are not related parties, to each other or to the fund to which they provide services simply because they each provide services to the fund, even if any of the parties are economically dependent upon the income from such services. However, any such party could meet the definition of 'key management personnel' of the fund if it provides key management personnel services (see section 3.1.9 above). In addition, any shared ownership (e.g., control, joint control, or significant influence) between such parties should be evaluated to determine if the parties are related.

An interest in an unconsolidated structured entity as defined by IFRS 12 *Disclosure of Interests in Other Entities* held by a reporting entity does not make the structured entity a related party to the reporting entity unless it would otherwise meet the definition of a related party (for example, because the structured entity is an associate of the reporting entity).

4 Disclosure of controlling relationships

IAS 24 asserts that, in order to enable users of financial statements to form a view about the effects of related party relationships on an entity, it is appropriate to disclose the related party relationship when control exists, irrespective of whether there have been transactions between the related parties. *[IAS 24.14]*. Accordingly, IAS 24 requires an entity to disclose:

- The name of its parent and, if different
- The ultimate controlling party

If neither the entity's parent nor the ultimate controlling party produces consolidated financial statements available for public use, the name of the next most senior parent that does so must also be disclosed. *[IAS 24.13]*.

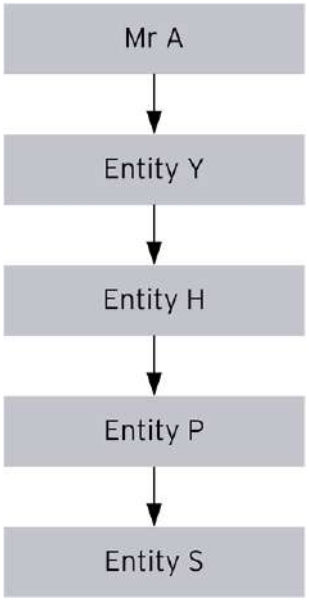
The 'next most senior parent' is the first parent in the group above the immediate parent that produces consolidated financial statements available for public use. *[IAS 24.16]*. Consequently, in some circumstances, an entity may need to disclose the names of three parents.

Disclosure must be made even if the parent or ultimate controlling party does not prepare financial statements. In the situation when the ultimate controlling party is an individual, rather than an entity, the reporting entity is likely to have to disclose the name of the next most senior parent in addition since the individual undoubtedly does not produce financial statements for public use. IAS 1 requires disclosure of the 'ultimate parent' of the group. *[IAS 1.138(c)]*. This is not necessarily synonymous with the 'ultimate controlling party' where that party is an individual. This is illustrated below.

Illustration 4-1: Disclosure of parent, ultimate parent and ultimate controlling party

Entity S is controlled by Entity P which in turn is controlled by Entity H which in turn is controlled by Entity Y. Mr A is the controlling party of Entity Y. Entities P and Y do not produce consolidated financial statements available for public use.

The group structure is illustrated as follows:



For Entity S's financial statements:

IAS 24 requires disclosure of Entity P (the parent), Entity H (the next most senior parent that produces consolidated financial statements available for public use) and Mr A (the ultimate controlling party). In addition, IAS 1 requires disclosure of Entity Y (the ultimate parent of the group).

For Entity P's financial statements:

IAS 24 requires disclosure of Entity H (the parent) and Mr A (the ultimate controlling party). In addition, IAS 1 requires disclosure of Entity Y (the ultimate parent of the group).

For Entity H's financial statements:

IAS 24 requires disclosure of Entity Y (the parent) and Mr A (the ultimate controlling party). IAS 1 does not require any additional disclosure.

For Entity Y's financial statements

IAS 24 requires disclosure of Mr A (ultimate controlling party).

The ultimate controlling party could be a group of individuals or entities acting together. IAS 24 is silent on the issue of individuals or entities acting together to exercise joint control. However, IFRS 3 *Business Combinations* states that a group of individuals can be regarded as a controlling party when, as a result of contractual arrangements, they collectively have the power to govern that entity's financial and operating policies so as to obtain benefits from its activities. *[IFRS 3.B2]*. In such circumstances, these entities or individuals should be identified as the controlling party. However, as discussed in section 3 above, IAS 24 emphasises that attention should be directed to the substance of any related party relationship and not merely the legal form. It is likely that such an informal arrangement would at least give such individuals acting collectively significant influence over the reporting entity and as such, those individuals would be related parties to the reporting entity under IAS 24.

IAS 24 also clarifies that the requirement to disclose related party relationships between a parent and its subsidiaries is in addition to the disclosure requirements of IAS 27 and IFRS 12. *[IAS 24.15]*. IAS 27 requires a parent's separate financial statements to disclose:

- A list of the significant investments in subsidiaries, joint ventures and associates including the name, place of business (and, if different, country of incorporation)
- Proportion of ownership interest (and if different, proportion of voting power held)
- A description of the method used to account for such investments - see Chapter 9 at section 3.1

IFRS 12 requires an entity to disclose information to enable users to understand the composition of a group - see Chapter 14 at section 4.1.

4.1 Disclosable transactions

A related party transaction is defined as "a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged." *[IAS 24.9]*. Read literally, this definition requires many transactions to be disclosed more than once. For example, if an entity buys goods on credit from a related party and pays for them 30 days later, both the original purchase and the final payment represent a 'transfer of resources' 'between a reporting entity and a related party' and, therefore, on a literal reading, are required to be separately disclosed. However, we doubt that this reading is the IASB's intention, and the nature of the disclosures required by IAS 24 seems to support this interpretation.

The definition of a related party transaction implies that transactions are disclosable only for the period in which parties are related. For example, where a reporting entity has disposed of a subsidiary during the reporting period, only transactions with the subsidiary up to the date of disposal are related party transactions in the financial statements of the reporting entity. Similarly, if a person became a member of key management personnel of a reporting entity during a reporting period, no disclosure is required of any remuneration paid to that person before that person's appointment as key management personnel. Likewise, transactions with a party in the comparative period are not disclosable as related party transactions if in the comparative period that party was not related to the reporting entity. Transactions with a party are not disclosable in the current year if the related party relationship had ceased before the beginning of the current period although, transactions in the comparative period are disclosed.

IAS 24 is unclear whether disclosure of outstanding balances at the reporting date is required in situations where an entity ceases to be a related party during the reporting period. In such situations, one view is that outstanding balances are not disclosable since the entity is not a related party as at the reporting date. A second view is that if the outstanding balances as at the reporting date comprise of amounts related to the transactions when the entities were related, such outstanding balances should be included in related party disclosures.

How we see it

In our view, either view is acceptable. However, if an entity becomes a related party during the year, outstanding balances as at the reporting date, that include amounts related to transactions entered into when the entities were unrelated, are disclosable.

In the case that entities become related after the reporting date, but before the financial statements were authorised for issue, it may be necessary to disclose the relationship, if it is considered by management to be a material non-adjusting event, in accordance with IAS 10 *Events after the Reporting Period* - see Chapter 34. *[IAS 10.21]*.

There is no requirement in IAS 24 to disclose information about related party transactions in one comprehensive note. However, it may be more useful to users of the financial statements to present information this way.

IAS 1 requires that, except where a standard permits otherwise (which IAS 24 does not), comparative information in respect of the previous period must be disclosed for all amounts reported in the current period's financial statements. *[IAS 1.38]*. This applies to all transactions for which a related party relationship existed in the prior period, but as noted above, does not apply to transactions with a party which only became related in the current period.

4.2 Materiality

In determining whether an entity discloses related party transactions in financial statements, the general concept of materiality is applied. IAS 24 does not refer specifically to materiality since this requirement is in IAS 1, which states that "an entity need not provide a specific disclosure required by an IFRS if the information resulting from that disclosure is not material." *[IAS 1.31]*. Omissions, misstatements or obscuring of information are material within IAS 1 if "it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity. Materiality depends on the nature or magnitude of information, or both. An entity assesses whether information, either individually or in combination with other information, is material in the context of its financial statements taken as a whole." *[IAS 1.7]*.

The nature of the qualitative aspect of materiality in respect of related party transactions is made explicit in the non-mandatory Practice Statement 2 - *Making Materiality Judgements*, issued by the IASB Board in September 2017. *[PS 2.48]*. The statement lists the involvement of a related party of the entity as an entity-specific qualitative materiality factor of an entity's transaction, other event or condition. It further explains that the presence of a qualitative factor lowers the thresholds for the quantitative assessment and that the more significant the qualitative factors, the lower the quantitative factors will be. *The Conceptual Framework for Financial Reporting*, issued in March 2018, also emphasises that materiality is an entity-specific aspect of relevance, based on nature, magnitude or both and what could be material in a particular situation cannot be predetermined, nor can a uniform quantitative threshold be specified. *[CF 2.11]*.

This qualitative aspect of materiality may have the effect that any related party transaction whose disclosure is considered sensitive (e.g., key management compensation or for tax reasons perhaps) is by definition material because it is expected by the reporting entity to influence a user of the financial statements.

How we see it

It may not be possible to avoid disclosing sensitive related party transactions on the grounds that they are quantitatively immaterial. In addition, a transaction conducted at advantageous terms to either the related party or the reporting entity is more likely to be material than one conducted at arm's length. Since IAS 24 requires disclosure of related party transactions irrespective of whether consideration is received, disclosure cannot be avoided on the argument that, since there is no consideration, the transaction must be immaterial.

4.3 Disclosure of key management personnel compensation

IAS 24 requires disclosure of key management personnel compensation including the amount of outstanding balances, for example, unpaid bonuses and commitments.

There is no requirement in IAS 24 to disclose individual key management personnel compensation. Instead, entities are required to disclose key management personnel compensation in total and for each of the following categories:

- Short-term employee benefits
- Post-employment benefits
- Other long-term benefits
- Termination benefits
- Share-based payment *[IAS 24.17]*

These disclosures must be provided within the notes to the financial statements even when the same (or perhaps even more detailed) information is presented outside the financial statements. This is supported by Practice Statement 2, which emphasises that publicly available information does not relieve an entity of the obligation to provide material information in its financial statements (paragraph 26 of the Practice Statement). With regard to interim reports, IAS 34 *Interim Financial Reporting* requires the disclosure of related party transactions if those transactions are significant (see Chapter 37 at section 4.3.8). *[IAS 34.15B(j)]*.

IAS 24 (see section 3.1.9 above) clarifies that where an entity obtains key management personnel services from another entity ('management entity') it is not required to apply the requirements above to the compensation paid or payable by the management entity to the management entity's employees or directors. *[IAS 24.17A]*.

4.3.1 Compensation

'Compensation' includes all employee benefits (as defined in IAS 19 *Employee Benefits*) including employee benefits to which IFRS 2 *Share-based Payment* applies. Employee benefits are all forms of consideration given by an entity, or on behalf of the entity, in exchange for services rendered to the entity by the employees. Employee benefits also include such consideration paid on behalf of a parent of the entity in respect of the entity. *[IAS 24.9]*. Therefore, the compensation disclosed by an entity in its financial statements is that which is for services to that entity, irrespective of whether it is paid by the reporting entity or by another entity or individual on behalf of the reporting entity. Further, the disclosures must include outstanding balances and commitments. Compensation includes: *[IAS 24.9]*

Extract from IAS 24

9 **The following terms are used in this Standard with the meanings specified:**

...

***Compensation* includes ...**

(a) short-term employee benefits, such as wages, salaries and social security contributions, paid annual leave and paid sick leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

(b) post-employment benefits such as pensions, other retirement benefits, post-employment life insurance and post-employment medical care;

(c) other long-term employee benefits, including long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation;

(d) termination benefits; and

(e) share-based payment.

...

IAS 24 is a disclosure standard only and therefore, does not provide guidance about the basis on which the amount for each of the categories above is determined. As observed in the Basis for Conclusions, the IASB noted that the guidance on compensation in IAS 19 is sufficient to enable an entity to disclose the relevant information, which suggests that the IASB is expecting the compensation amounts to be based on the expense recognised under the relevant standards (IAS 19 or IFRS 2). *[IAS 24.BC10]*. This is commonly observed practice. It is helpful to remember that the definition of compensation states that "employee benefits are all forms of consideration paid, payable or provided by the entity, or on behalf of the entity, in exchange for services rendered to the entity" *[IAS 24.9]* and therefore, compensation should be disclosed, even when provided by the parent or another group company. This remains the case in situations when no recharge for the cost of those services is made to the entity to whom the members of key management personnel are providing services; the absence of a management recharge does not negate the fact that employee benefits have been paid or provided on behalf of the entity for services rendered to that entity. In circumstances where a recharge has not been made to a subsidiary, it will usually be possible for management of the subsidiary to obtain information regarding the cost of the services from its parent. In the rare circumstances where this is not practicable, judgement needs to be exercised in order to meet the disclosure objective in IAS 24 (for example, an apportionment might be made).

Issues relating to each of the categories are discussed below.

For an illustrative example of the disclosure of key management personnel compensation, see Practical example 4-1 in section 4.3.9 below.

4.3.2 Short-term employee benefits

As indicated in section 4.3.1 above, short-term employee benefits include wages, salaries and social security contributions, paid annual leave and paid sick leave, profit-sharing and bonuses (if expected to be settled wholly before twelve months after the end of the reporting period). Most of these should not cause difficulty, since the expense for such items under IAS 19 is generally equivalent to the amount payable for the period. The disclosures would also include outstanding balances and commitments.

Non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) must also be included within the amount disclosed for short-term employee benefits. *[IAS 24.9]*. In some cases, these might have been provided at no direct cost to the entity. In such circumstances, it would appear reasonable to attribute either a value for non-monetary benefits (for example, the attributable tax benefit), so as to describe them quantitatively, or to describe such benefits qualitatively.

4.3.3 Post-employment benefits

As indicated in section 4.3.1 above, these include pensions, other retirement benefits, post-employment life insurance and post-employment medical care. The inclusion of this category confirms that amounts are disclosed while members of key management are providing services. If amounts were only disclosed when the benefits are payable, then in many cases, there would be no disclosure since the individuals would no longer be members of key management. The definition of related party transaction includes 'obligations between a reporting entity and a related party'. This implies that post-employment benefit obligations, including commitments, between the reporting entity and the members of key management during the period covered by the financial statements are disclosed.

For defined contribution plans, it seems appropriate that the amount included is based on the total expense recognised under IAS 19, which is the equivalent of the contributions paid or payable to the plan for service rendered in the period.

The main issue related to defined benefit plans is to determine an appropriate calculation for the disclosable amount for the period. IAS 24 is silent on how the disclosable amount should be determined. One approach would be to determine the disclosable amount based only on the service cost related to those individuals, on the grounds that the other items recognised as an expense under IAS 19 relate more closely to the overall plan than to the individuals. A second approach to determine the disclosable amount would be to include an amount based on all components of the IAS 19 expense recognised in total comprehensive income. The total amounts recognised under IAS 19 for defined benefit plans includes items such as interest, actuarial remeasurement gains and losses and the effects of curtailments and settlements. This approach requires an apportionment of the total expense to the extent that it relates to the individuals concerned. An entity should apply a consistent accounting policy for determining the amounts disclosed.

4.3.4 Other long-term benefits

As indicated in section 4.3.1 above, these include long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and, if they are not expected to be settled wholly before twelve months after the end of the reporting period, profit sharing, bonuses and deferred compensation. Since the accounting for such items under IAS 19 is on a similar basis to that for post-employment benefits similar issues to those discussed in section 4.3.3 above are applicable.

4.3.5 Termination benefits

These should not cause difficulty, since an entity generally recognises such items, particularly for key management personnel, in line with the recognition criteria included in IAS 19.

4.3.6 Share-based payment transactions

This category includes share options, share awards or cash-settled awards granted in return for service by the members of key management. Such compensation is accounted for under IFRS 2. For equity-settled share-based payment transactions, such as share options or share awards, IFRS 2 broadly requires measurement of their fair value at grant date, and that expense is recognised over the period that employees render services. For cash-settled share-based payment transactions, IFRS 2 requires measurement and recognition based on the cash ultimately paid.

IAS 24 does not specify a basis on which the compensation disclosed should be determined. One basis would be to disclose an amount based on the expense under IFRS 2. This basis could lead to negative compensation being disclosed, for example, as a result of the reversal of a cumulative expense relating to share-based payments whose non-market vesting condition has not been satisfied. In this case, the reporting entity should consider whether additional disclosure is necessary to explain the amount and the change from the prior year. Another basis would be to disclose amounts based on the fair value that the individual received (based on the value of the shares at date of vesting, or at date of exercise of share options or the cash that is ultimately payable) rather than over the period of the service. An entity should adopt a consistent accounting policy for determining the amounts disclosed. In determining an appropriate accounting policy, the entity should also consider consistency with other disclosures related to key management personnel compensation made outside the financial statements.

4.3.7 Reporting entity part of a group

One additional practical difficulty for an entity in a group is that the disclosure of its key management personnel compensation is for the services rendered to the reporting entity. Accordingly, where key management personnel of the reporting entity also provide services to other entities within the group, an apportionment of the compensation is necessary. Likewise, where the reporting entity receives services from key management personnel that are also key management personnel of other entities within the group, the reporting entity may have to impute the compensation received. Such apportionments and allocations require judgement and an assessment of the time commitment involved.

4.3.8 Key management personnel compensated by other entities

A reporting entity also applies the principles set out in section 4.3.7 above to situations in which the other entity is a third party, outside of the group, but is a related party.

4.3.9 Illustrative disclosure of key management personnel compensation

An example of the disclosure of key management personnel compensation can be found in the financial statements of BP p.l.c.

Practical example 4-1: BP p.l.c. (2020) **United Kingdom**

Annual Report and Form 20-F 2020 [extract]

Notes on financial statements [extract]

34. Remuneration of senior management and non-executive directors [extract]

Remuneration of directors and senior management

			$ million
	2020	2019	2018
Total for all senior management and non-executive directors			
Short-term employee benefits	17	30	25
Pensions and other post-retirement benefits	2	2	2
Share-based payments	52	32	32
Termination benefits	8	—	—
Total	79	64	59

Senior management comprises members of the leadership team, see pages 78-79 for further information.

Short-term employee benefits
These amounts comprise fees and benefits paid to the non-executive chairman and non-executive directors, as well as salary, benefits and cash bonuses for senior management. Deferred annual bonus awards, to be settled in shares, are included in share-based payments.

Pensions and other post-retirement benefits
The amounts represent the estimated cost to the group of providing pensions and other post-retirement benefits to senior management in respect of the current year of service measured in accordance with IAS 19 'Employee Benefits'.

Share-based payments
This is the cost to the group of senior management's participation in share-based payment plans, as measured by the fair value of options and shares granted, accounted for in accordance with IFRS 2 'Share-based Payments'.

Termination benefits
Termination benefits include compensation to senior management for loss of office.

5 Disclosure of other related party transactions, including commitments

IAS 24 requires an entity that has had related party transactions during the periods covered by its financial statements to disclose the nature of the related party relationship as well as information about those transactions and outstanding balances, including commitments, necessary for users to understand the potential effect of the relationship on the financial statements. *[IAS 24.18]*.

5.1 Related party transactions requiring disclosure

IAS 24 gives the following as examples of transactions to be disclosed, if they are with a related party. The list is not intended to be exhaustive:

- Purchases or sales of goods (finished or unfinished)
- Purchases or sales of property and other assets
- Rendering or receiving of services
- Leases
- Transfers of research and development
- Transfers under licence agreements
- Transfers under finance arrangements (including loans and equity contributions in cash or in kind)
- Provisions of guarantees or collateral
- Commitments to do something if a particular event occurs or does not occur in the future, including executory contracts (recognised and unrecognised)

  And
- Settlement of liabilities on behalf of the entity or by the entity on behalf of that related party *[IAS 24.21]*

IAS 24 does not contain any exemptions based on the nature of the transaction. Consequently, related party transactions include transactions such as dividend payments and the issue of shares under rights issues to major shareholders or key management personnel (i.e., those that fall within the definition of related parties), even where they participate on the same basis as other shareholders. Further, not all transactions may need to be disclosed, provided due attention is paid to the qualitative aspects of materiality, discussed in section 4.2 above.

Related party transactions also include transactions with those individuals identified as related parties where their dealings with the entity are in a private capacity, rather than in a business capacity.

Participation by a parent or subsidiary in a defined benefit plan that shares risks between group entities is a transaction between related parties (see Chapter 31 at section 3.3.2). *[IAS 24.22]*.

As indicated in section 4.1 above, disclosure is required irrespective of whether or not consideration is received, which means that IAS 24 applies to gifts of assets or services and to asset swaps. Common examples of such transactions which may occur within a group include the following, though this list is not exhaustive:

- Administration by an entity of another entity within a group (or of its post-employment benefit plan) free of charge
- Transfer of tax assets from one member of a group to another without payment
- Rent-free leases (accommodation) or the loan of assets at no charge
- Guarantees by directors of bank loans to the entity

5.1.1 Aggregation of items of a similar nature

Presumably in order to minimise the volume of disclosures, IAS 24 permits aggregation of items of a similar nature, except when separate disclosure is necessary for an understanding of the effects of the related party transactions on the financial statements of the entity, subject to considerations of materiality - see section 4.2 above. *[IAS 24.24]*. IAS 24 does not expand on this requirement, but it seems appropriate that, for example, purchases or sales of goods with other subsidiaries within a group can be aggregated, but it may be appropriate to show any purchases or sales of property, plant, and equipment or of intangible assets with such entities as a separate category. However, the level of aggregation is limited by the separate disclosure of transactions with particular categories of related parties (see section 5.2 below).

5.1.2 Commitments

IAS 24 provides no definition of commitments, though definitions relating to commitments are present in other standards. IFRS 12 states that the commitments relating to joint ventures are those that may give rise to a future outflow of cash or other resources, *[IFRS 12.B18]*, and IFRS 9 defines a firm commitment as "a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates". *[IFRS 9 Appendix A]*. However, commitments should be considered more widely than these definitions: a typical example of a disclosable commitment might be the agreement to pay certain benefits to an employee on the termination of employment.

IAS 24 specifically mentions executory contracts (recognised and unrecognised) as commitments requiring disclosure. *[IAS 24.21(i)]*. Executory contracts are excluded from the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* unless they are onerous to the reporting entity. An executory contract is a contract under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. *[IAS 37.3]*. An example of an executory contract would be a contract to buy an asset at a future date where neither the transfer of the asset nor the payment of consideration has occurred.

The words "commitments to do something if a particular event occurs or does not occur in the future" can potentially have a wide application and does not limit itself to contractual commitments required to be disclosed by other standards.

With respect to the type of transaction to be disclosed, IFRS 12 provides a list of illustrative, but not exhaustive, examples of the type of unrecognised commitments that could relate to joint ventures. Some of these examples could apply equally to other related party arrangements. IFRS 12 clarifies that the commitments required to be disclosed under IAS 24 in respect of joint ventures include an entity's share of commitments made jointly with other investors with joint control of a joint venture. *[IFRS 12.B18]*.

IFRS 12 provides the following illustrations of commitments relating to joint ventures that would typically be disclosable under IAS 24.18 and could apply equally to other related party arrangements:

- Unrecognised commitments to contribute funding or resources as a result of, for example:
  - The constitution or acquisition agreements of a joint venture (that, for example, require an entity to contribute funds over a specific period)
  - Capital intensive projects undertaken by a joint venture
  - Unconditional purchase obligations, comprising procurement of equipment, inventory or services that an entity is committed to purchasing from, or on behalf of, a joint venture
  - Unrecognised commitments to provide loans or other financial support to a joint venture
  - Unrecognised commitments to contribute resources to a joint venture, such as assets or services
  - Other non-cancellable unrecognised commitments relating to a joint venture
- Unrecognised commitments to acquire another party's ownership interest (or a portion of that ownership interest) in a joint venture if a particular event occurs or does not occur in the future. *[IFRS 12.B19, IFRS 12.B20]*.

Provisions of guarantees, which are a form of commitment, require separate disclosure. Disclosure of commitments to purchase property, plant and equipment and intangible assets in aggregate is required separately by IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* respectively. *[IAS 16.74(c), IAS 38.122(e)]*.

5.2 Disclosures required for related party transactions, including commitments

The standard states that, at a minimum, the disclosures must include:

(a) The amount of the transactions

(b) The amount of outstanding balances, including commitments and:
  (i) Their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement
  (ii) Details of any guarantees given or received

(c) Provisions for doubtful debts related to the amount of outstanding balances

And

(d) The expense recognised during the period in respect of bad or doubtful debts due from related parties *[IAS 24.18]*

The standard gives no exemption from disclosure on the grounds of sensitivity or confidentiality.

The requirement in (b) above could be read literally as requiring outstanding balances and commitments to be amalgamated into a single balance. However, commitments such as executory contracts do not give rise to outstanding balances. In practice, narrative disclosure of the terms and conditions of material commitments will be necessary.

There is no requirement to disclose individually significant transactions. However, as discussed in section 6 below, there is such a requirement for transactions with government-related entities where a reporting entity has decided to apply the disclosure exemption.

The disclosures are required to be made separately for each of the following categories:

(a) The parent
(b) Entities with joint control of, or significant influence over, the entity
(c) Subsidiaries
(d) Associates
(e) Joint ventures in which the entity is a joint venturer
(f) Key management personnel of the entity or its parent

And

(g) Other related parties *[IAS 24.19]*

How we see it

In our view, the references in (a) and (f) above to 'the parent' should be read as including all parents of the entity, i.e., its immediate parent, any intermediate parent and the ultimate parent.

In the context of the financial statements of an entity within a group, it is insufficient to disclose related party transactions for a single category of 'group companies'. Separate categories are required for parent(s), subsidiaries and 'other related parties'.

IAS 24 does not identify the following relationships as a separate category of related party, and therefore, information related to the following relationships would be included within the category 'other related parties':

- Fellow subsidiaries
- Subsidiaries of an investor with significant influence
- Associates of the entity's controlling investor

However, a preparer should consider separate disclosure of transactions with the above related parties if this would provide useful information to users of the entity's financial statements.

The classification of amounts payable to, and receivable from, related parties in the different categories is an extension of the disclosure requirement in IAS 1 for an entity to present information either in the statement of financial position or in the notes. *[IAS 1.77]*. The categories are extended to provide a more comprehensive analysis of related party balances and apply to related party transactions. *[IAS 24.20]*. Note that local regulations in different jurisdictions may provide for specific disclosure requirements and these should be considered in addition to the requirements in IAS 24.

IAS 24 emphasises that an entity should not state that related party transactions are on an arm's length basis unless the reporting entity can demonstrate such terms and conditions. *[IAS 24.23]*. To substantiate that related party transactions are on an arm's length basis an entity would need to demonstrate that a transaction with similar terms and conditions could be obtained from an independent third party.

In 2004, the IFRS IC received a request to supplement the minimum disclosures contained in IAS 24.18. The request asked that the disclosure of, for example, the purpose and economic substance of transactions, the identity of related parties, the extent of management involvement, special risks and the effect of such transactions on the financial statement should be specifically required. The IFRS IC did not take this onto their agenda and this was not reflected in the subsequent revision of IAS 24 in 2009.

The company financial statements of Schroders plc provide the following disclosures of related party relationships with subsidiaries.

Practical example 5-1: Schroders plc (2020) **United Kingdom**

Annual Report and Accounts 2020 [extract]

Notes to the accounts [extract]

37. Related party transactions

The Company is not deemed to be controlled or jointly controlled by a party directly or through intermediaries under IFRS. As a result, the related parties of the Company comprise principally subsidiaries, joint ventures and associates, key management personnel, close family members of key management personnel and any entity controlled by those parties.

The Company has determined that key management personnel comprises only the Board of Directors.

Transactions between related parties

Details of transactions between the Company and its subsidiaries, which are related parties of the Company, and transactions between the Company and other related parties, excluding compensation (which is set out in note 31), are disclosed below:

	2020					
	Revenue £m	Expenses £m	Interest receivable £m	Interest payable £m	Amounts owed by related parties £m	Amounts owed to related parties £m
Subsidiaries of the Company	370.9	18.9	4.1	0.1	1,525.0	(12.2)
Key management personnel	0.3	–	–	–	1.0	(30.7)

	2019					
	Revenue £m	Expenses £m	Interest receivable £m	Interest payable £m	Amounts owed by related parties £m	Amounts owed to related parties £m
Subsidiaries of the Company	418.0	18.5	8.5	0.1	1,496.3	(14.7)
Key management personnel	0.3	–	–	(0.1)	–	(46.3)

Transactions with related parties were made at market rates. The amounts outstanding are unsecured and will be settled in cash.

The consolidated financial statements of J Sainsbury plc provide the following disclosures of related party relationships with joint ventures and associates.

Practical example 5-2: J Sainsbury plc (2021) **United Kingdom**

Annual Report and Financial Statements 2021 [extract]

Notes to the consolidated financial statements [extract]

43 Related party transactions [extract]

b) Joint ventures and associates

Transactions with joint ventures and associates

For the 52 weeks to 6 March 2021, the Group entered into various transactions with joint ventures and associates as set out below. All transactions with joint ventures and associates are at arms-length.

	2021 £m	2020 £m
Dividends and distributions received	**4**	141
Disposals of joint ventures	**–**	(21)
Rental expenses paid	**(6)**	(14)

Year-end balances arising from transactions with joint ventures and associates

	2021 £m	2020 £m
Payables		
Other payables	**(2)**	18

The financial statements of British Sky Broadcasting Group plc illustrate the disclosure of transactions with a party controlled by a close family member of key management:

Practical example 5-3: British Sky Broadcasting Group plc (2014) United Kingdom

Annual Report 2014 [extract]

Notes to the consolidated financial statements [extract]

28. Transactions with related parties and major shareholders [extract]

c) Other transactions with related parties

A close family member of one Director of the Company runs Freud Communications Limited ("Freud"), which has provided external support to the press and publicity activities of the Group. During the year the Group incurred expenditure amounting to £1 million (2013: £1 million) with Freud. At 30 June 2014 there was £1 million (2013: less than £1 million) due to Freud.

...

The financial statements of BP p.l.c. illustrate the disclosure of commitments to related parties:

Practical example 5-4: BP p.l.c. (2020) United Kingdom

Annual Report and Form 20-F 2020 [extract]

Notes on financial statements [extract]

13. Capital commitments

Authorized future capital expenditure for property, plant and equipment (excluding right-of-use assets) by group companies for which contracts had been signed at 31 December 2020 amounted to $8,009 million (2019 $11,382 million, 2018 $8,319 million). bp has contracted capital commitments amounting to $1,087 million (2019 $77 million, 2018 $25 million) in relation to joint ventures and $183 million (2019 $787 million, 2018 $1,227 million) in relation to associates. bp's share of contracted capital commitments of joint ventures amounted to $900 million (2019 $1,024 million, 2018 $619 million).

5.3 Disclosure of expense incurred with management entity

As discussed in section 3.1.9 above, disclosure of amounts incurred by the entity for the provision of key management personnel services by a separate management entity is required. *[IAS 24.18A]*.

6 Disclosures with government-related entities

IAS 24 provides an exemption from the disclosure requirements of IAS 24.18, discussed in section 5.2 above, in relation to related party transactions and outstanding balances, including commitments, with:

(a) A government that has control or joint control of, or significant influence over, the reporting entity

And

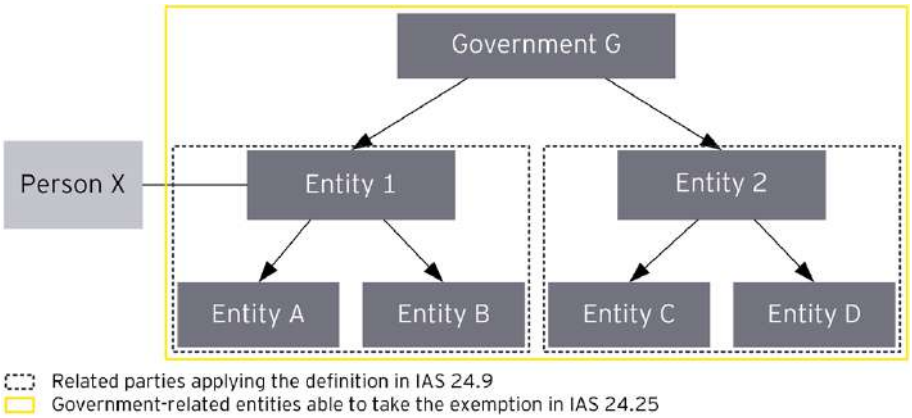
(b) Another entity that is a related party because the same government has control or joint control of, or significant influence over, both the reporting entity and the other entity *[IAS 24.25]*

The effect of this exemption is to treat all entities which are under the direct or indirect control of the same government as related parties and to exempt them from the disclosure requirements of IAS 24.18, though, as can be seen below, this exemption does not alter the definition of a related party relationship.

From the wording of (a) and (b) above, it would be possible to conclude that a reporting entity which is significantly influenced by a government is related to another entity also significantly influenced by the same government. This is not the case. The definition of a related party in IAS 24 does not include entities that are subject to significant influence from the same entity (see sections 3.1 and 3.1.3 above) and the wording in IAS 24.25 cannot add to the definition of a related party.

The application of the disclosure exemption afforded by IAS 24.18 is illustrated in the diagram below, which is based on an illustrative example accompanying IAS 24.

Illustration 6-1: Application of the disclosure exemption for government-related entities



Government G directly controls Entities 1 and 2 and indirectly controls Entities A, B, C and D. Person X is a member of the key management personnel of Entity 1.

Entities 1, A and B are all related because Entity 1 controls both entities. Similarly, Entities 2, C and D are all related because Entity 2 controls both entities. Without the government control, these groups would not be related to each other; however, the government control effectively renders both groups related, because Government G directly controls Entities 1 and 2 and indirectly Entities A, B, C and D. Therefore, the exemption will apply to any entity within these two groups.

For example, for Entity A's financial statements the exemption applies to: (a) transactions with Government G, as this government ultimately controls Entity A; (b) transactions with Entity 1 and Entity B. Entity 1 and Entity B are related parties of entity A because Entity 1 controls Entity A and B, but they are also related because they are ultimately controlled by Government G and (c) transactions with Entities 2, C and D which are related entities because they are controlled by the same government as A, i.e., Government G.

The exemption does not apply to transactions with Person X because Person X is not controlled by Government G.

The use of the disclosure exemption is conditional on the reporting entity making the following disclosures about the transactions and related outstanding balances with the government-related entities:

(a) The name of the government and the nature of its relationship with the reporting entity (i.e., control, joint control or significant influence).

(b) The following information in sufficient detail to enable users of the entity's financial statements to understand the effect of related party transactions on its financial statements:

  (i) The nature and amount of each individually significant transaction.

  (ii) For other transactions that are collectively, but not individually, significant, a qualitative or quantitative indication of their extent. Types of transactions include those discussed in section 5.1 above. *[IAS 24.26]*.

The wording in paragraph 26 does not explicitly mention 'commitments' when referring to 'related outstanding balances'. However, given that IAS 24 describes a commitment as a subset of outstanding balances, disclosure of individually and collectively significant commitments with government-related entities is likely to be required.

In using its judgement to determine the level of detail to be disclosed in accordance with the requirements in (b) above, a reporting entity considers the closeness of the related party relationship and other factors, including materiality, relevant in establishing the level of significance of the transaction such as whether it is:

(a) Significant in terms of size

(b) Carried out on non-market terms

(c) Outside normal day-to-day business operations, such as the purchase and sale of businesses

(d) Disclosed to regulatory or supervisory authorities

(e) Reported to senior management

(f) Subject to shareholder approval *[IAS 24.27]*

Disclosure of the nature and amount of each individually significant transaction is not a requirement for other related party transactions (see section 5.2 above). The Board considered that this requirement should not be too onerous for a reporting entity because:

(a) Individually significant transactions should be a small subset, by number, of total related party transactions
(b) The reporting entity should know what these transactions are
(c) Reporting such items on an exceptional basis takes into account cost-benefit considerations *[IAS 24.BC45]*

The Board also considered that more disclosure of individually significant transactions would better meet the objective of IAS 24 because this approach focuses on transactions that, through their nature or size, are of more interest to users and are more likely to be affected by the related party relationship. *[IAS 24.BC46]*. In response to concerns about whether a reporting entity would be able to identify whether the counterparty to such transactions was a government-related entity, the Board concluded that "management will know, or will apply more effort in establishing, who the counterparty to an individually significant transaction is and will have, or be able to obtain, background information on the counterparty". *[IAS 24.BC47, IAS 24.BC48]*.

Practical example 6-1 below from the financial statements of The Royal Bank of Scotland Group plc illustrates disclosure summarising the types of transactions with government-controlled entities that are related parties and details of an individually material transaction.

Practical example 6-1: The Royal Bank of Scotland Group plc (2019) United Kingdom

Annual Report and Accounts 2020 [extract]

Notes to the financial statements [extract]

25 Related parties [extract]

UK Government

The UK government through HM Treasury is the ultimate controlling party of NatWest Group plc. The UK government's shareholding is managed by UK Government Investments Limited, a company wholly owned by the UK Government. As a result, the UK government and UK Government controlled bodies are related parties of the Group.

At 31 December 2020, HM Treasury's holding in NatWest Group's ordinary shares was 61.9%.

RBS plc enters into transactions with many of these bodies. Transactions include the payment of: taxes principally UK corporation tax (Note 7) and value added tax; national insurance contributions; local authority rates; and regulatory fees and together with banking transactions such as loans and deposits undertaken in the normal course of banker-customer relationships.

The following are other Illustrations of the type of disclosures required for transactions with government-related entities based on illustrative examples accompanying the standard:

Illustration 6-2: Individually significant transaction carried out on non-market terms

On 15 January 20X2 the company sold a 10-hectare piece of land to an entity controlled by Government G for CU5,000,000. On 31 December 20X2 a plot of land in a similar location, of similar size and with similar characteristics, was sold for CU3,000,000. There had not been any appreciation or depreciation of the land in the intervening period. See Note X for disclosure of government assistance as required by IAS 20.

Illustration 6-3: Individually significant transaction because of size of transaction

In the year ended 31 December 20X2 Government G provided the company with a loan equivalent to 50% of its funding requirement, repayable in quarterly instalments over the next five years. Interest is charged on the loan at a rate of 5%, which is comparable to that charged on the company's external bank loans.

Illustration 6-4: Collectively significant transactions

The company's significant transactions with Government G and other entities controlled, jointly controlled or significantly influenced by Government G are a large portion of its sales of goods and purchases of raw materials [alternatively - about 50% of its sales of goods and services and about 35% of its purchases of raw materials].

The company also benefits from guarantees by Government G of the company's bank borrowing. See Note X of the financial statements for disclosure of government assistance as required by IAS 20.

In Illustration 6-4 above, either a qualitative or a quantitative disclosure is permitted for transactions that are collectively but not individually significant.

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Appendix B - Defined terms

Extract from IAS 24

9 The following terms are used in this Standard with the meanings specified:

A *related party* is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the 'reporting entity').

(a) A person or a close member of that person's family is related to a reporting entity if that person:
  (i) has control or joint control of the reporting entity;
  (ii) has significant influence over the reporting entity; or
  (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

(b) An entity is related to a reporting entity if any of the following conditions applies:
  (i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).
  (ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).
  (iii) Both entities are joint ventures of the same third party.
  (iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.
  (v) The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.
  (vi) The entity is controlled or jointly controlled by a person identified in (a).
  (vii) A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).
  (viii) The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.

A *related party transaction* is a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.

Close members of the family of a person are those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity and include:

(a) that person's children and spouse or domestic partner;

(b) children of that person's spouse or domestic partner; and

(c) dependants of that person or that person's spouse or domestic partner.

Compensation includes all employee benefits (as defined in IAS 19 *Employee Benefits*) including employee benefits to which IFRS 2 *Share-based Payment* applies. Employee benefits are all forms of consideration paid, payable or provided by the entity, or on behalf of the entity, in exchange for services rendered to the entity. It also includes such consideration paid on behalf of a parent of the entity in respect of the entity. Compensation includes:

(a) short-term employee benefits, such as wages, salaries and social security contributions, paid annual leave and paid sick leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

(b) post-employment benefits such as pensions, other retirement benefits, post-employment life insurance and post-employment medical care;

(c) other long-term employee benefits, including long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation;

(d) termination benefits; and

(e) share-based payment.

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

Government refers to government, government agencies and similar bodies whether local, national or international.

A *government-related entity* is an entity that is controlled, jointly controlled or significantly influenced by a government.

The terms 'control' and 'investment entity', 'joint control' and 'significant influence' are defined in IFRS 10, IFRS 11 *Joint Arrangements* and IAS 28 *Investments in Associates and Joint Ventures* respectively and are used in this Standard with the meanings specified in those IFRSs.

Chapter 36 Statement of cash flows

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Overview

IAS 7 *Statement of Cash Flows* requires the provision of information about the historical changes in cash and cash equivalents of an entity by means of a statement of cash flows. IAS 7 requires that this statement of cash flows, which is a primary financial statement, classifies cash flows as operating, investing or financing.

This chapter addresses the preparation of the statement of cash flows and the related disclosures required by IAS 7. The chapter addresses the practical issues that frequently arise when attempting to classify cash flows as operating, investing and financing, and includes a number of areas where judgement may be required. The chapter also discusses the definitions of cash and cash equivalents, and the difficulties commonly encountered when applying these definitions.

What you need to know

- IAS 7 requires all entities to prepare a statement of cash flows that reports changes in cash and cash equivalents in the period.
- Cash flows must be classified as operating, investing or financing, having regard to the definitions in IAS 7, in a manner that is most appropriate to the business of the entity.
- Only investments that are held to meet short term cash commitments can be classified as cash equivalents.
- Non-cash transactions must be excluded from the statement of cash flows.
- IAS 7 sets out additional disclosure requirements, including:
  - Information on changes in liabilities arising from financing activities
  - Details of components of cash and cash equivalents and the policy the entity adopts for determining the composition of cash and cash equivalents
  - The amount of significant cash and cash equivalent balances not available for use by the entity

1 Introduction

1.1 Background

IAS 7 is one of the older standards in IFRS accounting standards, having been issued in 1992.

The standard specifies how entities report information about the historical changes in cash and cash equivalents and applies to all entities regardless of their business activities, including financial institutions. Modifications to IAS 7 since it was originally published have been limited resulting in a standard that is much shorter and more succinct than many new and revised IFRS accounting standards. It was last updated in 2023 to require entities to provide disclosures about supply chain financing arrangements.

IAS 7 requires that inflows and outflows of cash and cash equivalents are classified and reported under three different headings being:

- Operating activities
- Investing activities
- Financing activities *[IAS 7.10]*

The resulting information in the statement of cash flows should provide insight into an entity's ability to generate cash to fund operations, reinvest to maintain or expand operating capacity, repay debt and distribute dividends, and how it manages cash.

The definitions of operating, investing and financing activities in the standard, which are covered in section 1.5 below, provide guidance on how to distinguish the cash flows by activity. The standard is accompanied by a number of illustrative examples. These illustrative examples are referred to, where relevant, throughout this chapter.

1.2 The statement of cash flows as a primary financial statement

The statement of cash flows is a primary financial statement and must be presented with equal prominence to the statement of profit or loss and comprehensive income, the statement of financial position and the statement of changes in equity. *[IAS 1.11]*. Arguably, it provides some of the most important information in the financial statements, as all entities need cash to run their day-to-day operations, pay their obligations and provide returns to investors, regardless of their particular line of business or geographical location.

This information, when combined with information in the rest of the financial statements, is useful in assessing factors that may affect the entity's liquidity, financial flexibility, profitability, and risk.

The *Conceptual Framework for Financial Reporting* (the Conceptual Framework) highlights the importance of information about cash flows in the reporting period as a means to help users understand a reporting entity's operations, evaluate its financing and investing activities, assess its liquidity or solvency and interpret other information about financial performance. *[CF 1.20]*. This was rightly noted by the IFRS IC in its July 2014 agenda decision regarding the presentation and content of the condensed statement of cash flows in the interim financial statements according to IAS 34 *Interim Financial Reporting*. The agenda decision[1] noted that even a condensed statement of cash flows should include all information that is relevant in understanding the entity's ability to generate cash flows and the entity's needs to utilise these cash flows. Cash flow information also helps users to assess management's stewardship of the entity's economic resources. The Conceptual Framework guidance is further discussed in Chapter 2 at section 4.2.

1.3 Transparency and consistency of cash flow presentation

In recent years, the statement of cash flows has become an area of scrutiny for investors as well as regulators from a number of jurisdictions, with both classification errors and insufficient disclosures highlighted as key areas of concern.

This is partly because the use of cash flows as a key performance metric in entities' communications to the financial markets has become increasingly common along with, and sometimes even in replacement of, other Key Performance Indicators (KPIs) more focused on the generation of income.

1 *IFRIC Update*, July 2014, available on the IFRS Foundation's website.

This is also because the definitions of operating, investing and financing activities in IAS 7 are broad and only illustrated by lists of examples which are not exhaustive. Whilst it is tempting to think that a statement of cash flows will be a simple matter of fact with less need for judgement around recognition and measurement of cash flows compared to other areas of the financial statements, the lack of clarity in the standard as to how some cash flows from common transactions are required to be categorised has resulted in diversity amongst preparers. Some common areas where judgement may be required are discussed in sections 3 and 4 below in reference to the definition of cash and cash equivalents and classification.

In addition, the interaction of IAS 7 with new standards such as IFRS 9 *Financial Instruments*, IFRS 15 *Revenue from Contracts with Customers* and IFRS 16 *Leases* has led to further difficulties in applying the standard.

The IFRS IC has received numerous requests for clarification on the requirements of the standard. However, many of these clarifications have never been finalised, leaving preparers and users faced with many practical difficulties, particularly in the application of the classification requirements of the standard.[2] Some of the most common difficulties are discussed in the remainder of this chapter.

The preparation of a cash flow statement is not merely a mechanical exercise. As a result, investors and regulators have focused on the adequacy of disclosures explaining how the requirements of IAS 7 have been applied. Where the appropriate classification of cash flows in the cash flow statement is not clear from IAS 7 and an entity has therefore applied judgement to determine the appropriate presentation of material items based on the principles of IAS 7, these judgements must be clearly disclosed. This is further discussed in section 4.4 below.

1.4 Future developments

1.4.1 IFRS 18 *Presentation and Disclosure in Financial statements*

IFRS 18 *Presentation and Disclosure in Financial Statements*, which supersedes IAS 1 *Presentation of Financial Statements* for reporting periods beginning on or after 1 January 2027 (with earlier application permitted) was issued by the IASB in April 2024. The standard makes limited consequential amendments to the existing requirements of IAS 7.

The amendments eliminate the current policy choice in IAS 7 for classification of cash flows from interest and dividends in the statement of cash flows. Dividends paid will be included in financing cash flows. Entities that do not have a specified main business activity of investing in assets or providing finance to customers will be required to classify interest paid as financing activities, and interest and dividends received as cash flows from investing activities. For entities that do have a specified main business activity of investing in assets or providing finance to customers, the classification of dividends received, interest paid and interest received will be impacted by the classification of the related income and expenses in the statement of profit or loss.

When applying the indirect approach, IAS 7 is amended to require that the starting point for determining cash flows from operating activities is the operating profit or loss subtotal, which is a required subtotal in the income statement under IFRS 18.

IFRS 18 and the impact on the statement of cash flows is discussed further in Chapter 4 at section 5.1.

1.4.2 IFRS 19 *Subsidiaries without Public Accountability: Disclosures*

IFRS 19 *Subsidiaries without Public Accountability: Disclosures* was issued by the IASB in May 2024 to simplify the preparation of financial statements by eligible subsidiaries. Eligible subsidiaries that elect to apply IFRS 19 are allowed to provide reduced disclosures while still applying the recognition, measurement and presentation requirements in other IFRS accounting standards. IFRS 19 is effective for annual reporting periods beginning on or after 1 January 2027, with earlier application permitted (subject to jurisdictional endorsement). See Chapter 4 at section 7 for further details on the requirements of IFRS 19.

2 *IASB Update*, April 2013, available on the IFRS Foundation's website.

1.4.3 Derecognition of financial assets and financial liabilities settled through electronic transfers - amendments to IFRS 9

In September 2021, the IFRS IC was asked when a financial asset settled by a cash payment received via an electronic transfer system is derecognised. The discussion was extended to include the derecognition of a financial liability settled by a payment in the same scenario. The IFRS IC identified diversity in practice for the timing of derecognition of financial assets and financial liabilities, not just those settled via an electronic transfer system, but also using other methods. As a result of this, the IFRS IC decided to hand this matter over to the IASB who included this in the IFRS 9 PIR for Classification and Measurement.

In May 2024, the IASB issued the Amendments to the Classification and Measurement of Financial Instruments, which included clarifications to the application guidance for derecognition of financial assets and liabilities as a response to the above. The amendments are effective for annual reporting periods beginning on or after 1 January 2026, with early application allowed.

Chapter 48 at sections 3.5 and 6.1 the amendments are discussed in more detail. Chapter 48 at section 9.2 discusses the transitional requirements.

1.4.4 Other proposals

In July 2022, the IASB issued a Feedback Statement on the Third Agenda Consultation, following publication of a Request for Information in March 2021. The Feedback Statement summarises the input received on the IASB's six key activities and work plan for the period 2022 to 2026, and the IASB's response to the comments and suggestions made by stakeholders.

The statement communicated that the IASB intends to include in its research project pipeline for 2022 to 2026 a project on Statement of Cash Flows and Related Matters. As part of its initial work, the IASB will consider whether the project should aim to review IAS 7 comprehensively or, instead, to make more targeted improvements.

1.5 Terms used in IAS 7

Extract from IAS 7	
6	The following terms are used in this Standard with the meanings specified: *Cash* comprises cash on hand and demand deposits. *Cash equivalents* are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. *Cash flows* are inflows and outflows of cash and cash equivalents. *Operating activities* are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities. *Investing activities* are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. *Financing activities* are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

[IAS 7.6].

2 Objective and scope of IAS 7

2.1 Objective

The objective of IAS 7 is to require entities to provide information about changes in cash and cash equivalents in the reporting period in a statement which classifies cash flows from operating, investing and financing activities. The standard aims to give users of financial statements a basis to evaluate the entity's ability to generate cash and cash equivalents and its needs to utilise those cash flows. *[IAS 7 Objective]*.

The standard explains that a statement of cash flows, in combination with the rest of the financial statements, provides information to users to enable them to evaluate the changes in net assets of an entity, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows to adapt to changing circumstances and opportunities. *[IAS 7.4]*. The historical cash flow information is often used as an indicator of the amount, timing and certainty of future cash flows. It is also useful in examining the relationship between profitability and net cash flow and the impact of changing prices. *[IAS 7.5]*.

2.2 Scope

A statement of cash flows is required to make up a complete set of any financial statements in accordance with IFRS accounting standards. *[IAS 1.10]*. IAS 7 therefore applies to all entities, regardless of size, operations, ownership structure or industry, and includes wholly owned subsidiaries and banks, insurance entities and other financial institutions. There are no exemptions from the requirements of the standard. The standard argues that users of an entity's financial statements are interested in how the entity generates and uses cash and cash equivalents regardless of the nature of its activities and irrespective of whether cash can be viewed as the product of the entity, as may be the case with a financial institution. All entities need cash to conduct their operations, to pay their obligations, and to provide returns to their investors. Accordingly, all entities are required to present a statement of cash flows. *[IAS 7.3]*.

3 Defining cash and cash equivalents

Since the objective of a statement of cash flows is to provide an analysis of changes in cash and cash equivalents, an understanding of the definition of cash and of cash equivalents is essential to its preparation.

A statement of cash flows under IAS 7 excludes movements between items that are cash and cash equivalents because these are components of an entity's cash management, rather than part of its operating, investing and financing activities. *[IAS 7.9]*.

Amounts that fail to meet the definitions of cash and cash equivalents, for example due to restrictions (as in Illustration 3-2 in section 3.2.5 below), cannot be included as part of cash and cash equivalents for the purposes of preparing the statement of cash flows. In the statement of financial position, such amounts must be presented separately from cash and cash equivalents.

Cash flows relating to restricted amounts that fail to meet the definition of cash and cash equivalents would generally meet the definition of investing activities, as they relate to the acquisition or disposal of investments (see section 4.2 below). Cash held in a foreign currency or investments acquired in a currency other than the functional currency of the entity ('foreign currency') are not excluded from qualifying as cash and cash equivalents merely because they are denominated in a foreign currency, provided they meet the other criteria discussed above.

3.1 Cash

Extract from IAS 7	
6	**The following terms are used in this Standard with the meanings specified:** ***Cash* comprises cash on hand and demand deposits.** ...

[IAS 7.6].

IAS 7 defines cash as "cash on hand and demand deposits" and includes no other requirements with respect to determining whether an item qualifies as cash. This is in contrast to the definition of cash equivalents which, as explained in section 3.2 below, includes the requirement that cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes.

In defining 'cash', IAS 7 does not explain what is meant by 'demand deposits', perhaps because the term is commonly understood as amounts that can be withdrawn on demand, without prior notice being required or a penalty being charged (for example, by an additional fee or forfeiture of interest). In contrast to 'demand deposits', term deposits are discussed in section 3.2.3 below.

In practice, cash may be held by an entity for a specific purpose or may be subject to restrictions on its use, imposed either by the bank, by the entity or by a third party.

The nature of any restriction on use of cash (and cash equivalents - see section 3.2.5 below) must be carefully assessed to determine if the balance still meets the definition of cash in the standard.

3.1.1 Restrictions on the use of cash

In March 2022, the IFRS IC issued an agenda decision[3] following a request about whether an entity includes a demand deposit as a component of cash and cash equivalents in its statements of cash flows and financial position when the demand deposit is subject to contractual restrictions on use agreed with a third party.

In the fact pattern described in the request, the entity:

- Holds a demand deposit whose terms and conditions do not prevent the entity from accessing the amounts held in it (that is, were the entity to request any amount from the deposit, it would receive that amount on demand).
- Has a contractual obligation with a third party to keep a specified amount of cash in that separate demand deposit and to use the cash only for specified purposes. If the entity were to use the amounts held in the demand deposit for purposes other than those agreed with the third party, the entity would be in breach of its contractual obligation.

3 *IFRIC Update*, March 2022, available on the IFRS Foundation's website.

The IFRS IC concluded that

- Restrictions on the use of a demand deposit arising from a contract with a third party do not result in the deposit no longer being cash unless those restrictions change the nature of the deposit in a way that it would no longer meet the definition of cash in IAS 7.
- In the fact pattern described in the request, the contractual restrictions on use of the amounts held in the demand deposit do not change the nature of the deposit - the entity can access those amounts on demand.

The IFRS IC therefore concluded that the entity includes the demand deposit as a component of 'cash and cash equivalents' in its statement of cash flows.

The IFRS IC also noted that:

- IAS 1 requires the entity to disaggregate the cash and cash equivalents line item in the statement of financial position and present the demand deposit separately when this is relevant to an understanding of its financial position. *[IAS 1.54, IAS 1.55]*.
- IAS 7 requires an entity to disclose the components of cash and cash equivalents: applying this requirement, in this fact pattern, the entity discloses the demand deposit as a component of cash and cash equivalents. *[IAS 7.45]*.
- The entity must also consider whether to disclose additional information in the context of the requirements in IFRS 7 *Financial Instruments: Disclosures* about liquidity risk and how the entity manages that risk.
- If the information provided in accordance with IAS 7 and IFRS 7 is insufficient to enable users of financial statements to understand the impact of the restrictions on the entity's financial position, the entity considers whether additional disclosures are required. *[IAS 1.31]*.

Where the restrictions on use do not arise from a separate contractual arrangement with a third party but are part of the terms and conditions directly relating to use of and access to the bank account so that cash cannot be withdrawn on demand the cash held in the bank account will fail to meet the definition of cash. However, it is possible that it may meet the definition of cash equivalents. Section 3.2 below discusses considerations relevant for the classification of a deposit other than cash as cash equivalent.

The IFRS IC agenda decision discussed in this section does not address the classification of cash held by a subsidiary of a group that meets the definition of cash in respect of the subsidiary but for which use is restricted within the wider group, for example, cash and cash equivalents held by a subsidiary operating under exchange controls or other legal restrictions that prevent their general use by the parent or other subsidiaries. Section 11.1.4 below discusses the disclosure requirements that apply in these situations.

3.1.2 Cryptocurrencies vs. Central Bank Digital Currencies (CBDC)

In a June 2019 agenda decision, the IFRS IC defined a cryptocurrency as a crypto-asset with all of the following characteristics:

- a digital or virtual currency recorded on a distributed ledger that uses cryptography for security,
- not issued by a jurisdictional authority or other party, and
- does not give rise to a contract between the holder and another party.

In the agenda decision the IFRS IC observed that cryptocurrencies did not have at that time the characteristics of cash. In particular, the IFRS IC noted that, although some cryptocurrencies could be used in exchange for particular goods or services, it was not aware of any cryptocurrency that was used as a medium of exchange or as the monetary unit in pricing goods or services to such an extent that it would have been the basis on which all transactions were measured and recognised in financial statements.[4]

Until now, the volume of transactions in which cryptocurrencies are used as a medium of exchange has remained quite low and some crypto-assets are not used as a medium of exchange at all at this stage. There are some jurisdictions where payment in bitcoin, for example, is accepted, but currently, the acceptance of cryptocurrencies by a merchant is not mandated in most jurisdictions.

4 *IFRIC Update*, June 2019, available on the IFRS Foundation's website.

How we see it

We are not aware of any cryptocurrencies that would currently be considered cash.

In future periods, a holder would need to consider whether those cryptocurrencies represent a medium of exchange and unit of account to such extent that it could be the basis on which the holder recognises and measures all transactions in its financial statements (i.e., it could act as the functional currency of an entity).

Cryptocurrencies also currently do not meet the definition of cash equivalents because they are generally not convertible to known amounts of cash, nor are they subject to an insignificant risk of change in value or have maturities.

Cryptocurrencies are discussed in more detail in Chapter 18 at section 11.6 and in our *Applying IFRS: Accounting by holders of crypto assets*.[5]

In contrast, many governments and central banks worldwide are exploring the possibility of using government-backed digital currencies. Central Bank Digital Currencies (CBDC) are issued and regulated by a nation's monetary authority or central bank. They are the digital form of a country's fiat currency. For example, in October 2021, the Central Bank of Nigeria (CBN) issued guidelines for the operation of a permissioned blockchain based CBDC named 'eNaira'. As per the Guidelines, eNaira is the digital form of the Nigerian fiat currency (Naira), issued by the CBN at par with the physical Naira (that is 1:1), as a direct liability of the CBN and as legal tender and part of the currency circulation. CBN exclusively can mint, distribute, redeem and destroy eNaira.

How we see it

Unlike cryptocurrencies discussed above, we believe that a Central Bank Digital Currency would normally be considered as cash because it is the digital form of a country's fiat currency. This is because it is issued by a central bank, as a direct liability of that central bank and as legal tender in the jurisdiction of that Central bank recognised as a medium of exchange in the country of issuance, where prices are expressed in the local currency, of which the CBDC is the digital version.

3.1.3 Client money

Some financial institutions and other entities hold money on behalf of clients. The terms on which such money is held can vary widely. This is discussed in more detail in Chapter 48 at section 8.

There are numerous types of arrangements that result in an entity holding client money, and conversely result in an entity depositing their money in a client account held by another entity. It is impossible to generalise as to the appropriate treatment in either of the parties' financial statement as this will be dependent on a careful assessment of the terms and conditions of each specific arrangement. However, as explained in Chapter 48 at section 8, there are a number of factors that must be considered.

From the perspective of the depositary entity (i.e., the entity that holds the money on behalf of its client) it is important to identify precisely how the funds are held. Are they required to be segregated in bank accounts separate from that of the depositary entity itself or are they allowed to be commingled with those of the depositary entity? Other key considerations include:

- Which party is at risk from the failure of assets, such as bank accounts, in which the client money is held?
- The status of the funds in the event of the insolvency of either the reporting entity or its client
- Whether the reporting entity can use the cash for its own purposes as opposed to administering the cash on behalf of the client in its capacity as an agent

  And
- Which party has the benefit of income from the assets

If the depositary entity assesses that the funds will be included as an asset on its statement of financial position, it would then need to assess what kind of financial asset this represents; cash or cash equivalents, by applying the definitions in IAS 7. A corresponding liability would also be recognised. Any restrictions on the use of the cash or cash equivalents must be considered and disclosed as explained in section 11.1 below.

From the perspective of the entity depositing its money in a client account held by another entity, it would be necessary to consider whether the funds still meet the definition of cash (see section 3.1 above). This would only be the case if the funds are available to withdraw on demand, and without penalty, directly by the entity. *[IAS 7.6]*. If the funds held are subject to an advance notice period before they can be withdrawn or used, or there are other restrictions on their withdrawal, it is unlikely that they will meet the definition of cash.

5 Applying IFRS, *Accounting by holders of crypto-assets: Updated October 2021*, EY, October 2021, available on ey.com/IFRS.

Depending on the specific facts and circumstances, the funds may meet the definition of a 'cash equivalent' however, this would only be the case if the definition of cash equivalents is met, including the requirement that the purpose of the funds is to meet short-term cash commitments of the entity as explained in section 3.2 below.

If the definitions of cash and cash equivalents are not met, the funds will be presented as a receivable in the financial statements of the entity depositing its money in a client account.

3.2 Cash equivalents

Extract from IAS 7	
6	**The following terms are used in this Standard with the meanings specified:** **...** ***Cash equivalents*** **are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.** **...**
7	Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents, for example in the case of preferred shares acquired within a short period of their maturity and with a specified redemption date.

[IAS 7.6, IAS 7.7].

It is important to understand the reporting entity's cash management policies, especially when considering whether balances that are not obviously cash on hand and demand deposits would be classified as cash equivalents, as the standard states that cash equivalents are held to meet short-term cash commitments rather than for investment or other purposes. *[IAS 7.7]*. Cash management includes the investment of cash in excess of immediate needs into cash equivalents, *[IAS 7.9]*, such as short-term investments.

For investments to qualify as a cash equivalent, they must be:

- Short term
- Highly liquid
- Readily convertible into known amounts of cash

  And
- Subject to an insignificant risk of changes in value *[IAS 7.6]*

However, the purpose for which the investments are held must also be determined. Where investments meet the four criteria above but are not held by the entity to meet short term cash commitments, they cannot be classified as cash equivalents.

As discussed below, careful consideration of facts and circumstances and judgement may be needed to determine whether an investment meets the definition of cash equivalents.

3.2.1 Short-term investments

Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. The standard argues that, normally, only an investment with a short maturity of, say, three months or less from the date of acquisition qualifies as a cash equivalent - see section 3.2.3 below. Equity investments are excluded unless they are cash equivalents in substance. IAS 7 provides an example of such an instrument, being redeemable preference shares acquired within a short period of their maturity and with a specified redemption date. *[IAS 7.7]*. The IFRS IC considered, in July 2009,[6] what the standard means when it refers to a 'known amount of cash' and confirmed that the amount of cash that will be received must be known at the time of the initial investment. Accordingly, traded commodities, such as gold bullion, would not be eligible for inclusion in cash equivalents because the proceeds to be realised from such an investment is determined at the date of disposal rather than being known or determinable when the investment is made.

6 *IFRIC Update*, July 2009, available on the IFRS Foundation's website.

3.2.2 Money market funds

Entities commonly invest in money market-type funds such as an open-ended mutual fund that invests in money market instruments like certificates of deposit, commercial paper, treasury bills, bankers' acceptances and repurchase agreements. Although there are different types of money market funds, they generally aim to provide investors with low-risk, low-return investment while preserving the value of the assets and maintaining a high level of liquidity. The question then arises as to whether investments in such funds can be classified as cash equivalents. As discussed below, entities may consider the underlying investments of the fund when assessing the significance of the risk of changes in value, however when determining whether classification as a cash equivalent is appropriate, the unit of account is the investment in the money market fund itself.

To meet the definition of a cash equivalent, an investment must be short term; highly liquid; readily convertible to a known amount of cash; and subject to insignificant risk of changes in value. IAS 7 considers a maturity date of three months or less from the date of acquisition to be short-term in the context of maturity, however money market funds generally do not have a legal maturity date. Instead, if the investments are puttable and can be sold back to the fund at any time, they meet the short-term criterion.

Typically, investments in money market funds are redeemed directly with the fund, therefore in assessing liquidity of the investment, focus must be on the liquidity of the fund itself. In making this assessment, entities must consider the nature of any redemption restrictions in place as these may prevent the redemption of the investment in the short term. Alternatively, if a money market fund investment is quoted in an active market, it might be regarded as highly liquid on that basis.

The short-term and highly liquid investment must also be readily convertible into known amounts of cash and be subject to an insignificant risk of changes in value. *[IAS 7.6]*. As discussed in section 3.2.1 above, this means that the amount of cash that will be received must be known at the time of the initial investment. Accordingly, investments in shares or units of money market funds cannot be considered as cash equivalents simply because they are convertible at any time at the then market price in an active market.

The IFRS IC also confirmed that an entity would have to satisfy itself that any investment was subject to an insignificant risk of change in value for it to be classified as a cash equivalent.[7]

How we see it

In our view, in order for an entity to satisfy itself that an investment in a money market fund is subject to an insignificant risk of change in value, the entity must conclude that the range of possible returns is very small.

This evaluation is first made at the time of acquiring the investment and reassessment is required if the facts and circumstances change. The evaluation will involve consideration of factors such as:

- the maturity of the underlying investments of the fund
- the credit rating of the fund; the nature of the investments held by the fund (i.e., not subject to volatility)
- the extent of diversification in the portfolio (which is expected to be very high)
- the investment policy of the fund

And

- any mechanisms by the fund to guarantee returns (for example by reference to short-term money market interest rates)

Investments are often held for purposes other than to act as a ready store of value that can be quickly converted into cash when needed to meet short-term cash commitments. It is therefore important, even where the criteria above are met, to understand the purpose of an investment in a particular money market fund. Where an investment otherwise satisfies the criteria in IAS 7.6 but is not held by the entity to satisfy short-term cash commitments, it must not be classified as a cash equivalent. *[IAS 7.7]*.

Substantial judgement may be required in assessing whether an investment in money market funds can be classified as a cash equivalent. Therefore, appropriate disclosure is essential. As discussed in section 11 below, entities are required to disclose the composition of cash equivalents and, where relevant, this will include significant judgements made in classifying investments in money market funds.

7 *IFRIC Update*, July 2009, available on the IFRS Foundation's website.

3.2.3 Investments with maturities greater than three months

The longer the term of an investment, the greater the risk that a change in market conditions (such as interest rates) can significantly affect its value. For this reason, IAS 7 excludes most equity investments from cash equivalents and restricts the inclusion of other investments to those with a short maturity (which the standard illustrates as three months or less from the date of their acquisition by the entity). *[IAS 7.7]*.

An investment with a term on acquisition of, say, nine months is not reclassified as a cash equivalent from the date on which there is less than three months remaining to its maturity. This is because the classification as cash equivalent is based on the maturity and the nature of the instrument at acquisition. The fact that the instrument is now approaching its maturity does not change its nature nor the purpose for which it was acquired.

In the final analysis, cash equivalents are held to meet short-term cash commitments and amounts can only be included in cash equivalents if they can be regarded as being nearly as accessible as cash and essentially as free from exposure to changes in value as cash.

For example, an entity might justify including in cash equivalents a fixed deposit with an original term longer than three months if it effectively functions like a demand deposit. Typically, a fixed deposit will carry a penalty charge for withdrawal prior to maturity. A penalty will usually indicate that the investment is held for investment purposes rather than the purpose of meeting short-term cash needs. However, some fixed deposits still offer interest at a prevailing demand deposit rate in the event of early withdrawal, with any penalty limited to the entity being required to forego the incremental higher interest that it would have received if the deposit were held to maturity. In this case, it may be arguable that there is effectively no significant penalty for early withdrawal, as the entity receives at least the same return that it otherwise would have in a demand deposit arrangement.

How we see it

In our view, investments in deposit accounts that upon withdrawal are subject to penalties of such significance, that the funds obtained are appreciably different than the funds that would have been obtained had a shorter-term investment been initially purchased, are not consistent with the assertion that the investment was held to meet short-term cash needs.

Significance is viewed from the perspective of the entity, taking into consideration the environment in which it operates. If the investor would be indifferent to the penalty because the funds obtained are relatively consistent with the funds that would have been obtained had a shorter-term investment been initially purchased, the terms of the instrument are consistent with the assertion that the investment was held for meeting short-term cash needs.

This can be seen in the following Illustration:

Illustration 3-1: Investments with a maturity of greater than three months

Entity A places funds with a bank in a fixed deposit with a stated maturity date of six months. The features of the fixed deposit are as follows:

- If held to maturity, the deposit bears interest at a fixed six-month rate (FD rate) determined at the date of deposit. The FD rate is significantly higher than the interest rates offered for a typical demand deposit account (DD rate). The DD rate is significantly higher than zero.
- Interest accrues on a daily basis based on the FD rate.
- The entity can redeem the fixed deposit at any time before the maturity date. When redeemed, the deposit must be redeemed in full. The entity may not increase the deposit amount subsequent to the initial investment. A penalty charge in the form of forfeited interest is imposed upon early redemption (see Scenario 1 and Scenario 2 that illustrate common terms used to calculate the penalty charge).
- The entity asserts that the investment may be used to meet short-term cash commitments.

Scenario 1

If the entity redeems the fixed deposit at any time before the maturity date, the entity will not be entitled to any interest. The entity will only receive the original principal amount.

Scenario 2

If the entity redeems the fixed deposit at any time before the maturity date, the entity is entitled to interest based on the typical DD rate from the initial deposit date to the date of redemption plus the original principal amount. The balance (if any) of the interest at the FD rate in excess of the DD rate is forfeited as an early withdrawal penalty.

In both scenarios 1 and 2 above, the principal amount is always redeemed in full.

Analysis

The conclusion depends on the facts and circumstances. Whether the deposit meets the definition of a cash equivalent is a matter of judgement. The principle is that to be a cash equivalent, the entity must hold the investment for meeting short-term cash needs.

Scenario 1

The fixed deposit has a stated maturity period from the date of deposit but allows the entity to redeem the fixed deposit immediately; accordingly, the instrument could be viewed as short-term and readily convertible. However, in this scenario, the penalty results in the entity earning no interest. If the deposit had been placed in a demand deposit account rather than in the fixed deposit, the interest earned would have been significantly higher than zero, as set out in the fact pattern. This represents an economic penalty which must be evaluated to determine whether it creates a sufficiently large disincentive such that the entity would not withdraw the funds before the maturity date. This assessment may be subject to some degree of judgement based on facts and circumstances. If such a large disincentive exists, this would be inconsistent with the assertion that the investment is held for meeting short-term cash needs and the fixed deposit would not meet the definition of a cash equivalent.

Scenario 2

The fixed deposit is similar to an account with a one-day demand deposit interest rate that earns 'bonus' interest if the deposit is maintained until a specified date (maturity). The potential bonus interest that is forfeited upon early withdrawal is not viewed as a penalty, because the rate of interest received is consistent with management's investment purpose to meet short-term cash commitments rather than an investment to be held until the maturity date. Therefore, the fixed deposit qualifies as a cash equivalent.

Even if the DD rate is not significantly higher than zero, as long as it is not negative, the interest received on early redemption is still consistent with management's investment purpose to meet short-term cash commitments and the fixed deposit qualifies as a cash equivalent.

In scenario 2 in the above example, the investment is classified as a cash equivalent because it meets all criteria and is held for meeting short-term cash needs. A consequence of this classification is that the calculation of the effective interest rate (EIR) in accordance with IFRS 9 must be done on a consistent basis. IFRS 9 requires that, when calculating the EIR, all contractual terms of the financial instrument, for example prepayments, call and similar options, are considered. See Chapter 46 at section 3.4. *[IFRS 9 Appendix A]*. In this example, it is implicit in the classification that the entity may need to withdraw the deposit to meet short-term cash commitments and, as a consequence, will only receive interest at the (lower) demand deposit rate. Therefore, the EIR must reflect this intention.

3.2.4 Bank overdrafts

Although bank borrowings are generally considered to be financing activities, there are circumstances in which bank overdrafts repayable on demand are included as a component of cash and cash equivalents. This is only in cases where bank overdrafts are repayable on demand and the use of short-term overdrafts form an integral part of an entity's cash management practices. Evidence supporting the latter assertion would be that the bank balance often fluctuates from being positive to overdrawn. *[IAS 7.8]*.

The IFRS IC observed that where overdrafts do not often fluctuate from being negative to positive, this is an indicator that the arrangement does not form part of an entity's cash management and, instead, represents a form of financing.[8]

3.2.5 Restrictions on the use of cash equivalents

The nature of any restriction on the use of each item classified as cash equivalents must be carefully assessed to determine whether the restrictions affect the ability to meet the definition of cash equivalents in the standard.

As discussed in section 3.2 above, for investments to qualify as a cash equivalent, they must be short term, highly liquid, readily convertible into known amounts of cash and subject to insignificant risk of changes in value. *[IAS 7.6]*.

However, the purpose for which the investments are held must also be considered and this is a matter of facts and circumstances. Where investments meet the four criteria above but are not held by the entity to meet short term cash commitments, they cannot be classified as cash equivalents. Therefore, any restrictions on the use of an investment, whether arising directly from the contractual terms and conditions of the investment or arising from a separate contractual arrangement with a third party, that prevent the

8 *IFRIC Update*, June 2018, available on the IFRS Foundation's website.

investment being used to meet short term cash commitments, would result in the investment failing to meet the definition of a cash equivalent.

Illustration 3-2: Investment which is not held to meet short term cash commitments

Entity B has in issue loan notes with a remaining 2 years until maturity. One of the provisions of the financing agreement is that Entity B maintains CU30 million minimum cash balance in a separate bank account continuously until the loan notes are fully redeemed. If the balance on the relevant bank account falls below CU30 million, Entity B is obliged to notify a breach of contract, which triggers certain penalties and could, in certain circumstances, constitutes an early redemption event. Entity B chooses to deposit the CU30 million in a 60-day fixed maturity deposit account.

Analysis

The fixed deposit does not meet the definition of cash as it is not cash on hand and is not held in a demand deposit. *[IAS 7.6]*. The stated maturity period from the date of deposit is less than 3 months; accordingly, the instrument could be viewed as short-term and highly liquid. In addition, the nature of the bank deposit is that it is readily convertible into known amounts of cash and subject to insignificant risk of changes in value. However, the fixed deposit will not be used by Entity B to meet short term cash commitments, as the funds are being held to meet the provisions of a financing agreement which extends for a period of 2 years. Therefore, the cash in the account does not meet the definition of cash equivalents.

The requirement to consider the purpose for which the investment is held arises as a result of paragraph 7 of IAS 7 which states that cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. *[IAS 7.7]*. This can be contrasted with the definition of cash (see section 3.1 above) which does not contain any requirement to consider how or when the cash will be used and therefore ignores any restrictions on the use of cash arising from a contract with a third party. See section 3.1.1 above for a discussion on the classification of cash subject to restrictions.

3.3 Reassessment of cash and cash equivalents after initial recognition

There is no specific requirement in IAS 7 for the re-assessment of the criteria for classification as cash or cash equivalents after initial recognition. However, it is implicit in the definitions in IAS 7 that the amounts must still meet those definitions at the end of each reporting period to be presented as such. Changes that may affect the criteria for classification could arise from contractual or non-contractual changes. For contractual changes, it will usually be clear when these changes are made and what the nature of the changes are. Such changes could affect the nature of the asset and require the new asset to be tested against the definition of cash and cash equivalents.

Other changes in facts and circumstances could also require careful consideration and the application of judgement. For cash equivalents, reassessment may be particularly relevant when looking at the requirements that cash equivalents are highly liquid and subject to an insignificant risk of changes in value.

For example, since initial recognition of an investment as a cash equivalent, there may have been adverse changes to the credit status of the counterparty to the investment or a significant decline in the economic stability of the jurisdiction in which the funds are invested. At the end of the reporting period, the investment may no longer meet the definition of cash equivalents since it is no longer highly liquid and readily convertible into known amounts of cash and is now subject to more than an insignificant risk of changes in value.

However, as discussed in section 3.2.3 above, an investment with a term on acquisition of, say, nine months is not reclassified as a cash equivalent from the date on which there is less than three months remaining to its maturity. This is because the classification as cash equivalent is based on the maturity and the nature of the instrument at acquisition. The fact that the instrument is now approaching its maturity does not change its nature nor the purpose for which it was acquired.

3.4 Current or non-current classification

In respect of classification as current or non-current, for entities that present current and non-current assets and liabilities in the statement of financial position, IAS 1 requires that cash and cash equivalents are classified as current "unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period." *[IAS 1.66(d)]*.

As discussed in section 3.1.1 above, in March 2022, the IFRS IC issued an agenda decision concluding that restrictions on the use of a demand deposit arising from a contract with a third party do not result in the deposit no longer being cash, unless those restrictions change the nature of the deposit in a way that it would no longer meet the definition of cash in IAS 7. This raises the question as to how the requirements of IAS 1 paragraph 66(d) apply to cash subject to such restrictions. However, the submission which gave rise to the agenda decision did not ask the IFRS IC to consider how the requirements of IAS 1.66(d) are applied and, the IFRS IC did not conclude on whether the demand deposit in the fact pattern would be classed as current or non-current.

In respect of cash equivalents, the application of IAS 1.66(d) is far more straightforward, given that paragraph 7 of IAS 7 states that "Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes."

How we see it

In our view, cash equivalents will always be classified as current. This is because cash equivalents must be held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. Any restrictions that prevent the asset from being exchanged or used to settle a liability for at least 12 months after the reporting period would result in the asset failing to meet the definition of cash equivalents.

4 Classification in the statement of cash flows

Extract from IAS 7	
10	**The statement of cash flows shall report cash flows during the period classified by operating, investing and financing activities.**

[IAS 7.10].

This classification is intended to allow users to assess the impact of these three types of activity on the financial position of the entity and the amount of its cash and cash equivalents. Whilst not stated explicitly in the standard, the presentation of operating, investing and financing cash flows usually follows this sequence in practice, and a total net cash flow for each standard heading must be shown. Comparative figures are required for all items in the statement of cash flows and the related notes. *[IAS 1.38]*.

The components of cash flows are classified as operating, investing or financing activities in a manner which is most appropriate to the business of the entity. *[IAS 7.11]*. For example, the purchase of investments is likely to be classified as an operating cash flow for a financial institution, but as an investing cash flow for a manufacturer. Additionally, a single transaction may comprise elements of differently classified cash flows. For example, when repayments on a loan include both interest and capital, the element reflecting the interest expense may be included in either operating activities or financing activities (see section 4.4.1 below) whereas the capital repayment must be classified as a financing cash flow. *[IAS 7.12]*.

A format of the statement of cash flows is illustrated in Practical example 4-1 below. As permitted by the standard, AstraZeneca PLC has included interest paid under operating activities, interest received under investing activities and dividends paid under financing activities.

Practical example 4-1: AstraZeneca PLC (2023) **United Kingdom**

AstraZeneca Annual Report & Form 20-F Information 2023 [extract]

Financial Statement [extract]

Consolidated Statement of Cash Flows

for the year ended 31 December

	Notes	2023 $m	2022 $m	2021 $m
Cash flows from operating activities				
Profit/(loss) before tax		**6,899**	2,501	(265)
Finance income and expense	3	**1,282**	1,251	1,257
Share of after tax losses of associates and joint ventures	11	**12**	5	64
Depreciation, amortisation and impairment		**5,387**	5,480	6,530
Increase in trade and other receivables		**(1,425)**	(1,349)	(961)
(Increase)/decrease in inventories		**(669)**	3,941	1,577
Increase in trade and other payables and provisions		**2,394**	1,165	1,405
Gains on disposal of intangible assets	2	**(251)**	(104)	(513)
Gains on disposal of investments in associates and joint ventures	2	**–**	–	(776)
Fair value movements on contingent consideration arising from business combinations	20	**549**	82	14
Non-cash and other movements	17	**(386)**	(692)	95
Cash generated from operations		**13,792**	12,280	8,427
Interest paid		**(1,081)**	(849)	(721)
Tax paid		**(2,366)**	(1,623)	(1,743)
Net cash inflow from operating activities		**10,345**	9,808	5,963
Cash flows from investing activities				
Acquisition of subsidiaries, net of cash acquired	27	**(189)**	(48)	(9,263)
Payments upon vesting of employee share awards attributable to business combinations	27	**(84)**	(215)	(211)
Payment of contingent consideration from business combinations	20	**(826)**	(772)	(643)
Purchase of property, plant and equipment		**(1,361)**	(1,091)	(1,091)
Disposal of property, plant and equipment		**132**	282	13
Purchase of intangible assets		**(2,417)**	(1,480)	(1,109)
Disposal of intangible assets		**291**	447	587
Movement in profit-participation liability	2	**190**	–	20
Purchase of non-current asset investments		**(136)**	(45)	(184)
Disposal of non-current asset investments		**32**	42	9
Movement in short-term investments, fixed deposits and other investing instruments		**97**	(114)	96
Payments to associates and joint ventures	11	**(80)**	(26)	(92)
Disposal of investments in associates and joint ventures		**–**	–	776
Interest received		**287**	60	34
Net cash outflow from investing activities		**(4,064)**	(2,960)	(11,058)
Net cash inflow/(outflow) before financing activities		**6,281**	6,848	(5,095)
Cash flows from financing activities				
Proceeds from issue of share capital		**33**	29	29
Issue of loans and borrowings		**3,816**	–	12,929
Repayment of loans and borrowings		**(4,942)**	(1,271)	(4,759)
Dividends paid		**(4,481)**	(4,364)	(3,856)
Hedge contracts relating to dividend payments		**(19)**	(127)	(29)
Repayment of obligations under leases		**(268)**	(244)	(240)
Movement in short-term borrowings		**161**	74	(276)
Payments to acquire non-controlling interests		**–**	–	(149)
Payment of Acerta Pharma share purchase liability		**(867)**	(920)	–
Net cash (outflow)/inflow from financing activities		**(6,567)**	(6,823)	3,649
Net (decrease)/increase in Cash and cash equivalents in the period		**(286)**	25	(1,446)
Cash and cash equivalents at the beginning of the period		**5,983**	6,038	7,546
Exchange rate effects		**(60)**	(80)	(62)
Cash and cash equivalents at the end of the period	17	**5,637**	5,983	6,038

Having reviewed a variety of requests received from constituents for further guidance on the classification of cash flows, the IFRS IC and the IASB have reiterated the general requirement set out in IAS 7.11 that the primary principle for classification of cash flows should be in accordance with the nature of the activity in a manner that is most appropriate to the business of the entity.[9] However, at its March 2013 meeting, the IFRS IC discussed how the definitions of operating, investing and financing cash flows in IAS 7 could be made clearer and thus could lead to a more consistent application of the primary principle but concluded that clarifying the application of the primary principle was a matter that was too broad for the IFRS IC to address.[10] As a result, pending any change to the standard, there is likely to be some diversity in practice on how some common transactions are presented in the statement of cash flows.

4.1 Cash flows from operating activities

Operating activities are defined as "the principal revenue-producing activities of the entity and other activities that are not investing or financing activities". *[IAS 7.6]*. The standard states that the value of information on operating cash flows is twofold. It provides a key indicator of the extent to which the entity has generated sufficient cash flows from its operations to repay debt, pay dividends and make investments to maintain and increase its operating capability, without recourse to external sources of financing. Also, information about the components of historical operating cash flows may assist in the process of forecasting future operating cash flows, when used in conjunction with other financial statement information. *[IAS 7.13]*. Cash flows from operating activities generally result from transactions and other events that enter into the determination of profit or loss. Examples include: *[IAS 7.14]*

- Cash receipts from the sale of goods and the rendering of services
- Cash receipts from royalties, fees, commissions and other revenue
- Cash payments to suppliers for goods and services
- Cash payments to and on behalf of employees
- Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities
- Cash receipts and payments from contracts held for dealing or trading purposes (see section 4.4.12 below regarding the allocation of cash flows paid or received under derivative contracts)

Operating activities is also a 'default category' for any cash flows that do not meet the criteria of investing or financing cash flows. For example, as discussed in section 9.3.1 below, acquisition-related costs in a business combination that must be recognised as an expense, *[IFRS 3.53]*, would also be classified as operating cash flows because there is no related asset that would justify classification as an investing cash flow. *[IAS 7.16]*.

The nature of the business conducted by the entity will be a relevant factor in determining the appropriate classification of cash flows as operating, investing or financing. For example, when an entity holds securities and loans for dealing or trading purposes, they are similar to inventory acquired specifically for resale. Therefore, any related cash flows are classified as operating activities. Similarly, cash advances and loans made by financial institutions are usually classified as operating activities, since they relate to the main revenue-generating activity of that entity (see section 10.1 below). *[IAS 7.15]*.

The proceeds from the sale of property, plant and equipment, which are usually included in cash flows from investing activities, are an example of an item that enters into the determination of profit or loss that is not usually an operating cash flow. *[IAS 7.14]*. However, the proceeds from sales of assets previously held for rental purposes are classified as cash flows from operating activities if the entity routinely sells such assets in its ordinary course of business. Similarly, cash payments to manufacture or acquire property, plant and equipment held for rental to others, and that are routinely sold in the ordinary course of business after rental, are also classified as cash flows from operating activities (see section 4.4.7 below). *[IAS 7.14]*.

Cash flows from operating activities may be reported on a gross or net basis, also known as the direct and indirect methods. *[IAS 7.18]*. The use of the direct or indirect method is an accounting policy choice and must be applied consistently from period to period. Any change in method must be reported under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. This would require comparatives to be restated and additional disclosures given, including the reasons for the change in policy. *[IAS 8.29]*.

9 *IASB Update*, April 2013, available on the IFRS Foundation's website.

10 *IASB Update*, April 2013, available on the IFRS Foundation's website.

4.1.1 The direct method

Under the direct method, major classes of gross cash receipts and gross cash payments are disclosed. *[IAS 7.18]*. IAS 7 encourages entities to use the direct method, because it provides information which may be useful in estimating future cash flows and which is not available under the indirect method. *[IAS 7.19]*.

Under the direct method, information about major classes of gross cash receipts and payments may be obtained either:

(a) From the accounting records of the entity

Or

(b) By adjusting sales, cost of sales (interest and similar income and interest expenses and similar charges for a financial institution) and other items in the statement of comprehensive income for changes during the period in inventories and operating receivables and payables, other items for which the cash effects are investing or financing cash flows and other non-cash items *[IAS 7.19]*

A statement of cash flows prepared under the direct method must include the same disclosures of gross cash receipts and gross cash payments irrespective of which approach has been used to determine their value. There is no requirement for entities using the approach described in (b) above to present a reconciliation showing the adjustments made between, for example, revenue in the statement of comprehensive income and cash receipts from customers.

Telefonica, S.A. is an example of an entity using the direct method for presenting its cash flows from operating activities, as illustrated in Practical example 4-2 below.

Practical example 4-2: Telefónica, S.A. (2023) Spain

Consolidated Annual Report 2023 [extract]

Consolidated financial statements 2023 [extract]

Consolidated statements of cash flows for the years ended December 31

Millions of euros	Notes	2023	2022	2021
Cash received from operations	(Note 28)	47,314	46,925	46,415
Cash paid from operations	(Note 28)	(34,646)	(34,778)	(34,379)
Net payments of interest and other financial expenses net of dividends received	(Note 28)	(565)	(292)	(1,309)
Taxes (paid)/proceeds	(Note 28)	(454)	(92)	(459)
Net cash flow provided by operating activities	**(Note 28)**	**11,649**	**11,763**	**10,268**

...

4.1.2 The indirect method

The indirect method arrives at the same value for net cash flows from operating activities but does so by working back from amounts reported in the statement of comprehensive income. There are two approaches for presenting the net cash flows from operating activities when using the indirect method. The most common approach adjusts reported profit or loss for the effects of:

(a) Changes in inventories and operating receivables and payables during the period

(b) Non-cash items such as depreciation, provisions, deferred taxes, unrealised foreign currency gains and losses, and undistributed profits of associates

And

(c) All other items for which the cash effects are investing or financing cash flows *[IAS 7.20]*

Woodside Energy Group Ltd has used this adjusted profit approach to present its indirect method statement of cash flows, as illustrated in Practical example 4-3 below.

Practical example 4-3: Woodside Energy Group Ltd (2023) **Australia**

2023 ANNUAL REPORT [extract]
FINANCIAL STATEMENTS [extract]
CONSOLIDATED STATEMENT OF CASH FLOWS [extract]

	Notes	2023 US$m	2022 US$m	2021 US$m
Cash flows from/(used in) operating activities				
Profit after tax for the period		1,722	6,575	2,036
Adjustments for:				
Non-cash items				
Depreciation and amortisation		3,960	2,808	1,582
Depreciation of lease assets		179	140	108
Change in fair value of derivative financial instruments		349	960	31
Net finance costs		34	12	203
Tax expense		1,551	2,599	1,254
Exploration and evaluation written off		77	164	265
Impairment losses	B.4	1,917	-	10
Impairment reversals	B.4	-	(900)	(1,058)
Restoration movement		147	272	68
Gain on disposal of oil and gas properties (including revaluation gain)		-	(494)	-
Movement in onerous contracts provision		-	(245)	(95)
Other		(226)	(254)	30
Changes in assets and liabilities				
Decrease/(increase) in trade and other receivables		107	(77)	(39)
Increase in inventories		(31)	(146)	(4)
Increase in lease assets		-	-	(16)
(Decrease)/increase in provisions		(114)	131	(75)
Decrease in lease liabilities		-	(31)	(25)
Increase in other assets and liabilities		(736)	(961)	(128)
(Decrease)/increase in trade and other payables		(135)	184	75
Cash generated from operations		8,801	10,737	4,222

...

Alternatively, the indirect method of presentation can show separately revenues and expenses, adjusted for non-cash, investing or financing items, making up operating profit before working capital changes. *[IAS 7.20]*. An example of this rarely used alternative is given at the end of Example A in the Illustrative Examples accompanying IAS 7. *[IAS 7.IE Example A]*

4.1.2.A Starting point for the reconciliation

When an entity adjusts reported profit or loss under the indirect method, a question arises as to which measure of profit or loss to use as a starting point for the reconciliation. IAS 7 does not define 'profit or loss'. The term is defined in IAS 1 paragraph 7 as "Profit or loss is the total of income less expenses, excluding the components of other comprehensive income." Paragraph 88 of IAS 1 refers to the profit and loss for the period as containing "all items of income and expense recognised in a period ..." which might suggest that profit or loss after tax (as in Practical example 4-3 above) must be used. However, Example A in the Illustrative Examples accompanying IAS 7 illustrates the indirect method by showing profit before tax as a starting point (as is also shown in Practical example 4-1 above). *[IAS 7.IE Example A]*.

How we see it

In our view, profit before tax and profit after tax can both be used as the starting point for the reconciliation.

We also observe in practice that there may be other profit measures currently used such as operating profit or similar. In our view, it is acceptable for an operating result sub-total to be used as a starting point for the reconciliation provided that it is a clearly identified sub-total on the face of the income statement, is reconciled to profit before or after tax on the face of the income statement and is representative of all the operating activities of the entity. In our view, alternative performance measures such as profit or loss before non-recurring operating items would not be acceptable starting points for the reconciliation.

Entities should take into consideration the views of local regulators who make take a stricter view of this matter.

It is relevant to note that IFRS 18 (which is mandatory for reporting periods beginning on or after 1 January 2027) makes consequential amendments to IAS 7 to require that the starting point for determining cash flows from operating activities is the operating profit or loss subtotal. This operating profit or loss subtotal is defined in IFRS 18 and will be a required subtotal in the statement of financial performance. See Chapter 4 at section 5.1.

In the Basis for Conclusions to these amendments, the IASB sets out its rationale for this decision, explaining that an entity using operating profit or loss needs to present fewer adjustments to the starting point, which simplifies the presentation of the operating cash flows category. Fewer adjustments are needed because, compared to profit or loss, operating profit or loss includes fewer items of income and expenses for which the cash effects are classified as investing or financing cash flows. In addition, the difference between cash flows from operating activities and operating profit or loss provides a measure of operating accruals which some users may find useful. *[IAS 7(2027).BC47]*.

4.1.2.B Adjusting for changes in working capital

To obtain the information on working capital movements for the indirect method, the figures in the statement of financial position must be analysed according to the three standard headings of the statement of cash flows. Thus, the reconciliation of profit or loss to cash flow from operating activities will include the increase or decrease in receivables or payables, but only in respect of those elements thereof that relate to operating activities. For example, amounts owed in respect of the acquisition of property, plant and equipment (other than assets held for rental and subsequent sale), intangible assets, or non-operational investments will be excluded from the movement in payables included in this reconciliation.

Furthermore, when a group has acquired a subsidiary during the year, the change in working capital items will have to be split between the increase due to the acquisition (to the extent that the purchase consideration was settled in cash, this will be shown under investing activities) and the element related to post-acquisition operating activities which will be shown in the reconciliation. Further considerations needed when preparing a statement of cash flows for a group are explained in section 9 below.

4.2 Cash flows from investing activities

Investing activities are defined as "the acquisition and disposal of long-term assets and other investments not included in cash equivalents". *[IAS 7.6]*. This separate category of cash flows allows users of the financial statements to understand the extent to which expenditures have been made for resources intended to generate future income and cash flows. Cash flows arising from investing activities include:

(a) Payments to acquire, and receipts from the sale of, property, plant and equipment, intangibles and other long-term assets (including payments and receipts relating to capitalised development costs and self-constructed property, plant and equipment).

(b) Payments to acquire, and receipts from the sale of, equity or debt instruments of other entities and interests in jointly controlled entities (other than payments and receipts for those instruments considered to be cash equivalents or those held for dealing or trading purposes).

(c) Advances and loans made to, and repaid by, other parties (other than advances and loans made by a financial institution).

And

(d) Payments for, and receipts from, futures contracts, forward contracts, option contracts and swap contracts, except when the contracts are held for dealing or trading purposes, or the cash flows are classified as financing activities (see section 4.4.12 below regarding allocation of cash flows on derivative contracts). *[IAS 7.16]*.

As part of its annual improvement project, the IASB added in 2008 that only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities. *[IAS 7.16]*. Therefore, cash flows relating to costs recognised as an expense cannot be classified within investing activities. As a result, payments including those for exploration and evaluation activities and for research and development that are recognised as an asset are classified as investing cash flows, while entities that recognise such expenditures as an expense would classify the related payments as operating cash flows.

This requirement was added in response to submissions made to the IFRS IC about the classification of expenditure incurred with the aim of generating future revenues, but that may not always result in the recognition of an asset. Examples included exploration and evaluation expenditure, advertising and promotional activities, staff training, and research and development. *[IAS 7.BC3]*. The IASB believes this approach aligns the classification of investing cash flows with the presentation in the statement of financial position, reduces divergence in practice and, therefore, results in financial statements that are easier for users to understand. *[IAS 7.BC7]*. It does not seem unreasonable that recurrent expenditure on items such as research and expensed mining costs are classified as operating cash flows. However, application to other items that do not give rise to an asset in the statement of financial position, such as acquisition-related costs (discussed in section 9.3.1 below) and the settlement of contingent consideration in a business combination (discussed in section 9.3.3 below) may prove to be more complicated.

The IFRS IC and the IASB have discussed the application of this requirement in practice, as some users appear to have given precedence to the classification of cash flows consistently with the classification of the related item in the statement of financial position, *[IAS 7.BC7]*, (sometimes referred to as the 'cohesiveness principle') over the objective in the standard to classify cash flows in accordance with the nature of the activity giving rise to the cash flow. *[IAS 7.11]*. In its discussion, the IASB agreed that the primary principle for the classification of cash flows should be in accordance with the nature of the activity, and that the requirement for the recognition of an asset should be read as a constraint on the application of the primary principle, rather than as a competing principle.[11]

Major classes of gross receipts and gross payments arising from investing activities are reported separately, except for those items that IAS 7 permits to be reported on a net basis, as discussed in section 5.2 below. *[IAS 7.21]*.

4.3 Cash flows from financing activities

Financing activities are defined as those "activities that result in changes in the size and composition of the contributed equity and borrowings of the entity". *[IAS 7.6]*. The standard states that this information is useful in predicting claims on future cash flows by providers of capital to the entity. *[IAS 7.17]*. However, it would seem more likely that information on financing cash flows would indicate the extent to which the entity has had recourse to external financing to meet its operating and investing needs in the period. The disclosure of the value and maturity of the entity's financial liabilities, as required by IFRS 7, would contribute more to predicting future claims on cash flows. *[IFRS 7.39]*. Cash flows arising from financing activities include:

(a) Proceeds from issuing shares or other equity instruments

(b) Payments to owners to acquire or redeem the entity's shares

(c) Proceeds from issuing, and outflows to repay, debentures, loans, notes, bonds, mortgages and other short or long-term borrowings

And

(d) Payments by a lessee for the reduction of the outstanding liability relating to a lease *[IAS 7.17]*

In consolidated financial statements, financing cash flows will include those arising from changes in ownership interests in a subsidiary that do not result in a loss of control (see section 9.2 below). *[IAS 7.42A]*.

Major classes of gross receipts and gross payments arising from financing activities must be reported separately, except for those items that can be reported on a net basis, as discussed in section 5.2 below. *[IAS 7.21]*.

Disclosure requirements in respect of changes in liabilities arising from financing activities are discussed in section 11.2 below.

4.4 Allocating items to operating, investing and financing activities

Sometimes it is not clear how to classify cash flows amongst operating, investing and financing activities. IAS 7 provides additional guidance on the classification of certain transactions, including interest, dividends and income taxes, while other questions are not addressed explicitly in the standard. These, as well as some common areas where judgement may be required to classify cash flows, are discussed below.

11 *IASB Update*, April 2013, available on the IFRS Foundation's website.

Where the appropriate classification is not clear from IAS 7 and an entity has therefore applied judgement to determine the appropriate presentation of material items based on the principles of IAS 7, additional disclosure may be needed to explain these judgements. IAS 1 requires disclosure of the judgements that management has made that have the most significant effect on the amounts recognised in the financial statements, *[IAS 1.122],* as well as information that is relevant to an understanding of any of the entity's financial statements. *[IAS 1.112]*. (See Chapter 3 at section 5.1).

4.4.1 Interest and dividends

An entity is required to disclose separately cash flows from interest and dividends received and paid, and their classification as either operating, investing or financing activities must be applied in a consistent manner from period to period. *[IAS 7.31]*. For a financial institution, interest paid, and interest and dividends received are usually classified as operating cash flows. However, IAS 7 notes that there is no consensus on the classification of these cash flows for other entities and goes on to state that:

- Interest paid may be classified under either operating or financing activities.
- Interest received and dividends received may be included in either operating or investing cash flows. *[IAS 7.33]*.

The standard allows dividends paid to be classified as a financing cash flow (because they are a cost of obtaining financial resources) or as a component of cash flows from operating activities. *[IAS 7.34]*.

In Practical example 4-1 in section 4 above, AstraZeneca PLC has included interest paid under operating activities, interest received under investing activities and dividends paid under financing activities, as permitted by the standard. A different treatment is adopted by Telefonica, S.A. in Practical example 4-2 in section 4.1.1 above, where interest paid, interest received and dividends received are all included as operating cash flows and dividends paid are included as financing cash flows.

All these treatments comply with the standard; however, the most appropriate treatment will depend on the nature of the entity and its activities. For example, if an entity does not include interest received or dividends received within revenue it may be more appropriate to include the interest or dividend cash inflows as investing cash flows rather than operating cash flows. This is because cash flows from operating activities are primarily derived from the principal revenue-generating activities of the entity, *[IAS 7.14]*, and the amount of cash flows arising from operating activities is intended to be a key indicator of the extent to which the operations of the entity have generated sufficient cash flows to repay loans, pay dividends and make new investments without recourse to external sources of financing. *[IAS 7.13]*. Similarly, an entity could treat interest and dividends paid as financing cash flows because they are a cost of obtaining financial resources. *[IAS 7.34]*.

In addition, the standard requires the total amount of interest paid during the period to be disclosed in the statement of cash flows, whether it has been recognised as an expense or capitalised as part of the cost of an asset in accordance with IAS 23 *Borrowing Costs*. *[IAS 7.32]*. A literal reading of this requirement might suggest that interest paid must be presented as a single figure under operating or financing activities. However, it could also be appropriate to classify payments of interests in accordance with the classification of the underlying asset to which those payments were capitalised provided that, when this is done, the total amount of interest paid is also disclosed either on the face of the statement of cash flows or in the notes. For example, payments of interest that is capitalised as part of the cost of property, plant and equipment would be classified as part of an entity's investing activities, and payments of interest that is capitalised as part of the cost of inventories would be classified as part of an entity's operating activities. An attempt to clarify the issue through an annual improvement[12] was never finalised, mainly because the IFRS IC observed that amendments to IAS 7 relating to classification of cash flows should not be made on a piecemeal basis unless the classification was evident from the current guidance in IAS 7 and an amendment to IAS 7 would make that classification clearer.[13]

Where an entity has issued shares that are classified as financial liabilities in accordance with IAS 32 *Financial Instruments: Presentation* (see Chapter 43), the dividends paid on those shares will be presented in the statement of cash flows as either operating or financing in line with the entity's presentation of other interest paid.

12 Exposure Draft ED 2012/1, *Annual Improvements to IFRSs 2010-2012 Cycle*, IASB, May 2012, available on the IFRS Foundation's website.

13 *IASB Update*, April 2013.

4.4.2 Taxes on income

Cash flows arising from taxes on income shall be separately disclosed within operating cash flows unless they can be specifically identified with investing or financing activities. *[IAS 7.35]*.

Whilst it is possible to match elements of tax expense to transactions for which the cash flows are classified under investing or financing activities; taxes paid are usually classified as cash flows from operating activities because it is often impracticable to match tax cash flows with specific elements of tax expense. Also, those tax cash flows may arise in a different period from the underlying transaction. *[IAS 7.36]*. However, when it is practicable to make this determination, the tax cash flow is identified as an investing or financing activity in accordance with the individual transaction that gives rise to such cash flows. In cases where tax cash flows are allocated over more than one class of activity, disclosure is required of the total amount for taxes paid. *[IAS 7.36]*.

4.4.3 Sales taxes and other non-income tax cash flows

Although it sets out requirements for the treatment of taxes on income, IAS 7 does not specifically address the treatment of cash flows relating to other taxes, such as value added tax (VAT) or other sales taxes and duty. The IFRS IC has considered whether it should add the question about VAT to its agenda and decided that it was not appropriate to develop an interpretation.

In explaining why, it would not add this question to its agenda, the IFRS IC noted that "IAS 7 does not explicitly address the treatment of VAT" and added that "while different practices may emerge, they are not expected to be widespread".[14]

Given the availability of alternative treatments, the IFRS IC noted that it would be appropriate in complying with IAS 1 for entities to disclose whether cash flows are presented inclusive or exclusive of related VAT.[15]

How we see it

In our view, entities can choose to disclose sales taxes and other non-income tax receipts and payments separately in the statement of cash flows or as part of the related cash inflows and outflows. Even if presented separately, the tax cash flows are presented as operating, investing or financing in accordance with the classification of the underlying transactions that gives rise to the tax cash flows.

4.4.4 Cash contributions to a long-term employee benefit fund

As discussed in section 4.1 above, the definition of operating activities in IAS 7 includes as one of its examples "cash payments to and on behalf of employees". *[IAS 7.14(d)]*. Such cash outflows would typically involve wages and salaries paid to employees, taxes paid on behalf of employees and any other employee benefit contributions made on behalf of employees. Where a company makes contributions to a long-term employee benefit fund on behalf of its employees, those cash outflows are part of the compensation for employment services and are classified as operating cash flows.

4.4.5 Cash flows from factoring of trade receivables

Another question not explicitly addressed in the standard is the classification of cash receipts from the factoring of trade receivables.

In the case of debt factoring, an entity aims to receive cash flows from trade receivables more quickly than would arise from normal collection from customers, generally by transferring rights over those receivables to a financial institution. This raises questions as to whether the transfer results in derecognition of the trade receivables, or to the continued recognition of the trade receivables and the recognition of a financial liability for the funding received from the factoring entity. The characteristics determining which of these accounting treatments would be appropriate are discussed in Chapter 48 at sections 4.5 and 5.

14 *IFRIC Update*, August 2005, available on the IFRS Foundation's website.

15 *IFRIC Update*, August 2005, available on the IFRS Foundation's website.

How we see it

In our view, the classification of the cash receipt from the financial institution depends on the accounting treatment of the trade receivables. Only to the extent that the factoring arrangement results in the derecognition of the original trade receivable would it be appropriate to regard the cash receipt in the same way as any other receipt from the sale of goods and rendering of services and classify it in operating activities.

In cases where the trade receivable is not derecognised and a liability is recorded, the nature of the arrangement is a borrowing secured against trade receivables and accordingly we believe that the cash receipt from factoring must be treated in the same way as any short-term borrowing and included in financing activities. *[IAS 7.17(c)]*. The later cash inflow from the customer for settlement of the trade receivable would be included in operating cash flows and the reduction in the liability to the financial institution would be a financing outflow. Following the principle in IFRS 9 for the disclosure of income and expense relating to a transferred asset that continues to be recognised, *[IFRS 9.3.2.22]*, these two amounts would not be offset in the statement of cash flows. However, it would be acceptable for the entity to disclose the net borrowing receipts from, and repayments to, the financial institution, if it was determined that these relate to advances made for and the repayment of short-term borrowings such as those which have a maturity period of three months or less. *[IAS 7.23A(c)]*.

In some cases, the factoring arrangement requires customers to remit cash directly to the financial institution, but the arrangement does not result in the derecognition of the original trade receivables. As, discussed above, the initial cash receipt from factoring is included in financing activities. *[IAS 7.17]*. However, there is currently diversity as to whether, and how, the cash received by the financial institution from customers are presented in the entity's statement of cash flows.

When the transfer does not give rise to derecognition of the trade receivable by the reporting entity, the reporting entity may determine that the factoring entity is acting as its agent and is therefore collecting the cash on its behalf before drawing down amounts to settle the liability it is owed by the reporting entity. In this case, the entity would report an operating cash inflow from the customer and a financing cash outflow to the financial institution when the financial institution collects the cash from the customers. See section 5.3 below for further discussion of the presentation of cash paid or received on an entity's behalf. Alternatively, if the reporting entity determines that the factoring agent is not acting as its agent, the entity will reflect the later settlement of the debt by the customer as a non-cash transaction with no cash flows reported at the time of the ultimate derecognition of the trade receivable and the related factoring liability.

4.4.6 Cash flows from supply-chain financing and reverse factoring arrangements

The IFRS IC discussed the application of IFRS accounting standards to reverse factoring arrangements in their June 2020 and December 2020 meetings. The IFRS IC described reverse factoring arrangements simply as ones in which a financial institution agrees to pay amounts an entity owes to the entity's suppliers and the entity agrees to pay the financial institution at the same date as, or a date later than, suppliers are paid.

An agenda decision[16] was published in December 2020, outlining how IFRS accounting standards are applied to the different aspects of accounting for such arrangements. The agenda decision considers the presentation in the statement of financial position, the derecognition of a financial liability, the presentation in the statement of cash flows and disclosure in the notes to the financial statements. Details of the agenda decision and the impact on the statement of financial position can be found in Chapter 50 at section 7.4.3.B and on the notes to the financial statements in Chapter 50 at section 7.4.3.E.

In respect of the presentation in the statement of cash flows, an entity that has entered into a reverse factoring arrangement would need to determine whether to classify cash flows under the arrangement as cash flows from operating activities or cash flows from financing activities.

16 *IFRIC Update*, December 2020, available on the IFRS Foundation's website.

This in turn poses the following challenges:

- Does the presentation of the liability to the financial institution in the statement of financial position impact the presentation of cash flows? For example, if the liability is presented outside of trade and other payables, must the ultimate payment to the financial institution be presented as a financing outflow? Or can it instead be presented as an operating cash flow based on the nature of the activities that initially led to the recognition of the trade payable that was settled through the supply-chain financing?
- Will the remittance of cash directly to the supplier by the financial institution be reflected at all in the statement of cash flow or is it a non-cash transaction?

With respect to the first question above, the agenda decision notes that "the committee observed that an entity's assessment of the nature of the liabilities that are part of the arrangement may help in determining whether the related cash flows arise from operating or financing activities. For example, if the entity considers the related liability to be a trade or other payable that is part of the working capital used in the entity's principal revenue-producing activities, the entity presents cash outflows to settle the liability as arising from operating activities in its statement of cash flows. In contrast, if the entity considers that the related liability is not a trade or other payable because the liability represents borrowings of the entity, the entity presents cash outflows to settle the liability as arising from financing activities in its statement of cash flows".

How we see it

In our view, the agenda decision does not preclude an entity from presenting the repayment of the liability owed to the factor as an operating cashflow based on the nature of the transaction that led to the initial recognition of the liability to the entity's supplier, notwithstanding a presentation in the statement of financial position of the liability to the financial institution outside of trade and other payables. This is because there is no automatic link between the statement of financial position and the statement of cash flows.[17] In both cases, such presentations must be applied consistently and disclosed and explained in the notes.

As regards the identification of cash flows and the second question above, the agenda decision notes that "Investing and financing transactions that do not require the use of cash or cash equivalents are excluded from an entity's statement of cash flows (paragraph 43 of IAS 7). Consequently, if a cash inflow and cash outflow occur for an entity when an invoice is factored as part of a reverse factoring arrangement, the entity presents those cash flows in its statement of cash flows. If no cash inflow or cash outflow occurs for an entity in a financing transaction, the entity discloses the transaction elsewhere in the financial statements in a way that provides all the relevant information about the financing activity (paragraph 43 of IAS 7)". *[IAS 7.43]*.

How we see it

In our view, the agenda decision does not go beyond confirming the requirements of the standard when it states that if no cash flows are involved, then no cash flows are presented in the cash flow statement. In practice, a careful analysis of the relationship between the entity and the financial institution is needed to determine whether the financial institution is acting as an agent on behalf of the entity and receiving and incurring cash flows on its behalf. This will inform the appropriate presentation in the statement of cash flows. We discuss this issue further, including factors to consider in analysing the relationship between the entity and the financial institution, in section 5.3 below.

In its agenda decision, the IFRS IC rightly observed that assessing how to present liabilities and cash flows related to reverse factoring arrangements may involve judgement and emphasised the requirement in IAS 1 to disclose judgements that management has made in this respect if they are among the judgements made that have the most significant effect on the amounts recognised in the financial statements, *[IAS 1.122]*, as well as any information that is relevant to an understanding of any of the entity's financial statements. *[IAS 1.112]*.

The agenda decision suggests that the issue is only about whether to classify the associated cash flows as operating or financing activities. However, we note that if the cost of the goods or services is capitalised into a longer-term asset such as property, plant and equipment, or possibly an intangible asset, the classification decision would be between investing and financing activities. This may be particularly relevant in asset intensive industries such as telecommunications or the extractive industries.

17 IASB Staff Paper, Project: *Supply Chain Financing Arrangements-Reverse Factoring*, Paper topic: *Comment letters on tentative agenda decision*, IFRS IC Meeting, December 2020, paragraph 50. Available on the IFRS Foundation's website.

In the agenda decision the IFRS IC noted that the effects of reverse factoring arrangements may also need to be included in the disclosure of:

- Changes in liabilities arising from financing activities, as required by IAS 7.44A (see section 11.2 below). If an entity classifies the cash flows arising from a reverse factoring arrangement as financing, or will do so in the future, the related liabilities and cash and non-cash changes are included in this disclosure.

  And

- Liquidity risk, as required by IFRS 7, *[IFRS 7.33, IFRS 7.34, IFRS 7.35, IFRS 7.39, IFRS 7.B11F]*, because the entity has concentrated a portion of its liabilities with one financial institution rather than a diverse group of suppliers - see Chapter 50 at section 7.4.3.E. Also, some suppliers may have become accustomed to, or reliant on, earlier payment of their trade receivables under the reverse factoring arrangement. If the financial institution were to withdraw the reverse factoring arrangement, those suppliers could demand shorter credit terms, which would affect the entity's liquidity, particularly if the entity was already in financial distress.

In the process of finalising the agenda decision, the IFRS IC and the Board acknowledged that user information needs may not be met by the current requirements in respect of such arrangements. This resulted in the Board issuing *Supplier Finance Arrangements (Amendments to IAS 7 and IFRS 7)* (the amendments) in May 2023. The disclosure requirements in the amendments are intended to assist users of financial statements in understanding the effects of supplier finance arrangements on an entity's liabilities, cash flows and exposure to liquidity risk. The amendments, which are effective for annual reporting periods beginning on or after 1 January 2024, are discussed in more detail in section 11.4 below.

Early adoption of the amendments is permitted. However, many entities may choose to wait until the mandatory adoption date, not least because they may need to improve their financial reporting systems and/or obtain legal permission from finance providers in order to collect the information that is required to provide the new disclosures. In periods prior to the adoption of the amendments, if the entity has entered into reverse factoring arrangements, management must exercise judgement as to the appropriate level of disclosures.

How we see it

In our view, prior to the adoption of the amendments to IAS 7 and IFRS 7 on disclosures relating to supplier finance arrangements, additional disclosure will still be necessary whenever these arrangements have a material impact on the financial statements to explain the nature of the arrangements and amounts involved, the financial reporting judgements made and impacts thereof and, more specifically, the level of debt and the statement of cash flows.

In Practical example 4-4 below, Wm Morrison Supermarkets Limited discloses how they present liabilities and cash flows associated with their supply chain financing arrangements:

Practical example 4-4: Wm Morrison Supermarkets Limited (2023) United Kingdom

Annual Report and Financial Statements for the 52 weeks ended 29 October 2023 [extract]

Financial statements [extract]

Notes to the Group financial statements [extract]

5 Working capital and provisions [extract]

5.1 Accounting policies [extract]

Supply chain financing

The Group offers suppliers the option to access supply chain financing through certain third party providers. These facilities allow suppliers to receive payments earlier than the contractual payment terms. The Group did not receive any fees or rebates from the providers where the suppliers choose to utilise these facilities. Payment terms continue to be agreed directly between the Group and suppliers, and are independent of supply chain financing being available.

The Group makes an assessment of its supply chain finance arrangements to determine if the associated balance is appropriately presented as trade payables or as borrowings. This assessment considers factors such as the commercial purpose of the facility, the nature and specific terms of the arrangements and the credit terms in place with the banks and suppliers. Based on this assessment, the Group has determined that it is appropriate to present amounts outstanding through the supply chain financing arrangement as trade payables. Consistent with this classification, the reported cash flows are reported within cash generated from operations within the consolidated statement of cash flows.

4.4.7 Property, plant and equipment held for rental

Payments to acquire and receipts from the sale of, property, plant and equipment are usually included in investing cash flows; however, this is not always the case.

A number of entities routinely sell assets that were previously held for rental, for example, car rental companies that acquire vehicles with the intention of holding them as rental cars for a limited period and then selling them. IAS 16 *Property, Plant and Equipment* requires an entity, that, in its ordinary course of business, routinely sells items of property, plant and equipment that it has held for rental to others, to classify the proceeds on the sale of such property, plant and equipment as revenue. *[IAS 16.68A]*. Accordingly, the proceeds from the sale of such assets are classified as cash flows from operating activities, as are cash payments to manufacture or acquire property, plant and equipment held for rental to others and routinely sold in the ordinary course of business. *[IAS 7.14]*.

In our view, the requirement to classify payments for such property, plant and equipment held for rental under operating cash flows is intended to avoid initial expenditure on purchases of assets being classified as investing activities, while inflows from sales are recorded within operating activities. However, this means that management will need to determine, at the time of acquisition or manufacture, which of the assets that it intends to rent out will be ultimately held for sale in the ordinary course of business.

4.4.8 Cash received as compensation for an insured loss

As noted in section 4.2 above, cash flows arising from investing activities include receipts from the sale of property, plant and equipment and other long-term assets. *[IAS 7.16(b)]*. This classification would also be appropriate if the receipt of cash came from insurance proceeds received to cover for the loss or damage of such assets. It would not be appropriate to present the cash inflow as an operating cash flow as the insurance proceeds are not derived from the principal revenue-generating activities of the business. *[IAS 7.14]*. However, the nature of the claim giving rise to the cash inflow must be carefully considered. If the claim relates only partially to the loss of damage of a long-term asset, it may be necessary for the cash inflows to be allocated between cash flows from operating activities (e.g., for the compensation for business interruption) and cash flows from investing activities.

4.4.9 Cash flows for service concession arrangements

Because a cash flow is only classified in investing activities if it results in a recognised asset in the statement of financial position, a question arises regarding the classification of the cash inflows and outflows of the operator of a service concession arrangement that is within the scope of IFRIC 12 *Service Concession Arrangements*.

IFRIC 12 features two possible accounting models - the intangible asset model or the financial asset model. Under both models, the service element relating to the construction of the infrastructure asset is accounted for in accordance with IFRS 15 and the revenue recognised gives rise to an intangible or a financial asset, in the form of a receivable, respectively. It is unclear whether cash flows incurred in the construction or upgrade phase must always be regarded as operating cash flows because they relate to the provision of construction services; or whether they are more accurately classified as investing activities, as they reflect cash outflows that result in the recognition of an asset.

In the case of an arrangement under the intangible asset model, the cash flows incurred during construction or upgrading could be classified in investing activities as they relate to the acquisition of an intangible that will generate future income and cash flows. Once the operating phase is reached, the cash inflows received would be most appropriately classified in operating activities as most operating and maintenance costs are likely to be executory and will be accounted for as incurred.

On the other hand, when the financial asset model applies, cash outflows during the construction phase may be considered to represent the provision of financing to the grantor and as such an investing outflow. In a corollary of the discussion on deferred payments in section 7.1 below, where the time value of money is significant to the transaction, the substance of the transaction may be the provision of a loan. Where this is the case the repayment of such an instrument by the grantor during the operating phase would be considered an investing cash flow (or potentially split between investing and operating cash flows for the capital and interest components respectively, depending on the policy of the entity).

Since there is no specific guidance relating to the classification of cash flows for service concession arrangements, current practice is mixed. IFRIC 12 is discussed in more detail in Chapter 26.

4.4.10 Treasury shares

Treasury shares are an entity's own equity instruments that are acquired and held by the entity, a subsidiary, or other members of the consolidated group. The consideration paid or received for treasury shares is recognised directly in equity and not as a movement in investments. *[IAS 32.33]*. Similarly, IAS 7 requires that payments and receipts to acquire or dispose of treasury shares are classified within financing activities. *[IAS 7.17]*. Even where such treasury shares are acquired by the entity as part of an equity-settled share-based payment transaction, the cash outflow is classified under financing activities. Whilst cash payments to and on behalf of employees are classified under operating activities, *[IAS 7.14]*, the acquisition of treasury shares does not settle a transaction between the entity and its employees. An equity-settled share-based payment transaction is completed when the entity transfers its equity instruments to employees in consideration for the services received.

When a cash payment is made by a subsidiary to its parent or a trust that holds treasury shares as part of an equity-settled share-based payment arrangement, the payment is accounted for as a deduction from equity in the separate financial statements of the subsidiary, on the grounds that the payment does not settle the transaction with the employees, but is effectively a distribution to the parent or the trust (see Chapter 30 at section 12.2.7). Having regarded this as a distribution, it follows that the cash flow must be classified as either operating or financing, according to the entity's policy on dividends as discussed in section 4.4.1 above.

4.4.11 Cash flows related to the costs of a share issue

Costs directly related to the issue of shares are required to be deducted from equity. *[IAS 32.35]*. As the costs reduce the amount of the proceeds received from the share issue, they are classified as a financing cash flow. *[IAS 7.17(a)]*. However, where a proposed share issue is cancelled, there would be no proceeds from the issue to record and the related expenses would be included in profit and loss rather than equity. As such, the definition of a financing cash flow would not be met, and the transaction costs would be classified in operating cash flows.

4.4.12 Cash flows paid or received under derivative contracts

Payments and receipts relating to derivative contracts can be classified within operating, investing or financing in different circumstances. Where the contract is held for dealing or trading purposes, the cash flows are classified under operating activities. *[IAS 7.14(g)]*. IAS 7 requires that payments for, and receipts from, futures contracts, forward contracts, option contracts and swap contracts are classified as cash flows from investing activities, except when the contracts are held for dealing or trading purposes, or the cash flows are classified as financing activities. *[IAS 7.16(g)]*.

The standard adds that when a contract is accounted for as a hedge of an identifiable position, the cash flows of the contract are classified under the same heading as the cash flows of the position being hedged. *[IAS 7.16]*. An example is an interest rate swap. An entity wishing to convert an existing fixed rate borrowing into a floating rate equivalent could enter into an interest rate swap under which it receives interest at fixed rates and pays at floating rates. All the cash flows under the swap are reported under the same cash flow heading as interest paid (i.e., as financing activities or operating activities, in accordance with the entity's determined policy, as discussed in section 4.4.1 above), because they are equivalent to interest or are hedges of interest payments.

More generally, IFRS 9 adds to the requirements of IAS 7 by clarifying that cash flows arising from hedging instruments are classified as operating, investing or financing activities, on the basis of the classification of the cash flows arising from the hedged item and that this should be consistent with the classification of these instruments as hedging instruments under IFRS 9. *[IFRS 9.IG G.2]*.

This seems to leave an open question as to how an entity classifies the cash flows from a derivative contract that is considered by management as part of a hedging relationship, but for which the entity elects not to apply hedge accounting (taking all movements to profit or loss)? Since IAS 7 has not been updated to reflect IFRS 9, this question is not dealt with explicitly in IAS 7.

How we see it

In our view, if a hedging relationship would qualify for hedge accounting had it been so designated, but has not been accounted for applying the hedge accounting requirements of IFRS 9, it would be permitted for the cash flows from the hedging instrument to be presented in the same category as the cash flows of the position being hedged.

This can be explained in the following Illustration:

Illustration 4-1: Cash flows from derivatives not designated as hedges

Company A has the euro as its functional currency. On 1 January 20X1, it sells goods to a US customer for which it charges US$1,000,000. The spot exchange rate on this date is 1:1 and it recognises revenue of €1,000,000. Payment is due to be received on 30 June 20X1. A enters into a forward contract to exchange US$1,000,000 for €1,095,000 on 30 June 20X1. The hedging relationship would qualify to be accounted for applying the hedge accounting requirements of IFRS 9. However, Company A does not designate it as a hedge because the effects of movements on the contract and those of retranslating the receivable will already offset in profit or loss. On 30 June 20X1 the exchange rate is such that A receives the equivalent of €1,200,000 from its customer and pays €105,000 on the forward contract.

Taken literally, IAS 7 would suggest that, because the forward contract is not held for dealing or trading purposes and is not accounted for as a hedge of an identifiable position, the €105,000 cash outflow on the forward contract cannot be classified under operating activities. As such, the €105,000 would have to appear in investing or possibly financing cash flows. However, had the entity elected to apply hedge accounting, the standard would require the €105,000 to be included in operating cash flows. Therefore, as explained above, in our view entity A could include the payment on the forward contract in cash flows from operating activities.

4.4.13 Debt instrument issued at a discount or redeemed at a premium

Cash outflows that represent the repayment of the principal amount of a loan or other debt instrument are classified as financing activities. *[IAS 7.17]*. As noted in section 4.4.1 above, interest paid may be classified under either operating or financing activities. Therefore, where an entity adopts a policy of classifying interest under operating activities, it may be necessary to consider carefully the nature of any payment to the lender to ensure the appropriate classification between operating and financing. This will be particularly relevant where the pattern of payments differs from the recognition of the interest expense in profit or loss.

For example, a company that issues a zero-coupon bond at nominal value, with a premium payable on redemption, will not make any interest payments over the life of the bond. However, in accounting for the financial liability at amortised cost under IFRS 9, the entity will recognise interest at the EIR, calculated to reflect the premium payable on redemption, as explained in Chapter 46 at section 3.1. This raises the question of how to present the cash paid on redemption. Is it appropriate to present the entire cash outflow within financing activities as the redemption of a debt instrument?

How we see it

In our view, when an entity adopts a policy of classifying interest under operating activities and the cash paid on redemption is presented in the statement of cash flows, a split must be made to show the amount that relates to the interest cost (within operating activities) and the amount that relates to the repayment of the principal (within financing activities). The same principles would be applied where a debt is issued at a discount or in any other situation where the pattern of cash flows relating to interest on a financial liability are not reflected in the pattern of recognition of the interest cost.

4.4.14 Early settlement of a debt instrument

A similar issue to that discussed in sections 4.4.13 above is how to present the cash payments on early settlement of a loan or other borrowing. As already noted in section 4.3 above, cash flows arising from financing activities include outflows to repay borrowings. However, in some situations an element of the cash paid on early settlement could be viewed as compensation to the lender for lost interest.

Lenders will often include a prepayment penalty provision in loan agreements that can be based on a number of factors, including an approximation of the interest that will not be paid as a result of early settlement. This would support a split presentation of the cash outflow between repayment of borrowings and cash outflow for interest. Alternatively, the nature of the entire cash outflow may also be viewed as relating to a financing activity, being the extinguishment of a liability, which is then be presented as one amount in the financing activities section of the statement.

4.4.15 Receipt of a government grant

The accounting requirements for government grants are set out in IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* and are covered in Chapter 25.

Neither IAS 20 nor IAS 7 provide guidance on where in the statement of cash flows to present the cash inflows from the receipt of government grants. The IFRS IC discussed in July 2012 the presentation of cash flows for several fact patterns including government grants.[18] The issue was further discussed in March 2013. The IFRS IC observed that the primary principle behind the classification of cash flows in IAS 7 is that cash flows should be classified on the basis of the nature of the activity in a manner that is most appropriate to the business of the entity in accordance with paragraph 11 of IAS 7 and with the definitions of operating, investing and financing activities in paragraph 6 of IAS 7. In the course of the discussions held, staff initially suggested that grants were providing a source of financing to the entity, and consequently cash received would be part of the entity's financing activities. In a later meeting, however, it reached a different conclusion that cash received from a government grant should be presented as an operating cash flow instead, on the basis that although cash inflows from a grant provide the entity with financing for the designated asset/activity, a grant does not represent a borrowing activity because there is no expectation that the resource will be returned to the provider of finance; or that the provider of finance will be appropriately compensated. Eventually, the IFRS IC concluded that clarifying the application of the primary classification principle in IAS 7 was a matter too broad for it to address and discontinued its work.[19]

Consequently, until and unless the IASB addresses this issue as part of its upcoming project on the cash flow statement, there is likely to be diversity in practice for the presentation of all government grants in the statement of cash flows, whether related to assets or to income. Cash flows received from government grants could be considered to be financing by nature because they provide a source of financing to the entity. Alternatively, cash flows received from government grants (or only those from grants related to income) could be presented as operating cash flows by default since they do not seem to meet the definition of financing activities and cash flows received from government grants related to assets could be presented as investing cash flows as they relate to an investing activity.

How we see it

Selecting the most appropriate presentation will be a matter of judgement. Once adopted, the presentation principles must be applied consistently and clear disclosure of the principles and the impact thereof on the cash flow statement must be provided in accordance with IAS 1.

As discussed in section 5.2.1 below, IAS 7 requires the cash inflow from the receipt of a government grant to be presented gross in the statement of cash flows as there is no exception provided to the presentation of gross cash receipts and payments in the standard for such transactions. IAS 20 further emphasises this requirement specifically for government grants related to assets regardless of whether or not the government grant is deducted from the related asset for presentation purposes in the statement of financial position. *[IAS 20.28]*.

4.4.16 Classification of cash flows - future impact of IFRS 18 *Presentation and Disclosure in Financial statements*

IFRS 18 was issued in April 2024 and becomes effective for reporting periods beginning on or after 1 January 2027. The standard will replace IAS 1 and makes limited consequential amendments to the current requirements of IAS 7. These are explained in Chapter 4 at section 5.1.

18 *IFRIC Update*, July 2012, available on the IFRS Foundation's website.

19 *IFRIC Update*, March 2013, available on the IFRS Foundation's website.

5 Other cash flow presentation matters

5.1 Material cash flows

IAS 1 requires the nature and amount of material items of income and expense to be disclosed separately. *[IAS 1.97]*. It also requires additional line items, headings and sub-totals to be presented on the face of the statement of financial position or of the statement(s) presenting profit or loss and other comprehensive income when this is relevant to an understanding of the entity's financial position. *[IAS 1.55, IAS 1.85]*. IAS 1 does not refer to material cash flows and IAS 7 contains no specific requirements in relation to such disclosures. However, it may be similarly appropriate for material cash flows or cash flows relating to material items in the statements of financial position or of comprehensive income to be presented as separate line items on the face of the statement of cash flows, although they would remain classified according to their nature as either operating, investing or financing cash flows. *[IAS 1.97]*.

How we see it

In our view, where specific events and transactions significantly affect the amount of cash flows reported in the cash flow statement, they must be disclosed and explained in the notes in accordance with IAS 1, regardless of whether they are presented as separate line items on the face of the cash flow statement.

Examples of such events and transactions are the receipt of significant government grants, a change in the pattern of payments to suppliers or from customers or in the contractual terms of payments, the introduction of trade receivables factoring arrangements or supply chain financing or extension of existing arrangements.

5.2 Gross or net presentation of cash flows

Major classes of gross receipts and gross payments arising from investing and financing activities must be reported separately. *[IAS 7.21]*. IAS 7 permits but does not require, certain cash flows to be presented on a net basis as follows: *[IAS 7.22]*.

Extract from IAS 7

22 **Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:**

(a) cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the entity; and

(b) cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.

Examples given in the standard of cash receipts and payments that reflect the activities of customers rather than those of the entity are the acceptance and repayment of demand deposits by a bank, funds held for customers by an investment company and rents collected on behalf of, and paid over to, the owners of properties. *[IAS 7.23]*.

Examples given in the standard of cash receipts and payments in which turnover is quick, the amounts are large, and the maturities are short include advances made for and the repayment of:

(a) Principal amounts relating to credit card customers

(b) The purchase and sale of investments

(c) Other short-term borrowings, such as those with a maturity on draw down of three months or less *[IAS 7.23A]*

See section 10.2 below for discussion of the gross or net presentation of cash flows for financial institutions.

5.2.1 Gross or net presentation of cash flows - government grants

IAS 7 requires the cash inflow from the receipt of a government grant to be presented gross in the statement of cash flows as there is no exception provided to the presentation of gross cash receipts and payments in the standard for such transactions. IAS 20 further emphasises this requirement specifically for grants related to assets regardless of whether or not the government grant is deducted from the related asset for presentation purposes in the statement of financial position. *[IAS 20.28]*.

The classification of cash flows from the receipt of a government grant is discussed in section 4.4.15 above.

Government grants are discussed in more detail in Chapter 25.

5.3 Presentation of cash paid or received on an entity's behalf

As discussed in section 7 below, IAS 7 requires that transactions that do not require the use of cash or cash equivalents are excluded from an entity's statement of cash flows. *[IAS 7.43]*. Examples of such non-cash transactions provided in the standard are the conversion of debt to equity; acquiring assets by assuming directly related liabilities or by entering into a lease; and issuing equity as consideration for the acquisition of another entity. *[IAS 7.44]*.

However, there is no broader guidance in IAS 7, or elsewhere in IFRS accounting standards, to help determine whether cash flows should be included in the statement of cash flows because the entity has directed another party to pay and/or receive cash on its behalf and so, in substance, the cash flows are the entity's cash flows. This is a matter of judgement based on facts and circumstances.

There may be transactions that, in substance, involve cash flows of the entity, without the cash resources of the entity actually changing. For example, where an entity purchases an item of property and finances the purchase by borrowing the funds from a financial institution, it may arrange for the money to be paid directly by the financial institution to the seller rather than receive the cash inflow from the loan into its bank account and make a subsequent cash payment to the seller. The relationship between the entity and the financial institution may be determined to be fiduciary in nature with the financial institution acting as an agent of the entity and receiving and incurring cash flows on its behalf.

In all situations, the nature of the relationship with the third party will need careful examination, including assessment of the terms and conditions of each specific arrangement. Factors to consider as part of the consideration could include:

- Who is directing the payment or receipt? If the reporting entity is directing the movement of the cash, it is more likely that the third party will be acting as its agent and therefore the cash flows will be cash flows of the entity.
- Who controls the timing and amount of the payment or receipt? If the reporting entity has control over the timing and the amount this may suggest the third party is acting as its agent and that the payment or receipt is, in substance, the entity's cash flow.
- Why has the arrangement with the third party been established and who benefits from the arrangement? If the arrangement has been established for the convenience of the reporting entity (for example because they do not have a bank account in a certain jurisdiction) this may provide evidence that the cash flow is, in substance, the entity's cash flow.

How we see it

Where it is determined that cash flows made or received by a third party are, in substance, cash flows of the entity, these cash flows must be reported in the statement of cash flows of the entity.

Appropriate disclosures will be important, in particular, disclosure of the facts considered, and the judgements management has made in applying IAS 7 in accordance with paragraphs 117 and 122 of IAS 1 (see Chapter 3 at section 5.1.1.A).

This issue is also discussed in the context of specific scenarios in section 4.4.5 above (factoring of trade receivables), section 4.4.6 above (supply-chain financing arrangements and reverse factoring arrangements), section 8.1 below (the in-substance purchase of an asset) and section 9.5.3 below (group treasury arrangements).

6 Foreign currency cash flows

Foreign currency cash flows can arise either when an entity enters into transactions where the cash payments or receipts are denominated in a foreign currency or when the consolidated financial statements of a group include the cash flows of a subsidiary whose functional currency is different from the presentation currency of the group (e.g., a foreign subsidiary).

IAS 21 *The Effects of Changes in Foreign Exchange Rates* excludes from its scope the translation of cash flows of a foreign operation and the presentation of foreign currency cash flows in a statement of cash flows. *[IAS 21.7]*. Nevertheless, IAS 7 requires foreign currency cash flows to be reported in a manner consistent with IAS 21. *[IAS 7.27]*.

The requirements for entities falling within the scope of IAS 29 *Financial Reporting in Hyperinflationary Economies* are discussed in Chapter 17.

6.1 Foreign currency denominated transactions

When an entity enters into a transaction denominated in a currency other than its functional currency, there are no direct consequences for the statement of cash flows until payments are received or made. Once payment is made or received, the cash outflows or inflows are recorded in the entity's accounting records at the exchange rate prevailing at the date of payment and these amounts are reflected in the statement of cash flows. *[IAS 7.25]*. If the entity's presentation currency is different from its functional currency, the functional currency cash flows are translated into the presentation currency at the rates at the date of the cash flows. *[IAS 7.26]*.

For practical reasons, an entity can apply a rate that approximates the actual rate on the date of the cash flow (such as a weighted average for a period) but, like the requirements of IAS 21 for income and expenses, translation using the exchange rate as at the end of the reporting period is not permitted. *[IAS 7.27]*.

For operating cash flows presented using the direct method (see section 4.1.1 above), investing and financing cash flows, these requirements are relatively easy to understand, i.e., the amounts reported should be the cash paid or received, translated at the exchange rate prevailing at the date of the payment or receipt or a rate approximating that. For operating cash flows presented using the indirect method, there are additional complications which are considered below.

6.1.1 Operating cash flows presented using the indirect method

For operating cash flows presented using the indirect method, the entity presents the net cash flows from operating activities by working back from amounts reported in the income statement (see section 4.1.2 above). The most common approach adjusts reported profit or loss for the effects of:

(a) Changes in inventories and operating receivables and payables during the period

(b) Non-cash items such as depreciation, provisions, deferred taxes, unrealised foreign currency gains and losses, and undistributed profits of associates

And

(c) All other items for which the cash effects are investing or financing cash flows *[IAS 7.20]*

The exchange differences reported in profit or loss may include realised and unrealised gains and losses arising from operating activities and investing and financing activities. Entities must therefore determine what adjustments to make to profit or loss to ensure that foreign currency items are only included in the operating cash flow reconciliation to the extent that cash flows have occurred and that they relate to operating activities. This is discussed in the sections below.

6.1.1.A Realised and unrealised gains and losses relating to operating activities

For realised gains or losses that relate to operating items such as sales or purchases of inventory by an entity, no adjustment is needed to get from profit or loss to operating cash flows if the starting point for the reconciliation is profit before tax or profit after tax. This is because it will include both the amount recorded at the date of sale and the amount of the exchange difference on settlement, the combination of which gives the amount of the actual cash flow.

For unrealised gains or losses that relate to operating items, no adjustment will be needed as the unrealised exchange gain or loss is generally already reflected in the movement in the related payable or receivable included in the reconciliation to operating cash flows. Alternatively, some entities may choose to reflect these gains and losses as a reconciling item and then also include an equivalent adjustment in the movement in the related receivable or payable, however this method is rarely seen in practice.

6.1.1.B Realised and unrealised gains and losses relating to non-operating activities

For realised gains or losses arising on a settled transaction relating to investing or financing activities, an adjustment is needed to reconcile reported profit or loss to the net cash flow from operating activities.

For example, the foreign currency purchase of property, plant and equipment would be recorded at the rate prevailing on the date of the purchase and, if not paid for immediately, a creditor would be recorded for the same amount. Any exchange difference arising on final settlement of the creditor would be taken to profit or loss as an exchange gain or loss.

If left unadjusted, operating cash flows determined using the indirect approach would include this amount of exchange gain or loss. In addition, the investing cash flow for the asset purchase would be unadjusted and recorded at the purchase date exchange rate, rather than at the exchange rate prevailing at the date of settlement of the creditor. Therefore, this difference needs to be considered in calculating the cash flow to be shown under the relevant classification, in this case investing cash flows, so that the cash flow for the purchase of the asset reflects the exchange rate at the date of settlement of the related creditor. The difference also needs to be adjusted by subtracting or adding back the exchange gain or loss in the reconciliation of operating cash flows.

For unrealised gains or losses relating to investing or financing activities, an adjustment must be made to reconcile reported profit or loss to the net cash flow from operating activities. This is because the unrealised exchange differences will be reflected in the income statement as an exchange gain or loss. If left unadjusted, the reconciliation of operating cash flows prepared using the indirect approach would total to a figure for operating cash flows which would incorrectly include this amount of non-operating, unrealised exchange gain or loss.

6.2 Cash and cash equivalent balances denominated in foreign currencies

Unrealised gains and losses arising from exchange rate movements on foreign currency cash and cash equivalents are not cash flows. However, it is necessary to include these exchange differences in the statement of cash flows in order to reconcile the movement in cash and cash equivalents at the beginning and end of the reporting period. The effect of exchange rate movements on cash and cash equivalents is presented as a single amount at the foot of the statement of cash flows, separately from operating, investing and financing cash flows and includes the differences, if any, had those cash flows been reported at end of period exchange rates. *[IAS 7.28]*. An example of this is illustrated in Practical example 4-1 in section 4 above.

This reconciling item reflects:

- The difference between the opening and closing exchange rate used multiplied by the foreign currency cash balances held at the beginning of the year.

  And

- The difference between the exchange rates used to translate foreign currency cash flows (e.g., an average rate) and the closing exchange rate multiplied by the net cash flow activity for the period measured in the foreign currency.

6.3 Consolidated financial statements including foreign subsidiaries

Section 9.1 below discusses the general principles of preparing a consolidated statement of cash flows. When the group contains a foreign subsidiary, the cash flows of that subsidiary must be translated into the presentation currency of the group using the exchange rates prevailing at the dates of the cash flows. *[IAS 7.26]*. This is similar to the treatment of foreign currency transactions discussed at section 6.1 above. A rate that approximates the actual rate on the date of the cash flow (such as a weighted average for a period) can be used. *[IAS 7.27]*. However, this does not apply to the cash flows of a foreign subsidiary whose functional currency is the currency of a hyperinflationary economy as all amounts, including cash flows, are translated at the closing rate at the date of the most recent statement of financial position. See Chapter 16 at section 6.1 for more discussion on translating amounts in a functional currency that is the currency of a hyperinflationary economy.

6.3.1 The indirect method and foreign subsidiaries

Entities should exercise care when applying the indirect method at the 'more consolidated level' as described in section 9.1 below when there are foreign subsidiaries. If the translated financial statements are used, exchange differences will be included in the movements between the opening and closing group balance sheets. For example, if inventories held by a US subsidiary of a UK parent increase from $240 to $270 during the year and the opening exchange rate of £1=$1.60 becomes £1=$1.80 by the year-end, inventories will be reported as an unchanged amount of £150 in both balance sheets. This could result in the reconciliation showing no movement between opening and closing inventories which would be incorrect. In these circumstances it would be advisable for an entity to take the functional currency financial statements of the foreign subsidiary as the starting point, or otherwise ensure the exchange differences have been correctly reflected.

6.3.2 Exchange differences on retranslation of foreign subsidiaries reported in other comprehensive income.

All exchange differences arising on translation of foreign operations will have been recognised in other comprehensive income - see Chapter 16 at section 6.1. Such exchange differences are not cash flows, and will therefore not be reported as such in the consolidated statement of cash flows. However, any exchange differences relating to the translation of cash and cash equivalents held in foreign currencies by the foreign subsidiaries will be included in the reconciliation of cash and cash equivalents at the beginning and end of the period, as reported at the foot of the statements of cash flows - see section 6.2 above.

7 Non-cash transactions and transactions on deferred terms

Non-cash transactions only ever appear in a statement of cash flows as adjustments to profit or loss for the period when using the indirect method of presenting cash flows from operating activities as discussed in section 4.1.2 above. Investing and financing transactions that do not involve cash or cash equivalents are always excluded from the statement of cash flows. Disclosure is required elsewhere in the financial statements in order to provide all relevant information about these investing and financing activities. *[IAS 7.43]*. Examples of such non-cash transactions include the conversion of debt to equity; acquiring assets by assuming directly related liabilities or by entering into a lease; and issuing equity as consideration for the acquisition of another entity. *[IAS 7.44]*. Similarly, asset exchange transactions and the issue of bonus shares out of retained earnings are disclosed as non-cash transactions. Practical example 7-1 below shows the disclosures made by China Mobile Limited.

Practical example 7-1: China Mobile Limited (2020) **Hong Kong**

ANNUAL REPORT 2020 [extract]

Consolidated Statement of Cash Flows [extract]

...

Significant non-cash transactions

The Group recorded payables of RMB63,817 million (as at 31 December 2019: RMB64,480 million) due to equipment suppliers as at 31 December 2020 for additions of construction in progress during the year then ended. In addition, the Group recorded lease liabilities of RMB16,870 million (as at 31 December 2019: RMB13,219 million) as at 31 December 2020 for additions of right-of-use assets during the year then ended.

...

7.1 Asset purchased on deferred terms from the supplier

When an asset is purchased on deferred terms granted by the supplier directly, it may not be clear whether the associated cash flows should be classified within investing activities or within financing activities, as the repayment of borrowings.

It could be argued that the payment of a deferred amount would not meet the definition of investing cash flows, because it does not result in recognition of an asset, but rather a reduction of a liability. However, as discussed in section 4 above, the IFRS IC and the IASB have affirmed in 2013 their position that in determining the classification of cash flows, the nature of the activity is still the primary principle to be considered.[20]

Accordingly, the classification of the payment comes down to a judgement as to whether its nature relates to the acquisition of an asset or the repayment of a liability.

How we see it

The settlement of a short-term payable for the purchase of an asset is an investing cash flow. Where the period between acquisition and payment is significant, judgement must be applied to determine whether the definition of a financing cash flow has now been met.

One method that may be used to determine whether the transaction involves a financing component is to look to the requirements in IFRS 15 in respect of whether a contract contains a significant financing component (see Chapter 28 at section 5.5). *[IFRS 15.60]*.

The liability recorded for the deferred consideration would be classified and subsequently measured in accordance with IFRS 9 (see Chapter 44 at section 2). In this case, the liability might need to be split to separate cash flows for the interest components, depending on the accounting policy of the entity - see section 4.4.1 above.

Where an asset is acquired on deferred terms it would, where significant, require disclosure as a non-cash transaction in accordance with paragraph 43 of IAS 7 (see section 11.3 below).

Where an entity acquires a right-of-use asset under a lease, IAS 7 is clear that the transaction is a non-cash transaction. *[IAS 7.44]*. The cash flow presentation of leasing transactions is discussed in section 8 below.

7.2 Asset disposals on deferred terms

As explained in section 7 above, investing and financing transactions that do not involve cash or cash equivalents are always excluded from the statement of cash flows and disclosure is required of these non-cash transactions. *[IAS 7.43]*. Therefore, if an asset is sold but no payments is received in the period of the sale, there will be no amounts reported in the statement of cash flows. Where the arrangement is determined to be the provision of finance by the vendor, for example the derecognition of property, plant and equipment by the lessor under a finance lease, subsequent cash receipts to reduce the receivable from the purchaser would be investing cash flows, but appropriately described, for example as the receipt of deferred consideration rather than the proceeds on sale of property, plant and equipment. *[IAS 7.16]*.

7.3 Revenue contracts with deferred payment terms

As discussed in Chapter 28 at section 5.5, a contract with a customer that has a significant financing component would be separated into a revenue component (for the notional cash sales price) and a loan component (for the effect of the deferred or advance payment terms). *[IFRS 15.60]*. In the case of deferred payment terms this gives rise to two cash flow components i.e., the revenue component cash flows must be classified as cash flows from operating activities, and the cash flows related to the significant financing component must be classified consistently with the entity's choice to present cash flows from interest received. *[IAS 7.31, IAS 7.33]*. If the customer pays in advance, however, the sum of the cash amount and the accrued interest represent revenue, and thus there is only one cash flow component (being the advance payment) which must be classified as a cash inflow from operating activities. *[IAS 7.14]*.

20 *IASB Update*, April 2013, available on the IFRS Foundation's website.

7.4 Variable and contingent consideration for asset acquisitions outside of a business combination

Contingent consideration paid on a business combination is discussed in section 9.3.3 below. The purchase price of intangible assets or tangible assets acquired outside of a business combination also sometimes includes variable or contingent consideration for example to resolve an uncertainty or a difference in views about the initial value of the asset transferred.

Accounting for the contingent consideration element of such asset purchases is discussed in Chapter 18 at section 4.5 for intangible assets, and Chapter 19 at section 4.1.9 for property, plant and equipment. As explained in those chapters, such transactions can be very complex and payment can be dependent on a number of factors, with no specific guidance provided in IAS 38 *Intangible Assets* or IAS 16. Therefore, an entity must develop and consistently apply an accounting policy for the initial and subsequent measurement of such assets that results in information that is relevant and reliable in its particular circumstances.

Once such an accounting policy is developed, the presentation in the statement of cash flows should be informed by the accounting treatment adopted in the statement of financial position.

As discussed in section 7.1 above, even though the reason for the cash flows in a genuine contingent consideration is to acquire a long-term asset, classifying the resulting cash flows as investing would only be appropriate if the cash flows are in settlement of an expenditure that results in a recognised asset in the statement of financial position. *[IAS 7.16]*. This is because paragraph 16 of the standard requires the classification of cash flows from investing activities in the statement of cash flows to be aligned with the presentation of recognised assets in the statement of financial position rather than to reflect an entity's judgement as to the most appropriate classification based the entity's business and the definitions of investing activities. *[IAS 7.BC5, IAS 7.BC6, IAS 7.BC7]*.

How we see it

In our view, cash payments up to the amount capitalised in relation to the acquired assets would be classified in investing activities. Since variable and contingent consideration generally arises for reasons other than the provision of finance to the acquirer, any resulting payments would generally not seem to be eligible for classification as financing cash flows. As a result, any variable and contingent consideration in excess of the amount that has been capitalised as part of the cost of the asset (whether on initial recognition or to reflect changes in variable and contingent consideration that have been capitalised in line with the entity's accounting policy for such payments), would need to be presented as operating cash flows by default.

However, if the accounting variability of the contingent consideration is driven from factors such as currency, time value of money or the existence of an embedded derivative that are within the scope of other standards (e.g., IAS 21, IFRS 9), the cash flow presentation must be consistent with such standards.

8 Cash flows from leasing transactions

8.1 Accounting as lessee

As noted in section 7.1 above, where an entity acquires a right-of-use asset under a lease, the acquisition of the asset is clearly a non-cash transaction. The requirements of IFRS 16 are covered in Chapter 24. The presentation and disclosure requirements of IFRS 16 for lessees are discussed in Chapter 24 at sections 5.7 and 5.8. In relation to the cash flow presentation, a lessee classifies:

(a) Cash payments for the principal portion of the lease liability within financing activities.

(b) Cash payments for the interest portion of the lease liability in a consistent manner to the presentation other interest paid (i.e., as operating or financing - see section 4.4.1 above).

And

(c) Short-term lease payments, payments for leases of low-value assets and variable lease payments not included in the measurement of the lease liability within operating activities. *[IFRS 16.50]*.

IFRS 16 also requires disclosure of the total cash outflow for leases. *[IFRS 16.53(g)]*. This will include lease payments for short-term leases and leases of low-value assets and variable lease payments. See Chapter 24 at section 5.8.

A lessee must also include lease liabilities (and the related cash and non-cash movements) in the disclosures required by IAS 7.44A of changes in liabilities arising from financing activities - see section 11.2 below.

However, care may be needed sometimes to distinguish a lease from a purchase of an asset based on the substance of that transaction and not its legal form. IFRS 16 applies to contracts that convey the right to use an underlying asset for a period of time and does not apply to transactions that transfer control of the underlying asset to an entity - such transactions are sales or purchases within the scope of other standards. *[IFRS 16.BC139, IFRS 16.BC140]*. Consequently, if a contract grants rights that represent the in-substance purchase of an item of property, plant and equipment, such transaction may need to be presented as the purchase of the underlying asset (regardless of whether legal title transfers) either on deferred terms (see section 7.1 above) if entered into directly with the manufacturer or dealer of the asset or together with the provision of financing if entered into with a financial institution which purchases the underlying asset on the entity's behalf from a designated supplier. In the latter case, this raises the question as to whether the payment of the supplier directly by the financial institution will be treated as a non-cash transaction or as a transaction in which the financial institution is acting as a paying agent for the entity. In this case, the entity would report an investing cash outflow to the supplier and a financing cash inflow from the financial institution upon taking control of the underlying asset and subsequent financing cash outflows when the liability is settled in future periods.

In all cases, determining whether another party is acting as agent for the entity is key to whether the cash flows are presented in the statement of cash flows or whether the transaction is disclosed as a non-cash transaction. In all these situations, the nature of the relationship with the third party will need careful examination to ensure that the entity complies with the requirement in IAS 7 that "investing and financing transactions that do not require the use of cash or cash equivalents are excluded from an entity's statement of cash flows". *[IAS 7.43]*. Factors to consider in making this determination are discussed in section 5.3 above.

8.2 Payments made by the lessee before commencement date

Where a lessee makes a lease payment to the lessor at or before the commencement date, this payment is included in the initial measurement of the right-of-use asset (see Chapter 24 at section 5.2.1). The nature of the activity giving rise to this cash outflow must be considered to determine how it is presented in the statement of cash flows.

For example, if the payment represents all or substantially all of the total lease payments to be made over the lease term, the lessee classifies the cash outflow as an investing activity, being the acquisition of the right of use asset. *[IAS 7.16]*. In contrast, if the payment is only the first of the periodic lease payments that the lessee will make and is financing in nature, being a payment for the reduction of the lease liability, the cash outflow would then be classified as a financing activity. *[IAS 7.17(e)]*.

8.3 Lease incentives

Lease incentives are defined in IFRS 16 as "payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee" and are discussed in Chapter 24 at section 4.5.2. *[IFRS 16 Appendix A]*.

Neither IFRS 16 nor IAS 7 provide specific guidance on the presentation of the cash inflows from lease incentives. It is however clear that IAS 7 considers a lease transaction to be essentially the provision of finance by the lessor to the lessee. *[IAS 7.17(e)]*. IFRS 16 defines lease payments as "Payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term … less any lease incentives". *[IFRS 16 Appendix A]*. Therefore, lease incentives are clearly a reduction of the payments made to the lessor as repayment for the financing provided.

How we see it

Considering this definition of lease payments in the context of IAS 7, in our view, the appropriate presentation of cash flows from lease incentives would be to present the corresponding cash flows as part of financing activities in the statement of cash flows, regardless of whether they are received after the commencement date of the lease and are deducted from the lease liability or before the lease commencement date.

Where lease incentives are received in the same period that lease payments are made, these cash inflows and outflows must, where material, be separately presented and not netted. See section 5.2 above.

8.4 Sale and leaseback transactions

A sale and leaseback transaction involves the transfer of an asset by an entity (the seller-lessee) to another entity (the buyer-lessor) and the leaseback of the same asset by the seller-lessee. Sale and leaseback transactions are discussed in Chapter 24 at section 8.

In terms of presentation in the statement of cash flows, IFRS 16 refers only to leases, requiring the cash payments for the principal portion of the lease liability to be presented in financing activities and cash payments for the interest portion to be presented in in a consistent manner to the presentation other interest paid - see section 8.1 above. *[IFRS 16.50]*. Nothing is included in IFRS 16 or IAS 7 with respect to cash flow presentation in the case of a sale and leaseback transaction.

Presentation of the cash flows relating to the sale and leaseback transaction for a seller-lessee will depend on how the transaction is accounted for under IFRS 16, specifically whether the transfer of the asset is accounted for as a sale of the asset in accordance with the requirements of IFRS 15. *[IFRS 16.99]*.

If the transaction does not satisfy the requirements of IFRS 15 to be accounted for as a sale (i.e., not a sale and leaseback transaction), the cash received is classified in the cash flow statement as a cash inflow from financing activities because the substance of the transaction is that the lessee has raised finance, with the asset provided as security. The resulting financial liability is accounted for under IFRS 9, *[IFRS 16.103]*, and the seller-lessee splits the cash outflows between repayment of the principal and payment of interest. Repayments of the principal are classified as financing cash flows, whereas interest must be presented in a manner consistent with the presentation of other interest paid in statement of cash flows (see section 4.4.1 above). *[IFRS 16.50, IFRS 16.BC211]*.

If the transaction does satisfy the requirements of IFRS 15 to be accounted for as a sale, the analysis is more complex, as the cash received comprises an amount reflecting the fair value of the underlying asset plus the amount of any additional financing provided by the buyer-lessor to the seller-lessee. *[IFRS 16.101]*. This will be reflected in the statements of cash flows by splitting the proceeds between investing cash flows and financing cash flows. However, there are different approaches as to how this split could be determined. From an economic standpoint, the seller-lessee has sold only its interest in the value of the underlying asset at the end of the leaseback - it has retained its right to use the asset for the duration of the leaseback. Therefore, the amount that would be shown as an investing cash inflow must reflect this.

How we see it

In our view there are two acceptable approaches for determining the split between investing cash flows and financing cash flows. One approach is to present the investing cash inflow as the amount of the sale proceeds that reflects the proportion of the fair value of the underlying asset that is not retained by the seller-lessee. Any excess would be presented as part of cash flows from financing activities. This presentation in the statement of cash flows would be consistent with the requirement in IFRS 16 to recognise only the amount of any gain or loss on the sale and leaseback relating to the rights that have been transferred to the buyer-lessor and also to measure the right-of-use asset as a proportion of the previous carrying amount of the underlying asset. Alternatively, the seller-lessee may also present any excess of the sale proceeds over the fair value of the asset as financing cash inflows and the remaining proceeds as investing cash inflows.

This can be seen in Illustration 8-1 below (see also Chapter 24 at section 8.2.4), which uses an example in IFRS 16 as a starting point and further expands on the example to demonstrate the presentation of cash flows in the statement of cash flows. *[IFRS 16.IE Example 24]*.

Illustration 8-1: Sale and leaseback transaction: presentation of cash flows

An entity (Seller-lessee) sells a building to another entity (Buyer-lessor) for cash of CU2,000,000. Immediately before the transaction, the building is carried at a cost of CU1,000,000. At the same time, Seller-lessee enters into a contract with Buyer-lessor for the right to use the building for 18 years, with annual payments of CU120,000 payable at the end of each year. The terms and conditions of the transaction are such that the transfer of the building by Seller-lessee satisfies the requirements for determining when a performance obligation is satisfied in IFRS 15. Accordingly, Seller-lessee and Buyer-lessor account for the transaction as a sale and leaseback. This example ignores any initial direct costs.

The fair value of the building at the date of sale is CU1,800,000. The amount of the excess sale price of CU200,000 (CU2,000,000 - CU1,800,000) is recognised as additional financing provided by the Buyer-lessor to Seller-lessee.

At the commencement date, Seller-lessee measures the right-of-use asset arising from the leaseback of the building at the proportion of the previous carrying amount of the building that relates to the right-of-use retained by Seller-lessee, which is CU699,556. This is calculated as: CU1,000,000 (the carrying amount of the building) ÷ CU1,800,000 (the fair value of the building) × CU1,259,200 (the discounted lease payments for the 18-year right-of-use asset) and represents 70% of the building's carrying amount.

The above example in IFRS 16 does not discuss the presentation of cash flows in the statement of cash flows.

In our view, in its statement of cash flows, the Seller-lessee presents financing cash inflows of CU1,459,200 (being the sum of the lease liability of CU1,259,200 and the additional financing provided by the Buyer-lessor of CU200,000) and the remaining CU540,800 (i.e., CU2,000,000 - CU1,459,200) as investing cash inflows.

An alternative approach in this example, could be to treat only the excess of any sale proceeds above the fair value of the underlying asset of CU200,000 (i.e., CU2,000,000 - CU1,800,000) as financing cash flows with CU1,800,000 presented within investing activities.

8.5 Accounting as lessor

For lessors, IFRS 16 is silent on the presentation of cash flows arising from their leasing activities. However, since lessor accounting under IFRS 16 is substantially unchanged from the accounting under the predecessor standard, IAS 17 *Leases*, in practice, the presentation of cash flows for lessors should be established and well understood. In summary, the cash inflows from operating leases will form part of the cash flows from operating activities. *[IAS 7.14]*. The cash inflows from finance leases will follow the treatment set out in section 7.2 above in relation to assets disposed of on deferred terms.

9 Additional IAS 7 considerations for groups

IAS 7 does not distinguish between single entities and groups, and there are no specific requirements as to how an entity prepares a consolidated statement of cash flows. In the absence of specific requirements, cash inflows and outflows would be treated in the same way as income and expenses under IFRS 10 *Consolidated Financial Statements*. Applying these principles, the statement of cash flows presented in consolidated financial statements will reflect only the flows of cash and cash equivalents into and out of the group, i.e., consolidated cash flows are presented as those of a single economic entity. *[IFRS 10 Appendix A]*. On the same basis, the cash flows of a consolidated subsidiary must be included in the consolidated statement of cash flows for the same period as its results are reported in the consolidated statement of comprehensive income, i.e., from the date the group gains control until the date it loses control. *[IFRS 10.B88]*.

Cash flows that are internal to the group (such as payments and receipts for intra-group sales, management charges, dividends, interest and financing arrangements) must be eliminated. *[IFRS 10.B86]*. However, transactions with non-controlling interests as well as with associates, joint ventures and unconsolidated subsidiaries would not be eliminated and are discussed in greater detail below.

9.1 Preparing a consolidated statement of cash flows

In principle, the group statement of cash flows will be compiled from those prepared by individual subsidiaries with intra-group cash flows being eliminated as part of the aggregation process. This would generally be the case for entities presenting operating cash flows under the direct method, where information on gross cash receipts and payments has been obtained from each group entity's accounting records.

In practice, however, it may be possible to prepare a statement of cash flows at a more consolidated level, by starting with the disclosures in the consolidated statement of comprehensive income and statement of financial position and then applying the adjustments reflected as part of the financial statement consolidation process, together with information provided on external cash flows by individual subsidiaries. Thus, an entity adopting the direct method could use this information to derive the value of the major classes of gross cash receipts and gross cash payments. *[IAS 7.19]*. An entity presenting operating cash flows under the indirect method would use this information to calculate the values for movements in inventories, operating receivables and payables and other non-cash items that appear in the reconciliation of consolidated profit or loss to the group's cash flow from operating activities. *[IAS 7.20]*. As noted in section 6.3 above, groups with foreign subsidiaries will need to take extra care when using this method to ensure exchange differences are treated appropriately.

Cash flows from investing and financing activities could similarly be derived from a reconciliation of the relevant headings in the consolidated statement of comprehensive income to statement of financial position movements. However, for this to be possible, subsidiaries would have to provide supplementary information (as part of internal group reporting) to prevent gross cash flows from being netted off and to ensure that the cash flows are shown under the correct classifications. In particular, detailed information about receivables and payables would be essential to ensure that the movements in operating, investing and financing receivables and payables are identified.

9.2 Transactions with non-controlling interests

Dividends paid to non-controlling interest holders in subsidiaries are included under cash flows from financing activities or operating activities, in accordance with the entity's determined policy for dividends paid (see section 4.4.1 above).

IFRS 10 requires entities to distinguish between transactions that give rise to a change in control and those that do not, because a transaction when there is no change in control is effectively one with the owners in their capacity as owners. *[IFRS 10.BCZ168]*. Changes in ownership interests in a subsidiary that do not result in a loss of control are therefore accounted for as equity transactions, and the resulting cash flows are classified in the same way as other transactions with owners. *[IAS 7.42B]*. Accordingly, IAS 7 requires cash flows arising from changes in ownership interests in a subsidiary that occur after control is obtained, but do not give rise to a loss of control to be classified as cash flows from financing activities. *[IAS 7.42A]*.

9.3 Acquisitions and disposals

Extract from IAS 7	
39	The aggregate cash flows arising from obtaining or losing control of subsidiaries or other businesses shall be presented separately and classified as investing activities.
40	An entity shall disclose, in aggregate, in respect of both obtaining and losing control of subsidiaries or other businesses during the period each of the following: (a) the total consideration paid or received; (b) the portion of the consideration consisting of cash and cash equivalents; (c) the amount of cash and cash equivalents in the subsidiaries or other businesses over which control is obtained or lost; and (d) the amount of the assets and liabilities other than cash or cash equivalents in the subsidiaries or other businesses over which control is obtained or lost, summarised by each major category.
40A	...
41	The separate presentation of the cash flow effects of obtaining or losing control of subsidiaries or other businesses as single line items, together with the separate disclosure of the amounts of assets and liabilities acquired or disposed of, helps to distinguish those cash flows from the cash flows arising from the other operating, investing and financing activities. The cash flow effects of losing control are not deducted from those of obtaining control.

[IAS 7.39, IAS 7.40, IAS 7.41].

Cash flows arising from changes in ownership interests in a subsidiary that do not result in a loss of control are classified as financing cash flows (see section 9.2 above). *[IAS 7.42A]*.

The aggregate amount of cash paid or received as consideration is reported in the statement of cash flows net of cash and cash equivalents acquired or disposed of. *[IAS 7.42]*. The cash flow effects of losing control are not deducted from those of gaining control. *[IAS 7.41]*. This implies that entities must present one analysis for all acquisitions and another for all disposals, such as that presented by Naspers Limited, shown in Practical example 9-1 below.

Practical example 9-1: Naspers Limited (2023) **South Africa**

Annual financial statements [extract]

Consolidated statement of cash flows [extract]

Cash flows from investing activities [extract]

	Notes	31 March 2023 US$'m	31 March 2022 US$'m
...			
Acquisitions of subsidiaries and businesses, net of cash	12	**(18)**	(1 896)
Disposals of subsidiaries and businesses, net of cash	13	**2 055**	20
...			

Notes to the consolidated annual financial statements [extract]

12. Acquisitions of subsidiaries and businesses

	31 March 2023 US$'m	31 March 2022 US$'m
Fair value of assets and liabilities:		
Property, plant and equipment	**-**	16
Investments and loans	**-**	-
Other intangible assets	**5**	309
Net current (liability)/assets	**5**	90
Deferred taxation	**-**	(81)
Long-term liabilities	**(2)**	(10)
Total fair value of assets and liabilities	**8**	324
Non-controlling interests	**-**	(16)
Goodwill recognised	**11**	1 692
Purchase consideration	**19**	2 000
Net cash in subsidiaries and businesses acquired	**(1)**	(104)
Net cash outflow from acquisitions of subsidiaries and businesses	**18**	1 896

13. Disposals of subsidiaries and businesses

	31 March 2023 US$'m	31 March 2022 US$'m
Carrying values of assets and liabilities:		
Property, plant and equipment	**-**	2
Disposal groups classified as held for sale	**2 011**	-
Goodwill	**10**	8
Other intangible assets	**2**	16
Net current assets/(liabilities)	**1**	7
Deferred taxation	**-**	(4)
Long-term liabilities	**-**	(1)
Foreign currency translation reserve on equity	**(202)**	1
	1 822	29
Gain on disposal - net	**24**	21
Gain on disposal shown as part of discontinued operations	**568**	-
Selling price	**2 414**	50
Net cash in subsidiaries and businesses disposed of	**(340)**	(15)
Shares received as settlement	**(21)**	(33)
Amounts relating to prior year disposal	**2**	22
Amounts to be received in the future	**-**	(4)
Net cash inflow from disposals of subsidiaries and businesses	**2 055**	20

9.3.1 Acquisition-related costs

IFRS 3 *Business Combinations* requires acquisition-related costs (other than those costs relating to the issue of equity or debt securities) to be recognised as an expense in the period in which the costs are incurred and the services are received. *[IFRS 3.53]*. As discussed in section 4.2 above, the definition of investing activities in IAS 7, states that "only expenditures that result in a recognised asset in the statement of financial position" give rise to investing cash flows. *[IAS 7.16]*. As a result, cash flows relating to acquisition costs recognised as an expense must be classified within operating activities.

9.3.2 Deferred and other non-cash consideration

Not all acquisitions or disposals of businesses are satisfied in full by the exchange of cash. Any non-cash consideration, such as shares issued by either party or amounts to be paid or received by the entity at a later date, is not included in the amount presented under investing activities. *[IAS 7.43]*. Instead, the non-cash element of the acquisition or disposal is disclosed. As explained in more detail in section 7.1 above, the purchase of assets on deferred terms can be a complicated area because it may not be clear whether to classify the associated cash flows within investing activities or within financing activities, as the repayment of borrowings. Hence, judgement is required when determining the appropriate classification of the deferred payment in the statement of cash flows. These same principles apply on the acquisition of a business involving deferred consideration.

9.3.3 Contingent consideration paid on business combinations

When a business combination agreement allows for adjustments to the cost of the combination that are contingent on one or more future events, IFRS 3 requires the acquirer to recognise the acquisition-date fair value of the contingent consideration, *[IFRS 3.39]*, and classify an obligation to pay the contingent consideration as a liability or as equity in accordance with the provisions of IAS 32. *[IFRS 3.40]*. Changes resulting from events after the acquisition date, such as meeting a performance target, are not reflected by adjusting the recorded cost of the business combination. Where a liability has been recognised for the contingent consideration payable, any subsequent payment in excess of or below the carrying amount of the liability is recognised in profit or loss. *[IFRS 3.58]*.

The primary principle for the classification of cash flows is the nature of the activity giving rise to the cash flow, according to the definitions of operating, investing and financing activities in the standard. This might imply that all payments relating to a business combination must be classified as investing cash flows. However, as discussed in section 4.2 above, the Board added a requirement in IAS 7 that only expenditures that result in a recognised asset are eligible for classification as investing activities. *[IAS 7.16]*.

How we see it

In our view, cash payments up to the amount recognised for the acquisition-date fair value of the contingent consideration (and thereby included in the carrying value of the acquired assets including goodwill) would be classified in investing activities. Since contingent consideration generally arises for reasons other than the provision of finance to the acquirer, any resulting payments would generally not seem to be eligible for classification as financing cash flows. As a result, any contingent consideration in excess of the amount that was recorded on the acquisition date, would need to be presented as operating cash flows by default.

9.3.4 Contingent consideration conditional on continuing employment

As discussed in Chapter 10 at section 11.2, a transaction that remunerates employees or former owners of the acquiree for future services is excluded from the business combination accounting and accounted for separately. *[IFRS 3.52]*. Therefore, cash flows relating to payment of purchase consideration that is conditional on the continuing employment of the vendors in the business or the existing employees of the business must be classified within operating activities and not within investing activities. This faithfully reflects the fact that these payments are not part of the consideration transferred on a business combination but are remuneration for post-combination services received. *[IFRS 3.B55(a)]*.

9.3.5 Contingent consideration received on disposals

When an entity disposes of a subsidiary, it presents the cash flows separately within investing activities. This will be the case even for the receipt of contingent consideration because the cash inflow is still an investing cash flow being the receipt from the sale of equity or debt instruments of another entity (see section 4.2 above). *[IAS 7.16]*.

9.3.6 Settlement of amounts owed by the acquired entity

A question that sometimes arises is how to treat a payment made by the acquirer, in the consolidated statement of cash flows, to settle amounts owed by a newly acquired subsidiary. If the repayment is made before the acquisition date, the acquiree is not yet part of the group controlled by the acquirer and the debt will not be included in the consolidated balance sheet. Therefore, any payment to settle that debt represents a payment made to acquire the debt instrument of another entity and this would be included under investing activities. *[IAS 7.16]*.

If the repayment is made at or after the acquisition date, it may be more challenging to determine whether the cash outflow should be presented as investing or financing. The repayment may be negotiated with the vendor as a condition of the acquisition agreement or may be triggered by a pre-existing change of control clause in the agreement between the acquired entity and the lender. Alternatively, the payment may be made after the acquisition date and not negotiated and agreed as part of the business combination.

IAS 7 defines investing activities as "the acquisition and disposal of long-term assets and other investments not included in cash equivalents" and financing activities as "activities that result in changes in the size and composition of the contributed equity and borrowings of the entity". *[IAS 7.6]*. As discussed in Section 4 above, the primary principle for classification of cash flows should be in accordance with the nature of the activity in a manner that is most appropriate to the business of the entity. *[IAS 7.11]*. Therefore, depending on the facts and circumstances associated with repayment, the cash outflow may represent either an investing activity or a financing activity in the consolidated cash flow statement of the acquirer.

How we see it

Judgement will be needed, based on consideration of all the specific facts and circumstances associated with the payment, to determine whether the cash outflow is one that is investing in nature or financing in nature.

In our view, in determining the nature of activities associated with the cash outflow, it is important to consider who is requiring or directing the repayment. If the acquirer is directing the movement of the cash because it has made a choice to repay the external borrowings, perhaps because it wants the acquired entity to be debt free or wishes to arrange financing with its own lenders, then it is more likely that the transaction will be financing in nature. However, if the acquirer is forced to repay the borrowings, for example by a pre-existing change of control clause that the external lender has chosen to exercise, then the payment has been triggered by the business combination and is more likely to be investing in nature.

It should be noted that the inclusion of a clause in the acquisition agreement requiring the repayment of the loan by the acquirer is not, in itself, justification for presenting the cash outflow as investing. Although this could be viewed as providing the acquirer with no discretion as to whether it makes the repayment, the acquirer would have been able to influence the content of the acquisition agreement and hence, may have had some choice as to whether this clause was included. In this case, other factors would need to be considered before a conclusion is reached that the cash flow is investing in nature.

Clear disclosure of the presentation treatment adopted in the statement of cash flows will be important, in particular, disclosure of the facts considered, and the judgements management has made in determining the nature of the cash flow, in accordance with paragraphs 117 and 122 of IAS 1 (see Chapter 3 at section 5.1.1.A).

Other factors that may provide supporting evidence as to the nature of the repayment include:

- ***How close is the timing of the repayment to the date of the acquisition and what is the reason for any difference in timing?***

  The longer the period of time elapsed between the acquisition date and the date of repayment, the more likely it is that the payment is financing in nature. However, it will also be necessary to consider the reason for any significant delay. For example, if the timing of the payment is out of the control of the acquirer, such as where this is dictated by the bank through a change of control clause, a difference in timing may not always be indicative of the payment being financing in nature.

- ***Why is the payment being made by the acquirer directly to the lender rather to the vendor or the acquiree who will then repay the borrowings? Is it for the convenience of the vendor or for the convenience of the acquirer?***

  If the arrangement has been established purely for the convenience of the acquirer so that they do not need to transfer the cash to the acquiree to repay the borrowings after acquisition, then this suggests that this is part of the financing activities of the group. However, if the vendor has requested that this amount negotiated as part of the acquisition cost be paid directly by the acquirer to the bank, rather than to the vendor who will then repay the borrowings, it is more likely that the cash outflow is investing in nature.

If it is determined that the cash outflow is financing in nature, being the repayment of the borrowings of the acquired entity which is now part of the group, using funds provided by the parent, this is presented as a cash outflow from financing activities in the consolidated statement of cash flows. *[IAS 7.17]*.

If it is determined that the cash outflow is investing in nature because it is part of the payment to acquire control of the acquired entity, then it is presented as an investing cash outflow. Care should be taken when considering whether the payment is part of the consideration for the business combination under IFRS 3 as the payment is not made to the vendor. This is because IFRS 3 paragraph 51 explains that amounts that are not part of what the acquirer and vendor exchanged in the business combination, i.e., amounts that are not part of the exchange for the acquiree, must be accounted for as separate transactions (see Chapter 10 at section 11).

9.3.7 Settlement of intra-group balances on a demerger

A similarly fine distinction might apply on the demerger of subsidiaries. These sometimes involve the repayment of intra-group indebtedness out of the proceeds from external finance raised by the demerged subsidiary. If the external funding is raised immediately prior to the subsidiary leaving the group, it is strictly a financing inflow in the consolidated statement of cash flows, being cash proceeds from issuing short or long-term borrowings. *[IAS 7.17]*. If the subsidiary both raises the external funding and repays the intra-group debt after the demerger, the inflow is shown in the consolidated statement of cash flows under investing activities, being a cash receipt from the repayment of advances and loans made to other parties. *[IAS 7.16]*.

9.3.8 Acquisition of a business that is not a subsidiary

A business combination may be enacted through the acquisition of a subsidiary (i.e., a business held in a separate legal entity) or through the acquisition of a group of assets and liabilities that constitute a business (sometimes referred to as 'a purchase of net assets and trade'). Paragraphs 39 and 40 of IAS 7 refer to "obtaining or losing control of subsidiaries or other businesses" and hence are applicable to both types of business combination.

Therefore, the cash flows arising on the acquisition and disposal of a group of assets and liabilities that constitute a business would be classified as investing activities. In addition, the considerations set out in sections 9.3.1 to 9.3.7 above in respect of deferred and contingent consideration, acquisition costs and settlement of amounts must also be applied. The disclosure requirements in IAS 7.40 would also be required.

9.4 Cash flows of associates, joint arrangements and investment entities

9.4.1 Investments in associates and joint ventures

Changes in cash and cash equivalents relating to associates or joint ventures accounted for under the equity or cost method will be reflected in the entity's statement of cash flows only to the extent of the cash flows between the group and the investee. *[IAS 7.37]*. The same concept would apply to associates or joint ventures carried at fair value as allowed by IAS 28 *Investments in Associates and Joint Ventures* (discussed in Chapter 12). Examples include cash dividends received and loans advanced or repaid. *[IAS 7.37]*. Cash flows in respect of an entity's investment in an equity accounted associate or joint venture would also be presented. *[IAS 7.38]*.

Cash dividends received from equity accounted associates and joint ventures would be classified as operating or investing activities in accordance with the entity's determined policy for other dividends received (see section 4.4.1 above). Loans advanced or repaid would be classified as investing activities. *[IAS 7.16]*. Where the net cash inflow from operating activities is determined using the indirect method, the group's share of profits or losses from equity-accounted investments will appear as a non-cash reconciling item in the cash flow statement (see section 4.1.2 above).

The cash flows arising on the acquisition and disposal of an associate or a joint venture would be classified as investing activities. In addition, the considerations set out in section 9.3 above in respect of deferred and contingent consideration on acquisition and disposal of a subsidiary must also be applied when determining the appropriate classifications of cash flows relating to the acquisition and disposal of associates and joint ventures.

9.4.2 Cash flows of joint operations

IAS 7 does not specifically deal with the treatment of the cash flows of joint operations. However, following the principles in IFRS 11 *Joint Arrangements* that all transactions shall be reflected in the accounts of the joint operator's financial results to the extent of its interests in those transactions, *[IFRS 11.20]*, the cash flows of the joint arrangement are already included in the operator's financial statements and no additional adjustments are required to reflect the activities of the joint operation.

The treatment of cash flows for the acquisition and disposal of a joint operation is less clear as there is an argument for presentation either as a single net cash flow in investing activities (as is required for the cost of a business combination, discussed in section 9.3 above); or as separate cash flows, classified according to the nature of the underlying assets and liabilities acquired. IFRS 11 requires an entity to determine whether the activity undertaken by a joint operation constitutes a business as defined in IFRS 3 and to apply business combination or asset acquisition accounting in accordance with that analysis. *[IFRS 11.21A]*.

How we see it

In our view, an entity presents the cash flows for the acquisition and disposal of a joint operation consistently with the treatment of the joint operation as either a business or a group of assets and liabilities as required by IFRS 11.21A. Therefore, acquisitions and disposals of operations meeting the definition of a business would give rise to a single investing cash flow, and acquisitions and disposals of operations not regarded as a business would give rise to cash flows presented according to the nature of the assets and liabilities acquired or disposed.

9.4.3 Cash flows in investment entities

IFRS 10 includes an exception to the consolidation principle for a parent that meets the definition of an investment entity. An investment entity measures its investments in subsidiaries, other than those solely providing services that relate to its investment activities, at fair value through profit or loss in accordance with IFRS 9 instead of consolidating those subsidiaries. The investment entity exception is discussed in Chapter 7 at section 10. IAS 7 does not specifically address the treatment of cash flows related to subsidiaries held at fair value in an investment entity. However, as discussed in section 4.1 above, the nature of the business conducted by the parent will be a relevant factor in determining the appropriate classification of these cash flows as operating, investing or financing. An investment entity has a business purpose to invest solely for capital appreciation, investment income, or both. *[IFRS 10.B85B]*. Therefore, investing in subsidiaries is part of the main revenue-generating activity of the parent and so any related cash flows are classified as operating activities.

The disclosures required by an investment entity on the acquisition of subsidiaries are less than those required for other entities. Investment entities need only disclose the total consideration paid or received and the portion of the consideration consisting of cash and cash equivalents. *[IAS 7.40, IAS 7.40A]*.

9.5 Cash flows in separate financial statements

9.5.1 Cash flows of subsidiaries, associates and joint ventures

IAS 7 addresses the treatment of cash flows of associates, joint ventures and subsidiaries accounted for by use of the cost method, restricting its reporting in the statement of cash flows to the cash flows between investor and the investee, for example, to dividends and advances as discussed in section 9.4.1 above. *[IAS 7.37]*. This treatment would also be applied to associates, joint ventures and subsidiaries either held at fair value through profit or loss or accounted using the equity method in the separate financial statements, as allowed by IAS 27 *Separate Financial Statements* and discussed in Chapter 9 at section 2.

As noted in section 4.1 above, the nature of the business conducted by the entity will be a relevant factor in determining the appropriate classification of cash flow as operating, investing or financing, having regard to the definitions of operating, investing and financing activities in paragraph 6 of IAS 7. This principle applies to the presentation of cash payments and receipts between a parent and its subsidiaries, associates and joint ventures in the cash flow statement which forms part of the separate financial statements of the parent. For example, where a parent provides a loan to a subsidiary, an associate or a joint venture, it will be necessary to consider whether the cash outflow (and the subsequent cash inflow when the loan is repaid) is presented as part of operating activities or investing activities in the separate financial statements of the parent. *[IAS 7.13, IAS 7.16]*. Conversely, where a subsidiary, an associate or a joint venture provides a loan to the parent, this is much more clearly part of financing activities of the parent. *[IAS 7.17]*. See sections 4.1 to 4.3 above for details of the definitions of operating, investing and financing activities in IAS 7.

9.5.2 Group cash pooling and cash sharing arrangements

Many groups use some form of cash pooling or cash sharing arrangement to manage the group's cash position on a consolidated basis, effectively concentrating the group's cash in one place. Such arrangements seek to maximise the return for the group as a whole on its cash, minimise the cost of funding and give visibility to the group of its combined cash and currency position.

The terms and conditions of such arrangements vary, and it is important to understand the specific nature of the pooling or sharing arrangement in place, in order to determine the appropriate accounting treatment.

In sections 9.5.3 and 9.5.4 below we discuss three of the most common types of arrangements.

9.5.3 Group treasury arrangements

Some groups adopt treasury arrangements under which cash resources are held centrally, either by the parent company or by a designated subsidiary company. Any excess cash is transferred to the central bank account which is in the name of the designated 'treasury entity'. In some cases, each individual group company might not even have its own bank account, with all receipts and payments being made directly from the centrally controlled funds.

Each individual group company will need to consider how to present the funds transferred to the treasury entity at the period end; as cash, as cash equivalents or as a short-term intercompany receivable, by examining the specific facts and circumstances of each arrangement with reference to the definitions of cash and of cash equivalents as discussed in sections 3.1 and 3.2 above.

In order to meet the definition of cash, the individual company must be able to withdraw the funds from the treasury entity on demand without prior notice being required and without penalty. To meet the definition of cash equivalents, the funds must be held by the individual company for the purpose of meeting short-term cash commitments and be a short-term highly liquid investment that is readily convertible into known amounts of cash and subject to insignificant risk of changes in value. *[IAS 7.6, IAS 7.7]*.

In relation to the definitions of both cash and cash equivalents, one important factor to consider is the liquidity of the treasury entity holding the cash on behalf of the group companies and of the group as a whole. Clearly, if the treasury entity is limited in its ability to "release" cash to other group companies due to liquidity constraints, it will be difficult to justify that the other group companies have a balance that is available for withdrawal on demand (as in the definition of cash) or "highly liquid" (as required by the definition of cash equivalents). *[IAS 7.6]*.

When looking at the definition of cash equivalents (see section 3.2 above), the funds deposited also need to be subject to an insignificant risk of change in value. *[IAS 7.7]*. As explained in section 3.2.2 above, this means that the entity must conclude that the range of possible returns is very small. Therefore, the use of the funds by the treasury entity (e.g., the nature and diversification of the investments made by the treasury entity) as well as the credit risk of the treasury entity and the group as a whole, will be important facts to consider.

A further question arises as to whether the subsidiary must prepare a statement of cash flows if there is no cash or cash equivalents balance held at each period end and, in some cases, at any time during the year.

How we see it

In our view, the preparation of the statement of cash flows will be based upon the actual cash flows during the period regardless of cash and cash equivalents balance held directly by the entity. Where no cash flows through an entity, but rather all transactions flow through the group treasury function acting on behalf of the entity, the entity would still record receipts from debtors and payments to suppliers, albeit with an associated deposit to or withdrawal from a balance with another group company. Just as a bank processes payments and receipts as agent for the account holder, so the group treasury function is acting as agent for the entity, and these transactions will be reflected in a statement of cash flows.

For guidance to assist in the determination of whether another entity is acting on behalf of the reporting entity, as the entity's agent, see section 5.3 above.

Where the subsidiary makes net deposits of funds to, or net withdrawals of funds from the designated group entity during the reporting period, a further question arises as to how to present these movements in the subsidiary's statement of cash flows. As explained above, these transactions normally give rise to intercompany balances. Therefore, the deposits or withdrawals must be evaluated against the definitions of the categories of cash flows and presented as either operating activities or alternatively as investing or financing activities, as appropriate. Further consideration may be made as to whether these cash flows meet the criteria for net presentation as discussed in section 5.2 above.

9.5.4 Cash pooling

Groups often use what are commonly known as cash pooling arrangements. Typically, these will involve a number of subsidiaries within a group each having a legally separate bank account with the same bank, but these accounts are managed, with the agreement of the bank, on a consolidated basis. For example, interest will normally be determined on a notional basis using the net balance of all accounts; similarly, any overdraft limit will normally apply to the net balance. Typical characteristics of notional cash pooling and physical cash pooling are discussed below however arrangements vary. Therefore, terms and conditions of each arrangement must be reviewed carefully to ensure that the accounting treatment adopted is appropriate for that specific arrangement.

9.5.4.A Notional cash pooling

Notional cash pooling arrangements allow the group to net off the balances of different accounts across jurisdictions, without physically moving the cash to a header or master account, but with each individual entity continuing to have access to the cash it has deposited in its individual account, sometimes called a 'memo' or 'mirror' account. This is, in essence, an interest rate adjustment, and the ownership of the cash does not change.

In such cases, therefore, each entity will continue to report its cash as 'cash and cash equivalents'.

9.5.4.B Physical cash pooling

Typically, in these arrangements, which are also known as zero balancing, cash concentration or physical cash sweeping, the group physically sweeps excess cash out of the individual bank accounts to a 'header account' on a daily basis. In these arrangements, the ownership of the cash changes: the relationship moves from a deposit with a third-party bank to a loan to the group entity that is the holder of the 'header account'. As in the group treasury arrangements discussed in section 9.5.3 above, the individual companies will need to consider whether to present these balances at the period end as cash, as cash equivalents or as a short-term intercompany receivable.

The presentation of cash balances in cash pooling arrangements in the group accounts, in particular whether the individual balances must be presented net or gross, is discussed in Chapter 50 at section 7.4.1.E.

10 Additional IAS 7 considerations for financial institutions

IAS 7 applies to banks, insurance entities and other financial institutions. Nevertheless, there are some differences in its application as compared to entities that are not financial institutions. For example, in considering the components of cash and cash equivalents, banks would not usually have borrowings with the characteristics of an overdraft, and cash for their purposes would normally include cash and balances at central banks, together with loans and advances to other banks repayable on demand. NatWest Group plc discloses such items as components of its cash and cash equivalents, as shown in Practical example 10-1 below.

Practical example 10-1: NatWest Group plc (2023) **United Kingdom**

Annual Report and Accounts 2023 [extract]

Financial statements [extract]

Notes to the consolidated financial statements [extract]

30 Analysis of cash and cash equivalents

Non-cash and other add back items and movements in operating assets and liabilities are adjusted for in the cash flow statement. Loans to banks and treasury bills with an original maturity of less than three months that are readily convertible to known amounts of cash and subject to insignificant risk of change in value.

	2023 £m	2022 £m	2021 £m
Cash and balances at central banks	104,262	144,832	177,757
Trading assets	8,851	8,551	7,137
Other financial assets	139	19	16
Loans to banks (1)	5,572	5,047	5,796
Cash and cash equivalents	118,824	158,449	190,706

(1) Includes cash collateral posted with bank counterparties in respect of derivative liabilities of £4,434 million (2022 - £4,895 million; 2021 - £4,293 million).

...

IAS 7 contains a number of additional provisions affecting the preparation of statements of cash flow by financial institutions. These are covered in broad outline below.

10.1 Operating cash flows

Cash advances and loans made by financial institutions are usually classified as operating activities (and not as investing activities, as they are for other entities) since they relate to a financial institution's main revenue-producing activity. *[IAS 7.15, IAS 7.16(e)]*. Similarly, receipts from the repayment of loans and advances would be included in operating cash flows. *[IAS 7.16(f)]*.

Interest paid and interest and dividends received are usually classified as operating cash flows for a financial institution. *[IAS 7.33]*.

For an insurance entity, cash receipts and cash payments for premiums and claims, annuities and other policy benefits would be included in its operating cash flows as these relate to the principal activities of the entity.

Under the direct method of reporting operating cash flows, a financial institution that does not obtain information from its accounting records can derive the disclosures for major classes of gross cash receipts and payments by adjusting interest and similar income and interest expense and similar charges and other items recognised in profit or loss for:

(a) Changes during the period in operating receivables and payables

(b) Other non-cash items

And

(c) Other items for which the cash effects are investing or financing cash flows *[IAS 7.19]*

Subject to the differences noted above, the principles for a financial institution presenting operating cash flows under the indirect method are the same as those discussed in section 4.1.2 above for other entities.

10.2 Reporting cash flows on a net basis

Cash flows from each of the following activities of a financial institution may be reported on a net basis:

(a) Cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date

(b) The placement of deposits with and withdrawal of deposits from other financial institutions

And

(c) Cash advances and loans made to customers and the repayment of those advances and loans *[IAS 7.24]*

11 Disclosures

IAS 7 contains a number of specific disclosure requirements to supplement the information that is presented in the statement of cash flows. These are explained below.

In addition, disclosure may be needed to explain the judgements management has made during the preparation of the statement of cash flows, especially where the appropriate classification of an item is not clear from IAS 7. IAS 1 requires disclosure of the judgements that management has made that have the most significant effect on the amounts recognised in the financial statements, *[IAS 1.122]*, as well as any information that is relevant to an understanding of any of the entity's financial statements. *[IAS 1.112]*.

11.1 Disclosure of cash and cash equivalents

IAS 7 paragraphs 45 to 48 include requirements for specific disclosures relating to the composition of cash and cash equivalents. These cover:

- The components of cash and cash equivalents and a reconciliation to the amounts in the statement of financial position (see section 11.1.1 below)
- The policy adopted in determining the composition of cash and cash equivalents (see section 11.1.2 below)
- Details of any change in the policy for determining components of cash and cash equivalents (see section 11.1.3 below)
- The amount of significant cash and cash equivalent balances held by the entity that are not available for use by the group (see section 11.1.4 below).

11.1.1 The components of cash and cash equivalents and reconciliation with items in the statement of financial position

Cash and cash equivalents is one of the required line items that must be presented on the face of the statement of financial position. *[IAS 1.54]*.

However, items forming part of cash and cash equivalents for IAS 7 purposes may not all be shown as a single line item in the statement of financial position. Therefore, disclosure is required to reconcile the line items in the statement of financial position to the amount of cash and cash equivalents in the statement of cash flows: *[IAS 32.42, IAS 7.45]*

Extract from IAS 7

45	**An entity shall disclose the components of cash and cash equivalents and shall present a reconciliation of the amounts in its statement of cash flows with the equivalent items reported in the statement of financial position.**

For example, as discussed in section 3.2.4 above, there are circumstances in which bank overdrafts repayable on demand are included as a component of cash and cash equivalents. In the statement of financial position, the bank overdrafts will be presented as financial liabilities, separate from cash, unless a legal right of set off exists. Therefore, a reconciliation will be needed.

Keller Group plc provides such a reconciliation below:

Practical example 11-1: Keller Group plc (2023) — **United Kingdom**

Annual Report and Accounts 2023 [extract]
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21 Cash and cash equivalents

	2023 £m	2022 £m
Bank balances	**105.2**	97.0
Short-term deposits	**46.2**	4.1
Cash and cash equivalents in the balance sheet	**151.4**	101.1
Bank overdrafts	**(2.4)**	(6.9)
Cash and cash equivalents in the cash flow statement	**149.0**	94.2

Cash and cash equivalents include £4.4m (2022: £8.5m) of the Group's share of cash and cash equivalents held by joint operations, and £1.1m (2022: £1.4m) of restricted cash which is subject to local country restrictions as it is held as collateral in support of bank guarantees.

11.1.2 The composition of cash and cash equivalents

The standard requires disclosure of the policy an entity adopts in determining the composition of cash and cash equivalents. *[IAS 7.46]*. Where an entity has applied judgement in interpreting the definitions of cash and cash equivalents (see sections 3.1 and 3.2 above) these judgements must be disclosed.

An example of this disclosure is given in Example C in the Illustrative Examples accompanying IAS 7. *[IAS 7.IE Example C]*.

If an entity changes the purpose for which it holds certain investments, for example a deposit which was previously held for short term cash management is now held to generate an investment return, this would be a change in facts and circumstances, which must be accounted for prospectively.

Similarly, where an entity that previously included its bank overdraft as part of cash and cash equivalents (see section 3.2.4 above) determines that the overdraft no longer forms an integral part of its cash management practices, this must be accounted for prospectively and the overdraft would be reclassified out of cash and cash equivalents and shown as a reconciling item in the cash flow statement. The requirement to present a reconciliation of the amounts in the statement of cash flows is discussed in section 11.1.1 above.

11.1.3 Details of any change in the policy for determining components of cash and cash equivalents

If an entity changes its policy for determining components of cash and cash equivalents the effect of the change is reported in accordance with IAS 8. *[IAS 7.47]*.

11.1.4 The amount of significant cash and cash equivalent balances held by the entity that are not available for use by the group

It is possible for a subsidiary of a group to have amounts held in a bank account that meet the definition of cash in respect of the subsidiary but for which use is restricted within the wider group. In these circumstances, IAS 7 requires disclosure of the amount of significant cash and cash equivalent balances held by an entity that are not available for use by the group, together with a commentary by management to explain the circumstances of the restriction. *[IAS 7.48]*.

Examples include cash and cash equivalents held by a subsidiary operating under exchange controls or other legal restrictions that prevent their general use by the parent or other subsidiaries. *[IAS 7.49]*.

In addition, there may be other circumstances that restrict how cash and cash equivalents can be used by an entity. However, IAS 7 does not contain any specific disclosure requirements in respect of such restrictions. In Exposure Draft ED/2014/6 - *Disclosure Initiative - Proposed amendments to IAS 7*, issued in December 2014, the IASB noted that additional restrictions, such as financial disincentives to utilising certain cash balances, or other considerations may also be relevant to understanding the liquidity of the entity, as they affect the decision to utilise cash and cash equivalents. The example was given of tax liabilities that would arise on the repatriation of foreign cash and cash equivalent balances. The Exposure Draft proposed that where such matters exist, they would need to be disclosed. Although the IASB did not finalise these proposals, disclosure of restrictions must be considered in the context of the liquidity disclosures required by IFRS 7 and more generally, whenever it is material to an understanding of the entity's financial statements. *[IAS 1.112]*.

IFRS 12 *Disclosure of Interests in Other Entities* also contains disclosure requirements in consolidated financial statements of the nature and extent of significant restrictions on the group's ability to access or use assets, and settle liabilities, of its subsidiaries. These disclosures, which are discussed in Chapter 14 at section 4.3, are likely to be relevant for restricted cash and cash equivalent balances held by subsidiaries.

11.2 Changes in liabilities arising from financing activities

Extract from IAS 7	
44A	**An entity shall provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes.**

[IAS 7.44A].

Liabilities arising from financing activities are liabilities for which cash flows were, or future cash flows will be, classified in the statement of cash flows as cash flows from financing activities (see section 4.3 above). In addition, the disclosure requirement also applies to changes in financial assets (such as assets that hedge liabilities arising from financing activities) if cash flows from those financial assets were, or future cash flows will be, included in cash flows from financing activities. *[IAS 7.44C]*.

The following changes are required to be disclosed to explain the movements in these instruments:

(a) Changes from financing cash flows

(b) Changes arising from obtaining or losing control of subsidiaries or other businesses

(c) The effect of changes in foreign exchange rates

(d) Changes in fair values

And

(e) Other changes *[IAS 7.44B]*

The standard suggests that these disclosures could be presented in the form of a reconciliation of the opening and closing balances in the statement of financial position for liabilities arising from financing activities. Where such a reconciliation is presented, sufficient information must be provided to enable items included in the reconciliation to be linked to the statement of financial position and the statement of cash flows. *[IAS 7.44D]*. If an entity provides the disclosure required by IAS 7.44A in combination with disclosures of changes in other assets and liabilities, it must disclose the changes in liabilities arising from financing activities separately from changes in those other assets and liabilities. *[IAS 7.44E]*.

The IFRS IC discussed these requirements further in June 2019.[21] In providing the disclosures required by IAS 7.44A, the IFRS IC noted that the requirements of IAS 1 on aggregation and disaggregation would apply (see Chapter 3 at section 4.1.5). Therefore, an entity must disclose any individually material liability (or asset) and any material reconciling item (i.e., cash or non-cash changes) separately in the reconciliation. An entity must also consider whether additional explanation is needed in order to enable users of financial statements to evaluate changes in liabilities arising from financing activities. The disclosures must be structured and disaggregated appropriately to ensure that they:

- Provide information about the entity's sources of finance
- Enable investors to check their understanding of the entity's cash flows
- Enable investors to link items to the statement of financial position and the statement of cash flows, or related notes

Illustration 11-1 below illustrates how an entity might satisfy the requirement to reconcile liabilities arising from financing activities. The cash flows shown in the example should reconcile to the net of the financing cash inflows and outflows in the statement of cash flows.

Illustration 11-1: Reconciliation of liabilities arising from financing activities

	20X1	Cash flows	Non-cash changes			20X2
			Acquisition	New leases	Exchange differences	
	CU	CU	CU	CU	CU	CU
Bank loans	1,040	250	200	-	25	1,515
Lease liabilities	-	(90)	-	900	10	820
Financing liabilities	1,040	160	200	900	35	2,335

21 *IFRIC Update*, June 2019, available on the IFRS Foundation's website.

In Practical example 11-2 below, Inspired PLC also presents the disclosure in a tabular format, but with the categories of liabilities across the top of the table.

Practical example 11-2: Inspired PLC (2023) **United Kingdom**

Annual Report & Accounts 2023 [extract]
Financial Statements [extract]
Notes to the Group financial statements [extract]
21. Bank borrowings [extract]

...

	Long-term borrowings £000	Lease liabilities £000	Total £000
...			
At 31 December 2022	49,479	1,420	50,899
Cash flows			
Drawdown	7,850	–	7,850
Interest paid	(3,668)	(90)	(3,758)
Repayment	–	(1,013)	(1,013)
Non-cash			
Additions to right of use assets	–	1,846	1,846
Interest rate swap revaluation	(17)	–	(17)
Interest charge	3,668	90	3,758
Debt issue costs releases	229	–	229
At 31 December 2023	**57,541**	**2,253**	**59,794**

11.3 Other specific disclosure requirements

IAS 7 contains a number of other specific disclosure requirements which have been discussed in sections 4 to 10 above. These are:

The total amount of interest paid during the period, whether it has been recognised as an expense or capitalised as part of the cost of an asset. *[IAS 7.32]*. See section 4.4.1 above.

- Disclosures in respect of obtaining and losing control of subsidiaries or other businesses during the period. *[IAS 7.40]*. See section 9.3 above.
- Disclosure of non-cash transaction. *[IAS 7.43]*. See section 7 above.

11.4 Supplier finance arrangements

In May 2023, the IASB published *Supplier Finance Arrangements - Amendments to IAS 7 and IFRS 7* to require an entity to provide additional disclosures about its supplier finance arrangements. The amendments are effective for annual reporting periods beginning on or after 1 January 2024.

The disclosure requirements in the amendments are intended to enable users of financial statements to assess the effects of supplier finance arrangements on an entity's liabilities, cash flows and exposure to liquidity risk. *[IAS 7.44F]*. The disclosures aim to enable users to understand how the entity might be affected if the arrangements were no longer available to it *[IAS 7.BC29(b)]*. The disclosure requirements in the amendments do not apply to an entity's arrangements that finance receivables or inventory. Also, an entity is not required to identify other actions its suppliers might have taken to finance their receivables (for example, factoring of receivables) *[IAS 7.BC32(c)]*. The scope of the disclosure requirements is discussed in section 11.4.1 below.

The amendments clarify the characteristics of supplier finance arrangements.

Extract from IAS 7

44G **Supplier finance arrangements are characterised by one or more finance providers offering to pay amounts an entity owes its suppliers and the entity agreeing to pay according to the terms and conditions of the arrangements at the same date as, or a date later than, suppliers are paid. These arrangements provide the entity with extended payment terms, or the entity's suppliers with early payment terms, compared to the related invoice payment due date. Supplier finance arrangements are often referred to as supply chain finance, payables finance or reverse factoring arrangements. Arrangements that are solely credit enhancements for the entity (for example, financial guarantees including letters of credit used as guarantees) or instruments used by the entity to settle directly with a supplier the amounts owed (for example, credit cards) are not supplier finance arrangements.**

[IAS 7.44G].

The amendments introduce a number of specific disclosure requirements, covering the terms and conditions of the arrangements, information about the carrying amounts associated with the arrangements and details of the non-cash changes in the carrying amounts. *[IAS 7.44H]*.

Extract from IAS 7

44H To meet the objectives in paragraph 44F, an entity shall disclose in aggregate for its supplier finance arrangements:

(a) the terms and conditions of the arrangements (for example, extended payment terms and security or guarantees provided). However, an entity shall disclose separately the terms and conditions of arrangements that have dissimilar terms and conditions.

(b) as at the beginning and end of the reporting period:

(i) the carrying amounts, and associated line items presented in the entity's statement of financial position, of the financial liabilities that are part of a supplier finance arrangement.

(ii) the carrying amounts, and associated line items, of the financial liabilities disclosed under (i) for which suppliers have already received payment from the finance providers.

(iii) the range of payment due dates (for example, 30-40 days after the invoice date) for both the financial liabilities disclosed under (i) and comparable trade payables that are not part of a supplier finance arrangement. Comparable trade payables are, for example, trade payables of the entity within the same line of business or jurisdiction as the financial liabilities disclosed under (i). If ranges of payment due dates are wide, an entity shall disclose explanatory information about those ranges or disclose additional ranges (for example, stratified ranges).

(c) the type and effect of non-cash changes in the carrying amounts of the financial liabilities disclosed under (b)(i). Examples of non-cash changes include the effect of business combinations, exchange differences or other transactions that do not require the use of cash or cash equivalents (see paragraph 43)

The amendments require an entity to aggregate information about its supplier finance arrangements. This is because, in most cases, aggregated information about an entity's supplier finance arrangements will satisfy the information needs of users of financial statements. *[IAS 7.BC36]*. However, an entity must disaggregate information about unusual or unique terms and conditions of individual arrangements when they are dissimilar. *[IAS 7.44H]*. Explanatory information about payment due dates, when those payment due date ranges are wide, must also be disaggregated. In considering whether, and if so, how to aggregate (or disaggregate) this information, the IASB noted that paragraphs 29 -31 of IAS 1 are relevant when making this assessment. *[IAS 7.BC38]*. Accordingly, an entity must ensure it provides an appropriate level of disaggregation of information to avoid obscuring material information. The requirements of IAS 1 in respect of materiality and aggregation are discussed in Chapter 3 at section 4.1.5.

Each of the required disclosures is discussed in turn from section 11.4.2 below.

11.4.1 Scope of the disclosure requirements

Paragraph 44G of IAS 7 explains that supplier finance arrangements are characterised by one or more finance providers offering to pay amounts an entity owes its suppliers and the entity agreeing to pay according to the terms and conditions of the arrangements at the same date as, or a date later than, suppliers are paid. *[IAS 7.44G]*. While this paragraph clarifies the characteristics of supplier finance arrangements, it does not define which arrangements are within the scope of the disclosure requirements. Therefore, determining which arrangements are in the scope may require judgement.

For example, when a purchasing entity is aware that a supplier is factoring its debtors to a third party, and consequently, the entity settles the outstanding balance with the third party directly, would the purchasing entity need to provide the disclosures required by paragraph 44H even if they had not been party to that agreement?

The wording of paragraph 44F of IAS 7 requires an entity to "disclose information about **its** supplier finance arrangements" (emphasis added) which could be read to imply that this only includes arrangements that the entity itself is party to, and not arrangements between other parties.

However, paragraph 44F also explains that the disclosures are to enable users of financial statements to assess the effects of those arrangements on the entity's liabilities and cash flows and on the entity's exposure to liquidity risk which could be interpreted as being wider in scope, possibly covering arrangements that the entity isn't party to but that could impact its liquidity risk. *[IAS 7.44F]*.

In the Basis for Conclusions to the amendments, it is noted that in developing the requirements, the IASB considered various types of supplier finance arrangements and noted that an entity might enter into arrangements with varying structures and for various reasons. *[IAS 7.BC31]*. IAS 7.44G defines the arrangements within the scope of the disclosures as being those that provide the entity with extended payment terms, or the entity's suppliers with early payment terms, compared to the related invoice payment due date. Paragraph BC32(c) explains that the scope of the requirements is confined to arrangements that finance "amounts an entity owes its suppliers" and that an entity is not required to identify other actions its suppliers might have taken to finance their receivables (for example, factoring of receivables). *[IAS 7.BC32]*.

As a result, judgement may be required in order to determine whether certain arrangements are within the scope of the requirements of IAS 7.44F to 44H.

How we see it

Identifying whether an arrangement is within the scope of the new requirements may involve significant judgement in some circumstances and disclosure of this judgement would be required under IAS 1.122. Care must be taken to assess all relevant facts and circumstances before concluding. It will be relevant to consider the purpose and design of the arrangement with the third-party finance provider, including indicators such as who initiated the scheme, whether it is available to all customers as part of the supplier's standard terms and conditions or only to the entity and what benefits, if any, the entity obtains from it.

This assessment should be performed having regard to the disclosure objective of paragraph 44F which is to "provide information that enables users of financial statements to assess the effects of those arrangements on the entity's liabilities and cash flows and on the entity's exposure to liquidity risk." and how the entity might be affected if the arrangements were no longer available to it.

Illustration 11.2 below explains how the requirements might be applied to certain scenarios.

However, it should be noted that IAS 1.17(c) requires entities to provide additional information to achieve fair presentation and IAS 1.112(c) requires notes to provide additional information if it is relevant to the understanding of the financial statements (see Chapter 3 at section 3.4 and section 4.1.1.A). Therefore, even if a reporting entity concludes that an arrangement does not contain all the characteristics identified in paragraph 44G of IAS 7, it must still carefully consider the extent to which disclosure of the information specified in paragraphs 44H is relevant to an understanding of its financial statements.

Illustration 11-2: Scope of supplier finance arrangements disclosures

An entity purchases goods from a supplier at a cost of CU100. Normal industry terms for the purchase would be 3 months payment terms. As a result of the supplier entering into and maintaining a factoring arrangement with a third party, the entity is required to settle the debt directly with the third party and is required to provide certain information (for example half-year reports and annual financial statements) which would allow the third party to assess the credit risk attached to the entity in order to appropriately tailor the terms of the arrangement.

Question

Is the purchasing entity ('the entity') required to provide the supplier finance arrangement disclosures, as envisaged in IAS 7.44F and 44G, in each of the three scenarios below?

Scenario 1 - Entity is aware that the supplier is factoring its debtors

The entity is aware that the supplier is factoring its debtors to a third party, and consequently, the entity will be required to settle the outstanding balance with the third party directly. The entity is required to settle the invoice of CU100 within the normal industry terms of 3 months.

Scenario 2 - Entity obtains payment terms of 6 months by virtue of the supplier's arrangement

The entity is aware that the supplier is factoring its debtors to a third party, and consequently, the entity will be required to settle the outstanding balance with the third party directly. The entity obtains payment terms of 6 months by virtue of the supplier's arrangement with the third party. The invoiced amount is CU105 to compensate for finance charges.

Scenario 3 - Entity can opt for the extended terms

The purchase agreement between the entity and its supplier includes different payment term options and related costs. At the inception of each purchase, the supplier informs the entity about the possibility of receiving an extension of the due date (from 3 months to 6 months), should the supplier still have the financing facilities available to it through its pre-arranged factoring agreement with the third-party finance provider. If the entity opts for the extended terms, the supplier will issue an invoice for CU105 and 6 month payment terms. If the entity does not opt in, the supplier issues an invoice for CU100 and 3 month payment terms.

Analysis

Scenario 1

How we see it

In the absence of any other relevant facts or contractual conditions, we believe, it would be appropriate for the entity to conclude that the entity is not required to provide supply chain financing disclosure as it is not a party to the arrangement and indeed does not benefit from the arrangement. This is purely an arrangement of the supplier with a third party to factor the supplier's debtors. As noted in section 11.4.1 above, in the Basis for Conclusions paragraph BC32(c) explains that the scope of the requirements is confined to arrangements that finance "amounts an entity owes its suppliers" and that an entity is not required to identify other actions its suppliers might have taken to finance their receivables (for example, factoring of receivables). The disclosure objective in IAS 7.44F refers to information to enable users of financial statements to assess the effects of those arrangements on the entity's liabilities and cash flows and on the entity's exposure to liquidity risk. This arrangement has had no impact on the entity's liabilities, cash flows or exposure to credit or liquidity risk. This example provides limited facts; entities need to look at all aspects of the arrangement to reach a conclusion.

Scenario 2

In this scenario, care must be taken to assess all relevant facts and circumstances before concluding. It will be relevant to consider the purpose and design of the arrangement with the third-party finance provider, including indicators such as who initiated the scheme and whether it is available to all customers as part of the supplier's standard terms and conditions or only to the entity. This assessment should be performed having regard to the disclosure objective of paragraph 44F which is to "provide information that enables users of financial statements to assess the effects of those arrangements on the entity's liabilities and cash flows and on the entity's exposure to liquidity risk."

How we see it

In the absence of any other relevant facts or contractual conditions, we believe, it would be consistent with the disclosure objective in paragraph 44F to consider that such arrangement is part of the entity's supplier finance arrangements. This is because, the entity is allowed to pay an amount greater than the invoice amount, at a date later than the related invoice date. This example provides limited facts; entities need to look at all aspects of the arrangement to reach a conclusion.

Scenario 3

In this scenario, care must be taken to assess all relevant facts and circumstances before concluding. It will be relevant to also consider the purpose and design of the arrangement with the third-party finance provider, including indicators such as who initiated the scheme and whether it is available to all customers as part of the supplier's standard terms and conditions or only to the entity. This assessment should be performed having regard to the disclosure objective of paragraph 44F which is to "provide information that enables users of financial statements to assess the effects of those arrangements on the entity's liabilities and cash flows and on the entity's exposure to liquidity risk."

How we see it

In our view, in the absence of any other relevant facts or contractual conditions, we believe that it would be consistent with the disclosure objective in paragraph 44F to consider that such arrangement is part of the entity's supplier finance arrangements. This is because, the optional extended payment terms and related costs offered by the supplier are explicitly linked to the financing facilities available to the supplier through its pre-arranged factoring agreement with the third-party finance provider. If the entity chooses to utilise the extended payment terms, the entity becomes party to an arrangement in which the supplier is paid (by the finance provider) at an earlier date, than the date the entity settles its payment obligation towards the finance provider. Paragraph 44F explains that the disclosures are to enable users of financial statements to assess the effects of supplier finance arrangements on the entity's liabilities and cash flows and on the entity's exposure to liquidity risk. If the arrangement between the supplier and finance provider was to cease to exist, the purchasing entity's liquidity would be affected. This example provides limited facts; entities need to look at all aspects of the arrangement to reach a conclusion.

11.4.2 Disclosure of the terms and conditions of the arrangements

This disclosure is to inform users of the financial statements that such arrangements are in place and to explain their nature. As noted above, an entity must disaggregate information about terms and conditions of significant individual arrangements when they are dissimilar. This may include the extended payment terms, security or guarantees provided, and any other terms and conditions relevant to meeting the disclosure objective of enabling users of the financial statements to assess the impact on the entity's liabilities, cash flows and liquidity risk. *[IAS 7.44F, IAS 7.44H(a)]*.

11.4.3 Disclosure of carrying amounts

The amendments require an entity to provide quantitative information about the carrying amount of supplier finance arrangement financial liabilities and the line items in the statement of financial position in which those liabilities are presented. This will include separate disclosure of the amount of the liabilities where the supplier has already taken payment from the third part finance provider. *[IAS 7.44H(b)(i), IAS 7.44H(b)(ii)]*. This information is required as at the beginning and end of each reporting period. *[IAS 7.44H(b)]*. See section 11.4.6 below for discussion of transitional reliefs that apply in the first year of application.

Illustration 11-3 below, which is not part of the amendments but is based on the example in the IASB's "Investor Perspectives: Supplier finance - New disclosure requirements to aid investors" document,[22] shows one possible way of how a company might satisfy the requirements of IAS 7.44H(b)(i)and (ii):

Illustration 11-3: Carrying amount of liabilities that are part of supplier finance arrangements

Carrying amount of liabilities	20X2	20X1
	CU	CU
Presented within trade and other payables	**1,500**	**1,000**
Of which suppliers have received payment	1,000	800
Presented within finance payables	**1,000**	**750**
Of which suppliers have received payment	900	650

22 *Investors Perspectives - Supplier finance: new disclosure requirements to aid investors*, May 2023, available on the IFRS Foundation's website.

11.4.4 Disclosure of the range of payment due dates

An entity is required to disclose the range of payment due dates (for example, 30 to 40 days after the invoice date) for payables within the supplier finance arrangements and for comparable trade payables. The standard includes an example of what is meant by "comparable trade payables", which would be trade payables with the same line of business or jurisdiction, but which have not been included in any supply finance agreements. When those payment due date ranges are wide, explanatory information about payment due dates, or additional ranges, must be provided. *[IAS 7.44H(b)(iii)]*. This information is required as at the beginning and end of each reporting period. *[IAS 7.44H(b)]*. See section 11.4.6 below for discussion of transitional reliefs that apply in the first year of application.

Illustration 11-3 below, which is not part of the amendments but is based on the example in the IASB's "Investor Perspectives: Supplier finance - New disclosure requirements to aid investors" document,[23] shows one possible way of how a company might satisfy the requirements of IAS 7.44H(b)(iii):

Illustration 11-4: Range of payment due dates

Range (days) of payment due dates	20X2	20X1
Liabilities that are part of the arrangement	85-90 days after invoice date	80-90 days after invoice date
Comparable trade payables that are not part of an arrangement	60-70 days after invoice date	60-65 days after invoice date

11.4.5 Disclosure of the type and effect of non-cash changes

The amendments require disclosure of the type and effect of non-cash changes in the carrying amounts of the financial liabilities that are part of a supplier finance arrangement. These non-cash changes include the effect of business combinations, exchange differences or other transactions that do not require the use of cash or cash equivalents. *[IAS 7.44H(c)]*. Disclosure of this information enables users of financial statements to assess the carrying amounts of financial liabilities on a more comparable basis from one reporting period to the next and to understand how these non-cash changes affect the entity's cash flows. *[IAS 7.BC37]*.

See section 4.4.6 above for discussion of the presentation of cash flows arising from supplier finance arrangements, including consideration of when cash payments made on behalf of the reporting entity should be reflected in the entity's cash flow statement.

11.4.6 Effective date and transitional arrangements

The amendments are effective for annual reporting periods beginning on or after 1 January 2024. *[IAS 7.62]*. The amendments contain some transitional reliefs from disclosures in the first year of application, meaning that in the annual reporting period in which the amendments are first applied comparative information is not required.

In addition, no disclosures are required in the first year of application of the opening amounts for payables for which the suppliers have already received payment from finance providers or for the range of payment due dates. *[IAS 7.63]*. However, the requirement to provide quantitative information about the carrying amount of supplier finance arrangement financial liabilities and the line items in the statement of financial position in which those liabilities are presented (see section 11.4.2 above) is not subject to this transitional relief. As a result, this information will need to be disclosed at the beginning of that first period as well as at the end, meaning that an entity will need to ensure that it has collected the necessary information to enable it to provide these disclosures. For example, an entity with a 31 December reporting date will be required to apply the amendments for the first time in the annual reporting period ending 31 December 2024. The disclosure of supplier finance arrangement financial liabilities and the line items in the statement of financial position in which those liabilities are presented will be required as at 1 January 2024 and at 31 December 2024. *[IAS 7.44H(b)(i)]*.

23 *Investors Perspectives - Supplier finance: new disclosure requirements to aid investors*, May 2023, available on the IFRS Foundation's website.

The amendments clarify that entities are not required to provide disclosures according to the new requirements in any interim reporting period during the first annual reporting period in which the amendments apply. *[IAS 7.63]*.

11.5 Voluntary disclosures

IAS 7 sets out a number of disclosures which are encouraged but which are not mandatory. *[IAS 7.50]*.

Extract from IAS 7

50 Additional information may be relevant to users in understanding the financial position and liquidity of an entity. Disclosure of this information, together with a commentary by management, is encouraged and may include:

(a) the amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities;

(b) [deleted]

(c) the aggregate amount of cash flows that represent increases in operating capacity separately from those cash flows that are required to maintain operating capacity; and

(d) the amount of the cash flows arising from the operating, investing and financing activities of each reportable segment (see IFRS 8 *Operating Segments*).

Although these disclosures are only encouraged in IAS 7, disclosure of the amount of undrawn borrowing facilities that may be available must be considered in the context of the liquidity disclosures required by IFRS 7 and more generally, whenever it is material to an understanding of the entity's financial statements. *[IAS 1.112]*. (See Chapter 3 at section 5.1).

11.5.1 Cash flows to increase and maintain operating capacity

IAS 7 does not contain any guidance as to how to distinguish cash flows for expansion from cash flows for maintenance in relation to the voluntary disclosure referred to under (c) above. The standard merely states that this information is useful in helping the user to determine whether the entity is investing adequately in the maintenance of its operating capacity or whether it may be sacrificing future profitability for the sake of current liquidity and distributions to owners. *[IAS 7.51]*.

Hongkong Land Holdings Limited distinguishes renovations expenditure from developments capital expenditure in its analysis of investing cash flows.

Practical example 11-3: Hongkong Land Holdings Limited (2023) **Bermuda**

Annual Report 2023 [extract]
Financial Statements [extract]
Consolidated Cash Flow Statement [extract]

	Note	2023 US$m	2022 US$m
...			
Investing activities			
Major renovations expenditure		**(85.3)**	(94.6)
Repayments from associates and joint ventures	*20 (a)*	**1,183.3**	435.3
Investments in associates and joint ventures	*20 (a)*	**(401.4)**	(254.3)
Advances to associates and joint ventures	*20 (a)*	**(434.3)**	(798.6)
Disposal of subsidiaries		**29.3**	–
Disposal of joint ventures		**8.5**	–
Acquisition of subsidiaries		**(30.9)**	(14.5)
Cash flows from investing activities		**269.2**	(726.7)
...			

11.5.2 Segment cash flow disclosures

Disclosure of segmental cash flows is encouraged because it reveals the availability and variability of cash flows in each segment and allows users to understand the relationship between the cash flows of the business as a whole and those of its component parts. *[IAS 7.52]*. However, it should be noted that IFRS 8 *Operating Segments* does not require any segmental cash flow disclosures. See Chapter 32 for guidance on IFRS 8.

IAS 7 is accompanied by an example of the segmental disclosure. *[IAS 7.IE Example A part D]*. However, this example simply reports the operating, investing and financing cash flows of its two segments with no reconciliation of the total to the statement of cash flows. In practice, it might be difficult to allocate financing cash flows across the entity's reportable segments, given that this may not be how treasury functions tend to operate.

A.P. Møller - Mærsk A/S provided an analysis of operating cash flows and capital expenditure (part of its investing cash flows) by reportable segment. The entity did not disclose financing cash flows by reportable segment (comparative information is provided in the financial statements but is not reproduced here).

Practical example 11-4: A.P. Møller - Mærsk A/S (2017) **Denmark**

2017 Annual Report [extract]
Financials [extract]
Consolidated financial statements 2017 [extract]
Notes 1 Segment information [extract]

	Maersk Line*	APM Terminals	Damco	Svitzer	Maersk Container Industry	Total reportable segments
...						
Cash flow from operating activities	2,389	827	-101	179	75	3,369
Cash flow used for capital expenditure	-6,142	-672	-4	-96	-20	-6,934
Free cash flow	**-3,753**	**155**	**-105**	**83**	**55**	**-3,565**
...						

12 Requirements of other standards

12.1 Cash flows of discontinued operations

IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* requires an entity to disclose information on the net cash flows of discontinued operations. *[IFRS 5.33]*.

Extract from IFRS 5

33 An entity shall disclose:

(a) ...

(c) the net cash flows attributable to the operating, investing and financing activities of discontinued operations. These disclosures may be presented either in the notes or in the financial statements. These disclosures are not required for disposal groups that are newly acquired subsidiaries that meet the criteria to be classified as held for sale on acquisition (see paragraph 11).

(d) ...

These disclosures can be presented either on the face of the statement of cash flows or in the notes. Disclosure is not required for disposal groups that are newly acquired subsidiaries which are classified as held for sale on acquisition in accordance with IFRS 5. *[IFRS 5.33(c)]*. The general presentation requirements of IFRS 5 are dealt with in Chapter 5.

IFRS 5 does not amend the requirements of IAS 7.10 to present cash flows classified by activity - see section 4 above. Cash flows from discontinued operations must be analysed amongst each of the three categories. However, the disclosures required by IFRS 5 can be provided in different ways, since IFRS 5 permits presentation on the face of the statement of cash flows or in the notes.

In the Practical example below, Netcare Limited elected to show the cash flows of discontinued operations on the face of the statement of cash flows. In the notes to the financial statements, Netcare Limited further analyses these cash flows by separate major business line.

Practical example 12-1: Netcare Limited (2012) **South Africa**

2012 ANNUAL INTEGRATED REPORT [extract]

Financials [extract]

Annual financial statements [extract]

GROUP STATEMENT OF CASH FLOWS

for the year ended 30 September

Rm	Notes	2012	2011
Cash flows from operating activities			
Cash received from customers		**25 401**	23 645
Cash paid to suppliers and employees		**(20 208)**	(18 073)
Cash generated from operations	A	**5 193**	5 572
Interest paid		**(1 976)**	(1 836)
Continuing operations		**(1 959)**	(1 817)
Discontinued operations		**(17)**	(19)
Taxation paid	B	**(740)**	(674)
Continuing operations		**(720)**	(658)
Discontinued operations		**(20)**	(16)
Capital reductions paid			(83)
Ordinary dividends paid		**(694)**	(553)
Ordinary dividends paid by subsidiaries		**(4)**	(3)
Preference dividends paid		**(46)**	(47)
Distributions to beneficiaries of the HPFL trusts		**(43)**	(47)
Net cash from operating activities		**1 690**	2 329
Continuing operations		**1 646**	2 285
Discontinued operations		**44**	44
Cash flows from investing activities			
Purchase of property, plant and equipment		**(1 365)**	(1 327)
Continuing operations		**(1 354)**	(1 316)
Discontinued operations		**(11)**	(11)
Proceeds on disposal of property, plant and equipment		**52**	415
Additions to intangible assets		**(30)**	(81)
Increase in investments and loans		**(522)**	(250)
Interest received		**162**	115
Increase in equity interest in subsidiaries		**(32)**	(11)
Proceeds from disposal of businesses	C	**309**	
Net cash from investing activities		**(1 426)**	(1 139)
Continuing operations		**(1 416)**	(1 128)
Discontinued operations		**(10)**	(11)
Cash flows from financing activities			
Proceeds from issue of ordinary shares		**105**	74
Disposal of treasury shares		**129**	123
Equity premium on repurchase of convertible bonds			(10)
Long-term debt raised		**565**	477
Short-term debt repaid		**(503)**	(1 544)
Net cash from financing activities		**296**	(880)
Continuing operations		**296**	(869)
Discontinued operations			(11)
Net increase in cash and cash equivalents		**560**	310
Translation effects on cash and cash equivalents of foreign entities		**131**	210
Cash and cash equivalents at beginning of year		**1 805**	1 285
Cash and cash equivalents of businesses disposed	C	**(27)**	
Cash and cash equivalents at end of year	D	**2 469**	1 805

NOTES TO THE GROUP ANNUAL FINANCIAL STATEMENTS [extract]
12. Discontinued operations and assets held for sale [extract]
12.1 Discontinued operations [extract]

Rm	Care	Transform	Total
2012			
...			
Cash flows from operating activities	**17**	**27**	**44**
Cash flows from investing activities	**(3)**	**(7)**	**(10)**
...			
2011			
...			
Cash flows from operating activities	39	5	44
Cash flows from investing activities	(3)	(8)	(11)
Cash flows from financing activities	(14)	3	(11)
...			

In contrast, Pennon Group plc presents the information required by IFRS 5 in the notes to the financial statements with no analysis of continuing and discontinued operations on the face of the statement of cash flows.

Practical example 12-2: Pennon Group plc (2020) **United Kingdom**

Annual Report & Accounts 2020 [extract]
Financial statements [extract]
Notes to the financial statements [extract]
46. Discontinued operations and non-current assets held for sale [extract]
...
The tables below show the results of the discontinued operations which are included in the Group income statement and cash flow statement for the year ended 31 March 2020, together with the classes of assets and liabilities comprising the operations held for sale in the Group balance sheet as at 31 March 2019.
...

	2020 £m	2019 £m
Cash flows from operating activities	**149.1**	69.2
Cash flows from investing activities	**(133.0)**	(255.6)
Cash flows from financing activities	**(23.1)**	(73.1)
Net decrease in cash and cash equivalents from discontinued operations, net of inter-company	**(7.0)**	(259.5)

12.2 Cash flows arising from the exploration of mineral resources

IFRS 6 *Exploration for and Evaluation of Mineral Resources* requires that an entity discloses the amounts of operating and investing cash flows arising from the exploration for and evaluation of mineral resources. *[IFRS 6.24(b)]*. The requirements of IFRS 6 are discussed in Chapter 39. The requirement for investing cash flows to give rise to the recognition of an asset, discussed in section 4.2 above, is particularly relevant to entities applying IFRS 6.

12.3 Cash flows arising from interests in subsidiaries, joint ventures and associates

IFRS 12 requires an entity to disclose in its consolidated financial statements summarised financial information about the cash flows for each subsidiary that has non-controlling interests that are material to the entity. *[IFRS 12.B10(b)]*. These amounts are stated before inter-company eliminations. *[IFRS 12.B11]*.

For each material joint venture and associate, an entity is also required to disclose dividends received from the joint venture or associate *[IFRS 12.B12(a)]* and, for joint ventures, the amount of cash and cash equivalents. *[IFRS 12.B13(a)]*. In addition, the standard requires disclosure of any significant restrictions on the ability of joint ventures or associates to transfer funds to the entity in the form of cash dividends, or to repay loans or advances made by the entity. *[IFRS 12.22(a)]*. IFRS 12 is discussed in Chapter 14.

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Appendix B - Defined terms

Extract from IAS 7

6 The following terms are used in this Standard with the meanings specified:

Cash comprises cash on hand and demand deposits.

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Cash flows are inflows and outflows of cash and cash equivalents.

Operating activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

Chapter 37 Interim financial reporting

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Overview

This chapter addresses the requirements of IAS 34 *Interim Financial Reporting*. Practical examples and Illustrations are used to demonstrate the presentation and disclosure requirements in IAS 34. In addition, the chapter also provides guidance on the overall recognition and measurement principles in interim financial reports.

IAS 34 prescribes the minimum content of an interim financial report and the principles for recognition and measurement in complete or condensed financial statements for an interim period. IAS 34 does not require an entity to prepare an interim financial report, rather, IAS 34 applies if an entity elects or is required to publish an interim financial report in accordance with IFRS accounting standards.

What you need to know

- IAS 34 provides guidance on the form and content of interim financial statements.
- IAS 34 specifies the periods, including comparative information, for which interim financial reports must be presented.
- The overall principle on measurement, in IAS 34, is based on a year-to-date approach. IAS 34 includes guidance on the application of year-to-date approach on specific areas such as pensions.
- IAS 34 requires significant transactions and events and other information to be disclosed in interim financial statements.
- While entities are generally familiar with its requirements, application of IAS 34 continues to be challenging for entities especially considering difficulties related to the distinction between a discrete and an integral approach.

1 Introduction

One of the major issues in interim financial reporting is whether the interim period is a discrete period, or whether an interim period is an instalment of the full year. Under the first approach, an entity uses the same accounting policies and principles for annual financial statements as for interim periods. Under the second approach, the purpose of the interim report is to give investors, analysts and other users a guide to the expected outcome for the full year, which requires modifications to the policies and principles used in annual financial reporting. The former approach is generally referred to as the 'discrete' approach, and the latter as the 'integral' approach.

The integral approach is not defined but implies deferring or accruing items of income or expense in order to present measures of performance for that interim period that are more indicative of the expected outcome for the year as a whole. Critics say that this approach obscures the results of the interim period. Proponents say that such modifications prevent distortion; an interim period is a more artificial interval than a financial year, and that to report transactions outside of the context of the annual operating cycle for which they are incurred could potentially present a misleading picture.

In practice, the distinction between discrete and integral approaches is less clear-cut than the description above suggests. IAS 34 requires an entity to use a 'year-to-date' approach, *[IAS 34.28]*, which is largely based on the requirement to report the entity's financial position as at the interim reporting date, but for which certain estimates and measurements are based on the expected financial position of the entity at year-end. However, the standard does not allow such estimates and measurements to amount to the 'smoothing' of results (shifting revenue and expenses between different reporting periods in order to present the impression that a business has steady earnings). For example, the estimate of tax expense for an interim period is based on actual profits earned as at the interim reporting date and not the expected tax expense for the year divided by the number of interim reporting periods, as discussed in section 9.5 below.

The extent of disclosures in interim reports raises similar questions as to the purpose. If interim reporting is simply a more frequently published version of annual reporting, then the form and content of the interim report must be the same. However, if interim reporting is only an instalment of a longer period, then a reporting package that highlights changes in circumstances during an interim period makes more sense than an update of all the disclosures in an entity's annual financial statements. IAS 34 allows an entity to include either a complete set of financial statements or a condensed version in the interim report. *[IAS 34.4]*. While some companies present a full set of financial statements in their interim reports, predominant practice under IFRS accounting standards is to present the condensed version. The differences between full and condensed interim financial statements are discussed in section 3 below.

There is no requirement for entities that prepare annual financial statements in conformity with IFRS accounting standards to prepare interim financial statements in accordance with IAS 34. The fact that an entity may not have provided interim financial reports at all or may have provided interim financial reports that do not comply with this standard does not prevent the entity making an explicit and unreserved statement of compliance with IFRS accounting standards in respect of its annual financial statements. *[IAS 34.2]*. Historically, interim reporting was the prerogative of capital markets and regulators and IAS 34 leaves governments, securities regulators, stock exchanges and others to determine which entities are required to report interim information, how often and how soon after the reporting period. *[IAS 34.1]*. Accordingly, adherence to local regulatory or legal requirements in interim financial reports is required.

Nevertheless, governments and regulators often refer to compliance with IAS 34 as part of their own requirements for interim financial reporting.

1.1 Definitions

Extract from IAS 34

Definitions

4 **The following terms are used in this Standard with the meanings specified:**

Interim period is a financial reporting period shorter than a full financial year.

Interim financial report means a financial report containing either a complete set of financial statements (as described in IAS 1 _Presentation of Financial Statements_ (as revised in 2007)) or a set of condensed financial statements (as described in this Standard) for an interim period.

An interim report is distinguishable from an annual report in that the period being reported is shorter than a full financial year. Furthermore, it may also be distinguishable from annual reports in that the financial statements therein are presented on a condensed format, although an entity may choose to apply the same format as applied in a complete set of annual financial statements. *[IAS 34.4]*.

2 Objective and scope of IAS 34

2.1 Objective

Extract from IAS 34

Objective

The objective of this Standard is to prescribe the minimum content of an interim financial report and to prescribe the principles for recognition and measurement in complete or condensed financial statements for an interim period. Timely and reliable interim financial reporting improves the ability of investors, creditors, and others to understand an entity's capacity to generate earnings and cash flows and its financial condition and liquidity.

It is key to note that IAS 34 prescribes minimum requirements in complete or condensed financial statements, but it still requires judgement to be applied in determining the disclosures to be made. See section 4.1 below for discussion on including disclosures that are significant. The objective also places emphasis on reliable information being made available on a timely basis. *[IAS 34 Objective]*.

2.2 Scope

IAS 34 does not prescribe which entities are required to publish interim financial reports, how often, or how soon after the end of an interim period. The standard notes that governments, securities regulators, stock exchanges, and accountancy bodies often require entities whose debt or equity securities are publicly traded to publish interim financial reports. *[IAS 34.1]*. Therefore, in the absence of any specific regulatory requirement (or obligation of the entity, for example, by covenant), entities are not required to publish interim financial information in a form that complies with IAS 34. Instead, IAS 34 only applies if an entity either elects or is required to publish an interim financial report in accordance with IFRS accounting standards. *[IAS 34.1]*. Accordingly, if an entity's interim financial report states that it complies with IFRS accounting standards, then the requirements of IAS 34 must be met in full. *[IAS 34.3]*.

The decision to present interim financial reports in accordance with IFRS accounting standards operates independently of the annual financial statements. Hence, entities may still prepare annual financial statements conforming to IFRS accounting standards even if their interim financial statements do not comply with IAS 34. *[IAS 34.2]*.

Nevertheless, the IASB encourages publicly traded entities to provide interim financial reports that conform to the recognition, measurement and disclosure principles set out in IAS 34. Those entities are specifically encouraged:

(a) To provide interim financial reports at least as of the end of the first half of their financial year.

And

(b) To make their interim financial reports available not later than 60 days after the end of the interim period. *[IAS 34.1]*.

However, an entity can only describe an interim financial report as complying with IFRS accounting standards if it meets all of the requirements of IAS 34. *[IAS 34.3]*. Accordingly, an entity that applies all IFRS accounting standards recognition and measurement requirements in its interim financial report but does not include all the required disclosures in IAS 34, cannot describe the interim financial report as complying with IFRS accounting standards.

As shown in the Practical example below, Bluejay Mining plc has disclosed that although the interim financial statements for the period ended 30 June 2023 are prepared in accordance with IFRS accounting standards as adopted by the United Kingdom, it has not selected to apply IAS 34.

Practical example 2-1: Bluejay Mining plc (Half-year 2023) **United Kingdom**

Interim Results for the six months ended 30 June 2023 [extract]

NOTES TO THE INTERIM FINANCIAL STATEMENTS [extract]

2. Basis of Preparation

The condensed consolidated interim financial statements have been prepared in accordance with the requirements of the AIM Rules for Companies. As permitted, the Company has chosen not to adopt IAS 34 "Interim Financial Statements" in preparing this interim financial information. The condensed consolidated interim financial statements should be read in conjunction with the annual financial statements for the year ended 31 December 2022. The interim financial statements have been prepared in accordance with UK adopted International Accounting Standards.

...

3 Components, form and content of an interim financial report under IAS 34

As explained above, an entity may choose to include a complete or a condensed set of financial statements in an interim financial report. The standard does not prohibit or discourage an entity from:

- Publishing a complete set of financial statements (as described in IAS 1 *Presentation of Financial Statements*) in its interim financial report, rather than condensed financial statements and selected explanatory notes.

  Or

- Including in condensed interim financial statements more than the minimum line items or selected explanatory notes as set out in IAS 34. *[IAS 34.7]*.

The recognition and measurement guidance in the standard, together with the note disclosures required by the standard, apply to both complete and condensed financial statements presented for an interim period. This means that a complete set of financial statements, prepared for an interim period, would include all of the disclosures required by IAS 34 as well as those required by other IFRS accounting standards. *[IAS 34.7]*.

3.1 Complete set of interim financial statements

An entity that publishes a complete set of financial statements in its interim financial report must include the same components that is included in a complete set of financial statements as defined in IAS 1. *[IAS 34.9]*.

Extract from IAS 34

5 IAS 1 defines a complete set of financial statements as including the following components:

(a) a statement of financial position as at the end of the period;

(b) a statement of profit or loss and other comprehensive income for the period;

(c) a statement of changes in equity for the period;

(d) a statement of cash flows for the period;

(e) notes, material accounting policy information and other explanatory information;

(ea) comparative information in respect of the preceding period as specified in paragraphs 38 and 38A of IAS 1; and

(f) a statement of financial position as at the beginning of the preceding period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements in accordance with paragraphs 40A-40D of IAS 1.

An entity may use titles for the statements other than those used in this Standard. For example, an entity may use the title 'statement of comprehensive income' instead of 'statement of profit or loss and other comprehensive income'.

Entities may use alternative titles for the above statements other than those stated above. For example, an entity may use the title 'statement of comprehensive income' instead of 'statement of profit or loss and other comprehensive income'. *[IAS 34.5]*. Also, an entity can refer to the 'statement of financial position' as 'balance sheet'.

If an entity publishes a complete set of financial statements in its interim financial report, the form and content of those statements must conform to the requirements of IAS 1. *[IAS 34.9]*. These requirements are discussed in Chapter 3 at section 3. In addition, the entity must disclose the information specifically required by IAS 34 for interim financial reports as well as those required by other IFRS accounting standards (particularly those discussed in section 4 below). *[IAS 34.7]*.

In respect of paragraph 5(e) above that refers to disclosure of material accounting policies, see Chapter 3 at section 5.1.1 and section 6 below for guidance on application of the Practice Statement 2 - *Making Materiality Judgements* (PS 2) in interim financial statements.

3.2 Condensed interim financial statements

In the interest of timeliness, cost, and avoiding repetition of previously reported information, an entity might be required to or elect to give less information at interim dates as compared with its annual financial statements. The standard defines the minimum content of an interim report, as including condensed financial statements and selected notes. *[IAS 34.6, IAS 34.8, IAS 34.8A]*

Extract from IAS 34

Minimum components of an interim financial report

8 An interim financial report shall include, at a minimum, the following components:

(a) a condensed statement of financial position;

(b) a condensed statement or condensed statements of profit or loss and other comprehensive income;

(c) a condensed statement of changes in equity;

(d) a condensed statement of cash flows; and

(e) selected explanatory notes.

8A If an entity presents items of profit or loss in a separate statement as described in paragraph 10A of IAS 1 (as amended in 2011), it presents interim condensed information from that statement.

IAS 34 requires entities to confirm that the same accounting policies and methods of computation are followed in the interim financial statements as compared to their most recent annual financial statements or, if those policies or methods have changed, to describe the nature and effect of the change (see section 4.2 below). *[IAS 34.16A(a)]*. Accordingly, an entity only departs from the presentation as applied in its most recent annual financial statements if it has determined that the format will change in its next annual financial statements.

The condensed statement of profit or loss and other comprehensive income referred to at (b) above must be presented using the same format as the entity's annual financial statements. Accordingly, if an entity presents a separate statement of profit or loss in its annual financial statements, then it must present a separate statement in the interim financial report as well. Similarly, if a combined statement of profit or loss and other comprehensive income is presented in the annual financial statements, the same format must be adopted in the interim financial report. *[IAS 34.8A]*.

As a minimum, the condensed financial statements must include each of the headings and subtotals that were included in the entity's last annual financial statements. *[IAS 34.10]*. However, the condensed financial statements do not need to look exactly like the year-end financial statements. Whilst IAS 34 requires 'headings and subtotals' to be the same, there is no similar requirement for the 'line items' under those headings referred to in IAS 1. *[IAS 1.54, IAS 1.82]*.

A literal reading could mean that an entity is only required to present non-current assets, current assets, etc. on an interim statement of financial position. However, one of the purposes of an interim report is to help the users of the financial statements to understand the changes in financial position and performance of the entity since the previous annual reporting period. *[IAS 34.15]*. To that end, IAS 34 also requires additional line items or notes to be included if their omission makes the condensed financial statements misleading. *[IAS 34.10]*. In addition, the overriding goal of IAS 34 is to ensure that the interim report includes all information necessary to understand the financial position and the performance during the interim period. *[IAS 34.25]*.

Presenting, in the interim financial statements, most of the line items presented in the annual financial statements has the benefit of providing the most information to help users of the financial statements understand the changes since the previous year-end. Nonetheless, entities may aggregate line items used in the annual financial statements, if doing so does not render the information misleading or prevent users of the financial statements from performing meaningful trend analysis. *[IAS 1.30A]*. In response to a submission relating to the presentation and content of the condensed statement of cash flows, the IFRS IC expressed a view that a three-line condensed statement of cash flows showing only a total for each of operating, investing and financing cash flows would generally not meet the requirements of IAS 34 as set out above.[1]

Consideration must also be given to regulatory requirements, for example, where a regulator requires an entity to present certain line items using some form of materiality criteria (e.g., in terms of amount, percentage relative to headings, or percentage change from prior periods).

How we see it

Selecting an appropriate presentation approach in condensed interim financial statements depends on several factors such as materiality, regulatory requirements, and the overarching objective of IAS 34. Accordingly, in some cases line items in the annual financial statements may be combined into more aggregated line items in the condensed interim financial statements.

However, in our view, aggregating information in a condensed interim statement of financial position to present only non-current assets, current assets, etc. would be inconsistent with the objectives of IAS 34 and judgement is required to determine which line items provide useful information for decision-makers and accordingly, which are presented.

The following Illustration shows one possible way in which an entity might choose to combine line items presented separately in the annual financial statements when preparing a condensed set of interim financial statements. However, such presentation is at the discretion of management, based on facts and circumstances, including materiality (as noted above), regulatory environment, and the overarching goal of IAS 34 to provide relevant information. *[IAS 34.25]*.

1 *IFRIC Update*, March 2014, available on the IFRS Foundation's website.

Illustration 3-1: Presenting the same headings and sub-totals in condensed interim financial statements

Statement of financial position	Annual financial statements	Condensed interim financial statements
Assets		
Non-current assets		
Intangible assets	●	●
Property, plant and equipment	●	●
Right-of-use assets	●	●
Deferred tax assets	●	●
Investments in associates and joint ventures	○	
Equity instruments at FVOCI	○	
Other non-current assets	○	○
Total non-current assets	●	●
Current assets		
Inventories	○	
Trade and other receivables	●	●
Customer contract assets	○	
Current income tax assets	○	
Other current assets	○	○
Cash and cash equivalents	●	●
Total current assets	●	●
Total assets	●	●
Liabilities		
Current liabilities		
Trade and other payables	●	●
Customer contract liabilities	○	
Current income tax liabilities	○	
Borrowings	●	●
Provisions	○	
Other current liabilities	○	○
Total current liabilities	●	●
Non-current liabilities		
Borrowings	●	●
Pension obligations	●	●
Deferred tax liabilities	●	●
Provisions	○	
Other non-current liabilities	○	○
Total non-current liabilities	●	●
Total liabilities	●	●
Equity		
Share capital	●	●
Other reserves	●	●
Retained earnings	●	●
Total equity	●	●

● Presents the same line item in the annual and the interim financial statements

○ Presents line items that have been combined in the interim financial statements

Statement of profit or loss and other comprehensive income	Annual financial statements	Condensed interim financial statements
Revenue from contracts with customers	○	
Rental income	○	
Total revenue	○	○
Cost of sales	●	●
Gross profit	●	●
Selling and distribution expenses	○	
General and administrative costs	○	
Impairment losses on financial assets	○	
Other operating expenses	○	
Total operating expenses	○	○
Operating profit	●	●
Finance costs	●	●
Finance income	●	●
Share of profit of associates and joint ventures	●	●
Profit before tax	●	●
Income tax expense	●	●
Profit for the period	●	●
Other comprehensive income to be reclassified to profit or loss in subsequent periods		
Translation of foreign operations	○	
Net gain on hedge of net investment	○	
Related income tax expense	○	
Net other comprehensive income to be reclassified to profit or loss in subsequent periods	○	○
Other comprehensive income that will not be reclassified subsequently to profit or loss		
Actuarial losses on defined benefit plans	○	
Net gain/loss on equity instruments at FVOCI	○	
Related income tax credit	○	
Net other comprehensive income that will not be reclassified subsequently to profit or loss	○	○
Total other comprehensive income	●	●
Comprehensive income for the period	●	●
● Presents the same line item in the annual and the interim financial statements		
○ Presents line items that have been combined in the interim financial statements		

Statement of cash flows	Annual financial statements	Condensed interim financial statements
Operating activities		
Profit before tax	●	●
Non-cash adjustments:		
Depreciation and amortisation	○	
Gain on disposal of property	○	
Finance cost	○	
Impairment losses on financial assets	○	
Share of net profit of associate	○	
Movements in pensions	○	
Total non-cash adjustments	○	○
Working capital adjustments:		
Trade and other receivables	○	
Inventories	○	
Customer contract assets and liabilities	○	
Trade and other payables	○	
Total working capital adjustments	○	○
Net cash flows generated from operations	●	●
Income taxes paid	●	●
Acquisition expenses paid	●	●
Net cash flows from operating activities	●	●
Investing activities		
Interest received	●	●
Proceeds from sale of property	●	●
Purchases of property	●	●
Purchase of intangible assets	●	●
Proceeds from sale of equity instruments at FVOCI	●	●
Net cash flows from investing activities	●	●
Financing activities		
Proceeds from borrowings	●	●
Repayment of borrowings	●	●
Payment of lease liabilities Interest paid	● ●	● ●
Dividends paid	●	●
Net cash flows from financing activities	●	●
Net increase in cash and cash equivalents	●	●
Net foreign exchange difference	●	●
Cash and cash equivalents at beginning of year	●	●
Cash and cash equivalents at end of year	●	●
● Presents the same line item in the annual and the interim financial statements		
○ Presents line items that have been combined in the interim financial statements		

A statement of changes in equity is not presented in this Illustration.

3.3 Requirements that apply to both complete and condensed interim financial information

The general principles for preparing annual financial statements are equally applicable to condensed interim financial statements. These principles include fair presentation, going concern, the accrual basis of accounting, materiality and aggregation, and offsetting. (See Chapter 3 at section 4.1).

Furthermore, the following requirements apply irrespective of whether an entity provides complete or condensed financial statements for an interim period:

- If applicable, basic and diluted earnings per share must be presented on the face of the statement that presents items of profit or loss for an interim period. *[IAS 34.11]*. If the entity presents items of profit or loss in a separate statement, it must present basic and diluted earnings per share in that statement. *[IAS 34.11A]*.
- If the last annual financial statements were consolidated financial statements, the interim financial report must also be prepared on a consolidated basis, if the entity continues to be a parent in the interim period. *[IAS 34.14]*.

If the entity's last annual financial report included the parent's separate financial statements and consolidated financial statements, IAS 34 neither requires nor prohibits the inclusion of the parent's separate financial statements in the interim financial report. *[IAS 34.14]*.

Although not an explicit requirement under IAS 34, it is relevant and good practice to disclose the date on which the interim financial statements are authorised for issue as it helps the users to understand the context of any disclosure of events after the interim reporting date. *[IAS 10.17]*.

3.4 Management commentary

A management commentary is not required by IAS 34 but is frequently included by entities in their interim financial reports along with the interim financial statements. In most cases, the requirement for a narrative review comes from local stock market regulations and the entities must, therefore, follow the relevant guidance issued by those regulators.

IAS 34 allows information required under the standard to be presented outside the interim financial statements, i.e., in other parts of interim financial report (such as a management commentary or risk report). *[IAS 34.16A]*. The standard itself does not establish specific requirements for the content of a management commentary beyond what must be contained in (or cross-referred from) the interim financial statements (see section 4.2.3 below).

4 Disclosures in condensed financial statements

IAS 34 combines a number of disclosure principles:

- Entities must provide information about events and transactions in the interim period that are significant to an understanding of the changes in financial position and performance since the last annual reporting period. In this context, it is not necessary to provide relatively insignificant updates to information reported in the last annual financial statements (see section 4.1 below). *[IAS 34.15, IAS 34.15A]*.
- In addition, to information that explains significant changes since the last annual reporting period, a number of specific disclosures are required to be given, if this is not disclosed elsewhere in the interim financial report. *[IAS 34.16A]*.
- The materiality assessment for disclosure is based on the interim period by itself, to ensure all information is provided that is relevant to understanding the entity's financial position and its performance during the interim period (see section 6 below). *[IAS 34.25]*.

How we see it

Overall, applying the disclosure principles described above requires the exercise of judgement by an entity regarding what information is significant and relevant. The practice of interim reporting confirms that entities take advantage of that room for judgement, both for disclosures provided in the notes to the interim financial statements and outside the interim financial statements.

4.1 Significant events and transactions

IAS 34 presumes that users of an entity's interim financial report also have access to its most recent annual financial report. *[IAS 34.15A]*. On that basis, an interim financial report must explain events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the previous annual reporting period and provide an update to the relevant information included in the financial statements of the previous year. *[IAS 34.15, IAS 34.15C]*. The inclusion of only selected explanatory notes is consistent with the purpose of an interim financial report which is to update the latest complete set of annual financial statements. Accordingly, condensed financial statements avoid duplicating previously reported information and focus on new activities, events, and circumstances. *[IAS 34.6]*.

Extract from IAS 34

15B The following is a list of events and transactions for which disclosures would be required if they are significant: the list is not exhaustive.

(a) the write-down of inventories to net realisable value and the reversal of such a write-down;

(b) recognition of a loss from the impairment of financial assets, property, plant, and equipment, intangible assets, assets arising from contracts with customers, or other assets, and the reversal of such an impairment loss;

(c) the reversal of any provisions for the costs of restructuring;

(d) acquisitions and disposals of items of property, plant, and equipment;

(e) commitments for the purchase of property, plant, and equipment;

(f) litigation settlements;

(g) corrections of prior period errors;

(h) changes in the business or economic circumstances that affect the fair value of the entity's financial assets and financial liabilities, whether those assets or liabilities are recognised at fair value or amortised cost;

(i) any loan default or breach of a loan agreement that has not been remedied on or before the end of the reporting period;

(j) related party transactions;

(k) transfers between levels of the fair value hierarchy used in measuring the fair value of financial instruments;

(l) changes in the classification of financial assets as a result of a change in the purpose or use of those assets; and

(m) changes in contingent liabilities or contingent assets.

The standard specifies that the above list of events and transactions is not exhaustive and the interim financial report must explain any additional events and transactions that are significant to an understanding of changes in the entity's financial position and performance. *[IAS 34.15, IAS 34.15B]*. Therefore, when information relating to items not on the above list changes significantly, an entity must still provide disclosure in the interim financial statements in sufficient detail to explain the nature of the change and any changes in estimates. This would apply, for example, if:

- The range of reasonably possible changes in key assumptions has significantly changed since the end of the last annual reporting period. If this is the case an update of relevant sensitivity disclosures may be required.
- The values of non-financial assets and liabilities that are measured at fair value change significantly.

The considerations in the preceding paragraph related to the disclosure of information about significant changes including the examples related to key assumptions and sensitivity is also relevant when an entity prepares its first interim financial statements adopting a new accounting pronouncement as discussed in section 8.1.2 below.

4.1.1 Relevance of other IFRS accounting standards in condensed financial statements

Whilst other IFRS accounting standards specify disclosures required in a complete set of financial statements, if an entity's interim financial report includes only condensed financial statements as described in IAS 34, then the disclosures required by those other IFRS accounting standards are not mandatory. However, if disclosure is considered to be necessary in the context of an interim report, those other IFRS accounting standards provide guidance on the appropriate disclosures for many of these items. *[IAS 34.15C]*. For example, in meeting the requirements of (g) above to disclose the impact of corrections of prior period errors, the requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* would be relevant to consider (see Chapter 3 at section 5.3).

In practice, entities exercise judgement to determine whether including the disclosures required by other IFRS accounting standards are material to an understanding of the entity and will provide a benefit to users of the interim financial statements. *[IAS 34.25]*. For example, the existence of acquisitions and disposals of items of property plant and equipment does not automatically require the interim report to include a reconciliation of the carrying amount at the beginning and end of the interim period. *[IAS 16.73(e)]*. In many cases, a narrative disclosure would be sufficient, and in some cases, the change may be immaterial, and therefore, no disclosures are required. However, in an interim period with multiple material changes, for example, when assets are acquired by purchase, obtained in a business combination, transferred to a disposal unit, and disposed of in the normal course of business, such a reconciliation could be judged to be an appropriate way of presenting this information in the interim financial statements.

4.2 Other disclosures required by IAS 34

In addition to disclosing significant events and transactions as discussed in section 4.1 above, IAS 34 requires an entity to include certain specific information, listed below, in the notes to its interim financial statements or elsewhere in the interim financial report. *[IAS 34.16A].* The inclusion of the disclosure requirements listed below among the items required by the standard to be given, distinguishes them from the items listed in section 4.1 above, which are disclosed to update information presented in the most recent annual financial report. *[IAS 34.15]*. Therefore, disclosure of the following information is required for each interim reporting period, subject only to a materiality assessment in relation to that interim report. *[IAS 34.25]*. In making that judgement, care needs to be taken to ensure any omitted information does not make the interim financial report incomplete and therefore misleading.

(a) A statement that the same accounting policies and methods of computation are followed in the interim financial statements as in the most recent annual financial statements or, if those policies or methods have changed, a description of the nature and effect of the change.

(b) Explanatory comments about the seasonality or cyclicality of interim operations.

(c) The nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that are unusual because of their nature, size, or incidence.

(d) The nature and amount of changes in estimates of amounts reported in prior interim periods of the current year or changes in estimates of amounts reported in prior years.

(e) Issues, repurchases, and repayments of debt and equity securities.

(f) Dividends paid (aggregate or per share) separately for ordinary shares and other shares.

(g) Certain segment disclosures required by IFRS 8 *Operating Segments* as discussed in section 4.4 below.

(h) Events after the interim period that are not reflected in the financial statements for the interim period.

(i) The effect of changes in the composition of the entity during the interim period, including business combinations, obtaining or losing control of subsidiaries and long-term investments, restructurings, and discontinued operations. For business combinations, the entity must disclose the information required under IFRS 3 *Business Combinations* (see Chapter 10 at section 16). This is discussed further in sections 4.2.1 and 4.2.2 below.

(j) For financial instruments, certain fair value disclosures required by IFRS 7 *Financial Instruments: Disclosures* and IFRS 13 *Fair Value Measurement* as discussed in section 4.5 below.

(k) For entities becoming, or ceasing to be, investment entities, as defined in IFRS 10 *Consolidated Financial Statements*, the disclosures in IFRS 12 *Disclosure of Interests in Other Entities* as required by IFRS 12.9B (see Chapter 14 at section 4.6.2).

(l) The disaggregation of revenue from contracts with customers required by paragraphs 114 and 115 of IFRS 15 *Revenue from Contracts with Customers*. The requirement to disclose disaggregated revenue in interim financial statements is similar to the requirements applicable to annual financial statements. See Chapter 28 at section 10.5.1.A for illustrative examples of disclosures. *[IAS 34.16A]*.

This information is disclosed on a financial year-to-date basis, *[IAS 34.16A]*, except for the information relating to business combinations as discussed in more detail in section 4.2.1 below.

4.2.1 Disclosure relating to business combinations

The requirement in item (i) in section 4.2 above for disclosures of business combinations applies not only for those effected during the current interim period, but also to business combinations after the reporting period but before the interim financial report is authorised for issue. *[IFRS 3.59(b), IFRS 3.B66]*. See Chapter 10 at section 16.1.2 and section 16.4.

As noted above, IAS 34 requires disclosure of the effect of changes in the composition of the entity during the interim period, including business combinations, obtaining or losing control of subsidiaries and long-term investments, restructurings, and discontinued operations.

For business combinations, IAS 34 cross refers to the disclosure requirements of IFRS 3, including the requirement to disclose details of business combinations after the reporting period. An entity is not required to provide all the disclosures for business combinations after the reporting period, if the accounting for the business combination is incomplete as at the date on which the financial statements are authorised for issue. In this case, the entity must state which disclosures cannot be made and the reasons why they cannot be made. *[IFRS 3.B66]*.

IFRS 3 requires disclosures in aggregate for business combinations effected during the reporting period that are individually immaterial. *[IFRS 3.B65]*. However, materiality is assessed for the interim period financial data, *[IAS 34.23]*, which implies that IAS 34 may require detailed disclosures on business combinations that are material to an interim period, even if they could be aggregated for disclosure purposes in the annual financial statements.

4.2.2 Disclosures relating to disposals, discontinued operations and restructurings

If an entity has operations that are discontinued or disposed of during an interim period, these operations must be presented separately in the condensed interim statement of comprehensive income following the principles set out in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. In addition, if an entity has non-current assets or a disposal group classified as held for sale or distribution at the end of the interim reporting period, then these must be measured in accordance with the requirements of IFRS 5 and presented separately from other assets and liabilities in the condensed interim statement of financial position.

An entity contemplating a significant restructuring that will have an impact on its composition must follow the guidance in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* for the recognition of any restructuring cost, *[IAS 37.71]*, and IAS 19 *Employee Benefits* for termination benefits. *[IAS 19.165(b)]*. In subsequent interim periods, any significant changes to provisions will require disclosure. *[IAS 34.15B(c), IAS 34.16A(d)]*.

4.2.3 Location of the specified disclosures in an interim financial report

IAS 34 defines an 'interim financial report' as "a financial report containing either a complete set of financial statements… or a set of condensed financial statements… for an interim period". *[IAS 34.4]*. Therefore, since an interim financial report contains the interim financial statements, it is clear that these are two different concepts. Accordingly, an entity is not required to disclose the information listed in section 4.2 above in the interim financial statements themselves (but rather, might include the disclosures in the management commentary), as long as a cross-reference is provided from the financial statements to the location of the information included in another part of the interim financial report. *[IAS 34.16A]*.

Additionally, for a cross-reference to be acceptable, the information given 'elsewhere in the interim financial report' needs to both satisfy the disclosure requirements in IFRS accounting standards and be available on the same terms as the interim financial statements, i.e., users must have access to the referenced material (for example, the management commentary or a risk report) on the same basis and at the same time as they have for accessing the interim financial statements from which the reference is made. *[IAS 34.16A]*.

The cross-reference must identify the specific part that includes the required disclosure to allow the reader to easily navigate within the interim financial report.

4.2.3.A Transition disclosures in subsequent interim financial statements in the year of adoption

Section 8.1.2.A below includes guidance regarding the considerations given to which new IFRS accounting standards and interpretations are mandatory in the next (current year) annual financial statements, when preparing interim financial information.

An entity may prepare more than one set of interim financial statements during the year of adoption of new or amended accounting standards and interpretations (e.g., quarterly interim reporting). In that case, the entity must provide information consistent with that which was disclosed in its first interim financial statements for that year but updated for the latest information (see section 8.1.2 below). In some cases, the additional disclosures in a subsequent interim period only relate to information that is relevant to that subsequent interim period as IAS 34.16A allows for cross-referencing to other documents available on the same terms and at the same time.

Entities must consider the views of local regulators when planning not to repeat in the current interim financial statements any disclosures already included in previous interim reports or other documents. That is because there are different views among regulators as to whether the nature and effect of changes including transition disclosures (see section 8.1.2 below) must be repeated in full in each set of interim financial statements issued during the year or whether cross-referencing to earlier interim financial statements or other documents outside the current interim report is acceptable. For example, in April 2018 the European Securities and Markets Authority (ESMA) published its report on the activities of accounting enforcers in 2017. In it, ESMA clarified that they expect issuers applying IFRS 15 for the first time and using a modified retrospective approach to provide the disclosures about transition required by IFRS 15.C8 in all interim periods that include the date of initial application of IFRS 15.[2]

In any event, if an entity becomes aware of new information about the transitional impact of the new IFRS accounting standards as at the date of initial application in a subsequent interim period, the previously reported disclosures must be updated in that later interim period to reflect the new information.

Local regulators may have additional requirements. For example, foreign private issuers reporting under IFRS accounting standards that are required to file interim statements may be affected by the SEC's reporting requirement to provide both the annual and interim period disclosures prescribed by the new IFRS accounting standard, to the extent not duplicative, in each interim report in the year of adoption.[3]

2 Report, *Enforcement and Regulatory Activities of Accounting Enforcers in 2017*, ESMA, 03 April 2018, para. 63. Available on ESMA's website.

3 CF Full FRM Update (sec.gov), Division of Corporation Finance - Financial Reporting Manual, SEC, 1500: *Interim Period Reporting Considerations (All Filings)*.

4.3 Practical examples and Illustrations of disclosures

The Practical examples and Illustrations below illustrate the disclosures required by IAS 34.

4.3.1 Inventory write-down and reversals

In the Practical example below, BP p.l.c. discloses write-downs of its inventories in the current and corresponding periods and a change in the valuation method consequent to a change in strategic direction. *[IAS 34.15B(a)]*.

Practical example 4-1: BP p.l.c. (Second quarter and half-year 2021) — United Kingdom

Group results: Second quarter and half year 2021 [extract]

Notes [extract]

Note 10. Inventory valuation

A provision of $17 million was held against hydrocarbon inventories at 30 June 2021 ($80 million at 31 March 2021 and $289 million at 30 June 2020) to write them down to their net realizable value. As a result of the changes in strategic direction of the group and the evolution of the trading strategy set out in Note 1, from 1 January, certain inventory, totalling $11.0 billion as at 30 June 2021 ($10.2 billion as at 31 March 2021), is now treated as trading inventory and is valued at fair value whereas the equivalent inventory was previously valued at the lower of cost or net realisable value in prior periods.

In the Practical example below, Tharisa plc discloses the reversal of an inventory write-down in the current period. *[IAS 34.15B(a)]*.

Practical example 4-2: Tharisa plc (Half-year 2023) — Cyprus

INTERIM MANAGEMENT REPORT [extract]

INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS 31 MARCH 2023 [extract]

NOTES TO THE INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS [extract]

13. INVENTORIES [extract]

Certain PGM finished products, which previously were provided for in full, were reprocessed to an acceptable saleable condition. This resulted in a reversal of a write down previously recognised. The reversal amounts to US$1.1 million at 31 March 2023 (31 March 2022: write down of US$0.5 million and 30 September 2022: write down of US$2.0 million). The provision and the net realisable value write down were allocated to the PGM segment.

...

4.3.2 Recognition and reversal of impairment losses

In the Practical example below, AngloGold Ashanti Limited has disclosed impairment losses recognised during the interim period including an indication of the cash-generating unit, reportable segment and class of assets where the impairment losses are recognised. *[IAS 34.15B(b)]*.

Practical example 4-3: AngloGold Ashanti Limited (Half-year 2023) South Africa

Interim 2023 Results Report for the six months ended 30 June 2023 [extract]

Notes for the six months ended 30 June 2023 [extract]

4 Impairment, derecognition of assets and (loss) profit on disposal [extract]

Impairments

The group's non-financial assets, other than inventories and deferred tax assets, are assessed for impairment or reversal of impairment indicators at each reporting date or whenever events or changes in circumstances indicate that the carrying value may not be recoverable.

Córrego do Sítio ("CdS")

CdS is owned and operated by AngloGold Ashanti Mineração ("AGA Mineração") in Brazil. The CdS mining complex has been in operation since 1989 and consists of open pit and underground mines. The property is currently in a production stage. Management is currently assessing various options related to the CdS mining complex cash generating unit ("CGU"), ranging from operational improvements through the Full Asset Potential review programme to putting the operations under care and maintenance. In 2022, an impairment loss of $189m was recognised in respect of the CdS mining complex CGU. During the first half of 2023, the CdS mining complex CGU experienced further operational underperformance and as a result a further impairment loss of $39m was recognised on the remaining asset balances and new capital expenditures incurred during 2023. The impairment losses in 2022 and the first half of 2023 were recognised and included in the Americas segment.

Cuiabá

Cuiabá is owned and operated by AGA Mineração in Brazil. It has been in operation since 1834 and is an underground mine. The property is currently in the production stage. In 2022, an impairment loss of $70m was recognised in respect of the Cuiabá mining complex CGU. During the first half of 2023, Cuiabá recognised a further impairment loss of $53m largely due to the current suspension of operating activities at the Queiroz metallurgical plant while additional buttressing at the Calcinados TSF is designed and completed, and a decision not to restart operations during the dry season (contrary to what was originally planned). The impairment losses in 2022 and the first half of 2023 were recognised and included in the Americas segment.

Impairment Allocation:

	Tangible Assets				
Cash Generating Unit	Mine Development Cost	Mine Infrastructure	Assets under construction	Land	Total Impairment
US Dollar million	Six months ended Jun 2023				
Córrego do Sítio	26	7	5	1	39
Cuiabá	—	25	28	—	53
	26	**32**	**33**	**1**	**92**

...

In the Practical example below, as part of its note on segments, Equinor ASA discloses the reversal of impairment losses during the reporting period. *[IAS 34.15B(b)]*. The note also provides an explanation of the reasons for the reversal.

Practical example 4-4: Equinor ASA (Second quarter 2021) Norway

Second quarter 2021: Financial statements and review [extract]

Notes to the Condensed interim financial statements [extract]

2 Segments [extract]

In the second quarter of 2021 Equinor recognised net impairment reversals of USD 276 million of which USD 113 million was impairments of acquisition cost and signature bonuses classified as exploration expenses. The line item Exploration expenses in the Consolidated statement of income also includes impairment of capitalised exploration well cost. For information regarding impairment of capitalised exploration cost, see note 6 Property, plant and equipment and intangible assets.

In the E&P International segment the net impairment reversal was USD 93 million. Impairments of USD 95 million related to exploration licenses in South America and were classified as exploration expenses. Net impairment reversal of other assets of USD 188 million were mainly related to an asset in the Europe and Asia area caused by positive change in the short-term price assumptions and a North America offshore asset valued at fair value less cost to sell following the reclassification to held for sale.

In the E&P Norway segment the net impairment reversal was USD 396 million mainly related to an offshore asset caused by a positive change in the short-term price assumptions.

In the MMP segment the impairments were USD 185 million mainly related to a refinery valued at fair value less cost to sell following the reclassification to held for sale.

4.3.3 Acquisitions and disposals of property, plant and equipment

In the Practical example below, Synlait Milk Limited gives a narrative description of its acquisitions, disposals and other movements in property, plant and equipment and intangible assets in the interim period. *[IAS 34.15B(d)]*.

Practical example 4-5: Synlait Milk Limited (Half-year 2022) **New Zealand**

CONDENSED INTERIM FINANCIAL STATEMENTS [extract]
For the six months ended 31 January 2022 [extract]
NOTES TO THE CONDENSED INTERIM FINANCIAL STATEMENTS [extract]

09. PROPERTY, PLANT AND EQUIPMENT

During the six months ended 31 January 2022, $27.0m has been added to capital work in progress relating primarily to the Pokeno plant modification project. During this period, $5.1m of historical work in progress relating primarily to routine capital expenditure has been transferred to fixed assets. $12.6m of property, plant, and equipment was derecognised in relation to the sale and leaseback of the Group's Auckland land and buildings. Refer to note 2 for further detail.

10. INTANGIBLE ASSETS

During the six months ended 31 January 2022, $16.9m has been added to intangible work in progress relating primarily to the SAP ERP implementation project. During this period, $0.5m of historical work in progress relating primarily to routine capital expenditure has been transferred to intangible assets. In addition, $3.2m of New Zealand Units were acquired during the period.

4.3.4 Capital commitments

In the Practical example below, Sembcorp Industries Ltd discloses its commitments for capital expenditure. *[IAS 34.15B(e)]*. The note explains that these are additional capital commitments entered into during the interim period.

Practical example 4-6: Sembcorp Industries Ltd (Half-year 2022) **Singapore**

CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS & DIVIDEND ANNOUNCEMENT [extract]
FOR THE HALF-YEAR ENDED JUNE 30, 2022 [extract]
UNAUDITED RESULTS FOR THE HALF-YEAR ENDED JUNE 30, 2022 [extract]

12. COMMITMENTS

Commitments not provided for in the financial statements are as follows:

		GROUP	
(S$ million)	Note	As at June 30, 2022	As at December 31, 2021
Commitments in respect of acquisition of investments	(i)	–	1,020
Commitments in respect of contracts placed for property, plant and equipment	(ii)	545	152
Uncalled commitments to subscribe for additional shares in joint ventures and other investments		10	52
Commitments in respect of a civil settlement in China		45	45
		600	1,269

(i) The two acquisitions were completed in 1H2022 (see Note 5e and 7b).

(ii) The increased commitments in 1H2022 mainly related to the building, owning and operating of 200MW of Energy Storage Systems on Jurong Island, Singapore as well as construction of a 150MW battery at Wilton International, Teesside, UK.

4.3.5 Litigation settlements

In the Practical example below, African Rainbow Minerals Limited provides information about significant litigation and the related settlement during the second half-year interim period in 2021. *[IAS 34.15B(f)]*. The disclosure quantifies the settlement amount and indicates the accounting treatment of the litigation as at the end of the previous reporting period.

Practical example 4-7: African Rainbow Minerals Limited (Half-year 2021) South Africa

INTERIM RESULTS for the six months ended 31 December 2021 [extract]
Condensed group interim financial statements [extract]
Notes to the condensed group interim financial statements [extract]
23 CONTINGENT LIABILITIES [extract]

ARM COAL

The South African Revenue Services (SARS) disallowed Glencore Operations South Africa (Pty) Ltd (GOSA) diesel rebates on the basis that the diesel was not considered to be used in the primary production activities in the mining process. GOSA lost the SARS internal appeal process and took the matter to the High Court. The matter was heard in the High Court, which ruled in favour of GOSA. SARS however appealed the ruling through the Supreme Court of Appeal (SCA). The dispute was heard on 27 May 2021 and judgment was handed down on 10 August 2021 where the SCA ruled in favour of SARS.

At 30 June 2021, this matter was disclosed as a contingent liability. During the current reporting period, the calculated shortfall of R8 million has been paid to SARS.

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4.3.6 Changes in circumstances affecting fair values

In its interim report for 2021, Yorkshire Building Society describes the effect of volatility in financial markets during the period. *[IAS 34.15B(h)]*.

Practical example 4-8: Yorkshire Building Society (Half-year 2021) United Kingdom

HALF-YEARLY FINANCIAL REPORT: 30 JUNE 2021 [extract]
Interim Management Report [extract]
Business highlights [extract]
Our financial performance [extract]
Income Statement [extract]

- A fair value volatility gain of £11.4m was recorded in the six months to 30 June 2021 (2020 H1: £7.9m loss), mainly as a consequence of the external interest rate environment and the effect this has on mortgage pipeline interest rate swaps.

4.3.7 Default or breach of loan covenants not remedied before the end of interim period

The Illustration below shows disclosure of a loan default that has not been remedied on or before the end of the reporting period, *[IAS 34.15B(i)]*, and the consequential impact on classification of the loans in the interim financial statements.

Illustration 4-1: Disclosure of default of loan covenant

As at 30 June 20X2, Entity A did not comply with certain financial covenants set out in its existing agreements for the ordinary bond loans issued by the Entity amounting to CU100 million (hereinafter the Existing OBLs) and had not repaid matured loan instalments of CU100 million from the Existing OBLs. Consequently, as of 30 June 20X2, all Existing OBLs are classified as short-term liabilities.

4.3.8 Related party transactions

In Practical example 4-9 below, Deutsche Bank Aktiengesellschaft discloses related party transactions. *[IAS 34.15B(j)]*.

Practical example 4-9: Deutsche Bank Aktiengesellschaft (Half-year 2022) Germany

Interim Report as of June 30, 2022 [extract]
Interim consolidated financial statements [extract]
Other financial information [extract]

Related party transactions

Parties are considered to be related if one party has the ability to directly or indirectly control the other party or exercise significant influence over the other party in making financial or operational decisions. The Group's related parties include:

- key management personnel including close family members and entities which are controlled, significantly influenced by, or for which significant voting power is held by key management personnel or their close family members,
- subsidiaries, joint ventures and associates and their respective subsidiaries, and
- post-employment benefit plans for the benefit of Deutsche Bank employees.

Transactions with key management personnel

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of Deutsche Bank Group, directly or indirectly. The Group considers the members of the Management Board as currently mandated and the Supervisory Board of the parent company to constitute key management personnel for purposes of IAS 24. Among the Group's transactions with key management personnel as of June 30, 2022, were loans and commitments of € 5 million and deposits of € 13 million. As of December 31, 2021, there were loans and commitments of € 8 million and deposits of € 13 million among the Group's transactions with key management personnel. In addition, the Group provides banking services, such as payment and account services as well as investment advice, to key management personnel and their close family members.

Transactions with subsidiaries, associates and joint ventures

Transactions between Deutsche Bank AG and its subsidiaries meet the definition of related party transactions. If these transactions are eliminated on consolidation, they are not disclosed as related party transactions. Transactions between the Group and its associated companies and joint ventures and their respective subsidiaries also qualify as related party transactions.

Transactions for subsidiaries, joint ventures and associates are presented combined in below table as these are not material individually.

Loans issued and guarantees granted

in € m.	Jun 30, 2022	Dec 31, 2021
Loans outstanding, beginning of period	**153**	**214**
Net movement in loans during the period	(50)	159
Changes in the group of consolidated companies	0	0
Exchange rate changes/other[1]	2	(221)
Loans outstanding, end of period[1,2]	**105**	**153**
Other credit risk related transactions:		
Allowance for loan losses	0	0
Provision for loan losses	0	0
Guarantees and commitments	91	28

[1] Prior years' comparatives aligned to presentation in the current year.
[2] There were no past due loans as of June 30, 2022 and December 31, 2021. For the above loans, the Group held collateral of € 0 million and € 0 million as of June 30, 2022 and December 31, 2021, respectively.

Deposits received

in € m.	Jun 30, 2022	Dec 31, 2021
Deposits, beginning of period	**63**	**49**
Net movement in deposits during the period	(23)	14
Changes in the group of consolidated companies	0	0
Exchange rate changes/other	0	0
Deposits, end of period	**41**	**63**

Other transactions

Trading assets and positive market values from derivative financial transactions with associated companies amounted to € 18 million as of June 30, 2022, and € 2 million as of December 31, 2021. Trading liabilities and negative market values from derivative financial transactions with associated companies were € 0 million as of June 30, 2022, and € 0 million as of December 31, 2021.

Other assets related to transactions with associated companies amounted to € 38 million as of June 30, 2022, and € 42 million as of December 31, 2021. Other liabilities related to transactions with associated companies were € 5 million as of June 30, 2022, and € 1 million as of December 31, 2021.

Transactions with pension plans

The Group has business relationships with a number of pension plans pursuant to which it provides financial services, including investment management. Pension funds may hold or trade Deutsche Bank AG shares or securities. As of June 30, 2022, transactions with these plans were not material for the Group.

4.3.9 Transfers between different levels of fair value hierarchy

In the Practical example below HSBC Holdings plc discloses details of the transfers of items between level 1 and level 2 of the fair value hierarchy. *[IAS 34.15B(k)]*.

Practical example 4-10: HSBC Holdings plc (Half-year 2022) **United Kingdom**

Interim Report 2022 [extract]

Interim condensed financial statements [extract]

Notes on the interim condensed financial statements (unaudited) [extract]

6 Fair values of financial instruments carried at fair value [extract]

Transfers between Level 1 and Level 2 fair values

	Assets				Liabilities		
	Financial investments	Trading assets	Designated and otherwise mandatorily measured at fair value	Derivatives	Trading liabilities	Designated at fair value	Derivatives
	$m	$m	$m	$m	$m	$m	$m
At 30 Jun 2022							
Transfers from Level 1 to Level 2	**2,407**	**1,937**	**538**	–	**55**	–	–
Transfers from Level 2 to Level 1	**4,066**	**3,488**	**99**	–	**203**	–	–
At 31 Dec 2021							
Transfers from Level 1 to Level 2	8,477	6,553	1,277	103	181	–	212
Transfers from Level 2 to Level 1	6,007	4,132	768	–	638	–	–

Transfers between levels of the fair value hierarchy are deemed to occur at the end of each quarterly reporting period. Transfers into and out of levels of the fair value hierarchy are primarily attributable to observability of valuation inputs and price transparency.

...

4.3.10 Contingent liabilities

In the Practical example below, Jerónimo Martins, S.G.P.S., S.A. discloses changes in its contingent liabilities during the interim period. *[IAS 34.15B(m)]*. The note focuses on changes from the previous annual financial statements rather than repeating information already appearing in the last annual financial statements.

Practical example 4-11: Jerónimo Martins, S.G.P.S., S.A. (First Half 2023) **Portugal**

2023 FIRST HALF CONSOLIDATED REPORT AND ACCOUNTS [extract]

II - Condensed Consolidated Financial Statements [extract]

Notes to the Consolidated Financial Statements [extract]

18 Contingencies [extract]

Contingent liabilities

During the first half of 2023, the following changes occurred to the contingencies mentioned in the 2022 Annual Report:

Competition Authorities proceedings:

...

- In Poland, the Company Jeronimo Martins Polska, S.A. (JMP) was notified, in 2019, by the Polish Office of Competition and Consumer Protection (UOKiK) on the opening of one investigation proceeding, regarding missing price labels on shelves and discrepancies between prices on the shelves and the ones indicated at the checkouts.

  In August 2020, UOKiK notified the JMP of the decision, concluding with the imposition of a fine of 115 million zloty (c. €25 million). JMP, disagreeing with the understanding and conclusion of this Authority, filed an appeal to the Court of Competition and Consumer Protection (CCCP). On 29 September 2022 the court in the first instance sustained the UOKiK decision and dismissed the appeal. Convinced of the merits of its defence and has factual and legal arguments to be used, JMP filed an appeal to the Second Instance Court. On 27 June 2023 the Court of Appeals dismissed JMP's appeal, making UOKiK decision final. Nevertheless, JMP sustaining its position, will file an extraordinary appeal to the Supreme Court.

  During the year 2020, JMP was notified by UOKiK on the opening of one proceeding related to the disclosure of country of origin of fruit and vegetable products at store level. On 22 April 2021 UOKiK notified JMP of the decision on the case, imposing a fine of 60 million zloty (c. €13 million). The mentioned decision is not final, so JMP, disagreeing with the understanding and conclusion of this Authority, filed an appeal before the CCCP. On 17 April 2023 the CCCP sustained UOKiK's decision. JMP filed the appeal to the Court of Appeals.

  On 10 August 2022 the President of UOKiK initiated the proceedings regarding the promotional campaign 'Biedronka's Anti-inflation Shield', having on 13 April 2023 issued a decision to impose a fine of 161 million zloty (c. €36 million). JMP filed an appeal to the CCCP.

...

4.3.11 Accounting policies and methods of computation

In the Practical example below, Daimler AG discloses changes to the accounting policies applied in its 2019 interim report. *[IAS 34.16A(a)]*. Using the guidance in IAS 8, Daimler AG provides information for the adoption of IFRS 16 *Leases*.

Practical example 4-12: Daimler AG (Second quarter 2019) **Germany**

Interim report Q2 2019 [extract]

Notes to the Interim Consolidated Financial Statements [extract]

1. Presentation of the Interim Consolidated Financial Statements [extract]

IFRSs initially applied in the reporting period

In January 2016, the IASB published **IFRS 16 Leases**, replacing IAS 17 Leases and IFRIC 4 Determining Whether an Arrangement Contains a Lease and other interpretations. IFRS 16 abolishes for lessees the previous classification of leasing agreements as either operating or finance leases. Instead, IFRS 16 introduces a single lessee accounting model, requiring lessees to recognize assets for the right to use as well as leasing liabilities for the outstanding lease payments. This means that leases that were previously not reported in the Consolidated Statement of Financial Position will have to be reported in the future – very similar to the current accounting of finance leases.

...

Daimler applies IFRS 16 for the first time at January 1, 2019. In compliance with the transition regulations, Daimler does not adjust the prior-year figures and presents the not significant accumulated transitional effects in retained earnings.

Daimler as lessee uses the following practical expedients of IFRS 16 at the date of initial application:

- With leases previously classified as operating leases according to IAS 17, the lease liability is measured at the present value of the outstanding lease payments, discounted by the incremental borrowing rate at January 1, 2019. The weighted average incremental borrowing rate was 2.27%. The respective right-of-use asset is generally recognized at an amount equal to the lease liability.

- An impairment review is not performed. Instead, a right-of-use asset is adjusted by the amount of any provision for onerous leases recognized in the Statement of Financial Position at December 31, 2018.

- Regardless of their original lease term, leases for which the lease term ends at the latest on December 31, 2019 are recognized as short-term leases.

- At the date of initial application, the measurement of a right-of-use asset excludes the initial direct costs.

- Current knowledge is given due consideration when determining the lease term if the contract contains options to extend or terminate the lease.

In the context of the transition to IFRS 16, right-of-use assets of €3,777 million (including finance leases of €335 million) and lease liabilities of €3,790 million were recognized at January 1, 2019. The following reconciliation (see ↗ E.08) to the opening balance for lease liabilities as at January 1, 2019 is based on the other financial obligations from rental agreements and operating leases at December 31, 2018.

E.08

Reconciliation to the lease liabilities in accordance with IFRS 16

In millions of euros	
Other financial obligations resulting from rental agreements and operating leases in accordance with IAS 17 at December 31, 2018	3,800
Exemptions for short-term leases	-226
Exemptions for leases of low-value assets	-36
Payments related to options to extend or terminate a lease	256
Payments related to non-lease components	77
Others	75
Obligations from operating lease arrangements (undiscounted)	3,946
Discounting	-503
Obligations from operating lease arrangements (discounted)	3,443
Carrying amount of liabilities from finance leases in accordance with IAS 17 at December 31, 2018	347
Carrying amount of lease liability in accordance with IFRS 16 at January 1, 2019	3,790

The right-of-use assets and lease liabilities include assets and liabilities, which were recognized until December 31, 2018 as finance leases in accordance with IAS 17.

In the Practical example below, Rio Tinto plc discloses changes to the accounting policies applied in its 2023 interim results. *[IAS 34.16A(a)]*. Using the guidance in IAS 8, Rio Tinto plc provides information for the adoption of an amendment to IAS 12 *Income Taxes*.

Practical example 4-13: Rio Tinto plc (2023) **Australia**

Annual Report 2022 [extract]

Condensed consolidated interim financial statements for the six months ended 30 June 2023 [extract]

Selected explanatory notes to the interim financial statements [extract]

2 Changes in accounting policies [extract]

New standards and amendments applicable for the current period

Deferred Tax related to Assets and Liabilities arising from a Single Transaction (Amendments to IAS 12 'Income Taxes' (IAS 12), mandatory in 2023 and endorsed by the UK)

At 1 January 2023, we adopted narrow-scope amendments to IAS 12 and have restated comparative periods in accordance with the transition arrangements. These amendments introduce an exclusion to the initial recognition exemption application for transactions giving rise to equal and offsetting taxable and deductible temporary differences.

Under the amendments, separate deferred tax assets and liabilities are calculated and recognised, prior to application of any required recovery testing and permitted offsetting, and subsequent movements in those deferred tax assets and liabilities are recognised in the income statement. Our previous accounting policy stated that "where the recognition of an asset and liability from a single transaction gives rise to equal and offsetting temporary differences, we apply the initial recognition exemption allowed by IAS 12, and consequently recognise neither a deferred tax asset nor a deferred tax liability in respect of these temporary differences".

The most significant impact of implementing these amendments was from temporary differences related to the Group's provisions for close-down and restoration, and lease obligations and corresponding capitalised closure costs and right-of-use assets. Adjustments to deferred tax assets and liabilities related to these balances have been recognised as at 1 January 2021, being the beginning of the earliest comparative period to be presented in the financial statements for the year ended 31 December 2023, with the cumulative effect recognised as an adjustment to retained earnings or other components of equity at that date. For other transactions, the impact of which was immaterial, the amendments apply only to those taking place on or after 1 January 2021. The impact on equity attributable to owners of Rio Tinto at 1 January 2023 of implementing the amendments to IAS 12 is as follows:

At 1 January	**2023 US$m**	2022 US$m	2021 US$m
Equity attributable to owners of Rio Tinto (previously reported)	**50,175**	51,415	47,054
Impact of IAS 12 amendments[(a)]	**459**	515	516
Restated equity attributable to owners of Rio Tinto	**50,634**	51,930	47,570

(a) Retained earnings adjustments at 1 January 2023 and 2022 include the impact of income statement adjustments for the years ended 31 December 2022 and 2021, respectively.

The restatement of deferred tax balances for the comparative reporting date is as follows:

	31 December 2022 US$m
Deferred tax assets (previously reported)	2,766
Impact of IAS 12 amendments	30
Deferred tax assets (restated)	**2,796**
Deferred tax liabilities (previously reported)	(3,601)
Impact of IAS 12 amendments	437
Deferred tax liabilities (restated)	**(3,164)**
Net impact of IAS 12 amendments on deferred tax balances	**467**
Comprising, prior to offsetting of balances:	
Deferred tax assets arising from:	
- Provisions and other liabilities	1,586
- Capital allowances	(57)
	1,529
Deferred tax liabilities arising from Capital allowances	(1,062)

Restatement of pre-offset balances at 31 December 2022 represents additional gross deferred tax liabilities of US$922 million and gross deferred tax assets of US$1,380 million in relation to close-down and restoration obligations and related capitalised closure costs, and additional gross deferred tax liabilities of US$140 million and gross deferred tax assets of US$149 million in relation to lease liabilities and related right-of-use assets.

The impact of restatement on net earnings for the six months ended 30 June 2022 is a net credit of US$35 million related to depreciation of closure and right of use assets and settlement of closure and lease liabilities.

4.3.12 Seasonality or cyclicality of operations

Practical example 4-14 below shows how Ardagh Group S.A. discloses the effects of seasonality in its interim report. *[IAS 34.16A(b)]*. The note explains the impact of seasonality on revenue, cash flows and working capital.

Practical example 4-14: Ardagh Group S.A. (First Quarter 2024) **Luxembourg**

Interim Report for the three months ended March 31, 2024 [extract]
Unaudited Consolidated Interim Financial Statements [extract]
NOTES TO THE UNAUDITED CONSOLIDATED INTERIM FINANCIAL STATEMENTS [extract]

18. Seasonality of operations

The Group's revenue and cash flows are both subject to seasonal fluctuations, with the Group generally building inventories in anticipation of these seasonal demands resulting in working capital requirements typically being the greatest at the end of the first quarter of the year.

The demand for our metal beverage products is strongest during spells of warm weather and therefore demand typically peaks during the summer months, as well as in the period leading up to holidays in December. Demand for beverage products within our Glass Packaging business is similarly strongest during the summer and during periods of warm weather, as well as during the period leading up to holidays in December.

The Group manages the seasonality of working capital principally by supplementing operating cash flows with drawings under our Global Asset Based Loan Facilities.

4.3.13 Amounts that are unusual because of their nature, size or incidence

Sanofi discloses the nature and effects of unusual items in Practical example 4-15 below by identifying 'restructuring costs' and similar items. *[IAS 34.16A(c)]*. The footnote provides further information on the nature of the costs. The note provides information about unusual items that might be important in the analysis of interim period performance. Paragraph 15 of IAS 34 also requires an explanation of events and transactions that are significant to an understanding of the changes in the financial position and performance of the entity since the end of the last annual financial statements. See Practical example 4-21 in section 4.3.17 below for another example illustrating disclosures about restructuring activities.

Practical example 4-15: Sanofi (Half-year 2023) **France**

HALF-YEAR FINANCIAL REPORT 2023 [extract]

1. CONDENSED HALF-YEAR CONSOLIDATED FINANCIAL STATEMENTS [extract]

NOTES TO THE CONDENSED HALF-YEAR CONSOLIDATED FINANCIAL STATEMENTS AS OF JUNE 30, 2023 [extract]

B/ SIGNIFICANT INFORMATION FOR THE FIRST HALF OF 2023 [extract]

B.16. RESTRUCTURING COSTS AND SIMILAR ITEMS

Restructuring costs and similar items comprise the following:

(€ million)	June 30, 2023 (6 months)	June 30, 2022 (6 months)	December 31, 2022 (12 months)
Employee-related expenses	185	524	507
Charges, gains or losses on assets[(a)]	86	(2)	261
Compensation for early termination of contracts (other than contracts of employment)	—	—	1
Costs of transformation programs	265	266	547
Other restructuring costs	11	4	20
Total	**547**	**792**	**1,336**

(a) This line consists of impairment losses and accelerated depreciation charges related to site closures (including leased sites), and gains or losses on divestments of assets arising from reorganization decisions made by Sanofi.

Restructuring costs and similar items were €245 million lower in the first half of 2023 than in the first half of 2022. For the first half of 2023 they include the impact of French pension reforms on future annuities under the rules of each severance plan, while for the first half of 2022 they mainly comprised severance costs recognized further to the announcements made during that period. Also included in restructuring costs are the impacts of ongoing transformational projects, primarily those associated with the creation of the standalone Consumer Healthcare entity and the implementation of Sanofi's new digital strategy.

4.3.14 Issues, repurchases and repayments of debt and equity securities

Practical example 4-16 below illustrates the disclosure of material changes in borrowings. *[IAS 34.16A(e)]*.

Practical example 4-16: Anheuser-Busch InBev NV/SA (Half-year 2022) **Belgium**

Unaudited Interim Report for the six-month period ended 30 June 2022 [extract]

Notes to the consolidated financial statements [extract]

17. Interest-bearing loans and borrowings [extract]

The current and non-current interest-bearing loans and borrowings amount to 83.3 billion US dollar as at 30 June 2022, compared to 88.8 billion US dollar as at 31 December 2021.

As at 30 June 2022, the company had no outstanding balance on commercial papers (31 December 2021: nil). The commercial papers include programs in US dollar and euro with a total authorized issuance up to 5.0 billion US dollar and 3.0 billion euro, respectively.

In 2022, Anheuser-Busch InBev SA/NV (AB InBev) announced that its wholly-owned subsidiary Anheuser- Busch InBev Finance Inc. ("ABIFI") exercised its option to redeem the outstanding principal amounts for an aggregate principal amount of 3.1 billion US dollar of the following series of notes:

Date of redemption	Issuer (abbreviated)	Title of series of notes redeemed	Currency	Original principal amount outstanding (in million)	Principal amount redeemed (in million)
9 February 2022	ABIFI	3.650% Notes due 2026	USD	1 633	1 633
1 March 2022	ABIFI	4.915% Notes due 2046	USD	1 470	1 470

Net debt is defined as non-current and current interest-bearing loans and borrowings and bank overdrafts minus debt securities and cash and cash equivalents. Net debt is a financial performance indicator that is used by AB InBev's management to highlight changes in the company's overall liquidity position.

AB InBev's net debt decreased to 75.9 billion US dollar as at 30 June 2022, from 76.2 billion US dollar as at 31 December 2021. Aside from operating results that are net of capital expenditures, the net debt is impacted mainly by the payment of interests and taxes (3.8 billion US dollar), dividend payments to shareholders of AB InBev and Ambev (1.3 billion US dollar) and foreign exchange impact on net debt (2.3 billion US dollar decrease of net debt).

...

Practical example 4-17 below illustrates the disclosure of changes in treasury stock resulting from disposal of treasury stock through third-party allotment. *[IAS 34.16A(e)]*.

Practical example 4-17: Nippon Telegraph and Telephone Corporation (Third quarter 2021) **Japan**

Quarterly Securities Report: From October 1, 2021 to December 31, 2021 [extract]

Notes to Condensed Quarterly Consolidated Financial Statement [extract]

10. Equity and Other Equity Items [extract]

(1) Issued Shares and Treasury Stock [extract]

Reconciliation of the number of issued shares and treasury stock

(shares)

	Issued Shares	Treasury Stock
As of April 1, 2020	3,900,788,940	265,592,712
Purchase of treasury stock under resolution of the board of directors	—	93,906,900
Repurchase of treasury stock based on less-than-one-unit share purchase demand	—	62,528
Disposal of treasury stock based on additional less-than-one-unit share purchase demand	—	(10,456)
Disposal of treasury stock through third-party allotment	—	(80,775,400)
As of March 31, 2021	3,900,788,940	278,776,284
Purchase of treasury stock under resolution of the board of directors		79,358,500
Repurchase of shares based on less-than-one-unit share purchase demand	—	92,144
Disposal of treasury stock based on additional less-than-one-unit share purchase demand	—	(3,032)
Cancellation of treasury stock	(278,776,284)	(278,776,284)
As of December 31, 2021	3,622,012,656	79,447,612

In addition to the above, 1,089,760 shares held by the BIP trust are recorded as "treasury stock" in Condensed Consolidated Financial Statements.

On November 10, 2021, the Board of Directors resolved that NTT would cancel 278,776,284 of its shares on November 17, 2021, and as a result of NTT cancelling such shares on November 17, 2021, additional paid-in capital decreased by ¥1,292 million and retained earnings decreased by ¥730,623 million.

Acquisition of Toyota Motor Corporation's Shares and Disposal of Treasury Stock by Way of Third-party Allotment

On March 24, 2020, the Board of Directors resolved that NTT would enter into a memorandum of understanding for a business and capital alliance (the "Alliance") with Toyota Motor Corporation ("Toyota") and entered into the Alliance on the same day. On April 9, 2020, Toyota and NTT mutually executed a comprehensive underwriting agreement for a third-party allotment of treasury stock of both parties based on the memorandum of understanding. NTT acquired Toyota's shares and conducted a disposition of shares of the NTT's treasury stock through the third-party allotment with Toyota as the subscriber for the shares on the same day.

Overview of a disposition of shares of the NTT's treasury stock through the third-party allotment, with Toyota as the subscriber for the shares

(1) Disposition date	April 9, 2020
(2) Type and number of shares disposed	80,775,400 shares of the NTT's common stock
(3) Disposition price	¥2,476 per share
(4) Amount of funds raised	¥199,999,890,400
(5) Percentage to the total number of issued and outstanding shares held by Toyota	2.07% of the NTT's issued and outstanding common stock

4.3.15 Dividends paid

In the Practical example below, Nestlé S.A. discloses dividends paid during the interim period. *[IAS 34.16A(f)]*.

Practical example 4-18: Nestlé S.A. (Half-Year 2023) **Switzerland**

Half-Year Report January-June 2023 [extract]
Unaudited Condensed Interim Consolidated Financial Statements [extract]
Notes [extract]
8. Equity [extract]

8.2 Dividend
The dividend related to 2022 was paid on April 26, 2023, in accordance with the decision taken at the Annual General Meeting on April 20, 2023. Shareholders approved the proposed dividend of CHF 2.95 per share, resulting in a total dividend of CHF 7829 million.

4.3.16 Events after the interim reporting date

In the Practical example below, Sappi Limited reports the sale of its interest in a subsidiary and other events which took place after the end of the interim period. *[IAS 34.16A(h)]*.

Practical example 4-19: Sappi Limited (Third Quarter Results 2024) **South Africa**

Third Quarter Results for the period ended June 2024 [extract]
Condensed consolidated interim financial statements for the quarter and nine months ended June 2024 [extract]
Notes to the condensed group results [extract]

10. Events after balance sheet date

On 15 July 2024, we concluded the sale of the shares in Sappi Lanaken NV for €50 million of which €40 million will be paid in cash. The transaction is unconditional and expected to close during October 2024.

During July 2024 numerous fires, driven by extreme weather conditions, were experienced in Sappi's plantations in Mpumalanga and KwaZulu-Natal in South Africa. Approximately 7,500 hectares were burnt at an estimated cost of US$7 million (ZAR130 million).

On 17 July 2024, a fire and subsequent explosion occurred on a supplier's truck at the group's Saiccor Mill resulting in estimated damage and lost profitability of US$5 million (ZAR100 million). The mill was completely shut down for four days.

4.3.17 Changes in the composition of the entity

The notion of changes in the composition of the entity is broadly defined to include acquisitions, restructurings, obtaining or losing control of subsidiaries and long-term investments and discontinued operations. In the case of business combinations, the entity must disclose the information required by IFRS 3. *[IAS 34.16A(i)]*. See Chapter 10 at section 16.

In the Practical example below, Nine Entertainment Co. Holdings Limited discloses changes in the group structure resulting from a business combination during the interim period. The note has also explained significant judgements and estimates involved in the fair value measurements related to the business combination.

Practical example 4-20: Nine Entertainment Co. Holdings Limited (Half year 2021) **Australia**

APPENDIX 4D AND HALF YEAR FINANCIAL REPORT [extract]

Notes to the Consolidated Financial Statements for the half year ended 31 December 2021 [extract]

6. Other [extract]

6.1 Business combinations and acquisition of non-controlling interests

Acquisition of Insight Data Solutions Group

On 15 October 2021, Property Data Solutions (2) Pty Ltd, a wholly-owned subsidiary of the Domain Group, acquired 100% of the share capital in Insight Data Solutions Holdings Pty Ltd and its subsidiaries (IDS Group). The acquisition marks another step forward in executing on Domain's marketplace strategy to expand its addressable market beyond Agents and Consumers to Financial Institutions, and Government. The acquisition of the IDS Group establishes Domain as a market leading provider of land and property valuation, insights and analytics services into the Government sector, and significantly expands the size of the Property Data Solutions pillar of Domain's marketplace

A summary of the acquisition is as follows:

Entity or business acquired:	Insight Data Solutions Group
Principal activity:	Land and property valuation and insights and analytics services in the Government sector
Date of acquisition:	15 October 2021
Ownership interest as at 31 December 2021:	100%

The provisionally determined fair values of the identifiable assets and liabilities acquired are detailed below, with their measurement to be finalised within one year from the date of acquisition.

PROVISIONAL FAIR VALUE ON ACQUISITION INSIGHT DATA SOLUTIONS GROUP	$'000
Current assets	
Cash	622
Trade and other receivables	37
Total current assets	659
Non-current assets	
Intangible assets [1]	3,379
Property, plant and equipment	21
Deferred tax assets	358
Total non-current assets	3,758
Total assets	4,417
Current liabilities	
Payables	5,953
Provisions	496
Total current liabilities	6,449
Total liabilities	6,449
Total identifiable net liabilities at fair value	(2,032)
Goodwill arising on acquisition	83,643
Total identifiable net liabilities and goodwill attributable to the Group	81,611

PROVISIONAL FAIR VALUE ON ACQUISITION INSIGHT DATA SOLUTIONS GROUP	$'000
Purchase consideration	
Cash paid	54,720
Contingent consideration	26,891
Total purchase consideration	81,611
Net cash outflow on acquisition	
Cash paid	(54,720)
Cash acquired	622
Net cash outflow	(54,098)

Goodwill of $83.6 million was recognised at the time of acquisition. The goodwill comprises expected synergies arising from the acquisition. Goodwill is allocated entirely to the Domain segment. None of the goodwill recognised is expected to be deductible for income tax purposes.

Purchase Consideration

The consideration of the acquisition is to be paid in an upfront cash consideration and multiple tranches that are contingent on the future financial and commercial performance of the IDS Group, relating to securing and delivering services under new government contracts, over the performance period ending in June 2027.

The first tranche cash payment of $54.7 million was settled on 15 October 2021. Other tranches are due to be settled during the performance period between completion and June 2027.

The on target and maximum consideration for the transaction including the undiscounted contingent consideration is $134.7 and $153.7 million. The expectation at acquisition is that it will be cash settled, however, the purchase agreement allows for a portion to be settled in equity at the Board of Directors' discretion

As at the acquisition date, the discounted fair value of the contingent consideration was estimated to be $26.9 million. The fair value of the contingent consideration determined at the date of acquisition reflects the probabilities of securing certain new government contracts and achieving budgeted financial targets. As at 31 December 2021, no remeasurement charge has been recognised through profit or loss since there were no significant changes in the assumptions used from the date of acquisition.

The contingent consideration is recognised as a financial liability on the balance sheet and is measured at fair value through the profit and loss. The contingent consideration is accounted for in accordance with *AASB 9 Financial Instruments* and disclosed as a financial liability (contingent consideration) as the amount to be paid is variable, based upon the post-acquisition financial and commercial performance of the IDS Group.

AASB 3 Business Combinations allows a measurement period after a business combination to provide the acquirer a reasonable time to obtain the information necessary to identify and measure all of the various components of the business combination as of the acquisition date. The period cannot exceed one year from the acquisition date.

Costs incurred and expensed in relation to the acquisition amounted to $1.6 million as disclosed in Note 2.4.

Significant judgements, estimates and assumptions

Contingent consideration from business combinations is valued at fair value on the acquisition date as part of the business combination. When the contingent consideration meets the definition of a financial liability, it is remeasured to fair value at each reporting date with revaluations recognised within the Consolidated Statement of Profit or Loss and Other Comprehensive Income.

The determination of the fair value is based on discounted cashflows. The key assumptions include the probability and timing of meeting commercial and financial performance targets and the discount factor. Management has obtained external expert advice for these key assumptions and continues to seek further advice (where applicable) on these throughout the measurement period.

No remeasurement was required at the reporting date. Future developments with the business performance of the IDS Group will require revisions to this estimate. The maximum potential contingent consideration to be paid is $99.0 million based on the IDS Group securing and delivering specified government contracts over the earn out period ending in June 2027.

The contingent consideration is classified as an 'other payable' and is disclosed as part of 'Trade and other payables' on the Consolidated Balance Sheet.

In the Practical example below, Roche Holding Ltd discloses information on its ongoing significant restructuring activities.

Practical example 4-21: Roche Holding Ltd (Half-year 2021) Switzerland

HALF-YEAR REPORT 2021 [extract]

Notes to the Roche Group Interim Consolidated Financial Statements [extract]

7. Global restructuring plans

During the six months ended 30 June 2021 the Group expanded the implementation of various global restructuring plans initiated in prior years, including an organisational transformation in the Diagnostics Division and various resourcing optimisation initiatives in the Pharmaceuticals Division.

Global restructuring plans: costs incurred in millions of CHF

	Diagnostics	Site consolidation	Other plans	Total
Six months ended 30 June 2021				
Global restructuring costs				
– Employee-related costs	107	23	276	406
– Site closure costs	31	5	19	55
– Divestment of products and businesses	0	0	0	0
– Other reorganisation expenses	25	1	24	50
Total global restructuring costs	**163**	**29**	**319**	**511**
Additional costs				
– Impairment of goodwill	0	0	0	0
– Impairment of intangible assets	0	0	0	0
– Legal and environmental cases	0	0	0	0
Total costs	**163**	**29**	**319**	**511**

...

Diagnostics Division. During the six months ended 30 June 2021 strategy plans in the Diagnostics Division incurred costs of CHF 115 million, which were mainly employee-related.

Other global restructuring plans. During the six months ended 30 June 2021 employee-related costs mainly come from initiatives in the Pharmaceuticals Division and the outsourcing of IT and other functions to shared service centres and external providers.

...

In the Practical example below, Saudi Arabian Oil Company describes the impact of its significant divestment during the interim period.

Practical example 4-22: Saudi Arabian Oil Company (Second quarter and half year 2021) Saudi Arabia

Second quarter interim report [extract]

Notes to the condensed consolidated interim financial report [extract]

17. Sale of equity interest in subsidiary - Aramco Oil Pipelines Company ("AOPC")

On June 17, 2021, the Company sold a 49% equity interest in AOPC, a newly formed wholly-owned subsidiary of the Company, to EIG Pearl Holdings S.à r.l. ("EIG") for upfront sale proceeds of SAR 46,547 ($12,412) in cash.

EIG is an entity owned by a consortium of investors led by EIG Global Energy Partners. EIG, as a shareholder of AOPC, is entitled to receive quarterly distributions of its pro rata share of AOPC's available cash when the Company pays discretionary dividends to its ordinary shareholders. EIG's shareholding represents a non-controlling interest and, therefore, the upfront sale proceeds have been recognized in this condensed consolidated interim financial report as a non-controlling interest within equity.

Immediately prior to the closing of the transaction, the Company leased the usage rights to its stabilized crude oil pipelines network to AOPC for a 25-year period. Concurrently, AOPC granted the Company the exclusive right to use, operate and maintain the pipelines network during the 25-year period in exchange for a quarterly, volume-based tariff payable by the Company to AOPC. The tariff is backed by minimum volume commitments. The Company will at all times retain title to, and operational control of, the pipelines.

4.4 Segment information

If an entity is required to disclose segment information in its annual financial statements, certain segment disclosures are required in its interim financial report. IFRS 8 is discussed in more detail in Chapter 32.

An entity applying IFRS 8 in its annual financial statements must include the following information in its interim financial report about its reportable segments:

(a) Segment revenues from external customers (if included in the measure of segment profit or loss reviewed by or otherwise regularly provided to the chief operating decision maker).

(b) Intersegment revenues (if included in the measure of segment profit or loss reviewed by or otherwise regularly provided to the chief operating decision maker).

(c) A measure of segment profit or loss.

(d) A measure of total assets and liabilities for a particular reportable segment if such amounts are regularly provided to the chief operating decision maker and if there has been a material change from the amount disclosed in the last annual financial statements for that reportable segment.

(e) A description of differences in the basis of segmentation or in the basis of measurement of segment profit or loss from the last annual financial statements.

(f) A reconciliation of the total profit or loss for reportable segments to the entity's profit or loss before income taxes and discontinued operations. However, if an entity allocates such items as income taxes to arrive at segment profit or loss, the reconciliation can be to the entity's profit or loss after those items. The entity must separately identify and describe all material reconciling items. *[IAS 34.16A(g)]*.

In Practical example 4-23 below, Polski Koncern Naftowy ORLEN S.A. Capital Group discloses revenues, costs, financial results and increases in non-current assets in its interim financial report for the first quarter 2023. In addition, the comparative information for the three months ended 31 March 2022 is also disclosed but is not reproduced here.

Practical example 4-23: Polski Koncern Naftowy ORLEN S.A. Capital Group (First quarter 2023) **Poland**

CONSOLIDATED QUARTERLY REPORT [extract]

INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS [extract]

EXPLANATORY NOTES TO THE INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS [extract]

4. Segment's data

As at 31 March 2023 the operations of the ORLEN Group were conducted in:

- the Refining segment, which includes refinery products processing and wholesale, oil production and sale as well as supporting production,
- the Petrochemical segment, which includes the production and wholesale of petrochemicals, production and sale of chemicals and supporting production,
- the Energy segment, which includes production, distribution and sale of electricity and heat and trading in electricity,
- the Retail segment, which includes mainly activity carried out at petrol stations and activity of RUCH Group,
- the Upstream segment, which includes activity related to exploration and extraction of mineral resources conducted through the ORLEN Upstream Group, LOTOS Upstream Group, LOTOS Petrobaltic Group, PGNiG Upstream Norway,
- the Gas segment, which is a new operating segment separated as a result of the merger in 4th quarter of 2022 with the PGNiG Group and includes he sale of imported natural gas, extracted from deposits and purchased on gas exchanges, distribution of natural gas through the distribution network to individual, industrial and wholesale customers as well as operation, repairs and expansion of the distribution network;
- and Corporate Functions, which include activities related to management, administration and remaining activities not allocated to separate operating segments i.e. reconciling items.

The allocation of the ORLEN Group's companies to operating segments and Corporate Functions was presented in note 3.3.

Revenues, costs, financial results, increases in non-current assets

for the 3-months period ended 31 March 2023

	NOTE	Refining Segment (unaudited)	Petrochemical Segment (unaudited)	Energy Segment (unaudited)	Retail Segment (unaudited)	Upstream Segment (unaudited)	Gas Segment (unaudited)	Corporate Functions (unaudited)	Adjustments (unaudited)	Total (unaudited)
External revenues	5.1	27 827	4 456	13 001	13 106	1 955	49 754	171	-	110 270
Inter-segment revenues		11 515	1 197	2 318	48	5 049	6 079	239	(26 445)	-
Sales revenues		39 342	5 653	15 319	13 154	7 004	55 833	410	(26 445)	110 270
Total operating expenses		(35 712)	(6 071)	(12 635)	(13 154)	(5 543)	(50 381)	(870)	26 437	(97 929)
Other operating income	5.5	561	238	145	14	126	921	16	-	2 021
Other operating expenses	5.5	(235)	(27)	(71)	(17)	(650)	(722)	(37)	-	(1 759)
(Loss)/reversal of loss due to impairment of trade receivables		1	1	(37)	-	(15)	29	(6)	-	(27)
Share in profit from investments accounted for using the equity method		6	-	(6)	-	1	(3)	1	-	(1)
Profit/(Loss) from operations		**3 963**	**(206)**	**2 715**	**(3)**	**923**	**5 677**	**(486)**	**(8)**	**12 575**
Net finance income and costs	5.6									784
(Loss)/reversal of loss due to impairment of loans and interest on trade receivables										(14)
Profit before tax										**13 345**
Tax expense										(4 192)
Net profit										**9 153**
Depreciation and amortisation	5.2	**365**	**291**	**559**	**233**	**825**	**519**	**86**	**-**	**2 878**
EBITDA		**4 328**	**85**	**3 274**	**230**	**1 748**	**6 196**	**(400)**	**(8)**	**15 453**
Increases in non-current assets		**952**	**638**	**876**	**594**	**1 340**	**863**	**42**	**-**	**5 305**

...

Assets by operating segments

	31/03/2023 (unaudited)	31/12/2022
Refining Segment	95 222	73 034
Petrochemical Segment	25 033	23 809
Energy Segment	54 870	47 487
Retail Segment	14 773	14 539
Upstream Segment	34 533	37 547
Gas Segment	95 187	70 314
Segment assets	**319 618**	**266 730**
Corporate Functions	39 102	36 253
Adjustments	(79 716)	(30 656)
	279 004	**272 327**

Operating segments include all assets except for financial assets, tax assets and cash, which are presented as part of the Corporate Functions. Assets used jointly by the operating segments are allocated based on revenues generated by individual operating segments.

4.5 Fair value disclosures for financial instruments

IAS 34 requires that an entity must include the following in its interim financial report in relation to financial instruments: *[IAS 34.16A(j)]*

(a) Disclosures to help users of the financial statements assess the valuation techniques and inputs used to develop the fair value measurements used for financial instruments in the statement of financial position and, for financial instruments measured using unobservable inputs, the effect of those measurements on profit or loss or other comprehensive income in the period, *[IFRS 13.91]*, (see Chapter 15 at section 19.1).

(b) Certain disclosures for fair value measurements that are included in the statement of financial position after initial recognition, including the carrying amount, categorisation within the fair value hierarchy and additional disclosures for those not classified as level 1 (see Chapter 15 at section 19.3). *[IFRS 13.93]*.

(c) Accounting policy disclosures relating to how the entity has determined appropriate classes of financial assets and liabilities for which information about fair value measurement is given; how it determined when transfers between levels of the fair value hierarchy have occurred; and how the entity has measured any groups of financial assets and liabilities managed on the basis of its net exposure (see Chapter 15 at sections 19.1.2.A and 19.2). *[IFRS 13.94, IFRS 13.95, IFRS 13.96]*.

(d) Disclosures regarding liabilities measured at fair value and issued with inseparable third-party credit enhancements (see Chapter 15 at section 19.5). *[IFRS 13.98]*.

(e) Disclosures about fair value required by IFRS 7, including for each class of financial asset and financial liability, a comparison between fair value and carrying amount, unless the carrying amount is a reasonable approximation of the fair value. *[IFRS 7.25, IFRS 7.26, IFRS 7.29(a)]*.

(f) The specific disclosures required by IFRS 7 where an entity did not recognise a day one gain/loss on initial recognition of a financial asset or financial liability because the fair value was different from the transaction price and that fair value was neither evidenced by a quoted price in an active market for an identical asset or liability nor based on a valuation technique that uses only data from observable markets. *[IFRS 7.28]*. Refer to Chapter 50 at section 4.5.

Quantitative disclosures would normally be given in a tabular format unless another format is more appropriate. *[IFRS 13.99]*. The entity must assess whether the disclosures are sufficient to meet the disclosure objectives of IFRS 13 as set out in IFRS 13.91. This requires judgements to be made about the level of detail; how much emphasis to place on each of the various requirements; and level of aggregation or disaggregation. If necessary, additional information must be given in order to meet those objectives (see Chapter 15 at section 19.1). *[IFRS 13.92]*.

The general requirement in IAS 34 is to provide information related to significant events and transactions or updates to information reported in the last annual financial statements. *[IAS 34.15]*. However, the wording of IAS 34 indicates that the information related to financial instruments as described in IAS 34.16A(j) must be disclosed in the interim financial report even if there are no changes from that disclosed in the last annual financial statements. This is because the standard includes this disclosure requirement among the items required by the standard to be given "in addition to disclosing significant events and transactions…", *[IAS 34.16A]*, and therefore distinguishes this from the items listed in section 4.1 above, which are disclosed to update information presented in the most recent annual financial report. *[IAS 34.15]*. Therefore, as discussed in section 4.2 above, disclosure of the above information is required for each interim reporting period, subject only to a materiality assessment in relation to that interim report. *[IAS 34.25]*. The extent to which these disclosures are provided in the interim financial report is a matter of judgement and in making that judgement, care would need to be taken to ensure any omitted information would not make the interim financial report incomplete and therefore misleading.

An entity may also consider meeting the disclosure requirement through cross-reference to the information disclosed in other parts of the interim report as discussed in section 4.2.3 above.

The Practical example below from the first quarter financial report of Samsung Electronics Co., Ltd. illustrates disclosures related to the fair value hierarchy and valuation techniques used. The entity has applied a tabular format to disclose quantitative information, including valuation techniques and inputs, which is generally encouraged in IFRS 13.

Practical example 4-24: Samsung Electronics Co., Ltd. (Quarter ended March 31, 2022) **South Korea**

2022 Interim Business Report: For the quarter ended March 31, 2022 [extract]

III. Financial Affairs [extract]

3. Notes to consolidated financial statements [extract]

25. Financial Risk Management [extract]

(E) Fair value estimation [extract]

(2) Fair value hierarchy classifications of the financial instruments that are measured or disclosed at fair value as of March 31, 2022 and December 31, 2021 are as follows:

	March 31, 2022			
(In millions of Korean won)	**Level 1**	**Level 2**	**Level 3**	**Total balance**
1) Assets				
Short-term financial assets at fair value through profit or loss	-	31,642	21,414	53,056
Financial assets at fair value through other comprehensive income	10,783,382	-	2,418,176	13,201,558
Financial assets at fair value through profit or loss	374,950	-	1,121,172	1,496,122
Other	-	606,248	22,305	628,553
2) Liabilities				
Current Debentures	-	6,417	-	6,417
Debentures	-	533,885	-	533,885
Other	-	398,723	5,438	404,161

	December 31, 2021			
(In millions of Korean won)	**Level 1**	**Level 2**	**Level 3**	**Total balance**
1) Assets				
Short-term financial assets at fair value through profit or loss	-	35,620	5,137	40,757
Financial assets at fair value through other comprehensive income	11,608,708	-	2,357,131	13,965,839
Financial assets at fair value through profit or loss	478,401	-	1,046,943	1,525,344
Other	-	307,213	21,003	328,216
2) Liabilities				
Current Debentures	-	554,106	-	554,106
Debentures	-	546,339	-	546,339
Other	-	331,956	5,438	337,394

The levels of the fair value hierarchy and its application to financial assets and liabilities are described below.

- Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities
- Level 2: Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly
- Level 3: Inputs for the asset or liability that are not based on observable market data (that is, unobservable inputs)

The fair value of financial instruments traded in active markets is based on quoted market prices at the statements of financial position date. A market is regarded as active if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service, or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. The quoted market price used for financial assets held by the Company is the current bid price. These instruments are included in Level 1. The instruments included in Level 1 are listed equity investments, most of which are classified as financial assets at fair value through other comprehensive income.

The fair value of financial instruments that are not traded in an active market (for example, over-the-counter derivatives) is determined by using valuation techniques. These valuation techniques maximize the use of observable market data where it is available and rely as little as possible on entity-specific estimates. If all significant inputs required to fair value an instrument are observable, the instrument is included in Level 2.

If one or more of the significant inputs are not based on observable market data, the instrument is included in Level 3.

The Company performs the fair value measurements required for financial reporting purposes, including Level 3 fair values and discusses valuation processes and results at least once every quarter in line with the Company's quarterly reporting dates. The Company's policy is to recognize transfers between levels at the end of the reporting period, if corresponding events or changes in circumstances have occurred.

Specific valuation techniques used to value financial instruments include:

- Quoted market prices or dealer quotes for similar instruments
- The fair value of forward foreign exchange contracts is determined using forward exchange rates at the statements of financial position date, with the resulting value discounted back to present value

Other techniques, such as discounted cash flow analysis, are used to determine fair value for the remaining financial instruments. For trade and other receivables that are classified as current assets, the book value approximates a reasonable estimate of fair value.

(3) Valuation technique and the inputs

The Company utilizes a present value technique to discount future cash flows using a proper interest rate for corporate bonds, government and public bonds, and bank debentures that are classified as Level 2 in the fair value hierarchy.

The following table presents the valuation technique and the inputs used for major financial instruments classified as Level 3 as of March 31, 2022.

(In millions of Korean won and percentage)

Classification	Fair value	Valuation technique	Level 3 inputs	Input range (Weighted average)
Financial assets at fair value through other comprehensive income				
Samsung Venture Investment	27,331	Discounted cash flow	Permanent growth rate	-1.0%~1.0%(0.0%)
			Weighted average cost of capital	19.3%~21.3%(20.3%)
MiCo Ceramics Co., Ltd.	25,666	Discounted cash flow	Permanent growth rate	-1.0%~1.0%(0.0%)
			Weighted average cost of capital	13.2%~15.2%(14.2%)
TCL China Star Optoelectronics Technology Co., Ltd. (CSOT)	1,349,356	Discounted cash flow	Permanent growth rate	-1.0%~1.0%(0.0%)
			Weighted average cost of capital	11.1%~13.1%(12.1%)
China Star Optoelectronics Semiconductor Display Technology Ltd. (CSOSDT)	402,939	Discounted cash flow	Permanent growth rate	-1.0%~1.0%(0.0%)
			Weighted average cost of capital	11.1%~13.1%(12.1%)
Others				
Put option on equity instruments	22,305	Binomial model	Risk-free discount rate	2.4%~2.5%, 2.5%
			Price volatility	19.2%~29.2%(24.2%)
				24.3%~34.3%(29.3%)

4.6 Disclosure of compliance with IFRS accounting standards

If an interim financial report complies with the requirements of IAS 34, this fact must be disclosed. Furthermore, an interim financial report cannot be described as complying with IFRS accounting standards unless it complies with all the requirements of IFRS accounting standards, *[IAS 34.19]*, a requirement similar to that found in IAS 1. *[IAS 1.16]*. Therefore, an entity would only provide a statement of compliance with IFRS accounting standards (as opposed to IAS 34 alone) in its interim report if it prepared a complete set of interim financial statements.

The Practical example below illustrates basis of preparation of an entity that asserts compliance with IAS 34 in its interim financial report rather than with IFRS accounting standards.

Practical example 4-25: BMW Group (Half-year 2022) **Germany**

HALF-YEAR REPORT: 30 June 2022 [extract]

INTERIM GROUP FINANCIAL STATEMENTS [extract]

NOTES TO THE GROUP FINANCIAL STATEMENTS [extract]

ACCOUNTING PRINCIPLES AND POLICIES [extract]

01 Basis of preparation [extract]

The consolidated financial statements of Bayerische Motoren Werke Aktiengesellschaft (BMW Group Financial Statements or Group Financial Statements) at 31 December 2021 were drawn up in accordance with International Financial Reporting Standards (IFRS), as endorsed by the European Union (EU), and the supplementary requirements of § 315e (1) of the German Commercial Code (HGB). The Interim Group Financial Statements (Interim Report) at 30 June 2022, which have been prepared in accordance with International Accounting Standard (IAS) 34 (Interim Financial Reporting), have been drawn up using, in all material respects, the same accounting methods as those utilised in the 2021 Group Financial Statements. The BMW Group applies the option of publishing condensed group financial statements. All Interpretations issued by the IFRS Interpretations Committee which are mandatory at 30 June 2022 have been applied. The Interim Report also complies with German Accounting Standard No. 16 (GAS 16) – Interim Financial Reporting – issued by the German Accounting Standards Committee e. V. (GASC).

...

When entities either choose or are required by local regulations to meet other requirements in addition to IAS 34, the statement of compliance can be more complicated. In Practical example 4-25 above, BMW Group simply adds a statement confirming its compliance with the specific German Accounting Standard on interim reporting and the supplementary requirements of the German Commercial Code. Additional complexity can arise when the entity seeks to meet the requirements of its (IFRS-based accounting standards) local GAAP as well as IFRS accounting standards as issued by the IASB.

Practical example 4-26 below shows how the dual listed BHP Group Plc disclosed compliance with the requirements of IFRS accounting standards, Australian Accounting Standards and the requirements of the Financial Conduct Authority in the United Kingdom in respect of their interim financial report.

Practical example 4-26: BHP Group Plc (Half year ended 31 December 2021) **Australia**

BHP RESULTS FOR THE HALF YEAR ENDED 31 DECEMBER 2021 [extract]

BHP Financial Report: Half year ended 31 December 2021

Notes to the Financial Statements [extract]

1. Basis of preparation

This general purpose Financial Report for the half year ended 31 December 2021 is unaudited and has been prepared in accordance with IAS 34 'Interim Financial Reporting' as issued by the International Accounting Standards Board (IASB) and AASB 134 'Interim Financial Reporting' as issued by the Australian Accounting Standards Board (AASB) and the Disclosure and Transparency Rules of the Financial Conduct Authority in the United Kingdom and the Australian Corporations Act 2001 as applicable to interim financial reporting.

...

The Practical example above also highlights a potential compliance issue for adopters of IFRS-based accounting standards, such as entities in Australia, the United Kingdom and the European Union. Because of the time taken to secure local endorsement of standards issued by the IASB, an entity may not be able to state at a particular reporting date that the financial statements comply with both IFRS accounting standards as issued by the IASB and IFRS accounting standards as endorsed locally.

For example, when the IASB issues a new accounting standard or an amendment that is effective for the annual period which includes the current interim reporting period, entities may not be able to, or cannot risk to, comply with IAS 34 (as issued by the IASB) in their interim financial statements, either because there is a requirement to apply locally endorsed standards in the interim financial statements or to avoid the risk of applying a new standard or an amendment in their full year financial statements that is not yet locally endorsed. The alternative would be for an entity to publish interim financial information prepared under locally endorsed standards, for example, IFRS accounting standards as endorsed by the European Union. In such cases, the basis of preparation must state that IAS 34 is being applied in this context.

4.7 Disclosure in relation to the going concern assumption

Although IAS 34 does not specifically address the issue of going concern, the general requirements of IAS 1 apply to both a complete set and to condensed interim financial statements. *[IAS 1.4]*. IAS 1 states that when preparing financial statements, management assesses an entity's ability to continue as a going concern, and that the financial statements are prepared on a going concern basis unless management either intends to liquidate the entity or cease trading or has no realistic alternative but to do so. *[IAS 1.25]*. The going concern assessment is discussed in more detail in Chapter 3 at section 4.1.2.

Under IAS 1, the assessment is made based on all available information about the future, which at a minimum is twelve months from the end of the reporting period. *[IAS 1.26]*. Therefore, with respect to interim reporting under IAS 34, the minimum period for management's assessment is also at least twelve months from the interim reporting date; it is not limited, for example, to one year from the date of the most recent annual financial statements. In fact, local stock market requirements and other regulations might set a longer minimum period over which management are required to assess entity's ability to continue as a going concern, for example, to consider a minimum period of twelve months after the date of approval of the interim financial statements.

Illustration 4-2: Going concern assessment under IAS 1

An entity's financial year-end is 31 December (calendar year) and its annual financial statements as of 31 December 20X1 are prepared on a going concern basis. In assessing the going concern assumption as at 31 December 20X1, management considered all future available information through to 31 December 20X2.

In preparing its quarterly interim financial statements (condensed or complete) as at 31 March 20X2, management must evaluate all future available information to at least 31 March 20X3.

If management becomes aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity must disclose those uncertainties in its interim financial statements. If the entity does not prepare financial statements on a going concern basis, it must disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern. *[IAS 1.25]*. The requirements in paragraph 25 of IAS 1 also applies to interim financial statements. *[IAS 1.4]*.

In its 2022 interim report, Vesuvius plc considers a period of at least twelve months after the date of approval of the interim financial statements, in accordance with local regulatory requirements.

Practical example 4-27: Vesuvius plc (Half-year 2022) **United Kingdom**

Half Year Results for the six months ended 30 June 2022 [extract]

Notes to the Condensed Group Financial Statements [extract]

Basis of preparation [extract]

1.3 Going concern

The Directors have prepared cash flow scenarios for the Group for a period at least 12 months from the date of approval of the 2022 Interim Condensed Financial Statements. These forecasts reflect an assessment of current and future end market conditions, including the impact of covid-related lockdowns in China and war in Ukraine, and their impact on the Group's future trading performance. The analysis undertaken includes a severe but plausible downside scenario which assumes a decline in business activity and profitability in H2 2022 to the level achieved in H2 2020. Relative to H1 2022, this implies an c.30% decline in sales and a c.60% decline in Trading Profit, with no improvement from this level assumed in 2023. Even in this downside scenario, the forecasts show that the Group's maximum net debt / EBITDA (pre-IFRS 16 in-line with the covenant calculation) does not exceed 1.0x, compared to a leverage covenant of 3.25x.

On the basis of the exercise described above and the Group's available committed liquidity which stands at £416m at 30 June 2022, the Directors consider that the Group and the Company have adequate resources to continue in operational existence for a period of at least 12 months from the date of signing of these Interim Condensed Financial Statements. Accordingly, they continue to adopt a going concern basis in preparing the Condensed Financial statements of the Group and the Company.

5 Periods for which interim financial statements are required to be presented

Irrespective of whether an entity presents condensed or complete interim financial statements, the components of its interim reports must include information required by IAS 34.20. *[IAS 34.20]*.

Extract from IAS 34

20 Interim reports shall include interim financial statements (condensed or complete) for periods as follows:

(a) statement of financial position as of the end of the current interim period and a comparative statement of financial position as of the end of the immediately preceding financial year.

(b) statements of profit or loss and other comprehensive income for the current interim period and cumulatively for the current financial year to date, with comparative statements of profit or loss and other comprehensive income for the comparable interim periods (current and year-to-date) of the immediately preceding financial year. As permitted by IAS 1 (as amended in 2011), an interim report may present for each period a statement or statements of profit or loss and other comprehensive income.

(c) statement of changes in equity cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

(d) statement of cash flows cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

An interim report may present for each period either a single statement of 'profit or loss and other comprehensive income', or separate statements of 'profit or loss' and 'comprehensive income'. *[IAS 1.10A, IAS 34.20(b)]*. The condensed statement of comprehensive income referred to at (b) above must be presented in a manner consistent with the entity's annual financial statements. Accordingly, if the entity presents a separate statement for items of profit or loss in its annual financial statements, it must present a separate condensed statement of profit or loss in the interim financial report. *[IAS 34.8A]*.

If an entity's business is highly seasonal, then the standard encourages reporting additional financial information for the twelve months up to the end of the interim period, and comparative information for the prior twelve-month period, in addition to the financial statements for the periods set out above. *[IAS 34.21]*.

The standard does not require an entity to present a statement of financial position as at the end of the comparable interim period. However, in practice many entities reporting under IFRS accounting standards disclose this information, either on a voluntary basis, or due to local regulations. Similarly, many entities also present the income statement for the immediately preceding full year. Such presentation is allowed under IAS 34. See section 5.1.4 below regarding the requirement to present a third statement of financial position.

The examples below illustrate the periods that an entity is required to disclose under IAS 34. *[IAS 34.22, IAS 34.IE A]*.

Illustration 5-1: Entity publishes interim financial reports half-yearly

If an entity's financial year ends on 31 December (calendar year), it must present the following financial statements (condensed or complete) in its half-yearly interim financial report as of 30 June 20X3:

Half-yearly interim report	End of the current interim period	End of the comparative interim period	Immediately preceding year-end
	30/6/20X3	30/6/20X2	31/12/20X2
Statement of financial position	●		●
Statement(s) of profit or loss and other comprehensive income			
▸ Current period and year-to-date (6 months) ending	●	●	
▸ 12 months ending	○	○	
Statement of changes in equity			
▸ Year-to date (6 months) ending	●	●	
▸ 12 months ending	○	○	
Statement of cash flows			
▸ Year-to-date (6 months) ending	●	●	
▸ 12 months ending	○	○	
● Required			
○ Disclosure encouraged if the entity's business is highly seasonal			

If an entity publishes a separate interim financial report for the final interim period (i.e., second half of its financial year), it presents the following financial statements (condensed or complete) in its second half-yearly interim financial report as of 31 December 20X3:

Second half-yearly interim report	End of the current interim period	End of the comparative interim period
	31/12/20X3	31/12/20X2
Statement of financial position	●	●
Statement(s) of profit or loss and other comprehensive income		
▸ Current period (6 months) ending	●	●
▸ Year-to-date (12 months) ending	●	●
Statement of changes in equity		
▸ Year-to-date (12 months) ending	●	●
Statement of cash flows		
▸ Year-to-date (12 months) ending	●	●
● Required		

Illustration 5-2: Entity publishes interim financial reports quarterly

If an entity's financial year ends on 31 December (calendar year), it must present the following financial statements (condensed or complete) in its quarterly interim financial report for the first quarter of 20X3:

First quarter interim report	End of the current interim period	End of the comparative interim period	Immediately preceding year-end
	31/3/20X3	31/3/20X2	31/12/20X2
Statement of financial position	●		●
Statement(s) of profit or loss and other comprehensive income			
▸ Current period and year-to-date (3 months) ending	●	●	
▸ 12 months ending	○	○	
Statement of changes in equity			
▸ Year-to-date (3 months) ending	●	●	
▸ 12 months ending	○	○	
Statement of cash flows			
▸ Year-to-date (3 months) ending	●	●	
▸ 12 months ending	○	○	
● Required			
○ Disclosure encouraged if the entity's business is highly seasonal			

Second quarter interim report	End of the current interim period	End of the comparative interim period	Immediately preceding year-end
	30/6/20X3	30/6/20X2	31/12/20X2
Statement of financial position	●		●
Statement(s) of profit or loss and other comprehensive income			
▸ Current period (3 months) ending	●	●	
▸ Year-to-date (6 months) ending	●	●	
▸ 12 months ending	○	○	
Statement of changes in equity			
▸ Year-to-date (6 months) ending	●	●	
▸ 12 months ending	○	○	
Statement of cash flows			
▸ Year-to-date (6 months) ending	●	●	
▸ 12 months ending	○	○	
● Required			
○ Disclosure encouraged if the entity's business is highly seasonal			

Third quarter interim report	End of the current interim period	End of the comparative interim period	Immediately preceding year-end
	30/9/20X3	30/9/20X2	31/12/20X2
Statement of financial position	●		●
Statement(s) of profit or loss and other comprehensive income			
▸ Current period (3 months) ending	●	●	
▸ Year-to-date (9 months) ending	●	●	
▸ 12 months ending	○	○	
Statement of changes in equity			
▸ Year-to-date (9 months) ending	●	●	
▸ 12 months ending	○	○	
Statement of cash flows			
▸ Year-to-date (9 months) ending	●	●	
▸ 12 months ending	○	○	
● Required			
○ Disclosure encouraged if the entity's business is highly seasonal			

If an entity publishes a separate interim financial report for the final interim period (i.e., fourth quarter of its financial year), it presents the following financial statements (condensed or complete) in its fourth quarter interim financial report as of 31 December 20X3:

Fourth quarter interim report	End of the current interim period	End of the comparative interim period
	31/12/20X3	31/12/20X2
Statement of financial position	●	●
Statement(s) of profit or loss and other comprehensive income		
▸ Current period (3 months) ending	●	●
▸ Year-to-date (12 months) ending	●	●
Statement of changes in equity		
▸ Year-to-date (12 months) ending	●	●
Statement of cash flows		
▸ Year-to-date (12 months) ending	●	●
● Required		

5.1 Other comparative information

The extent to which comparative information is required in the notes to the interim financial statements will depend on whether the entity has satisfied the requirements of IAS 34 by the preparation of a set of condensed financial statements or by the preparation of a complete set of financial statements.

5.1.1 Complete set of financial statements

Paragraph 4 of IAS 1 clarifies that IAS 1 is not applicable to condensed interim financial statements prepared under IAS 34 except for IAS 1.15 to 35. However, for entities presenting a complete set of financial statements the requirements of IAS 1.38 will apply, although these requirements need to be considered in the context of the requirements in IAS 34.20 (discussed in section 5 above). *[IAS 1.38]*. Further, IAS 34.9 clarifies that the form and content of complete set of financial statements published as interim financial report must conform with the requirements of IAS 1 for a complete set of financial statements. Accordingly, the requirement to present comparative information in the notes to a set of complete financial statements also applies to a set of complete financial statements prepared to comply with IAS 34.

Extract from IAS 1	
38	**Except when IFRSs permit or require otherwise, an entity shall present comparative information in respect of the preceding period for all amounts reported in the current period's financial statements. An entity shall include comparative information for narrative and descriptive information if it is relevant to understanding the current period's financial statements.**

5.1.2 Disclosure of movement in non-current assets and liabilities

Illustration 5-3: Disclosing movements on non-current assets in a complete set of interim financial statements

An entity preparing complete IFRS accounting financial statements is required to reconcile the carrying amount at the beginning and end of the period showing movements during that period for both intangible assets and property, plant and equipment. *[IAS 38.118, IAS 16.73]*. Therefore, an entity presenting complete IFRS accounting financial statements for the six months ended 30 June 20X2 would disclose the movements in intangible assets and in property, plant and equipment between 1 January 20X2 and 30 June 20X2.

How we see it

In our view, when interim financial statements are prepared as a complete set of financial statements in accordance with IAS 1, the comparative information on movements in assets and liabilities is for the corresponding interim period. Therefore, in a set of half-year financial statements, the comparative information will be for the first six months of the previous year. Accordingly, IAS 1 requires the entity, in the fact pattern above, to reconcile movements during the comparative interim period, between 1 January 20X1 and 30 June 20X1, even though the entity is not required to present a statement of financial position as at 30 June 20X1 (as shown in Illustration 5-1 in section 5 above).

IAS 1 is written in the context of annual financial statements and the comparative information is generally expected to be for a 12-month period. However, for the purpose of interim financial reports, IAS 1.38 (that includes the requirement for minimum comparative information, see Chapter 3 at section 2.4) is read in conjunction with IAS 34.20 (that includes the requirement about the periods for which interim financial statements are presented, see section 5 above). Then it is clear that in the context of interim financial reports 'the previous period' is not the annual period, but the previous interim period, as the purpose of the information is to facilitate an understanding of performance in the current period.

The components of the financial statements that reflect performance for the period (e.g., the statements of comprehensive income, cash flow and changes in equity) are required to include comparative statements for the comparable interim period of the immediately preceding financial year. Therefore, to be consistent, all notes indicating activity for the interim period (i.e., the movement in assets and liabilities for the period) include information for the comparable interim period of the immediately preceding financial year.

Because the comparative statement of financial position required by IAS 34 reflects the end of the preceding financial year, the closing balance in the movement schedule for the comparative period will not reconcile to the comparative statement of financial position. Therefore, in addition to presenting comparative information for the corresponding interim period, it is suggested that entities preparing a complete set of interim financial statements also include information for the previous full year in the case of the statement of financial position, such as the required comparative information for the current interim period and reconciliations to the previous year-end statement of financial position. In Illustration 5-3 above, this requirement could be achieved by reconciling movements in non-current assets during the second six months of the previous year (between 1 July 20X1 and 31 December 20X1) or alternatively could present comparative reconciliations from 1 January 20X1 to 30 June 20X1 and from 1 January 20X1 to 31 December 20X1.

For explanatory notes that analyse and explain the balances in the statement of financial position as at the period end (such as information on the carrying amount of inventories as required by IAS 2 *Inventories*), entities must consider including such notes supporting the statement of financial position as at the end of the preceding financial year.

5.1.3 Condensed financial statements

For entities presenting condensed financial statements under IAS 34, there is no explicit requirement that comparative information be presented in the explanatory notes. Where an explanatory note is required by the standard (such as for inventory write-downs, impairment provisions, segment revenues etc.) or otherwise determined to be needed to provide useful information about changes in the financial position and performance of the entity since the end of the last annual reporting period, *[IAS 34.15]*, entities must consider whether to provide explanatory notes for each period presented. However, in certain cases it would be unnecessary to provide comparative information where this repeats information that was reported in the notes to the most recent annual financial statements. *[IAS 34.15A]*. For example, it would only be necessary to provide information about business combinations in a comparative period when there is a revision of previously disclosed fair values. Further, entities preparing condensed financial statements under IAS 34 must also consider the discussion in section 5.1.2 above regarding the disclosure of movements in non-current assets and liabilities.

5.1.4 Third statement of financial position

If an entity presents complete financial statements and restates comparative information (e.g., following a change in accounting policy, correction of an error, or reclassification) and this restatement is material, then the entity must present a third statement of financial position at the beginning of the earliest comparative period in its interim financial reporting accordance with IAS 1. *[IAS 1.10(f)]*. The requirement to present a third statement of financial position is in addition to a comparative statement of financial position as of the end of the immediately preceding financial year. *[IAS 34.20(a)]*. No such requirement to present a third statement of financial position applies in the case of an entity preparing a condensed set of interim financial statements, *[IAS 1.BC33]*, however, additional disclosures are required in the case of correction of prior period errors, *[IAS 34.15B(g)]*, or when accounting policies are changed, *[IAS 34.16A(a)]*, (see section 4.3.11 above).

5.2 Length of interim reporting period

IAS 34 does not limit interim reporting to quarterly or half-yearly periods; an interim period may be any period shorter than a full financial year. *[IAS 34.4]*. Nevertheless, interim reporting for a period other than quarterly or half-yearly is not a common practice.

5.3 Change in financial year-end

The requirement in IAS 34 to present a comparative statement of profit or loss and other comprehensive income "for the comparable interim periods (current and year-to-date) of the immediately preceding financial year…", *[IAS 34.20]*, can give rise to diversity in practice in the case of an entity that changes its annual financial reporting date. For example, an entity changing its reporting date from 31 December to 31 March would change its half-yearly reporting date from 30 June to 30 September and therefore, present its first half-yearly report after its new annual reporting date for the six-month period from 1 April to 30 September. A 'comparable' comparative interim period in this scenario could be taken to mean the six months ended 30 September in the prior year, as illustrated in Illustration 5-4 below.

Illustration 5-4: Entity changes financial year-end

An entity changes its financial year-end from 31 December (calendar year) to 31 March, and first reflects the change in its annual financial statements for the period ended 31 March 20X2. It determines that the requirement for comparable comparative information in IAS 34 requires it to present the following financial statements (condensed or complete) in its half-yearly interim financial report for the six months ending 30 September 20X2:

Half-yearly interim report	End of the current interim period	End of the comparative interim period	Immediately preceding year-end
	30/9/20X2	30/9/20X1	31/03/20X2
Statement of financial position	●		●
Statement(s) of profit or loss and other comprehensive income			
▸ Current period and year-to-date (6 months) ending	●	●	
▸ 12 months ending	○	○	
Statement of changes in equity			
▸ Year-to date (6 months) ending	●	●	
▸ 12 months ending	○	○	
Statement of cash flows			
▸ Year-to-date (6 months) ending	●	●	
▸ 12 months ending	○	○	
● Required			
○ Disclosure encouraged if the entity's business is highly seasonal			

The entity in the Illustration above did not show information for the half-year ended 30 June 20X1 as the comparative period, notwithstanding the fact that this period would have been the reporting date for the last published half-yearly report.

Other interpretations of IAS 34 in this regard are also possible. As illustrated in the Practical example below, Sirius Minerals Plc changed its annual financial reporting period-end from March to December, which resulted in the company reporting on a shorter (nine-month) annual financial period ended 31 December 2015. For its next set of condensed interim financial statements (for the six months ended 30 June 2016), Sirius Minerals Plc presented comparative information for the first six months of the previous annual financial period, being the six months ended 30 September 2015. The company has also included information for the previous annual reporting period (in this case the shortened nine-month period ended 31 December 2015), in common with many United Kingdom reporters who present comparative information for the previous annual reporting period in addition to the information required by IAS 34.

Practical example 5-1: Sirius Minerals Plc (Half-year 2016) **United Kingdom**

CONDENSED INTERIM UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS [extract]

For the six-month period ended 30 June 2016 [extract]

NOTES TO THE FINANCIAL STATEMENTS [extract]

1. ACCOUNTING POLICIES [extract]

BASIS OF PREPARATION

The condensed interim unaudited consolidated financial statements for the six-month period ended 30 June 2016 have been prepared in accordance with the Disclosure and Transparency Rules of the Financial Conduct Authority and with IAS 34 'Interim Financial Reporting' as adopted by the European Union ("EU"). As a result of changing the accounting reference date, from 31 March to 31 December, these financial statements should be read in conjunction with the condensed financial statements for the six-month period ended 30 September 2015 which have been prepared in accordance with IFRSs as adopted by the EU. Comparability with the current period is maintained due to the low seasonality of the Group's operations.

The accounting policies applied are consistent with those of the Group financial statements for the nine-month period ended 31 December 2015, which have also been voluntarily included in these financial statements for reference.

How we see it

Given the lack of clarity in IAS 34 as to the meaning of 'comparable' in the case where the current financial year runs for a period that is different to 'the immediately preceding financial year', in our view, there are arguments to support each of the interpretations shown in Illustration 5-4 and Practical example 5-1 above.

In the Practical example above, Sirius Minerals Plc noted that it had considered seasonality of its operations in determining whether the information presented for a prior interim period is comparable. As noted in section 5 above and illustrated in Illustration 5-2 in that section, in cases where the entity's business is highly seasonal, IAS 34 encourages the reporting of additional financial information for the twelve months up to the end of the interim period, and comparative information for the prior twelve-month period, in addition to the financial statements for the periods set out above. *[IAS 34.21]*.

5.4 Comparatives following a financial period longer than a year

The discussion in section 5.3 above demonstrates that when an entity changes its annual reporting date, the determination of comparative periods in the interim financial statements could be interpreted differently without definitive guidance in IAS 34.

Another situation where confusion may be caused by the requirement to present comparative information for "the comparable interim periods (current and year-to-date) of the immediately preceding financial year…", *[IAS 34.20]*, arises when the previous annual financial statements related to a period other than twelve months. This situation is not uncommon for a newly incorporated entity, which might have either a shorter or a longer reporting period in its first financial year.

Consider an entity that has a long initial accounting period of eighteen months and that is required to prepare interim financial reports on a quarterly basis. Accordingly, it would have six 'quarters' in its first financial reporting period and in line with the requirements of IAS 34, the entity would present statements of profit or loss and other comprehensive income, changes in equity and cash flows for each three-month period and cumulatively for the year-to-date. In the next financial year, however, the previously published year-to-date amounts would no longer be comparable. The following Illustration shows this situation.

Illustration 5-5: Disclosing comparatives in interim financial statements when the preceding financial year covers a longer period

An entity's financial year-end is 31 December and it issues quarterly interim financial statements. It was incorporated on 1 July 20X0 and prepared its first set of 'annual' financial statements for a period of eighteen months to 31 December 20X1. In this period, the entity prepared interim financial statements under IAS 34 for each of the three-month periods ended 30 September 20X0, 31 December 20X0, 31 March 20X1, 30 June 20X1, 30 September 20X1 and 31 December 20X1. Each interim report contained information for the three-month period (statement of profit or loss and other comprehensive income) and the year-to-date (statements of profit or loss and other comprehensive income, cash flows, and changes in equity), which started on 1 July 20X0.

In the next year, a twelve-month annual reporting period, the entity is preparing its interim financial report for the three months ending and year-to-date 30 June 20X2. Accordingly, it presents statements of profit or loss and other comprehensive income for the three-month period from 1 April 20X2 to 30 June 20X2 and presents statements of profit or loss and other comprehensive income, changes in equity and cash flows for the year-to-date (from 1 January 20X2 to 30 June 20X2). Under IAS 34, the entity is also required to present comparative statements of profit or loss and other comprehensive income, cash flows, and changes in equity for the comparable interim periods in the preceding financial year. However, in its interim report for the three months ended 30 June 20X1, i.e., in the prior financial year, the entity had presented information for the three month period from 1 April 20X1 to 30 June 20X1 (statements of profit or loss and other comprehensive income) as well as for the year-to-date period, from 1 July 20X0 to 30 June 20X1 (statements of profit or loss and other comprehensive income, changes in equity and cash flows), which was then a period of twelve months.

The entity determines that the year-to-date comparative statements would cover the same period in the preceding year as the current year, which in this case would be for the three-month period from 1 April 20X1 to 30 June 20X1 and for the six-month period from 1 January 20X1 to 30 June 20X1.

It must be noted in the above Illustration that none of the interim financial statements issued in the entity's first (eighteen month) reporting period would contain comparative information. In particular, no comparatives would be required for the three-month periods ended 30 September 20X1 and 31 December 20X1 because the corresponding periods in the preceding calendar year (i.e., 30 September 20X0 and 31 December 20X0) actually form part of the same (eighteen month) financial period and therefore comparatives from a preceding financial reporting period did not exist.

5.5 When the comparative period is shorter than the current period

The same considerations apply when determining the comparable comparative period in the following circumstances when a newly incorporated entity's first financial year was less than twelve months.

Illustration 5-6: Disclosing comparatives in interim financial statements when the preceding financial year covers a shorter period

An entity was incorporated on 17 December 20X1 and its equity shares were admitted to trading on a recognised stock market in April 20X2. It determined that its annual reporting date will be 30 June each year and issued its first set of annual financial statements for the period ended 30 June 20X2.

In compliance with the rules of the stock market, the entity issues its first half-yearly report for the six months ended 31 December 20X2. This begs the question whether the comparative period for these interim financial statements would be the short period from 17 December 20X1 (i.e., the date of incorporation) to 31 December 20X1 or the first six months following the entity's incorporation, from 17 December 20X1 to 16 June 20X2.

As in Illustration 5-5 in section 5.4 above, the entity could determine that the period-to-date comparative statements would cover the same period in the preceding annual reporting period as the current year, which in this case would be from 17 December 20X1 to 31 December 20X1. The entity must provide sufficient disclosure to explain the particular circumstances and the limited comparability with the current period.

6 Materiality

In making judgements on recognition, measurement, classification, or disclosures in interim financial reports, the overriding goal in IAS 34 is to ensure that an interim financial report includes all information relevant to understanding an entity's financial position and performance during the interim period. *[IAS 34.25]*. The standard refers to IAS 1, which defines information as material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity. *[IAS 1.7, IAS 34.24]*. However, IAS 34 notes that IAS 1 does not contain quantitative guidance on materiality. *[IAS 34.23]*. IAS 34 requires materiality to be assessed based on the interim period financial data. *[IAS 34.23]*.

Therefore, decisions on the recognition and disclosure of unusual items, changes in accounting policies or estimates, and errors are based on materiality in relation to the interim period figures to determine whether non-disclosure is misleading. *[IAS 34.25]*.

Neither the previous year's annual financial statements nor any expectations of the financial position at the current year-end are relevant in assessing materiality for interim reporting. However, the standard acknowledges that interim measurements may rely on estimates to a greater extent than measurements of annual financial data. *[IAS 34.23]*.

IFRS Practice Statement 2 is a non-mandatory statement and does not form part of IFRS accounting standards. See Chapter 3 at section 4.1.8 for a discussion on PS 2.

PS 2 includes guidance that specifically relates to materiality judgements for interim reporting. Whilst an entity considers the same materiality factors as in its annual assessment, it would also take into consideration the shorter time period and the different purpose of an interim financial report in the following respects:

(a) Assessing whether information in the interim financial report is material in relation to the interim period financial data, not annual data. *[IAS 34.25]*.

(b) Applying the materiality factors on the basis of both the current interim period data and also, whenever there is more than one interim period (e.g., in the case of quarterly reporting), the data for the current financial year to date.

(c) Considering whether to provide in the interim financial report information that is expected to be material to the annual financial statements. However, information that is expected to be material to the annual financial statements need not be provided in the interim financial report if it is not material to the interim financial report. *[PS 2.85]*.

As regards purpose, the guidance suggests that entities also have regard to the fact that an interim financial report is intended to provide an update on the latest complete set of annual financial statements. Information that is material to the interim period, but was already provided in the latest annual financial statements, does not need to be reproduced in the interim financial report, unless something new occurs or an update is needed. *[IAS 34.15, IAS 34.15A, PS 2.87]*.

When an entity concludes that information about estimation uncertainty is material, it needs to disclose that information. As discussed in section 10 below, measurements included in interim financial reports often rely more on estimates than measurements included in the annual financial statements. *[IAS 34.41]*. That fact does not, in itself, make the estimated measurements material. Nevertheless, relying on estimates for interim financial data to a greater extent than for annual financial data might result in more disclosures about such uncertainties being material, and thus, being provided in the interim financial report, compared with the annual financial statements. *[PS 2.88]*.

7 Disclosure in annual financial statements

An estimate of an amount reported in an interim period can change significantly during the remainder of the year. An entity that does not present a separate interim financial report for its final interim period must disclose the nature and amount of significant changes in estimates in a note to the annual financial statements for that year. *[IAS 34.26]*. This disclosure requirement is intended to be narrow in scope, relating only to the change in estimate, and does not create a requirement to include additional interim period financial information in the annual financial statements. *[IAS 34.27]*.

The requirement to disclose significant changes in estimates since the previous interim reporting date is consistent with IAS 8 and IAS 34.16A(d). These standards require disclosure of the nature and the amount of a change in estimate that has a material effect in the current reporting period or is expected to have a material effect in subsequent periods. IAS 34 cites changes in estimates in the final interim period relating to inventory write-downs, restructurings, or impairment losses recognised in an earlier interim period as examples of items that are required to be disclosed. *[IAS 34.27]*.

As noted above, IAS 34.27 clarifies that the requirements in paragraph 26 are narrow in scope and only relate to changes in estimates. This raises the question as to what, if any, disclosures are required in the annual financial statements for that year if an entity identifies an error in amounts reported in the interim financial report before the annual financial statements are issued. IAS 34 does not include specific requirements for disclosure in relation to an error identified in an interim financial report. However, IAS 1.17(c) requires entities to provide additional information to achieve fair presentation and IAS 1.112(c) requires notes to provide additional information if it is relevant to the understanding of the financial statements (see Chapter 3 at section 3.4 and section 4.1.1.A). Therefore, an entity that prepares interim financial reports applying IAS 34 considers the principles in paragraph 26 by analogy and the requirements in IAS 1 to determine whether to disclose the nature and amount of the error in a note to the financial statements for that year.

8 Recognition and measurement

The recognition and measurement requirements in IAS 34 arise mainly from the requirement to report the entity's financial position as at the interim reporting date, but also requires certain estimates and measurements to take into account the expected financial position of the entity at year-end, where those measures are determined on an annual basis (as in the case of income taxes). Some preparers misinterpret this approach as representing some form of hybrid of the discrete and integral methods to interim financial reporting wherein an entity applies the same accounting policies and principles used in the annual financial statements, however, modified to defer or accrue items of income or expenses to indicate the expected outcome for the year as a whole. This can cause confusion in application and can lead to the accusation that IAS 34 seems internally inconsistent.

In requiring the year-to-date to be treated as a discrete period, IAS 34 prohibits the recognition or deferral of revenues and costs for interim reporting purposes unless such recognition or deferral is appropriate at year-end. As with a set of annual financial statements complying with IAS 8, IAS 34 requires changes in estimates and judgements reported in previous interim periods to be revised prospectively, whereas changes in accounting policies and errors are required to be recognised by prior period adjustment. However, IAS 34 sometimes departs from the year-to-date approach to allow looking beyond the interim reporting period, for example in estimating the tax rate to be applied on earnings for the period.

The recognition and measurement requirements of IAS 34 apply regardless of whether an entity presents a complete or condensed set of financial statements for an interim period, *[IAS 34.7]*, and are discussed below.

8.1 Same accounting policies as in annual financial statements

The principles for recognising assets, liabilities, income and expenses for interim periods are the same as in the annual financial statements. *[IAS 34.29]*. Accordingly, IAS 34 states: *[IAS 34.28]*

Extract from IAS 34	
28	**An entity shall apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an entity's reporting (annual, half-yearly, or quarterly) shall not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes shall be made on a year-to-date basis.**

8.1.1 Measurement on a year-to-date basis

Measurement on a year-to-date basis acknowledges that an interim period is a part of a full year and allows adjustments to be made to estimates of amounts reported in prior interim periods of the current year. *[IAS 34.29]*.

This does not override the requirement that the principles for recognition and the definitions of assets, liabilities, income, and expenses for interim periods are the same as in annual financial statements. *[IAS 34.29]*. Therefore, for assets, the same tests of future economic benefits apply at interim dates as at year-end. Costs that, by their nature, would not qualify as assets at year-end, do not qualify for recognition at interim dates either. Similarly, a liability at the end of an interim reporting period must represent an existing obligation at that date, just as it must at the end of an annual reporting period. *[IAS 34.32]*. Under IAS 34, as under the IASB's *Conceptual Framework*, an essential characteristic of income and expenses is that the related inflows and outflows of assets and liabilities have already occurred. If those inflows or outflows have occurred, the related income and expense are recognised; otherwise, they are not recognised. *[IAS 34.33]*.

The standard lists several circumstances that illustrate these principles:

- Inventory write-downs, impairments, or provisions for restructurings are recognised and measured on the same basis as at a year-end. Except for reversal of impairment losses recognised on goodwill (see section 9.2 below), later changes in the original estimate are recognised in the subsequent interim period, either by recognising additional accruals or reversals of the previously recognised amount. *[IAS 34.30(a)]*.
- Costs that do not meet the definition of an asset at the end of an interim period are not deferred in the statement of financial position (see section 9.1 below), either to await information on whether such costs meet the definition of an asset, or to smooth earnings over interim periods within a year. *[IAS 34.30(b)]*. For example, costs incurred in acquiring an intangible asset before the recognition criteria under IAS 38 *Intangible Assets* are met are expensed. Only those costs incurred after the recognition criteria are met can be recognised as an asset; there is no reinstatement as an asset in a later period of costs previously expensed because the recognition criteria were not met at that time. *[IAS 38.71]*.
- Income tax expense is "…recognised in each interim period based on the best estimate of the weighted-average annual income tax rate expected for the full financial year" (see section 9.5 below). "Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual income tax rate changes." *[IAS 34.30(c)]*.

Another example would be acquisition costs (excluding debt or share issue costs) incurred in relation to a business combination, which are required to be accounted as expenses in the periods in which the costs are incurred and the services are received. *[IFRS 3.53]*. Such costs would not qualify for deferral at an interim reporting date, even if the business combination to which the costs relate had not been completed until after the interim reporting date.

The year-to-date approach differs from the discrete approach in that the financial position and performance at each reporting date are evaluated not as an isolated period but as part of a cumulative period that builds up to a full year, whose results should not be influenced by interim reporting practices. Amounts reported for previous interim periods are not retrospectively adjusted, and therefore, year-to-date measurements may involve changes in estimates of amounts reported in previous interim periods of the current year. As discussed in sections 4.2 and 7 above, IAS 34 requires disclosure of the nature and amount of material changes in previously reported estimates in the interim financial report and when a separate interim financial report is not presented for the final interim period, in the full year financial statements. *[IAS 34.16A(d), IAS 34.26, IAS 34.34, IAS 34.35, IAS 34.36]*. However, the principle that the results of the full year should not be influenced by interim reporting practices, has been challenged, as the IASB and IFRS IC have identified and tried to resolve certain conflicts between IAS 34 and other IFRS accounting standards, as discussed in section 9.2 below.

8.1.2 New accounting pronouncements and other changes in accounting policies

One of the objectives of the year-to-date approach is to ensure that a single accounting policy is applied to a particular class of transactions throughout a year. *[IAS 34.44]*. To allow accounting policy changes as of an interim date would mean applying different accounting policies to a particular class of transactions within a single year. This would make interim allocation difficult, obscure operating results, and complicate analysis and understandability of the interim period information. *[IAS 34.45]*.

Under IAS 34, an entity uses the same accounting policies in its interim financial statements as in its most recent annual financial statements, adjusted for accounting policy changes that will be in the next annual financial statements, and to determine measurements for interim reporting purposes on a year-to-date basis. *[IAS 34.28]*.

Unless transition rules are specified by a new IFRS accounting standard or interpretation, IAS 34 requires a change in accounting policy to be reflected by:

(a) Restating the financial statements of prior interim periods of the current year and the comparable interim periods of any prior financial years that will be restated in the annual financial statements under IAS 8.

(b) When it is impracticable to determine the cumulative effect at the beginning of the year of applying a new accounting policy to all prior periods, adjusting the financial statements of prior interim periods of the current year and comparable interim periods of prior years to apply the new accounting policy prospectively from the earliest date practicable. *[IAS 34.43]*.

Therefore, regardless of when in a financial year an entity decides to adopt a new accounting policy, it has to be applied from no later than the beginning of the current financial year. *[IAS 34.44]*. For example, if an entity that reports on a quarterly basis decides in its third quarter to change an accounting policy, it must restate the information presented in earlier quarterly financial reports to reflect the new policy as if it had been applied from the start of the annual reporting period.

IAS 34.16A(a) requires entities to confirm that the same accounting policies and methods of computation are followed in the interim financial statements as compared to their most recent annual financial statements or, if those policies or methods have changed, to describe the nature and effect of the change (see sections 3.2 and 4.2 above). Accordingly, in the first set of interim financial statements published applying a new accounting policy or method an entity must disclose the nature and effect of the change in the policies or methods including a description of the new accounting policy or the method adopted.

The only exception to the restatement of all comparative periods is when it is impracticable to determine the cumulative effect of applying a new accounting policy at the beginning of the year of application (see Chapter 3 at section 4.7). IAS 1 states that application of a requirement is 'impracticable' when the entity cannot apply it after making every reasonable effort to do so. *[IAS 1.7]*.

8.1.2.A New pronouncements becoming mandatory during the current year

When preparing interim financial information, consideration is given to which new IFRS accounting standards and interpretations are mandatory in the next (current year) annual financial statements. As noted above, IAS 34.28 requires an entity to apply accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. Accordingly, the entity adopts the new or amended accounting standards and interpretations that are expected to be reflected in its next annual financial statements, when preparing the interim financial reports in that year.

For example, IFRS 16 was mandatory for annual periods beginning on or after 1 January 2019. *[IFRS 16.C1]*. For an entity with a 30 September year-end, the first annual report for which it was required to apply the standard would have been for the year ended 30 September 2020. Therefore, the entity would have applied the standard in its half-yearly report for the six months ending 31 March 2020.

A change in accounting policy would require a restatement of prior comparative financial statements, except for new IFRS accounting standards that have specific application and transition requirements. *[IAS 34.43]*. For example, IFRS 16.C5(b) allows an entity to apply the requirements in IFRS 16 without restating the prior comparative period (see Chapter 24 at section 10.2).

An entity that applies IFRS 17 *Insurance Contracts,* in its interim financial statements prepared applying IAS 34, must make an accounting policy choice as to whether to change the treatment of accounting estimates made in the previous interim or annual financial statements. *[IFRS 17.B137]*. See Chapter 51 at section 15.4. In such instances, the entity must consider disclosing information required by IAS 34.16A(d) in respect of changes in estimates as discussed in section 4.2 above.

8.1.2.B Voluntary changes of accounting policy

Extract from IAS 8

14 An entity shall change an accounting policy only if the change:

(a) is required by an IFRS; or

(b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

An entity can also elect at any time during a year to apply a new IFRS accounting standard or interpretation before it becomes mandatory (unless early adoption is prohibited) through a voluntary change in accounting policy. However, IAS 1 and IAS 8 only permit an entity to change an accounting policy if the information results in information that is 'reliable and more relevant' to the users of the financial statements. *[IAS 8.14(b)]*.

After concluding that a voluntary change in accounting policy is permitted and appropriate, its effect is reflected in the first interim report the entity presents after the date on which the entity changed its policy and comparative interim period information is restated. Under IAS 8, a change in accounting policy is reflected by retrospective application, with restatement of prior period financial data as far back as is practicable unless specific transitional reliefs are available on the adoption of the new accounting standard or interpretation. However, if the cumulative amount of the adjustment relating to previous financial years is impracticable to determine, then under IAS 8, the new policy is applied prospectively from the earliest date practicable. *[IAS 34.44]*. Under IAS 34, an entity is not allowed to reflect the effect of such a voluntary change in accounting policy from a later date than the beginning of the current year, such as at the start of the most recent interim period in which the decision was made to change the policy. *[IAS 34.44]*. To allow two different accounting policies to be applied to a particular class of transactions within a single year would make interim allocations difficult, obscure operating results, and complicate analysis and understandability of the interim period information. *[IAS 34.45]*.

One exception to this principle of retrospective adjustment of earlier interim periods is when an entity changes from the cost model to the revaluation model under paragraph 31 of IAS 16 *Property, Plant and Equipment* or IAS 38.75 (see Chapter 3 at section 4.4.2). These are not changes in accounting policy that are covered by IAS 8 in the usual manner, but instead are required to be treated as a revaluation in the period i.e., from the date on which the decision is made and the revaluation is determined. *[IAS 8.17]*. In the case of a policy change from cost to revaluation, the triggering event is the decision to adopt a policy of revaluation. The date of the first valuation must be consistent with that date. The revalued amount of the assets concerned is applicable only from the date of the revaluation and accordingly, the depreciation expense prior to the date of the revaluation must remain on the old, historic cost basis. Therefore, the general requirements of IAS 34 do not override the specific requirements of IAS 8 to treat such changes prospectively.

To avoid using two differing accounting policies for a particular class of assets in a single financial year, consideration must be given to changing from the cost model to the revaluation model at the beginning of the financial year. Otherwise, an entity will depreciate assets based on cost for early interim periods and based on the revalued amounts for later interim periods.

8.1.2.C New pronouncements becoming mandatory in future annual reporting periods

There is no explicit requirement in IAS 34 for a condensed set of financial statements to include disclosures about IFRS accounting standards and interpretations that take effect in future annual reporting periods. However, if an entity has obtained new information about the impact of issued but not yet effective amendments of IFRS accounting standards, it must consider whether to include updated information in the condensed interim financial statements. An entity that prepares a complete set of interim financial statements that has not applied a new IFRS accounting standard which has been issued but is not yet effective must disclose the information required in IAS 8.30 (see Chapter 3 at section 5.1.2).

8.1.3 Voluntary changes in presentation

An entity may wish to change the presentation of the interim financial statements from that used in prior interim reporting periods. In such situations, before changing the presentation used in its interim report from that of previous periods, management must consider:

(a) The interaction of the requirements of IAS 34 to include in a set of condensed financial statements the same headings and sub-totals as the most recent annual financial statements. *[IAS 34.10]*.

(b) The requirement in IAS 34 to apply the same accounting policies as the most recent or the next annual financial report. *[IAS 34.28]*.

(c) The requirements of IAS 1 as they will relate to those next annual financial statements.

IAS 1 states that an entity must retain the presentation and classification of items in the financial statements, unless it is apparent following a significant change in the nature of operations or a review of the financial statements that another presentation is more appropriate, or unless the change is required by IFRS accounting standards. *[IAS 1.45]*.

If a presentation is changed, the entity must also reclassify comparative amounts for both earlier interim periods of the current financial year and comparable periods in prior years. *[IAS 34.43(a)]*. In such cases, an entity must disclose the nature of the reclassifications, the amount of each item (or class of items) that is reclassified, and the reason for the reclassification. *[IAS 1.41, IAS 8.29]*.

8.2 Seasonal businesses

Some entities do not earn revenues or incur expenses evenly throughout the year, for example, agricultural businesses, holiday companies, domestic fuel suppliers, or retailers who experience peak demand at Christmas. The financial year-end is often chosen to fit their annual operating cycle, which means that an individual interim period would give little indication of annual performance and financial position.

An extreme application of the integral approach would suggest that they must predict their annual results and contrive to report half of that in the half-year interim financial statements. However, this approach does not portray the reality of their business in individual interim periods, and is, therefore, not permitted under the year-to-date approach adopted in IAS 34. *[IAS 34.28]*.

8.2.1 Revenues received seasonally, cyclically, or occasionally

Extract from IAS 34	
37	**Revenues that are received seasonally, cyclically, or occasionally within a financial year shall not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the entity's financial year.**

Examples of the revenues referred to in the extract above include dividend revenue, royalties, government grants, and seasonal revenues of retailers; such revenues are recognised when they occur. *[IAS 34.37, IAS 34.38]*.

IAS 34 also requires an entity to explain the seasonality or cyclicality of its business and the effect on interim reporting (see section 4.3.12 above). *[IAS 34.16A(b)]*. If businesses are highly seasonal, IAS 34 encourages reporting of additional information for the twelve months up to the end of the interim period and comparatives for the prior twelve-month period (see section 5 above). *[IAS 34.21]*.

8.2.2 Costs incurred unevenly during the year

IAS 34 prohibits the recognition or deferral of costs for interim reporting purposes if recognition or deferral of that type of cost is inappropriate at year-end, *[IAS 34.39]*, which is based on the principle that assets and liabilities are recognised and measured using the same criteria as at year-end. *[IAS 34.29, IAS 34.31]*. This principle prevents smoothing of costs in seasonal businesses. Furthermore, the recognition of assets or liabilities at the interim date would not be appropriate if they would not qualify for recognition at the end of an annual reporting period. *[IAS 34.32]*.

For direct costs, this approach has limited consequences, as the timing of recognising these costs and the related revenues is usually similar. However, for indirect costs, the consequences may be greater, depending on which IFRS accounting standard an entity follows.

For example, manufacturing entities that use fixed production overhead absorption rates recognise an asset in respect of attributable overheads based on the normal capacity of the production facilities in accordance with IAS 2. Any variances and unallocated overheads at the interim date are expensed. *[IAS 2.13]*.

Entities applying IFRS 15 can capitalise allocations of costs incurred in fulfilling a contract with a customer that are not within the scope of another IFRS accounting standard only if those costs meet the criteria set out in paragraph 95 of IFRS 15. *[IFRS 15.95]*. The circumstances in which IFRS 15 allows an asset to be recognised in relation to costs incurred to fulfil a contract are discussed in Chapter 28 at section 9.3.2. If the criteria are not met at the reporting date, the costs are expensed. What is clear is that an entity cannot diverge from these requirements for recognising an expense or an asset just because information is being prepared for an interim period.

9 Examples of the recognition and measurement principles

Part B of the illustrative examples accompanying the standard provides several examples that illustrate the recognition and measurement principles in interim financial statements. *[IAS 34.40]*. In addition, IFRIC 10 *Interim Financial Reporting and Impairment* addresses the reversal of impairment losses recognised on goodwill in the interim periods. These examples are discussed below.

9.1 Property, plant and equipment and intangible assets

9.1.1 Depreciation and amortisation

Depreciation and amortisation for an interim period is based only on assets owned during that interim period and does not consider asset acquisitions or disposals planned for later in the year. *[IAS 34.IE B24]*.

An entity applying a straight-line method of depreciation (amortisation) does not allocate the depreciation (amortisation) charge between interim periods based on the level of activity. However, under IAS 16 and IAS 38 an entity may use a 'units of production' method of depreciation, which results in a charge based on the expected use or output (see Chapter 19 at section 5.6.2). An entity can only apply this method if it most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. The chosen method must be applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits. *[IAS 16.62, IAS 38.98]*. Therefore, an entity cannot apply a straight-line method of depreciation in its annual financial statements, while allocating the depreciation charge to interim periods using a 'units of production' based approach.

9.1.2 Impairment of assets

IAS 36 *Impairment of Assets* requires an entity to recognise an impairment loss if the recoverable amount of an asset declines below its carrying amount. *[IAS 34.IE B35]*. An entity must apply the same impairment testing, recognition, and reversal criteria at an interim date as it would at year-end. *[IAS 34.IE B36]*.

However, IAS 34 states that an entity is not required to perform a detailed impairment calculation at the end of each interim period. Rather, an entity must perform a review for indications of significant impairment since the most recent year-end to determine whether such a calculation is needed. *[IAS 34.IE B36]*. Nevertheless, the standard does not exempt an entity from performing impairment tests at the end of its interim periods. For example, an entity that recognised an impairment charge in the immediately preceding year, may find that it needs to update its impairment calculations at the end of subsequent interim periods because impairment indicators remain. IFRIC 10 does not allow the reversal of an impairment loss recognised on goodwill in a previous interim period (see section 9.2 below).

9.1.3 Recognition of intangible assets

An entity must apply the same IAS 38 definitions and recognition criteria for intangible assets in an interim period as in an annual period. Therefore, costs incurred before the recognition criteria are met must be recognised as an expense. *[IAS 34.IE B8]*. Expenditures on intangibles that are initially expensed under IAS 38 cannot be reinstated and recognised as part of the cost of an intangible asset subsequently (e.g., in a later interim period). *[IAS 38.71]*. Furthermore, 'deferring' costs as assets in an interim period in the hope that the recognition criteria will be met later in the year is not permitted. Only costs incurred after the specific point in time at which the criteria are met must be recognised as part of the cost of an intangible asset. *[IAS 34.IE B8]*.

9.1.4 Capitalisation of borrowing costs

An entity that recognises finance expenses in the cost of a qualifying asset under IAS 23 *Borrowing Costs* must determine the amount to be capitalised from the actual finance cost during the period (when funds are specifically borrowed), *[IAS 23.12]*, or, when the asset is funded out of general borrowings, by applying a capitalisation rate equal to the weighted-average of the finance costs attributable to actual borrowings outstanding during the period, *[IAS 23.14]*, (see Chapter 22 at sections 5.2 and 5.3). For interim financial reporting, measurement must be on a year-to-date basis, *[IAS 34.28]*, regardless of how often the entity issues interim reports during a year. For example, an entity that issues quarterly interim reports would have to revise its estimated capitalisation rate in successive quarters during the same year for changes in actual year-to-date borrowings and finance costs. As required in IAS 34, the cumulative effect of changes in the estimated capitalisation rate must be recognised in the current quarter (as a change in estimate) and not retrospectively. *[IAS 34.36]*. In such situations entities must consider the requirement in IAS 34.16A(d) (see sections 7 and 8.1.1 above) to disclose the nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year.

9.2 Reversal of goodwill impairment losses recognised in a previous interim period (IFRIC 10)

The two requirements in IAS 34, to apply the same accounting policies in interim financial reports as are applied for the annual financial statements, and to use year-to-date measurements for interim reporting purposes, do not sit easily together when considering the reversal of goodwill impairment. IAS 36 prohibits the reversal in a subsequent period of an impairment loss recognised for goodwill. *[IAS 36.124]*.

As discussed in section 9.1.2 above, the requirement to use the same accounting policies means that an entity must apply the same impairment testing, recognition, and reversal criteria at the end of an interim period as it would at year-end. *[IAS 34.IE B36]*.

However, the use of year-to-date measurements implies that the calculation of impairments as at interim reporting dates in the same annual reporting period must be based on conditions as at the end of each interim period and determined independently of assessments at earlier interim dates. Applying this requirement of IAS 34 would lead to reversals of previously reported impairments if conditions change and justify a higher carrying value for the related asset.

IFRIC 10 addresses the interaction between the requirements of IAS 34 and the recognition of impairment losses on goodwill in IAS 36, and the effect of that interaction on subsequent interim and annual financial statements. *[IFRIC 10.2]*.

Whilst it may be unlikely for the conditions causing an impairment of goodwill at an interim date to reverse before year-end, IFRIC 10 states that the specific requirements of IAS 36 take precedence over the more general statement in IAS 34. *[IFRIC 10.BC9]*. As such, IFRIC 10 prohibits the reversal of an impairment loss recognised in a previous interim period in respect of goodwill. *[IFRIC 10.8]*. As a result, in an unlikely event where the conditions giving rise to an impairment do reverse in successive interim periods, there can be situations where two entities facing an identical set of circumstances, yet with different frequency of interim reporting, could end up reporting different annual results.

IFRIC 10 cannot be applied by analogy to derive a general principle that the specific requirements of an IFRS accounting standard take precedence over the year-to-date approach in IAS 34. *[IFRIC 10.9]*.

9.3 Employee benefits

9.3.1 Employer payroll taxes and insurance contributions

If employer payroll taxes or contributions to government sponsored insurance funds are assessed on an annual basis, the employer's related expense must be recognised in interim periods using an estimated average annual effective rate, even if it does not reflect the timing of payments. A common example contained in Appendix B to IAS 34 is employer payroll tax or insurance contribution subject to a certain maximum level of earnings per employee. Higher income employees would reach the maximum income before year-end, and the employer would make no further payments for the remainder of the year. *[IAS 34.IE B1]*.

9.3.2 Year-end bonuses

The nature of year-end bonuses vary widely. Some bonus schemes only require continued employment whereas others require certain performance criteria to be attained on a monthly, quarterly, or annual basis. Payment of bonuses may be purely discretionary, contractual or based on years of historical precedent. *[IAS 34.IE B5]*. A bonus is recognised for interim reporting only if: *[IAS 34.IE B6]*

(a) The entity has a present legal or constructive obligation to make such payments as a result of past events.

And

(b) A reliable estimate of the obligation can be made.

A present obligation exists only when an entity has no realistic alternative but to make the payments. *[IAS 19.19]*. IAS 19 gives guidance on accounting for profit sharing and bonus plans (see Chapter 31 at section 12.3).

In recognising a bonus at an interim reporting date, an entity must consider the facts and circumstances under which the bonus is payable and determine an accounting policy that recognises an expense reflecting the obligation on the basis of the services received to date. Several possible accounting policies are illustrated in Illustration 9-1 below.

Illustration 9-1: Measuring interim bonus expense

An entity pays an annual performance bonus if earnings exceed CU10 million, under which 5% of any earnings in excess over CU10 million will be paid up to a maximum of CU500,000. Earnings for the six months ended 30 June 20X2 are CU7 million, and the entity expects earnings for the full year ended 31 December 20X2 to be CU16 million.

The following table shows various accounting policies and the expense recognised thereunder in the interim financial statements for the six months ended 30 June 20X2.

	Expense (CU)
Method 1	
▸ Constructive obligation exists when earnings target is met	Nil
Method 2	
▸ Assume earnings for remainder of year will be same	200,000
Method 3	
▸ Proportionate recognition based on full-year estimate	131,250
Method 4	
▸ One-half recognition based on full-year estimate	150,000

Method 1 is generally not appropriate, as this method disregards the fact that the entity has a present obligation under the performance bonus arrangement when the employees have provided services during the first six months towards earning the bonus.

Likewise, Method 2 is generally not appropriate, as the expense of CU200,000 [(CU14 million - CU10 million) × 5%] assumes that the employees will continue to provide services in the latter half of the year to achieve the bonus target, but does not attribute any services to that period.

In contrast to Methods 1 and 2, Method 3 illustrates an accounting policy whereby an estimate is made of the full-year expense and attributed to the period based on the proportion of that bonus for which employees have provided services at 30 June 20X2. The amount recognised is calculated as (CU7 million ÷ CU16 million) × [5% × (CU16 million - CU10 million)].

Similar to Method 3, Method 4 also takes the approach of recognising an expense based on the full year estimate, but allocates that full-year estimate equally to each period (which is similar to the approach used for share-based payment transactions). The amount recognised is calculated as [50% × 5% × (CU16 million - CU10 million)].

Depending on facts and circumstances, Methods 3 and 4 may be appropriate methods to use to recognise the bonus expense in the interim period. Alternatively, an entity may determine that another basis, which considers both the constructive obligation that exists as of 30 June 20X2, and the services performed to date, is also appropriate.

9.3.3 Pensions

Pension costs for an interim period are calculated on a year-to-date basis using the actuarially determined pension cost rate at the end of the prior year, adjusted for significant market fluctuations and for significant one-off events, such as plan amendments, curtailments and settlements. *[IAS 34.IE B9]*.

In the absence of such significant market fluctuations and one-off events, the estimate of the actuarial liabilities is rolled forward in the scheme based on assumptions as at the beginning of the year and adjusted for significant changes in the membership of the scheme. If there are significant changes to pension arrangements during the interim period (such as changes resulting from a material business combination or from a major redundancy programme) consideration must be given to obtaining a new actuarial valuation of scheme liabilities. Similarly, if there are significant market fluctuations, such as those arising from changes in corporate bond markets, the validity of the assumptions in the last actuarial estimate, such as the discount rate applied to scheme liabilities, must be reviewed and revised as appropriate.

IAS 19 requires an entity to determine net interest using the net defined benefit liability or asset and the discount rate determined at the start of the annual reporting period unless the defined benefit or liability is remeasured. *[IAS 19.123A]*. Accordingly, the net interest costs during the interim period are based on the discount rate determined at the end of the preceding financial year. This rate is applied to measure net interest costs during the interim period. Similarly, service costs during the interim period are not updated for changes in discount rate.

In Practical example 9-1 below International Consolidated Airlines Group, S.A. discloses changes in the discount rates used for pension obligations.

As with all approximations, the appropriateness in the circumstances must be considered.

Practical example 9-1: International Consolidated Airlines Group, S.A. (Half-year 2022) **Spain**

SIX MONTHS RESULTS ANNOUNCEMENT [extract]

Unaudited Condensed Consolidated Interim Financial Statements [extract]

NOTES TO THE ACCOUNTS [extract]

15. EMPLOYEE BENEFIT OBLIGATIONS [extract]

Scheme liability assumptions

At June 30, 2022, the assumptions used to determine the obligations under the APS and NAPS were reviewed and updated to reflect the market condition at that date. Principal assumptions were as follows:

	June 30, 2022		December 31, 2021	
Per cent per annum	APS	NAPS	APS	NAPS
Discount rate	**3.70**	**3.75**	1.80	1.90
Rate of increase in pensionable pay	**3.45**	**-**	3.55	-
Rate of increase of pensions in payment	**3.45**	**2.80**	3.55	2.85
RPI rate of inflation	**3.45**	**3.20**	3.55	3.30
CPI rate of inflation	**2.85**	**2.80**	2.95	2.85

...

9.3.4 Vacations, holidays, and other short-term paid absences

IAS 19 distinguishes between accumulating and non-accumulating paid absences. *[IAS 19.13]*. Accumulating paid absences are those that are carried forward and can be used in future periods if the current period's entitlement is not used in full. IAS 19 requires an entity to measure the expected cost of and obligation for accumulating paid absences at the amount the entity expects to pay as a result of the unused entitlement that has accumulated at the end of the reporting period (see Chapter 31 at section 12.2.1). IAS 34 requires the same principle to be applied at the end of interim reporting periods. Conversely, an entity cannot recognise an expense or liability for non-accumulating paid absences at the end of an interim reporting period, just as it would not recognise any at the end of an annual reporting period. *[IAS 34.IE B10]*.

9.4 Inventories and cost of sales

9.4.1 Inventories

The recognition and measurement principles of IAS 2 are applied in the same way for interim financial reporting as for annual reporting purposes. At the end of a financial reporting period an entity would determine inventory quantities, costs, and net realisable values. However, IAS 34 does comment that to save cost and time, entities often use estimates to measure inventories at interim dates to a greater extent than at annual reporting dates. *[IAS 34.IE B25]*.

Net realisable values are determined using selling prices and costs to complete and dispose at the end of the interim period. A write-down must be reversed in a subsequent interim period only if it would be appropriate to do so at year-end (see Chapter 23 at section 3.3). *[IAS 34.IE B26]*.

9.4.2 Contractual or anticipated purchase price changes

Both the payer and the recipient of volume rebates, or discounts and other contractual changes in the prices of raw materials, labour, or other purchased goods and services must anticipate these items in interim periods if it is probable that these have been earned or will take effect. However, discretionary rebates and discounts cannot be recognised because the resulting asset or liability would not meet the recognition criteria in the IASB's *Conceptual Framework*. *[IAS 34.IE B23]*. Where relevant, entities must consider further guidance on the application of variable consideration in respect of contracts with customers (see Chapter 28 at section 5.2).

9.4.3 Interim period manufacturing cost variances

Price, efficiency, spending, and volume variances of a manufacturing entity must be recognised in profit or loss at interim reporting dates to the same extent that those variances are recognised at year-end. It is not appropriate to defer variances expected to be absorbed by year-end, which could result in reporting inventory at the interim date at more or less than its actual cost. *[IAS 34.IE B28]*.

9.5 Taxation

Taxation is one of the most difficult areas of interim financial reporting, primarily because IAS 34 does not clearly distinguish between current income tax and deferred tax, referring only to 'income tax expense'. This causes tension between the approach for determining the expense and the asset or liability in the statement of financial position. In addition, the standard's provisions combine terminology, suggesting an integral approach to measurement with guidance requiring a year-to-date basis to be applied in respect of recognition. The integral method appears to be the basis used in determining the effective income tax rate for the whole year, but that rate is applied to year-to-date profit in the interim financial statements. In addition, under a year-to-date basis, the estimated rate is based on tax rates and laws that are enacted or substantively enacted by the end of the interim period. Changes in legislation expected to occur before the end of the current year are not recognised in preparing the interim financial report. The assets and liabilities in the statement of financial position, at least for deferred taxes, are derived solely from a year-to-date approach, but sometimes the requirements of the standard are unclear. For example, as discussed in sections 9.5.2.C and 9.5.4 below, two approaches to determine effective annual average tax rate are noted wherein an entity may include the impact of remeasuring closing deferred tax balances at the end of the financial year in the estimate of effective annual average tax rate or exclude such impact on the estimated rate.

9.5.1 Measuring interim income tax expense

IAS 34 states that income tax expense must be accrued using the "best estimate of the weighted average annual income tax rate expected for the full financial year…" and applying that rate to actual pre-tax income for the interim period. *[IAS 34.30(c), IAS 34.IE B12]*. Whilst the standard also describes this rate as "the tax rate that would be applicable to expected total annual earnings…", *[IAS 34.IE B12]*, this is not the same as estimating the total tax expense for the year and allocating a proportion of that to the interim period (even though it might sometimes appear that way), as demonstrated in the discussion below. Additional considerations in relation to current tax expense (income) arising from Pillar Two income taxes are discussed in section 9.5.7 below.

Because taxes are assessed on an annual basis, using this approach to determine the annual effective income tax rate and applying it to year-to-date actual earnings is consistent with the basic concept in IAS 34, that the same recognition and measurement principles apply in interim financial reports as in annual financial statements. *[IAS 34.IE B13]*.

In estimating the weighted-average annual income tax rate, an entity must reflect a blend of any progressive tax rate structure expected to be applicable to the full year's earnings, including changes in income tax rates scheduled to take effect later in the year that are enacted or substantively enacted as at the end of the interim period. *[IAS 34.IE B13]*. This situation is shown in Illustration 9-2 below. *[IAS 34.IE B15]*.

Illustration 9-2: Measuring interim income tax expense - progressive tax rates

An entity reporting quarterly expects to earn CU10,000 pre-tax each quarter and operates in a jurisdiction with a tax rate of 20% on the first CU20,000 of annual earnings and 30% on all additional earnings. Actual earnings match expectations. The following table shows the income tax expense reported each quarter:

(All values in CU)	Pre-tax earnings	Effective tax rate	Tax expense
First quarter	10,000	25%	2,500
Second quarter	10,000	25%	2,500
Third quarter	10,000	25%	2,500
Fourth quarter	10,000	25%	2,500
Annual	**40,000**		**10,000**

CU10,000 of tax is expected to be payable for the full year on CU40,000 of pre-tax income (CU20,000 @ 20% + CU20,000 @ 30%), implying an average annual effective income tax rate of 25% (CU10,000 ÷ CU40,000).

In the above Illustration, it might look as if the interim income tax expense is calculated by dividing the total expected tax expense for the year (CU10,000) by the number of interim reporting periods (4). However, this is only the case in this example because profits are earned evenly over each quarter. The expense is actually calculated by determining the effective annual income tax rate and multiplying that rate to year-to-date earnings, as illustrated in Illustration 9-3 below. *[IAS 34.IE B16]*.

Illustration 9-3: Measuring interim income tax expense - quarterly losses

An entity reports quarterly, earns CU15,000 pre-tax profit in the first quarter but expects to incur losses of CU5,000 in each of the three remaining quarters (thus having zero income for the year), and operates in a jurisdiction in which its standard statutory annual income tax rate is 20%. The following table shows the income tax expense reported each quarter:

(All values in CU)	Pre-tax earning	Effective tax rate	Tax expense
First quarter	15,000	20%	3,000
Second quarter	(5,000)	20%	(1,000)
Third quarter	(5,000)	20%	(1,000)
Fourth quarter	(5,000)	20%	(1,000)
Annual	-		-

The above Illustration shows how an expense is recognised in periods reporting a profit and a credit is recognised when a loss is incurred. This result is very different from allocating a proportion of the expected total income tax expense for the year, which in this case is zero.

If an entity operates in a number of tax jurisdictions, or where different income tax rates apply to different categories of income (such as capital gains or income earned in particular industries), the standard requires that to the extent practicable, an entity:

- Estimates the average annual effective income tax rate for each taxing jurisdiction separately and applies it individually to the interim period pre-tax income of each jurisdiction.

  And

- Applies different income tax rates to each individual category of interim period pre-tax income. *[IAS 34.IE B14]*.

This means that the entity must perform the analysis illustrated in Illustration 9-2 above for each tax jurisdiction and arrive at an interim tax charge by applying the tax rate for each jurisdiction to actual earnings from each jurisdiction in the interim period. However, the standard recognises that, whilst desirable, such a degree of precision cannot be achieved in all cases and allows using a weighted-average rate across jurisdictions or across categories of income, if such rate approximates the effect of using rates that are more specific. *[IAS 34.IE B14]*.

Illustration 9-4: Measuring interim tax expense - many jurisdictions

An entity operates in 3 countries, each with its own tax rates and laws. In order to determine the interim tax expense, the entity determines the effective annual income tax rate for each jurisdiction and applies those rates to the actual earnings in each jurisdiction, as follows:

(All values in CU)	Country A	Country B	Country C	Total
Expected annual tax rate	25%	40%	20%	
Expected annual earnings	300,000	250,000	200,000	750,000
Expected annual tax expense	75,000	100,000	40,000	215,000
Actual half-year earnings	140,000	80,000	150,000	370,000
Interim tax expense	35,000	32,000	30,000	97,000

By performing a separate analysis for each jurisdiction, the entity determines an interim tax expense of CU97,000, giving an effective average tax rate of 26.2% (CU97,000 ÷ CU370,000). Had the entity used a weighted-average rate across jurisdictions, using the expected annual earnings, it would have determined an effective tax rate of 28.7% (CU215,000 ÷ CU750,000), resulting in a tax expense for the interim period of CU106,190 (CU370,000 @ 28.7%). Whether the difference of nearly CU9,000 lies within the range for a reasonable approximation is a matter of judgement.

9.5.2 Changes in the effective tax rate during the year

9.5.2.A Enacted changes for the current year that apply after the interim reporting date

As noted above, the estimated income tax rate applied in the interim financial report must reflect changes that are enacted or substantively enacted as at the end of the interim reporting period, but scheduled to take effect later in the year. *[IAS 34.IE B13]*. IAS 12 acknowledges that in some jurisdictions, announcements by government have substantively the same effect as enactment. *[IAS 12.48]*. Accordingly, an entity must determine the date on which a change in tax rate or tax law is substantively enacted based on the specific constitutional arrangements of the jurisdiction (see Chapter 29 at section 5.1).

Illustration 9-5: Measuring interim income tax expense - progressive tax rates

Taking the fact pattern in Illustration 9-2 above, assume that the 30% tax rate (on earnings above CU20,000) was substantively enacted as at the second quarter reporting date and applicable before year-end. In that case, the estimated income tax rate for interim reporting would be the same as the estimated average annual effective income tax rate computed in that example (i.e., 25%) after considering the higher rate, even though the entity's earnings are not above the required threshold at the half-year.

If legislation is enacted only after the end of the interim reporting period but before the date of authorisation for issue of the interim financial report, its effect is disclosed as an event after the interim period that has not been reflected in the financial statements for the interim period. *[IAS 34.16A(h)]*. This is consistent with the requirement under IAS 10 *Events after the Reporting Period* where estimates of tax rates and related assets or liabilities are not revised in these circumstances. *[IAS 10.22(h)]*.

9.5.2.B Changes to previously reported estimated income tax rates for the current year

IAS 34 requires an entity to re-estimate at the end of each interim reporting period the estimated average annual income tax rate on a year-to-date basis. *[IAS 34.IE B13]*. Accordingly, the amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period if that estimate changes. *[IAS 34.30(c)]*. Illustration 9-6 below shows adjustment in the third quarter resulting from change in effective tax rate. IAS 34 requires disclosure in interim financial statements of material changes in estimates of amounts reported in an earlier period or, in the annual financial statements, of material changes in estimates of amounts reported in the latest interim financial statements. *[IAS 34.16A(d), IAS 34.26]*.

Illustration 9-6: Changes in the effective tax rate during the year

Taking the fact pattern in Illustration 9-2 above, an entity reporting quarterly expects to earn CU10,000 pre-tax each quarter; from the start of the third quarter the higher rate of tax on earnings over CU20,000 increases from 30% to 40%. Actual earnings continue to match expectations. The following table shows the income tax expense reported in each quarter:

(All values in CU)	Period pre-tax earnings	Pre-tax earnings: year to date	Effective tax rate	Tax expense: year to date	Period tax expense
First quarter†	10,000	10,000	25%	2,500	2,500
Second quarter†	10,000	20,000	25%	5,000	2,500
Third quarter	10,000	30,000	30%	9,000	4,000
Fourth quarter	10,000	40,000	30%	12,000	3,000
Annual	**40,000**				**12,000**

† As previously reported from Illustration 9-2 using an effective tax rate of 25%.

The increase in the tax rate means that CU12,000 of tax is expected to be payable for the full year on CU40,000 of pre-tax income (CU20,000 @ 20% + CU20,000 @ 40%), implying an average annual effective income tax rate of 30% (CU12,000 ÷ CU40,000). With cumulative pre-tax earnings of CU30,000 as at the end of the third quarter, the estimated tax liability is CU9,000, requiring a tax expense of CU4,000 (CU9,000 - CU2,500 - CU2,500) to be recognised during that quarter. In the final quarter, earnings of CU10,000 results in a tax charge of CU3,000 using the revised effective rate of 30%.

9.5.2.C Enacted changes applying only to subsequent years

In many jurisdictions, tax legislation is enacted that takes effect not only after the interim reporting date but also after year-end. Such circumstances are not addressed explicitly in the standard. As IAS 34 does not clearly distinguish between current income tax and deferred tax, combined with the different approaches taken in determining the expense recognised in profit or loss compared to the statement of financial position, these issues can lead to confusion in this situation.

On the one hand, the standard states that the estimated income tax rate for the interim period includes enacted or substantively enacted changes scheduled to take effect later in the year. *[IAS 34.IE B13]*. This implies that the effect of changes that do not take effect in the current year is ignored in determining the appropriate rate for current tax. On the other hand, IAS 34 also requires that the principles for recognising assets, liabilities, income and expenses for interim periods are the same as in the annual financial statements. *[IAS 34.29]*. In annual financial statements, deferred tax is measured at the tax rates expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) enacted or substantively enacted by the end of the reporting period, as required by IAS 12. *[IAS 12.47]*. Therefore, an entity must recognise the effect on deferred tax measurement of a change applying to future periods if enacted by the end of the interim reporting period.

These two requirements seem to be mutually incompatible. As discussed in section 5 above, IAS 34 makes sense only in the context of calculating the effective current tax rate on income earned in the period. Once a deferred tax asset or liability is recognised, it must be measured under IAS 12. Therefore, an entity must recognise an enacted change applying to future years in measuring deferred tax assets and liabilities as at the end of the interim reporting period. One way to treat the cumulative effect to date of this remeasurement is to recognise it in full, by a credit to profit or loss or to other comprehensive income, depending on the nature of the temporary difference being remeasured, in the period during which the tax legislation is enacted, in a similar way to the treatment shown in Illustration 9-6 above, and as illustrated in Illustration 9-7 below.

Illustration 9-7: Enacted changes to tax rates applying after the current year

An entity reporting half-yearly operates in a jurisdiction subject to a tax rate of 30%. Legislation is enacted during the first half of the current year, which reduces the tax rate to 28% on income earned from the beginning of the entity's next financial year. Based on a gross temporary difference of CU1,000, the entity reported a deferred tax liability in its most recent annual financial statements of CU300 (CU1,000 @ 30%). Of this temporary difference, CU200 is expected to reverse in the second half of the current year and CU800 in the next financial year. Assuming that no new temporary differences arise in the current period, what is the deferred tax balance at the interim reporting date?

Whilst the entity uses an effective tax rate of 30% to determine the tax expense relating to income earned in the period, it must use a rate of 28% to measure those temporary differences expected to reverse in the next financial year. Accordingly, the deferred tax liability at the half-year reporting date is CU284 (CU200 @ 30% + CU800 @ 28%).

Alternatively, if the effective current tax rate is not distinguished from the measurement of deferred tax, it could be argued that IAS 34 allows the reduction in the deferred tax liability of CU16 (CU300 - CU284) to be included in the estimate of the effective income tax rate for the year. Approach 2 in Illustration 9-10 below applies this argument.

How we see it

In our view, because IAS 34 does not distinguish between current and deferred taxes, either approach illustrated above would be acceptable provided that is applied consistently.

9.5.3 Difference in financial year and tax year

If an entity's financial year and the income tax year differ, the income tax expense for the interim periods of that financial year must be measured using separate weighted-average estimated effective tax rates for each of the income tax years applied to the portion of pre-tax income earned in each of those income tax years. *[IAS 34.IE B17]*. In other words, an entity must compute a weighted-average estimated effective tax rate for each income tax year, rather than for its financial year.

Illustration 9-8: Difference in financial year and tax year

An entity's financial year ends 30 June and it reports quarterly. Its taxable year end is 31 December. For the financial year that begins 1 July 20X1 and ends 30 June 20X2, the entity earns CU10,000 pre-tax each quarter.

The estimated average annual income tax rate is 30% in the income tax year to 31 December 20X1 and 40% in the year to 31 December 20X2. *[IAS 34.IE B18]*.

Quarter ending (All values in CU)	Pre-tax earnings	Effective tax rate	Tax expense
30 September 20X1	10,000	30%	3,000
31 December 20X1	10,000	30%	3,000
31 March 20X2	10,000	40%	4,000
30 June 20X2	10,000	40%	4,000
Annual	**40,000**		**14,000**

9.5.4 Tax loss and tax credit carrybacks and carryforwards

Appendix B to IAS 34 repeats the requirement in IAS 12 that for carryforwards of unused tax losses and tax credits, a deferred tax asset must be recognised to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised. In assessing whether future taxable profit is available, the criteria in IAS 12 are applied at the interim date. If these criteria are met as at the end of the interim period, the effect of the tax loss carryforwards is included in the estimated average annual effective income tax rate. *[IAS 34.IE B21]*.

Illustration 9-9: Tax loss carryforwards expected to be recovered in the current year

An entity that reports quarterly has unutilised operating losses of CU10,000 for income tax purposes at the start of the current financial year for which a deferred tax asset has not been recognised. The entity earns CU10,000 in the first quarter of the current year and expects to earn CU10,000 in each of the three remaining quarters. Excluding the effect of utilising losses carried forward, the estimated average annual income tax rate is 40%. Including the carryforward, the estimated average annual income tax rate is 30%. Accordingly, tax expense is determined by applying the 30% rate to earnings each quarter as follows: *[IAS 34.IE B22]*

(All values in CU)	Pre-tax earnings	Effective tax rate	Tax expense
First quarter	10,000	30%	3,000
Second quarter	10,000	30%	3,000
Third quarter	10,000	30%	3,000
Fourth quarter	10,000	30%	3,000
Annual	**40,000**		**12,000**

This result is consistent with the general approach for measuring income tax expense in the interim report, in that any entitlement for relief from current tax due to carried forward losses is determined on an annual basis. Accordingly, its effect is included in the estimate of the average annual income tax rate and not, for example, by allocating all of the unutilised losses against the earnings of the first quarter to give an income tax expense of zero in the first quarter and CU4,000 thereafter.

In contrast, the year-to-date approach of IAS 34 means that the benefits of a tax loss carryback are recognised in the interim period in which the related tax loss occurs, *[IAS 34.IE B20]*, and are not included in the assessment of the estimated average annual tax rate, as shown in Illustration 9-3 above. This approach is consistent with IAS 12, which requires the benefit of a tax loss that can be carried back to recover current tax already incurred in a previous period to be recognised as an asset. *[IAS 12.13]*. Therefore, a corresponding reduction of tax expense or increase of tax income is also recognised. *[IAS 34.IE B20]*.

Where previously unrecognised tax losses are expected to be utilised in full in the current year, it seems intuitive to recognise the recovery of those carried forward losses in the estimate of the average annual tax rate, as shown in Illustration 9-9 above. Where the level of previously unrecognised tax losses exceeds expected taxable profits for the current year, a deferred tax asset must be recognised for the carried forward losses that are now expected to be utilised, albeit in future years. Illustration 9-9 described two approaches where tax loss carryforwards exceed expected profits in the current year.

Illustration 9-10: Tax loss carryforwards in excess of current year expected profits

An entity that reports half-yearly has unutilised operating losses of CU75,000 for income tax purposes at the start of the current financial year for which no deferred tax asset has been recognised. At the end of its first interim period, the entity reports a profit before tax of CU25,000 and expects to earn a profit of CU20,000 before tax in the second half of the year. The entity reassesses the likelihood of generating sufficient profits to utilise its carried forward tax losses and determines that the IAS 12 recognition criteria for a deferred tax asset are satisfied for the full amount of CU75,000. Excluding the effect of utilising losses carried forward, the estimated average annual income tax rate is the same as the enacted or substantially enacted rate of 40%.

As at the end of the current financial year the entity expects to have unutilised losses of CU30,000 (CU75,000 carried forward less current year pre-tax profits of CU45,000). Using the enacted rate of 40%, a deferred tax asset of CU12,000 is recognised at year-end. How is this deferred tax asset recognised in the interim reporting periods?

Approach 1

Under the first approach, the effective tax rate for the effect of the change in the assessment of recoverability of the unused tax losses carried forward to future periods that existed at the beginning of the current financial year is not adjusted. The estimate of the average annual effective tax rate includes only those carried forward losses expected to be utilised in the current financial year and a separate deferred tax asset is recognised for those carried forward losses now expected to be utilised in future annual reporting periods.

In the fact pattern above, using CU45,000 of the carried forward tax losses gives an average effective annual tax rate of nil, as follows:

Estimation of the annual effective tax rate - Approach 1 (All values in CU)	
Expected annual tax expense before utilising losses carried forward (45,000 @ 40%)	18,000
Tax benefit of utilising carried forward tax losses (45,000 @ 40%)	(18,000)
Expected annual tax expense before the effect of losses carried forward to future annual periods	-
Expected annual effective tax rate	0%
Effect of tax losses carried forward to future periods (75,000 - 45,000 @ 40%)	(12,000)
Tax income to be recognised in the interim period	**(12,000)**

The remaining tax losses give rise to a deferred tax asset of 12,000, which is recognised in full at the half-year, to give reported profits after tax as follows:

(All values in CU)	First half-year	Second half-year	Annual
Profit before income tax	25,000	20,000	45,000
Income tax (expense)/credit			
- At expected annual effective rate	-	-	-
- Recognition of deferred tax asset	12,000	-	12,000
Net profit after tax	**37,000**	**20,000**	**57,000**

Approach 2

Under the second approach, the effective tax rate for the effect of the change in the assessment of recoverability of the unused tax losses carried forward to future periods that existed at the beginning of the current financial year is adjusted. The estimate of the average annual effective tax rate reflects the expected recovery of all the previously unutilised tax losses from the beginning of the period in which the assessment of recoverability changed. In the fact pattern above, recognition of the unutilised tax losses gives an average effective annual tax rate of -26.67%, as follows:

Estimation of the annual effective tax rate - Approach 2 (All values in CU)	
Expected annual tax expense before utilising losses carried forward (45,000 @ 40%)	18,000
Tax benefit of recognising unutilised tax losses (75,000 @ 40%)	(30,000)
Expected annual tax credit after recognising unutilised tax losses	(12,000)
Expected annual effective tax rate (-12,000 ÷ 45,000)	-26.67%

This approach results in reported profits after tax as follows:

(All values in CU)	First half-year	Second half-year	Annual
Profit before income tax	25,000	20,000	45,000
Income tax (expense)/credit			
- At expected annual effective rate	6,667	5,333	12,000
Net profit after tax	**31,667**	**25,333**	**57,000**

Approach 1 is consistent with the requirements of IAS 12 as it results in recognising the full expected deferred tax asset as soon as it becomes "probable that taxable profit will be available against which the deductible temporary difference can be utilised…". *[IAS 12.24]*. Further, applying IAS 34.29 that provides the principles for recognising assets, liabilities, income, and expenses for interim periods are the same as in annual financial statements, this deferred tax asset is fully recognised at the end of the first half-year.

How we see it

Given that IAS 34 does not specifically address the situation illustrated above and is unclear about whether the effective tax rate reflects changes in the assessment of the recoverability of carried forward tax losses, we also believe that Approach 2 is acceptable.

9.5.5 Derecognition of deferred tax assets that are no longer recoverable

As explained in section 9.5.4 above, IAS 34 requires that the benefits of tax loss and tax credit carrybacks and carryforwards are reflected in the estimated annual effective income tax rate in the interim period in which the related tax loss occurs or, if later, in the period when that loss is determined to be recoverable. *[IAS 34.IE B20, IAS 34.IE B21]*. Illustration 9-10 in section 9.5.4 above shows how an entity might account for the effect of previously unrecognised tax losses being determined to be recoverable during a later interim period. This raises a question how an entity accounts for the derecognition of a deferred tax asset in the interim reporting period when it is determined to no longer be recoverable.

Illustration 9-11: Derecognition of deferred tax assets that are no longer recoverable

An entity that reports half-yearly has previously recognised deferred tax assets of CU30,000 resulting from unutilised tax losses of CU75,000. Excluding the effect of utilisation of losses carried forward, the estimated average annual income tax rate is the same as the enacted or substantially enacted rate of 40%.

Due to adverse changes in its customer markets, the level of earnings has reduced compared to previous estimates and at the end of its first interim period, the entity reports a profit before tax of CU20,000 and expects to earn a profit of CU5,000 before tax in the second half of the year. The entity reassesses the likelihood of generating sufficient taxable profits to utilise its carried forward tax losses and determines that as at the end of the current financial year it expects to have unutilised losses of CU50,000 (CU75,000 carried forward less current year pre-tax profits of CU25,000) but that it will only be able to utilise CU15,000 of those losses. Using the enacted rate of 40%, a deferred tax asset of CU6,000 is recognised at year-end (i.e., a deferred tax asset of CU14,000 is derecognised). How is this derecognition recognised in the interim reporting periods?

Approach 1

Under the first approach, the irrecoverable portion of the deferred tax asset is de-recognised in its entirety in the period when the reassessment is carried out, as follows:

In the fact pattern above, using CU25,000 of the carried forward tax losses in the current year gives an average effective annual tax rate of nil, as follows:

Estimation of the annual effective tax rate - Approach 1	CU
Expected annual tax expense before utilising losses carried forward (CU25,000 @ 40%)	10,000
Tax benefit of utilising carried forward tax losses (CU25,000 @ 40%)	(10,000)
Current tax expense	**0**

Deferred tax expense - utilisation of recognised tax losses (CU25,000 @ 40%)	(10,000)
Expected annual tax expense before the effect of losses carried forward to future annual periods	(10,000)
Expected annual effective tax rate (CU10,000 ÷ CU25,000)	40%
Effect of derecognising tax losses carried forward ([CU75,000 - CU25,000 - CU15,000] @ 40%)	(14,000)
Tax expense to be recognised in the interim period	**(24,000)**

Of the remaining tax losses of CU50,000 only CU15,000 are expected to be utilised, requiring the previously recognised deferred tax asset to be reduced by CU14,000 ([CU50,000 - CU15,000] @ 40%, which is recognised in full at the half-year, to give reported profits after tax as follows:

(All values in CU)	First half-year	Second half-year	Annual
Profit before income tax	20,000	5,000	25,000
Income tax expense			
- at expected annual effective rate (40%)	(8,000)	(2,000)	(10.000)
- derecognition of deferred tax asset	(14,000)	0	(14,000)
Net (loss)/profit after tax	**(2,000)**	**3,000**	**1,000**

Approach 2

Under the second approach, the estimate of the average annual effective tax rate reflects the revision to estimates of the expected recovery of the unutilised tax losses from the beginning of the period. In the fact pattern above, derecognition of the related deferred tax asset gives an average effective annual tax rate of 96%, as follows:

Estimation of the annual effective tax rate - Approach 2	CU
Expected annual tax expense before utilising losses carried forward (CU25,000 @ 40%)	10,000
Tax benefit of utilising carried forward losses in the year (CU25,000 @ 40%)	(10,000)
Current tax expense	**0**
Deferred tax expense (utilisation of recognised tax losses (CU25,000 @ 40))	(10,000)
Change to estimate of recoverable tax losses (CU50,000 - CU15,000 @ 40%)	(14,000)
Expected annual tax expense after accounting for unutilised tax losses	**(24,000)**
Expected annual effective tax rate (CU24,000 ÷ CU25,000)	**96%**

This approach results in reported profits after tax as follows:

(All values in CU)	First half-year	Second half-year	Annual
Profit before income tax	20,000	5,000	25,000
Income tax (expense)/credit			
- at expected annual effective rate (96%)	(19,200)	(4,800)	(24,000)
Net profit after tax	**800**	**200**	**1,000**

How we see it

Approach 1 is consistent with the year-to-date approach and the general requirement of IAS 34 to apply for assets, the same tests of future economic benefits at interim dates as at the end of an entity's financial year. Under this approach, a portion of the deferred tax asset is not recoverable and is therefore derecognised in its entirely. Approach 2 is consistent with the integral approach applied for the measurement of income taxes in IAS 34. As noted in section 9.5.4 above, IAS 34 does not address this specific situation, but requires that when tax losses become recoverable the effect of the tax loss carryforward is reflected in the computation of the estimated average annual effective income tax rate. Under this approach, there remains a deferred tax asset (of CU2,800) in the balance sheet despite it having been determined that this asset is not expected to be recovered. Although Approach 1 is a more faithful representation of the financial position as at the end of the interim period, we believe that both approaches are acceptable.

9.5.6 Tax credits

IAS 34 also discusses in more detail the treatment of tax credits, which may for example be based on amounts of capital expenditures, exports, or research and development expenditures. Such benefits are often granted and calculated on an annual basis under tax laws and regulations and therefore, are generally reflected in the estimated annual effective income tax rate used in the interim report. However, if tax benefits relate to a one-time event, they must be excluded from the estimate of the annual rate and deducted separately from income tax expense in that interim period, in the same way that special tax rates applicable to particular categories of income are not blended into a single effective annual tax rate. Occasionally, some tax credits are more akin to a government grant, which are recognised in the interim period in which they arise. *[IAS 34.IE B19]*. Similar considerations arise in determining the extent to which the existence of non-taxable income or non-deductible expenditure must be incorporated into the estimate of the weighted-average annual income tax rate expected for the full financial year. This requires the exercise of judgement.

In the Practical example 9-2 below, Anheuser-Busch InBev NV/SA explains the reasons for an increase in the effective tax rate in the interim period and the effect of expenditure that is not deductible for tax purposes.

Practical example 9-2: Anheuser-Busch InBev NV/SA (Half-year 2023) Belgium

Unaudited Interim Report for the six-month period ended 30 June 2023 [extract]

Notes to the consolidated financial statements [extract]

9. Income taxes [extract]

...

The total income tax expense for the six-month period ended 30 June 2023 amounts to 1 192m US dollar compared to 1 244m US dollar for the six-month period ended 30 June 2022. The effective tax rate for the six-month period ended 30 June 2023 was 31.9% compared to an effective tax rate of 26.3% for the six-month period ended 30 June 2022.

The 2023 effective tax rate was negatively impacted by non-deductible losses from derivatives related to hedging of share-based payment programs and hedging of the shares issued in a transaction related to the combination with Grupo Modelo and SAB, while the 2022 effective tax rate was positively impacted by non-taxable gains from these derivatives.

...

9.5.7 Pillar Two Income Taxes

Governments around the world are introducing local legislation to implement the Base Erosion and Profit Shifting (BEPS) Pillar Two Model Rules published by the Organisation for Economic Co-operation and Development (OECD). The Pillar Two model rules apply to multinational enterprises (MNEs) with revenue in excess of EUR 750 million per their consolidated financial statements. These rules introduce new taxing mechanisms under which MNEs would pay a minimum level of tax. The mechanism for calculating additional taxes payable under these rules is complex and in recognition of the complexities involved, the IASB issued *International Tax Reform-Pillar Two Model Rules - Amendments to IAS 12* (the Amendments) in May 2023. Pillar Two income taxes and the related amendments to IAS 12 are discussed in Chapter 29 at section 4.6.

The amendments to IAS 12, have introduced a mandatory exception to the accounting and disclosure of information related to deferred taxes arising from the jurisdictional implementation of the Pillar Two model rules. *[IAS 12.4A]*. However, the amendments have introduced the following disclosure requirements that may be relevant to interim financial statements:

(a) to disclose that the entity has applied the exception to recognising and disclosing information about deferred tax assets and liabilities related to Pillar Two income taxes. *[IAS 12.88A]*.

(b) to disclose separately its current tax expense (income) related to Pillar Two income taxes. *[IAS 12.88B]*.

(c) in periods in which Pillar Two legislation is enacted or substantively enacted but not yet in effect, to disclose known or reasonably estimable information that helps users of financial statements understand the entity's exposure to Pillar Two income taxes arising from that legislation. *[IAS 12.88C]*.

(d) To meet the disclosure requirement in (c) above, an entity shall disclose 'qualitative and quantitative information about its exposure to Pillar Two income taxes at the end of the reporting period'. *[IAS 12.88D]*

The amendment provides a relief from including disclosures in paragraphs (b) to (d) above in any interim period ending on or before 31 December 2023. *[IAS 12.98M(b)]*.

IAS 34 was not consequentially amended to reflect the new requirements introduced in IAS 12. Accordingly, the general principles and requirements in IAS 34, in respect of a condensed interim financial statement (see section 3.2 above), also apply to the requirements in paragraphs 88A-88D of IAS 12 related to Pillar Two income taxes. Where an entity prepares a complete set of financial statements the guidance in section 3.1 above is applicable.

How we see it

In our view, where an entity publishes condensed interim financial statements in its interim financial report, the information regarding mandatory exception as required in (a) above must be included in the condensed interim financial statements published for interim periods within the first annual reporting period the mandatory exception is applied. This is consistent with the requirements in IAS 34.16A(a) to disclose details of any changes in accounting policies and methods of computation compared with the most recent annual financial statements, as discussed in sections 8.1.2 and 8.1.2.A above.

Further, the principles in paragraph 15 and 16A of IAS 34, regarding disclosure of items that are significant to an understanding of the performance of an entity in an interim period, may apply to disclosure of information required in paragraphs (b) to (d) above except in condensed interim financial statements prepared for interim periods ending on or before 31 December 2023, as mentioned above.

Where an entity publishes complete financial statements in its interim financial report, the requirements in IAS 1 would apply as discussed in section 3.1 above.

As described in (b) above, in the periods when the Pillar Two legislation becomes effective, IAS 12.88B requires an entity to disclose separately its current tax expense (income) arising from Pillar Two Model Rules. The current tax expense for Pillar Two income taxes is measured under the existing principles in IAS 34 as discussed in section 9.5.1 above, i.e., by applying a best estimate of the weighted average annual income tax rate expected for the full financial year to the actual pre-tax income of the interim period. However, given paragraph 88B of IAS 12 requires an entity to disclose separately its current tax expense (income) arising from Pillar Two income taxes, such current tax expense (income) needs to be calculated separately from the interim expense (income) for other taxes in scope of IAS 12.

Lastly, entities must consider whether Pillar Two tax legislation is a source of estimation uncertainty that needs to be disclosed in the annual financial statements as required by IAS 1.125. (See Chapter 3 at section 5.2.1). Any update to this information is disclosed in the interim financial statements as required by IAS 34.15 (see Section 4.1 above).

In the Practical example 9-3 below, Shell plc separately discloses the current tax expense related to Pillar Two income taxes as required by (b) above:

Practical example 9-3: Shell plc (Quarter 1 2024) **United Kingdom**

1st QUARTER 2024 UNAUDITED RESULTS [extract]

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS [extract]

8. Other notes to the unaudited Condensed Consolidated Interim Financial Statements [extract]

...

Taxation charge/credit

Quarters			$ million
Q1 2024	Q4 2023	Q1 2023	
3,604	1,099	5,582	**Taxation charge/(credit)**
			Of which:
3,525	1,099	5,582	Income tax excluding Pillar Two income tax
79	–	–	Income tax related to Pillar Two income tax

On June 20, 2023, the UK substantively enacted Pillar Two Model Rules, effective as from January 1, 2024.

...

9.6 Foreign currency translation

9.6.1 Foreign currency translation gains and losses

An entity measures foreign currency translation gains and losses for interim financial reporting using the same principles that IAS 21 *The Effects of Changes in Foreign Exchange Rates* requires at year-end (see Chapter 16). *[IAS 34.IE B29]*. An entity must use the actual average and closing foreign exchange rates for the interim period (i.e., it may not anticipate changes in foreign exchange rates for the remainder of the current year in translating at an interim date). *[IAS 34.IE B30]*. Where IAS 21 requires translation adjustments to be recognised as income or expense in the period in which they arise, the same approach must be used in the interim report. An entity cannot defer some foreign currency translation adjustments at an interim date, even if it expects the adjustment to reverse before year-end. *[IAS 34.IE B31]*.

9.6.2 Interim financial reporting in hyperinflationary economies

Interim financial reports in hyperinflationary economies are prepared using the same principles as at year-end. *[IAS 34.IE B32]*. IAS 29 *Financial Reporting in Hyperinflationary Economies* requires that the financial statements of an entity that reports in the currency of a hyperinflationary economy be stated in terms of the measuring unit current at the end of the reporting period, and the gain or loss on the net monetary position be included in net income. In addition, comparative financial data reported for prior periods must be restated to the current measuring unit. *[IAS 34.IE B33]*. As shown in Illustration 5-1 and Illustration 5-2 in section 5 above, IAS 34 requires an interim report to contain many components, which are all restated at every interim reporting date.

The measuring unit used is the same as that as of the end of the interim period, with the resulting gain or loss on the net monetary position included in that period's net income. An entity cannot annualise the recognition of gains or losses, or estimate an annual inflation rate in preparing an interim financial report in a hyperinflationary economy. *[IAS 34.IE B34]*.

IAS 29 applies from the beginning of the reporting period in which an entity identifies the existence of hyperinflation in the country in whose currency it reports. *[IAS 29.4]*. Accordingly, for interim reporting purposes, IAS 29 must be applied from the beginning of the interim period in which the hyperinflation is identified. In addition, when presenting year-to-date information in accordance with paragraph 20(b) of IAS 34, IAS 29 must be applied from the beginning of the annual financial year. Furthermore, the IFRS IC has clarified that in the reporting period in which an entity identifies the existence of hyperinflation in the economy of its functional currency, adoption of IAS 29 must be fully retrospective, by applying its requirements as if the economy had always been hyperinflationary. *[IFRIC 7.3]*. The requirement to adopt IAS 29 fully retrospectively applies only to the entity with a functional currency of a hyperinflationary economy and does not apply to its parent entity that has a functional currency of a non-hyperinflationary economy or the group that consolidates the entity (see Chapter 17 at section 11.3).

See Chapter 17 for more detailed discussion regarding interim financial reporting in hyperinflationary economies.

9.7 Provisions, contingencies and accruals for other costs.

9.7.1 Provisions

IAS 34 requires an entity to apply the same criteria for recognising and measuring a provision at an interim date as it would at year-end. *[IAS 34.IE B4]*. Hence, an entity must recognise a provision when it has no realistic alternative but to transfer economic benefits because of an event that has created a legal or constructive obligation. *[IAS 34.IE B3]*. The standard emphasises that the existence or non-existence of an obligation to transfer benefits is a question of fact and does not depend on the length of the reporting period. *[IAS 34.IE B4]*. Also, as noted in section 8.1.1 above, measurement on a year-to-date basis requires that a liability at the end of an interim reporting period must represent an existing obligation at that date, just as it must at the end of an annual reporting period. *[IAS 34.32]*. Entities cannot anticipate obligations that are expected to arise later in the annual reporting period.

The obligation is adjusted upward or downward at each interim reporting date, if the entity's best estimate of the amount of the obligation changes. The standard states that any corresponding loss or gain must normally be recognised in profit or loss. *[IAS 34.IE B3]*. However, an entity applying IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* might instead need to adjust the carrying amount of the corresponding asset rather than recognise a gain or loss (see Chapter 27 at section 6.3). *[IFRIC 1.4, IFRIC 1.5, IFRIC 1.6]*.

9.7.2 Other planned but irregularly occurring costs

Many entities budget for costs that they expect to incur irregularly during the year, such as advertising campaigns, employee training and charitable contributions. Even though these costs are planned and expected to recur annually, they tend to be discretionary in nature. Therefore, it is generally not appropriate to recognise an obligation at the end of an interim financial reporting period for such costs that are not yet incurred, as they do not meet the definition of a liability. *[IAS 34.IE B11]*.

As discussed in section 8.2.2 above, IAS 34 prohibits the recognition or deferral of costs incurred unevenly throughout the year at the interim date if recognition or deferral would be inappropriate at year-end. *[IAS 34.39]*. Accordingly, such costs must be recognised as they are incurred and an entity cannot recognise provisions or accruals in the interim report to adjust these costs to their budgeted amount.

9.7.3 Major planned periodic maintenance or overhaul

The cost of periodic maintenance, a planned major overhaul, or other seasonal expenditures expected to occur after the interim reporting date cannot be recognised for interim reporting purposes unless an event before the end of the interim period causes the entity to have a legal or constructive obligation. The mere intention or necessity to incur expenditures in the future is not sufficient to recognise an obligation as at the interim reporting date. *[IAS 34.IE B2]*. Similarly, an entity may not defer and amortise such costs if they are incurred early in the year, but do not satisfy the criteria for recognition as an asset as at the interim reporting date.

9.7.4 Variable lease payments

Variable lease payments can create legal or constructive obligations that are recognised as liabilities even though such amounts are not included in the lease liability in the period. If a lease includes variable payments based on achieving a certain level of annual sales (or annual use of the asset), an obligation can arise in an interim period before the required level of annual sales (or usage) is achieved. If the entity expects to achieve the required level of annual sales (or usage), it must recognise a liability as it has no realistic alternative but to make the future lease payment. *[IAS 34.IE B7]*. See Chapter 24 at section 4.5.8 for further discussion on variable lease payments.

9.7.5 Levies charged by public authorities

When governments or other public authorities impose levies on entities in relation to their activities, as opposed to income taxes, it is not always clear when the liability to pay a levy arises and a provision must be recognised. IFRIC 21 *Levies* addresses this issue. The scope of the Interpretation is limited to provisions within the scope of IAS 37 and specifically need not be applied to emissions trading schemes. *[IFRIC 21.2, IFRIC 21.6]*.

The Interpretation requires that for an activity within its scope, an entity must recognise a liability for a levy only when the activity that triggers payment, as identified by the relevant legislation, occurs. *[IFRIC 21.8]*. The Interpretation states that neither a constructive nor a present obligation arises as a result of being economically compelled to continue operating; or from any implication of continuing operations in the future arising from the use of the going concern assumption in the preparation of financial statements (see Chapter 27 at section 6.8). *[IFRIC 21.9, IFRIC 21.10]*.

The Interpretation states that the same recognition principles must be applied in the interim financial statements. Therefore, a liability for any levy cannot be anticipated if there is no present obligation to pay the levy at the end of the interim reporting period. Similarly, a liability cannot be deferred if a present obligation to pay the levy exists at the end of the interim period. *[IFRIC 21.13]*.

This is relatively simple when a levy is triggered on a specific day or when a specific event occurs. When a levy is triggered progressively, for example as the entity generates revenues, the levy is accrued over time. At any time in the year, the entity would have a present obligation to pay an amount of levy that would be based on revenues generated to that date and recognises a liability and an expense on that basis. *[IFRIC 21.11]*.

The following Illustrations show the above principles in a number of scenarios and demonstrate how the appropriate accounting treatment has to reflect the specific facts and circumstances that apply in determining an entity's obligation to pay the levy in line with the relevant legislation.

When the legislation provides that a levy is triggered by an entity operating in a market only at the end of the annual reporting period, no liability is recognised until the last day of the annual reporting period. No amount is recognised before that date in anticipation of the entity still operating in the market. This means that in the interim financial reports for that year, no liability for the levy expense is recognised. Only if the entity reports for the last quarter of that year would the expenditure appear in an interim report. *[IFRIC 21.IE1 Example 3]*.

If a levy is triggered in full as soon as the entity commences generating revenues, the liability is recognised in full on the first day that the entity commences generating revenue. In this case, the entity does not defer any expense and amortise this amount over the year or otherwise allocate it to subsequent interim periods. The Illustration below demonstrates this situation. *[IFRIC 21.IE1 Example 2]*.

Illustration 9-12: A levy is triggered in full as soon as the entity generates revenue

An entity has a calendar year end. In accordance with legislation, a levy is triggered in full as soon as the entity generates revenue in 20X3. The amount of the levy is determined by reference to revenue generated by the entity in 20X2. The entity generated revenue in 20X2 and starts to generate revenue in 20X3 on 3 January 20X3.

In this example, the liability is recognised in full on 3 January 20X3 because the obligating event, as identified by the legislation, is the first generation of revenue in 20X3. The generation of revenue in 20X2 is necessary, but not sufficient, to create a present obligation to pay a levy. Before 3 January 20X3, the entity has no obligation. In other words, the activity that triggers the payment of the levy as identified by the legislation is the first generation of revenue at a point in time in 20X3.

The generation of revenues in 20X2 is not the activity that triggers the payment of the levy. The amount of revenue generated in 20X2 only affects the measurement of the liability.

In the interim financial report, because the liability is recognised in full on 3 January 20X3, the expense is recognised in full in the first interim period of 20X3. The expense cannot be deferred until subsequent interim periods and shall not be anticipated in previous interim periods.

Another situation is when a levy is triggered in full as soon as the entity generates revenue from an activity above a certain annual threshold. This is shown in the following Illustration. *[IFRIC 21.IE1 Example 4]*.

Illustration 9-13: A levy is triggered in full as soon as the entity generates revenue from a certain activity above an annual threshold, which is reduced *pro rata* when the entity ceases participation in that activity during the year

A bank has a calendar year-end. In accordance with legislation, a bank levy is triggered only if the bank generated revenue above the annual threshold of CU10 million in 20X3. The amount of the levy payable is calculated based on 0.1% of the annual threshold of CU10 million and is assessed as at 31 December every year. i.e., annual revenue below CU10 million attracts no levy and revenue of at least CU10 million attracts a levy of CU10,000 (0.1% × CU10 million). However, if the bank ceases operations during the year, the annual threshold of CU10 million will then be reduced *pro rata*, based on the number of days the bank was in operation during the year and the levy payable will then be based on 0.1% of the pro-rated annual threshold.

The owners of the bank ceased operation with effect from 1 July 20X3. As at 31 March 20X3 and 30 June 20X3, the revenue generated amounted to CU4 million and CU8 million, respectively.

In this example, the liability is recognised in the interim financial report as follows:

31 March 20X3:	Nil
30 June 20X3:	Nil
30 September 20X3:	CU5,000 (CU10 million × (6/12 months) × 0.1%)
31 December 20X3:	CU5,000 (CU10 million × (6/12 months) × 0.1%)

Based on discussions by the IFRS IC during their March 2015 meeting, the threshold for determining the entity's liability would only be reduced (or pro-rated) if, and only if, the entity stops the relevant activity before the end of the annual assessment period.[4] This means that the pro-rated annual threshold would only apply from the date the entity stops the relevant activity in the market.

At 31 March 20X3 and 30 June 20X3, the bank has not ceased operations and the annual threshold remains at CU10 million. Since the revenue generated as at 31 March 20X3 and 30 June 20X3 did not meet the annual threshold, no liability is recognised under IFRIC 21 on both dates.

In contrast, the bank ceased operation from 1 July 20X3. Hence, the annual threshold would have been pro-rated and reduced to CU5 million at that date.

For the quarters as at 30 September and 31 December 20X3, a liability of CU5,000 must thus be recognised accordingly.

In many countries, property taxes are levied by municipalities or other local government bodies on the owner of a property. Such taxes are relevant and may be material to entities in certain sectors (e.g., real estate). Even within a single jurisdiction, there could be several different property tax mechanisms. Generally, each property tax arrangement must be assessed on its own merits. To facilitate such assessments, we have explored some example fact patterns of property tax mechanisms in the following Illustrations:

Illustration 9-14: A levy is triggered in full as soon as the entity holds the property at a specified date

In accordance with the legislation, property tax is imposed on the registered owner of the property as at 1 April each year. The amount payable is calculated based on 0.1% of the appraised value estimated by the tax authorities as at 1 April each year. Payments are to be made in arrears in instalments on June, September, December and March month-end dates and any unpaid instalments remain as the liability of the registered owner of the property as at 1 April.

The law also states that if the property is sold during the year, there will be no refund from the government to the seller. The new property owner will only be liable to pay the property tax on 1 April of the coming year, subsequent to the date of purchase.

An entity has a calendar year-end and prepares quarterly interim financial reports. It holds a property as at 1 April 20X3, which has an appraised value of CU50 million. On 30 June 20X3, it sold the property to another entity.

In this example, the liability is recognised in the interim financial report as follows:

31 March 20X3:	Nil, since the obligating event is not until 1 April, assuming that all previous year instalments have been paid on time
1 April 20X3:	CU50,000 (CU50 million × 0.1%), i.e., the liability is recognised in full

4 *IFRIC Update*, March 2014, available on the IFRS Foundation's website.

For the subsequent interim period's reports as at 30 June, 30 September and 31 December, the liability recognised in the statement of financial position would be CU50,000 less the instalment payments made during the year.

If in a variation to the above fact pattern, the seller is able to obtain a refund of a proportionate share of the paid property tax (i.e., CU37,500) from the buyer of the property and this refund will form part of the sales price of the property based on the sales contract between the buyer and the seller, it would not change the accounting for the levy under IFRIC 21.

Yet another situation arises where a levy is triggered progressively.

Illustration 9-15: A levy is triggered progressively as the entity holds the asset through a specified period of time

In accordance with the legislation, property tax is imposed on the registered owner of the property as at 1 April each year. The amount payable is calculated based on 0.1% of the appraised value estimated by the tax authorities as at 1 April each year. Payments are to be made in instalments at every March, June, September and December month-end.

The law does not explicitly state that the property tax relates to a period of time. However, if the property is sold during the year, the amount of property tax will be pro-rated for the period from 1 April to the date of sale, and any excess will be refunded to the entity by the government. The new property owner will only be liable to pay the property tax upon the date of purchase, for the period from the date of purchase.

An entity has a calendar year-end and prepares quarterly interim financial reports. It holds a property as at 1 April 20X3 to 31 March 20X4, which has an appraised value of CU50 million as at 1 April 20X3. Prior to 1 April 20X3 the entity did not hold any property. For simplicity, assume that the appraised value does not change year on year.

In this example, although the law does not explicitly state that the property tax relates to the entity holding the property over a period of time, it is evident that the obligating event occurs rateably over the 12-month period from 1 April to 31 March. This is because the law allows for a pro-rated refund to be given to the entity for the period whereby the entity no longer holds the property. This implies that it is a time-based progressive levy.

As such, the levy is triggered over a 12-month period and the liability is recognised rateably over the 12-month period. In contrast with Illustration 9-13, it is not the ownership of the property at a specified date that is the obligating even. Rather, it is the continued holding of the property throughout the period that gives rise to the obligating event.

As such, the liability is recognised in the interim report as follows:

31 March 20X3:	Nil
30 June 20X3:	CU12,500 (CU50,000 divided by 4), less any instalment payments made
30 September 20X3:	CU25,000 (cumulative portion of the prior quarter and current quarter), less any instalment payments made
31 December 20X3:	CU37,500 (cumulative portion of the prior two quarters and current quarter), less any instalment payments made
31 March 20X4:	CU50,000 (cumulative portion of the prior three quarter and current quarter), less any instalment payments made

The impact on interim reports for the various types of levies is summarised below:

Illustrative examples	Obligating event	Recognition of liability in interim reports
Levy triggered progressively as revenue is generated in specified period	Generation of revenue in the specified period	Recognise progressively based on revenue generated
Levy triggered in full as soon as revenue is generated in one period, based on revenues from a previous period	First generation of revenue in subsequent period	Recognise only if first revenue generated in interim period
Levy triggered in full if entity operates as a bank at the end of the annual reporting period	Operating as a bank at the end of the reporting period	Recognise only if interim period includes the last day of the annual reporting period specified in the legislation. Otherwise, a provision would not be permitted to be recognised in interim reports
Levy triggered if revenues are above a minimum specified threshold (e.g., when a certain level of revenue has been achieved)	Reaching the specified minimum threshold	Recognise only where the minimum threshold has been met or exceeded during the interim period. Otherwise, a provision would not be permitted to be recognised in interim reports

These requirements illustrate what is meant by the concept of the 'year-to-date' basis in IAS 34 which is discussed in section 8 above.

9.8 Earnings per share

Earnings per share (EPS) in an interim period is computed in the same way as for annual periods. However, IAS 33 *Earnings per Share* does not allow diluted EPS of a prior period to be restated for subsequent changes in the assumptions used in those EPS calculations. *[IAS 33.65]*. This approach might be perceived as inconsistent to the year-to-date approach which must be followed for computing EPS for an interim period. For example, if an entity, reporting quarterly, computes diluted EPS in its first quarter financial statements, it cannot restate the reported diluted EPS subsequently for any changes in the assumptions used. However, following a year-to-date approach, the entity must consider the revised assumptions to compute the diluted EPS for the six months in its second quarter financial statements, which, in this case would not be the sum of its diluted EPS for first quarter and the second quarter.

10 Use of estimates

IAS 34 requires that the measurement procedures followed in an interim financial report must be designed to ensure that the resulting information is reliable and that all material financial information that is relevant to an understanding of the financial position or performance of the entity is appropriately disclosed. Whilst estimation is necessary in both interim and annual financial statements, the standard recognises that preparing interim financial reports generally requires greater use of estimates than at year-end. *[IAS 34.41]*. Because the standard accepts a higher degree of estimation by the entity, the measurement of assets and liabilities at an interim date may involve less use of outside experts in determining amounts for items such as provisions, contingencies, pensions or non-current assets revalued at fair values. Reliable measurement of such amounts may simply involve updating the previously reported year-end position. The procedures may be less rigorous than those at year-end. The Illustration below is based on Part C of the illustrative examples to IAS 34. *[IAS 34.42]*.

Illustration 10-1: Use of estimates

Inventories	Full stock-taking and valuation procedures may not be required for inventories at interim dates, although it may be done at year-end. It may be sufficient to make estimates at interim dates based on sales margins.
Classifications of current and non-current assets and liabilities	Entities may do a more thorough investigation for classifying assets and liabilities as current or non-current at annual reporting dates than at interim dates.
Provisions	Determining the appropriate provision (such as a provision for warranties, environmental costs, and site restoration costs) may be complex and often costly and time-consuming. Entities sometimes engage outside experts to assist in the annual calculations. Making similar estimates at interim dates often entails updating of the prior annual provision rather than the engaging of outside experts to do a new calculation.
Pensions	IAS 19 requires an entity to determine the present value of defined benefit obligations and the fair value of plan assets at the end of each reporting period and encourages an entity to involve a professionally qualified actuary in measurement of the obligations. As discussed in section 9.3.3 above, market values of plan assets as at the interim reporting date must be available without recourse to an actuary, and reliable measurement of defined benefit obligations for interim reporting purposes can often be extrapolated from the latest actuarial valuation.
Income taxes	Entities may calculate income tax expense and deferred income tax liability at annual dates by applying the tax rate for each individual jurisdiction to measures of income for each jurisdiction. Paragraph 14 of Appendix B (see section 9.5.1 above) acknowledges that while that degree of precision is desirable at interim reporting dates as well, it may not be achievable in all cases, and a weighted-average of rates across jurisdictions or across categories of income is used if it is a reasonable approximation of the effect of using more specific rates.
Contingencies	The measurement of contingencies may involve the opinions of legal experts or other advisers. Formal reports from independent experts are sometimes obtained for contingencies. Such opinions about litigation, claims, assessments, and other contingencies and uncertainties may or may not also be needed at interim dates.
Revaluations and fair value accounting	IAS 16 allows an entity to choose as its accounting policy the revaluation model whereby items of property, plant and equipment are revalued to fair value. IFRS 16 allows a lessee to measure right-of-use assets applying the revaluation model in IAS 16 if those right-of use assets relate to a class of property, plant and equipment to which the lessee applies the revaluation model in IAS 16. Similarly, IAS 40 *Investment Property* requires an entity to measure the fair value of investment property. An entity must revalue at the end of the interim reporting period, but may choose not to rely on professionally qualified valuers to the extent that is required at year-end.

Intercompany reconciliations	Some intercompany balances that are reconciled on a detailed level in preparing consolidated financial statements at year-end might be reconciled at a less detailed level in preparing consolidated financial statements at an interim date.
Specialised industries	Because of complexity, costliness, and time, interim period measurements in specialised industries might be less precise than at year-end.

Although an entity is not required to use professionally qualified valuers at interim reporting dates, and may only update the previous year-end position, the entity is required to recognise impairments in the relevant interim period (see section 9.1.2 above).

11 Effective dates and transitional rules

11.1 First-time presentation of interim reports complying with IAS 34

IAS 34 does not contain any general transitional rules. Therefore, a reporting entity already applying IFRS accounting standards must apply the requirements of IAS 34 in full and without any transitional relief when it first chooses (or is required) to publish an interim financial report prepared under IFRS accounting standards.

For example, an entity that has already published annual financial statements prepared under IFRS accounting standards and either chooses (or is required) to prepare interim financial reports in compliance with IAS 34 must present all the information required by the standard for the current interim period, cumulatively for the current year-to-date, and for comparable periods (current and year-to-date) of the preceding year. *[IAS 34.20]*. The absence of any transitional provisions requires such entities to restate previously reported interim financial information to comply with IAS 34 and to present information relating to comparative interim periods, such as in respect of segment disclosures or in relation to asset write-downs and reversals thereof, which might not previously have been reported.

11.1.1 Condensed financial statements in the year of incorporation or when an entity converts from its local GAAP to IFRS accounting standards

The standard defines 'interim period' as a financial reporting period shorter than a full financial year, *[IAS 34.4]*, and requires the format of condensed financial statements for an interim period to include each of the headings and subtotals that were included in the entity's most recent annual financial statements. *[IAS 34.10]*.

Entities that have converted from local GAAP to IFRS accounting standards and have not yet presented annual financial statements under IFRS accounting standards are subject to additional requirements under IFRS 1 *First-time Adoption of International Financial Reporting Standards* when presenting interim reports in accordance with IAS 34. Such requirements are discussed in detail in Chapter 6 at section 6.6. IAS 34 provides no guidance for an entity that either is required or chooses to issue interim financial statements before it has prepared a set of annual financial statements compliant with IFRS accounting standards. This situation as stated above might arise in the entity's first year of its existence or in the year in which the entity converts from its local GAAP to IFRS accounting standards. Whilst the standard does not prohibit the entity from preparing a condensed set of interim financial statements, it does not specify how an entity would interpret the minimum disclosure requirements of IAS 34 when there are no annual financial statements to refer to.

The entity must consider making additional disclosures to recognise that a user of this first set of interim financial statements does not have the access otherwise assumed by the standard to the most recent annual financial report of the entity. Accordingly, the explanation of significant events and transactions and changes in financial position in the period must be more detailed than the update normally expected in IAS 34. *[IAS 34.15, IAS 34.15A]*. In the absence of any specific regulatory requirements to which the entity is subject, the following are examples of additional considerations that would apply:

- Since it is not possible to make a statement that the same accounting policies and methods of computation have been applied, *[IAS 34.16A(a)]*, the entity must disclose all those accounting policies and methods of computation in the same level of detail as it would in a set of annual financial statements. When the entity issues interim reports on a quarterly basis, the first quarter interim report must provide the above-mentioned details; subsequent quarterly reports could refer to the details included in the first quarter report.
- Similarly, the disclosure of the nature and amount of changes in estimates of amounts reported in prior periods will have to go into more detail than just the changes normally required to be disclosed. *[IAS 34.16A(d)]*.
- Mere disclosure of transfers between levels of the fair value hierarchy used in measuring the fair value of financial instruments, *[IAS 34.15B(k)]*, would not be meaningful unless put in the context of how those fair values are determined (e.g., methods used, any assumptions applied) and providing a detailed classification of all such financial instrument measurements using fair value hierarchy, based on the significance of the inputs used.
- Rather than disclosing changes in the basis of segmentation or in the basis of measurement of segment profit and loss, *[IAS 34.16A(g)(v)]*, a full description will be necessary, as will the disclosure of segment assets and liabilities, *[IAS 34.16A(g)(iv)]*, where such information is required to be disclosed in the annual financial statements. *[IAS 34.16A(g)]*.
- More extensive disclosure than simply the changes since the last report date will be required for contingent liabilities and contingent assets. *[IAS 34.15B(m)]*.
- In the absence of a complete set of annual financial statements complying with IFRS accounting standards, the entity must include each of the headings and subtotals in the condensed financial statements that it would expect to include in its first financial statements prepared under IFRS accounting standards. *[IAS 34.10]*.

12. Future developments

12.1 IFRS 18 Presentation and Disclosure in Financial Statements

IFRS 18, which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted), was issued by the IASB in April 2024.

See Chapter 4 at Section 5.4 for the consequential amendments to IAS 34 and Chapter 4 at Section 6.1 for further details on the transitional impact on interim financial reporting.

12.2 IFRS 19 Subsidiaries without Public Accountability: Disclosures

IFRS 19 was issued by the IASB in May 2024 to simplify the preparation of financial statements by eligible subsidiaries. Eligible subsidiaries, that elect to apply IFRS 19, are allowed to provide reduced disclosures while still applying the recognition, measurement and presentation requirements in other IFRS accounting standards.

IFRS 19 is effective for annual reporting periods beginning on or after 1 January 2027, with earlier application permitted (subject to jurisdictional endorsement).

See Chapter 4 at Section 7 for further details on the requirements of IFRS 19.

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Appendix B - Defined terms

Extract from IAS 34

Definitions

4 The following terms are used in this Standard with the meanings specified:

Interim period is a financial reporting period shorter than a full financial year.

Interim financial report means a financial report containing either a complete set of financial statements (as described in IAS 1 *Presentation of Financial Statements* (as revised in 2007)) or a set of condensed financial statements (as described in this Standard) for an interim period.

Chapter 38 Agriculture

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Overview

IAS 41 *Agriculture* prescribes the accounting treatment for most agricultural activity, from the initial recognition of a biological asset to the harvest of agricultural produce.

IAS 41 applies to some, but not all biological assets. In particular, IAS 41 excludes bearer plants, as defined, from its scope. Instead, they are within the scope of IAS 16 *Property, Plant and Equipment* and are subject to all of the requirements therein. However, agricultural produce growing on bearer plants (e.g., fruit growing on a tree) are within the scope of IAS 41 and are treated as biological assets.

Government grants related to agricultural activity are also within the scope of IAS 41. IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* applies to all other government grants and to disclosures about other government assistance.

This chapter discusses the requirements of IAS 41, along with the requirements that apply to bearer plants within the scope of IAS 16. It also discusses the accounting for trees held to generate carbon offsets for use or sale. The requirements of IAS 16 are discussed in Chapter 19. The requirements of IAS 20 are discussed in Chapter 25.

What you need to know

- IAS 41 prescribes the accounting treatment for biological assets, agricultural produce at the point of harvest and government grants related to agricultural activity.
- Bearer plants are within the scope of IAS 16, but IAS 41 applies to the produce growing on a bearer plant.
- Biological assets and agricultural produce at the point of harvest within the scope of IAS 41 are measured at fair value less costs to sell, with limited exceptions. IAS 41 includes a rebuttable presumption that fair value can be reliably measured for biological assets.

1 Introduction

IAS 41 applies to most biological assets, agricultural produce at the point of harvest, and government grants related to agricultural activity. Produce growing on a bearer plant is within the scope of IAS 41, but the bearer plants they grow on are within the scope of IAS 16.

Practical difficulties may arise when determining which assets are within the scope of the standard, particularly for arrangements that involve leases or concessions. Entities may also find it particularly challenging to apply two different measurement models under two different standards to bearer plants, as defined, and the produce growing thereon. However, it is IAS 41's application of the fair value model that can be the most challenging and contentious.

The nature of agricultural activity can create uncertainty or may conflict with traditional accounting models, particularly because the critical events associated with biological transformation (growth, degeneration, production, and procreation) that alter the substance of biological assets are difficult to deal with in an accounting model based on historical cost and realisation.

As a result, for assets that are in-scope, IAS 41 requires the application of the fair value model to animals and plant life alike, with limited relief. Under this approach, a market price for an animal or part-grown crop is presumed to exist (or is presumed to be reliably measurable if there is no such market price) and the animal or part-grown crop must be valued at this price in the entity's financial statements. The fair value model is applied to all biological assets that are in scope, regardless of whether they are consumed as part of the agricultural activity (consumable biological assets) or not (bearer biological assets).

2 Objective, definitions and scope

2.1 Objective

The stated objective of IAS 41 is: *[IAS 41 Objective]*

Extract from IAS 41

Objective

The objective of this Standard is to prescribe the accounting treatment and disclosures related to agricultural activity.

2.2 Definitions

2.2.1 Agriculture-related definitions

IAS 41 defines 'agricultural activity' as "the management by an entity of the biological transformation and harvest of biological assets for sale or for conversion into agricultural produce or into additional biological assets". *[IAS 41.5]*.

The standard states that 'agricultural activity' covers a wide range of activities, e.g., "raising livestock, forestry, annual or perennial cropping, cultivating orchards and plantations, floriculture, and aquaculture (including fish farming)". *[IAS 41.6]*. Nevertheless, these agricultural activities have certain common features:

"(a) *Capability to change*. Living animals and plants are capable of biological transformation;

"(b) *Management of change*. Management facilitates biological transformation by enhancing, or at least stabilising, conditions necessary for the process to take place (for example, nutrient levels, moisture, temperature, fertility, and light). Such management distinguishes agricultural activity from other activities. For example, harvesting from unmanaged sources (such as ocean fishing and deforestation) is not agricultural activity; and

"(c) *Measurement of change*. The change in quality (for example, genetic merit, density, ripeness, fat cover, protein content, and fibre strength) or quantity (for example, progeny, weight, cubic metres, fibre length or diameter, and number of buds) brought about by biological transformation or harvest is measured and monitored as a routine management function." *[IAS 41.6]*.

Biological transformation under IAS 41 "comprises the processes of growth, degeneration, production, and procreation that cause qualitative or quantitative changes in a biological asset". *[IAS 41.5]*. The standard explains that biological transformation results in the following types of outcomes:

"(a) asset changes through (i) growth (an increase in quantity or improvement in quality of an animal or plant), (ii) degeneration (a decrease in the quantity or deterioration in quality of an animal or plant), or (iii) procreation (creation of additional living animals or plants); or

(b) production of agricultural produce such as latex, tea leaf, wool, and milk." *[IAS 41.7]*.

IAS 41 defines the following additional terms that are used throughout the standard: *[IAS 41.5]*

- A *biological asset* is a living animal or plant.
- A *group of biological assets* is an aggregation of similar living animals or plants.
- *Agricultural produce* is the harvested product of the entity's biological assets.
- *Harvest* is the detachment of produce from a biological asset or the cessation of a biological asset's life processes.
- *Costs to sell* are the incremental costs directly attributable to the disposal of an asset, excluding finance costs and income taxes.

The standard provides examples to illustrate the above definitions. In addition to providing these examples, the standard notes that some of the plants mentioned in the table below may meet the definition of bearer plants and, therefore, be within the scope of IAS 16. However, the produce growing on such plants is within the scope of IAS 41 (see sections 2.2.1.A and 2.3.3 below) and is considered a biological asset. *[IAS 41.5C]*. Figure 2-1 below is based on those examples, but has been modified to provide examples of possible bearer plants and produce growing on those plants: *[IAS 41.4]*

Figure 2-1: Examples of biological assets (including possible bearer plants), agricultural produce and products that are the result of processing after harvest

Biological assets that may meet the definition of a bearer plant	Biological assets (including produce growing on a bearer plant)	Agricultural produce	Products that are the result of processing after harvest
	Sheep	Wool	Yarn, carpet
	Trees in a timber plantation	Felled trees	Logs, lumber
	Dairy cattle	Milk	Cheese
	Pigs	Carcass	Sausages, cured hams
Cotton plants	Growing cotton	Harvested cotton	Thread, clothing
Sugar-cane roots	Growing sugarcane	Harvested cane	Sugar
Tobacco plants	Leaves on the tobacco plants	Picked leaves	Cured tobacco
Tea bushes	Leaves on the tea bushes	Picked leaves	Tea
Grape vines	Grapes on the vines	Picked grapes	Wine
Fruit trees	Fruit on the trees	Picked fruit	Processed fruit
Oil palms	Growing fruit	Picked fruit	Palm oil
Rubber trees	Latex	Harvested latex	Rubber products

2.2.1.A Definition of bearer plants

A bearer plant is defined as "a living plant that:

(a) is used in the production or supply of agricultural produce;

(b) is expected to bear produce for more than one period; and

(c) has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales". *[IAS 41.5]*.

All of the above criteria need to be met for a plant to be considered a bearer plant.

The definition captures plants that would intuitively be considered to be bearers, for instance, grape vines. Some plants may appear to be consumable, such as the root systems of perennial plants (e.g., sugar cane, bamboo or asparagus), but due to the perennial nature of their root systems, it is likely they will also meet the definition of a bearer plant.

Annual crops and other plants that are held solely to be harvested as agricultural produce (e.g., many traditional arable crops such as maize, wheat and soya, as well as trees grown for lumber), are explicitly excluded from the definition of a bearer plant. In addition, plants that have a dual use (i.e., plants cultivated to bear agricultural produce, but for which there is more than a remote likelihood that the plant itself will be harvested and sold as agricultural produce, beyond incidental scrap sales) are not bearer plants. *[IAS 41.5A]*. This may be the case when, for example, an entity holds rubber trees to sell both the latex as agricultural produce and the trees as lumber.

Bearer animals, like bearer plants, may be held solely for the produce that they bear. However, when IAS 41 was amended to exclude bearer plants from its scope, bearer animals were explicitly excluded from the amendments and continue to be accounted for under IAS 41 on the basis that the measurement model would become more complex if applied to such assets.

How we see it

Determining whether an asset meets the definition of a bearer plant may not be entirely intuitive. Careful assessment is, therefore, important. We believe that judgement is needed, in particular in determining:

- Whether the plant will be used in the production or supply of agricultural produce
- Whether the plant is expected to bear produce for more than one period
- What constitutes incidental scrap sales

We discuss these areas of judgement in more detail below.

- *Used in the production or supply of agricultural produce*

  Judgement might be needed to determine whether a plant is used in the production or supply of agricultural produce, rather than consumed in the process. For example, some plants that are generally thought of as consumable are harvested twice, but with the first harvest having the principal purpose of improving the yield of the second harvest. It is not clear whether the fact that there are two harvests is sufficient to make these plants bearer assets.

  For certain plants, new produce may be capable of being grown from various parts of the plant (e.g., pineapples). For others, the plant itself may be cut back and re-grown. For example, after a harvest of bananas, the banana plant may be cut down to its base and re-grown the next year to produce more bananas. In such situations, judgement may be needed to determine which part of the plant might be the bearer plant (e.g., the banana palm or the base).

- *Expected to bear produce for more than one period*

  The definition of a bearer plant requires that a plant be expected to bear produce for more than one period. It would seem appropriate to think of an annual period in this context. However, the standard does not use this term, so an entity needs to consider if an interim period, a season or a production cycle (i.e., through to harvest) might also be appropriate.

- *Incidental scrap sales*

  Whether the likelihood of the plant being sold as agricultural produce is remote is also a matter of judgement. However, it is intended to be a high hurdle. The standard does allow for the fact that there may be some 'incidental scrap sales', but this term is not defined.

  The standard notes that bearer plants might be cut down and sold as scrap, (e.g., for firewood) at the end of their productive life and states that "such incidental scrap sales would not prevent the plant from satisfying the definition of a bearer plant". *[IAS 41.5B]*. However, in the example given in the standard (i.e., firewood), it is reasonably evident that such sales would be 'incidental'. Since no further guidance is given in the standard, entities need to apply judgement in determining what constitutes 'scrap sales' (e.g., would it include ad-hoc sales before the productive life ends, such as selling trees removed while thinning?). Furthermore, the standard does not clarify at what level sales cease to be incidental and whether this is a qualitative or quantitative assessment. Therefore, judgement could be needed.

Frequently asked questions

Question 2-1: What IFRS accounting standard applies if a plant initially meets the definition of a bearer plant, but this subsequently changes?

In addition to the considerations above, an entity might also need to reassess whether a plant meets the definition of a bearer plant after initial recognition. If a plant initially meets the definition of a bearer plant, but this subsequently changes, would IAS 41 then apply instead of IAS 16? Neither IAS 16 nor IAS 41 address this question or specify how to transfer such assets between IAS 16 and IAS 41 (or *vice versa*).

How we see it

In the absence of guidance, management will need to apply judgement in developing an accounting policy (in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*) in these situations. For example, entities might look to the requirements in IAS 40 *Investment Property* on transfers of property to, or from investment property for guidance on determining the threshold for when to account for a transfer of bearer plants to biological assets. IAS 40.57 requires a transfer when there is 'a change in use' and states that "A change in use occurs when … there is evidence of the change in use. In isolation, a change in management's intentions for the use of a property does not provide evidence of a change in use".

It is, however, important to note that the Basis for Conclusions on IAS 16 states, "The Board noted that it would be rare for transfers to take place between IAS 16 and IAS 41 for bearer plants, particularly in the light of the Board's decision to change criterion (c) of the definition of a bearer plant to 'has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales'". *[IAS 16.BC83]*.

2.2.2 General definitions

IAS 41 defines the general terms it uses throughout the standard as follows: *[IAS 41.8]*

- *Carrying amount* is the amount at which an asset is recognised in the statement of financial position.
- *Government grants* are as defined in IAS 20 (see Chapter 25).

IFRS 13 *Fair Value Measurement* defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date". *[IAS 41.8, IFRS 13.9]*. Measuring fair value in accordance with IFRS 13 is discussed further in section 4 below and in Chapter 15.

2.3 Scope

IAS 41 applies to most biological assets, agricultural produce at the point of harvest, and government grants involving biological assets measured at fair value less costs to sell. However, to be within the scope of IAS 41, these items must relate to agricultural activity. *[IAS 41.1]*. As discussed in section 2.2.1 above, agricultural activity refers to "the management by an entity of the biological transformation and harvest of biological assets for sale or for conversion into agricultural produce or into additional biological assets". *[IAS 41.5]*. It is important to note that this definition does not focus on the primary purpose of holding such assets or the number of sales that may result. In fact, the definition refers to 'sale or conversion'; therefore, an entity need not intend to sell the biological assets or agricultural produce in order for the entity to be undertaking agricultural activity. Furthermore, the standard contemplates an entity applying IAS 41 to assets that it will use itself; the Basis for Conclusions refers, as an example, to an entity accounting for trees as biological assets within IAS 41 when it intends to use the harvested logs in the construction of a building for its own use. *[IAS 41.B8]*.

IAS 41 explicitly excludes the following assets from its scope: *[IAS 41.2]*

- Bearer plants (see section 2.2.1.A above), which are within the scope of IAS 16 (see Chapter 19), however, produce growing on a bearer plant is still within the scope of IAS 41
- Government grants that relate to bearer plants, to which IAS 20 applies (see Chapter 25)
- Land related to agricultural activity, which are accounted for under either IAS 16 (see Chapter 19) or IAS 40 (see Chapter 20) *[IAS 41.B55, IAS 41.B56, IAS 41.B57]*
- Intangible assets related to agricultural activity, for instance the costs of developing new disease resistant crops, which are accounted for under IAS 38 *Intangible Assets* (see Chapter 18) *[IAS 41.B58, IAS 41.B59, IAS 41.B60]*

  And
- Right-of-use assets arising from a lease of land related to agricultural activity, which is accounted for under IFRS 16 *Leases* (see Chapter 24)

2.3.1 Biological assets outside the scope of IAS 41

Biological assets are outside the scope of IAS 41 when they are not used in agricultural activity. For example, animals in a zoo (or game park) that does not have an active breeding programme and rarely sells any animals or animal products would be outside the scope of the standard. Another example is activities in the pharmaceutical industry that involve the culture of bacteria. Such activity would not fall within the scope of IAS 41. While the bacteria could be considered a biological asset, the development of a culture by a pharmaceutical company would not constitute agricultural activity. Refer to section 2.3.7 below for further discussion on trees held to generate carbon offsets.

Biological assets outside the scope of IAS 41 will normally fall within the scope of either IAS 16 (see Chapter 19) or IAS 2 *Inventories* (see Chapter 23).

2.3.2 Agricultural produce before and after harvest

IAS 41 applies to agricultural produce (i.e., harvested produce) at the point of harvest only; not subsequent to harvest. Under IAS 41, unharvested agricultural produce is considered to be part of the biological asset from which it will be harvested. Therefore, before harvest, agricultural produce is not accounted for separately from the biological asset from which it comes. For example, milk is accounted for as part of the dairy cow right up to the moment at which the cow is milked.

Subsequent to harvest, agricultural produce is accounted for under IAS 2 or another standard, if applicable. *[IAS 41.3]*. Under IAS 2, agricultural produce is initially recognised as inventory at its fair value less costs to sell (measured in accordance with IAS 41), which becomes its cost for IAS 2 purposes (see Chapter 23). *[IAS 41.B41, IAS 41.B42, IAS 41.B43, IAS 41.B44, IAS 41.B45]*.

2.3.3 Bearer plants and produce growing on a bearer plant

IAS 41 explicitly excludes bearer plants (see section 2.2.1.A above) from its scope; instead, IAS 16 applies to these assets (see Chapter 19). However, the produce growing on a bearer plant remains within the scope of IAS 41. *[IAS 41.2(b)]*.

Entities will need to carefully assess which of its plants meet the definition of a bearer plant. This is because the scope exclusion, while focused on the definition of a bearer plant, also affects the accounting treatment for the produce growing on a bearer plant and any related government grants (see section 3.3 below).

Bearer plants and their agricultural produce are considered to be two separate assets for accounting purposes (i.e., two units of account), with different measurement models being applied under different standards (see section 3.2.3 below for further discussion).

In developing the requirements for bearer plants, the Board noted that bearer plants are held by an entity solely to grow produce over their productive life, similar to plant and equipment and, therefore, do not directly affect the entity's future cash flows. As a result, it decided that bearer plants need to be treated as property, plant and equipment in accordance with IAS 16. However, the IASB believes that "the same argument is not true for the produce growing on the bearer plants that is undergoing biological transformation until it is harvested (for example, grapes growing on a grape vine). The Board observed that the produce is a consumable biological asset growing on the bearer plant and the growth of the produce directly increases the expected revenue from the sale of the produce. Consequently, fair value measurement of the growing produce provides useful information to users of financial statements about future cash flows that an entity is expected to realise". *[IAS 41.BC4B]*. The Board also indicated that such produce ultimately has a market value on its own, whereas the bearer plants on which it grows generally do not. As such, the Board decided that produce growing on a bearer plant would remain within the scope of IAS 41, which is expected to ensure consistency between produce growing in the ground and produce growing on a bearer plant. *[IAS 41.BC4A, IAS 41.BC4B, IAS 41.BC4C, IAS 41.BC4D]*.

2.3.4 Products that are the result of processing after harvest

IAS 41 does not deal with the processing of agricultural produce after harvest. The standard makes it clear that, even if the processing is considered "a logical and natural extension of agricultural activity, and the events taking place … bear some similarity to biological transformation, such processing is not included within the definition of agricultural activity". *[IAS 41.3]*. For example, the process of brewing beer - in which yeast (a fungus) converts sugars into alcohol - would not meet the definition of agricultural activity in the standard. Similarly, cheese production would fall outside the definition of agricultural activity.

2.3.5 Leases of biological assets (excluding bearer plants)

Leases involving biological assets are common in some jurisdictions, for example, the leasing of a sheep farm, where the lessee rents the farm, including the land, sheep and other assets, tends the sheep and sells the wool (agricultural produce). Other examples include leased dairy cows, or leased vineyards, as is illustrated below.

Illustration 2-1: Renting out land with producing vines under an operating lease

Entity A owns a vineyard that includes the following main assets: vineyard land, vineyard infrastructure (e.g., trellises), winery buildings, winery plant and machinery (crushing equipment, distilling equipment), vines and grapes.

The vineyard (the vineyard land and vines) is rented out (as an operating lease) such that the lessee can grow and harvest grapes, and in some instances process the grapes using the winery plant and equipment. Entity A (the lessor) is not entitled to the grapes harvested from the vines. There is no adjustment or contingent rental at the end of the lease for payments or rebates in the movement of the market value of the vines during the lease term.

Under the contract, the lessee must manage the vines including pruning, irrigation, fertilisation, soil management and other necessary activities to preserve and maintain the vineyard and the vines in a proper and efficient state of cultivation in accordance with best viticultural practice. These obligations protect the lessor's interest in the vines by maintaining the long-term health and productivity of the vineyard, and are similar in nature to the obligations of a lessee of a building to ensure that the building is in a suitable condition to be re-let at the end of the lease.

Entity A does not actively participate in the managing of the vines themselves, or the soil that the vines grow in, and it does not have any employees or contractors who are viticulturists. Also, Entity A does not participate in the operating plans or budgets of the lessees.

The risks associated with claims and damages to the vineyard including diseases reside with the lessee for the term of the lease. The lessee takes the risk of loss of grapes from the vines, and takes the risk of deterioration (or improvement) in yields and quality because of disease and weather. Entity A is only at risk for deterioration of the vines from disease at the end of the lease, when renewals are renegotiated.

The grapes produced on Entity A's vineyard are predominantly premium quality grapes. However, these grapes do not have any unique qualities and can be replaced by the grapes grown in the same area under similar conditions.

Any upgrades to the vineyard, such as additional vines plantations or change in grape varieties, made by the lessee must be agreed with Entity A in advance. The upgrades are carried out by the lessee on behalf of Entity A, with Entity A reimbursing upgrade costs to the lessee. The upgrades attract additional lease payments.

Entity A considers the definition of agricultural activity in IAS 41. Entity A notes there is the capability for biological transformation, they are able to measure those changes and there is also harvest of produce resulting from that biological transformation. There is also management of the biological transformation, even though Entity A does not manage the change itself (the lessee manages that change instead).

How we see it

IAS 41 does not specify who must do the managing. Therefore, we believe the definition of agricultural activity can be met even when an entity is not directly managing the biological transformation itself.

Therefore, Entity A concludes that renting out of land containing vines producing grapes under an operating lease by a lessor is within that definition. As a result, the vines are a bearer plant (see section 2.3.3 above) related to agricultural activity and the grapes growing on the vines are biological assets related to agricultural produce.

2.3.5.A Leases of biological assets (excluding bearer plants) - lessee accounting

IFRS 16 excludes from its scope the lessee accounting for leases of biological assets that are within the scope of IAS 41. *[IFRS 16.3(b)]*. The scope exemption in IFRS 16 does not specify whether the asset would be recognised in accordance with IAS 41; only that it is an asset that would be within the scope of IAS 41. Nor does it explain how an entity would account for its lease liability since it is outside the scope of IFRS 16.

Entities affected by this scope exemption will need to use judgement to develop an appropriate accounting policy, considering the requirements of IAS 8[1] (see Chapter 3). *[IAS 8.10, IAS 8.11, IAS 8.12, IAS 8.13]*.

It is important to note that leases of bearer plants that are within the scope of IAS 16 are not excluded from the scope of IFRS 16. "Consequently, leases of bearer plants such as orchards and vineyards held by a lessee are within the scope of IFRS 16". *[IFRS 16.BC68(b)]*.

2.3.5.B Leases of biological assets (excluding bearer plants) - lessor accounting

Chapter 24 contains a discussion of lessor accounting. For lessors, leases of biological assets, including those within the scope of IAS 41, are within the scope of IFRS 16. A lessor would account for its leases as either operating or finance leases in accordance with IFRS 16. *[IFRS 16.67-97]*.

For finance leases of biological assets, the lessor would:

- Account for the net investment in the lease (i.e., the lease receivable, not the biological asset) in accordance with IFRS 16.

For operating leases of biological assets, the lessor would:

- Account for the lease payments as income in accordance with IFRS 16.
- Present the leased biological asset in accordance with its nature, consistent with other assets in the scope of IAS 41.
- Account for other rights and obligations under the lease (e.g., lease income) in accordance with IFRS 16.
- Make disclosures both in accordance with IFRS 16, and for the asset subject to the operating lease, in accordance with IAS 41. *[IFRS 16.81-88]*.

Beyond discussing certain costs, depreciation and impairment, IFRS 16.81-88 do not specifically discuss how to recognise and measure the asset subject to an operating lease if it is within the scope of IAS 41. *[IFRS 16.81-88]*.

How we see it

IFRS 16.BC58-BC66 outlines the IASB's rationale in retaining the requirements of the predecessor standard to IFRS 16, IAS 17 *Leases*, for lessors, virtually unchanged. Furthermore, IAS 41.B82(n), which outlined the interaction between IAS 41 and IAS 17, was not amended on the issuance of IFRS 16. Therefore, it is likely that lessors will continue to measure a biological asset in accordance with IAS 41.

Such lease arrangements may include the land to which the asset is attached. Any leased land would need to be separately accounted for under the relevant standard, for example IAS 16 or IAS 40, as it is explicitly excluded from the scope of IAS 41 (see section 2.3 above). *[IAS 41.2(e)]*.

It is worth noting that, unless specifically excluded from its scope, IAS 41 applies to all biological assets when they relate to agricultural activity. *[IAS 41.1]*. In the example discussed above in section 2.3.5, where the sheep are leased under an operating lease, the wool is the agricultural produce. The sheep are being managed to produce that wool, albeit by the lessee and not the lessor. Since IAS 41 does not specify who must do the managing, the definition of agricultural activity is met. Therefore, the leased sheep would be a lease of biological assets within the scope of IAS 41. Similarly, in Illustration 2-1 in section 2.3.5 above, Entity A concludes the definition of agricultural activity is met even though it is the lessee that does the management, rather than Entity A.

2.3.6 Concessions

A concession typically involves a government, or other controlling authority, granting land to an entity, but requiring that the land be used for a specific purpose, for example, growing certain crops for a minimum period of time.

The treatment of each concession will depend on the specific facts and circumstances. However, if the concession requires an entity to undertake agricultural activity, as defined in IAS 41 (see section 2.2.1 above), the biological assets (excluding bearer plants, but including the produce growing on bearer plants) and agriculture produce will be within the scope of IAS 41. The grant received can also be within the scope of the standard. However, the land granted would be within the scope of IAS 16 or IAS 40 (see Chapters 19 and 20, respectively), and any bearer plants would be within the scope of IAS 16. The discussion in section 3.3 below addresses the treatment of government grants related to biological assets (other than bearer plants).

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1 The consequential amendments resulting from IFRS 18 *Presentation and Disclosure in Financial Statements*, once effective, changes the title of IAS 8 to 'Basis of Preparation of Financial Statements' to better reflect the amended content of IAS 8.

2.3.7 Trees held to generate carbon offsets for use or sale

Climate change and carbon emissions are a global concern. In an effort to offset some of their emissions, entities might buy or plant trees that will absorb carbon dioxide (i.e., act as carbon sinks) and thereby generate carbon offsets. Similarly, forestry companies might change their business models to defer, or cease, planned harvests to generate carbon offsets. In light of the current demand, some entities also sell carbon credits generated by the trees over time.

Entities that directly owns such trees (rather than indirectly through investments in entities that owns the trees) will need to determine whether the trees are:

- Biological assets related to agricultural activity to which IAS 41 applies
- Bearer plants related to agricultural activity to which IAS 16 applies

  Or
- Assets not related to agricultural activity, in which case, it is likely an entity would apply the requirements in IAS 16

Determining the nature of the asset is fundamental to this assessment. As discussed in sections 2.2.1 and 2.3 above to be within the scope of IAS 41 or to be a bearer plant within the scope of IAS 16, the trees must relate to agricultural activity. *[IAS 41.1(a), IAS 41.5]*. The accounting requirements that apply, depending on the nature of the asset are discussed in section 3.2.4 below.

Although IFRS accounting standards need to be applied to the individual trees (i.e., the unit of account), in practice, entities might be able to assess each stand (A group of trees occupying a specific area that are sufficiently uniform (e.g., species, age)) of trees or groups of stands if the intended use of those trees is consistent. It may not be possible to account for an entire forest in the same way if an entity intends to use different parts of the forest in different ways.

(a) Determine whether the definition of agricultural activity is met

Trees are living plants and, therefore, meet the definition of a biological asset. *[IAS 41.5]*. However, to be within the scope of IAS 41 or to be a bearer plant within the scope of IAS 16, they must relate to agricultural activity. *[IAS 41.1(a)]*.

Considering the definition of agricultural activity in section 2.2.1 above, by their very nature, trees will be subject to biological transformation (growth, degeneration, production and procreation processes), which will result in qualitative and quantitative changes over time. Such change for trees can be measured. *[IAS 41.5, IAS 41.6, IAS 41.7]*. However, for there to be agricultural activity, as defined in IAS 41, the entity also needs both of the following:

- Management of change

  What constitutes management is discussed in section 2.2.1 above. For trees, management normally includes silviculture activities, such as planting, pruning, thinning, and fertilising. Harvesting unmanaged sources (deforestation) will not meet the definition of agricultural activity. *[IAS 41.6]*.
- Harvest of agricultural produce

  Also discussed in section 2.2.1 above, IAS 41 limits the definition of agricultural produce to that which can be harvested. This includes harvesting produce growing on, or in, the trees (e.g., fruit, latex) and felling the trees. The harvested produce need not solely be for sale; an entity might also harvest for its own use (e.g., lumber used by an entity in constructing a building for its own use). *[IAS 41.B8]*.

How we see it

While carbon dioxide is absorbed and oxygen is produced by the trees, the oxygen cannot be captured at the point of production and detached in the manner contemplated by the definition of agricultural produce in IAS 41. Similarly, in our view, carbon offsets are not agricultural produce of trees.

IAS 41 does not provide guidance on the extent of harvest needed to qualify as an agricultural activity. If the entity actively manages the trees, thinning the trees will involve harvesting some trees to give space for others to grow. Trees can also be felled to create, or maintain, an access road. Even if the entity does not plan to harvest, a wind or a water event might naturally fell the trees. It is not clear the extent to which such felling might constitute harvesting of agricultural produce (and, therefore, agricultural activity) if the entity were to sell (e.g., at stump) or use the logs.

How we see it

The definition of a bearer plant permits incidental scrap sales (e.g., trees sold for firewood) not to taint the definition of bearer plants (see section 2.3.3 above). It is not clear whether an entity could analogise to this guidance. That is, would it be possible not to meet the definition of agricultural activity if the only harvesting were for incidental scrap sales? While very limited scrap sales might not prevent an entity from applying the bearer plant guidance by analogy, more extensive sales would generally lead to a conclusion that the entity is engaged in agricultural activity.

(b) Determine whether the bearer plant definition is met

If an entity determines there is agricultural activity, it will need to determine whether the trees are bearer plants. Trees related to agricultural activity will be within the scope of IAS 41, unless they meet the definition of a bearer plant. IAS 16 applies to the bearer plants, however, any produce growing in, or on, the trees would be treated as biological assets under IAS 41 until harvest (i.e., as two units of account).

Bearer plants are a subset of biological assets. They are living plants that: are used in the production or supply of agricultural produce; are expected to bear produce for more than one period; and have a remote likelihood of being sold as agricultural produce themselves, except for incidental scrap sales. Examples might include rubber trees, oil palms and fruit trees. However, IAS 41 makes it clear that "plants cultivated to be harvested as agricultural produce (for example, trees grown for use as lumber)", and "trees that are cultivated both for their fruit and their lumber)" (i.e., those with dual purpose) are not bearer plants. *[IAS 41.5, IAS 41.5A, IAS 41.5B]*.

Since bearer plants must relate to agricultural activity, trees held solely to produce carbon offsets will not be bearer plants. However, it is likely that some bearer plants might also produce carbon offsets.

Where it is determined that the trees are not held in relation to agricultural activity, it is likely that an entity would apply the requirements in IAS 16 (refer to section 3.2.4 below, and Chapter 19 at section 3.1.8).

(c) Determine the nature of the asset

The considerations discussed above will, in turn, determine the nature of the asset. The consequent accounting requirements are discussed in section 3.2.4 below.

Figure 2-2: Trees held to generate carbon offsets: determining the nature of the asset

Nature of the asset	Agricultural activity	Bearer plant definition	Example
Biological asset related to agricultural activity	Yes	Not met	Trees in a plantation forest with deferred harvest to allow generation of carbon offsets
Bearer plant related to agricultural activity	Yes	Met	Rubber trees held to generate carbon offsets as well as harvest produce within those trees
Asset not related to agricultural activity	No	Not met	Trees held to generate carbon offsets that are unmanaged and/or not harvested

How we see it

If the trees are held solely to generate carbon offsets, whether sold or used, determining the nature of the asset may require judgement.

After initial recognition, it is not clear whether reassessment might be required if circumstances change. For example, assume an entity had no intention of felling the trees, but that subsequently changed for some of the trees due to windthrow. If these circumstances were to arise, an entity would need to apply the hierarchy in IAS 8 to develop an appropriate policy.

3 Recognition and measurement principles

3.1 Recognition

The standard includes the following recognition requirements for biological assets (including produce growing on a bearer plant) and agricultural produce: *[IAS 41.10]*

Extract from IAS 41

10 An entity shall recognise a biological asset or agricultural produce when, and only when:

(a) the entity controls the asset as a result of past events;

(b) it is probable that future economic benefits associated with the asset will flow to the entity; and

(c) the fair value or cost of the asset can be measured reliably.

Considerations for the recognition of produce growing on a bearer plant are discussed in section 3.2.3.B below.

In agricultural activity, an entity may evidence control by, for example, "legal ownership of cattle and the branding or otherwise marking of the cattle on acquisition, birth, or weaning". *[IAS 41.11]*.

3.2 Measurement

3.2.1 Biological assets within the scope of IAS 41

3.2.1.A Initial and subsequent measurement

A biological asset that is within the scope of IAS 41 (i.e., excluding bearer plants, but including produce growing on a bearer plant) is measured on initial recognition and at the end of each reporting period at its fair value less costs to sell, unless an entity can demonstrate at initial recognition that its fair value cannot be measured reliably. *[IAS 41.12]*. In the latter case, the entity measures the biological asset at historic cost less any accumulated depreciation and any accumulated impairment losses (see section 3.2.6 below), unless/until the fair value becomes reliably measurable. *[IAS 41.30]*.

3.2.1.B Subsequent expenditure

IAS 41 does not prescribe how an entity accounts for subsequent expenditure in relation to biological assets, because the (then) IASC believed this to be unnecessary with a fair-value-based measurement approach. *[IAS 41.B62]*.

Such expenditure may be expensed as incurred or capitalised as additions to the related biological asset. However, under the fair value model, the biological asset will be re-measured at the end of each reporting period. As such, any amounts capitalised will only result in a reallocation between expenses and the fair value gain or loss for the biological asset. Therefore, an entity's policy in relation to subsequent expenditure will have no effect on its equity or net profit or loss, although it will affect all of the following:

- The reconciliation of changes in the carrying amount of biological assets
- The classification of the expenditure in the income statement as either an expense or as part of the net gain or loss on biological assets
- The presentation of subsequent expenditure on biological assets in the statement of cash flows as either operating or investing activities, as appropriate

How we see it

In our view, an entity needs to select an accounting policy for subsequent expenditure that is broadly consistent with the principles in other standards, such as IAS 16 and IAS 38.

In the case of livestock, for example, an entity could expense maintenance costs, such as routine vaccinations, while treating costs that increase the originally expected yield of the asset as capital expenditure. In this case, an entity must consider whether it is appropriate to add costs that improve initially anticipated yields (such as additional vaccinations or feed supplements) to the carrying value of the asset. However, such additions would be adjusted at each period end when the biological asset concerned is revalued to its new fair value. Judgement might be required to determine whether costs that take place after maturity (e.g., vaccinations or feed supplements) would be maintenance costs or improvements. Furthermore, care will be needed when costs are related to both bearer plants and produce growing on a bearer plant or when it is not clear to which of those assets it relates. This is discussed further in section 3.2.3 below.

In September 2019, the IFRS IC discussed a submission about the accounting for costs related to the biological transformation of biological assets (subsequent expenditure) applying IAS 41. The submitter asked whether an entity: (a) recognises subsequent expenditure as an expense when incurred; or (b) capitalises the subsequent expenditure (i.e., adds it to the carrying amount of the asset).

The IFRS IC decided not to take the issue onto its standard setting agenda noting that IAS 41 does not specify requirements on the accounting for subsequent expenditure and an entity can either capitalise subsequent expenditure or recognise it as an expense when incurred. The IFRS IC observed that capitalising subsequent expenditure or recognising it as an expense has no effect on the fair value measurement of biological assets nor does it have any effect on profit or loss; however, it affects the presentation of amounts in the statement of profit or loss.

The IFRS IC drew attention to the requirements of:

- Paragraph 13 of IAS 8, whereby an entity would apply its accounting policy for subsequent expenditure consistently to each group of biological assets

  And

- Paragraphs 117-124 of IAS 1 *Presentation of Financial Statements* whereby an entity would also disclose the selected accounting policy if that disclosure would assist users of financial statements in understanding how those transactions are reflected in reported financial performance *[IAS 1.117-124, IAS 8.13]*

The IFRS IC also noted that when "assessing how to present such subsequent expenditure in the statement of profit or loss, an entity would apply the requirements in paragraphs 81-105 of IAS 1". In particular, an "entity would:

- Applying paragraph 85, 'present additional line items (including by disaggregating the line items listed in paragraph 82), headings and subtotals in the statement(s) presenting profit or loss and other comprehensive income when such presentation is relevant to an understanding of the entity's financial performance'; and
- Applying paragraph 99, present in the statement(s) presenting profit or loss and other comprehensive income or in the notes 'an analysis of expenses recognised in profit or loss using a classification based on either their nature or their function within the entity, whichever provides information that is reliable and more relevant'". *[IAS 1.85, IAS 1.99]*.[2]

The presentation of items in the statement of profit or loss is further discussed in Chapter 3 at section 3.2.

3.2.2 Agricultural produce

Agricultural produce harvested from an entity's biological assets is initially "measured at its fair value less costs to sell at the point of harvest". *[IAS 41.13]*. The standard presumes that an entity can always reliably measure this amount and hence does not permit valuation at historical cost. *[IAS 41.32, IAS 41.B43]*.

The value resulting from initial measurement is subsequently used as cost in applying IAS 2 (if the agricultural produce is to be sold, see Chapter 23), IAS 16 (if harvested logs are used for the construction of a building, see Chapter 19) or other applicable IFRS accounting standards. *[IAS 41.13, IAS 41.B8]*.

An important reason for requiring agricultural produce at the point of harvest to be measured at fair value was to ensure that the basis of measurement would be consistent with that of biological assets and to avoid inconsistent and distorted reporting of current period performance upon harvest of agricultural produce. *[IAS 41.B42]*.

2 *IFRIC Update*, September 2019, available on the IFRS Foundation's website.

3.2.3 Requirements for produce growing on a bearer plant

3.2.3.A Requirements for bearer plants in the scope of IAS 16

Bearer plants are subject to all of the recognition and measurement requirements in IAS 16 (see Chapter 19), including the following (see Figure 3-1 below):

- Before maturity, bearer plants must be measured at their accumulated cost, similar to the accounting treatment for a self-constructed item of plant and equipment before it is available for use. *[IAS 16.22A]*.

  And
- After the bearer plant is mature, entities have a policy choice to measure the bearer plants using either the cost model or the revaluation model. *[IAS 16.29]*. It is important to note that:
  - If the revaluation model is selected, revaluations need to take place with sufficient regularity to ensure the carrying amount does not differ materially from the asset's fair value had it been measured at the end of the reporting period. *[IAS 16.22A]*.
  - Entities following either model need to determine the useful life of the bearer plant in order to depreciate it. The useful life needs to be re-evaluated each year. *[IAS 16.51]*.

    And
  - Unlike biological assets within the scope of IAS 41, items of property, plant and equipment within the scope of IAS 16 are not scoped out of IAS 36 *Impairment of Assets*. Entities, therefore, need to assess whether there are indicators that a bearer plant is impaired at the end of each reporting period. If such indicators exist, the bearer plant will be subject to an impairment test in accordance with IAS 36. *[IAS 16.63, IAS 36.8, IAS 36.9]*. An impairment loss is recognised if the carrying value is higher than the bearer asset's recoverable amount (being the higher of the asset's fair value less costs of disposal and its value in use). *[IAS 36.60]*. The requirements of IAS 36 are discussed in Chapter 21.

The requirements for bearer plants do not completely eliminate volatility in profit or loss, as entities still need to recognise any changes in the fair value of agricultural produce growing on the bearer plant, as discussed in section 3.2.3.B below.

Figure 3-1: Measurement requirements for bearer plants (assuming fair value can be reliably measured)

Timing	Measurement requirement
At initial recognition	▸ Measured separately from any related agricultural produce (i.e., two units of account). ▸ Measured at cost, accumulated until maturity.
Subsequent measurement requirements	▸ Measured separately from any related agricultural produce (i.e., two units of account). ▸ Measured at: ▸ Cost, less any subsequent accumulated depreciation and impairment, with changes recognised in profit or loss. Or ▸ Fair value at each revaluation date, less any subsequent accumulated depreciation and impairment. Revaluation adjustments (and impairment, to the extent it reverses previous revaluation increases) recognised in other comprehensive income; all other changes recognised in profit or loss.

IAS 16 is written with property, plant and equipment in mind. As such, entities may need to use judgement to apply its requirements to bearer plants and we note the following areas for consideration.

(a) Unit of account for bearer plants

IAS 16 does not specify the unit of account for bearer plants. Therefore, entities need to use the general requirements of IAS 16 (see Chapter 19) and need to consider that IAS 41 applies to each item of produce growing on a bearer plant.

The Basis for Conclusions to IAS 16 notes that "IAS 16 does not prescribe the unit of measure, or the extent to which items can be aggregated and treated as a single item of property, plant and equipment. Consequently, applying the recognition criteria in IAS 16 to bearer plants will require judgement. This gives an entity flexibility, depending on its circumstances, to decide how to aggregate individual plants for the purpose of determining a measurable unit of bearer plants". *[IAS 16.BC81]*.

(b) Determining when a bearer plant is mature

IAS 16 requires an entity to determine when a bearer plant reaches maturity - that is, when it is in the "location and condition necessary for it to be capable of operating in the manner intended by management". *[IAS 16.16(b)]*. This determination is important because it is when an entity must cease capitalising costs as part of the initial cost of the asset. The requirements for bearer plants seem to assume that the point in time when a plant is capable of producing (which is referred to as 'maturity') marks a distinct end to all bearer plants' biological transformation. However, the life cycles of plants can vary widely, and it may be difficult, in practice, to identify when maturity has been reached.

Determining at what stage during biological transformation a bearer plant would be considered mature could, therefore, be challenging. Alternatives could include:

- When the bearer plant is capable of producing its first crop
- When the produce is expected to be of sufficient quality to be sold (e.g., macadamia trees start producing fruit after 3-4 years, but only reach commercial levels when the trees are 7 years old)

  Or
- When the growth phase of biological transformation is complete for the bearer plant (and thereafter the plant is expected to degenerate or its productive capacity is expected to decline)

The Board decided not to provide specific application guidance for bearer plants. As such, entities need to apply judgement to determine when a bearer plant is mature for accounting purposes. In reaching its decision not to provide additional guidance, the IASB noted that options, such as those listed above, would have needed further defining and could have led to interpretive issues. Furthermore, the Board noted that "a similar scenario arises for a factory or retail outlet that is not yet capable of operating at full capacity and did not think that this was a major issue in practice". *[IAS 16.BC82]*. Entities, therefore, need to carefully consider the requirements of IAS 16, including those related to sales prior to an item of property, plant and equipment being available for use (see Chapter 19).

(c) Determining initial cost for bearer plants (prior to maturity)

IAS 16 requires that: *[IAS 16.22A]*

Extract from IAS 16	
22A	Bearer plants are accounted for in the same way as self-constructed items of property, plant and equipment before they are in the location and condition necessary to be capable of operating in the manner intended by management. Consequently, references to 'construction' in this Standard should be read as covering activities that are necessary to cultivate the bearer plants before they are in the location and condition necessary to be capable of operating in the manner intended by management.

While IAS 16 provides guidance (see Chapter 19) that entities need to consider for bearer plants, there are differences between traditional plant and equipment and biological assets. As such, entities need to apply judgement in determining which costs can be capitalised. For example, as a plant is growing, an entity will incur costs related to water, fertiliser, greenhouses, etc. The entity needs to assess whether these costs are directly attributable to the bearer plant reaching maturity.

Another example is the cost of abnormal amounts of wasted material, labour and other resources. IAS 16 does not permit these costs to be included in the cost of a self-constructed asset. *[IAS 16.22]*. Entities need to determine what constitutes a normal level of wastage for bearer plants. For example, many bearer plants die before maturity (e.g., due to disease or adverse weather) and are subject to planned thinning. Whether either or both of these is normal wastage requires judgement.

(d) Costs incurred after maturity

A number of costs, such as fertilising, pruning and thinning are incurred after maturity and can improve the quality of the produce or extend the productive life of a bearer plant. Entities need to use judgement to determine whether these costs are maintenance costs or are considered to be improvements.

In addition, after maturity many costs are incurred to benefit both the bearer plant and the produce growing on the bearer plant. Entities need to carefully consider the basis on which to allocate costs between a bearer plant and the produce growing on a bearer plant when the costs are incurred in relation to both assets (e.g., fertilising costs).

(e) Depreciation and impairment considerations

Entities need to carefully consider an appropriate depreciation rate for their bearer plants. Similar considerations are discussed in section 3.2.6.B below in relation to biological assets for which the cost model is used under IAS 41. The model in IAS 16 generally assumes that improvements in productivity and quality of produce do not occur after maturity without additional expenditure to improve the asset. However, many plants mature with age and cultivation. As discussed in section 2.2.1 above, biological transformation continues after a bearer plant begins to produce and includes degeneration. *[IAS 41.5, IAS 41.7]*. A decline in productivity might, therefore, occur only at the end of a plant's productive life, which differs from wear and tear on an item of machinery.

Applying the requirements of IAS 36 to a bearer plant may also be challenging. For example, an individual bearer plant may not generate its own cash inflows and may, therefore, need to be tested for impairment as part of a cash generating unit. In addition, the produce growing on a bearer plant is treated as a separate asset from the bearer plant and, because it is measured at fair value less costs to sell on an ongoing basis under IAS 41, it is excluded from the scope of IAS 36. When testing the bearer plant for impairment, entities need to determine whether or not they can include the produce currently growing on the bearer plant in their impairment assessment.

(f) Revaluation model in IAS 16

IAS 16 permits an entity, after initial recognition to apply the revaluation model. However, this is not the same as applying the fair value model in IAS 41. The former is one that recognises valuation adjustments in other comprehensive income as a form of capital maintenance; the latter is a model that recognises valuation adjustments in the income statement as part of periodic performance. In addition, unlike the model in IAS 41, if the revaluation model is applied under IAS 16 entities are required to:

- Depreciate bearer plants between revaluations, with the depreciation expense recognised in profit or loss
- Identify appropriate indicators of impairment for bearer plants in accordance with IAS 36, and assess annually whether indicators exist. If impairment indicators do exist, then those bearer plants are tested for impairment (as discussed above)

  And
- Maintain cost records for each bearer plant so as to separately track those impairments that are recognised in profit or loss and those impairments that are recognised in other comprehensive income

Furthermore, an entity is unable to recognise increases in fair value that arise from a bearer plant's biological transformation in profit or loss, during the periods in which it is held and used. Since bearer plants are considered property, plant and equipment, the sale of a bearer plant results in a gain or loss on disposal, while revenue is recognised only in relation to sales of agricultural produce.

Despite these challenges, entities could elect to measure their bearer plants using the revaluation model to ensure consistency with the produce growing on them or because the fair value information is useful. That is, a change in the productive capacity of a bearer plant, or a change in the prices for the future output of a bearer plant, can provide useful information.

3.2.3.B Requirements for agricultural produce growing on bearer plants

As noted in section 3.2.3.A above, IAS 16 and IAS 41 require an entity to recognise a bearer plant separately from produce growing on it from the time it exists until the point of harvest.

Produce growing on a bearer plant remains within the scope of IAS 41 and is measured at fair value less costs to sell, with changes recognised in profit or loss as the produce grows. In the IASB's view, this requirement ensures that produce growing in the ground as an annual crop (e.g., wheat) and produce growing on a bearer biological asset (e.g., grapes) are accounted for consistently. *[IAS 41.BC4D]*. As a result, changes in the fair value of such agricultural produce continue to be recognised in profit or loss at the end of each reporting period.

Figure 3-2: Measurement requirements for produce growing on bearer plants

Timing	Measurement requirement
At the end of each reporting period prior to harvest (i.e., biological asset)	Measured separately from the bearer plant at fair value less costs to sell.
At the point of harvest (i.e., agricultural product)	Measured separately from the bearer plant at fair value less costs to sell.
After harvest	Measured separately from the bearer plant. Fair value less costs to sell at the point of harvest becomes initial cost for the purpose of applying IAS 2 or another applicable IFRS accounting standard (see section 2.3.2 above).

(a) Determining when agricultural produce exists

As discussed in section 3.1 above, IAS 41.10 provides criteria for recognising biological assets and agricultural produce. *[IAS 41.10]*. However, since produce growing on a plant is not acquired, but grown, it may be difficult to determine when that produce exists and can be recognised for accounting purposes. Would an entity, for example, wait for physical evidence, e.g., blossom on a tree? If so, how would this be done when the produce is within the bearer plant and not visible, such as with maple or rubber trees? Entities also need to check their procedures for ensuring that sufficient information is gathered, i.e., identifying each item of produce growing on a bearer plant when it is at the right stage of development to be recognised. The key question when assessing the recognition criteria (see section 3.1 above) may be whether it is probable that future economic benefits will flow to the entity. At such an early stage of development, this may be difficult to determine for each item of produce growing on the bearer plant. However, historical information about similar bearer plants and their produce may be of help.

Determining when produce on a bearer plant exists is important as it affects when an entity would recognise and initially measure fair value less costs to sell. This, in turn, determines when an entity assesses whether it is able to measure produce at fair value reliably (or otherwise apply the measurement exception discussed in section 3.2.6 below).

(b) Applying the requirements for biological assets to produce growing on a bearer plant

IAS 41 does not explicitly address the accounting for produce growing on a bearer plant. Instead, the standard says that "produce growing on bearer plants is a biological asset". *[IAS 41.5C]*. Therefore, an entity is required to apply the accounting required for other biological assets to such produce. This has a number of consequences, including the following:

- The unit of account is each item of produce, not the produce growing on each plant as a group. However, while the unit of account is the individual item, an entity is permitted to group these together for measurement purposes (see section 4.2.2 below).
- Each item of produce growing on a bearer plant must be measured at fair value less costs to sell from the time it is recognised until the point of harvest, unless the measurement exception for biological assets for which the fair value cannot be reliably measured at initial recognition is applicable. (See section 3.2.6 below, including discussion by the IFRS IC in 2017 in relation to applying these requirements to produce growing on a bearer plant).

  The fair value less costs to sell may initially be negligible. That is, a market participant acquiring the bearer plant would only pay a negligible amount for the produce in the early stages of development because they would want to be compensated for the costs, they would need to incur to continue growing the produce through to harvest and for the related risks, such as crop failure or price falls during the maturation period. Furthermore, cost to sell needs to be deducted from the fair value of the asset. As discussed in section 3.2.3.A above, entities also need to carefully consider which costs relate to a bearer plant and which relate to the produce growing on the bearer plant.

  The different stages of maturity of the produce and the allocation of the costs related to both the bearer plants and to the produce may make valuing the produce on its own challenging. Measuring fair value for produce growing on a bearer plant also presents the same challenges as measuring part-grown biological assets and those that are physically attached to land (as discussed in sections 4.7 and 4.6.2.A below, respectively).

- The disclosure requirements that apply to biological assets also apply to produce growing on a bearer plant (see section 5 below). Some of the required disclosures may be challenging for entities. For example, IAS 41.46 requires an entity to disclose non-financial measures or estimates of physical quantities for each group of biological assets. *[IAS 41.46]*. While entities might gather such information for management reporting purposes, they need to ensure that information is available for produce growing on bearer plants separately from the bearer plants on which they are growing.

3.2.4 Requirements for trees held to generate carbon offsets for use or sale

As discussed in section 2.3.7 above, to determine the accounting requirements that apply to trees held to generate carbon offsets, entities need to determine the nature of the asset, i.e., whether the trees are:

- Biological assets related to agricultural activity to which IAS 41 applies
- Bearer plants related to agricultural activity to which IAS 16 applies

  Or
- Assets not related to agricultural activity, in which case, it is likely that an entity would apply the requirements in IAS 16 (refer to Chapter 19 at section 3.1.8).

Figure 3-3: Trees held to generate carbon offsets: applicable standard(s) and measurement requirements

Nature of the asset	Applicable standard(s)	Measurement requirements
Biological asset related to agricultural activity	IAS 41	Fair value less costs to sell at initial recognition (see section 3.2.1 above) and subsequently (see section 3.2.1.B above for considerations relating to subsequent expenditure). If the presumption that fair value can be reliably measured is rebutted on initial recognition (see section 3.2.6 below), an entity is permitted to measure a biological asset at its cost less any accumulated depreciation until fair value becomes reliably measurable. *[IAS 41.30]*.
Bearer plant related to agricultural activity	Produce growing on, or in, the bearer plant: IAS 41 (treated as biological assets under that standard)	Fair value less costs to sell at initial recognition (see section 3.2.2 above) and subsequently (see section 3.2.3.B above). If the presumption that fair value can be reliably measured is rebutted on initial recognition (see section 3.2.6 below), an entity is permitted to measure a biological asset at its cost less any accumulated depreciation until fair value becomes reliably measurable. *[IAS 41.30]*.
	Trees: IAS 16	Initial recognition at cost determined using the requirements for bearer plants; choice between cost or revaluation model subsequently (see section 3.2.3.A above).
Assets not related to agricultural activity	Likely to be IAS 16	Initial recognition at cost determined using the general requirements for property, plant and equipment; choice between cost or revaluation model subsequently.

As Figure 3-3 above illustrates, the accounting requirements can vary depending on the nature of the asset.

If IAS 41 applies, the trees (or produce growing on a bearer plant) are measured at fair value less costs to sell both at initial recognition and subsequently (unless the measurement exception applies because fair value cannot be reliably measured), with recognition of those changes through profit or loss.

If IAS 16 applies (see Chapter 19), the initial measurement requirements will differ depending on whether the asset is a bearer plant or not:

- Bearer plants: they are measured at their accumulated cost, similar to the accounting treatment for a self-constructed item of plant and equipment before it is 'available for use', which is typically when they are mature (see section 3.2.3.A above).
- Other assets: they are measured at their accumulated cost until they are available for use, which will generally be as soon as they are planted. An entity would not need to apply the requirements for bearer plants.

Subsequently, under IAS 16, entities have a policy choice to measure trees (whether bearer plants or not) using either the cost model or the revaluation model.

- If the revaluation model is selected, revaluations need to take place with sufficient regularity to ensure the carrying amount does not differ materially from the asset's fair value had it been measured at the end of the reporting period. In addition, unlike IAS 41, revaluation changes are recognised through other comprehensive income.
- Entities following either model need to determine the useful life of the trees in order to depreciate them. The useful life needs to be re-evaluated each year.
- Unlike biological assets in the scope of IAS 41, property, plant and equipment is not scoped out of IAS 36 (refer to Chapter 21). Entities, therefore, need to assess whether there are indicators that the trees are impaired at the end of each reporting period. If such indicators exist, an impairment loss will be recognised if the carrying value is higher than the asset's recoverable amount (being the higher of the asset's fair value less costs of disposal and its value in use).

How we see it

While measurement of fair value can be complex and subject to measurement uncertainty, determining the cost of growing trees can also be challenging. For example, pruning and thinning maintains the trees in the forest, but can also improve yield. It might also be difficult to determine an appropriate useful life for a growing asset. Therefore, regardless of the measurement requirements, entities might need to apply judgement in accounting for such trees. Similar considerations apply to bearer plants (discussed further in section 3.2.3.A above) and to biological assets if the cost model in IAS 41 applies (discussed further in section 3.2.6.B below).

3.2.5 Gains and losses

IAS 41 requires gains and losses arising on the initial recognition of a biological asset (including produce growing on a bearer plant) at fair value less costs to sell to be included in profit or loss for the period in which they arise. *[IAS 41.26]*. The standard warns that: *[IAS 41.27]*

Extract from IAS 41	
27	A loss may arise on initial recognition of a biological asset, because costs to sell are deducted in determining fair value less costs to sell of a biological asset. A gain may arise on initial recognition of a biological asset, such as when a calf is born.

Subsequent to initial recognition, reported gains or losses essentially represent the difference between two fair values. As such, the standard effectively decouples profit recognition from a sales transaction. One consequence of this approach is to anticipate some of the profit that will be realised, often by a matter of years for long-term crops, such as trees.

The implications for initial recognition of agricultural produce are similar - an entity need to recognise a gain or loss on agricultural produce upon harvesting if the fair value of the harvested produce is different from the pre-harvest valuation. *[IAS 41.29]*. The standard requires that "A gain or loss arising on initial recognition of agricultural produce at fair value less costs to sell … be included in profit or loss for the period in which it arises". *[IAS 41.28]*.

3.2.6 Inability to measure fair value reliably

3.2.6.A Rebutting the presumption

Under IAS 41, there is a presumption that the fair value of all biological assets (including produce growing on a bearer plant) can be measured reliably. This presumption can only be rebutted on initial recognition for a biological asset (not agricultural produce).

How we see it

In our view, such a rebuttal will be rare as, to be able to do so, an entity must demonstrate both of the following:

(a) Quoted market prices for the biological asset (including produce growing on a bearer plant) are not available.

And

(b) Alternative fair value measurements for the biological asset are determined to be clearly unreliable.

The following considerations are relevant when determining whether the presumption can be rebutted.

Since IAS 41 requires that the fair value of a biological asset (including produce growing on a bearer plant) be measured in accordance with IFRS 13 (see Chapter 15), an entity needs to consider the requirements of that standard in order to determine whether fair value can be reliably measured.

In relation to (a) above, it is important to note that IAS 41 does not restrict the criteria to quoted prices in an active market. Therefore, in order to rebut the presumption, an entity needs to determine that quoted prices in both active and inactive markets are unavailable for the asset.

If an entity is able to determine that quoted prices for the asset are unavailable, it still needs to determine that all other methods for measuring fair value are clearly unreliable before it can rebut the presumption. This is not the same identifying that a fair value measurement is complex and/or subjective. That is, measuring fair value often involves estimation and significant judgement, but this does not mean that it is automatically unreliable. Furthermore, the requirement is for the measurements to be 'clearly unreliable', which is arguably a higher hurdle than 'unreliable'.

Determining that alternative fair value measurements are clearly unreliable is likely to include, but not be limited to, considering the reliability of the following factors:

- Estimates of quantities on hand and the stage of development - while estimates are often required of quantities on hand (including current stage of biological transformation and anticipated yields for future agricultural produce), the mere fact that estimates are used is not sufficient to demonstrate that fair value is unreliable. Rather, an entity needs to demonstrate that their estimates of the quantity and current state of their biological assets are often incorrect. This may be challenging for entities to demonstrate if the underlying information is regularly used by management to make decisions about future operations of the business.
- Prices for the asset in a future state (e.g., for the mature biological asset or the agricultural produce that will ultimately be harvested).
- Prices for similar assets that can be used as an input into the fair value measurement - this could include plants and animals that are similar to the asset held by the entity or the ultimate agricultural produce that will result from managing the biological transformation of the asset held by the entity.
- Cash flow projections for the asset.
- The replacement cost of the asset.

Entities might also need to consider whether other entities (within a country or globally) are able to demonstrate that fair value can be reliably measured for the same or similar assets.

In 2017, the IFRS IC received a request to consider whether fruit growing on oil palms is considered an example of a biological asset for which an entity might rebut the fair value presumption applying IAS 41.30. The IFRS IC rejected this request observing that its role is not to conclude upon very specific application questions, particularly when they relate to the application of the judgements required in applying IFRS accounting standards. In rejecting the request, "the Committee concluded that the reference to 'clearly unreliable' in paragraph 30 of IAS 41 indicates that, to rebut the presumption, an entity must demonstrate that any fair value measurement is clearly unreliable. Paragraph BC4C of IAS 41 suggests that, when developing the amendments to IAS 41 on bearer plants, the Board's expectation was that fair value measurements of produce growing on bearer plants might be clearly unreliable when an entity encounters significant practical difficulties. However, the Committee observed that the converse is not necessarily true - i.e., if an entity encounters significant practical difficulties, this does not necessarily mean that any fair value measurement of produce is clearly unreliable".[3] *[IAS 41.30, IAS 41.BC4C]*. In addition to these observations, the IFRS IC noted that possible differences in supportable assumptions, (which might give rise to significantly different measurements) do not constitute evidence of 'significant practical difficulties' as discussed in IAS 41.BC4C. This is because these would not, on their own, result in fair value measurements that are clearly unreliable.

3 *IFRIC Update*, June 2017, available on the IFRS Foundation's website.

The IFRS IC's observations indicate that a rebuttal of the presumption that the fair value can be measured reliably will be rare. If they cannot rebut the presumption, entities will need to measure fair value and that fair value may be subject to significant estimation uncertainty. As a result, the Committee also emphasised that entities need to comply with the disclosure requirements in IAS 1.125 (regarding significant assumptions and estimates) and those in IFRS 13.91 so as to assist users of financial statements understand the valuation techniques, inputs used and the effect of measurements that use Level 3 inputs.[4] *[IAS 1.125, IFRS 13.91]*.

An entity that previously measured a biological asset at its fair value less costs to sell cannot revert to a cost-based measurement in a later period, even if a fair value can no longer be measured reliably. *[IAS 41.31]*. The standard assumes that reliable estimates of fair value would rarely, if ever, cease to be available. *[IAS 41.B36]*. This assumption holds during times of heightened market volatility or uncertainty. A more detailed discussion of some of the practical problems associated with determining fair value in the absence of a market price can be found in section 4.7 below.

If an entity rebuts the presumption at initial recognition and then it becomes possible at a later date to measure the fair value of a biological asset reliably, the entity is required to apply the fair value model to that asset from that date onwards. *[IAS 41.30]*. In developing the standard, the (then) IASC noted in this respect that "in agricultural activity, it is likely that fair value becomes measurable more reliably as biological transformation occurs and that fair value measurement is preferable to cost in those cases". Therefore, the IASC "decided to require fair value measurement once fair value becomes reliably measurable". *[IAS 41.B35]*.

IAS 41 presumes that the fair value of a non-current biological asset that "meets the criteria to be classified as held for sale (or is included in a disposal group that is classified as held for sale) in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*" can always be measured reliably. *[IAS 41.30]*.

Frequently asked questions

Question 3-1: Can acquisition-related transaction costs be taken into account when subsequently measuring fair value?

In situations where the cost model is initially applied and then fair value becomes reliably measurable, a question that sometimes arises is whether acquisition-related transaction costs (i.e., those that have been incurred by the entity on purchasing the asset) that have been capitalised can be taken into account when subsequently measuring the fair value component of 'fair value less costs to sell'. Fair value is a market-based measure and is defined in IFRS 13 as an exit price. The objective is to measure the price that would be obtained in a transaction between market participants to sell an asset; not the costs each party would incur in order to transact - those costs reflect the characteristics of the transaction and not of the asset being hypothetically sold.

How we see it

In light of the above, we believe it would be inappropriate to include acquisition-related transaction costs when measuring fair value, particularly since a seller would not incur such costs.

In addition, as discussed in section 4.6.4.A below, IFRS 13 specifically states that transaction costs that would be incurred in a transaction to sell an asset are not part of fair value (that is, they are not added to, or deducted from, the exit price used to measure fair value). *[IFRS 13.25]*. However, IAS 41 requires 'costs to sell' to be deducted from fair value, measured in accordance with IFRS 13, before recognition in the financial statements leading to a lower valuation than a pure IFRS 13 valuation.

3.2.6.B The cost model

If, on initial recognition, an entity rebuts the presumption and demonstrates that fair value cannot be measured reliably, it applies the cost model to the biological asset (including produce growing on a bearer plant), i.e., the asset is measured at cost less any accumulated depreciation and any accumulated impairment losses. *[IAS 41.30]*.

When determining cost, accumulated depreciation and accumulated impairment losses an entity needs to consider the requirements of IAS 2, IAS 16 and IAS 36. *[IAS 41.33]*. Refer to Chapter 23, Chapter 19 and Chapter 21, respectively, for discussion on each of these standards. IAS 41 provides no further guidance on the application of the cost model or the extent to which entities need to consider the requirements of these standards.

4 *IFRIC Update*, June 2017, available on the IFRS Foundation's website.

How we see it

Both IAS 2 and IAS 16 establish frameworks within which to determine cost. The nature of the biological asset could be helpful when determining which approach to use. The nature of the biological asset could also be helpful in determining when to commence depreciation and the useful life of the asset.

Consumable biological assets that are to be harvested as agricultural produce or sold as biological assets, for example livestock to be slaughtered or held for sale, fish in farms or crops to be harvested, could be more consistent with inventories accounted for in accordance with IAS 2. Bearer biological assets, such as dairy cows could be more consistent with plant and equipment accounted for in accordance with IAS 16. When the IASB issued the bearer plants amendments, it noted that, although bearer plants are dissimilar in form to plant and machinery, similarities in how they are used supported accounting for them in the same way. *[IAS 16.BC67]*.

IAS 16.55 requires depreciation to commence when an asset is available for use. *[IAS 16.55]*. Determining when a biological asset is available for use may be more obvious in relation to bearer biological assets. For example, a cow may be considered available for use as soon as it is sufficiently mature to produce milk. However, for consumable biological assets defining when an asset is available for use is less clear because the period between these assets reaching maturity and being sold or harvested is typically short.

The last component of the cost model is the assessment of impairment in accordance with IAS 36. That standard requires an entity to determine the recoverable amount of an asset or cash-generating unit (CGU) and compare it to its carrying amount in order to determine whether the asset or CGU is impaired. Recoverable amount is defined by IAS 36 as the higher of either the value in use or fair value less costs of disposal of the asset or CGU (IAS 36 is discussed in Chapter 21).

How we see it

Entities that have demonstrated that fair value cannot be reliably determined for a biological asset need to ensure they apply a consistent approach when determining the recoverable amount of that asset. As such, using a value in use approach to determine recoverable amount will be required, possibly at the CGU level. Even in this situation, entities may need to carefully consider whether information used to measure value in use could be used to measure the fair value of the biological asset.

An entity that uses the reliability exception (and, therefore, applies the cost model) is required to disclose certain additional information in its financial statements. This is discussed further in section 5.3 below. *[IAS 41.B37]*.

3.3 Government grants

Government grants involving biological assets that are within the scope of IAS 41 (i.e., excluding bearer plants, which are specifically scoped out of IAS 41) are only accounted for under IAS 20 if the biological asset is "measured at its cost less any accumulated depreciation and any accumulated impairment losses" as discussed in section 3.2.6 above (see Chapter 25 for a discussion of government grants within the scope of IAS 20). *[IAS 41.37, IAS 41.38]*. IAS 41 applies to government grants relating to all other biological assets (including produce growing on a bearer plant) accounted for at fair value less costs to sell.

What is not clear is whether government grants that relate to both a bearer plant and the produce growing on that bearer plant would be within the scope of either IAS 20 or IAS 41. It is also not clear how an entity would deal with a government grant if the related biological asset is initially measured in accordance with the cost model in IAS 41 (and so applies IAS 20 to the related government grant), but later is measured at fair value less costs to sell because fair value becomes reliably measurable. Entities will need to use judgement in relation to such grants.

Under IAS 20, government grants are either:

- Recognised as deferred income and then recognised in profit or loss on a systematic basis over the useful life of the asset

  Or

- Deducted in calculating the carrying amount of the asset and then recognised in profit or loss over the life of a depreciable asset as a reduced depreciation expense

Under IAS 41, an unconditional government grant related to a biological asset that is "measured at its fair value less costs to sell shall be recognised in profit or loss when, and only when, the government grant becomes receivable". *[IAS 41.34]*. An entity is, therefore, not permitted under IAS 41 to deduct a government grant from the carrying amount of the related asset. This would be inconsistent with a "fair value model in which an asset is measured and presented at its fair value" because the entity would recognise even conditional government grants in income immediately. *[IAS 41.B66]*.

Any conditional government grant related to a biological asset measured at its fair value less costs to sell - including government grants that require an entity not to engage in a specified agricultural activity - are only recognised when the conditions attaching to the grant are met. *[IAS 41.35]*. IAS 41 permits an entity to recognise a government grant as income only to the extent that it: (i) has met the terms and conditions of the grant; and (ii) has no obligation to return the grant. The following Illustration, which is derived from an example in IAS 41, shows how an entity applies these requirements. *[IAS 41.36]*.

Illustration 3-1: Conditional government grants

A government grant requires an entity to farm in a particular location for five years and requires the entity to return the entire government grant if it farms for less than five years. The government grant is not recognised as income until the five years have passed.

Another government grant allows for part of the government grant to be retained based on the passage of time. The entity recognises this government grant as income on a time proportion basis.

4 Measuring fair value less costs to sell

4.1 The interaction between IAS 41 and IFRS 13

IFRS 13 specifies how to measure fair value. However, it does not specify what must be measured at fair value or when a fair value measurement must be performed. Therefore, an entity applies IAS 41 to determine what to measure at fair value less costs to sell and when to measure fair value (i.e., the measurement date). The entity then applies IFRS 13 to measure 'fair value', taking into consideration the specific requirements in IAS 41 (see section 4.5 below). 'Costs to sell', measured in accordance with IAS 41, are then deducted.

As discussed in section 5 below, disclosures in relation to the fair value measurement will need to be provided in accordance with IFRS 13 and also IAS 41, to the extent that it requires additional agriculture-specific disclosures.

The following sections consider further the interaction between IFRS 13 and IAS 41 and highlight some of the key requirements of IFRS 13 relating to biological assets and agricultural produce. See Chapter 15 for a discussion of the requirements in IFRS 13.

4.2 Establishing what to measure

4.2.1 Unit of account

The unit of account identifies what is being measured for financial reporting purposes, i.e., the level of aggregation (or disaggregation) for presentation and disclosure purposes. For example, whether the information presented and disclosed in the financial statements is for an individual asset or for a group of assets.

The unit of account in IAS 41 is the individual biological asset or agricultural produce. For example, the standard applies to the individual trees in a forest, not the forest as a whole. As discussed in section 4.2.2 below, the standard does permit grouping of assets to facilitate measuring fair value, but this does not change the unit of account.

Another important factor is that the asset is being measured in its current form, and not as it will be once mature. Therefore, understanding the different stages of maturity for the asset and determining what stage the asset is in at the measurement date is crucial. Consider for example a farmer raising chickens, the farmer needs to consider the various stages from egg, to hatchling, day-old chick, partly-grown and finally mature chicken. The different stages the chickens are in at the measurement date could result in different methods and inputs being used to measure fair value, and different assumptions, for example different principal markets at each stage (see section 4.6.3 below). Also refer to section 4.7 below for a further discussion on measuring fair value for part-grown or immature biological assets.

4.2.2 Grouping of assets

IAS 41 states that: *[IAS 41.15]*

Extract from IAS 41	
15	The fair value measurement of a biological asset or agricultural produce may be facilitated by grouping biological assets or agricultural produce according to significant attributes; for example, by age or quality. An entity selects the attributes corresponding to the attributes used in the market as a basis for pricing.

For example, when undertaking a valuation of livestock, an entity may group each of the animals in the herd based on factors such as species, age, weight and the expected yield.

4.3 When to measure fair value

In order to apply the requirements of IFRS 13, an entity needs to determine when to measure fair value, i.e., the measurement date. IFRS 13 relies on the standard that requires, or permits, the fair value measurement to specify this date, i.e., IAS 41 for biological assets (including produce growing on a bearer plant) and agricultural produce.

As discussed in section 3.2.1.A above, biological assets within the scope of IAS 41 are required to be measured at fair value less costs to sell at initial recognition and subsequently, on a recurring basis, at least at the end of each reporting period.

The fair value less costs to sell of agricultural produce is measured on the date that it is harvested (see section 3.2.2 above).

4.4 Determining costs to sell

Costs to sell are defined in IAS 41 as "the incremental costs directly attributable to the disposal of an asset, excluding finance costs and income taxes". *[IAS 41.5]*.

Therefore, of all the costs that are necessary for a sale to occur, costs to sell only include those costs that would otherwise not arise. However, costs already included within the fair value measurement, such as transportation costs, are excluded from costs to sell. Examples of costs to sell could include brokers' and dealers' commissions, levies by regulatory agencies and commodity exchanges, transfer taxes and duties. *[IAS 41.BC3, IAS 41.B22]*.

4.5 Measuring fair value: IAS 41-specific requirements

4.5.1 Use of external independent valuers

IAS 41 does not require an entity to use an external independent valuer to determine the value of biological assets. In fact, the Board rejected a proposal to require external independent valuations because they are "not commonly used for certain agricultural activity and it would be burdensome to require an external independent valuation. The Board believes that it is for entities to decide how to determine fair value reliably, including the extent to which independent valuers need to be involved". *[IAS 41.B33]*. Furthermore, the Board also noted that requiring the disclosure of the extent to which the carrying amount of biological assets reflects a valuation by an external independent valuer would not be appropriate for the same reasons. *[IAS 41.B81]*.

4.5.2 Obligation to re-establish a biological asset after harvest

It is common in certain industries, particularly where a biological asset is physically attached to land, for an entity to have an obligation to re-establish a biological asset after harvest. The standard gives the example of an entity that has an obligation to replant the trees in forest after harvest.

IAS 41 does not permit an entity to include the costs of re-establishing a biological asset after harvest when using estimated future cash flows to measure fair value. *[IAS 41.22]*. This is consistent with the unit of account being the individual biological asset (see section 4.2.1 above). For example, an entity that owns a forest might consider its intention, or obligation, to replace its trees in the future if it were measuring the fair value of the forest as a whole. However, the entity is required by IAS 41 to measure the individual trees that are actually planted in the forest on the measurement date. It would be inconsistent to consider replanting, since removal of an existing tree (in order to plant a new tree) would be the end of that asset's useful life.

The IFRS IC considered such obligations in May 2004 and confirmed its previous decisions that, if an entity has an obligation to re-establish a biological asset after harvest, that obligation is attached to the land and does not affect the fair value of the biological assets currently growing on the land.

The problem of how to account for an obligation to replant was considered by the Board in 2007. Circumstances can arise where an entity is legally obliged (whether by law or contract) to replant a biological asset after harvest. The interaction of the fair value measurement basis of IAS 41, the prohibition on including the replanting costs in determining that fair value in IAS 41.22 and the potential recognition of a provision for the cost of replanting in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (see Chapter 27) when the biological asset is harvested, could lead to a net expense being recognised at the point of harvest.

Even in situations where there is a legal obligation to replant, an entity cannot consider replanting when measuring the fair value of a biological asset.

4.5.3 Forward sales contracts

When an entity enters into a contract to sell its biological assets (including produce growing on a bearer plant) or agricultural produce at a future date, the standard does not permit it to measure those assets at the contracted price, stating that "the fair value ... is not adjusted because of the existence of a contract". *[IAS 41.16]*.

When IAS 41 was developed, the Board considered whether the standard should require sales contracts to be measured at fair value but concluded that no solution would be practicable without a complete review of the accounting for commodity contracts that are not accounted for as financial instruments. *[IAS 41.B50-B54]*.

It follows from this that, if an entity engaged in agricultural activity enters into forward sales contracts for its produce, it will need to consider whether such contracts are within the scope of IFRS 9 *Financial Instruments*. IFRS 9.2.4 states "This standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements". *[IFRS 9.2.4]*. Accordingly, an agricultural commodity sales contract will be accounted for under IFRS 9 by an entity that intends to net settle that contract, even if it is also a producer of the underlying agricultural produce. Conversely, a farmer who intends to settle a forward sales contract for barley by physical delivery would not typically account for the contract under IFRS 9, but would treat it as an executory contract. However, IFRS 9 is applied to such contracts if an entity designates them as measured at fair value through profit or loss in accordance with IFRS 9.2.5. *[IFRS 9.2.5]*. This issue is discussed further in Chapter 41.

4.5.4 Onerous contracts

Although a forward sales contract that is scoped out of IFRS 9 is treated as an executory contract, IAS 41 notes that, if the contracted price is lower than the fair value of the assets, the contract for the sale of a biological asset (including produce growing on a bearer plant) or agricultural produce may be an onerous contract, as defined in IAS 37. If it meets the definition of an onerous contract, it is accounted for under IAS 37 *[IAS 41.16]* - the accounting for onerous contracts is dealt with in Chapter 27.

However, IAS 41 provides no further guidance on the subject of when such a contract becomes onerous. The standard is also silent on what this might mean, given the fact that IAS 37 defines an onerous contract as "a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it". *[IAS 41.B50, IAS 41.B51, IAS 41.B52, IAS 41.B53, IAS 41.B54]*. In other words, a contract that is not loss-making, but that has a contract price lower than the fair value of the produce concerned, is not automatically defined as onerous by IAS 37, yet seems to be regarded as onerous under IAS 41.

How we see it

In our view, a contract to sell a biological asset at an amount that is below its fair value less costs to sell (and, therefore, its carrying amount) would be regarded as onerous under IAS 37.

4.5.5 Financing cash flows and taxation

IAS 41 does not permit an entity to include any cash flows for financing an asset when using estimated future cash flows to measure fair value. *[IAS 41.22]*.

Previously, the standard also required an entity to exclude tax cash flows when measuring fair value in accordance with IAS 41. *[IAS 41(2021).22]*. However, in May 2020 the Board issued an amendment to IAS 41 as part of its *Annual Improvements to IFRS Standards 2018-2020* which removed that requirement. The amendment became effective for annual periods beginning on or after 1 January 2022 and applied prospectively.[5] This amendment aligned the requirements in IAS 41 on fair value measurement with those in IFRS 13, which allows the use of post-tax cash flows and post-tax discount rates when measuring fair value.

The previous exclusion of taxation had been practically challenging if an entity used an income approach to measure fair value. Valuers typically prepared post-tax calculations, discounting post-tax cash flows using a post-tax discount rate. If this approach was used to derive a pre-tax equivalent fair value, entities needed to ensure the assumptions related to tax were not entity-specific. As discussed in section 4.6 below, IFRS 13 requires that assumptions used to measure fair value reflect what market participants would consider.

5 Annual Improvements to IFRS Standards 2018-2020, May 2020, pp.15-17.

4.6 Measuring fair value: overview of IFRS 13's requirements

4.6.1 The fair value measurement framework

The objective of a fair value measurement is "to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions". *[IFRS 13.B2]*. In order to measure the fair value of a biological asset or agricultural produce, an entity needs to determine all of the following: *[IFRS 13.B2]*

- The particular asset that is the subject of the measurement (consistent with its unit of account - see section 4.2 above)
- The valuation premise that is appropriate for the measurement (consistent with its highest and best use - see section 4.6.2 below)
- The principal market (or in the absence of a principal market, the most advantageous market) for the asset or liability (see section 4.6.3 below)
- The valuation technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use when pricing the asset and the level of the fair value hierarchy within which the inputs are categorised (see sections 4.6.3 and 4.6.4 below)

When valuations are subject to significant measurement uncertainty due to market volatility and there is a wider range of possible estimates of fair value measurement, an entity is required to apply judgement to determine the point within that range that is most representative of fair value measurement in the circumstances.

Climate change can have a tangible effect on an entity's assets and liabilities now or in the future. Entities might be subject to real or perceived risks or opportunities as a result of climate change, both physical risks (such as rising water levels, changing weather patterns, increased pollution levels) and transition risks (such as known or anticipated changes to laws and regulations or commitments to agreed targets or spending to mitigate the effects of pollution). Entities need to ensure that their fair value measurements appropriately consider relevant climate-related risk factors and opportunities.

Since fair value focuses on what market participants in the principal (or most advantageous) market would consider when pricing the asset or liability, care is needed in determining whether, and to what extent, climate change might affect the assumptions used to measure fair value. This might include, for example, how market participants believe climate-related risks would affect the price of the asset or liability; the effect of restrictions imposed on assets in response to climate change (if it is a characteristic of the asset); and the highest and best use of a non-financial asset, which must be physically possible, legally permissible and financially feasible, and is presumed to be the entity's current use. Sustainability reporting disclosures might provide more information about an asset or liability and, therefore, affect what market participants would be willing to pay. However, determining the impact of that information on market participant assumptions, inputs and sensitivities, is likely to require significant judgement.[6]

4.6.2 Highest and best use and valuation premise

IFRS 13 requires that the fair value of non-financial assets, such as biological assets and agricultural produce, take into account "a market participant's ability to generate economic benefits by using the asset in its *highest and best use* or by selling it to another market participant that would use the asset in its highest and best use" (emphasis added). *[IFRS 13.27]*.

The objective in determining highest and best use is to identify the use by market participants that would maximise the value of the asset, either on its own or with other assets and/or liabilities. Therefore, in order to determine the highest and best use of a non-financial asset, an entity needs to make the assessment from the perspective of market participants (see section 4.6.3 below).

Importantly, IFRS 13 starts with the presumption that the highest and best use is an asset's current use. Alternative uses are not considered unless market or other factors suggest that market participants would use that asset differently to maximise the value of that asset. *[IFRS 13.29]*. If such factors exist, an entity would only consider those alternative uses that are physically possible, legally permissible and financially feasible. *[IFRS 13.28]*. Appropriately determining an asset's highest and best use is a critical step and can have significant implications on the measurement of fair value. Therefore, this assessment is based on the weight of evidence available. Careful consideration is needed to ensure consistent assumptions regarding the principal market (or in the absence of a principal market, the most advantageous market) and the participants in that market, since highest and best use is determined from the market participants' perspective.

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6 For more information on the topic of accounting for climate change refer to our publication titled *Applying IFRS: Connected Financial Reporting: Accounting for Climate Change* available on ey.com.

Determining highest and best use is discussed further in Chapter 15. As discussed in Chapter 15 and in section 5.2 below, additional disclosures are required if an entity determines that the highest and best use of a non-financial asset is different from its current use.

Dependent on its highest and best use, the fair value of the non-financial asset will either be measured based on the value it would derive on a stand-alone basis or in combination with other assets or other assets and liabilities (known as the valuation premise). *[IFRS 13.31]*. For example, as discussed in section 4.6.2.A below, the highest and best use of a biological asset might be in combination with the land to which it is physically attached. For produce growing on a bearer plant, it may also be in combination with the bearer plant upon (or within) which it grows.

Even in situations where the valuation premise of a biological asset (including produce growing on a bearer plant) is 'in combination with other assets and/or liabilities', the objective of a fair value measurement is still to measure the price to sell the biological asset, not the combined group. IFRS 13 assumes that the market participants that would purchase the biological asset would use it in combination with those other assets and/or liabilities. That is, if the market participants already had those other assets and/or liabilities, what price would the market participants pay to acquire the biological asset? In reality, sales are unlikely to be structured in this way. Entities might need to sell the 'other assets and/or liabilities' in order to sell the biological asset (particularly if they are physically attached, as is discussed in section 4.6.2.A below). However, regardless of how an entity might structure an actual sale, IFRS 13 contemplates a hypothetical sale and specifically states that, when the highest and best use is the use of the asset in combination with other assets and/or liabilities, a fair value measurement assumes that the market participant acquiring the asset already holds the complementary assets and/or the associated liabilities. *[IFRS 13.32]*.

In practice, an entity may need to measure the price to sell the biological asset by measuring the price for the combined assets and/or liabilities and then allocating that fair value to the various components. IFRS 13 does not specify which allocation approaches can or cannot be used. Therefore, an entity must use its judgement to select the most appropriate technique. Even if this approach is used, the objective is to measure the fair value of the biological asset assuming it is sold consistent with its unit of account, which for a biological asset is the individual asset. *[IFRS 13.32]*. This is discussed further in section 4.6.2.A below.

4.6.2.A Biological assets attached to land

IAS 41 observes that biological assets are often physically attached to land, for example, crops growing in a field. In many cases, there will be no separate market for biological assets in their current condition and location. The objective of a fair value measurement is to determine the price for the asset in its current form. However, as discussed in section 4.7 below (see also Chapter 15 at section 4.2), if no market exists for an biological asset in its current form, but there is a market for the converted or transformed asset, an entity would adjust the price that would be received for the converted or transformed asset for the costs a market participant would incur to recondition the asset (after acquiring the asset in its current condition) and the compensation they would expect for the effort in order to measure fair value.

IFRS 13 does not require a market to be observable or active in order to measure fair value. However, it is clear that, if there is a principal market for the asset, the fair value measurement represents the price in that market at the measurement date (regardless of whether that price is directly observable or estimated using another valuation technique). This price must be used even if a price in a different market is potentially more advantageous. *[IFRS 13.18]*. While the price need not be observable to measure fair value, the standard does require an entity to prioritise observable inputs in the principal (or in the absence of a principal market, the most advantageous) market over unobservable inputs. *[IFRS 13.67]*.

If an income approach (such as a discounted cash flow approach) is used to measure the biological asset (excluding the land) and the land, to which the asset is physically attached, is owned by the entity, care is needed to ensure that fair value measurement is not overstated. This is because land owned by the entity would not derive any expected cash outflows. It is, therefore, common for entities to include a notional rental charge for the land, reflecting what would be paid to rent the land, using market participant assumptions.

IAS 41 suggests that where there is no separate market for biological assets in their current form and they are physically attached to land, an active market might exist for the combined assets, i.e., for the biological assets, land and land improvements. If this is the case, an entity could use the information regarding the combined assets to determine the fair value of the biological assets. *[IAS 41.25]*. Similar considerations will also be relevant for produce growing on a bearer plant, which is unlikely to have a separate market in its current form and is physically attached to the bearer plant and, in turn, to the land.

IFRS 13 defines an active market as: *[IFRS 13 Appendix A]*

Extract from IFRS 13

Appendix A
Defined terms

active market	A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

Whether such a market exists for the combined assets is a matter of judgement, taking into consideration all the relevant facts and circumstances. However, an entity needs to have sufficient evidence to support such an assumption.

Importantly, the unit of account established by IAS 41 is an individual asset (see section 4.2.1 above). Therefore, if fair value is measured for the combined assets, the total fair value would need to be allocated to each component in order to derive the fair value for the biological asset or produce growing on a bearer plant (as is illustrated by Figure 4-1 below). As discussed in section 4.6.2 above, IFRS 13 does not provide guidance on how to perform such an allocation. IAS 41 suggests the use of the residual method as one possible way to allocate the fair value between the biological assets and the land. However, this might be difficult to apply in practice, as illustrated in Illustration 4-1 below. Therefore, entities will need to apply judgement when determining the appropriate allocation.

Illustration 4-1: Assets attached to land

Entity A acquired a 10-hectare vineyard on 1 January 20X1 for CU1,200. The purchase price of the vineyard was attributed as follows:

1 January 20X1	CU
Purchase price	1,200
Land	(780)
Vineyard improvements	(130)
Grape vines	(255)
Grapes growing on the vines	35

At the end of its financial year Entity A needs to determine the fair value of the grapes growing on the vines in accordance with IAS 41 and invites two equally skilled professional valuers to determine their value.

	Valuer 1	Valuer 2
31 December 20X1	**CU**	**CU**
Fair value of an average 10-hectare vineyard	1,105	1,100
Adjustment for soil and climatic conditions	135	150
Estimated fair value of Entity A's vineyard	1,240	1,250
Fair value of the land	(830)	(825)
Fair value of vineyard improvements	(135)	(125)
Fair value of grape vines	(245)	(250)
Grapes growing on the vines	30	50

Valuer 1 and Valuer 2 make a virtually identical assessment of the market values of the vineyard, the land, vineyard improvements and the grape vines. Nevertheless, because the value of grapes growing on the vines is calculated by subtracting all the other known elements from the total value of the vineyard, a noticeable difference arises in the valuation of the grapes growing on the vines. In a similar vein, entities that use only one valuer need to be aware that even small changes in assumptions from period-to-period could have a significant impact on the valuation of biological assets or plants growing on a bearer plant and, therefore, reported profits or losses. For this reason, IFRS 13 requires extensive disclosures about assumptions used in determining fair value.

In April 2012, the IFRS IC received a request to clarify the use of the residual approach, as discussed in IAS 41.25 (in light of the requirement in IFRS 13 to measure the fair value of non-financial assets based on their highest and best use). Specifically, the IFRS IC was asked to consider the situation where a biological asset was physically attached to land and no separate market for the biological asset existed in its current condition and location. The submitter of the request assumed entities would apply IAS 41.25, measure the biological asset and land on a combined basis and use the residual approach to derive a fair value for the biological asset. The submitter was concerned about situations where the highest and best use of the biological asset is in combination with the land, but the value of the land could be higher if measured assuming some alternative use (such as property development). In these circumstances, the allocated fair value of the biological asset might be nil or negligible. The fact pattern was further complicated because it was assumed the land to which the biological asset was attached was measured using the cost model in accordance with IAS 16.[7]

The IFRS IC elected not to take the issue onto its agenda, but noted that, in the development of IFRS 13, the IASB had considered the situation where the highest and best use of an asset in a group of assets is different from its current use. However, "IFRS 13 does not explicitly address the accounting implications if those circumstances arise and the fair value measurement of the asset based on its highest and best use assumes that other assets in the group need to be converted or destroyed". The IFRS IC also observed that this issue may affect non-financial assets within the scope of other standards, not just those within the scope of IAS 41.[8] The IFRS IC asked the IASB to provide clarification of the accounting requirements for the issues it had considered. However, as outreach indicated the issue was not widespread, in May 2013, the IASB decided it could, instead, be considered for review in the Post-Implementation Review (PIR) of IFRS 13.[9] Most respondents to the IASB's requests for information as part of its PIR of IFRS 13 that had experience with biological assets said that fair value measurement of biological assets was challenging (highlighting specific aspects that are challenging) and asked for additional guidance (particularly in relation to measuring the fair value of growing produce) and/or changes to IAS 41. However, there were different views about how the Board could help.[10]

In considering all of the feedback to its request for information, the Board completed its review of findings and concluded in March 2018 that IFRS 13 is working as it intended. It also decided to:

"a. feed the PIR findings regarding the usefulness of disclosures into the Board's work on Better Communication in Financial Reporting, in particular, into the Targeted Standards-level Review of Disclosures and the Primary Financial Statements projects;

b. continue liaising with the valuation profession, monitor new developments in practice and promote knowledge development and sharing; and

c. conduct no other follow-up activities as a result of findings from the PIR."[11]

In relation to education about measuring the fair value of biological assets, "the Board concluded that, although there might be inconsistent application in fair value measurement of biological assets, detailed application questions are best addressed by the valuation profession, and not by accounting standard-setters".[12] Determining the highest and best use of an asset requires judgement (see section 4.6.2 above), but an entity starts with the presumption that the highest and best use is an asset's current use. As discussed above, IAS 41.25 is only relevant where there is no separate market for a biological asset or produce growing on a bearer plant in its current form and it (or the bearer plant on which it grows) is physically attached to land. In addition, that paragraph suggests an active market may exists for the combined assets (e.g., land and biological asset) and, therefore, that an observable price in that market for the assets (on a combined basis) could be used to derive fair value for the biological asset. *[IAS 41.25]*. Selecting appropriate valuation techniques with which to measure fair value in accordance with IFRS 13 requires judgement. Some might use the residual approach to do this, as indicated in the submission. However, IAS 41.25 does not require the use of the residual approach; it is only mentioned as an example.

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7 IASB Staff Paper 13: Project: *IAS 41* Agriculture *and IFRS 13* Fair Value Measurement, Paper topic: *Valuation of biological assets using a residual method*, IFRS IC Meeting, May 2012. Available on the IFRS Foundation's website.

8 *IFRIC Update*, March 2013, available on the IFRS Foundation's website.

9 *IASB Update*, May 2013, available on the IFRS Foundation's website.

10 IASB Staff Paper 7B: Project: *Post-implementation Review of IFRS 13* Fair Value Measurement, Paper topic: *Background-Detailed analysis of feedback received*, IASB meeting, March 2018. Available on the IFRS Foundation's website.

11 IFRS Project Reporting and Feedback Statement: *Post-implementation Review of IFRS 13* Fair Value Measurement, IASB, December 2018, page 8. Available on the IFRS Foundation's website.

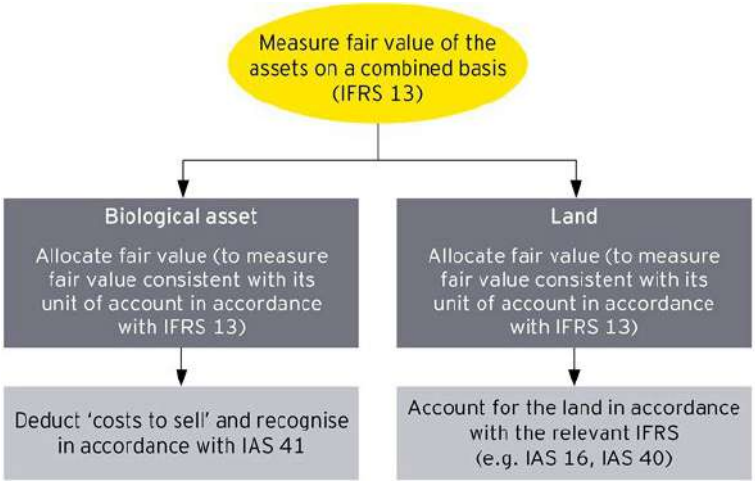
12 IFRS Project Reporting and Feedback Statement: *Post-implementation Review of IFRS 13* Fair Value Measurement, IASB, December 2018, page 16. Available on the IFRS Foundation's website.

The IASB reaffirmed this when they considered this matter in May 2013. They also noted that IFRS 13 encourages the use of multiple valuation techniques, where appropriate.[13]

How we see it

The outcome from a fact pattern such as the one the IFRS IC discussed may be somewhat counterintuitive. However, the fact that the fair value of the land, in that situation, would not be recognised in the financial statements is, in our view, irrelevant to the measurement of fair value. The objective of a fair value measurement does not change regardless of whether it is recognised or unrecognised.

Figure 4-1: Applying IAS 41.25 to measure the fair value of a biological asset



4.6.3 Selecting appropriate assumptions

Selecting the appropriate assumption with which to measure the fair value of biological assets and agricultural produce can often be difficult. According to IFRS 13 (see Chapter 15), an entity selects assumptions that:

- Market participants would use, i.e., they are not entity-specific
- Are consistent with the unit of account and characteristics of the asset, including an asset's condition and location and any restrictions on the use or sale of the asset
- Are consistent with an orderly transaction to sell the asset in the principal market, or in the absence of a principal market, the most advantageous market

  And
- Maximise the use of observable inputs and minimise the use of unobservable inputs (based on the fair value hierarchy)

IFRS 13 clarifies that the transaction to sell the asset would be between market participants, not between the entity and a market participant. In addition, assumptions need to reflect those that market participants generally would assume, not those of a particular market participant. In order to select the appropriate assumptions, an entity would identify characteristics of market participants. At a minimum, IFRS 13 assumes that market participants will be independent of each other, knowledgeable about the asset, able and willing to enter into a transaction for the asset. *[IFRS 13 Appendix A]*. An entity need not identify specific market participants, but needs to identify the distinguishing characteristics of market participants. *[IFRS 13.23]*.

Identifying the appropriate market participants (or their characteristics) depends on the principal market for the asset or, in the absence of a principal market, the most advantageous market (see Chapter 15 for further discussion). *[IFRS 13.23]*. There is a general presumption in IFRS 13 that the principal market is the one in which the entity would normally enter into a transaction to sell the asset, unless there is evidence to the contrary. *[IFRS 13.17]*.

13 *IASB Update*, May 2013, available on the IFRS Foundation's website.

In times of market volatility, additional judgement may be needed to select appropriate assumption for fair value measurement. IFRS 13 has specific guidance on evaluating whether there has been a significant decrease in the volume or level of activity for an asset (see Chapter 15 at section 7.1) and identifying transactions that are not orderly (Chapter 15 at section 7.2). It also provides guidance on estimating fair value when there has been a significant decrease in volume and level of activity (Chapter 15 at section 7.3).

4.6.3.A Condition and location

Fair value measured in accordance with IFRS 13 takes into consideration an asset's condition and location, provided they are a characteristic of the asset being measured that a market participant would consider when pricing the asset. *[IFRS 13.11]*.

This will have a direct impact on what is being measured. For example, entities measuring partly grown crops may also need to consider the fair value of the land in which they are planted (see section 4.6.2.A above). It may also require an entity to consider alternative markets. For example, an entity that rears chickens have to consider whether there is a market for immature chicks and/or day-old chicks and not just consider the market for mature chickens as the only market available. Another example is the market for vines versus the market for grapes, or seeds versus seedlings.

It is possible for a market to exist in one geographical area, but not in another area. For example, transportation costs may limit the geographical size of the market for agricultural produce significantly, possibly to the point where a local cooperative or factory is the only buyer.

If no market exists for an asset in its current form, but there is a market for the converted or transformed asset, an entity adjusts the fair value for the costs a market participant would incur to re-condition the asset (after acquiring the asset in its current condition) and the compensation they would expect for the effort.

If the location of a biological asset or agricultural produce would require it to be transported to the market in order to sell it, transportation costs would be deducted from the market price in order to measure fair value. Given the logistical problems and generally high costs of transporting living animals and plants, there could be many different fair values for identical biological assets depending on their location.

4.6.4 Valuation techniques in IFRS 13

IFRS 13 does not limit the types of valuation techniques an entity might use to measure fair value. However, it does require the valuation techniques to be consistent with one of three approaches: the market approach; the income approach; or the cost approach. *[IFRS 13.62]*. According to IFRS 13, multiple techniques need to be used, when applicable. Therefore, judgement is needed to select the techniques that are appropriate in the circumstances. *[IFRS 13.63]*. Selecting appropriate valuation techniques is discussed further in Chapter 15 at section 13.

IFRS 13 does not prioritise the use of one valuation technique over another, or require the use of only one technique. Instead, IFRS 13 establishes a hierarchy for the inputs used in those valuation techniques, requiring an entity to maximise observable inputs and minimise the use of unobservable inputs (this is discussed further in Chapter 15 at section 15). *[IFRS 13.74]*. The best indication of fair value is a quoted price in an active market for the identical asset. However, even when fair value needs to be estimated, an entity must maximise the use of observable inputs and minimise the use of unobservable inputs.

A significant decrease in volume or activity in a market can also influence which valuation techniques are used, how those techniques are applied and whether inputs are observable at the measurement date. This is discussed further in Chapter 15 at section 7.3.

4.6.4.A Cost as an approximation of fair value

IFRS 13 defines fair value as a current exit price, not an entry price. Therefore, while exit and entry prices may be identical in many situations, the transaction price (an entry price) is not presumed to represent the fair value of an asset or liability measured in accordance with IFRS 13 on its initial recognition. *[IFRS 13.57, IFRS 13.58, IFRS 13.59]*.

IAS 41 indicates that cost can sometimes approximate fair value. The standard gives two situations where this might occur: *[IAS 41.24]*

- When little biological transformation has taken place since cost was initially incurred - seedlings planted immediately prior to the end of a reporting period and newly acquired livestock are given as examples

  Or

- When the impact of the biological transformation on price is not expected to be material - for example, during the initial phase of growth for a pine plantation with a 30-year production cycle

Even in such situations, the objective is still to measure fair value in accordance with IFRS 13. Therefore, as with an entry price on initial recognition, an entity cannot presume that cost approximates fair value. Instead, it must ensure cost is materially consistent with a current exit price for the asset.

How we see it

Entities need to carefully consider which costs could be included in the entry price. IFRS 13 specifically states that transaction costs are not part of fair value (that is, they are not added to or deducted from the exit price), therefore, we would not expect an entity to deduct such costs from the entry price - particularly as 'costs to sell' are deducted from fair value before being recognised in the financial statements. Nor would we expect entities applying a fair value model to include acquisition-related transaction costs within an entry price used to approximate fair value.

4.7 The problem of measuring fair value for part-grown or immature biological assets

Entities may be required to measure their biological assets part way through the transformation process, particularly when the time to harvest is greater than 12 months. In these circumstances, there may not be an active market for the asset in its current condition and location. In the absence of an active market, preparers often use a discounted cash flow model to estimate fair value.

In these situations, a common question is whether an entity can take into consideration the future biological transformation when estimating the fair value of a biological asset.

As discussed in section 4.6.3.A above, IFRS 13 makes it clear that the fair value of an asset considers characteristics of an asset, such as its current condition and location. An entity must consider this objective in determining an appropriate discount rate and estimating its future cash flows, which must be based on assumptions market participants would use. Therefore, if a market participant would consider the potential for future growth or maturation, the related cash flows and risks from that additional biological transformation are included in determining the appropriate fair value. Assume, for example, that a particular breed of chicken is considered mature between 16 and 24 weeks of age and an entity needs to measure the fair value of a 10-week-old chick at the measurement date. An immature chick at 10 weeks of age is closer in age to a mature chicken than to a day-old chick. There may not be an observable price for 10-week-old chicks and, therefore, an entity might use the price of a mature chicken as an input, adjusting for the risks and cash flows that market participants would incur (as well as a reasonable profit margin) since the chick is only 10 weeks old at the measurement date (see section 4.7.1 below for further discussion).

It is important to consider the requirements of IFRS 13 (Chapter 15) for determining the principal, or most advantageous, market for the specific unit of account. Therefore, in applying IAS 41, an entity needs to identify the principal market for each individual asset. An entity first determines the markets that it can access, which could include local and/or foreign markets. Then it determines which of those markets has the greatest volume and liquidity in relation to the particular asset; this is the principal market (also refer to Chapter 15 at section 5). It would be reasonable for an entity to conclude there are different principal markets for different types of assets, for example, for different species of fish. It is also possible to have different principal markets at different maturation stages (e.g., for eggs, day old chicks and mature chickens).

IFRS 13 requires that, if there is a principal market for the asset or liability, the fair value measurement shall represent the price in that market at the measurement date (regardless of whether that price is directly observable or estimated using another valuation technique). The price in the principal market must be used even if the price in a different market is potentially more advantageous. *[IFRS 13.18]*. Since an entity can consider the expected cash flows the asset can generate in its principal market, the entity is not permitted to use available prices in other active markets for part-grown biological assets. Even in situations where there is no principal market, once the most advantageous market has been selected, an entity would not look to other markets for available prices or use prices in the most advantageous market if market participants would not consider them.

4.7.1 The use of prices for similar assets, for which observable prices do exist, as an input into the fair value measurement

The original version of IAS 41 had caused confusion in this area, as it had required that the estimation of future cash flows "exclude any increases in value from additional biological transformation and future activities of the entity". *[IAS 41(2008).21]*. This seemed to suggest that the value of immature biological assets is based on values in their current condition, rather than recognising that part of the value must logically lie in their potential, given appropriate husbandry, to grow to full size. The IASB amended IAS 41 to clarify that entities need to consider the risks associated with cash flows from additional biological transformation in determining the cash flows, the discount rate or some combination of the two provided a market participant would take the additional biological transformation into consideration.

While IAS 41.21 was subsequently deleted by the introduction of IFRS 13, this clarification is consistent with the requirements in that standard and is helpful in understanding its requirements in situations where prices are available in an active market for part-grown biological assets, but that market is not the principal market (or in the absence of a principal market, the most advantageous market).

This issue is illustrated by an extract from (the former) CESR's database of enforcement decisions published in April 2007 (Decision ref. EECS/0407-11) in relation to the fair value measurement requirements in IAS 41 (prior to the issuance of IFRS 13). Norwegian fish farmers had developed a practice of recording live immature fish at cost on the basis that they were unable to value them reliably in accordance with IAS 41.30. The Norwegian regulator took the view that slaughtered fish sold whole and gutted need to be considered the same as live salmon under paragraph 18(b) of the 2012 version of IAS 41 (IAS 41(2012)) and that it was possible to value the live immature fish based on the market price for slaughtered fish of the same size. Smaller fish are sold on the market because they are harvested with mature fish, however their value per kilo is significantly below that of mature fish and the Norwegian fish farming entities did not, therefore, believe that it was appropriate to use their market price as a basis for fair value. The regulator's decision was appealed to the Norwegian Ministry of Finance and the database reports the conclusion as follows:

> "The Ministry of Finance upheld the decision of the enforcer, with some adjustments and additions. Most significantly, the final ruling upholds the enforcer's decision that slaughtered salmon which is sold whole and gutted is in an accounting sense to be considered as a similar asset of live salmon, according to IAS 41.18(b) and that this also applies to so-called immature farmed salmon. Hence, the observable prices of slaughtered salmon shall be used as a basis for determining the fair value of live immature salmon. The key amendment to the decision made by the Ministry of Finance is that it added certain comments relating to how the term 'adjustments to reflect differences' in IAS 41.18(b) was to be applied. The adjustments should reflect the differences between the price of an immature salmon and the hypothetical market price in an active market for live immature salmon."

As a result of this decision, the Norwegian entities were required to record immature salmon at fair value, rather than at cost, by making appropriate adjustments to available market prices for similar sized slaughtered fish.

While IFRS 13 has now replaced the requirements in paragraph 18(b) of IAS 41 (2012) to which this decision related, the same approach could be used when measuring fair value in accordance with that standard. IFRS 13 prioritises the use of observable inputs for identical or similar items when measuring fair value. Therefore, in situations where an active market does not exist for the asset in its current form, entities might use prices for similar assets, for which observable prices do exist, as an input into the fair value measurement. *[IFRS 13.82(a), IFRS 13.82(b)]*.

As discussed in the Norwegian salmon example above and in Chapter 15 at section 4.2.1, an entity would need to identify any differences between the asset being measured at fair value and similar assets (e.g., a converted or transformed assets), for which observable market prices are available. The entity would then adjust the similar asset's market price for the costs a market participant would incur (after acquiring the asset in its current condition) and the compensation they would expect for the effort. Such adjustments could affect the categorisation of the fair value measurement (as a whole) within the fair value hierarchy. Categorisation within the hierarchy is done for disclosure purposes and affects how much information must be disclosed about the fair value measurement (see section 5.2 below). IFRS 13 requires that, "If an observable input requires an adjustment using an unobservable input and that adjustment results in a significantly higher or lower fair value measurement, the resulting measurement would be categorised within Level 3 of the fair value hierarchy". *[IFRS 13.75]*. Categorisation within IFRS 13's fair value hierarchy is discussed further in Chapter 15 at section 15.

5 Disclosure

5.1 General

In addition to the discussion in this chapter, our publication, *Good Group (International) Limited - Agriculture*, which is a supplement to *Good Group (International) Limited - Illustrative consolidated financial statements,* [14] includes illustrative disclosures for biological assets, including bearer plants, and agricultural produce, as required by IFRS 13, IAS 16 and IAS 41.

5.1.1 Statement of financial position

IAS 1 requires biological assets (including produce growing on a bearer plant) to be presented separately on the face of an entity's statement of financial position (see Chapter 3). *[IAS 1.54]*. As discussed in section 2.3.2 above, agricultural produce after the point of harvest is accounted for under IAS 2 or another applicable IFRS accounting standard (e.g., IAS 16). IAS 2 does not require agricultural produce to be disclosed separately on the face of the statement of financial position (see Chapter 23). The following extract from the Illustrative Examples to IAS 41 illustrates the requirement to disclose biological assets in the statement of financial position. *[IAS 41.IE Example 1]*.

Extract from IAS 41 Illustrative Examples

A1 Example 1 illustrates how the disclosure requirements of this Standard might be put into practice for a dairy farming entity. This Standard encourages the separation of the change in fair value less costs to sell of an entity's biological assets into physical change and price change. That separation is reflected in Example 1. Example 2 illustrates how to separate physical change and price change.

A2 The financial statements in Example 1 do not conform to all of the disclosure and presentation requirements of other Standards. Other approaches to presentation and disclosure may also be appropriate.

Example 1 XYZ Dairy Ltd

Statement of financial position

XYZ Dairy Ltd **Statement of financial position**	Notes	31 December 20X1	31 December 20X0
ASSETS			
Non-current assets			
Dairy livestock - immature[(a)]		52,060	47,730
Dairy livestock - mature[(a)]		372,990	411,840
Subtotal - biological assets	3	425,050	459,570
Property, plant and equipment		1,462,650	1,409,800
Total non-current assets		**1,887,700**	**1,869,370**
Current assets			
Inventories		82,950	70,650
Trade and other receivables		88,000	65,000
Cash		10,000	10,000
Total current assets		**180,950**	**145,650**
Total assets		**2,068,650**	**2,015,020**

14 Available on ey.com/IFRS.

EQUITY AND LIABILITIES		
Equity		
Issued capital	1,000,000	1,000,000
Retained earnings	902,828	865,000
Total equity	**1,902,828**	**1,865,000**
Current liabilities		
Trade and other payables	165,822	150,020
Total current liabilities	**165,822**	**150,020**
Total equity and liabilities	**2,068,650**	**2,015,020**

(a) An entity is encouraged, but not required, to provide a quantified description of each group of biological assets, distinguishing between consumable and bearer biological assets or between mature and immature biological assets, as appropriate. An entity discloses the basis for making any such distinctions.

5.1.1.A Current versus non-current classification

IAS 1[15] requires an asset to be classified as current when: *[IAS 1.66]*

(a) The entity expects to sell, consume or realise the asset in its normal operating cycle.

(b) The asset is primarily for trading purposes.

(c) The entity expects to realise the asset within 12 months after the reporting period.

Or

(d) The asset is cash or a cash equivalent (as defined in IAS 7 *Statement of Cash Flows*, see Chapter 36), unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

If these criteria are not met, the asset is classified as non-current.

The classification of agricultural produce is usually consistent with an entity's assessment for its inventories, i.e., typically classified as a current asset because it will be sold, consumed or realised as part of the normal operating cycle.

The classification of biological assets (including produce growing on a bearer plant) typically varies based on the nature of the biological asset and the time it takes to mature.

For consumable biological assets that only have one harvest, classification will depend on when the asset will be harvested and sold. For example, livestock held for slaughter would likely be realised within 12 months after the end of the reporting period or as part of the normal operating cycle, and therefore would be classified as a current asset. Pine trees in a forest usually take more than 20 years to mature. Therefore, pine forests are usually classified as non-current.

Bearer biological assets, such as dairy cows or animals used for breeding, are often classified as non-current. Such assets usually provide multiple harvests, which may extend beyond one accounting period. Therefore, in order to classify the asset appropriately, an entity would need to consider the period over which it will derive future economic benefits from the asset, which is likely to be when the biological asset will be sold, replaced or removed. This is essentially consistent with determining the useful life of an item of property, plant and equipment in accordance with IAS 16.

In situations where biological assets are classified as non-current, there is some debate about whether a portion should be classified as current. Some believe that, particularly for bearer biological assets, the asset should be classified as non-current, consistent with the classification of property, plant and equipment under IAS 16. In this situation, an entity would probably only classify the asset as current when it is held for sale in accordance with IFRS 5 (see Chapter 5). Others argue that, since the unit of account in IAS 41 is the individual asset (see section 4.2.1 above), a portion of a group of biological assets could be classified as current. The current portion would be comprised of biological assets that will be removed permanently (e.g., sold, uprooted or otherwise removed) within 12 months after the end of the reporting period. Determining such a split may be more obvious for consumable biological assets with only one harvest, for example, the trees in a forest an entity expects to harvest within 12 months of the end of the reporting period. For other biological assets, care is needed to ensure that it is the final removal of the biological asset itself that is considered and not its agricultural produce. An example of the final removal of such biological assets includes dairy cows in a herd that an entity sells for slaughter.

15 Refer to section 5.1.5 for more on IFRS 18, which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027.

How we see it

Regardless of which of the above approaches is used, an entity needs to be consistent from period to period across all similar types of biological assets. An entity also needs to assess whether its policy for classifying, or not classifying, a portion of its biological assets as current needs to be disclosed (see Chapter 3 for further discussion).

Produce growing on a bearer plant (e.g., grapes on a vine) are accounted for in accordance with IAS 41, separately from the bearer plant (which is within the scope of IAS 16, see section 3.2.3 above). As a result, entities need to consider the appropriate classification of any produce growing on a bearer plant. It is likely that produce growing on a bearer plant will be a current asset, unless it takes more than an operating cycle (e.g., a year) to mature.

5.1.1.B Bearer plants

The disclosure requirements of IAS 16 are applicable to bearer plants (see Chapter 19). Bearer plants are an example of a separate class of property, plant and equipment listed in IAS 16.37, therefore, the disclosure requirements of IAS 16.73 are provided for bearer plants separately to those of other classes. *[IAS 16.37, IAS 16.73]*.

The Practical example below, from the consolidated financial statements of T&G Global Limited, is an example of disclosures provided of bearer plants (trees and vines) under IAS 16 and of the produce growing on the bearer plants (unharvested fruit) under IAS 41.

Practical example 5-1: T&G Global Limited (2023) **New Zealand**

Annual Report 2023 [extract]
Financials [extract]
Notes to the financial statements [extract]
Operating assets [extract]

8. Biological assets

Biological assets consists of unharvested fruit growing on bearer plants, and are stated at fair value based on their present location and condition less estimated point-of-sale costs. Any gain or loss from changes in the fair value of biological assets is recognised in the income statement.

Point-of-sale costs include all other costs that would be necessary to sell the assets.

The fair value of the Group's apples, berries, citrus fruit and tomatoes are determined by management using a discounted cash flow approach.

Costs are based on current average costs and referenced back to industry standard costs. The costs are variable depending on the location, planting and the variety of the biological asset. A suitable discount rate has been determined in order to calculate the present value of those cash flows. The fair value of biological assets at or before the point of harvest is based on the value of the estimated market price of the estimated volumes produced, net of harvesting and growing costs. Changes in the estimates and assumptions supporting the valuations could have a material impact on the carrying value of biological assets and reported profit.

The following significant assumptions and considerations have been taken into account in determining the fair value of the Group's biological assets:

- Forecasts for the following year based on management's view of projected cash flows, including sales and margins, adjusted for inflation, location and variety of crops.
- The Group has unhedged projected cash flows from sales in foreign currencies. These have been translated to the Group's functional currency at average exchange rates sourced from financial institutions based on forecasted sales profiles.
- Discount rates to adjust for risks inherent to the crop, including natural events, disease or any other adverse factors that may impact the quality, yield or price.
- Any significant changes to management of the crop in the current and following year.

Valuation process

Within the Group's finance team are individuals who work closely with the Group's key biological asset categories during the year. These finance team members are also responsible for performing valuations of the Group's biological assets for financial reporting purposes.

Discussions of valuation processes and results are held between the Chief Financial Officer and the finance team at least once every six-months in line with the Group's reporting requirements.

The main level 3 inputs used by the Group are derived and evaluated as follows:

- Production yields, including tray carton equivalents per hectare and tonnes per hectare, are determined based on historical production trends for each orchard and forecasted expected yields based on the underlying age and health of the orchards.
- Annual gate prices represent management's assessment of expected future returns for the biological assets based on historical trends, current market pricing, and known market factors at balance date.
- Discount rates are determined by reference to historical trends and loss events, and an assessment of the time value of money and any risks specific for the current crop being valued.
- The fair value of biological assets and the level 3 inputs to the fair value model are analysed at the end of each reporting period.

As part of the analysis the level 3 inputs are reviewed and assessed for reasonableness with reference to current market conditions. The calculated fair value of biological assets is also reviewed to determine if it is a fair reflection of management's expected returns for each crop type.

The cash outflows used in the fair value calculation include notional cash flows for land and bearer plants owned by the Group. They are based on market rent payable for orchards of similar size.

	Apples $'000	Tomatoes $'000	Citrus $'000	Blueberries $'000	Total $'000
2022					
Balance at 1 January	18,914	3,634	2,516	65	25,129
Capitalised costs	38,549	-	6,211	1,439	46,199
Change in fair value less costs to sell	768	6,484	1,961	(475)	8,738
Decrease due to harvest	(36,776)	(6,614)	(8,747)	(327)	(52,464)
Balance at 31 December	21,455	3,504	1,941	702	27,602
2023					
Balance at 1 January	**21,455**	**3,504**	**1,941**	**702**	**27,602**
Capitalised costs	**20,248**	**-**	**5,378**	**1,800**	**27,426**
Change in fair value less costs to sell	**(1,238)**	**4,522**	**2,004**	**1,013**	**6,301**
Decrease due to harvest	**(20,476)**	**(4,223)**	**(6,987)**	**(1,394)**	**(33,080)**
Balance at 31 December	**19,989**	**3,803**	**2,336**	**2,121**	**28,249**

Fair value measurement

Techniques applied by the Group which are used to value biological assets are considered to be level 3 in the fair value hierarchy. Inputs are not based on observable market data (that is, unobservable inputs). There have been no transfers between levels during the year.

The unobservable inputs used by the Group to fair value its biological assets are detailed below:

Produce	Unobservable inputs	Range of unobservable inputs	
		2023	2022
	Tray carton equivalent (TCE) per hectare per annum	**81 to 3,380**	162 to 4,416
	Weighted average TCE per hectare per annum	**1,264**	1,915
Apples	Export prices per export TCE	**$26 to $64**	$31 to $58
	Weighted average export prices per export TCE per annum	**$33.74**	$44.85
	Risk-adjusted discount rate	**31%**	25%
	Tonnes per hectare per annum	**129 to 480**	148 to 512
	Weighted average tonnes per hectare per annum	**329**	349
Tomatoes	Annual price per kilogram (kg) per season	**$1.57 to $25.77**	$1.65 to $25.73
	Weighted average price per kg per season	**$6.01**	$4.34
	Risk-adjusted discount rate	**27%**	25%
	Tonnes per hectare per annum	**31**	37
	Weighted average tonnes per hectare per annum	**31**	37
Citrus	Annual gate price per tonne per season	**$553 to $3,314**	$739 to $4,260
	Weighted average gate price per tonne per season	**$1,958**	$3,269
	Risk-adjusted discount rate	**25%**	14%
	Tonnes per hectare per annum	**2.9 to 6.5**	3.4
	Weighted average tonnes per hectare per annum	**4.9**	3.4
Blueberries	Annual gate price per kg per season	**$8.00 to $30.80**	$8.26 to $19.29
	Weighted average gate price per kg per season	**$21.76**	$19.15
	Risk-adjusted discount rate	**22%**	18%

As the yield per hectare and gate price or export price per TCE increases, the fair value of biological assets increases. As the discount rate used increases, the fair value of biological assets decreases.

For the Group's apples crop, an increase or decrease of 10% in the discount rate would result in a fair value change of $1.0 million and $1.1 million respectively (2022: 5% change in discount rate would result in fair value change of $0.5 million).

For the Group's tomatoes, citrus, and blueberry crops, an increase or decrease of 10% in the discount rate would not have a material impact on the fair value of the crop.

For the Group's apples crop, an increase or decrease of 10% in volumes would result in a fair value change of $3.3 million. For the Group's tomatoes crop, an increase or decrease of 10% in volume would result in a fair value change of $2.2 million and $2.1 million respectively (2022: 5% increase or decrease in volumes would result in a fair value change of $1.9 million and $0.5 million respectively).

For the citrus and blueberry crops, an increase or decrease of 10% in volumes would not have a material impact on the fair value of the crop.

Risk

Being involved in agricultural activity, the Group is exposed to financial risks arising from adverse climatic or natural events that could impact on the Group's biological assets through damage to crop caused by severe weather events. In the current year, the Group has assessed that the expectation of severe weather events is higher than previously assumed. As such, the Group has increased its discount rates this year when calculating the fair value of its biological assets. The TCE per hectare per annum assumption used in the biological assets calculation for Apples has been reduced to reflect the impact on Cyclone Gabrielle. In its sensitivity analyses of the impact of changes in volumes and discount rates to the fair value of crop, the Group has also increased the sensitivity of these calculations from 5% to 10%.

The Group continues to work with research partners to develop and commercialise new categories of fruit that can thrive in a warming climate, for example Tutti™ the world's first specifically bred hot climate tolerant apple variety.

Financial risk arises through adverse changes in market prices or volumes harvested, and adverse movements in foreign exchange rates.

Price risk is minimised by close monitoring of commodity prices and factors that influence those commodity prices. The Group also takes reasonable measures to ensure that harvests are not affected by climatic and natural events, disease, or any other factors that may negatively impact on the quality and yield of crop. Foreign currency risk is mitigated by using derivative instruments such as foreign currency hedging contracts to hedge foreign currency exposure.

Activity on productive owned and leased land

The productive owned and leased land growing different types of biological assets and by agricultural product types are detailed in the table below:

	Hectares		Production units		
	2023	2022	2023	2022	Unit measure
Apples	**444**	578	**573,336**	1,156,124	TCE
Tomatoes	**24**	24	**8,463,825**	8,478,183	kg
Citrus	**90**	90	**2,778,756**	3,465,186	kg
Blueberries	**19**	11	**94,888**	37,138	kg

10. Property, plant and equipment [extract]

Commercial land and improvements, orchard land and improvements, and buildings are stated at their fair value less accumulated depreciation and impairment losses. All other items of property, plant and equipment are stated at their cost less accumulated depreciation and impairment losses.

Revaluations

The Group's policy is to revalue commercial land and improvements, orchard land and improvements, and buildings every three years with valuations being performed by independent registered valuers based on the price that would be received to sell the asset in an orderly transaction between market participants under current market conditions. Valuation assessments are performed earlier than every three years if market evidence suggests that property values have moved materially since the time of the last valuation assessment.

All property valuers used are members of the New Zealand Institute of Valuers, with the exception of the valuers appointed in Belgium and the United Kingdom who have the appropriate expertise as required in those jurisdictions.

The revaluations are conducted on a systematic basis across the Group so that the asset revaluations are performed with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at balance date. Where valuations are not obtained for land and improvements, and buildings, the carrying values of these assets are reassessed for any material change.

Any revaluation increase arising on the revaluation of such land and buildings is credited to the property's revaluation reserve, except to the extent that it reverses a revaluation decrease for the same asset previously recognised as an expense, in which case the increase is credited to profit or loss to the extent of the decrease previously expensed. A decrease in carrying amount arising on the revaluation of such land and buildings is charged as an expense to the extent that it exceeds the balance, if any, held in the property's revaluation reserve relating to a previous revaluation of that asset.

Depreciation

Depreciation of property, plant and equipment, other than commercial and orchard land which is not depreciated, is calculated on a straight-line basis so as to expense the cost of the assets, or the revalued amounts, to their expected residual values over their useful lives as follows:

Asset	Time
• Commercial land improvements	15 to 50 years
• Orchard land improvements	15 to 50 years
• Buildings	15 to 50 years
• Bearer plants	7 to 40 years
• Glasshouses	33 years
• Motor vehicles	5 to 7 years
• Plant and equipment and hire containers	3 to 15 years

Impairment

Items of property, plant and equipment are assessed for indicators of impairment at each reporting date. An impairment loss is recognised immediately in profit or loss, unless the relevant asset is carried at a revalued amount, in which case the impairment loss is treated as a revaluation decrease and to the extent that the impairment loss is greater than the related revaluation surplus, the excess impairment loss is recognised in profit or loss.

	Commercial land and improvements $'000	Orchard land and improvements $'000	Buildings $'000	Bearer plants $'000	Glass-houses $'000	Motor vehicles $'000	Plant and equipment and hire containers $'000	Work in progress $'000	Total $'000
At 1 January 2022									
Cost or valuation	41,189	89,400	115,983	46,513	28,323	7,347	139,030	59,584	527,369
Accumulated depreciation and impairment	(546)	(1,282)	(3,850)	(8,964)	(14,817)	(4,664)	(93,440)	-	(127,563)
Net carrying amounts	40,643	88,118	112,133	37,549	13,506	2,683	45,590	59,584	399,806
Year ended 31 December 2022									
Opening net carrying amounts	40,643	88,118	112,133	37,549	13,506	2,683	45,590	59,584	399,806
Additions	127	182	1,503	294	688	308	7,093	89,756	99,951
Reclassifications	589	360	6,612	8,085	-	-	8,480	(24,126)	-
Depreciation	(1,262)	(862)	(7,028)	(3,045)	(1,020)	(760)	(10,535)	-	(24,512)
Disposals	(172)	(21,314)	(1,395)	(7,428)	-	(82)	(967)	(11,171)	(42,529)
Impairment through profit and loss	-	(1,383)	(1,714)	-	-	-	-	-	(3,097)
Revaluations	3,774	(3,680)	(10,654)	-	-	-	-	-	(10,560)
Depreciation write back on revaluations	1,159	713	7,388	-	-	-	-	-	9,260
Transfer to asset held for sale	(8,965)	(2,363)	(15,822)	-	-	-	-	-	(27,150)
Foreign exchange movements	(97)	310	(301)	-	-	7	(5)	(6)	(92)
Closing net carrying amounts	35,796	60,081	90,722	35,455	13,174	2,156	49,656	114,037	401,077
At 31 December 2022									
Cost or valuation	36,422	61,043	93,180	44,441	29,012	6,862	152,843	114,037	537,840
Accumulated depreciation and impairment	(626)	(962)	(2,458)	(8,986)	(15,838)	(4,706)	(103,187)	-	(136,763)
Net carrying amounts	35,796	60,081	90,722	35,455	13,174	2,156	49,656	114,037	401,077
Year ended 31 December 2023									
Opening net carrying amounts	**35,796**	**60,081**	**90,722**	**35,455**	**13,174**	**2,156**	**49,656**	**114,037**	**401,077**
Additions	**237**	**182**	**3,602**	**223**	**432**	**798**	**4,066**	**58,970**	**68,510**
Reclassifications	**10,995**	**(4,205)**	**56,914**	**10,018**	**-**	**-**	**34,710**	**(108,432)**	**-**
Depreciation	**(1,186)**	**(795)**	**(7,124)**	**(2,390)**	**(1,021)**	**(722)**	**(10,901)**	**-**	**(24,139)**
Disposals	**(134)**	**(879)**	**(723)**	**(9,023)**	**(8)**	**(122)**	**(2,362)**	**(11,109)**	**(24,360)**
Revaluations	**39**	**(4,502)**	**(24,457)**	**-**	**-**	**-**	**-**	**-**	**(28,920)**
Depreciation write back on revaluations	**1,009**	**298**	**6,549**	**-**	**-**	**-**	**-**	**-**	**7,856**
Foreign exchange movements	**205**	**-**	**526**	**-**	**-**	**(66)**	**309**	**9**	**983**
Closing net carrying amounts	**46,961**	**50,180**	**126,009**	**34,283**	**12,577**	**2,044**	**75,478**	**53,475**	**401,007**

	Commercial land and improvements $'000	Orchard land and improvements $'000	Buildings $'000	Bearer plants $'000	Glass-houses $'000	Motor vehicles $'000	Plant and equipment and hire containers $'000	Work in progress $'000	Total $'000
At 31 December 2023									
Cost or valuation	47,776	51,426	128,820	44,100	27,600	6,971	185,049	53,475	545,217
Accumulated depreciation and impairment	(815)	(1,246)	(2,811)	(9,817)	(15,023)	(4,927)	(109,571)	-	(144,210)
Net carrying amounts	46,961	50,180	126,009	34,283	12,577	2,044	75,478	53,475	401,007

...

Climate considerations

The Group has identified climate-related risks that could impact on the Group's property, plant, and equipment through damage to commercial and orchard land and buildings due to severe weather events, or decline in the value of the Group's bearer plants as exisiting crop could be grown in areas with declining land suitablity for horticultural activity.

During the year the Group wrote off assets damaged as a result of Cyclone Gabrielle and also incurred higher insurance costs to ensure it has optimal insurance programmes in place. The Group continually assesses its risk in this area and looks for opportunities to diversify growing regions or invest in new crop varieties that will thrive in hot climates. Continued investment in protection structures, such as hail netting, also mitigates the risk of damage through severe weather events.

The Group has also identified a risk around the increasing cost of doing business due to the convergence of climate-related cost increases in glasshouse growing. One of the Group's strategies to mitigate this risk in the current year is the investment in new thermal screens at the Group's glasshouse growing operations.

5.1.2 Income statement

IAS 1 is silent on the presentation of gains and losses on biological assets (including produce growing on a bearer plant) and agricultural produce in the income statement.

IAS 41 requires that: *[IAS 41.40]*

Extract from IAS 41	
40	**An entity shall disclose the aggregate gain or loss arising during the current period on initial recognition of biological assets and agricultural produce and from the change in fair value less costs to sell of biological assets.**

The standard only requires disclosure of the aggregate gain or loss; it does not require or encourage disaggregating the gain or loss. *[IAS 41.B78, IAS 41.B79]*. Example 1 of the Illustrative Examples to IAS 41 illustrates gains on biological assets and agricultural produce presented near the top of the income statement, although it is not entirely clear from the example whether losses on biological assets should be presented in the same position or elsewhere in the income statement. *[IAS 41.IE Example 1]*.

The Practical example below is from the consolidated financial statements of Mondi plc. The Mondi plc group recognised changes in fair value less costs to sell in profit or loss, but did not separately disclose that amount on the face of the financial statements. Instead, as is illustrated below, the change in the fair value less costs to sell of biological assets was separately disclosed in the notes to the financial statements.

Practical example 5-2: Mondi plc (2023) **United Kingdom**

Integrated report and financial statements 2023 [extract]

Financial statements [extract]

Notes to the consolidated financial statements [extract]

1 Basis of preparation [extract]

Critical accounting judgements and significant accounting estimates

The preparation of the Group's consolidated financial statements includes the use of estimates and assumptions. Although the estimates used are based on management's best information about current circumstances and future events and actions, actual results may differ from those estimates. The critical accounting judgements and significant accounting estimates with a significant risk of a material change to the carrying value of assets and liabilities within the next year in terms of IAS 1, 'Presentation of Financial Statements', are:

Significant accounting estimates

- Fair value of forestry assets – refer to note 14
- Actuarial valuations of retirement benefit obligations – refer to note 24

Other areas of judgement and accounting estimates

The consolidated financial statements include other areas of judgement and accounting estimates. While these areas do not meet the definition under IAS 1 of significant accounting estimates or critical accounting judgements, the recognition and measurement of certain material assets and liabilities are based on assumptions and/or are subject to longer-term uncertainties. The other areas of judgement and accounting estimates include:

- Hyperinflation accounting – refer to notes 1 and 35
- Climate change – refer to note 1
- Taxation – refer to notes 7 and 35
- Residual values and useful economic lives of property, plant and equipment – refer to notes 10 and 35
- Fair value of assets acquired and liabilities assumed in business combinations – refer to notes 25 and 35

Climate change

Management has considered the impact of climate change in preparing these consolidated financial statements, in particular in the context of the disclosures included in the Strategic report, including the Group's science-based Net-Zero GHG emission reduction targets as detailed in the Mondi Action Plan 2030 (MAP2030) Taking Action on Climate section on pages 51-64. These considerations, which are integral to the Group's strategy, did not have a material impact on the accounting estimates and judgements, including the following areas:

- Estimates of future cash flows used in the impairment assessment of goodwill – refer to note 12
- Assumptions used in the fair value measurement of forestry assets – refer to note 14
- Residual values and useful economic lives of property, plant and equipment – refer to note 35
- Fair value of assets acquired and liabilities assumed in business combinations – refer to note 25

While these considerations did not have a material impact on the areas set out above, this may change in future periods as management evolves its understanding of climate change-related impacts on the Group.

35 Accounting policies [extract]

Non-current non-financial assets excluding goodwill, deferred tax and net retirement benefits assets [extract]

Agriculture – owned forestry assets (note 14)

Owned forestry assets are biological assets measured at fair value less costs to sell, calculated by applying the expected selling price, less costs to harvest and deliver, to the estimated volume of timber on hand at each reporting date. The fair value less costs to sell is determined using a market-based approach. The estimated volume of timber on hand is determined based on the maturity profile of the area under afforestation, the species, the geographic location, climate and other environmental considerations and excludes future growth. The product of these is then adjusted for risks associated with forestry assets.

Changes in fair value are recognised in the consolidated income statement within other net operating expenses. At point of harvest, the carrying value of forestry assets is transferred to inventory and recorded as a felling cost reduction to the fair value of forestry assets.

Directly attributable costs incurred during the year of biological growth and investments in standing timber are capitalised and presented within cash flows from investing activities.

14 Forestry assets [extract]

€ million	2023	2022
At 1 January	485	348
Investment in forestry assets	48	49
Fair value gains	128	169
Felling costs	(87)	(78)
Currency movements	(55)	(3)
At 31 December	**519**	**485**
Mature	359	309
Immature	160	176

The Group has 254,858 hectares (2022: 252,857 hectares) of owned and leased land available for forestry activities, all of which is in South Africa. 80,614 hectares (2022: 80,227 hectares) are set aside for conservation activities and infrastructure needs. 1,044 hectares (2022: 1,045 hectares) relate to non-core activities. The balance of 173,200 hectares (2022: 171,585 hectares) are under afforestation, which forms the basis of the valuation set out above.

Mature forestry assets are those plantations that are harvestable, while immature forestry assets have not yet reached that stage of growth. Timber is harvested according to a rotation plan, once trees reach maturity. The maturity period ranges from 6.5 to 14.5 years (2022: 6.5 to 14.5 years) depending on species, climate and location.

The fair value of forestry assets is a level 3 measure in terms of the fair value measurement hierarchy, consistent with prior years.

The following assumptions have a significant impact on the valuation of the Group's forestry assets:

- The net selling price is defined as the selling price less the costs of transport, harvesting, extraction and loading, and all selling prices and costs are denominated in South African rand. The net selling price is based on third-party transactions and is influenced by the species, maturity profile and location of timber. In 2023, the net selling price used ranged from the South African rand equivalent of €15 per tonne to €53 per tonne (2022: €14 per tonne to €47 per tonne), with a weighted average of €34 per tonne (2022: €33 per tonne).
- The conversion factor, which is used to convert hectares of land under afforestation to tonnes of standing timber, is dependent on the species, the maturity profile of the timber, the geographic location and a variety of other environmental factors, such as the anticipated impact of climate change on water scarcity and fire risks. In 2023, the conversion factors ranged from 7.6 to 25.0 (2022: 7.9 to 23.9).
- The risk premium on immature timber of 12.4% (2022: 12.5%) is based on an assessment of the risks associated with forestry assets in South Africa and is applied for the years the immature timber has left to reach maturity. A risk premium on mature timber of 4.0% (2022: 4.0%) was applied. The risk premium applied to immature and mature timber includes factors for the anticipated impact of climate change on water scarcity and fire risks. An increase in the severity and frequency of extreme weather events, such as higher temperatures, changes in rainfall patterns and drought conditions, may result in higher timber losses in future years caused by stronger winds, erosion, fires, pests and diseases.

The valuation of the Group's forestry assets is determined in South African rand and converted to euro at the closing exchange rate on 31 December of each year.

Management has performed sensitivity analyses of reasonably possible changes in the significant assumptions and the EUR/ZAR exchange rate. The sensitivity table is based on historical experience; however, the estimates may vary by greater amounts. Therefore, the Board considers the forestry assets valuation to be a significant accounting estimate. The reported value of owned forestry assets would change as follows should there be a change in these underlying assumptions on the basis that all other factors remain unchanged:

€ million	2023	2022
Effect of €5/tonne increase in net selling price	79	75
Effect of 1% increase in conversion factor (hectares to tonnes)	6	5
Effect of 1% increase in risk premium	(8)	(7)
Effect of 10% increase in EUR/ZAR exchange rate	(47)	(44)

IAS 41 is not clear about how gains should be presented in the income statement. IAS 1 prohibits offsetting of income and expenses in the income statement, unless required or permitted by another standard. *[IAS 1.32]*. Therefore, if the sale of biological assets or agricultural produce meets the definition of revenue under IFRS 15 *Revenue from Contracts with Customers*, i.e., "income arising from the ordinary activities of the entity", *[IFRS 15 Appendix A]*, it is presented on a gross basis in the income statement. Furthermore, if the sale of biological assets results from a contract with a customer and is within the scope of IFRS 15, it would be accounted for in accordance with IFRS 15 and presented as revenue from contracts with customers (see Chapter 28). However, for an entity's sales of non-current biological assets "that do not generate revenue but are incidental to the main revenue-generating activities of the entity. An entity presents the results of such transactions, when this presentation reflects the substance of the transaction or other event, by netting any income with related expenses arising on the same transaction". *[IAS 1.34]*. However, under IAS 41 the gross margin on agricultural produce sold shortly after harvest may be negligible, as the produce may have been previously carried at a valuation near to its sales price.

5.1.3 Groups of biological assets

The standard requires an entity to provide a narrative or quantitative description of each group of biological assets. *[IAS 41.41, IAS 41.42]*. An entity is encouraged to provide "a quantified description of each group of biological assets, distinguishing between consumable and bearer biological assets or between mature and immature biological assets, as appropriate". *[IAS 41.43]*. The standard suggests that an entity may separately disclose the carrying amounts of: *[IAS 41.43, IAS 41.44]*

- Consumable biological assets (i.e., assets that are to be harvested as agricultural produce, sold as biological assets or produce growing on a bearer plant)

  And

- Bearer biological assets (i.e., assets that are not consumable, but rather are self-regenerating)

The standard continues by suggesting that an entity "may further divide those carrying amounts between mature and immature assets. These distinctions provide information that may be helpful in assessing the timing of future cash flows". *[IAS 41.43]*. Mature biological assets are defined by the standard as those assets "that have attained harvestable specifications (for consumable biological assets) or are able to sustain regular harvests (for bearer biological assets)". *[IAS 41.45]*. If an entity makes such distinctions, it discloses the basis for making those distinctions. *[IAS 41.43]*.

5.1.4 Other disclosures

If not disclosed elsewhere in information published with the financial statements, an entity is required to describe:

"(a) the nature of its activities involving each group of biological assets; and

"(b) non-financial measures or estimates of the physical quantities of:

"(i) each group of the entity's biological assets at the end of the period; and

"(ii) output of agricultural produce during the period". *[IAS 41.46]*.

In addition, an entity shall disclose the following information:

(a) The existence and carrying amounts of biological assets whose title is restricted, and the carrying amounts of biological assets pledged as security for liabilities *[IAS 41.49]*

(b) The amount of commitments for the development or acquisition of biological assets *[IAS 41.49]*

(c) Financial risk management strategies related to agricultural activity *[IAS 41.49]*

(d) A reconciliation of changes in the carrying amount of biological assets between the beginning and the end of the current period, which includes: *[IAS 41.50]*

  (i) The gain or loss arising from changes in fair value less costs to sell

  (ii) Increases due to purchases

  (iii) Decreases attributable to sales and biological assets classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5

  (iv) Decreases due to harvest

  (v) Increases resulting from business combinations

  (vi) Net exchange differences arising on the translation of financial statements into a different presentation currency, and on the translation of a foreign operation into the presentation currency of the reporting entity

  And

  (vii) Other changes

Fair value measurement disclosures are discussed in section 5.2 below and in Chapter 15.

The standard also encourages, but does not require, an entity "to disclose, by group or otherwise, the amount of change in fair value less costs to sell included in profit or loss due to physical changes and due to price changes", because this information is "useful in appraising current period performance and future prospects, particularly when there is a production cycle of more than one year". *[IAS 41.51, IAS 41.B74, IAS 41.B75, IAS 41.B76, IAS 41.B77]*. IAS 41 notes that physical change itself can be broken down further into growth, degeneration, production and procreation, but the standard does not specifically encourage disclosure of this information. *[IAS 41.52]*. The following example from the standard, explains how an entity would go about separating the effect of physical changes from those of price changes. *[IAS 41.IE Example 2]*.

Extract from IAS 41 Illustrative Examples

Example 2 Physical change and price change

The following example illustrates how to separate physical change and price change. Separating the change in fair value less costs to sell between the portion attributable to physical changes and the portion attributable to price changes is encouraged but not required by this Standard.

A herd of 10 2 year old animals was held at 1 January 20X1. One animal aged 2.5 years was purchased on 1 July 20X1 for 108, and one animal was born on 1 July 20X1. No animals were sold or disposed of during the period. Per-unit fair values less costs to sell were as follows:

2 year old animal at 1 January 20X1	100	
Newborn animal at 1 July 20X1	70	
2.5 year old animal at 1 July 20X1	108	
Newborn animal at 31 December 20X1	72	
0.5 year old animal at 31 December 20X1	80	
2 year old animal at 31 December 20X1	105	
2.5 year old animal at 31 December 20X1	111	
3 year old animal at 31 December 20X1	120	
Fair value less costs to sell of herd at 1 January 20X1 (10 × 100)		1,000
Purchase on 1 July 20X1 (1 × 108)		108
Increase in fair value less costs to sell due to price change:		
10 × (105 - 100)	50	
1 × (111 - 108)	3	
1 × (72 - 70)	2	55
Increase in fair value less costs to sell due to physical change:		
10 × (120 - 105)	150	
1 × (120 - 111)	9	
1 × (80 - 72)	8	
1 × 70	70	237
Fair value less costs to sell of herd at 31 December 20X1		
11 × 120	1,320	
1 × 80	80	1,400

In January 2012, the IFRS IC considered a request for clarification in relation to IAS 41.51. The submitter was concerned that this paragraph may be contributing to an unacceptable application of the market approach to valuing biological assets. To remedy this, the submitter suggested that the disclosure be amended as part of annual improvements so that it would only be encouraged when the entity's biological assets are at the same level of biological transformation as those quoted in an active market. However, the IFRS IC did not believe an amendment was needed, noting that IAS 41.51 addresses disclosures, not measurement. The IFRS IC also pointed out that the requirements for measuring fair value are set out in IFRS 13, which is not affected by IAS 41.51.[16]

In addition to the above required and encouraged disclosures, the standard notes that agricultural activity is "often exposed to climatic, disease and other natural risks. If an event occurs that gives rise to a material item of income or expense, the nature and amount of that item are disclosed in accordance with IAS 1" (see Chapter 3). For example, an entity may need to disclose events such as "an outbreak of a virulent disease, a flood, a severe drought or frost, and a plague of insects". *[IAS 41.53]*.

16 *IFRIC Update*, January 2012, available on the IFRS Foundation's website.

Many of the uncertainties and judgements inherent in the valuations and also climate-related risk and events, that have to be made under IAS 41 are discussed in the financial statements of T&G Global Limited (as shown in section 5.1.1.B above), Mondi plc (as shown in section 5.1.2 above), Mowi ASA and Sappi Limited, as shown in the following Practical examples.

Practical example 5-3: Mowi ASA (2023) **Norway**

Integrated Annual Report 2023 [extract]

3 Group results [extract]

Financial statement and notes [extract]

NOTE –3A - ESTIMATES AND JUDGEMENTS [extract]

BIOLOGICAL ASSETS

Biological assets comprise eggs, juveniles, smolt and fish in the sea. These assets are measured at fair value less cost to sell, unless the fair value cannot be measured reliably. The estimation of the fair value relies on a series of uncertain assumptions, e.g., biomass volume, biomass quality, size distribution, market prices, expected future costs, remaining time to harvest and total time to harvest.

Mowi measures all deviations in biomass volume compared to estimates when a site is harvested out. Except for situations where there has been an incident causing mass mortality, particularly early in the cycle, combined with an inability to count and weigh fish after the event in fear of further stressing the fish, volume deviations are normally minor. Similarly, excluding the effects of soft flesh and melanin, the quality of the fish can normally be estimated with a relatively high degree of accuracy. Categorisation of quality is normally set per country based on averages, but can be set individually per site when needed. The size distribution shows some degree of variation but normally not to an extent that significantly changes the estimated value of the biomass (the value of two fish at five kg is very similar to the value of two fish weighing four and six kg, respectively).

The accumulated cost of the fish per kg will only deviate from the estimate if the volume is different from the estimate. For the estimation of future costs, there is uncertainty with regard to feed prices, other input costs and biological development. Mowi measures cost deviations vs. budget as part of the follow up of business units. Excluding special situations (incidents etc.), the deviations in costs vs budgets are normally limited for a group of sites, although individual sites might show deviations. The estimation of costs influences the biomass value through the recognised fair value adjustment in the statements of comprehensive income and financial position (calculated as fair value less accumulated biological costs).

The key element in the estimation of fair value is the assumed market price. The assumed market price is the price that we expect to receive on the future date when the live fish is harvested. We derive these prices from a variety of sources, normally a combination of the prices achieved in the previous month and the contracts most recently entered into. For salmon of Norwegian, Scottish, Icelandic and Faroese origin, quoted forward prices (Nasdaq) are normally used in the estimation, see Note 2. The use of third-party forward prices improves the reliability and comparability of the price estimation.

For further information about biological asset values please see Note 6, Biological assets.

NOTE 3B - ENVIRONMENTAL RISK

Climate change represents both risks and opportunities for Mowi. We recognise the growing significance of climate change on our business and the increasing role of producing food from the ocean as a solution to climate change. Mowi has developed a sustainability strategy, the Leading the Blue Revolution Plan. It sets ambitious goals to ensure our salmon is raised in the ocean in harmony with nature and local coastal communities, using an eco-efficient value chain while offering solutions to global challenges such as climate change and plastic pollution.

Climate change has been identified as an operational, strategic, reporting and compliance risk to Mowi which can potentially impact our business in the short, medium, and long term. Mowi follows the COSO (Committee of Sponsoring Organisations) enterprise risk framework to assess and identify risks, including climate change risks. The risk of climate change on Mowi's financial position can be classified into two types of risks; physical risk and transition risk. Physical risks are related to the increase and severity of extreme weather and long-term environmental changes. The physical related climate risks and opportunities relate to extreme weather events, sea levels and temperatures, the frequency of algae blooms, and the availability of the raw materials for our fish feed (medium to long term impact). Transition risks refer to the changes in technological advancements within clean energy, shifts in consumer behaviour and political interventions, such as restrictions and costs related to emissions etc. The transition risks and opportunities include legislation or regulations imposing overall caps or taxes on greenhouse gas emissions, or mandating the increased use of electricity from renewable energy sources (short-term impact). An increased recognition of seafood as a low carbon footprint protein is a transitional opportunity for Mowi.

These risks can affect Mowi in multiple ways, such as winters storms or el ninos giving tougher conditions, an increase of algae blooms and jelly fish due to increased water temperature can reduce quality and cause mortality on fish reducing revenue, or result in increased operating expenses with increased level of maintenance on nets and pens with tougher climate and expenses based on access to raw material in our fish feed, additional expenses for taxes with new regulation, or expenses to adapt our way of business to changed expectations from stakeholders. The changes, however, can also provide opportunities with faster growing fish in higher sea temperatures and increased revenues. The risk can also impact the carrying amount and useful life of both tangible and intangible assets as weather tear or regulation might require earlier replacements.

These risks and opportunities are part of our risk assessment as part of the annual budget and long term plan process and considered in our impairment testing at year end. The long-term effects of climate change are uncertain, but we believe that Mowi will play an increasing role in producing healthy nutritious food through an eco-efficient value chain. No impairment related to environmental risk is recognised as of year end and there has been no change in useful life for our assets.

Practical example 5-4: Sappi Limited (2023) South Africa

2023 Group Annual Financial Statements [extract]

Notes to the Group Annual Financial Statements [extract]

2. Accounting policies [extract]

2.3 Critical accounting policies and key sources of estimation uncertainty [extract]

2.3.4 Plantations

Plantations are stated at fair value less costs to sell with all changes in fair value being recognised in profit or loss. The fair value of forestry assets is a Level 3 measure in terms of the fair value measurement hierarchy. The group uses a combination of both the income approach and the market approach in determining fair value as it believes that these methods yield the most appropriate valuations. The income approach which uses discounted cash flows is applied to immature timber due to the extended time period required for the timber to reach maturity whereas the market approach which is based on the selling price of similar assets is applied to mature timber due to its shorter time period to maturity.

The key inputs are the selling prices, costs to sell, discount rates, volume and growth estimations. The impact of these inputs are disclosed in note 12.

- Selling prices and costs to sell

The net selling price is defined as the selling price less the costs to sell which include the costs of transport, harvesting, loading and overheads. The selling prices are based on external third-party transactions during the year and are benchmarked against international pricing of recent market transactions and which are influenced by species, maturity profile and location of timber. Forecast consumer price indexes are also considered for both timber prices and costs to sell.

A current net selling price is used for mature timber that is expected to be felled within 12 months from the end of the reporting period as such timber is expected to be used in the short term whereas a market trend related fair value price is used for immature timber and mature timber that is expected to be felled 12 months after the reporting date.

- Discount rate

The discount rate used is the real pre-tax discount rate. This is applied to pre-tax cash flows.

- Volume and growth estimations

The group focuses on good husbandry techniques which include ensuring that the rotation of plantations is met with adequate planting activities for future harvesting. The age threshold used for quantifying immature timber is dependent on the rotation period of the specific timber genus which varies between five and 18 years. In the Southern African region, softwood less than eight years and hardwood less than five years are classified as immature timber.

Trees are generally felled at the optimum age when ready for intended use. At the time the tree is felled, it is taken out of plantations and accounted for under inventory and reported as a depletion cost (fellings).

Depletion costs includes harvesting (fellings) and damages. The fair value of timber felled is determined using the current net selling price while damages are calculated using the market trend related fair value price. Damages are written-off against standing timber to record loss or damage caused by fire, storms, disease and stunted growth. Harvesting (fellings) depletion costs are accounted for as actual tons multiplied by the current net selling price. Damages depletion costs are accounted for as actual damaged tons multiplied by the market trend related fair value price. Damaged tons are calculated using the projected growth to rotation age and are extrapolated to current age on a straight-line basis.

The group has projected growth estimation over a period of five to 18 years per rotation. In deriving this estimate, the group established a long-term sample plot network which is representative of the species and sites on which trees are grown and the measured data from these permanent sample plots were used as input into the group's growth estimation. Periodic adjustments are made to existing models for new genetic material.

Volume and growth assumptions are used in determining standing tons at valuation date.

The associated costs for managing plantations are recognised as silviculture costs in cost of sales (see note 4). Silviculture costs are presented as operating activities in the statement of cash flows.

12. Plantations

US$ million	2023	2022
Fair value of plantations at beginning of year	**382**	477
Additions	**–**	7
Gains arising from growth	**74**	74
Fire, flood, storms and related events	**(1)**	(1)
In-field inventory	**(1)**	–
Gain arising from fair value price changes	**123**	(38)
Harvesting – agriculture produce (fellings)	**(69)**	(55)
Translation differences	**(20)**	(82)
Fair value of plantations at end of year	**488**	382

The group has 399,996 hectares (2022: 399,996 hectares) of owned and leased land available for forestry activities. 138,785 hectares (2022: 138,391 hectares) are set aside for conservation activities. The balance of 261,211 hectares (2022: 261,605 hectares) are under afforestation which forms the basis of the valuation set out above.

The fair value of forestry assets is a Level 3 measure in terms of the fair value measurement hierarchy, consistent with the prior year.

The following assumptions have a significant impact on the valuation of the forestry assets:

- A market trend related fair value price that closely approximates the spot fair value price. At year-end the gross weighted average timber price was US$49 per tonne (2022: US$45 per tonne) and the costs to sell was US$32 per tonne (2022: US$32 per tonne).
- A real pre-tax discount rate of 14.61% was used for immature timber (2022: 14.49%)
- Approximately 29 million standing tons of timber (2022: 29 million standing tons) were valued
- The average annual growth is measured at approximately 17 tons (2022: 17 tons) of timber per hectare.

Sappi amended its plantation valuation technique in the fourth quarter from using a 12-quarter historical average fair value price for immature and mature timber to be felled more than 12 months after each reporting period to a market trend related fair value price that closely approximates the spot fair value price. The 12-quarter average rate did previously approximate the spot rate but due to changing macro-economic conditions this was no longer the case. The effect of this change in estimate resulted in a favourable US$78 million adjustment which is included in the overall US$123 million price fair value adjustment for the year. We believe that this change in valuation technique will closely approximate the spot fair value price at future measurement dates.

The valuation of the group's forestry assets is determined in South African Rand and converted to US$, the group's presentation currency, at the closing exchange rate.

A sensitivity analysis of a change in each of these assumptions is tabled below:

US$ million	2023	2022
Effect of 1% impact in gross selling price	**4**	2
Effect of 1% impact in costs to sell	**(3)**	(2)
Effect of 1% impact in net selling price	**2**	1
Effect of 1% impact in discount rate	**(3)**	(2)
Effect of 1% impact in volume	**5**	4
Effect of 1% impact in rate of growth	**1**	1

5.1.5 Developments in presentation and disclosure

IFRS 18 *Presentation and Disclosure in Financial Statements*, which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted) was issued by the IASB in April 2024. See Chapter 4 for further details on the new concepts and requirements of IFRS 18.

IFRS 19 *Subsidiaries without Public Accountability*: *Disclosures* was issued by the IASB in May 2024 to simplify the preparation of financial statements by eligible subsidiaries. Eligible subsidiaries that elect to apply IFRS 19 are allowed to provide reduced disclosures while still applying the recognition, measurement and presentation requirements in other IFRS accounting standards. IFRS 19 is effective for annual reporting periods beginning on or after 1 January 2027, with earlier application permitted. IFRS 19 contains no reduced disclosure impact for IAS 41 disclosures. See Chapter 4 for further details on the requirements of IFRS 19.

5.2 Fair value measurement disclosures

IFRS 13 specifies the disclosures that are required for fair value measurements of biological assets and agricultural produce.

IFRS 13 requires a substantial amount of information to be disclosed about fair value measurements, for example:

- The methods and assumptions used in measuring fair value
- The categorisation of a fair value measurement (as a whole) within the fair value hierarchy, i.e., Level 1, 2 or 3, and, for recurring fair value measurements, any transfers between levels in the hierarchy
- A detailed reconciliation of movements for fair value measurements classified within Level 3 of the hierarchy, along with narrative sensitivity analysis

  And
- The highest and best use of a non-financial asset if it differs from its current use, including why the non-financial asset is being used in a manner that differs from its highest and best use *[IFRS 13.93]*

Chapter 15 at section 19 discusses IFRS 13's disclosure requirements in more detail.

In times of heightened market volatility and uncertainty, entities should pay particular attention to the IFRS 13 disclosure requirements on the sensitivity of Level 3 measurements to changes in significant unobservable inputs. These are discussed in Chapter 15 at section 19.3.8.

In instances where climate-related risk factors have a material impact on fair value measurements, additional disclosures could be required, particularly for those categorised within Level 3 of the fair value hierarchy. This includes any changes in the valuation processes, and sensitivity to changes in unobservable inputs and the interrelationship of those inputs. Entities might need to consider whether additional information is needed to meet the disclosure objective in IFRS 13. Should they wish to convey more information (e.g., the entity's incorporation of climate-related factors for its own purposes, rather than financial reporting), entities need to consider whether disclosure within the financial statements is appropriate or it is better presented in the management's discussion and analysis (MD&A).

Entities need to ensure that any climate change variables incorporated in a fair value measurement are those that market participants would consider when pricing the asset or liability to ensure it is an IFRS 13 fair value measurement. More information about climate-related risks will be made available in future, including information disclosed outside the financial statements, for example, following the publication of IFRS S2 *Climate-related Disclosures* by the International Sustainability Standards Board (ISSB). Reliably pricing climate-related risk and incorporating climate change variables into valuations is expected to gradually improve.

Significant judgement may be needed when considering climate-related factors in fair value measurements, which might lead to greater estimation uncertainty. As a result, entities will need to provide sufficient transparency in their disclosures about the impact of climate-related risks on fair value measurements.

The following Practical example illustrates fair value disclosures for biological assets, as do the Practical examples in sections 5.1.1.B, 5.1.2 and 5.1.4 above.

Practical example 5-5: Mowi ASA (2023) Norway

Integrated Annual Report 2023 [extract]
3 Group results [extract]
Financial statement and notes [extract]
NOTE 6 – BIOLOGICAL ASSETS [extract]

VALUATION OF BIOLOGICAL ASSETS

Biological assets are, in accordance with IAS 41, measured at fair value less cost to sell. All fish at sea are subject to a fair value calculation, while broodstock and smolt are measured at cost less impairment losses.

Biomass measured at fair value, is categorised at Level 3 in the fair value hierarchy, as the input is mostly unobservable. In line with IFRS 13, the highest and best use of the biological assets is applied for the valuation. In accordance with the principle for highest and best use, we consider that the fish have optimal harvest weight at 4 kg gutted. This corresponds to a live weight of approximately 4.8 kg (there may be regional variances). Fish of this weight or above are classified as ready for harvest (mature fish), while fish that have still not achieved this weight are classified as not ready for harvest (immature fish). The valuations are carried out at business unit level based on a common model and basis for assumptions established at group level. All assumptions are subject to monthly quality assurance and analysis at the group level.

The valuations are based on an income approach and takes into consideration unobservable input based on biomass in the sea, the estimated growth rate and cost to completion at site level. Mortality, quality of the fish going forward and market price are considered at business unit level. A special assessment is performed for sites with high/low performance due to disease or other deviating factors. The market prices are derived from observable market prices where available.

ASSUMPTIONS USED FOR DETERMINING FAIR VALUE OF LIVE FISH

The estimated fair value of the biomass will always be based on uncertain assumptions, even though the group has built substantial expertise in assessing these factors. Estimates are applied to the following factors; biomass volume, the quality of the biomass, size distribution, cost, mortality and market prices.

Biomass volume: The biomass volume is in itself an estimate based on the number of smolt released into the sea, the estimated growth from the time of stocking, estimated mortality based on observed mortality in the period, etc. There is normally little uncertainty with regard to biomass volume.

The level of uncertainty will, however, be higher if an incident has resulted in mass mortality, especially early in the cycle, or if the fish's health status restricts handling. If the total biomass at sea was 1% lower than our estimates, this would result in an change in value of EUR -6.5 million.

The quality of the biomass: The quality of the biomass can be difficult to assess prior to harvesting, if the reason for downgrading is related to muscle quality (e.g. the effect of Kudoa in Canada). In Norway downgraded fish is normally priced according to standard rates of deduction compared to a Superior quality fish. In our fair value model for salmon of Norwegian origin, we have used EUR 0.21 and EUR 0.61 as deductions from Superior grade for Ordinary and Production grade quality respectively. In other countries the price deductions related to quality are not as standardised. The quality of harvested fish has been good in 2023. For the Group as a whole, 88% of the fish were graded as Superior quality. A one percentage point change from Superior quality to Production grade quality would result in a change in value of EUR -3.8 million.

The size distribution: Fish in sea grow at different rates, and even in a situation with good estimates for the average weight of the fish there can be a considerable spread in the quality and weight of the fish. The size distribution affects the price achieved for the fish, as each size category of fish is priced separately in the market. When estimating the biomass value, a normal size distribution is applied.

Cost: For the estimation of future costs, there is uncertainty with regard to feed prices, other input costs and biological development. Mowi measures cost deviations vs. budget as part of the follow up of business units. Excluding special situations (incidents etc.), the deviations in costs vs budgets are normally limited for a group of sites, although individual sites might show deviations. The estimation of costs influences the biomass value through the recognised fair value adjustment in the statements of comprehensive income and financial position (calculated as fair value less accumulated biological costs).

Mortality: Normalised mortality will affect the fair value estimates both as a reduction of estimated harvesting volumes and because cost to completion includes cost incurred on fish that eventually will perish.

Market price: The market price assumption is very important for the valuation and even minor changes in the market price will result in significant changes in the valuation. The methodology used for establishing the market price is explained in Note 2. A EUR 0.1 decrease in the market price would result in a decrease in value of EUR 17.1 million.

The market price risk is reduced through fixed price/volume customer contracts and financial contracts, as well as our downstream integration as explained in Note 13.

Climate Risk : Climate risk is included in the assessment for calculating the Fair value of live fish. Due to the short time period relevant for the Fair value uplift (maximum of 2 years) climate risk has not had a material effect on the valuation of biomass in sea.

WRITE-DOWN OF BIOMASS AND INCIDENT-BASED MORTALITY

Incident-based mortality is accounted for when a site either experiences elevated mortality over time or substantial mortality due to an incident at the farm (outbreak of disease, lack of oxygen etc). The cost of incident based mortality is included in "cost of materials" in the statement of comprehensive income. The fair value element is adjusted through fair value adjustment on incident based mortality, and included in net fair value adjustment in the statement of comprehensive income.

RECONCILIATION OF CHANGES IN THE CARRYING AMOUNT OF BIOLOGICAL ASSETS (EUR MILLION)	2023	2022
Carrying amount as of 01.01	1 912.5	1 529.5
Cost to stock	2 570.5	2 259.3
Net fair value adjustment	37.4	113.7
Mortality for fish in sea	-97.4	-88.7
Cost of harvested fish expensed	-2 265.7	-1 964.5
Write-downs	-15.6	-18.3
Effects of business combinations	13.7	83.3
Currency translation differences	-12.0	-1.9
Total carrying amount of biological assets as of 31.12	**2 143.6**	**1 912.5**

...

SENSITIVITY EFFECT ON FAIR VALUE (SALMON ONLY) AT YEAR-END (EUR MILLION)	PRICE -0.1 EUR	BIOMASS -1% LWT	QUALITY -1% SUP
Mowi Norway	-8.7	-4.4	-0.5
Mowi Chile	-2.4	-0.4	-0.4
Mowi Canada	-2.4	-0.6	-1.3
Mowi Scotland	-2.6	-0.6	-1.5
Mowi Faroe Islands	-0.6	-0.3	—
Mowi Ireland	-0.1	—	—
Arctic Fish	-0.3	-0.2	—
Total sensitivity effect on fair value	**-17.1**	**-6.5**	**-3.8**

...

5.3 Additional disclosures if fair value cannot be measured reliably

If an entity rebuts the presumption that fair value can be reliably measured on initial recognition of a biological asset (including produce growing on a bearer plant) and measures the asset at its cost less any accumulated depreciation and any accumulated impairment losses it is required to disclose the following information:

(a) If the entity holds such assets at the end of the period: *[IAS 41.54]*
   (i) A description of the biological assets
   (ii) An explanation of why fair value cannot be measured reliably
   (iii) If possible, the range of estimates within which fair value is highly likely to lie
   (iv) The depreciation method used
   (v) The useful lives or the depreciation rates used
   And
   (vi) The gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period

(b) If the entity held such assets at any point during the current period: *[IAS 41.55]*
   (i) Any gain or loss recognised on disposal of such biological assets
   (ii) The reconciliation required by IAS 41.50 (see section 5.1.4 above) shall disclose amounts related to such biological assets separately
   (iii) That reconciliation shall include the following amounts included in profit or loss related to those biological assets:
      - Impairment losses
      - Reversals of impairment losses
      And
      - Depreciation

(c) If the entity held such assets and their fair value became reliably measurable during the current period: *[IAS 41.56]*
   (i) A description of the biological assets
   (ii) An explanation of why fair value has become reliably measurable
   And
   (iii) The effect of the change

5.4 Government grants

An entity that has received government grants related to agricultural activity covered by IAS 41 is required to disclose the following information: *[IAS 41.57]*

Extract from IAS 41

Government grants

57 **An entity shall disclose the following related to agricultural activity covered by this Standard:**

(a) the nature and extent of government grants recognised in the financial statements;

(b) unfulfilled conditions and other contingencies attaching to government grants; and

(c) significant decreases expected in the level of government grants.

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Appendix C - Defined terms

Extract from IAS 41

5 The following terms are used in this Standard with the meanings specified:

Agricultural activity is the management by an entity of the biological transformation and harvest of biological assets for sale or for conversion into agricultural produce or into additional biological assets.

Agricultural produce is the harvested produce of the entity's biological assets.

A *bearer plant* is a living plant that:

(a) is used in the production or supply of agricultural produce;

(b) is expected to bear produce for more than one period; and

(c) has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.

A *biological asset* is a living animal or plant.

Biological transformation comprises the processes of growth, degeneration, production, and procreation that cause qualitative or quantitative changes in a biological asset.

Costs to sell are the incremental costs directly attributable to the disposal of an asset, excluding finance costs and income taxes.

A *group of biological assets* is an aggregation of similar living animals or plants.

Harvest is the detachment of produce from a biological asset or the cessation of a biological asset's life processes.

Chapter 39 Extractive industries

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Overview

The purpose of this chapter is to focus on issues that are specific to entities operating in the extractives industries, specifically mining entities and oil and gas entities. Entities in the extractives industries face a range of complex accounting issues as a result of the uncertainties involved in mineral exploration and extraction, the wide range of risk sharing arrangements, and government involvement in the form of mandatory participations and special tax regimes. At the same time, however, some of the business arrangements that are aimed at mitigating certain risks give rise to financial reporting complications.

Historically the IASB ('Board') and its predecessor, the IASC, have not addressed the specific accounting issues that arise in the extractive industries and have in many instances excluded minerals and mineral products/reserves from the scope of their accounting standards. Other than IFRS 6 *Exploration for and Evaluation of Mineral Resources,* there are no standards specific to the extractive industries. It is the combination of industry specific factors noted above, a lack of specific guidance in IFRS accounting standards and a long history of industry practice and guidance from previous GAAPs that have given rise to a range of accounting practices in the extractive industries.

Currently there is no IFRS accounting standard that addresses all of the specific issues of the extractive industries although attempts to devise such a standard commenced quite some time ago. Furthermore, draft proposals to date have not addressed many of the specific issues that affect the extractive industries.

This chapter looks to explore some of the common accounting challenges faced by extractive industries entities in applying the direct and analogous requirements and guidance provided by IFRS accounting standards. Other than IFRS 6, the underlying requirements of other relevant standards are covered in other chapters and cross referenced rather than being repeated in this chapter.

What you need to know

- This chapter focuses on financial reporting issues affecting mining entities and oil and gas entities.
- To date, there is no IFRS accounting standard that addresses all the specific financial reporting issues of the extractive industries.
- This chapter explores some of the common accounting challenges faced by extractives entities in applying the direct and analogous requirements of the accounting standards.
- Recent developments: On 23 May 2023, the IASB issued *International Tax Reform-Pillar Two Model Rules - Amendments to IAS 12 (the Amendments).* The amendments have introduced:
  - A mandatory temporary exception to the accounting for deferred taxes arising from the jurisdictional implementation of the Pillar Two model rules. See Chapter 29 at sections 4.6.2.A and 4.6.2.B
  - Disclosure requirements for affected entities to help users of the financial statements better understand an entity's exposure to Pillar Two income taxes arising from that legislation, particularly before its effective date. See Chapter 29 at sections 4.6.2.C and 4.6.2.B
- In March 2024, the IASB issued an Exposure Draft *Business Combinations-Disclosures, Goodwill and Impairment* (proposed amendments to IFRS 3 and IAS 36) (the ED).[1] The proposed amendments to IFRS 3 add new disclosure requirements that would result in an entity disclosing:
  - For a strategic business combination, information about the performance of business combinations, specifically, information about the entity's acquisition-date key objectives and targets and the extent to which those key objectives and targets are met in subsequent periods;

    And
  - Quantitative information about synergies expected to arise as a result of a business combination. See Chapter 10 at section 1.2.1

1 Exposure Draft, ED/2024/1 *Business Combinations-Disclosures, Goodwill and Impairment*, IASB, March 2024. Available on the IFRS Foundation's website.

1 Introduction and background

1.1 Defining extractive industries

'Extractive industries' were defined in the IASC's Issues Paper *Extractive Industries* (IASC Issues Paper) published in November 2000 as "…those industries involved in finding and removing wasting natural resources located in or near the earth's crust".[2] However, this chapter adopts a slightly narrower focus and concentrates on the accounting issues that affect mining entities and oil and gas entities. The IASC Issues Paper was prepared by the IASC as part of its original project on 'extractive industries' which was led by an IASC Steering Committee on Extractive Industries. This paper considered a broad range of issues including reserves and resources estimation, historical and valuation-based concepts of measurement of resources related assets, treatment of removal and restoration costs, impairment, revenue, inventories and arrangements to share risks and costs. While it was non-authoritative, this paper is referred to throughout this chapter where relevant as it provided a broad range of information on the common practices observed in the extractive industries and the common terms used.

IFRS accounting standards currently use the term 'minerals' and 'mineral assets' when referring to the extractive industries as a whole. This is used as a collective term to include both mining and oil and gas reserves and resources. In contrast, a distinction between the two industries was introduced in the *Extractive Activities* DP (discussed below in section 1.3), where the term 'minerals' has been used to refer to the mining sector and the term 'oil and gas' has been used to refer to the oil and gas sector.

For the purposes of this chapter, consistency with the current wording in IFRS accounting standards will be maintained and therefore, unless stated otherwise, 'minerals' and 'mineral assets' will encompass both mining and oil and gas.

Historically, the IASB and its predecessor, the IASC, have avoided dealing with specific accounting issues in the extractive industries by excluding minerals and mineral products/reserves from the scope of their accounting standards. Currently, minerals and mineral products/reserves are excluded, at least in part, from the scope of the following standards:

- IAS 2 *Inventories* *[IAS 2.3(a), IAS 2.4]*
- IAS 16 *Property, Plant and Equipment* *[IAS 16.3(d)]*
- IFRS 16 *Leases* *[IFRS 16.3(a)]*
- IAS 38 *Intangible Assets* *[IAS 38.2(d)]*
- IAS 40 *Investment Property* *[IAS 40.4(b)]*

While these standards exclude 'minerals' from their scope, the exact wording of the scope exclusions differ between standards - see section 3.1.1 below for more information. In addition, although minerals and mineral products/reserves themselves are excluded from the scope of many standards, assets used for the exploration, development and extraction of minerals are covered by existing IFRS accounting standards.

Many of the financial reporting issues that affect entities that operate in the extractive industries are a result of the environment in which they operate. Specific accounting issues arise because of the uncertainties involved in mineral exploration and extraction, the wide range of risk sharing arrangements, and government involvement in the form of mandatory participations and special tax regimes. At the same time, however, some of the business arrangements that are aimed at mitigating certain risks give rise to financial reporting complications. The financial reports of these entities need to reflect the risks and rewards to which they are exposed. In many cases, there are legitimate differences of opinion about how an entity is required to account for these matters.

The IASC Issues Paper identified the following characteristics of activities in the extractive industries, which are closely related to the financial reporting issues that are discussed in this chapter:

- *High risks* - In the extractive industries there is a high risk that the amounts spent in finding new mineral resources will not result in additional commercially recoverable reserves. In financial reporting terms, this means that it can remain uncertain for a long period whether or not certain expenditures give rise to an asset. Further risks exist in relation to production (i.e., quantities actually produced may differ considerably from those previously estimated) and price (i.e., commodity prices are often volatile).

2 IASC Issues Paper, Issues Paper Extractive Industries, IASC, November 2000, 1.5.

- *Little relationship between risks and rewards* - In the extractive industries, a small expenditure may result in finding mineral deposits with a value of many times the amount of the expenditure. Conversely, large expenditures can frequently result in little or no future production. This has given rise to different approaches in financial reporting that can be broadly categorised as follows: (1) expense all expenditures as the future benefits are too uncertain; (2) capitalise some or all expenditures as the cumulative expenditures may be matched to the cumulative benefits, or (3) recognise the mineral assets found at fair value.
- *Long lag between expenditure and production* - Exploration and/or development may take years to complete. During this period, it is often far from certain that economic benefits will be derived from the costs incurred.
- *High costs of individual projects* - The costs of individual projects can be very high (e.g., offshore oil and gas projects and deep mining projects). Exploration expenditures that are carried forward pending the outcome of mineral acquisition and development projects may be highly significant in relation to the equity and the total assets of an entity.
- *Unique cost-sharing arrangements* - High costs and high risks, as discussed above, often lead entities in the extractive industries to enter into risk-sharing arrangements and other funding arrangements (e.g., joint arrangements, farm-out arrangements, carried interest arrangements, oilfield services arrangements, contract mining and streaming arrangements). These types of arrangements, which are much more common in the extractive industries than elsewhere, often give rise to their own financial reporting issues.
- *Intense government oversight and regulation* - The regulation of the extractive industries ranges from "outright governmental ownership of some (especially petroleum) or all minerals to unusual tax benefits or penalties, price controls, restrictions on imports and exports, restrictions on production and distribution, environmental and health and safety regulations, and others". Governments may also seek to charge an economic rent for resources extracted. These types of government involvement give rise to financial reporting issues, particularly when the precise nature of the government involvement is not obvious.
- *Scarce non-replaceable assets* - Mineral reserves are unique and scarce resources that an entity may not be able to replace in any location or in any form.
- *Economic, technological and political factors* - While these factors are not unique to the extractive industries, the IASC Issues Paper argues that they tend to have a greater impact on the extractive industries because:

  "(a) fluctuating market prices for minerals (together with floating exchange rates) have a direct impact on the economic viability of reserves and mineral properties. A relatively small percentage change in long-term prices can change decisions on whether or when to explore for, develop, or produce minerals;

  (b) there is a sharp impact from cost changes and technological developments. Changes in costs and, probably more significantly, changes in technology can significantly change the economic viability of particular mineral projects; and

  (c) in almost every country, mineral rights are owned by the state. In those countries where some mineral rights are privately owned, public reliance on adequate sources of minerals for economic and defence purposes often leads to governmental regulations and control. At other times, governmental policies may be changed to levy special taxes or impose governmental controls on the extractive industries."

While it may be the case that the above factors affect the extractive industries more than others, to the extent that they also arise in the pharmaceutical, bio-technology, agricultural and software industries, some of these risks give rise to further financial reporting issues. However, those industries are not affected by the combination of these circumstances to the same extent as is the case with the extractive industries. It is a combination of these factors, a lack of specific guidance in IFRS accounting standards and a long history of industry practice and guidance from previous GAAPs that have given rise to a range of accounting practices in the extractive industries.

There is no IFRS accounting standard that addresses all of the specific issues of the extractive industries although there has been past attempts to devise such a standard. It has been observed that , previous draft proposals to date would not have addressed many of these specific issues that affect the extractive industries.

1.1.1 Definition of key terms

The most important terms and abbreviations used which are specific to the extractive industries or IFRS 6 are defined in this chapter when discussed or in the defined terms at Appendix B below. However, alternative or more detailed definitions of financial reporting terms, and of mining and oil and gas technical terms and abbreviations, can be found in publications such as, but not limited to:

- *Issues Paper Extractive Industries*, IASC, November 2000
- *Petroleum Resources Management System*, Society of Petroleum Engineers, 2007 (revised June 2018 (v. 1.03))
- *The Australasian Code for Reporting of Exploration Results, Mineral Resources and Ore Reserves* (the JORC Code), Australasian Joint Ore Reserves Committee (the JORC Committee)
- The former UK Oil Industry Accounting Committee Statement of Recommended Practice (OIAC SORP) (see section 1.4 below)

1.2 The development of IFRS 6 *Exploration for and Evaluation of Mineral Resources*

In December 2004, the IASB issued IFRS 6 which addresses the accounting for one particular aspect of the extractive industries, being exploration and evaluation (E&E) activities. IFRS 6 was originally issued as a form of interim guidance to clarify the application of IFRS accounting standards and the IASB's *Conceptual Framework* to E&E activities. This was because mineral rights and mineral resources are outside the scope of IAS 16 and IAS 38, and while E&E expenditures are significant to entities engaged in extractive activities, there were different views on how these expenditures are required to be accounted for under IFRS accounting standards. Other standard-setting bodies had diverse accounting practices for E&E assets which often differed from practices in other sectors with analogous expenditures. *[IFRS 6(2010).IN1]*.

One of the IASB's goals in developing IFRS 6, at the time, was to avoid unnecessary disruption for both users and preparers. The Board therefore proposed to limit the need for entities to change their existing accounting policies for E&E assets. As a result, IFRS 6 defines what E&E expenditures are, makes limited improvements to existing accounting practices for E&E expenditures, such as specifying when entities need to assess E&E assets for impairment in accordance with IAS 36 *Impairment of Assets,* and requires certain disclosures.

Given that IFRS 6 was originally intended to be an interim measure, between 2018 and 2023 the IASB embarked on a research project to determine whether to amend or replace IFRS 6, this included research on improving:

- The recognition and measurement requirements to reduce the diversity of accounting policies used in practice for exploration and evaluation expenditure;
- The disclosure requirements to increase the transparency, comparability and relevance of information provided in financial statements about that expenditure and the related activities; and
- Other IFRS accounting standards to address matters relating to extractive activities identified by stakeholders that are not in the scope of IFRS 6.

The outcome of the IASB's activities resulted in them deciding not to develop new or amended recognition, measurement or disclosure requirements for exploration and evaluation expenditure or other aspects of accounting for extractive activities. This was because the IASB did not find compelling evidence that standard-setting would be necessary.

The IASB also acknowledged that diverse accounting policies for exploration and evaluation expenditure would continue to be used in practice. Diversity mainly arises from entities making decisions about:

- whether to capitalise exploration and evaluation expenditure as assets;
- which types of expenditure are capitalised;
- when to start and stop capitalising that expenditure; and what unit of account is applied to that expenditure (such as whether to aggregate expenditure by oil well, licence area or country).

Similarly, the IASB did not find evidence of a significant financial reporting problem that could be addressed by standard-setting, despite evidence of diversity, some of which could be explained by an entity's particular circumstances. It was noted that the extractives industry has well-established accounting practices that predate IFRS 6. Feedback from investors and other users of financial statements suggested those diverse accounting policies were not a significant concern. Overall, the research findings suggested that any improvements to financial reporting that might result from amending or replacing the requirements in IFRS 6 or other IFRS accounting standards are likely to be outweighed by the costs of developing and implementing any such changes.

Following from the above decisions, the IASB did decide to remove the word 'Temporary' from the headings of the section in IFRS 6 that exempts an entity from applying some of the requirements in IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors, to its accounting policies for exploration and evaluation expenditure.

IFRS 6 specifically exempts an entity from applying the application of paragraphs 11-12 in IAS 8, to its accounting policies for exploration and evaluation expenditure. Paragraphs 11-12 of IAS 8 specify a hierarchy of criteria that an entity uses to develop an accounting policy if no IFRS accounting standard applies to a particular item.

It should be noted that an entity is still required to apply paragraph 10 of IAS 8 when developing its accounting policies, requiring accounting policies to be developed that result in information that is relevant and reliable.

IFRS 6 defines E&E expenditures and E&E assets as follows: *[IFRS 6 Appendix A]*

Extract from IFRS 6

Appendix A
Defined terms

exploration and evaluation assets	**Exploration and evaluation expenditures** recognised as assets in accordance with the entity's accounting policy.
exploration and evaluation expenditures	Expenditures incurred by an entity in connection with the **exploration for and evaluation of mineral resources** before the technical feasibility and commercial viability of extracting a mineral resource are demonstrable.

The detailed requirements of IFRS 6 are discussed in section 3 below.

1.3 The IASB Extractive Activities Project and April 2010 Discussion Paper

In April 2010, subsequent to the issuance of IFRS 6 and as part of the long running project to finalise the issue of developing separate accounting principles for extractive industries, the IASB published the staff Discussion Paper *Extractive Activities* (the DP or the *Extractive Activities* DP). The DP was developed by a research team comprising members of the Australian, Canadian, Norwegian and South African accounting standard-setters.[3]

The DP addressed some of the financial reporting issues associated with exploring for and finding minerals, oil and natural gas deposits, developing those deposits and extracting the minerals, oil and natural gas. These were collectively referred to as 'extractive activities' or, alternatively, as 'upstream activities'.[4] The aim of the project was to create a single accounting and disclosure model that would only apply to upstream extractive activities in both the minerals and oil and gas industries. This would have represented a change from IFRS 6, which included exploration and evaluation activities relating to minerals, oil, natural gas and similar non-regenerative resources within its scope. The project team decided against a broader scope in the DP as this would result in the need to develop additional definitions, accounting models and disclosures.[5]

The DP concluded that there were similarities in the main business activities, and the geological and other risks and uncertainties of both the minerals and oil and gas industries.[6] There were also similarities in the definitions of reserves and resources used by the Committee for Mineral Reserves International Reporting Standards (CRIRSCO) and the Society of Petroleum Engineers Oil and Gas Reserves Committee (SPE OGRC).[7] The DP therefore proposed that there should be a single accounting and disclosure model that applies to all extractive activities (as defined, see section 1.1 above).

3 Discussion Paper DP/2010/1, *Extractive Activities*, IASB, April 2010, p.7. Available on the IFRS Foundation's website.

4 Discussion Paper DP/2010/1, *Extractive Activities*, IASB, April 2010, para. 1.1. Available on the IFRS Foundation's website.

5 Discussion Paper DP/2010/1, *Extractive Activities*, IASB, April 2010, paras. 1.4-1.5. Available on the IFRS Foundation's website.

6 Discussion Paper DP/2010/1, *Extractive Activities*, IASB, April 2010, para. 1.9. Available on the IFRS Foundation's website.

7 Discussion Paper DP/2010/1, *Extractive Activities*, IASB, April 2010, para. 1.10. Available on the IFRS Foundation's website.

While it has been generally acknowledged that the issues addressed in the DP are important, a significant number of respondents to the DP commented that the scope of the DP did not address many of the more complex accounting issues where practice is diverse and greater consistency is required.

These issues included:

- The lack of guidance on complex areas such as farm-out and farm-in transactions (see section 6.2 below)
- Accounting for production sharing and royalty agreements (see sections 5.3 and 5.7 below)

The main proposals in the DP as well as subsequent feedback and findings from the IASB's Extractive Activities project have been summarised in section 1.3 as well as in the sections below.

1.3.1 Definitions of reserves and resources

The DP explored a number of alternatives for defining reserves and resources. The definition used is "…reserves and resources are either the most significant assets or amongst the most significant assets for most entities engaged in extractive activities. Assessing the financial position and performance of an entity engaged in extractive activities in order to make economic decisions therefore requires an understanding of the entity's minerals or oil and gas reserves and resources, which are the source of future cash flows".[8]

Feedback from investors as part of the IASB's Extractive Project also suggested that information about reserves and resources is important for forecasting and valuation modelling and analyses used for the purposes of acquisition accounting and in assessing an assets recoverable amount. Reserve and resource information can also be an important input in determining financial statement items such as depreciation, impairment losses and decommissioning provisions.

Whilst, many stakeholders suggested that the IASB consider whether to develop requirements for entities to disclose reserve and resource information in financial statements. Equally, many stakeholders also noted that requiring the disclosure of reserve and resource information is beyond the remit of the IASB and of financial statements. In most jurisdictions with large extractive industries, regulators already require the disclosure of reserve and resource information. To this end, most investors suggested they obtain sufficient reserve and resource information for the majority of entities they follow.

The IASB was also concerned that any new disclosure requirements for reserve and resource information could diverge from local regulations, creating confusion for users of financial statements. Stakeholders also highlighted significant costs of auditing reserve and resource information in financial statements. For these reasons, the IASB did not find sufficient evidence to develop new requirements for the disclosure of reserve and resource information in financial statements.

This chapter considers the definitions of reserves and resources that could be considered for use in financial reporting. See section 2 below for further discussion.

1.3.2 Asset recognition

The DP proposed that legal rights (i.e., exploration rights and extraction rights) should form the basis of a mineral asset or oil and gas asset. An asset should be recognised when the legal rights are acquired. Associated with these legal rights is information about the (possible) existence of minerals or oil and gas, the extent and characteristics of the deposit, and the economics of their extraction. The project team believed that rights and information associated with minerals or oil and gas properties satisfy the asset recognition criteria. While such information does not represent a separate asset, the project team proposed that information obtained from subsequent exploration and evaluation activities and development works would be treated as enhancements of the asset represented by the legal rights.

When considering the appropriate unit of account (see section 4 below), the DP proposed that the geographical boundary of the unit of account would be defined initially on the basis of the exploration rights held. As exploration, evaluation and development activities took place, the unit of account would contract progressively until it became no greater than a single area, or group of contiguous areas, for which the legal rights were held, and which are managed separately and would be expected to generate largely independent cash flows.

8 Discussion Paper DP/2010/1, *Extractive Activities*, IASB, April 2010, para. 2.1. Available on the IFRS Foundation's website.

1.3.3 Asset measurement

The DP considered both current value (e.g., fair value) and historical cost as potential measurement bases for minerals and oil and gas assets. Based on their findings and taking the views of users and preparers into account, the project team concluded that minerals and oil and gas assets should be measured at historical cost and that detailed disclosures should be provided to enhance the relevance of the financial statements. The project team acknowledged that its choice of historical cost as the measurement basis was based to a large extent on doing the 'least harm'.

In relation to impairment, it was considered that the IAS 36 impairment testing model was not feasible for exploration properties given the early stage of such properties. Therefore, the DP concluded that exploration properties should only be tested for impairment whenever, in management's judgement, there is evidence that suggests that there is a high likelihood that the carrying amount of an exploration asset will not be recovered in full. This would require management to apply a separate set of indicators to such properties in order to assess whether their continued recognition as assets would be justified. In addition, further disclosures would be required in respect of the impairment of exploration properties due to the fact that management may take different views on the exploration properties. These would include separate presentation of exploration properties, the factors that led to an impairment being recognised, and management's view as to why the remaining value of the asset or the other exploration assets is not impaired. This impairment assessment would need to be conducted separately for each exploration property.

1.3.4 Disclosure

The DP proposed extensive disclosures aimed at ensuring users of financial reports could "…evaluate:

- the value attributable to an entity's minerals or oil and gas assets;
- the contribution of those assets to current period financial performance; and
- the nature and extent of risks and uncertainties associated with those assets".

The DP proposed detailed disclosures about the quantities of reserves and resources, and production revenues and costs. If the assets are measured at historical cost, then detailed information should be disclosed about their current value and how it was determined. If, instead, the assets are measured at fair value then detailed information should be disclosed about that fair value and how it was determined.

It is noted that a number of the proposed disclosures differed from US GAAP. These included disclosures of:

- Key reserve estimate assumptions and sensitivity analysis (not required by US GAAP)
- Proved and probable reserves (US GAAP only requires proved reserves, with an option to disclose probable reserves)

Likewise, the IASB, in their Extractive Project, also explored three areas to determine whether more useful information could be disclosed about:

- accounting policies applied to exploration and evaluation expenditure to improve transparency;
- cumulative exploration and evaluation expenditure to improve comparability of entities applying different accounting policies; and
- risks and uncertainties associated with exploration and evaluation expenditure and activities to improve assessments of future cash flows.

However, the IASB's research found that the benefits of such additional information would likely be marginal, because information about an entity's accounting policy applied to exploration and evaluation expenditure is often not material for large entities primarily engaged in production activities to users of financial statements.

The IASB also noted that IFRS 6 requires an entity to disclose its accounting policies for exploration and evaluation expenditure, including the recognition of exploration and evaluation assets. The IASB expects that other requirements-for example, amendments to IAS 1 Presentation of Financial Statements and IFRS Practice Statement 2 Making Materiality Judgements in 2021, and requirements developed in its Primary Financial Statements project (IFRS 18[9])-should lead to entities providing more transparent information about how they account for exploration and evaluation expenditure when that information is material. Therefore, the IASB decided, based on its research, that there was not a compelling case for standard-setting for the other disclosure suggestions.

9 IFRS 18 *Presentation and Disclosure in Financial Statements*, which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted) was issued by the IASB in April 2024. See Chapter 4 for further details on the new concepts and requirements of IFRS 18

1.3.5 Publish What You Pay proposals

At the time of the DP development, a coalition of non-governmental organisations had promoted, and continues to promote, a campaign called Publish What You Pay (PWYP), proposing that entities undertaking extractive activities should be required to disclose, in their financial reports, the payments they make to each host government. Furthermore, PWYP recommended that its disclosure proposals should be incorporated into an eventual IFRS accounting standard for extractive activities. Given this, a section in the DP was dedicated to the PWYP proposals. The DP acknowledged that the disclosure of payments made to governments provides information that would be of use to capital providers in making their investment and lending decisions but noted that providing this information might be difficult and costly for some entities.

These proposals were partially in response to a perception that in certain countries some mining entities and oil and gas entities are not paying their "…fair share" in exchange for extracting scarce natural resources. In addition, there had been increasing political pressure to expand the disclosure of payments to governments by entities within extractive industries as a means of reducing corruption by shining a light on these payments. As well as the proposals made in the DP, there were also increasing calls for transparency in the reporting of taxes and other payments to governments. This led to a variety of transparency or publish what you pay types of initiatives being introduced in different jurisdictions around the world (e.g., US, Europe, UK, Canada, Australia, to name just a few), however these are outside the scope of IFRS accounting standard and are governed by specific legislation.

1.4 Status of the Statement of Recommended Practice, UK Oil Industry Accounting Committee, June 2001 (OIAC SORP)

The Oil Industry Accounting Committee (OIAC), based in the United Kingdom, had previously developed a Statement of Recommended Practice (SORP) titled *Accounting for Oil and Gas Exploration, Development, Production and Decommissioning Activities*, which was updated and adopted by the UK Accounting Standards Board (ASB) in 2001.

The main function of the OIAC SORP had been to set out best practice in relation to activities in the oil and gas industry that were not covered directly by the main body of UK accounting standards. However, as much of the OIAC SORP has now been superseded by subsequent changes to accounting standards, the OIAC concluded that the SORP was no longer applicable in directing best practice guidance. From 1 January 2015, non-listed UK GAAP reporting entities moved to new accounting standards - FRS 100 *Application of Financial Reporting Requirements*, FRS 101 *Reduced Disclosure Framework* and FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* and were required by FRS 101 and FRS 102 to apply IFRS 6. As such, there will be no intention to further update the SORP for future industry developments or changes in accounting standards. The ASB indicated it would continue to provide the OIAC SORP as a reference document, but it would primarily be for educational purposes, it would not carry the authoritative accounting weight it did previously and would not be reviewed or endorsed by the UK Financial Reporting Council (UK FRC). In the future, the OIAC may, when considered necessary, issue guidance notes addressing industry specific accounting matters under IFRS accounting standards and UK GAAP but these will not be endorsed by the UK FRC.

Given the long history of entities in certain jurisdictions looking to the OIAC SORP for guidance for oil and gas accounting and reporting, and the lack of definitive guidance elsewhere, the SORP is likely to continue to be a valuable source of industry guidance e.g., reserves reporting (see section 2.4.1 below). However, we highlight the importance of having to overlay IFRS pronouncements and guidance as and when they are available.

Throughout this chapter the OIAC SORP will be referred to as the 'former OIAC SORP' because it has been decommissioned.

1.5 Guidance under national accounting standards

Entities complying with IFRS accounting standards do not have a free hand in selecting accounting policies - indeed the very purpose of a body of accounting literature is to restrict such choices. IAS 8 makes it clear that when a standard or an interpretation specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item should be determined by applying the standard or interpretation and considering any relevant implementation guidance issued by the IASB. *[IAS 8.7]*.

However, in the extractive industries there are many circumstances where a particular event, transaction or other condition is not specifically addressed by IFRS. When this is the case, IAS 8 sets out a hierarchy of guidance to be considered in the selection of an accounting policy (see Chapter 3 at section 4.3).

The primary requirement of the standard is that management should use its judgement in developing and applying an accounting policy that results in information that is both relevant and reliable. *[IAS 8.10]*.

In making the judgement, management should refer to, and consider the applicability of, the following sources in descending order:

(a) The requirements in standards and interpretations dealing with similar and related issues.

And

(b) The definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the *Conceptual Framework*. *[IAS 8.11]*.

Management may also take into account the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices, to the extent that these do not conflict with the sources in (a) and (b) above. *[IAS 8.12]*.

The stock exchanges in Australia, Canada, South Africa, the United Kingdom and the United States have historically been home to the majority of the listed mining entities and oil and gas entities. Consequently, it is organisations from those countries that have been the most active in developing both reserves and resources measurement standards and accounting standards specifically for entities engaged in extractive activities. In developing an accounting policy for an issue that is not specifically dealt with in IFRS accounting standards, an entity operating in an extractive industry may find it useful to consider accounting standards developed in these countries. It should be noted, however, that the requirements in such guidance were developed under national accounting standards and may contradict specific requirements and guidance in IFRS accounting standards that deals with similar and related issues.

1.6 Upstream versus downstream activities

Upstream activities in the extractive industries are defined as "…exploring for, finding, acquiring, and developing mineral resources up to the point that the reserves are first capable of being sold or used, even if the enterprise intends to process them further".[10] *Downstream activities* are "…the refining, processing, marketing, and distributing of petroleum, natural gas, or mined mineral (other than refining or processing that is necessary to make the minerals that have been mined or extracted capable of being sold)".[11]

Thus, activities that are required to make the product saleable or usable are generally considered to be upstream activities. For example, the removal of water to produce dry gas would be an upstream activity, because otherwise the gas cannot be sold at all. However, refining crude oil is considered to be a downstream activity, because crude oil can be sold.

This chapter focuses on upstream activities in the extractive industries as they are primarily affected by the issues discussed above. However, downstream activities are discussed to the extent that they give rise to issues that are unique to the extractive industries (e.g., provisional pricing clauses) or are subject to the same issues as upstream activities (e.g., production sharing contracts).

1.6.1 Phases in upstream activities

Although there is not a universally accepted classification of upstream activities in the extractive industries, the IASC Issues Paper identified the following eight phases which other authors also commonly identify:[12]

(a) *Prospecting* - Prospecting involves activities undertaken to search for an area of interest, a geologic anomaly or structure that may warrant detailed exploration.[13] Prospecting is undertaken typically before mineral rights in the area have been acquired, and if the prospecting results are negative, the area of prospecting generally will be abandoned and no mineral rights acquired.[14] However, sometimes it will be necessary to acquire a prospecting permit as the prospecting activities require access to the land to carry out geological and geophysical tests.[15]

10 IASC Issues Paper, 1.16.

11 IASC Issues Paper, 1.18.

12 IASC Issues Paper, 2.3.

13 IASC Issues Paper, 2.5.

14 IASC Issues Paper, 2.6.

15 IASC Issues Paper, 2.10.

(b) *Acquisition of mineral rights* - The acquisition phase involves the activities related to obtaining legal rights to explore for, develop, and/or produce wasting resources on a mineral property.[16] Legal rights may be acquired in a number of ways as discussed in section 5 below.

(c) *Exploration* - Exploration is the detailed examination of a geographical area of interest that has shown sufficient mineral-producing potential to merit further exploration, often using techniques that are similar to those used in the prospecting phase.[17] In the mining sector, exploration usually involves taking cores for analysis, sinking exploratory shafts, geological mapping, geochemical analysis, cutting drifts and crosscuts, opening shallow pits, and removing overburden in some areas.[18] In the oil and gas sector, exploration involves techniques such as shooting seismic, core drilling, and ultimately the drilling of an exploratory well to determine whether oil and gas reserves do exist.[19]

(d) *Appraisal or evaluation* - This involves determining the technical feasibility and commercial viability of mineral deposits that have been found through exploration.[20] This phase typically includes:[21]

(i) Detailed engineering studies and drilling of additional wells by oil and gas entities to determine how the reservoir can best be developed to obtain maximum recovery.

(ii) Determination by mining entities of the volume and grade of deposits through drilling of core samples, trenching, and sampling activities in an area known to contain mineral resources.

(iii) Examination and testing by mining entities of extraction methods and metallurgical or treatment processes.

(iv) Surveying transportation and infrastructure requirements.

(v) Conducting market and finance studies.

And

(vi) Making detailed economic evaluations to determine whether development of the reserves is commercially justified.

(e) *Development* - Development is the establishment of access to the mineral reserve and other preparations for commercial production. In the mining sector, development includes sinking shafts and underground drifts, making permanent excavations, developing passageways and rooms or galleries, building roads and tunnels, and advance removal of overburden and waste rock.[22] In the oil and gas sector, the development phase involves gaining access to, and preparing, well locations for drilling, constructing platforms or preparing drill sites, drilling wells, and installing equipment and facilities.[23]

(f) *Construction* - Construction involves installing facilities, such as buildings, machinery and equipment to extract, treat, and transport minerals.[24]

(g) *Production* - The production phase involves the extraction of the natural resources from the earth and the related processes necessary to make the produced resource marketable or transportable.[25]

(h) *Closure and decommissioning* - Closure means ceasing production, removing equipment and facilities, restoring the production site to appropriate conditions after operations have ceased and abandoning the site.[26]

The above phases are not necessarily discrete sequential steps. Instead, the phases often overlap or take place simultaneously. Nevertheless, they provide a useful framework for developing accounting policies in the extractive industries. Accounting for expenditures depends very much on the phase during which they are incurred; for example, as discussed further below, costs incurred in the prospecting phase cannot be recognised as assets, whereas most costs incurred in the construction phase should be capitalised.

16 IASC Issues Paper, 2.12.

17 IASC Issues Paper, 2.24.

18 IASC Issues Paper, 2.26.

19 IASC Issues Paper, 2.27.

20 IASC Issues Paper, 2.29.

21 IASC Issues Papers, 2.29, 2.30.

22 IASC Issues Paper, 2.32.

23 IASC Issues Paper, 2.34.

24 IASC Issues Paper, 2.36.

25 IASC Issues Paper, 2.38.

26 IASC Issues Paper, 2.42.

2 Mineral reserves and resources

As noted in section 1.1 above, IFRS accounting standards currently use the term 'minerals' and 'mineral assets' when referring to the extractive industries as a whole. This is used as a collective term to include reserves and resources associated with both mining and oil and gas activities. For the purposes of this chapter, consistency with the current wording in IFRS accounting standards will be maintained and therefore, unless stated otherwise, 'minerals' and 'mineral assets' will encompass both mining and oil and gas.

This section provides some information on the underlying principles used by entities in the mining and oil and gas sectors to estimate the quantity of recoverable mineral reserves and resources for their respective sectors, that the entity owns or has a right to extract. At the commercial level, these estimates are considered of paramount importance by stakeholders in making investment decisions and are also fundamental in accounting for mining activities and oil and gas activities.

The importance of estimating reserves and resources is matched by the difficulty in doing so, both technically and methodologically. For example, there is no firm consensus amongst regulators and the industries on which commodity prices should be used in reserves and resources estimation (i.e., historical, spot or forward-looking). We therefore aim to provide an introduction to this subject, and to explain the main methods used to arrive at reserves and resources estimates, including the valuation methods used once quantities have been estimated. In our view, without a sound grasp of the issues surrounding the estimation of reserves and resources, including the main methods used to arrive at reserves and resources estimates, and the valuation methods used once quantities have been estimated, it is difficult to make an informed judgement as to how to account for mineral extraction activities.

Mineral reserves and resources are often the most valuable assets of entities in the mining sector and oil and gas sector and mineral reserves, and resources estimates are a very important part of the way these entities report to their stakeholders. However, in an entity's financial statements, assets relating to the extraction of mineral reserves and resources are generally measured under IFRS accounting standards at their historical cost which generally, other than by coincidence, will not be their market value. Currently, IFRS accounting standards do not require disclosure of reserves and resources, though certain national standards (e.g., US GAAP) and stock exchange regulators (e.g., US Securities and Exchange Commission (SEC), Australian Securities Exchange (ASX), Toronto Stock Exchange (TSX), Johannesburg Stock Exchange (JSE), Securities Commission Malaysia (SC) to name just a few) do require disclosure of certain categories of quantities. There are, therefore, variances in the categories of reserves and resources that are disclosed as either mandated or voluntary disclosures, as well as differences between those relating to mining and oil and gas operations.

Notwithstanding there are no specific disclosure requirements in IFRS accounting standards, reserves and resources estimates are required in order to apply historical cost accounting under IFRS in:

- Assessing whether and for how long to capitalise E&E costs, based on an expectation of future commercial production from resource estimates (see section 3.2 below)
- Calculating the annual depreciation, depletion and amortisation charge under the units of production method (see section 16.1.3 below)
- Calculating deferred stripping cost adjustments (applicable to mining entities only - see section 15.5 below)
- Determining impairment charges and reversals under IAS 36 (see section 11 below)
- Determining whether a gain or loss should be recognised on transactions such as asset swaps, carried interest arrangements and farm-in or farm-out arrangements (see section 6 below)
- Determining the fair value of acquired mineral reserves and resources when applying the acquisition method of accounting under IFRS 3 *Business Combinations* (see section 8 below)
- Estimating the timing of decommissioning or restoration activities (see section 10 below)

Reserves and resources reporting in the mining sector and oil and gas sector have been under development since the beginning of the twentieth century. However, reserves and resources estimation techniques in these sectors have developed largely independently as a result of the different nature of the reserves and resources involved. Therefore, the definitions and terminology used in the oil and gas sector and mining sector are discussed separately in sections 2.2 and 2.3 below respectively. Disclosure is discussed in section 2.4 below.

The international efforts to harmonise reserve and resource estimation and reporting are also discussed below.

2.1 International harmonisation of reserve reporting

The project team concluded in the *Extractive Activities* DP (see section 1.3 above) that the nature and extent of the similarities between the CRIRSCO Template (mining) and the PRMS reserve and resource definitions (oil and gas) indicate that these definitions are capable of providing a platform for setting comparable accounting and disclosure requirements for both mining and oil and gas activities. While the Extractive Activities Project proceeded quite differently from the direction contemplated in the DP, at that time the project team did recommend that the CRIRSCO Template and the PRMS definitions of reserves and resources would have been a suitable platform. Nonetheless, there is, however, some tension between the definition of an asset in the IASB's *Conceptual Framework* and the assumptions underlying the reserves and resources definitions.[27] The points of tension highlighted in the DP include:

- The CRIRSCO Template and the PRMS both make use of entity-specific assumptions that are applied to derive a reserve or resource estimate, whereas IFRS accounting standards typically requires that estimates should make use of economic assumptions that reflect market-based evidence, where available.
- The CRIRSCO Template and the PRMS require certain "… conditions that must exist before a resource can be converted into a reserve". In contrast, management's intentions are not a feature of the Conceptual Framework's definition of an asset.

In 2009, the SEC revised its oil and gas reserves and resources estimation and disclosure requirements. The primary objectives of the final rule - *Modernization of Oil and Gas Reporting (Release No. 33-8995)* - were to increase the transparency and information value of reserve disclosures and improve comparability among oil and gas entities, including comparability between domestic registrants and foreign private issuers. The final rule for oil and gas reporting includes some specific disclosure requirements, including the disclosure of non-traditional resources, such as bitumen, shale, coalbed methane, as oil and gas reserves not mineral reserves, disclosure of proved undeveloped reserves, and the optional disclosure of probable and possible reserves.

In 2018, the SEC adopted new rules for entities in the mining sector. The new rules became effective for the first fiscal year beginning on or after 1 January 2021. The primary objectives of the final rule - *Modernization of Property Disclosures for Mining Registrants (Release No.33-10570)* - were to improve mining property disclosure requirements and policies by more closely aligning them with current industry and global regulatory practices and disclosure requirements, as embodied in the CRIRSCO standards. SEC Industry Guide 7 was rescinded, and these new mining property disclosure requirements were added as a new subpart of Item 102 of Regulation S-K under the Securities Act of 1933 and the Securities Exchange Act of 1934.[28] The CRIRSCO standards to be applied under this final rule, including classification of reserves and resources, is explained in section 2.3.1 below.

Despite both disclosure requirements having now been modernised, some key differences still remain. Some of these include:

- For oil and gas entities, the SEC does not allow the term 'resources' to be used in reports
- The SEC requirement for oil and gas entities is to use 12-month average prices under SEC Release No. 33-8995, to represent existing economic conditions to determine the economic producibility of oil and gas reserves for disclosure purposes whereas the SEC requirement for mining entities is to use a price for each commodity that provides a reasonable basis for establishing the prospects of economic extraction when assessing mineral resources, and that provides a reasonable basis for establishing that the project is economically viable when determining mineral reserves, which may be a historical or forward-looking price, as long as the qualified person discloses and explains, with particularity, his or her reasons for using the selected price, including the material assumptions underlying the selection

27 Discussion Paper DP/2010/1, *Extractive Activities*, IASB, April 2010, para. 2.48. Available on the IFRS Foundation's website.

28 Modernization of Property Disclosures for Mining Registrants (Release No.33-10570)

2.2 Petroleum reserve estimation and reporting

The *SPE/WPC/AAPG/SPEE Petroleum Resources Management System* (SPE-PRMS), which was first published in 2007, is the leading framework for the estimation and reporting of petroleum reserves and resources. It was prepared by the Oil and Gas Reserves Committee of the Society of Petroleum Engineers (SPE) and reviewed and sponsored by the World Petroleum Council (WPC), the American Association of Petroleum Geologists (AAPG) and the Society of Petroleum Evaluation Engineers (SPEE), and subsequently supported by the Society of Exploration Geophysicists (SEG), the Society of Petrophysicists and Well Log Analysts (SPWLA) and the European Association of Geoscientists & Engineers (EAGE).[29] The definitions and guidelines in the SPE-PRMS, which are internationally used within the oil and gas sector, deal with:[30]

- Classification and categorisation of resources
- Evaluation and reporting
- Estimation of recoverable quantities

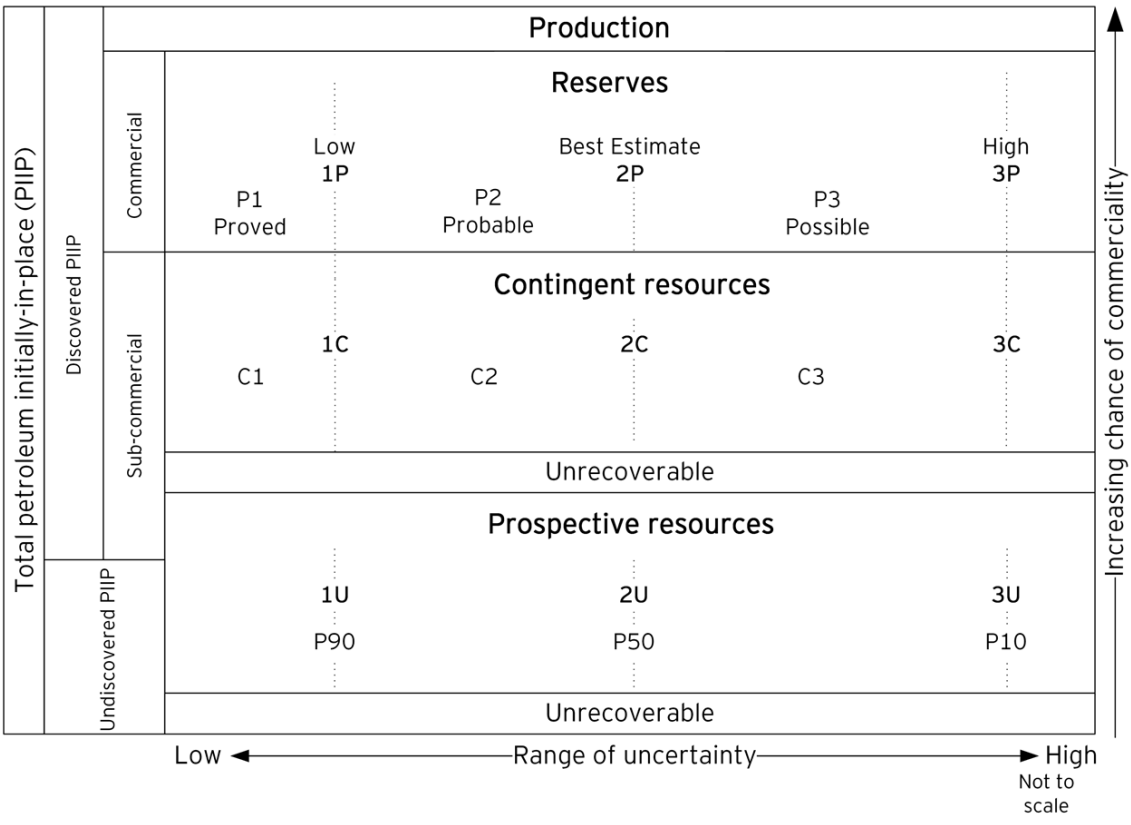
"Most of the major regulatory agencies have developed disclosure guidelines that impose classification rules similar to, but not directly linked to, the SPE-PRMS", and most "… typically mandate disclosure of only a subset of the total reserves and resources defined in the SPE-PRMS. For example, the SEC specifies that only Proved Reserves should be disclosed",[31] but now allows for optional disclosure of Probable Reserves.

In June 2018, the SPE Board approved the latest version of the SPE-PRMS, with two errata updates made in 2018 and 2022.

2.2.1 Basic principles and definitions

The following graphically presents the SPE-PRMS resources classification system:[32]

Figure 2-1: Resources classification framework



29 SPE-PRMS, Petroleum Resources Management Systems, Society of Petroleum Engineers, 2007 (revised June 2018).

30 SPE-PRMS, Petroleum Resources Management Systems, Society of Petroleum Engineers, 2007 (revised June 2018).

31 INFORMATION FOR OBSERVERS, Board Meeting: 22 June 2007, London, Project: *Extractive Activities research project*, Subject: *Comparison of Petroleum and Minerals Reserves and Resource Classification Systems (Agenda Paper 13A)*, IASB, pages 3-4. Available on the IFRS Foundation's website.

32 INFORMATION FOR OBSERVERS, Board Meeting: 22 June 2007, London, Project: *Extractive Activities research project*, Subject: *Comparison of Petroleum and Minerals Reserves and Resource Classification Systems (Agenda Paper 13A)*, page 8. Available on the IFRS Foundation's website. And SPE-PRMS, Figure 1-1.

The horizontal axis reflects the *range of uncertainty* of "… estimated quantities potentially recoverable from an accumulation by a project, while the vertical axis represents the *chance of commerciality*, that is, the chance that the project will be developed and reach commercial producing status."[33]

The SPE-PRMS defines proved, probable and possible reserves as follows:

- "*Reserves* are those quantities of petroleum anticipated to be commercially recoverable by application of development projects to known accumulations from a given date forward under defined conditions. Reserves must further satisfy four criteria: they must be discovered, recoverable, commercial, and remaining (as of the evaluation date) based on the development project(s) applied. Reserves are further categorized in accordance with the level of certainty associated with the estimates and may be sub-classified based on project maturity and/or characterized by development and production status."[34]
- "*Proved Reserves* are those quantities of petroleum, which, by analysis of geoscience and engineering data, can be estimated with reasonable certainty to be commercially recoverable … from known reservoirs and under defined economic conditions … If deterministic methods are used, the term reasonable certainty is intended to express a high degree of confidence that the quantities will be recovered. If probabilistic methods are used, there should be at least a 90% probability that the quantities actually recovered will equal or exceed the estimate."[35]
- "*Probable Reserves* are those additional Reserves which analysis of geoscience and engineering data indicate are less likely to be recovered than Proved Reserves but more certain to be recovered than Possible Reserves. It is equally likely that actual remaining quantities recovered will be greater than or less than the sum of the estimated Proved plus Probable Reserves (2P). In this context, when probabilistic methods are used, there should be at least a 50% probability that the actual quantities recovered will equal or exceed the 2P estimate."[36]
- "*Possible Reserves* are those additional reserves which analysis of geoscience and engineering data suggest are less likely to be recoverable than Probable Reserves. The total quantities ultimately recovered from the project have a low probability to exceed the sum of Proved plus Probable plus Possible (3P) Reserves, which is equivalent to the high estimate scenario. When probabilistic methods are used, there should be at least a 10% probability that the actual quantities recovered will equal or exceed the 3P estimate."[37]

The SPE-PRMS distinguishes between Contingent and Prospective Resources:

- "The term *Resources* as used herein is intended to encompass all quantities of petroleum naturally occurring on or within the Earth's crust, both discovered and undiscovered (recoverable and unrecoverable), plus those quantities already produced. Further, it includes all types of petroleum whether currently considered 'conventional' or 'unconventional' resources."[38]
- "*Contingent Resources* are those quantities of petroleum estimated, as of a given date, to be potentially recoverable from known accumulations, but the applied project(s) are not yet considered mature enough for commercial development due to one or more contingencies." Contingent Resources have an associated chance of development. "Contingent Resources may include, for example, projects for which there are currently no viable markets, or where commercial recovery is dependent on technology under development, or where evaluation of the accumulation is insufficient to clearly assess commerciality. Contingent Resources are further categorized in accordance with the range of certainty associated with the estimates and may be sub-classified based on project maturity and/or economic status."[39]
- "*Prospective Resources* are those quantities of petroleum estimated, as of a given date, to be potentially recoverable from undiscovered accumulations by application of future development projects. Prospective Resources have both an associated chance of discovery and a chance of development. Prospective Resources are further categorized in accordance with the range of certainty associated with recoverable estimates, assuming their discovery and development and may be sub-classified based on project maturity."[40]

33 SPE-PRMS, p.2.

34 SPE-PRMS, p.3.

35 SPE-PRMS, pp.10-11.

36 SPE-PRMS, p.11.

37 SPE-PRMS, p.13.

38 SPE-PRMS, p.2.

39 SPE-PRMS, p.3.

40 SPE-PRMS, p.3.

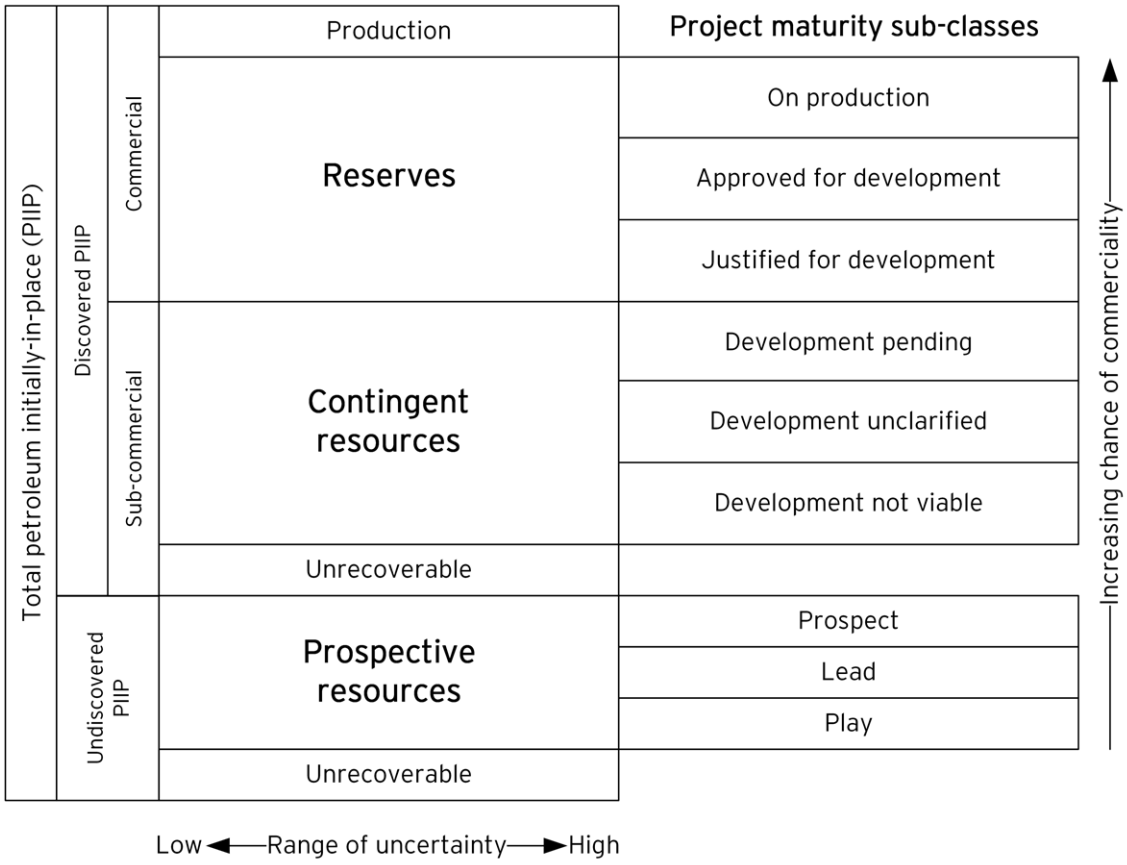
Total petroleum initially-in-place (PIIP) is all quantities of petroleum that are estimated to exist in naturally occurring accumulations, discovered and undiscovered, before production. "*Discovered PIIP* is that quantity of petroleum that is estimated, as of a given date, to be contained in known accumulations before production."[41] "*Undiscovered PIIP* is that quantity of petroleum estimated, as of a given date, to be contained within accumulations yet to be discovered."[42]

"*Production* is the cumulative quantity of petroleum that has been recovered at a given date."[43] *Unrecoverable Resources* are that portion of Discovered or Undiscovered PIIP evaluated, as of a given date, to be unrecoverable by the currently defined project(s). "A portion of these quantities may become recoverable in the future as commercial circumstances change or technological developments occur; the remaining portion may never be recovered because of physical/chemical constraints represented by subsurface interaction of fluids and reservoir rocks."[44]

2.2.2 Classification and categorisation guidelines

The SPE-PRMS provides guidance on classifying resources depending on the relative maturity of the development projects being applied to yield the recoverable quantity estimates.[45]

Figure 2-2: Sub-classes based on project maturity



As Figure 2-2[46] above illustrates, "development projects (and their associated recoverable quantities) may be sub-classified according to project maturity levels and the associated actions (business decisions) required to move a project forward to commercial production".[47]

41 SPE-PRMS, p.3.
42 SPE-PRMS, p.3.
43 SPE-PRMS, p.3.
44 SPE-PRMS, p.3.
45 SPE-PRMS, p.7.
46 SPE-PRMS, Figure 2-1.
47 SPE-PRMS, p.7.

The SPE-PRMS also provides guidance on categorising resources, depending on the associated degrees of uncertainty, into the following cumulative categories:[48]

- 1P denotes low estimate of reserves, i.e., Proved Reserves
- 2P denotes the best estimate of reserves, i.e., the sum of Proved plus Probable reserves
- 3P denotes high estimate of reserves, i.e., the sum of Proved plus Probable plus Possible reserves
- 1C denotes low estimate of Contingent Resources
- 2C denotes best estimate of Contingent Resources
- 3C denotes high estimate of Contingent Resources
- 1U denotes the unrisked low estimate qualifying as Prospective Resources
- 2U denotes the unrisked best estimate qualifying as Prospective Resources
- 3U denoted the unrisked high estimate qualifying as Prospective Resources

Additionally, guidance is provided on categorisation of reserves and resources related to incremental projects, such as workovers, infill drilling and improved recovery.[49]

To promote consistency in project evaluations and reporting, the SPE-PRMS provides guidelines on the economic assumptions that are to be used, measurement of production, and resources entitlement and recognition,[50] and also provides guidance on the analytical procedures, and on the deterministic and probabilistic methods to be used.

2.3 Mining resource and reserve reporting

The *Australasian Code for Reporting of Exploration Results, Mineral Resources and Ore Reserves* (JORC Code) is prepared by the Joint Ore Reserves Committee (JORC) of the Australasian Institute of Mining and Metallurgy, Australian Institute of Geoscientists and Minerals Council of Australia. The JORC was established in 1971, the first edition of the JORC Code was published in 1989,[51] with the most recent edition of the JORC Code issued in 2012. This version of the JORC code and associated ASX listing rules relating to the disclosure of reserves and resources by ASX listed mining and oil and gas exploration and production entities came into effect on 1 December 2013.

Subsequently, many jurisdictions have established similar national reporting standards. These include:

- Canada: *CIM Definition Standards on Mineral Resources and Reserves*, Canadian Institute of Mining, Metallurgy and Petroleum (CIM)
- Chile: *Certification Code of Exploration Prospects, Mineral Resources and Ore Reserves*, Instituto de Ingenieros de Minas de Chile (IIMCh)
- Pan-European Reserves Reporting Committee (PERC) in the United Kingdom, Ireland and Western Europe
- Peru: *Code for Reporting on Mineral Resources and Ore Reserves*, Joint Committee of the Venture Capital Segment of the Lima Stock Exchange
- South Africa: *South African Code for the Reporting of Exploration Results, Mineral Resources and Mineral Reserves*, South African Mineral Resource Committee (SAMREC)
- United States: *Guide for Reporting Exploration Information, Mineral Resources and Mineral Reserves*, Society for Mining, Metallurgy and Exploration (SME)

In July 2006, CRIRSCO first published a generic International Reporting Template for reporting mineral resources and mineral ore reserves, modelled on those of the JORC Code, and the latest update occurred in November 2019. This reflects best practice national reporting standards but excludes national regulatory requirements. The template serves as a guide to national standard-setters that do not have a reporting standard or who want to revise their existing standard to an internationally acceptable form.[52] "The system is primarily targeted at establishing international best practice standards for regulatory and public disclosures and combines the basic components of a number of national reporting codes and guidelines that have been adopted in similar forms by all the major agencies outside of the SEC. The classification is applied, with small modifications or extensions, by most mining entities for the purpose of internal resource management."[53]

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48 SPE-PRMS, p.37.

49 SPE-PRMS, pp.11-12.

50 SPE-PRMS, pp.13-19.

51 JORC Code, Australasian Code for Reporting of Exploration Results, Mineral Resources and Ore Reserves, Joint Ore Reserves Committee of the Australasian Institute of Mining and Metallurgy, Australian Institute of Geoscientists and Minerals Council of Australia (JORC), 2004, para. 1.

52 Stephenson and Weatherstone, Developments in International Mineral Resource and Reserve Reporting, p.5.

53 INFORMATION FOR OBSERVERS, Board Meeting: 22 June 2007, London, Project: *Extractive Activities research project*, Subject: *Comparison of Petroleum and Minerals Reserves and Resource Classification Systems (Agenda Paper 13A)*, page 3. Available on the IFRS Foundation's website.

In the United States, public disclosures of mineral resources and mineral reserves for mining entities are regulated by the SEC. As discussed in section 2.1 above, in 2018 the SEC revised its rules applicable to mining entities. The SEC rules, are intended to be substantially similar to those of other CRIRSCO-based codes, however they are not identical to any single CRIRSCO-based code. Also, they are aimed at eliminating overlapping disclosure requirements and providing one standard set of disclosure rules for mining registrants.[54]

2.3.1 CRIRSCO International Reporting Template (November 2019)

Set out below are the main requirements of the CRIRSCO International Reporting Template (CRIRSCO Template) to the extent that they are relevant to financial reporting by mining entities.

2.3.1.A Scope

The main principles governing the operation and application of the CRIRSCO Template are transparency, materiality and competence. These are aimed at ensuring that the reader of a public report is provided with:[55]

- Sufficient information that is clear and unambiguous (transparency)
- A report that contains all relevant information which investors and their professional advisers would reasonably require and would reasonably expect to find, to be able to form a reasoned and balanced judgement about the Exploration Targets, Exploration Results, Mineral Resources or Mineral Reserves being reported (materiality)
- Information that is based on work that is the responsibility of suitably qualified and experienced persons who are subject to an enforceable professional code of ethics and rules of conduct (competence)

A *public report* is a report "… prepared for the purpose of informing investors or potential investors and their advisors on Exploration Targets, Exploration Results, Mineral Resources or Mineral Reserves. They include, but are not limited to, annual and quarterly company reports, media releases, information memoranda, technical papers, website postings and public presentations".[56] The CRIRSCO Template is applicable to all solid minerals, including diamonds, other gemstones, industrial minerals, stone and aggregates, and coal.[57] The CRIRSCO Template provides supplementary rules on reporting related to coal, diamonds and industrial minerals, due to the special nature of those types of deposit.

A public report should be prepared by a *competent person*, defined in the CRIRSCO Template as "… a minerals industry professional, who is a [National Reporting Organisation (NRO) to insert appropriate membership class and name of Professional Organisation (PO)] or other Recognised Professional Organisations (RPOs) with enforceable disciplinary processes including the powers to suspend or expel a member".[58]

54 Modernization of Property Disclosures for Mining Registrants (Release No.33-10570)

55 CRIRSCO Template, International Reporting Template for the public reporting of exploration targets, exploration results, mineral resources and mineral reserves, CRIRSCO, November 2019, 2.6-2.8.

56 CRIRSCO Template, 2.9.

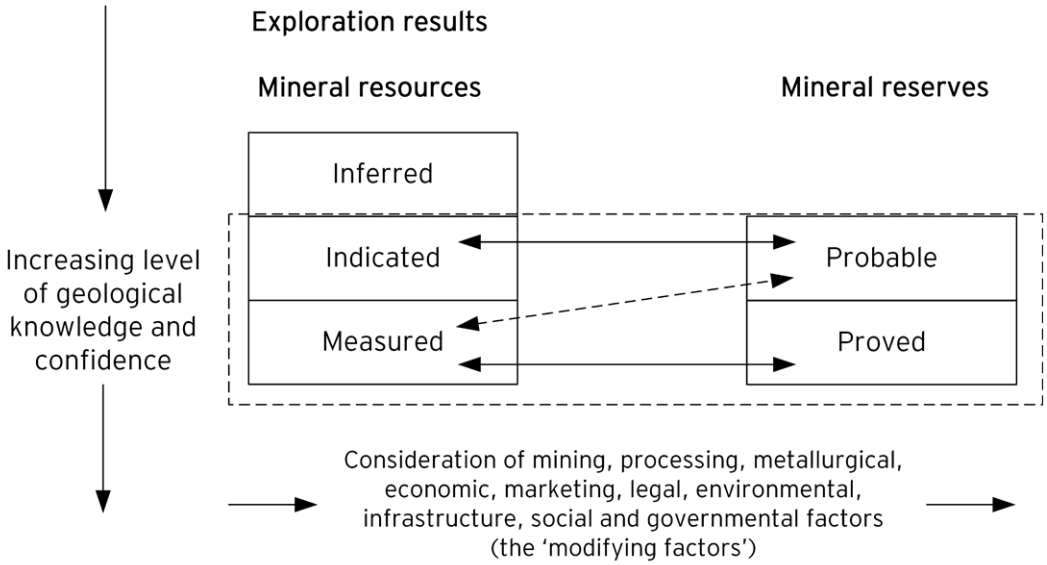
57 CRIRSCO Template, 2.3.

58 CRIRSCO Template, 3.6.

2.3.1.B Reporting terminology

The general relationship between Exploration Results, Mineral Resources and Mineral Reserves can be summarised in the following diagram:[59]

Figure 2-3: The general relationship between results, resources and reserves



The terms in the above diagram are defined as follows:

"*Exploration Results* include data and information generated by mineral exploration programmes that might be of use to investors but which do not form part of a declaration of Mineral Resources or Mineral Reserves."[60] The CRIRSCO Template specifically requires that any information relating to Exploration Results be expressed in such a way that it does not unreasonably imply that potentially economic mineralisation has been discovered.[61]

"A *Mineral Resource* is a concentration or occurrence of solid material of economic interest in or on the Earth's crust in such form, grade, quality and quantity that there are reasonable prospects for eventual economic extraction. The location, quantity, grade or quality, continuity and other geological characteristics of a Mineral Resource are known, estimated or interpreted from specific geological evidence and knowledge, including sampling. Mineral Resources are sub-divided, in order of increasing geological confidence, into Inferred, Indicated and Measured categories."[62]

- "An *Inferred Mineral Resource* is that part of a Mineral Resource for which quantity and grade or quality are estimated on the basis of limited geological evidence and sampling. Geological evidence is sufficient to imply but not verify geological and grade or quality continuity. An Inferred Resource has a lower level of confidence than that applying to an Indicated Mineral Resource and must not be converted to a Mineral Reserve. It is reasonably expected that the majority of Inferred Mineral Resources could be upgraded to Indicated Mineral Resources with continued exploration."[63]
- "An *Indicated Mineral Resource* is that part of a Mineral Resource for which quantity, grade or quality, densities, shape and physical characteristics are estimated with sufficient confidence to allow the application of Modifying Factors in sufficient detail to support mine planning and evaluation of the economic viability of the deposit. Geological evidence is derived from adequately detailed and reliable exploration, sampling and testing and is sufficient to assume geological and grade or quality continuity between points of observation. An Indicated Mineral Resource has a lower level of confidence than that applying to a Measured Mineral Resource and may only be converted to a Probable Mineral Reserve."[64]

59 CRIRSCO Template, Figure 1.
60 CRIRSCO Template, 6.1.
61 CRIRSCO Template, 6.3.
62 CRIRSCO Template, 7.1.
63 CRIRSCO Template, 7.4.
64 CRIRSCO Template, 7.8.

- "A *Measured Mineral Resource* is that part of a Mineral Resource for which quantity, grade or quality, densities, shape and physical characteristics are estimated with confidence sufficient to allow the application of Modifying Factors to support detailed mine planning and final evaluation of the economic viability of the deposit. Geological evidence is derived from detailed and reliable exploration, sampling and testing and is sufficient to confirm geological and grade or quality continuity between points of observation. A Measured Mineral Resource has a higher level of confidence than that applying to either an Indicated Mineral Resource or an Inferred Mineral Resource. It may be converted to a Proved Mineral Reserve or to a Probable Mineral Reserve."[65]
- "Modifying factors are considerations used to convert Mineral Resources to Mineral Reserves. These include, but are not restricted to, mining, processing, metallurgical, infrastructure, economic, marketing, legal, environmental, social and governmental factors."[66]
- "A *Mineral Reserve* is the economically mineable part of a Measured and/or Indicated Mineral Resource. It includes diluting materials and allowances for losses, which may occur when the material is mined or extracted and is defined by studies at Pre-Feasibility or Feasibility level as appropriate that include application of Modifying Factors. Such studies demonstrate that, at the time of reporting, extraction could reasonably be justified."[67]
- "A *Probable Mineral Reserve* is the economically mineable part of an Indicated, and in some circumstances, a Measured Mineral Resource. The confidence in the Modifying Factors applying to a Probable Mineral Reserve is lower than that applying to a Proved Mineral Reserve. A Probable Mineral Reserve has a lower level of confidence than a Proved Mineral Reserve but is of sufficient quality to serve as the basis for a decision on the development of the deposit."[68]
- "A *Proved Mineral Reserve* is the economically mineable part of a Measured Mineral Resource. A Proved Mineral Reserve implies a high degree of confidence in the Modifying Factors. A Proved Mineral Reserve represents the highest confidence category of reserve estimate."[69]

The CRIRSCO Template contains more detailed guidance on how a competent person should decide on mineral resource and mineral reserve classification and contains a checklist and guideline for the preparation of public reports.

2.4 Disclosure of mineral reserves and resources

Mineral reserves and resources, or subcategories thereof, are a significant element in communications by mining entities and oil and gas entities to their stakeholders. IFRS accounting standards requires an entity to provide "additional disclosures when compliance with the specific requirements in IFRS accounting standards is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance". *[IAS 1.17(c)]*. IFRS does not specifically require mineral reserve and resource disclosures to be included in financial statements. However, disclosures regarding these mineral quantities will generally be relevant under IFRS to provide users with the information they need to understand the entity's financial position and performance. For example, when reserves and resource quantities are used as inputs to impairment and/or depreciation calculations, financial reports may disclose the basis for the reserves and resources being included in the calculation.

As noted in section 2 above, entities have to use reserves data and sometimes resources data for a number of accounting purposes and the methodology should be consistent with the definitions in the IFRS *Conceptual Framework* for asset recognition.

How we see it

We believe that disclosures about mineral resources and reserves and the methodology used in their estimates would generally be necessary under IFRS for users to understand the entity's financial position and performance. The extent of mineral and reserve disclosures within financial statements are generally qualitative not quantitative. Further information is typically disclosed outside of the financial statements, with the extent of such additional information dependent on jurisdictional requirements.

65 CRIRSCO Template, 7.10.

66 CRIRSCO Template, 4.7.

67 CRIRSCO Template, 8.1.

68 CRIRSCO Template, 8.7-8.8.

69 CRIRSCO Template, 8.9-8.10.

In addition, if management uses different reserves and/or resources categories for different purposes, for example those used for investment appraisal purposes versus those used for impairment and depreciation calculations and/or rehabilitation calculations, this should be clearly identified in the relevant accounting policies.

In the absence of guidance under IFRS, entities not subject to the requirements of a national regulator could consider using the disclosure requirements of other standard-setters as a starting point in developing their own policies. The sections below discuss the disclosure requirements of several standard-setters for mineral reserve and resource quantities for oil and gas entities and mining entities (see sections 2.4.1 and 2.4.2 respectively below) and reserve values (see section 2.4.3 below).

However, while disclosure of information about mineral reserves and resources is clearly very useful, users of financial statements are encouraged to be aware that there is a variety of variances between the requirements of different jurisdictions. Therefore, comparisons between entities may be difficult or even impossible. In particular, the following aspects are important:

- *Proven and probable reserves* - The definition of reserves can vary e.g., the former OIAC SORP permitted disclosure of either 'proven and probable' or 'proved developed and undeveloped' reserves, whereas Accounting Standards Codification (ASC) Topic 932-235-50 - *Extractive Activities - Oil and Gas - Notes to Financial Statements - Disclosure* - requires disclosure of 'proved reserves, proved developed reserves and proved undeveloped reserves'.
- *Commodity price* - The quantity of economically recoverable reserves may depend to a large extent on the price assumptions that an entity uses. Differences often arise because the entity:
  - Uses its own long-term price assumption which, for example, was permitted under the former OIAC SORP.
  - Is required to use 12-month average prices, which is required by the SEC Release No. 33-8995 in the oil and gas sector.

    Or
  - Is required to use a reasonable price, which is required to comply with the SEC's Regulation S-K subpart 1300 in the mining sector.
- *Royalties* - Royalties payable in-kind to the government or legal owner of the mineral rights may or may not be included in reserves.
- *Non-controlling interests* - Generally 'reserves' include all reserves held by the parent and its consolidated subsidiaries. While in many jurisdictions mining entities and oil and gas entities are required to disclose the reserves attributable to significant non-controlling interests, this is not always required.
- *Associates, joint arrangements and other investments* - An entity could have economic ownership of reserves through investments in associates and joint arrangements, equity interests (see section 7 below) or royalty yielding contracts (see section 5.7 below). Such reserves are generally not included in consolidated reserves but could have to be disclosed separately.
- *Production sharing contracts and risk service contracts* (see sections 5.3 and 5.5.1 respectively below) Frequently the mining company or oil and gas company does not legally own the mineral reserves and resources in the ground, i.e., the government retains legal ownership. A significant amount of judgement concerning the nature of the rights and economic interests of the entity could be required to determine whether the entity is the economic owner of any reserves or resources. Depending on the reserve reporting framework that the entity is subject to, such 'economic' reserves could or could not be included in reserves or resources.

In addition to those matters set out above, there could be other variances in the 'reserves' definition and disclosure requirements in different jurisdictions of which users of IFRS financial statements need to be aware of. Such differences could affect IFRS financial reporting directly.

2.4.1 Oil and gas sector

Many oil and gas entities are required to disclose information about reserve quantities in accordance with the rules and requirements of the stock exchange on which they are listed. However, those oil and gas entities that are not subject to the specific disclosure requirements of a stock exchange or other local regulator could consider the need to disclose reserves and resources information to provide users with the information they need to understand the entity's financial position and performance.

Entities could continue to consider disclosing the information previously required under the former OIAC SORP or could look to the example disclosures contained in the 2010 DP in section 1.3.4 above. Alternatively, entities could follow the disclosures required under ASC 932-235--0 - *Disclosure of Standardised Measure of Oil and Gas* (ASC 932-235-50), as required by SEC Regulation S-K.

2.4.2 Mining sector

Similarly, many mining entities are required to disclose information about reserve quantities in accordance with the rules and requirements of the stock exchange on which they are listed. Mining entities that are subject to the SEC rules and regulations will need to consider compliance with Regulation S-K subpart 1300. However, those mining entities that are not subject to the specific disclosure requirements of a stock exchange or other local regulator could still wish to consider disclosing the information required under SEC Regulation S-K subpart 1300 (which replaced Industry Guide 7). However, if an entity was to do this, they would need to understand not only the content of SEC Regulation S-K subpart 1300, but also the current interpretation of this content by the SEC's staff. While many of the definitions may seem familiar, the SEC staff's interpretations could differ considerably from those of regulators in other countries.

2.4.3 Disclosure of the value of reserves

As part of its work on the *Extractive Activities* DP and the subsequent Extractive Activities project (see section 1.3.4 above) the IASB staff considered whether a disclosure-focused approach might be appropriate in an extractive industries financial reporting standard. It is in this context that the DP noted that, "given the near unanimity of the feedback from users on the lack of relevance of either historical cost or current value accounting for reserves and resources, … a disclosure-focused approach needs to be considered as one alternative in the discussion paper".[70]

One of the key issues to consider before developing a disclosure-focused approach is whether disclosure of the value of mineral reserves should be a requirement. A secondary issue is whether the mineral reserves should be disclosed at their fair value or at a standardised measure of value, similar to the requirement under ASC 932-235-50 which is based on discounted net cash flows.

This disclosure requirement is not uncontroversial, as the 'standardized measure of oil and gas' (often abbreviated to SMOG) does not represent the market value of an entity's proved reserves. However, the standardised measure of the value of oil and gas reserves greatly reduces the impact of management's opinion about future development on the value calculated, e.g., the method prescribes the discount rate and commodity price to be used. While this may not take into account relevant insights that management may have, the advantage is that comparability of the disclosures between entities is increased. As illustrated in Practical example 2-1, some entities caution against over-reliance on these disclosures.

Practical example 2-1: BP p.l.c. (2022) **United Kingdom**

bp Annual Report and Form 20-F 2022 [extract]

Financial statements [extract]

Supplementary information on oil and natural gas (unaudited) [extract]

Standardized measure of discounted future net cash flows and changes therein relating to proved oil and gas reserves

The following tables set out the standardized measure of discounted future net cash flows, and changes therein, relating to crude oil and natural gas production from the group's estimated proved reserves. This information is prepared in compliance with FASB Oil and Gas Disclosures requirements.

Future net cash flows have been prepared on the basis of certain assumptions which may or may not be realized. These include the timing of future production, the estimation of crude oil and natural gas reserves and the application of average crude oil and natural gas prices and exchange rates from the previous 12 months. Furthermore, both proved reserves estimates and production forecasts are subject to revision as further technical information becomes available and economic conditions change. bp cautions against relying on the information presented because of the highly arbitrary nature of the assumptions on which it is based and its lack of comparability with the historical cost information presented in the financial statements.

…

70 INFORMATION FOR OBSERVERS, Board Meeting: 22 June 2007, London, Project: *Extractive Activities research project*, Subject: *Possible principles for a historical cost accounting model that accompanies decision-useful disclosures of minerals and oil & gas reserves and resources (Agenda Paper 15C)*, IASB, para. 6. Available on the IFRS Foundation's website.

It is clear that reaching agreement as to what constitutes useful and relevant disclosures about the value of mineral reserves is not straightforward and will be controversial. Still, in September 2008, the Board indicated support for the *Extractive Activities* DP to propose the disclosure of "a current value measurement, such as a standardised measure of discounted cash flows, and the key assumptions necessary for a user to make use of that measurement". This would not be disclosed if the minerals or oil and gas assets are measured on the balance sheet at fair value or some other current value measurement. In that case, an entity would provide disclosures similar to those required in the US (by ASC 820-10-50-1, 2, 3 - *Fair Value Measurements - Disclosures*).[71] Accordingly, the DP concluded that:

- If the assets are measured at historical cost, then detailed information should be disclosed about their current value (either fair value or standardised measure) and how it was determined.
- If, instead, the assets are measured at fair value then detailed information should be disclosed about that fair value and how it was determined.

These proposals have not culminated in any changes to published IFRS accounting standards.

2.4.3.A ASC 932-235-50 - Disclosure of Standardised Measure of Oil and Gas

All entities engaged in significant oil and gas producing activities that report under US GAAP or are SEC IFRS filers are required by ASC 932-235-50 to disclose a standardised measure of discounted future net cash flows relating to proved oil and gas reserve quantities. There may also be non-US GAAP oil and gas entities who, while they are not subject to these specific disclosure requirements, still elect to refer to these when determining the reserves and resources information to provide to their users. ASC 932-235-50 is highly prescriptive and should be reviewed directly in full to ensure compliance with its requirements.

71 *IASB Update*, September 2008, page 3. Available on the IFRS Foundation's website.

3 IFRS 6 *Exploration for and evaluation of mineral resources*

3.1 Objective and scope

The IASB's objective in developing IFRS 6, as noted in section 1.2 above, was restricted to making limited improvements to existing accounting practices for exploration and evaluation (E&E) expenditures. E&E expenditures are "expenditures incurred by an entity in connection with the exploration for and evaluation of mineral resources before the technical feasibility and commercial viability of extracting a mineral resource are demonstrable", while E&E assets are "exploration and evaluation expenditures recognised as assets in accordance with the entity's accounting policy". *[IFRS 6 Appendix A]*.

IFRS 6 is limited to specifying the financial reporting for the exploration for and evaluation of mineral resources, which the standard defines as "the search for mineral resources, including minerals, oil, natural gas and similar non-regenerative resources after the entity has obtained legal rights to explore in a specific area, as well as the determination of the technical feasibility and commercial viability of extracting the mineral resource". *[IFRS 6 Appendix A]*. The standard also specifies when entities need to assess E&E assets for impairment in accordance with IAS 36 and requires certain disclosures.

An entity cannot apply IFRS 6 to expenditures incurred before the exploration for and evaluation of mineral resources (e.g., expenditures incurred before the entity has obtained the legal rights to explore a specific area such as prospecting and acquisition of mineral rights) or after the technical feasibility and commercial viability of extracting a mineral resource are demonstrable (e.g., development, construction, production and closure). *[IFRS 6.5]*. Furthermore, it deals only with E&E expenditures and does not provide guidance on other sector-specific issues that may arise during the E&E phase.

Equipment used in the E&E phase, e.g., property, plant and equipment and any other intangibles, such as software, are not in the scope of IFRS 6, instead, they are in the scope of IAS 16 or IAS 38.

3.1.1 Scope exclusions in other standards relating to the extractive industries

In the Basis for Conclusions on IFRS 6 the IASB confirmed that "…even though no IFRS has addressed extractive activities directly, all IFRS (including International Accounting Standards and Interpretations) are applicable to entities engaged in the exploration for and evaluation of mineral resources that make an unreserved statement of compliance with IFRS in accordance with IAS 1". *[IFRS 6.BC6]*. However, certain aspects of activities that occur in the extractive industries that fall outside the scope of IFRS 6 are excluded from the scope of other standards.

Various standards exclude 'minerals' from their scope, but the exact wording of the scope exclusions differs from standard to standard. Therefore, it would be incorrect to conclude that the same aspects of the extractive industries' activities are excluded from the scope of these standards:

- IAS 2 does not apply to the measurement of minerals and mineral products, "…to the extent that they are measured at net realisable value in accordance with well-established practices in those industries". *[IAS 2.3(a), IAS 2.4]*. The practice of measuring minerals and mineral products inventories at net realisable value is, in reality, relatively rare in many areas of the extractive industries although not unheard of.
- IAS 16 does not apply to "…mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources". *[IAS 16.3(d)]*. In addition, the standard does not apply to "…the recognition and measurement of exploration and evaluation assets". *[IAS 16.3(c)]*. Equipment used in extracting reserves is within the scope of IAS 16.
- IFRS 16 does not apply to "…leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources". *[IFRS 16.3(a)]*. However, leases including leases of right-of-use assets in a sublease of assets used for exploration or evaluation activities are in the scope of IFRS 16.
- IAS 38 does not apply to "…expenditure on the exploration for, or development and extraction of, minerals, oil, natural gas and similar non-regenerative resources" or to the recognition and measurement of E&E assets. *[IAS 38.2(c), IAS 38.2(d)]*.
- IAS 40 does not apply to "…mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources". *[IAS 40.4(b)]*.

3.2 Recognition of exploration and evaluation assets

3.2.1 Developing an accounting policy under IFRS 6

When developing its accounting policy for E&E expenditures, IFRS 6 requires an entity recognising E&E assets to apply IAS 8.10. *[IFRS 6.6, IFRS 6.BC19]*. Hence, management is required to use its judgement in developing and applying an accounting policy that results in information that is relevant and reliable. *[IAS 8.10]*. However, IFRS 6 does provide an exemption from IAS 8.11 and 12, *[IFRS 6.7, IFRS 6.BC17]*, which "…specify sources of authoritative requirements and guidance that management is required to consider in developing an accounting policy for an item if no IFRS applies specifically to that item" (the so-called 'hierarchy', see Chapter 3 at section 4.3). In developing such a policy, IFRS 6 imposes a number of significant constraints on an entity's choice of accounting policy because:

- An entity needs to specify which expenditures are recognised as E&E assets and apply that accounting policy consistently (see section 3.3.1 below). *[IFRS 6.9]*.
- Expenditures related to the development of mineral resources should not be recognised as E&E assets (see section 3.3.1 below). *[IFRS 6.10]*.
- The requirement to apply IAS 16, IAS 38 and IAS 36 after the E&E phase affects the choice of accounting policies during the E&E phase. In January 2006, the IFRS IC clarified that "…it was clear that the scope of IFRS 6 consistently limited the relief from the hierarchy to policies applied to E&E activities and that there was no basis for interpreting IFRS 6 as granting any additional relief in areas outside its scope".[72] For example, an entity may be able to apply the full cost method of accounting (see section 3.2.4 below) during the E&E phase, but it will not be able to apply that policy after the E&E phase.

The IASB believed that waiving these requirements in IFRS 6 would "…detract from the relevance and reliability of an entity's financial statements to an unacceptable degree". *[IFRS 6.BC23]*.

3.2.2 Options for an exploration and evaluation policy

Entities active in the extractive industries have followed, and continue to follow, a large variety of accounting practices for E&E expenditure, which range "…from deferring on the balance sheet nearly all exploration and evaluation expenditure to recognising all such expenditure in profit or loss as incurred". *[IFRS 6.BC17]*. As mentioned earlier, IFRS 6 provides an exemption from IAS 8.11 and 8.12. The inference from this is that the standard 'grandfathers' all existing practices by not requiring these to have any authoritative basis. The Basis for Conclusions states that "…the Board decided that an entity could continue to follow the accounting policies that it was using when it first applied the IFRS's requirements, provided they satisfy the requirements of paragraph 10 of IAS 8 … with some exceptions …". *[IFRS 6.BC22]*. These exceptions in IFRS 6, described above, have a rather more profound impact than may be obvious at first sight and, in fact, instead of allowing previous national GAAP accounting policies, IFRS 6 effectively prohibits many of them.

There are several methods adopted by oil and gas entities (and modified by some mining entities) to account for E&E costs. These include successful efforts, full cost and area of interest accounting. These methods have evolved through the use of previous GAAPs and industry practice. While these terms and methods (or similar methods) are commonly used in the sector, none of these is specifically referred to in IFRS accounting standards.

We explore below each of these methods and consider to what extent they are compliant with the requirements of IFRS accounting standards.

3.2.3 Successful efforts method

The successful efforts methods that have been developed by different accounting standard-setters are generally based on the successful efforts concept as set out in US GAAP, under which generally only those costs that lead directly to the discovery, acquisition, or development of specific, discrete mineral resources and reserves are capitalised and become part of the capitalised costs of the cost centre. Costs that when incurred fail to meet this criterion are generally charged to expense in the period they are incurred. Some interpretations of the successful efforts concept allow entities to capitalise the cost of unsuccessful development wells.[73]

72 *IFRIC Update*, January 2006, page 3. Available on the IFRS Foundation's website.

73 IASC Issues Paper, 4.18.

Under the successful efforts method, an entity will generally consider each individual mineral lease, concession, or production sharing contract as a cost centre.

How we see it

When an entity applies the successful efforts method under IFRS, it will need to account for prospecting costs incurred before the E&E phase under IAS 16 or IAS 38. As economic benefits are highly uncertain at this stage of a project, prospecting costs will typically be expensed as incurred. Costs incurred to acquire undeveloped mineral rights, however, must be capitalised under IFRS if an entity expects an inflow of future economic benefits. To the extent that costs are incurred within the E&E phase of a project, IFRS 6 does not prescribe any recognition and measurement rules. Therefore, it would be acceptable for such costs to be recorded as assets and written off when it is determined that the costs will not lead to economic benefits or to be expensed as incurred if the outcome is uncertain.

Deferred costs of an undeveloped mineral right may be depreciated over some determinable period, subject to an impairment test each period with the amount of impairment charged to expense, or an entity may choose to carry forward the deferred costs of the undeveloped mineral right until the entity determines whether the property contains mineral reserves.[74] However, E&E assets should no longer be classified as such "…when the technical feasibility and commercial viability of extracting mineral resources are demonstrable". *[IFRS 6.17]*. At that time, the asset should be tested for impairment under IAS 36, reclassified in the statement of financial position and accounted for under IAS 16 or IAS 38. If it is determined that no commercial reserves are present, then the costs capitalised should be expensed. Costs incurred after the E&E phase should be accounted for in accordance with the applicable IFRS accounting standards (i.e., IAS 16 and IAS 38).

It is worth noting that with the emergence of unconventional resource E&E projects, such as shale, coal seam and tight oil or gas, the potential timeframe to determine the technical feasibility and commercial viability of a resource can be considerably longer than that of a conventional resource. This is primarily due to the scale of work required to determine the technical feasibility and commercial viability of these more complex and/or less accessible resources in a higher cost environment. Such feasibility determinations may include the drilling and analysing of a significant number of wells over an extended period of time. As such, the overall success of a drilling campaign targeting unconventional resources may not be determined until completion of the campaign - as opposed to the more common well by well basis that is often the case for conventional projects.

Therefore, the costs incurred on unconventional projects over an extended E&E campaign, may be carried forward under existing policies adopted, including capitalisation under a successful efforts policy that permits such treatment, until such time as the broader resource body is deemed to be either successful or unsuccessful.

How we see it

The essence of most successful efforts approaches is that costs are capitalised pending evaluation, and this would be acceptable under IFRS accounting standards.

74 IASC Issues Paper, 4.20.

Practical example 3-1 below from the financial statements of Harbour Energy plc illustrates a typical successful efforts method accounting policy applied under IFRS accounting standards.

Practical example 3-1: Harbour Energy plc (2022) **United Kingdom**

Annual Report & Accounts 2022 [extract]

Financial statements [extract]

Notes to the consolidated financial statements [extract]

2. Significant accounting policies [extract]

Oil and gas assets

Intangibles

Pre-licence costs

Pre-licence costs are expensed in the period in which they are incurred.

Licence and property acquisition costs

Licence and property acquisition costs paid in connection with a right to explore in an existing exploration area are capitalised as exploration and evaluation costs within intangible assets.

Licence and property acquisition costs are reviewed at each reporting date to confirm that there is no indication that the carrying amount exceeds the recoverable amount. If no future activity is planned or the related licence has been relinquished or has expired, the carrying value of the property acquisition costs is written off through the income statement. Upon recognition of proved reserves and internal approval for development, the relevant expenditure is transferred to oil and gas properties within development and production assets.

Exploration and evaluation costs

Once the legal right to explore has been acquired, costs directly associated with the exploration are capitalised as exploration and evaluation (E&E) intangible non-current assets until the exploration is complete and the results have been evaluated. If no potential commercial resources are discovered, the exploration asset is written off.

All such capitalised costs are subject to technical, commercial and management review, as well as review for indicators of impairment at least annually. This is to confirm the continued intent to develop or otherwise extract value from the discovery. When this is no longer the case, the costs are written off through the income statement.

When proved reserves of oil or natural gas are identified and development is sanctioned by management, the relevant capitalised expenditure is first assessed for impairment and, if required, any impairment loss is recognised, then the remaining balance is transferred to oil and gas properties within development and production assets. No amortisation is charged during the exploration and evaluation phase.

Farm-outs – in the exploration and evaluation phase

The Group does not record any expenditure made by the farmee on its account. It also does not recognise any gain or loss on its exploration and evaluation farm-out arrangements but re-designates any costs previously capitalised in relation to the whole interest as relating to the partial interest retained. Any cash consideration received directly from the farmee is credited against costs previously capitalised in relation to the whole interest with any excess accounted for by the farmor as a gain on disposal.

Property, plant and equipment – oil and gas assets

Oil and gas development and production assets are accumulated generally on a field-by-field basis. This represents expenditure on the construction, installation or completion of infrastructure facilities such as platforms, pipelines and the drilling of development wells, including E&E expenditures incurred in finding commercial reserves transferred from intangible E&E assets, as outlined in the intangible asset policy above, which is capitalised as oil and gas properties within development and production assets.

The initial cost of an asset comprises its purchase price or construction cost, any costs directly attributable to bringing the asset into operation, the initial estimate of the decommissioning obligation and, for qualifying assets, where relevant, borrowing costs. The purchase price or construction cost is the aggregate amount paid and the fair value of any other consideration given to acquire the asset.

An item of development and production expenditure and any significant part initially recognised is derecognised upon disposal or when no future economic benefits are expected. Any gain or loss arising on derecognition of the asset (calculated as the difference between the net disposal proceeds and the carrying amount of the asset) is included in the income statement.

Expenditure on major maintenance includes refits, inspections or repairs comprising the cost of replacement assets or parts of assets, inspection costs and overhaul costs. Where an asset, or part of an asset, that was separately depreciated and is now written off is replaced and it is probable that future economic benefits associated with the item will flow to the Group, the expenditure is capitalised. All other day-to-day repairs and maintenance costs are expensed as incurred.

Depreciation, depletion and amortisation (DD&A) of oil and gas assets

All costs relating to a development are accumulated and not depreciated until the commencement of production. Depreciation is provided generally on a field-by-field basis, using the unit of production method by reference to the ratio of production in the year and the related commercial proven and probable reserves of the field, considering future development expenditures necessary to bring those reserves into production.

When there is a change in the estimated total recoverable proven and probable reserves of a field, that change is accounted for in the depreciation charge over the revised remaining proven and probable reserves.

Acquisitions, asset purchases and disposals

Acquisitions of oil and gas properties are accounted for using the acquisition method when the assets acquired, and liabilities assumed constitute a business.

Transactions involving the purchase of an individual field interest, or a group of field interests, that do not constitute a business, are treated as asset purchases irrespective of whether the specific transactions involve the transfer of the field interests directly or the transfer of an incorporated entity. Accordingly, no goodwill and no deferred tax gross up arises, and the consideration is allocated to the assets and liabilities purchased on an appropriate basis.

Proceeds on disposal are applied to the carrying amount of the specific intangible asset or oil and gas property disposed of and any surplus is recorded as a gain on disposal in the income statement.

Decommissioning

A provision for decommissioning is recognised in full when the related facilities are installed. The amount recognised is the present value of the estimated future expenditure. A corresponding amount equivalent to the provision is also recognised as part of the cost of the related oil and gas property. This is subsequently depreciated as part of the capital costs of the production facilities. Any change in the present value of the estimated expenditure is dealt with from the start of the financial year as an adjustment to the opening provision and the oil and gas property. The unwinding of the discount is included as a finance cost.

3.2.4 Full cost method

The full cost method under most national GAAPs required all costs incurred in prospecting, acquiring mineral interests, exploration, appraisal, development, and construction to be accumulated in large cost centres, e.g., individual countries, groups of countries, or the entire world.[75] However, although an entity is permitted by IFRS 6 to develop an accounting policy without reference to other IFRS accounting standards or to the hierarchy, as described in section 3.2.1 above, IFRS 6 cannot be extrapolated or applied by analogy to permit application of the full cost method outside the E&E phase. This was confirmed by the IFRS IC in January 2006.[76]

There are several other areas in which application of the full cost method under IFRS is restricted because:

- IFRS 6 requires E&E assets to be classified as tangible or intangible assets according to the nature of the assets. *[IFRS 6.15]*. In other words, even when an entity accounts for E&E costs in relatively large pools, it will still need to distinguish between tangible and intangible assets.
- While the full cost method under most national GAAPs requires the application of some form of 'ceiling test', IFRS 6 requires - when impairment indicators are present - an impairment test to be performed in accordance with IAS 36 (although in accordance with IFRS 6, E&E assets can be allocated to CGUs or groups of CGUs (which may include producing CGUs), provided certain criteria are met - see section 3.5.2 below for further information).
- Once the technical feasibility and commercial viability of extracting mineral resources are demonstrable, IFRS 6 requires that E&E assets shall no longer be classified as such and need to be tested for impairment under IAS 36 and reclassified in the statement of financial position and accounted for under IAS 16 or IAS 38. *[IFRS 6.17]*. This means that it is not possible to account for successful and unsuccessful projects within one cost centre or pool.

75 IASC Issues Paper, 4.45.

76 *IFRIC Update*, January 2006, page 3. Available on the IFRS Foundation's website.

For these reasons it is not possible to apply the full cost method of accounting under IFRS accounting standards without making very significant modifications in the application of the method. An entity might want to use the full cost method as its starting point in developing its accounting policy for E&E assets under IFRS. However, it will rarely be appropriate to describe the resulting accounting policy as a 'full cost method' because key elements of the full cost method are not permitted under IFRS accounting standards.

In July 2009, the IASB published an amendment to IFRS 1 *Additional Exemptions for First-time Adopters (Amendments to* IFRS 1*)*, which introduced a first-time adoption exemption for first-time adopters that accounted under their previous GAAP for "…exploration and development costs for oil and gas properties in the development or production phases … in cost centres that include all properties in a large geographical area" (i.e., the full cost method).[77] Under the exemption, a first-time adopter may elect to measure oil and gas assets at the date of transition to IFRS accounting standards on a deemed cost basis (see Chapter 6 at section 5.4), but does not permit continued application of the previous GAAP accounting policy.

3.2.5 Area-of-interest method

The area-of-interest method is an accounting concept by which "…costs incurred for individual geological or geographical areas that have characteristics conducive to containing a mineral reserve are deferred as assets pending determination of whether commercial reserves are found. If the area of interest is found to contain commercial reserves, the accumulated costs are capitalised. If the area of interest is found to contain no commercial reserves, the accumulated costs are charged to expense".[78]

Some consider the area-of-interest method to be a version of the successful efforts method that uses an area-of-interest, rather than an individual licence, as its unit of account. Others believe that the area-of-interest method is more akin to the full cost method applied on an area-of-interest basis.[79] "Under the area-of-interest concept, all costs identified with an area of interest would be deferred and capitalised if commercial reserves are later determined to exist in the area. However, costs incurred up to the point that an area of interest is identified (prospecting costs) are often charged to expense by those who consider that they are applying the area-of-interest concept. Costs of individual unsuccessful activities incurred on a specific area of interest, such as drilling an exploratory well that finds no reserves, are accumulated as part of the total cost of the area of interest."[80]

While IFRS 6 will often not permit all aspects of an area-of-interest method defined by a national GAAP, an entity that uses relatively small areas of interest may be able to implement the method in a meaningful way under IFRS. The area-of-interest method is more common in the mining sector than in the oil and gas sector. Still, there are some entities that apply the method to oil and gas activities.

Practical example 3-2: BHP Group Limited (2022) Australia

Annual Report 2022 [extract]
Financial Statements [extract]
1.6 Notes to the Financial Statements [extract]
Resource assets [extract]
11 Property, plant and equipment [extract]

Recognition and measurement

Property, plant and equipment

Property, plant and equipment is recorded at cost less accumulated depreciation and impairment charges. Cost is the fair value of consideration given to acquire the asset at the time of its acquisition or construction and includes the direct costs of bringing the asset to the location and the condition necessary for operation and the estimated future costs of closure and rehabilitation of the facility.

Right-of-use assets are measured at cost, less any accumulated depreciation and impairment losses, and adjusted for any remeasurement of lease liabilities. Refer to note 21 'Leases' for further details. Right-of-use assets are presented within the category of property, plant and equipment according to the nature of the underlying asset leased.

Exploration and evaluation

Exploration costs are incurred to discover mineral resources. Evaluation costs are incurred to assess the technical feasibility and commercial viability of resources found.

Exploration and evaluation expenditure is charged to the income statement as incurred, except in the following circumstances in which case the expenditure may be capitalised:

- the exploration and evaluation activity is within an area of interest that was previously acquired as an asset acquisition or in a business combination and measured at fair value on acquisition or
- the existence of a commercially viable mineral deposit has been established

…

77 *Amendments to IFRS 1, Additional Exemptions for First-time Adopters*, IASB, July 2009, D8A.

78 IASC Issues Paper, 4.16(b).

79 IASC Issues Paper, 4.36.

80 IASC Issues Paper, 4.39.

3.2.6 Changes in accounting policies

Extract from IFRS 6

Changes in accounting policies

13 **An entity may change its accounting policies for exploration and evaluation expenditures if the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs. An entity shall judge relevance and reliability using the criteria in IAS 8.**

14 To justify changing its accounting policies for exploration and evaluation expenditures, an entity shall demonstrate that the change brings its financial statements closer to meeting the criteria in IAS 8, but the change need not achieve full compliance with those criteria.

The standard permits a change in an entity's accounting policies for E&E expenditures only if "…the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs". *[IFRS 6.13]*. In making such a change, an entity should judge the relevance and reliability using the criteria in IAS 8. *[IFRS 6.BC49]*. The entity should justify the change by demonstrating that the change "…brings its financial statements closer to meeting the criteria in IAS 8, but the change need not achieve full compliance with those criteria". *[IFRS 6.14]*.

3.3 Measurement of exploration and evaluation assets

IFRS 6 draws a distinction between measurement at recognition (i.e., the initial recognition of an E&E asset on acquisition) and measurement after recognition (i.e., the subsequent treatment of the E&E asset).

The standard requires that upon initial recognition, E&E assets should be measured at cost, *[IFRS 6.8]*, which is the same as the initial recognition requirements found in IAS 16, *[IAS 16.15]*, and IAS 38. *[IAS 38.24]*. Therefore, the question arises as to what may be included in the cost of an item. The standard contains considerable guidance on this matter, under the heading 'Elements of cost of exploration and evaluation assets' (see also section 3.3.1 below).

After initial recognition, IFRS 6 allows one of two alternatives to be chosen as the accounting policy for E&E assets that it must apply consistently to all E&E assets, being either the cost model or the revaluation model. *[IFRS 6.12]*.

Under the cost model, the item is carried at cost less impairment. Entities that apply the cost model should therefore develop an accounting policy within the constraints of IFRS 6 (see section 3.2.1 above). As a result, an entity will either develop an accounting policy based on the successful efforts type of method or area-of-interest type of method (see sections 3.2.3 and 3.2.5 above) - that requires capitalisation of E&E costs pending evaluation; or develop a policy similar to the full cost type of method, which capitalises all E&E costs (successful and unsuccessful), although it is not possible to continue using this method outside the E&E phase (see section 3.2.4 above).

The alternative is the revaluation model, which is not defined in IFRS 6 itself. Instead, the standard requires an entity to classify E&E assets as tangible or intangible assets (see section 3.4 below) and apply the IAS 16 revaluation model to the tangible assets and the IAS 38 revaluation model to the intangible assets (see Chapter 19 at section 6 and Chapter 18 at section 8.2). Practically, what this means is that E&E classified as intangible assets may not be revalued, since the IAS 38 revaluation model may only be applied to intangible assets that are traded in an active market. *[IAS 38.72, IAS 38.75, IFRS 6.BC29, IFRS 6.BC30]*.

3.3.1 Types of expenditure in the exploration and evaluation phase

The standard requires an entity to determine an accounting policy specifying which expenditures are recognised as E&E assets and apply the policy consistently. *[IFRS 6.9]*.

Extract from IFRS 6

9 An entity shall determine an accounting policy specifying which expenditures are recognised as exploration and evaluation assets and apply the policy consistently. In making this determination, an entity considers the degree to which the expenditure can be associated with finding specific mineral resources. The following are examples of expenditures that might be included in the initial measurement of exploration and evaluation assets (the list is not exhaustive):

(a) acquisition of rights to explore;

(b) topographical, geological, geochemical and geophysical studies;

(c) exploratory drilling;

(d) trenching;

(e) sampling; and

(f) activities in relation to evaluating the technical feasibility and commercial viability of extracting a mineral resource.

In permitting geological and geophysical costs (G&G costs) to be included in the initial measurement of E&E assets, IFRS differs from US GAAP - ASC 932 - *Extractive Activities - Oil and Gas*, which does not permit capitalisation of G&G costs,[81] and may differ from the requirements under other national standards.

IFRS 6 allows an accounting policy choice as to how to treat expenditures on administration and other general overhead costs; however, the chosen policy should be consistent with one of the treatments available under other IFRS accounting standards, i.e., expense or capitalise. *[IFRS 6.BC28]*. This is because there are inconsistencies between IAS 16 (which does not allow such costs to be capitalised), IAS 2 (which requires capitalisation of production overheads but not general administration) and IAS 38 (which only allows capitalisation if directly attributable to bringing the asset into use, otherwise capitalisation is prohibited).

Expenditures related to the development of mineral resources should not be recognised as E&E assets. Instead, the IASB's *Conceptual Framework* and IAS 38 should be applied in developing guidance on accounting for such assets. *[IFRS 6.10]*. IFRS does not define 'development of mineral resources, but notes that "...development of a mineral resource once the technical feasibility and commercial viability of extracting the mineral resource had been determined was an example of the development phase of an internal project". *[IFRS 6.BC27]*.

The timing of transferring expenditure from the exploration phase to the development phase is discussed in further detail in section 3.4.1 below.

How we see it

Entities need to develop an accounting policy on which expenditures are recognised as E&E assets and which expenditures are recognised as part of the development of mineral resources. While the above guidance is not a full definition, we believe that until a development is approved, accumulated costs are considered E&E assets and are accounted for under IFRS 6.

The standard specifically requires the application of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to any obligations for removal and restoration that are incurred during a particular period as a consequence of having undertaken the exploration for and evaluation of mineral resources. *[IFRS 6.11]*.

How we see it

Although IFRS 6 did not make a corresponding amendment to the scope of IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* which applies to such liabilities when they are recognised in property, plant and equipment under IAS 16, we believe that the interpretation can also be applied in relation to E&E assets. However, if the E&E costs were originally expensed, then the future costs of any related removal and restoration obligations must also be expensed.

81 ASC 932-720-25-1, Extractive Activities - Oil and Gas - Other Expenses - Recognition.

Practical example 3-3 below from Glencore plc illustrates a typical accounting policy for E&E assets for a mining company.

Practical example 3-3: Glencore plc (2022) Jersey

Annual Report 2022 [extract]
Financial Statements 2022 [extract]
Notes to the financial statements [extract]
1. Accounting policies [extract]
Property, plant and equipment [extract]

(ii) Exploration and evaluation expenditure

Exploration and evaluation expenditure relates to costs incurred in the exploration and evaluation of potential mineral and petroleum resources and includes costs such as exploration and production licences, researching and analysing historical exploration data, exploratory drilling, trenching, sampling and the costs of pre-feasibility studies. Exploration and evaluation expenditure for each area of interest, other than that acquired from another entity, is charged to the consolidated statement of income as incurred except when the expenditure is expected to be recouped from future exploitation or sale of the area of interest and it is planned to continue with active and significant operations in relation to the area, or at the reporting period end, the activity has not reached a stage which permits a reasonable assessment of the existence of commercially recoverable reserves, in which case the expenditure is capitalised. As the intangible component (i.e. licences) represents an insignificant and indistinguishable portion of the overall expected tangible amount to be incurred and recouped from future exploitation, these costs along with other capitalised exploration and evaluation expenditure are recorded as a component of property, plant and equipment. Purchased exploration and evaluation assets are recognised at their fair value at acquisition.

As the capitalised exploration and evaluation expenditure asset is not available for use, it is not depreciated. All capitalised exploration and evaluation expenditure is monitored for indications of impairment. Where a potential impairment is indicated, an assessment is performed for each area of interest or at the CGU level. To the extent that capitalised expenditure is not expected to be recovered it is charged to the consolidated statement of income.

Administration costs that are not directly attributable to a specific exploration area are charged to the consolidated statement of income. Licence costs paid in connection with a right to explore in an existing exploration area are capitalised and amortised over the term of the permit.

Practical example 3-4 below from BP p.l.c. illustrates an accounting policy for E&E assets for an oil and gas company.

Practical example 3-4: BP p.l.c. (2022) United Kingdom

bp Annual Report and Form 20-F 2022 [extract]
Financial statements [extract]
Notes on financial statements [extract]
1. Significant accounting policies, judgements, estimates and assumptions [extract]
Intangible assets [extract]

Oil and natural gas exploration and appraisal expenditure

Oil and natural gas exploration and appraisal expenditure is accounted for using the principles of the successful efforts method of accounting as described below.

Licence and property acquisition costs

Exploration licence and leasehold property acquisition costs are capitalized within intangible assets and are reviewed at each reporting date to confirm that there is no indication that the carrying amount exceeds the recoverable amount. This review includes confirming that exploration drilling is still under way or planned or that it has been determined, or work is under way to determine, that the discovery is economically viable based on a range of technical and commercial considerations, and sufficient progress is being made on establishing development plans and timing. If no future activity is planned, the remaining balance of the licence and property acquisition costs is written off. Lower value licences are pooled and amortized on a straight-line basis over the estimated period of exploration. Upon internal approval for development and recognition of proved or sanctioned probable reserves of oil and natural gas, the relevant expenditure is transferred to property, plant and equipment.

Exploration and appraisal expenditure

Geological and geophysical exploration costs are recognized as an expense as incurred. Costs directly associated with an exploration well are initially capitalized as an intangible asset until the drilling of the well is complete and the results have been evaluated. These costs include employee remuneration, materials and fuel used, rig costs and payments made to contractors. If potentially commercial quantities of hydrocarbons are not found, the exploration well costs are written off. If hydrocarbons are found and, subject to further appraisal activity, are likely to be capable of commercial development, the costs continue to be carried as an asset. If it is determined that development will not occur, that is, the efforts are not successful, then the costs are expensed.

...

Costs directly associated with appraisal activity undertaken to determine the size, characteristics and commercial potential of a reservoir following the initial discovery of hydrocarbons, including the costs of appraisal wells where hydrocarbons were not found, are initially capitalized as an intangible asset. Upon internal approval for development and recognition of proved or sanctioned probable reserves, the relevant expenditure is transferred to property, plant and equipment. If development is not approved and no further activity is expected to occur, then the costs are expensed.

The determination of whether potentially economic oil and natural gas reserves have been discovered by an exploration well is usually made within one year of well completion, but can take longer, depending on the complexity of the geological structure. Exploration wells that discover potentially economic quantities of oil and natural gas and are in areas where major capital expenditure (e.g. an offshore platform or a pipeline) would be required before production could begin, and where the economic viability of that major capital expenditure depends on the successful completion of further exploration or appraisal work in the area, remain capitalized on the balance sheet as long as such work is under way or firmly planned.

...

3.3.2 Capitalisation of borrowing costs in the exploration and evaluation phase

IAS 23 *Borrowing Costs* requires capitalisation of borrowing costs that are "…directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset". *[IAS 23.8]*. An E&E asset will generally meet the definition of a qualifying asset as it "…necessarily takes a substantial period of time to get ready for its intended use or sale". *[IAS 23.5]*. However, IAS 23 requires capitalisation of borrowing costs only when it is "…probable that they will result in future economic benefits to the entity and the costs can be measured reliably". *[IAS 23.9]*. Unlike IAS 23, IFRS 6 permits capitalisation of E&E assets even when it is not probable that they will result in future economic benefits.

How we see it

Unless an entity's E&E project has resulted in the classification of mineral resources as proven or probable, it is unlikely that future economic benefits from that project can be considered probable. In these circumstances, it is consistent with the requirements of IFRS 6 and IAS 23 to capitalise an E&E asset but not capitalise borrowing costs in respect of it.

3.4 Presentation and classification

E&E assets should be classified consistently as either tangible or intangible assets in accordance with the nature of the assets acquired. *[IFRS 6.15]*. For example, drilling rights may be presented as intangible assets, whereas vehicles and drilling rigs are tangible assets. A tangible asset that is used in developing an intangible asset should still be presented as a tangible asset. However, to the "…extent that a tangible asset is consumed in developing an intangible asset, the amount reflecting that consumption is part of the cost of the intangible asset". For example, the depreciation of a drilling rig would be capitalised as part of the intangible E&E asset that represents the costs incurred on active exploration projects. *[IFRS 6.16, IFRS 6.BC33]*. This assessment requires judgement, and we observe different classification practices across the mining industry and the oil and gas industry.

3.4.1 Reclassification of E&E assets

E&E assets should no longer be classified as such when "…technical feasibility and commercial viability of extracting a mineral resource are demonstrable". *[IFRS 6.17]*.

Determining when technical feasibility and commercial viability have been demonstrated may involve significant judgement, particularly in relation to complex assets or projects where feasibility assessment may be ongoing over an extended period of time; for example, Liquefied Natural Gas (LNG) projects, unconventional assets, large scale, technically challenging projects, or where significant upfront investment in long lead items is required.

How we see it

A final investment decision being approved is often a common signal that technical feasibility and commercial viability have been determined and accordingly capitalisation of costs as part of E&E assets is no longer permitted. However, absent this, other factors may also need to be considered, such as the booking of significant quantities of commercial reserves, approval of budgeted expenditure to commence commercial development activities or the actual commencement of expenditure on development activities.

It should be noted that both technical feasibility and commercial viability must be demonstrated before an asset can be transferred out of E&E. Activities that occur prior to this point which are aimed at assessing the viability of a resource, may still be regarded as E&E in nature and must be accounted for accordingly.

Before reclassification, E&E assets are required to be assessed for impairment individually or as part of a cash-generating unit and any impairment loss should be recognised. *[IFRS 6.17]*.

3.5 Impairment

In some cases, and particularly in exploration-only entities, E&E assets do not generate cash inflows and there is insufficient information about the mineral resources in a specific area for an entity to make reasonable estimates of an E&E asset's recoverable amount. This is because the exploration for and evaluation of the mineral resources has not reached a stage at which information sufficient to estimate future cash flows is available to the entity. Without such information, it is not possible to estimate either fair value less costs of disposal ('FVLCD') or value in use ('VIU'), the two measures of recoverable amount in IAS 36. Therefore, without some sort of alternate impairment assessment approach, this would have led to immediate write-off of exploration expenditure.

Therefore, modifications were made to the impairment testing approach. Under IFRS 6, the assessment of impairment should be triggered by changes in facts and circumstances. However, once an entity had determined that there is an impairment trigger for an E&E asset, IAS 36 should be used to measure, present and disclose that impairment in the financial statements. This is subject to the special requirements with respect to the level at which impairment is assessed. *[IFRS 6.BC37]*.

IFRS 6 makes two important modifications to IAS 36:

- It defines separate impairment testing 'triggers' for E&E assets.
- It allows groups of cash-generating units to be used in impairment testing. *[IFRS 6.18, IFRS 6.19, IFRS 6.20]*.

3.5.1 Impairment testing 'triggers'

E&E assets should be assessed for impairment when facts and circumstances suggest that the carrying amount of an E&E asset may exceed its recoverable amount. *[IFRS 6.18]*.

Under IFRS 6, one or more of the following facts and circumstances could indicate that an impairment test is required. The list is not intended to be exhaustive. *[IFRS 6.20]*.

Extract from IFRS 6

20 One or more of the following facts and circumstances indicate that an entity should test exploration and evaluation assets for impairment (the list is not exhaustive):

(a) the period for which the entity has the right to explore in the specific area has expired during the period or will expire in the near future, and is not expected to be renewed.

(b) substantive expenditure on further exploration for and evaluation of mineral resources in the specific area is neither budgeted nor planned.

(c) exploration for and evaluation of mineral resources in the specific area have not led to the discovery of commercially viable quantities of mineral resources and the entity has decided to discontinue such activities in the specific area.

(d) sufficient data exist to indicate that, although a development in the specific area is likely to proceed, the carrying amount of the exploration and evaluation asset is unlikely to be recovered in full from successful development or by sale.

In any such case, or similar cases, the entity shall perform an impairment test in accordance with IAS 36. Any impairment loss is recognised as an expense in accordance with IAS 36.

Finding that an exploratory or development well does not contain oil or gas in commercial quantities (i.e., finding a 'dry hole') is not listed in IFRS 6 as an impairment indicator. If finding a dry hole marks the end of budgeted or planned exploration activity, indicator (b) above would require impairment testing under IAS 36. Similarly, if the dry hole led to a decision that activities in the area would be discontinued, indicator (c) would require that an impairment test be performed, and indicator (d) requires an entity to do an impairment test if it is unlikely that it will recover the E&E costs from successful development or sale. However, absent one of these indicators being met, in isolation, drilling a dry hole would not necessarily trigger an impairment test. For example, if the first well in a three well campaign is a dry hole, but the entity still intends to drill the remaining two wells, an impairment trigger may not exist.

3.5.2 Specifying the level at which E&E assets are assessed for impairment

When deciding the level at which E&E assets should be assessed, rather than introduce a special CGU for E&E assets, IFRS 6 allows CGUs to be aggregated in a way consistent with the approach applied to goodwill in IAS 36. *[IFRS 6.BC40-BC47]*. Therefore, an entity should determine an accounting policy for allocating E&E assets to CGUs or to CGU groups for the purpose of assessing them for impairment. *[IFRS 6.21]*. Each CGU or group of CGUs to which an E&E asset is allocated should not be larger than an operating segment (which is smaller than a reportable segment) determined in accordance with IFRS 8 *Operating Segments*. *[IFRS 6.21]*. See also Chapter 21 at section 8.1.4.

Hence, the level identified by an entity for the purposes of testing E&E assets for impairment may be comprised of one or more CGUs. *[IFRS 6.22]*.

3.5.3 Cash-generating units comprising successful and unsuccessful E&E projects

IFRS 6 does not specifically address whether successful and unsuccessful E&E projects can be combined in a single CGU (which will occur under full cost accounting and may occur under area of interest accounting). There are some issues to consider before doing this:

- Regardless of whether there is an impairment trigger (see section 3.5.1 above), IFRS 6 requires E&E assets to be tested for impairment before reclassification "…when the technical feasibility and commercial viability of extracting a mineral resource are demonstrable". *[IFRS 6.17]*. That means that the successful conclusion of a small E&E project and its reclassification out of E&E would result in an impairment test of a much larger CGU and possible recognition of an impairment loss on that larger CGU.
- Successful E&E projects should be reclassified as tangible or intangible assets under IAS 16 and IAS 38, respectively. *[IFRS 6.15]*. Therefore, a CGU comprising both successful and unsuccessful E&E projects would be subject to the impairment triggers in both IFRS 6 and IAS 36. This would significantly increase the frequency of impairment testing. *[IFRS 6.20, IAS 36.8-17]*.
- An entity should carefully consider the consequences of including several E&E projects in a CGU, because the unsuccessful conclusion of one project would usually trigger an impairment test of the entire CGU. *[IFRS 6.20]*.

3.5.4 Order of impairment testing

CGUs often contain other assets as well as E&E assets. When developing IFRS 6, Exposure Draft ED 6 *Exploration for and Evaluation of Mineral Resources* specifically stated that such other assets should be tested for impairment first, in accordance with IAS 36, before testing the CGU inclusive of the E&E assets.[82] However, IFRS 6 does not specifically address this topic.

How we see it

Although IFRS 6 does not specifically address the order of impairment testing, we believe that as the impairment test is completed in accordance with IAS 36, and a similar approach is adopted as that applied to goodwill, the order of the impairment testing as set out in IAS 36 would apply. That is, an entity would test the underlying assets/CGU without the E&E assets first, recognise any write down (if applicable) and then test the CGU/CGU group with the E&E assets allocated.

3.5.5 Additional considerations if E&E assets are impaired

In some circumstances, an entity that recognises an impairment of an E&E asset must also decide whether or not to derecognise the asset because no future economic benefits are expected, as shown in Illustration 3-1 below.

Illustration 3-1: Impairment losses on E&E assets

Entity A's exploration activity in a specific area does not discover oil and/or gas resources. Therefore, A recognises an impairment of the cash-generating unit and derecognises the related E&E assets.

Entity B's exploration activity in a specific area leads to the discovery of a significant quantity of resources, but these are located in a complex reservoir. Therefore, at present the costs of extraction of the discovered resources do not justify the construction of the required infrastructure. Nevertheless, B's management believes that the surrounding area has strong potential to yield other discoveries on other geological structures and it is considered possible that the required infrastructure will be constructed in the future, although at this stage management has no plans to undertake further exploration activity. Entity B recognises an impairment of the E&E assets, but since it expects future economic benefits the related E&E assets are not derecognised.

If an entity concludes that production is not technically feasible or commercially viable, that provides evidence that the related E&E asset needs to be tested for impairment. It is also possible that such evidence may indicate that no future economic benefits are expected from such assets and therefore any remaining assets should be derecognised. When considering the two examples above, in Entity A's situation, no oil and/or gas resources were discovered and based on current plans, no future economic benefits were expected from the related E&E assets so they were derecognised. Whereas in Entity B's situation, while oil and/or gas resources were discovered, extraction was not commercially viable at this stage. So, while an impairment was recognised, the remaining assets were not derecognised as management did expect future economic benefits to flow from such assets.

82 ED 6, Exploration for and Evaluation of Mineral Resources, IASB, January 2004, 14.

Although IFRS 6 does not specifically deal with derecognition of E&E assets, the entity should derecognise the E&E asset because the asset is no longer in the exploration and evaluation phase and hence outside the scope of IFRS 6 and other asset standards such as IAS 16 and IAS 38 would require derecognition under those circumstances. Once derecognised, the costs of an E&E asset that have been written off cannot be re-recognised as part of a new E&E asset, so unlike an impairment, the write off is permanent.

3.5.6 Income statement treatment of E&E write downs - impairment or exploration expense

In some circumstances, it may be unclear whether an E&E asset is impaired, or whether a write off of unsuccessful exploration is required. In an unconventional project, or in circumstances where costs have been carried forward for some time pending determination of technical feasibility and commercial viability, judgement will be required in concluding on the most appropriate income statement presentation. Key considerations may include whether the objectives of drilling or other expenditure programs have been met, whether the indicative impairment triggers in IFRS 6 have been met, and management's future intentions for the asset.

3.5.7 Reversal of impairment losses

Any impairment loss on an E&E asset recognised in accordance with IFRS 6 needs to be reversed if there is evidence that the loss no longer exists or has decreased. The entity must apply the requirements specified in IAS 36 for reversing an impairment loss (see Chapter 21 at section 11.4). *[IFRS 6.BC48, IAS 36.109-123]*.

3.6 Disclosure

There are a range of disclosures required by IFRS 6 in order to identify and explain "...the amounts recognised in its financial statements arising from the exploration for and evaluation of mineral resources". *[IFRS 6.23]*. These are set out below. *[IFRS 6.24]*.

Extract from IFRS 6

24 To comply with paragraph 23, an entity shall disclose:

(a) its accounting policies for exploration and evaluation expenditures including the recognition of exploration and evaluation assets.

(b) the amounts of assets, liabilities, income and expense and operating and investing cash flows arising from the exploration for and evaluation of mineral resources.

Practical example 3-5 below from Tullow Oil plc's 2022 financial statements illustrates the disclosures required by IFRS 6.

Practical example 3-5: Tullow Oil plc (2022) **United Kingdom**

2022 Annual Report and Accounts [extract]

Financial statements [extract]

Group income statement [extract]

	Notes	2022 $m	2021 Restated[1] $m
Continuing activities			
Revenue	2	**1,783.1**	1,285.4
Cost of sales	4	**(697.5)**	(638.9)
Gross profit		**1,085.6**	646.5
Administrative expenses	4	**(51.0)**	(64.1)
Gain on bargain purchase	15	**196.8**	–
Gain on disposals	8	**–**	120.3
Other gains and losses	19	**3.1**	–
Exploration costs written off	9	**(105.2)**	(59.9)
Impairment of property, plant and equipment, net	10	**(391.2)**	(54.3)
Restructuring costs and other provisions	4	**(4.2)**	(61.8)

...

Group balance sheet [extract]

	Notes	2022 $m	2021 $m
ASSETS			
Non-current assets			
Intangible exploration and evaluation assets	9	**288.6**	354.6
Property, plant and equipment	10	**2,981.4**	2,914.6
Other non-current assets	11	**327.1**	489.1
Deferred tax assets	21	**14.5**	354.4
		3,611.6	4,112.7

...

Group cash flow statement [extract]

	Notes	2022 $m	2021 Restated[1] $m
Cash flows from investing activities			
Proceeds from disposals	11	**68.1**	132.8
Purchase of additional interest in joint operation	15	**(126.8)**	–
Purchase of intangible exploration and evaluation assets	28	**(42.6)**	(86.1)
Purchase of property, plant and equipment	28	**(263.8)**	(150.4)
Interest received		**8.9**	2.0
Net cash used in investing activities		**(356.2)**	(101.7)

...

Accounting Policies [extract]

(k) Intangible, exploration and evaluation assets and oil and gas assets

The Group adopts the successful efforts method of accounting for exploration and evaluation costs. Pre-licence costs are expensed in the period in which they are incurred. All licence acquisition, exploration and evaluation costs and directly attributable administration costs are initially capitalised in cost centres by well, field or exploration area, as appropriate.

These costs are then written off as exploration costs in the income statement unless commercial reserves have been established or the determination process has not been completed and there are no indications of impairment.

Exploration and evaluation assets are tested for impairment when reclassified to development assets, or whenever facts and circumstances indicate impairment. An impairment loss is recognised for the amounts by which the exploration and evaluation assets' carrying amount exceeds their recoverable amount. The recoverable amount is the higher of the exploration and evaluation asset's fair value less cost to sell and their value in use.

Once commercial reserves are found, exploration and evaluation assets are tested for impairment and transferred to development assets. No depreciation and/or amortisation is charged during the exploration and evaluation phase.

All field development costs are capitalised as property, plant and equipment. Property, plant and equipment related to production activities is amortised in accordance with the Group's depletion and amortisation accounting policy.

Cash consideration received on farm-down of exploration and evaluation assets is credited against the carrying value of the asset. The excess amount over the carrying value of the asset is recognised as a gain on disposal of exploration and evaluation assets in the statement of profit or loss.

...

Notes to the Group Financial Statements [extract]

Note 9. Intangible exploration and evaluation assets

	2022 $m	2021 $m
At 1 January	**354.6**	368.2
Additions[1]	**39.2**	46.3
Amounts written off	**(105.2)**	(59.9)
At 31 December	**288.6**	354.6

...

An entity should treat E&E assets as a separate class of assets and make the disclosures required by IAS 16 and IAS 38 for tangible E&E assets and intangible E&E assets, respectively. *[IFRS 6.25, IFRS 6.BC53]*.

3.6.1 Statement of cash flows

IAS 7 *Statement of Cash Flows* states that only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities. *[IAS 7.16]*. The IASB specifically notes that "...the exemption in IFRS 6 applies only to recognition and measurement of exploration and evaluation assets, not to the classification of related expenditures in the statement of cash flows". *[IFRS 6.BC23B]*. This means that an entity that expenses E&E expenditure will not be able to classify the associated cash flows as arising from investing activities.

4 Unit of account

One of the key issues in the development of accounting standards and in the selection of accounting policies by preparers, is deciding the level at which an entity should separately account for assets, i.e., what is the 'unit of account'? The definition of the unit of account has significant accounting consequences, as can be seen in the Illustration below.

Illustration 4-1: Unit of account - dry well

An oil and gas company concludes, based on a number of exploration wells, that oil and gas reserves are present. However, it needs to drill a number of delineation wells to determine the amount of reserves present in the field. The first delineation well that is drilled is a dry hole, i.e., no reserves are found.

There are two ways of looking at the cost of drilling the dry hole:

- The dry hole provides important information about the extent of the oil and gas reserves present in the oil field and should therefore be capitalised as part of the larger oil field.

  Or

- The dry hole will not produce oil in the future and in the absence of future economic benefits the costs should be expensed immediately.

This example suggests that assets or actions that have no value or meaning at one level may actually be valuable and necessary at another level.

The unit of account plays a significant role in:

- Recognition and derecognition of assets
- Determining the rate of depreciation or amortisation
- Deciding whether certain costs should be capitalised
- Undertaking impairment testing
- Determining the substance of transactions
- Application of the measurement model subsequent to recognition of the asset
- Determining the level of detail of the disclosures required

The decisions about the unit of account will consider, *inter alia*, cost/benefits and materiality, whether the items are capable of being used separately, their useful economic lives, whether the economic benefits that the entity will derive are separable and the substance of the transaction. To some degree the choice of the unit of account will depend on industry practice, as discussed below.

In Illustration 4-1 above, an individual dry hole might not be considered a separate asset because individual wells are typically not capable of being used separately, their economic benefits are inseparable, the wells are similar in nature and the substance of the matter can only be understood at the level of the project as a whole. However, in concluding on whether to capitalise or expense the cost of the individual dry hole as set out in Illustration 4-1 above, an entity will consider its specific accounting policy and its definition of the unit of account. This is discussed further in section 4.1 below.

4.1 Unit of account in the extractive industries

In the extractive industries the definition of the unit of account is particularly important in deciding whether certain costs may be capitalised, determining the rate of depreciation and in impairment testing. Historically entities in the extractive industries have accounted for preproduction costs using methods such as:

- Successful efforts method
- Full cost method
- Area-of-interest method

These are discussed further in sections 3.2.3 to 3.2.5 above. A key issue under each of these methods is determining the appropriate unit of account, which is referred to in the industry as the 'cost centre' or 'pool'. In practice, entities would define their cost centres along geographical, political or legal boundaries or align them to the operating units in their organisation. The IASC Issues Paper listed the following, commonly used, cost centres that have been used pre-IFRS:[83]

- The world
- Each country or group of countries in which the entity operates
- Each contractual or legal mineral acquisition unit, such as a lease or production sharing contract
- Each area of interest (geological feature, such as a mine or field, that lends itself to a unified exploration and development effort)
- Geological units other than areas of interest (such as a basin or a geologic province)
- The entity's organisational units

IFRS does not provide industry specific guidance on determining appropriate units of account for the extractive industries.

How we see it

We believe that in determining the unit of account, a logical place to start would be the legal rights and then apply the criteria discussed in section 4 above (i.e., cost/benefits and materiality, whether the items are capable of being used separately, their economic useful lives, whether the economic benefits that the entity will derive are separable and the substance of the transaction), to assess whether the unit of account is required to be larger or smaller. The other cost centres listed above might result in a unit of account that is unjustifiably large when viewed in the light of the factors influenced by the unit of account as set out in section 4 above.

The definition of 'unit of account' was considered in the *Extractive Activities* DP (see section 1.3 above). While the DP would not need to be considered in the context of the IAS 8 hierarchy, it did draw attention to the fact that the selection of an appropriate unit of account might need to take into account the stage of the underlying activities. In particular, the DP proposed that "…the geographical boundary of the unit of account would be defined initially on the basis of the exploration rights held. As exploration, evaluation and development activities take place, the unit of account would contract progressively until it becomes no greater than a single area, or group of contiguous areas, for which the legal rights are held and which is managed separately and would be expected to generate largely independent cash flows".[84] The DP's view was that the components approach in IAS 16 "would apply to determine the items that should be accounted for as a single asset".[85] However, the DP suggested that an entity may decide to account for its assets using a smaller unit of account.

The thinking underlying the above proposal in the DP would be relevant in the following types of situations:

- Certain transactions in the extractive industries (e.g., carried interest arrangements) result in the creation of new legal rights out of existing legal rights. Whenever this is the case, an entity needs to assess whether such transactions give rise to new units of account. If so, the accounting policies should be applied to those new units of account rather than the previous unit/s of account.
- When an entity acquires a business that owns reserves and resources, it needs to consider whether it should define the unit of account at the level of the licence or separate ore zones or reservoirs within the licence.

Determining the unit of account is an area that requires a significant amount of judgement, which may need to be disclosed under IAS 1 *Presentation of Financial Statements* together with other judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. *[IAS 1.122]*.

As the prevalence of unconventional oil and gas projects increases, the determination of the unit of account is becoming an increasingly common topic. With unconventional programs, the objectives of individual wells or drilling campaigns may differ to those for a conventional drilling program. It may be that the drilling of each well provides important information about the extent of the oil and gas reserves present in the oil and gas field, but multiple wells need to be drilled before a decision can be made regarding success. So unlike conventional oil and gas projects, concluding whether a well cost should be capitalised may not be possible on an individual well basis immediately after each well is drilled. In these circumstances, an entity may determine that the costs of an individual well should be carried forward pending further analysis.

83 IASC Issues Paper, 6.14.

84 Discussion Paper DP/2010/1, *Extractive Activities*, IASB, April 2010, page 9. Available on the IFRS Foundation's website.

85 Discussion Paper DP/2010/1, *Extractive Activities*, IASB, April 2010, page 9. Available on the IFRS Foundation's website.

5 Legal rights to explore for, develop and produce mineral properties

An entity can acquire legal rights to explore for, develop and produce wasting resources on a mineral property by:[86]

(a) Purchasing of minerals (i.e., outright ownership)

(b) Obtaining a lease or concession (see sections 5.1 and 5.2 below)

(c) Entering into a production-sharing contract or production-sharing agreement (see section 5.3 below)

(d) Entering into a pure-service contract (see section 5.4 below)

(e) Entering into a service contract (also called a service agreement or risk service contract) (see section 5.5.1 below)

(f) Entering into a joint operating agreement (see section 5.6 below)

(g) Retaining an overriding royalty or other royalty interest subsequent to sale of an interest (see section 5.7 below)

Although many of these are more commonly encountered in the oil and gas sector, which is reflected in many of the examples and Illustrations below, they are not restricted to this sector and mining entities can and do enter into similar arrangements.

The IASC Issues Paper noted that "in the mining sector, rights to explore for, develop, and produce minerals are often acquired by purchase of either the mineral rights alone (which does not include ownership of the land surface) or by purchase of both mineral rights and surface rights. In other cases, they are acquired through a right to mine contract, which grants the enterprise the rights to develop and mine the property and may call for a payment at the time the contract becomes effective and subsequent periodic payments. In the mining sector, rights to explore for, develop, and produce minerals may also be acquired by mineral leases from private owners or from the government".[87]

In the oil and gas sector, entities usually obtain the rights to explore for, develop, and produce oil and gas through mineral leases, concession agreements, production-sharing contracts, or service contracts.[88] Arrangements similar to production sharing contracts are also common in the mining sector. The type of legal arrangement used depends to a large extent on the legal framework of the country and market practice. The main features of each of these legal rights to access mineral reserves and resources, except for the outright ownership of minerals, are discussed below.

Practical example 5-1 below from the financial statements of TotalEnergies SE illustrates the different types of legal arrangements that an oil and gas company may enter into to secure access to mineral reserves and resources.

86 IASC Issues Paper, 2.12.

87 IASC Issues Paper, 2.13.

88 IASC Issues Paper, 2.14.

Practical example 5-1: TotalEnergies SE (2022) France

Universal Registration Document 2022 including the Annual Financial Report [extract]

2 Business overview for fiscal year 2022 [extract]

2.3 Upstream oil and gas activities [extract]

2.3.5 Contractual framework of Upstream oil and gas production activities

Licenses, permits and contracts governing the ownership of oil and gas interests by TotalEnergies' entities have terms that vary from country to country and are generally granted by or entered into with a government entity or a state-owned company or sometimes with private owners. These agreements usually take the form of concessions or production-sharing contracts.

In the framework of oil concession agreements, the oil company (or consortium) owns the assets and the facilities and is entitled to the entire production. In exchange, the operating risks, costs and investments are the oil company's or the consortium's responsibility and it agrees to remit to the relevant host country, usually the owner of the subsoil resources, a production-based royalty, income tax, and possibly other taxes that may apply under local tax legislation.

The production sharing contract (PSC) involves a more complex legal framework than the concession agreement. It defines the terms and conditions of production sharing and sets the rules governing the cooperation between the company (the contractor) or consortium (the contracting group) in possession of the license and the host country, which is generally represented by a state-owned company. The latter can thus be involved in operating decisions, cost accounting and production allocation. The contractor (or contractor group) undertakes the execution and financing, at its own risk, of all exploration, development or operational activities. In exchange, it is entitled to a portion of the production, known as "cost oil", the sale of which is intended to cover its incurred expenses (capital and operating costs). The balance of production, known as "profit oil", is then shared in varying proportions, between the contractor (or the contracting group), on the one hand, and the host country or state-owned company, on the other hand.

Today, concession agreements and PSCs can coexist, sometimes in the same country. Even though there are other contractual models, TotalEnergies' license portfolio is comprised mainly of concession agreements.

On most licenses, the partners and authorities of the host country, often assisted by international accounting firms, perform joint venture and PSC cost audits and ensure the observance of contractual obligations.

In some countries, TotalEnergies has also signed contracts called "risked service contracts", which are similar to production sharing contracts. However, the profit oil is replaced by a defined or determinable cash monetary remuneration, agreed by contract, which depends in particular on field performance parameters such as the amount of barrels produced.

Oil and gas exploration and production activities are subject to authorization granted by public authorities (licenses), which are granted for specific and limited periods of time and include an obligation to relinquish a large portion, or the entire portion in case of failure, of the area covered by the license at the end of the exploration period.

TotalEnergies pays taxes on income generated from its oil and gas production and sales activities under its concessions, PSCs and risked service contracts, as required by local regulations. In addition, depending on the country, TotalEnergies' production and sales activities may be subject to a number of other taxes, fees and withholdings, including special petroleum taxes and fees. The taxes imposed on oil and gas production and sales activities are generally substantially higher than those imposed on other industrial or commercial businesses.

5.1 Mineral lease

In most countries, the government owns all minerals and rights over those minerals, but in some other countries, minerals and mineral rights can also be directly owned by individuals. While these contracts are negotiated individually, and therefore each may be different, they typically share a large number of common features, which are discussed below:

(a) The *owner/lessor* of the mineral rights retains a *royalty interest*, which entitles it to a specified percentage of the mineral produced. The lessor is normally only required to pay for its share of the severance taxes and the costs of getting the production into a marketable state, but not for any exploration and development costs. The *royalty* is either payable in cash or payable in kind. Although the lessor is normally not interested in receiving its royalty in kind, the option of receiving the royalty in kind is often included for tax purposes.

(b) The lessee obtains a *working interest* under the mineral lease, which entitles it to explore for, develop, and produce minerals from the property at its cost. The working interest can be held by more than one party, in which case a *joint operating agreement* needs to be executed (see section 5.6 below).

(c) Upon signing of the mineral lease agreement, the lessee typically pays the lessor a *lease bonus* or *signature bonus*, which is a one-off upfront payment in exchange for the lessor's signing of the mineral lease agreement.

(d) It is in the lessor's interest for the lessee to explore the property as quickly as possible. To ensure that the lessee does not delay exploration and development unnecessarily, the following terms are typically included:

- Most mineral leases define a *primary term* during which the lessee is required to commence drilling.
- Normally the lessee has a *drill or exploration obligation* that must be met within a certain period. However, by paying *delay rentals* the lessee can defer commencement of drilling or exploration.
- The mineral lease will remain in force once the obligatory drilling/exploration programme has been completed successfully and production commences, but the lease will be cancelled if activities are suspended for a prolonged period.

(e) Most mineral leases provide that the lessee and the lessor have the right to assign their interest to another party without approval from the owner/lessor. This means that both the lessee and the lessor can create new rights out of existing rights (see section 5.7 below).

(f) Under many oil and gas lease contracts, the lessee can be required to pay *shut-in royalties* when a successful well capable of commercial production has been completed, but production has not commenced within a specified time.

(g) The lessor is typically not entitled to royalties on any minerals consumed in producing further minerals from a property.

5.2 Concessionary agreements (concessions)

Concessionary agreements or concessions are mineral leases "…under which the government owning mineral rights grants the concessionaire the right to explore, develop, and produce the minerals".[89] However, unlike a production sharing contract (see section 5.3 below), under a concessionary agreement, the extractive industries company retains title to the assets constructed during the term of the concession. Furthermore, the company bears all the risks and there is no profit-sharing arrangement with the government. Rather, the government is entitled to a royalty computed in much the same way as a royalty under lease contracts.[90] In addition, depending on the country's fiscal policies, the government will typically also collect taxes such as duties, severance or production taxes, and income taxes.

In some jurisdictions, the government may retain the option to participate in the project as a working interest owner in the property. In this case, the company initially holds 100% of the working interest. If the project is successful and reserves are found, the national oil company or entity representing the government becomes a working interest owner and will pay for its proportionate share of the investment.

5.3 Traditional production sharing contracts

A production sharing contract (PSC) or production sharing arrangement (PSA) is a contract between a national oil company (NOC) or the government of a host country and a contracting entity (contractor) to carry out oil and gas exploration and production activities in accordance with the terms of the contract, with the two parties sharing mineral output.[91] While these arrangements have historically been more commonly found in the oil and gas sector, similar types of arrangements do exist in the mining sector.

In such countries, the ownership of the mineral reserves and resources in the ground does not pass to the contractor. Instead, the contractor is permitted to recover its costs and share in the profits from the exploration and production activities. Although the precise form and content of a PSC may vary, the following features are likely to be encountered in traditional oil and gas PSCs:[92]

(a) The government retains ownership of the reserves and resources and grants the contractor the right to explore for, develop, and produce the reserves.

(b) The government is often directly involved in the operation of the property, either by way of an *operating committee* that comprises representatives of the contractor and the government or NOC, or by requiring the contractor to submit its annual work programme and corresponding annual budget to the government or NOC for approval. The contractor is responsible to the NOC for carrying out operations in accordance with contract terms.

(c) Upon signing of the PSC, the contractor pays the government a *signature bonus*, which is a once-off upfront payment in exchange for the government's signing of the PSC.

(d) The contractor pays the government a *production bonus* upon commencement of production and when the average production over a given period first exceeds a threshold level.

(e) The government is entitled to a *royalty payment* that is calculated as a percentage of the net production (i.e., net of petroleum lost, flared or re-injected) and which is payable in kind or in cash at the option of the government. The royalty rate applicable is not necessarily a fixed percentage, but may depend on the production volume or destination of the production (e.g., different rates may apply to crude oil and gas that is exported).

89 IASC Issues Paper, 2.21.

90 IASC Issues Paper, 2.21.

91 IASC Issues Paper, Glossary.

92 IASC Issues Paper, 2.19.

(f) The contractor provides all financing and technology necessary to carry out operations and pays all the costs specified.

(g) The contractor is typically required to bear all the risks related to exploration and, perhaps, development (i.e., the government does not have a working interest during the exploration and development phases).

(h) The contractor is frequently required to provide infrastructure, such as streets, electricity, water systems, roads, hospitals, schools, and other items during various phases of activities. Additionally, the contract customarily requires the contractor to provide specified training of personnel. Infrastructure and training costs may or may not be recoverable from future production by the contractor.[93]

(i) The contractor may have a *domestic market obligation* that requires them to meet, as a priority, the needs of domestic oil and/or gas consumption in the host country. Alternatively, the contractor may be required to sell oil and/or gas to the NOC at the official oil or gas price.

(j) The contractor is normally committed to completing a *minimum work programme* in each of the phases of the project, which generally needs to be completed within a specified period. If the work is not performed, the contract may require the unspent amount to be paid in cash to the government.

(k) A PSC normally requires *relinquishment* of a certain percentage of the original contract area by the end of the initial term of the exploration period. A further reduction is typically required by the end of the exploration period. The government can negotiate a new contract with another party for the continued exploration of the surrendered acreage. Any data and information relating to the surrendered area often becomes the exclusive property of the government.

(l) Equipment that is acquired for the development and production activities normally becomes the property of the government or NOC.

(m) Operating costs and specified exploration and development costs are recoverable out of *cost recovery oil*, which is a specified percentage of production revenues after the royalty payment each year. The PSC specifies whether particular types of cost are recoverable or non-recoverable. Recoverable costs not recovered by the contractor in the current period can be carried forward to the following reporting period for recovery purposes.

(n) Revenues remaining after royalty and cost recovery are called *profit oil*. Profit oil is split between the government and the contractor on a predetermined basis.

(o) Many PSCs provide that the income tax to which the contractor is subject is deemed to have been paid to the government as part of the payment of profit oil (see section 21.2 below).

(p) Some PSCs give the contractor the right to set up a decommissioning reserve fund which enables the contractor to recover the costs associated with future decommissioning and site restoration. In cases where the PSC terminates before the end of the life of the field, the government is typically responsible for decommissioning and site restoration.

Even in situations where the provisions of a PSC are fairly straightforward at first sight, it may be rather complicated to calculate the entitlement of each of the parties involved as is shown in the Illustration below.

Illustration 5-1: Production sharing contract

An oil and gas company (contractor) entered into a PSC that includes the following terms:

- The oil and gas company pays for all exploration costs
- The government is entitled to:
  - 15% royalty on the production
  - Severance tax of CU2.50 per barrel
  - CU5 million production bonus when average production first exceeds 25,000 barrels per day

  And
  - 10% of the profit oil
- Operating expenses are recoverable before exploration costs
- Development costs are recoverable after exploration costs
- Cost recovery oil is capped at 45% of the annual production
- The national oil company (NOC) and the contractor have a 51% and 49% working interest, respectively

93 IASC Issues Paper, 12.12(b).

How should the production be allocated between parties, assuming the following for 20X1?

- Annual production in 20X1 is 10 million barrels
- Recoverable operating costs in 20X1 are CU25 million
- The average oil price in 20X1 is CU100/barrel (this amount is used to convert any amount calculated in monetary units i.e., CU, back into volumetric units i.e., barrels of oil)
- During 20X1 average production exceeded 25,000 barrels per day for the first time
- Unrecovered exploration costs at the beginning of 20X1 were CU180 million
- Unrecovered development costs at the beginning of 20X1 were CU275 million

		Barrels	Contractor (49%)	NOC (51%)	Government
			bbls	bbls	bbls
Production in 20X1	a	10,000,000			
Royalty 15% of 10,000,000 =	b	1,500,000			1,500,000
Severance tax 10,000,000 × CU2.50 ÷ CU100 =	c	250,000			250,000
Cost oil					
Operating costs CU25,000,000 ÷ CU100 =	d	250,000	122,500	127,500	
Exploration cost CU180,000,000 ÷ CU100 =	e	1,800,000	1,800,000		
Development cost CU275,000,000 ÷ CU100, but capped at 2,450,000 (i.e., g - d - e)	f	2,450,000	1,200,500	1,249,500	
Total cost oil 45% of 10,000,000 =	g	4,500,000			
Production bonus CU5,000,000 ÷ CU100 =	h	50,000			50,000
Profit oil: a - b - c - g - h =	i	3,700,000			
Government profit oil 10% of 3,700,000 =	j	370,000			370,000
Working interest in profit oil 3,700,000 - 370,000 =	k	3,330,000	1,631,700	1,698,300	
Total: (b + c + g + h + i) =		10,000,000	4,754,700	3,075,300	2,170,000
Unrecovered development costs CU275,000,000 - (2,450,000 × CU100) =		CU30,000,000	CU14,700,000	CU15,300,000	

The above example illustrates not only that calculating an entity's share in the production of the current period requires a detailed knowledge of the PSC's provisions, but also that calculating the contractor's share of the remaining reserves requires a number of assumptions.

The reserves and production that the parties are entitled to varies depending on the oil price. Had the average oil price in 20X1 been CU50/barrel the parties' entitlements would have been as follows: Contractor 5,540,400 barrels, NOC 2,019,600 barrels and Government 2,440,000 barrels. The quantity of reserves and production attributable to each of the parties often reacts to changes in oil prices in ways that, at first, might seem counterintuitive.

It is important to note that the type and nature of contracts emerging continue to evolve. New contracts have some attributes of PSCs but do differ from the traditional PSC. We discuss these in more detail in section 5.5 below.

5.4 Pure-service contracts

A pure-service contract is an agreement between a contractor and a host government that typically covers a defined technical service to be provided or completed during a specific period of time. The service company investment is typically limited to the value of equipment, tools, and personnel used to perform the service. In most cases, the service contractor's reimbursement is fixed by the terms of the contract with little exposure to either project performance or market factors. Payment for services is normally based on daily or hourly rates, a fixed turnkey rate, or some other specified amount. Payments may be made at specified intervals or at the completion of the service. Payments, in some cases, may be tied to the field performance, operating cost reductions, or other important metrics.

The risks of the service company under this type of contract are usually limited to non-recoverable cost overruns, losses owing to client breach of contract, default, or contractual dispute. Such a contract is generally considered to be a services contract that gives rise to revenue from the rendering of services and not income from the production of mineral. Therefore, the minerals produced are not included in the normal reserve disclosures of the contractor,[94] and the contractor bears no risk if reserves are not found. It is worth noting that such contracts do need to be assessed to determine whether the arrangement contains a lease in accordance with the requirements of IFRS 16. See section 17.1 below for more information. As noted above with respect to PSCs, the type and nature of contracts continue to evolve. These new contracts also have some attributes of services contracts but do differ from pure-service contracts. We discuss these in more detail in section 5.5 below.

5.5 Evolving contractual arrangements

The type and nature of contracts emerging has and continues to evolve. New contracts have some attributes of PSCs but do differ from the traditional PSC. As these contractual arrangements continue to evolve, determining the accounting implications of these contracts becomes increasingly complex. This not only has an impact on the accounting for such contracts but also on whether, and the extent to which, the contractor entity is able to recognise reserves in relation to its interests in mineral volumes arising from these contracts.

Each contractual arrangement needs to be analysed carefully to determine whether reserves recognition in relation to these contractual interests in mineral volumes is appropriate. Such an analysis would include, at a minimum:

- The extent of risk to which the contractor party is exposed, including exploration and/or development risk
- The structure of the contractor's reimbursement arrangements and whether it is subject to performance/reservoir risk or price risk
- The ability for the contractor to take product in-kind, rather than a cash reimbursement only

Other facts and circumstances may also be relevant in reaching the final assessment. Given the varying terms and conditions that exist within these contracts and the fact that they are continuing to change/evolve, each contract will need to be individually analysed and assessed in detail.

94 IASC Issues Paper, 12.68.

5.5.1 Risk service contracts

An example of a contractual arrangement that has continued to evolve is a risk service contract (RSC). Unlike pure-service contracts, under an RSC (also called risked service agreement or at-risk service contract), a fee is not certain: an entity (contractor) agrees to explore for, develop, and produce minerals on behalf of a host government, but the contractor is at risk for the amount spent on exploration and development costs. That is, if no minerals are found in commercial quantities, no fee is paid.[95] Although an RSC does not result in the contractor's ownership of the minerals in place, the contractor may be at risk for the costs of exploration and may have economic interest in those minerals. the IASC Issues Paper noted that in the case of RSCs:[96]

- The fee may be payable in cash or in minerals produced.
- The contract may call for the contractor to bear all or part of the costs of exploration that are usually recoverable, in whole or in part, from production. If there is no production, there is no recovery.
- The contract may also give the contractor the right to purchase part of the minerals produced.

As noted in Practical example 5-1 above from TotalEnergies SE' financial statements, RSCs are similar to PSCs in a number of respects. Although the precise form and content of an RSC may vary, the following features are common:

(a) The repayment of expenses and the compensation for services are established on a monetary basis.

(b) An RSC is for a limited period, after which the government or national oil company will take over operations.

(c) Under an RSC, the contractor does not obtain ownership of the mineral reserves or production.

(d) The contractor is normally required to carry out a minimum amount of work in providing the contracted services.

(e) The fee that is payable to the contractor covers its capital expenditure, operating costs and an agreed-upon profit margin.

(f) Ownership of the assets used under the contract passes to the government when the contractor has been reimbursed for its costs.

The SPE's *Guidelines for the Evaluation of Petroleum Reserves and Resources* notes in connection with RSCs that "under the existing regulations, it may be more difficult for the contractor to justify reserves recognition, and special care must be taken in drafting the agreement. If regulations are satisfied, reserves equivalent to the value of the cost-recovery-plus-revenue-profit split are normally reported by the contractor".[97]

The nature and terms and conditions of these RSCs continue to change over time. Therefore, each contract will need to be analysed in detail to determine how it should be accounted for.

5.6 Joint operating agreements

When several entities are jointly involved in an arrangement (e.g., joint ownership of a property, production sharing contract or concession), they will need to enter into some form of joint operating agreement (JOA). A JOA is a contract between two or more parties to a joint arrangement that sets out the rights and obligations to operate the property. Typically, a JOA designates one of the working interest owners as the operator and it governs the operations and sharing of costs between parties. A JOA does not override, but instead builds upon, the contracts that are already in place (such as production sharing contracts). In fact, many production sharing contracts require the execution of a JOA between the parties.

A JOA may give rise to a joint arrangement under IFRS 11 *Joint Arrangements* if certain criteria are met. This is discussed in more detail in section 7.1 below.

95 IASC Issues Paper, 12.69.

96 IASC Issues Paper, 2.23.

97 Guidelines for the Evaluation of Petroleum Reserves and Resources - A Supplement to the SPE/WPC Petroleum Reserves Definitions and the SPE/WPC/AAPG Petroleum Resources Definitions, Society of Petroleum Engineers, 2001, p.120.

5.7 Different types of royalty interests

Mining entities and oil and gas entities frequently enter into royalty arrangements with owners of mineral rights (e.g., governments or private land-owners). These royalties are often payable upon the extraction and/or sale of minerals. The royalty payments may be based on a specified rate per unit of the commodity (e.g., tonne or barrel) or the entity may be obliged to dispose of all of the relevant production and pay over a specified proportion of the aggregate proceeds of sale, often after deduction of certain extraction costs.

There are also other types of arrangements, which may be referred to as royalty payments/arrangements, but may potentially represent a different type of arrangement. Under these arrangements, the royalty holder may have retained (or obtained) a more direct interest in the underlying production and may undertake mineral extraction and sale arrangements independently. We discuss these further below.

5.7.1 Working interest and basic royalties

As discussed in section 5.1 above, under a mineral lease, the owner/lessor of the mineral rights retains a *basic royalty* interest (or non-operating interest), which entitles it to a specified percentage of the mineral produced, while the lessee obtains a *working interest* (or operating interest) under the mineral lease, which entitles it to explore for, develop, and produce minerals from the property.

If the owner of a working interest cannot fund or does not wish to bear the risk of exploration, development or production from the property, it may be able to - if this is permitted by the underlying lease - sell the working interest or to create new types of interest out of its existing working interest. By creating new types of non-operating interests, the working interest owner is able to raise financing and spread the risk of the development. The original working interest holder may either:

- Retain the non-operating interest and transfer the working interest (i.e., the rights and obligations for exploring, developing and operating the property)
- Carve out and transfer a new non-operating interest to another party, while retaining the working interest

The following non-operating interests are commonly created in practice:[98]

- Overriding royalties (see section 5.7.2 below)
- Production payment royalties (see section 5.7.3 below)
- Net profits interests (see section 5.7.4 below)

5.7.2 Overriding royalties

An *overriding royalty* is very similar to a basic royalty, except that the former is created out of the operating interest and if the operating interest expires, the overriding royalty also expires.[99] An overriding royalty owner bears only its share of production taxes and sometimes the costs incurred to get the product into a saleable condition.

5.7.3 Production payment royalties

A *production payment royalty* is the right to recover a specified amount of cash or a specified quantity of minerals, out of the working interest's share of gross production. For example, the working interest holder may assign a production payment royalty to another party for CU12 million, in exchange for a repayment of CU15 million plus 12% interest out of the first 65% of the working interest holder's share of production. Production payments that are specified as a quantity of minerals are often called volumetric production payments or VPPs.

5.7.4 Net profits interests

A *net profits interest* is similar to an overriding royalty. However, the amount to be received by the royalty owner is a share of the net proceeds from production (as defined in the contract) that is paid solely from the working interest owner's share. The owner of a net profits interest is not liable for any expenses.

98 D. R. Jennings, J. B. Feiten and H. R. Brock, Petroleum Accounting, Principles, Procedures, & Issues, 5th edition, Professional Development Institute, Denton (Texas), pp.165-169.

99 IASC Issues Paper, 12.9.

5.7.5 Revenue and royalties: gross or net?

Many mineral leases, concession agreements and production sharing contracts require the payment of a royalty to the original owner of the mineral reserves or the government. The accounting treatment for government and other royalties payable has historically been diverse, as it has not been entirely clear whether revenue should be presented net of royalty payments or not. Historically, many entities have presented revenue net of those royalties that are paid in kind. This was on the basis that the entity had no legal right to the royalty product and hence, never received any inflow of economic benefits from those volumes. However, when the entity is required to sell the physical product in the market and remit the net proceeds (after deduction of certain costs incurred) to the royalty holder, the entity could be considered to have control of those volumes to such an extent that it was appropriate to present revenue on a gross basis and include the royalty payment within cost of sales or taxes (depending on how the royalty is calculated). See section 12.11.2 below for further discussion.

Practical examples 5-2 and 5-3 below, from the financial statements of Barrick Gold Corporation and BHP Group Limited respectively, illustrate typical accounting policies for royalties under IFRS.

Practical example 5-2: Barrick Gold Corporation (2022) — **United Kingdom**

Barrick Annual Report 2022 [extract]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS [extract]

2. MATERIAL ACCOUNTING POLICY INFORMATION [extract]

k) Royalties

Certain of our properties are subject to royalty arrangements based on mineral production at the properties. The primary type of royalty is a net smelter return ("NSR") royalty. Under this type of royalty we pay the holder an amount calculated as the royalty percentage multiplied by the value of gold production at market gold prices less third-party smelting, refining and transportation costs. Royalty expense is recorded on completion of the production or sales process in cost of sales. Other types of royalties include:

- Net profits interest ("NPI") royalty to a party other than a government,
- Modified NSR royalty,
- Net smelter return sliding scale ("NSRSS") royalty,
- Gross proceeds sliding scale ("GPSS") royalty,
- Gross smelter return ("GSR") royalty,
- Net value ("NV") royalty,
- Land tenement ("LT") royalty, and a
- Gold revenue royalty.

Practical example 5-3: BHP Group Limited (2022) — **Australia**

Annual Report 2022 [extract]

1.6 Notes to the Financial Statements [extract]

Performance [extract]

6 Income tax expense [extract]

Recognition and measurement [extract]

Royalty-related taxation

Royalties are treated as taxation arrangements (impacting income tax expense/(benefit)) when they are imposed under government authority and the amount payable is calculated by reference to revenue derived (net of any allowable deductions) after adjustment for temporary differences. Obligations arising from royalty arrangements that do not satisfy these criteria are recognised as current liabilities and included in expenses.

Practical example 5-4 below, from the financial statements of Equinor ASA, illustrates some of the complications that may arise in determining revenue when an entity sells product on behalf of the government.

Practical example 5-4: Equinor ASA (2022) **Norway**

Annual report and Form 20-F [extract]

Notes to the Consolidated financial statements [extract]

7 Total revenues and other income [extract]

Transactions with the Norwegian State

Equinor markets and sells the Norwegian State's share of oil and gas production from the Norwegian continental shelf (NCS). The Norwegian State's participation in petroleum activities is organised through the SDFI (the Norwegian State's Direct Financial Interests). All purchases and sales of the SDFI's oil production are classified as purchases [net of inventory variation] and revenues from contracts with customers, respectively.

Equinor sells, in its own name, but for the SDFI's account and risk, the SDFI's production of natural gas. These gas sales and related expenditures refunded by the SDFI are presented net in the Consolidated financial statements. Natural gas sales made in the name of Equinor's subsidiaries are also presented net of the SDFI's share in the Consolidated statement of income, but this activity is reflected gross in the Consolidated balance sheet.

Accounting judgement related to transactions with the Norwegian State

Whether to account for the transactions gross or net involves the use of significant accounting judgement. In making the judgement, Equinor has considered whether it controls the State-originated crude oil volumes prior to onwards sales to third party customers. Equinor directs the use of the volumes, and although certain benefits from the sales subsequently flow to the SDFI, Equinor purchases the crude oil volumes from the SDFI and obtains substantially all the remaining benefits. On that basis, Equinor has concluded that it acts as principal in these sales.

Regarding gas sales, Equinor concluded that ownership of the gas had not been transferred from the SDFI to Equinor. Although Equinor has been granted the ability to direct the use of the volumes, all the benefits from the sales of these volumes flow to the SDFI. On that basis, Equinor is not considered the principal in the sale of the SDFI's natural gas volumes.

Reference is made to note 27 Related parties for detailed financial information regarding transactions performed between Equinor and SDFI.

...

The SPE-PRMS (see section 2.2 above) notes that "...royalty quantities must be deducted from the lessee's entitlement to resources so that only the net revenue interest quantities are recognized". In some agreements, production taxes imposed by the host government may be referred to as royalties. These payment obligations are expressed in monetary terms and are typically linked to production rates, quantities produced cost recovery, the value of production (price sensitive), or the profits derived from it. These payments are not associated with an interest retained by the lessor/host. Thus, such payment obligations are effectively a production tax instead of a royalty. In such cases, the production and underlying resources are controlled by the lessee/contractor who may (subject to contractual terms and/or regulatory guidance) elect to report these obligations as a tax without a corresponding reduction in lessor/contractor's entitlement.[100]

100 SPE-PRMS, pp.23-24.

6 Risk-sharing arrangements

As discussed in section 1.1 above, the high costs and high risks in the extractive industries often lead entities to enter risk-sharing arrangements. The following types of risk-sharing arrangements are discussed in this chapter:

- Carried interests (see section 6.1 below)
- Farm-ins and farm-outs (see section 6.2 below)
- Asset swaps (see section 6.3 below)
- Unitisations (see section 15.4.1 below)
- Investments in subsidiaries, joint arrangements and associates (see section 7 below)
- Production sharing contracts (see section 5.3 above), which result in a degree of risk sharing with local governments
- Risk service contracts (see section 5.5.1 above)

6.1 Carried interests

Carried interests often arise when a party in an arrangement is either unable or unwilling to bear the risk of exploration or is unable or unwilling to fund its share of the cost of exploration or development. A carried interest is an agreement under which one party (the carrying party) agrees to pay for a portion or all of the pre-production costs of another party (the carried party) on a licence in which both own a portion of the working interest.[101] In effect, commercially, the carried party is trading a share of any production to which it is entitled in the future in exchange for the carrying party funding one or more phases of the project. In other words, the parties create a new interest out of an existing working interest. If the project is unsuccessful then the carrying party will not be reimbursed for the costs that it has incurred on behalf of the carried party. If the project is successful then the carrying party will be reimbursed either in cash out of proceeds of the share of production attributable to the carried party, or by receiving a disproportionately high share of the production until the carried costs have been recovered.[102]

6.1.1 Types of carried interest arrangements

Carried interest arrangements tend to fall into one of the following two categories:

- *Financing-type arrangements* - the carrying party provides funding to the carried party and receives a lender's return on the funds provided, while the right to additional production acts as a security that underpins the arrangement.
- *Purchase/sale-type arrangement* - the carried party effectively sells an interest or a partial interest in a project to the carrying party. The carrying party will be required to fund the project in exchange for an increased share of any proceeds if the project succeeds, while the carried party retains a reduced share of any proceeds.

In practice, however, it is not always easy to determine in which category a particular carried interest arrangement falls, as shown in the Illustration below.

Illustration 6-1: Carried interests

Scenario 1

The carrying party has proposed a CU10 million project, which has a very high chance of succeeding. The carried party, which is unable to fund its share of the project, agrees that the carrying party is entitled to recover its cost plus 7% interest by giving it a disproportionately high share of the production. If the production from this project is insufficient to repay the initial investment, the carried party should reimburse the carrying party out of its share of production from other fields within the same licence.

Scenario 2

The carrying party has proposed a project that may cost up to CU6 million, the outcome of which is uncertain. The carried party, which is unwilling to participate in the project, agrees that the carrying party is entitled to all production from the project until it has recovered three times its initial investment.

101 Former Oil Industry Association Committee Statement of Recommended Practice Accounting for Oil and Gas Exploration, Development, Production and Decommissioning Activities (July 2001) 'Former OIAC SORP' 149.

102 Former OIAC SORP 150.

Scenario 3

The carrying party has proposed a project that may cost up to CU5 million, which has a good chance of succeeding. The carrying party has a 60% interest in the licence and the carried party holds the remaining 40%. The carried party, which is unable to fund its share of the project, agrees that the carrying party is entitled to an additional 25% of the production until the carrying party has recovered its costs plus a 20% return.

When entering into a carried interest arrangement, an entity must assess whether the arrangement is a financing-type arrangement or purchase/sale-type arrangement. Some of the indicators that a carried interest arrangement should be accounted for as a financing-type arrangement are that:

- The carried party is unable to fund its share of the project.
- The risks associated with the development are not significant, i.e., financing-type arrangements will be more common in the development stage.
- The carrying party receives a return that is comparable to a lender's rate of return.

Indicators that a carried interest arrangement should be treated as a purchase/sale-type arrangement include:

- The carrying party and carried party have genuinely different opinions about the chances of success of the project, and the carried party could fund its share of the project if it wanted to.
- There are significant uncertainties about the outcome of the project. Purchase/sale-type arrangements are therefore more common in the E&E phase.
- The arrangement gives the carrying party voting rights in the project.
- There are significant uncertainties about the costs of the project, perhaps because it involves use of a new technology or approach.
- The carrying party could lose all of its investment or possibly earn a return significantly in excess of a lender's rate of return.
- The carrying party can only recover its investment from the project that is subject to the arrangement and there is no recourse to other assets or interests of the carried party.

In Illustration 6-1 above, scenario 1 has the characteristics of a financing-type arrangement, while scenario 2 has those of a purchase/sale-type arrangement. However, when an arrangement (such as scenario 3) has financing-type and purchase/sale-type characteristics (e.g., as a result of the relative bargaining strength of the parties), an entity will need to analyse the arrangement carefully and exercise judgement in developing an appropriate accounting policy.

The following types of carried interest arrangements are discussed below:

- Carried interest arrangements in the E&E phase (see section 6.1.2 below)
- Financing-type carried interest arrangements in the development phase (see section 6.1.3 below)
- Purchase/sale-type carried interest arrangements in the development phase (see section 6.1.4 below)

6.1.2 Carried interest arrangements in the E&E phase

While IFRS 6 should be applied to accounting for E&E expenditures, the standard does not address other aspects of accounting by entities engaged in the exploration for and evaluation of mineral resources. *[IFRS 6.4]*. That leaves unanswered the question of whether carried interest arrangements can ever fall within the scope of IFRS 6.

In the case of a purchase/sale-type carried interest arrangement the transaction, at least in economic terms, leads to the acquisition of an E&E asset by the carrying party and a disposal by the carried party.

On the other hand, a finance-type carried interest arrangement (which is generally not as common in the E&E phase) that has no significant impact on the risks and rewards that an entity derives from the underlying E&E working interest, may be more akin to a funding arrangement.

How we see it

We believe that given the nature of purchase/sale-type carried interest arrangements in the E&E phase, these would fall within the scope of IFRS 6.

For finance-type carried interest arrangements, as IFRS 6 deals only with accounting for E&E expenditures and assets, it is a matter of judgement whether or not the accounting for these is considered to be outside the scope of IFRS 6.

For purchase/sale-type carried interest arrangements in the E&E phase, we believe that an entity has two options: either to develop an accounting policy under IAS 8 as discussed in section 6.1.4 below, or, on transition to IFRS or first application under IFRS, to develop an accounting policy under IFRS 6 that is based on a previous national GAAP that contains such guidance.

In practice this usually means that:

- The carrying party accounts for its expenditures under a carried interest arrangement in the same way as directly incurred E&E expenditure (see sections 3.2 and 3.3 above).
- The carried party would not record expenditure incurred by the carrying party on its behalf subsequent to the arrangement commencing. However, the carried party may need to recognise a loss when the terms of the transaction indicate that the existing carrying value of the asset is impaired.

If a finance-type carried interest arrangement is considered to be outside the scope of IFRS 6, it might be appropriate to account for it in the same way as finance-type carried interest arrangements that relate to projects that are not in the E&E phase (see section 6.1.3 below).

6.1.3 Financing-type carried interest arrangements in the development phase

As financing-type carried interest arrangements do not result in the transfer of the economic risks and rewards of the underlying working interest between parties, such arrangements are not accounted for as a sale (purchase) by the carried party (carrying party). Instead, these arrangements are in effect secured borrowings in which the underlying asset is used as collateral that provides an identifiable stream of cash flows.

These arrangements are most appropriately accounted for as giving rise to a financial asset for the carrying party and a financial liability for the carried party.

The carried party will continue to recognise the expenditure incurred in relation to its full share of the working interest prior to the execution of the carried interest arrangement, and a corresponding financial liability for the amount that it is expected to reimburse to the carrying party as the pre-production costs being met by the carrying party are incurred, irrespective of whether it is a non-recourse arrangement or not. Under IFRS 9 *Financial Instruments*, any financial liability would likely be measured at amortised cost unless it meets the definition of a derivative or is designated at fair value through profit or loss. See Chapter 44 at section 2 for more information. As a financial liability measured at amortised cost, under IFRS 9, the carried party should accrete interest on the liability and reduce the loan to the extent the carrying party recovers its costs. It should be noted, however, that the application of the effective interest rate method under IFRS 9 requires adjustment of the carrying amount when the entity revises its estimates of the payments to be made. *[IFRS 9.B5.4.6]*.

Conversely the carrying party should recognise a financial asset for the amount that it expects to recover as a reimbursement as the pre-production costs (which are being met by the carrying party) are incurred. Under IFRS 9, an entity would need to determine the classification of the financial asset based on an assessment of the entity's business model for managing financial assets and the contractual cash flow characteristics of the financial asset. See Chapter 44 at section 1 for more information. Where the entity expects to recover all of its investment (so it is considered a debt instrument and not an equity instrument), the terms are solely payments of principal and interest and its business model is to hold the investment in order to collect contractual cash flows, the financial asset will be carried at amortised cost. This could be the case in financing-type carried interest arrangements. Where there is exposure to other factors, e.g., uncertainty about recovery and the exposure is through something other than principal and interest, the financial asset could have to be carried at fair value through profit or loss.

This approach to accounting for carried interest arrangements might not be appropriate if there were more than an insignificant transfer of risk (without necessarily resulting in a purchase/sale-type carried interest arrangement). The transfer of risk would suggest that:

- The carried party should recognise a provision under IAS 37 rather than a liability under IAS 32 *Financial Instruments: Presentation* and IFRS 9. Any financial liability would likely be measured at amortised cost unless it meets the definition of a derivative or was designated at fair value through profit or loss. See Chapter 44 at section 2 for more information.
- The carrying party should account for its right to receive reimbursement as a financial asset at fair value through profit or loss under IFRS 9 or a reimbursement right under IAS 37.

6.1.4 Purchase/sale-type carried interest arrangements in the development phase

The accounting suggested in this section for the carried party is the same as that set out in paragraph 155 of the former OIAC SORP. It stated that the disposal should be accounted for in accordance with the entity's normal accounting policy.

Historically, some entities have accounted for these types of transactions on a cash basis, i.e., the carried party does nothing and the carrying party accounts for its actual cash outlays. It is hard to see how this can be justified under IFRS accounting standards.

In purchase/sale-type carried interest arrangements, the carried party effectively sells part of its interest in a project to the carrying party. For example, the carried party could sell part of its interest in the mineral reserves to the carrying party which, in exchange, is obliged to fund the remaining costs of developing the field. Consequently, the arrangement has two elements, the purchase/sale of mineral reserves and the funding of developments costs, which should be accounted for in accordance with their substance. Therefore, the carried party should:

- Derecognise the part of the asset that it has sold to the carrying party, consistent with the derecognition principles of IAS 16 or IAS 38. *[IAS 16.67, IAS 38.112]*. Determining the amount to be derecognised could require a considerable amount of judgement depending on how the interest sold is defined.
- Recognise the consideration received or receivable from the carrying party.
- Recognise a gain or loss on the transaction for the difference between the net disposal proceeds and the carrying amount of the asset disposed of. Recognition of a gain would be appropriate only when the value of the consideration can be determined reliably. If not, then the carried party should account for the consideration received as a reduction in the carrying amount of the underlying assets. See section 12.6.1.A below and Chapter 28 for discussion of how IFRS 15 *Revenue from Contracts with Customers* could impact such calculations.

  And
- Test the retained interest for impairment if the terms of the arrangement indicate that the retained interest may be impaired.

In accounting for its purchase, the carrying party should:

- Recognise an asset that represents the underlying (partially) undeveloped interest acquired at cost in accordance with the principles of IAS 16 or IAS 38. *[IAS 16.15, IAS 38.21]*. Cost is defined in these standards as "the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs". *[IAS 16.6, IAS 38.8]*.

  And
- Recognise a liability for the obligation to make defined payments on behalf of the carried party, which relate to the carried party's share of future investments.

The application of this approach is shown in Illustration 6-2 below.

Illustration 6-2: Carried interests

An oil and gas company is developing an oil field. Assume that the company did not capitalise any E&E costs in relation to the field, but that by 1 January 20X2 it had capitalised CU250 million of costs in relation to the construction of property, plant and equipment. To complete the development of the oil field and bring it to production a further investment in property, plant and equipment of CU350 million is required in the first half of 20X2.

At 1 January 20X2, the oil and gas company (the carried party) enters into a purchase/sale-type carried interest arrangement with a carrying party, which will fund the entire CU350 million required for the further development of the field. Upon entering into the carried interest arrangement, the carried party's entitlement to oil is expected to be reduced from 15,000,000 barrels of oil to 9,000,000 barrels of oil, i.e., its interest in the oil field and the related property, plant and equipment has been reduced to 60% (9,000,000 ÷ 15,000,000). In practice, calculating the portion of the interest sold may require a considerable amount of judgement (e.g., in scenario 2 in Illustration 6-1 above it would not be straightforward to calculate the portion of the interest sold).

Both parties believe that the fair value of the oil field and related property, plant and equipment will be CU1 billion once the remaining investment of CU350 million has been made. Consequently, the fair value of the oil field and related property, plant and equipment at 1 January 20X2 is CU650 million (CU1 billion - CU350 million).

The fair value of the interest acquired (which comprises a portion of the oil field and a portion of the related property, plant and equipment) by the carrying party is CU260 million (40% × CU650 million). In exchange for its interest, the carrying party will pay CU50 million in cash and undertakes to pay the remaining investments related to the carried party's interest.

The carried party accounts for the transaction as follows:

Dr	Cash received from the carrying party		CU50	
Dr	Capital calls to be paid by the carrying party (60% × CU350 million) †		CU210	
	Cr	Property, plant and equipment (40% × CU250 million)		CU100
	Cr	Gain on sale (40% × (CU650 million - CU250 million))		CU160

† *The carried party has obtained the commitment from the carrying party to make certain payments on its behalf.*

If the carried party had recognised a loss on the interest sold, it would need to perform an impairment test on the interest retained.

The carrying party accounts for the transaction as follows:

Dr	Assets acquired (CU50 million + CU210 million) †		CU260	
	Cr	Cash paid to the carried party		CU50
	Cr	Capital calls payable on behalf of the carried party (60% × CU350 million)‡		CU210

† *As discussed above, the cost of property, plant and equipment is defined as the fair value of the consideration. In an arm's length transaction, the fair value of property, plant and equipment acquired is normally equal to the fair value of the consideration paid. The fair value of the portion of the oil field and the portion of the related property, plant and equipment acquired is (40% × CU650 million) CU260 million.*

‡ *The carrying party has assumed a liability to make these payments on behalf of the carried party. The carrying party will also be required to pay (40% × CU350 million) CU140 million for its own share of the future investments, but that amount is only recognised as a liability upon recognition of the related property, plant and equipment.*

The receivable recognised by the carried party and the corresponding liability recognised by the carrying party are reduced over the course of the construction of the assets to which they relate. The carrying party reduces the liability as it funds the carried party's share of the investment and the carried party recognises its share of the assets being constructed while reducing the balance of the receivable.

6.2 Farm-ins and farm-outs

A farm-out (from the viewpoint of the transferor) or a farm-in (from the viewpoint of the transferee) was defined in the former OIAC SORP as "the transfer of part of an oil and gas interest in consideration for an agreement by the transferee (farmee) to meet, absolutely, certain expenditure which would otherwise have to be undertaken by the owner (farmor)".[103] Farm-in transactions generally occur in the exploration or development phase and are characterised by the transferor (i.e., farmor) giving up future economic benefits, in the form of reserves, in exchange for a (generally) permanent reduction in future funding obligations.

Under a carried interest arrangement, the carried party transfers a portion of the risks and rewards of a property, in exchange for a funding commitment from the carrying party. Under a farm-in arrangement, the farmor transfers all the risks and rewards of a proportion (i.e., a straight percentage) of a property, in exchange for a commitment from the farmee to fund certain expenditures. Therefore, a farm-out represents the complete disposal of a proportion of a property and is similar to purchase/sale-type carried interest arrangements as discussed in section 6.1.4 above.

The following types of farm-in arrangements are separately discussed below:

- Farm-in arrangements in the E&E phase (see section 6.2.1 below)
- Farm-in arrangements outside the E&E phase (see section 6.2.2 below)

103 Former OIAC SORP 16.

6.2.1 Farm-in arrangements in the E&E phase

IFRS 6 deals only with accounting for E&E expenditures and does not address other aspects of accounting by entities engaged in the exploration for and evaluation of mineral resources. *[IFRS 6.4]*. That leaves open the question of whether farm-in arrangements can ever fall within the scope of IFRS 6.

How we see it

A farm-in arrangement leads to the acquisition of an E&E asset by the farmee and a disposal by the farmor. We believe that a farm-in arrangement would fall within the scope of IFRS 6. Hence an entity has two options: either to develop an accounting policy under IAS 8 as discussed in section 6.2.2 below or to develop an accounting policy under IFRS 6. In practice many entities use the second option and apply an accounting policy to farm-in arrangements that is based on a previous national GAAP. If an entity applies its previous GAAP accounting policy in respect of farm-in arrangements, we would expect the entity also to make the farm-in disclosures required by its previous GAAP.

Accounting policies for farm-in arrangements in the E&E phase that are based on an entity's previous national GAAP will often require that:

- The farmee recognises its expenditure under the arrangement in respect of its own interest and that retained by the farmor, as and when the costs are incurred. The farmee accounts for its expenditures under a farm-in arrangement in the same way as directly incurred E&E expenditure.
- The farmor accounts for the farm-out arrangement as follows:
  - The farmor does not record any expenditure made by the farmee on its behalf.
  - The farmor does not recognise a gain or loss on the farm-out arrangement, but rather redesignates any costs previously capitalised in relation to the whole interest as relating to the partial interest retained.

    And
  - Any cash consideration received is credited against costs previously capitalised in relation to the whole interest with any excess accounted for by the farmor as a gain on disposal.

While it may be unlikely an E&E asset would meet the definition of a business, an entity would still need to consider this for farm-ins in the E&E phase. See section 6.2.2.B below.

6.2.2 Farm-in arrangements outside the E&E phase: accounting by the farmee

A farm-in represents the complete acquisition of a proportion of a property. The accounting for such an arrangement will depend on whether the entity is farming into an asset or into an arrangement that is considered a business (and which is a joint operation), or whether the farm-in results in the arrangement becoming a joint operation. See Chapter 10 at section 3.2 for discussion of the definition of a business.

6.2.2.A Farming into an asset

Where a farmee farms into an asset, regardless of whether it is a joint operation or results in the formation of a joint operation, it should recognise an asset that represents the underlying (partially) undeveloped interest acquired at cost in accordance with IAS 16 or IAS 38, *[IAS 16.15, IAS 38.21]*, and recognise a liability that reflects obligations to fund the farmor's share of the future investment from which the farmee itself will not derive any future economic benefits.

Farm-in arrangements can be structured in numerous ways, some requiring payment of a fixed monetary amount while others are more flexible and state, for example, that capital expenditures over the next five years will be paid for by the farmee regardless of what those amounts may be.

How we see it

Accounting for farm-in arrangements depends on the nature of the transaction. In some cases, the liability may meet the definition of a financial liability under IAS 32 and therefore would be required to be accounted for in accordance with IFRS 9. In other scenarios, such as the latter example above, the liability may meet the definition of a provision under IAS 37 as the timing and amount of the liability are uncertain and a decision may need to be made on when a provision would need to be recognised.

The topic of variable and contingent consideration payments for an asset purchase was discussed by the IFRS IC between 2011 and 2016, and an agenda decision was published in March 2016. The IFRS IC determined that the issue was too broad for it to address within the confines of existing standards and recommended that the IASB address the accounting for variable payments comprehensively. However, at the time of writing this is not listed as an active research project on the IASB's work plan. See section 8.4.1 below for further discussion on accounting for variable and contingent consideration in an asset acquisition.

6.2.2.B Farming into a business which is a joint operation or results in the formation of a joint operation

Where a farmee farms into a project that is considered to be a business (as defined in IFRS 3) which is either a joint operation or results in the formation of a joint operation, historically there has been some diversity in how this was to be accounted for. Some have applied the business combination principles in IFRS 3 and other standards and some have applied the asset acquisition accounting principles (as discussed above in section 6.2.2.A).

This issue was resolved by the IASB issuing an amendment to IFRS 11 which was effective for annual reporting periods commencing on or after 1 January 2016. This amendment requires that where an entity acquires an interest in a joint operation which constitutes a business, the business combination accounting principles of IFRS 3 and other standards must be applied. See Chapter 10 at section 3.2 for discussion of the definition of a business.

See Chapter 13 at section 8.3.1 for further discussion on this issue. These requirements will include such interests acquired through a farm-in.

It is important to note that for the IFRS 11 amendment to mandatorily apply, the definition of a joint operation in accordance with IFRS 11 must be met, i.e., there must be joint control. Where there is joint control, the amendment applies to all entities party to the joint operation whether or not the entity is a party that has joint control. IFRS 11 specifies that: *[IFRS 11.23]*

Extract from IFRS 11

23 A party that participates in, but does not have joint control of, a joint operation shall also account for its interest in the arrangement in accordance with paragraphs 20-22 if that party has rights to the assets, and obligations for the liabilities, relating to the joint operation. If a party that participates in, but does not have joint control of, a joint operation does not have rights to the assets, and obligations for the liabilities, relating to that joint operation, it shall account for its interest in the joint operation in accordance with the IFRSs applicable to that interest.

How we see it

When it comes to accounting for the acquisition of an interest in an arrangement which does not meet the definition of a joint operation under IFRS 11, i.e., there is no joint control, there is no specific guidance as to how this is required to be accounted for. That is, it is not clear whether an entity can, or is required to, apply similar provisions to those applicable to acquiring an interest in a joint operation (discussed above). Until this is formally addressed, we do not consider IFRS 3 needs to be applied, and accounting for the transaction as an asset acquisition would be appropriate. However, whereby the underlying business meets the definition of a business and would be in scope of IFRS 3 if there was joint control, we would accept entities applying IFRS 3 as an accounting policy choice. In practice we see both approaches being applied and consider it important that there is adequate disclosure of the accounting policy adopted and judgements made.

6.2.3 Farm-in arrangements outside the E&E phase: accounting by the farmor

In accounting for a farm-in arrangement the farmor should:

- Derecognise the proportion of the asset that it has sold to the farmee, consistent with the principles of IAS 16 or IAS 38. *[IAS 16.67, IAS 38.112]*.
- Recognise the consideration received or receivable from the farmee, which represents the farmee's obligation to fund the capital expenditure in relation to the interest retained by the farmor.

- Recognise a gain or loss on the transaction for the difference between the net disposal proceeds and the carrying amount of the asset disposed of. *[IAS 16.71, IAS 38.113]*. Recognition of a gain would be appropriate only when the value of the consideration can be determined reliably. If not, then the carried party should account for the consideration received as a reduction in the carrying amount of the underlying assets.

  And

- Test the retained interest for impairment if the terms of the arrangement indicate that the retained interest may be impaired.

Under IAS 16, IAS 38 and IFRS 15, the amount of consideration to be included in the gain/loss arising from the derecognition of an item of property, plant and equipment or an intangible asset, and hence the receivable that is recognised, is determined in accordance with the requirements for determining the transaction price under IFRS 15. Subsequent changes to the estimated amount of the consideration included in the gain or loss calculation shall be accounted for in accordance with the requirements for changes in the transaction price in IFRS 15. *[IAS 16.72, IAS 38.116]*. See Chapter 28 at section 2.6.3 and Chapter 28 at section 5.9 for more information.

Any part of the consideration that is receivable in the form of cash will meet the definition of a financial asset under IAS 32, *[IAS 32.11]*, and should be accounted for in accordance with IFRS 9, either at amortised cost or fair value depending on the nature of the receivable or how the farmor designates the receivable. See Chapter 44 at section 1 for more information on classifying a financial asset under IFRS 9.

Practical example 6-1 below describes the farm-out transactions of Bowleven Plc.

Practical example 6-1: Bowleven Plc (2022) — United Kingdom

Annual Report and Accounts 2022 [extract]
Financial Statements [extract]
Notes forming part of the financial statements [extract]
8 Intangible exploration assets [extract]

Etinde Farm-Out in 2015

On 16 March 2015, the Group completed a farm-out of part of its interest in the Etinde asset to LUKOIL Overseas West Project Limited (LUKOIL) and New Age (African Global Energy) Limited (New Age). The operatorship of Etinde transferred to New Age on that date with Bowleven retaining a 25% non-operated interest. $165 million initial cash proceeds were received on 16 March 2015 along with a further $15 million on 30 September 2016. In accordance with the Company's then policy under IFRS 6 *'Exploration for and Evaluation of Mineral Assets'* the Group deducted the net proceeds received from the carrying value of intangible exploration assets in the prior years.

In addition to these cash payments, there was an amount of deferred consideration:
- up to $40 million (net) carry for two Etinde appraisal wells, including testing (or cash alternative in 2020); and
- $25 million cash contingent upon and to be received at Etinde development project FID.

The $40 million (maximum) net carry for the two Etinde appraisal wells was fully utilised in FY2018 and the deferred consideration balance recognised at that date was fully utilised.

The remaining $25 million is currently disclosed as a contingent asset (Note 20) and will be credited to intangible exploration assets once sufficient certainty on FID project sanction is achieved.

6.3 Asset swaps

Asset exchanges are transactions that have challenged standard-setters for a number of years. For example, an entity might swap certain intangible assets that it does not require or is no longer allowed to use for those of a counterparty that has other surplus assets. It is not uncommon for entities to exchange assets as part of their portfolio and risk management activities or simply to meet demands of competition authorities.

The key accounting issues that need to be addressed are:

- Whether such an exchange should give rise to a profit when the fair value of the asset received is greater than the carrying value of the asset given up
- Whether the exchange of similar assets should be recognised

In the extractive industries an exchange of assets could involve property, plant and equipment (PP&E), intangible assets, investment property or E&E assets, which are in the scope of IAS 16, IAS 38, IAS 40 and IFRS 6, respectively. Hence there are three possible types of exchanges (which will be discussed below), involving:

(a) Only E&E assets

(b) Only PP&E, intangible assets and/or investment property

(c) A combination of E&E assets, PP&E, intangible assets and/or investment property

6.3.1 E&E assets

Accounting for E&E assets, and therefore also accounting for swaps involving only E&E assets, falls within the scope of IFRS 6. *[IFRS 6.3]*. As that standard does not directly address accounting for asset swaps, it is necessary to consider its hierarchy of guidance in the selection of an accounting policy. IFRS 6 does not require an entity to look at other standards and interpretations that deal with similar issues, or the guidance in the IASB's *Conceptual Framework*. *[IFRS 6.7]*. Instead, it allows entities to develop their own accounting policies, or use the guidance issued by other standard-setters, thereby effectively allowing entities to continue using accounting policies that they applied under their previous national GAAP. Therefore, many entities, especially those which consider that they can never determine the fair value of E&E assets reliably, have selected an accounting policy under which they account for E&E assets obtained in a swap transaction at the carrying amount of the asset given up. An alternative approach, which is also permitted under IFRS 6, would be to apply an accounting policy that is based on the guidance in other standards as discussed below.

6.3.2 PP&E, intangible assets and investment property

Three separate international accounting standards contain virtually identical guidance on accounting for exchanges of assets: IAS 16, IAS 38 and IAS 40. These standards require the acquisition of PP&E, intangible assets or investment property, as the case may be, in exchange for non-monetary assets (or a combination of monetary and non-monetary assets) to be measured at fair value. The cost of the acquired asset is measured at fair value unless:

(a) The exchange transaction lacks 'commercial substance'.

Or

(b) The fair value of neither the asset received nor the asset given up is reliably measurable. *[IAS 16.24, IAS 38.45, IAS 40.27]*.

For more information, see Chapter 19 at section 4.4 (PP&E), Chapter 18 at section 4.7 (intangible assets) and Chapter 20 at section 4.6 (investment properties).

6.3.3 Exchanges of E&E assets for other types of assets

An entity that exchanges E&E assets for PP&E, intangible assets or investment property needs to apply an accounting treatment that meets the requirements of IFRS 6 and those of IAS 16, IAS 38 or IAS 40. There is no specific guidance in IFRS 6 relating to asset swaps therefore an entity will need to develop an accounting policy in accordance with the requirements of IAS 8 as permitted by IFRS 6. As discussed above, exchanges involving PP&E, intangible assets and investment property that have commercial substance must be accounted for at fair value. Since this treatment is also allowed under IFRS 6, an entity that exchanges E&E assets for assets within the scope of IAS 16, IAS 38 or IAS 40 could apply an accounting policy that complies with the guidance in those standards.

7 Investments in the extractive industries

Extractive industries are characterised by the high risks associated with the exploration for and development of mineral reserves and resources. To mitigate those risks, industry participants use a variety of ownership structures that are aimed at sharing risks, such as joint investments through subsidiaries, joint arrangements, associates or equity interests. IFRS accounting standards define a subsidiary, an associate and a joint arrangement as follows: *[IFRS 10 Appendix A, IAS 28.3]*

Extract from IFRS 10

Appendix A
Defined terms

subsidiary	An entity that is controlled by another entity.

Extract from IAS 28

3 **The following terms are used in this Standard with the meanings specified:**

An *associate* is an entity over which the investor has significant influence.

…

A *joint arrangement* is an arrangement of which two or more parties have joint control.

…

Sometimes entities in the extractive industries do not own 100% of their subsidiaries, and there can often be significant non-controlling shareholders that share in some of the risk and rewards. Accounting for non-controlling interests is discussed in detail in Chapter 8 at section 5. Furthermore, the existence of put and/or call options over non-controlling interests may transfer some of the risks between the parent entity and the non-controlling shareholders. This issue is discussed in detail in Chapter 8 at section 6.

- Joint arrangements are discussed further in section 7-1 below.
- Undivided interests - participations in projects which entitle the reporting entity only to a share of the production or use of an asset, and do not of themselves give the entity any form of control, joint control or significant influence (see section 7.2 below).
- Associates are discussed further in Chapter 12 a- section 2.
- Equity interests - entities over which the reporting entity cannot exercise any control, joint control or significant influence (see Chapters 44 and 45).

7.1 Joint arrangements

Joint arrangements have always been, and continue to be, a common structure in the extractive industries. Such arrangements are used to bring in partners to source new projects, combine adjacent mineral licences, improve utilisation of expensive infrastructure, attract investors and help manage technical or political risk or comply with local regulations. The majority of entities operating in the extractive industries are party to at least one joint arrangement. However, not all arrangements that are casually described as 'joint arrangements' or 'joint ventures' meet the definition of a joint arrangement under IFRS accounting standards.

Accounting for joint arrangements is governed by IFRS 11. Given the prevalence of joint arrangements in the extractive industries, careful analysis of IFRS 11, in conjunction with the requirements of IFRS 10 *Consolidated Financial Statements* (see Chapter 7), is required. Chapter 13 contains a full discussion on IFRS 11 and its requirements and therefore while some specific areas for extractives entities to consider are set out below, this section should be read in conjunction with that chapter.

We also discuss some issues relating to the acquisition of interests in joint operations (see section 8.3 below).

A joint arrangement in the scope of IFRS 11 is an arrangement over which two or more parties have joint control. *[IFRS 11.4]*. (See section 7.1.1 below for further discussion on the definition of joint control). Under IFRS 11, there are two- types of joint arrangements - 'joint operations' and 'joint ventures'. *[IFRS 11 Appendix A]*.

Extract from IFRS 11

Appendix A
Defined terms

joint operation	A **joint arrangement** whereby the parties that have **joint control** of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement
joint venture	A **joint arrangement** whereby the parties that have **joint control** of the arrangement have rights to the net assets of the arrangement

Classification between these two types of arrangements is based on the rights and obligations that arise from the contractual arrangement. An entity will need to have a detailed understanding of the specific rights and obligations of each of its arrangements to be able to determine the impact of this standard.

Subsequent to the issuance of IFRS 11, the IFRS IC discussed various implementation issues particularly when it came to classifying a joint arrangement that is structured through a separate vehicle. In March 2015, the IFRS IC issued an agenda decision dealing with a range of issues, including:

- How and why particular facts and circumstances create rights and obligations
- Implication of 'economic substance'
- Application of 'other facts and circumstances' to specific fact patterns:
  - Output sold at a market price
  - Financing from a third party
  - Nature of output (i.e., fungible or bespoke output)
  - Determining the basis for 'substantially all of the output'

This agenda decision includes a number of fact patterns which could be relevant for extractive industries, including (for example) the impact on agreements to purchase a joint arrangement's output. See Chapter 13 at sections 5.4.2 and 5.4.3 for further discussion.

7.1.1 Assessing joint control

Joint control is defined in IFRS 11 as: *[IFRS 11.7, IFRS 11 Appendix A]*

Extract from IFRS 11

Appendix A
Defined terms

joint control	The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

IFRS 11 describes the key aspects of joint control as follows:

- *Contractually agreed* - contractual arrangements are usually, but not always, written, and set out the terms of the arrangements. *[IFRS 11.5(a), IFRS 11.B2]*.
- *Control and relevant activities* - IFRS 10 describes how to assess whether a party has control, and how to identify the relevant activities, which are described in more detail in Chapter 7 at sections 3 and 4.1. Some of the aspects of 'relevant activities' and 'control' that are most relevant to extractives arrangements are discussed in sections 7.1.1.A and 7.1.2 below, respectively. *[IFRS 11.8, IFRS 11.B5]*.
- *Unanimous consent* - means that any party (with joint control) can prevent any of the other parties, or a group of the parties, from making unilateral decisions about the relevant activities without its consent. *[IFRS 11.B9]*. Joint control requires sharing of control or collective control by two or more parties. Some of the aspects of 'unanimous consent' for extractives arrangements are discussed in section 7.1.1.B below.

For more information on assessing joint control see Chapter 13 at section 4.

7.1.1.A Relevant activities

Relevant activities are those activities of the arrangement which significantly affect the returns of the arrangement. Determining what these are for each arrangement may require significant judgement.

Examples of decisions about relevant activities include, but are not limited to:

- "Establishing operating and capital decisions of the investee, including budgets" *[IFRS 10.B12(a)]* - for an arrangement in the extractive industries, this may include approving the operating and/or capital expenditure programme for the next year
- "Appointing and remunerating an investee's key management personnel or service providers and terminating their services or-employment" *[IFRS 10.B12(b)]* - for example, appointing a contract miner or oil field services provider to undertake operations

For more information on identifying relevant activities, see Chapter 7 at section 4.1 and Chapter 13 at section 4.1.

7.1.1.B Meaning of unanimous consent

Unanimous consent means that any party with joint control can prevent any of the other parties, or a group of parties, from making unilateral decisions about relevant activities.

For further discussion on unanimous consent, see Chapter 13 at section 4.3.

In some extractive industries operations, decision-making may vary over the life of the project, e.g., during the exploration and evaluation phase, the development phase or the production phase. For example, it may be agreed at the time of initially entering the contractual arrangement that during the exploration and evaluation phase, one party to the arrangement may be able to make all of the decisions, whereas once the project enters the development phase, decisions may then require unanimous consent.

How we see it

To determine whether the arrangement is jointly controlled, it will be necessary to decide (at the point of initially entering the contractual arrangement, and subsequently, if facts and circumstances change) which of these activities, e.g., exploration and evaluation and/or development, most significantly affect the returns of the arrangement. This is because the arrangement will only be considered to be a joint arrangement if those activities which require unanimous consent are the ones that most significantly affect the returns. This will be a highly judgemental assessment.

For further information on the impact of different decision-making arrangements over various activities, see Chapter 13 at section 4.1.

7.1.2 Determination of whether a manager/lead operator of a joint arrangement has control

It is common in the extractive industries for one of the parties to be appointed as the operator or manager of the joint arrangement. The manager is frequently referred to as the operator, but as IFRS 11 uses the terms 'joint operation' and 'joint operator' with specific meanings, to avoid confusion we refer to such a party as the manager/lead operator. The other parties to the arrangement could delegate some of the decision-making rights to this manager/lead operator. In many instances, it is considered that the manager/lead operator does not control the joint arrangement, but simply carries out the decisions of the parties under the joint venture (or operating) agreement (JOA), i.e., the manager/lead operator acts as an agent. This view is based on the way in which these roles are generally established and referred to, or perceived, in the industries. Under IFRS 11, consideration is given to whether the manager/lead operator actually controls the arrangement. This is because when decision-making rights have been delegated, IFRS 10 describes how to assess whether the decision-maker is acting as a principal or an agent, and therefore, which party (if any) has control.

Careful consideration of the following will be required:

- Scope of the manager's/lead operator's decision-making authority
- Rights held by others (e.g., protective rights and removal rights)
- Exposure to variability in returns through the remuneration of the manager/lead operator
- Variable returns held through other interests (e.g., direct investments by the manager/lead operator in the joint arrangement)

Of these factors, rights held by others and variable returns held through other interests will be particularly relevant for mining entities and oil and gas entities. Each of the above is discussed in Chapter 7 at section 6 in more detail.

It is important to note that assessing whether an entity is a principal or an agent will require consideration of all factors collectively. See Chapter 7 at section 6.1 for more details regarding the principal versus agent requirements.

Where it is determined that a manager is acting as a principal and therefore controls an arrangement, the impact of this will depend upon the rights and obligations conveyed by the arrangement (see sections 7.1.2.A and 7.1.2.B below for further discussion on this issue). Where it is determined that the manager/lead operator is acting as an agent, the manager/lead operator would only recognise its own interests in the joint arrangement (the accounting for which will depend upon whether it is a joint operation or joint venture) and its operator/management fee.

7.1.2.A Implications of controlling a joint operation

While the principal versus agent assessment could lead to a conclusion that a manager/lead operator has control, if the joint arrangement is a joint operation, and each party has specific rights to, and obligations for, the underlying assets and liabilities of the arrangement by virtue of the contract, then the manager/lead operator does not control anything over and above its own direct interest in those assets and liabilities. Therefore, it still only recognises its interest in those assets and liabilities conveyed to it by the contractual arrangement. This accounting applies regardless of whether the arrangement is in a separate vehicle or not, as the contractual terms are the primary determinant of the accounting. Note that IFRS 11 defines a separate vehicle as "a separately identifiable financial structure, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality". *[IFRS 11 Appendix A]*. To explain this further, it is worth considering the two types of joint arrangements contemplated by IFRS 11 - one that is not structured through a separate vehicle (e.g., a contract alone) and one that is structured through a separate vehicle.

No separate vehicle: Even if the manager/lead operator 'controlled' the arrangement, there is really nothing for it to control. This is because each party would continue to account for its rights and obligations arising from the contract, e.g., it would apply IAS 16 to account for its rights to any tangible assets, IAS 38 to account for its rights to any intangible assets or IFRS 9 to account for its obligations for any financial liabilities etc. Additionally, the consolidation requirements of IFRS 10 would not apply as they only apply to entities and, in most circumstances, a contract does not create an entity.

Separate vehicle: If a manager/lead operator controls an arrangement structured through a separate vehicle, e.g., a company or trust, one may consider that an entity would automatically look to IFRS 10 and consolidate the arrangement and account for the interests of the other parties as non-controlling interests. However, in such situations, a contract may exist which gives other parties to the arrangement direct rights to, and obligations for, the underlying assets and liabilities of that arrangement. Therefore, this requires consideration of the impact of such an arrangement on the separate financial statements of the joint operation.

Given this, the rights and obligations arising from the contractual arrangement should be accounted for first. That is, each party to the arrangement would be required to recognise its respective share of the assets and liabilities (applying each IFRS accounting standard as appropriate, e.g., IAS 16, IAS 38, IFRS 9 etc.).

To the extent that the parties to the arrangement have specific rights to the assets, or obligations for the liabilities, from the perspective of the separate vehicle, this means that the rights to, and obligations for, its assets and liabilities have been contracted out to other parties (i.e., the parties to the contractual arrangement) and therefore there may be no assets or liabilities remaining in the separate vehicle to recognise.

Consequently, from the perspective of the manager/lead operator of the joint arrangement, who may be considered to control the separate vehicle, it would initially account for its and other parties' rights and obligations arising from the contract. Then when it looks to consolidate the separate vehicle, there may be nothing left to consolidate, as the separate vehicle may effectively be empty. However, this would only apply where the separate vehicle was an entity as IFRS 10 only applies to entities.

How we see it

Where parties to an arrangement genuinely have contractual rights to, and obligations for, the underlying assets and liabilities of the arrangement, concluding that a manager/lead operator controls the arrangement does not change the accounting for either the manager/lead operator or the non-operator parties. However, the disclosure requirements would likely differ, since IFRS 12 *Disclosure of Interests in Other Entities* does not apply to joint arrangements in which a party does not have joint control, unless that party has significant influence.

The disclosure requirements of IFRS 12 are discussed in Chapter 14.

7.1.2.B Implications of controlling a joint venture

If a manager/lead operator has control of a joint venture which was structured through a separate vehicle which is considered to be an entity, the manager/lead operator would have to consolidate the separate vehicle and recognise any non-controlling interest(s). However, if the joint venture is structured through a separate vehicle that is not an entity, IFRS 10 would not apply, and the manager/lead operator would apply the relevant IFRS accounting standards.

7.1.3 Parties to a joint arrangement without joint control or control

The accounting treatment of an interest in a contractual arrangement that does not give rise to joint control or control depends on the rights and obligations of the party.

7.1.3.A Joint operations

In some cases, a mining company or oil and gas company may be involved in a joint operation, but it does not have joint control or control of that arrangement.

How we see it

If the joint arrangement is a joint operation (i.e., joint control exists between two or more parties), and the party has rights to the assets and obligations for the liabilities relating to that joint operation, it does not matter whether the party in question has control, joint control or not - the accounting is the same as that for a joint operation under IFRS 11.

This is similar to the situation discussed above in section 7.1.2.A and is discussed in more detail in Chapter 13 at section 6.4. *[IFRS 11.23]*. The critical aspect of this accounting is whether there is joint control by two or more parties within the arrangement (and therefore it is a joint operation in accordance with IFRS 11). However, the disclosure requirements would likely differ, since IFRS 12 does not apply to joint arrangements in which a party does not have joint control, unless that party has significant influence. The disclosure requirements of IFRS 12 are discussed in Chapter 14.

If the party does not have rights to the assets and obligations for the liabilities relating to the joint operation, it accounts for its interest in the joint operation in accordance with other applicable IFRS accounting standards. *[IFRS 11.23]*. For example, if it:

(a) Has significant influence over a separate vehicle which is an entity - apply IAS 28 *Investments in Associates and Joint Ventures*

(b) Has significant influence over a separate vehicle which is not an entity - apply other applicable IFRS accounting standards

(c) Does not have significant influence over a separate vehicle - account for that interest as a financial asset under IFRS 9

(d) Has an interest in an arrangement without a separate vehicle - apply other applicable IFRS accounting standards

7.1.3.B Joint ventures

In some cases, a mining company or oil and gas company could be involved in a joint venture, but it does not have joint control or control of that arrangement. In this instance it would account for its interest as follows:

(a) Significant influence over a separate vehicle which is an entity - still apply IAS 28, *[IFRS 11.25]*, however, there are some minor disclosure differences for an associate versus a joint venture as defined in IFRS 11 (see Chapter 14 at section 5).

(b) Significant influence over a separate vehicle which is not an entity - apply other applicable IFRS accounting standards.

(c) Does not have significant influence over a separate vehicle - account for that interest as a financial asset under IFRS 9 at fair value through profit or loss or other comprehensive income unless the investment was held for trading. See Chapter 44 at sections 1.2 and 3 for further information on IFRS 9. *[IFRS 11.25, IFRS 11.C14]*.

7.1.4 Managers/lead operators of joint arrangements

It is clear that a participant in a joint operation is required to recognise its rights to the assets, and its obligations for the liabilities (or share thereof), of the joint arrangement. Therefore, it is important that an entity fully understands what these rights and obligations are and how these may differ between the parties.

See section 7.1.2 above for a discussion of the principal versus agent assessment that needs to be considered when an entity is appointed as manager/lead operator of a joint arrangement and what impact that assessment might have on the manager's/lead operator's accounting.

7.1.4.A Reimbursements of costs

A manager/lead operator often carries out activities on behalf of the joint arrangement on a no gain, no loss basis. Generally, these activities can be identified separately and are carried out by the manager/lead operator in its capacity as an agent for the joint arrangement, which is effectively the principal in those transactions. The manager/lead operator receives reimbursement of direct costs recharged to the joint arrangement. Such recharges are reimbursements of costs that the manager/lead operator incurred as an agent for the joint arrangement and therefore, have no effect on profit or loss in the statement of comprehensive income (or income statement) of the manager/lead operator.

In many cases, a manager/lead operator also incurs certain general overhead and other expenses in carrying out activities on behalf of the joint arrangement. As these costs can often not be specifically identified, many joint operating agreements allow the manager/lead operator to recover the general overhead expenses incurred by charging an overhead fee that is based on a fixed percentage of the total costs incurred by the joint arrangement for the year. Although the purpose of this recharge is very similar to the reimbursement of direct costs, the manager/lead operator is not acting as an agent in this case. Therefore, the manager/lead operator would be required to recognise the general overhead expenses and the overhead fee in profit or loss in its statement of comprehensive income (or income statement) as an expense and income, respectively.

A specific example of this is where the manager/lead operator of a joint arrangement enters into a lease with a third-party supplier, who then carries out activities on behalf of the joint arrangement with the leased asset and is entitled to reimbursement from the non-operator parties. This is discussed further in section 18 below.

7.1.4.B Direct legal liability for costs incurred and contracts entered into

The manager/lead operator of a joint arrangement may have a direct legal liability to third party creditors in respect of the entire balance arising from transactions related to the joint arrangement, e.g., suppliers, lessors etc.[104] IFRS accounting standards prohibits the offsetting of such liabilities against the amounts recoverable from the other joint arrangement participants. *[IAS 1.32, IAS 32.42]*. The manager/lead operator may therefore need to recognise and/or disclose, for example, some of the leases or supply arrangements that it has entered into on behalf of the joint arrangement, as if it had entered into these in its own name. This is discussed further in section 18.1 below.

7.1.4.C Joint and several liability

It is also possible that there could be liabilities in the arrangement where the obligation is joint and several. That is, an entity is not only responsible for its proportionate share, but it is also liable for the other party's or parties' share(s) should it/they be unable or unwilling to pay. A common example of this in the extractives industries is restoration, rehabilitation and decommissioning obligations.

In these instances, each party not only takes up its proportionate share of the decommissioning/restoration obligation, they are also required to assess the likelihood that the other party(ies) will not be able or willing to meet their obligation for their share. The facts and circumstances would need to be assessed in each case, and any additional liability would be accounted for, and disclosed, in accordance with IAS 37.

Any increase in the provision would be accounted for under IFRIC 1, if it related to a restoration or decommissioning liability that had both been included as part of an asset measured in accordance with IAS 16 and measured as a liability in accordance with IAS 37 (see Chapter 27 at sections 6.3.1 and 6.3.2 for more details). Such an addition to the asset would also require an entity to consider whether this is an indication of impairment of the asset as a whole, and if so, would need to test for impairment in accordance with IAS 36. Increases that do not meet the requirements of IFRIC 1 would be recognised in profit or loss.

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7.1.5 Non-operators of joint arrangements

How we see it

For expenses and liabilities incurred by the manager/lead operator directly in its own name which it recharges to the non-operators, the non-operator entities would be required to recognise an amount payable to the operator for such amounts. Depending on the nature of these arrangements, these may need to be recognised as a financial instrument under IAS 32 and IFRS 9, as a lease under IFRS 16 (where a sublease exists between the lead operator and the joint arrangement), or potentially a provision under IAS 37, and not under the standard which relates to the type of cost being reimbursed.

For example, the non-operator's share of employee entitlements relating to the manager's employees who work on the joint project would not be recognised as an employee benefit under IAS 19 *Employee Benefits*. In addition, the related disclosure requirements of IAS 19 would not apply, instead the disclosure requirements of other standards, e.g., IFRS 7 *Financial Instruments: Disclosures* would apply.

Expenses and liabilities incurred by the manager/lead operator jointly on behalf of all of the parties to the arrangement would have to be recognised by each of the non-operator parties in proportion to their respective interests in the arrangement. Such amounts would be recognised for the costs incurred on an accruals basis for production costs, operating expenses etc. and associated 'joint venture payables' would be recognised. With respect to longer term arrangements, such as leases entered into by the lead operator on behalf of the joint arrangement, the non-operator parties would consider the broader contractual arrangements to determine whether or not there was a lease by the joint operation. This is discussed further in section 18.5.1 below.

7.2 Undivided interests

Undivided interests are usually subject to joint control (see Chapter 13 at section 4.4.1) and can, therefore, be accounted for as joint operations. However, some JOAs do not establish joint control but are, instead, based on some form of supermajority voting whereby a qualified majority (e.g., 75%) of the participants can approve decisions. This situation usually arises when the group of participants is too large for joint control to be demonstrable or when the main investor wants to retain a certain level of influence.

Where joint control does not exist, such undivided interests cannot be accounted for as joint operations in the scope of IFRS 11. Instead, the appropriate accounting treatment by the investor depends on the nature of the arrangement:

- If the investor has rights to the underlying assets then the arrangement would be required to be accounted for as a tangible or intangible asset under IAS 16 or IAS 38, respectively. The investor's proportionate share of the operating costs of the asset (e.g., repairs and maintenance) would be required to be accounted for in the same way as the operating costs of wholly owned assets.
- If the investor is entitled only to a proportion of the cash flows generated by the asset, then its investment will generally meet the definition of a financial asset under IAS 32. As the investor is exposed to risks other than just credit risk, such investments are unlikely be considered debt instruments and instead would be considered equity investments under IFRS 9. Equity instruments are normally measured at fair value through profit or loss under IFRS 9. *[IFRS 9.4.1.4]*. However, on initial recognition, an entity may make an irrevocable election (on an instrument-by-instrument basis) to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument within the scope of IFRS 9. See Chapter 44 at section 1 for a detailed analysis of the impact of IFRS 9 on the classification of this investment.

With respect to such undivided interests, entities also enter into arrangements in which they buy and sell parts of undivided assets, e.g., carried interests (see section 6.1 above) and farm-in arrangements outside the E&E phase (see sections 6.2.2 and 6.2.3 above).

How we see it

Although neither IAS 16 nor IAS 38 addresses part-disposals of undivided assets, it is industry practice to apply the principles in those standards when the vendor disposes of these interests in circumstances in which it can demonstrate that it neither controls nor jointly controls the whole of the original asset. In these circumstances, the principles of IAS 16 and IAS 38 are applied and the entity derecognises part of the asset, having calculated an appropriate carrying value for the part disposed of, and a gain or loss on disposal.

See Chapter 18 at section 9.5.1 and Chapter 19 at section 7.3.

8 Acquisitions

8.1 Business combinations versus asset acquisitions

When an entity acquires an asset or a group of assets, careful analysis is required to identify whether what is acquired constitutes a business or represents only an asset or group of assets. Accounting for business combinations is discussed in detail in Chapter 10.

8.1.1 Differences between asset purchase transactions and business combinations

The reason it is important to distinguish between an asset acquisition and a business combination is because the accounting consequences are significantly different. The main differences between accounting for an asset acquisition and a business combination can be summarised as follows:

- Goodwill or a bargain purchase (also sometimes referred to as negative goodwill) only arise in business combinations.
- Assets and liabilities are accounted for at fair value in a business combination, while they are assigned a carrying amount based on their relative fair values in an asset acquisition (see section 8.4 below).
- Transaction costs should be recognised as an expense under IFRS 3, but can be capitalised on an asset acquisition.
- In an asset acquisition, no deferred tax will arise in relation to acquired assets and assumed liabilities as the initial recognition exception for deferred tax under IAS 12 applies. See Chapter 29 at section 7.2 for further details. See Chapter 10 at section 2.2.2 where additional differences are discussed.

8.1.2 Definition of a business

IFRS 3 defines a business as: *[IFRS 3 Appendix A]*

Extract from IFRS 3

Appendix A
Defined terms

business	An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities.

In assessing whether a transaction is the acquisition of a business or an asset acquisition, an entity can elect to first apply a concentration test. Under the concentration test, an acquired set of activities and assets is not a business if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets. Where the concentration test is not met, an entity will perform a qualitative analysis to determine whether it has acquired an input and a substantive process that together significantly contributes to the ability to create outputs. *[IFRS 3.B7A]*

See Chapter 10 at section 3.2 for further discussion on the definition of a business.

Determining whether a particular set of integrated activities and assets is a business, and/or whether the optional concentration test applies, will often require a significant amount of judgement, particularly for oil and gas entities and mining entities depending on the stage of the asset in the asset life cycle.

For entities in the extractives industries, in applying the concentration test in IFRS 3, the following practical considerations are relevant:

- Single identifiable asset: this includes any asset or group of assets that would be recognised and measured as a single identifiable asset in a business combination. For example, oil and gas field and well equipment, or a mining property and mining equipment;
- Similar identifiable assets: this may include producing and approved for development properties, in the same geographical region. These may be considered similar if an entity concludes that they do not have significantly different risk characteristics.

For more information on the concentration test (including considerations relating to a identifying a single identifiable asset and/or a group of similar identifiable assets) refer to Chapter 10 at section 3.2.3.

8.2 Business combinations

8.2.1 Goodwill in business combinations

Prior to the adoption of IFRS accounting standards, many mining entities and oil and gas entities assumed that the entire consideration paid for upstream assets should be allocated to the identifiable net assets acquired. That is, any excess of the consideration transferred over the fair value of the identifiable net assets (excluding mineral reserves and resources) acquired would then have been included within mineral reserves and resources acquired and goodwill would not generally be recognised. However, goodwill could arise as a result of synergies, overpayment by the acquirer, or when IFRS accounting standards requires that acquired assets and/or liabilities are measured at an amount that is not fair value (e.g., deferred taxation).

How we see it

It is unlikely to be appropriate for mining entities or oil and gas entities to simply assume that goodwill would never arise in a business combination and that any differential automatically goes to mineral reserves and resources. Mineral reserves and resources and any exploration potential (if relevant) acquired would be expected to be valued separately. Any excess of the consideration transferred over and above the supportable fair value of the identifiable net assets (which include mineral reserves, resources and acquired exploration potential), is required to be allocated to goodwill.

By virtue of the way IFRS 3 operates, if an entity were simply to take any excess of the consideration transferred over the fair value of the identifiable net assets acquired to mineral reserves and resources, they could end up having to allocate significantly larger values to minerals reserves and resources than expected. This is because, under IFRS 3, an entity is required to provide for deferred taxation on the temporary differences relating to all identifiable net assets acquired (including mineral reserves and resources), but not on temporary differences related to goodwill. Therefore, if any excess was simply allocated to mineral reserves and resources, to the extent that this created a difference between the carrying amount and the tax base of the mineral reserves and resources, IAS 12 would give rise to a deferred tax liability on the temporary difference, which would create a further excess. This would then result in an iterative calculation in which the deferred tax liability recognised would increase the amount attributed to mineral reserves and resources, which would in turn give rise to an increase in the deferred tax liability (see Chapter 29 at section 7.2.2). Given the very high marginal tax rates to which extractive activities are often subject (i.e., tax rates of 60% to 80% are not uncommon) the mineral reserves and resources might end up being grossed up by-a factor of 2.5 to 5 (i.e., 1 ÷ (1 - 60%) = 2.5). Such an approach would only be acceptable if the final amount allocated to mineral reserves and resources remained in the range of fair values determined for those mineral reserves and resources. If not, such an approach would lead to excessive amounts being allocated to mineral reserves and resources which could not be supported by appropriate valuations.

In March 2020, the IASB published a comprehensive Discussion Paper *Business Combinations - Disclosures, Goodwill and Impairment*.[105] The project arose as a result of the post-implementation review of IFRS 3. As part of this project, the IASB is exploring whether to retain the impairment only approach (as currently applied or simplified) or reintroduce the amortisation of goodwill. In December 2022, the IASB decided to add this project to its standard-setting programme. At the time of writing, the IASB expects to issue an exposure draft of the proposed changes in the first half of 2024. For more detail on the IASB's preliminary views see Chapter 10 at section 1.2.1

105 Discussion Paper DP/2020/1, *Business Combinations - Disclosures, Goodwill and Impairment*, IASB, March 2020. Available on the IFRS Foundation's website.

Practical example 8-1 below from Glencore plc financial statements illustrates a typical accounting policy for business combinations in which excess consideration transferred is treated as goodwill.

Practical example 8-1: Glencore plc (2022) Jersey

Annual Report 2022 [extract]
Financial Statements [extract]
Notes to the financial statements [extract]
1. Accounting policies [extract]

Business combinations and goodwill

Acquisitions of subsidiaries and businesses are accounted for using the acquisition method of accounting. The cost of the acquisition is measured at fair value, which is calculated as the sum of the acquisition date fair values of the assets transferred, liabilities incurred to the former owners of the acquiree and the equity interests issued in exchange for control of the acquiree.

The identifiable assets, liabilities and contingent liabilities ('identifiable net assets') are recognised at their fair value at the date of acquisition. Acquisition-related costs are recognised in the consolidated statement of income as incurred.

Where a business combination is achieved in stages, Glencore's previously held interests in the acquired entity are remeasured to fair value at the acquisition date (i.e. the date Glencore attains control) and the resulting gain or loss, if any, is recognised in the consolidated statement of income.

Goodwill is measured as the excess of the sum of the consideration transferred, the amount of any non-controlling interests in the acquiree, and the fair value of the acquirer's previously held equity interest in the acquiree (if any) over the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed.

...

8.2.2 Impairment of assets and goodwill recognised on acquisition

There are a number of circumstances in which the carrying amount of assets and goodwill acquired as part of a business combination and as recorded in the consolidated accounts, may be measured at a higher amount through recognition of notional tax benefits, also known as tax amortisation benefits (i.e., the value has been grossed up on the assumption that its carrying value is deductible for tax) or deferred tax (which can increase goodwill as described above). Application of IAS 36 to goodwill which arises upon recognition of deferred tax liabilities in a business combination is discussed in Chapter 21 at section 8.3.1.

8.2.3 Value beyond proven and probable reserves (VBPP)

In the mining sector specifically, the 'value beyond proven and probable reserves' (VBPP) is defined as the economic value of the estimated cash flows of a mining asset beyond that asset's proven and probable reserves.

While this term is specifically relevant to the mining sector by virtue of specific guidance in US GAAP, the concept may be equally relevant to the oil and gas sector, i.e., the economic value of an oil and gas licence/area beyond the proven and probable reserves.

For mining entities, there are various situations in which mineralisation and mineral resources might not be classified as proven or probable:

- Prior to the quantification of a resource, a mining company could identify mineralisation following exploration activities. However, it may be too early to assess if the geology and grade is sufficiently expansive to meet the definition of a resource.
- Acquired Exploration Potential (AEP) represents the legal right to explore for minerals in a particular property, occurring in the same geological area of interest.
- Carrying out the required assessments and studies to obtain classification of mineral reserves can be very costly. Consequently, these activities are often deferred until they become necessary for the planning of future operations. Significant mineral resources are often awaiting the initiation of this process.
- If an entity acquires a mining company at a time when commodity prices are particularly low, the mineral resources owned by the acquiree may not meet the definition of proven or probable reserves because extraction might not be commercially viable.

While the above types of mineralisation and mineral resources cannot be classified as proven or probable, they will often be valuable because of the future potential that they represent (i.e., reserves may be proven in the future and commodity price increases may make extraction commercially feasible).

IFRS 3 requires that an acquirer recognises the identifiable assets acquired and liabilities assumed that meet the definitions of assets and liabilities at the acquisition date. *[IFRS 3.11]*.

While the legal or contractual rights that allow an entity to extract minerals are not themselves tangible assets, the mineral reserves concerned clearly a-e. The legal or contractual rights - that allow an entity to extract mineral reserves and resources - acquired in business combinations should be recognised, without exception, at fair value.

An entity that acquires mineral reserves and resources that cannot be classified as proven or probable, could consider accounting for the VBPP as part of the value allocated to mining assets, to the extent that a market participant would include VBPP in determining the fair value of the asset, rather than as goodwill.[106] In practice, the majority of mining entities treat mining assets, the related mineral reserves and resources and licences as tangible assets on the basis that they relate to minerals in the ground, which are themselves tangible assets. However, some entities present the value associated with E&E assets as intangible assets.

AEP would often be indistinguishable from the value of the mineral licence to which it relates. Therefore, the classification of AEP could vary depending on how an entity presents its mining assets and licences. If an entity presents them as tangible assets, they may be likely to treat AEP (or its equivalent), where applicable, as forming part of mineral properties, and hence AEP would be classified as a tangible asset. For an entity that classifies some of its mineral assets as intangible assets, e.g., E&E assets, then they may classify AEP as an intangible also.

Determining the fair value of VBPP requires a considerable amount of expertise. An entity must not only take account of commodity spot prices but also consider the effects of anticipated fluctuations in the future price of minerals, in a manner that is consistent with the expectations of a market participant. An entity would consider all available information including current prices, historical averages, and forward pricing curves and maximise the use of observable inputs. Those market participant assumptions typically are consistent with the acquiring entity's operating plans for developing and producing minerals. However, entities need to undertake steps to demonstrate this is true (to ensure compliance with the requirements of IFRS 13 *Fair Value Measurement*). The potential upside associated with mineral resources that are not classified as reserves can be much larger than the downward risk. A valuation model that only takes account of a single factor, such as the spot price, historical average or a single long-term price, without considering other information that a market participant would consider, would generally not be able to reflect the upward potential that determines much of the value of VBPP. Consequently, an entity may need to apply option valuation techniques in measuring VBPP.

There are commonly considered to be three categories of VBPP, including:

- Mineral resources not yet tested for economic viability
- Early mineralisation
- Acquired exploration potential (AEP)

The CRIRSCO reporting standards consider the geological definition of mineral resources that have not yet been tested for economic viability, which is the first category of VBPP. Valuation techniques used for this category include:

- Probability weighted discounted-cash flows
- Resource reserve conversion adjustment
- Comparable transactions
- Option valuation

In relation to early mineralisation, the second category of VBPP, while it may represent a discovery, its true value will be determined by further appraisal/evaluation activities to confirm whether a resource exists. This category of VBPP is often grouped with the next (and final) category, being AEP, even though it has a higher intrinsic value, and is valued using:

- Cost based methods
- Budgeted expenditure methods
- Comparable sales
- Farm-in/out values
- Sophisticated option pricing

In relation to AEP, the basis for its valuation varies from studying historic cost to the use of sophisticated option valuation techniques.

106 ASC 930-805-30-1 Extractive Activities - Mining - Business Combinations - Initial Measurement (pre-codification EITF 04-3, Mining Assets: Impairment and Business Combinations, EITF, March 2004).

As VBPP does not provide current economic benefits, there is no need to allocate its cost against current revenue and hence no need for amortisation or depreciation. However, as part of the process of completing the acquisition accounting, an entity would need to form a view about how that value will ultimately be ascribed to future discoveries and converted into proven and probable reserves and then ultimately transferred to a category of assets that are then depreciated. Such methodologies might include a per unit (e.g., tonnes/ounces) basis or possibly an area (e.g., acreage) basis. VBPP would need to be tested for impairment under IAS 36 if, depending on the classification of VBPP, there is an indicator of impairment under that standard or IFRS 6. The VBPP could ultimately be impaired because it may never be converted into proven or probable reserves, but impairment may not be confirmed until the entity is satisfied that the project will not continue.

An impairment of VBPP is required to be recognised if its book value exceeds the higher of fair value less costs of disposal and value in use. In practice, there may not be a convenient method to determine the value in use. Hence, impairment testing will often need to rely on an approach based on fair value less costs of disposal.

Practical example 8-2 below illustrates that AngloGold Ashanti Limited does not subsume the 'value beyond proven and probable reserves' in goodwill but instead recognises it as part of the value ascribed to mineral resources.

Practical example 8-2: AngloGold Ashanti Limited (2022) **South Africa**

Annual Financial Statements 2022 [extract]
Financial Statements [extract]
Group - Notes to the financial statements [extract]
1 Statement of compliance [extract]
1.2 Significant accounting judgements and estimates [extract]
Use of estimates [extract]

Carrying value of goodwill

Where an investment in a subsidiary, joint venture or an associate is made, any excess of the consideration transferred over the fair value of the attributable Mineral Resource including value beyond Proved and Probable Mineral Reserve, exploration properties and net assets is recognised as goodwill.

...

8.3 Acquisition of an interest in a joint operation that is a business

One area where there had historically been a lack of clarity was how to account for acquisitions of interests in joint operations (under IFRS 11) which constitute businesses. However, an amendment to IFRS 11 was made to clarify this, which applied prospectively to acquisitions that occurred on or after 1 January 2016. The amendment stated that where an entity is acquiring an interest in a joint operation that is a business as defined in IFRS 3, it is required to apply, to the extent of its share in accordance with IFRS 11.20, all of the principles of business combinations accounting in IFRS 3, and in other IFRS accounting standards, that do not conflict with IFRS 11. In addition, the entity must disclose the information that is required in those IFRS accounting standards in relation to business combinations. However, if an entity acquires an interest in an asset/group of assets that is (are) not a business as defined in IFRS 3, then it would apply the guidance on asset acquisitions that IFRS accounting standards already provides. *[IFRS 11.BC45I]*.

The requirements apply to the acquisition of an initial interest in a joint operation or where the acquisition leads to the formation of a joint operation that constitute a business, and also to the acquisition of additional interests in a joint operation to the extent that joint control is maintained. The amendment also makes it clear that any previously held interest in the joint operation would not be remeasured if the joint operator acquires an additional interest while retaining joint control.

In addition to the matters outlined above, there are a number of additional issues which have been raised in relation to joint operations. These include:

- *A passive investor in a joint operation becomes a joint operator:* In this situation, the issue is whether a previously held interest in the assets and liabilities of a joint operation that is a business is remeasured to fair value when the investor's acquisition of an additional interest results in the investor becoming a joint operator (i.e., assumes joint control) in that joint operation.

  The IFRS IC considered this issue and tentatively decided that the previously held interest in this situation should not be remeasured. The IASB agreed with this decision and an amendment was issued as part of the 2015-2017 annual improvements cycle. This amendment clarifies that the previously held interests in a joint operation are not remeasured where a party that participates in, but does not have joint control of, a joint operation obtains joint control of the joint operation in which the activity of the joint operation constitutes a business as defined in IFRS 3. *[IFRS 11.BC45A, IFRS 11.BC45H]*.

- *Obtaining control over a joint operation:* Where a party obtains control over a joint operation structured through a separate vehicle, over which it previously had joint control, it is required to apply the business combination achieved in stages accounting requirements in IFRS 3, if the acquiree meets the definition of a business. This includes remeasuring previously held interests in the assets and liabilities of the joint operation at fair value. In doing so, the acquirer remeasures its entire previously held interest in the joint operation (see Chapter 10 at sections 3.2 and 9).

See Chapter 13 at section 8.3 for more information on the above matters.

8.4 Asset acquisitions

The acquisition of an asset, group of assets or an entity that does not constitute a business is not a business combination. In such cases the acquirer is required to identify and recognise the individual identifiable assets acquired and liabilities assumed. The cost of the acquisition is then allocated to the individual identifiable assets acquired and liabilities assumed on the basis of their relative fair values at the date of purchase. Such a transaction or event does not give rise to goodwill. *[IFRS 3.2(b)]*. Thus, existing book values or values in the acquisition agreement may not be appropriate.

As noted in section 8.1 above, there are some key differences between an asset acquisition and a business combination. These are discussed in more detail in Chapter 10 at section 2.2.2.

In November 2017, the IFRS IC issued an agenda decision that clarified how an entity accounts for the acquisition of a group of assets that does not constitute a business. This is also discussed in Chapter 10 at section 2.2.2.

8.4.1 Asset acquisitions and variable and contingent consideration

The terms of an arrangement to acquire an asset or a group of assets/net assets that do not constitute a business might include variable or contingent amounts. Transactions involving variable or contingent consideration elements are often very complex and payment may depend on a number of factors. Examples might include variable or contingent payments based on an index or rate, variable or contingent payments which depend upon the purchasers' future actions, variable or contingent payments related to the condition of the asset, or variable or contingent payments related to the asset's performance. For the extractive industries, such examples include royalty-based payments based on production or some formula, e.g., net smelter royalties. Some arrangements may contain more than one source of variability. Further complexity can also arise, for example, because some such arrangements may be akin to profit sharing agreements which are not addressed in any standard.

The topic of variable payments for an asset purchase was discussed by the IFRS IC between 2011 and 2016, and an agenda decision was published in March 2016. The IFRS IC's discussions considered both the accounting at the date of purchasing the asset and subsequently, and distinguished between those variable payments that depend on the purchaser's future activity and those that do not. The IFRS IC determined that the issue was too broad for it to address within the confines of existing standards and recommended that the IASB address the accounting for variable payments comprehensively. In May 2016, the IASB tentatively agreed that this issue would be included in the research pipeline between 2017 and 2021. At the time of writing this is not listed as an active research project on the IASB's work plan.

A critical step in analysing the accounting for the purchase of an item of PP&E in an arrangement involving variable or contingent consideration is to fully understand the contractual arrangements, understanding the nature of the contingent or variable payments. This includes developing a full understanding of whether those variable or contingent payments are linked to the initial value of the asset, or to its future performance, whether the contingency or variability is within or outside of the purchasers' control and whether the variable payment is a payment for some other goods or services from the seller. In some cases, the contract may establish an obligation for the contingent payment at the outset, whilst in others it might be determined that the arrangement is an executory contract, and the liability to make the contingent payments is only recognised later once either party fulfils its obligations under the contract.

The two key issues with regards to the accounting for variable or contingent consideration in an asset purchase are:

- Whether and when to recognise a liability for that variable or contingent consideration.
- Whether subsequent changes to the estimate of variable or contingent consideration should be accounted for as part of the cost of the acquired asset.

How we see it

Consistent with the discussions in Chapter 19 at section 4.1.9, in light of the discussions held by the IFRS IC and in the absence of clear guidance in the final agenda decision, with respect to whether and when the obligation to make variable or contingent payments should be recognised as a liability, entities will need to develop an accounting policy. In doing so, entities will need to apply the hierarchy in IAS 8. The policy selected should result in information that is relevant and reliable in the particular circumstances and must be consistently applied to similar transactions. Different payments may have different types of variability. Therefore, it might be appropriate for an entity to have different policies for dissimilar transactions.

As discussed above, currently, there is no explicit guidance on the treatment of variable or contingent consideration in the acquisition of an asset and there is diversity in practice in the accounting for these types of arrangements. With respect to the first question, examples of some accounting policies an entity may want to consider regarding initial recognition of the asset include the following:

- The cost of the asset on initial recognition includes the fair value of all variable or contingent consideration at the date of acquisition. A corresponding liability is recognised for the same amount.
- The cost of the asset on initial recognition excludes any variable or contingent payments. Accordingly, no liability is recognised for those contingent or variable amounts.

The second question that needs to be addressed is how an entity must account for subsequent payments and changes to the estimate of variable or contingent consideration. Depending on the facts and circumstances of the arrangement an entity may determine that:

1. Variability arises from exchange rates, time value of money, or embedded derivatives - Changes in the carrying amount of a recognised liability that arise from exchange rates are accounted for in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates* and IFRIC 22, while the time value of money and embedded derivatives are accounted for in accordance with IFRS 9;
2. Variability is directly linked to the quality o- quantity of the asset(s) received - In these cases, the initial recognition of the asset and liability were based on an accounting estimate that is subsequently updated in accordance with IAS 8.37; or
3. The variability in the arrangement does not fall under (1) or (2) above and an accounting policy needs to be developed to address it.

In the latter case, an entity will need to apply the requirements of IAS 8 to develop an accounting policy that it should apply consistently to all similar transactions. The accounting policy developed will need to address whether the change in the estimate of variable or contingent consideration should be capitalised as part of the cost of the asset or expensed. This determination is usually based on the reason for the contingent payment and entities should consider the substance of the arrangement in determining the appropriate treatment.

It is only appropriate for subsequent changes to a recognised liability to be recognised as part of the cost of the asset to the extent that it relates to future economic benefits embodied in the asset initially received. For example, if the contingency or variability is viewed as being linked to the quality or quantity of the asset initially received. Variability arising due to other factors, such as its use over time, would generally be expensed.

How we see it

With respect to whether subsequent payments of variable or contingent consideration or changes to the measurement of a previously recognised liability to make variable or contingent payments are included as part of the cost of the acquired asset or expensed as incurred, until this matter is resolved by the IASB, where the accounting for the variability or contingency is not prescribed in another standard, an entity should adopt and apply a consistent accounting policy in accordance with the hierarchy in IAS 8.

As above, an entity should exercise judgement in developing and consistently applying an accounting policy that results in information that is relevant and reliable in the particular circumstances.

If information about any selected accounting policy is expected to be material to users of the financial statements, that accounting policy information should be disclosed.

For the detailed discussions of the key accounting considerations related to the treatment of variable or contingent payments in the acquisition of an asset, including the general approaches applied in practice and the related discussions by the IFRS IC and the IASB, see Chapter 19 at section 4.1.9.

8.4.2 Accounting for land acquisitions

Obtaining the legal rights to explore for, develop and produce minerals can be achieved in a number of ways, as outlined in section 5 above. One of these ways is through the outright purchase of the minerals and the land on, or under, which the minerals are located. In undertaking such a transaction, it is not uncommon for an entity to pay an amount in excess of the intrinsic value of the land itself. In such a situation, an entity needs to ensure it appropriately allocates the purchase price between the fair value of the land and the fair value of the mineral or surface mining rights acquired. The amount allocated to land will be capitalised and not depreciated, whereas the amount allocated to the minerals or surface mining rights will form part of the total cost of mining assets and will ultimately be depreciated on a units of production basis over the economically recoverable reserves to which it relates.

9 Functional currency

9.1 Determining functional currency

Determining functional currency correctly is important because it will, for example, affect the volatility of revenue and operating profit resulting from exchange rate movements, determine whether transactions can be hedged or not and influence the identification of embedded currency derivatives. The movements may give rise to temporary differences that affect profit or loss. *[IAS 12.41]*. While under IAS 21 an entity can select any presentation currency, it does not have a free choice in determining its functional currency. Choice of functional currency is discussed in detail in Chapter 16 at section 4; below is a summary of the application of the requirements to the extractive industries.

IAS 21 requires an entity to determine separately the functional currency of each entity within a consolidated group. There is no concept of the functional currency of the group, only a presentation currency. Therefore, the functional currency of an operating subsidiary may differ from that of the group's parent and/or foreign sales company to which it sells its production. The factors taken into account in determining functional currency may differ for operating entities and for group entities that are financing or intermediate holding entities (see Chapter 16 at section 4.2). *[IAS 21.9]*.

Extract from IAS 21

9 The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. An entity considers the following factors in determining its functional currency:

(a) the currency:

(i) that mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and

(ii) of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.

(b) the currency that mainly influences labour, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled).

While the currency referred to under (a)(i) above will often be the currency in which sales prices for its goods and services are denominated and settled, this is not always the case. The US dollar is used for many commodities as the contract or settlement currency in transactions (e.g., iron ore, oil), but the pricing of transactions is often driven by factors completely unrelated to the US dollar or the US economy (e.g., it may be influenced more by demand from the local economy or other economies such as China).

As the extractive industries are international, it is often difficult to determine the currency of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services. Therefore, factor (a)(ii) above will often prove to be inconclusive when a particular product is produced in many different countries.

It will generally be fairly straightforward to identify the currency that mainly influences an entity's key inputs (i.e., factor (b) above). In developing countries an entity will often need to import a significant proportion of its key inputs (e.g., fuel, equipment and expatriate workers) and even local inputs in an economy with a high inflation rate will often be linked to the US dollar. In such a case, the local currency is less likely to be the main currency that influences an entity's key inputs. In most developed countries, however, the inputs tend to be denominated in the local currency, although some inputs (e.g., major items of equipment) may be denominated in another currency. As the extractive industries are capital intensive, the cost of equipment often far exceeds the operating expenses incurred. Equipment is often purchased in US dollars.

When the factors described above are mixed, as they often are in practice, and the functional currency is not obvious, management should use its judgement "to determine the functional currency that most faithfully represents the economic effects of the transactions,events and conditions". *[IAS 21.12]*. If the above factors are inconclusive then an entity should also consider the following secondary factors:

- The currency in which funds from financing activities (i.e., issuing debt and equity instruments) are generated
- The currency in which receipts from operating activities are usually retained
- The functional currency of the reporting entity that has the foreign operation as its subsidiary, branch, associate or joint venture *[IAS 21.10, IAS 21.11]*

After considering both the primary and secondary factors the functional currency may not be obvious because, for example, revenue is denominated in US dollars while virtually all expenses are denominated in the local currency. In that situation management may conclude that revenue, while denominated in US dollars, is in fact influenced by a basket of currencies. It is therefore possible that entities operating in a similar environment can reach different conclusions about their functional currency. Even in developed countries there is a general bias towards the US dollar as the functional currency.

Although local statutory and tax requirements should be ignored in determining the functional currency, there may be a requirement to keep two sets of accounting records when an entity concludes that its local currency is not its functional currency.

Practical example 9-1 below from Rio Tinto plc illustrates a typical currency translation accounting policy of a mining company.

Practical example 9-1: Rio Tinto plc (2022) **United Kingdom**

Annual Report 2022 [extract]
Financial statements [extract]
Notes to the Rio Tinto plc Financial Statements [extract]
A Principal accounting policies [extract]

c. Currency translation

Items included in the financial statements are measured using the currency of the primary economic environment in which the company operates (the functional currency). The financial statements are presented in US dollars, which is the company's functional and presentation currency. Transactions denominated in other currencies, including the issue of shares, are translated into the functional currency using the exchange rates prevailing at the date of the transaction.

Foreign exchange gains and losses resulting from the settlement of such transactions, and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies, are recognised in the profit and loss account.

Exchange rates used are consistent with the rates used by the Group as disclosed in the consolidated financial statements on page 151.

9.2 Changes in functional currency

IAS 21 requires management to use its judgement to determine the entity's functional currency so that it most faithfully represents the economic effects of the underlying transactions, events and conditions that are relevant to the entity. *[IAS 21.12]*. Note that IAS 21 requires the functional currency to be determined by reference to factors that exist during the reporting period. Therefore, an entity should ignore future developments in its business, no matter how likely those developments are. For example, even if an entity is convinced that in three years' time it will have revenues that will be denominated in US dollars, this is not a factor to be considered in determining its functional currency today. This is particularly relevant for entities in the extractive industries given the nature of their operations. For example, a company may conclude that during the development phase of the project the local currency is its functional currency but that once production and sales commence the US dollar will become its functional currency. Alternatively, exposure to a particular currency may increase during a period.

This is illustrated in Practical example 9-2 below from Anglo American Platinum Limited's 2022 financial statements.

Practical example 9-2:	Anglo American Platinum Limited (2022)	South Africa

Audited annual financial statements 2022 [extract]
1 Compliance and assurance [extract]
Significant accounting principles [extract]
Basis of preparation [extract]

Functional currency

The financial statements are presented in South African rand, which is the presentation currency of the group and the functional currency of the company and its most significant operating subsidiary, namely Rustenburg Platinum Mines Limited.

During the first half of the year, a review of the functional currency of Anglo Platinum Marketing Limited (APML) was conducted. An increase in trading activities with third parties, additions to the marketing team to support these activities, and enhanced trading limits that allow greater autonomy and more structured third-party transactions, led management to conclude that the marketing entity is becoming less of an extension of the mining and processing operations, and its functional currency should be changed from South African rand to US dollars from 1 January 2022. Refer to notes 5, 20 and 31 where specific impacts of the change have been highlighted.

Once the functional currency is determined, the standard allows it to be changed only if there is a change in those underlying transactions, events and conditions. For example, a change in the currency that mainly influences the sales prices of goods and services may lead to a change in an entity's functional currency. *[IAS 21.36]*.

Practical example 9-3 below, from Santos Limited's financial statements, provides an example of a change in conditions that resulted in a change in functional currency. Accounting for a change in functional currency is discussed in Chapter 16 at section 5.5.

Practical example 9-3:	Santos Limited (2019)	Australia

Annual Report [extract]
Notes to the Consolidated Financial Statements [extract]
Section 8: Other [extract]
8.4 Accounting policies [extract]

(b) Functional currency

The Group performed a reassessment of the functional currency of the Parent entity (Santos Limited) and certain entities within the Group, resulting in it changing functional currency to US dollars, effective 1 January 2019. Prior to 1 January 2019, Santos Limited and these entities had a functional currency of Australian dollars.

The change in functional currency was driven by a reassessment of the primary and where necessary, secondary indicators of economic environment that impacts the cash inflows and outflows of the companies. This included factors such as a change in mix of income stream and in some instances where companies were acting as extensions of the Parent. The US dollar was determined to be the currency that predominantly impacted each of the companies.

The presentation currency of the Group remains US dollars.

10 Decommissioning and restoration/rehabilitation

The operations of entities engaged in extractive industries can have a significant impact on the environment. Decommissioning or restoration activities at the end of a mining or oil and gas operation may be required by law, the terms of mineral licences or an entity's stated policy and past practice. The associated costs of decommissioning, remediation or restoration can be significant. The accounting treatment for such costs is therefore critical. Different terms may be used, often interchangeably, to essentially refer to the same activity, e.g., restoration, remediation and rehabilitation. In this section we shall use the words decommissioning and restoration.

Accounting for decommissioning and restoration costs is governed by the requirements of IAS 37 and IFRIC 1. The discussion below should be read in conjunction with Chapter 19 (Property, Plant and Equipment) in section 4.3, Chapter 27 (Provisions, Contingent Liabilities and Contingent Assets) in section 6.3 and Chapter 29 (Income Taxes) in sections 7.3 and 7.3.1.A. Some of the specific issues to consider with respect to such provisions are listed below:

- Initial recognition - see section 10.1.1 below
- Initial measurement - see section 10.1.2 below
- Discount rates - see Chapter 27 at section 4.3
- Decommissioning or restoration costs incurred in the production phase - see section 10.1.3 below
- Changes in decommissioning and restoration/rehabilitation costs - see Chapter 27 at sections 6.3.1 and 6.3.2
- Treatment of foreign exchange differences - see section 10.2 below
- Accounting for deferred taxes - see Chapter 29 at-section 7.3
- Indefinite life assets - see section 10.3 below
- Funds established or put aside to meet a decommssioning or restoration obligation - see Chapter 27 at section 6.3.3

The Board is currently developing proposals for three targeted improvements to IAS 37. This would involve aligning the definition of a liability and requirements for identifying liabilities with the *Conceptual Framework*. At the time of writing, resulting amendments are expected to replace IFRIC 21 with new application requirements for levies. The IASB has also indicated an intention to add new examples to the Guidance on implementing IAS 37 to illustrate the application of the requirements, and to update the explanations for some of the existing examples, without changing those conclusions.[107] In addition, the IASB is developing proposals to clarify which costs to include in the measurement of a provision, and whether the rate at which an entity discounts a provision should reflect the entity's own credit risk. At the time of writing, discussions are ongoing, with an Exposure Draft expected in the last quarter of 2024.[108] See Chapter 27 at section 1.1

10.1 Recognition and measurement issues

10.1.1 Initial recognition

How we see it

Initial recognition of a decommissioning or restoration provision only on commencement of commercial production is generally not appropriate under IFRS accounting standards, because the obligation to remove facilities and to restore the environment typically arises during the development/construction of the facilities, with some further obligations arising during the production phase. Therefore, a decommissioning or restoration provision is typically recognised during the development or construction phase (see section 1.6.1 above) of the project, i.e., before any production takes place, and is required to be included as part of the cost of the assets acquired or constructed (if they are capitalised).

It may also be necessary to recognise a further decommissioning or restoration provision during the production phase (see section 10.1.3 below).

107 *IASB Update, April 2024*, available on the IFRS Foundation's website.

108 *IFRS Foundation work plan*, IFRS Foundation website (accessed June 2024).

While the damage caused in the exploration phase may generally be immaterial, an entity should recognise a decommissioning or restoration provision where the damage is material and the entity will be required to carry out remediation. The accounting for such a provision will depend on how the related E&E costs have been accounted for. If the E&E costs are capitalised, the associated decommissioning costs should also be capitalised. However, if the E&E costs are expensed, any associated decommissioning or restoration costs should also be expensed.

Finally, even if decommissioning and restoration were not planned to take place in the foreseeable future (for example because the related assets are continually renewed and replaced), IAS 37 would still require a decommissioning or restoration provision to be recognised. However, in these cases the discounted value of the obligation may be comparatively insignificant.

Practical example 10-1 below shows Woodside Energy Group Ltd's sensitivity analysis for restoration obligations.

Practical example 10-1: Woodside Energy Group Ltd (2022) — Australia

ANNUAL REPORT [extract]
Financial Statements [extract]
Notes to the financial statements [extract]
D. Other assets and liabilities [extract]
D.5 Provisions [extract]
Keyimates and judgements [extract]
(a) Restoration obligations [extract]
Inherent uncertainties [extract]

A range of pre-tax discount rates between 3.4% and 4.7% (2021: 0.4% to 2.4%) has been applied. If the discount rates were decreased by 0.5% then the provision would be $316 million higher. If the cost estimates were increased by 10% then the provision would be $627 million higher. The proportion of the non-current balance not expected to be settled within 10 years is 54% (2021: 65%).

10.1.2 Measurement of the liability

Measurement of a decommissioning or restoration provision requires a significant amount of judgement because:

- The amount of remedial work required will depend on the scale of the operations. In the extractives industries the environmental damage may vary considerably depending on the type and development of the project.
- The amount of remedial work further depends on environmental standards imposed by local regulators, which may vary over time.
- Detailed decommissioning and remedial work plans will often not be developed until fairly shortly before closure of the operations.
- Decommissioning and restoration provisions are often subject to local governmental regulation and are therefore required to comply with prescribed closure plans and activities. In this case, it may not always be clear which costs are directly attributable to decommissioning or restoration (e.g., security costs, maintenance cost, ongoing environmental monitoring and employee termination costs). Careful attention may be needed to determine which cash flows fall within the scope of the recognition and measurement requirements under IAS 37.
- The timing of the decommissioning or restoration depends on when the fields or mines cease to produce at economically viable rates, which depends upon future commodity prices and reserves.
- The actual decommissioning or restoration work will often be carried out by specialised contractors, the cost of which will depend on future market prices for the necessary remedial work.

Many of the uncertainties above can only be finally resolved towards the end of the production phase, shortly before decommissioning and restoration are to take place. A significant increase in the decommissioning or restoration provision resulting from revised estimates would result in recognition of an additional asset. However, as IFRIC 1 specifically states that any addition to an asset as a result of an increase in a decommissioning or restoration provision is considered to be a trigger for impairment testing, a significant increase in a decommissioning or restoration provision close to the end of the production phase may lead to an immediate impairment of that additional asset. Conversely, a decrease in the decommissioning or restoration provision could exceed the carrying amount of the related asset, in which case the excess should be recognised as a gain in profit or loss.

10.1.3 Decommissioning or restoration costs incurred in the production phase

IAS 16 considers "the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located…" to be part of the cost of an item of property, plant and equipment. *[IAS 16.16(c)]*. However, an entity is required to apply IAS 2 "to the costs of obligations for dismantling, removing and restoring the site on which an item is located that are incurred during a particular period as a consequence of having used the item to produce inventories during that period". *[IAS 16.18]*. That means that such additional decommissioning or restoration costs resulting from production activities should be included in the cost of inventories, *[IAS 2.10]*, while decommissioning costs resulting from the construction of assets during the production phase should be accounted for as discussed above.

An entity that incurs abnormal amounts of costs (e.g., costs of remediation of soil contamination from oil spills or overflowing of a tailings pond) should not treat these as part of the cost of inventories under IAS 2, but expense them immediately. *[IAS 2.16]*.

10.2 Treatment of foreign exchange differences

In most cases it will be appropriate for the exchange differences arising on provisions to be taken to profit or loss in the period they arise. However, it may be that an entity has recognised a decommissioning provision under IAS 37 and capitalised it as part of the initial cost of an asset under IAS 16. One practical difficulty with decommissioning provisions recognised under IAS 37 is that due to the long period over which the actual cash outflows will arise, an entity may not know the currency in which the transaction will actually be settled. Nevertheless, if it is determined that it is expected to be settled in a foreign currency it will be a monetary item. The main issue then is what should happen to any exchange differences.

As discussed in Chapter 27 at section 6.3.1, IFRIC 1 applies to any decommissioning or similar liability that has been both included as part of an asset and measured as a liability in accordance with IAS 37. IFRIC 1 requires, *inter alia*, that any adjustment to such a provision resulting from changes in the estimated outflow of resources embodying economic benefits (e.g., cash flows) required to settle the obligation should not be taken to profit or loss as it occurs, but should be added to or deducted from the cost of the asset to which it relates. Therefore, the requirement of IAS 21 to take the exchange differences arising on the provision to profit or loss in the period in which they arise conflicts with this requirement in IFRIC 1.

How we see it

It is our view that IFRIC 1 is the more relevant pronouncement for decommissioning purposes, therefore we consider that exchange differences on decommissioning and restoration/rehabilitation provisions are not required to be taken to profit or loss but dealt with in accordance with IFRIC 1.

10.3 Indefinite life assets

While the economic lives of oil fields and mines are finite, certain infrastructure assets (e.g., pipelines and refineries) are continually being repaired, replaced and upgraded. While individual parts of such assets may not have an indefinite economic life, these assets may occupy a particular site for an indefinite period.

Regardless of whether the related asset has an indefinite life, the decommissioning provision will normally meet the criteria relating to the recognition of a provision as set out in IAS 37.14(a) and (b), in that an entity will have a present obligation and it will be probable that an outflow of resources will be required to settle the obligation. With respect to the final criterion in IAS 37.14(c), while it might seem that a reliable estimate of the decommissioning provision cannot be made if the underlying asset has an indefinite life, 'indefinite' does not mean that the asset has an infinite life but that the life is long and has not yet been determined. IAS 37 presumes that "Except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision." *[IAS 37.25]*.

Therefore, it should be extremely rare for an entity to conclude that it cannot make a reliable estimate of the amount of the obligation. Even if an entity did conclude in an extremely rare case that no reliable estimate could be made, there would still be a contingent liability and the following disclosures would be required:

- A brief description of the nature of the contingent liability
- Where practicable:
  - An estimate of its financial effect, measured under IAS 37.36 to IAS 37.52
  - An indication of the uncertainties relating to the amount or timing of any outflow

    And
  - The possibility of any reimbursement *[IAS 37.26, IAS 37.86]*

Finally, it should be noted that the discounted value of decommissioning costs that will only be incurred far into the future may be relatively insignificant.

11 Impairment of assets

The following issues require additional attention when a mining company or oil and gas company applies the impairment testing requirements under IFRS accounting standards:

- Impairment indicators (see section 11.1 below)
- Identifying cash-generating units (see section 11.2 below)
- Projections of cash flows (see sections 11.4.2 and 11.5.1 below)
- Cash flows from mineral reserves and resources and the appropriate discount rate (see section 11.4.2.A below)
- Commodity price assumptions (see sections 11.4.3 and 11.5.2 below)
- Future capital expenditure (see sections 11.4.4 and 11.5.3 below)
- Foreign currency cash flows (see sections 11.4.5 and 11.5.4 below)
- Consistency in cash flows and the carrying amount of CGU (see section 11.4.1 below)

The general requirements of IAS 36 are covered in Chapter 21.

11.1 Impairment indicators

Impairment indicators applicable to assets of mining entities and oil and gas entities are found in two places, IFRS 6 and IAS 36. IFRS 6 describes a number of situations in which an entity is required to test E&E assets for impairment, discussed in section 3.5.1 above, while an entity is required to apply the impairment indicators in IAS 36 to assets other than E&E assets. The lists of impairment indicators in IFRS 6 and IAS 36 are not exhaustive. Entities operating in the extractive industries could also consider carrying out an impairment test in the following situations:[109]

- Declines in prices of products or increases in production costs
- Governmental actions, such as new environmental regulations, imposition of price controls and tax increases
- Actual production levels from the cost centre or cost pool are below forecast and/or there is a downward revision in production forecasts
- Serious operational problems and accidents
- Capitalisation of large amounts of unsuccessful pre-production costs in the cost centre
- Decreases in reserve estimates
- Increases in the anticipated period over which reserves will be produced
- Substantial cost overruns during the development and construction phases of a field or mine
- Adverse drilling results

Practical example 11-1 below shows BHP Group Limited's accounting policy for impairment testing.

109 IASC Issues Paper, 9.26.

Practical example 11-1: BHP Group Limited (2022) **Australia**

Annual Report 2022 [extract]

Financial Statements [extract]

1.6 Notes to the Financial Statements [extract]

Resource assets [extract]

13 Impairment of non-current assets [extract]

Recognition and measurement

Impairment tests for all non-financial assets (excluding goodwill) are performed when there is an indication of impairment. Goodwill is tested for impairment at least annually. Where the asset does not generate cash flows that are independent from other assets, the Group estimates the recoverable amount of the cash generating unit (CGU) to which the asset belongs, being the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. If the carrying amount of the asset or CGU exceeds its recoverable amount, the asset or CGU is impaired and an impairment loss is charged to the income statement so as to reduce the carrying amount in the balance sheet to its recoverable amount.

Previously impaired assets (excluding goodwill as impairment losses are not reversed in subsequent periods) are reviewed for possible reversal of previous impairment at each reporting date. Impairment reversal cannot exceed the carrying amount that would have been determined (net of depreciation) had no impairment loss been recognised for the asset or CGU. Such reversal is recognised in the income statement. There were no reversals of impairment in the current or prior year.

How recoverable amount is calculated

The recoverable amount is the higher of an asset's or CGU's fair value less cost of disposal (FVLCD) and its value in use (VIU).

Fair value less cost of disposal

FVLCD is an estimate of the amount that a market participant would pay for an asset or CGU, less the cost of disposal. FVLCD for mineral assets is generally determined using independent market assumptions to calculate the present value of the estimated future post-tax cash flows expected to arise from the continued use of the asset, including the anticipated cash flow effects of any capital expenditure to enhance production or reduce cost, and its eventual disposal where a market participant may take a consistent view. Cash flows are discounted using an appropriate post-tax market discount rate to arrive at a net present value of the asset, which is compared against the asset's carrying value. FVLCD may also take into consideration other market-based indicators of fair value. FVLCD are based primarily on Level 3 inputs as defined in note 23 'Financial risk management' unless otherwise noted.

Value in use

VIU is determined as the present value of the estimated future cash flows expected to arise from the continued use of the asset in its present form and its eventual disposal or closure. VIU is determined by applying assumptions specific to the Group's continued use and cannot take into account future development. These assumptions are different to those used in calculating FVLCD and consequently the VIU calculation is likely to give a different result (usually lower) to a FVLCD calculation.

Key judgements and estimates

Judgements: Assessment of indicators of impairment or impairment reversal and the determination of CGUs for impairment purposes require significant management judgement.

Indicators of impairment may include changes in the Group's operating and economic assumptions, including those arising from changes in reserves or mine planning, updates to the Group's commodity supply, demand and price forecasts, or the possible additional impacts from emerging risks including those related to climate change and the transition to a low carbon economy.

Climate change

Impacts related to climate change and the transition to a low carbon economy may include:

- demand for the Group's commodities decreasing, due to policy, regulatory (including carbon pricing mechanisms), legal, technological, market or societal responses to climate change, resulting in a proportion of a CGU's reserves becoming incapable of extraction in an economically viable fashion
- physical impacts related to acute risks resulting from increased frequency or severity of extreme weather events, and those related to chronic risks resulting from longer-term changes in climate patterns

The Group's assessment of the potential impacts of climate change and the transition to a low carbon economy continues to mature. As outlined in the Basis of Preparation, where sufficiently developed, the potential financial impacts on the Group of climate change and the transition to a low carbon economy have been considered in the assessment of indicators of impairment, including:

- the Group's current assumptions relating to demand for commodities and carbon pricing, including their impact on the Group's long-term price forecasts
- the Group's operational emissions reduction strategy

Estimates: The Group performs a recoverable amount determination for an asset or CGU when there is an indication of impairment or impairment reversal.

When the recoverable amount is measured by reference to FVLCD, in the absence of quoted market prices or binding sale agreement, estimates are made regarding the present value of future post-tax cash flows. These estimates are made from the perspective of a market participant and include prices, future production volumes, operating costs, capital expenditure, closure and rehabilitation costs, taxes, risking factors applied to cash flows and discount rates. The cash flow forecasts may include net cash flows expected from the extraction, processing and sale of material that does not currently qualify for inclusion in ore reserves. Reserves and resources are included in the assessment of FVLCD to the extent that it is considered probable that a market participant would attribute value to them.

When recoverable amount is measured using VIU, estimates are made regarding the present value of future cash flows based on internal budgets and forecasts and life of asset plans. Key estimates are similar to those identified for FVLCD, although some assumptions and values may differ as they reflect the perspective of management rather than a market participant.

All estimates require management judgements and assumptions and are subject to risk and uncertainty that may be beyond the control of the Group; hence, there is a possibility that changes in circumstances will materially alter projections, which may impact the recoverable amount of assets/CGUs at each reporting date. While no indicators of impairment, or impairment reversal, were identified across the Group's CGUs at 30 June 2022, with the exception of the Cerro Colorado CGU, the carrying value of the Spence CGU is the most susceptible to changes in the significant estimates outlined below in the next reporting period.

The significant estimates impacting the Group's recoverable amount determinations are:

Commodity prices

Commodity prices were based on latest internal forecasts which assume short-term market prices will revert to the Group's assessment of long-term price. These price forecasts reflect management's long-term views of global supply and demand, built upon past experience of the commodity markets and are benchmarked with external sources of information such as analyst forecasts. Prices are adjusted based upon premiums or discounts applied to global price markers to reflect the location, nature and quality of the Group's production, or to take into account contracted prices.

Future production volumes

Estimated production volumes were based on detailed data and took into account development plans established by management as part of the Group's long-term planning process. When estimating FVLCD, assumptions reflect all reserves and resources that a market participant would consider when valuing the respective CGU, which in some cases are broader in scope than the reserves that would be used in a VIU test. In determining FVLCD, risk factors may be applied to reserves and resources which do not meet the criteria to be treated as proved.

Cash outflows (including operating costs, capital expenditure, closure and rehabilitation costs and taxes)

Cash outflows are based on internal budgets and forecasts and life of asset plans. Cost assumptions reflect management experience and expectations. Tax assumptions reflect existing tax and royalty regimes and rates applicable in the jurisdiction of the CGU. In the case of FVLCD, cash flow projections include the anticipated cash flow effects of any capital expenditure to enhance production or reduce cost where a market participant may take a consistent view. VIU does not take into account future development.

Discount rates

The Group uses real post-tax discount rates applied to real post-tax cash flows. The discount rates are derived using the weighted average cost of capital methodology. Adjustments to the rates are made for any risks that are not reflected in the underlying cash flows, including country risk.

11.2 Identifying cash-generating units (CGUs)

An entity is required under IAS 36 to test individual assets for impairment. However, "if it is not possible to estimate the recoverable amount of an individual asset then an entity should determine the recoverable amount of the CGU to which the asset belongs". *[IAS 36.66]*. A CGU is defined by the standard as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. *[IAS 36.6]*. See Chapter 21 at section 3 for further discussion about how an entity is required to determine its CGUs.

In determining appropriate CGUs, mining entities and oil and gas entities could need to consider some of the following issues:

(a) Active markets for intermediate products (see section 11.2.1 below)

(b) External users of the processing assets (see section 11.2.2 below)

(c) Fields or mines that are operated as one 'complex' through the use of shared infrastructure (see section 11.2.3 below)

(d) Stand-alone fields or mines that operate on a portfolio basis (see section 11.2.4 below)

These issues are discussed further below.

11.2.1 Markets for intermediate products

In vertically integrated operations, the successive stages of the extraction and production process are often considered to be one CGU as it is not possible to allocate net cash inflows to individual stages of the process. This is common in some mining operations. However, if there is an active market for intermediate commodities (e.g., bauxite, alumina and aluminium) then a vertically integrated mining company needs to consider whether its smelting and refining operations are part of the same CGU as its mining operations. If there is an active market for the output produced by an asset or group of assets, the assets concerned are identified as a separate CGU, even if some or all of the output is used internally. If extraction and smelting or refining are separate CGUs and the cash inflows generated by the asset or each CGU are based on internal transfer pricing, the best estimate of an external arm's length transaction price should be used in estimating the future cash flows to determine the asset's or CGU's VIU. *[IAS 36.70]*. See Chapter 21 at section 3.

11.2.2 External users of processing assets

When an entity is able to derive cash inflows from its processing assets (e.g., smelting or refining facilities) under tolling arrangements (see section 20 below), the question arises as to whether or not those processing assets are a separate CGU. If an entity's processing assets generate significant cash inflows from arrangements with third parties then those assets are likely to be a separate CGU.

11.2.3 Shared infrastructure

When several fields or mines share infrastructure (e.g., pipelines to transport gas or oil onshore, railways, ports or refining and smelting and other processing facilities), the question arises as to whether the fields or mines and the shared infrastructure is required to be treated as a single CGU. Treating the fields or mines and the shared infrastructure as part of the same CGU is not appropriate under the following circumstances:

(a) If the shared infrastructure is relatively insignificant

(b) If the fields or mines are capable of selling their product without making use of the shared infrastructure

(c) If the shared infrastructure generates substantial cash inflows from third parties as well as the entity's own fields or mines

(d) If the shared infrastructure is classified as a corporate asset, which is defined under IAS 36 as "…assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units". *[IAS 36.6]*. In that case, the entity should apply the requirements in IAS 36 regarding corporate assets, which are discussed in Chapter 21 at section 4.2.

However, if none of the conditions under (a) to (d) above apply then it could be appropriate to treat the fields or mines and the shared infrastructure as one CGU.

Any shared infrastructure that does not belong to a single CGU but relates to more than one CGU still need to be considered for impairment purposes. It is considered that there are two ways to do this and an entity should use the method most appropriate. Shared infrastructure can be allocated to individual CGUs or the CGUs can be grouped together to test the shared assets (similar to the way corporate assets are tested - see commentary above).

Under the first approach, the shared assets should be allocated to each individual CGU or group of CGUs on a reasonable and consistent basis. The cash flows associated with the shared assets, such as fees from other users and expenditure, should be allocated similarly and should form part of the cash flows of the individual CGU. Under the second approach, the group of CGUs that benefit from the shared assets are grouped together with the shared assets to test the shared assets for impairment.

11.2.4 Fields or mines operated on a portfolio basis

Mining entities and oil and gas entities sometimes operate a 'portfolio' of similar mines or fields, which are completely independent from an operational point of view. However, IAS 36 includes the following illustrative example. *[IAS 36.IE Example 1C]*.

Illustration 11-1: Single product entity

Entity M produces a single product and owns plants A, B and C. Each plant is located in a different continent. A produces a component that is assembled in either B or C. The combined capacity of B and C is not fully utilised. M's products are sold worldwide from either B or C. For example, B's production can be sold in C's continent if the products can be delivered faster from B than from C. Utilisation levels of B and C depend on the allocation of sales between the two sites.

Although there is an active market for the products assembled by B and C, cash inflows for B and C depend on the allocation of production across the two sites. It is unlikely that the future cash inflows for B and C can be determined individually. Therefore, it is likely that B and C together are the smallest identifiable group of assets that generates cash inflows that are largely independent.

The same rationale could also be applied by a mining company that, for example, operates two coal mines on a portfolio basis, or an oil and gas company that, for example, operates two fields within the one PSC and the entitlement to revenue is dependent on production of, the revenue earned and costs incurred across the PSC, not on a field by field basis. However, judgement needs to be exercised before concluding that it is appropriate to treat separate fields or mines as one CGU, particularly when the production costs of the output of fields or mines differ considerably. This is because there may be a desire to combine them into one CGU, so that the higher cost fields or mines are protected by the headroom of the lower cost fields or mine, thereby avoiding a recognition of an impairment charge.

How we see it

To be able to combine fields or mines on a portfolio basis, an oil and gas company or a mining company would have to be able to demonstrate that the future cash inflows for the individual fields or mines cannot be determined individually and therefore, the combined group represents the smallest identifiable group of assets that generates cash inflows that are largely independent.

11.3 Basis of recoverable amount - value-in-use or fair value less costs of disposal

The standard requires the carrying amount of an asset or CGU to be compared with its recoverable amount, which is the higher of fair value less costs of disposal (FVLCD) and value-in-use (VIU). *[IAS 36.18]*. If either the FVLCD or the VIU is higher than the carrying amount, no further action is necessary as the asset is not impaired. *[IAS 36.19]*. Recoverable amount is calculated for an individual asset, unless that asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. *[IAS 36.22]*.

In sections 11.4 and 11.5 below we further consider the practical and technical aspects associated with the calculation of VIU and FVLCD respectively for mining entities and oil and gas entities.

11.4 Calculation of VIU

IAS 36 defines VIU as: *[IAS 36.6]*

Extract from IAS 36

6 **The following terms are used in this Standard with the meanings specified:**

...

Value in use **is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.**

Estimating the VIU of an asset/CGU involves estimating the future cash inflows and outflows that will be derived from the use of the asset and from its ultimate disposal in its current condition and discounting them at an appropriate rate. *[IAS 36.31]*. There are complex issues involved in determining the cash flows and choosing a discount rate and often there is no agreed methodology to follow. IAS 36 contains detailed and explicit requirements concerning the data to be assembled to calculate VIU that can best be explained and set out as a series of steps. The steps in the process are:

- Step 1: Dividing the entity into CGUs (see section 11.2 above)
- Step 2: Allocating goodwill to CGUs or CGU groups (see Chapter 21 at section 8.1)
- Step 3: Identifying the carrying amount of CGU assets (see section 11.4.1 below)
- Step 4: Estimating the future pre-tax cash flows of the CGU under review (see sections 11.4.2 to 11.4.5 below)
- Step 5: Identifying an appropriate discount rate and discounting the future cash flows (see Chapter 21 at section 7.2 and below in section 11.4.2.A)
- Step 6: Comparing carrying value with VIU (assuming FVLCD is lower than carrying value) and recognising impairment losses (see Chapter 21 at sections 7.3 and 11)

11.4.1 Consistency in cash flows and book values attributed to the CGU

An essential requirement of impairment testing under IAS 36 is that the recoverable amount of a CGU must be determined in the same way as for an individual asset and its carrying amount must be determined on a basis that is consistent with the way in which its recoverable amount is determined. *[IAS 36.74, IAS 36.75]*.

The carrying amount of a CGU includes only those assets that can be attributed directly or allocated on a reasonable and consistent basis. These must be the assets that will generate the future cash inflows used in determining the CGU's VIU. It does not include the carrying amount of any recognised liability, unless the recoverable amount of the cash-generating unit cannot be determined without taking it into account.

For practical reasons, the entity may determine the recoverable amount of a CGU after taking into account assets and liabilities such as receivables or other financial assets, trade payables, pensions and other provisions that are outside the scope of IAS 36 and not part of the CGU. *[IAS 36.79]*. If the cash flows of a CGU are determined taking into account these sorts of items, then it is essential that cash flows and assets and liabilities within CGUs are prepared on a consistent basis.

Specific issues mining entities and oil and gas entities will need to consider are:

- Environmental provisions and similar provisions and liabilities (see section 11.4.1.A below)
- The impact of cash flows associated with lease liabilities recognised in accordance with IFRS 16 (see Chapter 21 at section 7.1.9)
- Working capital such as trade debtors, trade payables and inventories (see Chapter 21 at sections 4.1 and 4.1.3 for further discussion)

11.4.1.A Environmental provisions and similar provisions and liabilities

IAS 36 requires the carrying amount of a liability to be excluded from the carrying amount of a CGU unless the recoverable amount of the CGU cannot be determined without consideration of that liability. *[IAS 36.76, IAS 36.78]*. This typically applies when the asset/CGU cannot be separated from the associated liability. See Chapter 21 at section 4.1.1 for further discussion of some of the practical challenges associated with this issue when it comes to environmental provisions and similar provisions and liabilities.

11.4.2 Projections of cash flows

IAS 36 requires that in calculating VIU an entity base its cash flow projection on the most recent financial budgets/forecasts approved by management, excluding any estimated future cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance. The assumptions used to prepare the cash flows should be reasonable and supportable, which can best be achieved by benchmarking against market data or performance against previous budgets. These projections cannot cover a period in excess of five years, unless a longer period can be justified. *[IAS 36.33(b)]*. Entities are permitted to use a longer period if they are confident that their projections are reliable, based on past experience. *[IAS 36.35]*.

In practice, most production or mining/field plans will cover a period of more than five years and hence management will typically make financial forecasts for a corresponding period. The use of such longer-term forecasts could be appropriate where it is based on proved and probable reserves and expected annual production rates. Assumptions as to the level of reserves expected to be extracted are expected to be consistent with the latest estimates prepared by reserve engineers; annual production rates are expected to be consistent with those of preceding periods; and price and cost assumptions are expected to be consistent with the final period of specific assumptions.

11.4.2.A Cash flows from mineral reserves and resources and the appropriate discount rate

As discussed in sections 2.2 and 2.3 above, a significant amount of work is required before an entity can conclude that its mineral resources should be classified as mineral reserves. In practice, an entity may not have formally completed all of the detailed work that is required in order to designate mineral resources as mineral reserves. IAS 36 requires the cash flow projection used in calculating the VIU of assets to be based on "…reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset". *[IAS 36.33(a)]*. Therefore, while ordinarily the starting point for the calculation of VIU would be based upon the mineral reserves recorded, it could sometimes be appropriate under IAS 36 to take into account mineral resources that have not formally been designated as mineral reserves. However, an entity would need to adjust the discount rate it uses in its VIU calculation for the additional risks associated with mineral resources for which the future cash flow estimates have not been adjusted. *[IAS 36.55]*. If the risks have been factored into the future cash flow estimates modelled, an entity is required to be aware not to also adjust for this risk via the discount rate applied.

The requirements of IAS 36 for determining an appropriate discount rate are discussed in detail in Chapter 21 at section 7.2.

11.4.3 Commodity price assumptions

Forecasting commodity prices is never straightforward, because it is not usually possible to know whether recent changes in commodity prices are a temporary aberration or the beginning of a longer-term trend. Management usually takes a longer-term approach to estimates of commodity prices for internal management purposes, but these are not always consistent with the VIU requirements. Given the long life of most mines and oil fields, an entity must not consider price levels only for the past three or four years. Instead, it is required to consider future pricing based on future supply and demand levels in a changing environment particularly with respect to climate risk. Historical price levels for longer periods, and how these prices were influenced by changes in underlying supply and demand levels, may provide some insight into pricing but must be considered in the context of future supply and demand.

For actively traded commodities, there are typically forward price curves available and, in such situations, these provide another reference point for forecast price assumptions.

The commodity assumptions need to match the profile of the life of the mine or oil field. Spot prices and forward curve prices (where they are available as at the impairment testing date) are more relevant for shorter life mines and oil fields, or for pricing of volumes in the earlier years of a longer life mines or oil fields. Long-term price assumptions are more relevant for longer life mines and oil fields and are typically used beyond the initial 2-3-year period for which forward curve pricing may be used. Forecast prices (where available) are required to be used for the future periods covered by the VIU calculation. Where the forward price curve does not extend far enough into the future, the price at the end of the forward curve is generally held steady or reverts to a longer-term average price (in real terms), where appropriate.

The future cash flows relating to the purchase or sale of commodities might be known from forward purchase or long-term sales contracts for which prices are either fixed or vary based on an index e.g., inflation. Use of these contracted prices in the VIU calculation in place of the spot price or forward curve price for the contracted volumes will generally be acceptable. However, it is possible that some of these forward contracts might be accounted for as derivatives contracts at fair value in accordance with IFRS 9, and therefore the related assets or liabilities will be recognised in the statement of financial position. It is important to ensure consistency between the carrying values included in the CGU and the cash flows included in the VIU calculation with respect to cash flow hedges, whether they qualify for hedge accounting or not. This is discussed further in Chapter 21 at section 4.1.5.

The commodity price is a key assumption in calculating the VIU of any mine or oil field. Only in the context of impairment testing of goodwill and indefinite life intangible assets does IAS 36 specifically require disclosure of:

(i) A description of each key assumption on which management has based its cash flow projections for the period covered by the most recent budgets/forecasts. Key assumptions are those to which the unit's ('group of units') recoverable amount is most sensitive.

(ii) A description of management's approach to determining the value(s) assigned to each key assumption, whether those value(s) reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information. *[IAS 36.134(d)(i), IAS 36.134(d)(ii), IAS 36.134(e)(i), IAS 36.134(e)(ii)]*.

How we see it

In practice, considerable differences may exist between entities in their estimates of future commodity prices. Therefore, we recommend disclosure of the actual commodity prices used in calculating the VIU of any mine or oil field that does not have any goodwill or indefinite life intangibles allocated to it, even though this is not specifically required by IAS 36 as these would generally be considered a significant judgement or estimate and hence would require disclosure under IAS 1.

A possible approach to such disclosures is illustrated in Practical example 11-2 below from the financial statements of BP p.l.c.

Practical example 11-2: BP p.l.c. (2022) **United Kingdom**

bp Annual Report and Form 20-F 2022 [extract]

Parent company financial statement of BP p.l.c. [extract]

Notes on financial statements [extract]

1. Significant accounting policies, judgements, estimates and assumptions [extract]

Investments [extract]

Significant judgements and estimates: recoverability of asset carrying values [extract]

Oil and natural gas properties

For upstream oil and natural gas properties in subsidiaries, expected future cash flows are estimated using management's best estimate of future oil and natural gas prices, and production and reserves and certain resources volumes. The estimated future level of production in all impairment tests is based on assumptions about future commodity prices, production and development costs, field decline rates, current fiscal regimes and other factors. A change in the discount rate, reserves, resources or the oil and gas price assumptions in the next financial year may result in a recoverable amount of one or more of these assets above or below the current carrying amount and therefore there is a risk of impairment reversals or charges in that period. Management consider that reasonably possible changes in the discount rate or forecast revenue, arising from a change in oil and natural gas prices and/or production could result in a material change in their carrying amounts within the next financial year.

Oil and natural gas prices

The price assumptions used for value in use impairment testing are based on those used for investment appraisal. bp's carbon emissions cost assumptions and their interrelationship with oil and gas prices are described in 'Judgements and estimates made in assessing the impact of climate change and the transition to a lower carbon economy' on page 185. The investment appraisal price assumptions are recommended by the senior vice president economic & energy insights after considering a range of external price sets and supply and demand profiles associated with various energy transition scenarios. They are reviewed and approved by management. As a result of the current uncertainty over the pace of transition to lower-carbon supply and demand and the social, political and environmental actions that will be taken to meet the goals of the Paris climate change agreement, the scenarios considered include those where those goals are met as well as those where they are not met.

During the year, bp's price assumptions applied in value-in-use impairment testing (in real 2021 terms) for Brent oil assumption from 2024 up to 2030 was increased to $70 per barrel to reflect near term supply constraints before steadily declining to $45 per barrel by 2050 continuing to reflect the assumption that as the energy system decarbonises, falling oil demand will cause oil prices to decline. The price assumptions for Henry Hub gas up to 2035 and up to 2050 were increased to $4 per mmBtu and $3.50 per mmBtu respectively to reflect the increased demand for US gas production to offset reduced Russian gas flows. These price assumptions are derived from the central case investment appraisal assumptions, adjusted where applicable to reflect short-term market conditions (see page 28). A summary of the group's revised price assumptions for Brent oil and Henry Hub gas, applied in 2022 and 2021, in real 2021 terms, is provided below. The assumptions represent management's best estimate of future prices at the balance sheet date, which sit within the range of external scenarios considered as appropriate for the purpose. They are considered by bp to be in line with a range of transition paths consistent with the temperature goal of the Paris climate change agreement, of holding the increase in the global average temperature to well below 2°C above pre-industrial levels and pursuing efforts to limit the temperature increase to 1.5°C above pre-industrial levels. However, they do not correspond to any specific Paris-consistent scenario. An inflation rate of 2% (2021 2%) is applied to determine the price assumptions in nominal terms.

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The parent company financial statements of BP p.l.c. on pages 291-349 do not form part of bp's Annual Report on Form 20-F as filed with the SEC.

Practical example 11-3 below illustrates a similar type of disclosure by Newcrest Mining Limited from its 30 June 2022 financial statements, in this case as part of the key assumption disclosures within its impairment disclosures.

Practical example 11-3: Newcrest Mining Limited (2022) **Australia**

Newcrest Annual Report 2022 [extract]
Consolidated Financial Statements [extract]
Notes to the Consolidated Financial Statements [extract]
12. Impairment of Non-Financial Assets [extract]
(c) Key Judgements, Estimates and Assumptions [extract]

The table below summarises the key assumptions used in the carrying value assessments as at 30 June 2022, and for comparison also provides the equivalent assumptions used in 2021:

	As at 30 June 2022					As at 30 June 2021				
Assumptions for financial year	2023	2024	2025	2026	Long term (2027+)	2022	2023	2024	2025	Long term (2026+)
Gold (US$ per ounce)	$1,750	$1,650	$1,550	$1,550	$1,500	$1,750	$1,700	$1,550	$1,500	$1,500
Copper (US$ per pound)	$3.70	$3.60	$3.50	$3.50	$3.50	$3.75	$3.50	$3.30	$3.30	$3.30
AUD:USD exchange rate	$0.73	$0.75	$0.75	$0.75	$0.75	$0.78	$0.78	$0.77	$0.76	$0.75
CAD:USD exchange rate	$0.80	$0.80	$0.80	$0.80	$0.80	$0.80	$0.80	$0.80	$0.80	$0.80
USD:PGK exchange rate	K3.52	K3.52	K3.52	K3.52	K3.52	K3.51	K3.51	K3.51	K3.51	K3.51

Commodity prices and exchange rates estimation approach

Commodity price and foreign exchange rates are estimated with reference to external market forecasts and reviewed at least annually. The rates applied have regard to observable market data including spot and forward values, and to market analysis including equity analyst estimates.

Metal prices

Newcrest has updated its US dollar gold price estimates and its US dollar copper prices applied as at 30 June 2022. These changes were to align with observable market data, taking into account spot prices during the 2022 financial year and Newcrest's analysis of observable market forecasts for future periods. Newcrest has maintained its long-term gold price.

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11.4.4 Future capital expenditure

When determining VIU, although the standard permits an entity to take account of cash outflows required to make an asset ready for use, i.e., those relating to assets under construction, *[IAS 36.42]*, it does not allow inclusion of cash outflows relating to future restructuring to which an entity is not yet committed, or, improving or enhancing an asset's performance. *[IAS 36.44]*. This may have a significant impact on relatively new assets and on fields or mines that will be developed over time. Note that while enhancement capital expenditure may not be recognised, routine or replacement capital expenditure necessary to maintain the function or current performance of the asset or assets in the CGU has to be included. Entities must therefore distinguish between maintenance and enhancement expenditure. This distinction may not be easy to draw in practice but, for example, an anticipated increase in mineral reserves as a consequence of incurring future capital expenditure may be an indicator that the expenditure is enhancement expenditure.

11.4.5 Foreign currency cash flows

An entity in the extractive industries will often sell its product in a currency that is different from the one in which it incurs its production costs (e.g., silver production may be sold in US dollars while production costs may be incurred in pesos). In such situations, impairment testing and calculating VIU under IAS 36 require that the foreign currency cash flows should first be estimated in the currency in which they will be generated and then discounted using a discount rate appropriate for that currency. An entity is then required to translate the present value calculated in the foreign currency using the spot exchange rate at the date of the VIU calculation. *[IAS 36.54]*. This is to avoid the problems inherent in using forward exchange rates, which are based on differential interest rates. Using such forward rates would result in double-counting the time value of money, first in the discount rate and then in the forward rate. *[IAS 36.BCZ49]*.

This requirement, however, is more complex than it may initially appear. Effectively, this method requires an entity to perform separate impairment tests for cash flows generated in different currencies, but make them consistent with one another so that the combined effect is meaningful. This can be a difficult exercise to undertake. Many different factors need to be considered, including relative inflation rates and relative interest rates, as well as appropriate discount rates for the currencies in question. Because of this, the possibility for error is significant, given this, it is important for entities to seek input from experienced valuers who will be able to assist them in dealing with these challenges.

11.5 Calculation of FVLCD

FVLCD is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, less the costs of disposal. *[IAS 36.6]*. FVLCD is less restrictive in its application than VIU and can be easier to work with, which may be why some entities choose to use this approach for impairment testing purposes. While IAS 36 does not impose any restrictions on how an entity determines the FVLCD, there are specific requirements in IFRS 13 as to how to determine fair value. IFRS 13 is discussed in more detail in Chapter 15.

The concept of fair value in IFRS 13 is explicitly an exit price notion. FVLCD, like fair value, is not an entity-specific measurement, but is focused on market participants' assumptions for a particular asset or liability. Under IFRS 13, for non-financial assets, entities have to consider the highest and best use (from a market participant perspective) to which the asset could be put. However, it is generally presumed that an entity's current use of those mining or oil and gas assets or CGUs would be its highest and best use (unless market or other factors suggest that a different use by market participants would maximise the value of the asset).

IFRS 13 does not limit or prioritise the valuation technique(s) an entity might use to measure fair value. An entity could use any valuation technique, or multiple techniques, as long as it is consistent with one of three valuation approaches: market approach, income approach and cost approach and is appropriate for the type of asset/CGU being measured at fair value. However, IFRS 13 does focus on the type of inputs to be used and requires an entity to maximise the use of relevant observable inputs and minimise the use of the unobservable inputs.

Historically, many mining entities and oil and gas entities have calculated FVLCD using a discounted cash flow (DCF) valuation technique. This approach differs from VIU in a number of ways. One of the key differences is that FVLCD would require an entity to use assumptions that a market participant would be likely to take into account rather than entity-specific assumptions. For example, as mining sector and oil and gas sector market participants invest for the longer term, they would not restrict themselves to a limited project time horizon. Therefore, the cash flow forecasts included in a FVLCD calculation could cover a longer period than may be used in a VIU calculation. Moreover, market participants would also likely take into account future expansionary capital expenditure related to subsequent phases in the development of a mining property in a FVLCD calculation, whereas this is not permitted in a VIU calculation. Having said this, some of the issues discussed above for a VIU calculation also need to be considered for a FVLCD calculation which uses a DCF model (we discuss some of these further below). As illustrated in Practical example 11-1 in section 11.1 above, BHP uses this approach in determining the FVLCD for its mineral assets.

11.5.1 Projections of cash flows

As required by IFRS 13, the assumptions and other inputs used in a FVLCD DCF model are required to maximise the use of observable market inputs. These are required to be both realistic and consistent with what a typical market participant would assume.

11.5.2 Commodity price assumptions

Similar to a VIU calculation, commodity price is a key assumption in calculating the FVLCD of any mine or oil field when using a DCF model, and therefore similar issues as those discussed for a VIU calculation (see section 11.4.3 above) apply. On the same basis, while the specific disclosure requirements relating to price assumptions in IAS 36 technically only apply in the context of impairment testing of CGUs to which goodwill and indefinite life intangible assets are allocated, because there can be considerable differences between entities in their estimates of future commodity prices, we recommend additional disclosures be provided. Regardless of the specific requirements of IAS 36, an entity is also required to consider the disclosure requirements relating to significant judgements or estimates and hence the requirements of IAS 1. *[IAS 1.122, IAS 1.125]*. For example, an entity may wish to disclose the actual commodity prices used in calculating the FVLCD of any mine or oil field, as these would generally be considered a significant judgement or estimate and hence would require disclosure under IAS 1.

11.5.3 Future capital expenditure

There are no restrictions similar to those applicable to a VIU calculation when determining FVLCD provided that it can be demonstrated that a market participant would be willing to attribute some value to the future enhancement and that the requirements of IFRS 13 have been complied with. IFRS 13 is discussed in more detail in Chapter 15.

The treatment of future capital expenditure in an impairment test is discussed in more detail in Chapter 21 at section 7.1.2.

11.5.4 Foreign currency cash flows

For FVLCD calculations, the requirements relating to foreign currency cash flows are not specified other than they must reflect what a market participant would use when valuing the asset or CGU. In practice, entities that use a DCF analysis when calculating FVLCD will incorporate a forecast for exchange rates into their calculations rather than using the spot rate. A key issue in any forecast is the assumed timeframe over which the exchange rate may return to lower levels. This assumption is generally best analysed in conjunction with commodity prices in order to ensure consistency in the parameters used, i.e., a rise in prices will usually be accompanied by a rise in currency.

11.6 Low mine or field profitability near end of life

While mining entities and oil and gas entities would like to achieve steady profitability and returns over the life of a project, it is not uncommon to see profitability declining over the life of a mine or field. From an economic perspective, a mining company or oil and gas company will generally continue to extract minerals as long as the cash inflows from the sale of minerals exceed the cash cost of production.

From a mining perspective, most mine plans aim to maximise the net present value of mineral reserves by first extracting the highest-grade ore with the lowest production costs. Consequently, in most mining operations, the grade of the ore mined steadily declines over the life of the mine which results in a declining annual production, while the production costs (including depreciation/amortisation) per volume of ore, e.g., tonne, gradually increases as it becomes more difficult to extract the ore. From an oil and gas perspective, both oil and gas may be produced from the same wells but ordinarily oil generates greater revenue per barrel of oil equivalent sold relative to gas. As the oil is often produced in greater quantities first, this means that the oil and gas operation is often more profitable in the earlier years relative to later years.

Consequently, where there is a positive net cash flow, a mining company or oil and gas company will continue to extract minerals even if it does not fully recover the depreciation of its property, plant and equipment and mineral reserves, as is likely to occur towards the end of the mine or field life. In part, this is the result of the depreciation methods applied:

- The straight-line method of depreciation allocates a relatively high depreciation charge to periods with a low annual production.
- A units of production method based on the quantity of ore extracted allocates a relatively high depreciation charge to production of lower grade ore compared to the price at which such ore is sold.
- A units of production method based upon the quantity of petroleum product produced in total terms allocates an even depreciation charge per barrel of oil equivalent, whereas the revenue earned varies.
- A units of production method based on the quantity of minerals produced allocates a relatively high depreciation charge to production of minerals that are difficult to recover.

Each of these situations is most likely to occur towards the end of the life of a mine or field. It is possible the methods of depreciation most commonly used in each of the sectors do not allocate a sufficiently high depreciation charge to the early life of a project when production is generally most profitable. An entity is required to therefore be mindful of the fact that relatively small changes in facts and circumstances can lead to an impairment of assets.

Following on from this, the impairment tests in the early years of the life of a mine or field will often reveal that the project is cash flow positive and is able to produce a recoverable amount that is sufficient to recoup the carrying value of the project, i.e., the project is not impaired. However, when the impairment tests are conducted in later years, while the mine or field may still be cash flow positive, i.e., the expected cash proceeds from the future sale of minerals still exceed the expected future cash costs of production and hence management will continue with the mining or oil and gas operations, as margins generally reduce towards the end of mine or field life, the impairment tests may not produce a recoverable amount sufficient to recoup the remaining carrying value of the mine or field. Therefore, it will need to be impaired.

It is possible, when preparing the impairment models for a mine or field, for an entity to identify when (in the future) the remaining net cash inflows may no longer be sufficient to recoup the remaining carrying value, that is, when compared to the way in which the assets are expected to be depreciated over the remaining useful life. However, provided the recoverable amount as at the date of the impairment test exceeds the carrying amount of the mine or field, there is no requirement to recognise any possible future impairment. It is only when the recoverable amount actually falls below the carrying amount that an impairment must be recognised.

12 Revenue recognition

The sub-sections below consider some of the specific revenue recognition issues faced by mining entities and oil and gas entities under the requirements as set out in IFRS 15 (see Chapter 28 for more details) or where they may earn other revenue (or other income) in the scope of other standards (see Chapter 28 at section 2.6).

12.1 Revenue in the development phase

Given the nature of extractive industries projects, there are many instances where income may be generated prior to the commencement of commercial production and the asset moving into the production phase.

Some mining examples include:

- During the evaluation phase, i.e., when the technical feasibility and commercial viability are being determined, an entity may 'trial mine', to determine which development method would be the most profitable and efficient in the circumstances, and which metallurgical process is the most efficient. Ore mined through trial mining may be processed and sold during the evaluation phase.
- As part of the process of constructing a deep underground mine, the mining operation may extract some saleable 'product' during the construction of the mine e.g., sinking shafts to the depth where the main ore-bearing rock is located.
- At the other end of the spectrum, income may be earned from the sale of product from 'ramping up' the mine to production at commercial levels.

Some oil and gas examples include:

- Onshore wells are frequently placed on long-term production test as part of the process of appraisal and formulation of a field development plan. Test production may be sold during this time.
- Testing the start-up of an LNG plant or gas processing plant.

There may be instances during the construction/development phase, i.e., before an asset is ready for its intended use, where an entity enters into incidental operations that are not, in themselves, necessary to bring the asset itself into the location and condition necessary for it to be capable of operating in the manner intended by management. The standard gives the example of income earned by using a building site as a car park prior to starting construction. An extractives example may be income earned from leasing out the land surrounding the mine site or an onshore gas field to a local farmer to run his sheep on.

Under IAS 16, the cost of an item of property, plant and equipment includes "…any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management". *[IAS 16.16(b)]*.

IAS 16 makes it clear that because incidental operations such as these are not necessary to bring an item to the location and condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are to be recognised in profit or loss and included in their respective classifications of income and expense. *[IAS 16.21]*. Such incidental income is not offset against the cost of the asset.

Where there has been historical divergence in practice with respect to revenue that is considered integral to development, IAS 16 provides guidance in these instances. This is discussed in sections 12.1.1 and 12.1.2 below.

12.1.1 Revenue is integral to development

IAS 16 requires that the cost of an item of PP&E includes any costs directly attributable to bringing that asset to the location and condition necessary for it to be capable of operating in the manner intended by management. Specifically, one type of cost identified in IAS 16.17(e), is the cost of testing whether the asset is functioning properly, in practice this was determined after deducting the net proceeds from selling any items produced while making the asset available for use.

Effective January 2022, IAS 16 was amended to prohibit the deduction of sales proceeds from the cost of an item of PP&E. Instead, an entity would recognise such sales proceeds, together with the costs of producing those items (production costs), in profit or loss, applying the applicable IFRS.

In applying the provisions of IAS 16, the following is noted:

- The costs of producing items of inventory before an asset is ready for its intended use must be recognised in profit or loss in accordance with applicable standards, and the entity measures the cost of those items applying the measurement requirements of IAS 2. *[IAS 2.34, IAS 16.20A]*.
- Neither specific presentation nor disclosure requirements for the sale of items that are part of an entity's ordinary activities are required.
- For the sale of items that are not part of an entity's ordinary activities (and to which an entity does not apply IFRS 15 and IAS 2), an entity is required to:
  - Disclose separately the sales proceeds and their related production costs recognised in profit or loss. *[IAS 16.74A(b)]*.
  - Specify the line item(s) in the statement of profit or loss and other comprehensive income that include(s) the sales proceeds and the production costs. *[IAS 16.74A(b)]*.

It is noted that, these requirements would lead to greater visibility of an entity's different revenue classes, should this revenue be so material that separate disclosures are required by IFRS 15 or other relevant standards, it would direct more attention to the date at which an asset is ready for its intended use, i.e., the commissioning date. This is a critical date as it impacts other aspects of the accounting for such assets, such as when costs (including borrowing costs) should cease to be capitalised, when accounting for stripping costs changes (mining entities only), and when depreciation commences.

The Basis for Conclusions indicate that, while the IASB observed that an entity would have to apply judgement in identifying the costs, the amendments would require little more judgement beyond that already required to apply current IFRS accounting standards when allocating costs incurred. *[IAS 16.BC16J]*.

The Basis for Conclusions also acknowledges that such an approach would mean that the cost of such inventories would exclude depreciation of any PP&E relating to the production of such inventory, that is not yet available for use. *[IAS 16.BC16F, IAS 16.BC16G]*.

Various approaches have been observed in practice to determine the amount to be included in cost of goods sold. These are discussed in section 12.1.2 below. Similar issues and considerations are likely to continue to arise and will require entities to exercise judgement. It is expected that entities will use their disclosures to clarify their approach to pre-commissioning/testing revenue and the determination of cost of goods sold.

In addition, significant judgement will also continue to be required to determine when the asset is in the location and condition to be capable of operating as intended by management, i.e., when it is ready for its intended use. In the absence of specific guidance, divergence in this judgement will also continue so entities could consider providing clear disclosures.

12.1.2 Approaches to cost allocations where revenue is integral to development

IAS 16 requires an entity to separately identify the production costs associated with selling volumes before an asset is ready for its intended use. An entity is required to identify and measure production costs applying the measurement requirements in paragraphs 9-33 of IAS 2 Inventories.

The key challenge with this issue is usually not how to measure the revenue but how to distinguish those costs that were directly attributable to developing the operating capability of the mine or field from those that represented the cost of producing saleable material. It can be extremely difficult to apportion these costs. Consequently, there is a risk of misstatement of gross profits if these amounts recorded as revenue and the amount of costs included in profit or loss as cost of goods sold were too low or too high.

Other GAAPs have previously provided further guidance that had influenced some of the costing approaches adopted under IFRS accounting standards. The various approaches observed in practice to determine the amount to be included in cost of goods sold include:

- An amount equivalent to the revenues was charged to cost of sales and credited against the asset to record a zero net margin on such production (similar to the guidance in the former OIAC SORP)
- A standard or expected cost of production was ascribed to the volumes produced, e.g., weighted average cost per tonne/barrel based on actual results over a historical period, e.g., the last two or three years; or for new mines or fields, the expected cost per tonne/bbl as set out in the business, mine or field plan, producing a standard margin
- Recognising only the incremental cost of processing the product
- Recognising nothing in cost of goods sold

While diverse treatments may have previously been adopted and accepted in practice, it is unlikely the third and fourth cost of goods sold approaches would be appropriate because they would not provide a fair reflection of the cost to produce the saleable product as required by IAS 16.

12.2 Sale of product with delayed shipment

From time to time, an entity may enter into a sales arrangement where the purchaser pays a significant portion of the final estimated purchase price but then requests delayed shipment, for example, because of limited storage space. These sales can sometimes also be referred to as 'in store sales' or 'bill-and-hold' sales. These are commonly seen in the mining sector.

The application guidance in IFRS 15 specifically addresses bill-and-hold arrangements. IFRS 15 states that an entity will need to determine when it has satisfied its performance obligation to transfer a product by evaluating when a customer obtains control of that product (see Chapter 28 at section 7.2 for more information on transfer of control). In addition to applying these general requirements, an entity must also meet the criteria to be able to demonstrate control has passed for a bill-and-hold arrangement. *[IFRS 15.B79, IFRS 15.B80, IFRS 15.B81, IFRS 15.B82]*. See Chapter 28 at section 7.5 for more information.

IFRS 15 also states that even if an entity recognises revenue for the sale of a product on a bill-and-hold basis, it will also need to consider whether it has remaining performance obligations (e.g., for custodial services or security services) to which the entity will need to allocate a portion of the transaction price. *[IFRS 15.B82]*. See Chapter 28 at section 7.5 for more information.

12.3 Inventory exchanges with the same counterparty

Mining entities and oil and gas entities may exchange inventory with other entities in the same line of business, which is often referred to as 'loans/borrows'. This can occur with commodities such as oil, uranium, coal or certain concentrates, for which suppliers exchange or swap inventories in various locations to supplement current production, to facilitate more efficient management of capacity and/or to help achieve lower transportation costs.

IFRS 15 scopes out certain non-monetary "exchanges between entities in the same line of business to facilitate sales to customers or potential customers." *[IFRS 15.5(d)]*. The legacy scope exclusion in IAS 18 *Revenue* was different. IAS 18.12 used the words 'similar in nature and value' and did not focus on the intention of the exchange. Therefore, some transactions that were treated as exchanges of dissimilar goods (and, hence, revenue-generating under IAS 18) may no longer be considered to be revenue-generating if the entities are in the same line of business and the exchange is intended to facilitate sales to customers or potential customers. Conversely, some exchanges of similar items (and, therefore, excluded from IAS 18) may not be intended to facilitate sales to customers or potential customers and would, therefore, be within the scope of IFRS 15.

Accounting for exchanges of inventories requires a degree of judgement particularly:

- Interpreting what 'same line of business' means and how broadly or narrowly this should be interpreted
- Whether the exchange is to facilitate sales to customers or potential customers
- Whether the transaction is non-monetary and the impact of settling net in cash may have on this assessment

Furthermore, while the scope section of IFRS 15 makes it clear that such inventory exchanges do not result in revenue generation, it does not provide application guidance on how these transactions between the two parties would be accounted for and no other specific requirements exist within IFRS accounting standards. Despite this, any receivable or payable balance would not entirely meet the definition of inventory in IAS 2 but instead would likely be a non-monetary receivable or payable. The product receivable or payable would normally be recorded at cost within current assets or liabilities. However, given the lack of clarity, diversity in accounting practice could continue.

12.4 Over-lift and under-lift (oil and gas)

In jointly owned oil and gas operations, it is often not practical for each participant to take in kind or to sell its exact share of production during a period. In most periods, some participants in the jointly owned operations will be in an over-lift position (i.e., they have taken more product than their proportionate entitlement) while other participants may be in an under-lift position (i.e., they have taken less product than their proportionate entitlement).

Generally, costs are invoiced to the participants in a joint operation in proportion to their equity interest, creating a mismatch between the proportion of revenue lifted and sold and the proportion of costs borne.

Imbalances between volumes for which production costs are recognised and volumes sold (for which revenue is recognised in accordance with IFRS 15) may be settled between/among joint operation participants either in cash or by physical settlement. The accounting could be different depending on the specific terms of the agreement. Such lifting imbalances are usually settled in one of three ways:[110]

- In future periods the owner in an under-lift position may sell or take product in excess of their normal entitlement, while the owner in an over-lift position will sell or take less product than the normal entitlement.
- Cash balancing may be used, whereby the over-lift party will make a cash payment to the under-lift party for the value of the imbalance volume.

  Or
- If the co-owners have joint ownership interests in other properties, they may agree to offset balances in the two properties to the extent possible.

12.4.1 Accounting for imbalances in revenue under IFRS 15

Revenue from contracts with customers that falls within the scope of IFRS 15 should be treated according to the requirements of IFRS 15. Sales of product by a participant in a joint operation to external customers are within the scope of IFRS 15 and should be recognised when the sales actually occur i.e., when the entity satisfies its performance obligation by transferring a promised good or service (i.e., an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset. *[IFRS 15.31]*.

Transactions with other joint operation participants are unlikely to fall within the scope of IFRS 15 and, hence, would not form part of revenue from contracts with customers. *[IFRS 15.5(d), IFRS 15.6]*. This is consistent with IFRS 15.BC52 to IFRS 15.BC56, the March 2015 IFRS IC agenda decision on IFRS 11 ('Recognition of revenue by a joint venture'), and IFRS 11 which states that "A joint operator shall account for the assets, liabilities, revenues and expenses relating to its interest in a joint operation in accordance with the IFRS accounting standards applicable to the particular assets, liabilities, revenues and expenses". *[IFRS 11.21, IFRS 15.BC53-BC56]*.

This was confirmed in the IFRS IC agenda decision issued in March 2019 ('Sale of Output to an Operator'). The IFRS IC concluded that "in the fact pattern described in the request, the joint operator recognises revenue that depicts only the transfer of output to its customers in each reporting period, i.e., revenue recognised applying IFRS 15. This means, for example, the joint operator does not recognise revenue for the output to which it is entitled but which it has not received from the joint operation and sold. The IFRS IC concluded that the principles and requirements in IFRS accounting standards provide an adequate basis for a joint operator to determine its revenue from the sale of its share of output arising from a joint operation as described in the request. Consequently, the IFRS IC decided not to add this matter to its standard-setting agenda."[111]

Accordingly, where a participant in a joint operation has contractual arrangements with customers which do fall within the scope of IFRS 15, it should record revenue from those contracts under IFRS 15, that is, based on its actual sales to customers in that period. No adjustments are to be recorded in revenue to account for any variance between the actual share of production volumes sold to date and the share of production which the party has been entitled to sell to date.

Revenue from contracts with customers recognised in accordance with IFRS 15 is a subset of total revenue recognised by an entity, and must be presented separately as required by IFRS 15. *[IFRS 15.113(a)]*. However, recording adjustments through other revenue in order to align total revenue earned (i.e., revenue from contracts with customers under IFRS 15 plus other revenue) with the share of production the joint operation participant is entitled to in the period, would not be appropriate. Recording the amounts earned in one period in other revenue and, subsequently, recording them as revenue under IFRS 15 in a future period (or *vice versa*), would result in recycling of revenue earned between two line items in profit or loss and would not be appropriate.

110 IASC Issues Paper, 10.27.

111 IFRIC Update, March 2019.

12.4.2 Consideration of cost of goods sold where revenue is recognised in accordance with IFRS 15

If revenue is recognised based on actual sales to customers in the period, and costs are based on invoiced costs to the participants in a joint operation in proportion to their equity interest, there will be a mismatch between the proportion of revenue lifted and sold and the proportion of costs borne.

Entities could determine that it is appropriate to adjust production costs to align volumes for which production costs are recognised with volumes sold (for which revenue has been recognised in accordance with IFRS 15). The accounting for the adjustments to cost of goods sold will depend on whether the imbalances are settled between/among joint operation participants in cash or by physical settlement, as well as whether the joint operation is in an overlift or underlift position.

In the case of physical settlement, an overlift participant would recognise a liability for future expenses by way of future production costs that are not matched by corresponding future revenues. This overlift liability meets the definition of a provision under IAS 37, as the timing and amount of the settlement are uncertain. In applying IAS 37, the amount recognised as a provision should be "…the best estimate of the expenditure required to settle the present obligation at the end of the reporting period," *[IAS 37.36]*, which is "…the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time." *[IAS 37.37]*.

The overlift liability is recorded at the market value or cost of the production imbalance, depending on whether the overlift liability is considered to represent: i) a provision for production costs attributable to the volumes sold in excess of current entitlement (which would likely be recorded at cost); or, ii) an obligation for physical delivery of petroleum product (taken out of the entity's future entitlements) for which fair value measurement may be more appropriate.

Conversely, an underlift participant may recognise an underlift asset depending on whether the underlift participant considers they have: i) a right equivalent to a prepaid commodity purchase; or ii) a right to additional physical inventory, and therefore, applies IAS 2 by analogy. Consistent with IAS 2, an underlift asset would be measured at the lower of cost or net realisable value, *[IAS 2.9]*, or otherwise at net realisable value, if there is a well-established industry practice. *[IAS 2.3(a)]*.

If an overlift or underlift adjustment is recorded in cost of goods sold at fair value, this will result in the joint operator's gross margin reflecting the gross margin that would be earned based on its entitlement interest. If an adjustment were recorded through cost of goods sold at cost, the gross margin shown would reflect the gross margin attributed to the volumes actually sold to customers.

In some instances, not accounting for the effects of imbalances has been justified on the grounds that operating costs for the period should be expensed as incurred because they relate to the period's production activity and not to the revenues recognised.[112]

In the case of cash balancing, the underlift asset or overlift liability meets the definition of a financial asset or financial liability respectively, in accordance with IAS 32 and therefore, should be accounted for in accordance with IFRS 9. The initial recognition of that financial asset or financial liability would be at fair value. Depending on the designation of the financial asset or financial liability, subsequent measurement would be either at amortised cost or fair value.

Practical example 12-1 below sets out Equinor ASA's disclosure of its accounting for revenues relating to oil and natural gas properties in which the group has an interest with other entities.

Practical example 12-1: Equinor ASA (2022) **Norway**

Annual Report and Form 20-F 2022 [extract]
Consolidated financial statements of the Equinor group [extract]
Notes to the Consolidated financial statements [extract]
7 Total revenues and other income [extract]
Accounting policies [extract]
Revenue from contracts with customers [extract]

Revenues from the production of oil and gas in which Equinor shares an interest with other companies are recognised on the basis of volumes lifted and sold to customers during the period (the sales method). Where Equinor has lifted and sold more than the ownership interest, an accrual is recognised for the cost of the overlift. Where Equinor has lifted and sold less than the ownership interest, costs are deferred for the underlift.

112 IASC Issues Paper, 10.29.

12.4.3 Facility imbalances

Imbalances that are similar to overlifts and underlifts can also arise on facilities such as pipelines when a venturer delivers more or less product into a pipeline than it takes out in the same period. The resulting accounting issues arising are similar to those concerning overlifts and underlifts.

12.5 Production sharing contracts/arrangements (PSCs)

These arrangements are discussed more generally in section 5.3 above. It is necessary to consider whether such contracts are within the scope of IFRS 15. That is, whether the relationship between the government entity and the contracting enterprise (i.e., the mining company or oil and gas company) represents one between a customer and a supplier.

IFRS 15 defines a customer as: *[IFRS 15 Appendix A]*

Extract from IFRS 15

Appendix A
Defined terms

customer	A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

See Chapter 28 at sections 2.3 and 2.4 for details.

There are no specific requirements within IFRS accounting standards governing the accounting for PSCs, which has resulted in accounting approaches that have evolved over time. These contracts are generally considered to be more akin to working interest relationships than pure services contracts. This is because the contracting enterprise assumes risks associated with performing the exploration, development and production activities and receives a share (and often a greater share) of future production as specified in the contract. When an entity determines it has an interest in the mineral rights themselves, revenue is recognised only when the mining company or oil and gas company receives its share of the extracted minerals under the PSC and sells those volumes to third-party customers. In other arrangements, the entity's share of production is considered a fee for services (e.g., construction, development and/or operating services) which is recognised as the services are rendered to the national government entity.

IFRS 15 notes that, in certain transactions, while there may be payments between parties in return for what appears to be goods or services of the entity, a counterparty may not always be a 'customer' of the entity. Instead, the counterparty may be a collaborator or partner that shares the results from the activity or process (such as developing an asset in a collaboration arrangement) rather than to obtain the output of the entity's ordinary activities. Generally, contracts with collaborators or partners are not within the scope of the standard, except as discussed below. *[IFRS 15.6]*.

The IASB decided not to provide additional application guidance for determining whether certain revenue generating collaborative arrangements are in the scope of the standard. In the Basis for Conclusions to IFRS 15, it explains that it would not be possible to provide application guidance that applies to all collaborative arrangements. *[IFRS 15.BC54]*.

In determining whether the contract between a government entity and a contracting enterprise is within the scope of the standard, an entity must look to the definition of a customer and what constitutes its 'ordinary activities' and there should also be a transfer of control of a good or service to the customer (if there is one). It may be that certain parts of the PSC relationship involve the contracting enterprise and the national government entity acting as collaborators (and, hence, that part of the arrangement would be outside the scope of IFRS 15), while for other parts of the arrangement the two parties may act as supplier and customer. The latter is in the scope of IFRS 15 and an analysis of the impact of the requirements will be necessary. See Chapter 28 at section 2.3.

12.6 Forward-selling contracts to finance development

Mineral and oil and gas exploration and development are highly capital intensive businesses and different financing methods have arisen. At times, obtaining financing for these major projects may be difficult, particularly if equity markets are tight and loan financing is difficult to obtain. Some common structured transactions involve the owner of the mineral interests, or oil and gas interests, i.e., a mining entity or oil and gas entity (the producer), selling a specified volume of future production from a specified property/field to a third party 'investor' for cash. Such arrangements can be referred to as streaming arrangements.

A common example in the mining sector might be a precious metal streaming arrangement where a bulk commodity producer (e.g., a copper producer who has a mine that also produces precious metals as a by-product) enters into an arrangement with a streaming company (the investor). Here the producer receives an upfront cash payment and may also receive an ongoing predetermined per ounce payment for part or all of the by-product precious metal (the commodity) production - ordinarily gold and/or silver, which is traded on an active market. By entering into these contracts, the mining entity is able to access funding by monetising the non-core precious metal, while the investor receives the future production of precious metals without having to invest directly in, or operate, the mine.

We also note that similar types of arrangements are used in the oil and gas sector as a source of funding.

These arrangements can take many forms and accounting for such arrangements can be highly complex. In many situations there is no specific guidance for accounting for these types of arrangements under IFRS accounting standards.

12.6.1 Accounting by the producer

Generally, the accounting for these arrangements by the producer could be one of the following:

- *A sale of a mineral interest* (under IAS 16 or IAS 38) *and a contract to provide services such as extraction, refining*, etc., in accordance with IFRS 15. This would occur when the arrangement effectively transfers control over a portion of the mine from the producer to the investor and there is an obligation to provide future extraction services.
- *A commodity contract*, which is outside the scope of IFRS 9 and in the scope of IFRS 15. This would only occur when the arrangement is an executory contract to deliver an expected amount of the commodity in the future to the investor from the producer's own operation (i.e., it meets the 'own-use' exemption). If the commodity contract does not meet the own-use exemption, the arrangement will be in scope of IFRS 9.
- *A financial liability* (i.e., debt) in accordance with IAS 32 and IFRS 9. A key factor in determining whether the contract is a financial liability is whether the contract establishes an unavoidable contractual obligation for the producer to make payments in cash or another financial asset, *[IAS 32.11, IAS 32.16(a)]*, that is, whether the arrangement has more of the characteristics of debt.

Whether the arrangement constitutes, a sale of mineral interest, a contract to provide services, a forward sale of a commodity or a debt, is subject to significant judgement.

In each classification, the producer must assess and determine whether the arrangement contains separable embedded derivatives. That is, the producer would need to determine whether the arrangement contains a component or terms which had the effect that some of the cash flows of the combined instrument (being the arrangement) vary in a similar way to a stand-alone derivative (i.e., an embedded derivative).

For both the producer and the investor, each arrangement will have very specific facts and circumstances that will need to be understood and assessed, as different accounting treatments may apply in different circumstances. Understanding the economic motivations and outcomes for both the producer and the investor and the substance of the arrangement are necessary to ensure a robust and balanced accounting conclusion can be reached. In many cases, the route to determining the classification will be a non-linear and iterative process.

The potential implications of IFRS 15 need to be considered for transactions which are considered to be either a sale of a mineral interest with a contract to provide services or a commodity contract.

12.6.1.A Sale of a mineral interest with a contract to provide services

When the nature of the arrangement indicates that the investor's investment is more akin to an equity interest in the project (rather than debt), this could indicate that the producer has essentially sold an interest in a property to the investor in return for the advance. In such a situation, the arrangement would likely be considered (fully or partially) as a sale of a mineral interest. In some instances, some of the upfront payment may also relate to an extraction services contract representing the producer's obligation to extract the investor's share of the future production.

To apply this accounting, an entity would have to be able to demonstrate that the criteria in relation to the sale of an asset in IAS 16 and IAS 38 have been satisfied; that the investor bears the risks and economic benefits of ownership related to the output and control over a portion of the property (a mineral interest); and agrees to pay for a portion or all of the production costs of extracting and/or refining its new mineral interest to the producer. Some of the relevant risks include:

- Production risk (which party bears the risk the project will be unable to produce output or will have a production outage)
- Resource risk (which party bears the risk the project has insufficient reserves to repay the investor)
- Price risk (which party bears the risk the price of the output will fluctuate)

If this is possible, IFRS 15 would indicate that part of this arrangement is outside scope of IFRS 15 and will need to be accounted for in accordance with the applicable IFRS accounting standards. Consequently, the amount paid by the investor will need to be allocated between the sale of the mineral interest and the provision of future extraction services. The mere fact that a portion of consideration was received upfront and a remainder of consideration may be received over the life of the operation does not necessarily mean the upfront payment solely relates to the sale of the mineral interest, or that the subsequent payments due on production relate solely to the provision of future extraction services.For the portion allocated to the sale of the mineral interest, the issues discussed in section 12.9.3 below will need to be considered.

For the portion allocated to the future extraction services, the following provisions of IFRS 15 will need to be considered:

- The identification of performance obligations, i.e., future extraction services (see Chapter 28 at section 4)
- The determination of the transaction price and whether it contains a significant financing component (see Chapter 28 at sections 5 and 5.5)
- The allocation of the transaction price to those performance obligations and how subsequent changes to the transaction price should be allocated (see Chapter 28 at sections 6 and 6.5)
- Whether the performance obligations are satisfied over time or at a point in time (see Chapter 28 at sections 7.1 and 7.2)

Given the period over which these extraction services are to be provided may extend for quite some time into the future and/or may change (particularly if they relate to the remaining life of the mine or field), this may lead to some complexity in the accounting. A reasonable degree of uncertainty still exists as to how these issues should be addressed and how they will impact such arrangements.

12.6.1.B Commodity contract - forward sale of future production

A producer and an investor may agree to enter such an arrangement where both parties have an expectation of the amount of the commodity to be delivered under the contract at inception (for example, based on the reserves) and that there may or may not be additional resources. On the basis that the reserves will be delivered under the contract (and the contract cannot be net settled in cash), the mining company or oil and gas company has effectively pre-sold its future production and the investor has made an upfront payment/advance which would be considered a deposit for some or all of the commodity volumes to be delivered at a future date.

In this case, the arrangement is a commodity contract that falls outside the scope of IAS 32 and IFRS 9, but only if the contract will always be settled through the physical delivery of the commodity which has been extracted by the producer as part of its own operations (i.e., it meets the 'own-use exemption' discussed in section 13.1 below). *[IAS 32.8, IFRS 9.2.4]*.

To determine if the own-use exemption applies and continues to apply, the key tests are whether the contract will always be settled through the physical delivery of a commodity (that is, not in cash and would not be considered to be capable of net settlement in cash), and that the commodity will always be extracted by the producer as part of its own operations. This means that there is no prospect of the producer settling part, or the entire advance, by delivering a different commodity or purchasing the commodity on the open market or from a third party.

The issues to be considered under IFRS 15 will be the same as those relating to the provision of future extraction services (see section 12.6.1.A above).

Practical example 12-2 below sets out Barrick Gold Corporation's assessment of its streaming arrangements under IFRS 15.

Practical example 12-2: Barrick Gold Corporation (2022) **Canada**

Annual Report 2022 [extract]

Notes to consolidated financial statements [extract]

2. Material accounting policy information [extract]

e) Revenue Recognition [extract]

Streaming Arrangements

As the deferred revenue on streaming arrangements is considered variable consideration, an adjustment is made to the transaction price per unit each time there is a change in the underlying production profile of a mine (typically in the fourth quarter of each year). The change in the transaction price per unit results in a cumulative catch-up adjustment to revenue in the period in which the change is made, reflecting the new production profile expected to be delivered under the streaming agreement. A corresponding cumulative catch-up adjustment is made to accretion expense, reflecting the impact of the change in the deferred revenue balance.

3. Critical judgements, estimates, assumptions, and risks [extract]

Streaming Transactions

The upfront cash deposit received from Royal Gold on the gold and silver streaming transaction for production linked to Barrick's 60% interest in the Pueblo Viejo mine has been accounted for as deferred revenue since we have determined that it is not a derivative as it will be satisfied through the delivery of non-financial items (i.e., gold and silver) rather than cash or financial assets. It is our intention to settle the obligations under the streaming arrangement through our own production and if we were to fail to settle the obligations with Royal Gold through our own production, this would lead to the streaming arrangement becoming a derivative. This would cause a change to the accounting treatment, resulting in the revaluation of the fair value of the agreement through profit and loss on a recurring basis. Refer to note 29 for further details.

The deferred revenue component of our streaming agreements is considered variable and is subject to retroactive adjustment when there is a change in the timing of the delivery of ounces or in the underlying production profile of the relevant mine. The impact of such a change in the timing or quantity of ounces to be delivered under a streaming agreement will result in retroactive adjustments to both the deferred revenue recognized and the accretion recorded prior to the date of the change. Refer to note 2e. For further details on streaming transactions, including our silver sale agreement with Wheaton Precious Metals Corp. ("Wheaton"), refer to note 29.

12.6.2 Accounting by the investor

From the investor's perspective, where the accounting becomes more complex is where the investor has acquired a right to receive cash, some quantity or value of a particular commodity, or the option to choose one or the other, or some combination of both. From the investor's perspective, there are generally four common accounting outcomes that are frequently observed:

- Acquisition of a mineral interest (under the principles of IAS 16 or IAS 38) and potentially a prepayment in relation to future services such as extraction, refining, etc., - this would occur when the arrangement effectively transfers control over a portion of the mine/field from the producer to the investor and there is a right to receive future extraction services
- Commodity contract, which is outside the scope of IFRS 9 and in the scope of IAS 38 likely as a prepayment - this would only occur when the arrangement is an executory contract to receive an expected amount of the commodity in the future from the producer and it meets the 'own-use' exemption for the investor. If the commodity contract does not meet the own-use exemption, the arrangement will be in scope of IFRS 9
- A financial asset (i.e., a receivable or some sort of other financial asset) in accordance with IFRS 9 - this would occur when the arrangement establishes a contractual right to receive cash or another financial asset in the future
- A mix of all three

The accounting implications of each for the investor, from a profit or loss perspective, can be significantly different.

12.7 Trading activities

Many mining and metals and oil and gas entities engage in trading activities (e.g., crude oil cargos or coal) and they may either take delivery of the product or resell it without taking delivery. Even when an entity takes physical delivery and becomes the legal owner of a commodity, it may still only be as part of its trading activities. Such transactions do not fall within the normal purchase and sales exemption (see section 13.1 below) when "for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin." *[IAS 32.9(c), IFRS 9.2.6(c)]*. Where the entity has a practice of settling similar physical commodity-based contracts net in cash, these contracts also do not fall within the normal purchase and sales exemption. *[IAS 32.9(b), IFRS 9.2.6(b)]*. In that case, the purchase and sales contracts should be accounted for as derivatives within the scope of IFRS 9.

12.8 Embedded derivatives in commodity arrangements

IFRS 15 states that if a contract is partially within scope of this standard and partially in the scope of another standard, entities will first apply the separation and measurement requirements of the other standard(s). *[IFRS 15.7]*. Therefore, to the extent that there is an embedded derivative contained within a revenue contract, e.g., provisional pricing mechanisms (discussed in more detail in section 12.8.1 below), diesel price linkage in a crude oil contract, or oil price linkage in a gas sales contract, these will continue to be assessed and accounted for in accordance with IFRS 9.

Under IFRS 9, if a feature of a revenue contract is considered to be an embedded derivative that is not closely related to a non-financial host contract; the embedded derivative is required to be separated from the non-financial host contract. If it is closely related, it is not required to be separated. In the event that the embedded derivative is considered to be closely related to the non-financial host contract, once transfer of control of the product has occurred and the entity has an unconditional right to receive cash and the host contract becomes a financial asset (i.e., a receivable), the accounting changes.

Under IFRS 9, embedded derivatives are not separated from a host financial receivable. Instead, the receivable will fail the contractual cash flows test. As a consequence, the whole receivable will have to be subsequently measured at fair value through profit or loss from the date of recognition of that receivable. See Chapter 44 at section 1 for more information on the classification of financial assets under IFRS 9.

IFRS 15 does not impact the treatment of embedded derivatives under IFRS 9. Revenue within the scope of IFRS 15 will be recognised when control passes to the customer and will be measured at the amount to which the entity expects to be entitled. Any subsequent fair value movements in the receivable would be recognised in profit or loss. However, as a result of the specific disclosure requirements of IFRS 15, these need to be presented separately from IFRS 15 revenue. This is discussed in relation to provisionally priced sales in section 12.8.1 below.

12.8.1 Provisionally priced sales contracts

Sales contracts for certain commodities (e.g., copper and oil) often provide for provisional pricing at the time of shipment. The final sales price is often based on the average quoted market prices during a subsequent period (the 'quotational period' or 'QP'), the price on a fixed date after delivery or the amount subsequently realised by another party (e.g., the smelter or refiner, net of tolling charges).

As discussed in section 13.2.2 below, these QP pricing exposures may meet the definition of an embedded derivative under IFRS 9. The treatment of embedded derivatives in commodity contracts is discussed in more detail in section 12.8 above.

From a revenue recognition perspective, under IFRS 15, revenue will be recognised when control passes to the customer and will be measured at the amount to which the entity expects to be entitled, being the estimate of the price expected to be received at the end of the QP, i.e., the forward price. *[IFRS 15.47]*. Furthermore, any changes in volume, for example between initial and final assays (where material), will be accounted for as variable consideration under IFRS 15 on the basis that volume adjustments are directly related to the satisfaction of an entity's performance obligation.

If shipping is considered to be a separate performance obligation, some of the revenue may need to be allocated between the sale of the commodity and provision of shipping services. See section 12.12 below for further discussion.

With respect to the presentation of any fair value movements in the receivable from the date of sale, entities have often presented the QP movements as part of revenue. IFRS 15 does not address the presentation of fair value movements in receivables. Likewise, IFRS 9 does not specify where such movements should be presented in profit or loss.

IFRS 15 only addresses a subset of total revenue (i.e., revenue from contracts with customers). That is, transactions outside the scope of IFRS 15 might result in the recognition of revenue. However, while IFRS 15 does not specifically prohibit fair value movements of a receivable from being described as revenue, it does specifically require an entity to disclose revenue from contracts with customers separately from its other sources of revenue, either in the statement of comprehensive income or in the notes. *[IFRS 15.113]*. Therefore, entities will need to track these separately.

The Practical examples below set out the accounting policy for provisionally priced sales for Rio Tinto plc and Anglo American Platinum Limited under IFRS 15.

Practical example 12-3: Rio Tinto plc (2022) **United Kingdom**

Annual Report 2022 [extract]
Financial statements [extract]
Notes to the 2022 financial statements [extract]
Our financial performance [extract]
6 Revenue by destination and product [extract]
Recognition and measurement [extract]

Certain of the Group's products may be provisionally priced at the date revenue is recognised and a provisional invoice issued; however, substantially all iron ore and aluminium sales are reflected at final prices in the results for the period. Provisionally priced receivables are subsequently measured at fair value through the income statement under IFRS 9 "Financial Instruments" as described in note 24. The final selling price for all provisionally priced products is based on the price for the quotational period stipulated in the contract. Final prices for copper concentrate are normally determined between 30 and 120 days after delivery to the customer. The change in value of the provisionally priced receivable is based on relevant forward market prices and is included in sales revenue; refer to "Other revenue" within the sales by product disclosure below.

...

(a) Consolidated sales revenue includes both revenue from contracts with customers, accounted for under IFRS 15, and subsequent movements in provisionally priced receivables, accounted for under IFRS 9, and included in "other revenue" above.

...

Practical example 12-4: Anglo American Platinum Limited (2022) **United Kingdom**

Integrated Annual Report 2022 [extract]
Financial statements and other financial information [extract]
Notes to the financial statements [extract]
Other items [extract]
39. Accounting policies [extract]
C. Financial performance [extract]
Revenue recognition [extract]

Revenue is derived principally from commodity sales. A sale is recognised when control has been transferred. This is usually when title and insurance risk have passed to the customer and the goods have been delivered to a contractually agreed location. Revenue from contracts with customers is measured at the fair value of consideration received or receivable as at the date control is transferred, after deducting discounts, volume rebates, value added tax and other sales taxes. Sales of metal concentrate are stated at their invoiced amount which is net of treatment and refining charges.

Sales of certain commodities are provisionally priced such that the price is not settled until a predetermined future date and is based on the market price at that time or a specified period to that date. These sales are marked to market at each reporting date using the forward price for the period equivalent to that outlined in the contract. Revenue on provisionally priced sales is recognised with reference to the forward market price when control passes to the customer and is classified as revenue from contracts with customers. Subsequent mark-to-market adjustments are recognised in revenue from other sources.

...

12.9 Royalty income

Entities in the extractive industries sometimes enter into arrangements whereby they may receive some form of royalty income. This may arise when they sell some or all their interest in a mining project or oil and gas project and in return agree to accept a future royalty amount which may be based on production and/or payable in cash or in kind. Alternatively, the acquiring entity may pay a net profit interest, that is, a percentage of the net profit (calculated using an agreed formula) generated by the interest sold. There may be other types of arrangements where the mining company or oil and gas company grants another entity a right in return for other types of payments - for example streaming arrangements (see section 12.6 above for more detail).

Accounting for mineral rights and mineral reserves is scoped out of a number of standards including IAS 16, IAS 38 and IFRS 16. Consequently, diverse practice has emerged in the accounting for such transactions.

With respect to these royalty arrangements, these can take a number of different forms and different accounting approaches have emerged. These may include:

- *Future receipt is solely dependent on production:* For some arrangements, the future royalty stream is solely dependent on future production, such that, if there is no future production, no royalty income will be received.

  In some instances, the inflows (i.e., the royalty income) and the associated royalty receivable, are only recognised once the related mineral is extracted and the royalty is due, rather than when the interest in the project is originally sold. When such royalty receipts occur, they are often disclosed as either revenue or other income.

  An alternate approach observed is that the sale of the mineral interest is considered to create a contractual right to receive these royalty amounts (i.e., a contractual right to receive cash). Therefore, such royalty amounts (and, hence, the related receivable) would be recognised at the date of disposal and included in the calculation of the gain or loss on sale. Further divergence exists as to how subsequent movements in the receivable are recognised in profit or loss (i.e., as revenue or as other gains/losses).

  There is more specific guidance when the royalty receivable represents contingent consideration in the sale of a business (see Chapter 41 at section 2.7.1.B).

- *Minimum additional amount due, but timing linked to production:* In other arrangements, the entity may be entitled to receive a certain additional (minimum) amount of cash regardless of the level of production, but the timing of receipt is linked to future production. This type of arrangement is considered to establish a contractual right to receive cash at the point when the disposal transaction occurs. Therefore, an entity recognises a receivable and the associated income when the arrangement is entered into and this will form part of the gain or loss on sale of the mineral interest.

The impact of IFRS 15 will depend on whether the royalty arrangement is considered to arise from a collaborative arrangement, in the context of a supplier-customer relationship, or from the sale of a non-financial asset.

12.9.1 Royalty arrangements with collaborative partners

As discussed in section 12.5 above, IFRS 15 only addresses contracts with customers for goods or services provided in the ordinary course of an entity's business, it does not apply to arrangements between collaborative partners. *[IFRS 15.6]*. Where royalties are received by an entity as part of such an arrangement, they will generally not be in the scope of IFRS 15, unless the collaborator or partner meets the definition of a customer for some, or all, aspects of the arrangement. See section 12.9.2 below.

12.9.2 Royalty arrangements with customers

IFRS 15 does not scope out revenue from the extraction of minerals. Therefore, regardless of the type of product being sold, if the counterparty to the contract is determined to be a customer, then the contract will be in scope of IFRS 15.

If a royalty arrangement is considered to be a supplier-customer relationship (and, hence, is in scope), mining entities and oil and gas entities may face a number of challenges in applying IFRS 15 to these arrangements. These may include identifying the performance obligations, determining the transaction price (e.g., if consideration is variable and dependent upon actions by the customer, which would be the case for the future extraction of minerals), applying the constraint on variable consideration, and reallocating the transaction price when and if there is a change in the transaction price. See Chapter 28 for more details on these requirements.

When considering the accounting for such royalties, IFRS 15 contains specific requirements that apply to licences of intellectual property, which may appear similar to some types of royalty arrangements in extractives industries. However, it is important to note that the IFRS 15 requirements only apply to licences of intellectual property and not all sales-based or usage-based royalties. So, the general requirements applicable to variable consideration, including those relating to the constraint, will need to be considered (see Chapter 28 at section 5.2 for further discussion).

12.9.3 Royalty arrangements and the sale of non-financial items

If the royalty arrangement is not considered to relate to a contract with a customer nor to a collaborative arrangement, but instead, relates to the sale of a non-financial asset (e.g., an interest in a mining project or oil and gas project), IFRS 15 may still impact these arrangements. This is because the requirements for the recognition and measurement of a gain or loss on the transfer of some non-financial assets that are not the output of an entity's ordinary operations (e.g., property, plant and equipment in the scope of IAS 16), refer to the requirements of IFRS 15 (see Chapter 28 at section 2.6.3 for more detail).

Specifically, an entity needs to:

- Determine the date of disposal and, therefore, the date of derecognition (i.e., the date control transfers to the acquirer) (see Chapter 28 at section 7.2 for more detail)
- Measure the consideration to be included in the calculation of the gain or loss arising from disposal including any variable consideration requirements (see Chapter 28 at section 5 for more detail)
- Recognise any subsequent changes to the estimated amount of consideration (see Chapter 28 at section 5.9 for more detail)

Mineral rights and mineral reserves (and, hence, the associated capitalised costs) are outside the scope of both IAS 16 and IAS 38. However, in selecting an accounting policy for the disposal of these assets, in practice, most entities look to the principles of these two standards. Therefore, these requirements are likely to be applied by analogy to arrangements in which an entity sells all (or part) of its mining properties or oil and gas properties and some of the consideration comprises a royalty-based component.

There is also a lack of clarity as to how to apply the requirements of IFRS 15 to such arrangements where, by virtue of the royalty rights, the vendor is considered to have retained an interest in the mineral property.

This may impact what is recognised or derecognised from the balance sheet in terms of mineral assets and/or financial assets, and also the gain/loss that is recognised in profit or loss.

There is more specific guidance on when the royalty receivable represents contingent consideration in the sale of a business (see Chapter 10 at section 7.1 and Chapter 43 at section 4.3).

12.10 Modifications to commodity-based contracts

Mining entities and oil and gas entities frequently enter into long-term arrangements for the sale, transportation or processing of commodities. Over time, these contractual arrangements may be amended to effect changes in tenure, volume, price, or delivery point, for example. This may take the form of amendments, new tranches under existing agreements, or new contractual arrangements. IFRS 15 contains requirements on how to account for changes to a contract depending on whether the change is considered to be a contract modification, a new contract, or a combination of both. Further guidance on contract modifications is set out in Chapter 28 at section 3.4.

12.11 Principal versus agent considerations in commodity-based contracts

When identifying performance obligations, there may be some arrangements for which an entity needs to determine whether it is acting as principal or agent. This will be important as it affects the amount of revenue the entity recognises. That is, when the entity is the principal in the arrangement, the revenue recognised is the gross amount to which the entity expects to be entitled. When the entity is the agent, the revenue recognised is the net amount the entity is entitled to retain in return for its services as the agent. The entity's fee or commission may be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party. The critical factor to consider here is whether the entity has control of the good or service before transferring on to its customer. See Chapter 28 at section 4.4 for more information on the principal versus agent indicators.

12.11.1 Relationships with joint arrangement partners

It is not uncommon for valid vendor-customer relationships to exist alongside joint arrangement/collaborator contracts such as joint operating agreements or production sharing contracts. The manager/lead operator of a joint arrangement may have a vendor-customer contract to purchase volumes produced by the non-operating parties. The manager/lead operator would then on sell the product to third parties, and depending on the specific contract terms, could be acting as the principal in the onward sale, or as agent that is selling on behalf of the other joint arrangement partners.

Similarly, an entity with a gathering station or processing plant could purchase commodities from other parties with tenements or fields in the same region at the point of entry into the plant. Both the seller and purchaser would have to consider whether the purchaser is a principal or an agent in the onward sale to the third-party customer and account for the revenue accordingly.

Practical example 12-5: Equinor ASA (2022) **Norway**

Annual Report on Form 20-F 2022 [extract]
Consolidated financial statements of the Equinor group [extract]
Notes to the Consolidated financial statements [extract]
7 Total revenues and other income [extract]
Accounting policies [extract]

Transactions with the Norwegian State
Equinor markets and sells the Norwegian State's share of oil and gas production from the Norwegian continental shelf (NCS). The Norwegian State's participation in petroleum activities is organised through the SDFI (the Norwegian State's Direct Financial Interests). All purchases and sales of the SDFI's oil production are classified as purchases [net of inventory variation] and revenues from contracts with customers, respectively.

Equinor sells, in its own name, but for the SDFI's account and risk, the SDFI's production of natural gas. These gas sales and related expenditures refunded by the SDFI are presented net in the Consolidated financial statements. Natural gas sales made in the name of Equinor's subsidiaries are also presented net of the SDFI's share in the Consolidated statement of income, but this activity is reflected gross in the Consolidated balance sheet.

Accounting judgement related to transactions with the Norwegian State
Whether to account for the transactions gross or net involves the use of significant accounting judgement. In making the judgement, Equinor has considered whether it controls the State-originated crude oil volumes prior to onwards sales to third party customers. Equinor directs the use of the volumes, and although certain benefits from the sales subsequently flow to the SDFI, Equinor purchases the crude oil volumes from the SDFI and obtains substantially all the remaining benefits. On that basis, Equinor has concluded that it acts as principal in these sales.

Regarding gas sales, Equinor concluded that ownership of the gas had not been transferred from the SDFI to Equinor. Although Equinor has been granted the ability to direct the use of the volumes, all the benefits from the sales of these volumes flow to the SDFI. On that basis, Equinor is not considered the principal in the sale of the SDFI's natural gas volumes.

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12.11.2 Royalty payments

As discussed in section 5.7.5 above, mining entities and oil and gas entities frequently enter into a range of different royalty arrangements with owners of mineral rights (e.g., governments or private land-owners) and at times, the treatment is diverse. It is unclear whether, and how, such arrangements should be accounted for under IFRS 15.

In situations where the royalty holder retains or obtains a direct interest in the underlying production, it may be that the relationship between the mining company or oil and gas company and the royalty holder is more like a collaborative arrangement (and, hence, is not within the scope of IFRS 15). See section 12.5 above for further discussion.

If these royalty payments are in scope, the requirements relating to principal versus agent in IFRS 15 will be helpful in assessing how these royalty payments should be presented. Specifically, an entity will need to determine whether it obtains control of all the underlying minerals once extracted, sells the product to its customers and then remits the proceeds to the royalty holder. If so, the mining company or oil and gas company will be considered to be acting as the principal and, hence, would recognise the full amount as revenue with any payments to the royalty holder being recognised as part of cost of goods sold (or possibly as an income tax, depending on the nature of the royalty payment - see section 21 below for further discussion on determining when an arrangement is an income tax). Where the entity does not obtain control over those volumes, it may be acting as the royalty holder's agent and extracting the minerals on its behalf.

The principal versus agent assessment under IFRS 15 is discussed in more detail in Chapter 28 at section 4.4 and the issue of how sales (and other similar) taxes should be accounted for are discussed in Chapter 28 at section 5.1.

12.12 Shipping

Given the location of the commodities produced in the mining sector and oil and gas sector, they generally have to be shipped to the customer. Such transportation may occur by road, rail or sea. The terms associated with shipping can vary depending on the method of shipping and the contract.

When applying IFRS 15, there are a number of factors to consider in relation to shipping terms linked to customer contracts which are set out below in sections 12.12.1 to 12.12.2.

12.12.1 Identification of performance obligations

Subsequent to the issuance of IFRS 15, there was some debate as to whether shipping represented a separate performance obligation. The issue was raised with the joint Transition Resources Group (TRG) and was also considered by the IASB and US FASB. The US FASB amended their standard to allow US GAAP entities to elect to account for shipping and handling activities performed after the control of a good has been transferred to the customer as a fulfilment cost (i.e., an expense). Without such an accounting policy choice, a US GAAP entity that has shipping arrangements after the customer has obtained control may determine that the act of shipping is a performance obligation under the standard. The IASB did not permit a similar policy choice under IFRS 15.

Given this, when assessing customer contracts, mining entities and oil and gas entities need to consider the requirements of IFRS 15 to determine whether shipping is a separate performance obligation. It is likely that any shipping services provided to a customer after the customer obtains control over a good will represent a separate performance obligation. If this is the case the transaction price for that contract will need to be allocated to the various performance obligations including shipping. Revenue will then be recognised when the goods are delivered and when the shipping services have been provided, either at a point in time or over time.

Practical example 12-6 below illustrates how Rio Tinto plc has identified shipping services in certain types of arrangements to be separate performance obligations.

Practical example 12-6: Rio Tinto plc (2022) **United Kingdom**

Annual Report 2022 [extract]
2022 Financial statements [extract]
Notes to the 2022 financial statements [extract]
Our financial performance [extract]
6 Revenue by destination and product [extract]
Recognition and measurement [extract]

Revenue is principally derived from sale of commodities. We sell the majority of our products on CFR or CIF Incoterms. This means that the Group is responsible (acts as principal) for providing shipping services and, in some instances, insurance after the date at which control of goods passes to the customer at the loading port. The Group, therefore, has separate performance obligations for freight and insurance services that are provided solely to facilitate sale of the products it produces. Other Incoterms commonly used by the Group are Free on Board (FOB), where the Group has no responsibility for freight or insurance once control of the goods has passed at the loading port, and Delivered at Place (DAP), where control of the goods passes when the product is delivered to the agreed destination. For these Incoterms there is only one performance obligation, being the provision of product at the point where control passes.

...

12.12.2 Satisfaction of performance obligations - control assessment

Under IFRS 15, an entity recognises revenue only when it satisfies a performance obligation by transferring control of a promised good or service to the customer and control may be transferred over time or at a point in time. See Chapter 28 for more information.

When assessing contracts with customers, mining entities and oil and gas entities need to carefully examine the terms of their contracts, including shipping terms, in light of the indicators of control, to assess how shipping is required to be accounted for. See Chapter 28 at section 10.3 for more information on presentation considerations relating to shipping costs.

It is also worth noting that there may be some shipping arrangements where title to the goods must pass to the carrier during transportation, but the related contract includes a clause that requires the carrier to sell the goods back to the mining company or oil and gas company at the same or another specified price. The impact of repurchase clauses is discussed in section 12.14 below.

Practical example 12-7 below illustrates how Anglo American Platinum Limited recognises revenue from shipping services over time.

Practical example 12-7: Anglo American Platinum Limited (2022)	United Kingdom

Integrated Annual Report 2022 [extract]
Financial statements and other financial information [extract]
Notes to the financial statements [extract]
Other items [extract]
39. Accounting policies [extract]
C. Financial performance [extract]
Revenue recognition [extract]

Revenue from services is recognised over time in line with the policy above. For contracts which contain separate performance obligations for the sale of commodities and the provision of freight services, the portion of the revenue representing the obligation to perform the freight service is deferred and recognised over time as the obligation is fulfilled. In situations where the Group is acting as an agent, amounts billed to customers are offset against the relevant costs.

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12.13 Gold bullion sales (mining only)

Under IFRS 15, revenue is recognised only when the identified performance obligation is satisfied by transferring the promised good or service to the customer. A good or service is transferred when the customer obtains control of that good or service.

When mining entities sell gold bullion, there is generally a period of time (usually a matter of days) between when the bullion leaves the mine site with the security shipper and when the gold (fine metal) is credited to the metal account of the customer. In the intervening period, the gold bullion is sent to the refinery where it is refined, 'out turned', and finally, the fine metal is transferred or credited to the customer's metal account.

At the time when the gold bullion leaves the mine site, given the way these transactions are commonly structured, the customer may not control the bullion and the IFRS 15 indicators that determine whether control has transferred, may not be present. That is, the customer may not have the ability to direct the use of, or receive the benefit from, the gold bullion. Instead, these indicators may only be present when the gold bullion is actually credited to the customer's metal account.

Whereas the above applies to contracts for the sale of bullion, most precious metals producers do not have in-house refining capabilities to refine to commercial bullion standards. Instead, they may produce semi-refined bars that are shipped to third party refiners (who specialize in refining to bullion standard), and are then converted into bullion. As a manner of optimizing working capital and aligning cash flows with production, it is common for gold producers to arrange the sale of the "material metal content", meaning the gold contained in the semi-refined bars at a point prior to it being refined into bullion. Under these arrangements, key terms (price and quantity) have been agreed to, the producer may be entitled to payment, and the customer has the ability to direct the metals at a point prior to the completion of refining into bullion. Terms may be indicative of multiple performance obligations (the transfer of control over the material metal content, and the separate arrangement for provision of refining services), and control over the material metal content may pass to the customer at a point prior to it having been converted into refined bullion. Careful consideration of contractual terms will be required.

12.14 Repurchase agreements

Some agreements in the extractive industries include repurchase provisions, either as part of a sales contract or as a separate contract, that relate to the goods in the original agreement or similar goods (e.g., tolling, processing or shipping agreements). The application guidance to IFRS 15 clarifies the types of arrangements that qualify as repurchase agreements. The repurchased asset may be the asset that was originally sold to the customer, an asset that is substantially the same as that asset or another asset of which the asset that was originally sold is a component. *[IFRS 15.B64]*.

IFRS 15 specifically notes that repurchase agreements generally come in three forms:

- An entity's obligation to repurchase the asset (a forward)
- An entity's right to repurchase the asset (a call option)

  And
- An entity's obligation to repurchase the asset at the customer's request (a put option) *[IFRS 15.B65]*

Where a repurchase agreement exists, this may change whether and when revenue is recognised. See Chapter 28 at section 7.3 for more details on repurchase agreements. See section 20 below for discussion on tolling arrangements.

12.15 Multi-period commodity-based sales contracts

In the extractive industries, entities commonly enter into long-term (multi-period) commodity-based sales contracts. There are a range of different issues to be considered when applying IFRS 15 in accounting for such arrangements.

12.15.1 Identify the contract

Judgement will need to be applied when identifying the contract for these long-term arrangements. A contract is an agreement between two or more parties that creates enforceable rights and obligations. *[IFRS 15 Appendix A]*. Entities will need to determine what the enforceable part of the contract is. For example, whether there is a specified minimum the customer must buy (e.g., in take-or-pay contracts - see section 12.16 below), whether it is the overall agreement, sometimes referred to as the master services agreement, or whether it is each purchase order. See Chapter 28 at section 3 for more details.

12.15.2 Identify the performance obligations

The next step is to identify all the promised goods or services within the contract to determine which will be treated as separate performance obligations. Chapter 28 at section 4 explores in detail the requirements for determining whether a good or service is distinct, whether the transfer of a good or service represents a separate performance obligation and/or whether (and when) they need to be bundled.

During the development of IFRS 15, some respondents thought it was unclear whether a three-year service or supply contract would be accounted for as a single performance obligation or a number of performance obligations covering smaller time periods (e.g., yearly, quarterly, monthly, daily) or individual units such as ounces, tonnes or barrels.

IFRS 15 clarifies that even if a good or service is determined to be distinct, if that good or service is part of a series of goods and services that are substantially the same and have the same pattern of transfer, that series of goods or services is treated as a single performance obligation. However, before such a treatment can be applied, specific criteria must be met. See Chapter 28 at section 4.2.1 for further discussion and guidance.

Given the nature of these multi-period commodity-based sales arrangements, each unit (e.g., each metric tonne (mt) of coal or each barrel of oil), would likely be a distinct good and therefore, each unit would represent a separate performance obligation that is satisfied at a point in time. Because such goods are satisfied at a point in time, they would not meet the criteria to be considered a series of distinct goods that would have to be treated as a single performance obligation.

In addition, any option for additional goods or services will need to be evaluated to determine if those goods or services should be considered a separate performance obligation. See Chapter 28 at section 4.6 for further discussion.

Practical example 12-8 below illustrates Rio Tinto plc's policy for identifying performance obligations in commodity sales contracts.

Practical example 12-8: Rio Tinto plc (2022) — **United Kingdom**

Annual Report 2022 [extract]
2022 Financial statements [extract]
Notes to the 2022 financial statements [extract]
Our financial performance [extract]
6 Revenue by destination and product [extract]
Recognition and measurement [extract]

Within each sales contract, each unit of product shipped is a separate performance obligation. Revenue is generally recognised at the contracted price as this reflects the stand-alone selling price. Sales revenue excludes any applicable sales taxes. Sales of copper concentrate are stated net of the treatment and refining charges which will be required to convert it to an end product.

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Practical example 12-9 below illustrates Equinor ASA's policy for identifying performance obligations, and, whether they are recognised at a point in time or over time.

Practical example 12-9: Equinor ASA (2022) — **Norway**

Annual Report on Form 20-F 2022 [extract]
Consolidated financial statements of the Equinor group [extract]
Notes to the Consolidated financial statements [extract]
7 Total revenues and other income [extract]
Accounting policies [extract]

Revenue from contracts with customers
Revenue from the sale of crude oil, natural gas, petroleum products and other merchandise is recognised when a customer obtains control of those products, which normally is when title passes at point of delivery, based on the contractual terms of the agreements. Each such sale normally represents a single performance obligation. In the case of natural gas, which is delivered on a continuous basis through pipelines, sales are completed over time in line with the delivery of the actual physical quantities.

...

12.15.3 Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (e.g., some sales taxes). When determining the transaction price, an entity should consider the effects of all the following:

- Variable consideration (including any related constraint)
- A significant financing component (i.e., the time value of money)
- Non-cash consideration
- Consideration payable to a customer

In many cases, the transaction price is readily determinable because the entity will receive payment at or near the same time as it transfers the promised good or service and the price is fixed for the minimum committed purchases. However, determining the transaction price may be more challenging when it is variable in amount, when payment is received at a time that is different from when the entity provides the goods or services and the effect of the time value of money is significant to the contract, or when payment is in a form other than cash. See Chapter 28 at section 5 for more information.

For a fixed price contract, this step will be relatively straightforward. For variable price contracts, determining the transaction price may appear to be significantly more complex than for a fixed price contract. Many commodity sales contracts contain market-based or index-based pricing terms that create variable consideration. After separating out any parts of the transaction price that are within the scope of another standard (e.g., IFRS 9, see section 12.8 above), an entity will need to determine whether it should partially or fully constrain the portion of the variable transaction price. Chapter 28 at section 5.2 discusses variable consideration and, in particular, the requirements relating to the constraint.

12.15.4 Allocate the transaction price

The next step is to allocate the transaction price to the performance obligations, generally in proportion to their stand-alone selling prices (i.e., on a relative stand-alone selling price basis), with two exceptions relating to the allocation of variable consideration and discounts. See Chapter 28 at section 6 for detail. With commodity-based sales contracts, there are a number of things to consider depending on whether the transaction price is variable (or contains a variable component), fixed and/or whether there is a discount. Some factors to consider with variable and fixed consideration are discussed below, while the allocation of a discount is discussed in Chapter 28 at section 6.4.

12.15.4.A Variable consideration

If certain criteria are met, an entity will need to allocate variable consideration (e.g., the market- or index-based price) to one or more, but not all, performance obligations (i.e., the distinct commodities transferred in that period) or distinct goods or services in a series (where relevant), instead of using the relative stand-alone selling price allocation approach to allocate variable consideration proportionately to all performance obligations. See Chapter 28 at section 6 for detail on these criteria.

12.15.4.B Fixed consideration

Entities that have fixed-price commodity-based sales contracts that call for deliveries over multiple periods need to determine the stand-alone selling price of the performance obligations to allocate the transaction price if they do not qualify to be combined into a single performance obligation as a series of distinct goods (discussed further in section 12.15.2 above). IFRS 15 states that the stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. *[IFRS 15 Appendix A]*. This is best evidenced by the observable price of a good or service when the entity sells it separately in similar circumstances and to similar customers. In other cases, it must be estimated. Estimating the stand-alone selling price may require judgement in long-term fixed-price commodity-based sales contracts, particularly when forward prices are available for the commodity being sold in a location with an active market.

If stand-alone selling prices are not directly observable, entities are required to consider all information (including market conditions, entity-specific factors and information about the customer or class of customer) that is reasonably available to determine the stand-alone selling price for each performance obligation. An entity could consider a number of factors in making this estimate, such as the forward curve, spot prices, expectations of market supply and demand shifts that are not represented in the forward curve or spot prices and expected transportation and storage capacity constraints that lead to premiums or discounts. Entities are required to maximise the use of observable inputs and apply similar estimation methods consistently in similar circumstances. The standard sets out a number of different approaches for doing this. See Chapter 28 at section 6 for further discussion.

12.15.5 Recognise revenue

Finally, an entity will recognise revenue once each performance obligation is satisfied which will occur when control of the good transfers to the customer. As discussed earlier, for long-term commodity-based sales arrangements, the performance obligations are likely to be satisfied at a point in time. See Chapter 28 for more information on how to determine when a performance obligation is satisfied. The precise timing of when control transfers to a customer may be impacted by the shipping terms associated with each contract. See section 12.12 above and Chapter 28 at section 7.2 for further discussion on shipping.

Practical example 12-10 below illustrates Rio Tinto plc's policy for determining when control of its commodity sales passes.

Practical example 12-10: Rio Tinto plc (2022) — **United Kingdom**

Annual Report 2022 [extract]
2022 Financial statements [extract]
Notes to the 2022 financial statements [extract]
Our financial performance [extract]
6 Revenue by destination and product [extract]
Recognition and measurement [extract]

Sales revenue is recognised on individual sales when control transfers to the customer. In most instances, control passes and sales revenue is recognised when the product is delivered to the vessel or vehicle on which it will be transported once loaded, the destination port or the customer's premises. There may be circumstances when judgment is required based on the five indicators of control below:

- The customer has the significant risks and rewards of ownership and has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service.
- The customer has a present obligation to pay in accordance with the terms of the sales contract. For shipments under the Incoterms Cost, Insurance and Freight (CIF)/Carriage Paid to (CPT)/Cost and Freight (CFR) this is generally when the ship is loaded, at which time the obligation for payment is for both product and freight.
- The customer has accepted the asset. Sales revenue may be subject to adjustment if the product specification does not conform to the terms specified in the sales contract but this does not impact the passing of control. Assay and specification adjustments have been immaterial historically.
- The customer has legal title to the asset. The Group usually retains legal title until payment is received for credit risk purposes only.
- The customer has physical possession of the asset. This indicator may be less important as the customer may obtain control of an asset prior to obtaining physical possession, which may be the case for goods in transit.

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12.16 Take-or-pay contracts

A take-or-pay contract is a specific type of long-term commodity-based sales agreement between a customer and a supplier in which the pricing terms are set for a specified minimum quantity of a particular good or service. The customer must pay the minimum amount as per the contract, even if it does not take the volumes. There may also be options for additional volumes in excess of the minimum.

We discuss some of the broader accounting considerations associated with these contracts further in section 19.2 below. When applying IFRS 15, in addition to the issues outlined in section 12.15 above, the matters outlined below may also need to be considered.

12.16.1 Volumes paid for, but not taken

A feature unique to take-or-pay contracts is the terms relating to payments made for volumes not taken, as explained further in section 19.2.1 below. The requirements of IFRS 15 may result in different accounting considerations and possibly different conclusions depending on the specific facts and circumstances of each arrangement.

12.16.1.A Payments cannot be applied to future volumes

If payments received for unused volumes cannot be applied to future volumes, the seller has no obligation to deliver the unused volumes in the future. Such amounts can generally only be recognised as revenue once the seller's obligations no longer exist (i.e., once the customer's right to volumes has expired unused).

For most take-or-pay contracts, such an assessment may only be possible at the end of a pre-defined period (e.g., the end of each contract year). This is because the customer's rights have technically not expired and the entity is still obliged to deliver volumes if the customer requests them, until the end of the stated period. This treatment is consistent with current practice.

The standard does, however, consider whether it may be possible to recognise revenue in relation to a customer's unexercised rights earlier through the requirements relating to breakage. This is discussed in more detail in section 12.16.2 below.

12.16.1.B Payments can be applied to future volumes

If payments received for unused volumes can be applied to future volumes, the seller has received consideration in advance for some future unsatisfied performance obligations (i.e., the delivery of the unused volumes at some point in the future). This amount represents a contract liability.

In this situation, an entity will need to determine how such future volumes can be taken. That is, whether the timing of the future transfer of those volumes is at the discretion of the customer or is determined by the entity itself. This determination will be important as it may require an assessment of the time value of money (i.e., the existence of a significant financing component). See Chapter 28 at section 5.5 for further discussion.

It will also be necessary for an entity to understand whether the customer is likely to take its unused volumes as this may require an assessment of the requirements relating to unexercised customer rights or breakage (see section 12.16.2 below for further information). This could impact the amount and timing of revenue recognised.

Such determinations will need to be made in light of the contract terms and an assessment of the expected customer behaviours. For example, such an assessment may involve considering whether the make-up volumes:

- Will be the first volumes taken at the start of the following period
- Can only be taken after the minimum volumes have been satisfied in the following periods
- Can only be taken after a certain amount of time or at the end of the contract period

12.16.2 Breakage (customers' unexercised rights)

The standard requires that when an entity receives consideration that is attributable to a customer's unexercised rights, the entity is to recognise a contract liability equal to the amount prepaid by the customer (because the entity has not yet satisfied the performance obligations to which the payment relates). However, IFRS 15 discusses the situation where, in certain industries, customers may pay for goods or services in advance, but may not ultimately exercise all of their rights to these goods or services - either because they choose not to or are unable to. IFRS 15 refers to these unexercised rights as 'breakage'. *[IFRS 15.B44, IFRS 15.B45, IFRS 15.B46, IFRS 15.B47]*.

IFRS 15 states that when an entity expects to be entitled to a breakage amount, the expected breakage will be recognised as revenue in proportion to the pattern of rights exercised by the customer. Otherwise, breakage amounts will only be recognised when the likelihood of the customer exercising its right becomes remote. See Chapter 28 at section 7.9 for more information.

This may apply to take-or-pay contracts, for which payments are received in relation to make-up volumes and the customer's rights remain unexercised. Such breakage provisions may be applicable if:

- A customer is unable to use the make-up volumes in other areas of its own operations.
- A customer is unable to store the make-up volumes and use them after the take-or-pay contract has expired.
- A customer is unable to take delivery of the make-up volumes and sell them into the market.
- There are limitations (physical or contractual) that prevent the customer from taking all of the make-up volumes.

For take-or-pay contracts, this may mean that an entity may be able to recognise revenue in relation to breakage amounts in an earlier period, provided it can demonstrate it is not required to constrain its estimate of breakage. This could potentially occur in the following ways:

- At contract inception, the mining entity or oil and gas entity may be able to reliably estimate the amount of breakage and would include that amount in the transaction price and allocate that to expected actual usage.
- If the entity cannot estimate an amount of breakage, it will recognise the revenue associated with those unexercised rights when it becomes remote that they will be exercised. This could occur during a make-up period after the initial term of the contract or when the deficiency make-up period expires outright (which would be consistent with current accounting).

It is also possible that, given the nature of these arrangements and the inherent uncertainty in being able to predict a customer's behaviour, it may be difficult to satisfy the requirements relating to constraint because the entity's experience may not be predictive of the outcome at this level of certainty (i.e., highly probable).

13 Financial instruments

13.1 Normal purchase and sales exemption

Contracts to buy or sell non-financial items generally do not meet the definition of a financial instrument because the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party do not establish a present right or obligation of either party to receive, deliver or exchange a financial asset. For example, contracts that provide for settlement only by the receipt or delivery of non-financial items (e.g., forward purchase of oil or a forward purchase of copper) are not financial instruments. However, some of these contracts are traded in a standardised form on organised markets in the same way as derivative financial instruments. The parties buying and selling the contract are, in effect, trading the underlying commodity. The ability to buy or sell a commodity contract for cash does not alter the characteristics of the contract and make it into a financial instrument. Nevertheless, some contracts to buy or sell non-financial items that can be settled net or by exchanging financial instruments, or in which the non-financial item is readily convertible to cash, are within the scope of the IAS 32 and IFRS 9 as if they were financial instruments. *[IAS 32.8, IAS 32.AG20]*.

IAS 32 and IFRS 9 are required to be applied to those contracts to buy or sell a non-financial item that can be settled net as if the contracts were financial instruments, whether this be in cash, another financial instrument, or by exchanging financial instruments, unless the contracts were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. *[IAS 32.8, IFRS 9.2.4]*.

There are various ways in which a contract to buy or sell a non-financial item can be settled net, including:

(a) The terms of the contract permit either party to settle it net

(b) The ability to settle the contract net is not explicit in its terms, but the entity has a practice of settling similar contracts net (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse)

(c) For similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin

(d) The non-financial item that is the subject of the contract is readily convertible to cash, e.g., precious metals or base metals quoted on the London Metal Exchange are considered to be readily convertible to cash *[IAS 32.9, IFRS 9.2.6]*

There is no further guidance in IFRS 9 explaining what is meant by 'readily convertible to cash'. Typically, a non-financial item would be considered readily convertible to cash if it consists of largely fungible units and quoted spot prices are available in an active market that can absorb the quantity held by the entity without significantly affecting the price. Further discussion on the net settlement criteria can be found in Chapter 41 at section 3.2.

Commodity-based contracts that are excluded from IAS 32 and IFRS 9 are contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. Contracts that fall within this exemption, which is known as the 'normal purchase or sale exemption', 'executory contract exemption' or 'own-use exemption', are accounted for as executory contracts. An entity recognises such contracts in its statement of financial position only when one of the parties meets its obligation under the contract to deliver either cash or a non-financial asset. *[CF 4.46]*.

The IASB views the practice of settling net or taking delivery of the underlying and selling it within a short period after delivery as an indication that the contracts are not normal purchases or sales. Therefore, contracts to which (b) or (c) apply cannot be subject to the normal purchase or sale exception. Other contracts that can be settled net are evaluated to determine whether this exemption can actually apply. *[IAS 32.9, IFRS 9.2.6, IFRS 9.BCZ2.18]*.

A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, in accordance with (a) or (d) must be accounted for under IFRS 9 and does not qualify for use of the normal purchase or sale exemption. *[IFRS 9.2.7, IFRS 9.BCZ2.18]*.

The conditions associated with the use of the normal purchase or sale exemption often pose problems for mining entities and oil and gas entities because, historically, they have settled many purchase and sales contracts on a net basis.

A further problem may arise when a mining company or oil and gas company holds a written option for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements - because IFRS 9 would require such contracts to be accounted for as derivative financial instruments.

How we see it

From time-to-time mining entities and oil and gas entities may need to settle contracts for the sale of commodities on a net basis because of operational problems. Such a situation may mean that the company would usually need to treat those contracts as derivative financial instruments under IFRS 9 as they may now have a practice of settling net under (b) or (c) above. Where this situation is caused by a unique event beyond management's control, a level of judgement will be required to determine whether that would prevent the company from applying the own use exemption to similar contracts. This is required to be assessed on a case-by-case basis.

Judgement will also be required as to what constitutes 'similar contracts'. The definition of similar contracts in IFRS 9, *[IFRS 9.2.6]*, considers the intended use for such contracts. This means that contracts identical in form may be dissimilar due to their intended use, e.g., own purchase requirements versus proprietary trading. If the intended use is for normal purchase or sale, such an intention must be documented at inception of the contract. A history of regular revisions of expected purchase or sale requirements could impair the ability of a company to distinguish identical contracts as being dissimilar.

IFRS 9 provides a fair value option for own use contracts. At the inception of a contract, an entity may make an irrevocable designation to measure an own use contract at fair value through profit or loss (the 'fair value option') even if it was entered into for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirement. However, such designation is only allowed if it eliminates or significantly reduces an accounting mismatch that would otherwise arise from not recognising that contract because it is excluded from the scope of IFRS 9. *[IFRS 9.2.5]*.

See Chapter 41 at section 3.3 for more information on the normal purchase and sales exemption.

Practical example 13-1 below from Alkane Resources Limited's 2022 financial statements illustrate how this could affect an entity's reported financial position.

Practical example 13-1: Alkane Resources Limited (2022) — Australia

Annual Report 2022 [extract]
Financial report [extract]
Financial Statements [extract]
Notes to the consolidated financial statements [extract]
Note 27. Commitments [extract]

(b) Physical gold delivery commitments

As part of its risk management policy, the group enters into derivatives including gold forward contracts and gold put options to manage the gold price of a proportion of anticipated gold sales.

Alkane purchased gold forward sales and put options as part of a risk mitigation strategy on any potential downward price pressure while Tomingley was processing the low grade stockpiles during the year.

The gold forward sales contracts disclosed below did not meet the criteria of financial instruments for accounting purposes on the basis that they met the normal purchase/sale exemption because physical gold would be delivered into the contract. Accordingly, the contracts were accounted for as sale contracts with revenue recognised in the period in which the gold commitment was met. The balances in the table below relate to the value of the contracts to be delivered into by transfer of physical gold.

	Gold for physical delivery Ounces	Contracted gold sale price per ounce ($)	Value of committed sales $'000
30 June 2022			
Fixed forward contracts			
Within one year	36,800	2,716	99,949
30 June 2021			
Fixed forward contracts			
Within one year	24,000	2,307	55,368

13.2 Embedded derivatives

A contract that qualifies for the normal purchase and sale exemption still needs to be assessed for the existence of embedded derivatives. An embedded derivative is a component of a hybrid or combined instrument that also includes a non-derivative host contract; it has the effect that some of the cash flows of the combined instrument vary in a similar way to a stand-alone derivative. In other words, it causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other underlying variable (provided in the case of a non-financial variable that the variable is not specific to a party to the contract). *[IFRS 9.4.3.1]*.

The detailed requirements regarding the separation of embedded derivatives and the interpretation and application of those requirements under IFRS 9 are discussed in Chapter 42. A number of issues related to embedded derivatives that are of particular importance to the extractive industries are discussed in sections 13.2.1 to 13.2.4 below.

13.2.1 Foreign currency embedded derivatives

The most common embedded derivatives in the extractive industries are probably foreign currency embedded derivatives which arise when a producer of minerals sells these in a currency that is not the functional currency of any substantial party to the contract, the currency in which the price of the related commodity is routinely denominated in commercial transactions around the world or a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place. *[IFRS 9.B4.3.8(d)]*. A more detailed analysis of these requirements can be found in Chapter 42 at section 4.2.1.

13.2.2 Provisionally priced sales contracts

As discussed above in section 12.8.1, sales contracts for certain commodities (e.g., copper and oil) often provide for provisional pricing at the time of shipment, with final pricing based on the average market price for a particular future period, i.e., the 'quotational period'.

If the contract is cancellable without penalty before delivery, the price adjustment feature does not meet the definition of a derivative because there is no contractual obligation until delivery takes place.

If the contract is non-cancellable, the price adjustment feature is considered to be an embedded derivative. The non-financial contract for the sale or purchase of the product, e.g., copper or oil, at a future date would be treated as the host contract.

For non-cancellable contracts, there will be a contractual obligation, but until control passes to the customer, the embedded derivative would be considered to be closely related to the non-financial host commodity contract and does not need to be recorded separately.

As discussed in section 12.8.1 above, revenue is recognised when control passes to the customer. At this point, the non-financial host commodity contract is considered to be satisfied and a corresponding receivable is recognised. However, the receivable is still exposed to the price adjustment feature. As discussed in section 12.8 above, under IFRS 9, embedded derivatives are not separated from financial assets, i.e., from the receivable. Instead, the receivable will need to be measured at fair value through profit or loss in its entirety. See Chapter 44 at section 1 for more information on the classification of financial assets.

13.2.3 Long-term supply contracts

Long-term supply contracts sometimes contain embedded derivatives because of a desire to shift certain risks between contracting parties or as a consequence of existing market practices. The fair value of embedded derivatives in long-term supply contracts can be highly material to the entities involved. For example, in the mining sector electricity purchase contracts sometimes contain price conditions based on the commodity that is being sold, which provides an economic hedge for the mining company. While the electricity price component (if fixed) would meet the definition of an embedded derivative, it would be considered closely related to the host contract and hence would not have to be separated. However, the linkage to the commodity price would be unlikely to be considered closely related and would likely have to be separately accounted for as an embedded derivative. In the oil and gas sector the sales price of gas is at times based on the price of electricity, which provides an economic hedge for the utility company that purchases the gas, and would also likely represent an embedded derivative that has to be separately accounted for. See Chapter 42 at section 4.2.2 for further discussion.

13.2.4 Development of gas markets

Where there is no active local market in gas, market participants may enter into long-term contracts that are priced on the basis of a basket of underlying factors, such as oil prices, electricity prices and inflation indices. In the absence of an active market in gas, such price clauses are not considered to give rise to embedded derivatives because there is no accepted benchmark price for gas that could have been used instead.

An entity that applies IFRS 9 is required to assess whether an embedded derivative is required to be separated from the host contract (provided that host contract is not a financial asset (see section 12.8 above for more information)) and accounted for as a derivative when the entity first becomes a party to the contract. *[IFRS 9.B4.3.11]*. Subsequent reassessment of embedded derivatives under IFRS 9 is generally prohibited. *[IFRS 9.B4.3.11]*. See Chapter 42 at section 6 for more information. Therefore, in the case of gas, when an active market subsequently develops, an entity is not permitted to separate embedded derivatives from existing gas contracts, unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract. However, if the entity enters into a new gas contract with exactly the same terms and conditions, it would be required to separate embedded derivatives from the new gas contract.

How we see it

Judgement is required in determining whether there is an active market in a particular geographic region and the relevant geographic market for any type of commodity. Where no active market exists, consideration will need to be given to the industry practice for pricing such commodity-based contracts. A pricing methodology that is consistent with industry practice would generally not be considered to contain embedded derivatives.

Practical example 13-2 below from BP International Limited's financial statements shows the company's previous approach to embedded derivatives before and after the development of an active gas trading market in the UK, and demonstrates that the fair value of embedded derivatives in long-term gas contracts can be quite significant.

Practical example 13-2: BP International Limited (2021) **United Kingdom**

ANNUAL REPORT AND FINANCIAL STATEMENTS 2021 [extract]

Notes to the financial statements [extract]

20. Derivatives and other financial instruments [extract]

Embedded derivatives

Prior to the development of an active gas trading market, UK gas contracts were priced using a basket of available price indices, primarily relating to oil products, power and inflation. After the development of an active UK gas market, certain contracts were entered into or renegotiated using pricing formulae not directly related to gas prices, for example, oil product and power prices. In these circumstances, pricing formulae have been determined to be derivatives, embedded within the overall contractual arrangements that are not clearly and closely related to the underlying commodity. The resulting fair value relating to these contracts is recognized on the balance sheet with gains or losses recognized in the profit and loss account. All embedded derivatives are valued using inputs that include price curves for each of the different products that are built up from active market pricing data. Where necessary, these are extrapolated to the expiry of the contracts (the last of which is in 2018) using all available external pricing information. Additionally, where limited data exists for certain products, prices are interpolated using historic and long-term pricing relationships.

...

13.3 Volume flexibility in supply contracts

It is not uncommon for other sales contracts, such as those with large industrial customers, to contain volume flexibility features. For example, a supplier might enter into a contract requiring it to deliver, say, 100,000 units at a given price as well as giving the counterparty the option to purchase a further 20,000 units at the same price. Often such a supply contract will be readily convertible to cash as parties to the contract can settle the contract on a net basis, as discussed in section 13.1 above. For example, precious metals or base metals quoted on the London Metal Exchange or oil contracts are considered to be readily convertible to cash, whereas bulk materials without spot prices (e.g., coal and iron ore) are generally not considered to be readily convertible to cash. However, with increasing levels of liquidity in certain commodities, this view may need to be reconfirmed/re-challenged before concluding that this remains the case.

If the customer has access to markets for the non-financial item and, following the guidance of the IFRS IC the supplier might consider such a contract to be within the scope of IFRS 9 as it contains a written option (see Chapter 41 at section 3.3.3). However, some would say that the supplier could split the contract into two separate components for accounting purposes: a forward contract to supply 100,000 units (which may qualify as a normal sale and so meet the recognition exemption) and a written option to supply 20,000 units (which would not). Arguments put forward include:

- The parties could easily have entered into two separate contracts, a forward contract and a written option.
- It is appropriate to analogise to the requirements for embedded derivatives and separate a written option from the normal forward sale or purchase contract because it is not closely related.

Some contracts, however, contain operational volume tolerances such as, in the case of certain oil purchase and sale contracts, a volume that is plus or minus a certain (often quite small) percentage of the stated quantity. These tolerances relate to physical changes in the volume during transportation caused by, for example, evaporation. The optionality within the contract typically cannot be monetised by either party but, instead is a practical requirement of the contract. In such cases, the optionality would not be considered a separate derivative within the scope of IFRS 9. In other cases, however, the volume tolerance may be greater than that which is required for practical reasons. This optionality could give one party the ability to benefit from changing underlying prices and could be considered a separate derivative. Judgement is required in assessing the nature of these volume tolerances.

This issue is discussed in more detail in Chapter 41 at sections 3.3.4 and 3.3.5.

13.4 Hedging sales of metal concentrate (mining)

In the mining sector certain commodities are often sold in the form of a concentrate that comprises two or more metals and impurities. These concentrates are the output of mines and are sold and shipped to smelters for treatment and refining in order to extract the metals in their pure form from the concentrate (or, alternatively, the concentrate may be sold to traders who will subsequently sell and ship to smelters). The metal content of concentrate varies depending on the mine and grade of ore being mined. The sales proceeds of concentrate are typically determined as the total of the payments for the actual content of each of the metals contained in a given concentrate shipment and they reflect the condition in which the metal is sold (i.e., unrefined, still being dissolved in concentrate). Typical pricing formulas are based on the price for dissolved metal off the quoted price for refined metal (e.g., the London Metal Exchange (LME)), with deductions for amounts that reflect the fact that the metal sold is not treated and/or refined. Actual deductions may vary by contract but typically comprise treatment and refining charges, price participation clauses, transportation, impurity penalties, etc.

Under IFRS 9, an entity is permitted to designate a risk component of a non-financial item as the hedged item in a hedging relationship, provided the risk component is separately identifiable and reliably measurable. See Chapter 49 for IFRS 9 hedge accounting requirements and Chapter 49 at section 2.2 for further information on hedging of risk components. These considerations also apply from the perspective of an entity that purchases metals in the form of a concentrate.

14 Inventories

Inventories are required to be measured at the lower of cost and net realisable value under IAS 2. However, IAS 2 does not apply to the measurement of "... minerals and mineral products, to the extent that they are measured at net realisable value in accordance with well-established practices in those industries". *[IAS 2.3(a)]*. There is also an exception for "commodity broker-traders who measure their inventories at fair value less costs to sell. When such inventories are measured at fair value less costs to sell, changes in fair value less costs to sell are recognised in profit or loss in the period of the change". *[IAS 2.3(b)]*. This is discussed further in section 14.4 below.

Where inventory is measured at cost, various cost methods are acceptable under IFRS accounting standards and include specific identification, weighted average costs, or first-in first-out (FIFO). Last-in first-out (LIFO) is not permitted under IFRS accounting standards. *[IAS 2.BC9]*.

The IFRS IC received a request for clarification on how to determine which costs should be included as part of the "costs necessary to make the sale" when determining the net realisable value in accordance with IAS 2. The IFRS IC confirmed via their agenda decision that entities are not permitted to limit the cost to only those that are incremental. Judgement will be needed to determine which costs are necessary to sell inventories and an entity will be required to consider specific facts and circumstances, including the nature of the inventory. See Chapter 23 at section 3.3.1.B for further information.

Issues that mining entities and oil and gas entities commonly face in relation to inventory include:

- Point of recognition (see section 14.1 below)
- Cost absorption in the measurement of inventory
- Method of allocating costs to inventory, e.g., FIFO or weighted average
- Determination of joint and by-products and measurement consequences (see section 14.2 below)
- Accounting for core inventories (see section 14.3 below)
- Measuring inventory at fair value (see section 14.4 below)

Additional issues relating to inventory for mining entities include:

- Accounting for stockpiles of long-term, low grade ore (see section 14.5 below)
- Heap leaching (see section 14.6 below)

14.1 Recognition of work in progress

Determining when to start recognising inventory is more of an issue for mining entities than oil and gas entities. Inventory is recognised when it is probable that future economic benefits will flow to the entity and the asset has a cost or value that can be reliably measured.

Oil and gas entities often do not separately report work-in-progress inventories of either oil or gas. As is noted in the IASC Issues Paper "the main reason is that, at the point of their removal from the earth, oil and gas frequently do not require processing and they may be sold or may be transferred to the enterprise's downstream operations in the form existing at the time of removal, that is, they are immediately recognised as finished goods. Even if the oil and gas removed from the earth require additional processing to make them saleable or transportable, the time required for processing is typically minimal and the amount of raw products involved in the processing at any one time is likely to be immaterial".[113] However, if more than an insignificant quantity of product is undergoing processing at any given point in time then an entity may need to disclose work-in-progress under IAS 2. *[IAS 2.8, IAS 2.37]*.

For mining entities, it has become accepted practice to recognise work-in-progress at the point at which ore is broken and the entity can make a reasonable assessment of quantity, recovery and cost.[114]

113 IASC Issues Paper, 11.17.

114 IASC Issues Paper, 11.9-11.16.

Practical example 14-1 from the financial statements of Harmony Gold Mining Company Limited illustrates the need for judgement in determining when work-in-progress can be recognised.

Practical example 14-1: Harmony Gold Mining Company Limited (2022) **South Africa**

Financial Report 2022 [extract]

Notes to the group financial statements [extract]

23 Inventories [extract]

Accounting policy

Inventories, which include bullion on hand, gold-in-process, gold in lock-up, ore stockpiles and consumables, are measured at the lower of cost and net realisable value. Net realisable value is assessed at each reporting date and is determined with reference to relevant market prices.

The cost of bullion, gold-in-process and gold in lock-up is determined by reference to production cost, including amortisation and depreciation at the relevant stage of production. Ore stockpiles are valued at average production cost. Stockpiles and gold in lock-up are classified as non-current assets where the stockpile's volume exceeds current processing capacity and where a portion of static gold in lock-up is expected to be recovered more than 12 months after balance sheet date.

Gold-in-process inventories represent materials that are currently in the process of being converted to a saleable product. In-process material is measured based on assays of the material fed to process and the projected recoveries at the respective plants. In-process inventories are valued at the average cost of the material fed to process attributable to the source material coming from the mine or stockpile plus the in-process conversion costs, including the applicable depreciation relating to the process facility, incurred to that point in the process. Gold-in-process includes gold in lock-up, which is generally measured from the plants onwards. Gold in lock-up is expected to be extracted when plants are demolished at the end of their useful lives, which is largely dependent on the estimated useful life of the operations feeding the plants.

At the group's open pit operations, gold-in-process represents production in broken ore form.

Consumables are valued at weighted average cost value after appropriate allowances for slow-moving and redundant items.

Measurement issues can arise in relation to work-in-progress for concentrators, smelters and refineries, where significant volumes of product can be located in pipes or vessels, with no uniformity of grade. Work-in-progress inventories may also be in stockpiles, for example underground, where it is more difficult to measure quantities.

Processing varies in extent, duration and complexity depending on the type of mineral and different production and processing techniques that are used. Therefore, measuring work-in-progress, as it moves through the various stages of processing, is difficult and determining the quantities of work-in-progress may require a significant degree of estimation. Practice varies in this area, which is a reflection of the genuine differences mining entities face in their ability to assess mineral content and predict production and processing costs.

Practical example 14-2 below from the financial statements of Anglo American Platinum Limited illustrates the complexity involved in making such estimates.

Practical example 14-2: Anglo American Platinum Limited (2022) **South Africa**

Audited Annual Financial Statements 2022 [extract]
Compliance and assurance [extract]
Significant accounting principles [extract]
Critical accounting estimates and judgements [extract]
Critical accounting estimates [extract]

Metal inventory

Work-in-progress metal inventory is valued at the lower of net realisable value (NRV) and the average cost of production or purchase less the NRV of by-products produced during the period.

For own-mined production, joint products inventory is measured by allocating total production costs to each joint product. Production cost is allocated to the joint products using a 3E (platinum, palladium and rhodium) and nickel revenue split. The allocation to each 3E metal is then based on production volumes.

The allocated production costs per metal is then divided by the output per metal to arrive at a unit cost per metal. Production costs are determined on a 12-month rolling average basis and own-mined production costs and processing costs are adjusted for periods of prolonged abnormal production.

For purchase of concentrate (POC), costs are allocated to each joint product based on the actual POC cost per joint product. The allocated POC costs per metal are then divided by the output per metal to arrive at a unit cost per metal. POC costs are determined on a six-month rolling average basis.

POC agreements are provisionally priced contracts to acquire inventory. The final price of the inventory is only determined three months into the future when quantities and prices are confirmed. Changes in prices include impacts of changes in US dollar metal price as well as foreign exchange rates, as the final price is determined in South African rand. Changes in pricing between the delivery date and the date that prices are confirmed is capitalised to inventory as it forms part of the cost directly related to bringing the inventory to its present location and condition.

The quantity of ounces of joint products in work-in-progress is calculated based on the following factors:

- The theoretical inventory at that point in time, which is calculated by adding the inputs to the previous physical inventory and then deducting the outputs for the inventory period
- The inputs and outputs include estimates due to the delay in finalising analytical values
- The estimates are subsequently trued up to the final metal accounting quantities when available
- The theoretical inventory is then converted to a refined equivalent inventory by applying appropriate recoveries depending on where the material is within the production pipeline. The recoveries are based on actual results as determined by the inventory count and are in line with industry standards
- Unrealised profits and losses are excluded from the inventory valuation before determining the lower of NRV and cost calculation.

Other than at the precious metal refinery, an annual physical count of work-in-progress is done, usually around February of each year. The precious metal refinery is subject to a physical count, usually every three years, but this could occur more frequently, by exception. A physical count of work-in-progress, including at the precious metal refinery, was performed in February 2022. Refer to note 40 for the impact of the results of the count.

Ore in circuit for a mining company at the end of a reporting period can be very difficult to measure as it is generally not easily accessible. The value of materials being processed therefore needs to be estimated based on inputs, throughput time and ore grade. The significance of the value of ore in circuit will depend on the type of commodity being processed. For example, precious metals producers could have a material value in process at reporting period end.

14.2 Sale of by-products and joint products

In the extractive industries it is common for more than one product to be extracted from the same reserves, e.g., copper is often found together with gold and silver and oil, gas and gas liquids are commonly found together. Products produced at the same time are classified as joint products or by-products and are usually driven by the importance of the different products to the viability of the mine or field. The same commodity could be treated differently based on differing grades and quantities of products. In most cases where more than one product is produced there is a clear distinction between the main product and the by-products. In other cases, the distinction may not be as clear.

The decision as to whether these are joint products or whether one is a by-product, is important, as it impacts the way in which costs are allocated. This decision could also affect the classification of sales of the various products.

14.2.1 By-products

A by-product is a secondary product obtained during the course of production or processing, having relatively small importance when compared with the principal product or products. *[IAS 2.14]*.

Extract from IAS 2

14 A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

By-products that are significant in value are required to be accounted for as joint products as discussed in section 14.2.2 below. However, there are some entities that treat such by-product sales as a negative cost, i.e., by crediting these against cost of goods sold of the main product. See Chapter 28 at section 2.5.

How we see it

We do not believe that it would appropriate for an entity to recognise the sale of by-products or scrap materials as a reduction of cost of goods sold. This is because recognising the sale of by-products or scrap materials as a reduction of cost of goods sold might inappropriately reflect the cost of raw materials used in manufacturing the main product. However, this interpretation would not apply if other accounting standards allow for recognition as a reduction of costs. The treatment of by-product revenue as a negative cost is not in accordance with IFRS accounting standards and would likely only be acceptable on the basis of materiality.

In our view, the language used in IAS 2 only relates to the allocation of the costs of conversion between the main product and by-product. It does not allow the proceeds from a sale of by-products to be presented as a reduction of cost of goods sold.

If an entity determines the sale of by-products or scrap materials is in the course of its ordinary activities (even if they are not significant), the entity would recognise those sales as revenue from contracts with customers under IFRS 15. If an entity determines that such sales are not in its ordinary course of business, the entity would recognise those sales as either other income or other revenues (i.e., separate from revenue from contracts with customers) because they represent sales to non-customers.

Practical examples 14-3 and 14-4 below illustrates how Rio Tinto plc and Anglo American Platinum Limited respectively account for their by-product revenue under IFRS 15.

Practical example 14-3: Rio Tinto plc (2022) **United Kingdom**

Annual Report 2022 [extract]
2022 Financial statements [extract]
Notes to the 2022 financial statements [extract]
Our financial performance [extract]
6 Revenue by destination and product [extract]
Recognition and measurement [extract]

Revenues from the sale of significant by-products, such as gold, are included in sales revenue. Third-party commodity swap arrangements principally for delivery and receipt of smelter-grade alumina are offset within operating costs. Sundry revenue incidental to the main revenue-generating activities of the operations is treated as a credit to operating costs.

...

Practical example 14-4: Anglo American Platinum Limited (2022) **United Kingdom**

Integrated Annual Report 2022 [extract]
Financial statements and other financial information [extract]
Notes to the financial statements [extract]
Other items [extract]
39. Accounting policies [extract]
C. Financial performance [extract]
Revenue recognition [extract]

Revenues from the sale of material by-products are recognised within revenue from contracts with customers at the point control passes. Where a by-product is not regarded as significant, revenue may be credited against operating costs.

...

Although IAS 2 does not require extensive disclosures in respect of by-products, if amounts are material, disclosure of the following information, which many extractive entities provide on a voluntary basis, will greatly assist users:

- Accounting policies applied to by-products
- Line items in the primary financial statements in which revenues and capitalised amounts have been disclosed
- Quantities of by-products sold
- Average prices of by-products sold

14.2.2 Joint products

Joint products are two or more products produced simultaneously from a common raw material source, with each product having a significant relative sales value. One joint product cannot be produced without the other and the products cannot be identified separately until a certain production stage, often called the 'split-off point', is reached. Joint products are very common in both the oil and gas sector (e.g., crude oil when run through a refinery produces a variety of products) and the mining sector.

Joint products, by definition, are all significant in value and require that an entity allocate on a rational and consistent basis the costs of conversion that are not separately identifiable for each product. The IASC Issues Paper outlined two approaches that have found acceptance in practice:[115]

(1) Allocation on the basis of physical characteristics

In the oil and gas sector, entities often combine quantities of oil and gas based on their relative energy content (i.e., 6,000 cubic feet of gas is roughly equal in energy to one barrel of oil). This method, however, does not take account of the fact that, for example, gas is cheaper per unit of energy than oil because the latter is more difficult to transport.

(2) Allocation on the basis of relative values

This approach is more common in the mining sector where often it is not possible to identify a relevant physical characteristic that can be used to combine quantities of different products. The drawback of this method is that it results in very similar profit margins for each of the joint products, which may not be reflective of the underlying economic reality (i.e., one of the joint products, if mined in isolation, might have a completely different profit margin).

How we see it

While neither allocation method described above is perfect, both approaches are currently permitted under IFRS accounting standards.

It is true also that whichever method is selected, it is unlikely to have a material effect on reported profit overall. Practical example 14-5 below illustrates the application of approach (b) by Anglo American Platinum Limited.

115 IASC Issues Paper, 7.61-7.68.

Practical example 14-5: Anglo American Platinum Limited (2022) **United Kingdom**

Integrated Annual Report 2022 [extract]
Financial statements and other financial information [extract]
Notes to the financial statements [extract]
Other items [extract]
39. Accounting policies [extract]
E. Working capital [extract]

Inventories

Inventory and work in progress are measured at the lower of cost and net realisable value, except for inventory held by commodity broker-traders which is measured at fair value less costs to sell and are disclosed separately to the extent that they are material. The production cost of inventory includes an appropriate proportion of depreciation and production overheads. Cost is determined on the following basis:

- Raw materials and consumables are measured at cost on a first in, first out (FIFO) basis or a weighted average cost basis
- Work in progress and finished products are measured at raw material cost, labour cost and a proportion of production overhead expenses
- Metal and coal stocks are included within finished products and are measured at average cost.

At precious metals operations that produce 'joint products', cost is allocated among precious metal products according to production volumes.

Inventory is recognised as a current asset where it is expected to be consumed in the next 12 months. Stockpiles are classified as non-current where stockpiles are not expected to be processed in the next 12 months and there is no market to sell the product in its current state.

14.3 Core inventories

In certain industries, for example the petrochemical sector, certain processes or storage arrangements require a core of inventory to be presented in the system at all times in order for it to function properly. For example, in order for a crude oil refining process to take place, the plant must contain a certain minimum quantity of oil. This oil can only be taken out once the plant is abandoned and could then only be sold as sludge. Similarly, underground gas storage caves are filled with gas, but a substantial part (in some instances 25%) of that gas can never be sold as its function is to pressurise the cave, thereby allowing the remaining 75% to be extracted. Even though the gas will be turned around on a continuous basis, at any one time, 25% of it will never be available to sell and cannot be recouped from the cave. Finally, long distance pipelines contain a significant volume of gas that keeps them operational.

Similar examples of core inventories exist in the mining sector where certain processes or processing facilities require a core or minimum amount of inventory to be present in the system at all times. These may include:

- Potlines in the aluminium industry
- Blast furnaces in the steel industry
- Electrowinning plants
- Carbon in leach processing in the gold industry

The key issue with such minimum amounts of inventory is whether they are required to be accounted for as inventory in accordance with IAS 2 or as PP&E in accordance with IAS 16.

How we see it

If an item of inventory is not held for sale or consumed in a production process but is necessary to the operation of a facility during more than one operating cycle, and its cost cannot be recouped through sale (or is significantly impaired), this item of inventory is required to be accounted for as an item of PP&E under IAS 16 rather than as inventory under IAS 2. This applies even if the part of inventory that is deemed to be an item of PP&E cannot be separated physically from the rest of inventory.

These matters will always involve the exercise of judgement, however, in the above instances, we consider that:

- The deemed PP&E items do not meet the definition of inventories
- Although it is not possible to physically separate the chemicals involved into inventory and PP&E categories, there is no accounting reason why one cannot distinguish between identical assets with different uses and therefore, account for them differently. Indeed, IAS 2 does envisage such a possibility when discussing different cost formulas. *[IAS 2.25]*.
- The deemed PP&E items are necessary to bring another item of PP&E to the condition necessary for it to be capable of operating in the manner intended by management. This meets the definition of the costs of PP&E in IAS 16 upon initial recognition. *[IAS 16.16(b)]*.
- Recognising these items as inventories would lead to an immediate loss because these items cannot be sold or consumed in a production process, or during the process of rendering services. This does not properly reflect the fact that the items are necessary to operate another asset over more than one operating cycle.

By contrast, core inventory that is not necessary to operate the asset and that is recoverable (e.g., gas in a pipeline) is considered to be held for sale or to be consumed in the production process or process of rendering services. Therefore, such gas is accounted for as inventory.

The issue of core inventories or 'minimum fill' was considered by the IFRS IC in March and July 2014. The staff paper considered by the IFRS IC proposed that base or cushion gas in storage facilities (required to maintain adequate cavern pressure) and pipeline fill (i.e., the minimum volume of oil or gas to be kept in a pipeline to ensure its operability) would be required to be accounted for as PP&E under IAS 16 where the carrying amount was not considered recoverable through sale or consumption in the production process (which is consistent with our views above). After consideration of this issue, the IFRS IC noted that, although there was diversity in practice between industries, there was no, or only limited, diversity in practice within the industries for which the issue is significant (including extractive industries). Given there was not sufficient diversity within industry, they decided not to continue with the development of an interpretation, and to remove this item from its agenda.

Practical example 14-6 below from the financial statements of ENGIE SA shows how cushion gas is accounted for as a tangible asset that is depreciated over its economic life.

Practical example 14-6: ENGIE SA (2022) **France**

2022 Management Report and Annual Consolidated Financial Statements [extract]

Notes to the consolidated financial statements [extract]

Note 13 fixed assets [extract]

13.3 Property, plant and equipment [extract]

Accounting standards [extract]

Cushion gas

"Cushion" gas injected into underground storage facilities is essential for ensuring that reservoirs can be operated effectively, and is therefore inseparable from these reservoirs. Unlike "working" gas which is included in inventories (*see Note 22.2 "Inventories"*), cushion gas is reported in other property, plant and equipment.

Note 22 working capital requirements, inventories, other assets and other liabilities [extract]

Accounting standards [extract]

Gas inventories

Gas injected into underground storage facilities includes working gas, which can be extracted without adversely affecting the subsequent operation of the reservoirs, and cushion gas, which is inseparable from the reservoirs and essential for their operation (*see Note 13.3 "Property, plant and equipment"*).

Working gas is classified in inventories and measured at weighted average purchase cost upon entering the transportation network regardless of its source, including any regasification costs.

Group inventory outflows are valued using the weighted average unit cost method.

...

14.4 Inventory carried at fair value

As noted earlier, inventories are required to be measured at the lower of cost and net realisable value under IAS 2. However, IAS 2 does not apply to the measurement of "... minerals and mineral products, to the extent that they are measured at net realisable value in accordance with well-established practices in those industries". *[IAS 2.3(a)]*. There is also an exception for "...commodity broker-traders who measure their inventories at fair value less costs to sell. When such inventories are measured at fair value less costs to sell, changes in fair value are recognised in profit or loss in the period of the change". *[IAS 2.3(b)]*.

An extractives company that wishes to use the exemption relating to minerals and mineral products outlined above would need to demonstrate that valuation at net realisable value was a well-established practice in its industry, which may be difficult to do for base metals inventory.

The commodity broker-trader exemption above is commonly used by entities that engage in commodity trading. Practical example 14-7 below from the financial statements of BP p.l.c. illustrates a typical accounting policy for an oil and gas company that makes use of this exemption.

Practical example 14-7: BP p.l.c. (2022) **United Kingdom**

bp Annual Report and Form 20-F 2022 [extract]

Financial statements [extract]

Notes on financial statements [extract]

1. Significant accounting policies, judgements, estimates and assumptions [extract]

Inventories

Inventories, other than inventories held for short-term trading purposes, are stated at the lower of cost and net realizable value. Cost is typically determined by the first-in first-out method and comprises direct purchase costs, cost of production, transportation and manufacturing expenses. Net realizable value is determined by reference to prices existing at the balance sheet date, adjusted where the sale of inventories after the reporting period gives evidence about their net realizable value at the end of the period.

Inventories held for short-term trading purposes are stated at fair value less costs to sell and any changes in fair value are recognized in the income statement.

Supplies are valued at the lower of cost on a weighted-average basis and net realizable value.

14.5 Stockpiles of low-grade ore (mining)

Mining entities often stockpile low grade ore that cannot be economically processed at current market prices or to give priority to the processing of higher-grade ore. Low-grade ore stockpiles may not be processed for many years until market prices or technology have improved or until no higher-grade ore remains available. Practical example 14-8 below from AngloGold Ashanti illustrates that stockpiles of low-grade ore may be held for many years.

Mineralised waste that is stockpiled in the hope, but without the expectation, that it may become economical to process in the future is required to be accounted for in the same way as overburden and other waste materials (see section 15.5 below). Low-grade ore that is stockpiled with the expectation that it will be processed in the future is required to be accounted for in the same way as high-grade ore. However, if the cost of the low-grade ore exceeds its net realisable value, an entity is required to recognise an impairment charge that it might need to reverse at some point in the future if (and when) commodity prices were to increase.

Where the processing of low-grade ore may be deferred until it becomes economically viable and management intends to process the stockpile in the future, the ore is often presented as non-current inventory under IAS 2. Such stockpiles are required to be measured at the lower of cost and net realisable value. *[IAS 2.9]*.

How we see it

IAS 2 provides limited guidance in how to determine net realisable value. In allocating production costs to the low-grade ore stockpiles, and in subsequently assessing net realisable value, significant judgement will be involved and key estimates and assumptions made are required to be disclosed where material.

Given this limited guidance, in allocating production costs to the low-grade, ore stockpile and in subsequently assessing net realisable value, an entity could consider the following:

- Timing of sale: what is a reasonable and supportable assumption about the time it takes to sell.
- Commodity prices: whether to use those at the reporting date or future commodity prices. The commodity price at the reporting date may not be representative of the price that can realistically be expected to prevail when the ore is expected to be processed. The assumptions as to the long-term commodity prices used in the estimate of the sales proceeds and the expected timing of realisation, would generally be required to be consistent with those used in the Life of Mine Plan and other models that would be used for valuation and impairment purposes.
- Costs of processing: these may change in the future because of inflation, technological changes and new environmental regulations.
- Storage costs: specifically, how these should be factored in.
- Time value of money: depending on how net realisable value is determined and what inputs are used, the time value of money could impact the calculation of net realisable value. IAS 2 is silent as to how to address the time value of money and does not consider the degree to which the use of future commodity prices may already reflect the time value of money.

Practical example 14-8 below shows how AngloGold Ashanti Limited accounts for ore stockpiles.

Practical example 14-8: AngloGold Ashanti Limited (2022) **South Africa**

Annual Financial Statements 2022 [extract]

Financial statements [extract]

Group - Notes to the financial statements [extract]

1. Statement of compliance [extract]

1.2 Significant accounting judgements and estimates [extract]

Use of estimates [extract]

Stockpiles and metals in process

Costs that are incurred in or benefit the production process are accumulated in stockpiles and metals in process values. Net realisable value tests are performed at least annually and represent the estimated future sales price of the product, based on prevailing and long-term metals prices, less estimated costs to complete production and bring the product to sale.

Surface and underground stockpiles and metals in process are measured by estimating the number of tonnes added and removed from the stockpile, the number of contained ounces based on assay data, and the estimated recovery percentage based on the expected processing method. Stockpile ore tonnages are verified by periodic surveys.

Although the quantities of recoverable metal are reconciled by comparing the grades of ore to the quantities of metals actually recovered (metallurgical balancing), the nature of the process inherently limits the ability to precisely monitor recoverability levels. As a result, the metallurgical balancing process is constantly monitored and engineering estimates are refined based on actual results over time.

Variations between actual and estimated quantities resulting from changes in assumptions and estimates that do not result in write-downs to net realisable value are accounted for on a prospective basis.

The carrying value of inventories (excluding finished goods and mine operating supplies) for the Group at 31 December 2022 was $306m (2021: $299m; 2020: $382m).

Annexure A [extract]

Summary of material accounting policies [extract]

Inventories [extract]

Inventories are valued at the lower of cost and net realisable value after appropriate allowances for redundant and obsolete items. Cost is determined on the following bases:

- [illegible]
- [illegible]
- ore stockpiles are valued at the average moving cost of mining and stockpiling the ore. Stockpiles are classified as a non-current asset where the stockpile exceeds current processing capacity;

...

Practical example 14-9 below illustrates the disclosure relating to the reversal of impairment of stockpiled ore.

Practical example 14-9: IAMGOLD Corporation (2022) **Canada**

Annual Report 2022 [extract]

Consolidated financial statements [extract]

Notes to consolidated financial statements [extract]

10. Inventories

	December 31, 2022	December 31, 2021
Finished goods	$ 42.6	$ 95.2
Ore stockpiles	30.4	33.6
Mine supplies	126.9	173.3
	199.9	302.1
Non-current ore stockpiles	92.4	124.1
	$ 292.3	$ 426.2

For the year ended December 31, 2022, the Company recognized a net realizable value write-down in finished goods amounting to $6.7 million (December 31, 2021 - $7.8 million).

For the year ended December 31, 2022, the Company recognized a net realizable value write-down in current ore stockpiles amounting to $2.1 million (December 31, 2021 - $6.9 million) and a net reversal of previously recorded net realizable value write-downs in non-current ore stockpiles amounting to $17.0 million (December 31, 2021 - net realizable write-down of $73.8 million).

For the year ended December 31, 2022, the Company recognized a write-down in mine supplies inventories amounting to $2.4 million (December 31, 2021 - $4.8 million).

14.6 Heap leaching (mining)

Heap leaching is a process which may be used for the recovery of metals from low grade ore. The crushed ore is laid on a slightly sloping, impermeable pad and leached by uniformly trickling a chemical solution through the heaps to be collected in ponds. The metals are subsequently extracted from the pregnant solution. Although heap leaching is one of the lowest cost methods of processing, recovery rates are relatively low.

Despite the estimation and measurement challenges associated with heap leaching, ore loaded on heap leach pads is usually recognised as inventory. An entity that develops an accounting policy for heap leaching needs to consider the following:

- The metal recovery factor is relatively low and will vary depending on the metallurgical characteristics of the material on the heap leach pad. The final (actual) recovery is therefore unknown until leaching is complete. Therefore, an entity will need to estimate the quantity of recoverable metal on each of its heap leach pads, based on laboratory test work or historical ore performance.
- The assayed head grade of ore added to the heap.
- The ore stockpiles on heap leach pads are accounted for as inventories that are measured at cost under IAS 2. As the valuable metal content is leached from these ore stockpiles, the cost basis is depleted based upon expected grades and recovery rates. The depletion charge would be accounted for as part of the cost of production of work in progress or finished goods.
- The level at which the heap leach pads are measured - that is, whether they are measured separately, in groups or in total. The preferred approach is to consider each pad separately (where possible) because this reduces the expected volatility in ore type to more manageable levels.
- Ore stockpiles on heap leach pads from which metals are expected to be recovered in a period longer than 12 months are generally classified as non-current assets.

Practical examples 14-10 and 14-11 below from the financial statements of AngloGold Ashanti Limited and Kinross Gold Corporation illustrate the issues that an entity will need to consider in developing an accounting policy for heap leaching.

Practical example 14-10: AngloGold Ashanti Limited (2022) **South Africa**

Annual Financial Statements 2022 [extract]
Financial statements [extract]
Annexure A [extract]
Summary of material accounting policies [extract]
Inventories [extract]

Inventories are valued at the lower of cost and net realisable value after appropriate allowances for redundant and obsolete items. Cost is determined on the following bases:

- metals in process are valued at the average total production cost at the relevant stage of production;
- gold doré/bullion is valued on an average total production cost method;
- ore stockpiles are valued at the average moving cost of mining and stockpiling the ore. Stockpiles are classified as a non-current asset where the stockpile exceeds current processing capacity;
- by-products, which include silver and sulphuric acid, are valued using an average total production cost method;
- mine operating supplies are valued at average cost; and
- heap leach pad materials are measured on an average total production cost basis.

...

Practical example 14-11: Kinross Gold Corporation (2022) **Canada**

2022 Annual Report [extract]
Notes to the consolidated financial statements [extract]
3. Summary of significant accounting policies [extract]

vi. Inventories

Inventories consisting of metal in circuit ore, metal in-process and finished metal are valued at the lower of cost or net realizable value ("NRV"). NRV is calculated as the difference between the prevailing or long-term metal price estimates, and estimated costs to complete production into a saleable form and estimated costs to sell.

Metal in circuit is comprised of ore in stockpiles and ore on heap leach pads. Ore in stockpiles is coarse ore that has been extracted from the mine and is available for further processing. Costs are added to stockpiles based on the current mining cost per tonne and removed at the average cost per tonne. Costs are added to ore on the heap leach pads based on current mining costs and removed from the heap leach pads as ounces are recovered, based on the average cost per recoverable ounce of gold on the leach pad. Ore in stockpiles not expected to be processed in the next twelve months is classified as long-term.

The quantities of recoverable gold placed on the leach pads are reconciled by comparing the grades of ore placed on the leach pads to the quantities of gold actually recovered (metallurgical balancing); however, the nature of the leaching process inherently limits the ability to precisely monitor inventory levels. As a result, the metallurgical balancing process is constantly monitored and the engineering estimates are refined based on actual results over time. Variances between actual and estimated quantities resulting from changes in assumptions and estimates that do not result in write downs to NRV are accounted for on a prospective basis. The ultimate actual recovery of gold from a leach pad will not be known until the leaching process has concluded. In the event that the Company determines, based on engineering estimates, that a quantity of gold contained in ore on leach pads is to be recovered over a period exceeding twelve months, that portion is classified as long-term.

In-process inventories represent materials that are in the process of being converted to a saleable product.

Materials and supplies are valued at the lower of average cost and NRV.

Write-downs of inventory are recognized in the consolidated statement of operations in the current period. The Company reverses inventory write downs in the event that there is a subsequent increase in NRV.

15 Property, plant and equipment

15.1 Major maintenance and turnarounds/renewals and reconditioning costs

Some assets (e.g., refineries, smelters and gas processing plants) require major maintenance at regular intervals, which is often described as an overhaul or turnaround in the oil and gas sector and renewal or reconditioning in the mining sector. When an entity incurs further costs in relation to an item of PP&E, IAS 16 requires it to determine the nature of the costs. Where such costs provide access to future economic benefits they are required to be capitalised. Costs of day-to-day servicing (e.g., costs of labour and consumables, and possibly the cost of small parts) are required to be expensed as incurred. *[IAS 16.12]*. If the costs relate to the replacement of a part of the entire asset, then the entity derecognises the carrying amount of the part that is replaced and recognises the cost of the replacement part. *[IAS 16.13]*. However, the part need not represent a physical part of the asset.

When a major inspection, renewal or reconditioning project is performed, its cost should be recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria of IAS 16 are satisfied. Any remaining carrying amount of the cost of the previous inspection/renewal (which will be distinct from physical parts) is derecognised. This is not affected by whether the entity identified the cost of the previous inspection when the item was initially acquired or constructed. *[IAS 16.14]*. See Chapter 19 at section 3.3.2.

Subsequent costs that meet the recognition criteria must therefore be capitalised even if the costs incurred merely restore the assets to their original standard of performance, and the remaining carrying amount of any cost previously capitalised must be expensed. However, under IAS 37 an entity cannot provide for the costs of planned future maintenance (e.g., turnarounds, renewals/reconditions) as is shown in Illustration 15-1, based on Example 11A in IAS 37. *[IAS 37.IE Example 11A]*.

Illustration 15-1: Refurbishment costs - no legislative requirement

A furnace has a lining that needs to be replaced every five years for technical reasons. At the end of the reporting period, the lining has been in use for three years.

Under IAS 37 no provision should be recognised as there is no present obligation. The cost of replacing the lining is not recognised because, at the end of the reporting period, no obligation to replace the lining exists independently of the company's future actions - even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining. Instead of a provision being recognised, the depreciation of the lining takes account of its consumption, i.e., it is depreciated over five years. The re-lining costs then incurred are capitalised with the consumption of each new lining shown by depreciation over the subsequent five years.

Even a legal requirement to refurbish does not make the costs of a turnaround/renewal a liability under IAS 37, because no obligation exists independently of the entity's future actions - the entity could avoid the future overhaul expenditure by its future actions, for example, by selling the refinery or the asset that is being renewed/reconditioned. *[IAS 37.IE Example 11B]*.

Practical example 15-1 below from BP p.l.c. illustrates a typical accounting policy for repairs, maintenance and inspection costs under IFRS accounting standards.

Practical example 15-1: BP p.l.c. (2022) **United Kingdom**

bp Annual Report and Form 20-F 2022 [extract]

Financial statements [extract]

Notes on financial statements [extract]

1. Significant accounting policies, judgements, estimates and assumptions [extract]

Property, plant and equipment [extract]

Expenditure on major maintenance refits or repairs comprises the cost of replacement assets or parts of assets, inspection costs and overhaul costs. Where an asset or part of an asset that was separately depreciated is replaced and it is probable that future economic benefits associated with the item will flow to the group, the expenditure is capitalized and the carrying amount of the replaced asset is derecognized. Inspection costs associated with major maintenance programmes are capitalized and amortized over the period to the next inspection. Overhaul costs for major maintenance programmes, and all other maintenance costs are expensed as incurred.

...

Turnarounds/renewals can have a considerable impact on financial performance because of additional costs incurred and lower revenues. Therefore, fairly detailed information is generally disclosed about turnaround costs incurred in the past and turnarounds planned in the future.

15.2 Well workovers and recompletions (oil and gas)

Well workovers or recompletions are often required when the producing oil sands become clogged and production declines or other physical or mechanical problems arise.[116] Workover costs that relate to the day-to-day servicing of the wells (i.e., primarily the costs of labour and consumables, and possibly the cost of small parts) must be expensed as incurred. However, as discussed in section 15.1 above, costs incurred to restore a well to its former level of production is required to be capitalised under IFRS accounting standards, but an entity would be required to derecognise any relevant previously capitalised well completion costs. However, to the extent that an entity can forecast future well workovers, it will need to depreciate the original well completion costs over a shorter economic life. Conversely, if an entity unexpectedly incurs well workover costs, it may need to consider whether those additional costs result in the need to perform an impairment test.

15.3 Care and maintenance

At certain times, a mining operation, gas plant or other substantial component of operations may be suspended because of a change in circumstances which may include a weakening of global demand for the commodity, lower prices, higher costs, changes in demand for processing, changes in exchange rates, changes in government policy or other events of nature such as seismic events or cyclones. Such changes mean that continuing with production or further development becomes uneconomical. Instead of permanently shutting down and abandoning the mine or plant, the operations and development are curtailed and the mine, plant or operation is placed on 'care and maintenance'. This can happen either in the development phase or the production phase.

A decision to put an asset such as a mine or gas plant on care and maintenance would be an indicator of impairment (see section 11.1 above). An impairment test would need to be conducted and if the recoverable amount of the CGU is less than the carrying amount, an impairment loss would need to be recognised.

While the asset remains in care and maintenance, expenditures are still incurred but usually at a lower rate than when the mine or gas plant is operating. A lower rate of depreciation for tangible non-current assets is also usually appropriate due to reduced wear and tear. Movable plant and machinery would generally be depreciated over its useful life. Management should consider depreciation to allow for deterioration. Where depreciation for movable plant and machinery had previously been determined on a units of production basis, this may no longer be appropriate.

Management should also ensure that any assets for which there are no longer any future economic benefits, i.e., which have become redundant, are written off.

The length of the closure and the associated care and maintenance expenditure may be estimated for depreciation and impairment purposes. However, it is not appropriate to recognise a provision for the entire estimated expenditure relating to the care and maintenance period. All care and maintenance costs are to be expensed as incurred.

Development costs amortised or depreciated using the units of production method would no longer be depreciated. Holding costs associated with such assets should be expensed in profit or loss in the period they are incurred. These may include costs such as security costs and site property maintenance costs.

The costs associated with restarting a mine or gas plant which had previously been on care and maintenance should only be capitalised if they improve the asset beyond its original operating capabilities. Entities will need to exercise significant judgement when performing this assessment.

116 IASC Issues Paper, 6.64.

15.4 Unitisations and redeterminations

15.4.1 Unitisations

A unitisation arrangement is "…an agreement between two parties each of which owns an interest in one or more mineral properties in an area to cross-assign to one another a share of the interest in the mineral properties that each owns in the area; from that point forward they share, as agreed, in further costs and revenues related to the properties".[117] The parties pool their individual interests in return for an interest in the overall unit, which is then operated jointly to increase efficiency.[118] Once an area is subject to a unitisation arrangement, the parties share costs and production in accordance with their percentages established under the unitisation agreement. The unitisation agreement does not affect costs and production associated with non-unitised areas within the original licences, which continue to fall to the original licensees.[119]

IFRS accounting standards do not specifically address accounting for a unitisation arrangement. Therefore, the accounting for such an arrangement depends on the type of asset that is subject to the arrangement. If the assets subject to the arrangement were E&E assets, then the transaction would fall within the scope of IFRS 6, which provides a temporary exemption from IAS 8 (see section 3.2.1 above). An entity would be permitted to develop an accounting policy for unitisation arrangements involving E&E assets that is not based on IFRS accounting standards. However, unitisations are unlikely to occur in the E&E phase when technical feasibility and commercial viability of extracting a mineral resource are not yet demonstrable.

For unitisations that occur outside the E&E phase, as there is no specific guidance in IFRS accounting standards, an entity will need to develop an accounting policy in accordance with the IAS 8 hierarchy. The first step in developing an accounting policy for unitisations is setting criteria for determining which assets are included within the transaction. Particularly important is the assessment as to whether the unitisation includes the mineral reserves themselves or not. The main reason for not including the mineral reserves derives from the fact that they are subject to redetermination (see section 15.4.2 below).

The Illustration below, which is taken from the IASC Issues Paper, shows how a unitisation transaction might work in practice.

Illustration 15-2: Unitisation[120]

Entities E and F have carried out exploration programs on separate properties owned by each in a remote area near the Antarctic Circle. Both entities have discovered petroleum reserves on their properties and have begun development of the properties. Because of the high operating costs and the need to construct support facilities, such as pipelines, dock facilities, transportation systems, and warehouses, the entities decide to unitise the properties, which mean that they have agreed to combine their properties into a single property. A joint operating agreement is signed and Entity F is chosen as operator of the combined properties. Relevant data about each entity's properties and costs are given as follows:

Party E	
Prospecting costs incurred prior to property acquisition	CU8,000,000
Mineral acquisition costs	CU42,000,000
Geological and geophysical exploration costs (G&G)	CU12,000,000
Exploratory drilling costs:	
▸ Successful	CU16,000,000
▸ Unsuccessful	CU7,000,000
Development costs incurred	CU23,000,000
Estimated reserves, agreed between parties (in barrels)	30,000,000
Party F	
Prospecting costs incurred prior to property acquisition	CU3,000,000
Mineral acquisition costs	CU31,000,000

117 IASC Issues Paper, 12.14.

118 Former OIAC SORP 175.

119 Former OIAC SORP 176.

120 IASC Issues Paper, 12.14.

Geological and geophysical exploration costs (G&G)	CU17,000,000
Exploratory drilling costs:	
▸ Successful	CU24,000,000
▸ Unsuccessful	CU4,000,000
Development costs incurred	CU36,000,000
Estimated reserves, agreed between parties (in barrels)	70,000,000

Ownership ratio in the venture is to be based on the relative quantity of agreed-upon reserves contributed by each party (30% to E and 70% to F). The parties agree that there should be an equalisation between them for the value of pre-unitisation exploration and development costs that directly benefit the unit, but not for other exploration and development costs. That is, there will be a cash settlement between the parties for the value of assets (other than mineral rights) or services that each party contributes to the unitisation. This is done so that the net value contributed by each party for the specified expenditures will equal that venturer's share of the total value of such expenditures at the time unitisation is consummated. Thus, the party contributing a value less than that party's share of ownership in the total value of those costs contributed by all the parties will make a cash payment to the other party so that each party's net contribution will equal that party's share of total value. The agreed amounts of costs to be equalised that are contributed by E and F are:

Expenditures made by:	**E**	**F**	**Total**
	CU	*CU*	*CU*
Successful exploratory drilling	12,000,000	12,000,000	24,000,000
Development costs	18,000,000	30,000,000	48,000,000
Geological and geophysical exploration	4,000,000	14,000,000	18,000,000
Total expenditure	34,000,000	56,000,000	90,000,000

As a result of this agreement, F is obliged to pay E the net amount of CU7,000,000 to equalise exploration and development costs. This is made up of the following components:

a) CU4,800,000 excess of value of exploratory drilling received by F (CU16,800,000 = 70% × CU24,000,000) in excess of value for successful exploratory drilling contributed (CU12,000,000)

Plus

b) CU3,600,000 excess of value of development costs received by F in the unit (CU33,600,000 = 70% × CU48,000,000) in excess of the value of development costs contributed by F (CU30,000,000)

Less

c) CU1,400,000 excess of value of G&G costs contributed by F (CU14,000,000) over the value of the share of G & G costs owned by F after unitisation (CU12,600,000 = 70% × CU18,000,000)

Although the reserves are unitised in the physical sense (i.e., each party will end up selling oil or gas that physically came out of the reserves of the other party), in volume terms the parties remain entitled to a quantity of reserves that is equal to that which they contributed. However, the timing of production and the costs to produce the reserves may be impacted by the unitisation agreement. The Illustration below explains this in more detail.

Illustration 15-3: Reserves contributed in a unitisation

Entities A and B enter into a unitisation agreement and contribute Licences A and B, respectively. The table below shows the initial determination, redetermination and final determination of the reserves in each of the fields.

	Initial determination		Redetermination		Final determination	
	mboe		**mboe**		**mboe**	
Licence A	20	40.0%	19	37.3%	21	38.9%
Licence B	30	60.0%	32	62.7%	33	61.1%
	50	100.0%	51	100.0%	54	100.0%

Although Licences A and B were unitised, ultimately Entity A will be entitled to 21 mboe and Entity B will be entitled to 33 mboe, which is exactly the same quantity that they would have been entitled to had there been no unitisation.

How we see it

To the extent that the unitisation of the mineral reserves themselves lacks commercial substance (see section 6.3.2 above), it could be appropriate to exclude the mineral reserves in accounting for a unitisation. Where the unitisation significantly affects the risk and timing of the cash flows or the type of product (e.g., a unitisation could lead to an exchange of, say, gas reserves for oil reserves), there is likely to be substance to the unitisation of the reserves.

If the assets subject to the unitisation arrangement are not E&E assets, or not only E&E assets, then it is necessary to develop an accounting policy in accordance with the requirements of IAS 8. Unitisation arrangements generally give rise to joint control over the underlying assets or entities:

(a) If the unitisation arrangement results in joint control over a joint venture, then the parties must apply IFRS 11 (see Chapter 13) and IAS 28 (see Chapter 12) and provide the relevant disclosures in accordance with the requirements contained in IFRS 12 (see Chapter 14).

(b) If the unitisation arrangement gives rise to a joint operation or results in a swap of assets that are not jointly controlled, then each of the parties must account for the arrangement as an asset swap (see section 6.3 above).

Under both (a) and (b) above, a party to a unitisation agreement would report a gain (or loss) depending on whether the fair value of the interest received is higher (or lower) than the carrying amount of the interest given up.

15.4.2 Redeterminations

The percentage interests in a unitisation arrangement are based on estimates of the relative quantities of reserves contributed by each of the parties. As field life progresses and production experience is gained, many unitisation agreements require the reserves to be redetermined, which often leads the parties to conclude that the recoverable reserves in one or perhaps both of the original properties are not as previously estimated. Unitisation agreements typically require one or more 'redeterminations' of percentage interests once better reservoir information becomes available. In most cases, the revised percentage interests are deemed to be effective from the date of the original unitisation agreement, which means that adjustments are required between the parties in respect of their relative entitlements to cumulative production and their shares of cumulative costs.[121]

Unitisation agreements normally set out when redeterminations need to take place and the way in which adjustments to the percentage interests should be effected. The former OIAC SORP described the process as follows:

(a) "Adjustments in respect of cumulative 'capital' costs are usually made immediately following the redetermination by means of a lump sum reimbursement, sometimes including an 'interest' or uplift element to reflect related financing costs."[122]

(b) "Adjustments to shares of cumulative production are generally effected prospectively. Participants with an increased share are entitled to additional 'make-up' production until the cumulative liftings are rebalanced. During this period adjusted percentage interests are applied to both production entitlement and operating costs. Once equity is achieved the effective percentage interests revert to those established by the redetermination."[123]

How we see it

An adjustment to an entity's percentage interest due to a redetermination is not a prior period error under IFRS accounting standards. Instead, the redetermination results from new information or new developments and therefore, must be treated as a change in an accounting estimate. Accordingly, a redetermination does not result in a retrospective adjustment but instead would be accounted for prospectively.

Redeterminations give rise to some further accounting issues which are discussed below.

121 Former OIAC SORP 177-178.

122 Former OIAC SORP 179-180.

123 Former OIAC SORP 179-180.

15.4.2.A Redeterminations as capital reimbursements

How we see it

Under many national GAAPs, redeterminations are accounted for as reimbursement of capital expenditure rather than as sales/purchases of a partial interest. Given that this second approach could result in the recognition of a gain upon redetermination, followed by a higher depreciation charge per barrel, it has become accepted industry practice that redeterminations would typically be accounted for as reimbursements of capital expenditure under IFRS accounting standards.

Both approaches are shown in Illustration 15-4 below.

In addition, a redetermination gives rise to a number of questions, for example, how the entities account for:

- The adjustment of their share in the remaining reserves
- The 'make-up' oil obligation
- Their revised shares in the decommissioning liabilities

The 'make-up' oil obligation and the revised shares in the decommissioning liabilities are discussed further following the Illustration below.

Illustration 15-4: Redetermination (1)

Entities A and B have a 10% and 90% interest in a unitised property, respectively. On 1 January 20X1, after three years of operations, their interests in the property are redetermined. The relevant data about each entity's interest in the property are as follows:

	A	B	Total
Percentage interest after initial determination	10%	90%	100%
Percentage interest after redetermination	8%	92%	100%
Initial reserves at 1/1/2021 (million barrels of oil equivalent)	100 mboe	900 mboe	1000 mboe
Total production from 2018 to 2020	30 mboe	270 mboe	300 mboe
Remaining reserves at 31/12/2020 before redetermination	70 mboe	630 mboe	700 mboe
Reserves after redetermination at 1/1/2021	56 mboe	644 mboe	700 mboe
'Make-up' oil: 300 mboe × (10% - 8%) =	-6 mboe	6 mboe	-
Total entitlement at 1/1/2021	50 mboe	650 mboe	700 mboe
	CU	*CU*	*CU*
Exploration and development asset at 1/1/2018	400	3,600	4,000
Units of production depreciation:			
CU400 ÷ 100 mboe × 30 mboe =	120		120
CU3,600 ÷ 900 mboe × 270 mboe =		1,080	1,080
Exploration and development asset at 31/12/2020 before redetermination	280	2,520	2,800
	A	**B**	**Total**
Total investment based on 'initial determination': A: 10% of CU4,000 = CU400 and B: 90% of CU4,000 = CU3,600	400	3,600	4,000
Total investment based on redetermination: A: 8% of CU4,000 = CU320 and B: 92% of CU4,000 = CU3,680	320	3,680	4,000
Reimbursement of exploration and development costs	80	-80	-
Decommissioning asset at 1/1/2018	100	900	1,000

Units of production depreciation:			
CU100 ÷ 100 mboe × 30 mboe =	30		30
CU900 ÷ 900 mboe × 270 mboe =		270	270
Decommissioning asset at 31/12/2020 before redetermination	70	630	700
Decommissioning provision at 1/1/2018	100	900	1,000
Accreted interest from 1/1/2018 to 31/12/2020	20	180	200
Decommissioning provision at 31/12/2020 before redetermination	120	1,080	1,200
Reduction in decommissioning provision	-24	24	-
Decommissioning provision at 1/1/2021: A: 8% of CU1,200 = CU96 and B: 92% of CU1,200 = CU1,104	96	1,104	1,200

There are different ways in which an entity might interpret the effect of a redetermination on the exploration and development asset:

(a) Reimbursement of capital expenditure

(b) Sale/purchase of a partial interest

Reimbursement of capital expenditure

Under this approach, the redetermination is treated as a reimbursement of capital expenditure and the 'make-up' oil is accounted for prospectively. This would lead Entity A to make the following journal entries:

Dr	Cash		CU80	
	Cr	Exploration and development asset		CU80

The reimbursement of exploration and development costs is accounted for as a reduction in the exploration and development asset.

The overall impact on the statement of financial position of both Entities A and B is summarised in the table below:

	A	B	Total
	CU	*CU*	*CU*
Exploration and development asset at 31/12/2020 before redetermination	280	2,520	2,800
Reimbursement of exploration and development costs	-80	80	-
Exploration and development asset at 1/1/2021 after redetermination	200	2,600	2,800

Before the redetermination both A and B would record depreciation of the exploration and development asset of CU4/barrel (i.e., A: CU400 ÷ 100 mboe = CU4/barrel and B: CU3,600 ÷ 900 mboe = CU4/barrel). After the redetermination the depreciation of the exploration and development asset is still CU4/barrel for both A and B (i.e., A: CU200 ÷ 50 mboe = CU4/barrel and B: CU2,600 ÷ 650 mboe = CU4/barrel).

Sale/purchase of a partial interest

The second approach, which is sometimes advocated, is to treat the redetermination as the equivalent of a sale or purchase of part of an interest.

Dr	Cash		CU80	
	Cr	Exploration and development asset: (8% - 10%) ÷ 10% × CU280 =		CU56
	Cr	Gain on disposal of exploration and development asset		CU24

The reimbursement of exploration and development costs is accounted for as a partial disposal of the exploration and development asset.

However, Entity B will treat its entire payment of CU80 to Entity A as the cost of the additional 2% interest that it 'acquired' in the redetermination. The overall impact on the statement of financial position of both Entities A and B is summarised in the table below:

	A	B	Total
	CU	*CU*	*CU*
Exploration and development asset at 31/12/2020 before redetermination	280	2,520	2,800
Reimbursement of exploration and development costs	-56	80	-
Exploration and development asset at 1/1/2021 after redetermination	224	2,600	2,824

After the redetermination the depreciation of exploration and development asset for Entity A is (CU224 ÷ 50 mboe =) CU4.48/barrel and for Entity B is (CU2,600 ÷ 650 mboe =) CU4/barrel.

15.4.2.B 'Make-up' oil

As indicated in Illustration 15-4 above, Entity B would be entitled to 6 mboe of 'make-up' oil out of Entity A's share of the production. This raises the question whether Entity A is required to recognise a liability for the 'make-up' oil and whether Entity B is required to recognise an asset for the 'make-up' oil that it is entitled to.

'Make-up' oil is in many ways comparable to an overlift or underlift of oil, because after the redetermination it appears that Entity A is effectively in an overlift position (i.e., it has sold more product than its proportionate share of production) while Entity B is in an underlift position (i.e., it has sold less product than its proportionate share of production).

IFRS accounting standards do not directly address accounting for underlifts and overlifts (as discussed in section 12.4 above) or accounting for 'make-up' oil following a redetermination. Consequently, an entity that is entitled to receive or is obliged to pay 'make-up' oil will need to apply the hierarchy in IAS 8 to develop an accounting policy that is compliant with current IFRS accounting standards. In doing so, the entity could look to the accounting standards of another standard-setter with a similar conceptual framework, such as US GAAP or UK GAAP, in which case the entity would not recognise an asset or liability and account for the 'make-up' oil prospectively.

Under many unitisation agreements, entities are required to give up oil only to the extent that there is production from the underlying field. Under these circumstances, Entity A would have no obligation to deliver oil or make another form of payment to the other parties under the unitisation agreement. In those cases, the 'make-up' oil obligation would not meet the definition of financial liability under IAS 32 or that of a provision under IAS 37. It may also be considered that Entity B cannot recognise an asset, because its right to 'make-up' oil only arises because of a future event (i.e., the future production of oil).

15.4.2.C Decommissioning provisions

Another effect of a redetermination is that it may increase or decrease an entity's share of the decommissioning liability in relation to the project, as shown in the Illustration below.

Illustration 15-5: Redetermination (2)

Assuming the same facts as in Illustration 15-4 above, how should Entities A and B account for the change in the decommissioning provision?

Under IFRIC 1 the change in a decommissioning provision should be added to, or deducted from, the cost of the related asset in the current period. However, if a decrease in the liability exceeds the carrying amount of the asset, the excess should be recognised immediately in profit or loss. *[IFRIC 1.5]*.

This would lead Entities A and B to make the following journal entries:

Entity A

Dr	Decommissioning provision		CU24	
	Cr	Decommissioning asset		CU24

Entity B

Dr	Decommissioning asset		CU24	
	Cr	Decommissioning provision		CU24

The decommissioning asset is adjusted in accordance with IFRIC 1 *for the change in the decommissioning provision.*

If Entity A had recognised a gain of CU24 upon the reduction of the decommissioning liability, this would have resulted in an increase in the depreciation of the decommissioning asset from (CU100 ÷ 100 mboe =) CU1/barrel to (CU70 ÷ 50 mboe =) CU1.40/barrel. The IFRIC 1 approach avoids this although it increases the depreciation of the decommissioning asset slightly to (CU56 ÷ 50mboe =) CU1.12/barrel, as the decommissioning provision is also affected by the accretion of interest. Nevertheless, the approach required by IFRIC 1 is largely consistent with the treatment of a redetermination as a reimbursement of capital expenditure as in Illustration 15-4 above.

15.5 Stripping costs in the production phase of a surface mine (mining)

In surface mining operations it is necessary to remove overburden and other waste materials to gain access to ore from which minerals can be extracted - this is also referred to as stripping. IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine* specifies how stripping costs incurred during the production phase of a surface mine are to be accounted for. IFRIC 20 considers the different types of stripping costs encountered in a surface mining operation. These costs are separated into those incurred in the development phase of the mine (i.e., pre-production) and those that are incurred in the production phase. *[IFRIC 20.2, IFRIC 20.3]*. For these purposes, the mine is considered to be an asset that is separate from the mineral rights and mineral reserves, which are outside the scope of IAS 16. *[IAS 16.3(d)]*.

15.5.1 Scope of IFRIC 20

Generally, those costs incurred in the development phase of a mine would be capitalised as part of the depreciable cost of building, developing and constructing the mine, under the principles of IAS 16. Ultimately, these capitalised costs are depreciated or amortised on a systematic basis, usually by using the units of production method, once production commences. The stripping costs incurred in the development phase of a mine are not within the scope of IFRIC 20.

Instead, the interpretation applies to all waste removal (stripping) costs incurred during the production phase of a surface mine (production stripping costs). *[IFRIC 20.2]*. It does not apply to oil and natural gas extraction and underground mining activities. Also, it does not address the question of whether oil sands extraction is considered to be a surface mining activity and therefore whether it is in scope or not. *[IFRIC 20.BC4]*.

Despite the importance of the term 'production phase', this is not defined in the Interpretation, or elsewhere in IFRS accounting standards. See section 15.5.2 below for further discussion of production phase.

Stripping activity undertaken during the production phase may create two benefits (1) the extraction of ore (inventory) in the current period and (2) improved access to the ore body to be mined in a future period. Where the benefits are realised in the form of inventory produced, the production stripping costs are to be accounted for in accordance with IAS 2. Where the benefits are improved access to ore to be mined in the future, these costs are to be recognised as a non-current asset, if the required criteria are met (see section 15.5.2 below). The Interpretation refers to this non-current asset as the 'stripping activity asset'. *[IFRIC 20.8]*.

15.5.2 Determining when production phase commences

As noted above, there is no specific guidance or definition in IFRS accounting standards relating to the concept of production phase. The production phase is considered to commence once the asset is in the location and condition necessary for it to be capable of operating in the manner intended by management. Given the nature of mining and metals projects, the key area of judgement is determining exactly when an asset is in the location and condition necessary for it to be capable of operating as intended by management.

The determination of the commencement of the production phase, which is also often referred to as the commissioning date, not only affects stripping costs, but also affects many other accounting issues in the extractive industries, described in more detail below. These include the cessation of the capitalisation of other costs, including borrowing costs, the commencement of depreciation or amortisation (see section 16 below), and the treatment of certain pre-production revenues (see section 12.1 above).

For some larger mining and metals entities, determining the production date may not be as critical as it may be for a smaller entity, particularly when that smaller entity only has one major mining project. In some instances, a difference of a week could have a material impact.

No specific guidance exists within IFRS accounting standards, particularly as to what it means for an asset to be 'in the location and condition necessary for it to be capable of operating as intended by management'. Consequently, various approaches have evolved. It is common for many entities to simply refer to the achievement of 'commercial production' as the point at which the assets are commissioned, i.e., ready for their intended use, without providing any detail as to exactly what commercial production means. Having said this, some entities identify 'production start date' as a significant judgement and provide more detailed disclosures.

How we see it

In our experience, many entities distinguish start-up/commissioning from post-commissioning costs, which can also be referred to as ramp-up or operating costs. Start-up/commissioning costs are often capitalised when the asset is available for use, but is incapable of operating at normal levels without the necessary start-up/commissioning period. Generally, this allows costs associated with the physical capabilities of a mining and metals project to be capitalised, but not the costs incurred as a result of the need to build up demand. Deliberate or avoidable delays in achieving physical completion or obtaining necessary approvals to operate the mine are likely to be deemed abnormal and expensed as incurred.

While disclosures may sometimes be limited, as part of the process of assessing when a mining and metals project is ready for its intended use, a variety of factors are often considered with varying degrees of emphasis placed on each. The specific factors used are generally determined by the unique nature of each mine and are impacted by the complexity of the project and its location.

While not specifically contained in any IFRS accounting standards guidance, some common examples of the range of factors that are often considered include:

- The level of capital expenditure compared to the estimated construction cost
- A majority of the assets making up the mining project are substantially complete and ready for use
- Completion of a reasonable period of testing of the mine plant and equipment
- The project has been turned over to operations from the development team
- A specified percentage of design capacity for the mine and/or mill, e.g., 50% to 70%, has been achieved over a continuous period, e.g., three months
- The percentage grade (metal content) of ore being mined is sufficiently economic and consistent with the overall mine plan
- The ability to produce the commodity in a saleable form (within specifications and the *de minimis* rule)
- The ability to sustain ongoing production over a certain period, e.g., one to three months

Generally, no single factor is considered more important than another. Entities must be cautious in how they apply these factors as they can sometimes be open to abuse. Each factor must be considered in context with the facts and circumstances of the specific project.

15.5.3 Recognition criteria - stripping activity asset

IFRIC 20 states that: *[IFRIC 20.9]*

Extract from IFRIC 20

9 An entity shall recognise a stripping activity asset if, and only if, all of the following are met:

(a) it is probable that the future economic benefit (improved access to the ore body) associated with the stripping activity will flow to the entity;

(b) the entity can identify the component of the ore body for which access has been improved; and

(c) the costs relating to the stripping activity associated with that component can be measured reliably.

Instead of being a separate asset, the stripping activity asset is to be accounted for as an addition to, or as an enhancement of, an existing asset. This means that the stripping activity asset will be accounted for as part of an existing asset. *[IFRIC 20.10]*. IFRIC 20 does not specify whether the stripping activity asset is a tangible or intangible asset. Instead, it simply states that it is required to be classified as tangible or intangible according to the nature of the existing asset of which it is part - so it will depend upon whether an entity classifies its mine assets as tangible or intangible.

The Interpretation considers that the stripping activity asset might add to or improve a variety of existing assets, such as, the mine property (land), the mineral deposit itself, an intangible right to extract the ore or an asset that originated in the mine development phase. *[IFRIC 20.BC10]*. In most instances, entities classify their producing mine assets as tangible assets; therefore, it is likely that the stripping activity assets will also be classified as tangible assets.

15.5.4 Initial recognition

The stripping activity asset is to be initially measured at cost. This will be the accumulation of costs directly incurred to perform the stripping activity that benefits the identified component of ore, plus an allocation of directly attributable overhead costs. *[IFRIC 20.12]*. Examples of the types of costs expected to be included as directly attributable overhead costs are items such as salary costs of the mine supervisor overseeing that component of the mine, and an allocation of rental costs of any equipment hired specifically to perform the stripping activity. *[IFRIC 20.BC12]*.

Some incidental operations may take place at the same time as the production stripping activity that are not necessary for the production stripping activity to continue as planned. The costs associated with these incidental operations are not to be included in the cost of the stripping activity asset. *[IFRIC 20.12]*. An example provided in the Interpretation is the building of an access ramp in the area in which the production stripping activity is taking place. These ancillary costs must be recognised as assets or expensed in accordance with other IFRS accounting standards.

15.5.4.A Allocating costs between inventory and the stripping activity asset

If the costs of waste removal can be directly allocated between inventory and the stripping activity asset, then the entity should allocate those costs accordingly. However, it may be difficult in practice to identify these costs separately, particularly if inventory is produced at the same time as access to the ore body is improved. This is likely to be very common in practice. Where this is the case, the Interpretation permits an entity to use an allocation approach that is based on a relevant production measure as this is considered to be a good indicator of the nature of benefits that are generated for the activity taking place in the mine. *[IFRIC 20.13]*.

The Interpretation provides a (non-exhaustive) list of some of the possible metrics that could be used to determine the appropriate allocation basis: *[IFRIC 20.13]*

Extract from IFRIC 20

13 … Examples of such measures include:

(a) cost of inventory produced compared with expected cost;

(b) volume of waste extracted compared with expected volume, for a given volume of ore production; and

(c) mineral content of the ore extracted compared with expected mineral content to be extracted, for a given quantity of ore produced.

An allocation basis which uses sales value or relative sales value is not acceptable. *[IFRIC 20.BC15]*.

The production measure is calculated for each identified component of the ore body. Application of this allocation methodology effectively involves a comparison of the expected level of activity for that component with the actual level of activity for the same component, to identify when additional activity may have occurred and may be creating a future benefit. See section 15.5.4.B below for further discussion about how to determine a component.

Where the actual level of activity exceeds the expected level of activity, the waste removal activity incurred at the expected level and its associated costs would then form part of the cost of inventory produced in that period. Any excess of actual activity over the expected level (and the associated costs of such excess activity) needs to be considered to determine whether it represents a stripping activity asset.

It is important to note that where actual stripping levels exceed those expected for the identified component, this will not automatically result in the recognition of a stripping activity asset. An entity will need to assess whether the removal of such additional waste has actually resulted in a future economic benefit, i.e., improved access to future ore. If not, such costs should not be capitalised as an asset, but instead should be recognised in profit or loss in the period incurred. For example, the mining of an unexpected fault or dyke should not be capitalised but instead expensed as incurred.

Where actual waste removal activity is less than the expected level of activity, only the actual waste removed and its associated costs, not the expected costs, will form part of the cost of inventory produced in that period. This is because continuing to recognise waste costs at the expected level would require an entity to recognise a deferred stripping liability. This is not permitted under IFRIC 20 or generally under IFRS accounting standards because, in the absence of a legal or constructive obligation to continue to mine the deposit, such costs would not satisfy the criteria to be recognised as a liability.

It is worth noting that while some of the allocation approaches set out in the Interpretation are similar to the life-of-mine average strip ratio approach used by many entities prior to the introduction of IFRIC 20, there are differences.

The key difference is that the level at which the expected level of activity is to be determined when calculating the relevant production measure is likely to be lower than that which was previously used for the life-of-mine average strip ratio approach. The life-of-mine average strip ratio approach used the entire ore body, whereas IFRIC 20 requires this to be determined for each component of the ore body, which is expected to be a subset of the ore body. See section 15.5.4.B below for further discussion about how to determine a component.

The other difference relates to the way in which any stripping activity asset is recognised in profit or loss. Under the life-of-mine average stripping ratio approach, a portion of the deferred stripping asset was recognised in profit or loss when the actual stripping ratio fell below the expected average life-of-mine strip ratio. Under IFRIC 20 however, the stripping activity asset is to be depreciated or amortised over the useful life of the identified component of the ore body that becomes more accessible. The units of production (UOP) method is to be used unless another method is more appropriate. *[IFRIC 20.15]*.

It is important to note that the calculation of the expected production measure for each component will need to be reviewed and updated if there are material changes to the mine plan for that component (for example due to differences in actual versus budgeted performance or changes in future mining plans resulting from other factors, e.g., changes in commodity prices or increases in costs). If these changes impact the expected production measure for the remaining life of the component, then the IFRIC 20 calculations will need to be updated and applied on a prospective basis. The calculation of the expected production measures will also be required if and when new components commence production.

Illustration 15-6: Allocating costs between inventory and the stripping activity asset

Scenario A - actual performance measure exceeds the expected performance measure

The following example illustrates how an entity would allocate costs between inventory and the stripping activity asset where the actual performance measure exceeds the expected performance measure for a component in a particular period.

Assume Entity A has a mine which comprises two separate pits which are accessing one ore body. For the purposes of IFRIC 20, each pit is identified as a component. Pit 1 has a total life of three years and at reporting period end, has been in production for one year. Pit 2 has a total life of five years but production has not yet commenced.

At the commencement of production from pit 1, the company has forecast the following mining and stripping activity:

Expected ore to be extracted over the 3 years	1,000 tonnes
Expected volume of waste to be extracted over the 3 years	3,000 tonnes

During the current period, the following had occurred in relation to the production from pit 1:

Cost incurred for mining activity	CU13,000,000 (a)
Actual tonnes of ore removed	100 tonnes (b)
Actual tonnes of waste removed	1,200 tonnes (c)
Average cost per tonne in year 1 = (a) ÷ [(b) + (c)]	CU10,000

The company determined that it is not practically possible to identify separately what portion of the waste removal costs leads to the extraction of inventory and what portion to improved access to future ore. This is because these two activities were occurring simultaneously as there were multiple shovels in operation in multiple parts of the component and a single haulage fleet was used.

Given this, the company has decided that it will allocate costs by comparing the actual volume of waste and ore extracted (the actual strip ratio) in the period with the expected volume of waste and ore (expected strip ratio) for the life of the component i.e., for pit 1.

The allocation of the actual waste removal costs incurred will involve the following steps:

Step 1: Calculate the expected strip ratio for pit 1

Expected volume of waste to be extracted ÷ expected volume of ore to be extracted

= 3,000 tonnes ÷ 1,000 tonnes

= 3.00 (expected strip ratio)

This means that for every 1 tonne of ore extracted over the life of pit 1, the company expects (on average) to remove 3 tonnes of waste.

Step 2: Calculate the additional waste extracted compared to the expected waste extracted for the actual volume of ore extracted

Actual volume of ore extracted × expected strip ratio

= 100 tonnes × 3 tonnes

= 300 tonnes

Actual volume of waste extracted in year 1 = 1,200 tonnes

Additional waste extracted in year 1 = actual waste extracted less expected waste to be extracted

= 1,200 tonnes - 300 tonnes

= 900 tonnes of additional waste was extracted

Step 3: Allocate mining costs between inventory and the stripping activity asset

Stripping activity asset

Additional waste tonnes removed × cost per tonne

= 900 tonnes × CU10,000

= CU9,000,000

Inventory

Total mining costs incurred less costs allocated to the stripping activity asset

= CU13,000,000 - CU9,000,000

= CU4,000,000

This comprises:

(1) The cost of extracting the inventory tonnes

= 100 × CU10,000

= CU1,000,000

Plus:

(2) The cost of waste removal allocated directly to inventory (which was allocated at the expected level of 3:1)

= 300 tonnes × CU10,000

= CU3,000,000

Scenario B - actual strip ratio is less than the expected strip ratio

Assume the same basic fact pattern as per Scenario A above, but with different actual mining results for pit 1 in the current period:

Cost incurred for mining activity	CU13,000,000 (a)
Actual tonnes of ore removed	1,200 tonnes (b)
Actual tonnes of waste removed	100 tonnes (c)
Average cost per tonne in year 1 = (a) ÷ [(b) + (c)]	CU10,000

The allocation of the actual waste removal costs incurred will involve the following steps:

Step 1: Calculate the expected strip ratio for pit 1

Expected volume of waste to be extracted ÷ expected volume of ore to be extracted

= 3,000 tonnes ÷ 1,000 tonnes

= 3.00 (expected strip ratio)

This means that for every 1 tonne of ore extracted over the life of pit 1, the company expects (on average) to remove 3 tonnes of waste.

Step 2: Calculate the additional waste extracted compared to the expected waste extracted for the actual volume of ore extracted

Actual volume of ore extracted × expected strip ratio

= 1,200 tonnes × 3 tonnes

= 3,600 tonnes

Actual volume of waste extracted in year 1 = 100 tonnes

During the current period the actual strip ratio was only 0.0833. As this is less than the expected strip ratio, as explained above, there is no additional waste removed during the period.

Step 3: Allocate mining costs between inventory and the stripping activity asset

Stripping activity asset

As the actual strip ratio was below the expected strip ratio, no additional waste was removed during the period; therefore, there is no amount to be added to the stripping activity asset.

Inventory

As the actual amount of waste removed during the current period is less than the expected level of waste for the life of the component, and there is no amount to be allocated to the stripping activity asset, then the total mining costs for the period will be allocated to inventory.

= CU13,000,000

This comprises:

(1) The cost of extracting the inventory tonnes

= 1,200 × CU10,000

= CU12,000,000

Plus:

(2) The cost of waste removal allocated directly to inventory (which is allocated based on the actual waste tonnes removed during the period)

= 100 tonnes × CU10,000

= CU1,000,000

15.5.4.B Identifying the component of the ore body

Identifying the various components of the ore body is one of the critical steps in applying IFRIC 20. This is necessary for several reasons:

(a) Production stripping costs can only be capitalised as an asset if the component of the ore body for which access has been improved, can be identified.

(b) To allocate stripping activity costs between inventory and the stripping activity asset, an entity needs to determine the expected level of activity for each component of the mine.

(c) The stripping activity asset is required to be depreciated or amortised on a systematic basis, over the expected useful life of the identified component of the ore body that becomes more accessible as a result of the stripping activity.

The Interpretation provides limited guidance on how to identify components, although it does appear a component is expected to be a subset of the whole ore body. This view is supported in several parts of IFRIC 20.

- A 'component' refers to the specific volume of the ore body that is made more accessible by the stripping activity; the identified component of the ore body would typically be a subset of the total ore body of the mine; and a mine may have several components, which are identified during the mine planning stage. *[IFRIC 20.BC8]*.
- The depreciation or amortisation requirements state that the expected useful life of the identified component of the ore body that is used to depreciate or amortise the stripping activity asset will differ from the expected useful life that is used to depreciate or amortise the mine itself and the related life-of-mine assets, unless the stripping activity provides improved access to the whole of the ore body. *[IFRIC 20.BC17]*.

In practice, the identification of components of an ore body is a complex process which requires a significant amount of management judgement. While it is considered that an entity's mine plan will provide the information required allowing these judgements to be made with reasonable consistency, this may not be a straightforward exercise, and it will be particularly challenging for the more complex mines. This is because ore bodies vary significantly in shape and size and are more haphazard than often illustrated in simple examples. Management may identify components in a number of different ways. These could include identifying discrete components in the mine plan, such as phases, sections, push backs, cutbacks, lay backs, blocks, etc.; examining annual production plans; or examining push back campaigns. Whatever approach is adopted, it is essential that the components are recognisable to those who are responsible for mine planning as they will be the ones who will need to track progress as ore is removed and will need to update the assessment of components should the mine plan change. Given this, practice has revealed that when identifying the components of an ore body, it is essential that input is obtained from those who best understand the mine plan, i.e., the mining engineers and operational personnel.

The identification of components will need to be reassessed and updated (if necessary) whenever there are material changes to the mine plan. Given this, an entity will need to establish systems, processes, procedures and controls to ensure it is able to identify when material changes to the mine plan have occurred that would require the IFRIC 20 calculations to be updated. Identification of components will also be required when an entity commences production on a new component of the ore body or in relation to a new ore body.

15.5.5 Subsequent measurement

After initial recognition, the stripping activity asset must be carried at its cost or revalued amount less depreciation or amortisation and less impairment losses, in the same way as the existing asset of which it is a part. *[IFRIC 20.14]*. The stripping activity asset is to be depreciated or amortised on a systematic basis, over the expected useful life of the identified component of the ore body that becomes more accessible as a result of the stripping activity. *[IFRIC 20.15]*.

The units of production method is effectively required to be applied unless another method is more appropriate. *[IFRIC 20.15]*. The expected useful life of the identified component that is used to depreciate or amortise the stripping activity asset will generally differ from the expected useful life that is used to depreciate or amortise the mine itself and the related life-of-mine assets, unless the stripping activity provides improved access to the whole of the ore body (this is expected to be rare). *[IFRIC 20.16]*.

Consistent with the units of production method used for other mining assets, the calculation of the units of production rate will be completed when a stripping activity asset is first recognised. It will then need to be reviewed (and if necessary, updated) at the end of each reporting period, or when the mine plan changes. The new units of production rate will be applied prospectively.

Given the depreciation or amortisation of the stripping activity asset represents the consumption of the benefits associated with the stripping activity asset, and those benefits are realised by the extraction of the ore to which the stripping activity asset relates (i.e., the ore for which access was improved by the removal of this waste in prior periods), this depreciation or amortisation effectively represents part of the cost of extracting that ore in future periods. In accordance with IAS 2, such costs must be included in the cost of that subsequent ore. This effectively means that the depreciation or amortisation of the stripping activity asset is required to be recapitalised as part of the cost of the inventory produced in those subsequent periods. Once the inventory is sold, those costs will be recognised in profit or loss as part of cost of goods sold.

15.5.6 Disclosures

IFRIC 20 has no specific disclosure requirements. However, the general disclosure requirements of IAS 1 are relevant, e.g., the requirements to disclose significant accounting policies, *[IAS 1.117]*, and significant judgements, estimates and assumptions. *[IAS 1.125]*. For many entities, it is likely that the accounting policy for stripping costs would be considered a significant accounting policy which would therefore warrant disclosure, as would the judgements, estimates and assumptions they make when applying this policy.

Practical example 15-2 below from Rio Tinto plc illustrates an IFRIC 20 accounting policy disclosure.

Practical example 15-2: Rio Tinto plc (2022) **United Kingdom**

Annual Report 2022 [extract]
2022 Financial statements [extract]
Notes to the 2022 financial statements [extract]
Our operating assets [extract]
13 Property, plant and equipment [extract]

Deferred stripping

In open pit mining operations, overburden and other waste materials must be removed to access ore from which minerals can be extracted economically. The process of removing overburden and waste materials is referred to as stripping. During the development of a mine (or, in some instances, pit; see below), before production commences, stripping costs related to a component of an orebody are capitalised as part of the cost of construction of the mine (or pit). These are then amortised over the life of the mine (or pit) on a units of production basis.

Where a mine operates several open pits that are regarded as separate operations for the purpose of mine planning, initial stripping costs are accounted for separately by reference to the ore from each separate pit. If, however, the pits are highly integrated for the purpose of mine planning, the second and subsequent pits are regarded as extensions of the first pit in accounting for stripping costs. In such cases, the initial stripping (such as overburden and other waste removal) of the second and subsequent pits is considered to be production phase stripping (see below).

Key judgment – Deferral of stripping costs

We apply judgment as to whether multiple pits at a mine are considered separate or integrated operations. This determines whether the stripping activities of a pit are classified as pre-production or production phase stripping and, therefore, the amortisation base for those costs. The analysis depends on each mine's specific circumstances and requires judgment: another mining company could make a different judgment even when the fact pattern appears to be similar.

The following factors would point towards the initial stripping costs for the individual pits being accounted for separately:

- If mining of the second and subsequent pits is conducted consecutively following that of the first pit, rather than concurrently;
- If separate investment decisions are made to develop each pit, rather than a single investment decision being made at the outset;
- If the pits are operated as separate units in terms of mine planning and the sequencing of overburden removal and ore mining, rather than as an integrated unit;
- If expenditures for additional infrastructure to support the second and subsequent pits are relatively large; and
- If the pits extract ore from separate and distinct orebodies, rather than from a single orebody.

If the designs of the second and subsequent pits are significantly influenced by opportunities to optimise output from several pits combined, including the co-treatment or blending of the output from the pits, then this would point to treatment as an integrated operation for the purposes of accounting for initial stripping costs. The relative importance of each of the above factors is considered in each case.

In order for production phase stripping costs to qualify for capitalisation as a stripping activity asset, three criteria must be met:

- It must be probable that there will be an economic benefit in a future accounting period because the stripping activity has improved access to the orebody;
- It must be possible to identify the "component" of the orebody for which access has been improved; and
- It must be possible to reliably measure the costs that relate to the stripping activity.

A "component" is a specific section of the orebody that is made more accessible by the stripping activity. It will typically be a subset of the larger orebody that is distinguished by a separate useful economic life (for example, a pushback).

Recognition and measurement

Phase	Development Phase	Production Phase	
Stripping activity	Overburden and other waste removal during the development of a mine before production commences.	Production phase stripping can give access to two benefits: the extraction of ore in the current period and improved access to ore which will be extracted in future periods.	
Period of benefit	After commissioning of the mine.	Future periods after first phase is complete.	Current and future benefit are indistinguishable.
Capitalised to mining properties and leases in property, plant and equipment	During the development of a mine, stripping costs relating to a component of an orebody are capitalised as part of the cost of construction of the mine.	It may be the case that subsequent phases of stripping will access additional ore and that these subsequent phases are only possible after the first phase has taken place. Where applicable, the Group considers this on a mine-by-mine basis. Generally, the only ore attributed to the stripping activity asset for the purposes of calculating the life-of-component ratio is the ore to be extracted from the originally identified component.	Stripping costs for the component are deferred to the extent that the current period ratio exceeds the life-of-component ratio.
Allocation to inventory	Not applicable	Not applicable	The stripping cost is allocated to inventory based on a relevant production measure using a life-of-component strip ratio. The ratio divides the tonnage of waste mined for the component for the period either by the quantity of ore mined for the component or by the quantity of minerals contained in the ore mined for the component. In some operations, the quantity of ore is a more appropriate basis for allocating costs, particularly when there are significant by-products.
Component	A "component" is a specific section of the orebody that is made more accessible by the stripping activity. It will typically be a subset of the larger orebody that is distinguished by a separate useful economic life (for example, a pushback).		
Life-of-component ratio	The life-of-component ratios are based on the ore reserves of the mine (and for some mines, other mineral resources) and the annual mine plan; they are a function of the mine design and, therefore, changes to that design will generally result in changes to the ratios. Changes in other technical or economic parameters that impact the ore reserves (and for some mines, other mineral resources) may also have an impact on the life-of-component ratios even if they do not affect the mine design. Changes to the ratios are accounted for prospectively.		
Depreciation basis	Depreciated on a "units of production" basis based on expected production of either ore or minerals contained in the ore over the life of the component unless another method is more appropriate.		

...

13 Property, plant and equipment [extract]

Property, plant and equipment - Owned [extract]

(a) At 31 December 2022, the net book value of capitalised production phase stripping costs totalled US$2,497 million, with US$2,038 million within "Property, plant and equipment" and a further US$460 million within "Investments in equity accounted units" (2021: total of US$2,432 million, with US$2,017 million in "Property, plant and equipment" and a further US$415 million within "Investments in equity accounted units"). During the year, capitalisation of US$411 million was partly offset by depreciation of US$331 million (including amounts recorded within equity accounted units). Depreciation of deferred stripping costs in respect of subsidiaries of US$246 million (2021: US$201 million; 2020: US$145 million) is included within "Depreciation for the year".

...

16 Depreciation, depletion and amortisation (DD&A)

16.1 Requirements under IAS 16 and IAS 38

The main types of depreciable assets of mining entities and oil and gas entities are property, plant and equipment, intangible assets and mineral reserves, although the exact titles given to these types of assets may vary.

While "…mineral rights and expenditure on the exploration for, or development and extraction of, minerals, oil, natural gas and similar non-regenerative resources" are outside the scope of IAS 16 and IAS 38, any items of property, plant and equipment (PP&E) and other intangible assets that are used in the extraction of mineral reserves should be accounted for under IAS 16 and IAS 38. *[IAS 16.2, IAS 16.3, IAS 38.2]*.

For items of PP&E, various descriptions are used for such assets which can include producing mines, mine assets, oil and gas assets and producing properties. Whatever the description given, IAS 16 requires depreciation of an item of PP&E over its useful life. Depreciation is required to be calculated separately for each part (often referred to as a 'component'), of an item of PP&E with a cost that is significant in relation to the total cost of the item, unless the item can be grouped with other items of PP&E that have the same useful life and depreciation method. *[IAS 16.43, IAS 16.45]*.

How we see it

The guidance in IAS 16 relating to parts of an asset does not apply directly to intangible assets as IAS 38 does not apply a 'parts' approach, nor does it apply to mineral rights. Given this, entities are encouraged to use the general principles for determining an appropriate unit of account that are outlined in section 4 above.

IAS 16's general requirements are described in Chapter 19 and IAS 38 is addressed in Chapter 18.

16.1.1 Mineral reserves

In the absence of a standard or an interpretation specifically applicable to mineral reserves and their related expenditures, which are technically outside the scope of IAS 16 and IAS 38, management needs to develop an accounting policy for the depreciation or amortisation of mineral reserves. These need to be developed in accordance with the hierarchy in IAS 8, taking into account the requirements and guidance in Standards and Interpretations dealing with similar and related issues and the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the *Conceptual Framework*. *[IAS 8.11]*. In practice, an entity will generally develop an accounting policy that is based on the depreciation and amortisation principles in IAS 16 and IAS 38, which deal with similar and related issues.

16.1.2 Assets depreciated using the straight-line method

The straight-line method of depreciation is generally preferred in accounting for the depreciation of property, plant and equipment. The main practical advantages of the straight-line method are considered to be its simplicity and the fact that its results are often not materially different from the units of production method if annual production is relatively constant.[124] In general, the straight-line method is considered to be preferable for:

- Assets whose loss in value is more closely linked to the passage of time than to the quantities of minerals produced (e.g., front-end loaders that are used in stripping overburden and production of minerals)
- Assets that are unrelated to production and that are separable from the field or mine (e.g., office buildings)
- Assets with a useful life that is either much longer (e.g., offshore platforms) or much shorter (e.g., drill jumbos) than that of the field or mine in which they are used
- Assets used in fields or mines whose annual production is relatively constant. However, if assets are used in fields or mines that are expected to suffer extended outages, due to weather conditions or periodic repairs and maintenance, then the straight-line method may be less appropriate
- Assets that are used in more than one field or mine (e.g., service trucks)

124 IASC Issues Paper, 7.13.

If the production of a field or mine drops significantly towards the end of its productive life, then the straight-line method may result in a relatively high depreciation charge per unit of production in these latter years. In those cases, an entity may need to perform an impairment test on the assets involved.

Practical example 16-1 below indicates the assets to which BHP Group Limited applies the straight-line method.

Practical example 16-1: BHP Group Limited (2022) **Australia**

Annual Report 2022 [extract]

1.6 Notes to the Financial Statements [extract]

Resource assets [extract]

11 Property, plant and equipment [extract]

Recognition and measurement [extract]

Depreciation

Depreciation of assets, other than land, assets under construction and capitalised exploration and evaluation that are not depreciated, is calculated using either the straight-line (SL) method or units of production (UoP) method, net of residual values, over the estimated useful lives of specific assets. The depreciation method and rates applied to specific assets reflect the pattern in which the asset's benefits are expected to be used by the Group. The Group's proved reserves for petroleum assets and proved and probable reserves for minerals assets are used to determine UoP depreciation unless doing so results in depreciation charges that do not reflect the asset's useful life. Where this occurs, alternative approaches to determining reserves are applied, such as using management's expectations of future oil and gas prices rather than yearly average prices, to provide a phasing of periodic depreciation charges that better reflects the asset's expected useful life.

Where assets are dedicated to a mine or petroleum lease, the useful lives below are subject to the lesser of the asset category's useful life and the life of the mine or petroleum lease, unless those assets are readily transferable to another productive mine or lease.

Assets classified as held for sale are measured at the lower of their carrying amount and fair value less cost to sell and therefore not depreciated. BMC and Petroleum were classified as held for sale since November 2021 and December 2021 respectively.

Key estimates

The determination of useful lives, residual values and depreciation methods involves estimates and assumptions and is reviewed annually. Any changes to useful lives or any other estimates or assumptions, including the expected impact of climate change and the transition to a lower carbon economy, may affect prospective depreciation rates and asset carrying values. The table below summarises the principal depreciation methods and rates applied to major asset categories by the Group.

Category	Buildings	Plant and equipment	Mineral rights and petroleum interests	Capitalised exploration, evaluation and development expenditure
Typical depreciation methodology	SL	SL	UoP	UoP
Depreciation rate	25-50 years	3-30 years	Based on the rate of depletion of reserves	Based on the rate of depletion of reserves

16.1.3 Assets depreciated using the units of production method

When it comes to assets relating to mineral reserves, the units of production method is the most common method applied. "The underlying principle of the units of production method is that capitalised costs associated with a cost centre are incurred to find and develop the commercially producible reserves in that cost centre, so that each unit produced from the centre is assigned an equal amount of cost."[125] The units of production method thereby effectively allocates an equal amount of depreciation to each unit produced, rather than an equal amount to each year as under the straight-line method.

When the level of production varies considerably over the life of a project (e.g., the production of oil fields is much higher in the periods just after the start of production than in the final periods of production), depreciation based on a units of production method will produce a more equal cost per unit from year to year than straight-line methods. Under the straight-line method, the depreciation charge per unit in the early years of production could be much less than the depreciation per unit in later years. "That factor, coupled with the fact that typically production costs per unit increase in later years, means that the profitability of operations would be distorted if the straight-line method is used, showing larger profits in early years and lower profits in later years of the mineral resource's life. The higher cost per unit in later years is, in part, due to fewer units being produced while many production costs remain fixed and, in part, a result of many variable costs per unit increasing over time because reserves may be harder to extract, there may be greater equipment repairs, and similar other factors."[126] Nevertheless, even under the units of production method, profitability often drops significantly towards the end of the productive life of a field or mine. When this happens, an entity will need to carry out an impairment test and may need to recognise an impairment charge (see section 11 above).

125 IASC Issues Paper, 7.19.

126 IASC Issues Paper, 7.20.

In general, the units of production method is considered to be preferable for:

- Assets used in fields or mines whose annual production may vary considerably over their useful economic life
- Assets whose loss in value is more closely linked to the quantities of minerals produced than to the passage of time (e.g., draglines used in the extraction of mineral ore)
- Assets that are used in production or that are inseparable from the field or mine (e.g., wells and well heads)
- Assets with a useful life that is the same as that of the field or mine in which they are used
- Assets that are used in only one field or mine (e.g., overland conveyor belts)

Practical example 16-1 above indicates the classes of asset to which BHP apply the units of production method.

The practical application of the units of production method gives rise to the following issues that require entities to exercise a considerable degree of judgement in determining the:

(a) Units of production formula (see section 16.1.3.A below)

(b) Reserves base (see section 16.1.3.B below)

(c) Unit of measure (see section 16.1.3.C below)

(d) Joint and by-products (see section 16.1.3.D below)

As discussed in section 16.1.3.B below, the asset base that is subject to depreciation is required to be consistent with the reserves base that is used, which may require an entity to exclude certain costs from (or include future investments in) the depreciation pool.

16.1.3.A Units of production formula

There are a number of different ways in which an entity could calculate a depreciation charge under the units of production method. The most obvious of these is probably the following formula:

$$\text{Depreciation charge for the period} = \text{Current period's production} \times \frac{\text{Cost of the asset at the beginning of the period} - \text{Cumulative depreciation and impairment at the beginning of the period}}{\text{Opening reserves estimated at the beginning of the period}}$$

The reserves estimate used in the above formula is the best estimate of the reserves at the beginning of the period, but by the end of the period a revised and more accurate estimate is often available. Therefore, it could be considered that in order to take into account the most recent information, the opening reserves could be calculated by adding the 'closing reserves estimated at the end of the period' to the 'current period's production'. However, reserves estimates might change for a number of reasons:

(a) More detailed knowledge about existing reserves (e.g., detailed engineering studies or drilling of additional wells which occurred after the commencement of the period)

(b) New events that affect the physical quantity of reserves (e.g., major fire in a mine)

(c) Changes in economic assumptions (e.g., higher commodity prices)

It is generally not appropriate to take account of these events retrospectively. For example, changes in reserves estimates that result from events that took place after the end of the reporting period (such as those under (b) and (c)) are non-adjusting events that should be accounted for prospectively in accordance with IFRS accounting standards. *[IAS 8.36, IAS 10.3]*. Changes in reserves estimates that result from new information or new developments which do not offer greater clarity concerning the conditions that existed at the end of the reporting period (such as those under (a)) are not considered to be corrections of errors; instead, they are changes in accounting estimates that should be accounted for prospectively under IFRS accounting standards. *[IAS 8.5, IAS 8.36]*.

Determining whether actual changes in reserves estimates is required to be treated as adjusting or non-adjusting events will depend upon the specific facts and circumstances and may require significant judgement.

Usually, an entity will continue to invest during the year in assets in the depreciation pool (see section 16.1.3.B below for a discussion of 'depreciation pools') that are used to extract minerals. This raises the question as to whether or not assets that were used for only part of the production during the period should be depreciated on a different basis. Under the straight-line method, an entity will generally calculate the depreciation of asset additions during the period based on the assumption that they were added (1) at the beginning of the period, (2) in the middle of the period or (3) at the end of the period.

While method (2) is often the best approximation, methods (1) and (3) are generally not materially different when the accounting period is rather short (e.g., monthly or quarterly reporting) or when the level of asset additions is relatively low compared to the asset base.

The above considerations explain why the units of production formula that is commonly used in the extractive industries is slightly more complicated than the formula given above:

$$\text{Depreciation charge for the period} = \text{Current period's production} \times \frac{\text{Cost of the asset at the end of the period} - \text{Cumulative depreciation and impairment at the beginning of the period}}{\text{Reserves estimated at the end of the period} + \text{Current period's production}}$$

This units of production formula is widely used in the oil and gas sector by entities that apply US GAAP or did apply the former OIAC SORP. In the mining sector, however, both the first and the second units of production formulae are used in practice. To reiterate, when using the second formula, consideration is required as to whether actual changes in reserves estimates are required to be treated as adjusting or non-adjusting events.

16.1.3.B Reserves base

An important decision in applying the units of production method is selecting the reserves base that will be used. The following reserves bases could in theory be used:

(a) Proved developed reserves (see (a) below)

(b) Proved developed and undeveloped reserves (see (b) below)

(c) Proved and probable reserves (see (c) below)

(d) Proved and probable reserves and a portion of resources expected to be converted into reserves (see (d) below)

(e) Proved, probable and possible reserves

The term 'possible reserves', which is used in the oil and gas sector, is associated with a probability of only 10% (see section 2.2.1 above). Therefore, it is generally not considered acceptable to include possible reserves within the reserves base in applying the units of production method.

It is important that whatever reserves base is chosen the costs applicable to that category of reserves are included in the depreciable amount to achieve a proper matching of costs and production.[127] For example, "if the cost centre is not fully developed … there may be costs that do not apply, in total or in part, to proved developed reserves, which may create difficulties in matching costs and reserves. In addition, some reserve categories will require future costs to bring them to the point where production may begin".[128]

IFRS accounting standards does not provide any guidance on the selection of an appropriate reserves base or cost centre (i.e., unit of account) for the application of the units of production method. The relative merits for the use of each of the reserves bases listed under (a) to (c) above are discussed in detail below.

(a) Proved developed reserves

Under some national GAAPs that have accounting standards for the extractive industries, an entity is required to use proved developed reserves as its reserves base for the depreciation of certain types of assets. An entity would therefore calculate its depreciation charge on the basis of actual costs that have been incurred to date. However, the cost centre frequently includes capitalised costs that relate to undeveloped reserves. To calculate the depreciation charge correctly, it will be necessary to exclude a portion of the capitalised costs from the depreciation calculation. Illustration 16-1 below, which is taken from the IASC Issues Paper, illustrates how this might work.

127 IASC Issues Paper, 7.36.

128 IASC Issues Paper, 7.39.

Illustration 16-1: Exclusion of capitalised costs relating to undeveloped reserves[129]

In an offshore oil and gas field, a platform may be constructed from which 20 development wells will be drilled. The platform's cost has been capitalised as a part of the total cost of the cost centre. If only 5 of the 20 wells have been drilled, it would be inappropriate to depreciate that portion of platform costs, as well as that portion of all other capitalised costs, that are deemed to be applicable to the 15 wells not yet drilled. Only 5/20ths of the platform costs would be subject to depreciation in the current year, while 15/20ths of the platform costs (those applicable to the 15 undrilled wells) would be withheld from the depreciable amount. The costs withheld would be transferred to the depreciable amount as the additional wells are drilled. In lieu of basing the exclusion from depreciation on the number of wells, the exclusion (and subsequent transfer to depreciable amount) could be based on the quantity of reserves developed by individual wells compared with the estimated total quantity of reserves to be developed.

Similarly, an appropriate portion of prospecting costs, mineral acquisition costs, exploration costs, appraisal costs, and future dismantlement, removal, and restoration costs that have been capitalised is required to be withheld from the depreciation calculation if proved developed reserves are used as the reserves base and if there are undeveloped reserves in the cost pool.[130]

By withholding some of the costs from the depreciation pool, an entity is able to achieve a better matching of the costs incurred with the benefits of production. This is particularly important in respect of pre-development costs, which provide future economic benefits in relation to reserves that are not yet classified as 'proved developed'.

However, excluding costs from the depreciation pool may not be appropriate if it is not possible to determine reliably the portion of costs to be excluded or if the reserves that are not 'proved developed' are highly uncertain. It may not be necessary to exclude any costs at all from the depreciation pool if those costs are immaterial, which is sometimes the case in mining operations.

As illustrated in Practical example 16-2, Shell plc, in reporting under IFRS accounting standards, applies the units of production method based on proved developed reserves.

Practical example 16-2: Shell plc (2022) **United Kingdom**

Annual Report and Accounts 2022 [extract]

Consolidated Financial Statements [extract]

Notes to the Consolidated Financial Statements [extract]

2. Significant accounting policies, judgements and estimates [extract]

Property, plant and equipment and intangible assets other than goodwill [extract]

Depreciation, depletion and amortisation

Property, plant and equipment related to hydrocarbon production activities are in principle depreciated on a unit-of-production basis over the proved developed reserves of the field concerned, other than assets whose useful lives differ from the lifetime of the field which are depreciated applying the straight-line method. However, for certain Integrated Gas and Upstream assets, the use for this purpose of proved developed reserves, which are determined using the Securities and Exchange Commission (SEC) mandated yearly average oil and gas prices, would result in depreciation charges for these assets which do not reflect the pattern in which their future economic benefits are expected to be consumed as, for example, it may result in assets with long-term expected lives having accelerated or being fully depreciated within one year. Therefore, in these instances, other approaches are applied to determine a reserves base for the purpose of calculating depreciation, such as using management's expectations of future oil and gas prices rather than yearly average prices and using total proved reserves to provide a phasing of periodic depreciation charges that more appropriately reflects the expected utilisation of the assets concerned. (See Note 12)

Rights and concessions in respect of proved properties are depleted on the unit-of-production basis over the total proved reserves of the relevant area. Where individually insignificant, unproved properties may be grouped and depreciated based on factors such as the average concession term and past experience of recognising proved reserves.

...

(b) Proved developed and undeveloped reserves

Another approach that is common under IFRS accounting standards is to use 'proved developed and undeveloped reserves' as the reserves base for the application of the units of production method. This approach reflects the fact that it is often difficult to allocate costs that have already been incurred between developed and undeveloped reserves and has the advantage that it effectively straight-lines the depreciation charge per unit of production across the different phases of a project. For example, if the depreciation cost in phase 1 of the development is CU24/barrel and the depreciation cost in phase 2 of the development could be CU18/barrel, an entity that uses proved developed and undeveloped reserves as its reserves base might recognise depreciation of, say, CU22/barrel during phase 1 and phase 2.

129 IASC Issues Paper, 7.41.

130 IASC Issues Paper, 7.42.

Application of this approach is complicated by the fact that phase 1 of the project will start production before phase 2 is completed. To apply the units of production method on the basis of proved developed and undeveloped reserves, the entity would need to forecast the remaining investment related to phase 2. The approach does not appear unreasonable at first sight, given that the proved reserves are reasonably certain to exist and "...the costs of developing the proved undeveloped reserves will be incurred in the near future in most situations, the total depreciable costs can also be estimated with a high degree of reliability".[131] Nevertheless, the entity would therefore define its cost pool (i.e., unit of account) as including both assets that it currently owns and certain future investments.

How we see it

Although there is no specific precedent within IFRS accounting standards for using such a widely defined unit of account, the approach above is not prohibited, and in practice it has gained a broad measure of acceptance within the extractive industries.

(c) Proved and probable reserves

The arguments in favour of using 'proved and probable reserves' as the reserves base in applying the units of production method are similar to those discussed at (b) above. The IASC Issues Paper summarised the arguments in favour of this approach as follows:

> "Proponents of [using "proved and probable reserves" as the reserve base] use the same arguments given for including proved undeveloped reserves and related future costs in calculating depreciation. They point out that in a cost centre in which development has only begun a large part of capitalised prospecting, mineral acquisition, exploration, and appraisal costs may apply to probable reserves. Often in this situation there are large quantities of probable reserves, lacking only relatively minor additional exploration and/or appraisal work to be reclassified as proved reserves. They argue that, in calculating depreciation, it would be possible to defer all costs relating to the probable reserves if either proved developed reserves only, or all proved reserves, were to be used as the quantity on which depreciation is based. They contend that using probable and proved reserves in the reserve base and including in the depreciable costs any additional costs anticipated to explore and develop those reserves provides more relevant and reliable information."[132]

The main drawbacks of this approach are that estimates of probable reserves are almost certainly different from actual reserves that will ultimately be developed and estimates of the costs to complete the development are likely to be incorrect because of the potentially long time scales involved.[133] Nevertheless, this approach has also found a considerable degree of acceptance under IFRS accounting standards among mining entities and oil and gas entities that were permitted to apply the approach under their national GAAP before (e.g., UK GAAP). Both Tullow Oil plc and Anglo American Platinum Limited apply this approach, as illustrated in Practical examples 16-3 and 16-4 respectively below.

Practical example 16-3: Tullow Oil plc (2022) — **United Kingdom**

2022 Annual Report and Accounts [extract]
Financial Statements [extract]
Accounting policies [extract]

(l) Commercial reserves

Commercial reserves are proven and probable oil and gas reserves, which are defined as the estimated quantities of crude oil, natural gas and natural gas liquids which geological, geophysical and engineering data demonstrate with a specified degree of certainty to be recoverable in future years from known reservoirs and which are considered commercially producible. There should be a 50% statistical probability that the actual quantity of recoverable reserves will be more than the amount estimated as proven and probable reserves and a 50% statistical probability that it will be less.

(m) Depletion and amortisation

All expenditure carried within each field is amortised from the commencement of production on a unit of production basis, which is the ratio of oil and gas production in the period to the estimated quantities of commercial reserves at the end of the period plus the production in the period, generally on a field-by-field basis or by a group of fields which are reliant on common infrastructure. Costs used in the unit of production calculation comprise the net book value of capitalised costs plus the estimated future field development costs required to recover the commercial reserves remaining. Changes in the estimates of commercial reserves or future field development costs are dealt with prospectively.

131 IASC Issues Paper, 7.46.

132 IASC Issues Paper, 7.49.

133 IASC Issues Paper, 7.50.

Practical example 16-4: Anglo American Platinum Limited (2022) **United Kingdom**

Annual Report 2022 [extract]
Financial statements and other financial information [extract]
Notes to the financial statements [extract]
Other items [extract]
39. Accounting policies [extract]
D. Capital base. [extract]
Property, plant and equipment [extract]

Depreciation of property, plant and equipment
Mining properties are depreciated to their residual values using the unit of production method based on Proved and Probable Ore Reserves and, in certain limited circumstances, other Mineral Resources included in the Life of Asset Plan. These other Mineral Resources are included in depreciation calculations where, taking into account historical rates of conversion to Ore Reserves, there is a high degree of confidence that they will be extracted in an economic manner. This is the case principally for diamond operations, where depreciation calculations are based on Diamond Reserves and Diamond Resources included in the Life of Asset Plan. This reflects the unique nature of diamond deposits where, due to the difficulty in estimating grade, Life of Asset Plans frequently include significant amounts of Inferred Resources.

...

(d) Proved and probable reserves and a portion of resources expected to be converted into reserves (mining entities only)

We observe in practice that some mining entities adopt a slightly different approach when depreciating some of their mining assets. They use proven and probable reserves and a portion of resources expected to be converted into reserves. Such an approach tends to be limited to mining entities where the type of mineral and the characteristics of the ore body indicate that there is a high degree of confidence that those resources will be converted into reserves. For example, this is very common for underground operations that only perform infill drilling just prior to production commencing. This is done so that capital is not spent too early before it is really needed.

Such resources can comprise measured, indicated and inferred resources, and even exploration potential. Determining which of those have a high degree of confidence of being extracted in an economic manner will require judgement. Such an assessment will take into account the specific mineralisation and the 'reserves to resource' conversion that has previously been achieved for a mine.

Such an approach is generally justified on the basis that it helps to ensure the depreciation charges reflect management's best estimate of the useful life of the assets and provides greater accuracy in the calculation of the consumption of future economic benefits.

Anglo American applies this approach, as illustrated in Practical example 16-4 above, as does Rio Tinto plc, as illustrated in Practical example 16-5 below.

Practical example 16-5: Rio Tinto plc (2022) **United Kingdom**

Annual Report 2022 [extract]
2022 Financial statements [extract]
Notes to the 2022 financial statements [extract]
Our operating assets [extract]
13 Property, plant and equipment [extract]

Units of production basis

For mining properties and leases and certain mining equipment, consumption of the economic benefits of the asset is linked to production. Except as noted below, these assets are depreciated on the units of production basis.

In applying the units of production method, depreciation is normally calculated based on production in the period as a percentage of total expected production in current and future periods based on ore reserves and, for some mines, other mineral resources. Other mineral resources may be included in the calculations of total expected production in limited circumstances where there are very large areas of contiguous mineralisation, for which the economic viability is not sensitive to likely variations in grade, as may be the case for certain iron ore, bauxite and industrial mineral deposits, and where there is a high degree of confidence that the other mineral resources can be extracted economically. This would be the case when the other mineral resources do not yet have the status of ore reserves merely because the necessary detailed evaluation work has not yet been performed and the responsible technical personnel agree that inclusion of a proportion of measured and indicated resources in the calculation of total expected production is appropriate based on historical reserve conversion rates.

The required level of confidence is unlikely to exist for minerals that are typically found in low-grade ore (as compared with the above), such as copper or gold. In these cases, specific areas of mineralisation have to be evaluated in detail before their economic status can be predicted with confidence.

Sometimes the calculation of depreciation for infrastructure assets, primarily rail and port, considers measured and indicated resources. This is because the asset can benefit current and future mines. The measured and indicated resource may relate to mines which are currently in production or to mines where there is a high degree of confidence that they will be brought into production in the future. The quantum of mineral resources is determined taking into account future capital costs as required by the JORC code. The depreciation calculation, however, applies to current mines only and does not take into account future development costs for mines which are not yet in production. Measured and indicated resources are currently incorporated into depreciation calculations in the Group's Australian iron ore business.

An entity preparing its financial statements under IFRS accounting standards will need to choose between using 'proved developed reserves', 'proved developed and undeveloped reserves', 'proved and probable reserves' and, for mining entities in relation to certain mines, 'proved and probable reserves and a portion of resources expected to be converted into reserves' as its reserves base. Each of these approaches is currently acceptable under IFRS accounting standards. Preparers of financial statements should, however, be aware of the difficulties that exist in ensuring that the reserves base and the costs that are being depreciated correspond. Users of financial statements need to understand that comparability between entities reporting under IFRS accounting standards may sometimes be limited and need to be aware of the impact that each of the approaches has on the depreciation charge that is reported. Given this, detailed disclosures are essential.

16.1.3.C Unit of measure

Under the units of production method, an entity assigns an equal amount of cost to each unit produced. Determining the appropriate unit by which to measure production requires a significant amount of judgement. An entity could measure the units of production by reference to physical units or, when different minerals are produced in a common process, cost could be allocated between the different minerals on the basis of their relative sales prices.

(a) Physical units of production method

If an entity uses the physical units of production method, each physical unit of reserves (such as barrels, tonnes, ounces, gallons, and cubic metres) produced is assigned a *pro rata* portion of undepreciated costs less residual value.

Illustration 16-2: Physical units of production method[134]

If an entity produces 100 units during the current period and the estimated remaining commercial reserves at the end of the period are 1,900 units, the units available would be 2,000. The fractional part of the depreciable basis to be charged to depreciation expense would be 100/2,000. Therefore, if the depreciable basis was 5,000 monetary units, the depreciation for the period would be 250 monetary units.

134 IASC Issues Paper, 7.23.

In applying the physical units of production method, a mining company needs to decide whether to use either 1) the quantity of ore produced; or 2) the quantity of mineral contained in the ore as the unit of measure.[135] Similarly, an oil and gas company needs to decide whether to use either 1) the volume of hydrocarbons; or 2) the volume of hydrocarbons plus gas, water and other materials. When mining different grades of ore, a mining company's gross margin on the subsequent sale of minerals will fluctuate far less when it uses the quantity of minerals as its unit of measure. While a large part of the wear and tear of equipment used in mining is closely related to the quantity of ore produced, the economic benefits are more closely related to the quantity of mineral contained in the ore.

How we see it

Both of the approaches, mentioned above, are currently acceptable under IFRS accounting standards.

(b) Revenue-based units of production method

Another possible approach in applying the units of production method that may have been used by some entities previously is to measure the units produced based on the gross selling price of mineral.[136] However, this approach is no longer permitted. This is because as part of the 2011-2013 cycle of annual improvements the IASB approved an amendment to IAS 16 and IAS 38 to clarify that a revenue-based depreciation or amortisation method would not be appropriate.

16.1.3.D Joint and by-products

In the extractive industries, it is common for more than one product to be extracted from the same reserves (e.g., copper mines often produce gold and silver; lead and zinc are often found together; and many oil fields produce both oil and gas). When the ratio between the joint products or between the main product and the by-products is stable, this does not pose any complications. Also, if the value of the by-products is immaterial then it will often be acceptable to base the depreciation charge on the main product. In other cases, however, it will be necessary to define a unit of measure that takes into account all minerals produced. The IASC Issues Paper listed the following approaches in defining conversion factors used in computing depreciation when joint products are extracted:[137]

"(a) physical characteristics:

(i) based on volume: such as barrels, litres, gallons, thousand cubic feet or cubic metres;

(ii) based on weight: such as tonnes, pounds, and kilograms; or

(iii) based on energy content (British thermal units) of oil and gas;

(b) gross revenues for the period in relation to estimated total gross revenues of the current period and future periods (more commonly seen in the mining sector); and

(c) net revenues for the period in relation to total net revenues of the current and future periods."

Calculation of a conversion factor based on volume or weight has the benefit of being easy to apply and can lead to satisfactory results if the relative value of the products is fairly stable. For example, some mining entities that produce both gold and silver from the same mines express their production in millions of ounces of silver equivalent. This is calculated as the sum of the ounces of silver produced plus their ounces of gold produced multiplied by some ratio of the gold price divided by the silver price. For example, if the gold price was CU900 and the silver price was CU12, this would provide a ratio of 1/75 - so the quantity of gold would be multiplied by 75 to determine the equivalent ounces of silver. However, these ratios can change depending on the relationship between gold and silver.

Calculation of a conversion factor based on other physical characteristics is quite common in the oil and gas sector. Typically, production and reserves in oil fields are expressed in millions of barrels of oil equivalent (mmboe), which is calculated by dividing the quantity of gas expressed in thousands of cubic feet by 6 and adding that to the quantity of oil expressed in barrels. This conversion is based on the fact that one barrel of oil contains as much energy as 6,000 cubic feet of gas. While this approach is commonly used, it is important to recognise two limiting factors: the actual energy conversion factor will not always be 1:6 but may vary between 1:5½ to 1:6½ and the market price of gas per unit of energy (typically BTU) is often lower than that of oil because of government price controls and the need for expensive infrastructure to deliver gas to end users.

135 IASC Issues Paper, 7.24.

136 IASC Issues Paper, 7.25.

137 IASC Issues Paper, 7.61.

An approach that is commonly used (more so in the mining sector than the oil and gas sector) in calculating a conversion factor when joint products are extracted, is to base it on gross revenues. As discussed in section 16.1.3.C above, the main drawback of this method is that it requires an entity to forecast future commodity prices. Despite this drawback, there will be situations where no other viable alternative exists for calculating an appropriate conversion factor.

Finally, it is possible to calculate a conversion factor based on net revenue after deducting certain direct processing costs. An argument in favour of this method is that gross revenues do not necessarily measure the economic benefits from an asset. However, taken to an extreme this argument would lead down a path where no depreciation is charged in unprofitable years, which is clearly not an acceptable practice.

Accounting for the sale of joint products and by-products is addressed in section 14.2 above.

16.2 Block caving - depreciation, depletion and amortisation (mining)

Given the nature of mining operations, determining the appropriate unit of account has always been a matter requiring considerable judgement for mining entities. See section 4 above for further discussion.

Block cave mining is a mass mining method that allows for the bulk mining of large, relatively lower grade, ore bodies for which the grade is consistently distributed throughout. The word 'block' refers to the layout of the mine - which effectively divides the ore body into large sections, with areas that can be several thousand square metres in size. This approach adopts a mine design and process which involves the creation of an undercut by fracturing the rock section underneath the block through the use of blasting. This blasting destroys the rock's ability to support the block above. Caving of the rock mass then occurs under the natural forces of gravity (which can be in the order of millions of tonnes) when a sufficient amount of rock has been removed underneath the block. The broken ore is then removed from the base of the block. This mine activity occurs without the need for drilling and blasting, as the ore above continues to fall while the broken ore beneath is removed. Broken ore is removed from the area at the extraction level through the use of a grid of draw points. These effectively funnel the broken ore down to a particular point so that it can be collected and removed for further processing.

Block caving has been applied to large scale extraction of various metals and minerals, sometimes in thick beds of ore but more usually in steep to vertical masses. Examples of block caving operations include Northparkes (Australia), Palabora (South Africa), Codelco (Chile) and Freeport (Indonesia).[138]

Block cave mining does require substantial upfront development costs, as initial underground access followed by large excavations (undercutting), must be completed to gain access and initially 'undermine' the block that is to cave. In addition, large underground and above ground haulage and milling infrastructure must be constructed to extract and then process the ore that a successful cave will generate.

One of the key issues to be addressed is how these substantial upfront development costs, in addition to the ongoing development costs associated with each block (i.e., to extend the undercutting beneath each new block and construct the draw points for each block) should be treated for depreciation or amortisation.

Generally, these costs are depreciated or amortised on a units of production basis - therefore, in determining useful life, it is necessary to determine what the appropriate reserves base should be for each of these different types of costs. For example, in relation to the costs associated with initially going underground and constructing the main haulage tunnel which will be used to access and extract the reserves from the entire ore body, the useful life associated with such assets may be the reserves of the entire ore body.

In relation to the costs associated in constructing the milling infrastructure, it is possible that such assets may be used to process ore from multiple ore bodies. Therefore, the useful life of such assets may be the reserves of multiple ore bodies. However, this will depend upon the specific facts and circumstances of the particular development.

For those costs associated with each individual block, e.g., the undercutting costs directly attributable to each block and the costs associated in constructing the draw points for that block, the appropriate reserves base may potentially only be those to be extracted from that particular block, which may only be a component of the entire ore body.

The approach adopted by each entity will be determined by the specific facts and circumstances of each mine development, such as the nature of the block cave mining technique employed and how the associated assets will be used. Such an assessment will require entities to exercise considerable judgement. Appropriate disclosures are recommended where significant judgements and estimates are considered material.

138 Underground Block Caving: A Guide for Investors | INN (investingnews.com) (accessed 09/06/2015).

17 IFRS 16 *Leases*

IFRS 16 governs the accounting for leases. IFRS 16 requires lessees to recognise most leases on their balance sheet as lease liabilities together with corresponding right-of-use assets. However, lessees can make accounting policy elections to apply accounting similar to operating lease accounting under IAS 17 *Leases* to short-term leases and leases of low-value assets.

Lessees will apply a single model for most leases. The profit or loss impact will largely comprise interest (on the lease liability) and depreciation (of the right-of-use asset). There may also be other lease expenses which continue to be recognised as an operating expense, e.g., variable payments not based on an index or rate, short-term lease payments and lease payments relating to low-value assets.

Lessor accounting is substantially unchanged from the previous IAS 17 accounting. Lessors are required to classify their leases into two types: finance leases and operating leases. Lease classification determines how and when a lessor recognises lease revenue and what assets a lessor records.

While the requirements of the IFRS 16 model are discussed in detail in Chapter 24, some of the key aspects of IFRS 16 that are particularly relevant to mining entities and oil and gas entities include:

- Scope and exclusions (see section 17.1 below and Chapter 24 at section 2.2)
- Definition of a lease (see section 17.2 below and Chapter 24 at section 3)
- Leases of subsurface rights (see section 17.1.3 below and Chapter 24 at section 3.1.2)
- Substitution rights (see section 17.3 below and Chapter 24 at section 3.1.3)
- Identifying and separating lease and non-lease components and allocating contract consideration (see section 17.4 below and Chapter 24 at section 3.2)
- Identifying lease payments (see section 17.5 below and Chapter 24 at section 4.5)
- Allocating contract consideration (see section 17.6 below and Chapter 24 at section 3.2.3.B)
- Interaction of leases and asset retirement obligations (see section 17.7 below)
- Arrangements entered into by joint arrangements (see section 18 below)

17.1 Scope and scope exclusions

17.1.1 Mineral rights

Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources are excluded from the scope of IFRS 16, *[IFRS 16.3]*, (amongst other types of arrangements - see Chapter 24 at section 2.2 for the full list of scope exclusions).

IFRS 16 does not specify whether the scope exclusion for leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources applies broadly to other leases that relate to, or are part of, the process of exploring for, or using, those resources. For example, in some jurisdictions, the minerals are owned by the government, but the land within which the minerals are located is privately owned. In these jurisdictions, a mining and metals entity needs to enter into a mineral lease with the government as well as a surface lease (i.e., the right to use the land) with the private landowner. IFRS 16's Basis for Conclusions states that IFRS 6 specifies the accounting for rights to explore for, and evaluate, mineral resources. *[IFRS 16.BC68(a)]*.

The US GAAP leases standard (ASC 842 *Leases*), includes more specific guidance on how this scope exclusion should be applied. It states that leases of minerals, oil, natural gas and similar non-regenerative resources, including the intangible rights to explore for those resources and the rights to use the land in which those natural resources are contained (unless those rights of use include more than the right to explore for natural resources) are outside the scope of ASC 842. For example, in the event that there is also a corporate head office building on part of the land, an apportionment would be applied, and the scope exclusion would not apply to the portion of the land upon which the head office is built. However, equipment used to explore for the natural resources is within the scope of ASC 842.2.

IFRS 16 is not specific as to whether the scope exclusion only applies to mineral rights in the E&E phase or whether it also applies to other rights (e.g., exploitation and/or extraction rights that arise in connection with development and production phases). The wording of the exclusion specifies that it applies to 'leases to *explore for or use* minerals' (emphasis added), which suggests that it applies more broadly (i.e., to the E&E, development and production phases). However, the reference to IFRS 6 in the Basis for Conclusions of IFRS 16 *[IFRS 16.BC68(a)]* may infer that the exclusion is limited to rights in the E&E phase.

How we see it

Entities will need to apply judgement to determine how broadly to interpret and apply this scope exclusion relating to mineral rights under IFRS 16. Most mining entities and oil and gas entities generally apply the above scope exclusion to the mineral rights in the E&E, development and production phases. We would expect that given the wording in the main body of the standard, the scope exclusion would apply to mineral rights in all phases. We would also expect that consistent with ASC 842, in the event that rights extend to more than the right to explore for or use natural resources, the scope exclusion would not apply. We would not expect the scope exclusion to extend to equipment used to explore, develop or produce mineral rights.

17.1.2 Land easements or rights of way

Land easements or rights of way are rights to use, access or cross another entity's land for a specified purpose. For example, a land easement might be obtained for the right to construct and operate a pipeline or other assets (e.g., a railway line) over, under or through an existing area of land or body of water while allowing the landowner continued use of the land for other purposes (e.g., farming), as long as the landowner does not interfere with the rights conveyed in the land easement.

When determining whether a contract for a land easement or right of way is a lease, mining entities and oil and gas entities will need to assess whether there is an identified asset and whether the customer obtains substantially all of the economic benefits of the identified asset and has the right to direct the use of that asset(s) throughout the period of use.

This will require careful consideration of the rights and obligations in each arrangement and conclusions may vary given that the nature of these contracts can also vary by jurisdictions. The issue of accounting for land easements is discussed in Chapter 24 at section 3.1.2.

17.1.3 Subsurface rights

In June 2019, the IFRS IC discussed a contract for subsurface rights.[139] In the contract described, a pipeline operator obtains the right to place an oil pipeline in underground space for 20 years in exchange for consideration. The contract specifies the exact location and dimensions (path, width and depth) of the underground space within which the pipeline will be placed. The landowner retains the right to use the surface of the land above the pipeline, but it has no right to access or otherwise change the use of the specified underground space throughout the 20-year period of use. The customer has the right to perform inspection, repairs and maintenance work (including replacing damaged sections of the pipeline when necessary).

During the discussion, the IFRS IC noted the following:

- Paragraph 3 of IFRS 16 requires an entity to apply IFRS 16 to all leases, with limited exceptions. In the contract described in the request, none of the exceptions in IFRS 16.3 and IFRS 16.4 apply. In particular, the IFRS IC noted that the underground space is tangible. Accordingly, if the contract contains a lease, IFRS 16 applies to that lease. If the contract does not contain a lease, the entity would then consider which other IFRS accounting standard applies.
- Applying IFRS 16.B9, to meet the definition of a lease the customer must have both:
  - The right to obtain substantially all the economic benefits from use of an identified asset throughout the period of use.
  - The right to direct the use of the identified asset throughout the period of use.
- The specified underground space is physically distinct from the remainder of the land. The contract's specifications include the path, width and depth of the pipeline, thereby defining a physically distinct underground space. The space being underground does not in itself affect whether it is an identified asset - the specified underground space is physically distinct in the same way that a specified area of space on the land's surface would be physically distinct. As the landowner does not have the right to substitute the underground space throughout the period of use, the IFRS IC concluded that the specified underground space is an identified asset as described in IFRS 16.B13-B20.
- The customer has the right to obtain substantially all the economic benefits from use of the specified underground space throughout the 20-year period of use. The customer has exclusive use of the specified underground space throughout that period of use.

139 *IFRIC Update*, June 2019, available on the IFRS Foundation's website.

- The customer has the right to direct the use of the specified underground space throughout the 20-year period of use because the customer has the right to operate the asset throughout the period of use without the supplier having the right to change those operating instructions. How and for what purpose the specified underground space will be used (i.e., to locate the pipeline with specified dimensions through which oil will be transported) is predetermined in the contract. The customer has the right to operate the specified underground space by having the right to perform inspection, repairs and maintenance work. The customer makes all the decisions about the use of the specified underground space that can be made during the 20-year period of use.

Consequently, the IFRS IC concluded that the contract described in the request contains a lease as defined in IFRS 16. The customer would therefore apply IFRS 16 in accounting for that lease.

17.2 Definition of a lease

A lease is defined in IFRS 16 as: *[IFRS 16 Appendix A]*

Extract from IFRS 16

Appendix A
Defined terms

lease	A contract, or part of a contract, that conveys the right to use an asset (the **underlying asset**) for a period of time in exchange for consideration.

To be a lease, a contract must convey the right to control the use of an identified asset.

As discussed above, a wide variety of arrangements exist in the mining sector and oil and gas sector that may provide a right to control the use of an identified asset(s). Some examples include:

- Mining or oil field services contracts (e.g., equipment used to deliver a service, including drilling contracts)
- Shipping, freight and other transportation arrangements, including railway infrastructure and harbour loading services contracts
- Refining, processing and tolling arrangements
- Storage arrangements (including certain capacity portions of such arrangements)

Also, while not specific to the mining sector or oil and gas sector, there are many other arrangements commonly entered into by mining entities and oil and gas entities that will also need to be considered. Such arrangements include outsourcing arrangements, such as IT, and utility supply arrangements; such as those for the purchase of gas, electricity, water or telecommunications.

All of these arrangements will need to be assessed to determine whether they represent, or contain, a lease.

17.3 Substitution rights

IFRS 16 states that even if an asset is specified in an arrangement, a customer does not have the right to use an identified asset if, at inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use. *[IFRS 16.B14]*. A substitution right is substantive if the supplier has both the practical ability to substitute alternative assets throughout the period of use and the supplier would benefit economically from exercising its right to substitute the asset. *[IFRS 16.B14]*. If the customer cannot readily determine whether the supplier has a substantive substitution right, the customer presumes that any substitution right is not substantive. *[IFRS 16.B19]*.

Entities will need to carefully evaluate whether a supplier's substitution right is substantive based on facts and circumstances at inception of the contract. In many cases, it will be clear that the supplier will not benefit from the exercise of a substitution right because of the costs associated with substituting an asset. *[IFRS 16.BC113]*. For example, an asset is highly customised and/or significant costs have been incurred to ensure the asset meets the specifications required by the contract such that the supplier would not benefit economically from exercising its substitution right. In addition, the supplier's substitution rights may not be substantive if alternative assets are not readily available to the supplier or they could not be sourced by the supplier within a reasonable period of time and hence there is no practical ability to substitute them.

See Chapter 24 at section 3.1.3 for further discussion.

17.4 Identifying and separating lease and non-lease components

Many contracts may contain a lease(s) coupled with an agreement to purchase or sell other goods or services (non-lease components). Examples of contracts in the mining sector and oil and gas sector that could contain a lease and significant non-lease components for services provided by the supplier include but are not limited to:

- Transportation and storage contracts, which generally require the supplier to operate the facilities, and/or provide staff/crew
- Outsourced mining services contracts or oilfield services arrangements including closure arrangements
- Exploration drilling contracts, which typically include operation services

For these contracts, IFRS 16 requires an entity to account for each lease component within the contract as a lease separately from non-lease components of the contract, unless the entity applies the practical expedient to combine lease and associated non-lease components. *[IFRS 16.12]*. The non-lease components are identified and accounted for separately from the lease component(s), in accordance with other standards. For example, the non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to IFRS 15 by lessors (suppliers).

See Chapter 24 at section 3.2 for further information.

17.5 Identifying lease payments included in the measurement of the lease liability

Some lease agreements include payments that are described as variable or may appear to contain variability but are in-substance fixed payments because the contract terms require the payment of a fixed amount that is unavoidable. Such payments are lease payments included in the measurement of the lease liability and right-of-use assets at the commencement date.

For example, consideration paid for the use of equipment, such as drilling rigs, is typically expressed as a rate paid for each operating day, hour or fraction of an hour. The types of rates a lessee may be charged include:

- Full operating rate - a rate charged when the rig is operating at full capacity with a full crew (in which case there could be a non-lease component of crew services)
- Standby rate or cold-stack rate - a rate charged when the lessee unilaterally puts the rig on standby
- Major maintenance rate - a minimal rate, or in some cases a 'zero rate' charged when the lessor determines that maintenance needs to be performed and the rig is not available for use by the lessee
- Inclement weather rate - a minimal rate, or in some cases a 'zero rate' charged when weather makes it dangerous to operate the rig and, therefore, it is not available for use by the lessee

How we see it

There will likely be variability in the pricing of a drilling contract, however, typically there will be a minimum rate in these types of contracts. This amount would likely be the lowest rate that the lessee would pay while the asset is available for use by the lessee. Depending on the contract, this rate may be referred to using terms such as a standby or cold-stack rate. When identifying lease payments in an arrangement, mining entities and oil and gas entities would only consider rates that apply when the asset is available for use.

Illustration 17-1: Identifying lease payments - inclement weather

Upstream Entity A enters into a 3-year contract with Rig Owner for the right to use Drilling Rig 1 over a three-year period. The contract is considered to contain a lease. The contract specifies the rates a lessee may be charged and these include:

- Full operating rate of CU100,000 per day - charged when the rig is operating at full capacity with a full crew.
- Standby rate of CU40,000 per day - charged when the lessee unilaterally puts the rig on standby.

  And
- Inclement weather rate of zero CU per day - charged when weather makes it dangerous to operate the rig and, therefore, it is not available for use by the lessee.

Analysis

In calculating the lease liability, the standby rate of CU40,000 per day for 3 years would be used. The inclement weather rate is not applicable in calculating the minimum lease payments as the rate only applies when the asset is not available for use.

Illustration 17-2: Identifying lease payments - major maintenance

Mining entity Z enters into an arrangement with Equipment Supplier T for the lease of a piece of processing equipment to be utilised at the mine site. The contract requires payment of CU10,000 per day for the equipment, but stipulates Supplier T perform 10 days per annum of major maintenance that is required on the equipment. The day rate for those 10 major maintenance days is zero CU per day.

Analysis

In calculating the lease liability, the rate of CU10,000 per day would be used. However, the rate would only be applied for 355 days each year on the basis that the contractual arrangement clearly sets out that there are 10 days per annum where the equipment will not be available for use to allow for major maintenance to be undertaken and that a zero day rate will apply on those days. Accordingly, contractually, the minimum lease payments are in fact lower, as the equipment will only be available for 355 days per annum.

This differs from the zero day rate that applies for inclement weather in Illustration 17-1 above because the period of time when the inclement weather rate will apply, is outside of the control of both parties.

See Chapter 24 at section 4.5 for further discussion.

17.6 Allocating contract consideration

Lessees allocate the consideration in the contract to the lease and non-lease components on a relative stand-alone price basis. However, IFRS 16 provides a practical expedient that permits lessees to make an accounting policy election, by class of underlying asset, to account for each separate lease component of a contract and any associated non-lease components as a single lease component. Lessors are required to apply IFRS 15 to allocate the consideration in a contract between the lease and non-lease components, generally, on a relative stand-alone selling price basis. See Chapter 24 at section 3.2.3.B for further information.

17.7 Interaction of leases with asset retirement obligations

When undertaking remediation and rehabilitation activities, it may be possible that a mining company or oil and gas company enters into an arrangement with a supplier that is, or contains, a lease. The costs associated with these activities form a significant component of the costs which make up the asset retirement obligation (ARO) that was recognised by the mining company or oil and gas company at commencement of the mine or field.

Assuming this lease is not a short-term lease and does not relate to the lease of a low-value asset, a right-of-use asset and lease liability will need to be recognised. One of the issues to consider is whether the mining company or oil and gas company's recognition of the lease liability results in the derecognition of the ARO liability recognised on the balance sheet. Given that prior to the commencement of any ARO-related activities, the mining company or oil and gas company still has an obligation to rehabilitate under IAS 37, it cannot derecognise the ARO liability. Instead, it now has a separate lease liability for the financing of the lease of the asset. Accordingly, acquiring the right-of-use asset does not result in the derecognition of the ARO liability, rather, it would be the activity undertaken or output of the asset which would ultimately settle the ARO liability. This approach would be consistent with a scenario where an asset, e.g., the leased asset, had been purchased, using bank finance, and the finance liability relating to the bank debt used to purchase the asset, is separately recognised on the balance sheet.

As such, at the point prior to any ARO activity (assuming this occurs at end of mine/field life), the mining company or oil and gas company has:

- No ARO asset (fully amortised)
- An ARO liability for the full ARO estimate
- A right-of-use asset
- A lease liability

See Chapter 24 at sections 5.2 and 5.3 for discussion on measurement of the right-of-use asset and lease liability.

The impacts of this will include:

- Amortisation of the right-of-use asset across the period of use
- Interest expense on the lease liability
- Interest expense arising from the unwinding on the discount on the ARO liability, assuming interest continues to unwind over the remediation and rehabilitation activity period
- The use (reduction) of the ARO liability (as the leased asset is used to settle the obligation)

Consideration should be given to the requirements of IAS 37, *[IAS 37.61, IAS 37.62]*, which sets out that a provision shall be used only for expenditures for which the provision was originally recognised, i.e., that expenditures that relate to the original provision are set against it. See Chapter 27 at section 4.9.

18 Interaction of IFRS 16 and IFRS 11

In the mining and metals sector and oil and gas sector, it is common for a group of entities to collaboratively perform exploration, development and/or production activities using a joint operation ('JO').[140] In such circumstances, a single party will often be appointed to be responsible for undertaking the operations on behalf of parties to the JO (i.e., the lead operator). The arrangement is often governed by a joint operating agreement ('JOA'). There may also be other contractual arrangements that govern the relationship and activities between the non-operator parties and the lead operator, some arrangements may involve specific agreements such as rig sharing agreements, and these may be verbal or written.

These agreements generally provide the lead operator with a right to recover the costs it incurs on behalf of the non-operator parties, including costs related to leasing assets to be used in the JO. Some stakeholders may have previously considered that the right to recover costs pursuant to a separately negotiated JOA meant that the lead operator was only required to recognise a lease liability incurred as part of a contract with a third party supplier (lessor) in proportion to its interest in the JO.

One issue highlighted during the implementation of IFRS 16, was how a lead operator is required to recognise lease-related assets and liabilities when it is the sole signatory to a contract that is or contains a lease. This issue was taken to the IFRS IC in 2019 and they discussed a question relating to lease arrangements in a JO under IFRS 16. The question asked was how a lead operator recognises a lease liability. The question specifically focused on situations where the JO is not structured through a separate vehicle and the lead operator, as the sole signatory, enters into a lease contract with a third party supplier (lessor) for an item of property, plant and equipment that will be operated jointly as part of the JO's activities. The lead operator has the right to recover a share of the lease costs from the other joint operators in accordance with the contractual and other arrangements governing the JO.

The IFRS IC concluded that in accordance with IFRS 11, a joint operator identifies and recognises both:

(a) Liabilities it incurs in relation to its interest in the JO

(b) Its share of any liabilities incurred jointly with other parties to the joint arrangement.

It observed that identifying the liabilities a joint operator incurs and those incurred jointly requires an assessment of the terms and conditions of all contractual agreements that relate to the JO, including consideration of the laws pertaining to those agreements.[141] It also acknowledged contractual agreements relating to each JO are likely to differ.

The IFRS IC further observed, in accordance with IFRS 11, the liabilities a joint operator recognises include those for which it has primary responsibility.[142] Also, in the fact pattern as it was presented, the conclusion was that the JOA and related contractual arrangements did not extinguish or transfer the lead operator's primary responsibility for the lease liability.[143] Therefore, as sole signatory and where a lead operator has primary responsibility for a lease, the lead operator recognises 100% of the lease liability.

The IFRS IC concluded that the principles and requirements in IFRS accounting standards provide an adequate basis for the lead operator to identify and recognise its liabilities in relation to its interest in a JO and, consequently, the IFRS IC decided not to add this matter to its standard-setting agenda.[144]

Consequently, if the lead operator is the primary obligor in a lease arrangement, even when the underlying asset will be used to satisfy the activities of the JO, the lead operator must account for the lease by recognising the full lease liability measured in accordance with IFRS 16. In this circumstance, even though the lead operator has a right to recover costs from the non-operator parties, including their share of the lease obligation, it is not appropriate for the lead operator to only recognise its proportionate share of the lease liability by relying on the terms and conditions of the JOA or other arrangements with the non-operator parties to which the third party supplier is not a party. This is because the JOA and other arrangements are separately negotiated with the non-operators and do not extinguish the lead operator's obligation for the lease with the third party supplier.

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140 Appendix A of IFRS 11 defines a joint operation as a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets and obligations for the liabilities, relating to the arrangement.

141 IASB Staff Paper 9: Project: *Liabilities in relation to a joint operator's interest in a joint operation (IFRS 11)*, Paper topic: *Agenda decision to finalise, IFRS IC Meeting, March 2019*, para. 30(a). Available on the IFRS Foundation's website.

142 IASB Staff Paper 9: Project: *Liabilities in relation to a joint operator's interest in a joint operation (IFRS 11)*, Paper topic: *Agenda decision to finalise, IFRS IC Meeting, March 2019*, para. 30(b). Available on the IFRS Foundation's website.

143 IASB Staff Paper 9: Project: *Liabilities in relation to a joint operator's interest in a joint operation (IFRS 11)*, Paper topic: *Agenda decision to finalise, IFRS IC Meeting, March 2019*, para. 28. Available on the IFRS Foundation's website.

144 *IFRIC Update*, March 2019, available on the IFRS Foundation's website.

As a direct consequence of this decision, the immediate issue is then to determine who has primary responsibility for the arrangement with the third party supplier. Determining whether a lead operator, each joint operator party, or the JO itself, has primary responsibility for obligations such as a lease liability, could require a detailed evaluation of all relevant terms and conditions and facts and circumstances, including the legal environment in which the arrangement(s) operate (see section 18.1 below).

While the agenda decision addressed the accounting for lease liabilities in relation to a joint operator's interest in a JO, it did not address some of the related issues that often arise in these situations.

This section explores and discusses some of these related issues and the potential considerations for arrangements between lead operators and the other joint operators (referred to as non-operator parties) of a JO, particularly in relation to their respective rights and obligations. It explores a range of factors that may need to be considered when assessing how to account for these contractual arrangements, and acknowledges different conclusions could be reached for different joint arrangements and in different jurisdictions.

This section primarily considers situations where the lead operator has a lease with a third party supplier for which it has primary responsibility, and then specifically focuses on determining how the contractual arrangement(s) between the lead operator and the non-operator parties should be assessed and accounted for under IFRS accounting standards.[145] However, similar issues may arise where the lead operator owns the asset used on a JO.

There may also be some similar concerns, i.e., identification of a lease and other consequential impacts, where the lead operator and the non-operator parties (together, the parties to the JO) enter into an arrangement directly with a third party supplier. However, this is not the primary focus of this section.

Some of the potential follow-on issues to consider include, but may not be limited to:

- Who is the customer (see section 18.2 below)
- Whether the arrangement between the lead operator and the JO is, or contains, a sublease (see section 18.3 below)
- Depending on the conclusion reached in determining whether the arrangement between the lead operator and the JO contains a sublease (see section 18.3 below), determining the appropriate accounting by the lead operator (see section 18.4 below) and the non-operator parties (see section 18.5 below)

See Chapter 24 for a general discussion of the requirements of IFRS 16.

18.1 Determining who has primary responsibility

Determining whether a lead operator, each party to the JO or the JO itself, has primary responsibility for obligations, such as a lease liability, may require a careful evaluation of all relevant terms and conditions as well as facts and circumstances and the legal environment in which the arrangement(s) operate.

When assessing the fact pattern presented to the IFRS IC, the analysis in the March 2019 Agenda paper[146] specifically focused on the derecognition requirements of IFRS 9. The Agenda paper noted that an entity could only derecognise a liability when it was extinguished, i.e., when the entity discharges the liability or is legally released from primary responsibility for the liability either by process of laws or by the creditor.

It also referred to the considerations the IASB undertook when developing IFRS 16 and whether an intermediate lessor should be permitted to offset payments received under the sublease against the liability recognised on the head lease. The IASB decided not to permit this on the basis that each contract was negotiated separately, with the counterparty to the sublease being different to the counterparty to the head lease. As such, the obligations arising from the head lease were generally not extinguished by the terms and conditions of the sublease. This analysis indicated that the legal form of the arrangements is essential in determining who has primary responsibility. As noted above, the outcome may vary depending on the legal jurisdiction in which the arrangements operate.

Where it is established the lead operator has primary responsibility, the IFRS IC decision made it clear that the lead operator will initially recognise the entire lease liability and related right-of-use asset in accordance with IFRS 16.

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145 When considering the implications of these issues from a US GAAP perspective, while the IFRS and US GAAP lease standards are aligned with respect to the definition of a lease, there is no equivalent US standard to IFRS 11 when accounting for joint arrangements. Also, as noted above, contractual arrangements can and will differ between JO's and legal jurisdictions. Given this, it cannot be assumed the issues identified in this chapter and the analysis that would be required to determine the accounting under IFRS would be the same under US GAAP.

146 IASB Staff Paper 9: Project: *Liabilities in relation to a joint operator's interest in a joint operation (IFRS 11)*, Paper topic: *Agenda decision to finalise, IFRS IC Meeting, March 2019*, paras. 35-39. Available on the IFRS Foundation's website.

Before undertaking the lease assessment, set out in section 18.2 below, it is critical to first determine who the customer is. This is because a lease arises when a customer has a right to control the use of an identified asset for a period of time in exchange for consideration.

18.2 Identifying the customer when there is a JO

Once it has been established the lead operator has primary responsibility for the lease arrangement with the third party supplier, it is then necessary to assess the arrangement(s) between the lead operator and the JO. In undertaking this assessment, it is important to remember that where there is a joint arrangement, IFRS 16 makes it clear that for the purposes of identifying a lease, it is the JO that is the customer in the arrangement with the lead operator rather than each of the parties to the JO individually.[147]

However, the IFRS IC staff paper also noted IFRS 16.B11 was developed to apply only when assessing whether a contract contains a lease and in determining who is the 'customer' as per the requirements of IFRS 16. It has no further effect on the required accounting for the lease or the joint arrangement, or when assessing who is the customer for the purposes of other standards.[148] See section 18.4.2 below for further discussion of where the term customer is used in other standards.

18.3 Determining whether the contractual arrangement between the lead operator and the JO contains a sublease

When assessing the nature of the relationship between the lead operator and the JO and the potential consequential accounting outcomes, including whether there is a sublease, all relevant enforceable contracts, facts and circumstances and the relevant legal environment, need to be considered.

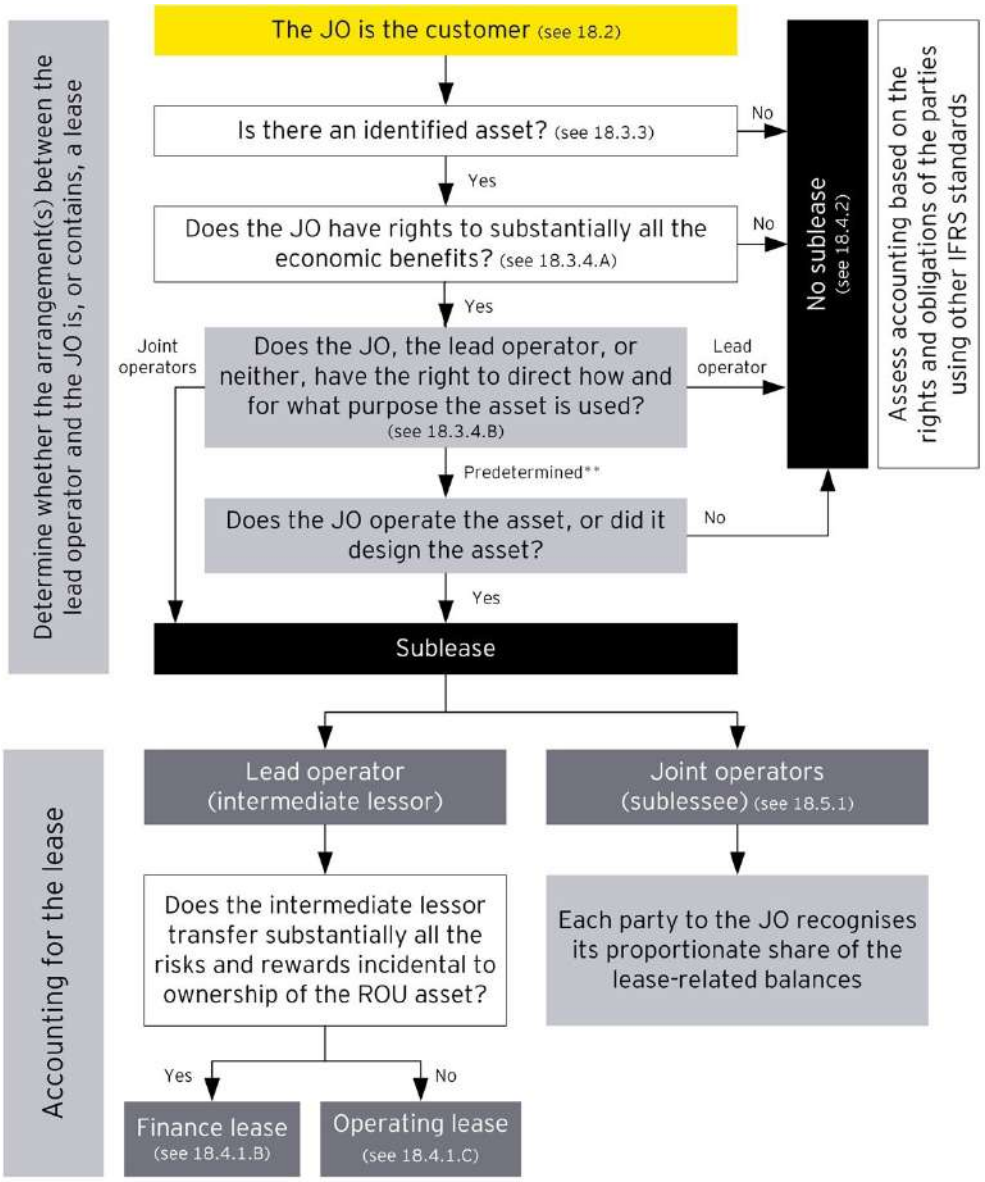
Some examples of potential contracts that may need to be considered when identifying relevant facts and circumstances and enforceable rights and obligations are set out in section 18.3.1 below. Some of the factors that need to be assessed to determine whether there is a sublease arrangement in place are discussed in section 18.3.2 below.

This overall assessment process is summarised in the following flow chart:

147 IFRS 16.B11 specifically states that when a contract to receive goods or services is entered into by a joint arrangement [as defined in IFRS 11], or, on behalf of a joint arrangement, for the purpose of a lease assessment, the joint operators to the joint arrangement, collectively, are considered to be the customer in the contract.

148 IASB Staff Paper 9: Project: *Liabilities in relation to a joint operator's interest in a joint operation (IFRS 11)*, Paper topic: *Agenda decision to finalise, IFRS IC Meeting, March 2019*, para. 17; and IASB Staff Paper 3: Project: *IFRS 11* Joint Arrangements *-Joint Operations*, Paper topic: *Initial Consideration, IFRS IC Meeting,* September 2018, paras. 40-44. Available on the IFRS Foundation's website.

Figure 18-1: Determining whether the contractual arrangements between the lead operator (as the supplier) and the JO (as the customer) is, or contains, a sublease; and the subsequent accounting for the arrangement



** In accordance with IFRS 16.B24, a customer has the right to direct the use of an identified asset throughout the period of use if the relevant decisions about how and for what purpose the asset is used are predetermined and: (i) the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or (ii) the customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

18.3.1 Assessing the contractual arrangements between the lead operator and the non-operator parties to the JO

18.3.1.A Joint operating agreement

It is common in the extractives industries for a JOA to exist between the parties to the JO. Depending on the terms of the JOA, the underlying activities may be determined and governed by the field/mine development plan and/or the annual operating plans and these may require the unanimous consent or a majority vote of the parties to the JO. In some instances, the JOA may not be explicit as to how all aspects of the JO will operate, particularly when it comes to determining which party (i.e., the lead operator or the JO) has the right to control the use of the assets used to perform the activities of the JO. In other instances, the JOA may give the lead operator primary authority over the development and operations plan for the field/mine and/or the right to determine the relevant decisions over certain assets (e.g., the right to determine when and whether specific assets will be used in the development and operations plan).

As JOAs can vary between JOs and across jurisdictions as they relate to control and responsibility for the activities pursuant to the development and operations plan, each arrangement needs to be carefully considered based on individual facts and circumstances to identify the enforceable rights and obligations.

18.3.1.B Other enforceable contractual arrangements (written and verbal)

Other enforceable contractual arrangements, written and/or verbal, may also affect the rights and obligations of the lead operator and the non-operator parties and thus need to be taken into consideration. For example, for significant assets such as a deep-water drilling rig that is integral to the activities of the JO, a separate contractual arrangement between the lead operator and non-operator parties may exist. This may have been required to evidence the non-operator parties' agreement to use of the specific drilling rig and specific contractual terms including the payment terms, prior to the lead operator entering into the lease arrangement with the third-party lessor. This may take the form of a written agreement, or, for example, could be via enforceable verbal agreements reached through the operating committee meetings of the JO which are then minuted.

The extent and nature of contractual arrangements can vary between JOs and relevant legal environments in different jurisdictions. Given this, the specific facts and circumstances and enforceability of each contractual arrangement need to be considered to determine the rights and obligations of the lead operator and the JO.

18.3.2 Determining if there is a sublease

Once it has been established there is a customer-supplier relationship between the lead operator and the JO, the next step is to determine whether there is a lease.

IFRS 16 states that a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. *[IFRS 16.9]*. In assessing whether a contract conveys the right to control the use of an identified asset for a period of time, an entity assesses whether, throughout the period of use, the customer has both:

- The right to obtain substantially all of the economic benefits from use of the identified asset
- The right to direct the use of the identified asset

The key factor to determine whether there is a sublease is whether it is the lead operator (as the supplier) or the JO (as the customer) that has the right to control the use of the identified asset.

18.3.3 Determining if there is an identified asset

18.3.3.A Specified asset - explicit or implicit

The first step in a lease assessment is to determine if there is an identified asset. As noted in the introduction in section 18 above, this assessment will be the same irrespective of whether the asset in question is owned or leased by the lead operator. However, the focus of this subsection is on situations where the asset in question is leased by the lead operator from a third-party supplier.

An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that it is made available for use by the customer. A capacity or other portion of an asset, that is not physically distinct, may be an identified asset if the customer's rights to use that asset represent substantially all of the capacity of the asset and thereby provide the customer with the right to obtain substantially all of the economic benefits from use of the asset. For example, a capacity portion of a pipeline or processing plant being used by the JO, could be an identified asset if the portion represents substantially all of the capacity, even if it is not physically distinct.

When analysing the contractual arrangement between the lead operator and the third-party supplier, if a capacity or other portion of an asset has been appropriately evaluated, the right to use the asset still needs to be assessed to determine whether it is an identified asset for the purpose of evaluating the existence of a sublease between the lead operator and the JO. This assessment will be based not only on the enforceable terms and conditions of the contractual arrangement between the lead operator and the non-operator parties, but also other relevant facts and circumstances, *[IFRS 16.2]*, inclusive of supplier substitution rights (see section 18.3.3.B below for a discussion on substantive substitution rights).

Illustration 18-1: Identified asset - explicitly identified

A lead operator enters into a lease with a third-party supplier for the use of an identified drilling rig for a period of three years. This drilling rig is to be used on JO1 for the full three-year period and this has been discussed and agreed between all parties to the JO at its Operating Committee (OpComm) and has been documented in the OpComm meeting minutes, which are enforceable under this JOA and for this jurisdiction. The lead operator has no substantive substitution rights with respect to this drilling rig throughout the three-year term of the arrangement with JO1.

Analysis: The drilling rig is an identified asset. The drilling rig is explicitly specified in OpComm meeting minutes, and there are no substantive substitution rights.

Illustration 18-2: Identified asset - capacity portion of an asset

A lead operator enters into a lease with a third-party supplier for the right to use an explicitly specified iron ore processing plant for three years. The lead operator then uses this processing plant to process iron ore received from multiple JO's, including JO1. The JOA between the lead operator and JO1 requires the lead operator to undertake all iron ore processing activities using the processing plant which the lead operator has leased. Given the quantity of JO1's iron ore which needs to be processed and the capacity of the processing plant, this arrangement provides JO1 with the right to substantially all of the processing plant's capacity. The lead operator has no substantive substitution rights with respect to this processing plant.

Analysis: The processing plant is an identified asset. While the capacity portion of the processing plant is not physically distinct, as JO1 has the right to substantially all of the processing plant's capacity, JO1 has the right to obtain substantially all of the economic benefits from use of the processing plant. Also, there are no substantive substitution rights.

18.3.3.B Substantive substitution rights

IFRS 16 states that even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. *[IFRS 16.B14]*. In determining whether the lead operator has the substantive right to substitute the asset throughout the period of use, it will be necessary to consider whether the lead operator has the practical ability to substitute (e.g., due to having a portfolio of similar underlying assets which it owns or leases and can easily substitute), and, whether it would benefit economically from doing so.

Demonstrating there is an economic benefit from substitution is a high hurdle, as the customer (i.e., the JO) has to be able to demonstrate the supplier has the practical ability to substitute the underlying asset and the supplier's economic benefits associated with substituting the asset, throughout the period of use, would exceed its costs. If the customer cannot readily determine whether the supplier has a substantive substitution right, the customer presumes the right is not substantive. *[IFRS 16.B19]*.

Illustration 18-3: Identified asset - explicitly identified but multiple assets available

A lead operator enters into a lease with a third-party supplier for the use of helicopter XYZ for a period of three years. The lead operator plans to use helicopter XYZ for flights to and from JO1 (a remote mining operation) for the full three-year period. The use of helicopter XYZ has been agreed between the lead operator and the non-operator parties to JO1.

However, while all the parties to JO1 have agreed to use helicopter XYZ, the lead operator also leases two other helicopters of the same specifications, and all three helicopters are retained at the same nearby air base. The minutes from the same OpComm meeting also confirm that to maximise efficiency of operations, the lead operator is permitted to utilise helicopter XYZ on the lead operator's other unrelated nearby JOs and the similar helicopters can be used on JO1 provided each continues to meet specified safety requirements.

The lead operator's lease arrangements with its third-party suppliers allow each of the three helicopters leased by the lead operator to be used for flights to and from each of its mining operations.

Analysis: The arrangement does not contain an identified asset. The lead operator has substantive substitution rights as it has access to two other helicopters that can fly to and from the JO1 mine site. Also, as the helicopters are of the same specification and are held at the same nearby air base, practically substitution can occur. The lead operator would substitute where it provides for efficiency of operations, and accordingly, an economic benefit would arise from substitution. Therefore, notwithstanding helicopter XYZ is explicitly specified in the minutes to the OpComm meeting for JO1, there is no identified asset as the lead operator has a substantive right of substitution.

The existence of a substantive substitution right must be considered on a lease-by-lease basis taking into consideration the specific facts and circumstances existing at lease inception. Given the nature of some assets used within these types of contractual arrangements and the location of the underlying assets, it will often be difficult to demonstrate that the lead operator has a substantive right to substitute the asset under these circumstances. This is because it is likely the lead operator may not have the practical ability to substitute the assets and, even so, costs of substitution would be high. Therefore, it may be difficult to demonstrate, throughout the period of use, that the benefits of substitution are greater than the costs.

18.3.4 Determining if the customer has the right to control the use of an identified asset

As discussed in section 18.2 above, when applying the requirements of IFRS 16 (as outlined below) and specifically when considering the concept of the customer, it is the JO that is the customer. The JO (as the customer) has the right to control the use of an identified asset if it has both the right to obtain substantially all of the economic benefits from use and the right to direct the use of the asset. It would be inappropriate to conclude that a contract does not contain a lease on the grounds that each of the parties to the JO either obtains only a portion of the economic benefits from use of the underlying asset or does not unilaterally direct the use of the underlying asset. *[IFRS 16.BC126]*.

18.3.4.A Right to obtain substantially all of the economic benefits from the use of the identified asset

To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use (e.g., by having exclusive use of the asset throughout that period).

There may be some situations where there is a difference between an asset's nominal/expected capacity and the capacity expected to be used by the customer. This may impact the assessment of whether a customer has the right to substantially all of the economic benefits from the use of the identified asset.

Illustration 18-4: Assessing 'substantially all' when the customer's use of the asset is not 100% of the nominal operating capacity

A lead operator enters into a 30-year lease with Supplier A to transport gas through a pipeline. The lead operator has the right to use 100% of the pipeline. The lead operator will then use the pipeline to transport gas for JO1. At the commencement of the arrangement with JO1, JO1 has the right to use 70% of the pipeline's nominal capacity. The pipeline is located in a remote area where the probability of another customer using the excess capacity of the pipeline is remote.

Analysis: Where the likelihood of another customer using the excess capacity is not substantive, JO1 will be considered to have the right to obtain substantially all of the economic benefits from using the pipeline throughout the period of use.

Determining whether JO1 has the right to obtain substantially all of the economic benefits from using the pipeline throughout the period of use requires consideration of all facts and circumstances. This includes considering the reason for the unused excess capacity.

In this situation, the assessment should be performed based on JO1's right to use 70% of the capacity, combined with an assessment of the likelihood of another customer using the excess capacity.

There is a range of factors to take into consideration when determining whether the JO has the right to substantially all of the economic benefits from the use of an asset. These include (but are not limited to):

- The importance of these types of assets used in the activities of JOs in the mining sector/oil and gas sector and the location of the assets, e.g., in locations which are difficult to get to and/or are remote
- Whether they are located on the mining entity's/oil and gas entity's property
- The likelihood of another customer being able to access any excess capacity

18.3.4.B The right to direct the use of the asset

IFRS 16 states that a customer can obtain the right to direct the use of an identified asset throughout the period of use if the customer has the right to direct how and for what purpose the asset is used throughout the period of use.

When assessing the range of service arrangements used in the mining sector/oil and gas sector, to determine if they are, or contain, leases, it is essential to understand what and who dictates how and for what purpose an identified asset is used. In undertaking this assessment, the decision-making rights most relevant to changing how and for what purpose an identified asset is used throughout the period of use are considered. Decision-making rights are relevant when they affect the economic benefits to be derived from use.

When assessing arrangements between a lead operator and a JO, it is critical to assess whether it is the lead operator or the JO as a whole, that has the right to direct the use of the asset. This involves obtaining an understanding of the JOA and other relevant enforceable arrangements to determine who has the right to make (and change) the key decisions with respect to the use of the asset throughout the period of use.

Under IFRS 11, a joint arrangement exists where:

- The contractual arrangement gives all the parties, or a group of the parties, control over the arrangement collectively.
- The decisions about the relevant activities require the unanimous consent of the parties sharing control. *[IFRS 11.5, IFRS 11.7]*.

For arrangements in the extractives industries, under the terms of a JOA, approval of the mine plan or field plan and/or annual operating budget may be considered a relevant activity, and, for this to require unanimous consent of all parties to the JO for approval. Identification of relevant activities and determining which require unanimous consent, is a critical part of the rationale to support joint control such that the arrangement is a joint arrangement in scope of IFRS 11.

When assessing who has the right to direct the use of an asset in accordance with IFRS 16, in some arrangements, the lead operator may retain this right and therefore there will be no sublease between the lead operator and JO.

However, if the enforceable terms of the JOA and other arrangements in place and relevant facts and circumstances support this, it is possible the JO may have the right to direct the use of an identified asset(s) used as part of the activities of the JO.

For example, where it has been concluded that the mine plan or field plan is specific enough that it provides the JO the right to determine how and for what purpose an identified asset is used throughout the period of use and subsequent changes to that mine plan or field plan require unanimous consent, then the JO may direct the use of the identified asset. If the JO also has the right to substantially all of the economic benefits from use of the asset, the JO (as the customer) has the right to control the use of the asset.

Illustration 18-5: Right to direct the use - dedicated asset

Company A, in its role as lead operator, enters into a 10-year lease (head lease) for a Floating Production Storage Offloading (FPSO) vessel with a third-party supplier, as sole signatory and has primary responsibility for the lease payments. It recognises the entire lease liability and related right-of-use asset in respect of the head lease. The FPSO is highly specialised to allow for production from a single specified field, owned by JO1, on which it is to be deployed. The FPSO will be used by JO1 for 10 years.

The enforceable terms of the JOA for JO1 specify that the lead operator is responsible for sourcing an appropriate FPSO to be used on JO1 for 10 years. Once identified, the lead operator will not have a substantive right to substitute the underlying FPSO during the 10-year period.

In addition, in this example, the field development and operations plans, which determine how and for what purpose the FPSO is used throughout the period of use, require the unanimous consent of the parties to JO1. Due to changing oil prices, costs, field performance, etc. the parties to JO1 also have the right to change these plans. Therefore, such decisions are the relevant decisions impacting the economic benefits derived from use of the FPSO.

The lead operator recovers its costs related to the lease of the FPSO payable to the third-party supplier by billing all parties to JO1, pro-rated based on their equity interests in JO1 throughout the 10-year right of use term.

Analysis: There is a sublease between the lead operator and the JO. In this instance, given the enforceable terms of the JOA and other relevant facts and circumstances, the FPSO is implicitly identified and JO1 has the right to substantially all of the economic benefits and has the right to direct the use of the identified FPSO throughout the period of use.

Illustration 18-6: Right to direct the use - asset can be used on multiple locations for multiple JOs

Company B is the lead operator for a range of different JOs, each of which have exploration licences in close proximity to each other. Exploration and appraisal drilling is expected to occur over a two-year period. Company B's equity interest in each JO varies. Given expected upcoming drilling activity, Company B enters into a lease with a third-party supplier for a drilling rig for a period of two years.

Under the terms of the JOAs governing each of the JOs, Company B is required to execute drilling activity over the coming two years over a number of the licences, but has flexibility in determining the exact timing of drilling to be performed on each respective licence.

Company B has the substantive right to determine when and where to drill for each licence and can change such decisions, throughout the period of use. The JOs have no right to make or change relevant decisions about the use of the asset, even when the drilling rig is currently in use on their respective licences.

Throughout the period in which the rig is drilling on a licence, Company B has the right to recover costs incurred from the respective JOs relative to the equity interests of each of the non-operator parties. When the drilling rig is idle, Company B has no right to recover costs from any JO.

Analysis: The arrangements between the lead operator and the JOs do not contain a sublease. In this situation, the lead operator has the right to make the relevant decisions about the use of the drilling rig. Those decisions include determining when and where to use the drilling rig throughout the period of use. No single JO has the right to control the use of the drilling rig over the full two-year lease term; rather, Company B has the right to control the use of the drilling rig.

Illustration 18-7: Right to direct the use - asset only used on one JO

Company C is the lead operator for JO2, an onshore field in the development phase. Development drilling is planned for the next 15 months and the field development plan sets out that 30-60 wells will be drilled within a pre-approved budget. Company C has entered into a 15 month lease with a third party supplier to secure a drilling rig for the activity.

Under the terms of the JOA governing JO2, Company C is required to utilise its knowledge of the field to execute the drilling programme that maximises the economics of JO2's development plan. In this example, Company C has the right to determine whether, when and where each well will be drilled within the licence area and has the right to change such decisions, throughout the period of use. JO2 has no right to make or change relevant decisions about the use of the asset.

Throughout the period in which the rig is drilling on the licence, Company C has the right to recover costs incurred from the JO2 non-operator parties relative to their equity interests in the licence.

Analysis: The arrangement between the lead operator and the JO does not contain a sublease. In this situation, the lead operator has the right to make the relevant decisions about the use of the drilling rig. In this example, those decisions include determining whether, when and where to use the drilling rig throughout the period of use. In this example, Company C has the right to control the use of the drilling rig throughout the period of use.

18.3.4.C Right to direct the use is predetermined

IFRS 16 also considers circumstances whereby the right to direct the use of the asset is 'predetermined'. That is, a customer has the right to direct the use of an identified asset throughout the period of use if the relevant decisions about how and for what purpose the asset is used are predetermined and: (i) the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or (ii) the customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use. *[IFRS 16.B24]*. The concept of predetermined has not been considered in detail in this subsection.

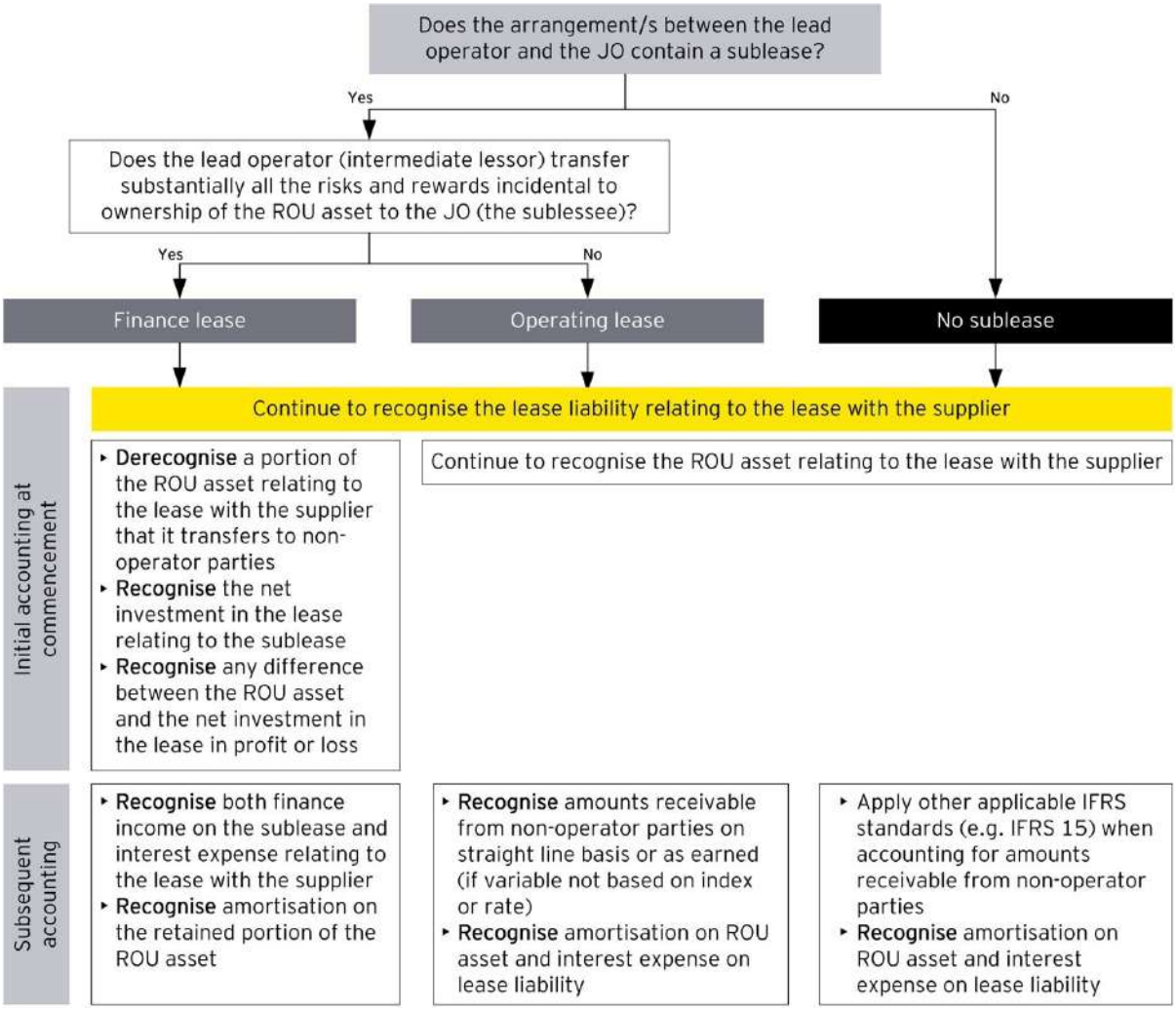
There are a range of factors entities will need to consider to determine whether a sublease exists between a lead operator and a JO. Entities need to ensure the evidence used to support conclusions about joint control for the purposes of applying IFRS 11 (in particular, the factors used to conclude that there is a joint arrangement and the lead operator is not controlling the arrangement itself, but instead is just carrying out the decisions of the parties to the joint arrangement), is taken into consideration when determining who has the right to control the use of an identified asset used as part of the JO activities in accordance with IFRS 16, i.e., the lead operator or the JO.

18.4 Accounting by the lead operator

Where the lead operator is the sole signatory to, and has primary responsibility for, the contract that is or contains a lease with the third-party supplier, the lead operator is required to initially recognise 100% of the right-of-use asset and the related lease liability in accordance with IFRS 16. Regardless of whether the JOA and related arrangements are considered to contain a sublease, for as long as the lead operator remains a party to the lease arrangement with the third-party supplier, the lead operator will continue to recognise 100% of the lease liability. This is on the basis that the JOA and related arrangements do not extinguish or transfer the lead operator's enforceable rights and obligations under the contract with the third-party supplier and instead, the lead operator retains the primary responsibility for the lease liability. However, the subsequent accounting for the right-of-use asset and the accounting for the amounts received or receivable from the non-operator parties will depend on whether a sublease exists, and if there is a sublease, whether it is a finance lease or operating lease.

A summary of the potential outcomes is as follows:

Figure 18-2: Lead operator's accounting for the contractual arrangement with the JO - potential accounting outcomes



18.4.1 JOA and/or related contractual arrangements are, or contain, a sublease

18.4.1.A Classifying the sublease

Lessor accounting remains largely unchanged from that prescribed by the previous accounting standard, IAS 17. Therefore, the lessor needs to determine whether the arrangement transfers substantially all the risks and rewards incidental to ownership of the underlying asset and if so, it is a finance lease. When assessing the lease classification, this is undertaken by reference to the right-of-use asset arising from the head lease, not by reference to the underlying asset. If the head lease is a short-term lease that the lead operator, as a lessee, has accounted for applying the practical expedient, *[IFRS 16.6]*, the sublease is classified as an operating lease.

For more information on classifying leases by a lessor see Chapter 24 at section 6.1.

Illustration 18-8: Classifying the sublease - finance lease

Company A, as lead operator of JO1, enters into a 10-year contract with a third-party supplier that contains a lease (head lease) for a FPSO vessel as a sole signatory and has primary responsibility for the lease payments. Therefore, the lead operator recognises 100% of the lease liability and the related right-of-use asset.

The FPSO is used on JO1 and for the purposes of this Illustration, it has been concluded that the arrangement contains a 10-year sublease.

The FPSO is highly specialised to allow for production from a single specified licence, owned by JO1, on which it is to be deployed, and hence can only be used by JO1 (as the sublessee), without major modifications. The FPSO has an estimated useful life of 25 years.

Analysis: The sublease is classified as a finance lease. The sublease is classified by reference to the right-of-use asset in the head lease and not the underlying FPSO. The lease term for the sublease represents all (and hence a major part) of the life of the right-of-use asset, as the sublease is for 10 years and the tenure of the right-of-use asset is also 10 years. Furthermore, the asset is specialised in nature.

Illustration 18-9: Classifying the sublease - operating lease

Company A, as lead operator of JO1, enters into a contract with a third-party supplier that contains a lease of an excavator for five years (head lease). The excavator is not specialised.

For the purposes of this Illustration, it has been concluded the arrangement contains a 2-year sublease of the excavator.

Analysis: The sublease is classified as an operating lease. The sublease is classified with reference to the right-of-use asset in the head lease and not the underlying excavator. The lease period does not represent a major part of the life of the right-of-use asset, because the sublease is only for two years and the right-of-use asset is for five years. Also, there are no other factors in this example which would indicate there is a finance lease.

18.4.1.B Accounting for the sublease - finance lease

At commencement of the sublease: the lead operator, as intermediate lessor:

- Derecognises a portion of the right-of-use asset which had been recognised in relation to the lease with the third-party supplier - the portion derecognised represents the portion of the right-of-use asset transferred to the non-operator parties
- The portion of the right-of-use asset retained represents the lead operator's share of the sublease as a participant in the JO recognised in accordance with IFRS 11
- Recognises a net investment in the lease - the net investment in the lease is measured as the sum of the discounted lease payments receivable from the non-operator parties in respect of the sublease and any unguaranteed residual value in the right-of-use asset accruing to the lead operator as intermediate lessor
- Recognises any difference between the portion of the right-of-use asset derecognised and the net investment in the lease recognised in profit or loss
- Continues to recognise the existing lease liability relating to the lease with the third-party supplier in its statement of financial position, which represents the lease payments it owes to the third-party supplier as the head lessor

During the term of the sublease: the lead operator, as the intermediate lessor, recognises finance income on the sublease (net investment in the lease), amortisation of its share of the right-of-use asset which is retained in its books and interest expense on the lease liability relating to the head lease. For more information on accounting for finance leases by a lessor see Chapter 24 at section 6.3. Any variable lease payments that do not depend on an index or rate (e.g., performance- or usage-based payments) are recognised in profit or loss (unless they are included in the carrying amount of another asset in accordance with other IFRS accounting standards) in the period in which the event that triggers the payment occurs.

Illustration 18-10: Accounting for the sublease - finance lease

Assume the lead operator recognises a right-of-use asset and lease liability of CU100 on a head lease (assume there were no other adjustments required against either of these balances), and the arrangement between the lead operator and the JO contains a sublease classified as a finance lease.

The lease term for the head lease and sublease are both 10 years, have the same commencement dates, and the timing and amounts of the lease payments are identical.

The lead operator remains primarily obligated for the lease, including the lease payments under the head lease.

The lead operator (as a participant in the JO) has a 40% interest in the JO. The entries recognised by the lead operator will be, as follows:

Commencement of the head lease

Dr	Right-of-use asset		CU100	
	Cr	Lease liability (head lease)		CU100

Journal entry to recognise the head lease determined using the sum of the discounted lease payments.

Commencement of the sublease

Dr	Net investment in the lease		CU60	
	Cr	Right-of-use asset		CU60

Journal entry to derecognise a portion of the right-of-use asset relating to the head lease equal to the non-operators' interests in the lease between the lead operator and the JO and recognise the discounted value of the sum of the related amounts receivable from the non-operator parties.

Net impact for lead operator

Dr	Right-of-use asset[#]		CU40	
Dr	Net investment in the lease		CU60	
	Cr	Lease liability (head lease)		CU100

[#] *The right-of-use asset retained by the lead operator represents the lead operator's 40% share of the lease between itself and the JO which it recognises because it is also a participant in the JO.*

18.4.1.C Accounting for the sublease - operating lease

At lease commencement: the lead operator, as intermediate lessor:

- Continues to recognise the right-of-use asset relating to the lease with the third-party supplier
- Continues to recognise the lease liability relating to the lease with the third-party supplier in its statement of financial position, which represents the lease payments it owes to the third-party supplier as the head lessor

During the term of the sublease: the lead operator, as the intermediate lessor, recognises amortisation of the right-of-use asset and interest expense on the lease liability relating to the lease with the third-party supplier. It also recognises payments received from the non-operator parties as income, on either a straight-line basis or another systematic basis if that better represents the pattern in which benefit is expected to be derived from the use of the asset. Any variable lease payments that do not depend on an index or rate (e.g., performance- or usage-based payments) are recognised in profit or loss (unless they are included in the carrying amount of another asset in accordance with other IFRS accounting standards) in the period in which the event that triggers the payment occurs.

18.4.2 JOA and/or related contractual arrangements are not, do not contain, a sublease

When the contractual arrangements between the lead operator and the JO do not contain a sublease, the lead operator continues to recognise the right-of-use asset and related lease liability in relation to the lease with the third-party supplier at lease commencement and will recognise amortisation of the right-of-use asset and interest on the lease liability across the term of the lease.

The arrangement with the JO will then likely represent an executory contract and the accounting by the lead operator for amounts receivable from the non-operator parties will depend on the nature of this arrangement. Some of the potential accounting considerations may include the matters listed below. When undertaking these assessments, as discussed in section 18.2 above, it is important to note that the determination of the customer for the purposes of applying IFRS 16 does not necessarily impact the determination of a customer for the purposes of other standards. For example, a customer, for the purposes of IFRS 15, is determined by applying the specific requirements and guidance of IFRS 15.

- Provision of JO management services whereby the JO is considered to be a customer: the arrangement will be in the scope, and the lead operator will apply the provisions, of IFRS 15. Revenue will be recognised at the amount the lead operator expects to be entitled to in exchange for providing the JO management services to the JO as the relevant performance obligations are satisfied. See Chapter 28 for more information on factors to consider when applying IFRS 15.
- JO does not represent a customer: where the lead operator does not consider it is providing JO management services to the non-operator parties within the scope of IFRS 15, the lead operator will need to apply other relevant IFRS accounting standards, or when no specific IFRS accounting standards are applicable, use judgement to determine the appropriate accounting treatment for the arrangement. The lead operator will need to apply IAS 8[149] to determine the nature of the relationship and whether and when it should recognise amounts receivable from the non-operator parties. Specifically, the lead operator will need to assess whether the provisions of IFRS 9 relating to financial assets apply or whether the reimbursement requirements of IAS 37 apply. The lead operator will also need to assess whether these amounts represent a form of income or a direct reimbursement of expenditure.

18.4.3 Other issues to consider

In addition to the above, there are a number of other potential issues that a lead operator may need to consider when evaluating the overall accounting implications, which include but are not limited to:

- Capitalisation of costs: where the activities of the JO are being undertaken in relation to a project that is in the exploration and evaluation (E&E) phase or the development phase, depending on the lead operator's accounting policies, it may need to consider whether some of the costs incurred, e.g., a portion of the amortisation of the right-of-use asset and/or interest expense on the lease liability, are required to be capitalised. The lead operator will need to assess whether such costs meet the requirements for capitalisation under the relevant standards (including IAS 23 which explicitly scopes in interest in respect of leases under IFRS 16), and if so, determine the amount that is required to be capitalised versus the amount that are required to be expensed.
- Mismatch between the lead operator's costs and the amounts receivable from the non-operator parties: in each period, the lead operator's accounting for the expenses relating to the lease with a third party which are to effectively be reimbursed by the non-operator parties, will not necessarily be equivalent to the amounts receivable from the non-operator parties. This is because the IFRS 16 accounting for the lease with the third-party supplier will generally be more front ended and will comprise amortisation of the right-of-use asset and interest on the lease liability. This will differ from the income a lead operator will recognise under sublease operating accounting or executory contract accounting. This will lead to timing mismatches for the lead operator in its profit or loss.
- Presentation of amounts receivable from the non-operator parties (where the arrangement is not a 'sublease which is a finance lease', i.e., it is either an operating lease or not a sublease): in this situation, a question that may be asked is whether any amounts receivable from the non-operator parties can be offset against the amounts recognised by the lead operator. This question is generally raised because from an economic perspective, the non-operator parties are effectively paying their respective share of the cash costs incurred by the lead operator on the lease with the third-party supplier. Hence, some lead operators may prefer to present the effects of this on a net basis, if/where possible.

149 The consequential amendments resulting from IFRS 18 *Presentation and Disclosure in Financial Statements*, once effective, changes the title of IAS 8 to '*Basis of Preparation of Financial Statements*' to better reflect the amended content of IAS 8. See Chapter 4 for further details on the requirements of IFRS 18.

When assessing this offsetting issue, the following needs to be considered:

- Ability to offset: IAS 1, *[IAS 1.32]*, and the Conceptual Framework, *[CF 7.10]*, provide the requirements and guidance with respect to offsetting of assets and liabilities and income and expenses. IAS 1 states offsetting is not allowed unless required/permitted by another standard and the Conceptual Framework notes it is generally not permitted as offsetting classifies dissimilar items together. Given this, it is expected the ability to achieve offsetting will be rare.
- Lead operator capitalises its costs as part of an E&E or development asset: in such a situation, the lead operator would only be able to capitalise the portion of the costs incurred on the head lease relating to its ownership in the JO assets. This is on the basis that it would not receive the future economic benefits associated with the costs attributable to the non-operator parties. These costs would therefore need to be recognised in profit or loss (P&L). See below for further discussion on the issues this would present.
- Lead operator recognises its costs in P&L: in this situation, the question is whether the lead operator can offset the amounts receivable from non-operator parties directly against the line items within P&L in which it has recognised the costs relating to the lease with the third-party supplier. The challenges here may include:
- Mismatches in amounts (as discussed above)
- Whether such amounts received can be offset and if so, upon what basis
- If a valid argument could be mounted to support offsetting, which is considered difficult to achieve, given the lead operator will be recognising amortisation and interest, it is unclear how the amounts received would be allocated between the two line items

18.5 Accounting by the non-operator parties

As discussed in section 18.4 above, where the lead operator is the sole signatory to, and has primary responsibility for, the contract that is or contains a lease with the third-party supplier, the lead operator is required to initially recognise 100% of the lease-related balances. The accounting by the non-operator parties will then depend on whether the JOA and/or related contractual arrangements contain a sublease or not.

18.5.1 JOA and/or related contractual arrangements contain a sublease

When the JO is the sublessee, under IFRS 16, there is no longer any differentiation between operating or finance leases. As a result, there will be a right-of-use asset and lease liability in relation to the lease with the lead operator, for which each participant in the JO will, in accordance with IFRS 11, need to:

- Recognise its proportionate share of the right-of-use asset and lease liability based on its respective interest in the JO
- During the term of the sublease:
  - Recognise amortisation of its share of the right-of-use asset
  - Recognise interest expense in relation to its share of the lease liability

18.5.2 JOA and/or related contractual arrangements do not contain a sublease

Where the JOA and/or related contractual arrangements do not contain a sublease, IFRS 16 does not apply to the JO. Therefore, the non-operator parties will likely continue to recognise amounts payable to the lead operator consistently based on their existing accounting policies.

18.5.3 Other factors to consider when evaluating the overall accounting

In addition to the above, there are a number of other potential factors which non-operator parties will need to consider when evaluating the overall accounting, which include but are not limited to:

- Capitalisation of costs: where the activities of the JO are being undertaken in relation to a project that is in the E&E phase or the development phase, depending on the non-operator's accounting policies, it may need to consider whether the costs incurred, e.g., amortisation of the right-of-use asset and/or interest expense on the lease liability, are required to be capitalised. Each non-operator party will need to assess whether such costs meet the eligibility requirements for capitalisation in accordance with the relevant standard (including IAS 23), their own policies and appropriate industry practice. If so, the amount that will need to be capitalised versus the amount that will be expensed will need to be identified.

- Cash flow impact: the profile over which right-of-use amortisation and interest expense will be recognised will vary depending on the nature of the particular asset and could vary significantly from the pattern in which cash costs are incurred. This is because it is expected that most lead operators will seek to align cost recovery with the pattern in which their cash costs are incurred. This is likely to lead to timing and potentially overall measurement differences between amounts incurred and cash outflows recognised.

18.6 Other practical considerations

In addition to the issues discussed above, there are other factors requiring consideration which are relevant to both the lead operator and non-operator parties.

18.6.1 Access to information

If the contractual arrangement between the lead operator and the JO are concluded to contain a sublease, or the JO itself is considered to have entered into a lease directly with a third-party supplier, the parties to the JO will need to recognise their respective share of the lease liability, right-of-use asset, amortisation expense, interest expense and variable lease payments, if any. To do this, the lead operator will need to provide non-operator parties with the required information. Therefore, parties to the JO will need to discuss and agree what information is required, who will prepare and provide such information and when such information will be made available.

Where lead operators agree to prepare, or are required to prepare, such information on behalf of the non-operator parties, the non-operator parties will need to consider whether there are any material differences in accounting policies which need to be adjusted for before recognising such amounts in their own financial statements.

18.6.2 Impact on systems and processes

Where leases are concluded to exist, this may require significant alterations to systems and processes. Lead operators will be required to consider the ability of existing systems and processes to execute joint interest billing going forward in light of these changes. Non-operator parties will need to consider whether their systems and processes are capable of accounting for leases.

Entities are encouraged to liaise closely with parties to each of their JOs, sharing sufficient information so that each member of the JO is able to determine their appropriate accounting.

19 Long-term contracts and leases

Given the nature of the extractive industries, mining entities and oil and gas entities regularly enter into a wide range of long-term contracts. These may relate to the provision of services or the sale of goods. There are a number of potential issues to be addressed when considering the accounting for these arrangements, these are discussed below. This section is required to be read in conjunction with the general discussion set out in Chapter 24.

19.1 Embedded leases

IFRS 16 requires an entity to determine whether a contract is, or contains, a lease at the inception of the contract. *[IFRS 16.9]*. The assessment of whether a contract is or contains a lease will be straightforward in most arrangements. However, judgement may be required in applying the definition of a lease to certain arrangements. For example, in contracts that include significant services, determining whether the contract conveys the right to direct the use of an identified asset may be challenging.

There are a range of arrangements commonly found in the extractive industries which may convey the right to control the use of an identified asset to the customer, as well as provide the customer with related services or outputs. This may include:

- Outsourcing arrangements
- Take-or-pay and similar contracts (see section 19.2 below)
- Service arrangements - such as contract mining services arrangements or oilfield services arrangements
- Throughput arrangements (which may take the form of a take-or-pay arrangement)
- Tolling contracts (see section 20 below)
- Contractor facilities located on the mining company's or oil and gas company's property
- Storage facility arrangements
- Energy-related or utility contracts, e.g., gas, electricity, telecommunications, water
- Transportation/freight/shipping/handling services contracts

IFRS 16 makes it clear that these types of arrangements (or part thereof) could be within the scope of IFRS 16 if it meets the definition of a lease, e.g., if it conveys to the lessee the right to use an asset (the underlying asset) for a period of time in in exchange for consideration. *[IFRS 16 Appendix A]*. This is regardless of the fact that the arrangement is not described as a lease and is likely to grant rights that are significantly different from those in a formal lease agreement. IFRS 16 is to be applied to each lease component within the contract as a lease separately from non-lease components of the contract unless the entity applies the practical expedient to combine the lease and associated non-lease components. *[IFRS 16.12]*. The detailed requirements of IFRS 16 and the definition of a lease are discussed in Chapter 24 at section 3.

See sections 17 and 18 above for a discussion of the impact of IFRS 16 on mining entities and oil and gas entities and Chapter 24 for a general discussion on IFRS 16.

Barrick Gold Corporation's acknowledgement that non-lease contracts need to be assessed for the existence of embedded leases under IFRS 16 is provided in Practical example 19-1 below.

Practical example 19-1: Barrick Gold Corporation (2018) **Canada**

Annual Report 2018 [extract]
Notes to Consolidated Financial Statements [extract]
2. Significant Accounting Policies [extract]
z) New Accounting Standards Issued But Not Yet Effective [extract]
IFRS 16 Leases [extract]

these lease payments will be recorded as financing outflows in our cash flow statement. We have developed a full implementation plan to determine the impact on our financial statements and internal controls. In the fourth quarter of 2017, we formed an IFRS 16 working group and began the process of compiling all of our existing operating leases and service contracts. In the first quarter of 2018, we began reviewing the relevant agreements to identify which of the operating leases and service contracts are in scope for IFRS 16. In the second quarter of 2018, we had largely completed our review of existing service contracts for embedded leases and had identified all operating leases. In the third quarter of 2018, we continued our review of existing service contracts for embedded leases, began developing a valuation approach to discount our population of leases, and evaluated various leasing software tools to assist with the increased accounting and disclosure requirements arising from the new leasing standard. In the fourth quarter of 2018, we performed a completeness test to validate the population of service

19.2 Take-or-pay contracts

A 'take-or-pay' contract is a specific type of long-term commodity-based sales agreement between a customer and a supplier in which the pricing terms are set for a specified minimum quantity of a particular good or service. The customer must pay the minimum amount as per the contract, even if it does not take the volumes. There may also be options for additional volumes in excess of the minimum. Take-or-pay contracts for the supply of gas are particularly common, because entities developing gas fields need to make very significant investments in infrastructure such as pipelines, liquefaction plants and shipping terminals, to make transport of gas to the end-consumer economically viable. In order to raise the funds to finance such investments, it is crucial to know that there is a profitable market for the gas, as it cannot easily be diverted and sold in an alternative market or to an alternative customer.

While take-or-pay contracts perhaps most commonly involve the supply of gas, they can also include other arrangements such as contracts for pipeline capacity or LNG regasification facilities. Take-or-pay contracts are also used in the mining sector, e.g., with some coal contracts, though less frequently than in the oil and gas sector. Often take-or-pay contracts permit the purchaser to recover payments for quantities not taken, by allowing the purchaser to take more than the minimum in later years and to apply the previously paid-for undertake amount towards the cost of product taken in the later years.[150]

The following issues need to be considered in accounting for take-or-pay contracts:

- *Structured entities* - If a take-or-pay contract transfers the majority of the risks and rewards from the development of a mine or gas field to the customer, it is necessary to consider whether the entity developing the gas field has, in effect, become a structured entity of that customer and therefore, the customer needs to consider the level of influence it has over that mining entity or oil and gas entity (see Chapter 7 at section 4.4.1).

150 IASC Issues Paper, 10.26.

- *Embedded leases* - Take-or-pay contracts are often for a very significant portion of the output of the gas field that it relates to. Therefore, as illustrated in Practical example 19-1 above, the operator and customer need to consider whether the take-or-pay contract contains a lease of the related assets (see section 19.1 above for further discussion).
- *Embedded derivatives* - As illustrated in Practical example 19-2 below, the price of gas sold under take-or-pay contracts is often based on a 'basket' of fuel prices and/or inflation price indices. If there is an active market for gas then this often means that an embedded derivative needs to be separated from the underlying host take-or-pay contract (see section 13.2 above).
- *Guarantees* - Lenders are often willing to provide funding for the development of a gas field only if the operator can present a solid business case, which includes a 'guaranteed' stream of revenue from a reputable customer. In such cases, the take-or-pay contract acts as a form of credit enhancement or possibly as a guarantee. The operator and customer may need to consider whether the take-or-pay arrangement includes a guarantee that is required to be accounted for under IFRS 9 (see Chapter 41 at section 2.4).
- *Make-up product and undertake* - A customer that fails to take the specified volume during the period specified must nevertheless pay for the agreed-volume. However, a take-or-pay contract sometimes permits the customer to take an equivalent amount of production (makeup product) at a later date after the payment for the guaranteed amount has been made (see section 12.16 above and section 19.2.1 below).

Practical example 19-2 below from the financial statements of ENGIE SA gives an overview of some of these important terms and conditions that exist in take-or-pay contracts.

Practical example 19-2: ENGIE SA (2017) **France**

2017 Registration Document [extract]

2 Risk factors [extract]

2.3 Operational risks [extract]

2.3.1.1 Purchase and sale of natural gas

The Group has established a procurement portfolio composed in part of long-term contracts, including some with a take-or-pay clause which, under certain conditions, stipulates that minimum quantities will be taken during a period.

In case of major gas supply interruption (for example, due to an interruption of Russian deliveries or an interruption of transit in Ukraine) or an interruption of LNG supply (for example, from Yemen or Egypt), or difficulty in renewing certain contracts under favorable economic conditions, the replacement cost for gas, including transportation, could be higher and affect the Group's margins. To mitigate this risk, the Group has a number of tools for flexibility and modulation (flexibility in long-term contracts, storage and regasification capacity, and purchasing in the marketplaces) as well as a diversified portfolio.

Prices of long-term purchase contracts (partially indexed to the price indices of oil products) may be decorrelated from selling prices or prices in the gas markets. This spread might have a significant impact on the Group's results. Long-term contracts include price adjustment clauses, so that the economic balance between producer and buyer can be altered. The Group's buy/sell margin may therefore change according to price adjustments in LNG or gaseous gas contracts and the state of the gas market in general.

Negotiations in recent years have led to the integration of market indices in long-term contracts and/or to the reduction of the difference between the contract price and market price. They have also led to increased frequency of price revisions.

19.2.1 Make-up product and undertake

Under some take-or-pay arrangements, a customer who is required to pay for the product not taken will often have no right of future recovery. The customer is required to recognise an expense equal to the payment made, while the operator recognises the same amount as revenue. However, if the substance of the relationship between the operator and customer is such that a renegotiation of the arrangement is probable then it may be more appropriate for the operator to recognise the penalty payment as a contract liability, i.e., deferred revenue. The customer, however, is still required to recognise an expense in this case as it does not have a legal right to receive reimbursement or makeup product.[151]

The accounting is different when a customer that is required to pay for product not taken has a right to take makeup product in the future.

In this case, the operator would recognise a contract liability, i.e., unearned revenue, in relation to the 'undertake' measured in accordance with IFRS 15, as it represents an obligation for the operator to have to provide the product in the future. The operator only recognises revenue in accordance with IFRS 15 once the make-up product has been taken by the customer, i.e., the performance obligation is satisfied. Only once the make-up period has expired or it is clear that the purchaser has become unable to take the product, would the liability be eliminated and revenue recognised.[152] For a discussion of the IFRS 15 considerations for these types of arrangements, see section 12.16 above.

From the customer's perspective, it would normally recognise a prepaid amount representing the make-up product that it is entitled to receive in the future. However, if the customer is entitled to more make-up product than it can sell, it may need to recognise an impairment charge.

151 IASC Issues Paper, 10.23.

152 IASC Issues Paper, 10.24.

20 Tolling arrangements

In the mining sector it is common for entities to provide raw material to a smelter or refiner for further processing. If the raw material is sold to the smelter or refiner and the relevant criteria are satisfied, the mining company recognises revenue in accordance with IFRS 15. However, under a 'tolling' arrangement a mining company generally supplies, without transferring ownership, raw material to a smelter or refiner which processes it for a fee and then returns the finished product to the customer. Alternatively, the mining company may sell the raw material to the smelter or refiner, but is required to repurchase the finished product. In the latter of the two situations, no revenue is required to be recognised under IFRS 15 when the raw material is shipped to the smelter or refiner as the customer, i.e., the smelter or refiner, has not obtained control of the raw materials. An entity must carefully assess the terms and conditions of its tolling arrangements to determine:

- When and if it is appropriate to recognise revenue
- Whether those arrangements contain embedded leases that require separation under IFRS 16 (see section 19.1 above)
- Whether the tolling arrangement is part of a series of transactions with a joint arrangement
- Whether the toll processing entity is a structured entity that requires consolidation under IFRS 10 (see Chapter 7 at section 4.4.1 for more information)

Practical example 20-1 below describes a tolling arrangement between Alberta Petroleum Marketing Commission and Canadian Natural Resources Partnership.

Practical example 20-1: Alberta Petroleum Marketing Commission (2022) Canada

Annual Report [extract]

Management discussion and analysis [extract]

STURGEON REFINERY - TOLLPAYER

NWRP was formed on February 16, 2011 and constructed, and now operates the Sturgeon Refinery. On February 16, 2011, essentially identical processing agreements were entered into by the APMC and Canadian Natural Resources Partnership ("CNR") (collectively, the "Processing Agreements"). The Processing Agreements were 30-year tolling arrangements which contract the APMC and CNR as Tollpayers ("Tollpayers") for 75 percent and 25 percent of the Refinery capacity, respectively, and were in effect commencing June 1, 2018. The Refinery commenced commercial operation on June 1, 2020. In accordance with the Processing Agreements, NWRP will process 37,500 bbls/d of bitumen feedstock for the APMC. As required by the terms of the Processing Agreements, a trust account (the Initial Proceeds Trust Account or "IPTA") has been established to facilitate the payments to and from the Tollpayers and NWRP. As part of the Optimization Transaction, the Processing Agreements were amended on June 30, 2021, effective wherein the term of the Processing Agreements were extended by 10 years to 2058. The APMC has exercised judgment in determining that the tollpayer arrangement is a joint operation in which it has a 75 percent interest in the assets, liabilities, revenue, and expenses, and records its 75 percent interest in the APMC financial statements. The Commission is unconditionally obligated to pay its 75 percent pro rata share of the debt component of the monthly fee-for-service toll over the 40-year tolling period. Sales of diesel and refined products and associated refining tolls are recognized in the Sturgeon Refinery segment.

...

For a discussion on the impacts of IFRS 15 on repurchase agreements, see section 12.14 above.

21 Taxation

As mentioned in section 1.1 above, one of the characteristics of the extractive industries is the intense government involvement in their activities, which ranges from "outright governmental ownership of some (especially petroleum) or all minerals to unusual tax benefits or penalties, price controls, restrictions on imports and exports, restrictions on production and distribution, environmental and health and safety regulations, and others".[153]

Mining entities and oil and gas entities typically need to make payments to governments in their capacity as:

- Owner of the mineral resources
- Co-owner or joint arrangement partner in the projects
- Regulator of, among other things, environmental matters and health and safety matters
- Tax authority

The total payment to a government is often described as the 'government take'. This includes fixed payments or variable payments that are based on production, revenue, or a net profit figure; and which may take the form of fees, bonuses, royalties or taxes. Determining whether a payment to government meets the definition of income tax is not straightforward.

IAS 12 is required to be applied in accounting for income taxes, defined as including:

(a) All domestic and foreign taxes which are based on taxable profits

(b) Taxes, such as withholding taxes, which are payable by a subsidiary, associate or joint arrangements on distributions to the reporting entity *[IAS 12.1, IAS 12.2]*

As discussed in Chapter 29 at section 4.1, it is not altogether clear what an income tax actually is. In the extractive industries the main problem with the definition in IAS 12 occurs when:

(a) A government raises 'taxes' on sub-components of net profit (e.g., net profit before financing costs or revenue minus allowed costs)

(b) There is a mandatory government participation in certain projects that entitle the government to a share of profits as defined in a joint operating agreement

A considerable amount of judgement is required to determine whether a particular arrangement falls within the definition of 'income tax' under IAS 12 or whether it is another form of government take. From a commercial perspective the overall share of the economic benefits that the government takes is much more important than the distinction between its different forms. In practice, most governments receive benefits from extractive activities in several different ways, as discussed below. Governments can choose any of these methods to increase or decrease their share of the benefits.

However, the distinction is crucial given the considerable differences in the accounting treatments and disclosures that apply to income taxes, other taxes, fees and government participations. For example, it will affect where these amounts are presented in the profit or loss, e.g., in operating costs or income tax expense; and it will determine whether deferred tax balances are required to be recognised and the related disclosures provided.

21.1 Excise duties, production taxes and severance taxes

Excise duties, production taxes and severance taxes result in payments that are due on production (or severance) of minerals from the earth. Depending on the jurisdiction and the type of mineral involved, they are calculated:

(a) As a fixed amount per unit produced

(b) As a percentage of the value of the minerals produced

(c) Based on revenue minus certain allowable costs

21.1.1 Production-based taxation

If the tax is based on a fixed amount per unit produced or as a percentage of the value of the minerals produced, then it will not meet the definition of an income tax under IAS 12. In these cases, the normal principles of liability recognition under IAS 37 apply in recognising the tax charge.

153 IASC Issues Paper, 1.27.

Another issue that arises is whether these taxes are, in effect, collected by the entity from customers on behalf of the taxing authority, as an agent. In other cases, the taxpayer's role is more in the nature of principal than agent. The regulations differ significantly from one country to another. The practical accounting issue that arises concerns the interpretation of the requirements of IFRS 15 which states that the "…transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes)". *[IFRS 15.47]*. Specifically, should excise duties, production taxes and severance taxes be deducted from revenue (net presentation) or included in the production costs and, therefore, revenue (gross presentation)? See section 12.11.2 above for further discussion on the impact of IFRS 15 on the presentation of royalty payments.

The appropriate accounting treatment will depend on the particular circumstances. In determining whether gross or net presentation is appropriate, the entity needs to consider whether it is acting in a manner similar to that of an agent or principal. For further discussion of principal versus agent under IFRS 15, see section 12.11 above and Chapter 28 at section 4.4 and presentation of royalties in section 5.7.5 above.

Given that excise duties, production taxes and severance taxes are aimed at taxing the production of minerals rather than the sale of minerals, they are considered to be a tax on extractive activities rather than a tax collected by a mining company or oil and gas company on behalf of the government. Based on this, the tax would be presented as a production cost.

However, it may be considered that when the excise duty, production tax or severance tax is payable in kind, that the mining company or oil and gas company never receives any of the benefits associated with the production of the associated minerals. Hence, it would be more appropriate to present revenue net of the production or severance tax as it is in substance the same as a royalty payment.

21.1.2 Petroleum revenue tax (or resource rent tax)

Determining whether a petroleum revenue tax (PRT) (or resource rent tax (RRT)) is a production- or profit-based tax is often not straightforward.

In some parts of the world the specific PRT or RRT that applies may be considered similar to an income tax in that the tax is a percentage of revenue minus certain costs. However, there are also a number of other features of a PRT or RRT that are not commonly found in income taxes or in some other resource rent taxes:

- There may be allowances, such as oil allowances, where there is a physical quantity of oil that is PRT exempt in each field, subject to a cumulative maximum over the life of the field.
- The tax may be levied on individual oil fields rather than the entity owning the oil field as a whole.

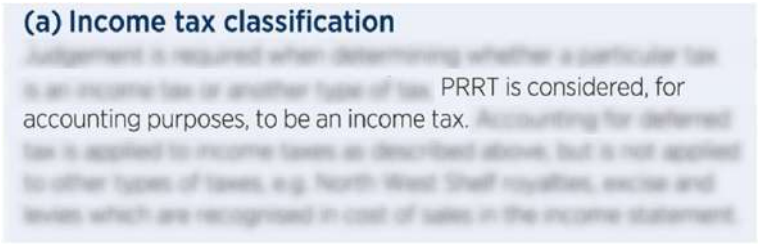
There are many different types of PRTs or RRTs around the world, some of which are clearly not income taxes, while others have some of the characteristics of an income tax. In determining whether a particular production tax meets the definition of an income tax under IAS 12, an entity will need to assess whether or not the tax is based on (or closely enough linked to) net profit for the period. If it does not meet the definition of an income tax, an entity must develop an accounting policy under the hierarchy in IAS 8.

Practice is mixed, which means that while some entities may treat a particular PRT or RRT as an income tax under IAS 12 and hence provide for current and deferred taxes (see Practical example 21-1 below), others may consider the same tax to be outside the scope of IAS 12.

Entities also need to consider whether there is any country specific legislation or accounting standard requirements that mandates whether a PRT or RRT is treated as an income tax. One example of this is in Australia where Petroleum Resource Rent Tax (PRRT) is required to be treated as an income tax.

Practical example 21-1: Woodside Energy Group Ltd (2022)	Australia

Annual Report 2022 [extract]
Notes to the financial statements [extract]
A. Earnings for the year [extract]
A.5 Taxes [extract]
Key estimates and judgements [extract]



(a) Income tax classification

PRRT is considered, for accounting purposes, to be an income tax.

As illustrated in Practical example 21-2 below, BHP Group Limited assesses resource rent taxes and royalties individually to determine whether they meet the definition of an income tax or not.

Practical example 21-2: BHP Group Limited (2022)	Australia

Annual Report 2022 [extract]
Financial Statements [extract]
1.6 Notes to the Financial Statements [extract]
Performance [extract]
6 Income tax expense [extract]
Recognition and measurement [extract]

Royalty-related taxation

Royalties are treated as taxation arrangements (impacting income tax expense/(benefit)) when they are imposed under government authority and the amount payable is calculated by reference to revenue derived (net of any allowable deductions) after adjustment for temporary differences. Obligations arising from royalty arrangements that do not satisfy these criteria are recognised as current liabilities and included in expenses.

21.2 Grossing up of notional quantities withheld

Many production sharing contracts provide that the income tax to which the contractor is subject is deemed to have been paid to the government as part of the payment of profit oil to the government or its representative (e.g., the designated national oil company) (see section 5.3 above). This raises the question as to whether an entity must be presenting current and deferred taxation arising from such 'notional' income tax, which is only deemed to have been paid, on a net or a gross basis.

Illustration 21-1: Grossing up of notional quantities withheld

Entity A is the operator of an oil field that produces 10 million barrels of oil per year. Under the production sharing contract between entity A and the national government, entity A and the government are entitled to 4,000,000 and 6,000,000 barrels of oil, respectively. The production sharing contract includes the following clause:

> 'The share of the profit petroleum to which the government is entitled in any calendar year in accordance with the production sharing contract shall be deemed to include a portion representing the corporate income tax imposed upon and due by entity A, and which will be paid directly by the government on behalf of entity A to the appropriate tax authorities.'

Assuming the following facts, how should entity A account for the income tax that it is deemed to have paid in 20X1:

- The normal corporate income tax rate in the country in which entity A operates is 40%
- Entity A made a net profit of CU30 million in 20X1

  And
- The average oil price during the year was CU50/barrel

Gross presentation

Entity A's profit after 40% corporate income tax was CU30 million. Therefore, its profit before tax would have been CU50 million (i.e., CU30 million ÷ (100% - 40%)). In other words, the government is deemed to have paid corporate income tax of CU20 million on behalf of entity A. Therefore, the government is deemed to have taken 400,000 barrels (i.e., CU20 million ÷ CU50/barrel) out of entity A's share of the production. Hence, entity A's share of production before corporate income tax was 4,400,000 barrels (i.e., 4,000,000 barrels + 400,000 barrels).

Net presentation

Under the net presentation approach, entity A ignores the corporate income tax that was deemed to have been paid by the government because it is not a transaction that entity A was party to *or* because the deemed transaction did not actually take place.

The disadvantage of presenting such tax on a gross basis is that the combined production attributed to the entity and that attributable to the government exceeds the total quantity of oil that is actually produced (i.e., in the above example the government and entity A would report a combined production of 10.4 million barrels whereas actual production was only 10 million barrels). Similarly, if the reserves were to be expressed on the same basis as revenues, the reserves reported by the entity would include oil reserves that it would not actually be entitled to.

On the other hand, if the host country has a well-established income tax regime that falls under the authority of the ministry of finance and the production sharing contract requires an income tax return to be filed, then the entity would have a legal liability to pay the tax until the date on which the national oil company or the ministry responsible for extractive activities (e.g., the ministry of mines, industry and energy) pays the tax on its behalf. In such cases, it may be appropriate to present revenue and income tax on a gross basis.

21.3 Deferred tax accounting for decommissioning obligations

In May 2021, the Board issued *Deferred Tax related to Assets and Liabilities arising from a Single Transaction - Amendments to* IAS 12. The Board amended IAS 12 to reduce diversity in the way that entities account for deferred tax on transactions and events, such as leases and decommissioning obligations, that lead to the initial recognition of both an asset and a liability. The amendments narrow the scope of the initial recognition exception under IAS 12, so that it no longer applies to transactions that give rise to equal taxable and deductible temporary differences.

How we see it

Entities in the extractive industries will need to consider the recoverability of any deferred tax asset recognised in relation to decommissioning obligations considering the long-dated nature of their projects.

The amendments also clarify that where payments that settle a liability are deductible for tax purposes, it is a matter of judgement (having considered the applicable tax law) whether such deductions are attributable for tax purposes to the liability recognised in the financial statements (and interest expense) or to the related asset component (and interest expense). This judgement is important in determining whether any temporary differences exist on initial recognition of the asset and liability.

For further discussion see Chapter 29 at section 7.3.1.

22 Events after the reporting period

22.1 Reserves proven after the reporting period

IAS 10 *Events after the Reporting Period* distinguishes between two types of events:

- Adjusting events after the reporting period being those that provide evidence of conditions that existed at the end of the reporting period.
- Non-adjusting events after the reporting period being those that are indicative of conditions that arose after the reporting period. *[IAS 10.3]*.

This raises the question as to how an entity should deal with information regarding mineral reserves that it obtains after the end of its reporting period, but before its financial statements are authorised for issue i.e., finalised. For example, suppose that an entity concludes after the year-end that its remaining mineral reserves at that date were not 10 million barrels (or tonnes) but only 8 million barrels (or tonnes). As discussed in section 16.1.3.A above, a company needs to assess whether such a change in mineral reserves is required to be treated as an adjusting event in accordance with IAS 10 (i.e., the new estimate provides evidence of conditions that existed previously) or as a change in estimate in accordance with IAS 8 (i.e., the new estimate resulted from new information or new developments).

22.2 Business combinations - application of the acquisition method

If the initial accounting for a business combination can be determined only provisionally by the end of the period in which the combination is effected - because either the fair values to be assigned to the acquiree's identifiable assets, liabilities or contingent liabilities or the fair value of the combination can be determined only provisionally - the acquirer would account for the combination using those provisional values. Where, as a result of completing the initial accounting within 12 months from the acquisition date, adjustments to the provisional values have been found to be necessary, IFRS 3 requires them to be recognised from the acquisition date. *[IFRS 3.45]*. Specifically, IFRS 3 states that the provisional values are to be retrospectively adjusted to reflect new information obtained about facts and circumstances that existed as at the acquisition date and, if known, would have affected the measurement of the amounts recognised as at that date. This raises the question of how an entity should account for new information that it receives regarding an acquiree's reserves before it has finalised its acquisition accounting.

Illustration 22-1: Acquisition of an entity that owns mineral reserves

Entity A acquires Entity B for CU27 million at 31 October 20X0. At the time it assigned the following fair values to the acquired net assets:

	CU million
Mineral reserves (assuming reserves of 10 million barrels)	10
Other net assets acquired	5
Goodwill	12
Consideration transferred	27

At 30 June 20X1, after conducting a drilling programme which commenced in March 20X1, Entity A obtains information about the reserves (as at 30 June 20X1), which when added to the production for the period (i.e., from 31 October 20X0 to 30 June 20X1) reveals that the mineral reserves at the date of acquisition were not 10 million barrels, as previously thought, but were only 8 million barrels.

Can Entity A revise its initial acquisition accounting to reflect the fact that the mineral reserves are only 8 million barrels, rather than 10 million?

The answer to this question is not straightforward and it is a matter of significant judgement which needs to be made based on the facts and circumstances of each individual situation.

IFRS 3 requires assets acquired and liabilities assumed to be measured at fair value as at the acquisition date. It then defines fair value as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. The challenge with the new information obtained about the mineral reserves in Illustration 22-1 above is determining whether it provided new information about facts and circumstances that existed as at the acquisition date or whether it resulted from events that occurred after the acquisition date. As discussed in section 16.1.3.A above, it is difficult to determine exactly what causes a reserve estimate to change, i.e., whether the facts and circumstances existed at acquisition date or whether it was due to new events.

In Illustration 22-1 above, the new reserves information arose as a result of a drilling programme that commenced five months after the acquisition date and it is not entirely clear why the reserves estimate changed. One may therefore conclude that as entity A should be valuing the mineral reserves acquired on the basis of information that a knowledgeable, willing party would and could reasonably have been expected to use in an arm's length transaction at 31 October 20X0, that this new information should not have an impact on the provisional accounting. This is on the basis that this new information was not available at acquisition date and could not reasonably have been expected to be considered as part of the acquisition.

Similarly, if entity A had concluded at 30 June 20X1 that its internal long-term oil price assumption was CU60/barrel instead of CU70/barrel that would not have any effect on the acquisition accounting. Entity A should be valuing the mineral reserves on the basis of information that a knowledgeable, willing party would have used in an arm's length transaction at 31 October 20X0; this may, of course, have been neither CU60/barrel nor CU70/barrel.

The conclusion may differ however, if the drilling programme had been completed and the information was available at acquisition date, but due to the pressures of completing the transaction, entity A had not been able to assess fully or take into account all of this information e.g., it had not had time to properly analyse all of the information available in the data room. In this instance, it would be appropriate to adjust the provisional accounting.

22.3 Completion of E&E activity after the reporting period

As discussed in section 3.5.1 above, IFRS 6 requires E&E assets to be tested for impairment when "exploration for and evaluation of mineral resources in the specific area have not led to the discovery of commercially viable quantities of mineral resources and the entity has decided to discontinue its activities in the specific area". *[IFRS 6.20]*. An entity that concludes, after its reporting period, that an exploration and evaluation project is unsuccessful, is required to account for this conclusion as:

- A *non-adjusting event* if the conclusion is indicative of conditions that arose after the reporting period, for example new information or new developments that did not offer greater clarity concerning the conditions that existed at the end of the reporting period (one possible example may be drilling that only commenced after reporting date). The new information or new developments are considered to be changes in accounting estimates under IAS 8. Also, based on the information that existed at the reporting period, the fair value less costs of disposal of the underlying E&E asset might well have been in excess of its carrying amount. *[IAS 8.5]*.
- An *adjusting event* if the decision not to sanction the project for development was based on information that existed at the reporting date. Failure to use, or misuse of, reliable information that was available when financial statements for those periods were authorised for issue and could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements, would constitute an error under IAS 8. *[IAS 8.5]*.

Evaluating whether information obtained subsequent to the reporting period but before the financial statements are authorised for issue is an adjusting or non-adjusting event may require significant judgement. The conditions are required to be carefully evaluated based on the facts and circumstances of each individual situation.

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Appendix B - Defined terms common in the Extractive Industries

The glossary below defines some of the terms and abbreviations commonly used in the extractive industries.[154]

Term / Abbreviation	Definition / Explanation
Abandon	To discontinue attempts to produce oil or gas from a well or lease, plug the reservoir in accordance with regulatory requirements and recover equipment.
Area-of-interest method	An accounting concept by which costs incurred for individual geological or geographical areas that have characteristics conducive to containing a mineral reserve are deferred as assets pending determination of whether commercial reserves are found. If the area of interest is found to contain commercial reserves, the accumulated costs are capitalised. If the area is found to contain no commercial reserves, the accumulated costs are charged to expense.
Barrels of oil equivalent (BOE)	Using prices or heating content, units of sulphur, condensate, natural gas and by products are converted to and expressed in equivalent barrels of oil for standard measurement purposes.
British Thermal Unit (BTU)	A measure of the amount of heat required to raise the temperature of one pound of water one degree Fahrenheit at the temperature at which water has its greatest density (39 degrees Fahrenheit).
Bullion	Metal in bars, ingots or other uncoined form.
Business	An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities. *[IFRS 3 Appendix A]*.
Carried interest	An agreement by which an entity that contracts to operate a mineral property and, therefore, agrees to incur exploration or development costs (the carrying party) is entitled to recover the costs incurred (and usually an amount in addition to actual costs incurred) before the entity that originally owned the mineral interest (the carried party) is entitled to share in revenues from production.
Carried party	The party for whom funds are advances in a carried interest arrangement.
Carrying party	The party advancing funds in a carried interest agreement.
Cash-generating unit	A cash-generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or group of assets. *[IAS 36.6]*.
Concession	A contract, similar to a mineral lease, under which the government owning mineral rights grants the concessionaire the right to explore, develop, and produce the minerals.
Corporate assets	Corporate assets are assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units. *[IAS 36.6]*.

154 IASC Issues Paper, Glossary of Terms.

Term / Abbreviation	Definition / Explanation
Cost	Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRS accounting standards, e.g., IFRS 2 *Share-based Payment*. *[IAS 16.6]*.
Cost recovery oil	Oil revenue paid to an operating entity to enable that entity to recover its operating costs and specified exploration and development costs from a specified percentage of oil revenues remaining after the royalty payment to the property owner.
Customer	A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration. *[IFRS 15 Appendix A]*.
Customer smelter	A smelter which processes concentrates from independent mines. Concentrates may be purchased or the smelter may be contracted to do the processing for the independent company.
Delay rental	Annual payments by the lessee of a mineral property to the lessor until drilling has begun.
Delineation well	A well to define, or delineate, the boundaries of a reservoir.
Development well	A well drilled to gain access to oil or gas classified as proved reserves.
Downstream activities	The refining, processing, marketing, and distributing of petroleum, natural gas, or mined mineral (other than refining or processing that is necessary to make the minerals that have been mined or extracted capable of being sold).
Dry gas	Natural gas composed of vapours without liquids and which tends not to liquefy.
Dry hole	An exploratory or development well that does not contain oil or gas in commercial quantities.
Entitlements method	A method of revenue recognition by which a joint venturer records revenue based on the share of production for the period to which that venturer is entitled.
Exploration and evaluation assets	Exploration and evaluation expenditures recognised as assets in accordance with the entity's accounting policy. *[IFRS 6 Appendix A]*.
Exploration and evaluation expenditures	Expenditures incurred by an entity in connection with the exploration for and evaluation of mineral resources before the technical feasibility and commercial viability of extracting a mineral resource are demonstrable. *[IFRS 6 Appendix A]*.
Exploration for and evaluation of mineral resources	The search for mineral resources, including minerals, oil, natural gas and similar non-regenerative resources after the entity has obtained legal rights to explore in a specific area, as well as the determination of the technical feasibility and commercial viability of extracting the mineral resource. *[IFRS 6 Appendix A]*.
Exploratory well	A well drilled to find and produce oil or gas in an unproved area, to find a new reservoir in a field previously found to be productive of oil or gas in another reservoir, or to extend a known reservoir.
Farm out and farm in	An agreement by which the owner of operating rights in a mineral property (the farmor) transfers a part of that interest to a second party (the farmee) in return for the latter's paying all of the costs, or only specified costs, to explore the property and perhaps to carry out part or all of the development of the property if reserves are found.

Term / Abbreviation	Definition / Explanation
Full cost method	An accounting concept by which all costs incurred in searching for, acquiring, and developing mineral reserves in a cost centre are capitalised, even though a specific cost clearly resulted from an effort that was a failure.
Geological and geophysical costs (G&G)	Costs of topographical, geological, geochemical, and geophysical studies.
Infill drilling	Technical and commercial analyses may support drilling additional producing wells to reduce the spacing beyond that utilised within the initial development plan. Infill drilling may have the combined effect of increasing recovery efficiency and accelerating production.
Joint control	The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control. *[IFRS 11 Appendix A]*.
Joint operating agreement (JOA)	A contract between two parties to a sharing arrangement that sets out the rights and obligations to operate the property if operating interests are owned by both parties after a sharing arrangement.
Joint operation	A joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement. *[IFRS 11 Appendix A]*.
Joint venture	A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. *[IFRS 11 Appendix A]*.
Lease	A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration. *[IFRS 16 Appendix A]*.
Over-lift or under-lift	Over-lift is the excess of the amount of production that a participant in a joint venture has taken as compared to that participant's proportionate share of ownership in total production. Under-lift is the shortfall in the amount of production that a participant in a joint venture has taken as compared to that participant's proportionate share of ownership in total production.
Production sharing contract (PSC)	A contract between a national oil company or the government of a host country and a contracting entity (contractor) to carry out oil and gas exploration and production activities in accordance with the terms of the contract, with the two parties sharing mineral output.
Profit oil	Revenue in excess of cost recovery oil and royalties.
Recompletion	The process of re-entering a previously completed well to install new equipment or to perform such services necessary to restore production.
Redetermination	A retroactive adjustment to the relative percentage interests of the participants in a field that is subject to a unitisation agreement.
Risk service contract	A contract by which an entity agrees to explore for, develop, and produce minerals on behalf of a host government in return for a fee paid by the host government.
Royalty	A portion of the proceeds from production, usually before deducting operating expenses, payable to a party having an interest in a lease.
Sales method	A method of revenue recognition by which a joint venturer records revenue based on the actual amount of product it has sold (or transferred downstream) during the period. No receivable or other

Term / Abbreviation	Definition / Explanation
	asset is recorded for undertaken production (underlift) and no liability is recorded for overtaken production (overlift).
Separate vehicle	A separately identifiable financial structure, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality. *[IFRS 11 Appendix A]*.
Stripping ratio	The ratio of tonnes removed as waste relative to the number of tonnes of ore removed from an open pit mine.
Subsidiary	An entity that is controlled by another entity. *[IFRS 10 Appendix A]*.
Successful efforts method	An accounting concept that capitalises only those upstream costs that lead directly to finding, acquiring and developing mineral reserves, while those costs that do not lead directly to finding, acquiring and developing mineral reserves are charged to expense.
Take-or-pay contracts	An agreement between a buyer and seller in which the buyer will still pay some amount even if the product or service is not provided. If the purchaser does not take the minimum quantity, payment is required for that minimum quantity at the contract price. Normally, deficiency amounts can be made up in future years if purchases are in excess of minimum amounts.
Unitisation	An agreement between two parties, each of which owns an interest in one or more mineral properties in an area, to cross-assign to one another a share of the interest in the mineral properties that each owns in the area; from that point forward they share, as agreed, in further costs and revenues related to the properties.
Upstream activities	Exploring for, finding, acquiring, and developing mineral reserves up to the point that the reserves are first capable of being sold or used, even if the entity intends to process them further.
Value in use	Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit. *[IAS 36.6]*.
Workovers	Major repairs, generally of oil and gas wells.

Chapter 40 Financial instruments: Introduction

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Overview

This chapter explains which standards contain the IASB's requirements for the recognition, measurement, presentation and disclosure of financial instruments and summarises information about their development and structure. The actual requirements of these standards are addressed in the subsequent ten chapters.

What you need to know

- For most entities' financial instruments, the relevant accounting standards are IAS 32 *Financial Instruments: Presentation*, IFRS 7 *Financial Instruments: Disclosures* and IFRS 9 *Financial Instruments*.
- Some entities, most commonly banks, continue to apply some, or all of, the hedge accounting requirements of IAS 39 *Financial Instruments: Recognition and Measurement* rather than those of IFRS 9.
- The most significant recent amendments to these standards address issues arising from IBOR Reform and the post-implementation review of IFRS 9's classification and measurement requirements.
- The IASB has a number of active and research projects on its agenda that could over the next several years change the accounting standards applying to financial instruments, for example those addressing power purchase agreements, financial instruments with the characteristics of equity, dynamic risk management and amortised cost measurement.

1 Standards applying to financial instruments

The subject matter of this and the next ten chapters is the recognition, measurement, presentation and disclosure of financial instruments, the IASB's accounting requirements for which are regarded by many as some of the more difficult to understand. There are many likely reasons for this, including the fact that it is such a broad topic encompassing some of the more complex contracts entities enter into. In addition, the requirements have been subject to a process of almost continual change over the last 20 years or so and are dealt with in a number of different standards and other pronouncements.

The following are the standards which deal primarily with the accounting for financial instruments:

- IAS 32
- IAS 39
- IFRS 7
- IFRS 9

In addition, a number of interpretations address the requirements of these standards, including:

- IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*
- IFRIC 16 *Hedges of a Net Investment in a Foreign Operation*
- IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*

Information about the development of the standards is set out in sections 2 to 5 below.

2 IAS 32

The original version of IAS 32 was published in March 1995. The presentation requirements of the standard were subject to significant review during 2002 and 2003, and a revised standard was published in December 2003. IFRS 7, which was published in August 2005, superseded the disclosure requirements in IAS 32 and the title of the latter standard was changed to reflect this. In February 2008, the IASB amended IAS 32 to change the classification of certain puttable financial instruments and instruments of limited life entities from liabilities to equity. Further amendments to IAS 32, designed to clarify its requirements for offsetting (or netting) of financial instruments (covered in Chapter 50 at section 7.4.1), were issued in December 2011 and numerous other amendments have been made throughout the life of the standard.

The IASB has for some time recognised that the classification of financial instruments as liabilities or equity in accordance with IAS 32 (covered in Chapter 43) presents many challenges and, in November 2023, published an exposure draft of proposed amendments to the standard. These aim to address some of the more common issues encountered in practice in this area, but it is intended that changes to classification outcomes will be limited, particularly to those shown to provide more useful information to users of financial statements. The exposure draft also develops certain presentation and disclosure proposals that were included in *Financial Instruments with Characteristics of Equity*, a discussion paper published in June 2018. The comment period for the exposure draft ended in March 2024 and, at the time of writing, the IASB is considering the feedback received.

3 IAS 39

IAS 39 was originally published in March 1999. Its origins could be found in US GAAP and at a high level there were only limited differences between the two systems. In particular, both adopted a similar 'mixed attribute' model whereby some financial instruments were measured by reference to their historical cost and some by reference to their fair value.

By dealing with most aspects of virtually all financial instruments, it was the longest, and by far the most complex, standard issued by the IASC which also established a process to develop and publish guidance in the form of Questions and Answers (Q&As). IAS 39, like IAS 32, was subject to significant review during 2002 and 2003 and a revised standard, incorporating most of the Q&As as implementation guidance, was published in December 2003.

Many other changes have been made to IAS 39 since its original publication, including amendments in March 2004 allowing the use of hedge accounting for certain portfolio (or macro) fair value hedges of interest rate risk. However, subject to limited exceptions, most of the requirements of IAS 39 are now superseded by or carried forward into IFRS 9. Those exceptions are:

- Any entity may continue applying the hedge accounting requirements of IAS 39 instead of those in IFRS 9 even after applying the rest of IFRS 9.

  And

- Any entity may apply the macro fair value hedge accounting requirements of IAS 39 for hedges of interest rate risk in addition to the hedge accounting requirements of IFRS 9.

In addition, entities using the IFRS for SMEs can for the time being, instead of applying the requirements set out in that standard, choose to apply the recognition and measurement provisions of IAS 39.

This publication reflects the reduced applicability of IAS 39 by covering its requirements only at a high level, although there are explanations in Chapter 49 at section 13 of the more important differences between hedge accounting under IAS 39 and IFRS 9. Entities' continued ability to apply the remaining parts of IAS 39 will depend on the outcome of the IASB's project addressing dynamic risk management activities (see section 5 below).

4 IFRS 7

A project principally focused on revising the then IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* evolved into a comprehensive review of all disclosure requirements related to financial instruments. This resulted in the publication of IFRS 7 in August 2005, superseding IAS 30 and the disclosure requirements in IAS 32.

IFRS 7 has been subject to a number of amendments since its publication. The requirements relating to liquidity risk were improved in the light of experience gained in the financial crisis; disclosures about transfers of financial assets were enhanced following an aborted attempt to revise the requirements addressing derecognition of financial assets; and disclosure requirements about offsetting and netting agreements were added. To complement the requirements in IFRS 9 addressing the classification and measurement of financial instruments, a significant number of amendments and additions were made to IFRS 7 setting out extensive disclosure requirements for impairments and hedge accounting.

More recently, disclosure requirements relating to IBOR Reform and to the changes to IFRS 9 published in May 2024 (see section 5 below) were added to the standard. IFRS 7 is addressed in Chapter 50.

5 IFRS 9

In April 2009, during the financial crisis, the IASB committed itself to a comprehensive review of IAS 39. The IASB's plan split this project into the following three phases, each of which would result in the publication of requirements replacing the corresponding parts of IAS 39:

- Classification of financial assets and financial liabilities
- Impairment and the effective interest method

  And
- Hedge accounting

IFRS 9, like IAS 39, contains a mixed attribute accounting model. Consequently, some instruments are measured at amortised cost and others at fair value. Similarly, certain gains and losses on remeasurement to fair value are recognised in profit or loss and some in other comprehensive income. The impairment requirements of IFRS 9 reflect an 'expected loss' approach which results in the earlier recognition of impairment losses compared to the 'incurred loss' model of IAS 39.

The hedge accounting phase of the project was designed to simplify hedge accounting, expand the relationships for which hedge accounting could be applied and align the accounting requirements more closely with entities' risk management practices. IFRS 9 does not itself address portfolio hedge accounting and, viewed in isolation, is less accommodating than IAS 39 in this respect. However, IFRS 9 does allow for the continued application of the portfolio fair value hedge accounting requirements of IAS 39 alongside its more general hedge accounting requirements. In addition, entities wishing to use the portfolio cash flow hedge accounting guidance in IAS 39 can continue applying the entirety of IAS 39's hedge accounting requirements, although none of the benefits of applying the hedge accounting requirements of IFRS 9 would then be available.

The IASB has for many years been working on a project which aims to eliminate any need for this continued application of IAS 39 (and also the so-called EU 'carve-out' - see Chapter 1 at section 4.2.1.A) and a discussion paper, *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging*, was published in April 2014. From this the IASB has developed and refined core areas central to an accounting model that it says might enable investors to understand the effect of a company's dynamic risk management. The IASB has started developing these areas into proposals to be published in an exposure draft, which at the time of writing is planned for publication in the first half of 2025. The hedge accounting requirements of IFRS 9 are covered in Chapter 49 which also highlights important differences between those requirements and those of IAS 39.

The first version of IFRS 9 was published in November 2009 with significant amendments following in October 2010 and November 2013 before it was substantially completed in July 2014. In October 2017, the IASB published limited amendments to the standard designed to address concerns about the classification of financial assets containing certain prepayment features.

Most entities were required to adopt IFRS 9 for periods commencing on or after 1 January 2018, with certain insurers being allowed to defer application until adoption of IFRS 17 *Insurance Contracts*, which was mandatory for periods commencing on or after 1 January 2023.

During the development of IFRS 9, the IASB worked closely with its counterparts at the FASB with the aim of aligning, as far as possible, the financial reporting requirements for financial instruments in accordance with IFRS and US GAAP. The measurement of fair values under the two bodies of GAAP is to a large extent the same and in June 2016 the FASB published a new standard requiring impairment of financial assets to be based on expected losses, although it is somewhat different to the approach in IFRS 9. The FASB has made various other amendments to US GAAP in recent years, but important differences remain in the areas of classifying and measuring financial instruments and hedge accounting and there are significant differences in other areas including the approach to offsetting financial assets and financial liabilities.

Many jurisdictions have now replaced or substantially finalised the replacement of interbank offered rates (IBORs) with alternative rates, the long-term viability of the former having been brought into question following the financial crisis. The IASB responded to these reforms in two phases. The first was designed to mitigate the effects of these reforms on hedge accounting in the period before financial instruments were issued or modified to reference these alternative rates. The second addressed changes made to contractual cash flows, including modifications of financial assets and financial liabilities, and to hedging relationships when an interest rate benchmark was replaced. As a result, IFRS 9 (and IAS 39) were amended in September 2019 and August 2020 and these amendments are addressed in *Supplement: IBOR Reform*.

The IASB conducts post-implementation reviews to assess the effects of new standards or major amendments to standards on investors, entities and auditors after the requirements have been widely applied for some time. The review of IFRS 9 has been divided into three phases, reflecting the way the standard was developed. In May 2024, following completion of the first phase (classification and measurement), the IASB issued amendments to IFRS 9, primarily designed to clarify how financial assets with contingent features (including ESG-linked instruments) and contractually linked instruments should be classified (which is covered in Chapter 44).

The IASB completed the second phase (impairment) of the post-implementation review of IFRS 9 in July 2024 and is expected to consider when to start its review of the hedge accounting requirements of IFRS 9 after it completes its work on power purchase agreements noted below. The review concluded that the impairment requirements in IFRS 9 are generally working as intended, although the IASB has added a research project to its pipeline to review matters relating to amortised cost measurement including modifications of financial assets and liabilities, derecognition and write-off of financial assets, the application of the effective interest method to floating rate financial instruments and the interaction of these areas. In addition, the IASB will investigate targeted improvements to the credit risk disclosure requirements in IFRS 7.

The IASB will sometimes consider amendments to standards to reflect emerging or other issues brought to its attention, often after referral from the IFRS IC. For example, the May 2024 amendments mentioned above also clarify how the derecognition requirements of IFRS 9 should be applied to financial assets and financial liabilities and create an exception to its general principles for certain electronic payment systems. Further information about electronic payments and derecognition of financial assets and financial liabilities is included in Chapter 48. In May 2024, the IASB also proposed amendments to IFRS 9 that address power purchase agreements. These would allow certain contracts for renewable electricity that might otherwise be within the scope of IFRS 9 to be accounted for as executory contracts; they would also relax the criteria for applying cash flow hedge accounting to make it easier for certain contracts for renewable electricity that are within the scope of IFRS 9 to be designated in such hedge relationships. Assessing whether contracts to purchase non-financial items such as power or renewable electricity are within the scope of IFRS 9 is covered in Chapter 41 and, as noted earlier, hedge accounting is covered in Chapter 49.

6 Structure and objectives of the standards

The main text of the standards is supplemented by application guidance (which is an integral part of each standard).[1] IAS 32 and IFRS 9 are each supplemented by illustrative examples and IFRS 7 and IFRS 9 by implementation guidance. These examples and implementation guidance accompany, but are not part of, the standards.[2]

The objective of IAS 32 is set out as: *[IAS 32.2]*

Extract from IAS 32

2 The objective of this Standard is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.

For IFRS 9 it is set out as: *[IFRS 9.1.1]*

Extract from IFRS 9

Chapter 1 Objective

1.1 The objective of this Standard is to establish principles for the financial reporting of *financial assets* and *financial liabilities* that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity's future cash flows.

Finally, the objective of IFRS 7 is set out as: *[IFRS 7.1]*

Extract from IFRS 7

1 The objective of this IFRS is to require entities to provide disclosures in their financial statements that enable users to evaluate:

(a) the significance of financial instruments for the entity's financial position and performance; and

(b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.

1 IAS 32, Application Guidance, para. before para. AG1, IFRS 7, Appendix B, Application guidance, para. after main heading, IFRS 9, Appendix B, Application guidance, para. after main heading.

2 IAS 32, Illustrative Examples, para. after main heading, IFRS 7, Guidance on implementing, para. after main heading and IFRS 9, Illustrative Examples, para. after main heading and Guidance on Implementing, para. before main heading Section A.

Chapter 41 Financial instruments: Definitions and scope

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Overview

The standards which address financial instruments are IAS 32 *Financial Instruments: Presentation*, IFRS 7 *Financial Instruments: Disclosures* and IFRS 9 *Financial Instruments*, which for most entities became effective for periods beginning on or after 1 January 2018 and replaced substantially all of the requirements relating to the recognition and measurement of financial instruments in IAS 39 *Financial Instruments: Recognition and Measurement*. Insurers that met specified criteria were permitted to continue with the application of IAS 39 for accounting periods that commenced before 1 January 2023. All insurers are required to apply IFRS 9 for periods that commenced on or after 1 January 2023. As set out in Chapter 49 at section 1.3, entities are permitted to elect an accounting policy choice to continue applying the hedge accounting requirements of IAS 39 instead of those in IFRS 9.

In many cases, it will be clear whether an asset, liability, equity instrument, or other similar instrument must be accounted for in accordance with one or more of these standards. However, at the margins, determining whether these standards must be applied is not so easy.

Firstly, one needs to determine whether the definition of a financial instrument is met; secondly, not all financial instruments are within the scope of each of these standards - some are within the scope of other standards and some are not within the scope of any standard; and finally, certain contracts that do not meet the definition of a financial instrument are within the scope of some of these standards.

In general, this chapter does not attempt to discuss differences between the IFRS and US GAAP guidance on this topic as the standards are not converged. Therefore, differences between IFRS and US GAAP could exist that are not discussed in this chapter.

What you need to know

This chapter addresses the definition and scope of financial instruments in three main sections covering the following broad areas:

- Application of the definitions used in IFRS, i.e., determining what a financial instrument actually is (see section 1 below).
- Determining which financial instruments are within the scope of which standards (see section 2 below).

  And
- Assessing whether a non-financial contract is to be accounted for as if it were a financial instrument (see section 3 below).

1 What is a financial instrument?

1.1 Definitions

The main terms used in the standards that apply to financial instruments are defined in IAS 32 as follows: *[IAS 32.11]*

Extract from IAS 32

11 The following terms are used in this Standard with the meanings specified:

A *financial instrument* is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

A *financial asset* is any asset that is:

(a) cash;

(b) an equity instrument of another entity;

(c) a contractual right:

(i) to receive cash or another financial asset from another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

(d) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

A *financial liability* is any liability that is:

(a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D.

An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

...

For the purpose of these definitions, 'entity' includes individuals, partnerships, incorporated bodies, trusts and government agencies. *[IAS 32.14]*.

1.2 Applying the definitions

1.2.1 The need for a contract

The terms 'contract' and 'contractual' are important to the definitions and refer to "an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law". Such contracts may take a variety of forms and need not be in writing. *[IAS 32.13]*.

Frequently asked questions

Question 1-1: What constitutes a contract in the context of gaming transactions?

The IFRS IC examined the question of what constitutes a contract in the context of gaming transactions. This is because, in some jurisdictions, a wager does not give rise to a contract that is enforceable under local contract law. The IFRS IC staff noted that a gaming transaction constitutes an agreement between two or more parties that has clear economic consequences for both. Furthermore, in most countries, gambling is heavily regulated and only parties acting within a regulated framework are licensed to operate gaming institutions, so that such entities cannot realistically fail to pay out on a good wager and therefore, the gaming institution will have little or no discretion as to whether it pays out on the bet. Consequently, the IFRS IC agreed that a wager should be treated as a contract.[1]

A contractual right or contractual obligation to receive, deliver or exchange financial instruments is itself a financial instrument. Additionally, a chain of contractual rights or contractual obligations meets the definition of a financial instrument if it will ultimately lead to the receipt or payment of cash or to the acquisition or issue of an equity instrument. *[IAS 32.AG7]*.

Assets and liabilities relating to non-contractual arrangements that arise as a result of statutory requirements imposed by governments, such as income taxes or levies are not financial liabilities or financial assets because they are not contractual. *[IAS 32.AG12]*. Accounting for income taxes is dealt with in more detail in another standard, IAS 12 *Income Taxes* (see Chapter 29), while levies are covered by IFRIC 21 *Levies* (see Chapter 27 at section 6.8).

Similarly, constructive obligations as defined in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (see Chapter 27 at section 3.1.1) do not arise from contracts and are therefore not financial liabilities. *[IAS 32.AG12]*.

1.2.2 Simple financial instruments

The most common and simplest form of financial instrument is cash. *[IAS 32.AG3]*.

Extract from IAS 32

AG3 Currency (cash) is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and recognised in financial statements. A deposit of cash with a bank or similar financial institution is a financial asset because it represents the contractual right of the depositor to obtain cash from the institution or to draw a cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability.

In addition to cash, the following common financial instruments give rise to financial assets representing a contractual right to receive cash in the future, and corresponding financial liabilities representing a contractual obligation to deliver cash in the future:

(a) Trade accounts receivable and payable

(b) Notes receivable and payable

(c) Loans receivable and payable

And

(d) Bonds receivable and payable

In each case, one party's contractual right to receive (or obligation to pay) cash is matched by the other party's corresponding obligation to pay (or right to receive). *[IAS 32.AG4]*.

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1 INFORMATION FOR OBSERVERS, IFRIC Meeting: May 2007, London, Project: *Gaming Transactions (Agenda Paper 11(i))*, IASB, paras. 25 -27; and *IFRIC Update*, July 2007. Available on the IFRS Foundation's website.
Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

Another type of financial instrument is one for which the economic benefit to be received or given up is a financial asset other than cash. For example, a note payable in government bonds gives the holder the contractual right to receive, and the issuer the contractual obligation to deliver, government bonds, not cash. The bonds are financial assets because they represent obligations of the issuing government to pay cash. Therefore, the note is a financial asset of the note holder and a financial liability of the note issuer. *[IAS 32.AG5]*.

Perpetual debt instruments (such as perpetual bonds, debentures and capital notes) normally provide the holder with the contractual right to receive payments on account of interest at fixed dates extending indefinitely, either with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the future. For example, an entity may issue a financial instrument requiring it to make annual payments in perpetuity equal to a stated interest rate of 8% applied to a stated par or principal amount of CU1,000. Assuming 8% is the market rate of interest for the instrument when issued, the issuer assumes a contractual obligation to make a stream of future interest payments having a net present value (or fair value) of CU1,000 on initial recognition. The holder and issuer of the instrument have a financial asset and a financial liability, respectively. *[IAS 32.AG6]*.

1.2.3 Contingent rights and obligations

The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute (as in the examples in section 1.2.2 above), or it may be contingent on the occurrence of a future event. A contingent right or obligation, e.g., to receive or deliver cash, meets the definition of a financial asset or a financial liability. *[IAS 32.AG8]*.

For example, a financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender, if the borrower defaults. The contractual right and obligation exist because of a past transaction or event (the assumption of the guarantee), even though the lender's ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on a future act of default by the borrower. *[IAS 32.AG8]*.

Illustration 1-1: Does contingent consideration arising from the sale of a business meet the definition of a financial instrument?

An entity sells its entire shareholding in a subsidiary to a third party. The terms of the arrangement require the buyer to transfer an additional amount of cash if a specified event occurs in the future. The question is whether the seller accounts for this contingent consideration as a financial instrument. The following three scenarios are considered.

Scenario 1

The additional consideration is contingent on the market price of the shares issued to affect the business combination. This share price-based contingency meets the definition of a financial asset and a derivative because the seller has a contractual right to receive an amount whose value changes in response to changes in the market price of the shares.

Scenario 2

The additional consideration is contingent on the acquiree maintaining or achieving specified earnings levels in future periods, such as revenue or EBITDA. This earnings-based contingency meets the definition of a financial asset as it represents a contractual right to receive cash or other financial assets. Whether it meets the definition of a derivative depends on whether the seller's accounting policy is to view revenue / EBITDA as a financial or non-financial variable (see Chapter 42 at section 1.1.3). If the seller's policy is to view the underlying earnings-based variable as a financial variable, then the contract meets the definition of a derivative. If the seller's policy is not to view the underlying earnings-based variable as a financial variable, then the contract does not currently meet the definition of a derivative, because the variable is specific to a party to the contract. In this case, it will still be accounted for at fair value through profit or loss as it will fail the 'contractual cash flow characteristics' test due to the linkage of the cash flows to the acquiree's earnings.

Scenario 3

The additional consideration is contingent on a favourable court ruling on a case initiated by the business prior to its sale, and all the proceeds will be passed to the seller. This legal contingency does not meet the definition of a derivative or a financial asset. Although a contract exists between the buyer and the seller, in this circumstance, the buyer is not exposed to any risks or rewards arising from the contract. Generally, the buyer acts as an agent for the seller and transfers any proceeds received from a favourable outcome in court to the seller. In the consolidated financial statements of the seller, the contract is not a derivative but a right to receive future contingent proceeds, which meets the definition of a contingent asset. Therefore, it must be accounted for in accordance with the requirements of IAS 37. Therefore, if the acquiree recognised such a contingent asset prior to the sale, and the buyer acts as an agent in a manner noted above, the seller would not derecognise the contingent asset in its consolidated financial statements at the time of the sale.

Even though contingent rights and obligations can meet the definition of a financial instrument, they are not always recognised in the financial statements as such. For example, contingent rights and obligations may be insurance contracts within the scope of IFRS 17 *Insurance Contracts* (see Chapter 51 at section 2.3 and section 3.7) or may otherwise be excluded from the scope of IFRS 9 (see section 2 below). *[IAS 32.AG8]*.

1.2.4 Leases

A lease typically creates an entitlement of the lessor to receive, and an obligation of the lessee to make, a stream of payments that are substantially the same as blended payments of principal and interest under a loan agreement. The lessor accounts for its investment in the amount receivable under a finance lease rather than the underlying asset itself. Accordingly, a lessor regards a finance lease as a financial instrument. In contrast, a lessor does not recognise its entitlement to receive lease payments under an operating lease. The lessor continues to account for the underlying asset itself rather than any amount receivable in the future under the contract. Accordingly, a lessor does not regard an operating lease as a financial instrument, except as regards individual payments currently due and payable by the lessee. *[IAS 32.AG9]*.

IFRS 16 *Leases* requires a lessee to recognise a lease liability (with a corresponding right-of-use asset) at the commencement date of the lease, at the present value of the lease payments that are not paid at that date. *[IFRS 16.22, IFRS 16.26]*. Accordingly, under IFRS 16, a lessee regards a lease as giving rise to a financial liability.

Nevertheless, as discussed in more detail in section 2.2 below, whilst leases can give rise to financial instruments for lessors and for lessees respectively, those financial instruments are not always accounted for under IFRS 9.

1.2.5 Non-financial assets and liabilities and contracts thereon

Physical assets (e.g., inventories, property, plant and equipment), right-of-use assets and intangible assets (e.g., patents and trademarks) are not financial assets. Control of such assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset. *[IAS 32.AG10]*. For example, whilst gold bullion is highly liquid (and perhaps more liquid than many financial instruments), it gives no contractual right to receive cash or another financial asset, and so is therefore a commodity, not a financial asset. *[IFRS 9.IG B.1]*.

Assets like prepaid expenses, for which the future economic benefit is the receipt of goods or services rather than the right to receive cash or another financial asset, are not financial assets. Similarly, items like deferred revenue and most warranty obligations are not financial liabilities, because the outflow of economic benefits associated with them is the delivery of goods and services rather than a contractual obligation to pay cash or another financial asset. *[IAS 32.AG11]*.

Contracts to buy or sell non-financial items do not meet the definition of a financial instrument because the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party, do not establish a present right or obligation of either party to receive, deliver or exchange a financial asset. For example, contracts that provide for settlement only by the receipt or delivery of a non-financial item (e.g., an option, future or forward contract on silver and many similar commodity contracts) are not financial instruments. However, as set out in section 3 below, certain contracts to buy or sell non-financial items that can be settled net or by exchanging financial instruments, or in which the non-financial item is readily convertible into cash are included within the scope of IAS 32 and IFRS 9 respectively, essentially because they exhibit similar characteristics to financial instruments. *[IAS 32.AG20]*.

Frequently asked questions

Question 1-2: Cash deposits in respect of returnable containers

In some industries, e.g., brewing and heating gas, entities distribute their products in returnable containers. Often, these entities will collect a cash deposit for each container delivered, which they have an obligation to refund on return of the container. The IFRS IC addressed the classification of these obligations in November 2007, in particular whether they meet the definition of a financial instrument.[2] It is easy to jump to the conclusion (as the IFRS IC did initially)[3] that such an arrangement represents a contract to exchange a non-financial item (the container) for cash and is therefore outside the scope of IFRS 9. However, the IFRS IC recognised that this analysis holds true only if, in accounting terms, the container ceases to be an asset of the seller when the sale is made, i.e., it is derecognised. If the container is not derecognised, the customer cannot be regarded as receiving the non-financial asset because the accounting treatment regards the seller as retaining the asset. Instead, the deposit represents an obligation for the seller to transfer cash and therefore, the seller classifies it as a financial liability.[4]

Some contracts are commodity-linked, but do not involve settlement through the physical receipt or delivery of a commodity. Instead, they specify settlement through cash payments that are determined according to a formula in the contract. For example, the principal amount of a bond may be calculated by applying the market price of oil prevailing at the maturity of the bond to a fixed quantity of oil, but is settled only in cash. Such a contract constitutes a financial instrument. *[IAS 32.AG22]*.

Financial instruments also include contracts that give rise to a non-financial asset or non-financial liability in addition to a financial asset or financial liability. Such arrangements often give one party an option to exchange a financial asset for a non-financial asset. For example, an oil-linked bond may give the holder the right to receive a stream of fixed periodic interest payments and a fixed amount of cash on maturity, with the option to exchange the principal amount for a fixed quantity of oil. The desirability of exercising this option will vary over time depending on the fair value of oil relative to the exchange ratio of cash for oil (the exchange price) inherent in the bond, but the intentions of the bondholder do not affect the substance of the component assets. The financial asset of the holder and the financial liability of the issuer make the bond a financial instrument, regardless of the other types of assets and liabilities also created. *[IAS 32.AG23]*.

1.2.6 Payments for goods and services

Where payment on a contract involving the receipt or delivery of physical assets is deferred past the date of transfer of the asset, a financial instrument arises at the date of transfer. In other words, the sale or purchase of goods on trade credit gives rise to a financial asset (a trade receivable) and a financial liability (a trade payable) when the goods are transferred. This is the case even if an invoice is not issued at the date of transfer. However, where required by IFRS 15 *Revenue from Contracts with Customers*, a financial instrument would arise at an earlier date. *[IAS 32.AG21]*.

IAS 32 does not explain whether the same logic should apply to the delivery of other, less tangible, non-financial items, e.g., construction or other services. IFRIC 12 *Service Concession Arrangements* provides guidance on how operators of service concessions over public infrastructure assets must account for these arrangements. Where an operator obtains an unconditional contractual right to receive cash from the grantor in exchange for construction or other services, the accrued revenue represents a financial asset. This is the case even if payment is not due immediately and even if it is contingent on the operator ensuring that the underlying infrastructure meets specified quality or efficiency requirements (see Chapter 26 at section 4.2). *[IFRIC 12.16]*.

2 INFORMATION FOR OBSERVERS, IFRIC Meeting: November 2007, London, Project: *Deposits on returnable containers (Agenda Paper 7B)*, IASB, paras. 1 and 2. Available on the IFRS Foundation's website.
Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

3 *IFRIC Update*, November 2007, available on the IFRS Foundation's website.
Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

4 *IFRIC Update*, May 2008, available on the IFRS Foundation's website.
Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

1.2.7 Equity instruments

Equity instruments include non-puttable ordinary shares, some puttable and similar instruments, some types of preference shares and warrants or written call options that allow the holder to subscribe for or purchase a fixed number of non-puttable ordinary shares in the issuing entity, in exchange for a fixed amount of cash or another financial asset. *[IAS 32.AG13]*. The definition of equity instruments is considered in more detail in Chapter 43 at section 4.1.

1.2.8 Derivative financial instruments

In addition to primary instruments such as receivables, payables and equity instruments, financial instruments also include derivatives such as financial options, futures and forwards, interest rate swaps and currency swaps. Derivatives normally transfer one or more of the financial risks inherent in an underlying primary instrument between the contracting parties without any need to transfer the underlying instruments themselves (either at inception of the contract or even, where cash settled, on termination). *[IAS 32.AG15, IAS 32.AG16]*.

There are important accounting consequences for financial instruments that are considered to be derivatives, and the defining characteristics of derivatives are covered in more detail in Chapter 42 at section 1.

As noted in section 1.2.5 above, certain derivative contracts on non-financial items are included within the scope of IAS 32 and IFRS 9, even though they are not, strictly, financial instruments as defined. These contracts are covered in more detail in section 3 below.

On inception, the terms of a derivative financial instrument generally give one party a contractual right (or obligation) to exchange financial assets or financial liabilities with another party under conditions that are potentially favourable (or unfavourable). Some instruments embody both a right and an obligation to make an exchange and, as prices in financial markets change, those terms may become either favourable or unfavourable. *[IAS 32.AG16]*.

A put or call option to exchange financial assets or financial liabilities gives the holder a right to obtain potential future economic benefits associated with changes in the fair value of the underlying instrument. Conversely, the writer of an option assumes an obligation to forgo such potential future economic benefits or bear potential losses associated with the underlying instrument. The contractual right (or obligation) of the holder (or writer) meets the definition of a financial asset (or liability). The financial instrument underlying an option contract could be any financial asset, including shares in other entities and interest-bearing instruments. An option may require the writer to issue a debt instrument, rather than transfer a financial asset, but the instrument underlying the option would constitute a financial asset of the holder if the option were exercised. The option-holder's right (or writer's obligation) to exchange the financial asset under potentially favourable (or unfavourable) conditions is distinct from the underlying financial asset to be exchanged upon exercise of the option. The nature of the holder's right and of the writer's obligation (which characterises such contracts as a financial instrument) are not affected by the likelihood that the option will be exercised. *[IAS 32.AG17]*.

Another common type of derivative is a forward contract. For example, consider a contract in which two parties (the seller and the purchaser) promise in six months' time to exchange CU1,000 cash (the purchaser will pay cash) for CU1,000 face amount of fixed rate government bonds (the seller will deliver the bonds). During those six months, both parties have a contractual right and a contractual obligation to exchange financial instruments (cash in exchange for bonds). If the market price of the government bonds rises above CU1,000, the conditions will be favourable to the purchaser and unfavourable to the seller, and *vice versa* if the market price falls below CU1,000. The purchaser has a contractual right (a financial asset) similar to the right under a call option held and a contractual obligation (a financial liability) similar to the obligation under a put option written. The seller has a contractual right (a financial asset) similar to the right under a put option held and a contractual obligation (a financial liability) similar to the obligation under a call option written. As with options, these contractual rights and obligations constitute financial assets and financial liabilities separate and distinct from the underlying financial instruments (the bonds and cash to be exchanged). Both parties to a forward contract have an obligation to perform at the agreed time, whereas performance under an option contract occurs only if and when the holder of the option chooses to exercise it. *[IAS 32.AG18]*.

Other types of derivative also embody a right or obligation to make a future exchange, including interest rate and currency swaps, interest rate caps, collars and floors, loan commitments, note issuance facilities and letters of credit. An interest rate swap contract can be seen as a variation of a forward contract in which the parties agree to make a series of future exchanges of cash amounts, one amount calculated with reference to a floating interest rate and the other with reference to a fixed interest rate. Futures contracts are another variation of forward contracts, with the primary difference being that futures contracts are standardised and traded on an exchange. *[IAS 32.AG19]*.

1.2.9 Dividends payable

As part of its project to provide authoritative accounting guidance for non-cash distributions (see Chapter 9 at section 2.4.2), the IFRS IC, in January 2008, found itself debating the seemingly simple question of how to account for a declared but unpaid cash dividend (or, more accurately, which standard applies to such a liability). Although there are clear indicators within IFRS accounting standards that an obligation to pay a cash dividend is a financial liability, *[IAS 32.AG13]*, the IFRS IC originally decided that it was appropriate to apply the principles in IAS 37 to all dividends payable, *[IFRIC 17.BC25],* a decision that appeared to have been made more on the grounds of expediency rather than using any robust technical analysis. By the time IFRIC 17 *Distributions of Non-cash Assets to Owners* was published in November 2008, the IFRS IC had modified its position slightly. Aside from standards dealing with the measurement of liabilities that are clearly not relevant (e.g., IAS 12), they considered that others, except IAS 37 or IFRS 9,[5] were not applicable because they addressed liabilities arising only from exchange transactions. *[IFRIC 17.BC22]*. IFRIC 17 specifies the accounting treatment to be applied to distributions without linking to any individual standard. *[IFRIC 17.BC27]*. The IFRS IC concluded that it was not appropriate to conclude that all dividends payable are to be regarded as financial liabilities.[6] Therefore, entities will have to exercise judgement to determine whether IAS 37 or IFRS 9 must be applied to declared but unpaid cash dividends.

1.2.10 Crypto-assets

Crypto-assets have diverse terms and conditions, and the purpose for holding them differs. As a result, the holders and issuers of crypto-assets will need to evaluate their own facts and circumstances in determining which IFRS accounting standards classification and measurement requirements need to be applied (see Chapter 18 at section 11.6). Generally, crypto-assets are not considered to be financial instruments, as in many cases, they do not give rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

It has been observed that certain crypto-assets may provide different rights to the holder, depending on facts and circumstances. For example, a holder of a crypto-asset may have a right to convert the crypto-asset into cash only if the holder has a bank account with a particular party. In such case, the same crypto asset may meet the definition of a financial asset for holders with a bank account but not for others.

The accounting for crypto-assets that meet the definition of intangible assets is discussed in Chapter 18 at section 11.6. For crypto-assets that are classified as inventories refer to Chapter 23 at section 2.3.1.F. The distinction between cryptocurrencies and Central Bank Digital Currencies, as well as considerations on whether these are considered to meet the definition of cash and cash equivalents is discussed in Chapter 36 at section 3.1.

5 Paragraph BC 22 of IFRIC 17 refers to IAS 39. For the purpose of this paragraph the reference to IAS 39 has been superseded by IFRS 9.

6 *IFRIC Update*, July 2008, available on the IFRS Foundation's website.
Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

2 Scope

IAS 32, IFRS 7 and IFRS 9 apply to the financial statements of all entities that are prepared in accordance with International Financial Reporting Standards. *[IAS 32.4, IFRS 7.3, IFRS 9.2.1]*. In other words, there are no exclusions from the presentation, recognition, measurement, or even the disclosure requirements of these standards based on the nature of the reporting entity, even for entities that do not have publicly traded securities or those that are subsidiaries of other entities.

The standards do not, however, apply to all of an entity's financial instruments, some of which are excluded from their scope, for example, insurance contracts (see Chapter 51). These exceptions are considered in more detail in sections 2.1 to 2.14 below. Conversely, certain contracts over non-financial items that behave in a similar way to financial instruments but do not actually fall within the definition - essentially some commodity contracts - are included within the scope of the standards and these are considered in section 3 below.

2.1 Subsidiaries, associates, joint ventures and similar investments

Most interests in subsidiaries, associates, and joint ventures that are consolidated or equity accounted in consolidated financial statements are outside the scope of IAS 32, IFRS 7 and IFRS 9. However, such instruments must be accounted for in accordance with IFRS 9 and disclosed in accordance with IFRS 7 in the following situations: *[IAS 32.4(a), IFRS 7.3(a), IFRS 9.2.1(a)]*

- In separate financial statements of the parent or investor if the entity chooses not to account for those investments at cost or using the equity method as described in IAS 28 *Investments in Associates and Joint Ventures* (see Chapter 9 at section 2). *[IAS 27.10, IAS 27.11, IAS 28.44]*.
- When investments in an associate or a joint venture held by a venture capital organisation, mutual fund, unit trust or similar entity are classified as financial instruments at fair value through profit or loss on initial recognition (see Chapter 12 at section 3.3). *[IAS 28.18]*. When an entity has an investment in an associate, a portion of which is held indirectly through a venture capital organisation, mutual fund, unit trust or similar entity including an investment-linked insurance fund, the entity may elect to measure that portion of the investment in the associate at fair value through profit or loss regardless of whether the venture capital organisation, mutual fund, unit trust or similar entity has significant influence over that portion of the investment. If the election is made, the equity method must be applied to any remaining portion of the investment. *[IAS 28.19]*.

  And

- An investment in a subsidiary by an investment entity that is measured at fair value through profit or loss using the investment entity exception (see Chapter 7 at section 2.2.3). *[IFRS 10.31]*.

In January 2013, the IFRS IC concluded that impairments of investments in subsidiaries, associates and joint ventures accounted for at cost in the separate financial statements of the investor are dealt with by IAS 36 *Impairment of Assets* - not IFRS 9.[7]

Frequently asked questions

Question 2-1: Which standard applies to impairment of long-term interests in an associate or joint venture that, in substance, form part of the net investment in the associate or joint venture?

Whilst the scope of IFRS 9 excludes interests in associates and joint ventures accounted for using the equity method, *[IFRS 9.2.1(a)]*, it was initially unclear whether the scope also excludes long-term interests in an associate or joint venture that, in substance, form part of the net investment in the associate or joint venture (see Chapter 12 at section 10.3). However, in October 2017, the IASB issued an amendment to IAS 28 clarifying that IFRS 9, including its impairment requirements, applies to the measurement of long-term interests in an associate or a joint venture that form part of the net investment in the associate or joint venture, but to which the equity method is not applied. *[IAS 28.14A]*.

IAS 32, IFRS 7 and IFRS 9 apply to most derivatives on interests in subsidiaries, associates and joint ventures, irrespective of how the investment is otherwise accounted for. However, IFRS 9 does not apply to instruments containing potential voting rights that, in substance, give access to the economic benefits arising from an ownership interest which is consolidated or equity accounted (see Chapter 8 at section 2.2, Chapter 12 at section 6.3.1 and Chapter 13 at section 4.2.2). *[IFRS 10.B91]*.

7 *IFRIC Update*, January 2013, available on the IFRS Foundation's website.
Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

From the perspective of an entity issuing derivatives, the requirements of IFRS 9 and IFRS 7 do not apply if such derivatives meet the definition of an equity instrument of the entity. *[IFRS 7.3(a), IFRS 9.2.1(a)]*. For example, a written call option allowing the holder to acquire a subsidiary's shares that can be settled only by delivering a fixed number of those shares in exchange for a fixed amount of cash might meet the definition of equity in the group's consolidated financial statements (see section 2.6 below and Chapter 43 at section 5.1).

Sometimes an entity will make a strategic investment in the equity of another party. These are often made with the intention of establishing or maintaining a long-term operating relationship with the investee. Unless they are equity accounted as associates or joint ventures, these investments are within the scope of IFRS 9. *[IFRS 9.B2.3]*.

2.2 Leases

Whilst all financial assets and liabilities arising from leases are within the scope of IAS 32 and IFRS 7, they are only within the scope of IFRS 9 to the following extent:

- Lease receivables and lease liabilities are subject to the derecognition provisions (see Chapter 48).
- Lease receivables are subject to the 'expected credit loss' requirements (see Chapter 47 at sections 5 and 10.2).

  And
- The relevant provisions that apply to derivatives embedded within leases (see Chapter 42 at section 4.3).

Otherwise the applicable standard is IFRS 16 (see Chapter 24), not IFRS 9. *[IFRS 9.2.1(b)]*.

In March 2022, the IFRS IC considered a rent concession in which a lessor legally released the lessee from its obligation to make specifically identified lease payments, some of which are amounts contractually due but not paid (which the lessor had recognised as an operating lease receivable).The IFRS IC concluded that, in the period before the rent concession is granted, the lessor measures expected credit losses on the operating lease receivable as required by IFRS 9, and must consider its expectations of forgiving lease payments recognised as part of that receivable. *[IFRS 9.5.5.17]*. Furthermore, the IFRS IC concluded that the derecognition requirements in IFRS 9 apply to forgiven lease payments that the lessor had included in an operating lease receivable on the date the rent concession is granted; and the lease modification requirements in IFRS 16 apply to forgiven lease payments that the lessor had not included in an operating lease receivable. This issue is discussed in more detail in Chapter 24 at section 6.5.2.

In July 2024, the IASB issued amendments to IFRS 9 related to derecognition of lease liabilities. Paragraph 2.1(b)(ii) of IFRS 9 has been amended by adding a cross-reference to paragraph 3.3.3 of IFRS 9 to resolve potential confusion for a lessee applying the derecognition requirements in IFRS 9. This is to clarify that, when a lease liability (or part of a lease liability) is extinguished or transferred to another party, the difference between the carrying amount and the consideration paid, including any non-cash assets transferred or liabilities assumed, is recognised in profit or loss. A lessee is required to apply this amendment for annual reporting periods beginning on or after 1 January 2026. Earlier application is permitted. This amendment does not address how a lessee distinguishes between a lease modification as defined in IFRS 16 and an extinguishment of a lease liability in accordance with IFRS 9. This is discussed further in chapter 24 at sections 5.5.4.C and 6.5.2.

2.3 Insurance and similar contracts

Although insurance contracts as defined in IFRS 17 often satisfy the definition of a financial instrument, they are generally excluded from the scope of IAS 32, IFRS 7 and IFRS 9. However, those standards apply to certain embedded derivatives (see section 2.3.3 below), investment components (see section 2.3.3 below), financial guarantee contracts (see section 2.4 below), rights and obligations that are financial instruments arising under credit card contracts (see section 2.3.4 below) and loan contracts that transfer significant insurance risk only on settlement the policyholder's obligation created by the contract (see section 2.3.5 below). *[IAS 32.4(d), IFRS 7.3(d), IFRS 9.2.1(e)]*. IFRS 17 is discussed in Chapter 51.

Extracts from IFRS 17

Appendix A
Defined terms

financial risk	The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.
insurance contract	A contract under which one party (the insurer or issuer) accepts significant **insurance risk** from another party (the **policyholder**) by agreeing to compensate the **policyholder** if a specified uncertain future event (the **insured event**) adversely affects the policyholder.
insurance risk	Risk, other than **financial risk**, transferred from the holder of a contract to the issuer

[IFRS 17 Appendix A].

In many cases, it will be quite clear whether a contract is an insurance contract or not, although this will not always be the case and IFRS 17 contains guidance on this definition (see Chapter 51 at section 3). *[IFRS 17.B2-B30]*.

The application guidance makes it clear that insurers' financial instruments that are not within the scope of IFRS 17 must be accounted for under IFRS 9. *[IFRS 9.B2.4]*.

2.3.1 Weather derivatives

Contracts which require a payment based on climatic variables (often referred to as 'weather derivatives') or on geological or other physical variables are within the scope of IFRS 9 unless they fall within the scope of IFRS 17. *[IFRS 9.B2.1]*. Generic or standardised contracts will rarely meet the definition of insurance contracts because the variable is unlikely to be specific to either party to the contract. *[IFRS 17.B26(k), IFRS 17.B27(g)]*. This is shown in the following Illustration.

Illustration 2-1: Rainfall contract - derivative financial instrument or insurance contract?

Company E has contracted to lease a stall at an open-air event from which it plans to sell goods to people attending the event. The event will be held at a village approximately 100 km from Capital City.

Because E is concerned that poor weather may deter people from attending the event, it enters into a contract with Financial Institution K, the terms of which are that, in return for a premium paid by E on inception of the contract, K will pay a fixed amount of money to E if, during the day of the event, it rains for more than three hours at the meteorological station in the centre of Capital City.

The non-financial variable in the contract, i.e., rainfall at the meteorological station, is not specific to E. E will only suffer loss as a result of rainfall at the village, not at Capital City. Also, because the potential payment to be received is for a fixed amount, it might not be possible to demonstrate that E has suffered a loss for which it has been compensated. Therefore, E must account for the contract as a financial instrument under IFRS 9.

2.3.2 Contracts with discretionary participation features

IFRS 17 is clear that investment contracts that have the legal form of an insurance contract but do not expose the insurer to significant insurance risk (see Chapters 51) are financial instruments and not insurance contracts. *[IFRS 17.B27(a)]*. Investment contracts (normally taking the form of life insurance policies) which contain what are called discretionary participation features, essentially rights of the holder to receive additional benefits whose amount or timing is, contractually, at the discretion of the issuer are accounted for under IFRS 17 if (and only if) the entity also issues insurance contracts, as the IASB believes that applying IFRS 17 to these contracts in these circumstances would provide more relevant information about the contracts than would be provided by applying other standards. *[IFRS 17.3(c), IFRS 17.BC65(a)]*. In rare cases, where an entity issues contracts with discretionary participation features but does not issue any insurance contracts, those contracts would fall within the scope of IAS 32 and IFRS 9.

If investment contracts with discretionary participation features are accounted for under IFRS 17, they would be outside the scope of IAS 32, IFRS 9 and IFRS 7. *[IAS 32.4(d), IFRS 9.2.1(e), IFRS 7.3(d)]*.

2.3.3 Separating financial instrument components including embedded derivatives from insurance contracts

IFRS 17 requires entities to apply IFRS 9 to determine whether a contract contains an embedded derivative to be separated and to apply IFRS 9 to those components that are separated. *[IFRS 9.2.1(e), IFRS 17.11(a)]*. IFRS 7 applies to all embedded derivatives that are separately accounted for. *[IFRS 7.3(d)]*.

IFRS 17 requires an entity to separate an investment component (amounts an insurance contract requires the entity to repay to the policyholder in all circumstances, regardless of whether an insured event occurs *[IFRS 17 Appendix A]*) from a host insurance contract if the component is 'distinct' (see Chapter 51 at section 5.2). The separated component is accounted for and disclosed in accordance with IFRS 9 and IFRS 7 unless it is an investment contract with discretionary participation features within the scope of IFRS 17. *[IFRS 7.3(d), IFRS 9.2.1(e), IFRS 17.11(b)]*.

2.3.4 Credit card contracts and similar arrangements which give rise to insurance risk

Credit card contracts or similar arrangements can in some circumstances meet the definition of an insurance contract. For example, some credit cards, charge cards, consumer financing and bank account contracts involve the lender providing guarantees to its customer in respect of products purchased using the arrangement. IFRS 17 excludes such contracts from its scope if, and only if, the entity does not reflect an assessment of the insurance risk associated with an individual customer in setting the price of the contract with that customer. If excluded from IFRS 17, these contracts would be within the scope of IFRS 9. However, if, and only if, the insurance coverage is a contractual term of such a financial instrument, the entity shall separate that component and apply IFRS 17 to it (see Chapter 51 at section 2.3.1.D). *[IFRS 17.7(h), IFRS 9.2.1(e)(iv)]*. Other IFRS accounting standards, such as IFRS 15 or IAS 37, might apply to other components of the contract, such as other service components or insurance components required by law or regulation. *[IFRS 17.BC94C]*.

2.3.5 Loan contracts that transfer significant insurance risk only on settlement of the policyholder's obligation created by the contract

Some contracts meet the definition of an insurance contract but limit the compensation for insured events to the amount otherwise required to settle the policyholder's obligation created by the contract. These might include loans with death waivers such as lifetime or equity release mortgages in which the borrower's obligation on death or incapacitation is limited to the value of the property on which the loan is secured. If such contracts are not otherwise excluded from the scope of IFRS 17, an entity can elect to apply either IFRS 17 or IFRS 9 to such contracts that it issues. The choice must be made for each portfolio of insurance contracts and the choice for such a portfolio is irrevocable (see Chapter 51 at section 2.3.3). *[IFRS 17.8A]*.

2.3.6 Amounts receivable from an intermediary

Most insurers use intermediaries as a link between them and a policyholder to arrange an insurance contract. In many of these arrangements, the policyholder pays the cash premiums to the intermediary but the contractual arrangement between the insurer and the intermediary allows the intermediary to pay the premiums to the insurer at a later date. In some situations, when the policyholder has paid the premiums to the intermediary, the policyholder has not discharged its obligation to the insurer. In other situations, when the policyholder has paid the premiums to the intermediary, the policyholder has discharged its obligation under the insurance contract and the insurer is obliged to provide insurance contract services to the policyholder. Normally, if the policyholder has discharged its obligation under the insurance contract and the intermediary fails to pay the premiums to the insurer, the insurer does not have the right to recover the premiums from the policyholder, or to cancel the insurance contract.

In situations when the policyholder has paid the premiums to the intermediary and has discharged its obligation under the insurance contract, the issue is whether the premiums receivable from the intermediary are future cash flows within the boundary of an insurance contract and included in the measurement of the group of insurance contracts applying IFRS 17 or are a separate financial asset applying IFRS 9. IFRS 17 is silent on whether future cash flows within the boundary of an insurance contract are removed from the measurement of a group of insurance contracts only when these cash flows are recovered or settled in cash. This matter was discussed by the IFRS IC in September 2023 which concluded that an insurer could determine that cash flows are removed from the measurement of a group of insurance contracts and accounted for under IFRS 9 either when the cash flows are recovered or settled in cash (View 1) or when the policyholder's obligation under the insurance contract is discharged (View 2). See Chapter 51 at section 9.12 for a detailed discussion.

2.4 Financial guarantee contracts

Where a contract meets the definition of a financial guarantee contract (see section 2.4.1 below), the issuer is normally required to apply specific accounting requirements within IFRS 9, which are different from those that apply to other financial liabilities. Usually, the contract is measured at fair value on initial recognition and subsequently at the higher of the amount of the loss allowance determined in accordance with the impairment requirements of IFRS 9 (see Chapter 47 at section 11.2) and the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15 (see Chapter 46 at section 2.8). *[IFRS 9.4.2.1]*. There are exceptions to this general requirement and these are dealt with in section 2.4.2 below.

2.4.1 Definition of a financial guarantee contract

Extract from IFRS 9

Appendix A
Defined terms

financial guarantee contract	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

[IFRS 9 Appendix A].

2.4.1.A Reimbursement for loss incurred

Some credit-related guarantees (or letters of credit, credit derivative default contracts or credit insurance contracts) do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index. Such guarantees are not financial guarantee contracts, as defined in IFRS 9, nor are they insurance contracts within the scope of IFRS 17. Rather, they are derivatives and accordingly fall within the scope of IFRS 9. *[IFRS 9.B2.5(b), IFRS 17.B27(f), IFRS 17.B30]*.

When a debtor defaults on a guaranteed loan a significant time period may elapse prior to full and final legal settlement of the loss. Because of this, certain credit protection contracts provide for the guarantor to make a payment at a fixed point after the default event using the best estimate of loss at the time. Such payments typically terminate the credit protection contract with no party having any further claim under it whilst ownership of the loan remains with the guaranteed party. In situations like this, if the final loss on the debtor exceeds the amount estimated on payment of the guarantee, the guaranteed party will suffer an overall financial loss; conversely, the guaranteed party may receive a payment under the guarantee but eventually suffer a smaller loss on the loan. Therefore, such a contract will often not meet the essence of the definition of a financial guarantee. However, if the payment is designed to be a reasonable estimate of the loss actually incurred, such a feature (which is common in many conventional insurance contracts) will sometimes allow the contract to be classified as a financial guarantee contract. This will particularly be the case if such payments are agreed by both parties in order to settle the financial guarantee, as opposed to being specified as part of the original contract.

Also, such a contract is likely to meet the definition of a guarantee if it was structured in either of the following ways:

- The contract requires the guarantor to purchase the defaulted loan for its nominal amount.

  Or

- On settlement of the final loss, the contract provides for a further payment between the guarantor and guaranteed party for any difference between that amount and the initial loss estimate that was paid.

However, if there are circumstances in which the holder of the guarantee could be reimbursed for a loss that it has not incurred, for example where the guarantee is traded separately from the underlying debt and the holder could have acquired it without owning the underlying debt instrument, the guarantee does not meet the definition of a financial guarantee contract.

2.4.1.B Debt instrument

Although the term 'debt instrument' is used extensively as a fundamental part of the definition of a 'financial guarantee contract', it is not defined within the financial instruments or insurance accounting standards.

The term 'debt instrument' will typically be considered to include trade debts, overdrafts and other borrowings, including mortgage loans and certain debt securities. Entities often provide guarantees of payments due with respect to other items and determining whether they are consistent with the definition of a 'financial guarantee contract' may not be straightforward. For example, there may be instances where a guarantee is issued over an exposure which will only crystalise at a future date. An example is a guarantee issued over an executory contract that is outside the scope of IFRS 9. Another example is a guarantee over a debt instrument that may arise from a currently undrawn loan commitment, if the loan is drawn at a future date. The issue is whether these guarantees are issued over debt instruments.

The IFRS IC received a request in 2024 about how an entity accounts for guarantees that it issues. The request described three fact patterns in the context of an entity's separate financial statements. In the fact patterns, an entity issues several types of contractual guarantees on obligations of a joint venture. As part of the analysis, the IFRS IC noted that the IASB, at its April 2024 meeting, discussed diversity in practice in the interpretation of the term 'debt instrument' in the definition of a financial guarantee contract. The IASB decided to consider during its next agenda consultation the broader application questions related to financial guarantee contracts, including about the meaning of the term 'debt instrument' in the definition of a financial guarantee contract. In September 2024, the IFRS IC tentatively concluded that an entity applies judgement in interpreting the meaning of the term 'debt instrument' when determining whether a guarantee is accounted for as a financial guarantee contract.[8]

How we see it

IFRS 9 does not explicitly require the debt instrument to exist when the guarantee is issued. If the guarantee covers losses incurred due to failure to make specified payments by a specified debtor for amounts that are due and payable at the point of the guarantee being called, we believe the guarantee is over a debt instrument. As such, these types of guarantees would be financial guarantees if all other criteria for financial guarantees are met.

Illustration 2-2: Guarantee issued over a lessor's receipts under a lease contract

Entity A leases an asset to Entity B. Entity A is concerned about the credit risk that may arise for lease payments that become payable over the lease term. Entity C, an unrelated third party to Entity A and Entity B, issues a guarantee to reimburse Entity A for losses that Entity A may incur for non-payment of amounts due and payable under the lease agreement. For this guarantee to be considered a financial guarantee, the guarantee must relate to losses arising from a debt instrument.

If the lease is classified as a finance lease, the guarantee issued by Entity C is considered a financial guarantee since a finance lease, in substance, gives rise to a loan agreement (see section 1.2.4 above).

If the lease is classified as an operating lease, lease payments are only recognised by Entity A as financial instruments, hence a debt instrument, when they are due. The issue is whether a guarantee over future debt instruments would be considered a financial guarantee when it is issued. As discussed in section 2.4.1.B above, IFRS 9 does not explicitly require the debt instrument to exist when the guarantee is issued. If the guarantee covers losses incurred due to non-payment by a specified debtor for amounts that are due and payable at the point of the guarantee being called, we believe that the guarantee is over a debt instrument. Therefore, the guarantee issued by Entity C would be considered a financial guarantee, since it only covers losses for amounts that are due at the time of the guarantee being called.

8 Guarantees Issued on Obligations of Other Entities; IFRIC update September 2024; agenda paper 2

An additional complexity arises in respect of guarantees issued over derivative contracts. In such contracts, the issuer agrees to compensate the holder for losses incurred by the holder due to a default event on a derivative contract that the holder is a party to. For such guarantees, it is important to consider whether the guaranteed amount can be considered a debt instrument and whether the guarantee gives rise to 'specified payments'. There are two broad views. Those who hold the view that the guaranteed amount is a debt instrument argue that if such a guarantee covers losses due to non-payment of amounts under a derivative contract that crystalise upon default, it is a guarantee over a debt instrument and it does give rise to 'specified payments'. They argue that the payments are specified when it matters, i.e., when the guarantee is triggered. Those who argue that the guaranteed amount is not a debt instrument argue that a guarantee over a derivative cannot be a financial guarantee contract because the nature of the derivative exposure is transferring broader market risks which are inconsistent with the definition of a 'debt instrument'. In September 2023, the IFRS IC considered this question. However, its findings indicated that the issue does not have widespread effects and it does not have (and nor is it expected to have) a material effect on those affected. Consequently, the IFRS IC decided not to add a standard-setting project to the work plan and it did not conclude on the matter in an agenda decision.

How we see it

In the absence of specific guidance in IFRS accounting standards, we believe that an entity has an accounting policy choice to account for a guarantee over a derivative as either a financial guarantee contract or not. This policy must be applied consistently.

Should one conclude that such a guarantee does not meet the definition of a financial guarantee contract, one must still examine how the related obligations under the contract should be accounted for. This could be either as a derivative financial instrument (accounted for at fair value through profit or loss under IFRS 9) or as an insurance contract (accounted for under IFRS 17). This analysis depends on whether the risk transferred by the guarantee (primarily credit risk) is considered a financial risk or an insurance risk (see section 2.3 above). Other types of guarantees have similar complications - for example guarantees of pension plan contributions to funded defined benefit schemes. Where such a guarantee is in respect of discrete identifiable payments, the analysis above is equally applicable.

2.4.1.C Form and existence of contract

The application guidance to IFRS 9 emphasises that, whilst financial guarantee contracts may have various legal forms (such as guarantees, some types of letters of credit, credit default contracts or insurance contracts), their accounting treatment does not depend on their legal form. *[IFRS 9.B2.5]*.

In some cases, guarantees arise, directly or indirectly, as a result of the operation of statute or regulation. In such situations, it is necessary to examine whether the arrangement gives rise to a contract as that term is used in IAS 32. For example, in some jurisdictions, a subsidiary may avoid filing its financial statements or having them audited if its parent and fellow subsidiaries guarantee its liabilities by entering into a deed of cross guarantee. In other jurisdictions, similar relief is granted if group companies elect to make a statutory declaration of guarantee. In the first situation, it would seem appropriate for the issuer to regard the deed as a contract and hence, any guarantee made under it would be within the scope of IFRS 9. The statutory nature of the declaration in the second situation makes the analysis more difficult. Although the substance of the arrangement is little different from the first situation, statutory obligations are not financial liabilities and are therefore outside the scope of IFRS 9.

2.4.2 Issuers of financial guarantee contracts

In general, issuers of financial guarantees contracts must apply IAS 32, IFRS 9 and IFRS 7 to those contracts even though they meet the definition of an insurance contract in IFRS 17 if the risk transferred is significant. *[IFRS 9.B2.5(a)]*. However, if an entity has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either IFRS 9 or IFRS 17 (see Chapter 51 at section 2.3.1.B). That election may be made contract by contract, but the election for each contract is irrevocable. *[IAS 32.4(d), IFRS 7.3(d), IFRS 9.2.1(e), IFRS 17.7(e)]*. This concession does not extend to contracts that are similar to financial guarantee contracts but are actually derivative financial instruments (see section 2.4.1.A above).

The IASB was concerned that entities other than credit insurers could elect to apply IFRS 4 *Insurance Contracts* (the preceding insurance standard to IFRS 17) to financial guarantee contracts and consequently (if their accounting policies permitted) recognise no liability on inception. Therefore, it imposed the restrictions outlined in the previous paragraph. *[IFRS 9.BCZ2.12]*. The application guidance to IFRS 9 states that assertions that an issuer regards contracts as insurance contracts are typically found throughout the issuer's communications with customers and regulators, contracts, business documentation as well as in their financial statements. Furthermore, insurance contracts are often subject to accounting requirements that are distinct from the requirements for other types of transactions, such as contracts issued by banks or commercial companies. In such cases, an issuer's financial statements would typically include a statement that the issuer had used those accounting requirements, i.e., ones normally applied to insurance contracts. *[IFRS 9.B2.6]*. This option had been intended as a temporary solution, pending the publication of IFRS 17. However, the Board decided to carry forward to IFRS 17 the option to account for a financial guarantee contract as if it were an insurance contract, without any substantive changes, because the option has worked in practice and results in consistent accounting for economically similar contracts issued by the same entity. *[IFRS 17.BC93]*.

Accounting for the revenue associated with financial guarantee contracts issued in connection with the sale of goods is dealt with under IFRS 15 (see Chapter 28). *[IFRS 9.B2.5(c)]*.

2.4.3 Holders of financial guarantee contracts

Financial guarantee contracts held are not within the scope of IFRS 9 because they are insurance contracts (see section 2.3 above). *[IFRS 9.2.1(e)]*. However, IFRS 17 does not apply to insurance contracts that an entity holds (other than reinsurance contracts held) either. *[IFRS 17.7(g)]*. Therefore, financial guarantee contracts held by an entity are not required to be recognised separately by IFRS 9 or IFRS 17.

For the purposes of measuring ECL, IFRS 9 requires the estimate of expected cash shortfalls to reflect the cash flows expected from collateral and other credit enhancements that are part of the contractual terms and are not recognised separately by the entity. *[IFRS 9.B5.5.55]*. This means that a financial guarantee contract held which is considered to be an integral component of the guaranteed debt instrument will be accounted for as part of the ECL on that debt instrument (see Chapter 47 at section 5.8.1).

However, the holder of a financial guarantee contract which is not considered to be integral to the underlying debt instrument will need to develop an accounting policy in accordance with the 'hierarchy' in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The IAS 8 hierarchy specifies criteria to use if no IFRS accounting standard applies specifically (see Chapter 3 at section 4). *[IFRS 17.BC66]*.

How we see it

In developing a policy for a financial guarantee contract which is not considered integral to the underlying debt instrument, entities could look to the requirements of IAS 37 dealing with contingent assets (see Chapter 27 at section 3.2.2) or reimbursement assets (see Chapter 47 at section 5.8.1.B), at least as far as recoveries under the contract are concerned. In certain situations, it could also be appropriate for the holder of a financial guarantee contract to account for it as an asset at fair value through profit or loss. This might be the case if the guaranteed asset has itself been classified as at fair value through profit or loss.

2.4.4 Financial guarantee contracts between entities under common control

There is no exemption from the measurement requirements of IFRS 9 for guarantees issued between parents and their subsidiaries, between entities under common control nor by a parent or subsidiary on behalf of a subsidiary or a parent (unlike an exemption under US GAAP). *[IFRS 9.BCZ2.14]*.

Therefore, for example, where a parent guarantees the borrowings of a subsidiary, the guarantee must be accounted for as a standalone instrument in the parent's separate financial statements. However, for the purposes of the parent's consolidated financial statements, such guarantees are normally considered an integral part of the terms of the borrowing (see Chapter 43 at section 4.8) and therefore must not be recognised independently of the borrowing.

2.5 Loan commitments

Loan commitments are firm commitments to provide credit under pre-specified terms and conditions. *[IFRS 9.BCZ2.2]*. The term can include arrangements such as offers to individuals in respect of residential mortgage loans as well as committed borrowing facilities granted to a corporate entity. The definition of a loan commitment requires that the terms and conditions are pre-specified. As such, all the terms and conditions do not need to be fixed but rather they need to be specified at the time when the commitment is entered into. For example, a commitment to provide a loan with a variable interest rate could meet the definition of a loan commitment.

A loan commitment meets the definition of a derivative financial instrument since it represents a written option for the potential borrower to obtain a loan at a specified rate (see section 1.2.8 above and Chapter 42 at section 1). *[IFRS 9.BCZ2.2]*. However, a pragmatic decision has been taken by the IASB to simplify the accounting for holders and issuers of many loan commitments. *[IFRS 9.BCZ2.3]*. Accordingly, loan commitments that cannot be settled net - in practice, most loan commitments - may be excluded from the scope of IFRS 9, with the exception of the impairment requirements and derecognition provisions (see Chapters 47 and 48), but are included within the scope of IFRS 7. *[IFRS 9.2.1(g), IFRS 7.4]*.

How we see it

Although a loan commitment represents a written option to provide credit to the holder of the commitment, we believe it is appropriate to apply the exclusion from IFRS 9 to non-optional loan commitments provided the necessary conditions above are met. An example of a non-optional loan commitment is where the holder is contractually obligated to take out credit at a future date.

However, the exclusion is available only for firm commitments to provide credit and therefore, it will be applicable only where there is a commitment to lend funds. *[IFRS 9.BCZ2.2]*. Consider, for example, a contract between entities A and B that gives B the right to sell a transferable (but unquoted) debt security to A issued by entity C that B currently owns. Even if, on subsequent acquisition, A will measure the debt security at amortised cost or fair value through other comprehensive income, the contract would not be considered a loan commitment as it does not involve A providing credit to B.

Some loan commitments, however, are within the scope of IFRS 9, namely: *[IFRS 9.2.1(g)]*

- Those that are designated as financial liabilities at fair value through profit or loss (this could be appropriate if the associated risk exposures are managed on a fair value basis or because designation eliminates an accounting mismatch) *[IFRS 9.2.3(a), IFRS 9.4.2.2]*.
- Commitments that can be settled net in cash or by delivering or issuing another financial instrument *[IFRS 9.2.3(b)]*.
- All those within the same class where the entity has a past practice of selling the assets resulting from its loan commitments shortly after origination. The IASB sees this as achieving net settlement *[IFRS 9.2.3(a)]*.

  And
- Commitments to provide a loan at a below-market interest rate (see Chapter 45 Illustration 3-1) *[IFRS 9.2.3(c)]*.

For loan commitments at a below-market interest rate, IFRS 9 contains specific measurement requirements which are different from those applying to other financial liabilities. IFRS 9 requires the commitments to be measured at fair value on initial recognition and subsequently amortised to profit or loss using the principles of IFRS 15 (see Chapter 28) but requires the expected credit loss allowance to be used, if higher. *[IFRS 9.4.2.1(d)]*. The reason for this accounting treatment is that the IASB was concerned that liabilities resulting from such commitments might not be recognised in the statement of financial position because, often, no cash consideration is received. *[IFRS 9.BCZ2.7]*.

IFRS 9 contains only limited guidance on what 'net settlement' means in respect of commitments that can be settled net in cash. Clearly a fixed interest rate loan commitment that gives the lender and/or the borrower an explicit right to settle the value of the contract (taking into account changes in interest rates etc.) in cash or by delivery or issuing another financial instrument would be considered a form of net settlement and therefore a derivative. However, paying out a loan in instalments (for example, a mortgage construction loan where instalments are paid out in line with the progress of construction) is not regarded as net settlement. *[IFRS 9.2.3(b)]*. Most loan commitments could be settled net by renegotiating the terms of the contract. However, of more relevance is the question of whether one party has the practical ability to settle net, e.g., because the terms of the contract allow net settlement or by the use of some market mechanism.

Illustration 2-3: Is a loan commitment to a special purpose entity (SPE) scoped out of IFRS 9 if the substance of the arrangement is different from a normal loan commitment?

Paragraphs 2.1(g) and 2.3 of IFRS 9 scope out some loan commitments from IFRS 9, although they indicate that such loan commitments are still covered by the impairment and derecognition requirements of the standard. The guidance provided in IFRS 9.2.3 seems to focus on straight forward loan commitments to entities with a genuine business activity, which are normally provided on the basis that the borrower meets certain conditions precedent prior to drawing. This raises the question of whether a loan commitment to an SPE, even if it meets the scope exception criteria, should indeed be scoped out of IFRS 9 if the substance of the arrangement is different from a normal loan commitment.

In practice, the following three scenarios can be found when a loan commitment has been provided to an SPE that is not consolidated by the entity providing the loan commitment. The question is if these loan commitments must be accounted for under IFRS 9 and measured at fair value through profit or loss, or if they are subject only to the impairment and derecognition requirements of IFRS 9.

Scenario 1

An SPE has been established to act as the counterparty to a single derivative trade. The SPE will operate on autopilot and the loan commitment will be drawn upon in the event there is a payment due under the terms of the derivative (with the premium on the derivative being passed to the facility provider as the commitment fee).

Scenario 2

An SPE has been established to invest in a diversified portfolio of highly liquid instruments. Funding will be provided to the SPE through subordinated loan notes, other loan financing and repurchase agreements. The SPE will also enter into a revolving or static loan commitment with a bank; the primary purpose being to fund its liquidity needs. When the SPE is unable to finance its operations through its current financing arrangements it will draw on the loan commitment. This will be at the discretion of the SPE.

Scenario 3

Similar to the situation outlined in scenario 2, but the liquidity facility also supports the 'first loss' of the SPE so that when there is a credit event or credit downgrade within the SPE, the loan commitment will be drawn upon to fund the losses.

Conclusion

Consideration will need to be given to the nature and exact terms of the loan commitment. It is important to emphasise that loan commitments on standard market terms will normally be provided on the basis that the borrower meets certain conditions precedent prior to drawing. In particular, lenders will often withdraw the loan commitments in the event there is a significant decline in the borrower's credit rating.

In scenarios 1 and 3 above, the loan commitment provided to the SPE is akin to an equity instrument as it will absorb the first loss of the vehicle. Whilst it is not explicitly stated in IFRS 9 or the Basis for Conclusions, we do not believe that the Board would have considered a standard market loan commitment to include these and similar facilities. Therefore, a loan facility provided to an SPE must be excluded from the scope of IFRS 9 if, under normal operating conditions, it would be highly probable that the loan would be repaid if drawn. In other words, loan commitments that are structured to give rise to an exposure that in substance is another financial instrument, such as equity, need to be scoped into IFRS 9. This assessment must be made when an entity becomes a party to the loan commitment. It does not need to be reassessed subsequently. Applying this to each of the three scenarios:

Scenario 1

The commitment meets the definition of a loan commitment and does not meet the criteria of IFRS 9.2.3 to be scoped within IFRS 9. However, as the SPE only holds one asset - the derivative - and it is prohibited from owning any other assets, in substance, the transaction is the same as if the counterparty had entered into a normal market credit derivative. We do not consider that this was the type of transaction the Board envisioned when drafting the scope exemption and therefore it must be accounted for under IFRS 9 as a derivative.

Scenario 2

So long as the facility will be drawn to meet the financing requirements of the SPE and at the inception of the commitment there was an expectation that there was a high probability that the funds will be re-paid by the SPE, it would be excluded from the scope of IFRS 9. However, to carry out the assessment, it will be important to perform a detailed review of the origination documents to understand the exact terms and conditions of the facility.

Scenario 3

The facility will only be drawn when there is a credit event or downgrade, with the probability being that the funds will not be returned to the finance provider. Therefore, we consider this must be included in the scope of IFRS 9 and accounted for as a derivative, even though it might not meet the criteria of IFRS 9.2.3 to be scoped into IFRS 9. *[IFRS 9.2.1(g), IFRS 9.2.3]*.

Where the entity has a past practice of selling the assets shortly after origination, no guidance is given on what is meant by a class (although the Basis for Conclusions makes it clear that an entity can have more than one). *[IFRS 9.BCZ2.6]*. Therefore, an assessment will need to be made based on individual circumstances.

Illustration 2-4: Identifying classes of loan commitment

A banking group has two main operating subsidiaries, one in country A and the other in country B. Although they share common functions (e.g., information systems) the two subsidiaries' operations are clearly distinct.

Both subsidiaries originate similar loans under loan commitments. In country A there is an active and liquid market for the assets resulting from loan commitments issued in that country. The subsidiary operating in that country has a past practice of disposing of such assets in this market shortly after origination. There is no such market in country B.

The fact that one subsidiary has a past practice of settling its loan commitments net (as the term is used in the standard) would not normally mean that the loan commitments issued in country B are required to be classified as at fair value through profit or loss.

The above example is relatively straightforward - in some circumstances it may be more difficult to define the class. However, there is no reason why an individual entity (say a subsidiary of a group) cannot have two or more classes of loan commitment, e.g., where they result in the origination of different types of assets that are clearly managed separately. Any associated entitlement to fees must be accounted for in accordance with IFRS 15 or IFRS 9 (see Chapter 28 and Chapter 46 at section 2.8, respectively). No accounting requirements are specified for holders of loan commitments, but they will normally be accounted for as executory contracts - essentially, this means that fees payable will be recognised as an expense in a manner that is appropriate to the terms of the commitment. Any resulting borrowing will obviously be accounted for as a financial liability under IFRS 9.

IFRS 9 contains no guidance on how to account for loan commitments that are originated with different business models in mind. For example, an entity may enter into a loan commitment where it has the intention to sell or sub-participate a portion of the loan immediately after origination and to hold the remaining balance of the loan to collect contractual cash flows. As the entity has a past practice of selling some of the resulting assets that arise from these commitments shortly after origination, it cannot consider the entire loan commitment (if it is considered to be a single unit of account) to be outside the scope of IFRS 9. However, it is unclear whether the single loan commitment can be split into separate units of account and accounted for accordingly.

A similar challenge occurs when determining the classification of a loan that is originated with the intention of sub-participating a portion and retaining the rest (see Chapter 44 at Illustration 4-12: Loans that are to be sub-participated).

How we see it

An entity could consider the activities of originating loan commitments with an intention to (i) hold the resulting drawn asset to collect its contractual cash flows and (ii) to sell or sub-participate it as two separate business models and portfolios. A split approach to account for the loan commitment is likely to be acceptable if the entity can forecast with reasonable confidence that a portion of the loan arising from the commitment will be sold and a portion will not. The portion of the loan commitment where the intention is to sell the resulting loan would be in scope of IFRS 9.2.3(a) and accounted for at fair value through profit or loss. The portion of the loan commitment where the intention is to hold the resulting loan will be out of the scope of IFRS 9.2.3(a).

2.5.1 Performance guarantees

Performance guarantees, sometimes referred to as surety bonds, fidelity bonds, performance bonds and bid bonds, are contracts that provide compensation if another party fails to perform a contractual obligation, for example an obligation to construct a building. IFRS 17 considers these to be examples of contracts that are insurance contracts if the resulting transfer of insurance risk is significant (see Chapter 51 at section 3.7.1). *[IFRS 17.B26(f)]*. These contracts differ from financial guarantee contracts in that financial guarantee contracts are based on underlying financial obligations, rather than non-financial ones.

In some cases, performance guarantees include, or are issued in conjunction with, indemnity agreements that give the issuer of the performance guarantee the right to claim back any amounts paid out from the party whose non-performance led to the guarantee being called. Judgement is required to determine whether such arrangements are insurance contracts in the scope of IFRS 17 or financial instruments accounted for under IFRS 9. It is particularly important to assess if the performance guarantee and the indemnity clause constitute a single unit of account and, if they do, whether the resulting unit of account gives rise to a transfer of significant insurance risk. A difficulty that arises in making the assessment is that this kind of contract is a tripartite agreement and, therefore, it is not always clear from whose perspective the transfer of insurance risk needs to be evaluated. Different conclusions could be reached depending on the angle from which this is assessed. Therefore, a reporting entity has an accounting policy choice when evaluating from whose perspective there is a transfer of insurance risk in a tripartite agreement. This policy must be applied consistently. As such, for identical facts and circumstances, the same conclusion must be reached for all transactions within a reporting entity and for all transactions included in a consolidated group.

Illustration 2-5: Performance guarantees with an indemnity clause

Entity B, a builder, enters into a contract with Entity D, a developer, to construct a bridge. In order to reduce the risk of the Entity B not performing on its obligation to build the bridge, Entity D requires Entity B to source a performance guarantee from Entity F, a financial institution.

Entity B pays for, and Entity F duly issues, a performance guarantee under which Entity F agrees to compensate Entity D for losses suffered due to Entity B's failure to perform its non-financial obligations in terms of the construction contract.

The performance guarantee also includes an indemnity clause whereby Entity F has the right to claim back from Entity B any amounts paid out to Entity D as a result of Entity B's non-performance.

In such cases, Entity F must exercise judgement based on the specific arrangement to assess if the performance guarantee and the indemnity clause constitute a single unit of account and if the resulting unit(s) of account give rise to a transfer of significant insurance risk. If Entity F determines that the performance guarantee and the indemnity agreement are a single unit of account that does not give rise to a transfer of significant insurance risk, this unit of account will be a financial instrument, accounted for under IFRS 9. If Entity F determines that the unit(s) of account give rise to a transfer of significant insurance risk, they will be accounted for in terms of IFRS 17.

See Chapter 2 at section 7.1.1, Chapter 42 at section 7, Chapter 51 at section 4 for further guidance on determining the unit of account and Chapter 51 at section 3.5 for guidance on assessing the transfer of significant insurance risk.

2.6 Equity instruments

2.6.1 Equity instruments issued

Financial instruments (including options and warrants) that are issued by the reporting entity and meet the definition of equity instruments in IAS 32 (see section 1.1 above and Chapter 43 at sections 3 and 4) are outside the scope of IFRS 9, unless the election in IAS 32.33A is applied. *[IAS 32.33A, IFRS 9.2.1(d)]*. Under IAS 32.33A, where an entity reacquires its own equity to hold in an investment fund that provides investors with benefits determined by units in the fund or as an underlying item for groups of insurance contracts with direct participation features, it may elect on an instrument-by-instrument basis to continue to account for the treasury share as issued equity. In such case, the reacquired instrument is accounted as if it were a financial asset and measured at fair value through profit or loss in accordance with IFRS 9. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. For further details, see Chapter 43 at section 9.2. *[IAS 32.33A]*.

In principle, IFRS 7 applies to issued equity instruments except for those that are derivatives based on interests in subsidiaries, associates or joint ventures (see section 2.1 above). *[IFRS 7.3(a)]*. However, this is of largely academic interest because IFRS 7 specifies no disclosure requirements for issued equity instruments.

In fact, the scope of IFRS 7 for these types of instruments is even more curious. Firstly, it is explained that derivatives over subsidiaries, associates and joint ventures that are equity instruments from the point of view of the issuer are excluded from the scope of IFRS 7 because equity instruments are not remeasured and hence do not expose the issuer to statement of financial position and income statement risk. Also, the disclosures about the significance of financial instruments for financial position and performance are not considered relevant for equity instruments. *[IFRS 7.BC8]*. Given the reasons quoted, it is not entirely clear why the IASB did not exclude all instruments meeting the definition of equity in IAS 32 from the scope of IFRS 7, e.g., non-puttable ordinary shares issued by the reporting entity. Secondly, it is very difficult to see how a derivative over a reporting entity's associate or joint venture could ever meet the definition of equity from the perspective of the reporting entity.

2.6.2 Equity instruments held

From the point of view of the holder, equity instruments are within the scope of IFRS 7 and IFRS 9 (unless they meet the exception in section 2.1 above). *[IFRS 7.3, IFRS 9.2.1(d)]*.

2.7 Business combinations

2.7.1 Contingent consideration in a business combination

2.7.1.A Payable by an acquirer

For business combinations accounted for under IFRS 3 *Business Combinations*, contingent consideration that meets the definition of a financial asset or liability will be measured at fair value, with any resulting gain or loss recognised in profit or loss in accordance with IFRS 9 (see Chapter 10 at section 7.1). *[IFRS 3.58(b)(i)]*.

Further, contingent consideration arising from an acquiree's prior business combination that an acquirer assumes in its subsequent acquisition of the acquiree does not meet the definition of contingent consideration in the acquirer's business combination. Rather, it is one of the identifiable liabilities assumed in the subsequent acquisition. Therefore, to the extent that such arrangements are financial instruments, they are within the scope of IAS 32, IFRS 9 and IFRS 7.[9]

2.7.1.B Receivable by a vendor

IFRS 9 does not go on to explain whether the vendor should be accounting for the contingent consideration in accordance with its provisions.

In most cases, the vendor will have a contractual right to receive cash or another financial asset from the purchaser and, therefore, it is hard to avoid the conclusion that the contingent consideration meets the definition of a financial asset and hence is within the scope of IFRS 9, not IAS 37. IFRS 10 *Consolidated Financial Statements* requires consideration received on the loss of control of an entity or business to be measured at fair value, which is consistent with the treatment required by IFRS 9 for financial assets. *[IFRS 10.B98, IFRS 9.5.1.1]*.

2.7.2 Contracts between an acquirer and a vendor in a business combination

IFRS 9 does not apply to forward contracts between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination (as defined in IFRS 3 Appendix A) at a future acquisition date. In order to qualify for this scope exclusion, the term of the forward contract must not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction, for example to accommodate the completion of necessary regulatory and legal processes. *[IFRS 9.2.1(f), IFRS 9.BCZ2.39]*.

How we see it

The scope exemption with regards to forward contracts to buy or sell an acquiree that will result in a business combination applies to all types of business combinations. This is irrespective of whether the business combination is structured to be achieved through a transfer of an equity interest, a transfer of net assets or any other type of arrangement.

The scope exclusion under IFRS 9 applies only when completion of the business combination is not dependent on further actions of either party. Option contracts allow one party to control the occurrence or non-occurrence of future events depending on whether the option is exercised. Consequently, option contracts that on exercise will result in the reporting entity obtaining control of another entity are within the scope of IFRS 9, whether they are currently exercisable or not. *[IFRS 9.BCZ2.40, IFRS 9.BCZ2.41]*.

9 *IASB Update*, June 2009, available on the IFRS Foundation's website.

It was suggested that 'in-substance' or 'synthetic' forward contracts, e.g., the combination of a written put and purchased call where the strike prices, exercise dates and notional amounts are equal, or a deeply in- or out-of-the-money option, should be excluded from the scope of IFRS 9. However, the IASB staff did not agree with the notion that synthetic forward contracts (which do provide optionality to one or both parties) are substantially identical to forward contracts (which commit both parties). The IASB staff accepted that in normal financial instrument transactions, the economics of a synthetic forward will be favourable to one party to the contract and would therefore result in its exercise, but a similar assumption does not necessarily hold true in business combination transactions because one party may choose not to exercise the option due to other factors. Therefore, it is not possible to assert that the contracts will always result in a business combination.[10]

The acquisition of an interest in an associate represents the acquisition of a financial instrument, not an acquisition of a business. Therefore, the scope exclusion does not apply by analogy to contracts to acquire investments in associates and similar transactions. *[IFRS 9.BCZ2.42]*.

Another related issue is the treatment at a consolidated level of forward contracts to purchase an entity that owns a single asset, such as a ship or building, which does not constitute a business. This type of contract could be within the scope of IFRS 9, since the contract would not qualify for the scope exclusion discussed above. *[IFRS 9.2.1(f)]*. The reason a contract for a business combination is normally considered to be a financial instrument seems to be because there is often a substantive reason (for example related to tax) to sell an asset within a 'corporate wrapper' and therefore it may be argued that the 'corporate wrapper' changes the substance of the transaction, so that it represents a contract to purchase equity instruments rather than the underlying asset. Consequently, it could be argued, even at a consolidated level, that a contract to purchase a controlling interest in a single asset company meets the definition of a financial instrument.

On the other hand, it could be argued that the substance of the contract is the purchase of the underlying asset because, at a consolidated level, the entity will never recognise the shares but will recognise the underlying asset. The implication of this argument is that the contract might qualify for the own use exemption (see section 3 below) and therefore be scoped out of IFRS 9.

How we see it

Given the lack of clear guidance, entities have an accounting policy choice as to whether, at a consolidated level, a forward contract to purchase all the shares in a single asset entity that does not constitute a business is in substance an acquisition of equity instruments or the acquisition of the underlying asset of the entity.

Although forward contracts between an acquirer and a vendor in a business combination are scoped out of IFRS 9 and hence are not accounted for as derivatives, they are still within the scope of IFRS 7.

2.8 Contingent pricing of property, plant and equipment and intangible assets

IAS 32 is clear that the purchase of goods on credit gives rise to a financial liability when the goods are delivered (see section 1.2.6 above) and that a contingent obligation to deliver cash meets the definition of a financial liability (see section 1.2.3 above). *[IAS 32.AG8, IAS 32.AG21]*. Consequently, it would seem that a financial liability arises on the outright purchase of an item of property, plant and equipment or an intangible asset, where the purchase contract involves variable or contingent consideration, for example amounts based on the performance of the asset. Further, because there is no exemption from applying IFRS 9 to such contracts, one might expect that such a liability would be accounted for in accordance with IFRS 9, i.e., any measurement changes to that liability would flow through the statement of profit or loss. This would be consistent with the accounting treatment for contingent consideration arising from a business combination under IFRS 3 (see section 2.7.1.A above). *[IFRS 3.58(b)(i)]*.

10 INFORMATION FOR OBSERVERS, Board Meeting: March 2009, London, Project: *Annual Improvements Project - Comment Letter Analysis* Subject: *IAS 39* Financial Instruments: Recognition and Measurement - *Scope exemption for business combination contracts (IAS 39.2(g)) (Agenda Paper 10C)*, IASB, paras. 13 and 15. Available on the IFRS Foundation's website. Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

However, in practice, contracts can be more complex than suggested in the previous paragraph. The variable or contingent payment for these types of transactions may be dependent on a number of factors. Examples might include variable payments based on an index or rate, variable payments which are dependent upon the purchaser's future actions, variable or contingent payments related to the condition of the asset itself or variable or contingent payments related to the asset's performance. Some arrangements may contain more than one source of variability. Further complexity can also arise when arrangements are akin to profit sharing or collaboration agreements which are not addressed in any standard.

The topic of variable payments for an asset purchase was discussed by the IFRS IC between 2011 and 2016, and an agenda decision was published in March 2016. The IFRS IC's discussions considered both the accounting at the date of purchasing the asset and subsequently, and distinguished between those variable payments that depend on the purchaser's future activity and those that do not. The IFRS IC determined that the issue was too broad for it to address within the confines of existing standards and recommended that the IASB address the accounting for variable payments comprehensively.[11] In May 2016, the IASB tentatively agreed that this issue would be included in the research pipeline between 2017 and 2021. At the time of writing this is not listed as an active research project on the IASB's work plan.

A critical step in analysing the accounting for the purchase of an item of PP&E or an intangible asset in an arrangement involving variable or contingent consideration is to fully understand the contractual arrangements, including the nature of the contingent or variable payments. This includes developing a full understanding of whether those contingent payments are linked to the initial value of the asset, or to its future performance, whether the contingency or variability is within or outside of the purchasers' control and whether the variable payment is a payment for some other goods or services from the seller. In some cases, the contract may establish an obligation for the contingent payment at the outset, whilst in others it might be determined that the arrangement is an executory contract, and the liability to make the contingent payments is only recognised later once either party fulfils its obligations under the contract.

The two key issues with regards to the accounting for variable consideration in an asset purchase are 1) whether and when to recognise a liability for that variable consideration, and 2) whether subsequent changes to the estimate of variable or contingent consideration should be accounted for as part of the cost of the acquired asset.

Looking at the first question of when a liability to make variable or contingent payments would be recognised, if the arrangement is not considered to be an executory contract, one consideration is whether those payments are dependent on the entity's future activity, or not. IAS 32.25 stipulates that where the contingency is outside the control of both the issuer and the holder, a contingent obligation to deliver cash meets the definition of a financial liability (see Chapter 43 at section 4.3). Therefore, if the obligation to make the variable payment does not depend on the acquiring entity's future activity, it would seem appropriate to recognise a financial liability in respect of the contingent amounts. *[IAS 32.25]*. However, it is acknowledged that whilst this view was tentatively agreed during the course of the IFRS IC discussions on the topic, ultimately, this was not clarified or confirmed as part of the final agenda decision. Furthermore, the final agenda decision notes that there are questions about the accounting for variable payments subsequent to the purchase of the asset, and in making that statement the IFRS IC did not distinguish between the different types of variable payments.

How we see it

In light of the discussions held by the IFRS IC and the absence of clear guidance in the final agenda decision, entities will need to develop and apply an accounting policy in respect of whether and when the obligation to make contingent payments is recognised as a liability. The policy selected should result in information that is relevant and reliable in the particular circumstances and must be consistently applied to similar transactions. Different payments may have different types of variability. Therefore, it might be appropriate for an entity to have different policies for dissimilar transactions. If information about the selected accounting policy is expected to be material to users of the financial statements, that accounting policy information should be disclosed.

11 *IFRIC Update*, March 2016, available on the IFRS Foundation's website.

Examples of some accounting policies an entity may want to consider regarding initial recognition of the asset include the following:

- The cost of the asset on initial recognition includes the fair value of all variable or contingent consideration at the date of acquisition. A corresponding liability is recognised for the same amount.
- The cost of the asset on initial recognition excludes any variable or contingent payments. Accordingly, no liability is recognised for those contingent or variable amounts.

If the accounting policy selected gives rise to a liability in scope of IFRS 9, depending on the classification (see Chapter 44 at section 2), the liability should be subsequently measured at either amortised cost or fair value though profit or loss (see Chapter 46 at section 2.4). For the second question on whether subsequent changes to the estimate of variable or contingent consideration should be accounted for as part of the cost of the acquired asset, see Chapter 18 at section 4.5.

Where contingent consideration arises on the sale of an asset that is within the scope of IAS 16 *Property, Plant and Equipment* - or IAS 38 *Intangible Assets* - then the requirements of IFRS 15 apply in determining the amount of consideration to be included in the gain or loss on derecognition of the asset (see Chapter 28 at section 2.6.3). *[IAS 16.72, IAS 38.116]*. IFRS 15 requires that variable consideration (which includes contingent consideration) be estimated, using one of two methods, but requires that the amount of the estimate included within the transaction price be constrained to avoid significant reversals in future periods (see Chapter 28 at section 5.2). *[IFRS 15.50]*. During 2019 and 2020, the IFRS IC and the IASB discussed whether IFRS 10 or IFRS 15 applies when an entity loses control of a single asset entity containing real estate as part of its ordinary activities. In June 2022, the Board assessed this matter as a low priority and concluded this topic could be explored if identified as a priority in the next agenda consultation.[12] As noted in section 2.7.1.B above, IFRS 10 requires consideration received on the loss of control of a subsidiary to be measured at fair value. *[IFRS 10.B98(b)(i)]*. Therefore, depending on which standard is applied to the disposal, the accounting outcome could be very different when contingent consideration is involved. This issue is discussed in more detail in Chapter 8 at section 3.2 and Chapter 28 at Question 2-11.

2.9 Employee benefit plans and share-based payment

Employers' rights and obligations under employee benefit plans, which are dealt with under IAS 19 *Employee Benefits* are excluded from the scope of IAS 32, IFRS 7 and IFRS 9. *[IAS 32.4(b), IFRS 7.3(b), IFRS 9.2.1(c)]*. The IFRS IC noted in November 2005 that IAS 19 indicates that employee benefit plans include a wide range of formal and informal arrangements and concluded it was clear that the exclusion of employee benefit plans from IAS 32 (and by implication IFRS 7 and IFRS 9) includes all employee benefits covered by IAS 19, for example a liability for long service leave.[13]

Similarly, most financial instruments, contracts and obligations arising from share-based payment transactions, which are dealt with under IFRS 2 *Share-based Payment* are also excluded. However, IAS 32, IFRS 7 and IFRS 9 do apply to contracts to buy or sell non-financial items in share-based transactions that can be settled net (as that term is used in this context) unless they are considered to be 'normal' sales and purchases (see section 3 below). *[IAS 32.4(f)(i), IFRS 7.3(e), IFRS 9.2.1(h)]*. For example, a contract to purchase a fixed quantity of oil in exchange for issuing a fixed number of shares that could be settled net would be excluded from the scope of IAS 32, IFRS 7 and IFRS 9 only if it qualified as a 'normal' purchase (which would be unlikely).

In addition, IAS 32 applies to treasury shares (see Chapter 43 at section 9) that are purchased, sold, issued or cancelled in connection with employee share option plans, employee share purchase plans, and all other share-based payment arrangements. *[IAS 32.4(f)(ii)]*.

2.10 Reimbursement rights in respect of provisions

Most reimbursement rights in respect of provisions arise from insurance contracts and are therefore outside the scope of IFRS 9 as set out in section 2.3 above. The scope of IFRS 9 is also restricted so as not to apply to other financial instruments that are rights to payments to reimburse the entity for expenditure it is required to make to settle a liability that it has recognised as a provision in accordance with IAS 37 in the current or an earlier period. *[IFRS 9.2.1(i)]*.

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12 Project Report and Feedback Statement: *Post-implementation Review: IFRS 10* Consolidated Financial Statements, *IFRS 11* Joint Arrangements, *IFRS 12* Disclosure of Interests in Other Entities, IASB, June 2022.

13 *IFRIC Update*, November 2005, available on the IFRS Foundation's website.

However, a residual interest in a decommissioning or similar fund that extends beyond a right to reimbursement, such as a contractual right to distributions once all the decommissioning has been completed or on winding up the fund, could be an equity instrument within the scope of IFRS 7 and IFRS 9. *[IFRS 7.3, IFRIC 5.5]*.

2.11 Disposal groups classified as held for sale and discontinued operations

The disclosure requirements in IFRS 7 do not apply to financial instruments within a disposal group classified as held for sale or within a discontinued operation, except for disclosures about the measurement of those assets and liabilities (see Chapter 50 at section 4) if such disclosures are not already provided in other notes to the financial statements. *[IFRS 5.5B]*. However, additional disclosures about such assets (or disposal groups) may be necessary to comply with the general requirements of IAS 1 *Presentation of Financial Statements* - particularly for financial statements to achieve a fair presentation and to disclose information about assumptions made and the sources of estimation uncertainty (see Chapter 3 at sections 4.1.1.A and 5.2.1 respectively). *[IAS 1.15, IAS 1.125, IFRS 5.5B]*.

2.12 Indemnification assets

IFRS 3 specifies the accounting treatment for 'indemnification assets', a term that is not defined but is described as follows: *[IFRS 3.27]*

Extract from IFRS 3

27 The seller in a business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability. For example, the seller may indemnify the acquirer against losses above a specified amount on a liability arising from a particular contingency; in other words, the seller will guarantee that the acquirer's liability will not exceed a specified amount. As a result, the acquirer obtains an indemnification asset. …

How we see it

From the perspective of the acquirer, an indemnification asset will normally meet the definition of a financial asset within IAS 32. In some situations, the asset might be seen as similar to a reimbursement right (see section 2.10 above). However, there will be cases where these assets are, strictly, within the scope of IFRS 9, creating something of a tension with IFRS 3. This appears to be nothing more than an oversight and, in our view, entities need to apply the more specific requirements of IFRS 3 when accounting for these assets which are covered in more detail in Chapter 10 at section 5.6.4.

2.13 Rights and obligations within the scope of IFRS 15

An unconditional right to consideration (i.e., only the passage of time is required before the payment of that consideration is due) in exchange for goods and services transferred to the customer (a receivable) is accounted for in accordance with IFRS 9. *[IFRS 9.2.1(j), IFRS 15.108]*. A conditional right to consideration in exchange for goods or services transferred to a customer (a contract asset) is accounted for in accordance with IFRS 15, which requires an entity to assess contract assets for impairment in accordance with IFRS 9. *[IFRS 15.107]*. Other rights and obligations within the scope of IFRS 15 are generally not accounted for as financial instruments.

The credit risk disclosure requirements within IFRS 7.35A-35N apply to those rights that IFRS 15 specifies are accounted for in accordance with IFRS 9 for the purposes of measurement of impairment gains and losses (i.e., contract assets). *[IFRS 7.5A]*.

2.14 Commodity loans

Commodity loan transactions could be structured in many ways. The accounting for these transactions is complex and small differences in fact patterns can affect the accounting outcome. As such, an entity must apply judgement in accounting for commodity loans by considering the specific facts and circumstances in the transaction.

Frequently asked questions

Question 2-2: How to account for a commodity loan transaction?

In March 2017, the IFRS IC considered a request on how to account for a commodity loan transaction.[14] Specifically, the transaction they considered was one in which a bank (reporting entity) borrows gold from a third party (contract 1) and then lends that gold to a different third party for the same term and for a higher fee (contract 2). The bank enters into the two contracts in contemplation of each other, but the contracts are not linked (i.e., the bank negotiates the contracts independently of each other). In each contract, the borrower obtains legal title to the gold at inception and has an obligation to return, at the end of the contract, gold of the same quality and quantity as that received. In exchange for the loan of gold, each borrower pays a fee to the respective lender over the term of the contract but there are no cash flows at inception of the contract.

The IFRS IC was asked whether, for the term of the two contracts, the bank that borrows and then lends the gold recognises:

(a) An asset representing the gold (or the right to receive gold)

And

(b) A liability representing the obligation to deliver gold

The IFRS IC observed that the particular transaction in the submission might not be clearly captured within the scope of any IFRS accounting standard. In the absence of a IFRS accounting standard that specifically applies to a transaction, an entity applies paragraphs 10 and 11 of IAS 8 in developing and applying an accounting policy to the transaction.[15]

The related Staff paper[16] noted that in order to make the judgement described in IAS 8, the reporting entity would first assess whether any of the requirements in IFRS accounting standards deal with 'similar and related issues'. The entity's conclusion on which, if any, requirements deal with similar and related issues could result in different accounting outcomes. For example:

'Similar and related' issue in existing IFRS accounting standard	Accounting by Reporting Entity	Reporting Entity recognises an asset and a liability as a result of the transaction?
Securities lending (IFRS 9)	Account for the transaction as if the gold is not transferred from the Lender to the Reporting Entity.	No
Revenue transaction/transfer of inventory (IFRS 15/IAS 2 *Inventories*)	Account for the purchase of gold and receipt of inventory from the Lender, and a sale of gold and transfer of inventory to the Borrower.	Yes
Lease (IFRS 16)	Reporting Entity is the intermediate lessor in a sublease. As such, the Reporting Entity recognises a lease liability owing to the Lender and a lease receivable from the Borrower.	Yes
None	If the transaction is analysed by applying the principles in the Conceptual Framework, the Reporting Entity would conclude that it has a liability (the obligation to deliver gold to Lender in 12 months' time) and an asset (the right to receive gold from Borrower in 12 months' time) as a result of the transaction.	Yes

14 The IFRS IC analysis was primarily in the context of standards that were effective at the time of the discussion.

15 *IFRIC Update*, March 2017, available on the IFRS Foundation's website.

16 IASB Staff paper 10, Project: *Commodities*, Paper topic: *Commodity loans*, IFRS IC Meeting, November 2016. Available on the IFRS Foundation's website.

3 Contracts to buy or sell commodities and other non-financial items

Contracts to buy or sell non-financial items do not generally meet the definition of a financial instrument (see section 1.2.5 above). However, many such contracts are standardised in form and traded on organised markets in much the same way as some derivative financial instruments. The application guidance explains that a commodity futures contract, for example, may be bought and sold readily for cash because it is listed for trading on an exchange and may change hands many times. *[IAS 32.AG20]*. In fact, this is not strictly true because such contracts are bilateral agreements that cannot be transferred in this way. Rather, the contract would normally be 'closed out' (rather than sold) by entering into an offsetting agreement with the original counterparty or with the exchange on which it is traded.

The ability to buy or sell such a contract for cash, the ease with which it may be bought or sold (or, more correctly, closed out), and the possibility of negotiating a cash settlement of the obligation to receive or deliver the commodity, do not alter the fundamental character of the contract in a way that creates a financial instrument. The buying and selling parties are, in effect, trading the underlying commodity or other asset. However, the IASB is of the view that there are many circumstances where they need to be accounted for as if they were financial instruments. *[IAS 32.AG20]*.

Accordingly, the provisions of IAS 32, IFRS 7 and IFRS 9 are normally applied to those contracts to buy or sell non-financial items that can be settled net in cash or another financial instrument or by exchanging financial instruments or in which the non-financial instrument is readily convertible to cash, effectively as if the contracts were financial instruments (see section 3.2 below). However, there is one exception for what are commonly termed 'normal' purchases and sales or 'own use' contracts (these are considered in more detail in section 3.3 below). *[IAS 32.8, IFRS 7.5, IFRS 9.2.4]*.

Typically, the non-financial item will be a commodity, but this is not necessarily the case. For example, an emission right, which is an intangible asset (see Chapter 18 at section 11.2), is a non-financial item. Therefore, these requirements would apply equally to contracts for the purchase or sale of emission rights if they could be settled net. These requirements will also be appropriate for determining whether certain commodity leases are within the scope of IFRS 9. Commodity leases generally do not fall within the scope of IFRS 16 as they do not relate to a specific or identified asset (see section 2.14 above for commodity leases accounting considerations).

A contract that qualifies for the own use exemption still needs to be assessed for the existence of embedded derivatives, which would not disqualify the underlying contract from falling within the own use exemption. An embedded derivative within a normal purchase or sale contract must be accounted for in accordance with section 4.3 of IFRS 9 and bifurcated from the underlying purchase or sales contract if required (see Chapter 42 at section 4).

A contract to buy or sell non-financial items that qualifies for the own-use exemption is accounted for as an executory contract. IAS 37 defines an executory contract as a contract under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. *[IAS 37.3]*. The costs associated with executory contracts are normally expensed as incurred using accrual accounting, rather than requiring recognition of any liabilities or assets. Importantly, executory contracts still need to be monitored on an ongoing basis because provisions would need to be recognised if the contracts becomes onerous (see Chapter 27 at section 2.2.1.A).

In 2022, the IASB was asked to consider questions about contracts to buy and sell non-financial items as part of the post implementation review of the classification and measurement requirements in IFRS 9. No further actions were noted by the IASB because it considered the concerns not to be widespread or expected to have a material effect.[17] In 2023, specific questions relating to power purchase agreements (PPAs) for renewable energy were submitted to the IFRS IC and escalated to the IASB.[18] On 8 May 2024, the IASB published the Exposure Draft (ED), Contracts for Renewable Electricity, Proposed amendments to IFRS 9 and IFRS 7.[19] See section 3.3.7 below for more details regarding the proposed amendments.

17 Project Report and Feedback Statement, Post-implementation Review IFRS 9 Financial Instruments-Classification and Measurement, IASB, December 2022. Available on IASB's website.

18 Application of the 'Own-Use' Exception in the Light of Current Market and Geopolitical Questions (IFRS 9 Financial Instruments); IFRIC update June 2023; agenda paper 2

19 IASB proposes amendments for renewable electricity contracts. Available on the IFRS Foundation's website.

3.1 Decision process for contracts to buy or sell non-financial items

Extract from IFRS 9

2.4 **This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. However, this Standard shall be applied to those contracts that an entity designates as measured at fair value through profit or loss in accordance with paragraph 2.5.**

2.5 **A contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contract was a financial instrument, may be irrevocably designated as measured at fair value through profit or loss even if it was entered into for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. This designation is available only at inception of the contract and only if it eliminates or significantly reduces a recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from not recognising that contract because it is excluded from the scope of this Standard (see paragraph 2.4).**

2.6 There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:

(a) when the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;

(b) when the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);

(c) when, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short term fluctuations in price or dealer's margin; and

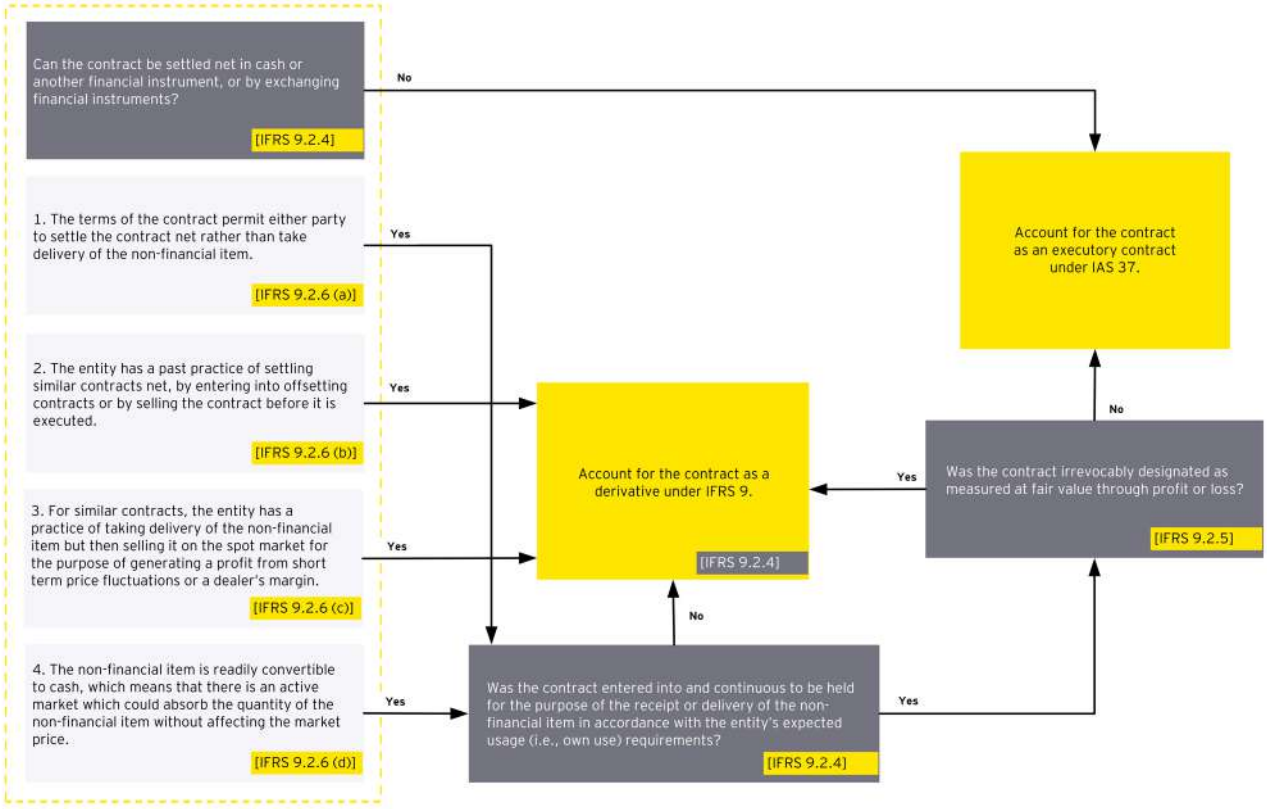
(d) when the non-financial item that is the subject of the contract is readily convertible to cash.

A contract to which (b) or (c) applies is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and, accordingly, is within the scope of this Standard. Other contracts to which paragraph 2.4 applies are evaluated to determine whether they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and, accordingly, whether they are within the scope of this Standard.

[IFRS 9.2.4, IFRS 9.2.5, IFRS 9.2.6]

The figure below provides a summary of factors to consider in determining whether contracts to buy or sell non-financial items are within the scope of IAS 32, IFRS 7 and IFRS 9. Section 3.2 and section 3.3 below consider these factors in more detail.

Figure 3-1: Contracts to buy or sell non-financial items scope decision chart



IFRS 9 must be applied to contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. Therefore, the first decision point in assessing the scoping of these contracts is to understand whether the contract is capable of being net settled. IFRS 9.2.6 provides four examples of factors that must be considered in determining whether the contract can be net settled (see section 3.2 below). If the contract cannot be net settled, the contract is accounted for as an executory contract.

If the contract can be net settled, the next decision point involves understanding the reason why it can be net settled. According to IFRS 9.2.6, a contract to which IFRS 9.2.6(b) or IFRS 9.2.6(c) applies is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements. *[IFRS 9.2.4, IFRS 9.2.6]*. Such contracts must be accounted for as if they were derivatives under IFRS 9.

If the contract can be net settled as a result of IFRS 9.2.6(a) or (d), further assessment is required to determine whether the contract is held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements. This is commonly referred to as the own use exception (see section 3.3 below). *[IFRS 9.2.4, IFRS 9.2.6]*.

If it is held for own use, it is treated as an executory contract, provided the entity does not designate it as measured at fair value through profit or loss (see section 3.3.6 below). *[IFRS 9.2.5]*. If it is not held for own use purposes, the contract is accounted for as if it were a derivative.

3.2 Contracts that may be settled net

IFRS 9 explains that there are various ways in which a contract to buy or sell a non-financial item can be settled net, including when: *[IAS 32.9, IFRS 9.2.6, IFRS 9.BCZ2.18]*

(a) The terms of the contract permit either party to settle it net.

(b) The ability to settle the contract net is not explicit in its terms, but the entity has a practice of settling similar contracts (see section 3.3.1 below) net (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse).

(c) For similar contracts (see section 3.3.2 below), the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin.

And

(d) The non-financial item that is the subject of the contract is readily convertible to cash.

There is no further guidance in IFRS 9 explaining what is meant by 'readily convertible to cash'.

How we see it

Typically, a non-financial item would be considered readily convertible to cash if it consists of largely fungible units and quoted spot prices are available in an active market that can absorb the quantity held by the entity without significantly affecting the price. Entities must exercise significant judgement when assessing whether a non-financial item is readily convertible to cash.

Whether there exists an active market for a non-financial item, particularly a physical one such as a commodity, will depend on its quality, location or other characteristics such as size or weight. For example, if a commodity is actively traded in London, this may have the effect that the same commodity located in, say, Rotterdam is considered readily convertible to cash as well as if it was located in London. However, if it were located in Siberia it might not be considered readily convertible to cash if more than a little effort were required (often because of transportation needs) for it to be readily sold. Refer to Chapter 15 at section 7.1.1 for factors to consider in determining whether an active market exists.

Like loan commitments, most contracts could as a matter of fact be settled net if both parties agreed to renegotiate terms.

How we see it

Again, we do not believe the IASB intended the possibility of such renegotiations to be considered in determining whether such contracts may be settled net. Of more relevance is the question of whether one party has the practical ability to settle net, e.g., in accordance with the terms of the contract or using some market mechanism.

3.3 Own use contracts

As indicated in section 3 above, the provisions of IAS 32, IFRS 9 and IFRS 7 are not normally applied to those contracts to buy or sell non-financial items that can be settled net if they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements ('own use'). *[IAS 32.8, IFRS 7.5, IFRS 9.2.4]*. However, an entity may in certain circumstances be able to designate such a contract at fair value through profit or loss (see section 3.3.6 below). It should be noted that this is a two-part test, i.e., in order to qualify as a normal purchase or sale, the contract needs to both (a) have been entered into, and (b) continue to be held, for that purpose. Consequently, a reclassification of an instrument can be only one way. *[IAS 32.8, IFRS 9.2.4]*. For example, if a contract that was originally entered into for the purpose of delivery ceases to be held for that purpose at a later date, it must subsequently be accounted for as a financial instrument under IFRS 9. Conversely, where an entity holds a contract that was not originally held for the purpose of delivery and was accounted for under IFRS 9, but subsequently its intentions change such that it is expected to be settled by delivery, the contract remains within the scope of IFRS 9. The IASB views the practice of settling net or taking delivery of the underlying and selling it within a short period after delivery as an indication that the contracts are not normal purchases or sales. Therefore, contracts to which (b) or (c) in section 3.2 above apply cannot be subject to the normal purchase or sale exception. Other contracts that can be settled net are evaluated to determine whether this exception can apply. *[IAS 32.9, IFRS 9.2.6, IFRS 9.BCZ2.18]*.

The implications of this requirement are considered further in sections 3.3.1 and 3.3.2 below.

The implementation guidance illustrates the application of the exception as follows: *[IFRS 9.IG A.1]*

Illustration 3-1: Determining whether a copper forward is within the scope of IFRS 9

Company XYZ enters into a fixed-price forward contract to purchase 1,000 kg of copper in accordance with its expected usage requirements. The contract permits XYZ to take physical delivery of the copper at the end of twelve months, or to pay or receive a net settlement in cash, based on the change in fair value of copper.

The contract is a derivative instrument because there is no initial net investment, the contract is based on the price of copper, and it is to be settled at a future date. However, if XYZ intends to settle the contract by taking delivery and has no history of settling similar contracts net in cash, or of taking delivery of the copper and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, the contract is accounted for as an executory contract rather than as a derivative.

The Illustration below considers whether a prepayment for a commodity that is readily convertible to cash is within the scope of IFRS 9.

Illustration 3-2: Prepayment of a commodity that is readily convertible to cash

Company Z makes a prepayment of CU1 million to Company Y for a commodity. The prepayment will be settled by Company Y physically delivering 1000kg of the commodity to Company Z at a future date. The commodity is readily convertible to cash.

The accounting for this contract by Company Z depends on facts and circumstances. Despite the commodity being readily convertible to cash, if Company Z entered into the prepaid contract in accordance with its expected purchase, sale or usage requirements for that commodity, as per IFRS 9.2.4 and IFRS 9.2.6 the prepaid contract is held for own use purposes. As such, the prepayment will not be in scope of IFRS 9, unless Entity Z designates the contact at fair value through profit or loss in accordance with IFRS 9.2.5 (see section 3.3.6 below). If the contract is not accounted for within the scope of IFRS 9, the prepayment will be accounted for as a non-financial asset to reflect Company Z's right to receive the commodity. Furthermore, Entity Z must consider whether the prepayment includes a significant financing component that must be accounted for separately (see chapter 28 at section 5.5).

In accordance with IFRS 9.2.4 and IFRS 9.2.6, if the prepaid contract is not held for own use purposes by Company Z, the prepaid contract can be settled net in cash since it is readily convertible to cash. As such, the prepayment will be within the scope of IFRS 9 and accounted for as if it were a derivative at fair value through profit or loss.

Sometimes a market design or process imposes a structure or intermediary that prevents the producer of a non-financial item from physically delivering it to the customer. For example, a gold miner may produce gold bars (doré) that are physically delivered to a mint for refining and, whilst remaining at the mint, the gold could be credited to either the producer's or a counterparty's 'gold account'. Where the producer enters into a contract for the sale of gold which is settled by allocating gold to the counterparty's gold account, this may constitute 'delivery' as that term is used in the standard. Accordingly, a contract that is expected to be settled in this way could potentially be considered a normal sale (although of course it would need to meet all the other requirements). However, if the gold is credited to the producer's account and the sale contract was settled net in cash, this would not constitute delivery. In these circumstances, treating the contract as a normal sale would, in effect, link a non-deliverable contract entered into with a customer with a transaction to buy or sell through an intermediary as a single synthetic arrangement, contrary to the general requirements on linking contracts discussed in Chapter 42 at section 7.[20]

3.3.1 Net settlement of similar contracts

If the terms of a contract to buy or sell a non-financial item do not explicitly provide for net settlement but an entity has a practice of settling similar contracts net (see section 3.3.1.A below), that contract must be considered as capable of being settled net (see section 3.2 above). Net settlement could be achieved either by entering into offsetting contracts (see section 3.3.1.B below) with the original counterparty or by selling the contract before its maturity. In these circumstances the contract cannot be considered a normal sale or purchase and is accounted for in accordance with IFRS 9 (see section 3.2 above). *[IAS 32.9, IFRS 9.2.6, IFRS 9.BCZ2.18]*.

20 *IFRIC Update*, August 2005, available on the IFRS Foundation's website.
Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

3.3.1.A The meaning of 'similar contracts'

'Similar contracts' is not a defined term in IFRS accounting standards. However, in plain English, it refers to contracts which are almost, but not exactly, the same. At face value, this could be assessed by comparing the nature of the rights and obligations that the counterparties are exposed to as a result of the contracts' terms. However, such an interpretation of 'similar contracts' could be particularly troublesome. For example, it is common for entities in, say, the energy sector to have a trading arm that is managed completely separately from their other operations. These trading operations commonly trade in contracts on non-financial assets, the terms of which are similar, if not identical, to those used by the entity's other operations for the purpose of physical supply. Accordingly, the standard might suggest that the own use exemption is unavailable to any entity that has a trading operation that trades in similar contracts.

However, generally, under IFRS 9, contracts could be dissimilar, even if they are identical in form, when management enters into the contracts with different intentions. An example is the classification of a financial asset between the different categories. An entity might own two identical bonds issued by the same entity and classify one bond as fair value through profit or loss and the other bond as amortised cost. In such a situation, classification is not solely based on the legal form of the contract but also on management's intention for the contract.

We believe that this distinction must also be made in interpreting 'similar contract' for the purposes of applying IFRS 9.2.6(b). Therefore, both the nature of the rights and obligations arising from the contractual terms and the business within which the contract will be used (e.g., trading or physical supply) must be considered.

How we see it

For the purposes of IFRS 9.2.6(b), contracts are 'similar' if the nature of the rights and obligations arising from their contractual terms is similar and the entity intends to use them within the same business (e.g., for trading or physical supply).

3.3.1.B The meaning of 'offsetting'

The reference in IFRS 9.2.6(b) to 'offsetting' raises the question of whether the offsetting contract must offset all risks including credit risk in order for the practice of entering into offsetting contracts to be considered 'net settlement'. IFRS 9 does not contain guidance on the meaning of the term 'offsetting' in the context of the application of IFRS 9.2.6.

How we see it

Offsetting can be interpreted as matching positions with equal and opposite movements in risk, for the purpose of limiting or eliminating risk. When an entity purchases a non-financial item and sells the item within a short period after delivery, the entity will normally have credit risk on the gross amount. Paragraph 2.6(b) of IFRS 9 indicates that offsetting can occur with the counterparty, by entering into offsetting contracts or by selling the contract before its maturity. The word 'or' implies that it is not necessary to offset the credit risk component of the contract as in the latter situation, the counterparty may not be the same counterparty as in the original contract. It would, accordingly, be inconsistent to require that all risks, including credit risk, must be offset for a contract to be considered offsetting under IFRS 9.2.6(b).

Consequently, in our view, for a contract to be considered net settled by entering into offsetting contracts in accordance with IFRS 9.2.6(b), the new contract must offset all risks other than credit risk.

3.3.1.C Changes in the purpose for which contracts are being held

It is possible that a contract is entered into entirely for own use requirements and during the life of the contract these expectations change. The standard is clear that, in order to qualify for the own use exemption, the contract needs to both (a) have been entered into, and (b) continue to be held, for own use requirements. *[IAS 32.8, IFRS 9.2.4]*. Consequently, a reclassification of a contract can only be one way. If some or all of a contract that was originally entered into for own use at a later date ceases to be held for own use purposes, the entire contract will no longer qualify for the own use exemption and must subsequently be accounted for as a financial instrument under IFRS 9. Once scoped into IFRS 9 these contracts will, in most cases, meet the definition of a derivative and will therefore be measured at fair value through profit or loss. This will result in immediate recognition of the cumulative fair value gain or loss on the entire contract in profit or loss, including the portion which relates to any part that is still held for own use. Conversely, where an entity holds a contract that was not originally held for own use and was therefore accounted for under IFRS 9, but subsequently the contract begins to be held for own use, the contract remains within the scope of IFRS 9.

The standard contains no further guidance on what degree of net settlement would be necessary to create a practice of net settlement that would prevent an entity from treating similar contracts as own use.

How we see it

We do not believe that any net settlement automatically taints an entity's ability to apply the own use exemption to similar contracts, as long as it is isolated and infrequent. For example, if an entity is required to net settle a number of contracts as a result of an exceptional disruption arising from external events at a production facility, this isolated net settlement would not constitute a practice of net settlement, and would therefore not taint the entity's ability to use the exemption for other similar contracts. However, judgement will need to be applied based on the facts and circumstances of each individual case.

It stands to reason that regular revisions of own use requirements that result in the inability to continue applying the own use exemption for the respective contracts, could jeopardise the exemption for similar contracts in future, because the entity does not appear to be able to forecast its own use requirements reliably. This is similar to the situation under hedge accounting when 'highly probable' forecast transactions frequently fail to take place as forecast. For this reason, if an entity operates an own use and a trading business, it is important that the two businesses are clearly distinguished.

3.3.1.D Non-performance penalty clauses

It is common for commodity contracts to have penalty clauses relating to non-delivery or incomplete delivery (by the seller) and non-acceptance of all, or part of, the delivery (by the buyer) of the minimum contracted quantities.

Commodity contracts could be within the scope of IFRS 9 if they can be settled net in cash. *[IFRS 9.2.4, IFRS 9.2.6]*. A non-performance penalty clause in a fixed-price commodity supply contract could provide the entity with the ability to settle that contract net in cash. The following scenarios arise:

Scenario 1 - Fixed Penalty

The buyer (seller) will pay a fixed penalty to the seller (buyer) if it accepts (delivers) less than the minimum contracted quantity. An alternative to Scenario 1 would be where either of the parties must pay for the quantities not delivered or not accepted at the fixed contracted price.

Scenario 2 - Asymmetrical default clause

The buyer will pay a penalty for the minimum quantities it fails to take delivery of, being the difference between the fixed contract price and the market price, if the market price is lower than the contract price. The seller will pay a penalty for the minimum quantities it fails to deliver, being the difference between the fixed contract price and the market price, if the market price is higher than the contract price.

Scenario 3 - Symmetrical default clause

The buyer will pay a penalty for the minimum quantities it fails to take delivery of, being the difference between the fixed contract price and the market price, if the market price is lower than the contract price. However, if the market price is higher than the fixed contract price the seller must pay the difference to the buyer.

How we see it

Neither a fixed penalty nor an asymmetrical variable penalty meets the criteria to be treated as net settled in cash per IFRS 9.2.6(a), and therefore will not cause the contract to be within the scope of IFRS 9.

A symmetrical variable penalty does meet the criteria of net settled in cash per IFRS 9.2.6(a). However, the contract could still be outside the scope of IFRS 9 because of the 'own use' exemption. This exemption will not apply if the entity has a practice of net cash settlement in accordance with IFRS 9.2.6(b) (i.e., the symmetrical default clause is exercised on non-delivery).

A fixed price penalty (Scenario 1) does not reflect changes in market value and is not always economically beneficial to the defaulting party. Accordingly, a fixed price penalty does not meet the net cash settlement criteria in IFRS 9.2.6(a). *[IFRS 9.2.6]*.

For the asymmetrical variable penalty clause (Scenario 2), the defaulting party has an obligation to compensate the counterparty for the loss the counterparty incurs due to unfavourable market prices at the time of the default. It does not give the defaulting party the right to demand any potential gain the counterparty realises because of the default. Such clauses are designed to compensate the non-defaulting counterparty for losses incurred. Generally, the amount of the penalty represents the loss incurred. Accordingly, asymmetrical variable non-performance penalties do not represent net cash settlement provisions for the purpose of applying IFRS 9.2.6(a). *[IFRS 9.2.6]*.

For the symmetrical variable penalty clause (Scenario 3), the defaulting party has both an obligation to compensate the counterparty for the loss the counterparty suffers as a consequence of the default and a right to receive any gain the counterparty realises as a consequence of the default. Such clauses are considered net-settlement clauses. In this case, the seller may be acting as the buyer's broker. For example, if the buyer takes less than the minimum quantity per the contract, the seller is effectively selling it on the market on the buyer's behalf. If the buyer took the minimum quantity and sold the unwanted quantity on the market, this would constitute net-settlement. Symmetrical variable penalty clauses are often exercised by counterparties that enter into the commodity contract for speculative purposes.

While a symmetrical variable penalty meets the criteria of net settled in cash per IFRS 9.2.6(a), the contract is outside the scope of IFRS 9 if the 'own use' exemption in IFRS 9.2.4 above applies. If the entity has a practice of settling these contracts net in cash, as contemplated in IFRS 9.2.6(b), the 'own use' exemption will not apply and the contract will, therefore, be in the scope of IFRS 9. *[IFRS 9.2.4, IFRS 9.2.6]*.

3.3.2 Commodity broker-traders and similar entities

To be exempted from the scope of IFRS 9, a contract for the purchase or sale of a non-financial item that can be settled net in cash or another financial instrument or by exchanging financial instruments, must be transacted in accordance with the entity's expected purchase, sale or usage requirements. *[IFRS 9.2.4, IFRS 9.2.6]*.

An entity's 'expected purchase, sale or usage requirements' is not defined within IFRS accounting standards, therefore its intentions and actual behaviour must be considered when making an assessment.

How we see it

IFRS 9 contains no further guidance on what degree of net settlement (or trading) is necessary to make the normal sale or purchase exemption inapplicable, but in many cases, it will be reasonably clear. For example, in our view, the presumption must be that contracts entered into by a commodity broker-trader that measures its inventories at fair value less costs to sell in accordance with IAS 2 (see Chapter 23 at section 2.3) fall within the scope of IFRS 9. However, there will be situations that are much less clear-cut, and the application of judgement will be necessary.

The following factors may be considered when making an assessment to determine whether the entity enters into contracts with the intention of making a profit from trading activities and/or whether it enters into non-trading contracts in accordance with its expected purchase, sale or usage requirements:

Factor	Indicator of trading activities	Indicator of transactions in accordance with expected purchase, sale or usage requirements
How the entity intends to profit from the contract	The entity seeks to profit from short term price fluctuations or by making a margin between the bid and ask prices. This may involve taking price exposure and actively monitoring movements in price and closing out positions to capture more profit from such movements.	Generation of a profit margin by creating a market between normal buyers and sellers of a commodity, by entering into back-to-back sales and purchase contracts with a stable customer base, at a relatively consistent spread such that the current spot or future price is less relevant.
Customer base/contract counterparty	Counterparties vary based on market conditions as, typically, the entity or the customer initiates the trade due to market opportunity.	Trades are usually with a stable customer base who are normally producers or users within the value chain (refer to the value chain indicator below).
How an entity manages its business	Business is managed based on a 'mark to market' profit reflecting the fair value changes of contracts.	Business is managed based on a planned production or sale process and customer supply and demand and is measured based on gross margin.
How staff are remunerated	Remuneration includes a significant bonus component, based on mark to market profits of the forward contracts.	Remuneration is unlikely to include significant bonuses based on mark to market profits of the forward contracts.
Whether value is added by linking parties in the value chain.	Sales and purchases contracts made with counterparties that also trade and/or are not end users of the commodity themselves may indicate that the entity intends to profit from trading rather than from creating links between various counterparties in the commodity value chain.	The entity enters into purchase and sales contracts with producers and users of the commodity creating links within the value chain for the commodity. This may include repackaging but it is not necessary to repackage the commodity to be eligible for the expected purchase, sale or usage expectation.
Settlement of the contracts	Contracts are regularly settled net, for example, by entering into offsetting contracts with the same counterparty and physically delivering the net difference between the contracts (note that this would automatically bring such contracts into the scope of IFRS 9).	Contracts are always settled by physical delivery.

This is not an exhaustive list and the weight applied to each factor requires the application of judgement as, in many situations, mixed factors may be present. Consideration of an entity's control environment may be warranted where seemingly similar contracts are entered into for different purposes. This analysis can be made at a consolidated level or separately by business activity/unit (i.e., it is possible for management to deem one business activity as trading while another may be within expected purchase, sale or usage requirements, depending on the specific facts and circumstances of each business activity).

Entities could irrevocably designate a purchase or sale of a non-financial item at fair value through profit or loss, even if the purchase or sale of a non-financial item would otherwise be outside the scope of IFRS 9 (see section 3.3.6 below). *[IFRS 9.2.5]*.

Again, the reference in the standard to 'similar contracts' in this context may be troublesome for certain entities. However, as noted in section 3.3.1.A above, we believe contracts must be 'similar' as to their purpose within the business (e.g., for trading or for physical supply) not just as to their contractual terms.

3.3.3 Written options that can be settled net

The IASB do not believe that a written option to buy or sell a non-financial item that can be settled net can be regarded as being for the purpose of receipt or delivery in accordance with the entity's expected sale or usage requirements. Essentially, this is because the entity cannot control whether or not the purchase or sale will take place. Accordingly, IAS 32, IFRS 7 and IFRS 9 apply to written options that can be settled net according to the terms of the contract or where the underlying non-financial item is readily convertible to cash (see (a) and (d) in section 3.2 above). *[IAS 32.10, IFRS 9.2.7, IFRS 9.BCZ2.18]*.

Illustration 3-3: Determining whether a put option on an office building is within the scope of IFRS 9

Company XYZ owns an office building. It enters into a put option with an investor, which expires in five years and permits it to put the building to the investor for CU150 million. The current value of the building is CU175 million. The option, if exercised, may be settled through physical delivery or net cash, at XYZ's option.

XYZ's accounting depends on its intention and past practice for settlement. Although the contract meets the definition of a derivative, XYZ does not account for it as a derivative if it intends to settle the contract by delivering the building in the event of exercise and there is no past practice of settling net.

The investor, however, cannot conclude that the option was entered into to meet its expected purchase, sale, or usage requirements because it does not have the ability to require delivery. The contract could be settled net and is a written option. Regardless of past practices, its intention does not affect whether settlement is by delivery or in cash. Accordingly, the investor accounts for the contract as a derivative. As noted in Chapter 46 at section 2.4, this will involve remeasuring the derivative to its fair value each reporting period with any associated gains and losses recognised in profit or loss.

However, if the contract were a forward contract rather than an option, required physical delivery and the investor had no past practice of settling net (either in cash or by way of taking delivery and subsequently selling within a short period), the contract would not be accounted for as a derivative. *[IFRS 9.IG A.2]*.

3.3.4 Electricity and similar 'end-user' contracts

There have been problems in determining whether IAS 32, IFRS 7 and IFRS 9 apply to contracts to sell non-financial items (for example electricity or natural gas) to 'end-users' such as retail customers. The non-financial items will often be considered readily convertible to cash (see section 3.2 above), at least by the supplier. Accordingly, contracts to supply such items might be considered contracts that can be settled net.

Furthermore, end-user contracts often enable the customer to purchase as much of the non-financial item as needed at a given price to satisfy its usage requirements, i.e., the supplier does not have the contractual right to control whether or not the sale will take place. This might suggest that, from the perspective of the supplier, the contract is a written option with the consequence that it could not regard it as meeting the normal sale and purchase exemption (see section 3.3.3 above).

However, many argued that this was not necessarily the case, particularly in the following circumstances:

- The non-financial item is an essential item for the customer.
- The customer does not have access to a market where the non-financial item can be resold.
- The non-financial item is not easily stored in any significant amounts by the customer.

  And
- The supplier is the sole provider of the non-financial item for a certain period of time.

In circumstances such as these, the apparent optionality within the contract is not exercisable by the retail customer in any economic sense. The customer will purchase volumes required whether the terms in the contract are advantageous or not and would not have the practical ability to sell any excess amounts purchased. Such a contract can have both a positive value and a negative value for the supplier when compared with market conditions and therefore fails to exhibit one of the key characteristics of an option, i.e., that it has only a positive value for the holder (the customer) and only a negative value for the writer (the supplier). In many respects, the positive value stems from an intangible, rather than financial, aspect of the contract, being the likelihood that the customer will exercise the option. Accordingly, it was often argued that such contracts must not be considered written options (and therefore not within the scope of IFRS 9).

Even if contracts such as these are considered to be within the scope of IFRS 9, it is common for the supplier to have the ability to increase the price charged at relatively short notice. Also, the customer may be able to cancel the contract without penalty and switch to another supplier. Features such as these are likely to reduce any fair value that the contract can have.

Only a small number of energy suppliers appeared to regard these contracts as falling within the scope of IFRS 9. The IFRS IC noted that the guidance already explains what constitutes a written option, essentially confirming that in this context a written option arises where a supplier does not have the contractual right to control whether or not a sale will take place.[21]

The IFRS IC also noted that "in many situations these contracts are not capable of net cash settlement", and therefore would not be within the scope of IFRS 9. No detailed explanation was provided of why the ability of the supplier to readily realise the non-financial item for cash does not enable it to settle the contract net (as that term is used in IFRS 9).[22] However, we understand the reason underlying the comment to be the inability of the counterparty to realise the non-financial item (and hence the contract) for cash. This establishes a useful principle that may be applied in similar situations, i.e., a contract is not capable of net settlement if the contract is an option and the option holder cannot readily realise the non-financial item for cash.

How we see it

End user commodity contracts are not within the scope of IFRS 9.2.7 when:

- The non-financial item is a 'necessity' and the purchaser (e.g., a retail customer such as a consumer or small enterprise) does not have access to a market where the non-financial item can be resold.
- The non-financial item is not easily stored in any significant amounts by the purchaser, and the supplier is the sole provider of the non-financial item for a certain period (i.e., there is an exclusivity agreement between seller and the purchaser).
- The contract cannot be cash settled and the purchaser can be expected to purchase the volume it requires whether the terms in the contract are advantageous or not.

Such contracts can have either a positive or a negative value for the supplier when compared with its costs to produce. Accordingly, these contracts do not meet the definition of an option or a written option in accordance with IFRS 9, because such options can only have a positive value for the holder and only a negative value for the supplier. Therefore, they are not within the scope of IFRS 9.2.7.

End user-commodity contracts could meet the definition of options and written options, in whole or part, and be within the scope of IFRS 9.2.7 when the purchaser has access to the market or to other distributors through supply contracts that the purchaser only exercises if the contract terms are advantageous for the purchaser. Such contracts will only have a negative value for the supplier and are within the scope of IFRS 9 when the non-financial item is readily convertible to cash or the contract can otherwise be settled net in cash in accordance with IFRS 9.2.6. *[IFRS 9.2.6, IFRS 9.2.7]*.

3.3.5 Other contracts containing volume flexibility

It is not uncommon for other sales contracts, such as those with large industrial customers, to contain volume flexibility features. For example, a supplier might enter into a contract requiring it to deliver 100,000 units at a given price, as well as giving the counterparty the option to purchase a further 20,000 units at the same price. The customer has access to markets to readily convert the non-financial item to cash and, following the guidance of the IFRS IC (see section 3.3.4 above), the supplier might consider such a contract to be within the scope of IFRS 9 as it contains a written option.

However, the supplier could split the contract into two separate components for accounting purposes: a forward contract to supply 100,000 units (which may qualify as a normal sale) and a written option to supply 20,000 units (which would not). Arguments put forward include:

- The parties could easily have entered into two separate contracts, a forward contract and a written option.

  And

- It is appropriate to analogise to the requirements for embedded derivatives and separate a written option from the normal forward sale or purchase contract because it is not closely related (see Chapter 42 at section 4).

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21 *IFRIC Update*, March 2007; and INFORMATION FOR OBSERVERS, IFRIC meeting: January 2007, London, Project: *IAS 39* Financial Instruments: Recognition and Measurement - *Written options in retail energy contracts (Agenda Paper 14(iv))*, IASB, paras. 9-11. Available on the IFRS Foundation's website.
Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

22 *IFRIC Update*, March 2007; and INFORMATION FOR OBSERVERS, IFRIC meeting: January 2007, *London*, Project: *IAS 39* Financial Instruments: Recognition and Measurement - *Written options in retail energy contracts (Agenda Paper 14(iv))*, IASB, para. 15. Available on the IFRS Foundation's website.
Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

The IFRS IC was asked to consider the appropriate treatment of such contracts but in spite of noting significant diversity in practice the issue has not been addressed.[23]

How we see it

Entities could apply either of these interpretations as an accounting policy choice. The contract can be considered a written option in its entirety or the option contained in the contract can be considered separate from the fixed quantity sale contract.

If the option is considered separate from the fixed quantity sale contract, the components of the contract are accounted for separately as an executory contract for the fixed quantity of sales and a written option (within the scope of IFRS 9) for the additional quantity that may be delivered. Each component is evaluated individually based on the terms of the contract to determine whether the non-financial item scope exemption set out in IFRS 9.2.4 to 2.7 is met.

However, the entity must adopt a consistent accounting policy for similar contracts.

3.3.6 Fair value option

Own use contracts are accounted for as executory contracts, with the idea that any fair value change of the contract is not relevant given that the contract is used for the entity's own use. However, participants in several industries often enter into similar contracts both for own use and for trading purposes and manage all the contracts together with derivatives on a fair value basis (so as to manage the fair value risk to close to nil). In such a situation, own use accounting leads to an accounting mismatch, as the fair value change of the derivatives and the trading positions cannot be offset against fair value changes of the own use contracts.

To eliminate the accounting mismatch, an entity could apply hedge accounting by designating own use contracts as hedged items in a fair value hedge relationship. However, hedge accounting in these circumstances is administratively burdensome and often produces less meaningful results than fair value accounting. Furthermore, entities enter into large volumes of commodity contracts and, within the large volume of contracts, some positions may naturally offset each other. An entity would therefore typically hedge on a net basis. *[IFRS 9.BCZ2.24]*.

Alternatively, IFRS 9 provides a 'fair value option' for own use contracts. At inception of a contract, an entity may make an irrevocable designation to measure an own use contract at fair value through profit or loss in spite of it being entered into for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirement. However, such designation is only allowed if it eliminates or significantly reduces an accounting mismatch that would otherwise arise from not recognising that contract because it is excluded from the scope of IFRS 9. *[IFRS 9.2.5]*.

3.3.7 Proposed amendments to IFRS 9 and IFRS 7 - Renewable Energy Contracts

3.3.7.A Introduction

On 8 May 2024, the IASB published the ED, *Contracts for Renewable Electricity*, which proposes amendments to IFRS 9 and IFRS 7.[24] The ED contains proposed amendments to:

- Include factors that entities need to consider when applying the 'own-use' requirements in IFRS 9.2.4 to certain contracts for renewable electricity.
- Permit hedge accounting where a contract for renewable electricity with specific characteristics is used as a hedging instrument.

  And
- Add disclosure requirements to enable investors to understand the effects of these contracts on a company's financial performance and future cash flows.

The scope of contracts to which the amendments apply is limited to purchase contracts for renewable electricity that meet specified criteria.

23 IASB Staff paper 16, Project: *Tentative agenda decisions*, Topic: *IAS 39 - Forward contracts with volumetric optionality on non-financial items that are readily convertible to cash*, IFRS IC Meeting, January 2010. Available on the IFRS Foundation's website. Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

24 IASB proposes amendments for renewable electricity contracts. Available on the IFRS Foundation's website.

The comment period closed on 7 August 2024. The IASB aims to finalise any changes by the end of 2024, with the proposal that the new requirements will be available for companies to apply as soon as possible after they are finalised. At the time of writing this publication, the amendments and transition date have not been finalised. Please refer to the IASB website for further information on new developments with respect to the proposed amendments.

The ED is the culmination of work to date which began with a submission to the IFRS IC in 2023 dealing with specific questions relating to power purchase agreements (PPAs).[25] As a result of the submission, the IASB added a maintenance project to the work plan to explore narrow-scope amendments to IFRS 9 to better reflect how financial statements are affected by PPAs.[26]

The narrow-scope proposed amendments cover both physical PPAs (which require physical delivery of the electricity produced) and virtual PPAs (which require net settlement of the difference between the prevailing market price, and the contractually agreed price for the volume of electricity produced from a referenced production facility). This is in response to stakeholders highlighting that the objective of both physical PPAs and virtual PPAs is to ensure access to renewable electricity, and to fix the price per unit of electricity purchased or sold. The economic outcomes are the same, but, in many cases, the design and operation of the electricity market determines the types of contracts entities can enter into.

See Chapter 49 at section 3.2.6.A for details regarding the proposed amendments for hedge accounting. See Chapter 50 at section 10 for details regarding the proposed disclosure amendments.

3.3.7.B Scope of proposed amendments

The proposed amendments only apply to a contract for renewable electricity with both of the following characteristics:

- The source of production of the renewable electricity is nature-dependent so that the supply cannot be guaranteed at specified times or for specified volumes. Examples of such sources of production include wind, sun and water.
- The contract exposes the purchaser to substantially all the volume risk under the contract through 'pay-as-produced' features. Volume risk is the risk that the volume of electricity produced does not align with the purchaser's demand for electricity at the time of production.

The IASB emphasises that the proposed amendments cannot be applied by analogy to other contracts, items or transactions.

The IASB intended the scope of the proposed amendments to be narrow enough to minimise the risk of unintended consequences. Also, the proposed amendments do not cover the accounting for renewables energy certificates (RECs).

3.3.7.C Proposed amendments to the own-use exception

IFRS 9 must be applied to contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into, and continue to be held, for the purpose of the receipt or delivery of a non-financial item, in accordance with the entity's expected purchase, sale or usage requirements (see section 3 above).

The proposed amendments provide guidance for the application of the own-use exception to contracts that meet the scoping characteristics outlined above in section 3.3.7.B. Where the scoping characteristics are met, when assessing if the own-use exception is applicable, an entity considers at inception of the contract, and at each subsequent reporting date:

- The purpose, design and structure of the contract, including the expected delivery of electricity over the remaining duration of the contract.

  And

- The reasons for past and expected sales of unused renewable electricity within a short period after delivery, and whether such sales are in accordance with the entity's expected purchase or usage requirements.

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25 Application of the 'Own-Use' Exception in the Light of Current Market and Geopolitical Questions (IFRS 9 Financial Instruments); IFRIC update June 2023; agenda paper 2

26 Application of the Own-use Exception to Some Physical Power Purchase Agreements-Exploring possible narrow-scope amendments to IFRS 9; IASB update July 2023; Agenda Paper 12A

A sale of unused renewable electricity is in accordance with the entity's expected purchase or usage requirements only if all the criteria below are met:

- The sale arises from the entity's exposure to volume risk, giving rise to mismatches between the renewable electricity delivered, and the entity's electricity demand at the time of delivery.
- The design and operation of the market in which the electricity is sold results in the entity not having the practical ability to determine the timing, or price, of the sale of unused electricity.

  And
- The entity expects to purchase at least an equivalent volume of electricity, within a reasonable time (for example, one month) after the sale, i.e., the entity remains a net-purchaser over a reasonable amount of time.

When assessing if the volumes expected to be delivered are in accordance with the entity's expected purchase or usage requirements, an entity doesn't need to make detailed estimates for extended periods in the future. Rather, an entity may extrapolate projections from reasonable and supportable information available at the reporting date.

The IASB's objective here is to align the proposals with the underlying principle in IFRS 9 that the distinction when assessing the own-use exception is management's intention (evidenced by facts and circumstances) when entering into a contract. Importantly, the IASB notes that if an entity enters into a contract that is expected to continuously deliver more electricity than the entity needs, such an 'oversized' contract would not be in accordance with the entity's expected usage requirements.

The net-purchaser criteria could allow application of the own-use exemption when an entity has frequent and substantial sales during the contract, but only on condition that it remains a net-purchaser over a reasonable amount of time. The latter may preclude contracts for renewable electricity set-up for sites on a ramp-up phase where structural excesses are expected over a time horizon which is longer than a reasonable amount of time. In such cases, applying hedge accounting to a wider scope of forecasted purchases (involving other sites) may be an option to reduce the volatility arising from fair valuing the contract.

The proposed amendments to IFRS 9 balance the need to ensure that the new requirements uphold the underlying principles behind the own-use exception while reflecting management's intention in entering into the contract. Ongoing assessment based on reasonable and supportable information available at the reporting date about changes in the entity's purchase or usage requirements aim to ensure that contracts are reclassified as derivatives in a timely manner if the own-use exception requirements are no longer met.

3.3.7.D Transition and effective date

The proposed effective date for the amendments is not stated in the exposure draft. However, in the questions for comment,[27] the IASB has asked whether an effective date of 'annual reporting periods beginning on or after 1 January 2025' would be appropriate and if it would allow entities enough time to prepare to apply the amendments. They also indicate that early adoption will be permitted.

Transition for the amendments to the own-use requirements will be retrospective. However, an entity is not required to restate prior periods and it is only permitted to do so if it can be done without using hindsight. If an entity does not restate prior periods, it must recognise any difference between the previous carrying amount, and the carrying amount at the beginning of the reporting period in which the amendments are first applied, in opening retained earnings of that reporting period.

27 IASB proposes amendments for renewable electricity contracts. Available on the IFRS Foundation's website.

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Appendix C - Defined terms

Extract from IFRS standards - Definitions	
contract assets	Those rights that IFRS 15 *Revenue from Contracts with Customers* specifies are accounted for in accordance with this Standard for the purposes of recognising and measuring impairment gains or losses. *[IFRS 9 Appendix A]*.
credit risk	The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. *[IFRS 7 Appendix A]*.
derivative	A financial instrument or other contract within the scope of this Standard with all three of the following characteristics. (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying'). (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. (c) it is settled at a future date. *[IFRS 9 Appendix A]*.
dividends	Distributions of profits to holders of equity instruments in proportion to their holdings of a particular class of capital. *[IFRS 9 Appendix A]*.
equity instrument	**An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.** *[IAS 32.11]*.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. *[IFRS 13 Appendix A]*.
financial asset	**A *financial asset* is any asset that is:** **(a) cash;** **(b) an equity instrument of another entity;** **(c) a contractual right:** **(i) to receive cash or another financial asset from another entity; or** **(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or** **(d) a contract that will or may be settled in the entity's own equity instruments and is:** **(i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or** **(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.** *[IAS 32.11]*.

financial guarantee contract	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. *[IFRS 9 Appendix A]*.
financial instrument	**A *financial instrument* is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.** *[IAS 32.11]*.
financial liability	**A *financial liability* is any liability that is:** **(a) a contractual obligation:** **(i) to deliver cash or another financial asset to another entity; or** **(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or** **(b) a contract that will or may be settled in the entity's own equity instruments and is:** **(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or** **(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.** **As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D.** *[IAS 32.11]*.
financial liability at fair value through profit or loss	A financial liability that meets one of the following conditions: (a) it meets the definition of **held for trading**. (b) upon initial recognition it is designated by the entity as at fair value through profit or loss in accordance with paragraph 4.2.2 or 4.3.5. (c) it is designated either upon initial recognition or subsequently as at fair value through profit or loss in accordance with paragraph 6.7.1. *[IFRS 9 Appendix A]*.
finance lease	A lease that transfers substantially all the risks and rewards incidental to ownership of an **underlying asset**. *[IFRS 16 Appendix A]*.
firm commitment	A binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates. *[IFRS 9 Appendix A]*.
forecast transaction	An uncommitted but anticipated future transaction. *[IFRS 9 Appendix A]*.

lease	A contract, or part of a contract, that conveys the right to use an asset **(the underlying asset)** for a period of time in exchange for consideration. *[IFRS 16 Appendix A]*.
lessee	An entity that obtains the right to use an **underlying asset** for a period of time in exchange for consideration. *[IFRS 16 Appendix A]*.
lessor	An entity that provides the right to use an **underlying asset** for a period of time in exchange for consideration. *[IFRS 16 Appendix A]*.
loans payable	Loans payable are financial liabilities, other than short-term trade payables on normal credit terms. *[IFRS 7 Appendix A]*.
operating lease	A lease that does not transfer substantially all the risks and rewards incidental to ownership of an **underlying asset**. *[IFRS 16 Appendix A]*.
puttable instrument	**A *puttable instrument* is a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.** *[IAS 32.11]*.

Chapter 42 Financial instruments: Derivatives and embedded derivatives

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Overview

Under IFRS 9 *Financial Instruments*, the question of whether an instrument is a derivative or not, is an important one for accounting purposes. Derivatives are normally recorded in the statement of financial position at fair value with any changes in value reported in profit or loss (see Chapter 46 at section 2), although there are some exceptions, e.g., derivatives over own equity (see Chapter 43 at section 11) and those that are designated in certain effective hedge relationships (see Chapter 49).

IFRS 9 also contains the concept of an embedded derivative which is described as a component of a hybrid or combined instrument that also includes a non-derivative host contract. In certain circumstances embedded derivatives are required to be accounted for separately as if they were freestanding derivatives, which is considered in more detail in sections 3 to 6 below. Under IFRS 9, the requirement to separate embedded derivatives only applies to financial liabilities not measured at fair value through profit or loss and non-financial items. Embedded derivatives are not separated from financial assets within the scope of IFRS 9, thus the requirements of IFRS 9 are applied to the hybrid contract as a whole.

In section 7 below we consider situations when two or more financial instruments should be accounted for as if they were a single instrument, together with the connected question of linkage (for financial reporting purposes) of transactions more generally.

This chapter does not deal with valuation of derivative financial instruments. Chapter 15 outlines the requirements of IFRS 13 *Fair Value Measurement*, a standard that defines fair value and provides principles-based guidance on how to measure fair value under IFRS. The impact of IBOR Reform on accounting for derivatives and embedded derivatives is included in *Supplement: IBOR Reform*, in particular at section 3.2.

This chapter refers to a number of discussions by the IASB and the IFRS IC on topics relevant to derivatives and embedded derivatives. A number of these discussions were held in the context of IAS 39 *Financial Instruments: Recognition and Measurement*, prior to the effective date of IFRS 9 on 1 January 2018. Those discussions which remain relevant to IFRS 9 have been retained in this chapter. Any differences that exist between the IFRS and US GAAP guidance on derivatives and embedded derivatives are not addressed in this chapter as the standards are not converged.

What you need to know

- The embedded derivative guidance applies to financial liability instruments in scope of IFRS 9 and also contracts such as leases, insurance contracts and executory contracts.
- The assessment whether an embedded derivative should be separated from the host contract is performed when the entity becomes a party to the contract. IFRS 9 prohibits subsequent reassessment.
- For an embedded derivative to be closely related, the related economic characteristics and risks of this embedded feature need to be similar to the host contract.
- Sustainability-linked features in financial liabilities are usually a non-financial variable specific to a party in the contract and therefore do not meet the definition of a derivative. Therefore, they will often not have to be separated from the host contract and separately accounted for.
- For financial assets, it is prohibited under IFRS 9 to separate embedded derivatives. See Chapter 44 at section 1.1 for the relevant guidance.

1 Definition of a derivative

IFRS 9 defines derivatives as follows:

Extract from IFRS 9

Appendix A
Defined terms

derivative	A financial instrument or other contract within the scope of this Standard with all three of the following characteristics. (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying'). (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. (c) it is settled at a future date.

These three defining characteristics are considered further below. *[IFRS 9 Appendix A]*.

1.1 Changes in value in response to changes in underlying

1.1.1 Notional amounts

A derivative usually has a notional amount, such as an amount of currency, number of shares or units of weight or volume, but does not require the holder or writer to invest or receive the notional amount at inception.

Illustration 1-1: Notional amount of a derivative

Company XYZ, whose functional currency is the US dollar, has placed an order with a company in France for delivery in six months' time. The price to be paid in six months' time is €2,000,000. To hedge the exposure to currency risk, Company XYZ enters into a contract with an investment bank to convert US dollars to euros at a fixed exchange rate. The contract requires the investment bank to remit €2,000,000 in exchange for US dollars at a fixed exchange rate of 1.65 (US$3,300,000). The notional amount of the contract in euro term is €2,000,000.

While a derivative usually has a notional amount, this is not always the case. A derivative could require a fixed payment or payment of an amount that can change (but not proportionally with a change in the underlying) as a result of some future event that is unrelated to a notional amount. For example, a contract that requires a fixed payment of €1,000 if six-month SOFR increases by 100 basis points is a derivative, even though a notional amount is not specified (at least not in the conventional sense). *[IFRS 9.BA.1]*. A further Illustration is shown below.

Illustration 1-2: Derivative containing no notional amount

Company XYZ enters into a contract that requires payment of CU1,000 if Company ABC's share price increases by CU5 or more during a six-month period; Company XYZ will receive CU1,000 if the share price decreases by CU5 or more during the same six-month period; no payment will be made if the price swing is less than CU5 up or down.

The settlement amount changes with an underlying, Company ABC's share price, although there is no notional amount to determine the settlement amount. Instead, there is a payment provision that is based on changes in the underlying. Provided all the other characteristics of a derivative are present, which they are in this case, such an instrument is a derivative.[1]

1 IGC Q&A 10-6. Whilst the Implementation Guidance Committee (IGC) discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

1.1.2 Underlying variables

It follows from the definition (see section 1 above) that a derivative will always have at least one underlying variable. The following underlying variables are referred to in the standard, but this is not an exhaustive list (we have provided an example for each of the underlyings):

- Specified interest rate (e.g., EONIA)
- Financial instrument price (e.g., the share price of an entity)
- Commodity price (e.g., the price of a barrel of oil)
- Foreign exchange rate (e.g., the £/$ spot rate)
- Index of prices or rates (e.g., Consumer Price Index)
- Credit rating (e.g., Fitch)
- Credit index (e.g., AAA rated corporate bond index)

  And
- Non-financial variable (e.g., index of earthquake losses or of temperatures)

A contract to receive a royalty, often in exchange for the use of certain property that is not exchange-traded, where the payment is based on the volume of related sales or service revenues is accounted for under IFRS 15 *Revenue from Contracts with Customers* (see Chapter 28 at section 8.5) and not as a derivative.

Derivatives that are based on sales volume or another non-financial variable specific to one party to the contract are not necessarily excluded from the scope of IFRS 9, especially where there is another (financial) underlying in the contract, as set out in the next Illustrations.

Illustration 1-3: Derivative containing two underlyings - foreign currency forward

Company XYZ, whose functional currency is the US dollar, sells products in France denominated in euros. Company XYZ enters into a contract with an investment bank to convert euros to US dollars at a fixed exchange rate. The contract requires Company XYZ to remit euros based on its sales volume in France in exchange for US dollars at a fixed exchange rate of 1.00.

The contract has two underlying variables, the foreign exchange rate and the volume of sales, no initial net investment, and a payment provision. Therefore, as the implementation guidance explains, it is a derivative. IFRS 9 does not exclude from its scope derivatives that are based on sales volume. *[IFRS 9.IG B.8]*.

Illustration 1-4: Derivative containing two underlyings - equity kicker

A venture capital investor, Company V, provides a subordinated loan to Company A and agrees that in addition to interest and repayment of principal, if Company A lists its shares on a stock exchange, Company V will be entitled to receive shares in Company A free of charge or at a very low price (an 'equity kicker'). As a result of this feature, interest on the loan is lower than it would otherwise be.

As the implementation guidance explains, the equity kicker meets the definition of a derivative because its value changes in response to changes in the share price of the borrower, it requires no initial net investment and is settled at a future date. The implementation guidance further explains that the equity kicker meets the definition of a derivative even though the right to receive shares is contingent upon the future listing of the borrower. *[IFRS 9.IG C.4]*.

However, contracts that are linked to variables that might be considered non-financial, such as an entity's revenue, can sometimes cause particular interpretative problems as discussed below.

1.1.3 Non-financial variables specific to one party to the contract

The definition of a derivative (see section 1 above) refers to underlyings that are non-financial variables not specific to one party to the contract. This reference was introduced by IFRS 4 *Insurance Contracts* to help determine whether a financial instrument is an insurance contract (see Chapter 41 at section 2.3). An insurance contract is likely to contain such an underlying, for example the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract. Non-financial variables that are not specific to one party to the contract might include an index of earthquake losses in a particular region or an index of temperatures in a particular city. *[IFRS 9.BA.5]*. Those based on climatic variables are sometimes referred to as 'weather derivatives'. *[IFRS 9.B2.1]*. For periods beginning on or after 1 January 2023, IFRS 4 will be replaced by IFRS 17 *Insurance Contracts*.

A change in the fair value of a non-financial asset is specific to the owner if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific non-financial asset held (a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, the change in that residual value is specific to the owner of the car, and so would not be a derivative. *[IFRS 9.BA.5]*.

Contracts with non-financial variables also arise in the gaming industry where a gaming institution takes a position against a customer. For example, a customer will pay a stake to a bookmaker such that the bookmaker is contractually obliged to pay the customer a specified amount if the bet is a winning one, e.g., if the specified horse wins a given race. The underlying variable (the outcome of the race) is clearly non-financial in nature, but it is unlikely to be specific to either party to the contract. Accordingly, such contracts will typically be derivative financial instruments.[2] In contrast, when a gaming company provides services to manage the organisation of games between two or more parties, this is unlikely to be a derivative and would normally be assessed under the principles of IFRS 15.

How we see it

It is not clear whether the reference to non-financial variables specific to one party to the contract means that all instruments with such an underlying would fail to meet the definition of a derivative or only those contracts that are insurance contracts, for which the reference was originally introduced. Until the standard is clarified, in our view, a legitimate case can be made for either view.

The IFRS IC considered this issue in the context of contracts indexed to an entity's revenue or EBITDA and initially came to a tentative conclusion that the exclusion was not restricted to insurance contracts.[3] However, that conclusion was later withdrawn and the IFRS IC referred the issue to the IASB, recommending that the standard be amended to limit the exclusion to insurance contracts.[4]

The IASB confirmed that it had intended the exclusion to apply only to contracts that are within the scope of IFRS 4[5] however, the IASB eventually decided not to proceed on this issue and the existing definition of a derivative (see section 1 above) was incorporated into IFRS 9 without alteration, leaving the issue unaddressed.

A further issue that arises is that it is not always clear whether a variable is non-financial. This is shown in Illustration 1-5 below where the underlying is associated with an embedded feature which might, or might not, meet the definition of a derivative.

Illustration 1-5: Borrowing with coupons linked to revenue

Company F, a manufacturing entity, issues a debt instrument for its par value of CU10m. It is repayable in ten years' time at par and an annual coupon is payable that comprises two elements: a fixed amount of 2.5% of the par value and a variable amount equating to 0.01% of Company F's annual revenues. Company F does not designate the instrument at fair value through profit or loss.

It is assumed that if Company F had instead issued a more conventional fixed rate borrowing for the same amount with the same maturity it would have been required to pay an annual coupon of 4% of the par value. Therefore, on the face of it, the debt contains an embedded feature that represents a swap with an initial fair value of zero whereby Company F receives a fixed amount annually (1.5% of CU10m) and pays a variable amount annually (0.01% of its annual revenues). The question is now whether this feature represents an embedded derivative that should be separated from the host contact by Company F and accounted for separately - see embedded derivative guidance in section 3 and section 4 below.

It is very hard to argue that the economic characteristics and risks of this embedded feature are closely related to the debt instrument and the variable (Company F's annual revenue) is clearly specific to Company F. The key issue is whether Company F's annual revenue is a financial or non-financial variable and therefore whether the embedded feature meets the definition of a derivative.

2 *IFRIC Update*, July 2007, available on the IFRS Foundation's website.
Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

3 *IFRIC Update*, July 2006, available on the IFRS Foundation's website.
Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

4 *IFRIC Update*, January 2007, available on the IFRS Foundation's website.
Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

5 *IASB Update*, February 2007, available on the IFRS Foundation's website.
Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

It is not only contracts with payments based on revenue that can cause such problems. Some contracts may require payments based on other measures taken or derived from an entity's financial statements such as EBITDA. The IFRS IC considered this matter in July 2006[6] and in January 2007 referred the matter to the IASB.[7] However, the IASB eventually decided not to deal with this issue.

Whilst it is tempting to regard an entity's revenue and EBITDA as financial variables, they are driven by a number of different factors many of which are clearly non-financial in nature, for example the general business risks faced by the entity. In addition, many of the drivers of EBITDA and revenue will be specific to that business, for example the location of the business, the nature of its goods or services and managements actions.

It is worth noting that if a company concludes that such coupons are not derivatives, they will have to exercise judgement on how to incorporate these variable coupons into their EIR calculations, in line with IFRS 9 B5.4.6. Further guidance on this topic can be found in Chapter 46 at section 3.4.1.

One company that has faced this issue in practice is Renault S.A. This company has issued liabilities on which coupons are linked to revenue and net profit. As can be seen in the following Practical example, Renault S.A states that its revenue-linked and net profit-linked features are not considered embedded derivatives and the liabilities are therefore carried at amortised cost. The Practical example below is from Renault S.A's 2021 accounts.

Practical example 1-1: Renault S.A (2021) France

CONSOLIDATED FINANCIAL STATEMENTS 2021 [extract]

6 Notes to the consolidated financial statement [extract]

6.2 Accounting policies and scope of consolidation [extract]

Note 2 - Accounting policies [extract]

2-W. Financial liabilities of the Automotive segments and Sales Financing debts [extract]

Redeemable shares of the Automotive segments are listed subordinated debt instruments that earn a variable return indexed on consolidated revenues. They are carried at amortized cost, determined by discounting forecast coupons using the effective interest rate on borrowings. The estimated effective interest rate takes account of indexation, and the amortized cost recorded in financial result is re-estimated when there is a significant change in future sales prospects, particularly when medium-term business plans are released.

6.5 Financial assets and liabilities, fair value and management of financial risks [extract]

Note 23 - Financial liabilities and sales financing debts [extract]

23-C. Changes in financial liabilities and sales financing debts [extract]

Changes in redeemable shares of the Automotive segments

The redeemable shares issued in October 1983 and April 1984 by Renault SA are subordinated perpetual shares listed on the Paris Stock Exchange. They earn a minimum annual return of 9% comprising a 6.75% fixed portion and a variable portion that depends on consolidated revenues and is calculated based on identical Group structure and methods.

...

6 *IFRIC Update*, July 2006, available on the IFRS Foundation's website.
Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

7 *IFRIC Update*, January 2007, available on the IFRS Foundation's website.
Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

In 2009, the IFRS IC was asked to consider the accounting treatment for an instrument that contains participation rights by which the instrument holder shares in the net income and losses of the issuer. However, the IFRS IC considered the issue without reconsidering the assumptions described in the request, including one that the financial liability did not contain any embedded derivatives.[8] In other words, the IFRS IC implicitly accepted that such a feature need not be separated, but did not indicate that separation was necessarily prohibited.

How we see it

In practice, we believe that an entity may make an accounting policy choice as to whether the entity's revenue, EBITDA or other measures taken or derived from the entity's financial statements, are financial or non-financial variables. Once an entity elects a particular policy, it must consistently apply that approach to all similar transactions.

More recently, entities have started to enter into debt instruments where a component of the interest margin is linked to various sustainability-linked targets. Changes in the interest margin may be dependent on achieving certain targets, such as an annual CO^2 reduction or a pre-defined sociological target. It should be considered whether this variability feature would meet the definition of a derivative, as defined in Appendix A of IFRS 9.

How we see it

In our view, this feature would usually not meet the definition of a derivative, as the sustainability-linked feature is a non-financial variable specific to a party in the contract, being the borrower. As such, no embedded derivative would exist. However, if the sustainability-linked feature is not specific to a party in the contract, then it could meet the definition of a derivative, provided the other characteristics in the definition of a derivative are met.

In the event that the sustainability-linked feature does meet the definition of a derivative, it should be assessed whether it is closely related to the non-derivative host contract. *[IFRS 9.4.3.3]*. This is addressed further in section 4 of this chapter.

1.2 Initial net investment

The second key characteristic of a derivative is that it has no initial net investment, or one that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors (see section 1 above). *[IFRS 9 Appendix A]*.

Currency swaps sometimes require an exchange of different currencies of equal value at inception. This does not mean that they would not meet the definition of a derivative, i.e., no initial net investment or an initial investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, as the following Illustration demonstrates.

Illustration 1-6: Currency swap - initial exchange of principal

Company A and Company B enter into a five-year fixed-for-fixed currency swap on euros and US dollars. The current spot exchange rate is €1 = US$1. The five-year interest rate in the US is 8%, while the five-year interest rate in Europe is 6%. On initiation of the swap, Company A pays €2,000 to Company B, which in return pays US$2,000 to Company A. During the swap's life, Company A and Company B make periodic interest payments to each other without netting. Company B pays 6% per year on the €2,000 it has received (€120 per year), while Company A pays 8% per year on the US$2,000 it has received (US$160 per year). On termination of the swap, the two parties again exchange the original principal amounts.

The currency swap is a derivative financial instrument since the contract involves a zero initial net investment (an exchange of one currency for another of equal fair value), it has an underlying, and it will be settled at a future date. *[IFRS 9 Appendix A]*.

8 *IFRIC Update*, May 2009, available on the IFRS Foundation's website.
Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

The following Illustrations illustrate how to assess the initial net investment characteristic in various prepaid derivatives - these can provide guidance when assessing whether what appears to be a non-derivative instrument is actually a derivative.

Illustration 1-7: Prepaid interest rate swap (prepaid fixed leg)

Company S enters into a CU1,000 notional amount five year pay-fixed, receive-variable interest rate swap. The interest rate of the variable part of the swap resets on a quarterly basis to three-month SOFR. The interest rate of the fixed part of the swap is 10% per annum. At inception of the swap, Company S prepays its fixed obligation of CU500 (CU1,000 × 10% × 5 years), discounted using market interest rates, while retaining the right to receive the SOFR-based interest payments on the CU1,000 over the life of the swap.

The initial net investment in the swap is significantly less than the notional amount on which the variable payments under the variable leg will be calculated and therefore requires an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market conditions, such as a variable rate bond. It therefore fulfils the 'no initial net investment or an initial investment that is smaller than would be required for other types of contracts that would be expected to have similar response to change in market factors' criterion. Even though Company S has no future performance obligation, the ultimate settlement of the contract is at a future date and its value changes in response to changes in SOFR. Accordingly, it is a derivative. *[IFRS 9.IG B.4]*.

Illustration 1-8: Prepaid interest rate swap (prepaid floating leg)

Instead of the transactions in Illustration 1-7 above, Company S enters into a CU1,000 notional amount five year pay-variable, receive-fixed interest rate swap. The variable leg of the swap resets on a quarterly basis to three-month SOFR. The fixed interest payments under the swap are calculated as 10% of the notional amount, i.e., CU100 per year. By agreement with the counterparty, Company S prepays and discharges its obligation under the variable leg of the swap at inception by paying a fixed amount determined according to current market rates, while retaining the right to receive the fixed interest payments of CU100 per year.

The cash inflows under the contract are equivalent to those of a financial instrument with a fixed annuity stream since Company S knows it will receive CU100 per year over the life of the swap. Therefore, all else being equal, the initial investment in the contract should equal that of other financial instruments consisting of fixed annuities. Thus, the initial net investment in the pay-variable, receive-fixed interest rate swap is equal to the investment required in a non-derivative contract that has a similar response to changes in market conditions. For this reason, the instrument does not exhibit characteristic 'no initial net investment or an initial investment that is smaller than would be required for other types of contracts that would be expected to have similar response to changes in market factors' requirement and is therefore not a derivative. *[IFRS 9.IG B.5]*.

The conclusions in Illustration 1-7 and Illustration 1-8 above are fundamentally different for what, on the face of it, appear to be very similar transactions. The key difference is that in Illustration 1-8 all possible cash flow variances are eliminated and, consequently, the resulting cash flows exhibit the characteristics of a simple non-derivative instrument, i.e., an amortising loan.

An option contract meets the definition because the premium is less than the investment that would be required to obtain the underlying financial instrument to which the option is linked. *[IFRS 9.BA.3]*.

The implementation guidance to IFRS 9 suggests that the purchase of a deeply in the money call option would fail to satisfy the original 'little net investment' test if the premium paid was equal or close to the amount required to invest in the underlying instrument. However, the implementation guidance on which Illustration 1-9 below is based explains that a contract is not a derivative if the initial net investment approximates the amount that an entity otherwise would be required to invest. *[IFRS 9.IG B.9]*.

Illustration 1-9: Prepaid forward purchase of shares

Company S also enters into a forward contract to purchase 100 shares in Company T in one year. The current share price is CU50 per share and the one year forward price CU55. Company S is required to prepay the forward contract at inception with a CU5,000 payment.

The initial investment in the forward contract of CU5,000 is less than the notional amount applied to the underlying, 100 shares at the forward price of CU55 per share, i.e., CU5,500. However, the initial net investment approximates the investment that would be required for other types of contracts that would be expected to have a similar response to changes in market factors because Company T's shares could be purchased at inception for the same price of CU50. Accordingly, the prepaid forward does not exhibit characteristic 'no initial net investment or an initial investment that is smaller than would be required for other types of contracts that would be expected to have similar response to changes in market factors' criterion and is therefore not a derivative. *[IFRS 9.IG B.9]*.

Many derivative instruments, such as futures contracts and exchange traded written options, require margin payments. The implementation guidance explains that a margin payment is not part of the initial net investment in a derivative but is a form of collateral for the counterparty or clearing house and may take the form of cash, securities, or other specified assets, typically liquid assets. Consequently, they are separate assets that are accounted for separately. *[IFRS 9.IG B.10]*.

However, while accounted for separately, the margin call and the derivative would be presented net in the statement of financial position if the offsetting requirements of IAS 32 *Financial Instruments: Presentation* are met (see Chapter 50 at section 7.4.1). In some jurisdictions, depending on the precise terms of the related contracts, margin payments may represent a partial settlement of a derivative.

1.3 Future settlement

The third characteristic is that settlement takes place at a future date. Sometimes, a contract will require gross cash settlement. However, as illustrated in the next Illustration, it makes no difference whether the future settlements are gross or net.

Illustration 1-10: Interest rate swap - gross or net settlement

Company ABC is considering entering into an interest rate swap with a counterparty, Company XYZ. The proposed terms are that Company ABC pays a fixed rate of 8% and receives a variable amount based on three-month SOFR, reset on a quarterly basis; the fixed and variable amounts are determined based on a CU1,000 notional amount; Company ABC and Company XYZ do not exchange the notional amount and Company ABC pays or receives a net cash amount each quarter based on the difference between 8% and three month SOFR. Alternatively, settlement may be on a gross basis.

The contract meets the definition of a derivative regardless of whether there is net or gross settlement because its value changes in response to changes in an underlying variable (SOFR), there is no initial net investment, and settlements occur at future dates - it makes no difference whether Company ABC and Company XYZ actually make the interest payments to each other (gross settlement) or settle on a net basis. *[IFRS 9.IG B.3]*.

The definition of a derivative also includes contracts that are settled gross by delivery of the underlying item, e.g., a forward contract to purchase a fixed rate debt instrument.

Expiry of an option at its maturity is a form of settlement even though there is no additional exchange of consideration. Therefore, even if an option is not expected to be exercised, e.g., because it is significantly 'out of the money', it can still be a derivative. *[IFRS 9.IG B.7]*. Such an option will have some value, albeit small, because it still offers the opportunity for gain if it becomes 'in the money' before expiry even if such a possibility is remote - the more remote the possibility, the lower its value.

2 Examples of derivatives

2.1 Common derivatives

The following table provides examples of contracts that normally qualify as derivatives. The list is not exhaustive - any contract that has an underlying may be a derivative. Moreover, as set out in Chapter 41 at section 2, even if an instrument meets the definition of a derivative, it may not fall within the scope of IFRS 9.

Type of contract	Main underlying variable
Interest rate swap	Interest rates
Currency swap (foreign exchange swap)	Currency rates
Commodity swap	Commodity prices
Equity swap	Equity prices (equity of another entity)
Credit swap	Credit rating, credit index, or credit price
Total return swap	Total fair value of the reference asset and interest rates
Purchased or written bond option (call or put)	Interest rates
Purchased or written currency option (call or put)	Currency rates
Purchased or written commodity option (call or put)	Commodity prices
Purchased or written stock option (call or put)	Equity prices (equity of another entity)
Interest rate futures linked to government debt (treasury futures)	Interest rates
Currency futures	Currency rates
Commodity futures	Commodity prices
Interest rate forward linked to government debt (treasury forward)	Interest rates
Currency forward	Currency rates
Commodity forward	Commodity prices
Equity forward	Equity prices (equity of another entity)

[IFRS 9.IG B.2].

Commodity futures are an example of a contract to buy or sell a non-financial item that will meet the definition of a derivative only when they can be settled net in cash or another financial instrument, or by exchanging financial instruments. The rules governing these types of transactions are detailed in Chapter 41 at section 3. This section also explains the exemption from the derivative rules for 'own use' contracts and the circumstances where this exemption is available. These considerations could also be relevant for Carbon Credits and Renewable Energy Certificates. For example, if an entity enters a forward contract to purchase carbon credits, this could meet the definition of a derivative. This will need to be assessed as the market for these products continues to evolve.

2.2 In-substance derivatives

The implementation guidance explains that the accounting should follow the substance of arrangements. In particular, non-derivative transactions should be aggregated and treated as a derivative when, in substance, the transactions result in a derivative. Indicators of this would include:

- They are entered into at the same time and in contemplation of one another
- They have the same counterparty
- They relate to the same risk

  And
- There is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction *[IFRS 9.IG B.6]*

The application of this guidance is illustrated in the following Illustration.

Illustration 2-1: In-substance derivative - offsetting loans

Company A makes a five-year fixed rate loan to Company B, while at the same time Company B makes a five-year variable rate loan for the same amount to Company A. There are no transfers of principal at inception of the two loans, since Company A and Company B have a netting agreement.

The combined contractual effect of the loans is the equivalent of an interest rate swap arrangement, i.e., there is an underlying variable, no initial net investment, and future settlement. This meets the definition of a derivative.

This would be the case even if there was no netting agreement, because the definition of a derivative instrument does not require net settlement (see Illustration 1-10 in section 1.3 above). *[IFRS 9.IG B.6]*.

The analysis above would be equally applicable if the loans were in different currencies - such an arrangement could synthesise a cross-currency interest rate swap and should be accounted for as a derivative if that is its substance.

2.3 Regular way contracts

Extract from IFRS 9

Appendix A
Defined terms

regular way purchase or sale	A purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

Such contracts give rise to a fixed price commitment between trade date and settlement date that meets the definition of a derivative. *[IFRS 9 Appendix A]*. However, because of the short duration of the commitments, they are not accounted for as derivatives but in accordance with special accounting rules. These requirements are discussed in Chapter 45 at section 2.2. *[IFRS 9.BA.4]*.

3 Embedded derivatives

An embedded derivative is a component of a hybrid or combined instrument that also includes a non-derivative host contract; it has the effect that some of the cash flows of the combined instrument vary in a similar way to a stand-alone derivative. In other words, it causes some or all of the cash flows, that otherwise would be required by the contract, to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other underlying variable (provided in the case of a non-financial variable that the variable is not specific to a party to the contract). *[IFRS 9.4.3.1]*.

Common examples of contracts that can contain embedded derivatives include non-derivative financial instruments (especially debt instruments), leases, insurance contracts and contracts for the supply of goods or services.

Under IFRS 9, the embedded derivative rules apply only to financial liabilities that are not measured at fair value through profit or loss and non-financial items. Embedded derivatives are not separated from financial assets within the scope of IFRS 9 because the requirements of IFRS 9 are applied to the hybrid contract as a whole. *[IFRS 9.4.3.2]*.

Normal sale or purchase contracts (see Chapter 41 at section 3) can also contain embedded derivatives.

In the Basis for Conclusions to IFRS 9, the IASB asserts that, in principle, all embedded derivatives that are not measured at fair value with gains and losses recognised in profit or loss ought to be accounted for separately, but explains that, as a practical expedient, they should not be where they are regarded as 'closely related' to their host contracts. In those cases, it is believed less likely that the derivative was embedded to achieve a desired accounting result. *[IFRS 9.BCZ4.92]*.

IFRS 9 defines when an embedded derivative in a host contract should be separated: *[IFRS 9.4.3.3]*

Extract from IFRS 9

4.3.3 If a hybrid contract contains a host that is not an asset within the scope of this Standard, an embedded derivative shall be separated from the host and accounted for as a derivative under this Standard if, and only if:

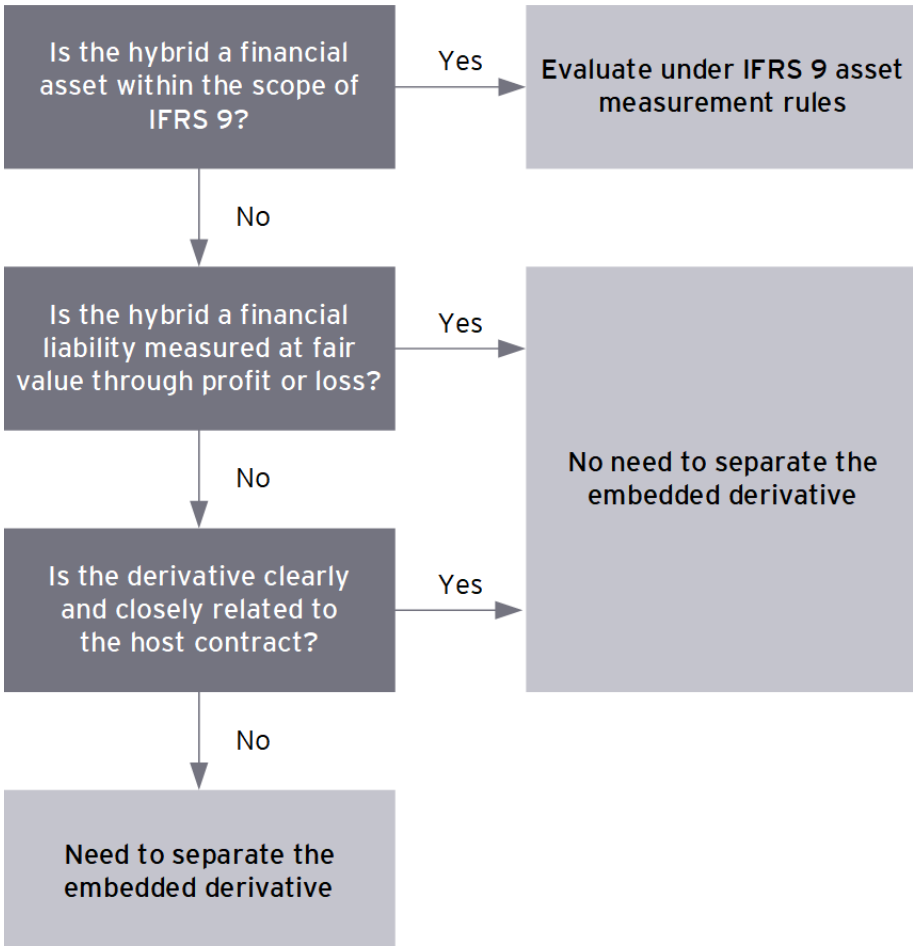
(a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host (see paragraphs B4.3.5 and B4.3.8);

(b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

(c) the hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss (ie a derivative that is embedded in a financial liability at fair value through profit or loss is not separated).

If any of these conditions are not met, the embedded derivative should not be accounted for separately, *[IFRS 9.4.3.3, IFRS 9.B4.3.8]*, i.e., an entity is prohibited from separating an embedded derivative that is closely related to its host contract. The process is similar, although not identical, to that applied when separating the equity element of a compound instrument by the issuer under IAS 32 (see Chapter 43 at section 6). The assessment of the closely related criterion should be made when the entity first becomes a party to a contract or in other words, on initial recognition of the contract (see section 6 below). *[IFRS 9.B4.3.11]*.

The decision-tree diagram below illustrates how to apply the above rules to an embedded derivative that meets the IFRS 9 definition of a stand-alone derivative:



The accounting treatment for a separated embedded derivative is the same as for a standalone derivative. Such an instrument (in this case, a component of an instrument) will normally be recorded in the statement of financial position at fair value with all changes in value being recognised in profit and loss (see section overview above, Chapter 46 at section 2), although there are some exceptions, e.g., embedded derivatives may be designated as a hedging instrument in an effective hedge relationship in the same way as standalone derivatives (see Chapter 49 at section 3.2.3).

A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument. *[IFRS 9.4.3.1]*.

Where the embedded derivative's fair value cannot be determined reliably on the basis of its terms and conditions, it may be determined indirectly as the difference between the hybrid (combined) instrument and the host instrument, if their fair values can be determined. *[IFRS 9.4.3.7]*. If an entity is unable to measure an embedded derivative that is required to be separated from its host, either on acquisition or subsequently, the entire contract is designated at fair value through profit or loss. *[IFRS 9.4.3.6]*.

4 Embedded derivatives: The meaning of 'closely related'

The standard does not define what is meant by 'closely related'. Instead, it illustrates what was intended by providing a series of situations where the embedded derivative is, or is not, regarded as closely related to the host. Making this determination can prove very challenging, not least because the illustrations do not always seem to be consistent with each other. This guidance is considered in the remainder of this subsection.

4.1 Financial instrument hosts

IFRS 9 includes the following guidance regarding financial instruments hosts: *[IFRS 9.B4.3.2]*

Extract from IFRS 9

B4.3.2 If a host contract has no stated or predetermined maturity and represents a residual interest in the net assets of an entity, then its economic characteristics and risks are those of an equity instrument, and an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related. If the host contract is not an equity instrument and meets the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument.

From the issuer's perspective, a hybrid instrument that meets the conditions for classification as equity under IAS 32 (see Chapter 43 at section 3) is excluded from the scope of IFRS 9. The application of these principles are considered in sections 4.1.1 to 4.1.9 below.

The application of these principles is not relevant to the holder of debt or equity instruments as embedded derivatives are not separated from financial assets within the scope of IFRS 9 as the requirements of IFRS 9 are applied to the hybrid contract as a whole. *[IFRS 9.4.3.2]*.

4.1.1 Foreign currency monetary items

A monetary item denominated in a currency other than an entity's functional currency is accounted for under IAS 21 *The Effects of Changes in Foreign Exchange Rates* with foreign currency gains and losses recognised in profit or loss. The embedded foreign currency derivative is considered closely related to the debt host and is not separated. In other words, it would not be considered a functional currency monetary item and a foreign currency forward contract. This also applies where the embedded derivative in a host debt instrument provides a stream of either principal or interest payments denominated in a foreign currency (e.g., a dual currency bond). *[IFRS 9.B4.3.8(c)]*.

4.1.2 Interest rate indices

Many debt instruments contain embedded interest rate indices that can change the amount of interest that would otherwise be paid or received. One of the simplest examples would be a floating rate loan whereby interest is paid quarterly based on three-month SOFR. More complex examples might include the following:

- Inverse floater - coupons are paid at a fixed rate minus SOFR
- Levered inverse floater - as above but a multiplier greater than 1.0 is applied to the resulting coupon
- De-levered floater - coupons lag overall movements in a specified rate, e.g., coupons equal a proportion of the ten-year constant maturity treasuries rate plus a fixed premium

  Or
- Range floater - interest is paid at a fixed rate but only for each day in a given period that SOFR is within a stated range

In such cases the embedded derivative is closely related to the host debt instrument unless:

(a) The hybrid instrument can be settled in such a way that the holder would not recover substantially all of its recognised investment.

  Or

(b) The embedded derivative could at least double the holder's initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract (often referred to as the 'double-double test'). *[IFRS 9.B4.3.8(a)]*.

If a holder is permitted, but not required, to settle the combined instrument in a manner such that it does not recover substantially all of its recognised investment, e.g., puttable debt, condition (a) is not satisfied, and the embedded derivative is not separated. *[IFRS 9.IG C.10]*. The standard does not define 'substantially all' and therefore judgement will need to be applied, considering all relevant facts and circumstances.

To meet condition (b), the embedded derivative must be able to double the initial return on the host contract and result in a rate of return that is at least twice what would be expected for a similar host contract at the time it takes effect. If it meets only one part of this condition, but not the other, the derivative is regarded as closely related to the host. Due to the requirement in IFRS 9.B4.3.8(a), which states: "could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract", the derivative embedded in a simple variable rate loan would be considered closely related to the host because the variable rate at any specific time would be a market rate.

As with all embedded derivatives, the assessment of condition (a) and (b) above is made when the entity becomes party to the contract (see section 3 above) on the basis of market conditions existing at that time. It is important to note that the assessment is based on the possibility of the holder not recovering its recognised investment or doubling its initial return and obtaining twice the then-market return. The likelihood of this happening is ignored in making the assessment. Therefore, even if the likelihood of this happening is low, the embedded derivative has to be separated from the host contract. The valuation of the embedded derivative would, however, consider the low probability of this happening, possibly resulting in a relatively low fair value at inception.

An example where the holder would not recover substantially all of its recognised investment would be a bond which becomes immediately repayable if SOFR increases above a certain threshold, at an amount significantly lower than its issue price. An Illustration is set out below.

Illustration 4-1: Leveraged inverse floater - not recovering substantially all of the initial investment

Company A issues a leveraged inverse floater loan note for its par value of CU20m. Interest is payable annually and is calculated as 10% minus 2 times three-month SOFR. At the time Company A issues the loan note, three-month SOFR is 3%, giving an initial return of 4%. There is no floor imposed on the interest rate and the rate could therefore be negative if SOFR increases above 5%. In such a case, the investor would need to pay interest on its investment, which would leave it unable to recover substantially all of its recognised investment. The embedded derivative is therefore not closely related to the host contract and will be accounted for separately by Company A.

An Illustration of condition (b) above, the 'double-double test', is set out below.

Illustration 4-2: Leveraged inverse floater - 'double-double test'

Assume the same fact pattern as in Illustration 4-1 above, except that there is a floor imposed on the coupon rate so that rate could not be negative. In such a case, the investor would recover substantially all of its recognised investment, meaning that no embedded derivative needs to be separated based on condition (a) above. However, before Company A could conclude on whether or not an embedded derivative needs to be recognised separately, it would need to evaluate condition (b) above. The first step is to assess whether there is a possible scenario in which the initial return of the investor would at least double. If SOFR falls to 0.5%, then the interest rate on the loan note would be 9%, which is more than double the investor's initial rate of return of 4%. The first part of the condition under (b) above is therefore fulfilled.

The question is now whether 9% is twice the market return for a contract with the same terms as the host contract. With SOFR being 0.5% this will most likely be the case, leaving both parts of condition (b) above fulfilled. The embedded derivative is therefore not closely related to the host contract and must be accounted for separately. If, however, it is concluded that 9% is not twice the market return for a contract with the same terms as the host contract, then only one part of the condition under (b) above would be fulfilled and the embedded feature would be considered closely related to the host with no requirement to record it separately.

Another Illustration is when the host contract contains an option to convert fixed-rate debt into floating-rate debt, this is set out below.

Illustration 4-3: Option to convert from fixed to floating

Company A issues a plain vanilla loan note for its par value of CU20m. Interest is payable annually and is set at 4% of the outstanding nominal. The contract contains an option to convert the loan note into a floating rate loan note paying 6-month SOFR plus 1% credit margin.

The holder has the right to exercise the conversion option, on specified dates, with no option to convert back into a fixed rate instrument. This floating rate loan note would mature on the same day as the initial fixed rate debt.

Such an option to convert fixed-rate debt into floating-rate debt is closely related to the fixed rate host debt and does not require separation. This is because, the contract is not leveraged and therefore will likely not lead to meeting condition (a). Further, the conversion option could not result in a rate of return more than double the market yield on a contract with similar terms to the host contract, unless the predetermined credit margin on conversion could mathematically result in a rate of return that is at least twice what the market rate of return would be for a contract with the same terms as the host contract. Therefore, condition (b) is also not met and the option would be closely related.

A recent example where it may be necessary to assess whether an embedded derivative exists is in the context of interest rate benchmark reform and the treatment of fallback provisions. See *Supplement: IBOR Reform* at section 3.2 for further detail.

4.1.3 Term extension and similar call, put and prepayment options in debt instruments

The application guidance explains that a call, put or prepayment option embedded in a host debt instrument is closely related to the host instrument if, on each exercise date, either i) the option's exercise price is approximately equal to the debt instrument's amortised cost or ii) the exercise price reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract; otherwise it is not regarded as closely related. *[IFRS 9.B4.3.5(e)]*. For embedded derivatives with more than one exercise date, there is no requirement to exclusively apply only assessment i) or ii) above to all dates, i.e., provided that either of the assessments is met for each exercise date, the embedded option will be considered to be closely related.

There is no elaboration on what is meant by the term 'approximately equal' and so judgement will need to be applied. In assessing whether the exercise price is approximately equal to the amortised cost at each exercise date, should one consider the amortised cost of the hybrid that would reflect the entity's original expectations regarding the future exercise of the prepayment option, or potential revised estimates applying the catch-up method to the amortised cost? This question is demonstrated in the following simple Illustration (which also provides further examples of the application of the effective interest method to instruments containing prepayment options).

Illustration 4-4: Embedded prepayment option

Company P borrows CU1,000 on terms that require it to pay annual fixed-rate coupons of CU80 and principal of CU1,000 at the end of ten years. The terms of the instrument also allow Company P to redeem the debt after seven years by paying the principal of CU1,000 and a penalty of CU100.

The debt instrument can be considered to comprise the following two components:

- A host debt instrument requiring ten annual payments of CU80 followed by a CU1,000 payment of principal

  And

- An embedded prepayment option, exercisable only at the end of seven years with an exercise price of CU1,100

If, at inception, the prepayment option was expected *not* to be exercised, the effective interest rate of the hybrid instrument would be 8%. This is the rate that would discount the expected cash flows of CU80 per year for ten years plus CU1,000 at the end of ten years to the initial carrying amount of CU1,000. The table below provides information about the amortised cost, interest income and cash flows using this assumption.

Year	(a) Amortised cost at the start of the year (CU)	(b = a × 8%) Interest and similar income (CU)	(c) Cash flows (CU)	(d = a + b - c) Amortised cost at the end of the year (CU)
1	1,000	80	80	1,000
2	1,000	80	80	1,000
3	1,000	80	80	1,000
4	1,000	80	80	1,000
5	1,000	80	80	1,000
6	1,000	80	80	1,000
7	1,000	80	80	1,000
8	1,000	80	80	1,000
9	1,000	80	80	1,000
10	1,000	80	80 + 1,000	-

However, if at the outset the option was expected to be exercised, the effective interest rate of the hybrid would be 9.08% as this is the rate that discounts the expected cash flows of CU80 per year for seven years, plus CU1,100 at the end of seven years, to the initial carrying amount of CU1,000. The table below provides information about the amortised cost, interest income and cash flows using this alternative assumption.

Year	(a) Amortised cost at the start of the year (CU)	(b = a × 9.08%) Interest and similar income (CU)	(c) Cash flows (CU)	(d = a + b - c) Amortised cost at the end of the year (CU)
1	1,000	91	80	1,011
2	1,011	92	80	1,023
3	1,023	93	80	1,036
4	1,036	94	80	1,050
5	1,050	95	80	1,065
6	1,065	97	80	1,082
7	1,082	98	80 + 1,100	-

On the face of it, therefore, comparing the amortised cost of the hybrid instrument with the exercise price of the option at the date it could be exercised suggests the prepayment option might be considered closely related if it was likely to be exercised (since the amortised cost will be approximately equal to the exercise price of CU1,100) but not if exercise was unlikely (since the amortised cost of CU1,000 is not approximately equal to the exercise price of CU1,100).

Unfortunately, the standard is silent on this issue and preparers of accounts will be required to exercise judgement as to the most appropriate method to use in their individual circumstances.

The standard also says that an option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host unless, at the time of the extension, there is a concurrent adjustment to the approximate current market rate of interest. *[IFRS 9.B4.3.5(b)]*. The current market rate of interest would take into consideration the credit risk of the issuer. Also, if an entity issues a debt instrument and the holder writes a call option on the debt instrument to a third party, the issuer regards the call option as extending the term to maturity of the debt instrument, provided the issuer can be required to participate in or facilitate the remarketing of the debt instrument as a result of the call option being exercised. *[IFRS 9.B4.3.5(b)]*. Such a component is presumably considered to represent part of a hybrid financial instrument contract rather than a separate instrument (see section 3 above).

Taken in isolation, the preceding paragraph and the first paragraph in this section on call, put or prepayment options appear reasonably straightforward to apply. However, in some situations, they are contradictory as set out in the following Illustration.

Illustration 4-5: Extension and prepayment options

Company Z borrows CU1,000 from Bank A on which it is required to pay CU50 per annum interest. Under the terms of the borrowing agreement, Company Z is required to repay CU1,000 in three years' time unless, at repayment date, it exercises an option to extend the term of the borrowing for a further two years. If this option is exercised CU50 interest per annum is payable for the additional term.

Company Z also borrows CU1,000 from Bank B on which it is required to pay CU50 per annum interest. Under the terms of this borrowing agreement, Company Z is required to repay CU1,000 in five years' time unless, at the end of three years, it exercises an option to redeem the borrowing for CU1,000.

In all practical respects these two instruments are identical - the only difference is the way in which the terms of the embedded options are expressed. In the first case, the guidance indicates that the term extension option is not closely related to the debt, as there is no concurrent adjustment to market interest rates. However, in the second case the prepayment option is considered closely related provided the amortised cost of the liability would be approximately CU1,000, the exercise price of the settlement option, at the end of year three, which it should be.

As set out in section 5.2 below, an embedded option-based derivative should be separated from its host contract on the basis of the stated terms of the option feature. However, in situations similar to the one described in Illustration 4-5 above, there is significant diversity in practice and we are aware of at least two ways in which entities have dealt with this contradiction in practice. Some entities have looked to the wording in the contract so that what is described as an extension option (or a prepayment option) is evaluated in accordance with the guidance for extension options (or prepayment options). Other entities have determined the most likely outcome of the hybrid instrument based on conditions at initial recognition and the alternative outcome is regarded as the 'option'. Under this latter approach, if Company Z in the Illustration above considered it was likely to repay its loans from Bank A and Bank B after three years, both loans would be regarded as having a two-year extension option. The first approach is based on the contractual terms, while the second approach is substance-based.

Another complication is that, viewed as a separate instrument, a term extension option is effectively a loan commitment. As loan commitments are generally outside the scope of IFRS 9, except for derecognition and impairment provisions (see Chapter 41 at section 2.5), some would argue they do not meet the definition of a derivative (see section 1 above). Accordingly, when embedded in a host debt instrument, a loan commitment would not be separated as an embedded derivative or, alternatively, would be separated and accounted for as a loan commitment.[9]

The IFRS IC discussed both above contradictions in March 2012, noting significant diversity in practice and recommended that the IASB consider this issue when it redeliberated the classification and measurement requirements of financial liabilities under IFRS 9. The IFRS IC decided that if the Board did not address this issue as part of its redeliberation, then the IFRS IC would revisit this issue and consider whether guidance should be provided to clarify the accounting for the issuer of a fixed-rate-debt instrument that includes a term-extending option.[10] This issue remains unaddressed in IFRS 9 with no indication from the IFRS IC about bringing it back onto its agenda. Preparers of financial statements are therefore left to apply their own judgement considering all the facts and circumstances.

For put, call and prepayment options, there is a further complication that the determination as to whether the option is closely related depends on the amortised cost of the instrument. It is not clear whether this reference is to the amortised cost of the host instrument, on the assumption that the option is separated, or to the amortised cost of the entire instrument on the assumption that the option is not separated. As can be seen in Chapter 46 at section 3.4, the existence of such options can affect the amortised cost, especially for a portfolio of instruments. Although one trade body has published guidance explaining that where early repayment fees are included in the calculation of effective interest, the prepayment option is likely to be closely related to the loan,[11] entities are largely left to apply their own judgement to assess which appears the most appropriate in the specific circumstances.

9 Staff paper, *Term-extending options in fixed rate debt instruments*, IFRS IC, March 2012. Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

10 *IFRIC Update*, March 2012, available on the IFRS Foundation's website.
Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

11 *Implementation of International Accounting Standards*, British Bankers' Association, July 2004, para. 10. Whilst the guidance was provided in the context of IAS 39, it holds true under IFRS 9.

Prepayment options are also considered closely related to the host debt instrument if the exercise price reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract. For these purposes, lost interest is the product of the principal amount prepaid multiplied by the interest rate differential, i.e., the excess of the effective interest rate of the host contract over the effective interest rate that the entity would receive at the prepayment date if it reinvested the principal amount prepaid in a similar contract for the remaining term of the host contract. *[IFRS 9.B4.3.5(e)(ii)]*. In other words, in order for the prepayment option to be considered closely related to the host, the exercise price of the prepayment option would need to compensate the lender for loss of interest by reducing the economic loss from that which would be incurred on reinvestment. *[IFRS 9.BCZ4.97]*. In making this assessment, the question may arise what interest rate should be used to discount the interest payments that would be lost if the prepayment option was exercised. If the discount rate used reflects an equivalent credit risk of the issuer, this would seem reasonable. However, the guidance does not prescribe the discount rate to be used and since the assessment is whether the lender would be reimbursed for an amount that is 'approximately equal' to the present value of lost interest, there is scope to exercise judgement in determining the appropriate discount rate.

Another question that may arise is whether the lost interest test requires the lender to be reimbursed for lost interest over the full remaining contractual term at the date of exercise. The assessment states that the interest may be 'an amount up to' the present value of the remaining interest. This suggests that the amount may be less than the remaining present value of the contractual interest over the full remaining contractual term. Where this is the case, the prepayment option would be deemed to be closely related.

From the perspective of the issuer of a convertible debt instrument with an embedded call or put option, the assessment of whether the option is closely related to the host debt instrument is made before separating the equity element in accordance with IAS 32. *[IFRS 9.B4.3.5(e)]*. This provides a specific relaxation from the general guidance on prepayment options above because, for accounting purposes, separate accounting for the equity component results in a discount on recognition of the liability component (see Chapter 42 at section 6.2), which means that the amortised cost and exercise price are unlikely to approximate to each other for much of the term of the instrument.

An embedded prepayment option in an interest-only or principal-only strip is regarded as closely related to the host contract provided the host contract (i) initially resulted from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative, and (ii) does not contain any terms not present in the original host debt contract. *[IFRS 9.B4.3.8(e)]*. Again, this is a specific relaxation from the general guidance on prepayment options above.

There are also many capital instruments which have prepayment options that are contingent on a future event, for example a change of tax law or accounting rules. The standard is silent about how to perform the assessment of whether a contingent prepayment option is closely related to the host contract (the 'closely related' assessment).

How we see it

In our view, whether a prepayment option is closely related to the host contract depends on the exercise price only and the contingency should not affect the assessment.

4.1.4 Interest rate floors and caps

IFRS 9 provides the following guidance related to interest rate floors and caps: *[IFRS 9.B4.3.8(b)]*

Extract from IFRS 9

B4.3.8 The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.

(a) …

(b) An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract …

(c) …

The standard does not clarify what is meant by 'market rate of interest', or whether the cap and floor should be considered as a single derivative, or a series of caplets and floorlets to be evaluated separately. Where the derivative rate is at a constant amount throughout the term of the debt, historically entities have often compared that rate with the current spot floating rate at inception of the contract to determine whether the embedded derivative is closely related.

How we see it

We do not believe it is necessary for both a cap and a floor to be present to be considered closely related. For example, a floor on the coupon paid on a debt instrument without a corresponding cap could be regarded as closely related to the host, provided it was below the market rate of interest on origination.

When interest rates are extremely low, or negative, floors are more commonly set at higher rates than current spot rates. As a result, entities would need to evaluate whether more sophisticated approaches to evaluate these features are more appropriate, e.g., by comparing the average forward rate over the life of the bond with the floor rate or by comparing the forward rate at each interest reset date with each floorlet rate.

The IFRS IC was asked, in January 2016, to clarify the application of the embedded derivatives requirements in a negative interest rate environment. The IFRS IC observed that:

- Paragraph B4.3.8(b) of IFRS 9 does not distinguish between positive and negative interest rate environments. As such an interest rate floor in a negative interest rate environment should be treated in the same way as in a positive interest rate environment.
- When applying IFRS 9.B4.3.8(b) in a positive or negative interest rate environment, an entity should compare the overall interest rate floor (i.e., benchmark interest rate referenced in the contract plus contractual spreads and if applicable any premiums, discounts or other elements that would be relevant to the calculation of the effective interest rate) for the hybrid contract to the market rate of interest for a similar contract without the interest rate floor (i.e., the host contract).

  And
- The appropriate market rate of interest for the host contract should be determined by considering the specific forms of the host contract and the relevant spreads (including credit spreads) appropriate for the transaction. They also noted that the term 'market rate of interest' is linked to the concept of fair value as defined in IFRS 13 and is described in IFRS 9 as the rate of interest "for a similar instrument (similar as to currency, term, type of interest and other factors) with a similar credit rating". *[IFRS 9.B5.1.1]*.

The IFRS IC determined that neither an Interpretation nor an amendment to a Standard was necessary and did not add this issue to its agenda.[12]

In practice, entities perform the assessment of whether a cap or floor satisfies the requirements of IFRS 9.B4.3.8 (b) by either considering the cap or floor as a single instrument and applying the corresponding average forward swap rate (e.g., comparing a 5-year swap rate against a 5-year cap/floor strike), or by considering the component caplets and floorlets making up the overall cap or floor using the forward rate for the payment date of each particular caplet or floorlet. It is also acceptable to compare each of the individual cap/floor strike rates with the corresponding forward interest rate and assess whether, on average, the total cap/floor is closely related.

Where the assessment is performed as a single instrument and an entity determines that the cap or floor is not closely related, then the whole embedded derivative is accounted for as a single, non-closely related, embedded derivative at fair value through profit or loss.

4.1.5 Inflation-linked debt instruments

It is quite common for some entities and governments to issue inflation-linked debt instruments, i.e., where interest and/or principal payments are linked to, say, a consumer price index. The only embedded derivative guidance in IFRS 9 relating to embedded inflation-linked features is provided in the context of leases (see section 4.3.2 below). If that guidance is accepted as applying to finance leases, it should also apply to debt instruments because finance leases result in assets and liabilities that are, in substance, no different to debt instruments (see Chapter 41 at section 1.2.4). Further, in much finance theory, either real (applied to current prices) or nominal (applied to inflation adjusted prices) interest rates are used, suggesting a strong link between inflation and interest rates. Finally, a government or central bank will generally raise short-term interest rates as inflation rises and reduce rates as inflation recedes, which also suggests a close relationship between the two.

12 *IFRIC Update*, January 2016, available on the IFRS Foundation's website.

How we see it

We believe it would often be appropriate to treat the embedded derivative in inflation-linked debt as similar to an interest rate index and refer to the guidance in section 4.1.2 above to determine whether the index is regarded as closely related to the debt.

Typically, the index will be closely related to the debt where it is based on inflation in an economic environment in which the bond is issued/denominated, it is not significantly leveraged in relation to the debt and there is a sufficiently low risk of the investor not recovering its initial investment. An investor may lose their initial investment on an inflation-linked instrument if cumulative inflation over the life of the bond is negative and the rate is not floored at zero. Although this risk is often small, an argument could be constructed to separate the embedded derivative on the grounds that the initial investment could not be fully recovered.

The staff of the IFRS IC has expressed a view that it would be appropriate to treat the embedded derivative in inflation-linked debt as closely related in economic environments where interest rates are mainly set so as to meet inflation targets, as evidenced by strong long-run correlation between nominal interest rates and inflation. In such jurisdictions, they considered the characteristics and risks of the inflation embedded derivative to be closely related to the host debt contract.[13] Further, in debating the application of the effective interest method to such instruments (see Chapter 46 at section 3.6) they have implicitly acknowledged that these instruments do not necessarily contain embedded derivatives requiring separation.

4.1.6 Commodity- and equity-linked interest and principal payments

Equity-indexed or commodity-indexed interest or principal payments embedded in a host debt instrument, i.e., where the amount of interest or principal is indexed to the value of an equity instrument or commodity (e.g., gold), are not closely related to the host debt instrument because the risks inherent in the embedded derivative are dissimilar to those of the host. *[IFRS 9.B4.3.5(c), IFRS 9.B4.3.5(d)]*. This is shown in Illustration 4-6 below.

Illustration 4-6: Bond linked to a commodity price

A mining company issues a ten-year debt instrument for its par value of CU15m. Interest is payable annually and consists of guaranteed interest of 5% per annum and contingent interest of 0.5% if the price of commodity A increases above CU300 in the relevant year, 1% if the price of commodity A increases above CU400 in the relevant year or 1.5% if the price of commodity A increases above CU500 in the relevant year. The mining company could have issued the bond without the contingent interest rate feature at a rate of 6%.

The commodity price feature is a swap contract to receive 1% fixed interest and pay a variable amount of interest depending on the price of commodity A. This feature is not closely related to the debt host contract.

A common type of transaction that does not involve a debt instrument is where refiners of commodities enter into purchase contracts for mineral ores, whose price is adjusted subsequent to delivery, based on the quoted market price of the refined commodity extracted from the ore. These arrangements, often called provisionally priced contracts, can provide the refiner with a hedge of the fair value of its inventories and/or related sales proceeds which vary depending on subsequent changes in quoted commodity prices.

Like the debt instruments noted above, any payable (or receivable) recognised at the time of delivery will contain an embedded commodity derivative. In these circumstances, any payable will either need to be fair valued through profit or loss or the embedded derivative will need to be separated. Since the receivable is an asset within the scope of IFRS 9, the embedded derivative cannot be separated.

However, it would not normally be regarded as necessary to account separately for such an embedded derivative prior to delivery of the non-financial item. This is because, until delivery occurs, the contract is considered executory and the pricing feature would be considered closely related to the commodity being delivered (see section 4.2.2 below).

13 Information for Observers of March 2006 IFRS IC meeting, *Hedging Inflation Risk* (Agenda Paper 12), IASB, March 2006, para. 32. Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

4.1.7 Credit-linked notes

Credit derivatives are sometimes embedded in a host debt instrument whereby one party (the 'beneficiary') transfers the credit risk of a particular reference asset, which it may not own, to another party (the 'guarantor'). Such credit derivatives allow the guarantor to assume the credit risk associated with the reference asset without directly owning it. *[IFRS 9.B4.3.5(f)]*.

Whilst the economic characteristics of a debt instrument will include credit risk, should the embedded derivative be a credit derivative linked to the credit standing of an entity other than the issuer, it would not normally be regarded as closely related to the host debt instrument if the issuer were not required, through the terms of the financial instrument, to own the reference asset.

For example, a structured entity may issue various tranches of debt instruments that are referenced to a group of assets, such as a portfolio of bonds, mortgages or trade receivables, and the credit exposure from those assets is allocated to the debt instruments using a so called 'waterfall' feature. The waterfall feature itself does not normally result in the separation of an embedded credit derivative; it is the location or ownership of the reference assets that is most important to the assessment.[14] If the structured entity is required to hold the reference assets, the credit risk embedded in the debt instruments is considered closely related. However, if the issuer of the debt instruments held a credit derivative over the reference assets rather than the assets themselves, the embedded credit derivative would not be regarded as closely related.

4.1.8 Instruments with an equity kicker

In some instances, venture capital entities provide subordinated loans on terms that entitle them to receive shares if and when the borrowing entity lists its shares on a stock exchange, as illustrated in the following Illustration, which is based on the same fact pattern as Illustration 1-4 in section 1.1.2 above.

Illustration 4-7: Equity kicker

A venture capital investor, Company V, provides a subordinated loan to Company A and agrees that in addition to interest and repayment of principal, if Company A lists its shares on a stock exchange, Company V will be entitled to receive shares in Company A free of charge or at a very low price (an 'equity kicker'). As a result of this feature, interest on the loan is lower than it would otherwise be. The loan is not measured by Company A at fair value with changes in fair value recognised in profit or loss.

The economic characteristics and risks of an equity return are not closely related to those of the host debt instrument. The equity kicker meets the definition of a derivative because it has a value that changes in response to the change in the price of Company A's shares, requires only a relatively small initial net investment, and is settled at a future date. It does not matter that the right to receive shares is contingent upon the borrower's future listing (although the probability of this event occurring will influence the fair value of the embedded derivative). *[IFRS 9.IG C.4]*.

Similarly, the derivative embedded in a bond that is convertible (or exchangeable) into equity shares of a third party will not be closely related to the host debt instrument.

4.1.9 Puttable instruments

Another example of a hybrid contract is a financial instrument that gives the holder a right to put it back to the issuer (a 'puttable instrument') in exchange for an amount that varies with the change in an equity or commodity price or index. Where the host is a debt instrument, the embedded derivative that creates the indexed principal payment cannot be regarded as closely related to that debt instrument. As the principal payment can increase and decrease, the embedded derivative is a non-option derivative whose value is indexed to the underlying variable (see section 5.1 below). *[IFRS 9.B4.3.5(a), IFRS 9.B4.3.6]*.

14 Information for Observers (December 2008 IASB meeting), *Clarification of accounting for investments in collateralised debt obligations* (Agenda Paper 6E), IASB, December 2008 and Q&As on accounting for some collateralised debts obligations (CDOs) - prepared by staff of the IASB, IASB, February 2009. Whilst the IASB discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

From the perspective of the issuer of a puttable instrument that can be put back at any time for cash equal to a proportionate share of the net asset value of an entity (such as units of an open-ended mutual fund or some unit-linked investment products), the effect of the issuer separating an embedded derivative and accounting for each component is to measure the combined instrument at the redemption amount that would be payable at the end of the reporting period if the holder were to exercise its right to put the instrument back to the issuer. *[IFRS 9.B4.3.7]*.

For the holder of such an instrument, the requirements of the standard are applied to the instrument as a whole, resulting in such investments in puttable instruments being recognised at fair value through profit or loss in their entirety. *[IFRS 9.4.3.2]*.

This treatment was clarified by the IFRS IC in May 2017 when the IFRS IC confirmed that the election to present subsequent changes in fair value in other comprehensive income was not available to these instruments, as they did not meet the definition of an equity instrument.[15]

Whilst it was not explicitly stated, the ineligibility of such instruments to make this election means they must be recognised at fair value through profit or loss.

4.2 Contracts for the sale of goods or services

4.2.1 Foreign currency derivatives

An embedded foreign currency derivative in a contract that is an insurance contract, or not a financial instrument, is closely related to the host contract provided it is not leveraged, does not contain an option feature and requires payments denominated in one of the following currencies:

(i) The functional currency of any substantial party to the contract - see section 4.2.1.A below

(ii) The currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions) - see section 4.2.1.B below

Or

(iii) A currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (e.g., a relatively stable and liquid currency that is commonly used in local business transactions or external trade) - see section 4.2.1.C below

Therefore, in all of the above cases the embedded foreign currency derivative is not accounted for separately from the host contract. *[IFRS 9.B4.3.8(d)]*. These criteria are examined in more detail below.

4.2.1.A Functional currency of counterparty

In principle, the assessment of criterion (i) in section 4.2.1 above is straightforward. In practice, however, the functional currency of the counterparty to a contract will not always be known with certainty and, in some cases, can be a somewhat subjective assessment even for the counterparty's management (assuming the counterparty is a corporate entity) - see Chapter 16 at section 4. Consequently, entities will need to demonstrate they have taken appropriate steps to make a reasonable judgement as to their counterparties' functional currencies. Where available, a counterparty's financial statements will provide evidence of its functional currency. Otherwise, it would often be appropriate to assume that an entity operating in a single country has that country's currency as its functional currency, although if there are indicators to the contrary these would have to be considered.

Another practical problem that arises in applying this criterion is identifying which parties to a contract are 'substantial'. IFRS 9 does not provide any further guidance, but it is generally considered that such a party should be one that is acting as principal to the contract. Therefore if, as part of a contract, a parent provides a performance guarantee in respect of services to be provided by its operating subsidiary, the parent may be seen to be the substantial party to the contract and not the subsidiary, where the subsidiary is acting as an agent. However, if the guarantee is not expected to be called upon, the parent would not normally be considered a substantial party to the contract. Particular care is necessary when assessing a contract under which one party subcontracts an element of the work to another entity under common control, say a fellow subsidiary with a different functional currency, although in most cases it will only be the primary contractor that is considered a substantial party.

15 *IFRIC Update*, May 2017, available on the IFRS Foundation's website.

4.2.1.B Routinely denominated in commercial transactions

For the purposes of criterion (ii) in section 4.2.1 above, the currency must be used for similar transactions all around the world, not just in one local area. For example, if cross-border transactions in natural gas in North America are routinely denominated in US dollars and such transactions are routinely denominated in euros in Europe, neither the US dollar nor the euro is a currency in which the good or service is routinely denominated in international commerce. *[IFRS 9.IG C.9]*. Accordingly, the number of items to which this will apply will be limited - in practice it will be mainly commodities that are traded in, say, US dollars throughout much of the world. Examples include crude oil, jet fuel, certain base metals (including aluminium, copper and nickel) and some precious metals (including gold, silver and platinum). One other notable item might be wide-bodied aircraft where it appears that Boeing and Airbus, the two major manufacturers, routinely denominate sales in US dollars.

In September 2014, the IFRS IC received a request relating to the routinely denominated criterion. They were asked to consider whether a licensing agreement denominated in a currency, in which commercial transactions of that type were routinely denominated around the world, held an embedded foreign currency derivative that was closely related to the economic characteristics of the host contract.[16]

The IFRS IC noted that the issue related to a contract for a specific type of item and observed that an assessment of routinely denominated criterion is based on evidence of whether or not such commercial transactions are denominated in that currency all around the world and not merely in one local area. They further observed that the assessment of the routinely denominated criterion is a question of fact and is based on an assessment of available evidence.

4.2.1.C Commonly used currencies

The IASB noted that the requirement to separate embedded foreign currency derivatives may be burdensome for entities that operate in economies in which business contracts denominated in a foreign currency are common. For example, entities domiciled in small countries may find it convenient to denominate business contracts with entities from other small countries in an internationally liquid currency (such as the US dollar, euro or yen) rather than the local currency of any party to the transaction. Also, an entity operating in a hyperinflationary economy may use a price list in a hard currency to protect against inflation, for example an entity that has a foreign operation in a hyperinflationary economy that denominates local contracts in the functional currency of the parent. *[IFRS 9.BCZ4.94]*.

Unfortunately, however, the assessment of whether or not a particular currency meets this requirement in a particular situation has not been straightforward in practice and this question reached the attention of the IFRS IC in May 2007.

The IFRS IC debated this matter in four consecutive meetings before referring the matter to the IASB. During its debates, the IFRS IC noted that entities should:[17]

- Identify where the transaction takes place.

  This is not as straightforward as it might seem. For example, consider a Polish company that manufactures components in Poland and exports them to a third party in the Czech Republic. Should the sale of components be regarded as a transaction occurring in Poland or in the Czech Republic?[18] It is likely that the Polish company would regard it as occurring in Poland and the Czech entity in the Czech Republic, but this is not entirely beyond debate.
- Identify currencies that are commonly used in the economic environment in which the transaction takes place.

  Entities need to address what the population of transactions in the economic environment is. Some might suggest that transactions to which (i) or (ii) in section 4.2.1 above apply should be excluded, although this is not a view shared by the staff of the IFRS IC which considered that all transactions should be included.[19]

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16 *IFRIC Update*, September 2014, available on the IFRS Foundation's website.
Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

17 *IFRIC Update*, May 2007, available on the IFRS Foundation's website.
Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

18 Information for Observers (May 2007 IFRS IC meeting), *IAS 39: Financial Instruments: Recognition and Measurement AG33(d)(iii) of IAS 39* (Agenda Paper 11(v)), IASB, May 2007, paras. 12-14. Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

19 Information for Observers, paras. 18-19. Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

Entities should also consider what an economic environment is. The guidance in IFRS 9.IG C.7, on which Illustration 4-8 in section 4.2.1.D below is based, implies that a country could be an economic environment. The references to local business transactions and to external trade in section 4.2.1 (iii) above suggest that other examples of economic environment are the external trade or internal trade environment of the country in which the transaction takes place. The question remains as to whether there could be other economic environments, for example the luxury goods market in a country. Depending on the view taken, a different treatment could arise.[20] In considering the issue subsequently, the IASB staff noted their understanding that all of these views (and possibly more, such as the internal or external trade of a specific company) were being applied in practice.[21]

The IFRS IC had also been asked to provide guidance on how to interpret the term 'common', but understandably was reluctant to do so.[22] The IASB staff noted that there is no guidance as to the quantum of transactions or value that would need to be denominated in a foreign currency to conclude that the currency was commonly used and that a related matter is whether 'common' should be considered in the context of a particular entity, of an industry, or of a country.[23]

The IASB staff noted other related interpretive questions raised by constituents including the following:[24]

- What evidence does an entity require to support the notion that the use of a currency is common?
- Does the reporting entity need to investigate published statistics?
- If the reporting entity has to look for statistics, what percentage of business needs to be conducted in that currency to assert that use of the currency is common?
- Whether the consideration that a currency is commonly used should exclude from the population set those transactions falling under (i) or (ii) in section 4.2.1 above?

They concluded that there are a variety of views on the appropriate interpretation of this guidance and, consequently, that there is significant diversity in practice.[25]

Ultimately, however, no additional guidance has been included within IFRS 9 and, therefore, determining what constitutes 'common' remains a matter where judgement is required.

4.2.1.D Examples and other practical issues

The application of the guidance above is illustrated below.

Illustration 4-8: Oil contract denominated in Swiss francs

A Norwegian company agrees to sell oil to a company in France. The oil contract is denominated in Swiss francs, although oil contracts are routinely denominated in US dollars in international commerce and Norwegian krone are commonly used in contracts to purchase or sell non-financial items in Norway. Neither company carries out any significant activities in Swiss francs.

The Norwegian company should regard the supply contract as a host contract with an embedded foreign currency forward to purchase Swiss francs. The French company should regard it as a host contract with an embedded foreign currency forward to sell Swiss francs. *[IFRS 9.IG C.7]*.

20 Information for Observers, paras. 20-28. Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

21 Information for Observers (December 2007 IASB meeting), *Application of paragraph AG33(d)(iii) - Bifurcation of embedded foreign currency derivative* (Agenda Paper 3C), IASB, December 2007, para. 11. Whilst the IASB discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

22 Information for Observers (May 2007 IFRS IC meeting), *IAS 39: Financial Instruments: Recognition and Measurement AG33(d)(iii) of IAS 39* (Agenda Paper 11(v)), IASB, May 2007, para. 44. Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

23 Information for Observers (December 2007 IASB meeting), *Application of paragraph AG33(d)(iii) - Bifurcation of embedded foreign currency derivative* (Agenda Paper 3C), IASB, December 2007, paras. 12-13. Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

24 Information for Observers, para. 14. Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

25 Information for Observers, para. 15. Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

The implementation guidance on which this Illustration is based does not state in which currency the host contract should be denominated (this will also be the currency of the second leg of the embedded forward contract). The currency should be chosen so that the host does not contain an embedded derivative requiring separation. In theory, therefore, it could be Norwegian krone or euro (the functional currencies of the parties to the contract) or US dollars (the currency in which oil contracts are routinely denominated in international commerce). Typically, however, an entity will use its own functional currency to define the terms of the host contract and embedded derivative.

A second issue arises where the terms of the contract require delivery and payment on different dates. For example, assume the contract was entered into on 1 January, with delivery scheduled for 30 June and payment required by 30 September. Should the embedded derivative be considered a six-month forward contract maturing on 30 June, or a nine-month forward contract maturing on 30 September? Conceptually at least, the latter approach seems more satisfactory, because it does not introduce into the notional terms cash flows at a point in time (i.e., on delivery) when none exist in the combined contract. In practice, however, the former approach is used far more often and is not without technical merit. It avoids the recognition of an embedded foreign currency derivative between the delivery and payment dates on what would be a foreign currency denominated monetary item, something that is prohibited by IFRS 9 (see section 4.1.1 above).

Illustration 4-9: Oil contract, denominated in US dollars and containing a leveraged foreign exchange payment

Company A, whose functional currency is the euro, enters into a contract with Company B, whose functional currency is the Norwegian Krone, to purchase oil in six months for US$1,000. The host oil contract will be settled by making and taking delivery in the normal course of business and is not accounted for as a financial instrument because it qualifies as a normal sale or purchase contract (see Chapter 41 at section 3.3). The oil contract includes a leveraged foreign exchange provision whereby the parties, in addition to the provision of, and payment for oil, will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian Krone applied to a notional amount of US$100,000.

The payment of US$1,000 under the host oil contract can be viewed as a foreign currency derivative because the dollar is neither Company A nor Company B's functional currency. However, it would not be separated as the US dollar is the currency in which crude oil transactions are routinely denominated in international commerce.

The leveraged foreign exchange provision is in addition to the required payment for the oil transaction. It is unrelated to the host oil contract and is therefore separated and accounted for as an embedded derivative. *[IFRS 9.IG C.8]*.

In practice, all but the simplest contracts will contain other terms and features that can often make it much more difficult to isolate the precise terms of the embedded foreign currency derivative (and the host). For example, a clause may allow a purchaser to terminate the contract in return for making a specified compensation payment to the supplier. The standard offers little guidance whether such a feature should be included within the terms of the host, of the embedded foreign currency derivative or, possibly, of both. Other problematic terms can include options to defer the specified delivery date and options to order additional goods or services.

Another practical issue arises when part of the contract price is in a currency that is neither party's functional currency, nor meets the other exemptions in IFRS 9.B4.3.8(d). The question arises whether that component of the contract should be treated as an embedded derivative and accounted for separately.

How we see it

In our view, when part of the contract price is in a currency that is neither party's functional currency, nor meets the other exemptions in IFRS 9.B4.3.8(d), the entity treats that component of the contract as an embedded derivative and accounts for it separately.

4.2.2 Inputs, ingredients, substitutes and other proxy pricing mechanisms

It is common for the pricing of contracts for the supply of goods, services or other non-financial items to be determined by reference to the price of inputs to, ingredients used to generate, or substitutes for the non-financial item, especially where the non-financial item is not itself quoted in an active market. For example, a provider of call centre services may determine that a large proportion of the costs of providing the service will be employee costs in a particular country. Accordingly, it may seek to link the price in a long-term contract to supply its services to the relevant wage index, effectively to provide an economic hedge of its exposure to changes in employee costs. Similarly, the producer of goods may index the price of its product to the market value of commodities that are used in the production process.

The standard contains little or no detailed guidance for determining whether or not such pricing features should be considered closely related to the host contract. However, the general requirement of the standard to assess the economic characteristics and risks would suggest that where a good link to the inputs can be established, such features will normally be considered closely related to the host, unless they were significantly leveraged.

Other proxy pricing mechanisms may arise in long-term supply agreements for commodities where there is no active market in the commodity. For example, in the 1980s, when natural gas first started to be extracted from the North Sea in significant volumes, there was no active market for that gas and thus no market price on which to base the price of long-term contracts. Because of this, suppliers and customers were willing to enter into such contracts where the price was indexed to the market price of other commodities such as crude oil that could potentially be used as a substitute for gas. For contracts entered into before the development of an active gas market, such features would normally be considered closely related, especially if similar pricing mechanisms were commonly used by other participants in the market.

Where there is an active market price for the non-financial items being supplied under the contract, different considerations apply.

How we see it

In our view, if the non-financial item for which an active market exists is priced by indexing it to a proxy, this mechanism is a strong indication that the entity has entered into a speculative position and we would not normally consider such features to be closely related to the host.

The separation of these types of embedded derivatives can be seen in the following Practical example from BP p.l.c.'s financial statements. Although this was disclosed under IAS 39, there is no reason to believe that the outcome would be different under IFRS 9.

Practical example 4-1: BP p.l.c. (2014) **United Kingdom**

Annual Report and Form 20-F 2014 [extract]

Notes on financial statements [extract]

28. Derivative financial instruments [extract]

Embedded derivatives

The group is a party to certain natural gas contracts containing embedded derivatives. Prior to the development of an active gas trading market, UK gas contracts were priced using a basket of available price indices, primarily relating to oil products, power and inflation. After the development of an active UK gas market, certain contracts were entered into or renegotiated using pricing formulae not directly related to gas prices, for example, oil product and power prices. In these circumstances, pricing formulae have been determined to be derivatives, embedded within the overall contractual arrangements that are not clearly and closely related to the underlying commodity. The resulting fair value relating to these contracts is recognized on the balance sheet with gains or losses recognized in the income statement.

Key information on the natural gas contracts is given below.

At 31 December	2014	2013
Remaining contract terms	**5 months to 3 years and 9 months**	1 year and 5 months to 4 years and 9 months
Contractual/notional amount	**70 million therms**	153 million therms

...

4.2.3 Inflation-linked features

Apart from those related to leases (see section 4.3.2 below), there is no reference in the guidance to contracts containing payments that are linked to inflation. Many types of contracts contain inflation-linked payments and it would appear sensible to apply the guidance in respect of leases to these contracts. Consider, for example, a long-term agreement to supply services under which payments increase by reference to a general price index and are not leveraged in any way. In cases such as this, the embedded inflation-linked derivative would normally be considered closely related to the host, provided the index related to a measure of inflation in an appropriate economic environment, such as the one in which the services were being supplied.

4.2.4 Floors and caps

Similar to debt instruments (see section 4.1.4 above), provisions within a contract to purchase or sell an asset (e.g., a commodity) that establishes a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out-of-the-money at inception and are not leveraged. *[IFRS 9.B4.3.8(b)]*.

4.2.5 Fund performance fees

In the investment management industry, it is common for a fund manager to receive a fee based on the performance of the assets managed in addition to a base fee. For example, if a fund's net asset value increases over its accounting year, the manager may be entitled to a percentage of that increase. The contract for providing investment management services to the fund clearly contains an embedded derivative (the underlying is the value of the fund's assets).

How we see it

In our view, it would normally be appropriate to regard such fund performance fee type features as closely related to the host contract.

Performance-based fees are examples of variable consideration, which is discussed in more detail in Chapter 28 at sections 5.2.2 and 5.2.3.

4.3 Leases

IFRS 9 provides the following guidance for embedded derivatives within lease contracts: *[IFRS 9.B4.3.8(f)]*

Extract from IFRS 9

B4.3.8 The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.

(a) ...

(f) An embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is (i) an inflation-related index such as an index of lease payments to a consumer price index (provided that the lease is not leveraged and the index relates to inflation in the entity's own economic environment), (ii) variable lease payments based on related sales or (iii) variable lease payments based on variable interest rates.

(g) ...

These examples are dealt with in sections 4.3.1 to 4.3.4 below.

4.3.1 Foreign currency derivatives

A lessor's finance lease receivable or a lessee's lease payable, which is recognised in accordance with IFRS 16 *Leases*, is accounted for as a financial instrument, albeit one that is not subject to all of the measurement requirements of IFRS 9 (see Chapter 41 at section 1.2.4). Therefore, a lease denominated in a foreign currency will not generally be considered to contain an embedded foreign currency derivative requiring separation, because the payable or receivable is a monetary item within the scope of IAS21.

However, under IFRS 16, an operating lease for a lessor and a short-term lease for a lessee, is accounted for as an executory contract. Accordingly, where the lease payments are denominated in a foreign currency, the analysis in section 4.2.1 above is applicable and it may be necessary to separate an embedded derivative. See Illustration 5-1 in section 5.1 below for an example of a foreign exchange currency derivative requiring separation from a (hybrid) lease contract.

4.3.2 Inflation-linked features

An embedded derivative in a lease is considered closely related to the host if it is an inflation-related index such as an index of lease payments to a consumer price index, provided that the lease is not leveraged and the index relates to inflation in the entity's own economic environment. *[IFRS 9.B4.3.8(f)(i)]*.

4.3.3 Contingent rentals based on related sales

Where a lease requires contingent rentals based on related sales, that embedded derivative is considered to be closely related to the host lease. *[IFRS 9.B4.3.8(f)(ii)]*.

4.3.4 Contingent rentals based on variable interest rates

If a derivative embedded within a lease arises from contingent rentals based on variable interest rates, it is considered closely related. *[IFRS 9.B4.3.8(f)(iii)]*.

4.4 Insurance contracts

The guidance in sections 4.1.2 to 4.1.4, 4.1.6 and 4.2.1 above also applies to insurance contracts. IFRS 4 added two further illustrations to IFRS 9 that deal primarily with insurance contracts.

A unit-linking feature embedded in a host financial instrument, or host insurance contract, is closely related to the host if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund. A unit-linking feature is a contractual term that requires payments denominated in units of an internal or external investment fund. *[IFRS 9.B4.3.8(g)]*.

A derivative embedded in an insurance contract is closely related to the host if the embedded derivative and host are so interdependent that the embedded derivative cannot be measured separately, i.e., without considering the host contract. *[IFRS 9.B4.3.8(h)]*.

Derivatives embedded within insurance contracts are covered in more detail in Chapter 51 at section 5.1.

5 Identifying the terms of embedded derivatives and host contracts

The IASB has provided only limited guidance on determining the terms of a separated embedded derivative and host contract. Accordingly, entities may find this aspect of the embedded derivative requirements particularly difficult to implement. In addition to the guidance set out below, Illustration 4-8 and Illustration 4-9 in section 4.2.1.D above also identify the terms of an embedded derivative requiring separation. For guidance on assessing whether day one profits can arise on the separation of an embedded derivative, please refer to Chapter 45 at section 3.5.

5.1 Embedded non-option derivatives

IFRS 9 does not define the term 'non-option derivative' but suggests that it includes forwards, swaps and similar contracts. An embedded derivative of this type should be separated from its host contract on the basis of its stated or implied substantive terms, so as to result in it having a fair value of zero at initial recognition. *[IFRS 9.B4.3.3]*.

The IASB has provided implementation guidance on separating non-option derivatives in the situation where the host is a debt instrument. It is explained that, in the absence of implied or stated terms, judgement will be necessary to identify the terms of the host (e.g., whether it should be a fixed rate, variable rate or zero-coupon instrument) and the embedded derivative. However, an embedded derivative that is not already clearly present in the hybrid should not be separated, i.e., a cash flow that does not exist cannot be created. *[IFRS 9.IG C.1]*.

For example, if a five-year debt instrument has fixed annual interest payments of CU40 and a principal payment at maturity of CU1,000 multiplied by the change in an equity price index, it would be inappropriate to identify a floating rate host and an embedded equity swap that has an offsetting floating rate leg. The host should be a fixed rate debt instrument that pays CU40 annually because there are no floating interest rate cash flows in the hybrid instrument. *[IFRS 9.IG C.1]*.

Further, as noted above, the terms of the embedded derivative should be determined so that it has a fair value of zero on inception of the hybrid instrument. It is explained that if an embedded non-option derivative could be separated on other terms, a single hybrid instrument could be decomposed into an infinite variety of combinations of host debt instruments and embedded derivatives. This might be achieved, for example, by separating embedded derivatives with terms that create leverage, asymmetry or some other risk exposure not already present in the hybrid instrument. *[IFRS 9.IG C.1]*.

Finally, it is explained that the terms of the embedded derivative should be identified based on the conditions existing when the financial instrument was issued, *[IFRS 9.IG C.1]*, or when a contract is required to be reassessed (see section 6 below).

The following Illustration illustrates how a foreign currency derivative embedded in a (hybrid) lease contract, that is not closely related, could be separated.

Illustration 5-1: Separation of embedded derivative from a lease

Company X has Indian Rupees (INR) as its functional currency. On 1 January 20X1 Company X entered into a nine-month lease over an item of PP&E which required payments of US$100,000 on 31 March 20X1, 30 June 20X1 and 30 September 20X1. The functional currency of the lessor is not US dollars; the price of such leases is not routinely denominated in US dollars and US dollars is not a currency that is commonly used in the economic environment in which the lease took place (see section 4.3.1 above). Accordingly, the embedded foreign currency derivative is not closely related to the lease.

On 1 January 20X1 the spot exchange rate was 40 and the forward exchange rates for settlement on 31 March 20X1, 30 June 20X1 and 30 September 20X1 were 41, 42 and 43 respectively. The terms of the embedded derivative could be determined as follows:

31 March 20X1	Pay US$100,000	Receive INR4,100,000
30 June 20X1	Pay US$100,000	Receive INR4,200,000
30 September 20X1	Pay US$100,000	Receive INR4,300,000

Given the terms of the embedded derivative above, the host contract will be a nine-month lease over the same PP&E as the hybrid lease contract, commencing 1 January 20X1 and with scheduled payments of INR 4,100,000, INR 4,200,000 and INR 4,300,000 on 31 March 20X1, 30 June 20X1 and 30 September 20X1. It can be seen that this host, after separation of the foreign currency derivative, an INR denominated lease, does not contain an embedded derivative requiring separation and the combined terms of the two components sum to the terms of the hybrid contract.

5.2 Embedded option-based derivative

As for non-option derivatives, IFRS 9 does not define the term 'option-based derivative' but suggests that it includes puts, calls, caps, floors and swaptions. An embedded derivative of this type should be separated from its host contract on the basis of the stated terms of the option feature. *[IFRS 9.B4.3.3]*.

The implementation guidance explains that the economic nature of an option-based derivative is fundamentally different from a non-option derivative and depends critically on the strike price (or strike rate) specified for the option feature in the hybrid instrument. Therefore, the separation of such a derivative should be based on the stated terms of the option feature documented in the hybrid instrument. Consequently, in contrast to the position for non-option derivatives (see section 5.1 above), an embedded option-based derivative would not normally have a fair value of zero. *[IFRS 9.IG C.2]*.

In fact, if the terms of an embedded option-based derivative were identified so as to result in it having a fair value of zero, the implied strike price would generally result in the option being infinitely out-of-the-money, i.e., it would have a zero probability of the option feature being exercised. However, since the probability of exercising the option feature is generally not zero, this would be inconsistent with the likely economic behaviour of the hybrid. *[IFRS 9.IG C.2]*.

Similarly, if the terms were identified to achieve an intrinsic value of zero, the strike price would equal the price of the underlying at initial recognition. In this case, the fair value of the option would consist only of time value. However, this may also be inconsistent with the likely economic behaviour of the hybrid, including the probability of the option feature being exercised, unless the agreed strike price was indeed equal to the price of the underlying at initial recognition. *[IFRS 9.IG C.2]*.

5.3 Multiple embedded derivatives

The Standard includes the following guidance related to the issue of multiple embedded derivatives: *[IFRS 9.B4.3.4]*

Extract from IFRS 9

B4.3.4 Generally, multiple embedded derivatives in a single hybrid contract are treated as a single compound embedded derivative. However, embedded derivatives that are classified as equity (see IAS 32 *Financial Instruments: Presentation*) are accounted for separately from those classified as assets or liabilities. In addition, if a hybrid contract has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other.

For example, if a debt instrument has a principal amount related to an equity index and that amount doubles if the equity index exceeds a certain level, it is not appropriate to separate both a forward and an option on the equity index because those derivative features relate to the same risk exposure. Instead, the forward and option elements are treated as a single compound embedded derivative. Similarly, for an embedded call, put or prepayment option, if the risk associated with the option varies distinctly in different periods over the debt instrument's life, it would still be considered as a single embedded derivative. For the same reason, an embedded floor or cap on interest rates should not be separated into a series of 'floorlets' or 'caplets' (i.e., single interest rate options).[26]

On the other hand, if a hybrid debt instrument contains, for example, two options that give the holder a right to choose both the interest rate index on which interest payments are determined and the currency in which the principal is repaid, those two options may qualify for separation as two separate embedded derivatives since they relate to different risk exposures and are readily separable and independent of each other.[27]

26 IGC Q&A 23-8. Whilst the IGC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

27 IGC Q&A 23-8. Whilst the IGC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

6 Reassessment of embedded derivatives

On initial recognition, a contract should be reviewed to assess whether it contains one or more embedded derivatives requiring separation. However, the issue arises whether an entity is required to continue to carry out this assessment after it first becomes a party to a contract, and if so, with what frequency. *[IFRS 9.BCZ4.99]*.

The question is relevant, for example, when the terms of the embedded derivative do not change but market conditions change and the market was the principal factor in determining whether the host contract and embedded derivative are closely related. Instances when this might arise are embedded foreign currency derivatives in host contracts that are insurance contracts or contracts for the purchase or sale of a non-financial item denominated in a foreign currency. *[IFRS 9.BCZ4.100, IFRS 9.B4.3.8(d)]*.

Consider, for example, an entity that enters into a purchase contract denominated in US dollars. If, at the time the contract is entered into, US dollars are commonly used in the economic environment in which the transaction takes place, the contract will not contain an embedded foreign currency derivative requiring separation. Subsequently however, the economic environment may change such that transactions are now commonly denominated in euros, rather than US dollars. Countries joining the European Union may encounter just such a scenario.

Clearly, in this situation, an embedded foreign currency derivative would be separated from any new US dollar denominated purchase contracts, assuming they would not otherwise be considered closely related. However, should the entity separately account for derivatives embedded within its existing US dollar denominated contracts that were outstanding prior to the change in the market?

Conversely, the entity may have identified, and separately accounted for, embedded foreign currency derivatives in contracts denominated in euros that were entered into before the economic environment changed. Does the change in economic circumstances mean that the embedded derivative should now be considered closely related and not separately accounted for as a derivative? *[IFRS 9.BCZ4.100, IFRS 9.BCZ4.101]*

IFRS 9 confirms that entities should assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. Subsequent reassessment is prohibited unless there is a change in the terms of a contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case an assessment is required. An entity determines whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows on the contract. *[IFRS 9.B4.3.11]*.

For a financial liability, a change to the terms of the contract which significantly modifies the cash flows may also require derecognition of the original instrument and recognition of a new instrument. This is discussed in more detail in Chapter 48 at section 6.

6.1 Acquisition of contracts

IFRS 9 requires an entity to assess whether an embedded derivative needs to be separated from the host contract and accounted for as a derivative when it first becomes a party to that contract. Therefore, if an entity purchases a contract that contains an embedded derivative, it assesses whether the embedded derivative needs to be separated and accounted for as a derivative on the basis of conditions at the date it acquires it, not the date the original contract was established. *[IFRS 9.BCZ4.106]*.

6.2 Business combinations

From the point of view of a consolidated entity, the acquisition of a contract within a business combination accounted for using the acquisition method under IFRS 3 *Business Combinations, in principle,* is not different from the acquisition of a contract in general. Consequently, an assessment of the acquiree's contracts should be made on the date of acquisition as if the contracts themselves had been acquired. *[IFRS 3.15, IFRS 3.16(c)]*.

Under IFRS 3, on the acquisition date, the entire contract is to be recorded at fair value. For classification and subsequent measurement, IFRS 3.16 requires an acquirer to assess whether an embedded derivative should be separated from the host contract in accordance with IFRS 9. If, on the acquisition date, the acquirer assesses there is an embedded derivative that needs to be separated and accounted for as a derivative, another question that arises is how the acquirer should separate the embedded derivative from the host contract. IFRS 9 requires a non-option embedded derivative to be separated from its host contract on the basis of its stated or implied substantive terms, so as to result in it having a fair value of zero at initial recognition. *[IFRS 9.B4.3.3]*. In applying IFRS 9.B4.3.3, it should be noted that IFRS 9.IG C.1 requires the terms of an embedded derivative to be determined so that it has a fair value of zero on inception of the hybrid instrument and that the terms of the embedded derivative should be identified based on the conditions existing when the financial instrument was issued (contract inception). *[IFRS 9.IG C.1]*.

In the context of a business acquisition, the initial recognition of an acquired contract is at the acquisition date, which could be sometime after the date the contract was originally signed. This leads to the question of how the acquirer should apply the guidance in IFRS 9.B4.3.3 in the context of a business acquisition, specifically, whether the acquirer should separate an embedded derivative so as it has zero fair value at contract inception or zero fair value at the acquisition date, which is the initial recognition date of the acquirer.

How we see it

We believe that IFRS 9.B4.3.3 doesn't contemplate a contract that is acquired upon a business acquisition subsequent to its inception, and therefore, the guidance in IFRS 9.IG C.1 could be referred to in applying IFRS 9 B4.3.3 for this situation. IFRS 9.B4.3.3 also refers to "stated or implied substantive terms" and in the absence of explicit contractual terms, implied terms could be determined based the market conditions at the time the contract was issued. We therefore believe that one appropriate approach is to determine the terms of the embedded derivative so as it had a fair value of zero on contract inception, i.e., when the hybrid contract was initially signed.

The following Illustration illustrate how an acquirer could separate an embedded derivative at the acquisition date.

Illustration 6-1: Separation of embedded derivative from a VPPA acquired as part of business combination

A business operating a windfarm enters into a virtual power purchase agreement (VPPA) contract on 1/1/20X0 for 15 years to sell to a third party (the purchaser) its output, which is made up of electricity and renewable energy credits (RECs) for a bundled fixed price of $50.

Due to the operation of the market, electricity must always be transferred via the energy market operator, which means the windfarm business supplies electricity to the energy market operator (at spot price), which in turn supplies electricity to the purchaser (at spot price). Consequently, the VPPA contract incorporates two elements:

- a sale of electricity designed as a contract for difference (CfD), that is net cash-settled, over the notional volume of electricity supplied (by the windfarm business to the market operator), based on the difference between the fixed price (received by the windfarm business from the purchaser) and spot price (paid by the windfarm business to the purchaser); and
- a sale of RECs from the windfarm business to the purchaser. The RECs obtained by the windfarm business, from electricity it produces, are transferred directly to the purchaser.

The electricity component of the VPPA is an embedded derivative that is to be separated from the residual host, being the sale of RECs, unless the entire VPPA is accounted for at fair value through profit or loss. At inception of the VPPA contract, when separating the embedded derivative, the $50 bundled price is split in a manner that the forward electricity derivative has a fair value of zero and the residual amount determines the forward sale price of the RECs. Based on the conditions at inception (e.g., electricity price curve), this results in the implied fixed price of the forward electricity derivative of $30 and the remaining $20 price is allocated to the forward sale price of RECs. Subsequently, the electricity derivative is carried at fair value through profit or loss, and fair value is measured with reference to market price of electricity (among other factors) and the $30 fixed price allocated in the unbundling exercise.

At 1/1/20X3, an acquirer purchases the windfarm business in a business combination that is to be accounted for under IFRS 3. At the acquisition date, the entire contract is fair valued based on the current market conditions. For classification and subsequent measurement, the existence of any embedded derivatives is also to be assessed by the acquirer. In this case, the embedded electricity component is assessed for separation by the acquirer and determined that it is a separable embedded derivative, which the acquirer will choose to separately account for at fair value. In order to separate, the acquirer will need to split the $50 bundled fixed price for the electricity component and RECs component.

The basis for splitting the $50 bundled fixed price by the acquiree at contract inception may be used by the acquirer for splitting the price. In accordance with IFRS 9.IG C.1, which requires the terms of an embedded derivative to be determined so that it has a fair value of zero on inception of the hybrid instrument, this approach is considered an appropriate one.

Determining the terms of the embedded derivative so it has fair value of zero at the acquisition date could result in an uneconomical outcome, since after contract inception, the electricity market could have moved such that the fixed price allocated to each component (in order for the electricity embedded derivative to have zero fair value at the acquisition date) no longer reflects the substance of the contract as negotiated initially, which is a bundle contract with a bundle price made of two priced components. This could happen in the situation when, in order for the electricity component to have fair value of zero at the acquisition date, and based on the conditions at the acquisition date, the implied fixed price of the electricity component is determined to be $50, thus the price allocated to the REC component is zero.

Neither IFRS 9 nor IFRS 3 applies to a combination of entities or businesses under common control or the formation of a joint venture. *[IFRS 3.2, IFRS 9.B4.3.12]*.

How we see it

However, in our view, if the acquisition method is applied to a combination of entities or businesses under common control or the formation of a joint venture, the requirements set out in IFRS 3 should be followed.

6.3 Remeasurement issues arising from reassessment

IFRS 9 does not address remeasurement issues arising from a reassessment of embedded derivatives. One of the reasons for prohibiting reassessment in general was the difficulty in determining the accounting treatment following a reassessment, which is explained in the following terms.

Assume that an entity, when it first became party to a contract, separately recognised a host asset not within the scope of IFRS 9, and an embedded derivative liability. If the entity were required to reassess whether the embedded derivative was to be accounted for separately and if the entity concluded sometime after becoming a party to the contract that the derivative was no longer required to be separated, then questions of recognition and measurement would arise. In the above circumstances, the entity could: *[IFRS 9.BCZ4.105]*

(a) Remove the derivative from its statement of financial position and recognise in profit or loss a corresponding gain or loss. This would lead to recognition of a gain or loss even though there had been no transaction and no change in the value of the total contract or its components.

(b) Leave the derivative as a separate item in the statement of financial position. The issue would then arise as to when the item is to be removed from the statement of financial position. Should it be amortised (and, if so, how would the amortisation affect the effective interest rate of the asset), or should it be derecognised only when the asset is derecognised?

(c) Combine the derivative (which is recognised at fair value) with the asset (which may not be recognised at fair value). This would alter the carrying amount of the asset even though there had been no change in the economics of the whole contract.

IFRS 9 states that subsequent reassessment is appropriate only when there has been a change in the terms of the contract that 'significantly' modifies the cash flows, accordingly the above issues are not expected to arise. *[IFRS 9.BCZ4.105]*.

7 Linked and separate transactions and 'synthetic' instruments

A derivative that is attached to a financial instrument, but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument. *[IFRS 9.4.3.1]*.

This is also the case where a synthetic instrument is created by using derivatives to 'alter' the nature of a non-derivative instrument, as illustrated in the following Illustration:

Illustration 7-1: Investment in a synthetic fixed-rate debt

Company A issues a five-year floating rate debt instrument. At the same time, it enters into a five year pay-fixed, receive-variable interest rate swap with Entity B. Company A considers the combination of the two instruments to be a synthetic fixed rate instrument.

Embedded derivatives are terms and conditions that are included in non-derivative host contracts and it is generally inappropriate to treat two or more separate financial instruments as a single combined, or synthetic, instrument. Each of the financial instruments has its own terms and conditions and may be transferred or settled separately. Therefore, the debt instrument and the swap must be classified separately. *[IFRS 9.IG C.6]*.

It is asserted that these transactions differ from those discussed in section 2.2 above because those had no substance apart from the resulting interest rate swap. *[IFRS 9.IG C.6]*.

Although some might argue that the substance of the two transactions above is the resulting synthetic fixed rate debt instrument, this interpretation is clearly not allowed under the standard.

Interestingly, the guidance does not address a much more common situation whereby a company both borrows from, and transacts a related derivative with, the same counterparty - typically the borrowing will be floating rate and the derivative a perfectly matched pay-fixed, receive-floating interest rate swap.

In fact, the subject of linking transactions for accounting purposes is a difficult one, especially in the context of financial instruments. The IASB's *Conceptual Framework* specifies that transactions should be reported in accordance with their substance and economic reality and not merely their legal form, *[CF 2.12]*, and linking transactions can be seen as dealing with the question of how to interpret this principle.

IAS 32 and IFRS 9 deal with the subject in a piecemeal way. For example, in addition to the synthetic instrument in the Illustration above:

- Two or more non-derivative contracts that are, 'in substance', no more than a single derivative are treated as a single derivative (see section 2.2 above).
- Derivatives that are 'attached' to a non-derivative financial instrument may sometimes be regarded as part of a single combined instrument (see section 3 above).
- In classifying an instrument in consolidated financial statements as equity or a financial liability, all terms and conditions agreed between members of the group and holders of the instrument are considered (see Chapter 43 at section 4.8).
- If a loan is guaranteed by a third party, the expected credit loss determined in accordance with IFRS 9 should be calculated based on the combined credit risk of the guarantor and the guaranteed party if the guarantee is 'integral' to the contractual terms of the loan (see Chapter 47 at section 5.8.1.A).

  And
- Determining the appropriate accounting treatment for a transaction that involves the transfer of some or all rights associated with financial assets, without the sale of the assets themselves, inevitably involves linking separate contracts to assess whether the transaction results in derecognition of the assets. For example, there might be one contract defining the continued ownership of the asset and another obliging the owner to transfer the rights associated with the asset to a third party (see Chapter 45 at section 2, Chapter 46 at section 2 and Chapter 48 at section 3 and section 4).

The IFRS IC first considered the subject of linkage in 2002 and has, in the past, made certain recommendations to the IASB. In fact, the requirement to take account of linked terms when classifying instruments as debt or equity in consolidated financial statements was introduced into IAS 32 in December 2003 following the IFRS IC's deliberations. Despite agreeing proposed indicators for when transactions should be linked, and proposed guidance on accounting for linked transactions, these have never been published as an interpretation or standard.[28]

In August 2013, the IFRS IC received a request to clarify whether three different transactions should be accounted for separately or be aggregated and treated as a single derivative. The IFRS IC decided not to add this issue to its agenda but noted that in order to determine whether to aggregate and account for the three transactions as a single derivative, reference should be made to B.6 (see section 2.2 above) and C.6 (see Illustration 7-1 above) of the Implementation Guidance to IFRS 9 and IAS 32.AG39. The IFRS IC noted that the application of the guidance in IFRS 9.B.6 requires judgement and that the indicators in that paragraph may help an entity to determine the substance of the transaction, but that the presence or absence of any single specific indicator alone may not be conclusive.[29]

Consequently, in considering the borrowing and swap situation above, we are left principally with the guidance in IFRS 9. It is likely that the swap and the loan have their own terms and conditions and may be transferred or settled independently of each other. Therefore, the principles in Illustration 7-1 above would suggest separate accounting for the two instruments. Applying the guidance in section 2.2 above (aggregating non-derivative transactions and treating them as a derivative) would also suggest separate accounting in most cases. Even though the instruments are transacted with the same counterparty, there will normally be a substantive business purpose for transacting the instruments separately.

It seems clear that in situations involving two separate legal contracts, in most cases, the two instruments will be regarded as separate for accounting purposes. However, in certain situations the linkage between those contracts (normally itself contractual) may be such that for accounting purposes those contracts cannot be regarded as existing independently of each other.

28 *IFRIC Update*, April 2002, *IFRIC Update*, July 2002 and *IFRIC Update*, February 2003 and *IASB Update*, October 2002, available on the IFRS Foundation's website.
Whilst the IFRS IC discussions were held in the context of IAS 39, the discussions also hold true under IFRS 9.

29 *IFRIC Update*, March 2014, available on the IFRS Foundation's website.
Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9.

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Appendix B - Defined terms

Extract from IFRS 9

Appendix A
Defined terms

derivative	A financial instrument or other contract within the scope of this Standard with all three of the following characteristics. (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying'). (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. (c) it is settled at a future date.
regular way purchase or sale	A purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

Chapter 43 Financial instruments: Financial liabilities and equity

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Overview

The distinction between an equity instrument and a financial liability, from the perspective of the issuer can be complex. Some instruments, while being legally equity, can have characteristics that are, in substance, those of a financial liability, while other instruments can have a number of different features with the characteristics of both debt and equity.

To provide consistent classification of such instruments, the IASB established principles for presenting financial instruments as liabilities or equity from the perspective of the issuer in IAS 32 *Financial Instruments: Presentation*. Such principles are based on the contractual terms of the instrument. In general, an instrument will be a liability of the issuer, if the issuer has an obligation to deliver cash or another financial asset. However, exceptions can apply, such as when a transaction will be settled in the issuer's own shares, where the classification will generally depend on whether the number of shares to be delivered is fixed or variable. In other cases, an instrument may have some features which meet the definition of equity and others which meet the definition of a financial liability. IAS 32 sets out principles for the classification and measurement of such 'compound' instruments.

Where financial liabilities are settled with equity instruments IFRIC 19, *Extinguishing Financial Instruments with Equity Instruments* provides accounting guidance. In addition, IAS 32 establishes principles for offsetting financial assets and financial liabilities as well as for the classification of the related interest, dividends, gains and losses. The accounting for treasury shares is also dealt with in IAS 32.

Over the years complex forms of financing have been developed, incorporating equity and financial liability elements. The classification and accounting for such instruments under IAS 32 can be complex and require a considerable amount of analysis and judgement to allocate the different elements of the instrument.

This chapter summarises the requirements of IAS 32 with regards to the classification of financial instruments as financial assets, financial liabilities or equity, the accounting for compound instruments and treasury shares, the settlement of financial liabilities with equity, including debt for equity swaps, as well as the presentation of interest, dividends and gains or losses on equity and financial liabilities.

What you need to know

- IAS 32 establishes the principles for classifying financial instruments as liabilities or equity from the perspective of the issuer.
- Classification principles are based on the contractual terms of the instrument.
- The standard and related guidance considers both financial instruments with debt or equity features and instruments which are settled with the issuing entity's own equity, including the IFRIC 19 guidance on debt for equity swaps.
- Some complex financial instruments can exhibit the characteristics of both financial liabilities and equity and therefore determining the classification of these instruments can require considerable analysis and judgement.
- Where financial instruments contain both equity and liability components, the standard sets out the principles for splitting the instrument between liability and equity and measuring the component parts.
- The guidance in IAS 32 provides the requirements for:
  - The accounting treatment for treasury shares
  - The offsetting of financial assets and financial liabilities (covered in Chapter 50)

1 Introduction

1.1 Background

The accounting treatment of liabilities (such as loans or bonds) and equity instruments (such as shares, stock or warrants) by their issuer was not historically regarded as presenting significant problems. Essentially the accounting was dictated by the legal form of the instrument, since the traditional distinction between equity and liabilities is clear. The issue of equity creates an ownership interest in a company, remunerated by dividends, which are accounted for as a distribution of retained profit, not a charge made in arriving at the result for a particular period. Liabilities, such as loan finance, on the other hand, are remunerated by interest, which is charged to profit or loss as an expense. In general, lenders rank before shareholders in priority of claims over the assets of the company, although in practice there may also be differential rights between different categories of lenders and classes of shareholders. The two forms of finance often have different tax implications, both for the investor and the investee.

In economic terms, however, the distinction between share and loan capital can be far less clear-cut than the legal categorisation would suggest. For example, a redeemable preference share could be considered to be, in substance, much more like a liability than equity. Conversely, many would argue that a bond which can never be repaid but which will be mandatorily converted into ordinary shares deserves to be thought of as being more in the nature of equity than of debt, even before conversion has occurred.

The ambiguous economic nature of such instruments has encouraged the development of a number of complex forms of finance which exhibit characteristics of both equity and debt. The 'holy grail' is generally to devise an instrument regarded as a liability by the tax authorities (such that the costs of servicing it are tax-deductible) but treated as equity for accounting and/or regulatory purposes (so that the instrument is not considered as a component of net borrowings).

The accounting classification of an instrument as a liability or equity is much more than a matter of allocation - i.e., where particular amounts are shown in the financial statements. The requirement of IFRS accounting standards for certain liabilities, in particular derivatives, to be carried at fair value means that the classification of an item as a liability can introduce significant volatility into reported results, that would not arise if the item were classified as an equity instrument. This is because changes in the fair value of an equity instrument are not recognised in the financial statements of the issuer. *[IAS 32.36]*.

Moreover, the extent to which an entity funds its operations through debt or equity is regarded as highly significant not only by investors, but also by other users of financial statements such as regulators and tax authorities. This means that the question of whether a particular instrument is a liability or equity raises issues of much greater and wider sensitivity than the mere matter of financial statement classification.

1.2 Development of IFRS accounting standards on classification of liabilities and equity

Under IFRS accounting standards, the classification of items as liabilities or equity is dealt with mainly in IAS 32, with some cross-reference to IFRS 9 *Financial Instruments*.

IAS 32 was originally issued in March 1995 and subsequently amended in 1998 and 2000. However, in December 2003, the previous version of IAS 32 was withdrawn and superseded by a new version, which has itself been amended by subsequent new pronouncements, most notably IFRS 7 *Financial Instruments: Disclosures* (see Chapter 50) and the amendment to IAS 32 *Puttable Financial Instruments and Obligations Arising on Liquidation* (superseded version of IAS 32).

The main text of IAS 32 is supplemented by application guidance (which is an integral part of the standard),[1] and by illustrative examples (which accompany, but are not part of, the standard).[2]

1 IAS 32, Application Guidance, para. after main heading.

2 IAS 32, Illustrative Examples, para. after main heading.

The IFRS IC has issued two interpretations of IAS 32 discussed in this chapter:

- IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* (see section 4.6.6 below)

  And

- IFRIC 19 (see section 7 below)

A joint attempt of the IASB and the FASB to develop a new model, in which classification of an instrument was based on whether the instrument would be settled with assets or with equity instruments of the issuer, was suspended in October 2010 due to significant challenges raised by a small group of external reviewers of a draft exposure draft.

In October 2014, the IASB resumed the *Financial Instruments with Characteristics of Equity Research Project* (FICE project) to explore further how to distinguish liabilities from equity claims. Following the issue of a Discussion Paper (the FICE DP) in June 2018, the IASB reached tentative decisions to address certain known practice issues by clarifying some of the underlying principles in IAS 32 and expanding the disclosures required (see section 12 below). The IASB published an Exposure Draft (ED) of proposed amendments to IAS 32, IFRS 7 and IAS 1 *Presentation of Financial Statements* in November 2023. In addition to clarifying the classification requirements in IAS 32, the ED proposes enhanced presentation and disclosures for financial liabilities and equity instruments. The IASB will commence further discussions on each of the FICE topics in Q4 2024 and expects to complete its discussions by Q2 2026.

2 Objective and scope

2.1 Objective

The objective of IAS 32 is "to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities". *[IAS 32.2]*. The standard, and its associated IFRIC interpretations, address:

- The classification of financial instruments, by their issuer, into financial assets, financial liabilities and equity instruments (see sections 3 to 6 below).
- Settling a financial liability with an equity instrument (see section 7 below).
- The classification of interest, dividends, losses and gains (see section 8 below).
- Treasury shares - i.e., an entity's own equity instruments held by the entity (see section 9 below).
- Forward contracts or options for the receipt or delivery of the entity's own equity instruments (see section 11 below).

  And

- The circumstances in which financial assets and financial liabilities must be offset (see Chapter 50 at section 7.4.1).

The principles in IAS 32 complement the principles for recognising and measuring financial assets and financial liabilities in IFRS 9, and for disclosing information about them in IFRS 7. *[IAS 32.3]*. Additional relevant guidance is provided by IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* and IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*.

2.2 Scope

The scope of IAS 32 is discussed in detail in Chapter 41 at section 2.

3 Definitions

The following definitions in IAS 32 are relevant to the issues discussed in this chapter. Further general discussion on the meaning and implications of the definitions may be found in Chapter 41 at section 1. *[IAS 32.11, IFRS 9 Appendix A]*.

Extract from IAS 32

Definitions

11 The following terms are used in this Standard with the meanings specified:

A *financial instrument* is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

A *financial asset* is any asset that is:

(a) cash;

(b) an equity instrument of another entity;

(c) a contractual right:

(i) to receive cash or another financial asset from another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

(d) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

A *financial liability* is any liability that is:

(a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D.

An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13 *Fair Value Measurement*.)

A *puttable instrument* is a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

Extract from IFRS 9

Appendix A
Defined terms

derivative	A financial instrument or other contract within the scope of this Standard with all three of the following characteristics: (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying'). (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. (c) it is settled at a future date.

As an exception to the general definition of a financial liability, an instrument that meets the definition of a financial liability is nevertheless classified as an equity instrument, if it has all the features and meets the conditions in IAS 32.16A and 16B (see section 4.6.2 below) or IAS 32.16C and 16D (see section 4.6.3 below). *[IAS 32.11]*.

The definition of fair value is the same definition as used in IFRS 13 *Fair Value Measurement* (see Chapter 15 at section 3).

In these definitions (and throughout IAS 32 and the discussion in this chapter):

- *Contract* and *contractual* refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing. *[IAS 32.13]*.
- *Entity* includes individuals, partnerships, incorporated bodies, trusts and government agencies. *[IAS 32.14]*.

4 Classification of instruments

Extract from IAS 32

15 The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.

The most important issue dealt with by IAS 32 is the classification of financial instruments (or their components) by their issuer as financial liabilities, financial assets or equity instruments, including non-controlling interests. The rule in IAS 32 for classification of items as financial liabilities or equity is essentially simple. An issuer of a financial instrument must classify the instrument (or its component parts) on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument (see section 3 above). *[IAS 32.15]*. The application of this principle in practice, however, is often far from straightforward.

IAS 32 considers the question of whether a transaction is a financial liability or an equity instrument at two levels. First, it examines whether an individual instrument (or class of instruments) issued by the entity is a financial liability or equity. This is principally discussed in this section, although some of the provisions discussed in sections 5 and 6 below may also be relevant.

Second, where an entity settles a transaction using instruments issued by it that, when considered in isolation, would be classified as equity, IAS 32 requires the entity to consider whether the transaction considered as a whole is in fact a financial liability. This will typically be the case where a transaction is settled by issuing a variable number of equity instruments equal to an agreed value. This is principally discussed in sections 5 and 6 below, although some of the provisions discussed here in section 4 may also be relevant.

The appropriate classification is made on initial recognition of the instrument and, in general, not changed subsequently (see section 4.9 below on reclassification of instruments).

4.1 Definition of equity instrument

The application of the basic definitions in IAS 32 means that an instrument is an equity instrument only if both the following conditions are met:

- The instrument includes no contractual obligation either:
  - To deliver cash or another financial asset to another entity.

  Or
  - To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.
- If the instrument will, or may, be settled in the issuer's own equity instruments, it is either:
  - A non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments.

  Or
  - A derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose, the issuer's own equity instruments do not include instruments that have all the features and meet the conditions described in IAS 32.16A and 16B (see section 4.6.2 below) or IAS 32.16C and 16D (see section 4.6.3 below) or instruments that are contracts for the future receipt or delivery of the issuer's own equity instruments. *[IAS 32.16]*.

As a pragmatic exception to these basic criteria, an instrument that would otherwise meet the definition of a financial liability is nevertheless classified as an equity instrument if it is either:

- A puttable instrument with all the features, and meeting the conditions described, in IAS 32.16A and 16B (see section 4.6.2 below).

  Or
- An instrument entitling the holder to a *pro rata* share of assets on a liquidation with all the features, and meeting all the conditions, described in IAS 32.16C and 16D. *[IAS 32.16]*. This is discussed further in section 4.6.3 below.

Broadly speaking, apart from this exemption, an instrument can only be classified as equity under IAS 32:

- If the issuer has an unconditional right to avoid delivering cash or another financial instrument (see section 4.2 below).

  Or

- If it is settled through the entity's own equity instruments, it is for an exchange of a fixed amount of cash for a fixed number of the entity's own equity instruments.

In all other cases it would be classified as a financial liability.

4.2 Contractual obligation to deliver cash or other financial assets

It is apparent from section 4.1 above that a critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of one party to the financial instrument (the issuer) either:

- To deliver cash or another financial asset to the other party (the holder)

  Or

- To exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer *[IAS 32.17]*

IAS 32 focuses on the contractual rights and obligations arising from the terms of an instrument, rather than on the probability of those rights and obligations leading to an outflow of cash or other resources from the entity, as would be the case for a provision accounted for under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (see Chapter 27). Thus, IAS 32 may well:

- Classify as equity an instrument that is virtually certain to result in regular cash payments by the entity

  But

- Treat as a liability an instrument which:
  - Gives its holder a right to receive cash rather than equity which no rational holder would exercise

    Or

  - Exposes the issuer to a liability to repay the instrument contingent on an external event so remote that no liability would be recognised if IAS 37 rather than IAS 32 were the applicable standard.

The holder of an equity instrument (e.g., a non-puttable share) may be entitled to receive a *pro rata* share of any dividends or other distributions of equity that are made. However, since the issuer does not have a contractual obligation to make such distributions (because it cannot be required to deliver cash or another financial asset to another party), the instrument is not a financial liability of the issuer. *[IAS 32.17]*. The price or value of such an instrument may well reflect a general expectation by market participants that distributions will be made on a regular basis, but, under IAS 32, the absence of a contractual obligation requires the instrument to be classified as equity.

IAS 32 requires the issuer of a financial instrument to classify a financial instrument by reference to its substance rather than its legal form, although it is conceded that substance and form are 'commonly', but not always, the same. Typical examples of instruments that are equity in legal form but liabilities in substance are certain types of preference share (see section 4.5 below) and certain units in open-ended funds, unit trusts and similar entities (see section 4.6 below). *[IAS 32.18]*. Conversely, a number of entities have issued instruments which behave in most practical respects as perpetual (or even redeemable) debt, but which IAS 32 requires to be classified as equity (see section 4.5 below). IAS 32 further clarifies that a financial instrument is an equity instrument, and not a financial liability, not merely if the issuer has no legal obligation to deliver cash or other financial assets to the holder at the reporting date, but only if it has an unconditional right to avoid doing so in all future circumstances other than an unforeseen liquidation. Thus, a financial instrument (other than one classified as equity under the exceptions discussed in section 4.6 below) is classified as a financial liability even if:

- The issuer's ability to discharge its obligations under the instrument is restricted (e.g., by a lack of funds, the need to obtain regulatory approval to make payments on the instrument, or a shortfall of distributable profits, or other statutory restriction). *[IAS 32.19, IAS 32.AG25]*.

  Or

- The holder has to perform some action (e.g., formally exercise a redemption right) in order for the issuer to become obliged to transfer cash or other financial assets. *[IAS 32.19]*.

In September 2015, the IFRS IC considered the classification of a prepaid card and how the unspent balance on such a card would be accounted for. The IFRS IC specifically considered a prepaid card with the following features:

- No expiry date
- Cannot be refunded, redeemed or exchanged for cash
- Redeemable only for goods and services
- Redeemable only at selected merchants which could include the entity
- Upon redemption by the cardholder at a merchant, the entity has a contractual obligation to pay cash to the merchant
- No back-end fees, e.g., the balance on the prepaid card does not reduce unless spent by the cardholder

  And
- Is not issued as part of a customer loyalty programme

The IFRS IC observed that the liability of the entity for the prepaid card meets the definition of a financial liability, because the entity has a contractual obligation to deliver cash to the merchants on behalf of the cardholder, conditional upon the cardholder using the prepaid card to buy goods or services and the entity does not have an unconditional right to avoid delivering cash to settle this contractual obligation.[3]

Following the receipt of responses to the draft agenda decision, the IFRS IC, in March 2016, limited the fact pattern to where the card could only be redeemed at specified third-party merchants and not at the entity itself but otherwise did not change its conclusion.

The IFRS IC determined that neither an interpretation nor an amendment to a standard was necessary.[4]

One of the key consequences of this decision is that if the card gives rise to a financial liability, then the unspent balance on the card cannot be derecognised. Any unredeemed portion of the card will continue to be recognised as a liability in perpetuity as financial liabilities can only be derecognised when extinguished. *[IFRS 9.3.3.1]*. It is also of note that the balances on such cards are regarded as financial liabilities even though they do not meet the strict IAS 32 definition of a financial instrument, as the balance on the prepaid card will not constitute a financial asset in the hands of the cardholder.

4.2.1 Relationship between an entity and its members

The unconditional right of the entity to avoid delivering cash or another financial asset in settlement of an obligation is crucial in differentiating a financial liability from an equity instrument.

In some entities, the right to declare dividends and/or redeem capital is reserved for the members of the entity in general meeting, as a matter either of the entity's own constitution or of general legislation in the jurisdiction concerned. The effect of such a right may be that the members can require payment of a dividend irrespective of the wishes of management. Even where management has the right to prevent a payment declared by the members, the members will generally have the right to appoint the management and can therefore appoint management that will not oppose an equity distribution declared by the members. This raises the question whether an entity whose members have such rights must classify all its distributable retained earnings as a liability, on the grounds that the members could require earnings to be distributed as dividend, or capital to be repaid, at any time.

How we see it

The role of the entity's shareholders is critical in determining the classification of financial instruments when the shareholders can decide whether the entity delivers cash or another financial asset.

In our view an action reserved for the entity's shareholders in general meeting, is effectively an action of the entity itself. It is therefore at the discretion of the entity itself (as represented by the members in general meeting) that retained earnings are paid out as a dividend.

If on the other hand, decisions by the shareholders are not made as part of the entity's corporate governance decision making process but made in their capacity as holders of particular instruments, we would consider that the shareholders are separate from the entity.

3 *IFRIC Update*, September 2015, available on the IFRS Foundation's website.

4 *IFRIC Update*, March 2016, available on the IFRS Foundation's website.

It is therefore important to understand the relationship between the entity and its members. Shareholders can make decisions as part of the corporate governance decision making process of the entity (generally exercised in a general meeting) or separate from the entity's corporate governance decision making process, in their capacity as holders of particular instruments.

Accordingly, in the case where an action is reserved for the entity's shareholders in a general meeting referred to above, such earnings are classified as equity, and not as a financial liability, until they become a legal liability of the entity.

In the case where the decision is not made as part of the entity's corporate governance decision making process the entity would not have an unconditional right to avoid delivering cash or another financial asset and would have to classify the financial instrument as a financial liability.

This issue was brought to the IFRS IC in January 2010. The IFRS IC identified that diversity may exist in practice in assessing whether an entity has an unconditional right to avoid delivering cash, if the contractual obligation is at the ultimate discretion of the issuer's shareholders, and consequently whether a financial instrument must be classified as a financial liability or equity. However, the IFRS IC concluded that the Board's then current project on financial instruments with characteristics of equity was expected to address the distinction between equity and non-equity instruments on a timely basis, and that the IFRS IC would therefore not add this to its agenda.[5] In October 2010 the project was suspended but was restarted in October 2014. The Board is currently considering several IAS 32 practice issues, including those concerning contingent settlement provisions (see section 12 below).

4.2.2 Implied contractual obligation to deliver cash or other financial assets

A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may nevertheless establish an obligation indirectly through its terms and conditions. *[IAS 32.20]*.

IAS 32.20 provides two examples:

Extract from IAS 32

20 A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions. For example:

(a) a financial instrument may contain a non-financial obligation that must be settled if, and only if, the entity fails to make distributions or to redeem the instrument. If the entity can avoid a transfer of cash or another financial asset only by settling the non-financial obligation, the financial instrument is a financial liability.

(b) a financial instrument is a financial liability if it provides that on settlement the entity will deliver either:

(i) cash or another financial asset; or

(ii) its own shares whose value is determined to exceed substantially the value of the cash or other financial asset.

Although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option (see paragraph 21).

The basic requirement of IAS 32.20 is for an entity to recognise a financial liability when it can only avoid using cash to settle an obligation by transferring a financial asset or a non-financial asset, in other words settlement of the obligation cannot be avoided in any other way. Then, given that the entity's own shares are not an asset, subparagraph (b)(ii) avoids a potential loophole: if the value of the shares would exceed the amount of cash that would be required to settle the liability, the entity will be economically compelled to settle the cash amount and hence, has a financial liability (see section 5.2.4. below).

5 *IFRIC Update*, January 2010, available on the IFRS Foundation's website.

This accounting treatment was illustrated by a question put to the IFRS IC in 2015.[6] They considered an arrangement whereby an entity received cash from a government to fund a research and development project. The cash was repayable to the government only if the entity decided to exploit and commercialise the results of the project. If the project was not commercially exploited, the entity was obliged to transfer the rights to the research to the government.

The IFRS IC observed in May 2016[7] that, in this case, the cash receipt gave rise to a financial liability. In reaching their conclusion, the IFRS IC took the view that the entity could avoid transferring cash only by settling the obligation with a non-financial instrument (the rights to the research). The IFRS IC further noted that the cash received from the government does not meet the definition of a forgivable loan in IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, as the government does not undertake to waive repayment of the loan but requires settlement in cash or by transfer of the rights to research. However, they also noted that the entity would be required at initial recognition to assess whether the cash received from the government is something other than a financial instrument, for example the difference between the cash received and the fair value of the financial liability may represent a government grant that must be accounted for in accordance with IAS 20.

This last sentence implies that where the fair value of the alternative settlement option is less than fair value of the cash settlement option, IAS 32.20 only requires a financial liability to be recorded to the extent of the fair value of the alternative settlement option. But, in this example, the IFRS IC did not discuss what the fair value of the research and development might be. The IFRS IC discussion demonstrates that where entities receive loans, with alternative repayment conditions involving settlement with a non-financial asset, judgement will be necessary in assessing the substance of the settlement requirements and determining the value at inception of the non-financial asset.

4.3 Contingent settlement provisions

Some financial instruments may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be classified as a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances), that are beyond the control of both the issuer and the holder of the instrument. These might include:

- A change in a stock market index or a consumer price index
- Changes in interest rates
- Changes in tax law
- The issuer's future revenues, net income or debt-to-equity ratio *[IAS 32.25]*

Or

- Variable or contingent payments for an asset purchase (see section 4.3.1 below)

Some financial instruments may contain more than one source of variability. Further complexity can also arise when variability and contingent arrangements are akin to profit sharing agreements, which are not addressed in any standard.

IAS 32 provides that, since the issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability), the instrument is a financial liability of the issuer unless:

- The part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine (see section 4.3.2 below).
- The issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer (see section 4.3.3 below).

  Or

- The instrument is classified as equity under the exceptions discussed in section 4.6 below. *[IAS 32.25]*.

Whether or not the contingency is within the control of the issuer is therefore an important consideration when classifying financial instruments with contingent settlement provisions as either financial liabilities or equity (see section 4.3.5 below).

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6 *IFRIC Update*, November 2015, available on the IFRS Foundation's website.

7 *IFRIC Update*, May 2016, available on the IFRS Foundation's website.

It is interesting that 'future revenues, net income or debt-to-equity ratio' are given as examples of contingencies beyond the control of both the issuer and the holder of the instrument, since, in some cases, these matters are within the control of the entity. For example, if a payment under a financial instrument is contingent upon revenue rising above a certain level, the entity could avoid the payment by ceasing to trade before revenue reaches that level. Indeed, IAS 37 argues that certain expenses (such as legally required maintenance costs) that an entity is certain to incur if it continues to trade are not liabilities until they become legally due, because the entity could avoid them by ceasing to trade by that date. As in section 4.2.2 above, the analysis in IAS 32 appears to be relying on the concept of 'economic compulsion' (i.e., the entity would not rationally cease its activities merely in order to avoid making a contingent payment), even though this does not feature in the definition of 'contingent liability' in IAS 37, nor indeed in the classification of many instruments under IAS 32.

In the context of the IASB's FICE project, the IASB is assessing the accounting for contingent settlement provisions and proposed amendments to the requirements in the FICE Exposure Draft published in November 2023 (see section 12.4 below).

4.3.1 Variable or contingent payments for an asset purchase

The topic of variable payments for an asset purchase was discussed by the IFRS IC between 2011 and 2016, and an agenda decision was published in March 2016. The IFRS IC's discussions considered both the accounting at the date of purchasing the asset and subsequently, and distinguished between those variable payments that depend on the purchaser's future activity and those that do not. The IFRS IC determined that the issue was too broad for it to address within the confines of existing standards and recommended that the IASB address the accounting for variable payments comprehensively. In May 2016, the IASB tentatively agreed that this issue would be included in the research pipeline between 2017 and 2021. At the time of writing this is not listed as an active research project on the IASB's work plan.

A critical step in analysing the accounting for the purchase of an item of PP&E in an arrangement involving variable or contingent consideration is to fully understand the contractual arrangements, understanding the nature of the contingent or variable payments. This includes developing a full understanding of whether those contingent payments are linked to the initial value of the asset, or to its future performance, whether the contingency or variability is within or outside of the purchasers' control and whether the variable payment is a payment for some other goods or services from the seller. In some cases, the contract may establish an obligation for the contingent payment at the outset, whilst in others it might be determined that the arrangement is an executory contract, and the liability to make the contingent payments is only recognised later once either party fulfils its obligations under the contract.

The two key issues with regards to the accounting for variable consideration in an asset purchase are 1) whether and when to recognise a liability for that variable consideration, and 2) whether subsequent changes to the estimate of variable or contingent consideration should be accounted for as part of the cost of the acquired asset.

Looking at the first question of when a liability to make variable or contingent payments would be recognised, if the arrangement is not considered to be an executory contract, one consideration is whether those payments are dependent on the entity's future activity, or not. IAS 32.25 stipulates that where the contingency is outside the control of both the issuer and the holder, a contingent obligation to deliver cash meets the definition of a financial liability (see section 4.3 above). Therefore, if the obligation to make the variable payment does not depend on the acquiring entity's future activity, it would seem appropriate to recognise a financial liability in respect of the contingent amounts. *[IAS 32.25]*. However, it is acknowledged that whilst this view was tentatively agreed during the course of the IFRS IC discussions on the topic, ultimately, this was not clarified or confirmed as part of the final agenda decision. Furthermore, the final agenda decision notes that there are questions about the accounting for variable payments subsequent to the purchase of the asset, and in making that statement the IFRS IC did not distinguish between the different types of variable payments.

How we see it

In light of the discussions held by the IFRS IC and the absence of clear guidance in the final agenda decision, entities will need to develop and apply an accounting policy in respect of whether and when the obligation to make contingent payments is recognised as a liability. In doing so, entities will need to apply the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Error*. The policy selected should result in information that is relevant and reliable in the particular circumstances and must be consistently applied to similar transactions. Different payments may have different types of variability. Therefore, it might be appropriate for an entity to have different policies for dissimilar transactions.

If information about the selected accounting policy is expected to be material to users of the financial statements, that accounting policy information should be disclosed.

As described above, there is no explicit guidance on the treatment of variable or contingent consideration in the acquisition of an asset and there is diversity in practice for these types of arrangements. Therefore, examples of some accounting policies an entity may want to consider regarding initial recognition of the asset include the following:

- The cost of the asset on initial recognition includes the fair value of all variable or contingent consideration at the date of acquisition. A corresponding liability is recognised for the same amount.
- The cost of the asset on initial recognition excludes any variable or contingent payments. Accordingly, no liability is recognised for those contingent or variable amounts.

The second question that needs to be addressed is how the entity must account for subsequent payments and changes to the estimate of variable or contingent consideration. Depending on the facts and circumstances of the arrangement an entity may determine that:

1) Variability arises from exchange rates, time value of money, or embedded derivatives - Changes in the carrying amount of a recognised liability that arise from exchange rates are accounted for in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates* and IFRIC 22 *Foreign Currency Transactions and Advance Consideration*, while the time value of money and embedded derivatives are accounted for in accordance with IFRS 9;
2) Variability is directly linked to the quality or quantity of the asset(s) received - In these cases the initial recognition of the asset and liability were based on an accounting estimate that is subsequently updated in accordance with IAS 8.37; or
3) The variability in the arrangement does not fall under (1) or (2) above and an accounting policy needs to be developed to address it.

In the latter case, an entity will need to apply the requirements of IAS 8 to develop an accounting policy that it should apply consistently to all similar transactions. The accounting policy developed will need to address whether the change in the estimate of variable or contingent consideration should be capitalised as part of the cost of the asset or expensed. This determination is usually based on the reason for the contingent payment and entities should consider the substance of the arrangement in determining the appropriate treatment.

It is only appropriate for subsequent changes to a recognised liability to be recognised as part of the cost of the asset to the extent that it relates to future economic benefits embodied in the asset initially received. For example, if the contingency or variability is viewed as being linked to the quality or quantity of the asset initially received. Variability arising due to other factors, such as its use over time, would generally be expensed.

How we see it

Until this matter is resolved by the IASB, where the accounting for the variability or contingency is not prescribed in another standard, an entity should adopt and apply a consistent accounting policy in relation to whether subsequent payments or changes to the measurement of a recognised liability to make contingent or variable payments are included as part of the cost of an acquired asset or expensed as incurred, in accordance with the hierarchy in IAS 8.

An entity should exercise judgement in developing and consistently applying an accounting policy that results in information that is relevant and reliable in the particular circumstances.

If information about the selected accounting policy is expected to be material to users of the financial statements, that accounting policy information should be disclosed.

4.3.2 Contingencies that are 'not genuine'

A requirement to settle an instrument in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine (see section 4.3 above) if the requirement would arise 'only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur'. *[IAS 32.AG28]*.

Similarly, if the terms of an instrument provide for its settlement in a fixed number of the entity's equity instruments, but there are circumstances, beyond the entity's control, in which such settlement may be contractually precluded, and settlement in cash or other assets required instead, those circumstances can be ignored if there is 'no genuine possibility' that they will occur. In other words, the instrument continues to be regarded as an equity instrument and not as a financial liability. *[IAS 32.AG28]*.

Guidance in IAS 32 on the meaning of 'not genuine' in this context is unfortunately restricted to the thesaurus of synonyms ('extremely rare, highly abnormal and very unlikely to occur') above. It is, however, helpful to consider the changes made when, in 2003, SIC-5 *Classification of Financial Instruments - Contingent Settlement Provisions*[8] was withdrawn, and its substance incorporated in these provisions of IAS 32. SIC-5 had previously required redemption terms to be ignored if they were 'remote'. Examples given by SIC-5 were where the issue of shares is contingent merely on formal approval by the authorities, or where cash settlement is triggered by an index reaching an 'extreme' level relative to its level at the time of initial recognition of the instrument.[9]

IAS 32 deliberately did not reproduce the reference to, or the examples of, 'remote' events in SIC-5. In the Basis for Conclusions to IAS 32 the IASB states that it does not believe it is appropriate to disregard events that are merely 'remote'. *[IAS 32.BC17]*. Thus, under the revised version of IAS 32, it is not appropriate to disregard a redemption term, that is triggered only when an index reaches an extreme level. This suggests that it is not open to an entity to argue (for example) that a bond that is redeemed in cash only, if the entity's share price falls below, or fails to reach, a certain level, can be treated as an equity instrument on the grounds that there is no genuine possibility that the share price will perform in that way.

In general, terms are included in a contract for an economic purpose and therefore are genuine. The current reference in IAS 32 to terms that are 'not genuine' is presumably intended to deal with clauses inserted into the terms of financial instruments for some legal or tax reason (e.g., to make conversion technically 'conditional' rather than mandatory) but having no real economic purpose or consequence.

An example of a clause that has caused some debate on this point is a 'regulatory change' clause, generally found in the terms of capital instruments issued by financial institutions such as banks and insurance companies. Such entities are generally required by local regulators to maintain certain minimum levels of equity or highly subordinated debt (generally referred to as regulatory capital) in order to be allowed to do business.

A 'regulatory change' clause will typically require an instrument which, at the date of issue, is classified as regulatory capital to be repaid if it ceases to be so classified. The practice so far of the regulators in many markets has been to make changes to a regulatory classification with prospective effect only, such that any instruments already in issue continue to be regarded as regulatory capital even though they would not be under the new rules.

This has led some to question whether a 'regulatory change' clause can be regarded as a contingent settlement provision which is 'not genuine'.[10] This is ultimately a matter for the judgement of entities and their auditors in the context of the relevant regulatory environment(s). This judgement has not been made easier by the greater unpredictability of the markets (and therefore of regulators' responses to it) since the last financial crisis.

4.3.3 Liabilities that arise only on liquidation

As noted in section 4.3 above, IAS 32 provides that a contingent settlement provision that comes into play only on liquidation of the issuer may be ignored in determining whether or not a financial instrument is a financial liability. IAS 32 refers specifically to 'liquidation'. In other words, if an instrument provides for redemption on the occurrence of events that are a possible precursor of liquidation (e.g., extreme insolvency, the financial statements not being prepared on a going concern basis, or the entity being placed under the protection of Chapter 11 of the United States Bankruptcy Code) but falling short of formal liquidation, the instrument must be treated as a financial liability. The same applies to an instrument over own equity, which is subject to a master netting agreement, such as the ISDA Master Agreement, where default or other early termination events may lead to net cash settlement. In such cases, the contingency for net settlement on default cannot be ignored and the instrument must be classified as a financial asset or liability (see sections 5.2.7 and 6.6.6 below). Also, where liquidation is in the control of the holder, the instrument will be a liability as this exception only applies to contingencies beyond the control of both the issuer and the holder.

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8 SIC-5 *Classification of Financial Instruments - Contingent Settlement Provisions*, SIC, May 1998 (superseded December 2003).

9 SIC-5, para. 9.

10 INFORMATION FOR OBSERVERS: Board meeting: *January 2007, London*, Project: *Liability and Equity*, Subject: *Overview of IAS 32 (Agenda paper 12B)*, para. 39. Available on the IFRS Foundation's website.

4.3.4 Liabilities that arise only on a change of control

A number of entities have issued instruments on terms, that require the issuing entity to transfer cash or other financial assets only in the event of a change in control of the issuing entity. This raises the question of whether such an event is outside the control of the issuing entity, with the effect that any instrument containing such a provision would be classified as a liability, to the extent of any obligations arising on a change of control.

Whether a change of control is outside the control of the entity can be far from straightforward. As noted in section 4.2.1 above, it is our view that, where the power to make a decision is reserved for the members of an entity in general meeting, for the purposes of such a decision, the members and the entity are one and the same. *[IAS 32.AG28]*.

How we see it

We consider that a change of control requiring the approval of the members in general meeting would normally need to be regarded as within the control of the entity. Conversely, we regard a change of control as not within the control of the entity where it can be effected by one or more individual shareholders without reference to the members in general meeting, for example where a shareholder holding 40% of the ordinary equity sells its shares to another party already owning 30%.

4.3.5 Some typical contingent settlement provisions

The matrix below gives a number of contingent settlement provisions that we have encountered in practice, some common, some rather esoteric, together with our view as to whether they must be regarded as outside the control of the reporting entity. If a contingent settlement provision is regarded as outside the control of the issuing entity, the instrument will be classified as a liability by the issuer. If a contingent settlement provision is regarded as within the control of the reporting entity, the instrument will be classified as equity, provided that it has no other features requiring its classification as a liability and that the contingent settlement event is also outside the control of the holder.

Contingent settlement event	Within the issuer's control?
Issuer makes a distribution on ordinary shares.	Yes. Dividends on ordinary shares are discretionary (see also section 4.2 above).
Upon the successful takeover of the issuer (i.e., a 'control event').	It depends. See section 4.3.4 above.
Event of default under any of the issuer's debt facilities.	No
Appointment of a receiver, administrator, entering a scheme of arrangement, or compromise agreement with creditors.	No. Whether this leads to the instrument being classified as equity or liability will depend on the respective requirements in each jurisdiction. In cases when these events do not necessarily result in liquidation of the issuer, this leads to classification as a liability (see section 4.3.3 above).
Upon commencement of proceedings for the winding up of the issuer.	No, but this does not lead to classification as a liability due to the requirement to ignore settlement provisions arising only on liquidation (see section 4.3.3 above).
Incurring a fine exceeding a given amount, or commencement of an investigation of the issuer by, a government agency or a financial regulator.	No
A change in accounting, taxation, or regulatory regime which is expected to adversely affect the financial position of the issuer.	No
Suspension of listing of the issuer's shares from trading on the stock exchange for more than a certain number of days.	Probably not, but it will depend on the jurisdiction and whether the reasons for suspension are always within the control of the entity.

Contingent settlement event	Within the issuer's control?
Commencement of war or armed conflict.	No
Issue of a subordinated security that ranks equally or in priority to the securities.	Yes
Issue of an IPO prospectus prior to the conversion date.	Yes
Execution of an effective IPO.	No. The execution of a successful IPO is not within the control of the issuer. However, a contractual obligation to pay cash in the event of an IPO taking place is within the control of the issuer as the issuer can determine whether an IPO occurs or not and thus can avoid the obligation to pay cash.
Disposal of all or substantially all of the issuer's business undertaking or assets.	Yes
Change in credit rating of the issuer.	No
A payment is made by an entity under the terms of a financial instrument that was issued for the purchase of an asset, where the amount paid depends on the performance of the asset after purchase.	It depends. See section 4.3.1 above.

4.4 Examples of equity instruments

4.4.1 Issued instruments

Under the criteria above, equity instruments under IAS 32 will include non-puttable common (ordinary) shares and some types of preference share (see section 4.5 below). *[IAS 32.AG13]*.

Whilst non-puttable shares are typically equity, an issuer of non-puttable ordinary shares nevertheless assumes a liability when it formally acts to make a distribution and becomes legally obliged to the shareholders to do so. This may be the case following the declaration of a dividend, or when, on a winding up, any assets remaining after discharging the entity's liabilities become distributable to shareholders. *[IAS 32.AG13]*. For example, if an entity has issued CU100 million of equity instruments on which it declares a dividend of CU2 million, it recognises a liability of only CU2 million. Whether or not a liability arises on declaration of a dividend will depend on local legislation or the terms of the instruments or both.

IAS 32 also treats some puttable instruments (see section 4.6.2 below) and some instruments, that impose an obligation on the issuer to deliver a *pro rata* share of net assets only on liquidation (see section 4.6.3 below) that would otherwise be classified as financial liabilities, as equity instruments. However, a contract that is required to be settled by the entity receiving or delivering either of these types of 'deemed' equity instrument is a financial asset or financial liability, even when it involves the exchange of a fixed amount of cash or other financial assets for a fixed number of such instruments. *[IAS 32.22A, IAS 32.AG13]*.

4.4.2 Contracts to issue equity instruments

A contract settled using equity instruments is not necessarily itself regarded as an equity instrument. The classification of contracts settled using issued equity instruments is discussed further in section 5 below.

Warrants or written call options that allow the holder to subscribe for or purchase a fixed number of non-puttable common (ordinary) shares in the issuing entity in exchange for a fixed amount of cash or another financial asset, or the fixed stated principal of a bond, are classified as equity instruments. *[IAS 32.22, IAS 32.AG13]*. The meaning of a 'fixed' amount of cash is not as self-evident as it might appear and is discussed further in section 5.2.3 below. The meaning of the 'fixed stated principal' of a bond is discussed further in section 6.3.2.A below.

Conversely, an instrument is a financial liability (or financial asset) of the issuer if it gives the holder the right to obtain:

- A variable number of non-puttable common (ordinary) shares in the issuing entity in exchange for a fixed amount of cash or another financial asset. *[IAS 32.21]*.

  Or

- A fixed number of non-puttable common (ordinary) shares in the issuing entity in exchange for a variable amount of cash or another financial asset. *[IAS 32.24]*.

An obligation for the entity to issue or purchase a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is classified as an equity instrument of the entity. However, if such a contract contains an obligation, or even a potential obligation, for the entity to pay cash or another financial asset, it gives rise to a liability for the present value of the redemption amount (which results in a reduction of equity, not an expense, see section 5.3 below). *[IAS 32.23, IAS 32.AG13]*.

A purchased call option or other similar contract, acquired by an entity that gives it the right to reacquire a fixed number of its own equity instruments in exchange for delivering a fixed amount of cash or another financial asset, is not a financial asset of the entity. Rather, it is classified as an equity instrument, and any consideration paid for such a contract is therefore deducted from equity (see section 11.2.1 below). *[IAS 32.22, IAS 32.AG14]*. This requirement refers only to contracts which require the entity to settle gross (i.e., the entity pays cash in exchange for its own shares). Contracts which can be net settled (i.e., the party for whom the contract is loss-making delivers cash or shares equal to the fair value of the contract to the other party) are generally treated as financial assets or financial liabilities. This is discussed in more detail in section 11 below.

4.5 Preference shares and similar instruments

Whilst some of the discussion below (and the guidance in IAS 32) is, for convenience, framed in terms of 'preference shares', it must be applied equally to any financial instrument, however described, with similar characteristics. In practice, many such instruments are not described as shares (possibly to avoid weakening any argument that, for fiscal purposes, they are tax-deductible debt rather than non-deductible equity).

Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or an equity instrument, IAS 32 requires an issuer to assess the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. *[IAS 32.AG25]*.

IAS 32 does this in part by drawing a distinction between:

- Instruments mandatorily redeemable or redeemable at the holder's option (see section 4.5.1 below)

  And

- Other instruments i.e., those redeemable only at the issuer's option or not redeemable (see sections 4.5.2 to 4.5.4 below)

4.5.1 Instruments redeemable mandatorily or at the holder's option

A preference share (or other instrument) that:

- Provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date

  Or

- Gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount

Contains a financial liability, since the issuer has an obligation, or potential obligation, to transfer cash or other financial assets to the holder. This obligation is not negated by the potential inability of an issuer to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves. *[IAS 32.18(a), IAS 32.AG25]*.

It is more correct to say (in the words of the application guidance) that an instrument 'contains' a financial liability than to say (as the main body of the standard does) that it 'is' a financial liability. For example, if a preference share is issued on terms that it is redeemable at the holder's option, but dividends are paid entirely at the issuer's discretion, it is only the amount payable on redemption that is a liability. This would lead to a 'split accounting' treatment (see section 6 below), whereby, at issue, the net present value of the amount payable on redemption would be classified as a liability and the balance of the issue proceeds as equity. *[IAS 32.AG37]*.

Non-discretionary dividends, on the other hand, establish an additional liability component. In such a case there is a contractual obligation to pay cash in respect of both the redemption of the principal and the required dividend payments up to the redemption of the instrument. The liability would be recognised at an amount equal to the present value of both the redemption amount and the non-discretionary dividends. Assuming that the dividends were set at market rate, which is generally the case, this would typically result in an overall liability classification of the whole instrument. While dividend payments might be set at a fixed percentage of the nominal value, this does not need to be the case. Any non-discretionary obligation to pay dividends creates a liability that needs to be recorded on initial recognition of the instrument. If an entity has an obligation that is non-discretionary, for example to pay out a percentage of it profits, then that gives rise to a financial liability (see Chapter 42 at section 1.1.3 for discussions around embedded derivatives and non-financial variables specific to one party to the contract).

4.5.2 Instruments redeemable only at the issuer's option or not redeemable

A preference share (or other instrument) redeemable in cash only at the option of the issuer does not satisfy the definition of a financial liability in IAS 32, because the issuer does not have a present or future obligation to transfer financial assets to the shareholders. In this case, redemption of the shares is solely at the discretion of the issuer. An obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares. *[IAS 32.AG25]*.

Likewise, where preference shares are non-redeemable, there is clearly no financial liability in respect of the 'principal' amount of the shares. In reality there may be little distinction between shares redeemable at the issuer's option and non-redeemable shares, given that in many jurisdictions an entity can 'repurchase' its 'irredeemable' shares subject to no greater restrictions than would apply to a 'redemption' of 'redeemable' shares.

Ultimately, the classification of preference shares redeemable only at the issuer's option or not redeemable according to their terms must be determined by the other rights that attach to them. IAS 32 requires the classification to be based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. *[IAS 32.AG26]*.

If the share does establish a contractual right to a dividend, subject only to restrictions on payment of dividends in the relevant jurisdiction, it contains a financial liability in respect of the dividends. This would lead to a 'split accounting' treatment (see section 6 below), whereby the net present value of the right to receive dividends would be shown as a liability and the balance of the issue proceeds as equity. Where the dividends are set at a market rate at the date of issue, it is likely that the issue proceeds would be equivalent to the fair value (at the date of issue) of dividends payable in perpetuity, so that the entire proceeds would be classified as a financial liability.

However, when redemption of the preference shares and distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments. The classification of preference share distributions as an equity component or a financial liability component is not affected by, for example:

- A history of making distributions
- An intention to make distributions in the future
- A possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends on the ordinary shares if dividends are not paid on the preference shares - see section 4.5.3 below)
- The amount of the issuer's reserves
- An issuer's expectation of a profit or loss for a period

  Or
- An ability or inability of the issuer to influence the amount of its profit or loss for the period *[IAS 32.AG26]*

The treatment of non-redeemable preference shares or other instruments with preferred rights under IAS 32 is a particularly difficult issue, since such shares often inhabit the border territory between financial liabilities and equity instruments. However, the starting point is that a non-redeemable preference share whose dividend rights are simply that a dividend (whether of a fixed, capped or discretionary amount) will be paid at the issuing entity's sole discretion, is equivalent to an ordinary equity share and therefore appropriately characterised as equity.

4.5.3 Instruments with a 'dividend blocker' or a 'dividend pusher' clause

4.5.3.A Instruments with a 'dividend blocker'

A number of entities have issued non-redeemable instruments (or instruments redeemable only at the issuer's option) with the following broad terms:

- A discretionary annual coupon or dividend will be paid up to a capped maximum amount

  And

- Unless a full discretionary coupon or dividend is paid to holders of the instrument, no dividend can be paid to ordinary shareholders

This restriction on dividend payments to ordinary shareholders is colloquially referred to as a 'dividend blocker' clause. Because payments of annual coupons or dividends are at the discretion of the issuer and the instrument is non-redeemable, the issuer has an unconditional right to avoid delivering cash or another financial asset. This is not negated by the fact that the issuer cannot pay dividends to ordinary shareholders if no coupon or dividend is paid to the holder of the instruments. The instrument is therefore classified as equity in its entirety.

The economic reality is that many entities that issue such instruments are able to do so at a cost not significantly higher than that of callable perpetual debt. This indicates that the financial markets regard 'dividend blocker' clauses as providing investors with reasonable security of receiving their 'discretionary' coupon or dividend, given the adverse economic consequences for the entity of not paying it (if sufficiently solvent to do so), namely:

- The disaffection of ordinary shareholders who could not receive any dividends.

  And

- The fact that the entity would find it very difficult to raise any similar finance again.

These factors could admit an argument that such instruments are equivalent to perpetual debt, which give rise to a financial liability of the issuer (see section 4.7 below), in all respects, except that the holder has no right to sue for non-payment of the discretionary dividend. However, the analysis in IAS 32 is based on the implicit counter-argument that the position of a holder of an instrument, all payments on which are discretionary, is equivalent to that of an ordinary shareholder. Ordinary shares do not cease to be equity instruments simply because an entity that failed to pay dividends to its ordinary shareholders, when clearly able to do so, would be subject to adverse economic pressures from those shareholders, and might find it very difficult to raise additional share capital.

Aviva plc has issued instruments with 'dividend blocker' clauses that are accounted for as equity instruments (see, in particular, the final sentences of Practical example 4-1 below).

Practical example 4-1: Aviva plc (2019) **United Kingdom**

Annual report and accounts 2019 [extract]

IFRS financial statements [extract]

Notes to the consolidated financial statements [extract]

37 – Direct capital instrument and tier 1 notes

Notional amount	2019 £m	2018 £m
5.9021% £500 million direct capital instrument – Issued November 2004	**500**	500
6.875% £210 million STICS – Issued November 2003	—	231
Total	**500**	731

The direct capital instrument (the DCI) was issued on 25 November 2004. The DCI has no fixed redemption date but the Company may, at its sole option, redeem all (but not part) of the principal amount on 27 July 2020, at which date the interest rate changes to a variable rate, or on any respective coupon payment date thereafter. The variable rate will be the six month sterling deposit rate plus margin.

The Step-up Tier one Insurance Capital Securities ('STICS') were issued on 21 November 2003 by Friends Life Holdings plc, substituted as issuer by Aviva plc on 1 October 2015. These had no fixed redemption date, however, on 17 October 2019 notification was given that the Group would redeem the tier one notes at the first call date on 21 November 2019. On the notification date the instruments were reclassified as a financial liability of £210 million, representing the fair value and redemption cost at that date. The resulting difference of £21 million between the carrying amount of £231 million and fair value of £210 million has been charged to retained earnings. The instruments were cancelled on 25 November 2019.

The Company has the option to defer coupon payments on the DCI on any relevant payment date. Deferred coupons shall only be satisfied should the Company exercise its sole option to redeem the instruments.

No interest will accrue on any deferred coupon on the DCI. Deferred coupons on the DCI will be satisfied by the issue and sale of ordinary shares in the Company at their prevailing market value, to a sum as near as practicable to (and at least equal to) the relevant deferred coupons. In the event of any coupon deferral, the Company will not declare or pay any dividend on its ordinary or preference share capital. These instruments have been treated as equity. Please refer to accounting policy AE.

4.5.3.B Instruments with a 'dividend pusher'

A variation of the financial instrument discussed in section 4.5.3.A above is one with a so called 'dividend pusher' clause which, in practice, often comes with the following broad terms:

- A discretionary annual coupon or dividend will be paid up to a capped maximum amount
- Payment of the annual coupon or dividend is required if the entity pays dividends to ordinary shareholders

  And
- The instrument is non-redeemable (or redeemable only at the issuer's option)

The annual coupons or dividends are at the discretion of the issuer and the instrument is non-redeemable, indicating an unconditional right of the issuer to avoid delivering cash or another financial asset to the holder of the instrument. Whether the 'dividend pusher' clause introduces a contractual obligation to deliver cash or another financial asset depends on whether the payments of dividends to ordinary shareholders (referenced in the dividend pusher clause) are themselves discretionary. In general, payments of dividends to ordinary shareholders are at the discretion of the issuer of those shares. The 'dividend pusher' clause therefore does not introduce a contractual obligation, meaning that the issuer has an unconditional right to avoid delivering cash or another financial asset. Thus, the instrument is classified as equity in its entirety.

4.5.4 Perpetual instruments with a 'step-up' clause

Some perpetual instruments are issued on terms that they are not required to be redeemed. However, if they are not redeemed on or before a given future date, any coupon or dividend paid after that date is increased, usually to a level that would give rise to a cost of finance higher than the entity would normally expect to incur. This effectively compels the issuer to redeem the instrument before the increase occurs. A provision for such an increase in the coupon or dividend is colloquially referred to as a 'step-up' clause. A 'step-up' clause is often combined with a 'dividend-blocker' or 'dividend pusher' clause (see sections 4.5.3.A and 4.5.3.B above).

Paragraph 22 of the version of IAS 32 in issue before its revision in December 2003 (see section 1.2 above) specifically addressed 'step-up' clauses as follows:

"A preferred share that does not provide for mandatory redemption or redemption at the option of the holder may have a contractually provided accelerating dividend such that, within the foreseeable future, the dividend yield is scheduled to be so high that the issuer would be economically compelled to redeem the instrument".[11]

The Basis for Conclusions to the current version of IAS 32 indicates that this example was removed because it was insufficiently clear, but there was no intention to alter the general principle of IAS 32 that an instrument that does not explicitly establish an obligation to deliver cash or other financial assets may establish an obligation indirectly through its terms and conditions (see section 4.2.2 above). *[IAS 32.BC9]*. This has led some to suggest that any instrument with a 'step-up' clause contains a financial liability.

How we see it

In our view, the existence of a step-up clause in an issued financial instrument is irrelevant to the analysis required by IAS 32. If an instrument, whether redeemable or not, contains a contractual obligation to pay a coupon or dividend, it is a liability, irrespective of the 'step-up' clause. However, if the coupon or dividend, both before and after the step-up date, is wholly discretionary, then the instrument, absent other contractual terms that make it a liability, is an equity instrument, again irrespective of the step-up clause. (see sections 4.5.1 and 4.5.2 above).

This analysis was confirmed by the IFRS IC in March 2006 in its discussion of the classification of an instrument that included a 'step-up' dividend clause that would increase the dividend at a pre-determined date in the future. The IFRS IC agreed that this instrument included no contractual obligation ever to pay the dividends or to call the instrument and must therefore be classified as equity under IAS 32.[12]

11 IAS 32, (pre-2003 version - issued March 1995 and revised December 1998 and October 2000), para. 22.

12 *IFRIC Update*, March 2006, available on the IFRS Foundation's website.

4.5.5 Relative subordination

Some have argued that instruments with 'dividend-blocker', 'dividend-pusher' or 'step-up' clauses (see sections 4.5.3 and 4.5.4 above) do not meet the definition of an equity instrument. Those that take this view, point out that IAS 32.11 defines an equity instrument as "any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities" (see section 3 above), whereas many instruments of the type described in sections 4.5.3 and 4.5.4 above are typically entitled only to a return of the amount originally subscribed on a winding up, rather than to any 'residual interest' in the assets. However, such an instrument does not meet the definition of a liability either, for all the reasons set out above.

Moreover, as noted in section 4.1 above, IAS 32.16 indicates that, in applying the definition in IAS 32.11, an entity concludes that an instrument is equity if and only if the criteria in IAS 32.16 are met. In other words, an instrument is equity if it satisfies the criteria of IAS 32.16, whatever construction might be placed on IAS 32.11.

In March 2006, the IFRS IC considered various issues relating to the classification of instruments under IAS 32, and agreed that IAS 32 was clear that the relative subordination on liquidation of a financial instrument was not relevant to its classification under IAS 32, even where the instrument ranks above an instrument classified as a liability.[13] This supports the view that an instrument can be classified as equity even if there are restrictions on participation by its holder in a liquidation or on winding up.

However, in February 2008, the IASB issued an amendment to IAS 32 (see section 1.2 above) which, in very specific circumstances, requires the relative subordination of an instrument to be taken into account in determining its classification as debt or equity (see section 4.6 below).

4.5.6 Economic compulsion

The discussion in sections 4.5.1 to 4.5.5 above illustrates that, while IAS 32 requires the issuer of a financial instrument to classify a financial instrument by reference to its substance rather than its legal form, in reality the substance is determined, if not by the legal form, then certainly by the precise legal rights of the holder of the financial instrument concerned. Ultimately, the key determinant of whether an instrument is a financial liability or an equity instrument of the issuer is whether the terms of the instrument give the holder a contractual right to receive cash or other financial assets which can be sued for at law, subject only to restrictions outside the terms of the instrument (e.g., statutory dividend controls).

By contrast, terms of an instrument that effectively force the issuer to transfer cash or other financial assets to the holder, although not legally required to do so (often referred to as 'economic compulsion'), are not taken into account.

In response to a submission for a possible agenda item, in March 2006 the IFRS IC discussed the role of contractual and economic obligations in the classification of financial instruments under IAS 32.

The IFRS IC agreed that IAS 32 is clear that, in order for an instrument to be classified as a liability, a contractual obligation must be established (either explicitly or indirectly) through the terms and conditions of the instrument. Economic compulsion, by itself, would not result in a financial instrument being classified as a liability.

The IFRS IC also noted that IAS 32 restricts the role of 'substance' to consideration of the contractual terms of an instrument, and that anything outside the contractual terms is not considered for the purpose of assessing whether an instrument is classified as a liability under IAS 32.[14]

4.5.7 'Linked' instruments

An entity may issue an instrument (the 'base' instrument) that requires a payment to be made if, and only if, a payment is made on another instrument issued by the entity (the 'linked' instrument). An example of such an instrument would be a perpetual instrument with a 'dividend blocker' clause (see section 4.5.3.A above), on which the issuing entity is required to pay a coupon only if it pays a dividend to ordinary shareholders. Absent other terms requiring the perpetual instrument to be classified as a liability, it is classified as equity on the basis that the event that triggers a contractual obligation to make a payment (i.e., payment of an ordinary dividend) is itself not a contractual obligation.

13 *IFRIC Update*, March 2006, available on the IFRS Foundation's website.

14 *IFRIC Update*, March 2006, available on the IFRS Foundation's website.

If, however, where payments on the linked instrument are contractually mandatory (such that the linked instrument contains a liability), it is obvious that the base instrument must also contain a liability. This is due to the fact that, in this case, the event that triggers a contractual obligation to make a payment on the base instrument (i.e., a payment on the linked instrument) is a contractual obligation that the issuing entity cannot avoid. This analysis was confirmed by the IFRS IC in March 2006 following discussion of linked instruments with similar terms to these.[15]

This issue had arisen in practice in the context that the linked instrument was often very small and callable by the issuer, but on terms that required its classification as a liability under IAS 32. This would allow the issuer, with no real difficulty, to redeem the linked instrument at will and thus convert the base instrument from a liability to equity at any time. This had led some to argue that only the linked instrument must be classified as a liability.

4.5.8 'Change of control', 'taxation change' and 'regulatory change' clauses

A number of entities have issued instruments with 'dividend blocker', 'dividend pusher' and 'step-up' clauses (see sections 4.5.3 and 4.5.4 above), which would otherwise have been treated as equity by IAS 32, but have wished to account for them as liabilities, perhaps because they can then be hedged in a way that allows hedge accounting to be applied (see section 10 below). Methods of achieving this have included the use of a *de minimis* linked liability instrument, or the inclusion of a clause requiring the repayment of the instrument in the event of a change of control. This raises the question of whether a change of control is within the control of the entity (such that the instrument is equity) or not (such that the instrument is debt), which is discussed in more detail in section 4.3.4 above.

Another common method of converting an instrument that would otherwise be classified by IAS 32 as equity into debt is to add a clause requiring repayment of the instrument in the event of a fiscal or regulatory change (that in reality may be a remote possibility), see section 4.3.2 above.

4.6 Puttable instruments and instruments repayable only on liquidation

4.6.1 The issue

A 'puttable instrument' is essentially a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset (see section 3 above). Prior to its amendment in February 2008 (see section 1.2 above), IAS 32 classified any puttable instrument as a financial liability, including instruments where the legal form gives the holder a right to a residual interest in the assets of the issuer.

This classification produced what some regarded as an inappropriate result in the financial statements of entities such as open-ended mutual funds, unit trusts, partnerships and some co-operative entities. Such entities often provide their unit holders or members with a right to redeem their interests in the issuer at any time for cash. Under IAS 32, prior to the February 2008 amendment, an entity whose holders had such rights might report net assets of nil, or even negative net assets, since what would, in normal usage, have been regarded as its 'equity' (i.e., assets less external borrowings) was classified as a financial liability.

For example, the owners of some co-operatives and professional partnerships are entitled to have their ownership interests repurchased at fair value. However, such entities typically do not reflect that fair value in their financial statements, because a significant part of the value may be represented by property accounted for at cost rather than fair value or by internally generated goodwill, which cannot be recognised in financial statements prepared under IFRS accounting standards.

Clearly, if such an entity were to recognise a liability for the right of its owners to be bought out at fair value, it would show net liabilities, which would increase (creating accounting losses) the more the fair value of the entity increases, and decrease (creating accounting profits) the more the fair value decreases. Moreover, any distributions to the owners of such entities would be shown as a charge to, rather than a distribution of, profit.

15 *IFRIC Update*, March 2006, available on the IFRS Foundation's website.

Similar concerns were raised in relation to limited-life entities. In some jurisdictions, certain types of entity are required to be wound up after a certain period of time, either automatically, or unless the members resolve otherwise. Some entities may also have a limited life under their own governing charter, or equivalent document. For example:

- A collective investment fund might be required to be liquidated on, say, the tenth anniversary of its foundation.

  Or

- A partnership might be required to be dissolved on the death or retirement of a partner.

Such an entity arguably had no equity under IAS 32 prior to the February 2008 amendment, since its limited life imposes an obligation, outside the entity's control, to distribute all its assets. Again, some questioned whether it was very meaningful to show such an entity as having no equity.

To deal with these concerns, IAS 32 was amended in February 2008. In the meantime, the IFRS IC had published IFRIC 2 which addresses the narrower issue of the classification of certain types of puttable instrument, typically issued by co-operative entities (see section 4.6.6 below).

The effect of the amended standard is that certain narrowly defined categories of puttable instruments (see section 4.6.2 below) and instruments repayable on a pre-determined liquidation (see section 4.6.3 below) are classified as equity, notwithstanding that they have features that would otherwise require their classification as financial liabilities.

Moreover, as discussed further in section 4.6.5 below, one of the criteria for classifying such an instrument as equity, is that it is the most subordinated instrument issued by the reporting entity. This represents a significant, and controversial, departure from the normal approach of IAS 32 that the classification of an instrument must be determined only by reference to the contractual terms of that instrument, rather than those of other instruments in issue. This may mean that two entities may classify an identical instrument differently, if it is the most subordinated instrument of one entity but not of the other. It may also mean that the same entity may classify the same instrument differently at different reporting dates.

It was essentially these departures from the normal requirements of IAS 32 that led two members of the IASB to dissent from the amendment. In their view, it is not based on a clear principle, but comprises "several paragraphs of detailed rules crafted to achieve a desired accounting result … [and] … to minimise structuring opportunities".[16]

Where the exceptions in sections 4.6.2 and 4.6.3 below do not apply, IAS 32 takes the view that the effect of the holder's option to put the instrument back to the issuer for cash or another financial asset is that the puttable instrument meets the definition of a financial liability (see section 3 above). *[IAS 32.18(b)]*.

The IASB believes that the accounting treatment required by IAS 32 for instruments not subject to the exceptions in sections 4.6.2 and 4.6.3 below is appropriate, but points out that the classification of members' interests in such entities as a financial liability does not preclude:

- The use of captions such as 'net asset value attributable to unitholders' and 'change in net asset value attributable to unitholders' on the face of the financial statements of an entity that has no equity capital (such as some mutual funds and unit trusts).

  Or

- The use of additional disclosure to show that total members' interests comprise items such as reserves that meet the definition of equity and puttable instruments that do not. *[IAS 32.18(b), IAS 32.BC7, IAS 32.BC8]*.

The illustrative examples appended to IAS 32 give specimen disclosures to be used in such cases (see Chapter 50 at section 7.4.6).

16 *Amendments to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements: Puttable Instruments and Obligations Arising on Liquidation*, IASB, February 2008, paras. DO1-DO6.

4.6.2 Puttable instruments

Extract from IAS 32

Puttable instruments

16A A puttable financial instrument includes a contractual obligation for the issuer to repurchase or redeem that instrument for cash or another financial asset on exercise of the put. As an exception to the definition of a financial liability, an instrument that includes such an obligation is classified as an equity instrument if it has all the following features:

(a) It entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation. The entity's net assets are those assets that remain after deducting all other claims on its assets. A pro rata share is determined by:

(i) dividing the entity's net assets on liquidation into units of equal amount; and

(ii) multiplying that amount by the number of the units held by the financial instrument holder.

(b) The instrument is in the class of instruments that is subordinate to all other classes of instruments. To be in such a class the instrument:

(i) has no priority over other claims to the assets of the entity on liquidation; and

(ii) does not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments.

(c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features. For example, they must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class.

(d) Apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, the instrument does not include any contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity, and it is not a contract that will or may be settled in the entity's own equity instruments as set out in subparagraph (b) of the definition of a financial liability.

(e) The total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the profit or loss, the change in the recognised net assets, or the change in the fair value of the recognised and unrecognised net assets of the entity over the life of the instrument (excluding any effects of the instrument).

16B For an instrument to be classified as an equity instrument, in addition to the instrument having all the above features, the issuer must have no other financial instrument or contract that has:

(a) total cash flows based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of such instrument or contract) and

(b) the effect of substantially restricting or fixing the residual return to the puttable instrument holders.

For the purposes of applying this condition, the entity shall not consider non-financial contracts with a holder of an instrument described in paragraph 16A that have contractual terms and conditions that are similar to the contractual terms and conditions of an equivalent contract that might occur between a non-instrument holder and the issuing entity. If the entity cannot determine that this condition is met, it shall not classify the puttable instrument as an equity instrument.

IAS 32 classifies a puttable instrument as an equity instrument if it has all the above features. *[IAS 32.16A, IAS 32.16B]*. Profit or loss and the change in recognised net assets must be determined in accordance with relevant IFRS accounting standards. *[IAS 32.AG14E]*.

In applying this condition in section 16B, the entity must not consider non-financial contracts with a holder of an instrument described in (a) to (e) above that have contractual terms and conditions that are similar to the contractual terms and conditions of an equivalent contract that might occur between a non-instrument holder and the issuing entity. If the entity cannot determine that this condition is met, it must not classify the puttable instrument as an equity instrument. *[IAS 32.16B]*.

Some of these criteria raise issues of interpretation, which are addressed in section 4.6.4 below.

4.6.3 Instruments entitling the holder to a *pro rata* share of net assets only on liquidation

Extract from IAS 32

Instruments, or components of instruments, that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation

16C Some financial instruments include a contractual obligation for the issuing entity to deliver to another entity a pro rata share of its net assets only on liquidation. The obligation arises because liquidation either is certain to occur and outside the control of the entity (for example, a limited life entity) or is uncertain to occur but is at the option of the instrument holder. As an exception to the definition of a financial liability, an instrument that includes such an obligation is classified as an equity instrument if it has all the following features:

(a) It entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation. The entity's net assets are those assets that remain after deducting all other claims on its assets. A pro rata share is determined by:

(i) dividing the net assets of the entity on liquidation into units of equal amount; and

(ii) multiplying that amount by the number of the units held by the financial instrument holder.

(b) The instrument is in the class of instruments that is subordinate to all other classes of instruments. To be in such a class the instrument:

(i) has no priority over other claims to the assets of the entity on liquidation; and

(ii) does not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments.

(c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments must have an identical contractual obligation for the issuing entity to deliver a pro rata share of its net assets on liquidation.

16D For an instrument to be classified as an equity instrument, in addition to the instrument having all the above features, the issuer must have no other financial instrument or contract that has:

(a) total cash flows based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of such instrument or contract) and

(b) the effect of substantially restricting or fixing the residual return to the instrument holders.

For the purposes of applying this condition, the entity shall not consider non-financial contracts with a holder of an instrument described in paragraph 16C that have contractual terms and conditions that are similar to the contractual terms and conditions of an equivalent contract that might occur between a non-instrument holder and the issuing entity. If the entity cannot determine that this condition is met, it shall not classify the instrument as an equity instrument.

Some of the criteria for classifying as equity financial instruments that entitle the holder to a *pro rata* share of assets only on liquidation are similar to those (in section 4.6.2 above) for classifying certain puttable instruments as equity. The difference between these criteria and those for puttable instruments are:

- There is no requirement for there to be no contractual obligations other than those arising on liquidation.
- There is no requirement to consider the expected total cash flows throughout the life of the instrument.

  And

- The only feature that must be identical among the instruments in the class is the obligation for the issuing entity to deliver to the holder a *pro rata* share of its net assets on liquidation.

The reason for the more relaxed criteria in this case is that the IASB took the view that, given that the only obligation in this case arises on liquidation, there was no need to consider obligations other than those on liquidation. However, the IASB notes that, if an instrument does contain other obligations, these may need to be accounted for separately under IAS 32. *[IAS 32.BC67]*.

Some of these criteria raise some issues of interpretation, which are addressed in section 4.6.4 below. *[IAS 32.16C, IAS 32.16D]*.

4.6.4 Clarification of the exemptions in sections 4.6.2 and 4.6.3 above

The conditions for treating certain types of puttable instruments (see section 4.6.2 above) and instruments repaying a *pro rata* share of net assets on liquidation (see section 4.6.3 above) as equity are complex. IAS 32 provides some clarification in respect of the following matters:

- Instruments issued by a subsidiary (see section 4.6.4.A below)
- Determining the level of subordination of an instrument (see condition (b) in sections 4.6.2 and 4.6.3 above), (see section 4.6.4.B below)
- The meaning of 'no obligation to deliver cash or another financial asset' (see condition (d) in section 4.6.2 above) in respect of instruments with a requirement to distribute a minimum proportion of profit to shareholders (see section 4.6.4.D below)
- Other instruments that substantially fix or restrict the residual return to the holder of an instrument (see section 4.6.2 above *[IAS 32.16B(b)]* and section 4.6.3 above *[IAS 32.16D(b)]*), (see section 4.6.4.E below)

  And
- Transactions entered into by an instrument holder other than as owner of the entity (see section 4.6.4.F below)

One matter on which IAS 32 does not provide further clarification is the meaning of 'identical features' (see condition (c) in section 4.6.2 above). This is dealt with in section 4.6.4.C below.

4.6.4.A Instruments issued by a subsidiary

A subsidiary may issue an instrument that is classified as equity in its separate financial statements under one of the exceptions summarised in sections 4.6.2 and 4.6.3 above. However, in the consolidated financial statements of the subsidiary's parent, such an instrument is not recorded as a non-controlling interest, but as a financial liability. *[IAS 32.AG29A]*. This reflects the fact that the exceptions in sections 4.6.2 and 4.6.3 above are both subject to the condition that the instrument concerned is the most subordinated instrument issued by the reporting entity. The IASB took the view that a non-controlling interest, by its nature, can never be regarded as the residual ownership interest in the consolidated financial statements. *[IAS 32.BC68]*.

4.6.4.B Relative subordination of the instrument

The exceptions in sections 4.6.2 and 4.6.3 above are both subject to the criterion, condition (b), that the instrument concerned is the most subordinated instrument issued by the reporting entity. As noted in section 4.6.1 above, this represents a departure from the normal principle of IAS 32 that the classification of an issued instrument as a financial liability or equity is determined by reference only to the contractual terms of that instrument.

To determine whether an instrument is in the most subordinate class, the entity calculates the instrument's claim on a liquidation as at the date when it classifies the instrument. The entity reassesses the classification if there is a change in relevant circumstances (for example, if it issues or redeems another financial instrument). *[IAS 32.AG14B]*. This is discussed further in section 4.6.5 below.

An instrument that has a preferential right on liquidation of the entity is not regarded as an instrument with an entitlement to a *pro rata* share of the net assets of the entity. An example might be an instrument that entitles the holder to a fixed dividend on liquidation, in addition to a share of the entity's net assets, when other instruments in the subordinate class with a right to a *pro rata* share of the net assets of the entity do not have the same right on liquidation. *[IAS 32.AG14C]*.

If an entity has only one class of financial instruments, that class is treated as if it were subordinate to all other classes. *[IAS 32.AG14D]*.

How we see it

In our view, the test of whether the instrument is the most subordinated has to be applied according to the legal rights of the various classes of instruments, even where what is legally the most subordinated instrument in issue is entitled to the return of only a nominal sum on liquidation, which may be dwarfed by the entitlement of other classes of shares.

The requirement for a puttable instrument to be in the most subordinate class of instruments issued by an entity does not preclude other, non-puttable, instruments from being classified as equity at the same time. In an agenda decision issued in March 2009, the IFRS IC noted that a financial instrument is first classified as a liability or equity instrument in accordance with the general requirements of IAS 32. That classification is not affected by the existence of puttable instruments.[17] Thus, for example, founders' shares in an investment fund, which are entitled only to the return of their par value on liquidation, would be classified as equity even if less subordinate than a class of puttable shares which also qualify for equity classification. Conversely, if the founders' shares were the most subordinate instruments, the puttable shares would have to be classified as liabilities.

4.6.4.C Meaning of 'identical features'

Condition (c) in IAS 32.16C requires that "all financial instruments in the class of instruments that is subordinate to all other classes of instruments" have identical features. For example, they must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class. The word 'identical' does not normally need much further explanation in the English language. Nevertheless, some have questioned how literally the word must be interpreted in this case.

Consider, for example, an investment fund that issues several types of puttable shares, each equally subordinate, having identical redemption and dividend rights, but different minimum subscription thresholds and subscription fees. Do all these instruments have identical features for the purpose of this exemption?

How we see it

In our view the identical features condition in IAS 32.16C(c) is primarily designed to ensure that the redemption rights of the shares do not differ. Terms with features that do not have the potential to impact the redemption rights of the instrument will not necessarily fail the 'identical features' test.

Accordingly, terms that take effect before the shares are issued (as in the example above), or are not financial, do not cause instruments to fail the 'identical features' test. Examples of features which are not financial might include rights to information or management powers.

When considering whether instruments have identical features, it is important to consider whether rights and obligations arise as a result of holding the instrument or from some other cause. Consider, as an example, a closed end fund with a predetermined maturity, incorporated as a partnership limited by shares, which has two classes of shares: a management share subscribed for by the general partner; and ordinary shares subscribed for by the limited partners. Upon the dissolution of the entity, the general partner is entitled to a fixed rate management fee and a fee based on the performance of the fund, otherwise the assets are distributed to both classes of shareholder on a *pro rata* basis. As the management and ordinary shares rank *pari passu* with each other, neither is subordinate to the other and both the management share and the ordinary shares would be classified as equity. The management and performance fees payable to the general partner are returns for managing the fund rather than equity returns in their capacity as a shareholder. For transactions entered into by an instrument holder other than as an owner of equity, see section 4.6.4.F below. The fact that the different classes of shares have different names is irrelevant to the analysis.

4.6.4.D No obligation to deliver cash or another financial asset

One of the conditions for classifying a financial instrument as equity in section 4.6.2 above is that the instrument does not include any contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.

Some entities, particularly ones with limited lives, are required by their constitution to distribute a minimum proportion of profits to shareholders or partners each year. Subject to the matters discussed in section 4.2 above, such a requirement will normally result in the puttable instrument being considered a liability. It might be argued, firstly, that no obligation arises in these circumstances until profits are made, and secondly that such distributions only represent advance payments of the residual interest in the entity and so are consistent with equity classification. However, the IASB discussed this issue while developing the 2008 amendment and concluded that a contractual obligation existed, the measurement of which was uncertain. Nevertheless, the IASB declined to provide further guidance on this issue as they considered that it would have implications for other projects.

17 *IFRIC Update*, March 2009, available on the IFRS Foundation's website.

In May 2010, the IFRS IC considered a request to clarify whether puttable income trust units, that include contractual provisions to make distributions on a *pro rata* basis, can be classified as equity. The submission to the IFRS IC argued that such *pro rata* obligations would not prevent the instrument from being classified as equity, by analogy to the *Classification of Rights Issues* amendment to IAS 32 (October 2009). The IFRS IC decided not to propose any amendment to IAS 32 to deal with this issue, making it fairly clear in the process that they did not believe such an instrument would qualify to be classified as equity.

4.6.4.E Instruments that substantially fix or restrict the residual return to the holder of an instrument

A condition for classifying a financial instrument as equity in sections 4.6.2 or 4.6.3 above is that the issuing entity has no other financial instrument or contract that has:

- Total cash flows based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity.

  And

- The effect of substantially restricting or fixing the residual return.

IAS 32 notes that the following instruments, when entered into on normal commercial terms with unrelated parties, are unlikely to prevent instruments that otherwise meet the criteria in sections 4.6.2 or 4.6.3 above from being classified as equity:

- Instruments with total cash flows substantially based on specific assets of the entity
- Instruments with total cash flows based on a percentage of revenue
- Contracts designed to reward individual employees for services rendered to the entity

  And

- Contracts requiring the payment of an insignificant percentage of profit for services rendered or goods provided *[IAS 32.AG14J]*

4.6.4.F Transactions entered into by an instrument holder other than as owner of the entity

IAS 32 observes that the holder of a financial instrument subject to one of the exceptions in sections 4.6.2 or 4.6.3 above may enter into transactions with the entity in a role other than that of an owner. For example, an instrument holder also may be an employee of the entity. IAS 32 requires that only the cash flows and the contractual terms and conditions of the instrument that relate to the instrument holder as an owner of the entity be considered when assessing whether the instrument must be classified as equity under conditions (a) to (e) in IAS 32.16A or conditions (a) to (c) in IAS 32.16C. *[IAS 32.AG14F]*.

An example might be a limited partnership that has limited and general partners. Some general partners may provide a guarantee to the entity and be remunerated for providing that guarantee. In such situations, the guarantee and the associated cash flows relate to the instrument holders in their role as guarantors and not in their roles as owners of the entity. Therefore, such a guarantee and the associated cash flows would not result in the general partners being considered subordinate to the limited partners and would be disregarded when assessing whether the contractual terms of the limited partnership instruments and the general partnership instruments are identical. *[IAS 32.AG14G]*.

Another example might be a profit or loss sharing arrangement that allocates profit or loss to the instrument holders based on services rendered or business generated during the current and previous years. Such arrangements are regarded as transactions with instrument holders in their role as non-owners and must not be considered when assessing the criteria in conditions (a) to (e) in IAS 32.16A above or conditions (a) to (c) in IAS 32.16C above. By contrast, profit or loss sharing arrangements, that allocate profit or loss to instrument holders based on the nominal amount of their instruments relative to others in the class, represent transactions with the instrument holders in their roles as owners and must be considered when assessing the criteria in conditions (a) to (e) in IAS 32.16A above or conditions (a) to (c) in IAS 32.16C above. *[IAS 32.AG14H]*.

IAS 32 notes that, in order for a transaction with an owner to be assessed as being undertaken in that person's capacity as a non-owner, the cash flows and contractual terms and conditions of the transaction must be similar to those of an equivalent transaction that might occur between a non-instrument holder and the issuing entity. *[IAS 32.AG14I]*.

4.6.5 Reclassification of puttable instruments and instruments imposing an obligation only on liquidation

As noted in section 4.6.4.B above, IAS 32 requires the entity to continually reassess the classification of such an instrument. The entity classifies a financial instrument as an equity instrument from the date on which it has all the features and meets the conditions set out in sections 4.6.2 or 4.6.3 above, and reclassifies the instrument from the date on which it ceases to have all those features or meet all those conditions.

For example, if an entity redeems all its issued non-puttable instruments, any puttable instruments that remain outstanding and that have all of the features and meet all the conditions in section 4.6.2 above, are reclassified as equity instruments from the date of redemption of the non-puttable instruments. *[IAS 32.16E]*.

Where an instrument, previously classified as an equity instrument, is reclassified as a financial liability, the financial liability is measured at fair value at the date of reclassification, with any difference between the carrying value of the equity instrument and the fair value of the financial liability at the date of reclassification being recognised in equity. *[IAS 32.16F(a)]*.

Where an instrument, previously classified as a financial liability, is reclassified as an equity instrument, the equity instrument is measured at the carrying value of the financial liability at the date of reclassification. *[IAS 32.16F(b)]*.

4.6.6 IFRIC 2

The issue that ultimately led to the publication of IFRIC 2 was the appropriate accounting treatment for the members' contributed capital of a co-operative entity, where the members are entitled to ask for the return of their investment. However, the scope of IFRIC 2 is not confined to co-operative entities and extends to any entity whose members may ask for a return of their capital. *[IFRIC 2.1, IFRIC 2.2, IFRIC 2.3, IFRIC 2.4]*.

IFRIC 2 states that the contractual right of the holder of a financial instrument to request redemption does not, in itself, require that financial instrument to be classified as a financial liability. Rather, the entity must consider all the terms and conditions of the financial instrument in determining its classification as a financial liability or equity. Those terms and conditions include relevant local laws, regulations and the entity's governing charter in effect at the date of classification, but not expected future amendments to those laws, regulations or charter. *[IFRIC 2.5]*.

Accordingly, IFRIC 2 provides that an instrument, that would be classified as equity if the holder did not have the right to request redemption, must be classified as an equity instrument where:

- The entity has the unconditional right to refuse redemption
- Local law, regulation or the entity's governing charter imposes an unconditional prohibition on redemption

  Or
- The members' shares meet the criteria in sections 4.6.2 or 4.6.3 above for classification as equity *[IFRIC 2.6, IFRIC 2.7, IFRIC 2.8]*

IFRIC 2 distinguishes between those prohibitions on redemption in local law, regulation or the entity's governing charter that are 'unconditional' (i.e., they apply at any time) and those which prohibit redemption only when certain conditions, such as liquidity constraints, are met or not met. Prohibitions that apply only in certain circumstances are ignored and therefore would not result in equity classification. *[IFRIC 2.8]*. This is consistent with the fact that under IAS 32 the classification of an instrument as debt or equity is not influenced by considerations of liquidity (see section 4.2 above).

In some cases, there may be a partial prohibition on redemption. For example, redemption may be prohibited where its effect would be to reduce the number of members' shares or the amount of paid-in capital below a certain minimum. In such cases, only the amount subject to a prohibition on redemption is treated as equity, unless:

- The entity has the unconditional right to refuse redemption as described above.

  Or
- The members' shares meet the criteria in sections 4.6.2 or 4.6.3 above for classification as equity.

If the minimum number of members' shares or amount of paid-in capital changes, an appropriate transfer is made between financial liabilities and equity. *[IFRIC 2.9]*.

Any financial liability for the redemption of instruments not classified as equity, is measured at fair value. In the case of members' shares with a redemption feature, the entity measures the fair value of the financial liability for redemption at no less than the maximum amount payable under the redemption provisions of its governing charter or applicable law, discounted from the first date that the amount could be required to be paid. *[IFRIC 2.10]*.

In accordance with the general provisions of IAS 32 regarding interest and dividends (see section 8 below), distributions to holders of equity instruments are recognised directly in equity, net of any income tax benefits. Interest, dividends and other returns relating to financial instruments classified as financial liabilities are expenses, regardless of whether those amounts paid are legally characterised as dividends, interest or otherwise. *[IFRIC 2.11]*.

IFRIC 2 clarifies that, where members act as customers of the entity (for example, where it is a bank and members have current or deposit accounts or similar contracts with the bank), such accounts and contracts are financial liabilities of the entity. *[IFRIC 2.6]*.

It should be noted that in the FICE DP (see section 12 below), the IASB noted that the requirements in IFRS accounting standards to account for financial instruments have been designed around the concept of a contract. They further noted that IFRIC 2 was developed for a very specific fact pattern and that they did not believe that the analysis in IFRIC 2 is more broadly applicable.[18] The effects of laws or regulations is an area the IASB intends to clarify as part of the ongoing FICE project and proposed amendments to the requirements in the FICE Exposure Draft published in November 2023 (see section 12.5 below).

4.7 Perpetual debt

'Perpetual debt' instruments are those that provide the holder with the contractual right to receive payments on account of interest at fixed dates, extending into the indefinite future, either with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the future. However, this does not mean that 'perpetual debt' is to be classified as equity, since the issue proceeds will typically represent the net present value of the liability for interest payments.

For example, an entity may issue a financial instrument requiring it to make annual payments in perpetuity equal to a stated interest rate of 8% applied to a stated par or principal amount of CU1 million. Assuming 8% to be the market rate of interest for the instrument when issued, the issuer assumes a contractual obligation to make a stream of future interest payments having a fair value (present value) of CU1 million. Thus, perpetual debt gives rise to a financial liability of the issuer. *[IAS 32.AG6]*.

4.8 Differences of classification between consolidated and single entity financial statements

4.8.1 Consolidated financial statements

In consolidated financial statements, IAS 32 requires an entity to present non-controlling interests (i.e., the interests of other parties in the equity and income of its subsidiaries) within equity, in accordance with IAS 1 (see Chapter 3 at section 3.1.5) and IFRS 10 *Consolidated Financial Statements* (see Chapter 8 at section 4 and Chapter 10 at section 8). *[IAS 32.AG29]*.

When classifying a financial instrument (or a component of it) in consolidated financial statements, an entity must consider all the terms and conditions agreed between all members of the group and the holders of the instrument in determining whether the group as a whole has an obligation to deliver cash or another financial asset, in respect of the instrument or to settle it in a manner that results in its classification as a financial liability. *[IAS 32.AG29]*.

For example, a subsidiary in a group may issue a financial instrument and a parent or other group entity may then agree additional terms directly with the holders of the instrument to guarantee some or all of the payments to be made under the instrument. The effect of this is that the subsidiary may have discretion over distributions or redemption, but the group as a whole does not. *[IAS 32.AG29]*.

Accordingly, the subsidiary may appropriately classify the instrument without regard to these additional terms in its individual financial statements. For the purposes of the consolidated financial statements, however, the effect of the other agreements between members of the group and the holders of the instrument is to create an obligation or settlement provision, so that the instrument (or the component of it that is subject to the obligation) is classified as a financial liability. *[IAS 32.AG29]*.

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18 Discussion Paper DP/2018/1: *Financial Instruments with Characteristics of Equity*, IASB, June 2018, para. 8.33-34. Available on the IFRS Foundation's website.

Thus, it is quite possible for a financial instrument to be classified as an equity instrument in the financial statements of the issuing subsidiary but as a financial liability in the financial statements of the group.

4.8.2 Single entity financial statements

The converse of the discussion in section 4.8.1 above is that it is not uncommon for instruments that are classified as equity in the consolidated financial statements to give rise to liabilities and embedded derivatives in the financial statements of individual members of the group.

This is because a group wishing to raise finance for its operations will generally do so through a group entity specialising in finance-raising, which will then on-lend the proceeds of the finance raised to the relevant operating subsidiaries. The terms of the intragroup on-lending transactions will often be such that finance which constitutes equity from the perspective of group as a whole, may be a liability in the individual financial statements of the finance-raising entity itself.

For example, the finance-raising entity might issue an irredeemable instrument with a 'dividend blocker' clause (see section 4.5.3.A above), under the terms of which that entity is not required to make any payments to the holder unless the ultimate parent entity of the group pays a dividend to ordinary shareholders. Absent any other terms requiring its classification, in whole or in part, as a liability under IAS 32, the instrument will be treated as equity in the consolidated financial statements, since payments under the instrument are contingent on an event within the control of the group (payment of a dividend by the parent entity). In the finance-raising entity's single entity financial statements, however, the instrument must be classified as a liability, because the subsidiary cannot control the dividend policy of its parent and could therefore be forced to make payments to the holder of the instrument as a consequence of its parent entity paying a dividend.

Another common example is that a group may issue a convertible bond which is actually structured as a series of transactions along the following lines:

- A finance-raising subsidiary issues a bond, giving the holder a right to receive fixed, non-discretionary interest payments, which converts into preference shares of that subsidiary.

  And

- At the time that this conversion occurs, the parent entity is required to acquire the preference shares of the subsidiary from the holder (i.e., the previous bondholder) in exchange for equity of the parent.

Absent any other terms requiring classification as a liability under IAS 32, the instrument will be treated as a compound instrument, consisting of a liability and an equity component (see section 6 below) in the consolidated financial statements. The instrument as a whole might be classified as a liability in the subsidiary's financial statements, if (for example) the preference shares issued on conversion by the subsidiary have terms that require them to be classified as a liability by IAS 32. In that case, the subsidiary will have issued an instrument that the holder can exchange either for cash or for a debt instrument.

From the subsidiary's perspective, therefore, there is no equity component to the instrument and the overall instrument would be classified as a liability that, under the general rules of IFRS 9, must be recorded at fair value on initial recognition, which will typically be lower than the proceeds received. This is because the pricing of the instrument as a whole considers the conversion option that the holder receives, so that the interest is typically paid at a rate below the rate that would apply to a liability without a conversion option. In other words, the holder of the instrument 'pays' for the conversion option through a reduced entitlement to interest. The group accounts reflect the difference between the proceeds of issue and the fair value of the liability component as the equity component (see section 6 below).

How we see it

In the financial statements of a subsidiary that has issued a debt instrument that is convertible into its parent's shares, the most appropriate accounting treatment, in our view, would be to treat the difference between the proceeds of issue and the fair value of the subsidiary's liability as an equity contribution by the parent, reflecting the fact that the subsidiary can borrow on a reduced interest basis due to the conversion option issued by the parent.

Moreover, in the period prior to conversion, the parent is required to account for its contingent forward contract to acquire the preference shares in the finance company, in its separate accounts.

4.9 Reclassification of instruments

It happens from time to time that the terms of a financial instrument are modified in such a way that an instrument, that was an equity instrument at the original date of issue, would be classified as a financial liability if issued at the date of modification, or *vice versa*. Alternatively, the terms of the instrument may remain unaltered, but external circumstances may change. For example:

- An instrument might have been issued subject to a contingent settlement provision (see section 4.3 above) that, at the date of issue, was within the control of the issuer, but ceases to be so at a later date.
- An instrument might have been issued subject to a contingent settlement provision (see section 4.3 above) that, at the date of issue, was not considered genuine, but becomes so at a later date.

  Or
- An instrument might have been issued, requiring interest payments to be made when contractually mandatory interest payments are made on another instrument issued by the entity, the 'linked' instrument (see section 4.5.7 above), but this linked instrument is later repaid by the entity.

Such situations raise the question of whether such changes of terms or circumstances would lead to reclassification of the instruments affected in the financial statements and, if so, how the reclassification would be accounted for.

4.9.1 Change of terms

IAS 32 gives no guidance as to whether reclassification is required, permitted or prohibited. The requirement of IAS 32.15 that an instrument be classified 'on initial recognition' (see section 4 above) could be read as implying that classification occurs only on initial recognition and is not subsequently revisited.

However, an agenda decision by the IFRS IC (see section 4.9.1.A below) indicated that a change in the terms of an instrument is equivalent to the issue of a new instrument in settlement of the original instrument if the change in the terms of the instrument results in the instrument being classified as a financial liability. Such an exchange transaction would be accounted for by derecognising the settled instrument and recognising (and classifying as a financial liability or equity) the new replacement instrument.

4.9.1.A Equity instrument to financial liability

At its meeting in November 2006, the IFRS IC considered a situation in which an amendment to the contractual terms of an equity instrument resulted in the instrument being classified as a financial liability. Two issues were discussed:

- The measurement of the financial liability at the date of the amendment to the terms.

  And
- The treatment of any difference between the carrying amount of the previously recognised equity instrument and the amount of the financial liability recognised.

The IFRS IC decided not to add this issue to its agenda because, in its view, the accounting treatment is clear. The financial liability is initially recognised at fair value under the general provisions of IFRS 9 (see Chapter 45 at section 3). Any difference between the carrying amount of the liability and that of the previously recognised equity instrument is recognised in equity in accordance with the general principle of IAS 32 (see section 8 below) that no gain or loss is recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments.[19]

4.9.1.B Financial liability to equity instrument

How we see it

Where the terms of a financial liability are changed such that the instrument then meets the definition of an equity instrument, we believe, as above, that the instrument must be reclassified to equity.

19 *IFRIC Update*, November 2006, available on the IFRS Foundation's website.

That situation is analogous to a debt-for-equity swap as discussed in section 7 below and, therefore, must be accounted for in accordance with IFRIC 19, where that interpretation applies. The most likely situation in which IFRIC 19 would not apply would be in a transaction with shareholders in their capacity as shareholders, as discussed in section 7.3 below.

4.9.2 Change of circumstances - passage of time

The nature and risk profile of a financial instrument may change as a result of a change in circumstances. Such a change may occur simply as the result of the passage of time. For example, in 20X1 an entity might issue a bond mandatorily convertible at the end of 20X4. The conversion terms are that the holder will receive a number of the issuer's equity shares, being the lower of 100 shares or a number of shares determined according to a formula based on the share price at 31 December 20X1.

At the date of issue, this instrument is a financial liability since it involves an obligation to deliver a variable number of equity instruments. At 31 December 20X1, however, the number of shares to be delivered on conversion can be determined and becomes fixed.

How we see it

In our view, the liability component of a bond representing the obligation to deliver a variable number of equity instruments could be regarded as expiring if the number of equity instruments that must be delivered subsequently becomes fixed. This liability component could therefore be derecognised (see Chapter 48 at section 6), to be replaced with an equity component (see the discussion in section 7 below of the appropriate accounting treatment in such circumstances). This issue was discussed by the IFRS IC in March 2021, who however, noted that IAS 32 contains no general requirement for reclassifying financial liabilities and equity instruments (see paragraph below).

In March 2021, the IFRS IC received a request about the application of IAS 32 in respect of the reclassification of warrants. Specifically, the request described a warrant that provided the holder with the right to buy a fixed number of equity instruments of the issuer of the warrant for an exercise price that would be fixed at a future date. At initial recognition, because of the variability in the exercise price, the issuer classified these instruments as financial liabilities. The request asked whether the issuer reclassifies the warrant as an equity instrument following the fixing of the warrant's exercise price after initial recognition as specified in the contract, given that the fixed-for-fixed condition would be met at that stage.

The IFRS IC observed that IAS 32 contains no general requirements for reclassifying financial liabilities and equity instruments after initial recognition when the instrument's contractual terms are unchanged. The IFRS IC also acknowledged that similar questions about reclassification arise in other circumstances and that reclassification by the issuer has been identified as one of the practice issues being addressed as part of the FICE project. The IFRS IC concluded that the matter described in the request was too narrow for the Board or the IFRS IC to address and instead would more appropriately be considered as part of the Board's discussions on the FICE project. The IASB proposed amendments to the requirements for this area in the FICE Exposure Draft published in November 2023 (see section 12 below).[20]

4.9.3 Change of circumstances - other than passage of time

Changes of circumstances for reasons other than the passage of time are more challenging. For example, an entity might issue a convertible bond denominated in its functional currency at that time. Such a bond would have an equity component (see section 6 below). Subsequently, the entity's functional currency changes but the bond remains outstanding, now denominated in a currency other than the entity's functional currency. If a bond with these terms were issued after the change in functional currency, it would be classified in its entirety as a financial liability, since the principal of the bond would not be a 'fixed' amount by reference to the entity's functional currency (see section 5.2.3 below). This raises the question of whether the equity component of the bond must be reclassified as a financial liability on the change in functional currency.

In our view, there are arguments both for and against reclassification. As the arguments for reclassification are to some extent a rebuttal of those against reclassification, we discuss the latter first.

20 *IFRIC Update*, March 2021, available on the IFRS Foundation's website.

4.9.3.A Arguments against reclassification

The principal arguments against reclassification are:

(a) The requirement of IAS 32.15 to classify an instrument as a financial liability or equity 'on initial recognition' (see section 4 above) could be read as implying that such classification occurs only on initial recognition and is not subsequently revisited.

(b) The implementation guidance to IFRS 1 *First-time Adoption of International Financial Reporting Standards,* requires a compound instrument to be analysed into its components, based on the substance of the contractual arrangement, as at the date on which the instrument first satisfied the recognition criteria in IAS 32. *[IFRS 1.IG35, IFRS 1.IG36]*. Changes to the terms of the instrument after that date are taken into account on first-time adoption, but changes in circumstances are not.

This could be construed as establishing a more general principle that changes in the terms of instruments must be accounted for but changes in circumstances must not.

(c) IFRS 9 clarifies that the assessment of whether or not an embedded derivative is required to be separated from its host contract is undertaken when the entity first becomes party to the contract, and is not revisited in the light of any subsequently changing circumstances (see Chapter 42 at section 6). *[IFRS 9.B4.3.11]*.

(d) IFRIC 2 and the provisions of IAS 32 requiring certain types of puttable and redeemable instrument to be classified as equity (see section 4.6 above). Each require accounting recognition to be given to some changes in the classification of a financial instrument as the result of changing circumstances. This implies that, absent such specific guidance, the 'default' position would be that there would be no accounting consequences, an inference reinforced by the requirement that the provisions of IAS 32 requiring certain types of puttable and redeemable instrument to be classified as equity must not be applied by analogy to other transactions.

4.9.3.B Arguments for reclassification

The principal arguments in favour of reclassification are:

(a) The definitions of financial liability and equity both use the present tense, implying that the definitions are to be applied at each reporting date, absent any more specific provision against doing so.

This is consistent with our view that some transactions falling within the scope of IFRS 2 *Share-based Payment*, must be reclassified from equity-settled to cash-settled and *vice versa* in the light of changing circumstances (see Chapter 30 at section 10.2.3). However, it could be argued that such an analogy is inappropriate given the significant differences between the definitions of equity and financial liability in IAS 32 and those of equity-settled and cash-settled share-based payment transaction in IFRS 2 (see section 5.1.1 below).

(b) The provisions of IFRS 1 referred to in (b) in section 4.9.3.A above are contained in implementation guidance, which is not part of the standard. Moreover, it refers only to compound financial instruments, and appears to be implicitly addressing changes in market interest rates that might alter the arithmetical split of the instrument into its financial liability and equity components (see section 6 below), rather than more general changes in circumstances.

(c) The fact that IFRS 9 (see (c) in section 4.9.3.A above) was issued after IFRS 1 indicates that a general prohibition on reassessment must not be inferred from IFRS 1. Had the IASB wished to clarify that this was the case, they could easily have done so in IFRS 9.

However, it is equally difficult to argue that there is an implied 'default' requirement for reclassification, given the specific requirement for reclassification of certain puttable and redeemable instruments on a change in circumstances referred to in (d) in section 4.9.3.A above.

How we see it

What emerges from the analysis above is a lack of definitive general guidance as to whether reclassification of an instrument is permitted, required or prohibited. Accordingly, we believe that in some circumstances, such as a change in the entity's functional currency, the entity may choose, as a matter of accounting policy, either to reclassify or not to reclassify an instrument following that change of circumstances which, had it occurred before initial recognition of the instrument, would have changed its classification. The policy adopted must, in our view, be followed consistently in respect of all changes of circumstances of a similar nature, although changes in circumstances of different natures could have different accounting policies, e.g., a change in functional currency could have a different accounting policy from a change resulting from the passage of time.

However, some changes in circumstances can be more fundamental to the nature of the contract. For example, the change in circumstances could lead to the instruments delivered under a contract ceasing to be equity instruments of the reporting entity. This situation could arise where a parent had entered into a derivative involving delivery of the equity instruments of a subsidiary and subsequently loses control of that subsidiary. Here the former subsidiary's equity instruments would now represent financial assets rather than non-controlling interests (equity) of the group. In these circumstances, it may be more difficult to argue that not reclassifying the derivative contract is appropriate.

4.10 Special purpose acquisition companies (SPACs)

A SPAC is an entity that raises capital from investors in an IPO for the sole purpose of the future business acquisition of a target which typically has not been identified at the time of the SPAC's IPO.

4.10.1 Financial instruments issued by the SPAC

Through the life cycle of a SPAC transaction, the SPAC issues various financial instruments.

At formation, the SPAC typically issues shares, or a combination of founder shares and founder warrants, to the SPAC's sponsors, including the management team, at a nominal price in return for forming the SPAC. The shares can be ordinary shares or a special class of shares that will allow them to have a significant ownership interest in the SPAC if a successful acquisition occurs.

On its IPO, the SPAC will typically issue units consisting of ordinary shares (public shares) and warrants (public warrants) to third-party investors. The SPAC sponsors may also purchase warrants to acquire ordinary shares at the time of the IPO through a private placement (private warrants).

Finally, upon acquisition, the SPAC generally will issue additional ordinary shares to the selling shareholders of the target and will typically enter into earn-out arrangements with the selling shareholders, the SPAC sponsors and/or employees of the target based on the future share price of the combined entity.

4.10.2 Shares and warrants

Careful consideration should be given to whether ordinary shares and warrants issued by a SPAC before acquisition and upon acquisition are accounted for under IAS 32. If the shares or warrants are determined to be within the scope of IAS 32, their classification as financial liabilities or equity, must be determined by reference to the requirements in section 4 above. In particular, section 4.1 provides guidance on the definition of an equity instrument and section 4.2 on a contractual obligation to deliver cash or other financial assets, i.e., a financial liability.

It must also be assessed whether the issued shares and warrants represent share-based payments to which IFRS 2 must be applied. For example, if the shares or warrants are issued for nominal consideration in exchange for goods or services, then, generally, there would be a share-based payment arrangement and IFRS 2 applies. Likewise, if the identifiable consideration, if any, received appears to be less than the fair value of equity instruments granted or liabilities incurred, this may indicate that goods or services have been received, and that an expense may need to be recognised in accordance with IFRS 2. See Chapter 30 for further guidance and in particular section 2.2.4.L, which addresses the IFRS 2 scope requirements being applied to an entity issuing new ordinary shares and warrants to acquire a SPAC. The further discussion in relation to SPACs in section 4.10.3 to 4.10.6 below, relates to those issued financial instruments that are accounted for under IAS 32 and does not consider the treatment under IFRS 2. For a comparison of IAS 32 to IFRS 2, see section 5.1.1 below.

4.10.3 Founder shares

In many cases, founder shares convert into public shares upon successful completion of an acquisition. If an acquisition is not completed and the SPAC is liquidated, the founder shares are not redeemable and do not receive any proceeds on liquidation. If, as discussed in section 4.10.2 above, these shares are within the scope of IAS 32 rather than IFRS 2, their classification will be driven by whether the conversion passes the 'fixed-for-fixed' test. This test is described further in section 5 below.

Additionally, if the public shares into which the founder shares will be converted are not within the scope of IFRS 2 and will, themselves, be classified as financial liabilities at the conversion date, and the SPAC has no discretion over the conversion into public shares, the founder shares will also be classified as financial liabilities.

4.10.4 Public shares

Public shares often become redeemable at the option of the holder if an acquisition is approved. They may also become mandatorily redeemable if an acquisition is not completed within a prescribed period. Redemption features have the potential to result in an outflow of cash for the SPAC. This would result in the shares being classified as a financial liability under IAS 32, unless the SPAC has the unconditional ability to avoid such an outflow. See section 5.3 below for further guidance.

Where key decisions affecting potential redemptions, such as the approval of an acquisition or the extension of the period to complete an acquisition, are made via shareholder votes at a general meeting of the SPAC, it is important to assess whether the voting process forms part of the corporate governance decision-making processes of the SPAC and is, therefore, seen to be an action of the SPAC. Alternatively, it may reflect the private actions of shareholders in their capacity as holders of particular instruments, in which case, the outcome of the vote would not be within the control of the SPAC. For further guidance on this assessment, see section 4.2.1 above.

In July 2022, the Board ratified the IFRS IC's agenda decision that considered whether a SPAC, in applying IAS 32, classifies public shares it issues as financial liabilities or equity instruments when the SPAC is a listed entity established to acquire a yet-to-be-identified target entity.

In the fact pattern described, a SPAC has two classes of shares: founder shares and public shares. The public shareholders individually have the contractual right to demand a reimbursement of their shares if the SPAC's shareholders approve the acquisition of a target entity. The public shareholders are reimbursed if the SPAC is liquidated. The SPAC is liquidated if no target entity is acquired within a specified period. In addition, along with the founder shareholders, the public shareholders have the contractual right to extend the SPAC's life indefinitely if no target entity is acquired.

The request asked about the effect of the shareholders' contractual right to extend the SPAC's life indefinitely on the classification of its shares; in particular, whether the decision by shareholders to extend the SPAC's life is considered to be within the control of the SPAC. The IFRS IC observed that IAS 32 contains no requirements for how to assess whether a decision by shareholders is treated as a decision by the entity and acknowledged that similar questions about shareholder decisions arise in other circumstances. The IFRS IC concluded that the matter described in the request is, in isolation, too narrow to address in a cost-effective manner. As a result, it is being considered as part of the broader discussions on the FICE project, and proposed amendments to the requirements were included in the FICE Exposure Draft published in November 2023, as described in section 12.6 below.

4.10.5 Warrants

Warrants normally give the holder the right to purchase public shares at an agreed price. Classification of the warrants is driven by similar factors to the founder shares. If they are within the scope of IAS 32 (rather than IFRS 2 as discussed in section 4.10.2 above), the warrants need to be assessed against the 'fixed-for-fixed' test. It is also important to consider whether the underlying public shares would be classified as financial liabilities at the exercise dates. Additionally, net settlement features would result in the warrants being classified as liabilities.

The Illustration below demonstrates some of the relevant considerations when determining the accounting for public warrants by a SPAC when they are within the scope of IAS 32.

Illustration 4-1: Accounting for public warrants by a SPAC

SPAC A has issued public warrants as part of its IPO process. It has not approved an acquisition yet. After completion of an acquisition, each warrant gives the holder the right to subscribe for one public share in exchange for a fixed amount of cash in the SPAC's functional currency. At the exercise date, the public shares will be classified as equity. If exercised, the SPAC would have a choice over whether to gross or net settle the warrant in shares.

In this case, the warrant will be classified as a financial liability due to the existence of the net settlement option. The warrant does not meet the definition of an equity instrument because it can be settled otherwise than by the SPAC issuing a fixed number of its own shares in exchange for receiving a fixed amount of cash or another financial asset, as discussed in section 5.2.7 below.

If the warrants are required to be physically settled (i.e., delivery of shares in exchange for cash), they would be eligible for equity classification given that the conversion ratio is fixed, as discussed in section 5 below.

4.10.6 Classification of ordinary shares and warrants by a SPAC upon acquisition

Following the acquisition, the accounting for shares and warrants that were already outstanding and those that were newly issued upon the acquisition, the accounting in the consolidated financial statements of the combined entity will depend on various factors. These include the specific terms and conditions of the shares and warrants and the facts and circumstances of the acquisition including who is identified as the accounting acquirer. For example:

- The acquisition may trigger features in the shares and warrants that had been conditional upon the successful completion of an acquisition, such as redemption rights, or it may change the discretion that the issuing entity was deemed to have over such features. If this is the case and the SPAC is identified as the accounting acquirer, it could be necessary to consider whether instruments previously classified as equity should be de-recognised and re-recognised as liabilities if the equity criteria are no longer met, or vice versa. See section 4.9 above for further guidance on reclassification.
- In cases when the target is identified as the accounting acquirer, some of the newly issued instruments upon the acquisition could potentially be accounted for as a share-based payment. As noted in section 4.10.2, Chapter 30 provides guidance on accounting for share-based payments and section 2.2.4.L in particular describes the decision reached by the IFRS IC and ratified by the IASB in October 2022. The IFRS IC concluded that, in applying IFRS 2, the target receives a stock exchange listing service for which it has issued equity instruments as part of a share-based payment transaction, and it is measured as the difference between the fair value of the instruments issued to acquire the SPAC and the fair value of the identifiable net assets acquired. If IAS 32 applies, it could be necessary to assess the accounting for conditional features as discussed in section 4.9 above.

5 Contracts settled by delivery of the entity's own equity instruments

This Section deals with contracts, other than those within the scope of IFRS 2 (see Chapter 30), settled in equity instruments issued by the settler. Throughout the discussion here in section 5, 'equity instrument(s)' excludes certain puttable and redeemable instruments classified as equity under the exceptions discussed in sections 4.6.2 and 4.6.3 above (any contract involving the receipt or delivery of such instruments is a financial asset or liability - see section 4.1 above).

For an instrument to be classified as an equity instrument under IAS 32, it is not sufficient that it involves the reporting entity delivering or receiving its own equity (as opposed to cash or another financial asset). The number of equity instruments delivered, and the consideration for them, must be fixed - the so called 'fixed-for-fixed' requirement. Contracts that will be settled other than by delivery of a fixed number of shares for a fixed amount of cash do not generally meet the definition of equity. The IASB considered that to treat any transaction settled in the entity's own shares as an equity instrument would not deal adequately with transactions in which an entity is using its own shares as 'currency', for example, where it has an obligation to pay a fixed or determinable amount that is settled in a variable number of its own shares. *[IAS 32.BC21(a)]*. In such transactions the counterparty bears no share price risk and is therefore not in the same position as a 'true' equity shareholder.

Where such a contract is not classified as an equity instrument by IAS 32, it will be accounted for in accordance with the general provisions of IFRS 9 as either a financial liability or a derivative.

Broadly speaking:

- A non-derivative contract involving the issue of a fixed number of own equity instruments is an equity instrument (see section 5.1 below).
- A non-derivative contract involving the issue of a variable number of own equity instruments is a financial liability (see section 5.2.1 below).
- A derivative contract involving the sale or purchase of a fixed number of own equity instruments for a fixed amount of cash or other financial assets is an equity instrument (see section 5.1 below).
- A derivative contract for the purchase by an entity of its own equity instruments, even if for a fixed amount of cash or other financial assets (and therefore an equity instrument) may give rise to a financial liability in respect of the cash or other financial assets to be paid. However, the initial recognition of the liability results in a reduction in equity and not in an expense (see section 5.3 below). In other words, whilst there is a liability to pay cash under the contract, the contract itself is an equity instrument (and is therefore not subject to periodic remeasurement to fair value).
- A derivative contract involving the delivery or receipt of:
  - A fixed number of own equity instruments for a variable amount of cash or other financial assets
  - A variable number of own equity instruments for a variable amount of cash or other financial assets

    Or
  - An amount of cash or own equity instruments with a fair value equivalent to the difference between a fixed number of own equity instruments and a fixed amount of cash or other financial assets (i.e., a net-settled derivative contract)

  Is a financial asset or financial liability (see section 5.2 below).

  And
- A derivative financial instrument with settlement options is a financial asset or liability, unless all possible settlement options would result in classification as equity (see section 5.2.8 below).

There are some difficulties of interpretation surrounding the treatment of certain contracts to issue equity (see section 5.4 below).

In undertaking the analysis required by IAS 32, it is sometimes helpful, where the detailed guidance in the standard is not entirely clear, to consider whether the instrument or contract under discussion exposes the holder or the issuer to the risk of movements in the fair value of the issuer's equity. If the holder is at risk to the same degree as equity investors in the entity, it is likely that the instrument or contract must be classified as equity. If, however, the entity bears the risk of movements in the fair value of the entity's equity, or the holder bears some risk, but less than that borne by equity investors in the entity, it is likely that the contract must be classified, at least in part, as a liability.

It is important to remember that IAS 32.16(b) sets out two tests. Where an entity can control the circumstances under which a variable number of shares may be required to be delivered (e.g., as in the case of a down round clause (see section 6.6.8 below)) this can lead to different accounting treatments depending on whether the instrument or compound instrument is regarded as a derivative or non-derivative. Where the instrument is a non-derivative, the requirement is that there is no contractual obligation which could result in the issuer having to deliver a variable number of shares, in other words, all contractual requirements need to be considered. So, a non-derivative instrument which allows the issuer to settle for a variable number of shares would not necessarily lead to an instrument being classified as a liability as there is no contractual obligation on the issuer to do so. Whereas, if the instrument is a derivative, the requirement is solely whether the fixed-for-fixed test is met, other contractual terms of the instrument are not considered. Therefore, a written option to subscribe for a variable number of shares (or a conversion option within a convertible bond) under the conditions described above would result in the derivative or component being classified as a liability as the issuer's ability to avoid delivering a variable number of shares is not considered.

5.1 Contracts accounted for as equity instruments

A contract that will be settled by the entity delivering or receiving a fixed number of its own equity instruments in exchange for a fixed amount of cash (see section 5 above) or another financial asset is an equity instrument, although a liability may be recorded for any cash payable by the entity on settlement of the contract. An example would be an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond (see section 6.3.2.A below). *[IAS 32.22]*.

The fair value of such a contract may change due to variations in market interest rates and the share price. However, provided that such changes in fair value do not affect the amount of cash or other financial assets to be paid or received, or the number of equity instruments to be received or delivered on settlement of the contract, the contract is an equity instrument and accounted for as such. *[IAS 32.22]*.

Any consideration received (such as the premium received for a written option or warrant on the entity's own shares) is added directly to equity. Any consideration paid (such as the premium paid for a purchased option) is deducted directly from equity. Changes in the fair value of an equity instrument are not recognised in the financial statements. *[IAS 32.22, IAS 32.AG27(a)]*.

IAS 32 requires some types of puttable instruments (see section 4.6.2 above) and instruments that impose an obligation to deliver a *pro rata* share of net assets only on liquidation (see section 4.6.3 above) to be treated as equity instruments. However, a contract that is required to be settled by the entity receiving or delivering either of these types of equity instrument is a financial asset or financial liability, even when it involves the exchange of a fixed amount of cash or other financial assets for a fixed number of such instruments. *[IAS 32.22A, IAS 32.AG13]*.

5.1.1 Comparison with IFRS 2 *Share-based Payment*

The approach in IAS 32 differs from that in IFRS 2. IFRS 2 essentially treats any transaction that falls within its scope and can be settled only in shares (or other equity instruments) as an equity instrument, regardless of whether the number of shares to be delivered is fixed or variable (see Chapter 30 at section 1.4.1). The two standards also differ as regards to:

- The classification of financial instruments that can be settled at the issuer's option in either equity instruments or cash (or other financial assets). Broadly, IFRS 2 requires the classification to be based on the likely outcome, whereas IAS 32 focuses on the strict legal obligations imposed by the contract.

  And

- The definition of equity instrument. IFRS 2 refers to the exchange of a 'fixed or determinable' amount of cash, whereas IAS 32 refers to the exchange of a 'fixed' amount of cash. This means that written options to issue own equity with a foreign currency strike price are typically equity instruments under IFRS 2, but financial assets or liabilities under IAS 32, subject to the limited exception for short-term rights issues (see section 5.2.3.A below).

The IASB offers some (pragmatic rather than conceptual) explanation for these differences in the Basis for Conclusions to IFRS 2. First, it is argued that to apply IAS 32 to share option plans would mean that a variable share option plan (i.e., one where the number of shares varied according to performance) would give rise to more volatile (and typically greater) cost than a fixed plan (i.e., one where the number of shares to be awarded is fixed from the start), even if the same number of shares was ultimately delivered under each plan, which would have 'undesirable consequences'. *[IFRS 2.BC109]*. This serves only to beg the question of why it is not equally 'undesirable' for the same result to arise in accounting for share-settled contracts within the scope of IAS 32 rather than IFRS 2. Second, it is noted that this is just one of several inconsistencies between IFRS 2 and IAS 32 which will remain unaddressed for the foreseeable future as the IASB's review of accounting for debt and equity as part of the FICE project is addressing only a narrow and limited number of application issues, which does not include this one. *[IFRS 2.BC110]*. The topics covered in the FICE project are discussed further in section 12 below.

5.1.2 Number of equity instruments issued adjusted for capital restructuring or another event

Entities, particularly larger listed companies, routinely restructure their equity capital. This may take many forms, including:

- Structural changes in the issuer's ordinary shares (such as a share split, a share consolidation, or a reclassification of the outstanding ordinary shares of the issuer)
- A repurchase of shares
- A distribution of reserves or premiums, by way of extraordinary dividend
- A payment of a dividend, or extraordinary dividend, in shares

  Or
- A bonus share or rights issue to existing shareholders

Accordingly, contracts for the purchase or delivery of an entity's own equity often provide that the number of shares specified in the contract is modified in the event of such a restructuring. This provides protection to both the holder of the contract and to existing shareholders, by ensuring that their relative rights remain the same before and after the restructuring. For example, an entity with shares with a nominal (par) value of CU1 might enter into an agreement that requires it to issue '100 shares'. If, before execution of that agreement, the entity has split each CU1 share into ten CU0.10 shares, it must issue 1,000 (not 100) shares in order to give effect to the intention of the contract.

Such adjustment formulae are most commonly seen in the terms of convertible instruments (see section 6 below for convertible instrument classification), so that the number of shares into which the bonds eventually convert will take account of any capital restructuring between issue and conversion of the bond, with the broad intention of putting the holders of the bond in the same position with respect to other equity holders before and after the restructuring. In addition, the terms of many convertible instruments provide for similar adjustment upon the occurrence of other actions or events which would affect the position of the convertible bondholders relative to other equity holders. Such actions or events may include, for example:

- The payment of ordinary dividends
- An issue of equity at less than current market value
- The repurchase of equity at more than current market value
- The issue of further convertible securities at less than fair market value

  Or
- The acquisition of assets in exchange for equity at more than fair market value

This raises the question of whether a contract with any such terms can be classified as equity under IAS 32, since the number of shares ultimately issued on conversion is not fixed at the outset, but may vary depending on whether a restructuring or other event occurs before conversion.

How we see it

In our view, an adjustment to the number of equity instruments to be issued in the circumstances described above is not considered to result in the issue of a variable number of shares, where its purpose is to ensure that the bondholder's equity interest is not diluted or augmented.

In other words, if the adjustment attempts to put the holders of the instruments into the same economic position relative to ordinary shareholders after the restructuring as they were in before the restructuring, then the fixed-for-fixed criterion is still met. We consider that the potential dilution or augmentation in the bondholder's equity interest which is to be adjusted for must be determined in comparison to the effect of the event on the other equity holders in aggregate. Thus, if shares are issued to new shareholders at a discount, the dilution suffered by the bondholders must be calculated by reference to the total number of shares in existence following the new issue.

The effect of such an adjustment is that the risks and rewards of the bondholder are more closely aligned to those of a holder of ordinary shares. IAS 32 generally treats contracts involving a variable number of equity instruments as a financial liability because the effect of the variability is that the counterparty is not exposed to any movement in the fair value of the equity instruments between the inception and execution of the contract. In this case, however, the variability is introduced to ensure that the counterparty remains exposed to any movement in the fair value of the equity instruments and maintains the same interest in the equity relative to other shareholders.

The same question arises in circumstances where a convertible bond is convertible into a fixed percentage of equity. This is discussed in section 6.6.7 below.

However not all convertible securities with adjustable conversion ratios can be classified as equity. Where a convertible security has a contractual feature for the conversion ratio to be adjusted down to the lower price of any later issue in the underlying shares, the instrument will fail equity classification as this adjustment does not put the bondholders into the same economic position relative to other equity holders, but puts them into a better position. The modification feature is not fixed-for-fixed and therefore the conversion option is a financial liability. *[IAS 32.11(b)(ii)]*. As such it is an embedded derivative of a debt host rather than an equity component. The entity's ability to control the non-fixed-for-fixed settlement is not relevant to the assessment. This is because a derivative instrument that gives either party the choice over settlement is a financial asset or liability unless all the settlement alternatives would result in it being an equity instrument. *[IAS 32.26]*. The conversion option will therefore be treated as a derivative liability. This is discussed in more detail in section 6.6.8 below.

In practice, the dilution adjustment from issuance of shares or other securities is often based on average market prices of the underlying securities prior to the date a binding and irreversible issue or grant is announced (instead of the market price immediately prior to the announcement), usually to mitigate the risk of market manipulation.

How we see it

While the value of an adjustment based on an average market price, could exceed the value of the rights to a residual interest in the entity's equity caused by the transaction (as evidenced by the market price immediately prior to the announcement), and is not based entirely on the decrease in value, we believe the use of a 'market price' based on an average of several days prior is acceptable. This is because the intent of the averaging is to mitigate the risk of using prices that do not represent the 'true' market price due to price manipulation. Evaluating these adjustments is complex and requires the use of judgement.

The IFRS IC considered a number of 'fixed-for-fixed' issues raised by constituents at its November 2009 meeting. However, the IFRS IC concluded that the Board's project *Financial Instruments with Characteristics of Equity* (FICE) was expected to address issues relating to the fixed-for-fixed condition, and that the IFRS IC would therefore not add this to its agenda. The IASB proposed amendments to the guidance which relates to 'fixed-for-fixed' in the FICE Exposure Draft published in November 2023 (see section 12.2 below).

5.1.3 Stepped up exercise price

Another type of adjustment which is commonly found is where an entity issues subscription shares that have a stepped exercise price, which is fixed at inception and increases with the passage of time. Such subscription shares are typically issued as bonus shares on a *pro rata* basis to existing shareholders and give the holder the right (but not the obligation) to subscribe for a certain number of ordinary shares, at a certain price and at a certain time in the future.

How we see it

Our view is that subscription shares that have a stepped exercise price meet the 'fixed-for-fixed' condition only if the exercise prices are fixed at inception and for the entire term of the instrument, such that at any point in time the exercise price is pre-determined at the issuance of the subscription shares. If the exercise price per share is linked to an index of any kind, the 'fixed-for-fixed' condition is not met and the contract to issue the shares would not be classified as an equity instrument.

5.1.4 Exchange of fixed amounts of equity (equity for equity)

As discussed above, IAS 32 requires a contract settled in own equity to be classified as equity if, *inter alia*, it involves the exchange of a fixed amount of cash (or other financial assets) for a fixed amount of equity. This begs the question of how to classify a contract that provides for the exchange of a fixed amount of one class of the entity's equity for a fixed amount of another class. Examples might be:

- A warrant allowing the holder of a preference share classified as equity (see section 4.5 above) to exchange it for an ordinary equity share.

  Or

- In consolidated financial statements, an option for a shareholder of a partly-owned subsidiary (classified within equity in the consolidated financial statements) to exchange a fixed number of shares in the subsidiary for a fixed number of shares in the parent.

One view might be that, as a contract to exchange equity instruments does not fall within the definition of an 'equity instrument' in accordance with IAS 32, it must therefore be accounted for as a derivative.

The contrary view would be that the contract does not meet the definitions of either a financial asset or a financial liability either and given that it involves the exchange of equity instruments on a fixed-for-fixed basis must be accounted for as an equity instrument. Those who hold the latter view would argue that the absence of any reference to such 'fixed equity for fixed equity' contracts in IAS 32 does not reflect a conscious decision by the IASB, but rather indicates that the IASB never considered such contracts at all.

A third view might be that the analysis may depend upon the specific terms of the equity instruments. For example, if the equity instrument being exchanged has debt-like features (e.g., it pays regular, but discretionary, coupons), and is denominated in the same currency as the entity's functional currency, the contract would be classified as equity, but if it were denominated in a different currency, the contact would, for the reasons discussed in section 5.2.3 below, be classified as a derivative.

The IASB is considering this issue as part of the FICE project as reflected in the FICE Exposure Draft published in November 2023 (see section 12.2 below).

5.2 Contracts accounted for as financial assets or financial liabilities

5.2.1 Variable number of equity instruments

An entity may have a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligation.

The right or obligation may be for:

- A fixed amount, e.g., as many shares as are worth CU100.

  Or

- An amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments, such as movements in interest rates, commodity prices, or the price of a financial instrument, e.g., as many shares as are worth:
  - 100 ounces of gold
  - CU100 plus interest at SONIA plus 200 basis points
  - 100 government bonds

    Or

  - 100 shares in a particular entity

Such a contract is a financial asset or liability. Even though the contract must, or may, be settled through receipt or delivery of the entity's own equity instruments, the number of own equity instruments required to settle the contract will vary. The contract will therefore not fulfil the requirements of an equity instrument and is therefore a financial asset or financial liability. *[IAS 32.21, IAS 32.AG27(d)]*.

5.2.2 Fixed number of equity instruments for variable consideration

A contract that will be settled by the entity delivering or receiving a fixed number of its own equity instruments in exchange for a variable amount of cash or another financial asset is a financial asset or financial liability. An example is a contract for the entity to deliver 100 of its own equity instruments in return for an amount of cash calculated to equal the value of 100 ounces of gold, *[IAS 32.24]*, or 100 specified government bonds. As discussed in section 5.2.3 below, it would also include a contract for the entity to deliver 100 of its own equity instruments in return for a fixed amount of cash denominated in a currency other than its own functional currency.

5.2.3 Fixed amount of cash (or other financial assets) denominated in a currency other than the entity's functional currency

Some contracts require an entity to issue a fixed number of equity instruments in exchange for a fixed amount of cash denominated in a currency other than the entity's functional currency. Such contracts raise a problem of interpretation illustrated by the example in IAS 32.24 (referred to in section 5.2.1 above) of a contract being a financial asset or financial liability where the reporting entity is required "to deliver 100 of its own equity instruments in return for an amount of cash calculated to equal the value of 100 ounces of gold". If one substitutes '100 US dollars' for '100 ounces of gold', the latent problem becomes apparent.

Suppose a UK entity (with the pound sterling as its functional currency) issues a £100 bond convertible into a fixed number of its equity shares. As discussed in more detail in section 6 below, IAS 32 requires this to be accounted for by splitting it into a liability component (the obligation to pay interest and repay principal) and an equity component (the holder's right to convert into equity). In this case the equity component is the right to convert the fixed stated £100 principal of the bond (see section 6.3.2.A below) into a fixed number of shares.

Suppose instead, however, that the UK entity (with the pound sterling as its functional currency) issues a 100 US dollar bond convertible into a fixed number of its shares. The conversion feature effectively gives the bondholder the right to acquire a fixed number of shares for a fixed stated principal (see section 6.3.2.A below) of $100. Is the $100 a 'fixed amount' of cash, or is it to be regarded as being just as variable, in terms of its conversion into the functional currency of the pound sterling, as 100 ounces of gold?

If the conclusion is that $100 is a fixed amount of cash, the conversion right is accounted for as an equity component of the bond, in other words a value is assigned to it on initial recognition and it is not subsequently remeasured (see section 6.2.1 below). If, on the other hand, the conclusion is that $100 is not a fixed amount of cash, then the conversion right (as an embedded derivative not regarded by IFRS 9 as closely related to the host contract, see Chapter 42 at section 4) is accounted for as a separate derivative financial liability, introducing potentially significant volatility into the financial statements.

There is no obvious answer to this. A contention that the $100 is a 'fixed amount' of cash is hard to reconcile with the fact that a contract to issue shares for 'as many pounds sterling as are worth $100' would clearly involve the issue of a fixed number of shares for a variable amount of cash and would therefore not be an equity instrument.

The IFRS IC considered this issue at its meeting in April 2005. The IFRS IC noted that although this matter was not directly addressed in IAS 32, it was clear that, when the question is considered in conjunction with guidance in other standards, particularly IFRS 9, any obligation denominated in a foreign currency represents a variable amount of cash. Consequently, the IFRS IC concluded that a contract settled by an entity delivering a fixed number of its own equity instruments in exchange for a fixed amount of foreign currency must be classified as a liability.[21]

5.2.3.A Rights issues with a price fixed in a currency other than the entity's functional currency

In July 2009, as a result of a recommendation from the IFRS IC, the IASB reconsidered this matter in the specific context of rights issues (options to purchase additional shares at a fixed price) where the price is denominated in a currency other than the entity's functional currency. The IASB was advised that the IFRS IC's conclusion was being applied to rights issues, with the result that the rights were being accounted for as derivative liabilities with changes in fair value being recognised in profit or loss. As shown in Practical example 5-1 below. HSBC Holdings plc explained that such accounting would result in the recognition of a loss of $4.7 billion in the first quarter of 2009.

21 *IFRIC Update*, April 2005, available on the IFRS Foundation's website.

Practical example 5-1: HSBC Holdings plc (2009) **United Kingdom**

INTERIM MANAGEMENT STATEMENT - 11 May 2009 [extract]

Note

Accounting impact of HSBC's Rights Issue

On 2 March 2009, HSBC announced a 5 for 12 Rights Issue of 5,060 million new ordinary shares at 254 pence per share, which was authorised by the shareholders in a general meeting on 19 March 2009. The offer period commenced on 20 March 2009, and closed for acceptance on 3 April 2009. Under IFRSs, the offer of rights is treated as a derivative because substantially all of the issue was denominated in currencies other than the Company's functional currency of US dollars, and accordingly HSBC was not able to demonstrate that it was issuing a fixed number of shares for a fixed amount of US dollars, which is the criterion under IFRSs for HSBC to account for the offer of rights in shareholders' equity. The derivative liability was measured at inception of the offer as the difference between the share price at that date and the rights price, with a corresponding debit to shareholders' equity. The revaluation of this derivative liability over the offer period, arising from an increase in the share price, has resulted in the recognition of a loss in the income statement of US$4.7 billion. The derivative liability expired on acceptance of the offer, and the closing balance was credited to shareholders' equity. Accordingly, there is no overall impact on the Group's shareholders' equity, capital position or distributable reserves.

Consequently, in October 2009, the IASB made a limited amendment to IAS 32 so as to require a rights issue granted *pro rata* to an entity's existing shareholders for a fixed amount of cash to be classified as equity, regardless of the currency in which the exercise price is denominated. *[IAS 32.11]*.

This amendment does not apply to other instruments that grant the holder the right to purchase the entity's own equity instruments, such as the conversion feature in a convertible bond. It also does not apply to long-dated foreign currency rights issues, which are therefore classified as financial liabilities if the strike price is denominated in a foreign currency. The reason for the restricted scope of the amendment is that the IASB countenanced an exception to the 'fixed-for-fixed' concept in IAS 32 for short-dated rights issues only because the rights are distributed *pro rata* to existing shareholders, and can therefore be seen as a transaction with owners in their capacity as such. *[IAS 32.BC4I]*. The IASB does not consider long-dated transactions as primarily transactions with owners in their capacity as owners. *[IAS 32.BC4K]*.

5.2.4 Instrument with equity settlement alternative of significantly higher value than cash settlement alternative

A financial instrument is also a financial liability if it provides that on settlement the entity will deliver either:

(a) Cash or another financial asset

Or

(b) A number of its own shares whose value is determined to exceed substantially the value of the cash or other financial asset

IAS 32 explains that, although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option (see section 4.2.2 above). *[IAS 32.20]*.

5.2.5 Fixed number of equity instruments with variable value

A contract is a financial asset or financial liability if it is to be settled in a fixed number of shares, the value of which will be varied (e.g., by modification of the rights attaching to them) so as to be equal to a fixed amount or an amount based on changes in an underlying variable. *[IAS 32.AG27(d)]*.

5.2.6 Fixed amount of cash determined by reference to share price

An entity might enter into an option or forward contract to sell a fixed number of equity shares for a fixed price, where the price is determined by reference to the share price. For example, it might contract to sell 100 shares for CU10 each if the share price is between CU0 and CU10, and for CU15 each if the price is higher than CU10. Considered as a whole, the contract provides for the exchange of a fixed number of equity instruments for a variable amount of cash and is therefore a derivative financial liability.

5.2.7 Net-settled contracts over own equity

The value of a contract over an entity's own equity instruments at the date of settlement is the difference between the value of the fixed number of equity instruments to be delivered by one party and the fixed amount of cash (or other financial assets) to be delivered by the other party. If such a contract allows for net settlement, it can then be settled by a transfer (of cash, other financial assets, or the entity's own equity) of a fair value equal to this difference. It is inherent in the general definition of an equity instrument in IAS 32 that a contract settled by a single net payment (generally referred to as net cash-settled or net equity-settled as the case may be) is a financial asset or financial liability and not an equity instrument. This is notwithstanding the fact that an economically equivalent contract settled gross (i.e., by physical delivery of the equity instruments in exchange for cash or other financial assets) would be treated as an equity instrument.

5.2.8 Derivative financial instruments with settlement options

Extract from IAS 32	
26	**When a derivative financial instrument gives one party a choice over how it is settled (eg the issuer or the holder can choose settlement net in cash or by exchanging shares for cash), it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument.**

A derivative financial instrument may have settlement options, whereby it gives one or other party a choice over how it is settled (e.g., the issuer or the holder can choose settlement net in cash, net in shares, or by exchanging shares for cash). A derivative that gives one party a choice of settlement options is required to be treated as a financial asset or a financial liability, unless all possible settlement alternatives would result in it being an equity instrument. *[IAS 32.26]*. An example of a derivative financial instrument with a settlement option that is a financial liability is a share option that the issuer can decide to settle net in cash or by exchanging its own shares for cash. *[IAS 32.27]*.

These provisions will apply mostly to contracts involving the sale or purchase by an entity of its own equity instruments. However, they will also be relevant to those contracts to buy or sell a non-financial item in exchange for the entity's own equity instruments that are within the scope of IAS 32 (rather than IFRS 2) because they can be settled either by delivery of the non-financial item or net in cash or another financial instrument. Such contracts are financial assets or financial liabilities and not equity instruments. *[IAS 32.27]*.

Where an instrument is subject to multiple contingent events, there needs to be an assessment of whether the contingent events give rise to separate instruments embedded within the overall contract or whether there is one single instrument. If the contingent events give rise to components that are separable and independent of each other and relate to different risks, then they must be classified and accounted for separately from the host contract. If the components are not readily separable or independent of each other, then the contract will be classified based on its overall features, i.e., if the instrument does not satisfy the fixed-for-fixed test overall then it is classified as a liability even if individual components do meet the fixed-for-fixed criteria. For example, an instrument which obliges an issuer to deliver a fixed number of shares upon the consecutive occurrence of two contingent events, i.e., delivery under the second contingent event can only happen if the first contingent event has occurred, which relate to the same risks (such as interest rates, share price or performance of the entity in successive years), must be considered as one overall contract. Thus, while each individual contingency may satisfy the fixed-for-fixed test on their own, overall, the contract will result in a variable number of shares being delivered and so would be classified as debt.

5.3 Liabilities arising from gross-settled contracts for the purchase of the entity's own equity instruments

The following discussion relates only to contracts that must be settled by the counterparty delivering equity instruments (other than those classified as such under the exceptions discussed in section 4.6 above) and the entity paying cash (gross-settled contracts). Contracts which can be settled net (i.e., by payment of the difference between the fair value, at the time of settlement, of the equity instruments and that of the consideration given) are accounted for as financial assets or financial liabilities, *[IAS 32.AG27(c)]*, (see section 5.2.8 above and section 11 below).

IAS 32 requires some types of puttable instruments (see section 4.6.2 above) and instruments that impose an obligation to deliver a *pro rata* share of net assets only on liquidation (see section 4.6.3 above) to be treated as equity instruments. However, a contract that is required to be settled by the entity receiving or delivering either of these types of equity instrument is a financial asset or financial liability, even when it involves the exchange of a fixed amount of cash or other financial assets for a fixed number of such instruments. *[IAS 32.22A, IAS 32.AG27]*.

Entering into a gross-settled contract for the purchase of own equity instruments gives rise to a financial liability in respect of the obligation to pay the purchase or redemption price, *[IAS 32.23, IAS 32.AG27(a), IAS 32.AG27(b)]*, (but resulting, on initial recognition, in a reduction of equity rather than an expense). This treatment is intended to reflect the idea that a forward contract or written option to repurchase an equity share gives rise to a liability similar to that contained within a redeemable share (see section 4.5 above and section 11 below). *[IAS 32.BC12]*.

This is the case even if:

- The contract is an equity instrument
- The contract is a written put option (i.e., a contract that gives the counterparty the right to require the entity to buy its own shares) rather than a forward contract (i.e., a firm commitment by the entity to purchase its own shares)

  Or
- The number of shares subject to the contract is not fixed *[IAS 32.23, IAS 32.AG27(a), IAS 32.AG27(b)]*

The final bullet point above refers to, for example, a put option written by the entity whereby the counterparty can require the entity to purchase between 1,000 and 5,000 of its own equity shares at CU2 per share. In other words, the entity cannot avoid recognising a liability for the contract on the basis that it does not know exactly how many of its own shares it will be compelled to purchase.

When such a liability first arises it must be recognised, in accordance with IFRS 9, at its fair value, i.e., the net present value of the redemption amount. Subsequently, the financial liability is measured in accordance with IFRS 9 (see Chapter 46). *[IAS 32.23, IAS 32.AG27(b)]*. IAS 32 offers no guidance as to how this is to be calculated when, as might be the case with respect to a written put option such as that described in the previous paragraph, the number of shares to be purchased and/or the date of purchase is not known.

How we see it

In our view, for the purpose of determining fair value on initial recognition under IFRS 9, an instrument with a demand feature must adopt a 'worse case' approach, i.e., based on the maximum amount payable and at the earliest possible date. This would be consistent with the requirement of IFRS 13 that liabilities with a demand feature such as a demand bank deposit must be measured at the amount payable on demand (see Chapter 15 at section 10.5).

In other words, it must be assumed that the purchase will take place on the earliest possible date for the maximum number of shares, i.e., in the example above, the liability is for a written option on 5,000 shares. This is also consistent with IAS 32's emphasis, in the general discussion of the differences between liabilities and equity instruments, on a liability arising except to the extent that an entity has an 'unconditional' right to avoid delivering cash or other financial assets (see section 4.2 above).

The treatment discussed in the previous paragraph would lead to a different accounting treatment for written 'American' put options (i.e., those that can be exercised at any time during a period ending on a future date) and written 'European' put options (i.e., those that can be exercised only at a given future date). In the case of an American option, a liability would be recorded immediately for the full potential liability. In the case of a European option, a liability would be recorded for the net present value of the full potential liability, on which interest would be accrued until the date of potential exercise. This interpretation has the effect that:

- A gross-settled written American put option that is an equity instrument has no effect on profit or loss (because the full amount payable on settlement would be charged to equity on inception of the contract).

  But

- A gross-settled European put option that is an equity instrument does affect profit or loss (because the net present value of the amount payable on settlement would be charged to equity on inception of the contract and accrued to the full settlement amount through profit or loss).

If the contract expires without delivery of the shares, the carrying amount of the financial liability is reclassified to equity. This has the rather counterintuitive effect that a share purchase contract that expires unexercised (and therefore has no impact on the entity's net assets, other than the receipt or payment of the option premium) can nevertheless give rise to a loss to the extent that interest has been recognised on the liability between initial recognition and its transfer to equity (see Illustration 11-7 in section 11.3.2 below).

5.3.1 Contracts to purchase own equity during 'closed' or 'prohibited' periods

Financial markets often impose restrictions on an entity trading in its own listed securities for a given period (sometimes referred to as a 'closed' or 'prohibited' period) in the run-up to the announcement of its financial results for a period. However, an entity may well wish to continue to purchase its own listed equity throughout the closed period, for example as part of an ongoing share-buyback programme.

One method of achieving this may be for the entity, in advance of the closed period, to enter into a contract with a counterparty (such as a broker) whereby the counterparty purchases shares in the entity, which the entity is then obliged to acquire from the counterparty. Such a contract will give rise to a financial liability for the entity from the day on which it is entered into. As discussed above, this would initially be recorded at the net present value of the amount to be paid, with the unwinding of the discount on that liability recorded as a finance charge in profit or loss.

In addition, if the contract is for the purchase of a fixed number of shares for their market price (as opposed to the exchange of a fixed amount of cash for as many shares as are worth that amount), it will be necessary to remeasure the liability to reflect movements in the share price.

5.3.2 Contracts to acquire non-controlling interests

IFRS 10 requires non-controlling interests to be shown within equity in consolidated financial statements (see Chapter 8 at section 4.3). Accordingly, the requirements of IAS 32 relating to contracts over own equity instruments also generally apply, in consolidated financial statements, to forward contracts and put and call options over non-controlling interests.

This analysis was confirmed by the IFRS IC in November 2006, when it considered a request to clarify the accounting treatment of contracts to acquire non-controlling interests that are put in place at the time of a business combination. It is arguable that such contracts are more appropriately accounted for under the provisions of IFRS 3 *Business Combinations,* relating to deferred consideration. It may also be the case that such contracts have the effect that, while there is a non-controlling interest as a matter of law, the relevant subsidiary is nevertheless regarded by IFRS 10 as wholly-owned, in which case the acquirer also recognises a financial liability for the price payable to the non-controlling interest. A further discussion of these issues may be found in Chapter 8 at section 5.

The IFRS IC agreed that there was likely to be divergence in practice in how the related equity is classified, but did not believe that it could reach a consensus on this matter on a timely basis. Accordingly, the IFRS IC decided not to add this item to its agenda.

However, the IFRS IC noted that the requirements of IAS 32 relating to the purchase of own equity apply to the purchase of a minority interest. After initial recognition any liability, to which IFRS 3 is not being applied, will be accounted for in accordance with IFRS 9. The parent will reclassify the liability to equity if a put expires unexercised (See Chapter 8 at sections 6.2.3.B and 6.2.3C).[22] Whilst this comment was made in the context of the original version of IFRS 3 (issued in 2004), it would be equally applicable where the current version (issued in 2008) is applied.

5.3.2.A Put options over non-controlling interests - IFRS IC and IASB developments

The accounting for put options over non-controlling interests has been the subject of much debate over the years. For a summary of the IFRS IC and IASB developments on this issue see Chapter 8 at section 6, and Chapter 10 at section 8.5. The IASB is developing new guidance in this area as reflected in the FICE Exposure Draft, published in November 2023 (see section 12.3 below).

5.4 Gross-settled contracts for the sale or issue of the entity's own equity instruments

The following discussion relates only to contracts which must be settled by the entity delivering its own equity instruments (other than those classified as such under the exceptions discussed in section 4.6 above) and the counterparty paying cash (gross-settled contracts). Contracts which can be settled net (i.e., by payment of the difference between the fair value, at the time of purchase, of the shares and that of the consideration given) are accounted as financial assets or financial liabilities (see section 5.2.7 above). *[IAS 32.AG27(c)]*.

IAS 32 requires some types of puttable instruments (see section 4.6.2 above) and instruments that impose an obligation to deliver a *pro rata* share of net assets only on liquidation (see section 4.6.3 above) to be treated as equity instruments. However, a contract that is required to be settled by the entity receiving or delivering either of these types of equity instrument is a financial asset or financial liability, even when it involves the exchange of a fixed amount of cash or other financial assets for a fixed number of such instruments. *[IAS 32.22A, IAS 32.AG27]*.

If an entity enters into a gross-settled contract to sell its own equity instruments, the contract is economically the 'mirror image' of a contract for the purchase of own equity. However, there is no provision in IAS 32 that the contract gives rise to a financial asset in respect of the cash to be received from the counterparty, as compared to the specific provision that a contract to purchase own equity gives rise to a financial liability in respect of the cash to be paid to the counterparty (see section 5.3 above). Consequently, it appears that such contracts give rise to no accounting entries until settlement. This analysis is confirmed by an illustrative example to IAS 32 (see Illustration 11-2 in section 11.1.2 below).

Contracts for the sale or issue of an entity's own equity arise in situations such as those in Illustration 5-1 and Illustration 5-2 below.

Illustration 5-1: Share issue payable in fixed instalments

A government intends to privatise a nationalised industry with a functional currency of Euro (€) through an initial public offering (IPO) at €5 per share. In order to encourage widespread share ownership, the terms of the issue are that shares are issued on 1 January 20X8, but subscribers to the IPO are required to pay only €3 per share on 1 January 20X8 followed by two further instalments of €1 per share on 1 January 20X9 and 1 January 20Y0.

Illustration 5-2: Right to call for additional equity capital

A start-up technology entity with a functional currency of UK pounds sterling is unsure of its working capital requirements for the first few years of its operations. It therefore enters into an agreement with its major shareholders whereby it can require those shareholders to contribute an additional £2 per share at any time during the next seven years.

22 *IFRIC update*, November 2006, available on the IFRS Foundation's website.

One view might be that the situation in Illustration 5-1 above is not a contract for the future issue of equity, the share has already been issued, and so it would be quite appropriate to record a receivable for the deferred subscription payments. The accounting standard *IFRS for Small and Medium-Sized Entities* (IFRS for SMEs) indicates that a receivable must be recognised only for shares that have been issued, but that such a receivable must be recognised as a deduction from equity, not as an asset.[23] The standard states that this proposal is derived from IAS 32,[24] an assertion difficult to reconcile with the discussion above. Interestingly, an early IASB staff draft of the exposure draft of IFRS for SMEs (as made available on the IASB's website as at September 2006) admitted, with perhaps unintended candour, that this treatment is "not in any standard".[25]

How we see it

In our view, IAS 32 requires any receivable for a deferred subscription payment recognised in respect of an issued share to be shown as an asset.

On the other hand, it is clear from IAS 32 that no receivable would be recognised if the arrangement provided for the entity actually to issue further shares (*pro rata* to the shares initially issued) for CU1 on 1 January 20X9 and 1 January 20Y0.

23 *IFRS for SMEs*®, IASB, July 2009, para. 21.2.

24 *IFRS for SMEs*®, IASB, July 2009, Derivation Table.

25 IASB staff draft of proposed exposure draft International Financial Reporting Standard for Small and Medium-Sized Entities (as made available on the IASB's website as at September 2006) paras. 22.2-22.4.

6 Compound financial instruments

6.1 Background

Extract from IAS 32	
28	**The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components shall be classified separately as financial liabilities, financial assets or equity instruments in accordance with paragraph 15.**

While many financial instruments are either a liability or equity in their entirety, that is not true for all financial instruments issued by an entity. Some, referred to as compound instruments in IAS 32, contain both elements. A compound financial instrument is a non-derivative financial instrument that, from the issuer's perspective, contains both a liability and an equity component. *[IAS 32.28, IAS 32.AG30]*. Examples include:

- A bond, in the same currency as the functional currency of the issuing entity, convertible into a fixed number of equity instruments, which effectively comprises:
  - A financial liability (the issuer's obligation to pay interest and, potentially, to redeem the bond in cash)

    And
  - An equity instrument (the holder's right to call for shares of the issuer)

  IAS 32 states that the economic effect of issuing such an instrument is substantially the same as simultaneously issuing a debt instrument with an early settlement provision and warrants to purchase ordinary shares or issuing a debt instrument with detachable share purchase warrants. *[IAS 32.29]*. However, this analysis is questionable in the sense that, if an entity did issue such instruments separately, it is extremely unlikely that one would lapse as the result of the exercise of the other (as is the case on the conversion or redemption of a convertible bond).
- A mandatorily redeemable preference share with dividends paid at the issuer's discretion, which effectively comprises:
  - A financial liability (the issuer's obligation to redeem the shares in cash)

    And
  - An equity instrument (the holder's right to receive dividends if declared) *[IAS 32.AG37]*

IAS 32 requires the issuer of a non-derivative financial instrument to evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. This evaluation is based on the contractual terms of the financial instruments, the substance of the arrangement and the definition of a financial liability, financial asset and an equity instrument. If such components are identified, they must be accounted for separately as financial liabilities, financial assets or equity, *[IAS 32.28]*, and the liability and equity components shown separately in the statement of financial position. *[IAS 32.29]*.

This treatment, commonly referred to as 'split accounting', is discussed in more detail in sections 6.2 to 6.6 below. For simplicity, the discussion below (like that in IAS 32 itself) is framed in terms of convertible bonds, by far the most common form of compound financial instrument, but is equally applicable to other types of compound instruments, such as preference shares with different contractual terms in respect of dividends and re-payments of principal (see section 4.5 above).

6.1.1 Treatment by holder and issuer contrasted

'Split accounting' is to be applied only by the issuer of a compound financial instrument. The accounting treatment by the holder is dealt with in IFRS 9 and is significantly different. *[IAS 32.AG30]*. In particular:

- In the issuer's financial statements, under IAS 32:
  - On initial recognition of the instrument, the fair value of the liability component is calculated first and the equity component is treated as a residual.

    And
  - The equity component is never remeasured after initial recognition.
- In the holder's financial statements, under IFRS 9:
  - The instrument fails the criteria for measurement at amortised cost (in particular the 'contractual cash flow characteristics test') and is therefore almost always carried at fair value through profit or loss (see Chapter 44 at section 5).

6.2 Initial recognition - 'split accounting'

On initial recognition of a compound instrument such as a convertible bond, IAS 32 requires the issuer to:

(a) Identify the various components of the instrument

(b) Determine the fair value of the liability component (see below)

And

(c) Determine the equity component as a residual amount, essentially the issue proceeds of the instrument less the liability component determined in (b) above

The liability component of a convertible bond must be measured first, at the fair value of a similar liability that does not have an associated equity conversion feature, but including any embedded non-equity derivative features, such as an issuer's or holder's right to require early redemption of the bond, if any such terms are included.

In practical terms, this will be done by determining the net present value of all potential contractually determined future cash flows under the instrument, discounted at the rate of interest applied by the market at the time of issue to instruments of comparable credit status and providing substantially the same cash flows, on the same terms, but without the conversion option. The fair value of any embedded non-equity derivative features is then determined and 'included in the liability component', however, see the further discussion of this point in section 6.4.2 below. *[IAS 32.31]*.

Thereafter, the liability component is accounted for in accordance with the requirements of IFRS 9, for the measurement of financial liabilities (see Chapter 46). *[IAS 32.31, IAS 32.32]*.

IAS 32 notes that:

- The equity component of a convertible bond is an embedded option to convert the liability into equity of the issuer.
- The fair value of the option comprises its time value and its intrinsic value, if any.

  And
- This option has value on initial recognition even when it is out of the money. *[IAS 32.AG31(b)]*.

However, not all these features are directly relevant to the accounting treatment since the equity component is not (other than by coincidence) recorded at its fair value. Instead, in accordance with the general definition of equity as a residual, the equity component of the bond is simply the difference between the fair value of the compound instrument (total issue proceeds of the bond) and the liability component as determined above. Because of this 'residual' treatment, IAS 32 does not address the issue of how, or whether, the issue proceeds are to be allocated where more than one equity component is identified. It is important to note, that the equity component will not be remeasured subsequently.

The methodology of 'split-accounting' in IAS 32 has the effect that the sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the fair value that would be ascribed to the instrument as a whole. No gain or loss arises from the initial recognition of the separate components of the instrument. *[IAS 32.31]*.

This treatment is shown in Illustration 6-1 and Illustration 6-5 below in section 6.4.2.A. *[IAS 32.IE34, IAS 32.IE35, IAS 32.IE36]*.

Illustration 6-1: Convertible bond - basic 'split accounting'

An entity, whose functional currency is the Euro, issues 2,000 convertible bonds. The bonds have a three-year term and are issued at par with a face value of €1,000 per bond, giving total proceeds of €2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6% (i.e., €120,000 per annum). Each bond is convertible at any time up to maturity into 250 ordinary shares. When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9% per annum. The entity incurs issue costs of €100,000.

The economic components of this instrument are:

- A liability component, being a discounted fixed rate debt, perhaps with an imputed holder's put option (due to the holder's right to convert at any time).

  And
- An equity component, representing the holder's right to convert at any time before maturity. In effect this is a written call option (from the issuer's perspective) on American terms (i.e., it can be exercised at any time until maturity of the bond).

The practical problem with this analysis is that it is not clear what is the strike price of the holder's options to put the debt and call for shares, specifically whether it is the €2,000,000 face value of the bonds or the discounted amount at which they are recorded until maturity. Perhaps for this reason, IAS 32 does not require the true fair values of these components to be calculated.

Instead, the liability component is measured first at the net present value of the maximum potential cash payments that the issuer could be required to make. The difference between the proceeds of the bond issue and the calculated fair value of the liability is assigned to the equity component. The net present value (NPV) of the liability component is calculated as €1,848,122, using a discount rate of 9%, being the market interest rate for similar bonds having no conversion rights, as shown below.

Year	Cash flow		Discount factor	NPV of cash flow
		€	(at 9%)	€
1	Interest	120,000	1/1.09	110,092
2	Interest	120,000	$1/1.09^2$	101,001
3	Interest and principal	2,120,000	$1/1.09^3$	1,637,029
			Total liability component	1,848,122
			Total equity component (balance)	151,878
			Total proceeds	**2,000,000**

Next, it is necessary to deal with the issue costs of €100,000. In accordance with the requirements of IAS 32 for such costs (see section 8.1 below), these would be allocated to the liability and equity components on a *pro rata* basis. This would give the following allocation of the net issue proceeds.

	Liability component	Equity component	Total
	€	€	€
Gross proceeds (allocated as above)	1,848,122	151,878	2,000,000
Issue costs (allocated *pro rata* to gross proceeds)	(92,406)	(7,594)	(100,000)
Net proceeds	**1,755,716**	**144,284**	**1,900,000**

The €144,284 credited to equity is not subsequently remeasured (see section 6.2.1 below). On the assumption that the liability is not classified as at fair value through profit or loss, the €1,755,716 liability component would be accounted for under the effective interest rate method. It must be borne in mind that, after taking account of the issue costs, the effective interest rate is not the 9% used to determine the gross value of the liability component, but 10.998%, as shown below.

Year	Liability b/f	Interest at 10.998%	Cash paid	Liability c/f
	€	€	€	€
1	1,755,716	193,094	(120,000)	1,828,810
2	1,828,810	201,134	(120,000)	1,909,944
3	1,909,944	210,056	(2,120,000)	-
	Total finance cost	**604,284**		

The total finance cost can be proved as follows:

	€
Cash interest at 6%	360,000
Gross issue proceeds originally allocated to equity component	151,878
Issue costs allocated to liability component	92,406
	604,284

6.2.1 Accounting for the equity component

On initial recognition of a compound financial instrument, the equity component (i.e., the €144,284 identified in Illustration 6-1 above) is credited direct to equity and is not subsequently remeasured. IAS 32 does not prescribe:

- Whether the credit must be to a separate component of equity (although a transitional provision relating to the February 2008 amendment of IAS 32 suggests that there is such a requirement).

  Or

- If the entity chooses to treat it as such, how it must be described.

This ensures that there is no conflict between, on the one hand, the basic requirement of IAS 32 that there must be a credit in equity and, on the other, the legal requirements of various jurisdictions as to exactly how that credit must be allocated within equity.

After initial recognition, the classification of the liability and equity components of a convertible instrument is not revised, for example as a result of a change in the likelihood that a conversion option will be exercised, even when exercise of the option may appear to have become economically advantageous to some holders. IAS 32 points out that holders may not always act in the way that might be expected because, for example, the tax consequences resulting from conversion may differ among holders. Furthermore, the likelihood of conversion will change from time to time. The entity's contractual obligation to make future payments remains outstanding until it is extinguished through conversion, maturity of the instrument or some other transaction. *[IAS 32.30]*.

The amount originally credited to equity is subsequently neither remeasured nor reclassified to profit or loss. Thus, as shown in Illustration 6-1 above, the effective interest rate shown in profit or loss for a simple convertible bond will be equivalent to the rate that would have been paid for non-convertible debt. In effect, the dilution of shareholder value represented by the embedded conversion right is shown as an interest expense.

However, on conversion of a convertible instrument, it may be appropriate to transfer the equity component within equity (see section 6.3.1 below).

6.2.2 Temporary differences arising from split accounting

In many jurisdictions it is only the cash interest paid, and sometimes also the issue costs, that are deductible for tax purposes, rather than the full amount of the finance cost recognised in profit or loss under IAS 32. Moreover, some of these costs may be deductible in periods different from those in which they are recognised in the financial statements. These factors will give rise to temporary differences between the carrying value of the liability component of the bond and its tax base, giving rise to deferred tax required to be accounted for under IAS 12 *Income Taxes* (see Chapter 29, particularly Chapter 29 at section 6.1.2 and section 7.2.7).

6.3 Conversion, early repurchase and modification

6.3.1 Conversion at maturity

On conversion of a convertible instrument at maturity, IAS 32 requires the entity to derecognise the liability component and recognise it as equity. There is no gain or loss on conversion at maturity. *[IAS 32.AG32]*.

Thus, for example, if the bond in Illustration 6-1 in section 6.2 above were converted at maturity, the accounting entry required by IAS 32 would be:

Dr	Liability		€2,000,000	
	Cr	Equity		€2,000,000

The precise allocation of the credit to equity (e.g., as between share capital, additional paid-in capital, share premium, other reserves and so on) would be a matter of local legislation. In addition, IAS 32 permits the €144,284 originally allocated to the equity component in Illustration 6-1 above to be reallocated within equity. *[IAS 32.AG32]*.

6.3.2 Conversion before maturity

6.3.2.A 'Fixed stated principal' of a bond

The consideration given for the issue of equity instruments on conversion of a bond is the discharge by the holder of the issuer from the liability to pay any further interest or principal on the bond. If conversion can take place only at maturity, the amount of the liability transferred to equity on conversion will always (as in Illustration 6-1 in section 6.2 above) be €2,000,000. Hence, the conversion right involves the delivery of a fixed number of shares for the waiver of the right to receive a fixed amount of cash and so is clearly an equity instrument.

However, the bond in Illustration 6-1 above allows conversion at some point before the full term. Therefore, conversion might occur at the end of year 2, when the carrying value of the bonds would have been accreted to only €1,909,944. Hence, the carrying amount of the liability that is forgiven on conversion can vary depending on when conversion occurs. This begs the question as to whether the conversion right now involves the delivery of a fixed number of shares for the waiver of the right to receive a variable amount of cash, suggesting that it is no longer an equity instrument.

It is for this reason, in our view, that IAS 32 defines an equity instrument as one that involves the exchange of a fixed number of shares for the 'fixed stated principal' rather than the 'carrying amount' of a bond. In other words, IAS 32 regards the 'fixed stated principal' of the bond in Illustration 6-1 above as a constant €2,000,000. The intention is to clarify that the variation in the carrying amount of the bond during its term does not preclude the conversion right from being classified as an equity instrument.

6.3.2.B Accounting treatment

IAS 32 refers to the treatment summarised in section 6.3.1 above being applied on conversion 'at maturity'. This begs the question of the treatment required if a holder converts prior to maturity (as would have been possible under the terms of the bond in Illustration 6-1 above).

As noted in section 6.3.2.A above, IAS 32 concludes that the equity component of the bond is an equity instrument on the grounds that it represents the holder's right to call for a fixed number of shares for a fixed consideration, in the form of the 'fixed stated principal' of the bond.

It could be argued that the logical implication of this is that, on a holder's early conversion of the bond in Illustration 6-1 above, the issuer must immediately recognise a finance cost for the difference between the then carrying amount of the liability component of the bond and the fixed stated principal of €2,000,000. This would create a liability of €2,000,000 immediately before conversion, so as to acknowledge that the strike price under the holder's call option is the waiver of the right to receive a fixed stated principal of €2,000,000, rather than whatever the carrying value of the bond happens to be at the time.

How we see it

We take the view, supported by general practice, that on early conversion of a bond, as described above, all that is required is to transfer to equity the carrying value of the liability at the date of conversion.

In such a case, the consideration for the issue of equity instruments is the release, by the bondholder, of the issuer from its liability to make future contractual payments under the bond, measured at the net present value of those payments.

IFRIC 19 (which generally applies to debt for equity swaps (see section 7 below)) does not apply to the conversion of a convertible instrument in accordance with its original terms.

6.3.2.C Treatment of embedded derivatives on conversion

IAS 32 does not specifically address the treatment of any separated non-equity embedded derivatives outstanding at the time of conversion. The issue of principle is that, when a holder exercises its right to convert, it is effectively requiring the issuer to issue equity in consideration for the bondholder ceding its rights. These may include any right to receive future payments of principal and/or interest or to require early repayment of the bond. It seems entirely appropriate that any amounts carried in respect of such rights, including those reflected in the carrying amount of separated embedded derivatives, must be transferred to equity on conversion.

Where, however, conversion has the effect of removing an issuer's right (for example, to compel early redemption or conversion), an alternative view is that this could be seen as a loss to the issuer rather than as consideration given by the holder for an issue of equity.

How we see it

In our view, the loss of any rights by the issuer on conversion of a convertible bond by the holder simply represents a reduction in the proceeds received for the issue of equity and must therefore by accounted for as a charge to equity (see also section 8.1 below).

6.3.3 Early redemption or repurchase

It is not uncommon for the issuer of a convertible bond to redeem or repurchase it before the end of its full term, either through exercise of rights inherent in the bond, such as an embedded issuer call option, or through subsequent negotiation with bondholders.

IAS 32 contains guidance for the accounting treatment of an early redemption or repurchase of compound instruments following a tender offer to bondholders (see section 6.3.3.A below).

It is not entirely clear whether this guidance applies only to redemption pursuant to a subsequent negotiation with bondholders, or whether it also applies where redemption occurs through exercise of a right inherent in the original terms of the bond.

How we see it

If redemption of a convertible bond is based on a right inherent in the original terms of the bond, we believe an entity has an accounting policy choice, between allocating the consideration paid on early redemption, consistent with the original allocation of liability and equity, or accounting for a modification gain or loss on the financial liability (see section 6.3.4 below).

6.3.3.A Early repurchase through negotiation with bondholders

When an entity extinguishes a convertible instrument before maturity through an early redemption or repurchase in which the original conversion privileges are unchanged, IAS 32 requires the entity to allocate the consideration paid and any transaction costs for the repurchase or redemption to the liability and equity components of the instrument at the date of the transaction. *[IAS 32.AG33]*.

It is not entirely clear what is meant by a 'redemption or repurchase in which the original conversion privileges are unchanged'. However, we assume that it is intended to imply that the repurchase must occur without modification of the original terms of the compound instrument, and at a price representing a fair value for the instrument on its original terms. A repurchase based on a modification of the original terms of the instrument, or at a price implying a modification of them, must presumably be dealt with according to the provisions of IAS 32 for the modification of a compound instrument (see section 6.3.4 below) or those in IFRS 9 for the exchange and modification of debt (see Chapter 48 at section 6.2).

The method used for allocating the consideration paid and transaction costs to the separate components must be consistent with that used in the original allocation to the separate components of the proceeds received by the entity when the convertible instrument was issued (see section 6.2 above). *[IAS 32.AG33]*.

The issuer is therefore required to:

- Determine the fair value of the liability component and allocate this part of the purchase price to the liability component.
- Allocate the remainder of the purchase price to the equity component.

  And
- Allocate the transaction costs between the liability and equity component on a *pro rata* basis.

Once this allocation of the consideration has been made:

- The difference between the consideration allocated to the liability component and the carrying amount of the liability is recognised in profit or loss.

  And
- The amount of consideration relating to the equity component is recognised in equity. *[IAS 32.AG34]*.

The treatment of a negotiated repurchase at fair value of a convertible instrument is shown in Illustration 6-2 below, which is based on an illustrative example in IAS 32. *[IAS 32.IE39-46]*.

Illustration 6-2: Early repurchase of convertible instrument

For simplicity this example:

- Assumes that at inception, the face amount of the instrument was equal to the carrying amount of its liability and equity components in the financial statements - i.e., there was no premium or discount on issue.

  And

- Ignores transaction costs and tax.

On 1 January 20W7, an entity issued a convertible bond with a face value of CU100 million maturing on 31 December 20X6, at which point the holder may opt for repayment of CU100 million or conversion into 4 million shares. Interest is paid half-yearly in arrears at a nominal annual interest rate of 10% (i.e., CU5m per half year). At the date of issue, the entity could have issued non-convertible debt with a ten-year term bearing interest at 11%. On issue, the carrying amount of the bond was allocated as follows:

	CU million
Present value of the principal - CU100m payable at the end of ten years[1]	34.3
Present value of the interest - 20 half-yearly interest payments of CU5m[2]	59.7
Total liability component	94.0
Equity component (balance)	6.0
Proceeds of the bond issue	**100.0**

The amounts above are discounted using a semi-annual rate of 5.5% (11%÷2) as follows:

1 CU100m/1.055^{20}

2 CU5m × (1/1.055 +1/1.055^2+ 1/1.055^3+ … 1/1.055^{20})

On 1 January 20X2, the entity makes a tender offer to the holder of the bond to repurchase the bond at its then fair value of CU170 million, which the holder accepts. At the date of repurchase, the entity could have issued non-convertible debt with a five-year term with interest payable half-yearly in arrears at an annual coupon interest rate of 8%.

At the time of repurchase, the carrying amount of the liability component of the bond, discounted at the original semi-annual rate of 5.5% is as follows.

	CU million
Present value of the principal - CU100m payable at the end of five years[1]	58.5
Present value of the interest - 10 half yearly interest payments of CU5m[2]	37.7
Carrying value of liability component	**96.2**

1 CU100m/1.055^{10}

2 CU5m × (1/1.055 +1/1.055^2+ 1/1.055^3+ … 1/1.055^{10})

The fair value of the liability component of the bond, discounted at the current semi-annual rate of 4% (8%÷2) is as follows.

	CU million
Present value of the principal - CU100m payable at the end of five years[1]	67.6
Present value of the interest - 10 6-monthly payments of CU5m[2]	40.5
Fair value of liability component	**108.1**

1 CU100m/1.04^{10}

2 CU5m × (1/1.04 +1/1.04^2+ 1/1.04^3+ …1/1.04^{10})

The fair value calculation indicates that, of the repurchase price of CU170 million, CU108.1 million is to be treated as redeeming the liability component of the bond, and the balance of CU61.9 million as redeeming the equity component. This gives rise to the accounting entry:

		CU million	CU million
Dr	Liability component of bond	96.2	
Dr	Equity	61.9	
Dr	Debt settlement expense (profit or loss)	11.9	
	Cr Cash		170.0

The debt settlement expense represents the difference between the carrying value of the debt component (CU96.2m) and its fair value (CU108.1m).

Any costs of the repurchase would have been allocated between profit or loss and equity in proportion to the fair value of the liability and equity components at the time of redemption.

6.3.3.B Early repurchase through exercising an embedded call option

It is not entirely clear whether the guidance in section 6.3.3.A above applies only on early redemption or repurchase to a subsequent negotiation with bondholders, or whether it also applies where redemption occurs through exercise of rights inherent in the terms of the bond (for example an issuer call option at par allocated to the liability component and considered to be clearly and closely related to the host contract).

One way of accounting for such redemptions would be by applying the accounting treatment as discussed in section 6.3.3.A above.

If, however, this early repayment option was determined, on initial recognition of the convertible bond, to be clearly and closely related to the liability host contract (see section 6.4.2.A below), then it might be argued that the general measurement rules of IFRS 9 apply. In such a case the liability (including the embedded call option) would be measured at amortised cost (assuming that it was not designated at fair value through profit or loss on initial recognition). Accounting under the amortised cost method is based on an effective interest rate, calculated initially based on expected future cash flows. Any change in those expected cash flows is reflected in the carrying amount of the financial instrument, by computing the present value of the revised estimated future cash flows at the instrument's original effective interest rate, with any difference from the previous amortised cost carrying amount recorded in profit or loss. *[IFRS 9.B5.4.6]*.

A change in the expected repayment date would therefore require the amortised cost of the financial liability component to be remeasured. This treatment has the effect that the overall repayment amount at par is allocated to the liability portion of the compound instrument.

6.3.4 Modification

An entity may amend the terms of a convertible instrument to induce early conversion, for example by offering a more favourable conversion ratio or paying other additional consideration in the event of conversion before a specified date. At the date the terms are amended, the difference between the following two amounts is recognised in profit or loss:

- The fair value of the consideration the holder receives on conversion of the instrument under the revised terms

  And

- The fair value of the consideration the holder would have received under the original terms *[IAS 32.AG35]*.

IAS 32 illustrates this treatment, as shown in Illustration 6-3 below. *[IAS 32.IE47, IAS 32.IE48, IAS 32.IE49, IAS 32.IE50]*.

Illustration 6-3: Modification of the terms of a bond to induce early conversion

Suppose that the entity in Illustration 6-2 in section 6.3.3.A above wished, on 1 January 20X1, to induce the bondholder to convert the bond early. The original terms of the bond allowed for conversion into 4 million shares. The entity offers the bondholder the right to convert into 5 million shares during the period 1 January to 28 February 20X1. The market value of the entity's shares is CU40 per share.

The enhanced conversion terms offer the bondholder the right to receive an additional 1 million shares. Accordingly, the entity recognises a loss of CU40m (1m shares × share price CU40/share) in profit or loss.

6.4 The components of a compound instrument

6.4.1 Determining the components of a compound instrument

The most difficult aspect of 'split accounting' is often the initial assessment of whether the instrument consists of different components and if it does, what the various components of the instrument actually are. In the examples above, it is fairly clear that the instruments consist of different components and what the various components are. However, in some instruments the analysis is far from straightforward, as shown in Illustration 6-4 below.

Illustration 6-4: Analysis of compound financial instrument into components

An entity issues a bond for CU100, paying an annual cash coupon of 5% on the issue price and mandatorily convertible after five years on the following terms. If, at the date of conversion, the entity's share price is:

- CU1.25 or higher, the holder will receive 80 shares
- CU1.00 or lower, the holder will receive 100 shares
- In the range CU1.00 to CU1.25, the holder will receive such number of shares (between 80 and 100) as have a fair value of CU100.

Any analysis must begin by determining whether the bond as whole is a non-derivative instrument. This is the case, since the issuing entity receives full consideration for its issue. The next step is to assess whether the instrument consists of different components and, if it does, to break the instrument down into these components to identify any equity components in the whole.

The difficulty of this assessment is evidenced by two requests received by the IFRS IC to address the accounting for two instruments with substantially the same features as the one in Illustration 6-4 above, but with an additional early settlement option for the issuer, to settle the instrument at any time by delivering a maximum (fixed) number of shares (see section 6.6.4.A below).[26] While the request focused only on the additional early settlement option, and not on the classification of the 'basic' instrument (an instrument with the features described in Illustration 6-4 above), the accounting treatment of the 'basic instrument' was added to the IFRS IC's agenda. It was discussed during the January 2014 and May 2014 IFRS IC meetings.[27]

Four alternative views with significantly different accounting outcomes, ranging from classifying the whole financial instrument as a financial liability to various combinations of financial liabilities, equity instruments and/or derivative financial liabilities, were considered by the IFRS IC. In the end the IFRS IC noted that:

- The issuer's obligation to deliver a variable number of the entity's own equity instruments is a non-derivative that meets the definition of a financial liability in IAS 32.11(b)(i) in its entirety (see sections 3 and 4.1 above).

  And

- The definition of a liability in IAS 32 does not have any limits or thresholds regarding the degree of variability that is required.

Therefore, the contractual substance of the instrument is a single obligation to deliver a variable number of equity instruments at maturity, with the variation based on the value of those equity instruments. The IFRS IC noted further that such a single obligation to deliver a variable number of own equity instruments cannot be subdivided into components for the purposes of evaluating whether the instrument contains a component that meets the definition of equity. Even though the number of equity instruments to be delivered is limited and guaranteed by the cap and the floor, the overall number of equity instruments that the issuer is obliged to deliver is not fixed and therefore the entire obligation meets the definition of a financial liability.

The IFRS IC noted that the cap and the floor are embedded derivative features, whose values change in response to the price of the issuer's equity shares. Therefore, assuming that the issuer has not elected to designate the entire instrument under the fair value option, the issuer must separate those features and account for the embedded derivative features separately from the host liability contract, at fair value through profit or loss in accordance with IFRS 9 (see Chapter 42 at sections 3 and 4).

26 *IFRIC Update*, July 2013, available on the IFRS Foundation's website.

27 *IFRIC Update*, January 2014 and *IFRIC Update*, May 2014. Available on the IFRS Foundation's website.

The fact that the issue was submitted to the IFRS IC in the first place together with the fact that four possible accounting views were drawn up under the guidance of IAS 32, demonstrates how difficult and judgemental any analysis of increasingly complex instruments can be under the provisions of IAS 32.

6.4.2 Compound instruments with embedded derivatives

As noted above, in order to qualify for split accounting, a financial instrument, when considered as a whole, must be a non-derivative instrument. However, one or more of its identified components may well be embedded derivatives. Indeed, the conversion right in any convertible bond represents a holder's call option whereby the entity can be required to issue a fixed number of shares for a fixed consideration (the 'fixed stated principal' of the bond - see section 6.3.2.A above), which is accordingly identified as an equity component.

A bond may well contain other (non-equity) derivatives, such as options for either the issuer or the holder to require early repayment or conversion or to extend the period until conversion. The detailed guidance in IAS 32 requires the fair value of any embedded non-equity derivative features to be determined and included in the liability component when split accounting is applied (see section 6.2 above). *[IAS 32.31]*. They are then subject to the normal requirement of IFRS 9 for embedded derivatives to be accounted for separately if they are not considered to be closely related to the host contract (see Chapter 42 at section 4).

The issuer of a compound financial instrument with other embedded derivatives is therefore required to go through the following steps:

- First step:

  Determine the fair value of the liability component that does not have an associated equity conversion feature but including any embedded non-equity derivatives features.

- Second step:

  Determine the equity component as a residual amount by deducting the fair value of the liability component, including any embedded non-equity derivative features, from the fair value of the compound instrument (essentially its issue proceeds).

  And

- Third step:

  Assess whether the embedded non-equity derivative features are closely related to the host liability component. Any not closely related embedded non-equity derivative features are accounted for separately and therefore separated from the host liability component (see Chapter 42 at sections 3 and 4).

Note, on initial recognition, the sum of the initial carrying amounts of the various components, determined as indicated above, must equal the overall fair value of the compound instrument.

The separation of the liability and equity components of a compound financial instrument with multiple embedded derivative features is demonstrated in Illustration 6-5 below which is based on an illustrative example in IAS 32. *[IAS 32.IE37, IAS 32.IE38]*.

6.4.2.A Issuer call option - 'closely related' embedded derivatives

Illustration 6-5: Convertible bond - split accounting with multiple embedded derivative features

The proceeds received on the issue of a convertible bond, callable at par, are CU60 million, which equals the nominal amount of the convertible bond. The value of a similar bond without a call or equity conversion option is CU57 million. Based on an option-pricing model, it is determined that the value to the entity of the embedded call feature in a similar bond without an equity conversion option is CU2 million. In this case, the value is allocated to the liability component, to reduce the liability component to CU55 million (CU57m - CU2m) and the value allocated to the equity component is CU5 million (CU60m - CU55m). Because IFRS 9 requires the embedded derivative assessment to be done before separating the equity component and the call option is at par, the option is considered to be clearly and closely related and therefore not separated from the liability host contract.

Where (as is often the case) a convertible bond is callable at par, the call option would not be a separable derivative. IFRS 9 states that a call option is generally closely related to the host debt contract if the exercise price is approximately equal to the amortised cost of the host on each exercise (which would not, *prima facie* be the case). However, as an exemption to the general rule, IFRS 9 requires this assessment to be made in respect of any embedded call, put or prepayment option in a convertible bond before separating the equity component. *[IFRS 9.B4.3.5(e)]*. This has the effect that an issuer's call over a convertible bond at par is effectively deemed to be equal to its amortised cost for the duration of the instrument. This is discussed further in Chapter 42 at section 4.

6.4.2.B Issuer call option - 'not closely related' embedded derivatives

If a non-equity embedded derivative is considered not to be closely related to the host contract, then it must be accounted for separately. If, in Illustration 6-5 above, the issuer call option was at an amount that was not approximately equal to the amortised cost of the host, and not intended to reimburse the approximate present value of lost interest (see Chapter 42 at section 4 above), say at par plus CU5 million, then the call option would not be considered clearly and closely related and therefore must be accounted for separately. The issuer in Illustration 6-5 in section 6.4.2.A above would therefore record a derivative financial asset at its fair value of CU2 million, assuming it would have the same fair value as in Illustration 6-5 above, a liability component of CU57 million and an equity component of CU5 million. The call option would subsequently be remeasured at fair value through profit or loss.

There are cases where over-enthusiastic trawling for embedded derivatives may dredge up results so counter-intuitive that it is hard to believe that they were really intended by the IASB, as shown in Illustration 6-6 below.

Illustration 6-6: Foreign currency denominated equity instrument with issuer's redemption right

An entity with a functional currency of pounds sterling issues a Euro-denominated capital instrument for €145 million (equivalent to £100 million at the date of issue). Coupons on the instrument are paid entirely at the entity's discretion. The entity has the right, but not the obligation, in certain circumstances to redeem the instrument (in Euros) for an amount equal to the original issue proceeds.

Taken as a whole, this is an equity instrument, because it gives rise to no obligation to transfer cash or other financial assets to the holder. However, the issuer's right to redeem, if considered in isolation is not an equity instrument, but a financial asset (a call option over own equity), since it is a derivative involving the purchase of a fixed number of equity instruments for €145 million which, although fixed in Euros, is variable when translated into sterling. Suppose that the fair value of the call option, at the date of issue was £15 million.

This analysis would result in the following accounting entry on issue of the instrument:

		£m	£m
Dr	Cash	100	
Dr	Call option (statement of financial position)	15	
	Cr Equity		115

How we see it

In our view, it would be inappropriate to show an increase in net assets of £115 million in this example, when the only real transaction has been the raising of £100 million of equity for cash. In this particular case, split accounting is, in our view, not required since IAS 32.28 requires split accounting to be applied only where an instrument is determined to contain 'both a liability and an equity component'.

In this case, there is no liability component, since the embedded derivative that has potentially been identified is, and can only ever be, an asset; accordingly, 'split accounting' is not required.

6.5 Other issues

The following issues discussed earlier in this chapter are of particular relevance to convertible bonds:

- The IFRS IC's conclusion that a fixed amount of cash denominated in a currency other than the entity's functional currency is not a 'fixed amount' of cash (see section 5.2.3 above and sections 6.6.5 and 6.6.5.A below).

  And

- The treatment of instruments settled with equity instruments, the number of which varies to reflect major capital restructurings before settlement (see section 5.1.2 above).

These and other issues noted at various points above reinforce an increasing concern that the 'split accounting' rules in IAS 32 are implicitly based on a bond with terms much more straightforward than those of many, if not most, bonds currently in issue. See section 12 below for possible future developments.

6.6 Common forms of convertible bonds

6.6.1 Functional currency bond convertible into a fixed number of shares

The most common form of convertible bond, a functional currency bond convertible into a fixed number of own equity instruments at the discretion of the holder, is discussed in Illustration 6-1 in section 6.2 above.

6.6.2 Contingent convertible bond

A contingent convertible bond is a bond that is convertible, at the option of the holder, only on the occurrence of a contingent event outside of the control of the holder or the issuer. If the contingent event occurs then the holder has the option, but not the obligation, to convert. If the contingent event does not occur, then the bond will be settled in cash at maturity.

The fact that conversion is only contingent does not mean the instrument has no equity component. If, on occurrence of the contingent event, exercise of the conversion option would result in the exchange of a fixed number of the issuer's own equity instruments for a fixed amount of cash (in the functional currency of the issuing entity), the conversion option would meet the definition of an equity instrument under IAS 32 and the overall instrument would be treated as a compound instrument.

6.6.3 Bond convertible at the option of the issuer

Where a fixed rate convertible bond has a fixed conversion rate with conversion at the entity's discretion and with any accrued interest also being converted at the same rate then the instrument is equity in its entirety. For example, an entity with a Euro functional currency, issues a bond with the principal amount of €500,000. The principal amount may be converted into newly issued ordinary shares of the issuer at the sole discretion of the issuer at any time. The bond bears a mandatory annual fixed interest rate of 5%. The interest accrued may be converted at the sole discretion of the issuer and at the same fixed conversion ratio as the principal of the bond. In this case both the principal and interest are classified as equity because the conversion rate is fixed and conversion is at the entity's discretion.

6.6.4 Mandatorily convertible bond

A mandatorily convertible bond is an instrument that, at a certain time in the future, converts into shares of the issuing entity, rather than the conversion being at the option of either the holder or the issuer of the bond. The classification of a mandatorily convertible bond on initial recognition as debt or equity depends on:

- How the convertible bond will be settled

  And
- Whether the issuer is required to pay interest up to the point of conversion

If the fixed stated principal will be settled through the delivery of a fixed number of the issuer's own shares, and the principal of the convertible bond is in the functional currency of the issuing entity, then this feature of the bond is an equity instrument and accounted for as such (see sections 4.1 and 5.2.3 above). If interest on the bond is payable only at the discretion of the entity, then there is no liability component, and the entire bond is classified as an equity instrument. If, however, the entity is required to pay interest, the obligation to pay interest establishes a liability component, which is measured at the present value of the required interest payments.

If settlement can only occur through the delivery of a variable number of the issuer's own shares, calculated so that the fair value of these shares issued equals the principal amount (see section 5.2.1 above), and the entity is required to pay interest, then the entire bond is classified as a financial liability.

Illustration 6-7: Mandatorily convertible bond classified as equity

An entity, with a functional currency of Euro, issues 2,000 convertible bonds with a nominal value of €1,000 per bond, giving total proceeds of €2,000,000. The bonds have a three-year term, and interest is payable, at the discretion of the entity, annually in arrears at a nominal annual interest rate of 6% (i.e., €120,000 per annum). At maturity of the bond, each bond converts into 250 ordinary shares. Because the conversion option meets the definition of an equity instrument and payment of interest is at the discretion of the entity, the entire instrument is classified as an equity instrument. The entity records the following accounting entry.

Dr	Cash		€2,000,000	
	Cr	Equity		€2,000,000

Illustration 6-8: Mandatorily convertible bond classified as a compound instrument

Assume the same fact pattern as in Illustration 6-7 above, except that the entity has an obligation to pay interest annually in arrears at a nominal annual interest rate of 6% (i.e., €120,000 per annum). The obligation to pay interest over three years represents a liability of the issuing entity at the net present value, using a discount rate of 9%, which is the market interest rate.

Year	Cash flow		Discount factor	NPV of cash flow
		€	(at 9%)	€
1	Interest	120,000	1/1.09	110,092
2	Interest	120,000	$1/1.09^2$	101,001
3	Interest	120,000	$1/1.09^3$	92,662
			Total liability component	303,755
			Total equity component (balance)	1,696,245
			Total proceeds	**2,000,000**

The entity records the following accounting entry.

Dr	Cash		€2,000,000	
	Cr	Equity		€1,696,245
	Cr	Liability		€303,755

6.6.4.A Bond which is mandatorily convertible into a variable number of shares with an option for the issuer to settle early for a maximum number of shares

At its meeting in July 2013, the IFRS IC considered the IAS 32 classification for a financial instrument that is mandatorily convertible into a variable number of shares, subject to a cap and floor, but with an issuer option to settle by delivering the maximum (fixed) number of shares.[28] This is a financial instrument with essentially the same features as the one described in Illustration 6-4 above in section 6.4.1, but with an additional option for the issuer to settle the instrument at any time before maturity (see section 6.4.1 above for IAS 32 classification considerations for the 'basic financial instrument', ignoring the early settlement option). If the issuer chooses to exercise its early settlement option, it must deliver the maximum number of shares specified in the contract (e.g., 100 shares in Illustration 6-4 above and pay in cash all of the interest that would have been payable if the instrument had remained outstanding until its maturity date (a so called 'make-whole provision').

Applying the IAS 32 definitions of a financial liability and of an equity instrument to such a financial instrument would result in accounting for it as a compound instrument (i.e., a financial instrument consisting of an equity element and a financial liability element). IAS 32 states that a non-derivative financial instrument is an equity instrument if the instrument will be settled in the issuer's own equity instruments and includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments. *[IAS 32.11(b)(i)]*. With the early settlement option, the issuer has the right to avoid delivering a variable number of shares. A portion of the financial instrument would therefore meet the definition of equity and would be accounted for as such. The interest payments on the instrument, on the other hand, impose a contractual obligation on the issuer to deliver cash in all cases and therefore meet the definition of a financial liability and would be accounted for as such.

However, this analysis ignores the fact that in exercising the early settlement option, the issuer must deliver at an earlier time a potentially greater number of its own shares, plus all the interest in cash which would have been payable over the instrument's life. The issuer can avoid delivering a variable number of its own shares but only by giving away a potentially larger amount of economic value. The question asked of the IFRS IC was whether such an early settlement option must be considered when classifying the financial instrument under IAS 32.

28 *IFRIC Update*, July 2013, available on the IFRS Foundation's website.

In its analysis, the IFRS IC noted that the definitions of financial asset, financial liability and equity instrument in IAS 32 are based on the financial instrument's contractual rights and contractual obligations.[29] However, IAS 32 requires the issuer of a financial instrument to classify the instrument in accordance with the substance of the contractual arrangement. *[IAS 32.15]*. An issuer cannot assume that a financial instrument (or any component) meets the definition of an equity instrument simply because the issuer has the contractual right to settle the financial instrument by delivering a fixed number of equity instruments. The issuer would need to consider whether the early settlement option is substantive and, if it was concluded that it lacks substance, then it must be ignored for the classification assessment of the instrument.

It was noted that the guidance in IAS 32.20(b) is relevant because it provides an example of a situation in which one of an instrument's settlement alternatives is excluded from the classification assessment. Specifically, the example in that paragraph describes an instrument that the issuer will settle by delivering either cash or its own shares, and states that one of the settlement alternatives must be excluded from the classification assessment in some circumstances (see section 5.2.4 above).

To determine whether the early settlement option is substantive, the issuer would need to understand whether there are actual economic or business reasons that would lead the issuer to exercise the option. In making that assessment, the issuer could consider whether the instrument would have been priced differently if the issuer's early settlement option had not been included in the contractual terms. The IFRS IC also noted that factors such as the term of the instrument, the width of the range between the cap and the floor, the issuer's share price and the volatility of the share price could be relevant to the assessment of whether the issuer's early settlement option is substantive. For example, the early settlement option may be less likely to have substance, especially if the instrument is short-lived, if the range between the cap and the floor is wide and the current share price would equate to the delivery of a number of shares that is close to the floor. That is because the issuer may have to deliver significantly more shares to settle early than it may otherwise be obliged to deliver at maturity. The IFRS IC considered that in light of its analysis of the existing IFRS requirements, it would not add this issue to its agenda.

6.6.4.B Bond which is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event

Since the financial crisis, regulators have been looking to strengthen the capital base of financial institutions, particularly in the banking sector. Rising requirements for capital adequacy have resulted in banks looking into new forms of capital instruments. One form of such capital instruments are financial instruments that convert into a variable number of the issuer's own ordinary shares if the institution breaches a minimum regulatory requirement. This type of contingent event is called a 'non-viability' event.

While the exact terms of these instruments vary in practice, they do generally come with the following key features:

- No stated maturity, but the issuer can call the instrument for the par amount of cash.
- While the instrument has a stated interest rate (e.g., 5%), payment of interest is at the discretion of the issuer.

  And
- If the issuer breaches a minimum regulatory requirement (e.g., 'Tier 1 Capital ratio'), the instrument mandatorily converts into a variable number of the issuer's own ordinary shares. The number of shares delivered would depend on the current share price, i.e., the issuer must deliver as many shares as are worth the par amount of the instrument at conversion.

In July 2013, the IFRS IC considered a request to clarify the accounting for such instruments.[30] In its tentative agenda decision, the IFRS IC noted that the instrument is a compound instrument that is composed of the following two components:

- A liability component, which reflects the issuer's obligation to deliver a variable number of its own equity instruments, if the contingent non-viability event occurs.

  And
- An equity component, which reflects the issuer's discretion to pay interest.

29 *IFRIC Update*, January 2014, available on the IFRS Foundation's website.

30 *IFRIC Update*, July 2013, available on the IFRS Foundation's website.

To measure the liability component, the IFRS IC noted that the issuer must consider the fact that the contingent non-viability event could occur immediately because it is beyond the control of the issuer. Hence the liability component must be measured at the full amount that the issuer could be required to pay immediately. The equity component would be measured as a residual and thus would be measured at zero, because the instrument is issued at par and the value of the variable number of shares that will be delivered on conversion is equal to that fixed par amount.

The IFRS IC received 12 comment letters on the tentative agenda decision, many accepting that the IFRS IC's view is one way of analysing the financial instrument under IAS 32, but generally expressing the view that the relevant guidance in IAS 32 is unclear and that equally valid arguments could be made for other views. For instance, one view discussed at the time was that, when measuring the liability component, the issuer must consider the expected timing of the contingent non-viability event occurring and discount the liability accordingly. Therefore, if the issuer believed that the contingency would not occur in the near-term, the liability component would be recognised at an amount of less than par. The comments provided focused in particular on (a) the measurement of the liability component and (b) whether interest paid on the instrument, if any, would need to be recognised in equity or as interest in profit or loss. Based on the comments received, the IFRS IC decided, after further discussions in its January 2014 meeting, not to add this issue to its agenda and noted that the scope of the issues raised in the submission was too broad to be addressed in an efficient manner.[31] There is therefore the potential for diversity in practice until this issue is clarified by the IASB. This is shown by the following Illustration:

Illustration 6-9: Convertible bond mandatorily convertible upon 'non-viability' event

A bank issues €100 million of contingent convertible bonds. The bonds notionally pay fixed interest of 7% annually, however interest payments are at the sole discretion of the issuer provided that no dividend is paid on the ordinary shares of the issuer. The bonds are perpetual, but the issuer has the right to call the shares after five years and on every succeeding fifth anniversary thereafter.

The instrument is immediately converted into ordinary shares with a fair value equal to the par value of the bonds upon either:

- The bank's fully loaded Common Equity Tier 1 (CET 1) ratio falling below 7%

  Or

- The local regulator declaring a non-viability event

The instrument has both debt and equity features. The contingent settlement provision, which requires settlement in a variable number of shares upon a non-viability event, is a debt feature and the perpetual nature of the instrument and the discretionary interest payments are equity features. As discussed above there are a number of views that could be taken on how to classify this instrument.

Based on the IFRS IC's discussion, the view could be taken that the bonds are a compound instrument and that because the contingent settlement provision might be activated immediately, a liability for the par amount of the bond must be recorded. The equity component of the instrument representing the discretionary interest payments would therefore have no value.

However, this could be viewed as odd given that there is usually no expectation that a trigger event will occur when the instrument is first issued. As such, it might be considered more reasonable to estimate when a trigger event is most likely to occur and calculate the liability component on that basis, with the residual amount being classified as equity.

There is a further argument that the whole instrument falls within the definition of a liability rather than a compound instrument, as the entity may be required to deliver a variable number of shares for a non-derivative instrument. *[IAS 32.11(b)(i)]*.

The conversion trigger itself is not a separable embedded derivative as redemption at amortised cost is regarded as being closely related to the host contract. This is the case even if the debt and equity components of the instrument are separated, as the evaluation of the embedded derivative has to be performed prior to the separation of the equity component. *[IFRS 9.B4.3.5(e)]*. Similarly, the call option exercisable to extend the term of the instrument is not a separable embedded derivative as the option is at par and so is also closely related.

In the income statement any discretionary interest payments would be classified depending on whether the host is classified as a liability, in which case the payments would be interest, or as a compound instrument, in which case payments would be dividends (see section 8 below).

31 *IFRIC Update*, January 2014, available on the IFRS Foundation's website.

A further complication arises with the introduction of bank resolution regimes, such as the European Union's Banking Recovery and Resolution Directive (BRRD). These regimes subject certain financial instruments to bail-in, where banking regulators have the power to write down an instrument or convert it into another CET 1 instrument at their discretion.

As the right to convert the instrument is at the option of the regulator and not the issuer, the question arises whether this would mean that the instrument cannot be classified as equity. The exception for settlement in case of liquidation (see section 4.3.3 above) does not apply here as the regulator is likely to invoke the resolution tool well before liquidation occurs. IFRIC 2, which was developed with co-operatives and similar entities in mind, specifies that, if local laws and regulations in effect at the classification date unconditionally prevent the exercise of rights in accordance with the terms contained in the instrument's documentation, those rights must be ignored for the purpose of assessing whether the contract meets the definition of equity under IAS 32. *[IFRIC 2.8]*. However, this scenario is different from a scenario where the rights (e.g., the conversion or write-down of a financial instrument) are not part of the terms contained in the instrument's documentation but could be exercised by a regulator using local laws or regulation, which is generally the case with bank resolution regimes. It is important to note that, in the FICE DP (see section 12 below), the IASB wrote that IFRIC 2 was developed for a very specific fact pattern and that they did not intend to apply the analysis in IFRIC 2 more broadly.[32]

The main conclusion to be drawn from examples such as these is that the provisions of IAS 32, which were originally drafted in the mid-1990s to deal with 'traditional' convertible instruments, are not always adequate for dealing with the increasingly complex range of instruments available in the financial markets now. The IASB is endeavouring to address these issues as reflected in the FICE Exposure Draft, which was published by the IASB in November 2023, as discussed in section 12 below.

6.6.5 Foreign currency convertible bond

If an entity issues a bond in a currency other than its functional currency, the conversion option will not meet the definition of equity in IAS 32, even if the bond is convertible into a fixed number of shares. This is because a fixed amount of foreign currency (a currency different to the functional currency of the bond) is not a fixed amount of cash (see section 5.2.3 above). A foreign currency convertible bond is therefore classified as a financial liability under IAS 32, and then measured under the requirements of IFRS 9. An equity conversion option embedded in a financial liability is not considered by IFRS 9 to be clearly and closely related to the host contract and must be accounted for as a separate derivative financial instrument measured at fair value through profit or loss.

6.6.5.A Instrument issued by a foreign subsidiary convertible into equity the of parent

The IFRS IC's conclusion that (other than in the context of certain rights issues, see section 5.2.3.A above) a fixed amount of cash denominated in a currency other than the entity's functional currency is not a 'fixed amount' of cash (see section 5.2.3 above) leads to the rather counter-intuitive result that the classification of certain instruments in consolidated financial statements depends on the functional currency of the issuing entity.

If, in the Illustration in section 5.2.3 above, the UK entity's US subsidiary (with a functional currency of US dollars) issued the same $100 bond convertible into its own equity, convertible in turn into the UK parent's equity, the conversion right would (from the perspective of the US subsidiary) involve the issue of a fixed number of shares for a fixed amount of cash and thus be an equity instrument. Moreover, this classification would not change on consolidation since IFRS accounting standards has no concept of a group functional currency (see Chapter 16).

The IFRS IC discussed this issue at its meetings in July and November 2006. Specifically, it was asked to consider whether the fixed stated principal of the convertible instrument exchanged for equity of the parent on conversion can be considered 'fixed' if it is denominated in the functional currency of either the issuer of the exchangeable financial instruments (i.e., the US subsidiary in the example above) or the issuer of the equity instruments (i.e., the UK parent in the example).

The IFRS IC noted that a group does not have a functional currency. It therefore discussed whether a project needed to be added to its agenda to address which currency must be the reference point in determining whether the embedded conversion options are denominated in a foreign currency. The IFRS IC believed that the issue was sufficiently narrow that it was not expected to have widespread relevance in practice and therefore, decided not to take the issue onto its agenda.[33]

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32 Discussion Paper DP/2018/1: *Financial Instruments with Characteristics of Equity*, IASB, June 2018, para. 8.34. Available on the IFRS Foundation's website.

33 *IFRIC Update*, July 2006, available on the IFRS Foundation's website.

How we see it

In our view, given the absence of specific guidance, an entity may, as a matter of accounting policy, determine the classification, in its consolidated financial statements, of an instrument issued by a subsidiary that is convertible into the parent's shares, by reference either to that subsidiary's own functional currency or to the functional currency of the parent into whose equity the bond is convertible. This is because you can view the functional currency as being that of either:

- The subsidiary, because it is the party which is contractually obliged to deliver equity instruments, and therefore has exposure to the variability in the cash flows from the holders.

  Or

- The parent, as under the consolidation model in IFRS 10 Consolidated Financial Instruments a group is treated as a single entity, therefore, equity instruments issued by an entity in the group are treated as the equity of the group in the same way as if the parent had issued them.

The effect of a policy choice will be that, where the convertible instrument is denominated in a currency other than the designated reference functional currency, the consolidated financial statements will contain no equity component. This policy, and its consequences under IAS 32, must be applied consistently, as shown in Illustration 6-10 below.

Illustration 6-10: Convertible bond issued by a subsidiary with a functional currency different to that of the parent

Suppose that a UK entity with a functional currency of the pound sterling (GBP) has a US trading subsidiary with a functional currency of the US dollar (USD). The US subsidiary issues a bond convertible, at the holder's option, into equity of the UK parent.

If the parent's functional currency (GBP) is the reference currency, the accounting treatment of the holder's conversion right in the consolidated financial statements will be as follows:

- If the fixed stated principal of the bond is denominated in GBP: equity (stated principal of bond is fixed by reference to GBP).

  But

- If the fixed stated principal of the bond is denominated in a currency other than GBP: derivative (stated principal of bond is variable by reference to GBP).

If, however, the subsidiary's functional currency (USD) is the reference currency, a converse analysis applies, and the accounting treatment of the holder's conversion right in the consolidated financial statements will be as follows:

- If the fixed stated principal of the bond is denominated in USD: equity (stated principal of bond is fixed by reference to USD).

  But

- If the fixed stated principal of the bond is denominated in a currency other than USD: derivative (stated principal of bond is variable by reference to USD).

It may be that the IFRS IC's reluctance to issue guidance on this matter was influenced by the more subtle point that, in most cases, the issuing entity will not be, as in Illustration 6-10 above, a trading subsidiary, but rather a subsidiary created only for the purposes of the bond issue. IAS 21 suggests that the functional currency of such a 'single transaction' entity is the same as that of the parent for whose equity the bond will be exchanged, irrespective of the currency in which the bond is denominated (see Chapter 16 at section 4). In short, the IFRS IC was perhaps hinting that the real problem may be the misapplication of IAS 21 in the financial statements of the issuing subsidiary rather than the interpretation of IAS 32.

6.6.6 Convertibles with cash settlement at the option of the issuer

As discussed in section 5.2.8 above, IAS 32 requires a derivative with two or more settlement options to be treated as a financial asset or a financial liability unless all possible settlement alternatives would result in it being an equity instrument. Many convertible bonds currently in issue contain a provision whereby, if the holder exercises its conversion option, the issuer may instead pay cash equal to the fair value of the shares that it would otherwise have been required to deliver. This is to allow for unforeseen circumstances, such as an inability to issue the necessary number of shares to effect conversion at the appropriate time.

Where a bond has such a term, the conversion right is a derivative (in effect, a written call option over the issuer's own shares) which may potentially be settled in cash, such that there is a settlement alternative that does not result in it being an equity instrument. This means that the 'equity component' of a bond with an issuer cash settlement option is not in fact an equity instrument, but a financial liability. The financial reporting implication of this is that the conversion right must be accounted for as a derivative at fair value, with changes in value included in profit or loss, in other words the financial statements will reflect gains and losses based on the movement of the reporting entity's own share price.

6.6.7 Bond convertible into fixed percentage of equity

The terms of a convertible bond may allow conversion into a fixed percentage of outstanding shares of the issuer at the time of the conversion, so that the absolute number of shares to be issued is not fixed and is not known until conversion occurs. This raises the question of whether such a clause violates the 'fixed-for-fixed' criterion, or whether it can be seen as an anti-dilutive mechanism to keep the holder in the same economic position relative to other shareholders at all times (similarly to bonds whose conversion ratio is adjusted for changes in share capital, as discussed in section 5.1.2 above).

How we see it

Our view is that a conversion option that allows conversion into a fixed percentage of outstanding shares of the issuer cannot normally be classified as equity, because the entity's capital structure could change in ways that put the convertible bond holder into a better economic position relative to other shareholders.

6.6.8 Convertible bonds with down round or ratchet features

Some instruments that are convertible at a fixed price have clauses which provide that, if additional equity is subsequently issued at a price lower than the conversion price, then the conversion price is amended down to ensure the holders of the convertible instrument are not economically disadvantaged. These clauses are often called 'down round' or 'ratchet' clauses.

When assessing instruments with down round or ratchet clauses it is necessary to know whether the instrument or component being assessed is a non-derivative or a derivative instrument (see section 5.1.2 above, and also Chapter 42 at section 1). This is because, as discussed in section 5 above, there are two fixed-for-fixed tests in IAS 32.16(b).

In the case of a non-derivative instrument the test is whether there is a contractual obligation or not for the issuer to deliver a variable number of its own equity instruments. *[IAS 32.16(b)(i)]*. Therefore, the ability of the entity to prevent a down round or ratchet clause taking effect (by choosing not to issue shares at a lower price) is important and where that is the case the down round or ratchet feature is ignored.

In the case of a derivative instrument or derivative component of an instrument, the test is simply whether it will always be settled by exchanging a fixed number of shares for a fixed amount of cash or another financial instrument. *[IAS 32.16(b)(ii)]*. Therefore, the entity's ability to prevent the down round or ratchet clause taking effect does not affect the classification.

Illustration 6-11: Convertible bond with ratchet feature

A company, issues preference shares. The preference shares carry a discretionary dividend of 2%. The preference shareholders have a right to convert the preference shares into ordinary shares if there is an IPO or earlier if agreed by 60% of the preference shareholders. If not converted, preference shares are redeemable at par at the end of eight years from the issue date. The conversion ratio is fixed at inception at one ordinary share for one preference share. However, the ratio is subject to an anti-dilution clause. If the entity in future issues any new ordinary shares or convertible shares at a price or conversion price lower than the conversion price of the existing preference shares, the conversion price of the existing preference shares is adjusted down using a prescribed formula.

The requirement to redeem the issue at par after eight years creates a liability component which would be extinguished if the conversion option is exercised. As such, the presence of the redemption obligation makes the conversion option a derivative. In this case, the fact that the company has control over whether the ratchet feature is triggered through the issuance of new shares is not relevant. The derivative component cannot be settled only on a fixed-for-fixed basis and so the redemption obligation is a liability component.

7 Settlement of financial liability with equity instrument

Neither IAS 32 nor IFRS 9 specifically addresses the accounting treatment to be adopted where an entity issues non-convertible debt, but subsequently enters into an agreement with the debt holder to discharge all or part of the liability in exchange for an issue of equity. These transactions, which are sometimes referred to as 'debt for equity swaps', most often occur when the entity is in financial difficulties.

The IFRS IC noted that divergent accounting treatments for such transactions were being applied and decided to address this by developing an interpretation. As a result, IFRIC 19 was published in November 2009. *[IFRIC 19.1]*.

7.1 Scope and effective date of IFRIC 19

IFRIC 19 addresses the accounting by an entity when the terms of a financial liability are renegotiated and result in the entity issuing equity instruments to a creditor to extinguish all or part of the financial liability. It does not address the accounting by the creditor. *[IFRIC 19.2]*.

Further, the interpretation does not apply to transactions in situations where: *[IFRIC 19.3]*

- The creditor is also a direct or indirect shareholder and is acting in its capacity as a direct or indirect existing shareholder (see section 7.3 below).
- The creditor and the entity are controlled by the same party or parties before and after the transaction and the substance of the transaction includes an equity distribution by, or contribution to, the entity (see section 7.3 below).

  Or
- The extinguishment of the financial liability by issuing equity shares is in accordance with the original terms of the financial liability. This will most commonly arise on conversion of a convertible bond that has been subject to 'split accounting', the accounting for which is covered in section 6 above.

7.2 Requirements of IFRIC 19

Equity instruments issued to a creditor to extinguish all or part of a financial liability are treated as consideration paid and must normally be measured at their fair value at the date of extinguishment. However, if that fair value cannot be reliably measured, the equity instruments must be measured to reflect the fair value of the financial liability extinguished. The difference between the carrying amount of the financial liability and the consideration paid (including the equity instruments issued) must be recognised in profit or loss and must be disclosed separately. *[IFRIC 19.5, IFRIC 19.6, IFRIC 19.7, IFRIC 19.9, IFRIC 19.10, IFRIC 19.11]*.

These requirements are shown in the following simple Illustration:

Illustration 7-1: Discharge of liability for fresh issue of equity

During 20W4 an entity issued CU100 million bonds due to be repaid in 20X4. By 20X2 the entity is in some financial difficulty and reaches an agreement with the holders of the bonds whereby they will accept equity shares in the entity in full and final settlement of all amounts due under the bonds. On the date the agreement concludes, the carrying amount of the bonds is CU99 million and the fair value of the equity shares issued is CU60 million.

In this situation the entity would measure the equity instruments issued at their fair value of CU60 million and recognise a profit on extinguishment of CU39 million [CU99 million - CU60 million].

Debt for equity swaps often take place in situations when the terms of the financial liability such as covenants are breached and the liability has become, or will become, repayable on demand. Normally, the fair value of a financial liability with a demand feature is required by IFRS 13 to be measured at no less than the amount payable on demand, discounted from the first date that the amount could be required to be paid (see Chapter 15 at section 10.5). However, in the IASB's view, the fact that a debt for equity swap has occurred indicates that the demand feature is no longer substantive. Consequently, where the fair value of the equity instruments issued is based on the fair value of the liability extinguished, this particular aspect of IFRS 13 is not applied. *[IFRIC 19.7, IFRIC 19.BC22]*.

If only part of the financial liability is extinguished, some of the consideration paid might relate to a modification of the terms of the liability that remains outstanding. If so, the consideration paid must be allocated between the part of the liability extinguished and the part of the liability that remains outstanding. All relevant facts and circumstances relating to the transaction must be considered in making this allocation. *[IFRIC 19.8]*. Any consideration so allocated forms part of the assessment of whether the terms of that remaining liability have been substantially modified. If the remaining liability has been substantially modified, the modification must be accounted for as an extinguishment of the original liability and the recognition of a new liability in accordance with IFRS 9 (see Chapter 48 at section 6.2). *[IFRIC 19.10]*.

7.3 Debt for equity swaps with shareholders

As noted in section 7.1 above, a debt for equity swap is outside the scope of IFRIC 19 when the creditor is a shareholder acting in its capacity as such, or where the entity and the creditor are under common control and the substance of the transaction includes a distribution by, or capital contribution to, the entity.

How we see it

In our view, such transactions may be accounted for either in a manner similar to that required by IFRIC 19 or by recording the equity instruments issued at the carrying amount of the financial liability extinguished so that no profit or loss is recognised.

This latter method was in fact commonly applied to debt for equity swaps before the publication of IFRIC 19.

8 Interest, dividends, gains and losses

Extract from IAS 32

35 Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss. Distributions to holders of an equity instrument shall be recognised by the entity directly in equity. Transaction costs of an equity transaction shall be accounted for as a deduction from equity.

The basic principle of IAS 32 is that inflows and outflows of cash (and other assets) associated with equity instruments are recognised in equity and the net impact of inflows and outflows of cash (and other assets) associated with financial liabilities is ultimately recognised in profit or loss. Accordingly, IAS 32 requires:

- Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability to be recognised as income or expense in profit or loss.
- Distributions to holders of an equity instrument to be debited directly to equity.

  And
- The transaction costs of an equity transaction to be accounted for as a deduction from equity. *[IAS 32.35]*. This applies also to the costs of issuing equity instruments that are issued in connection with the acquisition of a business. *[IFRS 3.53]*.

The treatment of the costs and gains associated with instruments is determined by their classification in the financial statements under IAS 32, and not by their legal form. Thus, dividends paid on shares classified as financial liabilities (see section 4.5 above) will be recognised as an expense in profit or loss, not as an appropriation of equity.

The basic principle summarised above also applies to compound instruments and requires any payments in relation to the equity component to be recorded in equity and any payments in relation to the liability component to be recorded in profit or loss. (As discussed in section 6.6.4.B above, it is not clear whether this basic principle also applies when the full amount of the issuance proceeds of a compound instrument is allocated to the liability). A mandatorily redeemable preference share with dividends paid at the discretion of the entity results in the classification of a liability, equal to the net present value of the redemption amount and an equity classification equal to the excess of the proceeds over the liability component (the net present value of the redemption amount) (see section 4.5.1 above). Because the redemption obligation is classified as a liability, the unwinding of the discount on this component is recorded and classified as an interest expense. Any dividends paid, on the other hand, relate to the equity component and are therefore recorded as a distribution of profit. *[IAS 32.AG37]*.

Gains and losses associated with redemptions or refinancings of financial liabilities are recognised in profit or loss, whereas redemptions or refinancings of equity instruments are recognised as changes in equity. *[IAS 32.36]*. Similarly, gains and losses related to changes in the carrying amount of a financial liability are recognised as income or expense in profit or loss, even when they relate to an instrument that includes a right to the residual interest in the assets of the entity in exchange for cash or another financial asset (see section 4.6 above). However, IAS 32 notes that IAS 1 requires any gain or loss arising from the remeasurement of such an instrument to be shown separately in the statement of comprehensive income, where it is relevant in explaining the entity's performance. *[IAS 32.41]*.

Changes in the fair value of an instrument that meets the definition of an equity instrument are not recognised in the financial statements. *[IAS 32.36]*.

IAS 32 permits dividends classified as an expense (i.e., because they relate to an instrument, or component of an instrument, that is legally a share but classified as a financial liability under IAS 32) to be presented in the statement of comprehensive income or separate income statement (if presented), either with interest on other liabilities or as a separate item. The standard notes that, in some circumstances, separate disclosure is desirable, because of the differences between interest and dividends with respect to matters such as tax deductibility. Disclosure of interest and dividends is required by IAS 1 (see Chapter 3) and IFRS 7 (see Chapter 50). *[IAS 32.40]*.

8.1 Transaction costs of equity transactions

An entity typically incurs various costs in issuing or acquiring its own equity instruments, such as registration and other regulatory fees, amounts paid to legal, accounting and other professional advisers, printing costs and stamp duties. The transaction costs of an equity transaction are accounted for as a deduction from equity, but only to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided. The costs of an equity transaction that is abandoned are recognised as an expense. *[IAS 32.37]*.

Although IAS 32 does not provide a definition of directly attributable incremental costs, IFRS 9 does define an incremental cost as "one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument". *[IFRS 9 Appendix A]*. IFRS 9 also gives as examples of costs which do meet this criterion: fees and commission paid to agents, advisors, brokers and dealers, levies by regulatory agencies and security exchanges, and transfer taxes and duties. *[IFRS 9.B5.4.8]*. Such costs together with other directly related costs such as underwriting and printing costs are usually considered to be incremental and directly attributable to the issue of equity. Internal administrative or holding costs e.g., costs which would have been incurred in any case if the equity instrument had not been issued, are not considered to be incremental or directly attributable.

IAS 32 requires that only the costs of 'issuing or acquiring' equity are recognised in equity. Accordingly, it seems clear that the costs of listing shares already in issue must not be set off against equity but recognised as an expense.

The standard also requires that transaction costs that relate jointly to more than one transaction (for example, costs of a concurrent offering of some shares and a stock exchange listing of other shares) are allocated to those transactions using a basis of allocation that is rational and consistent with similar transactions. *[IAS 32.38]*. In its agenda decision of September 2008, the IFRS IC declined to provide further guidance on the extent of the transaction costs to be accounted for as a deduction from equity and how to allocate costs that relate jointly to more than one transaction, believing existing guidance to be adequate.

The IFRS IC noted that only incremental costs directly attributable to issuing new equity instruments or acquiring previously issued equity instruments are considered to be related to an equity transaction under IAS 32, but that the terms 'incremental' and 'directly attributable' are used with similar but not identical meanings in many Standards and Interpretations, leading to diversity in practice. It therefore recommended that the IASB develop common definitions for both terms to be added to the Glossary as part of the annual improvements process.[34] However, the IASB did not propose any such amendments in the next exposure draft published in August 2009.

It may well be that, in an initial public offering ('IPO'), for example, an entity simultaneously lists its existing equity and additional newly issued equity.

How we see it

Where an entity simultaneously lists its existing equity and additional newly issued equity, the total costs of the IPO are, in our view, allocated between the newly issued shares and the existing shares on a rational basis (e.g., by reference to the ratio of the number of new shares to the number of total shares), with only the proportion relating to the issue of new shares being deducted from equity.

However, in certain exceptional instances, facts and circumstances may indicate other possible bases of allocation of such costs. Examples of such different allocations could include:

- an allocation based on the proportion of the number of newly issued shares compared to the total number of shares sold through the offering (i.e., including the shares of existing shareholders who are selling shares as part of the offering). This approach may be appropriate if shareholders are using the listing as an exit strategy and the remaining existing shareholders have not incentivised or encouraged the entity to list for their benefit and there is evidence to support that the remaining shareholders do not intend to sell shares in the foreseeable future.
- an allocation entirely to the new shares sold. This approach may be appropriate if no existing shareholders are selling shares as part of the offering. Further, existing investors have not incentivised or encouraged the entity to list for their own benefit (i.e., the purpose of the listing is only to raise new capital) and there is evidence to support that the existing shareholders do not intend to sell shares in the foreseeable future.

34 *IFRIC Update*, September 2008, available on the IFRS Foundation's website.

Transaction costs that relate to the issue of a compound financial instrument are allocated to the liability and equity components of the instrument in proportion to the allocation of proceeds (see Illustration 6-1 in section 6.2 above). *[IAS 32.38]*.

IAS 32 does not specifically address the treatment of transaction costs incurred to acquire a non-controlling interest in a subsidiary, or to dispose of such an interest without loss of control in the consolidated financial statements of the parent entity. IFRS 10 indicates that "changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are equity transactions". *[IFRS 10.23]*.

How we see it

We believe that the transaction costs to acquire a non-controlling interest in a subsidiary, or to dispose of such an interest without loss of control, must be deducted from equity in accordance with the principles described above.

IAS 32 and IFRS 10 do not specify whether such costs must be allocated to the parent's equity or to the non-controlling interest, to the extent it is still reflected in the statement of financial position. In our view, this is a matter of choice based on the facts and circumstances surrounding the transaction, and any local legal requirements.

On any subsequent disposal of the subsidiary involving loss of control, the transaction costs previously recognised in equity must not be reclassified from equity to profit or loss, since they represent transactions with owners in their capacity as owners rather than components of other comprehensive income. *[IAS 1.106, IAS 1.109]*. The amount of transaction costs accounted for as a deduction from equity in the period is required to be disclosed separately under IAS 1 (see Chapter 3 at section 3.3) and IFRS 7 (see Chapter 50 at section 7.3).

Where a subsidiary issues shares, the transaction costs are accounted for as a deduction from equity, as discussed above. Where the subsidiary issues shares to a non-controlling interest as well as its parent, it gives rise to the question of how the transaction costs must be accounted for in the consolidated financial statements.

How we see it

In our view, transaction costs on the issue of shares by a subsidiary to a non-controlling interest and its parent must be allocated between the non-controlling interest and parent on a rational basis. The portion relating to shares issued to the non-controlling shareholders must be accounted for in the non-controlling interest. The portion relating to the parent entity no longer relates to an equity transaction at the group level and therefore is recognised as an expense in the consolidated financial statements.

8.2 Tax effects of equity transactions

As originally issued, IAS 32 required distributions to shareholders and transaction costs of equity instruments to be shown net of any tax benefit. *Annual Improvements to IFRSs 2009-2011 Cycle* issued in May 2012 amended IAS 32 to remove the reference to income tax benefit from IAS 32. This means that all tax effects of equity transactions are allocated in accordance with the general principles of IAS 12. *[IAS 32.35A]*.

Unfortunately, it is not entirely clear how IAS 12 requires the tax effects of certain equity transactions to be dealt with and judgement will be necessary in determining whether tax benefits in respect of distributions are to be recognised in equity or profit or loss (see Chapter 29 at section 10.3.5).

9 Treasury shares

Extract from IAS 32

33 If an entity reacquires its own equity instruments, those instruments ('treasury shares') shall be deducted from equity. No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. Such treasury shares may be acquired and held by the entity or by other members of the consolidated group. Consideration paid or received shall be recognised directly in equity.

Treasury shares are shares issued by an entity that are held by the entity. *[IAS 32.33]*. In consolidated financial statements, this will include shares issued by any group entity that are held by that entity or by any other members of the consolidated group. They will also include shares held by an employee benefit trust that is consolidated or treated as an extension of the reporting entity. Treasury shares will generally not include shares in a group entity held by any associates or the entity's pension fund. However, IAS 1 requires disclosure of own shares held by subsidiaries or associates, *[IAS 1.79(a)(vi)]*, and IAS 19 *Employee Benefits* requires disclosure of own shares held by defined benefit plans. *[IAS 19.143]*. Holdings of treasury shares may arise in a number of ways. For example:

- The entity holds the shares as the result of a direct transaction, such as a market purchase, or a buy-back of shares from shareholders as a whole, or a particular group of shareholders.
- The entity is in the financial services sector with a market-making operation that buys and sells its own shares along with those of other listed entities in the normal course of business, or holds them in order to 'hedge' issued derivatives.
- In consolidated financial statements:
  - The shares were purchased by another entity which subsequently became a subsidiary of the reporting entity, either through acquisition or changes in financial reporting requirements.

    Or
  - The shares have been purchased by an entity that is a consolidated SPE of the reporting entity.

The circumstances in which an entity is permitted to hold treasury shares are a matter for legislation in the jurisdiction concerned.

Treasury shares do not include own shares held by an entity on behalf of others, such as when a financial institution holds its own equity on behalf of a client. In such cases, there is an agency relationship and as a result those holdings are not included in the entity's statement of financial position, either as assets or as a deduction from equity. *[IAS 32.AG36]*.

If an entity reacquires its own equity instruments, IAS 32 requires those instruments to be deducted from equity. They are not recognised as financial assets, regardless of the reason for which they are reacquired. No gain or loss is recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. Accordingly, any consideration paid or received in connection with treasury shares must be recognised directly in equity. *[IAS 32.33, IAS 32.AG36]*.

IAS 1 requires the amount of treasury shares to be disclosed separately either on the face of the statement of financial position or in the notes (see Chapter 3 at section 3.1.6). In addition, IAS 32 requires an entity to make disclosure in accordance with IAS 24 *Related Party Disclosures* if the entity reacquires its own equity instruments from related parties (see Chapter 35 at section 4.1). *[IAS 32.34]*.

As in the case of the requirements for the treatment of the equity component of a compound financial instrument (see section 6 above), IAS 32 does not prescribe precisely what components of equity must be adjusted as the result of a treasury share transaction. This may have been to ensure that there was no conflict between, on the one hand, the basic requirement of IAS 32 that there must be an adjustment to equity and, on the other hand, the legal requirements of various jurisdictions as to exactly how that adjustment must be allocated within equity.

9.1 Transactions in own shares not at fair value

The requirement of IAS 32 that no profits or losses must ever be recognised on transactions in own equity instruments differs from the approach taken in IFRS 2. If an employee share award is characterised as an equity instrument under IFRS 2 (a 'share-settled' award) and settled in cash (or other assets) at more than its fair value, the excess of the consideration over the fair value is recognised as an expense (see Chapter 30).

It is not clear whether or not the IASB specifically considered transactions in own equity other than at fair value in the context of IAS 32, particularly since the relevant provisions of IAS 32 essentially reproduce requirements previously contained in SIC-16 *Share Capital - Reacquired Own Equity Instruments (Treasury Shares)*, which was implicitly addressing market purchases and sales at fair value. In other words, the provision can be seen merely as clarifying that, if an entity buys one of its own shares in the market for CU10 which it later reissues in the market at CU12 or CU7, it has not made, respectively, a profit of CU2 or a loss of CU3.

This is slightly different to the situation where an entity purchases an equity instrument for more than its fair value i.e., if the original purchase had been for CU11 when the market price was CU10. Such a transaction could occur, for example where the entity wishes to rid itself of a troublesome shareholder or group of shareholders. In this case, the entity might have to offer a premium specific to the holder over and above the 'true' fair value of the equity instruments concerned. However, in general, where an entity purchases an equity instrument for more than its fair value, this can be indicative that other consideration has been received by the entity. It must be noted that IFRS 2 is explicit that any excess of the consideration over the fair value of an equity instrument is recognised as an expense. *[IFRS 2.28(b)]*.

A transaction in which the entity issues shares (or reissues treasury shares) for cash or other assets with a fair value lower than the fair value of the shares would *prima facie* fall within the scope of IFRS 2, requiring the shortfall to be accounted for under IFRS 2 (see Chapter 30 at section 2.2.2.C).

9.2 IFRS 17 treasury share election

An entity applying IFRS 17 *Insurance Contracts* may elect not to deduct a treasury share from equity, when it either:

- Operates an investment fund that provides investors with benefits determined by units in the fund and recognises the amounts to be paid to those investors as financial liabilities.

  Or

- Issues groups of insurance contracts with direct participation features while holding the underlying items.

Where an entity reacquires its own equity to hold in an investment fund or as an underlying item in the above arrangements, it may elect to continue to account for the treasury share as equity with the reacquired instrument being accounted as if it were a financial asset measured through profit or loss in accordance with IFRS 9. The election is irrevocable and made on an instrument-by-instrument basis. *[IAS 32.33A]*.

10 'Hedging' of instruments classified as equity

A consequence of the requirement, discussed in sections 4.5.2 to 4.5.6 above, to treat discretionary instruments with certain debt-like characteristics as equity is that the issuer will not be able to adopt hedge accounting in respect of any instrument taken out as a hedge of the instrument (e.g., a receive fixed, pay floating interest rate swap taken out to hedge a fixed rate discretionary dividend on non-redeemable shares). This is because neither IFRS 9 nor IAS 39 *Financial Instruments: Recognition and Measurement*, if applicable, recognises a hedge of own equity as a valid hedging relationship (see Chapter 49).

Accordingly, if an issuer of an equity instrument bearing a fixed-rate discretionary coupon or dividend enters into an interest rate swap to hedge its cash outflows, the swap will be accounted for under the normal rules for derivatives not forming part of a hedging relationship i.e., at fair value with all value changes recognised in profit or loss (see Chapter 49 and Chapter 50). Although, economically speaking, any such gains and losses are offset by equal gains and losses (due to interest rate movements) on the shares, the latter, like all movements in the fair value of own equity, are ignored for financial reporting purposes under IFRS accounting standards.

11 Derivatives over own equity instruments

IAS 32 provides several detailed examples of the accounting treatment required, under the provisions of revised IAS 32 and IFRS 9, to be adopted by an entity for derivative contracts over its own equity instruments. Examples are given of each of the main possible permutations, namely:

- A forward purchase (see section 11.1.1 below)
- A forward sale (see section 11.1.2 below)
- 'Back-to-back' forward contracts (see section 11.1.3 below)
- A purchased call option (see section 11.2.1 below)
- A written call option (see section 11.2.2 below)
- A purchased put option (see section 11.3.1 below)

  And
- A written put option (see section 11.3.2 below)

All such contracts can be either:

(a) Net cash-settled (i.e., the contract provides that the parties will compare the fair value of the shares to be delivered by the seller to the amount of cash payable by the buyer and make a cash payment between themselves for the difference).

(b) Net share-settled (i.e., the contract provides that the parties will compare the fair value of the shares to be delivered by the seller to the amount of cash payable by the buyer and make a transfer between themselves of as many of the entity's shares as have a fair value equal to the difference).

(c) Gross settled (i.e., the contract provides that the seller will deliver shares to the buyer in exchange for cash).

  Or

(d) Subject to various settlement options, whereby the manner of settlement is not predetermined, and instead one or other party can choose the manner of settlement (i.e., gross, net cash or net shares).

The examples consider the above settlement options in turn for the main possible permutations of derivatives over own equity instruments.

All derivative contracts over own equity, where settlement is not exclusively by an exchange of a fixed number of shares for a fixed amount of cash, do not meet the definition of equity instruments in IAS 32 and are, in general, treated as derivative financial assets or liabilities (see section 5.2.8 above). IFRS 9, requires such contracts to be accounted for at fair value through profit or loss (see Chapter 45). Exemption to this rule applies to forward purchases and written put options with an option to settle gross (see sections 11.1.1 and 11.3.2 below).

11.1 Forward contracts

11.1.1 Forward purchase

In a forward purchase transaction, the entity and a counterparty agree that on a given future date the counterparty will sell a given number of the entity's shares to the entity. Such a contract is shown in Illustration 11-1 below. *[IAS 32.IE2-6]*.

Illustration 11-1: Forward purchase of shares

The reporting entity (A), which has a functional currency of CU and a year end of 31 December, and another party (B) enter into a forward contract for the purchase of A's shares by A, for which the following are the major assumptions.

Contract date	1 February 20X2
Maturity date	31 January 20X3
Fixed forward price to be paid on 31 January 20X3	CU104
Present value of forward price on 1 February 20X2	CU100
Number of shares under contract	1,000
Market price per share on 1 February 20X2	CU100
Market price per share on 31 December 20X2	CU110
Market price per share on 31 January 20X3	CU106
Fair value of forward to A on 1 February 20X2	CU0
Fair value of forward to A on 31 December 20X2	CU6,300
Fair value of forward to A on 31 January 20X3	CU2,000

For simplicity, it is assumed that no dividends are paid on the underlying shares (i.e., the 'carry return' is zero) so that the present value of the forward price equals the spot price when the fair value of the forward contract is zero. The fair value of the forward has been computed as the difference between the market share price and the present value of the fixed forward price. At settlement date this is CU2,000 representing 1,000 shares at CU2, being the difference between the market price of CU106 and the contract price of CU104.

A Net cash settlement

If the contract is entered into as net cash-settled on 1 February 20X2, settlement on 31 January 20X3 will take the form of receipt or delivery by A of a cash payment for the difference between the fair value of 1,000 of A's own shares, at 31 January 20X3, and CU104,000 (i.e., 1,000 shares at the forward price of CU104 per share). Since IAS 32 classifies such contracts as derivative financial assets or liabilities (see sections 11 and 5.2.7 above), which are carried at fair value through profit or loss under IFRS 9, A records the following accounting entries:

1 February 20X2

No entry is required because the fair value of the contract is zero at inception and no cash is paid or received

31 December 20X2

Dr	Forward contract (statement of financial position)		CU6,300	
	Cr	Gain on forward (profit or loss)		CU6,300

To record movement in fair value of forward from zero to CU6,300

31 January 20X3

Dr	Loss on forward (profit or loss)		CU4,300	
	Cr	Forward contract (statement of financial position)		CU4,300

To record movement in fair value of forward from CU6,300 to CU2,000

Dr	Cash		CU2,000	
	Cr	Forward contract (statement of financial position)		CU2,000

To record settlement of forward by payment of CU2,000 by B to A

B Net share settlement

If the contract is entered into as net share-settled on 1 February 20X2, settlement on 31 January 20X3 will take the form of receipt or delivery by A of as many of A's shares as have a fair value equal to the difference between the fair value, at 31 January 20X3, of 1,000 of A's own shares and CU104,000 (i.e., 1,000 shares at the forward price of CU104 per share). Because IAS 32 classifies such contracts as derivative financial assets or liabilities (see sections 11 and 5.2.7 above), which are carried at fair value through profit or loss under IFRS 9, A records the following accounting entries:

1 February 20X2

No entry is required because the fair value of the contract is zero at inception and no cash is paid or received

31 December 20X2

Dr	Forward contract (statement of financial position)		CU6,300	
	Cr	Gain on forward (profit or loss)		CU6,300

To record movement in fair value of forward from zero to CU6,300

31 January 20X3

Dr	Loss on forward (profit or loss)		CU4,300	
	Cr	Forward contract (statement of financial position)		CU4,300

To record movement in fair value of forward from CU6,300 to CU2,000

Dr	Equity		CU2,000	
	Cr	Forward contract (statement of financial position)		CU2,000

To record net settlement of forward by transfer of CU2,000 worth of A's shares (CU2,000/106=18.9 shares) by B to A. This is shown as a deduction from equity in accordance with IAS 32's requirements for treasury shares (see section 9 above).

C Gross settlement

If the contract is entered into as gross-settled on 1 February 20X2, settlement on 31 January 20X3 will take the form of receipt of 1,000 own shares by A in exchange for a payment of CU104,000 to B. IAS 32 classifies this derivative contract as an equity instrument giving rise to a financial liability for the present value of the purchase price amount payable in one year's time (see section 5.3 above). On the assumption that A accounts for this liability under the effective interest method in IFRS 9, A records the following accounting entries:

1 February 20X2

Dr	Equity		CU100,000	
	Cr	Liability for forward contract (statement of financial position)		CU100,000

To record net present value of liability on forward contract

31 December 20X2

Dr	Interest expense		CU3,660	
	Cr	Liability for forward contract (statement of financial position)		CU3,660

To accrue interest, under the effective interest rate method, on the liability to settle forward contract

31 January 20X3

Dr	Interest expense		CU340	
	Cr	Liability for forward contract (statement of financial position)		CU340

To accrue further interest, under the effective interest rate method, on the liability to settle forward contract

Dr	Liability for forward contract (statement of financial position)		CU104,000	
	Cr	Cash		CU104,000

To record settlement of the liability in cash

D Settlement options

If there are settlement options (such as net in cash, net in shares or by an exchange of a fixed amount of cash for a fixed number of shares), the forward contract is a financial asset or a financial liability - see section 5.2.7 above. The contract does not meet the definition of an equity instrument, because it can be settled otherwise than by delivery of a fixed amount of cash for a fixed number of equity instruments. If one of the settlement alternatives is gross settlement by an exchange of cash for shares, A recognises a liability for the obligation to deliver cash. Otherwise, A accounts for the forward contract as a derivative.

The implementation guidance to IAS 32 states that A must recognise a liability "if one of the settlement alternatives is to exchange cash for shares". As drafted, this applies whether the choice of settlement rests with A or B. This seems curious since, where A would always have the choice of net settlement, there would be no obligation for A to settle gross. We assume that the example is written on the presumption that the choice of settlement would normally rest with the counterparty rather than the entity or circumstances could arise in which the entity could not prevent gross settlement occurring, e.g., if the shares ceased to be listed before settlement of the contract. Paragraph 23 in the main body of the standard is clear that an equity contract gives rise to a liability for the purchase price of the shares only where there is an obligation for the entity to purchase its own equity.

How we see it

In our view, where the entity could in all circumstances choose to net settle a derivative on own shares, it is acceptable not to record a gross liability, and to account for the contract as a derivative financial asset or derivative financial liability.

If the only situation in which the entity could be forced to settle gross rather than net is where the obligation is not specified in the contract but in statute or regulation, it will also be necessary to assess whether this obligation is required to be considered (see sections 4.2 and 4.6.6 above).

11.1.2 Forward sale

In a forward sale transaction, the entity and a counterparty agree that on a given future date the entity will sell (or issue) a given number of the entity's shares to the counterparty. Such a contract is shown in Illustration 11-2 below. *[IAS 32.IE7-11]*.

Illustration 11-2: Forward sale of shares

The reporting entity (A), which has a functional currency of CU and a year end of 31 December, and another party (B) enter into a forward contract for the purchase of A's shares by B, for which the following are the major assumptions.

Contract date	1 February 20X2
Maturity date	31 January 20X3
Fixed forward price to be paid on 31 January 20X3	CU104
Present value of forward price on 1 February 20X2	CU100
Number of shares under contract	1,000
Market price per share on 1 February 20X2	CU100
Market price per share on 31 December 20X2	CU110
Market price per share on 31 January 20X3	CU106
Fair value of forward to A on 1 February 20X2	CU0
Fair value of forward to A on 31 December 20X2	CU(6,300)
Fair value of forward to A on 31 January 20X3	CU(2,000)

For simplicity, it is assumed that no dividends are paid on the underlying shares (i.e., the 'carry return' is zero) so that the present value of the forward price equals the spot price when the fair value of the forward contract is zero. The fair value of the forward has been computed as the difference between the market share price and the present value of the fixed forward price. At settlement date this is negative CU2,000 representing 1,000 shares at CU2, being the difference between the market price of CU106 and the contract price of CU104.

A Net cash settlement

If the contract is entered into as net cash-settled on 1 February 20X2, settlement on 31 January 20X3 will take the form of receipt or delivery by A of a cash payment for the difference between the fair value of 1,000 of A's own shares, at 31 January 20X3, and CU104,000 (i.e., 1,000 shares at the forward price of CU104 per share). Since IAS 32 classifies such contracts as derivative financial assets or liabilities (see sections 11 and 5.2.7 above), which are carried at fair value through profit or loss under IFRS 9, A records the following accounting entries:

1 February 20X2

No entry is required because the fair value of the contract is zero at inception and no cash is paid or received.

31 December 20X2

Dr	Loss on forward (profit or loss)		CU6,300	
	Cr	Forward contract (statement of financial position)		CU6,300

To record movement in fair value of forward from zero to CU(6,300)

31 January 20X3

Dr	Forward contract (statement of financial position)		CU4,300	
	Cr	Gain on forward (profit or loss)		CU4,300

To record movement in fair value of forward from CU(6,300) to CU(2,000)

Dr	Forward contract (statement of financial position)		CU2,000	
	Cr	Cash		CU2,000

To record net settlement of forward by payment of CU2,000 cash by A to B

B Net share settlement

If the contract is entered into as net share-settled on 1 February 20X2, settlement on 31 January 20X3 will take the form of receipt or delivery by A of a payment of as many of A's shares as have a fair value equal to the difference between the fair value, at 31 January 20X3, of 1,000 of A's own shares and CU104,000 (i.e., 1,000 shares at the forward price of CU104 per share). As IAS 32 classifies such contracts as derivative financial assets or liabilities (see sections 11 and 5.2.7 above), which are carried at fair value through profit or loss under IFRS 9, A records the following accounting entries:

1 February 20X2

No entry is required because the fair value of the contract is zero at inception

31 December 20X2

Dr	Loss on forward (profit or loss)		CU6,300	
	Cr	Forward contract (statement of financial position)		CU6,300

To record movement in fair value of forward from zero to CU(6,300)

31 January 20X3

Dr	Forward contract (statement of financial position)		CU4,300	
	Cr	Gain on forward (profit or loss)		CU4,300

To record movement in fair value of forward from CU(6,300) to CU(2,000)

Dr	Forward contract (statement of financial position)		CU2,000	
	Cr	Equity		CU2,000

To record net settlement of forward by delivery of CU2,000 worth of A's shares to B (CU2,000/106=18.9 shares)

C Gross settlement

If the contract is entered into as gross-settled on 1 February 20X2, settlement on 31 January 20X3 will take the form of delivery of 1,000 own shares by A to B in exchange for a payment of CU104,000. IAS 32 classifies this derivative contract as an equity instrument (see section 5.4 above) and therefore no entries are recorded other than on settlement on the contract. While a forward sale is economically a 'mirror' of a forward purchase and both are classified as equity instruments, the accounting impact is different. A forward sale does not result in any accounting entries until the shares are finally issued/delivered, while a forward purchase establishes an obligation to pay the settlement amount and therefore meets the definition of a financial liability which needs to be recorded upon entering the contract (see part C of Illustration 11-1 above in section 11.1.1).

31 January 20X3

Dr	Cash		CU104,000	
	Cr	Equity		CU104,000

To record settlement of forward contract through delivery of 1,000 shares for the payment of CU104,000

D Settlement options

If there are settlement options (such as net in cash, net in shares or by an exchange of cash and shares), the forward contract is a financial asset or a financial liability - see section 5.2.8 above. A accounts for the forward contract as a derivative (as in A and B above), with the accounting entry made on settlement determined by the manner of settlement (i.e., equity or cash).

11.1.3 'Back-to-back' forward contracts

The accounting treatment in sections 11.1.1 and 11.1.2 above produces rather strange results when applied to 'back-to-back' forward contracts, such as might be entered into by a financial institution with two different clients. Illustration 11-3 below illustrates the point.

Illustration 11-3: 'Back-to-back' forward contracts

Suppose that a bank entered into the forward purchase contract in Illustration 11-1 in section 11.1.1 above with a client and laid off its risk by entering into the reciprocal forward sale contract in Illustration 11-2 in section 11.1.2 above with a second client. If both contracts are required to be settled gross, the overall effect of the accounting entries required to be made by the bank (assuming that the bank was the reporting entity) in Illustration 11-1 and Illustration 11-2 above can be summarised as set out below. Note that these are not the actual entries that would be made, but the arithmetical sum of all the entries:

	CU	CU
Profit or loss (interest expense on liability for purchase contract)	4,000	
Equity (CU104,000 on sale less CU100,000 on purchase)		4,000

If the purchase contract is required to be settled gross, but the sale contract net in cash, the required accounting entries (again, not the actual entries, but the arithmetical sum of all the entries) can be summarised as:

	CU	CU
Profit or loss (loss on sale contract CU2,000 plus interest on liability for purchase contract CU4,000)	6,000	
Equity (purchase contract)	100,000	
Cash (CU104,000 on purchase, CU2,000 on sale)		106,000

If the purchase contract is required to be settled net in cash, but the sale contract gross, the required accounting entries (again, not the actual entries, but the arithmetical sum of all the entries) can be summarised as:

	CU	CU
Cash (CU104,000 in on sale, CU2,000 in on purchase)	106,000	
Profit or loss (gain on purchase contract)		2,000
Equity (sale contract)		104,000

If both contracts are net settled, no net gain or loss arises.

Some might argue that this exposes a flaw in the requirements of IAS 32. Self-evidently, these contracts are matched and therefore, if both run to term, will give rise to no economic profit or loss, irrespective of how they are settled. However, IAS 32 requires three different results to be shown depending on whether both contracts are settled gross, or one gross and the other net. This is less understandable in the case where both contracts are settled gross. However, in cases where one contract is settled net and that contract gives rise to an initial receipt or payment of cash, then some difference is bound to occur due to interest effects.

11.2 Call options

11.2.1 Purchased call option

In a purchased call option, the entity pays a counterparty for the right, but not the obligation, to purchase a given number of its own equity instruments from the counterparty for a fixed price at a future date. The accounting for such a contract is shown in Illustration 11-4 below. *[IAS 32.IE12-16]*.

Illustration 11-4: Purchased call option on own shares

The reporting entity (A), which has a functional currency of CU and a year end of 31 December, purchases a call option over its own shares from another party (B), for which the following are the major assumptions.

Contract date	1 February 20X2
Exercise date (European terms - i.e., can be exercised only on maturity)	31 January 20X3
Fixed exercise price to be paid on 31 January 20X3	CU102
Number of shares under contract	1,000
Market price per share on 1 February 20X2	CU100
Market price per share on 31 December 20X2	CU104
Market price per share on 31 January 20X3	CU104
Fair value of option to A on 1 February 20X2	CU5,000
Fair value of option to A on 31 December 20X2	CU3,000
Fair value of option to A on 31 January 20X3	CU2,000

The fair value of the option would be computed using an option pricing model and would be a function of a number of factors, principally the market value of the shares, the exercise price, and the time value of money.

A Net cash settlement

If the contract is entered into as net cash-settled on 1 February 20X2, then A can, on the exercise date 31 January 20X3, require B to make a cash payment to A for the excess, if any, of the fair value of 1,000 of A's own shares, as of 31 January 20X3, over CU102,000 (i.e., 1,000 shares at the option price of CU102 per share). Since IAS 32 classifies such contracts as derivative financial assets (see sections 11 and 5.2.7 above), which are carried at fair value through profit or loss under IFRS 9, A records the following accounting entries:

1 February 20X2

Dr	Call option asset		CU5,000	
	Cr	Cash		CU5,000

Payment of option premium (equal to fair value of option) to B

31 December 20X2

Dr	Loss on option (profit or loss)		CU2,000	
	Cr	Call option asset		CU2,000

To record movement in fair value of option from CU5,000 to CU3,000

31 January 20X3

Dr	Loss on option (profit or loss)		CU1,000	
	Cr	Call option asset		CU1,000

To record movement in fair value of option from CU3,000 to CU2,000

Dr	Cash		CU2,000	
	Cr	Call option asset		CU2,000

To record net settlement of option by payment of CU2,000 cash by B to A

B Net share settlement

If the contract is entered into as net share-settled on 1 February 20X2, then A can, on the exercise date 31 January 20X3, require B to deliver to A as many of A's own shares as have a fair value equal to any excess of 1,000 of A's own shares fair value, as of 31 January 20X3 over CU102,000 (i.e., 1,000 shares at the option price of CU102 per share). Since IAS 32 classifies such contracts as derivative financial assets (see sections 11 and 5.2.7 above), which are carried at fair value through profit or loss under IFRS 9, A records the following accounting entries:

1 February 20X2

Dr	Call option asset		CU5,000	
	Cr	Cash		CU5,000

Payment of option premium (equal to fair value of option) to B

31 December 20X2

Dr	Loss on option (profit or loss)		CU2,000	
	Cr	Call option asset		CU2,000

To record movement in fair value of option from CU5,000 to CU3,000

31 January 20X3

Dr	Loss on option (profit or loss)		CU1,000	
	Cr	Call option asset		CU1,000

To record movement in fair value of option CU3,000 to CU2,000

Dr	Equity		CU2,000	
	Cr	Call option asset		CU2,000

To record net settlement of option by transfer of CU2,000 worth of A's shares by B to A. This is shown as a deduction from equity in accordance with IAS 32*'s requirements for treasury shares (see section 9 above).*

C Gross settlement

If the contract is entered into as gross-settled, on 1 February 20X2, then A can, on the exercise date 31 January 20X3, require B to deliver 1,000 of A's shares in return for a payment by A of CU102,000. IAS 32 classifies such a derivative contract as an equity instrument (see section 5.4 above); therefore no entries are recorded, other than to record the cash flows arising under the contract:

1 February 20X2

Dr	Equity		CU5,000	
	Cr	Cash		CU5,000

Payment of option premium (equal to fair value of option) to B

31 January 20X3

Dr	Equity		CU102,000	
	Cr	Cash		CU102,000

To record gross settlement of option by payment of CU102,000 cash to B in exchange for 1,000 own shares. This is shown as a deduction from equity in accordance with IAS 32*'s requirements for treasury shares (see section 9 above).*

If the option had lapsed unexercised, because the market price of A's shares had fallen below CU102 as at 31 January 20X3, the CU5,000 premium would remain in equity, even though it is, from an economic perspective, clearly a loss rather than an amount paid to repurchase A's own shares. This is because IFRS accounting standards regards any holder of an instrument classified as equity under IAS 32 as an 'owner'.

In contrast to the treatment of a gross-settled forward purchase (see section 11.1.1 above) and a gross-settled written put option (see section 11.3.2 below), which also require a gross outflow of cash on settlement, there is no requirement to record a liability at the outset of the contract on which interest is accrued during the period of the contract. This is because:

- In a gross-settled forward purchase or written put option, the entity can be required to make a payment of cash.

  But

- In a purchased call option, there is no liability since the entity has no obligation to exercise its right to call for the shares even if the option is 'in the money' and it is in the entity's interest to do so.

D Settlement options

If there are different settlement options (such as net in cash, net in shares or by an exchange of cash and shares), the option is a financial asset. A accounts for the forward contract as a derivative (as in A and B above), with the accounting entry made on settlement determined by the manner of settlement (i.e., equity or cash).

11.2.2 Written call option

In a written call option, the entity receives a payment from a counterparty for granting to the counterparty the right, but not the obligation, to purchase a given number of the entity's own equity instruments from the entity for a fixed price at a future date. The accounting for such a contract is shown in Illustration 11-5 below. *[IAS 32.IE17-21]*.

Illustration 11-5: Written call option on own shares

The reporting entity (A), which has a functional currency of CU and a year end of 31 December, writes a call option over its own shares with another party (B), for which the following are the major assumptions.

Contract date	1 February 20X2
Exercise date (European terms - i.e., can be exercised only on maturity)	31 January 20X3
Fixed exercise price to be paid on 31 January 20X3	CU102
Number of shares under contract	1,000
Market price per share on 1 February 20X2	CU100
Market price per share on 31 December 20X2	CU104
Market price per share on 31 January 20X3	CU104
Fair value of option to A on 1 February 20X2	CU(5,000)
Fair value of option to A on 31 December 20X2	CU(3,000)
Fair value of option to A on 31 January 20X3	CU(2,000)

The fair value of the option would be computed using an option pricing model and would be a function of a number of factors, principally the market value of the shares, the exercise price, and the time value of money.

A Net cash settlement

If the contract is entered into as net cash-settled on 1 February 20X2, then B can, on the exercise date 31 January 20X3, require A to make a cash payment to B for the excess, if any, of the fair value of 1,000 of A's own shares, as of 31 January 20X3, over CU102,000 (i.e., 1,000 shares at the option price of CU102 per share). Since IAS 32 classifies such contracts as derivative financial liabilities (see sections 11 and 5.2.7 above), which are carried at fair value through profit or loss under IFRS 9, A records the following accounting entries:

1 February 20X2

Dr	Cash		CU5,000	
	Cr	Call option liability		CU5,000

Receipt of option premium (equal to fair value of option) from B

31 December 20X2

Dr	Call option liability		CU2,000	
	Cr	Gain on option (profit or loss)		CU2,000

To record movement in fair value of option from CU(5,000) to CU(3,000)

31 January 20X3

Dr	Call option liability		CU1,000	
	Cr	Gain on option (profit or loss)		CU1,000

To record movement in fair value of option from CU(3,000) to CU(2,000)

Dr	Call option liability		CU2,000	
	Cr	Cash		CU2,000

To record net settlement of option by payment of CU2,000 cash to B

B Net share settlement

If the contract is entered into as net share-settled on 1 February 20X2, then B can, on the exercise date 31 January 20X3, require A to deliver to B as many of A's own shares as have a fair value equal to any excess of 1,000 of A's own shares, as of 31 January 20X3, over CU102,000 (i.e., 1000 shares at the option price of CU102 per share). Since IAS 32 classifies such contracts as derivative financial liabilities (see sections 11 and 5.2.7 above), which are carried at fair value through profit or loss under IFRS 9, A records the following accounting entries:

1 February 20X2

Dr	Cash		CU5,000	
	Cr	Call option liability		CU5,000

Receipt of option premium (equal to fair value of option) from B

31 December 20X2

Dr	Call option liability		CU2,000	
	Cr	Gain on option (profit or loss)		CU2,000

To record movement in fair value of option from CU(5,000) to CU(3,000)

31 January 20X3

Dr	Call option liability		CU1,000	
	Cr	Gain on option (profit or loss)		CU1,000

To record movement in fair value of option from CU(3,000) to CU(2,000)

Dr	Call option liability		CU2,000	
	Cr	Equity		CU2,000

To record net settlement of option by issue of CU2,000 worth of A's shares to B

C Gross settlement

If the contract is entered into as gross-settled, on 1 February 20X2, then B can, on the exercise date 31 January 20X3, require A to deliver 1,000 of A's shares in return for a payment by B of CU102,000. IAS 32 classifies this derivative contract as an equity instrument (see section 5.4 above); therefore no entries are recorded, other than to record the cash flows arising under the contract:

1 February 20X2

Dr	Cash		CU5,000	
	Cr	Equity		CU5,000

Receipt of option premium (equal to fair value of option) to B

31 January 20X3

Dr	Cash		CU102,000	
	Cr	Equity		CU102,000

To record gross settlement of option by receipt of CU102,000 cash from B in exchange for 1,000 of A's own shares.

If the option had lapsed unexercised, because the market price of A's shares had fallen below CU102 as at 31 January 20X2, the CU5,000 premium would remain in equity, even though it is, from an economic perspective, clearly a gain rather than an amount received from an owner. This is because IFRS accounting standards regards any holder of an instrument classified as equity under IAS 32 as an 'owner'.

D Settlement options

If there are different settlement options (such as net in cash, net in shares or by an exchange of cash and shares), the option is a financial liability. A accounts for the forward contract as a derivative (as in A and B above), with the accounting entry made on settlement determined by the manner of settlement (i.e., equity or cash).

11.3 Put options

11.3.1 Purchased put option

In a purchased put option, the entity makes a payment to a counterparty for the right, but not the obligation, to require the counterparty to purchase a given number of the entity's own equity instruments from the entity for a fixed price at a future date. The accounting for such a contract is shown in Illustration 11-6 below. *[IAS 32.IE22-26]*.

Illustration 11-6: Purchased put option on own shares

The reporting entity (A), which has a functional currency of CU and a year end of 31 December, purchases a put option over its own shares from another party (B), for which the following are the major assumptions.

Contract date	1 February 20X2
Exercise date (European terms - i.e., can be exercised only on maturity)	31 January 20X3
Fixed exercise price to be paid on 31 January 20X3	CU98
Number of shares under contract	1,000
Market price per share on 1 February 20X2	CU100
Market price per share on 31 December 20X2	CU95
Market price per share on 31 January 20X3	CU95
Fair value of option to A on 1 February 20X2	CU5,000
Fair value of option to A on 31 December 20X2	CU4,000
Fair value of option to A on 31 January 20X3	CU3,000

The fair value of the option would be computed using an option pricing model and would be a function of number of factors, principally the market value of the shares, the exercise price, and the time value of money.

A Net cash settlement

If the contract is entered into as net cash-settled on 1 February 20X2, then A can, on the exercise date 31 January 20X3, require B to make a cash payment to A for the excess, if any, of CU98,000 (i.e., 1,000 shares at the option price of CU98 per share) over the fair value of 1,000 of A's own shares, as of 31 January 20X3. Because IAS 32 classifies such contracts as derivative financial assets or financial liabilities (see sections 11 and 5.2.7 above), which are carried at fair value through profit or loss under IFRS 9, A records the following accounting entries:

1 February 20X2

Dr	Put option asset		CU5,000	
	Cr	Cash		CU5,000

Payment of option premium (equal to fair value of option) to B

31 December 20X2

Dr	Loss on option (profit or loss)		CU1,000	
	Cr	Put option asset		CU1,000

To record movement in fair value of option from CU5,000 to CU4,000

31 January 20X3

Dr	Loss on option (profit or loss)		CU1,000	
	Cr	Put option asset		CU1,000

To record movement in fair value of option from CU4,000 to CU3,000

Dr	Cash		CU3,000	
	Cr	Put option asset		CU3,000

To record net settlement of option by receipt of CU3,000 cash from B

B Net share settlement

If the contract is entered into as net share-settled on 1 February 20X2, then A can, on the exercise date 31 January 20X3, require B to deliver to A as many of A's own shares as have a fair value equal to any excess of CU98,000 (i.e., 1,000 shares at the option price of CU98 per share) over the fair value of 1,000 of A's own shares, as of 31 January 20X3. Because IAS 32 classifies such contracts as derivative financial assets (see sections 11 and 5.2.7 above), which are carried at fair value through profit or loss under IFRS 9, A records the following accounting entries:

1 February 20X2

Dr	Put option asset		CU5,000	
	Cr	Cash		CU5,000

Payment of option premium (equal to fair value of option) to B

31 December 20X2

Dr	Loss on option (profit or loss)		CU1,000	
	Cr	Put option asset		CU1,000

To record movement in fair value of option from CU5,000 to CU4,000

31 January 20X3

Dr	Loss on option (profit or loss)		CU1,000	
	Cr	Put option asset		CU1,000

To record movement in fair value of option from CU4,000 to CU3,000

Dr	Equity		CU3,000	
	Cr	Put option asset		CU3,000

To record net settlement of option by receipt of CU3,000 worth of A's shares from B. This is shown as a deduction from equity in accordance with IAS 32's requirements for treasury shares (see section 9 above).

C Gross settlement

If the contract is entered into as gross-settled, on 1 February 20X2, then A can, on the exercise date 31 January 20X3, require B to take delivery 1,000 of A's shares in return for a payment by B of CU98,000. IAS 32 classifies this derivative contract as an equity instrument (see section 5.4 above); therefore no entries are recorded, other than to record the cash flows arising under the contract:

1 February 20X2

Dr	Equity		CU5,000	
	Cr	Cash		CU5,000

Payment of option premium (equal to fair value of option) to B

31 January 20X3

Dr	Cash		CU98,000	
	Cr	Equity		CU98,000

To record gross settlement of option by delivery of 1,000 own shares to B in exchange for CU98,000.

If the option had lapsed unexercised, because the market price of A's shares had risen above CU98 as at 31 January 20X3, the CU5,000 premium would remain in equity, even though it is, from an economic perspective, clearly a loss rather than an amount paid to repurchase A's own shares. This is because IFRS accounting standards regards any holder of an instrument classified as equity under IAS 32 as an 'owner'.

D Settlement options

If there are different settlement options (such as net in cash, net in shares or by an exchange of cash and shares), the option is a financial asset. A accounts for the forward contract as a derivative (as in A and B above), with the accounting entry made on settlement determined by the manner of settlement (i.e., equity or cash).

11.3.2 Written put option

In a written put option, the entity receives a payment from a counterparty for granting to the counterparty the right, but not the obligation, to sell a given number of the entity's own equity instruments to the entity for a fixed price at a future date. The accounting for such a contract is shown in Illustration 11-7 below. *[IAS 32.IE27-31]*.

Illustration 11-7: Written put option on own shares

The reporting entity (A), which has a functional currency of CU and a year end of 31 December, writes a put option over its own shares with another party (B), for which the following are the major assumptions.

Contract date	1 February 20X2
Exercise date (European terms - i.e., can be exercised only on maturity)	31 January 20X3
Fixed exercise price to be paid on 31 January 20X3	CU98
Number of shares under contract	1,000
Market price per share on 1 February 20X2	CU100
Market price per share on 31 December 20X2	CU95
Market price per share on 31 January 20X3	CU95
Fair value of option to A on 1 February 20X2	CU(5,000)
Fair value of option to A on 31 December 20X2	CU(4,000)
Fair value of option to A on 31 January 20X3	CU(3,000)

The fair value of the option would be computed using an option pricing model and would be a function of a number of factors, principally the market value of the shares, the exercise price, and the time value of money.

A Net cash settlement

If the contract is entered into as net cash-settled on 1 February 20X2, then B can, on the exercise date 31 January 20X3, require A to make a cash payment to B for the excess, if any, of CU98,000 (i.e., 1,000 shares at the option price of CU98 per share) over the fair value of 1,000 of A's own shares, as of 31 January 20X3. Because IAS 32 classifies such contracts as derivative financial liabilities (see sections 11 and 5.2.7 above), which are carried at fair value through profit or loss under IFRS 9, A records the following accounting entries:

1 February 20X2

Dr	Cash		CU5,000	
	Cr	Put option liability		CU5,000

Receipt of option premium (equal to fair value of option) from B

31 December 20X2

Dr	Put option liability		CU1,000	
	Cr	Gain on option (profit or loss)		CU1,000

To record movement in fair value of option from CU(5,000) to CU(4,000)

31 January 20X3

Dr	Put option liability		CU1,000	
	Cr	Gain on option (profit or loss)		CU1,000

To record movement in fair value of option from CU(4,000) to CU(3,000)

Dr	Put option liability		CU3,000	
	Cr	Cash		CU3,000

To record net settlement of option by payment of CU3,000 cash to B

B Net share settlement

If the contract is entered into as net share-settled on 1 February 20X2, then B can, on the exercise date 31 January 20X3, require A to deliver to B as many of A's own shares as have a fair value equal to any excess of CU98,000 (i.e., 1,000 shares at the option price of CU98 per share) over the fair value of 1,000 of A's own shares, as of 31 January 20X3. Because IAS 32 classifies such contracts as derivative financial assets (see sections 11 and 5.2.7 above), which are carried at fair value through profit or loss under IFRS 9, A records the following accounting entries:

1 February 20X2

Dr	Cash		CU5,000	
	Cr	Put option liability		CU5,000

Receipt of option premium (equal to fair value of option) from B

31 December 20X2

Dr	Put option liability		CU1,000	
	Cr	Gain on option (profit or loss)		CU1,000

To record movement in fair value of option from CU(5,000) to CU(4,000)

31 January 20X3

Dr	Put option liability		CU1,000	
	Cr	Gain on option (profit or loss)		CU1,000

To record movement in fair value of option from CU(4,000) to CU(3,000)

Dr	Put option liability		CU3,000	
	Cr	Equity		CU3,000

To record net settlement of option by issue of CU3,000 worth of own shares to B

C Gross settlement

If the contract is entered into as gross-settled on 1 February 20X2, then B can, on the exercise date 31 January 20X3, require A to take delivery of 1,000 of A's own shares in return for a payment by A of CU98,000. IAS 32 classifies this derivative contract as an equity instrument giving rise to a financial liability for the present value of the purchase price amount payable in one year's time (see section 5.3 above). On the assumption that A accounts for this liability under the effective interest method in IFRS 9, A records the following accounting entries:

1 February 20X2

Dr	Cash		CU5,000	
	Cr	Equity		CU5,000

Receipt of option premium (equal to fair value of option) from B

Dr	Equity		CU95,000	
	Cr	Liability (net present value of CU98,000 potentially payable under option)		CU95,000

Recording of potential liability to settle option

31 December 20X2

Dr	Interest (profit or loss)		CU2,750	
	Cr	Liability		CU2,750

To accrue interest, under the effective interest rate method, on the liability

31 January 20X3

Dr	Interest expense (profit or loss)		CU250	
	Cr	Liability		CU250

To accrue further interest, under the effective interest rate method, on the liability

Dr	Liability		CU98,000	
	Cr	Cash		CU98,000

To record gross settlement of option by delivery of by B of 1,000 shares in A in exchange for CU98,000

If the option had lapsed unexercised, because the market price of A's shares had risen above CU98 as at 31 January 20X3, the premium of CU5,000 would remain in equity and the liability of CU98,000 would be reclassified to equity. The economic consequence is clearly that A has made a profit of CU5,000 - the premium that it received from B, for which it has ultimately had to give nothing in return. However, the overall effect of the treatment that would be required by IAS 32 can be summarised as follows:

	CU	CU
Cash	5,000	
Profit or loss (interest on potential liability to pay cash)	3,000	
Equity (CU98,000 carrying amount of liability transferred at date of lapse less CU90,000 debited on 1 February 20X0)		8,000

To record a loss on a transaction that makes a profit might seem a distortion of economic reality; but in this case is a consequence of applying the *Conceptual Framework*.

D Settlement options

If there are different settlement options (such as net in cash, net in shares or by an exchange of cash and shares), the option is a financial liability. A accounts for the forward contract as a derivative (as in A and B above), with the accounting entry made on settlement determined by the manner of settlement (i.e., equity or cash). If one of the settlement alternatives is to exchange cash for shares, A recognises a liability for the obligation to deliver cash (as in C above). Otherwise, Entity A accounts for the put option as a derivative liability.

The implementation guidance to IAS 32 states that A must recognise a liability "if one of the settlement alternatives is to exchange cash for shares". *[IAS 32.IE31]*. As drafted, this applies whether the choice of settlement rests with A or B. This seems curious since, where A has the choice of settlement, there would be no obligation for A to settle gross. We assume that the example is written on the presumption that the choice of settlement of an option would normally rest with the buyer rather than the writer of the option. IAS 32.23 is clear that an equity contract gives rise to a liability for the purchase price of the shares only where there is an obligation for the entity to purchase its own equity (see section 5.3 above).

How we see it

In in our view, where the choice of settlement of a derivative on own shares is at the sole discretion of the entity, it is acceptable not to record a gross liability, and to account for the contract as a derivative financial liability.

12 Future developments

A number of commentators have questioned whether the current criteria used to distinguish equity from financial liabilities, both under IFRS accounting standards and US GAAP, are entirely satisfactory. In an agenda paper for the IASB board meeting in January 2007, the IASB staff highlighted the following broad categories of implementation issues arising from IAS 32:

- *Issues arising from specific rules in the standard*

  The specific provisions in IAS 32 were written with particular types of capital instrument in mind. Where these rules are applied to instruments that differ from those for which they were written, the result may be the classification of an item as debt or equity that does not faithfully represent the underlying instrument.
- *Counter-intuitive results*

  The classification of an instrument under IAS 32 can produce results that conflict with the general perception of how the instrument would be faithfully represented. An example is the treatment of certain puttable instruments, which was the subject of the amendment to IAS 32 in February 2008 discussed in sections 4.6.2 and 4.6.3 above.
- *Conflicts with the conceptual framework*

  Some provisions of IAS 32 conflict with the IASB's own conceptual framework. For example, IAS 32 requires some contracts over the entity's own equity, which are to be executed at a future date, to be accounted for as if they had been executed on inception of the contract. This contrasts with the required treatment under IFRS accounting standards of nearly all other executory contracts, such as purchase orders and contracts of employment, for which no liability is recorded, except to the extent that the contract is onerous.

The IASB staff noted that the first of these issues could potentially be resolved by a more principles-based revision to the drafting of IAS 32, whilst the other two issues raised more fundamental questions about the whole approach of the standard.[35]

The Memorandum of Understanding published by the IASB and the FASB in February 2006 set as one of its goals for 2008 "to have issued one or more due process documents relating to a proposed standard" on the distinction between liabilities and equity. The IASB fulfilled that commitment by publishing a discussion paper in February 2008. Following receipt of comments on the discussion paper, the IASB and the FASB ('the Boards') began further deliberations and proposed an exposure draft. In May 2010 this was distributed to a small group of external reviewers, who raised significant challenges. The reviewers felt that the proposed approach lacked clear principles and could produce inconsistent results when applied to broadly similar instruments.

12.1 Financial instruments with characteristics of equity project (FICE)

At a joint meeting in October 2010, the Boards suspended the project, acknowledging that they did not have the time necessary to deliberate the key issues. In October 2014 the IASB decided to resume the FICE project, to investigate potential improvements to:

- The classification of liabilities and equity in IAS 32, including investigating potential amendments to the definitions of liabilities and equity in the Conceptual Framework.

  And
- The presentation and disclosure requirements for financial instruments with characteristics of equity, irrespective of whether they are classified as liabilities or equity.

A key issue is that certain financial instruments, which have a wide range of differing characteristics, often cannot be easily classified as debt or equity as they can have features of both. The IASB looked at addressing this issue by modifying the approach in IAS 32 by:

- Clarifying what set of features is most useful in distinguishing between financial liabilities and equity.
- Using presentation to reflect similarities and differences not apparent from the liability and equity classification.

  And
- Using disclosures to bring out other similarities and differences.

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35 Information for observers: Board meeting: *January 2007, London*, Project: *Liability and Equity*, Subject: *Overview of IAS 32 (Agenda paper 12B)*, para. 48. Available on the IFRS Foundation's website.

The FICE DP was published in June 2018.[36] In it, the IASB put forward a preferred approach which would classify a financial instrument as a financial liability if it contained:

- An unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation.

  And/or

- An unavoidable contractual obligation for an amount independent of the entity's available economic resources.

Because the FICE DP proposed to classify more instruments as liabilities, it suggested that the revaluation of such liabilities must be recorded in other comprehensive income if they did not contain an unavoidable contractual obligation for an amount independent of the entity's available economic resources. This would include, for instance, shares puttable at fair value.

The FICE DP also proposed that total comprehensive income must be attributed between the different classes of equity.

After considering comments on the DP, the IASB decided in 2020 not to go ahead with the ideas proposed in the DP but to concentrate on addressing certain known practice issues by clarifying some of the underlying principles in IAS 32 and improving the information provided in the financial statements about the financial instruments issued by the entity. In particular, they identified the following areas:

- The classification of financial instruments that will or may be settled in the issuer's own equity instruments, e.g., the application of the fixed-for-fixed condition to particular derivatives on own equity and the classification of mandatorily convertible financial instruments (see sections 5.1, 5.2 and 6.6.4 above).
- Classification of particular financial instruments that contain obligations that arise only on liquidation of the entity, e.g., perpetual financial instruments (see section 4.7 above).
- Accounting for financial instruments that contain contingent settlement provisions, e.g., financial instruments with a non-viability clause (see section 6.6.4.B above).
- The effect of laws or regulations on the classification of financial instruments.
- The reclassification between financial liability and equity instruments, e.g., when circumstances change, or contractual terms are modified (see section 4.9 above).
- Accounting for obligations to redeem own equity instruments, e.g., accounting for put options over non-controlling interests (see section 5.3.2.A above and Chapter 10 at section 8.5).

Following completion of the Board's discussions on the topics listed above, in November 2023 the IASB published *Exposure Draft (IASB/ED/2023/5) Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1*, with a 120 day comment period which closed in March 2024.[37] At its meeting in July 2024, the IASB discussed an overview of feedback received on the Exposure Draft (ED)[38] with a view to agreeing next steps including a preliminary project timeline.[39] The project plan indicates that the IASB will commence further discussions on each of the topics from Q4 2024 with discussions expected to be completed by Q2 2026.

36 Discussion Paper DP/2018/1: *Financial Instruments with Characteristics of Equity*, IASB, June 2018. Available on the IFRS Foundation's website.

37 Exposure Draft: Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1, along with the Basis for Conclusions and Illustrative Examples and Implementation Guidance, November 2023, available on the IFRS Foundation's website.

38 Financial Instruments with Characteristics of Equity, Summary of feedback - users of financial statements, July 2024, available on the IFRS Foundation's website.

39 Financial Instruments with Characteristics of Equity, Project plan, July 2024, available on the IFRS Foundation's website.

12.2 Fixed-for-fixed

On the classification of financial instruments that will or may be settled in the issuer's own equity instruments, the Board's tentative decisions are reflected in the FICE ED, published in November 2023.[40]

The proposals include that for a derivative on own equity to meet the fixed-for-fixed condition in IAS 32, the amount of consideration to be exchanged for each of an entity's own equity instruments is required to be denominated in the entity's functional currency and must be fixed or vary only due to an adjustment which varies solely because of:

- Preservation adjustments that require the entity to preserve the relative economic interest of future shareholders to an equal or lesser extent than those of existing shareholders.

  Or

- Passage-of-time adjustments that are pre-determined and vary only with the passage of time and have the effect of fixing on initial recognition the present value of the amount of consideration exchanged for each of the entity's own equity instruments.

The ED proposes to classify as equity, a contract that can be settled by exchanging a fixed number of one class of an entity's own non-derivative equity instruments with a fixed number of another class of its own non-derivative equity instruments.

The ED also proposes that in classifying a derivative that gives one party a choice of settlement between two or more classes of an entity's own equity instruments the entity would consider whether the fixed-for-fixed condition is met for each class of its own equity instruments that may be delivered.

12.3 Disclosures for financial instruments that contain obligations that arise only on liquidation of the entity

The FICE ED includes proposed amendments to IFRS 7 to require an entity to disclose information on the nature and priority of claims against the entity on liquidation arising from financial liabilities and equity instruments.

The ED proposes that an entity disclose the carrying amount of each class of claims arising from these financial instruments and the line item in the statement of financial position where the claim is included. An entity must group the claims into classes based on their contractual nature and priority on liquidation, with specific requirements for the separate and consolidated financial statements.[41]

The objective is not to provide information about the priority of individual financial instruments on liquidation, but rather a categorisation of the capital structure to show differences in the quality of capital within the structure to help users assess the nature of the claims and how they affect the entity's liquidity and solvency.

The ED proposes that, for financial instruments with both financial liability and equity characteristics (except for stand-alone derivatives), an entity would be required to disclose in the notes to the financial statements:[42]

- 'Debt-like features' in financial instruments that are classified as equity instruments (for example, fixed coupons payable on a preference share).
- 'Equity-like features' in financial instruments that are classified as financial liabilities (for example, embedded derivatives on own equity that do not meet the fixed-for-fixed criterion, or 'write-down bonds', where the principal is reduced if the issuer's capital falls below a trigger level).
- The terms and conditions that determine the classification of such financial instruments as financial liabilities, equity instruments or compound financial instruments. This includes information about terms that become, or stop being effective with the passage of time before the end of the instrument's contractual term.
- The ED also proposes to require entities to disclose the potential dilution of ordinary shares arising from financial instruments that could be settled by delivering ordinary shares, such as convertible bonds and derivatives on own equity.[43] The disclosure also applies to share-based payment transactions to which IFRS 2, *Share-based Payment* applies and would be in addition to the normal IAS 33 *Earnings per share* diluted earnings per share disclosure.

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40 Exposure Draft: Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1, paragraphs 16, 22, 22B to 22D, AG27A and AG29B, November 2023, available on the IFRS Foundation's website.

41 Exposure Draft: Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1, IFRS 7, IFRS 7 new paragraph 30A and 30B, November 2023, available on the IFRS Foundation's website.

42 Exposure Draft: Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1, IFRS 7 new paragraphs 30C, 30D, 30E and 30F, November 2023, available on the IFRS Foundation's website.

43 Exposure Draft: Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1, IFRS 7 new paragraphs 30G and 30H, November 2023, available on the IFRS Foundation's website.

12.4 Accounting for financial instruments that contain contingent settlement provisions

For financial instruments with contingent settlement provisions, proposed changes to IAS 32 were included in the FICE ED.[44] The ED proposes to clarify the following:

- Financial instruments with contingent settlement provisions may be compound financial instruments with liability and equity components.
- The probability and estimated timing of occurrence or non-occurrence of uncertain future events (or the outcome of uncertain circumstances) have no effect on the initial and subsequent measurement. As a result, the liability component of a compound financial instrument with contingent settlement provisions, which could require immediate settlement if a contingent event occurs, is measured on initial recognition and subsequently at the present value of the settlement amount.
- Payments at the discretion of the issuer (such as dividends) are recognised in equity, even if all the proceeds are initially allocated to the liability component of a compound financial instrument such that the equity component has an initial carrying amount of zero.
- The term 'liquidation' in paragraph 25(b) of IAS 32 refers to the process that begins after an entity has permanently ceased its operations.

  And
- The assessment of whether a contractual term that is 'not genuine' under paragraph 25(a) of IAS 32 requires judgement based on the specific facts and circumstances and is not based on the probability or likelihood of the contingent event occurring.

The accounting for types of contingent settlement provisions that are not embedded in a financial instrument would not be subject to these potential future changes to IAS 32. Examples of such contingent settlement provision could include those which arise in the context of asset acquisitions in the extractive industries (see Chapter 39 at section 8.4.1) and contingent consideration in business combinations (see Chapter 10 at section 7.1).

12.5 The effect of laws or regulations

For the effect of laws or regulations, proposed changes to IAS 32 were included in the FICE ED.[45]

The FICE ED proposes that, when considering the classification of a financial instrument (or its component parts) as a financial asset, financial liability or equity instrument, an entity should consider only those contractual rights and obligations that are enforceable by law and that are in addition to those created by relevant laws or regulations. If a right or obligation is created by relevant laws or regulations, and would arise regardless of whether it is included in the contractual arrangement, an entity would not consider that right or obligation in its assessment.

12.6 Shareholders' discretion

For shareholders' discretion, proposed changes to IAS 32 were included in the FICE ED.[46] The ED proposes to clarify that whether an entity has an unconditional right to avoid delivering cash or another financial asset (or otherwise to settle a financial instrument in such a way that it would be a financial liability, see section 4.2 above) depends on the facts and circumstances in which shareholder discretion arises. Judgement is required to assess whether shareholder decisions are treated as entity decisions.

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44 Exposure Draft: Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1, IAS 32 paragraphs 16, 22, 22B to 22D, AG27A and AG29B, November 2023, available on the IFRS Foundation's website.

45 Exposure Draft: Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1, IAS 32 paragraphs 15A and AG24A to AG24B, November 2023, available on the IFRS Foundation's website.

46 Exposure Draft: Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1, IAS 32 paragraphs AG28A to AG28C, November 2023, available on the IFRS Foundation's website.

The ED proposes examples of the potential factors an entity would be required to consider in making the assessment (each of which would not be determinative on their own), including whether:

- A shareholder decision is a routine part of the operating and corporate governance process (e.g., the approval of dividends at an annual general meeting) or not (e.g., the approval of a change of control, which will often occur at a 'special' meeting and require more than a simple majority).
- The shareholder decision relates to an action proposed or a transaction initiated by the entity's management, so that shareholders merely approve or reject management's proposals, or if it is initiated by the shareholders or third parties.
- The shareholder decision affects different share classes differently, so that, for example, discretion by preference shareholders would be treated as indicative of a liability and separate voting by class would suggest voting as a class and not as part of the entity.
- A shareholder decision-making right may enable a shareholder to require the entity to redeem or pay a return on its shares in cash. Such decision making rights indicate that the shareholders would make their decisions as investors in the shares and is unlikely to be an entity decision.

12.7 Reclassification of financial liabilities and equity instruments

The proposed changes to IAS 32 for the reclassification of financial liabilities and equity instruments were included in the FICE ED.[47] The ED proposes to add a general requirement that prohibits reclassification of a financial instrument after initial recognition, unless paragraph 16E of IAS 32 applies (see section 4.6.5 above) or the substance of the contractual terms changes because of a change in circumstances external to the contractual arrangement.

If the substance of the contractual terms change because of changes in circumstance external to the contractual arrangement, an entity would:

- Measure a financial liability reclassified from equity at the fair value at the date of reclassification. Any difference between the carrying amount of the equity instrument and the fair value of the financial liability would be recognised in equity.
- Measure an equity instrument reclassified from a financial liability at the carrying value of the financial liability at the date of reclassification. No gain or loss would be recognised on reclassification.
- The reclassification would be accounted for prospectively from the date when the change in circumstances occurs. An entity must not reverse in profit or loss any previously recognised income, expense, gains or losses.

The ED also proposes examples of changes in circumstances that are external to the contractual arrangement requiring reclassification.

12.8 Obligations to purchase an entity's own equity instruments

For an entity's obligations to repurchase its own equity instruments (e.g., put options on non-controlling interests), the FICE ED proposes clarifications to the existing IAS 32 requirements.[48] These are as follows:

- The requirements in IAS 32 paragraph 23 for contracts containing an obligation for an entity to purchase its own equity instruments for cash or another financial asset, also apply to contracts for an entity to redeem its own equity instruments that will be settled in a variable number of another class of the entity's own equity instruments. *[IAS 32.23]*.
- On initial recognition of an obligation to redeem an entity's own equity instruments, if the entity does not yet have access to the rights and returns associated with ownership of the equity instruments to which the obligation relates, those equity instruments would continue to be recognised. The initial amount of the financial liability would be recognised as a debit entry in a component of equity other than non-controlling interests (NCI) (in the case of obligations involving NCI) or issued share capital (in the case of other obligations to purchase own shares).
- An entity is required to use the same approach for the initial and subsequent measurement of the financial liability that arises from a contingent settlement provision. In other words, the entity would measure the liability at the present value of the redemption amount and ignore the probability and estimated timing of the counterparty exercising that redemption right.

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47 Exposure Draft: Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1, IAS 32 paragraphs 32B to 32D and AG35A, November 2023, available on the IFRS Foundation's website.

48 Exposure Draft: Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1, IAS 32 paragraphs 23, AG27B to AG27D, November 2023, available on the IFRS Foundation's website.

- When remeasuring the financial liability that arises from an obligation to purchase its own equity instruments, an entity is required to recognise any gain or loss in profit or loss.
- On expiry without delivery of an obligation for an entity to purchase its own equity instruments:
  - The carrying amount of the financial liability would be removed from financial liabilities and included in the same component of equity as that from which it was reclassified on initial recognition of the financial liability.

    And
  - Any gains or losses previously recognised in profit or loss from remeasuring the financial liability would not be reversed. However, the entity may transfer the cumulative amount of those gains and losses from retained earnings to another component of equity.
- Written put options and forward purchase contracts on an entity's own equity instruments that are gross physically settled are presented gross. This is to align with the accounting for other obligations that are conditional on events or choices that are beyond the entity's control, and to better allow users to assess the entity's exposure to liquidity risk.

12.9 Presentation of equity instruments and financial liabilities

The FICE ED includes the proposed amendments to IAS 1 for the presentation of equity instruments and financial liabilities.[49] For the presentation of equity instruments, the ED proposes amendments to meet the needs of users of financial statements (particularly investors in ordinary shares), including transparency about whether an entity has issued other instruments classified as equity and to make a clear distinction of the returns to ordinary shareholders. The ED proposes to make amounts attributable to ordinary shareholders clearly visible in the entity's financial statements. The proposed amendments are for an entity to present:

- Line items in the statement of financial position to show issued capital and reserves attributable to ordinary shareholders of the parent separately from issued capital and reserves attributable to other owners of the parent.
- The components of equity to be reconciled in the statement of changes in equity for each class of ordinary share capital separately from each class of other contributed equity.
- In the statement of comprehensive income, to show an allocation of profit or loss and other comprehensive income attributable to ordinary shareholders of the parent separately from the respective amounts attributable to other owners of the parent.
- The amount of dividends recognised as distributions to ordinary shareholders separately from dividends recognised as distributions to other owners during the period.

For the presentation of financial liabilities, the IASB considered whether it is appropriate for an entity to recognise changes in the carrying amount of a financial liability in profit or loss when the financial liability contains a contractual obligation to pay the holder based on the entity's performance or changes in the entity's net assets. The IASB tentatively decided not to add to the existing presentation requirements for financial liabilities but to require disclosure of the total gains or losses in each reporting period that arise from measuring such financial liabilities.

12.10 Disclosures

The proposed amendments for the disclosure of equity instruments and financial liabilities were included in the FICE ED.[50] The ED proposes:

- To expand the objective of IFRS 7 to enable users of financial statements to understand how an entity is financed and what its current and potential ownership structure is, including potential dilution to the ownership structure from financial instruments issued at the reporting date.
- To delete the current references in IFRS 7 paragraph 3(a) which exclude derivatives that meet the definition of an equity instrument in IAS 32 from the scope of IFRS 7.

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49 Exposure Draft: Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1, IAS 1 paragraphs 54, 81B, 107 and 108, November 2023, available on the IFRS Foundation's website.

50 Exposure Draft: Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1, IFRS 7 paragraphs 1, 3, 12E, 17A, 30A to 30J and B5A to B5L, November 2023, available on the IFRS Foundation's website.

- To relocate the disclosure requirement currently in IAS 1 paragraph 80A to IFRS 7 and expand it to cover reclassifications when changes in the substance of the contractual terms arise from changes in circumstances external to the contractual arrangement. An entity would be required to disclose the amounts reclassified into and out of financial liabilities or equity, and the timing and reason for that reclassification.
  - To amend IFRS 7 paragraph 20(a)(i) to require the separate disclosure of gains or losses in each reporting period that arise from remeasuring financial liabilities containing contractual obligations to pay amounts based on an entity's performance or changes in the entity's net assets.
- To include disclosure requirements for compound financial instruments in IFRS 7 paragraph 17A.

The ED also proposes to require entities to disclose information about obligations that arise only on liquidation of the entity, as discussed in section 12.3 above.

12.11 Transition

The proposed transition requirements for the amendments to IAS 32, IFRS 7 and IAS 1 were included in the FICE ED.[51] The ED proposes that for an entity already applying IFRS accounting standards:

- If it is impracticable (as defined in IAS 8) for the entity to apply the effective interest method in IFRS 9 retrospectively, the entity is required to treat the fair value at the beginning of the earliest comparative period presented as the amortised cost of the financial liability at that date.
  - The entity is not required to separate the liability and equity components if the liability component of a compound financial instrument with a contingent settlement provision was no longer outstanding at the date of initial application.
  - To require the entity to disclose, in the reporting period that includes the date of initial application of the amendments, the nature and amount of any changes in classification resulting from initial application of the amendments. This includes the classification and carrying amount of the financial instrument immediately before applying the amendments and immediately after applying the amendments.
  - To provide transition relief from the quantitative disclosures in IAS 8 paragraph 28(f).
- Not to provide any transition relief from the requirements in IAS 34 *Interim Financial Reporting* for interim financial statements issued within the annual period in which the entity first applies the amendments.
- For first-time adopters, not to provide any additional transition relief.

51 Exposure Draft: Financial Instruments with Characteristics of Equity - Proposed amendments to IAS 32, IFRS 7 and IAS 1, IAS 32 paragraphs 97U to 97Z, November 2023, available on the IFRS Foundation's website.

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Appendix B - Defined terms

Extract from IFRS standards - Definitions	
derivative	A financial instrument or other contract within the scope of this Standard with all three of the following characteristics. (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying'). (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. (c) it is settled at a future date. *[IFRS 9 Appendix A]*.
equity instrument	**An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.** *[IAS 32.11]*.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. *[IFRS 13 Appendix A]*.
financial asset	**A *financial asset* is any asset that is:** **(a) cash;** **(b) an equity instrument of another entity;** **(c) a contractual right:** **(i) to receive cash or another financial asset from another entity; or** **(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or** **(d) a contract that will or may be settled in the entity's own equity instruments and is:** **(i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or** **(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.** **For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.** *[IAS 32.11]*.
financial instrument	**A *financial instrument* is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.** *[IAS 32.11]*.

financial liability	A *financial liability* is any liability that is: (a) a contractual obligation: (i) to deliver cash or another financial asset to another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or (b) a contract that will or may be settled in the entity's own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments. As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D. *[IAS 32.11]*.
puttable instrument	A *puttable instrument* is a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder. *[IAS 32.11]*.

Chapter 44 Financial instruments: Classification

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Overview

On 1 January 2018, IFRS 9 *Financial Instruments* (IFRS 9 or the standard) came into effect. The standard includes revised classification requirements for financial assets. Classification determines how financial instruments are accounted for in the financial statements and, in particular, how they are measured on an ongoing basis.

The more principle-based approach of IFRS 9 requires the careful use of judgement in its application. Some fact patterns have no simple and distinct outcome, and we highlight in this chapter the factors that need to be considered in arriving at a conclusion.

This chapter deals with the classification of financial assets and liabilities under IFRS 9. Other aspects of IFRS 9 are dealt with in the other financial instruments chapters. Definitions and scope are covered in Chapter 41. Derivatives and embedded derivatives are dealt with in Chapter 42. Recognition and initial measurement are dealt with in Chapter 45. Subsequent measurement is dealt with in Chapter 46. Chapter 47 deals with impairment of financial assets. Chapter 48 deals with derecognition. Chapter 49 deals with hedge accounting.

Differences between the IFRS accounting standards and US GAAP guidance on this topic are not addressed in this chapter as the standards are not converged. Therefore, the differences between IFRS accounting standards and US GAAP that exist are not discussed in this chapter.

What you need to know

- Financial assets are classified at amortised cost, fair value through other comprehensive income (FVOCI) or at fair value through profit or loss. This classification is based on the cash flow characteristics test and the business model assessment.
- A conditional fair value option through profit or loss may be elected for investments in debt instruments.
- A FVOCI option, with no recycling through profit or loss, is available for certain investments in equity instruments.
- Financial liabilities are classified at amortised cost or fair value through profit or loss.
- A conditional fair value option through profit or loss may be elected for financial liabilities. Under this approach, movements in fair value caused by own credit risk are generally recognised in other comprehensive income (OCI).
- Embedded derivatives within financial liability host contracts are classified separately from the host instrument if they meet the separation criteria. This is not the case for embedded derivatives in financial asset host contracts.
- Reclassification is only allowed for financial assets and even then, under limited circumstances.

1 Classifying financial assets: An overview

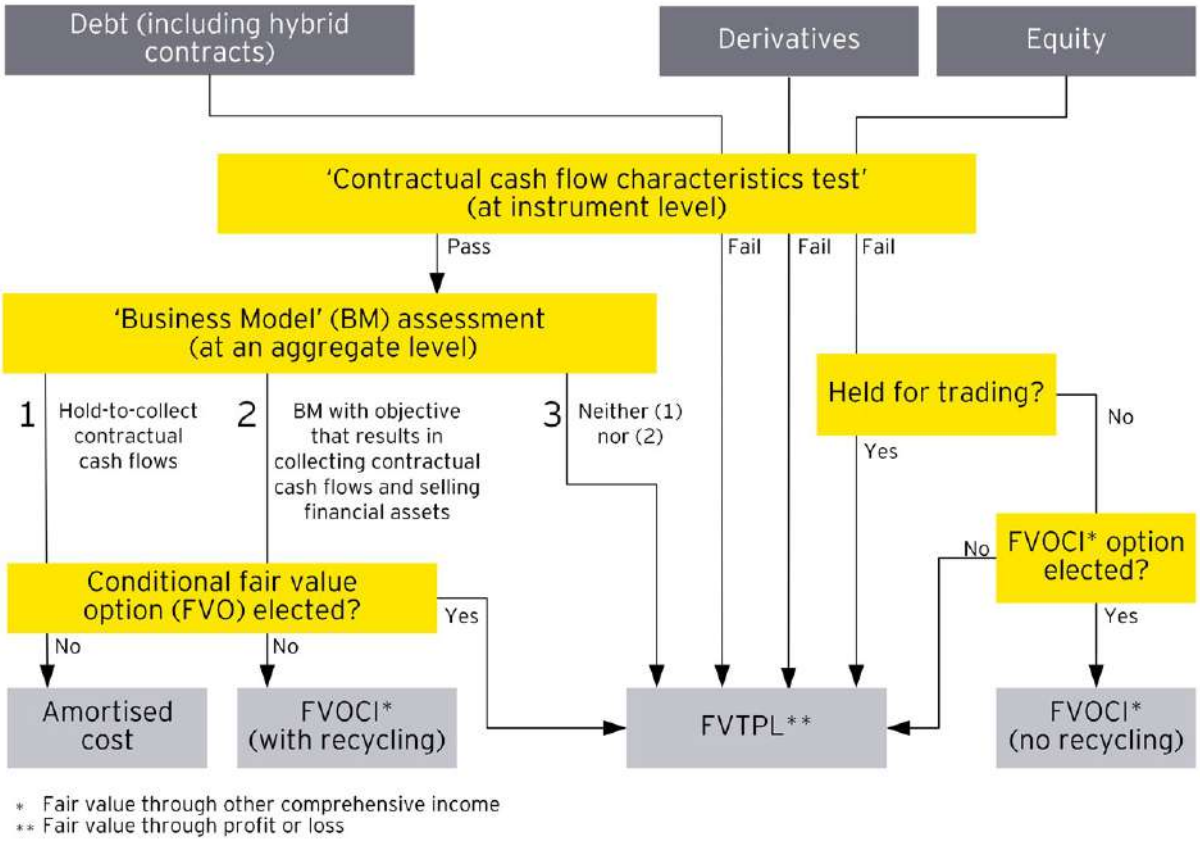
IFRS 9 has the following measurement categories for financial assets:

- Debt instruments at amortised cost
- Debt instruments at fair value through other comprehensive income with cumulative gains and losses reclassified to profit or loss upon derecognition
- Debt instruments, derivatives, and equity instruments at fair value through profit or loss

  And
- Equity instruments designated as measured at fair value through other comprehensive income with gains and losses remaining in other comprehensive income, i.e., without recycling to profit or loss upon derecognition

Apart from specific designation options, which are described in more detail in sections 6 and 7 below, the classification is based on both the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial assets. *[IFRS 9.4.1.1]*.

The diagram below illustrates the tests and assessments on which the classification of financial assets is based. It should be noted that either the business model test or the contractual cash flow characteristics test, can be conducted first in practice. The diagram also illustrates that the default category for measuring financial assets is fair value through profit or loss:



Subsequent measurement is covered in Chapter 46, particularly at section 2.1 (debt financial assets measured at amortised cost), section 2.3 (debt financial assets measured at fair value through other comprehensive income), section 2.4 (financial assets measured at fair value through profit or loss) and section 2.5 (investments in equity instruments designated at fair value through other comprehensive income). This includes the effective interest method and expected credit loss impairment model for financial assets measured at amortised cost and fair value through other comprehensive income. Fair value is determined in accordance with IFRS 13 *Fair Value Measurement* see Chapter 15.

1.1 Debt instruments

A debt instrument is normally measured at amortised cost if both of the following conditions are met: *[IFRS 9.4.1.2]*

(a) The financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows.

And

(b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

A debt instrument is normally measured at fair value through other comprehensive income if both of the following conditions are met: *[IFRS 9.4.1.2A]*

(a) The financial asset is held within a business model in which financial assets are managed to achieve a particular objective by both collecting contractual cash flows and selling financial assets.

And

(b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

The application of these conditions (the 'business model' assessment and 'contractual cash flow characteristics' test) is covered in more detail in sections 4 and 5 below, respectively.

The above requirements are applied to an entire financial asset, even if it contains an embedded derivative. *[IFRS 9.4.3.2]*. The assessment of the characteristics results in the entire financial asset either passing or failing the 'Solely Payments of Principal and Interest' (SPPI) test in its entirety. This differs from the treatment of embedded derivatives contained in financial liability host contracts (see section 2 below).

The application of these requirements to debt instruments means that, apart from the exceptions described in section 5.4 below, only relatively simple 'plain vanilla' debt instruments qualify to be measured at amortised cost or at fair value through other comprehensive income. Debt instruments that are neither measured at amortised cost nor at fair value though other comprehensive income are measured at fair value through profit or loss. *[IFRS 9.4.1.4]*. As will be shown in section 4.4 below, this includes instruments that are held for trading (see section 3 below).

Notwithstanding the criteria for debt instruments to be classified at amortised cost or at fair value through other comprehensive income, as described above, an entity may irrevocably designate a debt instrument as measured at fair value through profit or loss at initial recognition. This is allowed if doing so eliminates, or significantly reduces, a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch'). Such mismatches would otherwise arise from measuring assets or liabilities, or recognising the gains and losses on them, on different bases. *[IFRS 9.4.1.5]*. This is covered further in section 6 below.

In its Basis for Conclusions, the IASB noted that the fair value through other comprehensive income measurement category is intended for debt instruments for which both amortised cost information and fair value information are relevant and useful. This will be the case if their performance is affected by both the collection of contractual cash flows and the realisation of fair values through sales. *[IFRS 9.BC4.150]*.

The fair value through other comprehensive income measurement category may also help some insurers achieve consistency of measurement for assets held to back insurance liabilities under IFRS 17 *Insurance Contracts*. Under IFRS 17, insurers may, in certain circumstances, have a policy choice between including insurance finance income or expenses for the period in profit or loss in their entirety or disaggregating insurance finance income or expenses between profit or loss and other comprehensive income. To minimise accounting mismatches, we expect that insurance entities that have financial assets measured at fair value through other comprehensive income would elect to disaggregate insurance finance income and expenses. This is discussed in further detail in Chapter 51 at section 15.3.1. The fair value through other comprehensive income category should also help to address concerns raised by preparers who expect to sell financial assets in greater volume than would be consistent with a business model whose objective is to hold financial assets to collect contractual cash flows and would, without this category, have to record such assets at fair value through profit or loss.

It must be noted that:

(a) The fair value through other comprehensive income classification under IFRS 9 reflects a business model evidenced by facts and circumstances and is neither a residual classification nor an election.

(b) Debt instruments measured at fair value through other comprehensive income will be subject to the same impairment model as those measured at amortised cost. Accordingly, although the assets are recorded at fair value, the profit or loss treatment will be the same as for an amortised cost asset, with the difference between amortised cost, including impairment allowance, and fair value recorded in other comprehensive income.

And

(c) Only relatively simple debt instruments will qualify for measurement at fair value through other comprehensive income as they will also need to pass the contractual cash flow characteristics test.

1.2 Equity instruments and derivatives

Equity instruments and derivatives are normally measured at fair value through profit or loss. *[IFRS 9.5.7.1]*. However, on initial recognition, an entity may make an irrevocable election (on an instrument-by-instrument basis) to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument within the scope of IFRS 9. This option only applies to instruments that are neither held for trading (see section 3 below) nor contingent consideration recognised by an acquirer in a business combination to which IFRS 3 *Business Combinations* applies. *[IFRS 9.5.7.1(b), IFRS 9.5.7.5]*. For this election, the term equity instrument uses the definition in IAS 32 *Financial Instruments: Presentation*. The use of this election is covered further in section 7 below.

2 Classifying financial liabilities

Financial liabilities are classified and measured either at amortised cost or at fair value through profit or loss.

In addition, IFRS 9 specifies the accounting treatment for liabilities arising from certain financial guarantee contracts (see Chapter 41 at section 2.4 and Chapter 46 at section 2.8) and commitments to provide loans at below-market rates of interest (see Chapter 41 at section 2.5 and Chapter 46 at section 2.8).

Financial liabilities are measured at fair value through profit or loss when they meet the definition of held for trading (see section 3 below), *[IFRS 9 Appendix A]*, or when they are designated as such on initial recognition (see section 6 below). Designation at fair value through profit or loss is permitted when either: *[IFRS 9.4.2.2, IFRS 9.4.3.5]*

(a) It eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch'). Such mismatches would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.

(b) A group of financial liabilities, or financial assets and financial liabilities, is managed and its performance is evaluated on a fair value basis in accordance with a documented risk management or investment strategy, and information is provided internally on that basis to the entity's key management personnel (as defined in IAS 24 *Related Party Disclosures* see Chapter 35 at section 3.1.1.D).

Or

(c) A financial liability contains one or more embedded derivatives that meet certain conditions.

For financial liabilities designated as at fair value through profit or loss, the element of gains or losses attributable to changes in own credit risk is normally recognised in other comprehensive income with the remaining gains and losses recognised in profit or loss. *[IFRS 9.5.7.7]*. The amounts recognised in other comprehensive income are not recycled to profit or loss, even if the liability is repurchased. However, if this treatment of changes in fair value attributable own credit risk creates or enlarges an accounting mismatch in profit or loss, then the entity shall present all gains and losses on that liability in profit or loss. *[IFRS 9.5.7.8]*. The guidance indicates that an economic relationship is required in these cases. In other words, the designated liability's own credit risk must be offset by changes in the fair value of the other instrument. If there is no economic relationship between the liability's own credit risk and the fair value of the other instrument, then the gains and losses arising from the changes in credit risk cannot be recognised in profit or loss. 'Economic relationship' is not defined in the standard, but the IASB noted that the relationship need not be contractual, *[IFRS 9.BC5.41]*, and that such a relationship does not arise by coincidence. *[IFRS 9.BC5.40]*. However, judging from the example given in the standard (see Illustration 2-1 below) the IASB would not expect this to be very common.

Illustration 2-1: Liabilities at fair value through profit or loss: accounting mismatch in profit or loss

A mortgage bank provides loans to customers and funds those loans by selling bonds with matching characteristics (e.g., amount outstanding, repayment profile, term and currency) in the market. The contractual terms of the loans permit the mortgage customer to prepay its loan (i.e., satisfy its obligation to the bank) by buying the corresponding bond at fair value in the market and delivering that bond to the mortgage bank.

As a result of that contractual prepayment right, if the credit quality of the bond worsens (and, thus, the fair value of the mortgage bank's liability decreases), the fair value of the mortgage bank's loan asset also decreases. The change in the fair value of the asset reflects the mortgage customer's contractual right to prepay the mortgage loan by buying the underlying bond at fair value (which, in this example, has decreased) and delivering the bond to the mortgage bank. Therefore, the effects of changes in the credit risk of the liability (the bond) will be offset in profit or loss by a corresponding change in the fair value of a financial asset (the loan).

If the effects of changes in the liability's credit risk were presented in other comprehensive income there would be an accounting mismatch in profit or loss. Therefore, the mortgage bank is required to present all changes in fair value of the liability (including the effects of changes in the liability's credit risk) in profit or loss. *[IFRS 9.B5.7.10]*.

The standard also requires increased disclosure about an entity's methodology for making determinations about potential mismatches. The subsequent measurement of financial liabilities designated at fair value through profit or loss is discussed in further detail in Chapter 46 at section 2.4.

The definition of held for trading is dealt with in section 3 below and designation at fair value through profit or loss is covered further in section 6 below.

All other financial liabilities, other than derivatives, are generally classified as subsequently measured at amortised cost using the effective interest method. *[IFRS 9.4.2.1]*.

In contrast to the treatment for hybrid contracts with financial asset hosts, derivatives embedded within a financial liability host within the scope of IFRS 9 will often be separately accounted for. That is, they must be separated if they are not closely related to the host contract, they meet the definition of a derivative, and the hybrid contract is not measured at fair value through profit or loss (see Chapter 42 at section 4). Where an embedded derivative is separated from a financial liability host, the requirements of IFRS 9 dealing with the classification of financial instruments is applied separately to each of the host liability and the embedded derivative.

3 Financial assets and financial liabilities held for trading

The fact that a financial instrument is held for trading is important for its classification. Trading generally reflects active and frequent buying and selling, and financial instruments held for trading are normally used with the objective of generating a profit from short-term fluctuations in price or a dealer's margin. *[IFRS 9.BA.6]*.

For financial assets that are debt instruments, held for trading is a business model objective that results in measurement at fair value through profit or loss, as indicated in section 1.1 above and covered in more detail in section 4.4 below. Investments in equity instruments that are held for trading are disqualified from the option to present fair value movements in other comprehensive income (see section 7 below). They are therefore also required to be measured at fair value through profit or loss. Like financial assets, if a financial liability is held for trading it is classified as measured at fair value through profit or loss (see section 2 above).

Financial assets and liabilities held for trading are defined as those that: *[IFRS 9 Appendix A]*

- Are acquired or incurred principally for the purpose of sale or repurchase in the near term
- On initial recognition are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking

  Or
- Are derivatives (except for those that are financial guarantee contracts - see Chapter 41 at section 2.4 - or are designated effective hedging instruments - see Chapter 49 at section 3.2)

In respect of the first criterion above, it follows that if an entity originates a loan with an intention of syndicating all, or part, of it, the amount of the loan to be syndicated must be classified as held for trading, even if the bank subsequently fails to find sufficient commitments from other participants (a so called 'failed' loan syndication).

The term 'portfolio' in the second criterion is not explicitly defined in IFRS 9, but the context in which it is used suggests that a portfolio is a group of financial assets and/or financial liabilities that are managed together. If there is evidence of a recent actual pattern of short-term profit taking on financial instruments included in such a portfolio, those financial instruments qualify as held for trading even though an individual financial instrument may be held for a longer period of time. *[IFRS 9.IG B.11]*.

IFRS 9 also specifies that, in addition to derivatives that are not accounted for as hedging instruments, financial liabilities held for trading include: *[IFRS 9.BA.7]*

(a) Obligations to deliver financial assets borrowed by a short seller (i.e., an entity that sells financial assets it has borrowed and does not yet own).

(b) Financial liabilities that are incurred with an intention to repurchase them in the near term, such as quoted debt instruments that the issuer may buy back in the near term depending on changes in fair value.

  And

(c) Financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking. *[IFRS 9.BA.7(d)]*. However, the fact that a liability is used merely to fund trading activities does not in itself make that liability one that is held for trading. *[IFRS 9.BA.8]*.

4 Financial assets: The 'business model' assessment

The business model assessment is one of the two criteria assessed to classify financial assets. An entity's business model reflects how it manages its financial assets in order to generate cash flows and determines whether cash flows will result from collecting contractual cash flows, selling the financial assets or both. This assessment is performed based on scenarios that the entity reasonably expects to occur. This means the assessment excludes so-called 'worst case' or 'stress case' scenarios. For example, if an entity expects that it will sell a particular portfolio of financial assets only in a stress case scenario, this will not affect the entity's assessment of the business model for those assets if the entity does not reasonably expect it to occur. *[IFRS 9.B4.1.2A]*.

If cash flows are realised in a way that is different from the entity's expectations at the date that the entity assessed the business model (for example, if the entity sells more, or fewer, financial assets than it expected when it classified the assets), this does not give rise to a prior period error in the entity's financial statements (as defined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* see Chapter 3 at section 4.6). Nor does it change the classification of the remaining financial assets held in that business model (i.e., those assets that the entity recognised in prior periods and still holds), as long as the entity considered all relevant and objective information that was available at the time that it made the business model assessment. Classification of a financial asset is determined in accordance with the business model in place at the point of initial recognition and does not change thereafter except in the event of a reclassification. Reclassifications of financial assets are only permitted, or required, in rare circumstances (see section 8 below) which do not include a simple change in business model. However, when an entity assesses the business model for newly originated or newly purchased financial assets, it must consider information about how cash flows were realised in the past, along with all other relevant information. For instance, if a business model changes from being held to collect due to increasing sales out of the portfolio, any new assets recognised in the portfolio after such change would be classified in terms of the new business model (see Illustration 8-1 in section 8 below). Existing assets within the portfolio would continue to be measured at amortised cost. This means that if there is a change in the way that cash flows are realised then this will only affect the classification of new assets when first recognised in the future. *[IFRS 9.B4.1.2A]*.

An entity's business model for managing the financial assets is a matter of fact and typically observable through particular activities that the entity undertakes to achieve its objectives. An entity will need to use judgement when it assesses its business model for managing financial assets and that assessment is not determined by a single factor or activity. Rather, the entity must consider all relevant and objective evidence that is available at the date of the assessment. Such relevant and objective evidence includes but is not limited to: *[IFRS 9.B4.1.2B]*

(a) How the performance of the business model and the financial assets held within that business model are evaluated and reported to the entity's key management personnel

(b) The risks that affect the performance of the business model (and the financial assets held within) and, in particular, the way those risks are managed

And

(c) How managers of the business are compensated (for example, whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected)

In addition to these three forms of evidence, in most circumstances the expected frequency, value and timing of sales are important aspects of the assessment. These are covered in more detail in section 4.2.1 below. Entities will need to consider how and to what extent they document the evidence supporting the assessment of their business model.

4.1 The level at which the business model assessment is applied

The business model assessment should be performed based on the entity's business model as determined by the entity's key management personnel (as defined in IAS 24 see Chapter 35 at section 3.1.1.D). *[IFRS 9.B4.1.1]*.

An entity's business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective. This does not need to be the reporting entity level. The entity's business model does not depend on management's intentions for an individual instrument. Accordingly, this condition is not an instrument-by-instrument approach to classification and is determined on a higher level of aggregation. However, a single entity may have more than one business model for managing its financial instruments (for example, one portfolio that it manages in order to collect contractual cash flows and another portfolio that it manages in order to trade to realise fair value changes). *[IFRS 9.B4.1.2]*.

Similarly, in some circumstances, it may be appropriate to split a portfolio of financial assets into sub-portfolios to reflect how an entity manages them. *[IFRS 9.B4.1.2]*. Those portfolios would be split and treated as separate portfolios, provided the assets belonging to each sub-portfolio are defined. A sub-portfolio approach would not be appropriate in cases where an entity is not able to define which assets would be held to collect contractual cash flows and which assets would potentially be sold. It is clear that judgement will need to be applied when determining the level of aggregation to which the business model assessment is applied. Splitting a portfolio into two sub-portfolios might allow an entity to achieve amortised cost accounting for most of the assets within the portfolio, even if it is required to sell a certain volume of assets. The entity could define the assets it intends (or is required) to sell as one sub-portfolio while it defines the assets it intends to keep as another.

4.2 Hold to collect contractual cash flows

A financial asset which is held within a business model whose objective is to hold assets in order to collect contractual cash flows is measured at amortised cost (provided the asset also meets the contractual cash flow characteristics test). *[IFRS 9.4.1.2]*. An entity manages such assets to realise cash flows by collecting contractual payments over the life of the instrument instead of managing the overall return on the portfolio by both holding and selling assets. *[IFRS 9.B4.1.2C]*.

4.2.1 Impact of sales on the assessment

In determining whether cash flows are going to be realised by collecting the financial assets' contractual cash flows, it is necessary to consider the frequency, value and timing of sales in prior periods, whether the sales were of assets close to their maturity, the reasons for those sales, and expectations about future sales activity. However, the standard states that sales, in themselves, do not determine the business model and therefore cannot be considered in isolation. It goes on to say that, instead, information about past sales and expectations about future sales provide evidence related to how the entity's stated objective for managing the financial assets is achieved and, specifically, how cash flows are realised. An entity must consider information about past sales within the context of the reasons for those sales and the conditions that existed at that time as compared to current conditions. *[IFRS 9.B4.1.2C]*.

The key point is that the standard requires the consideration of expected future sales while past sales are of relevance only as a source of evidence. Under IFRS 9 there is no concept of tainting, whereby assets are reclassified if sales activity differs from what was originally expected. *[IFRS 9.B4.1.3]*.

Extract from IFRS 9

B4.1.3 Although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity. Thus, an entity's business model can be to hold financial assets to collect contractual cash flows even when sales of financial assets occur or are expected to occur in the future.

The following scenarios might be consistent with a hold to collect business model:

- The business model may be to hold assets to collect contractual cash flows even if the entity sells financial assets when there is an increase in the assets' credit risk. To determine whether there has been an increase in the assets' credit risk, the entity considers reasonable and supportable information, including forward looking information. Irrespective of their frequency and value, sales due to an increase in the assets' credit risk are not inconsistent with a business model whose objective is to hold financial assets to collect contractual cash flows because the credit quality of financial assets is relevant to the entity's ability to collect contractual cash flows. Credit risk management activities that are aimed at mitigating potential credit losses due to credit deterioration are integral to such a business model. Selling a financial asset because it no longer meets the credit criteria specified in the entity's documented investment policy is an example of a sale that has occurred due to an increase in credit risk. However, in the absence of such a policy, the entity may still be able to demonstrate in other ways that the sale occurred due to an increase in credit risk. *[IFRS 9.B4.1.3A]*.
- Sales that occur for other reasons, such as sales made to manage credit concentration risk (without an increase in the assets' credit risk), may also be consistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows. However, such sales are likely to be consistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows only if those sales are infrequent (even if significant in value) or insignificant in value both individually and in aggregate (even if frequent). *[IFRS 9.B4.1.3B]*.

- In addition, sales may be consistent with the objective of holding financial assets in order to collect contractual cash flows if the sales are made close to the maturity of the financial assets and the proceeds from the sales approximate the collection of the remaining contractual cash flows. *[IFRS 9.B4.1.3B]*. How an entity defines 'close' and 'approximate' will be a matter of judgement.

The overarching principle is whether the entity's key management personnel have decided that collecting contractual cash flows rather than selling financial assets is integral to achieving the objective of the business model. Under this objective, an entity will not normally expect that sales will be more than infrequent and more than insignificant in value. IFRS 9 does not explain how 'infrequent' and 'insignificant in value' is interpreted in practice. Those thresholds could lead to diversity in application, although it is an area where we expect that consensus and best practices will emerge over time.

4.2.1.A Assessing whether sales are 'infrequent'

If more than an infrequent number of sales are made from a portfolio and those sales are more than insignificant in value (either individually or in aggregate), the entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows. An increase in the frequency or value of sales in a particular period is not necessarily inconsistent with an objective to hold financial assets in order to collect contractual cash flows, if an entity can explain the reasons for those sales and demonstrate why those sales do not reflect a change in the entity's business model and, hence, sales will in future be lower in frequency or value. *[IFRS 9.B4.1.3B]*. This assessment is about expectations and not about intent. For instance, the fact that it is not the entity's objective to realise fair value gains or losses is not sufficient in itself to be able to conclude that measurement at amortised cost is appropriate.

Infrequent sales resulting from unanticipated funding needs (e.g., in a stress case scenario) would not contradict a hold to collect objective, even if such sales are significant in value. Assessing what constitutes a stress scenario is judgemental. However, the standard suggests relatively extreme circumstances by illustrating a stress scenario as a run on a bank's deposits (see Illustration 4-7 in section 4.6 below). Also, IFRS 9.B4.1.2A refers to 'worst case' and 'stress case' scenarios as scenarios that the entity does not reasonably expect to occur.

If a stress scenario that was previously not reasonably expected to occur becomes more probable due to new facts and circumstances, an entity will need to re-assess whether the scenario continues to constitute a stress scenario for the purpose of classifying new financial assets. For example, when sales have recently occurred as a result of unanticipated funding needs, an entity may assess that such a scenario is currently no longer reasonably expected not to recur within this portfolio, resulting in newly originated or newly purchased financial assets in this portfolio no longer being classified as in a hold to collect business model.

Furthermore, whether a third party (such as a banking regulator in the case of some liquidity portfolios held by banks) imposes the requirement to sell the financial assets, or that activity is at the entity's discretion, is not relevant to the business model assessment. *[IFRS 9.B4.1.3B]*.

Many organisations hold portfolios of financial assets for liquidity purposes. Assets in those portfolios are regularly sold because sales are required by a regulator to demonstrate liquidity, because the entity needs to cover everyday liquidity needs or because the entity tries to maximise the yield of the portfolio. It follows that such portfolios (except those that may be sold only in stress case scenarios) will probably not be measured at amortised cost depending on facts and circumstances (see also section 4.6 below).

4.2.1.B Assessing whether sales are 'insignificant in value'

With reference to measuring 'insignificant in value', the standard refers to more than an infrequent number of such sales being made out of a portfolio. *[IFRS 9.B4.1.3B]*. The reference point to measuring 'insignificant in value' could therefore be the portfolio, particularly as it is the portfolio that is subject to the business model assessment. The assessment of more than 'insignificant in value' therefore requires consideration of the sales value against the total size of the portfolio. In addition to the sales to value-based assessment, an entity could also consider whether the gain or loss on sale is significant compared to the total return on the portfolio. However, the gain or loss approach, on its own, would not be an appropriate method as the standard is specific about the importance of the value of sales in making the assessment. Loans could be sold at amounts close to their carrying value making it possible for very significant volumes of sales to generate insignificant gains or losses.

The standard is not explicit as to whether any test of insignificance is performed period-by-period, or by considering sales over the entire life of the portfolio. However, if a period-by-period approach were to be used, the determination of whether sales are insignificant in value would depend on the length of the period, which means that two entities with identical portfolios but with different lengths of the reporting period would arrive at different assessments. This could occur, for example, where one entity reports quarterly and the other semi-annually. Further, if a bank holds a portfolio of bonds with an average maturity of 20 years, sales of, say, 5% each year would mean that a considerable portion of the portfolio will have been sold before it matures, which would not seem to be consistent with a business model of holding to collect. Therefore, applying the average life of the portfolio would seem to be more relevant than applying the reporting period.

4.2.2 Transferred financial assets that are not derecognised

There are a number of circumstances where an entity may sell a financial asset, but those assets will remain on the selling entity's statement of financial position. For example, a bank may enter into a 'repo' transaction whereby it sells a debt security and at the same time agrees to repurchase it at a fixed price. Similarly, a manufacturer may sell trade receivables as part of a factoring programme and provide a guarantee to the buyer to compensate it for any defaults by the debtors. In each case, the seller retains substantially all risks and rewards of the financial assets and they would not be derecognised in accordance with the requirements of IFRS 9.

The inevitable question that arises in these circumstances is whether these transactions are regarded as sales when applying the business model assessment. In this context, Example 3 in IFRS 9.B4.1.4 contains only one passing reference to derecognition, but it does suggest that it is the accounting treatment and not the legal form of a transaction that determines whether the entity has ceased to hold an asset to collect contractual cash flows (see also Illustration 4-6 in section 4.6 below). Application of such an approach would give an intuitively correct answer for repo transactions, in which the seller is required to repurchase the asset at an agreed future date and price, and which are, in substance, secured financing transactions rather than sales. However, as the IASB did not provide the basis for the treatment in the example quoted above, it is not clear if accounting derecognition is always the basis for the assessment. For instance, if a loan is sold under an agreement by which the seller will indemnify the purchaser for any credit losses (for instance if it is factored with recourse) and so the asset is not derecognised, it is not clear whether there has been a sale for the purposes of the IFRS 9 business model assessment, given that the transferor will never retake possession of the asset. In contrast, in a repo transaction the transferor will ultimately regain possession of the asset and these are generally regarded as not being a sale for the purposes of the business model test.

How we see it

Except for instruments such as repos which are, in substance, secured financing transactions where the seller retains substantially all the risks and rewards and will regain possession of the asset, we believe an entity has an accounting policy choice of whether it considers the legal form of the sale or the economic substance of the transaction when analysing whether sales within a portfolio provide evidence related to how cash flows are realised.

4.3 Hold to collect contractual cash flows and selling financial assets

The fair value through other comprehensive income measurement category is a mandatory category for portfolios of financial assets that are held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets (provided the asset also meets the contractual cash flow test). *[IFRS 9.4.1.2A]*.

In this type of business model, the entity's key management personnel have decided that both collecting contractual cash flows and selling are fundamental to achieving the objective of the business model. There are various objectives that may be consistent with this type of business model. For example, the objective of the business model may be to manage everyday liquidity needs, to maintain a particular interest yield profile or to match the duration of the financial assets to the duration of the liabilities that those assets are funding. To achieve these objectives, the entity will both collect contractual cash flows and sell the financial assets. *[IFRS 9.B4.1.4A]*.

Compared to the business model with an objective to hold financial assets to collect contractual cash flows, this business model will typically involve greater frequency and value of sales. This is because selling financial assets is integral to achieving the business model's objective rather than only incidental to it. There is no threshold for the frequency or value of sales that can or must occur in this business model. *[IFRS 9.B4.1.4B]*.

How we see it

As set out in the standard, the fair value through other comprehensive income is a defined category and is neither a residual classification nor an election. However, in practice, entities may identify those debt instruments which are held to collect contractual cash flows (see section 4.2 above), those which are held for trading, those managed on a fair value basis (see section 4.4 below) and those for which the entity applies the fair value option to avoid a measurement mismatch, (see section 6.1 below), and then measure the remaining debt instruments at fair value through other comprehensive income. As a consequence, the fair value through other comprehensive income category might, in effect, be used as a residual, just because it is far easier to articulate business models that would be classified at amortised cost or at fair value through profit or loss.

4.4 Other business models

IFRS 9 requires financial assets to be measured at fair value through profit or loss if they are not held within either a business model whose objective is to hold assets to collect contractual cash flows or within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. A business model that results in measurement at fair value through profit or loss is where the financial assets are held for trading (see section 3 above). Another is where the financial assets are managed on a fair value basis (see Illustration 4-13 in section 4.6 below).

When the standard explains what it means by a portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis it refers to the requirements for designating financial liabilities as measured at fair value through profit or loss *[IFRS 9.B4.1.6]* and stipulates that such portfolios are present where a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in IAS 24), for example, the entity's board of directors and chief executive officer. *[IFRS 9.4.2.2(b)]*. Further, if an entity manages and evaluates the performance of a group of financial assets on a fair value basis, measuring that group at fair value through profit or loss results in more relevant information. *[IFRS 9.B4.1.33]*. Documentation of the entity's strategy need not be extensive but must be sufficient to demonstrate that the classification at fair value through profit or loss is consistent with the entity's risk management or investment strategy. *[IFRS 9.B4.1.36]*.

Both cases (both where assets are held for trading and where assets are managed on a fair value basis), are examples of an entity managing financial assets with the objective of realising cash flows through the sale of the assets. The entity makes decisions based on the assets' fair values and manages the assets to realise those fair values. As a consequence, the entity's objective will typically result in active buying and selling. Even though the entity will collect contractual cash flows while it holds financial assets in the fair value through profit or loss category, this is only incidental and not integral to achieving the business model's objective. *[IFRS 9.B4.1.5, IFRS 9.B4.1.6]*.

4.5 Business model for financial assets owned by a subsidiary that is held for sale

A question that arises over the application of IFRS 9 concerns how to apply the business model test in the consolidated accounts to a subsidiary which is classified as held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. In particular, when the financial assets of a subsidiary are held with the objective of collecting contractual cash flows but the subsidiary itself is held for sale under IFRS 5, should newly originated or acquired financial assets of the subsidiary be considered to be within a hold to collect or a hold to sell business model? Additionally, should existing financial assets of the subsidiary that are classified as measured at amortised cost be reclassified due to a change in business model?

The IFRS IC were asked precisely this question in November 2016. They noted that, in its consolidated financial statements, an entity assesses the relevant requirements of IFRS 9 from the group perspective and will advise the IASB when it comes to discuss this issue. This issue is not currently on the IASB's agenda and so until the IASB concludes on this issue, it is unclear how the business model test would be applied in these circumstances.[1]

1 *IFRIC Update*, November 2016, available on the IFRS Foundation's website.

4.6 Applying the business model test in practice

The application of the business model test is illustrated through a number of examples, in all the following Illustrations in this section it is assumed that the instruments will meet the contractual cash flows characteristics test.

Illustration 4-1: The level at which the business model assessment is applied

A global banking group operates two business lines, retail banking and investment banking. These businesses both operate in the same five locations by means of separate subsidiaries. Each subsidiary has its own Board of Directors that is responsible for carrying out the strategic objectives as set by the group's Board of Directors.

The financial assets held by the investment banking business are measured at fair value through profit or loss in line with the group's strategy, which defines the business model, to actively trade these financial assets. Within the retail banking business, four of the five subsidiaries hold debt securities in line with the group's objective to collect contractual cash flows. However, the fifth subsidiary holds a portfolio of debt securities that it expects to sell before maturity. These assets are not held for trading, but individual assets are sold if the portfolio manager believes he or she can reinvest the funds in assets with a higher yield. As a result, a more than infrequent number of sales that are significant in value are anticipated for this portfolio and it is unlikely that this portfolio would meet the amortised cost criteria if it were assessed on its own.

The bank will need to exercise judgement to determine the appropriate level at which to assess its business model(s). Hence, different conclusions are possible depending on the facts and circumstances.

This does not mean that the bank has an accounting policy choice, but it is, rather, a matter of fact that can be observed by the way the organisation is structured and managed. In many organisations, key management personnel may determine the overall strategy and then delegate their authority for executing the strategy to others. The combination of the overall strategy and the effect of the delegated authority are among the factors that can be considered in the determination of business models.

In the specified fact pattern, the determining factor is whether the fifth subsidiary is managed independently from the other four subsidiaries (and performance is assessed, and management is compensated accordingly). If it is separately managed, the number of business models is three (i.e., investment banking, one business model for the first four subsidiaries and a third business model for the fifth subsidiary). If not, the number of business models is two (i.e., one for retail banking and one for investment banking). In the case of two business models, all the debt securities held by the retail banking business would be accounted for at fair value through other comprehensive income, unless the sales activity of the fifth subsidiary is not significant to the retail banking portfolio.

Illustration 4-2: Splitting portfolios

Entity A has debt instruments worth CU100m, comprising notes with maturities of three to five years. CU3m of the portfolio is sold and reinvested at least once a year, while the remaining CU97m of investments are typically held to near their maturity. First, the entity needs to use judgement to determine whether it has:

(a) Two business models: (i) CU97m of debt instruments held to near their maturity; and (ii) CU3m of debt instruments which are actively bought and sold, provided those assets can be separately identified

Or

(b) One business model applied to the overall portfolio of CU100m debt investments

If scenario (a) above is considered more appropriate (e.g., the entity intends to continue to sell and reinvest a distinct part of the portfolio in the same proportions as it has in past years), the entity could achieve amortised cost classification for a majority of the debt instruments and would probably need to account for the remaining debt instruments at fair value through profit or loss. This is more likely to be the case where there is clearly a different management objective for the two groups of assets and their performance is measured, and management is compensated, accordingly.

Alternatively, if scenario (b) is considered more appropriate, the entity needs to determine whether the level of expected sales and repurchases is more than infrequent and is significant in value, requiring the whole portfolio to be measured at fair value through profit or loss or fair value through other comprehensive income (see section 4.2.1 above). Whether the assets are required to be measured at fair value through profit or loss instead of fair value through other comprehensive income also depends on whether the portfolio is managed on a fair value basis and fair value information is primarily used to assess asset's performance and to make decisions.

Illustration 4-3: Credit risk management activities

An entity holds investments to collect their contractual cash flows. The funding needs of the entity are predictable, and the maturity of its financial assets is matched to its estimated funding needs.

The entity performs credit risk management activities with the objective of maintaining the credit risk of the portfolio within defined risk limits. In the past, sales have typically occurred when the financial assets' credit risk has increased such that the assets no longer meet the entity's documented investment policy.

Reports to key management personnel focus on the credit quality of the financial assets and the contractual return. The entity also monitors fair values of the financial assets, among other information.

Irrespective of their frequency and value, sales due to an increase in the assets' credit risk are not inconsistent with a business model whose objective is to hold financial assets to collect contractual cash flows, because the credit quality of financial assets is relevant to the entity's ability to collect contractual cash flows.

Credit risk management activities that are aimed at avoiding potential credit losses due to credit deterioration are integral to such a business model. Selling a financial asset because it no longer meets the credit criteria specified in the entity's documented investment policy is an example of a sale that has occurred due to an increase in credit risk. However, this conclusion cannot be extended to sales to avoid excessive credit concentration (see also Illustration 4-4 below).

Although the entity considers, among other information, the financial assets' fair values from a liquidity perspective (i.e., the cash amount that would be realised if the entity needs to sell assets), the entity's objective is to hold the financial assets in order to collect the contractual cash flows.

Therefore, under the fact pattern specified, the entity will still be able to measure the portfolio at amortised cost.

In the absence of a documented investment or similar policy, the entity may be able to demonstrate in other ways that a sale only occurred due to an increase in credit risk. *[IFRS 9.B4.1.4 Example 1]*.

Illustration 4-4: Sales to manage concentration risk

An entity sells financial assets to manage the concentration of the entity's credit risk to a particular obligor, country, or industrial sector, without an increase in the assets' credit risk.

Such sales may be consistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows, but only to the extent that they are infrequent (even if significant in value) or insignificant in value both individually and in aggregate (even if frequent). That means such sales are treated no differently than sales for any other reason. Thus, if such sales are more than infrequent and are not insignificant in value (both individually and in aggregate), then the business model would not qualify to be held to collect, but is likely to be consistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows and to sell financial assets. *[IFRS 9.B4.1.3B]*.

Illustration 4-5: Credit-impaired financial assets in a hold to collect business model

An entity's business model is to purchase portfolios of financial assets, such as loans. Those portfolios may or may not include financial assets that are credit-impaired, that is, loans for which there have already been one or more events occurring before purchase that have had a detrimental impact on future cash flows. If payment on the loans is not made on a timely basis, the entity attempts to realise the contractual cash flows through various means - for example, by contacting the debtor by mail, telephone or other methods. The entity's objective is to collect contractual cash flows and the entity does not manage any of the loans in this portfolio with an objective of realising cash flows by selling them. In some cases, the entity enters into interest rate swaps to change the interest rate on particular financial assets in a portfolio from a floating interest rate to a fixed interest rate.

The objective of the entity's business model is to hold the financial assets in order to collect the contractual cash flows. The same analysis would apply even if the entity does not expect to receive all of the contractual cash flows (e.g., some of the financial assets are credit impaired at initial recognition). The fact that the entity has entered into derivatives to modify the cash flows of the portfolio does not in itself change the entity's business model. *[IFRS 9.B4.1.4 Example 2]*.

Illustration 4-6: Securitisation

An entity has a business model with the objective of originating loans to customers and subsequently to sell those loans to a securitisation vehicle. The securitisation vehicle issues instruments to investors. The originating entity controls the securitisation vehicle and thus consolidates it. The securitisation vehicle collects the contractual cash flows from the loans and passes them on to its investors.

It is assumed for the purposes of this example that the loans continue to be recognised in the consolidated statement of financial position because they are recognised by the securitisation vehicle.

The consolidated group originated the loans with the objective of holding them to collect the contractual cash flows and, therefore, measures them at amortised cost. The same conclusion may be drawn if the securitisation vehicle is not consolidated but the originating entity is unable to derecognise the assets (see section 4.2.2 above).

However, the originating entity has an objective of realising cash flows on the loan portfolio by selling the loans to the securitisation vehicle, so for the purposes of its separate financial statements it would not be considered to be managing this portfolio in order to collect the contractual cash flows, but to sell them. The loans would probably need to be recorded at fair value through profit or loss as long as they continue to be recognised. *[IFRS 9.B4.1.4 Example 3]*.

Illustration 4-7: Liquidity portfolio for stress case scenarios

A financial institution holds financial assets to meet liquidity needs in a 'stress case' scenario (e.g., a run on the bank's deposits). The entity does not anticipate selling these assets except in such a scenario. The entity monitors the credit quality of the financial assets and its objective in managing the financial assets is to collect the contractual cash flows. The entity evaluates the performance of the assets based on interest revenue earned and credit losses realised.

However, the entity also monitors the fair value of the financial assets from a liquidity perspective to ensure that the cash amount that would be realised if the entity needed to sell the assets in a stress case scenario would be sufficient to meet the entity's liquidity needs. Periodically, the entity makes sales that are insignificant in value to demonstrate liquidity.

The objective of the entity's business model is to hold the financial assets to collect contractual cash flows.

The analysis would not change even if during a previous stress case scenario, the entity made sales that were significant in value in order to meet its liquidity needs. However, see the discussion in section 4.2.1.A above regarding considerations for new financial assets when scenarios that were previously considered stress scenarios are no longer reasonably expected not to occur. Similarly, recurring sales activity that is insignificant in value is not inconsistent with holding financial assets to collect contractual cash flows.

However, the assessment would change if the entity periodically sells debt instruments that are significant in value to demonstrate liquidity, or if the entity sells the debt instruments to cover everyday liquidity needs. See Illustration 4-9 below. *[IFRS 9.B4.1.4 Example 4]*.

Illustration 4-8: Anticipated capital expenditure

A non-financial entity anticipates capital expenditure in a few years. The entity invests its excess cash in short-term and long-term financial assets so that it can fund the expenditure when the need arises. Many of the financial assets have contractual lives that exceed the entity's anticipated investment period. Therefore, the entity will need to sell some of the assets before maturity to meet those funding needs.

The objective of the business model is achieved by both collecting contractual cash flows and selling financial assets.

In contrast, consider an entity that anticipates a cash outflow in five years to fund capital expenditures and invests excess cash in short-term financial assets. When the investments mature, the entity reinvests the cash into new short-term financial assets. The entity maintains this strategy until the funds are needed, at which time the entity uses the proceeds from the maturing financial assets to fund the capital expenditures. Only insignificant sales occur before maturity (unless there is an increase in credit risk). The objective of such a business model is to hold financial assets in order to collect contractual cash flows. *[IFRS 9.B4.1.4C Example 5]*.

Illustration 4-9: Liquidity portfolio for everyday liquidity needs

A financial institution holds financial assets to meet its everyday liquidity needs. In the past, this has resulted in frequent sales activity and such sales have been significant in value. This activity is expected to continue in the future as everyday liquidity needs can rarely be forecast with any accuracy.

The objective of the business model is meeting everyday liquidity needs. The entity achieves this objective by both collecting contractual cash flows and selling financial assets. This means that both collecting contractual cash flows and selling financial assets are integral to achieving the business model's objective and the financial assets are measured at fair value through other comprehensive income. *[IFRS 9.B4.1.4C Example 6]*. The frequent and significant sales activity does not necessarily mean that the portfolio is held for trading because under the business model objective above, assets are not sold with the intention of short-term profit taking.

Illustration 4-10: Opportunistic portfolio management

A financial institution holds a portfolio of financial assets. The entity actively manages the return on the portfolio on an opportunistic basis trying to increase the return, without a clear intention of holding the financial assets to collect contractual cash flows (although it might end up holding the assets if no other investment opportunities arise). That return consists of collecting contractual payments as well as gains and losses from the sale of financial assets.

As a result, the entity holds financial assets to collect contractual cash flows and sells financial assets to reinvest in higher yielding financial assets. In the past, this strategy has resulted in frequent sales activity and such sales have been significant in value. It is expected that the sales activity will continue in the future.

The entity achieves the objective stated above by both collecting contractual cash flows and selling financial assets. Both collecting contractual cash flows and selling financial assets are integral to achieving the business model's objective and, thus, the financial assets are measured at fair value through other comprehensive income. *[IFRS 9.B4.1.4C Example 6]*.

Sometimes, entities may manage a portfolio to manage its yield. In such cases, the portfolio manager may be remunerated based on the overall yield of the portfolio and fair value gains or losses may not be considered in his or her remuneration. Furthermore, management's documented strategy and defined key performance indicators may emphasise optimising long-term yield rather than fair value gains or losses and accordingly, the entity's management reporting focuses on yield rather than fair value of the debt instruments within the portfolio. However, the fact that it is not the entity's objective to realise fair value gains or losses is not sufficient in itself to be able to conclude that measurement at amortised cost is appropriate as the business model objective is not only holding financial assets to collect contractual cash flows but also results in sales which are more than infrequent and significant in value. Thus, such a portfolio would be measured at fair value through other comprehensive income.

Illustration 4-11: Replication portfolios

Fact pattern 1: Insurance company

An insurer holds financial assets in order to fund insurance contract liabilities. The insurer uses the proceeds from the contractual cash flows on the financial assets to settle insurance contract liabilities as they come due. To ensure that the contractual cash flows from the financial assets are sufficient to settle those liabilities, the insurer undertakes significant buying and selling activity on a regular basis to rebalance its portfolio of assets and to meet cash flow needs as they arise.

The objective of the business model is to fund the insurance contract liabilities. To achieve this objective, the entity collects contractual cash flows as they come due and sells financial assets to maintain the desired profile of the asset portfolio. Thus, both collecting contractual cash flows and selling financial assets are integral to achieving the business model's objective and it follows that the financial assets are measured at fair value through other comprehensive income. *[IFRS 9.B4.1.4C Example 7]*.

Fact pattern 2: Bank

A bank allocates investments into maturity bands to match the expected duration of customers' time deposits. The invested assets have a similar maturity profile and amount to the corresponding deposits. The target ratio of assets to deposits for each maturity band has pre-determined minimum and maximum levels. For example, if the ratio exceeds the maximum level because of an unexpected withdrawal of deposits, the bank will sell some assets to reduce the ratio.

Meanwhile, new assets will be acquired when necessary (i.e., when the ratio of assets to deposits falls below the pre-determined minimum level). The expected repayment profile of the deposits would be updated on a quarterly basis, based on changes in customer behaviour.

The question is whether adjusting the assets/deposits ratio by selling assets to correspond with a change in the expected repayment profile of the deposits would mean that the business model is inconsistent with the objective of holding to collect the contractual cash flows. In these circumstances, an analogy can be drawn to the insurance company above.

If the bank has a good track record of forecasting its deposit repayments, so that sales are expected to be infrequent, it is possible that the objective of the business model is to hold the investments to collect contractual cash flows. But, if significant sales take place each year, it is likely to be difficult to rationalise such practice with this objective. Due consideration will need to be given to the magnitude of sales and the reasons for the sales.

Illustration 4-12: Loans that are to be sub-participated

An entity originates loans so that it holds part of the portfolio to maturity, but 'sub-participates' a portion of the loans to other banks, so that it transfers substantially all the risks and rewards and so achieves derecognition. The question arises whether, for the purposes of application of IFRS 9, the entity has one business model or two.

The entity could consider the activities of lending to hold and lending to sell or sub-participate as two separate business models, requiring different skills and processes. Whilst the financial assets resulting from the former would typically qualify for amortised cost measurement, those from the latter would probably not and would, therefore, most likely need to be measured at fair value through profit or loss. This split approach is likely to be acceptable as long as the entity is able to forecast with reasonable confidence that it will indeed hold the assets (or the proportion of a group of identical assets) that it determines to be measured at amortised cost.

How we see it

If a loan is assessed, in part, to be sold or sub-participated, this raises the additional issue of whether a single financial asset can be classified into two separate business models. We believe that this split classification is seen in practice and is also consistent with the derecognition principles of IFRS 9 (see Chapter 48 at section 3.4).

In some cases, an entity may fail to achieve the intended disposal, having previously classified a portion of a loan at fair value through profit or loss because of the intention to sell.

The standard requires classification to be determined in accordance with the business model applicable at the point of initial recognition of the asset. In this example, the fact that the entity fails to achieve an intended disposal does not trigger a reclassification in accordance with the standard as the threshold for reclassification requires a change in business model that must be significant to the entity's operations and demonstrable to external parties. Therefore, loans or portions of loans that the entity fails to dispose of would continue to be recorded at fair value through profit or loss.

Illustration 4-13: Portfolio managed on a fair value basis

An entity manages a portfolio and measures its performance on a fair value basis and makes decisions based on the fair value of the financial assets. Such an objective typically results in frequent sales and purchases of financial assets.

A portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis is neither held to collect contractual cash flows nor held both to collect contractual cash flows and to sell financial assets. In addition, a portfolio of financial assets that meets the definition of held for trading is not held to collect contractual cash flows or held both to collect contractual cash flows and to sell financial assets. The entity is primarily focused on fair value information and uses that information to assess the assets' performance and to make decisions.

Even though the entity will collect contractual cash flows while it holds financial assets in the fair value through profit or loss category, this is only incidental and not integral to achieving the business model's objective. Consequently, such portfolios of financial assets must be measured at fair value through profit or loss. *[IFRS 9.B4.1.5]*.

5 Characteristics of the contractual cash flows of the instrument

The assessment of the characteristics of a financial asset's contractual cash flows aims to identify whether they are 'solely payments of principal and interest on the principal amount outstanding'. Hence, the assessment is colloquially referred to as the 'SPPI test'.

The contractual cash flow characteristics test is designed to screen out financial assets on which the application of the effective interest method either is not viable from a pure mechanical standpoint or does not provide useful information about the uncertainty, timing and amount of the financial asset's contractual cash flows.

Because the effective interest method is essentially an allocation mechanism that spreads interest revenue or expense over time, amortised cost is only appropriate for simple cash flows that have low variability such as those of traditional unleveraged loans and receivables, and 'plain vanilla' debt instruments. Accordingly, the contractual cash flow characteristics test is based on the premise that it is only when the variability in the contractual cash flows maintains the holder's return in line with a 'basic lending arrangement' that the application of effective interest method provides useful information. *[IFRS 9.BC4.23, IFRS 9.BC4.158, IFRS 9.BC4.171, IFRS 9.BC4.172]*.

In this context, the term 'basic lending arrangement' is used broadly to capture both originated and acquired financial assets, the lender or the holder of which is looking to earn a return that compensates primarily for the time value of money and credit risk. However, such an arrangement can also include other elements that provide consideration for other basic lending risks such as liquidity risks, costs associated with holding the financial asset for a period of time (e.g., servicing or administrative costs) and a profit margin. *[IFRS 9.B4.1.7A, IFRS 9.BC4.182(b)]*.

In contrast, contractual terms that introduce a more than *de minimis* exposure (see section 5.4.1 below) to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. *[IFRS 9.B4.1.7A, IFRS 9.B4.1.18]*.

The IASB noted that it believes that amortised cost would provide relevant and useful information if the contractual cash flows do not introduce risks or volatility that are inconsistent with a basic lending arrangement. *[IFRS 9.BC4.180]*.

The following sections cover the main aspects of the contractual cash flow characteristics test, starting with the meaning of the terms 'principal' and 'interest' in sections 5.1 and 5.2 below, and discusses instruments that normally pass the test in section 5.3 below. So called 'modified' contractual cash flows and their effect on the contractual cash flow characteristics test are dealt with in section 5.4 below. Non-recourse assets are separately covered in section 5.5 below. Contractually linked instruments are covered in section 5.6 below. Loans with ESG features are specifically dealt with in section 5.4.7 below.

5.1 The meaning of 'principal'

'Principal' is not a defined term in IFRS 9. However, the standard states that, for the purposes of applying the contractual cash flow characteristics test, the principal is "the fair value of the asset at initial recognition" and that it may change over the life of the financial asset (for example, if there are repayments of principal). *[IFRS 9.4.1.3(a), IFRS 9.B4.1.7B]*.

The IASB believes that this usage reflects the economics of the financial asset from the perspective of the current holder; in other words, the entity would assess the contractual cash flow characteristics by comparing the contractual cash flows to the amount that it actually invested. *[IFRS 9.BC4.182(a)]*.

Illustration 5-1: The meaning of 'principal'

Entity A issued a bond with a contractually stated principal of CU1,000,000. The bond was originally issued at CU990,000. Because interest rates have risen sharply since the bond was originally issued, Entity B, the current holder of the bond, acquired the bond in the secondary market for CU975,000. From the perspective of entity B, the principal amount is CU975,000. The principal will increase over time as the discount of CU25,000 amortises out until it reaches the contractual amount of CU1,000,000 at the bond's maturity.

The principal is, therefore, not necessarily the contractual par amount, nor (when the holder has acquired the asset subsequent to its origination) is it necessarily the amount that was advanced to the debtor when the instrument was originally issued.

The description of 'principal' as the fair value of an instrument on initial recognition avoids a concern that any financial asset acquired or issued at a substantial discount would be leveraged and hence would not have economic characteristics of interest.

A clear understanding of what the standard means by 'principal' is also necessary for the appropriate and consistent application of the contractual cash flow characteristics test to prepayable financial assets (see section 5.4.4 below).

An entity must assess whether contractual cash flows are solely payments of principal and interest on the principal amount outstanding for the currency in which the financial asset is denominated. In assessing the time value of money element of the return, the entity must consider the currency in which the financial asset is denominated, because interest rates vary by currency (see Illustration 5-18 in section 5.4.5 below). *[IFRS 9.B4.1.8, IFRS 9.BC4.177]*.

5.2 The meaning of 'interest'

IFRS 9 states that the most significant elements of interest within a basic lending arrangement are typically the consideration for the time value of money and credit risk. In addition, interest may also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time. Furthermore, interest may include a profit margin that is consistent with a basic lending arrangement.

In extreme economic circumstances, interest can be negative if, for example, the holder of a financial asset effectively pays a fee for the safekeeping of its money for a particular period of time and that fee exceeds the consideration the holder receives for the time value of money, credit risk and other basic lending risks and costs.

However, contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. An originated or a purchased financial asset can be a basic lending arrangement irrespective of whether it is a loan in its legal form. *[IFRS 9.4.1.3(b), IFRS 9.B4.1.7A]*.

Leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. For example, stand-alone option, forward and swap contracts are financial assets that include such leverage. Thus, such contracts do not meet the SPPI test and cannot be subsequently measured at amortised cost or fair value through other comprehensive income. *[IFRS 9.B4.1.9]*.

The IASB notes that the assessment of interest focuses on what the entity is being compensated for (i.e., whether the entity is receiving consideration for basic lending risks, costs and a profit margin or is being compensated for something else), instead of how much the entity receives for a particular element. For example, the Board acknowledges that different entities may price the credit risk element differently. *[IFRS 9.BC4.182(b)]*. Although two entities may receive different amounts for the same element of interest, e.g., credit risk, they could both conclude that their consideration for credit risk is appropriate within a basic lending arrangement.

Time value of money is the element of interest that provides consideration for only the passage of time. The time value of money element does not provide consideration for other risks or costs associated with holding the financial asset. To make this assessment, an entity applies judgement and considers relevant factors such as the currency in which the financial asset is denominated, and the period for which the interest rate is set. *[IFRS 9.B4.1.9A]*.

The IASB also notes that, as a general proposition, the market in which the transaction occurs is relevant to the assessment of the time value of money element. For example, in Europe, it is common to reference interest rates to EURIBOR and in the United States it is common to reference interest rates to the prime rate. However, a particular interest rate does not necessarily reflect consideration for only the time value of money merely because that rate is considered 'normal' in a particular market. For example, if an interest rate is reset every year but the reference rate is always a 15-year rate, it would be difficult for an entity to conclude that such a rate provides consideration for only the passage of time, even if such pricing is commonly used in that particular market. Accordingly, the IASB believes that an entity must apply judgement to conclude whether the stated time value of money element meets the objective of providing consideration for only the passage of time. *[IFRS 9.BC4.178]*.

As part of the IASB's work to address the effects of IBOR reform on financial reporting, the IASB discussed in October 2019, whether or not backward-looking interest rates would satisfy the contractual characteristics test. See section 5.4.2 below for further consideration of when there are contractual features that modify the consideration for the time value of money.

5.3 Contractual features that normally pass the test

The most common instruments that normally pass the test are plain vanilla debt instruments which are acquired at par, have a fixed maturity and pay interest that is fixed at inception. Instruments that pay variable interest also normally pass the test, although further consideration is required in that case (see section 5.4.4 below).

There are several features that are common in many financial assets and which would not usually cause the contractual cash flow characteristics test to be failed. This section describes some of those features and instruments that are normally unproblematic, but also highlights cases that might result in an asset failing the contractual cash flow characteristics test. Features that are more complex and need more consideration are described in section 5.4 below.

5.3.1 Conventional subordination features

In many lending transactions the instrument is ranked relative to amounts owed by the borrower to its other creditors. An instrument that is subordinated to other instruments may be considered to have contractual cash flows that are payments of principal and interest on the principal amount outstanding if the debtor's non-payment arises only on a breach of contract and the holder has a contractual right to unpaid amounts of principal and interest on the principal amount outstanding even in the event of the debtor's bankruptcy.

For example, a trade receivable that ranks its creditor as a general creditor would qualify as having payments of principal and interest on the principal amount outstanding. This is the case even if the debtor has issued loans that are collateralised, which in the event of bankruptcy would give that loan holder priority over the claims of the general creditor in respect of the collateral but does not affect the contractual right of the general creditor to unpaid principal and other amounts due. *[IFRS 9.B4.1.19]*.

On the other hand, if the subordination feature limits the contractual cash flows in any other way or introduces any kind of leverage, the instrument would fail the contractual cash flow characteristics test.

5.3.2 Full recourse loans secured by collateral

The fact that a full recourse loan is collateralised does not in itself affect the analysis of whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding. *[IFRS 9.B4.1.13 Instrument D]*. However, a full recourse loan may, in substance, be non-recourse if the borrower has limited other assets, in which case an entity would need to assess the particular underlying assets (i.e., the collateral) to determine whether or not the contractual cash flows of the loan are payments of principal and interest on the principal amount outstanding. *[IFRS 9.B4.1.17]*. If there is insufficient equity or collateral in the borrower to ensure that payments of the contractual cash flows are made, then the loan may fail the contractual cash flow characteristics test. However, if sufficient equity or collateral is available then the contractual cash flow characteristics test may be met (see Illustration 5-26 in section 5.5 below). Judgement may be necessary in determining whether there is adequate collateral or equity to ensure that all the contractual cash payments will be made.

As part of the IFRS 9 Post Implementation Review (PIR), the IASB has made amendments to IFRS 9 in order to clarify the application of the contractual cash flow characteristics guidance to financial assets with non-recourse features (see section 10.2 below).

5.3.3 Bonds with a capped or floored interest rate

Some bonds may have a stated maturity date but pay a variable market interest rate that is subject to a cap or a floor. The contractual cash flows of such instrument could be seen as being an instrument that has a fixed interest rate and an instrument that has a variable interest rate.

These both represent payments of principal and interest on the principal amount outstanding as long as the interest reflects consideration for the time value of money, for the credit risk associated with the instrument during the term of the instrument and for other basic lending risks and costs, as well as a profit margin.

Therefore, such an instrument can have cash flows that are solely payments of principal and interest on the principal amount outstanding. A feature such as an interest rate cap or floor may reduce cash flow variability by setting a limit on a variable interest rate or increase the cash flow variability because a fixed rate becomes variable. *[IFRS 9.B4.1.13 Instrument C]*. If there is no leverage and no mismatch of term with respect to interest, then the instrument will pass the contractual cash flows characteristics test.

There is no requirement to determine whether the cap or floor is in the money on initial recognition.

Caps and floors will generally pass the SPPI test without further analysis, apart from some instruments, namely those with features that create leverage. These 'exotic' instruments would require detailed assessment and judgement. An instrument with a floor which is deeply in the money at origination is not seen as a problem for passing the contractual cash flows characteristics test.

We assume that a variable rate debt instrument that is subject to both a cap and a floor (known as a collar) would also satisfy the contractual cash flow characteristics test for the same reasons.

In many jurisdictions interest rates on loans are capped by law to an absolute amount or a multiple of an index rate. Whereas a capped interest rate meets the contractual cash flow characteristic test when the interest reflects the time value of money as discussed above, where the cap is referenced to a multiple of an index rate, it can be argued that the cap introduces leverage into the instrument. However, it can also be argued that the feature is not intended to introduce leverage into the market but to protect consumers, as a cap will only limit the total interest paid by the borrower. IFRS 9 also permits interest rates that are regulated to meet the contractual cash flow characteristic test if the interest rate represents consideration that is broadly consistent with the passage of time. *[IFRS 9.B4.1.9E]*. If the cap is introduced by the regulator to protect consumers by providing an estimate of the fair market interest rate it could be considered to represent consideration for the passage of time (see section 5.4.3 below).

The issue of whether regulator driven caps are consistent with the SPPI criteria was considered by the IASB as part of the PIR (see section 10.3 below), but not taken forward as it was not considered to be sufficiently widespread to merit amending IFRS 9 for.

5.3.4 Lender has discretion to change the interest rate

In some instances, the lender may have the right to unilaterally adjust the interest rates of its loans in accordance with its own business policy. However, if the borrower rejects the new rate, it has the right to terminate the contract and prepay the loan at either par, or par plus a pre-payment penalty. The prepayment terms would need to be assessed in combination with the lender's discretion to change the rate in order to assess overall SSPI compliance of the loan.

These features do not *per se* result in the loans failing the contractual cash flow characteristic test. However, whether the loan passes the test depends on facts and circumstances which require assessment on a case-by-case basis, specifically whether the adjusted interest rate represents consideration for the time value of money, credit risk and other basic lending risk and costs, as well as a profit margin. As part of this assessment, an entity might consider whether the change in interest rate applies to all similar loans, including new loans and the ones in issue, or only to one or certain individual borrowers (this excludes changes in interest rates due to changes in the credit spread of the borrower). The more targeted the increase is, the higher the likelihood that it is reflective of risks specific to the borrower and hence SPPI compliant.

Note that in practice a bank is likely to be restricted as to how much it can increase the interest rate: if it is set too high the borrower will prepay and the bank is unlikely to remain competitive.

5.3.5 Unleveraged inflation-linked bonds

For some financial instruments, payments of principal and interest on the principal amount outstanding are linked to an inflation index of the currency in which the instrument is issued. The inflation link is not leveraged. Linking payments of principal and interest on the principal amount outstanding to an unleveraged inflation index resets the time value of money to a current level. In other words, the interest rate on the instrument reflects 'real' interest. Thus, the interest amounts are consideration for the time value of money on the principal amount outstanding.

We believe measurement at amortised cost is possible even if the principal of an inflation-indexed bond is not protected, provided the inflation link is not leveraged. Payments on both the principal and interest will be inflation-adjusted and representative of 'real' interest which is consideration for the time value of money on the principal amount outstanding. *[IFRS 9.B4.1.13 Instrument A]*.

Illustration 5-2: Unleveraged inflation linked bond

Entity A invests in euro-denominated bonds with a fixed maturity issued by Entity B. Interest on the bond is linked directly to the inflation index of Eurozone Country C, which is Entity B's principal place of business. The question arises whether Entity A can measure the euro bonds at amortised cost or fair value through other comprehensive income given that interest is not linked to the inflation index of the entire Eurozone area.

The bond is denominated in euros and Eurozone Country C is part of the Eurozone, therefore, we consider the inflation link to be acceptable. The inflation index reflects the inflation rate of the currency in which the bond is issued since it is the inflation index of Entity B's economic environment, and the euro is the currency for that economic environment.

By linking the inflation index to the inflation rate of Eurozone Country C, Entity B is reflecting 'real' interest for the economic environment in which it operates. Hence, in these circumstances, Entity A may regard the interest as consideration for the time of value of money and credit risk associated with the principal amount outstanding on the bond.

As part of the post implementation review of IFRS 9 - Classification and Measurement, respondents to RFI asked whether linkage to an inflation index might cause some loans to fail the SPPI test as the adjustments may be considered as introducing leverage in the context of recent significant rises in inflation rates. In April 2022 the Staff expressed the view that the conclusion in IFRS 9 that a contractual link to an unleveraged inflation index represents consideration for the time value of money on the principal amount outstanding, remains relevant regardless of the level of inflation. In September 2022, the Board decided not to take further action on this matter.

5.3.6 Features which compensate the lender for changes in tax or other related costs

Some loans include clauses which require the borrower to compensate the lender for changes in tax or regulatory costs during the life of the loan. The interest rate for such loans is usually set at a rate which takes into account the specific tax or regulatory environment, e.g., interest receivable may be exempt from tax and the lender will consequently offer the borrower a below market rate. Any change to the tax laws which affect such an arrangement could result in a loss to the lender as tax could become deductible from interest receivable. The compensation clause is therefore intended to make the lender whole in the event of such a change. As the effect of such a clause is to enable the lender to maintain its profit margin it can be considered to be consistent with a basic lending arrangement.

5.4 Contractual features that may affect the classification

Sometimes, contractual provisions may affect the cash flows of an instrument such that they do not give rise to only a straightforward repayment of principal and interest. An entity is required to carefully assess those features in order to conclude whether the instrument passes the contractual cash flow characteristics test. It is important to note that the standard grants an exception for all features that are non-genuine or have only a *de minimis* impact and can be disregarded when making the assessment (see section 5.4.1 below).

Furthermore, the standard allows the time value of money element of interest to be 'modified' but only when the resulting cash flows could not be significantly different from an instrument that has an unmodified time value of money element (see section 5.4.2 below). It also allows regulated interest rates if they provide consideration that is broadly consistent with the passage of time and do not introduce risks that are inconsistent with a basic lending arrangement (see section 5.4.3 below).

An instrument may have other features that change the timing or amount of contractual cash flows which need to be assessed as to whether they represent payments of principal and interest on the principal outstanding. Examples of such features are variable interest rates, interest rates that step up, prepayment and extension options (see section 5.4.4 below) and sustainability-linked cash flows (see section 5.4.7 below).

Lastly, there are features that most likely result in an instrument failing the contractual cash flow characteristics test because they introduce cash flow volatility caused by risks that are inconsistent with a basic lending arrangement (see section 5.4.5 below).

5.4.1 *De minimis* and non-genuine features

A contractual cash flow characteristic does not affect the classification of the financial asset if it could have only a *de minimis* effect on the contractual cash flows of the financial asset (see section 5.4.1.A below).

In addition, if a contractual cash flow characteristic could have an effect on the contractual cash flows that is more than *de minimis* (either in a single reporting period or cumulatively) but that cash flow characteristic is not genuine, it does not affect the classification of a financial asset (see section 5.4.1.B below).

5.4.1.A *De minimis* features

The *de minimis* threshold concerns the magnitude of the possible effects of the contractual cash flow characteristic. To be considered *de minimis*, the impact of the feature on the cash flows of the financial asset must be expected to be *de minimis* in each reporting period and cumulatively over the life of the financial asset. This assessment is made at initial recognition of the instrument.

To make this determination, an entity must consider the possible effect of the contractual cash flow characteristic in each reporting period and cumulatively over the life of the financial instrument. That would be the case even if the feature could lead to a significant increase in cash flows in one period and a significant decrease in another period and these amounts offset each other on a cumulative basis. Likewise, if the feature's impact on a period's cash flows is always *de minimis* but its cumulative effect over time could be more than *de minimis* such a feature would not be considered *de minimis*. For such instruments the nature of the variability determines whether amortised cost would provide useful information by allocating cash flows over time.

Entities must consider what is meant by '*de minimis*'. This is not specifically defined within IFRS 9, however, the IASB Staff noted[2] that an entity should be able to conclude, without a detailed quantitative analysis, whether a feature is *de minimis*. If an entity is not able to conclude without a detailed quantitative analysis that a feature is *de minimis*, that would indicate that the feature is not *de minimis*. The same Staff paper includes the following example.

Illustration 5-3: The meaning of 'de minimis'

A financial asset contains a contractual provision that requires the issuer to comply with applicable regulatory requirements, including filing its financial statements with a regulatory body on a timely basis. If the issuer fails to do so, it is required to pay a fixed fee for each day until the financial statements are filed. The amount of such a daily fee is de minimis. The maximum amount of the fee that the issuer could be required to pay until the repayment feature is triggered is also de minimis.

In this example, the existence of a fee that could be triggered if the issuer fails to file its financial statements on time is not inconsistent with the SPPI condition because its impact on the asset's contractual cash flows is always de minimis. This analysis would apply to any feature regardless of its nature or trigger as long as its impact on the asset's contractual cash flows is always de minimis.

The analysis of whether a contractual feature is '*de minimis*' requires judgement, in particular in a low-interest environment where an adjustment can easily become significant in relative terms.

5.4.1.B Non-genuine features

Non-genuine features, as used in this context, are contingent features. A cash flow characteristic is not genuine if it affects the instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur. This means that although the feature can potentially lead to cash flows which are not solely payments of principal and interest, and those cash flows may even be significant, the instrument would still qualify for amortised cost or fair value through other comprehensive income measurement, depending on the business model. (See also Chapter 43 at section 4.3.1).

2 IASB Staff paper 6D: Project: *Financial Instruments: Classification and Measurement*, Paper topic: *Contractual Cash Flow Characteristics: The Meaning of 'Interest'*, IASB Meeting, September 2013. Available on the IFRS Foundation's website.

Illustration 5-4: The meaning of 'non-genuine'

IAS 32 requires terms of contracts that are not genuine to be ignored when assessing whether a financial instrument gives rise to an obligation to pay cash. An example of a clause that has caused some debate in this context is a 'regulatory change' clause, generally found in the terms of capital instruments issued by financial institutions such as banks and insurance companies. Such entities are generally required by local regulators to maintain certain minimum levels of equity or highly subordinated debt (generally referred to as regulatory capital) in order to be allowed to do business. *[IAS 32.25, IAS 32.AG29]*

A 'regulatory change' clause could typically require an instrument which, at the date of issue, is classified as regulatory capital to be repaid in the event that it ceases to be so classified. The practice so far of the regulators in many markets has been to make changes to a regulatory classification with prospective effect only, such that any instruments already in issue continue to be regarded as regulatory capital even though they would no longer be so under the new rules.

This has led some to question whether a 'regulatory change' clause can be regarded as a contingent settlement provision which is 'not genuine'. This is ultimately a matter for the judgement of entities in the context of the relevant regulatory environment(s). This judgement has not been made easier by the greater unpredictability of the markets (and therefore of regulators' responses to it) since the financial crisis. However, as the clause was inserted to provide regulators with flexibility in their actions, even if they do not normally exercise that flexibility, it would be difficult to argue that it is 'non-genuine'.

How we see it

Normally, terms are included in a contract for an economic purpose and therefore are, in general, genuine. The threshold 'not genuine' is presumably intended to deal with clauses that are inserted into the terms of financial instruments for some legal or tax reason, but have no real economic purpose or consequence.

Disregarding non-genuine features also means that the classification requirements of IFRS 9 cannot be overridden by introducing a contractual non-genuine cash flow characteristic in order to achieve a specific accounting outcome.

5.4.2 Contractual features that modify the consideration for the time value of money

In some cases, the time value of money element may be what the standard describes as 'modified' and so 'imperfect'. It cites, as an example, instances where the tenor of the interest rate does not correspond with the frequency with which it resets. In such cases, an entity must assess the modification to determine whether the contractual cash flows represent solely payments of principal and interest on the principal outstanding.

While the relationship between principal and the consideration for time value of money and credit risk does not need to be perfect, only relatively minor modifications of that relationship are consistent with payments that are SPPI. *[IFRS 9.BC4.174]*. In assessing whether or not any modification to the time value of money is consistent with the SPPI test, entities need to apply their own judgement.

In some circumstances, the entity may be able to make that determination by performing a qualitative assessment whereas, in other circumstances, it may be necessary to perform a quantitative analysis. *[IFRS 9.B4.1.9B]*. The IASB decided not to prescribe when an entity must perform a quantitative versus a qualitative assessment. *[IFRS 9.BC4.177(b)]*. The objective of a quantitative assessment is to determine whether or not the contractual (undiscounted) cash flows could be significantly different from the (undiscounted) cash flows that would arise if the time value of money element was not modified (referred to as 'the benchmark' cash flows).

For example, if the financial asset under assessment contains a variable interest rate that is reset every month to a one-year interest rate, the entity compares that financial asset to a financial instrument with identical contractual terms and credit risk, except the variable interest rate is reset monthly to a one-month interest rate. If the modified time value of money element could result in contractual (undiscounted) cash flows that are significantly different from the (undiscounted) benchmark cash flows, the financial asset fails the contractual cash flow characteristics test. To make this determination, the entity must consider the effect of the modified time value of money element in each reporting period and cumulatively over the life of the financial instrument. The reason for the interest rate being set this way is not relevant to the analysis. If it is clear, with little or no analysis, whether the contractual (undiscounted) cash flows on the financial asset under the assessment could (or could not) be significantly different from the (undiscounted) benchmark cash flows, an entity need not perform a detailed assessment. *[IFRS 9.B4.1.9C]*. 'Significantly different' is not defined in IFRS 9 and is a matter for management judgement.

When assessing a modified time value of money element, an entity must consider every interest rate scenario that is reasonably possible instead of every scenario that could possibly arise. This requirement is illustrated in Illustration 5-9 below.

If an entity concludes that the contractual (undiscounted) cash flows could be significantly different from the (undiscounted) benchmark cash flows, the financial asset does not pass the contractual cash flow characteristics test and therefore cannot be measured at amortised cost or fair value through other comprehensive income. *[IFRS 9.B4.1.9D]*.

The following table lists examples of modifications of the consideration for the time value of money which possibly meet the contractual cash flow characteristics test, depending on the outcome of the assessment described above.

Illustration 5-5: Examples of a modified time value of money component

	Modification	Fact pattern
1	Average interest rate	The stated coupon on a debt instrument is referenced to an average of long- and short-term benchmark interest rates for a specified period. For example, 3-month EURIBOR rate determined as an average of six-month and one-month rates during the previous quarter.
2	Lagging interest rate	The stated interest rate is referenced to lagging interest rates. For example, 6-month EURIBOR rate set for a 6-month period, but where the rate is fixed 2 months before the start of the interest period.
3	Tenor mismatch	The stated interest rate is reset to a reference interest rate, but the frequency of reset does not match the tenor of the reference rate. For example, the interest rate on a retail mortgage is reset semi-annually based on three-month US LIBOR.
4	Combination of the above	The stated interest rate is reset monthly to an average 12-month reference rate. The interest rate is fixed based on the average 12-month rate for every working day in the month before the start of the interest period.

The IASB staff paper for a Board meeting in September 2013[3] when the standard was being finalised, discussed this topic extensively. The staff noted that there is not a single appropriate way to determine the appropriate consideration for the time value of money for a particular instrument. Useful points that come from this discussion which entities could consider in their assessment are the following[4]:

- Determining whether rates that are determined by averaging observed rates for a particular period, or that are set by referencing a recent historical interest rate, or whether interest rate tenor mismatch features only provide consideration for the passage of time for a particular currency requires judgement.
- Determining whether the rate used is normal for the particular market (for the relevant duration and currency) in which the transaction occurs and whether the stated time value component of the interest rate provides compensation for just the passage of time also requires judgement. As a general proposition, the market is relevant (for example, because specific markets commonly use specific reference interest rates and because the passage of time has a link to the funding costs of the lender, which in its turn provides another link to the market). However, just because something is 'normal' in the market, that must not necessarily be accepted as the consideration just for the passage of time.

  And
- The indicators that could inform a qualitative assessment of whether any modification to the time value of money element would still be consistent with providing consideration just for the passage of time could include whether the feature has a meaningful fair value (i.e., whether the feature results in the premium or discount to the contractually stated notional amount - if it does, that would indicate consideration for other risks than just the passage of time).

3 IASB Staff paper 6D: Project: *Financial Instruments: Classification and Measurement*, Paper topic: *Contractual Cash Flow Characteristics: The Meaning of 'Interest'*, IASB Meeting, September 2013. Available on the IFRS Foundation's website.

4 IASB Staff paper 6D: Project: *Financial Instruments: Classification and Measurement*, Paper topic: *Contractual Cash Flow Characteristics: The Meaning of 'Interest'*, IASB Meeting, September 2013, para. 45 to para 51. Available on the IFRS Foundation's website.

Frequently asked questions

Question 5-1: Do backward-looking term rates cause instruments to fail the SPPI assessment?

In October 2019[5] the IASB considered whether, as part of IBOR reform, where some IBORs are replaced with backward-looking term rates (such as a rate for the next six months based on the average overnight rate for the previous six months), this would cause instruments to fail the SPPI assessment.

The IASB noted that there are no specific conditions or exceptions that would automatically disqualify contractual cash flows to be SPPI. The focus on any assessment of interest must be on what the entity is being compensated for (i.e., whether the entity is receiving consideration for basic lending risks, costs and a profit margin). The IASB concluded that the current guidance in IFRS 9 provides an adequate basis to determine whether alternative benchmark rates meet SPPI and that, provided the interest rate continues to reflect the time value of money and does not reflect other risks and features, the new instrument will pass the SPPI assessment. Entities will therefore need to apply judgement in assessing whether there are any modifications to the time value of money element in replacement benchmark rates and if there are, whether these modifications will pass the SPPI test.

Illustration 5-6: SPPI evaluation for SONIA

SONIA is a daily rate that has replaced LIBOR as the risk-free rate for sterling loans. Daily SONIA rates are compounded to determine the rate for an interest payment period such as three months. The interest to be paid is, therefore, only known at the end of the interest period. To facilitate timely payment of interest, it is useful for borrowers to know in advance what amount of interest is required to be paid. As such, the interest is determined five working days prior to the interest payment date, based on the compounded rate over a period starting and finishing five business days before the interest period begins and ends. In this instance, an entity may be able to assess from a qualitative perspective that there is no significant modification to the time value of money and, hence, the financial asset meets the SPPI criterion.

Illustration 5-7: SPPI evaluation for Adjustable-Rate Mortgages (ARMs)

ARMs are US dollar floating rate mortgages, that have historically been reset once a year, 45 days in advance of the period, and often based on LIBOR. After transition, it was recommended by the Alternative Reference Rates Committee (ARRC) that rates would be reset 45 days in advance, every six months, based on a 30-day compounded SOFR average plus a spread adjustment. The recommended spread adjustment was similar to that introduced by ISDA in its fallback for derivatives.

It was not the intent of the ARRC to introduce features that deviate from the time value of money. Rather, it has sought to achieve the optimal lending terms, considering the needs of both issuers and investors. The market is familiar with a rate that is fixed in advance once a year and the frequency of reset has been amended to once every six months in order to continue to provide certainty as to the next interest payment, and also to make the rate more responsive to changes in market rates. The rate is calculated 45 days in advance, consistent with previous practice, and given that SOFR term rates were not available yet, the rate was based on overnight SOFR plus a spread adjustment. The 30-day average was chosen to smooth out day-to-day SOFR volatility. Meanwhile, the spread adjustment was designed to reconcile SOFR (collateralised) to LIBOR (uncollateralised) and to capture the theoretical forward interest rate curve out to 6 months.

Although term-SOFR rates are now available, we understand that 30-day average SOFR is still used as the index for many ARMs. On the basis that the lender is being compensated only for credit risk and the time value of money, with a profit margin, and based on the quantitative analysis performed by the ARRC and published together with their recommendations to document their thought process,[6] it can be assessed qualitatively that an ARM would still satisfy the SPPI criterion and may be recorded by the lender at amortised cost or at fair value through OCI, depending on the IFRS 9 business model.

Time value of money does not include credit risk, so it is important to exclude it from the assessment. The standard suggests this is done by comparing the instrument with a benchmark instrument with the same credit risk, but presumably the comparison could be against an instrument with a different credit risk, as long as the effect of the difference can be excluded. *[IFRS 9.B4.1.9C]*.

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5 *IASB Update*, October 2019 and IASB Staff paper 14B: Project: *IBOR Reform and its Effects on Financial Reporting-Phase 2*, Paper topic: *Accounting implications from derecognition of a modified financial instrument*, IASB meeting, October 2019, paras. 30-50. Available on the IFRS Foundation's website.

6 *Options for using SOFR in Adjustable Rate Mortgages*, The Alternative Rates Committee, July 2019.

The following Illustrations show instruments with a modified time value of money element and how the benchmark test is applied to them.

Illustration 5-8: Interest rate period selected at the discretion of the borrower

An entity holds an instrument that is a variable interest rate instrument with a stated maturity date that permits the borrower to choose the market interest rate on an ongoing basis. For example, at each interest rate reset date, the borrower can choose to pay three-month LIBOR for a three-month term or one-month LIBOR for a one-month term.

The contractual cash flows are solely payments of principal and interest on the principal amount outstanding as long as the interest paid over the life of the instrument reflects consideration for basic lending risks and costs as well as a profit margin. Basic lending risks and costs include consideration for the time value of money, for the credit risk associated with the instrument and for other basic lending risks and costs. The fact that the LIBOR interest rate is reset during the life of the instrument does not in itself disqualify the instrument.

However, if the borrower is able to choose to pay a one-month interest rate that is reset every three months, the interest rate is reset with a frequency that does not match the tenor of the interest rate. Therefore, the time value of money element is modified. That is because the interest payable in each period is disconnected from the interest period.

In such cases, the entity must qualitatively or quantitatively assess the contractual cash flows against the cash flows of a benchmark instrument to determine whether the mismatch between the two sets of cash flows could be significantly different. The benchmark instrument is identical in all respects except that the tenor of the interest rate matches the interest period. If the analysis results in the conclusion that the two sets of cash flows could be significantly different, payments would not represent principal and interest on the principal amount outstanding.

The same analysis would apply if the borrower were able to choose between the lender's various published interest rates (e.g., the borrower can choose between the lender's published one-month variable interest rate and the lender's published three-month variable interest rate). *[IFRS 9.B4.1.13 Instrument B]*.

Illustration 5-9: Five-year constant maturity bond

Some bonds pay what is called a constant maturity interest rate. For example, an instrument with an original five-year maturity may pay a variable rate that is reset semi-annually but always reflects a five-year rate. In such cases, the time value of money element is modified. The entity must determine whether the instrument's cash flows could be significantly different from those on a bond with a similar maturity, credit risk and interest rate reset frequency, but that pays a semi-annual rate of interest.

In making this assessment, the entity cannot conclude that the contractual cash flows are solely payments of principal and interest on the principal amount outstanding, simply because the interest rate curve at the time of the assessment is such that the difference between a five-year interest rate and a semi-annual interest rate is not significant. Rather, the entity must also consider whether the relationship between the five-year interest rate and the semi-annual interest rate could change over the life of the instrument such that the contractual (undiscounted) cash flows over the life of the instrument could be significantly different from the (undiscounted) benchmark cash flows. *[IFRS 9.B4.1.9D]*.

In this example, if the entity considers future developments, it is unlikely that it can conclude that the contractual cash flows could not be significantly different from the benchmark cash flows, considering the magnitude of the mismatch between the interest rate tenor and reset frequency. The bond will always pay a five-year rate even though, except at the outset, this exceeds the instrument's remaining life. Therefore, the instrument is not likely to meet the SPPI test.

5.4.3 Regulated interest rates

As noted in section 5.3.3. above, in some jurisdictions the government or a regulatory authority sets interest rates. For example, such governmental regulation of interest rates may be part of a broad macroeconomic policy or it may be introduced to encourage entities to invest in a particular sector of the economy. In some of these cases, the objective of the time value of money element is not to provide consideration for only the passage of time. However, the Board notes that the rates are set for public policy reasons and thus are not subject to structuring to achieve a particular accounting result. *[IFRS 9.BC4.180]*. Consequently, as a concession, a regulated interest rate is considered by the IASB to serve as a proxy for the time value of money element for the purpose of applying the contractual cash flow characteristics test if that regulated interest rate:

- Provides consideration that is broadly consistent with the passage of time

  And

- Does not provide exposure to risks or volatility in the contractual cash flows that are inconsistent with a basic lending arrangement *[IFRS 9.B4.1.9E]*

As the standard does not establish criteria to determine whether a regulated rate provides consideration that is 'broadly consistent' with the passage of time, this is an area which clearly requires judgement based on the facts and circumstances. However, in the Basis for Conclusions, the board implies that the particular instrument described in the following Illustration would satisfy the two criteria above.

Illustration 5-10: Regulated interest rates - 'Livret A'

In France the interest rate on 'Livret A' savings products issued by retail banks is determined by the central bank and the government according to a formula that reflects protection against inflation and an adequate remuneration to provide incentive for investment. The legislation requires a particular portion of the amounts collected by the retail banks to be lent to a governmental agency that uses the proceeds for social programmes. The IASB noted that the time value element of interest on these accounts may not provide consideration for only the passage of time; however, the IASB believes that amortised cost would provide relevant and useful information as long as the contractual cash flows do not introduce risks or volatility that are inconsistent with a basic lending arrangement. *[IFRS 9.BC4.180]*.

5.4.4 Other contractual features that change the timing or amount of contractual cash flows

Some financial assets contain contractual provisions that change the timing or amount of contractual cash flows. For example, the asset may be prepaid before maturity, or its term may be extended. In such cases, the entity must determine whether the contractual cash flows that could arise over the life of the instrument due to those contractual provisions are solely payments of principal and interest on the principal amount outstanding.

To make this determination, the entity must assess the contractual cash flows that could arise both before, and after, the change in contractual cash flows. The entity may also need to assess the nature of any contingent event (i.e., the trigger) that would change the timing or amount of contractual cash flows. While the nature of the contingent event is not a determinative factor in assessing whether the contractual cash flows are solely payments of principal and interest, it may be an indicator.

For example, compare a financial instrument with an interest rate that is reset to a higher rate if the debtor misses a particular number of payments and a financial instrument with an interest rate that is reset to a higher rate if a specified equity index reaches a particular level. It is more likely in the former case that the contractual cash flows over the life of the instrument will be solely payments of principal and interest on the principal amount outstanding, because of the relationship between missed payments and an increase in credit risk. In contrast, in the latter case, the contingent event introduces equity price risk which is not a basic lending risk. *[IFRS 9.B4.1.10]*.

The following are examples of contractual terms that result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding: *[IFRS 9.B4.1.11]*

(a) A variable interest rate that is consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time (the consideration for credit risk may be determined at initial recognition only, and so may be fixed) and other basic lending risks and costs, as well as a profit margin (which are also likely to be fixed).

(b) A contractual term that permits the issuer (i.e., the debtor) to prepay a debt instrument or permits the holder (i.e., the creditor) to put a debt instrument back to the issuer before maturity and the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract.

And

(c) A contractual term that permits the issuer or holder to extend the contractual term of a debt instrument (i.e., an extension option) and the terms of the extension option result in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the extension of the contract.

Unfortunately, neither the standard itself nor the Basis for Conclusions specify what the IASB meant by 'reasonable additional compensation', although it seems clear that the IASB regards compensation to mean a payment by the party exercising the prepayment option to the other party. It also seems appropriate to include as reasonable additional compensation direct or indirect costs attributable to early termination or extension, ranging from costs for the additional paperwork to costs for adjusting a bank's hedging relationships. Penalties imposed by the lender on the borrower with the aim of reducing the lender's interest rate risk and discouraging the borrower from prepaying the debt, could also, in certain circumstances, be reasonable additional compensation. If the penalty clause is assessed not to be reasonable additional compensation, consideration should also be given to whether the penalty clause is genuine and how likely the penalty is to be triggered. If the borrower is not expected to exercise the prepayment option except in extremely rare or highly abnormal situations that are very unlikely to occur, then the penalty feature would not be genuine and the asset could still pass the SPPI test. *[IFRS 9.B4.1.18]*.

As part of the IFRS 9 PIR, the IASB have amended IFRS 9 in order to clarify the application of the guidance where there are contractual cash flows that change the timing or amount of contractual cash flows (see section 10 below).

5.4.4.A Prepayment - negative compensation

A financial asset can still meet the SPPI condition and be eligible for classification at amortised cost even if the contractual prepayment amount is more or less than the unpaid amounts of the principal and interest. This is because IFRS 9 contemplates either the borrower or the lender terminating the contract early. If the borrower terminates the loan early, the borrower may have to compensate the lender and the prepayment amount might be more than the unpaid amount of principal and interest. If the lender terminates the loan early, then the lender may need to compensate the borrower and so, in this case, the prepayment amount might be less than the unpaid amounts of principal and interest. In other words, with these asymmetrical break clauses, depending upon which party terminates the contract early, 'reasonable additional compensation' can include a prepayment amount which is more or less than the unpaid amounts of principal and interest.

But this is not the case with a symmetrical break clause which results in the party triggering early termination of the loan receiving rather than paying compensation ('negative compensation'). This could occur if the current market interest rate is higher than the effective interest rate of the debt instrument. In that case, with a symmetrical break clause, a prepayment by the borrower will be less than the unpaid amounts of principal and interest and therefore lead to the lender effectively compensating the borrower for the increase in interest rates even if the borrower chooses to prepay the debt instrument. As set out in the version of IFRS 9 originally issued in July 2014, such a feature would fail the SPPI test and result in the instrument being measured at fair value through profit and loss.

In October 2017, the IASB issued a narrow scope amendment to IFRS 9 to address this issue. The amendment clarified that a financial asset with a symmetrical prepayment option can be measured at amortised cost or fair value through other comprehensive income. A financial asset meets the contractual cash flow requirements if a contractual term permits (or requires) the issuer to prepay, or the holder to put back to the issuer, a debt instrument before maturity and the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding including reasonable compensation for the early termination of the contract, which irrespective of the event or circumstance that causes the early termination of the contract, may be paid or received. For example, a party may pay or receive reasonable compensation when it chooses to terminate the contract early or otherwise causes the early termination to occur. *[IFRS 9.B4.1.12A]*.

This condition ensures that the amendment only captures those financial assets that would otherwise have contractual cash flows that are solely payments of principal and interest but do not meet that criterion solely because a prepayment feature may give rise to negative compensation.

The IASB noted that compensation that reflects the effect of the change in the relevant market interest rate (e.g., interest lost as a result of early terminating the contract) did not introduce any contractual cash flows that were different from cash flows which were already accommodated by the existing exemption for prepayments which contain positive compensation. *[IFRS 9.BC4.225]*.

The IASB also noted that some financial assets are prepayable at their current fair value and others are prepayable at an amount that includes the fair value cost to terminate an associated hedging instrument. The IASB acknowledged that there may be circumstances in which such features meet the contractual cash flow requirements. It provided, as an example, the case when the calculation of the prepayment amount is intended to approximate to unpaid amounts of principal and interest plus or minus an amount that reflects the effect of the change in a relevant benchmark interest rate. However, the IASB also noted that this will not always be the case. *[IFRS 9.BC4.232]*. Therefore, an entity will have to assess the specific contractual cash flows for such instruments rather than automatically assuming that they will meet the contractual cash flow requirements.

The narrow scope amendment only applies to situations where the compensation is symmetrical and the signage is negative. Prepayments that include cash flows that reflect changes in an equity or commodity index will not meet this requirement.

The amendment was effective for annual periods beginning on or after 1 January 2019.

UBS Group AG, in its 2019 consolidated financial statements, considered the classification of instruments with two-way compensation clauses.

Practical example 5-1: UBS Group AG (2019) **Switzerland**

Annual Report 2019 [extract]

Notes to the UBS Group AG consolidated financial statements [extract]

Note 1 Summary of significant accounting policies [extract]

3) Financial Instruments [extract]

b) Classification, measurement and presentation [extract]

Contractual cash flow characteristics

In assessing whether the contractual cash flows are SPPI, the Group considers whether the contractual terms of the financial asset contain a term that could change the timing or amount of contractual cash flows arising over the life of the instrument, which could affect whether the instrument is considered to meet the SPPI criterion.

For example, the Group holds portfolios of private mortgage contracts and corporate loans in Personal & Corporate Banking that commonly contain clauses that provide for two-way compensation if prepayment occurs. The amount of compensation paid by or to UBS reflects the effect of changes in market interest rates. The Group has determined that the inclusion of the change in market interest rates in the compensation amount is reasonable for the early termination of the contract, and therefore results in contractual cash flows that are SPPI.

The IASB issued a webcast in June 2018, clarifying that a prepayment feature must be analysed to determine whether it gives rise to contractual cash flows that meet the contractual cash flows characteristics test, rather than relying on:

- How the feature is labelled
- Whether it is likely to be triggered

  Or
- Whether it reflects market practice

It also confirmed that in order to be eligible to be measured at amortised cost or fair value through other comprehensive income, a prepayable financial asset must meet the criteria outlined above or all the conditions relating to assets originated at a premium or discount described in section 5.4.4.B below.

5.4.4.B Prepayment - assets originated at a premium or discount

The strict application of the definition of principal in section 5.1 above would mean that debt instruments originated or acquired at a premium or discount, and which are prepayable at par, must be measured at fair value through profit or loss. This is because, if the issuer prepays, the holder may receive a gain that is less than or in excess of a basic lending return. The IASB, however, decided to provide a narrow scope exception to address this matter. Financial assets originated or acquired at a premium or discount that would otherwise have cash flows that are principal and interest, except for the effect of a prepayment option, are deemed to meet the above conditions, but only so long as:

(a) The prepayment amount substantially represents the contractual par amount and accrued (but unpaid) interest, which may include reasonable additional compensation for the early termination of the contract.

And

(b) The fair value of the prepayment feature on initial recognition of the financial asset is insignificant. *[IFRS 9.B4.1.12]*.

As a result of the amendment for prepayments with negative compensation, discussed above, the IASB also amended the criteria for (a) to clarify that reasonable compensation includes compensation paid or received for the early termination of a contract. *[IFRS 9.B4.1.12A]*.

The conditions described above apply regardless of whether (i) the prepayment provision is exercisable by the issuer or by the holder; (ii) the prepayment provision is voluntary or mandatory; or (iii) the prepayment feature is contingent.

This exception would allow some financial assets that otherwise do not have contractual cash flows that are solely payments of principal and interest to be measured at amortised cost or fair value through other comprehensive income (subject to the assessment of the business model in which they are held). In particular, the IASB observed that this exception will apply to many purchased credit-impaired financial assets with contractual prepayment features. If such an asset was purchased at a deep discount, the contractual cash flows would not be solely payments of principal and interest if, contractually, the asset could be repaid immediately at the par amount. However, that contractual prepayment feature would have an insignificant fair value if it is very unlikely that prepayment will occur. *[IFRS 9.BC4.193]*. Prepayment might be very unlikely because the debtor of a credit-impaired financial asset might not have the ability to prepay the financial asset.

Similarly, the IASB observed that this exception will apply to some prepayable financial assets that are originated at below-market interest rates. For example, this scenario may arise when an entity sells an item (for example, an automobile) and, as a marketing incentive, provides financing to the customer at an interest rate that is below the prevailing market rate. At initial recognition, the entity would measure the financial asset at fair value and, because of the below-market interest rate, the fair value would be at a discount to the contractual par amount. The IASB observed that in that case a contractual prepayment feature would likely have an insignificant fair value because it is unlikely that the customer will choose to prepay; in particular, because the interest rate is below-market and thus the financing is advantageous. *[IFRS 9.BC4.194]*.

For instruments that are initially recognised at a discount, the fair value of the prepayment option will usually be insignificant, because the discount is a function of either an increased credit risk of the borrower (as in the first example above) or a below-market interest rate (as in the second example), and in each case the prepayment option is unlikely to be exercised and so will have little fair value.

For instruments that are initially recognised at a premium because the coupon rate is above the current market rate, the application of this guidance is more difficult. While the prepayment option will likely have a more than insignificant fair value, this will usually also be reflected in the fair value at which the asset is acquired. For instance, an investor is unlikely to pay above par for a bond that pays an above market rate of interest if it can be prepaid at par at any time. It would seem that for the prepayment option to be relevant for the asset's classification, it would need to be constrained. The expectation would be that the borrower will exercise the option at the earliest opportunity as it will be in the economic interest of the borrower to do so. An example would be a bond that pays an above market rate of interest, with a remaining maturity of five years that can be prepaid but only after three years. Hence the bond will have an initial fair value greater than par due to the above market rate for the first three years, but will amortise to par after three years as the borrower is highly likely to exercise the prepayment option after three years. Consequently, the prepayment amount will substantially represent unpaid amounts of principal and interest on the principal amount outstanding at the point the option is exercised and will therefore pass the SPPI test. *[IFRS 9.B4.1.11(b)]*. This assessment will be performed only when the asset is first recognised. For example:

Illustration 5-11: Prepayable corporate loan recognised at a premium to par

Bank A buys a loan with a notional amount of CU10m from another bank for CU11m. The loan has ten years remaining to maturity and it is to a corporate that has the right to prepay the loan at par in five years' time. The loan is acquired at a premium as interest rates have fallen significantly since the loan was first advanced.

Bank A believes that exercise of the prepayment option will be beneficial to the corporate issuer and that the borrower is highly likely to exercise the option. It therefore concludes that the premium on the loan is amortised over the following five years and not over the full remaining contractual term of ten years. It further concludes that when the prepayment option is exercised it will substantially represent unpaid amounts of principal and interest on the principal amount outstanding and consequently classifies the loan as an amortised cost instrument.

However, it is possible that the borrower may not exercise the option even if it is beneficial to do so and this makes the assessment more complicated. If there is uncertainty over whether the prepayment option will be exercised, then the SPPI test may not be met and neither classification as amortised cost nor fair value through other comprehensive income can be applied unless the fair value of the prepayment amount is insignificant. *[IFRS 9.B4.1.12(c)]*.

This is particularly likely to be an issue with retail loans as, collectively, retail borrowers can act irrationally and not in accordance with their own best economic interests. Such behavioural factors are likely to force any entity acquiring a portfolio of retail loans at a premium to have to assess whether the fair value of the prepayment feature is insignificant or not. In practice, this will probably mean that the entity will need to compare the fair value of the retail loans with the fair value of similar hypothetical instruments without the prepayment option and determine whether the difference is insignificant or not. If the difference is deemed to be significant, then the portfolio would need to be classified as debt instruments at fair value through profit and loss. In contrast, an instrument which is prepayable at fair value does not fall under the exception stated above (see discussion in section 5.4.4.A above).

5.4.4.C Further examples of features that modify the timing or amount of contractual cash flows

The following Illustrations show further instruments with contractual features that modify the timing and amount of contractual cash flows such that the instruments pass the contractual cash flow characteristics test. Some examples include possible changes to the fact pattern which may change that assessment.

Illustration 5-12: Debt covenants

A loan agreement contains a covenant whereby the contractual spread above the benchmark rate will increase if the borrower's earnings before interest, tax, depreciation and amortisation (EBITDA) or its debt-to-equity ratio deteriorate by a specified amount by a specified date.

Whether this instrument passes the contractual cash flow characteristics test depends on the specific terms. The loan will pass the contractual cash flow characteristics test if the covenant serves to compensate the lender for taking on higher credit or liquidity risks.

However, if the covenant results in more than just credit or liquidity protection or provides for an increase in the rate of return which is not considered appropriate under a basic lending arrangement, the instrument will fail the test. For example, an increase in interest rate to reflect an increase in EBITDA would not satisfy the criteria.

Illustration 5-13: Auction Rate Securities (ARSs)

ARSs have long-term maturity dates, but their interest rate resets more frequently based on the outcome of an auction. As a result of the auction process, the interest rates are short-term and the instruments are treated like short-term investments.

If an auction fails (i.e., there are insufficient buyers of the bond to establish a new rate), the rate resets to a penalty rate. The penalty rate is established at inception and does not necessarily reflect the market rate when the auction fails. It is often intended to compensate the holder for the instrument's lack of liquidity as demonstrated by the auction failure. The auction process for many such securities failed during the financial crisis.

The classification at initial recognition must be based on the contractual terms over the life of the instrument. Although the presumption on acquisition may have been that the auctions were not expected to fail, the potential penalty rate is still considered in the assessment of the instrument's characteristics at initial recognition. If the penalty rate could be considered to compensate the holder for the longer-term credit risk of the instrument following the auction failure because of a reduction in market liquidity, it may be possible that the penalty rate reflects interest. However, as such instruments usually have multiple issues with different penalty rates (including some leverage in the form of multiples of the market rate), each different case would need to be carefully evaluated before a conclusion could be reached.

Illustration 5-14: Perpetual instruments with potentially deferrable coupons

An entity holds a perpetual instrument, but the issuer may call the instrument at any time, paying the holder the par amount plus accrued interest due.

The instrument pays interest, but payment of interest cannot be made unless the issuer is able to remain solvent immediately afterwards. There are two scenarios.

Scenario (a) interest is accrued on the deferred amounts.

The contractual cash flows could be payments of principal and interest on the principal amount outstanding.

An example in the standard states that the fact that the instrument is perpetual does not in itself mean that the contractual cash flows are not payments of principal and interest on the principal amount outstanding. In effect, a perpetual instrument has continuous (multiple) extension options. Such options may result in contractual cash flows that are payments of principal and interest on the principal amount outstanding if interest payments are mandatory and must be paid in perpetuity.

Also, the fact that the instrument is callable does not mean that the contractual cash flows are not payments of principal and interest on the principal amount outstanding, unless it is callable at an amount that does not substantially reflect payment of outstanding principal and interest on that principal amount outstanding. Even if the callable amount includes an amount that reasonably compensates the holder for the early termination of the instrument, the contractual cash flows could be payments of principal and interest on the principal amount outstanding. (See section 5.4.4 above).

Scenario (b) deferred interest does not accrue additional interest.

The contractual cash flows are not payments of principal and interest on the principal amount outstanding. This is because the issuer may be required to defer interest payments and additional interest does not accrue on those deferred interest amounts. As a result, interest amounts are not consideration for the time value of money on the principal amount outstanding.

Note that, in this example, the holder is not entitled to assess whether it is probable that interest may ever be deferred. As long as the feature is genuine, the deferral of interest must be considered in assessing whether interest amounts are consideration for the time value of money on the principal outstanding. *[IFRS 9.B4.1.14 Instrument H]*.

Illustration 5-15: Write-down or conversion imposed by regulator

Scenario (a) the provision is not a contractual feature

A regulated bank issues an instrument with a stated maturity date. The instrument pays a fixed interest rate and all contractual cash flows are non-discretionary.

However, the issuer is subject to legislation that permits or requires a national resolution authority to impose losses on holders of particular instruments, including the above-mentioned instrument, in particular circumstances. For example, the national resolution authority has the power to write-down the par amount of such an instrument or to convert it into a fixed number of the issuer's ordinary shares if the national resolution authority determines that the issuer is having severe financial difficulties, needs additional regulatory capital or is failing.

The holder would analyse the contractual terms of the financial instrument to determine whether they give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding and thus are consistent with a basic lending arrangement.

According to an example in the standard, this analysis would not consider the write-down or conversion that arises only because of the national resolution authority's power under statutory law to impose losses on the holders of such an instrument. That is because that power is not a contractual term of the financial instrument. *[IFRS 9.B4.1.13 Instrument E]*.

Although this example makes use of a principle that is widely applied in accounting for financial instruments, we note that it may seem inconsistent with the position taken in IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*, which requires an entity to include 'relevant local laws, regulations and the entity's governing charter in effect at the date of classification' when classifying a financial instrument as a liability or equity. However, in the IASB Discussion Paper on Financial Instruments with Characteristics of Equity (see Chapter 43 at section 4.6.6), it was noted that IFRIC 2 was developed for a very specific fact pattern and that the analysis in IFRIC 2 should not be applied more broadly, and as part of the Exposure Draft on Financial Instruments with Characteristics of Equity it was stressed that IFRIC 2 is a case where the law limits the enforceability of the contractual right and should only be read in that context. In this Exposure Draft, the IASB has proposed amendments to IAS 32.15A to require an entity to classify financial instruments as financial liabilities or equity by considering only those contractual rights and obligations that are enforceable by law and are in addition to those created by relevant laws or regulations. These proposals are consistent with the requirements for classification of financial assets in IFRS 9. *[IFRS 9.B4.1.13 Instrument E]*.

Scenario (b) the provision is a contractual feature

The contractual terms of the financial instrument permit or require the issuer or another entity to impose losses on the holder (e.g., by writing down the par amount or by converting the instrument into a fixed number of the issuer's ordinary shares), if the issuer fails to meet particular regulatory capital requirements (a non-viability event).

Provided the 'non-viability' provision is genuine, which will normally be the case, the instrument will fail the contractual cash flow characteristics test even if the probability is remote that such a loss will be imposed. *[IFRS 9.B4.1.13 Instrument E]*.

Note that payments that arise as a result of a regulator's statutory power and that are only referenced to in the contractual terms of the instrument are not considered in the analysis of the contractual payment features of the instrument. However, where such features are specific to the contract, they clearly need to be considered in such an analysis. This typically can happen where such an instrument is entered into by entities within the same group as a way of providing a mechanism for recapitalising subsidiaries and passing losses up within the group to the ultimate shareholders. Where a regulator does not have the statutory power to enforce the terms of instruments entered into between entities within the same group, the regulator will usually require the conversion/write-down features to be included in the contractual terms. This can result in such contracts failing the SPPI test.

In April 2022, as part of the Post-implementation Review of IFRS 9, the IASB discussed whether an entity needs to consider cash flows arising from bail-in legislation when the relevant legal requirements are reproduced or referred to in a contract. The Board agreed to consider this issue after its Financial Instruments with Characteristics of Equity project (see scenario (a)) has developed further.[7]

Illustration 5-16: Fixed rate bond prepayable by the issuer at fair value

A company acquires a bond which requires the issuer to pay a fixed rate of interest and repay the principal on a fixed date. However, the issuer has the right to prepay (or call) the bond before maturity, although the amount the issuer must pay is the fair value of the bond at the time of prepayment, i.e., the fair value of the contractual interest and principal payments that remain outstanding at the point of exercise. For example, if the bond has a term of five years and the call option is exercised at the end of the second year, the fair value would be calculated by discounting the principal and interest payments due over the remaining three years at the current market interest rate for a three-year bond with similar characteristics.

The exercise price represents the fair value of unpaid amounts of principal and interest on the principal amount outstanding at the date of exercise, albeit discounted at the current market interest rate rather than the original market interest rate.

The fact that the exercise price is the fair value could be interpreted as providing reasonable additional compensation to the holder for early termination, although this only holds true in a scenario where the market rate has fallen since the issue of the bond. If interest rates rise, the holder will not receive additional compensation for early termination and will receive less than the principal amount. In these circumstances, due to the negative compensation, the bond holder would not be receiving principal and interest, however prepayments with negative compensation can still meet the contractual cash flows characteristics test (see section 5.4.4.A above).

5.4.5 Contractual features that normally do not represent payments of principal and interest

In some cases, financial assets may have contractual cash flows that are not solely payments of principal and interest. *[IFRS 9.B4.1.14]*. Unless such a feature is *de minimis* or non-genuine, the instrument would fail the contractual cash flow characteristics test. *[IFRS 9.B4.1.18]*. Examples of such instruments with contractual cash flows that may not represent solely payments of principal and interest include instruments subject to leverage and instruments that represent investments in particular assets or cash flows.

Leverage is a contractual cash flow characteristic of some financial assets. It increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of just principal and interest. Stand-alone options, forwards and swap contracts are examples of financial assets that include such leverage. Thus, such contracts fail the contractual cash flow characteristics test and cannot be measured at amortised cost or fair value through other comprehensive income. *[IFRS 9.B4.1.9]*.

7 *IASB Update*, April 2022, available on the IFRS Foundation's website.

Illustration 5-17: Multiple of a benchmark interest rate

An entity holds an instrument for which the interest rate is quoted as a multiple of a benchmark interest rate (e.g., 2 times 3-month EURIBOR for a 3-month term).

Such features introduce leverage and the standard is explicit that leverage increases the variability of the contractual cash flows, resulting in them not having the economic characteristics of interest. As a result, such instruments would need to be measured at fair value through profit or loss. *[IFRS 9.B4.1.9]*.

However, a variable rate asset at a deep discount will not normally fail the contractual cash flow characteristics test. When the IASB deliberated the meaning of principal in September 2013, they did not distinguish between fixed and variable rate assets and do not seem to have intended a variable rate plain vanilla instrument to fail the contractual cash flow characteristics test. Moreover, a variable rate asset which is acquired or originated at a deep discount will normally be a purchased or originated credit impaired asset. As such, the effective interest rate used will be the credit-adjusted effective interest rate.

In addition to leverage features, contractual terms that introduce a more than *de minimis* exposure (see section 5.4.1 above) to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. *[IFRS 9.B4.1.7A, IFRS 9.B4.1.18]*.

The IASB noted that it believes that amortised cost would provide relevant and useful information if the contractual cash flows do not introduce risks or volatility that are inconsistent with a basic lending arrangement. *[IFRS 9.BC4.180]*.

Leverage in relation to a regulator-imposed cap that is set as a multiple of an indexed rate are discussed in section 5.3.3 above.

Illustration 5-18: Dual currency instruments

For some financial assets the interest payments are denominated in a currency that is different from the principal of the financial asset. IFRS 9 requires the assessment of "whether contractual cash flows are solely payments of principal and interest on the principal outstanding for the currency in which the financial asset is denominated". *[IFRS 9.B4.1.8]*.

This implies that any instrument in which interest is calculated based on a principal amount other than that payable on maturity will not pass the contractual cash flow characteristics test. For instance, if variable interest payments are computed based on a fixed principal amount in another currency, e.g., US dollars, although repayment of the principal is in sterling, the financial asset is not considered to have cash flows that are solely payments of principal and interest.

However, there may be instances where interest is denominated in a currency that is different from the principal currency, but the contractual cash flows could possibly constitute solely payments of principal and interest. For example, the principal amount of the bond is denominated (and redeemed at a fixed maturity) in Canadian dollars (CAD) and interest payments are fixed in Indian Rupees (INR) at inception based on the market interest rates and foreign exchange spot and forward rates at that time.

How we see it

While not explicit in the standard, if the bond can be separated into two components that, on their own, would meet the contractual cash flow characteristics test, then the combined instrument would do so. That is, if the bond can be viewed as the combination of a zero-coupon bond denominated in CAD and a stream of fixed payments denominated in INR, and if both instruments can be analysed as a stream of cash flows that are solely payments of principal and interest, then the sum of the two would do so as well.

The defining criterion is the fact that the interest payments have been fixed at inception and there is no exposure to changes in cash flows in the currency of denomination of the cash flows.

In September 2018, the IFRS IC was asked whether an instrument with the features described in Illustration 5-18 above met the SPPI test. The Committee observed that the financial instrument described was not common and consequently decided not to add this matter to its standard-setting agenda.[8]

8 *IFRIC Update*, September 2018, available on the IFRS Foundation's website.

Illustration 5-19: Convertible debt

An entity holds a bond that is convertible into equity instruments of the issuer.

The holder would analyse the convertible bond in its entirety, since IFRS 9 does not separate embedded derivatives from financial assets.

The contractual cash flows are not payments of principal and interest on the principal amount outstanding because they reflect a return that is inconsistent with a basic lending arrangement (see section 5 above) i.e., the return is also linked to the value of the equity of the issuer. *[IFRS 9.B4.1.14 Instrument F]*.

The assessment would change if the issuer were to use its own shares as 'currency'. That is, if the bond is convertible into a variable number of shares with a fair value equal to unpaid amounts of principal and interest on the principal amount outstanding. In this case, the bond might satisfy the contractual cash flow characteristics test and would be derecognised on conversion. However, such conversion features are often capped because, otherwise, the issuer could be required to deliver a potentially unlimited number of shares. The existence of such a cap, if genuine, would result in the failure of the test. Additionally, the use of a volume weighted average price approach to calculating the fair value of the shares at the conversion date could also result in the failure of the test.

Illustration 5-20: Inverse floater

An entity holds a loan that pays an inverse floating interest rate (i.e., the interest rate has an inverse relationship to market interest rates, such as 6% minus SONIA).

The contractual cash flows are not solely payments of principal and interest on the principal amount outstanding because an inverse floating rate does not represent consideration for the time value of money. *[IFRS 9.B4.1.14 Instrument G]*.

Illustration 5-21: Investment in open-ended money market or debt funds

In an open-ended fund, existing investors have the option of leaving the fund at any time. The price at which leavers exit the fund is normally based on the fair value of the fund's assets. Given that investors exit the fund at a price based on fair value, the cash flows of an investment in such a fund are not solely payments of principal and interest.

In addition, such investments would not normally qualify for the option for equity instruments, to present gains and losses in other comprehensive income, as they do not normally meet the definition of an equity instrument from the perspective of the fund (i.e., the issuer). See also section 7 below.

Illustration 5-22: Interest payments indexed to an equity index or the debtor's performance

If interest payments are indexed to a variable such as an equity index, the contractual cash flows are not payments of principal and interest on the principal amount outstanding. Payments indexed to the debtor's performance (e.g., the debtor's net income) would not pass the contractual cash flows characteristics test, unless it can be demonstrated that the indexing to the debtor's performance results in an adjustment that only compensates the holder for changes in the credit risk of the instrument. That is because the contractual cash flows would otherwise reflect a return that is inconsistent with a basic lending arrangement (see section 5 above). *[IFRS 9.B4.1.13 Instrument A]*.

5.4.6 Loan commitments

Some loan commitments are scoped into IFRS 9 in full. All other loan commitments are only in scope of IFRS 9 for impairment purposes (see Chapter 41 at section 2.5). This is because the IASB decided to exclude particular loan commitments from the scope of IAS 39 *Financial Instruments: Recognition and Measurement* (which was carried forward into IFRS 9) to simplify the accounting for holders and issuers of loan commitments. The effect of the exclusion is that an entity will not recognise and measure changes in fair value of these loan commitments that result from changes in market interest rates or credit spreads. This is consistent with the measurement of the loan that results if the holder of the loan commitment exercises its right to obtain financing, because changes in market interest rates do not affect the measurement of an asset measured at amortised cost. *[IFRS 9.2.1(g), IFRS 9.2.3, IFRS 9.BCZ2.3]*. This rationale applies well where the drawn commitment results in an amortised cost loan, but less so in other cases.

Where a loan commitment is granted long periods may elapse before the commitment is drawn down. The question therefore arises as to whether the drawdown of loans under an irrevocable loan commitment is assessed for classification based on conditions when the loan commitment came into being or when the loan is drawn down.

IFRS 9 requires that an entity shall recognise a financial asset in its statement of financial position when the entity becomes party to the contractual provisions of the instrument. When an entity first recognises a financial asset, it shall classify it in accordance with IFRS 9. *[IFRS 9.3.1.1]*. As the issuer of the irrevocable loan commitment becomes a party to the entire contractual cash flows of the loan at date the commitment is granted, it could be argued that any drawdowns could be treated as continuations of the original facility and that any loans drawn down are classified based on the conditions at the date of the origination of the loan commitment. Such an interpretation is consistent with how the expected credit losses are measured on loan commitments, "for the purpose of applying the impairment requirements, a financial asset that is recognised following a draw down on a loan commitment shall be treated as a continuation of that commitment instead of as a new financial instrument". *[IFRS 9.B5.5.47]*.

However, if a long period elapses between the origination of the irrevocable loan commitment and draw down it is possible that conditions affecting the assessment of classification might have changed considerably. For instance, a bank may grant a loan commitment to an SPE that has sufficient equity at the date the commitment is originated for the loan to be classified as measured at amortised cost but not at the time the loan is drawn down. This is something that could be usefully clarified by the IFRS IC or the Board.

If an entity has a past practice of selling the assets resulting from its loan commitments shortly after origination, it is required to apply IFRS 9 to all its loan commitments in the same class, meaning that there will be consistency in the measurement of the loan commitment and the resulting loan. However, If the resulting loan will be classified at fair value through profit or loss (FVPL), not because of the entity's business model, but because it will fail the contractual cash flow test, the default position in IFRS 9 is that the entity would apply the ECL model to the undrawn loan commitment and the FVPL model to the same commitment once it is drawn. To reduce this measurement inconsistency, the entity could designate the loan commitment at FVPL if it meets the criteria in paragraph 4.2.2 of IFRS 9. However, if the drawn portion would be classified and measured at fair value through other comprehensive income, there does not seem to be a way to completely eliminate the measurement inconsistency between the drawn and undrawn portions. *[IFRS 9.4.2.2]*. See Chapter 45 at section 3.7 for further detail on initial recognition of assets and liabilities arising from loan commitments.

5.4.7 Environmental, social and governance (ESG) linked loans

ESG loans are structured such that the interest rate varies based on whether the borrower achieves pre-determined ESG targets defined in the loan agreement. For example, the terms may include a reduction or increase in the interest rate if the borrower does, or does not, attain a certain rating on a type of green-building rating system for an agreed number of the borrower's manufacturing buildings. ESG targets can also include diversity-related targets such as gender representation targets at a defined level of management.

Such contingent rate adjustments may introduce additional variability to the cash flows of the loan which is linked to the underlying ESG performance of the borrower, that may not be consistent with a basic lending arrangement. Careful analysis of the terms of ESG loans is required to assess whether the cash flows represent solely payments of principal and interest.

Loans with ESG, green or sustainability-linked features that can cause changes to their contractual cash flows are different from what are commonly called 'green loans'. Green loans may refer to loans granted to borrowers who operate in environmentally friendly sectors such as solar power or to loans that are granted to finance activities that are 'green'. However, crucially, they do not necessarily include any terms which can cause their contractual cash flows to change due to 'green' targets after the loan has been issued.

In a basic lending arrangement, consideration for the time value of money and credit risk are typically the most significant elements of interest. However, in such an arrangement, interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time.

Contractual terms that introduce exposures to risks or volatility in the contractual cash flows that are unrelated to a basic lending arrangement, such as an exposure to changes in equity prices or commodity price, do not give rise to contractual cash flows that are solely payments of principal and interest. *[IFRS 9.B4.1.7A]*.

How we see it

There is no bright line to determine whether ESG features cause an instrument to fail the SPPI test. It is important to consider whether they provide commensurate compensation for basic lending risks, such as credit risk (see section 5.4.7.A below), or whether they introduce compensation for new risks that are inconsistent with basic lending arrangements (see section 5.4.7.C below). Some features may be *de minimis* or non-genuine (see section 5.4.7.B below). It is important to exercise judgement based on the facts and circumstances. As part of the IFRS 9 PIR, the IASB has amended IFRS 9 to clarify the requirements for assessing financial assets with contingent features, including ESG-features (see section 10.1 below).

5.4.7.A Compensation for credit risk

Instruments are more likely to meet the SPPI requirements if the attainment of the target resulting in a decrease (or an increase) in the interest rate is likely to result in the improvement (or the deterioration) of the borrower's credit risk during the life of the loan such that the change in interest rate is commensurate with the change in credit risk of the borrower. IFRS 9 acknowledges that clauses which allow changes to the timing and amount of contractual cash flows may not fail the SPPI test if there is a relationship between the changes and an increase in credit risk.

It is often difficult to demonstrate a commensurate link between the interest rate change due to the attainment of an ESG target and the credit risk of the borrower. This may be easier to prove if the entity can demonstrate that it takes the ESG metric into account when pricing and monitoring the credit risk on the loan. This could be the case if there is a link between the feature and the value of the collateral pledged against the loan (see Illustration 5-23 below); or if there is a link between the feature and the probability of default on the loan (see Illustration 5-24 below). If the link to credit risk is too indirect (see Illustration 5-25 below), the feature will have to be further assessed (see sections 5.4.7.B and 5.4.7.C below).

Some ESG features may affect the credit risk of the borrower over the long-term but not necessarily the credit risk of the loan. For example, continuous failure to meet ESG targets in the long-term might lead to the borrower's business becoming unsustainable and ultimately lead to its demise, but this may have very little effect on the borrower's ability to repay the loan (i.e., credit risk) over the expected remaining life of the loan.

If there is a link between the feature and the credit risk of the loan, the lender must also establish whether the magnitude of the change in the contractual cash flows due to the feature is commensurate with the anticipated change in credit risk. If the feature gives rise to leveraged exposure to the resulting credit risk, the loan is likely to fail the SPPI test. The exception to this is where the feature gives rise to non-commensurate changes in interest rates, not in an attempt to introduce leverage to the contract, but in an attempt to introduce a punitive interest rate to act as a disincentive against the borrower allowing its credit risk to deteriorate. In such cases, the objective of the non-commensurate change in interest is to reduce the lender's risk, similar to other common features of basic lending arrangements such as default penalties, rather than increasing its risk by introducing leverage.

This exception regarding punitive rates is not specific to ESG loans. In September 2013, the IASB Staff noted that even if an interest rate could be described by some as 'punitive' in the sense that the terms of the instrument require a significant increase in the interest rate upon a credit event and such feature is intended, in part, to discourage a specific behaviour (such as missing payments on a credit card), the increased rate could still be commensurate with the consideration for credit risk of the instrument if such behaviour occurs.[9]

9 IASB Staff paper 6D: Project: *Financial Instruments: Classification and Measurement*, Paper topic: *Contractual Cash Flow Characteristics: The Meaning of 'Interest'*. Available on the IFRS Foundation's website.

The following Illustrations demonstrate these considerations.

Illustration 5-23: ESG-linked loans

A bank grants a loan to fund the acquisition of a new fleet of vessels. The loan is collateralised by that fleet. In addition, the loan contains an ESG feature that reduces or increases the interest rate based on the borrower's performance against a commonly used metric in the industry for carbon emissions. The metric is based on the carbon emissions of the entity's fleet after factoring in the distance travelled by the fleet and the ships' size.

In this scenario, there may be a link between the emissions targets and the value of the collateral (the fleet). The bank would need to consider:

- Whether the value of the collateral (the fleet) is linked to the attainment of the carbon emission targets:
  - This might be the case, as, all things being equal, a better maintained and therefore more efficient fleet will attract a higher resale value than a less efficient fleet.
  - However, better efficiency may not necessarily indicate that the fleet is in a better condition. Efficiency will depend on other factors such as the ships' payloads, the skill of the crews in operating it, the time spent waiting to dock at busy ports and weather conditions.
  - Judgement would need to be exercised in determining the strength of the link based on the facts and circumstances.
- Whether the change in value of the fleet would affect the entity's assessment of the credit risk on the loan:
  - In this scenario, the fleet has been pledged as collateral on the loan. A more valuable fleet could therefore reduce the loss given default on the loan and therefore decrease the entity's assessment of the loans' credit risk.
  - However, if the loan is not collateralised, or if the metric considers the performance of additional ships that have not been pledged as collateral against the loan, the link with credit risk may be harder to demonstrate.
- Whether the change in the interest rate in response to the attainment of the emissions target can be considered appropriate compensation for the associated change in credit risk.

Illustration 5-24: ESG-linked loans

A ten-year loan is granted to a power generating entity to finance an overhaul of a coal-fired power plant. Operating this power plant is the entity's sole business. New local legislation will prohibit the power plant from continuing to operate if a specified CO_2 emissions target is not met on, or after, a date in 3 years' time. Therefore, the bank has included a series of annual targets in the loan terms, building up to the final deadline. If the power plant does not meet these contractual emissions targets, the interest rate on the loan increases.

The lender is likely to be able to demonstrate a link between the ESG feature and the credit risk of the loan. If the final emissions target is not met, the plant will not be able to operate. As this is the borrower's sole business, it would be unlikely that it will be able to repay the loan if that was to happen. The contractual emissions targets are designed to incentivise the borrower to incrementally work towards meeting the overall legislative target. The closer the borrower gets to the legislative deadline and the further it is from achieving it, the higher its credit risk becomes. The contractual features increase the interest rate in response to this increase in credit risk. Therefore, there is a clear link between the contractual targets and the credit risk on the loan.

The lender would also need to establish whether the magnitude of the change in the interest rate is commensurate with the change in credit risk. If the change is not commensurate, the lender must consider whether the feature is designed as a punitive feature to disincentivise against the borrower allowing its credit risk to increase by making slow progress towards the important legislative deadline If that is the case, the feature is likely to be consistent with the SPPI criterion

In practice, this link to credit risk may not be so clear. For example, the link may be blurred when the entity's credit risk is a function of multiple comingled businesses, but the loan and the ESG-feature relate to a single business, or portion thereof, or when the cost of attaining the ESG target is high and could out-weigh the benefits.

Illustration 5-25: ESG-linked loans

A short-term loan is granted to a food group. The interest rate on the loan varies depending on the performance of the group against an ESG scorecard. The scorecard includes three targets

(a) One based on the reduction in the Group's CO_2 emissions

(b) One based on the percentage of new hires that are female

And

(c) One based on the number of training hours in sustainable food production provided to previously underprivileged people

The group's performance against each target is weighted and used to determine an overall score. The interest rate will be reduced if the Group achieves a score above a predetermined level.

In this Illustration, achievement of the ESG target benefits the entity in a broader, intangible manner. For example, the Group could achieve the training target by providing training as a corporate social initiative to people who are not employed by the Group and have no contractual or financial relationship with the Group. While this may improve its reputation, and therefore possibly improve its business performance and credit risk in the long-term, such a link is indirect and, most likely, weak. Additionally, the loan is a short-term loan and therefore it will be difficult to demonstrate a link between the feature and the credit risk on the loan.

5.4.7.B *De minimis* or non-genuine ESG features

Lenders or holders must also consider whether the ESG feature is *de minimis* (see section 5.4.1.A above) or non-genuine (see section 5.4.1.B above). A lender may decide, as an operational simplification, to introduce a quantitative threshold below which features would be considered '*de minimis*' without a detailed analysis. There is judgement to be exercised in determining what the appropriate threshold is. This is especially relevant in a low-interest environment, whereby sustainability-linked discounts or penalties could easily become significant in relative terms.

5.4.7.C Compensation for other basic lending risks

In some markets, the presence of ESG features within certain types of lending arrangements is becoming increasingly common because of lenders being expected to support the transition towards greener businesses. In these cases, if the ESG feature is not *de minimis* and introduces cash flows that are not commensurate with the change in the credit risk on the loan, further analysis will be necessary to assess whether the feature causes the loan to fail the SPPI test.

In July 2021, the IASB Staff considered the classification of loans with sustainability-linked features. They noted that the key question to ask in analysing these loans is what the entity (the holder) is being compensated for. The nature of the contingent event (i.e., the trigger) of sustainability-linked adjustments is the borrower's performance against specified sustainability targets, but this does not automatically mean that the adjustments represent compensation for the entity's exposure to an actual sustainability risk of the borrower and therefore cause the loan to fail the SPPI test.[10]

Key to this argument was the feedback from stakeholders that many ESG-linked adjustments of these loans are a standardised fixed spread and represent a relatively small fraction of the total interest of the loans. They are standardised in a sense that they are not determined based on the assessment of the specific risks of the borrower meeting, or not meeting, the ESG targets. Although the ESG targets are bespoke to the individual borrower, the size and design of the ESG-linked adjustments are often standardised, regardless of what the ESG targets are and how likely it is they will be met. Where this is the case, it could indicate that the ESG features do not introduce compensation for bearing a specific ESG risk that is unrelated to a basic lending arrangement (like equity prices or commodity prices). Therefore, the feature would not cause the loan to fail the SPPI assessment.

10 IASB Staff paper 3B: Project: *Post implementation Review of IFRS 9 - Classification and Measurement*, IASB meeting, July 2021. Available on the IFRS Foundation's website.

In contrast, the Staff highlighted that they were not implying that ESG-linked adjustments may be SPPI because their size is small or because they are standard or common features. A small or common feature may well be inconsistent with a basic lending arrangement and contractual cash flows that are SPPI. However, while the size of the adjustment is not a determinative factor of the assessment, the Staff observed that the larger the adjustments are relative to the total interest of a loan, the more it might be an indication that adjustments represent compensation for a particular type of risk or exposure. In such cases, the borrower and the lender would have a stronger incentive to ensure that a large ESG-linked adjustment reflects the compensation for the relevant ESG risks assumed. If a financial asset compensates an entity for its exposure to ESG risks of the borrower, in the staff's preliminary view, such compensation is often unlikely to be consistent with contractual cash flows that are SPPI.

In addition to the size of the feature, as a further step in the analysis of ESG features that are not *de minimis* and which introduce cash flows that are not commensurate with the change in the credit risk on the loan, we believe that the following considerations may clarify whether the ESG feature introduces compensation for a new risk that is inconsistent with a basic lending arrangement:

- **The record of contract negotiations between the borrower and the lender**

  The negotiations between the counterparties may indicate whether the feature was included as a necessary concomitant to a basic lending arrangement; in response to one of the more traditional basic lending risks such as credit risk; or to introduce ESG risk and compensation into the loan.

- **The nature of the ESG feature**

  Paragraph 4.182 of the Basis for Conclusions to IFRS 9 expands on this concept of a basic lending arrangement and emphasises the importance of the pricing approach. If the ESG feature is priced to compensate the lender for a specific lending risk, such as credit risk, rather than to incentivise common 'good corporate citizen' behaviour, it would be more appropriate to assess the feature against the credit risk guidance in section 5.4.7.A above.

- **The lender's pricing decisions**

  The lower the level of precision used by the lender to measure and price the risks and volatility arising from the ESG feature, the greater an indication it is that the lender has not attempted to introduce compensation for an ESG risk and is simply trying to conclude a basic lending arrangement.

- **The extent to which the counterparties monitor and manage the resulting ESG risk**

  The less prominence that the counterparties give to measuring and managing the resulting ESG volatility and risk on the loan, the greater an indication it is that they were trying to conclude a basic lending arrangement rather than introducing compensation for a separate risk.

- **The level and frequency of data on the ESG feature that the borrower is required to report to the lender**

  Similar to the previous point, if the parties intended to introduce compensation for ESG risk, the borrower would be expected to provide more granular, frequent updates to the lender in respect of the ESG feature to enable the lender to monitor and manage its exposure.

The Board has amended the standard as part of the post-implementation review of IFRS 9 to provide guidance on how to apply the contractual cash flow test in the context of sustainability-linked loans. See section 10.1 below where amendments to IFRS 9 in respect of such loans are discussed.

5.5 Non-recourse assets

A financial asset may have contractual cash flows that are described as principal and interest, but those cash flows do not, in economic substance, represent the payment of principal and interest on the principal amount outstanding. *[IFRS 9.B4.1.15]*. For example, under some contractual arrangements, a creditor's claim is limited to specified assets of the debtor or the cash flows from specified assets (described in the standard as a 'non-recourse' financial asset). Another example given in the standard is contractual terms stipulating that the financial asset's cash flows increase as more automobiles use a particular toll road. Those contractual cash flows are inconsistent with a basic lending arrangement. *[IFRS 9.B4.1.16]*. As a result, the instrument would not pass the contractual cash flow characteristics test unless such a feature is *de minimis* or non-genuine. *[IFRS 9.B4.1.18]*.

However, the fact that a financial asset is non-recourse does not in itself necessarily preclude the financial asset from passing the contractual cash flow characteristics test (see also section 5.3.2 above). Furthermore, conventional subordination features do not preclude an asset from passing the test (see section 5.3.1 above).

The non-recourse provision in IFRS 9 is intended to prevent instruments that are linked to the performance of another asset from being classified as amortised cost or FVOCI without supporting analysis. Where an asset is non-recourse, the creditor is required to assess ('look through to') the particular underlying assets or cash flows to determine whether the contractual cash flows characteristics test is being met. *[IFRS 9.B4.1.17]*. When assessing a non-recourse asset, various factors could be considered, such as:

- Nature of borrower and its business
- Adequacy of loss absorbing capital (particularly for SPEs)
- Pricing of the loan, which (may indicate returns above a lending return)
- Performance figures such as Loan to Value ratios (LTVs), Debt Service Coverage Ratios (DSCR) and Interest Coverage Ratios (ICR)
- Expected sources of repayment

  Or
- Existence of other forms of economic recourse such as guarantees

The contractual cash flow characteristics are assessed at initial recognition of the asset and are not reassessed subsequently. For example, if at initial recognition the asset is non-recourse but is assessed as passing SPPI, there is no need to reassess subsequently.

The following Illustrations show instruments which normally fail the contractual cash flow characteristics test because their cash flows are not solely payments of principal and interest on the principal amount outstanding.

Illustration 5-26: Non-recourse loans

Non-recourse loans need careful consideration and many instruments that are non-recourse will fail the test. The following examples illustrate how the guidance above might be applied to non-recourse instruments that are common in practice and under which circumstances those instruments pass the contractual cash flow characteristics test:

(a) Project finance loans

Where a loan is given for the construction and maintenance of a toll road and the payments of cash flows to the lender are reduced or cancelled if less than a certain number of vehicles travel on that road, the loan is unlikely to pass the contractual cash flow characteristics test. Similarly, a loan with cash flows specifically referenced to the performance of an underlying business will not pass the test.

In other cases, where there is no such reference and there is adequate equity in the project to absorb losses before affecting the ability to meet payments on the loan, it may well pass the contractual cash flow characteristics test. In these cases, the adequacy of equity to absorb losses will be key.

(b) Loans to a special purpose entity (SPE)

Where a loan is provided to an SPE that funds the acquisition of other assets, whether that loan passes the contractual cash flow characteristics test will depend on the specific circumstances of the arrangement.

If the assets of the SPE are all debt instruments which would themselves pass the contractual cash flow characteristics test, the loan to the SPE might well pass it too. Furthermore, if the SPE uses the loan from the entity to fund investments in assets which will not themselves pass the contractual cash flow characteristics test, such as equity securities or non-financial assets, but the SPE has sufficient equity to cover the losses on its investments, the loan may again pass the contractual cash flow characteristics test. However, if the loan is the only source of finance to the SPE so that it absorbs any losses from the equity securities, it would not pass the contractual cash flow characteristics test. Whether the loan is legally non-recourse does not matter in this scenario because the SPE has limited other assets to which the lender can have recourse. Therefore, the SPE must have adequate equity for the interest to represent compensation for basic lending risk.

(c) Mortgages

There are many different types of mortgage loans and some are structured so that in the event of default the lender has legal recourse only to the property provided as collateral and not to the borrower. This type of arrangement is common in some states of the USA. Other mortgages may, in substance, be non-recourse if the borrower has limited resources with which to repay the loan.

In addition to the above examples, other loans could also be in substance non-recourse if there is a high loan to value ratio and the borrower has limited resources with which to repay the loan.

How we see it

IFRS 9 was not intended to require all normal collateralised loans which are legally non-recourse or in substance non-recourse due to the limited resources of the borrower (such as certain mortgages) to be accounted for at fair value through profit or loss. If a loan is granted at a rate of interest that compensates the lender for the time value of money and for the credit risk associated with the principal amount, it would, in our view, usually pass the contractual cash flow characteristics test, whether or not it is legally non-recourse.

However, if at inception, the expected repayment of a legally non-recourse loan is primarily driven by future movements in the value of the collateral so that the loan is, in substance, an investment in the real estate market, then measurement at amortised cost or fair value through other comprehensive income classification would most likely be inappropriate.

Under certain circumstances purchased or originated credit-impaired loans backed by collateral could also be non-recourse in substance, such as if the lender could only recover the loan by realising the collateral. This would in substance be similar to the lender buying the collateral directly.

As part of the IFRS 9 PIR, the IASB have amended IFRS 9 in order to clarify the application of the contractual cash flow characteristics guidance to financial assets with non-recourse features, including that the non-recourse features must be contractual (see section 10.3 below). This may impact loans that have been considered in-substance non-recourse on initial classification, but are not contractually non-recourse, including purchased or originated credit-impaired loans and originated mortgages.

5.6 Contractually linked instruments

In some types of transactions, an entity may prioritise payments to the holders of financial assets using multiple contractually linked instruments (CLI) that create concentrations of credit risk (known as tranches). Each tranche has a subordination ranking that specifies the order in which any cash flows generated by the issuer are allocated to the tranche. The mechanism for allocating cash flows to tranches is often referred to as a 'waterfall'. With these instruments, the holders of a tranche have the right to payments of principal and interest on the principal amount outstanding only if the issuer generates sufficient cash flows to satisfy the higher-ranking tranches. *[IFRS 9.B4.1.20]*. Examples of such types of instruments would be notes issued by securitisation structures such as collateralised debt obligations (CDOs).

Essentially, these investments can contain leveraged credit risk and, accordingly, the IASB believes that measuring such investments at amortised cost or fair value through other comprehensive income may be inappropriate in certain circumstances, hence the requirements for contractually linked instruments were developed.

In multi-tranche transactions that concentrate credit risk in the way described above, a tranche is considered to have cash flow characteristics that are payments of principal and interest on the principal amount outstanding only if the following three criteria are met: *[IFRS 9.B4.1.21]*

(a) The contractual terms of the tranche being assessed for classification (without looking through to the underlying pool of financial instruments) give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding (e.g., the interest rate on the tranche is not linked to a commodity index).

(b) The underlying pool of financial instruments must contain one or more instruments that have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding (the primary instruments) and any other instruments in the underlying pool must either: *[IFRS 9.B4.1.23, IFRS 9.B4.1.24, IFRS 9.B4.1.25]*

  (i) Reduce the cash flow variability of the primary instruments in the pool and, when combined with the primary instruments in the pool, result in cash flows that are solely payments of principal and interest on the principal amount outstanding.

  Or

  (ii) Align the cash flows of the tranches with the cash flows of the underlying primary instruments in the pool to address differences in and only in:

  - Whether the interest rate is fixed or floating
  - The currency in which the cash flows are denominated, including inflation in that currency

  Or

  - The timing of the cash flows.

For these purposes, when identifying the underlying pool of financial instruments, the holder must 'look through' the structure until it can identify an underlying pool of instruments that are creating (rather than passing through) the cash flows. *[IFRS 9.B4.1.22]*.

(c) The exposure to credit risk in the underlying pool of financial instruments inherent in the tranche is equal to, or lower than, the exposure to credit risk of all of the underlying pool of instruments (for example, the credit rating of the tranche is equal to or higher than the credit rating that would apply to a single borrowing that funded the underlying pool).

If any instrument in the pool does not meet the conditions in (b) above, then the tranche fails the SPPI test. In making this assessment, a detailed instrument-by-instrument analysis of the pool may not be necessary, however an entity must use judgement and perform sufficient analysis to determine whether the instruments in the pool meet the conditions in (b) above. *[IFRS 9.B4.1.25]*.

If the holder cannot assess whether a financial asset meets criteria (a) to (c) above at initial recognition, the tranche must be measured at fair value through profit or loss. *[IFRS 9.B4.1.26]*.

An entity would apply the above criteria listed in (a) to (c) to all contractually linked tranches that it holds. Therefore, if the criteria in (b) are not met, it would not be met for all tranches, and this will result in all the tranches failing the SPPI test, including the most senior tranche. This result may not seem intuitive, and consequently it is important that entities carefully consider when instruments would fall within the scope of the contractually linked instruments guidance.

As part of the IFRS 9 PIR, the IASB have amended IFRS 9 for assessing the contractual cash flow characteristics of a financial asset with CLI features (see section 10.2 below).

5.6.1 The scope of the 'contractually linked' guidance

To determine when the contractually linked instrument guidance, as discussed in section 5.6 above, needs to be applied, one needs to assess what it means for instruments to be 'contractually linked'. IFRS 9 does not provide an explicit definition of contractually linked instruments, but rather describes the general characteristics of such instruments. These include the following: *[IFRS 9.B4.1.20]*

- The existence of multiple contractually linked instruments that create concentrations of credit risk (so called 'tranches')
- Tranche subordination ranking specifying the order in which any cash flows are allocated

  And
- The holder has a right to receive payments only if the cash flows on higher-ranking tranches have been satisfied

In addition, the Basis for Conclusions refers to such instruments being issued by 'structured investment vehicles'. *[IFRS 9.BC4.26]*. Moreover, the guidance refers to 'the pool of underlying financial instruments', which are exposed to credit risk, as opposed to other types of assets. *[IFRS 9.B4.1.21]*.

How we see it

The reference to 'multiple' contractually linked instruments, in our view, means that there must be more than one tranche. If there is only a single tranche, consideration must be given to the non-recourse guidance (see section 5.6.2.A below).

There are various financing structures and types of instruments that can be issued by entities and so it may be unclear when the contractually linked instrument guidance as set out in section 5.6 above, must be applied. The assessment of whether there are multiple contractually linked instruments is an area of judgement which requires careful consideration of the specific facts and circumstances.

A number of other questions arise when evaluating the scope of the contractually linked instruments guidance. These include:

(i) Whether it only applies to such instruments that are issued by structured investment vehicles, or whether it covers a broader range of entities.

(ii) Whether the features must be explicitly set out in the instrument's contractual terms, or whether an instrument can be 'implicitly contractually linked'. For example, a structured investment vehicle could issue two instruments, one debt and one equity or it could issue two contractually linked debt instruments where the junior debt instrument is expected to behave more like equity, because it absorbs residual risk. Economically, these two structures may be very similar.

  And

(iii) Whether the guidance only applies where the underlying assets are financial instruments (see section 5.6.2.A below).

The Basis for Conclusions, in discussing the development of this guidance, states that it was revised so as to focus on the economic characteristics rather than the form and legal structure, *[IFRS 9.BC4.29]*, and is not based solely on the contractual features. *[IFRS 9.BC4.33]*. Furthermore, to make the judgement about whether an instrument has the required features to be classified as contractually linked, an entity must understand the characteristics of the underlying issuer. *[IFRS 9.BC4.34]*. The challenge in applying this guidance is that, despite the desire of the Board not to focus on legal form, the wording, including the title, 'contractually linked', frequently refers to the contractual form.

Consequently, while we believe that the guidance might also apply to some situations other than where the instruments are issued by structured investment vehicles and that the analysis must not focus on only the instruments' legal form, it does need to be guided by the general characteristics of contractually linked instruments as set out in the standard.

Further, the Basis for Conclusions states that subordination in itself must not preclude amortised cost measurement. The ranking of an entity's instruments is a common form of subordination that affects almost all lending transactions. Commercial law (including bankruptcy law) typically sets out a basic ranking for creditors. The IASB believes that it is reasonable to assume that commercial law does not intend to create leveraged credit exposure for credit risk associated with general creditors such as trade creditors and the credit risk associated with general creditors does not preclude the contractual cash flows representing the payments of principal and interest on the principal amount outstanding. *[IFRS 9.BC4.28]*.

To make the judgement as to whether the guidance must be applied to a particular financial asset, two of the considerations that could be evaluated include the following, noting that each consideration listed below will probably not be conclusive in isolation and the evaluation will depend on the specific facts and circumstances of the structure and how the instruments that are issued are linked together:

(a) Whether the subordination features are only applicable in the event of default:

If the subordination features only apply in the event of default (i.e., there is no cash flow 'waterfall' in the ordinary course of business), the subordination would not specify the order in which 'any cash flows generated by the issuer are allocated to the tranche', hence, one of the specific characteristics of contractually linked instruments referred to in IFRS 9.B4.1.20 as discussed above, would not be met.

(b) Whether non-payment of a junior tranche constitutes a breach of contract:

The nature of a contractually linked instrument is to introduce credit concentration features linked with higher yielding returns for junior instruments in exchange for providing credit protection to senior instruments. As such, if non-payment on the junior ranking instrument, because cash flows are directed to a more senior instrument, constitutes a breach of contract resulting in an event of default (so that the structure must be restructured or liquidated), it could be argued that the instrument does not provide such credit protection.

Application of some of the considerations is shown in the following Illustrations:

Illustration 5-27: Assessing whether instruments are contractually linked

Entity X sets up a special purpose vehicle (Entity Y) in order to finance the acquisition of a pool of financial instruments. Entity Y finances the acquisition of the pool of financial instruments through the following:

- Equity of CU50m from X
- Junior loan from Bank A of CU30m
- Senior loan from Bank B of CU20m

The terms of the loans stipulate that in the normal course of business, payments on the junior loan cannot be made unless all amounts due on the senior loan from Bank B has been settled. Non-payment of the junior loan does not trigger liquidation of Entity Y. The subordination features of the loans are not only applicable in the event of default. There is a 'waterfall' feature, that determines how profits from the pool of financial instruments must be allocated to the individual loans in the ordinary course of business.

Bank A and B would conclude, based on the terms of the junior and senior loans, that these two instruments are contractually linked. Therefore, they would need to assess both loans against the criteria as set out in IFRS 9.B4.1.21 in order to determine whether or not they qualify to be measured at amortised cost.

Illustration 5-28: Property development company with debt and equity

A property development company (Entity P) sets up a separate subsidiary to fund each development. The subsidiary (Entity S) obtains funding in the form of ordinary shares issued to its parent and a loan from the bank. Entity S uses the funds to develop a property. Entity S is not permitted to declare dividends prior to the repayment of the loan and the parent funding is considered sufficient to absorb any losses that are likely to arise. In addition to this the parent is required to inject further capital if the loan-to-value ratio of the collateral, deteriorates below a certain threshold.

In this example, there is only a single tranche of debt. Although the structure would result in the ordinary shares being exposed to the residual cash flows in this structure, the equity instrument is not contractually linked to the debt instrument in the ordinary course of business (i.e., there is no pre-defined 'waterfall' which would give the ordinary shareholders the right to receive payments if the cash flows on the loan have been satisfied). In addition, given that the shareholder funding is not only contractually established as equity but also imposes an obligation to inject sufficient capital to absorb any losses, the loan has the characteristics of normal bank lending. Consequently, the loan has the characteristics of a conventional bank loan and holder of the financial asset (the bank) would probably conclude that the contractually linked instrument guidance is not applicable.

5.6.2 Assessing the characteristics of the underlying pool

5.6.2.A Non-financial assets in the underlying pool

As already mentioned, the guidance on whether a contractually linked instrument would be SPPI refers to the need to look through to 'the underlying pool of financial instruments'. *[IFRS 9.B4.1.21(b), IFRS 9.B4.1.21(c), IFRS 9.B4.1.22]*. This has prompted the question as to whether the contractually linked instrument guidance only applies to structures where the underlying assets are financial instruments, as opposed to other assets such as property. However, the general characteristics of contractually linked instruments set out in the standard make no mention of the nature of the underlying assets.

How we see it

Currently, the scope of contractually linked instruments is based on the features of the instruments issued and not on the nature of the pool of assets underlying the instruments. As such, if a structure contains contractually linked instruments, then it would apply the contractually linked instruments guidance and not the requirements for non-recourse assets, irrespective of the nature of the underlying assets. However, the IASB have amended IFRS 9 as part of the PIR in order to clarify that the CLI guidance only applies where the underlying pool exclusively consists of financial instruments, including lease receivables (refer to section 10.2 below).

Contractually linked instruments referencing a pool of non-financial instruments do not meet the contractual cash flow characteristics test and cannot be classified at amortised cost. Additionally, in a structure where an SPE issues contractually linked notes referenced to a note issued by another SPE referencing a pool of non-financial assets, IFRS guidance would require the entity holding the instrument to look through all contractually linked instruments.

Because of the way the standard is written, the outcome of the contractual cash flow characteristics assessment will depend on the form of the arrangement. Arrangements which involve using multiple contractually linked instruments are assessed under the contractually linked instruments requirements while arrangements with non-recourse features, but without multiple tranches, are assessed under the non-recourse requirements. Therefore, the accounting outcome can vary depending on the structure employed. For instance, a non-recourse financial asset whose cash flows depend on vehicles using a toll road would be required to be assessed under the non-recourse requirement if structured as a single instrument but, if structured into tranches, would be assessed differently using the contractually linked instrument criteria. If the contractually linked instrument criteria are required to be applied, the underlying asset (the toll road in this example) would not be a financial instrument passing SPPI, and therefore the criteria in (b) as discussed in section 5.6 above, would not be met and the tranches would therefore not pass SPPI. However, as mentioned above, the IASB have amended IFRS 9 as part of the PIR to clarify that the CLI guidance will only apply where the underlying pool consists of financial instruments (refer to section 10.2 below).

5.6.2.B Liquidity facilities in the underlying pool

Some structures contain liquidity facilities which provide short-term funding to enable interest to be paid on notes when cash flows from the underlying assets are delayed, for instance a facility which provides liquidity to cover the cash flows needed for the SPE to operate and to pay interest to the noteholders for a short period. These facilities usually have a seniority above all other notes in the structure and a failure to pay on the facility would be considered a default of the SPE. Normally these liquidity features would not be considered a tranche of the structure and are seen as being an instrument in the pool rather than a tranche. This is because they are short-term and designed to align the cash flows in the structure in a similar way to plain vanilla derivative instruments in criterion (b) in section 5.6 above, rather than to absorb risks by the holder and thereby create concentrations of credit risk.

The characteristics of the liquidity facility are sufficiently different from the notes. If the liquidity facility does not have features that would fail the contractual cash flow characteristics test, then it would be treated as a short-term loan.

5.6.2.C Changes in the composition of the underlying pool

How we see it

In practice, it may be difficult for the holder to perform the look through test because the underlying reference assets of a collateralised debt obligation (CDO) may not all have been acquired at the time of investment. In such circumstances, the holder will need to consider, amongst other things, the intended objectives of the CDO as well as the manager's investment mandate before determining whether the investment qualifies for measurement at amortised cost or fair value through other comprehensive income.

If, after this consideration, the holder is able to conclude that all the underlying reference assets of the CDO will always have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding, the interest in the CDO can qualify for measurement at amortised cost or fair value through other comprehensive income. Otherwise, the investment in the CDO must be accounted for at fair value through profit or loss because it fails the contractual cash flow characteristics test, unless the effect is *de minimis*.

If the underlying pool of instruments can change after initial recognition in a way that does not meet condition (b) in section 5.6 above, the tranche must be measured at fair value through profit or loss. However, if the underlying pool includes instruments that are collateralised by assets that do not meet the conditions above (as will often be the case), the ability to take possession of such assets is disregarded for the purposes of applying this paragraph, unless the entity acquired the tranche with the intention of controlling the collateral. *[IFRS 9.B4.1.26]*.

5.6.2.D Assets with prepayment options in the underlying pool

The IASB noted that a key principle underlying the contractual cash flow provisions for contractually linked instruments was that an entity should not be disadvantaged simply by holding an asset indirectly if the underlying asset has cash flows that are solely principal and interest, and the holding is not subject to more-than-insignificant leverage or a concentration of credit risk relative to the underlying assets.

Accordingly, the IASB clarified that a tranche may have contractual cash flows that are solely payments of principal and interest even if the tranche is prepayable in the event that the underlying pool of financial instruments is prepaid. The Board noted that because the underlying pool of assets must have contractual cash flows that are solely payments of principal and interest, then, by extension, any prepayment features in those underlying financial assets are also required to be solely payments of principal and interest. *[IFRS 9.BC4.206(a)]*.

The Board's clarification that a prepayment feature in the underlying pool of assets does not necessarily prevent a tranche from meeting the contractual cash flow characteristics test is helpful. But, unless the underlying pool can only be acquired at origination, it may be difficult to 'look through' to the underlying pool to determine if its prepayment features would themselves be solely payments of principal and interest. This is because the information will often not be available to determine whether the assets were acquired at a premium or discount, and whether the fair value of any prepayment feature was insignificant on acquisition (see section 5.4.4 above). However, there may be instances where the investment vehicle has a clearly defined investment mandate or design which will provide the investor with sufficient information as to the nature of the underlying pool of assets.

5.6.2.E Derivatives and financial guarantee contracts in the underlying pool

For the purposes of criterion (b) in section 5.6 above, the underlying pool may contain financial instruments such as interest rate swaps. In order for these instruments not to preclude the use of amortised cost or fair value through other comprehensive income accounting for holders of a tranche, they must reduce the variability of cash flows, or align the cash flows of the tranches with the cash flows of the underlying pool of the primary instruments. Accordingly, an underlying pool that contains government bonds and an instrument that swaps government credit risk for (riskier) corporate credit risk would not have cash flows that represent solely principal and interest on the principal amount outstanding. *[IFRS 9.BC4.35(d)]*.

If the underlying pool of financial instruments contained a purchased credit default swap, this would not prejudice the use of amortised cost or fair value through other comprehensive income accounting provided it paid out only to compensate for the loss of principal and interest. In practice, however, it is far more common for underlying pools to contain written, rather than purchased, credit default swaps. Written credit default swaps and financial guarantees are a feature of 'synthetic' CDOs that typically gain exposure to instruments through derivatives rather than through purchasing financial instruments. As a consequence, while it may often be possible to obtain amortised cost or fair value through other comprehensive income accounting treatment for the more senior investments in 'cash' CDOs (i.e., those where the underlying pool comprises the reference debt instruments) tranches of 'synthetic' CDOs, would not pass the SPPI test.

5.6.2.F Assets transferred to the underlying pool which have failed derecognition

An underlying pool containing instruments which have failed derecognition in the books of the transferee will need to be assessed carefully to understand the cash flows involved. It should be noted that just because an asset has failed derecognition does not mean that the transferee is not exposed to any of the risks and rewards of that asset. Repo balances transferred into the underlying pool will probably not impact the pool's ability to pass the SPPI test, given the nature of the cash flows in a repo. However, in other cases, the transferee could be exposed to some of the risks or rewards associated with the failed sale asset. So, depending on the analysis of the instruments involved, it is possible that the nature of the transferred risks could result in an instrument held within the pool failing the contractual cash flows characteristic test.

5.6.3 Application of expected credit loss requirements to junior tranches that pass SPPI

While some contractually linked instruments may pass the SPPI test and consequently may be measured at amortised cost or fair value through other comprehensive income, the contractual cash flows of the individual tranches are normally based on a pre-defined waterfall structure (i.e., principal and interest are first paid on the most senior tranche and then successively paid on more junior tranches). Accordingly, one could argue that more junior tranches could never suffer a credit loss because the contractually defined cash flows under the waterfall structure are always equal to the cash flows that an entity expects to receive, and so would never be regarded as impaired. This is, because Appendix A of IFRS 9 defines 'credit loss' as the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive, discounted at the original effective interest rate.

However, consistent with treating these assets as having passed the contractual cash flow characteristics test, we believe that the impairment requirements of IFRS 9 (see Chapter 47) apply to such tranches if they are measured at amortised cost or fair value through other comprehensive income. Instead of the cash flows determined under the waterfall structure, an entity needs to consider the deemed principal and interest payments as contractual cash flows when calculating expected credit losses.

5.6.4 Assessing the exposure to credit risk in the tranche held

IFRS 9 does not prescribe a method for comparing the exposure to credit risk in the tranche held to that of the underlying pool of financial instruments.

For the more senior and junior tranches, it may become obvious with relatively little analysis whether the tranche is more or less risky than the underlying assets. In some cases, it might be possible to compare the credit rating allocated to the tranche as compared with that for the underlying pool of financial instruments, provided they are all rated.

However, in some circumstances involving complex securitisation structures, a more detailed assessment may be required. For example, it might be appropriate to prepare an analysis that involves developing various credit loss scenarios for the underlying pool of financial instruments, computing the probability weighted outcomes of those scenarios, determining the probability weighted effect on the tranche held, and comparing the relative variability of the tranche held with that of the underlying assets, which is shown in the following Illustration.

Illustration 5-29: Assessing the exposure to credit risk in the tranche held

Bank A is the sponsor of a securitisation vehicle (the SPE) and holds the junior notes issued by the SPE. The SPE's assets consist of a portfolio of residential mortgages that were originated and transferred to the SPE by Bank A. The SPE does not hold any derivatives. A number of other banks invest in the mezzanine, senior and super senior tranches of notes issued by the SPE. None of the banks has any further involvement with the SPE and all banks have assessed that the SPE is not required to be consolidated in their respective financial statements. The total notional amount of mortgage assets and notes issued is CU1,000m.

The following table shows a range of expected credit losses for the portfolio of mortgages as at inception and the estimated probability that those scenarios will occur.

	Loss	Estimated probability of loss	Estimated weighted average loss
	CU million	%	CU million
Scenario I	40	10%	4
Scenario II	70	25%	18
Scenario III	110	30%	33
Scenario IV	180	25%	45
Scenario V	230	10%	23
Weighted average loss expectancy			**123**

The probability weighted expected losses of the underlying assets therefore represent 12.3%.

The following table illustrates how an entity may compare the credit risk of the tranche with that of the underlying pool of financial instruments:

Tranche		Super senior	Senior	Mezzanine	Junior	**Total**
Notional amount (A) CU million		630	200	90	80	**1,000**
	Probability	Probability weighted expected losses of the tranches (CU million)*				
Scenario I	10%	-	-	-	4	**4**
Scenario II	25%	-	-	-	18	**18**
Scenario III	30%	-	-	9	24	**33**
Scenario IV	25%	-	2	23	20	**45**
Scenario V	10%	-	6	9	8	**23**
Expected loss by tranche (B)		-	8	41	74	**123**
Expected loss % by tranche (B)/(A)		0.0%	4.0%	45.6%	92.5%	**12.3%**
Credit risk of tranche is less than the credit risk of the underlying assets?		Yes	Yes	No	No	
Tranche passes the contractual cash flow characteristic test		Yes	Yes	No	No	

* For each scenario, expected losses are first allocated to the junior tranches and progressively to the more senior tranches until all expected losses are absorbed. For example, in Scenario IV, the loss of CU180m would be absorbed by the Junior tranche (CU80m), mezzanine tranche (CU90m) and senior tranche (CU10m). The probability weight of 25% for Scenario IV is then applied to the expected losses allocated to each tranche.

The junior notes have an expected loss which is, in percentage terms, greater than the overall expected loss on the underlying portfolio. Therefore, these notes must be accounted for at fair value through profit or loss. Similarly, the mezzanine notes have a greater expected loss than the underlying pool and would not pass the contractual cash flow characteristics test.

The expected losses on the senior notes and the super senior notes are lower than the overall expected loss on the underlying pool of instruments and may qualify for amortised cost or fair value through other comprehensive income treatment, provided all other IFRS 9 requirements are met and the instruments are not held for trading.

In this example, it might have been possible to come to the same conclusion without a numerical calculation for the junior and super senior tranches, but the technique is helpful to determine the treatment of the intermediary notes. In practice, it may also be necessary to apply judgement through a qualitative assessment of specific facts and circumstances.

5.7 Transferred financial assets held by a transferee and not qualifying for derecognition by the transferor

IFRS 9 states that, where a financial asset is transferred from one party to another in circumstances that preclude the transferor from derecognising the asset, the transferee should not recognise the transferred asset. Instead, the transferee derecognises the cash or other consideration paid and recognises a receivable from the transferor. *[IFRS 9.B3.2.15]*.

There may be various reasons for the transferor not achieving derecognition of transferred financial assets. Refer to Chapter 48 at sections 3.6 to 3.8 for further considerations on derecognition. In addition, depending on how the transfer is structured, there may be diversity in practise in terms of how the transferee accounts for the receivable and any related liabilities. Refer to Chapter 45 at section 2.1.6 for initial recognition considerations.

In certain securitisations, the transferor may retain an interest in the securitisation vehicle resulting in the transferor retaining substantially all the risks and rewards of the transferred assets, and the transferred assets failing derecognition. Examples of such an interest retained by the transferor include: the provision of guarantees or put options; an obligation to substitute non-preforming loans; deferred consideration; or the investment by the transferor in a junior tranche of the notes issued by the securitisation vehicle. The transferee needs to assess whether the 'failed sale' receivable it recognises as due from the transferor meets the SPPI criterion. The receivable due from the transferor would be dependent on the cash flows of the underlying transferred asset which failed to qualify for derecognition. Therefore, it is necessary for the transferee to assess the nature of these underlying cash flows and whether it results in the transferee receiving payments on its receivable that are solely principal and interest.

In the situation where the transferor invests in a subordinated tranche of the securitisation vehicle, the transferee could consider the non-recourse guidance (as discussed in section 5.5 above), as the return on the receivable due from the transferor, is limited to the cash flows from the underlying pool of transferred assets. In assessing whether the transferee's receivable meets the SPPI test, the transferee would 'look through' to the underlying cash flows from the transferred assets that it has rights to. Alternatively, the transferee could consider whether the contractually linked instruments guidance (as discussed in section 5.6 above) could be applied. In this assessment the transferee could view itself as holding the more senior tranche, with the transferor owning the junior tranche in the underlying assets (by virtue of its investment in the subordinated tranche of the securitisation), with both tranches being linked to the underlying pool of transferred assets. Applying either of these two approaches, the receivable is likely to be considered to pass the SPPI test if the underlying assets themselves pass the SPPI test. If the transferee can conclude the receivable meets the SPPI requirements and measures it at amortised cost, then it would need to apply the expected credit loss requirements to this receivable. Refer to Chapter 47 at section 7.7.1 for further considerations on impairment.

6 Designation at fair value through profit or loss

Financial assets or financial liabilities may be designated as measured at fair value through profit or loss at initial recognition if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise. *[IFRS 9.4.1.5, IFRS 9.4.2.2(a)]*.

Financial liabilities may also be designated at fair value through profit or loss where a group of financial liabilities, or financial assets and financial liabilities, is managed and its performance is evaluated on a fair value basis. *[IFRS 9.4.2.2(b)]*. Such a designation is not required for financial assets that are managed on a fair value basis as they will automatically be classified at fair value through profit or loss (see section 4.4 above).

Designation at fair value through profit or loss in the two situations described above is only permitted provided doing so results in the financial statements presenting more relevant information. *[IFRS 9.B4.1.27]*. Such a designation can be made only at initial recognition and cannot be revoked subsequently.

The decision to designate a financial asset or financial liability as measured at fair value through profit or loss is similar to an accounting policy choice, although, unlike an accounting policy choice, it is not required in all cases to be applied consistently to all similar transactions. However, for a group of financial assets and financial liabilities that are managed, and its performance is evaluated on a fair value basis, all eligible financial liabilities that are managed together should be designated. *[IFRS 9.B4.1.35]*. When an entity has a policy choice, IAS 8 requires the chosen policy to result in the financial statements providing reliable and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows. For example, in the case of the designation of a financial liability at fair value through profit or loss, an entity needs to demonstrate that it falls within at least one of the circumstances set out in IFRS 9.4.2.2. *[IFRS 9.B4.1.28]*.

In addition to the designations that result in more relevant information set out in IFRS 9.4.2.2., a hybrid contract with a host that is not an asset within the scope of IFRS 9 that contains one or more embedded derivatives meeting particular conditions may also be designated, in its entirety, at fair value through profit or loss. *[IFRS 9.4.3.5]*. These conditions are discussed in detail in section 6.3 below.

The fair value option cannot be applied to a portion or component of a financial instrument, e.g., changes in the fair value of a debt instrument attributable to one risk such as changes in a benchmark interest rate, but not credit risk. Further, it cannot be applied to proportions of an instrument. However, if an entity simultaneously issues two or more identical financial instruments, it is not precluded from designating only some of those instruments as being subject to the fair value option (e.g., if doing so achieves a significant reduction in an accounting mismatch). Therefore, if an entity issued a bond totalling CU100 million in the form of 100 certificates each of CU1 million, the entity could designate 10 specified certificates if to do so would meet at least one of the criteria noted above. *[IFRS 9.BCZ4.74, IFRS 9.BCZ4.75, IFRS 9.BCZ4.76]*.

The conditions under which financial instruments may be designated at fair value through profit or loss are discussed further in sections 6.1 to 6.3 below.

6.1 Designation eliminates or significantly reduces a measurement or recognition inconsistency (accounting mismatch)

The notion of an accounting mismatch necessarily involves two propositions. First, that an entity has particular assets and liabilities that are measured, or on which gains and losses are recognised, on different bases; and second, that there is a perceived economic relationship between those assets and liabilities. *[IFRS 9.BCZ4.61]*.

For example, absent any designation, a financial asset might be classified as subsequently measured at fair value and a liability the entity considers related would be subsequently measured at amortised cost (with changes in fair value not recognised). In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were measured as at fair value through profit or loss. *[IFRS 9.B4.1.29]*.

IFRS 9 gives the following examples of situations in which designation of a financial asset or financial liability as measured at fair value through profit or loss might eliminate or significantly reduce an accounting mismatch and produce more relevant information: *[IFRS 9.B4.1.30]*

(a) An entity has liabilities under insurance contracts whose measurement incorporates current information (as permitted by IFRS 17), and financial assets it considers related that would otherwise be measured at fair value through other comprehensive income or amortised cost.

(b) An entity has financial assets, financial liabilities, or both that share a risk, such as interest rate risk, that gives rise to changes in fair value that tend to offset each other. However, only some of the instruments would be measured at fair value through profit or loss (e.g., derivatives or those classified as held for trading). It may also be the case that the requirements for hedge accounting are not met, for example, because the requirements for hedge effectiveness are not met.

(c) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to changes in fair value that tend to offset each other and the entity does not use hedge accounting. This could be for different reasons, for example, because items giving rise to the accounting mismatch would not qualify for hedge accounting or because the entity does not want to use hedge accounting because of operational complexity. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example, the entity has financed a specified group of loans by issuing traded bonds, the changes in the fair value of which tend to offset each other. If, in addition, the entity regularly buys and sells the bonds but rarely, if ever, buys and sells the loans, reporting both the loans and the bonds at fair value through profit or loss eliminates the inconsistency in the timing of recognition of gains and losses that would otherwise result from measuring them both at amortised cost and recognising a gain or loss each time a bond is repurchased.

For practical purposes, an entity need not acquire all the assets and incur all the liabilities giving rise to the measurement or recognition inconsistency at exactly the same time. A reasonable delay is permitted provided that each transaction is designated as at fair value through profit or loss at its initial recognition and, at that time, any remaining transactions are expected to occur. *[IFRS 9.B4.1.31]*.

It would not be acceptable to designate only some of the financial assets giving rise to the inconsistency as at fair value through profit or loss if to do so would not eliminate or significantly reduce the inconsistency and would therefore not result in more relevant information. However, it would be acceptable to designate only some of a number of similar financial assets if doing so does achieve a significant reduction (and possibly a greater reduction than other allowable designations) in the inconsistency. *[IFRS 9.B4.1.32]*.

For example, assume an entity has a number of similar financial assets totalling CU100 million and a number of similar financial liabilities totalling CU50 million, but these are measured on a different basis. The entity may significantly reduce the measurement inconsistency by designating at initial recognition all the liabilities but only some of the assets (for example, individual assets with a combined total of CU45 million) as at fair value through profit or loss. However, because designation as at fair value through profit or loss can be applied only to the whole of a financial instrument, the entity in this example must designate one or more assets in their entirety. It could not designate either a component of an asset (e.g., changes in value attributable to only one risk, such as changes in a benchmark interest rate) or a proportion (i.e., percentage) of an asset. *[IFRS 9.B4.1.32]*.

6.2 A group of financial liabilities (or financial assets and financial liabilities) is managed and its performance is evaluated on a fair value basis

The second situation in which the fair value option may be used for financial liabilities is where a group of financial liabilities, or financial assets and financial liabilities, is managed, and its performance evaluated, on a fair value basis. In order to meet this condition, it is necessary for the group of instruments to be managed in accordance with a documented risk management or investment strategy and for information, prepared on a fair value basis, about the group of instruments to be provided internally to the entity's key management personnel (as defined in IAS 24 see Chapter 35 at section 3.1.1.D), for example, the entity's board of directors and chief executive officer. *[IFRS 9.4.2.2(b)]*.

If an entity manages and evaluates the performance of a group of financial liabilities or financial assets and financial liabilities in such a way, measuring that group at fair value through profit or loss results in more relevant information. The focus in this instance is on the way the entity manages and evaluates performance, rather than on the nature of its financial instruments. *[IFRS 9.B4.1.33]*. Accordingly, subject to the requirement of designation at initial recognition, an entity that designates financial instruments as at fair value through profit or loss on the basis of this condition should so designate all eligible financial instruments that are managed and evaluated together. *[IFRS 9.B4.1.35]*.

An entity may designate financial liabilities as at fair value through profit or loss if it has financial assets and financial liabilities that share one or more risks and those risks are managed and evaluated on a fair value basis in accordance with a documented policy of asset and liability management. For example, the entity may issue 'structured products' containing multiple embedded derivatives and manage the resulting risks on a fair value basis using a mix of derivative and non-derivative financial instruments. *[IFRS 9.B4.1.34]*.

An entity's documentation of its strategy need not be extensive (e.g., it need not be at the level of detail required for hedge accounting) but should be sufficient to demonstrate that using the fair value option is consistent with the entity's risk management or investment strategy. Such documentation is not required for each individual item but may be on a portfolio basis. The IASB notes that in many cases, the entity's existing documentation, as approved by its key management personnel, should be sufficient for this purpose. For example, if the performance management system for a department (as approved by the entity's key management personnel) clearly demonstrates that its performance is evaluated on a total return basis, no further documentation is required. *[IFRS 9.B4.1.36]*.

The IASB made it clear in its basis for conclusions that in looking to an entity's documented risk management or investment strategy, it makes no judgement on what an entity's strategy should be. However, the IASB believes that users, in making economic decisions, would find useful a description both of the chosen strategy and of how designation at fair value through profit or loss is consistent with that strategy. Accordingly, IFRS 7 *Financial Instruments: Disclosures* requires these to be disclosed (see Chapter 50 at section 4.3). *[IFRS 9.BCZ4.66]*.

6.3 Hybrid contracts with a host that is not an asset within the scope of IFRS 9

Extract from IFRS 9

4.3.5 Despite paragraphs 4.3.3 and 4.3.4, if a contract contains one or more embedded derivatives and the host is not an asset within the scope of this Standard, an entity may designate the entire hybrid contract as at fair value through profit or loss unless:

(a) the embedded derivative(s) do(es) not significantly modify the cash flows that otherwise would be required by the contract; or

(b) it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

As discussed in Chapter 42 at sections 4, 5 and 6, when an entity becomes a party to a hybrid financial instrument that contains one or more embedded derivatives and the host is not an asset within the scope of IFRS 9, the entity is required to identify any such embedded derivative, assess whether it is required to be separated from the host contract and, if so, measure it separately at fair value at initial recognition and subsequently. These requirements can be more complex, or result in less reliable measures, than measuring the entire instrument at fair value through profit or loss. For that reason, the entire instrument is normally permitted to be designated as at fair value through profit or loss. *[IFRS 9.B4.3.9]*.

Such designation may be used whether the entity is required to, or prohibited from, separating the embedded derivative from the host contract, except for those situations in (a) or (b) above - this is because doing so would not reduce complexity or increase reliability. *[IFRS 9.B4.3.10]*.

Little further guidance is given on what instruments might fall within (a) and (b) above. The Basis for Conclusions explains that, at one extreme, the terms of a prepayment option in an ordinary residential mortgage is likely to mean that the fair value option is unavailable to such a mortgage (unless it met one of the conditions in sections 6.1 and 6.2 above). At the other extreme, it is likely to be available for 'structured products' that contain several embedded derivatives which are typically hedged with derivatives that offset all (or nearly all) of the risks they contain irrespective of the accounting treatment applied to the embedded derivatives. *[IFRS 9.BCZ4.68, IFRS 9.BCZ4.69, IFRS 9.BCZ4.70]*.

Essentially, the IASB explains, the standard seeks to strike a balance between reducing the costs of complying with the embedded derivatives provisions and the need to respond to concerns expressed regarding possible inappropriate use of the fair value option. Allowing the fair value option to be used for any instrument with an embedded derivative would make other restrictions on the use of the option ineffective, because many financial instruments include an embedded derivative. In contrast, limiting the use of the fair value option to situations in which the embedded derivative must otherwise be separated would not significantly reduce the costs of compliance and could result in less reliable measures being included in the financial statements. *[IFRS 9.BCZ4.70]*.

Another question that arises is whether the fair value option applies to hybrid contracts with a host that would not otherwise be within the scope of IFRS 9. The standard refers broadly to "a contract in which the host is not an asset within the scope of IFRS 9". *[IFRS 9.4.3.5]*.

The IFRS IC considered this issue in 2007. It recommended, and the Board proposed, to clarify IAS 39.11A (now IFRS 9.4.3.5) as part of the annual improvements to IFRSs in 2008. As part of these deliberations, in December 2007,[11] the Board decided to replace the term 'contract' with the term 'financial instrument in the scope of IAS 39' to clarify that IAS 39.11A applies only to financial instruments. However, the Board did not finalise its proposal and the existing wording was carried over to IFRS 9 without amendment.

How we see it

In the absence of a finalised amendment, IFRS 9 remains unclear whether the fair value option applies to hybrid contracts with a host that would not otherwise be within the scope of IFRS 9.

11 *IASB Update*, December 2007, available on the IFRS Foundation's website.

7 Presentation of fair value changes on an equity investment in other comprehensive income instead of profit or loss

An entity may acquire an investment in an equity instrument that is not held for trading. At initial recognition, the entity may make an irrevocable election (on an instrument-by-instrument basis) to present in other comprehensive income subsequent changes in the fair value of such an investment. *[IFRS 9.5.7.5, IFRS 9.B5.7.1]*. IFRS 7 requires granular disclosures for each instrument so designated (see Chapter 50 at section 4.4.4).

For the purpose of this election, the term equity instrument is the one defined in IAS 32, application of which for issuers is dealt with in detail in Chapter 43. In particular circumstances, a puttable instrument (or an instrument that imposes on the entity an obligation to deliver to another party a *pro rata* share of the net assets of the entity only on liquidation) is classified by the issuer as if it were an equity instrument. This classification is an exception to the general requirements for financial liabilities and equity instruments. Consequently, such instruments do not actually meet the definition of an equity instrument and therefore the related asset cannot be designated at fair value through other comprehensive income by the holder. *[IFRS 9.BC5.21]*.

This conclusion was confirmed by the IFRS IC in September 2017, after they received a request to clarify exactly this point. The IFRS IC observed that 'equity instrument' is a defined term, and IAS 32 defines an 'equity instrument' as "any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities". The IFRS IC also observed that IAS 32.11 specifies that, as an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument by the issuer if it has all the features and meets the conditions in IAS 32.16A and 16B or IAS 32.16C and 16D (see Chapter 43 at section 4.6).

Accordingly, the IFRS IC concluded that a financial instrument that has all the features and meets the conditions in IAS 32.16A and 16B or IAS 32.16C and 16D does not meet the definition of an equity instrument in IAS 32 and as such is not eligible for the presentation election in IFRS 9.4.1.4.[12]

The Committee concluded that the requirements in IFRS 9 provide an adequate basis for the holder of the particular instruments described in the submission to classify such instruments. In light of the existing requirements in IFRS accounting standards, the IFRS IC determined that neither an IFRIC Interpretation nor an amendment to a standard was necessary. Consequently, the Committee decided not to add this matter to its standard-setting agenda.

Under IFRS 9 all derivatives are deemed to be held for trading. Consequently, this election cannot be applied to a derivative such as a warrant that is classified as equity by the issuer. However, it could be applied to investments in preference shares, 'dividend stoppers' and similar instruments (see Chapter 43 at section 4.5) provided they are classified as equity by the issuer.

The IASB had originally intended this accounting treatment to be available only for those equity instruments that represented a 'strategic investment'. These might include investments held for non-contractual benefits rather than primarily for increases in the value of the investment, for example where there is a requirement to hold such an investment if an entity sells its products in a particular country. However, the Board concluded that it would be difficult, and perhaps impossible, to develop a clear and robust principle that would identify investments that are different enough to justify a different presentation requirement and abandoned this restriction. *[IFRS 9.BC5.25(c)]*.

The example below illustrates the requirements for the designation of a non-derivative equity investment at fair value through other comprehensive income, specifically, the requirement that the instrument meets the definition of an equity instrument in accordance with IAS 32.

Illustration 7-1: Callable, perpetual 'Tier 1' debt instrument

Consider the example where entity A invests in a perpetual Tier 1 debt instrument, which is redeemable at the option of the issuer (entity B). The instrument carries a fixed coupon that is deferred if entity B does not pay a dividend to its ordinary shareholders. If a coupon is not paid it will not accrue additional interest. The instrument does not have a maturity date.

Under IFRS 9, such an instrument would not be eligible for amortised cost accounting by the holder. However, given that Entity B does not have a contractual obligation to pay cash, the instrument will qualify for classification at fair value through other comprehensive income, as it meets the definition of equity from the perspective of the issuer in accordance with IAS 32.

12 *IFRIC Update*, September 2017, available on the IFRS Foundation's website.

The subsequent measurement of instruments designated in this way, including recognition of dividends, is summarised in section 7.1 below and covered in detail in Chapter 46 at section 2.5.

The IASB discussed feedback from constituents on how this election operates as part of the IFRS 9 Post-implementation review, concluding that no changes were needed to the standard.

7.1 Gains and losses on investments in equity instruments designated at fair value through other comprehensive income

Although most gains and losses on investments in equity instruments designated at fair value through other comprehensive income will be recognised in other comprehensive income, dividends will normally be recognised in profit or loss. *[IFRS 9.5.7.6]*. However, the IASB noted that dividends could sometimes represent a return of investment instead of a return on investment. Consequently, the IASB decided that dividends that clearly represent a recovery of part of the cost of the investment are not recognised in profit or loss. *[IFRS 9.BC5.25(a)]*. Meanwhile, gains or losses recognised in other comprehensive income are never reclassified from equity to profit or loss on derecognition of the asset, and consequently, there is no need to review such investments for possible impairment.

Determining when a dividend does or does not clearly represent a recovery of cost could prove somewhat judgemental in practice, especially as the standard contains no further explanatory guidance. Also, because it is an exception to a principle, it could open up the possibility of structuring transactions to convert fair value gains into dividends through the use of intermediate holding vehicles. However, in the IASB's view, those structuring opportunities would be limited because an entity with the ability to control or significantly influence the dividend policy of the investee would generally not account for those investments in accordance with IFRS 9. *[IFRS 9.BC5.25(a)]*. The main exception to this would be investment entities, as defined in IFRS 10 *Consolidated Financial Statements,* but they are required to account for investments in subsidiaries (other than those providing investment-related services or activities) at fair value through profit or loss, hence for them this issue would not arise. Furthermore, the IASB requires disclosures that would allow the user to compare the dividends recognised in profit or loss and other fair value changes easily. *[IFRS 9.BC5.25(a)]*.

8 Reclassification of financial assets

In certain rare circumstances, non-derivative debt assets are required to be reclassified between the amortised cost, fair value through other comprehensive income and fair value through profit or loss categories. More specifically, when (and only when) an entity changes its business model for managing financial assets, it shall reclassify all affected financial assets in accordance with the requirements set out in IFRS 9. *[IFRS 9.4.4.1]*. Refer to Chapter 46 at section 2.7 for further details on how the reclassification requirements should be applied. In drafting IFRS 9, the IASB debated whether reclassifications should be permissible. In the October 2009 IASB meeting, the board tentatively decided to require reclassification where there is a change in business model, however, the "Board noted that such reclassifications would be expected to occur infrequently, if ever."[13]

IFRS 9 sets out the circumstances under which changes in the business model for managing financial assets will occur and notes that these changes are expected to be very infrequent. They must be determined by an entity's senior management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties. Accordingly, a change in the objective of an entity's business model will occur only when an entity either begins or ceases to carry on an activity that is significant to its operations; for example, when the entity has acquired or disposed of a business line (see section 4.5 above for the interaction between IFRS 9 and IFRS 5). Examples of a change in business model include the following: *[IFRS 9.B4.4.1]*

(a) An entity has a portfolio of commercial loans that it holds to sell in the short-term. The entity acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows.

(b) A financial services firm decides to shut down its retail mortgage business. That business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.

The examples above show that there needs to be a significant activity that has commenced or ceased before assets can qualify to be reclassified. The activity that is commencing or ceasing does not refer to the act of implementing different buying or selling decisions with regards to a portfolio of financial assets, but rather the 'activity' needs to be evidenced by a fundamental change in the operation of the business. These examples are also consistent with a high threshold being required for a business model change being "demonstrable to external parties".

In example (a) above, there is an acquisition of a company which ostensibly would be accompanied by the commencement of new business processes. For example, there may be new processes regarding managing the new product (such as new credit and collections process) there may also be new marketing processes to manage new clients. These changes could therefore evidence a significant change in the entity's operations. Similarly, in example (b) above, the financial services firm has ceased a significant operation by shutting down its retail mortgage business. This change in business line would be demonstrable to external parties as there would be an entire product line of the financial services firm (with all associated business activities to support that product line) which has discontinued. In both examples above, there would be noticeably significant changes to the entity which would evidence the significant change in operations. Moreover, any assets that are reclassified because of a change in business model, must be reclassified as a direct result of that model change.

In the absence of these types of changes in business activity, it would not be appropriate to reclassify financial assets. In some instances, entities may be prompted to change the manner in which they manage existing assets in response to external events such as changes in regulatory requirements (e.g., criteria regarding which assets constitute high quality liquid assets), or changes that are prompted due to certain assets no longer meeting internal credit quality requirements. In these examples, even if the entity is committed to changing the way in which they manage an existing, significant portfolio of financial assets, this change in intention by management would not be accompanied by the commencement or cessation of a significant operational activity. A change in intention alone, is one of the examples provided in IFRS 9 of changes that would not result in reclassification. *[IFRS 9.B4.4.3(a)]*. However, the entity would need to consider how this change in intention affects new financial assets originated or acquired within the portfolio (see Illustration 8-1 below).

13 *IASB Update*, October 2009, available on the IFRS Foundation's website.

The following are not considered to be changes in business model: *[IFRS 9.B4.4.3]*

(a) A change in intention related to particular financial assets (even in circumstances of significant changes in market conditions)

(b) A temporary disappearance of a particular market for financial assets

And

(c) A transfer of financial assets between parts of the entity with different business models

Illustration 8-1: Change in the way a portfolio is managed

An entity's business model objective for a portfolio meets the criteria for amortised cost measurement but, subsequently, the entity changes the way it manages the assets.

Having determined that the objective for a portfolio originally met the business model test to be classified at amortised cost, if the entity subsequently changes the way it manages the assets (which results in a more than an infrequent number of sales), so that the business model would no longer qualify for amortised cost accounting, the question of how the entity must measure the existing assets and any newly acquired assets then arises.

Although more than an infrequent number of sales have occurred, unless there has been a fundamental change in the entity's business model, the requirements of the standard regarding reclassification are unlikely to be triggered. Changes in the business model for managing financial assets that trigger reclassification of financial assets must be significant to the entity's operations and demonstrable to external parties. They are expected to be very infrequent.

Assuming that the assets are not reclassified, it is likely that the entity will have to divide the portfolio into two sub-portfolios going forward - one for the old assets and one for any new assets acquired.

Financial assets previously held will remain at amortised cost. New financial assets acquired will be measured at fair value through profit or loss or at fair value through other comprehensive income. Whether the assets are measured at fair value through profit or loss or at fair value through other comprehensive income depends on the new business model and the characteristics of the assets (see section 4 above).

Illustration 8-2: Change in business model by a subsidiary

Subsidiary S is acquired by Parent P.

Scenario A

Prior to the acquisition, Subsidiary S had a significant portfolio of loans which met the criteria for amortised cost measurement. Post the acquisition of S by P, S changes the way it manages the loans in line with the strategy of the group. The group intends to manage the portfolio of loans in S together with an existing portfolio of loans held by P, that are held for sale in the short-term. As a result of the alignment with the group strategy, S discontinues its debt collection function which is now no longer needed as the sales activity of the loans will be managed and performed by the existing sales division in P. The change has been assessed by the key management of S to be demonstrable to external parties as it results in a significant change in the business activities of S.

Even though Subsidiary S has not acquired a business line, but rather the subsidiary itself has been acquired, we believe that this would follow the principles established in paragraph B.4.4.1 of IFRS 9 such that in the absence of any other contrary indicators, a reclassification of Subsidiary S's portfolio of loans, in the separate financial statements of S, is required.

Scenario B

Prior to the acquisition, Subsidiary S had a portfolio of bonds within its banking portfolio which met the criteria for amortised cost measurement. Due to market movements, S transferred these bonds to its trading portfolio. S now holds bonds in this portfolio for trading purposes. However, there were no changes to S' business and the internal transfer did not qualify as a reclassification in line with paragraph B4.4.3(c) of IFRS 9. Therefore, S continued to classify and measure the bonds at amortised cost following the transfer. Further, there were no changes to S' business as a result of the acquisition that would trigger a reclassification for this portfolio of bonds. S therefore continues to classify the bonds at amortised cost following the acquisition.

At the acquisition date, P would classify these bonds in its consolidated financial statements based on its business model for them at the acquisition date. Given that the bonds are held for trading at the acquisition date, P would classify the bonds as fair value through profit or loss.

Reclassification on the basis of a change in a financial asset's contractual cash flows is not permitted, unless the asset is sufficiently modified that it is derecognised. *[IFRS 9.BC4.117]*. Also, the contractual cash flows may vary over that asset's life based on its original contractual terms. However, because an entity classifies a financial asset at initial recognition based on the contractual terms over the life of the instrument, reclassification on the basis of a financial asset's contractual cash flows is not permitted.

For instance, no reclassification is permitted or required if the conversion option of a convertible bond lapses. If, however, a convertible bond is converted into shares, the shares represent a new financial asset to be recognised by the entity. The entity would then need to determine the classification category for the new equity investment.

A related question to the above is to what extent the contractual cash flow characteristics test influences the test of whether a financial asset is sufficiently modified such that it is derecognised. It has been suggested that a modification which would result in the asset failing the contractual cash flow characteristics test is a 'substantial modification' that would result in derecognition of the asset (see also Chapter 48 at section 3.5.1). That is because an asset that is measured at fair value through profit or loss is substantially different to an asset measured at amortised cost or fair value through other comprehensive income. Whether or not a modified asset would still meet the contractual cash flow characteristics test or not could be a helpful indicator for the derecognition assessment.

8.1 When should reclassifications be applied?

The reclassification should be applied prospectively from the 'reclassification date', *[IFRS 9.5.6.1]*, which is defined as: *[IFRS 9 Appendix A]*

Extract from IFRS 9

Appendix A
Defined terms

reclassification date	The first day of the first reporting period following the change in business model that results in an entity reclassifying financial assets.

Accordingly, any previously recognised gains, losses or interest should not be restated. *[IFRS 9.5.6.1]*.

How we see it

'Reporting period' includes both annual (full IFRS) and interim (IAS 34 *Interim Financial Reporting*) financial reporting periods, if any. For example, an entity with a reporting date of 31 December might determine that there is a change in its business model in August 20X1. If the entity publishes quarterly reports in accordance with IAS 34, the reclassification date would be 1 October 20X1. However, if the entity only publishes half-yearly interim reports or no interim reports at all, the reclassification date would be 1 January 20X2. An entity may not set the reclassification date for a financial asset at any date before the beginning of the reporting period following the change in business model.

A change in the objective of an entity's business model must be affected before the reclassification date. For example, if a financial services firm decides on 15 February to shut down its retail mortgage business and hence must reclassify all affected financial assets on 1 April (i.e., the first day of the entity's next reporting period, assuming it reports quarterly), the entity must not accept new retail mortgage business or otherwise engage in activities consistent with its former business model after 15 February. *[IFRS 9.B4.4.2]*.

Where reclassifications occur, IAS 1 *Presentation of Financial Statements* and IFRS 7 contain disclosure requirements that may be relevant to explaining the impact of the reclassification. *[IAS 1.82(ca), IAS 1.82(cb), IFRS 7.20A]*.

8.2 Reassessment of IFRS 9 classifications upon initial application of IFRS 17

As an exception to the general reclassification requirements (see sections 8 and 8.1 above), IFRS 17 allows entities that have already adopted IFRS 9 to reassess certain aspects of the classification of their eligible financial assets and liabilities upon initial application of IFRS 17 (see Chapter 51 at section 17.6).

9 Contracts with insurance risk - interaction between IFRS 17 and IFRS 9

9.1 Loan contracts that transfer significant insurance risk only on settlement of the policyholder's obligation created by the contract

Some contracts meet the definition of an insurance contract but limit the compensation for insured events to the amount otherwise required to settle the policyholder's obligation created by the contract (for example, loans with death waivers). An entity may choose to apply either IFRS 17 or IFRS 9 to such contracts that it issues unless such contracts are excluded from the scope of IFRS 17. The election would be made at a portfolio level and would be irrevocable. *[IFRS 17.8A]*. Refer to Chapter 51 at section 2.3.3 and Chapter 41 at section 2.3.5 for further detail.

If an entity elects to apply IFRS 9 to such loan contracts and the insurance element is contractual (and not imposed as a result of laws or regulations), then it would cause the contract to fail the SPPI test. Note that any terms imposed by laws or regulations would not be considered in the analysis of the contractual payment features of the loan (refer to Illustration 5-15 above for further consideration of the impact of non-contractual features).

The insurance coverage might alternatively be issued as a separate contract to the underlying loan contract to which the coverage relates. In those situations, the separate insurance contract is in the scope of IFRS 17 and the loan contract could still pass the SPPI test, as it will not have the insurance cover embedded in the loan contract itself.

9.2 Credit card contracts (and other similar contracts) that provide insurance coverage

In certain jurisdictions, an entity issuing a credit card may be required to provide coverage for purchases made by the customer using the credit card. The coverage could include refunding the customer for any breach of contract by the supplier that is not rectified by the supplier. The issuer of the credit card would be entitled to be indemnified by the supplier for any loss incurred in satisfying its liability with the customer. It is common in these circumstances for the issuer of the credit card not to explicitly charge any fee for this coverage. The question then arises as to if the credit card is assessed as having transferred insurance risk that is significant, whether it would be an insurance contract within the scope of IFRS 17.

IFRS 4 *Insurance Contracts* had different criteria for separating components of an insurance contract when compared to IFRS 17 with the result that most entities separated the components of such contracts. For example, an entity applying IFRS 4 might account for the credit card component applying IFRS 9 (or IAS 39 for entities still applying that standard), the insurance component applying IFRS 4 and any other service component applying IFRS 15 *Revenue from Contracts with Customers*. The IASB acknowledged that entities had already identified methods to separate the components of such contracts, and so concluded that changing the existing accounting for these contracts would impose costs and disruption to entities for no significant benefit. *[IFRS 17.BC94B]*.

IFRS 17 excludes from its scope, credit card contracts (and other similar contracts that provide credit or payment arrangements) that meet the definition of an insurance contract if, and only if, the entity does not reflect an assessment of the insurance risk associated with an individual customer in setting the price of the contract with that customer.

Once a credit card contract is out of scope of IFRS 17, an entity needs to determine whether it provides the insurance coverage because it is required by law or regulation, or as part of the contractual terms of the credit card contract. For insurance coverage that is provided as part of the contractual terms of the credit card contract, the issuer will be required to separate the insurance coverage component and apply IFRS 17 to it, and then apply IFRS 9 to the remainder of the contract. There is therefore no insurance element that remains in the scope of IFRS 9 and hence the insurance element would not cause the credit card arrangement to fail the SPPI test. *[IFRS 17.7(h), IFRS 9.2.1(e)(iv)]*

Refer to Chapter 51 at section 2.3.1.D for further detail regarding the scoping requirements of IFRS 17 and to Chapter 41 at section 2.3.4 for further detail regarding the scoping of IFRS 9.

10 Post implementation review of IFRS 9 - Classification and Measurement

The IASB has divided its PIR of IFRS 9 into three phases: Classification and Measurement; Impairment; and Hedge Accounting. In 2021, it started the first phase relating to Classification and Measurement by issuing a request for information (RFI), that asked for views from constituents. In 2022, the IASB began deliberations to discuss and respond to the feedback received. In March 2023, the IASB issued: "Exposure Draft: Amendments to the Classification and Measurement of Financial Instruments" and following deliberations on the feedback received to the exposure draft, issued "Amendments to the Classification and Measurement of Financial Instruments" in May 2024. The amendments relating to classification are summarised in the sections below.

The amendments are applicable for annual periods beginning 1 January 2026. Entities are permitted to early adopt either all amendments, or only the amendments that relate to the classification of financial assets plus the related disclosure in IFRS 7 (refer to Chapter 50 section 10) before applying the other amendments later. *[IFRS 9(2026).7.1.13]*.

The amendments are applied retrospectively, and an entity is not required to restate prior periods. Restatement of prior periods is permitted if, and only if, it is possible to do so without the use of hindsight. If an entity does not restate prior periods, it shall recognise the effect of initially applying these amendments as an adjustment to the opening balance of financial assets and financial liabilities and the cumulative effect, if any, as an adjustment to the opening balance of retained earnings at the date of initial application. *[IFRS 9(2026).7.2.48]*.

How we see it

Even though some of the amendments represent clarifications to existing IFRS accounting standards, since they have required the IASB to make changes to IFRS 9, they only become applicable from their effective date.

In deciding whether to early adopt the amendments or those that apply for financial assets with contingent features, entities will need to consider the timing for when the amendments will be endorsed for use in their jurisdiction.

10.1 Financial assets with contingent features, including ESG-features

These contracts and our views on how they must be assessed for classification is currently explained above at section 5.4.7.

During the PIR, the accounting treatment for financial assets for which the interest rate varies depending on the achievement of ESG targets was identified as a high priority to be addressed by the IASB, as the matter was pervasive and could have substantial consequences. *[IFRS 9(2026).BC4.255]*.

The IASB has made two broad amendments. The first clarifies the assessment of whether the lender's compensation is consistent with a basic lending arrangement:

- The focus is on what the lender is compensated for rather than how much. Nonetheless, the amount of compensation may indicate that the lender is being compensated for something other than basic lending risks and costs.
- Contractual cash flows are inconsistent with a basic lending arrangement if they are indexed to a variable that is not a basic lending risk or cost (for example, the value of equity instruments, the price of a commodity) or if they represent a share of the debtor's revenue or profit.
- Such contractual cash flows are inconsistent with a basic lending arrangement even if such terms are common to the market in which the entity operates. *[IFRS 9(2026).B4.1.8A]*. The term 'basic lending arrangement' refers to the nature of a lending arrangement, rather than to an arrangement that is common or widespread in a particular market or jurisdiction. *[IFRS 9(2026).BC4.262]*.

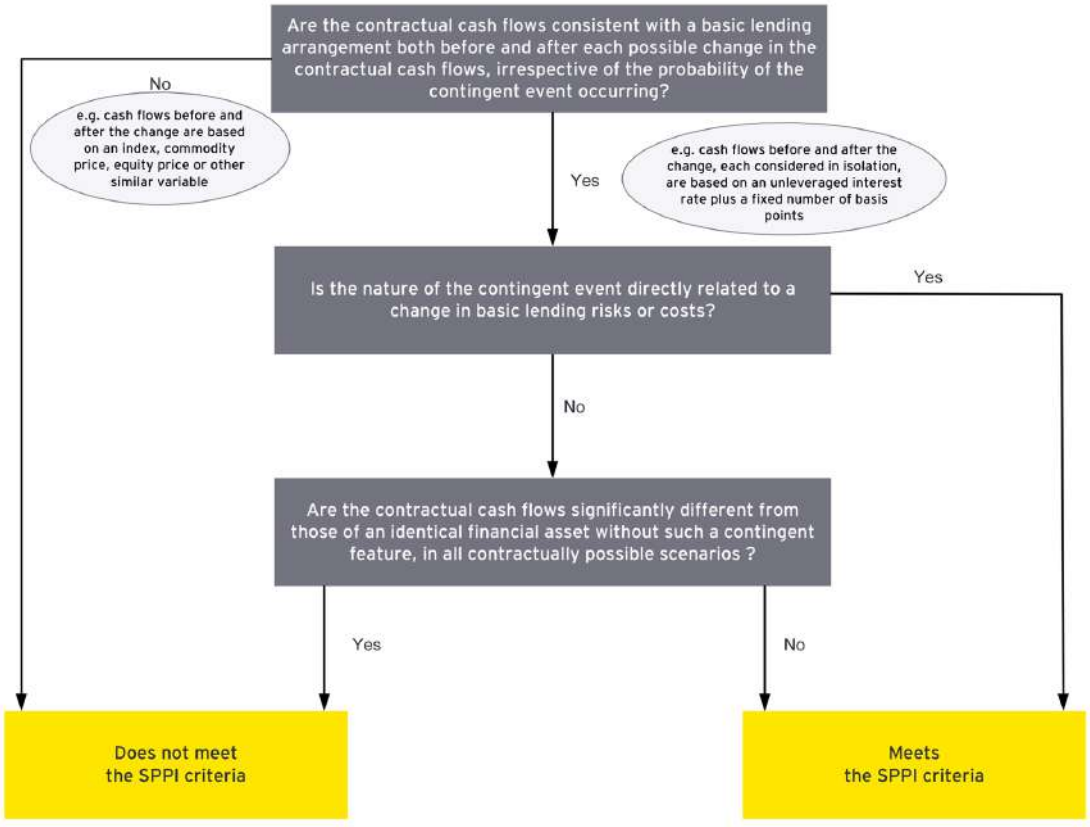
The second amendment covers how contractual terms that change the timing or amount of contractual cash flows should be assessed, considering:

- Whether the contractual cash flows that could arise both before and after the change would meet the SPPI requirements, irrespective of the probability of the contingent event occurring. The amendments clarify that the contractual cash flow assessment is based on all contractual cash flows that could arise over the life of the financial instrument - it is not a probability based assessment. This means an entity is required to consider the effect on contractual cash flows of any contingent event specified in the contract, however likely or unlikely the event is to occur (unless the terms are not genuine, as described in section 5.4.1.B). *[IFRS 9(2026).BC4.268]*.
- Whether the nature of the contingent event relates directly to, and the contractual cash flows change in the same direction as, changes in basic lending risks and costs. *[IFRS 9.B4.1.10]*. The amendments clarify that if the nature of the contingent event relates directly to, and the contractual cash flows change in the same direction as, changes in basic lending risks and costs, it is more likely that the contractual cash flows over the life of the instrument will be solely payments of principal and interest on the principal amount outstanding (for example, a financial instrument with an interest rate that is reset to a higher rate if the debtor misses a particular number of payments).

The amendments then adds that if a contingent feature gives rise to contractual cash flows that are consistent with a basic lending arrangement both before and after the change in contractual cash flows but the nature of the contingent event does not relate directly to changes in basic lending risks and costs, the SPPI requirements may still be met. For example, the interest rate on a loan is adjusted by a specified amount if the debtor achieves a contractually specified reduction in carbon emissions. This is provided that the contingent feature gives rise to contractual cash flows that are consistent with a basic lending arrangement both before and after the change and that are not 'significantly different' from the cash flows for an identical financial asset without such a contingent feature. The purpose of this analysis is to assess the effect the contingent feature could have on contractual cash flows. *[IFRS 9(2026).B4.1.10A, IFRS 9(2026).BC4.272]*.

Entities will need to consider all scenarios in which the contractual cash flows could possibly change and apply judgement to assess whether contractual cash flows arising from a contingent feature are 'significantly different' to an identical financial asset without such a feature. Entities are required to consider all possible combinations of contingent events occurring because all these possible scenarios are contractually specified. In some circumstances, an entity may be able to determine that with a qualitative assessment, but in other circumstances it may be necessary to perform a quantitative assessment. Entities will need to apply judgement to determine what is considered 'significantly different', and whether this represents a different threshold from '*de minimis*'. *[IFRS 9(2026).B4.1.10A, IFRS 9(2026).BC4.273]*.

The following diagram is a flowchart for determining whether a financial asset with contingent features passes the SPPI test:



The amendments include an example of an instrument whose contractual cash flows meet the SPPI criteria, and one that does not.

Illustration 10-1: Loan with interest rate adjusted for reductions in carbon emissions

A bank originates a loan with an interest rate that is adjusted every reporting period by a fixed number of basis points if the debtor achieves a contractually specified reduction in carbon emissions during the preceding reporting period. The maximum possible cumulative adjustments would not significantly change the interest rate on the loan.

In this scenario, the contractual cash flows are solely payments of principal and interest on the principal amount outstanding. The entity considers whether the contractual cash flows that could arise both before and after each change in contractual cash flows are solely payments of principal and interest. If the contingent event of achieving the carbon emissions target occurs, the interest rate is adjusted by a fixed number of basis points, resulting in contractual cash flows that are consistent with a basic lending arrangement. It is only because the nature of the contingent event itself does not relate directly to changes in basic lending risks and costs that the entity cannot conclude - without further assessment - whether the cash flows on the financial assets are solely payments of principal and interest. The entity therefore assesses whether, in all contractually possible scenarios, the contractual cash flows would not be significantly different from the contractual cash flows on a financial instrument with identical contractual terms, but without the contingent feature linked to carbon emissions. Because any adjustments over the life of the instrument would not result in contractual cash flows that are significantly different, the entity concludes that the loan has contractual cash flows that pass SPPI.

[IFRS 9(2026).B4.1.13 Instrument EA].

Illustration 10-2: Loan with interest rate adjusted to track movements in a carbon price index

A bank originates a loan with an interest rate that is adjusted every reporting period to track the movements in a market-determined carbon price index during the preceding reporting period. The contractual cash flows are indexed to a variable (the carbon price index), which is not a basic lending risk or cost. The contractual cash flows are therefore inconsistent with a basic lending arrangement, and do not meet the SPPI criterion. *[IFRS 9(2026).B4.1.14 Instrument I]*.

How we see it

The new criteria laid out by the IASB include additional specific guidance, including assessing whether cash flows could be 'significantly different', and may result in different outcomes to existing assessments. Therefore, preparers should reassess any conclusions under the new criteria when transitioning to the new requirements.

10.2 Contractually-linked instruments with non-recourse features

IFRS 9 contains guidance on when contractually linked instruments satisfy the SPPI criteria (see section 5.6 above). This guidance was designed primarily to address securitisation of debt instruments, but feedback from the RFI identified that the scope and meaning of several terms used in the guidance is unclear. This feedback led the IASB to include amendments to IFRS 9 to clarify that:

- CLIs must feature a 'waterfall' payment structure that creates concentration of credit risk by allocating losses disproportionately between different tranches. *[IFRS 9.B4.1.20]*.
- The underlying pool only includes financial instruments, and can include financial instruments not in the scope of IFRS 9 classification and measurement, such as lease receivables. However, lease receivables must have cash flows that are equivalent to SPPI (i.e., not subject to residual value risk nor indexed to a market rental rate). *[IFRS 9.B4.1.23]*. CLI structures that include non-financial assets are to be assessed under the non-recourse guidance (refer to sections 5.5 and 10.3).
- CLIs are not created where multiple debt instruments of differing seniority are issued to facilitate lending with enhanced credit protection to a creditor (or a group of creditors). This is the case, for example, if the structured entity issues senior and junior notes and the entity sponsoring the structured entity that holds the junior debt instrument has no practical ability to sell the junior instrument without the senior debt instrument becoming payable. In this case non-recourse guidance is to be applied. *[IFRS 9.B4.1.20A]*.

10.3 Other financial assets with non-recourse features

The amendments clarify that, for a financial asset to have non-recourse features, the creditor's contractual right to receive cash flows must be limited to the cash flows generated by specified assets, i.e., the entity is primarily exposed to the specified assets' performance risk not the debtor's credit risk. If a creditor has a contractual right to require a debtor to 'top-up' pledged assets, the creditor has recourse to the debtor. *[IFRS 9.B4.1.16A]*. In response to some respondents' questions about whether a financial asset only has non-recourse features if such features are explicit in the contractual terms, as opposed to being structurally implied (for example, when an entity purchases a financial asset that is credit-impaired on initial recognition), the IASB reiterated that there has to be a contractual, rather than a purely economic, limitation on the creditor's rights to receive contractual cash flows. This limitation can be established through a combination of contracts, such as in the case of a loan to a structured entity. *[IFRS 9(2026).BC4.286]*.

If a financial asset has non-recourse features, a 'look through' assessment of the link between the particular underlying assets or cash flows and the contractual cash flow is required. How this link is affected by other contractual arrangements, such as subordinated debt or equity instruments issued by the debtor shall be considered. *[IFRS 9.B4.1.17]*.

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Appendix C - Defined terms

Extract from IFRS standards - Definitions	
amortised cost of a financial asset or financial liability	The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any **loss allowance**. *[IFRS 9 Appendix A]*.
credit loss	The difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (ie all cash shortfalls), discounted at the original **effective interest rate** (or **credit-adjusted effective interest rate** for **purchased or originated credit-impaired financial assets**). An entity shall estimate cash flows by considering all contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) through the expected life of that financial instrument. The cash flows that are considered shall include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms. There is a presumption that the expected life of a financial instrument can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the expected life of a financial instrument, the entity shall use the remaining contractual term of the financial instrument. *[IFRS 9 Appendix A]*.
derivative	A financial instrument or other contract within the scope of this Standard with all three of the following characteristics. (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying'). (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. (c) it is settled at a future date. *[IFRS 9 Appendix A]*.
dividends	Distributions of profits to holders of equity instruments in proportion to their holdings of a particular class of capital. *[IFRS 9 Appendix A]*.
effective interest method	The method that is used in the calculation of the **amortised cost of a financial asset or a financial liability** and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period. *[IFRS 9 Appendix A]*.

effective interest rate	The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the **gross carrying amount of a financial asset** or to the **amortised cost of a financial liability**. When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the **expected credit losses**. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1-B5.4.3), **transaction costs**, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments). *[IFRS 9 Appendix A]*.
equity instrument	**An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.** *[IAS 32.11]*.
expected credit losses	The weighted average of **credit losses** with the respective risks of a default occurring as the weights. *[IFRS 9 Appendix A]*.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. *[IFRS 13 Appendix A]*.
financial asset	**A *financial asset* is any asset that is:** **(a) cash;** **(b) an equity instrument of another entity;** **(c) a contractual right:** **(i) to receive cash or another financial asset from another entity; or** **(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or** **(d) a contract that will or may be settled in the entity's own equity instruments and is:** **(i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or** **(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.** **For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.** *[IAS 32.11]*.
financial guarantee contract	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. *[IFRS 9 Appendix A]*.

financial instrument	A *financial instrument* is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. *[IAS 32.11]*.
financial liability	A *financial liability* is any liability that is: (a) a contractual obligation: (i) to deliver cash or another financial asset to another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or (b) a contract that will or may be settled in the entity's own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments. As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D. *[IAS 32.11]*.
financial liability at fair value through profit or loss	A financial liability that meets one of the following conditions: (a) it meets the definition of **held for trading**. (b) upon initial recognition it is designated by the entity as at fair value through profit or loss in accordance with paragraph 4.2.2 or 4.3.5. (c) it is designated either upon initial recognition or subsequently as at fair value through profit or loss in accordance with paragraph 6.7.1. *[IFRS 9 Appendix A]*.
held for trading	A financial asset or financial liability that: (a) is acquired or incurred principally for the purpose of selling or repurchasing it in the near term; (b) on initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or (c) is a **derivative** (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument). *[IFRS 9 Appendix A]*.
impairment gain or loss	Gains or losses that are recognised in profit or loss in accordance with paragraph 5.5.8 and that arise from applying the impairment requirements in Section 5.5. *[IFRS 9 Appendix A]*.

interim financial report	***Interim financial report*** **means a financial report containing either a complete set of financial statements (as described in IAS 1 *Presentation of Financial Statements* (as revised in 2007)) or a set of condensed financial statements (as described in this Standard) for an interim period.** *[IAS 34.4]*.
lessee	An entity that obtains the right to use an **underlying asset** for a period of time in exchange for consideration. *[IFRS 16 Appendix A]*.
loans payable	Loans payable are financial liabilities, other than short-term trade payables on normal credit terms. *[IFRS 7 Appendix A]*.
reclassification date	The first day of the first reporting period following the change in business model that results in an entity reclassifying financial assets. *[IFRS 9 Appendix A]*.

Chapter 45 Financial instruments: Recognition and initial measurement

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Overview

This chapter deals with the recognition and initial measurement of financial instruments as per IFRS 9 *Financial Instruments*. Chapter 41 provides a general background to financial instruments, and discusses which financial instruments are within the scope of which standards. Chapters 43 and 44 detail the classification requirements. This chapter then deals with the question of when financial instruments should be recognised in the financial statements, and the amount that they are measured at initially.

IFRS 9 requires that an entity must recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instrument. There are however certain exceptions to this general principle, and these are dealt with in this chapter.

Initial measurement is normally based on the fair value of an instrument and most, but not all, of the detailed requirements of IFRS accounting standards governing fair values are dealt with in IFRS 13 *Fair Value Measurement*, which is covered in Chapter 15. However, IFRS 9 also contains certain requirements addressing fair value measurements of financial instruments, and these are covered in this chapter.

The treatment of financial instruments after initial recognition is dealt with in subsequent chapters. In particular, Chapter 46 deals with the subsequent measurement of financial instruments, Chapter 47 deals with the impairment of financial assets, and Chapter 48 deals with the derecognition of financial instruments.

What you need to know

- The general principle for recognition is that an entity recognises a financial instrument when, and only when, it becomes a party to the contractual provisions of the instrument.
- As an exception, assets subject to regular way transactions are permitted to be recognised, or derecognised, either at the trade date or at the settlement date.
- The general principles for initial measurement are:
  - Financial instruments classified at fair value through profit or loss are normally measured at fair value.
  - Other financial instruments not classified at fair value through profit or loss are normally measured at fair value, but are adjusted for incremental and directly attributable transaction costs.
- There is an exception to the general initial measurement principles for certain trade receivables within the scope of IFRS 15 *Revenue from Contracts with Customers*.
- There are situations where the initial measurement of financial instruments require additional consideration, such as when there is a difference between the fair value at initial recognition, and the transaction price of the financial instrument. Some examples of where this difference may arise include where an entity has an interest free or low interest rate loan, or acquires financial assets and liabilities as part of a group that does not constitute a business, or simply that an entity has priced an instrument in a way that appears to result in it making an immediate (Day 1) profit. When such a difference arises, IFRS 9 has additional requirements and limitations about the recognition of such a difference.

1 Introduction

Initial measurement is normally based on the fair value of the financial instrument and most, but not all, of the detailed requirements of IFRS accounting standards governing fair values are dealt with in IFRS 13, which is covered in Chapter 15. IFRS 9 also contains requirements addressing the fair value measurement of financial instruments and these are covered in section 3.3 below.

Differences between the IFRS accounting standards and US GAAP guidance on this topic are not addressed in this chapter as the standards are not converged. Therefore, differences between IFRS accounting standards and US GAAP may exist that are not discussed further in this chapter.

2 Initial recognition

2.1 General requirements

IFRS 9 provides that an entity must recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instrument. *[IFRS 9.3.1.1, IFRS 9(2026).B3.1.2A]*. Before that, the entity does not have contractual rights or contractual obligations. Hence, there is no financial asset or financial liability, as defined in IAS 32 *Financial Instruments: Presentation*, to recognise. IFRS 9 provides a practical exception to the application of this general principle for 'regular way' purchases and sales (see section 2.2 below). Listed below are examples of the application of this principle.

2.1.1 Receivables and payables

Unconditional receivables and payables are recognised as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive, or a legal obligation to pay cash. *[IFRS 9.B3.1.2(a)]*.

2.1.2 Firm commitments to purchase or sell goods or services

Under IFRS, assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement. For example, an entity that receives a firm order for goods or services does not generally recognise an asset for the consideration receivable (and the entity that places the order does not generally recognise a liability for the consideration to be paid) at the time of the commitment, but instead delays recognition until the ordered goods or services have been shipped, delivered or rendered. *[IFRS 9.B3.1.2(b)]*.

This accounting applies on the assumption that the firm commitment to buy or sell non-financial items is not:

- Net settled and treated as if it were a derivative (see Chapter 41 at section 3.3.1)
- Irrevocably designated at fair value through profit or loss on initial recognition. This is only allowed if an accounting mismatch is eliminated or significantly reduced (see Chapter 41 at section 3.3.6)

  Or
- Designated as a hedged item in a fair value hedge (see Chapter 49 at section 5.1)

If any of the above situations apply, the firm commitment would be recognised as an asset or liability before delivery of the underlying goods or services. *[IFRS 9.B3.1.2(b), IFRS 9.2.4]*.

2.1.3 Forward contracts

A forward contract obliges one party to the contract to buy, and the other party to sell, an underlying asset that is the subject of the contract, for a fixed price at a future date (for further discussion on the treatment of a forward contract, see Chapter 41 at section 3).

In most cases, a forward contract to purchase or sell a financial asset is within the scope of IFRS 9. However, in certain cases it will not be in the scope, for example, a forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination at a future acquisition date (see Chapter 41 at section 2.7.2).

Certain forward contracts to buy or sell non-financial items that can be settled net, including where the non-financial item is readily convertible into cash, will be within the scope of IFRS 9 (see Chapter 41 at section 1.2.5). If a forward contract is within the scope of IFRS 9, it is recognised as an asset or a liability at commitment date, rather than on the date on which settlement takes place. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward at inception is zero. If the net fair value of the right and obligation is not zero, the contract is recognised as an asset or liability. *[IFRS 9.B3.1.2(c)]*.

2.1.4 Option contracts

An option contract is a contract which gives one party to the contract the right, but not the obligation, to buy from, or sell to, the other party to the contract the underlying asset, for a fixed price, at a future date (or during a period of time). An option giving the right to buy an asset is referred to as a 'call' option, and one giving the right to sell an asset as a 'put' option. An option is referred to as a 'bought' or 'purchased'

option from the perspective of the party with the right to buy or sell (the 'holder') and as a 'written' option from the perspective of the party with the potential obligation to buy or sell.

Option contracts that are within the scope of IFRS 9 are recognised as assets or liabilities when the holder or writer becomes a party to the contract (see Chapter 41 at section 1.2.8). *[IFRS 9.B3.1.2(d)]*.

2.1.5 Planned future transactions (forecast transactions)

Planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract. They are therefore, not recognised under IFRS 9. *[IFRS 9.B3.1.2(e)]*. However, transactions that have been entered into as a cash flow hedge of certain 'highly probable' future transactions are recognised under IFRS 9 (see Chapter 49 at section 5.2).

2.1.6 Transfers of financial assets not qualifying for derecognition by transferor - impact on recognition

IFRS 9 states that, where a financial asset is transferred from one party to another in circumstances that preclude the transferor from derecognising the asset, the transferee must not recognise the transferred asset. Instead, the transferee derecognises the cash or other consideration paid, and recognises a receivable from the transferor. *[IFRS 9.B3.1.1]*. If the transferor has both a right, and an obligation, to reacquire control of the entire transferred asset for a fixed amount (such as under a repurchase agreement - see Chapter 48 at section 4.1), the transferee will account for its receivable at amortised cost, if the criteria for classification as measured at amortised cost are met *[IFRS 9.B3.2.15]*.

Underlying this principle appears to be a concern that more than one party cannot satisfy the criteria in IFRS 9 for recognition of the same financial asset at the same time. However, this principle may not hold in all circumstances, since it is sometimes possible for the same asset to be simultaneously recognised by more than one entity, for example if a seller adopts settlement date accounting, and a purchaser trade date accounting (see section 2.2 below).

In addition, IFRS 9 clarifies that to the extent that a transfer does not qualify for derecognition, the transferor does not account for its contractual rights or obligations related to the transfer separately as derivatives, if recognising both the derivative and either the transferred asset, or the liability arising from the transfer, would result in recognising the same rights or obligations twice. For example, a call option retained by the transferor may prevent a transfer of financial assets from being accounted for as a sale. In that case, the call option is not separately recognised as a derivative asset. *[IFRS 9.B3.2.14]*.

Sometimes a transfer of financial assets (the 'underlying assets') can involve the transferee issuing to the transferor a non-derivative financial instrument, such as subordinated debt, the effect of which is that substantially all the risks and rewards of the assets are not transferred and therefore, the transferor does not derecognise the underlying assets. This is particularly common when the transferee is a securitisation vehicle. The subordinated debt could be issued as part of the consideration for the transferred assets, alongside the cash consideration. Alternatively, part of the cash consideration received in exchange for the underlying assets could be reinvested in the subordinated debt.

How we see it

In the circumstances described above, we would normally expect the transferor to apply by analogy the guidance for derivatives outlined above in IFRS 9 B3.2.14. As a result, the transferor would not recognise the non-derivative financial instrument as a separate asset. Instead, the transferor would recognise a financial liability equal to the net cash received. This will prevent the transferor from recognising as a financial asset the subordinated debt, while also still recognising the underlying asset that failed derecognition.

However, IFRS 9 is less clear about the transferee's position and an entity will need to determine whether it should recognise the subordinated loan as a separate financial liability, or to regard the subsequent cash flows on this loan as part of the cash flows arising on the receivable. The guidance in Chapter 42 at section 2.2 addresses whether two financial instruments should be accounted for as one (which in those cases would lead to the recognition of a derivative), and these principles can help the transferee determine whether it recognises both a financial liability and a receivable, or a derivative. However, this can be very judgemental, and we see a degree of diversity in the way securitisation vehicles account for these arrangements.

2.1.7 Collateral

The implementation guidance accompanying IFRS 9 addresses the recognition of cash collateral. When an entity receives cash collateral that is not legally segregated (e.g., not treated as 'client money'), it must recognise the cash, and a related payable to the entity providing such collateral. The reason for this is that the ultimate realisation of a financial asset is its conversion into cash, and hence, no further transformation is required before the economic benefits of the cash received can be realised. *[IFRS 9.IG D.1.1]*.

On the other hand, the entity providing the cash collateral derecognises the cash and recognises a receivable from the receiving entity. *[IFRS 9.IG D.1.1]*.

The accounting treatment of 'client money' is discussed in detail in Chapter 48 at section 8. The requirements related to non-cash collateral are addressed in Chapter 48 at section 5.5.2.

2.1.8 Principal versus agent

When an entity acts as an intermediary in transactions involving financial instruments, the question of whether it is acting as an agent, or a principal may arise. This is a particularly relevant matter for brokers and similar institutions. Diversity in practice in this regard had been observed, so the question was put to the IFRS IC in June 2017 about how brokers should account for back-to-back derivatives with their client and the central clearing counterparty.

Frequently asked questions

Question 2-1: In relation to clearing brokers and similar institutions, when dealing with centrally cleared client derivatives, is the clearing broker acting as an agent or a principal?

In June 2017, the IFRS IC concluded that the clearing broker first applies the requirements for financial instruments, and observed that:

- If the transaction(s) results in contracts that are within the scope of IFRS 9, then the clearing member applies to those contracts the recognition requirements of IFRS 9. In the statement of financial position, the clearing member presents the assets and liabilities arising from its contracts with the clearing house separately from those arising from its contracts with its clients, unless net presentation is required pursuant to the offsetting requirements in IAS 32. This implies that the clearing member is considered to act as principal in both the derivative contracts with the clearing house, and its clients.
- If the transaction is not within the scope of IFRS 9, and another standard does not specifically apply, only then would the clearing member apply the hierarchy in paragraphs 10-12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to determine an appropriate accounting policy for the transaction(s) (see Chapter 3 at section 4.3), e.g., using the principal versus agent guidance in IFRS 15 (see Chapter 28 at section 4.4).[1]

2.2 'Regular way' transactions

2.2.1 Financial assets: general requirements

As discussed in section 2.1 above, the general requirement under IFRS 9 is to recognise a financial asset or a financial liability in the statement of financial position when, and only when, an entity becomes a party to the contractual provisions of the instrument (i.e., the trade date). *[IFRS 9.3.1.1]*. However, the application of this general requirement to certain transactions, known as 'regular way' purchases and sales, presents some challenges. Below, we discuss those challenges and the accounting policy choice that IFRS 9 has provided as a solution.

A regular way purchase or sale is defined as: *[IFRS 9 Appendix A]*

1 *IFRIC Update*, June 2017, available on the IFRS Foundation's website.

Extract from IFRS 9

Appendix A
Defined terms

regular way purchase or sale	A purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

A contract that does not require delivery of the asset, and can be net settled (i.e., payment or receipt of cash or other financial assets equivalent to the change in value of the contract) is not a regular way transaction. Rather, it is accounted for between the trade date and settlement date as a derivative, in accordance with the requirements of IFRS 9 (see Chapter 46 at section 2.4). *[IFRS 9.B3.1.4]*.

Many financial markets provide a mechanism whereby all transactions in certain financial instruments (particularly quoted equities and bonds) entered into on a particular date are settled by delivery within a fixed number of days after that date. The date on which the entity commits itself to purchase or sell an asset is called the 'trade date', and the date on which it is settled by delivery of the assets that are the subject of the agreement, is called the 'settlement date'. *[IFRS 9.B3.1.5, IFRS 9.B3.1.6]*.

In practice, because entitlement to interest often accrues from the due settlement date, the settlement date is often determined with reference to the date that delivery is actually due. Consequently, if settlement is temporarily delayed, an entity using settlement date accounting will account for the purchase or sale of the security on the settlement due date, and recognise a payable or receivable until settlement actually occurs. This results in a disconnect between what occurs in practice, and the stated requirements of IFRS 9 whereby settlement date is the date on which settlement occurs.

Another practical implication of settlement date accounting is that, while legal title to the assets that are the subject of the transaction passes only on or after settlement date, the buyer is effectively exposed to the risks and rewards of ownership of the assets from the trade date.

Absent of any special provisions, the accounting treatment for regular way transactions under IFRS 9 would be that, between trade date and settlement date, an entity has a forward contract to purchase an asset (see section 2.1.3 above). Consequently, as for all derivatives, this forward contract would be recorded at fair value, with all changes in fair value recognised in profit or loss (see Chapter 46 at section 2.4), unless the special rules for hedge accounting apply (see Chapter 49). This would not only be somewhat onerous, but would also have the effect that changes in a financial asset's fair value between trade date and settlement date would be recognised in profit or loss, even though the asset itself may not be measured at fair value through profit or loss after initial recognition.

To avoid this, IFRS 9 permits assets subject to regular way transactions to be recognised, or derecognised, either as at the trade date ('trade date accounting') or as at the settlement date ('settlement date accounting'). *[IFRS 9.3.1.2, IFRS 9.B3.1.3]*. This accounting policy choice can be made separately for each of the main classification categories of financial assets identified by IFRS 9, i.e., debt instruments measured at amortised cost, debt instruments at fair value through other comprehensive income (FVOCI), financial assets mandatorily measured at fair value through profit or loss, debt instruments designated as measured at fair value through profit or loss and equity investments designated as measured at FVOCI (see Chapter 44 for further discussion on the classification of financial assets). Once chosen, the accounting policy needs to be applied consistently and symmetrically (i.e., to acquisitions and disposals) to each category. *[IFRS 9.B3.1.3]*.

Discussed below is additional guidance for determining whether a transaction meets the definition of 'regular way', as well as requirements relating to trade date and settlement date accounting.

2.2.1.A No established market

The definition of 'regular way' transactions refers to terms that require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned. Marketplace in this context is not limited to a formal stock exchange or organised over-the-counter market. Rather, it means the environment in which the financial asset is customarily exchanged. For example, a market for private issue financial instruments can be a marketplace. An acceptable time frame would be the period reasonably and customarily required for the parties to complete the transaction and prepare and execute closing documents. *[IFRS 9.IG B.28]*.

2.2.1.B Contracts not settled according to marketplace convention: derivatives

The contract must be accounted for as a derivative when it is not settled in the way established by regulation or convention in the marketplace concerned.

Illustration 2-1: Regular way transactions - forward contract

Entity A enters into a forward contract to purchase 1 million of B's ordinary shares in two months for CU10 per share. The contract requires A to take physical delivery of the shares and pay the counterparty CU10 million in cash. B's shares trade in an active public market at an average of 100,000 shares a day. Regular way delivery is three days.

As the transaction is not settled in the way established by regulation or convention in the marketplace concerned, it cannot be regarded as a regular way contract. Therefore, the transaction must be accounted for as a derivative. *[IFRS 9.IG B.29]*.

2.2.1.C Multiple active markets: settlement provisions

If an entity's financial instruments trade in more than one active market, and the settlement provisions differ in the various active markets, the provisions that apply are those in the market in which the purchase actually takes place.

For instance, an entity purchasing shares of a public company listed on a US stock exchange through a broker, where the settlement date of the contract is six business days later, could not apply the regular way trade exemption since trades for equity shares on US exchanges customarily settle in three business days. However, if the entity did the same transaction on an exchange outside the US that has a customary settlement period of six business days, the contract would meet the exemption for a regular way trade. *[IFRS 9.IG B.30]*.

2.2.1.D Exercise of an option

An option is typically accounted for as a derivative. However, following its exercise, the settlement of the option by delivery may be governed by regulation or convention in the options market, and could therefore, represent a regular way transaction. This is illustrated as outlined below.

Illustration 2-2: Regular way transactions - share purchase by call option

Entity A purchases a call option in a public market permitting it to purchase 100 shares of Entity X at any time over the next three months at a price of CU100 per share. If Entity A exercises its option, it has 14 days to settle the transaction according to regulation or convention in the options market. X shares are traded in an active public market that requires three-day settlement.

In this case, while the option will be accounted for as a derivative prior to being exercised, the purchase of shares by exercising the option is a regular way purchase of shares because settlement by delivery of the shares within 14 days is a regular way transaction. *[IFRS 9.IG B.31]*. This is the case even though if the shares had been acquired directly in the market, the market convention for settlement would have been three days.

2.2.2 Financial liabilities

The requirements above relating to regular way transactions apply only to transactions in financial assets. IFRS 9 does not contain any specific requirements about trade date and settlement date accounting for transactions in financial liabilities. Therefore, the general recognition and derecognition requirements for financial liabilities in IFRS 9 apply (see above in section 2.1). *[IFRS 9.IG B.32]*. Consequently, financial liabilities are recognised on the date the entity becomes a party to the contractual provisions of the instrument (see section 2.1 above). Such contracts are not recognised unless one of the parties has performed, or the contract is a derivative contract not exempted from the scope of IFRS 9 (see Chapter 41 at section 3.3). However, in practice the IFRS requirements relating to trade date and settlement date accounting (covered in section 2.2.1 above) have been applied as outlined below.

Frequently asked questions

Question 2-2: How are short sales of securities accounted for when the transaction terms require delivery of the securities within the time frame established generally by regulation or convention in the marketplace?

In January 2007, the IFRS IC addressed the accounting for short sales of securities, when the transaction terms require delivery of the securities within the time frame established generally by regulation or convention in the marketplace concerned. Constituents explained that in practice, many entities apply trade date accounting to such transactions. Specifically, industry practice recognised the short sales as financial liabilities at fair value with changes in fair value recognised in profit or loss. Profit or loss would be the same as if the short sales were accounted for as derivatives, but the securities would be presented differently in the statement of financial position.

The IFRS IC acknowledged that requiring entities to account for short positions as derivatives may create considerable practical problems for their accounting systems and controls with little, if any, improvement to the quality of financial information presented. For these reasons, and because there was little diversity in practice, the IFRS IC decided not to take the issue onto its agenda and thus this industry practice remains prevalent.[2]

2.2.3 Trade date accounting

As noted above, the trade date is the date on which an entity commits itself to purchase or sell an asset. Trade date accounting requires: *[IFRS 9.B3.1.5]*

(a) In respect of an asset to be bought: recognition on the trade date of the asset, and the liability to pay for it. This means that during the period between trade date and settlement date, the entity accounts for the asset as if it already owned it.

(b) In respect of an asset to be sold: derecognition on the trade date of the asset, together with recognition of any gain or loss on disposal, and the recognition of a receivable from the buyer for payment.

IFRS 9 notes that, generally, interest does not start to accrue on the asset and corresponding liability until the settlement date when title passes (see section 2.2.1 above where the difference between the date the asset is delivered, and the date it is due to be delivered, is discussed). *[IFRS 9.B3.1.5]*.

2.2.4 Settlement date accounting

As noted in section 2.2.1 above, IFRS 9 defines the settlement date as the date when an asset is delivered to or by an entity. Settlement date accounting requires *[IFRS 9.B3.1.6]*:

(a) In respect of an asset to be bought: Recognition of the asset on the settlement date (i.e., the date it is received by the entity). Any change in the fair value of the asset to be received during the period between the trade date and the settlement date is accounted for in the same way as the acquired asset. In other words:

- For assets carried at amortised cost, the change in fair value is not recognised (other than impairment losses which are considered from the trade date). This means that such financial assets are not measured at their fair value on the date of initial recognition (i.e., settlement date), but at the amount that represented the asset's fair value on the trade date. This is illustrated in Illustration 2-3A at section 2.2.5 below.
- For assets classified as financial assets at fair value through profit or loss, the change in fair value is recognised in profit or loss.

  And
- For financial assets measured at FVOCI, the change in fair value is recognised in other comprehensive income.

  Where such changes in fair value are recognised, the entity also recognises a corresponding receivable or payable. At settlement date, this receivable or payable is eliminated by adjusting the amount initially recognised for the financial asset. This results in the asset being recognised at its fair value at the settlement date (see Illustration 2-3 B and Illustration 2-3 C below for an example of the journal entries that would occur). *[IFRS 9.5.7.4]*.

2 *IFRIC Update*, January 2007, available on the IFRS Foundation's website. Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9 as the related requirements were brought into IFRS 9 unchanged.

(b) In respect of an asset to be sold: On the settlement date (i.e., the date the asset is delivered by the entity) the asset is derecognised, and any gain or loss on disposal is recognised along with a receivable, or cash from the buyer. *[IFRS 9.B3.1.6]*. Any change in the fair value of the asset between trade date and settlement date is not recorded in the financial statements of the seller, even though the asset continues to be held by seller (see Illustration 2-4 below for an example of the journal entries that would occur). This is because the seller's right to the changes in the fair value ceases on the trade date. *[IFRS 9.IG D.2.2]*.

The subsequent measurement of assets accounted for as regular way transactions is addressed in Chapter 46 at section 2.9.2.

2.2.5 Illustrative examples

Illustration 2-3 and Illustration 2-4 below (which are based on those examples in the implementation guidance appended to IFRS 9) illustrate the application of trade date and settlement date accounting to the various categories of financial asset identified by IFRS 9. *[IFRS 9.IG D.2.1, IFRS 9.IG D.2.2]*. For simplicity, these Illustrations do not address the accounting entries related to impairment charges.

Illustration 2-3: Trade date and settlement date accounting - regular way purchase

On 29 December 20X1 (trade date), an entity commits itself to purchase a financial asset for CU1,000, which is its fair value on trade date. On 31 December 20X1 (financial year-end) and on 4 January 20X2 (settlement date) the fair value of the asset is CU1,002 and CU1,003, respectively. The accounting entries to be recorded for the transaction will depend on how it is classified and whether trade date or settlement date accounting is used, as shown in the tables below:

A Financial asset accounted for at amortised cost

Trade date accounting				Settlement date accounting			
		CU	CU			CU	CU
29 December 20X1							
Dr	Financial asset	1,000			*No accounting entries*		
Cr	Liability to counterparty		1,000				
	To record purchase of asset and liability thereof						
31 December 20X1							
	No accounting entries				*No accounting entries*		
4 January 20X2							
Dr	Liability to counterparty	1,000		Dr	Financial asset	1,000	
Cr	Cash		1,000	Cr	Cash		1,000
	To record settlement of liability				*To record purchase of asset*		

B Financial asset accounted for at fair value through profit or loss

Trade date accounting				Settlement date accounting			
		CU	CU			CU	CU
29 December 20X1							
Dr	Financial asset	1,000			*No accounting entries*		
Cr	Liability to counterparty		1,000				
	To record purchase of asset and liability thereof						
31 December 20X1							
Dr	Financial Asset	2		Dr	Receivable	2	
Cr	Profit or loss		2	Cr	Profit or loss		2
	To record change in fair value of asset				*To record change in fair value of contract*		

4 January 20X2

Dr	Liability to counterparty	1,000		Dr	Financial asset	1,003	
Cr	Cash		1,000	Cr	Cash		1,000
Dr	Financial asset	1		Cr	Receivable		2
Cr	Profit or loss		1	Cr	Profit or loss		1
	To record settlement of liability and change in fair value of asset				*To record purchase of asset, change in fair value and settlement of contract*		

C Financial asset measured at FVOCI*

Trade date accounting				Settlement date accounting			
		CU	CU			CU	CU
29 December 20X1							
Dr	Financial asset	1,000			*No accounting entries*		
Cr	Liability to counterparty		1,000				
	To record purchase of asset and liability thereof						
31 December 20X1							
Dr	Financial Asset	2		Dr	Receivable	2	
Cr	OCI		2	Cr	OCI		2
	To record change in fair value of asset				*To record change in fair value of contract*		
4 January 20X2							
Dr	Liability to counterparty	1,000		Dr	Financial asset	1,003	
Cr	Cash		1,000	Cr	Cash		1,000
Dr	Financial asset	1		Cr	Receivable		2
Cr	OCI		1	Cr	OCI		1
	To record settlement of liability and change in fair value of asset				*To record purchase of asset, change in fair value and settlement of contract*		

* The same analysis applies whether the financial assets measured at FVOCI are debt instruments or equity instruments.

As illustrated above, for a regular way purchase, the key difference between trade date and settlement date accounting is the timing of recognition of a financial asset. Regardless of the method used, the net impact on profit or loss, OCI and net assets is the same.

Illustration 2-4: Trade date and settlement date accounting - regular way sale

On 29 December 20X1 (trade date) an entity enters into a contract to sell a financial asset for its then current fair value of CU1,010. The asset was acquired one year earlier for CU1,000 and its amortised cost is CU1,000. On 31 December 20X1 (financial year-end), the fair value of the asset is CU1,012. On 4 January 20X2 (settlement date), the fair value is CU1,013. The accounting entries to be recorded for this transaction will depend on how the asset is classified and whether trade date or settlement date accounting is used as shown in the tables below (any interest that might have accrued on the asset is disregarded).

A change in the fair value of a financial asset that is sold on a regular way basis is not recorded in the financial statements between trade date and settlement date, even if the entity applies settlement date accounting, because the seller's right to changes in the fair value ceases on the trade date.

A Financial asset accounted for at amortised cost

Trade date accounting				Settlement date accounting			
		CU	CU			CU	CU
Before 29 December 20X1 (cumulative net entries)							
Dr	Financial asset	1,000		Dr	Financial asset	1,000	
Cr	Cash		1,000	Cr	Cash		1,000
	To record acquisition of the asset a year earlier				*To record acquisition of the asset a year earlier*		
29 December 20X1							
Dr	Receivable from counterparty	1,010			*No accounting entries*		
Cr	Financial asset		1,000				
Cr	Gain on disposal (profit or loss)		10				
	To record disposal of asset						
4 January 20X2							
Dr	Cash	1,010		Dr	Cash	1,010	
Cr	Receivable from counterparty		1,010	Cr	Financial asset		1,000
				Cr	Gain on disposal (profit or loss)		10
	To record settlement of sale contract				*To record disposal of asset*		

B Financial asset accounted for at fair value through profit or loss

Trade date accounting				Settlement date accounting			
		CU	CU			CU	CU
Before 29 December 20X1 (cumulative net entries)							
Dr	Financial asset	1,010		Dr	Financial asset	1,010	
Cr	Cash		1,000	Cr	Cash		1,000
Cr	Profit or loss		10	Cr	Profit or loss		10
	To record acquisition and net change in fair value up to date				*To record acquisition and net change in fair value up to date*		
29 December 20X1							
Dr	Receivable from counterparty	1,010			*No accounting entries*		
Cr	Financial asset		1,010				
	To record disposal of asset						
4 January 20X2							
Dr	Cash	1,010		Dr	Cash	1,010	
Cr	Receivable from counterparty		1,010	Cr	Financial asset		1,010
	To record settlement of sale contract				*To record disposal of asset*		

C Debt instrument measured at FVOCI*

Trade date accounting					Settlement date accounting			
		CU	CU			CU	CU
Before 29 December 20X1 (cumulative net entries)							
Dr	Financial asset	1,010		Dr	Financial asset	1,010	
Cr	Cash		1,000	Cr	Cash		1,000
Cr	OCI		10	Cr	OCI		10
29 December 20X1							
Dr	Receivable from counterparty	1,010			*No accounting entries*		
Cr	Financial asset		1,010				
Dr	OCI**	10					
Cr	Gain on sale (profit or loss)		10				
	To record disposal of asset						
4 January 20X2							
Dr	Cash	1,010		Dr	Cash	1,010	
Cr	Receivable from counterparty		1,010	Cr	Financial asset		1,010
				Dr	OCI**	10	
				Cr	Gain on sale (profit or loss)		10
	To record settlement of sale contract				*To record disposal of asset*		

* The same analysis will apply to equity investments measured at FVOCI, except that IFRS 9 does not permit 'recycling' (i.e., transfers) of cumulative gains and losses from OCI to profit or loss. However, an entity may transfer the cumulative gains and losses within equity (e.g., from accumulated OCI to retained earnings).

** The transfers from OCI to profit or loss represent the 'recycling' of cumulative gains and losses required by IFRS 9 on disposal of a debt instrument accounted for at FVOCI (see Chapter 46 at section 2.3). Disposal is regarded as occurring on trade date when trade date accounting applies and on settlement date when settlement date accounting applies.

As illustrated above, for a regular way sale the key difference between trade date and settlement date accounting is the timing of the derecognition of a financial asset. There is also a consequential difference in the timing of the recognition of any gain or loss in profit and loss arising from the disposal of financial assets measured at amortised cost or FVOCI. For financial assets measured at fair value through profit and loss, there is no timing difference.

2.2.5.A Exchanges of non-cash financial assets

The implementation guidance to IFRS 9 addresses the situation in which an entity enters into a regular way transaction whereby it commits to sell a non-cash financial asset in exchange for another non-cash financial asset. In essence, the buying and selling legs of the exchange transaction are accounted for independently, reflecting the settlement date or trade date accounting policy selection for the relevant classification of asset, as illustrated below. *[IFRS 9.IG D.2.3]*.

Illustration 2-5: Trade date and settlement date accounting - exchange of non-cash financial assets

On 29 December 20X1 (trade date), an entity enters into a contract to sell Note Receivable A, which is carried at amortised cost, in exchange for Bond B, which will be classified as held for trading and measured at fair value. Both assets have a fair value of CU1,010 on 29 December 20X1, while the amortised cost of Note Receivable A is CU1,000. The entity uses settlement date accounting for financial assets at amortised cost and trade date accounting for assets held for trading.

On 31 December 20X1 (financial year-end), the fair value of Note Receivable A is CU1,012 and the fair value of Bond B is CU1,009.

On 4 January 20X2 (settlement date), the fair value of Note Receivable A is CU1,013 and the fair value of Bond B is CU1,007.

The following entries are made:

29 December 20X1

Dr	Bond B		CU1,010	
	Cr	Liability to counterparty		CU1,010

To record purchase of Bond B (trade date accounting)

31 December 20X1

Dr	Loss on Bond B (profit or loss)		CU1	
	Cr	Bond B		CU1

To record change in fair value of Bond B

4 January 20X2

Dr	Liability to counterparty		CU1,010	
	Cr	Note Receivable A		CU1,000
	Cr	Gain on disposal (profit or loss)		CU10

To record disposal of receivable A (settlement date accounting)

Dr	Loss on Bond B (profit or loss)		CU2	
	Cr	Bond B		CU2

To record change in fair value of Bond B

The simultaneous recognition, between 29 December and 4 January, of both the asset being bought, and the asset being given in consideration, may seem counter-intuitive. However, it is no different from the accounting treatment of any purchase of goods for credit which results in the period between delivery of, and payment for the goods, in the simultaneous recognition of the goods, the liability to pay the supplier, and the cash that will be used to settle the liability.

3 Initial measurement

3.1 General requirements

On initial recognition, financial assets and financial liabilities at fair value through profit or loss are normally measured at their fair value on the date they are initially recognised. The initial measurement of other financial instruments is based on their fair value, but adjusted in respect of any transaction costs that are incremental and directly attributable to the acquisition or issue of the financial instrument. *[IFRS 9.5.1.1]*. Furthermore, as outlined in Chapter 46 at section 3.1, there is also an adjustment to the fair value at initial recognition for fees received as these are included in the calculation of the effective interest rate. *[IFRS 9 Appendix A]*.

There are also certain exceptions and additional considerations to these general requirements that are addressed in the sections 3.2 to 3.7 below.

If at initial recognition, there is uncertainty about the collection of future cash flows relating to financial assets, this uncertainty is reflected in the fair value measurement at initial recognition. As a result, a separate allowance for expected credit losses relating to uncertain future cash flows is not recognised at initial recognition. However, at the first reporting date after initial recognition, for a financial asset subject to the impairment requirements of IFRS 9, an impairment assessment will be required. *[IFRS 9.5.5.3]*.

3.2 Short-term receivables and payables and trade receivables

With the exception of trade receivables arising from transactions within the scope of IFRS 15 dealt with below, short-term receivables and payables with no stated interest rate could be measured at invoice amounts, without discounting, when the effect of not discounting is immaterial. This approach is permitted because IAS 8 allows the application of accounting policies that are not in accordance with IFRS when the effect is immaterial. *[IFRS 13.BC138A, IAS 8.8]*.

In relation to trade receivables arising from transactions within the scope of IFRS 15, IFRS 9.5.1.3 indicates the following:

Extract from IFRS 9

5.1.3 Despite the requirement in paragraph 5.1.1, at initial recognition, an entity shall measure trade receivables at their transaction price (as defined in IFRS 15) if the trade receivables do not contain a significant financing component in accordance with IFRS 15 (or when the entity applies the practical expedient in accordance with paragraph 63 of IFRS 15).

Trade receivables within the scope of IFRS 15 are not always measured at fair value on initial recognition (see Chapter 28 at section 10.1.5). Trade receivables that do not have a significant financing component are required to be measured at initial recognition based on their transaction price as defined by IFRS 15.

Entities may also apply the practical expedient (i.e., for trade receivables with a significant financing component when at contract inception the entity expects that the period between the entity transferring a promised good or service to the customer, and the customer settling that trade receivable, is one year or less), in which case the trade receivables are also initially measured at their transaction price as defined by IFRS 15. *[IFRS 9.5.1.1, IFRS 9.5.1.3]*.

Other trade receivables (for example, those arising from an arrangement with a significant financing component where the practical expedient is not applied) must be recognised at their fair value in accordance with the general requirements in section 3.1 above.

In summary:

- If there is no significant financing component, or if the entity has applied the practical expedient in IFRS 15, the receivable is initially recognised at the transaction price, measured in accordance with IFRS 15.
- If there is a significant financing component, and the practical expedient has not been applied, the receivable is initially measured at fair value.

If as outlined above, upon initial measurement there is a difference between the measurement of the receivable under IFRS 9, and the corresponding amount of revenue, in most cases the difference is presented immediately in profit or loss (e.g., as an impairment loss). *[IFRS 15.108]*. However, in certain circumstances, further analysis of the reason for such a difference might be needed and that may lead to a different accounting treatment. For example, an entity may have an unconditional right to payment for the

full invoiced amount (i.e., a receivable), but the amount ultimately received could potentially be subject to a refund in the future. This could occur for example, where a customer is entitled to a retrospective volume rebate if the customer subsequently meets the agreed conditions. In such a case, the entity would recognise the difference between the revenue recognised and the receivable as a rebate liability, rather than in profit or loss (see Chapter 28 at section 10.1.5 for more detail). *[IFRS 15.IE208]*.

IFRS 13 has requirements relating to the fair value measurement of a financial liability with a demand feature (see Chapter 15 at section 10.5). *[IFRS 13.47]*.

3.3 Initial fair value, transaction price and 'day 1' profits

IFRS 9 and IFRS 13 acknowledge that the best evidence of the fair value of a financial instrument on initial recognition is normally the transaction price (i.e., the fair value of the consideration given or received), although this will not necessarily be the case in all circumstances (see Chapter 15 at section 12.1.1). *[IFRS 9.B5.1.1, IFRS 9.B5.1.2A, IFRS 13.58, IFRS 13.B4]*. Although IFRS 13 specifies how to measure fair value, IFRS 9 contains restrictions on recognising differences between the transaction price and the initial fair value as measured under IFRS 13 (referred to here as day 1 profits), which apply in addition to the requirements of IFRS 13 (see Chapter 15 at section 12.2). *[IFRS 9.5.1.1A, IFRS 13.60, IFRS 13.BC138]*.

It may be the case that the transaction price is determined to represent the fair value of a financial instrument at initial recognition, and a valuation technique that uses unobservable inputs will be used to measure the fair value of the item in subsequent periods. In this case, the valuation technique must be calibrated at initial recognition to ensure that the result of the valuation technique equals the transaction price, reflecting current conditions (see Chapter 15 at section 13.1.3.A). *[IFRS 13.64]*.

If an entity determines that the fair value on initial recognition differs from the transaction price, then the facts and circumstances leading to that difference need to be assessed to determine if part of the consideration is for something other than the financial instrument. For example, the difference may qualify for recognition as another type of asset, liability or other transaction such as an equity contribution from an owner (see section 3.3.1 below). *[IFRS 9.B5.1.1]*. Another Illustration is given in Chapter 24 at section 4.5.9 with regards to security deposits received in lease agreements where the deposit earns interest below the market rate.

If it is determined that the difference does not qualify for recognition as another type of asset, liability or as an equity transaction, then the day 1 profit is recognised as a gain or loss on initial recognition only if the fair value is based on a quoted price in an active market for an identical asset or liability (i.e., a Level 1 input), or based on a valuation technique that uses only data from observable markets. Otherwise, the day 1 profit is deferred. *[IFRS 9.B5.1.2A]*.

The deferred profit is recognised as an adjustment to the initial carrying amount of the financial asset or financial liability. This is on the basis that the financial asset or financial liability represents a single unit of account, and IFRS 9 requires that it be initially measured at the fair value, adjusted to defer the difference between the fair value and the transaction price. *[IFRS 9.B5.1.2A(b)]*.

However, there may be practical difficulties in adjusting the carrying amount of the financial instrument directly. For example, a portfolio approach may be used on initial recognition to measure the fair value of a number of financial instruments for which there is a resulting deferred profit, and the entity may have difficulty in allocating the deferred profit to the individual financial instruments. In such cases, the entity performs an analysis based on the facts and circumstances, and the general principles in IFRS accounting standards (including an assessment of materiality), to determine the appropriate treatment. Accordingly, in practice we have observed cases where the deferred profit is recognised separately from the individual financial assets and liabilities.

The deferred day 1 profit is subsequently recognised as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability. *[IFRS 9.B5.1.2A(b)]*.

As a result of the day 1 profit provisions discussed above, entities that trade in financial instruments are prevented from immediately recognising a profit on the initial recognition of many financial instruments that are not quoted in active markets, or whose fair value is not measured based on valuation techniques that use only observable inputs. Consequently, locked-in profits will emerge over the life of the financial instrument, although precisely how they should emerge is not at all clear.

The IASB has previously been asked to clarify whether straight-line amortisation was an appropriate method of recognising the day 1 profits, but it decided not to do so. IFRS 9 does not discuss this, although IAS 39 *Financial Instruments: Recognition and Measurement* used to state (without further explanation) that straight-line amortisation may be an appropriate method in some cases, but will not be appropriate in others. *[IAS 39(2017).BC222(v)(ii)]*.

As a result, one interpretation is that the deferred day 1 profit is recognised on a systematic basis over time (for example using straight line amortisation). However, if the underlying instrument has non-linear features (such as option based contracts), then non-linear amortisation may be more appropriate than straight-line amortisation. An alternative interpretation is that the deferred day 1 profit should remain unrecognised until all market inputs have become observable. The appropriate approach for the recognition of the deferred day 1 profit will depend on the particular facts and circumstances, and must be applied consistently to underlying financial instruments of a similar nature and type.

3.3.1 Interest-free and low-interest long-term loans

As noted in section 3.3 above, the fair value of a financial instrument on initial recognition is normally the transaction price. IFRS 9 further explains that if part of the consideration given or received was for something other than the financial instrument, the entity must measure the fair value of the financial instrument in accordance with IFRS 13. For example, the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts, discounted using the prevailing market rate(s) of interest for instruments that are similar as to currency, term, type of interest rate, credit risk and other factors. Any additional amount advanced is an expense or a reduction of income unless it qualifies for recognition as some other type of asset. *[IFRS 9.B5.1.1]*. IFRS 13 requires the application of a similar approach in such circumstances. *[IFRS 13.60]*. For example, an entity may provide an interest free loan to a supplier in order to receive a discount on goods or services purchased in the future, and the difference between the fair value and the amount advanced might well be recognised as an asset, for example under IAS 38 *Intangible Assets,* if the entity obtains a contractual right to the discounted supplies.

Similar issues often arise from transactions between entities under common control. In fact, IFRS 13 suggests a related party transaction might indicate that the transaction price is not the same as the fair value of an asset or liability *[IFRS 13.B4(a)]* (see Chapter 15 at section 12.1.1).

How we see it

Parent entities may lend money to subsidiaries on an interest-free or low-interest basis, where the loan is not repayable on demand. Where, in its separate financial statements, the parent (or subsidiary) is required to record a receivable (or payable) on initial recognition at a fair value that is lower than cost, the additional consideration will normally represent an additional investment in the subsidiary (or equity contribution from the parent). This is covered further in Chapter 9 at section 4.4.5.A.

Another example is a loan received from a government at a rate that appears to be below-market. If there is a benefit of a below-market rate loan (i.e., the excess of the consideration received over the initial carrying amount of the loan), then this may have to be accounted for as a government grant. *[IAS 20.10A]*. The treatment of government grants is discussed further in Chapter 25.

If a financial instrument is recognised where the terms are 'off-market' (e.g., the stated interest rate is lower than the market rate for similar loans), but instead a fee is paid or received in compensation, the instrument is recognised at its fair value i.e., net of the fee that is paid or received. *[IFRS 9.B5.1.2]*. This is outlined in the Illustration below.

Illustration 3-1: Off-market loan with origination fee

Bank J lends CU1,000 to Company K. The loan carries interest at 5% and is repayable in full in five years' time, even though the market rate for similar loans is 8%. To compensate J for the below market rate of interest, K pays J an origination fee of CU120. There are no other directly related payments by either party.

The loan is recorded at its fair value of CU880 (in this Illustration, assumed to be the net present value of CU50 interest payable annually for five years and CU1,000 principal repaid after five years, all discounted at 8%). This equals the net amount of cash exchanged (CU1,000 loan less CU120 origination fee), and hence no gain or loss is recognised on initial recognition of the loan. The upfront fee received of CU120 compensates Bank J for the interest shortfall of CU30 for each of the next five years, discounted at the market rate of 8%.

Applying the requirements of IFRS 9 to the simple fact pattern provided by the IASB is a relatively straightforward exercise. In practice, however, it may be more difficult to identify those fees that are required by IFRS 9 to be treated as part of the financial instrument, and those that are to be dealt with in another way, for example under IFRS 15. In particular, it may be difficult to determine the extent to which fees associated with a financial instrument that is not quoted in an active market represent compensation for off-market terms, or for the genuine provision of services.

3.3.2 Measurement of financial instruments following modification of contractual terms that leads to initial recognition of a new instrument

An entity may agree (with the holder or the issuer) to modify the terms of an instrument that it already recognises in its financial statements as a financial asset, a financial liability, or an equity instrument.

For modifications of financial assets and financial liabilities, an entity needs to consider whether the modification of the terms triggers derecognition of the existing instrument and recognition of a new instrument (see Chapter 48 at section 3.5.1 for assets and section 6.2 for liabilities). If derecognition is triggered, then on the derecognition of the financial asset (or financial liability), the difference between:

- The carrying amount as at the derecognition date,

  And

- The consideration received (or paid), including the value of the new instrument obtained, less any new liability assumed,

  Is recognised in profit or loss (see Chapter 48 at sections 5.1 and 6.3). *[IFRS 9.3.2.12]*.

The new instrument would initially be measured at fair value in accordance with the general requirements discussed in section 3.1 above. Any costs or fees incurred would usually be recognised as part of the gain or loss on derecognition, rather than as an adjustment to the carrying amount of the new debt. However, there may be very limited circumstances when fees or costs associated with the issue of new debt are not included in the gain or loss on derecognition. Where it is obvious that the fees have not been incurred as part of the modification or exchange, and instead are third party costs which are clearly incremental to the issue of new debt, for example payments of taxes or listing fees on the issue of new debt, then an entity may choose to adopt a policy whereby such costs are deducted from the carrying value of the new debt and amortised over its term, as long as the new debt is not classified as held at fair value through profit or loss (see Chapter 48 at section 6.2.5).

The accounting for a modification of a financial asset (or financial liability) that results in the recognition of a new financial asset (or financial liability) is dealt with in more detail in Chapter 48 at section 3.5.1 and section 6.2.

If the contractual terms of an issued equity instrument are modified, resulting in a conversion to a financial liability, the resulting treatment will depend on the terms of the modification. This is discussed in more detail below.

Frequently asked questions

Question 3-1: What is the appropriate treatment of an issued equity instrument where the contractual terms are modified such that it is subsequently reclassified as a financial liability?

This matter was previously discussed by the IFRS IC. When the contractual terms of an issued equity instrument are modified in such a manner that it is subsequently reclassified as a financial liability, it is measured at its fair value on the date it is initially recognised as a financial liability, with any difference between this amount, and the amount previously recorded in equity, taken to equity.

This is consistent with the requirements of IAS 32, which prohibit the recognition of gains or losses on the purchase, issue, or cancellation of an entity's own equity. *[IAS 32.36, IAS 32.33]*.[3]

3 *IFRIC Update*, November 2006, available on the IFRS Foundation's website. Whilst the IFRS IC discussion was held in the context of IAS 39, the discussion also holds true under IFRS 9 as the related requirements were brought into IFRS 9 unchanged.

Illustration 3-2: Changes in the contractual terms of an existing equity instrument

On 1 January 20X1, Company L issues a fixed rate cumulative perpetual instrument with a face value of CU10 million at par. Dividends on the instrument are cumulative but discretionary, and therefore, it is initially classified as equity. On 1 January 20X2, L adds a new clause to the instrument so that if L is subject to a change of control, L will be required to redeem the instrument at an amount equal to the face value plus any accumulated unpaid dividends. Upon assessment of the facts and circumstances, it is determined that this results in a reclassification of the instrument from equity to liability (see Chapter 43 at section 4.2. and section 4.3 for the considerations in this determination). The fair value of the instrument on 1 January 20X2 is CU12 million.

Upon reclassification, L recognises the financial liability at its then fair value of CU12 million and the difference of CU2 million is recognised in equity (e.g., retained earnings).

3.3.3 Financial guarantee contracts and off-market loan commitments

The requirement to measure financial instruments at fair value on initial recognition also applies to issued financial guarantee contracts that are within the scope of IFRS 9, as well as to commitments to provide a loan at a below-market interest rate (see Chapter 41 at sections 2.4 and 2.5).

When issued to an unrelated party in a stand-alone arm's length transaction, the fair value of a financial guarantee contract at inception is likely to equal the premium received, or receivable, unless there is evidence to the contrary. *[IFRS 9.B2.5(a)]*. There is likely to be such evidence where, say, a parent provided to a bank a financial guarantee in respect of its subsidiary's borrowings and charged no fee.

When an off-market loan is provided to an entity's subsidiary (see section 3.3.1 above), a 'spare debit' arises in the separate financial statements of the parent as a result of the recognition of the loan at fair value. The same situation can arise when a parent provides a subsidiary with an off-market loan commitment. Again, it is normally appropriate to treat this difference as an additional cost of investment in the subsidiary in the separate accounts of the parent (and as an equity contribution from the parent in the accounts of the subsidiary).

3.3.4 Loans and receivables acquired in a business combination

Consistent with IFRS 9 and IFRS 13, IFRS 3 *Business Combinations* requires financial assets acquired in a business combination to be measured by the acquirer on initial recognition at their fair value. *[IFRS 3.18]*.

IFRS 3 contains application guidance explaining that an acquirer does not recognise a separate valuation allowance (e.g., an expected credit loss allowance) in respect of loans and receivables for contractual cash flows that are deemed to be uncollectible at the acquisition date. This is because the effects of uncertainty in relation to the collection of future cash flows are included in the fair value measure at initial recognition (see Chapter 10 at section 5.5.5). *[IFRS 3.27, IFRS 3.B41, IFRS 3.BC252]*.

However, at the end of the first subsequent accounting period, a financial asset subject to the impairment requirements of IFRS 9 will be assessed for impairment. *[IFRS 9.5.5.3]*. This interaction between the initial and subsequent measurement of debt instruments acquired in a business combination, and the impairment model of IFRS 9, is discussed in more detail in Chapter 47 at section 7.4.

3.3.5 Acquisition of a group of assets that does not constitute a business

When acquiring a group of assets, an entity is required to assess whether a business has been acquired (see Chapter 10 at section 3.2). Where the group of assets does not constitute a business, IFRS 3 requires the acquiring entity to:

- Identify and recognise the individual identifiable assets acquired and liabilities assumed

  And
- Allocate the cost of the group to the individual identifiable assets and liabilities based on their relative fair values at the date of the acquisition *[IFRS 3.2(b)]*

Frequently asked questions

Question 3-2: What is the appropriate treatment in a transaction that does not constitute the acquisition of a business, when there are differences noted at initial recognition in the fair value, and measurement bases, of the underlying assets and liabilities acquired?

The IFRS IC considered how to allocate the transaction price to the identifiable assets acquired and liabilities assumed when:

- The sum of the individual fair values of the identifiable assets and liabilities is different from the transaction price

  And

- The group of assets includes identifiable assets and liabilities initially measured both at cost, and at an amount other than cost, e.g., financial instruments which are measured on initial recognition at their fair value

Such a transaction or event does not give rise to goodwill. The IFRS IC observed that if an entity initially considers that there might be a difference between the transaction price for the group, and the sum of the individual fair values of the identifiable assets and liabilities, it first reviews the procedures used to determine those individual fair values to assess whether such a difference truly exists, before allocating the transaction price.

The IFRS IC concluded that a reasonable reading of the requirements of IFRS 3 results in two possible ways of accounting for the acquisition of the group of assets:

(a) Under the first approach, the entity accounts for the acquisition of the group as follows:

- It identifies the individual identifiable assets acquired and liabilities assumed that it recognises at the date of the acquisition.
- It determines the individual transaction price for each identifiable asset and liability by allocating the cost of the group based on the relative fair values of those assets and liabilities at the date of the acquisition.

  And

- It applies the initial measurement requirements in applicable IFRS to each identifiable asset acquired and liability assumed. The entity accounts for any difference between the amount at which the asset or liability is initially measured, and its individual transaction price, by applying the relevant requirements. In the case of any financial instruments within the group, the entity treats the difference between the fair value and allocated transaction price as a day 1 profit, the requirements for which are discussed in section 3.3 above.

(b) Under the second approach:

- Any identifiable asset or liability that is initially measured at an amount other than cost is initially measured at the amount specified in the applicable IFRS, i.e., fair value in the case of a financial instrument.
- The entity deducts from the total transaction price the amounts allocated to the assets and liabilities initially measured at an amount other than cost.

  And

- Using this residual transaction price, the entity then determines the cost of the remaining identifiable assets and liabilities by allocating the residual transaction price, based on their relative fair values at the date of the acquisition.

The IFRS IC observed that an entity must apply one of the above approaches consistently, as an accounting policy choice, to all such acquisitions.[4]

4 *IFRIC Update*, November 2017, available on the IFRS Foundation's website.

3.4 Transaction costs

3.4.1 Accounting treatment

As noted in section 3.1 above, the initial measurement of some financial instruments is based on their fair value, but adjusted in respect of any transaction costs that are incremental and directly attributable to the acquisition or issue of the financial instrument. *[IFRS 9.5.1.1]*. The consequences of this requirement are:

- For financial instruments subsequently measured at amortised cost and, financial assets that are debt instruments subsequently measured at fair value through other comprehensive income, transaction costs are included in the calculation of the amortised cost using the effective interest method, in effect reducing (increasing) the amount of interest income (expense) recognised over the life of the instrument. *[IFRS 9.IG E.1.1]*.
- For financial assets that are equity instruments that are subsequently measured at fair value through other comprehensive income, transaction costs are recognised in other comprehensive income as part of the change in fair value at the next remeasurement and are never reclassified into profit or loss. *[IFRS 9.B5.7.1, IFRS 9.IG E.1.1]*.

  And

- Transaction costs relating to the acquisition or incurrence of financial instruments at fair value through profit or loss are recognised in profit or loss as they are incurred.

Transaction costs that relate to the issue of a compound financial instrument are allocated to the liability and equity components of the instrument in proportion to the allocation of proceeds. *[IAS 32.38]*. The initial recognition of a compound instrument is discussed in more detail in Chapter 43 at section 6.2.

Section 3.5 below addresses the accounting for transaction costs associated with the recognition of a hybrid financial liability where the embedded derivative is separated from the host.

Transaction costs, such as sale or disposal costs, that would be expected to be incurred on transfer or disposal of a financial instrument, are not included in the initial or subsequent measurement of the financial instrument. *[IFRS 9.IG E.1.1]*.

The following Illustration shows the accounting treatment of transaction costs for a financial asset classified as measured at fair value through other comprehensive income.

Illustration 3-3: Transaction costs - initial measurement of the related asset

Company A acquires an equity security that will be classified as measured at fair value through other comprehensive income. The security has a fair value of CU100 and this is the amount A is required to pay. In addition, A also pays a purchase commission of CU2. If the asset was to be sold, a sales commission of CU3 would be payable.

The initial measurement of the asset is CU102, i.e., the sum of its initial fair value and the purchase commission. The commission payable on sale is not considered for this purpose. If A had a reporting date immediately after the purchase of this security, it would measure the security at CU100 and recognise a loss of CU2 in other comprehensive income, which is never reclassified to profit or loss. *[IFRS 9.B5.2.2]*.

In the Illustration above, if the financial asset was a debt instrument measured at fair value through other comprehensive income, on initial recognition the transaction costs of CU2 would be included in the initial measurement, and subsequently amortised to profit or loss using the effective interest method. *[IFRS 9.B5.2.2]*. This is further discussed in Chapter 46 at section 2.3.

3.4.2 Identifying transaction costs

Transaction costs are defined as: *[IFRS 9 Appendix A]*

Extract from IFRS 9

Appendix A
Defined terms

transaction costs	Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see paragraph B5.4.8). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers, and dealers. They also include levies by regulatory agencies and securities exchanges, transfer taxes and duties. *[IFRS 9.B5.4.8]*.

Chapter 46 at section 3.1 addresses whether certain financial services fees should be considered an integral part of the effective interest rate of a financial instrument, which are accounted for similarly to transaction costs, and those that are not.

Debt premiums or discounts, financing costs and allocations of internal administrative or holding costs are not transaction costs. *[IFRS 9.B5.4.8]*.

In certain circumstances, it can be appropriate to regard the premium paid to acquire a financial guarantee contract as a transaction cost of the guaranteed financial asset. This is discussed further in Chapter 47 at section 5.8.1.A. Treating internal costs as transaction costs could open a number of possibilities for abuse by allowing entities to defer expenses inappropriately. Consequently, internal costs are treated as transaction costs only if they are incremental and directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. *[IAS 39(2017).BC222(d)]*.[5] Therefore, it will be rare for internal costs (other than, for instance, commissions paid to sales staff in respect of a product sold that results in the origination or issuance of a financial instrument) to be treated as transaction costs.

The determination of which costs are incremental and directly attributable can be highly judgemental, particularly when costs are incurred in advance of the instrument being recognised. For example, a lender may incur professional fees to value a property that would serve as collateral for a loan in advance of providing a quote to the customer. In this case, it is useful to consider the guidance in IAS 32 which specifies that if an equity transaction is abandoned, then the costs are recognised as an expense (see Chapter 43 at section 8.1). *[IAS 32.37]*. This suggests that the possibility of a transaction ultimately not occurring is not by itself a reason to not consider those costs as transaction costs. Where transaction costs are incurred in advance of the underlying financial instrument, they are normally capitalised as a prepayment.

3.5 Embedded derivatives and financial liability hosts

Under IFRS 9, an embedded derivative is separated from a financial liability host contract when certain conditions are met (see Chapter 42 at section 3). Embedded derivatives are not separated from financial assets within the scope of IFRS 9, and the requirements of IFRS 9 are applied to the hybrid contract as a whole. *[IFRS 9.4.3.2]*.

If there is a difference between the transaction price, and the fair value of the financial instrument as a whole, a day 1 profit will arise. However, this day 1 profit may only be recognised as a gain or loss on initial recognition if the hybrid instrument has a quoted price in an active market for an identical instrument (i.e., a level 1 input), or if it is valued using a valuation technique that uses only data from observable markets (see section 3.3 above). *[IFRS 9.B5.1.2A(a)]*.

In Chapter 42 at section 5, the treatment at initial recognition of an embedded derivative and the financial liability host contact is discussed. It is explained that an embedded non-option derivative is required to have a fair value of zero on initial recognition. By contrast, at initial recognition an embedded option-based derivative would not normally have a fair value of zero. Furthermore, the financial liability host instrument shall initially be measured based on the residual amount, after separating out the embedded derivative. *[IFRS 9.B4.3.3]*.

5 This discussion was included in the Basis for Conclusions to IAS 39. However, it holds true under IFRS 9 as the related requirements were brought into IFRS 9 unchanged.

IFRS 9 does not address how to allocate transaction costs that relate to a hybrid financial liability where an embedded derivative is separated from the financial liability host. Therefore, when allocating transaction costs to a hybrid financial instrument, entities should choose an accounting policy and apply it consistently. The approaches more commonly observed are:

- Approach 1: To allocate the transaction costs exclusively to the non-derivative financial liability host, in which case the transaction costs are included in full in the host liability's initial measurement.
- Approach 2: To allocate the transaction costs to the non-derivative financial liability host and the embedded derivative in proportion to their fair values at initial recognition, i.e., in a similar fashion to compound financial instruments. Under this approach:
  - The proportion attributable to the non-derivative financial liability host will be included in the host liability's initial measurement
  - The proportion attributable to the embedded derivative will be expensed as incurred as the embedded derivative is measured at fair value through profit or loss

If the embedded derivative is required to have an initial fair value of zero, then in essence, under Approach 2, no transaction costs will be allocated to the embedded derivative. Hence the choice of approach will usually only lead to a different outcome on initial recognition when the embedded derivative has a non-zero fair value, for example the embedded derivative has an option feature.

Approach 2 would need to be adapted if the embedded derivative is an asset, for example by allocating the transaction costs in proportion to the absolute fair values of the host and embedded derivative.

Illustration 3-4: Initial recognition of embedded derivatives and financial liability hosts (with transaction costs)

Background Information

- Entity E with a functional currency of euros, issues a zero-coupon bond with a par value of €100, which is determined to be the fair value of the hybrid instrument on that date. The proceeds received were €100.
- The bond has a maturity of 3 years. At that point the counterparty has the option to demand settlement at US$100 or €100.
- Transaction costs of €5 were incurred by Entity E.
- Entity E will account for the bond at amortised cost.
- As the settlement feature at maturity could be in a currency that is different to the nominal value, there is a resulting cross currency option.
- This embedded derivative is not considered to be closely related to the host liability measured at amortised cost, and therefore separation is required (see Chapter 42 section 4.2.1).
- The embedded derivative is assessed to be a liability, with a fair value on initial recognition of €20.

At initial recognition

- €20 is allocated to the derivative liability as the fair value at initial recognition.
- The financial liability host instrument is measured based on the residual amount, after separating out the embedded derivative. Therefore, a value of €80 (€100-€20=€80) is allocated initially to the liability.

Allocation of the transaction costs

- If Approach 1 is followed, the transaction costs are allocated exclusively to the non-derivative financial liability host. Consequently, the full €5 is allocated to the host liability. As the bond is carried at amortised cost, the transaction costs are included in full in the bond's initial measurement. As a result, the bond is initially recognised at €75; and the embedded derivative is initially measured at €20.
- If Approach 2 is followed, the transaction costs are allocated to the non-derivative financial liability host and the embedded derivative in proportion to their fair values. Consequently:
  - Transaction costs of €1 (€5x20/100) are allocated to the derivative. As the derivative is carried at fair value, the transaction costs of €1 are recognised immediately in profit and loss, and the embedded derivative is recognised initially at €20.
  - Transaction costs of €4 (€5x80/100) are allocated to the liability, and deducted from its initial carrying amount. As a result, the bond liability is initially recognised at €76 (€80-€4).

3.6 Regular way transactions

When settlement date accounting is used for 'regular way' transactions (see section 2.2.4 above) and those transactions result in the recognition of assets that are subsequently measured at amortised cost, there is an exception to the general requirement to measure the asset on initial recognition at its fair value (see section 3.1 above). In such circumstances, rather than being initially measured by reference to their fair value on the date they are first recognised, i.e., settlement date, these financial instruments are initially measured by reference to their fair value on the trade date (see Illustration 2-3A at section 2.2.5 above). *[IFRS 9.5.1.2]*.

In practice, the difference will rarely be significant because of the short time scale involved between trade date and settlement date. It is because of this short duration that regular way transactions are not recognised as derivative financial instruments, but accounted for as set out in section 2.2 above. *[IFRS 9.BA.4]*.

3.7 Assets and liabilities arising from loan commitments

Loan commitments are a form of derivative financial instrument, although for pragmatic reasons the IASB decided that certain loan commitments could be excluded from most of the recognition and measurement requirements of IFRS 9 (see Chapter 41 at section 2.5). Nevertheless IFRS 9 does require issuers to apply its impairment rules to such loan commitments (see Chapter 47 at section 11). *[IFRS 9.2.1(g)]*.

This creates a degree of uncertainty over how assets and liabilities arising from such arrangements should be measured on initial recognition, as discussed in the Illustration below.

For simplicity, any other amounts payable by the borrower to the lender (such as commitment and non-utilisation fees), have not been illustrated. The treatment of commitment fees received or paid is addressed in the frequently asked questions within Chapter 46 at section 2.8.

Illustration 3-5: Drawdown under a committed borrowing facility

- Company H obtains from Bank Q a committed facility allowing it to borrow up to CU10,000 at any time over the following five years, provided certain covenants specified in the facility agreement are not breached.
- Interest on any drawdowns is payable at the risk-free rate, plus a fixed margin, representing Q's initial assessment of H's credit risk, resulting in a variable market rate.
- Any such borrowings can be repaid at any time at the option of H, but must be repaid by the end of five years, unless the facility is renegotiated and extended. They also become repayable immediately in the event that H breaches the covenants.
- After one year, no drawdowns have been made and H's credit risk has increased (although it has not breached any of the covenants and there is no expectation of default). As a result of this change in credit risk, the fair value of the facility is CU200 (positive value to H, negative value to Q).
- Shortly afterwards, H draws down the maximum CU10,000 available under the facility.
- Because of the change in credit risk, the loan resulting from the drawdown has a fair value at that date of CU9,800. The CU200 difference between the fair value of CU9,800 of the financial instrument created, and the CU10,000 cash transferred effectively represents the change in fair value of the commitment arising from the change in H's credit risk.

Questions:

- Should Q (H) initially measure the resulting asset (liability) at its CU9,800 fair value or at CU10,000, being the amount of cash actually exchanged?
- If it is recognised at CU9,800, how is the 'spare' CU200 accounted for, and does Q (H) recognise this as a loss (profit)?

In order to be able to answer this question, we need to consider the accounting for the loan commitment up until the date of drawdown and how its carrying amount impacts the initial measurement of the resulting loan.

3.7.1 Loan commitments outside the scope of IFRS 9

In Illustration 3-5 above, the commitment cannot be settled net and it is not at a below-market interest rate. Therefore, unless H or Q designate the loan commitment at fair value through profit or loss, it will be outside the scope of IFRS 9.

The accounting for the loan commitment outside the scope of IFRS 9 would be as follows:

- At the next reporting date after Q and H enter into the loan commitment, Q would assess and record a provision for expected credit losses under the impairment requirements of IFRS 9 (see Chapter 47 at section 11), say CU10. Nothing else is recognised in the accounts of H in respect of the facility because the loan commitment is not recognised.
- When the credit risk increases in the following year, Q assesses and recognises any impact the increase in credit risk may have had on the provision for expected credit loss. Assume the ECL provision at this point has increased from CU10 to CU35.

Therefore, until the time of drawdown, the only accounting entries for Q are in relation to the impairment requirements applicable to loan commitments.

At the time the loan is drawn down, Q classifies the loan within financial assets at amortised cost and H classifies it within financial liabilities at amortised cost. The general requirement under IFRS 9 as noted in section 3.1 above would require the asset (liability) to be initially measured at its fair value, i.e., CU9,800.

This would result in:

- For Q, the recognition of a further loss of CU165 (CU200 - CU35).
- For H, the recognition of a profit of CU200.

This is because the spare CU200 arising as the difference between the fair value (CU9,800) and the amount delivered (CU10,000) does not represent any other asset or liability arising from the transaction.

However, the Basis for Conclusions on IFRS 9 explains that the effect of the loan commitment exception is to achieve consistency with the measurement basis of the resulting loan when the holder exercises its right, i.e., amortised cost. Changes in the fair value of these commitments arising from changes in market interest rates or credit spreads will therefore not be recognised or measured, in the same manner that changes in such rates and spreads would not affect the amortised cost of the financial asset (or financial liability) recognised once the right is exercised. *[IFRS 9.BCZ2.3]*. This is exactly what the 'spare' CU200 represents, so in accordance with the underlying rationale and objective of allowing loan commitments to be excluded from the scope of IFRS 9, it is appropriate to initially measure the asset or liability arising in this case at CU10,000. It is worth mentioning that the expected credit loss provision previously recognised for the loan commitment is incorporated into the allowance for the drawn down loan upon initial recognition, and then subsequently reassessed at each reporting date.

The treatment under the loan commitment exception is consistent with that of similar assets arising from regular way transactions recognised using settlement date accounting (see section 3.6 above). This is relevant because the IASB introduced the loan commitment exception as a result of issues identified by the IAS 39 Implementation Guidance Committee (IGC) and the only solution the IGC could identify at the time involved treating loan commitments as regular way transactions and using settlement date accounting.[6]

6 IAS 39 Implementation Guidance Committee (IGC), Q&A 30-1, July 2002.

The Illustration below is a continuation of Illustration 3-5 above, and demonstrates the accounting by Bank Q for the loan commitment and, subsequently, for the asset that results from the draw down.

Illustration 3-6: Drawdown under a committed borrowing facility - journals when outside the scope of IFRS 9

The journals below illustrate the accounting for a loan commitment that is outside the scope of IFRS 9 in line with the information provided in Illustration 3-5 and section 3.7.1 above.

Bank Q Journals

Financial asset accounted for at amortised cost

At first reporting date

			CU	CU
Dr	Profit or loss		10	
	Cr	ECL on commitment		10

To record a provision for expected credit losses under the impairment requirements of IFRS 9

At second reporting date

			CU	CU
Dr	Profit or loss		25	
	Cr	ECL on commitment		25

To record a provision for expected credit losses under the impairment requirements of IFRS 9

At draw down

			CU	CU
Dr	Loan receivable		10,000	
	Cr	Bank		10,000

To record loan on draw down

Immediately after draw down

			CU	CU
Dr	ECL on commitment		35	
	Cr	ECL on loan receivable		35

ECL previously recognised on loan commitment incorporated into ECL for the loan

The above discussion outlines the treatment for a loan commitment when the resulting asset is classified at amortised cost. The scope exemption for loan commitments does not apply where an entity has a past practice of selling the assets resulting from the loan commitments shortly after origination (see Chapter 41 at section 2.5). *[IFRS 9.2.3(a)]*. Consequently, where the resulting loan is classified as held for trading, the loan commitment would be within the scope of IFRS 9 and would be dealt with as per section 3.7.2 below.

3.7.2 Loan commitments within the scope of IFRS 9

If in the above example, Q accounted for the loan commitment at fair value through profit or loss (in line with IFRS 9.2.3(a), see Chapter 41 section 2.5), the issue of the spare CU200 would not arise. At the time the loan was drawn down, the commitment would have already been recognised as a CU200 liability and an equivalent loss would have been recorded in profit or loss. The loan would then be recognised at its fair value of CU9,800 and the CU200 balance of the cash movement over this amount would be treated as the settlement of the loan commitment liability. Therefore, no further gain or loss would need to be recognised at this point. Once the loan is recognised, it will be accounted for in accordance with IFRS 9 in line with its classification.

Illustration 3-7: Drawdown under a committed borrowing facility - journals when within the scope of IFRS 9

The journals below illustrate the accounting for a loan commitment that is within the scope of IFRS 9 in line with the information provided in Illustration 3-5 and accounted for at fair value through profit or loss as set out above.

Bank Q Journals

After 1 year

			CU	CU
Dr	Profit or loss		200	
	Cr	Loan commitment		200
To recognise the fair value of the loan commitment				

At draw down

			CU	CU
Dr	Loan receivable		9,800	
Dr	Loan commitment		200	
	Cr	Bank		10,000
To record loan on draw down, and settlement of the loan commitment				

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Appendix C - Defined terms

Extract from IFRS accounting standards - Definitions	
amortised cost of a financial asset or financial liability	The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any **loss allowance**. *[IFRS 9 Appendix A]*.
derivative	A financial instrument or other contract within the scope of this Standard with all three of the following characteristics. (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying'). (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. (c) it is settled at a future date. *[IFRS 9 Appendix A]*.
equity instrument	**An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.** *[IAS 32.11]*.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. *[IFRS 13 Appendix A]*.
financial asset	**A *financial asset* is any asset that is:** **(a) cash;** **(b) an equity instrument of another entity;** **(c) a contractual right:** **(i) to receive cash or another financial asset from another entity; or** **(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or** **(d) a contract that will or may be settled in the entity's own equity instruments and is:** **(i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or** **(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.** **For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.** *[IAS 32.11]*.

financial guarantee contract	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. *[IFRS 9 Appendix A]*.
financial instrument	**A *financial instrument* is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.** *[IAS 32.11]*.
financial liability	**A *financial liability* is any liability that is:** **(a) a contractual obligation:** **(i) to deliver cash or another financial asset to another entity; or** **(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or** **(b) a contract that will or may be settled in the entity's own equity instruments and is:** **(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or** **(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.** **As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D.** *[IAS 32.11]*.
financial liability at fair value through profit or loss	A financial liability that meets one of the following conditions: (a) it meets the definition of **held for trading**. (b) upon initial recognition it is designated by the entity as at fair value through profit or loss in accordance with paragraph 4.2.2 or 4.3.5. (c) it is designated either upon initial recognition or subsequently as at fair value through profit or loss in accordance with paragraph 6.7.1. *[IFRS 9 Appendix A]*.

held for trading	A financial asset or financial liability that: (a) is acquired or incurred principally for the purpose of selling or repurchasing it in the near term; (b) on initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or (c) is a **derivative** (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument). *[IFRS 9 Appendix A]*.
regular way purchase or sale	A purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned. *[IFRS 9 Appendix A]*.
transaction costs	Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see paragraph B5.4.8). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument. *[IFRS 9 Appendix A]*.
transaction price (for a contract with a customer)	The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a **customer**, excluding amounts collected on behalf of third parties. *[IFRS 15 Appendix A]*.

Chapter 46 Financial instruments: Subsequent measurement

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Overview

This chapter discusses the subsequent measurement of financial instruments under IFRS 9 *Financial Instruments*, including the requirements relating to amortised cost, the effective interest method, modifications of 'financial assets and liabilities' and 'foreign currency' revaluation. The subsequent measurement of financial assets and liabilities is dependent on their classification, which is covered in Chapter 44.

This chapter also discusses fees that are considered an integral part of the effective interest rate (EIR) and provides examples of how the effective interest method is applied to fixed and floating rate instruments, including those with additional features such as prepayment options or an inflation feature. Guidance is also provided on accounting for modifications of financial assets and liabilities that do not result in derecognition, including the treatment of modification fees.

Subsequent measurement of contingent consideration recognised by an acquirer in a business combination to which IFRS 3 *Business Combinations* applies, that falls within the scope of IFRS 9, is discussed in Chapter 10 at section 7.1.3. The impairment of financial instruments is addressed in Chapter 47.

Most, but not all, of the detailed requirements of IFRS accounting standards governing the measurement of fair values are dealt with in IFRS 13 *Fair Value Measurement*, which is covered in Chapter 15. The measurement of a financial liability with a demand feature is also covered in Chapter 15 at section 10.5. IFRS 9 contains certain requirements addressing fair value measurements of financial instruments and these are covered in sections 2.3 to 2.5 below.

What you need to know

- Subsequent to initial recognition, financial assets and liabilities are accounted for based on their classification at:

  (a) amortised cost,

  (b) fair value through other comprehensive income (FVOCI)

  Or

  (c) fair value through profit or loss (FVTPL).
- Amortised cost is determined using the EIR method. This calculation includes all fees and points that are an integral part of the EIR, as well as transaction costs, and all other premiums and discounts. The EIR method amortises all such fees, points, costs, premiums or discounts over the expected life of the instrument rather than the contractual life.
- For a fixed rate instrument, changes to estimated cash flows that do not result in derecognition of the instrument are accounted for by discounting the revised cash flows using the original EIR and recognising a catch-up adjustment in profit or loss. For a floating rate instrument, such revisions to estimated cashflows are accounted for by discounting the revised cash flows using a revised EIR with respect to floating features (such as the risk-free rate and, or, the credit spread).
- When a financial instrument is modified, and the modification does not result in derecognition, fees incurred or paid in connection with the modification are added to the carrying value of the instrument. IFRS 9 explicitly addresses certain issues, but in other cases judgement needs to be applied to determine the appropriate treatment.
- For FVOCI debt instruments, interest income, foreign exchange gains or losses and impairments (calculated based on the amortised cost of the instrument) are recognised immediately in profit or loss. All other changes in fair value are recognised in other comprehensive income (OCI). Fair value changes that have been recognised in OCI are recycled to profit or loss upon derecognition of the debt instrument.
- Equity instruments are normally measured at FVTPL. However, for equity instruments designated at FVOCI, gains and losses are recognised in OCI, while dividends are recognised in profit or loss, unless the dividend clearly represents a recovery of part of the cost of the investment. Unlike for FVOCI debt instruments, gains or losses recognised in OCI for equity instruments are never reclassified from equity to profit or loss. Consequently, there is no need to review such investments for impairment.
- IAS 21 *The Effects of Changes in Foreign Exchange Rates* applies to foreign currency denominated financial instruments.

1 Introduction

The initial classification of financial assets and liabilities determines their subsequent measurement at either fair value or amortised cost (see Chapter 44 for the requirements relating to classification). Most of the requirements for determining fair value are covered in IFRS 13 (see Chapter 15, although the International Accounting Standards Board (IASB or Board) included guidance in IFRS 9 about how to determine fair values for financial instruments for which no quoted market price is available (see section 2.6 below). Amortised cost and the effective interest method are covered in section 3 below.

2 Subsequent measurement and recognition of gains and losses

As explained in Chapter 44 at sections 1 and 2, financial assets and financial liabilities are classified into one of the following measurement categories: *[IFRS 9.4.1.1, IFRS 9.4.2.1]*

- Debt financial assets at amortised cost
- Debt financial assets at fair value through other comprehensive income (with cumulative gains and losses reclassified to profit or loss upon derecognition)
- Debt financial assets, derivatives and investments in equity instruments at fair value through profit or loss
- Investments in equity instruments designated as measured at fair value through other comprehensive income (with gains and losses remaining in other comprehensive income, without recycling)
- Financial liabilities at amortised cost

  Or
- Financial liabilities at fair value through profit or loss

Following the initial recognition of financial assets and financial liabilities, their subsequent accounting treatment depends principally on the classification of the instrument, although there are a small number of exceptions. These requirements are summarised in Figure 2-1 below and are considered in more detail in the remainder of this section.

Figure 2-1: Classification and subsequent measurement of financial assets and financial liabilities

Classification	Instrument type	Statement of financial position	Fair value gains and losses	Interest or dividends	Impairment	Foreign exchange
Financial assets and liabilities at amortised cost	Debt	Amortised cost	-	Profit or loss: interest calculated using the EIR	Profit or loss (financial assets)	Profit or loss
Debt financial assets at fair value through other comprehensive income	Debt	Fair value	OCI and recycled to profit or loss when derecognised	Profit or loss: interest calculated using the EIR	Profit or loss	Profit or loss (foreign exchange differences on the amortised cost) OCI (other changes)
Fair value through profit or loss (including derivatives not designated in effective hedges)	Debt, equity or derivative	Fair value	Profit or loss (see Chapter 50 at section 7.1.1 on presentation requirements) and OCI for changes in own credit risk for financial liabilities designated at FVTPL	Profit or loss (see Chapter 50 at section 7.1.1 on presentation requirements)	-	Profit or loss
Equity investments at fair value through other comprehensive income	Equity	Fair value	OCI (no recycling to profit or loss when derecognised)	Profit or loss: dividends (unless recovery of part of the cost of investment)	-	OCI (no recycling to profit or loss when derecognised)

In addition, IFRS 9 sets out the accounting treatment for certain financial guarantee contracts (see Chapter 41 at section 2.4) and loan commitments (see Chapter 41 at section 2.5).

2.1 Debt financial assets measured at amortised cost

Financial assets that are measured at amortised cost require the use of the effective interest method and are subject to the IFRS 9 impairment rules. *[IFRS 9.5.2.1, IFRS 9.5.2.2]*. Gains and losses are recognised in profit or loss when the instrument is derecognised or impaired, through the amortisation process and, if applicable, through modification or reclassification. *[IFRS 9.5.7.2]*. The effective interest method of accounting is dealt with in section 3 below, foreign currency translation in section 4 below, reclassification of financial assets in section 2.7 below, modification of financial assets in section 3.8 below and impairment is addressed in Chapter 47.

2.2 Financial liabilities measured at amortised cost

Liabilities that are measured at amortised cost require the use of the effective interest method with gains or losses recognised in profit or loss when the instrument is derecognised, as well as through the amortisation process and, if applicable, through modification if the modification does not result in derecognition. *[IFRS 9.5.3.1, IFRS 9.5.7.2]*. The effective interest method of accounting is dealt with in section 3 below, foreign currency retranslation is discussed in section 4 below and modification of financial liabilities is covered in section 3.8 below.

2.3 Debt financial assets measured at fair value through other comprehensive income

For financial assets that are debt instruments measured at fair value through other comprehensive income (see Chapter 44 at section 1.1), the IASB decided that both amortised cost and fair value information are relevant because debt instruments held by entities in this measurement category are held for both the collection of contractual cash flows and the realisation of fair values. *[IFRS 9.BC4.150]*.

After initial recognition, investments in debt instruments that are classified as measured at fair value through other comprehensive income are measured at fair value in the statement of financial position (with no deduction for sale or disposal costs). The amounts recognised in profit or loss are the same as the amounts that would have been recognised in profit or loss if the investment had been recorded at amortised cost. *[IFRS 9.5.7.11, IFRS 9.B5.7.1A]*. For example, the following amounts are recognised in profit or loss:

- Impairment gains and losses (see Chapter 47) derived using the same methodology that is applied to financial assets measured at amortised cost. *[IFRS 9.5.2.2, IFRS 9.5.5.2]*.
- Foreign exchange gains and losses (see section 4 below) calculated based on the amortised cost of the debt instruments. *[IFRS 9.B5.7.2, IFRS 9.B5.7.2A]*.
- Interest revenue calculated using the effective interest method (see section 3 below). *[IFRS 9.5.4.1]*.

  And
- Modification gains or losses for debt instruments that are modified (see section 3.8 below and Chapter 47 at section 8). *[IFRS 9.5.4.3, IFRS 9.5.7.10, IFRS 9.5.7.11]*.

Furthermore, the subsequent measurement of debt instruments at fair value through other comprehensive income involves the following:

- Other fair value gains and losses are recognised in OCI. *[IFRS 9.B5.7.1A, IFRS 9.5.7.1(d)]*.

  And
- When the debt instruments are derecognised, the cumulative gains or losses previously recognised in OCI are reclassified (i.e., recycled) from equity to profit or loss as a reclassification adjustment. *[IFRS 9.5.7.10]*.

It follows that the amount recognised in OCI (prior to derecognition) is the difference between the total change in fair value, and the amounts recognised in profit or loss (excluding any amounts received in cash, e.g., the coupon on a bond).

How we see it

Whilst IFRS 9.5.7.10 does not mention modification gains or losses as a component of a financial asset measured at FVOCI to be recorded in profit or loss and could therefore be read as suggesting that the modification gains or losses should not be recognised in profit or loss, we understand that it was the IASB's intention that they should be recognised in profit or loss. This is clear from reading IFRS 9.5.7.11 in conjunction with IFRS 9.5.4.3, which clarifies the accounting treatment of modifications as IFRS 9.5.7.11 clearly states that the amounts that are recognised in profit or loss are the same as the amounts that would have been recognised in profit or loss if the financial asset had been measured at amortised cost.

2.4 Financial assets and financial liabilities measured at fair value through profit or loss

After initial recognition, financial assets and financial liabilities that are classified as measured at fair value through profit or loss (including derivatives that are not designated in effective hedging relationships) are measured at fair value, with no deduction for sale or disposal costs (see Chapter 45 at section 3.1). *[IFRS 9.5.2.1, IFRS 9.5.3.1]*.

The standard helpfully points out that if the fair value of a financial asset falls below zero it becomes a financial liability (assuming it is measured at fair value). *[IFRS 9.B5.2.1]*. The standard does not explain what happens if the fair value of a financial liability becomes positive, but it is safe to assume that it becomes a financial asset and not a negative liability.

Gains and losses arising from remeasuring a financial asset or financial liability at fair value, that is not in a hedging relationship, are normally recognised in profit or loss. *[IFRS 9.5.7.1]*. However, there is an exception for non-derivative financial liabilities that are designated as measured at fair value through profit or loss. For these liabilities, the element of the gain or loss attributable to changes in credit risk (see section 2.4.1 below) is recognised in other comprehensive income (with the remainder of the fair value change recognised in profit or loss). *[IFRS 9.5.7.7]*. These amounts presented in other comprehensive income are not subsequently transferred to profit or loss. However, the cumulative gain or loss may be transferred within equity. *[IFRS 9.B5.7.9]*.

This exception does not apply to loan commitments or financial guarantee contracts, nor does it apply if it would create or enlarge an accounting mismatch in profit or loss (see section 2.4.2 below). *[IFRS 9.5.7.8, IFRS 9.5.7.9]*. In these cases, all changes in the fair value of the liability (including the effects of changes in the credit risk) are recognised in profit or loss. *[IFRS 9.B5.7.8]*.

2.4.1 Liabilities at fair value through profit or loss: calculating the gain or loss attributable to changes in credit risk

IFRS 7 *Financial Instruments: Disclosures* defines credit risk as: *[IFRS 7 Appendix A]*

Extract from IFRS 7

Appendix A
Defined terms

credit risk	The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

Credit risk is also part of non-performance risk as defined in IFRS 13 (see Chapter 15 at section 10.3). The change in fair value of a financial liability that is attributable to credit risk relates to the risk that the issuer will fail to pay that liability. It may not solely relate to the creditworthiness of the issuer but may be influenced by other factors, such as collateral.

For example, if an entity issues a collateralised liability and a non-collateralised liability that are otherwise identical, the credit risk of those two liabilities will be different, even though they are issued by the same entity. The credit risk on the collateralised liability will be less than the credit risk of the non-collateralised liability. In fact, the credit risk for a collateralised liability may be close to zero. *[IFRS 9.B5.7.13]*. It is important to distinguish between the terms 'credit risk' and 'the risk of default' as referred to in the impairment requirements of the standard (see Chapter 47 at section 6.1), since the latter does not include the benefit of collateral.

For these purposes, credit risk is different from asset-specific performance risk. IFRS 9.B5.7.14 notes that "…Asset-specific performance risk is not related to the risk that an entity will fail to discharge a particular obligation but instead it is related to the risk that a single asset or a group of assets will perform poorly (or not at all)". *[IFRS 9.B5.7.14]*. For example, consider the following two situations: *[IFRS 9.B5.7.15]*

(a) A liability with a unit-linking feature whereby the amount due to investors is contractually determined on the basis of the performance of specified assets. The effect of that unit-linking feature on the fair value of the liability is asset-specific performance risk, not credit risk.

(b) A liability issued by a structured entity with the following characteristics:

- The structured entity is legally isolated so the assets in the structured entity are ring-fenced solely for the benefit of its investors, even in the event of bankruptcy.
- The structured entity enters into no other transactions and the assets in the structured entity cannot be hypothecated.

  And

- Amounts are due to the structured entity's investors only if the ring-fenced assets generate cash flows.

Thus, in both cases, changes in the fair value of the liability primarily reflect changes in the fair value of the assets. The effect of the performance of the assets on the fair value of the liability is asset-specific performance risk, not credit risk.

Unless an alternative method more faithfully represents the change in fair value of a financial liability that is attributable to credit risk, the standard states that this amount shall be determined as the amount of change in the fair value of the liability that is not attributable to changes in market conditions that give rise to what it defines as 'market risk'. *[IFRS 9.B5.7.16]*. Examples of changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, foreign exchange rate or index of prices or rates. *[IFRS 9.B5.7.17]*.

The standard says that if the only significant relevant changes in market conditions for a financial liability are changes in 'an observed (benchmark) interest rate', the amount to be recognised in other comprehensive income can be estimated as follows: *[IFRS 9.B5.7.18]*

(a) First, to arrive at an instrument-specific component of the internal rate of return; the liability's internal rate of return at the start of the period is computed using the fair value and contractual cash flows at that time and the observed (benchmark) interest rate at the start of the period is deducted from this.

(b) Next, the present value of the cash flows associated with the liability is calculated using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of the observed (benchmark) interest rate at the end of the period and the instrument-specific component of the internal rate of return at the start of the period as determined in (a).

  And

(c) The difference between the fair value of the liability at the end of the period and the amount determined in (b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate and this is the amount to be presented in other comprehensive income.

It should be noted that 'market risk' is defined to include movements in 'a benchmark rate'. The latter term is not itself defined but typically it would encompass both risk free rates, such as AAA rated government bond rates or overnight rates, and interbank offer rates (IBOR) such as 3-month EURIBOR, which include an element of credit risk. It would therefore appear that the standard is ambivalent as to whether the amount of change in fair value that is attributable to changes in credit risk of a liability is measured by reference to risk free rates, or by comparison to the credit risk already present in an IBOR. Using the former, the amount will reflect all changes in credit risk of the liability, whereas using the latter, it will only reflect a portion of the changes in credit risk to the liability. Further, the change in credit risk will differ depending on which tenor is selected such as 3-month EURIBOR, 6-month EURIBOR or 12-month EURIBOR. From 2022, most benchmark rates are risk free rates (RFRs) based on actual transactions (see *Supplement: IBOR Reform* for more details). It would follow that the change in the amount attributable to credit risk reflects all changes in credit risk if using the new RFRs as benchmarks.

This method is illustrated in the following Illustration, adapted from that provided in the Illustrative Examples attached to the standard. *[IFRS 9.IE1, IFRS 9.IE2, IFRS 9.IE3, IFRS 9.IE4, IFRS 9.IE5]*.

Illustration 2-1: Estimating the change in fair value of an instrument attributable to its credit risk

On 1 January 20X1 Company J issues a 10-year bond with a par value of €150,000 and an annual fixed coupon rate of 8%, which is consistent with market rates for bonds with similar characteristics. J uses 3-month EURIBOR as its observable (benchmark) interest rate. At the date of inception of the bond, 3-month EURIBOR is 5%. At the end of the first year:

- 3-Month EURIBOR has decreased to 4.75%.

  And

- The fair value of the bond is €153,811 which is consistent with an interest rate of 7.6% (i.e., the remaining cash flows on the bond, €12,000 per year for nine years and €150,000 at the end of nine years, discounted at 7.6% equals €153,811).

For simplicity, this Illustration assumes a flat yield curve, that all changes in interest rates result from a parallel shift in the yield curve, and that the changes in 3-month EURIBOR are assumed to be the only relevant changes in market conditions.

The amount of change in the fair value of the bond that is not attributable to changes in market conditions that give rise to market risk is estimated as follows:

Step (a)

The bond's internal rate of return at the start of the period is 8%. Because the observed (benchmark) interest rate (3-month EURIBOR) is 5%, the instrument-specific component of the internal rate of return is deemed to be 3%.

Step (b)

The contractual cash flows of the instrument at the end of the period are:

- Interest: €12,000 [€150,000 × 8%] per year for each of years 20X2 (year 2) to 20Y0 (year 10).
- Principal: €150,000 in 20Y0 (year 10).

The discount rate to be used to calculate the present value of the bond is thus 7.75%, which is the 4.75% end of period 3-month EURIBOR rate, plus the 3% instrument-specific component calculated as at the start of the period, which gives a notional present value of €152,367 (€12,000 × (1 - 1.0775^{-9}) ÷ 0.0775 + €150,000 × 1.0775^{-9}), on the assumption that there has been no change in the instrument-specific component.

Step (c)

The market price of the liability at the end of the period (which will reflect the real instrument-specific component at the end of the period within the 7.6% yield) is €153,811. Therefore, J accounts for €1,444 (€153,811 - €152,367) as the increase in fair value of the bond that is not attributable to changes in market conditions that give rise to market risk.

This method assumes that changes in fair value other than those arising from changes in the instrument's credit risk or from changes in the 'observed (benchmark) interest rate' are not significant. It would not be appropriate to use this method if changes in fair value arising from other factors are significant. In such cases, an alternative method should be used that more faithfully measures the effects of changes in the liability's credit risk. For example, if the instrument in the Illustration contained an embedded derivative, the change in fair value of the embedded derivative must be excluded in determining the amount to be presented in other comprehensive income. *[IFRS 9.B5.7.19, IFRS 9.B5.7.16(b)]*. This ensures that only fair value changes attributable to credit risk are reflected in other comprehensive income and excludes the fair value changes attributable to the embedded derivative.

The above method will also produce an amount which includes any changes in the liquidity spread charged by market participants, over say 3-month EURIBOR, since such changes are not considered to be attributable to changes in market conditions that give rise to market risk. This method is applied in practice as the effect of a liquidity spread cannot normally be isolated from that of the credit spread.

As with all estimates of fair value, the measurement method used for determining the portion of the change in the liability's fair value that is attributable to changes in its credit risk should make maximum use of observable market inputs. *[IFRS 9.B5.7.20]*.

2.4.2 Liabilities at fair value through profit or loss: assessing whether an accounting mismatch is created or enlarged

If a financial liability is designated as at fair value through profit or loss, it must be determined whether presenting the effects of changes in the liability's credit risk in OCI would create or enlarge an accounting mismatch in profit or loss. The IASB expects this to be a rare occurrence. An accounting mismatch would be created or enlarged if presenting changes in credit risk in OCI would result in a greater mismatch in profit or loss, than if those amounts had been presented in profit or loss. *[IFRS 9.B5.7.5, IFRS 9.BC5.39]*.

In making that determination, an assessment should be made as to whether the effects of changes in the liability's credit risk are expected to be offset in profit or loss by a change in the fair value of another financial instrument measured at fair value through profit or loss. Such an expectation should be based on an economic relationship between the characteristics of the liability and the characteristics of the other financial instrument. *[IFRS 9.B5.7.6]*.

The determination is made at initial recognition and is not reassessed. For practical purposes, all the assets and liabilities giving rise to an accounting mismatch do not need to be entered into at exactly the same time - a reasonable delay is permitted provided that any remaining transactions are expected to occur. An entity's methodology for making the determination of whether an accounting mismatch is created or enlarged must be applied consistently for similar types of transactions. IFRS 7 requires an entity to provide qualitative disclosures in the notes to the financial statements about its methodology for making the accounting mismatch determination - see Chapter 50 at section 4.4.2. *[IFRS 9.B5.7.7]*.

If an accounting mismatch would be created or enlarged, the entity is required to present all changes in fair value (including the effects of changes in the credit risk of the liability) in profit or loss. In the absence of an accounting mismatch being created or enlarged, the entity is required to present the effects of changes in the liability's credit risk in OCI. *[IFRS 9.B5.7.8]*.

The following Illustration describes a situation in which an accounting mismatch would be created in profit or loss if the effects of changes in the credit risk of the liability were presented in OCI. *[IFRS 9.B5.7.10]*.

Illustration 2-2: Liabilities at fair value through profit or loss: accounting mismatch in profit or loss

A mortgage bank provides loans to customers and these are funded by issuing bonds with matching characteristics (e.g., amount outstanding, repayment profile, term and currency) in the market. The loans contain a prepayment feature which allows the mortgage customer to prepay its loan (i.e., satisfy its obligation to the bank) by buying the corresponding bond (which were originally used by the bank to fund the loans) at fair value in the market and delivering that bond to the mortgage bank.

As a result of that contractual prepayment right, if the credit quality of the bond worsens (resulting in the fair value of the mortgage bank's liability decreasing), the fair value of the mortgage bank's loan asset also decreases. The change in the fair value of the loan asset reflects the mortgage customer's contractual right to prepay the mortgage loan by buying the underlying bond at fair value (which, in this Illustration, has decreased) and delivering the bond to the mortgage bank. Therefore, the effects of changes in the credit risk of the liability (the bond) will be offset in profit or loss by a corresponding change in the fair value of a financial asset (the loan).

If the effects of changes in the liability's credit risk were presented in OCI there would be an accounting mismatch in profit or loss. Therefore, the mortgage bank is required to present all changes in fair value of the liability (including the effects of changes in the liability's credit risk) in profit or loss.

In Illustration 2-2 above, there is a contractual link between the effects of changes in the credit risk of the liability and changes in the fair value of the financial asset (i.e., as a result of the mortgage customer's contractual right to prepay the loan by buying the bond at fair value and delivering the bond to the mortgage bank). The standard states that an accounting mismatch may also occur in the absence of a contractual link, but does not provide any examples of when this might be the case. *[IFRS 9.B5.7.11]*.

However, the standard makes it clear that a mismatch that arises solely as a result of the measurement method does not affect the determination of whether presenting the effects of changes in the liability's credit risk in OCI would create or enlarge an accounting mismatch. For instance, an entity may not be able to isolate changes in a liability's credit risk from changes in liquidity risk. Consequently, when the entity presents the combined effect of both factors in OCI, a mismatch may occur because changes in liquidity risk are included in the fair value measurement movement of the entity's financial assets presented in profit or loss. However, such a mismatch is caused by measurement imprecision, not an offsetting relationship, and, therefore, does not affect the determination of an accounting mismatch. *[IFRS 9.B5.7.12]*.

The following Illustration presents another situation in which an accounting mismatch is not due to an economic relationship (in the sense intended by the IASB) between the movement in the fair value of the financial assets and the movement in the fair value of the financial liabilities related to the liabilities' own credit risk.

Illustration 2-3: Liabilities at fair value through profit or loss: no accounting mismatch in profit or loss

A bank issues structured products (consisting of a host debt contract and one or more embedded derivatives) in the market. These financial liabilities are designated as at fair value through profit or loss because they are managed on a fair value basis.

The bank invests the funds received in highly rated bonds, which are also designated as at fair value through profit or loss, and derivatives whose terms mirror those of the embedded derivatives in the structured products.

In periods when market credit spreads are volatile, it is expected that the effect of changes in credit spreads on the fair value of the structured products will be mainly compensated for by the effect of an offsetting credit spread movements on the bonds. This is because the credit quality of the bank is similar to the credit quality of the highly rated bonds in which the bank has invested.

Unlike Illustration 2-2 above, there is no direct link between the bank's own credit risk of the structured financial liabilities and the credit risk of the financial assets. The credit quality of the financial assets may be similar to that of the financial liabilities and these may move in a correlated manner as they are affected by similar movements in the general price of credit and other market risks, but the fair value of the financial assets will not move directly in response to changes in the bank's own credit risk.

Therefore, the requirements for an economic relationship are not met and all fair value changes attributable to changes in the credit risk of the financial liabilities should be taken to OCI.

2.5 Investments in equity instruments designated at fair value through other comprehensive income

After initial recognition, investments in equity instruments not held for trading that are designated as measured at fair value through other comprehensive income (see Chapter 44 at section 1.2) are measured at fair value, with no deduction for sale or disposal costs. *[IFRS 9.5.7.5]*. With the exception of dividends, the associated gains and losses (including any related foreign exchange component) are recognised in OCI. These investments are not subject to impairment testing. Amounts presented in OCI are not subsequently transferred to profit or loss, although the cumulative gain or loss may be transferred within equity. *[IFRS 9.B5.7.1, IFRS 9.B5.7.3]*.

Extract from IFRS 9

Appendix A
Defined terms

dividends	Distributions of profits to holders of equity instruments in proportion to their holdings of a particular class of capital.

[IFRS 9 Appendix A].

Dividends from these investments are recognised in profit or loss when the right to receive payment is established, the amount of the dividend can be measured reliably and it is probable that economic benefits will flow to the entity. *[IFRS 9.5.7.1A, IFRS 9.5.7.6]*. However, if the dividend clearly represents a recovery of part of the cost of the investment, it is not recognised in profit and loss (see Chapter 9 at section 2.4.1.C). *[IFRS 9.B5.7.1]*. In the Basis for Conclusions to IFRS 9 the IASB distinguish between dividends that represent a return *of* investment, and those dividends that are a return *on* the investment. *[IFRS 9.BC5.25(a)]*. However, determining when a dividend does or does not clearly represent a recovery of the cost of the investment can be highly judgemental, and a thorough understanding of the particular facts and circumstances is needed.

2.6 Unquoted equity instruments and related derivatives

IFRS 9 requires all investments in equity instruments and contracts on those instruments to be measured at fair value (see Chapter 15). However, it is recognised that in limited circumstances, cost may be an appropriate estimate of fair value. That may be the case if insufficient recent information is available to determine fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range. *[IFRS 9.B5.2.3]*.

Such guidance was provided to alleviate some of the concerns expressed by constituents and also, to replace the cost exception that was not brought forward to IFRS 9 from IAS 39 *Financial Instruments: Recognition and Measurement*, the previous standard for accounting for financial instruments. IAS 39 contained an exception from fair value measurement for investments in equity instruments (and some derivatives linked to those investments) that did not have a quoted price in an active market and whose fair value could not be reliably measured. Those equity investments were required to be measured at cost less impairment, if any. *[IFRS 9.BC5.13, IFRS 9.BC5.16, IFRS 9.BC5.18]*.

Extract from IFRS 9

B5.2.4 Indicators that cost might not be representative of fair value include:

(a) a significant change in the performance of the investee compared with budgets, plans or milestones.

(b) changes in expectation that the investee's technical product milestones will be achieved.

(c) a significant change in the market for the investee's equity or its products or potential products.

(d) a significant change in the global economy or the economic environment in which the investee operates.

(e) a significant change in the performance of comparable entities, or in the valuations implied by the overall market.

(f) internal matters of the investee such as fraud, commercial disputes, litigation, changes in management or strategy.

(g) evidence from external transactions in the investee's equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties.

[IFRS 9.B5.2.4].

This list is not intended to be exhaustive. All information about the performance and operations of the investee that becomes available after the date of initial recognition should be used and to the extent that any such relevant factors exist, they may indicate that cost might not be representative of fair value. In such cases, fair value should be estimated. *[IFRS 9.B5.2.5]*.

For the avoidance of doubt, IFRS 9 emphasises that cost is never the best estimate of fair value for investments in quoted equity instruments (or contracts on quoted equity instruments). *[IFRS 9.B5.2.6]*. Also, the IASB noted that for financial institutions and investment funds, the cost of an equity investment cannot be considered representative of fair value. *[IFRS 9.BC5.18]*.

2.7 Reclassifications of financial assets

In certain situations, financial assets are reclassified, and the situations in which a reclassification might arise are considered in more detail in Chapter 44 at section 8.

The reclassification must be applied prospectively from the reclassification date which is defined as: *[IFRS 9.5.6.1, IFRS 9 Appendix A]*

Extract from IFRS 9

Appendix A
Defined terms

reclassification date	The first day of the first reporting period following the change in business model that results in an entity reclassifying financial assets.

Accordingly, any previously recognised gains, losses (including impairment gains and losses) or interest should not be restated. *[IFRS 9.5.6.1]*. For example, when a financial asset is reclassified so that it is measured at fair value, its fair value is determined at the reclassification date. Any gain or loss arising from a difference between the previous carrying amount and fair value should be recognised in profit or loss of the current period without restating prior periods. *[IFRS 9.5.6.2]*. Moreover, when a financial asset is reclassified so that it is measured at amortised cost, its fair value at the reclassification date becomes its new gross carrying amount. *[IFRS 9.5.6.3]*. The effective interest rate is determined on the basis of the fair value of the asset at the date of reclassification. *[IFRS 9.B5.6.2]*. Below is a table summarising the treatment of financial assets on reclassification. *[IFRS 9.5.6.2, IFRS 9.5.6.3, IFRS 9.5.6.4, IFRS 9.5.6.5, IFRS 9.5.6.6, IFRS 9.5.6.7, IFRS 9.B5.6.1, IFRS 9.B5.6.2]*.

Original classification	New classification	Accounting
Amortised cost	FVTPL	The fair value of the asset is measured at the reclassification date. Any gain or loss arising from a difference between the fair value and the previous amortised cost of the financial asset is recognised in profit or loss.
FVTPL	Amortised cost	The fair value of the asset at the reclassification date is the new gross carrying amount. The EIR is determined on the basis of the fair value at reclassification date and impairment is calculated based on this EIR and as if the date of reclassification date was the date of initial recognition.
Amortised cost	FVOCI	The fair value of the asset is measured at the reclassification date. Any gain or loss arising from a difference between the previous amortised cost and the fair value, is recognised in OCI. The EIR and the measurement of expected credit losses are not adjusted.
FVOCI	Amortised cost	The fair value of the asset at reclassification date is new gross carrying amount. At reclassification date, the cumulative gain or loss previously recognised in OCI is removed from equity and adjusted against the fair value. The EIR and the measurement of expected credit losses are not adjusted.
FVTPL	FVOCI	The asset continues to be carried at fair value. The EIR is determined on the basis of the fair value at reclassification date.
FVOCI	FVTPL	The asset continues to be carried at fair value. At reclassification date, the cumulative gain or loss previously recognised in OCI is reclassified from equity to profit and loss as a reclassification adjustment.

2.8 Financial guarantees and loan commitments

Loan commitments are generally excluded from IFRS 9, with the exception of the impairment requirements and derecognition provisions (see Chapters 47 and 48). However, loan commitments are within the scope of IFRS 9 if they have been designated as financial liabilities at fair value through profit or loss, can be settled net in cash or by delivering or issuing another financial instrument, or if they are commitments to provide a loan at a below-market interest rate (see Chapter 41 at section 2.5 for more details on the scoping). *[IFRS 9.2.1(g), IFRS 9.2.3]*.

Loan commitments that can be settled net in cash or by delivering or issuing another financial instrument are derivatives and are therefore measured at fair value through profit and loss.

Loan commitments issued to provide a loan at a below-market interest rate, and financial guarantees issued, are measured on initial recognition at their (negative) fair value which is generally equal to the premium received where the transaction is undertaken at an arm's length (see Chapter 45 at section 3.3.3) *[IFRS 9.2.3(c), IFRS 9.B2.5(a)]*. Subsequently these are measured on the statement of financial position at the higher of: *[IFRS 9.4.2.1(c), IFRS 9.4.2.1(d)]*

- The amount of the loss allowance determined in accordance with the impairment requirements of IFRS 9 (see Chapter 47 at section 11).
  And
- The amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15 *Revenue from Contracts with Customers* (see Chapter 28). Typically, any upfront premium will be amortised over the related guarantee period.

For a financial guarantee contract, this assumes that it did not arise from a failed derecognition transaction (see section 2.9.3 below). *[IFRS 9.4.2.1(b), IFRS 9.4.2.1(c)]*.

While the requirements outlined above address the statement of financial position presentation, the income statement presentation is not specified. For example, it is unclear whether the initial premium received should be recognised as 'revenue' with a separate additional remeasurement for the impairment allowance or whether a single net amount should be presented in the profit and loss account shown in the revenue or impairment line depending on the comparison of the 'higher of' test. There is a further issue of whether any amounts recorded in the impairment line should be restricted to ensure there is no reversal of impairment that would exceed the cumulative impairment losses recorded in prior periods. Due to the lack of guidance in this area, diversity may arise in practice.

For financial guarantees, there were discussions by the IFRS Transition Resource Group for Impairment of Financial Instruments (ITG) on whether future premiums to be received affect the measurement of the expected credit loss (ECL) allowance and this is discussed further at Chapter 47 at sections 1.5 and 11.

The discussions above deal with the accounting implications for the issuer of financial guarantees and loan commitments. There are also accounting implications for the holder to consider. For example, in November 2018 the IFRS IC discussed whether the cash flows expected, in general, from a financial guarantee contract or any other credit enhancement can be included in the measurement of expected credit losses (see Chapter 47 at section 5.8.1). A further issue to consider is how fees paid or received in relation to loan commitments are treated. This is dealt with in more detail below.

Frequently asked questions

Question 2-1: How should fees received (or paid) upfront to secure a loan commitment be accounted for in the Statement of Comprehensive Income?

Fees paid to obtain a loan commitment from an issuer may be paid up-front, over the life of the commitment, or in arrears on the undrawn amount (sometimes called non-utilisation fees). The fees may be paid to obtain a term loan, a line-of-credit, or a revolving debt arrangement.

The accounting treatment of all types of fees received or paid depends on whether:

- It is probable (more likely than not) at inception that the loan commitment will be utilised in whole or in part.

  And

- Once utilised, the loan commitment expires (that is, if the loan is repaid no further amount can be drawn).

Usually, the second criterion is met when the commitment includes a specified repayment schedule. Therefore, this criterion is not met for a revolving debt arrangement or a line-of-credit when the borrower can borrow and repay funds at the borrower's option numerous times during the life of the loan commitment (see Question 2-4 below).

When both criteria above are met, and it is probable that the total loan commitment will be utilised, the fees payable for the loan commitment are recognised by both the issuer and the borrower over the life of the loan using the EIR method. *[IFRS 9.B5.4.2(b), IFRS 9.B5.4.3(b)]*. As the fees are integral to the EIR they are apportioned consistently with the amounts borrowed and recognised over the resulting loan's expected life using the EIR method (see section 3.1 below). The exception to this is when the borrower or issuer will account for draw downs on the facility at fair value through profit or loss. In this case, the fees would be recognised in profit or loss when the draw down occurs.

Although the guidance in IFRS 9.B5.4.2(b) and IFRS 9.B5.4.3(b) is in the context of the accounting for commitment fees received by the issuer, this guidance can also be applied to the accounting by the borrower. Furthermore, the deferral of the commitment fees paid by the borrower when it is probable there will be a drawdown of a specific loan is also consistent with the definition of an asset in the IASB's *Conceptual Framework* because there are potential economic benefits. *[CF 4.3, CF 4.4, CF 4.14, CF 4.16]*.

Question 2-2: How should fees received (or paid) to secure a loan commitment be accounted for when management initially expects only a portion of the loan commitment to be utilised?

If both criteria outlined in Question 2-1 above have been met for a portion of the loan commitment only, then the fees are apportioned between the amount expected to be utilised, and the amount not expected to be utilised. The fees related to the amount expected to be utilised are recognised over the resulting loans' expected life using the EIR method in line with the reasoning outlined in Question 2-1 above. *[IFRS 9.B5.4.2(b)]*.

The remaining portion of the fees is expensed by the borrower over the commitment period, for example on a straight-line basis. This is on the basis that the commitment fees paid by the borrower meet the definition of a prepayment made to the lender for liquidity services made available to the borrower. *[IAS 38.70]*.

The issuer accounts for the remaining portion of the fee income under IFRS 15 as compensation for the service of providing the facility and recognises it when (or as) it fulfils its performance obligation in making the facility available. *[IFRS 9.B5.4.3(b)]*. This is on the basis, that the issuer has a performance obligation to stand ready to make the facility available to the borrower (i.e., a promise to provide a service of making a certain amount of cash available to the borrower during the commitment period). *[IFRS 15.26(e)]*. For each performance obligation identified, it needs to be determined whether it is satisfied over time or at a point in time, and is accounted for accordingly (see Chapter 28). *[IFRS 15.32, IFRS 15.35(a)]*.

Question 2-3: How should fees received (or paid) to secure a loan commitment be accounted for when management does not expect any of the loan commitment to be utilised?

In line with the reasoning outlined in Question 2-2 above, if management do not expect any of the loan commitment to be utilised, the fees are expensed by the borrower over the commitment period, for example on a straight-line basis. The issuer accounts for the fee income under IFRS 15 as compensation for the service of providing the facility and recognises it when (or as) it fulfils its performance obligation in making the facility available.

Question 2-4: How should fees received (or paid) to secure a loan commitment be accounted for when the loan commitment does not expire after being utilised?

Some loan commitments, once drawn, do not expire. For example, access bond and credit card arrangements normally provide a loan facility which can be drawn down, repaid and then drawn again without any additional commitment fees being charged. When this is the case, the fees are not integral to any particular financial asset or liability resulting from draw downs on the loan commitment, and therefore, are not part of any EIR. Consequently, the fees are expensed by the borrower over the commitment period, for example on a straight-line basis.

The issuer accounts for the fee income under IFRS 15 as compensation for the service of providing the facility and recognises it when (or as) it fulfils its performance obligation in making the facility available (see Chapter 28). *[IFRS 15.35(a)]*.

2.9 Exceptions to the general principles

2.9.1 Hedging relationships

Financial assets and financial liabilities that are designated as hedged items are subject to measurement under the hedge accounting requirements of IFRS 9, or IAS 39 if the entity chooses as its accounting policy to continue to apply the hedge accounting requirements of IAS 39. *[IFRS 9.5.2.3, IFRS 9.5.3.2, IFRS 9.5.7.3, IFRS 9.7.2.21]*.

Furthermore, derivatives and non-derivative debt financial instruments may be designated as hedging instruments which can affect whether fair value or foreign exchange gains and losses are recognised in profit or loss or in other comprehensive income. *[IFRS 9.B5.7.2]*.

Hedge accounting is covered in Chapter 49.

2.9.2 Regular way transactions

Except for its rules on transfers of assets, IFRS 9 requires an entity to recognise a financial asset in its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument and to derecognise a financial asset when, and only when, the contractual rights to the cash flows from the financial asset expire (see Chapter 48 at section 3.5). *[IFRS 9.3.1.1, IFRS 9.3.2.3]*. In other words, IFRS 9 requires a financial asset to be recognised or derecognised on a trade date basis, i.e., the date that an entity commits itself to purchase or sell an asset. *[IFRS 9.B3.1.5]*. However, the standard permits financial assets subject to so called 'regular way purchase or sale' to be recognised, or derecognised, either as at the trade date or as at the settlement date (see Chapter 45 at section 2.2). *[IFRS 9.3.1.2, IFRS 9.B3.1.3]*. Whichever method is used, it is applied consistently and symmetrically (i.e., to acquisitions and disposals) to each of the main measurement categories of financial asset identified by IFRS 9 (see Chapter 45 at section 2.2). *[IFRS 9.B3.1.3]*.

Where settlement date accounting is used for regular way purchases or sales, any change in the fair value of the asset to be received arising between trade date and settlement date is not recognised for those assets that will be measured at amortised cost. For assets that will be recorded at fair value, such changes in value are recognised: *[IFRS 9.5.7.4, IFRS 9.B3.1.6]*

- In profit or loss for assets classified as measured at fair value through profit or loss

  And

- In other comprehensive income for debt instruments classified, and equity instruments designated, as measured at fair value through other comprehensive income

On disposal, changes in value of such assets between trade date and settlement date are not recognised because the right to changes in fair value ceases on the trade date. *[IFRS 9.IG D.2.2]*. The accounting for trade date and settlement date accounting on initial recognition, and derecognition, is dealt with in more detail is in Chapter 45 at sections 2.2.3, 2.2.4 and 2.2.5.

For financial assets measured at amortised cost or at fair value through other comprehensive income, IFRS 9 requires entities to use the trade date as the date of initial recognition for the purposes of applying the impairment requirements. *[IFRS 9.5.7.4]*. This means that entities that use settlement date accounting may have to recognise a loss allowance for financial assets which they have purchased but not yet recognised and, correspondingly, no loss allowance for assets that they have sold but not yet derecognised (see Chapter 47 at section 7.3.2).

2.9.3 Liabilities arising from failed derecognition transactions

There are special requirements for financial liabilities (including financial guarantee contracts) that arise when transfers of financial assets do not qualify for derecognition, or are accounted for using the continuing involvement approach. *[IFRS 9.4.2.1(b)]*. These are dealt with in Chapter 48 at section 5.3.

3 Amortised cost and the effective interest method

IFRS 9 contains four key definitions relating to measurement at amortised cost, which are set out below: *[IFRS 9 Appendix A]*

Extract from IFRS 9

Appendix A
Defined terms

amortised cost of a financial asset or financial liability	The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any **loss allowance**.
effective interest method	The method that is used in the calculation of the **amortised cost of a financial asset or a financial liability** and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period.
effective interest rate	The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the **gross carrying amount of a financial asset** or to the **amortised cost of a financial liability**. When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the **expected credit losses**. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1-B5.4.3), **transaction costs**, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).
gross carrying amount of a financial asset	The **amortised cost of a financial asset**, before adjusting for any **loss allowance**.

3.1 Effective interest rate (EIR)

For financial assets held at amortised cost, interest revenue is calculated by applying the EIR to the gross carrying amount. When calculating the EIR, an entity should estimate the expected cash flows by considering all the contractual terms of the financial instrument (e.g., prepayment, extension, call and similar options). However, IFRS 9 does not contain clear guidance on how the expected cash flows are estimated when calculating EIR. For example, it is unclear how to reflect conditionality attached to the contractual interest rate in the EIR (see section 3.1.3 below where this has been raised as part of the post implementation review of IFRS 9). The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the EIR, transaction costs, and all other premiums or discounts. *[IFRS 9 Appendix A]*. Except for purchased or originated financial assets that are credit-impaired on initial recognition, ECLs are not considered in the calculation of the EIR. This is because the recognition of ECLs is separate from the recognition of interest revenue (see Chapter 47 at section 3.1). *[IFRS 9 Appendix A, IFRS 9.BCZ5.67]*.

When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts that are included in the calculation of the EIR over the expected life of the financial instrument. However, there may be situations when discounts or premiums are amortised over a shorter period (see section 3.1.1 below).

Guidance related to what fees should and should not be considered integral is included in IFRS 9. Fees that are an integral part of the EIR of a financial instrument are treated as an adjustment to the EIR, unless the financial instrument is measured at fair value through profit or loss. In those cases, the fees are recognised as revenue or expense when the instrument is initially recognised. *[IFRS 9.B5.4.1]*.

Extract from IFRS 9

B5.4.2 Fees that are an integral part of the effective interest rate of a financial instrument include:

(a) origination fees received by the entity relating to the creation or acquisition of a financial asset. Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument.

(b) commitment fees received by the entity to originate a loan when the loan commitment is not measured in accordance with paragraph 4.2.1(a) and it is probable that the entity will enter into a specific lending arrangement. These fees are regarded as compensation for an ongoing involvement with the acquisition of a financial instrument. If the commitment expires without the entity making the loan, the fee is recognised as revenue on expiry.

(c) origination fees paid on issuing financial liabilities measured at amortised cost. These fees are an integral part of generating an involvement with a financial liability. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services.

B5.4.3 Fees that are not an integral part of the effective interest rate of a financial instrument and are accounted for in accordance with IFRS 15 include:

(a) fees charged for servicing a loan;

(b) commitment fees to originate a loan when the loan commitment is not measured in accordance with paragraph 4.2.1(a) and it is unlikely that a specific lending arrangement will be entered into; and

(c) loan syndication fees received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants).

[IFRS 9.B5.4.2, IFRS 9.B5.4.3].

It is important to note that the EIR is normally based on estimated, not contractual, cash flows and there is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of instruments), the contractual cash flows over the full contractual term of the financial instrument (or group of instruments) should be used. *[IFRS 9 Appendix A]*.

For fair value hedges in which the hedged item is recorded at amortised cost, the adjustment to the hedged item arising from the application of hedge accounting is amortised to profit or loss. This adjustment is based on a recalculated EIR at the date amortisation begins (see Chapter 49 at section 7.1.2).

The application of the effective interest method to floating-rate instruments and inflation-linked debt is considered in more detail in sections 3.3 and 3.6 below.

As set out in Chapter 43 at section 6, an issued compound financial instrument such as a convertible bond is accounted for as a financial liability component and an equity component. In accounting for the financial liability at amortised cost, the expected cash flows should be those of the liability component only and the estimate should not take account of the bond being converted.

3.1.1 The amortisation period

A key element in the EIR calculation is the determination of the amortisation period. Payments, receipts, discounts and premiums included in the effective interest method calculation are normally amortised over the expected life of the instrument and it will often be acceptable to amortise transaction costs on a straight-line basis over the life of the instrument on a basis of materiality.

However, there may be situations when discounts or premiums are amortised over a shorter period if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the related variable (e.g., interest rates) to which the fees, points paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the instrument's expected maturity. In such cases, the appropriate amortisation period is to the next repricing date. *[IFRS 9.B5.4.4]*.

For example, changes in market rates since the floating interest rate was reset to market rates will be amortised to the next date when the interest rate is reset to market rates. This is because the difference relates to the period to the next interest reset date as, at that date, the variable to which the difference relates (i.e., the interest rate) is reset to market rates. If, however, a premium or discount results from a change in the credit spread over the floating-rate specified in the financial instrument, or other variables that are not reset to market rates, it is amortised over the expected life of the instrument. *[IFRS 9.B5.4.4]*.

The following Illustration demonstrates the requirements of applying a discount arising on acquisition of a debt instrument resulting from a credit downgrade.

Illustration 3-1: Effective interest method - amortisation of discount arising from credit downgrade

A twenty-year bond is issued at CU100, has a principal amount of CU100, and requires quarterly interest payments equal to current three-month EURIBOR plus 1% over the life of the instrument. The interest rate reflects the market-based required rate of return associated with the bond issue at issuance. Subsequent to issuance, the credit quality of the bond deteriorates resulting in a rating downgrade. It therefore trades at a discount, although it is assessed not to be credit-impaired (see Chapter 47 at section 3.1). Company A purchases the bond for CU95 and classifies it as measured at amortised cost and not determined to be purchased credit-impaired on initial recognition.

The discount of CU5 is amortised to income over the period to the maturity of the bond and not to the next date interest rate payments are reset as it results from a change in credit spreads.[1] This is because it relates to an adjustment for credit quality which is not a variable that reprices to market rates before the expected maturity.

There are financial instruments which pay a fixed or lower rate of interest in an initial period of their life and subsequently convert to a standard variable rate. An issue arises as to whether the EIR should be calculated on a 'blended' basis, so as to obtain a consistent rate of return over the instrument's expected life or whether the initial period and subsequent period of different interest rates should be treated as two discrete periods, such that blending is not necessary.

Previously, under IAS 39, entities were required to calculate the EIR by discounting estimated "future cash payments, or receipts through the expected life of the instrument, or when appropriate, a shorter period". *[IAS 39(2017).9]*. Whilst IFRS 9 has removed 'when appropriate, a shorter period' in its definition in Appendix A to the standard, it has kept the reference to a 'shorter period' in IFRS 9.B5.4.4. It was, and still is, unclear as to what is meant by 'when appropriate' and this has led to some diversity in practice with some entities applying a blended rate rather than having different EIRs for discrete periods of interest.

Illustration 3-2 and Illustration 3-3 below demonstrates a loan whose interest is partially fixed and partially variable.

Illustration 3-2: Fixed rate mortgage which reprices to market interest rate

Bank E offers fixed-rate mortgages to customers with an initial fixed-rate for a term of 5 years, which is shorter than the overall term of the loan of 25 years. The fixed rate is a market rate at the date of the mortgage offer. After the fixed 5-year term, the initial rate on the loan reverts to a market rate to be determined at that point in time.

How we see it

The change in interest rate is to a current market rate and is made in accordance with the terms of the original instrument.

Consequently, it may be appropriate to treat this as a change in EIR, similar to the repricing of a floating-rate instrument. Therefore, the fixed rate may be applied for the initial 5 years followed by the new market rate when applying the effective interest method.

1 IAS 39 Implementation Guidance Committee (IGC), Q&A 76-1, July 2001.

Illustration 3-3: Bargain rate mortgage which reprices to market interest rate

Bank F issues the same mortgage as in Illustration 3-2 above, except that the initial fixed rate is determined to be a bargain rate.

How we see it

When the initial rate is a bargain rate, it may be required to calculate a blended rate, so as to obtain a consistent rate of return over the expected life of the mortgage.

The blended rate would be recalculated as and when the estimated future cash flows change.

3.1.2 Purchased or credit-impaired financial assets

Extract from IFRS 9

Appendix A
Defined terms

credit-impaired financial asset	A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired include observable data about the following events: (a) significant financial difficulty of the issuer or the borrower; (b) a breach of contract, such as a default or **past due** event; (c) the lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider; (d) it is becoming probable that the borrower will enter bankruptcy or other financial reorganisation; (e) the disappearance of an active market for that financial asset because of financial difficulties; or (f) the purchase or origination of a financial asset at a deep discount that reflects the incurred **credit losses**. It may not be possible to identify a single discrete event - instead, the combined effect of several events may have caused financial assets to become credit-impaired.
purchased or originated credit-impaired financial asset	Purchased or originated financial asset(s) that are **credit-impaired** on initial recognition.

For a purchased or originated credit-impaired financial asset (see Chapter 47 at section 3.3), the credit-adjusted EIR is applied when calculating the interest revenue and it is the rate that exactly discounts the estimated future cash payments or receipts through the expected life of the financial asset to the amortised cost of a financial asset. An entity is required to include the initial ECLs in the estimated cash flows when calculating the credit-adjusted EIR for such assets. *[IFRS 9.5.4.1(a), IFRS 9.B5.4.7, IFRS 9.Appendix A]*.

However, this does not mean that a credit-adjusted EIR should be applied solely because the financial asset has high credit risk at initial recognition. Rather, as outlined above, IFRS 9 contains specific definitions outlining the requirements relating to a credit impaired asset. Furthermore, the application guidance explains that a financial asset is only considered credit-impaired at initial recognition when the credit risk is very high or, in the case of a purchase, it is acquired at a deep discount. *[IFRS 9.B5.4.7]*.

For financial assets that are not purchased or originated credit-impaired but have subsequently become credit impaired, interest revenue is calculated by applying the EIR to the *amortised cost* in subsequent reporting periods. *[IFRS 9.5.4.1(b)]*. In subsequent reporting periods, if the credit quality of the financial asset improves so that the financial asset is no longer credit-impaired and the improvement can be related objectively to the occurrence of an event (such as an improvement in the borrower's credit rating), then on a prospective basis an entity should once again calculate the interest revenue by applying the EIR to the

gross carrying amount of the financial asset (and there is no catch up of contractual interest that was not recognised while the asset was credit impaired). *[IFRS 9.5.4.2]*.

Frequently asked questions

Question 3-1: Does 'subsequent reporting period' refer only to annual periods or does it also extend to interim reporting periods?

'Reporting period' refers to a period for which financial statements are produced in accordance with IFRS accounting standards. In some instances, the standards specifically refer to 'annual reporting period' (e.g., IFRS 9.7.2.15 and IFRS 9.7.2.33), which indicates that the more general references to 'reporting period' extend beyond annual reporting periods. Paragraph 4 of IAS 34 *Interim Financial Reporting* defines interim period as a 'financial reporting period shorter than a full financial year'. *[IAS 34.4]*. Therefore, both interim and annual reporting periods for which financial statements are prepared in compliance with IFRS (full or IAS 34) are 'reporting periods'. 'Subsequent reporting period' therefore refers to the next interim or annual reporting period, whichever comes sooner.

In line with the discussions above, it should be noted that if an entity produces quarterly financial statements that are not in compliance with IFRS (full or IAS 34), then the period cannot be considered a 'reporting period'.

Question 3-2: IAS 34.28 requires that the frequency of an entity's reporting shall not affect the measurement of its annual results. If interim reporting periods are 'reporting periods', are the IFRS 9 requirements to give effect to changes between gross and net interest calculation in the 'subsequent reporting period' inconsistent with the requirement in IAS 34.28, and in that case, which standard's guidance should be followed?

There is an internal conflict between the requirements of IFRS 9 and IAS 34.28.

How we see it

In our view, in the absence of further clarity, the specific requirements in IFRS 9 to give effect to changes between the gross and net interest calculation in the 'subsequent reporting period' take precedence over the more general requirements of IAS 34.28 that the frequency of an entity's reporting shall not affect the measurement of its annual results.

Question 3-3: Are entities allowed to perform the impairment assessments, with the resulting changes to the interest calculation, more frequently than their interim reporting periods, for example, monthly?

The IASB believes that, conceptually, the credit impairment of financial assets should be assessed on an ongoing basis, thus altering the interest revenue determination as the underlying economics change. However, it was noted that such an approach would be unduly onerous for preparers. Therefore, the IASB introduced a practical expedient that the assessment of whether a financial asset is credit impaired be required at the reporting date, with changes in the interest calculation effected from the beginning of the following reporting period. *[IFRS 9.BC5.78]*. This seems to prevent entities from having to update their staging and interest calculations on an ongoing basis. However, if entities voluntarily perform their staging assessment, and changes to interest calculations, more frequently than their reporting periods, this is not contrary to the objectives of IFRS 9, provided that the approach is applied consistently.

How we see it

An entity may assess whether a financial asset has become (or ceased to be) credit impaired more frequently than at its reporting dates. If it does so, any resulting changes between gross and net interest income presentation will occur more frequently than its next reporting period. The timing of these assessments is an accounting policy choice and should be evenly spaced and consistently applied.

For further guidance on 'reporting period' in the context of reclassifications of financial assets and hedge accounting, see Chapter 44 at section 8.1 and Chapter 49 at section 6.4, respectively.

See Chapter 47 at section 3.1 for a more detailed discussion on the application of the EIR to credit impaired assets.

3.1.3 Post implementation review

The post implementation review (PIR) of the classification and measurement requirements of IFRS 9 was completed in 2022. In December 2022, the IASB issued a report[2] containing feedback from the classification and measurement PIR and concluded the requirements are working as intended, however they noted that clarification was needed in certain areas to improve the understandability of the requirements.

In particular, the feedback on the EIR method highlighted that respondents found the following as the most challenging and interpretive areas:

- How to reflect conditions that are attached to the contractual interest rate in the EIR i.e., what expectations or uncertainties to consider in calculating the EIR and how to reflect conditionality. For example, how to treat an adjustment to the contractual interest rate based on the borrower's performance in meeting sustainability linked targets.

  And

- How to account for subsequent changes in estimates of future cash flows.

A related challenge is identifying when subsequent changes to estimated contractual cash flows are accounted for under IFRS 9.B5.4.5 because the change relates to a change in a floating market rate of interest. The alternative is that the change would be accounted for by applying IFRS 9.B5.4.6 such that the carrying value is updated for the present value of the revised estimated contractual cash discounted at the original EIR, which remains unchanged.

Other areas that the Board will consider developing clarifications and further explanations on are the following:

- The meaning of a 'floating rate' financial instrument and whether this refers to the overall contractual rate or only a component thereof
- The meaning of 'movements in market rates' and whether this includes contractually specified adjustments to the contractual interest rate

  And

- The effect modifications have on determining the EIR

In response to the above, the IASB decided to add a project to its research project pipeline, the "Amortised Cost Measurement" project, which will consider whether the requirements for applying the effective interest rate method can be clarified in an effective manner.

As discussed in Chapter 47 at section 1.6, the IASB has completed its PIR of the impairment requirements in IFRS 9. On 4 July 2024, the IASB published the project summary and feedback statement, in which the IASB concluded that the impairment requirements are working as intended. The IASB will explore whether it can clarify the requirements for modification, derecognition and write-off of financial instruments and the consequential effect on recognition of expected credit losses as part of its project on Amortised Cost Measurement.[3] Refer to section 3.8.4 below for further details.

3.2 Fixed interest rate instruments

The effective interest method is most easily applied to instruments that have fixed payments and a fixed term. The following Illustrations, adapted from the Implementation Guidance to the IFRS accounting standard, explain this. *[IFRS 9.IG B.26, IFRS 9.IG B.27]*.

Illustration 3-4: Effective interest method - amortisation of premium or discount on acquisition

At the start of 20X1, a company purchases a debt instrument with five years remaining to maturity for its fair value of CU1,000 (including transaction costs). The instrument has a principal amount of CU1,250 and carries fixed interest of 4.7% payable annually (CU1,250 × 4.7% = CU59 per year). In order to allocate interest receipts and the initial discount over the term of the instrument at a constant rate on the carrying amount, it can be shown that interest needs to be accrued at the rate of 10% annually. In each period, the amortised cost at the beginning of the period is multiplied by the EIR of 10% and added to the gross carrying amount. Any cash payments in the period are deducted from the resulting balance.

2 Project Report and Feedback Statement: *Post-implementation Review, IFRS 9* Financial Instruments-*Classification and Measurement*, IASB, December 2022. Available on the IFRS Foundation's website.

3 IASB Staff Paper 27C: Project: *Post-implementation Review of IFRS 9*-Impairment, Topic: *Interaction of impairment requirements with other requirements*, IASB meeting, April 2024. Available on the IFRS Foundation's website.

The table below provides information about the gross carrying amount, interest income, and cash flows of the debt instrument in each reporting period: *[IFRS 9.IG B.26]*

	(a)	*(b = a × 10%)*	*(c)*	*(d = a + b - c)*
	Gross carrying amount at the start of the year	Interest income	Cash flows	Gross carrying amount at the end of the year
Year	(CU)	(CU)	(CU)	(CU)
20X1	1,000	100	59	1,041
20X2	1,041	104	59	1,086
20X3	1,086	109	59	1,136
20X4	1,136	113	59	1,190
20X5	1,190	119	1,250 + 59	-

Illustration 3-5: Effective interest method - stepped interest rates

On 1 January 20X1, Company A issues a debt instrument for a price of CU1,250 (including transaction costs). The principal amount is CU1,250 which is repayable on 31 December 20X5. The rate of interest is specified in the debt agreement as a percentage of the principal amount as follows: 6% in 20X1 (CU75), 8% in 20X2 (CU100), 10% in 20X3 (CU125), 12% in 20X4 (CU150) and 16.4% in 20X5 (CU205). It can be shown that the interest rate that exactly discounts the stream of future cash payments to maturity is 10%. In each period, the amortised cost at the beginning of the period is multiplied by the EIR of 10% and added to the gross carrying amount. Any cash payments in the period are deducted from the resulting balance. Accordingly, the gross carrying amount, interest income and cash flows of the debt instrument in each period are as follows: *[IFRS 9.IG B.27]*

	(a)	*(b = a × 10%)*	*(c)*	*(d = a + b - c)*
	Gross carrying amount at the start of the year	Interest income	Cash flows	Gross carrying amount at the end of the year
Year	(CU)	(CU)	(CU)	(CU)
20X1	1,250	125	75	1,300
20X2	1,300	130	100	1,330
20X3	1,330	133	125	1,338
20X4	1,338	134	150	1,322
20X5	1,322	133	1,250 + 205	-

It can be seen that, although the instrument is issued for CU1,250 and has a maturity amount of CU1,250, its gross carrying amount (i.e., the amortised cost) does not equal CU1,250 at each reporting date.

Methods for determining the EIR for a given set of cash flows (as in the Illustrations above) include simple trial and error techniques as well as more methodical iterative algorithms. Alternatively, many spreadsheet applications contain goal-seek or similar functions that can also be used to derive EIRs.

3.3 Floating interest rate instruments

In most cases, a floating rate will be specified as a benchmark rate, such as EURIBOR or SONIA, plus (or for a very highly rated borrower, less) a fixed credit spread. Hence it might be more accurate to say that the rate has a floating component and a fixed component. But it is also possible for the credit spread to be periodically reset to a market rate. Neither 'floating-rate' nor 'market rates of interest' are defined in the standard. However, the IFRS IC noted in its January 2016 agenda decision on separation of an embedded floor from a floating rate host contract that the term 'market rate of interest' is linked to the concept of fair value as defined in IFRS 13 and is described in IAS 39.AG64 as the rate of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating (or the equivalent in IFRS 9.B5.1.1).[4] This implies that the market rate of interest may include the credit spread appropriate for the transaction and not just the benchmark component of the rate.

4 *IFRIC Update*, January 2016, available on the IFRS Foundation's website.

For floating-rate instruments, the periodic re-estimation of cash flows to reflect the movements in the market interest rates alters the EIR. The standard goes on to explain that where a floating rate financial asset or a floating-rate financial liability is initially recognised at an amount equal to the principal receivable or repayable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or the liability. *[IFRS 9.B5.4.5]*. This is normally interpreted to mean that entities should simply account for periodic floating-rate payments on an accrual basis in the period they are earned. An alternative treatment would consist of calculating the EIR based on a market-derived yield curve applicable for the entire life of the instrument. Applying this alternative approach, the calculated EIR is applied until estimated future cash flows are revised, at which point a new EIR is calculated based on the revised cash flow expectations and the current carrying amount. This more complicated treatment is explained in the following Illustration in which it is assumed that the instrument meets the criteria for measurement at amortised cost under IFRS 9. This is in line with the IFRS IC's discussion on inflation-linked instruments in May 2008 (see section 3.6 below). Any proposed change in the use of either approach described above, would need to be assessed against the requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to determine whether this would represent a change in estimate or change in accounting policy. For more details see Chapter 3 at section 4.2.

Illustration 3-6: Effective interest method - variable rate loan

At the start of July 20X1, Company G originates a floating-rate debt instrument. Its fair value is equal to its principal amount of CU1,000 and no transaction costs are incurred. The instrument pays, in arrears at the end of June, a variable rate coupon, determined by reference to 12-month EURIBOR at the start of each previous July. It has a term of five years and is repayable at its principal amount at the end of June 20X6.

On origination, 12-month EURIBOR is 5% and this establishes the first payment, to be made in June 20X2, at CU50. Based on a market-derived yield curve, G estimates that the subsequent floating-rate payments will be CU60, CU70, CU80 and CU90 (the yield curve rises steeply). It can be demonstrated that the interest rate that exactly discounts these estimated coupon payments and the CU1,000 principal at maturity to the current carrying amount of CU1,000 is 6.87%. This would be the EIR for the debt instrument. The EIR is recalculated as and when the estimated future cash flows change.

In the context of applying IFRS 9.B5.4.5, principal is understood to be the fair value of the financial instrument at initial recognition, and importantly that the principal amount may change over the life of the instrument (for example, if there are repayments of principal) (see Chapter 44 at section 5.1). *[IFRS 9.B4.1.7B]*. This would mean that floating rate financial instruments where there are repayments over the life, for example a floating rate loan with capital repayments required over the life, would still fall into the scope of IFRS 9.B5.4.5.

3.4 Prepayment, call and similar options

When calculating the EIR, all contractual terms of the financial instrument, for example prepayment, call and similar options, should be taken into account in the estimate of expected cash flows. *[IFRS 9 Appendix A]*. This assumes that the presence of such contractual terms does not cause the contractual cash flow characteristics test to fail, i.e., the contractual terms of the debt instrument give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (see Chapter 44 at section 5). The following simple Illustration shows how this principle is applied.

Illustration 3-7: Effective interest rate - embedded prepayment options

Bank ABC originates 1,000 ten-year loans of CU10,000 with 10% stated interest, prepayable at par. Prepayments are probable and it is possible to reasonably estimate their timing and amount. ABC determines that the EIR including loan origination fees received by ABC is 10.2% based on the contractual payment terms of the loans as the fees received reduce the initial carrying amount.

However, if the *expected* prepayments were considered, the EIR would be 10.4% since the difference between the initial amount and maturity amount is amortised over a shorter period.

The EIR that should be used by ABC for the loans in this portfolio is 10.4%.[5]

5 IAS 39 Implementation Guidance Committee (IGC), Q&A 10-19, July 2001.

If a hybrid contract contains a host that is a liability within the scope of IFRS 9, any embedded derivative (e.g., a prepayment option) that is separated from the host must be accounted for as a derivative (see Chapter 42 at section 4 and section 5). *[IFRS 9.4.3.3]*. Once separated, the embedded derivative should not be taken into account in applying the effective interest method of the host. However, if the embedded derivative is closely related and not separated from the host instrument, entities that measure the whole instrument at amortised cost must apply the effective interest method inclusive of the embedded derivative to determine the amount of interest to be recognised in profit or loss for each period (see Chapter 42 at section 3).

3.4.1 Revisions to estimated cash flows

The standard contains an explanation of how changes to estimates of payments or receipts (e.g., because of a reassessment of the extent to which prepayments will occur) should be dealt with.

When there is a change in estimates of payments or receipts, excluding changes in estimates of ECLs, the gross carrying amount of the financial asset or amortised cost of a financial liability (or group of instruments) should be adjusted to reflect actual and revised estimated cash flows. More precisely, the gross carrying amount of the financial asset or amortised cost of the financial liability should be recalculated by computing the present value of estimated future contractual cash flows that are discounted at the financial instrument's original EIR. Any consequent adjustment should be recognised immediately in profit or loss. *[IFRS 9.B5.4.6]*.

The revision of estimates is demonstrated in the following Illustration adapted from the Implementation Guidance to the IFRS accounting standard. *[IFRS 9.IG B.26]*.

Illustration 3-8: Effective interest method - revision of estimates

At the start of 20X1, a company purchases in a quoted market a debt instrument with five years remaining to maturity for its fair value of CU1,000 (including transaction costs). The instrument has a principal amount of CU1,250 and carries fixed interest of 4.7% payable annually (CU1,250 × 4.7% = CU59 per year). In order to allocate interest receipts and the initial discount over the term of the instrument at a constant rate on the carrying amount, it can be shown that interest needs to be accrued at the rate of 10% annually. In each period, the amortised cost at the beginning of the period is multiplied by the EIR of 10% and added to the gross carrying amount. Any cash payments in the period are deducted from the resulting balance.

In effect, this instrument has the same terms as the instrument in Illustration 3-4 in section 3.2 above, except that the contract also specifies that the borrower has an option to prepay the instrument and that no penalty will be charged for prepayment (i.e., any prepayment will be made at the principal amount of CU1,250 or a proportion thereof).

At inception, there is an expectation that the borrower will not prepay and so the information about the instrument's EIR, gross carrying amount, interest income and cash flows in each reporting period would be the same as that in Illustration 3-4 above. The table is repeated below and provides information about the gross carrying amount, interest income, and cash flows of the debt instrument in each reporting period.

	(a)	*(b = a × 10%)*	*(c)*	*(d = a + b - c)*
	Gross carrying amount at the start of the year	**Interest income**	**Cash flows**	**Gross carrying amount at the end of the year**
Year	**(CU)**	**(CU)**	**(CU)**	**(CU)**
20X1	1,000	100	59	1,041
20X2	1,041	104	59	1,086
20X3	1,086	109	59	1,136
20X4	1,136	113	59	1,190
20X5	1,190	119	1,250 + 59	-

On the first day of 20X3, the investor revises its estimate of cash flows. It now expects that 50% of the principal will be prepaid at the end of 20X3 and the remaining 50% at the end of 20X5. Therefore, the opening balance of the debt instrument in 20X3 is adjusted to an amount calculated by discounting the amounts expected to be received in 20X3 and subsequent years using the original EIR (10%). This results in a revised balance of CU1,138. The adjustment of CU52 (CU1,138 - CU1,086) is recorded in profit or loss in 20X3.

The table below provides information about the gross carrying amount, interest income and cash flows as they would be adjusted taking into account this change in estimate.

	(a)	*(b = a × 10%)*	*(c)*	*(d = a + b - c)*
	Gross carrying amount at start of year	Interest and similar income	Cash flows	Gross carrying amount at end of year
Year	(CU)	(CU)	(CU)	(CU)
20X1	1,000	100	59	1,041
20X2	1,041	104	59	1,086
20X3	1,086 + 52	114	625 + 59	568
20X4	568	57	30	595
20X5	595	60	625 + 30	-

This above calculation would be applicable whether the instruments were classified as measured at amortised cost or fair value through other comprehensive income under IFRS 9.

The standard and its related guidance do not state whether the catch-up adjustment in the Illustration above (CU52 in 20X3 in this case) should be classified as interest income or as some other income or expense, simply that it should be recognised in profit or loss.

This Illustration assumes that the prepayment option does not cause the debt financial asset to fail to comply with the amortised cost classification criteria. For this to be the case, the fair value of the prepayment feature on initial recognition would have to be insignificant. *[IFRS 9.4.1.2(b), IFRS 9.B4.1.12]*.

3.5 Perpetual debt instruments

Accounting for perpetual debt instruments is discussed in Chapter 43 at section 4.7. The fact that an instrument is perpetual does not change how the gross carrying amount is calculated. The present value of the perpetual stream of future cash payments, discounted at the EIR, equals the gross carrying amount in each period. *[IFRS 9.IG B.24]*.

However, in cases where interest is only paid over a limited amount of time, some or all the interest payments are, from an economic perspective, repayments of the gross carrying amount, as illustrated in the following Illustration. *[IFRS 9.IG B.25]*.

Illustration 3-9: Amortised cost - perpetual debt with interest payments over a limited amount of time

On 1 January 20X1, Company A subscribes CU1,000 for a perpetual debt instrument which yields 25% interest for the first five years and 0% in subsequent periods. The instrument is classified as measured at amortised cost. It can be determined that the effective yield is 7.93% and the gross carrying amount is shown in the table below.

	(a)	*(b = a × 7.93%)*	*(c)*	*(d = a + b - c)*
	Gross carrying amount at the start of the year	Interest income	Cash flows	Gross carrying amount at the end of the year
Year	(CU)	(CU)	(CU)	(CU)
20X1	1,000	79	250	829
20X2	829	66	250	645
20X3	645	51	250	446
20X4	446	36	250	232
20X5	232	18	250	-
20X6	-	-	-	-

3.6 Inflation-linked debt instruments

As noted in Chapter 42 at section 4.1.5, the issue of debt instruments whose cash flows are linked to changes in an inflation index is quite common. IFRS 9 often allows inflation-linked financial assets to be recorded at amortised cost or at fair value through other comprehensive income, as shown in Illustration 5-2 in Chapter 44 at section 5.3.5. Entities that record these instruments at amortised cost must apply the effective interest method to determine the amount of interest to be recognised in profit or loss for each period. In May 2008, the IFRS IC was asked to consider a request for guidance on this issue. The key issue is whether the changes in the cash flows on inflation-linked debt are equivalent to a repricing to the market rate and, therefore, inflation-linked debt can be treated as a floating rate instrument. Three ways of applying the effective interest method that were being used in practice were included in the request. These are summarised in the following Illustration that has been revised to reflect the requirements in IFRS 9 instead of IAS 39.[6]

Illustration 3-10: Application of the effective interest method to inflation-linked debt instruments

On 1 January 20X1, Company A issues a debt instrument for CU100,000 that is linked to the local Consumer Prices Index (CPI). The terms of the instrument require it to be repaid in full after five years at an amount equal to CU100,000 adjusted by the cumulative change in the CPI over those five years. Interest on the loan is paid at each year end at an amount equal to 5% of the principal (CU100,000) adjusted by the cumulative change in the CPI from issuance of the instrument. For IFRS 9 purposes, it is assumed that the debt instrument is not held for trading or designated at fair value through profit or loss and thereby, the debt instrument is classified as subsequently measured at amortised cost.

The following table sets out the expected annual inflation rates on issuance of the instrument and one year later:

	Expected annual inflation rates	
	At start of 20X1	*At start of 20X2*
20X1	0.7%	1.2%
20X2	2.6%	1.4%
20X3	2.8%	1.9%
20X4	2.8%	3.5%
20X5	2.8%	3.5%

During 20X1, actual inflation is 1.2%.

Approach 1 - application of IFRS 9.B5.4.6 (or the previous IAS 39.AG8 approach)

This approach follows the requirements set out in section 3.4.1 above. As outlined below, it does not view the debt as a floating-rate instrument and so calculates a fixed EIR. This is established on 1 January 20X1 based on expected cash flows at that time:

Date: end of	Expected cash flow	Calculation
	(CU)	
20X1	5,035	=5,000 × 1.007
20X2	5,166	=5,000 × 1.007 × 1.026
20X3	5,311	=5,000 × 1.007 × 1.026 × 1.028
20X4	5,459	=5,000 × 1.007 × 1.026 × 1.028 × 1.028
20X5	117,854	=105,000 × 1.007 × 1.026 × 1.028 × 1.028 × 1.028

It can be demonstrated that these expected cash flows produce an EIR of 7.4075%, i.e., the net present value of these cash flows, discounted at 7.4075%, equals CU100,000.

During 20X1, A applies the EIR to the financial liability to recognise an interest expense of CU7,408 (CU100,000 × 7.4075%), increasing the carrying amount of the financial liability to CU107,408 (CU100,000 + CU7,408). At the end of the year, A pays cash interest of CU5,060 (CU5,000 × 101.2%) reducing the liability to CU102,348 (CU107,408 - CU5,060). In addition, A must adjust the carrying amount of the financial liability so that it equals the net present value of expected future cash flows discounted at the original expected interest rate as determined based on original expectations.

6 *IFRIC Update*, July 2008, available on the IFRS Foundation's website.

The expected future cash flows are now as follows:

Date: end of	Cash flow	Calculation
	(CU)	
20X2	5,131	=5,000 × 1.012 × 1.014
20X3	5,228	=5,000 × 1.012 × 1.014 × 1.019
20X4	5,411	=5,000 × 1.012 × 1.014 × 1.019 × 1.035
20X5	117,615	=105,000 × 1.012 × 1.014 × 1.019 × 1.035 × 1.035

The net present value of these cash flows discounted at 7.4075% is CU102,050. Therefore, A recognises a gain as a result of the revision of estimated cash flows in profit and loss of CU298 (CU102,050 - CU102,348).

Approach 2 - application of IFRS 9.B5.4.5 using forecast future cash flows (or the previous IAS 39 AG7 approach)

This approach is referred to in section 3.3 above for simple floating-rate instruments. In outline, it calculates a floating-rate EIR based on current market expectations of future inflation.

The initial EIR is calculated and applied in the same way as Approach 1. However, no adjustment is made to the carrying amount of the financial liability at the end of 20X1 of CU102,348 or to the interest expense for 20X1 CU7,408 (CU100,000 × 7.4075%) as a result of A revising its expectations about inflation over the remaining term of the instrument at the start of 20X1.

Instead, a revised EIR is calculated at the start of 20X2 using the revised forecast cash flows (shown above under Approach 1, i.e., CU5,131 at the end of 20X2, CU5,228 at the end of 20X3, CU5,411 at the end of 20X4 and CU117,615 at the end of 20X5) and the current carrying amount (CU102,348). It can be demonstrated that this produces a revised EIR of 7.3236%, i.e., the net present value of those cash flows, discounted at 7.3236% equals CU102,348.

Applying this revised rate prospectively in 20X2 (and assuming estimates of future inflation are not revised again until the start of 20X3) there will be interest expense for 20X2 of CU7,496 (CU102,348 × 7.3236%).

Approach 3 - application of IFRS 9 B5.4.5 without forecasting future cash flows

This method is based on the traditional approach of accounting for floating-rate debt instruments and is commonly used under other bodies of GAAP. Rather than taking account of expectations of future inflation it takes account of inflation only during the reporting period.

Therefore, in 20X1, A would recognise interest expense of CU5,060 (CU100,000 × 5% × 1.012) as a result of accruing the variable interest payment in respect of 20X1. In addition, the actual inflation experienced during 20X1 increases the amount of principal that will be paid from CU100,000 to CU101,200 (CU100,000 × 1.012%). This increase, i.e., CU1,200, is effectively a premium to be paid on the redemption of the financial liability. IFRS 9 explains that a premium should normally be amortised over the expected life of an instrument. However, it goes on to explain that a shorter period should be used if this is the period to which the premium relates. *[IFRS 9.B5.4.4]*. In this case, the premium clearly relates to 20X1 as it arises from inflation during that year and so it is appropriately amortised in that year.

Consequently, the total interest expense for 20X1 using this approach would be CU6,260 (CU5,060 + CU1,200).

In analysing the submission, it initially appeared as if the IFRS IC staff completely rejected Approach 3. The submission argued that Approach 3 was justified by reference to IAS 29 *Financial Reporting in Hyperinflationary Economies*. The staff concluded that it was inappropriate to apply IAS 29 because that standard applies only to the financial statements of an entity whose functional currency is the currency of a hyperinflationary economy and instead the guidance in IAS 39 should be applied.

However, in their final rejection notice the IFRS IC noted that IAS 39.AG6 to AG8 provide the relevant application guidance and that judgement is required to determine whether an instrument is floating-rate and within the scope of IAS 39.AG7 or is within the scope of IAS 39.AG8.[7] Further, it was noted that IAS 39 was unclear as to whether future expectations about interest rates (and presumably, therefore, inflation) should be taken into account when applying IAS 39.AG7. This would appear to suggest that all three approaches noted in the Illustration would be consistent with the requirements of IAS 39 and therefore, since the requirements are unchanged, of IFRS 9. Any proposed change in the approach used by an entity would need to be assessed against the requirements of IAS 8 to determine whether this would represent a change in estimate or change in accounting policy. For more details see Chapter 3 at section 4.2.

7 *IFRIC Update*, July 2008, available on the IFRS Foundation's website.

3.7 Financial liabilities

3.7.1 Amortised cost financial liabilities with embedded features

Under IFRS 9, most complex financial assets are accounted for at fair value through profit or loss. The treatment of financial liabilities is, however, unchanged from that under IAS 39. The application of the effective interest method to liabilities with embedded derivatives that are deemed closely related to the host, or other embedded features not deemed to meet the definition of a derivative, is not always straightforward or intuitive. Specifically, it is not always clear how to deal with changes in the estimated cash flows of the instrument and in any given situation one needs to assess which is the most appropriate approach:

- The general requirements for changes in cash flows set out in IFRS 9.B5.4.6, equivalent to the previous IAS 39 AG8 approach, assuming a fixed original EIR (see section 3.4.1 above).

  Or

- Specific requirements for floating-rate instruments under IFRS 9.B5.4.5, equivalent to the previous IAS 39 AG7 approach (see section 3.3 above).

To illustrate the differences between the two approaches, consider an entity that issues a debt instrument for its par value of CU10m which is repayable in ten years' time on which an annual coupon is payable comprising two elements: a fixed amount of 2.5% of the par value and a variable amount equating to 0.01% of the entity's annual revenues. The instrument is not designated at fair value through profit or loss and it is judged that the embedded feature is not a derivative as outlined in Illustration 1-5 in Chapter 42 at section 1.1.3.

The requirements under IFRS 9.B5.4.5 and IFRS 9.B5.4.6 could give rise to significantly different accounting treatments. In the latter case, the issuer would need to estimate the amount of payments to be made over the life of the bond (which will depend on its estimated revenues for the next ten years) in order to determine the EIR to be applied. Any changes to these estimates would result in a catch-up adjustment, based on the rate as estimated on origination, to profit or loss and the carrying amount of the bond which, potentially, could give rise to significant volatility. In the former case the annual coupon would simply be accrued each year and changes in estimated revenues of future periods would have no impact on the accounting treatment until the applicable year.

In 2009, the IFRS IC was asked for guidance on how an issuer should account for a financial liability that contains participation rights by which the instrument holder shares in the net income and losses of the issuer. The holder receives a percentage of the issuer's net income and is allocated a proportional share of the issuer's losses. Losses are applied to the nominal value of the instrument to be repaid on maturity. Losses allocated to the holder in one period can be offset by profits in subsequent periods. The submission was asking how the issuer should account for such instruments in periods in which the issuer records a loss and allocates a portion of that loss to the participating financial instruments. Two possible views were submitted to IFRS IC:

- In the first view the requirements in IAS 39.AG8 (equivalent to IFRS 9.B5.4.6) do not apply. Rather, the requirements for derecognition should be applied and a gain equal to the allocated loss should be recognised in the current period (with an offsetting reduction in the carrying amount of the instrument).
- In a second view, the requirements in IAS 39.AG8 (equivalent to IFRS 9.B5.4.6) apply. Current period losses are one factor that the issuer would consider when it evaluates whether it needs to revise its estimated future cash flows and adjust the carrying amount of the participating financial instrument.

The IFRS IC noted that IAS 39.AG6 and AG8 (equivalent to IFRS 9.B5.4.4. and IFRS 9.B5.4.6) provide the relevant application guidance for measuring financial liabilities at amortised cost using the EIR method. The IFRS IC also noted that it was inappropriate to analogise to the derecognition guidance in IAS 39 because the liability has not been extinguished. Therefore, a gain equal to the allocated loss should not be recognised in the current period. Rather, current period losses should be considered together with further expectations when the issuer evaluates the need to revise its estimated future cash flows and adjust the carrying amount of the participating financial instrument.

It should be noted that the IFRS IC considered the issue without reconsidering the assumptions described in the request, namely that the financial liability: (a) did not contain any embedded derivatives, (b) was measured at amortised cost using the effective interest method, and (c) did not meet the definition of a floating-rate instrument.[8]

8 *IFRIC Update*, May 2009, available on the IFRS Foundation's website.

How we see it

In these situations, we believe that it would often be inappropriate to apply the requirements under IFRS 9.B5.4.5, principally because the entity's revenue does not represent a floating-rate that changes to reflect movements in market rates of interest. However, IFRS 9 does not contain clear guidance on how the expected cash flows are estimated when calculating EIR. Consequently, the EIR should be determined by estimating what the resultant cashflows will be. This may involve the use of judgement or assumptions based on the latest available, reliable information. The expected cash flows could be estimated using the most likely outcome method or a probability-weighted approach. The estimation technique used should remain consistent, unless there are changes in the circumstances on which the accounting estimate was based or as a result of new information, new developments or more experience.

In determining which estimation technique to use (i.e., the most likely outcome or a probability-weighted method), an entity could consider the principles in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* for determining a best estimate, see Chapter 27 section 4.1, as well as the principles in IFRIC 23 *Uncertainty over Income Tax Treatments* which requires an entity to use whichever method better predicts the resolution of the uncertainty, see Chapter 29 section 9.4.

There are some financial liabilities for which re-estimation of cash flows will only reflect movements in market interest rates but for which the use of IFRS 9.B5.4.5 would, arguably, not be appropriate. An example would be an 'inverse floater', on which coupons are paid at a fixed-rate minus EURIBOR (subject to a floor of zero).

For some financial liabilities, it might be considered appropriate to apply a combination of both the IFRS 9.B5.4.5 and IFRS 9.B5.4.6 approaches. An example would be the situation outlined above where the liability contains participation features, together with a floating rate element. In these situations, the EIR would be a combination of the current floating rate and initial expected revenue assumptions. IFRS 9.B5.4.6. would be applied to the revision of expected revenues, but the remainder of the interest coupon would be the floating-rate (also see section 3.3 above and section 3.8.1 below where further situations are outlined where a combination of both the IFRS 9.B5.4.5 and IFRS 9.B5.4.6 would be required).

In addition to determining whether IFRS 9.B5.4.5 or IFRS 9.B5.4.6 is applicable, there are further complexities involving the estimation of the expected cash flows both initially, and if required, on revision of the cashflows. There are also complications when distinguishing between a partial derecognition and a modification, and accounting for fees and costs as a result of modifying the original contract. To a large extent these complexities were raised as part of IFRS 9 PIR (see section 3.8.4 below).

3.7.2 Amortised cost financial liabilities with contractual linkage features

Another complex area is the accounting for a financial liability in a securitisation structure where a special purpose entity (SPE) invests in a portfolio of loans and raises funds by issuing listed non-recourse notes to investors. The SPE's contractual obligations on the listed notes are linked to the performance of the loans less the interest spread. This contractual linkage feature, where any losses suffered on the loans will be borne by the noteholders, will be accounted for as part of the listed notes liability. Consequently, the EIR of the notes will reflect an estimate of any expected cash shortfalls arising from credit losses on the underlying loan assets (since this affects the contractual payments required on the notes) *[IFRS 9.BCZ5.67]*.

With regards to how the expected cash flows are estimated when calculating EIR, IFRS 9 does not contain clear guidance. Consequently, the EIR should be determined by estimating what the resultant cashflows will be. This may involve the use of judgement or assumptions based on the latest available, reliable information. *[IAS 8.32]*. The expected cash flows could be estimated using the most likely outcome method or a probability-weighted approach. In determining which estimation technique to use (i.e., the most likely outcome or a probability-weighted method), an entity could consider the principles in IAS 37 for determining a best estimate, see Chapter 27 section 4.1, as well as the principles in IFRIC 23 which requires an entity to use whichever method better predicts the resolution of the uncertainty, see Chapter 29 section 9.4. The estimation technique used should remain consistent, unless there are changes in the circumstances on which the accounting estimate was based or as a result of new information, new developments or more experience. *[IAS 8.34]*. Any revisions to the estimated contractual cash payments on the listed notes due to the linkage feature should be accounted for as an adjustment to the amortised cost of the noteholder liability (discounted at the effective interest rate) and recognised in profit or loss (for more details, see Chapter 47 at section 7.7). *[IFRS 9.B5.4.6]*.

3.7.3 Amortised cost financial liabilities with contingent demand features

As discussed in section 3.4 above, the definition of effective interest rate makes it clear that entities are required to take prepayment, call and similar options into account when determining the EIR of a financial instrument. There are situations where the ability to exercise these options may be contingent on some future event. The Illustration below shows how an entity may need to revise its estimate of payments in the event that an entity breaches a debt covenant and the loan becomes repayable on demand.

Illustration 3-11: Loan repayable on demand due to breach of a covenant

Entity X (the borrower) borrows CU1,000 from Bank Y (the lender) at the beginning of 20X1. The loan attracts interest at a floating rate and is repayable in five years' time (i.e., at the end of 20X5). The borrower incurs transaction costs amounting to CU50. In the event that there is a breach of covenant, the financial liability becomes repayable on demand at the option of the lender.

Key assumptions:

- The loan is measured at amortised cost.
- At the end of the reporting period 20X3, Entity X has breached its debt covenant.
- The value of unamortised transaction costs at the end of 20X3 is CU20.

Analysis:

The loan contract provides Bank Y (the lender) with an option to demand repayment of the loan in the event that Entity X (the borrower) breaches a covenant. In determining the period over which the transaction costs should be amortised, Entity X would have had to assess the probability of the early repayment option being triggered and exercised at initial recognition. This would require an assessment of:

a) The likelihood of the option becoming exercisable (taking into account the probability of Entity X breaching covenants).

   And

b) The likelihood of the bank exercising its option in that instance.

This estimate could be determined using a most likely outcome approach or a probability-weighted approach, depending on the specific facts and circumstances. Any subsequent revision of the estimates of cash flows would need to be accounted for in accordance with IFRS 9.B5.4.6.

As a result of Entity X breaching its covenant at the end of 20X3 and the liability becoming repayable on demand at the option of the Bank Y, Entity X, as part of its re-estimation of the cash flows, would need to update its assessment of whether the bank is expected to exercise its option to demand repayment. The period over which the transaction costs are to be amortised would need to be updated accordingly. The gross carrying amount of the financial liability would need to be updated for any change in such estimate, with any consequential adjustment being recognised in profit or loss. *[IFRS 9.B5.4.6]*. In some cases, the entity may not have sufficient information to determine whether the lender will demand repayment of the loan, in which case it may be appropriate to accelerate the amortisation of the remaining unamortised transaction costs.

The assumptions that the borrower makes regarding whether the bank will demand repayment, should be consistent with the assumptions used for assessing the entity's ability to continue as a going concern.

How we see it

In the Illustration above, the loan (financial liability) is measured initially at fair value and subsequently at amortised cost. If the loan was subsequently measured at fair value, then the entity would have to consider IFRS 13.47 which requires that the fair value of a financial liability with a demand feature, is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. However, as illustrated above, where a loan that is subsequently measured at amortised cost becomes repayable on demand at some point after initial recognition, e.g., as result of a covenant breach, then the principles of IFRS 13.47 would not be applicable. Therefore, the amortisation of the remaining unamortised transaction costs would not necessarily need to be accelerated such that the loan reflects the amount that could be demanded by the bank. Rather in such a case, same as before the covenant breach, the amortised cost loan would need to be remeasured taking into account the entity's revised estimate of cash flows. This estimate would involve the use of judgement or assumptions based on the latest available, reliable information, including the status of negotiations with the bank and how this impacts the probability and timing of the bank demanding repayment.

The Illustration above explains how an entity needs to revise its estimate of the timing of cash flows in the event of breaching a covenant, and the loan becoming repayable on demand. In determining which estimation technique to use (i.e., the most likely outcome or a probability-weighted method), an entity could consider the principles in IAS 37 for determining a best estimate, see Chapter 27 section 4.1, as well as the principles in IFRIC 23 which requires an entity to use whichever method better predicts the resolution of the uncertainty, see Chapter 29 section 9.4.

An entity would also need to update its liquidity risk disclosures in response to the loan becoming repayable on demand. Refer to Chapter 50 at section 5.4 for further information. The assessment of whether the liability should be presented in the statement of financial position (as either current or non-current) is separate from the measurement considerations. In the above Illustration given that the breach occurred prior to the end of the reporting period, and there was no renegotiation of the terms of the loan that were concluded by period end, the loan would be classified as current. This would be the case regardless of whether the entity expects the bank to demand repayment or whether there is an expectation that the terms of the loan will be renegotiated. Refer to Chapter 3 at section 3.1.4 for further information.

3.8 Modified financial assets and liabilities

3.8.1 Accounting for modifications that do not result in derecognition

When the contractual cash flows of a financial asset are renegotiated or otherwise modified and the renegotiation or modification does not result in the derecognition of that financial asset (see Chapter 48 at section 3.5.1), an entity recalculates the gross carrying amount of the financial asset and recognises a modification gain or loss in profit or loss. The gross carrying amount of the financial asset is recalculated as the present value of the renegotiated or modified contractual cash flows that are discounted at the financial asset's original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets - see section 3.1.2 above). Any costs or fees incurred adjust the carrying amount of the modified financial asset and are amortised over the remaining term of the modified financial asset (see section 3.8.2 below). *[IFRS 9.5.4.3]*. This results in a revision of the original EIR (see section 3.8.2 below).

The accounting for modifications of financial assets that do not result in derecognition is similar to changes in estimates (see section 3.4.1 above), i.e., the original EIR is retained and there is a catch-up adjustment to profit or loss for the change in expected cash flows discounted at the original EIR. *[IFRS 9.B5.4.6]*. For example, this would be applicable where a borrower is granted a concession to delay interest payments if the entity concludes that the change in the terms is not a substantial modification and therefore does not result in the derecognition of the original loan and the recognition of a new loan.

In October 2017, the Board added wording to the Basis for Conclusions of IFRS 9 as part of the amendment for prepayment features with negative compensation (see Chapter 44 at section 5.4.4.A). This addition states that the requirements in IFRS 9 for adjusting the amortised cost of a financial liability when a modification (or exchange) does not result in the derecognition of the financial liability are consistent with the requirements for adjusting the gross carrying amount of a financial asset when a modification does not result in the derecognition of the financial asset. It adds that the requirements in IFRS 9 therefore provide an adequate basis for an entity to account for modifications and exchanges of financial liabilities that do not result in derecognition. *[IFRS 9.BC4.252, IFRS 9.BC4.253]*. Therefore IFRS 9 requires modifications of financial liabilities that do not result in derecognition to be accounted for similarly to modifications of financial assets. The amortised cost of the financial liability should be recalculated by computing the present value of estimated future contractual cash flows that are discounted at the financial instrument's original EIR. Any consequent adjustment should be recognised immediately in profit or loss. Any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability. *[IFRS 9.B3.3.6]*. This results in a revision of the original EIR (see section 3.8.2 below for more details on the treatment of modification fees, and the examples in Chapter 48 at section 6.2.5 and section 6.2.6).

In certain instances judgement may need to be applied to identify whether the substance of a payment made by a borrower to the lender represents additional interest or payment of principal to be accounted for as a modification of cash flows (in line with IFRS 9.BC4.253) rather than a transaction cost (in line with IFRS 9.B3.3.6) (see also Chapter 48 at section 6.2.5 to 6.2.7).

When the terms of a financial instrument are amended, application of the standard's guidance on modifications raises questions as to what the 'original effective interest rate' actually means, in particular when the original contractual terms introduce some form of variability in the rate. This has led to more general questions about when it may be appropriate to apply a prospective change to the effective interest rate in accordance with IFRS 9.B5.4.5, assuming the effective interest rate has a variable component, rather than applying a fixed effective interest rate. The following Illustrations focus on whether the changes in terms constitute a modification or whether it may be appropriate to apply IFRS 9.B5.4.5. The accounting treatment is clear in some of the fact patterns whilst an element of interpretation is required in others. These Illustrations address the accounting from the lender's perspective but are applicable to both financial assets and financial liabilities, since the same modification requirements apply to both, as discussed above.

Illustration 3-12: Changes in credit spread

Fact Pattern 1: A ratchet loan with a rate reset

Bank A issues a ratchet loan whereby the credit spread is increased in accordance with a scale of predetermined rates, on the occurrence of one or more predetermined events that are linked to the borrower's financial covenants (e.g., debt and equity or interest coverage ratios). These clauses are included to avoid the need to renegotiate the loan when the credit risk of the borrower changes and are considered to meet the standard's requirements for the loan to be recorded at amortised cost for the holder.

Analysis:

The credit spread is reset to reflect changes in credit risk and credit spreads are a component of a market interest rate as indicated by the January 2016 IFRS IC agenda decision (see section 3.1 above). Consequently, it would be appropriate to apply the guidance in B5.4.5. and account for the changes in the EIR prospectively on an accrual basis. *[IFRS 9.B5.4.5]*.

How we see it

For a vanilla floating rate loan (e.g., at EURIBOR plus 2%), it is widely accepted that resetting only the benchmark component of the rate would be regarded as a change in EIR in accordance with IFRS 9.B5.4.5. Similarly, in our view, resetting only the credit spread component when the reset is predetermined at inception can be regarded as a change in EIR as it is considered a component of the market interest rate. Although the amount of the reset is specified at inception rather than being the market credit spread at the reset date, this may be accounted for as a reset of the EIR provided that the predetermined rate changes reasonably approximate the market rates for the different credit qualities as observed at inception.

Fact Pattern 2: Renegotiation of loan covenant in return for a higher credit spread

Company B has a term loan which pays interest at EURIBOR plus 2% (assume the EIR is also EURIBOR plus 2% as there were no transaction costs, fees, discount nor premium). Company B is close to breaching a covenant, and as they would generally be unable to prepay in the case of a covenant breach, they renegotiate the loan to adjust the covenant in return for increasing the credit spread applied to the loan to 3%. The revised credit spread reflects the amended terms of the loan and Company B's current credit risk.

Analysis:

The change in rate results solely from a renegotiation of the terms and this change was not specified in the contract at inception. Unless it was specified in the original terms that the credit spread would be reset to predetermined rates based on specific events, the change should be treated as a modification in accordance with IFRS 9.5.4.3. This would mean retaining the original EIR of EURIBOR plus 2%, resulting in the computation and recognition of a gain or loss based on the change of spread discounted at this rate. *[IFRS 9.5.4.3]*.

Illustration 3-13: Modification - troubled debt restructuring

Company B enters into a fixed rate term loan. A few years later, the company is in financial difficulty and renegotiates with the lender to reduce or defer some of the payments due under the loan. The changes in the terms of the loan are not considered to result in a substantial modification and therefore it is not appropriate to derecognise the entire loan. This renegotiation is also not treated as a partial derecognition (see Chapter 48 at sections 3.4 and 3.5.1).

Analysis:

As the changes to the payments are not as a result of movements in market interest rates and this change was not specified in the contract at inception, it should be treated as a modification in accordance with IFRS 9.5.4.3. This would mean retaining the original fixed rate EIR, resulting in the computation and recognition of a gain or loss based on the change in the contractual payments discounted at this rate. *[IFRS 9.5.4.3]*.

Illustration 3-14: Modification - renegotiation of a fixed rate loan

Fact pattern 1: Renegotiation of a non-prepayable fixed rate loan with a partial rate reset

Company C has had a fixed-rate loan for several years, during which time the market interest rate has fallen. The terms of the loan do not include any ability for the company to prepay. Company C renegotiates the loan with the bank, to reduce the future interest payments to reflect a partial reset of the benchmark rate component of the rate. There has been no change in the credit risk or credit spread applicable to the loan and there are no other changes to the terms.

Analysis:

The change in rate results solely from a renegotiation of the terms and there was no existing prepayment option that would allow Company C to prepay and re-enter into a new loan with the revised rate. Consequently, the change should be treated as a modification in accordance with IFRS 9.5.4.3. This would mean retaining the original fixed rate EIR, resulting in the computation and recognition of a gain or loss based on the change in rate discounted at the original fixed EIR. *[IFRS 9.5.4.3]*.

Fact pattern 2: Renegotiation of fixed rate loan that is prepayable at par to a current market rate

Company D has a fixed rate loan that is prepayable at par, i.e., for unpaid principal and interest[9], at any time with no penalty. Company D renegotiates the terms of the loan with the lender to a new fixed market rate of interest. The renegotiation is assumed not to be considered a substantial modification.

How we see it

The standard is unclear on how to treat this fact pattern. In such circumstances, in our view, the lender may apply its judgement and select an appropriate accounting policy as shown in the analysis below.

Analysis:

Derecognition: The revision of the rate is in substance a settlement of the existing loan through the exercise of the prepayment option and commencement of a new loan at the market rate of interest. The cash flows of the original loan are deemed to have expired and should be derecognised with a corresponding new loan recognised at fair value on initial recognition. *[IFRS 9.3.2.3]*.

Modification - keeping the original EIR: The revision does not represent an expiry of the contractual cash flows and there was no actual prepayment of the loan. Since the rate reset is not specifically detailed in the contract at inception, the prepayment option is not viewed as a reset option. Accordingly, the revision is treated as a modification in accordance with IFRS 9.5.4.3. This would mean retaining the original fixed rate EIR, resulting in the computation and recognition of a gain or loss based on the change of rate discounted at the original fixed EIR. *[IFRS 9.5.4.3]*.

Modification - prospective change in EIR: The loan with a prepayment option at par with no penalty is considered analogous to a loan with an option to reset the interest rate to the then prevailing market rate. With such a prepayment option, Company D may prepay the fixed rate loan when interest rates decrease and refinance at a market rate of interest with the same or different lender, or force the same lender to renegotiate the existing interest rate to a market rate of interest. In both cases, the current lender is not entitled to receive the original fixed-rate over the full maturity of the loan. Accordingly, although the renegotiation is treated as a modification, the EIR is adjusted to reflect the new fixed market rate.

Fact pattern 3: Renegotiation of a fixed rate loan that is prepayable with compensation for the change in benchmark interest rate

Company E has a prepayable fixed-rate loan whereby the prepayment amount includes reasonable additional compensation to compensate for the change in benchmark interest rates. The prepayment clause is considered to meet the standard's requirements for the loan to be recorded at amortised cost. Company E renegotiates the terms of the loan with the lender to a new fixed market rate of interest. The renegotiation is assumed not to be considered as a substantial modification.

How we see it

The standard is unclear on how to treat this fact pattern. In such circumstances, in our view the lender may apply its judgement and select an appropriate accounting policy, as shown in the analysis below.

9 This assumes that the loan was not purchased or originated at a premium or discount.

Analysis:

Derecognition: The revision of the rate is in substance a settlement of the existing loan through the exercise of the prepayment option to prepay at fair value and commencement of a new loan at the market rate of interest. The cash flows of the original loan are deemed to have expired and should be derecognised with a corresponding new loan recognised at fair value on initial recognition.

Modification - keeping the original EIR: The revision does not represent an expiry of the contractual cash flows and there was no actual prepayment of the loan. In addition, the rate reset is not specifically detailed in the contract at inception and the prepayment amount requires compensation for the change in rates which differs from Fact pattern 2 above whereby it prepays at par with no penalty. Consequently, the loan cannot be analogised to a loan with an option to reset the interest rate to the then prevailing market rate. The revision should therefore be treated as a modification in accordance with IFRS 9.5.4.3. This would mean retaining the original fixed rate EIR, resulting in the computation and recognition of a gain or loss based on the change of rate discounted at the original fixed EIR. *[IFRS 9.5.4.3]*. Note that if the maturity of the renegotiated loan is at the same time extended compared to the original loan (for example from 10 years to 15 years), the penalty paid to compensate the lender for the movements in market rate over the residual maturity of the original 10-year loan should be amortised over this remaining period only and not over the extended maturity from years 11 to 15, consistently with the guidance on EIR and amortisation periods (see section 3.1.1 above).

In some instances, new legislation may be enacted that modifies the contractual cashflows of a financial asset or liability. If the change in the contractual cash flows does not result in derecognition, the modification is accounted for as follows:

- If the legislation is enforceable automatically, then the modification of the contractual cashflows is accounted for when the legislation is enacted. *[IFRS 9.5.4.3]*.

  Or

- If the change in law allows the customer a choice in whether or not they want to participate, then the cashflows under the new legislation are estimated, and any resulting changes are treated as a modification. *[IFRS 9.5.4.3]*. Over time the estimated cashflows are reassessed, and any revisions to the cashflow estimates are treated as a change in estimate as outlined in section 3.4.1 above. *[IFRS 9.B5.4.6]*.

Under both scenarios described above, the modification of the cashflows as a result of the new legislation is treated in line with IFRS 9.5.4.3. However, in the second scenario, as the legislation is not automatically enforced, the impact on the cashflows will be estimated based on an assessment of the timing and number of customers that will take up the changes, and this estimate is subsequently re-assessed to determine any revisions required.

3.8.2 Treatment of modification fees

Assuming that the modification does not result in the derecognition of the financial asset, IFRS 9 requires that changes in the contractual cash flows of the asset are recognised in profit or loss and any costs or fees incurred adjust the carrying amount of the modified financial asset and are amortised over the remaining term of the modified financial asset together with any pre-existing unamortised fees (see Chapter 48 at section 6.2.5 for further discussions and examples). *[IFRS 9.5.4.3]*. Therefore, once the calculation of the modification gain or loss has been performed, the original EIR determined at initial recognition will be revised to reflect any new costs or fees incurred.

Illustration 3-15: Accounting treatment of modification fees

The terms of a loan are modified and the revised contractual cash flows discounted at the original EIR, determined at initial recognition, are CU5,000 (CU6,050 receivable in two years discounted at 10% per annum). If the bank incurs external costs related to the modification of CU50, e.g., for valuation of collateral and legal services, the original EIR of 10% will be revised to approximately 9%, i.e., the discount rate that discounts CU6,050 receivable in two years to a present value of CU5,050.

For modified financial assets, while the standard deals with 'costs and fees incurred', it is not as clear as to the appropriate treatment by the lender when modification fees are charged to the borrower. One view could be that they should be included in the modification gain or loss as they are part of the modified contractual cash flows and do not represent 'fees incurred'.

Alternatively, one might argue that the fees charged to the borrower would adjust the carrying amount of the loan. As a variation to the above Illustration, assume there are no external fees incurred by the lender, rather CU60 of fees are charged to the customer. The effect of this approach would be to revise the carrying amount of the loan to CU4,940 (CU5,000 - 60) and the EIR to 11%. This would be consistent with

the principle in IFRS 9.B5.4.2, which explains that origination and commitment fees are an integral part of the EIR and, therefore, amortised over the term of the financial asset in accordance with the effective interest method. *[IFRS 9.B5.4.2]*.

With respect to the accounting by a borrower of modification fees paid by a borrower, IFRS 9 requires that any transaction costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability. *[IFRS 9.B3.3.6]*. This results in a revision of the original EIR, as explained above. This is in line with IFRS 9.BC4.253 that explains that the amortised cost of a financial liability should be adjusted in the same way that the gross carrying amount of a financial asset is adjusted when a modification does not result in the derecognition of the financial asset. *[IFRS 9.BC4.253, IFRS 9.5.4.3]*.

Since costs and fees paid to the lender are amortised over the remaining term of the modified liability, while changes to future cash flows paid to the lender are recognised immediately in profit or loss, it is necessary to consider whether the substance of a payment is different from its form. This is discussed in more detail in Chapter 48 at section 6.2.6.

3.8.3 Interbank Offered Rate (IBOR) reform

As a result of the reforms mandated by global regulators following the financial crisis, benchmark interbank offered rates (IBORs) have largely been replaced by new benchmark rates known as Risk Free Rates (RFRs).[10] In 2018, the IASB commenced a project to consider the accounting implications of the reform and divided its work into two phases:

- Phase 1: addressed issues affecting financial reporting in the period before replacement of an existing IBOR.

  And

- Phase 2: focused on issues that affect financial reporting when an existing interest rate benchmark is replaced with an RFR.

The IASB completed its project and published the amendments to several standards, including IAS 39 and IFRS 9, corresponding to Phase 1 and Phase 2 in September 2019 and August 2020 respectively. More information about how the amendments are applied in practise and their accounting implications is provided in *Supplement: IBOR Reform*.

3.8.4 Post implementation review

The IASB completed the post implementation review of the classification and measurement requirements of IFRS 9 in 2022. In December 2022, the IASB issued a report[11] containing feedback from the classification and measurement PIR and noted the requirements are working as intended, however they noted that clarification was needed in certain areas to improve the understandability of the requirements. The feedback on the requirements for the modification of financial assets and financial liabilities was that there is diversity in practice in applying the requirements. Respondents recommended that additional application guidance be provided to improve consistency of application, including guidance on:

- What constitutes a modification
- When a modification leads to derecognition, including how to assess whether a modification is substantial, and when to use quantitative or qualitative factors (or both)
- What the difference between partial derecognition and a modification is, and what the subsequent accounting is for the remaining modified instrument
- Calculating and recognising a modification gain or loss (including where this should be recognised)
- The effect on the EIR of a modification (for example, when the interest changes from fixed to floating or *vice versa*)
- The accounting for unamortised transaction costs and any fees received as part of the modification

  And

- The meaning of 'fees and costs incurred' in IFRS 9.5.4.3

10 The transition for all GBP, EUR, CHF and JPY LIBOR settings and the one week and two-month USD LIBOR settings was 31 December 2021. The transition for overnight and 12-month USD LIBOR was 30 June 2023, with remaining synthetic USD LIBOR settings (1-month, 3-month and 6-month) set to cease on 30 September 2024.

11 Project Report and Feedback Statement: *Post-implementation Review, IFRS 9* Financial Instruments-*Classification and Measurement*, IASB, December 2022. Available on the IFRS Foundation's website.

Respondents also noted it would be helpful if the IASB provides further guidance on the requirements for the modification of financial assets and in particular:

- To what extent the reason for the modification (for example, forbearance versus on market-negotiations) affects whether a modification results in derecognition
- The relationship between modifications, the application of the EIR method and the expected credit loss requirements

The IASB acknowledged the potential intersection of the application of amortised cost accounting, modification accounting and expected credit losses. The IASB decided to add to its research project pipeline the "Amortised Cost Measurement" project which will consider whether the requirements for accounting for the modification of financial assets and financial liabilities, can be clarified in an effective manner. As discussed in section 3.1.3 above, the IASB has also completed the PIR of IFRS 9 impairment and decided to explore whether it can clarify the requirements for modification, derecognition and write-off of financial instruments and the consequential effect on recognition of expected credit losses as part of its project on Amortised Cost Measurement.[12]

12 IASB Staff Paper 27C: Project: *Post-implementation Review of IFRS 9*-Impairment, Topic: *Interaction of impairment requirements with other requirements*, IASB meeting, April 2024. Available on the IFRS Foundation's website.

4 Foreign currencies

4.1 Foreign currency instruments

The provisions of IAS 21 apply to transactions involving financial instruments in just the same way as they do for other transactions, although the manner in which certain hedges are accounted for can override its general requirements.

Consequently, the statement of financial position measurement of a foreign currency financial instrument is determined as follows:

- First, it is recorded and measured in the foreign currency in which it is denominated, whether it is carried at fair value, cost, or amortised cost.
- Second, that amount is retranslated to the entity's functional currency using the closing rate. *[IAS 21.23]*.

Profit and loss items associated with financial instruments, e.g., dividends receivable, interest payable or receivable and impairments, are recorded at the spot rate ruling when they arise (although average rates may be used when they represent an appropriate approximation to spot rates throughout the period).

The reporting of exchange differences in profit or loss or in other comprehensive income depends on whether the instrument is a monetary item (e.g., debt instruments) or a non-monetary item (e.g., an equity investment), and whether it is designated as part of a foreign currency cash flow hedge. (This excludes the translation of foreign entities which is addressed in section 4.2 below.)

Foreign exchange differences arising on retranslating monetary items, including debt instruments measured at fair value through other comprehensive income, are generally recognised in profit or loss. However, those exchange differences must be recognised in other comprehensive income for instruments designated as a hedging instrument in a cash flow hedge or in a hedge of a net investment in a foreign operation (except to the extent that there is hedge ineffectiveness). Exchange differences must also be recorded in other comprehensive income for a fair value hedge of an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income (see section 2.5 above and Chapter 49). *[IFRS 9.B5.7.2, IFRS 9.B5.7.2A]*.

Any changes in the carrying amount of a non-monetary item are recognised in profit or loss or in other comprehensive income in accordance with IFRS 9. For example, for an instrument that is measured at fair value through profit or loss, all subsequent fair value changes, including the effect of foreign exchange, are recognised in profit or loss. Similarly, for an investment in an equity instrument where an entity has made an irrevocable election to present in other comprehensive income subsequent changes in the fair value of the investment, the entire change in the carrying amount, including the effect of changes in foreign currency rates, is presented in other comprehensive income. *[IFRS 9.5.7.5, IFRS 9.B5.7.3, IFRS 9.IG E.3.4]*.

In cases where some portion of the change in carrying amount is recognised in profit or loss and some in other comprehensive income, e.g., if the amortised cost of a foreign currency bond measured at fair value through other comprehensive income has increased in the foreign currency (resulting in a gain in profit or loss) but its fair value has decreased in the foreign currency (resulting in a loss recognised in other comprehensive income), those two components cannot be offset for the purposes of determining gains or losses that should be recognised in profit or loss or in other comprehensive income. *[IFRS 9.IG E.3.4]*.

The Board developed the example below to illustrate the separation of the currency component for a financial asset that is measured at fair value through other comprehensive income in accordance with IFRS 9.4.1.2A. To simplify the example, the Board did not reflect the need to record expected credit losses. *[IFRS 9.IG E.3.2]*. A more complex illustration, including expected credit losses is included in Illustration 9-2 in Chapter 47 at section 9.2.

Illustration 4-1: Foreign currency debt security measured at fair value through other comprehensive income (separation of currency component)

On 31 December 20X1, Company A, whose functional currency is the euro, acquires a dollar bond for its fair value of $1,000. The bond has five years to maturity and a $1,250 principal, carries fixed interest of 4.7% paid annually ($1,250 × 4.7% = $59 per year), and has an effective interest rate of 10%.

A classifies the bond as subsequently measured at fair value through other comprehensive income in accordance with IFRS 9.4.1.2A, and thus recognises gains and losses in other comprehensive income. The exchange rate is initially $1 to €1.50 and the carrying amount of the bond is €1,500 ($1,000 × 1.50).

			€	€
Dr	Bond		1,500	
	Cr	Cash		1,500

On 31 December 20X2, the dollar has appreciated and the exchange rate is $1 to €2.00. The fair value of the bond is $1,060 and therefore its carrying amount is €2,120 ($1,060 × 2.00). Its amortised cost is $1,041 (or €2,082 = $1,041 × 2.00) and the cumulative gain or loss to be included in other comprehensive income is the difference between its fair value and amortised cost, i.e., a gain of €38 (€2,120 - €2,082; or, alternatively, [$1,060 - $1,041] × 2.00).

Interest received on the bond on 31 December 20X2 is $59 (or €118 = $59 × 2.00). Interest revenue determined in accordance with the effective interest method is $100 ($1,000 × 10%) of which $41 ($100 - $59) is the accretion of the initial discount.

It is assumed that the average exchange rate during the year is $1 to €1.75 and that the use of an average exchange rate provides a reliable approximation of the spot rates applicable to the accrual of interest during the year. Therefore, reported interest revenue is €175 ($100 × 1.75) including accretion of the initial discount of €72 ($41 × 1.75).

The exchange difference recognised in profit or loss is €525, which comprises three elements: a €500 gain from the retranslation of the initial amortised cost ($1,000 × [2.00 - 1.50]); a €15 gain from the retranslation of interest revenue received ($59 × [2.00 - 1.75]) and a €10 gain on the retranslation of the interest revenue accreted ($41 × [2.00 - 1.75]).

			€	€
Dr	Bond		620	
Dr	Cash		118	
	Cr	Interest revenue (P&L)		175
	Cr	Exchange gain (P&L)		525
	Cr	Fair value change in other comprehensive income (equity)		38

On 31 December 20X3, the dollar has appreciated further and the exchange rate is $1 to €2.50. The fair value of the bond is $1,070 and therefore its carrying amount is €2,675 ($1,070 × 2.50). Its amortised cost is $1,086 (or €2,715 = $1,086 × 2.50) and the cumulative gain or loss to be included in other comprehensive income is the difference between its fair value and the amortised cost, i.e., a loss of €40 (€2,675 - €2,715; or, alternatively, [$1,070 - $1,086] × 2.50). Therefore, there is a debit to other comprehensive income equal to the change in the difference during 20X2 of €78 (€40 + €38).

Interest received on the bond on 31 December 20X3 is $59 (or €148 = $59 × 2.50). Interest revenue determined in accordance with the effective interest method is $104 ($1,041 × 10%), of which $45 ($104 - $59) is the accretion of the initial discount.

Using the same assumptions as in the previous year, interest income is €234 ($104 × 2.25) including accretion of the initial discount of €101 ($45 × 2.25).

The exchange difference recognised in profit or loss is €547, which again comprises three elements: a €521 gain from the retranslation of the opening amortised cost ($1,041 × [2.50 - 2.00]); a €15 gain from the retranslation of interest income received ($59 × [2.50 - 2.25]) and an €11 gain on the retranslation of the interest income accreted ($45 × [2.50 - 2.25]).

			€	€
Dr	Bond		555	
Dr	Cash		148	
Dr	Fair value change in other comprehensive income (equity)		78	
	Cr	Interest revenue (P&L)		234
	Cr	Exchange gain (P&L)		547

4.2 Foreign entities

IFRS 9 did not amend the application of the net investment method of accounting for foreign entities set out in IAS 21 (see Chapter 16 at section 6.3.1). Therefore, for the purpose of preparing its own accounts for inclusion in consolidated accounts, a foreign entity that is part of a group applies the principles in section 4.1 above by reference to its own functional currency. Consequently, the treatment of gains and losses on, say, trading assets held by a foreign entity should follow the treatment in the Illustration below, adapted from the Implementation Guidance of IFRS 9. *[IFRS 9.IG E.3.3]*.

Illustration 4-2: Interaction of IAS 21 and IFRS 9: foreign currency debt investment

Company A is domiciled in the US and its functional currency and presentation currency is the US dollar. A has a UK domiciled subsidiary, B, whose functional currency is sterling. B is the owner of a debt instrument which is held for trading and is therefore carried at fair value through profit or loss in accordance with IFRS 9.

In B's financial statements for 20X1, the fair value and carrying amount of the debt instrument is £100. In A's consolidated financial statements, the asset is translated into US dollars at the spot exchange rate applicable at the end of the reporting period, say 2.0, and the carrying amount is US$200 (£100 × 2.0).

At the end of 20X2, the fair value of the debt instrument has increased to £110. B reports the trading asset at £110 in its statement of financial position and recognises a fair value gain of £10 in profit or loss. During the year, the spot exchange rate has increased from 2.0 to 3.0 resulting in an increase in the fair value of the instrument from US$200 to US$330 (£110 × 3.0). Therefore, A reports the trading asset at US$330 in its consolidated financial statements.

Since B is classified as a foreign entity, A translates B's statement of comprehensive income 'at the exchange rates at the dates of the transactions'. Since the fair value gain has accrued through the year, A uses the average rate of 2.5 (= [3.0 + 2.0] ÷ 2) as a practical approximation. Therefore, while the fair value of the trading asset has increased by US$130 (US$330 - US$200), A recognises only US$25 (£10 × 2.5) of this increase in profit or loss. The resulting exchange difference, i.e., the remaining increase in the fair value of the debt instrument of US$105 (US$130 - US$25), is recognised in other comprehensive income until the disposal of the net investment in the foreign entity.

Another situation where foreign exchange differences on monetary items are recognised in other comprehensive income is when the long-term debt is considered to form part of the net investment in the foreign entity.

5 Future developments

In 2022 the IASB concluded its post implementation review of the classification and measurement requirements of IFRS 9 and decided to add to its project pipeline, the "Amortised Cost Measurement" project. The project will aim to review matters raised as part of the post implementation review, relating to the modification of financial assets and financial liabilities, the application of the effective interest rate method to floating rate instruments, and the interaction between these areas. Refer to section 3.1.3 above for more information.

The Amortised Cost Measurement project will also consider the related findings from the post implementation review of the impairment requirements of IFRS 9 (which was concluded in July 2024). In particular, it will consider the interaction between the requirements for modification, derecognition and write-off of financial instruments and the requirements for impairment. Refer to section 3.8.4 above for more information.

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Appendix C - Defined terms

Extract from IFRS standards - Definitions	
amortised cost of a financial asset or financial liability	The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any **loss allowance**. *[IFRS 9 Appendix A]*.
credit-impaired financial asset	A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired include observable data about the following events: (a) significant financial difficulty of the issuer or the borrower; (b) a breach of contract, such as a default or **past due** event; (c) the lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider; (d) it is becoming probable that the borrower will enter bankruptcy or other financial reorganisation; (e) the disappearance of an active market for that financial asset because of financial difficulties; or (f) the purchase or origination of a financial asset at a deep discount that reflects the incurred **credit losses**. It may not be possible to identify a single discrete event- instead, the combined effect of several events may have caused financial assets to become credit-impaired. *[IFRS 9 Appendix A]*.
credit risk	The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. *[IFRS 7 Appendix A]*.
dividends	Distributions of profits to holders of equity instruments in proportion to their holdings of a particular class of capital. *[IFRS 9 Appendix A]*.
effective interest method	The method that is used in the calculation of the **amortised cost of a financial asset or a financial liability** and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period. *[IFRS 9 Appendix A]*.
effective interest rate	The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the **gross carrying amount of a financial asset** or to the **amortised cost of a financial liability**. When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the **expected credit losses**. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1-B5.4.3), **transaction costs**, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments). *[IFRS 9 Appendix A]*.

gross carrying amount of a financial asset	The **amortised cost of a financial asset**, before adjusting for any **loss allowance**. *[IFRS 9 Appendix A]*.
reclassification date	The first day of the first reporting period following the change in business model that results in an entity reclassifying financial assets. *[IFRS 9 Appendix A]*.
purchased or originated credit-impaired financial asset	Purchased or originated financial asset(s) that are **credit-impaired** on initial recognition. *[IFRS 9 Appendix A]*.

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Overview

This chapter addresses the IFRS 9 *Financial Instruments* expected credit loss accounting model and discusses some practical and implementation issues resulting from the impairment requirements.

Since IFRS 9 was issued in 2014, a number of interpretation and application issues have been identified, many of which have been the subject of discussion by the IFRS Transition Resource Group for Impairment of Financial Instruments established by the IASB and further guidance has been provided by the IASB in the form of webcasts and educational materials (see section 1.4 below) and by banking regulators (see sections 1.5 and 7.1 below).

The key differences between the IFRS and US GAAP guidance on this topic are addressed in section 1.3 below, although the standards are not converged and other similarities and differences between IFRS and US GAAP may exist that are not discussed in this chapter.

This chapter also briefly describes the credit risk disclosures in relation to the expected credit loss model as set out in IFRS 7 *Financial Instruments: Disclosures* (see section 15 below). A more detailed discussion of the disclosure requirements can be found in Chapter 50 at section 5.3.

What you need to know

- The expected credit loss model applies to debt instruments held that are recorded at amortised cost or at fair value through other comprehensive income, such as loans, debt securities and trade receivables and, in addition, to lease receivables and most loan commitments and financial guarantee contracts.
- Under the general approach, all entities are required to recognise an allowance for either 12-month or lifetime expected credit losses, depending on whether there has been a significant increase in credit risk since initial recognition.
- The simplified approach, that is either required or available as an accounting policy choice for trade receivables, contract assets and lease receivables, does not require an entity to track the changes in credit risk, but instead requires the entity to recognise lifetime expected credit losses at each reporting date.
- For financial assets that are purchased or originated when they are already credit-impaired, entities are required to include the initial lifetime expected credit losses in a credit-adjusted effective interest rate instead of as an allowance, and to recognise subsequent changes in expected credit losses as an impairment gain or loss at each reporting date.
- The measurement of expected credit losses reflects a probability-weighted outcome, the time value of money and the best available forward-looking information.
- The need to incorporate forward-looking information means that application of IFRS 9 requires considerable judgement as to how changes in macroeconomic factors affect expected credit losses. The significant judgements required in making the expected credit loss calculation also means that it may be difficult to compare the reported results of different entities. However, entities are required to explain their inputs, assumptions and techniques used in estimating the expected credit loss requirements, which help provide transparency in respect of entities' credit risk and provisioning processes.
- The need to assess whether there has been a significant increase in credit risk in the expected credit loss model also requires judgement, specific data and processes.
- The expected credit loss model must also be applied to intercompany loans in the separate financial statements of group companies.

1 Introduction

In July 2014, the IASB issued the final version of IFRS 9, bringing together the classification and measurement, impairment and hedge accounting phases of the IASB's project to replace IAS 39 *Financial Instruments: Recognition and Measurement* and all previous versions of IFRS 9.

The IASB sought to address a key concern that arose as a result of the financial crisis in 2007 and 2008, that the incurred loss model in IAS 39 resulted in the delayed recognition of credit losses. As such, it introduced a forward-looking expected credit loss model. The expected credit loss requirements and application guidance in IFRS 9 are accompanied by 14 Illustrative Examples.

This section provides an overview of the impairment project, the IFRS 9 impairment requirements, key differences from the US GAAP as well as guidance provided by the IASB, the IFRS Transition Resource Group for Impairment of Financial Instruments and banking regulators.

1.1 Brief history and background of the impairment project

During the 2007/8 global financial crisis, the recognition of credit losses that were associated with loans and other financial instruments was identified as a weakness in existing accounting standards. This was primarily due to the fact that the previous impairment requirements under IAS 39 were based on an incurred loss model, i.e., credit losses were not recognised until a credit loss event had occurred. Since losses are rarely incurred evenly over the lives of loans, there was a mismatch in the timing of the recognition of the credit spread that is inherent in the interest accrued on loans over their lives and any impairment losses that were only recognised at a later date. A further identified weakness was the complexity of different entities using different approaches to calculate impairment.

In November 2009, the IASB issued an Exposure Draft - *Financial Instruments: Amortised Cost and Impairment* (the 2009 exposure draft) - that proposed an impairment model based on expected losses, rather than on incurred losses, for all financial assets recorded at amortised cost. In this approach, the initial expected credit losses were to be recognised over the life of a financial asset, by including them in the computation of the effective interest rate when the asset was first recognised. This would build an allowance for credit losses over the life of a financial asset and so match the recognition of credit losses with that of the credit spread implicit in the interest charged. Subsequent changes in credit loss expectations would be reflected in catch-up adjustments to profit or loss based on the original effective interest rate.

Comments received on the 2009 exposure draft and during the IASB's outreach activities indicated that constituents were generally supportive of a model that distinguished between the effect of initial estimates of expected credit losses and subsequent changes in those estimates. However, they were also concerned about the operational difficulties in implementing the model proposed.

To address these operational challenges, the IASB decided to decouple the measurement and allocation of initial expected credit losses from the determination of the effective interest rate (except for purchased or originated credit-impaired financial assets). Financial assets and their loss allowances would be measured separately, using an original effective interest rate that was not adjusted for initial expected credit losses. This approach would help address the operational challenges raised and allow entities to leverage their existing accounting and credit risk management systems and so reduce the extent of the necessary integration between these systems. *[IFRS 9.BC5.92]*.

By decoupling expected credit losses from the effective interest rate, an entity must measure the present value of expected credit losses using the original effective interest rate. This presents a dilemma, because measuring expected credit losses using such a rate double-counts the expected credit losses that were priced into the financial asset at initial recognition. This is because the fair value of the loan at original recognition already reflects the expected credit losses, so to provide for the expected credit losses as an additional allowance would be to double count these losses. Hence, the IASB concluded that it was not appropriate to recognise lifetime expected credit losses on initial recognition. In order to address the operational challenges whilst trying to reduce the effect of double-counting, as well as to replicate (approximately) the outcome of the 2009 exposure draft, the IASB decided to pursue a dual-measurement model that would require an entity to recognise: *[IFRS 9.BC5.93]*

- A portion of the lifetime expected credit losses from initial recognition as a proxy for recognising the initial expected credit losses over the life of the financial asset
- The lifetime expected credit losses when credit risk had increased since initial recognition (i.e., when the recognition of only a portion of the lifetime expected credit losses would no longer be appropriate because the entity has suffered a significant economic loss)

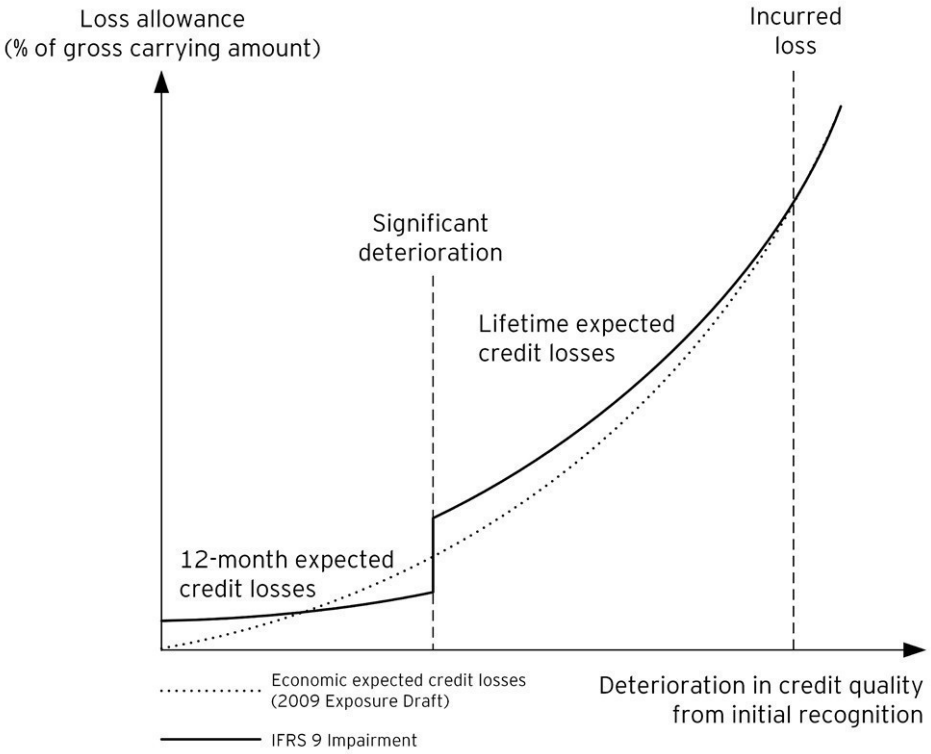
Subsequently, the IASB and FASB spent a considerable amount of time and effort developing a converged impairment model, however, ultimately, full convergence was not achieved (see Section 1.3 below). *[IFRS 9.BC5.96]*

In March 2013, the IASB published a new Exposure Draft - *Financial Instruments: Expected Credit Losses* (the 2013 ED), based on proposals that grew out of the joint project with the FASB. The 2013 ED proposed that entities recognise a loss allowance or provision at an amount equal to 12-month credit losses for those financial instruments that had not yet seen a significant increase in credit risk since initial recognition, and lifetime expected credit losses once there had been a significant increase in credit risk. This new model was designed to:

- Ensure a more timely recognition of expected credit losses than the existing incurred loss model
- Distinguish between financial instruments that have significantly deteriorated in credit quality and those that have not
- Better approximate the economic expected credit losses

This two-step model was designed to approximate the build-up of the allowance as proposed in the 2009 exposure draft, but involving less operational complexity. Figure 1-1 below illustrates the stepped profile of the new model, shown by the solid line, compared to the steady increase shown by the black dotted line proposed in the 2009 exposure draft (based on the original expected credit loss assumptions and assuming no subsequent revisions of this estimate). It shows that the two-step model first overstates the allowance (compared to the method set out in the 2009 exposure draft), then understates it as the credit quality deteriorates, and then overstates it once again as soon as the deterioration is significant.

Figure 1-1: Accounting for expected credit losses - 2009 exposure draft versus IFRS 9



The IASB finalised the impairment requirements and issued them in July 2014, as part of the final version of IFRS 9 effective for annual periods beginning on or after 1 January 2018.

1.2 Overview of the IFRS 9 impairment requirements

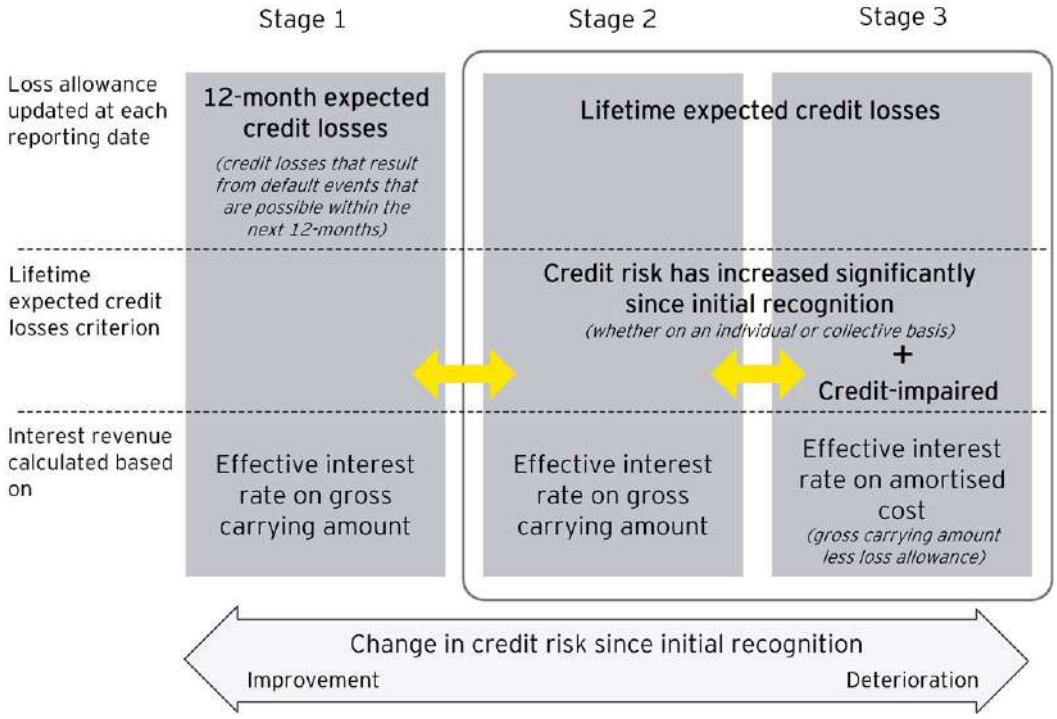
The impairment requirements in IFRS 9 are based on an expected credit loss model and replaced the IAS 39 incurred loss model. The expected credit loss model applies to debt instruments (such as bank deposits, loans, debt securities and trade receivables) recorded at amortised cost or at fair value through other comprehensive income, plus lease receivables and contract assets. Loan commitments and financial guarantee contracts that are not measured at fair value through profit or loss are also included in the scope of the expected credit loss model.

Conceptually, an impairment model is a necessary complement to an accounting model for financial assets that is based on the concept of realisation, i.e., when cash flows are received and paid. For financial assets

in the scope of the impairment model, the recognition of revenue follows the effective interest method, and gains and losses relating to changes in their fair value are generally only recognised in profit or loss when the financial asset is derecognised, and these gains or losses are realised. In order to avoid delaying the recognition of impairment losses, these accounting models are complemented by an impairment model that anticipates impairment losses by recognising them before they are realised. The impairment model of IFRS 9 does this on the basis of expected credit losses, which means impairment losses are anticipated earlier than under an incurred loss impairment model. In contrast, the accounting models for financial assets in IFRS 9 that are not based on the concept of realisation, i.e., those measured at fair value through profit or loss or at fair value through other comprehensive income without recycling (under the presentation choice for fair value changes of some investments in equity instruments, see Chapter 44 at section 7 and Chapter 46 at section 2.5) do not involve any separate impairment accounting. Those measurement categories implicitly include impairment losses in the fair value changes that are recognised immediately and without any later reclassification entries between other comprehensive income and profit or loss when they are realised.

The guiding principle of the expected credit loss model is to reflect the general pattern of deterioration, or improvement, in the credit quality of financial instruments. The expected credit loss approach has been commonly referred to as the three-bucket approach, although IFRS 9 does not use this term. Figure 1-2 below summarises the general approach in recognising either 12-month or lifetime expected credit losses.

Figure 1-2: General approach



The amount of expected credit losses recognised as a loss allowance or provision depends on the extent of credit deterioration since initial recognition. Under the general approach (see section 3.1 below), there are two measurement bases:

- 12-month expected credit losses (stage 1), which apply to all in scope assets as long as there is no significant deterioration in credit risk
- Lifetime expected credit losses (stages 2 and 3), which apply when a significant increase in credit risk has occurred on an individual or collective basis

When assessing significant increases in credit risk, there are a number of operational simplifications available, such as the low credit risk operational simplification (see section 6.4.1 below).

Stages 2 and 3 differ in how interest revenue is recognised. Under stage 2 (as under stage 1), there is a full decoupling between interest recognition and impairment, and interest revenue is calculated on the gross carrying amount. A financial asset is transferred to stage 3 when it is credit-impaired, defined as when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset, have occurred. These criteria are set out in more detail in section 3.1 below. Under stage 3, interest revenue is calculated on the amortised cost (i.e., the gross carrying amount adjusted for the impairment allowance). *[IFRS 9 Appendix A, IFRS 9.5.4.1]*.

As an exception to this model, there are separate rules if a financial asset is already credit-impaired on initial recognition (see section 3.3 below).

The following Illustration shows how the expected credit loss allowance changes when a loan moves from stage 1 to stage 3.

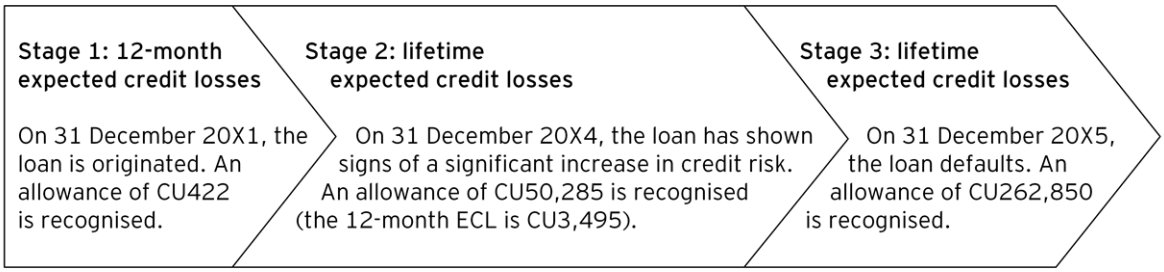
Illustration 1-1: Expected credit loss allowance in stages 1, 2 and 3 under the general approach

On 31 December 20X1, Bank A originates a 10 year loan with a gross carrying amount of CU1,000,000, with interest being due at the end of each year and the principal due on maturity. There are no transaction costs and the loan contracts include no options (for example, prepayment or call options), premiums or discounts, points paid, or other fees.

At origination, the loan is in stage 1 and a corresponding 12-month expected credit loss allowance is recognised in the year ending 31 December 20X1.

On 31 December 20X4, the loan has shown signs of significant deterioration in credit quality and Bank A moves the loan to stage 2. A corresponding lifetime expected credit loss allowance is recognised. In the following year, the loan defaults and is moved to stage 3.

The expected credit loss allowance in each stage is shown below and the detailed calculation is illustrated in Illustration 5-1 in section 5.4.1 below.



There are two alternatives to the general approach:

- The simplified approach, that is either required or available as a policy choice for trade receivables, contract assets and lease receivables (see section 3.2 below)
- The credit-adjusted effective interest rate approach, for purchased or originated credit-impaired financial assets (see section 3.3 below)

Expected credit losses are an estimate of credit losses over the next 12 months or the life of a financial instrument and, when measuring expected credit losses (see section 5 below), an entity needs to take into account:

- The probability-weighted outcome (see section 5.6 below), as expected credit losses are not simply either a best or a worst-case scenario, but, instead, reflect the possibility that a credit loss occurs and the possibility that no credit loss occurs. Following discussion at the IFRS Transition Resource Group for Impairment of Financial Instruments, this is understood to include a need to consider multiple economic scenarios (see section 5.6.1 below).
- The time value of money (see section 5.7 below).
- Reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions (see section 5.9 below).

1.3 Key differences from the FASB's standard

On 16 June 2016, the FASB issued an Accounting Standard Update (ASU), *Financial Instruments - Credit Losses (Topic 326)*, that aims to address the same fundamental issue that the IASB's expected credit loss model (in IFRS 9) addresses, namely the delayed recognition of credit losses resulting from the incurred credit loss model. It is therefore also an expected credit loss model, but it is not the same as the model in IFRS 9.

The key differences between the IFRS and US GAAP guidance on this topic are highlighted below. The standards are not converged and not all the similarities and differences between IFRS and US GAAP on this topic are described.

FASB differences

The most significant differences between the FASB's and the IASB's expected credit loss models are, as follows:

- The FASB's expected credit loss model (known as the current expected credit loss or CECL model) does not apply to debt securities measured at fair value through other comprehensive income (i.e., available for sale debt securities under US GAAP). Rather, for available for sale debt securities, an allowance is recognised to reflect estimated credit losses and is adjusted over time to reflect both positive and adverse changes in expected cash flows.
- The FASB's expected credit losses are calculated based on the losses expected over the remaining contractual life of an asset considering the effect of prepayments. An allowance for lifetime expected credit losses is required when the loan is initially recognised instead of 12-month expected credit losses under IFRS 9. As a result, the FASB's model does not require an entity to assess whether there has been a significant deterioration in credit quality, in contrast to the assessment required by IFRS 9. This is similar to the IFRS 9 simplified approach (see section 3.2 below).
- The FASB's standard does not require, nor does it prohibit, an entity to use probability-weighted outcomes. However, entities are required to incorporate the risk of loss, even if such a risk is remote, into their estimate. It is expected that an allowance of zero will only be appropriate in very limited circumstances.
- For acquired financial assets (or acquired groups of financial assets with shared risk characteristics) that, as of the date of acquisition, have experienced a more-than-insignificant deterioration in credit quality since origination, i.e., financial assets purchased with credit deterioration, as determined by an acquirer's assessment and that are measured at amortised cost, the FASB's model requires an entity to determine the initial amortised cost of the assets by adding the allowance for credit losses at the date of acquisition (the entity's initial estimate of expected credit losses) to the purchase price. The subsequent measurement of expected credit losses for financial assets purchased with credit deterioration is the same as originated assets or non-financial assets purchased with credit deterioration acquired assets. See section 3.3 below for the accounting treatment of purchased or originated credit-impaired assets under IFRS 9.
- Under IFRS 9, there is an exception for revolving credit facilities (e.g., commitments connected with overdrafts and credit cards), that does not restrict the measurement of expected credit losses to losses expected in the period over which the facility is contractually committed (see section 12 below for the IFRS 9 treatment). Under the FASB's model, no impairment allowance is required on commitments that are unconditionally cancellable or legally revocable without any conditions.

1.4 The IFRS Transition Resource Group for Impairment of Financial Instruments, IASB webcasts and educational materials

In 2014, the IASB set up an IFRS Transition Resource Group for Impairment of Financial Instruments that aimed to:

- Provide a public discussion forum to support stakeholders on implementation issues arising from the new impairment requirements that could create diversity in practice.
- Inform the IASB about the implementation issues and to help the IASB determine what action, if any, was needed to address them.[1]

However, the IFRS Transition Resource Group for Impairment of Financial Instruments did not issue any guidance.

Members of the IFRS Transition Resource Group for Impairment of Financial Instruments included financial statement preparers and auditors from various geographical locations with expertise, skills or practical knowledge on credit risk management and accounting for impairment. Board members and observers from the Basel Committee on Banking Supervision and the International Organisation of Securities Commissions also attended the meetings.

1 IASB Website Announcement, *IASB to establish transition resource group for impairment of financial instruments*, 23 June 2014. Available on the IFRS Foundation's website.

The IFRS Transition Resource Group for Impairment of Financial Instruments agenda papers were prepared by the IASB staff and were made public before the meetings. The staff also provided IFRS Transition Resource Group for Impairment of Financial Instruments meeting summaries, which are not authoritative. Both the staff papers and the meeting summaries represent educational reading on the issues submitted.

Following its inaugural meeting in December 2014 to discuss its operating procedures, the IFRS Transition Resource Group for Impairment of Financial Instruments met three times, on 22 April 2015, on 16 September 2015, and on 11 December 2015.

On 22 April 2015, the IFRS Transition Resource Group for Impairment of Financial Instruments discussed eight implementation issues raised by stakeholders. These included:[2]

- When applying the impairment requirements at the reporting date, whether and how to incorporate events and forecasts that occur after economic forecasts have been made, but before the reporting date, and between the reporting period end and the date of signing the financial statements (see section 5.9.4 below).
- Whether the impairment requirements in IFRS 9 must also be applied to other commitments to extend credit, in particular, a commitment (on inception of a finance lease) to commence a finance lease at a date in the future and a commitment by a retailer through the issue of a store account to provide a customer with credit when the customer buys goods or services from the retailer in the future (see section 11.1 below).
- Whether there is a requirement to measure expected credit losses at dates other than the reporting date, namely the date of derecognition and the date of initial recognition (see section 7.3.1 below).
- Whether an entity should consider the ability to recover cash flows through an integral financial guarantee contract when assessing whether there has been a significant increase in the credit risk of the guaranteed debt instrument since initial recognition (see section 6.1.1 below).
- The maximum period to consider when measuring expected credit losses on a portfolio of mortgage loans that have a stated maturity of 6 months, but contain a contractual feature whereby the term is automatically extended every 6 months subject to the lender's non-objection (see section 5.5 below).
- The maximum period to consider when measuring expected credit losses for revolving credit facilities and the determination of the date of initial recognition of the revolving credit facilities for the purposes of assessing them for significant increases in credit risk (see sections 5.3, 12.2.2, 12.2.4 and 12.5 below).
- Whether the measurement of expected credit losses for financial guarantee contracts issued should consider future premium receipts due from the holder and, if so, how (see section 11.3 below).
- The measurement of expected credit losses in respect of a modified financial asset, the calculation of the modification gain or loss and subsequent requirement to measure expected credit losses on the modified financial asset as well as the appropriate presentation and disclosure (see section 8.2 below).

On 16 September 2015, the IFRS Transition Resource Group for Impairment of Financial Instruments held its third meeting to discuss six implementation issues raised by stakeholders. These included:[3]

- How to identify a significant increase in credit risk for a portfolio of retail loans when identical pricing and contractual terms are applied to customers across broad credit quality bands (see section 6.4.5 below).
- The possibility of using behavioural indicators of credit risk for the purpose of the assessment of significant increases in credit risk since initial recognition (see section 6.2.5 below).
- When assessing significant increases in credit risk, whether an entity would be required to perform an annual review to determine whether circumstances still support the use of the 12-month risk of a default occurring as an approximation of changes in the lifetime risk of a default occurring (see section 6.4.3 below).
- When measuring expected credit losses for revolving credit facilities, how an entity should estimate future drawdowns on undrawn lines of credit when an entity has a history of allowing customers to exceed their contractually set credit limits on overdrafts and other revolving credit facilities (see section 12.3 below).

2 IASB Transition Resource Group for Impairment of Financial Instruments, Meeting Summary, 22 April 2015. Available on the IFRS Foundation's website.

3 IASB Transition Resource Group for Impairment of Financial Instruments, Meeting Summary, 16 September 2015. Available on the IFRS Foundation's website.

- At what level should forward-looking information be incorporated - at the level of the entity or on a portfolio-by-portfolio basis (see section 5.9.5 below).
- How to determine what is reasonable and supportable forward-looking information and how to treat shock events with material, but uncertain, economic consequences (see section 5.9.5 below).

On 11 December 2015, the IFRS Transition Resource Group for Impairment of Financial Instruments held its fourth meeting to discuss eleven implementation issues raised by stakeholders. These included:[4]

- What was meant by the 'current effective interest rate' when an entity recognises interest revenue in each period based on the actual floating-rate applicable to that period (see section 5.7 below).
- What was meant by 'part of the contractual terms', specifically whether a credit enhancement must be an explicit term of the related asset's contract in order for it to be taken into account in the measurement of expected credit losses, or whether other credit enhancements that are not recognised separately can also be taken into account (see section 5.8.1.A below).
- Whether cash flows that are expected to be recovered from the sale on default of a loan could be included in the measurement of expected credit losses (see section 5.8.2 below).
- Application of the revolving credit facilities exception set out in IFRS 9.5.5.20 to multi-purpose facilities (see sections 12.1 and 12.4 below).
- How future drawdowns should be estimated for charge cards when measuring expected credit losses if there is no specified credit limit in the contract (see section 12.1 below).
- How an entity should determine the starting-point and the ending-point of the maximum period to consider when measuring expected credit losses for revolving credit facilities (see section 12.2.2 below).
- When measuring expected credit losses, whether an entity can use a single forward-looking economic scenario or whether an entity needs to incorporate multiple forward-looking scenarios, and if so how (see sections 5.6.1, 5.6.2 and 5.9.5 below).
- When assessing significant increases in credit risk, whether an entity can use a single forward-looking economic scenario or whether the entity needs to incorporate multiple forward-looking scenarios, and if so how (see section 6.7 below).
- Whether there is a requirement to assess significant increases in credit risk for financial assets with a maturity of 12 months or less (see section 6 below).
- How to measure the gross carrying amount and loss allowance for credit-impaired financial assets that are not purchased or originated credit-impaired and that are measured at amortised cost (see section 14.1.2 below).
- Whether an entity is required to present the loss allowance for financial assets measured at amortised cost (or trade receivables, contract assets or lease receivables) separately in the statement of financial position (see section 14.1 below).

The IFRS IC discussed two issues in relation to the IFRS 9 expected credit loss model in November 2018:

- Whether the cash flows expected from a financial guarantee contract or any other credit enhancement can be included in the measurement of expected credit loss if the credit enhancement is required to be recognised separately applying IFRS accounting standards (see sections 5.8.1.A and 7.7.2 below).
- How an entity should present amounts recognised in the statement of profit or loss when a credit-impaired financial asset is subsequently cured, i.e., paid in full or no longer credit-impaired (see section 14.1.2 below).

In addition, as part of its activities to support implementation, the IASB has published three educational webcasts since IFRS 9 was published.[5]

- The first, on forward-looking information and multiple scenarios was released on 25 July 2016. It discussed when multiple scenarios need to be considered and the concept of non-linearity, consistency of scenarios, probability-weighted assessment of significant increase in credit risk, and approaches to incorporating forward-looking scenarios (see sections 5.6.1, 6.5.2, 6.5.3 and 6.7 below).
- The second, on the expected life of revolving facilities was released on 16 May 2017. It focused on how credit risk management actions would affect the expected life of revolving facilities for the purpose of measuring expected credit losses (see sections 12.2.3 and 12.5 below).

4 IASB Transition Resource Group for Impairment of Financial Instruments, Meeting Summary, 11 December 2015. Available on the IFRS Foundation's website.

5 IFRS 9 Financial Instruments: Educational webcasts and webinars, IASB, available on the IFRS Foundation's website.

- The third, on curing of a credit-impaired financial asset was released on 22 July 2019. It summarised the IFRS ICs discussion and explained the conclusion it reached on how a company should present amounts in its statement of profit or loss if a credit-impaired financial asset is subsequently paid in full or no longer credit-impaired (cured) (see section 14.1.2 below).

In light of the coronavirus pandemic, on 27 March 2020, the IASB published IFRS 9 *and covid-19 - Accounting for expected credit losses applying* IFRS 9 *Financial Instruments in the light of current uncertainty resulting from the covid-19 pandemic*, to clarify application of the IFRS 9 expected credit loss requirements (see sections 5.6.3, 5.9.5, 6.2.3 and 7.8.2 below).

1.5 Other guidance on expected credit losses

In November 2015, the Enhanced Disclosure Task Force published its report, *Impact of Expected Credit Loss Approaches on Bank Risk Disclosures*, in which it recommended disclosures for banks to provide with the implementation of the expected credit loss requirements of IFRS 9 and US GAAP (see section 15 below).

In December 2015, the Basel Committee on Banking Supervision issued its *Guidance on accounting for expected credit losses*, aimed primarily at internationally active banks, which sets out supervisory expectations regarding sound credit risk practices associated with implementing and applying an expected credit loss accounting framework (see section 7.1 below).

On 17 June 2016, the Global Public Policy Committee of representatives of the six largest accounting networks (the GPPC) published *The implementation of* IFRS 9 *impairment by banks - Considerations for those charged with governance of systemically important banks* (the GPPC guidance) to promote a high standard in the implementation of accounting for expected credit losses. It aims to help those charged with governance to evaluate management's progress during the implementation and transition phase. A year later, on 28 July 2017, the GPPC issued a paper titled *The Auditor's Response to the Risks of Material Misstatement Posed by Estimates of Expected Credit Losses under* IFRS 9 to assist audit committees to oversee the audit of expected credit losses (see section 7.2 below).

The European Central Bank issued a letter on 1 April 2020, IFRS 9 *in the context of the coronavirus (covid-19) pandemic,* that emphasised the importance of identifying and reporting asset quality deterioration. Subsequently, on 4 December 2020, the European Central Bank issued a letter to the CEOs of banks *Identification and measurement of credit risk in the context of the coronavirus (covid-19) pandemic* to provide banks with additional guidance on credit risk identification and measurement in the context of the coronavirus pandemic (see section 7.8.2 below).

The Task Force on Disclosures about Expected Credit Losses (DECL) sponsored by UK regulators have published their third report *Recommendations on a comprehensive set of IFRS 9 Expected Credit Loss disclosures* in September 2022, which includes updates to the second report along with illustrative best practice examples to further aid the quality and comparability of disclosures between large UK banks.[6] In addition, the European Securities and Market Authority published a report *On the application of the IFRS 7 and IFRS 9 requirements regarding banks' expected credit losses (ECL)* in December 2021 and has identified room for improvement in the level of compliance, comparability and transparency in the application of the relevant IFRS requirements.[7] We expect regulator focus to continue in this Area (see Chapter 50 at section 8).

1.6 Post Implementation Review

The IASB have completed their post-implementation review of IFRS 9 Financial Instruments Impairment. The objective of a post-implementation review is to assess whether the effects of applying the new requirements on users of financial statements, preparers, auditors and regulators are those the IASB intended when it developed the requirements. A post-implementation review does not automatically lead to standard-setting nor the resolution of every application question, however, the review can identify improvements to the relevant standard. On 4 July 2024 the IASB published *Post-Implementation Review of* IFRS 9 *Financial Instruments-Impairment Project and Feedback Statement*.[8]

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6 Taskforce on Disclosures about Expected Credit Losses (DECL) updated guidance. Available on the Financial Reporting Council UK website.

7 ESMA publishes Report on Expected Credit Loss disclosures of banks. Available on the European Securities and Market Authority website.

8 *Project Summary and Feedback Statement, Post-implementation Review of IFRS 9 Financial Instruments-Impairment*. Available on the IFRS Foundation's website.

Following the review the IASB concluded that the impairment requirements in IFRS 9 are working as intended and provide useful information to users of financial instruments. Specifically, they believe that the requirements:

- have led to more timely recognition of credit losses;
- provide useful information to investors about expected credit losses, although targeted improvements to credit risk disclosures were suggested;

  And

- can generally be applied consistently, with some areas requiring further clarification and guidance.

The IASB are now exploring whether the requirements for modification, derecognition and write-off of financial instruments, and the consequential effects on recognition of expected credit losses, can be clarified as part of its project on Amortised Cost Measurement (see Chapter 46 at section 5). Furthermore, the IASB has added a new project to its pipeline to investigate targeted improvements to the credit risk disclosure requirements in IFRS 7 *Financial Instruments: Disclosures*. It should be noted that now the IASB has concluded its PIR of impairment, any other previously identified areas where alternative treatments and accounting policy choices applied will remain, since no further guidance will be issued by the IASB with respect to the standard.

2 Scope

IFRS 9 requires an entity to recognise a loss allowance for expected credit losses on: *[IFRS 9.5.5.1]*

- Financial assets that are debt instruments such as loans, debt securities, bank balances and deposits and trade receivables (see section 10 below) that are measured at amortised cost. *[IFRS 9.4.1.2]*.
- Financial assets that are debt instruments measured at fair value through other comprehensive income (see section 9 below). *[IFRS 9.4.1.2A]*.
- Finance lease receivables (i.e., net investments in finance leases) and operating lease receivables under IFRS 16 *Leases* (see section 10.2 below and Chapter 24).
- Contract assets under IFRS 15 *Revenue from Contracts with Customers* (see section 10.1 below and Chapter 28). IFRS 15 defines a contract asset as "an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditional on something other than the passage of time (for example, the entity's future performance)". *[IFRS 15 Appendix A, IFRS 9 Appendix A]*.
- Loan commitments that are not measured at fair value through profit or loss under IFRS 9 (see sections 11 and 12 below). The scope therefore excludes loan commitments designated as financial liabilities at fair value through profit or loss, loan commitments that can be settled net in cash or by delivering or issuing another financial instrument and commitments to provide a loan at a below-market interest rate. *[IFRS 9.2.1(g), IFRS 9.2.3, IFRS 9.4.2.1(a), IFRS 9.4.2.1(d)]*.
- Financial guarantee contracts that are not measured at fair value through profit or loss under IFRS 9 (see section 11 below).

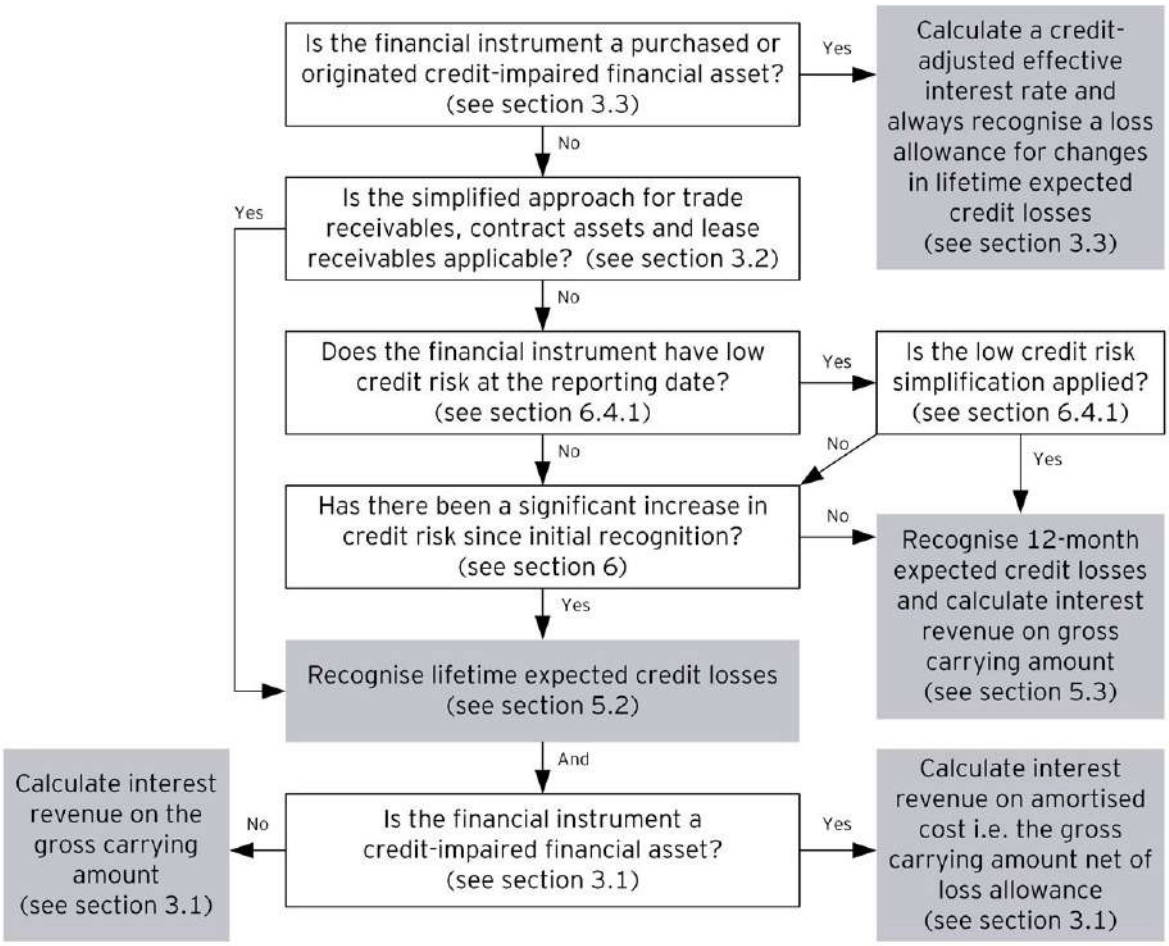
3 Approaches

In applying the IFRS 9 impairment requirements, an entity needs to follow one of the approaches below, subject to the conditions set out in each section:

- The general approach (see section 3.1 below)
- The simplified approach (see section 3.2 below)
- The purchased or originated credit-impaired approach (see section 3.3 below)

Figure 3-1 below, based on a diagram from IFRS 9, summarises the process steps in recognising and measuring expected credit losses.

Figure 3-1: Application of the impairment requirements at a reporting date



3.1 General approach

Under the general approach, at each reporting date, an entity recognises a loss allowance based on either 12-month expected credit losses or lifetime expected credit losses, depending on whether there has been a significant increase in credit risk on the financial instrument since initial recognition. *[IFRS 9.5.5.3, IFRS 9.5.5.5]*. The changes in the loss allowance balance are recognised in profit or loss as an impairment gain or loss. *[IFRS 9.5.5.8, IFRS 9 Appendix A]*.

Essentially, an entity must make the following assessment at each reporting date:

- For credit exposures where there have not been significant increases in credit risk since initial recognition, an entity is required to provide for 12-month expected credit losses, i.e., the portion of lifetime expected credit losses that represent the expected credit losses that result from default events that are possible within the 12 months after the reporting date (stage 1 in Figure 1-2 in section 1.2 above). *[IFRS 9.5.5.5, IFRS 9 Appendix A]*.
- For credit exposures where there have been significant increases in credit risk since initial recognition on an individual or collective basis, a loss allowance is required for lifetime expected credit losses, i.e., expected credit losses that result from all possible default events over the expected life of a financial instrument (stages 2 and 3 in Figure 1-2 in section 1.2 above). *[IFRS 9.5.5.3, IFRS 9.5.5.4, IFRS 9 Appendix A]*.

- In subsequent reporting periods, if the credit quality of the financial instrument improves such that there is no longer a significant increase in credit risk since initial recognition, then the entity reverts to recognising a loss allowance based on 12-month expected credit losses (i.e., the approach is symmetrical and the financial instrument is moved from stage 2 or stage 3 into stage 1 in Figure 1-2 in section 1.2 above). *[IFRS 9.5.5.7]*.

In certain circumstances, it is not practical to determine for every individual financial instrument whether there has been a significant increase in credit risk, because they may be individually immaterial and many in number and/or because there is no evidence available to do so. Consequently, it may be necessary to measure expected credit losses on a collective basis, to approximate the result of using comprehensive credit risk information that incorporates forward-looking information at an individual instrument level (see section 6.5 below). *[IFRS 9.B5.5.1, IFRS 9.BC5.141]*.

IFRS 9 includes practical expedients, in particular the use of a simplified approach (see section 3.2 below) and a provision matrix (see section 10.1 below), to help measure the loss allowance for trade receivables.

To help enable an entity's assessment of significant increases in credit risk, IFRS 9 also provides the following operational simplifications:

- A low credit risk threshold equivalent to investment grade (see section 6.4.1 below), where no assessment of significant increases in credit risk is required.
- The ability to rely on past due information if reasonable and supportable forward-looking information is not available without undue cost or effort (see section 6.4.2 below). This is subject to the rebuttable presumption that there has been a significant increase in credit risk if a loan is more than 30 days past due (see section 6.2.2 below).
- Use of a change in the 12-month risk of a default as an approximation for change in lifetime risk (see section 6.4.3 below).

The IFRS 9 Illustrative Examples also provide the following suggestions on how to implement the assessment of significant increases in credit risk:

- Assessment at the counterparty level (see section 6.4.4 below)
- A set transfer threshold by determining maximum initial credit risk for a portfolio (see section 6.4.5 below)

In stages 1 and 2, there is a complete decoupling between interest recognition and impairment. Therefore, interest revenue is calculated on the gross carrying amount (without deducting the loss allowance). If a financial asset subsequently becomes credit-impaired (stage 3 in Figure 1-2 in section 1.2 above), an entity is required to calculate the interest revenue by applying the effective interest rate, from the start of the subsequent reporting period, to the amortised cost of the financial asset (i.e., the gross carrying amount net of loss allowance) rather than the gross carrying amount. *[IFRS 9.5.4.1, IFRS 9 Appendix A]*.

A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is impaired includes observable data about such events. IFRS 9 provides a list of events for an individual asset assessment: *[IFRS 9 Appendix A]*

- Significant financial difficulty of the issuer or the borrower
- A breach of contract, such as a default or past due event
- The lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider
- It is becoming probable that the borrower will enter bankruptcy or other financial reorganisation
- The disappearance of an active market for that financial asset because of financial difficulties
- The purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses

It may not be possible for an entity to identify a single discrete event. Instead, the combined effect of several events may have caused the financial asset to become credit-impaired. *[IFRS 9 Appendix A]*.

There has also been some debate as to whether financial assets that are considered to be in default (e.g., because payments are more than 90 days past due) but that are fully collateralised (so that there is no expected credit loss) would qualify as credit-impaired and therefore have to be transferred to stage 3. Although the definition of credit-impaired refers to 'a detrimental impact on the estimated future cash flows', it is not clear whether this is read to include any recoveries from the realisation of collateral and IFRS 9 has no explicit requirements to consider collateral when assessing credit-impaired financial assets.

How we see it

There are some strong arguments in favour of aligning the criteria for transferring an asset to stage 3 with those for assessing whether it is in default, even if the asset is fully collateralised. First, IFRS 9 bases significant deterioration on risk of a default occurring and it would therefore seem inconsistent (and potentially confusing for users) if the value of collateral is considered for stage 3 allocation. Also, if collateral value were to influence the stage 3 allocation, this could result in some instability between stage 2 and stage 3, as exposures would potentially go back and forth depending on the collateral value.

Aligning stage 3 with the default status affects the scope of instruments to which the purchased or originated credit-impaired approach must be applied. However, for any exposure which is fully collateralised and where the expected loss is zero, classification as a purchased or originated credit-impaired financial asset, or classification between stage 1, 2 or 3 does not affect the accounting. If the expected loss is zero, it will not affect the effective interest rate calculation.

Also, IFRS 7 requires a quantitative disclosure about the collateral held as security and other credit enhancements for financial assets that are credit-impaired at the reporting date (e.g., quantification of the extent to which collateral and other credit enhancements mitigate credit risk). *[IFRS 7.35K(c)]*.

In subsequent reporting periods, if the credit quality of the financial asset improves so that the financial asset is no longer credit-impaired and the improvement can be related objectively to the occurrence of an event (such as an improvement in the borrower's credit rating), then the entity once again calculates the interest revenue by applying the effective interest rate to the gross carrying amount of the financial asset (i.e., the approach is symmetrical and the financial instrument is moved from stage 3 and into stage 1 or stage 2 in Figure 1-2 in section 1.2 above). *[IFRS 9.5.4.2]*.

When the entity has no reasonable expectations of recovering a financial asset, in its entirety or a portion thereof, then the gross carrying amount of the financial asset is directly reduced. A write-off constitutes a derecognition event (see section 14.1.1 below). *[IFRS 9.5.4.4]*.

3.2 Simplified approach

The simplified approach does not require an entity to track the changes in credit risk, but instead requires the entity to recognise a loss allowance based on lifetime expected credit losses at each reporting date. *[IFRS 9.5.5.15]*.

An entity is required to apply the simplified approach for trade receivables or contract assets that result from transactions within the scope of IFRS 15 and that do not contain a significant financing component, or when the entity applies the practical expedient for contracts that have a maturity of one year or less, in accordance with IFRS 15 (see Chapter 28). *[IFRS 9.5.5.15(a)(i)]*. Paragraphs 60-65 of IFRS 15 provide the requirements for determining the existence of a significant financing component in the contract, including the use of the practical expedient for contracts that are one year or less.

A contract asset is defined as an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance). *[IFRS 15 Appendix A]*. IFRS 15 describes contracts with a significant financing component as those for which the agreed timing of payment provides the customer or the entity with a significant benefit of financing on the transfer of goods or services to the customer. Hence, in determining the transaction price, an entity is required to adjust the promised amount of consideration for the effects of the time value of money. *[IFRS 15.60]*. However, if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer, and when the customer pays for that good or service will be one year or less, as a practical expedient, an entity need not adjust the promised amount of consideration for the effects of a significant financing component. *[IFRS 15.63]*.

How we see it

Application of the simplified approach to trade receivables and contract assets that do not contain a significant financing component intuitively makes sense. In particular, for trade receivables and contract assets that are due in 12 months or less, the 12-month expected credit losses are the same as the lifetime expected credit losses.

However, an entity has a policy choice to apply either the simplified approach or the general approach for the following: *[IFRS 9.5.5.16]*

- All trade receivables or contract assets that result from transactions within the scope of IFRS 15, and that contain a significant financing component in accordance with IFRS 15. The policy choice may be applied separately to trade receivables and contract assets (see section 10.1 below and Chapter 28). *[IFRS 9.5.5.15(a)(ii)]*.
- All lease receivables that result from transactions that are within the scope of IFRS 16. The policy choice may be applied separately to finance and operating lease receivables (see section 10.2 below and Chapter 24). *[IFRS 9.5.5.15(b)]*.

The IASB noted that offering this policy choice would reduce comparability. However, the IASB believes it would alleviate some of the practical concerns of tracking changes in credit risk for entities that do not have sophisticated credit risk management systems. *[IFRS 9.BC5.225]*.

In practice, trade receivables may be sold to a factoring bank. In those instances, where all risks and rewards are transferred to the bank, the trade receivables are derecognised by the transferring entity and recognised by the factoring bank which obtains the right to receive the payments made by the debtor for the invoiced amount. In such a case, we believe that the 'factored' trade receivables are outside the scope of the simplified approach for the purpose of the factoring bank when applying the IFRS 9 expected credit loss model. This is because the simplified approach is limited to trade receivables that result from transactions within the scope of IFRS 15, i.e., based on a contract to obtain goods or services. This is not the case for the factoring bank since it has acquired the trade receivables through a factoring agreement. Moreover, the simplified approach was introduced to assist entities with less sophisticated credit risk management systems. *[IFRS 9.BC5.104]*. Factoring banks are likely to have more sophisticated credit risk management systems in place.

How we see it

Trade receivables that are sold to a factoring bank and derecognised are outside the scope of the simplified approach for the factoring bank when applying the IFRS 9 expected credit loss model.

3.3 Purchased or originated credit-impaired financial assets

On initial recognition of a financial asset, an entity is required to determine whether the asset is credit-impaired. The criteria are set out in section 3.1 above. *[IFRS 9.5.5.3, IFRS 9.5.5.5, IFRS 9.5.5.13]*.

A financial asset may be purchased credit-impaired because the credit risk is very high and it has already met the criteria. Such an asset is likely to be acquired at a deep discount. However, this does not mean that an entity is required to apply the credit-adjusted effective interest rate to a financial asset solely because the financial asset has a high credit risk at initial recognition, if it has not yet met the criteria. *[IFRS 9.B5.4.7]*. Moreover, although one of the indicators that a financial asset is credit-impaired is that the asset is purchased at a deep discount, the purchased financial asset may be determined to be credit-impaired even if it is not purchased at a deep discount if the other indicators (see section 3.1 above) that the financial asset is credit-impaired are present. For instance, it is possible that a secured loan could be purchased credit-impaired, because one of the criteria is met, but not acquired at a deep discount due to the value of the collateral. It may be also possible that an entity originates a credit-impaired financial asset, for example, following a substantial modification of a distressed financial asset that resulted in the derecognition of the original financial asset (see section 8 below). *[IFRS 9.B5.5.26]*.

Again, this does not mean that the asset is considered credit-impaired just because it is high risk. Consider an example of a bank originating a loan of CU100,000 with interest of 30% per annum charged over the term of the loan, payable in monthly amortising instalments. The bank's customer has a high credit risk on origination and the bank expects a large portion of this type of customer to pay late or fail to pay some or all of their instalment payments. Although the loan is of high credit risk (which is supported by the high interest rate), none of the loss events listed above have occurred and the loan was not the result of a substantial modification and derecognition of a distressed debt, hence, the bank assesses the loan not to be credit-impaired on origination.

For financial assets that are considered to be credit-impaired on purchase or origination, the effective interest rate (see Chapter 46 at section 3) is calculated taking into account the initial lifetime expected credit losses in the estimated cash flows. *[IFRS 9.B5.4.7, IFRS 9 Appendix A, IFRS 9.BC5.214, IFRS 9.BC5.217]*. This is consistent with the original method for measuring impairment proposed in the 2009 exposure draft.

Consequently, no allowance is recorded for 12-month expected credit losses for financial assets that are credit-impaired on initial recognition. The rationale for not recording a 12-month expected credit loss allowance for these assets is that the losses are already reflected in the fair values at which they are initially recognised. The same logic could be applied to all the other financial assets which are not credit-impaired, arguing that they, too, are initially recognised at a fair value that reflects expectations of future losses. However, the distinction is made because the double-counting of 12-month expected credit losses on initial recognition would be too large for assets with such a high credit risk at initial recognition, for which default may have already occurred and the 12-month expected credit losses are already reflected in the initial fair value. The exclusion of initial expected credit losses from the computation of the effective interest rate would lead to a distortion that would be too significant to be acceptable.

For financial assets that were credit-impaired on purchase or origination, the credit-adjusted effective interest rate is also used subsequently to discount the expected credit losses. In subsequent reporting periods an entity is required to recognise:

- In the statement of financial position, the cumulative changes in lifetime expected credit losses since initial recognition, discounted at the credit-impaired effective interest rate (see section 5.7 below), as a loss allowance. *[IFRS 9.5.5.13, IFRS 9.B5.5.45]*.
- In profit or loss, the amount of any change in lifetime expected credit losses as an impairment gain or loss. An impairment gain is recognised if favourable changes result in the lifetime expected credit losses estimate becoming lower than the original estimate that was incorporated in the estimated cash flows on initial recognition when calculating the credit-adjusted effective interest rate. *[IFRS 9.5.5.14]*.

For favourable changes that result in lower lifetime expected credit losses than the original estimate on initial recognition, IFRS 9 does not provide guidance on where in the statement of financial position the debit entry is booked. In our view, the impairment gain is recognised as a direct adjustment to the gross carrying amount. This is supported by the application guidance in IFRS 9 on revision of estimates which requires adjusting the gross carrying amount of the financial asset. *[IFRS 9.B5.4.6]*. For purchased or originated credit-impaired financial assets, since the expected credit losses are included in the estimated cash flows when calculating the credit-adjusted effective interest rate, it would be consistent to follow the same principle and adjust the gross carrying amount when revising the original estimates of expected credit losses. An alternative treatment would be to recognise a negative loss allowance which would reflect the favourable changes in lifetime expected credit losses.

How we see it

For purchased or originated credit-impaired financial assets, if there are favourable changes that result in a lower lifetime expected credit losses than the original estimate on initial recognition, entities can recognise the impairment gain either as a direct adjustment to the gross carrying amount or as negative loss allowance.

Along with the other credit risk disclosures requirements (see section 15 below and Chapter 50 at section 5.3), the holder is required to explain how it has determined that assets are credit-impaired (including the inputs, assumptions and estimation techniques used). It is also required to disclose the total amount of undiscounted expected credit losses at initial recognition for financial assets initially recognised during the reporting period that were purchased or originated credit-impaired. *[IFRS 7.35H(c)]*.

Once a financial asset is classified as purchased or originated credit-impaired, it retains that classification until it is derecognised, i.e., when fully paid or written-off. The financial asset is never subject to a staging assessment and is required to be disclosed separately from financial assets that are subject to the general approach staging model. Therefore, a purchased or originated credit-impaired financial asset can never return to stage 1, even if the credit risk on the loan significantly improves.

The accounting treatment for a purchased credit-impaired financial asset is illustrated in the following Illustration.

Illustration 3-1: Calculation of the credit-adjusted effective interest rate and recognition of a loss allowance for a purchased credit-impaired financial asset

On 1 January 20X1, Company D issued a bond that required it to pay an annual coupon of CU800 in arrears and to repay the principal of CU10,000 on 31 December 20Y0. By 20X6, Company D was in significant financial difficulties and was unable to pay the coupon due on 31 December 20X6. On 1 January 20X7, Company V estimates that the holder could expect to receive a single payment of CU4,000 at the end of 20X8. It acquires the bond at an arm's length price of CU3,000. Company V determines that the debt instrument is credit-impaired on initial recognition, because of evidence of significant financial difficulty of Company D and because the debt instrument was purchased at a deep discount.

It can be shown that using the contractual cash flows (including the CU800 overdue) gives rise to an effective interest rate of 70.1% (the net present value of CU800 now and annually thereafter until 20Y0 and CU10,000 receivable at the end of 20Y0 equals CU3,000 when discounted at 70.1%). However, because the bond is credit-impaired, Company V calculates the effective interest rate using the estimated cash flows of the instrument. In this case, the effective interest rate is 15.5% (the net present value of CU4,000 receivable in two years equals CU3,000 when discounted at 15.5%).

All things being equal, interest income of CU465 (CU3,000 × 15.5%) would be recognised on the instrument during 20X7 and its carrying amount at the end of the year would be CU3,465 (CU3,000 + CU465). However, if at the end of the year, based on reasonable and supportable evidence, the cash flow expected to be received on the instrument had increased to, say, CU4,250 (still to be received at the end of 20X8), an adjustment would be made to the asset's amortised cost. Accordingly, its carrying amount would be increased to CU3,681 (CU4,250 discounted over one year at 15.5%) and an impairment gain of CU216 would be recognised in profit or loss.

On the other hand, if at the end of the year, based on reasonable and supportable evidence, the cash flow expected to be received on the instrument had decreased to, say, CU3,500 (still to be received at the end of 20X8), an adjustment would be made to the asset's amortised cost. Accordingly, its carrying amount would be decreased to CU3,031 (CU3,500 discounted over one year at 15.5%) and an impairment loss of CU434 would be recognised in profit or loss.

4 Impairment for corporates

For corporates, their trade receivables and contract assets are often short term in nature and so qualify for the practical expedients available under IFRS 9. These include the use of the simplified approach and a provision matrix, which help in measuring the loss allowance for short-term trade receivables: *[IFRS 9.B5.5.35]*

- The simplified approach does not require the tracking of changes in credit risk, but instead requires the recognition of lifetime expected credit losses at all times. *[IFRS 9.5.5.15]*. For trade receivables or contract assets that do not contain a significant financing component (see section 10.1 below), entities are required to apply the simplified approach. *[IFRS 9.5.5.15(a)(i)]*. For trade receivables or contract assets that do contain a significant financing component, and lease receivables (see section 10.2 below), entities have a policy choice to apply either the simplified approach (see section 3.2 above) or the general approach (see section 3.1 above). For other debt instruments like bonds or longer-term loan receivables, the general approach is required.
- IFRS 9 allows using a provision matrix as a practical expedient for determining expected credit losses on trade receivables (see section 10.1 below). Many corporates may already use a provision matrix to calculate their current impairment allowance, but they would need to calculate expected credit losses for receivables that are not yet delinquent and also consider how they can incorporate forward-looking information into their historical customer default rates (see section 5.9.3 below). Entities would also need to group receivables into various customer segments that have similar loss patterns (e.g., by geography, product type, customer rating or type of collateral) (see section 6.5 below).

The IFRS 9 expected credit loss model can present challenges for the measurement of other assets for which the general model applies. These include long-term trade receivables and contract assets for which the simplified approach is not applied, lease receivables and debt securities which are measured at amortised cost or at fair value through other comprehensive income (see section 9 below). For example, for debt securities classified as measured at fair value through other comprehensive income (see Chapter 44 at sections 4 and 5), the corporate would be required to recognise a loss allowance based on 12-month expected credit losses, even for debt securities that are highly rated (e.g., AAA- or AA-rated bonds).

Under the general approach, at each reporting date, an entity is required to assess whether there has been a significant increase in credit risk since initial recognition as this will determine whether 12-month expected credit losses or lifetime expected credit losses are recognised (see section 6 below). When applying the general approach, a number of operational simplifications and presumptions are available to help entities assess significant increases in credit risk since initial recognition. These include:

- If a financial instrument has low credit risk (equivalent to investment grade quality), then an entity may assume no significant increases in credit risk have occurred (see section 6.4.1 below). The low credit risk simplification may be useful for corporates as it provides relief for entities from tracking changes in the credit risk of high quality financial instruments. However, collateral does not influence whether a financial instrument has a low credit risk.
- If more forward-looking information (either on an individual or collective basis) is not available, there is a rebuttable presumption that credit risk has increased significantly when contractual payments are more than 30 days past due (see section 6.2.2 below). However, contract assets, by definition, cannot be past due. Therefore, corporates cannot rely on delinquency for staging of such assets.
- The change in risk of a default occurring in the next 12 months may often be used as an approximation for the change in risk of a default occurring over the remaining life when assessing significant increase in credit risk (see section 6.4.3 below).
- The assessment may be made on a collective basis (see section 6.5 below) or at the counterparty level (see section 6.4.4 below).

In measuring expected credit losses, financial institutions often already have sophisticated expected credit loss models and systems for capital adequacy purposes, including data such as the probability of default, loss given default and exposure at default. Many non-financial entities do not have models and systems in place that capture such information. One possibility is to make use of credit default swap spreads and bond spreads. For financial instruments that are rated by an external agency such as Standard & Poor's, for example, listed bonds, an entity may be able to use, as a starting point, historical default rates implied by such ratings. It must be stressed that the historical default rates implied by credit ratings assigned by agencies are historical rates for corporate debt and so they would not, without adjustment, satisfy the requirements of IFRS 9 as the standard requires the calculation of expected credit losses, based on current conditions and forecasts of future conditions, to be based on reasonable and supportable information. A significant challenge in applying the IFRS 9 impairment requirements to quoted bonds is that the historical

experience of losses by rating grade can differ significantly from the view of the market, as reflected in, for instance, credit default swap spreads and bond spreads.

Even for debt instruments that are not rated, it may be possible for entities to measure expected credit losses by estimating how external rating agencies would rate that instrument and using external rating agency loss data as an input. See Illustration 5-2 in section 5.4.1 below.

Bank deposits and current accounts that are classified as financial assets measured at amortised cost, are also subject to the general approach, even if treated as cash and cash equivalents. However, for most such instruments, given their maturity, the 12-month and lifetime expected credit losses are the same and will usually be small.

For any corporate that is a lessor, there may be a significant increase in allowances on finance leases, particularly if they chose to apply the simplified approach and record lifetime allowances (see section 10.2 below).

If the entity prepares separate financial statements under IFRS accounting standards, then the expected credit loss model will also apply to intercompany loans (see section 13 below). If revolving credit facilities are in place, then the entity will need to consider the period over which to measure expected credit losses and the portion of the undrawn revolving credit facility at the reporting date that is expected to be drawn down at the time of default in any period (limited, for facilities in stage 1 to the next twelve months) (see section 12 below). Corporates will also need to determine whether guarantees and other credit-enhancements can be reflected directly in the measurement of expected credit losses (see section 5.8.1 below).

The impairment disclosures required by IFRS 7 include inputs, assumptions and estimation methods used, operating simplifications applied and credit risk disclosures for trade receivables, contract assets or lease receivables measured under the simplified approach. The objective of the expanded disclosures is to enable users to understand the effect of credit risk on the amount, timing, and uncertainty of future cash flows (see section 15 below).

5 Measurement of expected credit losses

IFRS 9 defines credit loss as "the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e., all cash shortfalls), discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets)". When estimating the cash flows, an entity is required to consider: *[IFRS 9 Appendix A]*

- All contractual terms of the financial instrument (including prepayment, extension, call and similar options) over the expected life (see section 5.5 below) of the financial instrument. The maximum period to consider when measuring expected credit losses is the maximum contractual period (including extension options at the discretion of the borrower) over which the entity is exposed to credit risk (with an exception for revolving facilities).
- Cash flows from the sale of collateral held (see section 5.8.2 below) or other credit enhancements that are integral to the contractual terms.

Also, IFRS 9 goes on to define expected credit losses as "the weighted average of credit losses with the respective risks of a default occurring as the weights". *[IFRS 9 Appendix A]*. However, IFRS 9 does not prescribe specific approaches to estimate expected credit losses, but provides guidance on what the approaches must entail: [*IFRS 9.5.5.17]*

Extract from IFRS 9

5.5.17 An entity shall measure expected credit losses of a financial instrument in a way that reflects:

(a) an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;

(b) the time value of money; and

(c) reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

5.1 Definition of default

Extract from IFRS 9

B5.5.37 When defining default for the purposes of determining the risk of a default occurring, an entity shall apply a default definition that is consistent with the definition used for internal credit risk management purposes for the relevant financial instrument and consider qualitative indicators (for example, financial covenants) when appropriate. However, there is a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due unless an entity has reasonable and supportable information to demonstrate that a more lagging default criterion is more appropriate. The definition of default used for these purposes shall be applied consistently to all financial instruments unless information becomes available that demonstrates that another default definition is more appropriate for a particular financial instrument.

Default is not defined in IFRS 9 (see extract above) for the purposes of determining the risk of a default occurring. Because it is defined differently by different institutions (for instance, 30, 90 or 180 days past due), the IASB was concerned that defining default could result in a definition that is inconsistent with that applied internally for credit risk management. In particular, since default is the anchor point used to measure probabilities of default and losses given default in Basel modelling, requiring a different definition would require building a different set of models for accounting purposes. Therefore, IFRS 9 requires an entity to apply a definition of default that is consistent with how it is defined for normal credit risk management practices, consistently from one period to another. It follows that an entity might have to use different default definitions for different types of financial instruments. However, IFRS 9 stresses that an entity needs to consider qualitative indicators of default when appropriate in addition to days past due, such as breaches of covenants. *[IFRS 9.B5.5.37]*.

The IASB did not originally expect expected credit loss calculations to vary as a result of differences in the definition of default, because of the counterbalancing interaction between the way an entity defines default and the credit losses that arise as a result of that definition of default. *[IFRS 9.BC5.248]*. For instance, if an entity uses a shorter delinquency period of 30 days past due instead of 60 days past due, the associated loss given default will be correspondingly smaller as it is to be expected that more debtors that are 30 days past due will in due course recover. However, the notion of default is fundamental to the application of the model, particularly because it affects the subset of the population that is subject to the 12-month expected credit loss measure. *[IFRS 9.BC5.249]*.

IFRS 9 restricts diversity resulting from this effect by establishing a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due. This presumption may be rebutted only if an entity has reasonable and supportable information to support an alternative default criterion. *[IFRS 9.B5.5.37, IFRS 9.BC5.252]*.

A 90-day default definition would also be consistent with that used by banks for the advanced Basel II regulatory capital calculations (with a few exceptions).

How we see it

We observe that most banks have aligned their regulatory and accounting definitions of default. This generally means using 90 days past due under IFRS 9, with some exceptions for certain portfolios, such as mortgages, for which the regulatory definition may allow longer delinquency periods. Most banks have also aligned the accounting definition of credit-impaired for the purposes of transfers to stage 3 with the definition of default.

5.2 Lifetime expected credit losses

IFRS 9 defines lifetime expected credit losses as the expected credit losses that result from all possible default events over the expected life of a financial instrument, i.e., an entity needs to estimate the risk of a default occurring on the financial instrument during its expected life. *[IFRS 9 Appendix A, IFRS 9.B5.5.43]*. The expected life considered for the measurement of lifetime expected credit losses cannot be longer than the maximum contractual period (including extension options at the discretion of the borrower) over which the entity is exposed to credit risk. However, there is an exception for revolving facilities (see section 12 below).

Extract from IFRS 9

B5.5.29 For financial assets, a credit loss is the present value of the difference between:

(a) the contractual cash flows that are due to an entity under the contract; and

(b) the cash flows that the entity expects to receive.

Expected credit losses are estimated based on the present value of all cash shortfalls over the remaining expected life of the financial asset (see extract above). As expected, credit losses take into account both the amount and the timing of payments, a credit loss arises even if the holder expects to receive all the contractual payments due, but at a later date. *[IFRS 9.B5.5.28, IFRS 9.B5.5.29]*.

When estimating lifetime expected credit losses for undrawn loan commitments (see section 11 below), the provider of the commitment needs to:

- Estimate the expected portion of the loan commitment that will be drawn down over the expected life of the loan commitment. Except for revolving facilities (see section 12 below), the expected life will be capped at the maximum contractual period, including extension options at the discretion of the borrower, over which the entity is exposed to credit risk (see section 5.3 below for 12-month expected credit losses). *[IFRS 9.B5.5.31]*.
- Calculate the present value of cash shortfalls between the contractual cash flows that are due to the entity if the holder of the loan commitment draws down that expected portion of the loan and the cash flows that the entity expects to receive if that expected portion of the loan is drawn down. *[IFRS 9.B5.5.30]*.

For a financial guarantee contract (see section 11 below), the guarantor is required to make payments only in the event of a default by the debtor in accordance with the terms of the instrument that is guaranteed. Accordingly, the estimate of lifetime expected credit losses would be based on the present value of the expected payments to reimburse the holder for a credit loss that it incurs, less any amounts that the guarantor expects to receive from the holder, the debtor, or any other party. If an asset is fully guaranteed, the expected credit loss estimate for the financial guarantee contract would be consistent with the estimated cash shortfall estimate for the asset subject to the guarantee. *[IFRS 9.B5.5.32]*.

5.3 12-month expected credit losses

12-month expected credit losses are defined as "the portion of the lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date". *[IFRS 9 Appendix A]*. 12-month expected credit losses are further defined in IFRS 9.B5.5.43: *[IFRS 9.B5.5.43]*

Extract from IFRS 9

B5.5.43 For lifetime expected credit losses, an entity shall estimate the risk of a default occurring on the financial instrument during its expected life. 12-month expected credit losses are a portion of the lifetime expected credit losses and represent the lifetime cash shortfalls that will result if a default occurs in the 12 months after the reporting date (or a shorter period if the expected life of a financial instrument is less than 12 months), weighted by the probability of that default occurring. Thus, 12-month expected credit losses are neither the lifetime expected credit losses that an entity will incur on financial instruments that it predicts will default in the next 12 months nor the cash shortfalls that are predicted over the next 12 months.

Because the calculation is based on the probability of default, IFRS 9 emphasises that the 12-month expected credit loss is not the lifetime expected credit loss that an entity will incur on assets that it predicts will default in the next 12 months (i.e., for which the probability of default over the next 12 months is greater than 50%). For instance, the probability of default might be only 5%, in which case this is used to calculate 12-month expected credit losses, even though it is not probable that the asset will default. Also, the 12-month expected credit losses are not the cash shortfalls that are predicted over only the next 12 months. For an asset defaulting in the next 12 months, the lifetime expected credit losses that need to be included in the calculation will normally be significantly greater than just the cash flows that were contractually due in the next 12 months.

If the financial instrument has a maturity of less than 12 months, then the 12-month expected credit losses are the credit losses expected over the period to maturity.

For undrawn loan commitments (see section 11 below), an entity's estimate of 12-month expected credit losses are based on its expectations of the portion of the loan commitment that will be drawn down within 12 months of the reporting date. *[IFRS 9.B5.5.31]*.

As already mentioned in section 1.2 above, the IASB believes that 12-month expected credit losses serve as a proxy for the recognition of initial expected credit losses over time, as proposed in the 2009 exposure draft, and they mitigate the systematic overstatement of interest revenue that was recognised under IAS 39. *[IFRS 9.BC5.135]*. This practical approximation was necessary as a result of the decision to decouple the measurement and allocation of initial expected credit losses from the determination of the effective interest rate following the re-deliberations of the 2009 exposure draft. *[IFRS 9.BC5.199]*.

The stage 1, 12-month allowance overstates the necessary allowance for each financial instrument after initial recognition. However, this is offset by the fact that the allowance is not further increased (except for changes in the 12-month expected credit losses) until the instrument's credit risk has significantly increased and it is transferred to stage 2. For a portfolio of instruments with various origination dates, the overall provision may (very approximately) be a similar size as might be achieved using a more conceptually robust approach. Although there is no conceptual justification for an allowance based on 12-month expected credit losses, it was designed to be a pragmatic solution to achieve an appropriate balance between faithfully representing the underlying economics of a transaction and the cost of implementation.

How we see it

How accurate a proxy the 12-month and lifetime expected credit loss model is for a more conceptually pure approach will depend on the nature of the portfolio. Also, the effect of recording a 12-month expected credit loss in the first reporting period that a financial instrument is recognised will not have a significant effect on reported income if the portfolio is stable in size from one period to the next. The 12-month expected credit loss allowance may, however, significantly reduce the reported income for entities which are expanding the size of their portfolio.

Although the choice of 12 months is arbitrary, it is the same time horizon as used for the more advanced bank regulatory capital calculation under the Basel framework.[9] The definition of 12-month expected credit losses is similar to the Basel Committee's definition of expected credit loss, although the modelling requirements differ significantly.[10] The 12-month requirement under IFRS 9 will always differ from that computed for regulatory capital purposes, as the IFRS 9 measure is a point-in-time estimate, reflecting currently forecast economic conditions (see section 5.9.3 below), while the Basel regulatory figure is usually based on through-the-cycle assumptions of default and conservative estimates of losses given default. However, banks that use an advanced approach to calculate their capital requirements can use their existing systems and methodologies as a starting point and make the necessary adjustments to flex the calculation to comply with IFRS 9.

As mentioned above, the 12-month expected credit losses is defined as a portion of the lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date. *[IFRS 9 Appendix A]*. When measuring 12-month expected credit losses, one question is whether the cash shortfalls used take into account only default events within the next 12 months or subsequent default events as well. The issue arises for instruments that are expected to default and cure (i.e., to restore to performing) and then default again after curing.

IFRS 9 does not explicitly mention the treatment of cures and subsequent defaults when calculating expected credit losses. However, the IFRS Transition Resource Group for Impairment of Financial Instruments briefly talked about this in their discussion about the life of revolving credit card portfolios in April 2015: "As regards assets in Stage 2, it was acknowledged that the probability of assets defaulting and curing would have to be taken into account and that it would be necessary to build this into any models dealing with expected credit loss calculations. However, it was noted that materiality would need to be considered."[11]

How we see it

We conclude from the IFRS Transition Resource Group for Impairment of Financial Instruments discussion that cure events are only reflected in the calculation of the loss given default to the extent that they are expected to be effective. Consequently, if it is predicted that the asset will re-default in subsequent years, the re-default need not be included in the calculation of 12-month expected losses if the defaults are expected to be unrelated to the first default. In practice, however, IFRS 9 acknowledges that a variety of techniques can be used to meet the objective of expected credit loss measurement and that the definition of default may vary by product, across a bank and between banks.

When measuring expected credit losses, the treatment of re-defaults affects both the probability of default and the loss given default. Therefore, the same treatment is applied consistently to determine both the probability of default and the loss given default.

5.4 Probability of default and loss rate approaches

As mentioned above, the impairment requirements as per IFRS 9.5.1 do not prescribe specific approaches to estimate expected credit losses. Some of the common approaches include the PD and loss rate approaches (see sections 5.4.1 and 5.4.2 below, respectively).

9 Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards*, June 2006 and Basel III: *A global regulatory framework for more resilient banks and banking systems*, June 2011.

10 *Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012*.

11 Transition Resource Group for Impairment of Financial Instruments, Meeting Summary, 22 April 2015, para. 42(b). Available on the IFRS Foundation's website.

5.4.1 Probability of default approach

Following from Illustration 1-1 in section 1.2 above, calculations of the 12-month and lifetime expected credit losses are illustrated below.

Illustration 5-1: 12-month and lifetime expected credit loss measurement based on a probability of default approach

On 31 December 20X1, Bank A originates a 10 year bullet loan with a gross carrying amount of CU1,000,000, with interest being due at the end of each year and the principal due at maturity. In line with IFRS 9, Bank A must recognise an impairment allowance for the expected credit losses, considering current and forward-looking credit risk information.

The expected credit losses are a probability-weighted estimate of the present value of estimated cash shortfalls - i.e., the weighted average of credit losses, with the respective risks of a default occurring used as the weights. For this purpose, the following parameters must be estimated:

- Probability of default (PD) - Estimate of the likelihood of default over a given time horizon (e.g., from *ti-1* to *ti*). A default may only happen at a *ti* horizon if the facility has not been previously derecognized and is still in the portfolio. An early exit ('EE') may occur in case of default unless the facility reverts to performing without significant modification of the contractual terms. The marginal probability of default for the period *ti-1* to *ti* is then adjusted from the probability that an early exit occurred during the previous periods:

$$PD_{t_i} \times \prod_{J=1}^{J=j-1} (1 - EE_{t_j})$$

  We note that, for simplicity, Bank A may decide to model *EE* within the PD component.
- Loss given default (LGD) - Estimate of the loss arising in case a default occurs at a given time (e.g., *ti*). It is based on the difference between the contractual cash flows due and those that the lender would expect to receive, including from the realisation of any collateral. It is usually expressed as a percentage of the EAD.
- Exposure at default (EAD) - Estimate of the exposure at a future default date, taking into account expected changes in the exposure after the reporting date, including repayments of principal and interest, whether scheduled by contract or otherwise, expected drawdowns on committed facilities, and accrued interest from missed payments.
- Discount rate (r) - Rate used to discount an expected loss to a present value at the reporting date, i.e., the effective interest rate.

Based on these parameters, an expected credit loss can be computed for any horizon - typically for each due date of an exposure. The computation formula can be expressed as follows:

$$ECL_{t_n} = \sum_{t_i=t_1}^{t_i=t_n} \frac{PD_{t_i} \times \prod_{J=1}^{J=j-1}(1 - EE_{t_j}) \times LGD_{t_i} \times EAD_{t_i}}{(1 + r_i)^{t_i}}$$

Where:

i = each future payment

ti = maturity of the payment *i*

tn = horizon considered (either 12-month or lifetime)

Note that the figures in the tables below have been rounded to one or two decimal points.

Stage 1: 12-month expected credit losses of CU422

At origination, the loan is in stage 1. Thus, a corresponding 12-month expected credit loss allowance is recognised, i.e., the portion of the lifetime expected credit losses that result from default events that are possible within 12 months after the reporting date.

Based on statistical and qualitative information, Bank A has computed the following expected credit loss parameters at origination:

- As interest is paid on a yearly basis, expected credit losses are calculated using annual periods.
- Each year, exposure at default equals the outstanding principal plus accrued interest due at the end of the year. This bullet loan does not allow any prepayment, therefore the exposure at default is constant.
- The effective interest rate of the loan is assumed to be the contractual rate, which is 3%.
- Bank A sets EE = PDn-1 × 0.8, on the basis that a proportion of the loans which default are expected to cure and will once again be at risk of default.
- Based on provided guarantees and collateral, loss given default is estimated at 25% of EAD, whatever the date of default.

Year	Exposure at default	Discount rate	Cumulative probability of default @ origination	Marginal probability of default	Cumulative EE t-1 @ origination	Loss given default	Marginal expected credit loss	
	CU						CU	
20X1	1,000,000							
20X2	1,030,000	3%	0.17%	0.17%	0.00%	25%	422	12m expected credit loss
20X3	1,030,000	3%	0.49%	0.32%	0.14%	25%	775	
20X4	1,030,000	3%	0.86%	0.37%	0.39%	25%	877	
20X5	1,030,000	3%	1.38%	0.53%	0.69%	25%	1,196	
20X6	1,030,000	3%	1.84%	0.47%	1.11%	25%	1,027	
20X7	1,030,000	3%	2.37%	0.54%	1.47%	25%	1,141	
20X8	1,030,000	3%	2.85%	0.49%	1.90%	25%	1,014	
20X9	1,030,000	3%	3.30%	0.46%	2.28%	25%	912	
20Y0	1,030,000	3%	3.84%	0.56%	2.64%	25%	1,073	
20Y1	1,030,000	3%	4.50%	0.69%	3.07%	25%	1,280	
							9,717	Lifetime expected credit loss

$$\text{Marginal PD}_i = 1 - \frac{1 - \text{Cum PD}_i}{1 - \text{Cum PD}_{i-1}}$$

$$\text{Marginal ECL}_i = \frac{\text{PD}_i \times (1 - \text{Cum EE}_{i-1}) \times \text{LGD}_i \times \text{EAD}_i}{(1 + r_i)^i}$$

Stage 2: Lifetime expected credit losses of CU50,285

On 31 December 20X4 - 3 years after origination, the loan shows signs of significant deterioration in credit quality based on the creditworthiness of the obligor and forward-looking information, and Bank A moves it to stage 2. Illustration 6-4 in section 6.2.4 below shows the calculation underlying this assessment.

Consistent with the significant increase in credit risk, the probability of default of the obligor has increased. In consequence, the probability of an early exit has also increased, because of the higher level of default. For the purposes of this example, we assume that there are no significant fluctuations in collateral values and the loss given default remains constant.

Year	Exposure at default	Discount rate	Cumulative probability of default	Marginal probability of default	Cumulative EE t-1	Loss given default	Marginal expected credit loss	
	CU						CU	
20X4	1,000,000		0.00%					
20X5	1,030,000	3%	1.40%	1.40%	0.00%	25%	3,495	12m expected credit loss
20X6	1,030,000	3%	3.87%	2.51%	1.12%	25%	6,017	
20X7	1,030,000	3%	8.82%	5.15%	3.10%	25%	11,756	
20X8	1,030,000	3%	12.84%	4.40%	7.06%	25%	9,366	
20X9	1,030,000	3%	16.04%	3.67%	10.27%	25%	7,322	
20Y0	1,030,000	3%	18.98%	3.50%	12.83%	25%	6,585	
20Y1	1,030,000	3%	21.60%	3.23%	15.18%	25%	5,745	
							50,285	Lifetime expected credit loss

Stage 3: Lifetime expected credit losses of CU262,850

In the following year, on 31 December 20X5, the obligor does not pay the amount due. Based on credit information available, it is already considered to be in default and is moved to stage 3 - credit-impaired. At this time, the exposure is CU1,030,000.

Once a facility becomes credit-impaired, impairment must still represent expected credit losses. Therefore, it must be probability-based. At the reporting date, Bank A updates the appraisal value of the collateral and considers 3 probable scenarios:

- **Scenario 1 - Cure**: The obligor eventually pays the amounts past due and the loan reverts to performing. In this case, expected credit losses correspond to lifetime losses expected from loans that have recently defaulted. Based on its historical data and using the methodology described above, Bank A expects an expected credit loss of CU130,000.
- **Scenario 2 - Restructure**: Bank A comes to a restructuring agreement with the obligor. After 6 months of negotiation, the loan is written off and a new loan is initiated with a net present value of CU800,000.
- **Scenario 3 - Liquidation**: The loan is written off and the bank starts the collection of the contractual collateral. Bank A expects to sell the collateral within a year and to collect CU700,000 net of recovery costs.

The expected credit loss of each scenario can be calculated as follows:

$$ECL = EAD - \sum_{t_i = t_1}^{t_i = t_n} \frac{CF_{t_i} - RC_{t_i}}{(1 + r_i)^{t_i}}$$

Where:

ECL	= expected credit loss
CF	= expected future cash flows
RC	= expected recovery costs

Probable scenarios	Probability	EAD	Dis-count rate	Expected net future cash flows	Expected recovery time	Expected credit loss of each scenario	Weighted expected credit loss
		CU		CU		CU	CU
Scenario 1: Cure	20%	1,030,000	3%	900,000	0.0	130,000	26,000
Scenario 2: Restructure	40%	1,030,000	3%	800,000	0.5	241,737	96,695
Scenario 3: Liquidation	40%	1,030,000	3%	700,000	1.0	350,388	140,155
Weighted average expected credit loss						Lifetime expected credit loss	262,850
						% of EAD:	26%

$$ECL = EAD - \frac{\text{Exp. Net future CF}}{(1+r)^{\text{exp recovery time}}}$$

How we see it

Our observation of practice suggests that most sophisticated banks have developed their IFRS 9 solutions by adjusting and extending their Basel regulatory capital models. This is true for all types of model component: probability of default, loss given default and exposure at default. This is perhaps unsurprising given the historical investment large banks have made in their Basel models, and the fact that IFRS 9 shares fundamental similarities in expected loss modelling. But, for many banks, creating lifetime estimates and altering models to satisfy the complex and detailed expected credit loss impairment requirements on first application of IFRS 9 necessitated significant work on initial adoption and as the approach to ECL modelling continues to evolve.

However, many non-financial entities do not have models and systems in place that capture such information. One possibility is to make use of historical default rates as collected by credit rating agencies such as Standard and Poor's. This is shown in the Illustration below.

Illustration 5-2: Expected credit loss measurement using credit rating agency historical default rates

Introduction

A corporate uses a non-modelled approach to quantify the expected credit loss of a loan issued to Borrower X.

Fact Pattern

On 1 January 20X2, the corporate made a 2-year loan of CU1.5m to Borrower X. It needs to estimate its expected credit losses on the loan for its financial statements for the year ended 31 December 20X2. There is no specified collateral pledged for this loan. The lender has a general security agreement in place for the loan but it is subordinate to other bank debts of Borrower X. As a result, the loan is considered to be unsecured for the purpose of the expected credit loss measurement.

Borrower X is an unrated private company. However, its financial condition is such that the loan would appear to fit what Standard & Poor's would rate as a B-rated instrument: the balance sheet of Borrower X indicates that while the entity currently has the capacity to meet its financial commitments on the obligation, adverse business, financial, or economic conditions will likely impair the borrower's capacity or willingness to meet its financial commitments on the obligation.

The loan is assessed to be in stage 1 as the lender determines that there has not been a significant increase in credit risk. However, the economic environment is more uncertain than has been typical over the course of the last decade.

Expected credit loss Projection

The corporate calculates the expected credit losses using the normal formula (expected credit loss= *probability of default × loss given default × exposure at default, discounted at the effective interest rate*):

- A probability of default is initially estimated based on the historical default rates for loans which have 'B' credit ratings. The S&P global ratings study indicates that 'B' rated entities have a historical aggregate cumulative 12-month probability of default of 3.18%.[12] Given the uncertainties in the economic environment this historical probability of default needs to be adjusted. The corporate adjusts the S&P historical default rate to reflect current conditions and estimates a 12-month probability of default range of 4-6%.
- Given the subordination of the loan to other bank debts, the majority of the amount owed would probably be lost in the event of default, therefore, loss given default is estimated in the range of 80-100%.
- The exposure at default is known, i.e., CU1.5m, and the effective interest rate of the loan for this example is assumed to be the contractual rate, which is 3%. As a simplifying assumption, it is also assumed that any default is most likely to occur at the end of the year. The discounted exposure at default over 1 year is CU1.5m which, divided by 1.03 give a discounted amount of approximately CU1.46m, that can be multiplied by the probability of default and the loss given default.

Conclusion

With the assumptions that the discount rate is 3%, the 1-year probability of default is 4-6% and the loss given default is 80-100%, the expected credit loss for the loan is estimated to be in the range of CU46,602 - CU87,379 (see table below). However, this approach clearly acknowledges that there is a range of possible values for the expected credit loss and significant judgement is required to reach a final determination. This judgement would need to be documented using all available information without undue cost or effort, possibly including the current spreads of similar bonds that are 'B' rated, to narrow the range of possible values for the expected credit loss.

		Loss given default (CU)	
		80%	100%
Probability of default	4%	46,602	58,252
	6%	69,903	87,379

5.4.2 Loss rate approach

Not every entity calculates a separate risk of a default occurring and a loss given default, but instead uses a loss rate approach. Using this approach, the entity develops loss-rate statistics on the basis of the amount written off over the life of the financial assets. It must then adjust these historical credit loss trends for current conditions and expectations about the future. The following Illustrative Example 9 from IFRS 9 is designed to illustrate how an entity measures 12-month expected credit losses using a loss rate approach. *[IFRS 9.IE Example 9, IFRS 9.IE53-IE57]*.

Illustration 5-3: 12-month expected credit losses measurement based on a loss rate approach

Bank A originates 2,000 bullet loans with a total gross carrying amount of CU500,000. Bank A segments its portfolio into borrower groups (Groups X and Y) on the basis of shared credit risk characteristics at initial recognition. Group X comprises 1,000 loans with a gross carrying amount per client of CU200, for a total gross carrying amount of CU200,000. Group Y comprises 1,000 loans with a gross carrying amount per client of CU300, for a total gross carrying amount of CU300,000. There are no transaction costs and the loan contracts include no options (for example, prepayment or call options), premiums or discounts, points paid, or other fees.

Bank A measures expected credit losses on the basis of a loss rate approach for Groups X and Y. In order to develop its loss rates, Bank A considers samples of its own historical default and loss experience for those types of loans. In addition, Bank A considers forward-looking information, and updates its historical information for current economic conditions as well as reasonable and supportable forecasts of future economic conditions. Historically, for a population of 1,000 loans in each group, Group X's loss rates are 0.3%, based on four defaults, and historical loss rates for Group Y are 0.15%, based on two defaults.

12 S&P Global Ratings: *Default, Transition, and Recovery: 2021 Annual Global Corporate Default and Rating Transition Study, Table 24 Global Corporate Average Cumulative Default Rates (1981-2021)*, S&P Global, 13 April 2022. Available on S&P Global's website.

	Number of clients in sample	Estimated per client gross carrying amount at default	Total estimated gross carrying amount at default	Historic per annum average defaults	Estimated total gross carrying amount at default	Present value of observed loss (a)	Loss rate
Group	A	B	C = A × B	D	E = B × D	F	G = F ÷ C
X	1,000	CU200	CU200,000	4	CU800	CU600	0.30%
Y	1,000	CU300	CU300,000	2	CU600	CU450	0.15%

(a) Expected credit losses are discounted using the effective interest rate. However, for purposes of this example, the present value of the observed loss is assumed. *[IFRS 9.5.5.17(b)]*.

At the reporting date, Bank A expects an increase in defaults over the next 12 months compared to the historical rate. As a result, Bank A estimates five defaults in the next 12 months for loans in Group X and three for loans in Group Y. It estimates that the present value of the observed credit loss per client will remain consistent with the historical loss per client.

On the basis of the expected life of the loans, Bank A determines that the expected increase in defaults does not represent a significant increase in credit risk since initial recognition for the portfolios. On the basis of its forecasts, Bank A measures the loss allowance at an amount equal to 12-month expected credit losses on the 1,000 loans in each group amounting to CU750 and CU675 respectively. This equates to a loss rate in the first year of 0.375% for Group X and 0.225% for Group Y.

	Number of clients in sample	Estimated per client gross carrying amount at default	Total estimated gross carrying amount at default	Expected defaults	Estimated total gross carrying amount at default	Present value of observed loss	Loss rate
Group	A	B	C = A × B	D	E = B × D	F	G = F ÷ C
X	1,000	CU200	CU200,000	5	CU1,000	CU750	0.375%
Y	1,000	CU300	CU300,000	3	CU900	CU675	0.225%

Bank A uses the loss rates of 0.375% and 0.225% respectively to estimate 12-month expected credit losses on new loans in Group X and Group Y originated during the year and for which credit risk has not increased significantly since initial recognition.

The example above illustrates that under the loss rate approach, an entity would compute its loss rates by segmenting its portfolio into appropriate groupings (or sub-portfolios) based on shared credit risk characteristics and then updating its historical loss information with more forward-looking information. The loss rate was derived simply by computing the ratio between the present value of observed losses (the numerator) and the gross carrying amount of the loans (the denominator).

Expected credit losses must be discounted at the effective interest rate. However, in this example, the present value of the observed loss is just assumed. This is an additional area of complexity that entities have to take into account when trying to build upon their existing loss rate approaches.

How we see it

Although the loss rate approach does not require an explicit calculation of the risk of a default occurring, there has to be an estimate of the number of defaults in order to determine whether there has been a significant increase in credit risk (see section 6 below). Hence, IFRS 9 also requires any entities that intend to use this approach to track the likelihood of default.

5.5 Expected life versus contractual period

Lifetime expected credit losses are defined as the expected credit losses that result from all possible default events over the expected life of a financial instrument. *[IFRS 9 Appendix A]*. This is consistent with the requirement that an entity assesses whether the credit risk on a financial instrument has increased significantly since initial recognition by using the change in the risk of a default occurring over the expected life of the financial instrument. *[IFRS 9.5.5.9]*.

An entity must therefore estimate cash flows and the instrument's life by considering all contractual terms of the financial instrument (for example, prepayment, extension, call and similar options). There is a presumption that the expected life of a financial instrument can be estimated reliably. In those rare cases when it is not possible to reliably estimate the expected life of a financial instrument, the entity shall use the remaining contractual term of the financial instrument. *[IFRS 9 Appendix A, IFRS 9.B5.5.51]*.

Extract from IFRS 9

5.5.19 The maximum period to consider when measuring expected credit losses is the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period, even if that longer period is consistent with business practice.

[IFRS 9.5.5.19].

Although an exception to the maximum period to consider when measuring expected credit losses has been added for revolving facilities (see section 12 below), the IASB remains of the view that the contractual period over which an entity is committed to provide credit (or a shorter period considering prepayments) is the correct conceptual outcome. The IASB noted that most loan commitments will expire at a specified date, and if an entity decides to renew or extend its commitment to extend credit, it will be a new instrument for which the entity has the opportunity to revise the terms and conditions. *[IFRS 9.BC5.260]*.

This means that extension options are only reflected in the measurement of expected credit losses as long as this does not extend the horizon beyond the maximum contractual period over which the entity is exposed to credit risk. Extension options at the discretion of the lender are therefore excluded from the measurement of expected credit losses. Similarly, a lender's ability to require prepayment limits the horizon over which it is exposed to credit risk. The first prepayment date at the discretion of the lender therefore represents the maximum period to be reflected in the expected loss calculation.

When assessing the impact of extension options at the discretion of the borrower, an entity estimates both the probability of exercise of the extension option as well as the portion of the loan that will be extended if the extension option can be exercised for a portion of the loan only. This is consistent with how lifetime expected losses must be assessed for loan commitments where an entity's estimate of expected credit losses must be consistent with its expectations of drawdowns on that loan commitment. Although IFRS 9 is not explicit on this point, the effect of extension options is best modelled not by estimating an average life of the facility but by estimating the exposure at default each year over the maximum lifetime. This is because use of an average life would not reflect losses expected to occur beyond the average life. *[IFRS 9.B5.5.31]*.

Expected prepayments at the discretion of borrowers are also reflected in the measurement of expected credit losses. As with extension options, an entity must estimate both the probability of exercise of the prepayment option as well as the portion of the loan that will be prepaid if the prepayment option can be exercised for a portion of the loan only. As with extension options, IFRS 9 does not specify whether prepayment patterns are reflected through an amortising exposure at default over the maximum contractual period of the financial instruments or, rather, by shortening the horizon over which to measure expected credit losses to the average life of the financial instruments.

How we see it

Similar to the treatment of extension options, for prepayment options, in our view it is more appropriate to adjust the EAD for the facility each year over the maximum lifetime, rather than to shorten the period over which to measure expected credit losses. We consider this a more transparent way of incorporating product features and potential impacts of different macroeconomic scenarios that can, for example, affect pre-payment patterns and customers' ability to refinance.

Further complexity in assessing expected prepayments and extensions arises if one considers that the behaviour of borrowers is affected by their creditworthiness. This means that prepayment and extension patterns are probably estimated separately for stage 1 and stage 2 assets. This may represent a significant challenge, as making such estimates would require distinct historical observations for each of the stage 1 and 2 populations, which are unlikely to be available given that these populations were never identified in the past. Prepayment assumptions for stage 2 assets would need to factor in the probabilities that some may subsequently default and some may cure. A further complication is that expected prepayment and extension behaviour may vary with changes in the macroeconomic outlook.

IFRS 9 is clear that for loan commitments and financial guarantee contracts, the time horizon to measure expected credit losses is the maximum contractual period over which an entity has a present contractual obligation to extend credit. *[IFRS 9.B5.5.38]*. However, for revolving credit facilities (e.g., credit cards and

overdrafts), as an exception to the normal rule, this period is extended beyond the maximum contractual period and includes the period over which the entity is exposed to credit risk and expected credit losses would not be mitigated by credit risk management actions (see section 12 below). This exception is limited to facilities that include both a loan and an undrawn commitment component, that do not have a fixed term or repayment structure and usually have a short contractual cancellation period (for example, one day). *[IFRS 9.5.5.20, IFRS 9.B5.5.39, IFRS 9.B5.5.40]*.

Frequently asked questions

Question 5-1: What is the maximum period to consider when measuring expected credit losses for a portfolio of mortgage loans with a stated maturity but containing a contractual feature whereby the term is automatically extended subject to the lender's non-objection?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 22 April 2015 - Agenda paper no. 1)

At its April 2015 meeting, the IFRS Transition Resource Group for Impairment of Financial Instruments (see section 1.4 above) discussed how to determine the maximum period for measuring expected credit losses, by reference to the following example.

Illustration 5-4: Determining the maximum contractual period when measuring expected credit losses

Bank A manages a portfolio of variable rate mortgages on a collective basis. The mortgage loans are issued to retail customers in Country X with the following terms:

- The stated maturity is 6 months with an automatic extension feature whereby, unless the borrower or lender take action to terminate the loan at the stated maturity date, the loan automatically extends for the following 6 months, The interest rate is fixed for each 6-month period at the beginning of the period. The interest rate is reset to the current market interest rate on the extension date.
- The lender's right to refuse an extension is unrestricted.

It is assumed that the mortgage loans meet the criteria for amortised cost measurement under IFRS 9.4.1.2.

In practice, borrowers are generally expected not to elect to terminate their loans on the stated maturity date, because moving the mortgage to another bank, or applying for a new product, generally involves an administrative burden and has little or no economic benefit for the borrower.

Furthermore, Bank A does not complete regular credit file reviews for individual loans and as a result does not usually cancel the loans unless it receives information about an adverse credit event in respect of a particular borrower. On the basis of historical evidence, such loans extend many times and can last for up to 30 years.

The IFRS Transition Resource Group for Impairment of Financial Instruments noted that:

- IFRS 9 is clear that the maximum period to consider when measuring expected credit losses in this example would be restricted to 6 months, because this is the maximum contractual period over which the lender is exposed to credit risk, i.e., the period until the lender can next object to an extension. *[IFRS 9.5.5.19]*.
- IFRS 9 requires that extension options must be considered when determining the maximum contractual period, but does not specify whether these are lender or borrower extension options. However, if the extension option is within the control of the lender, the lender cannot be forced to continue extending credit and therefore such an option cannot be considered as lengthening the maximum period of exposure to credit risk. Conversely, if a borrower holds an extension option that could force the lender to continue extending credit, this would have the effect of lengthening the maximum contractual period of credit exposure.
- The maximum contractual period over which the entity is exposed to credit risk should be determined in accordance with the substantive contractual terms of the financial instrument. To further illustrate this point, a situation in which a lender is legally prevented from exercising a contractual right should be seen as distinct from a situation in which a lender chooses not to exercise a contractual right for practical or operational reasons.

- In the example presented, the facility is not of a revolving nature and the borrower does not have any such flexibility regarding drawdowns. Consequently, it would not be appropriate to analogise the 6-month mortgage loan to a revolving credit facility that has been fully drawn at the reporting date. Hence, the example falls outside the narrow scope exception for revolving credit facilities (e.g., credit cards and overdraft facilities) in which the maximum period to consider when measuring expected credit losses is over the period that the entity is exposed to credit risk and expected credit losses would not be mitigated by credit risk management actions, even if that period extends beyond the maximum contractual period (see section 12 below). *[IFRS 9.5.5.20]*.
- Consequently, it was acknowledged that there may be a disconnect between the accounting and credit risk management view in some situations (e.g., an entity may choose to continue extending credit to a long-standing customer despite being in a position to reduce or remove the exposure). See further discussion on the application of the revolving credit facilities exception to multi-purpose facilities (see section 12 below).

For demand deposits that have no fixed maturity and can be withdrawn by the holder on very short notice (e.g., one day, assuming there is no contractual or legal constraint that could prevent the holder from withdrawing its cash at any time), the period used by the holder of such demand deposits to estimate expected credit losses would be limited to the contractual notice period, i.e., one day. This is the maximum contractual period over which the holder is exposed to credit risk. In accordance with IFRS 9.5.5.19, extension periods at the option of the holder are excluded in estimating the maximum contractual period because the holder can unilaterally choose not to extend credit and thus can limit the period over which it is exposed to credit risk. Furthermore, demand deposits do not fall under the revolving credit facility exception (see section 12 below) as they do not comprise an undrawn element. *[IFRS 9.5.5.20]*.

Similar requirements apply to loans that are subject to a rollover facility at the discretion of the lender, where the lender has an option to extend for a further period during the term of the facility but is not committed or contractually obliged to grant the extension (e.g., the lender has granted a 1-month loan and the lender has the option to extend for a further period over the 1-year rollover facility). The period considered by the lender when estimating expected credit losses including the determination of the probability of default (see section 5.4.1 above) would be limited to the contractual period. In such instances, the probability of default would be determined based on the contractual payment at the end of the maximum contractual period, i.e., 1-month rather than 1-year, should the lender not extend the facility. The resulting expected credit losses reflects the consequences of credit not being extended, although this could include the impact of a scenario where the loan is extended as part of the recovery process (see section 5.6 below).

5.6 Probability-weighted outcome and multiple scenarios

Expected credit losses must reflect an unbiased and probability-weighted estimate of credit losses over the expected life of the financial instrument (i.e., the weighted average of credit losses with the respective risks of a default occurring as the weights). *[IFRS 9.5.5.17(a), IFRS 9 Appendix A, IFRS 9.B5.5.28]*.

IFRS 9 makes it clear that when measuring expected credit losses, in order to derive an unbiased and probability-weighted amount, an entity needs to evaluate a range of possible outcomes. *[IFRS 9.5.5.17(a)]*. This involves identifying possible scenarios that specify:

- The amount and timing of the cash flows for particular outcomes
- The estimated probability of these outcomes

Extract from IFRS 9

5.5.18	When measuring expected credit losses, an entity need not necessarily identify every possible scenario. However, it shall consider the risk or probability that a credit loss occurs by reflecting the possibility that a credit loss occurs and the possibility that no credit loss occurs, even if the possibility of a credit loss occurring is very low.
B5.5.41	The purpose of estimating expected credit losses is neither to estimate a worst-case scenario nor to estimate the best-case scenario. Instead, an estimate of expected credit losses shall always reflect the possibility that a credit loss occurs and the possibility that no credit loss occurs even if the most likely outcome is no credit loss.

[IFRS 9.5.5.18, IFRS 9.B5.5.41].

Although an entity does not need to identify every possible scenario, it will need to take into account the possibility that a credit loss occurs, no matter how low that probability is. This is not the same as a single estimate of the worst-case or best-case scenario, or the most likely outcome (i.e., when there is a low risk or probability of default with high loss outcomes, the most likely outcome could be no credit loss even though an allowance would be required based on probability-weighted cash flows). It is worthwhile noting that it is implicit that the sum of the weighted probabilities will be equal to one. A simple example of application of a probability-weighted calculation is shown in Illustration 5-5 in section 5.6.1 below.

Without taking into account multiple economic scenarios, calculating a probability-weighted amount does not require a complex analysis or a detailed simulation of a large number of scenarios and IFRS 9 suggests that relatively simple modelling may be sufficient. For instance, the average credit losses of a large group of financial instruments with shared risk characteristics may be a reasonable estimate of the probability-weighted amount. In other situations, the identification of scenarios that specify the amount and timing of the cash flows for particular outcomes and the estimated probability of those outcomes will probably be needed. In those situations, the expected credit losses shall reflect at least two outcomes in accordance with IFRS 9.5.5.18. *[IFRS 9.B5.5.42]*.

5.6.1 Single versus multiple forward-looking economic scenarios

Frequently asked questions

Question 5-2: Whether, when measuring expected credit losses and when assessing significant increases in credit risk, can an entity use a single forward-looking economic scenario or whether an entity needs to incorporate multiple forward-looking scenarios, and if so how?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 11 December 2015 - Agenda paper no. 1)

At the December 2015 IFRS Transition Resource Group for Impairment of Financial Instruments meeting (see section 1.4 above), the question was asked as to whether the use of multiple scenarios referred to in IFRS 9 relates only to what might happen to particular assets given a single forward-looking economic scenario (i.e., default or no default), or whether application of IFRS 9 requires an entity to use multiple forward-looking economic scenarios, and if so how.

The IFRS Transition Resource Group for Impairment of Financial Instruments members noted that the measurement of expected credit losses is required to reflect an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes. Consequently, when there is a non-linear relationship between the different forward-looking scenarios and their associated credit losses, using a single forward-looking economic scenario would not meet this objective. In such cases, more than one forward-looking economic scenario would need to be used in the measurement of expected credit losses.[13] For each scenario the associated expected credit losses would need to be multiplied by the weighting allocated to that scenario.

The IFRS Transition Resource Group for Impairment of Financial Instruments also discussed the use of multiple economic scenarios to assess whether exposures should be measured using lifetime economic losses (see section 6.7 below). It was noted by the IFRS Transition Resource Group for Impairment of Financial Instruments that if the same variable is relevant for determining significant increase in credit risk and for measuring expected credit losses, the same forward-looking scenarios should be used for both.

The IFRS Transition Resource Group for Impairment of Financial Instruments discussed a particular example in which there are considered to be three possible economic scenarios.[14] This is shown in the Illustration below.

Illustration 5-5: Incorporating single versus multiple forward-looking scenarios when measuring expected credit losses

Scenario	Future unemployment	Likelihood of occurrence	Expected credit losses
(a)	4%	20%	CU30
(b)	5%	50%	CU70
I	6%	30%	CU170

13 IASB Transition Resource Group for Impairment of Financial Instruments, Meeting Summary, 11 December 2015, para. 49, 11. Available on the IFRS Foundation's website.

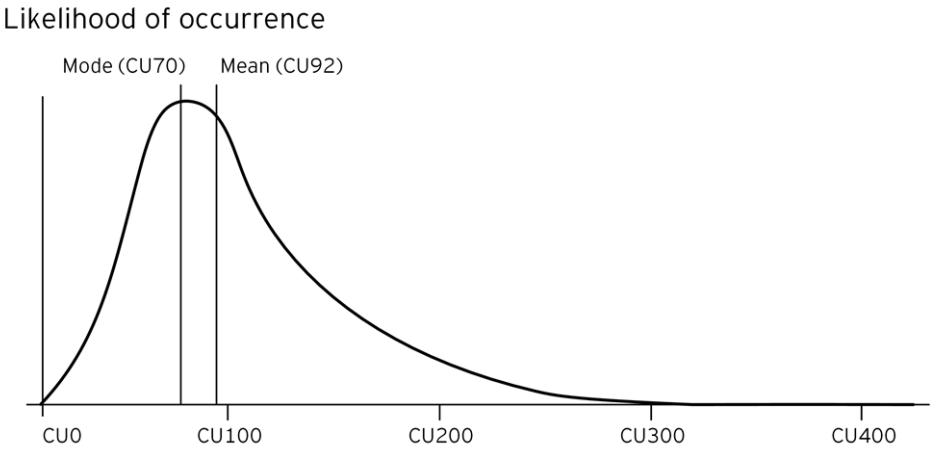
14 IASB Transition Resource Group for Impairment of Financial Instruments, Meeting Summary, 11 December 2015, paras. 50 and 51. Available on the IFRS Foundation's website.

Use of a single central economic scenario based on the most likely outcome of 5% unemployment, i.e., scenario (b), would give rise to an expected credit loss of CU70. However, using a probability-weighted range of scenarios, the expected credit loss would be CU92 ((CU30 × 0.2) + (CU70 × 0.5) + (CU170 × 0.3)). Consequently, the IFRS Transition Resource Group for Impairment of Financial Instruments observed that in this example, using a single central forward-looking economic scenario would not result in an unbiased and probability-weighted amount in accordance with IFRS 9.

The IFRS Transition Resource Group for Impairment of Financial Instruments was concerned about the distribution of possible losses often being 'non-linear', in that the increase in losses associated with those economic scenarios that are worse than the central forecast will be greater than the reduction in losses associated with those scenarios that are more benign. To use statistical terminology, the distribution is skewed. Depending on how it is calculated, a single scenario gives the mode of this distribution (i.e., the most likely outcome) or the median (i.e., the central forecast). In contrast, IFRS 9 requires the use of the mean (i.e., a probability-weighted estimation).

We have illustrated a possible distribution of the losses in the portfolio consistent with the above example in Figure 5-1 below.

Figure 5-1: Distribution of losses



At the IFRS Transition Resource Group for Impairment of Financial Instruments meeting, it was noted that there are a number of possible approaches that might be used to incorporate multiple economic approaches. IFRS 9 does not prescribe any particular method of measuring expected credit losses and the measurement should reflect an entity's own view, however, IFRS 9 requires that the expected losses must reflect:

- An unbiased and probability-weighted amount that is determined using a range of possible outcomes
- Reasonable and supportable information that is available without undue cost or effort at the reporting date

With respect to reasonable and supportable information, IFRS Transition Resource Group for Impairment of Financial Instruments members made the following observations:

- Although IFRS 9 does not specifically require an entity to consider external information, an entity should consider information from a variety of sources in order to ensure that the information used is reasonable and supportable.
- The information considered could vary depending on the facts and circumstances including the level of sophistication of the entity, geographical region and the particular features of the portfolio.
- While entities are not expected to consider every possible scenario, the scenarios considered should reflect a representative sample of possible outcomes.[15]

The IFRS Transition Resource Group for Impairment of Financial Instruments members recognised that materiality considerations would need to be taken into account.

15 IASB Transition Resource Group for Impairment of Financial Instruments, Meeting Summary, 11 December 2015, paras. 53. Available on the IFRS Foundation's website.

In an IASB webcast on 25 July 2016, it was noted that, having considered:

- Whether the effect of non-linearity is material
- Whether the entity has a reasonable and supportable basis for this multiple scenario analysis
- Whether the application is possible without undue cost or effort

A conclusion may sometimes be reached that it is not necessary to actually use multiple scenarios to apply the impairment requirements in IFRS 9. However, multiple scenarios must always be considered.

At the December 2015 IFRS Transition Resource Group for Impairment of Financial Instruments meeting, the IFRS Transition Resource Group for Impairment of Financial Instruments also noted that consideration should be given to the consistency of forward-looking information used for the measurement of expected credit losses and for other purposes within the organisation, such as budgeting and forecasting. The IFRS Transition Resource Group for Impairment of Financial Instruments members acknowledged that there might be differences, but observed that these should be understood and explainable.

The IFRS Transition Resource Group for Impairment of Financial Instruments members also observed that the incorporation of forward-looking scenarios will require judgement. Consequently, they emphasised the importance of the IFRS 7 disclosure requirements relating to how forward-looking information has been incorporated into the determination of expected credit losses (see Chapter 50 at section 5.3).[16]

5.6.2 Approaches to incorporate multiple economic scenarios

Since December 2015, banks have given significant attention to how multiple economic scenarios can be incorporated into expected credit loss calculations. We have seen three main approaches, as follows:

(a) Probability-weighted scenarios - this is similar to the method discussed at the IFRS Transition Resource Group for Impairment of Financial Instruments meeting in December 2015 and illustrated in Illustration 5-5 in section 5.6.1 above. It involves establishing a number of scenarios (typically three scenarios but we have seen varying numbers, generally between two and four), estimating the losses that would arise in those scenarios and allocating a weighting to each scenario. Unlike Illustration 5-5 in section 5.6.1 above, these do not normally model economic variables such as unemployment rates in isolation - to do so, would also require complex modelling of the correlations between those variables. Instead, each scenario is normally a coherent combination of economic variables. For example, a scenario relevant to mortgage loans might include assumptions about unemployment, interest rates and house prices. This approach is transparent, but it may be difficult to assign the weightings to each scenario, requiring judgement as well as experience of the past. When selecting scenarios and respective weights, we expect banks to take into consideration the entire distribution of macroeconomic scenarios and select points (i.e., scenarios) from that distribution, with their respective weights representing the portion of the distribution represented by the scenario. We would also expect that the mean of the selected scenarios and weights is similar to that of the entire distribution.

(b) The second approach is to calculate expected credit losses based on a central forward-looking scenario and to adjust the outcome where necessary by a factor to reflect the non-linearity of the loss distribution. In practice, it may be that a method similar to (a) above will need to be used in order to calculate this factor - so that it is not a very different approach. However, some banks view the merits of this approach as being less mechanistic and allowing more room for judgement.

(c) Monte Carlo simulation - this method seeks to calculate the expected losses associated with the entire distribution of possible scenarios around the bank's central economic forecast. It has the advantage that it does not require the bank to formulate specific scenarios or assign weightings to them, but the simulation is dependent on assumptions that could not be transparent to either users or preparers, so that this solution can seem like a 'black box'. It is also very demanding as to the volume of data that has to be manipulated and it is not how most banks manage credit risk today. This method is quite rarely applied in practice.

How we see it

In practice, three main approaches have been used by banks to incorporate multiple economic scenarios into expected credit loss calculations, i.e., probability-weighted scenarios, central forward-looking scenario adjusted for non-linearity of the loss distribution and Monte Carlo simulation.

16 IASB Transition Resource Group for Impairment of Financial Instruments, Meeting Summary, 11 December 2015, paras. 56. Available on the IFRS Foundation's website.

The effect of multiple scenarios will affect not just the probability of defaults but also the loss given defaults. For instance, for property-based lending it will be necessary to forecast the value of collateral associated with each economic scenario that is modelled. A consequence of this is that there may be a need to record an expected credit loss allowance for an asset that, based on the central forecast of future collateral values, is fully collateralised.

The use of multiple scenarios may also have an effect on the estimated EAD.

A number of other observations can be made about the use of multiple scenarios:

- Whichever approach is used to calculate the effect of non-linearity, it will be necessary for banks to communicate the result of the calculation in a manner which can be understood by readers of the financial statements. One possible approach would be for banks to report the losses associated with the central forecast and then, separately, the effect of the consideration of other scenarios. This would allow banks to communicate the amounts they expect to lose and would permit comparison between banks of the effect of the adjustment for non-linearity, even if the banks use different methods to make the calculation.
- It would seem that the effects of non-linearity depend on the countries in which banks operate and the economic characteristics of those countries. For instance, the effect of alternative scenarios of interest rates and unemployment may be greater in countries where there is more of a 'boom and bust' economic cycle. The size of the effect is also dependent on origination practices and the particular lending products - variable rate loans being more sensitive to interest rates than fixed-rate ones, while defaults on credit cards are more affected by unemployment rates. In some cases, the issue is seen as most relevant for exposures to a particular economic variable, an example being lending to companies involved in the oil industry. In this example, banks might model a number of scenarios as to how oil prices could evolve. A similar approach may be relevant for non-banks with similar exposures through long term construction contracts or leasing activities. There is also more likely to be non-linearity in the calculation of expected credit losses when exposures are collateralised by assets whose values also change in response to the economic conditions that drive the probability of default. An example is residential mortgage loans.
- It must be stressed that the IFRS Transition Resource Group for Impairment of Financial Instruments discussion highlighted the importance of calculating the effect of non-linearity using only reasonable and supportable information, implying that if the information is not available then there is a limit to what can be done. However, banks will also need to take into account their regulators' expectations (see section 1.5 above and section 7.1 below for Basel Committee guidance).

How we see it

The effect of non-linearity varies across the banks depending on the country of origin, economic conditions, and lending practices. It is important to disclose the effects of non-linearity in a manner that is readily understood by users of the financial statements.

The process of forecasting future economic conditions is discussed further in section 5.9.3 below.

5.6.3 Incorporating the impact of rare shock events

One of the main challenges in applying the IFRS expected credit loss model is to determine what is reasonable and supportable forward-looking information as per IFRS 9.5.5.17 and how to treat rare shock events with material, but uncertain, economic consequences. A major example of this is the coronavirus pandemic (which is addressed in more detail in section 7.8 below). On 27 March 2020, the IASB issued an education document in which it acknowledged that at the time it would likely be difficult to incorporate the specific effects of the coronavirus pandemic and government support measures on a reasonable and supportable basis.[17] However, changes in economic conditions are reflected in macroeconomic scenarios applied by entities and in their weightings. When it is not possible to reflect such information in models, the IASB expects post-model overlays or adjustments to be considered.

17 IFRS 9 and covid-19: *Accounting for expected credit losses applying IFRS 9* Financial Instruments *in the light of current uncertainty resulting from the covid-19 pandemic*, IASB, 27 March 2020. Available on the IFRS Foundation's website.

Whether the impact of an event such as the coronavirus pandemic is reflected in an individual ECL assessment (estimating the probability of default on an individual basis), factored into the scenario analysis of future macroeconomic conditions on a collective basis, or adjusted through management overlays, depends on the entity's systems and processes and the facts and circumstances. In practice, entities are likely to consider a combination of these approaches. In estimating the impact of the event, entities must, however, be careful to avoid double-counting the effects of the various assumptions applied in individual assessments, macroeconomic scenarios and management overlays.

In abnormal circumstances such as those created by the coronavirus pandemic, it may take time before entities detect changes in risk indicators at a specific borrower level and are able to reassess the affected exposures. In order to accelerate the reflection of such changes in credit quality not yet detected at an individual borrower level, it may be appropriate to adjust ratings and the probability of defaults on a collective basis; considering risk characteristics such as the industry or geographical location of the borrowers (see section 6.5 below). However, many methods for performing collective assessments make use of historical information, which are not relevant in such circumstances.

One of the features of the coronavirus pandemic was that there were two sources of uncertainty: the development and easing of the pandemic itself and also the extent and the effect of the government response. In addition to updating gross domestic product and other macroeconomic variables in an entity's multiple economic scenarios, a challenge was to estimate how the impact of the coronavirus pandemic and any related government programmes affected specific sectors, regions and borrowers.

The IASB educational document noted that a number of assumptions and linkages underlying the way expected credit losses has been implemented to date may no longer hold in the environment affected by the pandemic. For example, the relationship between gross domestic product and other macroeconomic variables, such as unemployment and interest rates, and sector-specific variables, such as oil prices, is very likely to be different from what has been experienced in the past and reflected in economic forecasting models. The probability weightings assigned to macroeconomic scenarios may also need to be revisited. We observed during the pandemic, the following main reasons for making model adjustments and overlays:

- The challenges of making macroeconomic economic forecasts and assigning weightings to scenarios, due to uncertainties as to the possible spread of coronavirus, the risk of new variants, vaccine roll out and efficacy and the impact of government support, as well as the operational and timing challenges in incorporating the latest available macroeconomic inputs into the expected credit loss models.
- The lack of reliable data to model the impact on loans and the need to adjust to level of defaults estimated by expected credit loss models, given that they were never designed to address such extreme and rapid changes in macroeconomic variables and to reflect the level of government support provided to borrowers.
- Uncertainties around the timing and extent of defaults for some borrowers and vulnerable sectors in the longer term, as customer relief and government support measures come to an end.

A number of banks have provided additional quantitative and qualitative disclosures in respect of overlays and post-model adjustments, including the processes and governance in place. However, there is diversity in the granularity of the disclosures as well as the accompanying narrative and supporting analysis (see section 7.8.5 below).

Another example of rare shock events with material, but uncertain, economic consequences is war or conflict between countries. An entity with lending activities will need to consider its operations and exposures to entities, individuals and governments impacted by the war or conflict including loans and trade receivables, financial guarantees granted, bank deposits and debt securities. Furthermore, any sanctions imposed will need to be considered in the assessment of cash shortfalls for the purpose of measuring expected credit losses as any assets seized or restrictions imposed may adversely affect the cash or assets that would have been used to provide security or repay the financial asset of the entity. Rising prices of commodities such as oil, gas and wheat, potential slowdown in the global economy, rising inflation and interest rates would also need to be taken into account as a result of war events or conflicts.

There are potentially rare shock events related to climate change such as severe drought or flooding causing damage and disruption to individuals and businesses that needs to be taken into consideration (see section 7.9 below).

Entities impacted will need to model possible outcomes using multiple scenarios and to the extent that expected credit loss models were not designed or calibrated with these circumstances in mind, it may be necessary to make use of post-model adjustments or overlays.

How we see it

In estimating overlays, the widespread nature and severity of the consequences of a rare shock event such as the coronavirus pandemic, a war or conflict between countries, or climate change related rare shock events are not directly comparable with any recent similar events. It may be appropriate for this purpose, to plot several possible scenarios of what might happen over the forecasting period and assign weightings to them, to ensure that any overlay reflects the inherent uncertainty and non-linearity of potential outcomes.

5.7 Time value of money

An entity needs to consider the time value of money when measuring expected credit losses, by discounting the estimated losses to the reporting date using a rate that approximates the effective interest rate of the asset. *[IFRS 9.5.5.17, IFRS 9.B5.5.44]*. This has two components:

- Discounting recoveries to the date of default, hence 'a credit loss arises even if the entity expects to be paid in full but later than when contractually due'. *[IFRS 9.B5.5.28]*.
- Discounting losses from the date of default to the reporting date. This is needed as the gross amortised cost of the asset is based on the contractual cash flows discounted at the effective interest rate, and therefore not discounting cash flows that are now not expected to be received would overstate the loss.

It is rare that customers just fail to pay amounts when due. In most cases, default also involves payments being paid late, while default can lead to the acceleration of payment of amounts that are not contractually due until a later date. Therefore, modelling losses involves modelling the timing of payments when default occurs and different patterns of timing of recoverable cash flows, such as the time it takes to foreclose on and sell collateral and complete bankruptcy proceedings, before the expected credit losses can be discounted back to the reporting date.

Of these two components, the first is typically included by banks in their calculation of the loss given default (although not necessarily using the effective interest rate). However, the second will also need to be calculated to comply with IFRS 9.

IFRS 9 and its Illustrative Examples are silent on how the calculation is made. In Illustrative Example 9 the present value of the observed loss is assumed and in Illustrative Example 8, a footnote states that, "Because the loss given default represents a percentage of the present value of the gross carrying amount, this example does not illustrate the time value of money".

One approach would be to model various scenarios as to how cash is collected once the loan has defaulted, and probability-weight the discounted cash flows of these various scenarios.

The discount rate is calculated as follows:

- For a fixed-rate financial asset, entities are required to determine or approximate the effective interest rate on the initial recognition of the financial asset, while for a floating-rate financial asset, entities are required to use the current effective interest rate. *[IFRS 9.B5.5.44]*.
- For a purchased or originated credit-impaired financial asset (see section 3.3 above), entities are required to discount expected credit losses using the credit-adjusted effective interest rate determined on the initial recognition of the financial asset. *[IFRS 9.B5.5.45]*.
- For a loan commitment (see section 11 below), entities are required to use the effective interest rate of the asset that will result once the commitment is drawn down. This would give rise to a consistent rate for a credit facility that includes both a loan (i.e., a financial asset) and an undrawn commitment (i.e., a loan commitment). If the effective interest rate of the resulting asset is not determinable, then entities are required to use the current risk-free rate (i.e., the discount rate that reflects the current market assessment of the time value of money). This is adjusted for risks specific to the cash flows, but only if the cash flows have not already been adjusted for these risks, in order to avoid double counting. *[IFRS 9.B5.5.47, IFRS 9.B5.5.48]*.
- For financial guarantee contracts (see section 11 below), entities are required to use the current risk-free rate adjusted for risks specific to the cash flows, again to the extent that those cash flows have not already been adjusted for the risks. *[IFRS 9.B5.5.48]*.
- For lease receivables (see section 10.2 below), entities are required to discount the expected credit losses using the same discount rate used in the measurement of the lease receivables in accordance with IFRS 16. *[IFRS 9.B5.5.46]*.

Loss given default data available from Basel models include a discounting factor and sometimes this may be different from the rate required by IFRS 9. Furthermore, the discount rate used in Basel models only covers the period between default and subsequent recoveries. Therefore, entities will have to find ways to adjust their loss given defaults to reflect the discounting effect required by IFRS 9 (i.e., based on a rate that approximates the effective interest rate and over the entire period from recoveries back to the reporting date). Given the requirement to use an approximation to the effective interest rate, entities will need to work out how to determine a rate that is sufficiently accurate. One of the challenges is to interpret how much flexibility is afforded by the term 'approximation'.

Frequently asked questions

Question 5-3: What is meant by the current effective interest rate used to discount expected credit losses when an entity recognises interest revenue in each period based on the actual floating rate applicable to that period?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 11 December 2015 - Agenda paper no. 7)

At its meeting in December 2015 (see section 1.4 above), the IFRS Transition Resource Group for Impairment of Financial Instruments also discussed what was meant by the current effective interest rate when an entity recognises interest revenue in each period based on the actual floating-rate applicable to that period. The IFRS Transition Resource Group for Impairment of Financial Instruments first noted that the definition of the effective interest rate in IFRS 9 was carried forward essentially unchanged from the definition within IAS 39. Consequently, similarly to IAS 39, IFRS 9 does not specify whether an entity should use the current interest rate at the reporting date or the projected interest rates derived from the current yield curve as at the reporting date. There should be consistency between the rate used to recognise interest revenue, the rate used to project future cash flows (including cash shortfalls) and the rate used to discount those cash flows (as discussed above).

In relation to the guidance in IFRS 9.B5.5.47 and B5.5.48 on loan commitments when the effective interest rate on the resulting asset is not determinable and for financial guarantee contracts, we make the following observations:

- Although it is not clear in IFRS 9, any adjustment for the risks specific to the cash flows would be a reduction of the risk-free rate, not an increase. This would be consistent with the approach applied to provisions in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and as was made clear in the staff paper presented to the Board when this treatment was discussed in December 2013.
- For loan commitments, when the effective interest rate on the resulting asset is not determinable, using the current risk-free rate adjusted for risks specific to the cash flows provides a prudent calculation of the expected credit losses, given that it is likely the entity which enters into the commitment will receive a credit spread on the loan if it is drawn down. It is in a much better position than the issuer of a financial guarantee contract, who will receive no credit spread if it is required to pay out on the guarantee.
- For financial guarantee contracts, the reduction in the risk-free discount rate will increase the present value of the obligation to pay claims to the guarantee holder. This reflects the additional compensation that would be demanded to take on this risky obligation, in particular to bear the risk that claims payments will be higher than the probability-weighted expected amount.

How we see it

For financial guarantee contracts, IFRS 9 requires that the risk-free discount rate is adjusted only if the cash flows have not already been adjusted for the associated risks. However, given that the cash flows should have already been estimated with regard to any non-linearities in the distribution of losses, the cash flows will have already been adjusted, at least partially, for risk. Hence any further adjustment will need to reflect only those risks not already captured.

5.8 Losses expected in the event of default

This section discusses the measurement of expected credit losses taking into account credit enhancements such as collateral and financial guarantees, cash flows from the sale of a defaulted loan and collection costs paid to an external debt collection agency.

5.8.1 Credit enhancements: collateral and financial guarantees

Although credit enhancements such as collateral and guarantees play only a limited role in assessing whether there has been a significant increase in credit risk (see section 6.1 below), they do affect the measurement of expected credit losses. For example, for a mortgage loan, even if an entity determines that there has been a significant increase in credit risk on the loan since initial recognition, if the expected proceeds from the collateral (i.e., the mortgaged property) exceeds the amount lent, then the entity may have very low or nil expected credit losses, and hence an allowance of close to zero.

Paragraph B5.5.55 of IFRS 9 sets out the requirements for measuring expected credit losses: *[IFRS 9.B5.5.55]*.

Extract from IFRS 9

Collateral

B5.5.55 For the purposes of measuring expected credit losses, the estimate of expected cash shortfalls shall reflect the cash flows expected from collateral and other credit enhancements that are part of the contractual terms and are not recognised separately by the entity. The estimate of expected cash shortfalls on a collateralised financial instrument reflects the amount and timing of cash flows that are expected from foreclosure on the collateral less the costs of obtaining and selling the collateral, irrespective of whether foreclosure is probable (ie the estimate of expected cash flows considers the probability of a foreclosure and the cash flows that would result from it). Consequently, any cash flows that are expected from the realisation of the collateral beyond the contractual maturity of the contract should be included in this analysis. Any collateral obtained as a result of foreclosure is not recognised as an asset that is separate from the collateralised financial instrument unless it meets the relevant recognition criteria for an asset in this or other Standards.

The wording in IFRS 9.B5.5.55 does not mean that the entity is required to assume that recovery will be through foreclosure only, but rather that the entity calculates the cash flows arising from the various ways that the asset may be recovered, only some of which may involve foreclosure, and to probability-weight these different scenarios (see Illustration 5-1 in section 5.4 above).

Although IFRS 9 does not refer to fair value when determining the valuation of the collateral, in practice, an entity is likely to estimate the cash flows from the realisation of the collateral, based on the fair value of the collateral. In the case of illiquid collateral, such as real estate, adjustments will probably need to be made for expected changes in the fair value, depending on the economic conditions at the estimated date of selling the collateral. Also, as described in sections 5.6.1 and 5.6.2 above, the entity considers multiple scenarios in ascribing value to collateral.

Also, any collateral obtained as a result of foreclosure is not recognised as an asset that is separate from the collateralised financial instrument unless it meets the relevant recognition criteria for an asset in IFRS 9 or other standards. *[IFRS 9.B5.5.55]*.

If a loan is guaranteed by a third-party as part of its contractual terms, it carries an allowance for expected credit losses based on the combined credit risk of the guarantor and the guaranteed party, by reflecting the effect of the guarantee in the measurement of losses expected on default.

5.8.1.A Guarantees that are part of the contractual terms

As already mentioned, IFRS 9.B5.5.55 states that "For the purposes of measuring expected credit losses, the estimate of expected cash shortfalls shall reflect the cash flows expected from collateral and other credit enhancements that are part of the contractual terms and are not recognised separately by the entity…".

Frequently asked questions

Question 5-4: What is meant by 'part of the contractual terms'?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 11 December 2015 - Agenda paper no. 5)

A challenge is interpreting what constitutes 'part of the contractual terms'. This was addressed by the IFRS Transition Resource Group for Impairment of Financial Instruments at its meeting in December 2015 (see section 1.4 above), specifically whether the credit enhancement must be an explicit term of the related asset's contract in order for it to be taken into account in the measurement of expected credit losses, or whether other credit enhancements that are not recognised separately can also be taken into account.

The IFRS Transition Resource Group for Impairment of Financial Instruments noted that:

- The definition of credit losses states that "…The cash flows that are considered shall include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms…". *[IFRS 9 Appendix A]*. Consequently, credit enhancements included in the measurement of expected credit losses should not be limited to those that are explicitly part of the contractual terms.
- An entity must apply its judgement in assessing what is meant by 'integral to the contractual terms' and in making that assessment, an entity should consider all relevant facts and circumstances.
- IFRS 7 requires disclosures to enable users of financial statements to understand the effect of collateral and other credit enhancements on the amounts arising from expected credit losses (see section 15 below and Chapter 50 at section 5.3).

Although not reflected in the official minutes of the IFRS Transition Resource Group for Impairment of Financial Instruments meeting, the IASB members highlighted during the course of the discussion that there was no intention to alter the treatment when drafting IFRS 9. In practice, previously under IAS 39, most banks incorporated guarantees as part of their measurement of losses given default.

The IFRS Transition Resource Group for Impairment of Financial Instruments also emphasised that IFRS 9.B5.5.55 was drafted only with the intention to caution against double counting those credit enhancements that are already recognised separately, and was not intended to limit the inclusion of credit enhancements that were previously included in IAS 39 allowances for loan-losses.

Question 5-5: Whether the cash flows expected from a financial guarantee contract or any other credit enhancement can be included in the measurement of expected credit losses if the credit enhancement is required to be recognised separately applying IFRS standards?

(IFRS Interpretations Committee meeting 27 November 2018 and 5 March 2019 - Agenda paper no. 6 and no. 12 respectively)

In November 2018 and March 2019, the IFRS IC referred to IFRS 9.B5.5.55 and observed that the cash flows expected from a credit enhancement are included in the measurement of expected credit losses only if the credit enhancement is both:

- Part of the contractual terms
- Not recognised separately by the entity

Similar to the IFRS Transition Resource Group for Impairment of Financial Instruments, the IFRS IC concluded that, if a credit enhancement is required to be recognised separately by IFRS accounting standards (an example would be a credit default swap that would need to be measured at fair value through profit or loss), an entity cannot include the cash flows expected from it in the measurement of expected credit losses. An entity applies the applicable IFRS accounting standard to determine whether it is required to recognise a credit enhancement separately. Paragraph B5.5.55 of IFRS 9 does not provide an exemption from applying the separate recognition requirements in IFRS 9 or other IFRS accounting standards.

However, the IFRS Transition Resource Group for Impairment of Financial Instruments discussion does not answer the question of how to interpret when a financial guarantee is 'integral to the contractual terms' when it is not mentioned in the contractual terms of the loan.

It seems reasonably clear that a credit default swap on a loan entered into by the lender to mitigate its credit risk on the loan, would not normally be classed as integral to a loan's contractual terms. The second criterion mentioned in IFRS 9.B5.5.55 is that the credit enhancement is not recognised separately and separate accounting for a derivative is clearly required by IFRS 9. Also, payment under a credit default swap does not normally require the holder of the instrument to have suffered the credit loss referenced by

the swap. As a result, cash flows from a credit default swap that is accounted for as a derivative would not be included in the measurement of expected credit losses of the associated loan.

For a financial guarantee (as defined in IFRS 9), one view is that it is integral to the contractual terms of a loan only if it is, at least implicitly, part of the contractual terms of the loan. Examples of an implicit contractual linkage might include:

- Inseparability: The financial guarantee is inseparable from the loan contract, i.e., the loan cannot be transferred without the guarantee.
- Local laws and regulations: Credit enhancements required by local laws and regulations that govern the loan contract but that are not specifically in the contract itself. For example, in some jurisdictions, legislation requires that lenders must take out financial guarantee contracts that contain little or no down payment in respect of certain loans.
- Business purpose: The guarantee and the loan have been contracted in contemplation of one another, i.e., the loan would not have been contracted without the guarantee.
- Market convention: The exposure and the financial guarantee are traded as a package in the market.

In response to the coronavirus pandemic, the European Securities and Market Authority issued a public statement on 25 March 2020, which referenced the IFRS Transition Resource Group for Impairment of Financial Instruments' meeting and observation in December 2015 that credit enhancements included in the measurement of expected credit losses should not be limited to those that are explicitly part of the contractual terms. The European Securities and Market Authority noted that this is the case, in particular, when the public guarantee is provided in conjunction with broadly applicable *ex-lege* debt moratoria or economic support and relief measures. The European Securities and Market Authority was of the view that the assessment of whether the public guarantee can be considered an integral part of the contractual terms or not, may involve judgement. The European Securities and Market Authority highlighted the importance that such judgements, to the extent significant, be clearly disclosed in the entity's financial statements.[18]

Another view might be that any contract that meets the definition of a financial guarantee under IFRS 9 can be considered 'integral to the contractual terms' of the guaranteed loan, when the guarantee is entered into at the same time as, or within a short time after, the loan is advanced. Alternatively, if an entity enters into a guarantee for a pre-existing loan, it would generally not be considered integral to that loan if it was not anticipated when the loan was originally granted. Whether a credit enhancement is integral depends on an assessment of the individual facts and circumstances and is likely to require judgement. The timing of entering into the loan and financial guarantee provides an indication but is not in all cases determinative on its own that the 'integral' criterion is met. This is consistent with the report issued by the European Securities and Market Authority on 17 May 2022 which noted that "the mere fact that the debt instrument (portfolio loans) is entered into at the same time as the debenture, which is a result of the business model and risk management strategy of the issuer, is not sufficient to conclude that credit enhancement is integral to the portfolio loan agreements".[19]

As the definition of a financial guarantee contract requires the loan to be specified in the contractual terms of the financial guarantee and it is necessary for the lender to incur a credit loss on the loan to be reimbursed, there is a clear contractual linkage that ensures that any credit loss incurred on the loan will be compensated by the financial guarantee and no compensation will arise on the financial guarantee unless a credit loss is actually incurred by the lender on the guaranteed loan.

Further, when the IASB considered and rejected an 'insurance approach' for credit default swaps as part of its hedge accounting deliberations, it was noted that doing so would be similar to the treatment of a collateral or a guarantee and so "would have a simple interaction with an impairment model" as it "would affect the estimate of the recoverable cash flows". Thus, at least at this stage of the development of IFRS 9, the Board appear to have regarded all guarantees (as opposed to credit default swaps) as capable of being treated as credit enhancements for the expected credit loss model *[IFRS 9.BC6.531, IFRS 9.BC6.534]*.

Most guarantees require payment of a premium. To the extent that the guarantee is considered integral to the loan, it would be consistent with this notion to treat the cost of the guarantee as a transaction cost of making the loan. This means that the lender would add this cost to the initial carrying amount of the loan and so reduce the future effective interest rate. It does not make a difference to the accounting for the loan whether the guarantee premium is paid upfront or in instalments over the life of the loan. If the premium is payable in instalments, it follows (at least, in theory, although the effect is unlikely to be material) that the full cost of the guarantee needs to be included in setting the loan's effective interest rate.

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18 ESMA Public statement, *Accounting implications of the COVID-19 outbreak on the calculation of expected credit losses in accordance with IFRS 9*, 25 March 2020. Available on the European Securities and Market Authority's website.

19 ESMA Report ESMA32-63-1224: *26th Extract from the EECS's Database of Enforcement*, 17 *May* 2022. Available on the European Securities and Market Authority's website.

5.8.1.B Guarantees that are not part of the contractual terms

Although it is not always clear as to when a financial guarantee contract would be regarded as part of the contractual terms as per IFRS 9.B5.5.55, this does not affect the profit or loss recognition by the lender if an asset can be recognised in respect of the guarantee. Such an outcome may be achieved by following either of the two approaches described below.

A financial guarantee contract is likely to satisfy the definition of an insurance contract in IFRS 17 *Insurance Contracts* but for the holder it will be excluded from the scope of IFRS 17 because it is a direct insurance contract held by a policyholder (as opposed to a policyholder of a reinsurance contract). *[IFRS 17.7(g)]*. It is therefore outside the scope of IFRS 9. *[IFRS 9.2.1(e)]*. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* addresses situations where no IFRS specifically applies to a transaction, i.e., the holder of a financial guarantee contract will normally need to develop its accounting policy in accordance with the hierarchy in IAS 8. *[IAS 8.10, IAS 8.11]*.

Applying the IAS 8 hierarchy, one possibility would be to look to IAS 37 and treat the guarantee as a right to a reimbursement in respect of the impairment loss. IAS 37 permits a reimbursement of a liability to be recognised as an asset, not exceeding the amount of the provision, when it is virtually certain that the reimbursement will be received if the obligation for which a provision has been established is settled. *[IAS 37.53]*. In this instance, the benefit of the guarantee would be recognised as an asset to the extent it is virtually certain a recovery could be made if the lender were to suffer the impairment loss on the loan. One of the key advantages of a financial guarantee contract, compared to a normal insurance contract, is that they are typically drawn up using standard terms and conditions and there is often little doubt that an obligation would arise for the guarantor if the reference asset were to default. However, care needs to be taken to establish, based on the contractual terms of the arrangement, that a right to a recovery would, indeed, be virtually certain.

To record a reimbursement asset under IAS 37, it is less clear whether the credit risk of the guarantor needs to be assessed in determining whether recovery would be virtually certain, or whether the guarantor's credit risk would only be reflected in measuring the reimbursement asset. One view is that the guarantor would either have to present a very low credit risk or else the guarantee would itself need to be collateralised in order to conclude that a reimbursement right can be recognised. In this case, care is also be taken to ensure that there is no correlation between the credit risk of the loan and that of the guarantor, as would be the case if the guarantor's financial strength were to reduce at the same time that the loan is likely to default. Applying this view, if a reimbursement is considered virtually certain, there would probably be no need also to reflect the guarantor's credit risk in the measurement of the asset. In contrast, the second view imposes a less stringent criterion for recognising an asset, but would reduce the recognised asset to reflect the probability that the guarantor may be unable to meet its obligation (perhaps by applying an expected credit loss deduction, by analogy to IFRS 9).

An alternative approach for recording an asset in respect of the guarantee would be to look to IFRS 3 *Business Combinations* and draw an analogy with indemnification assets. First, IFRS 3 requires all contingent liabilities to be recognised on a business combination, whether or not they are probable, which is closer to the IFRS 9 notion of an expected credit loss than the contingent liability recognition threshold under IAS 37. Second, IFRS 3 allows an indemnification asset to be recognised, measured on the same basis as the indemnified asset or liability, subject to any contractual limitations on its amount. Also, for an indemnification asset that is not subsequently measured at its fair value, the measurement is subject to management's assessment of the collectability of the indemnification asset. *[IFRS 3.57]*. Adopting this indemnification asset approach, the credit risk of the guarantor becomes a measurement, rather than a recognition issue. It would not be necessary to assess if the credit risk of the guarantor is very low, since credit risk is instead reflected in the measurement of the guarantee.

How we see it

Whether an analogy is made to a reimbursement right under IAS 37 or an indemnification asset under IFRS 3, an asset may be recognised in respect of an acquired financial guarantee contract in the statement of financial position, not exceeding the amount of the expected credit loss allowance on the guaranteed asset, and may result in an offsetting entry against expected credit loss in profit or loss, depending on the accounting policy of the lender. Except for the possible treatment of the guarantor's credit risk, using either of these approaches the overall effect on profit or loss for the lender may be often the same as if the guarantee was included in the measurement of the expected credit loss of the guaranteed asset. The right would, however, be presented as an asset rather than as a reduction of the impairment allowance.

Whereas it is relatively straightforward as to how to account for premiums paid for guarantees that are considered integral to a loan (as discussed in the previous section), it is less clear when the guarantee is not considered integral. If the entity who makes a loan and, at the same time, pays for a guarantee, records both the unamortised cost of the guarantee plus also a reimbursement or indemnification asset equivalent to the 12-month expected credit losses, the total amount at which the guarantee is initially recorded in the financial statements will exceed its fair value. This is because the cost of the guarantee will already include the guarantor's expectations of future losses. One view is to consider this to be 'double counting' and so, to restrict the reimbursement/indemnification right to the excess (if any) of the expected credit loss over the cost of the guarantee that is already reflected in the balance sheet.

There is another view that recognising both the unamortised cost of the guarantee and a reimbursement right/indemnification asset equal to the expected credit loss is necessary to be consistent with the accounting for the loan. Another way of expressing this is to say that it is appropriate for the guarantee to be recorded at more than its initial fair value as the guaranteed loan is recorded initially at less than its fair value by a similar amount, i.e., the expected credit loss. The subsequent amortisation of the cost of the guarantee would be balanced by the recognition of the credit spread in the interest earned on the loan.

ECL losses booked prior to a non-integral financial guarantee being entered into reflect the expected losses at that point. If a financial guarantee is entered into subsequently, it provides credit protection going forward and would not in itself cause the reversal of previously recognised ECL. Although it may provide a right to receive specified payments to reimburse the lender for losses it incurs should the borrower fail to make payments due, it cannot reverse or undo losses that were previously incurred in line with the IFRS 9 impairment requirements. This can be explained by the fact that the fair value of the expected credit losses recognised to date would be reflected in the premium payable by Entity A for the guarantee and therefore it would be inappropriate to reverse previously recognized credit losses and then transfer them to a later period as the guarantee premium is amortised through the income statement.

When considering the statement of financial position, under this approach the financial guarantee asset is essentially a combination of the reimbursement asset, and the unamortized premium paid. This approach mirrors the accounting by an issuer of a financial guarantee where the issuer recognises the guarantee at the higher of the ECL allowance, and unamortized premium *[IFRS 9.4.2.1(c)]*. Consequently, for the holder of the guarantee, on initial recognition the total financial guarantee asset recognised is the higher of the ECL allowance, and the unamortized premium.

The following illustrates the issue.

Illustration 5-6: Non-integral financial guarantee

On 1/1/20X1 Entity A grants a loan to Entity X of CU100. By the end of the reporting period at 31/12/20X1 there has been an increase in credit risk and an ECL allowance of CU1 was recognised. On 1/1/20X2 Entity A enters into a financial guarantee contract (FGC), which is not integral to the underlying asset, with Bank B, to guarantee the loan granted to Entity X and pays a premium upfront of CU4. As discussed above this can be looked at as representing a payment for the unamortised cost of the guarantee of CU3 and a reimbursement asset representing the ECL of CU1. It is judged virtually certain that the guaranteed amount will be received in the event of a claim, and that Bank B has a low credit risk.

From the perspective of Entity A, when the non-integral FGC is entered into for an existing underlying asset, ECL losses incurred prior to entering into the guarantee cannot be reversed, i.e., in the fact pattern above, on 1/1/20X2, Entity A cannot reverse out the ECL loss of CU1 that was incurred prior to entering into the guarantee.

How we see it

Irrespective of how the guarantee and reimbursement right/indemnification asset are measured, if the lender acquires the guarantee subsequent to making the loan and the loan has, in the meantime, increased in credit risk, it is likely that the lender will pay more for the guarantee, to reflect this increase in credit risk. If so, this additional amount will crystallise a loss for the lender and so is not recorded as a reimbursement/indemnification right and a reversal of a previously recognised impairment loss. When a non-integral guarantee is entered into for an existing underlying asset, any ECL losses incurred before the guarantee is entered into are not reversed.

5.8.1.C Government relief measures

Entities will need to consider any form of support provided by a government and this is dependent on whether its effect is to prevent a default by the borrower, or to compensate a lender for losses it suffers due to the borrower's default. In some cases, a government may provide direct financial support to a borrower. For example, the government may offer to compensate employees who have lost their job with a portion of their previous salary for a period of time. These forms of financial support prevent or reduce the extent to which a borrower would otherwise default on a loan. These forms of financial support are considered in a lender's assessment of significant increase in credit risk and the probability of default as it reduces the credit risk associated with the underlying loan.

In other cases, a guarantee may be issued to a lender to compensate it for losses it suffers due to default by a borrower. Such a guarantee does not prevent default by a borrower, but rather reduces the effect of any default. The accounting effect of such a guarantee depends on whether it is integral to the contractual terms of the guaranteed loan and whether it is required to be recognised separately by the lender.

If a guarantee is integral to the loan and is not required to be recognised separately by the lender, the guarantee is taken into account in calculating the loss given default of the guaranteed loan (see section 5.8.1.A above), however, it does not affect the significant increase in credit risk assessment. The coronavirus pandemic is an example of when the impact on the value of the enhancement (e.g., shares or bond prices, real-estate values and the credit standing of any guarantor) also needs to be considered.

If a guarantee is not considered to be integral, it may still meet the criteria to be recognised as a reimbursement asset by analogy to IAS 37. Where this applies, it would have to be recognised separately in the statement of financial position and may result in an offsetting entry against expected credit loss in profit or loss, depending on the accounting policy of the lender (see section 5.8.1.B above).

Where guarantees are issued by governments for a below-market rate fee, both borrowers and lenders will have to assess whether this constitutes a government grant to be accounted for and disclosed in accordance with IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. In performing such an assessment, entities will need to consider the level of the interest rate offered to the borrower on the guaranteed loan and whether the economics of the overall transaction provide a benefit to the lender, the borrower or to both. For example, if a benefit to a lender from a below-market rate fee on a guarantee is required to be partially offset by a reduction in the interest earned on the loan to the borrower, the value of any government grant to the lender may be reduced or eliminated. In such a case, the value of the grant accrues mainly to the borrower in the form of a below-market rate loan relative to the borrower's credit risk.

Parent or other group entities will be required to calculate expected credit losses in their separate financial statements in respect of guarantees they provide against the debts of other group companies.

5.8.2 Cash flows from the sale of a defaulted loan

Frequently asked questions

Question 5-6: Whether cash flows that are expected to be recovered in certain circumstances where an entity chooses to sell a defaulted loan to a third-party in order to maximise recovery cash flows could be included in the measurement of expected credit losses?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 11 December 2015 - Agenda paper no. 6)

At its meeting in December 2015 (see section 1.4 above), the IFRS Transition Resource Group for Impairment of Financial Instruments discussed whether cash flows that are expected to be recovered from the sale on default of a loan could be included in the measurement of expected credit losses. The IFRS Transition Resource Group for Impairment of Financial Instruments members noted that:

- Such cash flows should be included in the measurement of expected credit losses if:
  - (a) Selling the loan is one of the recovery methods that the entity expects to pursue in a default scenario.
  - (b) The entity is neither legally nor practically prevented from realising the loan using that recovery method.
  - (c) the entity has reasonable and supportable information upon which to base its expectations and assumptions.
- In order to support an entity's expectation that loan sales would be used as a recovery method in a default scenario, an entity's past practice would be an important consideration. However, future expectations, which may differ from past practice, would also need to be considered. With respect to the amount of recovery proceeds to be included in the measurement of expected credit losses, an entity should consider relevant market related information relating to loan sale prices.
- In these circumstances, the inclusion of recovery sale proceeds in the measurement of expected credit losses would be appropriate for financial instruments in all stages; stage 1, 2 and 3 (see section 3.1 above). This is because when measuring expected credit losses, IFRS 9 requires an entity to consider possible default scenarios for financial instruments in all three stages.
- Given that it is necessary to consider multiple scenarios in measuring expected credit losses (see section 5.6.1 above), it is possible that an entity will need to calculate the cash flows based on both a scenario in which the loan will be sold and one in which it will not. Expected sale proceeds would only be relevant when considering the possibility that a credit loss occurs (i.e., in a default scenario) and would not be relevant when considering the possibility that no credit loss occurs (i.e., in a performing scenario). For example, if, in the case of a particular loan, an entity concluded that there was a 10% probability of default occurring, it would only be when considering the outcome of this default scenario that expected sale proceeds would be considered. If, in that default scenario, the entity expected to recover 30% of the contractual cash flows of the loan through sale proceeds but only 25% through continuing to hold, then the loss given default would be 70% rather than 75%. In addition, the expected sale proceeds should be net of selling costs.

5.8.3 Treatment of collection costs paid to an external debt collection agency

Questions have arisen on how the collection costs paid to an external debt collection agency affect the measurement of expected credit losses. As an example, a bank engages the services of an external debt collection agency to recover accounts that are 90 days past due on its behalf and, in exchange, pays the agency a fee based on the amount recovered.

One view could be that in measuring the expected credit losses, all cash flows related to the recovery of the asset are considered in estimating the expected cash shortfalls. Therefore, the recoveries and any incremental and directly attributable payments made to the external agency are both considered, irrespective of whether the collections costs are deducted from the amount recovered or paid to the external debt collection agency separately. This view is based on the fact that IFRS 9 specifies that the estimate of cash flows from the realisation of collateral include the costs of obtaining the collateral. This can be read to suggest that all cash flows relating to the various ways of recovering the asset are considered in measuring the expected shortfall. An analogy can also be made with the IFRS Transition Resource Group for Impairment of Financial Instruments discussion on sales of assets where selling costs are to be included (see section 5.8.2 above). This also reflects that if the cash flows expected to be received are greater than those that would be realised if the agency were not used, excluding the collection

cost paid to the agency will understate the expected credit losses. Further, for assets that are purchased credit-impaired, these costs may already be implicit in the fair value at which they are acquired and so, unless these costs are included, the effective interest rate would be inflated.

Another view could be that only cash flows related to the contractual terms of the financial instrument are considered, apart from the costs of obtaining and selling collateral. This would exclude costs of an external debt collection agency. This view is based on the definition of a credit loss as "the difference between all contractual cash flows that are due to an entity in accordance with the contracts and all the cash flows that the entity expects to receive (i.e., net of all cash shortfalls). The cash flows that are considered shall include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms" *[IFRS 9 Appendix A]*. Since the collection costs paid to the agency are not part of the contractual terms of the financial instrument, nor a cost for realising collateral, then they are not considered in the calculation of expected credit losses. The reason for treating costs of realising collateral differently is that the proceeds from selling collateral is itself not a contractual cash flow of the instrument and the commercial value of the collateral would include provision for such costs. The analogy with sales of assets is considered irrelevant for the same reasons as they do not relate to the recovery of contractual cash flows.

Entities may take into account incremental collection costs incurred internally when measuring expected credit losses although this has not yet been seen widely in practice. An example of incremental internal collection costs would be incentives for employees to achieve certain collection targets. However, if the internal collection costs are not incremental, they cannot be included in the measurement of expected credit losses.

How we see it

The recoveries from a defaulted loan and any incremental and directly attributable payments made to an external agency can be included in the measurement of expected credit losses. This is the case irrespective of whether the collections costs are deducted from the amount recovered or paid to the external debt collection agency separately. Similarly, incremental collection costs incurred internally can be included in the measurement of expected credit losses, although it is unusual for such costs to be incremental and this has not yet been seen widely in practice.

5.9 Reasonable and supportable information

IFRS 9 requires an entity to consider reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions and that is relevant to the estimate of expected credit losses, including the effect of expected prepayments. *[IFRS 9.5.5.17(c), IFRS 9.B5.5.51]*.

5.9.1 Undue cost or effort

Extract from IFRS 9

B5.5.49 For the purpose of this Standard, reasonable and supportable information is that which is reasonably available at the reporting date without undue cost or effort, including information about past events, current conditions and forecasts of future economic conditions. Information that is available for financial reporting purposes is considered to be available without undue cost or effort.

[IFRS 9.B5.5.49].

The term undue cost or effort is not defined in IFRS 9, although it is clear from the guidance that information available for financial reporting purposes is considered to be available without undue cost or effort.

Beyond that, although IFRS 9 explains that entities are not required to undertake an exhaustive search for information, it does include, as examples of relevant information, data from risk management systems, as described in section 5.9.2 below.

What is available without undue cost or effort would be an area subject to management judgement in assessing the costs and associated benefits. This is consistent with the guidance in International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs) in relation to the application of undue cost or effort:

Extract from IFRS for SMEs

2.14B Considering whether obtaining or determining the information necessary to comply with a requirement would involve undue cost or effort depends on the entity's specific circumstances and on management's judgement of the costs and benefits from applying that requirement. This judgement requires consideration of how the economic decisions of those that are expected to use the financial statements could be affected by not having that information. Applying a requirement would involve undue cost or effort by an SME if the incremental cost (for example, valuers' fees) or additional effort (for example, endeavours by employees) substantially exceed the benefits that those that are expected to use the SME's financial statements would receive from having the information. An assessment of undue cost or effort by an SME in accordance with this Standard would usually constitute a lower hurdle than an assessment of undue cost or effort by a publicly accountable entity because SMEs are not accountable to public stakeholders.

BC232 The IASB also thinks that the clarifying guidance will help to emphasise two further points:

(a) that the undue cost or effort exemption is not intended to be a low hurdle. This is because an entity is required to carefully weigh the expected effects of applying the exemption on the users of the financial statements against the cost or effort of complying with the related requirement. In particular, the IASB observed that it would expect that if an entity already had, or could easily and inexpensively acquire, the information necessary to comply with a requirement, any related undue cost or effort exemption would not be applicable. This is because, in that case, the benefits to the users of the financial statements of having the information would be expected to exceed any further cost or effort by the entity.

(b) that an entity must make a new assessment of whether a requirement will involve undue cost or effort at each reporting date.

If the reporting entity is a bank, there would presumably be a higher hurdle to determine what credit risk information would require undue cost or effort, compared to a reporter that is not a bank, given that the benefit to users of its financial statements would be also expected to be higher. It is also an issue on which the Basel Committee has issued guidance (see section 7.1 below).

5.9.2 Sources of information

IFRS 9 provides some guidance on the information to consider when measuring expected credit losses: *[IFRS 9.B5.5.51]*

Extract from IFRS 9

B5.5.51 An entity need not undertake an exhaustive search for information but shall consider all reasonable and supportable information that is available without undue cost or effort and that is relevant to the estimate of expected credit losses, including the effect of expected prepayments. The information used shall include factors that are specific to the borrower, general economic conditions and an assessment of both the current as well as the forecast direction of conditions at the reporting date. An entity may use various sources of data, that may be both internal (entity-specific) and external. Possible data sources include internal historical credit loss experience, internal ratings, credit loss experience of other entities and external ratings, reports and statistics. Entities that have no, or insufficient, sources of entity-specific data may use peer group experience for the comparable financial instrument (or groups of financial instruments).

Although the expected credit losses reflect an entity's own expectations of credit losses, an entity also considers observable market information about the credit risk of particular financial instruments. *[IFRS 9.B5.5.54]*. Therefore, although entities with in-house economic teams will inevitably want to use their internal economic forecasts, while loss estimation models will be built based on historical data, they must not ignore external market data.

5.9.3 Information about past events, current conditions and forecasts of future economic conditions

Entities are not only required to use historical information (e.g., their credit loss experience) that is adjusted to reflect the effects of current conditions, but they are also required to consider how forecasts of future conditions would affect their historical data. A discussion of how this process needs to consider the existence of non-linearity in how expected losses will change with varying economic conditions and the need to assess multiple economic scenarios is included in section 5.6.1 above. This section explores some of the other challenges in forecasting future conditions and the consequent expected credit losses.

The degree of judgement that is required to estimate expected credit losses depends on the availability of detailed information. An entity is not required to incorporate detailed forecasts of future conditions over the entire expected life of a financial instrument. IFRS 9 notes that as the forecast horizon increases, the availability of detailed information decreases and the degree of judgement required to estimate expected credit losses increases. Therefore, an entity is not required to perform a detailed estimate for periods that are far in the future and may extrapolate projections from available, more detailed information. *[IFRS 9.B5.5.50]*. Most banks apply a 3 to 5 year period over which macro-economic variables are considered to be capable of being forecast.

Beyond the horizon to which economic conditions can be reliably forecast, the application guidance suggests that entities may often be able to assume that economic conditions revert to their long-term average. There are at least two methods of how this might be done: either by reverting to the average immediately beyond the forecast horizon, or by adjusting the forecast data to the long-term average over a few years. The latter would, perhaps, more effectively make use of all reasonable and supportable information.

Historical information is used as a starting point from which adjustments are made to estimate expected credit losses on the basis of reasonable and supportable information that incorporates both current and forward-looking information: *[IFRS 9.B5.5.52]*

- In most cases, adjustments would be needed to incorporate those effects that were not present in the past or to remove those effects that are not relevant for the future.
- In some cases, unadjusted historical information may be the best estimate, depending on the nature of the historical information and when it was calculated, compared to circumstances at the reporting date and the characteristics of the financial instrument being considered. But it is not assumed to be appropriate in all circumstances. *[IFRS 9.BC5.281]*.

Additionally, when considering whether historical credit losses are adjusted, an entity needs to consider various items, including:

- Whether the historical data captures expected credit losses that are through-the-cycle (i.e., estimates based on historical credit loss events and experience over the entire economic cycle) or point-in-time (i.e., estimates based on information, circumstances and events at the reporting date).
- The period of time over which its historical data has been captured and the corresponding economic conditions represented in that history. The historical data period may reflect unusually benign or harsh conditions unless it is long enough. Meanwhile, products, customers and lending behaviours all change over time. When using historical credit loss experience, it is important that information about historical credit losses is applied to groups that are defined in a manner that is consistent with the groups for which the historical credit losses were observed.

The estimates of changes in expected credit losses are directionally consistent with changes in related observable data from period to period (i.e., consistent with trends observed on payment status and macroeconomic data such as changes in unemployment rates, property prices, and commodity prices). Also, in order to reduce the differences between an entity's estimates and actual credit loss experience, the estimates of expected credit losses ought to be back-tested and re-calibrated, i.e., an entity regularly reviews its inputs, assumptions, methodology and estimation techniques used as well as its groupings of sub-portfolios with shared credit risk characteristics (see section 6.5 below).

Back-testing will be considerably more challenging for forecasts over several years than may be the case for just the 12-month risk of default, because detailed information is not available over the forecast horizon and the degree of judgement increases as the forecast horizon increases. *[IFRS 9.B5.5.52, IFRS 9.B5.5.53]*. Also, economic forecasts are usually wrong, as reality is much more complex than can ever be effectively modelled. Therefore, it is probably not a useful exercise to back-test macroeconomic assumptions against what actually transpires, but it is useful to back-test whether, for a given macroeconomic scenario, credit losses increased or decreased as expected.

In estimating expected credit losses, entities must consider how to bridge the gap between historical loss experience and current expectations. Estimating future economic conditions is only the first step of the exercise. Having decided what will happen to macroeconomic factors such as interest rates, house prices, unemployment and gross domestic product growth, entities then need to decide how they translate into expected credit losses. This will need to reflect how such changes in factors affected defaults in the past. However, it is possible that the forecast combination of factors may have never been seen historically together.

For many banks, Basel probability of defaults are used as a starting point but there is a need for a different calibration for IFRS 9, in order to transform a Basel probability of default into an unbiased point in time metric and include forward-looking expectations. Stress testing resources, previously working almost exclusively with capital issues, also play a role in calculating lifetime expected credit losses, although the scenarios modelled for IFRS 9 will not necessarily be stressed. However, estimating losses (especially given the need to consider multiple scenarios) will still be challenging for many entities.

5.9.4 Events and new information obtained after expected credit losses have been calculated

Frequently asked questions

Question 5-7: Whether and how to incorporate events and forecasts, when applying the impairment requirements at the reporting date, that occur:
(a) After economic forecasts have been made but before the reporting date
(b) Between the reporting period end and the date of signing the financial statements

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 22 April 2015 - Agenda paper no. 2)

In April 2015, the IFRS Transition Resource Group for Impairment of Financial Instruments (see section 1.4 above) debated whether, and how, to incorporate events and new information about forecasts of future economic conditions that occur after the expected credit losses have been estimated. Due to operational practicality, entities may perform their expected credit loss calculations before the reporting period end in order to publish their financial statements in a timely manner (e.g., forecasts of future economic conditions developed in November may be used as the basis for determining the expected credit losses at the reporting date as at 31 December). Further information may then become available after the period end. The IFRS Transition Resource Group for Impairment of Financial Instruments noted that:

- If new information becomes available before the reporting date, subject to materiality considerations in accordance with IAS 8, an entity is required to take into consideration this information in the assessment of significant increases in credit risk and the measurement of expected credit losses at the reporting date.
- IFRS 9 does not specifically require new information that becomes available after the reporting date to be reflected in the measurement of expected credit losses at the reporting date. If new information becomes available between the reporting date and the date the financial statements are authorised for issue, an entity needs to apply judgement, based on the specific facts and circumstances, to determine whether it is an adjusting or non-adjusting event in accordance with IAS 10 *Events after the Reporting Period* (see Chapter 34). Similarly, materiality considerations apply in accordance with IAS 8.
- Expected credit losses are similar in nature to the measurement of fair value at the reporting date, in that movements in fair value after the reporting date are generally not reflected in the measurement of fair value at the reporting date. *[IAS 10.11]*. For example, a change in interest rates or the outcome of a public vote after the reporting date would not normally be regarded as adjusting events for the ECL calculation.
- However, expected credit losses are a probability-weighted estimate of credit losses at the reporting date (see section 5.6 above). Accordingly, the determination of expected credit losses should take into consideration relevant possible future scenarios based on a range of expectations at the reporting date, using the information available at that date. Hence, the probabilities attached to future expected movements in interest rates and expected outcomes of a future public vote based on information available at the reporting date would be reflected in the determination of expected credit losses at that date.
- Entities need robust processes and appropriate governance procedures for incorporating information, including forecasts of future economic conditions, to ensure transparent and consistent application of the impairment requirements in IFRS 9. This includes processes for updating expected credit losses for new information that becomes available after the initial modelling has taken place up until the reporting date.

5.9.5 Other issues concerning forward-looking information

Frequently asked questions

Question 5-8: Implementation issues related to forward-looking information.

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 16 September 2015 - Agenda paper no. 4)

At its meeting on 16 September 2015 (see section 1.4 above), the IFRS Transition Resource Group for Impairment of Financial Instruments examined two further questions about the use of forward-looking information:

(a) The level at which forward-looking information should be incorporated - whether at the level of the entity or on a portfolio-by-portfolio basis?

(b) How to determine what is reasonable and supportable forward-looking information and how to treat shock events with material, but uncertain, economic consequences, such as an independence referendum? The same considerations could apply to events such as natural disasters. The question is particularly relevant within the context of information about emerging issues and uncertain future events, which is not usually included in an entity's current budgeting and forecasting processes.

With respect to the first issue, the IFRS Transition Resource Group for Impairment of Financial Instruments members confirmed that forward-looking information should be relevant for the particular financial instrument or group of financial instruments to which the impairment requirements are being applied. Different factors may be relevant to different financial instruments and, accordingly, the relevance of particular items of information may vary between financial instruments, depending on the specific drivers of credit risk. This is highlighted in Illustrative Example 5 to IFRS 9 (see Illustration 6-10 in section 6.5.3 below), in which expectations about future levels of unemployment in a specific industry and specific region are only relevant to a sub-portfolio of mortgage loans in which the borrowers work in that industry in that specific region. Conversely, it was also noted that if different financial instruments or portfolios being assessed share some similar risk characteristics, then relevant forward-looking information should be applied in a comparable and consistent manner to reflect those similar characteristics.

With respect to the second issue, the IFRS Transition Resource Group for Impairment of Financial Instruments members noted:

- There will be a spectrum of forward-looking information available, some of which will be reasonable and supportable and some of which will have little or no supportable basis. Determining the information that is relevant and reasonable and supportable and its impact on the assessment of significant increases in credit risk and measurement of expected credit losses can require a high level of judgement. In addition, it can be particularly challenging and difficult to determine the economic consequences (or 'second-order effects') of uncertain future outcomes. For example, while it may be possible to assess the likelihood of a particular event occurring, it may be more difficult to determine the effect of the event on the risk of a default occurring and/or on the credit loses that would be associated with that event using reasonable and supportable information.
- The objective of the IFRS 9 requirements for measuring expected credit losses is to reflect probability-weighted outcomes. Accordingly, information should not be excluded from the assessment of expected credit losses simply because:
  (a) The event has a low or remote likelihood of occurring
  Or
  (b) The effect of that event on the credit risk or the amount of expected credit losses is uncertain
- An entity should make an effort in good faith to estimate the impact of uncertain future events, including second-order effects, on the credit risk of financial instruments and the measurement of expected credit losses. The estimate should be based on all reasonable and supportable information that is relevant and available without undue cost and effort. Furthermore:
  (a) Estimates of expected credit losses should reflect an entity's own expectations of credit losses; however, entities should be able to explain how they have arrived at their estimate and how it is based on reasonable and supportable information.
  (b) Estimates of expected credit losses are, by their nature, approximations, which will be updated as more reasonable and supportable information becomes available over time.
  (c) Information does not necessarily need to flow through a statistical model or credit-rating process in order to determine whether it is reasonable and supportable and relevant for a particular financial instrument or group of financial instruments.

- If an entity could determine that an uncertain event has an impact on the probability of default, then it should be possible to make an estimate of the impact on expected credit losses, despite the potentially large range of outcomes. However, in some exceptional cases, it was acknowledged that it may not be possible to estimate the impact on expected credit losses, despite an entity's best efforts.
- In this regard, the importance of disclosure of forward-looking information that is relevant, but that cannot be incorporated into the determination of significant increases in credit risk and/or the measurement of expected credit losses because of the lack of reasonable and supportable information was emphasised. Such disclosures should be consistent with the objective in IFRS 7, which is to enable users of the financial statements to understand the credit risk to which the entity is exposed.
- The need for good governance and processes in this area, because of the uncertainties and continually changing circumstances associated with forward-looking information. Furthermore, an entity should be able to explain what information it had considered and why that information had been included or excluded from the determination of expected credit losses.

This IFRS Transition Resource Group for Impairment of Financial Instruments discussion predated that in December 2015 on the use of probability-weighted multiple economic scenarios (see section 5.6.1 above) and some of the points that were noted by the IFRS Transition Resource Group for Impairment of Financial Instruments probably need to be updated in the context of the later discussion. For instance, the IFRS Transition Resource Group for Impairment of Financial Instruments members noted that the impact of scenarios about some uncertain future events for which there is reasonable and supportable information, may need to be incorporated through the use of overlays to the 'base model' on a collective basis. In applying a multiple scenario approach, an entity will not use just one base model. Moreover, if the lender needs to estimate expected credit losses by considering multiple economic scenarios, it would follow that many shock events may already be included in that process (since some shock events might be assumed to occur every year), with the event and its various possible consequences occurring in some scenarios and not in others. There may still need to be cases when the effect of shock events is added through an additional 'overlay' to the modelled calculation of expected credit losses but, if so, as noted by the IFRS Transition Resource Group for Impairment of Financial Instruments members, care needs to be taken to avoid double counting the consequences of the event with what has already been assumed in the model.

Banks will also need to take account of guidance from their regulators (see section 7.1 below).

The IFRS Transition Resource Group for Impairment of Financial Instruments members also noted that the effects of uncertain future events may need to be reflected in the assessment of whether there has been a significant increase in credit risk.

An example of an uncertain future event that arose after the IFRS Transition Resource Group for Impairment of Financial Instruments discussion is the coronavirus pandemic (see section 7.8 below). On 27 March 2020, the IASB issued an educational document in which it acknowledged that it was likely to be difficult to incorporate the specific effects of the coronavirus pandemic and government support measures on a reasonable and supportable basis. However, changes in economic conditions should be reflected in macroeconomic scenarios applied by entities and in their weightings (see sections 5.6.1 and 5.6.2 above).[20] When it is not possible to reflect such information in models, the IASB expects post-model overlays or adjustments to be considered.

In addition, the IASB noted that although the circumstances of the coronavirus pandemic were difficult and created high levels of uncertainty, if ECL estimates were based on reasonable and supportable information and IFRS 9 was not applied mechanistically, useful information could be provided about expected credit losses. Indeed, in the stressed environment created by the pandemic, IFRS 9 and the associated disclosures provided much needed transparency to users of financial statements (see section 15 below and Chapter 50 at section 5.3).

20 IFRS 9 and covid-19: *Accounting for expected credit losses applying IFRS 9* Financial Instruments *in the light of current uncertainty resulting from the covid-19 pandemic*, IASB, 27 March 2020. Available on the IFRS Foundation's website.

6 General approach: determining significant increases in credit risk

One of the major challenges in implementing the general approach in the IFRS 9 expected credit loss model is to track and determine whether there have been significant increases in the credit risk of an entity's credit exposures since initial recognition.

The assessment of significant deterioration is key in establishing the point of switching between the requirement to measure an allowance based on 12-month expected credit losses and one that is based on lifetime expected credit losses. The assessment of whether there has been a significant increase in credit risk is therefore often referred to as 'the staging assessment'. IFRS 9 is prescriptive that an entity cannot align the timing of significant increases in credit risk and the recognition of lifetime expected credit losses with the time when a financial asset is regarded as credit-impaired or to an entity's internal definition of default. *[IFRS 9.B5.5.21]*. Financial assets will normally be assessed as having increased significantly in credit risk earlier than when they become credit-impaired (see section 3.1 above) or default occurs. *[IFRS 9.B5.5.7]*.

As this area involves significant management judgement, entities are required to provide both qualitative and quantitative disclosures under IFRS 7 to explain the inputs, assumptions and estimation used to determine significant increases in credit risk of financial instruments and any changes in those assumptions and estimates (see section 15 below and Chapter 50 at section 5.3). *[IFRS 7.35F(a), IFRS 7.35G(a)(ii), IFRS 7.35G(c)]*.

Frequently asked questions

Question 6-1: Whether in respect of financial instruments with a maturity of 12 months or less there is a requirement to assess significant increases in credit risk?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 11 December 2015 - Agenda paper no. 8)

At its meeting in December 2015 (see section 1.4 above), the IFRS Transition Resource Group for Impairment of Financial Instruments members reaffirmed that unless a more specific exception applies, IFRS 9 requires an entity to assess whether there has been a significant increase in credit risk for all financial instruments, including those with a maturity of 12 months or less. Consistently with this requirement, IFRS 7 requires corresponding disclosures that distinguish between financial instruments for which the loss allowance is equal to 12-month or lifetime expected credit losses. In addition, the IFRS Transition Resource Group for Impairment of Financial Instruments members noted that:

- The assessment of significant increases in credit risk is distinct from the measurement of expected credit losses as highlighted by IFRS 9.5.5.9. For example, a collateralised financial asset may have suffered a significant increase in credit risk, but owing to the value of the collateral there may not be an increase in the amount of expected credit losses even if measured on a lifetime rather than a 12-month basis.
- Assessing changes in credit risk would be consistent with normal credit risk management practices.
- The expected life of a financial instrument may change if it has suffered a significant increase in credit risk.

Finally, the IFRS Transition Resource Group for Impairment of Financial Instruments noted the importance of the IFRS 7 disclosure requirements and observed that disclosing information regarding the increase in credit risk since initial recognition provides users of financial statements with useful information regarding the changes in the risk of default occurring in respect of that financial instrument (see section 15 below and Chapter 50 at section 5.3).

6.1 Change in the risk of a default occurring

In order to make the assessment of whether there has been significant credit deterioration, an entity considers reasonable and supportable information that is available without undue cost or effort and compare the risk of a default occurring on the financial instruments over its life as at the reporting date and as at the date of initial recognition.

Extract from IFRS 9

5.5.9 At each reporting date, an entity shall assess whether the credit risk on a financial instrument has increased significantly since initial recognition. When making the assessment, an entity shall use the change in the risk of a default occurring over the expected life of the financial instrument instead of the change in the amount of expected credit losses. To make that assessment, an entity shall compare the risk of a default occurring on the financial instrument as at the reporting date with the risk of a default occurring on the financial instrument as at the date of initial recognition and consider reasonable and supportable information, that is available without undue cost or effort, that is indicative of significant increases in credit risk since initial recognition.

[IFRS 9.5.5.9].

For loan commitments, an entity considers changes in the risk of a default occurring on the potential loan to which a loan commitment relates.

For financial guarantee contracts, an entity considers the changes in the risk that the specified debtor will default. *[IFRS 9.B5.5.8]*.

An entity is required to assess significant increases in credit risk based on the change in the risk of a default occurring over the expected life of the financial instrument rather than the change in the amount of expected credit losses. *[IFRS 9.5.5.9]*. In a departure from the Basel regulatory wording and to avoid suggesting that statistical models are required (including the probability of default approach), the IASB changed the terminology from 'probability of a default occurring' to 'risk of a default occurring'. *[IFRS 9.BC5.157]*.

In order to make the IFRS 9 impairment model operational, the IASB considered a number of alternative methods for determining significant increases in credit risk, but these were rejected for the following reasons:

- *Absolute level of credit risk*: The IASB considered whether an entity should be required to recognise lifetime expected credit losses on all financial instruments at, or above, a particular credit risk at the reporting date. Although this approach is operationally simpler to apply (because an entity is not required to track changes in credit risk), such an approach would provide very different information. It would not approximate the economic effect of changes in credit loss expectations subsequent to initial recognition. In addition, it may also result in overstatement or understatement of expected credit losses, depending on the threshold set for recognising lifetime expected credit losses. *[IFRS 9.BC5.160]*. However, the IASB noted that an absolute approach could be used for portfolios of financial instruments with similar credit risk at initial recognition, by determining the maximum initial credit risk accepted and then comparing the maximum initial credit risk to the credit risk at the reporting date (see section 6.4.5 below). *[IFRS 9.BC5.161]*.
- *Change in the credit risk management objective*: The IASB also considered whether the assessment of significant deterioration should be based on whether an entity's credit risk management objective changes (e.g., monitoring of financial assets on an individual basis, or a change from collecting past due amounts to the recovery of these amounts). This approach is operationally relatively easy to apply. However, it may result in a delayed recognition of expected credit losses. *[IFRS 9.BC5.162]*.
- *Credit underwriting policies*: The IASB further considered whether the change in the entity's credit underwriting limit for a particular class of financial instrument at the reporting date (i.e., an entity would not originate new loans on the same terms) should form the basis of assessing significant increase in credit risk. The IASB noted that this approach is similar to the absolute approach above. Moreover, the change in an entity's credit underwriting limits may be driven by other factors that are not related to a change in the credit risk of its borrowers (e.g., the entity may incorporate favourable terms to maintain a good business relationship or to increase lending), or are dependent on circumstances existing at the reporting date that are not relevant to the particular vintages of financial instruments. *[IFRS 9.BC5.163, IFRS 9.BC5.164, IFRS 9.BC5.165]*.
- Similar to measuring expected credit losses, an entity may use different approaches when assessing significant increases in credit risk for different financial instruments: *[IFRS 9.B5.5.12]*

Extract from IFRS 9

B5.5.12 An entity may apply various approaches when assessing whether the credit risk on a financial instrument has increased significantly since initial recognition or when measuring expected credit losses. An entity may apply different approaches for different financial instruments. An approach that does not include an explicit probability of default as an input *per se*, such as a credit loss rate approach, can be consistent with the requirements in this Standard, provided that an entity is able to separate the changes in the risk of a default occurring from changes in other drivers of expected credit losses, such as collateral, and considers the following when making the assessment:

(a) the change in the risk of a default occurring since initial recognition;

(b) the expected life of the financial instrument; and

(c) reasonable and supportable information that is available without undue cost or effort that may affect credit risk.

In addition, because of the relationship between the expected life and the risk of default occurring, the change in credit risk cannot be assessed simply by comparing the change in the absolute risk of default over time, because the risk of default usually decreases as time passes if the credit risk is unchanged. *[IFRS 9.B5.5.11, IFRS 9.B5.5.12]*.

Entities that do not use probability of loss as an explicit input will have to use other criteria to identify a change in the risk of default occurring. These might include deterioration in a behavioural score, or other indicators, of a heightened risk of default. A collective approach may also be an appropriate supplement or substitute for an assessment at the individual instrument level (see section 6.5 below).

A number of operational simplifications and presumptions are available to help entities make this assessment (as described further below).

6.1.1 Impact of collateral, credit enhancements and financial guarantee contracts

As already stressed, the staging assessment is based on the change in the lifetime risk of default, not the amount of expected credit losses. *[IFRS 9.5.5.9]*. Hence the allowance for a fully collateralised asset may need to be based on lifetime expected credit losses (because there has been a significant increase in the risk of default) even though no loss is expected to arise. In such instances, the fact that the asset is being measured using lifetime expected credit losses may have more significance for disclosure than for measurement (see section 15 below).

The interaction between collateral, assessment of significant increases in credit risk and measurement of expected credit losses is illustrated in the following example from IFRS 9. *[IFRS 9.IE Example 3, IFRS 9.IE18-IE23]*.

Illustration 6-1: Highly collateralised financial asset

Company H owns real estate assets which are financed by a five-year loan from Bank Z with a loan-to-value ratio of 50%. The loan is secured by a first-ranking security over the real estate assets. At initial recognition of the loan, Bank Z does not consider the loan to be credit-impaired as defined in Appendix A of IFRS 9.

Subsequent to initial recognition, the revenues and operating profits of Company H have decreased because of an economic recession. Furthermore, expected increases in regulations have the potential to further negatively affect revenue and operating profit. These negative effects on Company H's operations could be significant and ongoing.

As a result of these recent events and expected adverse economic conditions, Company H's free cash flow is expected to be reduced to the point that the coverage of scheduled loan payments could become tight. Bank Z estimates that a further deterioration in cash flows may result in Company H missing a contractual payment on the loan and becoming past due.

Recent third-party appraisals have indicated a decrease in the value of the real estate properties, resulting in a current loan-to-value ratio of 70%.

At the reporting date, the loan to Company H is not considered to have low credit risk in accordance with IFRS 9.5.5.10. Bank Z therefore needs to assess whether there has been a significant increase in credit risk since initial recognition in accordance with IFRS 9.5.5.3, irrespective of the value of the collateral it holds. It notes that the loan is subject to considerable credit risk at the reporting date because even a slight deterioration in cash flows could result in Company H missing a contractual payment on the loan. As a result, Bank Z determines that the credit risk (i.e., the risk of a default occurring) has increased significantly since initial recognition. Consequently, Bank Z recognises lifetime expected credit losses on the loan to Company H.

Although lifetime expected credit losses should be recognised, the measurement of the expected credit losses will reflect the recovery expected from the collateral (adjusting for the costs of obtaining and selling the collateral) on the property as required by IFRS 9.B5.5.55 and may result in the expected credit losses on the loan being very small.

Frequently asked questions

Question 6-2: Whether an entity should consider the ability to recover cash flows through the integral financial guarantee contract when assessing whether there has been a significant increase in the credit risk of the guaranteed debt instrument since initial recognition?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 22 April 2015 - Agenda paper no. 5)

At its meeting on 22 April 2015, The IFRS Transition Resource Group for Impairment of Financial Instruments (see section 1.4 above) noted that IFRS 9 requires that measurement of the expected credit losses of the guaranteed debt instrument includes cash flows from the integral financial guarantee contract (see section 5.8.1 above). *[IFRS 9.B5.5.55]*. However, some IFRS Transition Resource Group for Impairment of Financial Instruments members commented that IFRS 9 is clear that recoveries from integral financial guarantee contracts should be excluded from the assessment of significant increases in credit risk of the guaranteed debt instrument. *[IFRS 9.5.5.9]*. This is because the focus of IFRS 9 is about the risk of the borrower defaulting when making such an assessment, as highlighted in the examples in B5.5.17 of IFRS 9. These examples clarify that information about a guarantee (or other credit enhancement) may be relevant to assessing changes in credit risk, but only to the extent that it affects the likelihood of the borrower defaulting on the instrument (see section 6.2.1 below for the list of examples). *[IFRS 9.B5.5.17]*. Furthermore, excluding recoveries from the financial guarantee contract, when assessing significant increases in credit risk, would be consistent with the treatment of other forms of collateral.

When assessing whether financial assets are credit-impaired, an entity does not take into account any recoveries from the realisation of the collateral.

While the value of collateral does not normally affect the assessment of significant increases in credit risk, if significant changes in the value of the collateral supporting the obligation are expected to reduce the borrower's economic incentive to make scheduled contractual payments, then this would have an effect on the risk of a default occurring. IFRS 9 provides an example where, if the value of collateral declines because house prices decline, borrowers in some jurisdictions have a greater incentive to default on their mortgages. *[IFRS 9.B5.5.17(j)]*.

The other examples provided by IFRS 9 of situations where the value of a credit enhancement could have an impact on the ability or economic incentive of the borrower to repay relate to guarantees or financial support provided by a shareholder, parent entity or other affiliate and to interests issued in securitisations:

- A significant change in the quality of the guarantee provided by a shareholder (or an individual's parent) if the shareholder (or parent) has an incentive and financial ability to prevent default by capital or cash infusion. *[IFRS 9.B5.5.17(k)]*.
- Significant changes, such as reductions, in financial support from a parent entity or other affiliate or an actual or expected significant change in the quality of credit enhancement, that are expected to reduce the borrower's ability to make scheduled contractual payments. For example, such a situation could occur if a parent decides to no longer provide financial support to a subsidiary, which as a result would face bankruptcy or receivership. This could, in turn, result in that subsidiary prioritising payments for its operational needs (such as payroll and crucial suppliers) and assigning a lower priority to payments on its financial debt, resulting in an increase in the risk of default on those liabilities. Credit quality enhancements or support include the consideration of the financial condition of the guarantor and/or, for interests issued in securitisations, whether subordinated interests are expected to be capable of absorbing expected credit losses (for example, on the loans underlying the security). *[IFRS 9.B5.5.17(l)]*.

6.1.2 Contractually linked instruments and subordinated interests

The last example in the previous section, referring to the effect of subordinated interests in a securitisation deserves some comment. IFRS 9 sets out rules to determine whether an investment in a contractually linked instrument such as a tranche of a securitisation, qualifies to be measured at amortised cost or at fair value through other comprehensive income (see Chapter 44 at section 5.6). *[IFRS 9.4.1.2, IFRS 9.4.1.2A, IFRS 9.B4.1.20-26]*. Some contractually linked instruments that are more senior tranches may pass the contractual cash flow characteristics test and consequently will be measured at amortised cost or fair value

through other comprehensive income. However, the contractual cash flows of the individual tranches are normally based on a pre-defined waterfall structure (i.e., principal and interest are first paid on the most senior tranche and then successively paid on more junior tranches). To this extent, contractually linked instruments do not default. Meanwhile, Appendix A of IFRS 9 defines 'credit loss' as "the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e., reflecting any cash shortfalls), discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets)". Under the contract, the issuer of a contractually linked instrument only passes on cash flows that it actually receives, so the contractually defined cash flows under the waterfall structure are always equal to the cash flows that a holder expects to receive. Accordingly, one could argue that contractually linked instruments never give rise to a credit loss, and so would never be regarded as impaired.

However, consistent with recording these assets at amortised cost or at fair value through other comprehensive income because they meet the solely payment of principal and interest criterion, the contractual terms of the contractually linked instrument are 'deemed' to give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. Hence, we believe that for the purposes of the effective interest method and impairment requirements of IFRS 9, the lender needs to consider the deemed principal and interest payments as the contractual cash flows, instead of the contractual cash flows determined under the waterfall structure. Accordingly, any failure of the instrument to pay the investor the full amount deemed to be due must be treated as a default and an estimation of the amount of any losses that will be incurred must be reflected in the credit loss allowance.

How we see it

IFRS 9 deems certain tranches of contractually linked instruments to satisfy the solely payment of principal and interest criterion to be recorded at amortised cost or at fair value through other comprehensive income. Consequently, the holder of a tranche to which this applies needs to consider the 'deemed' principal and interest payments as the contractual cash flows, instead of the contractual cash flows determined under the waterfall structure, for the purposes of the effective interest method and impairment requirements of IFRS 9.

It also follows that any changes in circumstances that may reduce the ability of the holder of a contractually linked instrument to receive the principal and interest would need to be considered in assessing whether there has been a significant increase in credit risk. This would include whether more subordinated interests are expected to continue to be capable of absorbing expected credit losses on the underlying loans. Therefore, the investment is measured based on lifetime expected credit losses if there are sufficient losses expected on the instruments underlying the securitisation such that they could not all be absorbed by subordinated interests in the structure, and so there is a significantly increased risk that the holder of a senior tranche will suffer a loss.

For contractually linked instruments where the issuer does not make payments to the holder to the extent that it does not receive sufficient cash from the underlying pool of assets or where there are non-recourse features, such as features that limit an entity's right to receive cash flows, the entity is first required to determine the revised gross carrying amount of the CLI instrument. The entity does this by taking into account the revised estimated contractual cash flows, then assessing the ECL of the revised gross carrying amount accordingly.

6.1.3 Determining change in the risk of a default under the loss rate approach

Under the loss rate approach, introduced in section 5.4.2 above, an entity develops loss-rate statistics on the basis of the amount written off over the life of the financial assets rather than using separate probability of default and loss given default statistics. Entities then must adjust these historical credit loss trends for current conditions and expectations about the future.

IFRS 9 is clear that although a loss rate approach may be applied, an entity needs to be able to separate the changes in the risk of a default occurring from changes in other drivers of expected credit losses for the purpose of assessing if there has been a significant increase in credit risk. *[IFRS 9.B5.5.12]*. Under the loss rate approach, the entity does not distinguish between a risk of a default occurring and the loss incurred following a default. This is not so much of an issue for measuring 12-month or lifetime expected credit losses. However, under the loss rate approach, an entity would not be able to implement the assessment of significant increases in credit risk that is based on the change in the risk of a default. Therefore, entities using the loss rate approach would need an overlay of measuring and forecasting the level of defaults, as illustrated in the extract of Example 9 from the Illustrative Examples to IFRS 9 (see Illustration 5-3 in section 5.4.2 above). For entities that currently use only expected loss rates it may be easier to develop a probability of default approach than to use the method described in this example.

6.2 Factors or indicators of changes in credit risk

Extract from IFRS 9

B5.5.16 Credit risk analysis is a multifactor and holistic analysis; whether a specific factor is relevant, and its weight compared to other factors, will depend on the type of product, characteristics of the financial instruments and the borrower as well as the geographical region. An entity shall consider reasonable and supportable information that is available without undue cost or effort and that is relevant for the particular financial instrument being assessed. However, some factors or indicators may not be identifiable on an individual financial instrument level. In such a case, the factors or indicators should be assessed for appropriate portfolios, groups of portfolios or portions of a portfolio of financial instruments to determine whether the requirement in paragraph 5.5.3 for the recognition of lifetime expected credit losses has been met.

Similar to measuring expected credit losses (see section 5 above), when assessing significant increases in credit risk, an entity considers all reasonable and supportable information that is available without undue cost or effort (see section 5.9.1 above) and that is relevant for an individual financial instrument, a portfolio, portions of a portfolio, and groups of portfolios. *[IFRS 9.B5.5.15, IFRS 9.B5.5.16]*.

The IASB notes that it did not intend to prescribe a specific or mechanistic approach to assess changes in credit risk and that the appropriate approach will vary for different levels of sophistication of entities, the financial instrument and the availability of data. *[IFRS 9.BC5.157]*. It is important to stress that the assessment of significant increases in credit risk often involves a multifactor and holistic analysis. The importance and relevance of each specific factor will depend on the type of product, characteristics of the financial instruments and the borrower as well as the geographical region. *[IFRS 9.B5.5.16]*.

The guidance in IFRS 9 is clear that in certain circumstances, qualitative and non-statistical quantitative information may indicate a significant increase in credit risk: *[IFRS 9.B5.5.18]*

Extract from IFRS 9

B5.5.18 In some cases, the qualitative and non-statistical quantitative information available may be sufficient to determine that a financial instrument has met the criterion for the recognition of a loss allowance at an amount equal to lifetime expected credit losses. That is, the information does not need to flow through a statistical model or credit ratings process in order to determine whether there has been a significant increase in the credit risk of the financial instrument. In other cases, an entity may need to consider other information, including information from its statistical models or credit ratings processes. Alternatively, the entity may base the assessment on both types of information, ie qualitative factors that are not captured through the internal ratings process and a specific internal rating category at the reporting date, taking into consideration the credit risk characteristics at initial recognition, if both types of information are relevant.

6.2.1 Examples of factors or indicators of changes in credit risk

IFRS 9 provides a non-exhaustive list of factors or indicators which an entity considers when determining whether the recognition of lifetime expected credit losses is required: *[IFRS 9.B5.5.17]*

Extract from IFRS 9

B5.5.17 The following non-exhaustive list of information may be relevant in assessing changes in credit risk:

(a) significant changes in internal price indicators of credit risk as a result of a change in credit risk since inception, including, but not limited to, the credit spread that would result if a particular financial instrument or similar financial instrument with the same terms and the same counterparty were newly originated or issued at the reporting date.

(b) other changes in the rates or terms of an existing financial instrument that would be significantly different if the instrument was newly originated or issued at the reporting date (such as more stringent covenants, increased amounts of collateral or guarantees, or higher income coverage) because of changes in the credit risk of the financial instrument since initial recognition.

(c) significant changes in external market indicators of credit risk for a particular financial instrument or similar financial instruments with the same expected life. Changes in market indicators of credit risk include, but are not limited to:

(i) the credit spread;

(ii) the credit default swap prices for the borrower;

(iii) the length of time or the extent to which the fair value of a financial asset has been less than its amortised cost; and

(iv) other market information related to the borrower, such as changes in the price of a borrower's debt and equity instruments.

(d) an actual or expected significant change in the financial instrument's external credit rating.

(e) an actual or expected internal credit rating downgrade for the borrower or decrease in behavioural scoring used to assess credit risk internally. Internal credit ratings and internal behavioural scoring are more reliable when they are mapped to external ratings or supported by default studies.

(f) existing or forecast adverse changes in business, financial or economic conditions that are expected to cause a significant change in the borrower's ability to meet its debt obligations, such as an actual or expected increase in interest rates or an actual or expected significant increase in unemployment rates.

(g) an actual or expected significant change in the operating results of the borrower. Examples include actual or expected declining revenues or margins, increasing operating risks, working capital deficiencies, decreasing asset quality, increased balance sheet leverage, liquidity, management problems or changes in the scope of business or organisational structure (such as the discontinuance of a segment of the business) that results in a significant change in the borrower's ability to meet its debt obligations.

(h) significant increases in credit risk on other financial instruments of the same borrower.

(i) an actual or expected significant adverse change in the regulatory, economic, or technological environment of the borrower that results in a significant change in the borrower's ability to meet its debt obligations, such as a decline in the demand for the borrower's sales product because of a shift in technology.

(j) significant changes in the value of the collateral supporting the obligation or in the quality of third-party guarantees or credit enhancements, which are expected to reduce the borrower's economic incentive to make scheduled contractual payments or to otherwise have an effect on the probability of a default occurring. For example, if the value of collateral declines because house prices decline, borrowers in some jurisdictions have a greater incentive to default on their mortgages.

(k) a significant change in the quality of the guarantee provided by a shareholder (or an individual's parents) if the shareholder (or parents) have an incentive and financial ability to prevent default by capital or cash infusion.

(l) significant changes, such as reductions in financial support from a parent entity or other affiliate or an actual or expected significant change in the quality of credit enhancement, that are expected to reduce the borrower's economic incentive to make scheduled contractual payments. Credit quality enhancements or support include the consideration of the financial condition of the guarantor and/or, for interests issued in securitisations, whether subordinated interests are expected to be capable of absorbing expected credit losses (for example, on the loans underlying the security).

(m) expected changes in the loan documentation including an expected breach of contract that may lead to covenant waivers or amendments, interest payment holidays, interest rate step-ups, requiring additional collateral or guarantees, or other changes to the contractual framework of the instrument.

(n) significant changes in the expected performance and behaviour of the borrower, including changes in the payment status of borrowers in the group (for example, an increase in the expected number or extent of delayed contractual payments or significant increases in the expected number of credit card borrowers who are expected to approach or exceed their credit limit or who are expected to be paying the minimum monthly amount).

(o) changes in the entity's credit management approach in relation to the financial instrument; ie based on emerging indicators of changes in the credit risk of the financial instrument, the entity's credit risk management practice is expected to become more active or to be focused on managing the instrument, including the instrument becoming more closely monitored or controlled, or the entity specifically intervening with the borrower.

(p) past due information, including the rebuttable presumption as set out in paragraph 5.5.11.

We make the following observations:

- With respect to the use of external market indicators of credit risk, the IASB noted that market prices are an important source of information that should be considered in assessing whether credit risk has changed. However, market prices cannot solely determine whether significant deterioration has occurred since they are also affected by non-credit risk related factors such as changes in interest rates or liquidity risks. *[IFRS 9.BC5.123]*.
- An increase in the risk of default on a loan could occur if a parent decides to no longer provide financial support to a subsidiary. This could in turn result in that subsidiary prioritising payments for its operational needs (such as payroll and crucial suppliers) and assigning a lower priority to payments on its financial debt, resulting in an increase in the risk of default on those liabilities.
- If entities make the staging assessment using their credit risk management systems, they will need to consider whether their systems take into account the various indicators listed above.
- Many financial institutions have readily available information about the pricing and terms of various types of loans issued to a specific customer (e.g., overdraft, credit cards and mortgage loans) in their credit risk management systems and processes. However, in practice, it would often be difficult to use such information because changes in pricing and terms on the origination of a similar financial instrument at the reporting date are not obviously related to a change in credit risk as other, more commercial, factors come into play (e.g., different risk appetites, change in management approach and underwriting standards). It may be challenging to link the two sets of information (i.e., pricing processes on the one hand and credit risk management on the other).
- Some collateralised loans are subject to cash variation margining requirements, which means that the trigger for default is normally the inability to pay a margin call. Therefore, in such circumstances the probability of default may be driven by the value of the collateral and changes in collateral values may need to be reflected in the staging assessment.
- Some of the factors or indicators are only relevant for the assessment of significant deterioration on an individual basis and not on a portfolio basis. These include, for example, a change in external market indicators of credit risk, including the credit spread, the credit default swap prices of the borrower or a decline in fair value of the asset. However, it is worth noting that external market information that is available for a quoted instrument may also be useful to help assess another instrument that is not quoted but which is issued by the same debtor or one who operates in the same sector.
- It is important to stress that the approach required by IFRS 9 is more holistic and qualitative than is necessarily captured by external credit ratings. Illustration 6-6 in section 6.4.1 below illustrates that there has in the past been significant differences between using agencies' credit ratings or using market data such as credit default swap spreads. The same point can of course be made about the use of internal credit ratings, especially if they are only reassessed on an annual basis. At the September 2015 meeting, the IFRS Transition Resource Group for Impairment of Financial Instruments observed that "credit grading systems were not designed with the requirements of IFRS 9 in mind and consequently, it should not be assumed that they will always be an appropriate means of identifying significant increases in credit risk".[21] The appropriateness of using internal credit grading systems as a means of assessing changes in credit risk since initial recognition depends on whether the credit grades are reviewed with sufficient frequency, include all reasonable and supportable information and reflect the risk of default over the expected life of the financial instrument.
- As credit grading systems vary, care needs to be taken when referring to movements in credit grades and how this reflects an increased risk of default occurring. In addition, the assessment of whether a change in credit risk grade represents a significant increase in credit risk in accordance with IFRS 9 depends on the initial credit risk of the financial instrument being assessed. Moreover, the relationship between credit grades and changes in the risk of default occurring differs between credit grading systems. For instance, in some cases, the changes in the risk of a default occurring will increase exponentially between grades whereas in others it will not.

21 IASB Transition Resource Group for Impairment of Financial Instruments, Meeting Summary, 16 September 2015, para. 17.

- Also, some of the above factors or indicators are very forward-looking, such as forecasts of adverse changes in business, financial or economic conditions that are expected to result in significant future financial difficulty of the borrower in repaying its debt. In practice, the analysis may have to be performed at the level of a portfolio rather than at an individual level when forward-looking information is not available at the individual level.

How we see it

With IFRS 9 not being prescriptive, we observe differences in how banks have implemented the assessment of significant increase in credit risk. These differences reflect various schools of thought along with differences in credit processes, business model, sophistication of the lender, the use of advanced models for regulatory capital purposes, availability of data (e.g., historic data at origination) and consistency of definitions across businesses or multiple systems. As use of models and availability of data can vary within a bank, a number of approaches may even be adopted within a single institution.

In general, entities use a combination of quantitative and qualitative drivers to assess significant increases in credit risk. Some of these are regarded as primary, others as secondary and some as backstops. The primary driver is usually expected to be the most forward-looking indicator and is generally based on a relative measure. The most common primary drivers used by the larger banks are:

- Changes in the lifetime risk of a default occurring, guided by scores and ratings
- Changes in the lifetime or 12-month probability of default
- Changes in ratings or credit scores for retail exposures and ratings for corporate exposures

Forbearance and watchlists are often used as secondary drivers and delinquency, usually more than 30 days past due, as a backstop (see section 6.2.2 below).

6.2.2 Past due status and more than 30 days past due rebuttable presumption

Extract from IFRS 9

5.5.11 If reasonable and supportable forward-looking information is available without undue cost or effort, an entity cannot rely solely on past due information when determining whether credit risk has increased significantly since initial recognition. However, when information that is more forward-looking than past due status (either on an individual or a collective basis) is not available without undue cost or effort, an entity may use past due information to determine whether there have been significant increases in credit risk since initial recognition. Regardless of the way in which an entity assesses significant increases in credit risk, there is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due. An entity can rebut this presumption if the entity has reasonable and supportable information that is available without undue cost or effort, that demonstrates that the credit risk has not increased significantly since initial recognition even though the contractual payments are more than 30 days past due. When an entity determines that there have been significant increases in credit risk before contractual payments are more than 30 days past due, the rebuttable presumption does not apply.

B5.5.2 Lifetime expected credit losses are generally expected to be recognised before a financial instrument becomes past due. Typically, credit risk increases significantly before a financial instrument becomes past due or other lagging borrower-specific factors (for example, a modification or restructuring) are observed. Consequently when reasonable and supportable information that is more forward-looking than past due information is available without undue cost or effort, it must be used to assess changes in credit risk.

The IASB is concerned that past due information is a lagging indicator. Typically, credit risk increases significantly before a financial instrument becomes past due or other lagging borrower-specific factors (for example, a modification or restructuring) are observed. Consequently, when reasonable and supportable information that is more forward-looking than past due information is available without undue cost or effort, it must be used to assess changes in credit risk and an entity cannot rely solely on past due information. *[IFRS 9.5.5.11, IFRS 9.B5.5.2]*. However, the IASB acknowledged that many entities manage credit risk on the basis of information about past due status and have a limited ability to assess credit risk on an instrument-by-instrument basis in more detail on a timely basis. *[IFRS 9.BC5.192]*. Therefore, if more forward-looking information (either on an individual or collective basis) is not available without undue cost or effort, an entity may use past due information to assess changes in credit risks. *[IFRS 9.5.5.11]*. However, contract

assets by definition, cannot be past due, therefore, entities cannot rely on delinquency for staging of such assets.

Whether the entity uses only past due information or also more forward-looking information (e.g., macroeconomic indicators), there is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due. However, IFRS 9 seems to make it clear that it is not possible to rebut the 30 days past due presumption just because of a favourable economic outlook. *[IFRS 9.5.5.11, IFRS 9.B5.5.19]*. The IASB decided that this rebuttable presumption was required to ensure that application of the assessment of the increase in credit risk does not result in a reversion to an incurred loss notion. *[IFRS 9.BC5.190]*.

Moreover, as already stressed earlier, IFRS 9 is clear that an entity cannot align the definition and criteria used to identify significant increases in credit risk (and the resulting recognition of lifetime expected credit losses) to when a financial asset is regarded as credit-impaired or to an entity's internal definition of default. *[IFRS 9.B5.5.21]*. An entity will normally identify significant increases in credit risk and recognise lifetime expected credit losses before default occurs or the financial asset becomes credit-impaired, either on an individual or collective basis (see section 6.5 below).

Extract from IFRS 9

B5.5.20 An entity can rebut this presumption. However, it can do so only when it has reasonable and supportable information available that demonstrates that even if contractual payments become more than 30 days past due, this does not represent a significant increase in the credit risk of a financial instrument. For example when non-payment was an administrative oversight, instead of resulting from financial difficulty of the borrower, or the entity has access to historical evidence that demonstrates that there is no correlation between significant increases in the risk of a default occurring and financial assets on which payments are more than 30 days past due, but that evidence does identify such a correlation when payments are more than 60 days past due.

An entity can rebut the 30 days past due presumption if it has reasonable and supportable information that is available without undue cost or effort, that demonstrates that credit risk has not increased significantly even though contractual payments are more than 30 days past due. *[IFRS 9.5.5.11, IFRS 9.B5.5.20]*. Also, in the context of the coronavirus pandemic, the 30 days past due backstop assumption may have needed to be rebutted in circumstances where the borrowers were experiencing temporary liquidity issues and whose long-term credit risk was unlikely to have been significantly affected by the pandemic (see section 7.8 below).

6.2.3 Concessions granted to a wide range of customers

In the context of the coronavirus pandemic, one of the accounting issues has been whether concessions made by lenders, such as changes in payment terms and the granting of payment holidays, will result in loans being move from stage 1 to stage 2.

The IASB noted in their educational material published on 27 March 2020 that IFRS 9 requires the application of judgement and both requires and allows entities to adjust their approach to determining expected credit losses in different circumstances (see section 7.8.2 below).[22] A number of assumptions and linkages underlying the way expected credit losses have been implemented may no longer hold in an environment affected by a pandemic. Entities should not continue to apply their existing expected credit loss methodology mechanically. For example, the extension of payment holidays to all borrowers in particular classes of financial instruments should not automatically result in all those instruments being considered to have suffered a significant increase in credit risk. This would be the case even if a moratorium results in a loss for the lender (e.g., if interest payments are reduced or waived), if it is provided irrespective of the borrowers' individual circumstances and the extension of payment holidays are assessed to be modifications rather than derecognition of the financial instruments (see section 8 below).

In other situations, if relief measures are available only to those who meet certain criteria, entities need to carefully assess whether such criteria themselves might indicate a significant increase in credit risk for the affected borrowers. For instance, a significant increase in credit risk is more likely to have occurred if a borrower applies for a relief measure which is available only to corporates which have suspended operations or individuals who have lost employment. Another example is if the relief, such as a deferral of loan payments, is offered to all participants in certain industries. This circumstance may indicate that

22 IFRS 9 and covid-19: *Accounting for expected credit losses applying IFRS 9* Financial Instruments *in the light of current uncertainty resulting from the covid-19 pandemic*, IASB, 27 March 2020. Available on the IFRS Foundation's website.

borrowers in that industry are exposed to a higher risk of business failure and, thus, a higher probability of default as a class. In combination with other reasonable and supportable information, this is more likely to result in the classification of the related loans and other exposures in this portfolio, or a portion of them, into stage 2. The assessment of whether there has been a significant increase in credit risk is made irrespective of the fact that a concession is imposed by laws or regulations. Entities are also expected to exercise judgement, in light of all facts and circumstances, including the effect of government support, to determine if the respective loans are credit-impaired and are therefore classified as stage 3.

Regulators stressed, in the context of the coronavirus pandemic, the need when assessing borrowers to differentiate a temporary liquidity need from a significant increase in credit risk. This meant that lenders distinguished between obligors whose long-term credit risk was unlikely to be significantly affected by the pandemic from those who might have been more permanently impacted.

Entities whose models include payment holidays or waiver of a covenant breach as automatic significant increase in credit risk triggers may need to include overlays to unwind the effects if they determine that the significant increase in credit risk trigger is not warranted. For retail loans, data will often not be available to determine whether a significant increase in credit risk has occurred for individual borrowers. For wholesale exposures, more information is generally available on individual obligors, although the significant increase in credit risk assessment will still be difficult. A lender may consider that borrowers in certain industries (e.g., airlines, tourism and hospitality) are exposed to a higher risk of business failure and, thus, an increased probability of default.

When it is not practical to determine significant increase in credit risk on an individual basis, a collective approach to staging is considered (see section 6.5 below). This will also be challenging. A possible method could be to transfer to stage 2 a portion of those customers who have been given a payment holiday or a waiver of a covenant breach, whose probability of default was already close to the level that would trigger a significant increase in credit risk. Any approach will require considerable judgement.

Where additional rounds of relief measures are extended to existing borrowers, the same considerations which were applicable to assessing the initial relief are also applicable in determining whether the additional relief constitutes a significant increase in credit risk. If the extension of the relief measures is offered only to selected borrowers (e.g., upon individual requests), it may be harder to conclude that a significant increase in credit risk has not occurred, as the need for additional relief may be in response to further deterioration in the borrower's financial position.

6.2.4 Illustrative Examples of factors or indicators when assessing significant increases in credit risk

The consideration of various factors or indicators when assessing significant increases in credit risk since initial recognition is illustrated in Illustration 6-2 and Illustration 6-3 below, which are based on Examples 1 and 2 in the Illustrative Examples to IFRS 9. *[IFRS 9.IE Example 1, IFRS 9.IE7-IE11, IFRS 9.IE Example 2, IFRS 9.IE12-IE17]*.

Illustration 6-2: Significant increase in credit risk

Company Y has a funding structure that includes a senior secured loan facility with different tranches. The security on the loan affects the loss that would be realised if a default occurs, but does not affect the risk of a default occurring, so it is not considered when determining whether there has been a significant increase in credit risk since initial recognition as required by IFRS 9.5.5.3. Bank X provides a tranche of that loan facility to Company Y. At the time of origination of the loan by Bank X, although Company Y's leverage was relatively high compared with other issuers with similar credit risk, it was expected that Company Y would be able to meet the covenants for the life of the instrument. In addition, the generation of revenue and cash flow was expected to be stable in Company Y's industry over the term of the senior facility. However, there was some business risk related to the ability to grow gross margins within its existing businesses.

At initial recognition, because of the considerations outlined above, Bank X considers that despite the level of credit risk at initial recognition, the loan is not an originated credit-impaired loan because it does not meet the definition of a credit-impaired financial asset in Appendix A of IFRS 9.

Subsequent to initial recognition, macroeconomic changes have had a negative effect on total sales volume and Company Y has underperformed on its business plan for revenue generation and net cash flow generation. Although spending on inventory has increased, anticipated sales have not materialised. To increase liquidity, Company Y has drawn down more on a separate revolving credit facility, thereby increasing its leverage ratio. Consequently, Company Y is now close to breaching its covenants on the senior secured loan facility with Bank X.

Bank X makes an overall assessment of the credit risk on the loan to Company Y at the reporting date, by taking into consideration all reasonable and supportable information that is available without undue cost or

effort and that is relevant for assessing the extent of the increase in credit risk since initial recognition. This may include factors such as:

(a) Bank X's expectation that the deterioration in the macroeconomic environment may continue in the near future, which is expected to have a further negative impact on Company Y's ability to generate cash flows and to de-leverage.

(b) Company Y is closer to breaching its covenants, which may result in a need to restructure the loan or reset the covenants.

(c) Bank X's assessment that the trading prices for Company Y's bonds have decreased and that the credit margin on newly originated loans have increased reflecting the increase in credit risk, and that these changes are not explained by changes in the market environment (for example, benchmark interest rates have remained unchanged). A further comparison with the pricing of Company Y's peers shows that reductions in the price of Company Y's bonds and increases in credit margin on its loans have probably been caused by company-specific factors.

(d) Bank X has reassessed its internal risk grading of the loan on the basis of the information that it has available to reflect the increase in credit risk.

Bank X determines that there has been a significant increase in credit risk since initial recognition of the loan in accordance with IFRS 9.5.5.3. Consequently, Bank X recognises lifetime expected credit losses on its senior secured loan to Company Y. Even if Bank X has not yet changed the internal risk grading of the loan it could still reach this conclusion - the absence or presence of a change in risk grading in itself is not determinative of whether credit risk has increased significantly since initial recognition.

Illustration 6-3: No significant increase in credit risk

Company C is the holding company of a group that operates in a cyclical production industry. Bank B provided a loan to Company C. At that time, the prospects for the industry were positive, because of expectations of further increases in global demand. However, input prices were volatile and given the point in the cycle, a potential decrease in sales was anticipated.

In addition, in the past Company C has been focused on external growth, acquiring majority stakes in companies in related sectors. As a result, the group structure is complex and has been subject to change, making it difficult for investors to analyse the expected performance of the group and to forecast the cash that will be available at the holding company level. Even though leverage is at a level that is considered acceptable by Company C's creditors at the time that Bank B originates the loan, its creditors are concerned about Company C's ability to refinance its debt because of the short remaining life until the maturity of the current financing. There is also concern about Company C's ability to continue to service interest using the dividends it receives from its operating subsidiaries.

At the time of the origination of the loan by Bank B, Company C's leverage was in line with that of other customers with similar credit risk and based on projections over the expected life of the loan, the available capacity (i.e., headroom) on its coverage ratios before triggering a default event, was high. Bank B applies its own internal rating methods to determine credit risk and allocates a specific internal rating score to its loans. Bank B's internal rating categories are based on historical, current and forward-looking information and reflect the credit risk for the tenor of the loans. On initial recognition, Bank B determines that the loan is subject to considerable credit risk, has speculative elements and that the uncertainties affecting Company C, including the group's uncertain prospects for cash generation, could lead to default. However, Bank B does not consider the loan to be originated credit-impaired.

Subsequent to initial recognition, Company C has announced that three of its five key subsidiaries had a significant reduction in sales volume because of deteriorated market conditions but sales volumes are expected to improve in line with the anticipated cycle for the industry in the following months. The sales of the other two subsidiaries were stable. Company C has also announced a corporate restructure to streamline its operating subsidiaries. This restructuring will increase the flexibility to refinance existing debt and the ability of the operating subsidiaries to pay dividends to Company C.

Despite the expected continuing deterioration in market conditions, Bank B determines, in accordance with IFRS 9.5.5.3, that there has not been a significant increase in the credit risk on the loan to Company C since initial recognition. This is demonstrated by factors that include:

(a) Although current sales volumes have fallen, this was as anticipated by Bank B at initial recognition. Furthermore, sales volumes are expected to improve, in the following months.

(b) Given the increased flexibility to refinance the existing debt at the operating subsidiary level and the increased availability of dividends to Company C, Bank B views the corporate restructure as being credit enhancing. This is despite some continued concern about the ability to refinance the existing debt at the holding company level.

(c) Bank B's credit risk department, which monitors Company C, has determined that the latest developments are not significant enough to justify a change in its internal credit risk rating.

As a consequence, Bank B does not recognise a loss allowance at an amount equal to lifetime expected credit losses on the loan. However, it updates its measurement of the 12-month expected credit losses for the increased risk of a default occurring in the next 12 months and for current expectations of the credit losses that would arise if a default were to occur.

A numerical illustration of how a significant increase in credit risk might be assessed is shown in Illustration 6-4 below.

Illustration 6-4: Assessment of a significant increase in credit risk based on a probability of default approach

This example is based on the same loan presented in Illustration 5-1 in section 5.4.1 above.

On 31 December 20X1, Bank A originates a 10-year bullet loan with a gross carrying amount of CU1,000,000, interest being due at the end of each year. Based on statistical and qualitative information - including forward-looking, Bank A has estimated a BBB rating for the loan.

Based on this rating, Bank A has computed a probability of default term structure at origination. Bank A's probability of default term structure is estimated with the annual probability of default expected for each future period. The lifetime probability of default is the product of each marginal probability of default during the considered period:

$$\text{lifetime PD}_k = 1 - \prod_{k=1}^{n} (1 - \text{marginal PD}_i)$$

Finally, based on the marginal probability of default computed for each future period, Bank A is able to compute the forward lifetime probability of default as follows:

Year	Cumulative probability of default at origination	Marginal 12-month probability of default	Remaining lifetime probability of default	Remaining annualised lifetime probability of default
20X1				
20X2	0.17%	0.17%	4.50%	0.46%
20X3	0.49%	0.32%	4.34%	0.49%
20X4	0.86%	0.37%	4.03%	0.51%
20X5	1.38%	0.53%	3.67%	0.53%
20X6	1.84%	0.47%	3.16%	0.53%
20X7	2.37%	0.54%	2.71%	0.55%
20X8	2.85%	0.49%	2.18%	0.55%
20X9	3.30%	0.46%	1.70%	0.57%
20Y0	3.84%	0.56%	1.24%	0.62%
20Y1	4.50%	0.69%	0.69%	0.69%

For the first year, the remaining lifetime probability of default is the cumulative probability of default at origination. Then, after a year, it starts decreasing, considering that the remaining period is shorter. After 2 years it is 4.03% and after 3 years it is only 3.67%. At the end of the loan, the remaining lifetime probability of default ends up at 0%.

In common with many institutions, Bank A chooses to compare an annualised lifetime probability of default instead of a cumulative probability of default. This has the advantage that business lines and risk analysts can easily map an annualised probability of default onto a rating scale. It also enables an absolute change in annualised lifetime probability of default, e.g., 20 basis points, to be set as a 'filter', to exclude small changes in lifetime probability of default from being assessed as significant that are considered to be 'noise'. For this purpose, Bank A calculates an annualised probability of default, using the residual cumulative curve. The annualised lifetime probability of default (PD) is calculated as follows:

$$\text{Annualised lifetime PD}_k = 1 - (1 - \text{lifetime PD}_k)^{1/t}$$

When t = horizon of the lifetime probability of default expressed in years

20X3: No significant increase in credit risk: Stage 1

On 31 December 20X3 - 2 years after origination, Bank A updates the rating of its obligor. The rating is now BB+.

A new probability of default term structure is estimated based on this information:

Year	Cumulative lifetime probability of default
20X4	0.67%
20X5	1.53%
20X6	3.70%
20X7	5.58%
20X8	5.89%
20X9	6.51%
20Y0	7.45%
20Y1	8.70%
Remaining annualised lifetime probability of default	1.13%
Forecast at origination	0.51%
Increase (multiple)	**2.20**

In this example, Bank A uses a significant increase in credit risk threshold of a 2.5 multiple of probability of default. For simplicity we ignore any qualitative or other indicators that a bank might use to make this assessment.

Comparing the remaining annualised probability of default estimated at origination (0.51%) with the remaining annualised probability of default at the reporting date (1.13%), the increase is still only × 2.2. We note that, had Bank A used a cumulative lifetime probability of default approach, it would compare 8.70% to 4.03%, which would also be a multiple of 2.2. The significant deterioration threshold set by Bank A is not met and therefore the loan remains in stage 1.

20X4: Significant increase in credit risk: *Stage 2*

On 31 December 20X4 - 3 years after origination, Bank A updates the rating of its obligor. Its rating is now BB-. Bank A updates its historical information for current economic conditions as well as reasonable and supportable forecasts of future economic conditions.

Year	Cumulative lifetime probability of default
20X5	1.40%
20X6	3.87%
20X7	8.82%
20X8	12.84%
20X9	16.04%
20Y0	18.98%
20Y1	21.60%
Remaining annualised lifetime probability of default	3.42%
Forecast at origination	0.53%
Increase (multiple)	**6.41**

As before, Bank A compares the remaining annualised probability of default estimated at origination (0.53%) with the remaining annualised probability of default at the reporting date (3.42%), an increase of 6.45 times the original probability of default. Had Bank A used a cumulative lifetime probability of default approach the comparison would be of 21.6% to 3.67%, a 6.41 fold increase. This time, the threshold of significant deterioration is met and the loan is moved to stage 2.

6.2.5 Use of behavioural factors

Frequently asked questions

Question 6-3: Whether an entity can use behavioural indicators of credit risk as a proxy for the assessment of significant increases in credit risk since initial recognition?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 16 September 2015 - Agenda paper no. 1)

At its meeting on 16 September 2015, the IFRS Transition Resource Group for Impairment of Financial Instruments (see section 1.4 above) discussed the following behavioural indicators of credit risk in determining whether there has been a significant increase in credit risk:

- Where a customer has made only the minimum monthly repayment for a specified number of months
- Where a customer has failed to make a payment on a loan with a different lender
- Where a customer has failed to make a specified number of minimum monthly repayments

The IFRS Transition Resource Group for Impairment of Financial Instruments members noted that:

- When assessing whether there has been a significant increase in credit risk, entities are required to consider a range of indicators rather than focussing on only one. Furthermore, while behavioural indicators have a role to play, the above behavioural indicators are often lagging indicators of increases in credit risk. Consequently, they should be considered in conjunction with other, more forward-looking information. In this regard, an entity must consider how to source and incorporate forward-looking information into the assessment of significant increases in credit risk and may need to do this on a collective basis if forward-looking information is not available at an individual financial instrument level.
- When considering the use of behavioural indicators, an entity should:
  - (a) Focus on identifying pre-delinquency behavioural indicators of increases in credit risk, e.g., increased utilisation rates or increased cash drawings on specific products.
  - (b) Only use indicators that are relevant to the risk of default occurring.
  - (c) Establish a link between the behavioural indicators of credit risk and changes in the risk of default occurring since initial recognition.
  - (d) Be mindful that while behavioural indicators are often predictive of defaults in the short term, they are often less predictive of defaults in the longer term, and, hence, might be lagging. Consequently, they potentially do not, on their own, signal significant increases in credit risk in a timely manner.
  - (e) Consider whether the use of behavioural indicators is appropriate for the type of product being assessed, e.g., if a loan has only back-ended payments, behavioural indicators based on timeliness of payment will not be appropriate.
- An entity is required to consider all information available without undue cost and effort and it should not be limited by the information that is available internally. For example, an entity should consider using third-party information from sources such as credit bureaus. However, information that is available to entities will vary across jurisdictions.
- When making the assessment of significant increases in credit risk, an entity should consider the possibility of segmenting the portfolio into groups of financial instruments with shared credit characteristics in such a way that similar indicators of credit risk could be used to identify increases in credit risk for specific sub-portfolios.
- It would not be appropriate to use the above behavioural indicators for the purposes of identifying low credit risk assets in accordance with IFRS 9.5.5.10 (see section 6.4.1 below), on the basis that such measures would not constitute a globally accepted definition of low credit risk as required by IFRS 9.

Other behavioural indicators, beyond those mentioned above, including items such as the level of cash advances, changes in expected payment patterns (e.g., moving from full payment to something less than full payment), and higher-than-expected utilisation of the facility, were raised at the meeting. Individually, these kinds of behaviours potentially are not determinative of a significant increase in credit risk but, when observed together, they may prove to be more indicative. By combining these indicators, an entity has the potential to transfer assets between stage 1 and stage 2 more meaningfully.

We also note that that one of the challenges with using behavioural information is that it depends on the starting point. That is, if the obligor's risk of default initially is consistent with a super-prime rating, the kind of deteriorating behaviour noted above would likely signal a significant shift. However, if the obligor originally had a sub-prime rating, then such behaviour might not indicate a significant increase in risk.

As noted by the IFRS Transition Resource Group for Impairment of Financial Instruments, while indicators that are more lagging may show a greater correlation with subsequent default, they are also likely to be less forward-looking. Although a probability of default approach may seem more sophisticated and forward-looking, it is still generally fed by behavioural information, even if it is combined, segmented and modelled in a more sophisticated way. If the only borrower-specific information is his behaviour, a forward-looking portfolio overlay will generally be required, whether a probability of default or a behavioural approach is used.

6.3 What is significant?

The assessment of whether credit risk has significantly increased depends, critically, on an interpretation of the word 'significant'. Some constituents who commented on the 2013 ED requested the IASB to quantify the term significant, however, the IASB decided not to do so, for the following reasons: *[IFRS 9.BC5.171, IFRS 9.BC5.172]*

- Specifying a fixed percentage change in the risk of default would require all entities to use the risk of default approach. As not all entities (apart from regulated financial institutions) use probability of defaults as an explicit input, this would have increased the costs and effort for those entities that do not use such an approach.
- Defining the amount of change in the risk of a default occurring would be arbitrary and this would depend on the type of products, maturities and initial credit risk.

IFRS 9 emphasises that the determination of the significance of the change in the risk of a default occurring depends on:

- The original credit risk at initial recognition: the same absolute change in probability of default for a financial instrument with a lower initial credit risk will be more significant than those with a higher initial credit risk (see section 6.1 above and Illustration 6-8 in section 6.4.5 below). *[IFRS 9.B5.5.9]*.
- The expected life or term structure: the risk of a default occurring for financial instruments with similar credit risk increases the longer the expected life of the financial instruments. Due to the relationship between the expected life and the risk of a default occurring, an entity cannot simply compare the absolute risk of a default occurring over time. For example, if the risk of a default occurring for a financial instrument with an expected life of 10 years at initial recognition is the same after five years, then this indicates that the credit risk has increased. IFRS 9 also states that, for financial instruments that have significant payment obligations close to the maturity of the financial instrument (e.g., those where the principal is only repaid at maturity), the risk of a default occurring may not necessarily decrease as time passes. In such cases, an entity needs to consider other qualitative factors. We note, however, that while the risk of default may decrease less quickly for an instrument with payment obligations throughout its contractual life, normally, the risk of default will still decrease as maturity approaches. *[IFRS 9.B5.5.10, IFRS 9.B5.5.11]*.

Some of these challenges are illustrated by examining the historical levels of default associated with the credit ratings of agencies, such as Standard & Poor's.

- It is apparent that the probability of defaults increase at a geometrical, rather than an arithmetic, rate as the credit ratings decline. Hence, the absolute increase in the probability of default between two relatively low risk credit ratings is considerably less than between two relatively higher risk ratings.
- The relative increase in probability of default between each of these ratings might be considered significant, since most involve a doubling or trebling of the probability of default. In contrast, because credit rating is an art rather than a science, the smaller changes in credit risk associated with the plus or minus notches in the grading system are less likely to be viewed as significant.
- In addition, as the time horizon increases, the probability of defaults also increase across all credit ratings (i.e., the probability of default increases with a longer maturity).

The majority of credit exposures that are assessed for significant credit deterioration will not have been rated by a credit rating agency. However, the same logic will apply when entities have developed their own probability of default models and are able to classify their exposure by probability of default levels.

The determination of what is significant will, for the larger banks, be influenced by the guidance issued by banking regulators (see section 7.1 below).

Given the exponential shape of the probability of default curve relative to ratings, some banks are considering that a bigger downgrade, as measured by the number of grades, would be significant for a higher quality loan than for one with a lower quality. The extent to which this is appropriate will depend on how the different grades map to probability of defaults. Also, the calibration of a significant deterioration has to take into account the fact that probability of default multiples for very good ratings only represent very small movements in absolute risk, whereas the same multiple applied to bad ratings can represent a significant change in the absolute amount of probability of default.

How we see it

Banks have varying views on how much of an increase in probability of default is significant. Also, while they may view a quantitative threshold, such as a doubling of probability of default, to be significant, many also require a minimum absolute probability of default increase, such as 50 basis points so as to avoid very high quality assets moving to stage 2 as a result of a very small change and to filter out 'noise'.

Banks have also introduced various metrics to assess the effect of different approaches to assess significant increase in credit risk and for management information. Examples include the volume of stage 2 assets compared to the total portfolio and compared to 12 months of lifetime expected losses, the volume of movement (back and forth) between stages 1 and 2, the amount of assets that jump directly from stage 1 to stage 3, the proportion of assets in stage 3 which went via stage 2, and how long assets were in stage 2 before moving to stage 3.

6.4 Operational simplifications

When assessing significant increases in credit risk, there are a number of operational simplifications available. These are discussed below.

6.4.1 Low credit risk operational simplification

IFRS 9 contains an important simplification that, if a financial instrument has a low credit risk, then an entity is allowed to assume at the reporting date that no significant increases in credit risk have occurred. The low credit risk concept was intended, by the IASB, to provide relief for entities from tracking changes in the credit risk of high-quality financial instruments. This simplification is optional and the low credit risk simplification can be elected on an instrument-by-instrument basis. *[IFRS 9.BC5.184]*.

This is a change from the 2013 ED, in which a low risk exposure was deemed not to have suffered significant deterioration in credit risk. *[IFRS 9.BC5.181, IFRS 9.BC5.182, IFRS 9.BC5.183]*. The amendment to make the simplification optional was made in response to requests from constituents, including regulators. The Basel Committee guidance (see section 7.1 below) considers the use of the low credit risk simplification a low-quality implementation of the expected credit loss model and that the use of this exemption is limited, except for holdings in securities.

For low risk instruments for which the simplification is used, the entity would recognise an allowance based on 12-month expected credit losses. *[IFRS 9.5.5.10]*. However, if a financial instrument is not, or no longer, considered to have low credit risk at the reporting date, it does not follow that the entity is required to recognise lifetime expected credit losses. In such instances, the entity has to assess whether there has been a significant increase in credit risk since initial recognition which requires the recognition of lifetime expected credit losses. *[IFRS 9.B5.5.24]*.

IFRS 9 lays out the criteria for determining when a financial instrument is considered to have low credit risk: *[IFRS 9.B5.5.22, IFRS 9.B5.5.23]*

Extract from IFRS 9

B5.5.22 The credit risk on a financial instrument is considered low for the purposes of paragraph 5.5.10, if the financial instrument has a low risk of default, the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations. Financial instruments are not considered to have low credit risk when they are regarded as having a low risk of loss simply because of the value of collateral and the financial instrument without that collateral would not be considered low credit risk. Financial instruments are also not considered to have low credit risk simply because they have a lower risk of default than the entity's other financial instruments or relative to the credit risk of the jurisdiction within which an entity operates.

B5.5.23 To determine whether a financial instrument has low credit risk, an entity may use its internal credit risk ratings or other methodologies that are consistent with a globally understood definition of low credit risk and that consider the risks and the type of financial instruments that are being assessed. An external rating of 'investment grade' is an example of a financial instrument that may be considered as having low credit risk. However, financial instruments are not required to be externally rated to be considered to have low credit risk. They should, however, be considered to have low credit risk from a market participant perspective taking into account all of the terms and conditions of the financial instrument.

The description of low credit risk is equivalent to investment grade quality assets, equivalent to a Standard and Poor's rating of BBB- or better, Moody's rating of Baa3 or better and Fitch's rating of BBB- or better. When applying the low credit risk simplification, financial instruments are not required to be externally rated. However, the IASB's intention was to use a globally comparable notion of low credit risk instead of a level of risk determined, for example, by an entity or jurisdiction's view of risk based on entity-specific or jurisdictional factors. *[IFRS 9.BC5.188]*. Therefore, an entity may use its internal credit ratings to assess what is low credit risk as long as this is consistent with the globally understood definition of low credit risk (i.e., investment grade) or the market's expectations of what is deemed to be low credit risk, taking into consideration the terms and conditions of the financial instruments being assessed. *[IFRS 9.B5.5.23]*.

The Basel Committee guidance (see section 7.1 below) states that the investment grade category used by ratings agencies is not considered homogeneous enough to be automatically considered low credit risk, and internationally active and sophisticated banks are expected to rely primarily on their own credit assessments.

In practice, entities with internal credit ratings will attempt to map their internal rating to the external credit ratings and definitions, such as Standard & Poor's, Moody's and Fitch. The description of the credit quality ratings by these major rating agencies are illustrated below.[23]

Figure 6-1: External credit ratings and definitions from the 3 major rating agencies

Standard & Poor's	Moody's	Fitch
Investment grade would usually refer to categories AAA to BBB (with BBB- being lowest investment grade considered by market participants).	Investment grade would usually refer to categories Aaa to Baa (with Baa3 being lowest investment grade considered by market participants).	Investment grade would usually refer to categories AAA to BBB (with BBB- being lowest investment grade considered by market participants).
BBB **Adequate capacity** to meet financial commitments, but more subject to **adverse economic conditions**.	**Baa** Obligations rated Baa are judged to be medium-grade and subject to moderate credit risk and as such may possess certain speculative characteristics.	**BBB: Good credit quality** Indicates that expectations of **default risk are currently low**. The capacity for payment of financial commitments is considered adequate but adverse business or economic conditions are more likely to impair this capacity.
The dividing line between investment grade and speculative grade		
BB Less vulnerable in the near-term but faces major on-going uncertainties to adverse business, financial and economic conditions.	**Ba** Obligations rated Ba are judged to be speculative and are subject to substantial credit risk.	**BB: Speculative** Indicates an elevated vulnerability to default risk, particularly in the event of adverse changes in business or economic conditions over time; however, business or financial flexibility exists which supports the servicing of financial commitments.

23 IASB Staff Paper 5B: Project: *Financial Instruments: Impairment*, Paper topic: *Operational simplifications - 30dpd and low credit risk*, IASB Meeting, 28 October - 1 November 2013. Available on the IFRS Foundation's website.

Examining the historical levels of default associated with the credit ratings of agencies such as Standard & Poor's, the probability of default of a BBB-rated loan is approximately treble that of one that is rated A. Hence, many entities would consider the increase in credit risk to be significant, if the low risk simplification is not used.

The low credit risk simplification will not be relevant if an entity originates or purchases a financial instrument with a credit risk which is already non-investment grade. Similarly, this simplification will also have limited use when the financial instrument is originated or purchased with a credit quality that is marginally better than a non-investment grade (i.e., at the bottom of the investment grade rating), because any credit deterioration into the non-investment grade rating would require the entity to assess whether the increase in credit risk has been significant.

Partly because of the Basel Committee guidance, most sophisticated banks are applying the low risk simplification only to securities. Investors that hold externally rated debt instruments are more likely to rely on external rating agencies data and use the low credit risk simplification. However, some sophisticated banks do not to use it at all, preferring to use the same criteria as for other exposures (e.g., changes in the lifetime risk of default as the primary indicator followed by other risk metrics such as credit scores and ratings). It is also important to emphasise that although ratings are forward-looking, it is sometimes suggested that changes in credit ratings are not reflected in a timely matter. Therefore, entities may have to take account of expected change in ratings in assessing whether exposures are low risk.

The following example from IFRS 9 illustrates the application of the low credit risk simplification. *[IFRS 9.IE Example 4, IFRS 9.IE24-IE28]*.

Illustration 6-5: Public investment-grade bond

Company A is a large listed national logistics company. The only debt in the capital structure is a five-year public bond with a restriction on further borrowing as the only bond covenant. Company A reports quarterly to its shareholders. Entity B is one of many investors in the bond. Entity B considers the bond to have low credit risk at initial recognition in accordance with IFRS 9.5.5.10. This is because the bond has a low risk of default and Company A is considered to have a strong capacity to meet its obligations in the near term. Entity B's expectations for the longer term are that adverse changes in economic and business conditions may, but will not necessarily, reduce Company A's ability to fulfil its obligations on the bond. In addition, at initial recognition the bond had an internal credit rating that is correlated to a global external credit rating of investment grade.

At the reporting date, Entity B's main credit risk concern is the continuing pressure on the total volume of sales that has caused Company A's operating cash flows to decrease.

Because Entity B relies only on quarterly public information and does not have access to private credit risk information (because it is a bond investor), its assessment of changes in credit risk is tied to public announcements and information, including updates on credit perspectives in press releases from rating agencies.

Entity B applies the low credit risk simplification in IFRS 9.5.5.10. Accordingly, at the reporting date, Entity B evaluates whether the bond is considered to have low credit risk using all reasonable and supportable information that is available without undue cost or effort. In making that evaluation, Entity B reassesses the internal credit rating of the bond and concludes that the bond is no longer equivalent to an investment grade rating because:

(a) The latest quarterly report of Company A revealed a quarter-on-quarter decline in revenues of 20% and in operating profit by 12%.

(b) Rating agencies have reacted negatively to a profit warning by Company A and put the credit rating under review for possible downgrade from investment grade to non-investment grade. However, at the reporting date the external credit risk rating was unchanged.

(c) The bond price has also declined significantly, which has resulted in a higher yield to maturity. Entity B assesses that the bond prices have been declining as a result of increases in Company A's credit risk. This is because the market environment has not changed (for example, benchmark interest rates, liquidity, etc. are unchanged) and comparison with the bond prices of peers shows that the reductions are probably company specific (instead of being, for example, changes in benchmark interest rates that are not indicative of company-specific credit risk).

While Company A currently has the capacity to meet its commitments, the large uncertainties arising from its exposure to adverse business and economic conditions have increased the risk of a default occurring on the bond. As a result of the factors described above, Entity B determines that the bond does not have low credit risk at the reporting date. As a result, Entity B needs to determine whether the increase in credit risk since initial recognition has been significant. On the basis of its assessment, Company B determines that the credit risk has increased significantly since initial recognition and that a loss allowance at an amount equal to lifetime expected credit losses should be recognised in accordance with IFRS 9.5.5.3.

Some of the challenges in assessing whether there has been a significant increase in credit risk (including the use of the low credit risk simplification) and estimating the expected credit losses, are shown in the following Illustration. It shows different ways of identifying a significant change in credit quality and different input parameters for calculating expected credit losses for a European government bond, which result in very different outcomes and volatility of the IFRS 9 expected credit loss allowance. It is also stressed that the default rates provided by external rating agencies are historical information. Entities need to understand the sources of these historical default rates and update the data for current and forward-looking information (see section 5.9.3 above) when measuring expected credit losses or assessing credit deterioration.

Illustration 6-6: Use of credit ratings and/or credit default swap spreads to determine whether there have been significant increases in credit risk and to estimate expected credit losses

Introduction

A significant challenge in applying the IFRS 9 impairment requirements to quoted bonds is that the credit ratings assigned by agencies such as Standard & Poor's, and the historical experience of losses by rating grade, can differ significantly with the view of the market, as reflected in, for instance, credit default swap spreads and bond spreads.

To illustrate the challenges of applying IFRS 9 to debt securities, we have examined how the expected credit loss could be determined for a real bond issued by a European government on 16 September 2008 and due to mature in 2025. For three dates, we applied the IFRS 9 calculations to this bond, which is assumed to have been acquired at inception. In January 2009, the Standard & Poor's credit rating of the government was AA+, as at origination, but by January 2012, its rating was downgraded to A. The bond was further downgraded to BBB- in March 2014 before recovery to BBB in May 2014.

Three approaches

Shown below are three approaches:

- Approach 1: Use of S&P credit ratings both to determine whether the bond has significantly increased in credit risk and to estimate expected credit losses.
- Approach 2: Use of S&P credit ratings to determine whether the bond has significantly increased in credit risk and credit default swap spreads to estimate expected credit losses.
- Approach 3: Use of credit default swap spreads both to determine whether the bond has significantly increased in credit risk and to estimate expected credit losses.

Based on the historical corporate probability of defaults from each assessed S&P credit rating (approach 1) and based on the credit default swap spreads (approaches 2 and 3), the loan-loss percentages were calculated below. For the calculations, a loss given default of 60% was applied. (Because the loss given default represents a percentage of the present value of the gross carrying amount, this example does not illustrate the effect of the time value of money).

The percentage loss allowances were, as follows:

	Credit ratings	Historical 12-month probability of default based on ratings	12-month probability of default based on credit default swap spread	Lifetime probability of default based on credit default swap spread	Loss allowance (%)		
					Approach 1	Approach 2	Approach 3
1 January 2009	AA+	0.02%	0.44%	12.81%	-	-	-
31 January 2009	AA+	0.02%	1.84%	30.48%	0.01	1.10	18.29
31 January 2012	A	0.06%	4.96%	51.48%	0.04	2.98	30.89
31 March 2014	BBB-	0.31%	0.57%	23.01%	0.18	0.34	13.81

Approach 1

According to the credit ratings, the bond was investment grade throughout this period. Hence, using the low risk simplification, the loss allowance would have been based on 12-month expected credit losses. Using the corporate historical default rates implied by the credit ratings and an assumption of 60% loss given default to calculate the expected credit losses, the 12-month allowance would have increased from 0.01% on 31 January 2009 to 0.04% three years later, increasing to 0.18% by 31 March 2014. It is stressed that the historical default rates implied by credit ratings are historical rates for corporate debt and so they would not, without adjustment, satisfy the requirements of IFRS 9. IFRS 9 requires the calculation of expected credit losses, based on current conditions and forecasts of future conditions, to be based on reasonable and supportable information. This is likely to include market indicators such as credit default swap and bond spreads, as illustrated by Approach 2.

Approach 2

In contrast to Approach 1, using credit default swap spreads to calculate the expected credit losses and the same assumption of 60% loss given default to calculate the expected credit losses, the 12-month allowance would have increased from 1.1% on 31 January 2009 to 2.98% three years later, declining to 0.34% by 31 March 2014. The default rates implied by the credit default swaps are significantly higher than would have been expected given the ratings of these bonds. The loss allowances are, correspondingly, very much higher and very volatile. It might be argued that credit default swap spreads are too responsive to short term market sentiment to calculate long term expected credit losses, but it may appear difficult to find other reasonable and supportable information to adjust these rates so as to dampen the effects of market volatility.

Approach 3

Credit ratings are often viewed by the market as lagging indicators. For these bonds, the ratings are difficult to reconcile with the default probabilities as assessed by the markets. It might be argued that it is not sufficient to focus only on credit ratings when assessing whether assets are low risk since, according to credit default swap spreads, the bond was not low risk at any time in the period covered in this example, as it showed a significant increase in 1 year probability of default after inception (based on credit default swap spreads). The 1 year probability of defaults increased from 0.44% on issue to 1.84% by 31 January 2009. Assessing the bond as requiring a lifetime expected credit loss at all three dates, based on credit default swap spreads, would have given much higher loss allowances of 18.29%, 30.89% and 13.81%.

The counter-view might be that credit default swap spreads are too volatile to provide a sound basis for determining significant deterioration. Perhaps the best way to make the assessment of whether a bond has increased significantly in credit risk is to use more than one source of data and to take account of the qualitative indicators as described in IFRS 9.

Conclusion

The calculated expected credit loss figures differ significantly depending on the approach taken as to how to determine a significant change in credit quality and the parameters used for the calculation. Those based on credit default swap spreads are both large and very volatile, reflecting the investor uncertainty during the period, when the possibility of default depended more on the political will of the European Union to maintain the integrity of the Eurozone than the economic forecasts for the particular country. As a result, the disparity between the effect of the use of credit grades and credit default swaps is probably more marked than for most other security investments. Nevertheless, the same challenges will be found with other securities, albeit on a smaller scale.

6.4.2 Delinquency

As already described in section 6.2.2 above, IFRS 9 allows use of past due information to assess whether credit risk has increased significantly, if reasonable and supportable forward-looking information (either at an individual or a collective level) is not available without undue cost or effort. This is subject to the rebuttable presumption that there has been a significant increase in credit risk if contractual payments are more than 30 days past due. *[IFRS 9.5.5.11]*. Similar to the low credit risk simplification (see section 6.4.1 above), the Basel Committee guidance (see section 7.1 below) considers that sophisticated banks ought not to use days past due information as a primary indicator, because it is a lagging indicator, but only as a backstop measure alongside other, earlier indicators.

Most sophisticated banks are following this regulatory guidance. In addition, it is a useful measure of the effectiveness of more forward-looking primary criteria to monitor the frequency that assets reach 30 days past due without having already been transferred to stage 2.

6.4.3 12-month risk as an approximation for change in lifetime risk

In determining whether there has been a significant increase in credit risk, an entity must assess the change in the risk of default occurring over the expected life of the financial instrument. Despite this, IFRS 9 states that: "...changes in the risk of a default occurring over the next 12 months may be a reasonable approximation of the changes in the lifetime risk of a default occurring... unless circumstances indicate that a lifetime assessment is necessary". *[IFRS 9.B5.5.13]*.

The IASB observed in its Basis for Conclusions that changes in the risk of a default occurring within the next 12 months generally should be a reasonable approximation of changes in the risk of a default occurring over the remaining life of a financial instrument and thus would not be inconsistent with the requirements. Also, some entities use a 12-month probability of default measure for prudential regulatory requirements and these entities can continue to use their existing systems and methodologies as a starting point for determining significant increases in credit risk, thus reducing the costs of implementation. *[IFRS 9.BC5.178]*.

However, for some financial instruments, or in some circumstances, the use of changes in the risk of default occurring over the next 12 months may not be appropriate to determine whether lifetime expected credit losses should be recognised. For a financial instrument with a maturity longer than 12 months, IFRS 9 gives the following examples: *[IFRS 9.B5.5.14]*

Extract from IFRS 9

B5.5.14 However, for some financial instruments, or in some circumstances, it may not be appropriate to use changes in the risk of a default occurring over the next 12 months to determine whether lifetime expected credit losses should be recognised. For example, the change in the risk of a default occurring in the next 12 months may not be a suitable basis for determining whether credit risk has increased on a financial instrument with a maturity of more than 12 months when:

(a) the financial instrument only has significant payment obligations beyond the next 12 months;

(b) changes in relevant macroeconomic or other credit-related factors occur that are not adequately reflected in the risk of a default occurring in the next 12 months; or

(c) changes in credit-related factors only have an impact on the credit risk of the financial instrument (or have a more pronounced effect) beyond 12 months.

Frequently asked questions

Question 6-4: Whether, and if so to what extent, an entity would be required to perform a review to determine whether circumstances still support the use of changes in the 12-month risk of a default occurring as an approximation of changes in the lifetime risk of default occurring?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 16 September 2015 - Agenda paper no. 2)

At its meeting on 16 September 2015 (see section 1.4 above), the IFRS Transition Resource Group for Impairment of Financial Instruments members discussed the use of changes in 12-month risk of default as a surrogate for changes in lifetime risk and commented as follows:

- An entity would be expected to complete a robust analysis up front in order to support the conclusion that changes in the 12-month risk of a default occurring was a reasonable approximation for the assessment of changes in the lifetime risk of default occurring.
- The level of initial analysis required would depend on the specific type of financial instrument being considered. Consequently, in some cases, a qualitative analysis would suffice whereas in less clear-cut cases, a quantitative analysis may be necessary. Also, it may be appropriate to segregate portfolios (e.g., by maturity) in order to facilitate the analysis for groups of similar financial instruments.
- An entity would need to be satisfied on an ongoing basis that the use of changes in the 12-month risk of a default occurring continued to be a reasonable approximation for changes in the lifetime risk of a default occurring.

At the meeting, the IFRS Transition Resource Group for Impairment of Financial Instruments members also discussed:

- The appropriate type of review that should be undertaken on an ongoing basis. While a quantitative review would not necessarily be required, it would depend on the specific facts and circumstances. One way of approaching an ongoing review would be as follows:
  (a) Identify the key factors that would affect the appropriateness of using changes in the 12-month risk of a default occurring as an approximation of changes in the lifetime risk of default occurring.
  (b) Monitor these factors on an ongoing basis as part of a qualitative review of circumstances.
  (c) Consider whether any changes in those factors indicated that changes in the 12-month risk of a default occurring was no longer an appropriate proxy for changes in a lifetime risk of default occurring.
- If it were determined that changes in the 12-month risk of a default occurring were no longer a reasonable approximation for the assessment of changes in the lifetime risk of a default occurring, an entity would be required to determine an appropriate approach to capture changes in the lifetime risk of a default occurring.
- It is important to emphasise that the guidance which permits an entity to use changes in the 12-month risk of a default as an approximation for the lifetime risk of default, is only relevant for the assessment of significant increases in credit risk and does not relate to the measurement of expected credit losses. When an entity is required to measure lifetime expected credit losses, that measurement must always reflect the lifetime risk of a default occurring.
- IFRS 9 does not prescribe how an entity should determine whether the use of changes in the 12-month risk of a default was an appropriate proxy for assessing changes in the lifetime risk of a default. However, it was noted that entities are required to disclose how they make the assessment of significant increases in credit risk, in accordance with IFRS 7.

How we see it

Most sophisticated banks are using the lifetime risk of default (or an annualised equivalent) rather than the 12-month risk of default or the Basel risk of default for assessing whether there has been a significant increase in credit risk. Movements in a 12-month risk of default are, for most products and conditions, strongly correlated with movements in the lifetime risk. However, these banks appreciate that 12-month probability of defaults may need to be adjusted or calibrated to reflect the longer-term macroeconomic outlook. Also, there are products such as interest-only mortgages and those with an introductory period in which no repayments are required, where additional procedures may need to be implemented in order to ensure that they are transferred to stage 2 appropriately.

6.4.4 Assessment at the counterparty level

As indicated by Example 7 in the Illustrative Examples to IFRS 9, assessment of significant deterioration in credit risk can be made at the level of the counterparty rather than the individual financial instrument. Such assessment at the counterparty level is only allowed if the outcome would not be different to the outcome if the financial instruments had been individually assessed. *[IFRS 9.BC5.168]*. In certain circumstances, assessment at the counterparty level would not be consistent with the impairment requirements. Both these situations are shown in the Illustration below, based on Example 7 in the Illustrative Examples to IFRS 9. *[IFRS 9.IE Example 7, IFRS 9.IE43-IE47]*.

Illustration 6-7: Counterparty assessment of credit risk

Scenario 1

In 20X1 Bank A granted a loan of CU10,000 with a contractual term of 15 years to Company Q when the company had an internal credit risk rating of 4 on a scale of 1 (lowest credit risk) to 10 (highest credit risk). The risk of a default occurring increases exponentially as the credit risk rating deteriorates so, for example, the difference between credit risk rating grades 1 and 2 is smaller than the difference between credit risk rating grades 2 and 3. In 20X6, when Company Q had an internal credit risk rating of 6, Bank A issued another loan to Company Q for CU5,000 with a contractual term of 10 years. In 20X8 Company Q fails to retain its contract with a major customer and correspondingly experiences a large decline in its revenue. Bank A considers that as a result of losing the contract, Company Q will have a significantly reduced ability to meet its loan obligations and changes its internal credit risk rating to 8.

Bank A assesses credit risk on a counterparty level for credit risk management purposes and determines that the increase in Company Q's credit risk is significant. Although Bank A did not perform an individual assessment of changes in the credit risk on each loan since its initial recognition, assessing the credit risk on a counterparty level and recognising lifetime expected credit losses on all loans granted to Company Q, meets the objective of the impairment requirements as stated in IFRS 9.5.5.4. This is because, even since the most recent loan was originated (in 20X6) when Company Q had the highest credit risk at loan origination, its credit risk has increased significantly. The counterparty assessment would therefore achieve the same result as assessing the change in credit risk for each loan individually.

Scenario 2

Bank A granted a loan of CU150,000 with a contractual term of 20 years to Company X in 20X1 when the company had an internal credit risk rating of 4. During 20X6 economic conditions deteriorate and demand for Company X's products has declined significantly. As a result of the reduced cash flows from lower sales, Company X could not make full payment of its loan instalment to Bank A. Bank A re-assesses Company X's internal credit risk rating, and determines it to be 7 at the reporting date. Bank A considered the change in credit risk on the loan, including considering the change in the internal credit risk rating, and determines that there has been a significant increase in credit risk and recognises lifetime expected credit losses on the loan of CU150,000.

Despite the recent downgrade of the internal credit risk rating, Bank A grants another loan of CU50,000 to Company X in 20X7 with a contractual term of 5 years, taking into consideration the higher credit risk at that date.

The fact that Company X's credit risk (assessed on a counterparty basis) has previously been assessed to have increased significantly, does not result in lifetime expected credit losses being recognised on the new loan. This is because the credit risk on the new loan has not increased significantly since the loan was initially recognised. If Bank A only assessed credit risk on a counterparty level, without considering whether the conclusion about changes in credit risk applies to all individual financial instruments provided to the same customer, the objective in IFRS 9.5.5.4 would not be met.

How we see it

Most banks manage their credit exposures on a counterparty basis and are keen to use their existing risk management processes to calculate the IFRS 9 expected credit losses where they can. This is particularly the case for those banks who seek to use processes such as the use of watch lists to make the assessment of whether there has been a significant increase in credit risk. However, IFRS 9 only allows use of a counterparty basis when it can be demonstrated that it would make no difference from making the assessment at an individual instrument level. It may be necessary for these banks to add procedures to track increase in the risk of default at the instrument level in order to comply with IFRS 9.

6.4.5 Determining maximum initial credit risk for a portfolio

The IFRS 9 credit risk assessment that determines whether a financial instrument attracts a lifetime expected credit loss allowance, or only a 12-month expected credit loss allowance, is based on whether there has been a relative increase in credit risk. One of the challenges identified by some constituents in responding to the 2013 ED was that many credit risk systems monitor absolute levels of risk, without tracking the history of individual loans (see section 6.1 above). To help address this concern IFRS 9 contains an approach that turns a relative system into an absolute one, by segmenting the portfolio sufficiently by loan quality at origination.

As indicated by Example 6 in the Illustrative Examples to IFRS 9 on which Illustration 6-8 below is based, an entity can determine the maximum initial credit risk accepted for portfolios with similar credit risks on initial recognition. *[IFRS 9.IE Example 6, IFRS 9.IE40, IFRS 9.IE41, IFRS 9.IE42]*. Thereby, an entity may be able to establish an absolute threshold for recognising lifetime expected credit losses.

Illustration 6-8: Comparison to maximum initial credit risk

Bank A has two portfolios of automobile loans with similar terms and conditions in Region W. Bank A's policy on financing decisions for each loan is based on an internal credit rating system that considers a customer's credit history, payment behaviour on other products with Bank A and other factors, and assigns an internal credit risk rating from 1 (lowest credit risk) to 10 (highest credit risk) to each loan on origination. The risk of a default occurring increases exponentially as the credit risk rating deteriorates so, for example, the difference between credit risk rating grades 1 and 2 is smaller than the difference between credit risk rating grades 2 and 3. Loans in Portfolio 1 were only offered to existing customers with a similar internal credit risk rating and at initial recognition all loans were rated 3 or 4 on the internal rating scale. Bank A determines that the maximum initial credit risk rating at initial recognition it would accept for Portfolio 1 is an internal rating of 4. Loans in Portfolio 2 were offered to customers that responded to an advertisement for automobile loans and the internal credit risk ratings of these customers range between 4 and 7 on the internal rating scale. Bank A never originates an automobile loan with an internal credit risk rating worse than 7 (i.e., with an internal rating of 8-10).

For the purposes of assessing whether there have been significant increases in credit risk, Bank A determines that all loans in Portfolio 1 had a similar initial credit risk. It determines that given the risk of default reflected in its internal risk rating grades, a change in internal rating from 3 to 4 would not represent a significant increase in credit risk but that there has been a significant increase in credit risk on any loan in this portfolio that has an internal rating worse than 5. This means that Bank A does not have to know the initial credit rating of each loan in the portfolio to assess the change in credit risk since initial recognition. It only has to determine whether the credit risk is worse than 5 at the reporting date to determine whether lifetime expected credit losses should be recognised in accordance with IFRS 9.5.5.3.

However, determining the maximum initial credit risk accepted at initial recognition for Portfolio 2 at an internal credit risk rating of 7, would not meet the objective of the requirements as stated in IFRS 9.5.5.4. This is because Bank A determines that significant increases in credit risk arise not only when credit risk increases above the level at which an entity would originate new financial assets (i.e., when the internal rating is worse than 7). Although Bank A never originates an automobile loan with an internal credit rating worse than 7, the initial credit risk on loans in Portfolio 2 is not of sufficiently similar credit risk at initial recognition to apply the approach used for Portfolio 1. This means that Bank A cannot simply compare the credit risk at the reporting date with the lowest credit quality at initial recognition (for example, by comparing the internal credit risk rating of loans in Portfolio 2 with an internal credit risk rating of 7) to determine whether credit risk has increased significantly because the initial credit quality of loans in the portfolio is too diverse. For example, if a loan initially had a credit risk rating of 4 the credit risk on the loan may have increased significantly if its internal credit risk rating changes to 6.

Frequently asked questions

Question 6-5: How an entity should determine whether there has been a significant increase in credit risk for a portfolio of loans advanced to customers across broad credit quality bands with identical pricing and contractual terms, for example, retail loans?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 16 September 2015 - Agenda paper no. 1)

At the IFRS Transition Resource Group for Impairment of Financial Instruments meeting on 16 September 2015 (see section 1.4 above), the question raised was influenced by the operational simplification described above, which allows an entity to assess if there has been a significant increase in credit risk by determining the maximum initial credit risk accepted for portfolios with similar credit risks on original recognition, and by reviewing which exposures now exceed this limit. The IFRS Transition Resource Group for Impairment of Financial Instruments discussed an example of a retail loan portfolio (Portfolio A) comprising customers who had been assigned initial credit grades between 1 and 5 (based on a 10 grade rating scale where 1 is the highest credit quality) and had been issued loans with the same contractual terms and pricing. The question was whether it would be appropriate to make the determination of significant increases in credit risk by using a single threshold approach such as that outlined for Portfolio 1 in Illustrative Example 6 of IFRS 9, on the basis that the exposures in Portfolio A could be considered to have a similar initial credit risk, or whether there were other more appropriate approaches such as, for example, defining a significant increase in credit risk as a specific number of notch increases in credit grade.

The IFRS Transition Resource Group for Impairment of Financial Instruments members observed that:

- When assessing whether there has been a significant increase in credit risk, it would not be appropriate for the entity to consider only factors such as pricing and contractual terms. In this regard, while the concept of economic loss was considered in developing the IFRS 9 model, the standard requires an assessment of changes in credit risk based on a wide range of factors including internal and external indicators of credit risk, changes to contractual terms, actual and expected performance/behaviours and forecasts of future conditions.
- Credit grading systems were not necessarily designed with the requirements of IFRS 9 in mind, and thus it should not be assumed that they will always be an appropriate means of identifying significant increases in credit risk. The appropriateness of using internal credit grading systems as a means of assessing changes in credit risk since initial recognition depends on whether the credit grades are reviewed with sufficient frequency, include all reasonable and supportable information and reflect the risk of default over the expected life of the financial instrument. As credit grading systems vary, care needs to be taken when referring to movements in credit grades and how this reflects an increased risk of default occurring. In addition, the assessment of whether a change in credit risk grade represents a significant increase in credit risk in accordance with IFRS 9 depends on the initial credit risk of the financial instrument being assessed. Because the relationship between credit grades and changes in the risk of default occurring differs between credit grading systems (e.g., in some cases the changes in the risk of a default occurring will increase exponentially between grades whereas in others it will not), this requires particular consideration.
- Consequently, the impairment model is based on an assessment of changes in credit risk since initial recognition, rather than the identification of a specific level of credit risk at the reporting date and a smaller absolute change in the risk of default occurring will be more significant for an asset that is of high quality on initial recognition than for one that is of low quality.
- In Example 6 in the Illustrative Examples to IFRS 9, the assessment of significant increases in credit risk of Portfolio 1 was made using a form of absolute approach. However, it was pointed out that this approach was still consistent with the objective of identifying significant increases in credit risk since initial recognition. In particular, only loans with an initial credit grade of 3 or 4 were included in Portfolio 1 and furthermore, the entity had concluded that a movement from credit grade 3 to 4 did not represent a significant increase in credit risk. Consequently, using a single threshold of credit grade 5 as a means of identifying a significant increase in credit risk since initial recognition served to capture changes in credit risk in a manner that achieved the objective of the impairment requirements.
- In contrast, in the fact pattern discussed, Portfolio A contained loans with initial credit grades ranging between 1 and 5. Questions were raised as to whether such a broad range of credit grades could be considered to represent a similar initial credit risk and the IFRS Transition Resource Group for Impairment of Financial Instruments members noted that in order to conclude that the assessment could be based on whether loans had a credit rating worse than 5, the entity would need to have determined that movements between credit grades 1 and 5 did not represent a significant increase in credit risk.
- Information available at an individual financial instrument level and/or built into a credit risk grading system could potentially not incorporate forward-looking information as required by IFRS 9. Consequently, the assessment of significant increases in credit risk may need to be supplemented by a collective assessment to capture forward-looking information. However, a collective assessment should not obscure significant increases in credit risk at an individual financial instrument level. In this regard, portfolio segmentation is important and entities should ensure that sub-portfolios are not defined too widely.

6.5 Collective assessment

Banks may have hundreds of thousands, or even millions, of small exposures to retail customers and small businesses. Much of the information available to monitor them is based on whether payments are past due and behavioural information that is mostly historical rather than forward-looking. As a result, such exposures tend to be managed on an aggregated basis, combining past due and behavioural data with historical statistical experience and sometimes macroeconomic indicators, such as interest rates and unemployment levels, that tend to correlate with future defaults. Also, even when exposures are managed on an individual basis, as is the case for most commercial loans, the information used to manage them could potentially not be sufficiently forward-looking to comply with IFRS 9.

To address these concerns, IFRS 9 introduced the idea of making a collective assessment for financial assets, to determine if there has been a significant increase in credit risk, if an entity cannot make the assessment adequately on an individual instrument level. This exercise must consider comprehensive information that incorporates not only past due data but other relevant credit information, such as forward-looking macroeconomic information. The objective is to approximate the result of using comprehensive credit information that incorporates forward-looking information at an individual instrument level. *[IFRS 9.B5.5.4]*. Hence, even if a financial asset is normally managed on an individual basis, it is also assessed collectively (i.e., based on macroeconomic indicators), if the entity does not have sufficient forward-looking information at the individual level to make the determination. The way that this might work would be to assess an asset collectively for impairment if it has already been assessed individually and found not to be impaired.

How we see it

Some kind of collective adjustment or overlay will be needed for many retail lending portfolios, given that most customer-specific information will not be forward-looking. In contrast, for commercial loans, the lender will typically have access to much more information and a forward-looking approach may already have been built into loan grading systems. Nevertheless, some banks have introduced an additional overlay for commercial loans so as to be more responsive to emerging macroeconomic and other risk developments.

Other banks use their existing watch list approaches to supplement their credit grading system when assessing whether there has been a significant increase in credit risk. This is because watch list systems can be more reactive to changing circumstances than formal credit gradings. Any one bank is likely to employ a variety of methods, depending on its products, systems and data.

In abnormal circumstances, for example during the coronavirus pandemic (see section 7.8 below), it may take time for an entity to detect actual changes in risk indicators for a specific counterparty. In order to accelerate the reflection of such changes in credit quality not yet detected at an individual level, it may be appropriate to adjust ratings and the probability of default on a collective basis, considering risk characteristics such as the industry or geographical location of the borrowers. For example, a supplier of products or services to the airline industry would likely consider, in the context of the coronavirus pandemic, that the probability of default (or loss rates, if a provision matrix approach is used) of its customers has increased irrespective of specific events identified at the level of individual counterparties.

It is worth noting that the language on when a collective approach is required is not entirely consistent within the standard. Paragraph B5.5.1 of IFRS 9 states that "it *may be* necessary to perform the assessment of significant increases in credit risk on a collective basis" (emphasis added), which is consistent with the requirement in IFRS 9.5.5.11, that an entity cannot rely solely on past due information if reasonable and supportable forward-looking information is available without undue cost or effort. However, IFRS 9.B5.5.4 states that "In some circumstances an entity does not have reasonable and supportable information that is available without undue cost or effort to measure lifetime expected credit losses on an individual instrument basis. In that case, lifetime expected credit losses *shall* be recognised on a collective basis…" (emphasis added). Banking regulators will probably ensure that this 'shall be' wording will be applied, at least for more sophisticated banks (see section 1.5 above and section 7.1 below). This raises a second concern: once significant deterioration has been identified for a portfolio, whether the entire portfolio would have to be measured using lifetime expected credit losses. This outcome would result in sudden, massive increases in provisions as soon as conditions begin to decline. Consequently, the Board, in finalising IFRS 9, set out examples of possible methods, using which only a segment or portion of the portfolio would be changed to lifetime expected credit losses.

Example 5 in the Illustrative Examples to IFRS 9 illustrates how an entity may assess whether its individual assessment is complemented with a collective one whenever the information at individual level is not sufficiently comprehensive and up-to-date. The following Illustrations have been adapted from that guidance.

6.5.1 Example of individual assessment of changes in credit risk

First, as a benchmark, Scenario 1 (an individual assessment) illustrates a situation where a bank has sufficient information at individual exposure level to identify a significant deterioration of credit quality.

Illustration 6-9: Individual assessment in relation to responsiveness to changes in credit risk

The bank assesses each of its mortgage loans on a monthly basis by means of an automated behavioural scoring process based on current and historical past due statuses, levels of customer indebtedness, loan-to-value measures, customer behaviour on other financial instruments with the bank, the loan size and the time since the origination of the loan. It is said that historical data indicates a strong correlation between the value of residential property and the default rates for mortgages.

The bank updates the loan-to-value measures on a regular basis through an automated process that re-estimates property values using recent sales in each post code area and reasonable and supportable forward-looking information that is available without undue cost or effort. Therefore, an increased risk of a default occurring due to an expected decline in residential property value adjusts the behavioural scores and the bank is therefore able to identify significant increases in credit risk on individual customers before a mortgage becomes past due if there has been a deterioration in the behavioural score.

The example concludes that if the bank is unable to update behavioural scores to reflect the expected declines in property prices, it would use reasonable and supportable information that is available without undue cost or effort to undertake a collective assessment to determine the loans on which there has been a significant increase in credit risk since initial recognition and recognize lifetime expected credit losses for those loans.

It is noted that, in this example, the main source of forward-looking information is expected future property prices. No account would appear to be taken of other economic data such as future levels of employment or interest rates. We assume that the Board took this approach to make the example simple, but as written, it implies that future property prices are considered to provide a sufficiently good guide to future defaults that it is not necessary to take account of other data as well.

6.5.2 Basis of aggregation for collective assessment

Next, IFRS 9 sets out how financial instruments may be grouped together in order to determine whether there has been a significant increase in credit risk. Any instruments assessed collectively must possess shared credit risk characteristics. It is not permitted to aggregate exposures that have different risks and, in so doing, obscure significant increases in risk that may arise on a sub-set of the portfolio. IFRS 9 provides some examples of shared credit risk characteristics: *[IFRS 9.B5.5.5]*

Extract from IFRS 9

B5.5.5 For the purpose of determining significant increases in credit risk and recognising a loss allowance on a collective basis, an entity can group financial instruments on the basis of shared credit risk characteristics with the objective of facilitating an analysis that is designed to enable significant increases in credit risk to be identified on a timely basis. The entity should not obscure this information by grouping financial instruments with different risk characteristics. Examples of shared credit risk characteristics may include, but are not limited to, the:

(a) instrument type;

(b) credit risk ratings;

(c) collateral type;

(d) date of initial recognition;

(e) remaining term to maturity;

(f) industry;

(g) geographical location of the borrower; and

(h) the value of collateral relative to the financial asset if it has an impact on the probability of a default occurring (for example, non-recourse loans in some jurisdictions or loan-to-value ratios).

IFRS 9 also states that the basis of aggregation of financial instruments to assess whether there have been changes in credit risk on a collective basis may have to change over time, as new information on groups of, or individual, financial instruments becomes available. *[IFRS 9.B5.5.6]*.

We make the following observations:

- As has been stressed earlier, the assessment of significant deterioration is intended to reflect the risk of default, not the risk of loss, hence collateral is normally ignored for the assessment. IFRS 9 nonetheless explains that the value of collateral relative to the financial asset would be relevant to the collective assessment if it has an impact on the risk of a default occurring. It cites, as an example, non-recourse loans in certain jurisdictions. The question of when such an arrangement would always meet the IFRS 9 classification and measurement characteristics of the Asset test is beyond the scope of this chapter. Loan-to-value or a house price index may be a useful indicator of significant collective deterioration in a wider range of circumstances than just where the loans are non-recourse. First, house prices are themselves a useful barometer of the economy and so higher loan-to-values and lower indices correlate with declining economic conditions. Second, loans that were originally advanced at higher loan-to-value may reflect more aggressive lending practices, with the consequence that such loans may exhibit a higher probability of default if economic conditions decline. Third, a borrower in trouble with a lower loan-to-value will likely sell his house to redeem the mortgage rather than defaulting on the mortgage (and, conversely, a borrower with a high loan-to-value will have less incentive not to default).
- By date of original recognition, we assume that the Board did not intend that loans are assessed in separate groups for each year of origination, but that vintages may be aggregated into groups that share similar credit risk characteristics. Loan products and lending practices, including the extent of due diligence, and key ratios, such as the loan-to-value and loan to income, change over time, often reflecting the economic conditions at the time of origination. The consequence is that loans from particular years are inherently riskier than others. For some banks, this might mean isolating those loans advanced just prior to the financial crisis from those originated earlier or in the subsequent, more careful lending environment. Also, there is a phenomenon termed seasoning, which describes how loans that have been serviced adequately for a number of years, over a business cycle, are statistically less likely to default in future, suggesting that older loans are assessed separately.
- Although the examples in IFRS 9 refer to regions, as the geographical location of borrowers, the groupings could be much larger, such as by country, or much smaller, if there are particular issues associated with particular towns. Hence the choice of geographical groupings will depend very much on the environment in which a bank operates.
- Other ways that loans might be grouped according to shared credit risk characteristics could include by credit score, by payment history, whether previously restructured or subject to forbearance but subsequently restored to a 12-month expected credit loss allowance, and manner of employment (as featured in Illustrative Example 5 in the Illustrative Examples to IFRS 9 under the bottom-up assessment discussed in Illustration 6-10 in section 6.5.3 below).
- The requirement that financial instruments that are assessed together must share similar credit risk characteristics means that a bank may have a substantial number of portfolios. Even a relatively small bank might have six different products (taking into account terms to maturity and types of collateral), three regions and three different vintage groups which, multiplied out, would give 54 different assessment groups. A larger global bank might need to monitor many more different portfolios. However, a balance will need to be struck between ensuring that portfolios are small enough to have sufficient homogeneity and yet not so small that there is too little historical data for losses to be reliably estimated.

How we see it

The requirement that groupings may have to be amended over time to assess changes in credit risk, means that there must be processes put in place to reassess whether loans continue to share similar credit risk characteristics. Yet, in practice, there will need to be a sufficient level of stability in the construction of portfolios to allow enough historical data to be gathered for reliable estimation of losses.

Finally, IFRS 9.B5.5.6 adds that, "if an entity is not able to group financial instruments for which the credit risk is considered to have increased significantly since initial recognition based on shared credit risk characteristics, the entity should recognise lifetime expected credit losses on a portion of the financial assets for which credit risk is deemed to have increased significantly".

As clarified by the IASB in its webcast on forward-looking information on 25 July 2016, it is possible that a bank is aware of differences in sensitivities of credit risk to a change in a particular parameter but is unable to group the assets on the basis of such sensitivity. In such instances, the bank may determine that the expected forward-looking scenario would result in significant increases in credit risk for a certain proportion of its portfolio.

6.5.3 Example of collective assessment ('bottom up' and 'top down' approach)

The main standard does not amplify how a collective assessment would be made but Example 5 in the Illustrative Examples to IFRS 9 provides two scenarios that explore the approach. *[IFRS 9.IE Example 5, IFRS 9.IE29-IE39]*.

Illustration 6-10: Collective assessment in relation to responsiveness to changes in credit risk ('bottom up' approach)

Region Two of Illustrative Example 5 in the Illustrative Examples to IFRS 9 introduces the so-called bottom-up method. It deals with a mining community within a region that faces unemployment risk due to a decline in coal exports and, consequently, anticipated future mine closures. Although most of the loans are not yet 30 days past due and, further, the borrowers are not yet unemployed, the bank re-segments its mortgage portfolio so as to separate loans to customers employed in the mining industry (based on information in the original mortgage application form).

For these loans (plus any others that are more than 30 days past due), Bank ABC recognises lifetime expected credit losses, while it continues to recognise 12-month expected credit losses for the other mortgage loans in the region. Any new loans to borrowers who rely on the coal industry would also attract only a 12-month allowance, until they also demonstrate a significant increase in credit risk.

The bottom-up method is described as an example of how to assess credit deterioration by using information that is more forward-looking than past due status. But this example also illustrates that collectively assessed groups may need to change over time, to ensure that they share similar credit risk characteristics. Once the coal mining industry begins to decline, those loans connected with it would no longer share the same risk characteristics as other loans to borrowers in the region, and so would need to be assessed separately. We also note that this example assumes that macroeconomic factors can be linked to the expected credit losses of a very specific portfolio. Further, in practice, most banks do not have the data to achieve this level of segmentation.

As already described above (possible criteria for grouping of financial assets with similar credit risk characteristics), the bottom-up approach could be applied to sub-portfolios differentiated by type of instrument, risk rating, type of collateral, date of initial recognition, remaining term to maturity, industry, geographical location of the borrower, or the loan-to-value ratio. A good example of this approach might be for exposures to borrowers that are expected to suffer major economic difficulties due to war or political upheaval, or borrowers with the weakest credit scores, who are expected to be more sensitive to a change in a relevant macroeconomic factor. In addition, as underwriting standards may vary or change, the portfolio might be sub-divided so as to reflect this. Note that the coal mines closures are, as yet, only anticipated, hence this example helps show how IFRS 9 is intended to be forward looking. The need to look forward is also illustrated in the next example.

Illustration 6-11: Collective assessment in relation to responsiveness to changes in credit risk ('top down' approach)

For Region Three of Illustrative Example 5 in the Illustrative Examples to IFRS 9, Bank ABC anticipates an increase in defaults following an expected rise in interest rates. Historically, an increase in interest rates has been a lead indicator of future defaults on floating-rate mortgages in the region. The bank regards the portfolio of variable rate mortgage loans in that region to be homogenous and it is incapable of identifying particular sub portfolios on the basis of shared credit risk characteristics. Hence, it uses what is described as a top-down method.

Based on historical data, the bank estimates that a 200 basis points rise in interest rates will cause a significant increase in credit risk on 20% of the mortgages. As a result, presumably because the bank expects a 200 basis points rise in rates, it recognises lifetime expected credit losses on 20% of the portfolio (along with those loans that are more than 30 days past due) and 12-month expected credit losses on the remainder of mortgages in the region.

The challenge posed by the top-down method is how to calculate the percentage of loans that have significantly deteriorated. That a rise in interest rates will likely lead to a significant deterioration in credit risk for some floating-rate borrowers, is not controversial. But working out whether they make up 5%, 20% or 35% of the portfolio would appear to be more of an art than science, and no two banks are likely to arrive at the same figure.

The IASB brought some useful clarification on this example in its 25 July 2016 webcast on forward-looking information:

- First, they clarified that one financial instrument cannot exist in stage 1 and in stage 2 at the same time. Therefore, the Board in the above example did not mean that each asset in the portfolio is to be regarded as 20% in stage 2 and 80% in stage 1. Instead, 20% of the assets are in stage 2, even if the bank does not yet know precisely which instruments are in stage 2.
- This allocation is intended to reflect that some assets in the portfolio will respond more adversely to a given change to the macroeconomic factor (e.g., unemployment rate) than others. Therefore, some assets in the portfolio may be considered to have significantly increased in credit risk while others have not. Judgement is required to determine how much of the portfolio moves to stage 2. An entity may, for example, determine that given the range of possible scenarios, 20% of the portfolio moves to stage 2 considering the different level of sensitivity of the assets in the portfolio to the different relevant credit risk drivers.
- As further explained in the next section on using multiple scenarios for the staging assessment (see section 6.7 below), it is important to note that the 20% is not the probability of occurrence of the more adverse scenario. Rather, it reflects the proportion of the portfolio deemed to have already significantly deteriorated based on the most recent probability-weighted average probability of default. This is due to the heightened sensitivity of this proportion of the portfolio to certain macroeconomic factors.

A further issue with the top-down approach is the question of what the lender does if it subsequently finds that differences in risk characteristics emerge within the portfolio, such that certain assets need to be measured using lifetime expected credit losses using the bottom-up approach. A similar question arises if individual assets subsequently need to be measured using lifetime expected credit losses, for instance, because they become 30 days past due. In practice, it is likely that banks, at each reporting date, will first allocate exposures to stage 2 based on an individual assessment and then apply a collective approach to the remaining stage 1 exposures. They are unlikely to 'roll-forward' the collective allowance.

Presumably the proportion of the portfolio expected credit losses in stage 2 can be measured once again using 12-month expected credit losses if economic conditions are expected to improve. However, any assets that are 30 days past due will continue to be treated as stage 2. *[IFRS 9.B5.5.19]*.

Because of these and similar difficulties, we are not currently aware of any banks who are using the top-down approach in the manner set out in the Illustrative Example. Banks prefer to know which loans are measured using lifetime expected credit losses, rather than a notional percentage of the population. In practice, the methods that are being used by banks are closer to a mixture of the bottom-up and top-down approaches, as described in Illustration 6-10 and Illustration 6-11 above. Macroeconomic indicators are assessed, as in the top-down approach, but the effect is determined by assessing the effect on particular exposures. One possible method is to determine the expected migration of loans through a bank's risk classification system, by recalibrating the probabilities of default based on forward-looking data. This could be used to forecast how many additional loans will get downgraded as well as the associated expected credit losses. Another is to focus on more vulnerable categories of lending, such as interest-only mortgages, secured loans with high loan-to-value ratios, or property development loans, and assess how these might respond to the economic outlook. The more information about customers that a lender possesses, the more this might look like the illustrated bottom-up approach. It is likely that banks will use different approaches for different portfolios, depending on how they are managed and what data is available (see section 5.6.3 above for further discussions on post-model overlays and adjustments when incorporating the impact of rare shock events, e.g., the coronavirus pandemic).

How we see it

In practice, lending businesses are likely to use a mixture of the bottom-up and top-down approaches and different approaches for different portfolios, depending on how they are managed and what data is available.

All the examples in the illustrative examples simplify the fact pattern to focus on just one driver of credit losses, whereas in reality, there will be many, and it is not possible to find a historical precedent for the combination of economic indicators that may now be present. Further, to delve into the past to predict the future requires a level of data that lending businesses may lack. The example in IFRS 9 bases the percentage on historical experience, but the past might potentially not be a reliable guide to the future. In practice, lending businesses need to determine the main macroeconomic variables that correlate with credit losses and focus on modelling these key drivers of loss.

The banks can make use of work carried out for stress testing. Also, banks generally use one single model to estimate forward-looking probability of defaults for both the assessment of significant increases in credit risk and the measurement of expected credit losses (see section 5.9.3 above).

6.6 Determining the credit risk at initial recognition of an identical group of financial assets

In practice, entities may hold a portfolio of debt securities that are identical and cannot be distinguished individually (e.g., all securities have the same international securities identification number (ISIN)) and over the lifetime of the portfolio, entities may acquire additional securities or sell some of those previously acquired. In such instances, entities have to determine the credit risk at initial recognition of those securities that remain in the homogeneous portfolio at the reporting date.

IFRS 9 contains no specific guidance on how to calculate the cost of financial assets for derecognition purposes when they are part of a homogenous portfolio. Under IAS 39, which was also silent on this topic, entities used to choose between three cost allocation methods for available-for-sale securities: the average cost method, the first-in-first-out (FIFO) method or the specific identification method. Specific identification can be applied if the entity is able to identify the specific items sold and their costs. For example, a specific security may be identified as sold by linking the date, amount and cost of securities bought with the sale transaction, provided that there is no other evidence suggesting that the actual security sold was not the one identified under this method.

For IFRS 9, the question arises whether entities can continue to apply one of the above methods for debt instruments, not only for determining the cost of the security at derecognition but also for determining their initial credit risk. We believe that:

- The method used for recognising and measuring impairment losses is normally the same as that used for determining the cost allocation method on derecognition.
- A FIFO approach or a specific identification method as described above constitute acceptable accounting policy choices to be applied consistently.
- However, it would not normally be appropriate to use the weighted-average method to determine the credit risk at initial recognition, as averaging the different levels of initial credit risk of debt securities purchased at different dates would result in an identical initial credit risk for each item. It, therefore, would create bias when assessing whether the credit risk of debt securities has increased significantly.

How we see it

The method for determining the credit risk at initial recognition of an identical group of financial assets is normally the same as the method used for determining the cost allocation on derecognition. This would include the FIFO approach or a specific identification method and it would not normally be appropriate to use the weighted-average method.

6.7 Multiple scenarios for the assessment of significant increases in credit risk

At its December 2015 meeting the IFRS Transition Resource Group for Impairment of Financial Instruments discussed not only the need to consider multiple scenarios for measurement of expected credit losses (see section 5.6.1 above), but also for the purposes of assessing whether exposures should be measured on a lifetime loss basis.

Similar to the measurement of expected credit losses, the IFRS Transition Resource Group for Impairment of Financial Instruments members noted that where there is a non-linear relationship between the different forward-looking scenarios and the associated risks of default, using a single scenario would not meet the objectives of IFRS 9. Consequently, in such cases, an entity would need to consider more than one forward-looking scenario. Further, there should be consistency, to the extent relevant, between the information used to measure expected credit losses and that used to assess significant increases in credit risk. An example of when the information might not be relevant is the value of collateral. It may be necessary to calculate the effect of multiple scenarios to value collateral to measure expected credit losses, but this information might not be relevant to assessing significant changes in credit risk unless the value has an effect on the probability of default occurring.[24]

As with the measurement of expected credit losses, the IFRS Transition Resource Group for Impairment of Financial Instruments members noted that IFRS 9 does not prescribe particular methods of assessing for significant increases in credit risk. Consequently, various methods could be applied, depending on facts and circumstances and these may include both quantitative and qualitative approaches. An entity should not restrict itself by considering only quantitative approaches when considering how to incorporate multiple forward-looking scenarios. Whichever approach is taken, it should be consistent with IFRS 9, considering reasonable and supportable information that is available without undue cost and effort. Once again, this is an area of judgement and so appropriate disclosures would need to be provided to comply with the requirements of IFRS 7 (see section 15 below and Chapter 50 at section 5.3).

A further issue was raised at the IFRS Transition Resource Group for Impairment of Financial Instruments meeting, which was not referred to in the minutes but was addressed in the 25 July 2016 IASB webcast. If a number of scenarios are applied to an individual asset, in some of which there is no significant increase in credit risk and in others there is, is it possible that it could be measured partly based on 12-month losses and partly on lifetime losses? It was not the intention of the IASB that an asset is regarded as being in more than one stage at the same time. For staging as well as for measurement, IFRS 9 applies to the unit of account which is the individual financial instrument. The financial asset cannot be considered to have partly significantly deteriorated and partly not. Hence, for instance, if the staging assessment is based on a mechanistic approach which considers the change in the lifetime probability of default, the entity uses the multiple scenario probability-weighted lifetime probability of default to assess whether there has been a significant increase in credit risk. The asset is then measured using the weighted 12-month probability of default if it is considered to be in stage 1, or the weighted lifetime probability of default if it is considered to be in stage 2.

However, as described in section 6.5.3 above, the webcast also noted that, for a collectively assessed portfolio of assets, only a proportion of the portfolio may be deemed to have significantly deteriorated while the rest of the portfolio has not, due to differences in sensitivities of credit risk to a change in a particular parameter.

The IASB also illustrated how multiple scenarios can be reflected in a non-probability of default-based approach, using the example of a scorecard system. If the entity determines that there is non-linearity in the effect of the scenarios on the credit risk of the customers, one possibility is to look at the scorecard inputs and to determine which of these inputs have a non-linear relationship with the macroeconomic parameters. The entity then adjusts the scorecard, for example, using a scaling factor to reflect the impact of non-linearity, assesses whether there has been a significant increase in credit risk and measures expected credit loss on the basis of the adjusted scorecard.

The approach set out in this discussion is broadly the same as 'the top down' approach to collective assessments illustrated by Illustration 6-11 in section 6.5.3 above.

It is important to note that the IFRS Transition Resource Group for Impairment of Financial Instruments did not state that it is always necessary to use multiple scenarios and probability-weighted lifetime probabilities of default to assess significant increases in credit risk.

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24 IASB Transition Resource Group for Impairment of Financial Instruments, Meeting Summary, 11 December 2015, paras. 58 and 59. Available on the IFRS Foundation's website.

What it did state is that:

(a) It is necessary to consider more than one scenario if there is non-linearity in the possible distribution of losses.

(b) Qualitative approaches may be included as well as quantitative ones, so that, for instance, it might be possible to take account of non-linearities by scaling the output from score cards.

(c) The assessment should be based on reasonable and supportable information that is available without undue cost or effort (see section 5.9.1 above).

Nevertheless, the IFRS Transition Resource Group for Impairment of Financial Instruments did state that there should be consistency, to the extent relevant, between the forward-looking information used for measurement and for the assessment of significant increases in credit risk. There would not always be a direct mapping of the relevant information, because in some cases information might have an impact on the measurement of expected credit losses but not on the assessment of significant increases in credit risk (and *vice versa*). Also, various methods of assessing for significant increases in credit risk could be applied, depending on the particular facts and circumstances, and an entity should not restrict itself by considering only quantitative approaches when considering how to incorporate multiple forward-looking scenarios.

On the 25 July 2016 webcast, the IASB also stressed the importance of adequate disclosures. Because there is no one right approach and because this area involves a high level of judgement, disclosures are very important to enable users of financial statements to understand how entities' credit risk is affected by forward-looking scenarios and how they have affected the application of the expected credit loss model. It would also be useful to disclose if relevant forward-looking information has not been reflected in the assessment of significant deterioration on the basis that it is not reasonable and supportable.

In practice, many banks that use multiple scenarios of lifetime probabilities of default to measure assets in stage 2, use them also for assessing if there has been a significant increase in credit risk. Moreover, as with measurement, banks will need to consider regulators' expectations (see section 7.1 below).

7 Other matters and issues in relation to the expected credit loss calculations

This section discusses other matters and issues that are relevant to applying the IFRS 9 impairment requirements.

7.1 Basel guidance on accounting for expected credit losses

The Basel Committee published the final version of its *Guidance on Credit Risk and Accounting for Expected Credit Losses* (sometimes referred to as 'the Basel guidance' or just 'the guidance') in December 2015 (see section 1.5 above). The guidance deals with lending exposures, and not debt securities, and does not address the consequential capital requirements.

The guidance was originally drafted for internationally active banks and more sophisticated banks in the business of lending. The final version does not limit its scope but allows less complex banks to apply, 'a proportionate approach' that is commensurate with the size, nature and complexity of their lending exposures. It also extends this notion to individual portfolios of more complex banks. It follows that determining what is proportionate will be a key judgement to be made, which is likely to be guided in some jurisdictions by banking regulators. The guidance issued in June 2016 by the GPPC (see section 7.2 below) will also be relevant in making this determination. The final version of the guidance acknowledges that due consideration may also be given to materiality.

The main section of the Basel Committee's guidance is intended to be applicable in all jurisdictions (i.e., for banks reporting under US GAAP as well as for banks reporting under IFRS) and contains 11 supervisory principles. The guidance is supplemented by an appendix that outlines additional supervisory requirements specific to jurisdictions applying the IFRS 9 expected credit loss model.

It is important to stress that the guidance is not intended to conflict with IFRS 9 (and, indeed, this has been confirmed by the IASB), but it goes further than IFRS 9 and, in particular, removes some of the simplifications that are available in the standard. It also insists that any approximation to what would be regarded as an 'ideal' implementation of expected credit loss accounting is designed and implemented so as to avoid 'bias'. The term 'avoidance of bias' is used several times in the guidance and we understand it to have its normal accounting meaning of neutrality. Hence, for instance, if a bank were ever dependent on past-due information to assess whether an exposure is measured on a lifetime expected credit loss basis, it is guided to "pay particular attention to their measurement of the 12-month allowance to ensure that expected credit losses are appropriately captured in accordance with the measurement objective of IFRS 9."[25]

Perhaps one of the most significant pieces of guidance provided by the Basel Committee relates to the important requirement in IFRS 9 that expected credit losses are measured using 'reasonable and supportable information'. The Basel Committee accepts that in certain circumstances, information relevant to the assessment and measurement of credit risk may not be reasonable and supportable and is therefore excluded from the expected credit loss assessment and measurement process. But, given that credit risk management is a core competence of banks, 'these circumstances would be exceptional in nature'.[26] This attitude pervades the guidance. It also states that management is expected "to apply its credit judgement to consider future scenarios" and "The Basel Committee does not view the unbiased consideration of forward-looking information as speculative".[27] The guidance, therefore, establishes a high hurdle for when it is not possible for an internationally active bank to estimate the effects of forward-looking information. It is possible that banking regulators would expect banks to make an estimate of the effects of events with an uncertain binary outcome that is highly significant, such as the result of a referendum as discussed by the IFRS Transition Resource Group for Impairment of Financial Instruments in September 2015 (see section 5.9.5 above).

25 Guidance on credit risk and accounting for expected credit losses, Basel Committee on Banking Supervision, December 2015, para. A55. Available on the Bank for International Settlements' website.

26 Guidance on credit risk and accounting for expected credit losses, Basel Committee on Banking Supervision, December 2015, para. 22. Available on the Bank for International Settlements' website.

27 Guidance on credit risk and accounting for expected credit losses, Basel Committee on Banking Supervision, December 2015, para. 21. Available on the Bank for International Settlements' website.

A connected piece of the guidance relates to another important principle in IFRS 9, that reasonable and supportable information should be available 'without undue cost or effort'. The guidance states that banks are not expected to read this 'restrictively'. It goes on to say that, "Since the objective of the IFRS 9 model is to deliver fundamental improvements in the measurement of credit losses … this will potentially require costly upfront investment in new systems and processes". Such costs "should therefore not be considered undue".[28]

Much of the guidance relates to systems and controls and he requirements of the main section that relate to accounting include:

(1) There should be commonality in the processes, systems, tools and data used to assess credit risk and to measure expected credit losses for accounting and for regulatory capital purposes.[29]

(2) When a bank's individual assessment of exposures does not adequately consider forward-looking information, it is appropriate to group lending exposures with shared credit risk characteristics to estimate the impact of forward-looking information, including macroeconomic factors (see section 6.5 above).[30] The grouping of lending exposures into portfolios with shared credit risk characteristics must be re-evaluated regularly (including re-segmentation in light of relevant new information or changes in the bank's expectations). Groupings must be granular enough to assess changes in credit risk and changes in a part of the portfolio must not be masked by the performance of the portfolio as a whole.[31]

(3) 'Adjustments' may be used to address events, circumstances or risk factors that are not fully considered in credit rating and modelling processes. But the Basel Committee expects that such adjustments will be temporary. If the reason for an adjustment is not expected to be temporary, then the processes should be updated to incorporate that risk driver. The guidance goes on to say that adjustments require judgement and create the potential for bias. Therefore, they should be subject to appropriate governance processes.[32]

(4) The "consideration of forward-looking information and macroeconomic factors is considered essential to the proper implementation of an expected credit loss model. It cannot be avoided on the basis that the banks consider the costs to be excessive or unnecessary or because there is uncertainty in formulating forward-looking scenarios". However, the Basel Committee recognises that an expected credit loss is "an estimate and thus may not perfectly predict actual outcomes. Accordingly, the need to incorporate such information is likely to increase the inherent degree of subjectivity in expected credit loss estimates, compared with impairment measured using incurred loss approaches". Also, the Basel Committee recognises that it is not always possible to demonstrate a strong link in formal statistical terms between certain types of information and the credit risk drivers. Consequently, a bank's experienced credit judgement will be crucial in establishing the appropriate level for the individual or collective allowance.[33]

(5) Although the final version of the guidance says less about disclosures than the draft version, given the publication of the Enhanced Disclosure Task Force recommendations, disclosure remains one of the key principles (see section 15 below and Chapter 50 at section 8.1).

28 Guidance on credit risk and accounting for expected credit losses, Basel Committee on Banking Supervision, December 2015, para. A47. Available on the Bank for International Settlements' website.

29 Guidance on credit risk and accounting for expected credit losses, Basel Committee on Banking Supervision, December 2015, para. 69. Available on the Bank for International Settlements' website.

30 Guidance on credit risk and accounting for expected credit losses, Basel Committee on Banking Supervision, December 2015, para. 57. Available on the Bank for International Settlements' website.

31 Guidance on credit risk and accounting for expected credit losses, Basel Committee on Banking Supervision, December 2015, paras. 46-49. Available on the Bank for International Settlements' website.

32 Guidance on credit risk and accounting for expected credit losses, Basel Committee on Banking Supervision, December 2015, paras. 50, 51 and 58. Available on the Bank for International Settlements' website.

33 Guidance on credit risk and accounting for expected credit losses, Basel Committee on Banking Supervision, December 2015, paras. 64 and 65. Available on the Bank for International Settlements' website.

The guidance is supplemented by an appendix that outlines additional supervisory requirements specific to jurisdictions applying the IFRS 9 expected credit loss model. The key requirements are outlined below:

(1) A bank's definition of default adopted for accounting purposes is guided by the definition used for regulatory purposes, which includes both a qualitative 'unlikeliness to pay' criterion and an objective 90-days-past-due criterion, described by the Basel Committee as a 'backstop'.

(2) The IFRS 9 requirement to assess whether exposures have significantly increased in credit risk "is demanding in its requirements for data, analysis and use of experienced credit judgement". The determination is made "on a timely and holistic basis", considering a wide range of current information. It is critical that banks have processes in place to ensure that financial instruments, whether assessed individually or collectively, are moved from the 12-month to the lifetime expected credit loss measurement as soon as credit risk has increased significantly. Credit losses very often begin to deteriorate a considerable period of time before an actual delinquency occurs and delinquency data are generally backward-looking. Therefore, "the Basel Committee believes that they will seldom on their own be appropriate in the implementation of an expected credit loss approach by a bank." Instead, banks need to consider the linkages between macroeconomic factors and borrower attributes, using historical information to identify the main risk drivers, and current and forecast conditions and experienced credit judgement to determine loss expectations. This applies not only to collective assessments of portfolios but also for assessments of individual loans. The guidance gives the example of a commercial property loan, for which the bank assesses the sensitivity of the property market to the macroeconomic environment and use information such as interest rates or vacancy rates to make the assessment.[34]

(3) In assessing whether there has been a significant increase in credit risk, banks should not rely solely on quantitative analysis. The guidance draws banks' attention to the list of qualitative indicators set out in IFRS 9.B5.5.17. Particular consideration should be given to a list of conditions, including an increased credit spread for a particular loan, a decision to strengthen collateral and/or covenant requirements, a downgrade by a credit rating agency or within the bank's internal credit rating system, a deterioration in future cash flows, or an expectation of forbearance or restructuring. Also, the guidance stresses that the sensitivity of the risk of a default occurring to rating downgrades increases strongly as rating quality declines. Therefore, the widths of credit risk grades need to be set appropriately, so that significant increases in credit risk are not masked. Further, "if a decision is made to intensify the monitoring of a borrower or class of borrowers, it is unlikely that such action would have been taken … had the increase in credit risk not been perceived as significant."[35]

(4) Exposures that are transferred to stage 2 and that are subsequently renegotiated or modified, but not derecognised, should not be moved back to stage 1 until there is sufficient evidence that the credit risk over the remaining life is no longer significantly higher than on initial recognition. "Typically, a customer would need to demonstrate consistently good payment behaviour over a period of time before the credit risk is considered to have decreased."[36]

(5) IFRS 9 includes a number of practical expedients (see section 6.4 above). However, as banks are in the business of lending and it is unlikely that obtaining relevant information will involve undue cost or effort, the Basel Committee expects their limited use by internationally active banks. For instance:
   (a) The long-term benefit of a high-quality implementation of an expected credit loss model that takes into account all reasonable and supportable information far outweighs the associated costs.
   (b) The use of the low credit risk simplification is considered a low-quality implementation of the expected credit loss model and its use should be limited (except for holdings in debt securities, which are out of scope of the guidance). Also, the reference to an investment grade rating in IFRS 9 is only given as an example of a low credit risk exposure. An investment grade rating given by a rating agenda cannot automatically be considered low credit risk because banks are expected to rely primarily on their own credit assessments.
   (c) Delinquency is a lagging indicator. Therefore, the Basel Committee expects banks not to use the more-than-30-days-past-due rebuttable presumption as a primary indicator of a significant increase in credit risk. Banks may only use the rebuttable presumption as a backstop measure, alongside other, earlier indicators, while any rebuttal of the presumption would have to be accompanied by a thorough analysis to show that 30 days past due is not correlated with a significant increase in credit risk.[37]

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34 Guidance on credit risk and accounting for expected credit losses, Basel Committee on Banking Supervision, December 2015, paras. A15-A21. Available on the Bank for International Settlements' website.

35 Guidance on credit risk and accounting for expected credit losses, Basel Committee on Banking Supervision, December 2015, paras. A23-A30. Available on the Bank for International Settlements' website.

36 Guidance on credit risk and accounting for expected credit losses, Basel Committee on Banking Supervision, December 2015, para. A44. Available on the Bank for International Settlements' website.

37 Guidance on credit risk and accounting for expected credit losses, Basel Committee on Banking Supervision, December 2015, paras. A45-A55. Available on the Bank for International Settlements' website.

7.2 Global Public Policy Committee (GPPC) guidance

On 17 June 2016, the GPPC published *The implementation of* IFRS 9 *impairment by banks - Considerations for those charged with governance of systemically important banks* ('the GPPC guidance'). The GPPC is the Global Public Policy Committee of representatives of the six largest accounting networks. This publication was issued to promote high-quality implementation of the accounting for expected credit losses in accordance with IFRS 9 and to help those charged with governance to identify the elements of a high-quality implementation. It was designed to complement other guidance such as that issued by the Basel Committee (see section 7.1 above) and the Enhanced Disclosure Task Force (see Chapter 50 at section 8.1). It does not purport to amend or interpret the requirements of IFRS 9 in any way. The first half of the GPCC guidance sets out key areas of focus for those charged with governance. This includes governance and controls, transition issues and ten questions that those charged with governance might wish to discuss. The second half of the guidance sets out a sophisticated approach to implementing each aspect of the requirements of IFRS 9, along with considerations for a simpler approach and what is not compliant. Where relevant to understanding the accounting requirements of IFRS 9, this guidance is reflected in this chapter.

The GPPC guidance regards determination of the level of sophistication of the approach to be used as one of the key areas of focus for those charged with governance. Consequently, it provides guidance on how to make this determination for particular portfolios. It sets out factors to consider at the level of the entity, such as the extent of systemic risk that the bank poses, whether it is listed or a public interest entity, the size of its balance sheet and off balance sheet credit exposures, and the level and volatility of historical credit losses. Portfolio-level factors include its size relative to that of the total balance sheet and its complexity, the sophistication of other lending-related modelling methodologies, the extent of available data, the level of historical losses and the level and volatility of losses expected in the future. The document stresses that a simpler approach is not necessarily a lower quality approach if it is applied to an appropriate portfolio.

Also, on 28 July 2017, the GPPC issued its second paper titled *The Auditor's Response to the Risks of Material Misstatement Posed by Estimates of Expected Credit Losses under* IFRS 9. This second paper was written in an effort to assist audit committees in their oversight of the bank's auditors with regard to auditing expected credit losses. It is addressed primarily to the audit committees of systemically-important banks (SIBs) because of the relative importance of SIBs to capital markets and global financial stability but is relevant for other banks as well. It ought to be read in conjunction with the initial guidance published in 2016.

7.3 Measurement dates of expected credit losses

7.3.1 Date of derecognition and date of initial recognition

Frequently asked questions

Question 7-1: Whether there is a requirement to measure Expected Credit Losses at dates other than the reporting date, namely the date of derecognition and the date of initial recognition?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 22 April 2015 - Agenda paper no. 7)

Impairment must be assessed and measured at the reporting date. IFRS 9 also requires a derecognition gain or loss to be measured relative to the carrying amount at the date of derecognition (see Chapter 50 at sections 4.2.1 and 7.1.1). This necessitates an assessment and measurement of expected credit losses for that particular asset as at the date of derecognition, as was confirmed by the discussions at the April 2015 IFRS Transition Resource Group for Impairment of Financial Instruments meeting (see section 1.4 above).

Essentially, the calculation of derecognition gains or losses is a two-step process:

- Step 1: expected credit losses are remeasured at the date of derecognition and presented in the separate impairment line item in the statement of profit or loss as per IAS 1.82(ba) *Presentation of Financial Statements*. The change in expected credit loss estimate should still reflect the reporting entity's view rather than the market's view of credit losses based upon the remaining contractual life of the financial asset. Also, the residual life of the asset should not be deemed to be nil because of the imminent sale and impairment losses that have not materialised should not be mechanically reversed to reflect the fact that the reporting entity will no longer be holding the debt security. This is consistent with Illustrative Examples 13 and 14 of IFRS 9. In particular, a footnote to the last journal entry in Illustrative Example 14 explains that the loss on sale includes the accumulated impairment amount.
- Step 2: Gains or losses on derecognition are calculated taking into account all expected credit losses for financial assets measured at amortised cost and all cumulative gains or losses previously recognised in other comprehensive income including those related to expected credit losses for financial assets measured at fair value through other comprehensive income. Unlike the requirement to present gains and losses arising from the derecognition of financial assets measured at amortised cost as a separate line item in the statement of profit or loss as per IAS 1.82(aa), there is no specific presentation requirement for financial assets measured at fair value through other comprehensive income.

Since that discussion, the IFRS Transition Resource Group for Impairment of Financial Instruments has discussed whether the expected sales of impaired assets should be reflected in the calculation of expected credit losses (see section 5.8.2 above). Given their conclusion that an entity should, it is quite possible that there will be little or no additional losses to record on derecognition that have not already been reflected in the impairment cost.

A similar issue is whether impairment needs to be measured at the date that an asset is modified (see section 8 below).

At the April 2015 meeting, the IFRS Transition Resource Group for Impairment of Financial Instruments also discussed a more difficult question, whether impairment must be measured as at the date of initial recognition for foreign currency monetary assets. The significance of this is whether subsequent gains and losses arising from foreign currency retranslation in the first accounting period should be calculated based on the initial gross amortised cost or a net amount, after deducting an impairment allowance. This would affect the allocation of subsequent gains and losses of the asset in this period to impairment or to foreign currency retranslation, so that it would be reported in different lines of the profit or loss account.

Differing views were expressed:

- A few IFRS Transition Resource Group for Impairment of Financial Instruments members supported the view that while IFRS 9 does not expressly require expected credit losses to be measured at the date of initial recognition, the requirements of other IFRS accounting standards, e.g., IAS 21 *The Effects of Changes in Foreign Exchange Rates*, may result in an entity measuring expected credit losses at the date of initial recognition. Also, Illustrative Example 14 in IFRS 9 implies the need to include expected credit losses on initial recognition in the measurement of foreign exchange gains and losses in respect of a foreign currency-denominated asset (see Illustration 9-2 in section 9.2 below). However, these members questioned the frequency with which an entity needed to perform that calculation and pointed out that considerations of materiality would be a key factor in making this decision.
- Some other IFRS Transition Resource Group for Impairment of Financial Instruments members were of the view that an entity is required to measure a financial asset at its fair value upon initial recognition and that consequently measuring expected credit losses at initial recognition would be inconsistent with that requirement. *[IFRS 9.5.1.1]*. IFRS 9 includes impairment as part of the subsequent measurement of a financial asset and, consequently, only requires an entity to begin measuring expected credit losses at the first reporting date after initial recognition (or on derecognition if that occurs earlier). *[IFRS 9.3.2.12, IFRS 9.5.5.3, IFRS 9.5.5.5, IFRS 9.5.5.13]*. While the requirements of other IFRS accounting standards should be applied to the loss allowance at that point, the application of those requirements should not result in an entity having to measure expected credit losses at a date earlier than that specifically required by IFRS 9.

The IFRS Transition Resource Group for Impairment of Financial Instruments also noted that the Illustrative Examples are non-authoritative and illustrate only one way of applying the requirements of IFRS 9. Measuring a 12-month expected credit loss using point in time, forward-looking information, every time that a foreign currency exposure is first recognised would not be feasible. Given that there was no consensus on this issue, we expect that there may be diversity in practice.

7.3.2 Trade date and settlement date accounting

For financial assets measured at amortised cost or at fair value through other comprehensive income, IFRS 9 requires entities to use the trade date as the date of initial recognition for the purposes of applying the impairment requirements. *[IFRS 9.5.7.4]*. This means that entities that use settlement date accounting for regular way purchases of debt securities may have to recognise a loss allowance for securities which they have purchased but not yet recognised and, correspondingly, no loss allowance for securities that they have sold but not yet derecognised. (See Chapter 45 at section 2.2 for further details on trade date accounting and settlement date accounting).

Irrespective of the accounting policy choice for trade date accounting versus settlement date accounting, the recognition of the loss allowance on the trade date ensures that entities recognise the loss allowance at the same time; otherwise, entities could choose settlement date accounting to delay recognising the loss allowance until the settlement date. The effect of this is similar to accounting for fair value changes on financial assets measured at fair value through other comprehensive income and those measured at fair value through profit or loss when settlement date accounting is applied (i.e., a measurement change needs to be recognised in profit or loss and the statement of financial position even if the related assets that are being measured are only recognised slightly later). It is also consistent with the treatment of expected credit losses in loans, where an expected credit loss is calculated in respect of a loan commitment between the date that the commitment is made and the loan is drawn down.

For settlement date accounting, the recognition of a loss allowance for an asset that has not yet been recognised raises the question of how that loss allowance is presented in the statement of financial position. The time between the trade date and the settlement date is somewhat similar to a loan commitment in that the accounting is off balance sheet, which suggests presentation of the loss allowance as a provision.

In practice, some entities tend to opt for settlement date accounting for regular way securities recorded at amortised cost, because they do not need the additional systems capabilities to account for the securities on trade date (i.e., they do not need to account for them until settlement date).

7.4 Interaction between the initial and subsequent measurement of debt instruments acquired in a business combination and the impairment model of IFRS 9

For debt instruments that are acquired in a business combination, the initial recognition and measurement is accounted for under IFRS 3. Consistent with IFRS 9 and IFRS 13 *Fair Value Measurement*, IFRS 3 requires financial assets acquired in a business combination to be measured by the acquirer on initial recognition at their acquisition-date fair value (see IFRS 3.18). (See Chapter 45 at section 3.3.4 and Chapter 10 at section 5.5.5). Paragraph B41 of the Application Guidance to IFRS 3, as amended by IFRS 9, elaborates on this, and explains that no loss allowance is recognised as part of the initial measurement of debt instruments that are acquired in a business combination: *[IFRS 3.B41]*

Extract from IFRS 3

Assets with uncertain cash flows (valuation allowances)

B41 The acquirer shall not recognise a separate valuation allowance as of the acquisition date for assets acquired in a business combination that are measured at their acquisition-date fair values because the effects of uncertainty about future cash flows are included in the fair value measure. For example, because this IFRS requires the acquirer to measure acquired receivables, including loans, at their acquisition-date fair values in accounting for a business combination, the acquirer does not recognise a separate valuation allowance for the contractual cash flows that are deemed to be uncollectible at that date or a loss allowance for expected credit losses.

Consequently, the accounting for impairment of debt instruments measured at amortised cost or fair value through other comprehensive income under IFRS 9 does not affect the accounting for the business combination.

- At the acquisition date, the acquired debt instruments are measured at their acquisition-date fair value in accordance with IFRS 3. No loss allowance is recognised as part of the initial measurement of debt instruments that are acquired in a business combination. This is the same treatment as would be the case for the acquisition of a portfolio of assets which is not part of a business combination.
- After their original recognition, the subsequent accounting for debt instruments acquired in a business combination is in the scope of IFRS 9. The impairment requirements in IFRS 9.5.5 are part of the subsequent measurement of those debt instruments (see IFRS 9.5.2.1 and 5.2.2 as well as the structure of the standard, i.e., that initial measurement is addressed in IFRS 9.5.1 and subsequent measurement is addressed in IFRS 9.5.2). Consequently, the recognition of an expected credit loss allowance in IFRS 9.5.5 occurs at the first reporting date after the business combination (see IFRS 9.5.5.3 and 5.5.5, which refer to measurement at the reporting date). This results in recognising a corresponding impairment loss in profit or loss (see IFRS 9.5.5.8). Therefore, at the first reporting date after the business combination, following the guidance in IFRS 9, a loss allowance is recognised. This will result in an impairment loss that is recognised in profit or loss (rather than an adjustment to goodwill), just as would be the case if the entity were to originate those assets or acquire them as a portfolio, rather than acquire them through a business combination. The assets will all be measured on the basis of 12-month expected credit losses unless the assets are purchased or originated credit-impaired or the assets have increased significantly in credit risk between the date of the business combination and the first reporting date.

How we see it

Despite the colloquial reference to a 'day one' loss that results from the expected credit loss impairment model in IFRS 9, it is important to understand that the recognition of a loss allowance for newly acquired (whether purchased or originated) debt instruments that are in the scope of the impairment requirements in IFRS 9.5.5 is a matter of subsequent measurement of those financial instruments. This means that the acquirer recognises the loss allowance for all debt instruments acquired in a business combination (that are subject to impairment accounting) in the reporting period that includes the business combination but not as part of that business combination, and with a corresponding impairment loss in profit or loss. As a result, these acquired assets are carried at a value below their fair value by what is often referred to as 'day two', when the 12-month expected credit loss is booked. This may seem counter-intuitive to many preparers and users of financial statements, but is clearly what is intended by IFRS 9.

The only exception to the need to record expected credit losses on day two is the specific accounting for purchased or originated credit-impaired financial assets (see section 3.3 above). This applies to financial assets which are already credit-impaired at the acquisition date. A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred (see section 3.1 above). Financial assets that are already credit-impaired at the acquisition date are not accounted for under the 'general approach' of the impairment model of IFRS 9 but instead follow a different application of the impairment model (see IFRS 9.5.5.13 and 5.5.14). This does not involve recognising the loss allowances for 12-month or lifetime expected credit losses. For such assets, the effective interest rate is determined using a cash flow estimate that includes all initial lifetime expected credit losses and no separate allowance is initially made for expected credit losses, as the expected credit loss is part of the 'credit-adjusted effective interest rate'. Subsequently, the cash flow estimate used for calculating amortised cost, including expected credit losses, is updated at each reporting date, so that any cumulative changes in lifetime expected credit losses since initial recognition is recognised as a loss allowance and corresponding gain or loss in profit or loss as expectations change. This differs from financial assets that are not purchased or originated credit-impaired, where an allowance must be made for expected credit losses (see sections 3.1 and 3.3 above).

It follows that, on a business combination, the acquirer needs to classify the acquired debt instruments that will be recorded at amortised cost or at fair value through other comprehensive income, according to whether they are purchased credit-impaired or not. If not, they will be regarded as stage 1 assets and be subject to a 12-month expected credit loss. If they are purchased credit-impaired, then there will be no need for an additional expected credit loss unless there is a subsequent change in estimated lifetime expected credit loss (see section 3.3 above). Furthermore, these purchased credit-impaired loans will always be treated as such and are never subsequently subject to the staging requirements. Also, none of the acquired assets, either performing or purchased credit-impaired, will be classified as stage 2 or stage 3 at the date of initial recognition.

A further issue for debt instruments acquired in a business combination is the application of the rebuttable presumption that there has been a significant increase in credit risk if the loan is 30 days past due (see section 6.2.2 above) and that default does not occur later than when a financial asset is 90 days past due (see section 5.1 above). For example, if loans are acquired two days before the acquirer's reporting date when they are already 29 days past due or 89 days past due, and if the acquirer were to apply the above rebuttable presumptions, such loans would be presumed to have significantly increased in credit risk (i.e., moved from stage 1 to stage 2) and have defaulted (i.e., moved from stage 1 to stage 3) respectively as at the reporting date.

- For the loans that were 29 days past due, arguably, given the heightened credit risk as at the acquisition date, the loans are unlikely to have significantly increased in credit risk over the short period of two days. Moving the loans from stage 1 to stage 2 would not be consistent with the relative measurement approach of the IFRS 9 impairment model, which is intended to track and determine whether there has been a significant increase in credit risk since initial recognition (see section 6 above). However, the acquirer is permitted to rebut the presumption and apply it only to those loans that are not past due when purchased, or else 'start the clock' only at the date of acquisition (see section 6.2.2 above for further discussion on the 30 days past due rebuttable presumption).
- For the loans that were 89 days past due, similar to the issue for loans that were 29 days past due, moving the loans from stage 1 directly to stage 3 could potentially not result in useful information for the users of the accounts. Acquirers are recommended to consider all the criteria set out in IFRS 9 to determine whether such loans were actually purchased credit-impaired (see section 3.3 above) and not to rely solely on the days past due.

7.5 Interaction between expected credit losses calculations and fair value hedge accounting

For a financial asset that becomes credit-impaired, IFRS 9 requires impairment to be measured by reference to the gross carrying amount of the asset, which would include the fair value hedge adjustment. *[IFRS 9.B5.5.33]*. Otherwise, a part of the asset's carrying amount would not have a loss allowance or the loss allowance would be overstated (in case of a negative fair value hedge adjustment). The effect of fair value hedge accounting is to adjust the effective interest rate, which affects the rate used to discount expected future cash flows. The rationale for this is that the original interest rate before the hedge becomes irrelevant once the carrying amount of the loan is adjusted for any changes in its fair value attributable to interest rate movements. Therefore, for a credit-impaired financial asset in stage 3, the effective interest rate would be adjusted to reflect any fair value hedge adjustment.

However, under the expected credit loss impairment model an allowance is required for all assets, i.e., including assets in stages 1 and 2, in addition to assets in stage 3. Hence, if the discount rate were to be adjusted whenever fair value hedge accounting is applied, then all fair value hedge adjustments would need to be taken into account in calculating expected credit losses. This would give rise to significant operational challenges.

IFRS 9 is not explicit on this matter, but two points in IFRS 9 would seem to be relevant. First, except for credit-impaired assets, the expected credit loss requirements are not based on an asset's 'carrying amount' but on the contractual cash flows that are expected to be lost. Second, IFRS 9 only requires a fair value hedge adjustment to be amortised when the hedged item ceases to be adjusted for changes in fair value attributable to the risk being hedged, which can be read to imply that until then there is no need to adjust the effective interest rate, and hence the rate used to discount expected credit losses. *[IFRS 9.6.5.10]*.

We believe the requirement is not clear and, so at least until it is clarified potentially as part of the hedge accounting PIR, there is an accounting policy choice for exposures that are the designated hedged items in fair value hedge relationships. One approach would be to adjust the effective interest rate whenever a fair value hedge adjustment is made and hence change the interest rate used to discount expected credit losses. The other approach would be not to adjust the effective interest rate or otherwise take into account the fair value hedge adjustment until the effective interest rate is adjusted to amortise the fair value hedge adjustment. *[IFRS 9.6.5.8]*. Such an adjustment to the effective interest rate is permitted to commence at any time but would, at the latest, be required when hedge accounting ceases or when the financial asset becomes credit-impaired, i.e., moved to stage 3 (see Chapter 49 at section 6.4.2.B).

How we see it

Entities have an accounting policy choice for exposures that are the designated hedged items in fair value hedge relationships, i.e., to adjust the effective interest rate whenever a fair value hedge adjustment is made and hence, change the interest rate used to discount expected credit losses, or not to adjust the effective interest rate until the fair value hedge adjustment is required to be amortised.

7.6 Changes in expected credit loss methodologies - errors, changes in estimates or changes in accounting policies

Many entities, having now had some experience of applying IFRS 9, may be considering changing various aspects of their expected credit loss methodologies. The potential changes could include the correction of errors found in the model, updating probability of default, loss given default and exposure at default for recent experience, making changes to how significant increases in credit risk are assessed, and amending the definition of default and write-off policies. The question that these potential amendments pose is whether they are accounted for as prior year errors or changes in accounting policies, both of which (if material) would be adjusted for retrospectively, or changes in estimates which would be accounted for as they arise.

The majority of such changes are likely to be changes in estimates. The only changes that will likely be treated as errors are those that are "omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

(a) was available when financial statements for those periods were authorised for issue; and

(b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements." *[IAS 8.5]*

Examples of errors would include failure to calculate expected credit losses on all relevant exposures, errors in input data and incorrect spreadsheet formulae. Most amendments to expected credit loss calculation methods, including use of more sophisticated or more up to date data, revisions to formulae or measurement on a more granular basis, are likely to be changes in estimates. It is unlikely that amendments to the calculation approach would be regarded as a change in accounting policy.

If changes are made to how credit risk is assessed for the staging assessment, care must be taken to distinguish between changes in how the risk is perceived and how it is measured, and changes in what is regarded as 'significant'. In contrast, the effect of a change of what is deemed to be 'significant' would normally be treated as a change in estimate.

How we see it

In general, it is not appropriate to reassess the credit risk of a financial asset on initial recognition, i.e., the probability of default on origination is not revised if the expected credit loss model is modified or improved. If the initial credit risk turns out to be riskier than expected, then the initial credit risk is not amended; it is possible that the asset will be transferred to stage 2 and the profit or loss impact would be accounted for as a change in estimate. On the other hand, if all that is amended is the way that the credit risk is measured, such as expressing the risk in terms of 12-month probability of defaults as opposed to lifetime probability of defaults, or using a different definition of default, it may be necessary to recalibrate the initial credit risk using the new measurement basis, so as to measure initial and current credit risk on a consistent basis.

7.7 Securitisations and special purpose entities

Securitisation transactions are carried out to transfer risk and/or raise finance from external investors by enabling them to invest in parcels of specific financial assets such as mortgage loans, credit card receivables, other consumer loans, or lease receivables. In a relatively simple structure, a special purpose entity issues notes to investors and lends the money raised to an entity (the 'originator'), secured by the portfolio of assets, either with recourse to the originator if the cash flows on the portfolio are insufficient to repay the loan, or sometimes with no recourse.

A typical more complicated structure involves the originator selling the portfolio of loans to the special purpose entity. In either case, the special purpose entity's equity share capital, which will typically be small, will often be owned by a trustee on behalf of a charitable trust. The loans will often be issued in series of tranches, with varying levels of risk, established through a 'waterfall' of payments, and at different rates of interest to reflect the risk. The originator will often continue to administer the loans as before, for which it will receive a service fee from the special purpose entity (see Chapter 48 at section 3.3).

Some of the common issues that have arisen in practice in relation to securitisations and special purpose entities include contractually linked instruments and subordinated interests (see section 6.1.2 above), the application by the special purpose entity of the expected credit loss requirements when the transferor is not able to derecognise the portfolio of loans (see section 7.7.1 below), and accounting for a financial liability issued by an special purpose entity (see section 7.7.2 below).

7.7.1 Expected credit loss requirements for the special purpose entity if the transferor is not able to derecognise the portfolio of loans

In many securitisation structures, the originator will retain some form of interest in the transferred assets which will preclude derecognition of the assets by the originator.

In the simplest types of structures, where the special purpose entity just lends money to the originator, secured on the portfolio, the special purpose entity will recognise this loan and measure expected credit losses accordingly. If the loan is without recourse to the originator, then the collateral value of the portfolio will be the most important element of the calculation.

In more complex cases, where the portfolio has been sold by the originator to the special purpose entity, the originator may retain an interest through various different mechanisms. These can include, for example, the provision of guarantees or put options, an obligation to substitute non-preforming loans, deferred consideration, or by the originator investing in a junior tranche of the notes issued by the special purpose entity. In each case, the special purpose entity does not recognise the transferred assets, but recognises a 'deemed loan' receivable from the originator for the amount of the proceeds paid to buy the transferred assets (see Chapter 48 at sections 3.3 and 3.6.2).

The 'deemed loan' is a financial asset which, following a similar approach to the classification of contractually linked instruments (as described in Chapter 44 at section 5.6), will often qualify to be recorded at amortised cost or at fair value through other comprehensive income. Assuming it is not measured at fair value through profit or loss, as described in section 6.1.2 above, it is subject to the expected credit loss requirements of IFRS 9. However, IFRS 9 does not set out how the expected credit losses on the deemed loan are determined and whether the performance of the underlying loans are reflected in the measurement of the deemed loan in the standalone accounts of the special purpose entity.

The special purpose entity is exposed to two sources of risk on the deemed loan: (1) the credit risk of the originator, in effect collateralised by the portfolio of loans, and (2) an exposure to the underlying portfolio, to the extent that the originator does not retain all the risks. For instance, if the originator indemnifies the special purpose entity for the first 5% of impairment losses, the special purpose entity is exposed to the originator if it is unable to pay out on the indemnity, but also to the underlying loans to the extent that losses exceed 5%. Although the second of these risks is not strictly a credit risk arising on the deemed loan, similar to the treatment of contractually linked instruments (see section 6.1.2 above), both of these sources of risk would be included by the special purpose entity in the measurement of expected credit losses.

It follows that, when determining whether there has been a significant increase in credit risk on the deemed loan, depending on the terms of the arrangement, the special purpose entity is likely to need both to look through to the staging of the underlying loans but also to take into account any change in the originator's credit risk. If the originator retains all the risks associated with the underlying loans, then the determination would only consider the originator's ability to pay.

Some securitisations are structured such that the special purpose entity is exposed to a very low risk of loss. This might be achieved, for instance, through the originator being paid deferred consideration dependent on the amounts realised from the loans or, if the special purpose entity lends to the originator secured by the loans and ensuring that there is sufficient excess collateral to absorb any losses expected to arise. In these circumstances it is possible that the special purpose entity's expected credit losses may be immaterial.

As will be apparent from this brief discussion, securitisation structures vary significantly, and each transaction will need to be assessed based on its own facts and circumstances. Disclosures will also play an important role in providing useful information to the users of the accounts with respect to the securitisation arrangements in place, the exposure to the originator, the credit quality of the underlying loans and how impairment is assessed.

7.7.2 Accounting for a financial liability issued by a special purpose entity

In many securitisation structures, a special purpose entity invests in a portfolio of loans and raises funds by issuing listed notes to investors. The special purpose entity's contractual obligations on the listed notes are linked to the performance of the loans less the interest spread as, typically, the listed notes bear an interest rate slightly lower than the loans to allow the special purpose entity to earn a spread that is sufficient to cover its operating costs and/or to provide some loss absorption capital. The retention of the interest spread and inability of the special purpose entity to pass the cash flows received from the loan to the noteholder 'without material delay' usually result in the special purpose entity failing the 'pass-through' test for the loans and so the special purpose entity cannot derecognise them (see Chapter 48 at sections 3.6.2 and 3.6.2.D).

Assuming that the loans held by the special purpose entity are recorded at amortised cost (or fair value through other comprehensive income), under IFRS 9, the special purpose entity is required to record expected credit losses on the loans. However, any losses suffered on the loans will be borne by the noteholders, due to the contractual linkage feature. This raises the question on how the linkage feature is accounted for.

In our view, the linkage feature is accounted for as part of the listed notes liability. In most circumstances, the linkage feature is not a credit derivative that is embedded in a host debt instrument and required to be separated (for instance, because it would allow one party to transfer the credit risk of a particular reference asset, which it may not own, to another party). *[IFRS 9.B4.3.5(f)]*. If the linkage feature is closely related to the liability (see Chapter 42 at section 4), it is not separated as an embedded derivative, and is therefore required to be accounted for as part of the amortised cost of the liability. In such instances, any revisions to the estimated contractual cash payments on the listed notes due to the linkage feature is accounted for as an adjustment to the amortised cost of the noteholder liability that is recognised in profit or loss as per IFRS 9.B5.4.6 (see Chapter 46 at section 3.4.1).

How we see it

The contractual linkage feature, where any losses suffered on the loans will be borne by the noteholders, is accounted for as part of the listed notes liability. Any revisions to the estimated contractual cash payments on the listed notes due to the linkage feature is accounted for as an adjustment to the amortised cost of the noteholder liability (discounted at the effective interest rate) and recognised in profit or loss.

Although the linkage feature might be thought of as a financial guarantee of the special purpose entity's loans, as it has the effect of transferring credit losses on the loans from the special purpose entity to the noteholders, it cannot be accounted for as a credit enhancement of the loans and thereby reduce the expected credit losses. Such a treatment is not consistent with the requirements of IFRS 9 and the IFRS IC discussion that if a credit enhancement is required to be recognised separately by IFRS accounting standards, an entity cannot include the cash flows expected from it in the measurement of expected credit losses (see section 5.8.1.A above).

As a consequence of accounting for the linkage feature as part of the listed notes liability, while the special purpose entity will recognise gains on the linkage feature if the loans deteriorate, as it records higher expected credit losses on the loans, the gains recognised under IFRS 9.B5.4.6 are unlikely to match the expected credit loss impairment expense, giving rise to some volatility of earnings. This is because the expected credit losses are calculated based on the probability-weighted amount of credit losses that is based on 12-month expected credit losses if the loans are in stage 1 and lifetime expected credit losses if the loans are in stages 2 and 3, whilst the gains recognised under IFRS 9.B5.4.6 are calculated based on the present value of the estimated future cash receipts. A possible approach to reduce the effect of this accounting mismatch is, on initial recognition, to irrevocably designate the loans and notes at fair value through profit or loss in order to eliminate or significantly reduces the measurement or recognition inconsistency, in accordance with IFRS 9.4.1.5 and 4.2.2 (see Chapter 44 at section 6).

7.8 Measuring expected credit losses during the coronavirus pandemic

7.8.1 Introduction

A major challenge that commenced in 2020 for the application of the IFRS expected credit loss model was the coronavirus pandemic. The virus significantly affected the world economy and also resulted in significant volatility in the financial and commodities markets. Many countries imposed travel bans on millions of people and many more were subject to quarantine measures. Businesses had to deal with lost revenue and disrupted supply chains. This gave rise to liquidity issues for many entities and also had consequential impacts on the credit quality of entities along the supply chain and also had knock on effects on retail loan portfolios (consumer and mortgage loans) as many businesses had to reduce staff numbers. The deterioration in credit quality of loan portfolios and trade receivables, as a result of the pandemic had a significant impact on expected credit loss measurement. In responding to these challenges, certain governments and central banks introduced, or directed or encouraged commercial banks to introduce, various types of relief measures. The consequence was that there were two sources of uncertainty for the calculation of expected credit losses: first, the potential development and consequences of the virus and, second, the extent and effect of the various relief measures. Whilst the coronavirus pandemic has largely abated and does not pose the same health and macroeconomic threat now, it is still worth considering the guidance issued by the IASB, governments and regulators in response to the uncertainty around the calculation of ECL caused by the crisis as the principles of the guidance provided may be applicable to other macroeconomic phenomena that could arise in future.

7.8.2 Guidance

A number of prudential and securities regulators, including the European Banking Authority, the European Central Bank, the European Securities and Market Authority, the Prudential Regulation Authority in the United Kingdom and The Office of the Superintendent of Financial Institutions in Canada (the regulators) published guidance on the regulatory and accounting implications of the pandemic. The IASB closely engaged with many prudential and securities regulators and others regarding the application of IFRS 9 in the context of the coronavirus pandemic.

On 27 March 2020, the IASB published a document for educational purposes, IFRS 9 *and covid-19 - Accounting for expected credit losses applying* IFRS 9 *Financial Instruments in the light of current uncertainty resulting from the covid-19 pandemic*. The document was broadly consistent with the guidance from the regulators and emphasised the following:

- IFRS 9 requires the application of judgement and both requires and allows entities to adjust their approach to determining expected credit losses in different circumstances.
- To assess significant increases in credit risks, IFRS 9 requires that entities assess changes in the risk of a default occurring over the expected life of a financial instrument. Both the assessment of significant increases in credit risk and the measurement of expected credit losses are required to be based on reasonable and supportable information that is available to an entity without undue cost or effort (see section 5.9.5 above).

- Entities were required to develop estimates based on the best available information about past events, current conditions and forecasts of economic conditions. In assessing forecast conditions, consideration should have been given both to the effects of coronavirus and the significant government support measures being undertaken (see sections 5.9.3, 5.9.5, and 5.8.1.C above).
- It was likely to be difficult at this time (March 2020) to incorporate the specific effects of coronavirus and government support measures on a reasonable and supportable basis. However, changes in economic conditions should be reflected in macroeconomic scenarios and if the effects of coronavirus could not be reflected in models, post-model overlays or adjustments would need to be considered
- Although circumstances at the time were difficult and created high levels of uncertainty, if expected credit loss estimates were based on reasonable and supportable information and IFRS 9 was not applied mechanistically, useful information could be provided about expected credit losses.

The European Central Bank also issued on 1 April 2020 *IFRS 9 in the context of the coronavirus (covid-19) pandemic* that emphasised the importance of identifying and reporting asset quality deterioration. Subsequently, on 4 December 2020, the European Central Bank issued a letter to the CEO of banks *Identification and measurement of credit risk in the context of the coronavirus (covid-19) pandemic*. The purpose of the letter was to provide banks with guidance on sound credit risk management policies and procedures to identify and measure credit risk in the context of coronavirus pandemic.

7.8.3 Calculation of expected credit losses

Whether the impact of an event such as the coronavirus pandemic was reflected in an individual expected credit loss assessment (estimating the probability of default on an individual basis), factored into the scenario analysis of future macroeconomic conditions on a collective basis, or adjusted through management overlays, depended on the entity's systems and processes and the facts and circumstances. In practice, entities were likely to consider a combination of these approaches. In estimating the impact of the event, entities needed to be careful to avoid double-counting the effects of the various assumptions applied in individual assessments, macroeconomic scenarios and management overlays.

For the purpose of measuring expected credit loss and for determining whether a significant increase in credit risk had occurred, an entity grouped financial instruments on the basis of shared credit risk characteristics and reasonable and supportable information available on a portfolio basis. The occurrence of the coronavirus pandemic might have changed the risk characteristics of certain loans or receivables, because the respective borrowers or customers might have engaged in businesses, or been located in areas, which had become affected, or were more prone to be affected, by the pandemic. Therefore, entities considered (re)segmenting (sub)portfolios as appropriate.

In abnormal circumstances such as those created by the coronavirus pandemic, it might take time before entities detect actual changes in risk indicators for a specific counterparty and be able to reassess the affected exposures. In order to accelerate the reflection of such changes in credit quality not yet detected at an individual borrower level, it might have been appropriate to adjust ratings and the probabilities of default on a collective basis, considering risk characteristics such as the industry or geographical location of the borrowers (see section 6.5 above).

The impact of the coronavirus pandemic was not specific to banks. Corporates using a provision matrix approach to calculate expected credit loss for trade receivables would have needed to make appropriate adjustments to their historical loss rates and reflect the current economic environment as well as forward looking information. For example, a supplier of products or services to the airline industry would likely have had to consider that the probability of default (or loss rates, if a provision matrix approach is used) of its customers had increased irrespective of specific events identified at the level of individual counterparties. Many methods for performing collective assessments make use of historical information, which potentially are not relevant in the circumstances. Further, it might have been necessary to reconsider if loans needed to be segmented differently than in the past to reflect the risk characteristics.

In estimating probability of default, loss rates and expected credit loss, entities considered the effect of any state aid plans to support customers through various measures (e.g., refinancing measures or other forms of financial support, including guarantees). Additionally, entities using multiple economic scenarios when estimating expected credit losses updated these scenarios to reflect the change in circumstances.

Many financial institutions consider multiple macroeconomic scenarios in the assessment of expected credit losses (see section 6.7 above). In addition to updating gross domestic product expectations for the various scenarios, a challenge was to estimate how the impact of the coronavirus pandemic and any related government programmes affected specific sectors, regions and borrowers, especially as the details surrounding many government programmes continued to evolve.

The IASB educational document noted that a number of assumptions and linkages underlying the way expected credit losses had been implemented prior to the pandemic might no longer hold in such an environment. For example, the relationship between gross domestic product and other macroeconomic variables, such as unemployment and interest rates, and sector-specific variables, such as oil prices, was very likely to be different from what had been experienced in the past and reflected in economic forecasting models. The probability weightings assigned to macroeconomic scenarios might also need to have been revisited.

Lenders also needed to assess how the value of collateral, such as the homes underlying mortgages or commercial property prices, would develop over the next few years. They would also need to take into account any guarantees from governments or other parties that were considered integral to the loans (see section 5.8.1.C above), having assessed the credit standing of the guarantor.

In estimating overlays, entities might consider historical experience. However, it appears clear that the widespread nature and severity of the consequences of the coronavirus pandemic was not directly comparable with any recent similar events. It might have been appropriate for this purpose, to plot several possible scenarios of what might have happened over the forecasting period and assign weightings to them, to ensure that any overlay reflected the inherent uncertainty and non-linearity of potential outcomes.

The IASB noted in their educational material that IFRS 9 requires the application of judgement and both requires and allows entities to adjust their approach to determining expected credit losses in different circumstances.

7.8.4 Determining whether there has been a significant increase in credit risk

In the context of the coronavirus pandemic, one of the accounting issues was whether concessions made by lenders, such as changes in payment terms and the granting of payment holidays, would result in loans being move from stage 1 to stage 2.

If payment terms were extended in light of the economic circumstances arising from the coronavirus pandemic, the terms and conditions of the extension would have been assessed to determine their impacts on the expected credit loss estimate as well as any other accounting impacts. For example, if the payment terms of a receivable were extended from 90 days to 180 days, this would likely not be considered a substantial modification of the receivable (see section 8 below). However, such an extension might result in an increase in probability of default, which would, in turn, affect the measurement of expected credit loss. For entities which did not apply the simplified model (see section 3.2 above), such extension might also result in moving the receivable to stage 2, depending on the extent and terms of the payment extension. However, if the same extension of payment terms was offered to an entire class of customers irrespective of individual circumstances, this generally would not result, by itself, in a stage movement.

A number of assumptions and linkages underlying the way expected credit losses had been implemented prior to the pandemic might no longer hold in an environment affected by a pandemic or similar macroeconomic event. Entities should not have continued to apply their existing expected credit loss methodology mechanically. The accounting impact of relief measures on expected credit losses depended on the details of the arrangements. For example, the extension of payment holidays or a waiver of a breach of covenant to all borrowers in particular classes of financial instruments would not automatically result in all those instruments being viewed as having suffered a significant increase in credit risk. This would be the case even if a moratorium resulted in a loss for the lender (e.g., if interest payments were reduced or waived), if it was provided irrespective of the borrowers' individual circumstances and the extension of payment holidays was assessed to be modifications rather than derecognition of the financial instruments (see section 8 below).

In other situations, if relief measures were available only to those who met certain criteria, entities would need to carefully assess whether such criteria themselves might have indicated a significant increase in credit risk for the affected borrowers. For instance, a significant increase in credit risk was more likely to have occurred if a borrower applied for a relief measure which was available only to corporates which had suspended operations or individuals who had lost employment. Another example was if the relief, such as a deferral of loan payments, was offered to all participants in certain industries. This circumstance might indicate that borrowers in that industry were exposed to a higher risk of business failure and, thus, a higher probability of default as a class. In combination with other reasonable and supportable information, this was more likely to result in the classification of the related loans and other exposures in this portfolio, or a portion of them, into stage 2. The assessment of significant increase in credit risk is made irrespective of the fact that a concession is imposed by laws or regulations. Entities were also expected to exercise judgement, in light of all facts and circumstances, including the effect of government support, to determine if the respective loans were credit-impaired and were therefore classified as stage 3.

Regulators have stressed, in the context of the coronavirus epidemic, the need when assessing borrowers to differentiate a temporary liquidity need from a significant increase in credit risk and highlighted that there might have been very limited information available to make this determination at an individual borrower level. This means that lenders distinguished between obligors whose long-term credit risk was unlikely to be significantly affected by the pandemic from those who might be more permanently impacted. In light of the above, the 30 days past due backstop assumption might need to be rebutted in these circumstances (see section 6.2.2 above).

Entities whose models included payment holidays or waiver of a covenant breach as an automatic significant increase in credit risk triggers might have needed to include overlays to unwind the effects if they determined that the significant increase in credit risk trigger was not warranted in this situation. For retail loans, data would often not be available to determine whether a significant increase in credit risk had occurred for individual borrowers. For wholesale exposures, more information was generally available on individual obligors, although the significant increase in credit risk assessment would still have been difficult. A lender might consider that borrowers in certain industries (e.g., airlines, tourism and hospitality) were exposed to a higher risk of business failure and, thus, an increased probability of default.

When it was not practical to determine significant increase in credit risk on an individual basis, a collective approach to staging was considered (see section 6.5 above). This would also have been challenging. A possible method could have been to transfer to stage 2 a portion of those customers who had been given a payment holiday or a waiver of a covenant breach, whose probability of default was already close to the level that would trigger a significant increase in credit risk. Any approach would have required considerable judgement.

Where additional rounds of relief measures were extended to existing borrowers, the same considerations which were applicable to assessing the initial relief were also applicable in determining whether the additional relief constituted a significant increase in credit risk. If the extension of the relief measures was offered only to selected borrowers (e.g., upon individual requests), it might have been harder to conclude that a significant increase in credit risk had not occurred, as the need for additional relief might be in response to further deterioration in the borrower's financial position.

7.8.5 Disclosures

Given the level of uncertainty and the sensitivity of judgements and estimates, the disclosure of the key assumptions used, and judgements made in estimating expected credit losses, as well as the concentration of risk, liquidity risk and the impact of any relief measures, were important (see section 15 below and Chapter 50 at section 5.3). Important disclosures would have included, for example, the values of the key macroeconomic inputs used in the multiple economic scenario analysis and the probability weights of these scenarios, as well as the assumptions used to determine how the different challenges for specific sectors and regions had been taken into account and the effect of any management overlays.

In addition, entities provided disclosures to allow users of financial statements to understand the nature of any material reliefs offered to their borrowers, including those enforced by governments, and how they had assessed whether they constituted forbearance, whether they resulted in a substantial modification of the contract, their effect on staging and the impact on the overall expected credit loss. Entities also disclosed any material form of government grant or government assistance received in accordance with IAS 20.

Entities also considered any guidance and expectations on disclosures of expected credit losses issued by prudential and securities regulators in their jurisdictions.

How we see it

The assessment of the impact of the coronavirus pandemic and recovery on expected credit losses required significant judgement, especially as it was not directly comparable with any recent similar events and the impact depended on government measures as much as the spread of the virus. Entities would have updated their macroeconomic scenarios and considered the use of top-down 'management overlays' to embed in the expected credit loss risks not otherwise fully captured by their models or to avoid overstating expected credit losses. Given the level of uncertainty and the sensitivity of judgements and estimates, disclosures of the key assumptions used and judgements made in estimating expected credit losses, as well as the impact of any relief measures, was important.

To promote consistency and enable comparability of the expected credit loss estimate in those instances, banks were expected to provide additional quantitative and qualitative disclosures. The disclosures banks presented included the following, where relevant:

- An explanation of the nature of the adjustments and how these were calculated for each material overlay and 'in' or 'post' model adjustment.
- The reasons for the adjustment and impact, specifically what risks it addressed, including whether it was made to incorporate scenarios that could not be modelled without undue cost or effort (for example, to incorporate the impact of certain forms of government support or to include the most recent macroeconomic information available), to address model limitations (for example, the fact that the model results were based on outdated correlations or assumptions), adjust the expected increase in delinquency currently concealed by moratoria or reflect increased sectorial idiosyncrasies.
- Quantitative analysis, including, as a minimum, the absolute size of the adjustment, the overall effect on the expected credit loss estimate resulting from it, especially if materially changed compared to the last year-end, and narrative to explain the movements and expectations on timing of withdrawal going forward. Alternatively, the impact could have been disclosed as a percentage of the overall expected credit loss.
- Allocation by product, business segment and type of overlay (model adjustments due to models working outside historical observations, uncertainty overlays, sector related overlays, etc.), highlighting possible offsetting effects between different types of overlays (for example, between an overlay applied for potential default suppression due to government support schemes and an overlay applied to adjust probability of defaults when models were working outside historical observations).

How we see it

A number of banks provided quantitative and qualitative information in respect of post-model adjustments and management overlays while others merely mentioned that total expected credit losses included these elements without providing further analysis. Disclosures provided were diverse, with some banks breaking down these elements into the segments/portfolios/products they related to, while others referred to them without providing a numerical analysis or merely providing a total. Given the significant size of the model adjustments and management overlays, we would expect increased transparency and granularity in the relevant disclosures and that such disclosures are sufficiently detailed and clear for the users of the financial statements to understand.

An example of disclosures dealing with the impact of the coronavirus pandemic on expected credit losses, methodology, critical estimates and judgements, how economic scenarios were reflected in expected credit loss calculations and management judgemental adjustments to the expected credit loss of a bank is illustrated in Practical example 7-1 below.

Practical example 7-1: HSBC Holdings plc (2022) **United Kingdom**

Annual Report and Accounts 2022 [extract]
Risk review [extract]
Credit risk [extract]

Measurement uncertainty and sensitivity analysis of ECL estimates

(Audited)

The recognition and measurement of ECL involves the use of significant judgement and estimation. We form multiple economic scenarios based on economic forecasts, apply these assumptions to credit risk models to estimate future credit losses, and probability weight the results to determine an unbiased ECL estimate. Management judgemental adjustments are used to address late-breaking events, data and model limitations, model deficiencies and expert credit judgements.

Amid a deterioration in the economic and geopolitical environment, management judgements and estimates continued to be subject to a high degree of uncertainty in relation to assessing economic scenarios for impairment allowances in 2022.

Inflation, economic contraction and high interest rates, combined with an unstable geopolitical environment and the effects of global supply chain disruption, contributed to elevated levels of uncertainty during the year.

At 31 December 2022, as a result of this uncertainty, additional stage 1 and 2 impairment allowances were recognised. Management continued to reflect a degree of caution both in the selection of economic scenarios and their weightings, and in the use of management judgemental adjustments, described in more detail below.

At 31 December 2022, there was a reduction in management judgemental adjustments compared with 31 December 2021. Adjustments related to Covid-19 and for sector-specific risks were reduced as scenarios and modelled outcomes better reflected the key risks at 31 December 2022.

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Description of economic scenarios

The economic assumptions presented in this section have been formed by HSBC with reference to external forecasts and estimates, specifically for the purpose of calculating ECL.

Economic forecasts in the Central scenario remain subject to a high degree of uncertainty. Upside and Downside scenarios are constructed so that they encompass the potential crystallisation of a number of key macro-financial risks.

At the end of 2022, risks to the economic outlook included the persistence of high inflation and its consequences on monetary policy. Rapid changes to public policy also increased forecast uncertainty.

In Asia, the removal of Chinese Covid-19-related public health restrictions presents a key source of potential upside risk, but with significant near-term uncertainty relating to a subsequent surge of infections. This policy change could also have global implications.

In Europe, risks relating to energy pricing and supply security remain significant. Geopolitical risks also remain significant and include the possibility of a prolonged and escalating Russia-Ukraine war, continued differences between the US and other countries with China over a range of economic and strategic issues, and the evolution of the UK's relationship with the EU.

Economic forecasts for our main markets deteriorated in the fourth quarter as GDP growth slowed. In North America and Europe, high inflation and rising interest rates have reduced real household incomes and raised business costs, dampening consumption and investment and lowering growth expectations. The effects of higher interest rate expectations and lower growth are evident in asset price expectations, with house prices forecasts, in particular, significantly lower.

In Asia, forecasts for Hong Kong and mainland China were cut following weaker than expected third-quarter GDP growth, and due to China's adherence to a stringent pandemic-related public health policy response for the majority of the year. While China made an abrupt reversal of the policy in December and GDP is expected to recover in 2023, there remains a very high degree of uncertainty to both the upside and downside, and consensus forecasts have been slow to adjust. The increased uncertainty over China's lifting of the restrictions has been reflected in management's assessment of scenario probabilities.

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Scenario weighting

In reviewing the economic conjuncture, the level of risk and uncertainty, management has considered both global and country-specific factors. This has led management to assign scenario probabilities that are tailored to its view of uncertainty in individual markets.

Key consideration around uncertainty attached to the Central scenario projections focused on:

- the progression of the Covid-19 pandemic in Asian countries, and the announcement of the removal of Covid-19-related measures and travel restrictions in mainland China and Hong Kong;
- further tightening of monetary policy, and the impact on borrowing costs in interest-rate sensitive sectors, such as housing;
- the risks to gas supply security in Europe, and the subsequent impact on inflation and commodity prices and growth; and
- the ongoing risks to global supply chains.

In mainland China and Hong Kong, the announcement of the relaxation of Covid-19-related measures and travel restrictions has led to increased uncertainty around the Central scenario projection. It was management's view that the easing of the policy could increase risks to the upside in the form of increased spending and travel. However, the continuing risks to the downside were also acknowledged, given the surge in Covid-19 infections and the potential for a new vaccine-resistant variant. This led management to assign a combined weighting of 75% to the consensus Upside and Central scenarios in both markets.

In the UK and US, the surge in price inflation and a squeeze on household real incomes have led to strong monetary policy responses from both central banks. Higher interest rates have increased recession risks and the prospects for outright decline in house prices. The UK faces additional challenges from the rise in energy prices and accompanying deterioration in the terms of trade. For Canada and Mexico, similar risk themes dominate, and the connectivity to the US has also been a key consideration. For the UK, the consensus Upside and Central scenarios had a combined weighting of 65%. In each of the other three markets, the combined weightings of the consensus Upside and Central scenarios were 75%.

In France, uncertainties around the outlook remain elevated due to high inflation and Europe's exposure to the Russia-Ukraine war through the economic costs incurred from the imposition of sanctions, trade disruption and energy dependence on Russia. The consensus Upside and Central scenarios had a combined weighting of 65%.

Management concluded that the outlook for the UAE was the least uncertain of all our key markets. It is benefiting from higher commodity prices and the revival in tourism and travel. The consensus Upside and Central scenarios had a combined weighting of 75%.

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Critical estimates and judgements

The calculation of ECL under IFRS 9 involves significant judgements, assumptions and estimates. The level of estimation uncertainty and judgement has remained elevated since 31 December 2021, including judgements relating to:

- the selection and weighting of economic scenarios, given rapidly changing economic conditions and a wide dispersion of economic forecasts. There is judgement in making assumptions about the effects of inflation and interest rates, global growth, supply chain disruption; and
- estimating the economic effects of those scenarios on ECL, particularly as the historical relationship between macroeconomic variables and defaults might not reflect the dynamics of current macroeconomic conditions.

How economic scenarios are reflected in ECL calculations

Models are used to reflect economic scenarios on ECL estimates. As described above, modelled assumptions and linkages based on historical information could not alone produce relevant information under the conditions experienced in 2022, and management judgemental adjustments were still required to support modelled outcomes.

We have developed globally consistent methodologies for the application of forward economic guidance into the calculation of ECL for wholesale and retail credit risk. These standard approaches are described below, followed by the management judgemental adjustments made, including those to reflect the circumstances experienced in 2022.

For our wholesale portfolios, a global methodology is used for the estimation of the term structure of probability of default ('PD') and loss given default ('LGD'). For PDs, we consider the correlation of forward economic guidance to default rates for a particular industry in a country. For LGD calculations, we consider the correlation of forward economic guidance to collateral values and realisation rates for a particular country and industry. PDs and LGDs are estimated for the entire term structure of each instrument.

For impaired loans, LGD estimates take into account independent recovery valuations provided by external consultants where available or internal forecasts corresponding to anticipated economic conditions and individual company conditions. In estimating the ECL on impaired loans that are individually considered not to be significant, we incorporate the forward economic guidance proportionate to the probability-weighted outcome and the Central scenario outcome of the performing population.

For our retail portfolios, the impact of economic scenarios on PD is modelled at a portfolio level. Historical relationships between observed default rates and macroeconomic variables are integrated into IFRS 9 ECL estimates by using economic response models.

The impact of these scenarios on PD is modelled over a period equal to the remaining maturity of the underlying asset or assets. The impact on LGD is modelled for mortgage portfolios by forecasting future loan-to-value profiles for the remaining maturity of the asset by using national level forecasts of the house price index and applying the corresponding LGD expectation.

These models are based largely on historical observations and correlations with default rates. Management judgemental adjustments are described below.

Management judgemental adjustments

In the context of IFRS 9, management judgemental adjustments are typically short-term increases or decreases to the ECL at either a customer, segment or portfolio level to account for late-breaking events, model and data limitations and deficiencies, and expert credit judgement applied following management review and challenge.

This includes refining model inputs and outputs and using adjustments to ECL based on management judgement and higher-level quantitative analysis for impacts that are difficult to model.

The effects of management judgemental adjustments are considered for both balances and ECL when determining whether or not a significant increase in credit risk has occurred and is allocated to a stage where appropriate. This is in accordance with the internal adjustments framework.

Management judgemental adjustments are reviewed under the governance process for IFRS 9 (as detailed in the section 'Credit risk management' on page 145). Review and challenge focuses on the rationale and quantum of the adjustments with a further review carried out by the second line of defence where significant. For some management judgemental adjustments, internal frameworks establish the conditions under which these adjustments should no longer be required and as such are considered as part of the governance process. This internal governance process allows management judgemental adjustments to be reviewed regularly and, where possible, to reduce the reliance on these through model recalibration or redevelopment, as appropriate.

The drivers of management judgemental adjustments continue to evolve with the economic environment and as new risks emerge.

At 31 December 2022, there was a $0.9bn reduction in management judgemental adjustments compared with 31 December 2021. Adjustments related to Covid-19 and for sector-specific risks were reduced as scenarios and modelled outcomes better reflected the key risks at 31 December 2022.

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Another example of disclosure dealing with the impact of the coronavirus pandemic on expected credit losses of a corporate is illustrated in Practical example 7-2 below.

Practical example 7-2: Centrica plc (2021) **United Kingdom**

Annual Report and Accounts 2021 [extract]

Notes to the Financial Statements [extract]

3. Critical accounting judgements and key sources of estimation uncertainty [extract]

Credit provisions for trade and other receivables

The economic effects of the significant increase in wholesale gas and electricity costs, and resultant increase in consumer tariffs alongside wider inflationary pressures as well as the ongoing effects of the COVID-19 pandemic and cost of living pressures have impacted the ability of the Group's customers to pay amounts due. The level of estimation uncertainty in determining the credit provisions required for customers in different sectors and geographies continues to be raised.

The methodology for determining provisions for credit losses on trade and other receivables and the level of such provision, along with associated sensitivities, are set out in note 17. Although the provisions recognised are considered appropriate, the use of different assumptions or changes in economic conditions could lead to movements in the provisions and therefore impact the Group Income Statement.

17. Trade and other receivables, and contract-related assets

Sensitivity to changes in assumptions

Typically, the most significant assumption included within the expected credit loss provisioning model that gives rise to estimation uncertainty is that future performance will be reflective of past performance and that there will be no significant change in the payment profile or recovery rates within each identified group of receivables. To address this risk, the Group reviews and updates default rates, by group, on a regular basis to ensure they incorporate the most up to date assumptions along with forward-looking information where available and relevant. The Group also considers regulatory changes and customer segment specific factors that may have an impact, now or in the future, on the recoverability of the balance.

The specific consideration of forward-looking information in the impairment model does not usually give rise to significant changes in the levels of credit losses. However, inflationary pressures, increasing wholesale gas and electricity costs and the impacts of the global COVID-19 pandemic, continue to cause uncertainty in economic outlook. The economic recovery remains vulnerable and there remains a level of estimation uncertainty inherent in determining credit loss provisions for the Group's trade receivables.

Where customers experience difficulties in settling balances, the increased ageing of these amounts results in an increase in provisions held in respect of them under the provision matrix approach employed. The Group has also considered changes in customer payment patterns, the specific circumstances of the customers and the economic impacts of the factors identified above, on the sectors in which they operate. Whilst economic recovery is expected, a level of unpredictability remains apparent.

The Group has considered macroeconomic forecasts in determining the level of provisions for credit losses. Customers are facing increases to their cost of living, including increased energy bills, higher inflation and higher interest rates. Support received under COVID-19 assistance programmes has now been withdrawn. Unbilled energy income is more susceptible to credit risk from such forward-looking factors due to the length of time between the balance sheet date and collection of the amounts in cash. The Group considers that future economic growth remains modest.

During 2021 the Group recognised impairment charges of £116 million (2020: £195 million) in respect of financial assets, representing 0.8% of Group revenue (2020: 1.6%) and 0.6% of Group revenue from business performance (2020: 1.3%). The lower impairment charges in 2021 are driven by a reversion to a normalised level of bad debt charges. The prior year included a £30 million macroeconomic uplift. As described above, the majority of the Group's credit exposure arises in respect of downstream energy receivables in British Gas Energy and Centrica Business Services. Credit losses in respect of these assets amounted to £104 million (2020: £179 million). This represents 1.1% (2020: 2.2%) of total UK downstream energy supply revenue from these segments of £9,162 million (2020: £8,262 million). Further details of segmental revenue are provided in note 4.

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7.9 Accounting for climate change

Climate change may affect an entity's assessment of expected credit losses, potentially leading to higher allowances for expected credit losses. The longer the term of the exposures and the greater the extent to which the counterparty is likely to be affected by climate change, the greater this effect is likely to be. Moreover, there is also the risk of climate change related rare shock events that needs to be taken into account, e.g., severe drought or heavy rainfall causing severe flooding, potentially resulting in damage to crops and homes, rising food prices and driving individuals and businesses into financial difficulties (see section 5.6.3 above) which could occur in the short term.

IFRS 9 requires use of forward-looking information to recognise expected credit losses. There is a variety of increasingly possible adverse future climate risk economic scenarios that could impact the probability of borrowers defaulting and the extent of losses that lenders may incur in the event of default. Climate risks are broadly categorised into physical and transition risks:

- Physical risks include the risk of loss due to specific weather events (such as storms or wildfires) and due to longer-term changes in weather trends (such as rising sea levels). Physical risks can impact the creditworthiness of borrowers due to business interruption, impacts on economic strength, asset values and unemployment.
- Transition risks relate to the risk of financial loss due to the economic transition toward a more sustainable economy. Transition risks could also result in a rapid deterioration of credit quality in sectors and/or countries affected, particularly if policy changes are radical or quickly implemented, and these factors are considered in a borrower's ability to repay and service debt.

From a credit risk perspective, physical and transition risks related to climate change could potentially impact:

- Probability of default affects staging of exposures and the measurement of expected credit loss allowances. Historical correlations that predict defaults may no longer be relevant. Methods for risk rating customers may, therefore, need to be updated as new financial and non-financial metrics capturing the impacts of climate change are made available. The impact of regulatory actions should also be considered.
- Loss given default affects the ultimate measurement of the expected credit loss allowance. Physical and transition risks may affect collateral values, for example, on mortgage loans, and lead to entities employing different collection strategies for distressed debt.
- Entities may make use of judgemental in-model or post-model adjustments to incorporate climate risks into their expected credit loss allowances, particularly in the short term due to data and model limitations. Enhanced governance processes will be required to support these judgements.
- Entities may need to incorporate climate risk factors into their macroeconomic scenarios and forward-looking information. The impact of climate risks on these scenarios is likely to be greater, the longer the duration of the underlying exposures and the greater an entity's exposure is to vulnerable sectors or geographies.
- Climate risk is likely to increase concentration risk exposures in vulnerable sectors or geographies. Sectors like agriculture and insurance may be particularly vulnerable to physical risks. For example, mining and oil and gas may be particularly exposed to transition risk. Some geographies such as those at or close to sea level or exposed to drought or flooding may be particularly exposed to physical risks. Entities will need to consider high risk sectors, industries, portfolios or geographies which require a collective staging assessment, e.g., high risk industries for climate change, mortgages in high flood-risk area and loans to the energy sector. Also, changes in risk concentrations may affect the modelling of expected credit loss allowances and the disclosure of credit risk concentrations.

Entities, particularly those with large credit risk exposures like banks, are in various stages of integrating climate risks into their risk frameworks, and there exist several challenges in this regard:

- Climate-related risks are uncertain, non-linear and pervasive.
- There are multiple projections and scenarios available to understand the size and impact of climate risk, but limited projections for economic and financial effects.
- Data and projections available are not always comparable, given divergence in taxonomies and standards globally.
- Entities need to collect new types of data on their customers and put in place new processes and governance.
- Identifying the right metrics to measure climate risk exposure can be challenging.
- Clarity or consensus on incorporating climate scenario analysis into risk assessments is still emerging.

This is an area which is likely to develop as the increased publication of sustainability reports will result in more data being available for use in ECL modelling. This is an area which attracts the attention of regulators and is likely to continue to do so. Regulators are also focussing on the connectivity between accounting and sustainability standards.

Practical example 7-3 shows how National Australia Bank Limited considered its exposure to climate risks as part of its credit risk assessment in its 2023 annual financial statements. In this example, the exposure to environmental, social and governance risks have been captured as part of a forward-looking adjustment.

Practical example 7-3: National Australia Bank Limited (2023) **Australia**

ANNUAL FINANCIAL REPORT 2023 [extract]
NOTES TO THE FINANCIAL STATEMENTS [extract]
NOTE 19 FINANCIAL RISK MANAGEMENT [extract]
Credit risk [extract]

ESG risks

The Group is exposed to ESG and other emerging risks. The following items are examples of how these risks may impact the Group:

- Increases in the frequency and severity of climatic events could impact customers' ability to service their loans or the value of the collateral held to secure the loans.
- Action taken by governments, regulators and society more generally, to transition to a low-carbon economy, could impact the ability of some customers to generate long-term returns in a sustainable way or lead to certain assets being stranded in the future.
- Failure to comply with environmental and social legislation (emerging and current) may impact customers' ability to generate sustainable returns and service their loans.
- If in future customers don't hold appropriate levels of insurance for physical assets against certain risks, this may impact the value the Group can recover in the event of certain natural disasters.

The Group considers these risks as part of the credit risk assessment and due diligence process before relevant customers are granted credit and for new product development. The Group also manages its total credit portfolio within established risk appetite and limits, particularly for specific industries or regions that are more exposed to these types of risks. In addition, the Group may recognise FLAs to the provision for credit impairment for the impact of adverse climate events. In the 2022 financial year, the Group recognised a FLA of $14 million for the potential impact of the Lismore floods (2023: nil).

Practical example 7-4 shows how ABN AMRO Bank N.V. accounted for the potential transition risk by including a management overlay in the ECL calculation.

Practical example 7-4: ABN AMRO Bank N.V. (2023) **Netherlands**

INTEGRATED ANNUAL REPORT 2023 [extract]
Risk, funding & capital [extract]
Risk management [extract]
Credit risk review [extract]
Individual and collective loan impairment allowances and management overlays [extract]

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During 2023, management overlays decreased to a total of EUR 260 million (31 December 2021: EUR 328 million). Overlays were mainly in place for risks in the corporate loans portfolio and comprised the following items:

- A management overlay of EUR 86 million (31 December 2022: EUR 123 million) that is applied for the geopolitical effects that are not fully captured by the latest projections in our macroeconomic scenarios (previously: overlay for the war in Ukraine)
- To cover anticipated additional risk costs relating to the wind-down of portfolios an overlay of EUR 31 million is in place. As the wind-down of the CIB non-core portfolio was completed this overlay was lowered in 2023 (31 December 2022: EUR 61 million)
- A new overlay of EUR 25 million was introduced for climate transition risk, following an update of the climate and environmental risk materiality assessment
- The overlay that was formed for the potential impact of the government's nitrogen reducing measures on clients in livestock farming businesses in the Netherlands amounting to EUR 35 million (31 December 2022: EUR 34 million)

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In its 2023 Annual report, UBS Group AG disclosed the impact of sustainability and climate risk on the measurement of ECL. As shown in Practical example 7-5, while the impact was not material, the reasons for this outcome were disclosed.

Practical example 7-5: UBS Group AG (2023) **Switzerland**

Annual Report 2023 [extract]
5 Financial statements [extract]
Consolidated financial statements [extract]
UBS Group AG consolidated financial statements [extract]
Notes to the UBS Group AG consolidated financial statements [extract]
Additional information [extract]
Note 20 Expected credit loss measurement [extract]
f) Sensitivity information [extract]

Sustainability and climate risk

Sustainability and climate risk may negatively affect clients or portfolios due to direct or indirect transition costs, or exposure to physical risks in locations likely to be impacted by climate change. Such effects could lead to a deterioration in credit worthiness, which in turn would have an impact on ECLs.

While some macroeconomic indicators used in the current PD models could be influenced by climate change, UBS currently does not use a specific sustainability and climate risk scenario in addition to the typically four general economic scenarios applied to derive the weighted-average ECL. The rationale for the approach at this point in time is the significance of model risks and challenges in calibration and probability weight assessment given the paucity of data.

Instead, UBS focuses on the process of vetting clients and business transactions and takes individual actions, where transition risk is deemed to be a significant driver of a counterparty's credit worthiness. This review process may lead to a downward revision of the counterparty's credit rating, or the adoption of risk mitigating actions, and hence affect the individual contribution to ECLs.

At the portfolio level, UBS has started to use stress loss assumptions to assess the extent to which sustainability and climate risk may affect the quality of the loans extended to small and medium-sized entities, large corporate clients and financial institutions. Initial tests were based on a set of assumptions presented by external parties (such as the Bank of England) and complemented by internally derived climate pathway scenarios. Such analysis undertaken during 2022 and reassessed during 2023 concluded that the counterparties are not expected to be significantly impacted by physical or transition risks, mainly as there are no material risk concentrations in high-risk sectors. The analysis of the corporate loan book has also shown that any potential significant impacts from transition costs or physical risks would materialize over a time horizon that exceeds in most cases the contractual lifetime of the underlying assets. Based on current information on regulatory developments, this would also apply to the portfolio of private clients' mortgages and real estate financing, given the long lead times for investments in upgrading housing stock.

As a result of the aforementioned factors, it was assessed that the magnitude of any impact of sustainability and climate risk on the weighted-average ECL would not be material as of 31 December 2023. Therefore, no specific post-model adjustment was made in this regard.

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In its 2023 Annual report NatWest Group plc disclosed it was including climate related assumptions into its macroeconomic model and quantified an ECL impact.

Practical example 7-6: NatWest Group plc (2023) **United Kingdom**

2023 Annual Report and Accounts [extract]
Risk and Capital Management [extract]
Credit Risk [extract]
Economic Loss Drivers [extract]

Climate transition

During 2023, NatWest Group continued to align its financial planning process with the climate transition planning process. This included adding climate policy and technology related transition assumptions into NatWest Group's base case macroeconomic scenario used for financial planning and assessment of ECL in this IFRS 9 reporting period. This resulted in an increase in ECL of less than £1 million.

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It is important to note that the factors outlined here should be considered by any entity that holds financial assets that are in the scope of the IFRS 9 impairment requirements - this includes financial institutions, as well as corporates. For example, Practical example 7-6 discloses how Rolls-Royce plc considered the impact of potentially vulnerable sectors when estimating ECL.

Practical example 7-7: Rolls-Royce Holdings plc (2023) **United Kingdom**

Annual Report 2023 [extract]
FINANCIAL STATEMENTS [extract]
Notes to the consolidated financial statements [extract]
1 Accounting policies [extract]
Climate change [extract]

Recoverability of trade receivables and contract assets – The impact of climate-related matters could have an impact on the Group's customers in the future, especially those customers in the Civil Aerospace division. No material climate-related issues have arisen during the year that have impacted the assessment of the recoverability of receivables. The Group's expected credit loss (ECL) provision uses credit ratings which inherently will include the market's assessment of the climate change impact on credit risk of the counter parties. Given the maturity time of trade receivables and the majority of contract assets, climate change is unlikely to cause a material increase on counter party credit risk in that time.

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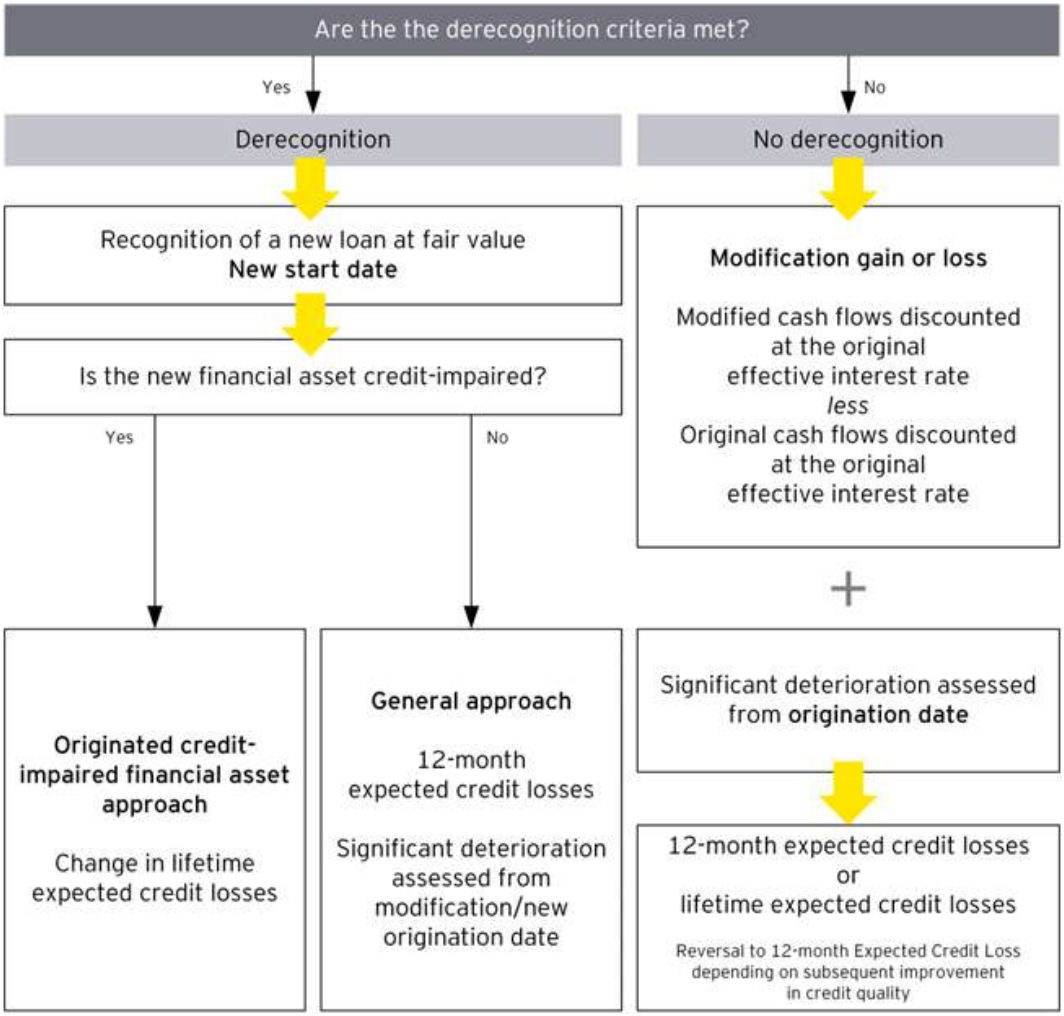
How we see it

The effect of climate risk on an entity's expected credit loss calculations is likely to be greater the longer the duration of the underlying exposures and the greater the entity's exposure to vulnerable sectors or geographies, although physical risks may also lead to short term exposures. Given the judgemental nature of incorporating climate risks into expected credit loss calculations, it is important that entities establish strong governance processes to support material judgements that they make in this regard, and that there are enhanced disclosures made about the risks and the impact of significant judgements and estimation uncertainty.

8 Modified financial assets

If the contractual cash flows on a financial asset are renegotiated or modified, the holder needs to assess whether the financial asset is derecognised (see Chapter 48 at section 3.5 and Chapter 46 at section 3.8 for further details on modification and derecognition). In summary, an entity should derecognise a financial asset if the cash flows are extinguished or if the terms of the instrument have substantially changed. This applies to all modifications whether they result from commercial or other reasons that are unrelated to credit risk.

Figure 8-1: Application of the derecognition and modification requirements and their interaction with expected credit loss assessment



8.1 Accounting treatment if modified financial assets are derecognised

In some circumstances, the renegotiation or modification of the contractual cash flows of a financial asset can lead to the derecognition of the existing financial asset and subsequently, the recognition of a new financial asset. *[IFRS 9.B5.5.25]*. This means that the entity is starting fresh and the date of the modification will also be the date of initial recognition of the new financial asset at its fair value. Typically, the entity will recognise a loss allowance based on 12-month expected credit losses at each reporting date until the requirements for the recognition of lifetime expected credit losses are met. However, in what IFRS 9 describes as 'some unusual circumstances' following a modification that results in derecognition of the original financial asset, there may be evidence that the new financial asset is credit-impaired on initial recognition (see section 3.3 above). Thus, the financial asset is recognised as an originated credit-impaired financial asset. *[IFRS 9.B5.5.26]*.

8.2 Accounting treatment if modified financial assets are not derecognised

In other circumstances, the renegotiation or modification of the contractual cash flows of a financial asset does not lead to the derecognition of the existing financial asset under IFRS 9. In such situations, the entity will:

- Continue with its current accounting treatment for the existing asset that has been modified.
- Recognise a modification gain or loss in profit or loss by recalculating the gross carrying amount of the financial asset as the present value of the renegotiated or modified contractual cash flows, discounted at the financial asset's original effective interest rate (or the credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets). Any costs or fees incurred adjust the carrying amount of the modified financial asset and are amortised over the remaining term of the modified financial asset (see section 3.1 above). *[IFRS 9.5.4.3, IFRS 9 Appendix A]*.
- Assess whether there has been a significant increase in the credit risk of the financial instrument, by comparing the risk of a default occurring at the reporting date (based on the modified contractual terms) and the risk of a default occurring at initial recognition (based on the original, unmodified contractual terms). A financial asset that has been renegotiated or modified is not automatically considered to have lower credit risk. The assessment considers the credit risk over the expected life of the asset based on historical and forward-looking information, including information about the circumstances that led to the modification. Evidence that the criteria for the recognition of lifetime expected credit losses are subsequently no longer met may include a history of up-to-date and timely payment in subsequent periods. This means a minimum period of observation will often be necessary before a financial asset may qualify to return to stage 1. *[IFRS 9.5.5.12, IFRS 9.B5.5.27]*.
- Make the appropriate quantitative and qualitative disclosures required for renegotiated or modified assets to enable users of financial statements to understand the nature and effect of such modifications (including the effect on the measurement of expected credit losses) and how the entity monitors its assets that have been modified (see section 15 below and Chapter 50 at section 5.3). *[IFRS 7.35F(f), IFRS 7.B8B, IFRS 7.35J]*.

If a financial asset is modified as part of forbearance and the modification results in forgiveness of part of the contractual cash flows, the entity might need to consider whether any portion of the financial asset should be written off before the modification takes place.

The following Illustration has been adapted from Example 11 of the Illustrative Examples to IFRS 9 to illustrate the accounting treatment of a loan that is modified. It is noted that it does not consider whether any of the contractual cash flows are written off, as a partial derecognition. *[IFRS 9.IE Example 11, IFRS 9.IE66-IE73]*.

Illustration 8-1: Modification of contractual cash flows

Bank A originates a five-year loan that requires the repayment of the outstanding contractual amount in full at maturity. Its contractual par amount is CU1,000 with an interest rate of 5%, payable annually. The effective interest rate is 5%. At the end of the first reporting period in Year 1, Bank A recognises a loss allowance at an amount equal to 12-month expected credit losses because there has not been a significant increase in credit risk since initial recognition. A loss allowance balance of CU20 is recognised. In Year 2, Bank A determines that the credit risk on the loan has increased significantly since initial recognition. As a result, Bank A recognises lifetime expected credit losses on the loan. The loss allowance balance is CU150 at the end of year 2.

At the end of Year 3, following significant financial difficulty of the borrower, Bank A modifies the contractual cash flows on the loan. It forgoes interest payments beyond year 3 until maturity and extends the contractual term of the loan by one year so that the remaining term at the date of the modification is three years. The modification does not result in the derecognition of the loan by Bank A.

As a result of that modification, Bank A recalculates the gross carrying amount of the financial asset as the present value of the modified contractual cash flows discounted at the loan's original effective interest rate of 5%. The difference between this recalculated gross carrying amount and the gross carrying amount before the modification is recognised as a modification gain or loss. Bank A recognises the modification loss (calculated as CU136) against the gross carrying amount of the loan, reducing it to CU864, and a modification loss of CU136 in profit or loss.

Bank A also remeasures the loss allowance, taking into account the modified contractual cash flows and evaluates whether the loss allowance for the loan continues to be measured at an amount equal to lifetime expected credit losses. Bank A compares the current credit risk (taking into consideration the modified cash flows) to the credit risk (on the original unmodified cash flows) at initial recognition. Bank A determines that

the loan is not credit-impaired at the reporting date but that credit risk has still significantly increased compared to the credit risk at initial recognition. It continues to measure the loss allowance at an amount equal to the lifetime expected credit loss, which is CU110 at the reporting date.

At each subsequent reporting date, Bank A continues to evaluate whether there has been a significant increase in credit risk by comparing the loan's credit risk at initial recognition (based on the original, unmodified cash flows) with the credit risk at the reporting date (based on the modified cash flows).

Two reporting periods after the loan modification (Year 5), the borrower has outperformed its business plan significantly compared to the expectations at the modification date. In addition, the outlook for the business is more positive than previously envisaged. An assessment of all reasonable and supportable information that is available without undue cost or effort indicates that the overall credit risk on the loan has decreased and that the risk of a default occurring over the expected life of the loan has decreased, so Bank A adjusts the borrower's internal credit rating at the end of the reporting period.

Given the positive overall development, Bank A re-assesses the situation and concludes that the credit risk of the loan has decreased and there is no longer a significant increase in credit risk since initial recognition. As a result, Bank A once again measures the loss allowance at an amount equal to 12-month expected credit losses.

Year	Beginning gross carrying amount CU	Impairment (loss)/gain CU	Modification (loss)/gain CU	Interest revenue CU	Cash flows CU	Ending gross carrying amount CU	Loss allowance CU	Ending amortised cost amount CU
	A	B	C	D Gross: A × 5%	E	F = A + C + D - E	G	H = F - G
1	1,000	(20)		50	50	1,000	20	980
2	1,000	(130)		50	50	1,000	150	850
3	1,000	40	(136)	50	50	864	110	754
4	864	24		43		907	86	821
5	907	72		45		952	14	938
6	952	14		48	1,000	0	0	0

Frequently asked questions

Question 8-1: How to determine the expected credit losses in respect of a modified financial asset if the modification had not resulted in a derecognition but the modified cash flows have been renegotiated in such a way as to represent the cash flows which the lender expects the borrower can repay?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 22 April 2015 - Agenda paper no. 8)

At its meeting on 22 April 2015, the IFRS Transition Resource Group for Impairment of Financial Instruments members (see section 1.4 above) noted that IFRS 9 is clear that an entity is required to calculate a new gross carrying amount and the gain or loss on modification taken to profit or loss is based on the renegotiated or modified contractual cash flows and excludes expected credit losses unless it is a purchased or originated credit-impaired financial asset. *[IFRS 9.5.4.3, IFRS 9 Appendix A]*. Consequently, an entity must calculate the gain or loss on modification as a first step before going on to consider the revised expected credit loss allowance required on the modified financial asset. Thereafter, the entity is required to continue to apply the impairment requirements to the modified financial asset in the same way as it would for other unmodified financial instruments, taking into account the revised contractual terms. *[IFRS 9.5.5.12]*. The revised expected credit loss cannot be assumed to be nil as, in accordance with IFRS 9.5.5.18, an entity is required to consider the possibility that a credit loss occurs, even if the likelihood of that credit loss occurring is very low. *[IFRS 9.5.5.18]*.

The IFRS Transition Resource Group for Impairment of Financial Instruments also discussed the appropriate presentation and disclosure requirements pertaining to modifications. These are discussed further in Chapter 50 at section 7.1.1.

How we see it

If an entity has no reasonable expectations of recovering a portion of the financial asset, which is subsequently forgiven, then this amount is arguably written off, as a partial derecognition. The gross carrying amount would be reduced directly before a modification gain or loss is calculated. This would mean that the loss will be recorded as an impairment loss, rather than as a loss on modification, and presented differently in the profit or loss account. In practice, it will often be difficult to disentangle the effects of modification and write-off, as some forgone cash flows may be compensated for by a higher interest rate applied to the remaining contractual amounts due.

9 Financial assets measured at fair value through other comprehensive income

For financial assets measured at fair value through other comprehensive income (see Chapter 44 at section 4.3), the expected credit losses do not reduce the carrying amount of the financial assets in the statement of financial position, which remains at fair value. Instead, an amount equal to the allowance that would arise if the asset was measured at amortised cost is recognised in other comprehensive income as the 'accumulated impairment amount'. *[IFRS 9.4.1.2A, IFRS 9.5.5.2, IFRS 9 Appendix A]*.

9.1 Accounting treatment for debt instruments measured at fair value through other comprehensive income

The accounting treatment and journal entries for debt instruments measured at fair value through other comprehensive income are shown in the following Illustration, based on Illustrative Example 13 in the Illustrative Examples to IFRS 9. *[IFRS 9.IE Example 13, IFRS 9.IE78, IFRS 9.IE79, IFRS 9.IE80, IFRS 9.IE81]*.

Illustration 9-1: Debt instrument measured at fair value through other comprehensive income

An entity purchases a debt instrument with a fair value of CU1,000 on 15 December 20X2 and measures the debt instrument at fair value through other comprehensive income. The instrument has an interest rate of 5% over the contractual term of 10 years, and has a 5% effective interest rate. At initial recognition the entity determines that the asset is not purchased or originated credit-impaired.

Dr	Financial asset - fair value through other comprehensive income		CU1,000	
	Cr	Cash		CU1,000

To recognise the debt instrument measured at its fair value

On 31 December 20X2 (the reporting date), the fair value of the debt instrument has decreased to CU950 as a result of changes in market interest rates. The entity determines that there has not been a significant increase in credit risk since initial recognition and that expected credit losses should be measured at an amount equal to 12-month expected credit losses, which amounts to CU30. For simplicity, journal entries for the receipt of interest revenue are not provided.

Dr	Impairment loss (profit or loss)		CU30	
Dr	Other comprehensive income[(a)]		CU20	
	Cr	Financial asset - fair value through other comprehensive income		CU50

To recognise 12-month expected credit losses and other fair value changes on the debt instrument

(a) The cumulative loss in other comprehensive income at the reporting date was CU20. That amount consists of the total fair value change of CU50 (i.e., CU1,000 - CU950) offset by the change in the accumulated impairment amount representing 12-month expected credit losses that was recognised (CU30).

Disclosure would be provided about the accumulated impairment amount of CU30.

On 1 January 20X3, the entity decides to sell the debt instrument for CU950, which is its fair value at that date.

Dr	Cash		CU950	
	Cr	Financial asset - fair value through other comprehensive income		CU950
Dr	Loss (profit or loss)		CU20	
	Cr	Other comprehensive income		CU20

To derecognise the fair value through other comprehensive income asset and recycle amounts accumulated in other comprehensive income to profit or loss, i.e., CU20

This means that in contrast to financial assets measured at amortised cost, there is no separate allowance but, instead, impairment gains or losses are accounted for as an adjustment of the revaluation reserve accumulated in other comprehensive income, with a corresponding charge to profit or loss (which is then reflected in retained earnings). The tax implications of debt instruments measured at fair value through other comprehensive income is discussed further in Chapter 29 at sections 10.4.1 and 10.4.2.

As explained in section 7.3.1 above, IFRS 9 requires a derecognition gain or loss to be measured relative to the carrying amount at the date of derecognition. This necessitates an assessment and measurement of expected credit losses for that particular asset as at the date of derecognition.

9.2 Interaction between foreign currency translation, fair value hedge accounting and impairment

The above example is relatively straightforward. A more complicated one, based on a foreign currency denominated financial asset which is also the subject of an interest rate hedge, is provided below. It is based on Illustrative Example 14 in the Illustrative Examples to IFRS 9 but has been adjusted so as to include the effect of discounting in the measurement of expected credit losses (see section 5.7 above). *[IFRS 9.IE82-IE102]*. Note that we do not address the additional complexities that will arise from the consideration of taxation, including deferred tax. The tax accounting implications of debt instruments measured at fair value through other comprehensive income is discussed further in Chapter 29 at sections 10.4.1 and 10.4.2.

Illustration 9-2: Interaction between the fair value through other comprehensive income measurement category and foreign currency denomination, fair value hedge accounting and impairment

The example assumes the following fact pattern and that, on initial recognition, expected credit losses are included when measuring foreign exchange gains and losses (see section 7.3.1 above):

- An entity purchases a bond denominated in a foreign currency (FC) for its fair value of FC100,000 on 1 January 20X2.
- The bond is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets and has contractual cash flows which are solely payments of principal and interest on the principal amount outstanding. Therefore, the entity classifies the bond as measured at fair value through other comprehensive income.
- The bond has five years remaining to maturity and a fixed coupon of 5% over its contractual life on the contractual par amount of FC100,000.
- The entity hedges the bond for its interest rate related fair value risk. The fair value of the corresponding interest rate swap at the date of initial recognition is nil.
- On initial recognition, the bond has a 5% effective interest rate which results in a gross carrying amount that equals the fair value at initial recognition.
- The entity's functional currency is its local currency (LC).
- As at 1 January 20X2, the exchange rate is FC1 to LC1.
- At initial recognition, the entity determines that the bond is not purchased credit-impaired. The entity applies a 12-month probability of default for its impairment calculation and assumes that payment default occurs at the end of the reporting period (i.e., after 12 months). In particular, the entity estimates the probability of default over the next 12 months at 2% and the loss given default at FC60,000, resulting in an (undiscounted) expected cash shortfall of FC1,200. The discounted expected cash shortfall is FC1,143 at 5% effective interest rate (see the example below for the detailed calculation).
- For simplicity, amounts for interest revenue are not provided. It is assumed that interest accrued is received in the period. Differences of 1 in the calculations and reconciliations are due to rounding.

The entity hedges its risk exposures using the following risk management strategy:

(a) For fixed interest rate risk (in FC) the entity decides to link its interest receipts in FC to current variable interest rates in FC. Consequently, the entity uses interest rate swaps denominated in FC under which it pays fixed interest and receives variable interest in FC.

(b) For foreign exchange (FX) risk, the entity decides not to hedge against any variability in LC arising from changes in foreign exchange rates.

The entity designates the following hedging relationship: a fair value hedge of the bond in FC as the hedged item with changes in benchmark interest rate risk in FC as the hedged risk. The entity enters into a swap that pays fixed and receives variable interest in FC on the same day and designates the swap as the hedging instrument. The tenor of the swap matches that of the hedged item (i.e., five years). This example assumes that all qualifying criteria for hedge accounting are met (see IFRS 9.6.4.1). The description of the designation is solely for the purpose of understanding this example (i.e., it is not an example of the complete formal documentation required in accordance with IFRS 9.6.4.1).

This example assumes that no hedge ineffectiveness arises in the hedging relationship. This assumption is made in order to better focus on illustrating the accounting mechanics in a situation that entails measurement at fair value through other comprehensive income of a foreign currency financial instrument that is designated in a fair value hedge relationship, and also to focus on the recognition of impairment gains or losses on such an instrument.

The entity decided not to amortise the fair value hedge adjustment to profit or loss before the hedge ceases or the asset is credit-impaired. Consequently, in this example, there is no adjustment to the effective interest rate due to fair value hedge accounting. However, such an adjustment to the effective interest rate would at the latest be required when the entity ceases to apply hedge accounting or when the asset becomes credit-impaired, i.e., moved to stage 3. (See section 7.5 above).

Situation as per 1 January 20X2

The table below illustrates the amounts recognised in the financial statements as per 1 January 20X2, as well as the shadow amortised cost calculation for the bond, based on the fact pattern described above (debits are shown as positive numbers and credits as negative numbers):

Financial Statements			Shadow Calculation		
	FC	LC		FC	LC
	Statement of financial position				
Bond (FV)	100,000	100,000	Gross carrying amount	100,000	100,000
Swap (FV)	-	-	Loss allowance	(1,143)	(1,143)
			Amortised cost	98,857	98,857
	Statement of profit or loss				
Impairment	1,143	1,143	FV hedge adjustment	-	-
FV hedge (bond)	-	-	Adjusted gross carrying amt.	100,000	100,000
FX gain/loss (bond)	-	-	Adjusted amortised cost	98,857	98,857
FV hedge (swap)	-	-			
FX gain/loss (swap)	-	-			
	Statement of other comprehensive income				
FV changes	-	-			
Impairment offset	(1,143)	(1,143)			
FV hedge adjustment	-	-			

As per 1 January 20X2, the entity recognises the bond and the swap at their initial fair values of LC100,000 and nil, respectively. The loss allowance of FC1,143 is recognised in profit or loss. The amount is calculated as the difference between all contractual cash flows that are due to the entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e., all cash shortfalls), discounted at the original effective interest of 5%, and weighted by the probability of the scenario occurring. To keep the example simple, it is assumed that default on the bond occurs one year after the date of the initial recognition, at which point the recoverable amount of the bond is received. This means that in the case of a default the entity expects cash flows of FC45,000 (which is the principal of FC100,000 plus one year of interest of FC5,000 less the loss given default of FC60,000). The latter loss is discounted by the 5% effective interest rate and weighted by the 2% probability of default to arrive at the loss allowance. The table below shows the expected credit loss calculation:

1 January 20X2 (values in FC)		Year 1	Year 2	Year 3	Year 4	Year 5
Contractual cash flows		5,000	5,000	5,000	5,000	105,000
Expected cash flows		45,000				
Expected cash shortfalls		40,000	(5,000)	(5,000)	(5,000)	(105,000)
NPV at 5%	(57,143)					
Probability of default	2%					
Net present value (probability-weighted) - this is the expected credit loss	(1,143)					

In accordance with IFRS 7.16A, the loss allowance for financial assets measured at fair value through other comprehensive income is not presented separately as a reduction of the carrying amount of the financial asset. As a consequence, the offsetting entry to the impairment loss of LC1,143 is recorded in other comprehensive income in the same period.

Situation as at 31 December 20X2

As of 31 December 20X2 (the reporting date), the entity observes the following facts:

- The fair value of the bond has decreased from FC100,000 to FC96,370, mainly because of an increase in market interest rates.
- The fair value of the swap has increased to FC1,837.
- In addition, as at 31 December 20X2, the entity determines that there has been no change to the credit risk on the bond since initial recognition. The entity still estimates the probability of default over the next 12 months at 2% and the loss given default at FC60,000, resulting in an (undiscounted) expected shortfall of FC1,200.
- As at 31 December 20X2, the exchange rate is FC1 to LC1.4.

The table below illustrates the amounts recognised in the financial statements between 1 January 20X2 (after the entries for the impairment loss of FC1,143 at 1 January, shown above) and 31 December 20X2, as well as the shadow amortised cost calculation for the bond (debits are shown as positive numbers and credits as negative numbers):

	Financial Statements			Shadow Calculation	
	FC	LC		FC	LC
	Statement of financial position				
Bond (FV)	96,370	134,918	Gross carrying amount	100,000	140,000
Swap (FV)	1,837	2,572	Loss allowance	(1,143)	(1,600)
			Amortised cost	98,857	138,400
	Statement of profit or loss				
Impairment	-	-	FV hedge adjustment	(1,837)	(2,572)
FV hedge (bond)	1,837	2,572	Adjusted gross carrying amount	98,163	137,428
FX gain/loss (bond)		(39,543)	Adjusted amortised cost	97,020	135,828
FV hedge (swap)	(1,837)	(2,572)			
FX gain/loss (swap)	-	-			
	Statement of other comprehensive income				
FV changes	3,630	4,625			
Impairment offset	-	-			
FV hedge adjustment	(1,837)	(2,572)			

Because the entity has maintained the expected cash shortfall pattern and its probability of occurring, the change in estimate is just the effect of deferral by a year of the expected date of default, which exactly offsets the unwinding of the discount.

The bond is a monetary asset. Consequently, the entity recognises the changes arising from movements in foreign exchange rates in profit or loss in accordance with IAS 21.23(a) and IAS 21.28 and recognises other changes in accordance with IFRS 9. For the purposes of applying IAS 21.28, the asset is treated as an asset measured at amortised cost in the foreign currency.

The change in the fair value of the bond since 1 January 20X2 amounts to LC34,918 and is recognised as a fair value adjustment to the carrying amount of the bond on the entity's statement of financial position.

The gain of LC39,543 due to the changes in foreign exchange rates is recognised in profit or loss. It consists of the impact of the change in the exchange rates during 20X2:

- On the original gross carrying amount of the bond, amounting to LC40,000.
- Offset by the loss allowance of the bond, amounting to LC457 (i.e., the difference of FC1,143 translated at the exchange rate as at 1 January 20X2 of FC1 to LC1 and FC1,143 translated at the exchange rate as at 31 December 20X2 of FC1 to LC1.4).

The difference between the change in fair value (LC34,918) and the gain recognised in profit or loss that is due to the changes in foreign exchange rates (LC39,543) is recognised in other comprehensive income. That difference amounts to LC4,625.

A gain of LC2,572 (FC1,837) on the swap is recognised in profit or loss and, because it is assumed that there is no hedge ineffectiveness, this amount coincides with the loss on the hedged item. Illustrative Example 14 of IFRS 9 seems to suggest that the hedging gain or loss of a debt instrument at fair value through other comprehensive income is recycled from other comprehensive income in the same period but, since IFRS 9.6.5.8(b) requires the hedging gain or loss on the hedged item to be recognised in profit or loss and the offsetting entry is to other comprehensive income, this is not strictly 'recycling'.

Situation as at 31 December 20X3

As of 31 December 20X3 (the reporting date), the entity observes the following facts:

- The fair value of the bond has further decreased from FC96,370 to FC87,114.
- The fair value of the swap has increased to FC2,092.
- Based on adverse macroeconomic developments in the industry in which the bond issuer operates, the entity assumes a significant increase in credit risk since initial recognition, and recognises the lifetime expected credit loss for the bond.
- The entity updates its impairment estimate and now estimates the lifetime probability of default at 20% and the loss given default at FC48,500, resulting in (undiscounted) expected cash shortfalls of FC9,700. (For simplicity, this example assumes that payment default will happen on maturity when the entire face value becomes due).
- As at 31 December 20X3, the exchange rate is FC1 to LC1.25.

The table below illustrates the amounts recognised in the financial statements between 31 December 20X2 and 31 December 20X3, as well as the shadow amortised cost calculation for the bond (debits are shown as positive numbers and credits as negative numbers):

	Financial Statements			Shadow Calculation	
	FC	LC		FC	LC
	Statement of financial position				
Bond (FV)	87,114	108,893	Gross carrying amount	100,000	125,000
Swap (FV)	2,092	2,615	Loss allowance	(8,379)	(10,474)
			Amortised cost	91,621	114,526
	Statement of profit or loss				
Impairment	7,236	9,045	FV hedge adjustment	(2,092)	(2,615)
FV hedge (bond)	255	319	Adj. gross carrying amt.	97,908	122,385
FX gain/loss (bond)		14,553	Adj. amortised cost	89,529	111,911
FV hedge (swap)	(255)	(319)			
FX gain/loss (swap)		276			
	Statement of other comprehensive income				
FV changes	9,256	11,472			
Impairment offset	(7,236)	(9,045)			
FV hedge adjustment	(255)	(319)			

The table below illustrates the expected credit loss calculation:

31 December 20X2 (values in FC)		Year 3	Year 4	Year 5
Contractual cash flows		5,000	5,000	105,000
Expected cash flows		5,000	5,000	56,500
Expected cash shortfalls		-	-	(48,500)
NPV at 5.8%	(41,896)			
Probability of default	20%			
Net present value (probability-weighted) - this is the expected credit loss	(8,379)			

Again, the table above shows how the expected credit loss is calculated as the net present value of the cash shortfalls, i.e., the difference between contractual and expected cash flows on each relevant date. The offsetting entry of the impairment loss FC7,236 (LC9,045) is recorded in other comprehensive income in the same period.

The change in the fair value of the bond since 31 December 20X2 amounts to a decrease of LC26,026 and is recognised as a fair value adjustment to the carrying amount of the bond on the entity's statement of financial position.

The loss of LC14,553 due to the changes in foreign exchange rates is recognised in profit or loss. It consists of the impact of the change in the exchange rates during 20X2:

- On the original gross carrying amount of the bond, amounting to a loss of LC15,000.
- On the loss allowance of the bond, amounting to a gain of LC171.
- On the fair value hedge adjustment, amounting to a gain of LC276.

The difference between the change in fair value (decrease of LC26,026) and the loss recognised in profit or loss that is due to the changes in foreign exchange rates (LC14,553) is recognised in other comprehensive income.

A gain of LC319 (FC255) on the swap is recognised in profit or loss and, because it is assumed that there is no hedge ineffectiveness, this amount coincides with the loss on the hedged item.

Situation as at 1 January 20X4

On 1 January 20X4, the entity decides to sell the bond for FC87,114, which is its fair value at that date and also closes out the swap at its fair value. For simplicity, all amounts, including the foreign exchange rate, are assumed to be the same as at 31 December 20X3.

Upon derecognition, the entity reclassifies the cumulative amount recognised in other comprehensive income of LC3,018 (FC2,415) to profit or loss. This amount is equal to the difference between the fair value and the adjusted amortised cost amount of the bond, including the fair value hedge adjustment at the time of its derecognition. The table below presents a reconciliation of those amounts.

Reconciliation of loss on derecognition (values in LC) to cumulative other comprehensive income				
Fair value per 1 January 20X4	108,893			
Adjusted amortised cost per 1 January 20X4	111,911			
Loss	**(3,018)**			
	Cumulative other comprehensive income	1 January 20X2	31 December 20X2	31 December 20X3
FV changes	**16,097**	-	4,625	11,472
Impairment	**(10,188)**	(1,143)	-	(9,045)
FV hedge adjustment	**(2,891)**	-	(2,572)	(319)
Total other comprehensive income to be reclassified	**3,018**			

This table presents the amount that has not yet been recycled and, therefore, must be reclassified to profit or loss on derecognition.

10 Trade receivables, contract assets and lease receivables

IFRS 9 provides some operational simplifications for trade receivables, contract assets and lease receivables. These are the requirement or policy choice to apply the simplified approach that does not require entities to track changes in credit risk (see section 3.2 above) and the practical expedient to calculate expected credit losses on trade receivables using a provision matrix (see section 10.1 below).

10.1 Trade receivables and contract assets

It is a requirement for entities to apply the simplified approach for trade receivables or contract assets that do not contain a significant financing component. However, entities have a policy choice to apply either the general approach (see section 3.1 above) or the simplified approach separately to trade receivables and contract assets that do contain a significant financing component (see section 3.2 above). *[IFRS 9.5.5.15(a)]*.

Also, entities are allowed to use practical expedients when measuring expected credit losses, as long as the approach reflects a probability-weighted outcome, the time value of money and reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions. *[IFRS 9.5.5.17, IFRS 9.B5.5.35]*. One of the approaches suggested in IFRS 9 is the use of a provision matrix as a practical expedient for measuring expected credit losses on trade receivables. To calibrate the matrix, the entity would adjust its historical credit loss experience with forward-looking information: *[IFRS 9.B5.5.35, IFRS 9.5.5.17]*

Extract from IFRS 9

B5.5.35 An entity may use practical expedients when measuring expected credit losses if they are consistent with the principles in paragraph 5.5.17. An example of a practical expedient is the calculation of the expected credit losses on trade receivables using a provision matrix. The entity would use its historical credit loss experience (adjusted as appropriate in accordance with paragraphs B5.5.51-B5.5.52) for trade receivables to estimate the 12-month expected credit losses or the lifetime expected credit losses on the financial assets as relevant. A provision matrix might, for example, specify fixed provision rates depending on the number of days that a trade receivable is past due (for example, 1 per cent if not past due, 2 per cent if less than 30 days past due, 3 per cent if more than 30 days but less than 90 days past due, 20 per cent if 90-180 days past due etc). Depending on the diversity of its customer base, the entity would use appropriate groupings if its historical credit loss experience shows significantly different loss patterns for different customer segments. Examples of criteria that might be used to group assets include geographical region, product type, customer rating, collateral or trade credit insurance and type of customer (such as wholesale or retail).

In practice, many corporates use a provision matrix to calculate their current impairment allowances. However, in order to comply with the IFRS 9 requirements, corporates have needed to consider how current and forward-looking information might affect their customers' historical default rates and, consequently, how the information would affect their current expectations and estimates of expected credit losses. The use of the provision matrix is shown in the following Illustration. *[IFRS 9.IE Example 12, IFRS 9.IE74, IFRS 9.IE75, IFRS 9.IE76, IFRS 9.IE77]*.

Illustration 10-1: Provision matrix

Company M, a manufacturer, has a portfolio of trade receivables of CU30 million in 20X2 and operates only in one geographical region. The customer base consists of a large number of small clients and the trade receivables are categorised by common risk characteristics that are representative of the customers' abilities to pay all amounts due in accordance with the contractual terms. The trade receivables do not have a significant financing component in accordance with IFRS 15. In accordance with IFRS 9.5.5.15, the loss allowance for such trade receivables is always measured at an amount equal to lifetime expected credit losses.

To determine the expected credit losses for the portfolio, Company M uses a provision matrix. The provision matrix is based on its historical observed loss rates over the expected life of the trade receivables and is adjusted for forward-looking estimates. At every reporting date, the historical observed loss rates are updated and changes in the forward-looking estimates are analysed. In this case it is forecast that economic conditions will deteriorate over the next year.

On that basis, Company M estimates the following provision matrix:

	Current	1-30 days past due	31-60 days past due	61-90 days past due	More than 90 days past due
Loss rate	0.3%	1.6%	3.6%	6.6%	10.6%

The trade receivables from the large number of small customers amount to CU30 million and are measured using the provision matrix.

	Gross carrying amount	Lifetime expected credit loss allowance (Gross carrying amount × lifetime loss rate)
Current	CU15,000,000	CU45,000
1-30 days past due	CU7,500,000	CU120,000
31-60 days past due	CU4,000,000	CU144,000
61-90 days past due	CU2,500,000	CU165,000
More than 90 days past due	CU1,000,000	CU106,000
	CU30,000,000	**CU580,000**

It is noted that this example, like many in IFRS 9, ignores the need to consider explicitly the time value of money, presumably in this case because the effect is considered immaterial.

10.2 Lease receivables

For lease receivables, entities have a policy choice to apply either the general approach (see section 3.1 above) or the simplified approach (see section 3.2 above) separately to finance and operating lease receivables (see Chapter 24). *[IFRS 9.5.5.15(b)]*.

When measuring expected credit losses for lease receivables, an entity:

- Uses the cash flows that are used in measuring the lease receivables in accordance with IFRS 16. *[IFRS 9.B5.5.34]*.
- Discounts the expected credit losses using the same discount rate used in the measurement of the lease receivables in accordance with IFRS 16. *[IFRS 9.B5.5.46]*.

There has been some discussion on whether the unguaranteed residual value of the asset subject to a finance lease is included in the calculation of expected credit losses under IFRS 9. The unguaranteed residual value is part of the gross investment in the finance lease, together with the minimum lease payments receivable by the lessor. Changes to unguaranteed residual value arise from fluctuations in the price that could be received for the leased asset at the end of the lease term. Paragraph 2.1(b) of IFRS 9 scopes out rights and obligations under leases to which IFRS 16 applies, except for the impairment of finance lease receivables (i.e., net investments in finance leases) and operating lease receivables recognised by a lessor (see section 2 above). IFRS 16 provides guidance on measurement of the unguaranteed residual value, which means that such measurement is within the scope of IFRS 16 rather than the impairment requirements of IFRS 9. *[IFRS 16.77]*.

How we see it

The URV of the asset underlying a finance lease is excluded from the calculation of expected credit losses under IFRS 9. This means that the collateral that is taken into account in measuring expected credit losses excludes any amounts attributed to unguaranteed residual value and recorded on the lessor's statement of financial position. In other words, any collateral taken into account in the calculation of expected credit losses is restricted to the fair value of the right of use of the asset and not that of the underlying asset itself.

A lessor is only required to apply the impairment requirements in IFRS 9 to an operating lease receivable from the date on which it recognises the receivable. Accrued operating lease income does not represent an operating lease receivable, i.e., an amount due and payable by the lessee to the lessor and therefore is not subject to the impairment requirements of IFRS 9.2.1.(b) (i).

Frequently asked questions

Question 10-1: How does the lessor account for forgiveness of lease payments before and after the rent concession is granted under IFRS 9 and IFRS 16?

(IFRS Interpretations Committee meeting 15 March 2022 and 13 September 2022 - Agenda paper no. 4)

At its meeting in March and September 2022, the IFRS IC discussed the lessor's application of IFRS 9 and IFRS 16 in accounting for a particular rent concession in which the only change to the lease contract is the lessor's forgiveness of lease payments due from the lessee under that contract (some of which are amounts contractually due but not paid which the lessor had recognised as an operating lease receivable and some of which are amounts that are not yet contractually due). No other changes are made to the lease contract, nor are there any other negotiations between the lessor and the lessee that might affect the accounting for the rent concession. Two questions were addressed:

(a) How the lessor applies the expected credit loss model in IFRS 9 to the operating lease receivable before the rent concession is granted if it expects to forgive payments due from lessee under the lease contract.

(b) Whether the lessor applies the derecognition requirements in IFRS 9 or the lease modification requirements in IFRS 16 in accounting for the rent concession.

At its September 2022 meeting, the IFRS IC concluded its discussions on the tentative agenda decision published in the March 2022 IFRS IC Update. The IASB at its October 2022 meeting did not object to this agenda decision, reflecting that the IASB agreed with the agenda decision.[38]

With respect to the first question discussed, the IFRS IC noted that as per paragraph 2.1(b)(i) of IFRS 9, operating lease receivables recognised by a lessor are subject to the derecognition and impairment requirements in IFRS 9. Consequently, the lessor is required to apply the impairment requirements in IFRS 9 to the gross carrying amount of an operating lease receivable from the date on which it recognises that receivable, taking into account applicable derecognition requirements in IFRS 9. The lessor estimates expected credit losses on the operating lease receivable by measuring any credit loss to reflect 'all cash shortfalls', which are the difference between all contractual cash flows due to the lessor in accordance with the lease contract and all the cash flows it expects to receive, determined using 'reasonable and supportable information' about 'past events, current conditions and forecasts of future economic conditions'.

The IFRS IC concluded that, before the rent concession is granted, the lessor measures expected credit losses on 'the operating lease receivable in a way that reflects 'an unbiased and probability-weighted amount …', 'the time value of money', and 'reasonable and supportable information …' as required by paragraph 5.5.17 of IFRS 9. This measurement of expected credit losses includes the lessor considering its expectations of forgiving lease payments recognised as part of that receivable.

With respect to the second question discussed, the IFRS IC concluded that:

- The lessor applies the derecognition requirements in IFRS 9 to forgiven lease payments that the lessor has recognised as an operating lease receivable.

  As per paragraph 2.1(b)(i) of IFRS 9, operating lease receivables recognised by a lessor are subject to the derecognition requirements in IFRS 9. On granting the rent concession, the lessor legally releases the lessee from its obligation to make specifically identified lease payments, some of which the lessor had recognised as an operating lease receivable and thus has given up its contractual rights to those specifically identified cash flows. Accordingly, the lessor concludes that the requirements in paragraph 3.2.3(a) of IFRS 9 have been met as its contractual rights to the cash flows from the operating lease receivable has expired. Therefore, on the date the rent concession is granted, the lessor remeasures expected credit losses on the operating lease receivable (and recognises any change to the expected credit loss allowance in profit or loss) and derecognises the operating lease receivable and associated expected credit loss allowance.
- The lessor applies the lease modification requirements in IFRS 16 to forgiven lease payments that the lessor has not recognised as an operating lease receivable (see Chapter 24 at section 6.5.2).

38 IFRIC Update September 2022. Available on the IFRS Foundation's website.

Other issues that have arisen in practice in relation to the IFRS 16 and IFRS 9 impairment requirements are covered further in Chapter 24. These include:

- Whether the finance income arising from a finance lease receivable is calculated based on the gross lease receivable or the net amount of the lease receivable less any expected credit losses (see Chapter 24 at section 6.3.3).
- Whether (and when) lease income is recognised when collectability is not probable. Regardless of the approach followed, IFRS 9 guidance on expected credit losses continues to be applicable to recognised lease receivables (see Chapter 24 at section 6.4.1).

11 Loan commitments and financial guarantee contracts

11.1 Definitions and scope

Loan commitments (see Chapter 41 at section 2.5) are described in IFRS 9 as "firm commitments to provide credit under pre-specified terms and conditions", while a financial guarantee contract (see Chapter 41 at section 2.4) is defined as "a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument". *[IFRS 9.BCZ2.2, IFRS 9 Appendix A]*.

If a lender is committed to provide a loan but has the ability to reprice the loan at the time of the draw-down, this will still meet the definition of a loan commitment that is subject to the IFRS 9 impairment requirements, as the lender is exposed to credit risk despite the repricing clause. However, the ability to reprice the loan may impact the exposure at default when measuring expected credit losses (see section 12.3 below).

The IFRS 9 impairment requirements apply to loan commitments and financial guarantee contracts that are not measured at fair value through profit or loss under IFRS 9, with some exceptions (see section 2 above).

Frequently asked questions

Question 11-1: Whether the impairment requirements in IFRS 9 must also be applied to other commitments to extend credit?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 22 April 2015 - Agenda paper no. 3)

The IFRS Transition Resource Group for Impairment of Financial Instruments (see section 1.4 above) discussed in April 2015 whether the impairment requirements in IFRS 9 must also be applied to other commitments to extend credit such as:

- A commitment (on inception of a finance lease) to commence a finance lease at a date in the future (i.e., a commitment to transfer the right to use an asset at the lease commencement date in return for a payment or series of payments in the future).
- A commitment by a retailer through the issue of a store account to provide a customer with credit when the customer buys goods or services from the retailer in the future.

The IFRS Transition Resource Group for Impairment of Financial Instruments appeared to agree with the IASB's staff analysis that the impairment requirements of IFRS 9 apply to an agreement that contains a commitment to extend credit by virtue of IFRS 9.2.1(g) if:

- The agreement meets the description of a loan commitment. *[IFRS 9.BCZ2.2]*.
- The agreement meets the definition of a financial instrument. *[IAS 32.11]*.
- None of the specific exemptions from the requirements of IFRS 9 apply. *[IFRS 9.2.1]*.

The IASB staff paper stated that some contracts, such as irrevocable finance lease agreements, might clearly contain a firm commitment at inception to provide credit under pre-specified terms and conditions. However, other cases might not be so clear cut, depending upon the specific terms of the agreement and other facts and circumstances (e.g., if the issuer of a store account has the discretion to refuse to sell products or services to a customer with a store card and hence can avoid extending credit).

In the examples discussed above, the finance lease and store account do not meet the definition of a financial instrument until the contractual right to receive cash is established, that is likely to be at the commencement of the lease term or when goods or services are sold. *[IAS 32.11, IAS 32.AG20]*. Only lease receivables are scoped into the IFRS 9 impairment requirements (see section 10.2 above). *[IFRS 9.2.1(b)]*. Consequently, there is no need to make provision for expected credit losses, in accordance with IFRS 9, until a financial lease receivable or a financial asset within the scope of IFRS 9 is recognised.

11.2 The calculation of expected credit losses

The application of the model to financial guarantees and loan commitments warrants some further specification regarding some of the key elements, such as the determination of the credit quality on initial recognition, cash shortfalls and the effective interest rate to be used in the expected credit loss calculations. These specifications are summarised in Figure 11-1 below, which also highlights the differences in recognising and measuring expected credit losses for financial assets measured at amortised cost or at fair value through other comprehensive income, loan commitments and financial guarantee contracts.

Figure 11-1: Summary of the application of the expected credit loss model to loan commitments and financial guarantee contracts

	Financial assets measured at amortised cost or at fair value through other comprehensive income	Loan commitments	Financial guarantee contracts
Date of initial recognition in applying the impairment requirements (see section 7.3.1 above)	Trade date. *[IFRS 9.5.7.4]*.	Date that an entity becomes a party to the irrevocable commitment. *[IFRS 9.5.5.6]*.	Date that an entity becomes a party to the irrevocable commitment. *[IFRS 9.5.5.6]*.
Period over which to estimate expected credit losses (see section 5.5 above)	The expected life up to the maximum contractual period (including extension options at the discretion of the borrower) over which the entity is exposed to credit risk and not a longer period. *[IFRS 9.5.5.19]*.	The expected life up to the maximum contractual period over which an entity has a present contractual obligation to extend credit. *[IFRS 9.B5.5.38]*. However, for revolving credit facilities (see section 12 below), this period extends beyond the contractual period over which the entity is exposed to credit risk and includes the period for which the expected credit losses would not be mitigated by credit risk management actions. *[IFRS 9.5.5.20, IFRS 9.B5.5.39, IFRS 9.B5.5.40]*.	The expected life up to the maximum contractual period over which an entity has a present contractual obligation to extend credit. *[IFRS 9.B5.5.38]*.
Cash shortfalls in measuring expected credit losses (see section 5.2 above)	Cash shortfalls between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive. *[IFRS 9.B5.5.28]*.	Cash shortfalls between the contractual cash flows that are due to the entity if the holder of the loan commitment draws down the loan and the cash flows that the entity expects to receive if the loan is drawn down. *[IFRS 9.B5.5.30]*.	Cash shortfalls are the expected payments to reimburse the holder for a credit loss that it incurs less any amounts that the entity (issuer) expects to receive from the holder, the debtor or any other party. *[IFRS 9.B5.5.32]*.
Effective interest rate used in discounting expected credit losses (see section 5.7 above)	The effective interest rate is determined or approximated at initial recognition of the financial instrument. *[IFRS 9.B5.5.44]*.	The effective interest rate of the resulting asset will be applied and if this is not determinable, then the current rate representing the risk of the cash flows is used. *[IFRS 9.B5.5.47, IFRS 9.B5.5.48]*.	The current rate representing the risk of the cash flows is used. *[IFRS 9.B5.5.48]*.
Assessment of significant increases in credit risk (see section 6 above)	An entity considers changes in the risk of a default occurring on the financial asset. *[IFRS 9.5.5.9]*.	An entity considers changes in the risk of a default occurring on the loan to which a loan commitment relates. *[IFRS 9.B5.5.8]*.	An entity considers the changes in the risk that the specified debtor will default on the contract. *[IFRS 9.B5.5.8]*.

Further discussion on the discount rate to be used for calculating expected credit losses on loan commitments and financial guarantee contracts is provided in section 5.7 above.

11.3 Financial guarantee contracts that require the holder to pay further premiums in the future

Frequently asked questions

Question 11-2: Whether the measurement of expected credit losses for financial guarantee contracts issued should consider future premium receipts due from the holder and, if so, how?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 22 April 2015 - Agenda paper no. 6)

At its meeting in April 2015, the IFRS Transition Resource Group for Impairment of Financial Instruments (see section 1.4 above) discussed the measurement of expected credit losses for an issued financial guarantee contract that requires the holder to pay further premiums in the future. Some members of the ITG agreed with the staff's analysis that the issuer of a financial guarantee contract should exclude future premium receipts due from the holder when measuring expected credit losses in respect of the expected cash outflows payable under the guarantee. When estimating the cash shortfalls, the amounts that the entity expects to receive from the holder should relate only to recoveries or reimbursements of claims for losses and would not include receipts of premiums. *[IFRS 9.B5.5.32]*. Moreover, the expected cash outflows under the guarantee depend upon the risk of default of the guaranteed asset, while the expected future premiums receipts are subject to the risk of default by the holder of the guarantee. Hence, these risks of default should be considered separately. In other words, the expected credit loss measurement should be carried out gross of any premiums receivable in the future.

In addition, an IFRS Transition Resource Group for Impairment of Financial Instruments member noted that the terms of a financial guarantee contract may affect the period of exposure to credit risk on the guarantee, for example if the guarantee were contingent or cancellable. This should be taken into consideration when measuring the expected credit losses of the guarantee.

IFRS 9 requires that financial guarantees and off-market loan commitments are measured at the 'higher of' the amount initially recognised less cumulative amortisation, and the expected credit loss. *[IFRS 9.4.2.1(c), IFRS 9.4.2.1(d)]*. For a financial guarantee contract issued to an unrelated party in a stand-alone arm's length transaction, premiums that are received in full at inception will likely be the same as the fair value of the guarantee at initial recognition (see Chapter 45 at section 3.3.3). In such circumstances, it is likely that no expected credit losses will need to be recognised immediately after initial recognition, as the initial fair value will normally exceed the lifetime expected credit losses. However, a financial guarantee contract for which premiums are receivable over the life of the guarantee will have a nil fair value at initial recognition. In such circumstances, the subsequent measurement of the financial guarantee contract is likely to be based on the expected credit loss allowance. This is shown in the Illustration below.

Illustration 11-1:	**Determining the initial and subsequent measurement of a financial guarantee contract where premiums are receivable upfront or over the life of the guarantee**
Scenario 1:	On 1 January 20X2, Bank A issues a 5 year financial guarantee of a loan with a nominal value of CU2,000,000 with 5% interest, with the full premium of CU100,000 receivable upfront at contract inception. This premium is recognised on a straight-line basis over the life of the guarantee. As at 31 December 20X4 and 20X5, Bank A assesses that there has been a significant increase in credit risk of the financial guarantee contract and as at 31 December 20X6, the debtor defaults and fails to make payments in accordance with the terms of the debt instrument. The lifetime expected credit losses estimated as at 31 December 20X2 and 20X3 are CU75,000 and CU55,000 respectively, with a significant increase in 20X4 and 20X5 to CU200,000 and CU500,000, respectively, and for the guaranteed amount of CU2,100,000 (being the principal and unpaid interest) in 20X6 when the debtor defaults. The 12-month expected credit losses are CU18,000 and CU25,000 as at 31 December 20X2 and 20X3.
Scenario 2:	Same facts as in Scenario 1 except that Bank B issues a 5 year financial guarantee of a loan with a nominal value of CU2,000,000, with premiums receivable over the life of the guarantee of CU20,000 each year, payable on 31 December 20X2, 20X3, 20X4, 20X5 and 20X6, i.e., a total of CU100,000. The fair value of the guarantee is nil at origination. If a claim is paid out under the financial guarantee contract, Bank B will lose the right to receive future premiums.

	31 Dec 20X2 CU	31 Dec 20X3 CU	31 Dec 20X4 CU	31 Dec 20X5 CU	31 Dec 20X6 CU
Scenario 1: Full premium of CU100,000 receivable at inception					
Initial fair value is CU100,000					
(a) Fair value less cumulative income recognised*	80,000	60,000	40,000	20,000	-
(b) Expected credit losses	18,000	25,000	200,000	500,000	2,100,000
Recorded value: higher of (a) or (b) in accordance with IFRS 9.4.2.1(c)	80,000	60,000	200,000	500,000	2,100,000
Scenario 2: Premium receivable over the life of contract, i.e., CU20,000 per annum					
Initial fair value is CU0 in accordance with IFRS 9.5.1.1					
(a) Fair value less cumulative income recognised*	-	-	-	-	-
(b) Expected credit losses	18,000	25,000	200,000	500,000	2,100,000
Recorded value: higher of (a) or (b) in accordance with IFRS 9.4.2.1(c)	18,000	25,000	200,000	500,000	2,100,000

* Based on the assumption of a straight-line amortisation of premiums received over the life of the financial guarantee.

Before there has been a significant increase in credit risk in 20X2 and 20X3, in Scenario 1, the measurement of the financial guarantee is based on the fair value, less cumulative income recognised in accordance with IFRS 15 whilst, in Scenario 2, the measurement is based on the expected credit loss allowance. However, once there has been a significant increase in credit risk, the measurement of the financial guarantee is based on the expected credit loss allowance in both scenarios. Consequently, the timing of receipt of premiums may have a significant effect on the measurement of the guarantee particularly when there has not been a significant increase in credit risk.

Although the accounting treatment in Scenario 2 in the example above may seem unintuitive, in that the guarantor must initially recognise expected credit losses even though it expects to receive future premium income, it is consistent with the impairment of loans on which a credit spread is also received over the life of the loan.

Normal loan commitments (i.e., those issued at market interest rates and therefore excluded from the scope of IFRS 9 except for impairment and derecognition) *[IFRS 9.2.1(g), IFRS 9.2.3]* are not subject to the 'higher of' test for subsequent measurement. *[IFRS 9.2.3(c), IFRS 9.4.2.1(d)]*. The consequence is that an expected credit loss is required for all normal loan commitments, whether or not any fees are paid upfront. This is consistent with the general requirement to provide for 12-month expected credit losses for any new loans that have not experienced significant increases in credit risk since initial recognition.

11.4 Cross-company guarantees

For the individual entities within a group, there may be instances where cross-company guarantee arrangements will meet the definition of financial guarantee contracts and hence will fall within the scope of the IFRS 9 expected credit loss requirements. *[IFRS 9.4.2.1(d)]*.

Where such guarantees are provided at below-market rates by holding companies or other group entities, the initial benefit provided may need to be accounted for as an equity transaction between group entities.

When estimating the expected credit losses on cross-company guarantees relating to loans to a group entity made by parties external to the group, each entity that is a party to the cross-company guarantee arrangement needs, for its standalone financial statements, to factor in the likelihood of it being called upon to make payments under the arrangement. A practical approach would be to determine the total expected credit losses and then allocate them to group entities, based on an assessment of which entities will most likely settle the guarantee if payment is required. In doing so, all reasonable and supportable information that is available, including the respective entities' relative financial strength in relation to other group entities will need to be taken into account. If one entity in the group is expected to reimburse the lender, then this will reduce the potential cash shortfall estimated by other entities within the group. For example, if the parent is in the strongest financial position and is expected to fully reimburse the lender for a loan issued to one of its subsidiaries, then the parent's estimate of cash shortfalls would be consistent with the cash shortfalls that the lender could suffer in the absence of the guarantee. However, once the expected payments from the parent are taken into account, this would significantly reduce the expected cash shortfalls estimated by other group entities. This will result in each entity recognising the appropriate probability-weighted estimate of credit losses. Requiring all entities to recognise an expected credit loss amount which does not take into account the likelihood of being called upon would not represent a probability-weighted estimate of credit losses and would not provide useful information to users of the financial statements.

Additional disclosures would be required to explain the arrangement, including the maximum amount to which the entity is exposed and how the expected credit loss amount has been calculated. *[IFRS 7.36(a), IFRS 7.35G]*. Also, IAS 24 *Related Party Disclosures* requires details of any guarantees given to, or received from, related parties to be disclosed. *[IAS 24.18, IAS 24.21]*.

11.5 Purchased or originated credit-impaired loan commitments and financial guarantee contracts

Another question that arises in practice is whether loan commitments and financial guarantee contracts can ever be accounted for as purchased or originated credit-impaired. The definition of 'purchased or originated credit-impaired' in IFRS 9 refers only to financial assets, not financial instruments (consistent with the definition of credit-impaired) but loan commitments and financial guarantees are not financial assets. So, if such an instrument is entered into when default is highly likely or has already occurred, and the potential loss is reflected in the price, how are the expected credit losses measured, so as to avoid double counting the loss?

This issue could be particularly relevant in the context of business combinations, where an entity may acquire loan commitments or financial guarantee contracts that are already credit-impaired. For financial guarantees, the 'higher of' test avoids the double-counting, as the fair value of the guarantee recognised as a liability on initial recognition will be higher than lifetime expected losses. For loan commitments, one view could be to consider they are at below-market interest rates on initial recognition (as the terms were fixed at a time where the loan commitment was not credit-impaired) and apply the higher of test; alternatively, one may consider that the guidance for financial assets may be applied by analogy to loan commitments. This would make sense as IFRS 9 treats loans that are drawn from a loan commitment as a continuation of the same financial instrument. For disclosure purposes, we believe such loan commitments and financial guarantees ought to also be reported as credit-impaired.

How we see it

For accounting and disclosure purposes, we believe loan commitments and financial guarantee contracts can be treated as purchased or originated credit-impaired if default is likely or has already occurred.

12 Revolving credit facilities

The 2013 ED specified that the maximum period over which expected credit losses are to be calculated is limited to the contractual period over which the entity is exposed to credit risk.[39] This would mean that the allowance for commitments that can be withdrawn at short notice by a lender, such as overdrafts and credit card facilities, would be limited to the expected credit losses that would arise over the notice period, which might be only one day. However, banks will not normally exercise their right to cancel the commitment until there is already evidence of significant deterioration, which exposes them to risk over a considerably longer period. Banks and banking regulators raised concerns on this issue and the IASB responded by introducing an exception for revolving credit facilities and setting out further guidance as well as an example addressing such arrangements.

In outline, the revolving credit facility exception requires the issuer of such a facility to calculate expected credit losses based on the period over which they expect, in practice, to be exposed to credit risk. However, the words of the exception are not very clear and it was discussed at all three IFRS Transition Resource Group for Impairment of Financial Instruments meetings. The IASB staff have also produced a webcast on the topic.

12.1 Scope of the exception

The guidance relates to financial instruments that 'include both a loan and an undrawn commitment component and for which the entity's contractual ability to demand repayment and cancel the commitment does not limit the entity's exposure to credit losses to the contractual notice period'. *[IFRS 9.5.5.20]*. Despite the use of the word 'both', the IFRS Transition Resource Group for Impairment of Financial Instruments agreed, in April 2015, that this guidance applies even if the facility has yet to be drawn down. It also applies if the facility has been completely drawn down, as it is the nature of revolving facilities that the drawn down component is periodically paid off before further amounts will be drawn down again in future.

IFRS 9 also describes three characteristics generally associated with such instruments: *[IFRS 9.B5.5.39]*

- They usually have no fixed term or repayment structure and usually have a short contractual cancellation period
- The contractual ability to cancel the contract is not enforced in day-to-day management, but only when the lender is aware of an increase in credit risk at the facility level
- They are managed on a collective basis

Products that are generally agreed to be in the scope of the exception include most credit card facilities and most retail overdrafts. However, even with these some caution needs to be applied, since we understand that there are credit card facilities which do not enable the issuer to demand repayment and cancel the facility, and which would therefore be out of scope.

What is less clear is the treatment of corporate overdrafts and similar facilities. It is relevant that all the IFRS Transition Resource Group for Impairment of Financial Instruments discussions as well as the webcast referred to credit cards and retail customers and not corporate exposures. The problem is partly that the guidance to IFRS 9 describes management on a collective basis as a characteristic that revolving facilities in the scope of the exception 'generally have', rather than a required feature as listed in IFRS 9.5.5.20. *[IFRS 9.B5.5.39]*. Some banks consider this is still a determining feature and that many of their corporate facilities are outside the scope of the exception because they are managed on an individual basis. Banks normally have a closer business relationship with their larger corporate customers than with most retail customers, and more data to manage the credit risk, such as access to regular management information. Other banks consider that facilities that are individually managed are still in the scope of the exception, notably because individual credit reviews are generally performed only on an annual basis (unless a significant event occurs). In addition, it is unclear exactly what is meant by 'managed on a collective basis' and where to draw the line between large corporates and smaller entities. It is noted that if a corporate facility is not deemed to be a revolving facility, but can be cancelled at short notice, the expected credit losses will be limited to those that arise over the notice period.

39 Exposure Draft ED/2013/3: *Financial Instruments: Expected Credit Losses*, IASB, March 2013, para. 17. Available on the IFRS Foundation's website.

Frequently asked questions

Question 12-1: Whether multi-purpose credit facilities would fall within the scope of IFRS 9.5.5.20 and whether the general characteristics identified in IFRS 9.B5.5.39 should be considered to be required characteristics, or merely examples of typical characteristics?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 11 December 2015 - Agenda paper no. 2)

At its December 2015 meeting (see section 1.4 above), the IFRS Transition Resource Group for Impairment of Financial Instruments discussed whether:

- Multi-purpose credit facilities, which have the ability to be drawn down in a number of different ways (e.g., as a revolving overdraft, a variable or fixed-rate loan with or without a fixed term or an amortising loan such as a mortgage) would fall within the scope exception.
- The general characteristics identified in IFRS 9.B5.5.39 should be considered to be required characteristics, or merely examples of typical characteristics.
- The existence of a fixed term of the loan once drawn down would prevent a facility from falling within the scope exception.

The IFRS Transition Resource Group for Impairment of Financial Instruments commented that:

- The supporting application guidance in IFRS 9.B5.5.39 reinforces the features described in IFRS 9.5.5.20 by setting out general characteristics which, while not determinative, are consistent with those features.
- The Basis for Conclusions of IFRS 9 provides further context around the type of financial instruments that the Board envisaged would fall within the scope exception. In particular, the exception was intended to be limited in nature and that it was introduced in order to address specific concerns raised by respondents in relation to revolving credit facilities that were managed on a collective basis. Also, it was understood that these types of financial instruments included both a loan and an undrawn commitment component and that they were managed, and expected credit losses were estimated, on a facility level; i.e., the drawn and undrawn exposure were viewed as one single cash flow from the borrower. *[IFRS 9.BC5.254-261]*.
- Consequently, both the drawn and undrawn components of these facilities were understood to have similar short contractual maturities, i.e., the lender had both the ability to withdraw the undrawn commitment component and demand repayment of the drawn component at short notice.
- An immediately revocable facility which has a fixed maturity (e.g., 5 years) would be consistent with the type of facility within the scope exception because the fixed term feature does not negate the lender's contractual right to cancel the undrawn component at any time. In contrast, an immediately revocable facility that has no fixed maturity but when drawn, can take the form of a loan with a fixed maturity (i.e., once it has been drawn, the lender no longer has the right to demand immediate repayment at its discretion) would not be consistent with the type of facility envisaged to be within the scope exception. This is because the fixed term feature does negate the lender's contractual right to demand repayment of the undrawn component. However, regarding this characteristic, the IFRS Transition Resource Group for Impairment of Financial Instruments members also highlighted the following:
  (a) An entity would first need to establish the unit of account to which the requirements of IFRS 9 should be applied. In this regard, they noted that even if there was only one legal contract supporting a particular multi-purpose credit facility, there might be more than one unit of account to consider.
  (b) If the fixed-term feature was for a shorter period, judgement would be required in order to determine whether such a fixed-term feature would prevent a particular financial instrument from falling within the scope exception (e.g., whether the borrower could consider the exposure on the drawn and undrawn components to be one single cash flow).
- IFRS 7 requires an entity to explain, among other things, the assumptions used to measure expected credit losses. Within the context of multi-purpose credit facilities, such disclosures are likely to be important in order to meet the disclosure objectives (see section 15 below and Chapter 50 at section 5.3).

While, according to the IFRS Transition Resource Group for Impairment of Financial Instruments, the drawn and undrawn exposures are viewed as 'one set of cash flows from the borrower', IFRS 9's Basis for Conclusions is slightly clearer. *[IFRS 9.BC5.259]*. It states that the loan and undrawn commitment are managed, and expected credit losses are estimated on a facility level. In other words, there is only one

set of cash flows from the borrower that relates to both components. Hence, the drawn and undrawn elements of a revolving facility within the scope of the exception would normally be viewed as only one unit of account. The IFRS Transition Resource Group for Impairment of Financial Instruments discussion seems to suggest that a new unit of account would be recognised if a borrower chose to draw down on a multi-purpose facility in the form of a term loan, because this is the point where this specific drawn portion ceases to share the key characteristic of a revolving facility, i.e., the entity's contractual ability to demand repayment and cancel the commitment.

Question 12-2: How future drawdowns should be estimated when a revolving credit facility might not have a specified credit limit in the contract?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 11 December 2015 - Agenda paper no. 3)

At its December 2015 meeting (see section 1.4 above), the IFRS Transition Resource Group for Impairment of Financial Instruments discussed charge cards and how expected credit losses on future drawdowns should be measured if there is no specified credit limit in the contract. The IFRS Transition Resource Group for Impairment of Financial Instruments members considered a specific fact pattern where the bank has the ability to approve each transaction at the time of sale based on the customer's perceived spending capacity using statistical models and inputs such as spending history and known income.

The IFRS Transition Resource Group for Impairment of Financial Instruments members noted that because the bank has the right to refuse each transaction at its discretion, and on the assumption that the bank actually exercises that right in practice, then:

- The contractual credit limit should be considered to be zero and consequently future drawdowns would not be taken into account.
- Furthermore, the facility described would not fall within the scope exception because there would be no undrawn commitment component (i.e., there is no firm commitment to extend credit).

However, the IFRS Transition Resource Group for Impairment of Financial Instruments members noted that their discussions focussed on the very specific fact pattern presented and observed that the conclusion could differ in other situations.

12.2 The period over which to measure expected credit losses

12.2.1 The requirements of IFRS 9

IFRS 9 has an exception for revolving credit facilities that requires the issuer of such a facility to calculate expected credit losses based on the period over which they expect, in practice, to be exposed to credit risk rather than limited to the contractual period over which the entity is exposed to credit risk: *[IFRS 9.5.5.20, IFRS 9.B5.5.40]*

Extract from IFRS 9

5.5.20 However, some financial instruments include both a loan and an undrawn commitment component and the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure to credit losses to the contractual notice period. For such financial instruments, and only those financial instruments, the entity shall measure expected credit losses over the period that the entity is exposed to credit risk and expected credit losses would not be mitigated by credit risk management actions, even if that period extends beyond the maximum contractual period.

B5.5.40 When determining the period over which the entity is expected to be exposed to credit risk, but for which expected credit losses would not be mitigated by the entity's normal credit risk management actions, an entity should consider factors such as historical information and experience about:

(a) the period over which the entity was exposed to credit risk on similar financial instruments;

(b) the length of time for related defaults to occur on similar financial instruments following a significant increase in credit risk; and

(c) the credit risk management actions that an entity expects to take once the credit risk on the financial instrument has increased, such as the reduction or removal of undrawn limits.

The above wording in IFRS 9is not very easy to interpret or apply. The period over which to measure expected credit losses and the relevant exposures are estimated based on historical experience and future expectations of when facilities are expected to no longer expose the lender to risk, because the customer (i) defaults; (ii) no longer uses the facility; or (iii) the credit line is reduced or removed by the lender. Ultimately, the estimation of the maximum period to consider would require judgement and consequently the disclosure requirements of IFRS 7 (such as those explaining inputs, assumptions and estimation techniques in relation to expected credit losses) would be relevant.

12.2.2 Guidance provided by the IFRS Transition Resource Group for Impairment of Financial Instruments

When assessing the period over which to measure expected credit losses for revolving credit facilities, it is clear that the starting-point is the reporting date. However, with respect to the ending-point, IFRS 9 is less clear.

IFRS 9 requires an entity to consider historical information and experience about the period over which the entity was exposed to credit risk on similar financial instruments, the length of time for related defaults to occur on similar financial instruments following a significant increase in credit risk; and the credit risk management actions that an entity expects to take once the credit risk on the financial instrument has increased, such as the reduction or removal of undrawn limits.

Also, the IFRS Transition Resource Group for Impairment of Financial Instruments discussed this issue in the April and December 2015 IFRS Transition Resource Group for Impairment of Financial Instruments meetings and commented that an entity also needs to consider the expected defaults, asset curing, and potential credit risk management actions the entity expects to be legally and operationally able to take and that serve to either terminate or limit the credit risk exposure in some way (e.g., reduction or removal of undrawn limits).

Frequently asked questions

Question 12-3: What is the maximum period to consider when measuring expected credit losses for revolving credit facilities?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 22 April 2015 - Agenda paper no. 4)

The IFRS Transition Resource Group for Impairment of Financial Instruments in April 2015 (see section 1.4 above), discussed how to determine the appropriate period when measuring expected credit losses for a portfolio of revolving credit card exposures in stages 1, 2 and 3 and commented that:

- An entity's ability to segment and stratify the portfolio into different sections of exposures in accordance with how those exposures are being managed will be relevant. For example, an entity may be able to identify exposures with specific attributes that are considered more likely to default and consequently would have shorter average lives than those that are expected to continue performing (see section 6.5 above).
- While IFRS 9 requires a period in excess of the maximum contractual period to be used when measuring expected credit losses, the fundamental aim was still to determine the period over which the entity is exposed to credit risk and an entity must consider all three factors set out in IFRS 9.B5.5.40. Consequently, expected defaults or potential credit risk management actions the entity expects to be legally and operationally able to take and that serve to terminate or limit the credit risk exposure in some way (e.g., reduction or removal of undrawn limits) could result in a shorter period of exposure than that indicated by the historical behavioural life of the facility. That is, the time horizon is not the period over which the lender expects the facility to be used, but the period over which the lender is, in practice, exposed to credit risk.

Question 12-4: When does the period start and end in assessing the maximum period when measuring expected credit losses for revolving credit facilities?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 11 December 2015 - Agenda paper no. 4)

At its December 2015 meeting (see section 1.4 above), the IFRS Transition Resource Group for Impairment of Financial Instruments continued the discussion on how an entity should determine the maximum period to consider when measuring expected credit losses for revolving credit facilities in accordance with IFRS 9.B5.5.40. This divided into two sub-questions:

(a) How should an entity determine the starting-point of the maximum period to consider when measuring expected credit losses?

(b) How should an entity determine the ending-point of the maximum period to consider when measuring expected credit losses, in particular, which credit risk management actions should an entity take into account in making this determination?

With respect to the starting-point, the IFRS Transition Resource Group for Impairment of Financial Instruments members observed that the requirements of IFRS 9.B5.5.40 do not alter the starting-point of the maximum period to consider when measuring expected credit losses and consequently, the appropriate starting-point should be the reporting date.

With respect to the ending-point, IFRS Transition Resource Group for Impairment of Financial Instruments members focused on which credit risk management actions an entity should take into account and noted that:

- An entity should consider:
  - (a) Only credit risk management actions that it expects to take rather than all credit risk management actions that it is legally and operationally able to take.
  - (b) Only those credit risk management actions that serve to mitigate credit risk and consequently, actions that do not mitigate credit risk such as the reinstatement of previously curtailed credit limits should not be considered.
  - (c) All credit risk management actions that it expects to take and that serve to either terminate or limit the credit risk exposure in some way.
- An entity's expected actions must be based on reasonable and supportable information. In this regard, consideration should be given to an entity's normal credit risk mitigation process, past practice and future intentions.
- The ending-point could be limited by the expected timing of the entity's next review process, but only if the entity's normal business practice is to take credit risk mitigation actions as part of this review process. Consequently, it may not always be appropriate to use the timing of the entity's next review process as a basis for determining the ending-point.
- In respect of assets in stage 2, the probability of assets curing or defaulting would need to be taken into account when determining the maximum period to consider when measuring expected credit losses.
- It was noted that a distinction should be made between credit risk management actions such as the reinstatement of a previously curtailed credit limit (that should not be taken into account) and considering how a particular stage 2 exposure that has not yet been subject to any credit risk mitigation actions will develop. For example, an entity may have determined that there has been a significant increase in credit risk since initial recognition in respect of a particular exposure but may not yet have taken any specific credit risk mitigation actions such as the curtailment or termination of the credit limit. In this case, consideration should be given to the possibility that the exposure may cure rather than default. In contrast, if an entity had taken credit risk mitigation action in respect of that exposure such as the curtailment of the credit limit, it would not be appropriate to take into consideration the possibility that the exposure may subsequently cure, resulting in a reinstatement of the previously curtailed credit limit when determining the maximum exposure period. In this regard, appropriate portfolio segmentation is crucial, in particular in relation to financial assets in stage 2.
- There is only one maximum exposure period to consider, which applies equally to both the drawn and undrawn components of a revolving credit facility, which is consistent with the way in which the facility is managed. Nevertheless, in measuring expected credit losses, credit risk mitigation actions may affect the drawn and undrawn components differently. For example, when an entity cancels the undrawn component, the possibility of any future drawdowns is removed, whereas when an entity demands repayment of the drawn component the recovery period associated with that drawn exposure still needs to be considered in measuring expected credit losses.
- Ultimately, the estimation of the maximum period to consider would require judgement and consequently the disclosure requirements of IFRS 7 (such as those explaining inputs, assumptions and estimation techniques in relation to expected credit losses) would be important (see section 15 below and Chapter 50 at section 5.3).

12.2.3 Guidance provided by the IASB webcast

On 16 May 2017 the IASB issued a webcast titled IFRS 9 *Impairment: The expected life of revolving facilities*. Like other IASB webcasts, this sets out the views of the speakers rather than the Board, but it is nevertheless regarded as important educational material. The webcast indicated that the expected life will be bound by expected defaults, or when the facility is no longer used by the customer, or the next review date to the extent that credit risk mitigation actions are expected to occur.

This webcast used the example of a portfolio of 100 similar facilities, 30 of which are expected to significantly increase in credit risk by the next credit review and, at the next credit review, based on past experience, 5 of these facilities will be cut. The key messages provided were:

- The entity assumes that the expected life of the portfolio will be limited by the period to the next credit review only for those 5 facilities. This is because the expected life can only be reduced to the next review date to the extent that mitigation actions are expected to occur.
- It is not necessary to know in advance which 5 facilities will be cut.
- The expected life of the other 95 facilities will be bounded by when they are expected to default or the point at which the facility is no longer used by the customer.
- Meanwhile, the expected life for the 5 facilities may be shorter than the time to the next review if they are expected to default.
- As discussed at the IFRS Transition Resource Group for Impairment of Financial Instruments, it will be necessary to segment the portfolio appropriately into groups of loans with similar credit and payment expectations in order to determine its expected life. If a facility is more likely to default, then it is also more likely to be subject to risk mitigation action.
- If the entity expects, based on past experience, to cut the facility only in part, by reducing the limit, then the life of the facility will be cut only for the portion of the facility that is expected to be withdrawn.

This example only looks forward to what it expects to happen by the time of the next credit review. Presumably it would be appropriate to extend the analysis to look beyond this to subsequent reviews and further reductions in facilities expected in the future to help determine the expected life of the remaining 95 facilities in the portfolio. This is illustrated by Illustration 12-1 below.

A second example in the webcast compared two entities: Entity A only cancels undrawn facilities that deteriorate to a risk classification of 20, while Entity B cancels any facility as soon as it deteriorates to a classification of 15 (and so lower risk than grade 20). It was concluded that, all else being equal, the expected life for entity A's portfolio will be longer than for entity B's portfolio.

As discussed at the IFRS Transition Resource Group for Impairment of Financial Instruments meetings, the IASB staff noted that it will be necessary to segment the portfolio appropriately into groups of loans with similar credit and payment expectations in order to determine its expected life.

It needs to be stressed that estimating the expected life of a revolving facility is of relevance mostly for those facilities that are measured using lifetime expected credit losses. The allowance for those assets in stage 1 will be calculated based only on losses associated with default in the next twelve months, which is likely to be the period used to measure expected credit losses unless the entity's risk mitigation activities indicate that a shorter period is to be used.

To recap, it would seem that a periodic credit review is normally taken into account when assessing the period over which to measure losses to the extent that it is expected to result in reduction or withdrawal of actual limits. Hence, for example, if normally 20% of facilities are withdrawn based on an annual review, then for 20% of the outstanding facilities the period to measure losses is limited by the timing of this next review. For the other 80% of the facilities, three things may happen: they may someday default, the facility may someday be reduced or withdrawn, or the borrower may someday cease to use the card. For the 80% it is necessary to model each of these possibilities, which means that the period over which to measure expected credit losses may extend for a number of years into the future. Under this view IFRS 9's requirement for any facilities measured using lifetime expected credit losses can be simply summarised as 'how much do you expect to lose'?

How we see it

In addition to forecasting the possibilities of the borrower defaulting or ceasing to use the revolving facility, a periodic credit review is normally taken into account when assessing the period over which to measure losses to the extent that it is expected to result in limit reduction or withdrawal.

The application of this approach is shown in the following Illustration.

Illustration 12-1: Estimating the life of revolving credit facilities

Of 1,000 facilities in stage 2 the entity estimates that each year:

- 10% will default every year in the first three years, but this reduces to 2% thereafter, as those facilities that do not default in the first three years are expected to have become significantly lower risk.
- 8% of holders will cease to use their card every year in the first three years but this increases to 15% thereafter once their financial position has improved.
- 15% of facilities will be withdrawn each year, as credit risk mitigation, over the first three years. After that period it is assumed that the credit risk is significantly reduced and none of the facilities are reduced thereafter.

No. of facilities in stage 2	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Balance brought forward	1,000	670	448	301	250	207	172
Defaults	(100)	(67)	(45)	(6)	(5)	(4)	(3)
Cease to use card	(80)	(54)	(35)	(45)	(38)	(31)	(26)
Facility withdrawn	(150)	(101)	(67)	-	-	-	-
Balance carried forward	670	448	301	250	207	172	143

In this example it is apparent that while the level of defaults quickly declines, a small portion of the portfolio has a very long life. The consequence is that the expected credit loss could be very significant. However, the example does not take account of the time value of money. Given the high interest rate charged on credit cards, the manner in which interest is included in the estimation of cash flows and how losses are discounted will have a major impact upon the expected credit loss measurement (see section 12.4 below).

One method that we have observed being applied to make this calculation is to track a portfolio of stage 2 facilities over a number of years and note how long it takes for the default rate to reduce to an immaterial level.

12.2.4 Interaction with derecognition

A further issue is the extent to which the period over which to measure expected credit losses is restricted by the normal derecognition principles of IFRS 9 and what could constitute a derecognition of the facility. In particular, it is unclear whether the existence of a contractual life and/or the lender's ability to revise the terms and conditions of the facility based on periodic credit reviews as thorough as that on origination, would be regarded as triggers for derecognition and so would also limit the life for expected credit loss measurement.

Frequently asked questions

Question 12-5: How to determine the date of initial recognition of a revolving credit facility for the purposes of the assessment of significant increases in credit risk?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 22 April 2015 - Agenda paper no. 4)

In April 2015, the IFRS Transition Resource Group for Impairment of Financial Instruments (see section 1.4 above) discussed how to determine the date of initial recognition of a revolving credit facility for the purposes of the assessment of significant increases in credit risk. The challenge presented was how to determine when changes are sufficiently significant to result in a derecognition of the original facility and recognition of a new facility. The IFRS Transition Resource Group for Impairment of Financial Instruments members discussed some of the factors that might be taken into consideration in making that judgement, such as issuing a new card, revising credit limits or conducting credit reviews.

It was noted that judgement would be required in making this assessment and that it would depend on the specific facts and circumstances. However, the following observations were made:

(a) In some circumstances issuing a new card may be indicative that the original facility has been derecognised, but in other cases, this may be a purely operational process and thus would not indicate that a new facility has been issued.

(b) Credit reviews in themselves may not indicate that a new facility has been issued.

Although this discussion was on how to determine the reference date for assessing if there has been a significant increase in credit risk, the notion that it depends on the derecognition of one facility and the recognition of a new one would, presumably, be equally relevant for assessing the period over which to measure expected credit losses. This is especially relevant for corporate overdraft facilities which are considered to be in the scope of the exception (see section 12.1 above). If, for instance:

(a) The facility has a clearly agreed contractual life of one year (in addition to a short cancellation notice period)

(b) The bank goes through a thorough credit process each year, similar to that on original application and using detailed financial and other information specific to the customer, before deciding whether to continue with the facility, increase it, reduce it or withdraw it

(c) The bank will at that time revise the terms and conditions of the facility to reflect the up-to-date credit quality of the borrower

(d) The bank derecognises the facility and recognises a new one, giving the associated required disclosures

Intuitively, it would seem that the bank is only exposed to credit risk for the period of a year.

This is consistent with the Basis for Conclusions which confirms the general principle that, "if an entity decides to renew or extend its commitment to extend credit, it will be a new instrument for which the entity has the opportunity to revise the terms and conditions." *[IFRS 9.BC5.260]*. Also, while IFRS 9.BC5.261, by starting with the word 'however', makes it clear that the revolving facilities amendment was an exception to this principle, it does not explicitly state that it is an exception to the entire principle. It only says that "the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure" remaining silent on an entity's ability to renew or extend credit. On the other hand, some believe that an ability to withdraw or cancel is in substance sufficiently similar to an ability to renew or extend, that they are treated the same. They also consider that the IASB webcast has made it clear that only expected reductions and withdrawals of facilities can be reflected in the assessment of the risk horizon. Consequently, a decision to maintain the facility, even if based on fully revised terms and conditions, would not be considered a risk management decision that shortens the life of the facility.

There are also differences of view as to whether a revolving facility can be derecognised (and so the expected derecognition can be reflected in the expected credit loss horizon) if the lender carries out an annual thorough periodic credit review at least equivalent to that when the facility was first granted, at which point it may revise the terms and conditions, but there is no contractual limit to the life of the facility, or if there is a contractual limit to the life of the facility but no thorough credit review at the point of renewal. In the first case, the contract allows for a periodic credit review equivalent to that on origination, performed on an individual rather than a collective basis and with an opportunity to revise the terms and conditions if the credit quality has changed, some believe that this could lead to derecognition of the facility and recognition of a new one. As a result, expected credit losses would only be measured over the period until the next periodic review. In the second case, the facility has a clearly agreed contractual life but its renewal is relatively automatic without a thorough review. Some believe that IFRS 9 is clear that a financial instrument is derecognised if it expires and therefore a thorough credit review is not required.

It is important for banks to disclose the basis on which they have made their calculations.

It needs to be stressed that this issue is of relevance mostly for those facilities that are measured using lifetime credit losses. The allowance for those assets in stage 1 will be calculated based only on losses associated with default in the next twelve months.

12.3 Exposure at default

To measure expected credit losses on revolving facilities, such as credit cards, it will be necessary to estimate several components that make up the exposure at default:

- The credit conversion factor, to determine the portion of the undrawn revolving credit facility at the reporting date that will be drawn down at the time of default in any period (limited for facilities in stage 1 to the next twelve months)
- The speed at which drawn down facilities are paid off
- The level of interest expected to be charged in the future on those facilities that are drawn down

These components will all need to be estimated based on past experience and future expectations, for sections of the portfolio that are segmented so that they have similar credit characteristics (see section 6.5.2 above). The estimation of interest is addressed further in section 12.4 below.

How we see it

In practice, for many credit cards, the exposure in the event of default reaches close to the credit limit and may even exceed it. However, IFRS 9 does not permit the use of a credit conversion factor of more than 100%. For this reason, the use of a conventional credit conversion factor model for estimating the exposure at default may need to be adjusted to comply with IFRS 9.

Frequently asked questions

Question 12-6: Whether an exposure in excess of the contractually agreed credit limit could be used when estimating the exposure at default for revolving credit facilities in accordance with IFRS 9 when an entity has a history of allowing customers to exceed their contractually set credit limits?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 16 September 2015 - Agenda paper no. 3)

At its meeting on 16 September 2015, the IFRS Transition Resource Group for Impairment of Financial Instruments (see section 1.4 above) discussed how an entity estimates future drawdowns on undrawn lines of credit and noted that:

- The exception for some types of revolving credit facilities set out in IFRS 9.5.5.20 relates to the contractual commitment period and does not address the contractual credit limit. IFRS 9 was clear in this regard and consequently, it would not be appropriate to analogise this specific exception to the contractual credit limit.
- Some members of the IFRS Transition Resource Group for Impairment of Financial Instruments pointed out that, in practice, the tenor and amount of revolving credit facilities are inextricably linked, because banks not only extend credit for a period in excess of their maximum contractual commitment period but also allow customers to make drawdowns in excess of the maximum contractually agreed credit limit as notified to the customer. Consequently, if amounts in excess of the maximum contractually agreed credit limits are not taken into account, there would be a potential disconnect between the accounting and credit risk management view.
- However, it was concluded that IFRS 9 limits the estimation of future drawdowns to the contractually agreed credit limit.

12.4 Time value of money

The time value of money is important in measuring expected credit losses for revolving facilities since interest rates (when interest is charged) are high. Hence it is important that any interest that is expected to be charged on drawn balances is included in the exposure at default and that an appropriate rate is used to discount expected credit losses. An additional complexity is introduced by credit cards, because they typically have a grace period in which no interest is charged as long as the amount drawn down is repaid within a specified period of time.

According to the guidance for 'normal' loan commitments, the expected credit losses on a loan commitment must be discounted using the effective interest rate, or an approximation thereof, that will be applied when recognising the financial asset resulting from the loan commitment. *[IFRS 9.B5.5.47]*. Applying this approach, the expected credit losses on the currently undrawn portion of a revolving facility is discounted based on the rate that is likely to be charged if it is drawn down. However, the IFRS Transition Resource Group for Impairment of Financial Instruments discussion on the scope of revolving credit facilities in December 2015 (see section 12.1 above) noted that the drawn and undrawn balances are viewed as one unit of account and so discounted at the same rate. This could be nil for a credit card customer that is a 'transactor', that is, one who repays any amount drawn down within the specified short period and so is charged no interest. If it is expected that interest will be charged at the high rate, which is likely for most facilities that are already 'revolvers', that is, those facilities where the borrower only pays off the minimum amounts permitted by the issuer (in effect, using the card to borrow money), then the discount rate is likely to be the high rate. If it is projected that a transactor, will at some stage become a revolver before it defaults, then it may be appropriate to calculate a blended discount rate.

In addition, at the same meeting, the IFRS Transition Resource Group for Impairment of Financial Instruments discussion on the use of floating-rates of interest to measure expected credit losses (see section 5.7 above) established a useful principle, that there should be consistency between the rate used to recognise interest revenue, the rate used to project future cash flows (including shortfalls) and the rate used to discount those cash flows.

Because the choice of interest rate used to project cash flows and to discount losses will depend on expectations of the borrower's behaviour, it will need to be made separately for segments of the portfolio with similar credit and payment characteristics.

While the high rates charged by a credit card issuer are sometimes fixed in the contract, the fact that the rate charged (nil or the high rate) depends on how quickly the customer repays the amount drawn, means that the rate can be thought of as 'floating', even if it does not vary with a benchmark rate of interest. This is important since otherwise it would be necessary to assess the effective interest rate on initial recognition and keep this fixed unless the facility is derecognised, ignoring any changes in customer behaviour.

Applying this principle, for a credit card customer that is a 'transactor', it would not be appropriate to discount expected credit losses (i.e., the lender applies an interest rate of nil). On the other hand, for a revolver, the high rate of interest is included in the forecast cash flows and in the discount rate.

However, any transactor who goes on to default is likely to begin paying off less than the full amount for a period of time before they default. To estimate the expected credit losses for this scenario, it will be necessary to include any interest that will be charged in this period. A consistent discount rate will then be a blended rate, of nil for the period over which the customer is expected to pay no interest and the high rate over the period in which they will pay the higher rate.

How we see it

In practice, it is likely that credit card issuers will often adopt procedures to discount their expected credit losses that may be less sophisticated than set out above, due to operational constraints and because the objective of IFRS 9 is to discount expected credit losses at an approximation of the effective interest rate. However, it is necessary to understand what is theoretically required by the standard in order to be able to assess whether a pragmatic approach is a reasonable approximation when determining the discount rate.

12.5 Determining significant increases in credit risk

As already mentioned in section 12.2 above, at its April 2015 meeting, the IFRS Transition Resource Group for Impairment of Financial Instruments discussed the starting reference date when assessing significant increases in credit risk for a portfolio of revolving credit facilities. There will typically be a diverse customer base, ranging from long-standing customers who have been with the bank for many years, to new customers who have only recently opened an account. IFRS 9's general rule is that the starting reference date is the date of original recognition. Consequently, the date of initial recognition for this purpose is the date the facility was issued and this is only changed if there has been a derecognition of the original facility. As discussed in section 12.2 above, it is not altogether clear what would qualify as a derecognition within the context of the revolving facility exception. If the lender derecognises a facility at the end of its contractual term and recognises a new one when it decides to renew or extend credit, consistent with the Basis for Conclusions, it would be consistent to assess if there has been a significant increase in credit risk from when the current facility was first recognised. *[IFRS 9.BC5.260]*. Similarly, it may make sense to use the date that the limit was increased if a facility is now far larger than would have been granted on original recognition. There is also a view that the credit risk on the date that the facility was last increased may be a useful proxy for the credit risk on the date of original recognition. There is a particular challenge on transition to IFRS 9, since entities may have limited data on the credit risk at the date of original recognition. (See section 5.9 above).

However, as discussed in section 12.2 above, another view is that only a reduction or cancellation of the facility would lead to the revolving facility being derecognised. In some circumstances, issuing a new card may be indicative that the original facility has been derecognised (e.g., replacement of a student credit card with a new credit card upon graduation), but in other cases, this may be a purely operational process and thus would not indicate that a new facility has been issued.

The IFRS Transition Resource Group for Impairment of Financial Instruments did not conclude further on this issue and it was not discussed in the IASB's webcast on 16 May 2017. Consequently, at the date of writing this issue had not been resolved.

13 Intercompany loans

For those entities that prepare separate IFRS financial statements, one of the challenges in complying with the IFRS 9 impairment requirements is the application to intercompany loans to members of the same group.

The two most common difficulties faced are the paucity of data to calculate the expected credit losses and the possibility that intercompany loans are either undocumented, or not documented in accordance with the substance of the arrangement. For instance, it is possible that a group entity is financed entirely by debt rather than partly through equity, so that the substance of the loan (at least in part) may be closer to an equity investment in that entity.

Although not explicitly stated, it is clear from IFRS 9 that the recognition of a loss allowance involves a debit to profit or loss (IFRS 9.5.5.8). There is no exception for intercompany loans. Therefore, it needs to be stressed that any expected credit losses measured on a loan to a group entity will require a charge to profit or loss. For instance, the expected credit loss on a loan to a subsidiary will result in an impairment expense and it cannot be capitalised as part of the investment in the subsidiary.

13.1 Scope of intercompany loans under IFRS 9

All intercompany loans measured at amortised cost or fair value through other comprehensive income are in the scope of the expected credit loss requirements (see Chapter 44 at sections 4.2 and 4.3). Paragraph 2.1(a) of IFRS 9 scopes out of the standard, interests in subsidiaries accounted for in accordance with IAS 27 *Separate Financial Statements* and IAS 27.10 allows investments in subsidiaries to be accounted for at cost as an alternative to applying IFRS 9. For such investments, impairment would be calculated applying IAS 36 *Impairment of Assets*. 'Investments' are not defined in IAS 27. Although IAS 27 is usually read to refer to investments in shares, an argument might be made that it can also cover intercompany arrangements which are, in substance, capital investments. However, in its September 2016 meeting, the IFRS IC seem to have ruled against this. The IFRS Interpretations Committee discussed the interaction of IFRS 9 and IAS 28 *Investments in Associates and Joint Ventures* where a loan is regarded as part of 'long-term interests that, in substance, forms part of the entity's net investment' as set out in IAS 28.38, which gives as an example, "an item for which settlement is neither planned nor likely to occur in the foreseeable future". The IFRS IC concluded that although a loan is considered as 'in substance part of the investment', for the purposes of allocating losses in IAS 28, it is still in the scope of IFRS 9 as it is not 'an investment' as mentioned in scope IFRS 9.2.1(a) and, except for the allocation of losses, is not accounted for using the equity method. Since then, in October 2017, the IASB amended IAS 28 to clarify that IFRS 9 applies to long term interests in associates and joint ventures.

The IFRS IC discussion was in the context of IAS 28 and not IAS 27. It is perhaps relevant that IFRS 9 in its scope paragraph refers to 'interests' in subsidiaries, rather than 'investments', although IAS 27 itself uses 'investments'. IAS 27 also allows investments to be at cost, rather than accounted for using the equity method. However, it would probably be difficult to sustain an argument that 'investments' as used in IAS 27, encompasses loans which are, in substance, part of the net investment, when the IFRS IC has concluded that the same term in IAS 28 does not.

On balance, an undocumented interest free loan to a subsidiary, when there is no expectation of repayment, may be better characterised for accounting purposes as a capital contribution. If this is the case, then it ought to be documented as such and then it may be measured at cost under IAS 27 and subject to the impairment requirements of IAS 36, rather than those of IFRS 9. The amendment of a loan (if previously documented as such) to a capital contribution would be similar to a forgiveness of the debt and therefore, as already mentioned above, may have (or be constrained by) tax implications and may only be capable of being repaid in the future if there are adequate distributable profits.

In addition, there might often be cases where the contractual terms of an intercompany loan which is not 'on demand' are determined to be 'off-market' (e.g., interest-free or below-market rate). In such cases, a portion is highly likely to be accounted for as a capital contribution within the scope of IAS 27, depending on the facts and circumstances. That being the case, the remaining portion would likely be within the scope of IFRS 9 (IFRS 9.B5.1.1 and B5.1.2), in which case measurement at amortised cost or fair value through other comprehensive income would require the financial instrument to pass the IFRS 9 solely payment of principal and interest criterion as otherwise it would need to be measured at fair value through profit and loss.

13.2 Intercompany loans repayable on demand

Assuming the intercompany loan meets the solely payment of principal and interest and business model criteria and is measured either at amortised cost or fair value through other comprehensive income, according to IFRS 9.5.5.19, the maximum period to consider when measuring expected credit losses is the maximum contractual period over which the entity is exposed to credit risk, even if a longer period is consistent with business practice. However, it would be inconsistent to base the period on the lender's ability to call the debt without also evaluating the probability of default based on the assumption that the debt will be called.

If a loan is repayable on demand, the period over which losses are calculated would normally be no more than 24 hours. If the borrowing group entity is able to repay the loan when demanded, the probability of default would usually be very small and the expected credit loss is likely to be immaterial. However, this treatment would not be appropriate for a loan that may be documented as on demand, but in substance provides long term finance (see Chapter 9 at section 4.3). The borrowing group entity would be unable to repay the loan if it is called at short notice, because it does not currently have access to the means to repay it or to other sources of financing, if the loan is called, the probability of default would be high and close to 100% if the entity could not repay it.

How we see it

The lender would be entitled to look to the manner of recovery of the amount due in calculating the loss given default, which may mean that it would allow the subsidiary a number of years to accumulate the funds to repay the loan. In instances where the lender expects to recover the full amount of the loan, the expected credit loss will be limited to the effect of discounting of the loan amount over the recovery period and if the loan is interest free, i.e., the effective interest rate is 0%, then there will be no impairment loss. In addition, the lender group entity will also need to consider the staging of these loans, which will require judgement (see section 6 above).

13.3 Determining the expected credit losses of intercompany loans

The Application Guidance to IFRS 9 provides a list of qualitative factors that are relevant in assessing changes in credit risk, all of which may be applicable to assessing whether a significant increase in credit risk has occurred on an intercompany loan (see section 6.2.1 above). Compared to most loans to third parties, a lender within a group is likely to have access to much more qualitative and quantitative information about the credit risk of the borrower. Consequently, the staging assessment is likely to be much better informed than for a third-party loan and will be, primarily, a qualitative exercise. In many cases, it will be reasonably clear whether there has been a significant increase in credit risk since the inception of the loan, although judgement will still be required to determine whether it is 'significant'. Circumstances that indicate a significant increase in credit risk may include a significant change in the business, financial or economic conditions, or regulatory, economic or technological environment in which the borrower operates, declining revenues and margins, or capital deficiencies. Any of these changes are likely to have a significant impact on the entity's ability to meet its debt obligations. *[IFRS 9.B5.5.17(f), IFRS 9.B5.5.17(g), IFRS 9.B5.5.17(i)]*.

Also, the credit risk on a loan depends in part on the level of loss absorbing equity of the borrowing entity. For those intercompany loans between fellow subsidiaries that are explicitly guaranteed by a parent, the expected credit loss may be much lower than those without a parental guarantee. Also, if the parent is listed and the guarantee is integral to the loan, the expected loss will normally be equal to the parent's probability of default multiplied by its loss given default. That is because the parent will usually be expected to ensure, if it can do so, that its subsidiary will not default (and the subsidiary is likely to default if the parent does). It will often be much easier to calculate an expected credit loss based on a parent probability of default and loss given default since there may be market quoted bond spreads, credit default swap spreads and credit ratings to draw upon. Therefore, it may be advisable to formally document guarantee arrangements between a parent and subsidiary when this is already the implicit basis on which the loan was entered into. Another scenario could be that the parent has no activities other than acting as a holding entity, in which case its probability of default will be closely aligned with that of its subsidiaries. There could also be situations where the subsidiary can be expected to survive even if the parent defaults.

How we see it

To the extent that the lender is the parent, it cannot, for its own accounting purposes, rely on guarantees given by itself. However, any group entity that does provide a guarantee will need to measure its exposure to the guarantee, hence the existence of a guarantee does not remove the challenge of calculating the probability of default and loss given default of the subsidiary. In general, the fact that a group intends to ensure that a subsidiary will never default does not eliminate the risk posed by that subsidiary's activities or remove the need for an expected credit loss allowance.

If there are cross-company guarantees within the group relating to loans from external parties of the group, each entity affected by the cross-company guarantee arrangement needs, for the calculation of expected credit losses in its standalone financial statements to factor in the cross-company guarantees in place (see section 11.4 above).

14 Presentation of expected credit losses in the statement of financial position

IFRS 9 uses the term 'loss allowance' throughout the standard as an umbrella term for expected credit losses that are recognised in the statement of financial position. However, that umbrella term leaves open the question of how those expected credit losses are presented in that statement. Their presentation differs by the type of the credit risk exposures that are in scope of the impairment requirements. *[IFRS 9 Appendix A]*. This section explains how presentation applies in the different situations.

Any adjustment to the loss allowance balance due to an increase or decrease of the amount of expected credit losses recognised in accordance with IFRS 9, is reflected in profit or loss in a separate line as an impairment gain or loss. *[IAS 1.82(ba), IFRS 9.5.5.8, IFRS 9 Appendix A]*.

14.1 Allowance for financial assets measured at amortised cost, contract assets and lease receivables

Expected credit losses on financial assets measured at amortised cost, lease receivables (see Chapter 24) and contract assets (see Chapter 28) are presented as an allowance, i.e., as an integral part of the measurement of those assets in the statement of financial position.

Unlike the requirement to show impairment losses as a separate line item in the statement of profit or loss, there is no similar consequential amendment to IAS 1 to present the loss allowance as a separate line item in the statement of financial position. *[IAS 1.82(ba)]*.

It is clear from IFRS 9 that the definition of amortised cost of a financial asset is after adjusting for any loss allowance and hence, the loss allowance would reduce the gross carrying amount in the statement of financial position (which is why an allowance is sometimes referred to as a contra asset account). *[IFRS 9 Appendix A]*. Accordingly, financial assets measured at amortised cost, contract assets and lease receivables are presented net of the loss allowance at their amortised cost in the statement of financial position.

Frequently asked questions

Question 14-1: Whether an entity is required to present the loss allowance for financial assets measured at amortised cost (or trade receivables, contract assets or lease receivables) separately in the statement of financial position?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 11 December 2015 - Agenda paper no. 10)

At the IFRS Transition Resource Group for Impairment of Financial Instruments meeting in December 2015 (see section 1.4 above), the IFRS Transition Resource Group for Impairment of Financial Instruments members first noted that irrespective of how the loss allowance is presented or how it is included in the measurement of the financial instrument, IFRS 7 contains disclosure requirements pertaining to the loss allowance for all financial instruments within the scope of the IFRS 9 impairment requirements. The IFRS Transition Resource Group for Impairment of Financial Instruments members also noted that, in contrast to the case of financial assets measured at fair value through other comprehensive income, neither IFRS 9 nor IFRS 7 contains any specific requirements regarding the presentation of the loss allowance for financial assets measured at amortised cost (or trade receivables, contract assets or lease receivables) on the face of the statement of financial position. In accordance with the general requirements of IAS 1, the financial statements should fairly present the financial position of an entity. However, the IFRS Transition Resource Group for Impairment of Financial Instruments members noted that IAS 1.54 does not list the loss allowance as an amount that is required to be separately presented on the face of the statement of financial position.

14.1.1 Write-off

IFRS 9 provides guidance on when the allowance is used, i.e., when it is applied against the gross carrying amount of a financial asset. This occurs when there is a write-off on a financial asset, which happens when the entity has no reasonable expectations of recovering the contractual cash flows on a financial asset in its entirety or a portion thereof. A write-off is considered a derecognition event. *[IFRS 9.5.4.4, IFRS 9.B3.2.16(r)]*.

For example, a lender plans to enforce the collateral on a loan and expects to recover no more than 30% of the value of the loan from selling the collateral. If the lender has no reasonable prospects of recovering any further cash flows from the loan, it should write off the remaining 70%. *[IFRS 9.B5.4.9]*. The example given in

IFRS 9 demonstrates that write-offs can be for only a partial amount instead of the entire gross carrying amount.

Some examples of circumstances which could lead to full or partial write off are where:

- Individually assessed loans that are secured, are written-off after the receipt of the proceeds from the realisation of the security, and there is no expectation that any further amounts will be recovered by any other means

  Or

- A borrower is declared bankrupt or insolvent, especially in the case of unsecured exposures where the liquidator or administrator has indicated that there are not sufficient resources available to satisfy the unsecured creditors

In practice, for collectively assessed loans, write-offs may also be effected within certain time frames post-default of a financial asset, for example unsecured loans may be written-off within a number of years after default.

The Illustration below shows how partial write-offs may be determined for a loan in stage 3.

Illustration 14-1: Partial write-offs for a loan in stage 3

As at 31 December 20X2, the lender has an impaired loan in stage 3 and determines that it has a 75% probability of recovering nothing and a 25% probability of recovering 20% of the value of the loan. Ignoring discounting, the overall expected credit loss would be 95% (i.e., 100% - (75% × 0% plus 25% × 20%)). The probability-weighted expectation is therefore a recovery of 5% of the loan balance.

As there is still 25% probability of recovering 20% of the value of the loan, the lender writes-off a partial amount of the loan, i.e., 80% of the loan balance, leaving 20% of the loan on the balance sheet and an expected credit loss of 15%.

Because IFRS 9 requires a loan to be written off in part when it is no longer expected that a portion of the amount due will be collected, the loan may be written off in partial amounts as stage 3 progresses. This means that there may be no single 'write-off point' but instead a continuum; e.g., a loan may initially be written off 50%, then 80% and finally 100%.

Practice varies in terms of write-off and is sometimes dependent on the influence of prudential regulators.

Write-off requirements in IFRS 9 are considered at each reporting date and are not delayed until some arbitrary past due date has been reached. On the other hand, if collection efforts continue and have some possibility of success, total write-off would also seem to be inappropriate.

If the amount of loss on write-off is greater than the accumulated loss allowance, the difference will be an additional impairment loss. In situations where a further impairment loss occurs, the question has arisen as to how it is presented: simply as a loss in profit or loss with a credit directly to the gross carrying amount; or first, as an addition to the allowance that is then applied against the gross carrying amount. The difference between those alternatives is whether the additional impairment loss flows through the allowance, showing up in a reconciliation of the allowance as an addition and a use (i.e., a write-off), or whether such additional impairment amounts bypass the allowance. The IASB's original 2009 exposure draft (see section 1.1 above) explicitly mandated that all write-offs could only be debited against the allowance, meaning that any direct write-offs against profit or loss without flowing through the allowance were prohibited.[40] IFRS 9 does not include any similar explicit guidance on this issue (see Chapter 46 at section 3.8.1 in relation to presentation of modification losses).

Similarly, IFRS 9 does not provide guidance on accounting for subsequent recoveries of a financial asset. Arguably, there would be a higher threshold when recognising an asset that has been previously written-off and this is likely to be when cash is received rather than when the criteria for write-off are no longer met. It might also be argued that such recoveries are often not significant, as write-off only occurs when there is no reasonable expectations of recovering the contractual cash flows. The occurrence of large recoveries subsequent to the recognition of total write-offs will give entities an indication to reconsider their approaches to future write-offs.

As the nature of recoveries are similar to reversals of impairment, it makes sense to present such recoveries in the impairment line in profit or loss as it would provide useful and relevant information to the users of the financial statements. *[IAS 1.82(ba)]*.

40 Exposure Draft ED/2009/12: *Financial Instruments: Amortised Cost and Impairment*, IASB, November 2009, para. B23. Available on the IFRS Foundation's website.

How we see it

IFRS 7 requires an entity to disclose its policies in relation to write-offs and also, the amounts written off during the period that are still subject to enforcement activity (see section 15 below and Chapter 50 at section 5.3). It is noted that there is a tension between this requirement and the criteria in IFRS 9 for write-off, since it may be difficult to argue that there is no reasonable expectation of recovering the contractual cash flows if the loan is still subject to enforcement activity.

14.1.2 Presentation of the interest revenue, gross carrying amount, amortised cost, expected credit loss expense and expected credit loss allowance for credit-impaired assets

For financial assets that are not purchased or originated credit-impaired financial assets but subsequently have become credit-impaired, i.e., moved to stage 3, in subsequent reporting periods the interest revenue is calculated by multiplying the effective interest rate by the net amortised cost, i.e., the gross carrying amount of the financial asset net of the expected credit loss allowance. *[IFRS 9.5.4.1(b)]*. However, the application of the effective interest rate to the amortised cost of the financial asset applies only to the calculation and presentation of interest revenue. The Basis for Conclusions confirms that this does not affect the measurement of the loss allowance. *[IFRS 9.BC5.75]*. As long as the asset was not credit-impaired on initial recognition, the effective interest rate is based on the contractual cash flows, excluding expected credit losses and this does not change when the asset becomes credit-impaired. *[IFRS 9.B5.4.4, IFRS 9 Appendix A]*. Consequently, the calculation of the gross carrying amount and the expected credit loss allowance, as disclosed in the notes to the financial statements, are not affected by the recognition of interest revenue moving from a gross to a net basis.

Frequently asked questions

Question 14-2: How the gross carrying amount and loss allowance for credit-impaired financial instruments that are not purchased or originated credit-impaired and that are measured at amortised cost should be calculated?

(IFRS Transition Resource Group for Impairment of Financial Instruments meeting 11 December 2015 - Agenda paper no. 9)

This was confirmed at a meeting of the IFRS Transition Resource Group for Impairment of Financial Instruments in December 2015 (see section 1.4 above), when a question was raised on how the disclosed figures for the gross carrying amount and loss allowance should each be calculated. The Illustration below is based on the IFRS Transition Resource Group for Impairment of Financial Instruments discussion but has been amended to reflect unpaid accrued interest in the gross carrying amount.

Illustration 14-2: Disclosing the gross carrying amount and loss allowance for credit-impaired financial assets that are not purchased or originated credit-impaired

The Bank originated a loan on 1 January 20X2, with an amortised cost of CU100 and an effective interest rate of 10% per annum. On 31 December 20X2, the loan is considered to be credit-impaired and so is moved to stage 3, and an impairment allowance is recognised of CU70. Accordingly, the gross carrying amount of the loan is now CU110 and the amortised cost is now CU40. During 20X3, no cash is received, and on 31 December 20X3, there is no change in the expected cash flows. Accordingly, the amortised cost becomes CU44 (being CU40 + (CU40 × 10%)). Three different ways could be used to reflect the changes in the net amortised cost in the gross carrying amount and the loss allowance. In Approach A, interest continues to be accrued in the measurement of the gross carrying amount at 10%, in Approach B, the interest accrued to the gross carrying amount is only the CU4 recorded in profit or loss, while in Approach C, no interest is added to the gross carrying amount:

Approach	A	B	C
	CU	CU	CU
Gross carrying amount*	121	114	110
Loss allowance	(77)	(70)	(66)
Amortised cost	44	44	44

* The gross carrying amount of CU121 is calculated by adding the effective interest rate of 10% per annum on the 31 December 20X2 gross carrying amount of CU110, i.e., 10% × CU110 = CU11.

The IFRS Transition Resource Group for Impairment of Financial Instruments members appeared to agree that only Approach A is IFRS 9-compliant. Thereby, for assets in stage 3, it is necessary to 'gross up' accrued interest income, to increase both the disclosed gross carrying amount and loss allowance in the notes to the financial statements. Approach A requires the entity to calculate:

(a) The gross carrying amount by discounting the estimated contractual cash flows (without considering expected credit losses) using the original effective interest rate

(b) The loss allowance by discounting the expected cash shortfalls using the original effective interest rate

Depending on the legal form of the loan, we assume that once interest is no longer contractually due, for instance when the bank moves to take possession of collateral, there would be no need to continue to make these gross up entries.

Moreover, the IFRS Transition Resource Group for Impairment of Financial Instruments did not consider the interaction between the recognition of interest income and the requirement to write off all or a proportion of the gross financial asset if there is no reasonable expectation of recovering the associated contractual cash flows. If there is no reasonable expectation that all of the contractual interest will be paid, then the lender presumably does not follow Approach A. Instead, a portion of the gross asset would be written off against the allowance, depending on the expectations of recovery. This could result in a lender reporting numbers closer to those in Approach B. By writing off accrued interest where there is no reasonable expectation of recovery, it may be possible to align the amounts disclosed for stage 3 loans under IFRS 9 with the figures that banking regulators require to be disclosed for non-performing loans.

The IASB is of the view that, conceptually, an entity assesses whether financial assets have become credit-impaired on an ongoing basis, thus, altering the presentation of interest revenue as the underlying economics change. However, the IASB noted that such an approach would be unduly onerous for preparers to apply. Thus, the IASB decided that an entity is required to make the assessment of whether a financial

asset is credit-impaired at the reporting date and then change the interest calculation from the beginning of the following reporting period. *[IFRS 9.BC5.78]*. This reference to reporting period is therefore in the context of a practical expedient.

How we see it

'Reporting period' includes both annual (full IFRS) and interim (IAS 34 *Interim Financial Reporting*) financial reporting periods for which financial statements are produced in accordance with IFRS. 'Subsequent reporting period' therefore refers to the next interim or annual reporting period, whichever comes sooner, where an entity is required to change between gross and net interest income presentation if the financial asset has become (or ceased to be) credit-impaired at the reporting date.

If entities voluntarily perform their staging and interest calculations more frequently than their reporting periods, this is not contrary to the objective of this requirement, provided that the approach is applied consistently. Arguably, if an entity is able to change the interest calculation earlier than the subsequent reporting date, then this would be a timelier adjustment and reflection of the interest revenue. However, this is not what IFRS 9 requires.

How we see it

An entity *may* assess whether a financial asset has become (or ceased to be) credit-impaired more frequently than at its reporting dates. If it does so, any resulting changes between gross and net interest income presentation will occur more frequently than at its next reporting period. Such an assessment may be made at the end of the period normally used by the entity for internal reporting purposes and when impairment is normally assessed, as opposed to applying an ad hoc period for this purpose. The timing of these assessments should be evenly spaced and consistently applied.

Frequently asked questions

Question 14-3: How an entity presents amounts recognised in the statement of profit or loss when a credit-impaired financial asset is subsequently cured (i.e., paid in full or no longer credit-impaired)?

(IFRS IC meeting 27 November 2018 and 5 March 2019 - Agenda paper no. 7 and no. 13 respectively)

At its meeting in November 2018 and March 2019, the IFRS IC noted that diversity in practice had arisen.

When a financial asset becomes credit-impaired, application of the effective interest rate to the amortised cost of the financial asset results in a difference between:

(a) The interest that would be calculated by applying the effective interest rate to the gross carrying amount of the credit-impaired financial asset

(b) The interest revenue recognised for that asset

If the financial asset cures and the full amount of interest income is subsequently received, how is this difference recorded? The IFRS IC concluded that, in the statement of profit or loss, an entity is required to present the difference as a reversal of impairment losses rather than as interest revenue following the curing of a credit-impaired financial asset.

In reaching its conclusion, the IFRS IC noted that IFRS 9.5.5.8 requires an entity to "recognise in profit or loss, as an impairment gain or loss, the amount of expected credit losses (or reversal) that is required to adjust the loss allowance at the reporting date to the amount that is required to be recognised in accordance with this Standard."

Applying IFRS 9.5.5.8, an entity recognises in profit or loss as a reversal of expected credit losses the adjustment required to bring the loss allowance to the amount that is required to be recognised in accordance with IFRS 9 (zero if the asset is paid in full). The amount of this adjustment includes the effect of the unwinding of the discount on the loss allowance during the period that the financial asset was credit-impaired. This means that the reversal of impairment losses may exceed the impairment losses recognised in profit or loss over the life of the asset.

On 22 July 2019, the IASB staff released an educational webinar which included an example explaining the accounting required to reflect the curing of a credit-impaired financial asset, consistent with the IFRS IC tentative agenda decision. This is shown in the Illustration below with amounts rounded to the nearest CU1 and 1%.

Illustration 14-3: Presentation of the interest revenue, gross carrying amount, amortised cost, expected credit loss expense and expected credit loss allowance for when assets move from stage 2 to stage 3 and *vice versa*

On 1 January 20X2, an entity originates a 5-year loan with a principal amount of CU100 and annual instalments of CU26 payable annually on 31 December, which results in an effective interest rate of 10%.

The entity measures expected credit losses for the first time at the first reporting date as at 31 December 20X2 after initial recognition. As at 31 December 20X2, the credit risk on the loan has increased significantly since initial recognition (i.e., the loan has moved from stage 1 to stage 2) and the entity recognised lifetime expected credit losses of CU66. For the reporting period to 31 December 20X2, the interest revenue would be calculated by applying the 10% effective interest rate to the gross carrying amount of the loan of CU100, i.e., CU10. The annual instalment of CU26 was received.

As at 31 December 20X3, the next annual instalment had not been paid and the loan is assessed to be credit-impaired (i.e., stage 3). For the reporting period to 31 December 20X3, the interest revenue would be calculated by applying the 10% effective interest rate to the gross carrying amount of the loan of CU84, i.e., CU8. To simplify the example, there is no change in the expected shortfalls in contractual cash flows between 31 December 20X2 and 31 December 20X4 even though the loan has deteriorated to stage 3. An impairment loss of CU7 is recognised for the unwinding of the discount based on the effective interest rate determined at initial recognition of 10%, in order to reflect the passage of time, i.e., 10% effective interest rate on the CU66 impairment loss allowance.

For the year to 31 December 20X4, the interest revenue would be calculated by applying the 10% effective interest rate to the amortised cost of the loan of CU19, i.e., CU2, instead of the gross carrying amount. Both the gross carrying amount and expected credit loss allowance are discounted and therefore, need to reflect the effect of the unwinding of the discount. The gross carrying amount needs to increase by CU9 and the expected credit loss allowance needs to increase by CU7, based on the effective interest rate determined at initial recognition of 10%, in order to reflect the passage of time. As interest revenue of CU2 has been recognised, both the gross carrying amount and expected credit loss allowance need to increase by an additional CU7 (reflected as unwinding of the discount).

To simplify the example, it is assumed that as at 1 January 20X5, the entity received the contractual amount due in full of CU101. CU80 of impairment losses are released as a credit to the impairment expense. In this example the impairment credit exceeds the impairment losses previously recognised in profit or loss over the life of the asset (CU66 + CU7 = CU73) due to the effect of the unwinding of the discount on the loss allowance during the period that the financial asset was credit-impaired.

	31 December 20X2	31 December 20X3	31 December 20X4	31 December 20X5
	Stage 2	*Stage 3*	*Stage 3*	*Fully repaid*
	CU	CU	CU	CU
Statement of financial position				
Gross carrying amount				
As at 1 Jan	100	84	92	101
Interest accrued (i.e., effective interest rate) on the gross carrying amount (stage 2) or amortised cost in the next reporting period (stage 3)	10	8	2	-
Unwinding of discount	-	-	7	-
Repayment	(26)	-	-	(101)
As at 31 Dec	84	92	101	-

Expected credit losses allowance				
As at 1 Jan	-	66	73	80
Impairment	66	-	-	(80)
Unwinding of discount	-	7	7	-
As at 31 Dec	66	73	80	-
Amortised cost				
As at 1 Jan	100	18	19	21
As at 31 Dec	18	19	21	-
Statement of profit or loss				
Interest revenue	10	8	2	-
Impairment loss/(reversal)	66	7	-	(80)

14.2 Provisions for loan commitments and financial guarantee contracts

In contrast to the presentation of impairment of assets, expected credit losses on loan commitments and financial guarantee contracts are presented as a provision in the statement of financial position, i.e., as a liability. *[IFRS 9 Appendix A]*.

Extract from IFRS 7

B8E For loan commitments and financial guarantee contracts the loss allowance is recognised as a provision. An entity should disclose information about the changes in the loss allowance for financial assets separately from those for loan commitments and financial guarantee contracts. However, if a financial instrument includes both a loan (ie financial asset) and an undrawn commitment (ie loan commitment) component and the entity cannot separately identify the expected credit losses on the loan commitment component from those on the financial asset component, the expected credit losses on the loan commitment should be recognised together with the loss allowance for the financial asset. To the extent that the combined expected credit losses exceed the gross carrying amount of the financial asset, the expected credit losses should be recognised as a provision.

[IFRS 7.B8E].

For financial institutions that offer credit facilities, commitments may often be partially drawn down, i.e., an entity may have a facility that includes both a loan (a financial asset) and an undrawn commitment (a loan commitment). If the entity cannot separately identify the expected credit losses attributable to the drawn amount and the undrawn commitment, IFRS 7 requires an entity to present the provision for expected credit losses on the loan commitment together with the allowance for the financial asset. IFRS 7 states, further, that if the combined expected credit losses exceed the gross carrying amount of the financial asset, then the expected credit losses should be recognised as a provision (see extract above).

14.3 Accumulated impairment amount for debt instruments measured at fair value through other comprehensive income

Rather than presenting expected credit losses on financial assets measured at fair value through other comprehensive income as an allowance, this amount is presented as the 'accumulated impairment amount' in other comprehensive income. This is because financial assets measured at fair value through other comprehensive income are measured at fair value in the statement of financial position and the accumulated impairment amount cannot reduce the carrying amount of these assets (see section 9 above for further details). *[IFRS 9.4.1.2A, IFRS 9.5.5.2, IFRS 9 Appendix A]*.

15 Disclosures

The credit risk disclosure requirements have expanded significantly and are supplemented by some detailed implementation guidance. The disclosure requirements in relation to the IFRS 9 expected credit losses model are dealt with in more detail in Chapter 50 at section 5.3, and this section provides only a high level summary.

The credit risk disclosure requirements will aim to enable users of financial statements to understand better an entity's credit risk management practices, its credit risk exposures, expected credit losses estimates and changes in credit risks. *[IFRS 7.35B]*. In order to meet this objective, an entity will need to disclose both quantitative and qualitative information that includes the following:

- Inputs, assumptions and estimation used (and any changes) to determine significant increases in credit risk of financial instruments, including the application of the low credit risk and more than 30 days past due operational simplifications (see section 6 above). *[IFRS 7.35F(a), IFRS 7.35G(a)(ii), IFRS 7.35G(c)]*.
- Inputs, assumptions and techniques used (and any changes) in measuring 12-month and lifetime expected credit losses, including the definition of default and the incorporation of forward-looking information (see section 5 above). *[IFRS 7.35F(b), IFRS 7.35G(a)(i), IFRS 7.35G(b), IFRS 7.35G(c), IFRS 7.B8A]*. How the financial instruments were grouped if the measurement of expected credit losses was performed on a collective basis (see section 6.5 above). *[IFRS 7.35F(c)]*.
- How collateral and other credit enhancements affect the estimate of expected credit losses, including a description of the nature and quality of collateral held and quantitative information about the collateral for financial assets that are credit-impaired (see sections 5.8.1 and 6.1.1 above). *[IFRS 7.35K, IFRS 7.B8F, IFRS 7.B8G]*.
- A reconciliation of the opening and closing balance of the loss allowance and explanations of the changes. This disclosure is required to be shown separately for: *[IFRS 7.35H]*
  - Financial instruments that are measured using 12-month expected credit losses
  - Those that are measured using lifetime expected credit losses
  - Those that are credit-impaired on initial recognition
  - Those that are subsequently credit-impaired
  - Trade receivables, contract assets and lease receivables measured under the simplified approach
- Explanation of how significant changes in the gross carrying amount of financial instruments during the period contributed to changes in the loss allowance. *[IFRS 7.35I]*.
- Inputs, assumptions and techniques used (and any changes) to determine whether a financial asset is credit-impaired (see sections 3.1 and 3.3 above). *[IFRS 7.35F(d), IFRS 7.35G(a)(iii), IFRS 7.35G(c)]*.
- For modified financial assets (see section 8 above): *[IFRS 7.35F(f), IFRS 7.B8B, IFRS 7.35J]*
  - The credit risk management practices (how an entity determines that a financial asset that is modified when its loss allowance was measured based on lifetime expected credit losses has improved to the extent that its allowance can now be reduced to 12-month expected credit losses, and how an entity monitors the extent to which such a loss allowance are subsequently brought back to lifetime expected credit losses).
  - The amortised cost before the modification and the net modification gain or loss recognised during the period for modified financial assets with a loss allowance measured at lifetime expected credit losses.
  - The gross carrying amount of those modified financial assets for which the loss allowance has changed from lifetime to 12-month expected credit losses during the period.
  - Quantitative information that will assist users to understand any subsequent increase in credit risk, including information about modified financial assets for which the loss allowance has reverted from 12-month expected credit losses to lifetime expected credit losses.
- The entity's credit risk exposure and significant credit risk concentrations, including the gross carrying amount of financial assets and the exposure to credit risk on loan commitments and financial guarantee contracts, by credit risk rating grades or past due status. This disclosure is required to be shown separately for: *[IFRS 7.35M, IFRS 7.B8H, IFRS 7.B8I]*
  - Those instruments that are measured using 12-month expected credit losses
  - Those that are measured using lifetime expected credit losses

Those that are credit-impaired on initial recognition

- Those that are subsequently credit-impaired
- Trade receivables, contract assets and lease receivables measured under the simplified approach

- The write-off policy and amounts written off during the period that are still subject to enforcement activity (see section 14.1.1 above). *[IFRS 7.35F(e), IFRS 7.35L]*.

In addition, the Enhanced Disclosure Task Force has developed common expected credit losses disclosure practices which are discussed in Chapter 50 at section 8.1.

How we see it

The disclosures required by IFRS 7 in respect of expected credit losses are substantial. It is critical for entities to align their credit risk management and financial reporting systems and processes, not only to estimate the loss allowance for expected credit losses, but also to produce a sufficient level of detailed information to meet the disclosure requirements in IFRS 7.

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Appendix C - Defined terms

Extract from IFRS 9

Appendix A
Defined terms

12-month expected credit losses	The portion of **lifetime expected credit losses** that represent the **expected credit losses** that result from default events on a financial instrument that are possible within the 12 months after the reporting date.
amortised cost of a financial asset or financial liability	The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any **loss allowance**.
contract assets	Those rights that IFRS 15 *Revenue from Contracts with Customers* specifies are accounted for in accordance with this Standard for the purposes of recognising and measuring impairment gains or losses.
credit-impaired financial asset	A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired include observable data about the following events: (a) significant financial difficulty of the issuer or the borrower; (b) a breach of contract, such as a default or past due event; (c) the lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider; (d) it is becoming probable that the borrower will enter bankruptcy or other financial reorganisation; (e) the disappearance of an active market for that financial asset because of financial difficulties; or (f) the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses. It may not be possible to identify a single discrete event- instead, the combined effect of several events may have caused financial assets to become credit-impaired.
credit loss	The difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (ie all cash shortfalls), discounted at the original **effective interest rate** (or **credit-adjusted effective interest rate** for **purchased or originated credit-impaired financial assets**). An entity shall estimate cash flows by considering all contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) through the expected life of that financial instrument. The cash flows that are considered shall include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms. There is a presumption that the expected life of a financial instrument can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the expected life of a financial instrument, the entity shall use the remaining contractual term of the financial instrument.

credit-adjusted effective interest rate	The rate that exactly discounts the estimated future cash payments or receipts through the expected life of the financial asset to the **amortised cost of a financial asset** that is a **purchased or originated credit-impaired financial asset**. When calculating the credit-adjusted effective interest rate, an entity shall estimate the expected cash flows by considering all contractual terms of the financial asset (for example, prepayment, extension, call and similar options) and **expected credit losses**. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1-B5.4.3), **transaction costs**, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the remaining life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).
effective interest method	The method that is used in the calculation of the **amortised cost of a financial asset or a financial liability** and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period.
effective interest rate	The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the **gross carrying amount of a financial asset or to the amortised cost of a financial liability**. When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the **expected credit losses**. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1-B5.4.3), **transaction costs**, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).
expected credit losses	The weighted average of **credit losses** with the respective risks of a default occurring as the weights.
financial guarantee contract	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.
gross carrying amount of a financial asset	The **amortised cost of a financial asset**, before adjusting for any **loss allowance**.
impairment gain or loss	Gains or losses that are recognised in profit or loss in accordance with paragraph 5.5.8 and that arise from applying the impairment requirements in Section 5.5.
lifetime expected credit losses	The **expected credit losses** that result from all possible default events over the expected life of a financial instrument.

loss allowance	The allowance for **expected credit losses** on financial assets measured in accordance with paragraph 4.1.2, lease receivables and **contract assets**, the accumulated impairment amount for financial assets measured in accordance with paragraph 4.1.2A and the provision for expected credit losses on loan commitments and **financial guarantee contracts**.
modification gain or loss	The amount arising from adjusting the **gross carrying amount of a financial asset** to reflect the renegotiated or modified contractual cash flows. The entity recalculates the gross carrying amount of a financial asset as the present value of the estimated future cash payments or receipts through the expected life of the renegotiated or modified financial asset that are discounted at the financial asset's original **effective interest rate** (or the original **credit-adjusted effective interest rate** for **purchased or originated credit-impaired financial assets**) or, when applicable, the revised **effective interest rate** calculated in accordance with paragraph 6.5.10. When estimating the expected cash flows of a financial asset, an entity shall consider all contractual terms of the financial asset (for example, prepayment, call and similar options) but shall not consider the **expected credit losses**, unless the financial asset is a **purchased or originated credit-impaired financial asset**, in which case an entity shall also consider the initial expected credit losses that were considered when calculating the original **credit-adjusted effective interest rate**.
past due	A financial asset is past due when a counterparty has failed to make a payment when that payment was contractually due.
purchased or originated credit-impaired financial asset	Purchased or originated financial asset(s) that are **credit-impaired** on initial recognition.
transaction costs	Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see paragraph B5.4.8). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

Appendix D - Illustrative Examples included in IFRS 9 and references

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Example 3	Highly collateralised financial asset	Section 6.1.1, Illustration 6-1
Example 4	Public investment-grade bond	Section 6.4.1, Illustration 6-5
Example 5	Responsiveness to changes in credit risk	Section 6.5.3, Illustration 6-10 and Illustration 6-11
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Example 10	Revolving credit facilities	Section 12.2.2
Example 11	Modification of contractual cash flows	Section 8.2, Illustration 8-1
Example 12	Provision matrix	Section 10.1, Illustration 10-1
Example 13	Debt instrument measured at fair value through other comprehensive income	Section 9.1, Illustration 9-1
Example 14	Interaction between the fair value through other comprehensive income measurement category and foreign currency denomination, fair value hedge accounting and impairment	Section 9.2, Illustration 9-2

Appendix E - IFRS Transition Resource Group for Impairment of Financial Instruments discussions

Date of ITG meeting	Agenda paper no.	Topic discussed	Reference in Chapter 46
22 April 2015	1	The maximum period to consider when measuring expected credit losses	Section 5.5
	2	Forecasts of future economic conditions	Section 5.9.4
	3	Loan commitments - scope	Section 11.1
	4	Revolving credit facilities	Section 5.3 Section 12.2.2 Section 12.2.4 Section 12.5
	5	Assessment of significant increase in credit risk for guaranteed debt instruments	Section 6.1.1
	6	Measurement of expected credit losses for an issued financial guarantee contract	Section 11.3
	7	Expected credit losses - measurement date	Section 7.3.1
	8	Measurement of expected credit losses in respect of a modified financial asset	Section 8.2
16 September 2015	1	Significant increases in credit risk	Section 6.2.5 Section 6.4.5
	2	Use of changes in the risk of a default occurring over the next 12 months when assessing for significant increases in credit risk	Section 6.4.3
	3	Measurement of expected credit losses for revolving credit facilities	Section 12.3
	4	Forward-looking information	Section 5.9.5 Section 7.1
11 December 2015	1	Incorporation of forward looking scenarios	Section 5.6.1 Section 5.6.2 Section 5.9.5 Section 6.7
	2	Scope of IFRS 9.5.5.20	Section 12.1 Section 12.4
	3	Measurement of expected credit losses for charge cards	Section 12.1
	4	Period over which to measure expected credit losses for revolving credit facilities	Section 12.2.2
	5	Collateral and other credit enhancements and the measurement of expected credit losses	Section 5.8.1.A Section 5.8.1.C
	6	Inclusion of cash flows expected from the sale on default of a loan in the measurement of expected credit losses	Section 5.8.2
	7	Meaning of current effective interest rate	Section 5.7
	8	Assessing for significant increases in credit risk for financial assets with a maturity of less than 12 months	Section 6
	9	Measurement of the loss allowance for credit-impaired financial assets	Section 14.1.2
	10	Presentation of the loss allowance for financial assets measured at amortised cost	Section 14.1

Appendix F - IFRS Interpretations Committee discussions and references

Topic discussed	Date discussed by IFRS IC	Agenda paper no.	Status at the time of writing	IFRS IC Update	Reference in Chapter 46
Credit enhancement in the measurement of expected credit losses (IFRS 9 *Financial Instruments*)	27 November 2018 and 5 March 2019	6	Agenda decision	November 2018 and March 2019	Section 5.8.1.A Section 7.7.2
Curing of a credit-impaired financial asset (IFRS 9 *Financial Instruments*)	27 November 2018 and 5 March 2019	7	Agenda decision	November 2018 and March 2019	Section 14.1.2
Lessor forgiveness of lease payments (IFRS 9 *Financial Instruments* and IFRS 16 *Leases*)	15 March and 13 September 2022	4	Agenda decision	March and September 2022	Section 10.2

Appendix G - IASB educational webcasts and guidance and references

Date of issuance	IASB educational webcast or guidance	Topic discussed	Reference in Chapter 46
25 July 2016	IASB educational webcast	IFRS 9: Forward-looking information and multiple scenarios	Section 5.6.1 Section 6.5.2 Section 6.5.3 Section 6.7
16 May 2017	IASB educational webcast	New IFRS 9 webcast: Impairment and the expected life of revolving facilities	Section 12.2.3 Section 12.5
22 July 2019	IASB educational webcast	IFRS 9 webinar: Curing of a credit-impaired financial asset	Section 14.1.2
27 March 2020	IASB educational guidance	Application of IFRS 9 in the light of the coronavirus uncertainty	Section 5.6.3 Section 5.9.5 Section 6.2.3 Section 7.8.2

Chapter 48 Financial instruments: Derecognition

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Overview

This chapter deals with the question of when financial instruments must be removed ('derecognised') from financial statements. It provides guidance including illustrations to explain when a financial asset, or a financial liability that has already been recognised in financial statements must no longer be included.

In deciding whether derecognition of financial assets is required, multiple factors need to be considered, including whether the contractual rights to the financial instrument have been transferred, whether the risks and rewards are retained and the extent to which the financial asset has been modified.

The question of derecognition goes further than just considering on balance sheet financial assets and liabilities and it encroaches on what is commonly referred to as 'off-balance sheet' finance. The outcome of the derecognition analysis can affect whether certain transactions are presented as financing (e.g., where funding is received and the related asset is not derecognised) or an off-balance sheet transaction (e.g., where sales proceeds are received, and the financial asset is derecognised).

FASB differences

Differences between IFRS accounting standards and the US GAAP guidance on this topic are not addressed in this chapter as the standards are not converged. Therefore, differences between IFRS accounting standards and US GAAP may exist that are not discussed in this chapter.

What you need to know

- To help the assessment of whether financial assets are derecognised, IFRS 9 *Financial Instruments* includes a decision tree that lays out the individual steps and the order in which they have to be considered. Any derecognition assessment for a financial asset should refer to this flowchart as a starting point.
- Certain types of structures and transactions, for example securitisations, result in an entity retaining ownership of a group of financial assets whilst assuming an obligation to pass the contractual cash flows received on to other parties. These require application of what are often referred to as the 'pass-through' rules to determine whether the assets have actually been transferred.
- Combinations of transactions entered into with the same counterparty at the same time as a transfer of a financial asset, such as a sale of a security with a total return swap, must be considered together when assessing whether the security has to be derecognised.
- For financial liabilities, the derecognition analysis considers whether the contractual obligations have been extinguished or expired.
- When a financial instrument is modified or restructured, it will be necessary to assess whether this represents the expiry of the original rights and obligations and hence whether the original instrument is derecognised to be replaced by a new instrument measured at fair value. This may apply for example if the terms of a loan are amended to extend the maturity and/or change the coupon.
- For a borrower, IFRS 9 contains more specific guidance for determining whether a modification results in derecognition of a financial liability than it does for a lender's financial asset, including the notion of a 10% test.

1 Interaction with other IFRS accounting standards

Under IFRS, many definitions relating to financial instruments are in IAS 32 *Financial Instruments: Presentation* while derecognition of financial assets and financial liabilities is currently addressed in IFRS 9. The definition of fair value, as defined in IFRS 13 *Fair Value Measurement* is also relevant for the application of the derecognition provisions in practice. This is discussed further in Chapter 15.

The provisions of IFRS 10 *Consolidated Financial Statements* are also very relevant to certain aspects of the derecognition of financial assets and financial liabilities. IFRS 10 is discussed in Chapter 7, but it is also referred to at various points below.

Whilst IFRS 9 introduced major changes to the way in which financial instruments were reflected in financial statements, its requirements relating to derecognition were substantially the same as those in IAS 39 *Financial Instruments: Recognition and Measurement*. Accordingly, consideration by the IFRS IC of the application of these parts of IAS 39 continue to be relevant under IFRS 9. Therefore, references to such discussions are included in this chapter as if the IFRS IC was considering IFRS 9.

Disclosure requirements in respect of transfers of financial assets are included in IFRS 7 *Financial Instruments: Disclosures* and these are discussed in Chapter 50 at section 6.

2 Definitions and scope

2.1 Definitions

The following definitions abbreviated from IAS 32, IFRS 9 and IFRS 13 are generally relevant to the discussion in this chapter.

Extract from IFRS standards - Definitions	
derecognition	The removal of a previously recognised financial asset or financial liability from an entity's statement of financial position. *[IFRS 9 Appendix A]*.
derivative	A financial instrument or other contract within the scope of this Standard with all three of the following characteristics. (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying'). (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. (c) it is settled at a future date. *[IFRS 9 Appendix A]*.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. *[IFRS 13 Appendix A]*.
financial asset	**A *financial asset* is any asset that is:** **(a) cash;** **(b) an equity instrument of another entity;** **(c) a contractual right:** **(i) to receive cash or another financial asset from another entity; or** **(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or** **(d) a contract that will or may be settled in the entity's own equity instruments and is:** **(i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or** **(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.** **For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.** *[IAS 32.11]*.

financial instrument	A *financial instrument* is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. *[IAS 32.11]*.
financial liability	A *financial liability* is any liability that is: (a) a contractual obligation: (i) to deliver cash or another financial asset to another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or (b) a contract that will or may be settled in the entity's own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments. As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D. *[IAS 32.11]*.
modification gain or loss	The amount arising from adjusting the **gross carrying amount of a financial asset** to reflect the renegotiated or modified contractual cash flows. The entity recalculates the gross carrying amount of a financial asset as the present value of the estimated future cash payments or receipts through the expected life of the renegotiated or modified financial asset that are discounted at the financial asset's original **effective interest rate** (or the original **credit-adjusted effective interest rate** for **purchased or originated credit-impaired financial assets**) or, when applicable, the revised **effective interest rate** calculated in accordance with paragraph 6.5.10. When estimating the expected cash flows of a financial asset, an entity shall consider all contractual terms of the financial asset (for example, prepayment, call and similar options) but shall not consider the **expected credit losses**, unless the financial asset is a **purchased or originated credit-impaired financial asset**, in which case an entity shall also consider the initial expected credit losses that were considered when calculating the original **credit-adjusted effective interest rate**. *[IFRS 9 Appendix A]*.

transaction costs	Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see paragraph B5.4.8). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument. *[IFRS 9 Appendix A]*.

2.2 Scope

The scope for application of IFRS 9 to financial instruments is detailed in Chapter 41 at section 2. The derecognition requirements within IFRS 9 apply more widely in that they also specifically apply to the following items which are normally dealt with outside of that Standard:

- Finance lease receivables (i.e., net investments in finance leases) and operating lease receivables recognised by a lessor *[IFRS 9.2.1(b)(i)]*
- Lease liabilities recognised by a lessee *[IFRS 9.2.1(b)(ii)]*

  And
- Loan commitments *[IFRS 9.2.1(g)]*

In July 2024, the IASB published a narrow-scope amendment regarding the derecognition of lease liabilities recognised by a lessee. In the amendment, they clarified that, when a lessee has determined that a lease liability has been extinguished in accordance with IFRS 9, the lessee is required to apply paragraph 3.3.3 of IFRS 9 and recognise any resulting gain or loss in profit or loss. Further information regarding these amendments and the effective date are discussed at section 9.3 below.

In the context of contracts with customers that fall into the scope of IFRS 15 *Revenue from Contracts with Customers*, when an entity satisfies a performance obligation by transferring a promised good or service, the entity has earned a right to consideration from the customer. *[IFRS 15.105]*. If the right to consideration is conditional, it is a contract asset (for example, when an entity must first satisfy another performance obligation in the contract before it is entitled to payment from the customer). On the other hand, if an entity has an unconditional right to receive consideration from the customer (i.e., only the passage of time is required before payment is due), the entity has a receivable. While IFRS 9, including its derecognition requirements, applies to receivables, *[IFRS 9.2.1(j), IFRS 15.108],* only the impairment requirements of IFRS 9 apply to contract assets. *[IFRS 15.107]*.

How we see it

In theory, entities could also apply the derecognition guidance in IFRS 9 by analogy to contract assets. However, in practice, we believe that it is unlikely that arrangements involving contract assets would meet the requirements for derecognition in IFRS 9, particularly if they are still conditional on the entity's future performance.

3 Derecognition – financial assets

3.1 Background

The requirements of IFRS 9 for derecognition of financial assets are primarily designed to deal with the accounting challenges posed by various types of off-balance sheet finance. As a result, the real focus of many of the rules for derecognition of assets is in fact the recognition of liabilities. The starting point for most of the transactions discussed below is that the reporting entity receives cash or other consideration in return for a transfer or 'sale' of all or part of a financial asset. This raises the question of whether such consideration is to be treated as sales proceeds or as a liability. IFRS 9 effectively answers that question by determining whether the financial asset to which the consideration relates must be derecognised (the consideration is treated as sales proceeds and there is a gain or loss on disposal) or continues to be recognised while the consideration is treated as a liability.

This underlying objective of the derecognition criteria helps to explain why IFRS 9 considers not only the economic position of the entity at the reporting date, but also prior transactions which gave rise to that position and the reporting entity's motives in undertaking them. For example, if, at a reporting date, an entity has two identical forward contracts for the purchase of a financial asset, the accounting treatment of the contracts may vary significantly if one contract relates to the purchase of an asset previously owned by the entity and the other does not.

This is because the derecognition rules of IFRS 9 are based on the premise that, if a transfer of an asset leaves the transferor's economic exposure to the transferred asset much as if the transfer had never taken place, the financial statements must represent that the transferor still holds the asset. Thus, if an entity sells 'say' a listed bond subject to a forward contract to repurchase the bond from the buyer at a fixed price, IFRS 9 argues that the entity is exposed to the risks and rewards of that bond as if it had never sold it, but has simply borrowed an amount equivalent to the original sales proceeds secured on the bond. IFRS 9 therefore concludes that the bond must not be removed from the statement of financial position and the sale proceeds must be accounted for as a liability (in effect the obligation to repurchase the bond under the forward contract - see section 4.1 below).

By contrast, if the entity were to enter into a second identical forward contract over another bond (i.e., one not previously owned by the entity), IFRS 9 would simply require it to be accounted for as a derivative at fair value (see Chapter 42). This might seem a rather counter-intuitive outcome of a framework that purports to report economically equivalent transactions in a consistent and objective manner. However, the IASB would argue that the two transactions are not economically equivalent; they are distinguished by the fact that, on entering into the forward contract over the originally owned asset, the entity received a separate cash inflow (i.e., the 'sale' proceeds from the counterparty), whereas, on entering into the second contract, it did not. This reinforces the point that the real focus of IFRS 9 is to determine the appropriate accounting treatment for that cash inflow and not that of the previously owned bond *per se*.

3.2 Decision tree

The provisions of IFRS 9 concerning the derecognition of financial assets are complex but are summarised in Figure 3-1 below. *[IFRS 9.B3.2.1]*. It may be helpful to refer to this while reading the discussion that follows.

It will be seen that the process presupposes that the reporting entity has correctly consolidated all its subsidiaries in accordance with IFRS 10, including any entities identified as consolidated structured entities, often called special purpose entities (SPEs) (see Chapter 7 at section 4.4.1 and section 3.3 below).

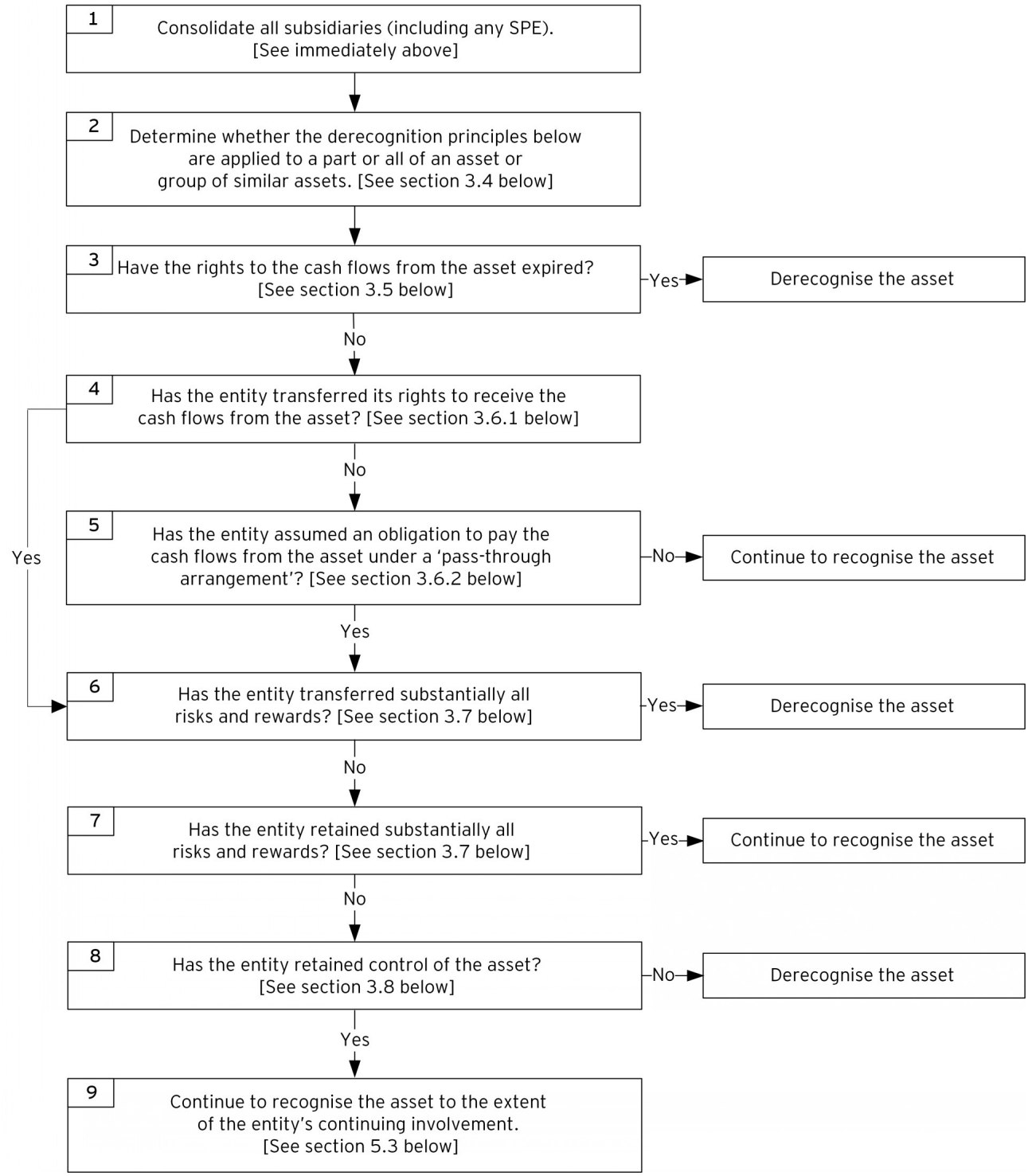
Under IFRS, a vehicle (or a structured entity) that, though not meeting a traditional definition of a subsidiary based on ownership of equity, is still controlled by the entity is often referred to as a (consolidated) SPE. IFRS 10 requires a reporting entity to consolidate another entity, including an SPE, when the reporting entity is exposed, or has rights, to variable returns from its involvement with the investee entity and has the ability to affect those returns through its power over the investee entity (see section 3.3 below).

It is clearly highly significant from an accounting perspective that an entity to which a financial asset or liability is transferred is a subsidiary or a consolidated SPE of the transferor. A financial asset (or financial liability) transferred from an entity to its subsidiary or consolidated SPE (on whatever terms) will continue to be recognised in the entity's consolidated financial statements through the normal consolidation procedures set out in IFRS 10. Thus, the requirements discussed in sections 3.4 to 3.8 below are irrelevant to the treatment, in an entity's consolidated financial statements, of any transfer of a financial asset by the entity to a subsidiary or consolidated SPE. Requiring consolidation of subsidiaries and certain SPEs means

that the same derecognition analysis applies whether the entity transfers the financial assets directly to a third-party investor, or to a subsidiary or consolidated SPE that carries out the transfer.

However, the criteria may be relevant to any onward transfer by the subsidiary or consolidated SPE, and to the transferor's separate financial statements, if prepared (see Chapter 9).

Figure 3-1: Derecognition flowchart



[IFRS 9.B3.2.1].

The subsequent steps towards determining whether derecognition is appropriate are discussed below. Some examples of how these criteria might be applied to some common transactions in financial assets are given in section 4 below. The accounting consequences of the derecognition of a financial asset are discussed in section 5 below.

3.2.1 Importance of applying tests in sequence

The derecognition rules in IFRS 9 are based on several different accounting concepts, in particular a 'risks and rewards' model and a 'control' model, which may lead to opposite conclusions.

For example, an entity (A) might have a portfolio of listed shares for which there is a deep liquid market. It might enter into a contract with a third-party counterparty (B) on the following terms. A sells the portfolio to B for CU10 million, agreeing to repurchase it in two years' time for CU10 million plus interest at market rates on CU10 million less dividends on the shares.

The nature of the portfolio is such that B is able to sell it to third parties (since it will easily be able to reacquire the necessary shares to deliver back to A under the repurchase agreement). This indicates that B has control over the portfolio and therefore, since the same asset cannot be controlled by more than one party, that A does not. Thus, under a 'control' model of derecognition, A would derecognise the portfolio.

However, the nature of the repurchase agreement is also such that A is exposed to all the economic risks and rewards of the portfolio as if it had never been sold to B (since the repurchase price effectively returns to A all dividends paid on the portfolio, and all movements in its market value, during its period of ownership by B). Thus, under a 'risks and rewards' model of derecognition, A would continue to recognise the portfolio.

IFRS 9 seeks to avoid the potential conflict between those accounting models by the practically effective requirement to consider them in the strict sequence in Figure 3-1 in section 3.2 above - i.e., the 'risks and rewards' model first and the 'control' model second. Thus, as will be seen from the discussion below (particularly in sections 4 and 5 below) if A transfers an asset to B on terms that B is free to sell the asset:

- If A retains substantially all the risks and rewards of the asset (i.e., the answer to Box 7 in Figure 3-1 is 'Yes'), B's right to sell is irrelevant and the asset continues to be recognised by A.

  But

- If A has neither transferred nor retained substantially all the risks and rewards of the asset (i.e., the answer to Box 7 in Figure 3-1 is 'No'), B's right to sell is highly relevant, indicating a loss of control over the asset by A (i.e., the answer to Box 8 in Figure 3-1 is 'No'), such that A derecognises the asset.

In other words, depending on the reporting entity's position in the decision tree in section 3.2 above, the fact that B has the right to sell the asset is either irrelevant or leads directly to derecognition of the asset by A. It is therefore crucial that the various asset derecognition tests in IFRS 9 are applied in the required order.

3.3 Consolidation of all subsidiaries (including any SPEs)

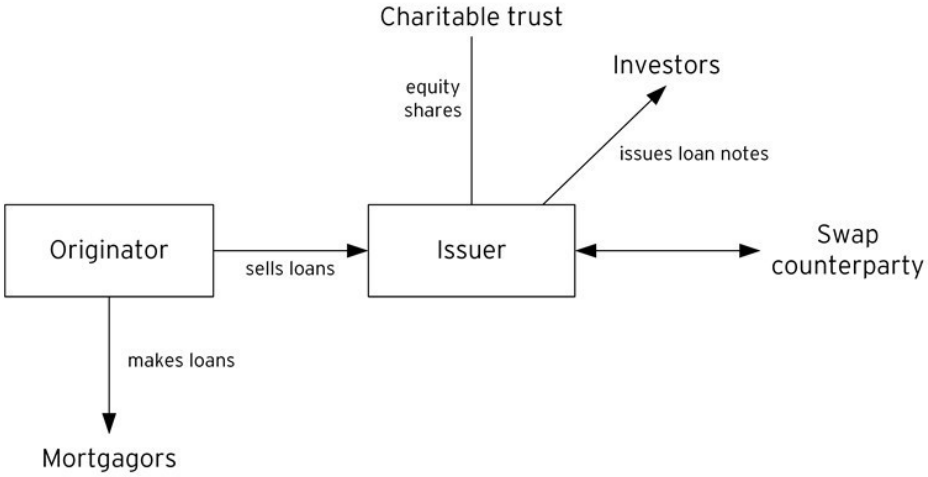
The discussion in this section refers to Box 1 in Figure 3-1 in section 3.2 above.

The first step of the decision tree, at least when preparing consolidating financial statements, is to ensure all subsidiaries are consolidated. This is because many transactions that could result in derecognition involve transactions with another member of the group, but these will be eliminated on consolidation. The analysis can be different for the standalone financial statements, in which case the entity would follow the remaining steps even where the transactions are with another group member.

This first step is particularly important in the context of securitisations, which is a process whereby finance can be raised from external investors by enabling them to invest indirectly in parcels of specific financial assets. The first main type of assets to be securitised was domestic mortgage loans, but the technique is regularly extended to other assets, such as credit card receivables, other consumer loans, or lease receivables. Securitisations are a complex area of financial reporting beyond the scope of a general text such as this to discuss in detail. However, it may assist in the understanding of the IASB's thinking to consider a 'generic' example of such a transaction.

A typical securitisation transaction involving a portfolio of mortgage loans would operate as follows. The entity which has initially advanced the loans in question (the 'originator') will sell them to another entity, an SPE, set up for that purpose (the 'issuer'). The share capital of the issuer, which will be small, will often be owned by a trustee on behalf of a charitable trust. The issuer will finance its purchase of these loans by issuing multiple types of loan notes, that have a subordination ranking specifying the order in which any cash flows generated by the mortgage loans are allocated to individual notes. The interest terms on the aggregate of these notes need to be related to the rate of interest receivable on the mortgages and to achieve this the issuer may need to enter into derivative instruments such as interest rate swaps. Any such swap counterparty may be the originator or a third party. The originator will continue to administer the loans as before, for which it will receive a service fee from the issuer.

The structure might therefore be as shown in this diagram:



Potential investors in the mortgage-backed loan notes will want to be assured that their investment is relatively risk free and the issue will normally be supported by obtaining a high rating from a credit rating agency. This may be achieved by using a range of credit enhancement techniques which will add to the security already inherent in the quality of the mortgage portfolio. Such techniques can include the following:

- Limited recourse to the originator in the event that the income from the mortgages falls short of the interest payable to the investors under the loan notes and other expenses. This may be made available in a number of ways: for example, by the provision of subordinated loan finance from the originator to the issuer; by the deferral of part of the consideration for the sale of the mortgages; or by the provision of a guarantee (see section 3.6.2.A below).
- The provision of short-term loan facilities to meet temporary shortfalls as a result of slow payments of mortgage interest (see section 3.6.2.B below).

  Or
- Insurance against default on the mortgages (see section 3.6.2.C below).

The overall effect of the arrangement is that outside investors have been brought in to finance a particular portion of the originator's activities. These investors have first call on the income from the mortgages which back their investment. The originator generally retains the residual interest in the differential between the rates paid on the notes and earned on the mortgages, net of expenses. Generally, this profit element is extracted by adjustments to the service fee. It has thus limited its upside interest in the mortgages, while its remaining downside risk on the whole arrangement will depend on the extent to which it has assumed obligations under the credit enhancement measures.

Determining whether issuer is a consolidated or unconsolidated SPE can be a highly judgemental area which requires careful analysis. For more guidance refer to Chapter 7 at section 4.6.

If the issuer is consolidated by the originator, then all intragroup transactions are eliminated and only the externally held notes will be accounted for. In most cases, the originator will not derecognise the securitised assets, but instead recognise the loan notes as financial liabilities, unless the issuer is able to demonstrate that it operates as a qualifying pass-through arrangement. For more guidance on pass-through arrangements refer to section 3.6.2.

If the issuer is not consolidated by the originator, then the originator should consider the transactions with the issuer using remaining steps on the decision tree. The application of IFRS 9 to securitisations is dealt with further in section 3.6.1 and section 3.6.2.

For a general discussion on the initial recognition and impairment considerations of the financial assets and liabilities for the transferee in a securitisation structure involving an SPE, we refer to Chapter 47 at section 7.7.

3.4 Determination of whether the derecognition principles apply to a part or all of an asset or groups of assets

The discussion in this section relates to Box 2 in Figure 3-1 in section 3.2 above.

IFRS 9 requires an entity, before evaluating whether, and to what extent, derecognition is appropriate, to determine whether the provisions discussed in this chapter are applied to the whole, or a part only, of a financial asset (or the whole or, a part only, of a group of similar financial assets).

It is important to remember throughout the discussion below that these are criteria for determining at what level the derecognition rules are applied, not for determining whether the conditions in those rules have been satisfied.

Extract from IFRS 9

3.2.2 Before evaluating whether, and to what extent, *derecognition* is appropriate under paragraphs 3.2.3-3.2.9, an entity determines whether those paragraphs should be applied to a part of a financial asset (or a part of a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety, as follows.

(a) Paragraphs 3.2.3-3.2.9 are applied to a part of a financial asset (or a part of a group of similar financial assets) if, and only if, the part being considered for derecognition meets one of the following three conditions.

(i) The part comprises only specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, paragraphs 3.2.3-3.2.9 are applied to the interest cash flows.

(ii) The part comprises only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of all cash flows of a debt instrument, paragraphs 3.2.3-3.2.9 are applied to 90 per cent of those cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the cash flows provided that the transferring entity has a fully proportionate share.

(iii) The part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of interest cash flows from a financial asset, paragraphs 3.2.3-3.2.9 are applied to 90 per cent of those interest cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the specifically identified cash flows provided that the transferring entity has a fully proportionate share.

(b) In all other cases, paragraphs 3.2.3-3.2.9 are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety). For example, when an entity transfers (i) the rights to the first or the last 90 per cent of cash collections from a financial asset (or a group of financial assets), or (ii) the rights to 90 per cent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8 per cent of the principal amount of the receivables, paragraphs 3.2.3-3.2.9 are applied to the financial asset (or a group of similar financial assets) in its entirety.

In paragraphs 3.2.3-3.2.12, the term 'financial asset' refers to either a part of a financial asset (or a part of a group of similar financial assets) as identified in (a) above or, otherwise, a financial asset (or a group of similar financial assets) in its entirety.

The various examples provided above illustrate that the tests in (a)(i) to (a)(iii) are to be applied very strictly. It is essential that the entity transfers 100%, or a lower fixed proportion, of a definable cash flow. In the arrangement in IFRS 9.3.2.2(b), the transferor provides a guarantee the effect of which is that the transferor may have to return some part of the consideration it has already received. This has the effect that the derecognition provisions must be applied to the asset in its entirety and not just to the proportion of cash flows transferred. If the guarantee had not been given, the arrangement would have satisfied condition (a) above, and the derecognition provisions would have been applied only to the 90% of cash flows transferred. *[IFRS 9.3.2.2]*. The application of these provisions has been further explained in section 5.

The criteria in IFRS 9.3.2.2, must be applied to the whole, or a part only, of a financial asset or the whole, or a part only, of a group of similar financial assets. This raises the question of what comprises a 'group of similar financial assets' - an issue that has been discussed by the IFRS IC and the IASB but without them being able to reach any satisfactory conclusions (see section 3.4.2 below).

In the derecognition provisions in IFRS 9, as well as the discussion in sections 3 to 5 of this chapter, the term 'financial asset' is used to refer to either the whole, or a part, of a financial asset (or the whole or a part of a group of similar financial assets). *[IFRS 9.3.2.2]*. It is therefore important to remember throughout the following discussion that a reference to an asset being derecognised 'in its entirety' does not necessarily mean that 100% of the asset is derecognised. It may mean, for example, that there has been full derecognition of, say, 80% of the asset to which the derecognition rules have applied separately (in accordance with the criteria above).

3.4.1 Transfer of asset (or part of asset) for only part of its life

The examples given in IFRS 9 implicitly appear to have in mind the transfer of cash flows from the date of transfer for the remainder of the life of an instrument. This raises the question of the appropriate accounting treatment where (for example) an entity with a loan receivable repayable in 10 years' time enters into a transaction whereby all the interest flows for the next 5 years only (or those for years 6 to 10) are transferred to a third party. There is no reason why such a transaction could not be considered for partial derecognition.

3.4.2 Derecognition of groups of similar financial assets

As described above, the derecognition provisions of IFRS 9 apply to the whole, or a part only, of a financial asset or a group, or a part of a group, of similar financial assets. However, transfers of financial assets, such as debt factoring or securitisations (see section 3.6 below), typically involve the transfer of a group of assets (and possibly similar liabilities) comprising:

- The non-derivative financial assets (i.e., the trade receivables or securitised assets) that are the main focus of the transaction.
- Financial instruments taken out by the transferor in order to mitigate the risk of those financial assets. These arrangements may either have already been in place for some time, or they may have been entered into to facilitate the transfer.

  And

- Non-derivative financial guarantee contracts that are transferred with the assets. These are not always recognised separately as financial assets, e.g., mortgage indemnity guarantees which compensate the lending bank if the borrower defaults and there is a deficit when the secured property is sold. Such guarantees may be transferred together with the mortgage assets to which they relate.

Financial instruments transferred with the 'main' assets also typically include derivatives such as interest rate and currency swaps. The entity may have entered into such arrangements in order to swap floating rate mortgages to fixed rate, or to change the currency of cash flows receivable from financial assets to match the currency of the borrowings, e.g., sterling into euros.

Both the IFRS IC and the IASB have considered whether the reference to transfers of 'similar' assets in IFRS 9 is intended to require:

- A single derecognition test for the whole 'package' of transferred non-derivative assets, and any associated financial instruments, as a whole

  Or

- Individual derecognition tests for each type of instrument (e.g., loan, interest rate swap, guarantee or credit insurance) transferred

The IASB and IFRS IC did not succeed in clarifying the meaning of 'similar assets'. The IFRS IC came to a tentative decision but passed the matter to the IASB, together with some related derecognition issues, in particular, the types of transaction that are required to be treated as 'pass through' and the effect of conditions attached to the assets that have been transferred (discussed in section 3.6.2 below). In November 2006 the IFRS IC issued a tentative decision not to provide formal guidance, based on the views publicly expressed by the IASB in the *IASB Update* for September 2006. The IFRS IC's decision not to proceed was withdrawn in January 2007 on the basis of comment letters received by the IFRS IC that demonstrated that the IASB's 'clarification' was, in fact, unworkable and further guidance was required after all. The IFRS IC announced this as follows:

> "In November 2006, the IFRIC published a tentative agenda decision not to provide guidance on a number of issues relating to the derecognition of financial assets. After considering the comment letters received on the tentative agenda decision, the IFRIC concluded that additional guidance is required in this area. The IFRIC therefore decided to withdraw the tentative agenda decision [not to provide further guidance] and add a project on derecognition to its agenda. The IFRIC noted that any Interpretation in this area must have a tightly defined and limited scope, and directed the staff to carry out additional research to establish the questions that such an Interpretation should address."[1]

The next section describes the IFRS IC's and IASB's attempts to establish the meaning of 'similar', which demonstrated the absence of a clear principle. There is bound to be diversity in practice in the light of the failure to provide an interpretation, so it is most important that entities establish an accounting policy that they apply consistently to the derecognition of groups of similar financial assets.

3.4.2.A The IASB's view and the IFRS IC's tentative conclusions

Although the IFRS IC initially tended to the view that the IASB intended a single test to be undertaken,[2] the IASB itself indicated that derivatives transferred together with non-derivative financial assets were not 'similar' to non-derivative financial assets for the purposes of what is now IFRS 9.3.2.2. Therefore, an entity would apply the derecognition tests in IFRS 9 to non-derivative financial assets (or groups of similar non-derivative financial assets) and derivative financial assets (or groups of similar derivative financial assets) separately, even if they were transferred at the same time.[3] The IASB also indicated that, in order to qualify for derecognition, transferred derivatives that could be assets or liabilities (such as interest rate swaps) would have to meet both the financial asset and the financial liability derecognition tests[4] - see the further discussion of this issue in section 6.4 below. Whilst the IASB's published decision referred only to derivatives transferred with the main non-derivative assets, observers of the relevant meeting reported that the IASB also took the view that the derecognition tests must also be applied separately to other financial assets, such as guarantees and credit insurance, transferred with the main assets.

This can have practical effects on many securitisations as currently structured (see section 3.3 above). The interpretation can make it easier to derecognise certain items (particularly non-derivative assets). This is because many derivatives themselves might not meet the appropriate derecognition criteria at all and would continue to be recognised. Also, a transaction might achieve a transfer of substantially all the risks and rewards (see Box 6 in Figure 3-1 in section 3.2 above, and section 3.7 below) of a transferred asset considered separately from any associated derivatives or guarantees, but not if the asset and the associated derivatives or guarantees are considered as a whole. However, the interpretation can well result in far more arrangements falling into the category of 'continuing involvement', where the entity has neither retained nor disposed of substantially all of the risks and rewards of ownership.

Suppose that an entity transfers a fixed rate loan subject to prepayment risk and a credit guarantee, but retains prepayment risk through an amortising interest rate swap, linked to the principal amount of the transferred loan, with the transferee. On the view that the loan and guarantee should be considered for derecognition as a whole, there was no real credit risk prior to the transfer because of the guarantee. The entity was exposed to prepayment risk and the risk of failure by the counterparty to the guarantee. On the assumption that the latter risk could be considered negligible, the only real risk was prepayment risk. Thus, on the view that the loan and guarantee should be considered for derecognition as a whole, they would probably not be derecognised because the entity would retain the only substantial risk (prepayment risk) to which it was exposed before the transfer - i.e., the transaction would fail the test of transferring substantially all risks and rewards in Box 6 in Figure 3-1 in section 3.2 above.

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1 *IFRIC Update*, January 2007, available on the IFRS Foundation's website.

2 *IFRIC Update*, May 2006, available on the IFRS Foundation's website.

3 *IASB Update*, September 2006, available on the IFRS Foundation's website.

4 *IASB Update*, September 2006, available on the IFRS Foundation's website.

Following the IASB's decision, the implication is that the derecognition criteria would be applied separately to the loan and the guarantee. Considered individually, the loan gives rise to prepayment risk and credit risk. On this analysis, the transfer would leave the entity with only one of the two substantial risks (i.e., prepayment risk, but not credit risk) that it bore previously. This could lead to the conclusion that the entity had neither transferred nor retained substantially all the risks of the loan, and that the loan would therefore be recognised only to the extent of the entity's continuing involvement (in this example, the interest rate swap) - see Box 9 in Figure 3-1 in section 3.2 above, and section 5.3 below. (This assumes the transferor had retained control of the asset, which would normally be the case in a transaction such as this.)

3.4.2.B What are 'similar assets'?

There are a number of different derivative and derivative-like instruments that can be transferred together with a non-derivative, including:

- Hedging instruments that are always assets, e.g., interest rate caps
- Hedging instruments that are always liabilities, e.g., written options
- Hedging instruments that may be an asset or liability at any point in time, e.g., interest rate swaps
- Purchased financial guarantee contracts (including those which are considered integral to a loan asset and those which are not) and credit insurance
- Guarantees that are not financial guarantee contracts but are commonly accounted for as derivatives, e.g., mortgage indemnity guarantee contracts

The IASB's interpretation, repeated in its Exposure Draft - *Derecognition*[5] - would require each of the first three to meet different derecognition treatments. Derivatives that could be financial assets or financial liabilities depending on movements in market value (e.g., interest rate and credit default swaps) would need to meet both the financial asset and financial liability derecognition requirements of IFRS 9 (even though at any one time they would be either an asset or a liability). The derecognition of financial liabilities requires *inter alia* legal release by the counterparty (see section 6 below). In many securitisations there is no cancellation, novation or discharge of swaps 'transferred' to a structured entity, in which case the transferor would not be able to derecognise the instrument. This would raise issues regarding the treatment of the retained swap, as it may not actually expose the entity to risks and rewards any longer. This is discussed further in section 3.6.2.E below.

The interpretation also raises the difficulty of allocating the single cash flow received from the transferee to the various financial instruments transferred. This is discussed further in section 3.6.1 below.

Given the withdrawal of the IFRS IC's 'non-interpretation', there is no underlying principle that would prevent any of the instruments described above being considered 'similar' to the main non-derivative. Therefore, an entity must establish an accounting policy that it applies consistently to all transactions involving the derecognition of assets, not only to those associated with securitisation arrangements. It must bear in mind that a narrow concept of 'similar', in which instruments are treated as separate assets, may make it easier to derecognise some of them but more likely to have to engage with the problems of continuing involvement and more difficult to achieve pass through (see section 3.6.2 below). Regardless of the accounting policy followed, a derivative that involves two-way payments between parties (i.e., the payments are, or could be, from or to either of the parties) shall be derecognised only when both the derecognition criteria for a financial asset and the derecognition criteria for a financial liability are met (see section 6.4 below). In establishing its accounting policy, an entity may wish to differentiate between financial guarantees that are integral to a loan asset and those which are not.

Once an entity has determined what is 'similar', it must consider the derecognition tests (pass through and transfer of risks and rewards) by reference to the same group of 'similar' assets (see section 3.6 below).

5 *Exposure Draft - Derecognition*, April 2009, available on the IFRS Foundation's website.

3.5 Have the contractual rights to cash flows from the asset expired?

The discussion in this section refers to Box 3 in Figure 3-1 in section 3.2 above.

The first step in determining whether derecognition of a financial asset is appropriate is to establish whether the contractual rights to the cash flows from that asset have expired. If they have, the asset is derecognised. Examples might be:

- A loan receivable is repaid
- The holder of a perpetual debt, whose terms provide for ten annual 'interest' payments that, in effect, provide both interest and a return of capital, receives the final payment of interest

  Or
- A purchased option expires unexercised

If the cash flows from the financial asset have not expired, it is derecognised when, and only when, the entity 'transfers' the asset within the specified meaning of the term in IFRS 9 (see section 3.6 below), and the transfer has the effect that the entity has either:

- Transferred substantially all the risks and rewards of the asset (see section 3.7 below)

  Or
- Neither transferred nor retained substantially all the risks and rewards of the asset (see section 3.7 below), and has not retained control of the asset (see section 3.8 below) *[IFRS 9.3.2.3]*

In September 2021, the IFRS IC was asked when a financial asset settled by a cash payment received via an electronic transfer system is derecognised. The discussion was extended to include the derecognition of a financial liability in the same scenario. The IFRS IC identified diversity in practice for the timing of derecognition of financial assets and financial liabilities, not just those settled via an electronic transfer system, but also using other methods. As a result of this, the IFRS IC decided to hand this matter over to the IASB who added this to the IFRS 9 Post-Implementation Review (PIR) for Classification and Measurement. In May 2024, the IASB issued the Amendments to the Classification and Measurement of Financial Instruments (amendments), which included clarifications to the application guidance for derecognition of financial assets and liabilities as a response to the above and introduced a limited exception allowing earlier derecognition of financial liabilities settled in cash using an electronic payment system which meet specific criteria (see section 6.1 below). These amendments are effective for annual reporting periods beginning on or after 1 January 2026, with early application allowed.

For financial assets, a clarification is provided in the application guidance to IFRS 9, which specifies that the derecognition date must be determined in line with IFRS 9.3.2.3, which states that this is when the contractual rights to the cash flows expire or when the asset is transferred. *[IFRS 9(2026).B3.1.2A]*. The amendments do not introduce any exception allowing an earlier derecognition of financial assets settled in cash using an electronic payment system and the Basis for Conclusions clarify that in the absence of having access to the cash, a confirmation from a debtor that a payment instruction has been initiated does not lead to the expiry of the right to receive cash. It is only when the cash is received that such a right expires. *[IFRS 9(2026).BC3.60]*.

In preparation for adopting the amendments, an entity needs to determine what derecognition date it currently applies to each of its financial assets, including those settled by a cash payment via an electronic transfer system, and to what extent this conforms to the amendments. The assessment should include all electronic transfer systems as well as other settlement methods such as cheques, debit cards and credit cards. This assessment requires a thorough understanding of the various cash settlement mechanisms and when a receivable that is being settled via that mechanism is transformed into a cash balance.

In the case of cheques, the IASB considered that the completion of the payment remains subject to settlement risk that is more than insignificant until the cash is delivered. *[IFRS 9(2026).BC3.55]*. This has the consequential impact that entities adopting the amendments are unable to derecognise a financial asset for which a cheque is received until the amount is cleared with the entity's bank account.

How we see it

Given that the IASB had to issue amendments to the standards to clarify the requirements in this area, in our view, an entity is not required to change its accounting policy on the timing of derecognition of a financial asset to conform with the amendments until when those are adopted. At that point, it can make use of the transitional guidance in IFRS 9.7.2.48. Details on transition requirements of the amendments are discussed further in Section 9.2 below.

The amendments that relate to financial liabilities are discussed in section 6.1 below.

3.5.1 Renegotiation of the terms of an asset

It is common for a borrower, particularly but not necessarily when in financial difficulties, to approach its major creditors for a renegotiation or a restructuring of its loans. The restructuring may involve a modification to the terms of a loan or an exchange of one debt instrument issued by the borrower for another. In these circumstances, IFRS 9 contains accounting requirements for the borrower to apply which address whether the restructured debt shall be regarded as:

- The continuation of the original liability, albeit with recognition of a modification gain or loss in profit or loss (see section 6.2 and particularly section 6.2.6 below)

  Or

- A new financial liability which replaces the original liability that is hence derecognised. In this case the borrower would recognise a gain or loss based on the difference between the fair value of the restructured debt and the carrying amount of the original liability (see section 6.2 below). *[IFRS 9.3.3.2, IFRS 9.B3.3.6]*.

However, IFRS 9 does not contain substantive guidance on when a modification of a financial asset shall result in derecognition. Rather, the Basis for Conclusions simply states that some modifications of contractual cash flows result in derecognition of a financial instrument and the recognition of a new instrument, but frequently they do not. *[IFRS 9.BC5.216, IFRS 9.BC5.227]*.

The IFRS IC acknowledged that determining when a modification of an asset should result in its derecognition is an issue that arises in practice and considered undertaking a narrow-scope project to clarify the requirements of IFRS 9. However, in May 2016 the IFRS IC concluded that the broad nature of the issue meant it could not be resolved in an efficient manner and decided not to further consider such a project.[6] Following the Post Implementation Review of IFRS 9 - Classification and Measurement, the IASB decided to add a research pipeline project to clarify the requirements in IFRS 9 for modifications of financial assets and liabilities, the application of the effective interest method to floating-rate financial instruments and the interaction of these two areas,[7] see also section 9.1 below.

Consequently, given the limited guidance as to which modifications of financial assets should lead to derecognition, there is diversity in practice in this area. Entities need to apply judgement in developing an appropriate accounting policy for determining which modifications of financial assets do, or do not, lead to derecognition of the original asset and recognition of a new asset. Examples of common contractual modifications are included in Chapter 46 at section 3.8.1.

Changes that may result in derecognition, individually or in tandem with others, depending on the facts and circumstances, include a change in the currency or in the basis of interest calculation (such as moving from fixed to floating) so that the original effective interest rate would no longer provide an appropriate measure of interest income, the introduction of significant new features into the instrument, such as adding a profit participation to a loan agreement, particularly where the characteristics of the asset would no longer satisfy the criteria of IFRS 9 to be recorded at amortised cost (see Chapter 44 at section 5.4.5), or a significant extension to the term of the instrument.

However, where the modification is part of a troubled debt restructuring, the objective of the changes is usually to maximise recovery of the original contractual cash flows rather than to originate a new asset on current market terms.

In some instances, when an entity modifies a financial asset, it concludes that it must derecognise the old instrument and recognise a new instrument at fair value with a new effective interest rate, see Chapter 45 at section 3.3.2. A worked example of a modification of a financial liability that results in derecognition is set out in Illustration 6-5 at section 6.2.7 below. The accounting treatment for modified assets and liabilities that are derecognised are mostly identical. There are two differences to note for financial assets: (i) any previously held ECL provision will be released and (ii) the new asset may be credit impaired at initial recognition, see Chapter 47 at section 3.3 and Chapter 47 at section 8.

IFRS 9 contains requirements on accounting for the modification of a financial asset when its contractual cash flows are renegotiated or otherwise modified and the asset is not derecognised. In those cases the entity shall recalculate the gross carrying amount of the financial asset and recognise a modification gain or loss in profit or loss. The gross carrying amount is recalculated as the present value of the renegotiated or modified contractual cash flows, discounted at the financial asset's original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets) or, when applicable, the revised effective interest rate calculated in accordance with IFRS 9.6.5.10. Any costs or

6 *IFRIC Update*, May 2016, available on the IFRS Foundation's website.

7 *IASB Update*, July 2022, available on the IFRS Foundation's website.

fees incurred adjust the carrying amount of the modified financial asset and are amortised over the remaining term of the modified financial asset. *[IFRS 9.5.4.3]*. These requirements are considered in more detail in Chapter 46 at section 3.8.

In August 2020 the IASB issued amendments to IFRS 9 to provide guidance on how to account for modifications of a financial asset due to the reform of interbank offered rates (see section 3.5.4 below).

3.5.2 IFRS IC discussions on asset restructuring in the context of Greek government debt

In February 2012, the Greek government announced the terms of a restructuring of certain of its issued bonds. One aspect involved the exchange of 31.5% of the principal amount of the bonds for twenty new bonds with different maturities and interest rates. The remaining portions of the bonds were either forgiven or exchanged for other securities issued by the European Financial Stability Facility, a SPE established by Eurozone states.

Soon afterwards, the IFRS IC was asked to address the appropriate accounting treatment for certain aspects of the restructuring, which they did initially in May 2012. One question the IFRS IC considered was whether the exchange of 31.5% of the principal amount of the original bonds for new bonds could be regarded as a continuation of that portion of the original asset or whether that portion should also be derecognised (it being widely accepted that the remaining portions of the bonds should be derecognised).

The IFRS IC first addressed whether the exchange should be regarded as a transfer. They noted that the bonds were transferred back to the issuer rather than to a third party and, as a consequence, concluded this particular restructuring should not be regarded as a transfer (see section 3.6.1 below). Instead, it would be evaluated to determine whether it amounted to an actual or in-substance expiry or extinguishment of the original cash flows.

The staff analysis was clear that a modification of terms can result in expiry of the asset's original rights to cash flows, although it would not always do so. This is because it is implicit within the requirements for measuring impairment losses that a modification would sometimes be regarded as a continuation of the original, albeit impaired, asset. Therefore, an entity would assess the modifications made against the notion of 'expiry' of the rights to the cash flows.[8]

The staff analysis indicated that the 'hierarchy' in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* would be applied in developing an appropriate accounting policy. Whilst this requires the application of judgement, it is not an absolute discretion. Consequently, it would be appropriate to analogise, at least to some extent, to those requirements in IFRS 9 applying to modifications and exchanges of financial liabilities, particularly the notion of 'substantial modification' and the fact that modifications and exchanges between an existing lender and borrower are seen as equivalent (see section 6.2 below). However, applying the '10% test' to determine whether a modification is substantial would not always be appropriate.

The IFRS IC did not explicitly conclude on this part of the staff analysis, particularly the question of when it would be appropriate to regard a modification or exchange as the expiry or in-substance extinguishment of the original asset. Instead, they simply noted that, in their view, derecognition of the original Greek government bonds would be the appropriate accounting treatment however this particular transaction was assessed, i.e., whether it was viewed as (a) an actual expiry of the rights of the original asset or (b) as a substantial modification that is accounted for as an extinguishment of the original asset (because of the extensive changes in the assets' terms). An agenda decision setting out the IFRS IC's conclusions was published in September 2012.[9]

Whilst that discussion resolved most of the issues associated with the restructuring of Greek government bonds, the wider topic continues to require the application of judgement and, as a result, potentially leads to inconsistent approaches being applied by different entities.

3.5.3 Novation of contracts to intermediary counterparties

A change in the terms of a contract may take the legal form of a 'novation'. In this context novation means that the parties to a contract agree to change that contract so that an original counterparty is replaced by a new counterparty.

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8 IASB Staff Paper 10-A, Project: *New items for consideration*, Topic: *IAS 39 Financial Instruments: Recognition and Measurement - Derecognition of financial asset*, IFRS Interpretations Committee Meeting, May 2012, paras. 32-36. Available on the IFRS Foundation's website.

9 *IFRIC Update*, September 2012, available on the IFRS Foundation's website.

For example, a derivative between a reporting entity and a bank may be novated to a central counterparty (CCP) as a result of the introduction of new laws or regulations. In these circumstances, the IASB explains that through novation to a CCP the contractual rights to cash flows from the original derivative have expired and as a consequence the novation meets the derecognition criteria for a financial asset. *[IFRS 9.BC6.336, IFRS 9.BC6.337]*. The novation to the CCP also releases the parties from their original obligations and the novation would therefore also meet the derecognition criteria for a financial liability, as discussed in section 6 below. Consequently, the novation of a derivative to a CCP would be accounted for as the derecognition of the original derivative and the recognition of the (new) novated derivative.

How we see it

Whilst the IASB reached the above conclusion in relation to novations of over-the-counter derivatives, it is our view that the principle is applicable to all novations of contracts underlying a financial instrument. Accordingly, when a counterparty changes as a result of a novation, the financial instrument shall be derecognised and a new financial instrument shall be recognised.

Although such a novation may not be expected to give rise to a significant gain or loss when the financial instrument derecognised and the new financial instrument recognised are both measured at fair value through profit or loss, the bid/ask spread and the effect of change in counterparty on credit risk may cause some value differences. Furthermore, a novation may result in discontinuation of hedge accounting if the original financial instrument was a derivative designated in a hedging relationship (see Chapter 49 at section 8.3 for further details).

3.5.4 Interbank Offered Rate (IBOR) Reform

Following recommendations from the Financial Stability Board, there have been various initiatives to replace current benchmark interest rates, such as interbank offered rates like LIBOR, with nearly risk-free rates. In view of these initiatives and the resulting uncertainty around the long-term viability of IBORs, the IASB added a two-stage project to its agenda. The first stage was to consider financial reporting issues that may arise prior to the replacement of IBORs; and the second stage was to consider issues arising from changes to contractual cash flows required by the replacement of IBORs. IBOR reform and the IASB's project, including how the derecognition requirements apply to consequential modifications of financial instruments, are discussed in more detail in the *Supplement: IBOR Reform*.

3.5.5 Write-offs

An entity is required to directly reduce the gross carrying amount of a financial asset when it has no reasonable expectations of recovery. Such a write-off is regarded as the asset being derecognised - effectively it is seen as an in-substance expiry of the associated rights. Write-offs can also relate to a portion of an asset. For example, consider an entity that plans to enforce the collateral on a financial asset and expects to recover no more than 30% of the financial asset from the collateral. If the entity has no reasonable prospects of recovering any further cash flows from the financial asset, it must write off the remaining 70%. *[IFRS 9.5.4.4, IFRS 9.B3.2.16(r), IFRS 9.B5.4.9]*.

3.6 Has the entity 'transferred' the asset?

An entity is regarded by IFRS 9 as 'transferring' a financial asset if, and only if, it either: *[IFRS 9.3.2.4]*:

(a) Transfers the contractual rights to receive the cash flows of the financial asset (see section 3.6.1 below)

Or

(b) Retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows on to one or more recipients in an arrangement that meets the conditions in section 3.6.2 below (a so-called 'pass-through arrangement')

The latter might be the case where the entity is a SPE or trust, and issues to investors beneficial interests in financial assets that it owns and provides servicing of those assets. *[IFRS 9.B3.2.2]*.

3.6.1 Transfers of contractual rights to receive cash flows

The discussion in this section refers to Box 4 in Figure 3-1 in section 3.2 above.

IFRS 9 does not define what is meant by the phrase "transfers the contractual rights to receive the cash flows of the financial asset" in (a) in section 3.6 above, possibly on the assumption that this is self-evident. However, this is far from the case, since the phrase raises a number of questions of interpretation.

There are two key uncertainties about the meaning of 'transferring the contractual rights' (which in turn determines whether a transaction falls within (a) or (b) in section 3.6 above):

- Whether it is restricted to transfers of legal title only or also encompasses transfers of equitable title or an equitable interest (see section 3.6.1.A below)

  And

- The effect of conditions attached to the transfers (see section 3.6.1.B below)

In the context of the restructuring of Greek government bonds (see section 3.5.2 above), the IFRS IC considered whether an exchange of debt instruments between a borrower and a lender should be regarded as a transfer. It was noted that the bonds were transferred back to the issuer rather than to a third party and, as a consequence, it was agreed that this particular restructuring should not be regarded as a transfer.[10] However, it was noted during the IFRS IC's discussion and in the comment process that applying such a conclusion more widely might not always be appropriate, e.g., in the case of a short-term sale and repurchase agreement over a bond with the bond issuer or the simple repurchase of a bond by the issuer for cash.

3.6.1.A Meaning of 'transfers the contractual rights to receive the cash flows'

In many jurisdictions, the law recognises two types of title to property: (a) legal title; and (b) 'equitable', or beneficial title. In general, legal title defines who owns an asset at law and equitable title defines who is recognised as entitled to the benefit of the asset. Transfers of legal title give the transferee the ability to bring an action against a debtor to recover the debt in its own name. In equitable transfers, however, the transferee joins the transferor in an action to sue the debtor for recovery of debt. As noted above, the issue here is whether 'transfers of contractual rights' are limited to transfers of legal title.

In a typical securitisation transaction across many jurisdictions, the transfer of contractual rights to receive cash flows are achieved via equitable or beneficial transfer of title in that asset, as the transfer of legal title in the asset would simply not be possible without either:

- A tri-partite agreement between the corporate entity, the finance provider and the debtor

  Or

- A clause in the standard terms of trade allowing such a transfer at the sole discretion of the corporate entity without the express consent of the debtor, so that transfer can be effected by a subsequent bi-partite agreement between the corporate entity and the finance provider.

The consent of the debtor is not normally obtained, or indeed practically obtainable, in many securitisations and similar transactions. In these arrangements, all cash flows that are collected are contractually payable to a new eventual recipient - i.e., the debtor continues to pay the transferor, while the transferor loses the right to retain any cash collected from the debtor without actually transferring the contract itself.

In March 2006 the IFRS IC began to consider whether there can be a transfer of the contractual right to receive cash flows in an equitable transfer.[11] The IFRS IC had already concluded, in November 2005, that retaining servicing rights (i.e., continuing to administer collections and distributions of cash as agent for the transferee) does not in itself preclude derecognition.[12] However, the IFRS IC then considered whether retention by the transferor of the contractual right to receive the cash from debtors for distribution on to other parties (as must inevitably happen if debtors are not notified) means that such a transaction does not meet test (a) in section 3.6 above, and thus must meet test (b) (pass-through), as discussed in section 3.6, in order to achieve derecognition. The IFRS IC referred this issue to the IASB, which indicated in September 2006 that:

> "A transaction in which an entity transfers all the contractual rights to receive the cash flows (without necessarily transferring legal ownership of the financial asset), would not be treated as a pass-through. An example might be a situation in which an entity transfers all the legal rights to specifically identified cash flows of a financial asset (for example, a transfer of the interest or principal of a debt instrument).

10 *IFRIC Update*, September 2012, available on the IFRS Foundation's website.

11 *Information for Observers*, IFRS IC Meeting, March 2006, available on the IFRS Foundation's website.

12 *IFRIC Update*, November 2005, available on the IFRS Foundation's website.

Conversely, the pass-through test would be applicable when the entity does not transfer all the contractual rights to cash flows of the financial asset, such as disproportionate transfers."[13]

The statement that such a transaction 'would not be treated as a pass-through' means (in terms of Figure 3-1 in section 3.2 above) that the answer to Box 4 is 'Yes', such that the pass-through test in Box 5 (see section 3.6.2 below) is by-passed.

How we see it

The IASB's conclusion appears to concede that the references in IFRS 9 to a transfer of the 'contractual' right to cash flows was intended to include an equitable transfer of those rights, a conclusion that the IASB repeated in its April 2009 Exposure Draft - *Derecognition*. In our view, the transfer of the contractual rights to cash flows could encompass both the transfer of legal title in the asset as well as transfer of equitable or beneficial title in the asset.

3.6.1.B Transfers subject to conditions

An entity may transfer contractual rights to cash flows but subject to conditions. The IFRS IC identified the following main types of condition[14]:

- *Conditions relating to the existence and legal status of the asset at the time of the transfer*

  These include normal warranties as to the condition of the asset at the date of transfer and other guarantees affecting the existence and accuracy of the amount of the receivable that may not be known until after the date of transfer.
- *Conditions relating to the performance of the asset after the time of transfer*

  These include guarantees covering future default, late payment or changes in credit risk, guarantees relating to changes in tax, legal or regulatory requirements, where the buyer may be able to require additional payments if it is disadvantaged or - in some cases - demand reversal of the transaction, or guarantees covering future performance by the seller that might affect the recoverable amount of the debtor.

All securitisations (and indeed, most transfers, whether of financial or non-financial assets) include express or implied warranties regarding the condition of the asset at the date of transfer.

How we see it

In the case of a securitisation of credit card receivables, these might include a representation that, for example, all the debtors transferred are resident in a particular jurisdiction, or have never been in arrears for more than one month in the previous two years. In our view, such warranties do not affect whether or not the transaction achieves derecognition. However, the ability of the transferor to reliably identify the receivables eligible to be transferred under such conditions is key to determine the scope of the derecognition analysis.

It is a different matter when it comes to guarantees of post-transfer performance.

In September 2006, the IASB expressed the view that neither conditions relating to the existence and value of transferred cash flows at the date of transfer nor conditions relating to the future performance of the asset would affect whether the entity has transferred the contractual rights to receive cash flows[15] (i.e., Box 4 in Figure 3-1 in section 3.2 above). In other words, a transaction with such conditions that otherwise met the criteria in Box 4 would not be subject to the pass-through test in Box 5.

However, the existence of conditions relating to the future performance of the asset might affect the conclusion related to the transfer of risks and rewards (i.e., Box 6 in Figure 3-1 in section 3.2 above) as well as the extent of any continuing involvement by the transferor in the transferred asset (i.e., Box 9 in Figure 3-1 in section 3.2. above).[16]

An entity must take a view that is consistent with its policies on these matters and, as in these other cases, hold this view consistently when considering the derecognition of any financial asset.

13 *IASB Update*, September 2006, available on the IFRS Foundation's website.

14 *IFRIC Update*, March 2006, available on the IFRS Foundation's website.

15 *IASB Update*, September 2006, available on the IFRS Foundation's website.

16 *IASB Update*, September 2006, available on the IFRS Foundation's website.

A transfer of contractual rights might further be subject to an offsetting arrangement between the contract parties. An example of a two-party offset arrangement is when the original debtor (e.g., a borrower or customer) has the right to offset amounts it is owed by the transferor (e.g., balances in a deposit account or arising from a credit note issued by the transferor) against the transferred asset. If such a right is exercised after the asset is transferred the transferor would be required to compensate the transferee.

How we see it

This would not, in our view, normally affect whether the entity has transferred the contractual rights to receive the cash flows of the original financial asset. Payments made by the transferor to the transferee as a result of the right of offset being exercised by the debtor simply transfer to the transferee the value the transferor obtained when its liability to the original debtor was settled.

There may also be tripartite offset arrangements where a party other than the original debtor (e.g., a subcontractor) has such offset rights.[17]

3.6.2 Retention of rights to receive cash flows subject to obligation to pay over to others (pass-through arrangement)

The discussion in this section refers to Box 5 in Figure 3-1 in section 3.2 above.

It is common in certain securitisation and debt sub-participation transactions (see section 3.3 above) for an entity to enter into an arrangement whereby it continues to hold the contractual rights to the cash flows and collect cash receipts from a financial asset (or more typically a pool of financial assets), but is obliged to pass on those receipts to a third party that has provided finance in connection with the financial asset. Whilst the term 'pass-through' for these arrangements does not actually appear in IFRS 9, it has become part of the language of the financial markets.

Under IFRS 9, an arrangement whereby the reporting entity retains the contractual rights to receive the cash flows of a financial asset (the 'original asset'), but assumes a contractual obligation to pay the cash flows to one or more recipients (the 'eventual recipients') is regarded as a transfer of the original asset if, and only if, all of the following three conditions are met:

(a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition (see section 3.6.2.B below).

(b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.

And

(c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except in cash or cash equivalents as defined in IAS 7 *Statement of Cash Flows* (see Chapter 36 at section 3) during the short settlement period from the collection date to the date of required remittance to the eventual recipients, with any interest earned on such investments being passed to the eventual recipients. *[IFRS 9.3.2.5]*.

These conditions are discussed further in section 3.6.2.D below.

IFRS 9 notes that an entity that is required to consider the impact of these conditions on a transaction is likely to be either:

- The originator of the financial asset in a securitisation transaction (see section 3.3 above)

  Or

- A group that includes a consolidated SPE that has acquired the financial asset and passes on cash flows to unrelated third-party investors *[IFRS 9.B3.2.3]*

IFRS 9 does not address whether it is necessary for a pass-through arrangement to be able to survive the bankruptcy of the transferor in order to be considered a transfer. Consequently, there is no explicit requirement in the standard to consider the likelihood of the transferor's bankruptcy when assessing pass-through arrangements. This issue was discussed by the IASB in its April 2009 Exposure Draft *Derecognition,* where it was proposed that bankruptcy remoteness would not form part of the derecognition model. This was seen at the time as an intentional divergence from US GAAP, which requires transferred

17 Information for Observers, IFRS IC Meeting, March 2006.

financial assets to be legally isolated from the transferor, its consolidated affiliates and its creditors, even in bankruptcy.[18] In practice, if the transferred assets are held in a ring-fenced structured entity this may protect cash flows to the transferee in the event of the transferor's bankruptcy.

We note that some transfer arrangements include a right by the transferor to use the cash flows collected under the pass-through arrangement to net settle other amounts owed by the transferee to the transferor. This means that, rather than a physical remittance of cash under IFRS 9.3.2.5(c), a net settlement occurs. On its own, net settlement would not preclude IFRS 9.2.3.5(c) from being met, as the form of settlement does not change the transferor's obligation to transfer the value embedded in the cash flows to the transferee without material delay.

3.6.2.A Recourse to originator

The conditions in section 3.6.2 above clearly have the effect that an arrangement that does not transfer the contractual rights to receive the cash flows and provides for direct recourse to the originator usually does not meet the definition of a 'transfer' for the purposes of pass-through and therefore does not qualify to be considered for derecognition. Direct recourse would include an arrangement whereby part of the consideration for the financial asset transferred was deferred depending on the performance of the asset.

How we see it

In our view, however, certain techniques for providing indirect recourse do not breach the conditions for transfer for the purposes of pass-through. These include, for example, the provision of certain types of insurance provided that the investors' only recourse is to the insurance policy (see section 3.6.2.C below).

If, however, the arrangement involves a transfer of the contractual rights to receive the cash flows, the recourse will have an impact on the originator's analysis of the risks and rewards. This is dealt with in more detail in section 4.3 below.

3.6.2.B Short-term loan facilities

Enhancing a securitised asset with the provision of loan facilities to meet temporary shortfalls as a result of slow payments from the asset would preclude an arrangement being regarded as a pass-through unless the facilities:

- Are made on a 'short-term' basis
- Are repayable irrespective of whether the slow payments are eventually received

  And
- Bear interest at market rates

The purpose of these restrictions is to ensure that IFRS 9 allows derecognition of assets subject to such facilities only where the facilities are providing a short-term cash flow benefit to the investor, and not when they effectively transfer slow payment risk back to the originator (as would be the case if the originator made significant interest-free loans to the investor). Clearly, therefore, the circumstances in which such funds can be advanced must be very tightly defined if pass-through is to be achieved.

3.6.2.C Insurance protection

The implications of the derecognition and pass-through requirements of IFRS 9 for transfers of groups of financial assets including insurance contracts have been considered by the IFRS IC and the IASB but their tentative conclusions were withdrawn. For a discussion of the issues and the alternative interpretations of 'similar' assets, see section 3.4.2.B above.

How we see it

The conditions for 'pass-through arrangements' are not, in our view, breached by the originator purchasing an insurance contract for the benefit of investors in the event of a shortfall in cash collections from the securitised assets, provided that the investors' only recourse is to the insurance policy. In other words, the originator cannot give a guarantee to investors to make good any shortfalls should the insurer become insolvent, nor can the originator provide any support to the insurer through a guarantee arrangement or a reinsurance contract.

18 *Exposure Draft - Derecognition*, April 2009, available on the IFRS Foundation's website.

3.6.2.D Treatment of collection proceeds

Securitisation contracts rarely require any amount received on the securitised assets to be immediately transferred to investors. This is for the obvious practical reason that it would be administratively inefficient, in the case of a securitisation of credit card receivables for example, to transfer the relevant portion of each individual, and relatively small, cash flow received from the hundreds, if not thousands, of cards in the portfolio. Instead, it is usual for transfers to be made in bulk on a periodic basis (e.g., weekly or monthly). This raises the question of what happens to the cash in the period between receipt by the issuer and onward transfer to the investors.

IFRS 9 requires cash flows from transferred financial assets for which derecognition is sought to be:

- Passed to the eventual recipients 'without material delay'

  And

- Invested only in cash or cash equivalents as defined in IAS 7 entirely for the benefit of the investors (see condition (c) in section 3.6.2 above)

These requirements mean that many securitisation arrangements may well fail to satisfy the pass-through test in section 3.6.2 above.

How we see it

The IASB does not expand further on the term 'without material delay'. It is not, in our view, intended to require settlement to noteholders on an unrealistically frequent basis such as daily, although we would normally expect payments to be made by the next quarterly coupon payment date to meet this condition.

Suppose that a credit card issuer wishes to raise five-year finance secured on its portfolio of credit card receivables. The assets concerned are essentially short term (being in most cases settled in full within four to eight weeks), whereas the term of the borrowings secured on them is longer. In practice, what generally happens is that, at the start of the securitisation, a 'pool' of balances is transferred to a securitisation SPE. The cash receipts from that 'pool' are used to pay interest on the borrowings, and to fund new advances on cards in the 'pool' or to purchase other balances. Such an arrangement, commonly referred to as a 'revolving' structure, appears to breach the requirement of the pass-through tests to:

- Pass on cash receipts without material delay (since only the amount of cash receipts necessary to pay the interest on the borrowings is passed on, with the balance being reinvested until the principal of the borrowings falls due).

  And

- Only invest in cash or cash equivalents as defined in IAS 7 in the period prior to passing them onto the investor. This is because the cash not required to pay interest on the borrowings is invested in further credit card receivables, which are not cash or cash equivalents as defined in IAS 7.

The IFRS IC confirmed in November 2005 that most 'revolving' structures do not meet the requirements of the pass-through test for funds to be passed on without material delay and to be invested only in cash and cash equivalents.[19]

In practice, we have observed the pass-through tests are applied very strictly such that any arrangement that provides for even a small tranche of the interest from such short-term deposits to be retained by or for the benefit of the originator will not satisfy the criteria for transfer under IFRS 9. Moreover, IFRS 9 requires that the reporting entity 'is not entitled' to invest the cash other than in cash or cash equivalents as described above. Thus, it appears that the criteria for transfer are not satisfied merely where the entity does not in fact invest the cash in any other way - it must be contractually prohibited from doing so. In practice, this is often achieved by having the funds paid into a trustee bank account that can be used only for the benefit of the providers of finance. Arrangements where re-investment occurs could meet the pass-through requirements if the investor has the substantive ability to choose whether or not to reinvest at the point where the re-investment needs to be made, and all other conditions in IFRS 9 3.2.5 are met. This is because in such a scenario the transferee is effectively realising the underlying cash flows and re-investing them, with cash flows happening on a net basis for operational ease.

The strict requirements of IFRS 9 in respect of cash received from assets subject to a pass-through arrangement raise the related, but broader, issue of the appropriate treatment of client money which is discussed in section 8 below.

19 *IFRIC Update*, November 2005, available on the IFRS Foundation's website.

3.6.2.E Transfers of non-optional derivatives along with a group of financial assets

As discussed in section 3.4.2 above, interest rate swaps that are transferred along with a group of non-derivative financial assets may be derecognised only when any associated obligation is also discharged, cancelled or expires (see section 6 below). This is because the pass-through criteria do not apply to a transfer of an interest rate swap which can be either a financial asset or a financial liability.

In a securitisation transaction involving the equitable transfer of an interest rate swap to an SPE, the swap would continue to be recognised by the transferor. The ongoing accounting consequences of this are less clear. The swap must clearly continue to be measured at fair value through profit or loss in accordance with the general requirement of IFRS 9 for the measurement of derivatives not in a hedging relationship (see Chapter 42). However, this would have the effect that the reporting entity reflected gains and losses in the income statement for a derivative in which it no longer has a beneficial interest. In such a case, the entity would presumably recognise the notional back-to-back swap which it has effectively entered into with the transferee, so as to offset the income statement effect of the original swap.

3.6.2.F 'Empty' subsidiaries or SPEs

If an entity enters into a transaction whereby:

- The entity transfers an asset to a subsidiary or SPE.

  And

- The subsidiary or SPE transfers the asset to noteholders on terms that satisfy the pass-through derecognition criteria in IFRS 9, as discussed in sections 3.2 and 3.6.2 above.

The overall effect will be that the individual financial statements of the subsidiary or SPE will include neither the transferred asset nor the finance raised from noteholders. This may well mean that the financial statements show nothing apart from the relatively small amount of equity of the entity and any related assets. This analysis is likely to be applicable only for relatively simple transfers, and not, for example, when derivatives are transferred along with the non-derivative assets.

3.7 Has the entity transferred or retained substantially all the risks and rewards of ownership?

The discussion in this section refers to Boxes 6 and 7 in Figure 3-1 in section 3.2 above.

Extract from IFRS 9

3.2.6 When an entity transfers a financial asset (see paragraph 3.2.4), it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In this case:

(a) if the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.

(b) if the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity shall continue to recognise the financial asset.

(c) if the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, the entity shall determine whether it has retained control of the financial asset. In this case:

(i) if the entity has not retained control, it shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.

(ii) if the entity has retained control, it shall continue to recognise the financial asset to the extent of its continuing involvement in the financial asset (see paragraph 3.2.16).

[IFRS 9.3.2.6].

IFRS 9 clarifies that the transfer of risks and rewards is evaluated by comparing the entity's exposure, before and after the transfer, to the variability in the amounts and timing of the net cash flows of the transferred asset. *[IFRS 9.3.2.7]*. Often it will be obvious whether the entity has transferred or retained substantially all risks and rewards of ownership. In other cases, it will be necessary to determine this by computing and comparing the entity's exposure to the variability in the present value (discounted at an

appropriate current market interest rate) of the future net cash flows before and after the transfer. All reasonably possible variability in net cash flows is considered, with greater weight being given to those outcomes that are more likely to occur. *[IFRS 9.3.2.8]*.

In some circumstances it may be appropriate to consider whether substantially all the risks and rewards of an asset have been transferred as a result of the cumulative effect of two separate transactions (see section 3.7.5 below).

3.7.1 Transfers resulting in transfer of substantially all risks and rewards

An entity has transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the amounts and timing of the net cash flows of the transferred asset is no longer significant in relation to the total variability. IFRS 9 gives the following examples of transactions that transfer substantially all the risks and rewards of ownership:

- An unconditional sale of a financial asset.
- A sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase (since this does not expose the entity to any risk of loss or give any opportunity for profit).
- A sale of a financial asset together with a put or call option that is deeply out of the money (i.e., an option that is so far out of the money it is highly unlikely to go into the money before expiry).

  Or
- The sale of a fully proportionate share of the cash flows from a larger financial asset in an arrangement, such as a loan sub-participation, that satisfies the criteria for a 'transfer' in section 3.6 above. *[IFRS 9.3.2.7, IFRS 9.B3.2.4]*.

Such transactions are discussed in more detail in section 4 below.

It is important to note that, in order for derecognition to be achieved, it is necessary that the entity's exposure to the variability in the amounts and timing of the net cash flows of the transferred asset is considered not in isolation, but 'in relation to the total variability' (see above). Thus, derecognition is not achieved simply because the entity's remaining exposure to the risks or rewards of an asset is small in absolute terms. It has also become clear, from the IFRS IC and IASB's discussions described in section 3.4.2 above, that derecognition also depends on the interpretation of 'asset' and of groups of similar assets that is applied by the entity and how this determines the total variability to be considered as a reference before and after the sale.

3.7.2 Transfers resulting in retention of substantially all risks and rewards

An entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer. *[IFRS 9.3.2.7]*. IFRS 9 gives the following examples of transactions in which an entity has retained substantially all the risks and rewards of ownership: *[IFRS 9.B3.2.5]*

Extract from IFRS 9

B3.2.5 Examples of when an entity has retained substantially all the risks and rewards of ownership are:

(a) a sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return;

(b) a securities lending agreement;

(c) sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity;

(d) a sale of a financial asset together with a deep in-the-money put or call option (ie an option that is so far in the money that it is highly unlikely to go out of the money before expiry); and

(e) sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.

Such transactions are discussed in more detail in section 4 below.

3.7.3 Transfers resulting in neither transfer nor retention of substantially all risks and rewards

IFRS 9 gives the following examples of transactions in which an entity has neither transferred nor retained substantially all the risks and rewards of ownership:

- A sale of a financial asset together with a put or call option that is neither deeply in the money nor deeply out of the money. *[IFRS 9.B3.2.16(h), IFRS 9.B3.2.16(i)]*. The effect of such an option is that the transferor will have either (in the case of purchased call option) capped its exposure to a loss in value of the asset but have potentially unlimited access to increases in value or (in the case of a written put option) capped its potential access to increases in value in the asset but assumed potential exposure to a total loss in value of the asset.

  And

- A sale of 90% of a loan portfolio with significant transfer of prepayment risk, but retention of a 10% interest, with losses allocated first to that 10% retained interest. *[IFRS 9.B3.2.17]*.

Such transactions are discussed in more detail in section 4 below.

3.7.4 Evaluating the extent to which risks and rewards are transferred - practical example

The following Illustration shows one approach to evaluating the extent to which risks and rewards associated with a portfolio of assets have been transferred.

Illustration 3-1: Risks and rewards analysis - variability in the amounts and timing of net cash flows

Entity X sells a portfolio of trade receivables with a total face value of CU1 million and an average due date of 45 days from the issuance of the invoice to Entity Y, an unrelated third party. After the sale, Entity X does not retain any residual benefits in the receivables. However, Entity X guarantees losses on the transferred portfolio up to a percentage of the total face value. Default losses, including late payments, as a percentage of face value ranged historically from 3% to 7%.

Assume the following two hypothetical situations:

- Fact pattern 1 - Entity X guarantees first losses on the portfolio up to 3.5% of the total face value.
- Fact pattern 2 - Entity X guarantees first losses on the portfolio up to 5% of the total face value.

The following calculations illustrate one possible approach for calculating the exposure to the variability in the amounts and timing of net cash flows.

Under this approach the reporting entity (Entity X) determines a number of reasonably possible scenarios that reflect the expected variability in the amounts and timing of net cash flows; these scenarios are then assigned a probability, with greater weighting being given to those outcomes that are more likely to occur. Next, Entity X calculates the expected future net cash flows for each scenario, discounted using an appropriate current market rate. The expected variability is then calculated using an appropriate statistical technique. In this example, the expected variability is calculated by first calculating the differences between the discounted expected cash flows for each scenario and the expected value (i.e., the sum of the probability weighted discounted expected cash flows for all possible scenarios) and then adding up these individual probability-weighted differences (separately for negative or positive). An alternative, and more statistically sound approach, is to compute the standard deviation considering the square root of the sum of the probability weighted squares of the differences as calculated above (i.e., the discounted expected net cash flows for each scenario minus the expected value). This method requires a significantly greater number of scenarios, with an individually assigned probability, in order to be statistically robust. We have also illustrated this approach in a simplified manner, using five scenarios.

The above steps are duplicated for net cash flows that the transferor, Entity X, remains exposed to after the transfer. Finally, the exposure to expected variability of net cash flows post transfer is compared to the corresponding expected variability before the transfer.

As the receivables are relatively short-term, the calculations below focus primarily on credit risk. For simplicity, the calculations below ignore the effect of discounting.

Fact pattern 1: Entity X guarantees first losses on the portfolio up to 3.5% of total face value.

Based on historical experience and supportable expectations Entity X has defined five scenarios of possible variability, each of which has been assigned a probability based on historical experience and current market information. In practice, obtaining this data may prove more challenging. These scenarios and probabilities are set out below.

Before Transfer

Total face value = CU1,000,000 = A

Possible credit loss	Discounted expected cash flows	Probability	Probability weighted discounted cash flows	Difference	Probability weighted negative variability	Probability weighted positive variability
B	C= A-[A×B]	D	E=C×D	F=C-Σ(E)	G=F×D if F<0	H=F×D if F>0
	CU		CU	CU	CU	CU
3.0%	970,000	3.5%	33,950	23,100	-	808.5
4.0%	960,000	20.0%	192,000	13.100	-	2620
5.0%	950,000	30.0%	285,000	3.100	-	930
6.0%	940,000	35.0%	329,000	(6,900)	(2,415)	-
7.0%	930,000	11.5%	106,950	(16,900)	(1,943.5)	-
		100.0%	946,900		**(4,358.5)**	**4,358.5**
					K	K
	Probability weighted discounted loss		CU53,100	I=A-Σ(E)		

After Transfer

Total face value = CU1,000,000 = A

Possible credit loss	Discounted expected negative cash flows	Probability	Probability weighted discounted negative cash flows	Difference	Probability weighted negative variability	Probability weighted positive variability
B	C=[A×(B)], max CU35,000	D	E=C×D	F=C-Σ(E)	G=F×D if F<0	H=F×D if F>0
	CU		CU	CU	CU	CU
3.0%	30,000	3.5%	1,050	(4,825)	(168.88)	-
4.0%	35,000	20.0%	7,000	175	-	35.00
5.0%	35,000	30.0%	10,500	175	-	52.50
6.0%	35,000	35.0%	12,250	175	-	61.25
7.0%	35,000	11.5%	4,025	175	-	20.13
		100.0%	34,825		**(168.88)**	**168.88**
	Probability weighted discounted loss		CU34,825	M=Σ(E)	L	L
	Percentage of variability retained by Entity X			L÷K	**(3.87%)**	**3.87%**

To avoid a mechanical determination and to leave room for judgement, IFRS 9 does not establish any bright-lines on what constitutes 'substantially all' risks and rewards of ownership. Therefore, judgement is needed to assess what is 'substantially all' in each particular situation considering, for example, the sensitivity of the calculation to certain changes in assumptions.

Assuming that Entity X determined that 'substantially all' represents 90% of total expected variability in the amounts and timing of net cash flows, it will conclude that it has transferred substantially all risks and rewards of ownership, as only 3.87% has been retained.

This conclusion may seem counterintuitive given that Entity X has retained 65.58% of the total expected losses (M ÷ I = CU34,825 ÷ CU53,100). However, IFRS 9 is clear that the transfer of risks and rewards is evaluated by comparing the transferor's exposure, before and after the transfer, to the variability in the amounts and timing of net cash flows of the transferred asset (IFRS 9.3.2.7). In practice, even when factoring with limited recourse, the transferor very often retains exposure to losses in excess of those reasonably expected to arise such that substantially all the variability is retained by the transferor.

The alternative approach mentioned above, is calculated in the following manner. Please note that the inputs to the formulas that are presented below, refer to the before and after transfer scenario respectively:

Possible credit loss	Probability weighted Standard Deviation NPV - before transfer	Probability weighted Standard Deviation NPV - after transfer
	F^2×D	F^2×D
	CU	CU
3.0%	18,676,350	814,822
4.0%	34,322,000	6,125
5.0%	2,883,000	9,188
6.0%	16,663,500	10,719
7.0%	32,845,150	3,522
Standard deviation	10,266	919
	A	B
Variability retained (B÷A)		8.95%

In this case, the alternative approach would lead to a higher measure of variability retained, but the same conclusion would still apply based on the 90% threshold mentioned above. In practice, a higher number of scenarios may be applied, which may narrow the difference between the two scenarios.

Fact pattern 2: Entity X guarantees first losses on the portfolio up to 5% of the total face value.

Total face value = CU1,000,000 = A

Before Transfer

Possible credit loss	Discounted expected cash flows	Probability	Probability weighted discounted cash flows	Difference	Probability weighted negative variability	Probability weighted positive variability
B	C= A-[A×B]D	E=C×D	F=C-Σ(E)	G=F×D if F<0	H=F×D if F>0	
	CU		CU	CU	CU	CU
3.0%	970,000	3.5%	33,950	23,100	-	808.5
4.0%	960,000	20.0%	192,000	13.100	-	2620
5.0%	950,000	30.0%	285,000	3.100	-	930
6.0%	940,000	35.0%	329,000	(6,900)	(2,415)	-
7.0%	930,000	11.5%	106,950	(16,900)	(1,943.5)	-
		100.0%	946,900		(4,358.5)	4,358.5
					K	K
Probability weighted discounted lossCU53,100			I = A-Σ(E)			

After Transfer

Possible credit loss	Discounted expected negative cash flows	Probability	Probability weighted discounted negative cash flows	Difference	Probability weighted negative variability	Probability weighted positive variability
B	C=[A×(B)], max CU40,000	D	E=C×D	F=C-Σ(E)	G=F×D if F<0	H=F×D if F>0
	CU		CU	CU	CU	CU
3.0%	30,000	3.5%	1,050	-17,300	-605.5	-
4.0%	40,000	20.0%	8,000	-7,300	-1460	-
5.0%	50,000	30.0%	15,000	2,700	-	810
6.0%	50,000	35.0%	17,500	2,700	-	945
7.0%	50,000	11.5%	5,750	2,700	-	310.5
		100.0%	47,300		(-2.065.5)	2,065.5
			M		L	L
Probability weighted discounted loss			CU 47,300	M=Σ(E)		
Percentage of variability retained by Entity X				L÷K	(47.39%)	47.39%

Now that Entity X stands ready to cover first losses up to 5%, it is not a surprise that its exposure to variability has increased to 47.39%. This means that Entity X has neither transferred nor retained substantially all risks and rewards of ownership in this case. Again, the fact that the seller now covers, after the sale, 89.08% (M ÷ I = CU38,650 ÷ CU41,550) of the total expected losses is not relevant to the analysis.

Similar to fact pattern 1, we have performed the variability analysis by comparing the standard deviations, before and after transfer.

Possible credit loss	Probability weighted Standard Deviation NPV - before transfer	Probability weighted Standard Deviation NPV - after transfer
	F^2×D	F^2×D
	CU	CU
3.0%	18,676,350	10,475,150
4.0%	34,322,000	10,658,000
5.0%	2,883,000	2,187,000
6.0%	16,663,500	2,551,500
7.0%	32,845,150	838,350
Standard deviation	10,266	5,168
	A	B
Variability retained (B÷A)		50.34%

In this case, derecognition will depend on whether the transferee (Entity Y) has the practical ability to sell the trade receivables unilaterally and without imposing additional restrictions on the transfer. The conclusion needs to take into account many factors. For example: (i) whether the transferee has legal title to the transferred receivables; (ii) whether there is a market for the transferred receivables or not; (iii) whether or not the seller has a call option or has written a put option over the transferred receivables; (iv) whether or not the guarantee of Entity X is transferable with the receivables; (v) whether the receivables are 'ring-fenced' in an SPE as a pledge for securities collateralised by the transferred assets, etc. This aspect of the analysis is covered in section 3.8 below.

3.7.5 Transfer of risks on a cumulative basis

The following Illustration shows that derecognition may be achieved by the transfer of substantially all the risks and rewards of ownership in two separate transactions.

Illustration 3-2: Risks and rewards analysis - two separate transactions

Entity X owns a pool of mortgages with a fixed rate of interest of 5%. The mortgages are guaranteed by a government agency and are effectively free of credit risk, but they are subject to variability due to prepayment risk. Entity X sells part of the cash flows from the mortgages (cash flows from the principal and a proportionate share of the interest payments equivalent to a return on the principal of 3%) to Entity Y but indemnifies Entity Y such that Entity Y is not exposed to any of the prepayment variability. Entity X indemnifies Entity Y by agreeing to make a compensatory payment(s) to Entity Y for lost interest on mortgages which are prepaid.

Subsequently, Entity X enters into a second transaction with Entity Z under which Entity Z receives the remaining cash flows from the mortgages and takes on the indemnity to Entity Y such that Entity X is no longer exposed to any prepayment variability.

Entity X assesses the risks and rewards of its interests in the mortgages on a cumulative basis. At the time of the sale to Entity Y, Entity X concludes that it has retained substantially all the risks and rewards of the mortgages because it has retained the prepayment variability and therefore continues to recognise them.

At the time of the transaction with Entity Z, Entity X concludes that it has now transferred substantially all the risks and rewards of the mortgages and therefore derecognises them.

3.8 Has the entity retained control of the asset?

The discussion in this section relates to Boxes 8 and 9 of Figure 3-1 in section 3.2 above.

If the transferring entity has neither transferred nor retained substantially all the risks and rewards of a transferred financial asset, IFRS 9 requires the entity to determine whether or not it has retained control of the financial asset. If the entity has not retained control, it must derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer. If the entity has retained control, it must continue to recognise the financial asset to the extent of its continuing involvement in the financial asset (see section 5.3 below). *[IFRS 9.3.2.6(c), IFRS 9.3.2.9]*.

Extract from IFRS 9

3.2.9 Whether the entity has retained control (see paragraph 3.2.6(c)) of the transferred asset depends on the transferee's ability to sell the asset. If the transferee has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer, the entity has not retained control. In all other cases, the entity has retained control.

3.8.1 Transferee's 'practical ability' to sell the asset

IFRS 9 provides further guidance in two scenarios. Firstly, when a transferred asset is subject to a repurchase option, second, when a transfer imposes additional restrictions on selling the transferred assets. If a transferred asset is sold subject to an option that allows the entity to repurchase it, the transferee may (subject to the further considerations discussed below) have the practical ability to sell the asset if it can readily obtain the transferred asset in the market if the option is exercised. *[IFRS 9.B3.2.7]*. For this purpose, there has to be an active market for the asset.

The transferee has the practical ability to sell the transferred asset only if the transferee can sell the transferred asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without imposing additional restrictions on the transfer. IFRS 9 requires that practical ability to sell the transferred asset be determined by considering what the transferee is able to do in practice, rather than solely by reference to any contractual rights or prohibitions. The standard notes that a contractual right to dispose of the transferred asset has little practical effect if there is no market for the transferred asset. *[IFRS 9.B3.2.8(a)]*.

An ability to dispose of the transferred asset also has little practical effect if it cannot be exercised freely. Accordingly, the transferee's ability to dispose of the transferred asset must be a unilateral ability independent of the actions of others. In other words, the transferee must be able to dispose of the transferred asset without needing to attach conditions to the transfer (e.g., conditions about how a loan asset is serviced, or an option giving the transferee the right to repurchase the asset). *[IFRS 9.B3.2.8(b)]*.

For example, the entity might sell a financial asset to a transferee, but the transferee has an option to put the asset back to the entity or has a performance guarantee from the entity. IFRS 9 argues that such an option or guarantee might be so valuable to the transferee that it would not, in practice, sell the transferred asset to a third party without attaching a similar option or other restrictive conditions. Instead, the transferee would hold the transferred asset so as to obtain payments under the guarantee or put option. Under these circumstances IFRS 9 regards the transferor as having retained control of the transferred asset. *[IFRS 9.B3.2.9]*.

However, the fact that the transferee is simply unlikely to sell the transferred asset does not, of itself, mean that the transferor has retained control of the transferred asset. *[IFRS 9.B3.2.9]*.

4 Practical application of the derecognition criteria

IFRS 9 gives a number of practical examples of the application of the derecognition criteria, which are discussed below.

In order to provide a link with Figure 3-1 in section 3.2 above we have used the following convention:

'Box 6, Yes'	The transaction would result in the answer 'Yes' at Box 6 in Figure 3-1.
'Box 7, No'	The transaction would result in the answer 'No' at Box 7 in Figure 3-1.

4.1 Repurchase agreements ('repos') and securities lending

4.1.1 Agreements to return the same asset

If a financial asset is:

- Sold under an agreement to repurchase it at a fixed price or at the sale price plus a lender's return

  Or

- Loaned under an agreement to return it to the transferor

The asset is not derecognised, because the transferor retains substantially all the risks and rewards of ownership, *[IFRS 9.B3.2.16(a)]*, (Figure 3-1, Box 7, Yes). The accounting treatment of such transactions is discussed in section 5.2 below.

4.1.1.A Transferee's right to pledge

If the transferee obtains the right to sell or pledge an asset that is the subject of such a transaction, the transferor reclassifies the asset on its statement of financial position as, for example, a loaned asset or repurchase receivable. *[IFRS 9.B3.2.16(a)]*.

It appears that this accounting treatment is required merely where the transferee has the 'right' to sell or pledge the asset. This contrasts with the requirements for determining whether an asset subject to a transaction in which the entity neither transfers nor retains substantially all the risks and rewards associated with the asset (Figure 3-1, Box 7, No) nevertheless qualifies for derecognition because the transferee has control (Figure 3-1, Box 8, No). In order for the transferee to be regarded as having control for the purposes of Box 8, any rights of the transferee to sell an asset must have economic substance - see section 3.8.1 above.

The accounting treatment of such transactions is discussed in section 5.2 below.

4.1.2 Agreements with right to return the same or substantially the same asset

If a financial asset is:

- Sold under an agreement to repurchase the same or substantially the same asset at a fixed price or at the sale price plus a lender's return

  Or

- Loaned under an agreement to return the same or substantially the same asset to the transferor

The asset is not derecognised because the transferor retains substantially all the risks and rewards of ownership, *[IFRS 9.B3.2.16(b)]*, (Figure 3-1, Box 7, Yes). The accounting treatment of such transactions is discussed in section 5.2 below.

4.1.3 Agreements with right of substitution

If a financial asset is the subject of:

- A repurchase agreement at a fixed repurchase price or a price equal to the sale price plus a lender's return

  Or

- A similar securities lending transaction

That provides the transferee with a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date, the asset sold or lent is not derecognised because the transferor retains substantially all the risks and rewards of ownership, *[IFRS 9.B3.2.16(c)]*, (Figure 3-1, Box 7, Yes). The accounting treatment of such transactions is discussed in section 5.2 below.

4.1.4 Net cash-settled forward repurchase

IFRS 9 gives some guidance on the treatment of net cash-settled options over transferred assets (see section 4.2.5 below), which in passing refers to net cash-settled forward contracts. This guidance indicates that the key factor for determining whether derecognition is appropriate remains whether or not the entity has transferred substantially all the risks and rewards of the transferred asset. *[IFRS 9.B3.2.16(k)]*. This suggests that an asset sold subject to a fixed price net-settled forward contract to reacquire it must not be derecognised (see sections 4.1.1 to 4.1.3 above) until the forward contract is settled (Figure 3-1, Box 7, Yes).

The accounting treatment of such transactions is discussed in section 5.2 below.

4.1.5 Agreement to repurchase at fair value

A transfer of a financial asset subject only to a forward repurchase agreement with a repurchase price equal to the fair value of the financial asset at the time of repurchase results in derecognition because of the transfer of substantially all the risks and rewards of ownership, *[IFRS 9.B3.2.16(j)]*, (Figure 3-1, Box 6, Yes). The accounting treatment of such transactions is discussed in section 5.1 below.

4.1.6 Right of first refusal to repurchase at fair value

If an entity sells a financial asset and retains only a right of first refusal to repurchase the transferred asset at fair value if the transferee subsequently sells it, the entity derecognises the asset because it has transferred substantially all the risks and rewards of ownership, *[IFRS 9.B3.2.16(d)]*, (Figure 3-1, Box 6, Yes).

IFRS 9 does not address the treatment of a financial asset sold with a right of first refusal to repurchase the transferred asset at a predetermined value that might well be lower or higher than fair value (e.g., an amount estimated, at the time at which the original transaction was entered into, as the future market value of the asset). One analysis might be that, since the transferee is under no obligation to put the asset up for sale, derecognition is still appropriate. Another analysis might be that, if the asset can ultimately only be realised by onward sale, the arrangement is nearer in substance to a transferor's call option (see section 4.2 below).

4.1.7 Wash sale

A 'wash sale' is the repurchase of a financial asset shortly after it has been sold. Such a repurchase does not preclude derecognition provided that the original transaction met the derecognition requirements. However, if an agreement to sell a financial asset is entered into concurrently with an agreement to repurchase the same asset at a fixed price or the sale price plus a lender's return, then the asset is not derecognised. *[IFRS 9.B3.2.16(e)]*. Such a transaction would be equivalent to those in sections 4.1.1 to 4.1.4 above.

4.2 Transfers subject to put and call options

An option contract is a contract which gives one party to the contract the right, but not the obligation, to buy from, or sell to, the other party to the contract the asset that is the subject of the contract for a given price (often, but not always, a price that is fixed) at a future date (or during a longer period ending on a future date). An option giving the right to buy an asset is referred to as a 'call' option and one giving the right to sell as a 'put' option. An option is referred to as a 'bought' or 'purchased' option from the perspective of the party with the right to buy or sell (the 'holder') and as a 'written' option from the perspective of the party with the potential obligation to buy or sell. An option is referred to as 'in the money' when it would be in the holder's interest to exercise it and as 'out of the money' when it would not be in the holder's interest to exercise it.

Under IFRS 9 an option is:

- 'Deeply in the money' when it is so far in the money that it is highly unlikely to go out of the money before expiry *[IFRS 9.B3.2.5(d)]*

  And

- 'Deeply out of the money' when it is so far out of the money that it is highly unlikely to become in the money before expiry *[IFRS 9.B3.2.4(c)]*

IFRS 9 does not elaborate on what it means by 'highly unlikely' in this context, although the Implementation Guidance to IAS 39 clarified that 'highly probable' (in the context of a 'highly probable forecast transaction' subject to a hedge) indicates a much greater likelihood of happening than the term 'more likely than not'. *[IAS 39.F.3.7]*.

4.2.1 Deeply in the money put and call options

If a transferred financial asset can be called back by the transferor, and the call option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership (Figure 3-1, Box 7, Yes).

Similarly, if the financial asset can be put back by the transferee, and the put option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership, *[IFRS 9.B3.2.16(f)]*, (Figure 3-1, Box 7, Yes).

The accounting treatment for such transactions would be similar to that for 'repos' as set out in Illustration 5-5 in section 5.2 below.

If a transferred asset continues to be recognised because of a transferor's call option or transferee's put option, but the option subsequently lapses unexercised, the asset and any associated liability would then be derecognised.

4.2.2 Deeply out of the money put and call options

A financial asset that is transferred subject only to a transferee's deeply out of the money put option, or a transferor's deeply out of the money call option, is derecognised. This is because the transferor has transferred substantially all the risks and rewards of ownership, *[IFRS 9.B3.2.16(g)]*, (Figure 3-1, Box 6, Yes).

4.2.3 Options that are neither deeply out of the money nor deeply in the money

Where a financial asset is transferred subject to an option (whether a transferor's call option or a transferee's put option) that is neither deeply in the money nor deeply out of the money, the result is that the entity neither transfers nor retains substantially all the risks and rewards associated with the asset, *[IFRS 9.B3.2.16(h), IFRS 9.B3.2.16(i)]*, (Figure 3-1, Box 7, No). It is therefore necessary to determine whether or not the transferor has retained control of the asset under the criteria summarised in section 3.8 above.

If a transferred asset continues to be recognised because of a transferor's call option or transferee's put option, but the option subsequently lapses unexercised, the asset and any associated liability would then be derecognised.

4.2.3.A Assets readily obtainable in the market

If the transferor has a call option over a transferred financial asset that is readily obtainable in the market, IFRS 9 considers that control of the asset has passed to the transferee (Figure 3-1, Box 8, No - see section 3.8 above). *[IFRS 9.B3.2.16(h)]*. This would presumably also be the conclusion where the transferee has a put option over a transferred financial asset that is readily obtainable in the market, although IFRS 9 does not specifically address this.

4.2.3.B Assets not readily obtainable in the market

If the transferor has a call option over a transferred financial asset that is not readily obtainable in the market, IFRS 9 considers that control of the asset remains with the transferor (Figure 3-1, Box 8, Yes - see section 3.8 above). Accordingly, derecognition is precluded to the extent of the amount of the asset that is subject to the call option. *[IFRS 9.B3.2.16(h)]*.

If the transferee has a put option over a transferred financial asset that is not readily obtainable in the market, IFRS 9 requires the transferee's likely economic behaviour to be assessed - in effect to determine whether the option gives the transferee the practical ability to sell the transferred asset (see section 3.8.1 above).

If the put option is sufficiently valuable to prevent the transferee from selling the asset, the transferor is considered to retain control of the asset and continues to account for the asset to the extent of its continuing involvement, *[IFRS 9.B3.2.16(i)]*, (Figure 3-1, Box 9). The accounting treatment required is discussed in section 5.3 below.

If the put option is not sufficiently valuable to prevent the transferee from selling the asset, the transferor is considered to have ceded control of the asset, and will derecognise it, *[IFRS 9.B3.2.16(i)]*, (Figure 3-1, Box 8, No).

The question of whether or not a put option is sufficiently valuable to prevent the transferee from selling the asset is not a matter of objective fact, but rather a function of the transferee's appetite for risk, its need for liquidity and so forth. It is not clear how the transferor can readily assess these factors.

4.2.4 Option to put or call at fair value

A transfer of a financial asset subject only to a put or call option with an exercise price equal to the fair value of the financial asset at the time of repurchase results in derecognition because of the transfer of substantially all the risks and rewards of ownership (Figure 3-1, Box 6, Yes). *[IFRS 9.B3.2.16(j)]*.

4.2.5 Net cash-settled options

Where a transfer of a financial asset is subject to a put or call option that will be settled net in cash, IFRS 9 requires the entity to evaluate the transfer so as to determine whether it has retained or transferred substantially all the risks and rewards of ownership. *[IFRS 9.B3.2.16(k)]*. IFRS 9 comments that "if the entity has not retained substantially all the risks and rewards of ownership of the transferred asset, it determines whether it has retained control of the transferred asset" - a repetition of the basic principles of the standard adding no clarification specific to this type of transaction.

However, net-cash settlement means that it is more likely that control has passed, as the transferee would not need to hold the assets in case the options are exercised.

4.2.6 Removal of accounts provision

A 'removal of accounts provision' is an unconditional repurchase (i.e., call) option that gives an entity the right to reclaim transferred assets subject to some restrictions. Provided that such an option results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership, IFRS 9 allows derecognition, except to the extent of the amount subject to repurchase (assuming that the transferee cannot sell the assets).

For example, if an entity transfers loan receivables with a carrying amount of CU100,000 for proceeds of CU100,000, subject only to the right to call back any individual loan(s) up to a maximum of CU10,000, CU90,000 of the loans would qualify for derecognition. *[IFRS 9.B3.2.16(l)]*.

4.2.7 Clean-up call options

A 'clean-up call' option is an option held by an entity that services transferred assets (and may be the transferor of those assets) to purchase remaining transferred assets when the cost of servicing the assets exceeds the entity's participation in their benefits. If such a clean-up call results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership, and the transferee cannot sell the assets, IFRS 9 precludes derecognition only to the extent of the amount of assets subject to the call option. *[IFRS 9.B3.2.16(m)]*.

4.2.8 Same (or nearly the same) price put and call options

IFRS 9 does not specifically address the transfer of an asset subject to both a transferee's option to put, and a transferor's option to call, the asset at a fixed price rather than at fair value (as discussed in section 4.2.4 above). Assuming that:

- Both options can be exercised simultaneously

  And

- Both the transferor and transferee behave rationally

It will clearly be in the interest of either the transferor or the transferee to exercise its option, so that the asset will be reacquired by the transferor. This indicates that the transferor has retained substantially all the risks and rewards of ownership.

However, if the two options were exercisable on different dates or at different prices, the effects of each option would need to be considered carefully.

4.2.9 Changes in probability of exercise of options after initial transfer of asset

IFRS 9 is not explicit as to the accounting consequences (if any) of an option that was considered at the time of the original transfer to be deeply out of the money subsequently becoming neither deeply in the money nor deeply out of the money, or even deeply in the money, (or any other of the possible permutations). This is explored further in Illustration 4-1 to Illustration 4-3 below.

Illustration 4-1: Financial asset transferred subject only to deeply out of the money call option

On 1 January 20X0 an entity transferred a financial asset to a counterparty, subject only to a call option to repurchase the asset at any time up to 31 December 20X4. At 1 January 20X0 the option was considered deeply out of the money and the asset was accordingly derecognised (see section 4.2.2 above).

At 31 December 20X3 market conditions have changed considerably and the option is now deeply in the money. What is the accounting consequence of this change?

There are no accounting consequences since, as noted in section 3.7 above, IFRS 9.B3.2.6 specifies that an asset previously derecognised because substantially all the risks and rewards associated with the asset have been transferred (as would be the analysis for an asset transferred subject only to a deeply out of the money call - see section 4.2.2 above) is not re-recognised in a future period unless it is reacquired. *[IFRS 9.B3.2.6]*. Instead, the increase in the fair value of the option would be captured in the financial statements as a gain under the normal requirement of IFRS 9 to account for derivatives at fair value with changes in value reflected in profit or loss (see Chapter 44 at section 1.2).

However, if the market changes were not demonstrably beyond any reasonable expectation as at 1 January 20X0 there might be an argument (given the definition of a deeply out of the money option as an option that is 'highly unlikely' to become in the money before expiry - see section 4.2 above) that the fact that the option is now not merely in the money, but deeply in the money, indicates that the original assessment that that option was deeply out of the money was in fact an accounting error requiring correction under IAS 8 (see Chapter 3 at section 4.6).

Illustration 4-2: Financial asset transferred subject only to deeply in the money call option

On 1 January 20X0 an entity transferred a financial asset to a counterparty, subject only to a call option to repurchase the asset at any time up to 31 December 20X4. At 1 January 20X0 the option was considered deeply in the money and the asset was accordingly not derecognised (see section 4.2.1 above).

At 31 December 20X3 market conditions have changed considerably and the option is now deeply out of the money. What is the accounting consequence of this change?

This is the mirror image of the fact pattern in Illustration 4-1. However, whereas IFRS 9 makes it clear that an asset previously derecognised is not re-recognised, there is no comparable provision that an asset that previously did not qualify for derecognition on the origination of a particular transaction may not later be derecognised as a result of a subsequent change in the assessed likely impact of the transaction. Because the standard does not explain the consequences, it is not clear when the asset can be derecognised subsequent to a sale transaction or whether there is any basis for derecognising the asset before the expiry of the option.

Assuming the asset in Illustration 4-2 above is not derecognised, the fall in the value of the option indicates a decline in the fair value of the asset which is likely to be required to be reflected in the financial statements under the normal requirements of IFRS 9. This would in turn appear to require a corresponding adjustment to the liability recognised for the sale proceeds, so as to avoid recognising a net loss in the income statement that has not actually been suffered.

Illustration 4-3: Financial asset transferred subject to call option neither deeply in the money nor deeply out of the money

On 1 January 20X0 an entity transferred a financial asset (an equity share) to a counterparty, subject only to a call option to repurchase the asset at any time up to 31 December 20X4. At 1 January 20X0 the option was considered to be neither deeply in the money nor deeply out of the money. However, the asset was readily marketable and freely transferable by the transferor and was accordingly derecognised because the entity, while neither transferring nor retaining substantially all the risks and rewards of the asset, no longer controls it (see section 4.2.3.A above).

At 31 December 20X3 the financial asset that was the subject of the transfer ceases to be listed and is therefore not readily marketable. Had this been the case at the time of the original transfer, the entity would have been regarded as retaining control of the asset, which would not have been derecognised (see section 4.2.3.B above). What is the accounting consequence of this change?

Again, matters are not entirely clear. The rule in IFRS 9.B3.2.6 that a previously derecognised asset will not be re-recognised (other than on reacquisition of the asset) applies, as drafted, only where derecognition results from a transfer of substantially all the risks and rewards associated with the asset. In this case, derecognition has resulted from a loss of control over, not a transfer of substantially all the risks and rewards associated with, the asset. There is therefore some ambiguity as to whether B3.2.6 is to be read:

- Generally as prohibiting any re-recognition of a derecognised asset

  Or

- Specifically as referring only to circumstances where derecognition results from transfer of substantially all the risks and rewards (i.e., it applies only to 'Box 6, Yes' transactions, and not to 'Box 8, No' transactions)

How we see it

We expect that the original decision to derecognise the asset will not be revisited, unless (in exceptional circumstances) the original assessment was an accounting error within the scope of IAS 8. The fact that the asset was transferred on terms that the transferee could freely dispose of the asset means that the transferor did indeed lose control at the time of the transaction.

4.3 Subordinated retained interests and credit guarantees

Where a financial asset is transferred, an entity may provide the transferee with credit enhancement by subordinating some or all of its interest retained in the transferred asset. Alternatively, an entity may provide the transferee with credit enhancement in the form of a credit guarantee that could be unlimited or limited to a specified amount. *[IFRS 9.B3.2.16(n)]*. Such techniques are commonly used in securitisation transactions (see section 3.3 above).

IFRS 9 notes that, if the entity retains substantially all the risks and rewards of ownership of the transferred asset, the asset continues to be recognised in its entirety. If the entity retains some, but not substantially all, of the risks and rewards of ownership and has retained control, derecognition is precluded to the extent of the amount of cash or other assets that the entity could be required to pay. *[IFRS 9.B3.2.16(n)]*.

4.4 Transfers involving swaps

4.4.1 Total return swaps

An entity may sell a financial asset to a transferee and enter into a total return swap with the transferee, whereby the transferor pays an amount equivalent to fixed or floating rate interest on the consideration for the transfer and receives an amount equivalent to the cash flows from, together with any increases or decreases in the fair value of, the underlying asset. In such a case, derecognition of all of the asset is prohibited, *[IFRS 9.B3.2.16(o)]*, since the transaction has the effect that substantially all the risks and rewards associated with the asset are retained by the transferor (Figure 3-1, Box 7, Yes).

4.4.2 Interest rate swaps

An entity may transfer a fixed rate financial asset and enter into an interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount equal to the principal amount of the transferred financial asset. IFRS 9 states that the interest rate swap does not preclude derecognition of the transferred asset, provided that the payments on the swap are not conditional on payments being made on the transferred asset. *[IFRS 9.B3.2.16(p)]*.

If, however, the transferor were to transfer an asset subject to prepayment risk (e.g., a domestic mortgage), and the transferor and transferee were to enter into an amortising interest rate swap (i.e., one whose notional amount amortises so that it equals the principal amount of the transferred financial asset outstanding at any point in time), the transferor would generally retain substantial prepayment risk through the swap. In this case, the transferor would (depending on the other facts of the transaction, such as the transfer or retention of credit risk) continue to recognise the transferred asset either in its entirety (Figure 3-1, Box 7, Yes) or to the extent of the transferor's continuing involvement (Figure 3-1, Box 9). *[IFRS 9.B3.2.16(q)]*.

Conversely, if the transferor and the transferee were to enter into an amortising interest rate swap, the amortisation of the notional amount of which is not linked to the principal amount outstanding on the transferred asset, the transferor would no longer retain prepayment risk. Therefore such a swap would not preclude derecognition of the transferred asset, provided the payments on the swap were not conditional on interest payments being made on the transferred asset and the swap did not result in the entity retaining any other significant risks and rewards of ownership on the transferred asset. *[IFRS 9.B3.2.16(q)]*.

4.5 Factoring of trade receivables

IFRS 9 does not specifically address one of the more common forms of 'off-balance sheet finance' - the factoring of trade receivables. The common aim of all factoring structures is to provide cash flow from trade receivables quicker than would arise from normal cash collections, which is generally achieved by a 'sale' of all, or certain selected, receivables to a financial institution. However, the conditions of such 'sales' are extremely varied (which may well explain the lack of any generic guidance in the standard), ranging from true outright sales and pass-through arrangements (resulting in full derecognition), to transactions with continuing involvement through guarantee or subordination arrangements. It will therefore be necessary for an entity to consider the terms of its particular debt-factoring arrangement(s) carefully in order to determine the appropriate application of the derecognition provisions of IFRS 9, particularly those discussed in sections 3.5 and 3.7 above.

Depending on circumstances, Illustration 5-1 (see section 5.1 below), Illustration 5-2 (see section 5.1.1 below), Illustration 5-6 (see section 5.4.1 below) and Illustration 5-12 (see section 5.4.4 below) may also be of particular relevance.

5 Accounting treatment

This part of the chapter deals with the accounting consequences of the derecognition criteria for financial assets - in other words how the principles discussed above translate into accounting entries.

In order to provide a link with Figure 3-1 in section 3.2 above we have used the following convention:

'Box 6, Yes' The transaction would result in the answer 'Yes' at Box 6 in Figure 3-1.

'Box 7, No' The transaction would result in the answer 'No' at Box 7 in Figure 3-1.

5.1 Transfers that qualify for derecognition

It is important to remember throughout this section that references to an asset being derecognised in its entirety include situations where a part of an asset to which the derecognition criteria are applied separately is derecognised in its entirety (see section 3.4 above). In this context, IFRS 9 uses the phrase 'in its entirety' in contrast to the accounting treatment applied to assets where there is continuing involvement (see section 5.3 below) where some, but not all, of a financial asset, or part of an asset, is derecognised.

If, as a result of a transfer, a financial asset is derecognised in its entirety but the transfer results in the transferor obtaining a new financial asset or servicing asset or assuming a new financial liability, or a servicing liability (see section 5.1.2 below), IFRS 9 requires the entity to recognise the new financial asset, servicing asset, financial liability or servicing liability at fair value. *[IFRS 9.3.2.11]*.

On derecognition of a financial asset in its entirety, IFRS 9 requires the difference between:

(a) The carrying amount of the asset

And

(b) The consideration received (including any new asset obtained less any new liability assumed)

To be recognised in profit or loss. *[IFRS 9.3.2.12]*. In addition, any cumulative gain or loss in respect of that asset which was previously recognised in other comprehensive income shall be reclassified from equity to profit or loss if the asset is a debt instrument accounted for at fair value through other comprehensive income under IFRS 9. *[IFRS 9.5.7.10]*.

Illustration 5-1 illustrates these requirements.

Illustration 5-1: Derecognition of whole of financial asset in its entirety

At 1 October 20X2 an entity has a debt instrument classified at fair value through other comprehensive income, carried at CU1,400, in respect of which a cumulative gain of CU200 has been recognised in equity. At that date, the asset is unconditionally sold to a third party in exchange for cash of CU2,500 and a loan note issued to the third party. The loan note bears a fixed rate interest below current market rates and is repayable at CU1,150 but is considered to have a fair value of CU1,100. The following accounting entries are made by the entity to record the disposal:

			CU	CU
Dr	Cash		2,500	
Dr	Equity ('recycling' of cumulative gain on asset)		200	
	Cr	Gain on disposal		200
	Cr	Asset		1,400
	Cr	Loan note		1,100

Thereafter the loan note will be accreted up to its repayable amount of CU1,150 over its expected life using the effective interest method (see Chapter 46 at section 3).

If the asset had been accounted for using the amortised cost method and had a carrying amount of (say) CU1,200 at the date of the transfer, the accounting entry would have been:

			CU	CU
Dr	Cash		2,500	
	Cr	Profit on disposal		200
	Cr	Asset		1,200
	Cr	Loan note		1,100

For simplicity, the calculations above ignore the release of the expected credit loss provision.

5.1.1 Transferred asset part of a larger asset

If the transferred asset is part of a larger financial asset, for example when an entity transfers interest cash flows that are part of a debt instrument (see section 3.4 above), and the part transferred qualifies for derecognition in its entirety, IFRS 9 requires the previous carrying amount of the larger financial asset to be allocated between the part that continues to be recognised and the part that is derecognised. The allocation is based on the relative fair values of those parts on the date of the transfer. For this purpose, the retained servicing asset (see section 5.1.2 below) is to be treated as a part that continues to be recognised.

IFRS 9 requires the difference between:

(a) The carrying amount allocated to the part derecognised

And

(b) The sum of:

(i) The consideration received for the part derecognised (including any new asset obtained less any new liability assumed)

And

(ii) Any cumulative gain or loss allocated to it previously recognised directly in equity

To be recognised in profit or loss. Any cumulative gain or loss that had been recognised in equity is allocated between the part that continues to be recognised and the part that is derecognised, based on the relative fair values of those parts. *[IFRS 9.3.2.13]*.

The requirement in (b)(ii) above for 'recycling' of any cumulative gain or loss previously recognised directly in equity applies to debt instruments accounted for at fair value through other comprehensive income under IFRS 9.

IFRS 9 notes that the accounting treatment prescribed for the derecognition of a part (or parts) of a financial asset requires an entity to determine the fair value of the part(s) that continue to be recognised. Where the entity has a history of selling parts similar to the part that continues to be recognised, or other market transactions exist for such parts, IFRS 9 requires recent prices of actual transactions to be used to provide the best estimate of its fair value. When there are no price quotations or recent market transactions to support the fair value of the part that continues to be recognised, the best estimate of the fair value is the difference between:

- The fair value of the larger financial asset as a whole

  And

- The consideration received from the transferee for the part that is derecognised *[IFRS 9.3.2.14]*

When measuring the fair values of the part that continues to be recognised and the part that is derecognised, in addition to the guidance above, an entity applies the fair value measurement requirements in IFRS 13 (see Chapter 15). *[IFRS 9.B3.2.11]*.

Illustration 5-2 illustrates the requirements for full derecognition of a part of an asset.

Illustration 5-2: Derecognition of part of financial asset in its entirety

On 1 January 20X0 an entity invested CU1 million in a loan with a par value of CU1 million. The loan pays interest of CU75,000 on 31 December annually in arrears and is to be redeemed at par on 31 December 20X8. The entity accounts for the loan at amortised cost.

On 1 January 20X4 it unconditionally sells the right to receive the remaining five interest payments to a bank. The derecognition provisions of IFRS 9 are applied to the interest payments as an identifiable part of the asset (see section 3.4 above), leading to the conclusion that they are required to be derecognised.

The consideration received for, and the fair value of, the future interest payments (based on the net present value, as at 1 January 20X4, of the payments at the current market interest rate that would be available to the borrower of 5%) is CU324,711 (CU75,000 ÷ 1.05 + CU75,000 ÷ 1.05^2 … + CU75,000 ÷ 1.05^5). By the same methodology the fair value of the principal repayment can be calculated as CU783,526 (CU1,000,000 ÷ 1.05^5), giving a total fair value for the loan of CU1,108,237.

In order to calculate the gain or loss on disposal, the total carrying value of the loan of CU1,000,000 is allocated between the part disposed of and the part retained, based on the fair values of those parts. This allocates CU292,998 (CU1,000,000 × CU324,711 ÷ CU1,108,237) to the interest payments disposed of and CU707,002 (CU1,000,000 × CU783,526 ÷ CU1,108,237) to the retained right to the repayment of principal.

This generates the accounting entry:

			CU	CU
Dr	Cash		324,711	
	Cr	Loan (portion of carrying amount allocated to interest payments)		292,998
	Cr	Gain on disposal		31,713

If the loan had instead been a bond accounted for at fair value through other comprehensive income, it would already have been carried at CU1,108,237, so that the basic disposal journal would simply be:

			CU	CU
Dr	Cash		324,711	
	Cr	Bond (portion of carrying amount allocated to interest payments)		324,711

However, as the bond was accounted for at fair value through other comprehensive income, it would also be necessary to recycle that portion of the cumulative revaluation gain of CU108,237 that relates to the interest 'component' of the total carrying value from equity to the income statement. IFRS 9 requires a *pro rata* allocation of the cumulative gain or loss in equity based on the total fair value of the interest and principal - this would deem CU31,713 (CU108,237 × CU324,711 ÷ CU1,108,237) of the cumulative revaluation gain to relate to interest. This would give rise to the further journal, resulting in the same gain on disposal as above:

			CU	CU
Dr	Equity		31,713	
	Cr	Gain on disposal (income statement)		31,713

For simplicity, the calculations above ignore the impact of the expected credit losses on the cumulative revaluation gain.

5.1.2 Servicing assets and liabilities

It is common for an entity to transfer a financial asset (or part of a financial asset) in its entirety, but to retain the right or obligation to service the asset, i.e., to collect payments as they fall due and undertake other administrative tasks, in return for a fee.

When an entity transfers a financial asset in a transfer that qualifies for derecognition in its entirety and retains the right to service the financial asset for a fee, IFRS 9 requires the entity to recognise either a servicing asset or a servicing liability for that servicing contract, as follows:

- If the fee to be received is not expected to compensate the entity adequately for performing the servicing, the entity shall recognise a servicing liability for the servicing obligation at its fair value.
- If the fee to be received is expected to be more than adequate compensation for the servicing, the entity shall recognise a servicing asset for the servicing right. This shall be recognised at an amount determined on the basis of an allocation of the carrying amount of the larger financial asset (as described in section 5.1.1 above). *[IFRS 9.3.2.10]*.

It is not immediately clear what is meant by this requirement. The application guidance expands on the point, as follows.

An entity may retain the right to a part of the interest payments on transferred assets as compensation for servicing those assets. The part of the interest payments that the entity would give up upon termination or transfer of the servicing contract is allocated to the servicing asset or servicing liability. The part of the interest payments that the entity would not give up is an interest-only strip receivable.

For example, if the entity would not give up any interest upon termination or transfer of the servicing contract, the entire interest spread is an interest-only strip receivable. Presumably, as the entity will still have a liability to service the portfolio, it will have to account for this if it allocates none of the interest spread as compensation for the servicing. For the purposes of applying the requirements for disposals of part of an asset discussed in section 5.1.1 above, the fair values of the servicing and interest-only strip receivable are used to allocate the carrying amount of the receivable between the part of the asset that is derecognised and the part that continues to be recognised. If there is no servicing fee specified, or the fee to be received is not expected to compensate the entity adequately for performing the servicing, a liability for the servicing obligation is recognised at fair value. *[IFRS 9.B3.2.10]*.

Unfortunately, IFRS 9 does not provide examples of what exactly is meant here, but we believe that something along the lines of Illustration 5-3 below was intended.

Illustration 5-3: Servicing assets and liabilities

An entity has a portfolio of originated domestic mortgages which are accounted for at amortised cost and have a carrying amount of CU10 million. The mortgages bear interest at a fixed rate of 7.5%. The average life of the mortgages in the portfolio (taking account of prepayment risk) is 12 years and the fair value of the serviced portfolio is CU11 million, representing CU4.5 million in respect of future interest payments and CU6.5 million in respect of the principal amounts. The entity assesses the amount that would compensate it for servicing the assets to be CU0.5 million.

The entity sells the entire portfolio to a bank (on terms such that it qualifies for derecognition under IFRS 9) but continues to service the portfolio. If the entity does not retain any part of the interest payments, the selling price would be the fair value of the assets of CU11 million (or very close to it). It would then assume a servicing liability of CU0.5 million, giving rise to the accounting entry:

			CU m	CU m
Dr	Cash		11.0	
	Cr	Mortgage portfolio		10.0
	Cr	Servicing liability		0.50
	Cr	Profit on disposal		0.50

Alternatively, it retains interest payments of 1% and the right to service the portfolio. The entity would not give up any interest upon termination or transfer of the servicing contract. The entity estimates that the fair value of the right to receive interest payments of 1% is CU0.6 million. In this case, the bank would be expected to pay fair value of CU10.4 million (or very close to it).

The standard states - see above - that, if (as is the case here) the entity would not give up any interest on termination or transfer of the contract, then the whole of the interest spread is an interest-only strip receivable. In order to calculate the amount of the portfolio to be derecognised, the carrying value of CU10 million is pro-rated (as in Illustration 5-2 in section 5.1.1 above) as to CU9.45 million disposed of (CU10m × 10.4 ÷ 11) and the part retained of CU0.55 million (CU10m × 0.6 ÷ 11). However, as it has allocated the full amount of the interest spread to an interest-only strip receivable, it would need to recognise a servicing liability of CU0.5 million in respect of its obligations under the contract. This gives rise to the following accounting entry:

			CU m	CU m
Dr	Cash		10.40	
Dr	Interest-only strip receivable		0.55	
	Cr	Mortgage portfolio (CU9.45 million disposed of plus CU0.55 million reclassified as interest-only strip receivable)		10.00
	Cr	Servicing liability		0.50
	Cr	Profit on disposal		0.45

If the entity were to retain only a portion of the interest spread on termination or transfer of the servicing contract equivalent to CU0.1 million out of the total retained interest spread of CU0.55 million, then IFRS 9 requires - see above:

- The part of the interest payments that the entity would not give up, i.e., the part which is not contingent on fulfilment of the servicing obligation (CU0.1 million) to be treated as an interest-only strip receivable.

  And

- The part of the interest payments that the entity would give up (i.e., CU0.45 million calculated as CU0.55 million of total retained interest spread less CU0.1 million in previous bullet) upon termination or transfer of the servicing contract to be allocated to the servicing asset or servicing liability.

This suggests that the following accounting entry would be made:

			CU m	CU m
Dr	Cash		10.40	
Dr	Interest-only strip receivable		0.10	
	Cr	Mortgage portfolio (CU9.45 million disposed of plus CU0.1m reclassified as interest-only strip receivable and CU0.45 million allocated to servicing liability)		10.00
	Cr	Servicing liability (CU0.50 million gross fair value less interest payments that would be lost on termination or transfer - CU0.45 million)		0.05
	Cr	Profit on disposal		0.45

A servicing asset is a non-financial asset representing a right to receive a higher than normal amount for performing future services. Accordingly, it would normally be accounted for in accordance with IAS 38 *Intangible Assets*. Similarly, a servicing liability represents consideration received in advance for services to be performed in the future and would normally be accounted for as deferred revenue in accordance with IFRS 15.

5.2 Transfers that do not qualify for derecognition through retention of risks and rewards

If a transfer does not result in derecognition because the entity has retained substantially all the risks and rewards of ownership of the transferred asset (see section 3.7 above), IFRS 9 requires the entity to continue to recognise the transferred asset in its entirety and recognise a financial liability for any consideration received. In subsequent periods, the entity recognises any income on the transferred asset and any expense incurred on the financial liability. *[IFRS 9.3.2.15]*. This treatment is illustrated by Illustration 5-4 and Illustration 5-5 below.

It should be noted that these provisions apply only where derecognition does not occur as a result of retention by the transferor of substantially all the risks and rewards of ownership of the transferred asset (Figure 3-1, Box 7, Yes). They do not apply where derecognition does not occur as a result of continuing involvement in an asset of which substantially all the risks and rewards of ownership are neither retained nor transferred (Figure 3-1, Box 8, Yes). Such transactions are dealt with by the separate provisions discussed in sections 5.3 and 5.4 below.

Illustration 5-4: Asset not qualifying for derecognition (risks and rewards retained)

An entity holds a loan of CU1,000 made on 1 January 20X0, paying interest of CU65 annually in arrears and redeemable at par on 31 December 20X4, which it accounts for at amortised cost (see Chapter 46 at section 3).

On 1 January 20X4 it enters into a transaction whereby the loan is sold to a bank for its then fair value of CU985, but with full recourse to the entity for any default on the loan. The guarantee provided by the entity has the effect that it retains substantially all the risks and rewards of the loan, which is therefore not derecognised (Figure 3-1, Box 7, Yes - see section 3.7.2 above). *[IFRS 9.B3.2.12]*.

The entity therefore continues to recognise the loan, and interest on it, as if it still held the loan. It accounts for the CU985 proceeds as a liability which must be accreted up using the effective interest method (see Chapter 46 at section 3) so that it will be equal to the carrying amount of the asset on the date on which it is expected that the asset will be derecognised.

In this case, the asset will be derecognised at maturity on 31 December 20X4 when a payment of CU1,065 (the final instalment of interest of CU65 and return of principal of CU1,000) is due. Accordingly, the liability must be accreted from CU985 to CU1,065 during the year ended 31 December 20X4.

The following accounting entries are made by the entity:

1 January 20X4

			CU	CU
Dr	Cash		985	
	Cr	Liability		985

Consideration received from bank

1 January-31 December 20X4

			CU	CU
Dr	Loan (CU1,065 at 31.12.20X4 - CU1,000 at 1.1.20X4)		65	
Dr	Interest on liability (income statement)		80	
	Cr	Interest on loan (income statement)		65
	Cr	Liability (CU1,065 at 31.12.20X4 - CU985 at 1.1.20X4)		80

Accretion of interest income on the loan and interest expense on the liability

31 December 20X4

			CU	CU
Dr	Liability		1,065	
	Cr	Loan receivable		1,065

'Redemption' of loan and 'discharge' of liability

This accounting treatment recognises an overall loss of CU15 in 20X4, which would be expected, as representing the difference between the carrying value of the asset at the date of transfer (CU1,000) and the consideration received (CU985). However, IFRS 9 requires the various elements of the transaction to be shown separately - it would not have been acceptable for the income statement simply to show a net loss of CU15.

If the transferred asset had been accounted for at fair value through profit or loss, it would already have been carried at CU985 at the date of transfer - i.e., the loss of CU15 would already have been reflected in the financial statements. The accounting entries at 1 January and 31 December 20X4 would be the same as above. However, the following accounting entries would then have been made during the year ended 31 December 20X4:

1 January-31 December 20X4

			CU	CU
Dr	Interest on liability (income statement)		80	
Dr	Loan (CU1,065 at 31.12. 20X4 - CU985 at 1.1.20X4)		80	
	Cr	Liability (CU1,065 at 31.12. 20X4 - CU985 at 1.1.20X4)		80
	Cr	Interest on loan (income statement)*		65
	Cr	Change in fair value of loan (income statement)*		15

Recognition of interest on, and change in fair value of, loan and accretion of interest on liability

* There is no IAS 1 *Presentation of Financial Statements* requirement to show the interest accrual and fair value gains and losses for this instrument separately.

Whilst the total amounts recorded in the income statement net to nil, they are arrived at by different methodologies - the CU80 increase in the carrying value of the loan receivable is recognised as the fair value changes whereas the CU80 interest on the liability is accrued at a constant effective interest rate. This means that, if the entity were to prepare financial statements at an interim date, it might well show a net gain or loss on the transaction at that date, notwithstanding that ultimately no gain or loss will be reflected.

Illustration 5-5: Asset not qualifying for derecognition ('repo' transaction)

An entity holds a government bond of CU2,000 issued on 1 January 20X0, paying interest of CU50 semi-annually in arrears and redeemable at par on 31 December 20X5, which it accounts for as a financial asset subsequently measured at amortised cost.

A Gross-settled transaction

On 1 January 20X4 the entity enters into a transaction whereby the bond is sold to a bank for its then fair value of CU1,800, and the entity agrees to repurchase it on 1 January 20X5 for CU1,844. As the legal owner of the loan at 30 June 20X4 and 31 December 20X4, the bank will receive the CU100 interest payable on the bond for the calendar year 20X4. This CU100, together with the CU44 difference between the sale and repurchase price gives the bank CU144, representing a lender's return of 8% on the CU1,800 sale proceeds. Accordingly, the effect of the transaction is that the entity has retained substantially all the risks and rewards of ownership of the bond (Figure 3-1, Box 7, Yes - see section 4.1 above).

The entity therefore continues to recognise the bond, and interest on it, as if it still held the bond. It accounts for the CU1,800 proceeds as a liability which must be accreted up to CU1,944 (the repurchase price due on 31 December 20X4 plus the interest on bonds collected by the bank) over the period to 31 December 20X4 using the effective interest method (see Chapter 46 at section 3). The following accounting entries are made by the entity:

1 January 20X4

			CU	CU
Dr	Cash		1,800	
	Cr	Liability		1,800

Consideration received from bank

1 January-31 December 20X4

			CU	CU
Dr	Interest on liability (income statement)		144	
Dr	Bond (CU2,100 at 31.12.20X4 - CU2,000 at 1.1.20X4)		100	
	Cr	Liability (CU1,944 at 31.12.20X4 - CU1,800 at 1.1.20X4)		144
	Cr	Interest on bond (income statement)		100

Accretion of income on bond and finance cost of liability

1 January-31 December 20X4

			CU	CU
Dr	Liability		100	
	Cr	Bond		100

Notional receipt of interest on bond at 30 June and 31 December and notional transfer thereof to bank

1 January 20X5

			CU	CU
Dr	Liability		1,844	
	Cr	Cash		1,844

Execution of repurchase contract

The above is arguably the strict translation into accounting entries of the accounting analysis under IFRS 9 for a situation where the entity still retains ownership of the bond throughout 20X4. As a matter of practicality, however, the same overall result could have been obtained by the following 'short-cut' approach, which avoids recording the notional receipt and transfer to the bank of bond interest received on 30 June and 31 December:

1 January 20X4

			CU	CU
Dr	Cash		1,800	
	Cr	Liability		1,800

Consideration received from bank

1 January-31 December 20X4

			CU	CU
Dr	Interest on liability (income statement)		144	
	Cr	Interest on bond (income statement)		100
	Cr	Liability (statement of financial position)		44

Accretion of income on bond and finance cost of liability

1 January 20X5

			CU	CU
Dr	Liability		1,844	
	Cr	Cash		1,844

Execution of repurchase contract

If (as would be likely, given the nature of the transferred asset) the bank has the right to sell or pledge the bond during the period of its legal ownership, it would be necessary to reclassify the bond as a repurchase receivable during the period of the bank's ownership (see section 4.1.1.A above). In other words, the following additional accounting entries would be required.

1 January 20X4

			CU	CU
Dr	Repurchase receivable		2,000	
	Cr	Bond		2,000

1 January 20X5

			CU	CU
Dr	Bond		2,000	
	Cr	Repurchase receivable		2,000

B Net-settled transaction

The entity might enter into the transaction above, but on terms that the repurchase contract was to be net-settled. In other words, on 1 January 20X5, a payment would be made to or by the bank for the difference between CU1,844 (the notional repurchase price) and the fair value of the bond at that date. Assuming that the fair value of the bond at 1 January 20X5 is CU1,860, the bank would be required to pay the entity CU16 (CU1,860 - CU1,844).

In this case, matters are further complicated by the fact that the economic effect of the net-settled forward is the same as if the entity sold the bond on 1 January 20X5. The following accounting entries would be made:

1 January 20X4

			CU	CU
Dr	Cash		1,800	
	Cr	Liability		1,800

Consideration received from bank

1 January-31 December 20X4

			CU	CU
Dr	Interest on liability (income statement)		144	
	Cr	Interest on bond (income statement)		100
	Cr	Liability (statement of financial position)		44

Accretion of income on bond and finance cost of liability

1 January 20X5

		CU	CU
Dr	Cash	16	
Dr	Liability	1,844	
Dr	Loss on derecognition of bond	140	
	Cr Bond		2,000

Net settlement of repurchase contract and recognition of loss on derecognition of the bond

The loss on derecognition at 1 January 20X5 of CU140 arises because the net-settled contract is equivalent to the entity disposing of the bond for its then fair value of CU1,860, which is CU140 lower than its amortised cost of CU2,000.

This illustrates the point that, where the terms of net-settled forward contract over a transferred asset are such that the original asset cannot be derecognised, the result will be that the entity's statement of financial position shows a gross position - i.e., the original asset and a liability for the consideration for the transfer until the forward contract actually settles. This may seem a strange accounting reflection of a contract that is required to be settled net. However, the IASB was to some extent forced into this approach as an anti-avoidance measure. It is clear from the analysis in sections 4.1.1 to 4.1.4 above that an asset sold subject to the obligation to repurchase the same or similar asset at a fixed price shall not be derecognised. If the accounting treatment were to vary merely because the contract was net-settled, it would be possible to avoid the requirements of IFRS 9 for continued recognition of assets subject to certain forward repurchase agreements simply by altering the terms of the agreement to allow net settlement.

5.3 Transfers with continuing involvement - summary

If an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset, but retains control of the transferred asset (see section 3.8 above), IFRS 9 requires the entity to continue to recognise the transferred asset to the extent of its 'continuing involvement' - i.e., the extent to which it is exposed to changes in the value of the transferred asset. *[IFRS 9.3.2.16]*. Such transactions fall within Box 9 of Figure 3-1 in section 3.2 above.

The concept of 'continuing involvement' was first introduced in the exposure draft of proposed amendments to IAS 32 and IAS 39 published in June 2002. The IASB's intention at that time was to move towards an accounting model for derecognition based entirely on continuing involvement. However, this approach (or at least the methodology for implementing it proposed in the exposure draft) received little support in the exposure period and the IASB decided to abandon it and revert largely to an accounting model for derecognition based on the transfer of risks and rewards. *[IFRS 9.BCZ3.4]*. Nevertheless, the continuing involvement approach remains relevant for certain transactions - mainly transfers of assets which result in the sharing, rather than the substantial transfer, of the risks and rewards.

The accounting requirements in respect of assets in which the entity has continuing involvement are particularly complex, and are summarised in sections 5.3.1 to 5.3.5 below, with worked examples in section 5.4 below. In particular, and in contrast to the treatment for transactions that do not qualify for derecognition through retention of substantially all risks and rewards (see section 5.2 above), the associated liability is often calculated as a balancing figure that will not necessarily represent the proceeds received as the result of the transfer (see section 5.3.3 below).

We have a general concern regarding the required accounting treatment for a continuing involvement, namely that IFRS 9 provides examples of how to deal with certain specific transactions rather than clear underlying principles. It can be difficult to determine the appropriate treatment for a continuing involvement that does not correspond fairly exactly to one of the examples in IFRS 9.

5.3.1 Guarantees

When the entity's continuing involvement takes the form of guaranteeing the transferred asset, the extent of the entity's continuing involvement is the lower of:

- The carrying amount of the asset

  And

- The maximum amount of the consideration received that the entity could be required to repay ('the guarantee amount') *[IFRS 9.3.2.16(a)]*

An example of this treatment is given in section 5.4.1 below.

It follows that if the transferor guarantees the entire amount of the transferred asset, no derecognition would be achieved, even though it may have passed other significant risks to the transferee.

5.3.2 Options

When the entity's continuing involvement takes the form of a written and/or purchased option (including a cash-settled option or similar provision) on the transferred asset, the extent of the entity's continuing involvement is the amount of the transferred asset that the entity may repurchase. However, in case of a written put option (including a cash-settled option or similar provision) on an asset measured at fair value, the extent of the entity's continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price. *[IFRS 9.3.2.16(b), IFRS 9.3.2.16(c)]*.

Examples of this treatment are given in sections 5.4.2 and 5.4.3 below.

5.3.3 Associated liability

When an entity continues to recognise an asset to the extent of its continuing involvement, IFRS 9 requires the entity to recognise an associated liability. *[IFRS 9.3.2.17]*. IFRS 9 provides that "despite the other measurement requirements in this Standard", the transferred asset and the associated liability are to be measured on a basis that reflects the rights and obligations that the entity has retained. The associated liability is measured in such a way that the net carrying amount of the transferred asset and the associated liability is equal to:

- If the transferred asset is measured at amortised cost, the amortised cost of the rights and obligations retained by the entity

  Or

- If the transferred asset is measured at fair value, the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis *[IFRS 9.3.2.17]*

This has the effect that the 'liability' is often calculated as a balancing figure that will not necessarily represent the proceeds received as the result of the transfer (see Illustration 5-6 to Illustration 5-10 in section 5.4 below). This does not fit very comfortably with the normal rules in IFRS 9 for the initial measurement of financial liabilities (see Chapter 45 at section 3) - hence the comment that this treatment applies "despite the other measurement requirements in this Standard". Further, the liability cannot be offset against the asset - see section 5.5.1 below.

5.3.4 Subsequent measurement of assets and liabilities

IFRS 9 requires an entity to continue to recognise any income arising on the transferred asset to the extent of its continuing involvement and to recognise any expense incurred on the associated liability. *[IFRS 9.3.2.18]*. This is comparable to the requirements in respect of assets not derecognised through retention of substantially all risks and rewards (see section 5.2 above).

When the transferred asset and associated liability are subsequently measured at fair value through profit and loss, IFRS 9 requires recognised changes in the fair value of the transferred asset and the associated liability to be accounted for consistently with each other in accordance with the general provisions of IFRS 9 for measuring gains and losses (see Chapter 46 at section 2) and not offset. *[IFRS 9.3.2.19]*. Moreover, if the transferred asset is measured at amortised cost, the option in IFRS 9 to designate a financial liability as at fair value through profit or loss (see Chapter 44 at section 6) is not applicable to the associated liability. *[IFRS 9.3.2.21]*.

5.3.5 Continuing involvement in part only of a larger asset

An entity may have continuing involvement in a part only of a financial asset, for example where the entity retains an option to repurchase part of a transferred asset, or retains a residual interest in part of an asset, such that the entity does not retain substantially all the risks and rewards of ownership, but does retain control.

In such a case, IFRS 9 requires the entity to allocate the previous carrying amount of the financial asset between the part that it continues to recognise under continuing involvement, and the part that it no longer recognises on the basis of the relative fair values of those parts on the date of the transfer. The allocation is to be made on the same basis as applies on derecognition of part only of a larger financial asset - see sections 5.1.1 and 5.1.2 above.

The difference between:

(a) The carrying amount allocated to the part that is no longer recognised

And

(b) The sum of:

(i) The consideration received for the part no longer recognised

And

(ii) Any cumulative gain or loss allocated to it that had been recognised directly in equity

Is recognised in profit or loss. A cumulative gain or loss that had been recognised in equity is allocated between the part that continues to be recognised and the part that is no longer recognised on the basis of the relative fair values of those parts. *[IFRS 9.3.2.13]*.

The 'recycling' of any cumulative gain or loss previously recognised directly in equity in (b)(ii) above would apply to debt instruments accounted for at fair value through other comprehensive income under IFRS 9. This was previously an explicit requirement of IAS 39, but has not been carried over to IFRS 9, something we suspect is nothing but an oversight.

This topic is discussed further in section 5.4.4 below.

5.4 Transfers with continuing involvement - accounting examples

The application guidance to IFRS 9 provides a number of clarifications and examples that demonstrate the application of the requirements provisions, as summarised in section 5.3 above, the substance of which is reproduced below.

5.4.1 Transfers of assets measured at amortised cost with guarantees

If a guarantee provided by an entity to pay for default losses on a transferred asset prevents the transferred asset from being derecognised to the extent of the continuing involvement, IFRS 9 requires:

(a) The transferred asset at the date of the transfer to be measured at the lower of:

(i) The carrying amount of the asset

And

(ii) The maximum amount of the consideration received in the transfer that the entity could be required to repay ('the guarantee amount')

And

(b) The associated liability to be initially measured at the guarantee amount plus the fair value of the guarantee (which is normally the consideration received for the guarantee)

Subsequently, the initial fair value of the guarantee is recognised in profit or loss on a time proportion basis in accordance with IFRS 15 and the carrying value of the asset is reduced by any impairment losses. *[IFRS 9.B3.2.13(a)]*.

This is illustrated in Illustration 5-6 below and in Illustration 5-7 below. These Illustrations do not set out the accounting for the continuing involvement in the transferred asset after the transfer, for example the recognition of expected credit losses.

Illustration 5-6: Continuing involvement through guarantee

An entity has a loan portfolio carried at CU10 million with a fair value of CU10.5 million. It sells the rights to 100% of the cash flows to a third party for a payment of CU10.55 million, which includes a payment of CU50,000 in return for the entity agreeing to absorb the first CU1 million of default losses on the portfolio. The loans are fixed rate loans with significant prepayment risk.

The guarantee has the effect that the entity has transferred substantially all the rewards, but not substantially all the risks, of the portfolio (Figure 3-1, Box 6, No). The prepayment risk and interest rate risk have been transferred to the transferee, so that the entity does not retain all significant risks of the loans (Figure 3-1, Box 7, No). The portfolio is not a readily marketable asset, so that the entity retains control of the asset (Figure 3-1, Box 8, Yes - see also section 3.8 above), and the continuing involvement provisions of IFRS 9 apply (Figure 3-1, Box 9).

The entity turns to the requirements above. The continuing involvement in the transferred asset must be measured at the lower of:

(i) The carrying amount of the asset transferred - i.e., CU10 million

And

(ii) The maximum amount of the consideration received in the transfer that the entity could be required to repay - i.e., CU1 million (the amount guaranteed)

Therefore, the entity will set up an asset that represents its continuing involvement in the transferred asset of CU1 million.

The entity then considers the carrying amount of the liability. This is required to be measured at the guarantee amount (i.e., CU1 million) plus the fair value of the guarantee (i.e., the CU50,000 guarantee payment), a total of CU1.05 million. Therefore, the entity's continuing involvement in the transaction will be reflected as follows:

			CU m	CU m
Dr	Cash		10.55	
Dr	Continuing involvement in the transferred asset		1.00	
	Cr	Loan portfolio transferred		10.00
	Cr	Continuing involvement liability		1.05
	Cr	Profit on disposal*		0.50

* *Cash received (CU10.55 million) less guarantee payment (CU50,000) = consideration for portfolio (CU10.5 million) less carrying amount of portfolio (CU10 million).*

Over the remaining life of the transaction, the CU50,000 of the liability that represents the consideration received for the guarantee is amortised to the income statement on a time proportion basis. This has the effect that the income earned by the entity for entering into the guarantee arrangement is reported as revenue on a time proportion basis *[IFRS 9.4.2.1(c)(ii)]*.

Amortisation of the premium over the remaining life of the transaction

			CU	CU
Dr	Continuing involvement liability		0.05	
	Cr	Profit or loss		0.05

If in a subsequent period credit losses of CU0.2 million are suffered, requiring a payment under the guarantee, IFRS 9 requires the following accounting entries to be made:

			CU m	CU m
Dr	Profit or loss (loss under guarantee)		0.20	
Dr	Continuing involvement liability		0.20	
	Cr	Cash (paid to transferee)		0.20
	Cr	Continuing involvement in the transferred asset		0.20

At maturity of the guarantee, assuming no further losses, the following entry will be recorded:

			CU m	CU m
Dr	Continuing involvement liability (CU1 - CU0.2)		0.80	
	Cr	Continuing involvement in the transferred asset		0.80

Illustration 5-7: Continuing involvement through guarantee covering 'slow payment risk'

An entity enters into a securitisation in which it transfers trade receivables (with a notional value of CU100 and an amortised cost of CU98 after recognising an expected credit loss allowance of CU2) to an SPE for consideration of CU97. The entity also retains the slow payment risk (the risk that the receivables pay later than the due date) to a limited extent through a 'funding charge' determined as an interest charge of 8% applied to the balance of any receivables that remain outstanding beyond their due date for a maximum of 60 days. Beyond 60 days, all slow payment risk (plus default risk) resides with the SPE.

The entity does not control the SPE, and therefore does not consolidate the SPE. It is determined that the transfer is a qualifying transfer and the entity neither retains nor transfers substantially all of the risks and rewards of ownership of the trade receivables, due to the retention of significant slow payment risk, but has retained control over the assets since the slow payment guarantee would preclude sales of the trade receivables by the transferee. Therefore, in accordance with IFRS 9.3.2.16(a), the entity continues to recognise the trade receivables to the extent of its continuing involvement.

Below we illustrate an example of how an entity could account for this scenario.

The entity derecognises the CU98 of trade receivables and, instead, recognises an asset representing the extent of the continuing involvement in the receivables which would be measured as CU100 x 8% x (60 ÷ 365) = CU1.32.

The entity must also recognise a liability, calculated so that the net of the asset of CU1.32 and the liability is equal to the fair value of the obligation retained, i.e., the slow payment risk. Hence, if the fair value of the retained obligation is CU0.5, the entity recognises an asset of CU1.32 and a liability of CU1.82.

The entity therefore recognises a loss on the transfer of the receivables of CU1.50 as follows:

			CU	CU
Dr	Cash		97.00	
Dr	Continuing involvement in the transferred asset		1.32	
Dr	Loss on disposal		1.50	
	Cr	Trade receivables (CU100 - CU2)		98.00
	Cr	Continuing involvement liability		1.82

The entity records the following entries subsequent to the transfer:

Amortisation of the premium over the sixty days guaranteed period

			CU	CU
Dr	Continuing involvement liability		0.50	
	Cr	Profit or loss		0.50

The following entry is made at maturity of the guarantee if there are no claims made during the guaranteed period

			CU	CU
Dr	Continuing involvement liability		1.32	
	Cr	Continuing involvement in the transferred asset		1.32

The following entry is made if there are claims of CU0.2 made during the guaranteed period and subsequently paid

			CU	CU
Dr	Profit or loss		0.20	
Dr	Continuing involvement liability		0.20	
	Cr	Cash		0.20
	Cr	Continuing involvement in the transferred asset		0.20

At maturity of the guarantee, assuming no further losses, the following entry would be recorded

			CU m	CU m
Dr	Continuing involvement liability (CU1.32 - CU0.2)		1.12	
	Cr	Continuing involvement in the transferred asset		1.12

5.4.2 Transfers of assets measured at amortised cost with an option

If a put or call option prevents derecognition (see sections 3.7.3 and 4.2 above) of a transferred asset measured at amortised cost, IFRS 9 requires the associated liability to be measured at cost (i.e., the consideration received) and subsequently adjusted for the amortisation of any difference between that cost and the amortised cost of the transferred asset at the expiration date of the option, as illustrated by Illustration 5-8 below. *[IFRS 9.B3.2.13(b)]*.

Illustration 5-8: Asset measured at amortised cost

An entity has a financial asset, accounted for at amortised cost, carried at CU98. It transfers the asset to a third party in return for consideration of CU95. The asset is subject to a call option whereby the entity can compel the transferee to sell the asset back to the entity for CU102. The amortised cost of the asset on the option exercise date will be CU100. The option is considered to be neither deeply in the money nor deeply out of the money. IFRS 9 therefore requires the entity to continue to recognise the asset to the extent of its continuing involvement (Figure 3-1, Box 9 - see also section 4.2.3 above).

The initial carrying amount of the associated liability is CU95. This is then accreted to CU100 (i.e., the amortised cost of the asset on exercise date - not the CU102 exercise price) through profit or loss using the effective interest method. Because the transferred asset is measured at amortised cost, the associated liability must also be accounted for at amortised cost, and not at fair value through profit or loss (see section 5.3.4 above). This will give rise to the following accounting entries:

Date of transfer

			CU	CU
Dr	Cash		95	
	Cr	Liability		95

After date of transfer

			CU	CU
Dr	Interest on liability		5	
Dr	Asset (CU100 - CU98)		2	
	Cr	Liability (CU100 - CU95)		5
	Cr	Income on asset		2

If the option is exercised, any difference between the carrying amount of the associated liability and the exercise price is recognised in profit or loss. This last requirement has the possibly counter-intuitive effect, that the question of whether the entity records a profit or loss on exercise of the option, is essentially a function of the difference between the liability (representing the amortised cost of the transferred asset) and the cash paid, not of whether it has in fact (i.e., in economic terms) made a gain or loss.

Thus, if the entity were to exercise its option at CU102 it would apparently record the accounting entry:

			CU	CU
Dr	Liability		100	
Dr	Loss		2	
	Cr	Cash		102

However, the entity would not have exercised the option unless the asset had been worth at least CU102 (i.e., CU2 more than its carrying amount), suggesting that the more appropriate treatment would be to add the CU2 to the cost of the asset.

Likewise, if instead of the entity having a call option, the transferee had a put option at CU98 which it exercised, the entity would apparently record the accounting entry:

			CU	CU
Dr	Liability		100	
	Cr	Profit		2
	Cr	Cash		98

However, the transferee would not have exercised its option unless the asset had been worth less than CU98 (i.e., CU2 less than its carrying amount). In this case, however, the IASB's thinking may have been that the exercise of the transferee's put option suggests an impairment of the asset which is required to be recognised in the financial statements (see Chapter 47 at section 5). This would not necessarily be the case (e.g., where a fixed-interest asset has a fair value below cost because of movements in interest rates but is not intrinsically impaired).

If the option were to lapse unexercised, the entity would simply derecognise the transferred asset and the associated liability, i.e.:

			CU	CU
Dr	Liability		100	
	Cr	Asset		100

5.4.3 Transfers of assets measured at fair value with an option

IFRS 9 discusses the application of continuing involvement accounting to transferred assets measured at fair value in terms of transferred assets subject to:

- A transferor's call option (see section 5.4.3.A below)
- A transferee's put option (see section 5.4.3.B below)

  And
- A 'collar' - i.e., a transferor's call option combined with a transferee's put option (see section 5.4.3.C below)

The way in which the rules are articulated in IFRS 9 is somewhat confusing, but in general the effect is that the transferred asset is recognised at:

- In the case of an asset subject to a transferor call option, its fair value (on the basis that the call option gives the transferor access to any increase in the fair value of the asset).

  And
- In the case of an asset subject to a transferee put option, the lower of fair value and the option exercise price (on the basis that the put option denies the transferor access to any increase in the fair value of the asset above the option price).

This methodology summarised below is applied both on the date on which the option is written and subsequently.

5.4.3.A Transferor's call option

If a transferor's call option prevents derecognition (see sections 3.7.3 and 4 above) of a transferred asset measured at fair value, the asset continues to be measured at its fair value. The associated liability is measured:

- If the option is in or at the money, at the option exercise price less the time value of the option

  Or
- If the option is out of the money, at the fair value of the transferred asset less the time value of the option

The adjustment to the measurement of the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the call option right, as illustrated by Illustration 5-9 below. *[IFRS 9.B3.2.13(c)]*.

Illustration 5-9: Asset measured at fair value subject to transferor's call option

An entity has a financial asset, accounted for at fair value through profit or loss, carried at CU80. It transfers the asset to a third party for CU75, subject to a call option whereby the entity can compel the transferee to sell the asset back to the entity for CU95. At the date of transfer, the call option has a time value of CU5.

The option is considered to be neither deeply in the money nor deeply out of the money. IFRS 9 therefore requires the entity to continue to recognise the asset to the extent of its continuing involvement (Figure 3-1, Box 9 - see also section 4.2.3 above), and to continue recording it at fair value. At the date of transfer, the call option is out of the money. IFRS 9 therefore requires the liability to be measured at the fair value of the transferred asset less the time value of the option, i.e., CU80 - CU5 = CU75. This has the result that the net of the carrying value of the asset (CU80) and the carrying value of the liability (CU75) equals the time value of the option (CU5), resulting in the following accounting entry:

Date of transfer

			CU	CU
Dr	Cash		75	
	Cr	Liability		75

A Transferred asset increases in value

Suppose that one year later the fair value of the asset is CU100 and the time value of the option is now CU3. The option is now in the money, so that the liability is measured at the option exercise price less the time value of the option, i.e., CU95 - CU3 = CU92. This has the result that the net of the carrying value of the asset (CU100) and the carrying value of the liability (CU92) equals the fair value of the option (CU8, representing CU3 time value and CU5 intrinsic value). The liability could have been more straightforwardly calculated as the fair value of the asset (CU100) less the fair value of the option (CU8) = CU92. This gives rise to the following accounting entries:

During year 1

			CU	CU
Dr	Asset (CU100 - CU80)		20	
	Cr	Liability (CU92 - CU75)		17
	Cr	Gain (profit or loss)		3

The CU3 gain recorded in profit or loss effectively represents the increase in the fair value of the option from CU5 to CU8 over the period. If the entity were able to exercise the option at this point, and did so, it would record the entry:

			CU	CU
Dr	Liability		92	
Dr	Loss (profit or loss)		3	
	Cr	Cash		95

The particular transaction results in no overall gain or loss being reflected in profit or loss (i.e., CU3 gain during the year less CU3 loss on exercise of option). This represents the net of the CU20 gain in the fair value of the asset (CU100 at the end of period less CU80 at the start) and the net cash outflow of CU20 (CU75 in on initial transfer, CU95 out on exercise of option). Alternatively, it could be considered that the entity has paid CU5 for the option (representing the time value at inception), which is offset against the gain made on the intrinsic value of CU8 on exercise.

B Asset decreases in value

Suppose instead that during the first year the fair value of the asset fell to CU65 and the time value of the option at the end of the year was only CU1. The liability would be measured at the fair value of the transferred asset less the time value of the option, i.e., CU65 - CU1 = CU64. This would generate the accounting entries:

During year 1

			CU	CU
Dr	Liability (CU64 - CU75)		11	
Dr	Loss (profit or loss)		4	
	Cr	Asset (CU65 - CU80)		15

Again, the overall loss shown in profit or loss represents the movement in the fair value of the option over the period from CU5 to CU1. Suppose that one year later there was no change in the fair value of the asset, and the option expired unexercised. The entity would then record the accounting entry:

At end of year 2

			CU	CU
Dr	Liability		64	
Dr	Loss (profit or loss)		1	
	Cr	Asset (statement of financial position)		65

This results in an overall loss for the transaction as a whole of CU5 (CU4 in year 1 and CU1 in year 2), which represents the option premium of CU5 paid on the date of transfer (i.e., the difference between the fair value of the asset at the date of original transfer (CU80) and the proceeds received (CU75)), which expired out of the money.

5.4.3.B Transferee's put option

If a transferee's put option prevents derecognition (see sections 3.7.3 and 4 above) of a transferred asset measured at fair value, IFRS 9 requires the asset to be measured at the lower of fair value and the option exercise price. The basis for this treatment is that the entity has no right to increases in the fair value of the transferred asset above the exercise price of the option. The associated liability is measured at the option exercise price plus the time value of the option. This ensures that the net carrying amount of the asset and the associated liability is the fair value of the put option obligation, as illustrated by Illustration 5-10 below. *[IFRS 9.B3.2.13(d)]*.

Illustration 5-10: Asset measured at fair value subject to transferee's put option

An entity has a financial asset, accounted for at fair value. On 1 January 20X2 it transfers the asset, then carried at CU98, to a third party, subject to a put option whereby the transferee can compel the entity to reacquire the asset for CU100. The option is considered to be neither deeply in the money nor deeply out of the money. IFRS 9 therefore requires the entity to continue to recognise the asset to the extent of its continuing involvement (Figure 3-1, Box 9 - see also section 4.2.3 above), and to continue recording it at the lower of (a) fair value and (b) CU100 (the exercise price of the option). Assuming that the transferee pays CU106 for the asset, representing CU98 fair value of the asset plus CU8 time value of the option, the entity would record the accounting entry:

1 January 20X2

			CU	CU
Dr	Cash		106	
	Cr	Liability		106

A Transferred asset increases in value

Suppose that at 31 December 20X2, the option has a time value of CU5 and the fair value of the asset is CU120. IFRS 9 requires the carrying value of the asset to be restricted to CU100 (the exercise price of the option). The liability is measured at the exercise price plus the time value of the option, i.e., CU100 + CU5 = CU105. This has the result that the net of the carrying value of the asset (CU100) and the carrying value of the liability (CU105) equals the fair value of the option to the transferor (-CU5). The fair value of an in the money option is positive for the buyer and negative for the writer.

This gives the accounting entry:

31 December 20X2

			CU	CU
Dr	Asset (CU100 - CU98)		2	
Dr	Liability (CU105 - CU106)		1	
	Cr	Gain (profit or loss)		3

The gain of CU3 effectively represents the decrease in the time value of the option (a gain from the transferor's perspective) from CU8 to CU5.

If the option were then to lapse unexercised, with no further change in the fair value of the asset, the entity would record the accounting entry:

On lapse of option

			CU	CU
Dr	Liability		105	
	Cr	Asset		100
	Cr	Gain (profit or loss)		5

The total gain on the transaction of CU8 (CU3 in Year 1 and CU5 on lapse) represents the option premium of CU8 (i.e., the difference between the total consideration of CU106 and the fair value of the asset of CU98) received at the outset.

B Transferred asset decreases in value

Suppose instead that at 31 December 20X2, the option has a time value of CU5 but the fair value of the asset is CU90. IFRS 9 requires the carrying value of the asset to be measured at its fair value of CU90. The liability is measured at the exercise price plus the time value of the option (i.e., to the transferee), i.e., CU100 + CU5 = CU105.

This gives the accounting entry:

31 December 20X2

			CU	CU
Dr	Liability (CU105 - CU106)		1	
Dr	Loss (profit or loss)		7	
	Cr	Asset (CU90 - CU98)		8

This has the result that the net of the carrying value of the asset (CU90) and the liability (CU105), i.e., (-CU15) represents the fair value of the option to the transferor (i.e., intrinsic value (-CU10) (CU100 exercise price

versus CU90 value of asset) + time value (-CU5)). The CU7 loss represents the increase in the fair value of the option (a loss to the transferor) from CU8 at the outset to CU15 at 31 December 20X2.

If the transferee were able to, and did, exercise its option at that point, the entity would record the accounting entry:

On exercise of option

			CU	CU
Dr	Liability		105	
	Cr	Cash		100
	Cr	Gain (profit or loss)		5

The overall CU2 loss (i.e., CU5 gain above and CU7 loss during Year 1) represents the net cash of CU6 received from the transferee (CU106 in at inception less CU100 out on exercise) less the CU8 fall in fair value of the transferred asset (CU98 at inception less CU90 at exercise).

5.4.3.C 'Collar' put and call options

Assets may be transferred in a way designed to ensure that the transferee is shielded from excessive losses on the transferred asset but has to pass significant gains on the asset back to the transferor. Such an arrangement is known as a 'collar', on the basis that it allocates a range of potential value movements in the asset to the transferee, with movements outside that range accruing to the transferor. A simple example would be the transfer of an asset subject to a purchased call option (allowing the transferor to reacquire the asset if it increases in value beyond a certain level) and a written put option (allowing the transferee to compel the transferor to reacquire the asset if it falls in value beyond a certain level).

If a collar, in the form of a purchased call and written put option, prevents derecognition (see sections 3.7.3 and 4 above) of a transferred asset measured at fair value, IFRS 9 requires the entity to continue to measure the asset at fair value. The associated liability is measured at:

- If the call option is in or at the money, the sum of the call exercise price and the fair value of the put option less the time value of the call option.

  Or

- If the call option is out of the money, the sum of the fair value of the asset and the fair value of the put option less the time value of the call option.

The adjustment to the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the options held and written by the entity, as illustrated by Illustration 5-11 below. *[IFRS 9.B3.2.13(e)]*.

Illustration 5-11: Asset measured at fair value subject to collar put and call options

An entity has a financial asset, accounted for at fair value, carried at CU100. On 1 January 20X2 it transfers the asset to a third party, subject to:

- A call option whereby the entity can compel the transferee to sell the asset back to the entity for CU120

  And

- A put option whereby the transferee can compel the entity to reacquire the asset for CU80

The options are considered to be neither deeply in the money nor deeply out of the money. IFRS 9 therefore requires the entity to continue to recognise the asset to the extent of its continuing involvement (Figure 3-1, Box 9 - see also section 4.2.3 above), and to continue recording it at fair value.

At the date of transfer, the time value of the put and call are CU1 and CU5 respectively. At the date of transfer, the call option is out of the money, so that the associated liability is calculated as the sum of the fair value of the asset and the fair value of the put option less the time value of the call option, i.e., (CU100 + CU1) - CU5 = CU96. The net of this and the fair value of the asset (CU100) is CU4 which is the net fair value of the two options (call CU5 less put CU1). Assuming that the transaction is undertaken at arm's length, the transferee would pay CU96 for the asset and the entity would record the accounting entry:

			CU	CU
Dr	Cash		96	
	Cr	Liability		96

A Transferred asset increases in value

Suppose that, at 31 December 20X2, the fair value of the asset is CU140, and the time value of the put and call are CU0.5 and CU2 respectively. The call option is now in the money, so that IFRS 9 requires the entity to recognise a liability equal to the sum of the call exercise price and fair value of the put option less the time value of the call option, i.e., (CU120 + CU0.5) - CU2 = CU118.5. The net of this and the carrying value of the asset (CU140) is CU21.5 which is the net fair value of the two options (call CU22 [time value CU2 plus intrinsic value CU20] less put CU0.5 = CU21.5). This gives the accounting entry:

31 December 20X2

			CU	CU
Dr	Asset (CU140 - CU100)		40.0	
	Cr	Gain (profit or loss)		17.5
	Cr	Liability (CU118.5 - CU96)		22.5

The gain represents the increase in fair value of the call option of CU17 (CU5 at outset and CU22 at 31 December 20X2) plus the CU0.5 decrease (a gain from the transferor's perspective) in the fair value of the put option (CU1 at outset and CU0.5 at 31 December 20X2).

If the entity were able to, and did, exercise its call option, it would record the entry:

Exercise of call option

			CU	CU
Dr	Liability		118.5	
Dr	Loss (profit or loss)		1.5	
	Cr	Cash		120.0

The overall gain of CU16 on the transaction (CU1.5 loss above and CU17.5 profit recorded in 20X2) represents the increase in fair value of the asset of CU40 (CU100 at outset, CU140 at 31 December 20X2) less the net CU24 paid to the transferee (CU120 paid on exercise of call less CU96 received on initial transfer).

B Transferred asset decreases in value

Suppose instead that, at 31 December 20X2, the fair value of the asset is CU78, and the time value of the put and call are CU0.5 and CU2 respectively. The call option is now out of the money, so that IFRS 9 requires the entity to recognise a liability equal to the sum of the fair value of the asset and the fair value of the put option (i.e., CU2.5 - time value CU0.5 plus intrinsic value CU2 [CU80 exercise price versus CU78 fair value of asset]) less the time value of the call option, i.e., (CU78 + CU2.5) - CU2 = CU78.5.

The net of this and the carrying value of the asset (CU78) is (-CU0.5) which is the net fair value of the two options (call CU2 less put CU2.5 = -CU0.5). This gives the accounting entry:

31 December 20X2

			CU	CU
Dr	Liability (CU78.5 - CU96)		17.5	
Dr	Loss (profit or loss)		4.5	
	Cr	Asset (CU78 - CU100)		22.0

The loss represents the decrease in the fair value of the call option of CU3 (CU5 at outset and CU2 at 31 December 20X2) plus the CU1.5 increase (a decrease from the transferor's perspective) in the fair value of the put option (CU1 at outset and CU2.5 at 31 December 20X2).

If the transferee were able to, and did, exercise its put option, the entity would record the entry:

Exercise of put option

			CU	CU
Dr	Liability		78.5	
Dr	Loss (profit or loss)		1.5	
	Cr	Cash		80.0

The overall loss of CU6 on the transaction (CU1.5 loss above and CU4.5 loss recorded in 20X2) represents the decrease in fair value of the asset of CU22 (CU100 at outset, CU78 at 31 December 20X2) offset by the net CU16 received from the transferee (CU96 received on initial transfer less CU80 paid on exercise of put).

5.4.4 Continuing involvement in part only of a financial asset

IFRS 9 gives the following example of the application of the continuing involvement approach to continuing involvement in part only of a financial asset. *[IFRS 9.B3.2.17]*.

Illustration 5-12: Continuing involvement in part only of a financial asset

An entity has a portfolio of prepayable loans whose coupon and effective interest rate is 10% and whose principal amount and amortised cost is CU10 million. It enters into a transaction in which, in return for a payment of CU9.115 million, the transferee obtains the right to CU9 million of any collections of principal plus 9.5% interest.

The entity retains rights to CU1 million of any collections of principal plus interest at 10%, plus the remaining 0.5% ('excess spread') on the remaining CU9 million of principal. Collections from prepayments are allocated between the entity and the transferee proportionately in the ratio of 1:9, but any defaults are deducted from the entity's interest of CU1 million until that interest is exhausted.

The fair value of the loans at the date of the transaction is CU10.1 million and the estimated fair value of the excess spread of 0.5% is CU40,000.

The entity determines that it has transferred some significant risks and rewards of ownership (for example, significant prepayment risk) but has also retained some significant risks and rewards of ownership because of its subordinated retained interest (Figure 3-1, Box 7, No) and has retained control (Figure 3-1, Box 8, Yes). It therefore applies the continuing involvement approach (Figure 3-1, Box 9).

The entity analyses the transaction as:

- A retention of a fully proportionate retained interest of CU1 million

  Plus

- The subordination of that retained interest to provide credit enhancement to the transferee for credit losses

The entity calculates that CU9.09 million (90% of CU10.1 million) of the consideration received of CU9.115 million represents the consideration for a fully proportionate 90% share. The remainder of the consideration (CU25,000) received represents consideration received by the entity for subordinating its retained interest to provide credit enhancement to the transferee for credit losses. In addition, the excess spread of 0.5% represents consideration received for the credit enhancement. Accordingly, the total consideration received for the credit enhancement is CU65,000 (CU25,000 received from transferee plus CU40,000 fair value of excess spread).

The entity calculates the gain or loss on the sale of the 90% share of cash flows. Assuming that separate fair values of the 90% part transferred and the 10% part retained are not available at the date of the transfer, the entity allocates the carrying amount of the asset in accordance with paragraph 3.2.14 of IFRS 9 as follows:

	Fair value	Percentage	Allocated carrying amount
Portion transferred	9,090	90%	9,000
Portion retained	1,010	10%	1,000
Total	10,100		10,000

The entity computes its gain or loss on the sale of the 90% share of the cash flows by deducting the allocated carrying amount of the portion transferred from the consideration received, i.e., CU90 (CU9,090 - CU9,000). The carrying amount of the portion retained by the entity is CU1,000.

In addition, IFRS 9 requires the entity to recognise the continuing involvement that results from the subordination of its retained interest for credit losses. Accordingly, it recognises an asset of CU1 million (the maximum amount of the cash flows it would forfeit under the subordination), and an associated liability of CU1.065 million (the maximum amount of the cash flows it would forfeit under the subordination, i.e., CU1 million, plus the fair value of the guarantee considered to be equal to the consideration received for the subordination of CU65,000). It also recognises an asset for the fair value of the excess spread which forms part of the consideration for the subordination.

This gives rise to the following accounting entry:

			CU'000	CU'000
Dr	Cash		9,115	
Dr	Asset for the subordination of the residual interest (continuing involvement in the transferred asset)		1,000	
Dr	Excess spread received for subordination		40	
	Cr	Loan portfolio		9,000
	Cr	Liability for subordination (continuing involvement liability)		1,065
	Cr	Gain on disposal		90

It is crucial to an understanding of this example that, as a result of the transaction, the original asset (the portfolio of prepayable loans) is being accounted for as two separate assets. Because the cash flows from the portfolio are split in fully proportionate (*pro rata*) shares (see section 3.4 above), each of these assets must be considered separately.

The first of these assets, the right to cash flows of CU9 million obtained by the transferee, continues to be recognised only to the extent of the entity's continuing involvement, which in this case is via the credit enhancement. The approach is very similar to continuing involvement through guarantee (see Illustration 5-6 in section 5.4.1 above), except that the liability for subordination includes the maximum cash flow that the entity might not receive from its retained share (i.e., CU1 million) rather than, as in Illustration 5-6, a potential cash outflow (the guarantee amount, which is the maximum amount that the entity could be required to repay). This is aggregated with the fair value of the amount received in respect of the credit enhancement, in order to calculate the full liability for subordination. This is similar to the way in which the fair value of the guarantee is added to the guarantee amount in order to calculate the associated liability. *[IFRS 9.B3.2.13(a)]*.

The second asset is the entity's proportionate retained share of CU1 million.

The effect is to gross up the statement of financial position with a subordination asset and liability. As IFRS 9 notes, immediately following the transaction, the carrying amount of the asset is CU2.04 million (i.e., CU1 million part retained plus CU1 million subordination asset plus CU40,000 excess spread) - in respect of an asset whose fair value is only CU1.01 million.

5.5 Miscellaneous provisions

IFRS 9 contains a number of accounting provisions generally applicable to transfers of assets, as discussed below.

5.5.1 Offset

IFRS 9 provides that, if a transferred asset continues to be recognised, the entity must not offset:

- The asset with the associated liability

  Or

- Any income arising from the transferred asset with any expense incurred on the associated liability *[IFRS 9.3.2.22]*

Whilst IFRS 9 does not say so specifically, this is clearly intended to apply both to assets that continue to be recognised in full and to those that continue to be recognised to the extent of their continuing involvement.

This requirement apparently overrides the offset criteria in IAS 32, *[IAS 32.42]*, as illustrated, for example, by the various situations highlighted in the discussion in section 4 and sections 5.1 to 5.4 above where a transaction required to be net-settled (which would normally be required to be accounted for as such under IAS 32) is accounted for as if it were to be gross-settled.

5.5.2 Collateral

If a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee, the accounting treatment for the collateral by both the transferor and the transferee depends on:

- Whether the transferee has the right to sell or repledge the collateral

  And

- Whether the transferor has defaulted

If the transferee has the right by contract or custom to sell or repledge a collateral asset, the transferor shall reclassify that asset in its statement of financial position (e.g., as a loaned asset, pledged equity instruments or repurchase receivable) separately from other assets.

If the transferee sells collateral pledged to it, it recognises the proceeds from the sale and a liability measured at fair value for its obligation to return the collateral.

If the transferor defaults under the terms of the contract and is no longer entitled to redeem the collateral, it derecognises the collateral, and the transferee either:

- Recognises the collateral as its asset initially measured at fair value

  Or

- If it has already sold the collateral, derecognises its obligation to return the collateral

In no other circumstances shall the transferor derecognise, or the transferee recognise, the collateral as an asset. *[IFRS 9.3.2.23]*.

5.5.3 Rights or obligations over transferred assets that continue to be recognised

Where a transfer of a financial asset does not qualify for derecognition, the transferor may well have contractual rights or obligations related to the transfer, such as options or forward repurchase contracts that are derivatives of a type that would normally be required to be recognised under IFRS 9.

IFRS 9 prohibits separate recognition of such derivatives, if recognition of the derivative together with either the transferred asset or the liability arising from the transfer would result in recognising the same rights or obligations twice.

For example, IFRS 9 notes that a call option retained by the transferor may prevent a transfer of financial assets from being accounted for as a sale (see section 4 above). In that case, the call option shall not be separately recognised as a derivative asset. *[IFRS 9.B3.2.14]*.

We would expect a similar approach to be taken to contractual rights associated with a non-derivative financial instrument issued to the transferor by the transferee in a transfer that does not qualify for derecognition. This commonly occurs when financial assets are transferred to a securitisation vehicle which issues a subordinated loan to the transferor as a result of which substantially all risks and rewards of the financial assets are retained by the transferor. In such case, only the cash received from the vehicle would be recorded as a liability.

5.6 Reassessing derecognition

IFRS 9 states that if an entity determines that, as a result of the transfer, it has transferred substantially all the risks and rewards of ownership of the transferred asset, it does not recognise the transferred asset again in a future period, unless it reacquires the transferred asset in a new transaction. *[IFRS 9.B3.2.6]*. We have noted earlier that there is some ambiguity as to whether this rule in IFRS 9.B3.2.6 is to be read generally as prohibiting any re-recognition of a derecognised asset or specifically as referring only to circumstances where derecognition results from transfer of substantially all the risks and rewards (i.e., it applies only to 'Box 6, Yes' transactions, and not to 'Box 8, No' transactions).

How we see it

Our view, as expressed in section 4.2 above, is that derecognition arising as a result of a transfer where substantially all the risks and rewards have been transferred cannot be reassessed following developments in the future. We would expect entities to apply this principle more broadly and include scenarios where derecognition occurs as a result of loss of control.

The risks and rewards of ownership retained by the entity may change as a result of market changes in such a way that, had the revised conditions existed at inception, they would have prevented derecognition of the asset. However, the original decision to derecognise the asset is not revisited, unless (in exceptional circumstances) the original assessment was an accounting error within the scope of IAS 8.

5.6.1 Reassessment of consolidation of subsidiaries and SPEs

As mentioned in Section 3.2, the first step of the derecognition analysis, when preparing consolidated financial statements, is to ensure all subsidiaries, including those that are SPEs, are consolidated. This is because many transactions that could result in derecognition of one subsidiary's financial assets involve transactions with another member of the group, but these transactions will be eliminated on consolidation. The assessment as to whether a particular SPE is controlled by the reporting entity is discussed in Chapter 7.

In the context of a securitisation, if an SPE (or issuer) is consolidated by the originator, then all intragroup transactions are eliminated and only the externally held notes issued by the SPE will be accounted for. In most cases, the originator will not derecognise the securitised assets, but instead recognise the loan notes as financial liabilities, unless the issuer is able to demonstrate that it operates as a qualifying pass-through arrangement. For more guidance on pass-through arrangements refer to section 3.6.2.

If the issuer is not consolidated by the originator, the originator may derecognise the assets transferred to the SPE that is not consolidated, using the remaining steps of the derecognition analysis. The application of IFRS 9 to securitisations is dealt with further in section 3.6.1 and section 3.6.2.

IFRS 10 requires an investor to reassess whether it controls an investee if facts and circumstances indicate that there are changes to any elements of control, including the investor's exposure, or rights, to variable returns from its involvement with the investee (see Chapter 7). *[IFRS 10.8]*. As such, there is a possibility that due to a subsequent deconsolidation of the transferee, the group may reach a different conclusion regarding the derecognition of the assets transferred.

6 Derecognition - financial liabilities

The provisions of IFRS 9 with respect to the derecognition of financial liabilities are generally more straightforward and less subjective than those for the derecognition of financial assets. However, they are also very different from the asset derecognition rules which focus primarily on the economic substance of the transaction. By contrast, the rules for derecognition of liabilities, like the provisions of IAS 32 for the identification of instruments as financial liabilities (see Chapter 43), focus more on legal obligations than on economic substance - or, as the IASB would doubtless argue, they are based on the view that the economic substance of whether an entity has a liability to a third party is ultimately dictated by the legal rights and obligations that exist between them.

IFRS 9 contains provisions relating to:

- The extinguishment of debt (see section 6.1 below)
- The substitution or modification of debt by the original lender (see section 6.2 below)

  And
- The calculation of any profit or loss arising on the derecognition of debt (see section 6.3 below)

Extract from IFRS 9	
3.3.1	**An entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished-ie when the obligation specified in the contract is discharged or cancelled or expires.**
3.3.2	**An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.**
3.3.3	**The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.**
3.3.4	If an entity repurchases a part of a financial liability, the entity shall allocate the previous carrying amount of the financial liability between the part that continues to be recognised and the part that is derecognised based on the relative fair values of those parts on the date of the repurchase. The difference between (a) the carrying amount allocated to the part derecognised and (b) the consideration paid, including any non-cash assets transferred or liabilities assumed, for the part derecognised shall be recognised in profit or loss.

[IFRS 9.3.3.1, IFRS 9.3.3.2, IFRS 9.3.3.3, IFRS 9.3.3.4].

6.1 Extinguishment of debt

IFRS 9 requires an entity to derecognise (i.e., remove from its statement of financial position) a financial liability (or a part of a financial liability - see section 6.1.1 below) when, and only when, it is 'extinguished', that is, when the obligation specified in the contract is discharged, cancelled, or expires. *[IFRS 9.3.3.1]*. This will be achieved when the debtor either discharges the liability (or part of it) by paying the creditor, or is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. *[IFRS 9.B3.3.1]*. Extinguishment of liabilities by legal release is discussed further in section 6.1.2 below. Situations whereby debt is repurchased by the issuer and unit-linked products are dealt with in section 6.1.5 below.

In September 2021, the IFRS IC was asked when a financial asset settled by a cash payment received via an electronic transfer system is derecognised. The discussion was extended to include the derecognition of a financial liability settled by a payment in the same scenario. The IFRS IC identified diversity in practice for the timing of derecognition of financial assets and financial liabilities, not just those settled via an electronic transfer system, but also using other methods. As a result of this, the IFRS IC decided to hand this matter over to the IASB who included this in the IFRS 9 PIR for Classification and Measurement.

In May 2024, the IASB issued the *Amendments to the Classification and Measurement of Financial Instruments*, which included clarifications to the application guidance for derecognition of financial assets and liabilities as a response to the above. These amendments are effective for annual reporting periods beginning on or after 1 January 2026, with early application allowed.

To improve the consistent application of the derecognition requirements to financial liabilities, a clarification was added to the application guidance to IFRS 9 which specifies that the entity derecognises a financial liability on the settlement date, which is the date on which the liability is extinguished because the obligation specified in the contract is discharged or cancelled or expires (see paragraph 3.3.1 above) or the liability otherwise qualifies for derecognition (see paragraph 3.3.2). *[IFRS 9(2026).B3.1.2A]*.

To address some operational concerns raised by stakeholders, the IASB also developed new requirements to permit an entity to derecognise, before the settlement date, a financial liability that will be settled in cash using an electronic payment system *[IFRS 9(2026).BC3.41]*. This narrow-scope exception from the settlement date accounting principle of IFRS 9 B3.1.2A is shown below.

Extract from IFRS 9

B3.3.8	Despite the requirement in paragraph B3.1.2A to derecognise a financial liability on the settlement date, when settling a financial liability (or part of a financial liability) in cash using an electronic payment system, an entity is permitted to deem the financial liability (or part of it) to be discharged before the settlement date if, and only if, the entity has initiated a payment instruction that resulted in: (a) the entity having no practical ability to withdraw, stop or cancel the payment instruction; (b) the entity having no practical ability to access the cash to be used for settlement as a result of the payment instruction; and (c) the settlement risk associated with the electronic payment system being insignificant.
B3.3.9	For the purpose of applying paragraph B3.3.8(c), settlement risk associated with an electronic payment system is insignificant if its characteristics are such that completion of the payment instruction follows a standard administrative process and the time between the criteria in paragraphs B3.3.8(a) and (b) being met and the cash being delivered to the counterparty is short. However, settlement risk would not be insignificant if completion of the payment instruction were subject to the entity's ability to deliver cash on the settlement date.
B3.3.10	An entity that elects to apply paragraph B3.3.8 to the settlement of a financial liability (or part of a financial liability) using an electronic payment system shall apply that paragraph to all settlements made through the same electronic payment system.

[IFRS 9(2026).B3.3.8, IFRS 9.B3.3.9, IFRS 9.B3.3.10].

This exception from the settlement date accounting principle of IFRS 9 B3.1.2A will need to be consistently applied on a system-by-system basis. Using this exception, an entity will need to assess what 'no practical ability to withdraw, stop or cancel the payment instruction' and 'insignificant settlement risk' means in its context. These assessments should be consistently applied.

How we see it

For financial liabilities, entities need to establish a thorough understanding of the various cash settlement mechanisms and when their amount payable that is being settled via that mechanism is transformed into a cash balance for the counterparty. This could be a complex matter, especially for entities operating with multiple payment systems and with cross-border operations.

A similar analysis will be required for entities seeking to apply the exception for financial liabilities, to assess whether and when the relevant criteria in IFRS 9 B3.3.8 are met, including with respect to the 'practical ability' requirements, which will require some judgement.

Where the conclusion is unclear (e.g., due to the features of the payment systems and/or the interaction with multiple payment systems and with laws and regulations of different jurisdictions), legal opinions could be required to establish when a liability has been extinguished.

Applying the amendments to the derecognition of financial liabilities is expected to be a significant undertaking for many entities. We discuss the transition requirements of the amendments in section 9.2 below.

How we see it

Given that the IASB had to issue amendments to the standard to clarify the requirements in this area, in our view, an entity is not required to change its accounting policy on the timing of derecognition of a financial liability to conform with the amendments until when those are adopted. At that point, it can make use of the transitional guidance in IFRS 9.7.2.48. Details on transition requirements of the amendments are discussed further in Section 9.2 below.

6.1.1 What constitutes 'part' of a liability?

The requirements of IFRS 9 for the derecognition of liabilities apply to all or 'part' of a financial liability. It is not entirely clear what is meant by 'part' of a liability in this context. The rules, and the examples, in IFRS 9 seem to be drafted in the context of transactions that settle all remaining cash flows (i.e., interest and principal) of a proportion of a liability, such as the repayment of CU25 million of a CU100 million loan, together with any related interest payments.

However, these provisions are presumably also intended to apply in situations where an entity prepays the interest only (or a proportion of future interest payments) or the principal only (or a proportion of future principal payments) on a loan.

6.1.2 Legal release by creditor

A liability can be derecognised by a debtor if the creditor legally releases the debtor from the liability. It is clear that IFRS 9 regards legal release as crucial, with the effect that very similar (if not identical) situations may lead to different results purely because of the legal form.

For example, IFRS 9 provides that:

- Where a debtor is legally released from a liability, derecognition is not precluded by the fact that the debtor has given a guarantee in respect of the liability. *[IFRS 9.B3.3.1(b)]*.

  But

- If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed the debt obligation, the debtor derecognises the debt obligation if, and only if, the creditor legally releases the debtor from its obligations. *[IFRS 9.B3.3.4]*.

The effect of these requirements is shown by Illustration 6-1.

Illustration 6-1: Transfer of debt obligations with and without legal release

Scenario 1

Entity A issues bonds that have a carrying amount and fair value of CU1,000,000. A pays CU1,000,000 to Entity B for B to assume responsibility for paying interest and principal on the bonds to the bondholders. The bondholders are informed that B has assumed responsibility for the debt. However, A is not legally released from the obligation to pay interest and principal by the bondholders. Accordingly, if B does not make payments when due, the bondholders may seek payment from A.

Scenario 2

Entity A issues bonds that have a carrying amount and fair value of CU1,000,000. A pays CU1,000,000 to Entity B for B to assume responsibility for paying interest and principal on the bonds to the bondholders. The bondholders are informed that B has assumed responsibility for the debt and legally release A from any further obligation under the debt. However, A enters into a guarantee arrangement whereby, if B does not make payments when due, the bondholders may seek payment from A.

It is reasonably clear that in either scenario above the bondholders are in the same economic and legal position - they will receive payments from B and, if B defaults, they will have recourse to A.

However, IFRS 9 gives rise to the anomalous result that:

- Scenario 1 is accounted for by the continuing recognition of the debt because no legal release has been obtained.

  But

- Scenario 2 is accounted for by derecognition of the debt, and recognition of a new guarantee, notwithstanding that the effect of the guarantee is to put A back in the same position as if it had not been released from its obligations under the original bond.

IFRS 9 also clarifies that, if a debtor:

- Transfers its obligations under a debt to a third party and obtains legal release from its obligations by the creditor

  But

- Undertakes to make payments to the third party so as to enable it to meet its obligations to the creditor

It derecognises the original debt, but recognises a new debt obligation to the third party. *[IFRS 9.B3.3.4]*.

Legal release may also be achieved through the novation of a contract to an intermediary counterparty. For example, a derivative between a reporting entity and a bank may be novated to a CCP. In these circumstances, the IASB explains that the novation to the CCP releases the bank from the responsibility to make payments to the reporting entity. Consequently, the original derivative meets the derecognition criteria for a financial liability and a new derivative with the CCP is recognised. *[IFRS 9.BC6.335]*. However, for hedge accounting purposes only, it is sometimes possible in these circumstances to treat the new derivative as a continuation of the original (see Chapter 49 at section 8.3.5).

6.1.3 'In-substance defeasance' arrangements

Entities sometimes enter into so-called 'in-substance defeasance' arrangements in respect of financial liabilities. These typically involve a lump sum payment to a third party (other than the creditor) such as a trust, which then invests the funds in (typically) very low-risk assets to which the entity has no, or very limited, rights of access. These assets are then applied to discharge all the remaining interest and principal payments on the financial liabilities that are purported to have been defeased.

It is sometimes argued that the risk-free nature of the assets, and the entity's lack of access to them, means that the entity is in substance in no different position than if it had actually repaid the original financial liability. However, IFRS 9 regards such arrangements as not giving rise to derecognition of the original liability in the absence of legal release by the creditor. *[IFRS 9.B3.3.3]*.

6.1.4 Extinguishment in exchange for transfer of assets not meeting the derecognition criteria

IFRS 9 notes that in some cases legal release may be achieved by transferring assets to the creditor which do not meet the criteria for derecognition (see section 3 above). In such a case, the debtor will derecognise the liability from which it has been released, but recognise a new liability relating to the transferred assets that may be equal to the derecognised liability. *[IFRS 9.B3.3.5]*. It is not entirely clear what is envisaged here, but it may be some such scenario as the following.

Illustration 6-2: Extinguishment of debt in exchange for transfer of assets not meeting derecognition criteria

An entity has a bank loan of CU1 million. The bank agrees to accept in full payment of the loan the transfer to it by the entity of a portfolio of corporate bonds with a market value of CU1 million. The entity and the bank then enter into a put and call option over the bonds, the effect of which will be that the entity will repurchase the bonds in three years' time at a price that gives the bank a lender's return on CU1 million. As discussed further in section 4.2.8 above, this would have the effect that the entity is unable to derecognise the bonds.

Under the provisions of IFRS 9, the entity would be able to derecognise the original bank loan, as it has been legally released from it. The provisions under discussion here have the overall result that a loan effectively continues to be recognised. Strictly, however, the analysis is that the original loan has been derecognised and a new one recognised. In effect the accounting is representing that the entity has repaid the original loan and replaced it with a new one secured on a bond portfolio.

We expect in this instance, the application of the requirement in IFRS 9.B3.3.5 to be based on IFRS 9.3.2.15, which requires the liability to reflect the consideration received. The consideration received in this instance likely reflects the fair value of the old loan that the borrower was legally released from.

6.1.5 Debt repurchased by the issuer

If the issuer of a debt instrument repurchases the instrument, the debt is extinguished even if the issuer is a market maker in that instrument, or otherwise intends to resell or reissue it in the near term. *[IFRS 9.B3.3.2]*. IFRS 9 focuses only on whether the entity has a legal obligation to reissue the debt, not on whether there is a commercial imperative for it to do so.

To cater for entities issuing unit-linked products or contracts with discretionary participation features, a limited exception to the requirement in paragraph B3.3.2 has been introduced on adoption of IFRS 17 *Insurance Contracts*, which became effective for periods beginning on or after 1 January 2023. *[IFRS 9.7.1.6]*. The conditions for using this exemption are set out in below extract.

Extract from IFRS 9

3.3.5 Some entities operate, either internally or externally, an investment fund that provides investors with benefits determined by units in the fund and recognise financial liabilities for the amounts to be paid to those investors. Similarly, some entities issue groups of insurance contracts with direct participation features and those entities hold the underlying items. Some such funds or underlying items include the entity's financial liability (for example, a corporate bond issued). Despite the other requirements in this Standard for the derecognition of financial liabilities, an entity may elect not to derecognise its financial liability that is included in such a fund or is an underlying item when, and only when, the entity repurchases its financial liability for such purposes. Instead, the entity may elect to continue to account for that instrument as a financial liability and to account for the repurchased instrument as if the instrument were a financial asset, and measure it at fair value through profit or loss in accordance with this Standard. That election is irrevocable and made on an instrument-by-instrument basis. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. (See IFRS 17 for terms used in this paragraph that are defined in that Standard.)

[IFRS 9.3.3.5].

6.2 Exchange or modification of debt by original lender

It is common for an entity, particularly but not necessarily when in financial difficulties, to approach its major creditors for a restructuring of its debt commitments - for example, an agreement to postpone the repayment of principal in exchange for higher interest payments in the meantime, or to roll up interest into a single 'bullet' payment of interest and principal at the end of the term. Such changes to the terms of debt can be effected in a number of ways, in particular:

- A notional repayment of the original loan followed by an immediate re-lending of all or part of the proceeds of the notional repayment as a new loan ('exchange')

  Or

- Legal amendment of the original loan agreement ('modification')

The accounting issue raised by such transactions is essentially whether there is, in fact, anything to account for. For example, if an entity owes CU100 million at floating rate interest and negotiates with its bankers to change the interest to a fixed coupon of 7%, does the accounting treatment have to reflect the fact that:

(a) The entity still owes CU100 million to the same lender, and so is in the same position as before?

  Or

(b) The modification of the interest profile has altered the net present value of the total obligations under the loan?

When a loan is repaid at maturity and a new loan is taken out with the same lender, this would not be a modification or exchange as the original loan was not modified or exchanged, it was settled in accordance with the original contractual terms. However, sometimes an existing loan will be replaced by a new one with the same lender before its maturity date. In these circumstances judgement will be required to assess whether to regard the original loan as being modified or exchanged or whether it should be regarded as being repaid and replaced by a new loan on market terms. This judgement involves consideration of how close to the maturity date of the original loan the transaction took place, compared to the term of the original loan. For example, if the transaction took place three months before the maturity of a 10-year loan, it is more likely to be considered a repayment and replacement than if the transaction took place six months before the maturity of a one-year loan.

IFRS 9 requires an exchange between an existing borrower and lender of debt instruments with 'substantially different' terms to be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability, or a part of it, (whether or not due to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. *[IFRS 9.3.3.2]*. The determination of whether an exchange or modification is substantially different is discussed further in section 6.2.1 below.

In August 2020, the IASB issued amendments to IFRS 9 to provide guidance on how to account for modifications of a financial liability due to the reform of interbank offered rates and this is discussed further in section 6.2.2 below.

Large borrowing arrangements may be transacted with multiple lenders in loan syndications and the issues arising from such arrangements are discussed further in section 6.2.3 below.

Sometimes a borrower may effect an exchange of debt through an intermediary and this is discussed further in section 6.2.4 below.

The accounting consequences for an exchange or a modification that results in extinguishment and one that does not lead to extinguishment are discussed in further detail in sections 6.2.5 to 6.2.7 below.

6.2.1 When is an exchange or modification of debt 'substantially different'?

IFRS 9 regards the terms of exchanged or modified debt as 'substantially different' if the net present value of the cash flows under the new terms (including any fees paid net of any fees received) discounted at the original effective interest rate is at least 10% different from the discounted present value of the remaining cash flows of the original debt instrument. *[IFRS 9.B3.3.6]*. This comparison is commonly referred to as 'the 10% test'.

Whilst IFRS 9 does not say so explicitly, it seems clear that the discounted present value of the remaining cash flows of the original debt instrument used in the 10% test must also be determined using the original effective interest rate, so that there is a 'like for like' comparison. This amount should also represent the amortised cost of the liability prior to modification.

In May 2020 the IASB issued *Annual Improvements to IFRS Standards 2018-2020*, which included amendments to IFRS 9 to clarify that only fees paid or received between the borrower and lender are included in the 10% test, therefore fees payable such as to the entity's legal advisors are excluded. The IASB believes that the clarification aligns with the objective of the test, which is to quantitatively assess the significance of any difference between the old and new contractual terms on the basis of the changes in the contractual cash flows between the borrower and lender. The amendments had to be adopted prospectively and had an effective date of periods commencing 1 January 2022 *[IFRS 9.7.1.9, IFRS 9.7.2.35, IFRS 9.B3.3.6]*.

Under certain circumstances extinguishment accounting for an exchange or modification of a liability may still be required, even where the net present value of the cash flows under the new terms is less than 10% different from the discounted present value of the remaining cash flows of the original debt instrument. Indeed, there may be situations where the modification of the debt is so fundamental that immediate derecognition is required whether or not the 10% test is satisfied. The following are examples of situations where derecognition of the original instrument could be required:

- An entity has issued a 'plain vanilla' debt instrument and restructures the debt to include an embedded equity instrument.
- An entity has issued a 5% euro-denominated debt instrument and restructures the instrument to an 18% Turkish lira-denominated debt instrument.

The present value of the cash flows of such restructured debts, discounted at the original effective interest rate, may not be significantly different from the discounted present value of the remaining cash flows of the original financial liability. However, the determination of the revised cashflows would require more judgemental assumptions compared to the original cash flows, which in itself could be an indicator that the modification is substantial. Further, even if the 10% test is not satisfied, the introduction of the equity-linked feature or a change in currency (unless the original and new currencies are pegged) could significantly alter the future economic risk exposure of the instrument.

How we see it

In the circumstances above the modification of terms are, in our view, regarded as representing a substantial change which would lead to derecognition of the original liability.

There are other modifications to the contractual terms of financial liabilities which may be considered substantial and therefore result in extinguishment accounting, for example a change in the basis of interest calculation (such as moving from fixed to floating rate) or a significant extension in the term of the debt. The assessment of such modifications will require judgement and they are to be considered along with other modifications made at the same time before concluding whether the modifications should be considered substantial.

6.2.2 Interbank Offered Rate (IBOR) Reform

Following recommendations from the Financial Stability Board there have been various initiatives to replace current benchmark interest rates, such as interbank offered rates like LIBOR, with nearly risk-free rates. In view of these initiatives and the resulting uncertainty around the long-term viability of IBORs, the IASB responded with two separate amendments. The Phase 1 Amendments (effective for years beginning on or after 1 January 2020, but with early application permitted) address the accounting consequences that may arise prior to the replacement of IBORs and the Phase 2 Amendments (effective for years beginning on or after 1 January 2021, but again with early application permitted) address the accounting consequences that arise from changes to contractual cash flows required by the replacement of IBORs.

For a comprehensive discussion the IASB's amendments to IFRS in response to IBOR reform, see *Supplement: IBOR Reform*.

6.2.3 Loan syndications

Large borrowing arrangements for a single borrower are often funded by multiple lenders in a process referred to as 'loan syndication'. In such circumstances the borrower must determine whether this arrangement represents a single loan with a single lender (often referred to as the 'lead lender') who enters into a sub-participation arrangement with the other lenders, or whether the arrangement represents multiple loans with multiple lenders. This determination will affect how changes to the arrangement are considered by the borrower to determine whether they represent a modification of the borrower's financial liability or an extinguishment of the original financial liability and the recognition of a new financial liability.

Where the borrower determines that it has a single loan agreement with a single lead lender, changes to this agreement must be considered by the borrower on an aggregate basis to determine whether the changes represent a modification or an extinguishment. Meanwhile, changes in the composition of the syndicate may not be relevant to the borrower, as long as the lead lender stays the same.

Where the borrower determines that it has multiple loans with multiple lenders, the borrower would consider changes to the borrowing arrangements with each lender separately. If one lender is replaced by a different lender, then the borrower must consider whether the replacement represents an extinguishment of the original loan and its replacement by another.

The assessment will require an analysis of the legal terms of the contract. Factors that need to be considered, individually or in combination, in assessing whether there is a single loan or multiple loans include the following:

- The borrower negotiates loan terms only with the lead lender or with individual lenders within the syndicate.
- The loan terms are identical or differ, depending on the lender.
- Loan repayments are automatically allocated among lenders on a *pro rata* basis, or the borrower may be able to selectively repay amounts to specific lenders within the syndicate.
- The borrower can only renegotiate with the lead lender or may selectively renegotiate loans with individual lenders or subsets of lenders within the syndicate.

  And
- Members of the syndicate may change without the permission of the borrower or such a change may require an amendment to the loan agreement.

6.2.4 Exchange of debt through an intermediary

Where a borrower repurchases a debt from an existing lender and immediately issues new debt to the same lender this is normally considered an exchange and the derecognition assessment will depend on whether the terms of the new and original debt are substantially different (see section 6.2.1 above). However, if a borrower repurchases debt from one or more existing lenders and issues new debt to new (i.e., different) lenders, then the existing debt is derecognised.

Rather than approach the existing lenders directly, a borrower may effect such an exchange through an intermediary (e.g., a bank). In such situations the intermediary might purchase existing debt held by existing lenders, and exchange it for new debt with the borrower, which is then transferred to new lenders shortly afterwards. In these situations, the borrower must determine whether the intermediary is acting as a principal (i.e., as lender) or is acting as an agent of the borrower.

If the intermediary is acting as a principal, then the transaction between the issuer and the intermediary is considered a debt exchange between an existing borrower and existing lender and derecognition is assessed based on whether the terms are substantially different. If the terms are not substantially different the debt is not derecognised.

If the intermediary is acting as an agent, the derecognition is assessed assuming the intermediary does not exist. In other words the borrower will be seen as repurchasing debt from existing lenders (resulting in its derecognition) and issuing new debt to new lenders.

The determination of whether the intermediary is acting as a principal or an agent will depend on the terms of the arrangements and the extent to which the intermediary is exposed to any risks. For example, where the intermediary risks its own funds to acquire the existing debt, is responsible for placing the new debt with new investors and is required to hold any debt that it is unable to sell on, it is more likely to be acting as a principal. Alternatively, if the intermediary does not risk its own funds to any significant degree, for example by agreeing to buy only the debt that it is able to sell on, it is more likely to be acting as an agent.

6.2.5 Costs and fees

An entity will almost always be required to pay fees to the lender and incur costs (such as legal expenses) on an exchange or modification of a financial liability.

If an exchange of debt instruments or modification of terms is accounted for as an extinguishment of the original debt and the recognition of new debt, IFRS 9 requires any costs or fees incurred to be recognised as part of the gain or loss on the extinguishment (see section 6.3 below). *[IFRS 9.B3.3.6A]*.

However, notwithstanding a literal reading of IFRS 9, there may be very limited circumstances when fees or costs associated with the issue of new debt do not need to be included in the gain or loss on extinguishment. Where it is obvious that the fees have not been incurred as part of the modification or exchange and instead are third party costs, which are clearly incremental to the issue of new debt for example payments of taxes or listing fees on the issue of new debt, then an entity may choose to adopt a policy whereby such costs are deducted from the carrying value of the new debt and amortised over its term, as long as the new debt is not classified as held at fair value through profit or loss. Examples of such costs will be limited as they must be clearly separate from costs related to the modification or exchange.

Where the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability. *[IFRS 9.B3.3.6A]*. This is shown in the following Illustration:

Illustration 6-3: Fees and costs incurred on modification of debt not treated as extinguishment

On 1 January 20X0 an entity borrowed CU100 million on, at that time, arm's length market terms, so that interest of 6% was to be paid annually in arrears and the loan repaid in full on 31 December 20X4. Transaction costs of CU4 million were incurred. Assuming that the loan had run to term, the entity would have recorded the following amounts using the effective interest method. The loan is originally recorded at the issue proceeds of CU100 million less transaction costs of CU4 million, and the effective interest rate of 6.975% is determined. For a more detailed discussion of the effective interest method, see Chapter 46 at section 3.

Year	Liability opening balance	Interest at 6.975%	Cash paid	Liability closing balance
	CU m	CU m	CU m	CU m
1.1.20X0	96.00			96.00
20X0	96.00	6.70	(6.00)	96.70
20X1	96.70	6.74	(6.00)	97.44
20X2	97.44	6.80	(6.00)	98.24
20X3	98.24	6.85	(6.00)	99.09
20X4	99.09	6.91	(106.00)	-

During the latter part of 20X1 the entity considers expanding its business in a way that would crystallise the lender's right to demand immediate repayment of the loan because such an action is not permitted under the detailed terms of the loan. Therefore, the entity approaches the lender with a view to amending those terms to permit the planned expansion, but without changing the cash flows on the loan. On 1 January 20X2, the lender agrees to amend the terms in return for which it charges the entity a fee of CU450,000. The entity also incurs directly attributable legal costs of CU50,000, bringing the total fees and costs incurred to CU500,000.

It can be shown that the net present value of the cash flows under the new terms, including the CU0.45 million of fees paid (but excluding the CU0.05 million of legal costs in line with the amendments to IFRS 9 within the

Annual Improvements to IFRS Standards 2018-2020 noted in section 6.2.1 above), discounted at the original effective interest rate is CU97.89 million. This compares to the carrying amount of CU97.44 million and because the remaining cash flows have not changed, the difference between the two simply represents the fees paid. This difference is just 0.46% of the original carrying amount, significantly less than 10%. The entity does not consider the changes to the detailed terms of the loan to be substantial and therefore concludes the modification does not result in the extinguishment of the liability.

Accordingly, the carrying amount of the liability is adjusted by the CU500,000 fees and costs incurred so that the revised carrying amount is CU96.94 million (CU97.44 million less CU0.50 million). In order to amortise this adjustment over the remaining term of the loan, the entity resets the effective interest rate of the loan, in this case to 7.170%, so that it is amortised in accordance with the effective interest method as follows:

Year	Liability opening balance	Interest at 7.169%	Cash paid	Liability closing balance
	CU m	CU m	CU m	CU m
1.1.20X2	96.94			96.94
20X2	96.94	6.95	(6.00)	97.89
20X3	97.89	7.02	(6.00)	98.91
20X4	98.91	7.09	(106.00)	-

It will be necessary to consider whether the substance of the CU0.45m in fees payable is different from its form, e.g., it may be more appropriate to account for a payment that is described as a fee as if it were a modification to the contractual cash flows, for example when the payment represents compensation for the lender's loss of future interest or compensation for increased risk (see section 6.2.6 below).

6.2.6 Modification gains and losses

In Illustration 6-3 in section 6.2.5 above, the remaining cash flows on the loan remained the same after the modification, but in practice they will often change. For example, in the situation set out in Illustration 6-3, if the substance of the CU450,000 fee had actually been a compensation for increased risk, the lender might have equally agreed to charge additional interest of, say, CU170,000 per year for the remaining three-year term of the loan instead of the CU450,000 fee at the time of the modification. Detailed calculations show an almost identical outcome when applying the 10% test to these revised facts, with the net present value of the cash flows under revised terms being CU97.89 million excluding the CU50,000 of legal costs, a difference of CU0.45 million or 0.46%. Again, it would be concluded that the modification does not result in derecognition of the liability.

IFRS 9 requires modifications of financial liabilities that do not result in derecognition to be accounted for similarly to modifications of financial assets (see Chapter 46 at section 3.8.1). The amortised cost of the financial liability is recalculated by computing the present value of estimated future contractual cash flows that are discounted at the financial instrument's original effective interest rate. Any consequent adjustment will be recognised immediately in profit or loss. *[IFRS 9.B5.4.6, IFRS 9.BC4.252, IFRS 9.BC4.253]*.

In the situation discussed above, this would result in the entity recognising a modification loss of CU450,000, being the net present value of the additional interest payable of CU170,000 per annum, discounted at the original effective interest rate of 6.975%.

This is different to the facts in Illustration 6-3 where the fees are assumed not to represent a modification to the contractual cash flows. This example highlights that the accounting treatment for costs and fees paid to the lender is different from that for changes to future cash flows paid to the lender. The former are amortised over the remaining term of the modified liability, the effects of the latter being recognised immediately in profit or loss.

How we see it

Therefore, in our view, it will be necessary to consider in some situations whether the substance of a payment is different from its form, e.g., it may be more appropriate to account for a payment that is described as a fee as if it were a modification to the contractual cash flows, for example when the payment represents compensation for the lender's loss of future interest or compensation for increased risk. This assessment may require some judgement to be applied.

6.2.7 Illustrative examples

Illustration 6-4 and Illustration 6-5 below illustrate some more complex modifications of debt.

Illustration 6-4: Modification of debt not treated as extinguishment

On 1 January 20X7 an entity borrowed CU100 million on, at that time, arm's length market terms, so that interest of 7% was to be paid annually in arrears and the loan repaid in full on 31 December 20X6. Transaction costs of CU5 million were incurred. Assuming that the loan had run to term, the entity would have recorded the following amounts using the effective interest method. The loan is originally recorded at the issue proceeds of CU100 million less transaction costs of CU5 million, and the effective interest rate is 7.736%.

Year	Liability b/f	Interest at 7.736%	Cash paid	Liability c/f
	CU m	CU m	CU m	CU m
1.1.20X7	95.00			95.00
20X7	95.00	7.35	(7.00)	95.35
20X8	95.35	7.38	(7.00)	95.73
20X9	95.73	7.40	(7.00)	96.13
20Y0	96.13	7.44	(7.00)	96.57
20Y1	96.57	7.47	(7.00)	97.04
20Y2	97.04	7.51	(7.00)	97.55
20Y3	97.55	7.55	(7.00)	98.10
20Y4	98.10	7.59	(7.00)	98.69
20Y5	98.69	7.63	(7.00)	99.32
20Y6	99.32	7.68	(107.00)	-

During 20Y1 the entity is in financial difficulties and approaches the lender for a modification of the terms of the loan. These are agreed on 1 January 20Y2, as follows. No cash interest will be payable in 20Y2 or 20Y3, although a fee of CU2 million must be paid to the lender immediately. From 20Y4 onwards interest of 9% on the CU100 million outstanding will be payable annually in arrears and the term of the loan will be extended for two years until 31 December 20Y8. Legal fees and other costs incurred are not material.

The entity is required to compute the present value of the new arrangement using the original effective interest rate of 7.736%. This gives a net present value for the modified debt of CU92.53 million, calculated as follows:

Year	Cash flow	CU m	Discount factor	CU m
1.1.20Y2	Fee	2.00	1	2.00
20Y4	Interest	9.00	$1/1.07736^3$	7.20
20Y5	Interest	9.00	$1/1.07736^4$	6.68
20Y6	Interest	9.00	$1/1.07736^5$	6.20
20Y7	Interest	9.00	$1/1.07736^6$	5.75
20Y8	Interest and principal	109.00	$1/1.07736^7$	64.70
			Total	92.53

This represents 95.4% of the current carrying value of the debt as at the end of 20Y1 of CU97.04 million, so that the net present value of the modified loan (discounted at the effective interest rate of the original loan) is 4.6% different from that of the original loan. This is less than 10%, so that the modification is not automatically required to be treated as an extinguishment under IFRS 9.

As noted in section 6.2.6 above, an entity recognises an immediate gain or loss when the cash flows on a loan are modified and the liability is not derecognised. In this situation this would result in the recognition of a gain of CU6.51 million (CU97.04 million current carrying value less CU90.53 million recalculated net present value, excluding the fees, which as set out in section 6.2.5 above adjust the carrying amount of the liability and are amortised over its remaining term). Allocating the fee based upon the effective interest method would result in an increase in the effective interest rate to 8.1213%.

The adjusted carrying amount of the liability of CU88.53 million (CU90.53 million net present value of cash flows on the borrowing less CU2 million fee) would be accreted using the effective interest method as follows:

Year	Liability b/f	Interest at 8.1213%	Cash paid	Liability c/f
	CU m	CU m	CU m	CU m
20Y2	88.53	7.19	-	95.72
20Y3	95.72	7.77	-	103.49
20Y4	103.49	8.41	(9.00)	102.90
20Y5	102.90	8.36	(9.00)	102.26
20Y6	102.26	8.30	(9.00)	101.56
20Y7	101.56	8.25	(9.00)	100.81
20Y8	100.81	8.19	(109.00)	-

Illustration 6-5: Modification of debt treated as extinguishment

Assume the same facts as in Illustration 6-4 above, except that on 1 January 20Y2 the entity comes to an arrangement with the lender to modify the terms of the loan as follows.

No cash interest will be paid in 20Y2 or 20Y3, although a fee of CU2 million must be paid to the lender immediately. From 20Y4 onwards interest of 12.5% will be paid annually in arrears, and the term of the loan will be extended for three years until 31 December 20Y9. Legal fees and other costs incurred are not material.

As in Illustration 6-4 above, the entity is required to compute the net present value of the new arrangement using the original effective interest rate of 7.736%. This gives a net present value for the modified debt of CU107.3 million calculated as follows:

Year	Cash flow	CU m	Discount factor	CU m
1.1.20Y2	Fee	2.00	1	2.00
20Y4	Interest	12.50	$1/1.07736^3$	10.00
20Y5	Interest	12.50	$1/1.07736^4$	9.28
20Y6	Interest	12.50	$1/1.07736^5$	8.61
20Y7	Interest	12.50	$1/1.07736^6$	7.99
20Y8	Interest	12.50	$1/1.07736^7$	7.42
20Y9	Interest and principal	112.50	$1/1.07736^8$	61.98
			Total	107.28

This represents 110.6% of the current carrying value of the debt as at the end of 20Y1 of CU97.04 million, so that the net present value of the modified loan (discounted at the effective interest rate of the original loan) is 10.6% different from that of the original loan. This is greater than 10%, so the modification is required to be treated as an extinguishment.

This will involve derecognising the existing liability and recognising a new liability. The modified loan must - in accordance with the initial measurement provisions of IFRS 9 (see Chapter 45) - be recognised at fair value and its amortised cost must be based on its own effective interest rate, not that applicable to the original loan.

The fee of CU2 million, which is required to be treated as integral to the cash flows of the modified loan for the purposes of comparing it with the original loan, must be expensed immediately if the test identifies an extinguishment and not be included in the effective interest calculation of the new loan.

The difficulty is obviously in determining the fair value of the modified loan. If the loan was in the form of a quoted bond, a market value might be available. Another possible approach might be to discount the cash flows of the modified loan at the interest rate at which the entity could have issued a new loan on similar terms to the modified loan. However, where (as may well be the case) the modification is being undertaken because the entity is in serious financial difficulty, it might be that no lender would be prepared to advance new finance, so that there are no comparable transactions to derive the borrowing rate from. Nevertheless, IFRS 9 contains no exemption from making an estimate of the fair value of the modified loan, and it would not be appropriate to simply assume that the nominal value of the new loan is the same as its fair value.

If it was assessed that the fair value of the modified loan was CU98 million, the accounting treatment for the modification would be (see also section 6.3 below):

			CU m	CU m
Dr	Original loan		97.04	
Dr	Loss on extinguishment of debt (income statement)		2.96	
	Cr	Modified loan		98.00
	Cr	Cash (fee)		2.00

In this particular case, this has the result that the actual gain or loss recognised (CU2.96 million) is smaller than the difference calculated between the net present value of the original and modified loan that led to the requirement to recognise the gain or loss in the first place, which is CU10.24 million (CU107.28 million - CU97.04 million). This differential will obviously be reflected in higher interest costs as the transaction matures. If the borrower was in financial difficulties, it is possible for the fair value of the modified loan to be significantly below its principal amount, which could give rise to a large profit on modification followed by very high interest charges over the remaining term.

6.2.8 Settlement of financial liability with issue of new equity instrument

A related area is the accounting treatment to be adopted where an entity issues non-convertible debt, but subsequently enters into an agreement with the debt-holder to discharge the liability under the debt in full or in part for an issue of equity instruments. This most often occurs when the entity is in financial difficulties. This topic is now dealt with in IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* which is discussed in Chapter 43 at section 7.

6.3 Gains and losses on extinguishment of debt

When a financial liability (or part of a liability) is extinguished or transferred to another party, IFRS 9 requires the difference between the carrying amount of the transferred financial liability (or part of a liability) and the consideration paid, including any non-cash assets transferred or liabilities assumed, to be recognised in profit or loss. *[IFRS 9.3.3.3]*.

If an entity repurchases only a part of a financial liability, it calculates the carrying value of the part disposed of (and hence the gain or loss on disposal) by allocating the previous carrying amount of the financial liability between the part that continues to be recognised and the part that is derecognised based on the relative fair values of those parts on the date of the repurchase. *[IFRS 9.3.3.4]*. In other words, the carrying amount of the liability is not simply reduced by consideration received.

This is illustrated in Illustration 6-6 below.

Illustration 6-6: Partial derecognition of debt

On 1 January 20X0 an entity issues 500 million CU1 10-year bonds which are traded in the capital markets. Issue costs of CU15 million were incurred and the carrying value of the bonds at 31 December 20X3 is CU490 million. On 31 December 20X3 the entity makes a market purchase of 120 million bonds at their then current market price of CU0.97. The entity records the following accounting entry:

			CU m	CU m
Dr	Bonds (120 ÷ 500 × CU490 million)		117.6	
	Cr	Cash (120 million × CU0.97)		116.4
	Cr	Gain on repurchase of debt		1.2

6.4 Derivatives that can be financial assets or financial liabilities

A derivative which involves two-way payments between parties, i.e., the payments are or could be from and to each of the parties, is derecognised only when it meets both the derecognition criteria for a financial asset and the derecognition criteria for a financial liability. *[IFRS 9.BC6.333]*. In practice, any transfer of such derivatives is likely to require the consent of the counterparty to the entity's legal release from its obligations under the contract, and the possible payment of a fee to compensate the counterparty for the difference between the creditworthiness of the entity and that of the transferee. Such procedures are much closer to those envisaged in the derecognition rules for financial liabilities than those implicit in the derecognition rules for financial assets.

6.5 Supply-chain finance

In December 2020 the IFRS IC finalised an agenda decision on reverse factoring arrangements, in which a financial institution agrees to pay amounts an entity owes to the entity's suppliers and the entity agrees to pay the financial institution at a date later than suppliers are paid. The decision focused on reverse factoring arrangements because the IFRS IC's outreach and research indicated that these are the most common supply-chain financing arrangements. While the decision only mentioned reverse factoring arrangements, it may be appropriate to apply the guidance to other types of supply-chain financing. The IFRS IC concluded that the principles and requirements in IFRS accounting standards provides an adequate basis for an entity to determine the presentation of liabilities that are part of reverse factoring arrangements.

Although the final agenda decision largely addresses presentation, disclosure and cash flow classification matters, it does state that an entity assesses whether and when to derecognise a liability that is (or becomes) part of a reverse factoring arrangement by applying the derecognition requirements in IFRS 9. Derecognition could occur if the purchaser is legally released from its original obligation to the supplier (see section 6.1.2 above) or the terms of the original liability are amended in a way that is considered a substantial modification (see section 6.2.1 above).

In May 2023, the IASB finalised its project on *Supplier Finance Arrangements*, which amended IAS 7 and IFRS 7. These additional disclosure requirements, are discussed in more detail in Chapter 36 at section 4.4.6 and Chapter 50 at section 7.4.3.

7 CUSIP 'netting'

The Committee on Uniform Securities Identification Procedures (CUSIP) number of a security is a unique identification number assigned to all stocks and registered bonds in the United States and Canada. CUSIP 'netting' is the practice whereby the balance of a security held by an entity is reduced by the balance of that same security which the entity has sold, but not yet purchased, a so-called 'short sale'. This practice is applied to ensure that the entity properly reflects its security positions and does not reflect a financial liability to repurchase a security when in fact there is no such obligation. This is based on the definition of a financial liability held for trading which includes "obligations to deliver financial assets borrowed by a short seller (ie an entity that sells financial assets it has borrowed **and does not yet own)"** (emphasis added). *[IFRS 9.BA.7]*.

This practice is based on the assumption that securities with the same CUSIP number are fungible, and therefore, it would not be appropriate to present a long and a short position for the same security. This practice is equally applicable to securities with the same ISIN number, a unique identification number used in other markets.

How we see it

While the practice is referred to as netting, in our view, this is really a recognition question - is it appropriate to recognise long and short positions in the same security at the reporting date? In principle, this is different from the offsetting of separate financial assets and financial liabilities when the offsetting rules within IAS 32.42 to 50 are met as discussed in Chapter 50 at section 7.4.1.

In our view, this practice is generally appropriate, i.e., the long and short positions may be derecognised, particularly where the securities are managed within the same pool of financial assets and financial liabilities, for example where internal security lending arrangements are in place to cover short positions, and both the long and short positions are classified under IFRS 9 as at fair value through profit or loss. Therefore, derecognition is appropriate when securities are managed together within the same trading book.

Where securities are not managed together, for example where the long position is held in the banking book and there is no intention of using this to settle a short position held in the trading book, it would be more challenging to achieve derecognition. In this situation the long position may be classified as at amortised cost or at fair value through other comprehensive income (see Chapter 44 at section 2) and derecognition based on a matching with trading short sale positions would seem to bring into question the business model conclusion. Short sale liabilities are part of the trading liabilities and the reference in the definition to the sale by an entity of "financial assets it has borrowed and does not yet own" would suggest that the focus is on the financial assets also held for trading.

8 Client money

A number of financial institutions and other entities hold money on behalf of clients. The terms on which such money is held can vary widely. In the case of normal deposits with a bank, the bank is free to use the client's money for its own purposes, with the client being protected by the capital requirements imposed by the regulatory authorities. By contrast there are cases (e.g., in the case of certain monies held by legal advisers on behalf of their clients in some jurisdictions) where funds held on behalf of clients must be kept in a bank account completely separate from that of the depositary entity itself, with all interest earned on the account being for the benefit of clients. There are also intermediate situations where, for example:

- Funds are required to be segregated in separate bank accounts but the depositary entity is allowed to retain some or all of the interest on the client accounts.

  Or

- Client funds are allowed to be commingled with those of the depositary entity, but some or all income on the funds must be passed on to clients.

This raises the question of how client monies shall be accounted for in the financial statements prepared in accordance with IFRS accounting standards. There is no specific guidance available and, as a result, it needs to be determined whether the client monies meet the definition of an asset from the Conceptual Framework. In particular, whether the funds are a present economic resource controlled by the entity and have the potential to create future economic benefits *[CF 4.3, CF 4.4]*.

If the entity concludes that the client money should be recognised as an asset, in the absence of specific guidance, the rules for the treatment of funds received under a pass-through arrangement (see section 3.6.2 above) shall be applied.

The types of arrangement to deal with client money are so varied that it is impossible to generalise as to the appropriate treatment. Key considerations include:

- Which party is at risk from the failure of assets, such as bank accounts, in which the client money is held
- The status of the funds in the event of the insolvency of either the reporting entity or its client
- Whether the reporting entity can use the cash for its own purposes as opposed to administering the cash on behalf of the client in its capacity as an agent

  And

- Which party has the benefit of income from the assets

The analysis for the two extreme cases seems relatively straightforward. In the case of a bank deposit (or any arrangement where the entity may freely use client cash for its own benefit), the general recognition criteria of IFRS 9 indicate that an asset and a liability shall be recognised. Conversely, where the entity is required to hold funds on behalf of clients in a bank account completely separate from the entity's own funds, with all interest earned on the account being kept for the benefit of clients, it is hard to see how such funds meet the general definition of an asset under the *Conceptual Framework for Financial Reporting*. Whilst the entity administers such funds in its capacity as an agent on behalf of the client, it can derive no economic benefits from them. The intermediate cases may be harder to deal with.

Sometimes the appropriate analysis will be that the depositary entity enjoys sufficient use of the client money that it must be recognised as an asset with a corresponding liability due to the client. This will be the case, for example, if the client money is commingled with the reporting entity's cash for a short period of time. During this period the reporting entity is exposed to the credit risk associated with the cash and is entitled to all income accruing. Hence, the reporting entity would recognise the cash as an asset and a corresponding liability. If the cash is later moved to a segregated client trust account, an analysis must be performed to determine whether or not the cash and the corresponding liability have to be derecognised from the reporting entity's statement of financial position.

9 Current and future developments

9.1 Modification of financial assets and liabilities

During the PIR of IFRS 9 - Classification and Measurement of financial instruments, the IASB decided not to immediately address feedback received in relation to modification of financial assets and liabilities. Instead, it decided to add a standard-setting project to its research pipeline to clarify the requirements in IFRS 9 at a later stage, namely the 'Amortised Cost Measurement Project'.[20]

The feedback indicated that many respondents consider that the current guidance should be supplemented by further clarifications and additional application guidance. They also expressed a concern about a lack of a clear principle on how to determine when modifications of financial assets result in derecognition, leading to diversity in practice, including significant application, audit and enforcement challenges. Further, it was noted that the requirements in IFRS 9 5.4.3 are less specific that the comparable requirements for financial liabilities.

Similarly, when the IASB received feedback on the interaction between the modification guidance and various components of the impairment model for financial assets during the Post-Implementation Review of IFRS 9 - Impairment, it decided not to address these issues as part of the PIR but consider these as part of the forthcoming Amortised Cost Measurement Project.[21]

At the point of writing, the IASB has given no information on the timing of the Amortised Cost Measurement Project.

9.2 Derecognition of financial assets and liabilities

Sections 3.5 and 6.1 illustrate the amendments that have been made to the IFRS 9's derecognition guidance for financial assets and liabilities as a result of the PIR Classification and Measurement. These amendments shall be applied by entities for annual reporting periods beginning on or after 1 January 2026. Earlier application of the amendments is permitted, subject to local endorsement. *[IFRS 9(2026).7.1.12]*.

The applicable transitional guidance in IFRS 9 explains that the entity applying the amendments is not required to restate prior periods to reflect the application of these amendments. An entity may restate prior periods if, and only if, it is possible to do so without the use of hindsight. If an entity does not restate prior periods, it shall recognise the effect of initially applying these amendments as an adjustment to the opening balance of financial assets and financial liabilities and the cumulative effect, if any, as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application *[IFRS 9(2026).7.2.48]*.

9.3 Annual Improvements to IFRS accounting standards-Derecognition of Lease Liabilities (Amendments to IFRS 9)

In July 2024, the IASB published a narrow-scope amendment regarding the derecognition of lease liabilities recognised by a lessee. In the amendment, they clarified that, when a lessee has determined that a lease liability has been extinguished in accordance with IFRS 9, the lessee is required to apply paragraph 3.3.3 and recognise any resulting gain or loss in profit or loss.

However, the amendment does not address how a lessee distinguishes between a lease modification as defined in IFRS 16 *Leases* and an extinguishment of a lease liability in accordance with IFRS 9. For further guidance on the accounting for lease liabilities, please refer to Chapter 24 Leases.

The amendment applies to annual reporting periods beginning on or after 1 January 2026 and earlier application is permitted, subject to local endorsement.

20 *AP3C Modification of financial assets and financial liabilities and amortised cost measurement and the effective interest method - prioritising PIR findings*, July 2022, available on the IFRS Foundation's website.

21 *IASB Update*, April 2024, available on the IFRS Foundation's website.

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Appendix B - Defined terms

Extract from IFRS standards - Definitions	
derecognition	The removal of a previously recognised financial asset or financial liability from an entity's statement of financial position. *[IFRS 9 Appendix A]*.
derivative	A financial instrument or other contract within the scope of this Standard with all three of the following characteristics. (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying'). (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. (c) it is settled at a future date. *[IFRS 9 Appendix A]*.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. *[IFRS 13 Appendix A]*.
financial asset	**A *financial asset* is any asset that is:** **(a) cash;** **(b) an equity instrument of another entity;** **(c) a contractual right:** **(i) to receive cash or another financial asset from another entity; or** **(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or** **(d) a contract that will or may be settled in the entity's own equity instruments and is:** **(i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or** **(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.** **For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.** *[IAS 32.11]*.
financial guarantee contract	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. *[IFRS 9 Appendix A]*.
financial instrument	**A *financial instrument* is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.** *[IAS 32.11]*.

financial liability	A *financial liability* is any liability that is: (a) a contractual obligation: (i) to deliver cash or another financial asset to another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or (b) a contract that will or may be settled in the entity's own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments. As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D. *[IAS 32.11]*.
modification gain or loss	The amount arising from adjusting the **gross carrying amount of a financial asset** to reflect the renegotiated or modified contractual cash flows. The entity recalculates the gross carrying amount of a financial asset as the present value of the estimated future cash payments or receipts through the expected life of the renegotiated or modified financial asset that are discounted at the financial asset's original **effective interest rate** (or the original **credit-adjusted effective interest rate** for **purchased or originated credit-impaired financial assets**) or, when applicable, the revised **effective interest rate** calculated in accordance with paragraph 6.5.10. When estimating the expected cash flows of a financial asset, an entity shall consider all contractual terms of the financial asset (for example, prepayment, call and similar options) but shall not consider the **expected credit losses**, unless the financial asset is a **purchased or originated credit-impaired financial asset**, in which case an entity shall also consider the initial expected credit losses that were considered when calculating the original **credit-adjusted effective interest rate**. *[IFRS 9 Appendix A]*.
transaction costs	Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see paragraph B5.4.8). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument. *[IFRS 9 Appendix A]*.

Chapter 49 Financial instruments: Hedge accounting

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Overview

This chapter discusses the hedge accounting requirements of IFRS 9 *Financial instruments*.

Most entities undertake some form of risk management, often using derivatives for that purpose. The hedge accounting requirements of IFRS 9 provide additional accounting guidance where financial instruments are transacted for the purpose of risk management. Application of the hedge accounting requirements is voluntary but is often desirable, as the normal IFRS accounting standards might not reflect the risk management in the statement of financial position and/or the statement of profit or loss and other comprehensive income.

This chapter deals with the various criteria that must be met in order to apply hedge accounting, as well as the associated accounting when hedge accounting is applied.

Although entities are still permitted to apply the hedge accounting requirements of IAS 39 *Financial Instruments: Recognition and Measurement*, this chapter only covers the hedge accounting requirements of IFRS 9 in any detail. A summary of the main differences between the IFRS 9 and IAS 39 hedge accounting requirements is however provided.

There are three permitted types of hedge relationships: a fair value hedge, a cash flow hedge and the hedge of a net investment in a foreign operation. In order to apply hedge accounting the hedge relationship must be formally documented up front and must include only eligible hedged item(s) and hedging instrument(s).

The qualification criteria for the application of hedge accounting must be met at inception of the hedge relationship and on an ongoing basis. They include:

- There is an economic relationship between the hedged item(s) and the hedging instrument(s)
- The effect of credit risk does not dominate the value changes that result from that economic relationship

  And
- An appropriate hedge ratio is used

Further, any hedge designation must be directionally consistent with actual risk management.

The application of hedge accounting is incremental to the usual treatment for the hedged item and/or hedging instrument in accordance with IFRS accounting standards. The accounting treatment of financial instruments as required by IFRS 9 is dealt with in earlier chapters. In particular, Chapter 42 deals with derivatives and embedded derivatives and Chapter 46 deals with the subsequent measurement of financial instruments.

The accounting entries for the application of hedge accounting are driven by the change in fair value of the hedging instrument and the change in present value of the hedged item. There is an expectation that such changes in value will largely offset, however to the extent this is not the case, it is likely to result in hedge ineffectiveness being recorded in profit or loss.

What you need to know

- Hedge accounting changes either the accounting for the hedged item or the hedging instrument in order to better represent an entity's risk management activities in the financial statements. It is a requirement that any hedge designations are directionally consistent with the entity's actual risk management.
- This is not to say that in all cases it will be possible to fully reflect risk management, given the strict criteria for application of hedge accounting, such as what qualifies as a hedging instrument or a hedged item to achieve hedge accounting. Meeting the criteria for both the initial and ongoing application of hedge accounting can be complex, in particular where risks have only partially been mitigated.
- The application of hedge accounting is driven by the hedge documentation and can only be applied prospectively. The use of hindsight is not permitted.
- Although the application of hedge accounting may reduce levels of profit or loss volatility from instruments transacted for risk management purposes, such as derivatives, it does not always follow that profit or loss volatility will be eliminated completely. It depends on the existence of any sources of ineffectiveness within the hedge relationship.
- Although the initial application of the hedge accounting requirements is a choice, once that choice is made for a particular transaction it must continue to be applied until the specific criteria for discontinuation are met. Discontinuation of hedge accounting is prospective only.

1 Introduction

1.1 Background

Chapter 40 provides a general background to the development of accounting for financial instruments and notes the fundamental changes that have been experienced in international financial markets. The markets for derivatives, especially, have seen remarkable and continued growth over the past four decades. This reflects the increasing use of such instruments by businesses, commonly to 'hedge' their financial risks. Accordingly, the accounting treatment for derivatives and hedging activities has taken on a high degree of importance.

'Hedging' itself is a much wider topic than hedge accounting and is not the primary subject of this chapter. It is an imprecise term although standard setters frequently describe hedging in terms of designating a hedging instrument that has a value that is expected, wholly or partly, to offset changes in the value or cash flows of a 'hedged position'. In this context, hedged positions normally include those arising from recognised assets and liabilities, contractual commitments and expected, but uncontracted, future transactions. Whilst this could be an appropriate description for many hedges, it does not necessarily capture the essence of all risk management activities involving financial instruments. Nevertheless, it forms the basis for the hedge accounting requirements under IFRS accounting standards.

Differences between the IFRS accounting standards and US GAAP guidance on this topic are not addressed in this chapter as the standards are not converged. Therefore, differences between IFRS accounting standards and US GAAP will exist that are not discussed in this chapter.

1.2 What is hedge accounting?

Every entity is exposed to business risks from its daily operations. Many of those risks have an impact on the cash flows or the value of assets and liabilities, and therefore, ultimately affect profit or loss. In order to manage these risk exposures, companies often enter into derivative contracts (or, less commonly, other financial instruments) to hedge them. Hedging can therefore be seen as a risk management activity in order to change an entity's risk profile.

Applying the default IFRS accounting standards requirements to those risk management activities can result in accounting mismatches when the gains or losses on a hedging instrument are not recognised in the same period(s) and/or in the same place in the financial statements as gains or losses on the hedged exposure. Many believe that the resulting accounting mismatches are not a good representation of those risk management activities. Hedge accounting is often seen as 'correcting' deficiencies in the accounting requirements that would otherwise apply to each leg of the hedge relationship. These deficiencies are an inevitable consequence of using a mixed-measurement model of accounting. Typically, hedge accounting involves recognising gains and losses on a hedging instrument in the same period(s) and in the same place in the financial statements as gains or losses on the hedged position. It could be used in a number of situations, for example to adjust (or correct) for:

Measurement differences

These might arise where the hedge is of a recognised asset or liability that is measured on a different basis to the hedging instrument. An example might be inventory that is recorded in the financial statements at cost, but whose value is hedged by a forward contract that enables inventory of the same nature to be sold at a predetermined price. In this case, both the hedging instrument and the hedged position exist and are recognised in the financial statements, but they are likely to be measured on different bases.

Avoiding the measurement difference could, in this situation, theoretically be achieved in a number of ways. One alternative would be not to recognise unrealised gains or losses on the forward contract, and for realised gains or losses to be deferred (e.g., separately as assets or liabilities or by including them within the carrying amount of the inventory) until the inventory is sold. On the other hand, if unrealised gains or losses on the forward contract were recognised in profit or loss, the measurement basis of the inventory could be changed to reflect changes in its fair value in profit or loss. (See sections 5.1 and 5.2 below for discussion of the permitted designations under IFRS 9).

Performance reporting differences

Even if the measurement bases of the hedging instrument and hedged item are the same, performance reporting differences might arise if gains and losses are reported in a different place in the financial statements. An example might be where an investment in shares is classified as fair value through other comprehensive income (FVOCI) (see Chapter 44 at section 7) and whose value is hedged by a put option. The investment and the put option are both measured at fair value. However, gains or losses on the

investment are recognised in other comprehensive income whilst those on the put option are recognised in profit or loss, therefore resulting in a mismatch in the income statement (or statement of comprehensive income). Similarly, gains or losses on retranslating the net assets of a foreign operation are recorded in other comprehensive income whilst retranslation gains or losses on a foreign currency borrowing used to hedge that net investment are, absent any form of hedge accounting, recorded in profit or loss.

In the case of the FVOCI investment and the put option, hedge accounting might involve reporting gains and losses on the investment in profit or loss, or gains and losses on the put option in other comprehensive income. For the foreign operation, hedge accounting normally involves reporting the retranslation gains and losses on both the borrowing and the foreign operation in other comprehensive income. (See sections 5.3, 7.3 and 7.8 below for discussion of the permitted designations under IFRS 9).

Recognition differences

These might arise where the hedge is of contractual rights or obligations that are not recognised in the financial statements. An example is a foreign currency denominated operating lease held by the lessor, where the unrecognised future contractual lease rentals to be received in another currency are hedged by a series of forward currency contracts (i.e., each receipt is effectively 'fixed' in functional currency terms).

In this case, one solution might be to treat the lease as a 'synthetic' functional currency denominated lease. A similar outcome would be obtained if unrealised gains and losses on each forward contract remained unrecognised or deferred until the accrual of the lease receivables it was hedging. (See section 5.2 below for discussion of the permitted designation under IFRS 9).

Existence differences

These might arise where the hedge is of cash flows arising from an uncontracted future transaction, i.e., a transaction that does not yet exist. An example is a foreign currency denominated sale expected next year that is hedged by a forward currency contract.

Again, a solution to this issue might involve treating the future sale as a 'synthetic' functional currency sale, deferring the gain or loss on the forward contract until the sale is recognised in profit or loss or it might involve not recognising the forward contract until it is settled. (See section 5.2 below for discussion of the permitted designation under IFRS 9).

1.3 Development of hedge accounting standards

The first comprehensive hedge accounting requirements issued by the IASB were contained in IAS 39. Hedge accounting under IAS 39 was often criticised as being complex and rules-based, and thus, ultimately not reflecting an entity's risk management activities. This was unhelpful for preparers and users of the financial statements alike. The IASB took this concern as the starting point of its project for a new hedge accounting model. Consequently, the objective of IFRS 9 is to reflect the effect of an entity's risk management activities in the financial statements. *[IFRS 9.6.1.1]*.

In addition, the financial crisis resulted in a significant amount of political pressure being brought to bear on standard setters in general and the IASB specifically. Responding to this pressure, in April 2009 the IASB announced a detailed six-month timetable for publishing a proposal to replace IAS 39. In order to expedite the replacement of IAS 39, the IASB divided the project into three phases: classification and measurement; amortised cost and impairment of financial assets; and hedge accounting.

In December 2010, the IASB issued the Exposure Draft ('ED' or the exposure draft) *Hedge Accounting*, being the proposals for the third part of IFRS 9. After redeliberating the proposals in 2011, in September 2012 the Board published a draft of *Chapter 6 - Hedge Accounting* - of IFRS 9, together with consequential changes to other parts of IFRS 9 and other IFRS accounting standards (the draft standard). The idea of the draft standard was to enable constituents to familiarise themselves with the new requirements.

Although the IASB did not ask for comments, a number of constituents asked the IASB to clarify certain elements of the draft standard. As a result, the IASB redeliberated some elements of the IFRS 9 hedge accounting requirements in its January 2013 and April 2013 meetings.

This resulted in the third version of IFRS 9, issued in November 2013, which included the new hedge accounting requirements. Finally, in July 2014 the IASB issued the all-encompassing final version of IFRS 9 that includes the new impairment requirements (see Chapter 47) and some amendments to the classification and measurement requirements (see Chapters 44 to Chapter 46). This also involved some minor consequential amendments to the hedge accounting requirements in IFRS 9, mainly because of the introduction of a new category for debt instruments measured at fair value through other comprehensive income with subsequent reclassification adjustments.

IFRS 9 does not provide any particular solutions for so-called 'macro hedge' accounting, the term used to describe the more complex risk management practices used by entities such as banks to manage risk in dynamic portfolios. In May 2012 the Board decided to decouple accounting for macro hedging from IFRS 9, and a separate project was set up to develop an accounting solution for dynamic risk management - the project name adopted by the IASB for an accounting solution for macro hedging. Work is still ongoing for the Dynamic Risk Management project. A discussion paper - *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* - was published in April 2014. No consensus was reached as a result of the discussion paper. The IASB continued to work on developing a model and has completed its initial deliberations on a new model for accounting for dynamic risk management. It is, therefore, now possible to understand, at a high level, how the new model is expected to work. Discussions are ongoing on a number of important topics in advance of the expected Exposure Draft in 2025. See section 10.1 below for more details.

IFRS 9 is effective for periods beginning on or after 1 January 2018 and replaces substantially all of IAS 39, including the hedge accounting requirements. However, given the fact IFRS 9 does not include an accounting solution for dynamic risk management, entities are permitted an accounting policy choice to continue applying the hedge accounting requirements of IAS 39 instead of those in IFRS 9. *[IFRS 9.7.2.21]*. See section 10.2 below.

Furthermore, for a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only for such a hedge), an entity may apply the related hedge accounting requirements in IAS 39 instead of those in IFRS 9. This choice relates only to a fair value portfolio hedge as described in IAS 39.81A and 89A and IAS 39.AG114 to AG132 (see section 10.2 below). *[IFRS 9.6.1.3]*. A decision to continue to apply this IAS 39 guidance is not part of the accounting policy choice to defer IAS 39 mentioned above.

This chapter focuses on the hedge accounting requirements of IFRS 9. The main differences between hedge accounting under IFRS 9 and the hedge accounting requirements in IAS 39 are discussed in section 13 below.

In developing IFRS 9, the IASB decided not to carry forward any of the hedge accounting related Implementation Guidance that accompanied IAS 39. However, the IASB emphasised that not carrying forward the Implementation Guidance did not mean that it had rejected the guidance. Implementation Guidance only accompanies, but is not part of, the standard. *[IFRS 9.BC6.93, IFRS 9.BC6.94, IFRS 9.BC6.95]*. An entity might have relied on particular Implementation Guidance in IAS 39 as an interpretation of the IAS 39 hedge accounting guidance. Accordingly, in many instances, the entity could also interpret the same outcome based on the IFRS 9 hedge accounting guidance - in the absence of contradicting guidance within IFRS 9. Hence much of the Implementation Guidance in IAS 39 remains relevant for the application of IFRS 9.

Accordingly, whilst this chapter predominantly focuses on the guidance included with IFRS 9, on occasion IAS 39 Implementation Guidance is included where this is considered to be relevant and helpful.

1.4 Objective of hedge accounting

The objective of the IFRS 9 hedge accounting requirements is to "represent, in the financial statements, the effect of an entity's risk management activities". The aim of the objective is "to convey the context of hedging instruments for which hedge accounting is applied in order to allow insight into their purpose and effect". *[IFRS 9.6.1.1]*. This is achieved by reducing the accounting mismatch by changing either the measurement or (in the case of certain firm commitments) recognition of the hedged exposure, or the accounting for the hedging instrument, but with some important improvements when compared to IAS 39.

This is a rather broad objective that focuses on an entity's risk management activities and reflects what the Board wanted to achieve with the new accounting requirements. However, this broad objective does not override any of the hedge accounting requirements, which is why the Board noted that hedge accounting is only permitted if all the new qualifying criteria are met (see section 6 below). *[IFRS 9.BC6.82]*.

1.5 Hedge accounting overview

Given the stated objective of IFRS 9 is for hedge accounting to represent an entity's risk management activities where possible, the first step in achieving hedge accounting under IFRS 9 is to identify the relevant risk management strategy and the objective for a particular hedge relationship. These form the foundations for hedge accounting under IFRS 9 (see section 6.2 below).

The standard defines three types of hedge relationships: *[IFRS 9.6.5.2]*

Extract from IFRS 9

6.5.2 There are three types of hedging relationships:

(a) fair value hedge: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.

(b) cash flow hedge: a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable-rate debt) or a highly probable forecast transaction, and could affect profit or loss.

(c) hedge of a net investment in a foreign operation as defined in IAS 21.

[IFRS 9.6.5.2].

Each of these are discussed in turn below (fair value hedges in section 5.1, cash flow hedges in section 5.2, and hedges of a net investment in a foreign operation in section 5.3).

An entity may choose to designate a hedging relationship between a hedging instrument and a hedged item in order to achieve hedge accounting. *[IFRS 9.6.1.2]*. Prior to hedge accounting being applied, all of the following steps must have been completed:

- Identification of eligible hedged item(s) and hedging instrument(s) (see sections 2 and 3 below)
- Identification of an eligible hedged risk (see section 2.2 below)
- Ensuring the hedge relationship meets the definition of one of the permitted types (a fair value, cash flow or net investment hedge) (see section 5 below)
- Satisfying the qualifying criteria for hedge accounting (see section 6 below)

  And
- Formal designation of the hedge relationship (see section 6.3 below)

Once these requirements are met, hedge accounting can be applied prospectively, but the ongoing qualifying criteria and assessments must continue to be met, otherwise hedge accounting will cease. (See section 8 below).

The table below summarises the application of hedge accounting for the three types of hedge relationships:

Figure 1-1: Accounting for hedge relationships

Hedge type	Fair value	Cash flow	Net investment
Hedged item	Carrying amount adjusted for changes in fair value with respect to the hedged risk. Adjusted through profit or loss. (1) (2)	N/A	N/A
Hedging instrument	N/A (2)	No change to carrying amount, but effective portion of change in fair value is recorded in OCI.	No change to carrying amount, but effective portion of change in fair value is recorded in OCI.
Resultant profit or loss	Ineffective portion (2)	Ineffective portion	Ineffective portion

(1) For debt instruments measured at FVOCI, the carrying amount of the hedged item is not adjusted through fair value hedge accounting. However, the changes in fair value with respect to the hedged risk are recorded in P/L instead of OCI.

(2) For equity instruments for which the option to present fair value changes in FVOCI has been taken, the carrying amount of the hedged item is not adjusted through fair value hedge accounting. Changes in fair value remain presented in OCI but the gain or loss on the hedging instruments is recognised in OCI. The ineffective portion of the hedge is also presented in OCI.

As it can be seen from the above, for a fair value hedge, an adjustment is made to the carrying value of the hedged item to reflect the change in value due to the hedged risk, with an offset to profit or loss for the change in value of the hedging instrument. Where the offset is not complete, this will result in ineffectiveness to be recorded in profit or loss (see section 7.4 below).

However, for both a cash flow and net investment hedge, the carrying amount of the hedged item, which for a cash flow hedge might not even yet be recognised, is unchanged. The effect of hedge accounting is to defer the effective portion of the change in value of the hedging instrument in other comprehensive income. Any ineffective portion will remain in profit or loss as ineffectiveness.

See section 7 below for more details on accounting for eligible hedges.

2 Hedged items

2.1 General requirements

The basic requirement for a hedged item is for it to be one of the following:

- A recognised asset or liability
- An unrecognised firm commitment
- A highly probable forecast transaction

  Or
- A net investment in a foreign operation

The hedged item must be reliably measurable and can be a single item, or a group of items (see section 2.5 below). A hedged item can also be a component of such an item(s) (see sections 2.2 and 2.3 below). *[IFRS 9.6.3.1, IFRS 9.6.3.2, IFRS 9.6.3.3]*.

Recognised assets and liabilities can include financial items and non-financial items such as inventory. Most internally-generated intangibles (e.g., for a bank, a core deposit intangible - see section 2.6.7 below) are not recognised assets and therefore cannot be hedged items. However, firm commitments that are not routinely recognised as assets or liabilities absent the effects of hedge accounting for such items, can be eligible hedged items. This would include loan commitments (see Chapter 41 at section 2.5). *[IFRS 9.6.3.1]*.

The term 'highly probable' is not defined in IFRS 9 but is often interpreted to mean a much greater likelihood of happening than 'more likely than not'. The Implementation Guidance within IAS 39 contained some guidance as to how the term highly probable is applied within the context of hedge accounting. This guidance can be considered relevant for IFRS 9 hedge accounting (see section 2.6.1 below).

A net investment in a foreign operation is defined in paragraph 8 of IAS 21 *The Effects of Changes in Foreign Exchange Rates* - to be the amount of the reporting entity's interest in the net assets of that operation (see Chapter 16 at section 6) (see section 5.3.2 below).

An aggregated exposure that is a combination of an exposure that could qualify as a hedged item and a derivative may also be designated as a hedged item (see section 2.7 below). *[IFRS 9.6.3.4]*.

Only assets, liabilities, firm commitments and forecast transactions with an external party qualify for hedge accounting. *[IFRS 9.6.3.5]*. As an exception, a hedge of the foreign currency risk of an intragroup monetary item qualifies for hedge accounting if that foreign currency risk affects consolidated profit or loss (see section 4.3.1 below). In addition, the foreign currency risk of a highly probable forecast intragroup transaction would also qualify as a hedged item if that transaction affects consolidated profit or loss. *[IFRS 9.6.3.6]*. (See section 4.3.2 below).

In the case of a financial liability containing an embedded derivative (see Chapter 42 at section 3), if the embedded derivative is accounted for separately from the host instrument, the hedged item would be the host instrument or components thereof, without regard for the embedded derivative (see sections 2.2 and 2.3 below); basing it on the hybrid instrument (i.e., the instrument including the embedded derivative) or the cash flows from the hybrid is not permitted. This is because derivatives are only permitted as a hedged item as part of an eligible aggregated exposure (see section 2.7 below).

An entity can designate an item in its entirety or a component of an item as the hedged item in a hedging relationship. An entire item comprises all changes in the cash flows or fair value of an item. A component comprises less than the entire fair value change or cash flow variability of an item. In that case an entity may designate only the following types of components (including combinations) as hedged items:

- Changes in the cash flows or fair value of an item attributable to a specific risk or risks (i.e., a risk component), including one sided risks (see section 2.2 below)
- One or more selected contractual cash flows

  And
- Components of a nominal amount, i.e., a specified part of the amount of an item (see section 2.3 below) *[IFRS 9.6.3.7]*

As noted, it is possible to designate a combination of eligible types of components as the hedged item. For example, in a fair value hedge of interest rate risk of a financial asset receiving a fixed rate coupon, it would be possible to designate 50% of the financial asset only for changes in the fair value with respect to a benchmark interest rate. This reflects a hedged item identified by a combination of both a nominal and a risk component, other combinations are also possible.

The reference to one sided risks refers to an ability to designate only changes in the cash flows or fair value of a hedged item above or below a specified price or other variable, or only changes within a specified hedged range. The intrinsic value of a purchased option hedging instrument (assuming that it has the same principal terms as the designated risk), but not its time value, reflects a one-sided risk in a hedged item. For example, an entity can designate the variability of future cash flow outcomes resulting from a price increase of a forecast commodity purchase, without including the risk of a price decrease within the hedge relationship. Such a situation could arise if the entity wanted to retain the opportunity to benefit from a lower commodity price, but protect itself against an increase by buying a call option. In such a situation, only cash flow losses that result from an increase in the price above the specified level are designated. The hedged risk does not include the time value of the purchased option (see section 3.6.4 below). *[IFRS 9.6.3.7(a)]*.

Only the portion of cash flows or fair value of a financial instrument that is designated as the hedged item are subject to the hedge accounting requirements. The accounting for other portions that are not designated as the hedged item remains unchanged. *[IFRS 9.B6.3.11]*.

The guidance also adds that to be eligible for hedge accounting, a risk component must be a separately identifiable component of the financial or non-financial item, and the changes in the cash flows or fair value of the item attributable to changes in that risk component must be reliably measurable. *[IFRS 9.B6.3.8]*. This is considered further in section 2.2 below.

There is no requirement to designate a hedged item only on initial recognition. Designation of hedged items sometime after their initial recognition (e.g., after a previous hedge relationship is discontinued) is permitted if consistent with an entity's risk management activities, although some additional complexity could arise when identifying risk components (see section 2.4.1 below). *[IFRS 9.B6.5.28]*.

2.2 Risk components

2.2.1 General requirements

Instead of hedging the total changes in fair values or cash flows, risk managers often enter into derivatives to hedge only specific risk components. Managing a specific risk component reflects that hedging all risks is often not economical and hence not desirable, or even not possible (because of a lack of suitable hedging instruments).

If designated, the usual hedge accounting requirements apply to a risk component in the same way as they apply to other hedged items that are not risk components. For example, the qualifying criteria apply, including that the hedging relationship must meet the hedge effectiveness requirements, and any hedge ineffectiveness must be measured and recognised, albeit only with respect to the hedged risk, and not the full item (see sections 6 and 7.4 below). *[IFRS 9.B6.3.11, IFRS 9.B6.4.1]*.

IFRS 9 permits an entity to designate a risk component of a financial or non-financial item as the hedged item in a hedging relationship. Designation of a risk component means that only changes in the cash flows or fair value of the hedged item with respect to the designated risk are subject to the hedge accounting requirements. So instead of considering value changes in the hedged item with respect to all risks that are value drivers, only value changes in the hedged item with respect to the designated risk component are considered for hedge accounting purposes. This is valuable as it is common for entities to economically hedge a specific risk within a hedged item rather than its full price risk. The ability to designate risk components in a hedge relationship is an important step in enabling entities to achieve the IASB's objective for hedge accounting, which is to "represent, in the financial statements, the effect of an entity's risk management activities". *[IFRS 9.6.1.1]*.

It should be noted, however, that only eligible risk components can be designated in hedge relationships. IFRS 9 provides guidance on this topic which is discussed in the sections below.

The key requirements for designating a risk component are that:

- A risk component is less than the entire item (see section 2.4 below)
- It must be a separately identifiable component of the item

  And
- The changes in the cash flows or fair value of the item attributable to the changes in that risk component must be reliably measurable *[IFRS 9.B6.3.7, IFRS 9.B6.3.8]*

A risk component can be contractually specified in the contract (see section 2.2.2 below) but non-contractually specified risk components could also be eligible (see section 2.2.3 below). *[IFRS 9.B6.3.10]*.

The IFRS 9 guidance requires that when identifying what risk components qualify for designation as a hedged item, in particular whether they are separately identifiable and reliably measurable, an entity assesses such risk components within the context of the particular market structure to which the risk(s) relate and in which the hedging activity takes place. *[IFRS 9.B6.3.9]*. However, this assessment is particularly relevant for non-contractual risk components, for which it is important to undertake a careful analysis of the specific facts and circumstances of the relevant markets. *[IFRS 9.BC6.176]*.

As noted above, a risk component could be contractually specified, or it could be implicit in the fair value or the cash flows of the item to which the component belongs. *[IFRS 9.B6.3.10]*. However, the mere fact that a physical component is part of the make-up of the whole item does not mean that the component necessarily qualifies as a risk component for hedge accounting purposes. A physical component is neither required nor by itself sufficient to meet the criteria for risk components that are eligible as a hedged item. However, depending on the relevant market structure, a physical component can help meet those criteria. The example of an eligible risk component that is often quoted is that of the crude oil component of refined products such as jet fuel. However, just because rubber is a physical component of car tyres that does not mean that an entity can automatically designate rubber as a risk component in a hedge of forecast tyre purchases or sales, since the price of tyres could be related only indirectly to the price of rubber. Further analysis of the pricing structure of the whole car tyre would be required.

The determination of eligible non-contractually specified risk components is a judgemental area, so it is likely that some diversity in practice exists (see section 2.2.3 below).

It was reaffirmed by the IASB in developing IFRS 9 that it is not considered possible to determine that credit risk is an eligible risk component of a financial item. It was explained that the spread between the risk-free rate and the market rate of interest incorporates credit risk, liquidity, funding and other unidentified risk components and margin elements. Although it is possible to determine that the spread includes credit risk, the credit risk cannot be isolated in a way that would allow the change in fair value that is attributable-solely to credit risk to be separately identifiable. A portion cannot just be a residual, i.e., an entity is not permitted to designate as a portion the residual fair value or cash flows of a hedged item or transaction if that residual does not have a separately measurable effect on the hedged item or transaction. *[IFRS 9.BC6.470, IFRS 9.BC6.517]*. However, IFRS 9 does introduce an alternative accounting solution for entities undertaking economic credit risk hedging activity (see section 11.1 below).

2.2.2 Contractually specified risk components

Potential hedged items such as financial instruments, or purchase or sales agreements could contain clauses that link the contractual cash flows via a specified formula to a benchmark rate or price. The examples below all include a contractually specified risk component:

- The interest rate on a financial instrument contractually linked to a benchmark interest rate plus a fixed incremental spread
- The coupon on a financial instrument contractually linked to an inflation or other financial index plus a determinable incremental spread
- The price of natural gas contractually linked in part to a gas oil benchmark price and in part to a fuel oil benchmark price
- The price of electricity contractually linked in part to a coal benchmark price and in part to transmission charges that include an inflation indexation
- The price of wires contractually linked in part to a copper benchmark price and in part to a variable tolling charge reflecting energy costs

  And
- The price of coffee contractually linked in part to a benchmark price of Arabica coffee and in part to transportation charges that include a diesel price indexation

In each of the above examples, for items other than financial assets (for which embedded derivatives are never separated), it is assumed that the contractual pricing component would not require separation as an embedded derivative (see Chapter 42 at sections 3 and 4).

The Illustration below provides a fuller example of the circumstances under which a contractually specified risk component might usefully be designated in a hedge relationship.

Illustration 2-1: Hedge of a contractually specified risk component - coal supply contract linked to the coal benchmark price and the Baltic Dry Index

An entity purchases coal from its coal supplier under a contract that sets out a variable price for coal linked to the coal benchmark price, represented by futures contracts for coal loaded at the Newcastle Coal Terminal in Australia, plus a logistics charge that is indexed to the Baltic Dry Index, reflecting that the delivery is at an overseas location. The contract sets out minimum purchase quantities for each month covered by its term.

The entity wishes to hedge itself against price changes related to the benchmark coal price but does not want to hedge the price variability resulting from the logistics costs represented by the indexation of the coal contract to the Baltic Dry Index. Therefore, the entity enters into Newcastle coal futures contracts whereby it purchases coal for the relevant delivery months. For each relevant delivery month the entity designates the futures contracts as a hedging instrument in a cash flow hedge of the benchmark coal price risk component of the future coal purchases under its supply contract.

In this case the risk component is contractually specified by the pricing formula in the supply contract. This means it is separately identifiable, because the entity knows exactly which part of the change in the future purchase price of coal under its particular supply contract results from changes in the benchmark price for coal and what part of the price change results from changes in the Baltic Dry Index. The risk component can also be reliably measured using the price in the futures market for the relevant delivery months as inputs for calculating the present value of the cumulative change in the hedged cash flows. An entity could also decide to hedge only its exposure to variability in the coal price that is related to transportation costs. For example, the entity could enter into forward freight agreements and designate them as hedging instruments, with the hedged item being only the variability in the coal price under its supply contract that results from the indexation to the Baltic Dry Index.

When contractually specified, a risk component would usually be considered separately identifiable. *[IFRS 9.BC6.174]*. Further, the risk component element of an index/price formula would usually be referenced to observable data, such as a published index/price index. Therefore, the risk component would most likely also be considered reliably measurable.

Nevertheless, difficulties can still arise where a contractual negative spread exists in the hedged item, as a risk component must be less than the entire item. *[IFRS 9.B6.3.7]*. A negative spread arises when the formula for the contractual coupon/price includes a spread that is subtracted from the hedged risk component, so that the full contractual coupon/price is lower than the identified risk component. This has become termed the 'sub-benchmark rate issue' (discussed in section 2.4 below).

2.2.3 Non-contractually specified risk components

Not all contracts define the various pricing elements and, therefore, specify risk components. In fact, we expect most risk components of financial and non-financial items not to be contractually specified. While it is certainly easier to determine that a risk component is separately identifiable and reliably measurable if it is specified in the contract, IFRS 9 is clear that there is no need for a component to be contractually specified in order to be eligible for hedge accounting. The assessment of whether a risk component qualifies for hedge accounting (i.e., whether it is separately identifiable and reliably measurable) has to be made 'within the context of the particular market structure to which the risk or risks relate and in which the hedging activity takes place'. *[IFRS 9.B6.3.9]*. We understand 'market structure' here to mean the basis upon which market prices are established or the market conventions that are in evidence. Prices are typically established through a number of 'building blocks'. So, for instance, a benchmark interest rate such as SONIA might currently form the first building block in the valuation of a debt instrument (see section 2.2.3.A below), while a benchmark price, such as the LME price for copper, might form the first building block for the pricing of a non-financial item (see section 2.2.3.B below). The 'sub-benchmark' rate issue, (see section 2.4 below) will arise from negative spread building blocks, if as a result the identified non-contractually specified risk component is larger than the full contract itself.

2.2.3.A Non-contractual risk components in financial instruments

It has been common practice to identify a non-contractually specified risk-free interest rate or other benchmark interest rate component of the total interest rate exposure of a fixed rate or zero coupon hedged financial instrument. This approach is supported by an example provided within the application guidance of IFRS 9, presented as Illustration 2-2 below. IAS 39 also provides support for this approach as follows: "for a fixed rate financial instrument hedged for changes in fair value attributable to changes in a risk-free or benchmark rate, the risk-free or benchmark rate is normally regarded as both a separately identifiable component of the financial instrument and reliably measurable". *[IAS 39.AG99F(a)]*.

Illustration 2-2: Identification of a benchmark interest rate component in fixed rate debt

Entity A has issued five-year debt with a fixed coupon of 5%. The debt is issued in an environment with a market in which a large variety of similar debt instruments are compared by their spreads to a benchmark rate (for example SONIA) and variable rate instruments in that environment are typically indexed to that benchmark rate. Interest rate swaps are frequently used to manage interest rate risk on the basis of the benchmark rate, irrespective of the spread on the debt instruments to that benchmark rate. The price of fixed rate debt instruments vary directly in response to changes in that benchmark rate as they happen. Accordingly, Entity A concludes that the benchmark rate is a separately identifiable and reliably measurable risk component of the fixed rate debt. *[IFRS 9.B6.3.10(d)]*.

When the debt was issued, the prevailing five-year benchmark rate was 2%. In pricing the debt, Entity A included an additional spread of 3% above the benchmark rate to reflect credit risk and other factors. Entity A then transacted an interest rate swap at the prevailing five-year benchmark rate (i.e., pay floating benchmark rate, receive 2%). Entity A is able to designate the benchmark interest rate component of the issued debt (i.e., a five-year debt paying a 2% coupon) as the hedged item in a fair value hedge for changes in the benchmark interest rate with the interest rate swap as the hedging instrument.

Whilst in the past LIBOR has often been identified as an eligible risk component of a fixed rate or zero coupon hedged financial instrument, as part of global Interest Rate Benchmark Reform markets have moved away from LIBOR as the predominant benchmark interest rate, replacing it with various Risk Free Rates (RFRs). Accordingly, where LIBOR still exists as a designated risk in a hedge relationship, an assessment will be required as to whether LIBOR continues to meet the separately identifiable criteria within the relevant market structure. The IASB have addressed this and other accounting issues arising from Interest Rate Benchmark Reform, issuing two amendments to IFRS 9, and other impacted standards (see the *Supplement: IBOR Reform* for further discussion).

The example below provides another example of a non-contractually specified risk component of a financial instrument. It also illustrates how the market structure might be used to support the eligibility of the benchmark rate as a risk component for the particular hedged item.

Illustration 2-3: Identification of a benchmark interest rate component in government bonds

Entity XYZ holds Country A government bonds and has chosen to hedge the associated interest rate risk with Country B government bonds futures. Country A and B are part of a group of countries that have integrated economic and political policies, hence it is generally understood that Country A and Country B are strongly linked economically. Furthermore, Country B government bonds are considered to represent a risk free return in the region. Pricing for Country A government bonds is generally performed in relation to Country B government bonds, with an additional spread added to reflect Country A's sovereign credit risk.

Based on the market structure presented above, one might conclude that for Country A government bonds, Country B bond yields represent an eligible risk component as it is a separately identifiable risk component that can be reliably measured.

Although only debt instruments are mentioned in the two Illustrations above, the guidance is also applicable to other financial instruments such as lease receivables or insurance contracts (see section 2.2.7 for discussion on identifying an eligible risk component within insurance contracts).

This section discusses only the possibility of identifying a non-contractual benchmark interest rate as an eligible risk component in a financial instrument. There is no discussion on the possibility of identifying an eligible credit risk component as such a risk component is precluded by IFRS 9 (see section 2.2.1 above).

2.2.3.B Non-contractual risk components in non-financial instruments

An entity might be able to identify a non-contractual component in a non-financial item if within the particular market structure for that item, price negotiations ordinarily reflect a benchmark price plus other charges, similar to the contractual examples listed in section 2.2.2 above, even if this formula is not explicitly stated in the contract. The existence of contractually specified risk components in similar transactions can be a relevant factor in the assessment of the market structure and so help identify risk components when they are not contractually specified.

It could also be possible to identify non-contractually specified risk components in highly probable forecast items that are the subject of a cash flow hedge. Once such forecast items become contractual commitments it is possible that the risk components will be specified in the contract. In this case, if the entity has a past practice of entering into similar contracts, it could be relatively straightforward to demonstrate that a risk component can be identified in the forecast transactions within the context of the market structure.

The following Illustration based on an example from the application guidance of IFRS 9 shows the 'separately identifiable and reliably measurable' assessment.

Illustration 2-4: Hedge of a non-contractually specified risk component - coffee purchases with a benchmark price risk component

An entity purchases a particular quality of coffee of a particular origin from its supplier for the current harvest under a contract that sets out a variable price linked to the benchmark price for coffee. The price is represented by the coffee futures price plus a fixed spread, reflecting the different quality of the coffee purchased compared to the benchmark plus a variable logistics services charge reflecting that the delivery is at a specific manufacturing site of the entity. The fixed spread is set for the current harvest period only. For any deliveries that fall into the next harvest period this type of supply contract is not yet available.

The entity might wish to lock in the benchmark coffee price for future harvests, even though it does not yet have a supply contract. For such hedges of future coffee harvests, the entity analyses the market structure for its coffee supplies, taking into account how the eventual deliveries of coffee that it receives are priced. The entity has an expectation that it will enter into similar supply contracts for each future harvest period once the crop relevant for its particular purchases is known and the spread can be set. In that sense, the knowledge about the pricing under existing supply contracts also informs the entity's analysis of the market structure more widely, including forecast purchases which are not yet contractually specified. This allows the entity to conclude that its exposure to variability of cash flows resulting from changes in the benchmark coffee price is a risk component that is separately identifiable and reliably measurable for forecast coffee purchases that fall into the next harvest period (i.e., prior to the existence of a supply contract), as well as those for the current harvest period which are under a supply contract. *[IFRS 9.B6.3.10(b)]*.

In this case the entity can enter into coffee futures contracts to hedge its exposure to the variability in cash flows from the benchmark coffee price and designate that risk component as the hedged item for harvests for which the pricing is not yet subject to a supply contract. This means that changes in the contractual price due to the variable logistics services charge and future changes in the spread reflecting the quality of the coffee, would be excluded from the hedging relationship.

The assessment of whether a risk component qualifies for hedge accounting is mainly driven by an analysis of whether there are different pricing factors that have a distinguishable effect on the item as a whole (in terms of its fair value or its cash flows). This evaluation would always have to be based on relevant facts and circumstances. While it is probably not necessary that each component of the price of the non-financial item is observable in the market (for instance, transport costs could be specific to a particular transaction), it will be necessary to demonstrate that components that are designated as hedged items do have a distinguishable effect and are not 'drowned out' by the variability of other, unobservable components. For example, it is relatively common for the calculation of fair value of an equity instrument for which there are no observable inputs to include discounting of future cash flows at a market rate of interest. However, it is difficult to conclude that changes in that market rate of interest would have a distinguishable effect on the fair value of the equity instrument. Hence it is very unlikely that interest rate risk would meet the criteria to be an eligible risk component for equity instruments.

The standard uses the refinement of crude oil to jet fuel as an example to demonstrate how the assessment of the market structure could be made to conclude that crude oil in a particular situation is an eligible risk component of jet fuel. *[IFRS 9.B6.3.10(c)]*. Crude oil is a physical input of the most common production process for jet fuel and there is a well-established price relationship between the two. The components of jet fuel will include the price of crude oil and the various 'crack spreads' relating to the refining process, plus possibly transport costs. While there might be no market to measure reliably the crack spreads beyond a certain time horizon, if it can be shown that the market does regard the crude oil price as a building block, and it has a distinguishable effect on the price of jet fuel, then the crude oil component could be designated as the hedged item for longer time periods. Similarly, it could be possible to designate the crack spread, if it can be traded or is otherwise sufficiently observable that it could be regarded as reliably measurable.

Therefore, in order to conclude that benchmark price components are eligible risk components of an item, there is an expectation that any residual building block component would either be relatively stable or else any fluctuations can be explained rationally within the particular market structure (e.g., quality differences or transportation costs). Accordingly, just because the full price of an item approximates to, or is highly correlated with, a particular benchmark price, that will be insufficient on its own to demonstrate that the benchmark price can be identified as a component within the context of the particular market structure.

Extending the example of crude oil, it is also a major input in the production process for plastic. However, the manufacturing process is complex and involves a number of steps. The process starts with crude oil being distilled into its separate 'fractions', of which only one (naphtha) is used for making plastic. Naphtha then undergoes a number of further processes before the various types of plastic are finally produced.

Consequently, any impact of a change in the price of crude oil on the price of plastic is likely to be significantly diluted by the costs of manufacturing and the passage of time.

Generally, the further 'downstream' in the production process an item is, the more difficult it is to find a distinguishable effect of any single pricing factor. The mere fact that a commodity is a major physical input in a production process does not automatically translate into a separately identifiable effect on the price of the item as a whole. For example, the price for pasta at food retailers in the medium to long term also responds to changes in the price for wheat, but there is no distinguishable direct effect from changes in wheat prices on the retail price for pasta, which remains unchanged for longer periods even though wheat prices are likely to change more frequently. If retail prices are only periodically adjusted in a way that directionally reflects the effect of wheat price changes, that is not sufficient to constitute a separately identifiable risk component.

Determining whether non-contractually specified risk components are eligible as hedged items requires judgement. The economic analysis ordinarily undertaken by an entity prior to undertaking risk management activity will most likely form the basis in making this judgement. However, care needs to be taken to ensure the existing economic analysis sufficiently meets the requirements of the standard, that a risk component is separately identifiable and reliably measurable within the relevant market structure. *[IFRS 9.B6.3.8, IFRS 9.B6.3.9]*. Given the judgements involved, diversity in practice could exist as to what are commonly accepted non-contractual risk components and the approach taken to determine their existence, depending on the particular facts and circumstances.

2.2.4 Partial term hedging

A common risk management technique is to hedge a risk for only a partial term for which it is outstanding, as illustrated in Illustration 2-5 below. The example, which is based on the Implementation Guidance of IAS 39, illustrates that a time portion of interest rate risk can be a separately identifiable and reliably measurable risk component of a financial instrument, and remains relevant under IFRS 9. Accordingly, it is possible to designate a financial instrument as a hedged item for the portion of risk that represents only part of the term that a hedged item remains outstanding. However, it is not possible to designate a partial term of a hedging instrument. *[IFRS 9.6.2.4]*.

Illustration 2-5: Partial term hedging

Company A acquires a 10% fixed-rate government bond with a remaining term to maturity of ten years and classifies it as at amortised cost. To hedge against the fair value exposure on the bond associated with the first five years' interest payments, it acquires a five year pay-fixed receive-floating swap.

The swap may be designated as hedging the fair value exposure of the interest rate payments on the government bond until year five and the change in value of the principal payment due at maturity to the extent affected by changes in the yield curve relating to the five years of the swap. *[IAS 39.F.2.17]*.

As the hedged risk is restricted to a partial term, then for effectiveness purposes only changes in the part of the yield curve related to that partial term are relevant in calculating the gain or loss on the hedged item. *[IFRS 9.B6.3.11]*. For effectiveness purposes the part of the yield curve relating to longer maturities is assumed to remain the same. Hence in this fact pattern, six months after initial designation, ineffectiveness would be measured by comparing the difference between the change in value of the hedged cash flows with respect to changes in the yield curve relating to the next four and a half years and the change in the full fair value of the interest rate swap.

Whilst the above Implementation Guidance uses the example of a financial instrument, the same conclusion could be reached for hedging a partial term of a non-financial instrument. For example, an entity might wish to hedge the foreign currency risk for the next three months from a highly probable forecast purchase cash flow in six months' time. The six month forward foreign currency rate is driven by the relationship between spot rates and forward rates for any given yield curve. Furthermore, the market is built on the premise that a six-month forward rate is a combination of the three-month forward rate (i.e., the market rate for months one to three), and the three-month forward forward rate (i.e., the market rate for months four to six). This market structure would appear to support being able to hedge a partial risk component of a highly probable forecast purchase cash flow.

Consistent with other documented risk components, if a partial term hedge is designated, the qualifying criteria apply, including that the hedging relationship must meet the hedge effectiveness requirements, and any hedge ineffectiveness must be measured and recognised, albeit only with respect to the hedged risk (i.e., the designated partial term), and not the full item (see section 2.1 above and sections 6 and 7.4 below). *[IFRS 9.B6.3.11, IFRS 9.B6.4.1]*.

An alternative risk management strategy would be a rollover strategy, i.e., when the maturity of the hedging instrument is intentionally shorter than the maturity of the hedged item, and there is an expectation that on expiry of the original hedging instrument it will be replaced by a new hedging instrument (see section 7.7 below). Applying a rollover strategy is not the same as identifying a risk component and so it is not the same as a partial term hedge.

2.2.5 Foreign currency as a risk component

One risk component that is frequently designated as an eligible risk component is foreign currency risk. *[IFRS 9.BC6.176]*. It is relatively easy to determine that foreign currency risk is a separately identifiable component of a financial instrument denominated in a foreign currency, and that the changes in the cash flows or fair value of the instrument attributable to changes in foreign currency risk are reliably measurable at least for most frequently traded currency pairs.

Similarly, for highly probable forecast foreign currency cash flows in a cash flow hedge, it could be relatively easy to conclude that variation in foreign currency rates does have a distinguishable effect on the hedged cash flows, unless the foreign currency is just a 'settlement currency' (see below). (See section 5.2 below for more discussion on cash flow hedges). Illustration 2-6 below provides an example of a cash flow hedge of highly probable forecast foreign currency cash flows.

It is less straight forward, however, to reach a similar conclusion for non-financial items purchased or sold in a foreign currency that are designated in a fair value hedge (see section 5.1 below for more discussion on fair value hedges). In June 2019,[1] the IFRS IC discussed whether foreign currency risk can be a separately identifiable and reliably measurable risk component of a non-financial asset held for consumption that an entity can designate as the hedged item in a fair value hedge accounting relationship. The IFRS IC confirmed their agenda decision on this topic at the September 2019 meeting.

As part of the discussion, the IFRS IC considered whether an entity could have exposure to foreign currency risk on a non-financial asset that is a separately identifiable and reliably measurable risk component. The IFRS IC concluded that this can be the case, depending on an assessment of the particular facts and circumstances within the context of the particular market structure. The IFRS IC further concluded that this would be the case if at a global level, changes in fair value of the non-financial asset are determined only in one particular currency and that currency is not the entity's functional currency. If the fair value of a non-financial asset is determined in a foreign currency, applying IAS 21 the measure of fair value that could affect profit or loss is the fair value translated into an entity's functional currency (translated fair value). The translated fair value of such a non-financial asset would change as a result of changes in the applicable exchange rate in a given period, even if the fair value (determined in the foreign currency) were to remain constant. For example, as purchases and sales of wide-bodied aircraft are routinely globally determined in US dollars, it might be possible for an entity with a functional currency other than US dollars to identify an eligible foreign currency risk component in a wide-bodied aircraft that it owns (see section 2.6.8 below).

As noted above, the IFRS IC discussion as to whether foreign currency risk is a separately identifiable and reliably measurable risk component of a non-financial asset held for consumption was part of a wider debate on the eligibility of designating such a risk component in a valid hedge relationship. In order to achieve hedge accounting for such a risk component, consideration must also be given to all the qualifying criteria for hedge accounting (see section 6 below) and in particular those discussed by the IFRS IC in June 2019. These include the requirement that the changes in fair value could affect profit or loss and that the relationship is consistent with the entity's actual risk management (see sections 2.6.8, 5.1 and 6.2.1 below). Illustration 2-7 below provides an example of a fair value hedge of inventory for which the price is determined globally in a foreign currency.

Prior to designation of foreign currency risk in a non-financial instrument in a fair value hedge, careful analysis and judgement will likely be required to determine that foreign currency risk is a separately identifiable component of a non-financial instrument for which the changes in the cash flows or fair value of the non-financial asset attributable to changes in that foreign currency risk are reliably measurable.

1 *IFRIC Update*, June 2019, available on the IFRS Foundation's website.

The IFRS IC also noted that the fact that market transactions are commonly settled in a particular currency does not necessarily mean that this is the currency in which the non-financial asset is priced and thus the currency in which its fair value is determined. The currency could be purely a 'settlement currency'. A 'settlement currency' might arise where the price is determined in one foreign currency but settled in another (i.e., the settlement currency) at the prevailing foreign currency rate on settlement. In that instance it is difficult to argue that changes in the foreign currency risk between an entity's functional currency and the settlement currency have a reliably measurable impact on the cash flows or fair value of the hedged item. In fact, it is the foreign currency risk between an entity's functional currency and the currency that drives the pricing of the hedged item that is more likely to be an eligible risk component.

Although the IFRS IC discussion was limited to foreign currency risk in a non-financial instrument in a fair value hedge, the guidance on a settlement currency is also relevant for highly probable forecast foreign currency cash flows.

Accordingly, consideration is required to determine that any 'foreign currency risk' is an eligible risk component in a non-financial instrument or highly probable forecast foreign currency cash flow, and is not merely due to the use of a settlement currency.

Furthermore, although it is not explicit in the standard, it seems reasonable that an entity could identify a risk component of an exposure for risk(s) excluding foreign currency risk. The designation of a foreign currency risk component, and a risk component excluding foreign currency risk for a cash flow hedge and a fair value hedge are both shown in the following Illustrations.

Illustration 2-6: Cash flow hedge of foreign currency denominated commodity risk

Company P has the Rand as its functional currency. It has forecast, with a high probability, the need to purchase a 1,000 barrels quantity of crude oil for US Dollars in twelve months' time. The price of crude oil is routinely denominated in US Dollars globally and so is the currency in which the price of crude oil is determined, hence it is clear that US Dollars are not purely a settlement currency. In that case it appears that both the US Dollar price of crude oil and the Rand to US Dollar exchange rate are each eligible risk components of the forecast purchase of crude oil by Company P.

Scenario 1: designation of a risk component excluding foreign currency risk

To hedge part of its exposure to the price risk inherent in this purchase, P enters into an exchange traded twelve-month cash-settled crude oil forward contract. The price at which the forward is determined is denominated in US dollars (there is no active market in Rand denominated crude oil futures) and P therefore fixes the US dollar price of the 1,000 barrels of oil to be purchased. As part of its risk management assessment P chooses not to hedge the risk associated with Rand to US dollar exchange rates. This might be because of illiquidity in the foreign currency markets for Rand or, perhaps, because P has forecast US dollar inflows that provide a natural hedge of the foreign currency risk.

P could designate the US Dollar crude oil forward contract as the hedging instrument in a cash flow hedge of changes in the US Dollar crude oil price in the highly probable forecast purchase of crude oil (see also Illustration 7.4 in section 7.2.1 below).

Scenario 2: designation of foreign currency as a risk component

To hedge part of the risk associated with Rand to US dollar exchange rates, P could transact a forward foreign currency contract to buy US dollar and sell Rand in twelve months' time. As part of its risk management assessment P chooses not to hedge the US Dollar crude oil price risk associated with the forecast purchase of crude oil. The foreign currency forward contract can be designated as the hedging instrument in a hedge of the foreign currency risk exposure to the US dollar denominated price risk associated with its forecast purchase of crude oil.

The forward foreign currency contract would hedge an amount of US dollars, e.g., USD10,000, so Company P would also need to ensure that it was highly probable that a cash flow of at least USD10,000 will arise from forecast purchases of oil. As P has chosen not to hedge changes in the US Dollar crude oil price, there is a risk that the amount of US Dollars paid on the purchase of the crude oil will be below USD10,000 if the US Dollar price of crude oil has fallen. The likelihood of this scenario will need to be factored into the highly probable assessment and could ultimately restrict the amount of US Dollar cash flows eligible to be designated within the hedge relationship (see section 2.6.1 below).

It is possible that subsequently P may choose to hedge the foreign currency risk in Scenario 1, or the crude oil price risk in Scenario 2 in addition to the existing risk management. The application of hedge accounting for this subsequent risk management activity is likely to require designation of an aggregated exposure which can be complex (see section 2.7.2 below).

Illustration 2-7: Fair value hedge of foreign currency denominated commodity risk

Company X has the euro as its functional currency. It has 1,000 tonnes of Commodity 1 inventory carried at cost as per IAS 2 *Inventories* (see Chapter 23 at section 3). Commodity 1 is routinely denominated in US Dollars globally. Commodity 1 and certain associated derivatives are readily traded in active markets at a US Dollar price.

Scenario 1: designation of a risk component excluding foreign currency risk

As part of its risk management activities Company X wishes to protect the value of its commodity inventory against falls in the US Dollar price of Commodity 1 over a three-month period.

To hedge the fair value risk of the inventory Company X transacts an exchange traded three-month cash-settled commodity forward contract to sell 1,000 tonnes of Commodity 1. The price at which the forward is determined is denominated in US Dollars. X is now protected again changes in the US Dollar fair value of the Commodity 1 inventory for the next three months.

X wishes to designate the commodity forward contract as the hedging instrument in a fair value hedge of the 1,000 tonnes of Commodity 1 inventory.

Although the inventory is carried at cost, fair values changes in the inventory could affect profit or loss when it is sold or written down (see section 5.1 below). *[IAS 39.F.3.6]*.

The fair value of Commodity 1 is based solely on the quoted US dollar price for Commodity 1 globally, and euro/US Dollar foreign currency risk is widely traded. Hence both the US Dollar price and the associated euro/US Dollar foreign currency risk are separately identifiable and reliably measurable risk components of X's Commodity 1 inventory.

X has transacted the commodity forward contract in line with its risk management activities.

In that case X can designate the Commodity 1 forward contract as the hedging instrument in a fair value hedge of changes in the US Dollar fair value of the 1,000 tonnes of Commodity 1 inventory.

Scenario 2: designation of foreign currency as a risk component

To hedge part of the risk associated with euro/US Dollar foreign currency rates arising from the 1,000 tonnes of Commodity 1 inventory, X transacts a forward foreign currency contract to sell US Dollar and buy euros in three months' time. As part of its risk management assessment X chooses not to hedge the US Dollar Commodity 1 price risk associated with the inventory.

Applying the same logic as in Scenario 1 above, euro/US Dollar foreign currency risk is an eligible risk component of the 1,000 tonnes of Commodity 1 inventory and the inventory could be designated as the hedged item within a fair value hedge with the forward foreign currency contract as the hedging instrument.

As the fair value of the Commodity 1 inventory varies due to both the US Dollar commodity price and the associated euro/US Dollar foreign currency risk the forward foreign currency contract would need to be designated as hedging a nominal bottom layer component defined by an amount of US dollars, e.g., USD2,000 (see section 2.3.1 below). There is an additional consideration when hedging the bottom layer in a fair value hedge that tracking of the hedged item to which the fair value hedge adjustment relates is required (see section 2.3.1 below). *[IFRS 9.B6.3.19]*. Since the amount of US dollars is driven by the price of the commodity, a decrease in the price of the commodity could lead to ineffectiveness if the bottom layer is breached.

2.2.6 Inflation as a risk component

A contractually specified inflation risk component of the cash flows of a recognised inflation-linked bond liability (assuming that there is no requirement to account for an embedded derivative separately - see Chapter 42 at section 3) is separately identifiable and reliably measurable, as long as other cash flows of the instrument are not affected by the inflation risk component. *[IFRS 9.B6.3.15]*.

However, IFRS 9 includes a rebuttable presumption that for financial instruments, unless contractually specified, inflation is not separately identifiable and reliably measurable. This means that there are limited cases under which it is possible to identify inflation as a non-contractually specified risk component of a financial instrument and designate that inflation component in a hedging relationship. Similar to other non-contractually specified risk components (see section 2.2.3 above), the analysis would have to be based on the particular circumstances in the respective market, which is, in this case, the debt market. *[IFRS 9.B6.3.9, IFRS 9.B6.3.13]*.

The notion of inflation being a separately identifiable component of a financial instrument is based on economic theory, specifically the Fisher equation, that the real interest rate equals the nominal interest rate minus the expected inflation rate. The equation is more accurately expressed as follows:

$(1 + i) = (1 + r) \times (1 + \pi)$

Where:

i = The nominal interest rate (i.e., the actual interest rate paid)

r = The real interest rate (i.e., the rate of interest after allowing for inflation)

π = The inflation rate

In a sufficiently liquid debt market, it will be possible to demonstrate the existence of the Fisher equation in practice and rebut the presumption that, unless contractually specified, inflation is not separately identifiable and reliably measurable in a financial instrument. The example below, derived from the application guidance of IFRS 9, explains a situation in which the presumption that inflation does not qualify as a risk component of a financial instrument can be rebutted.

Illustration 2-8: Inflation risk as an eligible risk component of a debt instrument

An entity wishes to hedge the inflation risk component of a debt instrument. The debt instrument is issued in a currency and country in which inflation-linked bonds are actively traded in a significant volume. The volume, liquidity and term structure of these inflation-linked bonds allow the computation of a real interest yield curve. This means that for the respective currency, inflation is a relevant factor that is separately considered by the debt markets. This situation supports that inflation is a factor that is separately considered in the debt market in a way that it is a separately identifiable and reliably measurable risk component. *[IFRS 9.B6.3.14]*.

In December 2020 the IFRS IC first considered whether a hedge of the variability in cash flows arising from changes in real rates, rather than nominal interest rates could be accounted for as a cash flow hedge. More specifically, the fact pattern considered was a hedge of a floating rate (LIBOR) debt with an inflation swap (which swaps the variable interest cash flows of the floating rate debt for variable cash flows based on an inflation index). The IFRS IC considered whether the entity can designate the swap in a cash flow hedge relationship as a hedge of the variable interest payments for changes in the real interest rate component. The IFRS IC confirmed its agenda decision in April 2021.[2]

Two key questions arose, both of which are discussed in more detail below:

- Whether that risk component is separately identifiable and reliably measurable as required by IFRS 9.6.3.7(a)

  And

- As a result, whether the entity has exposure to variability in cash flows that is attributable to the real interest rate risk component of the floating rate instrument as required by IFRS 9.6.5.2(b)

The IFRS IC noted that when assessing whether real interest rates are separately identifiable and reliably measurable for floating rate instruments, the relevant market structure is the one in which the floating rate instruments are issued and in which hedging activity will take place. For the market structure to support the eligibility of that risk component in the proposed cash flow hedge relationship, the real interest rate must represent an identifiable pricing element in setting the floating benchmark interest rate, thereby creating separately identifiable and reliably measurable cash flow variability in the floating rate instrument.

The IFRS IC concluded that, because nominal rates generally do not change as a direct result of changes in real interest rates, the existence of a term structure of zero-coupon real interest rates (see Illustration 2-8 above) is not, in itself, sufficient to overcome the rebuttable presumption that inflation (and by association real rates) are separately identifiable and reliably measurable in floating rate debt instruments. *[IFRS 9.B6.3.13]*.

The IFRS IC further noted that cash flows are, by their nature, denominated in nominal terms and that the interest rate for floating rate financial instruments is defined in nominal terms for a given currency. Therefore, the assessment of whether there is any variability in cash flows from floating rate debt due to changes in real rates must also be undertaken on a nominal basis. A nominal interest rate (such as LIBOR) could be influenced by expected inflation and the real interest rate in the long term. However, nominal interest rates do not change as a direct result of changes in inflation or the real interest rate (that is, they are not identifiable pricing elements in setting nominal rates).

2 *IFRIC Update*, April 2021, available on the IFRS Foundation's website.

The IFRS IC therefore concluded that there is no exposure to variability in cash flows that is attributable to changes in the real interest rate in the proposed cash flow hedge relationship and, thus cash flow hedge accounting would be precluded. *[IFRS 9.6.5.2(b)]*.

Consequently, the proposed real interest rate risk component in a hedge of floating rate debt is not an eligible hedged item in cash flow hedge relationship.

Based on this analysis, it is also clear that, although the rebuttable presumption in IFRS 9.B6.3.13 applies to both fair value hedges and cash flow hedges, the example in Illustration 2-8 above illustrates a rebuttal of the presumption in a fair value hedge only.

However, even when considering a rebuttal of the presumption for a fair value hedge there are not many currencies with a liquid market for inflation-linked debt instruments, therefore further limiting the availability of designating non-contractually specified inflation risk components of financial instruments. In addition, even where the presumption is successfully rebutted, the other qualifying criteria must be met in order to apply hedge accounting (see section 6 below). In particular, demonstrating the existence of an economic relationship such that the hedged item and the hedging instrument have values that are generally expected to move in opposite directions could prove challenging, given all the fair value drivers for an inflation derivative. *[IFRS 9.B6.4.4]*.

How we see it

Following the April 2021 final agenda decision of the IFRS IC (see above), and in consideration of the existing rebuttable presumption that inflation is not separately identifiable in a financial instrument unless contractual, coupled with the difficulties of meeting the hedge effectiveness requirements in a fair value hedge of inflation risk (in particular the existence of an economic relationship), it is difficult to identify a fact pattern for which hedge accounting for non-contractual inflation risk in a financial instrument might be achieved.

While IFRS 9 defines in what circumstances inflation can be a risk component for a financial instrument, inflation can be treated as a risk component for non-financial items under IFRS 9 in the same manner as any other risk component (as described in sections 2.2.2 and 2.2.3 above), i.e., the rebuttable presumption described in this section applies only to financial instruments.

2.2.7 Interest rate risk component in an insurance contract

Entities that write longer term insurance contracts (typically life products paying annuities) often use derivatives to manage the interest rate risk they associate with those insurance liabilities. On application of IFRS 17 *Insurance Contracts* (see Chapter 51) insurance entities may be inclined to apply hedge accounting to their interest rate risk management derivatives in order to avoid an accounting mismatch and better represent risk management in their financial statements.

IFRS 9 is silent on the application of hedge accounting to insurance contracts, hence the standard IFRS 9 hedge accounting criteria must be applied, in particular, the guidance on eligible hedged components. In order for a risk component to be eligible, the risk component must be separately identifiable and reliably measurable. This assessment must be made within the context of a particular market structure (see section 2.2.3.A above). *[IFRS 9.B6.3.8, IFRS 9.B6.3.9]*.

IFRS 9 provides guidance on how to determine whether a benchmark interest rate is separately identifiable and reliably measurable component of fixed rate debt within the market structure (see section 2.2.3.A above). *[IFRS 9.B6.3.10(d)]*. This guidance is also relevant in consideration of insurance contracts, however the bespoke and complex features often seen in insurance contracts make the guidance more difficult to interpret in the context of insurance contracts.

Given the wide variety of insurance contracts, and their complex nature arising from various interrelated risk drivers, the assessment of whether a benchmark interest rate risk is eligible as a hedged component of an insurance contract in a fair value hedge will need to be undertaken for the particular facts and circumstances. Consideration as to what is the 'particular market structure' will also be important. Often there is a lack of a clear primary and, possibly, even a secondary market for insurance contracts (i.e., evidence suggests that in many markets, very few sales of insurance contracts occur post origination). Therefore, in some circumstances, it has been suggested that it could be appropriate to interpret 'market structure' as meaning the basis upon which market origination prices are established or the market conventions for fair value determination if such common market practices exist, perhaps driven by regulation. If an eligible benchmark interest rate component exists, there is an expectation it can be demonstrated, within the market structure, that changes in benchmark interest rates do have a determinable impact on the pricing and/or fair values of the particular insurance contracts. This is an area where practice could evolve in the future.

When it has been determined that a benchmark interest rate component does exist within a group of insurance contracts, consideration must be given as to how lapse risk is incorporated into a hedge relationship (lapse risk is the risk that the actual behaviour of policy holders with respect to termination or breaking of insurance contracts is different to the assumptions used in pricing and managing those contracts). Like the identification of an eligible risk component, there will need to be an assessment of the relationship between lapse risk and benchmark interest rate risk within insurance contracts, taking into account the particular facts and circumstances to determine whether lapse risk is driven by changes in benchmark interest rate risk or not. If it is determined that lapse risk is driven by changes in benchmark interest rate risk, it must form part of the fair value adjustment. All the features of the hedged item whose fair value is affected by changes in the hedged risk must be included in the hedge relationship, otherwise the measurement of hedge effectiveness would not include the full fair value change with respect to the hedged risk. *[IFRS 9.BC6.204]*.

Whether or not changes in lapse risk must be incorporated in the remeasurement of the hedged component within a fair value hedge relationship could have a significant impact on the levels of ineffectiveness (see section 7.1.1 below). Lapse risk within a portfolio of insurance contracts is comparable to pre-payment risk in a portfolio of fixed rate prepayable mortgages for interest rate risk management purposes. Despite the fact insurance contracts are outside the scope of IFRS 9, they are typically financial instruments so it makes some sense to apply a parallel treatment to lapse risk in a portfolio of insurance contracts to the treatment of prepayment risk in prepayable fixed rate mortgages within the portfolio fair value hedging guidance in IAS 39 (see section 10 below). In that case if it can be demonstrated that lapse risk is not driven by changes in benchmark interest rate, then changes in lapse risk would not form part of the gain or loss on the hedged risk. *[IAS 39.AG121]*.

If it is determined that lapse risk is not driven by changes in benchmark interest rate risk and so will not form part of the fair value hedge adjustment, changes in lapse risk could still result in a designated hedged item no longer existing. Therefore, there will be a need to track any hedge designations to ensure fair value hedge adjustments are accounted for appropriately, and in particular are released to profit or loss if the hedged item no longer exists (see sections 7.1.2 and 8.3.1 below).

2.3 Components of a nominal amount

2.3.1 General requirement

A component of a nominal amount is a specified part of the amount of an item. *[IFRS 9.6.3.7(c)]*. This could be a proportion of an entire item (such as, 60% of a fixed rate loan of EUR100 million) or a layer component (for example, the 'bottom layer' of EUR60 million of a EUR100 million fixed rate loan that can be prepaid at fair value. 'Bottom layer' here refers to the portion of the loan that will be prepaid last). The type of component changes the accounting outcome. An entity must designate the component for accounting purposes consistently with its risk management objective (see section 6.2 below). *[IFRS 9.B6.3.16, IFRS 9.B6.3.17]*.

A component must be less than the entire item, *[IFRS 9.B6.3.7],* and must be defined in such a way that it is possible to determine whether the usual effectiveness criteria are met and ongoing ineffectiveness can be measured. (See sections 6.4 and 7.4 respectively below).

In particular the need for documented specificity of the hedged item was reiterated by the IFRS IC in March 2019 in a discussion within the context of the Application of the Highly Probable Requirement when a Specific Derivative is Designated as a Hedging Instrument (IFRS 9 and IAS 39).[3] The IFRS IC discussed the application of the highly probable requirement with respect to a specific derivative (a load following swap) designated as a hedging instrument. In a load following swap the notional amount of the derivative designated as a hedging instrument varies depending on the outcome of the hedged item (e.g., forecast energy sales). The IFRS IC observed that forecast sales cannot be specified solely as a percentage of sales during a period because that would lack the required specificity in terms of magnitude and timing (see section 2.6.1 and section 6.3.3 below). It follows that for all hedge designations a known amount or component of hedged item must be identified. This would preclude any designations for which the designated amount or component of the hedged item is contingent, for example on the performance of market rate or indices. It follows that if the notional amount of the hedging derivative varies (e.g., a foreign currency forward contract with notional of CU100m plus an embedded knock in option to increase the notional to CU150m if a particular foreign currency rate is reached) that variability cannot be replicated in the designation of the hedged item.

3 *IFRIC Update*, March 2019, available on the IFRS Foundation's website

Even if the foreign currency forward contract with the embedded knock in option in the example was designated as hedging a known amount of hedged item it is unlikely to be an eligible hedge relationship. Consideration of the existence of an economic relationship and potentially whether the hedging instrument is a net written option could preclude hedge accounting (see sections 3.2.2, 3.6.2 and 6.4.1 below).

An increasingly common example of contracts for which the notional amount may not be known in advance is long term contracts for renewable energy, often referred to as power purchase agreements. These could be either physical power purchase agreements (PPAs) or virtual power purchase agreements (VPPAs). In addition to the issues identified above in cases where the notional amount of the power purchase agreements is not known, achieving hedge accounting for these contracts can be very complex. In 2023 specific questions relating to power purchase agreements were submitted to the IFRS IC and escalated to the IASB. The IASB added a maintenance project to the work plan to explore whether narrow-scope amendments could be made to IFRS 9 to better reflect how financial statements are affected by purchase power agreements. On 8 May 2024, the IASB published the ED, Contracts for Renewable Electricity, Proposed amendments to IFRS 9 and IFRS 7. The ED contains proposed amendments to address how the 'own-use' requirements apply, permit hedge accounting if these contracts are used as hedging instruments, and disclosure requirements to enable investors to understand the effects of these contracts on a company's financial performance and future cash flows (see section 3.2.6.A below).[4]

Nominal layer components are frequently used in risk management activities in practice. For hedge accounting purposes it is possible to designate a layer in a defined, but open, population (see examples (a) and (c) below), or from a defined nominal amount (see examples (b) and (d) below). An open population is one where the items within the population are not restricted to items that already exist. IFRS 9 includes the following examples of layers that could be eligible for hedge designation: *[IFRS 9.B6.3.18]*

Extract from IFRS 9

B6.3.18 A layer component may be specified from a defined, but open, population, or from a defined nominal amount. Examples include:

(a) part of a monetary transaction volume, for example, the next FC10 cash flows from sales denominated in a foreign currency after the first FC20 in March 201X;[5]

(b) a part of a physical volume, for example, the bottom layer, measuring 5 million cubic metres, of the natural gas stored in location XYZ;

(c) a part of a physical or other transaction volume, for example, the first 100 barrels of the oil purchases in June 201X or the first 100 MWh of electricity sales in June 201X; or

(d) a layer from the nominal amount of the hedged item, for example, the last CU80 million of a CU100 million firm commitment, the bottom layer of CU20 million of a CU100 million fixed-rate bond or the top layer of CU30 million from a total amount of CU100 million of fixed rate debt that can be prepaid at fair value (the defined nominal amount is CU100 million).

5 In this Standard monetary amounts are denominated in 'currency units' (CU) and 'foreign currency units' (FC).

[IFRS 9.B6.3.18].

The ability to designate a 'bottom layer' nominal component for a group of forecast cash flows, such as the sale of the first 15,000 units of widgets, used in example (c) above, accommodates the fact that there could be a level of uncertainty as to the quantity of the hedged item. The bottom layer designation means that any uncertainty in forecast cash flows 'above' the bottom layer does not negatively impact the assessment as to whether the bottom layer itself is eligible as a hedged item (i.e., meets the highly probable requirement) (see section 2.6.1 below). However, it would not be possible to designate a 'top layer' nominal component for a group of forecast cash flows, as it is not possible to determine when that top layer occurs, as more forecast cash flows could always follow (see section 6.3.3 below). *[IAS 39.F.3.10]*.

There are additional requirements if a layer is designated within a fair value hedge. An entity must specify it as a portion of a nominal amount, e.g., the top CHF 20 million layer of a CHF 100 million fixed rate liability. Accounting for a fair value hedge requires remeasurement of the hedged item for fair value changes attributable to the hedged risk (see section 7.1.1 below). In addition, that fair value hedge adjustment must be recognised in profit or loss no later than when the hedged item is derecognised (see section 7.1.2 below). Accordingly, it is necessary to track the designated hedged item so it can be determined when the hedged item has been derecognised. Applying this requirement to the example of a top CHF 20 million layer of a CHF 100 million fixed rate liability, the total defined nominal amount of CHF 100 million fixed rate

4 IFRS - Power Purchase Agreements available on the IFRS Foundation's website.

liability must be tracked in order to identify when the specified CHF 20 million top layer is derecognised *[IFRS 9.B6.3.19]*. If it is not possible to define a nominal amount in a way that facilitates tracking of the hedged item to which the fair value hedge adjustment relates, then hedge accounting would be precluded.

Further analysis is also required on the ability to designate layers within a fair value hedge where there is prepayment risk (see section 2.3.2 below).

2.3.2 Layer component for fair value hedges with prepayment risk

Although IFRS 9 allows the designation of layer components from a defined nominal amount as long as it is consistent with an entity's risk management objective (see section 2.3.1 above), there are some additional considerations for fair value hedges where prepayment risk exists. *[IFRS 9.B6.3.18, IFRS 9.B6.3.19]*.

A layer component that includes a prepayment option does not qualify as a hedged item in a fair value hedge if the fair value of the prepayment option is affected by changes in the hedged risk, unless the changes in fair value of the prepayment option as a result of changes in the hedged risk are included when measuring the change in fair value of the hedged item (see Illustration 2-10 below). *[IFRS 9.B6.3.20]*. However, if the hedged item includes a prepayment option such that it is prepayable at fair value, the fair value of the option is not affected by changes in the hedged risk, and hence it would be possible to designate a layer component in a fair value hedge with little or no ineffectiveness due to changes in the fair value of the option when measuring the hedged item (see Illustration 2-9 below).

Illustration 2-9: Hedging a top layer of a loan prepayable at fair value

An entity borrows money by issuing a CU10m five-year fixed rate loan. The entity has a prepayment option to pay back CU5m at fair value. The entity wants to be able to make use of the prepayment option without the amount repayable on early redemption being affected by interest rate changes. Consequently, the entity would like to hedge the fair value interest rate risk of the prepayable part of the loan. The fair value of the prepayment option is not affected by changes in the hedged risk as the layer is prepayable at fair value, hence it is possible to designate the top layer in a fair value hedge of interest rate risk. To achieve this, the entity enters into a five-year receive fixed/pay variable interest rate swap (IRS) with a notional amount of CU5m. The entity designates the IRS in a fair value hedge of the interest rate risk of the CU5m top layer of the loan attributable to the benchmark interest rate. As a result, the top layer is adjusted for changes in the fair value that are attributable to changes in the hedged risk. The bottom layer, which cannot be prepaid and is not hedged, remains at amortised cost.

The gain or loss on the IRS will offset the change in fair value on the top layer attributable to the hedged risk. On prepayment, the fair value hedge adjustment of the top layer is part of the gain or loss from derecognition of a part of the loan as the result of the early repayment.

The situation illustrated by Illustration 2-9 above, of a hedge of a top layer of a loan, would not often be found in practice as most prepayment options in loan agreements allow, in our experience, for prepayment at the nominal amount (instead of at fair value). Moreover, if a financial asset included an option that allowed prepayment at fair value, that would affect the assessment of the characteristics of the contractual cash flows. That assessment is a part of the classification of financial assets and such a prepayment option might not be consistent with payments that are solely principal and interest (see Chapter 44 at section 5.4.4). However, the ability to designate a top layer in a fair value hedge could be helpful when hedging a group of fixed rate readily transferable financial instruments, see section 2.5.2 below.

As already mentioned above, IFRS 9 does not preclude fair value hedge accounting for layers including a prepayment option that are affected by changes in the hedged risk. However, in order to achieve hedge accounting for such a designation, changes in fair value of the prepayment option as a result of changes in the hedged risk have to be included in the assessment of whether the effectiveness requirements are met and when measuring the change in fair value of the hedged item.

Illustration 2-10 illustrates what this means in practice:

Illustration 2-10: Fair value hedge accounting designation using layers with and without prepayment risk

A bank originates a CU10m five-year fixed rate loan with a prepayment option to pay back CU5m at any time at par.

For risk management purposes, the loan is considered together with variable rate borrowings of CU10m. As a result, the bank is exposed to an interest margin risk resulting from the fix-to-floating interest rate mismatch. The bank expects the borrower to prepay CU2m and, therefore, wishes to hedge CU8m only. The bank enters into a five-year pay fixed/receive variable interest rate swap (IRS) with a notional amount of CU8m and designates CU5m of the IRS in a fair value hedge of the benchmark interest rate risk of the CU5m layer of the non-prepayable loan amount. In addition, the bank enters into a five year pay variable/receive fixed interest rate swaption with a notional amount of CU3m that is jointly designated with CU3m of the IRS to hedge the benchmark interest rate risk of the last remaining CU3m of the CU5m prepayable amount of the loan (a bottom layer of the prepayable portion of the loan).

As a result, the CU5m non-prepayable loan amount is adjusted for changes in the fair value attributable to changes in the hedged risk (the fixed rate benchmark interest rate risk of a fixed term instrument). This is also true for the CU3m bottom layer of the prepayable amount, but in addition it must also be adjusted for the effect of changes in the fair value of the prepayment option that exists within the designated CU3m layer, attributable to changes in interest rate risk. The unhedged CU2m top layer remains at amortised cost.

Therefore, the first CU2m of prepayments would have a gain or loss on derecognition determined as the difference between the amortised cost of the prepaid amount and par. For any further prepayments exceeding CU2m, the gain or loss on derecognition would be determined as the difference between the amortised cost including the fair value hedge adjustment and par.

In this case the inclusion of fair value changes in the designated prepayable layer is unlikely to result in ineffectiveness as offset is provided by the CU3m swaption. However, in cases where the prepayment risk is not economically hedged by the hedging instrument, changes in fair value of the prepayment option will lead to ineffectiveness which has the potential to distort the economic relationship. This is discussed in more detail below in Illustration 2-12.

When deciding on which instruments to transact in order to manage the interest rate risk in a prepayable portfolio, an entity will usually consider the likelihood of prepayment in a bottom layer. In particular it will consider whether the risk of prepayment is sufficient to justify the added expense of transacting a hedging instrument that can also be cancelled (e.g., an interest rate swap cancellable at zero cost or an offsetting swaption as described in Illustration 2-10 above). As part of these considerations, it is relatively common that from an economic perspective, an entity might view a bottom layer as having no prepayment risk attached at all and transact a non-cancellable hedging instrument accordingly.

Despite this economic view, the hedge accounting guidance requires consideration of the fair value changes of that bottom layer based on the contractual terms of the hedged item, which would include the prepayment option (see section 7.4.12 below). Hence, for many economic hedges of bottom layers of prepayable hedged items, the changes in the fair values of the hedging instrument and the hedged item will not normally be the same, due to the unit of account required from an accounting perspective. This has the potential to distort the economic relationship between the pre-payable hedged item and the hedging instrument to the extent that hedge accounting might be precluded (see section 6.4.1 below). While it is unlikely that such a risk management objective would be undertaken unless there was an expectation that an economic relationship exists, the existence of the economic relationship would need to be demonstrated, perhaps via the use of a quantitative assessment. Additionally, as the expectation that an economic relationship exists could change over time, especially if the prepayment option looks likely to become in the money, or exercised for any other reason, this expectation would need to be periodically reassessed based on the updated facts and circumstances. Further, any actual ineffectiveness would be measured and recorded in profit or loss (see section 7.4 below).

'Bottom layer' hedging strategies that avoid this source of ineffectiveness can only be applied if the hedged layer is not affected by the prepayment risk. This is best demonstrated by an example (see Illustration 2-11 below).

Illustration 2-11: Hedging a bottom layer (no prepayment risk) of a loan portfolio

A bank holds a portfolio of fixed rate loans with a total nominal amount of CU100m. The borrowers can, at any time during the tenor, prepay 20% of their (original) loan amount at par.

For risk management purposes, the loans are considered together with variable rate borrowings of CU100m. As a result, the bank is exposed to an interest margin risk resulting from the fix-to-floating interest rate mismatch. The bank expects CU20m of loans to be prepaid.

As part of the risk management strategy, the bank decides to hedge a part of the interest margin by entering into a pay fixed/receive variable interest rate swap (IRS). The objective is to hedge 95% of the amount of loans that is not prepayable using an IRS with a notional amount of CU76m (95% of CU80m). The hedged layer does not include a prepayment option. The IRS is designated in a fair value hedge of the interest rate risk of the CU76m bottom layer of the CU100m loan portfolio.

As a result, the bottom layer is adjusted for changes in the fair value attributable to changes in the hedged risk (i.e., benchmark interest rate risk). The extent to which the borrowers exercise their prepayment option (i.e., up to 20% of the original loan) does not affect the hedging relationship. Also, if the bank were to derecognise any of the loans for any other reason, the first CU4m of non-prepayable amount of derecognised loans would not be part of the hedged item (i.e., the CU76m bottom layer). However, if the nominal amount of the loan fell below CU76m, this would start to affect the hedging relationship.

Therefore, while IFRS 9 provides an effective solution for portfolios that feature a bottom layer that is not prepayable, as shown in Illustration 2-11 above, it does not provide an answer for portfolios that are fully prepayable at amount other than at fair value (for example, a residential fixed rate mortgage portfolio). The IASB decided to address hedging of such portfolios in its separate macro hedging project (see section 10 below). Until that project is finalised, entities are allowed to apply the portfolio fair value hedging guidance in IAS 39. *[IFRS 9.6.1.3]*.

Given the current lack of an effective hedge accounting solution within IFRS 9 for portfolios that feature a bottom layer that is prepayable, it is not uncommon for entities to consider alternative 'proxy' hedge accounting designations (see section 6.2.1 below). For example, an entity wishing to hedge an economic bottom layer within a group of items prepayable at par within a fair value hedge could identify specific items within the group (and designate those items only) or designate a percentage of the total as the hedged item. However, it is unlikely that an entity would choose to designate a hedge either way, as both these approaches are still likely to result in ineffectiveness. If specific items within the group were designated in a fair value hedge, and those specific items prepaid, then the designated hedged item would no longer exist, even if there was sufficient 'non-designated' items within the group to cover the amount designated. The issues arising from designation of a proportion are best explained with an example (see Illustration 2-12 below).

Illustration 2-12: Hedging a proportion of a prepayable loan portfolio

A bank holds a portfolio of fixed rate loans with a total nominal amount of CU100m. The borrowers can, at any time, prepay all of their (original) loan amount at par, plus an exit fee. The bank only expects 20% of the original loan amount to be prepaid before maturity.

For risk management purposes, the loans are considered together with variable rate borrowings of CU100m. As a result, the bank is exposed to an interest margin risk resulting from the fix-to-floating interest rate mismatch. The bank expects CU20m of loans to be prepaid.

As part of the risk management strategy, the bank decides to hedge the interest margin by entering into a pay fixed/receive variable interest rate swap (IRS). The objective is to hedge the amount of loans that they do not expect to prepay using an IRS with a notional amount of CU80m. The IRS is designated as a fair value hedge of 80% of the CU100m loan portfolio.

After two years, loans of CU10m are prepaid, which is less than 20% and therefore does not affect the economic hedge in place. However, because of the proportionate designation, this is considered a reduction in the hedged amount for hedge accounting purposes. As a result, the entity now has an IRS of CU80m designated as a hedge of loans of CU72m ([CU100m - CU10m] × 80%), which will inevitably lead to some ineffectiveness.

Another source of ineffectiveness will be fair value changes attributable to the embedded prepayment option within the loan portfolio, excluding changes in fair value of the embedded prepayment option that clearly arise from factors others than the change in hedged interest rate (see section 7.4.12 below).

A more common approach is for an entity hedging a bottom layer for risk management purposes is to use what is referred to as a proxy hedge, in which the hedged item might be floating rate liabilities and designate the derivatives as hedging them within a cash flow hedge (see section 6.2.1 below). This avoids the inclusion of fair value changes of the embedded prepayment option in the fixed rate loans as a source of potential ineffectiveness, but it does require the identification of sufficient suitable floating rate liabilities.

2.4 The 'sub-benchmark rate issue'

Some financial institutions are able to raise funding at interest rates that are below a benchmark interest rate (e.g., benchmark interest rate minus 15 basis points (bp)). In such a scenario, the entity might wish to remove the variability in future cash flows caused by movements in the benchmark interest rate. IFRS 9 does not allow the designation of a 'full' benchmark risk component (i.e., benchmark rate flat) in this situation, as a component cannot be more than the total cash flows of the entire item. Although historically this is often referred to as the 'sub-LIBOR issue' it is not specific to LIBOR. It will remain an issue for any funding raised below a benchmark rate even now the global Interest Rate Benchmark Reform forced markets to move away from LIBOR as the predominant benchmark interest rate (see the *Supplement: IBOR Reform*). However, as the risk-free rates that will replace LIBOR include a much smaller credit spread, the issue will become much less common in future. *[IFRS 9.B6.3.21, IFRS 9.B6.3.22]*.

Part of the reason for this restriction is that a contractual interest rate is often 'floored' at zero, so that interest will never become negative. The existence of floors can result in accounting and economic outcomes that are inconsistent with hedge accounting. For example, Entity B issues debt at a benchmark rate minus 15bp, but the interest payable is floored at zero. Entity B also enters into a benchmark rate hedging swap with the aim of removing the variability in future cash flows with respect to the benchmark rate, locking in an interest margin. Unless the hedging swap similarly has a floor, then if the benchmark rate decreases below 15bp this would cause cash flow variability for the hedging swap but not for the hedged item. Permitting the designation of a benchmark rate risk component in the hedged item and ignoring the effect of the floor on the variability of the interest cash flows would inappropriately defer hedge ineffectiveness (see section 7.4 below). Consequently, any designated component has to be less than or equal to the cash flows of the entire item. *[IFRS 9.B6.3.21, IFRS 9.BC6.225, IFRS 9.BC6.226, IFRS 9.BC6.227, IFRS 9.BC6.228]*.

In this scenario, the entity could instead designate, as the hedged item, the variability in cash flows of the entire liability (or a proportion of it), but only for changes attributable to the benchmark rate. *[IFRS 9.B6.3.24]*. Such a designation excludes any ineffectiveness from changes in the credit risk specific to the borrower, as these are excluded from the hedge relationship, however it will not be perfectly effective. Ineffectiveness could arise as follows in the hedge designation described above:

- For financial instruments that have an interest rate floor of zero in situations in which the forward curve for a part of the remaining hedged term is below 15 basis points. This is because the hedged item will have less variability in cash flows as a result of interest rate changes than a swap without such a floor. In fact, an expectation that the benchmark rate will consistently be below 15 basis points could cause the hedge relationship to fail the effectiveness criteria as there is no economic relationship between the hedged item and hedging instrument. This would preclude hedge accounting entirely (see section 6.4.1 below).

  However, if the benchmark rate is above 15 basis points and is not expected to go below it, this source of ineffectiveness would not be expected to arise. The hedged item will have the same cash flow variability as a liability without a floor.
- Ineffectiveness is also likely to occur for example from changes in the time value of the embedded floor in the hedged item, as no offset will arise from the fair value changes of a swap without a floor (see section 7.4.12 below).
- Even if the variability of cash flows in the hedged item and hedging instrument might be the same, the absolute cash flows are not, due to the inclusion of the negative spread in the hedged item. Accordingly, the discounted cash flows will not perfectly offset (see section 7.4 below).
- The discount curve used to discount the hedged cash flows needs to be based on a benchmark rate (see section 7.4.5 below). However, there is a choice between discounting the hedged cash flows at the benchmark rate or at the benchmark rate minus the negative credit spread (15 basis points in the example above), as the guidance is not prescriptive. The negative credit spread would not be updated for changes in the borrower's credit risk as that risk is excluded from the hedge relationship. This is consistent with the general hedge accounting approach of calculating a change in the present value of the hedged item with respect to the hedged risk and not a full fair value. The second option for discounting could improve effectiveness but some ongoing ineffectiveness is likely to remain (see section 7.4 below).

The prohibition on identifying a benchmark rate risk component in a variable instrument priced at a sub-benchmark rate (i.e., a benchmark rate minus a spread) as outlined above, has also some relevance for fixed rate instruments. Let us consider a fixed rate item that is originally priced based on a benchmark rate minus a spread, for example, a fixed-rate financial liability for which the contractual interest rate is initially fixed at 100 basis points below the benchmark rate. It would not be possible to identify the hedged item as having fixed interest cash flows equal to the benchmark, however an entity can designate as the hedged item the entire liability (i.e., principal plus interest equal to the benchmark rate minus 100 basis points) for changes in value attributable to changes in the benchmark rate. *[IFRS 9.B6.3.23]*.

The negative interest rate environment in some countries has further implications on the designation of risk components in connection with the sub-benchmark issue (see section 2.4.2 below).

While the example in the standard uses LIBOR as the benchmark rate component, it is clear that the requirement relates not just to financial items in general, but is a general prohibition on the cash flows of hedged risk components being larger than the cash flows of the entire hedged item. This means that the sub-LIBOR issue is also applicable to non-financial items where the contract price is linked to a benchmark price minus a differential. This is best demonstrated using an example derived from the application guidance of IFRS 9 (see Illustration 2-13 below).

Illustration 2-13: Sub-benchmark rate issue - selling crude oil at below benchmark price

An entity has a long-term sales contract to sell crude oil of a specific quality to a specified location. The contract includes a clause that sets the price per barrel at West Texas Intermediate (WTI) minus USD10 with a minimum price of USD30. The entity wishes to hedge the WTI benchmark price risk by entering into a WTI future. As outlined above, the entity cannot designate a 'full' WTI component, i.e., a WTI component that ignores the price differential and the minimum price.

However, the entity could designate the WTI future as a hedge of the entire cash flow variability under the sales contract that is attributable to the change in the benchmark price. When doing so, the hedged item would have the same cash flow variability as a sale of crude oil at the WTI price (or above), as long as the forward price for the remaining hedged term does not fall below USD40. *[IFRS 9.B6.3.25]*.

Where the hedged item has the same cash flow variability as the hedging instrument there could be an expectation that the hedge relationship will meet the effectiveness criteria. However, any ineffectiveness needs to be measured and recorded in profit or loss (see section 7.4 below).

In some cases, the contract price might not be defined as a benchmark price minus a fixed differential but as a benchmark price plus a pricing differential (the 'basis spread') that is sometimes positive and sometimes negative. The market structure could reveal that items are priced that way and there might even be derivatives available for the basis spread (i.e., basis swaps, for example the benchmark gas oil crack spread derivative which is a derivative for the price differential between crude oil and gas oil which reflects the refining margin *[IFRS 9.B6.3.10(c)(i)]*). Similar to Illustration 2-13 above, an entity could not designate the benchmark price component as the hedged item given that the cash flows of the benchmark price component could be more than the total cash flows of the entire item. Unfortunately, the standard does not provide any guidance as to how an entity might assess whether the basis spread could be negative or not. For example, it is not clear whether an entity is only required to look at the forward benchmark prices or whether it is required to consider all reasonably possible scenarios. The use of 'reasonably possible scenarios' in other places in IFRS 9 might indicate the latter.

A related question is whether the entity could designate the entire cash flow variability that is attributable to changes in only the benchmark price risk (as the entity alternatively does as shown in Illustration 2-13 above) if that risk is a non-contractually specified risk component. This assessment is likely to be similar to whether a non-contractually specified risk component is separately identifiable and reliably measurable (as outlined in section 2.2.3 above), which would be required in order to determine the variability of the entire cash flows with respect to changes in the benchmark price.

However, the presence of a spread that is sometimes negative could make this assessment more difficult. An entity needs to prove that the benchmark price cash flows plus or minus the spread make up the total cash flows. This might be the case, for example, if it can be proven that there are quality differences, such that the benchmark price is sometimes of better quality and sometimes worse than the hedged exposure. On the other hand, if the basis spread switches between positive and negative because of individual supply and demand drivers of either the benchmark price or the price of the hedged exposure, this could indicate that the benchmark price is not implicit in the fair value or cash flows of the hedged exposure. To illustrate this with an example, we could take WTI and Brent crude oil prices. While both prices might be highly correlated, WTI could not be identified as a benchmark price component in Brent because both prices have their own supply and demand drivers. Furthermore, it would not be possible to

determine whether either WTI is a risk component of Brent or *vice versa*, which demonstrates that there is no risk component that can be designated in a hedge relationship. In that case, hedge accounting would only be permitted if the full cash flows were designated for all changes in the contract price, and assuming the other eligibility requirements are met.

2.4.1 Late hedges of benchmark rate portions of fixed rate instruments

There is no requirement in IFRS 9 for hedge accounting to be designated on initial recognition of either the hedged item or the hedging instrument. *[IFRS 9.B6.5.28]*. In particular, it is not uncommon for risk management and/or hedge accounting to be applied sometime after initial recognition of the hedged item. This is often referred to as a 'late hedge'. There is no additional guidance in IFRS 9 on how to apply hedge accounting to 'late hedges' over and above the usual criteria. However, the identification of eligible risk components in fixed rate hedged items in late hedges can be problematic.

An example of the difficulties of such a designation is discussed in the application guidance to IFRS 9 with respect to a fixed rate financial instrument that is hedged sometime after its origination using an on market derivative, and interest rates have changed in the meantime, such that the fixed rate on the instrument is now below the benchmark rate i.e., the fixed rate in the hedging derivative. Despite the requirement for risk components to be less than or equal to the total cash flows of the entire item, in this case it could be possible for the entity to designate a risk component equal to the benchmark rate that is higher than the contractual rate paid on the item. This is provided that the benchmark rate is still less than the effective interest rate (yield) calculated as if the instrument had been purchased on the day it was first designated as the hedged item. *[IFRS 9.B6.3.21, IFRS 9.B6.3.23]*. This is illustrated below.

Illustration 2-14: Hedge of a portion of an existing fixed rate financial asset following a rise in interest rates

Company B originates a fixed rate financial asset of CU100 that has an effective interest rate of 6% at a time when the benchmark rate is 4%. B begins to hedge that asset sometime later using an on market derivative when the benchmark rate has increased to 8% and the fair value of the asset has decreased to CU90 (reflecting an effective yield of 9.5%). The asset matures in four years' time. The future annual cash flows on the financial asset are given below.

	1	2	3	4
Future cash flows on existing fixed rate financial asset	CU6	CU6	CU6	CU106

Because the current benchmark rate of 8% is less than this current effective yield of 9.5%, the entity can designate a benchmark rate component of 8% as a risk component of the 9.5% effective yield. If the entity does designate a benchmark rate component of 8%, the hedged cash flows will consist partly of the contractual interest cash flows and partly of the difference between the net present value discounted at the hedged risk of 8% (CU93) and the amount repayable on maturity (CU100). *[IFRS 9.B6.3.23]*. This is further demonstrated in the table below.

Effective Yield	Asset calculation basis	Asset value
Original EIR at 6%	Amortised cost	CU100
Current effective yield at 9.5%	Current fair value	CU90
Hedged risk at 8%	Net present value of the hedged item discounted at 8%	CU93

The guidance illustrated in Illustration 2-14 above will assist entities in designating hedges in a way that significantly reduces ineffectiveness. However, some ineffectiveness is still likely to arise if the hedging instrument has a fixed rate that reflects the 8% benchmark rate. This is because the timing of the 8% cash flows from the hedging instrument (i.e., an interest rate swap with a fixed leg at 8%) is unlikely to match fully the timing of the hedged cash flows, which are represented by the actual future contractual coupons (e.g., 6%) and an amount of principal payable on maturity.

It is also not uncommon for an existing derivative to be designated as a hedging instrument of new or existing fixed rate hedged items. It is likely that the existing hedging instrument will have a non-zero fair value on designation and will have a fixed rate that is different to the prevailing benchmark rate for the remaining term of the hedged item.

The ability to designate a risk component and/or a nominal amount of the fixed rate hedged item can be helpful in achieving fair value hedge accounting. *[IFRS 9.6.3.7]*. This is illustrated below.

Illustration 2-15: Hedge of a portion of a fixed rate financial liability with an existing derivative with a non-zero fair value

Company C issues new debt of CU200m fixed rate debt at par, the pricing of which was determined based on the prevailing benchmark rate of 1.5%, plus a credit spread of 200bp resulting in a fixed coupon of 3.5%. Company C identifies an existing CU200m receive fixed 2%, pay floating interest rate swap with the same residual maturity as the issued debt. The existing swap enables Company C to reduce the variability in the fair value of the issued debt with respect to the benchmark rate, consistent with their risk management.

The benchmark rate is a separately identifiable and reliably measurable risk component of the fixed rate debt, considering the market structure within which it was issued (see section 2.2.3.A above). Hence it is possible for Company C to designate the fair value hedge with respect only to changes in the benchmark rate.

It is also possible for Company C to identify a nominal component of the fixed rate debt, i.e., a specified part of the fixed rate debt (see section 2.3.1 above). *[IFRS 9.6.3.7(c)]*. In that case Company C could choose to designate the hedged item to be the full CU200m principal of the fixed rate debt, but only an amount equivalent to a 2% coupon of each actual fixed rate 3.5% interest coupon, for changes in fair value with respect to the benchmark rate.

Such a strategy has the benefit of improving offset of fair value changes in both the hedged item and the hedging instrument due to the benchmark rate, as both have a fixed rate of 2%. This could result in lower levels of ineffectiveness.

However, as fair value hedge accounting for the hedged item only reflects the cumulative fair value changes with respect to the hedged risk since designation, care would need to be taken to ensure an appropriate amortisation approach was applied such that the fair value hedge adjustment is fully amortised by maturity of the hedge relationship (see section 7.1.2 below).

This approach is only possible because the fixed rate on the interest rate swap (i.e., 2%) is less than the actual coupon on the fixed rate debt (i.e., 3.5%). If the swap rate was higher (e.g., 4%) then it would not be possible to designate the full CU200m principal of the fixed rate debt plus a 4% coupon as the hedged item, as any designated component has to be less than or equal to the cash flows of the entire item. *[IFRS 9.B6.3.21]*.

Company C could instead choose to designate the hedged item to be the full CU200m principal of the fixed rate debt but with an amount equivalent to a 1.5% coupon (i.e., the prevailing benchmark rate) for changes in fair value with respect to the benchmark rate. In that case some ineffectiveness would arise but the amortisation of the fair value hedge adjustment over the life of the hedge relationship is simpler.

This designation strategy would not work if hedging a floating rate instrument with an existing derivative with a non-zero fair value as it is not possible to identify an off-market risk component in a cash flow hedge to match an off-market hedging instrument (see section 7.4.3 below).

2.4.2 Negative interest rates

Some countries have, or have had negative interest rate environments, for example Switzerland, Japan and certain countries in the Eurozone. The requirements in consideration of whether a benchmark rate is an eligible risk component in a financial instrument are the same irrespective of whether the benchmark rate is positive or negative (see sections 2.2.2 and 2.2.3.A above). The following Illustration shows this for a fair value hedge.

Illustration 2-16: Negative interest rates and fair value hedges

Assume the following scenarios:

(a) Bank A enters into a €1 million loan to a corporate at a fixed coupon of 3.5%. The coupon has been determined considering the negative Euro Short-Term Rate (€STR) rate (the benchmark rate) of minus 0.15% plus a credit spread of 3.65%.

(b) Bank B acquires debt securities in the secondary market, issued by a highly rated corporate entity, with a €1 million notional and fixed coupon of 3.5%. In this fact pattern the debt was issued some years ago when benchmark interest rates were much higher. The purchase price of the debt is €1.185 million which results in an effective interest rate of minus 0.18%, consisting of the negative €STR rate (the benchmark rate) when the debt is acquired of minus 0.15% and a credit spread of minus 0.03%.

Both Bank A and Bank B want to hedge the fixed rate benchmark rate component and each enter into an interest rate swap with a €1 million principal, paying fixed minus 0.15% and receiving €STR. The banks wish to designate the benchmark rate component in a fair value hedge for changes in €STR.

In scenario a) it seems acceptable for the bank to designate the benchmark rate risk component because:

- It is included in the pricing of the hedged item and is thought to meet the separately identifiable and reliably measurable criteria (see section 2.2.3.A above).
- The benchmark rate can be positive or negative, therefore the cash flows representing that benchmark rate can also be positive or negative, even if they are part of overall positive cash flows (which is similar to a benchmark rate component of 4% hedging the benchmark rate risk in a coupon of 5%, except that the benchmark rate is negative in this case).

  And

- The benchmark rate cash flows are less than the cash flows in the hedged items (i.e., minus 0.15% which is less than 3.5%).

We would find it difficult to reach the same conclusion for scenario b) as the benchmark rate is higher than the effective interest rate (i.e., minus 0.15% which is greater than minus 0.18%). *[IFRS 9.B6.3.23]*. This is consistent with the fact that if a debt instrument were to be issued at par bearing a coupon of minus 0.18%, which included a credit spread of minus 0.03% when the benchmark rate was minus 0.15%, it would not be possible to identify a benchmark rate component for hedge accounting purposes. *[IFRS 9.B6.3.21]*.

In both scenarios, the banks would not be permitted to designate a payment of minus 0.15% of the principal as an eligible component of a receipt of a 3.5% coupon. *[IFRS 9.6.3.7(b)]*. This is because it is difficult to argue that a payment of a negative 0.15% of the principal is a portion of a receipt of 3.5% of that principal. However, this is not that relevant in scenario a) as it would be possible to designate a separately identifiable benchmark rate component in the total cash flows, as noted above.

Notwithstanding the above, in both cases, the banks can designate all the cash flows in the financial asset for changes in the benchmark rate, although this is likely to result in some ineffectiveness. *[IFRS 9.B6.3.21]*.

Illustration 2-16 above relates to fair value hedges of fixed rate instruments. When applying cash flow hedge accounting of interest rate risk in a negative interest rate environment, further complications arise if an instrument (typically the hedged item) is floored at zero. If there is an 'in the money floor' in the hedged item, such that no interest is currently payable or expected to be payable in the future, then there is no cash flow variability with respect to the hedged risk, hence cash flow hedge accounting is precluded (see sections 5 and 5.2 below). *[IFRS 9.6.5.2]*.

Further, in a negative interest rate environment if the hedged item contains a floor at zero, and no such floor exists in the hedging instrument, even if there was an expectation that interest rates might become positive again within the term of the hedge relationship, demonstrating that an economic relationship exists between the hedged item and hedging instrument could be tricky (see section 6.4.1 below), in which case hedge accounting would cease. *[IFRS 9.6.4.1(c)(i)]*. This is because until interest rate become positive again there is no variability in the hedged cash flows from changes in interest rates (i.e., they are fixed at zero), but cash flows on the floating leg of the hedging instrument will reflect all changes in the interest rate. In fact, such a strategy would result in increased cash flow variability as a result of the risk management activities. The issues arising from the existence of floors within a negative interest rate environment are similar to those within sub-benchmark rate instruments (see section 2.4 above).

2.5 Groups of items

2.5.1 General requirements

Extract from IFRS 9

6.6.1 A group of items (including a group of items that constitute a net position; see paragraphs B6.6.1-B6.6.8) is an eligible hedged item only if:

(a) it consists of items (including components of items) that are, individually, eligible hedged items;

(b) the items in the group are managed together on a group basis for risk management purposes; and

(c) in the case of a cash flow hedge of a group of items whose variabilities in cash flows are not expected to be approximately proportional to the overall variability in cash flows of the group so that offsetting risk positions arise:

(i) it is a hedge of foreign currency risk; and

(ii) the designation of that net position specifies the reporting period in which the forecast transactions are expected to affect profit or loss, as well as their nature and volume (see paragraphs B6.6.7-B6.6.8).

[IFRS 9.6.6.1]

Illustration 2-17: Hedging a portfolio of shares

An entity holds a portfolio of shares of Swiss companies that replicates the Swiss Market Index (SMI). The entity elected to account for the shares at fair value through other comprehensive income without subsequent reclassification to profit or loss, as allowed by IFRS 9 (see Chapter 44 at section 7). The entity decides to lock in the current value of the portfolio by entering into corresponding SMI futures contracts.

The individual shares would be eligible hedged items if hedged individually (using derivatives on the price of each share). As the objective of the portfolio is to replicate the SMI, the entity can also demonstrate that the shares are managed together on a group basis. The entity also assesses the compliance with the criteria for hedge accounting (see section 6 below). Consequently, the entity designates the SMI futures contracts as the hedging instrument in a hedge of the fair value of the portfolio. As a result, the gains or losses on the SMI futures are accounted for in OCI (without subsequent reclassification to profit or loss) in the same manner as the shares, thus eliminating the accounting mismatch (see section 2.6.3 below). *[IFRS 9.6.5.3]*.

Whether the items in the group are managed together on a group basis is a matter of fact, i.e., it depends on an entity's behaviour and cannot be achieved by mere documentation.

The IFRS 9 eligibly criteria for groups of items for hedge accounting also permits designation of net positions if an entity hedges on a net basis for risk management purposes. *[IFRS 9.BC6.435]*. Whether an entity hedges in this way is a matter of fact (not merely of assertion or documentation). Hence an entity cannot apply hedge accounting on a net basis solely to achieve a particular accounting outcome if that would not reflect its risk management approach. *[IFRS 9.6.6.1(b), IFRS 9.B6.6.1]*. In addition, there are some further restrictions for cash flow hedges of net positions (see section 2.5.3 below). *[IFRS 9.BC6.436]*.

IFRS 9 also contains special presentation requirements when hedging net positions, which are discussed in sections 2.5.3 and 9.3 below.

2.5.2 Hedging a component of a group

A group designation can also consist of a component of a group of items, such as a layer component of a group. A component could also be a proportion of a group of items, such as 50% of a fixed rate bond series with a total volume of CU100 million. Whether an entity designates a layer component or a proportionate component depends on the entity's risk management objective. *[IFRS 9.6.6.1, IFRS 9.6.6.2]*.

Extract from IFRS 9

6.6.3 A layer component of an overall group of items (for example, a bottom layer) is eligible for hedge accounting only if:

(a) it is separately identifiable and reliably measurable;

(b) the risk management objective is to hedge a layer component;

(c) the items in the overall group from which the layer is identified are exposed to the same hedged risk (so that the measurement of the hedged layer is not significantly affected by which particular items from the overall group form part of the hedged layer);

(d) for a hedge of existing items (for example, an unrecognised firm commitment or a recognised asset) an entity can identify and track the overall group of items from which the hedged layer is defined (so that the entity is able to comply with the requirements for the accounting for qualifying hedging relationships); and

(e) any items in the group that contain prepayment options meet the requirements for components of a nominal amount (see paragraph B6.3.20).

[IFRS 9.6.6.3].

The benefits of identifying a layer component, as discussed in section 2.3 above, are relevant when applied to a group of items. In fact, the bottom layer hedging strategy discussed in Illustration 2-11 in section 2.3.2 above is, in fact, a designation of a component of a group. The following Illustration provides a different example of designating a component of a group, this time a top layer.

Illustration 2-18: Hedging a top layer of a portfolio of financial liabilities

A bank completes a bond issuance of CU50 million that is made up of 50,000 fixed rate bonds with a face value of CU1,000 each. The bank expects that it will repurchase up to CU10 million of the issue before maturity. Therefore, it chooses to transact a receive fixed/pay variable interest rate swap with a notional amount of CU10 million, in order to hedge the benchmark rate component of the fair value interest rate risk of the volume that is expected to be repurchased. From an economic perspective, that hedge would allow repurchases of up to CU10 million total face value for which the gain or loss from changes in the benchmark rate would be compensated by the gain or loss on the swap. However, this can only be reflected in the accounting if the entity designates a CU10 million top layer. The entity would revalue the first CU10 million of face value of the bond issue expected to be repurchased for changes in the benchmark rate risk, and would include a fair value hedge gain or loss when determining the gain or loss on derecognition of the first CU10 million of bonds when they are repurchased.

If it was not permitted to designate a layer of a group of items, entities would in such cases either have to identify individual items within the group and designate them on a standalone basis, or prorate the fair value hedge gain or loss to the entire bond issue volume, as discussed in section 2.3.2 above. The IASB believes this would result in arbitrary accounting results and decided to allow a layer component designation for a group of items. *[IFRS 9.BC6.438, IFRS 9.BC6.439]*.

Designation of a layer component which includes a prepayment option is discussed in section 2.3.2 above.

Based on the information provided, the top layer in Illustration 2-18 above would meet the criteria in order for a top layer to be designated.

Extract from IFRS 9

B6.6.12 A hedging relationship can include layers from several different groups of items. For example, in a hedge of a net position of a group of assets and a group of liabilities, the hedging relationship can comprise, in combination, a layer component of the group of assets and a layer component of the group of liabilities.

[IFRS 9.B6.6.12].

The hedge of a net position of a group of assets and a group of liabilities is discussed in section 2.5.1 above and section 2.5.3 below.

2.5.3 Cash flow hedge of a net position

Many entities are exposed to foreign currency risk arising from purchases and sales of goods or services denominated in foreign currencies. Cash inflows and outflows occurring on forecast transactions in the same foreign currency are often economically hedged on a net basis, as illustrated in the below example.

Illustration 2-19: Economic 'natural hedge' of foreign currency cash flows

An entity with GBP as its functional currency anticipates foreign currency denominated sales of USD100 in 12 months and also intends to purchase fixed assets of USD80 in 12 months. USD80 of the cash inflows of the forecast sales are economically hedged together with the cash outflows for the forecast purchase of the fixed assets. A single foreign currency forward contract to sell USD20 in 12 months is transacted to hedge the net position arising from the sales and purchases.

In the case of a cash flow hedge of a group of items whose variabilities in cash flows are not expected to be approximately proportional to the overall variability in cash flows of the group so that offsetting or net risk positions arise, designation is only permitted for a hedge of foreign currency risk. Said differently, designation of a net position in a cash flow hedge is limited to hedges of foreign currency risk under IFRS 9. *[IFRS 9.6.6.1(c), IFRS 9.B6.6.7, IFRS 9.BC6.455]*.

The standard mechanics of cash flow hedge accounting cannot accommodate a hedged net position whose gross cash flows affect profit or loss in different periods (see section 7.2 below). Applying standard cash flow hedge accounting to Illustration 2-19 above, the gain or loss accumulated in other comprehensive income (OCI) on the USD20 of hedging instrument would be reclassified to profit or loss when the revenue transaction occurs. However, this will only offset the gain or loss on USD20 of the USD100 hedged revenue while the remaining revenue of FC80 and the fixed asset purchase of USD80 (i.e., the economic hedge) would still be measured at the spot rate. This would result in the bottom line profit for the period(s) not reflecting the economic hedge.

IFRS 9 amends the standard cash flow hedge accounting for such a net position in that the foreign currency gain or loss on the USD80 revenue cash flows that affect profit or loss in the earlier period must be carried forward to offset the foreign currency gain or loss on the fixed asset purchase cash flows that will affect profit or loss in later periods. This is achieved by deferring the gain or loss on the natural hedge in OCI, with a reclassification to profit or loss once the offsetting cash flows affect profit or loss (see section 9.3.1 and Illustration 2-20 below).

However, the gross transactions that make up the net position are recognised when they arise and will be measured at the spot foreign currency rate ruling at that time. They are not adjusted to reflect the result of the hedge. The whole impact of hedge accounting must be presented in a separate line item in profit or loss. *[IFRS 9.6.6.4]*.

This separate line item includes:

- The reclassification adjustment for gains or losses on the hedge of the net position
- The gain or loss on the natural hedge, with the counter-entry being recognised in OCI

  And
- The later reclassification adjustment of the gain or loss on the natural hedge from OCI to profit or loss. *[IFRS 9.B6.6.15]*.

The rather complicated accounting described above is best illustrated using an example:

Illustration 2-20: Cash flow hedge of a foreign currency net position

An entity having CAD as functional currency anticipates sales of GBP100m in 12 months and also plans a major capital expenditure (fixed assets) of GBP80m in 12 months. The anticipated sales and capital expenditure (i.e., the group of forecast transactions) are designated as the hedged item and the resulting net position is hedged with a forward contract to sell GBP20m in 12 months. The fixed assets will be depreciated on a straight-line basis over eight years. For simplicity, assume the spot rate equals the forward rate.

GBP/CAD spot rate	
At inception of the hedge (beginning of year 1)	1.50
After 12 months (end of year 1)	1.60

The entity would record the following journal entries (amounts in millions):

Year 1		CAD	CAD
Dr	Other comprehensive income	2	
	Cr Hedging derivative		2
To recognise the fair value loss from the hedging instrument in the statement of financial position and the cash flow hedge reserve (GBP20 × [1.50 - 1.60]).			
Dr	Cash	160	
	Cr Revenue from sales		160
To account for the sales volume of GBP100 at the current spot rate of 1.60 (GBP100 × 1.60).			
Dr	Property, plant and equipment	128	
	Cr Cash		128
To account for the purchase of GBP80 fixed assets at the current spot rate of 1.60 (GBP80 × 1.60).			
Dr	Hedging derivative	2	
	Cr Cash		2
To account for the settlement of the forward contract.			
Dr	Net position hedging gains/losses	2	
	Cr Other comprehensive income		2
To reclassify the cash flow hedge reserve from OCI to profit or loss.			
Dr	Net position hedging gains/losses	8	
	Cr Other comprehensive income		8
To defer the natural hedge gain from profit or loss to OCI (GBP80 × [1.60 - 1.50]).			

The net profit for the period is CAD 150, which represents the sale of GBP100 at the hedged rate of 1.50 (albeit presented in two different line items).

Years 2 to 9		CAD	CAD
Dr	Depreciation	16	
	Cr Property, plant and equipment		16
To account for the straight line depreciation of the fixed assets (CAD 128 × 12.5%).			
Dr	Other comprehensive income	1	
	Cr Net position hedging gains/losses		1
To reclassify part of the deferred gain from OCI to profit or loss (CAD 8 × 12.5%).			

The net loss for each period is 15, which represents depreciation (at 12.5%) of a fixed asset of GBP80 purchased at the hedged rate of 1.50.

Overview

Income statement (CAD)	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Total
Revenue from sale of goods	160									160
Depreciation		(16)	(16)	(16)	(16)	(16)	(16)	(16)	(16)	(128)
Net position hedging gains/losses	(10)	1	1	1	1	1	1	1	1	(2)
Profit for the period	150	(15)	(15)	(15)	(15)	(15)	(15)	(15)	(15)	30

Statement of financial position (CAD)	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9
Cash	30	30	30	30	30	30	30	30	30
Property, plant and equipment	128	112	96	80	64	48	32	16	-
Hedging reserve (OCI)	(8)	(7)	(6)	(5)	(4)	(3)	(2)	(1)	-

The transactions within a net position still must be measured at their spot rates, while the effect of the hedge is presented in a separate line item. *[IFRS 9.B6.6.15]*. In other words, although an entity could be economically hedged from a bottom line (or net) perspective, volatility will still arise in the amounts reported for the individual hedged transactions (on a gross basis), and it is only the bottom line of profit or loss that will reflect the benefits of the hedge.

For a net position to qualify for cash flow hedge accounting the hedge documentation has to include, for each type of item within the net position, its amount and nature as well as the reporting period in which it is expected to affect profit or loss. This is expected to be a relatively detailed record of what makes up the net position and how it will impact profit or loss, including the depreciation profile, if relevant. *[IFRS 9.6.6.1(c)(ii), IFRS 9.B6.6.7, IFRS 9.B6.6.8]*.

2.5.4 Nil net positions

IFRS 9 also addresses hedges of nil net positions. This refers to when entities hedge a group of items where the hedged items themselves fully offset the risk that is managed. An example would be similar to the scenario illustrated by Illustration 2-19 above but where the entity anticipates sales of GBP100m in 12 months and also plans a major capital expenditure of GBP100m in 12 months. Hedge accounting for a net nil position is possible, applying the same treatment as for hedges of net positions in section 2.5.1 and section 2.5.3 above, however there are some additional requirements that must be met.

Extract from IFRS 9

6.6.6 When the hedged item is a group that is a nil net position (ie the hedged items among themselves fully offset the risk that is managed on a group basis), an entity is permitted to designate it in a hedging relationship that does not include a hedging instrument, provided that:

(a) the hedge is part of a rolling net risk hedging strategy, whereby the entity routinely hedges new positions of the same type as time moves on (for example, when transactions move into the time horizon for which the entity hedges);

(b) the hedged net position changes in size over the life of the rolling net risk hedging strategy and the entity uses eligible hedging instruments to hedge the net risk (ie when the net position is not nil);

(c) hedge accounting is normally applied to such net positions when the net position is not nil and it is hedged with eligible hedging instruments; and

(d) not applying hedge accounting to the nil net position would give rise to inconsistent accounting outcomes, because the accounting would not recognise the offsetting risk positions that would otherwise be recognised in a hedge of a net position.

[IFRS 9.6.6.6].

2.6 Other eligibility issues for hedged items

2.6.1 Highly probable

Forecast transactions (or a component thereof) can only be eligible hedged items if they are highly probable of occurring (see section 2.1 above). *[IFRS 9.6.3.3]*. The term 'highly probable' is not defined in IFRS 9 but is often interpreted to have a much greater likelihood of happening than 'more likely than not'. The Implementation Guidance within IAS 39 contained some guidance as to how the term highly probable is applied within the context of hedge accounting and, this guidance can be considered relevant for IFRS 9 hedge accounting. The IAS 39 guidance indicates that an assessment of the likelihood that a forecast transaction will take place is not based solely on management's intention, it should be supported by

observable facts and the attendant circumstances. In such an assessment, an entity should consider the following:

- The frequency of similar past transactions
- The financial and operational ability of the entity to carry out the transaction
- Whether substantial commitments of resources have been made to a particular activity
- The extent of loss or disruption of operations that could result if the transaction does not occur
- The likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose

  And

- The entity's business plan *[IAS 39.F.3.7]*

Although, by the nature of a forecasted transaction, the terms and timing of the transaction may not be known with certainty, if the key terms cannot be estimated with reasonable specificity then it may be difficult to determine that the forecasted transaction is indeed highly probable. *[IAS 39.F.3.11]*. Reasonable specificity in terms of a identifying a forecast transaction is necessary both in order to measure any ineffectiveness from the hedge relationship (see section 7.4 below) and also to determine whether and when the documented hedged item occurs (see section 8.3 below).

In March 2019, the IFRS IC discussed the application of the highly probable requirement with respect to a specific derivative (a load following swap) designated as a hedging instrument.[5] In a load following swap the notional amount of the derivative designated as a hedging instrument varies depending on the outcome of the hedged item (e.g., forecast energy sales). As part of that specific discussion, the IFRS IC observed more generally that the terms of the hedging instrument do not affect the highly probable assessment because the highly probable requirement is applicable to the hedged item (see section 6.3.3 below). For example, an entity that wishes to hedge the foreign currency risk of a future business combination, can only achieve hedge accounting once the business combination itself is highly probable (see section 2.6.4 below). This is the case even if the hedging instrument is a deal contingent foreign currency contract, such that if the business combination does not go ahead, the foreign currency contract is terminated with no cash settlement.

In addition, an entity might also need to consider the impact of wider industry and business drivers as to whether cash flows are highly probable or not. For example:

- Whether forecast cash flows in a subsidiary that is due to be sold can be considered highly probable in the parent's consolidated financial statements (see section 7.2.4 below)

  Or

- If a designated benchmark interest rate is no longer expected to exist, whether forecast cash flows linked to that benchmark rate can be highly probable (see the *Supplement: IBOR Reform*)

The length of time until a forecast transaction is projected to occur is also a factor. Other factors being equal, the more distant a forecast transaction is, the less likely it is that it would be considered highly probable and the stronger the evidence required to determine that it is highly probable.

For example, a transaction forecast to occur in 5 years will often be less likely to occur than a transaction forecast to occur in one year. However, forecast interest payments for the next 20 years on variable rate debt would typically be highly probable if supported by an existing contractual obligation.

An entity might also need to consider the credit risk associated with the counterparty to a forecast transaction. Even though a forecast transaction does not involve credit risk, depending on the possible counterparties for the anticipated transaction, the credit risk that affects them can indirectly affect the assessment of whether the forecast transaction is highly probable or not (see section 6.4.2.B below).

In addition, other factors being equal, the greater the physical quantity or future value of the forecast transaction, in proportion to the entity's total transactions of the same nature, the less likely it is that the transaction would be considered highly probable. For example, less evidence generally would be needed to support forecast highly probable sales of 100,000 units in the next month than 950,000 units in that month, when recent sales have averaged 950,000 for the past 3 months.

A history of having designated hedges of forecast transactions and then determining that they are no longer expected to occur would call into question both an entity's ability to predict forecast transactions accurately and the propriety of using hedge accounting in the future for similar transactions. *[IAS 39.F.3.7]*. However, the standard contains no prescriptive 'tainting' provisions in this area. Therefore, entities are not

5 *IFRIC Update*, March 2019, available on the IFRS Foundation's website.

automatically prohibited from using cash flow hedge accounting if a forecast transaction fails to occur. Instead, whenever such a situation arises the particular facts, circumstances and evidence must be assessed to determine whether doubt has, in fact, been cast on an entity's ongoing hedging strategies.

It is also explained in the IAS 39 Implementation Guidance that cash flows arising after the prepayment date on an instrument that is prepayable at the issuer's option could be highly probable for a group or pool of similar assets for which prepayments can be estimated with a high degree of accuracy, e.g., mortgage loans, or if the prepayment option is significantly out of the money. In addition, the cash flows after the prepayment date may be designated as the hedged item if a comparable option exists in the hedging instrument (see section 7.4.12 below). *[IAS 39.F.2.12]*.

Further discussion on the hedge documentation requirements for designated highly probable forecast transactions is given in section 6.3.3 below.

2.6.2 Hedged items held at fair value through profit or loss

It does not immediately appear that it would be useful to designate a hedged item that is measured at fair value through profit or loss in a hedge relationship. However, because IFRS 9 could require certain variable rate assets to be measured at fair value through profit or loss (see Chapter 44 at section 5), designation as the hedged item in a cash flow hedge relationship could be desirable. Although the variable hedged item would be measured at fair value through profit or loss, an entity could still seek to hedge the variability of cash flows by entering into a hedging derivative. Because of the variable nature of the hedged item, such instruments might not be significantly exposed to changes in fair value caused by movements in the hedged risk whereas the hedging derivative will be. In this instance, application of cash flow hedge accounting facilitates deferral of fair value changes in the hedging derivative to the cash flow hedge reserve, which could better reflect the risk management strategy.

An additional reason that a hedge designation might be desirable for hedged items measured at fair value through profit or loss could be in order to achieve costs of hedging treatment for the time value, forward or foreign currency basis element of the hedging instrument (see section 7.5 below). For any such designation care would need to be taken that the usual qualifying criteria for hedge accounting are met (see section 6 below).

IFRS 9 provides confirmation that cash flow hedge accounting is not prohibited for all hedged items measured at fair value through profit or loss. It gives as an example of an eligible cash flow hedge where an entity uses a swap to change floating rate debt to fixed rate, even if the debt is measured at fair value. This is because there is a systematic way in which the cash flow hedge reserve can be reclassified, i.e., in the same way interest payments occur on the hedged instrument. A contrasting example is given of a forecast purchase of an equity instrument that, once acquired, will be accounted for at fair value through profit or loss. This is mentioned as an example of an item that cannot be the hedged item in a cash flow hedge, because any gain or loss on the hedging instrument that would be deferred could not be appropriately reclassified to profit or loss during a period in which it would achieve offset. *[IFRS 9.B6.5.2]*.

As well as providing confirmation that cash flow hedge accounting is not precluded for hedged items measured at fair value through profit or loss, the guidance in IFRS 9.B6.5.2 also appears to introduce an additional requirement that there is a systematic way in which the cash flow hedge reserve can be reclassified for such a hedge. *[IFRS 9.B6.5.2]*. Therefore, it seems that cash flow hedge accounting is not only precluded for equity instruments but also for any non-financial hedged items measured at fair value through profit or loss. The same difficulty with respect to a lack of a systematic way in which the cash flow hedge reserve would be reclassified also exists in a cash flow hedge of a forecast transaction to purchase equity instruments or non-financial hedged items that will be measured at fair value through profit or loss.

In addition, the reason why the instrument is measured at fair value through profit or loss will also be a factor in determining whether an instrument measured at fair value through profit or loss will be an eligible hedged item or not. Classification of an item at fair value through profit or loss could be because such an item is held for trading, managed on a fair value basis, designated as measured at fair value through profit or loss using the fair value option or because the contractual terms of the financial asset give rise on specified dates to cash flows that are not solely payments of principal and interest on the principal amount outstanding (see Chapter 44 at section 1). We discuss the eligibility of such instruments measured at fair value through profit or loss in the paragraphs below.

2.6.2.A Hedged items managed on a fair value basis

If an instrument is part of a portfolio that is managed on a fair value basis, there is a question as to whether it can be an eligible hedged item or not.

How we see it

For a portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis, an entity is primarily focused on fair value information and uses that information to assess the assets' performance and to make decisions. In our view, if the hedging instrument is also part of the same portfolio (or business model), and the entity has by definition determined that fair value is the most appropriate measure for that portfolio, then this would be inconsistent with the idea of cash flow hedging, whereby part of the fair value movements would be recorded in other comprehensive income, separately from the remaining fair value movements that would be recorded in profit or loss. We therefore believe cash flow hedge accounting would not ordinarily be appropriate in this scenario.

It would similarly be inconsistent with the idea of hedge accounting if forecast transactions that will be managed on a fair value basis when acquired, were part of a hedge relationship to hedge cash flow variability in the price prior to acquisition.

In the same way, it would not be appropriate to designate a financial asset managed on a fair value basis as a hedged item in a fair value hedge, in order to defer fair value changes in the time, forward or foreign currency basis element of the hedging instrument as a cost of hedging (see section 7.5 below).

However, there could be some situations where the cash flow interest rate risk on an asset that is part of a portfolio managed on a fair value basis might be managed outside of the portfolio (or business model), although we expect such a situation to be rare in practice. In these cases, the instrument hedging the interest rate risk is held separately from the managed portfolio. In such a scenario, cash flow hedge accounting is not necessarily inconsistent with the hedged asset being held at fair value through profit or loss. Such a situation is shown in the following Illustration:

Illustration 2-21: Interest rate risk managed separately from a credit risk portfolio managed on a fair value basis

Entity A has excess funds to invest and spreads these across various investment portfolios for which the credit risk is managed by individual portfolio managers on a fair value basis. The individual managers are likely to manage the fair value of the portfolio using credit risk derivatives such as credit default swaps. The entity, however, wishes to retain the management of interest rate risk centrally where it is aggregated with other interest rate exposures across the entity, e.g., from issued debt, and therefore instructs each portfolio manager to invest in order to achieve a 3m benchmark-based rate of return. Accordingly, the majority of assets within each investment portfolio will attract a floating rate and hence most of the portfolio's fair value volatility will arise from changes in credit risk. The interest rate risk is managed centrally and so any interest rate swaps used to fix some of the variability in the future cash flows from changes in interest rate risk are transacted centrally and not part of any investment portfolio, nor are they considered when reporting or assessing the performance of the individual investment portfolios. Each investment portfolio is managed based on its fair value, has discreet fair value financial information and each portfolio manager is assessed on the fair value performance of their portfolio. The entity concludes that the business model test is applied at the portfolio level and as such each investment portfolio is measured at fair value through profit or loss.

It is possible that in these circumstances the decision to enter into interest rate swaps and apply cash flow hedge accounting to an asset within the investment portfolios is not inconsistent with the fact the instrument is held at fair value through profit or loss, since that designation is driven by management of the fair value of credit and not the interest rate element.

2.6.2.B Hedged items held for trading

Derivatives are deemed to be held for trading (see Chapter 44 at section 3) and are therefore ineligible as hedged items on their own. *[IAS 39.F.2.1]*. A portfolio that is held for trading is one where assets and liabilities are acquired or incurred principally for the purpose of selling or repurchasing or short-term profit-taking. An entity achieves those objectives by either selling or repurchasing the financial instruments or by entering into an opposite trade to lock-in a gain. In this case hedge accounting of recognised assets and liabilities and highly probable transactions managed within a trading book will not be appropriate for the reasons set out below:

- It is consistent with the prohibition on derivatives being hedged items
- A trading portfolio is likely to be managed on a fair value basis and so a number of the considerations in section 2.6.2.A above will also apply. Furthermore, it is unlikely that any of the risks within the trading portfolio will be managed other than for trading purposes

  And
- In a trading portfolio where an entity might sell an asset in the near term, the asset will usually not be eligible for cash flow hedging as the future cash flows will not be highly probable

2.6.2.C Hedged items that have failed the contractual cash flows test

Where debt instruments are classified as fair value through profit or loss because they fail the contractual cash flow characteristics test (see Chapter 44 at section 5), the above arguments do not apply and so it appears that such instruments could be designated as the hedged item in a cash flow hedge, if all other qualifying criteria for hedge accounting are met (see section 6 below).

For other financial instruments subject to the contractual cash flow characteristics test, such as equities, the additional requirement for there to be a systematic way in which the cash flow hedge reserve would be reclassified into profit or loss would seem to preclude cash flow hedge accounting (see section 2.6.2 above).

2.6.3 Hedges of exposures affecting other comprehensive income

Only hedges of exposures that could affect profit or loss qualify for hedge accounting. *[IFRS 9.6.5.2]*. This would include hedged debt instruments measured at fair value through other comprehensive income (OCI) as although changes in fair value are initially recognised in OCI, on derecognition of such items any gains or losses held in OCI will be reclassified to profit or loss. *[IFRS 9.4.1.2A, IFRS 9.B5.7.1A]*. However, given the stated business model for debt instruments measured at fair value through OCI includes the possibility of selling financial assets, care would need to be taken to ensure that hedge accounting is not applied to cash flows that are not highly probable (see section 2.6.1 above).

The sole exception to the requirement that hedges could affect profit or loss is when an entity is hedging in a fair value hedge an investment in equity instruments for which it has elected to present changes in fair value in OCI, as permitted by IFRS 9. *[IFRS 9.6.5.3]*. Using that election, gains or losses on the equity investments will never be recognised in profit or loss (see Chapter 44 at section 1.2). *[IFRS 9.4.1.4]*.

For such a hedge, the fair value change of the hedging instrument is recognised in OCI. *[IFRS 9.6.5.8]*. Any hedge ineffectiveness is also recognised in OCI. *[IFRS 9.6.5.3]*. On sale of the investment, gains or losses accumulated in OCI are not reclassified to profit or loss, but could be transferred to retained earnings (see Chapter 44 at section 1.2). *[IFRS 9.B5.7.1]*. Consequently, the same also applies for any accumulated fair value changes on the hedging instrument, including any ineffectiveness (see section 7.8 below).

2.6.4 Hedges of a firm commitment to acquire a business

IFRS 9 notes that:

Extract from IFRS 9

B6.3.1 A firm commitment to acquire a business in a business combination cannot be a hedged item, except for foreign currency risk, because the other risks being hedged cannot be specifically identified and measured. Those other risks are general business risks.

[IFRS 9.B6.3.1].

It follows that a forecast business combination could be a hedged item for foreign currency risk in a cash flow hedge, as long as the highly probable criterion is met (see section 2.6.1 above).

The other risks in a future business combination- i.e., other than foreign currency risk, are said to be general business risks. IAS 39 provided additional guidance on hedging general business risks that appears relevant also to IFRS 9. A hedge of the risk of obsolescence of a physical asset or the risk of expropriation of property by a government is not eligible for hedge accounting (effectiveness cannot be measured because those risks are not reliably measurable). *[IAS 39.AG110]*. Similarly, the risk that a transaction will not occur is an overall business risk that is not eligible as a hedged item. *[IAS 39.F.2.8]*.

Nevertheless, transactions of the business to be acquired (for example floating rate interest payments on its borrowings) could potentially qualify as hedged items. For this to be the case it would need to be demonstrated that, from the perspective of the acquirer, those hedged transactions are highly probable (see section 2.6.1 above) and could impact the post-acquisition profit or loss of the acquirer (see section 5.2 below). Determining that the hedged transaction is highly probable might not be straightforward, as this requirement applies to both the business combination and the hedged transactions themselves.

2.6.5 Forecast acquisition or issuance of foreign currency monetary items

As already mentioned, there is a need for the hedged risk to have the potential to impact profit or loss in order to achieve hedge accounting. *[IFRS 9.6.5.2]*. Changes in foreign currency rates prior to the acquisition or issuance of a monetary item denominated in a foreign currency do not impact profit or loss as any foreign currency risk on the issue of debt will be offset by the foreign currency risk on the cash that will be spent or borrowed. Therefore, an entity cannot hedge the foreign currency risk associated with the forecast acquisition or issuance of a monetary item denominated in a foreign currency, such as the expected issuance of debt denominated in a currency other than the entity's functional currency.

However, it could be possible to designate a combination of the highly probable forecast acquisition or issuance of a foreign currency monetary item and an associated highly probable forecast foreign currency derivative as an aggregated exposure within a hedge accounting relationship, for the purpose of hedging the associated future interest rate risk (see section 2.7.3.D below).

2.6.6 Own equity instruments

Transactions in an entity's own equity instruments (including distributions to holders of such instruments) are generally recognised directly in equity by the issuer (see Chapter 43) and do not affect profit or loss. Therefore, such instruments cannot be designated as a hedged item (see section 5 below). *[IFRS 9.6.5.2]*. Similarly, a forecast transaction in an entity's own equity instruments (e.g., a forecast dividend payment) cannot qualify as a hedged item. However, a declared dividend that qualifies for recognition as a financial liability, e.g., because the entity has become legally obliged to make the payment, could qualify as a hedged item. For example, a recognised liability to pay a dividend in a foreign currency would give rise to foreign currency risk.

2.6.7 Core deposits

Financial institutions often receive a significant proportion of their funding from demand deposits, such as current account balances, savings accounts and other accounts that behave in a similar manner. Even though the total balance from all such customer deposits might vary, a financial institution typically determines a level of core deposits that it believes will be maintained for a particular time frame. These customer deposits or accounts usually pay a zero or low, stable interest rate which, while not contractually fixed, is generally insensitive to changes in market interest rates, and hence will behave like a fixed interest rate exposure from an interest rate risk perspective for the time frame over which they are expected to remain.

While these deposits can be withdrawn at little or short notice, typically they are left on deposit for a long time despite the low interest paid. Although the financial institution will not be able to determine which deposits will be withdrawn and which will persist, the overall level of withdrawal could be relatively predictable. Further, both existing and new deposits are generally considered fungible for interest rate risk management purposes, as new deposits will usually be on the same terms as any withdrawn deposits that they replace.

Risk management of the 'deemed' fixed rate interest rate risk exposure that financial institutions attribute to core deposits will often result in the need to transact interest rate derivatives, although achieving hedge accounting for these derivatives can be difficult.[6]

In order for items to be eligible hedged items in a fair value hedge, the fair value of the hedged items must vary with the hedged risk. However, IFRS 13 *Fair Value Measurement* states that the fair value of a financial liability with a demand feature (e.g., a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. *[IFRS 13.47]*. Therefore, the fair value of demand deposits will not vary with the hedged risk and fair value hedge accounting is precluded.

An alternative consideration is whether it is possible to designate a core deposit intangible asset (representing the value of this source of funding to the financial institution) as an eligible hedged item. The term 'core deposit intangible' could be used to represent the difference between:

(a) The fair value of a portfolio of core deposits

And

(b) The aggregate of the individual fair values of the liabilities within the portfolio, calculated in accordance with the requirements of IFRS 13

Generally, an internally generated core deposit intangible cannot be a hedged item because it is not a recognised asset. However, if a core deposit intangible is acquired together with a related portfolio of deposits, it is required to be recognised separately as an intangible asset (or as part of the related acquired portfolio of deposits) if it meets the recognition criteria in IAS 38 *Intangible Assets,* which it normally will (see Chapter 10 at section 5.5.2).

Theoretically, therefore, a recognised purchased core deposit intangible asset could be designated as a hedged item. However, this will only be the case if it meets the conditions for hedge accounting, including the requirement that the effectiveness of the hedge can be measured reliably. The Implementation Guidance of IAS 39 explains that because it is often difficult to measure reliably the fair value of a core deposit intangible asset other than on initial recognition, it is unlikely that this requirement will be met. *[IAS 39.F.2.3]*. In fact, this probably understates the difficulty.

For the reasons set out above, financial institutions are rarely, if ever, able to designate core deposits with the associated hedging instruments in hedge accounting relationships, despite the economic validity of these risk management activities. Accordingly, many financial institutions apply the special portfolio or macro hedge accounting guidance in IAS 39 (see section 10 below).

The IASB is however developing a new accounting model for dynamic risk management, focused on interest rate risk management by banks and similar financial institutions. In the development of the new accounting model, the IASB has tentatively decided that core demand deposits will be eligible for inclusion as risk exposures subject to dynamic risk management and hence part of the new accounting solution (see section 10.1 below).

2.6.8 Leases and associated right-of-use assets

IFRS 16 *Leases* requires that at the commencement date, a lessee recognises a right-of-use asset and a lease liability (see Chapter 24 at section 5.1). For lessee entities that hedge the foreign currency risk associated with a foreign currency lease liability, hedge accounting may not be required. This is because the foreign currency risk in the hedging instrument will naturally offset part of the IAS 21 retranslation of the lease liability. However, if the foreign currency risk from the lease liability is not economically hedged, the full foreign currency risk arising from future lease payments will be recognised in profit or loss with no hedging instrument providing offset to the IAS 21 retranslation of the lease liability. Accordingly, there could be an incentive either to start economically hedging the foreign currency risk in the lease liability and achieve hedge accounting or natural offset, or to try to achieve hedge accounting using existing foreign currency exposures. In each case, this would be subject to meeting the normal hedge accounting qualifying criteria.

Foreign currency lease liabilities could be either eligible hedged items or hedging instruments (see section 2.1 above and section 3.3.1 below respectively). It might be tempting to consider designating the lease liability as the hedging instrument in a fair value hedge of foreign currency risk in the associated right-of-use asset. A related fact pattern was discussed in June 2019 by the IFRS IC when a number of difficulties were identified.[7]

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6 Discussion Paper DP/2014/1, *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging*, IASB, April 2014, paras. 1.14-1.15 and 3.9.1-3.9.16. Available on the IFRS Foundation's website.

7 *IFRIC Update*, June 2019, available on the IFRS Foundation's website.

The IFRS IC considered whether foreign currency risk can be a separately identifiable and reliably measurable risk component of a non-financial asset held for consumption that an entity can designate as the hedged item in a fair value hedge accounting relationship. The IFRS IC concluded that, although in theory such a hedge could be possible, the particular facts and circumstances would need to be considered to ensure the hedge accounting criteria were met. The IFRS IC assessed the following key questions as part of their considerations:

Can an entity have exposure to foreign currency risk on a non-financial asset held for consumption that could affect profit or loss? Depending on the particular facts and circumstances, a non-financial asset might be priced-and its fair value determined-only in one currency at a global level and that currency is not the entity's functional currency. The translated fair value of such a non-financial asset would change as a result of changes in the applicable exchange rate in a given period, even if the fair value (determined in the foreign currency) were to remain constant. The Committee therefore observed that in such circumstances an entity is exposed to foreign currency risk. IFRS 9 does not require changes in fair value to be expected to affect profit or loss but, rather, that those changes could affect profit or loss. The IFRS IC observed that changes in fair value of a non-financial asset held for consumption could affect profit or loss if, for example, the entity were to sell the asset before the end of the asset's economic life (see section 5.1 below).

If an entity has exposure to foreign currency risk on a non-financial asset, is it a separately identifiable and reliably measurable risk component? The IFRS IC observed that foreign currency risk is separately identifiable and reliably measurable when the risk being hedged relates to changes in fair value arising from translation into an entity's functional currency of fair value that, based on an assessment within the context of the particular market structure, is determined globally only in one particular currency and that currency is not the entity's functional currency (see section 2.2.5 above).

Can the designation of foreign currency risk on a non-financial asset held for consumption be consistent with an entity's risk management activities? The IFRS IC observed that, in applying IFRS 9, an entity can apply hedge accounting only if it is consistent with the entity's risk management objective and strategy for managing its exposure (see section 6.2.1 below). The Committee noted that it would expect that an entity would manage and hedge exposure to foreign currency risk on the fair value of non-financial assets held for consumption only in very limited circumstances-in such circumstances, an entity would use hedging instruments to hedge only foreign currency risk exposure that it expects will affect profit or loss. This may be the case, for example, if (a) the entity expects to sell the non-financial asset (e.g., an item of property, plant and equipment) part-way through its economic life; (b) the expected residual value of the asset at the date of expected sale is significant; and (c) the entity manages and uses hedging instruments to hedge the foreign currency risk exposure only on the residual value of the asset. Furthermore, the Committee observed that risk management activities that aim only to reduce foreign exchange volatility arising from translating a financial liability denominated in a foreign currency applying IAS 21 are inconsistent with the designation of foreign exchange risk on a non-financial asset as the hedged item in a fair value hedge accounting relationship. In such circumstances, the entity is managing the foreign currency risk exposure arising on the financial liability, rather than managing the risk exposure arising on the non-financial asset.

In order to achieve fair value hedge accounting for a foreign currency risk component of a non-financial asset held for consumption, all three questions must be answered satisfactorily. It is unlikely that this will be the case for a fair value hedge of the foreign currency risk in a right-of-use asset, using the associated foreign currency lease liability as the hedging instrument. In most cases, there is not an exposure to foreign currency risk in the right-of-use asset that will affect profit or loss, the fair value of the right-of-use asset is unlikely to be determined globally only in one particular currency and such a hedge is often not consistent with the entity's risk management objective. Even if we consider the case of a right-of-use asset for a wide-bodied aircraft, for which it might be possible to determine that the fair value of the right-of-use asset is determined globally only in US dollars, hedge accounting is still unlikely to be achieved by designating the associated foreign currency lease liability as the hedging instrument if the expectation is that the non-financial asset will be consumed (rather than sold), given the requirement for the designation to be consistent with the entity's risk management objective.

One example of a designation that could potentially meet the criteria for fair value hedge accounting of foreign currency risk in a non-financial asset held for consumption would be the hedge of foreign currency risk by an entity that owned a wide-bodied aircraft, assuming such aircrafts are priced only in one currency at a global level and that currency is not the entity's functional currency (see Chapter 19). The entity owning the wide-bodied aircraft may expect to sell it partway through its economic life for a not insignificant residual value for which the entity manages the foreign currency exposure (perhaps by transacting a foreign currency forward contract). In that case it may be appropriate to conclude that the designation of the foreign currency risk from the residual value of the wide-bodied aircraft is consistent with the entity's risk management objective. Such a scenario is unlikely to be very common and any such designation would need to meet all the usual hedge accounting qualifying criteria (see section 6 below).

2.6.9 Hedge accounting for associates

It is permissible to hedge the foreign currency risk in a firm commitment or highly probable transaction to acquire a business in a business combination (see section 2.6.4 above). *[IFRS 9.B6.3.1]*. It follows that it is also possible for a firm commitment or a highly probable forecasted acquisition of an equity accounted associate (see Chapter 12) to be the hedged item for foreign currency risk.

Conversely it is not possible for an investor in an associate to identify specific transactions of that associate and apply hedge accounting to those specific transactions in the investor's own financial statements. This is true whether the associate is an existing associate or a highly probable forecast acquisition. Equity accounting for the associate reflects a single interest in the associate rather than a share of the specific transactions; a single transaction of the associate would not meet the separately identifiable and reliably measurable requirement to be an eligible risk component of an interest in an associate (see section 2.2 above and 5.1 below).

2.7 Aggregated exposures

2.7.1 Introduction

IFRS 9 introduced a hedge accounting concept known as 'an aggregated exposure'; the purpose of which was to facilitate hedge accounting that reflects the effect of risk management undertaken for a hedged position that includes a derivative. This will only be the case if the aggregated exposure combines an exposure with a derivative so that it creates a different aggregated exposure that is managed as one exposure for a particular risk. *[IFRS 9.B6.3.3]*. Further the aggregated exposure must be a combination of an exposure that could qualify as a hedged item, and a derivative together designated as a hedged item. *[IFRS 9.6.3.4]*.

The aggregated exposure is often a hedging relationship itself (the first-level relationship), however, in order for the aggregated exposure to qualify for hedge accounting, IFRS 9 only requires that the exposure could qualify as a hedged item (see section 2.1 above) and not that hedge accounting is actually applied. Applying hedge accounting to the aggregated exposure (the second-level relationship) gets even more complex when hedge accounting is not applied to the first-level relationship, and the entity is also unlikely to achieve its desired accounting result. *[IFRS 9.BC6.167]*. Therefore, in many cases we expect entities to apply hedge accounting where possible to the first-level relationship, even if it is not required by IFRS 9.

The guidance does not change the unit of account for instruments making up the aggregated exposure, specifically it is not accounted for as a 'synthetic' single item. Instead, an entity is required to consider the combined effect of the aggregated exposure for the purpose of assessing hedge effectiveness and measuring hedge ineffectiveness. *[IFRS 9.B6.3.4]*.

Whilst the ability to designate an aggregated exposure as a hedged item in a hedge relationship is expected to allow an entity to reflect better the effect of its risk management in the financial statements, the steps required to achieve this hedge accounting are quite complex. Furthermore, although some detailed examples of hedge accounting for aggregated exposures are provided in the Illustrative Examples within the Implementation Guidance of IFRS 9, there are still some areas of uncertainty. *[IFRS 9.IE115-147]*. We outline below the general requirements for hedge accounting for aggregated exposures.

2.7.2 Background

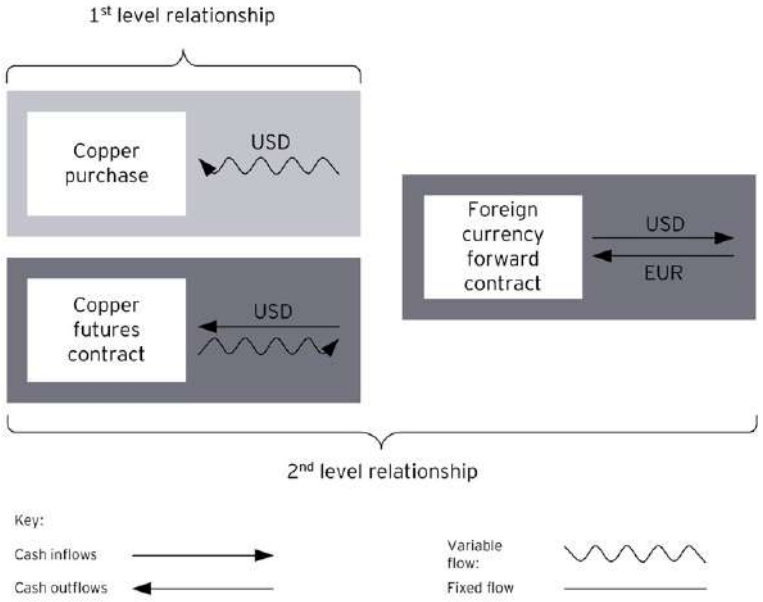
Entities often purchase or sell items (in particular, commodities) that expose them to more than one type of risk (e.g., commodity and foreign currency risk). When hedging those risk exposures, entities do not always hedge each risk for the same time period. This is best explained with an example:

Illustration 2-22: Aggregated exposure - copper purchase in a foreign currency

An entity manufacturing electrical wires is expecting to purchase copper in 12 months. The functional currency of the entity is euro (EUR). The copper price is fluctuating and is denominated in US dollars (USD), which is a foreign currency for the entity. The entity is exposed to two main risks, the copper price risk and the foreign currency risk.

The entity first decides to hedge the copper price fluctuation risk, using a copper futures contract. By doing so, the entity now has a fixed-price copper purchase denominated in a foreign currency and is therefore still exposed to foreign currency risk. (In this example we assume there is no 'basis risk' between the copper price exposures in the expected purchase and the futures contract, such as the effect of quality and the location of delivery).

Three months later, the entity decides to hedge the foreign currency risk by entering into a foreign currency forward contract to buy a fixed amount of USD in nine months. By doing so, the entity is hedging the aggregated exposure, which is the combination of the original exposure to variability of the copper price and the copper futures contract. The diagram below illustrates the two economic hedging relationships.



In the above example it would be possible for the entity to initially designate the copper futures contract as hedging variations in the copper purchase price in a cash flow hedge relationship and leave the foreign currency risk unhedged (see section 2.2.5 above). This is on the assumption that the relevant hedge accounting eligibility criteria are met (see section 6 below). However, when the entity transacts the foreign currency forward contract three months later the general hedge accounting guidance would provide the entity with two choices (see section 8.3 below):

- Discontinue the first hedging relationship (i.e., the copper price risk hedge) and re-designate a new relationship with joint designation of the copper futures contract and the foreign currency forward contract as the hedging instrument. This is likely to lead to some 'accounting' hedge ineffectiveness as the copper futures contract will now have a non-zero (i.e., off market) fair value on designation of the new relationship (see section 7.4.3 below).

  Or

- Maintain the copper price risk hedge and designate the foreign currency forward contract in a second relationship as a hedge of the variable USD copper purchase price. Even if the other hedge accounting requirements could be met, this means that the volume of hedged item is constantly changing as it is the variable copper purchase price that is now hedged for foreign currency risk, (i.e., without consideration of the effect of the copper futures). This will likely have an impact on the effectiveness of the hedging relationship, in particular if the variable USD copper price falls, as there might not be sufficient volume of USD cash flows from the designated hedged item in order to match the foreign currency forward contract.

As mentioned above, IFRS 9 includes an additional accounting choice for such a strategy which is to permit designation as hedged items the aggregated exposures that are a combination of an exposure that could qualify as a hedged item and a derivative. *[IFRS 9.6.3.4]*.

Consequently, in the scenario described in Illustration 2-22 above, the entity could designate the foreign currency forward contract in a cash flow hedge of the combination of the original exposure and the copper futures contract (i.e., the aggregated exposure) without affecting the first hedging relationship. In other words, it would not be necessary to discontinue and re-designate the first hedging relationship, as summarised in the table below:

IFRS 9 designations	1st level hedge relationship	2nd level hedge relationship
Hedge relationship	Cash flow hedge	Cash flow hedge
Hedged risk	Copper price	USD/EUR exchange rate
Hedged item	Copper purchases	Combination of copper purchases and copper futures contract
Hedging instrument	Copper futures contracts	Foreign currency forward contract
Designation	Designated when copper futures are transacted. Hedge is not affected by 2nd level hedge designation	Designated when foreign currency forward contract is transacted

It is important to keep in mind that the individual items in the aggregated exposure are accounted for separately, applying the normal requirements of hedge accounting (i.e., there is no change in the unit of account; the aggregated exposure is not treated as a 'synthetic' single item). For example, when hedging a combination of a variable rate loan and a pay fixed/receive variable interest rate swap (IRS), the loan would still be accounted for at amortised cost with the IRS accounted for at fair value through profit or loss and presented separately in the statement of financial position. An entity would not be allowed to present the IRS and the loan (i.e., the aggregated exposure) together in one line item (i.e., as if it was one single fixed rate loan). *[IFRS 9.B6.3.4]*.

However, when assessing the effectiveness and measuring the ineffectiveness of a hedge of an aggregated exposure, the combined effect of the items in the aggregated exposure must be taken into consideration. *[IFRS 9.B6.3.4]*. (See sections 6.4 and 7.4 below respectively). This is of particular relevance if the terms of the hedged item and the hedging instrument in the first hedging relationship do not perfectly match, e.g., if there is basis risk. Any ineffectiveness in the first level relationship would automatically also lead to some ineffectiveness in the second level relationship. However, this does not mean that the same ineffectiveness is recognised twice. The accounting for aggregated exposures is explained using a series of examples, below.

2.7.3 Accounting for aggregated exposures

The following examples in the sections below, partly derived from the Illustrative Examples in the Implementation Guidance of IFRS 9, help explain the concept of a hedge of an aggregated exposure. We have not repeated the detailed calculations provided in the Illustrative Examples, but have focused instead on explaining the required approach:

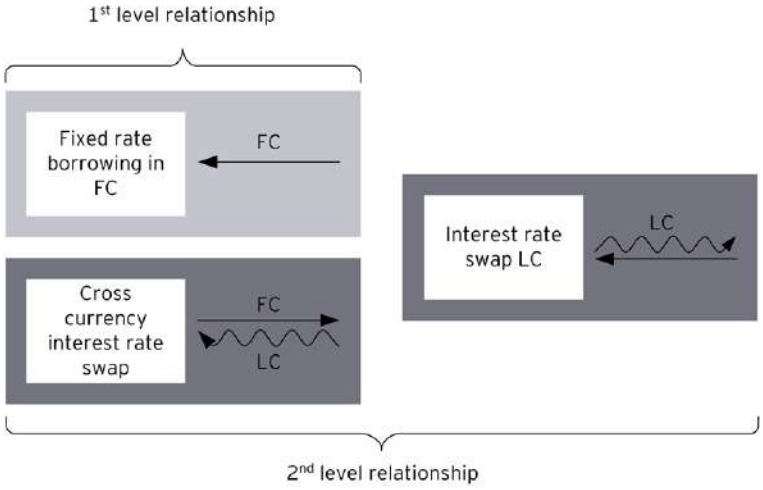
2.7.3.A Cash flow hedge of an aggregated exposure of foreign currency fixed rate loan and cross-currency interest rate swap

Illustration 2-23: Cash flow hedge of interest rate risk of an aggregated exposure made up of a fixed rate loan in a foreign currency and a cross-currency interest rate swap

This fact pattern is based on Example 17 in the Illustrative Examples. *[IFRS 9.IE128-137]*. An entity has a fixed rate borrowing denominated in a foreign currency (FC) and is therefore exposed to foreign currency risk and fair value risk due to changes in interest rates. The entity decides to swap the borrowing into a functional currency (LC) floating rate borrowing using a cross-currency interest rate swap (CCIRS). The CCIRS is designated as the hedging instrument in a fair value hedge (first-level relationship). By doing so, the entity has eliminated both the foreign currency risk and the fair value risk due to changes in interest rates. However, it is now exposed to variable functional currency interest payments.

Later, the entity decides to fix the amount of functional currency interest payments by entering into an interest rate swap (IRS) to pay fixed and receive floating interest in its functional currency. By doing so, the entity is hedging the aggregated exposure, which is the combination of the original exposure and the CCIRS. The IRS is designated as the hedging instrument in a cash flow hedge (second-level relationship). *[IFRS 9.IE131(b)]*.

The diagram below illustrates the interest flows in the two hedging relationships.



As noted above, the accounting for aggregated exposures can be complex. In this example the complexity lies in the calculation of the present value (PV) of the variability of cash flows of the aggregated exposure. This calculation is necessary in order to calculate the ineffectiveness in the second level relationship, in line with the usual hedge accounting requirements for cash flow hedges. *[IFRS 9.6.5.11(a)(ii)]*.

Example 17 in the Illustrative Examples demonstrates that the variability of the cash flows of the aggregated exposure can be calculated by creating a 'synthetic' aggregated exposure for calculation purposes only. *[IFRS 9.IE134(a)]*. This is similar to creating what is often referred to as a 'hypothetical derivative' for hedge relationships that do not include aggregated exposures (see section 7.4.4 below).

One leg of the synthetic aggregated exposure is based on the gross cash flows from the aggregated exposure, and the other leg is 'fixed at a blended rate' such that the present value of the whole synthetic aggregated exposure (in local currency) is nil on initial hedge designation. Similar to the role of the fixed leg in a hypothetical derivative, the fixed leg in the synthetic aggregated exposure is designed to reflect the level at which the hedged risk in the aggregated exposure could be locked in on initial designation of the second level relationship. The purpose of this is to capture the present value of the variability of cash flows of the aggregated exposure from that point onwards.

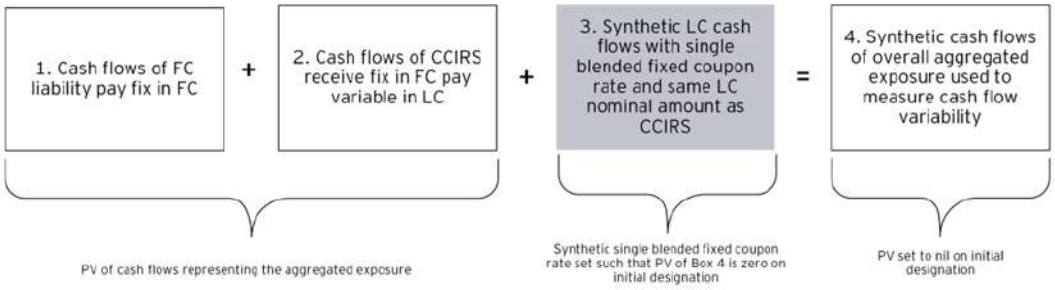
In this particular fact pattern, the leg in the synthetic aggregated exposure that represents the cash flows of the aggregated exposure is a combination of the future foreign currency cash outflows on the liability and the local and foreign currency cash outflows and inflows on the CCIRS. The 'blended' rate for the fixed leg of the synthetic aggregated exposure is calibrated so that the present value of the synthetic aggregated exposure in total is nil on designation of the second level relationship.

In the Illustrative Example, all the cash flows contributing to the leg that represents the cash flows of the aggregated exposure are recorded and valued on a gross basis. It follows that if the cash flows from the foreign currency fixed rate liability and those from the receive fixed foreign currency leg of the CCIRS do not exactly offset, then the resultant foreign currency 'net cash flow' will contribute to the synthetic aggregated exposure leg that represents the cash flows of the aggregated exposure. In this fact pattern where the hedging instrument in the second-level relationship is a local currency IRS without any foreign currency risk, fair value changes associated with such foreign currency net cash flow in the synthetic aggregated exposure would result in ineffectiveness. *[IFRS 9.IE134(a)]*.

When considering the determination of the synthetic aggregated exposure, if a first level relationship has been designated, it is important to consider how the derivative has been included in that first level relationship. The way in which a derivative is included in the aggregated exposure in the second level relationship must be consistent with the designation of that derivative as the hedging instrument in the first level relationship. For example, if an entity excludes the forward element or foreign currency basis spreads from its designation as a hedging instrument in the first level relationship (see section 3.6 below), then it should also exclude it from designation as part of an aggregated exposure in the second level relationship. This has the effect that if the forward element or foreign currency basis spreads are excluded from the first level relationship, those excluded elements are not considered to be fair value drivers of the aggregated exposure within the second level relationship.

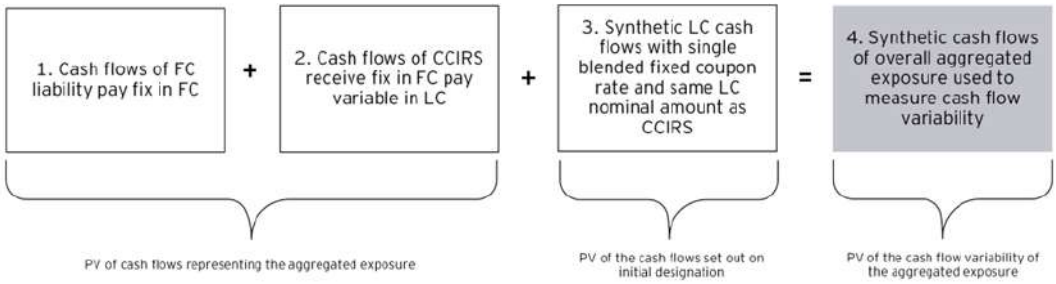
[IFRS 9.B6.3.4(b)].

The diagram below illustrates the methodology described above. The grey field identifies the output from the calculation, which is the calibrated fixed leg of the synthetic aggregated exposure that results in a zero present value for the overall synthetic aggregated exposure on initial designation of the second level relationship.



In each subsequent period, the local currency present values are updated to reflect changes in the cash flows representing the aggregated exposure, associated discount rates (and foreign currency rates if relevant), while holding the previously calibrated blended fixed rate on the synthetic aggregated exposure constant, similar to a hypothetical derivative (see section 7.4.4 below). The sum of the resulting present values of cash flows, i.e., the local currency present value of the overall synthetic aggregated exposure (which previously was calibrated to be nil as at designation), represents the present value of the cash flow variability of the aggregated exposure which is used for measurement of ineffectiveness. *[IFRS 9.IE134]*.

This is illustrated in the diagram below. The grey field represents the output from this calculation which is the current present value of the cash flow variability of the aggregated exposure.



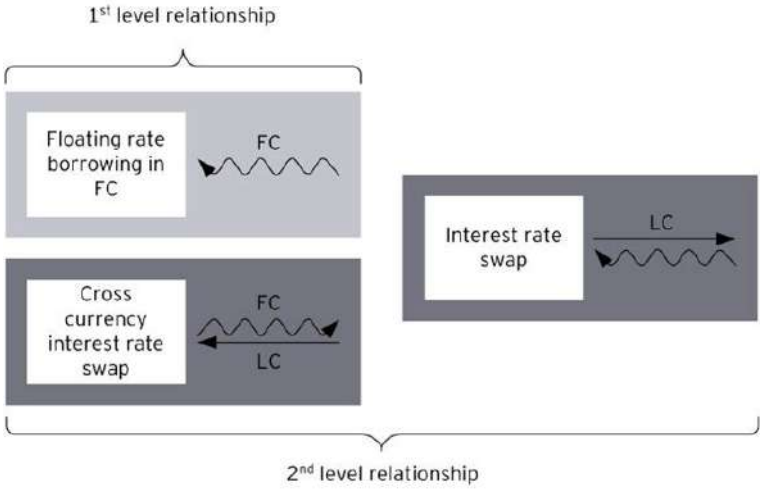
Ineffectiveness is then determined by comparing the change in calculated present value of the cash flow variability of the aggregated exposure and the fair value of the hedging instrument, (i.e., the local currency IRS). The normal ongoing cash flow hedge accounting treatment is applied to the change in fair value of the hedging instrument (see section 7.2 below). The accounting for the first level relationship in Illustration 2-23 above continues unaffected by the second level relationship.

2.7.3.B Fair value hedge of an aggregated exposure of foreign currency floating rate loan and cross-currency swap interest rate swap

Illustration 2-24: Fair value hedge of interest rate risk of an aggregated exposure made up of a floating rate loan in a foreign currency and a cross-currency interest rate swap

This fact pattern is based on Example 18 in the Illustrative Examples. *[IFRS 9.IE138-147]*. An entity has a floating rate borrowing denominated in a foreign currency (FC) and is therefore exposed to foreign currency risk and cash flow risk due to changes in interest rates. The entity decides to swap the borrowing into a functional currency (LC) fixed rate borrowing using a cross-currency interest rate swap (CCIRS). The CCIRS is designated as the hedging instrument in a cash flow hedge (first-level relationship). By doing so, the entity has eliminated both the foreign currency risk and the cash flow risk due to changes in interest rates. However, it is now exposed to a fair value risk resulting from changes in the functional currency interest rate curve.

Later, the entity decides to hedge this fair value risk and enters into an interest rate swap (IRS) that receives fixed rate and pays floating rate interest in its functional currency. By doing so, the entity is hedging the aggregated exposure, which is the combination of the original exposure and the CCIRS. The IRS is designated as the hedging instrument in a fair value hedge for changes in interest rates (second-level relationship). *[IFRS 9.IE139(b)]*. The diagram below illustrates the two hedging relationships.



The concept of economically hedging aggregated exposures as such is straightforward. However, the accounting for such relationships includes some complexity, as noted above. As for any hedge accounting relationship, there is a need to calculate the cumulative change in present value of the aggregated exposure in order to measure ineffectiveness in the second level hedge relationship. Paragraph IE144 in the IFRS 9 Illustrative Examples provides some direction as to how this will be achieved: similar to Illustration 2-23 above, this can be calculated as the change in local currency present value of the gross cash flows from the instruments making up the aggregated exposures. However, in this example there is no requirement to create a synthetic blended fixed leg, as the aggregated exposure itself is essentially fixed.

An additional complexity in Illustration 2-24 above, is that it is a cash flow hedge in the first-level relationship that is then designated as the hedged item in a fair value hedge. The cross-currency interest rate swap is both a hedging instrument (first level cash flow hedge relationship) and part of a hedged item (second level fair value relationship) at the same time. Accordingly, its fair value changes are initially recognised in other comprehensive income (OCI) through the first level cash flow hedge accounting, but at the same time, will also offset the fair value changes in profit or loss of the hedging IRS in the second-level fair value relationship. This requires a reclassification of the amounts recognised in OCI to profit or loss (to the extent they relate to the second-level relationship) to achieve the offset in the second-level fair value hedge relationship. Consequently, applying fair value hedge accounting to a cross-currency interest rate swap designated as the hedged item as part of an aggregated exposure affects where the hedging gains or losses from the first level cash flow hedge relationship are recognised (i.e., reclassification from the cash flow hedge reserve to profit or loss). *[IFRS 9.IE143]*.

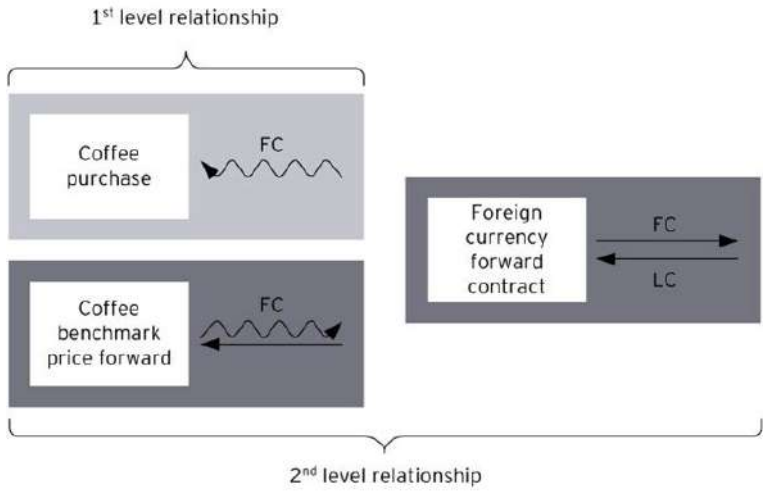
2.7.3.C Cash flow hedge of an aggregated exposure of coffee purchases and benchmark price coffee forward contract

As explained in the Illustrative Examples, the application of hedge accounting to an aggregated exposure gets even more complicated when basis risk is involved in one of the hedging relationships, in particular if basis risk is present in the first-level relationship. This is shown in Illustration 2-25 below.

Illustration 2-25: Cash flow hedge of foreign currency risk of an aggregated exposure made up of forecast commodity purchases and a commodity forward contract

This fact pattern is based on Example 16 in the Illustrative Examples *[IFRS 9.IE116-127]*. Entity A, with functional currency (LC), enters into a coffee benchmark price forward contract to hedge its highly probable coffee purchases in foreign currency (FC) in five years. The coffee price that Entity A expects to pay for its coffee purchases is different from the benchmark price. This differential could be because of differences in one or a combination of factors such as the type of coffee, the location or delivery arrangements. Entity A designates the benchmark price forward contract and the highly probably forecast transaction as a cash flow hedge (the first level relationship). The entity designates the entire price risk and not only the benchmark price risk as it was not able to separately identify a benchmark price component in the hedged item (see section 2.2.3 above). Accordingly, basis risk exists in the first level relationship. The entity is still exposed to foreign currency risk.

One year later, the entity hedges the foreign currency risk by entering into a foreign currency forward contract. The entity designates the aggregated exposure in the first level relationship and the foreign currency forward contract as a cash flow hedge (the second level relationship). *[IFRS 9.IE119(b)]*. The diagram below illustrates the two hedging relationships.



Example 16 in the Illustrative Examples of IFRS 9 demonstrates the accounting effort required in order to achieve hedge accounting for the aggregated exposure. First, the entity calculates the change in fair value of the hedged item and hedging instrument in the first level cash flow hedge relationship in foreign currency and translates them into local currency, using spot rates. Using these local currency equivalents, the entity calculates the ineffectiveness in the first level hedging relationship in the usual way. Second, the entity calculates the change in fair value of the aggregated exposure and the hedging instrument in the second-level cash flow hedge relationship in local currency. This results in the second level ineffectiveness. The existence of basis risk within the first level relationship complicates the measurement of ineffectiveness in the second level relationship described above. The aggregated exposure is a combination of the foreign currency cash flows expected from the highly probable coffee purchases (i.e., the hedged coffee purchase volume multiplied by the current forward price) and the undiscounted gain or loss on the commodity hedging contract (i.e., the expected price differential from benchmark coffee price movements in FC that Entity A will receive or pay under the commodity forward contract). If the first level relationship was a 'perfect hedge', the resultant foreign currency cash flow to be hedged in the second level relationship would be known. However, as commodity basis risk exists in the first level relationship, the hedged amount of foreign currency in the second level relationship will vary, as the basis spread between the price of the forecast coffee purchases and the underlying coffee price in the hedging contract varies. The hedging instrument in the second level relationship is just a foreign currency forward contract, and so its fair value changes are insensitive to commodity basis risk. Accordingly, additional ineffectiveness could arise in the second level relationship, due to the commodity basis risk that exists in the first level relationship. *[IFRS 9.IE122, IFRS 9.IE119(b)]*.

For example, at inception of the second level relationship, an entity might have expected a hedged aggregated cash flow of FC990 based on the price achieved in the commodity hedging contract and the level of basis risk that then existed. The expected aggregated hedged foreign currency cash flow at inception is calculated as follows:

Designated volume of hedged coffee purchases ×
prevailing forward coffee price for actual coffee purchases

Plus

Designated volume of the hedging instrument multiplied by the difference between the contractual forward coffee price and the current forward coffee price referenced in the forward contract.

However, at the date when the entity calculates the ineffectiveness, the expected aggregated cash flow from the forecast coffee purchase and the commodity hedging contract might be FC1,000 due to changes in the commodity basis risk in the first level relationship. In that case an entity would need to measure effectiveness as if the current expected hedged cash flow from the aggregated exposure was always the expectation at inception (i.e., FC1,000 in the example given above). *[IFRS 9.IE122, IFRS 9.IE123]*.

Specifically, for the second level relationship in this scenario the effective portion taken to OCI would be calculated as the lower of the following amounts: *[IFRS 9.6.5.11(a)]*

Change in fair value of the current expected hedged
cash flow from the aggregated exposure as if they had existed since inception.

(e.g., based on a hedged cash flow of FC1,000)

And

Change in fair value of the actual hedging instrument.

(e.g., based on original assumption of hedged flow of FC990)

As is usual for cash flow hedges (see section 7.2 below), ineffectiveness to be reported in the profit or loss is the change in fair value of the actual hedging instrument less the effective portion taken to OCI.

Hence it can be seen that for hedge effectiveness measurement purposes, not only is the change in fair value of the hedged cash flows affected by variations in the second level relationship hedged risk, but also by ineffectiveness in the first level relationship. This second driver of fair value change can be seen in the example above as, although the hedging instrument has a notional of FC990, the hedged cash flow is updated to FC1,000, to reflect ineffectiveness in the first level relationship. This is likely to result in incremental ineffectiveness in the second level relationship.

Example 16 in the Illustrative Examples demonstrates that to reduce the basis risk the entity could choose a hedge ratio other than 1:1 for the first level relationship (see section 6.4.3 below). In the example the entity selects the volume of foreign currency forward contract for the hedging instrument in the second level relationship based on the implied coffee forward price at the time the first level relationship was designated. This assumes the entity's original long-term expectations of the basis spread have not changed since the coffee forward was transacted, which might not always be the case. Alternatively, when identifying the optimal volume of the hedging instrument, an entity could conclude that the appropriate basis spread is the prevailing basis spread at the time of designation of the second level relationship. However, of course, the actual basis spread the entity will suffer is unknown.

Another layer of complexity would be added if the entity subsequently needed to rebalance the hedge relationship because of changes in the expected basis. The example, however, does not include this. Although the accounting for the second level relationship could be complex, the accounting for the first level hedge relationship in this example would continue to be unaffected by the existence of the second level relationship.

2.7.3.D Cash flow hedge of an aggregated exposure of forecast foreign currency debt and forecast cross-currency swap interest rate swap

The definition of an aggregated exposure also includes a forecast transaction of an aggregated exposure (i.e., uncommitted but anticipated future transaction that would give rise to an exposure and a derivative) if that aggregated exposure is highly probable. *[IFRS 9.6.3.4]*. An example, where this might be helpful, is when pre-hedging the interest rate risk in a forecast foreign currency debt issue:

Illustration 2-26: Cash flow hedge of interest rate risk of an aggregated exposure made up of forecast foreign currency debt and forecast cross-currency swap interest rate swap

Assume it is highly probable that an entity will issue foreign currency debt in six months' time. It is also highly probable that on issue the entity will transact a CCIRS, converting the debt to functional currency variable rate debt. The combination of the forecast foreign currency debt issuance and the forecast transaction of the CCIRS is economically a forecast functional currency variable rate debt issuance.

The entity wishes to hedge itself against increases in the variable functional currency interest rate between today and the issue of the debt in six months as well as over the term of the debt. Therefore, the entity enters into a forward starting pay fixed/receive variable functional currency IRS. The entity designates the IRS as a hedging instrument in a cash flow hedge of the forecast aggregated exposure.

In this example the first level relationship does not exist yet, as both the hedged item (foreign currency debt) and the hedging instrument (CCIRS) are forecast transactions. Hedge accounting for the 'second level hedge relationship' of the forecast aggregated exposure is still permitted though, on the condition that when the aggregated exposure occurs and is no longer forecast, it would be eligible as a hedged item. *[IFRS 9.6.3.4]*.

As noted above, only forecast aggregated exposures that are highly probable of occurring are eligible as hedged items in a second level hedge relationship (see section 2.6.1 above). Although all the terms of the highly probable forecasted aggregated exposure may not be known definitively in advance, it is important that they are known with reasonable specificity, both in order to measure any ineffectiveness from the hedge relationship (see section 7.4 below) and also to determine whether and when the documented hedged item occurs (see section 8.3 below). In particular, when measuring ineffectiveness, all key terms of the aggregated exposures that are relevant to the measurement of ineffectiveness must be determinable. It is less important that any features excluded from the hedge relationship are known. For example, in the scenario described in Illustration 2-26 above, if the foreign currency basis spreads of the forecast CCIRS will be excluded from the future hedge relationship in which the CCIRS is the hedging instrument and the foreign currency debt is the hedged item, foreign currency basis spreads are not a key term relevant for measurement of ineffectiveness in the hedge relationship of the forecast aggregated exposure (see section 2.7.3.A above). Documentation of the second level relationship should include the expectation that certain elements (e.g., foreign currency basis spreads) will be excluded in the first level relationship. *[IFRS 9.B6.3.4(b)]*.

2.7.3.E Cash flow hedge of an aggregated exposure of a net investment in a foreign operation and cross-currency swap interest rate swap

Just because an entity enters into an additional derivative transaction that relates to an existing hedging relationship it does not mean that this relationship qualifies as an aggregated exposure. This is demonstrated by the following Illustration.

Illustration 2-27: Cash flow hedging of an aggregated exposure that includes a net investment in a foreign operation and a cross currency interest rate swap

Parent A with functional currency Australian dollars (AUD) has a US dollar (USD) net investment exposure. It transacts a pay floating USD receive floating AUD cross-currency interest rate swap (CCIRS) and designates it in a hedge of a net investment in a foreign operation (see section 5.3 below). By doing so, the group is exposed to cash flow variability due to the floating rate exposure in AUD and USD. Parent A also enters into a pay floating/receive fixed AUD interest rate swap (IRS) to eliminate cash flow variability from changes in AUD interest rate risk, and wishes to designate this derivative as the hedging instrument item in a cash flow hedge for the aggregated exposure including the net investment in a foreign operation.

While there is an economic relationship between the net investment exposure and the CCIRS for foreign currency risk, there is no economic relationship between the aggregated exposure and the IRS for interest rate risk. This is because the USD floating interest rate cash flows on the CCIRS are not offset by the USD net investment, as it does not have cash flow variability that is closely linked to interest rates. Furthermore, aggregated exposures can only be designated if they are managed as one exposure for a particular risk, which is unlikely to be the case in this fact pattern given the lack of interest risk associated with the net investment. *[IFRS 9.B6.3.3]*.

3 Hedging instruments

3.1 General requirements

The basic requirement for a hedging instrument is for it to be one of the following (or a proportion thereof (see section 3.6 below)):

- A derivative measured at fair value through profit or loss, except for some written options (see section 3.2 below)
- A non-derivative financial asset or liability measured at fair value through profit or loss (see section 3.3 below)

  Or
- For a hedge of foreign currency risk, the foreign currency risk component of a non-derivative financial asset or liability (see section 3.3.1 below) *[IFRS 9.6.2.1, IFRS 9.6.2.2]*

Hedging instruments must also involve a party that is external to the reporting group. *[IFRS 9.6.2.3]*. Two or more financial instruments can be jointly designated as hedging instruments (see section 3.5 below). *[IFRS 9.6.2.5]*.

There is no requirement to designate a hedging instrument only on initial recognition. Designation of a hedging instrument sometime after its initial recognition (e.g., after a previous hedge relationship is discontinued) is permitted, although some additional ineffectiveness could arise (see sections 2.4.1 above and 7.4.3 below). *[IFRS 9.B6.5.28]*.

3.2 Derivatives as hedging instruments

The distinction between derivative and non-derivative financial instruments is covered in Chapter 42. The standard does not restrict the circumstances in which a derivative measured at fair value through profit or loss can be designated as a hedging instrument, except for some written options. A written option does not qualify as a hedging instrument, unless the written option is designated to offset a purchased option. Purchased options include those that are embedded in another financial instrument and not required to be accounted for separately (see Chapter 42 at section 4.1). *[IFRS 9.B6.2.4]*.

How we see it

Although not specifically mentioned in the standard, we believe that embedded purchased options in non-financial instruments that are not required to be bifurcated could also be designated as being hedged by a written option.

A single instrument combining a written option and a purchased option, such as an interest rate collar, cannot be a hedging instrument if it is a net written option at the date of the designation. Similarly, options that are transacted as legally separate contracts could be jointly designated as hedging instruments if the combined instrument is not a net written option at the date of designation. *[IFRS 9.6.2.6]*. There appears to be no requirement for the jointly designated options to be with the same counterparty. See section 3.2.2 below for further discussion as to what constitutes a net written option.

A contract that is considered a normal sale or purchase, and is therefore accounted for as an executory contract (see Chapter 41 at section 3), cannot be an eligible hedging instrument as it is not measured at fair value though profit or loss. However, IFRS 9 does provide an alternative to hedge accounting for normal sale or purchase contracts in that a fair value option designation may be possible at inception of the contract (see section 11.2 below).

In addition, a forecast transaction or planned future transaction cannot be the hedging instrument as it is not a recognised financial instrument, and is therefore not a derivative. *[IFRS 9.B3.1.2(e)]*.

3.2.1 Offsetting external derivatives

Where two offsetting derivatives are transacted at the same time, it is generally not permitted to designate one of them as a hedging instrument in a hedge when the derivatives are viewed as one unit of account. *[IFRS 9.6.2.4]*. Indicators that the two derivatives must be accounted for as one unit are as follows:

- The second derivative was entered into at the same time and in contemplation of the first
- There is a no apparent economic need or substantive business purpose for structuring the transactions separately, that could not also have been accomplished in a single transaction
- They relate to the same risk

  And
- The derivatives are with the same counterparty *[IFRS 9.IG B.6]*

This issue is also discussed in Chapter 42 at sections 2.2 and 7. It is emphasised that judgement must be applied in determining what a substantive business purpose is. For example, a centralised treasury entity could enter into third party derivative contracts on behalf of other subsidiaries to hedge their interest rate exposures and, to track those exposures within the group, enter into internal derivative transactions with those subsidiaries. It could also enter into a derivative contract with the same counterparty during the same business day with substantially the same terms as a contract entered into as a hedging instrument on behalf of another subsidiary as part of its trading operations, or because it wishes to rebalance its overall portfolio risk. In this case, there is a valid business purpose for entering into each contract. However, a desire to achieve hedge accounting for the hedged item is deemed not to be a substantive business purpose. *[IAS 39.F.1.14]*. This issue can also arise when derivatives transacted between the retail banking and investment banking legal entities within a banking group are novated to a central clearing party (see section 4.1.1 below).

The assessment as to whether such a substantive business purpose exists or not must be made based on the particular facts and circumstances, including consideration of the regulatory environment, and the judgement documented accordingly.

3.2.2 Net written options

It was explained in IAS 39 that an option an entity writes is not effective in reducing the profit or loss exposure of a hedged item. In other words, the potential loss on a written option could be significantly greater than the potential gain in value of a related hedged item. *[IAS 39.AG94, IFRS 9.BC6.151]*. This is the rationale for prohibiting a written option from qualifying as a hedging instrument unless it is designated as an offset to a purchased option, including one that is embedded in another financial instrument and not required to be accounted for separately (see Chapter 42 at section 3). An example of this might be a written call option that is used to hedge a callable liability. *[IFRS 9.B6.2.4]*. In contrast, a purchased option has potential gains equal to or greater than potential losses on a related hedged item and therefore has the potential to reduce profit or loss exposure from changes in fair values or cash flows. Accordingly, a purchased option can qualify as a hedging instrument. *[IAS 39.AG94]*.

It follows that a derivative such as an interest rate or foreign currency collar that includes a written option cannot be designated as a hedging instrument if the collar is a net written option.

Accordingly, determining whether an option contract or a combination of options (see section 3.5 below) constitutes a net written option is an important step in hedge designation, and can require judgement. The following factors, taken together, indicate that an instrument or combination of instruments is not a net written option:

- No net premium is received, either at inception or over the life of the combination of options - the distinguishing feature of a written option is the receipt of a premium to compensate for the risk incurred.
- Except for the strike prices, the critical terms and conditions of the written and purchased option components are the same, including underlying variable(s), currency denomination and maturity date.

  And
- The notional amount of the written option component is not greater than that of the purchased option component. *[IFRS 9.BC6.153]*.

The application of these requirements is better demonstrated in the following Illustrations.

Illustration 3-1: Hedging foreign currency risk of a forecast transaction using a combined option instrument

An entity is exposed to foreign currency risk resulting from a highly probable forecast transaction in a foreign currency. In order to hedge that exposure, the entity enters into a collar by combining a long call and a short put option. The premium paid on the long call option equals the premium received on the short put option (i.e., it is what is termed a 'zero cost collar').

The entity wishes to designate the combination of the two instruments in a cash flow hedge of its highly probable forecast transaction with respect to changes in foreign currency risk within the specified hedged range (see section 2.1 above). However, applying the requirements above, in order to determine whether the collar is a not a net written option, additional information would be required as consideration of premium on its own is insufficient.

Illustration 3-2: Foreign currency collar (or 'cylinder option')

Company E, which has sterling as its functional currency, has forecast that it is highly probable it will receive €1,000 in six months' time in respect of an expected sale to a customer in France.

E is concerned that sterling might have appreciated by the time the payment is received and wishes to protect the profit margin on the sale without paying the premium that would be required with an ordinary currency option. E also wishes to benefit from some of the upside in the event that sterling depreciates, so would prefer not to use a forward contract.

Accordingly, E enters into an instrument under which it effectively:

- Purchases an option that allows it to buy sterling for €1,000 from the counterparty at €1.53:£1.00

  And

- Sells an option that allows the counterparty to sell sterling to E for €1,000 at €1.47:£1.00

If, in six months' time, the spot exchange rate exceeds €1.53:£1.00, E will exercise its option to sell €1,000 at €1.53:£1.00, effectively fixing its minimum proceeds on the sale (in sterling terms) at £654. Similarly, if the rate is below €1.47:£1.00, the counterparty will exercise its option to buy €1,000 at €1.47:£1.00, effectively capping E's maximum proceeds on the sale at £680. If the rate is between €1.47:£1.00 and €1.53:£1.00, both options will lapse unexercised and E will be able to sell its €1,000 for sterling at the spot rate, generating between £654 and £680. So, the option only provides protection against changes in the €/£ spot exchange rate above €1.53 and below €1.47, the hedged range (see section 2.1 above).

The premium that E would pay to acquire the purchased option equals the premium it would receive to sell the written option and therefore no premium is paid or received on inception. The critical terms and conditions, including the notional amounts, of the written and purchased option components are the same except for the strike price. Therefore, E concludes that the instrument is not a net written option and, consequently, it could be used as the hedging instrument in a hedge of the foreign currency risk associated with the future sale.

It is possible that the counterparty might, instead, have offered E a variation on the instrument described above. If the notional amount on E's purchased option component had been reduced, say to €500, the counterparty could have offered a better rate on that component, say €1.51. However, in this case, the notional amount on the written option component would have been twice that of the purchased option component and the instrument would have been seen as a net written option. Accordingly, even if E had very good business reasons for using such an instrument to manage its foreign currency risk, it could not qualify as a hedging instrument. Therefore, hedge accounting would be precluded.

Illustration 3-3: 'Knock-out' swap

Company Y has a significant amount of long-dated floating rate borrowings. In order to hedge the cash flow interest rate risk arising from these borrowings, Y has entered into a number of matching pay-fixed, receive-floating interest rate swaps that effectively convert the interest rates on the borrowings to fixed-rate.

Under the terms of one of these swaps, on each fifth anniversary of its inception until maturity, the swap counterparty might choose to simply terminate the swap at no cost if the relevant floating rate on the interest rate swap exceeded 6%. This is often referred to as a knock-out feature. In return for agreeing to this, Y benefits by paying a lower interest rate on the fixed leg of the swap than it would on a conventional swap. In other words, Y receives a premium for taking on the risk of the counterparty cancelling the swap.

This instrument contains a net written option, i.e., the knock-out feature, and therefore cannot be used as a hedging instrument unless it is used in a hedge of an equivalent purchased option. (In practice, it is unlikely that the hedged borrowings will contain such an option feature).

Illustration 3-4: Zero cost interest rate collar

Company T has 3-year floating rate debt, paying monthly coupons based on a benchmark rate. Company T wants to protect against rises in the benchmark rate but also wishes to benefit to some extent from any reduction in that rate. In line within this risk management objective, Company T transacts a zero cost collar contract (i.e., no premium is paid or received). The terms of the collar are such that for each monthly fixing the benchmark rate is capped at 1.5% and floored at 1%. Accordingly, the contract is in fact a series of 36 purchased European collars with one collar expiring every month for the next 36 months. The critical terms such as notional, benchmark rate and fixing dates of the zero cost collar matches those of the hedged floating rate debt. The zero cost collar is designated as hedging variability in the benchmark rate with respect to the floating rate debt within the collar hedged range (i.e., benchmark rate < 1% or >1.5%). The zero cost collar is not a net written option. This is despite the fact it might very well be that if the zero cost collar were to be deconstructed into 36 single collars, for one or more individual months there might be a net premium receivable. This approach is consistent with the documentation of the collar as a single financial instrument, with a single 'overall' price, and a single hedge designation.

When hedging with a combination of options, assessing whether the combination is a net written option can be an essential step in order to achieve hedge accounting. This assessment must be undertaken on the date of the hedge designation. For example, if a combination is designated sometime after the combination was transacted, it is insufficient to conclude that the combination did not result in receipt of a premium as at the combination transaction date. Consideration must be given to the relative risks associated with the options within the combination on the date of designation. If the fair value of the combination is negative on designation date, then that is usually an indication that the instrument is considered a net written option at that time, and is therefore ineligible for hedge accounting.

See sections 3.6.4, 7.4.11 and 7.5.1 below for further discussion of the implications of using options as hedging instruments.

3.2.3 Embedded derivatives

Only derivatives that are measured at fair value through profit or loss are eligible hedging instruments. *[IFRS 9.6.2.1]*. Derivatives that are embedded in hybrid contracts, but that are not separately accounted for, cannot be designated as separate hedging instruments. *[IFRS 9.B6.2.1]*. Given that embedded derivatives in financial assets are not accounted for separately under IFRS 9 (see Chapter 44 at section 5), this guidance precludes designation of embedded derivatives in financial assets as separate hedging instruments. *[IFRS 9.BC6.119]*.

However, an embedded derivative that is accounted for separately from its host contract (either a financial liability or non-financial host) (see Chapter 42 at section 3), is measured at fair value through profit or loss, and therefore could be an eligible hedging instrument.

Illustration 3-5: Hedging with a sales commitment

Company J has the Japanese yen as its functional currency. J has issued a fixed-rate debt instrument with semi-annual interest payments that matures in two years with principal due at maturity of US$5 million. It has also entered into a fixed price sales commitment for US$5 million that matures in two years and is not accounted for as a derivative because it qualifies for the normal sales exemption.

Because the sales commitment is accounted for as a firm commitment (i.e., it is not recognised until at least one of the parties to the contract has performed (see Chapter 45 at section 2.1.2)) rather than a derivative instrument, it cannot be a hedging instrument in a hedge of the foreign currency risk associated with the debt instrument. However, if the foreign currency component of the sales commitment was required to be separated as an embedded derivative (essentially a forward contract to buy US dollars for yen) (see Chapter 42 at section 4.2.1) that component could be designated as the hedging instrument in such a hedge. *[IAS 39.F.1.2]*.

3.2.4 Credit break clauses

It is not uncommon for certain derivatives (e.g., long-term interest rate swaps) to contain terms that allow the counterparties to settle the instrument at a so-called 'fair value' in certain circumstances. The 'fair value' is usually not a true fair value as it excludes changes in credit risk. Such terms, often called 'credit break clauses', enable the counterparties to manage their credit risk in markets where collateral or margin accounts and master netting agreements are not used. They are particularly common where a long-duration derivative is transacted between a financial and non-financial institution. For example, the terms of a twenty-year interest rate swap could allow either party to settle the instrument at fair value on the fifth, tenth and fifteenth anniversary of its inception.

These terms can be seen as options on counterparty credit risk. However, provided the two parties have equivalent rights to settle the instrument at 'fair value', the credit break clause will generally not prevent the derivative from qualifying as a hedging instrument.

3.2.4.A Principal resetting cross-currency swaps

Another mechanism aimed at reducing ongoing credit risk in longer term derivatives is a principal resetting feature, typically within floating-floating cross-currency swaps. The principal resetting feature allows the fair value of the swap to be settled on a quarterly basis without terminating the swap itself.

Similar to a standard cross-currency swap, the fair value of a principal resetting floating-floating cross-currency swap changes in response to the movements in foreign currency rates; however, the principal resetting feature means that the fair value of the swap attributable to foreign currency spot movement is cash settled at each quarterly reset date, in addition to the normal interest settlements.

Depending on changes in foreign currency spot rates, this could result in either a cash inflow (for the positive fair value) or outflow (for the negative fair value) at the end of each quarter. The notional of the principal resetting swap is then reset to the prevailing foreign currency spot rate.

The resetting feature itself does not appear to preclude the swap from being an eligible hedging instrument (see section 3.2 above), however the implications of using such a swap as the hedging instrument in a hedge relationship need further consideration. This is best achieved by way of an example.

Illustration 3-6: Hedging with a principal resetting cross-currency swap

Company A has the Australian dollar as its functional currency. Company A has issued USD variable rate debt with principal due at maturity of USD100 million. Company A wishes to eliminate the foreign currency risk associated with the foreign currency debt and enters into a principal resetting cross-currency swap; the current terms of which are to receive a specified variable benchmark rate of interest on USD100m and pay a specified variable benchmark rate of interest plus a cross-currency spread on AUD148m. Interest coupons are settled (and reset) on a quarterly basis.

The principal reset feature requires that the fair value of the swap attributable to the foreign currency spot movement is cash settled at each quarterly reset date, and the principal of the receive USD leg is adjusted to reflect the prevailing spot rate.

If the foreign currency spot rate had changed such that on the first quarterly reset date it was AUD1.4:USD1, Company A would pay USD5.7m, and the USD principal would be adjusted to USD105.7m to reflect the prevailing foreign currency spot rate (AUD148m ÷ 1.4 = USD105.7m).

Company A could wish to designate the USD debt as the hedged item and the principal resetting swap as the hedging instrument, however, in order to achieve hedge accounting all the hedge accounting criteria must be met (see section 6 below). In this case, the impact of the variation in the swap principal could be problematic, in particular where, as in this example, it is the foreign currency leg of the swap that is reset, as this will most likely require some amendment to the hedge relationship. For example, after the first quarterly reset rate the pay USD leg of the principal reset swap is now USD105.7m, however the hedged item remains the USD100m variable rate debt.

Company A will need to consider how best to adjust the hedge relationship to reflect the ongoing risk management strategy and continue to meet the hedge accounting criteria (see section 8 below).

3.2.5 Basis swaps

A derivative which does not reduce risk at the transaction level cannot be a hedging instrument. Consider a 'basis swap' that effectively converts one variable interest rate index (say a central bank base rate) on a liability to another (say SONIA). A relationship of this nature would not normally qualify for hedge accounting because the hedging instrument does not reduce or eliminate risk in any meaningful way - it simply converts one risk to another similar risk.[8] For this reason, such an economic strategy would not qualify as either a fair value or cash flow hedge relationship (see sections 5.1 and 5.2 below).

A basis swap or similar instrument could qualify as a hedging instrument when considered in combination with another instrument (see section 3.5 below). For example, the basis swap described above and a pay-fixed, receive-SONIA interest rate swap could qualify as a hedging instrument in a cash flow hedge of a borrowing that pays interest based on a central bank rate. It could also be notionally decomposed and designated in hedges of offsetting gross asset and liability positions (see Illustration 3-12 in section 3.6.2 below).

However, a currency basis swap that converts foreign currency variable rate interest and principal cash flows from a financial instrument into variable rate interest and principal cash flows in functional currency could be eligible as a hedging instrument in a cash flow hedge, as variability in cash flows with respect to foreign currency has been reduced (or eliminated). The fact that variability in cash flows with respect to interest rate risk remains, does not preclude hedge accounting for foreign currency risk (see section 2.2.5 above and Illustration 3-11 in section 3.6.2 below).

3.2.6 Power Purchase Agreements

It is becoming increasingly common for entities to enter into long term contracts for renewable energy, often referred to as power purchase agreements. These could be either physical power purchase agreements (PPAs) or virtual power purchase agreements (VPPAs).

VPPAs do not involve the physical purchase or delivery of energy but are typically structured as a 'contract for difference' between the fixed price (per MW of energy) determined in the VPPA and the spot price at which energy could be purchased from the grid (i.e., net settled). The volume of energy determined in such contracts is usually based on all or a proportion of the energy produced from a referenced production facility, hence the volume is variable and cannot be determined with certainty in advance.

These contracts would typically meet the definition of a derivative (see Chapter 42 at section 1) and are often transacted as part of a risk management strategy for the physical purchase of energy used in a business. Therefore, a common question arises as to whether it is possible to achieve hedge accounting with VPPAs as the hedging instrument. A similar question arises for the purchaser in physical power arrangements (PPAs) which do not meet the 'own use' requirements and are also accounted for as derivatives (see Chapter 41 at section 3.3). As VPPAs and PPAs that do not meet the own use requirements are derivatives, they are eligible hedging instruments (see section 3.2 above), however there are still some challenges in achieving hedge accounting.

The main challenges in achieving hedge accounting for VPPAs and PPAs arise from the fact that, unlike most other contracts where cash flow variability only arises because of price uncertainty, in such contracts for renewable electricity, cash flow variability arises because of both price and volume uncertainty. This is due to the underlying volume of energy in the contract typically being based on a proportion of the energy produced from a referenced production facility.

In March 2019 the IFRS IC observed that forecast sales cannot be specified as a hedged item solely as a percentage of sales during a period because that would lack the required specificity in terms of magnitude and timing (see sections 2.3.1 and 2.6.1 above and section 6.3.3 below). It follows that, for all hedge designations, a known amount or component of hedged item must be identified. This precludes designating as the hedged item a proportion of the volume of energy produced by a referenced production facility.

When designating in a cash flow hedge a hedging instrument that is a VPPA or PPA for which the volume of energy is dependent on production, the need to designate a known volume of energy as the hedged item does not preclude hedge accounting, but it does create challenges.

In the case of a supplier of renewable energy, in order to achieve hedge accounting for forecast sales of energy, a known volume of energy must be designated. This is even though the VPPA is economically hedging a variable volume of energy equal to a proportion of the total energy produced.

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8 IASB Staff Paper 4B, Project: *Dynamic Risk Management*, Paper topic: *Derivatives used for DRM purposes*, IASB Meeting, June 2018, para. 11. Available on the IFRS Foundation's website.

Similarly, in the case of a purchaser, a known volume of energy purchased must be designated in order to achieve hedge accounting. This is the case even if the purchaser determines that it is highly probable its energy needs will exceed the expected volume of renewable electricity from the production facility as referenced in the VPPA or PPA.

It may be difficult to determine that an economic relationship exists between a hedged item based on a fixed volume of energy and a hedging instrument based on a variable volume (see section 6.4.1 below). Factors to consider within this assessment might be the existence of caps and/or floors on the volume of energy referenced in the VPPA or PPA, the likely volatility of volume of energy produced by the referenced producer, or other fair value drivers of the VPPA or PPA that do not exist in the designated hedged item. This is in addition to the usual consideration of any timing, pricing or index differences between the hedged item and hedging instrument. In any case, the difference in volume of energy that forms part of the hedged item and hedging instrument are likely to result in ineffectiveness (see section 7.4 below).

Given the identified challenges, specific questions relating to PPAs were submitted to the IFRS IC and escalated to the IASB in 2023.[9] The IASB then added a maintenance project to the work plan to explore whether narrow-scope amendments could be made to IFRS 9 to better reflect how financial statements are affected by VPPAs and PPAs.[10] In May 2024 the IASB issued an ED, Contracts for Renewable Electricity, Proposed amendments to IFRS 9 and IFRS 7. This is discussed further in section 3.2.6.A below.

3.2.6.A Proposed amendments for Contracts for Renewable Energy

On 8 May 2024, the IASB published the ED, Contracts for Renewable Electricity, Proposed amendments to IFRS 9 and IFRS 7.[11] The ED contains proposed amendments to:

- Address how the 'own-use' requirements apply.
- Overcome the challenges in achieving hedge accounting if these contracts are used as hedging instruments. And
- Add disclosure requirements to enable investors to understand the effects of these contracts on a company's financial performance and future cash flows.

The proposed amendments cover both PPAs and VPPAs. This is in response to stakeholders highlighting that the objective of both PPAs and VPPAs is to ensure access to renewable electricity, and to fix the price per unit of electricity purchased or sold.

The ED is a narrow scope amendment that relates only to the contracts for renewable electricity that meet specified scope criteria and it should not be applied by analogy to other contracts, items or transactions. (see Chapter 41 at section 3.3.7.B).[12]

The comment period closed on 7 August 2024. At the time of writing this publication, the amendments and transition date have not been finalised. Nevertheless, the IASB were hoping to finalise any changes by the end of 2024, with the proposal that the new requirements will be available for companies to apply as soon as possible after they are finalised.

See Chapter 41 at section 3.3.7 for details regarding the scope criteria of the proposed amendments and the proposed amendments to the own use exception.

To overcome the challenges in achieving hedge accounting with VPPAs or PPAs as hedging instruments (see section 3.2.6 above), the ED proposes amendments allowing the hedged item in a cash flow hedging relationship to be specified as a variable volume of electricity aligned with the renewable electricity from the production facility as referenced in the VPPA or PPA designated as hedging instrument. Where a hedging contract meets the scoping characteristics (see Chapter 41 at section 3.3.7), an entity can designate a variable nominal volume of forecast electricity transactions (either sales or purchases) as the hedged item, if and only if:

- The hedged item is specified as the variable volume of renewable electricity to which the hedging instrument relates; and
- The variable volume of forecast electricity transactions (either purchases or sales) designated above does not exceed the volume of future electricity transactions that are highly probable. Forecasted sales are not required to be highly probable if the hedging instrument relates to all or a proportion of the total future renewable electricity sales from the production facility.

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9 *IFRIC update*, June 2023, available on the IFRS Foundation's website.

10 *IASB update*, July 2023, available on the IFRS Foundation's website.

11 IASB proposes amendments for renewable electricity contracts.

12 Proposed amendments to IFRS 9 and IFRS 7 - Renewable Energy Contracts | EY - Global

When assessing the hedge effectiveness requirements (see section 6.4 below) and measuring ineffectiveness (see section 7.4 below) for hedging relationships that meet the above criteria, the same volume assumptions should be applied to the hedged item as those used for measuring the hedging instrument. The hedging relationship would, therefore, not be affected by any mismatch caused by a comparison of a fixed volume of energy with a variable volume. All the other assumptions and inputs used for measuring the hedged item, including pricing assumptions, must reflect the nature and characteristics of the hedged item and must not impute the features of the hedging instrument (see section 7.4.4 below).

The proposal is that the amendments to the hedge accounting guidance must be applied prospectively to new hedging relationships designated on or after the date the amendments are first applied. In addition, an entity is permitted to change the designation of the hedged item in a cash flow hedging relationship that was designated before the date the amendments are first applied, and is still in existence, without discontinuing the hedging relationship. However, entities will not be permitted to reinstate hedging relationships already discontinued at the date the amendments are applied.

How we see it

Although the proposed amendments provide a practical solution for in scope contracts by allowing the hedged item to be specified as the variable volume of renewable electricity to which the hedging instrument relates, entities must be aware that there may still be other sources of ineffectiveness in the hedging relationship.

In particular hedge ineffectiveness could still arise in the hedge of renewable electricity purchases in the following circumstances:

- If there is a difference between the timing of purchases and electricity production resulting in differences in the electricity prices achieved;
- If the volume of electricity covered by the contract for renewable electricity exceeds the volume of actual renewal electricity purchases;
- If there is basis risk between the electricity price in the market where forecast purchases are made (the hedged risk) and the market in which the contract for renewable electricity is settled. Such a scenario would occur, for example, if an entity that purchases electricity in one jurisdiction enters into a contract for renewable electricity with an entity that is based in another jurisdiction.

3.3 Non-derivative financial instruments

Under IFRS 9, entities are permitted to designate, as hedging instruments, non-derivative financial assets or non-derivative financial liabilities that are accounted for at fair value through profit or loss. This is meant in a strict sense. Consequently, a liability designated as at fair value through profit or loss (for which the amount of its change in fair value that is attributable to changes in the credit risk of that liability is presented in other comprehensive income (OCI)) does not qualify as a hedging instrument (see Chapter 49 at section 2). *[IFRS 9.6.2.2]*. This is because the entire fair value change is not recognised in profit or loss, which would in effect allow the entity to ignore its own credit risk when assessing and measuring hedge ineffectiveness and thus conflict with the concepts of hedge accounting.

Illustration 3-7 below sets out an example of a risk management strategy for which a non-derivative financial instrument could be an eligible hedging instrument.

Illustration 3-7: Hedge of a forecast commodity purchase with an investment in a commodity fund or an exchange traded commodity

An entity is exposed to variability in cash flows from highly probable forecast purchases of crude oil that are indexed to Brent crude oil. The entity wants to hedge its cash flow risk from changes in the price of Brent crude oil. Instead of using derivative contracts, the entity purchases exchange traded investments that replicate the performance of Brent futures contracts such as commodity funds or exchange traded commodities (ETCs). ETCs have the legal form of bonds that are coupled to the price development of a commodity (either directly at the spot price or with a commodity futures contract). They can be traded like exchange traded funds but, because they are legally debt securities, they involve credit risk of the issuer (which is usually mitigated by collateralisation through physically deposited commodities or other suitable collateral).

These investments are financial instruments that (under IFRS 9) would be accounted for at fair value through profit or loss (see Chapter 44 at section 5). Consequently, they could qualify as hedging instruments if all other qualifying criteria for hedge accounting are met (see section 6 below). In particular, the effectiveness assessment would have to take into account that the fair value change of the investments will differ from the present value of the cumulative change in the cash flows for the forecast purchases of crude oil (see section 6.4 below). This is because of aspects such as 'tracking errors' (i.e., that the investments do not perfectly replicate the performance of futures contracts) and that the investments are fully funded cash-instruments whereas the cash flows on the forecast transactions will only occur in the future.

The ability to designate non-derivative hedging instruments can be helpful if an entity does not have access to derivatives markets (e.g., because of local regulations that prohibit the entity from holding such instruments), or if an entity does not want to be subject to margining requirements nor enter into uncollateralised over-the-counter derivatives. Purchasing and selling financial investments in such cases can be operationally easier for entities than transacting derivatives.

IFRS 9 notes that: *[IFRS 9.B6.2.5]*

Extract from IFRS 9

B6.2.5 For hedges other than hedges of foreign currency risk, when an entity designates a non-derivative financial asset or a non-derivative financial liability measured at fair value through profit or loss as a hedging instrument, it may only designate the non-derivative financial instrument in its entirety or a proportion of it.

[IFRS 9.B6.2.5].

Portions and proportions of hedging instruments are discussed in section 3.6 below, but in the case of a non-derivative hedging instrument for a hedge other than of foreign currency risk, the guidance on portions is not applicable.

3.3.1 Hedge of foreign currency risk by a non-derivative financial instrument

For a hedge of foreign currency risk, the foreign currency component of a non-derivative financial asset or liability may be designated as a hedging instrument. *[IFRS 9.6.2.2]*. Non-derivative financial assets and liabilities need not be within the scope of IFRS 9 to qualify as hedging instruments. For example, although rights and obligations under lease agreements are for most purposes scoped out of IFRS 9, lease payables or finance lease receivables denominated in a foreign currency still meet the definition of a non-derivative financial instrument and are therefore eligible as hedging instruments in a hedge of foreign currency risk. Consideration must be given to all the qualifying criteria before hedge accounting is applied (see section 6 below), in particular as to whether the designation is consistent with the risk management objective and strategy for managing the hedged exposure (see section 2.6.8 above).

An equity instrument for which an entity has elected to present changes in fair value in OCI does not qualify as a hedging instrument in a hedge of foreign currency risk. *[IFRS 9.6.2.2]*. This reflects that fair value changes (including from foreign currency risk) are not recognised in profit or loss, which is incompatible with the mechanics of fair value hedges and cash flow hedges.

For hedges of foreign currency risk, the foreign currency risk component of a non-derivative financial instrument is determined in accordance with IAS 21. *[IFRS 9.B6.2.3]*. This means that an entity could, for example, hedge the spot risk of highly probable forecast sales in 12 months' time that are denominated in a foreign currency with a 7-year financial liability in the same foreign currency. However, when measuring ineffectiveness, IFRS 9 is explicit that the revaluation of the forecast sales for foreign currency risk would have to be on a discounted basis (i.e., a present value calculation of the spot revaluation, reflecting the time between the reporting date and the future cash flow date), whereas the hedging instrument (i.e., the IAS 21-based foreign currency component of the financial liability) would not (see sections 7.4.2 and 7.4.7 below). This would result in some ineffectiveness. *[IFRS 9.B6.5.4]*.

The following Illustration shows the types of permitted hedge relationships for foreign currency risk where the hedging instrument is a non-derivative financial instrument.

Illustration 3-8: Hedging with a non-derivative liability

Company J, which has GBP as its functional currency, has issued a fixed rate debt instrument with a principal due at maturity in two years of USD5 million. The debt is accounted for at amortised cost. J had also entered into a fixed price sales commitment, accounted for as an executory contract, for USD5 million that matures in two years as well.

J could not designate the debt instrument as a hedge of the exposure to *all* fair value changes of the fixed price sales commitment because the hedging instrument is a non-derivative liability that is not measured at fair value through profit or loss (and it would not be a good economic hedge anyway). However, J could designate the fixed rate debt instrument as a hedge of the foreign currency exposure associated with the future receipt of US dollars on the fixed price sales commitment.

In principle, there is no reason why a non-derivative financial instrument cannot be a hedging instrument in one hedge (of foreign currency risk) and a hedged item in another hedge (for example in a hedge of interest rate risk) (see section 3.6.2 below).

3.4 Own equity instruments

Extract from IFRS 9

B6.2.2 An entity's own equity instruments are not financial assets or financial liabilities of the entity and therefore cannot be designated as hedging instruments.

[IFRS 9.B6.2.2].

This prohibition would also apply to instruments that give rise to non-controlling interests in consolidated financial statements - under IFRS accounting standards it is clear that non-controlling interests are part of a reporting entity's equity (see Chapter 8 at section 5).

3.5 Combinations of instruments

Extract from IFRS 9

6.2.5 An entity may view in combination, and jointly designate as the hedging instrument, any combination of the following (including those circumstances in which the risk or risks arising from some hedging instruments offset those arising from others):

(a) derivatives or a proportion of them; and

(b) non-derivatives or a proportion of them.

[IFRS 9.6.2.5].

Further discussion on designation of proportions is provided in section 3.6 below. There is a requirement that any combination can only be designated as a hedging instrument if the combination is not a net written option (see section 3.2.2 above).

Illustration 3-9: Hedging with a combination of a derivative and non-derivative instrument

Company K with the euro as its functional currency has issued a yen denominated floating rate borrowing and entered into a matching receive-yen floating (plus principal at maturity), pay-US dollar floating (plus principal at maturity) cross-currency interest rate swap. These instruments, which effectively synthesise a US dollar floating rate borrowing, contain offsetting terms, i.e., the whole of the borrowing and the yen leg of the swap.

Company K could designate the combination of these two instruments in a hedge of the entity's foreign currency risk arising from, say, an asset with an identifiable exposure to US dollar exchange rates.

Designation of a combination of instruments as the hedging instrument does not change the unit of account for each individual instrument within the designated combination. Classification and measurement (see Chapter 44) and the usual eligibility criteria to be a hedging instrument (see section 3.1 above) are still applied to the individual instruments designated in combination as the hedging instrument. One exception is for the need for a hedging instrument to not be a net written option; this assessment should be made at the combined level, rather than at the individual instrument level (see section 3.2.2 above). The qualifying hedge accounting criteria and the associated incremental hedge accounting entries, however, are applied in consideration of the combination of instruments (see sections 6 and 7 below).

3.6 Portions and proportions of hedging instruments

In contrast to the position for hedged items (see section 2 above), there are significant restrictions on what components of an individual financial instrument can be carved out and designated as a hedging instrument. A qualifying instrument must be designated in its entirety as a hedging instrument, with only the following exceptions:

- A proportion of a hedging instrument (see section 3.6.1 below)
- The time value of options could be separated (see section 3.6.4 below)
- Forward elements of forward contracts could be separated (see section 3.6.5 below)
- Foreign currency basis spread could be separated (see section 3.6.5 below) *[IFRS 9.6.2.4]*
- The spot rate retranslation risk of a foreign currency non-derivative financial instrument could be separated (see section 3.3.1 above)

  And
- A derivative could be separated into notional component parts when each part is designated as a hedge and qualifies for hedge accounting (see section 3.6.2 below)

The hedge accounting guidance is applied only to the designated portion or proportion of the hedging instrument. However, if an entity chooses to separate the time value of an option, the forward element of a forward contract or the foreign currency basis spread from a hedge relationship, the costs of hedging guidance is also relevant (see section 7.5 below).

3.6.1 Proportions of instruments

It is possible to designate a proportion of the entire hedging instrument, such as 50% of the notional amount, in a hedging relationship. *[IFRS 9.6.2.4(c)]*. The proportion that is not designated is available for designation within other hedge relationships, such that a maximum of 100% of the notional is designated as a hedging instrument. Any proportions of an instrument not designated within hedge relationships are accounted for under the usual IFRS 9 classification and measurement guidance.

3.6.2 Hedging different risks with one instrument

Extract from IFRS 9

B6.2.6 A single hedging instrument may be designated as a hedging instrument of more than one type of risk, provided that there is a specific designation of the hedging instrument and of the different risk positions as hedged items. Those hedged items can be in different hedging relationships.

[IFRS 9.B6.2.6].

A single hedging instrument can also be used to hedge different risks within the same hedge relationship; one such frequent designation is of a single cross-currency swap used to hedge both foreign currency and interest rate risk in foreign currency debt.

An example where a single hedging derivative is used to hedge more than one risk in different hedging relationships is the use of a foreign currency forward to eliminate the resulting foreign currency risk from payables and receivables in two different foreign currencies, see Illustration 3-10 below, which is based on an example given in IAS 39. *[IAS 39.F.1.13]*.

Illustration 3-10: Foreign currency forward used to hedge the position arising from two hedged items with different foreign currencies

Company L, which has Japanese yen as its functional currency, issues five-year floating rate US dollar debt and acquires a ten-year fixed rate sterling bond. The principal amounts of the asset and liability, when converted into Japanese yen, are the same. L enters into a single foreign currency forward contract to hedge its foreign currency exposure on both instruments under which it receives US dollars and pays sterling at the end of five years.

Company L designates the foreign currency forward as the hedging instrument in a cash flow hedge of foreign currency risk on both the sterling bond and the US dollar debt.

Designating a single hedging instrument as a hedge of multiple types of risk is permitted if there is specific designation of the hedging instrument and the different risk positions.

Company L has Japanese yen as its functional currency, hence it is exposed to JPY/GBP and USD/JPY foreign currency risk from the sterling bond and the US dollar debt, respectively. Separation of these different risk positions can be achieved by documentation of the principal repayment of the bond and debt in their respective currency of denomination as the hedged items in separate cash flow hedge relationships.

In order to achieve specific designation of the hedging instrument, it is effectively decomposed and viewed as two forward contracts, each with an offsetting position in yen, i.e., L's functional currency. Each of the decomposed forward contracts is then designated in an eligible hedge accounting relationship.

Even though the bond has a ten year life and the foreign currency forward only protects it for the first five years, hedge accounting is permitted for only a portion of the exposure (see section 2.2.4 above).

Accordingly hedge accounting could be achieved, but only if all the hedge accounting qualification criteria continue to be met (see section 6 below).

In the above example a single hedging instrument is designated in a hedge of foreign currency risk arising from two separate hedged items. The hedges in the example could both be designated as either cash flow or fair value hedges (see sections 5.1.2 and 5.2.3 below). There is no reason why a single hedging instrument could not be designated in both a cash flow hedge and a fair value hedge for different risks, provided the usual conditions for achieving hedge accounting are met.

Illustration 3-11: Cross-currency interest rate swap hedging two foreign currency exchange rate exposures and fair value interest rate exposure

Applying the same fact pattern as in Illustration 3-10 above, but in this case Company L wishes to hedge not only the foreign currency exposure on both the bond and the debt, but the fair value interest rate exposure on the bond as well. To do this Company L enters into a matching cross-currency interest rate swap to receive floating rate US dollars, pay fixed rate sterling and exchange the US dollars for sterling at the end of five years.

Similar to Illustration 3-10 above, the cross-currency interest rate swap is effectively decomposed and viewed as two cross-currency swaps, each with an offsetting leg in yen, i.e., L's functional currency, as follows:

- Decomposed swap 1: receive floating rate yen, pay fixed rate sterling and exchange the sterling for yen at the end of five years

  And

- Decomposed swap 2: receive floating rate US dollars, pay floating rate yen and exchange the US dollars for yen at the end of five years

Therefore, the swap could be designated as a hedging instrument in separate hedges of the sterling bond and the US dollar liability as follows:

- Decomposed swap 1 designated in a fair value hedge (see section 5.1 below) as the hedging instrument against exposure to changes in present value of the sterling bond associated with the interest rate payments on the bond until year five and the change in present value of the principal payment due at maturity to the extent affected by changes in the yield curve relating to the five years of the swap (see Illustration 2-5 in section 2.2.4 above) as well as the exchange rate between sterling and yen.
- Decomposed swap 2 designated in a cash flow hedge (see section 5.2 below) as the hedging instrument against changes in all cash flows on the US dollar liability associated with USD/JPY foreign currency risk (see section 3.2.5 above).

Accordingly hedge accounting could be achieved, but only if all the hedge accounting qualification criteria continue to be met (see section 6 below).

As can be seen in Illustration 3-10 and Illustration 3-11 above, decomposition of a derivative hedging instrument by imputing notional legs is an acceptable means of splitting the fair value of a derivative hedging instrument into multiple components in order to achieve hedge accounting, as long as:

- The split does not result in the recognition of cash flows that are not evident from contractual terms of the derivative instrument
- The notional legs introduced must be offsetting
- All decomposed elements of the derivative instrument are included within an eligible hedge relationship

  And

- The designation is consistent with risk management (see section 6.2 below)

The IFRS IC confirmed such an approach to be acceptable under IAS 39 and there is no reason to believe that this would not also be the case under IFRS 9.[13] Consideration of the hedge accounting qualifying criteria for all relationships that include decomposed elements of a derivative instrument must be captured in the hedge documentation on designation, as normal.

The qualifying criteria assessment could be carried out for the total hedged position, i.e., incorporating all risks identified if these risks are inextricably linked, or for the decomposed parts separately, i.e., individually for each hedge relationship that includes a decomposed part of the derivative. However, if the assessment is undertaken separately, each hedge relationship that includes a decomposed part would need to meet the qualifying criteria. Otherwise, the derivative would not qualify for hedge accounting as part of it would not be included within an eligible hedge relationship. This restriction is necessary as a financial instrument can only be designated as a hedging instrument in its entirety or an eligible portion or proportion thereof (see section 3.6 above). For example, the 'knock-out swap' in Illustration 3-3 in section 3.2.2 above could not be split into, on the one hand, a conventional interest rate swap, to be used as a hedging instrument and, on the other hand, the knock-out feature (a written swaption with a strike of 6%, i.e., an option for the counterparty to enter into an offsetting interest rate swap with the same terms as the conventional swap). This is because the knock-out feature is unlikely to be designated and qualify for hedge accounting at all.

13 *IFRIC Update*, July 2007, available on the IFRS Foundation's website.

If the IFRS IC analysis of the decomposition of derivatives is applied to a basis swap, hedge accounting for that swap could be possible (see section 3.2.5 above). The swap would be designated as a hedge of appropriate asset and liability positions.

Illustration 3-12: Designation of a basis swap hedging different risk positions

Entity X has made a USD1m loan that earns SOFR based interest and incurred a USD1m liability that pays interest based on the central bank rate (FED). Entity X transacts a basis swap under which it pays SOFR based interest and receives interest based on the FED rate on a notional amount of USD1m in order to eliminate the interest rate mismatch between the loan and the liability. In this case, the basis swap could be decomposed into two interest rate swaps, both with an offsetting USD1m fixed rate leg, to facilitate hedge designations for each of the SOFR loan and central bank rate deposit within separate cash flow hedges.

The guidance above discussed various combinations of cash flow and fair value hedge relationships. However, there appears to be no reason why a single instrument could not, in theory, be designated in other combinations of hedges, for example a cash flow hedge and a hedge of a net investment.

Further, there also appears to be no reason why a non-derivative foreign currency financial instrument could not be a hedging instrument for foreign currency risk, perhaps of a net investment, but also be the hedged item for changes in interest rate risk. This could be the case if the different risk positions were appropriately identified, and all the hedge accounting qualification criteria are met (see section 6 below).

3.6.3 Restructuring of derivatives

An entity could exchange a derivative that does not qualify as a hedging instrument (say, the knock-out swap in Illustration 3-3 in section 3.2.2 above) for two separate derivatives that, together, have the same fair value and risk profile as the original instrument (say, a conventional interest rate swap and a written swaption). Such an exchange is likely to be motivated by a desire to obtain hedge accounting for one of these new instruments.

If a derivative that does not qualify as a hedging instrument is exchanged for two derivatives that, together, have the same characteristics as the original derivative, in order to determine whether the new arrangement can be treated as two separate derivatives, rather than a continuation of the original derivative, it is necessary to determine whether the exchange transaction has any substance, which is clearly a matter of judgement. If the exchange has no substance, then hedge accounting would still be precluded for either of the new derivatives, as the two 'separate' derivatives would in substance be a continuation of the original derivative (see section 3.2.1 above and Chapter 42 at sections 2.2 and 7).

In the case of the knock-out swap, if the two new contracts (e.g., a conventional interest rate swap and a swaption with a strike of 6%) had the same counterparty and, in aggregate, the same terms as the original contract this would not necessarily lead to the conclusion that the exchange lacked substance. However, if in addition, the swaption would be settled by delivery of the conventional interest rate swap in the event that it was exercised, this is a strong indicator that the exchange does lack substance.

3.6.4 Time value of options

An entity could choose to hedge for risk management purposes the variability of future cash flow outcomes resulting from a price increase (but not a decrease) of a forecast commodity purchase. This hedge of a 'one-sided risk' could be achieved by transacting a purchased option as the hedging instrument (see sections 3.2 and 3.2.2 above). In such a situation, it is permitted that only cash flow losses in the hedged item that result from an increase in the price above the specified level are designated within a hedge relationship. However, only the intrinsic value of a purchased option hedging instrument, not its time value, reflects this one-sided risk in the hedged item (assuming that it has the same principal terms as the designated risk). The hedged risk for a one-sided risk does not include the time value of a purchased option, because the time value is not a component of the forecast transactions that affects profit or loss (see section 7.4.12 below). *[IFRS 9.B6.3.12]*. As a result, changes in the time value of the option would give rise to hedge ineffectiveness.

To address this problem, an entity is permitted to designate as the hedging instrument only the change in the intrinsic value of an option and not the change in its time value. *[IFRS 9.6.2.4(a)]*. If it does so, the entity accounts for the time value of the option as a cost of hedging (see section 7.5 below). *[IFRS 9.6.5.15]*.

How we see it

No prescriptive guidance is provided as to how the intrinsic value of an option must be calculated if it is designated in a hedging relationship. We believe it is acceptable to calculate the intrinsic value with respect to either the prevailing relevant spot or forward price, consistent with the risk management objective.

The chosen approach must also be documented and consistently applied for that hedge relationship. This would include an expectation that the intrinsic value calculated to represent the one-sided hedged risk in the hedged item was calculated in the same way as the intrinsic value of the option (see sections 2.1 above and 7.4.4 below).

Whilst it may be operationally simpler to calculate the intrinsic value with respect to the prevailing relevant spot price, in particular for an option contract with multiple exercise dates (e.g., a series of interest rate caplets), it is more common for market participants to view the intrinsic value with respect to the relevant forward prices.

Irrespective of whether the spot or forward price is used to determine the intrinsic value, there is an expectation that the calculation should be made on a discounted basis. By way of example, when using the forward price, the intrinsic value would be calculated by projecting each cash flow using the relevant forward price for the relevant date, and comparing that to the strike price. The result, if positive would then be discounted back to the valuation date and aggregated for all positive cash flows to form the intrinsic value of the option contract. A similar calculation would be made if using the spot price, but each cash flow comparison would be the prevailing spot price versus the strike price, however the discounting affect would be different for each cash flow (see section 7.4.7 below for further discussion on discounting of spot revaluations).

Excluding the time value could make it administratively easier to process the hedges and it can certainly improve a hedge's effectiveness from an accounting perspective. However, accounting for the option time value as a cost of hedging does involve some complexity, in particular where the terms of the hedged item and hedging option are what is described in the standard as not 'closely aligned' (see section 7.5.1.A below).

The use of this exception is not mandatory. For example, a dynamic hedging strategy that assesses both the intrinsic value and time value of an option contract can qualify for hedge accounting (see section 6.3.2 below), although the time value is still likely to result in some ineffectiveness. In addition, an entity could use an option to hedge an exposure that itself contains optionality - see section 7.4.12 below for the challenges that arise with such a designation.

3.6.5 Forward element of a forward contract and foreign currency basis spread

IFRS 9 also permits (but does not require) an entity to separate the forward element and the spot element of a forward contract and designate only the change in the value of the spot element of a forward contract and not the forward element as the hedging instrument.

In addition, the foreign currency basis spread may be separated and excluded from the designation of a financial instrument as the hedging instrument. *[IFRS 9.6.2.4(b)]*.

Where the forward element or foreign currency basis are excluded from the designation as a hedging instrument, IFRS 9 permits a choice as to whether to account for the excluded portion as a cost of hedging (see section 7.5 below) or to continue measurement at fair value through profit or loss. This is, however, not an accounting policy choice, but an election for each designation. *[IFRS 9.6.5.16]*.

3.6.6 Hedges of a portion of a time period

A hedging instrument cannot be designated for a part of its change in fair value that results from only a portion of the time period during which the hedging instrument remains outstanding. This clarifies that an entity cannot designate a 'partial-term' component of a financial instrument as the hedging instrument, but only the entire instrument for its remaining life (notwithstanding that an entity could exclude from designation the time value of an option, the forward element of a forward contract or the foreign currency basis spread, see sections 3.6.4 and 3.6.5 above). *[IFRS 9.6.2.4]*. This does not mean that the hedge relationship must necessarily continue for the entire remaining life of the hedging instrument - the usual hedge discontinuation requirements apply (see section 8.3 below).

Illustration 3-13: Designation of hedging instrument with longer life than hedged item

Entity T has an interest rate swap with a remaining maturity of five years and 6 months. Entity T wishes to designate the swap as the hedging instrument with respect to interest rate risk in issued debt that matures in five years.

It would not be possible for Entity T to designate only payments and receipts from the swap that occur over the next five years (i.e., ignoring those after year five) as the hedging instrument. Instead, the whole derivative (i.e., including payments and receipts after year five) could be designated as the hedging instrument, although the hedging relationship might itself last for only five years.

However, hedge accounting can only be applied if the hedge effectiveness criteria are met (see section 6.4 below), which might not necessarily be immediately obvious from a qualitative assessment if there are significant mismatches in maturity between the hedged item and the hedging instrument (see section 6.4.1 below).

4 Internal hedges and other group accounting issues

One of the most pervasive impacts that hedge accounting can have on groups, especially those operating centralised treasury functions, is the need to reassess hedging strategies that involve intragroup transactions. To a layman this might come as something of a surprise because the standard does little more than reinforce the general principle that transactions between different entities within a group will be eliminated in the consolidated financial statements of that group. Nevertheless, where risk is centrally managed, the requirement to identify eligible hedged items and hedging instruments with counterparties that are external to the reporting group, and to ensure the qualifying criteria are met, can be a challenge.

IAS 39 included a significant volume of Implementation Guidance devoted to the subject of internal hedges. The requirements in IFRS 9 for hedged items and hedging instruments to be with a party external to the reporting group (and the associated exemptions to this rule) are unchanged from the requirements in IAS 39. Therefore, much of the IAS 39 guidance is still relevant under IFRS 9 and is frequently referred to within this section.

4.1 Internal hedging instruments

The starting point for this guidance is the principle of preparing consolidated financial statements in IFRS 10 *Consolidated Financial Statements* that requires "intragroup assets and liabilities, equity, income, expenses and cash flows to be eliminated in full" (see Chapter 8 at section 2.4). *[IFRS 10.B86(c)]*.

Although individual entities within a consolidated group (or divisions within a single legal entity) might enter into hedging transactions with other entities within the group (or divisions within the entity), such as internal derivative contracts to transfer risk exposures between different companies (or divisions), any such intragroup (or intra-entity) transactions are eliminated on consolidation. Therefore, such hedging transactions do not qualify for hedge accounting in the consolidated financial statements of the group, (or in the individual or separate financial statements of an entity for hedging transactions between divisions of the entity). *[IFRS 9.6.3.5, IAS 39.F.1.4]*. Effectively, this is because they do not exist in an accounting sense.

Accordingly, IFRS 9 is very clear that for hedge accounting purposes, only instruments that involve a party external to the reporting entity (i.e., external to the group or individual entity that is being reported on) can be designated as hedging instruments (see section 3.1 above). *[IFRS 9.6.2.3]*. However, where an internal contract is offset with an external contract, the external contract could potentially be regarded as the hedging instrument. In such cases, the hedging relationship (which is between the external transaction and the item that is the subject of the internal hedge) could qualify for hedge accounting, as long as such a representation is directionally consistent with the actual risk management activities. Where the hedge designation does not exactly mirror an entity's risk management activities it is commonly referred to as 'proxy hedging'. The eligibly of proxy hedging designations was discussed by the IASB in their deliberations in developing IFRS 9 (see section 6.2.1 below).

The following Illustration shows the approach.

Illustration 4-1: Internal derivatives

The banking division of Bank A enters into an internal interest rate swap with Bank A's trading division. The purpose is to hedge the interest rate risk exposure of a loan (or group of similar loans) in the banking division's loan portfolio. Under the swap, the banking division pays fixed interest payments to the trading division and receives variable interest rate payments in return.

Assuming a hedging instrument is not acquired from an external party, hedge accounting treatment for the hedging transaction undertaken by the banking and trading divisions is not allowed, because only derivatives that involve a party external to the entity can be designated as hedging instruments. Further, any gains or losses on intragroup or intra-entity transactions will be eliminated on consolidation. Therefore, transactions between different divisions within Bank A cannot qualify for hedge accounting treatment in Bank A's financial statements. Similarly, transactions between different entities within a group cannot qualify for hedge accounting treatment in Bank A's consolidated financial statements.

However, if, in addition to the internal swap in the above example, the trading division entered into an interest rate swap or other contract with an external party that offset the exposure hedged in the internal swap, hedge accounting would be permitted. For the purposes of hedge accounting, the hedged item is the loan (or group of similar loans) in the banking division and the hedging instrument is the external interest rate swap or other contract.

The trading division could aggregate several internal swaps or portions of them that are not offsetting each other (see section 4.2 below) and enter into a single third-party derivative contract that offsets the aggregate exposure. Such external hedging transactions could qualify for hedge accounting treatment provided that suitable hedged items in the banking division are identified and the other conditions for hedge accounting are met. *[IAS 39.F.1.4]*.

It follows that internal hedging instruments will only qualify for hedge accounting in the individual or separate financial statements of individual entities within the group, if they are external to the individual entity that is being reported on. *[IFRS 9.6.2.3]*.

The IAS 39 Implementation Guidance contains the following summary of the application of IAS 39 to internal hedging transactions: *[IAS 39.F.1.4]*

Extract from IAS 39

F.1.4 Internal hedges

…

The following summarises the application of IAS 39 to internal hedging transactions.

- IAS 39 does not preclude an entity from using internal derivative contracts for risk management purposes and it does not preclude internal derivatives from being accumulated at the treasury level or some other central location so that risk can be managed on an entity-wide basis or at some higher level than the separate legal entity or division.
- Internal derivative contracts between two separate entities within a consolidated group can qualify for hedge accounting by those entities in their individual or separate financial statements, even though the internal contracts are not offset by derivative contracts with a party external to the consolidated group.
- Internal derivative contracts between two separate divisions within the same legal entity can qualify for hedge accounting in the individual or separate financial statements of that legal entity only if those contracts are offset by derivative contracts with a party external to the legal entity.
- Internal derivative contracts between separate divisions within the same legal entity and between separate entities within the consolidated group can qualify for hedge accounting in the consolidated financial statements only if the internal contracts are offset by derivative contracts with a party external to the consolidated group.
- If the internal derivative contracts are not offset by derivative contracts with external parties, the use of hedge accounting by group entities and divisions using internal contracts must be reversed on consolidation.

…

[IAS 39.F.1.4].

The premise on which the restriction on internal hedging instruments is based does not always hold. Foreign currency intragroup balances might well give rise to gains and losses in profit or loss under IAS 21 that are not fully eliminated on consolidation. To address this, the foreign currency risk of such intragroup monetary items, as well as certain forecast intragroup transactions, could qualify as a hedged item in the consolidated financial statements if the other conditions for hedge accounting are met (see section 4.3 below).

However, although internal transactions are sometimes permitted to be hedged items, even those internal transactions that affect consolidated profit or loss cannot be used in consolidated financial statements as hedging instruments. This is somewhat surprising as one might consider the same arguments that led to the exception permitting intragroup monetary items and forecast intragroup transactions to be hedged items for changes in foreign currency risk to support allowing intragroup monetary items to be hedging instruments. However, during its deliberations of the hedge accounting model under IFRS 9 the IASB decided to retain this restriction, and so the guidance is equally relevant in applying IFRS 9. *[IFRS 9.BC6.148, IFRS 9.BC6.149]*.

IFRS 8 *Operating Segments* requires disclosure of segment information that is reported to the chief operating decision maker even if this is on a non-GAAP basis (see Chapter 32 at section 3.1). Consequently, for a hedge to qualify for hedge accounting in segment reporting, it is not always necessary for the hedging instrument to involve a party external to the segment.

4.1.1 Central clearing parties and ring fencing of banks

Following the introduction of legal or regulatory requirements requiring over-the-counter (OTC) derivatives to be novated to a central clearing party (CCP) or incentivising financial institutions to do so (see section 8.3.5 below), coupled with additional legislation in various jurisdictions for banks to separate core retail banking activities from investment banking activities, additional focus has arisen on 'internal derivatives' within a banking group.

When derivatives transacted between the retail banking and investment banking legal entities within a banking group are novated to a CCP, the CCP becomes the counterparty to the derivatives. This does not automatically mean that the external derivatives with the CCP are eligible for hedge accounting; judgement will be required as to whether the offsetting external derivatives must be considered in substance as a single contract in the consolidated financial statements. As part of this judgement, consideration must be given to the substantive business purpose for the practice of transacting derivatives between the retail banking and investment banking legal entities and, in particular, novating derivatives to a CCP - other than to achieve hedge accounting (see section 3.2.1 above). The assessment as to whether such a substantive business purpose exists or not must be made based on the particular facts and circumstances, including consideration of the regulatory environment, and the judgement documented accordingly.

4.2 Offsetting internal hedging instruments

As noted in section 4.1 above, if an internal contract used in a hedging relationship is offset with an external party, the external contract could be regarded as a hedging instrument and the hedge could qualify for hedge accounting. The IAS 39 Implementation Guidance elaborates on this further in the context of both interest rate and foreign currency risk management, particularly in the situation where the exposures from internal derivatives are offset before being laid off with a third party.

4.2.1 Interest rate risk

Sometimes, central treasury functions enter into internal derivative contracts with subsidiaries and, perhaps, divisions within the consolidated group to manage interest rate risk on a centralised basis. As noted in section 4.1 above, the internal contracts cannot qualify for hedge accounting in the consolidated financial statements. If, before laying off the risk, the internal contracts are first netted against each other and only the net exposure is offset in the marketplace with external derivative contracts, it can be even harder to identify suitable hedging instruments in order to achieve hedge accounting in the consolidated financial statements.

Where two or more internal derivatives used to manage interest rate risk on assets or liabilities at the subsidiary or division level are offset at the treasury level, the effect of designating the internal derivatives as hedging instruments is that the hedged non-derivative exposures at the subsidiary or division levels would be used to offset each other on consolidation. Since IAS 39 did not permit designating non-derivatives as hedging instruments (except for foreign currency exposures), the results of hedge accounting from the use of internal derivatives at the subsidiary or division level that are not laid off with external parties had to be reversed on consolidation. *[IAS 39.F.1.5]*. Although IFRS 9 does permit designation of non-derivative instruments as hedging instruments, this is only for financial instruments measured at fair value through profit or loss, which is unlikely to be the case in this scenario (see section 3.3 above).

It should be noted, however, that if:

- The internal derivatives offset each other on consolidation
- The internal derivatives are used in the same type of hedging relationship at the subsidiary or division level
- The hedged items affect profit or loss in the same period (in the case of cash flow hedges)

  And
- The hedges are perfectly effective at the subsidiary level

Then there will be no effect on profit or loss and equity of reversing the effect of hedge accounting on consolidation.

Just as the internal derivatives offset at the treasury level, their use as fair value hedges by two separate entities or divisions within the consolidated group will also result in the offset of the fair value amounts recognised in profit or loss. Similarly, their use as cash flow hedges by two separate entities or divisions within the consolidated group will also result in the fair value amounts being offset against each other in other comprehensive income. *[IAS 39.F.1.5]*.

However, reversal of subsidiary hedge accounting on consolidation could affect individual line items in both the consolidated income statement (or statement of comprehensive income) and the consolidated statement of financial position. This will be the case, for example, when internal derivatives that hedge assets (or liabilities) in a fair value hedge are offset by internal derivatives that are used as a fair value hedge of other assets (or liabilities) that are recognised in a different line item in the statement of financial position or income statement (or statement of comprehensive income). In addition, to the extent that one of the internal contracts is used as a cash flow hedge and the other is used in a fair value hedge, the effect

on profit or loss and equity would not offset since the gain (or loss) on the internal derivative used as a fair value hedge would be recognised in profit or loss and the corresponding loss (or gain) on the internal derivative used as a cash flow hedge would be recognised in other comprehensive income. *[IAS 39.F.1.5]*.

Notwithstanding this, under the principles set out in section 4.1 above, it could be possible to designate external derivative contracts as a hedge of some of the underlying exposures as shown in the following Illustration.

Illustration 4-2: Single external derivative offsets internal contracts on a net basis

Company A uses internal derivative contracts to transfer interest rate risk exposures from individual divisions to a central treasury function. The central treasury function aggregates the internal derivative contracts and enters into a single external derivative contract that offsets the internal derivative contracts on a net basis.

On one particular day the central treasury function enters into three internal receive-fixed, pay-variable interest rate swaps that lay off the exposure to variable interest cash flows on variable rate liabilities in other divisions and one internal receive-variable, pay-fixed interest rate swap that lays off the exposure to variable interest cash flows on variable rate assets in another division. It enters into an interest rate swap with an external counterparty that exactly offsets the net effect of the four internal swaps.

A cash flow hedge of an overall net position for interest rate risk does not qualify for hedge accounting under IFRS 9 (see section 2.5.3 above). However, designating a part of the variable rate assets or liabilities as the hedged position on a gross basis is permitted if the designation is directionally consistent with the actual risk management activities (see section 6.2.1 below). Therefore, even though the purpose of entering into the external derivative was to offset internal derivative contracts on a net basis, hedge accounting is permitted if the hedging relationship is defined and documented as a hedge of a part of the underlying cash inflows or cash outflows on a gross basis and assuming that the hedge accounting criteria are met. *[IAS 39.F.2.15]*.

4.2.2 Foreign currency risk

Although much of the discussion in section 4.2.1 above applies equally to hedges of foreign currency risk, there is one important distinction between the two situations. Non-derivative financial instruments are permitted to be used as the hedging instrument in the hedge of foreign currency risk. Therefore, in this case, internal derivatives could be used as a basis for identifying non-derivative external transactions that could qualify as hedging instruments or hedged items, provided that the internal derivatives represent the transfer of foreign currency risk on underlying non-derivative financial assets or liabilities (see Cases 3 and 4 in Illustration 4-3 below). However, for consolidated financial statements, it is necessary to designate the hedging relationship so that it involves only external transactions.

Forecast transactions and unrecognised firm commitments cannot qualify as hedging instruments (see section 3.1 above). Accordingly, to the extent that two or more offsetting internal derivatives represent the transfer of foreign currency risk on such items, hedge accounting cannot be applied. As a result, if any cumulative net gain or loss on an internal derivative has been included in the initial carrying amount of an asset or liability (a 'basis adjustment') (see section 7.2.2 below), it would have to be reversed on consolidation if it cannot be demonstrated that the offsetting internal derivative represented the transfer of a foreign currency risk on a financial asset or liability to an external hedging instrument. *[IAS 39.F.1.6]*. This means that the other side of the internal derivative would need to be matched by the foreign currency risk on an external financial instrument, which could be designated as the hedging instrument.

The following Illustration shows this principle of using internal derivatives to identify suitable external hedging instruments - it also illustrates the mechanics of accounting for fair value hedges and cash flow hedges, which are discussed in more detail in sections 7.1 and 7.2 below. *[IAS 39.F.1.7]*.

Illustration 4-3: Using internal derivatives to hedge foreign currency risk

In each of the following cases, 'FC' represents a foreign currency, 'LC' represents the local currency (which is the entity's functional currency) and 'TC' the group's treasury centre.

Case 1: Offset of hedges of foreign currency denominated monetary items

Subsidiary A has trade receivables of FC100, due in 60 days, which it hedges using a forward contract with TC. Subsidiary B has payables of FC50, also due in 60 days, which it hedges using a forward contact with TC.

TC nets the two internal derivatives and enters into a net external forward contract to pay FC50 and receive LC in 60 days.

At the end of month 1, FC weakens against LC. A incurs a foreign currency loss of LC10 on its receivables, offset by a gain of LC10 on its forward contract with TC. B makes a foreign currency gain of LC5 on its payables, offset by a loss of LC5 on its forward contract with TC. TC makes a loss of LC10 on its internal

forward contract with A, a gain of LC5 on its internal forward contract with B and a gain of LC5 on its external forward contract.

Accordingly, the following entries are made in the individual or separate financial statements of A, B and TC at the end of month 1 (assuming that forward foreign currency and spot exchange rates are exactly the same, which is unlikely in reality). Entries reflecting intragroup transactions or events are shown in italics.

	A's entries	*LC*	*LC*
Dr	Foreign currency loss	10	
	Cr Receivables		10
Dr	*Internal contract (TC)*	*10*	
	Cr Internal gain (TC)		*10*
	B's entries	*LC*	*LC*
Dr	Payables	5	
	Cr Foreign currency gain		5
Dr	*Internal loss (TC)*	*5*	
	Cr Internal contract (TC)		*5*
	TC's entries	*LC*	*LC*
Dr	*Internal loss (A)*	*10*	
	Cr Internal contract (A)		*10*
Dr	*Internal contract (B)*	*5*	
	Cr Internal gain (B)		*5*
Dr	External forward contract	5	
	Cr Foreign currency gain		5

Both A and B could apply hedge accounting in their individual financial statements provided all the necessary conditions were met. However, because gains and losses on the internal derivatives and the offsetting losses and gains on the hedged receivables and payables are recognised immediately in profit or loss without hedge accounting (as required by IAS 21), hedge accounting is unnecessary (see section 7.2.3 below for further information on hedges of foreign currency denominated monetary items).

In the consolidated financial statements, the internal derivative transactions are eliminated. In economic terms, B's payable hedges FC50 of A's receivables. The external forward in TC hedges the remaining FC50 of A's receivable. In the consolidated financial statements, hedge accounting is again unnecessary because monetary items are measured at spot foreign currency rates under IAS 21 irrespective of whether hedge accounting is applied.

The net balances, before and after elimination of the accounting entries relating to the internal derivatives, are the same, as set out below. Accordingly, there is no need to make any further accounting entries to meet the requirements of IFRS 9.

	DR	CR
	LC	*LC*
Receivables	-	10
Payables	5	-
External forward contract	5	-
Gains and losses	-	-
Internal contracts	-	-

Case 2: Offset of cash flow hedges

To extend the example, A also has highly probable future revenues of FC200 on which it expects to receive cash in 90 days. B has highly probable future expenses of FC500 (advertising cost), also to be paid for in 90 days. A and B enter into separate forward contracts with TC to hedge these exposures and TC enters into an external forward contract to receive FC300 in 90 days.

As before, FC weakens at the end of month 1. A incurs a 'loss' of LC20 on its anticipated revenues because the LC value of these revenues decreases and this is offset by a gain of LC20 on its forward contract with TC. Similarly, B incurs a 'gain' of LC50 on its anticipated advertising cost because the LC value of the expense decreases and this is offset by a loss of LC50 on its transaction with TC.

TC incurs a gain of LC50 on its internal transaction with B, a loss of LC20 on its internal transaction with A and a loss of LC30 on its external forward contract.

Both A and B satisfy the hedge accounting criteria and qualify for hedge accounting in their individual financial statements. A recognises the gain of LC20 on its internal derivative transaction in other comprehensive income and B does the same with its loss of LC50. TC does not claim hedge accounting, but measures both its internal and external derivative positions at fair value, which net to zero.

Accordingly, the following entries are made in the individual or separate financial statements of A, B and TC at the end of month 1. Entries reflecting intragroup transactions or events are shown in italics.

	A's entries	***LC***	***LC***
Dr	*Internal contract (TC)*	*20*	
	Cr Other comprehensive income		*20*
	B's entries	***LC***	***LC***
Dr	*Other comprehensive income*	*50*	
	Cr Internal contract (TC)		*50*
	TC's entries	***LC***	***LC***
Dr	*Internal loss (A)*	*20*	
	Cr Internal contract (A)		*20*
Dr	*Internal contract (B)*	*50*	
	Cr Internal gain (B)		*50*
Dr	Foreign currency loss	30	
	Cr External forward contract		30

IFRS 9 requires that, in the consolidated financial statements, the accounting effects of the internal derivative transactions must be eliminated.

If there were no hedge designation for the consolidated financial statements, the gains and losses recognised in other comprehensive income and profit or loss on the internal derivatives would be reversed. Consequently, a loss of LC30 would be recognised in profit or loss in respect of the external forward contract held by TC.

However, for the consolidated financial statements, TC's external forward contract on FC300 can be designated, at the beginning of month 1, as a hedging instrument of the first FC300 of B's highly probable future expenses. Therefore, LC30 of the gain recognised in other comprehensive income by B could remain in other comprehensive income on consolidation, because it involves an external derivative. Accordingly, the net balances, before and after elimination of the accounting entries relating to the internal derivatives, are as set out below and there is no need to make any further accounting entries.

	DR	**CR**
	LC	***LC***
External forward contract	-	30
Other comprehensive income	30	-
Gains and losses	-	-
Internal contracts	-	-

Case 3: Offset of hedges of foreign currency denominated monetary items and cash flow hedges

The example is extended further and it is assumed that the exposures and the internal derivative transactions are the same as in Cases 1 and 2. In other words, Subsidiary A has trade receivables of FC100, due in 60 days, and highly probable future revenues of FC200 on which it expects to receive cash in 90 days. Subsidiary B has payables of FC50, due in 60 days, and highly probable future expenses of FC500 to be paid for in 90 days. Each of these exposures is hedged using forward contacts with TC. However, in this case, instead of entering into two external derivatives to hedge separately the fair value and cash flow exposures, TC enters into a single net external derivative to receive FC250 in exchange for LC in 90 days.

Consequently, TC has four internal derivatives, two maturing in 60 days and two maturing in 90 days. These are offset by a net external derivative maturing in 90 days. The interest rate differential (and hence forward points) between FC and LC is minimal, and therefore the ineffectiveness resulting from the mismatch in maturities is expected to have a minimal effect on profit or loss in TC, and so has been ignored for the purposes of this example (see section 7.4.2 below).

As in Cases 1 and 2, A and B apply hedge accounting for their cash flow hedges and TC measures its derivatives at fair value. A recognises a gain of LC20 on its internal derivative transaction in other comprehensive income and B does the same with its loss of LC50.

Accordingly, the following entries are made in the individual or separate financial statements of A, B and TC at the end of month 1. Entries reflecting intragroup transactions or events are shown in italics.

	A's entries	***LC***	***LC***
Dr	Foreign currency loss	10	
	Cr Receivables		10
Dr	*Internal contract (TC)*	*10*	
	Cr Internal gain (TC)		*10*
Dr	*Internal contract (TC)*	*20*	
	Cr Other comprehensive income		*20*
	B's entries	***LC***	***LC***
Dr	Payables	5	
	Cr Foreign currency gain		5
Dr	*Internal loss (TC)*	*5*	
	Cr Internal contract (TC)		*5*
Dr	*Other comprehensive income*	*50*	
	Cr Internal contract (TC)		*50*
	TC's entries	***LC***	***LC***
Dr	*Internal loss (A)*	*10*	
	Cr Internal contract (A)		*10*
Dr	*Internal loss (A)*	*20*	
	Cr Internal contract (A)		*20*
Dr	*Internal contract (B)*	*5*	
	Cr Internal gain (B)		*5*
Dr	*Internal contract (B)*	*50*	
	Cr Internal gain (B)		*50*
Dr	Foreign currency loss	25	
	Cr External forward contract		25

The gains and losses recognised on the internal contracts in A and B can be summarised as follows:

	A	B	Total
	LC	***LC***	***LC***
Profit or loss (hedge of receivable/payables)	10	(5)	5
Other comprehensive income (hedge of revenue/expenses)	20	(50)	(30)
Total	30	(55)	(25)

In the consolidated financial statements, IFRS 9 requires the accounting effects of the internal derivative transactions to be eliminated.

If there were no hedge designation for the consolidated financial statements, the gains and losses recognised in other comprehensive income and profit or loss on the internal derivatives would be reversed. Consequently, a loss of LC30 would be recognised in profit or loss, made up of a net loss of LC5 in respect of the external receivable and payable held by A (loss LC10) and B (gain LC5), respectively, and the external forward contract held by TC (loss LC25).

However, for the consolidated financial statements, the following cash flow hedge designations can be made at the beginning of month 1:

- The payable of FC50 in B is designated as a hedge of the first FC50 of the highly probable future revenues in A.

  Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Payable LC5; Cr Other comprehensive income LC5.

- The receivable of FC100 in A is designated as a hedge of the first FC100 of the highly probable future expenses in B.

  Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Other comprehensive income LC10, Cr Receivable LC10.

  And

- The external forward contract on FC250 in TC is designated as a hedge of the next FC250 of highly probable future expenses in B.

  Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Other comprehensive income LC25; Cr External forward contract LC25.

Combining these entries produces the total net balances as follows:

	DR	CR
	LC	*LC*
Receivables	-	10
Payables	5	-
External forward contract	-	25
Other comprehensive income	30	-
Gains and losses	-	-
Internal contracts	-	-

Based on this designation, the total net balances achieved in the consolidated financial statements at the end of month 1 are the same as those that would be recognised if the hedge accounting effect of the internal derivatives were not eliminated. However, it should be noted this is a simplified example and any difference in timing between the hedged item and hedging instrument is assumed to have a minimal effect on profit or loss, and so no effect has been reflected here. This will not necessarily be the case in reality, therefore some additional ineffectiveness is likely to occur in the consolidated financial statements. For example, as the FC50 payable in B due in 60 days is designated as a hedge of the first FC50 of the highly probable future revenues in A expected to occur in 90 days, this difference in timing could result in ineffectiveness (see section 7.4.2 below).

Case 4: Offset of hedges of foreign currency denominated monetary items and cash flow hedges with adjustment to carrying amount of inventory

Similar transactions to those in Case 3 are assumed except that the anticipated cash outflow of FC500 in B relates to the purchase of inventory that is delivered after 60 days. When the inventory is recognised, the entity applies a basis adjustment to the hedged forecast non-financial items as required by IFRS 9 (see section 7.2.2 below).

To recap, Subsidiary A has trade receivables of FC100, due in 60 days, and highly probable future revenues of FC200 on which it expects to receive cash in 90 days. Subsidiary B has payables of FC50, due in 60 days, and a highly probable future purchase of inventory for FC500, to be delivered in 60 days and paid for in 90 days. Each of these exposures is hedged using forward contracts with TC, and TC enters into a single net external derivative to receive FC250 in exchange for LC in 90 days.

At the end of month 2, there are no further changes in exchange rates or fair values. At that date, the inventory is delivered and the loss of LC50 on B's internal derivative, recognised in other comprehensive income in month 1, is removed from equity and adjusts the carrying amount of inventory in B. The gain of LC20 on A's internal derivative hedging the highly probable future revenue remains in other comprehensive income as before.

In the consolidated financial statements, there is now a mismatch compared with the result that would have been achieved by unwinding and redesignating the hedges. The external derivative (FC250) and the proportion of receivable (FC50) in A offset FC300 of the anticipated inventory purchase in B. Offset will occur between the FC50 payable in B and a FC50 proportion of the receivable in A. There is a natural hedge between the remaining FC200 of anticipated cash outflow in B (inventory) and the anticipated cash inflow of FC200 in A (revenue). This last relationship would not qualify for hedge accounting under IFRS 9 as no valid hedging instrument exists, but as noted, hedge accounting is not required given the natural hedge achieved.

Accordingly, the following entries are made in the individual or separate financial statements of A, B and TC at the end of month 1. Entries reflecting intragroup transactions or events are shown in italics.

	A's entries (all at the end of month 1)	***LC***	***LC***
Dr	Foreign currency loss	10	
	Cr Receivables		10
Dr	*Internal contract (TC)*	*10*	
	Cr Internal gain (TC)		*10*
Dr	*Internal contract (TC)*	*20*	
	Cr Other comprehensive income		*20*
	B's entries (at the end of month 1)	***LC***	***LC***
Dr	Payables	5	
	Cr Foreign currency gain		5
Dr	*Internal loss (TC)*	*5*	
	Cr Internal contract (TC)		*5*
Dr	*Other comprehensive income*	*50*	
	Cr Internal contract (TC)		*50*
	B's entries (at the end of month 2)	***LC***	***LC***
Dr	Inventory	50	
	Cr Other comprehensive income		50
	TC's entries (all at the end of month 1)	***LC***	***LC***
Dr	*Internal loss (A)*	*10*	
	Cr Internal contract (A)		*10*
Dr	*Internal loss (A)*	*20*	
	Cr Internal contract (A)		*20*
Dr	*Internal contract (B)*	*5*	
	Cr Internal gain (B)		*5*
Dr	*Internal contract (B)*	*50*	
	Cr Internal gain (B)		*50*
Dr	Foreign currency loss	25	
	Cr External forward contract		25

The gains and losses recognised on the internal contracts in A and B can be summarised as follows:

	A	B	Total
	LC	***LC***	***LC***
Profit or loss (hedge of receivables/payables)	10	(5)	5
Other comprehensive income (hedge of revenue)	20	-	20
Basis adjustment (hedge of inventory)	-	(50)	(50)
Total	30	(55)	(25)

Combining these amounts with the external transactions (i.e., those not marked in italics above) produces the total net balances before elimination of the internal derivatives and unwind of associated ineligible hedge relationships as follows:

	DR	CR
(At the end of month 2)	*LC*	*LC*
Receivables	-	10
Payables	5	-
External forward contract	-	25
Other comprehensive income	-	20
Basis adjustment (inventory)	50	-
Gains and losses	-	-
Internal contracts	-	-

For the consolidated financial statements, the following cash flow hedge designations can be made at the beginning of month 1:

- The payable of FC50 in B is designated as a hedge of the first FC50 of the highly probable future revenues in A.

  Therefore, at the end of month 1, the following entry is made in the consolidated financial statements: Dr Payables LC5; Cr Other comprehensive income LC5.
- The receivable of FC100 in A is designated as a hedge of the first FC100 of the highly probable future inventory purchase in B.

  Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Other comprehensive income LC10; Cr Receivable LC10; and at the end of month 2, Dr Inventory LC10; Cr Other comprehensive income LC10.
- The external forward contract on FC250 in TC is designated as a hedge of the next FC250 of highly probable future inventory purchase in B.

  Therefore, at the end of month 1, the following entry is made in the consolidated financial statements: Dr Other comprehensive income LC25; Cr External forward contract LC25; and at the end of month 2, Dr Inventory LC25; Cr Other comprehensive income LC25.

This leaves FC150 of the future revenue in A and FC150 of future inventory purchase in B not designated in a hedge accounting relationship in the consolidated financial statements. The accounting consequence of this is discussed below.

The total net balances after elimination of the accounting entries relating to the internal derivatives and application of the eligible hedge designations above, are as follows:

	DR	CR
(At the end of month 2)	*LC*	*LC*
Receivables	-	10
Payables	5	-
External forward contract	-	25
Other comprehensive income	-	5
Basis adjustment (inventory)	35	-
Gains and losses	-	-
Internal contracts	-	-

These total net balances are different from those that would be recognised if the internal derivatives were not eliminated, and it is these net balances in the table above that IFRS 9 requires to be included in the consolidated financial statements. The accounting entries required to adjust the total net balances to eliminate the effect of the internal derivatives are as follows:

- To reclassify LC15 of the loss on B's internal derivative that is included in inventory to reflect that FC150 of the forecast purchase of inventory is not hedged by an external instrument (i.e., the external forward contract of FC250 in TC and the external payable of FC100 in A can hedge a maximum of FC350 of the forecast purchase of inventory).

  And

- To reclassify the gain of LC15 on A's internal derivative to reflect that the forecast revenues of FC150 to which it relates is not hedged by an external instrument.

The net effect of these two adjustments is as follows:

		LC	*LC*
Dr	Other comprehensive income	15	
	Cr Inventory		15

It is apparent that extending the principles set out in this relatively simple example to the more complex and higher volume situations that are likely to be encountered in practice is not going to be straightforward.

4.3 Internal hedged items

Only assets, liabilities, firm commitments or highly probable forecast transactions that involve a party external to the entity can be designated as hedged items. It follows that hedge accounting can be applied to transactions between entities in the same group only in the individual or separate financial statements of those entities and not in the consolidated financial statements of the group. *[IFRS 9.6.3.5]*. However, there are two exceptions with respect to foreign currency risk - intragroup monetary items and certain forecast intragroup transactions, discussed in sections 4.3.1 and 4.3.2 below.

4.3.1 Intragroup monetary items

IFRS 9 allows the foreign currency risk of an intragroup monetary item (e.g., a payable or receivable between two subsidiaries) to qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses under IAS 21 that are not fully eliminated on consolidation. Foreign exchange gains and losses on such items are not fully eliminated on consolidation when they are transacted between two group entities that have different functional currencies (see Chapter 16 at section 6.3), *[IFRS 9.6.3.6]*, as shown in the following Illustration.

Illustration 4-4: Hedge of intragroup foreign currency trade receivable

Company A has two subsidiaries, Company B and Company C. A and B have the euro as their functional currencies, while C has the US dollar as its functional currency. On 31 March, C purchases goods from B for US$110, payable on 30 June.

In this case, the intragroup trade receivable of US$110 could be designated as a hedged item in a hedge of foreign currency risk both by B in its separate financial statements and by A in its consolidated financial statements.

While B's foreign currency receivable is eliminated against C's foreign currency payable on consolidation, the exchange differences that arise for B cannot be eliminated since C has no corresponding exchange differences.

Thus, the intragroup monetary item results in an exposure to variability in the foreign currency amount of the intragroup monetary item that will affect profit or loss in the consolidated financial statements. Therefore, the intragroup monetary item could be designated as a hedged item in a foreign currency hedge.

In order to hedge the US$/euro foreign currency risk from the US$ intragroup trade receivable, B transacts a forward foreign currency contract to sell US$ and buy euros. If no hedge accounting was applied in A's consolidated financial statements, then the combination of the exchange difference recognised on B's intragroup foreign currency trade receivable and the fair value changes in the forward foreign currency contract would largely offset in consolidated profit or loss. However, residual profit or loss volatility from fair value movements in the forward element of the forward foreign currency contract could be reduced by hedge accounting, for example, by designating the forward foreign currency risk or application of the costs of hedging accounting for the forward element (see sections 7.2.3 and 7.5.2 respectively below).

The exception above relates solely to the eligibility of certain foreign currency intragroup monetary items as hedged item in the consolidated financial statements. An equivalent exception does not exist to allow such items to be designated as hedging instruments in the consolidated financial statements (see section 4.1 above).

4.3.2 Forecast intragroup transactions

IFRS 9 also contains a second exception allowing the foreign currency risk of a highly probable forecast intragroup transaction to qualify as a hedged item in a cash flow hedge in consolidated financial statements in certain circumstances. The transaction must be denominated in a currency other than the functional currency of the entity entering into that transaction (e.g., parent, subsidiary, associate, joint venture or branch) and the foreign currency risk must affect consolidated profit or loss (otherwise it cannot qualify as a hedged item). *[IFRS 9.6.3.6]*.

A forecast sale or purchase of inventory between members of the same group will affect profit or loss if there is an onward sale of the inventory to a party external to the group. Similarly, a forecast intragroup sale of plant and equipment from the group entity that manufactured it to a group entity that will use it in its operations may affect consolidated profit or loss. This could occur, for example, because the plant and equipment will be depreciated by the purchasing entity and the amount initially recognised for the plant and equipment may change if the forecast intragroup transaction is denominated in a currency other than the functional currency of the purchasing entity. *[IFRS 9.B6.3.5]*.

Ordinarily, a related external transaction is required to exist in order that a forecast intragroup transaction could affect consolidated profit or loss, and hence be an eligible hedged item in the consolidated financial statements. In that case, it is clear that the designated hedged item is the forecast intragroup transaction, which is therefore subject to the usual eligibility criteria for hedge accounting (see section 2 above). However, the highly probable criterion (see section 2.6.1 above) is also relevant for the existence of the external transaction in order to meet the requirement that the forecast foreign currency risk will affect consolidated profit or loss. The related external transaction also drives the timing of recycling of the effective portion of the hedge relationship (see section 7.2.2 below). Illustrations 4-6 and 4-7 below provide examples of eligible hedged forecast intragroup transactions.

Illustration 4-5: Hedge of intragroup foreign currency forecast purchase of machinery

Subsidiary X and Y are both subsidiaries of Parent Z. Subsidiary X, which has GBP as its functional currency, builds machinery and has a highly probable forecast sale of machinery to Subsidiary Y in 6 months' time for £100m. Subsidiary Y, which has euro as its functional currency, expects to use the purchased machinery over a 10-year period in the production of goods. *[IAS 16.6]*.

Y wishes to eliminate variability from GBP/euro foreign currency risk in the cost of the forecast machinery purchase and so transacts a forward foreign currency contract to buy £100m and sell €110m for settlement in 6 months' time.

In Y's separate financial statements Y could designate the forward foreign currency contract as a cash flow hedge of the GBP/euro foreign currency risk from the highly probable forecast purchase of machinery.

In Z's consolidated financial statements, the cash flow hedge would still be eligible as the euro carrying amount recognised by Y for the machinery will be depreciated and therefore ultimately impacts consolidated profit or loss.

The fact that Y expects to use the machinery in the production of goods is essential in order to justify recognition of the machinery as property plant and equipment under IAS 16 (see Chapter 19 at section 2.2) and subsequent depreciation, otherwise the intragroup sale of machinery would be fully eliminated on consolidation (see Chapter 8 at section 2.4).

Illustration 4-6: Hedge of intragroup foreign currency forecast purchase of inventory

Using the same fact pattern as in Illustration 4-5 above, but in this case, Subsidiary X has highly probable GBP sale of inventory to Subsidiary Y in 3 months time. Over the following 2 months, it is highly probable that Y will sell on the inventory externally.

Y wishes to eliminate variability from GBP/euro foreign currency risk in the cost of the forecast inventory purchase and so transacts a forward foreign currency contract to buy GBP and sell euro for settlement in 3 months' time.

In Y's separate financial statements Y could designate the forward foreign currency contract as a cash flow hedge of the GBP/euro foreign currency risk from the highly probable forecast purchase of inventory.

In Z's consolidated financial statements, the cash flow hedge would still be eligible as when revenue is eventually recognised on the highly probable external sales, consolidated profit or loss will be impacted by the cost of sale recognised from the intragroup sale of inventory. This means that consolidated profit or loss is ultimately affected by the foreign currency risk from the intragroup forecast purchase of inventory (see Chapter 8 at section 2.4 and Chapter 16 at section 6.3.3). In that case the GBP/euro foreign currency risk from the intragroup sale will affect consolidated profit or loss.

Over the subsequent 2 month period as Y sells the inventory externally, in Z's consolidated financial statements the effective portion of the cash flow hedge reserve will be recycled, as that is when the hedged risk impacts consolidated profit or loss.

Had the intragroup forecast sale of inventory been in a different foreign currency (e.g., US$) and if Y had hedged the US$/euro FX risk from those forecast purchases, such a hedge would not be eligible in Z's consolidated financial statements. This is because consolidated profit for this transaction will ultimately be impacted by GBP/euro foreign currency risk and not US$/euro.

Normally, royalty payments, interest payments and management charges between members of the same group will not affect consolidated profit or loss unless there is a related external transaction. *[IFRS 9.B6.3.5]*. No further guidance is provided as to what is meant by a 'related external transaction'. However, by way of example, in consideration of the eligibility of intragroup royalty costs, if those intragroup royalties are an unavoidable part of the highly probable forecasted external sale, for example to reflect patented technical knowhow developed by one subsidiary that is necessary for another subsidiary to produce a product for sale, then perhaps that would be sufficient to demonstrate that the external sales are related external transactions for the purposes of determining the eligibility of the intragroup royalty payments as hedged items. For each fact pattern, consideration will need to be given as to whether a related external transaction exists and whether the consolidated profit or loss is therefore affected by the intragroup transaction.

How we see it

Although the standard refers exclusively to forecast intragroup transactions, we believe there is no reason why these provisions do not also apply to intragroup firm commitments. Hence an intragroup firm commitment may be an eligible hedged item if the criteria for this second exception are met.

Further, a highly probable dividend receivable from a wholly owned subsidiary could be an eligible hedged item in a cash flow hedge in the parent's separate financial statements. However, this would not be the case in the parent's consolidated financial statements as the dividend does not affect consolidated profit or loss (see section 2.6.6 above).

4.4 Hedged item and hedging instrument held by different group entities

The IAS 39 Implementation Guidance explained that, in a group, it is not necessary for the hedging instrument to be held by the same entity as the one that has the exposure being hedged in order to qualify for hedge accounting in the consolidated financial statements. *[IAS 39.F.2.14]*. This is shown in the following Illustration.

Illustration 4-7: Subsidiary's foreign currency exposure hedged by parent

Company S is based in Switzerland and prepares consolidated financial statements in Swiss francs. It has an Australian subsidiary, Company A, whose functional currency is the Australian dollar and is included in the consolidated financial statements of S. A has forecast purchases in Japanese yen that are highly probable and S enters into a forward contract to hedge the change in yen relative to the Australian dollar.

Because A did not hedge the foreign currency exchange risk associated with the forecast purchases in yen, the effects of exchange rate changes between the Australian dollar and the yen will affect A's profit or loss and, therefore, would also affect consolidated profit or loss. Therefore, that hedge could qualify for hedge accounting in S's consolidated financial statements provided the other hedge accounting criteria are met. *[IAS 39.F.2.14]*.

By contrast, if Company A also has forecast purchases in Australian dollars, and S enters into a forward contract to hedge the change in Australian dollar relative to the Swiss francs, hedge accounting would not be permitted as changes between the Australian dollar and Swiss francs will not affect A's profit or loss nor consequently S's consolidated profit or loss.

Whilst the above is based on Implementation Guidance from IAS 39, it would appear to be still relevant under IFRS 9, as was explicitly confirmed for hedges of net investments within IFRIC 16 *Hedges of a Net Investment in a Foreign Operation*. (See section 5.3.3 below).

One of the key qualifying criteria that must be met when a hedging instrument is held by a different group entity in a fair value or cash flow hedge, is that the hedged risk could affect profit or loss (see sections 5.1 and 5.2 below). This is illustrated using the fact pattern in Illustration 4-8.

Illustration 4-8: Subsidiary's foreign currency exposure hedged by parent (2)

Using the same fact pattern as in Illustration 4-7 above, but in this case S has instead entered into a forward contract to hedge the change in Swiss francs relative to Japanese yen.

S cannot achieve cash flow hedge accounting for the forward contract to sell Swiss francs and buy yen in S's consolidated financial statements as there is no cash flow variability with respect to the Swiss francs/yen exchange rates that will affect consolidated profit or loss.

Consolidated profit or loss will be impacted by movements in the yen/Australian dollar exchange rates, as subsidiary A will recognise the purchase at the prevailing yen/Australian dollar exchange rate (consistent with the designated risk in the hedging strategy in Illustration 4-7 above). *[IAS 21.21]*.

S is exposed to Australian dollar/Swiss franc exchange rates on translation of the purchase on consolidation, but this is not a cash flow exposure. *[IAS 21.39(b)]*.

Accordingly, cash flow hedge accounting cannot be achieved as the hedged risk (i.e., the change in Swiss francs relative to Japanese yen) does not affect consolidated profit or loss.

It is also a requirement that for the group entity entering into the hedging instrument (i.e., the hedging entity), remeasurement of that hedging instrument with respect to the foreign currency risk has an impact on consolidated profit or loss, as otherwise the mechanics of hedge accounting cannot be applied. *[IFRS 9.6.5.11(a)(i)]*. This will usually be the case if the hedging instrument is a derivative but will not be if the hedging instrument is a monetary item in the same currency as the hedging entity's functional currency. This is illustrated using the fact pattern in Illustration 4-9.

Illustration 4-9: Group hedging entity has functional currency that is the same as the hedged exposure

Company UK is based in the UK and prepares consolidated financial statements in GBP. It has an American subsidiary, Company US, whose functional currency is the US dollar and is included in the consolidated financial statements of Company UK. Company US has forecast sales in GBP that are highly probable. Company US wishes to eliminate the US dollar/GBP foreign currency risk from the highly probable GBP sales and requests its parent, Company UK, to undertake an external hedging transaction.

Case 1: Company UK transacts a forward contract to sell GBP and buy US dollars to hedge Company US's foreign currency risk from the change in GBP relative to the US dollar. In Company UK's consolidated financial statements it would be possible to designate the forward contract as a hedge of Company US's GBP forecast sales. This is because both the hedged item and the hedging instrument impact consolidated profit or loss with respect to US dollar/GBP foreign currency risk.

Case 2: Company UK transacts a GBP loan as a hedging instrument for Company US's highly probable GBP forecast sales. In Company UK's consolidated financial statements it would not be possible to designate the GBP loan as a hedge of Company US's GBP forecast sales as there is no impact on consolidated profit or loss from the GBP loan with respect to US dollar/GBP foreign currency risk. This is because foreign currency risk does not arise in an entity from monetary items denominated in the same currency as its functional currency.

The above analysis only considers hedge accounting in Company UK's consolidated financial statements. Unless Company UK also transacted an internal hedging contract with Company US no protection would be provided against the US dollar/GBP foreign currency risk from the highly probable GBP sales in Company UK's standalone financial statements.

5 Types of hedging relationships

There are three types of hedging relationship defined in IFRS 9: *[IFRS 9.6.5.2]*

Extract from IFRS 9

6.5.2 There are three types of hedging relationships:

(a) fair value hedge: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.

(b) cash flow hedge: a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable-rate debt) or a highly probable forecast transaction, and could affect profit or loss.

(c) hedge of a net investment in a foreign operation as defined in IAS 21.

[IFRS 9.6.5.2].

Each of these definitions are considered further in the remainder of this section (fair value hedges in section 5.1, cash flow hedges in section 5.2, and hedges of a net investment in a foreign operation in section 5.3).

5.1 Fair value hedges

An example of a fair value hedge is a hedge of the exposure to changes in the fair value of a fixed rate debt instrument (not measured at fair value through profit or loss) as a result of changes in interest rates - if interest rates increase, the fair value of the debt decreases and *vice versa*. Such a hedge could be entered into either by the issuer or by the holder. *[IFRS 9.B6.5.1]*.

On the face of it, if a fixed rate loan that is measured at amortised cost or fair value through OCI and is held until it matures (as is the case for many such loans), changes in the fair value of the loan would not affect profit or loss. However, the fact that the loan could be sold, in which case fair value changes would affect profit or loss means that such a hedge relationship meets the requirement, set out in section 5 above, that variability in the hedged risk could affect profit or loss. The same would be true of a fixed rate borrowing even if settlement before maturity is very unlikely.

A variable rate debt could be the hedged item in a fair value hedge in certain circumstances. For example, the fair value of such an instrument will change if the issuer's credit risk changes. Accordingly, variable rate debt could be designated in a hedge of all changes in its fair value. There might also be changes in its fair value relating to movements in the market rate in the periods between which the variable rate is reset. For example, if a debt instrument provides for annual interest payments reset to the market rate each year, a portion of the debt instrument has an exposure to changes in fair value during the year. *[IAS 39.F.3.5]*.

In June 2019, within the context of a fair value hedge of foreign currency risk of a non-financial asset held for consumption, the IFRS IC discussed the requirement that to designate a hedged risk, an entity must conclude that the hedged risk 'could affect profit or loss'.[14]

Depending on the particular facts and circumstances, a non-financial asset might be priced-and its fair value determined-only in one currency at a global level and that currency is not the entity's functional currency. The translated fair value of such a non-financial asset would change as a result of changes in the applicable exchange rate in a given period, even if the fair value (determined in the foreign currency) were to remain constant. The Committee therefore observed that in such circumstances an entity is exposed to foreign currency risk. IFRS 9 does not require changes in fair value to be expected to affect profit or loss but, rather, that those changes could affect profit or loss. *[IFRS 9.6.5.2(a)]*. The IFRS IC observed that changes in fair value of a non-financial asset held for consumption could affect profit or loss if, for example, the entity were to sell the asset before the end of the asset's economic life.

14 *IFRIC Update*, June 2019, available on the IFRS Foundation's website.

Consequently, the IFRS IC concluded that, depending on the particular facts and circumstances, it is possible for an entity to have exposure to foreign currency risk on a non-financial asset held for consumption that could affect profit or loss. However, in order to achieve fair value hedge accounting for such a risk, the IFRS IC also noted the importance of:

- Consistency of any hedge designation with the entity's risk management objective and strategy for managing its exposure (see section 6.2.1 below)

  And

- The foreign currency risk to be a separately identifiable and reliably measurable risk component of the non-financial asset (see section 2.6.8 above)

In addition to the conclusion of the IFRS IC, the Implementation Guidance of IAS 39 also provides some assistance in understanding how the hedged risk could impact profit or loss, by way of an example. This guidance is given here and remains relevant under IFRS 9. The exposure to changes in the price of inventories that are carried at the lower of cost and net realisable value could also be the subject of a fair value hedge because their fair value will affect profit or loss when they are sold or written down. For example, a copper forward could be used as the hedging instrument in a hedge of the copper price associated with copper inventory. *[IAS 39.F.3.6]*.

Extract from IFRS 9

B6.3.2 An equity method investment cannot be a hedged item in a fair value hedge. This is because the equity method recognises in profit or loss the investor's share of the investee's profit or loss, instead of changes in the investment's fair value. For a similar reason, an investment in a consolidated subsidiary cannot be a hedged item in a fair value hedge. This is because consolidation recognises in profit or loss the subsidiary's profit or loss, instead of changes in the investment's fair value. A hedge of a net investment in a foreign operation is different because it is a hedge of the foreign currency exposure, not a fair value hedge of the change in the value of the investment.

[IFRS 9.B6.3.2].

How we see it

Assuming an investment in a subsidiary is held at cost or fair value through other comprehensive income, it would in our view be possible to designate the foreign currency risk in the carrying value of a foreign currency denominated investment in the parent entity's separate financial statements (see section 7.3.6 below). Further, we believe it would be possible to hedge the change in the entire fair value of the investment even if the fair value is not reflected in the parent entity's separate financial statements. This hedge relationship would most likely be treated as a fair value hedge and would require an adjustment to be made to the carrying value of the investment.

The ongoing accounting for fair value hedges is described in section 7.1 below.

5.1.1 Hedges of firm commitments

A hedge of a firm commitment (e.g., a hedge of the change in fuel price relating to an unrecognised contractual commitment by an electricity utility to purchase fuel at a fixed price) is considered a hedge of an exposure to a change in fair value. Accordingly, such a hedge is a fair value hedge. However, a hedge of the foreign currency risk of a firm commitment may be accounted for as either a fair value hedge or a cash flow hedge (this is discussed further in section 5.2.2 below). *[IFRS 9.B6.5.3]*.

5.1.2 Hedges of foreign currency monetary items

A foreign currency monetary asset or liability that is hedged using a forward exchange contract could be treated as a fair value hedge because its fair value will change as foreign currency rates change (see sections 7.1 and 7.2.3 below). Alternatively, it could be treated as a cash flow hedge because changes in exchange rates will affect the amount of cash required to settle the item (as measured by reference to the entity's functional currency) (see section 7.2 below).

5.2 Cash flow hedges

A cash flow hedge is a hedge of exposure to variability in cash flow attributable to a particular risk associated with an eligible hedged item that could affect profit or loss. The purpose of a cash flow hedge is to defer the gain or loss on the hedging instrument to a period or periods in which the hedged expected future cash flows affect profit or loss. An example of a cash flow hedge is the use of an interest rate swap to change floating rate debt (whether measured at amortised cost or fair value (see section 2.6.2 above)) to fixed rate debt, i.e., a hedge of a future transaction where the future cash flows being hedged are the future interest payments. *[IFRS 9.6.5.2(b), IFRS 9.B6.5.2]*.

As noted in section 5.1 above, a hedge of the exposure to changes in the fair value of a fixed rate debt instrument as a result of changes in interest rates could be treated as a fair value hedge. This could not be a cash flow hedge because changes in interest rates will not affect the cash flows on the hedged item, only its fair value.

It is also noted in section 7.1.2 below that a copper forward, say, could be used in a fair value hedge of copper inventory. Alternatively, the same hedging instrument could qualify as a cash flow hedge of the highly probable future sale of the inventory. *[IAS 39.F.3.6]*.

The following Illustration based on an example from the IAS 39 Implementation Guidance explains how a company might lock in current interest rates by way of a cash flow hedge of the anticipated issuance of fixed rate debt.

Illustration 5-1: Hedge of anticipated issuance of fixed rate debt

Company R periodically issues new bonds to refinance maturing bonds, provide working capital, and for various other purposes. When R decides it will be issuing bonds, it sometimes hedges the risk of changes in long-term interest rates to the date the bonds are issued. If long-term interest rates go up (down), the bond will be issued either at a higher (lower) rate, with a higher (smaller) discount or with a smaller (higher) premium than was originally expected. The higher (lower) rate being paid or decrease (increase) in proceeds is normally offset by the gain (loss) on the hedge.

In August 20X2 R decides it will issue GBP2m seven-year bonds in January 20X3. Historical correlation studies suggest that a seven-year UK treasury bond adequately correlates to the bonds R expects to issue, assuming a hedge ratio of 0.93 future contracts to one debt unit (see section 6.4.3 below). Therefore, it hedges the anticipated issuance of the bonds by selling ('shorting') GBP1.86m worth of futures on seven-year treasury bonds.

From August 20X2 to January 20X3 interest rates increase and the short futures positions are closed on the date the bonds are issued. This results in a GBP120,000 gain, which offsets the increased interest payments on the bonds and, therefore, will affect profit or loss over the life of the bonds. The hedge could qualify as a cash flow hedge of the interest rate risk on the forecast debt issuance (assuming all other conditions for hedge accounting are met) (see section 7.2 below for discussion on cash flow hedge accounting entries if hedge accounting is applied). *[IAS 39.F.2.2]*.

Similarly, the forecast reinvestment of interest cash flows from a fixed rate asset can be the subject of a cash flow hedge using, say, a forward rate agreement to lock in the interest rate that will be received on that reinvestment.

Another common cash flow hedging strategy is to eliminate variability in cash flows attributable to highly probable forecast sales or purchases (see sections 2.1 and 2.6.1 above).

Illustration 5-2: Hedge of highly probable forecast purchases

Company P regularly purchases coffee for use within its restaurant business. Company P has a risk management strategy to eliminate variability in purchases of ingredients over a rolling 12 month period. Company P determines that it has highly probable forecast purchases of 37,500 pounds of coffee every 3 months. Accordingly, Company P purchases four NYMEX coffee futures, each for 37,500 pounds of coffee, for settlement in March, July, September and December.

As Company P purchases the coffee each quarter, the purchase price will be determined based on the prevailing coffee price. By purchasing the coffee futures, any increase (or decrease) in the price Company P paid for the coffee will be offset to some extent by a change in price of the relevant coffee futures purchased for that quarter. The variation in price of the actual purchases will affect profit or loss, so the hedge of variation in the coffee price could be an eligible hedge accounting relationship under IFRS 9. The extent to which 'offset' does arise in profit or loss depends on the relationship between Company P's actual purchase price of coffee and the underlying coffee price in the futures contract (see section 7.4 below).

The ongoing accounting for cash flow hedges is described in section 7.2 below.

5.2.1 All-in-one hedges

The Implementation Guidance of IAS 39 made specific reference to an 'all in one hedge'. Although none of the IAS 39 Implementation Guidance on hedge accounting was carried forward into IFRS 9, much of it remains relevant under IFRS 9 (see section 1.3 above). *[IFRS 9.BC6.94, IFRS 9.BC6.95]*. Accordingly, the IAS 39 guidance on an 'all in one hedge' is discussed below with respect to application within IFRS 9.

There are situations where an instrument that is accounted for as a derivative is expected to be settled gross by delivery of the underlying asset in exchange for the payment of a fixed price. The IAS 39 Implementation Guidance states that such an instrument can be designated as the hedging instrument in a cash flow hedge of the variability of the consideration to be paid or received in the future transaction that will occur on gross settlement of the derivative contract itself. It is explained that this is acceptable because there would be an exposure to variability in the purchase or sale price without the derivative. It is important to note that, in order to qualify for a hedge of a highly probable forecast transaction, the hedging entity must have the intention (and the ability) to gross settle the derivative. For example, consider an entity that enters into a fixed price contract to sell a commodity and that contract is accounted for as a derivative under IFRS 9 (see Chapter 41 at section 3). This might be because the entity has a practice of settling such contracts net in cash or of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin. In this case, the fixed price contract may be designated as a cash flow hedge of the variability of the consideration to be received on the sale of the asset (a future transaction) even though the fixed price contract is the contract under which the asset will be sold. *[IAS 39.F.2.5]*.

Similarly, an entity may enter into a forward contract to purchase a debt instrument that will be settled by delivery of the debt instrument, but the forward contract is a derivative (some restrictions apply if the debt instrument is to be classified at fair value through profit or loss (see section 2.6.2 above)). This will be the case if its term exceeds the regular way delivery period in the marketplace (see Chapter 45 at section 2.2). In this case the forward may be designated as a cash flow hedge of the variability of the consideration to be paid to acquire the debt instrument (a future transaction), even though the derivative is the contract under which the debt instrument will be acquired. *[IAS 39.F.2.5]*.

Conversely, it is not possible to apply the all-in-one hedge strategy to a forward contract to purchase an equity instrument that will be settled by delivery of the equity instrument, where the forward contract is a derivative. This is because cash flow hedging of a forecast purchase of equity instrument is precluded, since any gain or loss on the hedging instrument that would be deferred could not be appropriately reclassified to profit (see section 2.6.2 above).

5.2.2 Hedges of foreign currency firm commitments

A hedge of the foreign currency risk of a firm commitment could be accounted for as a cash flow hedge or a fair value hedge (see section 5.1.1 above). *[IFRS 9.B6.5.3]*. This is because foreign currency risk affects both the cash flows and the fair value of the hedged item. Accordingly, a foreign currency cash flow hedge of a forecast transaction need not be redesignated as a fair value hedge when the forecast transaction becomes a firm commitment.

5.2.3 Hedges of foreign currency monetary items

A foreign currency monetary asset or liability that is hedged using a forward exchange contract could be treated as a fair value hedge because its fair value will change as foreign currency rates change. Alternatively, it could be treated as a cash flow hedge because changes in exchange rates will affect the amount of cash required to settle the item (as measured by reference to the entity's functional currency). There are some potential advantages to treating the hedge of a foreign currency monetary asset or liability using a forward exchange contract as a cash flow hedge (see section 7.2.3 below).

5.3 Hedges of net investments in foreign operations

Many reporting entities have investments in foreign operations which could be subsidiaries, associates, joint ventures or branches. As set out in Chapter 16 at section 4, IAS 21 requires an entity to determine the functional currency of each of its foreign operations as the currency of the primary economic environment of that operation. When translating the results and financial position of its foreign operation into a presentation currency, it is required to recognise foreign exchange differences in other comprehensive income until disposal of the foreign operation. *[IFRIC 16.1]*.

From the perspective of an investor (e.g., a parent) it is clear that an investment in a foreign operation is likely to give rise to a degree of foreign currency exchange rate risk and an entity with many foreign operations could be exposed to a number of foreign currency risks. *[IFRIC 16.4]*. Whilst equity method investments and investments in consolidated subsidiaries cannot be hedged items in a fair value hedge because changes in the investments' fair value are not recognised in profit or loss (see section 5.1 above), they could be designated in a net investment hedge relationship. A hedge of a net investment in a foreign operation is said to be different because it is a hedge of the foreign currency exposure, not a fair value hedge of the change in the value of the investment. *[IFRS 9.B6.3.2]*.

Conceptually, net investment hedging is somewhat unsatisfactory, as it mixes foreign currency translation risk (largely an accounting exposure) with transactional risk (much more an economic exposure). IFRIC 16 *Hedges of a Net Investment in a Foreign Operation* addresses the question of what does and does not constitute a valid hedging relationship, a topic on which IFRS 9 provides very little guidance.

IFRIC 16 applies to any entity that hedges the foreign currency risk arising from its net investments in foreign operations and wishes to qualify for hedge accounting in accordance with IFRS 9. *[IFRIC 16.7]*. It only applies to those hedges and should not be applied by analogy to other types of hedge accounting. *[IFRIC 16.8]*. For the avoidance of doubt, IFRIC 16 explains that such a hedge can be applied only when the net assets of that foreign operation are included in the financial statements. This will be the case for consolidated financial statements, financial statements in which investments such as associates or joint ventures are accounted for using the equity method or those that include a branch or a joint operation (as defined in IFRS 11 *Joint Arrangements*). *[IFRIC 16.2]*. For convenience, IFRIC 16 refers to such an entity as a parent entity and to the financial statements in which the net assets of foreign operations are included as consolidated financial statements and this section follows this convention. *[IFRIC 16.7]*.

Investments in foreign operations could be held directly by a parent entity or indirectly by its subsidiary or subsidiaries (see section 5.3.1 below). *[IFRIC 16.12]*.

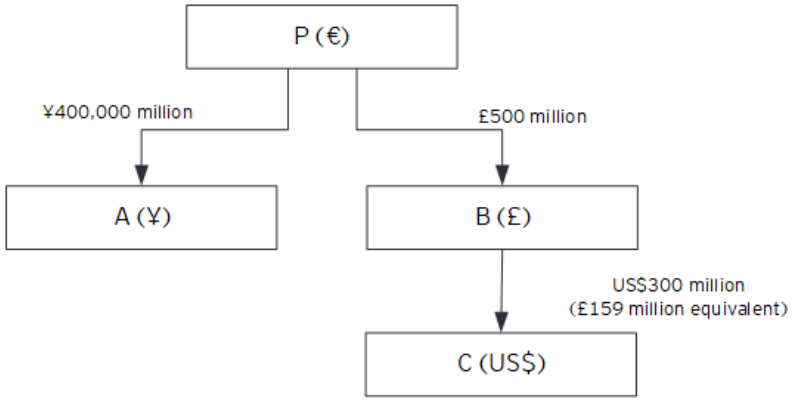
The requirements of IFRIC 16 are discussed in more detail in sections 5.3.1 to 5.3.3 below and, in the case of accounting for such a hedge, in section 7.3 below.

5.3.1 Nature of the hedged risk

Perhaps the most important decision made by the IFRS IC was that hedge accounting may be applied only to the foreign exchange differences arising between the functional currency of the foreign operation and the parent entity's functional currency. *[IFRIC 16.10]*. However, the hedged risk may be designated as the foreign currency exposure arising between the functional currency of the foreign operation and the functional currency of any parent entity (the immediate, intermediate or ultimate parent entity) of that foreign operation. The fact that the net investment is be held through an intermediate parent does not affect the nature of the economic risk arising from the foreign currency exposure to the ultimate parent entity. *[IFRIC 16.12]*. This principle is shown in the following Illustration.

Illustration 5-3: Nature of the hedged risk in a net investment hedge

Company P is the ultimate parent entity of a group and presents its consolidated financial statements in its functional currency of euro. It has two direct wholly owned subsidiaries, Company A whose functional currency is Japanese yen and Company B whose functional currency is sterling. B has a wholly owned subsidiary, Company C, whose functional currency is US dollars. P's net investment in A is ¥400,000 million. P's net investment in B is £500 million including the equivalent of £159 million representing B's net investment in C of US$300 million. P also has external borrowings of US$300 million. This corporate structure is illustrated as follows:



P, in its consolidated financial statements, could hedge its net investment in each of A, B and C for the foreign exchange risk between their functional currencies (Japanese yen, sterling and US dollars respectively) and euro. P could, as an alternative to hedging P's investment in C, hedge the foreign exchange risk between the functional currencies of B (sterling) and C (US dollars).

In its consolidated financial statements, B could hedge its net investment in C for the foreign exchange risk between C's functional currency (US dollars) and its own (sterling). *[IFRIC 16.AG1, IFRIC 16.AG2, IFRIC 16.AG3]*.

Where a non-derivative instrument is used as the hedging instrument, the designated risk must be the spot foreign exchange risk; if the hedging instruments were forward contracts (or other foreign currency derivatives), the forward or the spot foreign exchange risk could be designated as the hedged risk (see sections 7.3.3 and 7.3.4 below). *[IFRIC 16.AG2]*.

5.3.2 Amount of the hedged item for which a hedging relationship could be designated

In a hedge of the foreign currency risks arising from a net investment in a foreign operation, the hedged item can be an amount of net assets equal to or less than the carrying amount of the net assets of the foreign operation in the consolidated financial statements of the parent entity. *[IFRIC 16.11]*.

How we see it

Although the hedged item is described throughout IFRIC 16 with reference to the net assets, there is nothing within the guidance to suggest that a hedge of negative net assets would be precluded.

Illustration 5-4: Amount of hedged item in a net investment hedge

The facts are as in Illustration 5-3 above. If P wished to hedge the foreign exchange risk from its net investment in C, it could use its external borrowing of US$300 million as a hedging instrument and the hedged item could be an amount of net assets equal to or less than the US$300 million carrying amount of C in P's consolidated financial statements. *[IFRIC 16.AG4]*.

The carrying amount of the net investment takes account of monetary items receivable from or payable to a foreign operation for which settlement is neither planned nor likely to occur in the future. These balances are considered to be, in substance, part of the reporting entity's net investment in the foreign operation. *[IAS 21.15]*. A loan made to the foreign operation, for which settlement is neither planned nor likely to occur in the future, will increase the amount that can be hedged; if a loan is made by the foreign operation, the amount that can be hedged will be reduced. *[IFRIC 16.AG14]*.

In many cases the full economic value of a net investment will not be recognised in the financial statements. The most common reason will be the existence of, say, goodwill or intangible assets that are either not recognised or measured at an amount below their current value (see Chapter 10 and Chapter 18). In these situations, if an investor hedges the entire economic value of its net investment, it will not be able to obtain hedge accounting for the proportion of the hedging instrument that exceeds the recognised net assets.

A single hedging instrument can hedge the same designated risk only once. Consequently, in Illustration 5-3 and Illustration 5-4 above, P could not in its consolidated financial statements designate its external borrowing in a hedge of both the €/US$ spot foreign exchange risk and the £/US$ spot foreign exchange risk in respect of its net investment in C. *[IFRIC 16.AG6]*.

The carrying amount of the net assets of a foreign operation that may be designated as the hedged item in the consolidated financial statements of a parent depends on whether any lower level parent of the foreign operation has applied hedge accounting for all or part of the net assets of that foreign operation and whether that accounting has been maintained in the parent's consolidated financial statements. *[IFRIC 16.11]*. An exposure to foreign currency risk arising from a net investment in a foreign operation may qualify for hedge accounting only once in the consolidated financial statements. Therefore, if the same net assets of a foreign operation are hedged by more than one parent entity within the group (for example, both a direct and an indirect parent entity) for the same risk, only one hedging relationship will qualify for hedge accounting in the consolidated financial statements of the ultimate parent. *[IFRIC 16.13]*.

This is shown in the following Illustration.

Illustration 5-5: Amount of hedged item in a net investment hedge (different hedged risks)

The facts are the same as in Illustration 5-3 and Illustration 5-4 above except that P's net assets include £500 million external borrowings in addition to the US$300 million of external borrowings. If P wished to hedge the foreign exchange risk in relation to its net investments in B and C, the designations it could make in its consolidated financial statements include the following: *[IFRIC 16.AG10]*

- US$300 million of the US dollar borrowings designated as a hedge of the net investment in C with the risk being the spot foreign exchange exposure (€/US$) between P and C and up to £341 million of the sterling borrowings designated as a hedge of the net investment in B with the risk being the spot foreign exchange exposure (€/£) between P and B.

  Or

- US$300 million of the US dollar borrowings as a hedge of the net investment in C with the risk being the spot foreign exchange exposure (£/US$) between B and C and up to £500 million of the sterling borrowings designated as a hedge of the net investment in B with the risk being the spot foreign exchange exposure (€/£) between P and B.

The €/US$ risk from P's net investment in C is a different risk from the €/£ risk from P's net investment in B. However, in the first case described above, P would have already fully hedged the €/US$ risk from its net investment in C and if P also designated its £500 million of borrowings as a hedge of its net investment in B, £159 million of that net investment, representing the sterling equivalent of its US dollar net investment in C, would be hedged twice for £/€ risk in P's consolidated financial statements. *[IFRIC 16.AG11]*. The £341 million that could be designated is just £500 million less £159 million.

In the second case described above, because the designation of the US$/£ risk between B and C does not include the £/€ risk, P is also able to designate up to £500 million of its net investment in B with the risk being the spot foreign currency exposure (£/€) between P and B. *[IFRIC 16.AG12]*.

A hedging relationship designated by one parent entity in its consolidated financial statements need not be maintained by another higher level parent entity. However, if it is not maintained by the higher level parent entity, the hedge accounting applied by the lower level parent must be reversed before the higher level parent's hedge accounting is recognised. *[IFRIC 16.13]*. This is shown in the following Illustration.

Illustration 5-6: Hedge accounting applied by intermediate parent

The facts are the same as in Illustration 5-3 and Illustration 5-4 above, except that P's net assets include £500 million of external borrowings and B's net assets of £341 million include US$300 million of external borrowings which it designates as a hedge of the £/US$ risk of its net investment in C in its own consolidated financial statements.

P could maintain B's designation of that hedging instrument as a hedge of its net investment in C for the £/US$ risk and P could designate its £500 million external borrowings as a hedge of its entire net investment in B. The first hedge, designated by B, would be assessed by reference to B's functional currency (sterling) and the second hedge, designated by P, would be assessed by reference to P's functional currency (euro). In this case, only the £/US$ risk from P's net investment in C has been hedged in its consolidated financial statements by B's US dollar borrowings, not the entire €/US$ risk. Therefore, the entire €/£ risk from P's net investment in B may be hedged in P's consolidated financial statements. *[IFRIC 16.AG13]*.

Alternatively, P could reverse the hedging relationship designated by B. In this case, it could designate B's US$300 million external borrowing as a hedge of its net investment in C for the €/US$ risk and designate £341 million of its borrowings as a hedge of part of the net investment in B. In this case the effectiveness of both hedges would be computed by reference to P's functional currency (euro). Consequently, both the US$/£ and £/€ changes in value of B's US$300 million borrowing would be included in P's foreign currency translation reserve. Because P has already fully hedged the €/US$ risk from its net investment in C, it could hedge only up to £341 million for the €/GBP risk of its net investment in B. *[IFRIC 16.AG15]*.

5.3.3 Where the hedging instrument can be held

IFRIC 16 also states that the hedging instrument(s) may be held by any entity or entities within the group, including the foreign operation being hedged, provided the designation, documentation and qualification criteria of IFRS 9 are satisfied. However, this could only be the case for an instrument held by the foreign operation if the remeasurement of the hedging instrument with respect to the functional currency of the parent has an impact on consolidated profit or loss (e.g., in the case of a derivative hedging instrument). The hedging strategy of the group should be clearly documented because of the possibility of different designations at different levels of the group (see section 5.3.2 above). *[IFRIC 16.14, IFRIC 16.BC24A, IFRIC 16.BC24B, IFRIC 16.BC24C, IFRIC 16.BC24D]*. This is illustrated by Illustration 7-7 in section 7.3.1.

Where the entity holding the hedging instrument has a functional currency that is not the same as the parent by which the hedged risk is defined, this could result in some of the foreign exchange difference on the hedging instrument remaining in profit or loss - this is discussed further in section 7.3.1 below.

Clearly the reporting entity (which, in the case of consolidated financial statements, includes any subsidiary consolidated by the parent) must be a party to the hedging instrument. In Illustration 5-4 and Illustration 5-5 above, therefore, B could not apply hedge accounting in its consolidated financial statements in respect of a hedge involving the US$300 million borrowing issued by P because the hedging instrument is held outside of the group headed by B. *[IFRIC 16.AG6]*.

6 Qualifying criteria

6.1 General requirements

In order to qualify for hedge accounting as set out in section 7 below, all of the following criteria must be met:

- The hedging relationship consists only of eligible hedged items and eligible hedging instruments (see sections 2 and 3 above).
- At inception of the hedging relationship, there is formal designation and documentation of the hedging relationship and entity's risk management objective and strategy for undertaking the hedge (see section 6.2 below). That documentation shall include an identification of the hedging instrument, the hedged item, the nature of the risk being hedged and how the entity will assess the effectiveness requirements (including its analysis of the sources of hedge ineffectiveness and how it determines the hedge ratio (see section 6.3 below)).

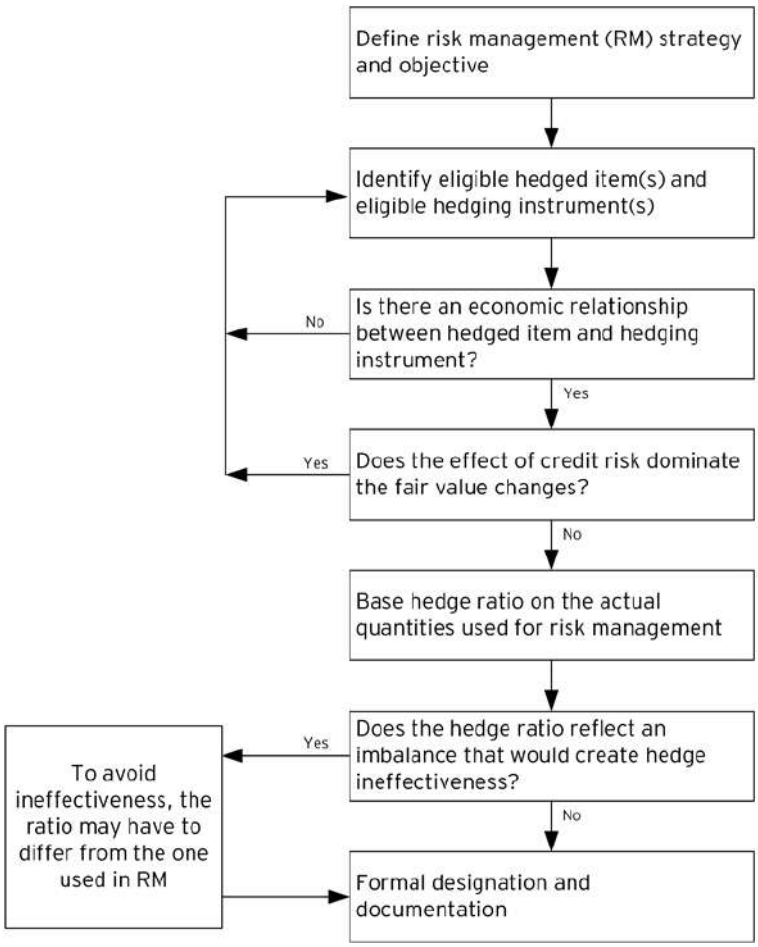
  And
- The hedging relationship meets all the following hedge effectiveness requirements (see section 6.4 below):
  - There is an economic relationship between the hedged item and the hedging instrument (see section 6.4.1 below).
  - The effect of credit risk does not dominate the value changes that result from that economic relationship (see section 6.4.2 below).

    And
  - The hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of the hedged item. However, that designation shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting. The second part of this requirement is an anti-abuse clause that is explained in more detail in in section 6.4.3 below. *[IFRS 9.6.4.1]*.

It is also a requirement that the designated hedge relationship is one of the three permitted types of hedges: a fair value hedge, a cash flow hedge, or a hedge of a net investment in a foreign operation (see sections 5.1, 5.2 and 5.3 respectively above). *[IFRS 9.6.5.2]*.

The required steps for designating a hedging relationship can be summarised in a flow chart as follows:

Figure 6-1: How to achieve hedge accounting



The initial effectiveness requirements also form the basis for the subsequent effectiveness assessment in order to continue to achieve hedge accounting, which is discussed in section 8 below.

6.2 Risk management strategy versus risk management objective

Linking hedge accounting with an entity's risk management activities requires an understanding of what those risk management activities are. IFRS 9 distinguishes between the risk management strategy and the risk management objective. One of the qualifying criteria for hedge accounting is that the risk management objective and strategy are documented. *[IFRS 9.6.4.1(b)]*.

The risk management strategy is established at the highest level of an entity and identifies the risks to which the entity is exposed, and whether and how the risk management activities will address those risks. For example, a risk management strategy could identify changes in interest rates of loans as a risk and define a specific target range for the fixed to floating rate ratio for those loans. The strategy is typically maintained for a relatively long period of time. However, it could include some flexibility to react to changes in circumstances. *[IFRS 9.B6.5.24]*.

IFRS 9 refers to the risk management strategy as normally being set out in "a general document that is cascaded down through an entity through policies containing more specific guidelines." *[IFRS 9.B6.5.24]*.

Presumably, the documentation of the risk management strategy does not need to be in a separate formal written document in all circumstances. Small and medium-sized entities with limited risk management activities that use financial instruments might not have a formal written document outlining their overall risk management strategy that they have in place. In some instances, individuals within the entity could be formally empowered to decide on what is done for risk management purposes. In such situations entities do not have the benefit of being able to incorporate the risk management strategy in their hedge documentation by reference to a formal policy document, but instead have to include a description of their risk management strategy directly in their hedge documentation.

Consequently, a more informal risk management strategy must be both reflected in the disclosures and 'compensated' by a more detailed documentation of the hedging relationships.

The risk management strategy is an important cornerstone of the hedge accounting requirements in IFRS 9. Consequently, the Board added specific disclosure requirements that are expected to allow users of the financial statements to understand the risk management activities of an entity and how they affect the financial statements (see Chapter 50 at section 4.3.1). *[IFRS 7.21A(a)]*. The disclosure requirements for the risk management strategy apply irrespective of whether or not an entity uses a formal written policy document as part of its risk management activities.

The risk management objective, on the contrary, is set at the level of an individual hedging relationship. It defines how a particular hedging instrument is designated to hedge a particular hedged item, and how that hedging instrument is used to achieve the risk management strategy. For example, this would define how a specific interest rate swap is used to 'convert' a specific fixed rate liability into a floating rate liability. Hence, a risk management strategy can involve many different hedging relationships whose risk management objective relates to executing that overall risk management strategy. *[IFRS 9.B6.5.24]*.

Illustration 6-1: Risk management strategies with related risk management objectives

The table below shows three examples of a risk management strategy with a related risk management objective.

Risk management strategy	Risk management objective
Maintain 40% of financial debt at floating interest rate	Designate an interest rate swap as a fair value hedge of a GBP100m fixed rate liability
Hedge foreign currency risk of up to 70% of forecast sales in USD up to 12 months in advance	In January 20X2 designate a foreign currency forward contract to hedge the foreign currency risk of the first USD100 sales in June 20X2
Manage the duration risk from a portfolio of fixed rate loans within particular risk limits.	Designate a group of derivatives as hedging the interest rate risk in the portfolio for 3 months or until the duration of the designated hedged items and hedging instruments are no longer sufficiently matched, if earlier.

It is essential to understand the difference between the risk management strategy and the risk management objective. In particular, even if the risk management strategy remains the same, a change in a risk management objective will affect the entity's ability to continue applying hedge accounting as documented (see section 8.3.3 below). Furthermore, voluntary discontinuation of a hedging relationship without a respective change in the risk management objective is not allowed. This is described in section 8.3 below.

The Implementation Guidance within IAS 39 contained some guidance that risk reduction on an entity-wide basis was not a condition for hedge accounting. Within the context of the risk management objective, that guidance remains relevant under IFRS 9. *[IAS 39.F.2.6]*. However, as the risk management strategy is established at the highest level of an entity, it would seem contrary to the objective of the hedge accounting if the strategy was to increase entity-wide risk. *[IFRS 9.6.1.1]*.

6.2.1 Designating 'proxy hedges'

The objective of the standard is "to represent, in the financial statements, the effect of an entity's risk management activities". *[IFRS 9.6.1.1]*. However, this does not mean that an entity can only designate hedging relationships that exactly mirror its risk management activities. The Basis for Conclusions notes that, in some circumstances, the designation for hedge accounting purposes is inevitably not the same as an entity's risk management view of its hedging, but that the designation reflects risk management in that it relates to the same type of risk that is being managed and the instruments used for this purpose. The IASB refer to this situation as 'proxy hedging' (i.e., designations that do not exactly represent the actual risk management). In redeliberating the September 2012 draft standard, the Board decided that proxy hedging is permitted, provided the designation is directionally consistent with the actual risk management activities.[15] Furthermore, where there is a choice of accounting hedge designation, there is no apparent requirement for an entity to select the designation that most closely matches the risk management view of hedging as long as the chosen approach is still directionally consistent with actual risk management. *[IFRS 9.BC6.98, IFRS 9.BC6.99, IFRS 9.BC6.100]*.

15 *IASB Update*, January 2013, available on the IFRS Foundation's website.

In June 2019, within the context of a fair value hedge of foreign currency risk of a non-financial asset held for consumption, the IFRS IC discussed the extent to which a designated hedge relationship must be consistent with an entity's risk management activities (see section 2.6.8 above).[16]

Paragraph 6.4.1(b) of IFRS 9 requires that, at the inception of a hedging relationship, "there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge". Accordingly, the IFRS IC observed that, in applying IFRS 9, an entity can apply hedge accounting only if it is consistent with the entity's risk management objective and strategy for managing its exposure. An entity therefore cannot apply hedge accounting solely on the basis that it identifies items in its statement of financial position that are measured differently but are subject to the same type of risk.

The IFRS IC observed that to the extent that an entity intends to consume a non-financial asset (rather than to sell it), changes in the fair value of the non-financial asset could be of limited significance to the entity. In such cases, an entity might not be economically managing or hedging risk exposures on the non-financial asset and, in that case, it cannot apply hedge accounting.

However, although the IFRS IC has reiterated the importance of consistency between designation of a hedge relationship and the entity's risk management objective and strategy, proxy hedging is still permitted, as long as the hedge designation is still directionally consistent with actual risk management. The examples below are common proxy hedging designations:

Illustration 6-2: Common proxy hedging designations

Net position cash flow hedging

IFRS 9 limits the designation of net positions in cash flow hedges to hedges of foreign currency risk (see section 2.5.3 above). However, in practice, entities often hedge other types of risk on a net cash flow basis. Such entities could still designate the net position as a gross designation. *[IFRS 9.BC6.100(a)]*.

For example, an entity holds CU2m of variable rate loan assets and CU10m of variable rate borrowings. The treasurer is hedging the cash flow risk exposure on the net position of CU8m, by entering into a pay fixed/receive variable interest rate swap (IRS) with a nominal amount of CU8m. Rather than designate the net CU8m as the hedged item, the entity could designate the IRS in a hedge of variable rate interest payments on a portion of CU8m of its CU10m variable rate borrowing.

The same approach could be applied when hedging the net foreign currency risk from forecast purchases and sales.

Risk components

An entity that hedges on a risk component basis in accordance with its risk management view might not meet the criteria for designating the hedged item as a risk component (see section 2.2 above). This does not mean that the entity is prohibited from applying hedge accounting altogether. The entity could designate the item in its entirety as the hedged item and apply hedge accounting, if all the qualifying criteria are met. *[IFRS 9.BC6.100(b)]*.

For example, in the case where the price of the hedged item is based on a benchmark rate plus a negative spread, it is not possible to identify a benchmark rate risk component in the hedged item (see section 2.4 above). However, it would be possible to designate the entire hedged item within a hedge relationship, if all the other criteria for hedge accounting were met.

Macro hedging strategies

Permitting proxy hedging is of particular relevance for banks wishing to apply macro cash flow hedging strategies (see section 10 below). Typically, banks manage the interest margin risk resulting from fixed-floating mismatches of financial assets and financial liabilities held at amortised cost on their banking books. Assume the assets are floating rate and the liabilities are fixed rate. The fixed-floating mismatches are offset by entering into receive fixed/pay variable interest rate swaps. Currently there is no hedge accounting model that perfectly accommodates such hedges of the interest margin. Consequently, banks are forced to use either fair value hedge accounting for the liabilities or cash flow hedge accounting for the assets, although the actual risk management activity is neither to hedge fair values nor cash flows, but to hedge the interest margin. Both cash flow hedge accounting and fair value hedge accounting would be directionally consistent with the risk management activity and so acceptable as proxy hedging designations. *[IFRS 9.BC6.98]*.

16 *IFRIC Update*, June 2019, available on the IFRS Foundation's website.

6.3 Documentation and designation

An entity may choose to designate a hedging relationship between a hedging instrument and a hedged item in order to achieve hedge accounting. *[IFRS 9.6.1.2]*. At inception of the hedging relationship the documentation supporting the hedge must include the identification of:

- The hedging relationship and entity's risk management objective and strategy for undertaking the hedge (see section 6.2 above)
- The hedging instrument (see section 3 above)
- The hedged item (see section 2 above)
- The nature of the risk being hedge (see section 2.2 above)

  And
- How the entity will assess the effectiveness requirements (including its analysis of the sources of hedge ineffectiveness and how it determines the hedge ratio (see section 6.4 below)) *[IFRS 9.6.4.1(b)]*

All the criteria in section 6.1 above, including the documentation requirements, must be met in order to achieve hedge accounting. *[IFRS 9.6.4.1]*. Accordingly, hedge accounting can be applied only from the date all the necessary documentation is completed and designation of a hedge relationship takes effect prospectively from that date. In particular, hedge relationships cannot be designated retrospectively.

Illustration 6-3: Hedge documentation

In order to meet the above documentation requirements, the hedge documentation must include definitive information on the following, where relevant:

IFRS 9.6.4.1 requirement	Detailed documentation required
Risk management objective and strategy (see section 6.2 above)	▸ Risk management strategy (could reference a formal policy document) ▸ Risk management objective (specific to the hedge relationship)
Hedging instrument	▸ Specific identification of hedging instrument(s), including whether hedging instrument(s) might be replaced by substitute hedging instruments (see section 8.3 below) ▸ Specified proportion (see section 3.6 above) ▸ Exclusion of time value, forward element or foreign currency basis (see sections 3.6.4 and 3.6.5 above) ▸ Whether part of a rollover strategy (see section 7.7 below) ▸ Whether part of a dynamic strategy (see section 6.3.2 below)
Hedged item	▸ Identification of hedged item(s) with sufficient specificity to determine whether/when the hedged item has occurred (see sections 6.3.3 and 8.3.4 below) ▸ Specified proportion or layer (see section 2.3 above) ▸ Specified risk component (see section 2.2 above) ▸ Which contractual cash flows (if not all) (see section 2.1 above) ▸ Timing of and rationale for forecast transactions being highly probable (see section 2.6.1 above)
Risk being hedged	▸ Hedge type (e.g., fair value, cash flow or net investment hedge) (see section 5 above) ▸ Specific identification of hedged risk ▸ Designation of a one side risk (see section 2.1 above)
Approach to effectiveness assessment (see section 6.4 below)	▸ Rationale for existence of an economic relationship ▸ Hedge ratio and how determined ▸ The effects of credit risk and how determined ▸ Method for assessing the effectiveness qualification criteria ▸ Sources of hedge ineffectiveness ▸ Frequency of assessment
Date of designation	▸ Date of designation ▸ Approval signature

Hedge effectiveness is the extent to which changes in the fair value or the cash flows of the hedging instrument offset changes in the fair value or the cash flows of the hedged item. When the hedged item is a risk component, the relevant change in fair value or cash flow of an item is the one that is attributable to the hedged risk (see section 2.2.1 above). *[IFRS 9.B6.4.1]*.

If there are changes in circumstances that affect the hedge effectiveness, an entity may have to change the method for assessing whether a hedge relationship meets the hedge effectiveness requirements, in order to ensure that the relevant characteristics of the hedging relationship, including the sources of ineffectiveness are still captured. The hedge documentation must be updated to reflect any such changes. *[IFRS 9.B6.4.2, IFRS 9.B6.4.17, IFRS 9.B6.4.19]*.

An entity can designate a new hedging relationship that involves the hedging instrument or hedged item of a previous hedging relationship, for which hedge accounting was (in part or in its entirety) discontinued (see section 2.4.1 above). This does not constitute a continuation but is a restart and requires redesignation. *[IFRS 9.B6.5.28]*. Hedge accounting will apply prospectively from redesignation, provided all other qualifying criteria are met. Even where the qualifying criteria are met, a hedge relationship in which an existing hedging instrument is designated, could result in higher levels of ineffectiveness (see section 7.4.3 below).

The need to meet the documentation requirements must not just be seen as a compliance exercise in order to achieve hedge accounting. The way in which the hedge relationship is documented can have significant implications on the way in which hedge accounting is applied, in particular in consideration of whether the hedge relationship must be discontinued (see section 8.3 below).

6.3.1 Business combinations

In a business combination accounted for using the purchase method of accounting, where the acquiree has designated hedging relationships, the question arises of whether the acquirer is:

- Permitted to continue to apply the hedge accounting model to hedge relationships designated previously by the acquiree, assuming it is consistent with the acquirer's strategies and policies

  Or

- Required to re-designate hedge relationships at the acquisition date[17]

IFRS 3 *Business Combinations* provides guidance that in order to obtain hedge accounting in their consolidated financial statements, acquirers are required to redesignate the acquiree's hedges. *[IFRS 3.15, IFRS 3.16(b)]*. Further, the acquirer must not recognise in its consolidated financial statements any amounts in equity in respect of any cash flow hedges of the acquiree relating to the period prior to acquisition (see section 7.2.4 below).

Redesignating the hedge relationships at the acquisition date means that if the hedging instrument has a fair value other than zero (see section 7.4.3 below), it is likely that ineffectiveness will be introduced in a hedge that might have been nearly 100% effective prior to the acquisition, particularly for cash flow hedges. To mitigate this, the acquirer could, subsequent to the combination, choose to settle the existing hedging instruments and replace them with similar 'on market' contracts with a zero fair value. Furthermore, this source of ineffectiveness could influence the chosen methodology used to demonstrate the existence of an economic relationship in order to qualify for hedge accounting in the acquirer's consolidated financial statements (see section 6.4.1 below). *[IFRS 9.B6.4.15]*.

For business combinations under common control, for which IFRS 3 is not applicable, see further discussion in Chapter 9 at section 4.4.2 and Chapter 11 at section 3.

For discussion on the ability to achieve hedge accounting for management of risks arising from a proposed business combination, see section 2.6.4 above.

17 INFORMATION FOR OBSERVERS, Board Meeting: *22 February 2007, London*, Project: *Business Combinations II*, Subject: *Reassessments (Agenda Paper 2B),* para. 25. Available on the IFRS Foundation's website.

6.3.2 Dynamic hedging strategies

A dynamic risk management strategy is one where the entity uses a dynamic process in which the exposure and the hedging instruments used to manage the exposure do not remain the same for long. *[IFRS 9.B6.5.24(b), IFRS 7.23C]*.

One such dynamic hedging strategy is where an entity assesses both the intrinsic value and time value of option contracts when hedging a risk exposure. Consider, as an example, a delta-neutral option hedging strategy (i.e., a strategy that is designed to create a net risk position (including the full option value) that is unlikely to be affected by small movements in the price of the underlying). In this situation it is helpful that there is no requirement to exclude the time value of hedging option contracts from the hedge relationship. IFRS 9 permits, but does not require, separation of the intrinsic and time value of an option contract and designation only of the intrinsic value as the hedging instrument (see section 3.6.4 above). *[IFRS 9.6.2.4(a)]*. Accordingly, for a delta-neutral option hedging strategy, it is possible to achieve hedge accounting without excluding the option time value, as long as the other qualifying criteria are met (see section 6.1 above).

Similarly, other dynamic hedging strategies under which the hedging instrument is constantly adjusted in line with the risk management strategy (perhaps in response to changes in the hedged items) in order to maintain a desired level of offset (e.g., to achieve a flat duration position, insensitive to changes in the fair value of the hedged item), could qualify for hedge accounting.

For a dynamic hedging strategy to qualify for hedge accounting, the documentation must specify how the hedge will be monitored and updated and how the effectiveness criteria will be assessed (see section 6.4 below). This would include documentation of the period over which the economic relationship assessment is considered, taking account of the dynamic nature of the hedge relationship (see section 6.4.1 below).

A key consideration is whether the periodic changes made as part of dynamic hedging strategy must be treated as:

- A discontinuation and redesignation of the hedge relationship. This will be the case if it is determined the risk management objective has changed (see section 6.2 above and section 8.3 below); or
- A rebalancing of the hedge relationship. This will be the case if it is determined that there is no change to the risk management objective for the hedge relationship but the change is in response to changes in the economic relationship between the hedged item and the hedging instrument (see section 6.2 above and section 8.2 below).

Such a determination is not a choice but based on facts and circumstances; for example, treatment as rebalancing is only permitted where entities change the quantity of hedged item compared to the quantity of hedging instrument (or *vice versa*) in response to changes in the economic relationship between them (i.e., changes to the hedge ratio are made), but the risk management objective otherwise continues as originally designated (see section 8.2 below). In contrast, the introduction of new types of hedging instruments would most likely be treated as a discontinuation and redesignation, as the use of new hedging instruments indicates that the entity no longer considers the existing hedging instruments to be sufficient to meet the risk management strategy.

A further example of a dynamic hedging strategy is a bank's interest rate risk management of an open portfolio of debt instruments, i.e., to which new exposures are frequently added, existing exposures mature, where frequent changes also occur to the hedged item(s) (see Illustration 8-8 in section 8.3.3 below). In that case, as the hedged items frequently change, the bank often looks at new hedging instruments and creates new relationships instead of continuing the relationship between the hedging instrument and the hedged item as they were designated previously. The risk management strategy remains the same, but there is no risk management objective that continues for those previously designated hedging relationships, which as such no longer exist. *[IFRS 9.B6.5.24(b)]*. Accounting for dynamic risk management of the associated risk in an open portfolio is the subject of a live project for the IASB (see section 10.1 below).

For any designated dynamic hedging strategies that do meet the IFRS 9 hedge accounting requirements, additional disclosures are required (see Chapter 50 at section 4.3.2). *[IFRS 7.23C]*.

6.3.3 Forecast transactions

In the case of a hedge of a forecast transaction, the documentation must identify the date on, or time period in which, the forecast transaction is expected to occur. This is because, in order to qualify for hedge accounting:

- The hedge must relate to a specific identified and designated risk *[IFRS 9.6.3.7]*
- It must be possible to measure its effectiveness reliably *[IFRS 9.6.3.2]*

  And

- The hedged forecast transaction must be highly probable (see section 2.6.1 above) *[IFRS 9.6.3.3]*

To meet these criteria, entities are not required to predict and document the exact date a forecast transaction is expected to occur. However, the time period in which the forecast transaction is expected to occur is required to be identified and documented within a reasonably specific and generally narrow range of time from a most probable date, as a basis for measuring hedge ineffectiveness. Consideration of the effectiveness criteria would need to reflect differences in timing of the hedged and hedging cash flows in a manner consistent with the designated hedged risk (see sections 6.4.1 and 7.4.2 below).

If a forecast transaction such as a commodity sale is properly designated in a cash flow hedge relationship, and subsequently its expected timing changes to an earlier (or later) period, this does not necessarily affect the validity of the original designation. If the entity can conclude that this transaction is the same as the one designated as being hedged, then hedge accounting might be able to continue (see section 8.3.4 below). However, ineffectiveness could arise due to the change in timing, as the calculation of the change in fair value of the hedged item would be based on the up-to-date expectation of the timing of the hedged forecast transaction. For example, if a forecast transaction was originally thought to occur in five months but is now expected one month earlier, the hedging instrument (still with five months remaining) will be designated for the remaining period of its existence, which will exceed the period to the forecast sale. Ineffectiveness will arise from the comparison of the change in value of the hedged item (with four months remaining) to the hedging instrument with a residual maturity of five months (see section 7.4.4 below).

Further, hedged forecast transactions must be identified and documented with sufficient specificity so that when the transaction occurs, it is clear whether the transaction is, or is not, the hedged transaction. Therefore, a forecast transaction may be identified as the sale of the first 15,000 units of a specific product during a specified three-month period (see section 2.3.1 above), but it could not be identified as the last 15,000 units of that product sold because they cannot be identified when they occur. For the same reason, a forecast transaction cannot be specified solely as a percentage of sales or purchases during a period, without also specifying the forecast value of forecast sales or purchases. The need for documented specificity of the hedged item was reiterated by the IFRS IC in March 2019 in a discussion within the context of the Application of the Highly Probable Requirement when a Specific Derivative is Designated as a Hedging Instrument (IFRS 9 and IAS 39)[18] (see section 2.6.1 above). However, specific questions relating to power purchase agreements (PPA's) for renewable energy were submitted to the IFRS IC and escalated to the IASB in 2023. This included the difficulties resulting from the prohibition on designating a percentage of sales or purchases as the hedged item. Subsequently, in 8 May 2024, the IASB published an ED, the ED proposes amendments allowing the hedged item in a cash flow hedging relationship to be specified as a variable volume of electricity aligned with the renewable electricity from the production facility as referenced in the PPA designated as the hedging instrument. The ED is a narrow scope amendment that relates only to the contracts for renewable electricity that meet specified scope criteria and it should not be applied by analogy to other contracts, items or transactions (see section 3.2.6.A above).

It might also be possible for a forecast transaction of an aggregated exposure to be an eligible hedged item (i.e., combination of a forecast derivative and non-derivative transaction) (see Illustration 2-26 in section 2.7.3.D above). *[IFRS 9.6.3.4]*

18 *IFRIC Update*, March 2019, available on the IFRS Foundation's website.

6.4 Assessing if the hedge effectiveness requirements are met

A hedging relationship can only qualify for hedge accounting if all the hedge effectiveness requirements are met, assuming the other qualifying criteria are also met (see section 6.1 above).

The hedge effectiveness requirements are as follows:

- There is an economic relationship between the hedged item and the hedging instrument (see section 6.4.1 below).
- The effect of credit risk does not dominate the value changes that result from that economic relationship (see section 6.4.2 below).

  And
- The hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of the hedged item. However, that designation shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting. The second part of this requirement is an anti-abuse clause that is explained in more detail in in section 6.4.3 below. *[IFRS 9.6.4.1(c)]*.

An entity shall assess at the inception of the hedging relationship, and on an ongoing basis whether the hedge effectiveness requirements are met (see section 8.1 below). The assessment relates to expectations about hedge effectiveness and is therefore only forward looking. The standard does not specify a particular method for assessing whether the effectiveness requirements are met, however the methods selected must be documented within the hedge documentation. Further, if there are changes in circumstances that affect the hedge effectiveness, an entity might have to change the method for assessing whether a hedge relationship meets the hedge effectiveness requirements, without interrupting the hedge relationship (see section 6.3 above). *[IFRS 9.B6.4.12, IFRS 9.B6.4.13, IFRS 9.B6.4.19]*.

How we see it

At a minimum, an entity must perform the ongoing assessment of hedge effectiveness at each reporting date or upon a significant change in circumstances affecting the hedge effectiveness requirements, whichever comes first.

'Reporting period' in this context refers to a period for which financial statements are produced in accordance with IFRS accounting standards. This includes both annual (full IFRS accounting standards) and interim (IAS 34 *Interim Financial Reporting*) financial reporting periods, if any. Other reporting periods such as internal reporting periods for which financial statements produced are not compliant with IFRS accounting standards are not 'reporting periods'. However, if an entity voluntarily performs this testing more frequently than their reporting periods, e.g., at the end of the period normally used by the entity for internal reporting purposes, this is not contrary to the objective of this requirement, provided this approach is consistently applied.

6.4.1 Economic relationship

The first effectiveness requirement means that the hedging instrument and the hedged item must generally be expected to move in opposite directions as a result of a change in the hedged risk. This is within the context of how the hedged item and hedging instrument have been designated as described in sections 2 and 3 above. *[IFRS 9.B6.4.1]*. The guidance does not require a belief that the value changes of the hedging instrument and the hedged item move in the opposite direction for the hedged risk in all circumstances, but that generally there is an expectation that they will systematically move in opposite directions. It is clear therefore, that there can be instances where the value changes in the hedged item and hedging instrument move in the same direction, although they will typically be expected to move in opposite directions.

IFRS 9 does not specify a method for assessing whether there is an economic relationship but provides the following guidance: *[IFRS 9.B6.4.13]*

Extract from IFRS 9

B6.4.13 This Standard does not specify a method for assessing whether a hedging relationship meets the hedge effectiveness requirements. However, an entity shall use a method that captures the relevant characteristics of the hedging relationship including the sources of hedge ineffectiveness. Depending on those factors, the method can be a qualitative or a quantitative assessment.

[IFRS 9.B6.4.13].

Determining which methods to use to assess whether there is an economic relationship, including statistical methods such as regression or sensitivity analysis, as well as the thresholds attached to them, will require judgement. No 'bright lines' are mandated by the guidance, nor is there a requirement for an entity to determine their own bright lines. *[IFRS 9.BC6.238]*. Instead, judgement is required in determining whether an economic relationship exists or not. However, it follows from the objective of the hedge accounting requirements, to represent the effect of an entity's risk management activities, that the main source of information to perform the assessment would be that an entity uses to perform its risk management activities. *[IFRS 9.6.1.1, IFRS 9.B6.4.18]*.

In practice, an entity will normally have assessed the economic relationship for risk management purposes and, in most cases, assuming sound risk management, we would expect that this assessment to be appropriate for accounting purposes as well. However, in some cases, existing risk management techniques might not adequately consider all sources of ineffectiveness, such that additional analysis could be required, although this is likely to be rare. The chosen technique will depend on the complexity of the relationship, availability of data, the time value of money and the level of uncertainty of offset in the hedge relationship. If there are changes in circumstances that affect hedge effectiveness, an entity may have to change the method for assessing whether an economic relationship exists. *[IFRS 9.B6.4.17]*. However, if the economic relationship has in fact broken down, a change in assessment methodology would be insufficient to fix it, and the hedge relationship must be discontinued (see section 8.3 below).

The requirement that there is an economic relationship may be fulfilled qualitatively for many hedging relationships, as the nominal amount, maturity and underlying of the hedging instrument often matches, or is closely aligned with, the hedged risk. *[IFRS 9.B6.4.14]*. Even though it is not sufficient to focus solely on changes in value due to the hedged risk (in particular for the hedging instrument (see section 3.1 above)), the economic relationship will often still be capable of being demonstrated using a qualitative assessment. Drivers of fair value movements that are excluded from the hedge relationship (e.g., a change in credit risk on a hedged bond, if the designated risk is the benchmark rate), can be ignored for the purposes of the assessment of whether there is an economic relationship. However, a change in credit risk in the hedged item will still be relevant in consideration of the requirement that the impact of credit risk must not be of a magnitude such that it dominates the value changes (see section 6.4.2 below).

A qualitative assessment could also be used to determine that an economic relationship does not exist. For example, a hedge of one-sided risk in forecast purchases could be designated as being hedged by an out-of-the-money call option. If the main driver of value change in the option is expected to be the time value of the option, (perhaps because the option is expected to remain out of the money) then it can easily be seen the hedged item and hedging instrument are generally not expected to move in opposite directions with respect to the hedged risk. Of course, in this example, if the time value of the option were to be excluded from the hedge relationship (see section 3.6.4 above), then it would be easier to demonstrate that there is an economic relationship.

When the critical terms of the hedging instrument and hedged item are not closely aligned, and there is increased uncertainty about the extent of offset, such that hedge effectiveness is more difficult to predict, as noted above, IFRS 9 suggests that "it might only be possible for an entity to conclude [that there is an economic relationship] on the basis of a quantitative assessment." *[IFRS 9.B6.4.16, IFRS 9.BC6.269]*. The standard does not provide any further guidance on when a quantitative assessment might be required or how it would be made. However, it would seem to be most relevant when the hedged item and the hedging instrument are each based on prices derived from different markets, as in the example of WTI and Brent crude oil, discussed below, where there is a reasonable chance that the value changes of the hedging instrument and the hedged item will frequently move in the same direction. Although judgement will be required, we expect the need for a quantitative assessment over and above what is already undertaken for risk management purposes, to be relatively infrequent. *[IFRS 9.B6.4.18]*.

The standard also mentions hedging relationships where a derivative with a non-zero fair value is designated as the hedging instrument, as an example of a situation where a quantitative assessment might be required to establish an economic relationship. It depends on the particular circumstances as to whether hedge effectiveness arising from the non-zero fair value could potentially have a magnitude that a qualitative assessment would not adequately capture. *[IFRS 9.B6.4.15]*. However, as noted above, the standard does not provide guidance on how large the non-zero fair value would have to be for a quantitative assessment to be required, or for an economic relationship to be considered not to exist.

The standard also mentions that a quantitative method, (e.g., regression analysis), might help demonstrate a suitable hedge ratio (see section 6.4.3 below). *[IFRS 9.B6.4.16]*.

The following Illustration shows an approach that uses a qualitative assessment.

Illustration 6-4: Economic relationship between HKD and USD

An entity has foreign currency exposures in both Hong Kong dollars (HKD) and US dollars (USD). The entity aggregates its exposures in the two currencies and only uses USD linked hedges to hedge those currency exposures.

Because the HKD is pegged to the USD in a way that allows fluctuations only within a very narrow band (between HKD 7.75 - HKD 7.85 per USD) the entity concludes that an economic relationship exists between its USD linked hedges (with the USD as the underlying) and its HKD denominated foreign currency exposures.

The entity monitors the currency peg for changes and treats the movements of the HKD within the narrow band as a source of some ineffectiveness for all hedges in which the hedged item relates to amounts denominated in HKD.

The standard cites an example where the price of the hedging instrument is based on the West Texas Intermediate (WTI) price of oil whereas the price of the hedged item is based on the Brent crude oil price. The values of the hedging instrument and the hedged item can both move in the same direction if, for example, there is only a minor change in the relative underlyings of each of the hedging instrument and hedged item (i.e., the WTI and Brent oil prices) but there is a change in the price differential between the two. However, no guidance is provided as to how frequently this would have to happen so as to lead us to reject the expectation that they would 'generally' move in opposite directions. One possibility might be to use correlation analysis to demonstrate that there is, over time, a reliable and systematic price relationship. *[IFRS 9.B6.4.4, IFRS 9.B6.4.5]*.

The assessment of whether there is an economic relationship must be based on an economic rationale rather than it just arising by chance, as could be the case if the relationship is based only on a statistical correlation. That is, causality cannot be assumed purely from correlation or, to quote the IASB, "the mere existence of a statistical correlation between two variables does not, by itself, support a valid conclusion that an economic relationship exists". *[IFRS 9.B6.4.6]*.

Conversely, a statistical correlation could provide corroboration of an economic rationale. For example, if it can be seen that value drivers exist such that there is an expectation that the value of the hedged item and hedging instrument would generally move in opposite directions, but that significant sources of ineffectiveness exist within a relationship that might counteract the offset, then quantitative analysis could assist in determining whether an economic relationship exists or not. For example, in the case of a fair value hedge of an inflation risk component in a fixed rate bond (assuming it is determined that there is an eligible risk component (see section 2.2.6 above)), quantitative analysis could provide additional evidence as to whether an economic relationship exists or not. In summary, a quantitative assessment alone is not enough to establish an economic relationship, but it could be useful in a small number of cases to support a qualitative analysis that an economic relationship exists.

The assessment of the economic relationship, whether qualitative or quantitative, would need to consider, amongst other possible sources of mismatch between the designated hedged item and the hedging instrument, the following:

- Maturity
- Volume or nominal amount
- Cash flow dates
- Interest rate basis, or quality and location basis differences
- Day count methods
- Features that arise only in either the designated hedged item or hedging instrument
- Differences in valuation methods and inputs such as discount rates or credit risk

  And
- The extent that the hedging instrument is already 'in the money', or 'out of the money' when designated

The assessment must be forward looking at all times. This does not mean that retrospective offset is never relevant, but it can only be relied upon if there is a reasonable expectation that it is representative of the future. *[IFRS 9.B6.4.12]*.

The assessment must include an analysis of the possible behaviour of the hedging relationship during its term to ascertain whether it can be expected to meet the risk management objective. *[IFRS 9.B6.4.6]*. The assessment must include consideration of all features of the hedging instrument and hedged item, and how they are expected to behave during the hedging relationship term. In the case of a deeply out of the money

knock-out option which is not replicated in the hedged item, if there was no expectation that the knock-out feature will be exercised then it could be possible to determine that there is an economic relationship, despite the fact that offset would not arise if the knock-out feature occurred (see Illustration 3-3 in section 3.2.2 above).This assessment would necessarily be repeated as part of the subsequent assessment of effectiveness, if the result of the assessment was that an economic relationship did not exist, the hedge would be discontinued prospectively (see section 8.1 below).

In some cases, it could be difficult to demonstrate that an economic relationship exists for the entire life of the hedged item and hedging instrument, for example in the case of a hedging instrument with a longer life than the hedged item (see section 3.6.6 above), where there is a prepayment option within the hedged item, which is not matched by the hedging instrument (see section 2.3.2 above), in a documented rollover strategy (see section 7.7 below) or in a documented dynamic hedging strategy (see section 6.3.2 above).

The assessment as to whether an economic relationship exists must consider possible behaviours over the 'term' of the hedging relationship. *[IFRS 9.B6.4.6]*. The meaning of the 'term' of the hedging relationship is not explicitly defined. In some cases, it would be appropriate to assume that it refers to the remaining life of the hedging instrument or hedged item, however, an entity's risk management must not be ignored in the assessment. *[IFRS 9.B6.4.18]*.

For example, in the case of a documented dynamic hedging strategy, using a process in which the hedged item(s) and/or the hedging instrument(s) do not remain the same for long (see section 6.3.2 above), there is an expectation that changes will be required in future to the hedge designation in order to continue to meet the risk management strategy. IAS 39 contained some explicit guidance on effectiveness testing for dynamic hedging strategies, that an entity "must be able to demonstrate an expectation that the hedge will be highly effective for a specified short period of time during which the hedge is not expected to be adjusted". *[IAS 39.AG107, IAS 39.F.1.9]*.

How we see it

While the above guidance has not explicitly been carried forward into IFRS 9, it appears consistent with the requirement to consider the entity's risk management when assessing whether an economic relationship exists.

An entity's risk management is the main source of information to perform an assessment of whether a hedging relationship meets the effectiveness requirements, for example whether an economic relationship exists between the hedged item and the hedging instrument.

Accordingly, we believe that the term of the hedging relationship and the assessment of whether there is an economic relationship must be consistent with the risk management objective.

Hence if it is the case, and is documented as such, that sources of ineffectiveness, for example, prepayment risk or duration mismatches, are expected to result in changes to the risk management objective for that hedge relationship (typically in a dynamic hedging strategy), then the relevant term of the hedging relationship for assessment purposes is until the hedge is expected to be reset or reassessed, rather than the life of the hedging instrument or hedged item. However, all ineffectiveness must be measured and recorded in the usual way, irrespective of whether the hedge term for assessment purposes is considered to be shorter than the life of either the hedged item or instrument (see section 7.4 below).

Similarly, in the case of a documented roll over strategy (see section 7.7 below), as part of the entity's risk management there is an expectation that rollover hedging instruments will be transacted in order to maintain the documented risk management objective. Therefore, when making an assessment of the hedge term of a rollover hedging strategy for the purposes of assessing the existence of an economic relationship, we believe the relevant hedge term will reflect the timing of the expected rollover, despite the fact that the risk management objective will not change at that time (see section 7.7 below).

When using a statistical method such as regression analysis, either to corroborate an economic relationship or to determine a suitable hedging ratio, an entity is required to consider its expectations of future developments. A prominent historic example is negative interest rates in some European countries (see section 2.4.2 above). Many variable debt instruments such as mortgages include an explicit or implicit floor while the interest rates swaps used to hedge the variability of cash flows of those exposures usually do not. Although the interest cash flows of the hedged item and the variable leg of the hedging instrument might well have been highly correlated in the past, in an environment where interest rates are expected to be negative in the foreseeable future, this might no longer be expected because of the floor in the hedged item. This means that an entity needs to incorporate changes in expectations and re-calibrate its regression analysis accordingly.

It might also be necessary to ensure any expectations or rationale applied when undertaking a qualitative assessment to determine whether an economic relationship exists, continue to be relevant for the current economic environment.

6.4.2 Credit risk and the effectiveness assessment

IFRS 9 requires that, to achieve hedge accounting, the impact of credit risk must not be of a magnitude such that it dominates the value changes, even if there is an economic relationship between the hedged item and hedging instrument. Credit risk can arise on both the hedging instrument and the hedged item in the form of counterparty credit risk or the entity's own credit risk.

Judgement must be used in determining when the impact of credit risk is 'dominating' the value changes. But clearly, to 'dominate' would mean that there would have to be a very significant effect on the fair value of the hedged item or the hedging instrument (i.e., 'the loss (or gain) from credit risk frustrating the effect of changes in the underlyings on the value of the hedging instrument or hedged item, even if those changes were significant'). However, the standard provides guidance that in the case where there is little change in the underlyings in a particular period, the fact that even small credit risk related changes in the value of the hedging instrument or the hedged item might affect the value more than the underlying does not create dominance. *[IFRS 9.B6.4.7]*.

Extract from IFRS 9

B6.4.8 An example of credit risk dominating a hedging relationship is when an entity hedges an exposure to commodity price risk using an uncollateralised derivative. If the counterparty to that derivative experiences a severe deterioration in its credit standing, the effect of the changes in the counterparty's credit standing might outweigh the effect of changes in the commodity price on the fair value of the hedging instrument, whereas changes in the value of the hedged item depend largely on the commodity price changes.

[IFRS 9.B6.4.8].

The assessment of the effect of credit risk on value changes for hedge effectiveness purposes, which often could be made on a qualitative basis, must not be confused with the requirement to measure and recognise the impact of credit risk on the hedging instrument and, where appropriate, the designated hedged item, which will normally give rise to hedge ineffectiveness recognised in profit or loss (see section 7.4.9 below).

The sections below provide more discussion on the assessment of whether credit risk arising in either the hedging instrument or hedged item dominates the value changes in the hedge relationship.

6.4.2.A Credit risk on the hedging instrument

IFRS 13 is clear that the effect of credit risk, both the counterparty's credit risk and the entity's own credit risk, must be reflected in the measurement of fair value (see Chapter 15 at section 10.3.2). The effect of counterparty and own credit risk on the measurement of the hedging instrument will obviously result in some hedge ineffectiveness, as the same credit risk does not usually arise in the hedged item. However, the expected effect of that ineffectiveness must not be of a magnitude that it frustrates the offsetting impact of a change in the values of the hedging instrument and the hedged item that results from the economic relationship (as explained in section 6.4.2 above).

We expect the assessment of the effect of credit risk to be a qualitative assessment in most cases. For example, entities typically have counterparty risk limits defined as part of their risk management policy. The credit standing of the counterparties is monitored on a regular basis. However, a quantitative assessment of the impact of credit risk on the value changes of the hedging relationship might be required in some instances, if the counterparty's credit standing deteriorates.

Nowadays, most over-the-counter derivative contracts between financial institutions are collateralised by cash margins. Furthermore, initiatives in several jurisdictions, such as, the European Market Infrastructure Regulation (EMIR) in the European Union or the Dodd-Frank Act in the United States, have resulted in more derivative contracts being collateralised by cash (see section 8.3.5 below).

Cash collateralisation significantly reduces the credit risk for both parties involved, meaning that credit risk is unlikely to dominate the change in fair value of such hedging instruments. This is also true for any derivatives that are a settled-to-market (STM) interest rate swap, in which the daily variation margin is used to settle the interest rate swap's outstanding fair value (see section 8.3.6 below).

6.4.2.B Credit risk on the hedged item

The analysis of the hedged item is somewhat different, as credit risk does not apply to all types of hedged items. For example, while loan assets typically have counterparty credit risk and financial liabilities bear the issuing entity's own credit risk, inventory and forecast transactions do not pose credit risk.

Credit risk is defined as: *[IFRS 7 Appendix A]*

Extract from IFRS 7

Appendix A
Defined terms

credit risk	The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

Credit risk cannot dominate the value change in a hedge of a forecast transaction as the transaction is, by definition, only anticipated but not committed. *[IFRS 9 Appendix A]*. Similarly, inventory does not involve credit risk.

This should be contrasted with the assessment of whether a forecast transaction is highly probable (see section 2.6.1 above). Even though such a transaction does not involve credit risk, depending on the possible counterparties for the anticipated transaction, the credit risk that affects them can indirectly affect the assessment of whether the forecast transaction is highly probable. For example, assume an entity sells a product to only one particular customer abroad for which the sales are denominated in a foreign currency and the entity does not have alternative customers to sell the product to in that currency (or other sales in that currency). In that case, the credit risk of that particular customer would indirectly affect the likelihood of the entity's forecast sales in that currency occurring. Conversely, if the entity has a wider customer base for sales of its product that are denominated in the foreign currency then the potential loss of a particular customer would not significantly (or even not at all) affect the likelihood of the entity's forecast sales in that currency.

It is noted in IFRS 9 that a magnitude that gives rise to dominance is one that would result in the loss (or gain) from credit risk frustrating the effect of changes in the underlying on the value of the hedging instrument or the hedged item, even if those changes were significant. *[IFRS 9.B6.4.7]*. The guidance refers to both a loss and a gain due to changes in credit risk for the hedged item and the hedging instrument. However, it will only be relevant to consider a decrease in credit risk for the hedged item, if such a change in credit risk would frustrate the hedge relationship. For example, a decrease in credit risk in a hedged financial asset is unlikely to cause the level of offset within the hedge relationship to become erratic, if credit risk is excluded from the hedge relationship. In contrast, this would not be the case for an increase in the credit risk of hedged financial assets, as higher levels of credit risk could affect the hedged cash flows themselves.

For regulatory and accounting purposes, banks usually have systems in place to determine the credit risk on their loan portfolios. Therefore, banks are likely to be able to identify loans for which credit risk is so high that it would require an assessment of whether credit risk is dominating the value changes in the hedging relationship.

The introduction of the impairment model of IFRS 9 (see Chapter 47) raised the question of whether there is a linkage between:

- The impairment model concept of a significant increase in credit risk (i.e., the move from 'stage one' to 'stage two') and the subsequent transfer of a credit-impaired financial assets to 'stage three'

  And

- The concept of when the effect of credit risk dominates the value changes of the hedged item that represent the hedged risk

There is no direct link between the stages of the impairment model and credit risk eligibility criterion of the hedge accounting model. However, in practice, an entity might consider the indicators cited in the definition of a credit-impaired financial asset (see Chapter 47 at section 3.1). This is because those indicators characterise situations with a magnitude of credit risk that normally suggests that its effect would dominate the value changes of the hedged item that represent the hedged risk. This implies that the hedge effectiveness criteria would cease to be met no later than when a financial asset is classified as credit-impaired (i.e., in stage three). How much earlier the hedge effectiveness criteria might be failed is a matter of judgement, which might need to be supported by quantitative assessment in some situations. But also, in the context of stage three of the impairment model, it should be remembered that the effect of credit risk

on the fair value of an item involves not only the probability of default but also the loss given default, whereas the indicators cited in the definition of a credit-impaired financial asset relate only to the probability of default. That difference is relevant when assessing whether credit risk is dominant in the case of items that are highly collateralised.

In practice, we expect that entities with a sound risk management would be unlikely to struggle with the assessment of when the effect of credit risk dominates the value changes of the hedged item that represent the hedged risk. This is because such entities would have developed suitable criteria for when risk exposures can no longer be economically hedged because credit risk creates too much uncertainty as to whether that exposure will eventually crystallise as per the terms in the contract from which it arises. Entities normally evaluate this for risk management purposes because they want to avoid being 'over-hedged' as a result of the offset from the hedged item for the gains or losses on the hedging instrument being eroded by credit risk. In other words, this is predominantly an economic question rather than an accounting consideration (similar to the discussion in section 6.4.2.A above regarding the credit risk of hedging instruments and entities' criteria for selecting counterparties for those instruments).

It has been suggested that there is also interaction between the hedge accounting model and the impairment model regarding the effect that a fair value hedge might have on the measurement of the expected credit loss (ECLs). Specifically, as IFRS 9 requires that expected cash flows are discounted at the effective interest rate (EIR) for the purposes of calculation of the ECL, the question is whether fair value hedge accounting changes the EIR of hedged financial assets for this purpose.

Where the hedged item in a fair value hedge is a financial instrument (or component thereof) for which the effective interest method of accounting is used, the adjustment must be amortised to profit or loss. Amortisation may begin as soon as the adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for hedging gains and losses. The adjustment must be based on a recalculated effective interest rate at the date amortisation begins (see sections 7.1.2 and 8.3.1 below). *[IFRS 9.6.5.10]*.

How we see it

As a fair value hedge adjustment is only required to be amortised when the hedged item ceases to be adjusted for changes in fair value attributable to the risk being hedged, arguably there is no need to adjust the EIR until then, and hence the rate used to discount ECLs. We believe the requirement is not clear and that there is an accounting policy choice on the matter (see Chapter 47 at section 7.5).

If an accounting policy choice is made that fair value hedges do change the EIR, then the EIR used for discounting the ECLs must be adjusted for the effects of fair value hedging. Under IFRS 9, every debt instrument recorded at amortised cost or at fair value through other comprehensive income has an associated ECL. This would mean, for every fair value hedge in relation to such financial assets, the measurement of the ECLs would require taking into account the effect of the fair value hedge accounting.

The systems used to assess the credit risk of loans would also usually permit banks to determine the appropriate economic hedge when hedging the interest rate risk of such loans, as illustrated by Illustration 6-5 below:

Illustration 6-5: Designating interest rate hedges of loan assets when credit risk is expected

Assume a bank wishes to hedge the interest rate risk of a portfolio of non-pre-payable loans that have similar credit risk characteristics. Economically, the bank will hedge only the cash flows it expects to collect. When expecting to collect 95% of all cash flows in a loan portfolio, the bank is likely to designate a bottom layer nominal amount reflecting the first 95% of cash flows only. A designation of a nominal amount equal to more than 95% would result in an economic over-hedge and would also increase the risk of credit risk dominating the value changes of the hedging relationship.

The designation of such a nominal component (often referred to as a bottom layer) is possible under IFRS 9 (as discussed in section 2.3 above). This type of designation would require that all items included in the layer are exposed to the same hedged risk so that the measurement of the hedged layer is not significantly affected by items that make up the 95% layer from the overall 100% of the portfolio. *[IFRS 9.6.6.3(c)]*. Therefore, the entity has to designate the same kind of benchmark interest rate risk component of each loan to make up the bottom layer. If there is a deterioration in the credit risk of a particular loan that results in credit risk dominating the economic relationship with the benchmark interest rate, such that its benchmark interest rate risk component will no longer qualify to be designated as a hedged item, it would not be considered to be part of the bottom layer unless and until those loans for which credit risk dominates the economic relationship exceed 5% of the portfolio.

For pre-payable loans the designation is more complicated as there are additional criteria to be applied in order to designate a bottom layer in such a portfolio within a fair value hedge (see section 2.3.2 above).

The example should not be taken to imply that for an individual loan with an expected loss of, say, 5% an entity could not hedge the interest rate risk using an interest rate swap that has a notional amount equal to the loan's face value. However, if the loan deteriorated in its credit quality to an extent where the credit risk-related changes in fair value start to dominate the interest rate risk-related changes, the hedging relationship would have to be discontinued.

6.4.3 The hedge ratio

The hedge ratio is the ratio between the amount of hedged item and the amount of hedging instrument. For many hedging relationships, the hedge ratio would be 1:1 as the underlying of the hedging instrument perfectly matches the designated hedged risk.

Some hedging relationships could include basis risk such that the fair value changes of the hedged item and the hedging instrument do not have a simple 1:1 relationship. In such cases, risk managers will generally set the hedge ratio so as to be other than 1:1, in order to improve the effectiveness of the hedge. Consequently, the third IFRS 9 hedge effectiveness requirement is that the hedge ratio used for accounting will ordinarily be the same as that used for risk management purposes. *[IFRS 9.6.4.1(c)(iii), IFRS 9.B6.4.9]*.

Illustration 6-6: Setting the hedge ratio

An entity purchases a raw material whose price is at a discount to the commodity benchmark price, reflecting that the raw material is not yet processed to the same extent as the benchmark commodity, as well as quality differences. The entity runs a rolling 12 month regression analysis at each month end to ascertain that the price of the commodity in the futures market and the price of the raw material remain highly correlated. The slopes of the regression analyses (commodity benchmark price to raw material price) over recent months varied between 1.237 and 1.276.

The entity considers that the pattern of its regression analyses is consistent with its longer term view that the raw material trades at an approximately 20% discount to the commodity benchmark price and does not indicate a change in trend but fluctuations around that discount. Therefore, the entity uses a notional amount of 1 tonne of a forward contract for the benchmark commodity to hedge highly probable forecast purchases of 1.25 tonnes of the raw material. Note that this is not exactly the same as the particular slope of the most recent monthly regression, which is not required because the standard requires only that the entity uses the hedge ratio that it actually uses for risk management purposes, and not that it is required to minimise ineffectiveness. The example also illustrates what the standard acknowledges: there is no 'right' answer, as different entities would run different regression analyses (e.g., in terms of frequency and data inputs used, which means there is no one hedge ratio that could be required). The fluctuation of the actual discount around the particular hedge ratio chosen for designating the hedging relationship will give rise to some ineffectiveness that will need to be recorded.

However, the standard requires the hedge ratio for accounting purposes to be different from the hedge ratio used for risk management if the latter hedge ratio reflects an imbalance that would create hedge ineffectiveness "that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting." *[IFRS 9.6.4.1(c)(iii), IFRS 9.B6.4.10]*. This complex language was introduced because the Board is specifically concerned with deliberate 'under-hedging', either to minimise recognition of ineffectiveness in cash flow hedges or the creation of additional fair value adjustments to the hedged item in fair value hedges. *[IFRS 9.B6.4.11(a)]*.

Illustration 6-7: Deliberate under-hedging in a cash flow hedge to avoid recognition of ineffectiveness

IFRS 9 requires the cash flow hedge reserve to be adjusted for the lower of (a) the cumulative gain or loss on the hedging instrument or (b) the cumulative change in fair value of the hedged item (see section 7.2 below). *[IFRS 9.6.5.11(a)]*. If (a) exceeds (b), the difference is recognised in profit or loss as ineffectiveness. On the other hand, no ineffectiveness is recognised if (b) exceeds (a).

An entity has highly probable forecast purchases of a raw material used in its manufacturing process. The average volume of raw material purchases is expected to be CU200 million per month. The entity wishes to hedge the commodity price risk on those forecast purchases. The only derivative available does not have an underlying risk exactly matching the one from the actual raw material hedged. The slope of a linear regression analysis is 0.93, indicating the ideal hedge ratio.

To seek to avoid recognition of accounting ineffectiveness, the entity ensures (b) will exceed (a), applying the accounting requirement discussed above. It enters into derivatives with a notional amount of only CU150m per month and designates the CU150 million of derivatives as hedging instruments in cash flow hedges of highly probable forecast purchases of CU200 million (thereby setting the hedge ratio at 0.75:1).

In this scenario, the hedge ratio would be considered unbalanced and only entered into to avoid recognition of accounting ineffectiveness. For hedge accounting purposes, the hedge ratio would have to be based on the expected sensitivity between the hedged item and the hedging instrument (in this example possibly around the 0.93:1 based on the linear regression analysis, which would give a hedged volume of CU161m). As a result, if the actual relative change in the fair value of the hedging instrument is greater than that on the hedged item because the relationship between the underlyings changes, some ineffectiveness will have to be recognised.

Illustration 6-8: Deliberate under-hedging in a fair value hedge to create fair value accounting

An entity acquires a CU50 million portfolio of debt instruments. The debt instruments fail the 'cash flow characteristics test' of IFRS 9 (i.e., the contractual cash flows do not solely represent payments of principal and interest on the principal amount outstanding) and are therefore accounted for at fair value through profit or loss (see Chapter 44 at section 5). *[IFRS 9.4.1.2(b), IFRS 9.4.1.2A(b), IFRS 9.4.1.4]*.

The treasurer dislikes the profit or loss volatility resulting from the fair value accounting. He realises that one of the entity's fixed rate bank borrowings has a similar term structure and that fair value changes on the liability due to interest rate risk would more or less offset the fair value changes on the asset portfolio. However, at the time of entering into the bank borrowing, the entity did not apply the fair value option to this liability (see Chapter 44 at section 6).

The treasurer enters into a CU1 million receive fixed/pay variable interest rate swap (IRS) and designates the IRS in a fair value hedge of CU50 million of fixed rate liability (thereby setting the hedge ratio at 0.02:1). As a result, the entire CU50 million of liability would be adjusted for changes in the hedged interest rate risk. There would still be a measurement mismatch as only fair value changes due to the interest rate risk components would offset between the portfolio of debt instruments and the designated hedged liability and there would be no offset for fair value changes in the portfolio of debt instruments due to other drivers.

In this scenario, the hedge ratio is unbalanced as the real purpose of the hedging relationship is to achieve fair value accounting (related to changes in interest rate risk) for CU49 million of the liability. The hedge ratio used for hedge accounting purposes would have to be different (likely close to 1:1). Such a designation is also unlikely to be directionally consistent with the entity's risk management objective and strategy and so would be precluded for that reason also (see section 6.2.1 above).

Alternatively, the entity could consider designating the CU50 million portfolio of debt instruments as the hedging instrument in a fair value hedge of the fixed rate bank borrowings for interest rate risk (see section 3.3 above), in that case a 1:1 hedge ratio might also be required.

However, the same mismatch as mentioned previously would still arise, as all changes in fair value of non-derivative hedging instruments must be considered to be part of the hedge relationship. For a hedging instrument it is not possible to restrict the fair value changes to interest rate risk only.

The above examples are of course extreme scenarios and instances of unbalanced hedge designations are likely to be rare; IFRS 9 does not however require an entity to designate a 'perfect hedge'. For instance, if the hedging instrument is only available in multiples of 25 metric tonnes as the standard contract size, an imbalance due to using, say, 400 metric tonnes nominal value of hedging instrument to hedge 409 metric tonnes of forecast purchases, would not be regarded as resulting in an outcome 'that would be inconsistent with the purpose of hedge accounting' and so would meet the qualifying criteria. *[IFRS 9.B6.4.11(b)]*.

The subsequent prospective effectiveness assessment requires consideration as to whether the accounting hedge ratio is still appropriate, or indeed whether a change is required. This 'rebalancing' of a live hedge relationship is further discussed in section 8.2 below.

7 Accounting for effective hedges

If any entity chooses to designate a hedging relationship of a type described in section 5 above, between a hedged item and a hedging instrument as described in sections 2 and 3 above and it meets the qualifying criteria set out in section 6 above, the accounting for the gain or loss on the hedging instrument and the hedged item will be as set out in this section. *[IFRS 9.6.1.2, IFRS 9.6.5.1]*.

7.1 Fair value hedges

7.1.1 Ongoing fair value hedge accounting

If a fair value hedge (see section 5.1 above) meets the qualifying conditions set out in section 6 above during the period, it must be accounted for as follows:

- The gain or loss on the hedging instrument shall be recognised in profit or loss (or OCI if the hedging instrument hedges an equity instrument for which an entity has elected to present changes in fair value in OCI in accordance with IFRS 9.5.7.5 (see section 2.6.3 above and Chapter 44 at section 1.2)).

  And

- The hedging gain or loss on the hedged item shall adjust the carrying amount of the hedged item (if applicable) and be recognised in profit or loss.

  If the hedged item is a debt instrument (or a component thereof) that is measured at fair value through OCI in accordance with IFRS 9.4.1.2.A (see Chapter 44 at section 1.1) the hedging gain or loss on the hedged item shall be recognised in profit or loss.

  If the hedged item is an equity instrument for which an entity has elected to present changes in fair value in OCI, those amounts shall remain in OCI.

Where a hedged item is an unrecognised firm commitment (or a component thereof), the cumulative change in the fair value of the hedged item subsequent to its designation is recognised as an asset or liability with a corresponding gain or loss recognised in profit or loss. *[IFRS 9.6.5.8]*.

The hedging gain or loss on the hedged item is not necessarily the full fair value change in the hedged item, but reflects the change in value since designation of the designated portion or component of the hedged item (see sections 2.2 and 2.3 above) attributable to the hedged risk. Any changes in the fair value of the hedged item that are unrelated to the hedged risk (or occurred prior to the hedge designation) must only be recognised in compliance with the normal requirements of IFRS accounting standards. *[IFRS 9.B6.3.11]*.

The gain or loss on the hedging instrument for the purposes of accounting for a fair value hedge, refers to all changes in fair value of the hedging instrument since designation in the hedge relationship. Only fair value changes with respect to the time value of an option, forward element of a forward contract or foreign currency basis spreads if excluded from the hedge designation (see sections 3.6.4 and 3.6.5 above), or a documented excluded proportion of the instrument (see section 3.6.1 above) are not included within the gain or loss on the hedging instrument.

Hedge ineffectiveness is the extent to which the changes in the fair value or the cash flows of the hedging instrument are greater or less that those on the hedged item. *[IFRS 9.B6.3.11, IFRS 9.B6.4.1]*. Where hedge ineffectiveness arises in a fair value hedge, a net amount will be recognised in profit or loss, (unless the hedged item is an equity instrument for which an entity has elected to present changes in fair value in OCI in accordance with IFRS 9.5.7.5, in which case it will be recognised in OCI). Hedge ineffectiveness is an important concept with IFRS 9, and measurement of it is considered more fully in section 7.4 below.

Although not clearly stated in IFRS 9, it is implied that the gain or loss on the hedging instrument (at least to the extent it is effective) and the hedging gain or loss on the hedged item is likely to be recognised in the same line item in profit or loss, to reflect the offsetting effect of hedge accounting (see Chapter 50 at section 7.1.3). *[IFRS 9.6.5.8]*.

The following simple examples illustrate how fair value hedge treatment would apply to a hedge of fair value interest rate risk on an investment in fixed rate debt. Illustration 7-1 below demonstrates the accounting for a fixed rate debt held at amortised cost as well as one measured at fair value through OCI.

Illustration 7-1: Fair value hedge

At the beginning of Year 1 an investor purchases a fixed rate debt security for £100. At the end of Year 1, the fair value of the debt security is £110. In order to protect this value, at the end of Year 1 the investor enters into a hedge by acquiring an interest rate derivative with a nil fair value and designates it in a fair value hedge of interest rate risk. By the end of Year 2, the derivative has a fair value of £5 and the debt security has a corresponding decline in fair value. Fair value changes in both the fixed rate debt security and the derivative have only occurred due to interest rates.

Case 1: the investor has classified the fixed rate debt security at amortised cost (see Chapter 44 at sections 4 and 5).

Case 2: the investor classifies the fixed rate debt security as measured at fair value through OCI (see Chapter 44 at section 1.1).

Case 1: debt held at amortised cost

The investor would record the following accounting entries:

Year 1

Beginning of year

			£	£
Dr	Debt security		100	
	Cr	Cash		100

To reflect the acquisition of the debt security.

Although the fair value of the debt security has changed by the end of Year 1, no accounting entries are applied as it is held at amortised cost.

Year 2

Beginning of year

			£	£
Dr	Derivative		-	
	Cr	Cash		-

To record the acquisition of the derivative at its fair value of nil.

End of year

			£	£
Dr	Derivative		5	
	Cr	Profit or loss		5

To recognise the increase in the derivative's fair value in profit or loss.

			£	£
Dr	Profit or loss		5	
	Cr	Debt security		5

Applying fair value hedge accounting, to recognise the decrease in the fair value of the debt security due to changes in interest rates since the hedge was designated at the beginning of Year 2.

Case 2: debt held at fair value through OCI

The investor would record the following accounting entries:

Year 1

Beginning of year

			£	£
Dr	Debt security		100	
	Cr	Cash		100

To reflect the acquisition of the debt security.

End of year

			£	£
Dr	Debt security		10	
	Cr	Other comprehensive income		10

To record the increase in the debt security's fair value in other comprehensive income.

Year 2

Beginning of year

			£	£
Dr	Derivative		-	
	Cr	Cash		-

To record the acquisition of the derivative at its fair value of nil.

End of year

			£	£
Dr	Other comprehensive income		5	
	Cr	Debt security		5

To record the decrease in the debt security's fair value in other comprehensive income.

			£	£
Dr	Derivative		5	
	Cr	Profit or loss		5

To recognise the increase in the derivative's fair value in profit or loss.

			£	£
Dr	Profit or loss		5	
	Cr	Other comprehensive income		5

Applying fair value hedge accounting, to recognise the decrease in the fair value of the debt security due to changes in interest rates since the hedge was designated at the beginning of Year 2.

For Case 1 in Illustration 7-1 above, the £5 credit to the carrying amount of the debt security reflects a change to the usual amortised cost accounting entries. However, for Case 2, the treatment is consistent with the usual accounting for instruments measured at fair value through OCI in accordance with IFRS 9.4.1.2A (see Chapter 46 at section 2.3). In both Cases, the £5 debit to profit or loss is a change to the usual accounting; the entry would not occur at all in Case 1 under amortised cost accounting and would be recognised in OCI rather than profit or loss in Case 2.

It can be seen that the 'benefit' of fair value hedge accounting is that the change in fair value of the hedged item with respect to interest rate risk provides offset in profit or loss for the change in fair value of the hedging instrument. In this simple example the offset is 'complete' as the change in fair value of the hedged item with respect to interest rate risk and the change in fair value of the hedging instrument are equal and opposite, however this will not always be the case. Where offset is not complete, some ineffectiveness will remain in profit or loss (see section 7.4 below).

As illustrated above for Case 1, for hedged items not held at fair value, the adjustment to both the carrying amount of the hedged item and profit or loss would only occur as a result of the application of fair value hedge accounting. However, when hedging the foreign currency risk on a foreign currency monetary item, IAS 21 retranslation gains or losses would be recognised in profit or loss in any event. Accordingly, any incremental adjustment to the carrying amount as part of fair value hedge accounting must not include the retranslation effect again (see section 5.1.2 above).

Where an unrecognised firm commitment is designated as a hedged item in a fair value hedge, the application of fair value hedge accounting requires that the subsequent cumulative change in its fair value attributable to the hedged risk be recognised as an asset or liability with a corresponding gain or loss recognised in profit or loss. Thereafter, the firm commitment would be a recognised asset or liability (albeit that its carrying amount will not represent either its cost or, necessarily, its fair value). The changes in the fair value of the hedging instrument would also be recognised in profit or loss. *[IFRS 9.6.5.8(b)]*.

It can be seen that applying fair value hedge accounting adjustments does not change the accounting for the hedging instrument (unless it hedges an equity instrument for which an entity has elected to present changes in fair value in OCI, or if the time value of an option, forward element of a forward contract or foreign currency basis spreads are excluded from the hedge and accounting for the costs of hedging is applied (see section 7.5 below)). This is true whether the hedging instrument is a derivative or non-derivative instrument. For example, if a foreign currency cash instrument was designated as the hedging instrument in a fair value hedge (see section 3.3.1 above), the foreign currency component of its carrying amount would continue to be measured in accordance with IAS 21.

7.1.2 Dealing with adjustments to the hedged item

In general, adjustments to the hedged asset or liability arising from the application of hedge accounting as described in section 7.1.1 above are dealt with in accordance with the normal accounting treatment for that item. For example, copper inventory might be the hedged item in a fair value hedge of the exposure to changes in the copper price. In this case, the adjusted carrying amount of the copper inventory becomes the cost basis for the purpose of applying the lower of cost and net realisable value test under IAS 2 (see Chapter 23 at section 3). *[IAS 39.F.3.6]*. See also section 8.3.1 below for further discussion on the accounting for discontinuation of fair value hedges.

Where the hedged item is a financial instrument (or component thereof) for which the effective interest method of accounting is used, the adjustment must be amortised to profit or loss. Amortisation may begin as soon as the adjustment exists and must begin no later than when the hedged item ceases to be adjusted for hedging gains and losses. The adjustment must be based on a recalculated effective interest rate at the date amortisation begins. *[IFRS 9.6.5.10]*. The purpose of the amortisation is to reflect the effect of the fair value hedge in the profit and loss, but also to ensure the adjustment is fully amortised by maturity. If the fair value of the hedged component is zero when designated and the hedge relationship remains in place to its maturity, it is likely that no additional amortisation will be required as the cumulative fair value adjustment to the hedged item will naturally revert to zero through ongoing fair value hedge accounting adjustments.

However, in other circumstances, such as when the fair value of the hedged component is not zero on designation and/or if the hedge relationship does not remain in place throughout the life of the hedge relationship, the cumulative fair value adjustment to the hedged item will not naturally revert to zero. This has the effect that a residual amount will remain on maturity of the hedged item unless an adjustment to the effective interest rate amortisation is applied. The purpose of this adjustment to the effective interest rate is to ensure the carrying amount of the hedged item is equal to its redemption amount on maturity.

If the hedged item is measured at fair value through OCI in accordance with IFRS 9.4.1.2A, it is the cumulative gain or loss previously recognised in OCI that is adjusted, not the carrying amount. *[IFRS 9.6.5.10]*.

See Chapter 47 at section 7.5 for details on how the recalculated effective interest rate interacts with the IFRS 9 expected credit loss calculation.

When a hedged item in a fair value hedge is a firm commitment (or component thereof) to acquire an asset or assume a liability, the initial carrying amount of the asset or liability that results from the entity meeting the firm commitment is adjusted to include the cumulative change in the fair value of the hedged item that was recognised in the statement of financial position. *[IFRS 9.6.5.9]*.

Illustration 7-2: Hedge of a firm commitment to acquire equipment

Company X has the euro as its functional currency. It has chosen to treat all hedges of foreign currency risk associated with firm commitments as fair value hedges. In January 20X2 it contracts with a US supplier (with the US dollar as its functional currency) to purchase an item of machinery it intends to use in its business. The machinery will be delivered at the start of July 20X2 and the contracted price, payable on delivery, is US$1,000.

X has no appetite to take on foreign currency exchange risk in relation to euro/US dollar exchange rates and so contracts with a bank to purchase US$1,000 at the start of July in exchange for €900 (the six-month forward exchange rate is US$1:€0.90). In other words, X has effectively fixed the price it will pay for the machinery (in euro terms) at €900.

The fair value of the forward exchange contract at the end of March 20X2 (X's year end) is €30 positive to X, and on delivery is €50 positive to X (the spot exchange rate on delivery is US$1:€0.95). Assuming the hedge is perfectly effective (this might be the case if the hedged risk is identified as the forward exchange rate - see section 7.4.7 below, and it is assumed that no sources of ineffectiveness such as foreign currency basis spreads exist - see section 7.4.8 below) and meets all the requirements for hedge accounting, the journal entries to record this hedging relationship would be as follows:

January 20X2

No entries are required as the firm commitment is unrecognised, the forward exchange contract is recognised but has a zero fair value and no cash is paid or received.

	March 20X2	**€**	**€**
Dr	Forward exchange contract	30	
	Cr Profit or loss		30

To recognise the change in fair value of the forward exchange contract in profit or loss.

		€	**€**
Dr	Profit or loss	30	
	Cr Firm commitment		30

To recognise the change in fair value of the (previously) unrecognised firm commitment in respect of changes in forward exchange rates in profit or loss.

	July 20X2	**€**	**€**
Dr	Forward exchange contract	20	
	Cr Profit or loss		20

To recognise the change in fair value of the forward exchange contract in profit or loss.

		€	**€**
Dr	Profit or loss	20	
	Cr Firm commitment		20

To recognise the change in fair value of the (now recognised) firm commitment in respect of changes in forward exchange rates in profit or loss.

		€	**€**
Dr	Cash	50	
	Cr Forward exchange contract		50

To record the settlement of the forward exchange contract at its fair value. (Only the net cash movement is reflected here, although settlement is likely to be on a gross basis).

		€	**€**
Dr	Machinery	950	
	Cr Cash		950

To record the settlement of the firm commitment at the contracted price of US$1,000 at the spot rate of US$1:€0.95.

			€	€
Dr	Firm commitment		50	
	Cr	Machinery		50

To remove the carrying amount of the firm commitment from the statement of financial position and adjust the initial carrying amount of the machinery that results from the firm commitment.

In summary, the result of these accounting entries is as follows:

			€	€
Dr	Machinery		900	
	Cr	Cash		900

Which is somewhat reassuring given the starting presumption, i.e., that X had effectively fixed the purchase price of its machine at €900.

7.2 Cash flow hedges

7.2.1 Ongoing cash flow hedge accounting

If a cash flow hedge (see section 5.2 above) meets the qualifying conditions set out in section 6 above during the period, it must be accounted for as follows: *[IFRS 9.6.5.11, IAS 1.92, IFRS 18.90]*

Extract from IFRS 9

6.5.11 As long as a cash flow hedge meets the qualifying criteria in paragraph 6.4.1, the hedging relationship shall be accounted for as follows:

(a) the separate component of equity associated with the hedged item (cash flow hedge reserve) is adjusted to the lower of the following (in absolute amounts):

(i) the cumulative gain or loss on the hedging instrument from inception of the hedge; and

(ii) the cumulative change in fair value (present value) of the hedged item (ie the present value of the cumulative change in the hedged expected future cash flows) from inception of the hedge.

(b) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (ie the portion that is offset by the change in the cash flow hedge reserve calculated in accordance with (a)) shall be recognised in other comprehensive income.

(c) any remaining gain or loss on the hedging instrument (or any gain or loss required to balance the change in the cash flow hedge reserve calculated in accordance with (a)) is hedge ineffectiveness that shall be recognised in profit or loss.

(d) the amount that has been accumulated in the cash flow hedge reserve in accordance with (a) shall be accounted for as follows:

(i) if a hedged forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a hedged forecast transaction for a non-financial asset or a non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, the entity shall remove that amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or the liability. This is not a reclassification adjustment (see IAS 1) and hence it does not affect other comprehensive income.

(ii) for cash flow hedges other than those covered by (i), that amount shall be reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment (see IAS 1) in the same period or periods during which the hedged expected future cash flows affect profit or loss (for example, in the periods that interest income or interest expense is recognised or when a forecast sale occurs).

(iii) however, if that amount is a loss and an entity expects that all or a portion of that loss will not be recovered in one or more future periods, it shall immediately reclassify the amount that is not expected to be recovered into profit or loss as a reclassification adjustment (see IAS 1).

[IFRS 9.6.5.11].

No specific guidance is provided on how to perform the recoverability test set out in IFRS 9.6.5.11(d)(iii) above, hence a hierarchy of guidance must be considered in the selection of an appropriate accounting policy, in line with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (see Chapter 3 at section 4.3). *[IAS 8.10]*. Accordingly, consideration is likely to be given to the guidance on the recoverability of assets which is contained in other IFRS accounting standards such as IAS 2 on determining net realisable value of inventory, IAS 36 *Impairment of Assets* on impairment testing of non-financial assets or IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* on onerous contracts. The outcome of applying these different methodologies could differ. Therefore, judgement is required in determining the most appropriate methodology based on the specific facts and circumstances of the hedge relationship. Although the recoverability test is described with respect to amounts that have been accumulated in the cash flow hedge reserve it also appears to be relevant for amounts accumulated in other comprehensive income from transaction related hedges for which the cost of hedging guidance has been applied (see section 7.5.1 below). *[IFRS 9.BC6.399]*.

Unlike fair value hedge accounting (see section 7.1.1 above), the application of cash flow hedge accounting does not amend the accounting for the hedged items, it is the accounting for the hedging instrument that is changed. However, cash flow hedge accounting only changes the accounting for the designated portion of the hedging instrument. For example, if the time value of an option, forward element of a forward contract or foreign currency basis spreads are excluded from the hedge (see section 7.5 below) or a proportion of the instrument is not designated (see section 3.6.1 above), the accounting for those excluded elements remains unchanged by cash flow hedge accounting. However, if the costs of hedging guidance is applied to the excluded time value of an option, forward element of a forward contract or foreign currency basis spreads, the accounting for those excluded portions will also change (see section 7.5 below).

The requirements set out in (a) above are often referred to as the 'lower of' requirements. This accounting treatment is shown in the following Illustrations.

Illustration 7-3: Cash flow hedge of anticipated commodity sale

On 30 September 20X2, Company A hedges the anticipated sale of 24 tonnes of pulp on 1 March 20X3 by entering into a short forward contract. The contract requires net settlement in cash, determined as the difference between the future spot price of 24 tonnes of pulp on a specified commodity exchange and £1m. A expects to sell the pulp in a different, local market.

A designates the forward contract as the hedging instrument in a cash flow hedge of changes in the pulp price on the cash flows from the anticipated sales. A determines that the hedge effectiveness requirements and the other hedge accounting criteria are met (see section 6 above).

On 31 December 20X2, the spot price of pulp has increased both in the local market and on the exchange, although the increase in the local market exceeds the increase on the exchange. As a result, the present value of the expected cash inflow from the sale on the local market is £1.1 million and the fair value of the forward is £85,000 negative. The hedge is still determined to meet the hedge effectiveness criteria. In particular Company A considers the difference in relative value changes in the local and exchange market price of pulp to be fluctuations around an appropriate hedge ratio, rather than an indication that the existing 1:1 hedge ratio is no longer appropriate (see section 6.4.3 above). *[IFRS 9.B6.5.11]*.

The cumulative change in the fair value of the forward contract is £85,000, while the fair value of the cumulative change in expected future cash flows on the hedged item is £100,000. Ineffectiveness is not recognised in the financial statements because the cumulative change in the fair value of the hedged cash flows exceeds the cumulative change in the value of the hedging instrument. The whole of the fair value change in the forward contract would be recognised in other comprehensive income.

	December 20X2	£'000	£'000
Dr	Other comprehensive income	85	
	Cr Forward contract		85

Illustration 7-4: Cash flow hedge of commodity risk component in anticipated foreign currency commodity purchase

On 31 Dec 20X2, Company A, which has the euro as its functional currency, hedges the highly probable anticipated purchase of 50 tonnes of aluminium on 31 March 20X3 by buying 50 tonnes of aluminium futures on the LME. The futures are net settled in cash, determined as the difference between the LME future spot price of 50 tonnes of aluminium and US$1.2m. Although A's aluminium purchase price is determined in US$, A does not wish to eliminate the associated foreign currency risk as it expects to have sufficient US$ funds available from anticipated US$ sales also in March 20X3. Given the market structure in which A purchases the aluminium, A has identified the US$ LME aluminium price as an eligible risk component in the highly probable anticipated purchase of aluminium (see section 2.2.3.B and 2.2.5 above). *[IFRS 9.6.3.7(a)]*.

A designates the futures contract as the hedging instrument in a cash flow hedge of changes in the LME US$ aluminium price risk component of the anticipated purchases. A determines that the hedge effectiveness requirements and the other hedge accounting criteria are met. In fact, as the hedged risk component matches exactly the underlying in the hedging futures, no major sources of ineffectiveness are anticipated. *[IFRS 9.B6.3.11]*.

At the 31 January 20X3, the US$ LME aluminium price has increased compared to the price at 31 December 20X0, and the euro/US$ foreign currency rate is 1:1.07.

As a result, the cumulative change in present value of the expected cash outflow from A's anticipated purchase of aluminium due to changes in the US$ LME price is an increase of US$0.1m. The fair value of the hedging futures contracts is US$0.1m positive. Other changes in A's anticipated purchase price for the 50 tonnes of aluminium are not considered within the hedge relationship, as hedge accounting is restricted to changes in the eligible risk component, in this case the US$ LME aluminium price. *[IFRS 9.B6.3.11]*. Hence the hedge is still determined to meet the hedge effectiveness criteria.

A undertakes the cumulative 'lower of' accounting in the euro, its functional currency, translating both the cumulative change in present value of the expected cash inflow from A's anticipated purchase of aluminium and the cumulative change in fair value of the hedging futures contracts at the prevailing foreign currency rate.

Accordingly, for hedge accounting purposes, both the cumulative change in the fair value of the futures contracts and the present value of the change in expected cash inflow from A's anticipated purchase of aluminium due to changes in the US$ LME price are €0.093m (= US$0.1m / 1.07) therefore the hedge is perfectly effective and no ineffectiveness should be recorded, the whole of the fair value change in the futures contract is recognised in other comprehensive income. *[IFRS 9.6.5.11(a)]*.

	January 20X3	€'000	€'000
Dr	Futures contracts	93	
	Cr Other comprehensive income		93

Illustration 7-5: Cash flow hedge of a floating rate liability

Company A has a floating rate liability of £1 million with five years remaining to maturity. It enters into a five year pay-fixed, receive-floating interest rate swap with the same principal terms to hedge the exposure to variable cash flow payments on the floating rate liability attributable to interest rate risk.

At inception, the swap's fair value is £nil. Subsequently, there is an increase of £49,000 which consists of a change of £50,000 resulting from an increase in market interest rates and a change of minus £1,000 resulting from an increase in the credit risk of the swap counterparty. There is no change in the fair value of the floating rate liability, but the fair value (present value) of the future cash flows needed to offset the exposure to variable interest cash flows on the liability increases by £50,000.

Even if A determines that the hedge of interest rate risk meets the hedge effectiveness requirements (which is quite likely based on the fact pattern), it is not fully effective if part of the change in the fair value of the derivative is due to the counterparty's credit risk (see section 7.4.9 below). The accounting will be to credit the effective portion of the swap's fair value change, £49,000, to other comprehensive income. There is no debit to profit or loss for the change in fair value of the swap attributable to the deterioration in the credit quality of the swap counterparty because the cumulative change in the present value of the future cash flows needed to offset the exposure to variable interest cash flows on the hedged item, £50,000, exceeds the cumulative change in value of the hedging instrument, £49,000.

Alternatively, if the fair value of the swap increased to £51,000 of which £50,000 results from the increase in market interest rates and £1,000 from a decrease in the swap counterparty's credit risk, there would be a credit to profit or loss of £1,000 for the change in the swap's fair value attributable to the improvement in the counterparty's credit quality. This is because the cumulative change in the value of the hedging instrument, £51,000, exceeds the cumulative change in the present value of the future cash flows needed to offset the exposure to variable interest cash flows on the hedged item, £50,000. The difference of £1,000 represents the ineffectiveness attributable to the swap and is recognised in profit or loss. *[IAS 39.F.5.2]*.

The above example illustrates that measurement of hedge ineffectiveness differs for a cash flow hedge when compared to a fair value hedge. In a cash flow hedge, if the fair value of the derivative increases by £10 and the present value of the hedged expected cash flows change by only £8, the £2 difference is recognised in profit or loss (as would be the case for a fair value hedge). However, in a cash flow hedge, if the present value of the hedged expected cash flows changes by £10, but the fair value of the derivative changes by only £8, this £2 of hedge ineffectiveness is not recognised in profit or loss (which would not be the case for a fair value hedge).

Because of this, an entity might consider deliberately under-hedging an exposure in a cash flow hedge. It might do this by targeting an offset of, say, 85% to 90%, however, whilst it still might be possible to demonstrate the existence of an economic relationship for such a designation (see section 6.4.1 above), it is unlikely to meet the hedge ratio requirements (as it seems the hedge ratio was established to avoid recognising ineffectiveness in a cash flow hedge) and so would most likely be precluded (see section 6.4.3 above). *[IFRS 9.B6.4.11(a)]*.

7.2.2 Reclassification of gains and losses recognised in cash flow hedge reserve from OCI to profit or loss

The amount that has been accumulated in the cash flow hedge reserve in accordance with section 7.2.1 above shall be accounted for as follows:

(a) If a hedged forecast transaction subsequently results in the recognition of a non-financial asset or liability, or a hedged forecast transaction for a non-financial asset or liability becomes a firm commitment for which fair value hedge accounting is applied, the entity shall remove that amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or liability. This is often referred to as a 'basis adjustment'. It is not a reclassification adjustment and hence it does not affect the statement of OCI for the period. Rather, it is presented as a separate item in the statement of changes in equity. *[IAS 1.96, IFRS 18.B89]*.

And

(b) For a hedged transaction in a cash flow hedge other than those covered in (a) above, that amount shall be reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment in the same period(s) during which the hedged expected future cash flows affect profit or loss, e.g., in the periods that interest income or interest expense is recognised or when a forecast sale occurs. *[IFRS 9.6.5.11(d), IAS 1.92, IFRS 18.90]*.

The treatments for (a) above are shown in the following Illustration.

Illustration 7-6: Hedge of a firm commitment to acquire equipment

Consider a variation of the situation in Illustration 7-2 in section 7.1.2 above whereby Company X has chosen to treat all hedges of foreign currency risk associated with firm commitments as cash flow hedges, rather than as fair value hedges, as permitted by the standard (see section 5.2.2 above). Otherwise, the underlying facts and assumptions are the same. The accounting entries made at the end of March 20X2 have not been reflected here (as they were in Illustration 7-2) because they are not relevant to the issue being illustrated.

The journal entries to record this hedging relationship would be as follows:

January 20X2

No entries are required as the firm commitment is unrecognised, the forward contract is recognised but has a zero fair value and no cash is paid or received.

	July 20X2		€	€
Dr	Forward contract		50	
	Cr	Other comprehensive income (cash flow hedge reserve)		50

To recognise the change in fair value of the forward contract and, because no ineffectiveness arises, the whole of this change is recognised in other comprehensive income.

			€	€
Dr	Cash		50	
	Cr	Forward contract		50

To record the settlement of the forward contract at its fair value.

			€	€
Dr	Machinery		950	
	Cr	Cash		950

To record the settlement of the firm commitment at the contracted price of US$1,000 at the spot rate of US$1:€0.95.

			€	€
Dr	Other comprehensive income (cash flow hedge reserve)		50	
	Cr	Machinery		50

To remove the gain recognised in other comprehensive income (cash flow hedge reserve) and adjust the carrying amount of the machinery that results from the hedged transaction by this amount. This is not a reclassification adjustment as per IAS 1 *Presentation of Financial Statements*[19] and so does not appear in other comprehensive income for the period but is presented as a separate item in the statement of changes in equity. *[IFRS 9.6.5.11(d)(i), IAS 1.96]*.

In summary, the result of these accounting entries is as follows:

			€	€
Dr	Machinery		900	
	Cr	Cash		900

Which again reflects the starting presumption, i.e., that X had effectively fixed the purchase price of its machine at €900.

In applying treatment (b) above to hedged items that are not forecast transactions that subsequently result in the recognition of a non-financial asset or liability, or a hedged forecast transaction for a non-financial asset or liability becomes a firm commitment for which fair value hedge accounting is applied, an appropriate reclassification method must be applied. When instruments such as conventional interest rate swaps with a zero fair value on designation are used as a hedging instrument in a cash flow hedge, it is common for entities to recognise net interest income or expense on the hedging instrument directly in profit or loss on an accrual basis to meet the requirements of treatment (b) above. Other changes in fair value of the hedging instrument (i.e., the 'clean value' or fair value excluding accrued interest) are recognised in other comprehensive income, subject to the 'lower of' requirements (see section 7.2.1 above). Such an approach avoids the need to reclassify from cash flow hedge reserve to profit or loss the net interest as the hedged item impacts profit or loss. However, care must be taken to ensure the portion of the gain or loss on the hedging instrument that is recognised in the cash flow hedge reserve appropriately excludes ineffectiveness, which must be recognised in profit or loss. The hedging derivative would still be recognised in the statement of financial position at the full fair value.

Although not clearly stated in IFRS 9, it is implied that the reclassification from the cash flow hedge reserve to profit or loss gain or loss is likely to be recognised in the same line item in profit or loss as the hedged transaction, to reflect the offsetting effect of hedge accounting (see Chapter 50 at section 7.1.3). *[IFRS 9.6.5.11(d)]*.

If a hedge of a foreign currency forecast intragroup transaction qualifies for hedge accounting (see section 4.3.2 above), any gain or loss that is recognised in other comprehensive income must be reclassified from cash flow hedge reserve to profit or loss in the same period(s) during which the foreign currency risk of the hedged transaction affects consolidated profit or loss. *[IFRS 9.B6.3.6]*. In order for the consolidated profit or loss to be affected by a foreign currency forecast intragroup transaction, an associated external forecast transaction must also exist. Accordingly, that external transaction also drives the timing of recycling of the effective portion of the hedge relationship.

Guidance is provided on the accounting for the amount that has been accumulated in the cash flow hedge reserve on discontinuation of hedge accounting (see section 8.3.2 below). *[IFRS 9.6.5.12]*.

19 IFRS 18 Presentation and Disclosure in Financial Statements, which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted) was issued by the IASB in April 2024. See Chapter 4 for further details on the new concepts and requirements of IFRS 18.

7.2.3 Recycling for a hedge of foreign currency monetary items

It was stated in section 5.2.3 above that using a forward foreign currency contract to hedge a foreign currency payable or receivable could be treated either as a fair value hedge, or a cash flow hedge. In a fair value hedge, the gain or loss on remeasurement of both the forward contract and the hedged item are recognised immediately in profit or loss. Even if the forward foreign currency risk was the designated hedged risk, then ineffectiveness would arise from changes in the forward points, as the retranslation of the foreign currency payable or receivable is restricted to the IAS 21 spot revaluation (see section 7.1.1 above). *[IFRS 9.B6.2.3]*.

However, in a cash flow hedge of the forward foreign currency risk, the cumulative gain or loss on remeasuring the forward contract is recognised in the cash flow hedge reserve (assuming no sources of ineffectiveness) and reclassified from the cash flow hedge reserve to profit or loss when the payable or receivable affects profit or loss (see section 7.2.2 above). Because the payable or receivable is remeasured continuously in respect of changes in foreign currency rates per IAS 21, there is a requirement for the gain or loss on the forward contract to be reclassified from the cash flow hedge reserve to profit or loss as the payable or receivable is remeasured, not when the payment occurs. There is variation in practice as to the method used to facilitate the reclassification over the period the payable or receivable affects profit or loss (see Illustration 7-18 in section 7.4.7 below).

The forward element of a forward contract can be excluded from a designated fair value or cash flow hedge relationship (designation of the spot exchange risk only - see section 3.6.5 above). In that case any fair value changes attributable to the forward element are recognised in other comprehensive income if accounted for as costs of hedging (see sections 7.4.7 and 7.5.2 below). *[IFRS 9.6.5.16]*.

7.2.4 Cash flow hedges within subsidiaries on acquisition or disposal

Where a reporting entity acquires a subsidiary that is applying cash flow hedge accounting, additional considerations arise. In applying the acquisition method of accounting in its consolidated financial statements, the reporting entity does not inherit the subsidiary's existing cash flow hedge reserve, since this clearly represents cumulative pre-acquisition gains and losses (see Chapter 10 at section 5.4). This has implications for the assessment of hedge effectiveness and the measurement of ineffectiveness because, so far as the group is concerned, it has effectively started a new hedge relationship with a hedging instrument that is likely to have a non-zero fair value (see section 6.3.1 above and section 7.4.3 below). Where a subsidiary is acquired as part of a transaction under common control and the acquisition method of accounting is not applied the situation is different (see Chapter 11 at section 3.3.4).

The standard does not address the situation when it is anticipated that a subsidiary will be disposed of. In November 2016, the IFRS IC discussed the issue of whether a group must discontinue hedge accounting in the consolidated financial statements where the group applies cash flow hedge accounting to forecast transactions that are anticipated in a subsidiary after the expected date of disposal of that subsidiary. The IFRS IC were of the tentative view that the assessment of a qualifying hedging relationship must be performed from the group's perspective based on whether the transaction is highly probable and could affect the group's profit or loss. Given that the forecast transactions are expected to occur only after the expected date of disposal of the subsidiary, these transactions are no longer expected to occur from the group's perspective as soon as the subsidiary is classified as held for sale. According to the IFRS IC's tentative view the forecast transactions would no longer be eligible hedged items and the group would discontinue hedge accounting from the date the subsidiary is classified as held for sale.[20] The IFRS IC suggested that outreach would be helpful to understand if diverse accounting is currently applied in practice and is likely to be an issue to be considered in the Post Implementation Review of the IFRS 9 hedge accounting guidance. If the IFRS IC's view is confirmed, existing accounting policies might need to be changed retrospectively, although this has still not happened at the time of writing.

20 *IFRIC Update*, November 2016, available on the IFRS Foundation's website.

7.3 Accounting for hedges of a net investment in a foreign operation

Hedges of a net investment in a foreign operation (see section 5.3 above), including a hedge of a monetary item that is accounted for as part of the net investment (see section 5.3.2 above and Chapter 16 at section 6.3.1), shall be accounted for similarly to cash flow hedges:

- The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge must be recognised in other comprehensive income and (as clarified by IFRIC 16) included with the foreign exchange differences arising on translation of the results and financial position of the foreign operation. *[IFRIC 16.3]*.

  And

- The ineffective portion shall be recognised in profit or loss. *[IFRS 9.6.5.13]*.

Accordingly, as a result of accounting for hedges of a net investment there is no change to the usual IAS 21 requirement to retranslate the net investment at the closing spot rate (see Chapter 16 at section 6.1). *[IAS 21.39]*. Consequently, as for cash flow hedge accounting, accounting for a net investment hedge only has the potential to change the accounting for the hedging instrument and only to the extent of the effective portion.

The cumulative gain or loss on the hedging instrument relating to the effective portion of the hedge that has been accumulated in the foreign currency translation reserve shall be reclassified from equity to profit or loss as a reclassification adjustment on disposal or, in certain circumstances, partial disposal of the foreign operation in accordance with IAS 21 (see Chapter 16 at section 6.6). *[IFRS 9.6.5.14]*.

The meaning of 'similarly to cash flow hedges' is not immediately clear and has been the subject of some debate. It is readily understood that the portion of the gain or loss on the hedging derivative that is determined to be an effective hedge must be recognised in other comprehensive income (as it would for a cash flow hedge). However, the wording in the standard also seems to indicate that ineffectiveness must be measured in the same way as for cash flow hedges, i.e., no ineffectiveness is recognised in profit or loss if the gain or loss on the hedging instrument is less, in absolute terms, than the gain or loss on the hedged item (see section 7.2.1 above). This is despite the fact that there appears to be no good reason why ineffectiveness is not also recognised in profit or loss if the gain or loss on the hedging instrument is less, in absolute terms, than the gain or loss on the hedged item. This is different to the accounting for net investment hedges under US GAAP,[21] for which it is clear that ineffectiveness must be recognised in profit or loss for under-hedges as well as over-hedges.

In its March 2016 meeting, the IFRS IC discussed this issue. The IFRS IC concluded that the guidance in IFRS 9 is sufficiently clear and would require an entity to apply the lower of test for net investment hedges. One of the arguments put forward was that the application of the lower of test in determining the effective portion of the gains or losses arising from the hedging instrument when accounting for net investment hedges, avoids the recycling of exchange differences arising from the hedged item that have been recognised in other comprehensive income before the disposal of the foreign operation. Such an outcome would be consistent with the requirements of IAS 21.[22]

Whilst the above accounting might appear relatively straight forward at first consideration, a number of additional complexities arise in the accounting for net investment hedges. The complexity is largely driven by the requirement to apply guidance written for a cash flow hedge to a situation where no cash flow arises, and the accounting for net investments in foreign operations within complex groups. These are further considered in the following sections. An overview of the various hedge designation alternatives for net investment hedges is also provided in section 7.3.4 below.

7.3.1 Identifying the effective portion in a net investment hedge

In accounting for a hedge of a net investment, IFRS 9 requires that the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge must be recognised in other comprehensive income. *[IFRS 9.6.5.13]*. IFRIC 16 provides some helpful guidance in calculating the effective portion of the gain or loss on the hedging instrument.

As set out in section 5.3.1 above, IFRIC 16 explains that the hedged risk in a net investment hedge is defined by reference to the functional currency of a parent of the foreign operation that is the subject of the hedge. The cumulative gain or loss on the hedging instrument that is determined to be effective is the

21 ASC 815-35-35-1 through 35-26 (formerly, Statement 133 Implementation Issue H8, *Foreign Currency Hedges: Measuring the Amount of Ineffectiveness in a Net Investment Hedge*).

22 *IFRIC Update*, March 2016, available on the IFRS Foundation's website.

change in value of the hedging instrument in respect of foreign exchange risk, this must also be computed by reference to the functional currency of this parent entity. *[IFRIC 16.15]*.

Depending on where the hedging instrument is held, in the absence of hedge accounting the total change in its value might be recognised in profit or loss, in other comprehensive income, or both (see Illustration 7-8 below). The interpretation states that the calculation of the effective portion is not affected by where the change in value of the hedging instrument would be recognised. In applying hedge accounting, the total effective portion of the change must be included in other comprehensive income. *[IFRIC 16.15]*.

Illustration 7-7: Identification of the effective portion in a net investment hedge (1)

Consider the situation outlined in Illustration 5-3 above (see section 5.3.1 above). In summary. Company P is the ultimate parent entity of a group and presents its consolidated financial statements in its functional currency of the euro. It has two direct wholly owned subsidiaries, Company A whose functional currency is Japanese yen and Company B whose functional currency is sterling. B has a wholly owned subsidiary, Company C, whose functional currency is US dollars. P's net investment in A is ¥400,000 million. P's net investment in B is £500 million including the equivalent of £159 million representing B's net investment in C of US$300 million. Also assume in this example that A has external borrowings of US$300 million and that A's borrowings are designated in a hedge of the €/US$ spot risk associated with P's net investment in C. In the absence of hedge accounting, the total US$/€ foreign exchange difference on A's US$300 million external borrowing would be recognised in P's consolidated financial statements as follows: *[IFRIC 16.AG5]*

- US$/¥ spot foreign exchange rate change, translated to euro, in profit or loss

  And

- ¥/€ spot foreign exchange rate change in other comprehensive income

The fact that gain or loss on the hedging instrument is split between profit or loss and OCI does not affect the calculation of the effective portion in applying paragraph 6.5.13 of IFRS 9.

The cumulative gain or loss on the hedging instrument that is determined to be effective is computed by reference to the functional currency of P, the hedging parent, which is euro. *[IFRIC 16.15]*. Hence, according to the guidance, all of the €/US$ foreign exchange difference on A's US$300 million external borrowing would, after the application of hedge accounting, be recognised in other comprehensive income and be included in the foreign currency translation reserve relating to C.

The guidance says this is because the change in value of both the hedging instrument and the hedged item are computed by reference to the functional currency of P (euro) against the functional currency of C (US dollars). *[IFRIC 16.AG4, IFRIC 16.AG7]*.

IFRIC 16 doesn't include a worked example. We have simplified the illustration by only revaluing the US$ liability at year end and assumed the following spot exchange rates:

	JPY:US$	US$:Euro	JPY:Euro
1/1/20X0	125.0	1.2	150.0
31/12/20X0	108.0	1.3	140.4

Without hedge accounting, the revaluation entries on 31/12/20X0 relating just to the hedging instrument held by A and P's investment in C would be:

			€m	*€m*
Dr	US$ liability		36.32	
	Cr	Profit or loss		36.32

To revalue the US$300m liability in A in profit or loss, translated into euros ((US$300m × 125) - (US$300m × 108) = JPY5,100m) ÷ 140.4). [IAS 21.39(b)].

Dr	OCI		17.09	
	Cr	US$ liability		17.09

To revalue A's US$300m liability from yen to euros, through OCI (US$300 × 125 ÷ 150) - (US$300m × 125 ÷ 140.4) as part of the revaluation of P's opening net investment in A from yen to euros. [IAS 21.39(a)].

Dr	OCI		19.23	
	Cr	Net assets of C		19.23

To revalue P's opening US$300m net investment in C from US$ into euros ((US$300m ÷ 1.2) - (US$300m ÷ 1.3)). [IAS 21.39(a)].

The hedge accounting entries would simply be to reverse the first two profit or loss and OCI entries in order to offset the third:

Dr	Profit or loss		36.32	
	Cr	OCI for yen/euro revaluation		17.09
	Cr	OCI for US$/euro revaluation		19.23

Illustration 7-8: Identification of the effective portion in a net investment hedge (2)

Using the same fact pattern as in Illustration 7-7 above, except, P designated its own US$ denominated borrowings in a hedge of the spot foreign exchange exposure (£/US$) between B and C, only the £/US$ part of the change in the value of the borrowings (the effective portion of the hedging instrument) would be included in P's foreign currency translation reserve relating to C. The remainder of the change (equivalent to the £/€ change on £159 million) would be included in P's consolidated profit or loss. *[IFRIC 16.AG12]*.

The calculation of the effective portion is not affected by whether the hedging instrument is a derivative or a non-derivative instrument or by the method of consolidation. *[IFRIC 16.15]*. Hence whether the direct or step-by-step method of consolidation is applied, the effective portion will be calculated in the same way (see Chapter 16 at sections 6.1.4 and 6.6). It should be noted however that the method of consolidation can result in a potential difference in the accounting outcome on disposal of a foreign operation (see section 8.3.8 below).

7.3.2 Non-derivative liabilities hedging a net investment

A foreign currency denominated non-derivative financial liability, such as a borrowing, can be used as the hedging instrument in a hedge of a net investment in a foreign operation (see section 3.3.1 above). *[IFRIC 16.14]*. This can be seen as purely an 'accounting' hedge, i.e., the retranslation gain or loss on the borrowing (an accounting entry representing a part of its change in fair value that is accounted for on a continuous basis) can offset the retranslation gain or loss on the net investment (another accounting entry). In fact, if the liability is:

- Denominated in the same currency as the functional currency of the hedged net investment
- Held by an entity with the same functional currency as the parent by which the hedged risk is defined
- Has an amortised cost that is lower than the net investment in the foreign operation

  And
- Is designated appropriately

Then the hedge is likely to be perfectly effective in terms of the offsetting retranslation gains and losses on the liability and the hedged proportion of the net investment.

If a borrowing or similar liability is denominated in a different currency to the functional currency of the net investment, it might still be possible to designate it as the hedging instrument. However, it will need to be demonstrated that the two currencies are sufficiently correlated so that the hedging instrument is expected to result in offsetting gains and losses over the period that the hedge is designated, i.e., an economic relationship exists (see section 6.4.1 above). This might be the case if the two currencies are formally pegged or otherwise linked to one another or if the relevant exchange rates move in tandem because of, say, similarities in the underlying economies.

Even if such a hedge meets the hedge effectiveness requirements (see section 6.4 above), it is likely to result in some ineffectiveness. Under US GAAP it is suggested that the retranslation gains and losses on the actual instrument must be compared to those on a hypothetical non-derivative (e.g., a borrowing in the correct currency) with any difference recognised in profit or loss.[23] This approach will normally be acceptable under IFRS 9, if applied in conjunction with the accounting requirements for net investment hedges (see section 7.3 above).

For hedges of foreign currency risk, the foreign currency risk component of a non-derivative financial instrument is determined in accordance with IAS 21. *[IFRS 9.B6.2.3]*. Therefore, when designating a foreign currency denominated non-derivative financial liability as the hedging instrument in a hedge of a net investment, it is only possible to designate the spot foreign exchange risk, and not a forward foreign exchange risk (see section 7.3.4 below). *[IFRIC 16.AG2]*.

23 ASC 815-35-35-1 to 35-26 (formerly, Statement 133 Implementation Issue H8, *Foreign Currency Hedges: Measuring the Amount of Ineffectiveness in a Net Investment Hedge*).

7.3.3 Derivatives hedging a net investment

It is clear that a derivative instrument may be designated as the hedging instrument in a hedge of a net investment. *[IFRIC 16.14]*. What is harder to determine is how various types of derivatives might be designated in a hedge of a net investment in order that the hedge relationship meets the usual hedge accounting criteria, and how the relationship must be accounted for. For example:

- Is it possible to designate the forward foreign currency risk as the hedged risk in a net investment hedge?
- How should the hedged risk in the net investment be represented for ineffectiveness measurement purposes when the hedging instrument is a derivative?
- What is the accounting treatment for any excluded portions of a derivative hedging instrument in a net investment hedge?

These questions will be considered in the remainder of this section.

In the application guidance to IFRIC 16, it is noted that if the hedging instrument is a forward contract, then it is possible to designate a forward foreign currency risk as the hedged risk in a hedge of a net investment (see section 3.6.5 above). *[IFRIC 16.AG2]*. Forward foreign currency risk must therefore be deemed to exist within the net investment. If the forward foreign currency risk is designated for a net investment hedge, then the entire change in fair value of the hedging instrument (including changes in the forward element) must be included in the calculation of the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge. *[IFRS 9.6.5.13]*. This could be achieved by using a hypothetical derivative that is also a forward foreign contract (see sections 7.3.4 and 7.4.4 below).

Like forward contracts, cross-currency interest rate swaps are sometimes used as hedging instruments in net investment hedges. It is often said that fixed-for-fixed cross-currency swaps are essentially a series of forward contracts and so arguably the treatment for forwards is equally applicable to cross-currency swaps. Therefore, it will also be possible for a fixed-for fixed cross-currency swap to be a good representation of the forward foreign currency risk in a net investment hedge (see sections 7.3.3.B and 7.3.4 below).

There is no reason why an option contract, that is not a written option, cannot be designated as the hedging instrument in a hedge of a net investment (see section 3.2.2 above). In fact, such a hedge is included as an example in the IFRS 9 application guidance. *[IFRS 9.B6.5.29(b)]*. However, it will most likely be helpful to designate only the change in intrinsic value of the option as the hedging instrument, as the time value does not exist in the hedged item (see section 7.5.1 below).

It is also possible to designate only the spot foreign currency risk associated with a derivative hedging instrument in a net investment hedge, thereby excluding other elements (e.g., the forward element) from the hedge relationship. *[IFRS 9.6.2.4(b)]*. In that case the hypothetical derivative would be a spot foreign currency contract.

Even when only spot risk is hedged, there is a requirement to consider the time value of money when measuring ineffectiveness (see sections 7.4.2 and 7.4.7 below). However, in the case of a hedge of a net investment, for which there are no cash flows or maturity date with respect to the hedged item, the concept of discounting the spot element back from the date the hedged item is expected to occur has no relevance. A net investment hedge is generally viewed as a hedge of an 'accounting' outcome, i.e., to offset the IAS 21 retranslation gain or loss on the net investment. In that sense the hedged item has already occurred and so the effect of the time value of money is zero (i.e., a discount factor of 1 is appropriate). Hence in the hedge of spot foreign currency risk within a net investment, and only in such a hedge, no discounting of the spot revaluation is required for the purposes of measuring ineffectiveness (see section 7.3.4 below).

Where such portions are excluded, they could be treated as costs of hedging (see section 7.5 below) or, alternatively, the excluded forward element of forwards and/or foreign currency basis spread could remain at fair value through profit or loss. *[IFRS 9.6.5.16]*. There is no choice of treatment for the excluded time value of options, as they must be treated as a cost of hedging. *[IFRS 9.6.5.15]*.

If using a derivative in the hedge of a net investment of a foreign operation, as foreign currency basis spread cannot be assumed to exist in a non-derivative hedged item, ineffectiveness will occur unless the cost of hedging treatment is applied to the foreign currency basis spread (see section 7.4.8 below). This treatment for hedges of a net investment is discussed in more detail in section 7.5.2.A below.

Given the variety of hedging instruments and designation choices available in the hedge of a net investment and also considering the limited specific guidance available within IFRS 9 on this topic, we provide more discussion in the rest of this section, focusing on the different hedging instruments.

Additional application guidance is provided in section 7.3.4 below, illustrating the different designation approaches in the hedge of a net investment and the associated accounting consequences.

7.3.3.A Forward currency contracts hedging a net investment

It is very common for forward currency contracts to be used as the hedging instrument in a hedge of a net investment and, as noted above, it is possible to designate a forward foreign currency risk for such a hedge (see section 7.3.3 above). *[IFRIC 16.AG2]*. In that case, the hedged foreign currency risk in the net investment hedge would ordinarily be represented by a hypothetical forward foreign currency contract.

If on the other hand the spot risk is designated (i.e., the hedged foreign currency risk in the net investment hedge is represented by a hypothetical spot foreign currency exposure), the costs of hedging guidance could be applied to the excluded portion rather than fair value changes in the excluded portion being recognised immediately in profit or loss (see section 7.5 below).

Under either designation, the minimum amount of net investment required to match the hedging instrument would be an amount equal to the foreign currency leg of the forward currency contract (see section 7.3.4 below).

It is clear under IFRS 9 that foreign currency basis spread cannot be assumed to exist in a non-derivative hedged item (including a foreign currency net investment), hence this will be an additional source of ineffectiveness, unless foreign currency basis spread is excluded from the hedging instrument (see sections 7.4.8 and 7.5.3 below). *[IFRS 9.B6.5.5]*.

7.3.3.B Cross-currency interest rate swaps hedging a net investment

Like forward contracts, cross-currency interest rate swap instruments are commonly used as hedging instruments in net investment hedges. However, the general suitability of a cross-currency swap as the hedging instrument in the hedge accounting of a net investment and what the appropriate hypothetical derivative would be for measuring ineffectiveness, depends very much on the type of cross-currency interest rate swap used.

At a conceptual level, it is easy to see that the changes in value of a cross-currency swap with two floating-rate legs are likely to offset the spot retranslation gains and losses of a net investment, provided the floating rate resets sufficiently frequently. Hence such a designation will most probably meet the requirement to demonstrate that an economic relationship exists, although some residual ineffectiveness is likely to occur from fair value changes in the most recently reset floating rate legs of the cross-currency swap and also from foreign currency basis spread (if not excluded from the hedge relationship (see sections 7.3.4, 7.4.8 and 7.5.2.A below)). With the transition from term IBOR rates to the use of daily compounding overnight risk-free rates as part of IBOR reform, ineffectiveness caused by floating legs will be significantly reduced (see the *Supplement: IBOR Reform*).

Although the forward element is not explicitly defined by the standard, it is explained that the difference between the forward rate and the spot rate (i.e., 'the forward element') represents the interest differential between the two currencies at inception (see section 3.6.5 above). *[IFRS 9.BC6.424]*. Accordingly, as the interest differential in a cross-currency swap with two floating-rate legs is not set at inception, it appears that it is not possible to designate the forward foreign currency risk for such a hedging instrument (see section 7.3.4 below).

It is also reasonably easy to see that a swap with one floating-rate leg and one fixed-rate leg could result in levels of ineffectiveness that would contradict the existence of an economic relationship between the hedged item and hedging instrument, which would preclude hedge accounting (see section 6.4.1 above). This is because the fair value of a swap with one floating-rate leg and one fixed-rate leg will change due to factors unrelated to changes in forward exchange rates.

As noted previously (see section 7.3.3 above), a fixed-for-fixed cross-currency swap is often viewed as a combination of a series of forward contracts, (i.e., each interest and principal fixed foreign currency cash flow and associated fixed functional currency cash flow is a forward contract, albeit based on a blended forward rate across the life of the instrument). Accordingly, it would make sense that designation of either the forward foreign currency risk or the spot foreign currency risk is permitted. This is well established in practice and is relatively uncontroversial. However, variation in practice does arise in how the spot and forward elements are identified when using a fixed-for-fixed cross-currency swap in the hedge of a net investment. This variation in practice is partly driven by the fact that IFRS 9 requires that net investment hedges shall be accounted for similarly to cash flow hedges. *[IFRS 9.6.5.13]*. This guidance, which requires the existence of cash flows within hedged items, therefore requires some interpretation when it is applied to hedged items for which no cash flows exist.

One alternative is to designate the fixed-for-fixed cross-currency swap, such that the amount of the hedged item would be equal to the sum of the undiscounted foreign currency interest and principal payments, (i.e., an amount higher than just the notional amount of the swap). This approach is consistent with a cash flow hedge view, since it best matches the cash flows on the swap, but arguably overstates the foreign exchange risk as it is based on undiscounted foreign currency exposures.

Another approach would be to designate the fixed-for-fixed cross-currency swap, such that the amount of the hedged item would equal just the undiscounted foreign currency principal payment (i.e., the notional amount of the swap). This approach is based on the view that the interest payments on the cross-currency swap economically represent the forward interest element within the swap, and so will not form part of the spot element. *[IFRS 9.BC6.416]*.

How we see it

We believe it is acceptable to designate amounts equal to either the sum of a fixed-for-fixed cross-currency swap's undiscounted foreign currency interest and principal payments, or just its notional principal, as the hedged item in a net investment hedge.

Both views are explained further in Illustration 7-9 below.

Illustration 7-9: Hedge of a foreign currency net investment using a cross-currency swap

Entity P, functional currency euro, has a £120m foreign currency net investment in Subsidiary S. S's functional currency is GBP. In order to hedge a proportion of the foreign currency EUR/GBP translation risk associated with P's net investment in S, P has transacted a 2 year fixed-for-fixed cross-currency swap as follows: a foreign currency leg with a notional amount of £100 million, paying 3% annually, and a functional currency leg with €110m notional, receiving 2.5% annually.

P chooses to designate the forward foreign currency risk in £106 million of the net investment (i.e., a proportion of the net investment is hedged by each foreign currency cash flow arising from the cross-currency swap, in this case the £100 million plus the two payments of interest of £3 million). The foreign currency risk for such a designated hedged item could be represented by a fixed-for-fixed cross-currency swap (this would be for both the hypothetical derivative used to measure the effective portion and the aligned hedging derivative if the costs of hedging guidance is applied to the cross-currency basis spread) (see sections 7.3.4, 7.4.4. and 7.5.2 below). If cost of hedging is not applied, then the changes in the fair value of the cross-currency swap due to cross-currency basis spreads would be recognised in profit or loss. *[IFRS 9.B6.5.5]*.

If P were to choose to designate the spot foreign currency risk of the £106 million of net investment, only the undiscounted spot revaluation of the aggregate of the swap foreign currency notional and interest payments would form part of the hedge relationship (see section 3.6.5 above). As no sources of ineffectiveness exist in this fact pattern, other changes in the fair value of the cross-currency swap would form part of the cost of hedging for the forward element and cross-currency basis spreads, if cost of hedging accounting is applied. If cost of hedging is not applied, then the other changes in the fair value of the cross-currency swap would be recognised in profit or loss.

Alternatively, P could choose to designate the fixed-for-fixed cross-currency swap with a foreign currency notional amount of £100 million as a hedge of the forward foreign currency risk in a net investment of only £100 million. In that case, (similar to the designation of £106 million of net investment above) the foreign currency risk for such a designated hedged item could be represented by a fixed-for-fixed cross-currency swap (this would be for both the hypothetical derivative used to measure the effective portion and the aligned hedging derivative if the costs of hedging guidance is applied to the cross-currency basis spreads). If cost of hedging is not applied, then the changes in the fair value of the cross-currency swap due to cross-currency basis spreads would be recognised in profit or loss.

If P were to choose to designate the spot foreign currency risk only of the £100 million net investment, only the undiscounted spot revaluation of the swap foreign currency notional would form part of the hedge relationship. As no sources of ineffectiveness exist in this fact pattern, other changes in the cross-currency swap fair value will form part of the cost of hedging for the forward element and cross-currency basis spreads. If the cost of hedging guidance is not applied, then the other changes in fair value of the cross-currency swap would be recognised in profit or loss.

See section 7.3.4 below for a further illustration of the different designation possibilities.

It can be seen from the above Illustrations that if there are no sources of ineffectiveness, then volatility in profit or loss from fair value changes in the hedging cross-currency swap can be eliminated under all designation alternatives if the cost of hedging guidance is also applied. However, given that volatility in profit or loss from changes in fair value due to cross-currency basis spreads can only be eliminated if the cost of hedging guidance is applied, it might be operationally simpler to hedge only the spot foreign currency risk, and apply the cost of hedging guidance to both the forward element and the cross-currency

basis spreads (see section 7.5.3.A below). This will result in both being amortised to profit or loss on a systematic and rational basis. However, under a forward foreign currency risk designation, the forward element would remain in foreign currency reserve, until the net investment was disposed of (see section 8.3.8 below).

7.3.3.C Purchased options hedging a net investment

It is possible to designate the intrinsic value of a purchased option as the hedging instrument (i.e., its time value is excluded from the hedge relationship) (see section 3.6.4 above). Such a designation would require the costs of hedging treatment to be applied. The costs of hedging accounting would require changes in fair value of the excluded time value to be initially recorded in other comprehensive income to the extent it relates to the hedged item (see section 7.5.1 below).

As discussed in section 3.6.4 above, designating the entire purchased option as the hedging instrument is likely to result in high levels of ineffectiveness and could challenge the existence of an economic relationship (see section 6.4.1 above). This is because no offset will arise for changes in the time value of the purchased option, as the time value is not a component of the hedged net investment. *[IFRS 9.B6.3.12]*.

7.3.4 Overview of alternatives for designation of a net investment hedge

As can be seen from the sections above there are a variety of different ways in which a net investment (NI) hedge can be designated. In order to compare and contrast the different outcomes for net investment hedge accounting, we set out below a high-level summary of some of the more common strategies for a net investment hedge. In the examples below within Figures 7-1, 7-2 and 7-3, for simplicity, we have assumed that there are no sources of ineffectiveness, including from foreign currency basis spreads. However, given that an assumption of no ineffectiveness from foreign currency basis spreads is an unlikely scenario, an indication of the effect of foreign currency basis spread is provided in the footnotes below the tables (also see section 7.4.8 below).

Figure 7-1: Designation of the spot element in a net investment hedge without application of costs of hedging

	Hedging instrument			
	Foreign currency issued debt	**Foreign currency forward contract**	**Floating-floating cross-currency swap**	**Fixed-fixed cross-currency swap**
Risk measure applied in identifying the designated portion of the hedging instrument and NI that is used to determine the effective portion of the hedge (the 'lower of assessment') (see section 7.3 above)	Undiscounted spot for NI and hedging instrument (1)	Undiscounted spot for NI and hedging instrument (1)	Undiscounted spot for NI and hedging instrument (1)	Undiscounted spot for NI and hedging instrument (1)
Hypothetical derivative representing the hedged risk in the NI (see section 7.4.4 below) (2)	Spot contract	Spot contract	Spot contract	Spot contract
Minimum amount of NI required to match the hedging instrument	Foreign currency debt amortised cost	Foreign currency leg of hedging foreign currency forward contract	Foreign currency principal of hedging swap	(a) Aggregate of foreign currency principal plus coupons of hedging swap Or (b) Foreign currency principal of hedging swap (3)

	Hedging instrument			
Accounting for NI **(no change to IAS 21 requirements (see section 7.3 above))**	Undiscounted spot to FX reserve	Undiscounted spot to FX reserve	Undiscounted spot to FX reserve	Undiscounted spot to FX reserve [4]
Accounting for changes in fair value of the hedging instrument	Undiscounted spot to FX reserve [5]	Undiscounted spot to FX reserve Residual changes in FV to P&L	Undiscounted spot to FX reserve Residual changes in FV to P&L	Undiscounted spot on principal and coupons to FX reserve Or Undiscounted spot on principal to FX reserve (a) and (b) residual changes in FV to P&L
Profit or loss profile after hedge accounting [6]	-	Forward element recognised in P&L including some fair value volatility over time [7]	Floating legs recognised in P&L, including some fair value volatility from coupon fixings over time [7]	Interest on fixed legs recognised in P&L, including fair value volatility from fixed legs over time [7] [8]
OCI profile after hedge accounting	-	-	-	- [8]

Figure 7-2: Designation of the forward element in a net investment hedge

	Hedging instrument			
	Foreign currency issued debt	**Foreign currency forward contract**	**Floating-floating cross-currency swap**	**Fixed-fixed cross-currency swap**
Risk measure applied in identifying the designated portion of the hedging instrument and NI that is used to determine the effective portion of hedge (the 'lower of assessment') (see section 7.3 above)	N/A [9]	Forward rate for NI and hedging instrument [10]	N/A [11]	Forward rate for NI and hedging instrument [10]
Hypothetical derivative representing the hedged risk in the NI (see section 7.4.4 below) [2]	N/A	Foreign currency forward contract	N/A	Fixed-fixed cross-currency swap
Minimum amount of NI required to match the hedging instrument	N/A	Foreign currency leg of hedging foreign currency forward contract	N/A	(a) Aggregate of foreign currency principal and coupons of hedging swap Or (b) Foreign currency principal of hedging swap [3]
Accounting for NI **(no change to IAS 21 requirements (see section 7.3 above))**	N/A	Undiscounted spot to FX reserve	N/A	Undiscounted spot to FX reserve [4]
Accounting for changes in fair value of the hedging instrument [15]	N/A	Full change in FV to FX reserve	N/A	Full change in FV to FX reserve
Profit or loss profile after hedge accounting [6]	N/A	- [7]	N/A	- [7]
OCI profile after hedge accounting	N/A	Forward element recognised in OCI, including some fair value volatility in OCI over time.	N/A	Fixed legs recognised in OCI including some fair value volatility in OCI over time. [4]

Figure 7-3: Designation of the spot element and application of costs of hedging for a net investment hedge

	Hedging instrument			
	Foreign currency issued debt	**Foreign currency forward contract**	**Floating-floating cross-currency swap**	**Fixed-fixed cross-currency swap**
Risk measure applied in identifying the designated portion of the hedging instrument and the NI that is used to determine the effective portion of the hedge (the 'lower of assessment') (see section 7.3 above)	N/A (12)	Undiscounted spot for NI and hedging instrument (1)	Undiscounted spot for NI and hedging instrument (1)(13)	Undiscounted spot for NI and hedging instrument (1)
Hypothetical derivative representing the hedged risk in the NI (see section 7.4.4 below) (2)	N/A	Spot contract	Spot contract	Spot contract
Minimum amount of NI required to match the hedging instrument	N/A	Foreign currency leg of foreign currency forward contract	Foreign currency principal of hedging swap	(a) Aggregate of foreign currency principal plus coupons of hedging swap Or (b) Foreign currency principal of hedging swap (3)
Aligned instrument (cost of hedging) (15)	N/A	Foreign currency forward contract	Floating-floating cross-currency swap (13)	Fixed-fixed cross-currency swap
Accounting for NI **(no change to IAS 21 requirements (see section 7.3 above))**	N/A	Undiscounted spot to FX reserve	Undiscounted spot to FX reserve	Undiscounted spot to FX reserve (4)
Accounting for changes in fair value of the hedging instrument (15)	N/A	Undiscounted spot to FX reserve Residual changes in fair value to separate component of equity, amortised to P&L over the life of the foreign currency forward contract (14)	Undiscounted spot to FX reserve Changes in fair value of aligned foreign currency basis to separate component of equity, and amortised to P&L over the life of the hedging swap Any residual fair value changes (e.g., once floating coupons are fixed) is taken to profit or loss (13)	(a) Undiscounted spot on principal and coupons of hedging swap to FX reserve Or (b) Undiscounted spot on principal of hedging swap to FX reserve (a) and (b) residual changes in FV to separate component of equity, and amortised to P&L over the life of the hedging swap (14)

		Hedging instrument		
Profit or loss profile after hedge accounting (14)(6)	N/A	Forward element amortised to P&L over the life of the FX forward	Floating legs recognised in P&L, including some fair value volatility from coupon fixings over time Cross-currency basis spread amortised to P&L over the life of the swap (13)	Fixed legs interest recognised in P&L over the life of the hedge
OCI profile after hedge accounting	N/A	Some volatility over the life of the hedge from forward element, but net nil on maturity of foreign currency forward contract	Some volatility over the life of the hedge from foreign currency basis spreads, but net nil on maturity of hedging swap	Some volatility over the life of the hedge from discounting of fixed legs, but net nil on maturity of hedging swap

(1) In the hedge of spot foreign currency risk within a NI, and only in such a hedge, no discounting of the spot revaluation is required for the purposes of measuring ineffectiveness as the hedged item does not have any cash flows or maturity date to discount back from (see section 7.3.3 above).

(2) Although in most cases the hypothetical derivative will take the same form as the hedging instrument (i.e., debt, foreign currency forward, foreign currency swap etc.) it is clear that the terms of the hypothetical derivative are based on the hedged item (NI in this case). Hence if there is a mismatch between the designated amount of NI and the hedging instrument, then ineffectiveness could arise as the hypothetical and actual hedging instrument will not be the same (see section 7.4.4 below).

(3) As per 7.3.3.B.

(4) The amounts in OCI will not be the same under designation a) and b). This is because the amount of designated NI is different under each designation, and so the amount of offset from the undiscounted spot revaluation of the designated NI will also be different.

(5) Where the hedging instrument is a non-derivative, the foreign currency risk component of a non-derivative financial instrument is determined in accordance with IAS 21 (see section 7.3.2 above).

(6) The above scenarios all assume no sources of ineffectiveness. Where sources of ineffectiveness do arise (e.g., insufficient NI is designated) some additional P&L volatility might arise, subject to the 'lower of assessment'.

(7) Although the above assumes that foreign currency basis does not exist, in reality profit or loss volatility would also arise from changes in fair value in the hedging instrument due to foreign currency basis spreads (unless the costs of hedging treatment is applied) (see sections 7.4.8 and 7.5 below).

(8) The amounts in P&L will not be the same under designation a) and b). This is because under designation a), in addition to the spot revaluation of the foreign currency principal being recognised in OCI, the undiscounted spot revaluation of the foreign currency coupons will also be recognised there rather than P&L. However, this additional spot revaluation will be offset in OCI by the additional amount of NI designated under designation a).

(9) Designation of the forward element is not permitted when hedging with a non-derivative (see section 7.3.2 above). *[IFRS 9.B6.2.3, IFRIC 16.AG2]*.

(10) As the forward element has been designated, the risk management objective must be to hedge the forward foreign currency risk over the life of the hedging instrument - in that case it is appropriate to infer a forward date for the purposes of hedge accounting. *[IFRIC 16.AG2]*.

(11) As the forward element in a floating-floating cross-currency swap has not been locked in, this is not a hedge of a forward rate, hence there is no forward element to designate (see section 7.3.3.B above). *[IFRS 9.6.2.4(b), IFRS 9.BC6.426]*.

(12) There are no eligible cost of hedging within a non-derivative hedging instrument, so designation is not permitted (see section 7.5 below).

(13) As the forward element in a floating-floating cross-currency swap has not been locked in, it is not possible to apply the costs of hedging guidance to a forward element - however the cost of hedging guidance is relevant for foreign currency basis (see sections 7.4.8 and 7.5.2 below).

(14) Although the above assumes that foreign currency basis does not exist, it is possible to apply the costs of hedging guidance to foreign currency basis under this designation, in the same way as for the forward element.

(15) Although when hedging NI it will be common for the aligned instrument to have the same terms as the hedging instrument, if there is insufficient NI and/or the hedging derivative did not have a zero fair value on designation, some differences will arise that could result in additional P&L volatility (see section 7.5.1.A below).

7.3.5 Combinations of derivative and non-derivative instruments hedging a net investment

It is not uncommon for entities to hedge their net investments using synthetic foreign currency debt instruments. For example, consider a parent with the euro as its functional currency that has a net investment in a Japanese subsidiary with yen as its functional currency. The parent might borrow in US dollars and enter into a pay-Japanese yen, receive-US dollar cross-currency interest rate swap. In this way the two instruments might be considered a synthetic Japanese yen borrowing, although they are required to be accounted for separately (see Chapter 42 at section 7).

As noted in section 3.5 above, a combination of derivatives and non-derivatives may be viewed in combination and jointly designated as a hedging instrument. *[IFRS 9.6.2.5]*. However, all the hedging instruments must be clearly identified in the hedge documentation (see section 6.3 above). *[IFRS 9.6.4.1(b)]*.

The European parent in the above fact pattern might wish to designate the spot rate only when hedging a net investment with a combination of derivatives and non-derivatives. Designation of the combination as hedging a forward rate is more problematic as the foreign currency risk component of a non-derivative financial instrument is restricted to the spot rate, in accordance with IAS 21 (see sections 3.3.1 and 7.3.4 above). *[IFRS 9.B6.2.3]*.

Another alternative could be to notionally decompose the cross-currency swap by introducing an interest bearing functional currency denominated leg and designating one part as a hedge of the borrowing and the other as a hedge of the net investment (see section 3.6.2 above).

7.3.6 Individual or separate financial statements

The discussion so far has concentrated on the accounting for a hedge of the foreign currency risk in a foreign operation in the parent's consolidated financial statements. However, all references to consolidated financial statements in the guidance on accounting for net investment hedges apply equally to standalone financial statements in which the net assets of a foreign operation are included. This will include financial statements in which investments in a foreign operation that is a joint venture, an associate or a branch are accounted for using the equity method. *[IFRIC 16.2, IFRIC 16.7]*.

In a parent's individual or separate financial statements there is an accounting policy choice as to how the investment in the foreign operation is accounted for:

- As an asset measured at cost
- As a financial asset in accordance with IFRS 9

  Or
- Using the equity method as described in IAS 28 *Investments in Associates and Joint Ventures* (see Chapter 12 at section 11) *[IAS 27.10]*

So although not explicitly stated in IFRIC 16, it would also be possible to apply the guidance on net investment hedges in standalone financial statements in which investments in subsidiaries are accounted for using the equity method. *[IFRS 9.6.5.2(c), IAS 21.44, IAS 27.10(c)]*.

Where net investment hedges have been designated in a parent's consolidated financial statements there is also the question of whether hedge accounting can be applied in that parent's individual or separate financial statements if the equity method is not applied. This question is only likely to arise where an eligible hedging instrument exists within the parent entity (e.g., the parent entity has foreign currency external borrowings which are designated as the hedging instrument in a net investment hedge in the consolidated financial statements).

In the reporting entity's individual or separate financial statements, if the accounting policy choice is to measure the investment either at cost or in accordance with IFRS 9, it is not accounted for as a net investment in a foreign operation and hence net investment hedge accounting is precluded. *[IFRS 9.6.5.2(c), IAS 21.8]*. This means a borrowing designated as the hedging instrument in a net investment hedge in the consolidated financial statements, could not be similarly designated in a net investment hedge for the purposes of the separate financial statements.

However, if hedge accounting is desirable, it could be possible to designate the borrowing as the hedging instrument in another type of hedge relationship.

How we see it

It would in our view be possible to designate the foreign currency risk in the carrying value of the foreign currency denominated investment in the parent entity's separate financial statements. Typically, this would be a fair value hedge of the foreign currency risk arising from the investment (see section 5.1 above). This will be an independent hedge relationship, separate from the net investment hedge in the consolidated financial statements. Therefore, all of the other hedge accounting criteria (including the documentation requirements) will need to be met for this hedge too. Of course, the effects of this hedge accounting will need to be reversed when preparing the group's consolidated financial statements (otherwise those financial statements will reflect as an asset or liability certain changes in the fair value of a parent's investment in its subsidiary which would be contrary to the general principles of IFRS 10 see Chapter 8).

7.4 Measuring ineffectiveness

7.4.1 General requirements

Hedge ineffectiveness is the extent to which the changes in the fair value or cash flows of the hedging instrument are greater or less than those on the hedged item. *[IFRS 9.B6.4.1]*.

All hedge ineffectiveness is recognised in the profit or loss for fair value hedges (except where the hedged item is an equity instrument measured at fair value through OCI) (see section 7.1.1 above). For cash flow and net investment hedges ineffectiveness is recognised in the profit or loss to the extent that the cumulative change in the fair value or cash flows of the hedging instrument are greater than those on the hedged item (see sections 7.2.1 and 7.3 above). Accordingly, the measurement of ineffectiveness is an important aspect of IFRS 9. *[IFRS 9.6.5.8, IFRS 9.6.5.11, IFRS 9.6.5.13]*.

Although, for many hedge relationships, it will be acceptable to undertake a qualitative assessment as to whether the hedge effectiveness requirements are met (see section 6.4 above) there is still a requirement to measure and record ineffectiveness appropriately within the financial statements. Other differences arise between assessing effectiveness for hedge qualification purposes and measuring ineffectiveness for the purposes of accounting for effective hedges. For example, in the hedge of foreign currency risk in a net investment the accounting for the net investment is restricted to the IAS 21 retranslation at the closing spot rate, but this is not the case in assessing effectiveness (see section 7.3 above).

In determining the ineffectiveness of a hedge relationship, it is important to closely follow the hedge designation. In particular it is necessary to determine the hedged risk, and whether any portions or proportions have been excluded from the hedged item (see sections 2.2 and 2.3 above) and/or the hedging instrument (see section 3.6 above). Hedge ineffectiveness only relates to those elements not excluded from the hedge relationship, and for the hedged item only, with respect to changes in the hedged risk, not the full price risk (see Illustration 7-4 in section 7.2.1 above). *[IFRS 9.B6.3.11, IFRS 9.B6.4.1]*. The initial designation and documentation of a hedge relationship is therefore very important and can in some cases significantly reduce the expected ineffectiveness levels from hedge relationships. However, it should be noted that not all sources of ineffectiveness can be eliminated via clever hedge designation. All sources of ineffectiveness must be documented as part of the hedge documentation. *[IFRS 9.6.4.1(b)]*.

The calculation of ineffectiveness compares the monetary amount of the change in fair value of the hedging instrument with the monetary amount of the change in fair value or cash flows of the hedged item or transactions attributable to the hedged risk, over the assessment period.

This is illustrated by the following simplified example:

Illustration 7-10: Calculation of ineffectiveness

An entity issues fixed rate debt at par of £100, with annual fixed interest of 3%. On the same day, the entity designates an existing interest rate swap in a fair value hedge relationship with the issued debt, for changes in SONIA. The existing swap has a notional of £100, a receive leg of 2.5% annually and a floating leg paying a compounded SONIA rate every 6 months. At the first quarterly reporting period after designation, (i.e., prior to settlement of any coupons on the debt or interest rate swap) the effectiveness would be calculated as follows:

	Hedged item (issued debt)	Hedging instrument (existing swap)
Fair value on initial designation	£100 CR	£4.5 CR
Fair value on first reporting date	£107 CR	£2.4 DR
Change in fair value of the hedging instrument over the assessment period		£6.9 gain
Change in fair value of the hedged item attributable to the hedged risk over the assessment period	£7 loss	

Hedge ineffectiveness is calculated by comparing the £6.9 gain on the hedging instrument with £7 loss on the hedged item over the assessment period.

Whilst it might be relatively obvious how to calculate the change in fair value or cash flows of a hedged item with fixed flows for changes in the hedged risk since designation (typically a fair value hedge) (see section 5.1 above), it is less obvious how this might be achieved where the hedged flows are not fixed, in particular, as hedged items with variable flows do not tend to attract fair value risk. This is discussed in more detail in sections 7.4.4 and 7.4.6 below.

7.4.2 The time value of money

Entities must consider the time value of money when measuring hedge ineffectiveness. This means that an entity must determine the value of the hedged item on a present value basis (thereby including the effect of the time value of money). *[IFRS 9.B6.5.4]*. The inclusion of the words "the changes in the fair value or cash flows" in the definition of ineffectiveness is unhelpful (see section 7.4.1 above), but the need for consideration of the time value of money is clear based on the noted application guidance of IFRS 9. In valuation practice, the effect of the time value of money is also included when measuring the fair value of financial instruments. Consequently, it is logical to apply the same principle to the hedged item as well.

It is possible to designate a spot element of a hedged item if it can be determined to be an eligible risk component (see section 2.2 above). Whilst a spot designation is relatively commonplace for both foreign currency and commodity risk, the need to consider the time value of money for effectiveness purposes for spot designations has been a matter of some debate in the past. The IAS 39 Implementation Guidance contains an example in which an entity designates changes in the spot element only. The example indicates that the time value of money is still relevant for the measurement of ineffectiveness even when the spot element is designated in a hedge relationship. Although the example is based on the IAS 39 Implementation Guidance it is still relevant under IFRS 9 (see section 7.4.7 below). *[IAS 39.F.5.6]*.

How we see it

IFRS 9 requires that the time value of money is considered when measuring ineffectiveness. Accordingly, when measuring ineffectiveness in the hedge of changes in spot risk this too must be undertaken on a present value basis, which means the spot rates used will need to be discounted from the date of the hedged cash flow.

There are a couple of exceptions to the requirement to use discounted spot when measuring ineffectiveness, such that the normal IAS 21 revaluation requirements are applied; in the hedge of foreign currency risk by a non-derivative financial instrument, and in the hedge of a net investment in a foreign operation, whereby the net investment and (if applicable) the non-derivative financial instrument are retranslated at the closing rate (an undiscounted spot rate) (see sections 3.3.1 and 7.3 above).

Illustration 7-11 below simply demonstrates how ineffectiveness can arise when there are differences in the timing of hedged and hedging cash flows, even when only hedging changes in spot risk.

Illustration 7-11: Impact of time value of money when measuring ineffectiveness

A manufacturing company in India, having the Indian Rupee as its functional currency, is expecting forecast sales in USD. The company assesses sales of USD1 million per month for the next twelve months to be highly probable and wishes to hedge the related foreign currency exposure. The company also holds a borrowing of USD20 million with a bullet repayment in fourteen months' time. Instead of entering into foreign currency forward contracts, the company designates the US dollar borrowing as a hedging instrument in hedges of the spot risk of the monthly highly probable US dollar sales.

When measuring hedge ineffectiveness, the revaluation of the forecast sales for foreign currency spot risk would have to be made on a discounted basis (i.e., a present value calculation reflecting the time between the reporting date and the individual future cash flow dates), whereas the revaluation of the hedging instrument would not (as this follows the requirements of IAS 21) (see section 3.3.1 above). *[IFRS 9.B6.2.3]*.

Similarly, if instead of using a US dollar borrowing as the hedging instrument, the entity transacted a forward foreign currency contract to sell USD12 million for Indian Rupee in 12 months' time, ineffectiveness will arise due to the differences in the timing of hedged and hedging cash flows. For the hedged cash flows, the revaluation for foreign currency spot risk would have to be a present value calculation reflecting the time between the reporting date and the individual future monthly cash flow dates. In the same way, to measure hedge effectiveness, the present value of the spot foreign currency revaluation of the hedging instrument would reflect the time value to the ultimate maturity of the forward contract, which is not the same as the timing of the hedged individual monthly forecast cash flows. The treatment of the excluded forward element of the forward contract is discussed further in section 7.5.2 below.

The requirement to calculate ineffectiveness on a present value basis intuitively makes sense in cases where the cash flows of the hedged item and hedging instrument are not aligned. It would seem inappropriate to have no ineffectiveness under a spot designation, for example in the situation described in section 3.3.1 above, where a 7-year financial liability denominated in a foreign currency is used as the hedging instrument for a 12 month forecast sale in that foreign currency. See Illustrations 7-17 and 7-18 in section 7.4.7 below for detailed examples of the accounting for hedge relationships where the foreign currency spot risk is designated.

7.4.3 Hedging using instruments with a non-zero fair value

There is no requirement for hedge accounting to be designated on initial recognition of either the hedged item or the hedging instrument. *[IFRS 9.B6.5.28]*. However, there is often a hidden danger when designating a derivative as a hedging instrument subsequent to its inception. For non-option derivatives, such as forwards or interest rate swaps, any fair value is likely to create 'noise' in measuring hedge ineffectiveness that might not be fully offset by changes in the hedged item, especially in the case of a cash flow hedge. This is because the derivative contains a 'financing' element (the initial fair value), gains and losses on which will not be replicated in the hedged item and therefore the hedge contains an inherent source of ineffectiveness. For example, if applying the hypothetical derivative method for measurement of ineffectiveness (see section 7.4.4 below) this financing element will be evident as the hypothetical derivative will be based on the prevailing market rates on designation, which will result in cash flows that differ from those of the actual now 'off market' derivative.

When hedging with an in the money option contract (i.e., it has positive intrinsic value), a similar issue arises. If applying the hypothetical derivatives method for measurement of ineffectiveness, any existing intrinsic value of the hedging option will not be replicated in the hypothetical derivative as it represents changes in the hedged risk in the period prior to the hedge designation and so is not relevant for the hedge relationship (see section 7.4.4 below).

Consequently, there is likely to be more ineffectiveness recognised and, in extremis, a quantitative assessment could be needed to demonstrate the existence of an economic relationship (see section 6.4.1 above). It depends on the circumstances whether hedge ineffectiveness arising from the financing element (or intrinsic value) on designation could have a magnitude that a qualitative assessment would not adequately capture. *[IFRS 9.B6.4.15]*. Only by coincidence will a derivative that was entered into previously still have a fair value that is zero, or close to zero, on the date of designation which would minimise this problem. In the case of a fair value hedge, it might be possible to designate a risk component that matches a non-option hedging instrument even though it has a non-zero fair value (see section 2.4.1 above).

This situation can not only arise when a derivative is designated or redesignated in a hedging relationship subsequent to its initial recognition, but also in a business combination (see section 6.3.1 above).

This same issue does not arise for hedged items that are designated after initial recognition, however difficulties can occur identifying eligible risk components (see section 2.4.1 above).

7.4.4 Hypothetical derivatives

A method commonly used in practice to calculate ineffectiveness of cash flow hedges (and net investment hedges) is the use of a so-called 'hypothetical derivative'. The method involves establishing a notional derivative that has terms that match the critical terms of the hedged exposure (normally an interest rate swap or forward contract with no unusual terms) and a zero fair value at inception of the hedging relationship. The fair value of the hypothetical derivative is then used as a proxy to measure the change in the value of the hedged item against which changes in value of the actual hedging instrument are compared to calculate ineffectiveness. The use of a hypothetical derivative is one possible way of determining the change in the value of the hedged item when measuring ineffectiveness. *[IFRS 9.B6.5.5]*.

IFRS 9 is clear that a hypothetical derivative has to be a replication of the hedged item and not the 'perfect hedge'. Also, the standard makes clear that any different method for determining the change in the value of the hedged item would have to give the same outcome. Consequently, an entity cannot include features in the hypothetical derivative that only exist in the hedging instrument, but not in the hedged item. *[IFRS 9.B6.5.5]*. Whilst this appears to be a logical requirement, it could have wider implications for cash flow hedges than many would have expected. An entity cannot simply assume no ineffectiveness for a cash flow hedge because the principal terms of the hedging instrument exactly match the principal terms of a hedged item, if there are differences in other features of the hedging instrument and the hedged item. For example, IFRS 13 requires an entity to reflect both the counterparty's credit risk and the entity's own credit risk when determining the fair value of a derivative. The same credit risk cannot be assumed in the hypothetical derivative. This difference in credit risk would result in some ineffectiveness (see sections 7.4.5 and 7.4.9 below).

It is possible to exclude the credit risk in the hedged item from the hedge relationship, for example by designating interest rate risk as the hedged risk (see section 2.2 above). This does not eliminate ineffectiveness from changes in the credit risk of the hedging derivative but prevents additional ineffectiveness from changes in the credit risk of the hedged item. (This assumes that credit risk is not of a magnitude such that it dominates the value changes of the hedged item (see section 6.4.2 above)).

Illustration 7-12 and Illustration 7-13 below provide simple examples of how an entity might establish and apply a hypothetical derivative for the calculation of ineffectiveness in a hedge relationship.

Illustration 7-12: Determination of a hypothetical derivative in a cash flow hedge of interest rate risk

Company X has purchased £200m of variable rate 5-year debt securities. The debt securities yield 1-month SONIA plus 100 basis points with coupons paid monthly. Company X wishes to mitigate cash flow variability from the debt securities by transacting a 5-year interest rate swap with £200m notional, receiving a fixed coupon of 2.0% quarterly and paying an overnight SONIA rate, compounded daily. The swap and the debt securities were acquired on the same day at prevailing market rates and designated in a cash flow hedge relationship for changes in 1-month SONIA, i.e., excluding credit risk from the debt securities.

As the hedged item and the hedging swap reference different indices, there is likely to be a difference between the hypothetical derivative and the actual hedging swap.

The hypothetical derivative representing the hedged risk in the issued debt might be determined as follows:

A 5-year interest rate swap with £200m notional, receiving 1-month SONIA, and paying a 2.02% fixed coupon monthly. The fixed coupon of 2.02% is calculated such that the hypothetical derivative has a zero fair value on the date of designation. The 2bp difference with the variable leg of the actual hedging swap reflects the difference between overnight SONIA compounding daily and 1-month SONIA (see section 7.4.5 below for a discussion on the selection of an appropriate discounting curve for calculation of fair value changes in the hypothetical derivative).

The fact that the actual hedging derivative is referenced to overnight SONIA and cash flows occur quarterly has no impact on the determination of the hypothetical derivative. The hypothetical derivative can only be based on features that arise in the hedged item, which attracts a monthly coupon. The difference between the hypothetical derivative and the hedging derivative is likely to lead to ineffectiveness (see section 7.4.1 above).

Illustration 7-13: Impact on ineffectiveness of changes in credit risk in the hedged item when the hedged risk is a benchmark rate component

Entity A has issued floating rate debt, paying a benchmark floating rate plus a credit spread of 1%. Entity A also transacts a pay fixed, receive benchmark interest rate swap in order to eliminate variability in cash flows from changes in the benchmark rate. The entity designates this swap as a hedge of the benchmark rate component of the issued debt and excludes credit risk on the debt from the hedge relationship. Accordingly, if subsequently Entity A's credit rating changes such that the current credit spread is now 0.95%, this will have no impact on the change in value of the hedged item for the purposes of measuring ineffectiveness, as credit risk in the hedged item has been excluded from the hedge relationship. Conversely, if there is a change in the credit risk with respect to the interest rate swap (either that of the counterparty or the entity itself), resulting in a change in the fair value of the interest rate swap, this would affect the measurement of hedge ineffectiveness. The credit risk associated with the interest rate swap includes both counterparty and own credit risk (see section 7.4.9 below).

When considering the credit risk of the hedged item, any changes must not be of a magnitude that it dominates the value changes in the hedged item such that the hedge effectiveness requirements are no longer met (see section 6.4.2.B above). That is unlikely to be the case for a change in credit spread from 1% to 0.95%.

One other example of when the features of the hedging instrument and the hedged item are likely to differ is when an entity hedges a debt instrument denominated in a foreign currency in a cash flow hedge with a cross-currency swap (irrespective of whether it is fixed-rate or variable-rate debt). IFRS 9 is explicit that when using a hypothetical derivative to calculate ineffectiveness, the hypothetical derivative cannot simply include an imputed charge for exchanging different currencies (i.e., the foreign currency basis spread) even though actual derivatives (for example, cross-currency interest rate swaps) under which different currencies are exchanged might include such a charge. *[IFRS 9.B6.5.5]*. Although cross-currency interest rate swaps are used to highlight the fact that foreign currency basis spreads must not be replicated in hypothetical derivatives, this issue is also likely to arise in other foreign currency contracts settled in the future. To address this, IFRS 9 includes the ability to account for the foreign currency basis spread as a cost of hedging (see section 7.5 below).

In many cases where the critical terms of the hedged item are closely matched by a hedging instrument which had a zero fair value on designation, the hypothetical derivative is likely to have similar terms to the actual hedging derivative - subject to the known differences mentioned above (e.g., foreign currency basis spreads and credit risk).

When hedging a one sided risk (i.e., to designate only changes in the cash flows or fair value of a hedged item above or below a specified price or other variable (see section 2.1 above)) additional considerations apply in determining an appropriate hypothetical derivative. Although the hypothetical derivative must be based on the features that occur in the hedged item, the hypothetical derivative must also reflect that one sided nature of the hedge relationship. *[IFRS 9.B6.5.5]*. This is usually achieved by the hypothetical derivative taking the form of the intrinsic value of a hypothetical option contract, matching the features of the hedged item where possible, but introducing a strike price above or below which the one sided risk arises. However, the time value associated with the hypothetical option contract is excluded from the hedge relationship as it is not a component of the hedged item (see section 7.4.11 below).

For hedges of risks other than one sided risks, the hypothetical derivative is required to have a zero fair value on designation. In the case of hypothetical derivatives for one sided risks, the intrinsic value of the hypothetical option must be zero (see section 3.6.4 above for discussion on acceptable ways to calculate the intrinsic value).

Illustration 7-14 below provides some examples as to how to identify an appropriate hypothetical derivative in the hedge of a one sided risk.

Illustration 7-14: Identifying an appropriate hypothetical derivative in the case of a one sided risk.

Company AA wishes to protect itself against a reduction in the price of Commodity X. It has highly probably forecast sales of 100 tonnes in 6 months time. The current price of 100 tonnes of Commodity X is CU11. Company AA purchases a floor with an underlying of 100 tonnes of Commodity X, for net settlement in 6 months time. Company AA designates the floor as a hedging instrument in a cash flow hedge of a one sided risk of Commodity X.

Set out below are three different scenarios each with a different strike price transacted in the actual hedging instrument.

Scenario 1

Company AA chooses to protect itself against a fall in the price of Commodity X below CU8, and so transacts an out of the money floor with a strike price of CU8, at premium of CU0.5. The floor has zero intrinsic value, the premium reflects time value.

The one sided risk is below CU8 so an appropriate hypothetical derivative would have a strike price of CU8, other terms of the hypothetical derivative must be based on the forecast sales in terms of timing and pricing features.

Scenario 2

Company AA chooses to protect itself against any fall in the price of Commodity X (i.e., below the current price of CU11), and so transacts an at the money floor with a strike price of CU11, at a premium of CU1. The floor has zero intrinsic value, the premium reflects time value.

The one sided risk is below CU11 so an appropriate hypothetical derivative would have a strike price of CU11, other terms of the hypothetical derivative must be based on the forecast sales in terms of timing and pricing features.

Scenario 3

Company AA transacts an in the money floor with a strike price of CU13, paying a premium of CU2.75, made up of intrinsic value of CU2 and time value of CU0.75.

If the floor was designated as the hedging instrument in a cash flow hedge of a one sided risk of Commodity X, the appropriate hypothetical derivative would have a strike price of CU11, i.e., the current market price for Commodity X and the level at which the intrinsic value reaches zero. The fact that the actual derivative is already in the money (i.e., has a positive intrinsic value) is not relevant for the hedged risk. The CU2 of intrinsic value represents changes in the price of Commodity X in the period prior to the hedge designation and so is not relevant for the hedge relationship. This would also be the case if Company AA had identified an existing in the money floor.

In all three scenarios, the time value associated with the hypothetical derivative is excluded from the hedge relationship as it is not a component of the hedged item (see section 7.4.11 below).

The issues in Illustration 7-14 above are also applicable in the determination of the aligned derivative when hedging a one sided risk and applying the cost of hedging (see section 7.5.1.A below).

The hypothetical derivative is first determined at inception of the hedge relationship based on the critical terms of the hedged item and prevailing market rates at that time. However, should any of the critical terms of the hedged item change subsequently, e.g., timing, volume or pricing inputs, then the hypothetical derivative will need to be updated to reflect those changes.

Although the terms of the hypothetical derivative are updated to reflect current expectations of the hedged item, it is still constructed based on market rates at inception of the hedge relationship. This is to ensure the cumulative change in fair value of the hedged item since inception of the hedge relationship is captured for measurement and assessment of effectiveness. *[IFRS 9.6.4.1(c), IFRS 9.6.5.11(a)]*.

Illustration 7-15 below provides an example of a hypothetical derivative being updated due to changes in the hedged item.

Illustration 7-15: Change in expectations with respect to the hedged item

Entity Z, with USD functional currency, as at 1/1/20X2 expects to purchase 10 industrial ovens from a UK supplier. The price of the ovens will be determined in GBP and will be agreed on 30/6/20X2 when the purchase is expected to be confirmed, for delivery and settlement 2 months later. Z considers the purchase of the 10 ovens on 31/8/20X2 to be highly probable.

On 1/1/20X2, the price for each oven is GBP5,000, and historically the GBP price has been very stable. The USD/GBP forward rate on 1/1/20X2 for delivery on 31/8/20X2 is 0.8.

Z wishes to reduce its exposure to changes in cash flow (the purchase price) due to foreign exchange risk and so enters into a foreign currency forward contract to buy GBP50,000 and sell USD62,500 for settlement on 31/8/20X2.

It is assumed that the hedge qualifying criteria are all met (see section 6.1 above), and the foreign currency forward contract is designated in a cash flow hedge of the USD/GBP forward exchange risk in the highly probable purchase of 10 ovens on 31/8/20X2.

As the critical terms of the hedged item and the hedging foreign currency forward contract match, and the forward contract was transacted with a zero fair value, the hypothetical derivative representing the hedged item will have the same terms as the actual hedging foreign currency forward contract. This will not always be the case as demonstrated in Illustration 7-12 above.

The following month it becomes clear that only 8 ovens are required by Entity Z. In addition, the supplier is facing delays in its production line and so will not be able to deliver the ovens until 30/10/20X2.

Given the changes in volume and timing of the hedged item, the hypothetical derivative must be updated accordingly. The hypothetical derivative must be updated to take the form of a foreign exchange forward contract as follows: to buy GBP40,000 and sell USD51,282 for settlement on 30/10/20X2.

The notional of the hypothetical derivative has been reduced to reflect the purchase of 8 rather than 10 ovens. The USD/GBP forward rate of 0.78 applied to the forward contract still reflects market rates on 1/1/20X2 but for the new delivery date of 30/10/20X2.

It can be seen that given the changes in expectations of the hedged item, the hypothetical derivative no longer matches the hedging derivative and so some ineffectiveness is likely to arise. Although prospectively it is likely that Entity Z would undertake a partial dedesignation of the hedging instrument to reflect the GBP10,000 of hedged items that no longer exists (see section 8.3 below).

Illustration 7-16 (see section 7.4.6 below) contains a comprehensive example of the accounting entries for a cash flow hedge of interest rate risk in a forecast debt issuance using a hypothetical derivative for the calculation of ineffectiveness.

7.4.5 Discount rates for calculating the change in value of the hedged item

The standard is clear that entities must consider the time value of money when measuring hedge ineffectiveness. This means that an entity must determine the value of the hedged item on a present value basis (thereby including the effect of the time value of money) (see section 7.4.2 above). *[IFRS 9.B6.5.4]*. Although capturing the effect of the time value of money is a key aspect of the application of hedge accounting, little guidance is provided on how to calculate the time value in the hedged item. By contrast, guidance is given on how to calculate the fair value changes for hedging instruments in various places: in IFRS 13 for those held at fair value through profit or loss (see Chapter 15), and in IAS 21 for non-derivative hedging instruments of foreign currency risk (see section 3.3.1 above).

For example, a key consideration for market participants in calculating the fair value of derivatives is the selection of an appropriate discount rate. Although an interest rate swaps (IRS) might be referenced to one benchmark rate (e.g., 1 month SONIA) the appropriate discount rates for calculating fair value in line with IFRS 13 guidance, might be derived from a different benchmark rate (e.g., OIS for cash collateralised trades) if that is how market participants would calculate the fair value. Overnight index swaps (OIS) are interest rate swaps where the floating leg is linked to a benchmark interest rate for overnight lending. Market participants typically use OIS rates as a discount curve for cash collateralised IRS as they reflect the credit risk of such an instrument.

The way in which the time value of a hedged item is captured can have a significant impact on the measurement of ineffectiveness. This is illustrated in the following two examples.

Consider firstly the example of a fair value hedge of a fixed rate bond for changes in an eligible benchmark interest rate risk component (see section 2.2.3.A above). It is clear that in order to capture the change in value of the hedged fixed cash flows attributable to changes in the benchmark interest rate, the discounting curve would have to be based on the designated benchmark interest rate. For a fair value hedge of a specified interest rate, to choose any other discounting curve would reflect a risk other than the designated hedged risk. For such hedges, in order to reflect the hedged risk, that choice of hedged risk predetermines the discounting rate to be applied to the hedged item. Hence for a fair value hedge, unless the benchmark rate designated as the hedged risk is the same as the discounting curve applied to the hedging instrument, ineffectiveness will arise. This is the case even if the hedged fixed cash flows match exactly the fixed cash flows of the hedging instrument.

Now contrast this with the example of a benchmark interest rate (e.g., SONIA) floating rate debt, swapped into a fixed rate of interest using a receive-benchmark rate, pay-fixed interest rate swap, designated in a cash flow hedge for changes in the benchmark interest rate. For the purposes of calculating the change in the value of the hedged item due to the hedged risk, the entity could use a hypothetical derivative (see section 7.4.4 above). When measuring the fair value of the actual and hypothetical interest rate swaps, the entity would start by using the specified benchmark rate forward curve to forecast the future floating cash flows. However, potentially the discount rate applied to those future cash flows might not be the same as that used for forecasting. In the case of a collateralised swap (for which the relevant discount rate is likely to be an overnight rate (e.g., OIS), unless the value of the hypothetical derivative is also calculated using an OIS discounting curve, even though the future cash flows might be the same, changes in value of the hypothetical derivative and the fair value of the actual swap will not be same - resulting in ineffectiveness.

How we see it

For those hedge relationships where the discounting curve is not predetermined by the hedged risk (e.g., a cash flow hedge of a benchmark interest rate, in contrast to a fair value hedge of a benchmark interest rate for which the discount rate must reflect the hedged benchmark rate) the standard is not prescriptive, and practice has evolved such that there appears to be an element of choice as to which benchmark interest rate is used as the basis for discounting in the calculation of changes in value of the hypothetical derivative used to reflect the hedged risk in a cash flow hedge.

We believe this choice is limited to a benchmark interest rate. For example, it is not permissible to use a discount rate that would reflect the ongoing specific credit risk inherent in the hedging instrument, as this would reflect a feature of the hedging instrument rather than the hedged item (see section 7.4.4 above). Put differently, although it might be possible to choose the discounting benchmark rate for the hedged item to be that which is used for discounting purposes for the actual derivative, no such choice exists to reflect elements of the valuation of the actual derivative such as the credit valuation adjustment (CVA) in determining value changes in the hedged item (see Chapter 15 at section 10.3.2). Hence changes in the specific credit risk inherent in the hedging instrument will still result in ineffectiveness. However, if the hedging derivative is collateralised, the use of an OIS curve for discounting the hedged item could result in very little ineffectiveness.

Similarly, the ability to choose a benchmark rate curve for discounting purposes when calculating a change in value of the hedged item, does not permit the inclusion of cross-currency spreads within such a curve - unless for a hedge of foreign currency risk and the cross-currency basis occurs in the hedged item (see section 7.4.4 above).

Any choice of discounting benchmark rate must be documented at the inception of the hedge relationship (see section 6.3 above).

As a result of the reforms mandated by the Financial Stability Board following the financial crisis, IBOR (including LIBOR) is being replaced by new 'official' benchmark rates, known as RFRs. IBOR Reform is ongoing, since whilst many IBORs have now transitioned to RFRs, some are temporarily continuing in synthetic form and some are still to transition. Such a change will necessarily affect both forecasting and discounting curves used to value financial instruments and could reduce the instances where there is a difference between discounting curves for the valuation of hedging derivatives and hedged items. However, this change in benchmark rates raises a number of accounting issues, including some related to hedge accounting. The IASB has published two amendments to IFRS 9 and other standards to address these issues: in September 2019, *Interest Rate Benchmark Reform, Amendments to* IFRS 9, IAS 39 *and* IFRS 7, and in August 2020 *Interest Rate Benchmark Reform Phase 2, Amendments to* IFRS 9, IAS 39, IFRS 7, IFRS 4 *Insurance Contracts and* IFRS 16 (see the *Supplement: IBOR Reform*).

7.4.6 Comprehensive example of calculation of measuring ineffectiveness for a cash flow hedge of a forecast transaction in a debt instrument

Illustration 7-16 below contains a comprehensive example of the calculation of ineffectiveness and associated accounting entries for a cash flow hedge of a forecast debt issuance. A hypothetical derivative is used to measure the present value of the cumulative change in the hedged expected cash flows from inception of the hedge in order to measure effectiveness (see section 7.4.4 above). *[IFRS 9.6.5.11(a)(ii)]*. Using a hypothetical derivative is one possible way of calculating the change in the value of the hedged item and is probably the most frequently used for cash flow hedges. *[IFRS 9.B6.5.5]*.

Illustration 7-16: Measuring ineffectiveness and associated accounting entries for a cash flow hedge of a forecast debt issuance

A forecast issuance of debt (or other interest-bearing liability or asset) for which the interest rate will be set when it is issued, creates a cash flow exposure to interest rate changes because the related interest payments will be based on the benchmark interest rate that exists when the forecast debt issuance occurs. In order to eliminate that cash flow variability with respect to market interest rates, it is common for entities to transact a forward starting interest rate swap in order to economically lock in the benchmark interest rate for the forecast debt issuance.

The forward starting interest rate swap could be designated as the hedging instrument in a cash flow hedge of benchmark interest rate risk from the forecast debt issuance. In order to be eligible for hedge accounting the forecast debt issuance must be highly probable of occurring (see section 2.6.1 above).

Fact Pattern

The date is 1/1/X0 and it is highly probable that Company X will issue a €100,000 one-year debt instrument in six months on 30/6/X0. The instrument will pay fixed interest quarterly with principal due at maturity on 30/6/X1.

X is exposed to interest rate increases and establishes a hedge of the interest cash flows of the forecast debt issue by entering into a forward starting interest rate swap. The swap has a term of one year and will start in six months time on 30/6/X0 to correspond with the terms of the forecast debt issue. X will pay a fixed rate and receive a variable rate on the interest rate swap. X designates the forward starting interest rate swap as the hedging instrument in a cash flow hedge of the benchmark interest rate risk component (e.g., 3M EURIBOR) within the forecast debt issue. When the forecast debt is issued, the interest rate swap is closed out and settled in cash.

The qualifying criteria for hedge accounting are all assumed to have been met (see section 6 above). X chooses to use the hypothetical derivative method in order to calculate ineffectiveness (see section 7.4.4 above).

As only the benchmark interest rate risk component has been designated, any other factors such as X's credit risk, are excluded from the hedge relationship, unless changes in such factors result in the debt being issued at a sub-benchmark rate (see section 2.4 above). For the purposes of this illustration, it is assumed that the debt is not issued at a sub-benchmark rate.

Set out below are the benchmark zero-coupon and forward rates required in order to establish the hypothetical derivative and to undertake the measurement of ineffectiveness and associated accounting entries.

Market data date	Annual benchmark interest rates	31/3/X0	30/6/XO	30/9/XO	31/12/X0	31/3/X1	30/6/X1
1/1/X0	Zero coupon rates	2.00%	2.25%	2.75%	3.50%	4.00%	4.25%
	Forward rates	2.00%	2.50%	3.76%	5.78%	6.02%	5.51%
31/3/X0	Zero coupon rates		3.00%	3.25%	3.75%	4.00%	4.25%
	Forward rates		3.00%	3.50%	4.76%	4.75%	5.26%
30/6/X0	Zero coupon rates			4.25%	5.00%	5.50%	5.75%
	Forward rates			4.25%	5.76%	6.51%	6.50%

Explanation of benchmark rates

The zero-coupon rates represent the interest rates that would be earned for principal amounts invested at inception in zero-coupon instruments without credit risk i.e., instruments where all interest is compounded and settled at maturity. For example, based on data as of 31/3/X0, a zero-coupon debt instrument issued on 31/3/X0 and having a maturity of 6 months (30/09/X0) will pay a zero-coupon interest rate of 3.25%.

The interest rates are expressed as annual rates, by convention. Please also note that the rates used in this example correspond to compounded rates (as opposed to nominal rates). As a consequence, in the above example, based on data as of 31/3/X0, the coupon paid for a principal amount invested at 31/3/X0 in a zero-coupon debt instrument with a maturity of 6 months will be equal to (1+3.25%)^(6/12)-1 = 1.61%. 1.61% is the *period*-zero coupon rate (as opposed to annual rate) corresponding to the *annual*-zero coupon rate of 3.25% for a period of 6 months The de-compounding to derive a 6 month coupon rate was achieved by the ^(6/12) element of the calculation.

Zero coupon rates are used to determine appropriate discount rates. Using again the benchmark data provided above, on 31/3/X0 the appropriate discount rate for a cash flow occurring on 30/9/X0 (i.e., 6 months later) would be 1.61%, as calculated above. Hence a cash flow of €100 occurring on 30/9/X0 would have a present value on 31/03/X0 of €100/ (1+1.61%) = €98.4.

The forward rates for each period are sometimes called forward forward rates beyond the first period. They represent the annualised market rate of interest that would accrue and be paid at the end of a single period assuming investment at the beginning of the forward-starting period. They are also expressed as annual rates in this example.

Forward rates can be derived from the zero coupon rates. For example, the 3 month forward rate starting on 31/3/X0 (i.e., in 3 months' time) is (((1+2.25%)^(6/12)) / ((1+2.00%)^(3/12)))^(12/3)-1 = 2.50%, based on current market data (as at 1/1/X0). The formulae is based on the premise that it is financially equivalent to invest €100 at inception (1/1/X0) for a period of 6 months (applying the 6 month zero coupon rate) and to invest €100 at inception (1/1/X0) for a period of 3 months (zero coupon and forward rate are equal for this period) and reinvest principal plus interests for another period of 3 months (at the forward rate for this 3 month period).

Forward rates are used to determine expected future cash flows. For example, the forward rate used to determine the expected cash flows of a future 3-month floating rate bond would be as follows:

A 3 month floating rate bond is expected to be issued on 30/6/X0, the expectation on 1/1/X0 would be that interest payable on maturity at 30/9/X0 would be €100,000 x ((1+3.76%)^(3/12)-1) = €926. 3.76% is the 3 month forward rate of interest starting on 30/6/X0 (in 6 months time), but quoted on an annual basis, so there is a need to convert it into a discreet 3 month basis rate by de-compounding, which is achieved by the ^(3/12) element of the previous calculation.

Calculation of the fixed rate of a debt instrument, based on market rates

When a fixed interest rate debt instrument with payment of quarterly coupons is expected to be issued at a future date, its expected fixed rate can be calculated based on zero coupon rates. This fixed interest rate would be equal to the fixed interest of an interest rate swap (IRS) exchanging it against floating interest rates, where the floating interest rates would be based on the forward interest rates corresponding to each period - this fixed rate is commonly referred to as the "swap rate".

In practice, this implied or expected fixed rate is calculated by solving for the fixed rate of interest that is required to bring the fair value of the swap to zero, or the fair value of the fixed rate debt to par using the zero coupon rates for discounting purposes. This is an iterative approach, often referred to as bootstrapping, and is too complex to demonstrate here. For an interest rate swap or a fixed rate debt with interest settling every 3 months with a forward starting date on 30/6/X0, the implied fixed rate would be calculated so that the fair value of the swap was zero, and the fair value of the fixed rate debt was par at 30/6/X0, but based on current market data (as at 1/1/X0).

In this example, using the above current market data (1/1/X0), and applying bootstrapping, the quarterly settled implied annual fixed rate on a 1-year fixed rate debt expected to be issued on 30/6/X0 would be 5.155%. This is quoted as an annual nominal rate, with the rate attributable to each quarterly settlement being calculated as 5.155%*3/12 = 1.289%. The fixed rate of an IRS with a forward starting date as of 30/06/X0, a maturity of 1 year and quarterly payments, would be the same.

The intention of Company X is to lock in the expected fixed rate of its future issuance at this implied fixed rate of 5.155% by settling the forward starting swap with this fixed interest rate.

Hypothetical derivative

The first step in measuring ineffectiveness using a hypothetical derivative is to determine its terms, i.e., establish a notional derivative that has terms that match the critical terms of the hedged exposure and a zero fair value at inception of the hedging relationship (see section 7.4.4 above). An interest rate swap with a notional of €100,000 starting in 6 months time with a maturity of 1 year paying a fixed rate

(quarterly) based on market data at 1/1/X0, receiving a benchmark swap rate would be an appropriate hypothetical derivative in this case.

The hedge is designated on the same day that the swap is transacted and, in this fact pattern, as no other sources of ineffectiveness exist, the hypothetical derivative also attracts the same fixed rate as the hedging swap of 5.155%. This will not always be the case, as an entity cannot include features in the hypothetical derivative that only exist in the hedging instrument, but not in the hedged item (see section 7.4.4 above).

The fair value of the hypothetical derivative can then be used as a proxy to measure the change in the present value of the hedged item against which changes in value of the actual hedging instrument are compared in order to calculate ineffectiveness.

Terms of the hypothetical derivative at 1/1/X0

	1/1/X0	31/3/X0	30/6/X0	30/9/X0	31/12/X0	31/3/X1	30/6/X1
Interest cash flows on the hypothetical derivative:	**€**	**€**	**€**	**€**	**€**	**€**	**€**
Fixed interest at 5.155%				(1,289)	(1,289)	(1,289)	(1,289)
Forecast floating interest[(1)]				926	1,415	1,473	1,350
Net interest cash flow				(363)	126	184	61
Present value of net cash flows at 1/1/X0 [(2)]				(355)	122	176	57
Total Present value at 1/1/X0	nil						

(1) Forecast floating interest is determined with respect to the forward rate for the quarterly period, in which case the annual rates need to be converted. For example, forecast floating rate coupon payable at 31/12/X0 = €100,000*((1+5.78%)^(3/12)-1) = €1,415

(2) Present value of net cash flows is calculated by discounting back to 1/1/X0 at the zero coupon rate for the period. For example, the present value of the net interest cash flow expected at 31/03/X1 is calculated as follows: €184*1/((1+4.00%)^(15/12)) = €176.

(3) Only the interest cashflows from the hypothetical derivative are considered above for the purposes of calculating the present value. This is because the theoretical cash flows described as principal in the fixed and floating legs offset exactly, and do not contribute to the present value of the derivative.

For the purposes of this illustration, we have assumed that there are no sources of ineffectiveness, such that changes in the present value of the hypothetical derivative will match exactly fair value changes in the hedging swap. Therefore, we have not set out the cash flows and fair values of the hedging swap, as they are the same as that of the hypothetical derivative in this case.

Measuring hedge effectiveness and accounting at 1/1/X0

No accounting entries are required at 1/1/X0, the hedged item is still only a forecast transaction, and the hedging swap was transacted for zero consideration, equal to its fair value.

Measuring hedge effectiveness and accounting at 31/3/X0

	31/3/X0	30/6/X0	30/9/X0	31/12/X0	31/3/X1	30/6/X1
Interest cash flows on the hypothetical derivative:	**€**	**€**	**€**	**€**	**€**	**€**
Fixed interest at 5.155%			(1,289)	(1,289)	(1,289)	(1,289)
Forecast floating interest [(1)]			864	1,169	1,168	1,289
Net interest cash flow			(425)	(120)	(121)	0
Present value of net cash flows at 31/3/X0			(418)	(117)	(116)	0
Total Present value at 31/3/X0	(651)					

(1)	Forecast floating interest is determined with respect to the forward rate for the quarterly period, in which case the annual rate needs to be converted. For example, forecast floating rate coupon payable at 30/6/X1 = €100,000*((1+5.26%)^(3/12)-1) = €1,289
(2)	Present value of net cash flows is calculated by discounting back to 31/3/X0 at the zero coupon rate for the period. For example, the present value of the net interest cash flow expected at 31/03/X1 is calculated as follows: (€121)/(1+4.00%) = (€116).

The accounting entries at 31/3/X0 are as follows:

			€	€
Dr	Cash flow hedge reserve		651	
	Cr	Derivative fair value		651

To record the change in the hedging swap fair value. As the cumulative change in fair value of the hedging swap exactly matches the cumulative change in present value of the hedged item (i.e., the hypothetical derivative), the full change in fair value of the hedging swap is taken to the cash flow hedge reserve within Other Comprehensive Income (OCI). (This will not always be true, in which case the 'lower of' assessment must be made to determine the effective portion to be taken to OCI (see section 7.2 above)).

No other accounting entries are required as no cash flows have yet arisen on the hedging swap or the forecast debt issuance.

Measuring hedge effectiveness and accounting at 30/6/X0

The forecast fixed rate debt is issued at a rate of 5.617%. This is based on the prevailing zero coupon rates (as provided in table of benchmark rates above) converted into the benchmark 1-year quarterly swap rate applying a bootstrapping methodology, (as mentioned above). Accordingly, the debt is issued at its par value of €100,000[24].

			30/6/X0	30/9/X0	31/12/X0	31/3/X1	30/6/X1
Interest cash flows on the hypothetical derivative:			**€**	**€**	**€**	**€**	**€**
Fixed interest at 5.155%				(1,289)	(1,289)	(1,289)	(1,289)
Forecast floating interest(1)				1,046	1,409	1,589	1,588
Net interest cash flow				(243)	120	300	299
Present value of net cash flows at 30/6/X0(2)				(240)	117	288	283
Total Present value at 30/6/X0			448				

(1)	Forecast floating interest is determined with respect to the forward rate for the quarterly period based on 30/6/X0 market data. For example, forecast floating rate coupon payable at 31/12/X0 = €100,000*((1+5.76%)^(3/12)-1) = €1,409.
(2)	Present values of net cash flows are calculated by discounting back to 30/6/X0 at the zero coupon rate for the period. For example, the present value of the net interest cash flow expected at 31/3/X1 is calculated as follows: €300*1/((1+5.50%)^(9/12)) = €288.

As the fixed rate debt has now been issued and there is no more variability in cash flows due to the benchmark interest rate risk, Company X closes out the hedging swap for its fair value at 30/6/X0 of €448. This results in the discontinuation of the hedge relationship prospectively as the hedging instrument no longer exists (see section 8.3 below).

24 Present value at 30/6/X0 of the 5.617% 1 year fixed rated debt, with quarterly coupons of 1.404% (i.e. annualised swap rate of 5.617%/4 = a quarterly coupon rate of 1.404%) is: €100,000 = €100,000*((1.404%/(1+4.25%)^(3/12)) + (1.404%/(1+5.0%)^6/12)) + (1.404%/(1+5.5%)^(9/12)) + ((1+1.404%)/(1+5.75%)^(12/12)))

The accounting entries at 30/6/X0 are as follows:

			€	€
Dr	Cash		100,000	
	Cr	Debt issuance		100,000

To record the cash proceeds raised from issuing at par €100,000 of 5.617% fixed rate debt paying a quarterly coupon.

			€	€
Dr	Derivative fair value		1,099	
	Cr	Cash flow hedge reserve		1,099

To record the change in the hedging swap fair value, an increase of €1,099 in the period. As the cumulative change in fair value of the hedging swap of €448 (i.e., = (€651) + €1,099) exactly matches the cumulative change in present value of the hedged item (i.e., the hypothetical derivative), the full change in fair value of the hedging swap is taken to the cash flow hedge reserve within Other Comprehensive Income (OCI). (This will not always be true, in which case the 'lower of' assessment must be made to determine the effective portion to be taken to OCI (see section 7.2 above)).

Dr	Cash		448	
	Cr	Derivative fair value		448

To record the full settlement of the hedging swap.

A summary of the cumulative accounting entries at 30/6/X0 is shown below:

DR/(CR)	Cash	Hedging Swap	Cash flow hedge reserve	Debt issuance	Interest expense
	€	€	€	€	€
31/3/X0					
Change in fair value of hedging swap		(651)	651		
30/6/X0					
Debt issuance	100,000			(100,000)	
Change in fair value of hedging swap		1,099	(1,099)		
Settlement of hedging swap	448	(448)			
Total	**100,448**	**-**	**(448)**	**(100,000)**	

Accounting entries at 30/9/X0

Now that the fixed rate debt has been issued, there is no more variability in the cash flows with respect to interest rate risk and the hedge relationship has been discontinued prospectively. The debt issued is accounted for at amortised cost, with an effective yield of 5.617% (with a linear calculation). Further, as the swap has been closed out, no further fair value changes will occur. Consequently, benchmark market data is not required for the accounting entries in the remaining periods.

The accounting entries at 30/9/X0 are as follows:

			€	€
Dr	Interest expense		1,404	
	Cr	Cash		1,404

To record the cash payment on the quarterly coupon payment (5.617%) on the debt issuance.

			€	€
Dr	Cash flow hedge reserve		112	
	Cr	Interest expense		112

To record the reclassification of the effective portion of the hedging swap's fair value change out of the cash flow hedge reserve to interest expense over the same periods that the hedged cash flows impact

profit or loss (see section 7.2 above). [IFRS 9.6.5.11(d)(ii)]. The reclassification has been calculated on a straight line basis over the four periods the debt is expected to impact profit or loss €112 = €448/4, although the standard does not specify a method.

The use of a revised effective interest rate would also be an acceptable method to reclassify the effective portion from the cash flow hedge reserve into profit or loss.

For cash flows hedges of floating rate debt for which the hedging derivative remains in place once the debt is issued, the effective portion of the hedging swap will continue to be remeasured. In that case the reclassification of that effective portion can in some cases be achieved by recognising changes in the clean fair value of the hedging derivative in the cash flow hedge reserve and the net interest payable/receivable recognised in interest expense (see section 7.2.2 above).

The accounting entries for 31/12/X0 and 31/3/X1 are exactly the same as those for 30/9/X0 and so are not repeated again here.

Accounting entries at 30/6/X1

			€	**€**
Dr	Interest expense		1,404	
	Cr	Cash		1,404

To record the cash payment on the quarterly coupon payment (5.617%) on the debt issuance.

			€	**€**
Dr	Cash flow hedge reserve		112	
	Cr	Interest expense		112

To record the reclassification of the effective portion of the hedging swap's fair value change *out of the cash flow hedge reserve to interest expense over the same periods that the hedged cash flows impact profit or loss (see section 7.2 above). [IFRS 9.6.5.11(d)(ii)].*

			€	**€**
Dr	Debt issuance		100,000	
	Cr	Cash		100,000

To record the repayment of the €100,000 fixed rate debt.

A summary of the cumulative accounting entries at 30/6/X1 is shown below:

DR/(CR)	Cash	Hedging Swap	Cash flow hedge reserve	Debt issuance	Interest expense
	€	**€**	**€**	**€**	**€**
B/F balances from 30/6/X0	100,448	-	(448)	(100,000)	
30/9/X0					
Interest coupon paid	(1,404)				1,404
Reclassification from OCI			112		(112)
31/12/X0					
Interest coupon paid	(1,404)				1,404
Reclassification from OCI			112		(112)
31/3/X1					
Interest coupon paid	(1,404)				1,404
Reclassification from OCI			112		(112)
30/6/X1					
Interest coupon paid	(1,404)				1,404

DR/(CR)	Cash	Hedging Swap	Cash flow hedge reserve	Debt issuance	Interest expense
Reclassification from OCI			112		(112)
Debt issuance repaid	(100,000)			100,000	
Total	**5,168**	**-**	**-**	**-**	**(5,168)**

It can be seen that after the effects of cash flow hedge accounting, total interest expense paid was €5,168, rather than the actual €5,617 interest expense paid on the debt issuance at 5.617%, reflecting the lower interest rate locked in on 1/1/X0. It is also important to note that there is nothing left in the cash flow hedge reserve when the hedged cash flows have all occurred and will no longer impact profit or loss. One other thing to note is that the 5.168% yield achieved following hedge accounting is not the same as the fixed leg of the hedging swap of 5.155%. The difference arises mainly from the effect of discounting on the future cash flows of the hedging swap on 30/6/X0 which is never unwound as the swap is closed out on that date once the debt is issued.[25]

7.4.7 Worked examples of spot rate and forward rate designations, plus the application of the costs of hedging accounting

It was explained in section 3.6.5 above that the spot and forward elements of a forward contract can be treated separately for the purposes of hedge designation. Further, that if only the spot element is selected, a further choice is available as to whether the excluded elements are accounted for as costs of hedging or not (see section 7.5 below). Illustration 7-17 below contrasts how the assessment of effectiveness and calculation of ineffectiveness must be applied for a hedge relationship depending on the choices made on designation.

Illustration 7-17: Cash flow hedge of highly probable forecast purchase of inventory in a foreign currency

Company A has the Local Currency (LC) as its functional and presentation currency.

On 1 January 20X3, A enters into a forward exchange contract to receive Foreign Currency (FC) 100,000 and deliver LC109,600 on 30 June 20X3 at an initial cost and fair value of zero. On inception, it designates the forward exchange contract as a hedging instrument in a cash flow hedge of a highly probable forecast purchase of a certain quantity of paper for FC100,000 on 30 June 20X3. It is assumed that all hedge accounting conditions in IFRS 9 are met.

The relevant foreign currency rates and associated fair values for the forward exchange contract are provided in the following table:

Date	Spot rate	Forward rate to 30 June 20X3	Fair value of forward contract
1 January 20X3	1.072	1.096	-
31 March 20X3	1.074	1.076	(1,980)
30 June 20X3	1.075	-	(2,100)

For simplification purposes foreign currency basis risk is assumed to be zero. The applicable yield curve in the local currency is flat at 4% per annum throughout the period. The fair value of the forward exchange contract is negative LC1,980 on 31 March 20X3 ({[1.076 × 100,000] - 109,600} ÷ $1.04^{(3/12)}$), and negative LC2,100 on 30 June 20X3 (1.075 × 100,000 - 109,600).

25 If Company X had issued a floating rate debt (instead of a fixed rate debt) and had not early settled the IRS as of 30/6/X0 (but kept it until its 30/6/X1 maturity) , then the total amount of interests paid on the debt plus the net interests paid / received on the IRS would have been exactly equal to €5,155 (corresponding exactly to the 'hedged' fixed rate).

Case 1: Changes in the forward rate of the forward exchange contract are designated in the hedge relationship

Ignoring ineffectiveness that might arise from other elements that have an impact on the fair value of the hedging instrument (such as foreign currency basis spreads (see section 7.4.8 below)), the hedge is expected to be fully effective because the critical terms of the forward exchange contract and the purchase contract are otherwise the same. The assessments of hedge effectiveness are based on the forward rate.

The accounting entries are as follows.

	1 January 20X3	*LC*	*LC*
Dr	Forward exchange contract	-	
	Cr Cash		-

To record the forward exchange contract at its initial fair value, i.e., zero.

	31 March 20X3	*LC*	*LC*
Dr	OCI - cash flow hedge reserve	1,980	
	Cr Forward exchange contract - liability		1,980

To recognise the change in the fair value of the forward exchange contract between 1 January 20X3 and 31 March 20X3, i.e., 1,980 - 0 = LC1,980, in other comprehensive income (OCI) within the cashflow hedge reserve. The hedge is considered fully effective because the loss on the forward exchange contract, LC1,980, exactly offsets the change in cash flows associated with the purchase contract based on the forward price {([1.076 × 100,000] - 109,600) ÷ $1.04^{(3/12)}$} - {([1.096 × 100,000] - 109,600) ÷ $1.04^{(6/12)}$ = -LC1,980. The negative figure denotes a reduction in the net present value of cash outflows and, therefore, effectively represents a 'gain' to offset the loss on the forward exchange contract in OCI.

The second element of the above equation equals zero (i.e., (1.096 × 100,000 - 109,600) = 0). This reflects the fact that the forward exchange contract is on market and accordingly has a zero present value on designation. Where this is the case, the calculation could be simplified as follows:

{([1.076 × 100,000] - 109,600) ÷ $1.04^{(3/12)}$} = -LC1,980.

	30 June 20X3	*LC*	*LC*
Dr	OCI - cash flow hedge reserve	120	
	Cr Forward exchange contract - liability		120

To recognise the change in the fair value of the forward exchange contract between 31 March 20X3 and 30 June 20X3, i.e., 2,100 -1,980 = LC120, in OCI within the cash flow hedge reserve. The hedge is considered fully effective because the loss on the forward exchange contract, LC120, exactly offsets the change in cash flows associated with the purchase contract based on the forward price {([1.075 × 100,000] - 109,600) } - {([1.076 × 100,000] - 109,600) ÷ $1.04^{(3/12)}$} = -LC120. The negative figure denotes a reduction in the net present value of cash outflows and, therefore, effectively represents a 'gain' to offset the loss on the forward exchange contract in OCI.

		LC	*LC*
Dr	Paper (purchase price)	107,500	
Dr	Paper (recycled hedging loss)	2,100	
	Cr OCI - cash flow hedge reserve		2,100
	Cr Payable		107,500

To record the purchase of the paper at the spot rate (1.075 × 100,000 = LC107,500) and remove the cumulative loss on the forward recognised in OCI from equity, LC2,100, and include it in the initial measurement of the purchased paper (see section 7.2.2 above). Accordingly, the initial measurement of the purchased paper is LC109,600 consisting of a purchase consideration of LC107,500 and a hedging loss of LC2,100. This represents the 1.096 forward foreign currency rate achieved through the forward exchange contract. *[IFRS 9.6.5.11(d)(i)]*.

The payable is recorded as a foreign currency monetary item of FC100,000, equivalent to LC107,500 (100,000 × 1.075) on initial recognition.

		LC	*LC*
Dr	Forward exchange contract - liability	2,100	
	Cr Cash		2,100

To record the net settlement of the forward exchange contract.

Case 2: Changes in the spot element of the forward exchange contract only are designated in the hedge relationship (costs of hedging guidance is not applied)

Ignoring ineffectiveness that might arise from other elements that have an impact on the fair value of the hedging instrument, (such as foreign currency basis spreads (see section 7.4.8 below)), the hedge is expected to be fully effective because the critical terms of the forward exchange contract and the purchase contract are the same and the change in the forward element of the forward exchange contract is excluded from the assessment of effectiveness.

The assessment of hedge effectiveness is based on changes in the present value of the spot element. For this purpose, the spot element is calculated as the foreign currency cashflow translated at the prevailing spot rate on assessment date, less the deemed local currency cashflow as per spot rates on designation date. The present value is then calculated by discounting the spot element from the date the hedged item is expected to occur back to the assessment date, using discount factors derived from the applicable local currency yield curve. Changes in value of the excluded forward element are outside the hedge relationship and will be taken to profit or loss.

	1 January 20X3	*LC*	*LC*
Dr	Forward exchange contract	-	
	Cr Cash		-

To record the forward exchange contract at its initial fair value, i.e., zero.

	31 March 20X3	*LC*	*LC*
Dr	Profit or loss (forward element)	2,178	
	Cr Forward exchange contract - liability		1,980
	Cr OCI - cash flow hedge reserve (spot element)		198

To recognise the change in the fair value of the forward exchange contract between 1 January 20X3 and 31 March 20X3, i.e., 1,980 - 0 = LC1,980. The change in the present value of the spot element of the forward exchange contract is a gain of LC198= {([1.074 × 100,000] - 107,200) ÷ $1.04^{(3/12)}$} - {([1.072 × 100,000] - 107,200) ÷ $1.04^{(6/12)}$}, which is recognised in OCI within the cash flow hedge reserve. As noted above, the second element of the above equation equals zero (i.e., (1.072 × 100,000) - 107,200 = 0). This reflects the fact that the spot element of the forward exchange contract is on market and accordingly has a zero present value on designation. Where this is the case, the calculation could be simplified as follows:

{([1.074 × 100,000] - 107,200) ÷ $1.04^{(3/12)}$} = LC198.

The present value of the spot element of the forward exchange contract is calculated, as there is a need to consider the time value of money for effectiveness purposes (see section 7.4.2 above).

The hedge is considered fully effective because the gain in the present value of the spot element of the forward exchange contract, LC198, exactly offsets the change in the purchase price at spot rates {([1.074 × 100,000] - 107,200) ÷ $1.04^{(3/12)}$} - {([1.072 × 100,000] - 107,200) ÷ $1.04^{(6/12}$} = LC198. The positive figure denotes an increase in the net present value of cash outflows and, therefore, effectively represents a 'loss' to offset the spot element gain on the forward exchange contract in OCI.

However, as the forward element is not part of the hedged risk, the change in value of the forward element of the forward exchange contract, a loss of LC2,178 = 1,980 + 198, is recognised in profit or loss. The value of the forward element is calculated as the difference between the full fair value change in the forward exchange contract and the change in the present value of the spot element.

	30 June 20X3	*LC*	*LC*
Dr	Profit or loss (forward element)	222	
	Cr Forward - liability		120
	Cr OCI - cash flow hedge reserve (spot element)		102

To recognise the change in the fair value of the forward exchange contract between 31 March 20X3 and 30 June 20X3, i.e., 2,100 - 1,980= LC120. The change in the present value of the spot element of the forward exchange contract is a gain of LC102 = {([1.075 × 100,000] - 107,200)} - {([1.074 × 100,000] - 107,200) ÷ $1.04^{(3/12)}$}, which is recognised in OCI within the cash flow hedge reserve.

The hedge is considered fully effective because the gain in the present value of the spot element of the forward exchange contract, LC120, exactly offsets the change in the purchase price at spot rates {([1.075 × 100,000] - 107,200)} - {([1.074 × 100,000] - 107,200) ÷ $1.04^{(3/12)}$} = LC102. The positive figure denotes an increase in the net present value of cash outflows and, therefore, effectively represents a 'loss' to offset the spot element gain on the forward exchange contract in OCI.

However, as the forward element is not part of the hedged risk, the change in value of the forward element of the forward exchange contract, a loss of LC222= -120 - 102, is recognised in profit or loss.

			LC	*LC*
Dr	Paper (purchase price)		107,500	
Dr	OCI - cash flow hedge reserve (spot element)		300	
	Cr	Paper (recycled hedging gain)		300
	Cr	Payable		107,500

To recognise the purchase of the paper at the spot rate (1.075 × 100,000 = LC107,500) and remove the cumulative gain on the spot element of the forward exchange contract that has been recognised in OCI within the cash flow hedge reserve (198 + 102 = LC300) and include it in the initial measurement of the purchased paper (see section 7.2.2 above). *[IFRS 9.6.5.11(d)(i)]*.

Accordingly, the initial measurement of the purchased paper is LC107,200, consisting of the purchase consideration of LC107,500 and a hedging gain of LC300. This represents the 1.072 spot foreign currency rate achieved through the forward exchange contract. The change in value of the forward element, a loss of LC2,400, remains in profit or loss.

			LC	*LC*
Dr	Forward exchange contract - liability		2,100	
	Cr	Cash		2,100

To record the net settlement of the forward exchange contract.

Case 3: Changes in the spot element of the forward exchange contract only are designated in the hedge relationship, while the forward element is treated as a cost of hedging

Ignoring ineffectiveness that might arise from other elements that have an impact on the fair value of the hedging instrument, (such as foreign currency basis spreads (see section 7.4.8 below)), the hedge is expected to be fully effective because the critical terms of the forward exchange contract and the purchase contract are the same and the change in the forward element of the forward exchange contract is excluded from the assessment of effectiveness.

The assessment of hedge effectiveness is based on changes in the present value of the spot element. For this purpose, the spot element is calculated as the foreign currency cashflow translated at the prevailing spot rate on assessment date, less the deemed local currency cashflow as per spot rates on designation date. The present value is then calculated by discounting the spot element from the date the hedged item is expected to occur back to the assessment date, using discount factors derived from the applicable local currency yield curve. Changes in value of the excluded forward element are outside the hedge relationship and are treated as a cost of hedging a transaction related hedged item. *[IFRS 9.6.5.15, IFRS 9.6.5.16]*.

	1 January 20X3		*LC*	*LC*
Dr	Forward exchange contract		-	
	Cr	Cash		-

To record the forward exchange contract at its initial fair value, i.e., zero.

	31 March 20X3		*LC*	*LC*
Dr	OCI - separate component of equity (forward element)		2,178	
	Cr	Forward exchange contract - liability		1,980
	Cr	OCI - cash flow hedge reserve (spot element)		198

To recognise the change in the fair value of the forward exchange contract between 1 January 20X3 and 31 March 20X3, i.e., 1,980 - 0 = LC1,980. The change in the present value of the spot element of the forward exchange contract is a gain of LC198= {([1.074 × 100,000] - 107,200) ÷ $1.04^{(3/12)}$} - {([1.072 × 100,000] - 107,200) ÷ $1.04^{(6/12)}$}, which is recognised in OCI within the cash flow hedge reserve. As noted above, the second element of the above equation equals zero (i.e., (1.072 × 100,000) - 107,200 = 0. This reflects the fact that the spot element of the forward exchange contract is on market and accordingly has a zero present value on designation. Where this is the case, the calculation could be simplified as follows:

{([1.074 × 100,000] - 107,200) ÷ $1.04^{(3/12)}$} = LC198.

The present value of the spot element of the forward exchange contract is calculated as there is a need to consider the time value of money for effectiveness purposes (see section 7.4.2 above).

The hedge is considered fully effective because the gain on the spot element of the forward exchange contract, LC198, exactly offsets the change in the purchase price at spot rates {([1.074 × 100,000] - 107,200) ÷ $1.04^{(3/12)}$} - {([1.072 × 100,000] - 107,200) ÷ $1.04^{(6/12}$} = LC198. The positive figure denotes an increase in the net present value of cash outflows and, therefore, effectively represents a 'loss' to offset the gain on the forward exchange contract in OCI.

Applying the costs of hedging guidance to the forward element of the forward exchange contract (see section 7.5 below), the change in the forward element (the change in value not designated as part of the hedged risk), a loss of LC2,178 = 1,980 + 198, is recognised in a separate component of equity.

In this example, as the critical terms of the hedged item and hedging instrument match, the value of the forward element is calculated as the difference between the full fair value change in the forward exchange contract and the change in the present value of the spot element.

Only the change in value of the forward element that relates to the hedged item can be accumulated in a separate component of equity, therefore where differences exist between the hedged item and hedging instrument, there is a need to calculate the appropriate forward element using an aligned instrument based on the terms of the hedged item (see section 7.5.1.A below).

	30 June 20X3		*LC*	*LC*
Dr	OCI - separate component of equity (forward element)		222	
	Cr	Forward exchange contract - liability		120
	Cr	OCI - cash flow hedge reserve (spot element)		102

To recognise the change in the fair value of the forward exchange contract between 31 March 20X3 and 30 June 20X3, i.e., 2,100 - 1,980= LC120. The change in the present value of the spot element of the forward exchange contract is a gain of LC102 = {([1.075 × 100,000] - 107,200)} - {([1.074 × 100,000] - 107,200) ÷ $1.04^{(3/12)}$}, which is recognised in OCI within the cash flow hedge reserve.

The hedge is considered fully effective because the gain in the spot element of the forward exchange contract, LC120, exactly offsets the change in the purchase price at spot rates {([1.075 × 100,000] - 107,200)} - {([1.074 × 100,000] - 107,200) ÷ $1.04^{(6/12)}$} = LC102. The positive figure denotes an increase in the net present value of cash outflows and, therefore, effectively represents a 'loss' to offset the spot element gain on the forward exchange contract in OCI.

Applying the costs of hedging guidance to the forward element of the forward exchange contract (see section 7.5 below); the change in value of the forward element of the forward exchange contract (the change in value not designated as part of the hedged risk) is a loss of LC222= -120 - 102), is recognised in a separate component of equity.

			LC	*LC*
Dr	Paper (purchase price)		107,500	
Dr	Paper (cost of hedging)		2,400	
Dr	OCI - cash flow hedge reserve (spot element)		300	
	Cr	Paper (recycled hedging gain)		300
	Cr	OCI - separate component of equity (forward element)		2,400
	Cr	Payable		107,500

To recognise the purchase of the paper at the spot rate (1.075 × 100,000 = LC107,500), remove the cumulative gain on the spot element of the forward exchange contract that has been recognised in OCI within the cash flow hedge reserve (198 + 102 = LC300) and the cost of hedging recognised in a separate component of equity (2,178 + 222 = LC2,400) and include them in the initial measurement of the purchased paper. The inclusion of the cost of hedging as part of the initial measurement of the purchased paper is consistent with the required treatment of such a transaction related hedged item. For a time-period related hedged item, such as an interest rate swap hedging interest rate risk in a debt security, the timing and presentation of the removal of amounts from the separate component of equity is different (see Illustration 7-18 and section 7.5.1 below). *[IFRS 9.6.5.11(d)(i), IFRS 9.6.5.15, IFRS 9.6.5.16]*.

Accordingly, the initial measurement of the purchased paper is LC109,600, consisting of the purchase consideration of LC107,500, a hedging gain of LC300 and the cost of hedging of LC2,400. This is equivalent to the 1.096 forward foreign currency rate achieved through the forward exchange contract.

		LC	*LC*
Dr	Forward exchange contract- liability	2,100	
	Cr Cash		2,100

To record the net settlement of the forward exchange contract.

In all these examples we have ignored foreign currency basis risk in the forward rate (see section 7.4.8 below). However, if we were to consider it, additional volatility in profit or loss may arise in Case 1,as foreign currency basis is not part of the hedged risk therefore any fair value changes in the hedging instrument due to foreign currency basis are not replicated in the hedged item. In Cases 2 and 3 above, the calculation method for the forward element would by default also include any foreign currency basis, i.e., the 'residual' after the spot element is deducted from the full fair value changes. However, in Case 3, foreign currency basis could be considered part of cost of hedging, similar to the forward element. *[IFRS 9.6.5.16]*.

The example illustrates that the time value of money is relevant for the assessment of effectiveness even when the spot element is designated in a hedge relationship (see section 7.4.2 above). However, in many circumstances the effect of discounting the revaluation of the spot element might not be material.

In the above example the strategy was to protect against changes in foreign currency rates until the date the forecast purchase is expected to occur, perhaps on the assumption that the resulting foreign currency payable will be settled on the same day. An alternative, perhaps more common, hedging strategy is to protect against changes in foreign currency rates until the date the payable is expected to be settled. It is usually possible to achieve hedge accounting for such a strategy. In fact, there are a number of ways in which hedge accounting could be achieved.

One such approach would be to designate the hedging instrument in a cash flow hedge to protect against changes in foreign currency rates in cash flows associated with a highly probable forecast purchase. Although the hedge relationship will end when the purchase is recognised, the hypothetical (and aligned) instrument (see section 7.4.4 above and section 7.5 below) could reflect the timing of the expected settlement of the associated trade payable, and so will provide good offset to changes in the hedging derivative over the life of the hedge relationship.

Once the forecast purchase is recognised and the hedge relationship has ended, the hedging instrument can then be designated in either a new fair value or cash flow hedge of the associated foreign currency trade payable for changes in foreign currency risk (see sections 5.1.2, 5.2.3 and 7.2.3 above). This would be a new hedge designation hence the issue of additional ineffectiveness associated with designating a hedging instrument that has a non-zero fair value might arise (see section 7.4.3 above). Illustration 7-18 below provides an example of the accounting for a cash flow hedge of a foreign currency trade receivable for changes in foreign currency risk. Alternatively, a choice could be made not to apply any further hedge accounting if the combination of accounting for the hedging derivatives at fair value through profit or loss and the IAS 21 retranslation of the trade payable provides sufficient natural offset (although fair value changes in the forward points are likely to result in some volatility in profit or loss).

Another alternative when hedging the foreign currency risk of a highly probable forecast purchase to the expected settlement date of the associated trade payable is to designate a cash flow hedge of both the foreign currency forecast purchase and associated foreign currency payable at the time the hedging instrument is transacted. However, this dual designation, whereby the documented hedged item changes from a highly probable forecast transaction to a recognised monetary item, does bring some additional complexity to the hedge relationship. Specifically, there is a need to calculate a change in value for each hedged item and allocate an appropriate share of the change in fair value of the hedging instrument to each hedged item.

The standard does not proscribe how to calculate the appropriate change in value of the hedged item and hedging instrument in a hedge of both the foreign currency forecast purchase and associated foreign currency payable. The IAS 39 Implementation Guidance includes an example of such a hedge, in which case all changes in value of the hedged item and hedging instrument are attributed to the 'live' element of the hedge relationship at any one time. *[IAS 39.F.5.6]*. So, until the forecast purchase is recognised, all changes in value are attributed to the hedge of the forecast purchase. Once the purchase is recognised and any remaining variability arises from the associated trade payable, all subsequent changes in value are attributed to the hedge of the trade payable. This approach is relatively simple, as it can be applied using only the actual hedged items and instruments, but it can result in an arbitrary allocation of the forward element (and foreign currency basis) of the hedging instrument to each hedged item, depending on prevailing market rates on the day the purchase is recognised.

Another potential method to assess the effectiveness and measure ineffectiveness in a hedge of both the foreign currency forecast purchase and associated foreign currency payable, is to notionally split the hedging instrument into the two phases of the hedge relationship and apply the usual hedge accounting requirements to each of the notionally split instruments (see section 3.6.2 above).

For example: a forecast foreign currency purchase is expected to occur on 30/6/20X2, the associated foreign currency trade payable is expected to settle on 30/9/20X2, and the hedging instrument (a forward foreign currency contract) matures on 30/9/20X2. In order to assess the effectiveness and measure ineffectiveness in the hedge relationship, both the hedged item and hedging instrument could be represented by a notional foreign currency forward contract maturing on 30/6/20X2 and a foreign currency swap with principal exchange on 30/6/20X2 and 30/9/20X2. (The combination of these matches the full hedged item and hedging instrument).

How we see it

We believe either of the above methods to allocate the change in value of the hedged item and hedging instrument in a hedge of both a foreign currency forecast purchase and associated foreign currency payable to be acceptable.

Notionally splitting the hedging instrument into the two phases of the hedge relationship is the more operationally complex of the two methods, as the accounting relies on instruments that have been notionally split. However, it does provide a more meaningful allocation of the forward element (and foreign currency basis) between the forecast purchase and the trade payable.

As noted above, some natural offset in profit or loss does occur when hedging the foreign currency risk in a foreign currency trade payable with a foreign currency forward contract. However, Illustration 7-18 below demonstrates how the accounting could be applied if designation in a hedge relationship is desirable.

Illustration 7-18: Cash flow hedge of foreign currency trade receivable

Company X has the Local Currency (LC) as its functional and presentation currency.

On 30 September 20X2, following the sale of inventory for FC500,000, X meets the criteria to recognize the associated revenue. Settlement for the sale is not due until 31 March 20X3, hence X also recognises a foreign currency trade debtor receivable due 31 March 20X3 at the transaction price of FC500,000. *[IFRS 9.5.1.3]*.

X also enters into forward exchange contract to deliver Foreign Currency (FC) 500,000 and receive LC1,110,000 on 31 March 20X3 at an initial cost and fair value of zero. On inception, it designates the forward exchange contract as a hedging instrument in a cash flow hedge of the recognised foreign currency trade receivable. It is assumed that all hedge accounting conditions in IFRS 9 are met.

The relevant foreign currency rates and associated fair values for the forward exchange contract are provided in the following table:

Date	Spot rate	Forward rate to 31 March 20X3	Fair value of forward contract
30 September 20X2	2.20	2.22	-
31 December 20X2	2.40	2.41	(94,301)
31 March 20X3	2.35	-	(65,000)

For simplification purposes foreign currency basis risk is assumed to be zero. The applicable yield curve in the local currency is flat at 3% per annum throughout the period. The fair value of the forward exchange contract is negative LC94,301 on 31 December 20X2 ({[2.41 × 500,000] - 1,110,000} ÷ $1.34^{(3/12)}$), and negative LC65,000 on 31 March 20X3 (2.35 × 500,000 - 1,110,000).

By transacting the forward exchange contract, X is now protected against changes in the spot rate of 2.20 on 30 September 20X2, and has locked in the forward points of LC10,000 (i.e., ([500,000 × 2.2] - 1,110,000)) within the forward exchange contract on that date.

Case 1: Changes in the spot element of the forward exchange contract only are designated in the hedge relationship (costs of hedging guidance is not applied)

Ignoring ineffectiveness that might arise from other elements that have an impact on the fair value of the hedging instrument, (such as foreign currency basis spreads (see section 7.4.8 below)), the hedge is expected to be fully effective because the critical terms of the forward exchange contract and the trade receivable are the same and the change in the forward element of the forward exchange contract is excluded from the assessment of effectiveness.

The assessment of hedge effectiveness is based on changes in the present value of the spot element. For this purpose, the spot element is calculated as the foreign currency cashflow translated at the prevailing spot rate on assessment date, less the deemed local currency cashflow as per spot rates on designation date. The present value is then calculated by discounting the spot element from the date the hedged item is expected to occur back to the assessment date, using discount factors derived from the applicable local currency yield curve. Changes in fair value of the excluded forward element are outside the hedge relationship and will be taken to profit or loss.

	30 September 20X2	*LC*	*LC*
Dr	Trade receivable	1,100,000	
	Cr Revenue		1,100,000

To record the foreign currency trade receivable at the transaction price of FC500,000 using the prevailing spot rate (i.e., 500,000 × 2.2 = LC1,100,000). It is assumed that the requirements to recognise as revenue are met (see Chapter 28).

		LC	*LC*
Dr	Forward exchange contract	-	
	Cr Cash		-

To record the forward exchange contract at its initial fair value, i.e., zero.

	31 December 20X2	*LC*	*LC*
Dr	Trade receivable	100,000	
	Cr FX retranslation P&L		100,000

To remeasure the trade receivable to prevailing spot rate i.e., [500,000 × 2.4] - [500,000 × 2.2] = LC100,000. [IAS 21.28].

		LC	*LC*
Dr	OCI - cash flow hedge reserve	99,264	
	Cr Forward exchange contract - liability		94,301
	Cr Profit or loss (forward element)		4,963

To recognise the change in the fair value of the forward exchange contract between 30 September 20X2 and 31 December 20X2, i.e., -94,301 - 0 = -LC94,301. The change in the present value of spot element of the forward exchange contract is a loss of LC99,264 = {([2.4 × 500,000] - 1,100,00) ÷ $1.03^{(3/12)}$} - {([2.2 × 500,000] - 1,100,00) ÷ $1.03^{(6/12)}$}, which is recognised in OCI within the cash flow hedge reserve. The present value of the spot element of the forward exchange contract is calculated as there is a need to consider the time value of money when measuring hedge ineffectiveness (see section 7.4.2 above).

The second element of the above equation equals zero (i.e., (2.2 × 500,000) - 1,100,00 = 0)). This reflects the fact that the forward exchange contract is on market and accordingly has a zero present value on designation. Where this is the case, the calculation could be simplified as follows:

{([2.4 × 500,000] - 1,100,00) ÷ $1.03^{(3/12)}$} = LC99,264

The hedge is considered fully effective because the loss on the present value of the spot element of the forward exchange contract, LC99,264, exactly offsets the change in cash flows associated with the trade receivable based on spot rates price {([2.4 × 500,000] - 1,100,000) ÷ $1.03^{(3/12)}$} - {([2.2 × 500,000] - 1,100,000) ÷ $1.03^{(6/12)}$} = LC99,264. The positive figure denotes an increase in the net present value of cash inflows and, therefore, effectively represents a 'gain' to offset the loss on the forward exchange contract in OCI.

However, as the forward element is not part of the hedged risk, the change in the forward element of the forward exchange contract, a gain of LC4,963 = -94,301 + 99,264, is recognised in profit or loss. The forward element is calculated as the difference between the full fair value change in the forward exchange contract and the change in the present value of the spot element.

		LC	*LC*
Dr	FX retranslation P&L	100,000	
	Cr OCI - cash flow hedge reserve		100,000

To reclassify the effective portion of the change in spot element of the forward exchange contract from the cash flow hedge reserve to profit or loss as a reclassification adjustment in the same period(s) during which the hedged expected future cash flows affect profit or loss. Because the trade receivable is remeasured continuously in respect of changes in foreign currency rates per IAS 21, there is a requirement for the gain or

loss on the forward contract to be reclassified from the cash flow hedge reserve to profit or loss as the receivable is remeasured, not when the payment occurs. The method used to facilitate the reclassification is not prescribed. (See section 7.2.3 above). Company X has chosen to immediately reclassify an amount equal to the IAS 21 retranslation on the trade receivable (see section 7.2.3 above), despite the fact that this is higher than the amount taken to OCI based on a discounted spot valuation. *[IFRS 9.6.5.11(d)(ii), IAS 21.28]*.

	31 March 20X3	*LC*	*LC*
Dr	FX retranslation P&L	25,000	
	Cr Trade receivable		25,000

To remeasure the trade receivable to prevailing spot rate i.e., [500,000 × 2.35] - [500,000 × 2.4] = -LC25,000. [IAS 21.28].

		LC	*LC*
Dr	Forward exchange contract - liability	29,301	
	Cr OCI - cash flow hedge reserve		24,264
	Cr Profit or loss (forward element)		5,037

To recognise the change in the fair value of the forward exchange contract between 31 December 20X2 and 31 March 20X3, i.e., -65,000 + 94,301 = LC29,301. The change in the present value of spot element of the forward exchange contract is a gain of LC24,264 = {([2.35 × 500,000] - 1,100,00)} - {([2.4 × 500,000] - 1,100,00) ÷ $1.03^{(3/12)}$}, which is recognised in OCI within the cash flow hedge reserve. The present value of the spot element of the forward exchange contract is calculated as there is a need to consider the time value of money when measuring hedge ineffectiveness (see section 7.4.2 above).

The hedge is considered fully effective because the gain on the forward exchange contract, LC29,301, exactly offsets the change in cash flows associated with the trade receivable based on the forward price {([2.35 × 500,000] - 1,110,000)} - {([2.41 × 500,000] - 1,110,000) ÷ $1.03^{(3/12)}$} = -LC29,301. The negative figure denotes a decrease in the net present value of cash inflows and, therefore, effectively represents a 'loss' to offset the gain on the forward exchange contract in OCI.

		LC	*LC*
Dr	OCI - cash flow hedge reserve	25,000	
	Cr FX retranslation P&L		25,000

To reclassify the effective portion of the change in fair value of the forward exchange contract from the cash flow hedge reserve to profit or loss as a reclassification adjustment in the same period(s) during which the hedged expected future cash flows affect profit or loss. Company X has chosen to immediately reclassify an amount equal to the IAS 21 retranslation on the trade receivable (see section 7.2.3 above). *[IFRS 9.6.5.11(d)(ii), IAS 21.28]*.

		LC	*LC*
Dr	Cash	1,175,000	
	Cr Trade receivable		1,175,000

To record the settlement of the trade receivable at the spot rate (2.35 × 500,000 = LC1,175,000)

		LC	*LC*
Dr	Forward exchange contract - liability	65,000	
	Cr Cash		65,000

To record the net settlement of the forward exchange contract.

Ultimately LC1,110,000 of cash was received, representing the 2.22 forward foreign currency rate achieved through the forward exchange contract, with changes in fair value of the forward element taken to profit or loss over the period. This resulted in a gain of LC10,000, representing the locked in forward points when the forward exchange contract was transacted.

A summary of the accounting entries is shown below:

DR/(CR)	Cash	Forward exchange contract	Receivable	OCI	Profit of Loss
	LC	LC	LC	LC	LC
30/09/20X2					
Record receivable			1,100,000		
31/12/20X2					
Change in FV		(94,301)		99,264	(4,963)
IAS 21 remeasure			100,000		(100,000)
Reclassification				(100,000)	100,000
31/03/20X3					
Change in FV		29,301		(24,264)	(5,037)
IAS 21 remeasure			(25,000)		25,000
Reclassification				25,000	(25,000)
Settle receivable	1,175,000		(1,175,000)		
Settle forward	(65,000)	65,000			
Total	**1,110,000**	**-**	**-**	**-**	**(10,000)**

Case 2: Changes in the spot element of the forward exchange contract only are designated in the hedge relationship, the forward element is treated as a cost of hedging

Ignoring ineffectiveness that might arise from other elements that have an impact on the fair value of the hedging instrument, (such as foreign currency basis spreads (see section 7.4.8 below)), the hedge is expected to be fully effective because the critical terms of the forward exchange contract and the trade receivable are the same and the change in the forward element of the forward exchange contract is excluded from the assessment of effectiveness.

The assessment of hedge effectiveness is based on changes in the present value of the spot element. For this purpose, the spot element is calculated as the foreign currency cashflow translated at the prevailing spot rate on assessment date, less the deemed local currency cashflow as per the spot rate on designation date. The present value is then calculated by discounting the spot element from the date the hedged item is expected to occur back to the assessment date, using discount factors derived from the applicable local currency yield curve.

Changes in fair value of the excluded forward element are outside the hedge relationship and are treated as a cost of hedging a time related hedged item. *[IFRS 9.6.5.15, IFRS 9.6.5.16]*. (See section 7.5.1 below).

	30 September 20X2	*LC*	*LC*
Dr	Trade receivable	1,100,000	
	Cr Revenue		1,100,000

To record the foreign currency trade receivable at the transaction price of FC500,000 using the prevailing spot rate (i.e., 500,000 × 2.2 = LC1,100,000). It is assumed that the requirements to recognise as revenue are met (see Chapter 24).

		LC	*LC*
Dr	Forward exchange contract	-	
	Cr Cash		-

To record the forward exchange contract at its initial fair value, i.e., zero.

	31 December 20X2	*LC*	*LC*
Dr	Trade receivable	100,000	
	Cr FX retranslation P&L		100,000

To remeasure the trade receivable to prevailing spot rate i.e., [500,000 × 2.4] - [500,000 × 2.2] = LC100,000. [IAS 21.28].

			LC	*LC*
Dr	OCI - cash flow hedge reserve		99,264	
	Cr	Forward exchange contract - liability		94,301
	Cr	OCI - separate component of equity (forward element)		4,963

To recognise the change in the fair value of the forward exchange contract between 30 September 20X2 and 31 December 20X2, i.e., -94,301 - 0 = -LC94,301. The change in the present value of spot element of the forward exchange contract is a loss of LC99,264= {([2.4 × 500,000] - 1,100,00) ÷ $1.03^{(3/12)}$} - {([2.2 × 500,000] - 1,100,00) ÷ $1.03^{(6/12)}$}, which is recognised in OCI within the cash flow hedge reserve. The present value of the spot element of the forward exchange contract is calculated as there is a need to consider the time value of money when measuring hedge ineffectiveness (see section 7.4.2 above).

As noted above, the second element of the above equation equals zero (i.e., (2.2 × 500,000) - 1,100,00 = 0). This reflects the fact that the spot element of the forward exchange contract is on market and accordingly has a zero present value on designation. Where this is the case, the calculation could be simplified as follows:

{([2.4 × 500,000] - 1,100,00) ÷ $1.03^{(3/12)}$}= LC99,264.

The hedge is considered fully effective because the loss on the present value of the spot element of the forward exchange contract, LC99,294, exactly offsets the change in cash flows associated with the trade receivable based on spot rates, i.e., {([2.4 × 500,000] - 1,100,000) ÷ $1.03^{(3/12)}$} - {([2.2 × 500,000] - 1,100,000) ÷ $1.03^{(6/12)}$} = LC99,294 The positive figure denotes an increase in the net present value of cash inflows and, therefore, effectively represents a 'gain' to offset the loss on the forward exchange contract in OCI.

Applying the costs of hedging guidance to the forward element of the forward exchange contract: the change in the forward element (the change in fair value not designated as part of the hedged risk), a gain of LC4,963 = -94,301 + 99,264, is recognised in a separate component of equity.

In this example as the critical terms of the hedged item and hedging instrument match, the forward element is calculated as the difference between the full fair value change in the forward exchange contract and the change in the present value of the spot element.

Only the forward element that relates to the hedged item can be accumulated in a separate component of equity, therefore where differences exist between the hedged item and hedging instrument, there is a need to calculate the appropriate forward element using an aligned instrument based on the terms of the hedged item. (See section 7.5.1.A below).

			LC	*LC*
Dr	FX retranslation P&L		100,000	
	Cr	OCI - cash flow hedge reserve		100,000

To reclassify the effective portion of the change in spot element of the forward exchange contract from the cash flow hedge reserve to profit or loss as a reclassification adjustment in the same period(s) during which the hedged expected future cash flows affect profit or loss. Because the trade receivable is remeasured continuously in respect of changes in foreign currency rates per IAS 21, there is a requirement for the gain or loss on the forward contract to be reclassified from the cash flow hedge reserve to profit or loss as the receivable is remeasured, not when the payment occurs. The method used to facilitate the reclassification is not prescribed. (See section 7.2.3 above). Company X has chosen to immediately reclassify an amount equal to the IAS 21 retranslation on the trade receivable, despite the fact that this is higher than the amount taken to OCI based on a discounted spot valuation. *[IFRS 9.6.5.11(d)(ii), IAS 21.28]*.

			LC	*LC*
Dr	OCI - separate component of equity (forward element)		5,000	
	Cr	FX retranslation P&L		5,000

To amortise the forward element at the time of designation as a (time-period related) cost of hedging on a systematic and rational basis over the period during which the trade receivable affects profit or loss. The amortisation is from the separate component of equity to profit or loss. The forward element at the time of designation is the locked in forward points within the forward exchange contract LC10,000 (i.e., ([500,000 × 2.2] - 1,110,000)), amortised on a straight line basis over the 6 months the trade receivable is live and affects profit and loss through the IAS 21 remeasurement. *[IFRS 9.6.5.11(d)(ii)]*.

	31 March 20X3	*LC*	*LC*
Dr	FX retranslation P&L	25,000	
	Cr Trade receivable		25,000

To remeasure the trade receivable to prevailing spot rate i.e., [500,000 × 2.35] - [500,000 × 2.4] = -LC25,000. [IAS 21.28].

		LC	*LC*
Dr	Forward exchange contract - liability	29,301	
	Cr OCI - cash flow hedge reserve		24,264
	Cr OCI - separate component of equity (forward element)		5,037

To recognise the change in the fair value of the forward exchange contract between 31 December 20X2 and 31 March 20X3, i.e., -65,000 + 94,301 = LC29,301. The change in the present value of spot element of the forward exchange contract is a gain of LC24,264 = {([2.35 × 500,000] - 1,100,00)} - {([2.4 × 500,000] - 1,100,00) ÷ $1.03^{(3/12)}$}, which is recognised in OCI within the cash flow hedge reserve. The present value of the spot element of the forward exchange contract is calculated as there is a need to consider the time value of money when measuring hedge ineffectiveness (see section 7.4.2 above).

The hedge is considered fully effective because the gain on the forward exchange contract, LC29,301, exactly offsets the change in cash flows associated with the trade receivable based on the forward price {([2.35 × 500,000] - 1,110,000)} - {([2.41 × 500,000] - 1,110,000) ÷ $1.03^{(3/12)}$} = -LC29,301. The negative figure denotes a decrease in the net present value of cash inflows and, therefore, effectively represents a 'loss' to offset the gain on the forward exchange contract in OCI.

		LC	*LC*
Dr	OCI - cash flow hedge reserve	25,000	
	Cr FX retranslation P&L		25,000

To reclassify the effective portion of the change in fair value of the forward exchange contract from the cash flow hedge reserve to profit or loss as a reclassification adjustment in the same period(s) during which the hedged expected future cash flows affect profit or loss. Company X has chosen to immediately reclassify an amount equal to the IAS 21 retranslation on the trade receivable. *[IFRS 9.6.5.11(d)(ii), IAS 21.28].*

		LC	*LC*
Dr	OCI - separate component of equity (forward element)	5,000	
	Cr FX retranslation P&L		5,000

To amortise the forward element at the time of designation as a (time-period related) cost of hedging on a systematic and rational basis over the period during which the trade receivable affects profit or loss. The amortisation is from the separate component of equity to profit or loss. The forward element at the time of designation is the locked in forward points within the forward exchange contract LC10,000 (i.e., ([500,000 × 2.2] - 1,110,000)), amortised on a straight line basis over the 6 months the trade receivable is live and affects profit and loss through the IAS 21 remeasurement. *[IFRS 9.6.5.11(d)(ii)].*

		LC	*LC*
Dr	Cash	1,175,000	
	Cr Trade receivable		1,175,000

To record the settlement of the trade receivable at the spot rate (2.35 × 500,000 = LC1,175,000)

		LC	*LC*
Dr	Forward exchange contract - liability	65,000	
	Cr Cash		65,000

To record the net settlement of the forward exchange contract.

Ultimately LC1,110,000 of cash was received, representing the 2.22 forward foreign currency rate achieved through the forward exchange contract, with the locked in forward points from the forward exchange contract when transacted recognised in profit or loss on a rational and systematic basis as a cost of hedging.

A summary of the accounting entries is shown below:

DR/(CR)	Cash	Forward exchange contract	Receivable	OCI	Equity	Profit of Loss
	LC	LC	LC	LC	LC	LC
30/09/20X2						
Record receivable			1,100,000			
31/12/20X2						
Change in FV		(94,301)		99,264	(4,963)	
IAS 21 remeasure			100,000			(100,000)
Reclassification				(100,000)		100,000
Cost of hedging					5,000	(5,000)
31/03/20X3						
Change in FV		29,301		(24,264)	(5,037)	
IAS 21 remeasure			(25,000)			25,000
Reclassification				25,000		(25,000)
Cost of hedging					5,000	(5,000)
Settle receivable	1,175,000		(1,175,000)			
Settle forward	(65,000)	65,000				
Total	1,110,000	-	-	-	-	(10,000)

In both these examples we have ignored foreign currency basis risk (see section 7.4.8 below), however, if we were to consider it, additional volatility in profit or loss may arise in Case 1, as foreign currency basis is not part of the hedged risk therefore any fair value changes in the hedging instrument due to foreign currency basis are not replicated in the hedged item. In Case 2 the calculation method for the forward element would by default also include any foreign currency basis, i.e., the 'residual' after the spot element is deducted from the full fair value changes. However, foreign currency basis could be considered part of cost of hedging, similar to the forward element *[IFRS 9.6.5.16]*.

Unlike in Illustration 7-17 above, we have not provided a comparison of a designation of the forward element when hedging the foreign currency risk in a foreign currency trade payable/receivable. This is because the designation as per Case 2: where only the spot element of the forward exchange contract is designated in the hedge relationship, with the forward element treated as a cost of hedging, appears to be what the IASB had in mind for such hedge relationships (see section 7.5.2 below). *[IFRS 9.BC6.422]*. However, we are aware that designation of the forward element when hedging a currency foreign currency trade payable/receivable does occur in practice, despite the resulting ineffectiveness (see section 7.2.3 above).

7.4.8 Foreign currency basis spreads

One phenomenon of the 2007/8 financial crisis was the increase in foreign currency basis spreads. The foreign currency basis is the charge above the risk-free rate in a foreign country to compensate for country and liquidity risk. Historically, basis spreads had been low, but increased significantly after the financial crisis and the following sovereign debt crisis. Volatility in foreign currency basis can create hedge ineffectiveness when using a cross-currency interest rate swap (CCIRS) to hedge the foreign currency and interest rate risk of a debt instrument issued in a foreign currency.

When designating the CCIRS in a fair value hedge, the gain or loss on the hedged item attributable to changes in the hedged interest rate risk is determined based on the foreign currency interest rate curve, therefore excluding currency basis. IAS 21 then requires such a monetary item in a foreign currency to be translated to the functional currency using the spot exchange rate. *[IAS 21.23]*. Conversely, the fair value of the CCIRS incorporates the foreign currency basis spread which results in ineffectiveness.

For a cash flow hedge, IFRS 9 is explicit that when using a hypothetical derivative to calculate ineffectiveness, the hypothetical derivative cannot simply impute a charge for exchanging different currencies (i.e., the foreign currency basis spread) even though actual derivatives (for example, cross-currency interest rate swaps) under which different currencies are exchanged might include such a charge (see section 7.4.4 above). *[IFRS 9.B6.5.5]*.

Although cross-currency interest rate swaps are used to highlight the fact that foreign currency basis spreads must not be replicated in hypothetical derivatives, this issue is also likely to arise in other foreign currency contracts settled in the future. This is also an issue for net investment hedges for which the hedging instrument is a derivative (see Illustration 7-9 in section 7.3.3.B above and section 7.5.3 below).

To address this, IFRS 9 identifies foreign currency basis spread as a 'cost of hedging'. Application of the costs of hedging accounting permits an appropriate portion of the change in the fair value of foreign currency basis spread to be taken to OCI rather than immediately recognised in profit or loss, see section 7.5.3 below.

7.4.9 The impact of the hedging instrument's credit quality

One of the key hedge effectiveness requirements in IFRS 9 is that the impact of credit risk must not be of a magnitude such that it dominates the value changes (see section 6.4.2 above). *[IFRS 9.6.4.1(c)(ii)]*. It is therefore clear that the credit quality of the hedging instrument, and hedged item are both relevant in determining the ongoing eligibility of a hedge relationship. However, the assessment of the effect of credit risk on value changes for hedge effectiveness purposes, which often can be made on a qualitative basis, must not be confused with the requirement to measure and recognise the impact of credit risk on the hedging instrument and, where appropriate, the designated hedged item, which will normally give rise to hedge ineffectiveness recognised in profit or loss (see sections 7.4.1 and 7.4.5 above).

Hedge ineffectiveness is the extent to which the changes in the fair value or cash flows of the hedging instrument are greater or less than those on the hedged item. *[IFRS 9.B6.4.1]*. Although it is permissible to exclude some components from a designated hedging instrument, and associated fair value changes, counterparty credit risk is not one of the permitted exclusions (see section 3.6 above). Accordingly, unless the hedged item attracts the same credit risk as the hedging instrument, it will be a source of ineffectiveness (see section 7.4.1 above). In practice, it is very unlikely to be the case that the hedged item and hedging instrument both attract the same credit risk. In particular, they will often not share the same counterparty, credit enhancement arrangements, term, exposure to credit risk and in a highly probable forecast transaction there could be no credit risk at all (see section 6.4.2.B above). In addition to changes in the hedging instrument's counterparty credit risk, changes in the reporting entity's own credit risk might also affect the fair value of the hedging instrument in ways that are not replicated in the hedged item (see Chapter 15 at section 10.3.2).

For a fair value hedge, the implications of this requirement are clear. If there is a change in the hedging instrument's credit risk, the hedging instrument's fair value will change, but there is unlikely to be an offsetting change in fair value for the hedged item. This will affect its effectiveness as measured. In most cases, credit risk in the hedged item does not form part of the designated hedged risk (see section 2.2 above) and so changes in fair value of the hedged item due to credit risk will not provide any offset to changes in the fair value of the hedging instrument due to its credit risk. However, as noted above, even if credit risk is not part of the designated risk, if changes in the fair value of the hedged item due to credit risk dominate the value changes in the hedge relationship, then the hedge must be discontinued (see section 6.4.2.B above and section 8.3 below).

For a cash flow hedge, the implications might not immediately be so obvious. It is relatively common for the measurement of ineffectiveness in a cash flow hedge to be calculated using a hypothetical derivative (see section 7.4.4 above). Hence, the effect of changes in the hedging instrument's credit risk on the measurement of ineffectiveness might be best explained in the context of a hypothetical derivative. The application guidance of IFRS 9 states that when applying the hypothetical derivative method, one cannot include features in the value of the hedged item that only exist in the hedging instrument, but not in the hedged item. *[IFRS 9.B6.5.5]*.

Given the prohibition on reflecting terms in the hypothetical derivative that do not exist in the hedged item, it is clear that, when using a hypothetical derivative for measuring ineffectiveness in a cash flow hedge, the counterparty credit risk on the hedging instrument will not, as a matter of course be deemed to be equally present in the hedged item (see section 7.4.5 above). *[IFRS 9.B6.5.5]*. For example, if the hedged item is a highly probable forecast transaction it might not involve any credit risk at all (see section 6.4.2.B above), so that there is no offset for the specific credit risk affecting the fair value of the hedging instrument. This would give rise to some ineffectiveness recorded in profit or loss.

The impact will be more pronounced where the hedging instrument is longer term, has a significant fair value and there exist no other credit enhancements such as collateral agreements or credit break clauses.

Nowadays, many derivative contracts between financial institutions are cash collateralised (see section 8.3.5 below) or settled-to-market (STM). For STM derivatives, the daily variation margin is used to settle the derivative's outstanding fair value position (see section 8.3.6 below). Both cash collateralisation and STM significantly reduces the credit risk for both parties involved. Accordingly, the residual credit risk due to these cash collateralised and STM derivatives is much less likely to be a significant source of ineffectiveness than for uncollateralised derivatives in the past.

7.4.10 Ineffectiveness from the most recently fixed variable leg of the hedging derivative

When measuring ineffectiveness in hedge relationships for which the designated hedging instruments is an interest rate swap or similar, fair value 'noise' is often generated between the dates on which the variable leg is reset to market, in particular for a fair value hedge. Currently the payments on an interest rate swap are typically established at the beginning of a reset period and paid at the end of that period. Between these two dates the swap is no longer a pure pay-fixed receive-variable (or *vice versa*) instrument because both the next payment and the next receipt are fixed. Accordingly, the corresponding changes in the fair value of the hedged item (e.g., fixed rate debt) will not strictly mirror that of the swap. This problem becomes more acute the less frequently variable interest rates are re-fixed to market rates.

This 'noise' is unlikely to be significant enough to influence whether there is an economic relationship or not, especially where the interval between re-pricings is frequent enough, e.g., quarterly rather than annual, in order to minimise the changes in fair value from the fixed net settlement or next interest payment (see section 6.4.1 above). However, ineffectiveness must always be measured and recognised in profit or loss (see section 7.4 above). This ineffectiveness is likely to be more significant when interest rates are more volatile, as experienced by a number of entities during the financial crisis starting in the second half of 2007.

However, as a result of the reforms mandated by the Financial Stability Board following the Financial Crisis, less fair value sensitivity is expected as IBORs are being replaced by new 'official' benchmark rates, known as RFRs. At the time of writing, most derivative RFRs are expected to be a compounded RFR rate with regular settlements (e.g., a rate equal to daily cumulative accrual at the overnight RFR rate, settled every 3 months). Some term rates do exist, but for example the U.S. Alternative Reference Rates Committee has recommended that the use of Term SOFR should be limited to specific purposes (see the *Supplement: IBOR Reform*).

Where a cumulative accrual RFR is applied this will reduce or fully eliminate the 'noise' from the revaluation of the floating leg, as the floating rate never becomes 'fixed' given the ongoing cumulative accrual at the prevailing overnight rate.

7.4.11 Effectiveness of options

It was explained in section 3.6.4 above that the time value of an option can be excluded from the hedge relationship and treated as a cost of hedging (see section 7.5 below). In many cases excluding the time value of an option could make it easier to demonstrate an expectation of offset from changes in the hedged item and the hedging instrument in the determination of the existence of an economic relationship (see section 6.4.1 above). In such cases, if the documented hedged risk is appropriately customised there will, in many cases, be very little ineffectiveness to recognise (other than for example that arising from changes in credit risk, basis risk or other terms that are not aligned between the hedged item and hedging option), as set out in the following Illustration.

Illustration 7-19: Out of the money put option used to hedge forecast sales of commodity

Company A expects highly probable forecast sales of 100 tonnes of commodity X in 6 months' time. The current unit price of commodity X is £100 per tonne. To partially protect itself against a decrease in the price of the commodity, A acquires a put option, which gives it the right to sell 100 tonnes of commodity X at £90 per tonne. Company A's objective is only to provide protection for price changes below £90 per tonne, and such a strategy is often referred to as a hedge of a one-sided risk. *[IFRS 9.B6.3.12]*.

A is permitted to designate changes in the option's intrinsic value as the hedging instrument to reflect the one-sided risk in the hedged item. The changes in the intrinsic value of the option provide protection against the risk of variability in the price of commodity X below or equal to the strike price of the put of £90 per tonne. For prices above £90 per tonne, the option is out of the money and has no intrinsic value. Accordingly, gains and losses on the forecast sales of commodity X for prices above £90 are not attributable to the hedged risk for the purposes of assessing whether an economic relationship exists or not, nor are they relevant when measuring ineffectiveness. *[IFRS 9.B6.3.11]*.

Therefore, when calculating the cumulative change in present value of the hedged forecast sales for the purposes of measuring ineffectiveness, no present value change would arise for variation in the price of commodity X above £90 per tonne. Changes in the fair value (present value) of the hedged forecast sales associated with price declines below £90 per tonne form part of the designated cash flow hedge and hence are included within the calculation of ineffectiveness. This can be achieved using a hypothetical derivative taking the form of the intrinsic value of a hypothetical option contract to represent the one-sided risk (see Illustration 7-14 in section 7.4.4 above).

Assuming there are no sources of ineffectiveness (i.e., including no change in credit risk), those changes are offset by changes in the intrinsic value of the put, resulting in zero ineffectiveness to be recognised in profit or loss (see section 7.2 above).

Changes in the time value of the put option are excluded from the designated hedging relationship and the costs of hedging guidance is applied (see section 7.5.1 below).

When hedging a one-sided risk, the hedged risk cannot include the time value of a purchased option, because the time value is not a component of the forecast transaction. *[IFRS 9.B6.3.12]*. Hence if, a purchased option is designated in its entirety as the hedging instrument of a one-sided risk arising from a forecast transaction, additional ineffectiveness will arise, as changes in the fair value of the hedged item will not provide any offset to changes in time value of the hedging instrument. This is consistent with the Implementation Guidance on hypothetical derivatives in IFRS 9 that prohibits the inclusion of features in the value of the hedged item that only exist in the hedging instrument (see section 7.4.4 above). *[IFRS 9.B6.5.5]*.

7.4.12 Hedged items with embedded optionality

As described in section 3.6.4 above, an entity can exclude the time value of the hedging instrument from the hedging relationship when hedging with options. Changes in value of the excluded time value must then be treated as a cost of hedging (see section 7.5 below). Such a strategy is sometimes applied when hedging highly probable forecast cash flows, in which case excluding the time value of the hedging option would most likely achieve a lower level of ineffectiveness from an accounting perspective (see section 7.4.11 above).

However, if the hedged item contains embedded optionality which is matched by optionality within the hedging instrument, including the time value from both the hedged item and hedging instrument in the hedge relationship could result in good levels of offset from the change in value of the hedged item and hedging instrument. This is because there will be a level of offset from changes in the time value of the hedging option and changes in the embedded time value in the hedged item. The following fact patterns provide examples of where there might be offsetting changes in time value:

- Entity A has purchased 10-year fixed rate debt. At the end of years five and seven, the issuer has the option to prepay the debt at par. Entity A could choose to eliminate variability in the fair value of the fixed rate debt by transacting a pay fixed receive floating interest rate swap, with matching prepayment options at five and seven years.
- Entity B has issued floating rate debt which includes an embedded floor (e.g., interest is floored at 0%). Entity B could choose to eliminate the variability in the cash flows above the floor (and lock in current low rates), by transacting a pay fixed and receive floating swap with an embedded floor.

In the case of Entity A above, it is relatively easy to conclude that the change in value of the embedded prepayment option must form part of the effectiveness assessment and measurement of ineffectiveness, as a fair value hedge. However, it is less clear in the case of Entity B since the arrangement would be a cash flow hedge.

IFRS 9 provides guidance on hedge accounting for purchased options hedging a one-sided risk in a forecast transaction. The guidance explains that only the intrinsic value of the option and not the option time value will represent the hedged item because time value is not a component of the forecast transaction that affects profit or loss. Therefore, if an entity designates a purchased option in its entirety, as the hedging instrument of a one-sided risk arising from a forecast transaction, the hedging relationship will not be perfectly effective. In this situation, there will be no offset between the cash flows relating to the time value of the option premium paid and the designated hedged risk. *[IFRS 9.B6.3.12]*.

How we see it

The guidance mentioned above on accounting for purchased options hedging a one-sided risk might be read not to permit including the change in the time value of an embedded option in a hedged item as part of the change in value of the hedged item when measuring ineffectiveness. However, the above guidance was written specifically for forecast transactions that do not include time value, whereas hedged items with embedded optionality do include time value. Therefore, we do not believe that IFRS 9 includes a prohibition on including option time value as part of the change in value of a hedged item that includes optionality.

A further requirement is that a cash flow hedge is a hedge of an exposure to variability in cash flows that could affect profit or loss. *[IFRS 9.6.5.2(b)]*. Arguably, a change in the time value of an embedded option within the hedged item does not affect profit or loss, nor does it result in cash flow variability.

How we see it

We believe that cash flow variability and the potential to affect profit or loss must be demonstrated for the designated hedged risk at the level of the hedged cash flows and not for other factors affecting the fair value of the hedged risk. However, the measurement of ineffectiveness must incorporate the cumulative change in fair value (present value) of the expected future cash flows of the entire hedged item, with respect to the designated hedged risk. The fair value of the hedged cash flows, which include the embedded optionality, includes the time value and not just the intrinsic value.

Further support for the above view is provided by the requirement that, when measuring ineffectiveness, it is not acceptable only to compare the cash flows of the hedged item and hedging instrument, since it is also necessary to consider the time value of money by discounting those cash flows. *[IFRS 9.B6.5.4]*. This is despite the fact that the time value of money does not affect profit or loss or cause variability in the cash flows in a cash flow hedge, but is considered a factor in the cumulative fair value (present value) of the future cash flows (consistent with IFRS 9.6.5.11(a)(ii)). This is also consistent with the requirement that the time value of any embedded optionality within the hedged item with respect to the hedged risk must be considered when measuring ineffectiveness, irrespective of whether the associated hedging instrument also has optionality. For a cash flow hedge, this can be achieved by using a hypothetical derivative that also reflects the embedded optionality (see section 7.4.4 above).

Other risk management strategies might arise whereby hedged items with optionality are economically hedged using hedging instruments without optionality, such as hedging floored or prepayable debt instruments against changes in interest rates using vanilla interest rate swaps. In that case it is not permitted to isolate only certain features in the hedged item that contribute to the change in fair value (present value) due to the hedged risk (e.g., interest rate risk) in order to better match the features of the hedging instruments. All the features of the hedged item whose fair value is affected by changes in the hedged risk must be included in the hedge relationship, otherwise the measurement of hedge effectiveness would not include the full fair value change with respect to the hedged risk. *[IFRS 9.BC6.204]*.

Instances could arise whereby the fair value of the embedded option clearly varies due to factors other than the hedged risk. For example, in the case of prepayable mortgages the fair value of the embedded prepayment option might change due to a shift in house prices, tax regime or other regulations. Where a specified risk component is designated, only changes in the fair value of the embedded option due to changes in the specified risk component are included as part of the change in value of the hedged item (see section 2.2.1 above). *[IFRS 9.B6.3.11, IFRS 9.B6.4.1]*. However, if there is uncertainty as to the factors that gave rise to the change in fair value of an embedded option, or it is not possible to separate reliably the change that arises from the hedged risk from changes relating to other factors, then the change is assumed to arise from the hedged risk. *[IAS 39.AG121]*. Further, where changes in the other factors (i.e., not the specified risk component) result in actual changes to the hedged cash flows, that cannot be ignored for hedge accounting purposes, in particular if the hedged cash flows no longer exists as a result.

7.5 Accounting for the costs of hedging

From a risk management perspective, entities typically consider the premium paid on an option (which, on inception, is often only time value), the forward element in a forward contract and any foreign currency basis spread, as a cost of hedging rather than a trading position. Economically, these 'costs' could be considered as a premium for protection against risk (i.e., an 'insurance premium'). *[IFRS 9.BC6.387]*. The IASB acknowledged these concerns when developing IFRS 9 and included a specific accounting treatment for changes in the fair value of the time value of an option contract, the forward element in a forward contract and foreign currency basis spread, to be excluded from the hedging instrument (see section 3.6 above) and treated separately. *[IFRS 9.6.2.4]*.

The excluded forward elements of forward contracts and foreign currency basis spreads can either remain at fair value through profit or loss, or be treated as 'costs of hedging', however, for the excluded time value of options the latter treatment is mandated. The 'costs of hedging' guidance in IFRS 9 is included in IFRS 9.6.5.15 and 6.5.16 and the associated application guidance in IFRS 9.B6.5.29 to 39. It must not be used by analogy more widely to exclude other portions not explicitly identified in the guidance (see section 3.6 above). *[IFRS 9.BC6.297]*.

On application of the costs of hedging accounting, fluctuations over time in the fair value of the time value of options, the forward element of forward contracts or foreign currency basis spreads, is recorded in other comprehensive income instead of affecting profit or loss immediately. Although the costs of hedging will ultimately be recognised in profit or loss, this will be in a manner consistent with the risk management activity.

It is important to note that because this accounting for 'costs of hedging' only applies if the time value of the option, the forward element of forward contracts or foreign currency basis spreads are excluded from the designation of the hedging relationship, the amounts deferred in other comprehensive income are not part of the cash flow hedge (or foreign currency reserve) but instead a different component of equity. The cash flow hedge reserve (or foreign currency reserve) only includes amounts that are gains or losses on hedging instruments that are determined to be an effective hedge (i.e., amounts that are included in the designation of a hedging relationship) (see section 7.4 above).

7.5.1 Time value of options

The fair value of an option consists of its intrinsic value and its time value. An entity can either designate an option as a hedging instrument in its entirety, or it can separate the intrinsic value and the time value and designate only the intrinsic value (see section 3.6.4 above). *[IFRS 9.6.2.4(a)]*.

If the option is designated in its entirety as a hedge of a non-option item, changes in the portion of the fair value attributable to the option time value result in ineffectiveness (see section 7.4.11 above). This is because only changes in the intrinsic value of the option will provide offset to the fair value changes attributable to the hedged risk. (The situation is different if the hedged item also includes optionality, see section 7.4.12 above, or if a delta-neutral hedging strategy is applied, see section 6.3.2 above). Depending on the level of ineffectiveness from changes in the time value, an entity could have difficulty determining that there is an economic relationship between the hedged item and the hedging option (see section 6.4.1 above).

If an entity chooses to exclude the time value from the designated hedging instrument it must apply the costs of hedging guidance, such that changes in the fair value of the time value of options (to the extent that they relate to the hedged item) are first recognised in OCI. Calculation of the extent to which the fair value changes relate to the hedged item requires the determination of a theoretical 'aligned instrument' based on the hedged item (see section 7.5.1.A below)). *[IFRS 9.6.5.15]*. It is worth noting that this treatment is not an accounting policy choice, as the treatment must be applied for all hedge relationships for which only the intrinsic value of the hedging option is designated within the hedge relationship. The subsequent treatment depends on the nature of the hedged transaction.

The standard differentiates between transaction related hedged items and time-period related hedged items: *[IFRS 9.6.5.15, IFRS 9.B6.5.29]*

- Transaction related hedged items: the time value of an option used to hedge such an item has the character of part of the cost of the transaction. Examples would be a hedge of forecast purchases of inventory or property, plant and equipment, and forecast sales or purchases, as well as purchases or sales resulting from firm commitments. It would also include hedging the foreign currency risk in a forecast acquisition of a business (see section 2.6.4 above).

  The amount that is accumulated in OCI is removed similarly to amounts accumulated in the cash flow hedge reserve (see section 7.2.2 above).

  So if the hedged transaction subsequently results in the recognition of a non-financial item (e.g., purchase of inventory or property, plant and equipment) the amount becomes a 'basis adjustment' (see Illustration 7-17 Case 3 in section 7.4.7 above for a worked example). This treatment is also applied in the hedge of a forecast business acquisition (see section 7.6 below).

  For other hedged transactions (e.g., forecast sales) the amount is reclassified to profit or loss in the same period or periods during which the hedged cash flows affect profit or loss.

- Time-period related hedged items: the time value of an option used to hedge such an item has the character of the cost of protection against a risk over a particular period of time (rather than a hedge of a transaction for which the transactions costs are accounted for as part of a one-off event).

  The amount that will be accumulated in OCI is amortised on a systematic and rational basis to profit or loss as a reclassification adjustment (see Illustration 7-18 Case 2 in section 7.4.7 above for a worked example). The amortisation period is the period during which the hedge adjustment for the option's intrinsic value could affect profit or loss (or other comprehensive income if the option is designated as the hedging instrument in a fair value hedge of an equity instrument accounted for at fair value through other comprehensive income (see section 2.6.3 above)). The appropriate amortisation period is illustrated in Illustration 7-20 below. *[IFRS 9.6.5.15]*.

  Examples of time-period related hedged items are hedges of interest expense or income in particular periods, already purchased inventory hedged for fair value changes, or a hedge of a net investment in a foreign operation. In the case of a forward starting interest rate option, the time value would be amortised over the interest periods that the option covers (i.e., the amortisation period would exclude the initial part of the option's life). *[IFRS 9.B6.5.30]*.

Illustration 7-20: Amortisation of time value of an option hedging a time-period related hedged item

If an interest rate option (a cap) is used to provide protection against increases in the interest expense on a floating rate bond, and for which the critical terms of the option and hedged item match, the time value of the cap is amortised to profit or loss as follows:

(a) If the cap hedges increases in interest rates for the first three years out of a total life of the floating rate bond of five years, the time value of that cap is amortised over the first three years.

Or

(b) If the cap is a forward starting option that hedges increases in interest rates for years two and three out of a total life of the floating rate bond of five years, the time value of that cap is amortised during years two and three. *[IFRS 9.B6.5.30]*.

By default, the time value will be zero at expiry of an option contract. For a transaction related hedged item, recognising the fair value changes of the time value in OCI means that on expiry, the aligned time value (i.e., the time value associated with the theoretical aligned instrument) that existed at designation will have accumulated in OCI (see section 7.5.1.A below). As mentioned above, once the hedged transaction happens, the accounting for the accumulated time value follows the accounting for any changes in fair value of the intrinsic value of the option recorded in the cash flow hedge reserve. *[IFRS 9.6.5.15(b)]*. Illustration 7-21 below illustrates how the costs of hedging accounting might be applied for a transaction related hedged item.

Illustration 7-21: Hedging the purchase of equipment (transaction related)

In the first quarter of a year, a manufacturing entity plans to purchase a new machine for its manufacturing process. Delivery of the machine is expected in the third quarter and the purchase price will be Swedish Krona (SEK) 5m. The entity has the Norwegian Krone (NOK) as its functional currency and, therefore, is exposed to foreign currency risk on this forecast transaction. The entity buys a call option to purchase SEK 5m in the third quarter, as it wishes to hedge the downside risk only. The terms of the option match the terms of the forecast transaction. The entity designates only the intrinsic value of the call option in a cash flow hedge of the highly probable forecast purchase of the machine.

At inception, the time value of the option amounts to NOK 30,000. The time value of the option amounts to NOK 16,000 at the end of the first quarter, NOK 7,000 at the end of the second quarter and zero at maturity.

Applying the IFRS 9 accounting requirements to the time value of the option results in the following movement within other comprehensive income (OCI), specifically the reserve within equity for accumulating amounts in relation to the time value of options associated with transaction related hedged items:

(All amounts in NOK thousands)	Q1	Q2	Q3
Reserve at beginning of quarter	-	(14)	(23)
Change in time value of option	(14)	(9)	(7)
Basis adjustment to machine			30
Reserve at end of quarter	**(14)**	**(23)**	**-**
Effect on OCI for the period	(14)	(9)	23

In the illustration above, the critical terms of the actual option match the terms of the forecast transaction and so the aligned time value matches that of the actual option. Consequently, the full change in the actual time value is taken to OCI as a cost of hedging. This will not always be the case, so it cannot be assumed that the aligned time value equals the actual time value (see section 7.5.1.A below).

As noted above, by default, the time value will be zero at expiry of an option contract. For a time-period related hedged item, recognising the fair value changes of the time value in OCI means that on expiry, the time value that existed at designation will have accumulated in OCI. For time-period related hedged items, the amount accumulated in OCI is amortised on a 'systematic and rational basis' to profit or loss, however the standard does not prescribe what on a 'systematic and rational basis' means in this context. *[IFRS 9.6.5.15(c)]*. A straight-line amortisation is likely to be appropriate in most cases.

Illustration 7-22: Hedging interest rate risk of a bond (time-period related) (1)

An entity issues a seven-year floating rate bond and wishes to protect itself against increases in the interest expense for the first two years. Therefore, the entity purchases an interest rate cap with a maturity of two years. The terms of the option match all other terms of the floating rate bond. Only the intrinsic value of the cap is designated as a hedging instrument in a cash flow hedge.

The time value on designation is CU20, which is amortised to profit or loss on a straight-line basis over the protection period (i.e., the first two years). The time value of the option amounts to CU13 at the end of the first year and zero at maturity.

Applying the IFRS 9 accounting requirements to the time value of the option results in the following movement within other comprehensive income (OCI), specifically the reserve within equity for accumulating amounts in relation to the time value of options associated with time-period related hedged items:

	Year 1	Year 2
Reserve at beginning of year	-	3
Change in time value of option	(7)	(13)
Amortisation of time value at inception	10	10
Reserve at end of year	**3**	**-**
Effect on OCI for the year	3	(3)
Effect on profit or loss for the year	(10)	(10)

How we see it

The standard is not prescriptive as to where in profit or loss the costs of time-period hedges accumulated in OCI is recycled. If the time value is considered akin to an insurance premium (the 'insurance premium view' mentioned previously (see section 7.5 above)), then it would follow that the cost could be reflected in the same line as profit or loss on the hedged item is recorded. This would be an accounting policy choice since the standard is not clear. However, when hedging forecast sales or purchases, one acceptable treatment would be presentation within the financial expense/income line item.

If hedge accounting is discontinued for a time-period related hedge relationship for which the costs of hedging treatment has been applied to the time value of the hedging option, the net amount (i.e., including cumulative amortisation) that has been accumulated in OCI must be immediately reclassified to profit or loss as a reclassification adjustment. This appears to be the case whether or not the hedged item is still expected to occur. This would reflect that the reason for amortising the amount would no longer apply after the insured amount (i.e., the hedged item) no longer qualifies for hedge accounting. *[IFRS 9.6.5.15(c), IFRS 9.BC6.399]*. In contrast, there is no equivalent guidance for discontinuation of transaction related hedges when the transaction is still expected to take place, and so there does not seem to be a need to reclassify the net amount accumulated in OCI immediately to profit or loss in that scenario. However, consideration as to the recoverability of amounts in other comprehensive income with respect to transaction related hedges might be required (see section 7.2.1 above). *[IFRS 9.BC6.399]*.

The accounting for the time value of options would also apply to combinations of options, for example, when hedging a highly probable forecast transaction with a zero-cost collar. When designating the intrinsic value only, the volatility resulting from changes in the time values of the two options would be recognised in other comprehensive income. However, the amortisation (in the case of time-period related hedged items) or the transaction costs deferred at the end of the life of the hedging relationship (for transaction related hedged items) would be nil when using a zero-cost collar, as the cumulative change in time value over the period would be nil. *[IFRS 9.B6.5.31]*.

7.5.1.A Aligned time value

Illustration 7-21 and Illustration 7-22 above both assume that the critical terms of the option match the hedged item. However, in practice, this is not always the case. The accounting treatment described above applies only to the extent the time value relates to the hedged item. Accordingly, an additional assessment has to be made if the critical terms of the option do not match the hedged item, to determine the extent to which this is the case. For that purpose, the actual time value has to be compared with that of a hypothetical option that perfectly matches the critical terms of the hedged item (in IFRS 9 referred to as the 'aligned time value'). *[IFRS 9.B6.5.32]*.

When the terms of the option are not aligned with the hedged item, the accounting for the time value in situations in which the aligned time value exceeds the actual time value is different to situations in which the actual time value exceeds the aligned time value. *[IFRS 9.B6.5.33]*.

If, at inception, the actual time value exceeds the aligned time value:

- The aligned time value at inception is treated in line with the general requirements outlined in section 7.5.1 above, depending on whether it is a time period or transaction related hedged item
- The change in the fair value of the aligned time value is recognised in OCI

  And
- The remaining difference in change in fair value between the actual time value and the aligned time value is recognised in profit or loss

If, at inception, the aligned time value exceeds the actual time value:

- The actual time value at inception is treated in line with the general requirements outlined in section 7.5.1 above, depending on whether it is a time period or transaction related hedged item except as follows:
  - The lower of the cumulative change in the fair value of the actual time value and the aligned time value is recognised in OCI

    And
  - The remaining difference in change in fair value between the actual time value and the aligned time value, if any, is recognised in profit or loss *[IFRS 9.B6.5.33]*

For the hedging strategy introduced in Illustration 7-22 above, this would change the accounting as follows:

Illustration 7-23: Hedging interest rate risk of a bond (time-period related) (2)

Scenario 1: Actual time value exceeds aligned time value

The actual time value at inception is CU20, and over time follows the same pattern as in Illustration 7-22 above. The aligned time value at inception is CU15. The aligned time value of the option amounts to CU9 at the end of the first year and zero at maturity.

	Year 1	Year 2
Change in actual time value of option	(7)	(13)
Change in aligned time value of option	(6)	(9)
Reserve in equity at beginning of year	**-**	**1.5**
Change in time value of option (based on aligned time value)	(6)	(9)
Amortisation of time value at inception (based on aligned time value)	7.5	7.5
Reserve in equity at end of year	**1.5**	**-**
Effect on OCI for the year	1.5	(1.5)
Remaining change in (actual) time value recognised in profit or loss (difference between the change in aligned time value and the actual time value of the option)	(1)	(4)
Effect on profit or loss for the year	(8.5)	(11.5)

The above accounting treats the difference between the actual and the aligned time value, consistent with its default classification, as a derivative at fair value through profit or loss.

Scenario 2: Actual time value is lower than aligned time value

The actual time value at inception is CU20, and over time follows the same pattern as in Illustration 7-22 above. The aligned time value at inception is CU24. The aligned time value of the option amounts to CU10 at the end of the first year and zero at maturity.

	Year 1	Year 2
Change in actual time value of option	(7)	(13)
Change in aligned time value of option	(14)	(10)
Reserve in equity at beginning of year	**-**	**3**
Change in time value of option (based on the lower of the cumulative change in aligned time value and actual time value)	(7)	(13)
Amortisation of time value at inception (based on actual time value)	10	10
Reserve in equity at end of year	**3**	**-**
Effect on OCI for the year	3	(3)
Remaining change in (actual) time value recognised in profit or loss (zero, because the aligned time value of the option exceeds the actual time value of the option at inception)	-	-
Effect on profit or loss for the year	(10)	(10)

The above 'lower of test' for the accounting of the time value ensures that the entity does not recognise more expense in profit or loss than the entity actually incurs (based on the time value at inception). *[IFRS 9.BC6.398]*. In this scenario, over the life of the option the cumulative change in fair value of the actual time value will always be lower than the cumulative change in fair value of the aligned time value, because the actual time value was lower at inception of the hedge relationship.

IFRS 9 does not define the 'aligned time value' in much detail but it is clear that it is a key part of the concept of 'costs of hedging'. However, guidance is provided such that an entity determines the aligned time value using the valuation of the option that would have critical terms that perfectly match the hedged item. The nominal amount, life and underlying of the option are mentioned as examples of critical terms that would be expected to be matched if the option was fully aligned with the hedged item. However, this is not an exhaustive list and in the case of a hedge of one sided risk, in order to determine how much of the option premium relates to the hedged item, it is also necessary for the aligned option to represent the one sided hedged risk, even though it does not appear within the hedged item (see section 2.1 above). This is achieved by setting a strike price within the aligned option such that the intrinsic value is zero at inception of the hedge. The same issue arises in the determination of a hypothetical derivative for a one sided risk (see Illustration 7-14 in section 7.4.4 above). Accordingly, in Illustration 7-14 the strike price in the aligned derivative for Scenario 3 would be restricted to the prevailing market price of the underlying commodity at the date of designation. *[IFRS 9.B6.5.32]*.

Although the aligned instrument is derived from the critical terms of the hedged item, this should be understood to be the designated components of the hedged item (see section 2.1 above). For example, if the hedged item was designated only for a partial term, then the aligned instrument would reflect that partial term, rather than the full life of the hedged item (see section 2.2.4 above). *[IFRS 9.B6.3.11]*.Further, it makes sense that regular pricing features are part of the aligned time value of an option, reflecting that they are part of the fair value of the financial instrument whose intrinsic value is designated as the hedging instrument. This is different from using a hypothetical derivative, which has the purpose of measuring the hedged item. For that purpose, features that are only in the hedging instrument but not the hedged item cannot be taken into account. This rationale does not apply for the purpose of accounting for the costs of hedging. This becomes clearer from the example of the foreign currency basis spread (see section 7.5.3 below); it cannot be included as part of a hypothetical derivative to measure the hedged item, but it is a cost of hedging.

However, similar to the need to update a hypothetical derivative to reflect changes in the timing of a forecast hedged item (see section 7.4.4 above), if expectations of the forecast transaction are revised, the terms of the 'aligned' instrument will need to be updated to reflect the change in timing. The updated aligned instrument must match all of the critical terms of the forecast transaction, as if the amended terms were known at inception of the hedge. A true up to the costs of hedging reserve and associated profit or loss for the cumulative effect of the revised aligned time value will be required.

7.5.2 Forward element of forward contracts

Entities using forward contracts in hedging relationships can designate the instrument in their entirety or exclude the forward element by designating the spot element only. The forward element is the difference between the spot and forward prices of currency forward contracts and cross currency interest rate swaps, representing the differential between the interest rates of the two currencies involved. When only the spot element is designated, an entity has a choice to apply costs of hedging accounting to the excluded forward element. This is, however, not an accounting policy choice, but an election for each designation. *[IFRS 9.6.5.16]*. If the costs of hedging guidance is not applied, designating the spot element of a forward contract results in the forward points (often also called the 'forward element') being accounted for at fair value through profit or loss (see section 3.6.5 above).

When designating the entire hedging instrument, it is usually desirable for the hedged item also to be measured at the forward rate instead of the spot rate in order to enhance effectiveness. For example, when hedging a highly probable forecast transaction, the hedged item, once transacted, could be measured with respect to the forward rate if the 'forward rate method' is designated (see section 7.4.7 above). However, the forward rate method does not provide a similar solution for hedges of foreign currency monetary items because of the IAS 21 requirement for such assets and liabilities to be measured at the spot rate. *[IFRS 9.BC6.422]*. See Illustration 7-17 in section 7.4.7 above for examples of how hedge accounting can differ when designating the spot or forward rate and on the application of the costs of hedging guidance.

When designating the spot element and applying the costs of hedging to the forward element, the change in fair value of the forward element is recognised in OCI and accumulated in a separate component of equity. The accounting for the forward element that exists at inception also follows the distinction between transaction related hedged items and time-period related hedged items that is made when accounting for the time value of an option (see in section 7.5.1 above). This means, in the case of a transaction related hedged item, that the change in the fair value of the forward element is deferred in OCI and included, like transaction costs, in the measurement of the hedged item (or it is reclassified to profit or loss when a hedged sale occurs). In case of a time-period related hedged item, the forward element that exists at inception is amortised from the separate component of equity to profit or loss on a systematic and rational basis. For example, if commodity inventory is hedged against changes in fair value for six months using a commodity forward contract with a corresponding life, the forward element of the forward contract would be allocated to profit or loss on a systematic and rational basis over that six month period. *[IFRS 9.6.5.16, IFRS 9.B6.5.34, IFRS 9.B6.5.35, IFRS 9.B6.5.36]*.

As a result of the above accounting, fluctuations in the fair value of the forward element over time will affect OCI, and the amount accumulated in OCI will be recognised in profit or loss when the hedged item affects profit or loss (in the case of a transaction related hedged item), or be amortised to profit or loss (in the case of a time-period related hedged item). The following Illustration is designed to demonstrate the accounting for the forward element of a hedging derivative, as a cost of hedging. The fact pattern is intentionally simplified in order to isolate the costs of hedging accounting.

Illustration 7-24: Funding swaps - designating the spot risk only and using costs of hedging accounting

A bank, having the Singapore Dollar (SGD) as its functional currency, borrows money by entering into a two-year zero coupon loan denominated in Japanese Yen (JPY). The loan is accounted for at amortised cost. The bank transfers the JPY funds into its functional currency and lends the money as a SGD denominated two-year zero coupon loan. To hedge the SGD/JPY exchange risk, the bank enters into a foreign currency forward contract to buy JPY against SGD in two years' time and designates it as a hedge of the spot JPY foreign currency risk. The fair value of the forward element at inception is SGD 20,000 and it is SGD 13,000 at the end of the first year and zero at maturity.

From an economic standpoint, the bank has now hedged the foreign currency risk and locked in the interest margin for the entire two-year period.

In economic theory, the forward points represent the difference in interest rates between the two currencies involved. Hence, the forward element that exists at inception is seen as one element of the interest margin, although other elements also exist (see section 7.5.3 below).

Applying the accounting for costs of hedging to the forward element of the forward contract results in the following movement within other comprehensive income (OCI):

(All amounts in SGD thousands)	Year 1	Year 2
Reserve in equity at beginning of year	-	3
Change in fair value of forward element	(7)	(13)
Amortisation of forward element at inception	10	10
Reserve in equity at end of year	3	-
Effect on OCI for the year	3	(3)
Effect on profit or loss for the year	(10)	(10)

The bank could present the amortisation of the forward element in the income statement as part of interest expense from the borrowing, so that when considered together with the interest income from the loan, the reported interest margin reflects the combined transaction, economically fixed in SGD (see Chapter 50 at section 7.1.3).

The forward element costs of hedging treatment is not solely applicable for simple foreign currency forward contracts, but applies equally to forward contracts with respect to other risks, such as commodity or interest rate. *[IFRS 9.BC6.416]*. We would also expect the treatment to apply to a fixed-for-fixed currency swap as arguably that is no more than a series of forward contracts applying a blended rate. However, if the hedging instrument was a currency swap with two floating-rate legs which did not have the effect of locking in a net interest margin in combination with the hedged item (e.g., in the hedge of a net investment (see section 7.3.4 above)), there is no eligible forward element to apply the costs of hedging guidance to. *[IFRS 9.BC6.423, IFRS 9.BC6.424]*. In addition, foreign currency contracts, such as forward contracts or currency swaps, usually attract foreign currency basis spreads, this too can be excluded from the hedge relationship and treated a as cost of hedging (see section 7.5.3 below).

Just like the accounting for the time value of an option, the accounting for the forward element as a cost of hedging applies only to the extent of the so-called 'aligned' forward element (i.e., only to the extent that the forward element relates to the hedged item - see section 7.5.1.A above). *[IFRS 9.B6.5.37]*.

How we see it

Although not explicitly mentioned in the guidance, we believe that the aligned forward element must be based on prevailing forward rates on designation, as otherwise the aligned forward element would include costs that do not relate to the hedged risk. This means that if an existing forward contract with a non-zero fair value is designated as hedging a hedged item for which the notional, residual life, and underlying all match the forward contract, it cannot be assumed that the forward element of the off-market hedging forward contract will be the same as the aligned forward contract.

Further, it is acceptable for the type of aligned instrument to match that of the actual instrument where that makes sense, for example if a fixed-for-fixed cross-currency swap is the hedging instrument it is likely to be acceptable for the aligned instrument also to be a fixed-for-fixed cross-currency swap, rather than a series of individual aligned forward contracts. The critical terms of the aligned fixed-for-fixed cross-currency swap would however still be driven by the critical terms of the hedged item, such as nominal amount, life and underlying, rather than assume they are necessarily the same as the actual hedging swap (see section 7.5.1.A above). *[IFRS 9.B6.5.37]*.

The above discussion focuses on the costs of hedging accounting where the forward element is excluded from the hedging instrument. It should be noted that most foreign currency instruments also include foreign currency basis spreads which can also be excluded from hedging instruments (see section 7.5.3 below).

7.5.2.A Forward element of forward contracts in a net investment hedge

It is possible to designate the forward rate as the hedged risk in a net investment hedge (see sections 7.3.3 and 7.3.4 above), but for some entities it might be preferable to designate only the spot rate, so a question arises as to the accounting treatment of the excluded forward element in a net investment hedge. The costs of hedging guidance (see section 7.5 above) is not specific to a particular type of hedge relationship, accordingly it can be applied to fair value, cash flow and net investment hedges (see section 5 above). In fact, the application guidance to IFRS 9, includes a net investment hedge as an example of a fact pattern for which the costs of hedging accounting could be applied. The example given is of a time-related hedge: a net investment that is hedged for 18 months using a foreign-exchange option, which would result in allocating the time value of the option to profit or loss over that 18-month period. *[IFRS 9.B6.5.29(b)]*. This guidance also confirms that for the purposes of accounting for the costs of hedging, a hedge of a net investment would ordinarily be treated as a time-period related hedge, in particular as in most cases there is no expectation of a hedged transaction (see section 7.5.1 above).

The application of the costs of hedging guidance to the excluded forward element of a forward contract is not an accounting policy choice, but an election for each designation. *[IFRS 9.6.5.16]*. If the costs of hedging guidance is not applied, designating the spot element of a forward contract in a net investment hedge results in the forward element being accounted for at fair value through profit or loss (see sections 3.6.5 and 7.3.4 above).

The costs of hedging accounting can only be applied to the extent that it relates to the hedged item, this is achieved by comparison with an 'aligned hedging instrument' (see section 7.5.1.A above). *[IFRS 9.6.5.15]*. The aligned hedging instrument must match the critical terms of the hedged item. *[IFRS 9.B6.5.37]*. Where the hedged item is a financial instrument or a forecast transaction for which specific terms exist, determining the aligned hedging instrument is relatively straight forward. However, given that a net investment hedge is largely an accounting concept, identifying appropriate terms for an aligned hedging instrument is more difficult. This issue also arises when determining a hypothetical derivative in a net investment hedge using a derivative (see section 7.3.3.B above).

Given that it is possible to designate the forward rate as the hedged risk in a net investment hedge and assess effectiveness using a hypothetical forward contract (see section 7.3.3.A above), it is relatively easy to conclude that an aligned hedging instrument for a net investment hedge could similarly be a simple forward. As a fixed-for-fixed cross-currency swap is generally considered to be a series of forwards, it would therefore also seem logical that a fixed-for-fixed cross-currency swap would be an acceptable aligned instrument, if consistent with the designation of the hedge relationship (see section 7.3.3.B above). There are various choices on designation that will influence the form taken by the aligned instrument in the hedge of a net investment using a derivative (see section 7.3.4 above).

Although the above analysis focuses on accounting for any excluded forward element in a net investment hedge, it is also relevant to foreign currency basis spreads (see section 7.5.3 below).

7.5.3 Foreign currency basis spreads in financial instruments

The foreign currency basis spread, a phenomenon that became very significant during the financial crisis, is a charge embedded in financial instruments that compensates for aspects such as country and liquidity risk as well as demand and supply factors. This charge only applies to transactions involving the exchange of foreign currencies at a future point in time (as, for example, in currency forward contracts or cross-currency interest rate swaps (CCIRS)).

Historically, the difference between the spot and forward prices of currency forward contracts and CCIRS only represented the differential between the interest rates of the two currencies involved, referred to as the forward element of forward contracts (see section 7.5.2 above). However, basis spreads increased significantly during the financial crisis and during the subsequent sovereign debt crisis and have become a significant and volatile component of the pricing of longer term forward contracts and CCIRS.

The standard cites currency basis spread as an example of an element that is only present in the hedging instrument, but not in a hedged item that is a single currency instrument. Consequently, this would result in some ineffectiveness even when using a hypothetical derivative for measuring ineffectiveness (see section 7.4.8 above). *[IFRS 9.B6.5.5]*.

When using a foreign currency forward contract or a CCIRS in a hedge, the foreign currency basis spread is an unavoidable 'cost' of the hedging instrument. Hence IFRS 9 permits the accounting for foreign currency basis spreads as a 'cost of hedging', similar to the time value of options and the forward element of forward contracts.[26] This means that, when designating a hedging instrument, an entity can exclude the foreign currency basis spread and account for it separately as a cost of hedging, in the same way as the accounting for time value of options or the forward element of forward contracts, as described in sections 7.5.1 and 7.5.2 above. *[IFRS 9.6.5.16, IFRS 9.B6.5.39]*.

The costs of hedging accounting treatment only applies to the extent the excluded time value of options, the forward element of forward contracts or foreign currency basis spread relates to the hedged item. IFRS 9 introduced the concept of an aligned instrument in order to calculate the extent to which the excluded portion relates to the hedged item (see section 7.5.1.A above). Similar to the requirements for determining a hypothetical derivative (see section 7.4.4 above), the aligned instrument must be based on the critical terms of the hedged item. However, an important distinction is that the aligned instrument will also include regular pricing features that would ordinarily be included in the perfect hedging instrument, e.g., foreign currency basis spreads. *[IFRS 9.B6.5.32]*.

How we see it

In a hedge of a net investment for which the hedged item has no cash flows on which the aligned foreign currency basis instrument can be based, we believe the critical term is the designated amount of foreign currency net investment. When constructing the aligned foreign currency instrument on designation of the hedge, other pricing features that relate to foreign currency basis and the risk management objective for the hedge relationship will necessarily have to be determined based on available hedging instruments at the time of designation. See Illustration 7-25 below for an example of how this might be applied.

Illustration 7-25: Hedge of a net investment with a floating-floating cross-currency swap, using costs of hedging accounting

Entity B, with a USD functional currency, has a GBP100m net investment in wholly owned Subsidiary X. B wishes to hedge the foreign currency translation risk from the GBP net investment in X and so transacts a 5 year cross-currency swap with a GBP pay leg and USD receive leg, both attracting a floating-rate of interest. The GBP notional of the swap is GBP100M. The swap is transacted at prevailing market rates and so initially has a zero fair value.

B designates the swap as the hedging instrument in a hedge of the spot foreign currency risk in a net investment hedge of the GBP100m net investment in X. B chooses to apply the costs of hedging accounting to the excluded foreign currency basis spreads.

The aligned instrument would also be a 5 year floating-floating cross-currency swap constructed of a GBP pay leg with a notional of GBP100m, and an equivalent USD receive leg based on prevailing market rates. The aligned instrument initially also has a zero fair value.

The aligned instrument therefore reflects the critical terms of the hedged item (i.e., the designated GBP100m net investment), the risk management objective (i.e., 5 year maturity) and the pricing feature with respect to foreign currency basis transacted (i.e., two floating legs). This aligned instrument can then be used to calculate the amount to be accumulated in a separate component of equity representing the cost of hedging related to foreign currency basis spread (see Illustration 7-26 in section 7.5.3.A below).

In this example the aligned instrument is the same as the actual hedging instrument, but this will not always be the case, in particular if using a hedging instrument with a non-zero fair value on designation.

Further, it is important to note that the aligned instrument in this example is constructed to reflect only the cost of hedging with respect to foreign currency basis. It would not be appropriate to apply the cost of hedging to the forward rate as well in this fact pattern, as the two floating-rate legs of the hedging instrument do not have the effect of locking in an interest differential. In that case there is no eligible forward element to apply the costs of hedging guidance to (see section 7.5.2 above). *[IFRS 9.BC6.423, IFRS 9.BC6.424]*.

Consistent with the approach to designation of the forward element as a cost of hedging, designation of foreign currency basis as a cost of hedging is not an accounting policy choice, but an election for each designation. However, if an entity designates the entire hedging instrument, fair value changes due to changes in the foreign currency basis spread would result in some ineffectiveness (see section 7.4.8 above).

26 *IASB Update*, January 2013, available on the IFRS Foundation's website.

It might be the case for some hedging instruments that contain both a forward element and foreign currency basis that it is more operationally efficient to designate only the spot risk and calculate the combined cost of hedging, rather than the forward element and foreign currency basis individually, or designating the forward rate and excluding only the foreign currency basis spread. Where the combined cost of hedging is selected, and only where no other sources of ineffectiveness arise, the combined cost of hedging for both a forward element and foreign currency basis could be determined as the residual fair value change after the relevant value change due to spot risk has been calculated (see section 7.3.4 and Illustrations 7-17 and 7-18 in section 7.4.7 above). The standard does not explicitly permit a combined treatment, but for many scenarios the aggregate of the individual costs of hedging accounting will equate to the costs of hedging accounting calculated on a combined basis.

7.5.3.A Measurement of the costs of hedging for foreign currency basis spread

Although the standard is clear that the costs of hedging accounting method can be applied to the foreign currency basis spread within hedging instruments, it is less clear as to how to identify the foreign currency basis spread for this purpose. We outline below two possible approaches for the identification of the foreign currency basis spread; other acceptable approaches could exist:

Approach 1: Based on the difference between the fair value of the actual foreign currency hedging instrument and the value of a hypothetical instrument derived and valued using market data excluding foreign currency basis spread. In this approach, the hypothetical instrument does not include any basis spread adjustment and has a fair value of zero based on market curves, excluding foreign currency basis spread.

Approach 2: Based on the difference between the fair value of the actual foreign currency hedging instrument and its value calculated using market data excluding foreign currency basis spread. In this approach, the hypothetical instrument includes a basis spread adjustment and has a non-zero fair value based on market curves, excluding foreign currency basis spread. This value at inception must be amortised from other comprehensive income into profit or loss on a systematic and rational basis.

Illustration 7-26: Calculation of the value of foreign currency basis spread

Entity A has functional currency of GBP and issued three year USD100m fixed rate debt on 31/12/X0, paying a semi-annual coupon of 3.75%. In order to eliminate variability in the fair value of the debt with respect to interest rate and foreign currency risk, Entity A transacted a foreign currency swap (Swap A) on the same day as follows:

Pay leg - GBP64.2m paying 6m benchmark interest rate +2.757% (semi-annual) maturing on 31/12/X3

Receive leg - USD100m paying 3.75% (semi-annual) maturing on 31/12/X3

The spread of 2.757% on the GBP floating leg includes an amount of -0.103% that represents the foreign currency basis spread priced into the swap contract. (Quoted prices for foreign currency basis spreads for many currency pairs are widely available).

Entity A designates the debt and Swap A in a fair value hedge of foreign currency and interest rate risk, and wishes to apply the costs of hedging approach to the foreign currency basis spread. The hedge is a time-period related hedge (see section 7.5.1 above).

The receive leg of Swap A matches the cash flows from the debt exactly. As the critical terms of the foreign currency basis swap are aligned with the hedged debt, there is no need to create an aligned foreign currency basis swap (see section 7.5.1.A above). For the purposes of this example no other valuation sources of ineffectiveness arise, although this is unlikely to be the case in practice.

Below are two possible approaches to calculating the value of the foreign currency basis spread to be recognised in other comprehensive income as part of the costs of hedging:

Approach 1 - Swap B

Entity A creates hypothetical Swap B. The receive leg of Swap B will exactly match the receive leg of Swap A (which also matches the debt). The pay leg of Swap B must be derived to achieve an overall zero fair value for Swap B on designation, based on market curves, excluding foreign currency basis spread. Accordingly, Swap B might look like the following:

Pay leg - GBP64.2m paying 6m benchmark interest rate +2.86% (semi-annual) maturing on 31/12/X3

Receive leg - USD100m paying 3.75% (semi-annual) maturing on 31/12/X3

(The spread of 2.86% on the GBP floating leg does not include an amount representing foreign currency basis spread).

The accounting for the hedge relationship would be as follows:

Instrument	Fair value on designation	Accounting
Debt	Nil	Value changes due to foreign currency and interest rate risk (using discount curves that do not reflect foreign currency basis spread) are recognised in profit or loss, and adjust the carrying value of the debt. (The recognised changes in value of the debt will be offset by changes in the fair value of Swap B's receive leg).
Swap B (hypothetical swap)	Nil	Changes in fair value due to foreign currency and interest rate risk (using discount curves that do not reflect foreign currency basis spread) are recognised in profit or loss.
Swap A (actual swap)	Nil	Changes in fair value of Swap A (i.e., using discount curves that reflect foreign currency basis spreads) LESS the calculated changes in the fair value of Swap B, are recognised in other comprehensive income as the costs of hedging. In the statement of financial position, Swap A is recognised at its fair value at all times.
Other comprehensive income		As the fair value of the foreign currency basis spread is zero at inception, there is no requirement for a systematic and rational amortisation of the costs of hedging from other comprehensive income into profit or loss. *[IFRS 9.6.5.15(c)]*. The value of the foreign currency basis spreads at inception (nil) equals the initial fair value of Swap A (nil) less the initial fair value of Swap B (nil).

Approach 2 - Swap C

Entity A creates hypothetical Swap C. The terms of Swap C exactly match the terms of Swap A, but Swap C would be fair valued based on market curves excluding foreign currency basis spread. (It should be noted that the receive leg of Swap C in this example also matches the debt). Swap C will have a fair value on designation which is equal to the net present value of the foreign currency basis spread included within the GBP pay leg (e.g., a negative spread of 0.103% in this example). Accordingly Swap C will look like the following:

Pay leg - GBP64.2m paying 6m benchmark interest rate +2.757% (semi-annual) maturing on 31/12/X3.

Receive leg - USD100m paying 3.75% (semi-annual) maturing on 31/12/X3

The fair value of Swap C on designation is an asset of £132k, this is calculated using market curves excluding foreign currency basis spread.

The accounting for the hedge relationship would be as follows:

Instrument	Fair value on designation	Accounting
Debt	Nil	Value changes due to foreign currency and interest rate risk (using discount curves that do not reflect foreign currency basis spread) are recognised in profit or loss, and adjust the carrying value of the debt. (The recognised changes in value of the debt will be offset by changes in the fair value of Swap C's receive leg).
Swap C (hypothetical swap)	£132k DR	Changes in fair value due to foreign currency and interest rate risk (using discount curves that do not reflect foreign currency basis spread) are recognised in profit or loss.
Swap A (actual swap)	Nil	Changes in fair value of Swap A (i.e., using discount curves that reflect foreign currency basis spreads) LESS the calculated changes in the fair value of Swap C, are recognised in other comprehensive income as the costs of hedging. In the statement of financial position, Swap A is recognised at its fair value at all times.

Instrument	Fair value on designation	Accounting
Other comprehensive income		The value of the foreign currency basis spread at inception must be amortised from other comprehensive income into profit or loss on a systematic and rational basis. *[IFRS 9.6.5.15(c)]*. The value of the foreign currency basis spread at inception (GBP132k CR) is the initial fair value of Swap A (nil) less the initial fair value of Swap C (GBP132k DR). Over the life of the hedge relationship the cumulative amortisation will result in the following: DR other comprehensive income GBP132k CR profit or loss GBP132k

The above fact pattern assumes that there are no sources of ineffectiveness and that the hedging derivative exactly matches the critical terms of the hedged item. In reality this is unlikely to always be the case, therefore additional complexity might need to be incorporated into the chosen approach for identifying the foreign currency basis spread. In particular, where the critical terms of the hedging derivative do not match those of the hedged item, it is the aligned foreign currency basis spread which is eligible for the costs of hedging treatment (see section 7.5.1.A above). In that case swap B and C (above) must be based on an aligned foreign currency derivative, i.e., one that would perfectly match the hedged item. Differences in fair value changes between the actual foreign currency derivative and the aligned foreign currency derivative will be an additional source of ineffectiveness (see section 7.5.2 above). *[IFRS 9.B6.5.37, IFRS 9.B6.5.38]*.

Although quoted prices for foreign currency basis spreads for many currency pairs are widely available, entities must not underestimate the complexities involved in eliminating the effect of foreign currency basis spreads from market forward foreign currency rates which generally do reflect foreign currency basis spreads.

7.6 Hedges of a firm commitment to acquire a business

A firm commitment to acquire a business in a business combination cannot be a hedged item, except for foreign currency risk (see section 2.6.4 above).

Consider the situation where an entity with euro as its functional currency enters into a binding agreement to purchase a subsidiary in six months. The subsidiary's functional currency is the US dollar. The consideration is denominated in US dollars and is payable in cash. The entity decides to enter into a forward contract to buy US dollars for euros to hedge its foreign currency risk on the firm commitment. The following options exist and the entity could choose the most appropriate accounting treatment:

- Because the hedge is a purchase of US dollars, it is, arguably, not a fair value hedge of the acquisition, since the acquisition is itself naturally hedged for changes in the fair value in the US dollar - that is, the entity is committed to buy a group of US dollar denominated assets and liabilities for a price denominated in US dollars. Nevertheless, the entity could still designate the transaction as the hedged item in a fair value hedge relationship, although this might not make intuitive sense (see section 5.1.1 above). *[IFRS 9.B6.5.3]*.
- The entity could instead designate the forward contract as a hedge of the cash flows associated with the committed purchase, which is a cash flow hedge (see section 5.2.2 above). *[IFRS 9.B6.3.1]*.

  Or

- If the anticipated business combination in this example is only a highly probable forecast transaction and not a firm commitment, then the entity can only apply cash flow hedging (see section 2.6.1 above).

If the transaction is a fair value hedge, then the carrying amount of the hedged item is adjusted for the gain or loss attributable to the hedged risk (see section 7.1 above). Since separately identifiable assets acquired and liabilities assumed must be recognised on initial consolidation at fair value in the consolidated financial statements of the acquirer, it follows that the gain or loss attributable to the hedged risk must be included in the consideration paid. In other words, the impact of the hedge affects the calculation of goodwill that is otherwise determined by the application of IFRS 3 (see Chapter 10 at section 7).[27]

27 *IFRIC Update*, January 2011, available on the IFRS Foundation's website.

During the hedging period, the effective portion of the gain or loss on a hedging instrument in a cash flow hedge is recognised in other comprehensive income (see section 7.2 above). Upon initial recognition of the acquisition, gains or losses recognised in other comprehensive income are included in the consideration paid for the business combination that is designated as the hedged item. *[IFRS 9.6.5.11(d)(i)]*. A similar treatment would be applied to any amounts in a separate component of equity relating to the costs of hedging (see section 7.5.1 above).

The adjusted carrying amount of goodwill, including the gain or loss from hedge accounting, will then be subject to the normal requirements to test for annual impairment (see Chapter 21 at section 8).

Once the purchase price is paid and the transaction is completed, the entity is 'long' US dollars as a result of recognising the US dollar net assets of the acquired entity. Those net assets would then be eligible for net investment hedging which would require selling US dollars to create an eligible hedging instrument, for example by entering into a foreign currency forward (see sections 5.3 and 7.3 above).

7.7 Hedge accounting for a documented replacement or rollover hedging strategy

The standard is clear that the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination of a hedge relationship if such replacement or rollover is part of the entity's documented risk management objective (see section 8.3 below). *[IFRS 9.6.5.6]*. However, there is minimal additional specific guidance provided on what is meant by, or the accounting for, a documented replacement or rollover hedging strategy.

How we see it

We believe that a rollover hedging strategy refers to a strategy whereby the maturity of the hedging instrument is intentionally shorter than the maturity of the hedged item, and there is an expectation that on expiry of the original hedging instrument it will be replaced by a new hedging instrument. The replacement hedging instrument is likely to have similar characteristics to the instrument being replaced.

A replacement hedging strategy is also not defined but is likely to include a strategy to replace hedging instruments if the credit risk from the existing instrument increases such that it exceeds acceptable levels.

Whether the risk management strategy is to be achieved through a replacement or rollover strategy is a matter of fact, and must have been documented as such at inception of the initial hedge and the usual qualifying conditions for hedge accounting must be met (see section 6 above).

An entity's risk management strategy is the main source of information to perform an assessment of whether a hedging relationship meets the effectiveness requirements, for example whether an economic relationship exists between the hedged item and the hedging instrument. *[IFRS 9.B6.4.18]*. Therefore, when making this assessment for a rollover hedging strategy, it will be necessary to consider whether the risk management strategy does envisage rolling over the hedging instrument (see section 6.4.1 above and Illustration 7-27 below). *[IFRS 9.B6.4.6]*.

The measurement of hedge ineffectiveness is undertaken on a cumulative basis (see sections 7.1.1 and 7.2.1 above). *[IFRS 9.6.5.8, IFRS 9.6.5.11]*. 'Cumulative' is generally understood to mean over the life of the hedge relationship. This will include historic gains and losses from previous periods in which the hedging instruments were rolled over or replaced, for as long as the hedge continues to remain live. The cumulative period is not reset just because a new replacement or rollover hedging instrument is transacted if it is part of a documented replacement or rollover strategy, as it is not an event that requires discontinuation of the hedge relationship. This is particularly relevant for a cash flow hedge in the identification of the hypothetical derivative, as demonstrated in Illustration 7-27 below (see also section 7.4.4 above).

Illustration 7-27: Hedge of a foreign currency risk in rollover cash flow hedging strategy

Company A has sterling as its functional currency. Company A expects highly probable foreign currency sales resulting in a forecast cash inflow of €2m in 9 months' time. Company A chooses to hedge the foreign currency risk and transacts an FX forward contract to sell €2m and receive GBP in 3 months' time. This is with an expectation that as the initial contract matures another 3-month contract will be transacted and then a third contract on maturity of the second contract. As part of the usual hedge documentation Company A has identified this as being a rollover strategy for foreign currency risk. Company A has determined that the effectiveness criteria are met on initial designation, this was on the assumption that the existing 3-month hedging contract will be rolled into a second and third 3-month hedging contract (see section 6.4 above).

The hedge relationship is not discontinued when the second and third FX forward contracts are transacted. The effectiveness requirements are assessed throughout the life of the hedge relationship, including consideration of the expected rollover of the hedging instruments (see section 6.4 above). The amount of ineffectiveness recorded is determined by a comparison of the change in fair value of the hedging instruments (the aggregate of the changes in fair value of the 3-month FX forward contracts) and the change in value of the hedged item (the highly probable cash flow in 9 months' time) for changes in foreign currency risk. This cumulative approach means the calculation would include fair value changes since designation of the hedge relationship, which would include the realised changes in fair value of the matured 3-month FX forward contracts.

If the hypothetical derivative method (see section 7.4.4 above) is adopted to calculate the change in value of the hedged item, a single hypothetical derivative would be used based on the expected timing of the forecast transaction (i.e., a 9-month FX forward contract).

It follows that if the costs of hedging guidance is applied to a hedge relationship with a documented replacement or rollover strategy then a replacement of the hedging instrument will not be deemed a discontinuation for the purposes of accounting for the costs of hedging either. This is particularly important for a time related hedge for which the amount accumulated in the separate component of equity is immediately reclassified to profit or loss when the hedge relationship is discontinued (see section 7.5.1 above).

An alternative risk management objective to a rollover strategy would be a partial term hedge, i.e., when the entity chooses to manage the hedged risk for only a partial term, perhaps because there is an expectation that a natural hedge will occur at some point in the future (see section 2.2.4 above). In that case there is no expectation that on expiry of the original hedging instrument it will be replaced by a new hedging instrument with similar characteristics to the instrument being replaced, hence it is not the same as a rollover strategy.

Accordingly, the documented risk management objective for such a hedge relationship (see section 6.2 above) will highlight if it is either a rollover strategy or a partial term hedge, and the assessment of the effectiveness requirements (see section 6.4 above) and measurement of ineffectiveness (see section 7.4 above) will be assessed on that basis.

Amortisation of any fair value adjustment made to the hedged item under a fair value hedge of a documented rollover strategy need not commence until the rollover hedge strategy is discontinued (see section 7.1.2 above).

7.8 Hedge accounting for an equity instrument designated at fair value through OCI

It is clear from the standard that it is possible to designate as the hedged item in a fair value hedge, an investment in an equity instrument for which the entity has elected on initial recognition to present changes in fair value in OCI (see section 2.6.3 above). *[IFRS 9.6.5.3]*. Applying that initial recognition election, with the exception of dividends received, means that subsequent gains or losses on the equity investments will never be recognised in profit or loss, (see Chapter 46 at section 2.5). However, for such a hedge, all fair value changes of the hedging instrument are recognised in OCI. *[IFRS 9.6.5.8]*.

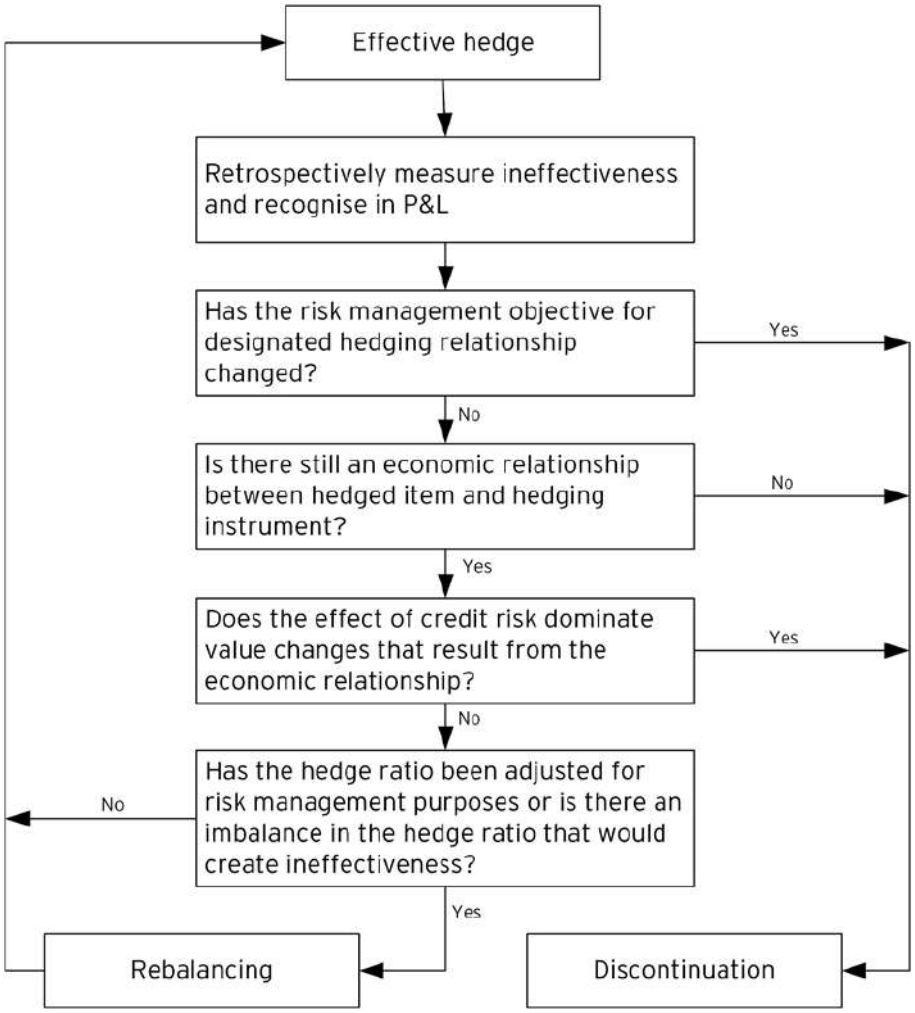
This treatment can lead to an accounting mismatch as value changes for the hedged item when a dividend is recognised will be reflected in profit or loss but remain in OCI for the hedging instrument.

8 Subsequent assessment of effectiveness, rebalancing and discontinuation

8.1 Assessment of effectiveness

A prospective effectiveness assessment is required on an ongoing basis, in a similar manner as at the inception of the hedging relationship (see section 6 above) and, as a minimum, at each reporting date or upon a significant change in circumstances, whichever comes first, in order to continue to apply hedge accounting. *[IFRS 9.B6.4.12]*. The flow chart below illustrates the assessment life cycle.

Figure 8-1: Effectiveness assessment and rebalancing



Each accounting period an entity first must assess whether the risk management objective for the hedging relationship has changed. A change in risk management objective is a matter of fact that triggers discontinuation prospectively. Discontinuation of hedging relationships is discussed in section 8.3 below.

An entity would also have to discontinue hedge accounting prospectively if it turns out that there is no longer an economic relationship (see section 6.4.1 above). This makes sense as whether there is an economic relationship is a matter of fact that cannot be altered by adjusting the hedge ratio (see section 6.4.3 above). The same is true for the impact of credit risk; if credit risk is now dominating the hedging relationship, then the entity must discontinue hedge accounting prospectively (see section 6.4.2 above). *[IFRS 9.6.5.6]*.

The hedge ratio might need to be adjusted if it turns out that the hedged item and hedging instrument do not move in relation to each other as expected, or if the ratio has changed for risk management purposes. This is referred to as 'rebalancing' and is discussed in section 8.2 below.

It can be seen from the above flow chart that hedge accounting can only continue prospectively if the risk management objective has not changed, and the effectiveness requirements continue to be met. Otherwise the hedge relationship must be discontinued (see section 8.3 below).

8.2 Rebalancing

8.2.1 Definition

Extract from IFRS 9

6.5.5 **If a hedging relationship ceases to meet the hedge effectiveness requirement relating to the hedge ratio (see paragraph 6.4.1(c)(iii)) but the risk management objective for that designated hedging relationship remains the same, an entity shall adjust the hedge ratio of the hedging relationship so that it meets the qualifying criteria again (this is referred to in this Standard as 'rebalancing'-see paragraphs B6.5.7-B6.5.21).**

[IFRS 9.6.5.5].

An entity is required to 'rebalance' the hedge ratio to reflect a change in the relationship between the hedged item and hedging instrument if it expects the new relationship to continue going forward.

Extract from IFRS 9

B6.5.7 Rebalancing refers to the adjustments made to the designated quantities of the hedged item or the hedging instrument of an already existing hedging relationship for the purpose of maintaining a hedge ratio that complies with the hedge effectiveness requirements. Changes to designated quantities of a hedged item or of a hedging instrument for a different purpose do not constitute rebalancing for the purpose of this Standard.

[IFRS 9.B6.5.7].

Rebalancing allows entities to refine their hedge ratio without discontinuation and redesignation, so reducing the need for designation of 'late hedges' and the associated accounting issues that can arise with such a hedge (see sections 2.4.1 and 7.4.3 above). *[IFRS 9.B6.5.7]*. Specifically, if entities change the quantity of hedged item compared to the quantity of hedging instrument in response to changes in the economic relationship between the hedged item and hedging instrument, when the risk management objective otherwise continues as originally designated that should be treated as a continuation of the hedging relationship. *[IFRS 9.BC6.303]*.

For instance, an entity could have designated a hedging relationship in which the hedging instrument and the hedged item have different but related underlying reference indices, rates or prices. If the relationship or correlation between those two underlyings change, the hedge ratio might need to change to better reflect the revised correlation and to continue to comply with the hedge effectiveness requirements. *[IFRS 9.B6.5.7, IFRS 9.B6.5.9]*.

By way of an example; an entity hedges an exposure to Foreign Currency A using a currency derivative that references Foreign Currency B. Foreign Currency A and B are pegged (i.e., their exchange rate is maintained within a band or at an exchange rate set by a central bank or other authority). If the exchange rate between Foreign Currency A and Foreign Currency B were changed (i.e., a new band or rate was set), rebalancing the hedging ratio to reflect the new exchange rate would ensure that the hedging relationship would continue to meet the hedge effectiveness requirements. *[IFRS 9.B6.5.10]*.

Any other changes made to the quantities of the hedged item or hedging instrument, for instance, a reduction in the quantity of the hedged item because some cash flows are no longer highly probable, would not be rebalancing. Such other changes to the designated quantities would need to be treated as a partial discontinuation if the entity reduces the extent to which it hedges, and a new designation of a hedging relationship if the entity increases it. *[IFRS 9.B6.5.7]*.

Changes that risk managers might make to improve hedge effectiveness but which are not caused by a change in the economic relationship between the hedged item and the hedging instrument are not rebalancing either as they would reflect a change in the risk management objective. *[IFRS 9.B6.5.15]*.An example of such a change is the transaction of derivatives related to a risk (or source of ineffectiveness) that was not considered in the original hedge relationship or a known risk (or source of ineffectiveness) that has become larger/more volatile since inception or that the entity intended to hedge dynamically to maintain a desired level of offset (see section 6.3.2 above).

Where differences in the underlying or risk variables within the hedged item and hedging instrument exist, it is likely that there is already a degree of hedge ineffectiveness within the hedge relationship (see section 7.4 above). The concept of rebalancing only comprises prospective changes to the hedge ratio, so any ineffectiveness is determined and recognised immediately before adjusting the hedging relationship for rebalancing. *[IFRS 9.B6.5.8]*.

For example, hedging a cotton purchase in India with NYMEX cotton futures contracts is likely to result in some ineffectiveness, as the hedged item and the hedging instrument do not share exactly the same underlying price. Rebalancing only affects the expected relative sensitivity between the hedged item and the hedging instrument going forward, as ineffectiveness from past changes in the sensitivity will have already been recognised in profit or loss.

The following Illustration provides some indications as to how to distinguish rebalancing from other changes to a hedge relationship:

Illustration 8-1: Rebalancing

Fact pattern 1

An entity is exposed to price changes in commodity A which is not widely traded as a derivative. The entity has proven that there is an economic relationship between commodity A and commodity B. Commodity B is widely traded as a derivative. In that case, the entity could use commodity B derivatives to hedge the price risk in commodity A. An initial hedge ratio of 1:1.1 is based on the expected relationship between the prices of commodity A and commodity B. The relationship subsequently changes such that a ratio of 1:1.15 is expected to be more effective.

The entity can account for the changes in the hedging relationship as rebalancing because the difference between the prices is caused by a change in the economic relationship between the hedged item and hedging instrument such that a change is required to the hedge ratio so that it complies with the hedge effectiveness requirements.

Fact pattern 2

An entity swaps a base rate floating rate loan into a fixed interest rate using a pay SONIA receive fixed swap. At inception, the entity is able to prove that there is an economic relationship between the base rate and SONIA and designates the swap and the loan in a cash flow hedge, although it expects some level of ineffectiveness (see section 6.4.1 above). Similar to fact pattern 1, the entity could use rebalancing to account for changes in the basis risk between the base rate and SONIA.

However, the entity subsequently transacts a SONIA versus base rate swap in order to eliminate the basis risk. The accounting consequences would depend on the reason for doing so and here we consider two scenarios:

(a) The entity can no longer prove that there is an economic relationship between the base rate and SONIA (although this is unlikely in practice).

(b) The entity can still prove that there is an economic relationship between the base rate and SONIA, but no longer wishes to suffer the resultant ineffectiveness arising from the basis risk.

In scenario a), the hedging relationship no longer meets the eligibility criteria and needs to be discontinued, as there is no longer an economic relationship between the hedged item and the hedging instrument. The entity cannot use rebalancing to avoid discontinuation because the hedge no longer meets the qualifying criteria (see section 8.3 below).

In scenario b), the entity tries to avoid ineffectiveness by contracting another hedging instrument. Arguably, the entity could continue with the original designation and account for the SONIA versus base rate swap as a derivative measured at fair value through profit or loss. However, given that the entity seeks to avoid ineffectiveness, it might want to apply hedge accounting to the base rate swap as well. If the entity wants to include the SONIA versus base rate swap in the original hedging relationship, it would represent a change in the documented risk management objective which requires discontinuation of the existing and re-designation of a new hedging relationship (see section 7.4.3 above for further discussion on designating hedging derivatives with a non-zero fair value in a hedge relationship).

Fact pattern 3

An entity with US dollars as its functional currency designated a fixed rate loan denominated in EUR and a US dollars/euro forward exchange contract in a cash flow hedge. Subsequently, the borrower suffers significant financial difficulties and the entity only expects to receive 90% of the contractual cash flows on the loan.

The entity cannot apply rebalancing because the changes in the cash flows of the hedged item are not caused by a change in the economic relationship between the underlying or risk variables within the hedged item and hedging instrument but by credit risk. Instead, the entity is required to assess whether credit risk dominates the fair value changes of the hedged item in which case the hedging relationship needs to be discontinued (see section 8.1 above). If it is determined that credit risk does not dominate the hedge relationship the entity might, adjust the amount of the hedging instrument to reflect the reduced volume of the hedged risk and treat this as a partial dedesignation (see section 8.3 below).

Fact pattern 4

An airline with a functional currency of Swiss francs enters into a firm commitment to purchase ten new wide-bodied airplanes in two years' time. The contract to purchase those airplanes is denominated in US dollars and the airline enters into a forward exchange contract to hedge the foreign currency exposure. There is no embedded foreign currency derivative to bifurcate, as sales of wide-bodied aircrafts appear to be routinely denominated in US dollars around the world (see Chapter 42 at section 4.2.1.B). The airline designates the firm commitment and the derivative in a fair value hedge. Six months into the contract, the aircraft manufacturer informs the airline that it has suffered significant delays in production and that the aircrafts will not be delivered in two years as originally planned but in three years. Payment is due when the airplanes are delivered.

The delay in payment might result in some ineffectiveness as the forward exchange and discounting rates for two years and three years are likely to be different (see section 7.4.4 above). However, the airline could not avoid this ineffectiveness by rebalancing, because the ineffectiveness is caused by the timing difference and not a change in the economic relationship between the underlying or risk variables within the hedged item and hedging instrument. Further, were the airline to alter the quantities of the hedged item or the hedging instrument (which is what rebalancing entails), it is unlikely to resolve the ineffectiveness.

8.2.2 Requirement to rebalance

Whether an entity is required to rebalance a hedging relationship is first and foremost a matter of fact, which is, whether the hedge ratio has changed for risk management purposes. An entity must rebalance a hedging relationship if that relationship has an unchanged risk management objective but no longer meets the hedge effectiveness requirements regarding the hedge ratio (see section 6.2 and section 6.4.3 above). This will, in effect, be the case if the hedge ratio is no longer the one that is actually used for risk management (see section 6.4.3 above). *[IFRS 9.6.5.5]*.

However, consistent with initial designation, the hedge ratio used for hedge accounting purposes might have to differ from the hedge ratio used for risk management if the latter would result in ineffectiveness that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting (see section 6.4.3 above). *[IFRS 9.B6.5.14]*. The guidance in IFRS 9 clarifies that an accounting outcome that would be inconsistent with the purpose of hedge accounting as the result of failing to adjust the hedge ratio for risk management purposes, would not meet the qualifying criteria for hedge accounting. This simply means that the qualifying criteria treat inappropriate hedge ratios in the same way, irrespective of whether they were achieved by acting (inappropriate designation) or failure to act (by not adjusting a designation that has become inappropriate). *[IFRS 9.B6.5.13]*.

IFRS 9 also clarifies that not every change in the extent of offset between the hedging instrument and the hedged item constitutes a change in the relationship that requires rebalancing. For example, hedge ineffectiveness arising from a fluctuation around an otherwise valid hedge ratio cannot be reduced by adjusting the hedge ratio. *[IFRS 9.B6.5.11, IFRS 9.B6.5.12]*. A trend in the amount of ineffectiveness on the other hand might suggest that retaining the hedge ratio would result in increased ineffectiveness going forward.

Accordingly, in order to continue to apply hedge accounting, an entity must rebalance the hedge ratio for accounting purposes if required as part of the prospective effectiveness assessment. IFRS 9 acknowledges that such an assessment is usually inherent in effective risk management monitoring, and so in many cases existing risk management process might be sufficient to determine whether accounting rebalancing is required or not. *[IFRS 9.BC6.301]*.

IFRS 9 does not specify the nature of the assessment to determine if rebalancing is required. Therefore, the nature of the assessment requires judgement based on the facts and circumstances of the hedge relationship. For example, a hedge involving two underlyings with correlation that has been historically volatile would likely require more robust analysis than two underlyings that have shown consistent correlation over many years. As another example, a relationship that has been under-hedging for four consecutive quarters would likely require more robust analysis than a relationship constantly moving to and from an over- and under-hedge position.

Regardless of the chosen assessment methodology, it is clear that rebalancing is not a mathematical optimization exercise. *[IFRS 9.BC6.310]*. Accordingly, hedges are not required to be perfectly effective, but judgement will be required to determine if rebalancing is necessary or not. Therefore, at each reporting date, entities must document the work performed to determine whether rebalancing is necessary or not, and any judgements made.

8.2.3 Mechanics of rebalancing

Extract from IFRS 9

B6.5.8 Rebalancing is accounted for as a continuation of the hedging relationship in accordance with paragraphs B6.5.9-B6.5.21. On rebalancing, the hedge ineffectiveness of the hedging relationship is determined and recognised immediately before adjusting the hedging relationship.

[IFRS 9.B6.5.8].

Once any hedge ineffectiveness has been recognised, rebalancing can be achieved by:

- Increasing the volume of the hedged item
- Increasing the volume of the hedging instrument
- Decreasing the volume of the hedged item

  Or
- Decreasing the volume of the hedging instrument *[IFRS 9.B6.5.16]*

Decreasing the volume of the hedging instrument or hedged item does not mean that the respective transactions or items no longer exist or are no longer expected to occur. As demonstrated in Illustration 8-2 and Illustration 8-3 below, rebalancing only changes what is designated in the particular hedging relationship.

Illustration 8-2: Rebalancing the hedge ratio by decreasing the volume of the hedging instrument

1 January

An entity expects to purchase 1m barrels of West Texas Intermediate (WTI) crude oil in 12 months. The entity designates a futures contract of 1.05m barrels of Brent crude oil in a cash flow hedge to hedge the highly probable forecast purchase of 1m barrels of WTI crude oil (hedge ratio of 1.05:1) in a cash flow hedge. This hedge ratio is consistent with risk management and is not designed to result in an accounting outcome that would be inconsistent with the purpose of hedge accounting.

30 June

At 30 June, the cumulative change in the value of the hedged item is CU200, while the cumulative change in the fair value of the hedging instrument is CU229.

The entity would account for the hedging relationship as follows (see section 7.2 above):

		CU	CU
Dr	Cash flow hedge reserve - OCI	200	
Dr	Hedge ineffectiveness - profit or loss	29	
	Cr Derivatives - hedging instruments		229

The treasurer of the entity is very sensitive to ineffectiveness and therefore considers rebalancing the hedging relationship.

The analysis of the treasurer shows that the sensitivity of Brent crude oil to WTI crude oil prices was not as expected. Going forward, the treasurer expects a different relationship between the two benchmark prices and decides to reset the hedge ratio to 0.98:1 accordingly.

Rebalancing on 30 June

The treasurer can either designate more WTI exposure or de-designate part of the Brent crude oil hedging instrument. The entity decides to do the latter, that is, discontinue hedge accounting for 0.07m barrels of Brent crude oil derivatives.

Of the total of 1.05m barrels of Brent derivative, 0.07m are no longer part of the hedging relationship. Therefore, the entity needs to reclassify 7/105 (or 6.7%) of the hedging instrument within their hedge accounting disclosures (see Chapter 50 at section 4.3). No immediate accounting entries are required to reflect the rebalancing in this case.

In Illustration 8-2 above, the entity no longer needs to hold this portion of the derivative any longer for hedging purposes and could, therefore, close it out. If the entity chooses to keep that portion of the derivative it will of course continue to result in volatility in the profit or loss, although it would no longer be presented as hedge ineffectiveness. As mentioned, the entity could have also rebalanced by designating more WTI exposure (assuming that the higher level of exposure is highly probable of occurring). Such an approach would also not result in any immediate accounting entries; the entity would simply designate more WTI exposure. However, the ongoing accounting can be more complex, which is discussed in more

detail below. The same would be true when rebalancing by increasing the volume of hedging instrument, in which case the entity would simply designate more of the same hedging instruments within the hedge relationship. This could be achieved either by entering into additional hedging instruments via a market transaction, or by designating existing derivatives that are not currently designated within a hedge relationship. *[IFRS 9.B6.5.16, IFRS 9.B6.5.17, IFRS 9.B6.5.18, IFRS 9.B6.5.19, IFRS 9.B6.5.20]*.

Illustration 8-3: Rebalancing the hedge ratio by decreasing the volume of hedged item

1 April

An entity has highly probable forecast purchases of diesel over the next 12 months. The entity expects to get monthly deliveries of 10,000 metric tonnes at the local market price. The entity designates a futures contract referenced to the Platts Diesel D2 price with a nominal amount of 9,500 metric tonnes in a cash flow hedge, to hedge 10,000 metric tonnes of highly probable diesel purchases in September (giving a hedge ratio of 1:0.95).

30 June

At 30 June, the cumulative change in the value of hedged item is CU820, while the cumulative change in the fair value of hedging instrument is CU650.

The entity would account for the hedging relationship as follows:

		CU	CU
Dr	Cash flow hedge reserve - OCI	650	
	Cr Derivatives - hedging instruments		650

To account for the fair value change of the hedging instrument.

Despite the hedge only being 79% effective, no hedging ineffectiveness is recorded as a result of the 'lower of test' in the standard. *[IFRS 9.6.5.11(a)]*. As per that paragraph, the amount accumulated in other comprehensive income has to be the lower of:

(i) The cumulative gain or loss on the hedging instrument

And

(ii) The cumulative change in fair value of the hedged item, with any remaining gain or loss on the hedging instrument being recorded in profit or loss (see section 7.2 above)

Based on an analysis, the entity now believes that the appropriate hedge ratio going forward is 1:1.05. Consequently, the entity can either increase the volume of hedging instrument or decrease the volume of hedged item. Based on a cost-benefit analysis the entity decides to reduce the volume of hedged item by 952 metric tonnes.

Rebalancing on 30 June

Rebalancing a hedge ratio by decreasing the volume of hedged item is considered a partial discontinuation of the hedging relationship. *[IFRS 9.B6.5.27(a)]*. The entity is discontinuing 952 (10,000 - (9,500 ÷ 1.05) = 952) metric tonnes of diesel purchases while 9,048 metric tonnes of forecast purchases remain in the hedging relationship. The hedge documentation is updated accordingly. No accounting entry is required (however, the entity would have to retain the information that 952 metric tonnes of diesel were the hedged item for some part of the total life of the hedging relationship and which amount in the cash flow hedge reserve relates to this quantity of diesel).

Even though the standard allows adjusting either the quantity of hedging instrument or the quantity of the hedged item, when rebalancing, entities are encouraged to consider that adjusting the hedged item will be operationally more complex than adjusting the hedging instrument because of the need to track the history of different quantities that were designated during the term of the hedging relationship. For example, if a quantity of 10 tonnes of a hedged item were added to increase the quantity of hedged item and later deducted to decrease it, those 10 tonnes would have been part of the hedged item for only a part of the life of the hedging relationship. However, the amount accumulated in the cash flow hedge reserve, would still, in part, relate to that quantity, even though it is not currently part of a cash flow hedge. Therefore, ongoing tracking of the 10 tonnes is required to ensure appropriate recycling of the amounts previously taken to the cash flow hedge reserve (see section 7.2.2 above). This can get more complex in situations in which the hedging relationship needs frequent rebalancing, if not all hedged transactions occur at the same time, or in conjunction with the cost formulas used for the measurement of the cost of inventory (for example a first in first out formula) (see Chapter 23 at section 3.2.2). In addition, risk management would normally adjust the quantity of the designated hedging instruments when rebalancing, since the hedged exposure is normally the 'given' and drives what hedges are needed.

When rebalancing a hedging relationship, an entity must update its analysis of the sources of ineffectiveness in the hedge documentation. *[IFRS 9.B6.5.21]*.

8.3 Discontinuation

An entity must discontinue hedge accounting prospectively if either of the following occurs:

- The hedging relationship ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable) (see sections 8.1 and 8.2 above). An example would include where an eligible hedged item no longer exists (see section 8.3.4 below).

  Or

- The hedging instrument expires or is sold, terminated, or exercised.

For the purpose of the second of these two occurrences, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if that is part of and consistent with a documented risk management objective, such as a rollover hedging strategy (see section 7.7 above).

There is a further exception, introduced when regulators began to mandate the clearing of over the counter derivatives through a central clearing house (see section 8.3.5 below).

These two occurrences are the only circumstances when a hedge is discontinued, as voluntary discontinuation is not permitted under IFRS 9.

Discontinuing hedge accounting can either affect a hedging relationship in its entirety or only a part of it (in which case hedge accounting continues for the remainder of the hedging relationship). *[IFRS 9.6.5.6, IFRS 9.B6.5.22, IFRS 9.B6.5.25]*.

The table below summarises the main scenarios resulting in either full or partial discontinuation:

Scenario	Discontinuation
The risk management objective has changed (see section 8.3.3 below)	Full or partial
There is no longer an economic relationship between the hedged item and the hedging instrument (see section 6.4.1 above)	Full
The effect of credit risk dominates the value changes of the hedging relationship (see section 6.4.2 above)	Full
As part of rebalancing, the volume of the hedged item or the hedging instrument is reduced (see section 8.2 above)	Partial
The hedging instrument expires	Full
The hedging instrument is (in full or in part) sold, terminated or exercised	Full or partial
The hedged item (or part of it) no longer exists or is no longer highly probable (see section 8.3.4 below)	Full or partial

A logical consequence of linking the discontinuation to the risk management objective is that, as already mentioned, voluntary discontinuations are not permitted just for accounting purposes. In developing the standard, the IASB noted that hedge accounting is an exception to the general accounting principles in IFRS accounting standards, in order to (better) present in the financial statements a particular risk management objective of a risk management activity. If that risk management objective is unchanged and the qualifying criteria for hedge accounting are still met, a voluntary discontinuation would be inconsistent with the original (valid) reason for applying hedge accounting. *[IFRS 9.B6.5.23]*. The Board believes that hedge accounting, including its discontinuation, must have a particular meaning, rather than just be a mere accounting exercise. *[IFRS 9.BC6.327]*. Based on this, the IASB decided not to allow voluntary discontinuation for hedges with unchanged risk management objectives. *[IFRS 9.BC6.331]*.

This change gave rise to concern among some constituents who argued that, given hedge accounting is optional, voluntary discontinuation should be permitted (as it was previously under IAS 39). *[IFRS 9.BC6.324]*.

However, many of the circumstances in which an entity applying IAS 39 might have voluntarily discontinued hedge accounting do not arise in the same way under IFRS 9. For example, it is not necessary to discontinue hedge accounting in order:

- To adjust the hedge ratio for a change in the expected relationship between the hedged item and the hedging instrument (see section 8.2 above)
- To hedge a secondary risk (e.g., where an entity first hedges the commodity price risk in a commodity purchase contract in foreign currency but later decides to hedge the foreign currency risk as well (see section 2.7 above))
- To amend the chosen effectiveness method if it becomes no longer appropriate (see section 6.3 above)

  Or

- Because some of the hedged cash flows are no longer expected to occur (see section 8.3.4 below)

These circumstances are all addressed in IFRS 9 by inclusion of: rebalancing, the ability to achieve hedge accounting for aggregated exposures, no longer requiring hedges to be 'highly effective' and partial discontinuation. Hence, voluntary discontinuation is not needed in such situations.

It is important to note that the risk management objective of an individual hedging relationship can change although the risk management strategy of the entity remains unchanged (see section 6.2 above and section 8.3.3 below)). *[IFRS 9.BC6.330]*. In fact, in most cases where an entity might wish to 'voluntarily dedesignate' a hedging relationship, this is usually driven by a change in the risk management objective, in which case the entity would actually be required to amend its hedge accounting under IFRS 9, for example when managing the risk from a portfolio on a dynamic basis (see section 8.3.3 below). The standard prohibits voluntary dedesignations when they are only made for accounting purposes.

As a result of the reforms mandated by the Financial Stability Board following the financial crisis, benchmark interbank offered rates (IBORs) such as LIBOR are being replaced by new 'official' benchmark rates, known as RFRs. Such a change will necessarily affect future cash flows in both contractual floating rate financial instruments currently referenced to IBOR, and highly probably forecast transactions for which IBOR is designated as the hedged risk. This raises a number of accounting questions, not least whether changes to the hedged or hedging instrument required by the reform might lead to the discontinuation of hedge relationships. In September 2019 and August 2020, the IASB issued amendments to IFRS 9 (and IAS 39) to address the accounting issues that arise as result of the reform (see the *Supplement: IBOR Reform*).

8.3.1 Accounting for discontinuation of fair value hedge accounting

On discontinuation of a hedge relationship for which the hedged item is a financial instrument (or component thereof) measured at amortised cost, any adjustment arising from a hedging gain or loss on the hedged item must be amortised to profit or loss. The amortisation is based on a recalculated effective interest rate at the date the amortisation begins (see section 7.1.2 above). The treatment of any fair value hedge adjustments on discontinuation must also be applied to partial discontinuations. *[IFRS 9.6.5.10]*.

Illustration 8-4: Discontinuation of fair value hedge of term loan for interest rate risk

Entity A enters into a fixed rate term loan for £300m. The loan is for 5 years and pays interest annually at a rate of 5%. Given that the debt was issued at par with no premium, discount or fees, the effective interest rate is 5% (see Chapter 46 at section 3.1).

A wishes to eliminate fair value variability due to changes in interest rate risk from the term loan and so at the same time also enters into an interest rate swap for £300m at the prevailing 5 year SONIA swap rate i.e., paying 3 month SONIA and receiving 3.5%.

A determines that all the criteria for hedge accounting are met and so designates the interest rate swap as the hedging instrument in a fair value hedge of the term loan with respect to changes in interest rate risk (see section 6 above).

After 1 year, the risk management objective of the hedge relationship changed such that A no longer wants protection from future changes in interest rates and so the interest rate swap is settled with the swap counterparty. A must discontinue the hedge relationship. Discontinuation is required in this case both because the hedging instrument no longer exists and because the risk management objective has changed, however, if only one of those circumstances arose, discontinuation would still be required (see section 8.3 above).

As the hedged item is no longer being adjusted for hedging gains and losses, a new effective interest rate is recalculated and amortisation using the new effective interest rate begins. *[IFRS 9.6.5.10]*. At that time the carrying amount of the hedged item included a fair value hedge adjustment of £25m, i.e., total carrying amount of the fixed rate term loan was £325m. A must now recalculate the effective interest rate of the fixed rate term loan, reflecting the carrying amount £325m and 4 remaining years of cash flows at 5%.

This equates to a new effective interest rate of 2.8% (i.e., £325m= (£15m/(1.028))+ (£15m/(1.028^2))+, (£15m/(1.028^3))+(£315m/(1.028^4))) which will be used to measure the loan at amortised cost until maturity or derecognition.

In the case of a debt instrument (or component thereof) that is a hedged item measured at fair value through other comprehensive income (see section 7.1.1 above), the amortisation is applied in the same manner as for financial instruments measured at amortised cost, but to other comprehensive income instead of by adjusting the carrying amount. *[IFRS 9.6.5.10]*.

On discontinuation of a fair value hedge for which the hedged item is not a financial instrument, the entity ceases to make any further adjustment arising from a hedging gain or loss on the hedged item, and any previous adjustment from fair value hedge accounting becomes part of the carrying amount of the hedged item, as per the general requirements when accounting for fair value hedges (see section 7.1.1 above). *[IFRS 9.6.5.8(b)]*.

If the hedged item no longer exists, which might be the reason the hedge relationship has been discontinued (see section 8.3.4 below), any hedging gain or loss on the hedged item will be accounted for on application of the usual derecognition guidance for the hedged item, as the gain or loss forms part of its carrying amount.

8.3.2 Accounting for discontinuation of cash flow hedge accounting

When an entity discontinues hedge accounting for a cash flow hedge, it must account for the amount that has been accumulated in the cash flow hedge reserve as follows:

- The amount remains in accumulated OCI if the hedged future cash flows are still expected to occur

  Or

- The amount is immediately reclassified to profit or loss as a reclassification adjustment if the hedged future cash flows are no longer expected to occur *[IFRS 9.6.5.12]*

After discontinuation, once the previously expected hedged cash flow occurs, any amount remaining in accumulated OCI must be accounted for depending on the nature of the underlying transaction consistent with the accounting for cash flow hedge relationships that are not discontinued (see section 7.2.2 above). *[IFRS 9.6.5.12]*. The treatment of the cash flow hedge reserve on discontinuation must also be applied to partial discontinuations.

Illustration 8-5: Discontinuation of cash flow hedge of term loan for interest rate risk

Entity X enters into a floating rate term loan for €500m. The loan is for 8 years and pays 3 month ESTR plus a credit spread of 200bp. X wishes to eliminate cash flow variability due to changes in interest rate risk from the term loan and so at the same time also enters into an interest rate swap for €500m at the prevailing 8 year ESTR rate i.e., receiving 3 month ESTR and paying 4.5% quarterly.

X determines that all the criteria for hedge accounting are met and so designates the interest rate swap as the hedging instrument in a cash flow hedge of the term loan with respect to changes in interest rate risk (see section 6 above).

After 2 years, the risk management objective of the hedge relationship changed such that X no longer wants protection from changes in interest rates and so the interest rate swap is settled with the swap counterparty. X must discontinue the hedge relationship. Discontinuation is required in this case both because the hedging instrument no longer exists and because the risk management objective has changed, however, if only one of those circumstances arose, discontinuation would still be required (see section 8.3 above).

At that time an amount of €36m had accumulated in the cash flow hedge reserve. X still expected the term loan to continue for the remaining 6 years. Although X is no longer protected from future changes in interest rate risk, in order to reflect the protection it received when the hedge relationship existed, X must recycle the amount accumulated in the cash flow hedge reserve to profit and loss as the hedged expected future cash flows affect profit or loss. *[IFRS 9.6.5.11(d)(ii)]*.

X recycles the €36m from cash flow hedge reserve to profit or loss over the remaining 6 years of the hedged cash flows. X applies this reclassification on a straight-line basis, i.e., €6m per annum, as a proxy for the effect of hedge accounting on future hedged cash flows.

After another year X expects a future influx of capital such that the term loan will not be required for its full maturity. X now expects to repay the term loan within 2 years, i.e., 3 years earlier than expected. In that case the hedged cash flows relating to the final 3 years of the term loan are no longer expected to occur and hence the accumulated amounts in the cash flow hedge reserve related to those cash flows must be immediately reclassified into profit or loss. *[IFRS 9.6.5.12(b)]*.

Of the remaining €30m accumulated in cash flow hedge reserve, €18m (i.e., €6m x 3 years) relates to the final 3 years of the original term of the loan and hence should be immediately reclassified to profit or loss.

8.3.3 Change in risk management objective

An entity must discontinue hedge accounting prospectively for a hedge relationship if there is a change in the risk management objective for that hedge relationship (see section 8.3 above). *[IFRS 9.B6.5.22]*. A change in risk management objective must be a matter of fact that can be observed in the entity's actual risk management (see section 6.2 above). The examples below, the first of which is derived from the application guidance to IFRS 9, demonstrate how this could be assessed in practice. *[IFRS 9.B6.5.24]*.

Illustration 8-6: Partial discontinuation as a result of a change in risk management objective

ABC Ltd is currently fully financed with variable rate borrowings (the tables in this example show nominal amounts in millions of euro (EUR)):

Non-current financial liabilities as of 1 January 20X1	Variable rate	Fixed rate
Variable rate borrowings	100	
Fixed rate borrowings		0
Total	**100**	**0**
	100%	0%

Risk management strategy

To maintain between 20% and 40% of long term debt at a fixed rate.

Risk management activity

To implement the strategy, the treasurer of ABC enters into a pay fixed/receive variable interest rate swap (IRS) with a notional amount of EUR30m and designates the IRS in a hedging relationship.

Risk management objective

Use a pay fixed/receive floating interest rate swap with a notional amount of EUR30m in a cash flow hedge of the interest payments on EUR30m of the variable rate borrowings in order to maintain 30% of the long-term borrowings at a fixed rate.

Non-current financial liabilities as of 1 January 20X1	Variable rate	Fixed rate
Variable rate borrowings	100	
Fixed rate borrowings		0
Pay fixed/receive variable interest rate swap	(30)	30
Total	**70**	**30**
	70%	30%

On 31 March 20X2, the entity needs further funding and takes advantage of lower interest rates by issuing a EUR50m fixed rate bond. At the same time, the entity decides to set its fixed rate exposure at 40% of total borrowings, still being within the existing risk management strategy.

Non-current financial liabilities as of 31 March 20X2	Variable rate	Fixed rate
Variable rate borrowings	100	
Fixed rate borrowings		50
Pay fixed/receive variable interest rate swap	(30)	30
Total	**70**	**80**
	47%	53%

It is evident that ABC is no longer within the target range of its risk management strategy. In order to execute the risk management strategy, ABC no longer needs part of its interest rate swap. In other words, the risk management objective for the hedging relationship has changed. Consequently, ABC discontinues EUR20m of the hedging relationship (a partial discontinuation). ABC could close out the risk from EUR20m of the IRS or ABC could choose to use the EUR20m of the IRS to hedge a different exposure or to transfer it to a trading book.

Going forward, ABC's debt financing and risk profile will be as follows: *[IFRS 9.B6.5.24(a)]*

Non-current financial liabilities as of 31 March 20X2	Variable rate	Fixed rate
Variable rate borrowings	100	
Fixed rate borrowings		50
Pay fixed/receive floating interest rate swap	(10)	10
Total	**90**	**60**
	60%	40%

The above example only illustrates the outcome of one particular course of action. The entity could also have adjusted its interest rate exposure in a different way in order to remain in the target range for its fixed rate funding, for instance by swapping EUR20m of the new fixed rate bond into variable rate funding. In that case, instead of discontinuing a part of the already existing cash flow hedge, the entity could have designated a new fair value hedge. The example in the application guidance of the standard is obviously a simplified one. In practice, entities tend to have staggered maturities for different parts of their financing. In such situations it would often be obvious from the maturity of the new interest rate swaps if they are a fair value hedge of the debt or a reduction of the already existing cash flow hedge volume. For example, if the new EUR50m fixed rate bond is for a longer period than the existing debt and the new interest rate swap is for the same longer period, it would suggest that it is a fair value hedge of the new fixed rate bond instead of a reduction of the cash flow hedge for the already existing debt. Conversely, a reduction of the cash flow hedge volume would be consistent with entering into a new interest rate swap that has the same remaining maturity as the existing interest rate swap and offsets its fair value changes on a part of the notional amount. Whichever way an entity chooses to incorporate a change in risk management activity into its hedge accounting solution, it must be directionally consistent with its risk management strategy (see section 6.2.1 above).

Illustration 8-7: Partial discontinuation of an interest margin hedge

XYZ Bank is holding a combination of fixed and variable rate assets and liabilities on its banking book. For risk management purposes, the bank allocates all the assets and liabilities to time bands based on their contractual maturity. As of 1January 20X1 the bank holds the following instruments in the 5-year time band (the tables in this example show nominal amounts in millions of euro (EUR)). For simplicity the example only reflects a single time band. In reality this is highly unlikely to be the case. Further, the risk management activity is also simpler than might be the case when considering numerous time bands:

Summary of instruments with a 5-year maturity	Assets: fixed rate	Liabilities: fixed rate	Assets: variable rate	Liabilities: variable rate
Bonds held			20	
Mortgages	30		10	
Retail loans	30		10	
Client term deposits				(60)
Bonds issued		(30)		(10)
Total	**60**	**(30)**	**40**	**(70)**
Fixed-variable interest mismatch	30	(30)		

The fixed-variable mismatch results in interest margin risk due to changes in interest rates.

Risk management strategy

To eliminate the interest margin risk resulting from fixed-variable interest mismatches.

Risk management activity

In order to achieve the risk management strategy, XYZ Bank enters into a pay fixed/receive variable interest rate swap (IRS) with a notional amount of EUR30m. For accounting purposes, the bank could either designate the IRS in a cash flow hedge of EUR30m of specific variable rate liabilities or in a fair value hedge of EUR30m of specific fixed rate assets (see section 6.2.1 above). Under the local regulatory requirements, fair value hedges are more favourable for the bank's regulatory capital.

Risk management objective

Using a EUR30m pay fixed/receive variable IRS in a fair value hedge of EUR30m of fixed rate retail loans to hedge a fixed-variable interest mismatch on fixed and variable rate assets and liabilities in the 5-year time band of XYZ Bank's banking book.

At the beginning of year 20X3, XYZ Bank attracts EUR10m of client term deposits as a result of a successful marketing campaign. The new term deposits all have a fixed interest rate for a maturity of three years, therefore, matching the (remaining) maturity of the instruments in the above time bucket. The XYZ Bank uses the proceeds from the new term deposits to buy back EUR10m of variable rate bonds that it has issued. The new situation in the (now) 3-year time band is:

Summary of instruments with a 3-year maturity	Assets: fixed rate	Liabilities: fixed rate	Assets: variable rate	Liabilities: variable rate
Bonds held			20	
Mortgages	30		10	
Retail loans	30		10	
Client term deposits		(10)		(60)
Bonds issued		(30)		(0)
Total	**60**	**(40)**	**40**	**(60)**
Fixed-variable interest mismatch	20		(20)	
Pay fixed/receive variable interest rate swap	(30)		30	

As a result of the change in funding, the risk management objective of the hedging relationship has changed. XYZ Bank is over-hedged and needs to discontinue EUR10m of its hedging relationship. Even though there is no change in the designated hedged items themselves, given that XYZ Bank's risk management strategy is to consider all interest margin risk, the risk management objective for the designated hedge has changed.

As stated above, whether the risk management objective has changed for a particular hedge relationship will be a matter of fact, and for many scenarios this will be obvious, as demonstrated in Illustration 8-6 and Illustration 8-7 above. However, for more complex risk management approaches, judgement will be required to determine whether the risk management objective has changed or not. An example would be when managing the risk from a portfolio on a dynamic basis but for which 'proxy' hedge accounting relationships have been designated (see section 6.2.1 above). The application guidance in IFRS 9 provides an example of how a change in the risk management objective is considered for a dynamic risk management approach.

Illustration 8-8: Change in risk management objective for an open portfolio of debt instruments

An entity manages the interest rate risk of an open portfolio of debt instruments. The resultant exposure from the open portfolio frequently changes due to the addition of new debt instruments and the derecognition of debt instruments (i.e., it is different from simply running off a position as it matures). Entity A applies a dynamic process in which both the exposure and the hedging instruments used to manage it do not remain the same for long. Consequently, Entity A frequently adjusts the hedging instruments used to manage the interest rate risk as the exposure changes. For example, debt instruments with 24 months' remaining maturity are designated as the hedged item for interest rate risk for 24 months. The same procedure is applied to other time buckets or maturity periods. After a short period of time, Entity A discontinues all, some or a part of the previously designated hedging relationships and designates new hedging relationships for maturity periods on the basis of their size and the hedging instruments that exist at that time. The discontinuation of hedge accounting in this situation reflects that those hedging relationships are established in such a way that Entity A looks at a new hedging instrument and a new hedged item instead of the hedging instrument and the hedged item that were designated previously. The risk management strategy remains the same, but there is no risk management objective that continues for those previously designated hedging relationships, which as such no longer exist.

In such a situation, the discontinuation of hedge accounting applies to the extent to which the risk management objective has changed. This depends on the situation of an entity and could, for example, affect all or only some hedging relationships of a maturity period, or only part of a hedging relationship. *[IFRS 9.B6.5.24(b)]*.

The above example would, in particular, appear to be relevant if an entity with a dynamic risk management approach to interest rate risk within an open portfolio designates its risk management activity as a macro cash flow hedge (see section 10.2 below). A change in risk management objective might also occur in the

case of a closed portfolio for which the managed risk has changed such that the entity looks to new hedging derivatives to meet the risk management strategy, for example if managing the duration risk from a portfolio of fixed rate loans to within particular risk limits (see Illustration 6-1 in section 6.2 above).

The situation is further complicated if a financial institution initiates risk management activity using internal derivatives. For example, interest rate risk from general banking activities could be managed centrally by a Group treasury function by transferring risk positions via internal derivatives to a Trading function. The Trading function would assume the interest rate risk from the internal derivatives within their trading book and transact external derivatives accordingly to match the trading desk limits and strategy. Hedge accounting can only be achieved to the extent that external derivatives are designated as hedging instruments of eligible hedged item within the general banking activities, as a proxy hedge (see sections 4.2.1 and 6.2.1 above).

The Group treasury could subsequently wish to change its interest rate risk position with the Trading function, perhaps due to a change in view of the shape of the relevant yield curve. In that case the Group treasury might amend the existing internal derivatives with the Trading function. The amended internal derivatives will impact the risk position managed by the Trading function but would not necessitate an equivalent change to any external derivatives. It appears clear that the Group treasury has changed its risk management objective for certain hedged items. However, as Group treasury only 'hedge' their risk via internal derivatives there is a question as to whether any designated proxy hedge relationships can be discontinued without any associated change to the external derivatives. Judgement is required, but if there is a clear change in risk management objective for particular hedged items within Group treasury, and the Trading function has autonomy to manage their own trading risk position including any internal derivatives, that could be sufficient to determine that the risk management objective for those hedged items designated in a proxy hedge has changed (or partially changed) and the hedge must be discontinued (or partially discontinued).

8.3.4 Documented hedged item no longer exists

Hedge accounting is only permitted for eligible hedged items, hence hedge accounting must be discontinued if the hedged item no longer exists (see section 8.3 above). Partial discontinuation is required if only a part of the hedged item no longer exists. *[IFRS 9.6.5.6]*. For partial discontinuations, it is important that the hedge relationship containing the remaining hedged item continues to meet the qualifying criteria in order to continue hedge accounting (see section 6 above).

Specific guidance is provided on the accounting for the adjustment arising from a hedging gain or loss on the hedged item in a fair value hedge or the amount accumulated in OCI in a cash flow hedge on discontinuation of a hedge relationship (see sections 8.3.1 and 8.3.2 above).

In many cases it will be straight forward to determine whether the hedged item exists or not, but in all cases that determination will need to be made with respect to the documented description of the hedged item made on initial designation (see section 6.3 above). The importance of the initial documentation of hedged items and the impact it can have over the life the hedge relationship is illustrated below in Illustration 8-9, Illustration 8-10 and Illustration 8-11. In all the examples below, it is assumed that the qualifying criteria for application of hedge accounting are met on initial designation (see section 6 above).

Illustration 8-9: Interruption of hedged forecast cash flows

An entity with sterling as its functional currency documents the designation of its forecast euro highly probable sales of €100,000 each month throughout 20X2 as hedged items in a cash flow hedge of the risk of changes in foreign currency rates (see sections 2.6.1 and 6.3.3 above). It hedges these sales by entering into a series of forward foreign currency contracts, one for each month. Business is severely interrupted for a number of months (e.g., from a fire in the warehouse or a global pandemic) such that sales in May, June and July are now expected to be zero. The hedged cash flows for May, June and July therefore no longer exist. Hedge accounting for those cash flows must be discontinued and the associated amounts in OCI recycled to profit or loss immediately. This is despite the fact that the entity could have unhedged euro sales in subsequent months, as they do not meet the description of the hedged item as documented. This is the case even if there is a belief that greater than originally expected euro sales in subsequent months would arise as a catch up of sales that did not take place in earlier months.

Illustration 8-10: Change in forecast hedged item

Entity X, a specialist supplier and fitter of luxury vehicles, with euro functional currency has negotiated a sale of a bespoke luxury yacht. It is highly probable the sale will be made to a particular US customer in September 20X2. Given the customized nature of the yacht specifications and the currency of the customer, the sales price was negotiated in US dollars (see section 2.2.5 above). Entity X designates the highly probable forecast sale of the bespoke luxury yacht for USD10m as the hedged item in a cash flow hedge of the risk of changes in foreign currency rates.

Subsequently the sale is delayed due to delivery issues, and it is now expected to occur in December 20X2. Although the expected timing has changed, the sale of the bespoke luxury yacht to the particular US customer is still highly probable and so the documented hedged item still exists. The change in timing could however result in some additional ineffectiveness (see sections 7.4.2 and 7.4.4 above).

Whilst Illustration 8-9 and Illustration 8-10 above both include a scenario in which the expectations of the entity undertaking the risk management activity have changed with respect to timing of foreign currency cash flows, it can be seen that the outcome for the hedge relationship is quite different. In Illustration 8-9 in which the hedged item is defined by its timing, i.e., sales in May, June and July 20X2, a change in timing would redefine the hedged item such that it is different to the original documented hedged item. By contrast, in Illustration 8-10 the definition of the hedged item is the highly probable sale of a bespoke luxury yacht itself. The time period in which a forecast transaction is expected to occur must be identified and documented within a reasonably specific and generally narrow range of time from a most probable date in order to determine that the forecast transaction is highly probable (see section 6.3.3 above). *[IAS 39.F.3.11]*. However, a change in the estimate of the timing of the sale of a bespoke luxury yacht does not of itself redefine the hedged item, hence it is still highly probable the original hedged item will occur.

Illustration 8-11: Change in hedged forecast debt issuance

As at 1 January 20X2 Entity A expects to issue highly probable 10 year floating rate debt in June 20X2. In order to hedge cash flow variability from changes in SONIA, Entity A transacts a forward starting 10 year pay fixed, receive SONIA interest rate swap (IRS) from June 20X2. The IRS is designated in a cash flow hedge for changes in SONIA interest rates.

There are a number of ways in which the hedged item (i.e., the forecast debt) might be documented for that hedge relationship. For the purposes of illustration, set out below are two possible ways key aspects of the hedged items might be described in the documentation. Additional information, not provided here, is likely to be required in order to meet all of the requirements of the standard (see section 6.3 above):

(a) The variability of cash flows on 10 year £100m debt expected to be issued in June 20X2 attributable to the risk of changes in SONIA

Or

(b) The variability of cash flows arising on forecast GBP interest flows (based on £100m principal) between June 20X2 and June 20X2, attributable to the risk of changes in SONIA

Let us now consider various scenarios that might arise sometime after designation of the hedge relationship, and how the documentation of the hedged item would affect the outcome for hedge accounting:

(i) £100m debt was issued in June 20X2, but at a fixed interest rate based on SONIA plus a spread

For both a) and b) it appears the documented hedged item still exists.

However, it is likely that the IRS would be closed out once the debt was issued. This would have no bearing on the hedge relationship, which would already have ended as there is no further variability in cash flows from the issued fixed rate debt. As the hedged items are still expected to occur, the amount accumulated in OCI must be reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment in the periods that interest expense is recognised in profit or loss (see section 7.2.2 above).

(ii) £100m floating rate debt (monthly coupons) was issued in September 20X2

If the issued debt met the description under a) in all areas other than timing, it is likely that the hedged item in a) still exists. However, some ineffectiveness will arise due to the change in timing of the hedged item. This case is similar to that of the specialist supplier and fitter of luxury vehicles in Illustration 8-10 above, for which the forecast sale of the bespoke luxury yacht was delayed. In both cases, the identification of the documented hedged item was defined by the transaction itself, rather than its timing.

For hedged item b) the hedged interest flows from June to August 20X2 do not exist (similar to the conclusion in Illustration 8-9 above), but the remaining interest flows until June 20X2 are still highly probable of occurring. Assessment of the effectiveness requirements and measurement of ineffectiveness must reflect the fact that the June to August 20X2 flows no longer exist. If a hypothetical derivative is used for assessment and measurement purposes it will need to be updated to reflect the fact that no interest flows will occur from

June to August 20X2 (see section 7.4.4 above). This will lead to an additional source of ineffectiveness which must be considered within the economic relationship assessment and is likely to lead to the recognition of ineffectiveness (see sections 6.4.1 and 7.2.1 above). Any amounts remaining in OCI relating to the June to August 20X2 cash flows that are no longer expected to occur must be recycled immediately to profit or loss (see section 8.3.2 above).

It can be seen that documentation of the hedged item on initial designation requires careful consideration, as it is a key determinant through the life of the hedge relationship as to whether the hedged item continues to exist.

Although it might seem potentially beneficial to be intentionally vague when documenting a hedged item in order to reduce the possibility that some unforeseen circumstance might require discontinuation of a hedge relationship, the documentation must be sufficiently specific in order to ascertain whether the hedged item has occurred or not. Having said that, this does not mean the hedge documentation needs to specify the hedged item in every single detail. As mentioned above, the key aim of the documentation is to provide clarity as to whether the hedged item has occurred or not, hence a balance needs to be struck to achieve an appropriate level of specificity. The Implementation Guidance within IAS 39 contained some guidance on the need for sufficient specificity of the documented hedged item, this guidance can be considered relevant for IFRS 9 hedge accounting (see section 6.3 above). *[IAS 39.F.3.10, IFRS 9.BC6.200]*.

The examples above all relate to highly probable forecast transactions, however the requirement to consider changes in the hedged item can also arise for recognised hedged items. This is illustrated below in Illustration 8-12.

Illustration 8-12: Change in hedged recognised variable rate debt

In 20X1 Entity B issued 100m of euro denominated 7 year variable rate debt paying €STR plus a spread. At the same time Entity B entered into a EUR100m interest rate swap receiving €STR and paying a fixed rate of interest. The swap was designated as a hedging instrument in a cash flow hedge of the variability in interest payable on the EUR100m debt with respect to changes in interest rates. It is assumed that the qualifying criteria for application of hedge accounting are met on initial designation (see section 6 above).

In 20X2, a product that Entity B has developed is proving very successful and in June 20X2 it unexpectedly receives a number of very lucrative offers to buy out the product. If an offer were accepted and settled then Entity B would no longer have need of the EUR100m debt and would repay the debt at par (as per the terms of the debt).

Even though the hedged variability is from a recognised instrument rather than a highly probable forecast one, there is still a requirement to consider whether the variability of the hedged item will occur. The importance of this consideration was evidenced in the IASB's discussion on the amendments to IFRS 9 for IBOR reform, for which the amendment was required to reflect uncertainty in the variability of both forecast and recognised IBOR related financial instruments (see the *Supplement: IBOR Reform*).

In this case, even though Entity B has not yet repaid the EUR100m debt, an assessment must be made in June 20X2 as to whether all the hedged future interest payments arising on the debt are highly probable or not. This will require judgement and would clearly need to consider management's plans for the sale of the product (see section 2.6.1 above). It is not acceptable to wait until a final decision is made on the potential sale and subsequent debt repayment.

It could be that management is not able to determine that certain interest payments are highly probable, which will result in a (partial) discontinuation of the hedge relationship (see section 8.3 and Illustration 8-5 in section 8.3.2 above). However, those interest payments might still be expected to occur (a lower hurdle than highly probable), in which case the amounts accumulated in OCI relating to those interest payments will remain there until they occur or are no longer expected to occur (see section 8.3.2 above).

8.3.5 Impact of novation to central clearing parties on cash flow hedges

The collapse of some financial institutions during the financial crisis highlighted the potential impact of credit risk on the global derivatives markets. In response to this, several jurisdictions introduced, legal or regulatory requirements that require or incentivise over-the-counter (OTC) derivatives to be novated to a central clearing party (CCP). The CCP would usually require the derivatives to be collateralised, thereby reducing (potentially significantly) the counterparty credit risk.

Following an urgent request, the IFRS IC concluded in January 2013 that an entity is required to discontinue hedge accounting where an OTC derivative that is designated as hedging instrument in a hedging relationship is novated to a CCP (unless, very unusually, the novation represented a replacement or rollover of the hedging instrument as part of a documented hedging strategy (see section 7.7 above)). This is because the novated derivative is derecognised and the new derivative contract, with the CCP as a

counterparty, is recognised at the time of the novation. *[IFRS 9.BC6.336]*. However, if the new derivative was designated in a cash flow hedge relationship accounting ineffectiveness would likely arise if the derivative is off market (see section 7.4.3 above). Consequently, the IFRS IC decided to recommend that the IASB make a narrow-scope amendment to IAS 39 to permit continuation of hedge accounting in such narrow circumstances.[28] In July 2013 the IASB amended IAS 39 after the publication of an exposure draft in February 2013 and the changes were also incorporated in IFRS 9 when the hedge accounting chapter was added in November 2013.

The relevant guidance in IFRS 9 states that an expiration or termination of the hedging instrument does not require discontinuation of the hedge relationship if:

- As a consequence of changes in laws or regulations, the original counterparty to the hedging instrument is replaced by a clearing counterparty (sometimes called a 'clearing organisation' or 'clearing agency') or a clearing member of a clearing organisation or a client of a clearing member of a clearing organisation, that are acting as counterparty in order to effect clearing by a central counterparty.
- Each of the original counterparties to the hedging instrument effects clearing with the same central counterparty.

  And

- Other changes, if any, to the hedging instrument are limited to those that are necessary to effect such a replacement of the counterparty. Such changes are limited to those that are consistent with the terms that would be expected if the hedging instrument were originally cleared with the clearing counterparty. These changes include changes in the collateral requirements, rights to offset receivables and payables balances, and charges levied. *[IFRS 9.6.5.6]*.

It can be seen from the guidance that the exception applies to some, but not all, voluntary novations to a CCP. In order for hedge accounting to continue, a voluntary novation must at least be associated with laws or regulations that are relevant to central clearing of derivatives. For example, a voluntary novation could be in anticipation of regulatory changes. However, the mere possibility of laws or regulations being introduced is not, in the view of the IASB, a sufficient basis for continuation of hedge accounting. *[IFRS 9.BC6.349]*. So, a novation needs to be required by laws or regulations (or at least associated with a change in law or regulations) for hedge accounting to be continued, allowing all novations to CCPs to be accommodated would be wider than the IASB had intended. *[IFRS 9.BC6.347]*.

Further, the exception also applies to so-called 'indirect clearing' arrangements whereby a clearing member of a CCP provides an indirect clearing service to its client or where a group entity is clearing on behalf of another entity within the same group since they are consistent with the objective of the amendments. *[IFRS 9.BC6.348]*.

A further impact of novating derivatives to a CCP is that the derivatives are likely to become collateralised by cash. The July 2013 amendments to IFRS 9 acknowledged this and provided clarity that such a change on novation to a CCP would not result in derecognition if such changes are limited to those that are consistent with the terms that would be expected if the hedging instrument were originally cleared with the clearing counterparty. *[IFRS 9.6.5.6(b)]*.

Cash collateralisation significantly reduces the credit risk for both parties involved, which will influence the fair value of derivatives novated. The application guidance clarifies that the change in the fair value of the hedging instrument that results from the changes to the contract in connection with the novation (e.g., a change in the collateral arrangements) must be included in the measurement of hedge ineffectiveness. *[IFRS 9.B6.4.3]*.

The other criteria for achieving hedge accounting will still need to be met in order to continue hedge accounting (see in section 6 above).

The amendment was only designed to be a narrow-scope amendment for the specific situation of novation of certain derivatives to a CCP associated with laws or regulation that are relevant to the clearing of derivatives, hence it must not be applied more widely to other scenarios. *[IFRS 9.BC6.347]*.

28 *IFRIC Update*, January 2013, available on the IFRS Foundation's website.

8.3.6 Settle to market derivatives within cash flow hedges

In December 2015, the London Clearing House (LCH) changed its rule book to introduce a new type of settled-to-market (STM) interest rate swap in addition to the previously existing collateralized-to-market (CTM) swaps.

In the existing CTM model, transactions cleared through LCH were subject to daily cash variation margining. This means that the replacement value of the trade is in effect paid or received as cash each day and there is no ability to recover any of the variation margin unless the fair value of the interest rate swap changes. In addition, the variation margin is also used to settle the periodic swaps payments, and, in case of early settlement, the variation margin is used to settle the outstanding derivative position. Interest is paid on the variation margin based on a risk-free overnight rate.

In the STM model, transactions have the same economic exposure and overall cash flows as in the CTM model, except that the previous daily variation margin is now treated as a settlement of the interest rate swap's outstanding fair value. While the swap is gradually settled, it remains the same swap with the same original terms (e.g., the fixed rate, maturity date etc.). Hence, the daily settlement under the STM model of a derivative designated as the hedging instrument in a hedge relationship does not mean it has expired or terminated, and so does not result in discontinuation of the hedge relationship (see section 8.3 above). In order to maintain the same economics, a new feature of the STM swap pricing is the Price Alignment Interest (PAI) that essentially replicates what would have been the interest on the collateral for a CTM swap into the STM swap pricing.

8.3.7 Change of hedging counterparty within the same consolidated group

An entity might be required to, or choose to, novate a hedging instrument from one entity within a consolidated group, to another entity within the same group. For example, following the vote by the United Kingdom to leave the European Union in June 2016, commonly known as 'Brexit', Corporate A (the hedging entity) might plan to novate existing hedging derivatives with Bank UK (the hedging counterparty entity), to Bank EU, both Bank UK and Bank EU are subsidiaries of the same global banking group. Alternatively, a banking group might undertake an internal reorganisation such that a portfolio of derivatives (or a whole business) is transferred into a different entity within the same banking group. In both instances a question arises as to whether such a change in hedging derivative counterparty will result in the discontinuation of a hedge relationship.

We set out below the accounting requirement from the perspective of the various parties in the fact pattern - on the assumption that all parties designate the novated derivative in an eligible hedge relationship, consistent with their risk management objective.

- In the standalone financial statements of the original hedging counterparty, (i.e., Bank UK in the Brexit example above), it is clear that a hedge relationship would be discontinued, as an eligible hedging instrument no longer exists within that hedging counterparty legal entity.
- In the standalone financial statements of the new hedging counterparty (i.e., Bank EU in the Brexit example above), it is clear that a new hedge relationship would need to be designated (including identification of an eligible hedged item), as this entity is not party to the instrument designated in the previous hedge relationship (unless the derivative and designated hedged item were both included in a business transferred as part of the common control transaction (see Chapter 11 at section 3.3.4)).
- In the consolidated financial statements of a parent that consolidates both the original hedging counterparty (i.e., Bank UK) and the new hedging counterparty (i.e., Bank EU), (i.e., the global banking group in the Brexit example above) the hedge relationship will continue. This is because an entity first consolidates all subsidiaries and then applies the derecognition guidance to financial instruments. *[IFRS 9.3.2.1]*. Accordingly, the hedging derivative still exists within the consolidated financial statement, hence there is no requirement to discontinue the hedge relationship.
- From the perspective of the hedging entity (i.e., Corporate A), the transfer of a derivative from one counterparty to another would ordinarily result in derecognition and hence a de-designation and re-designation of a hedge relationship (see section 8.3.5 above). However, the appropriate treatment will depend on the specific facts and circumstances.

8.3.8 Disposal of a hedged net investment

The amount relating to a net investment hedge that has been accumulated in the foreign currency translation reserve must be reclassified from equity to profit or loss as a reclassification adjustment on disposal or, in certain circumstances, partial disposal of the foreign operation in accordance with IAS 21 (see Chapter 16 at section 6.6 and section 7.3 above). *[IFRS 9.6.5.14]*.

When a foreign operation that was hedged is disposed of, the amount reclassified from the foreign currency translation reserve to profit or loss is as follows:

- In respect of the hedging instrument in the consolidated financial statements, the cumulative gain or loss on the hedging instrument that was determined to be an effective hedge (see section 7.3.1 above) *[IFRIC 16.16]*

  And

- In respect of the net investment, the cumulative amount of exchange differences relating to that foreign operation *[IAS 21.48, IFRIC 16.17]*

If an intermediate parent exists within the ultimate consolidation group, there is a choice of applying either the direct or step-by-step method of consolidation (see Chapter 16 at sections 6.1.4 and 6.6). If the step-by-step method of consolidation is used, the cumulative amount of exchange differences relating to that foreign operation accumulated in the foreign currency transaction reserve could be different to the equivalent amount had the direct method of consolidation been applied. This potential difference in the accounting outcome on disposal of a foreign operation is illustrated in Illustration 8-13 below.

This difference in accounting treatment could be eliminated, but there is no requirement to do so. An accounting policy choice must be taken as to whether the difference is eliminated or not, and such a choice must be applied consistently on disposal of all net investments. *[IFRIC 16.17]*.

Illustration 8-13: Disposal of foreign operation

Consider the same facts as in Illustration 5-3 and Illustration 5-4 in sections 5.3.1 and 5.3.2 above. In summary, Company P is the ultimate parent entity of a group and presents its consolidated financial statements in its functional currency of euro. It has two direct wholly owned subsidiaries, Company A whose functional currency is Japanese yen and Company B whose functional currency is sterling. B has a wholly owned subsidiary, Company C, whose functional currency is US dollars. P's net investment in A is ¥400,000 million. P's net investment in B is £500 million including the equivalent of £159 million representing B's net investment in C of US$300 million. The group has designated US$300 million of US dollar borrowings of A as a hedge of the net investment in C with the risk being the spot foreign currency exposure (€/US$) between P and C. If C were disposed of, the amounts reclassified to profit or loss in P's consolidated financial statements from its foreign currency translation reserve would be: *[IFRIC 16.16, IFRIC 16.17, IFRIC 16.AG8]*

- In respect of A's borrowing (the hedging instrument), the total change in value in respect of foreign currency risk that was recognised in other comprehensive income as the effective portion of the hedge (i.e., the retranslation effect on the US$300 million borrowing with respect to the EUR/USD foreign currency rate since initial designation).

  And

- In respect of the net investment in C, the amount determined by the entity's consolidation method:
  - If P uses the direct method, its foreign currency translation reserve ('FCTR') in respect of C will be determined directly by the EUR/USD foreign currency rate.
  - If P uses the step-by-step method, its FCTR in respect of C will be determined by the FCTR recognised by B reflecting the GBP/USD foreign currency rate, translated to P's functional currency using the EUR/GBP foreign currency rate.
- P's use of the step-by-step method for consolidation in prior periods does not require it to or preclude it from determining the amount of FCTR to be reclassified when it disposes of C to be the amount that it would have recognised if it had always used the direct method. However, it is an accounting policy choice which should be followed consistently on disposal of all net investments.

9 Presentation

For a comprehensive overview of the financial instruments related presentation requirements of IFRS 7 *Financial Instruments: Disclosures*, see Chapter 50 (in particular see Chapter 50 at section 4.3 and section 7.1.3 for hedge accounting presentation requirements). We present below only some of the key requirements for hedge accounting.

IFRS 9 includes plenty of guidance as to when gains and losses from hedge accounting must be recognised in profit or loss. The standard is much less precise as to where in the profit or loss such gains and losses are presented. However, it can be inferred that gains and losses from hedging instruments in hedging relationships would normally be presented in the same line item that is affected by the hedged item (at least to the extent the hedge is effective), rather than being shown separately, although this is not explicitly stated in IFRS 9 (see Chapter 50 at section 7.1.3).

The IFRS IC clarified in March 2018 that only interest on financial assets measured at amortised cost or on debt instruments measured at fair value through other comprehensive income are permitted to be included in the amount of interest revenue presented separately for items calculated using the effective interest method (see Chapter 50 at section 7.1.1). *[IAS 1.82(a), IFRS 18.75(b)(i)]*. At this meeting it was also concluded that the separate interest revenue line would encompass the effect of a qualifying hedge of interest rate risk, applying the hedge accounting requirements.[29]

9.1 Cash flow hedges

IFRS 9 requires that those amounts accumulated in the cash flow hedging reserve are reclassified from the cash flow hedge reserve as a reclassification adjustment in the same period or periods during which the hedged future cash flows affect profit or loss. The guidance provides as an example of the period over which such a reclassification must occur, as the "periods that interest income or interest expense is recognised" (see section 7.2.2 above). *[IFRS 9.6.5.11(d)(ii)]*. This clarifies that entities cannot simply account for the net interest payment on an interest rate swap straight into profit or loss but would have to present this as a reclassification adjustment between OCI and profit or loss. There is a requirement to disclose reclassification adjustments in the statement of comprehensive income (see Chapter 50 at section 7.2). *[IAS 1.92, IFRS 18.90]*.

If the hedged transaction subsequently results in the recognition of a non-financial item, the amount accumulated in equity is removed from the separate component of equity and included in the initial cost or other carrying amount of the hedged asset or liability. This accounting entry, sometimes referred to as 'basis adjustment', does not affect OCI of the period (see section 7.2.2 above). *[IFRS 9.6.5.11(d)(i)]*.

A similar approach would equally apply to situations where a hedged forecast transaction involving a non-financial asset or non-financial liability subsequently becomes a firm commitment for which fair value hedge accounting is applied.

For any other cash flow hedges, the amount accumulated in equity is reclassified to profit or loss as a reclassification adjustment in the same period or periods during which the hedged cash flows affect profit or loss. This accounting entry does affect OCI for the period and must be disclosed as a reclassification adjustment in OCI. *[IFRS 9.6.5.11(d), IAS 1.92, IFRS 18.90]*.

9.2 Fair value hedges

Entities recognise the gain or loss on the hedging instrument in profit or loss and adjust the carrying amount of the hedged item for the hedging gain or loss with the adjustment being recognised in profit or loss (see section 7.1.1 above).

For hedged items that are debt instruments measured at fair value through OCI in accordance with IFRS 9.4.1.2A (see Chapter 46 at section 2.3), the gain or loss on the hedged item results in recognition of that amount in profit or loss rather than accumulating in OCI. This means fair value hedge accounting changes the presentation of gains or loss on the hedged item, but the measurement of the debt instrument at fair value remains unaffected. *[IFRS 9.6.5.8(b)]*.

For hedged items that are equity instruments for which an entity has elected to present fair value changes in OCI without subsequent reclassification to profit or loss, the accounting for a fair value hedge is different because it does not affect profit or loss but, instead, OCI. There is no change to the accounting for the

29 *IFRIC Update*, March 2018, available on the IFRS Foundation's website

hedged item and the gain or loss on the hedging instrument is recognised in OCI (see sections 2.6.3, 7.1.1 and 7.8 above). *[IFRS 9.6.5.8]*.

9.3 Hedges of groups of items

9.3.1 Cash flow hedges

The designation of a group of items within a cash flow hedge, has no effect on the presentation in profit or loss of those designated hedged items. However, the presentation of the related hedging gains or losses in the statement of profit or loss depends on the nature of the group position. *[IFRS 9.B6.6.13, IFRS 9.B6.6.14, IFRS 9.B6.6.15]*. The required presentation for hedges of groups of items is discussed in more detail in Chapter 50 at section 7.1.3 and is summarised in the table below.

Figure 9-1: Presentation for a hedge of groups of items

Nature of position	Line items affected in profit or loss	Presentation in the income statement
Gross position	One line item	The amount reclassified from equity to profit or loss has to be presented in the same line item as the underlying hedged transaction.
	Multiple line items	The amount reclassified from equity to profit or loss has to be allocated to the line items affected by the hedged items on a systematic and rational basis but shall not result in a gross up of the net gains or losses on the hedging instrument.
Net position	Multiple line items	The amount reclassified from equity to profit or loss has to be presented in a separate line item.

Note that the designation of a net position cash flow hedge is only permitted when hedging foreign currency risk (see section 2.5.3 above).

For net position cash flow hedges, as the hedging gains and losses will be presented in a different line to that in which the hedged items are presented in profit or loss, such a hedge designation might not seem very attractive, as the presentation of the hedged transactions will not reflect the effect of the hedge. However, the Board was concerned that grossing-up the hedging gain or loss would result in non-existing gains or losses being recognised in the statement of profit or loss, which would be in conflict with general accounting principles. *[IFRS 9.BC6.457, IFRS 9.BC6.458]*. The Board also considered that such a presentation makes it transparent that an entity is hedging on a net basis and would clearly present the effect of those hedges of net positions on the face of the statement of profit or loss. *[IFRS 9.BC6.461]*. However, because of this presentation, in practice some entities might choose to continue to designate a proportion of a gross position rather than a net designation. Such a 'proxy designation' would be permitted provided the designation is directionally consistent with the actual risk management activities (see section 6.2.1 above). *[IFRS 9.BC6.98, IFRS 9.BC6.100(a)]*.

9.3.2 Fair value hedges

A special presentation in the income statement is prescribed for fair value hedges of groups of items with offsetting risk positions (i.e., hedges of a net position), whose hedged risk affects different profit or loss line items. Entities must present the hedging gains or losses of such a hedge in a separate line item in the income statement in order to avoid grossing up the hedging gain or loss on a single instrument into multiple line items. Hence in that situation the amount in the line item that relates to the hedged item itself remains unaffected. *[IFRS 9.6.6.4, IFRS 9.B6.6.16]*.

However, the treatment in the statement of financial position is different, in that the individual items in the group are separately adjusted for the change in fair value due to changes in the hedged risk. *[IFRS 9.6.6.5]*.

9.4 Costs of hedging

When applying the costs of hedging accounting to the time value of an option contract, the forward element of a forward contract or the foreign currency basis spread of a financial instrument, the treatment for the amount accumulated in a separate component of equity is dependent on the nature of the underlying hedged item (see section 7.5 above).

For transaction related hedges:

- If the hedged item subsequently results in the recognition of a non-financial asset or liability, or a firm commitment for a non-financial asset or liability for which fair value hedging will be applied, the amount accumulated in a separate component of equity is removed from equity and included directly in the carrying amount of the asset or liability. This is not a reclassification adjustment, and so does not affect the statement of OCI of the period. Rather, it is presented as a separate item in the statement of changes in equity.
- For other transaction related hedging relationships (such as a hedge of highly probable forecast sales), the amount accumulated in a separate component of equity is reclassified to profit or loss as a reclassification adjustment in the same period or periods during which the hedged expected future cash flows affect profit or loss. This is a reclassification adjustment, and so does affect OCI of the period.
- If all or a portion of the amount accumulated in a separate component of equity is not expected to be recovered, the amount that is not expected to be recovered is immediately reclassified into profit or loss (see section 7.2.1 above). This is a reclassification adjustment, and so does affect OCI of the period. *[IFRS 9.6.5.15(b)]*.

For time-period related hedges, the costs of hedging at the date of designation as a hedging instrument is required to be amortised on a systematic and rational basis over the period during which the hedged item impacts profit or loss (see section 7.5.1 above). The 'costs of hedging' in this context is the time value of an option contract, the forward element of a forward contract or the foreign currency basis spread, to the extent that it relates to the hedged item, (see section 7.5.1.A above). However, if the hedge relationship is discontinued, the net amount remaining in OCI (i.e., including cumulative amortisation) is immediately reclassified into profit or loss. Both are reclassification adjustments, and so do affect OCI of the period. *[IFRS 9.6.5.15(c)]*. The standard is however silent as to where in profit or loss the costs of hedging accumulated in OCI are to be recycled. Given the lack of explicit guidance, an accounting policy will need to be developed and applied consistently (see section 7.5.1 above).

10 Macro hedging

At a detailed level, the topic of portfolio (or macro) hedging for banks and similar financial institutions is beyond the scope of a general financial reporting publication such as this. However, no discussion of hedge accounting would be complete without an overview of the high level issues involved and an explanation of how the standard setters have tried to accommodate these entities.

Financial institutions, especially retail banks, usually have as a core business the collection of funds by depositors that are subsequently invested as loans to customers. This typically includes instruments such as current and savings accounts, deposits and borrowings, loans and mortgages that are usually accounted for at amortised cost. The difference between interest received and interest paid on these instruments (i.e., the net interest margin) is a main source of profitability.

A bank's net interest margin is exposed to changes in interest rates, a risk most banks (economically) hedge by entering into derivatives (mainly interest rate swaps). Applying the hedge accounting requirements as set out in IFRS 9 to such hedging strategies on an individual item-by-item basis can be difficult as a result of the characteristics of the underlying financial assets and liabilities:

- Prepayment options are common features of many fixed rate loans to customers (see sections 2.3.2 and 2.5.2 above). Customers exercise these options for many reasons, such as when they move house, and so not necessarily always in response to interest rate movements. Their behaviour can be predicted better on a portfolio basis rather than an item-by-item basis.
- As a result of the sheer number of financial instruments involved, banks typically apply their hedging strategies on a macro (or portfolio), dynamic basis, with the number of individual instruments in the hedged portfolio constantly changing.

In addition, not all exposures that form part of a bank's risk management of net interest margin are eligible as hedged items. For example, it is common for banks to attribute a 'deemed' fixed rate interest rate risk from their demand deposits, such as current account balances, savings accounts and other accounts paying either no or very low rates of interest, consistent with the bank's expectations as to how they will behave. These deemed fixed rate liabilities are often referred to as 'core demand deposits'. However, banks are prohibited by IFRS 9 from including core demand deposits in a manner that is consistent with their risk management strategy (see section 2.6.7 above). *[IAS 39.F.2.3]*.

IAS 39 includes some specific guidance originally designed with macro hedging in mind. Currently some of this guidance can still be applied even when IFRS 9 is applied (see section 10.2 below). *[IFRS 9.6.1.3]*. The IAS 39 macro hedging guidance exists for portfolio fair value, *[IAS 39.81A, IAS 39.89A, IAS 39.AG114 to 132]*, and cash flow hedge accounting, *[IAS 39.F.6.1, IAS 39.F.6.2, IAS 39.F.6.3]*, for interest rate risk. However, banks did not always use the IAS 39 macro hedge accounting solutions. This is because not all sources of interest rate risk qualify for hedge accounting, the use of the IAS 39 solutions can be operationally complex and cash flow hedge solutions result in volatility of other comprehensive income. Some European banks, instead, made use of the European Union's carve out of certain sections of the IAS 39 hedge accounting rules (see Chapter 1 at section 4.2.1.A).

The accounting for macro hedging was originally part of the IASB's project to replace IAS 39 with IFRS 9. However, the IASB realised that developing the new accounting model would take time and probably involve a different concept from hedge accounting. In May 2012, the Board therefore decided to decouple the part of the project related to the accounting for macro hedging from IFRS 9, allowing more time to develop an accounting model without affecting the timeline for the completion of the other elements of IFRS 9.[30] This separate project is referred to as Accounting for Dynamic Risk Management. The status of the project is discussed in section 10.1 below.

30 *IASB Update*, May 2012, available on the IFRS Foundation's website.

10.1 Accounting for dynamic risk management

In April 2014, the IASB issued the Discussion Paper - *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging*.[31] Most respondents supported the need for the project, but there was no consensus on a solution. Given the diversity in views, in July 2015 the IASB concluded that the insights that it had received from the comment letters and feedback so far did not enable it to develop proposals for an exposure draft. Accordingly, the IASB decided that the project should remain in the research programme, with the aim of publishing a second discussion paper, most likely with a new accounting model, without further developing the Portfolio Revaluation Approach to Macro Hedging.

Since November 2017 the IASB have been developing a new accounting model for the recognition and measurement for dynamic risk management (the DRM model). The IASB developed a model with the aim that it will enable investors to understand a company's dynamic risk management activities and to evaluate the effectiveness of those activities. Having developed the core aspects of the model, the IASB undertook outreach on the core DRM model to gather stakeholders' views prior to developing a consultation document. The outreach focused on whether the stakeholders felt the core DRM model would enable banks to better reflect their risk management strategies and activities in the financial statements. The outreach was undertaken between October 2020 and February 2021 and took the form of individual meetings with international banks that manage interest rate risk using dynamic management strategies.

The IASB discussed the feedback from the outreach at its April 2021 meeting. In principle, almost all participants supported the objective of the DRM model to better reflect interest rate risk management strategy and activities in the financial statements. However, many commented that some important refinements were necessary in order for the DRM model to meet its objective.

As a result of the outreach, the IASB tentatively decided to make some key refinements to the 'core areas' of DRM model, in order to respond to the concerns raised and key challenges identified in the outreach. Through the various IASB meetings since May 2021, the DRM model was further developed and at its meeting in May 2022, the IASB thought it had completed its deliberations on the outline of the proposed DRM hedge accounting model. The IASB then moved the project from its research programme to its standard-setting programme. However, since then the IASB has made various additional important tentative decisions in their meetings, with the latest in September 2024 (at the time of writing) on disclosure requirements. The IASB are expected to continue its discussions on the DRM model, including the proposed transition requirements, to be included in the future DRM exposure draft, expected in 2025.

For further information on the status of the DRM project and an explanation of how the model is expected to work see our publication Applying *IFRS : IASB continues to develop its DRM accounting model*.[32]

10.2 Applying hedge accounting for macro hedging strategies under IFRS 9

Because of its pending project on an accounting model specifically tailored to macro hedging (see section 10.1 above), the IASB created a scope exception from the IFRS 9 hedging accounting requirements that allows entities to use the fair value hedge accounting for portfolio hedges of interest rate risk, and only for such hedges, as defined and set out in IAS 39, until the project is finalised and becomes effective. *[IFRS 9.6.1.3]*. The specific guidance that defines what is meant by the fair value hedge accounting for portfolios of interest rate risk is set out in IAS 39.81A and 89A and IAS 39.AG114 to AG132. The application of this guidance for banks and similar financial institutions is beyond the scope of a general financial reporting publication such as this and so is not covered further within this publication.

However, IFRS 9 does not include a similar scope exception for the 'macro' cash flow hedge accounting set out in the Implementation Guidance to IAS 39, often applied by financial institutions to interest rate positions for which interest rate risk is managed on a net basis. *[IAS 39.F.6.1, IAS 39.F.6.2, IAS 39.F.6.3]*. The IASB is of the view that as the macro cash flow hedge accounting model is an application of the general hedge accounting model under IAS 39, the macro cash flow hedge accounting model could remain an application of the IFRS 9 hedge accounting guidance. Accordingly, the IASB did not want to make an exception for the macro cash flow hedge accounting approach and so decided to retain an earlier decision not to carry forward to IFRS 9 any IAS 39 Implementation Guidance on hedge accounting. *[IFRS 9.BC6.95]*.

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31 Discussion Paper DP/2014/1, *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging*, IASB, April 2014. Available on the IFRS Foundation's website.

32 Applying IFRS IASB continues to develop its DRM accounting model | EY - Global

However, many financial institutions were concerned that their understanding of the IAS 39 macro cash flow hedge accounting model was not totally consistent with IFRS 9 and that they would not be able to continue with their existing macro cash flow hedging strategies under IFRS 9.

Eventually, the IASB gave entities the following choices until the project on accounting for macro hedging is completed:

- To apply the hedge accounting requirements as set out in IFRS 9, in full.
- To apply the hedge accounting requirements as set out in IFRS 9 to all hedges except fair value hedges of the interest rate exposure of a portfolio of financial assets or financial liabilities; in that case an entity must also apply the paragraphs that were added to IAS 39 when that particular type of hedge was introduced (IAS 39.81A and 89A and IAS 39.AG114 to AG132) - i.e., an entity must apply all the hedge accounting requirements of IAS 39 (including the 80%-125% bright line effectiveness test as well) including the paragraphs that specifically address fair value hedges of the interest rate exposure of a portfolio of financial assets or financial liabilities); the choice to apply IAS 39 in these situations is the result of the scope of the hedge accounting requirements of IFRS 9 and available on a case-by-case basis (i.e., it is not an accounting policy choice). *[IFRS 9.6.1.3]*.

  Or

- To continue applying hedge accounting as set out in IAS 39 to all hedges until the project on accounting for macro hedging is completed; this is an accounting policy choice. *[IFRS 9.7.2.21]*. Because it is an accounting policy choice, an entity might later change its policy and start applying the hedge accounting requirements of IFRS 9 (subject to the transition requirements of IFRS 9 for hedge accounting) (see section 12.1 below). However, even if an entity chooses to continue to apply the hedge accounting requirements of IAS 39, the entity still must provide the hedge accounting disclosures that were developed during the IFRS 9 project because those disclosure requirements have become a part of IFRS 7 for which no similar accounting policy choice to continue to apply the previous requirements was provided. *[IFRS 9.BC6.104]*. Once an entity changes its accounting policy and starts to apply the hedge accounting requirements of IFRS 9, it cannot go back to applying IAS 39 (see section 12.1 below).

11 Alternatives to hedge accounting

11.1 Fair value option for credit risk exposures

Many financial institutions hedge the credit risk arising from loans or loan commitments using credit default swaps (CDS). This would often result in an accounting mismatch, as loans and loan commitments are typically not accounted for at fair value through profit or loss, whereas the CDSs would be. The most natural approach to hedge accounting would be to designate the credit risk as a risk component in a hedging relationship. However, the IASB noted that due to the difficulty in isolating the credit risk as a separate risk it does not meet the eligibility criteria for risk components (see section 2.2.1 above). As a result, the accounting mismatch creates profit or loss volatility. *[IFRS 9.BC6.470]*. The Exposure Draft leading up to IFRS 9 did not propose any changes in this area, however, the IASB asked its constituents to comment on three alternative approaches, none of which were that credit risk could be deemed an eligible risk component for hedge accounting. The feedback from constituents showed that accounting for credit risk hedging strategies is a major concern for many financial institutions. *[IFRS 9.BC6.491]*.

In its redeliberations the Board reconfirmed its view that credit risk does not qualify as a separate risk component for hedge accounting purposes. *[IFRS 9.BC6.504]*. However, the IASB decided that an entity undertaking economic credit risk hedging may, at any time, elect to account for all or a proportion of a debt instrument (such as a loan or a bond), a loan commitment or a financial guarantee contract, to the extent that any of these instruments is managed for changes in its credit risk, at fair value through profit or loss. This was one of the alternative approaches set out in the Exposure Draft. This election can only be made if the asset referenced by the credit derivative has the same issuer and subordination as the hedged exposure (i.e., both the issuer's name and seniority of the exposure match). The accounting for the credit derivative would not change, i.e., it would continue to be recorded at fair value through profit or loss. *[IFRS 9.6.7.1]*.

If the election is made, the difference at that time between the carrying value (if any) and the fair value of the financial instrument designated as at fair value through profit or loss is immediately recognised in profit or loss. In the case of a debt instrument accounted for as at fair value through other comprehensive income, the carrying amount (i.e., fair value) does not change but instead the gain or loss that has been accumulated in the revaluation reserve has to be reclassified to profit or loss, as a reclassification adjustment. *[IFRS 9.6.7.2]*. Different to a fair value hedge, once elected, the financial instruments hedged for credit risk are measured at their full fair value instead of just being adjusted for changes in the risk actually hedged. As a result, by economically hedging the credit risk exposure and applying the fair value option consistent with the guidance in IFRS 9.6.7.1, the entity also has to revalue the financial instrument for changes in interest rates, which could result in profit or loss volatility.

An entity must discontinue the specific accounting for credit risk hedges in line with its actual risk management. This would be the case when the credit risk either no longer exists or if the credit risk is no longer managed using credit derivatives (irrespective of whether the credit derivative still exists or is sold, terminated or settled). *[IFRS 9.6.7.3]*.

On discontinuation, the accounting for the financial instrument reverts to the same measurement category that had applied before the designation as at fair value through profit or loss. However, the fair value of the financial instrument on the date of discontinuing the accounting at fair value through profit or loss becomes the new carrying amount on that date. *[IFRS 9.6.7.4]*. For example, the fair value of a loan at the time of discontinuation becomes its new deemed amortised cost, which is also the basis to determine its new effective interest rate. This applies also to a debt instrument that reverts to accounting at fair value through other comprehensive income because it is required to affect profit or loss in the same way as a financial instrument at amortised cost. *[IFRS 9.5.7.11]*. This means the revaluation reserve only includes the gains and losses that arise after the date on which the accounting at fair value through profit or loss ceased.

For a loan commitment or a financial guarantee contract, the fair value at the date on which the accounting at fair value through profit or loss ceased is amortised over the remaining life of the instrument in accordance with the principles of IFRS 15 *Revenue from Contracts with Customers* unless the impairment requirements of IFRS 9 would require a higher amount than the remaining unamortised balance (see Chapter 46 at section 2.8). *[IFRS 9.4.2.1]*.

In contrast to the fair value option under IFRS 9 (see Chapter 44 at section 6), the possibility to elect to measure at fair value through profit or loss those financial instruments whose credit risk is managed using credit derivatives, has the following advantages:

- The election can be made after initial recognition of the financial instrument
- The election is available for a proportion of the instrument (instead of only the whole instrument)

  And
- The fair value through profit or loss accounting can be discontinued if credit risk hedging no longer occurs

Consequently, even though it is not an equivalent to fair value hedge accounting, this accounting does address several, but not all, concerns of entities that use CDSs for hedging credit exposures.

If credit exposures are designated as measured at fair value through profit or loss additional disclosure requirements apply (see Chapter 50 at section 4.3.4). *[IFRS 7.24G]*.

11.2 Fair value option for own use contracts

Contracts accounted for in accordance with IFRS 9 include those contracts to buy or sell non-financial items that can be settled net in cash, as if they were financial instruments (i.e., they are in substance similar to financial derivatives). Many commodity purchase and sale contracts meet the criteria for net settlement in cash because the commodities are readily convertible to cash. However, such contracts are excluded from the scope of IFRS 9 if they were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. *[IFRS 9.2.4]*. This is commonly referred to as the 'own use' scope exception. Own use contracts are further discussed in Chapter 41 at section 3.3.

Own use contracts are accounted for as normal sales or purchase contracts (i.e., executory contracts), with the idea that any fair value change of the contract is not relevant given the contract is used for the entity's own use. However, some entities in certain industries enter into contracts for own use and similar financial derivatives for risk management purposes and manage all these contracts together. In such a situation, own use accounting leads to an accounting mismatch as the fair value change of the derivative positions used for risk management purposes cannot be offset against fair value changes of the own use contracts.

To eliminate the accounting mismatch, an entity could apply hedge accounting by designating an own use contract as the hedged item in a fair value hedging relationship. However, hedge accounting in these circumstances is administratively burdensome. Furthermore, entities often enter into large volumes of commodity contracts and, within the large volume of contracts, some positions might offset each other. An entity would therefore typically hedge on a net basis.

To address this issue, IFRS 9 includes a fair value option for own use contracts. At inception of a contract, an entity may make an irrevocable designation to measure an own use contract at fair value through profit or loss (the 'fair value option'). However, such designation is only allowed if it eliminates or significantly reduces an accounting mismatch. *[IFRS 9.2.5]*.

Illustration 11-1: Processing and brokerage of soybeans and sunflowers

An entity is in the business of procuring, transporting, storing, processing and merchandising soybeans and sunflower seeds. The inputs and the outputs are agricultural commodities which are traded in liquid markets. The entity has both a broker business and a processing business, which are operationally distinct. However, the entity analyses and monitors its net commodity risk position, comprising inventories, physically settled forward purchase and sales contracts and exchange traded futures and options. The target is to keep the net fair value risk position close to nil.

Applying the guidance in IFRS 9.2.4, the physically settled forward contracts from the processing business have to be accounted for as own use contracts, whereas all other contracts are accounted for at fair value through profit or loss. The resulting accounting mismatch does not reflect how the entity is managing the overall fair value risk of those contracts.

If the entity applied the fair value option to the physically settled contracts, this would eliminate the accounting mismatch.

Some entities, especially in the power and utilities sector, enter into long-term own use contracts, sometimes for as long as 15 years. The business model of those entities would often be to manage those contracts together with other contracts on a fair value basis. However, there are often no derivatives available with such long maturities, while fair values for longer dated contracts could be difficult to determine. Hence, for risk management purposes a fair value based approach might only be used for the time horizon in which derivatives are available, i.e., sometime after inception of the contract. The fair value option is, however, only available on inception of the own use contract. As risk management of longer term own use contracts on a fair value basis usually occurs sometime after inception of the contract, the fair value option will mainly be useful for shorter-term own use contracts.

12 Effective date and transition

12.1 Effective date

IFRS 9 was effective for periods beginning on or after 1 January 2018 and replaced substantially all of IAS 39, including the hedge accounting requirements. However, as stated in sections 1.3 and 10.1 above, an entity has the accounting policy choice to continue applying hedge accounting as set out in IAS 39 to all hedges until the project on accounting for macro hedging is completed, instead of the requirements of Chapter 6 of IFRS 9. *[IFRS 9.7.2.21]*.

How we see it

We believe that an entity can choose to adopt the IFRS 9 hedge accounting requirements subsequent to the initial adoption of IFRS 9, as there is nothing in the transition guidance that indicates that an entity must continue to apply the accounting policy choice until the macro hedging project is finished. Adoption of IFRS 9 hedge accounting can only start from the beginning of a reporting period, and although not explicit in the standard, we believe that the reporting period can be an annual reporting period or an interim reporting period. However, it is not possible to switch back to the hedge accounting provisions of IAS 39 once Chapter 6 of IFRS 9 has been applied.

The IFRS 9 transition guidance is applicable when an entity first applies the requirements of the standard, and it is noted that more than one date of initial application could arise for the different requirements of IFRS 9. *[IFRS 9.7.2.2]*. Hence, we believe the transition guidance for IFRS 9 hedge accounting (Chapter 6), as described in IFRS 9.7.2.21 to 7.2.26, is applicable when an entity changes its accounting policy to apply IFRS 9 hedge accounting subsequent to the initial adoption of IFRS 9. However, for first time adopters of IFRS accounting standards, the transition guidance in IFRS 9 is not relevant, and hence the accounting policy choice to apply the hedge accounting requirements of IAS 39 is not available. Even if applying IFRS accounting standards for the first time, for a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only for such a hedge), an entity may apply the related hedge accounting requirements in IAS 39 instead of those in IFRS 9 (see section 1.3 above). *[IFRS 9.6.1.3]*.

It should also be noted that on subsequent adoption of IFRS 9 hedge accounting, comparatives will need to be restated for any retrospective application (albeit retrospective application is limited (see sections 12.2 and 12.3 below)). The transition guidance that permitted entities not to restate comparatives was only relevant on adoption of the classification and measurement requirements of IFRS 9. *[IFRS 9.7.2.15]*.

The accounting policy choice to continue to apply the hedge accounting requirements of IAS 39, effectively defers all of Chapter 6 of IFRS 9, (although not the IFRS 7 disclosure requirements on hedge accounting introduced by IFRS 9 (see Chapter 50 at section 4.3)). As the guidance on designating credit exposures at fair value through profit or loss (see section 11.1 above) is included within Chapter 6 of IFRS 9, it cannot be applied if an entity chooses to remain on IAS 39 for hedge accounting.

Furthermore, if an entity has an equity instrument classified at fair value through other comprehensive income as permitted by IFRS 9.5.7.5 and has chosen to continue to apply the IAS 39 hedge accounting requirements; we believe that such an equity instrument is not an eligible hedged item as it will not impact profit or loss (see section 13.2 below). *[IAS 39.86]*. This is because the specific guidance in IFRS 9.6.5.8 which permits designation of an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income in a fair value hedge is not applicable if the entity remains on IAS 39 hedge accounting (see section 2.6.3 above and section 13.2 below).

12.2 Prospective application in general

A hedging relationship can only be designated on a prospective basis, in order to avoid the use of hindsight. The same concern about using hindsight would also apply if the IFRS 9 hedge accounting requirements were to be applied retrospectively. Consequently, the IASB decided that hedge accounting in accordance with IFRS 9 has to be applied prospectively, with some limited exceptions. *[IFRS 9.7.2.22]*. Because the date of initial application can only be the beginning of a reporting period, an entity can only start applying the hedge accounting requirements of IFRS 9 prospectively from the beginning of a reporting period, and only if all qualifying criteria - including the hedge accounting documentation that conforms to IFRS 9 are met on that date. *[IFRS 9.7.2.2, IFRS 9.7.2.23]*.

When transitioning from applying hedge accounting under IAS 39 to IFRS 9, the standard clarifies that hedging relationships under IAS 39 which also qualify for hedge accounting under IFRS 9, are treated as continuing hedging relationships. *[IFRS 9.7.2.24]*. Hedge accounting under IAS 39 ceases in the very same second as hedge accounting under IFRS 9 starts, therefore resulting in no accounting entries on transition. However, entities might have to rebalance their hedges on transition to fulfil the effectiveness requirements under IFRS 9 (see sections 6.4.3 and 8.2 above) in which case any resulting gain or loss must be recognised in profit or loss. *[IFRS 9.7.2.25]*.

Entities will need to ensure the existing IAS 39 hedge documentation is updated to meet the requirements of IFRS 9 on the date of initial application (see section 6.3 above). As a minimum this would include the following:

- Reconsideration of the documented risk management strategy and objective
- The approach and rationale for concluding the eligibility criteria are met, specifically an explanation of the economic relationship, the effect of credit risk, and the hedge ratio
- Identification of all major sources of ineffectiveness
- Justification for designation of any risk components
- Deletion of the retrospective effectiveness assessment

  And
- The approach to costs of hedging (if applicable)

12.3 Limited retrospective application

The exceptions from prospective application of IFRS 9 are for the accounting treatment for the time value of options, when only the intrinsic value is designated; and, at the option of the entity, for the forward element of forward contracts, when only the spot element is designated, and the foreign currency basis spread of financial instruments (see section 7.5 above). However, retrospective application shall not be applied to items that have already been derecognised at the date of application. *[IFRS 9.7.2.1, IFRS 9.7.2.26]*.

12.3.1 Accounting for the time value of options

Entities must apply the new accounting treatment for the time value of options retrospectively, if in accordance with IAS 39, only the hedging option's intrinsic value was designated as part of the hedge relationship (see section 13.6 below). However, retrospective treatment is only applied to hedging relationships that existed at the beginning of the earliest comparative period and hedging relationships designated thereafter. *[IFRS 9.7.2.26(a), IFRS 9.BC7.49]*.

How we see it

We believe that in order for a hedge relationship to 'exist' as at the beginning of the earliest comparative period, it must have met all the hedge accounting conditions in IAS 39.88 on that date, including demonstration of effectiveness (see section 13 below).

There is also the restriction that IFRS 9 shall only be applied to items that have not been derecognised by the date of application, which would preclude any retrospective application to hedge relationships for which either of the hedging instrument or hedged item have been derecognised prior to that date. *[IFRS 9.7.2.1]*.

For those foreign entities registered with and reporting to the United States Securities and Exchange Commission and required to present two comparative years of income statements, this means they would have a longer period to adjust for the retrospective application of the new requirements.

Applying the new accounting requirement retrospectively might have a much wider impact on comparative periods than is at first apparent. Depending on the type of hedging relationship, many line items in the primary statements and many disclosures in the notes could be affected.

Illustration 12-1: Retrospective application of accounting for time value of option

An entity applies the IFRS 9 hedge accounting requirements for the first time in its accounting period beginning 1 September 20X2 and 1 September 20X1 is the beginning of its earliest comparative period presented.

As of 1 September 20X2, the entity had a hedging relationship in place in which the intrinsic value of an option was designated as the hedging instrument of the foreign currency risk of a highly probable forecast purchase of a machine on 30 November 20X2. For the purposes of this example, there is an assumption that no sources of ineffectiveness exist. When preparing the August 20X3 financial statements, the entity would have to:

- Determine the change in the time value of that option as of 1 September 20X1 and restate accumulated other comprehensive income (OCI) against retained earnings as of that date
- Determine the change in time value of that option from 1 September 20X1 to 31 August 20X2 and restate accumulated OCI against retained earnings as of that date
- Reflect the restatement in the statement of profit or loss and OCI and the statement of changes in equity for the comparative period

  And
- Reflect the restatement in the notes disclosures

12.3.2 Accounting for the forward element of forward contracts

Different to the accounting for the time value of options, entities have a choice of whether or not to apply retrospectively the new costs of hedging accounting for the forward element of forward contracts (see section 7.5.2 above). This is exclusively relevant for hedge relationships where, in accordance with IAS 39, only changes in the spot element of a hedging forward contract were designated within the hedge relationship. The choice applies on an all or nothing basis (i.e., if an entity elects to apply the accounting retrospectively, it must be applied to all hedging relationships that qualify for the election). The retrospective application would also only apply to those hedging relationships that 'existed' at the beginning of the earliest comparative period or that were designated thereafter (see section 12.3.1 above). *[IFRS 9.7.2.26(b), IFRS 9.BC7.49]*. Assets and liabilities cannot be adjusted to reflect hedges that had already finished at the start of the comparative period.

How we see it

If under IAS 39 the forward rate was designated in a hedge relationship (i.e., no portions are excluded from the hedging instrument (see section 3.6.5 above)), yet on application of IFRS 9 designation of only the spot rate is deemed preferable, we believe that such a change to the designation must be treated as discontinuation of the original relationship and the re-designation of a new relationship, hence the retrospective application for accounting for the forward element under IFRS 9 will not apply. In that case, see section 12.3.4 below.

12.3.3 Accounting for foreign currency basis spread

Similar to the retrospective transition guidance for the accounting for the forward element of forward contracts, it is also possible to apply retrospectively the accounting for foreign currency basis spreads (see in section 7.5.3 above) on transition to IFRS 9 hedge accounting. However, in contrast to the transition requirements for the forward element of forward contracts, the decision to apply retrospectively the costs of hedging guidance on foreign currency basis spreads can be made on a hedge-by-hedge basis, without a requirement that foreign currency basis had been excluded from the designation under IAS 39. This is owing to the differences in circumstances: IAS 39 did not have an exception for excluding a foreign currency basis spread from the designation of a financial instrument as a hedging instrument. The hedge-by-hedge choice can be made for those hedging relationships that 'existed' at the beginning of the earliest comparative period or that were designated thereafter (see section 12.3.1 above). *[IFRS 9.7.2.26(b), IFRS 9.BC7.49]*.

12.3.4 Re-designation of hedge relationships for non-financial risk components

IFRS 9 permits the designation of eligible risk components in non-financial hedged items (see section 2.2 above). Such a designation was not possible under IAS 39. This means, even if entities were economically hedging a risk component, they were obliged to designate the change in the entire hedged item as the hedged risk in order to achieve hedge accounting. Such a designation was likely to result in the recognition of ineffectiveness in profit or loss and in some cases failure of the effectiveness requirements.

On transition to IFRS 9 hedge accounting, entities might wish to amend hedge accounting relationships such that the hedged risk is an eligible risk component for non-financial hedged items. The question is whether that change in the documented hedged risk must result in the discontinuation of the original hedge relationship and the start of a new hedge relationship, or whether it can be treated as an amendment to the original designation such that the original hedge relationship continues. This question is particularly relevant for cash flow hedges, as on re-designation the non-zero fair value of the hedging instrument can result in subsequent ineffectiveness recorded in profit or loss (see section 7.4.3 above).

How we see it

We believe that a change in the documented hedged risk from the 'entire change in hedged item' to a risk component must be treated as a discontinuation of the original hedge relationship and the re-designation of a new hedge relationship, because it can be seen as either a change in the hedged item or a change in the documented risk management objective which both require discontinuation of a hedging relationship (see section 8.3 above).

The IASB was nervous of permitting any retrospective application of the IFRS 9 hedge accounting requirements, as such an application could involve the use of hindsight, for example as to whether it is beneficial or not to change the hedged risk to be an eligible risk component. The specific scenarios where retrospective application is permitted are generally those that either do not involve the use of hindsight as IFRS 9 application relied on particular choices that had already been made under IAS 39 (e.g., the designation of the intrinsic value of an option or the spot element of a forward). *[IFRS 9.BC7.48, IFRS 9.BC7.49]*. Due to the absence of a specific respective transition relief, it follows that a hedge relationship cannot continue if an eligible risk component under IFRS 9 is introduced into an existing IAS 39 hedge relationship.

The question has been asked as to whether this transition issue could be resolved by 'dual-designating' the hedge relationship, at the inception of the hedge, under both IAS 39 and IFRS 9. The IAS 39 designation would be for the full price risk, while the IFRS 9 designation would be of just the eligible risk component. Unfortunately, this does not work, because the switch from the IAS 39 hedge designation to the IFRS 9 hedge designation would reflect a change in risk management objective, which would result in discontinuation of the first hedge relationship (see section 8.3 above).

The logical follow-on question is whether an entity can continue with the original IAS 39 designation although it does not exactly represent the entity's risk management objective. We note that although the objective of hedge accounting under IFRS 9 is to represent an entity's risk management activities, *[IFRS 9.6.1.1]*, it does not require that it is an exact match. The Basis for Conclusions notes that, in some circumstances, the designation for hedge accounting purposes is inevitably not the same as an entity's risk management view of its hedging, but that the designation reflects risk management in that it relates to the same type of risk that is being managed and the instruments used for this purpose. The IASB refer to this situation as 'proxy hedging', which is an eligible way of designating the hedged item under IFRS 9 provided that it still reflects risk management (see section 6.2.1 above). One example of proxy hedging mentioned is those instances where the risk management objective is to hedge a risk component, but the accounting hedge designation is for the full price risk. *[IFRS 9.BC6.100(b)]*.

Where there is a choice of accounting hedge designation, there is no requirement for an entity to select the designation that most closely matches the risk management view of hedging as long as the chosen approach still reflects risk management. *[IFRS 9.BC6.97, IFRS 9.BC6.98]*. Consequently, it is permitted, on transition, to continue with an accounting designation of the full price risk even if the management objective was always to hedge a component of risk, provided all the other qualifying criteria are met (see section 6.1 above).

Both questions above were debated by the IFRS IC in September 2015 and January 2016. The final agenda decision reached by the IFRS IC is consistent with the analysis presented above.[33]

33 *IFRIC Update*, January 2016, available on the IFRS Foundation's website.

13 Main differences between the IFRS 9 and IAS 39 hedge accounting requirements

Most of the basics of hedge accounting are the same under both IFRS 9 and IAS 39, however there are some significant differences. We discuss the main differences between IFRS 9 and IAS 39 hedge accounting below.

IAS 39 includes some specific guidance originally designed with portfolio fair value hedges of interest rate risk. Equivalent guidance does not appear in IFRS 9, but entities applying hedge accounting under IFRS accounting standards may continue to apply the IAS 39 guidance on this topic - see section 10 above for further details.

IAS 39 includes extensive Implementation Guidance on the application of hedge accounting. In developing IFRS 9, the IASB decided not to carry forward any of the hedge accounting related Implementation Guidance that accompanied IAS 39. However, the IASB emphasised that not carrying forward the Implementation Guidance did not mean that it had rejected the guidance for the application of IFRS 9. *[IFRS 9.BC6.93, IFRS 9.BC6.94, IFRS 9.BC6.95]*. Much, but not all, of the Implementation Guidance in IAS 39 therefore remains relevant on application of IFRS 9 (see section 1.3 above).

13.1 The objective of hedge accounting

The objective of IFRS 9 hedge accounting is to represent in the financial statements, the effect of an entity's risk management activities that use instruments to manage exposures arising from particular risks that could affect profit or loss (or OCI in the case of equity investment designated at FVOCI). This approach aims to convey the context of hedging instruments for which hedge accounting is applied in order to provide insight into their purpose and effect. *[IFRS 9.6.1.1]*. There is no such objective within IAS 39.

The perceived purpose of hedge accounting under IAS 39 is to reduce the accounting mismatches caused by risk management activity, but it has no conceptual objective. Consequently, it is a more rules-based standard, which is particularly evident in the 80-125% quantitative threshold for the retrospective hedge effectiveness assessment (see section 13.4 below).

Similar to IFRS 9, IAS 39 includes a requirement to document the risk management strategy and risk management objective for undertaking the hedge (see section 6.2 above). *[IAS 39.88(a)]*. However, whereas, under IFRS 9, the risk management objective is rooted in risk management practice and determines whether the hedge relationship can be or must be discontinued, under IAS 39 it is just part of the accounting designation.

13.2 Eligible hedged items

The hedge accounting guidance under IAS 39 has a number of additional restrictions on the eligibility of hedged items that do not appear within the IFRS 9 guidance. Most important is the preclusion of designating any risk components in non-financial hedged items, other than foreign currency risk. The rationale at the time was the difficulty of isolating and measuring the appropriate portion of cash flows or fair value changes attributable to specific risks (other than foreign currency risks) in a non-financial asset or liability. *[IAS 39.82, IAS 39.AG100]*. This preclusion has been removed in IFRS 9 (see section 2.2 above).

The ability to designate an aggregated exposure, which includes a derivative as the hedged item in a second hedging relationship is not possible under IAS 39 (see section 2.7 above). In order to achieve hedge accounting for the hedging instrument in the 'second hedge relationship', under IAS 39 the first hedge relationship would need to be de-designated and a new hedge relationship with a combined hedging instrument (i.e., the hedging instrument from the first and second hedge relationship) would need to be designated. The combined hedging derivative is likely to have a non-zero fair value which could result in additional ineffectiveness for a cash flow hedge (see section 7.4.3 above).

In addition, IAS 39 includes a complete prohibition on designating inflation as a risk component unless there is a contractually specified inflation portion, which is a harsher position than in IFRS 9 (see section 2.2.6 above). *[IAS 39.AG99F]*.

IAS 39 permits designation of groups of hedged items, however the designation of a net position is prohibited under IAS 39, only gross designations are allowed. *[IAS 39.84]*. In addition, groups of hedged items are only eligible for designation under IAS 39 if the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items. *[IAS 39.83]*. This requirement does not form part of IFRS 9 hedge accounting (see section 2.5 above).

Although a hedge of a component of a nominal amount is permitted under IAS 39, the type of eligible component is more restrictive than under IFRS 9 (see section 2.3 above). For example, it is not possible to designate a layer of a hedged item in a fair value hedge under IAS 39. In order to achieve hedge accounting, designation of a proportion or specific cash flows within the hedged item would be required.

IFRS 9 includes an exception to the requirement that hedges could affect profit or loss, that is when an entity is hedging an investment in equity instruments for which it has elected to present changes in fair value in OCI (see section 2.6.3 above and Chapter 44 at section 1.2). *[IFRS 9.6.5.3]*. No such exception exists under IAS 39, hence hedge accounting is precluded for equity investments for which the entity has elected to present changes in fair value in OCI. *[IAS 39.86]*.

13.3 Eligible hedging instruments

Under IFRS 9 it is possible to designate, as hedging instruments, non-derivative financial assets or non-derivative financial liabilities that are accounted for at fair value through profit or loss (except for financial liabilities designated at fair value through profit or loss for which the amount of its change in fair value that is attributable to changes in the credit risk of that liability is presented in other comprehensive income) (see section 3.3 above). *[IFRS 9.6.2.2]*. However, this is not possible under IAS 39. It was previously possible only to designate a non-derivative financial instrument as the hedging instrument for a hedge of foreign currency risk, which is of course still permitted under IFRS 9 (see section 3.3.1 above). *[IAS 39.72]*.

Similar to IFRS 9, a standalone written option is prohibited from qualifying as a hedging instrument under IAS 39, unless it is as an offset to a purchased option, including one that is embedded in another financial instrument (see section 3.2.2 above). However, IAS 39 does not allow standalone written options to be designated within a combination of other hedging derivatives, even if the combination of all the derivatives is not a net written option. *[IAS 39.72]*.

13.4 Effectiveness criteria

Perhaps the most significant difference between IAS 39 and IFRS 9 are the criteria as to whether a hedge relationship is eligible for hedge accounting or not. Whilst IFRS 9 takes a principle-based approach (see sections 6.4 and 13.1 above), the eligibility criteria under IAS 39 are more rules-based. In particular, IAS 39 requires that:

- The entity expects the hedge to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistent with the originally documented risk management strategy for that particular hedging relationship.
- The hedge must be assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated. *[IAS 39.88]*.
- A hedge is regarded as highly effective only if both of the following conditions are met:
  (i) At the inception of the hedge, and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated.

  And

  (ii) The actual results of the hedge are within a range of 80% to 125%.

  For example, if actual results are such that the loss on the hedging instrument is LC120 and the gain on the cash instrument is LC100, offset can be measured by 120 ÷ 100, which is 120%, or by 100 ÷ 120, which is 83%. In this example, assuming the hedge meets the condition in (i), it would be concluded that the hedge has been highly effective. *[IAS 39.AG105]*.

It can be seen that IAS 39 requires that hedge relationships pass both a retrospective and prospective effectiveness test in order to achieve hedge accounting. The test itself is more restrictive, as it includes the requirement to achieve an arbitrary 80%-125% level of offset. The IFRS 9 effectiveness requirements are only forward looking, will normally be qualitative and permit judgement as to whether the requirements are met (see sections 6.4 and 8 above). Hence many more hedge relationships are precluded from hedge accounting under the stricter IAS 39 effectiveness tests. However, the requirement to measure and record any ineffectiveness is consistent under both IFRS 9 and IAS 39 (see section 7.4 above). *[IAS 39.89, IAS 39.96]*.

13.5 Discontinuation

There is significant overlap in the guidance on discontinuation of hedge accounting under IAS 39 and IFRS 9, however there are some important differences. Whilst discontinuation of a hedge relationship is only permitted under IFRS 9 if one of the mandatory discontinuation criteria occur (see section 8.3 above), there is no prohibition on voluntary discontinuation of designated hedge relationships under IAS 39. An entity can just choose to prospectively stop hedge accounting. *[IAS 39.91(c), IAS 39.101(d)]*.

If the IAS 39 effectiveness test is failed (see section 13.4 above), then the hedge relationship must be discontinued and hedge accounting ceases from the last time the hedge relationship was effective. Under IAS 39 there is no opportunity to amend the method of assessing effectiveness, rebalance the hedge relationship, or undertake a partial discontinuation (see sections 6.3, 8.2 and 8.3 above). *[IAS 39.F.4.4, IAS 39.91(b), IAS 39.101(b)]*. In addition, under IFRS 9, if discontinuation is required, this is only applied prospectively (see section 8.3 above).

The risk management objective plays a much more important role within IFRS 9 hedge accounting than under IAS 39 (see section 13.1 above). For example, there is no requirement to monitor whether the risk management objective has changed under IAS 39, as such a change is not one of the mandatory discontinuation criteria as it is under IFRS 9 (see section 8.3 above).

13.6 Hedge accounting mechanisms

The basic IAS 39 hedge accounting mechanics are the same as those under IFRS 9 (see section 7 above). However, IFRS 9 contains some accounting mechanisms that do not appear within IAS 39.

Although it is possible under IAS 39 to exclude the time value of a hedging option and the forward element of a forward contract from the hedging derivative, similar to IFRS 9 (see sections 3.6.4 and 3.6.5 above), the accounting treatment of the excluded components differ. Under IAS 39, it is not possible to apply the costs of hedging accounting to the excluded time value of an option or the forward element of a forward contract (see section 7.5 above). Accordingly, the excluded portions will remain at fair value through profit or loss. So, although the excluded time value or forward element do not affect the hedge effectiveness assessment (see section 13.4 above), they are likely to result in profit or loss volatility under IAS 39. *[IAS 39.74]*. It is also worth noting that under IAS 39 there is no opportunity to exclude the foreign currency basis from a hedging derivative (see sections 7.4.8 and 7.5.3 above).

Under IFRS 9, in a cash flow hedge of a forecast transaction that subsequently results in the recognition of a non-financial asset or liability, or a forecast transaction for a non-financial asset or liability that becomes a firm commitment for which fair value hedging is applied, the entity shall remove the accumulated amount in the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or liability (see section 7.2.2 above). Although IAS 39 allows this same treatment, it also permits an accounting policy choice for the amounts accumulated in the cash flow hedge reserve to be reclassified to profit or loss in the same period or periods during which the assumed asset or liability affects profit or loss. *[IAS 39.98, IAS 39.99]*. Where an accounting policy of adjusting such non-financial assets or liabilities is applied, unlike under IFRS 9 this reclassification adjustment is reported in the statement of OCI. *[IFRS 9.6.5.11(d)(i)]*.

IFRS 9 includes two alternatives to hedge accounting: the fair value option for credit risk exposures (see section 11.1 above) and a fair value option for own use contracts (see section 11.2 above). Neither of these alternatives are available under IAS 39.

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Appendix B - Defined terms

Extract from IFRS standards - Definitions	
amortised cost of a financial asset or financial liability	The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any **loss allowance**. *[IFRS 9 Appendix A]*.
credit risk	The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. *[IFRS 7 Appendix A]*.
currency risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. *[IFRS 7 Appendix A]*.
derecognition	The removal of a previously recognised financial asset or financial liability from an entity's statement of financial position. *[IFRS 9 Appendix A]*.
derivative	A financial instrument or other contract within the scope of this Standard with all three of the following characteristics. (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying'). (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. (c) it is settled at a future date. *[IFRS 9 Appendix A]*.
dividends	Distributions of profits to holders of equity instruments in proportion to their holdings of a particular class of capital. *[IFRS 9 Appendix A]*.
effective interest method	The method that is used in the calculation of the **amortised cost of a financial asset or a financial liability** and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period. *[IFRS 9 Appendix A]*.
effective interest rate	The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the **gross carrying amount of a financial asset** or to the **amortised cost of a financial liability**. When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the **expected credit losses**. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1-B5.4.3), **transaction costs**, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments). *[IFRS 9 Appendix A]*.

equity instrument	**An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.** *[IAS 32.11]*.
expected credit losses	The weighted average of **credit losses** with the respective risks of a default occurring as the weights. *[IFRS 9 Appendix A]*.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. *[IFRS 13 Appendix A]*.
financial asset	**A *financial asset* is any asset that is:** **(a) cash;** **(b) an equity instrument of another entity;** **(c) a contractual right:** **(i) to receive cash or another financial asset from another entity; or** **(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or** **(d) a contract that will or may be settled in the entity's own equity instruments and is:** **(i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or** **(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.** **For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.** *[IAS 32.11]*.
financial guarantee contract	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. *[IFRS 9 Appendix A]*.
financial instrument	**A *financial instrument* is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.** *[IAS 32.11]*.

financial liability	A *financial liability* is any liability that is: (a) a contractual obligation: (i) to deliver cash or another financial asset to another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or (b) a contract that will or may be settled in the entity's own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments. As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D. *[IAS 32.11]*.
financial liability at fair value through profit or loss	A financial liability that meets one of the following conditions: (a) it meets the definition of **held for trading**. (b) upon initial recognition it is designated by the entity as at fair value through profit or loss in accordance with paragraph 4.2.2 or 4.3.5. (c) it is designated either upon initial recognition or subsequently as at fair value through profit or loss in accordance with paragraph 6.7.1. *[IFRS 9 Appendix A]*.
firm commitment	A binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates. *[IFRS 9 Appendix A]*.
forecast transaction	An uncommitted but anticipated future transaction. *[IFRS 9 Appendix A]*.
hedge ratio	The relationship between the quantity of the hedging instrument and the quantity of the hedged item in terms of their relative weighting. *[IFRS 9 Appendix A]*.

held for trading	A financial asset or financial liability that: (a) is acquired or incurred principally for the purpose of selling or repurchasing it in the near term; (b) on initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or (c) is a **derivative** (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument). *[IFRS 9 Appendix A]*.
interest rate risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. *[IFRS 7 Appendix A]*.
interim financial report	Interim financial report means a financial report containing either a complete set of financial statements (as described in IAS 1 *Presentation of Financial Statements* (as revised in 2007)) or a set of condensed financial statements (as described in this Standard) for an interim period. *[IAS 34.4]*.
market risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: **currency risk, interest rate risk** and **other price risk.** *[IFRS 7 Appendix A]*.
regular way purchase or sale	A purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned. *[IFRS 9 Appendix A]*.

Chapter 50 Financial instruments: Presentation and disclosure

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Overview

Disclosure of financial instruments is largely dealt with in IFRS 7 *Financial Instruments: Disclosures* and presentation in IAS 32 *Financial Instruments: Presentation*.

IFRS 7 applies to both financial and non-financial institutions and the disclosures required will depend on the extent of an entity's use of financial instruments and its exposure to risk. IAS 32 addresses when an entity offsets financial assets and financial liabilities amongst other things.

This chapter summarises the presentation and disclosure requirements within IFRS 7 and IAS 32. The disclosures prescribed in IFRS 7 can be split into two broad categories. The first category is quantitative disclosures about the amounts in the statement of financial position and the statement of comprehensive income. The second category is the quantitative and qualitative risk disclosures which require detail on the nature and extent of risks an entity is exposed to because of financial instruments. The purpose of these disclosure requirements is to allow users of the financial statements to assess the significance of financial instruments on an entity's financial position and performance. The risk disclosures are required to be given 'through the eyes of management' and should reflect the way in which management perceives, measures, and manages the entity's risks.

IFRS 7 requires that for each class of financial assets and financial liabilities, the fair value of those classes of assets and liabilities are disclosed to permit comparisons with the associated carrying amount. This is briefly discussed in section 4.5.1, however the more detailed disclosures about fair value are required by IFRS 13 *Fair Value Measurement*, and these are discussed in Chapter 15.

This chapter discusses some of the practical issues associated with the disclosure requirements for transfers of financial assets in section 6 below.

The offsetting requirements of IAS 32 are discussed in section 7.4.1 below. The classification of financial instruments as equity, financial liabilities or financial assets, as prescribed by IAS 32, is covered in Chapter43.

In May 2024, the IASB issued amendments to the classification and measurement requirements in IFRS 9 *Financial Instruments* and made consequential amendments to IFRS 7 requiring entities to disclose additional information about financial assets and liabilities with contractual terms that reference contingent events (including those that are ESG linked) and equity instruments classified in at fair value through other comprehensive income. The amendments are effective for annual periods beginning on or after 1 January 2026. Early adoption is permitted with an option to early adopt the amendments for classification of financial assets and related disclosures only. These disclosure requirements are addressed in section 4.2.3 and section 4.4.4 below and Chapter 44 contains further details on the new guidance addressing the classification and measurement of financial assets.

There are some types of financial instruments that are exempt from IFRS 7, and which are covered by other chapters, including:

- Certain interests in subsidiaries, associates, and joint ventures when measured in accordance with IAS 27 or 28 - see Chapter 14
- Insurance contracts - see Chapter 51
- Employee benefit plans - see Chapter 31
- An entity's own equity instruments - see Chapter 43
- Share based payment transactions - see Chapter 30

What you need to know

- The scope of IFRS 7 is wider than that of IFRS 9. Therefore, IFRS 7 can apply to instruments that are not subject to the recognition and measurement provisions of IFRS 9, for example lease liabilities.
- The measurement basis (or bases) and other accounting policies used in preparing the financial statements that are relevant to an understanding of the financial statements are required to be disclosed by IFRS 7.
- IFRS 7 requires qualitative and quantitative disclosures for three main risks: credit risk, liquidity risk and market risk. The required disclosures focus on the risks that arise from financial instruments and the risk management initiatives taken by an entity.
- To offset two or more financial instruments in the statement of financial position, IAS 32 requires that an entity must currently have a legally enforceable right of set-off, and an intention to settle on a net basis or realise the asset and settle the liability simultaneously. The right of set-off must not be contingent on a future event and must be legally enforceable in all of the following circumstances:
  - (i) The normal course of business
  - (ii) An event of default

    And
  - (iii) An event of insolvency or bankruptcy of the entity or any of the counterparties

1 Introduction

IFRS 7 requires entities to provide disclosures in their financial statements that enable users to evaluate the significance of financial instruments for the entity's financial position during the period and at the end of the reporting period. IAS 32 specifies presentation for financial instruments.

The development of these standards is outlined below.

1.1 IAS 32

The original version of IAS 32 *Financial Instruments: Disclosure and Presentation* was published in March 1995 and, as its title suggested, contained requirements about the disclosures entities were to make about financial instruments. These requirements were superseded by IFRS 7 (see section 1.2 below), which also changed the name of the standard.

One of the topics IAS 32 continues to address is when entities offset financial assets and financial liabilities, the associated requirements for which are discussed in section 7.4.1 below. It also addresses the classification of financial instruments as equity, financial liabilities or financial assets, a topic covered in Chapter 43. IAS 32 has been amended several times since publication, including in December 2011 when the IASB addressed certain practical problems it had identified in its offsetting requirements.

1.2 IFRS 7

IFRS 7 emerged from a project principally focused on revising IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* a standard which, at the time, set out additional disclosure requirements for banks and similar entities. It was published in August 2005 and superseded IAS 30.

The standard has been subject to significant amendment since its original publication, in particular to address concerns raised during the financial crisis. These amendments aimed to improve the disclosures entities provide in a number of areas including liquidity risk, transfers of financial assets, offsetting, and fair values (most of the disclosures for which are now included in IFRS 13, see Chapter 15).

In July 2014, the IASB published a substantially final version of IFRS 9, its replacement for IAS 39 *Financial Instruments: Recognition and Measurement*. The new standard changed the framework for classifying and measuring financial assets and financial liabilities, introduced an expected loss approach for determining impairment losses on financial assets, and amended the requirements for applying hedge accounting. It also made several consequential amendments to IFRS 7, introducing extensive new disclosures in respect of impairment (see section 5.3 below) and hedge accounting (see section 4.3 below), as well as making other changes.

The objective of IFRS 7 is to require entities to provide disclosures in their financial statements that enable users to evaluate: *[IFRS 7.1]*.

- The significance of financial instruments for the entity's financial position and performance

  And

- The nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks

These objectives manifest themselves in two disclosure principles (see section 4 and section 5 below) which are designed to complement those for recognising, measuring and presenting financial assets and financial liabilities in IAS 32 and IFRS 9. *[IFRS 7.2]*.

2 Scope of IFRS 7

2.1 Entities required to comply with IFRS 7

Although IFRS 7 evolved from a project to update IAS 30 (which applied only to banks and similar financial institutions), it applies to all entities preparing their financial statements in accordance with IFRS accounting standards that have financial instruments. *[IFRS 7.BC6]*. The IASB considered exempting certain entities, including insurers, subsidiaries, and those that are small or medium-sized (SMEs), but decided that IFRS 7 should apply to all entities applying IFRS accounting standards. *[IFRS 7.BC9, IFRS 7.BC10, IFRS 7.BC11]*. Entities applying IFRS for SMEs are required to provide only reduced disclosures about financial instruments.

2.2 Financial instruments within the scope of IFRS 7

Chapter 41 at section 2 and section 3 contains a detailed explanation of the scope of IFRS 7. It is important to recognise that the scope of IFRS 7 is generally wider than that of IFRS 9. Therefore, IFRS 7 can apply to instruments that are not subject to the recognition and measurement provisions of IFRS 9. *[IFRS 7.4]*. For example, lease liabilities and certain loan commitments are within the scope of IFRS 7 even though they are not, or not wholly, within the scope of IFRS 9. Similarly, financial instruments that are unrecognised due to the application of settlement date accounting are also within the scope of IFRS 7 but not IFRS 9. Conversely, some financial instruments within the scope of IFRS 9, particularly those held in disposal groups or as part of discontinued operations, are not subject to all of the requirements in IFRS 7.

2.3 Interim reports

IAS 34 *Interim Financial Reporting* sets out the minimum content of an interim financial report. When an event or transaction is significant to an understanding of the changes in an entity's financial position or performance since the last annual financial period, IAS 34 requires the report to provide an explanation of, and update to, the information included in the last annual financial statements. *[IAS 34.15]*. The standard emphasises that relatively insignificant updates need not be provided. *[IAS 34.15A]*. The following disclosures which relate to financial instruments are required if significant: *[IAS 34.15B]*.

- Losses recognised from the impairment of financial assets
- Changes in the business or economic circumstances that affect the fair value of the entity's financial assets and financial liabilities, whether recognised at fair value or amortised cost
- Any loan default or breach of a loan agreement that has not been remedied on, or before, the end of the reporting period
- Transfers between levels of the fair value hierarchy used in the measurement of the fair value of financial instruments

  And
- Changes in the classification of financial assets as a result of a change in the purpose, or use of, those assets

In considering the extent of disclosures necessary to meet the requirements above, IAS 34 refers to the guidance included in other IFRS accounting standards, *[IAS 34.15C]*, which would include IFRS 7, but does not ordinarily require compliance with all the requirements in those standards.

IAS 34 also specifies additional disclosures to be given (normally on a financial year-to-date basis) about the fair value of financial instruments, including those discussed in section 4.5 below and a number required by IFRS 13. *[IAS 34.16A(j)]*. This requirement is not subject to the qualifications noted above and so, as discussed in further detail in Chapter 37 at section 4.5, these disclosures must always be given unless the information is not material.

The disclosures about offsetting of financial assets and financial liabilities (see section 7.4.2 below) need not be provided in condensed interim financial statements unless required by the more general requirements of IAS 34. *[IFRS 7.BC72B, IFRS 7.BC72C]*.

3 Structuring the disclosures

The main text of IFRS 7 is supplemented by application guidance, which is an integral part of the standard,[1] and by implementation guidance, which accompanies, but is not part of, the standard.[2] The implementation guidance suggests possible ways of applying some of the requirements of the standard but, it is emphasised, does not create additional requirements. *[IFRS 7.IG1]*.

Although the implementation guidance discusses each disclosure requirement in IFRS 7 separately, disclosures would normally be presented as an integrated package and individual disclosures might satisfy more than one requirement. For example, information about concentrations of risk might also convey information about exposure to credit or other risks. *[IFRS 7.IG2]*. This chapter follows a similar approach, whereby each topic is considered individually in the context of the requirements of the standard, as well as related application and implementation guidance.

3.1 Level of detail

Entities need to decide, in the light of their circumstances, how much detail to provide to satisfy the requirements of IFRS 7, how much emphasis to place on different aspects of the requirements, and how information is aggregated to display the overall picture without combining information with different characteristics. It is necessary to strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements and obscuring important information as a result of too much aggregation. For example, important information must not be obscured by including it among a large amount of insignificant detail. Similarly, information must not be aggregated so that it obscures important differences between individual transactions or associated risks. *[IFRS 7.B3]*.

This means that not all of the information suggested, say, in the implementation guidance is necessarily required. *[IFRS 7.IG5]*. On the other hand, there is a reminder that IAS 1 *Presentation of Financial Statements*[3] requires additional disclosures when compliance with the specific requirements in IFRS accounting standards are insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance (see Chapter 3 at section 4.1.1.A). *[IFRS 7.IG6]*.

3.2 Materiality

The implementation guidance to the original version of IFRS 7 drew attention to the definition of materiality in IAS 1 (see Chapter 3 at section 4.1.5), noting that a specific disclosure requirement need not be satisfied if the information is not material. *[IFRS 7(2010).IG3]*. The inclusion of such guidance was intended to provide a degree of reassurance that entities with few financial instruments and few risks (for example a manufacturer whose only financial instruments are accounts receivable and accounts payable) will give few disclosures, something that was borne out in other references within the standard and accompanying material. *[IFRS 7.BC10]*. Nevertheless, in May 2010, the IASB removed these references to materiality from IFRS 7 because they thought that they could imply that other disclosures in IFRS 7 are required even if those disclosures are not material, which was not the intention. *[IFRS 7.BC47A]*.

3.3 Classes of financial instrument

Certain disclosures required by IFRS 7 must be provided by class of financial instrument (see section 4.5.1, section 4.5.2, section 5.3 and section 6 below). For these, entities should group financial instruments into classes that are appropriate to the nature of the information disclosed and take into account the characteristics of those instruments. *[IFRS 7.6]*. It is clear from this requirement that the classes used need not be the same for each disclosure provided, e.g., one set of classes may be used to present information about credit risk (see section 5.3 below) and another for information about day 1 profits (see section 4.5.2 below).

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1 IFRS 7, Appendix B, Application guidance, para. after main heading.

2 IFRS 7, Guidance on implementing, para. after main heading.

3 IFRS 18 *Presentation and Disclosure in Financial Statements*, which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted) was issued by the IASB in April 2024. On adoption of IFRS 18 these aspects of IAS 1 are relocated to a renamed IAS 8 *Basis of Preparation of Financial Statements* and the cross-reference in IFRS 7.IG6 is amended accordingly.

It is emphasised that these classes are determined by the entity and are, thus, distinct from the categories of financial instruments specified in IFRS 9, which determines how financial instruments are measured and where changes in fair value are recognised. *[IFRS 7.B1]*. However, in determining classes of financial instruments an entity must, as a minimum, distinguish instruments measured at amortised cost from those measured at fair value, and treat as a separate class or classes those financial instruments outside the scope of IFRS 7. *[IFRS 7.B2]*.

For disclosures given by class of instrument, sufficient information must be provided to permit the information to be reconciled to the line items presented in the statement of financial position. *[IFRS 7.6]*.

4 Significance of financial instruments for an entity's financial position and performance

The IASB decided that the disclosure requirements in this area must result from the following disclosure principle: *[IFRS 7.7]*

Extract from IFRS 7	
7	**An entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.**

Furthermore, they concluded that this principle could not be satisfied unless other specified disclosures (which are dealt with in sections 4.1 to 4.5 below) are also provided. *[IFRS 7.7, IFRS 7.BC13]*.

4.1 Accounting policies

The main body of IFRS 7 contains a reminder of IAS 1's[4] requirement for an entity to disclose its material accounting policy information, which is discussed in Chapter 3 at section 5.1.1, and goes on to explain that the measurement basis (or bases) for financial instruments used in preparing the financial statements would be expected to be material accounting policy information. *[IFRS 7.21]*.

For financial assets and financial liabilities designated as measured at fair value through profit or loss (see Chapter 44 at section 6), such disclosure may include: *[IFRS 7.B5(a), IFRS 7.B5(aa)]*.

- The nature of the financial assets or financial liabilities designated as measured at fair value through profit or loss
- The criteria for so designating financial liabilities on initial recognition

  And
- How the conditions or criteria in IFRS 9 for such designation have been satisfied

Other accounting policy information that might be appropriate includes: *[IFRS 7.B5(c), IFRS 7.B5(e)]*

- Whether regular way purchases and sales of financial assets are accounted for at trade date or at settlement date (see Chapter 45 at section 2.2)

  And
- How net gains or net losses on each category of financial instrument are determined (see section 4.2.1 below), for example whether the net gains or net losses on items measured at fair value through profit or loss include interest or dividend income

  Although related, different considerations will apply to the requirement to present separately on the face of the statement of comprehensive income (or income statement) interest revenue calculated using the effective interest method - see section 7.1.1 below.

How we see it

In our view, when determining the net gains or losses on each category of financial instrument, interest income and interest expense (including, for example, that arising on short positions) must be treated consistently, i.e., both included or both excluded from the net gains and losses disclosed.

The application guidance also contains a reminder that IAS 1 (IAS 8)[5] requires entities to disclose the judgements, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements (see Chapter 3 at section 5.1.1.A). *[IFRS 7.B5] [IAS 1.122] [IAS 8(2027).27G]*. These might include those an entity has used in applying hedge accounting requirements of IFRS 9, for example those made in determining whether an economic relationship exists between the hedged item and the hedging instrument, how the hedge ratio was set, and how risk components were identified.

4 IFRS 18, which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted) was issued by the IASB in April 2024. On adoption of IFRS 18 these aspects of IAS 1 are relocated to paragraph 27A of the renamed IAS 8 *Basis of Preparation of Financial Statements* and the cross-reference in IFRS 7.21 is amended accordingly.

5 On adoption of IFRS 18, these aspects of IAS 1 are relocated to paragraph 27G of the renamed IAS 8 *Basis of Preparation of Financial Statements* for reporting periods beginning on or after 1 January 2027 (with earlier application permitted) and the cross-reference in IFRS 7.B5 is amended accordingly.

4.2 Income, expenses, gains and losses

Under IFRS 7, entities are required to disclose various items of income, expense, gains and losses. The disclosures below may be provided either on the face of the financial statements, subject to the requirements of IAS 1 or, when applied, IFRS 18 *Presentation and Disclosure in Financial Statements*, or in the notes. *[IFRS 7.20]*. However, in this context, it should be noted that IAS 1 does require certain line items to be disclosed separately in the profit or loss section of the statement of profit or loss (see section 7.1.1 below). IFRS 18 is even more specific about the presentation of items within profit or loss (see Chapter 4 for further details) which could lead to more of these disclosures being given in the notes.

4.2.1 Gains and losses by measurement category

The IASB concluded that information about the gains and losses arising on the various measurement categories of instrument is necessary to understand the financial performance of an entity's financial instruments given the different measurement bases used. Consequently, disclosure must be given of net gains or net losses arising on the following categories of instruments: *[IFRS 7.20(a)]*.

- Financial assets or financial liabilities measured at fair value through profit or loss, showing separately those on financial assets or liabilities:
  - Designated as such upon initial recognition (or subsequently when the credit risk of a financial asset is managed using a credit derivative)

    And
  - Mandatorily measured at fair value in accordance with IFRS 9, e.g., liabilities held for trading

    For financial liabilities designated at fair value through profit or loss, the amount of gain or loss recognised in other comprehensive income, i.e., relating to changes in fair value attributable to changes in credit risk (see Chapter 46 at section 2.4.1), must be shown separately.

How we see it

For financial instruments measured at fair value through profit or loss, it would be appropriate for interest expense on short positions to be presented in a manner consistent with the treatment of interest expense on long positions, i.e., either included in interest expense or in gains and losses on financial instruments at fair value through profit or loss as appropriate. The presentation is to be consistent from period to period and appropriate disclosure made in the entities accounting policy.

- Financial assets measured at amortised cost:

  All gains and losses must also be presented separately and the reasons for derecognition must also be given. *[IFRS 7.20A]*. Also, the total gains and losses must be shown separately on the face of the income statement or statement of comprehensive income (see section 7.1.1 below). *[IAS 1.82(aa), IFRS 18.75(b)(iii)]*.
- Financial liabilities measured at amortised cost

How we see it

In our view, if financial liabilities that are not at fair value through profit and loss (i.e., measured at amortised cost) are used to finance a portfolio of trading financial assets (for example, trading debt securities), it would be inappropriate to include the interest expense (funding costs) on such liabilities in net gains or net losses on financial assets or financial liabilities at fair value through profit or loss.

- Investments in equity instruments designated at fair value through other comprehensive income

  And
- Financial assets that are debt instruments measured at fair value through other comprehensive income, showing separately:
  - The amount of gain or loss recognised in other comprehensive income during the period

    And
  - The amount reclassified upon derecognition from accumulated other comprehensive income to profit or loss for the period

These disclosures are designed to complement the statement of financial position disclosure requirement described in section 4.4.1 below. *[IFRS 7.BC33]*.

The following is required to be disclosed in relation to interest and dividend income: *[IFRS 7.BC34]*

Extract from IFRS 7

BC34 Some entities include interest and dividend income in gains and losses on financial assets and financial liabilities measured at fair value through profit or loss and others do not. To assist users in comparing income arising from financial instruments across different entities, the Board decided that an entity should disclose how the income statement amounts are determined. For example, an entity should disclose whether net gains and losses on financial assets or financial liabilities measured at fair value through profit or loss include interest and dividend income (see Appendix B, paragraph B5(e)).

4.2.2 Interest income and expense

For financial assets or financial liabilities that are not measured at fair value through profit or loss, total interest income and total interest expense (calculated using the effective interest method) must be disclosed. Interest revenue for financial assets measured at amortised cost must be shown separately from interest revenue on debt instruments measured at fair value through other comprehensive income. *[IFRS 7.20(b)]*. This disclosure requirement is similar, but different, to the requirement to present separately on the face of the statement of comprehensive income (or income statement) interest revenue calculated using the effective interest method - see section 7.1.1 below.

In relation to hedge accounting, IFRS 9 does not explicitly state where in the profit or loss any gains and losses from hedge accounting should be presented. However, it can be inferred that gains and losses from hedging instruments in hedging relationships would normally be presented in the same line item that is affected by the hedged item (at least to the extent the hedge is effective), rather than being shown separately, (see Chapter 49 at section 9). Therefore, interest income calculated using the effective interest method can include:

- Reclassification adjustments on any hedging instruments (such as derivatives) designated in cash flow hedges of the variability in interest cash flows, in the same periods during which the hedged items expected future cash flows affect profit or loss, i.e., when the interest income is recognised in the Income Statement *[IFRS 9.6.5.11(d)(ii)]*

Conversely, lease liabilities and finance lease receivables are within the scope of IFRS 7 (see Chapter 41 at section 2.2) but are not accounted for using the effective interest method. There is no equivalent acknowledgement in IFRS 16 *Leases* or IFRS 9 that the disclosure of interest income and interest expense should be made on the basis of the finance cost and finance revenue recognised under the relevant standard for leases. However, this seems little more than an oversight and we consider it appropriate to include in the disclosure the amounts actually recognised under IFRS 16, rather than amounts calculated in accordance with the effective interest method.

As noted above, IFRS 7.20(b) requires disclosure of interest revenue using the effective interest method, however currently there is no specific requirement to disclose information on contractual terms that could affect the timing or amount of cash flows in the future. Therefore, in May 2024, the IASB issued amendments to IFRS 9 and IFRS 7 to help users of financial statements understand the effect of contractual terms that could change the timing or amount of contractual cash flows based on the occurrence (or non-occurrence) of a contingent event that is specific to the debtor. These proposals are discussed further in section 4.2.3 below.

4.2.3 Disclosure of terms that could change the timing or amount of contractual cash flows

In May 2024, the IASB issued *Amendments to the Classification and Measurement of Financial Instruments - Amendments to IFRS 9 and IFRS 7* to provide additional clarifications in relation to certain paragraphs related to the classification and measurement requirements of IFRS 9 and amend the related disclosures in IFRS 7.[6] In particular, additional disclosure requirements have been introduced to help users better understand the effect of contractual terms that could change the timing or amount of contractual cash flows based on the occurrence or non-occurrence of a contingent event that does not relate directly to changes in basic lending risks and costs. Examples of financial instruments that contain such terms are loans and bonds whose interest rates are linked to environmental, social and governance (ESG) targets or other contingent features not linked to the time value of money or credit risk of the borrower. Events directly related to changes in basic lending risks are for example penalty interest or early repayment triggers due to breaches of debt coverage ratios, or other proxies of credit risk, or missed payments. To enable users to assess the entity's future cash flows qualitative and quantitative information about these terms will be required. Entities are required to disclose, by class of financial asset or liability:

- A qualitative description of the nature of the contingent event
- Quantitative information about the possible changes to contractual cash flows that could result from those contractual terms (for example, the range of possible changes)

  And
- The gross carrying amount of financial assets and the amortised cost of financial liabilities subject to those contractual terms. *[IFRS 7(2026).20C]*.

The above disclosures are required separately for each class of financial assets measured at amortised cost or fair value through other comprehensive income and for each class of financial liabilities measured at amortised cost. *[IFRS 7(2026).20B]*. The requirements for determining appropriate classes of instruments are covered in section 3.3 above. This information is not required to be disclosed for financial instruments at fair value through profit and loss as the changes in fair value are considered to provide sufficient information to users to assess the future cash flows of those instruments.

The disclosures above also apply to contingent features of financial assets that do not result in contractual cash flows that are significantly different from those of financial instruments with identical contractual terms but without such features (and are therefore eligible to be measured at amortised cost or fair value through other comprehensive income in accordance with paragraph IFRS 9.B4.1.10A - see Chapter 44 at section 10). This is because such features may be qualitatively material or material in aggregate across a portfolio of financial assets. *[IFRS 7(2026).BC35ZZC]*.

An entity considers how much detail to disclosure, the appropriate level of aggregation or disaggregation, and whether users need additional explanations to evaluate any quantitative information disclosed. *[IFRS 7(2026).20B]*. For example, an entity discloses this information for a class of financial liabilities measured at amortised cost whose contractual cash flows change if the entity achieves a reduction in its carbon emissions. *[IFRS 7(2026).20D]*.

The amendments are effective for periods beginning on or after 1 January 2026, however entities can either early adopt all the amendments at the same time or early adopt only the amendments relating to the classification of financial assets and their related disclosures (as discussed in this section) and apply the other amendments from the effective date.

4.2.4 Fee income and expense

Entities must disclose fee income and expense (excluding amounts included in the effective interest rate calculation) arising from: *[IFRS 7.20(c)]*

- Financial assets or financial liabilities that are not measured at fair value through profit or loss

  And
- Trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions

These disclosures indicate the level of such activities and assist users in estimating the possible future income of the entity. *[IFRS 7.BC35]*.

6 Amendments to the Classification and Measurement of Financial Instruments - Amendments to IFRS 9 and IFRS 7, IASB, May 2024.

4.3 Hedge accounting

When developing IFRS 9 many constituents, users in particular, asked for improved disclosures that link more clearly an entity's risk management activities and how it applies hedge accounting. *[IFRS 7.BC35C]*. Consequently, IFRS 9 has significantly expanded the IFRS 7 disclosure requirements in respect of hedge accounting when compared to the previous IFRS 7 requirements, prior to IFRS 9 being adopted. The requirements are also supplemented by some detailed implementation guidance. The hedge accounting requirements of IFRS 9 are dealt with in Chapter 49.

Under IFRS 9, an entity may choose to continue applying certain, or all, of the hedge accounting requirements of IAS 39, rather than those in IFRS 9 (see Chapter 49 at section 10.2). In these circumstances, the disclosure requirements in IFRS 7 that were introduced by IFRS 9 must be followed, rather than those that previously applied under IAS 39. *[IFRS 9.BC6.104]*.

The requirements set out in section 4.3.1 to section 4.3.4 below apply for those risk exposures that an entity hedges and for which it elects to apply hedge accounting. The objective of these disclosures is to provide information about: *[IFRS 7.21A]*

- The entity's risk management strategy and how it is applied to manage risk

  Linking the application of hedge accounting to the entity's risk management strategy requires an understanding of the entity's risk management strategy and to facilitate this the IASB has introduced more guidance about the information to be included in a description of the risk management strategy of the entity (see section 4.3.1 below). *[IFRS 7.BC35P]*.
- How the entity's hedging activities may affect the amount, timing, and uncertainty of its future cash flows (see section 4.3.2 below)

  And
- The effect that hedge accounting has had on the entity's statement of financial position, statement of comprehensive income and statement of changes in equity (see section 4.3.3 below)

In order to meet these objectives, an entity will need to determine how much detail to disclose, how much emphasis to place on different aspects of the disclosure requirements, the appropriate level of aggregation or disaggregation, and whether additional explanations are needed to evaluate the quantitative information disclosed. The level of aggregation or disaggregation should be consistent with that used for meeting the disclosure requirements of related information elsewhere in IFRS 7 and in IFRS 13 (see Chapter 15 at section 19.1.2). *[IFRS 7.21D]*.

Some of the disclosure requirements in section 4.3.1 to section 4.3.3 below are required to be given by 'risk category'. This is not a defined term but appears to refer to the type of risk being hedged, rather than, say, the type of hedge relationship such as cash flow hedges and fair value hedges. Each risk category should be determined on the basis of the risk exposures an entity decides to hedge and for which hedge accounting is applied. These categories should be determined consistently for all hedge accounting disclosures. *[IFRS 7.21C]*. This should enable users to follow the various disclosures by type of risk, resulting in a much better understanding of the hedging activities and their impact on the financial statements.

These disclosures must be presented in a single note or separate section of the financial statements. To avoid duplication, IFRS 7 allows this information to be incorporated by cross-reference from the financial statements to some other statement that is available to users of the financial statements on the same terms and at the same time, such as a management commentary or risk report. Without the information incorporated by cross-reference, the financial statements are incomplete. *[IFRS 7.21B]*.

4.3.1 The risk management strategy

An entity must explain its risk management strategy for each risk category of risk exposures that it decides to hedge and for which hedge accounting is applied. This explanation should enable users of financial statements to evaluate, for example: *[IFRS 7.22A]*

- How each risk arises
- How each risk is managed

  This includes whether the entity hedges an item in its entirety for all risks or hedges a risk component (or components) of an item and why

  And
- The extent of risk exposures that are managed

To meet these requirements, the information must include, but is not limited to, a description of: *[IFRS 7.22B]*

- The hedging instruments that are used (and how they are used) to hedge risk exposures
- How the economic relationship between the hedged item and the hedging instrument is determined for the purpose of assessing hedge effectiveness
- How the hedge ratio is established

  And
- The sources of hedge ineffectiveness

When a specific risk component is designated as a hedged item, the following disclosure is required: *[IFRS 7.22C]*

Extract from IFRS 7

22C When an entity designates a specific risk component as a hedged item (see paragraph 6.3.7 of IFRS 9) it shall provide, in addition to the disclosures required by paragraphs 22A and 22B, qualitative or quantitative information about:

(a) how the entity determined the risk component that is designated as the hedged item (including a description of the nature of the relationship between the risk component and the item as a whole); and

(b) how the risk component relates to the item in its entirety (for example, the designated risk component historically covered on average 80 per cent of the changes in fair value of the item as a whole).

This information could include a description of whether the risk component is contractually specified, and if not, how the entity determined that the non-contractually specified risk component is separately identifiable and reliably measurable.

The following Illustration shows how an entity might present some of this information.

Illustration 4-1: Illustrative disclosure of risk management strategy for commodity price risk

Coffee price risk

Fluctuations in the coffee price are the main source of market risk for the Alpha Beta Coffee Group (the Group). The Group purchases Arabica coffee from various suppliers in South America. For this purpose, the Group enters into long-term contracts (for between one and three years) with its suppliers, in which the future coffee price is indexed to the USD Arabica benchmark coffee price, adjusted for transport costs that are indexed to diesel prices plus a quality coefficient that is reset annually for a crop period. In order to secure the volume of coffee needed, supply contracts are always entered into (or renewed) at least one year prior to harvest.

The Group forecasts the monthly volume of expected coffee purchases for a period of 18 months and manages the coffee price risk exposure on a 12-month rolling basis. For this purpose, the Group enters into futures contracts on the Arabica benchmark price and designates the futures contracts in cash flow hedges of the USD Arabica benchmark price risk component of its future coffee purchases. Some of those purchases are committed minimum volumes under the contracts and some purchases are highly probable forecast transactions (i.e., quantities in excess of the minimum purchases volumes and sometimes for periods for which no contract has yet been entered into). The underlying risk of the coffee futures contracts is identical to the hedged risk component (i.e., the USD Arabica benchmark price). Therefore, the Group has established a hedge ratio of 1:1 for all its hedging relationships. The USD Arabica benchmark price risk component is contractually specified in its purchase contracts, therefore, the Group considers the risk component to be separately identifiable and reliably measurable based on the price of coffee futures.

The Group does not hedge its exposure to the variability in the purchase price of coffee that results from the annual reset of the quality coefficient, because hedging that risk would require highly bespoke financial instruments that in the Group's view are not economical.

The Group's exposure to the variability in the purchase price of coffee that results from the diesel price indexation of the transport costs is integrated into its general risk management of logistics costs that aggregates exposures resulting from various logistics processes of the Group.

The Group determined the USD Arabica benchmark coffee price risk component that it designates as the hedged item on the basis of the pricing formula in the Group's coffee supply contracts (see the above description). That benchmark component is the largest pricing element. The quality coefficient depends on the particular crop in the region from which the Group sources its coffee, depending mainly on weather conditions that affect size and quality of the crop. Sometimes pest and plant diseases can have similar effects. Over the last 10 crop periods, the quality coefficient ranged between US cents 2-27 per pound (lb).

For the effect of the diesel price indexation, refer to the section 'Logistics costs management' in the Risk Management Report that is included in this Annual Report.

More information about how the Group manages its risk, including the extent to which the Group hedges, the hedging instruments used and sources of ineffectiveness, is provided in the Risk Management Report (see section 'Commodity Price Risk Management').

Disclosures about an entity's risk management strategy are an important cornerstone of the hedge accounting model, as they provide the link between an entity's risk management activities and how they affect the financial statements.

4.3.2 The amount, timing and uncertainty of future cash flows

For most hedge relationships, quantitative information must be disclosed by risk category that allows the evaluation of the terms and conditions of the hedging instruments and how they affect the amount, timing and uncertainty of future cash flows. *[IFRS 7.23A]*. This must include a breakdown disclosing: *[IFRS 7.23B]*

- The profile of the timing of the hedging instrument's nominal amount

  And

- If applicable, its average price or rate (e.g., strike or forward prices)

This requirement applies to cash flow hedges, fair value hedges, and hedges of a net investment, and meeting this requirement with concise information could prove challenging where an entity's use of hedge accounting is extensive. The following Illustration shows how an entity might present some of this information.

Illustration 4-2: Illustrative disclosure of timing, nominal amount and average price of coffee futures contracts

As of 31 December 20X0, Alpha Beta Coffee Group is holding the following coffee futures contracts to hedge the exposure on its coffee purchases over the next twelve months:

	Jan	Feb	Mar	Apr	May	...	Dec	Total
Notional amount of coffee futures contracts (in lb thousands) by month of their maturity	1,275	1,425	1,350	1,312	1,350	...	1,200	**16,275**
Average hedged rate (in US cents per lb)	122	125	128	133	135	...	139	**133**

Where a dynamic hedging process is used, an entity is exempt from the disclosure requirements in IFRS 7.23A and IFRS 7.23B and different information should be given. *[IFRS 7.23A, IFRS 7.23B]*. A dynamic process may be used in which both the exposure and the hedging instruments used to manage that exposure remain the same for only short periods of time because both the hedging instrument and the hedged item frequently change and the hedging relationship is frequently reset (or discontinued and restarted). This might occur, for example, when hedging the interest rate risk of an open portfolio of debt instruments. In these situations, the following must be disclosed: *[IFRS 7.23C(b)]*

- Information about what the ultimate risk management strategy is in relation to those hedging relationships
- A description of how the risk management strategy is reflected by using hedge accounting and designating those particular hedging relationships

  And

- An indication of how frequently the hedging relationships are discontinued and restarted as part of the process in relation to those hedging relationships

When the volume of hedging relationships in a dynamic process is unrepresentative of normal volumes during the period (i.e., the volume at the reporting date does not reflect the volumes during the period), that fact must be disclosed along with the reason volumes are believed to be unrepresentative. *[IFRS 7.24D]*.

For all hedges, a description of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term must be disclosed by risk category. *[IFRS 7.23D]*. If other sources of hedge ineffectiveness emerge in a hedging relationship, those sources must be disclosed by risk category along with an explanation of the resulting hedge ineffectiveness. *[IFRS 7.23E]*.

For cash flow hedges, a description of any forecast transaction for which hedge accounting had been used in the previous period, but which is no longer expected to occur, must be disclosed. *[IFRS 7.23F]*.

Originally the IASB had proposed that entities should disclose the total volume of risk the entity managed, irrespective of whether the entity actually hedges the full exposure. However, they were persuaded by many constituents saying this could result in disclosure of commercially sensitive information and did not carry this requirement forward to the final standard. *[IFRS 7.BC35U, IFRS 7.BC35W, IFRS 7.BC35X]*.

4.3.3 The effects of hedge accounting on financial position and performance

The following amounts related to designated hedging instruments must be disclosed:

- The carrying amount of the hedging instruments, presenting financial assets separately from financial liabilities.
- The line item in the statement of financial position that includes the hedging instrument.
- The change in fair value of the hedging instrument used as the basis for recognising hedge ineffectiveness for the period.

  And
- The nominal amounts (including quantities such as tonnes or cubic metres) of the hedging instruments.

This information should be given in a tabular format, separately by risk category and for fair value hedges, cash flow hedges and hedges of a net investment in a foreign operation, *[IFRS 7.24A]*, and the implementation guidance suggests it might be given in the following format. *[IFRS 7.IG13C]*.

Illustration 4-3: Amounts related to hedged instruments

	Nominal amount of the hedging instrument	Carrying amount of the hedging instrument		Line item in the statement of financial position where the hedging instrument is located	Changes in fair value used for calculating hedge ineffectiveness for 20X1
		Assets	Liabilities		
Cash flow hedges					
Commodity price risk					
- Forward sales contracts	xx	xx	xx	Line item XX	xx
Fair value hedges					
Interest rate risk					
- Interest rate swaps	xx	xx	xx	Line item XX	xx
Foreign exchange risk					
- Foreign currency loan	xx	xx	xx	Line item XX	xx

The following amounts related to hedged items must be disclosed:

- For fair value hedges:
  - The carrying amount of the hedged item recognised in the statement of financial position, presenting assets separately from liabilities
  - The accumulated amount of adjustments to the hedged item included in its carrying amount, again presenting assets separately from liabilities
  - The line item in the statement of financial position that includes the hedged item
  - The change in value of the hedged item used as the basis for recognising hedge ineffectiveness for the period

    And
  - The accumulated amount of adjustments to hedged financial instruments measured at amortised cost that have ceased to be adjusted for hedging gains and losses and which remain in the statement of financial position

- For cash flow hedges and hedges of a net investment in a foreign operation:
  - The change in value of the hedged item used as the basis for recognising hedge ineffectiveness for the period
  - The balances in the cash flow hedge reserve and the foreign currency translation reserve for continuing hedges

    And
  - The balances remaining in the cash flow hedge reserve and the foreign currency translation reserve from any hedging relationships for which hedge accounting is no longer applied

This information should be given in a tabular format, separately by risk category, *[IFRS 7.24B]*, and the implementation guidance suggests it might be given in the following format. *[IFRS 7.IG13D]*.

Illustration 4-4: Amounts related to hedged items

	Carrying amount of the hedged item		Accumulated amount of fair value hedge adjustments on the hedged item included in the carrying amount of the hedged item		Line item in the statement of financial position in which the hedged item is included	Change in value used for calculating hedge in-effectiveness for 20X1	Cash flow hedge reserve
	Assets	Liabilities	Assets	Liabilities			
Cash flow hedges							
Commodity price risk							
- Forecast sales	n/a	n/a	n/a	n/a	n/a	xx	xx
- Discontinued hedges (forecast sales)	n/a	n/a	n/a	n/a	n/a	n/a	xx
Fair value hedges							
Interest rate risk							
- Loan payable	-	xx	-	xx	Line item XX	xx	n/a
- Discontinued hedges (Loan payable)	-	xx	-	xx	Line item XX	n/a	n/a
Foreign exchange risk							
- Firm commitment	xx	xx	xx	xx	Line item XX	xx	n/a

The following amounts affecting the statement of comprehensive income must be disclosed:

- For fair value hedges:
  - Hedge ineffectiveness, i.e., the difference between the hedging gains or losses of the hedging instrument and the hedged item, recognised in profit or loss (or other comprehensive income for hedges of an equity instrument for which changes in fair value are presented in other comprehensive income)

    And
  - The line item in the statement of comprehensive income that includes the recognised hedge ineffectiveness

- For cash flow hedges and hedges of a net investment in a foreign operation:
  - Hedging gains or losses that were recognised in other comprehensive income in the reporting period
  - Hedge ineffectiveness recognised in profit or loss
  - The line item in the statement of comprehensive income that includes the recognised hedge ineffectiveness
  - The amount reclassified from the cash flow hedge reserve or the foreign currency translation reserve into profit or loss as a reclassification adjustment, differentiating in the case of cash flow hedges between:
    - Amounts for which hedge accounting had previously been used, but for which the hedged future cash flows are no longer expected to occur

      And
    - Amounts that have been transferred because the hedged item has affected profit or loss
  - The line item in the statement of comprehensive income that includes the reclassification adjustment

    And
  - For hedges of net positions, the hedging gains or losses recognised in a separate line item in the statement of comprehensive income

This information should be given in a tabular format, separately by risk category, *[IFRS 7.24C]*, and the implementation guidance suggests it might be given in the following format. *[IFRS 7.IG13E]*.

Illustration 4-5: Amounts affecting the statement of comprehensive income

Cash flow hedges(a)	Separate line item recognised in profit or loss as a result of a hedge of a net position(b)	Change in the value of the hedging instrument recognised in other comprehen-sive income	Hedge ineffective-ness recognised in profit or loss	Line item in profit or loss (that includes hedge ineffective-ness)	Amount re-classified from the cash flow hedge reserve to profit or loss	Line item affected in profit or loss because of the re-classification
Commodity price risk Commodity X	n/a	xx	xx	Line item XX	xx	Line item XX
▸ Discontinued hedge	n/a	n/a	n/a	n/a	xx	Line item XX

(a) The information disclosed in the statement of changes in equity (cash flow hedge reserve) should have the same level of detail as these disclosures.

(b) This disclosure only applies to cash flow hedges of foreign currency risk.

Fair value Hedges	Ineffectiveness recognised in profit or loss	Line item(s) in profit or loss (that include(s) hedge ineffectiveness)
Interest rate risk	xx	Line item XX
Foreign exchange risk	xx	Line item XX

The following Illustration shows another way an entity might present this information.

Illustration 4-6: Illustrative disclosure of the effects of hedge accounting on the financial position and performance

The impact of hedging instruments designated in hedging relationships as of 31 December 20X1 on the statement of financial position of Alpha Beta Coffee Group (the Group) is as follows:

Cash flow hedges	Notional amount	Carrying amount	Line item in the statement of financial position	Change in fair value used for measuring ineffectiveness for the period
Coffee price risk				
Arabica coffee futures	16,275lbs (thousands)	(4.5)	Short-term derivative financial liabilities	(1.0)
Interest rate risk				
Pay fixed/receive variable interest rate swap	EUR 50m	4.0	Long-term derivative financial assets	1.0

Fair value hedges	Notional amount	Carrying amount	Line item in the statement of financial position	Change in fair value used for measuring ineffectiveness for the period
Interest rate risk				
Receive fixed/pay variable interest rate swap	EUR 200m	(10.0)	Long-term derivative financial liabilities	(2.0)

The impact of hedged items designated in hedging relationships as of 31 December 20X1 on the statement of financial position of the Group is as follows:

Cash flow hedges	Change in value used for measuring ineffectiveness	Cash flow hedge reserve
Coffee price risk		
Coffee purchases	1.0	4.5
Interest rate risk		
Forecast interest payments	(0.9)	(3.9)

Fair value hedges	Carrying amount	Thereof accumulated fair value adjustments	Line item in the statement of financial position	Change in fair value used for measuring ineffectiveness for the period
Interest rate risk				
Fixed rate borrowings	211.0	11.0	Long-term borrowings	2.1

The above hedging relationships affected profit or loss and other comprehensive income as follows:

Cash flow hedges	Hedging gain or loss recognised in OCI	Ineffectiveness recognised in profit or loss	Line item in the statement of profit or loss for ineffectiveness	Amount reclassified from OCI to profit or loss	Line item in the statement of profit or loss for reclassification
Coffee price risk					
Hedges of forecast coffee purchases	(1.0)				
Interest rate risk					
Forecast interest payments	0.9	0.1	Other financial income	0.5	Interest expense

Fair value hedges	Ineffectiveness recognised in profit or loss	Line item in the statement of profit or loss for ineffectiveness
Interest rate risk		
Hedge of fixed rate borrowings	(0.1)	Other financial expenses

IAS 1 or, when applied, IFRS 18, requires the presentation of a reconciliation of each component of equity and an analysis of other comprehensive income (see section 7.2 and section 7.3 below). The level of information given in the reconciliation and analysis must: *[IFRS 7.24E]*[7]

- Differentiate between hedging gains or losses recognised in other comprehensive income and amounts reclassified to profit or loss, separately for:
  - Cash flow hedges for which the hedged future cash flows are no longer expected to occur
  - Those hedges for which the hedged item has affected profit or loss

  And
  - Amounts related to hedged forecast transactions that subsequently result in the recognition of a non-financial asset or liability, or a hedged forecast transaction for a non-financial asset or liability becomes a firm commitment for which fair value hedge accounting is applied, that are included directly in the initial cost or other carrying amount of the asset or the liability

    As noted in section 7.2 and section 7.3 below, this adjustment should not be included within other comprehensive income. *[IFRS 9.BC6.380]*. Instead, it should be presented within the statement of changes of equity, albeit separately from other comprehensive income.
- Differentiate between amounts associated with the time value of options that hedge transaction related hedged items and those that hedge time-period related hedged items where the time value of the option is recognised initially in other comprehensive income

  And
- Differentiate between amounts associated with forward elements of forward contracts and the foreign currency basis spreads of financial instruments that hedge transaction related hedged items and those that hedge time-period related hedged items where those amounts are recognised initially in other comprehensive income (see section 4.3.3.A below)

The information in the bullets above must be provided separately by risk category, although this disaggregation may be disclosed in the notes to the financial statements. *[IFRS 7.24F]*.

7 IFRS 18, which supersedes IAS 1 for reporting periods beginning On or after 1 January 2027 (with earlier application permitted) was issued by the IASB in April 2024. On adoption of IFRS 18 these aspects of IAS 1 and the cross-reference in IFRS 7.24E is amended accordingly.

The following extract from the financial statements of Vodafone Group Plc shows the type of disclosure about hedge accounting and hedge relationships that can be seen in practice. In addition to the information shown below, the table in the financial statements also includes, where relevant, the average maturity year, average foreign currency rate and average euro interest rate for each of the relevant line items.

Practical example 4-1: Vodafone Group Plc (2024) **United Kingdom**

Annual Report 2024 [extract]

Financials [extract]

Notes to the consolidated financial statements [extract]

22. Capital and financial risk management [extract]

Risk management strategy of hedge relationships

The risk strategies of the designated cash flow, fair value, and net investment hedges reflect the above market risk strategies.

The objective of the cash flow hedges is principally to convert foreign currency denominated fixed rate borrowings in US dollar, pound sterling, Australian dollar, Swiss franc, Hong Kong dollar, Japanese yen, Norwegian krona and US dollar floating rate borrowings into euro fixed rate borrowings and hedge the foreign exchange spot rate and interest rate risk. There are also cash flow hedges of certain subsidiary expenditure not denominated in functional currency of the entity, to hedge foreign exchange spot risk. Derivative financial instruments designated in cash flow hedges are cross-currency interest rate swaps and foreign exchange swaps and forwards. The swap maturity dates and liquidity profiles of the nominal cash flows match those of the underlying borrowings and exposures.

The objective of the net investment hedges is to hedge foreign exchange risk in foreign operations. Derivative financial instruments designated in net investment hedges are cross-currency interest rate swaps and foreign exchange swaps. The hedging instruments are rolled on an ongoing basis as determined by the nature of the business.

Hedge effectiveness is determined at the inception of the hedge relationship and through periodic prospective effectiveness assessments to ensure that an economic relationship exists between the hedged item and hedging instrument.

For hedges of foreign currency denominated borrowings and investments, the Group uses a combination of cross-currency and foreign exchange swaps to hedge its exposure to foreign exchange risk and interest rate risk and enters into hedge relationships where the critical terms of the hedging instrument match with the terms of the hedged item. Therefore the Group expects a highly effective hedging relationship with the swap contracts and the value of the corresponding hedged items to change systematically in the opposite direction in response to movements in the underlying exchange rates and interest rates. The Group therefore performs a qualitative assessment of effectiveness. If changes in circumstances affect the terms of the hedged item such that the critical terms no longer match with the critical terms of the hedging instrument, the Group uses the hypothetical derivative method to assess effectiveness.

Hedge ineffectiveness may occur due to:

a) The fair value of the hedging instrument on the hedge relationship designation date if the fair value is not nil;

b) Changes in the contractual terms or timing of the payments on the hedged item; and

c) A change in the credit risk of the Group or the counterparty with the hedging instrument.

The hedge ratio for each designation will be established by comparing the quantity of the hedging instrument and the quantity of the hedged item to determine their relative weighting; for all of the Group's existing hedge relationships the hedge ratio has been determined as 1:1.

The fair values of the derivative financial instruments are calculated by discounting the future cash flows to net present values using appropriate market rates and foreign currency rates prevailing at 31 March. The valuation basis is level 2 of the fair value hierarchy. This classification comprises items where fair value is determined from inputs other than quoted prices that are observable for the asset and liability, either directly or indirectly. Derivative financial assets and liabilities are included within trade and other receivables and trade and other payables in the statement of financial position.

The following table represents the carrying values and nominal amounts of derivatives in a continued hedge relationship as at 31 March.

At 31 March 2024	Nominal amounts €m	Carrying value assets €m	Carrying value liabilities €m	Other comprehensive income: Opening balance 1 April 2023 €m	Other comprehensive income: (Gain)/ Loss deferred to OCI €m	Other comprehensive income: Gain/(Loss) recycled to financing costs €m	Other comprehensive income: Closing balance 31 March 2024[1] €m	Weighted average: Maturity year	Weighted average: FX rate	Weighted average: Euro interest rate %
Cash flow hedges - foreign currency risk[2]										
Cross-currency and foreign exchange swaps:										
- US dollar bonds	16,756	2,689	188	(2,709)	1,775	124	(810)	2039	1.18	3.29
- Australian dollar bonds	288	–	2	(21)	14	(6)	(13)	2027	1.56	1.57
- Swiss franc bonds	624	80	–	(3)	(22)	15	(10)	2026	1.08	1.57
- Pound sterling bonds	4,771	45	362	(37)	244	126	333	2043	0.86	4.05
- Hong Kong dollar bonds	233	20	–	(5)	2	3	–	2028	9.08	1.92
- Japanese yen bonds	78	–	11	(12)	15	(9)	(6)	2037	128.53	2.47
- Norwegian krona bonds	241	–	47	(12)	13	(6)	(5)	2026	9.15	1.12
- Foreign exchange forwards[3]	287	–	42	(34)	(15)	7	(42)	2024	29.88	–
Cash flow hedges - foreign currency and interest rate risk[2]										
Cross currency swaps - US dollar bonds	–	–	–	(11)	11	–	–	–	–	–
Net investment hedge - foreign exchange risk[4]										
Cross currency and foreign exchange swaps - South African rand investment	1,505	176	–	952	(54)	–	898	2026	17.81	2.19
	24,783	**3,010**	**652**	**(1,892)**	**1,983**	**254**	**345**			

...

Notes:
1 Fair value movement deferred into other comprehensive income includes €251 million loss (2023: €383 million loss) and €10 million gain (2023: €17 million gain) of foreign currency basis outside the cash flow and net investment hedge relationships respectively.
2 For cash flow hedges, the movement in the hypothetical derivative (hedged item) mirrors that of the hedging instrument. Hedge ineffectiveness of the swaps designated in a cash flow hedge during the period was €67 million (2023: €nil).
3 Includes euro and US dollar forward contracts against Turkish lira to hedge foreign currency forecast expenditures in local markets. Notional amounts of €166 million (2023: €259 million) and $130 million or €121 million equivalent (2023: $134 million or €124 million equivalent) with weighted average exchange rates of 29.68 (2023: 18.36) and 30.15 (2023: 20.07) respectively to Turkish lira.
4 Hedge ineffectiveness of swaps designated in a net investment hedge during the period was €nil (2023: €nil).

The carrying value of bonds includes an additional €710 million loss (2023: €776 million loss) in relation to fair value of other bonds previously designated in fair value hedge relationships.

4.3.3.A Costs of hedging

Cost of hedging is an element that is only present in the hedging instrument and not in the hedged items. From a risk management perspective, entities typically consider the premium paid on a purchased option (which, on inception, is often only time value), the forward element in a forward contract and any foreign currency basis spread, as a cost of hedging rather than a trading position. Costs of hedging represents a source of ineffectiveness in a hedging relationship unless it is excluded from the designated hedging instrument. IFRS 9 defines the accounting treatment for changes in fair value when each of the aforementioned are excluded from a hedging relationship (see chapter 49 at section 7.5). *[IFRS 9.6.2.4]*.

The excluded forward elements of forward contracts and foreign currency basis spreads can either be measured at fair value through profit or loss, or be treated as 'costs of hedging', however, excluded time value of options must be accounted as 'costs of hedging'. *[IFRS 9.6.5.15, IFRS 9.6.5.16, IFRS 9.B6.5.29-39]*.

When applying 'costs of hedging' accounting, fluctuations in the fair value of the time value of options, the forward element of forward contracts or foreign currency basis spreads, is recorded in other comprehensive income instead of affecting profit or loss immediately. Although the costs of hedging will ultimately be recognised in profit or loss, this will be in a manner consistent with the risk management activity.

It is important to note that, because this accounting for 'costs of hedging' only applies if the time value of the option, the forward element of forward contracts or foreign currency basis spreads are excluded from the designation of the hedging relationship, the amounts deferred in accumulated other comprehensive income are not part of the cash flow hedge (or foreign currency reserve) but instead a different component of equity. The cash flow hedge reserve (or foreign currency reserve) only includes amounts that are gains or losses on hedging instruments that are determined to be an effective hedge (i.e., amounts that are included in the designation of a hedging relationship) (see chapter 49 at section 7.4).

The following extract in Practical example 4-2, from the financial statements of Anglian Water Services Limited, shows the type of disclosure that can be seen in practice.

Practical example 4-2: Anglian Water Services Limited (2024) United Kingdom

Annual Integrated Report 2024

Statutory accounts [extract]

Notes to the financial statements [extract]

17. Financial instruments [extract]

a) Market Risk [extract]

i) Foreign Currency [extract]

...

Fair valuation movements related to foreign currency basis which forms part of the pricing of cross currency interest rate swaps are treated as a cost of hedging for all foreign currency hedge designations within the Group. As such, it is excluded from hedge relationships and is only a source of ineffectiveness where hedge accounting has been interrupted.

The changes in fair value of foreign currency basis spread accumulated in the cash flow hedge reserve, are amortised to profit or loss on a rational basis over the term of the hedging relationship.

21. Hedging reserve [extract]

...

Cost of hedging reserve

	Group	
	2024 £m	2023 £m
At 1 April	1.7	0.3
(Losses)/gains on hedge relationships	(2.7)	1.8
Deferred tax movement on hedge relationships	0.6	(0.4)
At 31 March	(0.4)	1.7

The hedging reserve represents the cumulative effective portion of gains and losses arising on the change in fair value of hedging instruments, excluding those fair value movements identified as costs of hedging within the specific hedge relationship. The cost of hedging reserve captures the movement in the fair value of the cost of hedging component.

The table below provides additional information in relation to the annual movements and cumulative closing positions on the cash flow hedge reserves.

	Group					
	Annual movements		Cumulative reserves			
	Hedged item gain/(loss) £m	Hedge ineffectiveness gain/(loss) £m	Total hedge reserves continuing £m	Total hedge reserves discontinued £m	Deferred tax on hedge reserves £m	Total hedge reserves £m
At 31 March 2024						
Cash flow hedge of interest rate risk	(75.2)	-	3.1	16.0	(4.6)	14.5
At 31 March 2023						
Cash flow hedge of interest rate risk	(26.1)	-	65.2	(39.2)	(6.5)	19.5

4.3.4 Option to designate a credit exposure as measured at fair value through profit or loss

If a financial instrument, or a proportion of it, has been designated as measured at fair value through profit or loss because a credit derivative is used to manage the credit risk of that financial instrument, the following must be disclosed: *[IFRS 7.24G]*

- A reconciliation of each of the nominal amount and the fair value of the credit derivative at the beginning and end of the period
- The gain or loss recognised in profit or loss on initial designation

  And
- On discontinuation of measuring a financial instrument, or a proportion of it, at fair value through profit or loss, the fair value of that financial instrument that becomes the new carrying amount and the related nominal or principal amount

  Except for providing comparative information in accordance with IAS 1 or, when applied, IFRS 18, this information need not be given in subsequent periods.

4.3.5 Uncertainty arising from interest rate benchmark (IBOR) reform

Replacing interbank offered rates (IBOR) with alternative rates was one of the recommendations following the financial crisis and many jurisdictions have been making clear progress towards this. IBOR reform gives rise to a number of financial reporting issues, which the IASB approached in two phases. In September 2019, the IASB issued its first amendments to IFRS 9 that were designed to mitigate the effects of these reforms on hedge accounting in the period before financial instruments are issued or modified to reference alternative rates, and these mitigants are addressed in the Supplement: IBOR Reform. Consequential amendments were also made to IFRS 7 requiring information to be disclosed in respect of hedging relationships to which the mitigants in IFRS 9 are applied. The disclosure requirements are discussed in the Supplement: IBOR reform at section 6.1.

Disclosures introduced by the second phase of the IASB's project to address IBOR reform are considered in section 5.7 below.

At the time of writing, IBOR Reform is substantially complete as the most significant IBORs, including all the LIBORs, have now been replaced. However, there remain some local IBORs for which the work to replace them is still in progress or has only very recently been completed, hence the guidance in this chapter remains relevant.

4.4 Statement of financial position

4.4.1 Categories of financial assets and financial liabilities

The carrying amounts of each of the following categories of financial instrument must either be presented on the face of the statement of financial position or disclosed in the notes: *[IFRS 7.8]*

- Financial assets measured at fair value through profit or loss, showing separately:
  - Those designated as such upon initial recognition

    And
  - Those mandatorily measured at fair value in accordance with IFRS 9
- Financial liabilities measured at fair value through profit or loss, showing separately:
  - Those designated as such upon initial recognition

    And
  - Those that meet the definition of held for trading in IFRS 9
- Financial assets measured at amortised cost
- Financial liabilities measured at amortised cost

  And
- Financial assets measured at fair value through other comprehensive income, showing separately:
  - Debt instruments held within a business model to both collect contractual cash flows from, and to sell, the assets

    The carrying amount of debt instruments measured at fair value through other comprehensive income should not be reduced by a loss allowance and the loss allowance should not be presented separately in the statement of financial position as a reduction of the carrying amount of the financial asset. However, the loss allowance must be disclosed in the notes to the financial statements. *[IFRS 7.16A]*.

    And
  - Investments in equity instruments designated to be measured as such upon initial recognition

The IASB concluded that such disclosure would assist users in understanding the extent to which accounting policies affect the amounts at which financial assets and financial liabilities are recognised. *[IFRS 7.BC14]*.

Although accounted for identically, the carrying amounts of financial instruments that are mandatorily measured (e.g., classified as held for trading) and those designated at fair value through profit or loss are shown separately because designation is at the discretion of the entity. *[IFRS 7.BC15]*.

A derivative that is designated as a hedging instrument in an effective hedge relationship does not fall within any of the above categories and, strictly, is not required to be included in these disclosures. Disclosure requirements for hedges are set out in section 4.3 above. However, an entity could choose to disclose such derivatives in a separate category alongside the disclosures above.

4.4.2 Financial liabilities designated at fair value through profit or loss

Where a (non-derivative) financial liability has been designated at fair value through profit or loss, i.e., it is not classified as held for trading, the amount of change during the period and cumulatively (i.e., since initial recognition) in its fair value that is attributable to changes in credit risk must be disclosed. This disclosure should be provided for financial liabilities where the change is recognised in other comprehensive income (see Chapter 46 at section 2.4.1), and it should also be provided for financial liabilities where the change is recognised in profit or loss because recognising it in other comprehensive income would create or enlarge an accounting mismatch within profit or loss (see Chapter 46 at section 2.4.2). *[IFRS 7.10(a), IFRS 7.10A(a)]*.

Furthermore, if the disclosure is not considered to represent faithfully the change in the fair value of the financial liability attributable to changes in credit risk, the reasons for reaching this conclusion and the factors believed to be relevant should also be disclosed. *[IFRS 7.11(b)]*.

The IASB concluded that the difference between the carrying amount of such a liability and the amount the entity would be contractually required to pay at maturity to the holder of the obligation should also be disclosed. This disclosure is also required for liabilities where the change in fair value attributable to credit risk is recognised in other comprehensive income and for those where the change is recognised in profit or loss. *[IFRS 7.10(b), IFRS 7.10A(b)]*. The fair value may differ significantly from the settlement amount, particularly for liabilities with a long duration when the entity has experienced a significant deterioration in creditworthiness subsequent to issuance and the IASB concluded that knowledge of this difference would be useful. Also, the settlement amount is important to some financial statement users, particularly creditors. *[IFRS 7.BC22]*.

Where changes in the fair value of a financial liability attributable to credit risk are recognised in other comprehensive income, any transfers of the cumulative gain or loss within equity must be disclosed, including the reason for such transfers. *[IFRS 7.10(c)]*. Also, if such a financial liability is derecognised during the period, the amount (if any) presented in other comprehensive income that was realised at derecognition must be disclosed. *[IFRS 7.10(d)]*.

A detailed description of the methods used to calculate the changes in fair value attributable to changes in credit risk should be given, including an explanation of why the method is appropriate. This disclosure is required irrespective of whether those changes are recognised in other comprehensive income or in profit or loss. *[IFRS 7.11(a)]*.

Entities should also provide a detailed description of the methodology or methodologies used to determine whether presenting changes in the fair value of a liability attributable to credit risk in other comprehensive income would create or enlarge an accounting mismatch in profit or loss (see Chapter 46 at section 2.4.2). Where an entity is required to present such changes in profit or loss, this disclosure should include a detailed description of the economic relationship between the financial liability and other financial instrument(s) measured at fair value through profit or loss that are expected to offset those changes. *[IFRS 7.11(c)]*.

4.4.3 Financial assets designated as measured at fair value through profit or loss

Additional disclosure requirements apply to financial assets (or groups of such assets) that are designated at fair value through profit or loss if they would otherwise be measured at fair value through other comprehensive income or at amortised cost, namely: *[IFRS 7.9]*

- The maximum exposure to credit risk (see section 5.3.3 below) at the reporting date of the financial asset (or group of financial assets)
- The amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk
- The amount of change during the period and cumulatively (i.e., since initial recognition) in the fair value of the financial assets (or group of financial assets) that is attributable to changes in credit risk (see below)

  And

- The amount of change in the fair value of any related credit derivative or similar instrument that has occurred during the period and cumulatively since the financial asset was designated

Calculating the change in fair value attributable to changes in credit risk is approached in much the same way as for financial liabilities (see section 4.4.2 above). It may be determined either as the amount of change in fair value that is not attributable to changes in market conditions that give rise to market risk or by using an alternative method that more faithfully represents the amount of change in its fair value that is attributable to changes in credit risk. *[IFRS 7.9(c)]*.

A detailed description of the chosen method(s), including an explanation of why the method is appropriate, must be disclosed. If the disclosure is not considered to represent faithfully the change in the fair value of the financial asset attributable to changes in credit risk, the reasons for reaching this conclusion and the factors believed to be relevant must be disclosed. *[IFRS 7.11(a), IFRS 7.11(b)]*.

4.4.4 Investments in equity instruments designated at fair value through other comprehensive income

Where investments in equity instruments have been designated to be measured at fair value through other comprehensive income (see Chapter 44 at sections 1.2 and 7), disclosures should be made in accordance with IFRS 7.11A, and where such investments are derecognised during the reporting period, the disclosures should be made in accordance with IFRS 7.11B: *[IFRS 7.11A, IFRS 7.11B]*

Extract from IFRS 7

Investments in equity instruments designated at fair value through other comprehensive income

11A If an entity has designated investments in equity instruments to be measured at fair value through other comprehensive income, as permitted by paragraph 5.7.5 of IFRS 9, it shall disclose:

(a) which investments in equity instruments have been designated to be measured at fair value through other comprehensive income.

(b) the reasons for using this presentation alternative.

(c) the fair value of each such investment at the end of the reporting period.

(d) dividends recognised during the period, showing separately those related to investments derecognised during the reporting period and those related to investments held at the end of the reporting period.

(e) any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers.

11B If an entity derecognised investments in equity instruments measured at fair value through other comprehensive income during the reporting period, it shall disclose:

(a) the reasons for disposing of the investments.

(b) the fair value of the investments at the date of derecognition.

(c) the cumulative gain or loss on disposal.

Applying IFRS 7.11A(c) to each such investment may be onerous if an entity makes significant use of the fair value through other comprehensive income option. However, as noted in section 3.2 above, the concept of materiality does apply to disclosures, therefore this information could be provided separately only for those investments that are themselves material, whilst aggregated disclosures may suffice for immaterial items. In addition, as noted below, recent amendments to IFRS 7 remove the words "of each such investment" from paragraph 11A(c) which will remove this issue.

In May 2024, the IASB issued *Amendments to IFRS 9 and IFRS 7, Amendments to the Classification and Measurement of Financial Instruments* which, among other changes, amend paragraphs 11A and 11B of IFRS 7 and add application guidance to illustrate how those disclosures could be given. The disclosures required by paragraph 11A will, on adoption of the amendments, be required for each class of investment (see section 3.3 above). The change in fair value recognised in other comprehensive income during the period will also be required, showing separately amounts related to investments derecognised in the reporting period and those held at period-end. *[IFRS 7(2026).11A]*. This disclosure requirement together with the other requirements in paragraph 11B of IFRS 7, particularly that relating to the cumulative gain or loss on disposal provide users with information about what are generally considered realised gains or losses. *[IFRS 7(2026).BC22K]*.

The amendments also remove the requirement to disclose the fair value of each investment at the period-end as this would be onerous and does not necessarily provide useful information to the users of the financial statements. *[IFRS 7(2026).11A(c)]*. Entities are therefore only required to disclose the aggregate fair value for each class of investment at period-end. The considerations of IFRS 7.6 should be used to group financial instruments into classes. *[IFRS 7.6]*.

The amendments will now require entities to disclose any transfers of cumulative gains or losses within equity for instruments derecognised during the period. *[IFRS 7.11B]*. This requirement was added to mirror the existing requirement in paragraph IFRS 7.11A(e) to disclose any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers. *[IFRS 7(2026).BC22J]*.

The following example of disclosure is extracted from paragraph IG11A and IG11B of the Implementation Guidance to IFRS 7. *[IFRS 7(2026).IG11A, IFRS 7(2026).IG11B]*.

Extract from IFRS 7(2026)

Investments in equity instruments designated at fair value through other comprehensive income (paragraphs 11A and 11B)

IG11A …

Background

Having met the requirements in paragraph 5.7.5 of IFRS 9 Financial Instruments, Entity A has elected to present subsequent changes in the fair value of its investments in equity instruments in other comprehensive income. In accordance with its accounting policies, Entity A transfers accumulated gains or losses from other comprehensive income to retained earnings only when an investment is derecognised. Entity A has a reporting year end of 31 December.

As at 1 January 20X1 Entity A's equity investments had an aggregate carrying amount of CU800,000, and the cumulative changes in fair value of these investments recognised in accumulated other comprehensive income as at that date were CU200,000. There were no disposals from this portfolio before 1 January 20X1.

On 31 July 20X1 Entity A acquired a non-controlling interest in Entity Y, a non-listed entity, for CU155,000.

On 30 June 20X1 Entity A received CU1,000 of dividend income from Entity X. On 30 September 20X1 Entity A disposed of its investment in Entity X for CU200,000, resulting in a cumulative gain of CU50,000.

Entity A's remaining investments had an aggregate fair value of CU820,000, as at 31 December 20X1. Entity A received total dividend income of CU5,000 from these remaining investments in 20X1.

The total change in fair value of Entity A's equity investments during the period was CU65,000, including CU20,000 relating to its investment in Entity X.

IG11B …

Reference	Information provided in the notes to Entity A's financial statements
Paragraphs 11A(a), 11A(b) and 11B(d) of IFRS 7 and paragraphs 5.7.5 and B5.7.1 of IFRS 9	The following table shows the Company's equity investments in non-listed entities in Europe, the Middle East and Africa (EMEA). The Company holds these investments for strategic purposes on a medium- to long-term basis; the Company typically holds less than 5% interest in each entity and does not have a controlling interest in these entities. The investments are not held for trading. The Company has elected to present subsequent changes in the fair value of these investments in other comprehensive income. Accumulated gains or losses are transferred to retained earnings only when an investment is disposed of. On 31 July 20X1 the Company acquired a non-controlling interest (less than a 5% equity investment) in Entity Y, a non-listed entity.
Paragraph 11B(a) of IFRS 7	On 30 September 20X1 the Company disposed of its investment in Entity X because holding this investment is no longer aligned with the Company's investment strategy

Reference	Equity instruments designated at fair value through other comprehensive income		
		Carrying amount CU'000[(a)]	**Other comprehensive income CU'000[(b)]**
	Investment in EMEA		
	1 January 20X1	800	200
	Investments acquired	155	-
	Fair value gains for:		
[1]Paragraph 11A(f) of IFRS 7	Investments held at year end	45[1]	45
[2]Paragraph 11A(f) of IFRS 7	Investments disposed of	20[2]	20
[3]Paragraph 11B(b) of IFRS 7	Investments disposed of	(200)[3]	-
[4]Paragraph 11B(d) of IFRS 7	Transfers within equity following disposal	-	(50)[4]
[5]Paragraph 11A(c) of IFRS 7	**31 December 20X1**	**820[5]**	**215**
Paragraphs 11B(c) and 11B(d) of IFRS 7	The Company transferred a cumulative gain of CU50,000, relating to the disposal of its investment in Entity X, from other comprehensive income to retained earnings during the year.		
Paragraph 11A(d) of IFRS 7	The Company received CU6,000 dividend income from its equity investments during the year, including CU1,000 that was received from Entity X.		

(a) Entity A cross-refers from this column to the note in which the information required by paragraph 93 of IFRS 13 *Fair Value Measurement* is disclosed.

(b) Entity A cross-refers from this column to the statement of changes in other comprehensive income and the statement of changes in equity.

The amendments are effective for periods beginning on or after 1 January 2026, however entities can either early adopt all the amendments at the same time or early adopt only the amendments relating to the classification of financial assets and their related disclosures and apply the other amendments (including the ones addressed in this section) from the effective date.

4.4.5 Reclassification

The circumstances in which financial assets should or may be reclassified from one category to another in response to a change in an entity's business model are discussed in Chapter 44 at section 8. If, in the current or previous reporting periods, any such reclassifications have occurred, the following must be disclosed: *[IFRS 7.12B]*

Extract from IFRS 7

12B An entity shall disclose if, in the current or previous reporting periods, it has reclassified any financial assets in accordance with paragraph 4.4.1 of IFRS 9. For each such event, an entity shall disclose:

(a) the date of reclassification.

(b) a detailed explanation of the change in business model and a qualitative description of its effect on the entity's financial statements.

(c) the amount reclassified into and out of each category.

For assets previously measured at fair value through profit or loss that are reclassified so that they are measured at amortised cost or at fair value through other comprehensive income, the following information must be disclosed in each reporting period following reclassification until derecognition: *[IFRS 7.12C]*

Extract from IFRS 7

12C For each reporting period following reclassification until derecognition, an entity shall disclose for assets reclassified out of the fair value through profit or loss category so that they are measured at amortised cost or fair value through other comprehensive income in accordance with paragraph 4.4.1 of IFRS 9:

(a) the effective interest rate determined on the date of reclassification; and

(b) the interest revenue recognised.

Where financial assets previously measured at fair value through other comprehensive income have been reclassified since the last annual reporting date so that they are measured at amortised cost, the following must be disclosed:

- The fair value of the financial assets at the end of the reporting period

  And

- The fair value gain or loss that would have been recognised in profit or loss during the reporting period if the financial assets had not been reclassified

The same information should be given where financial assets previously measured at fair value through profit or loss have been reclassified since the last annual reporting date so that they are measured at amortised cost or at fair value through other comprehensive income. *[IFRS 7.12D]*.

4.4.6 Collateral

Where an entity has pledged financial assets as collateral for liabilities or contingent liabilities it should disclose the carrying amount of those assets and the terms and conditions relating to its pledge. This also applies to transfers of non-cash collateral where the transferee has the right, by contract or custom, to sell or repledge the collateral (see Chapter 48 at section 5.5.2). *[IFRS 7.14]*.

When an entity holds collateral (of financial or non-financial assets) and is permitted to sell or repledge the collateral in the absence of default by the owner of the collateral, it should disclose: *[IFRS 7.15]*

- The fair value of the collateral held
- The fair value of any such collateral sold or repledged, and whether the entity has an obligation to return it

  And

- The terms and conditions associated with its use of the collateral

Although some respondents to the exposure draft that preceded IFRS 7 (ED 7 *Financial Instruments: Disclosures*) argued for an exemption from this disclosure in cases where it is impracticable to obtain the fair value of the collateral held, the IASB concluded that it is reasonable to expect an entity to know the fair value of collateral that it holds and can sell even where there is no default. *[IFRS 7.BC25]*.

4.4.7 Compound financial instruments with multiple embedded derivatives

Where an instrument has been issued that contains both a liability and an equity component and the instrument has multiple embedded derivatives whose values are interdependent, such as a callable convertible debt instrument (see Chapter 43 at section 6.4.2), the existence of these features must be disclosed. *[IFRS 7.17]*. Accordingly, the impact on the amounts reported as liabilities and equity will be highlighted, something the IASB sees as important given the acknowledged arbitrary nature of the allocation under IAS 32 of the joint value attributable to this interdependence. *[IFRS 7.BC31]*.

4.4.8 Defaults and breaches of loans payable

Loans payable are defined as "financial liabilities, other than short-term trade payables on normal credit terms". *[IFRS 7 Appendix A]*. It is considered that disclosures about defaults and breaches of loans payable and other loan agreements provide relevant information about the entity's creditworthiness and its prospects of obtaining future loans. *[IFRS 7.BC32]*.

Accordingly, for any loans payable recognised at the reporting date, an entity is required to disclose: *[IFRS 7.18]*

- Details of any defaults during the period of principal, interest, sinking fund, or redemption terms
- The carrying amount of the loans payable in default at the reporting date

  And
- Whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue

If, during the period, there were breaches of loan agreement terms other than those described above, the same information must be disclosed if those breaches permitted the lender to demand accelerated repayment (unless the breaches were remedied, or the terms of the loan were renegotiated, on or before the reporting date). *[IFRS 7.19]*.

It is noted that any defaults or breaches may affect the classification of the liability as current or non-current in accordance with IAS 1 (see Chapter 3 at section 3.1.4). *[IFRS 7.IG12]*.

4.4.9 Interests in associates and joint ventures accounted for in accordance with IFRS 9

IAS 28 *Investments in Associates and Joint Ventures* allows an interest in an associate or a joint venture held by a venture capital or similar organisation to be measured at fair value through profit or loss in accordance with IFRS 9 (see Chapter 12 at section 3.3). In these circumstances, the disclosure requirements of IFRS 7 do apply to such financial instruments. In addition, IFRS 12 *Disclosure of Interests in Other Entities* contains additional disclosure requirements, over and above those in IFRS 7, which are dealt with in Chapter 14 at section 2.2.3.D and section 5.

4.5 Fair values

4.5.1 General disclosure requirements

The IASB sees the disclosure of information about the fair value of financial assets and liabilities as being an important requirement. It is explained in the following terms: *[IFRS 7.BC36]*

Extract from IFRS 7	
BC36	Many entities use fair value information internally in determining their overall financial position and in making decisions about individual financial instruments. It is also relevant to many decisions made by users of financial statements because, in many circumstances, it reflects the judgement of the financial markets about the present value of expected future cash flows relating to an instrument. Fair value information permits comparisons of financial instruments having substantially the same economic characteristics, regardless of why they are held and when and by whom they were issued or acquired. Fair values provide a neutral basis for assessing management's stewardship by indicating the effects of its decisions to buy, sell or hold financial assets and to incur, maintain or discharge financial liabilities. The Board decided that when an entity does not measure a financial asset or financial liability in its balance sheet at fair value, it should provide fair value information through supplementary disclosures to assist users to compare entities on a consistent basis.

Therefore, when financial assets or liabilities are not measured on a fair value basis, information on fair values should be given by way of supplementary disclosures to assist users in comparing entities on a consistent basis. *[IFRS 7.BC36]*.

More specifically, except as set out below, the fair value of each class of financial assets and liabilities must be disclosed in a way that permits comparison with the corresponding carrying amounts. *[IFRS 7.25]*. In providing this disclosure, instruments should be offset only to the extent that their related carrying amounts are also offset in the statement of financial position. *[IFRS 7.26]*. IFRS 13 contains guidance on determining fair values and includes more extensive disclosure requirements about the fair values disclosed. These are discussed in Chapter 15 at section 19.

Pragmatically, disclosure of fair values is not required for instruments whose carrying amount reasonably approximates their fair value, for example short-term trade receivables and payables. *[IFRS 7.29(a)]*. Where an entity has material amounts of longer-term receivables or payables the carrying amount will often not represent a reasonable approximation of fair value and in such cases the use of this concession will not be appropriate.

Similarly, disclosure need not be given of the fair value of lease liabilities. *[IFRS 7.29(d)]*.

4.5.2 Day 1 profits

In certain situations, there will be a difference between the transaction price for a financial asset or financial liability and the fair value that would be determined at that date in accordance with IFRS 13 (commonly known as a day 1 profit). *[IFRS 7.28]*. As set out in Chapter 45 at section 3.3, an entity should not recognise a day 1 profit on initial recognition of the financial instrument if the fair value is neither evidenced by a quoted price in an active market for an identical asset or liability (known as a Level 1 input) nor based on a valuation technique that uses only data from observable markets. Instead, the difference will be recognised in profit or loss in subsequent periods in accordance with IFRS 9 and the entity's accounting policy. *[IFRS 7.IG14]*.

Where such a difference exists, IFRS 7 requires disclosure, by class of financial instrument, of: *[IFRS 7.28]*

- The accounting policy for recognising that difference in profit or loss to reflect a change in factors (including time) that market participants would take into account when setting a price for the financial instrument
- The aggregate difference yet to be recognised in profit or loss at the beginning and end of the period and a reconciliation of changes in the amount of this difference

  And
- Why it was concluded that the transaction price was not the best evidence of fair value, including a description of the evidence that supports the fair value

In other words, disclosure is required of the profits an entity might think it has made but which it is prohibited from recognising, at least for the time being. This disclosure is shown in the following Illustration based on the implementation guidance. It is rather curious in that it illustrates a day 1 loss, not profit.

Illustration 4-7: Disclosure of deferred day 1 profits

On 1 January 20X0 Company R purchases financial assets that are not traded in an active market for CU15 million which represents their fair value at initial recognition. After initial recognition, R applies a valuation technique to measure the fair value of the financial assets. This valuation technique uses inputs other than data from observable markets. At initial recognition, the same valuation technique would have resulted in an amount of CU14 million, which differs from fair value by CU1 million. R has only one class of such financial assets with existing differences of CU5 million at 1 January 20X0. The disclosure in R's 20X1 financial statements would include the following: *[IFRS 7.IG14]*

Accounting policies

R uses the following valuation technique to measure the fair value of financial instruments that are not traded in an active market: [*insert description of technique* - not included in this example]. Differences may arise between the fair value at initial recognition (which, in accordance with IFRS 13 and IFRS 9, is normally the transaction price) and the amount determined at initial recognition using the valuation technique. Any such differences are [*description of R's accounting policy* - not included in this example].

In the notes to the financial statements

In the notes to the financial statements

As discussed in note X, [*insert name of valuation technique*] is used to measure the fair value of the following financial instruments that are not traded in an active market. However, in accordance with IFRS 13 and IFRS 9, the fair value of an instrument at inception is normally the transaction price. If the transaction price differs from the amount determined at inception using the valuation technique, that difference is [*description of R's accounting policy* - not included in this example].

The differences yet to be recognised in profit or loss are as follows:

	20X1	20X0
	CU m	CU m
Balance at beginning of year	5.3	5.0
New transactions	-	1.0
Recognised in profit or loss during the year	(0.7)	(0.8)
Other increases	-	0.2
Other decreases	(0.1)	(0.1)
Balance at end of year	4.5	5.3

UBS Group AG discloses the following information about recognition of day 1 profits.

Practical example 4-3: UBS Group AG (2023) **Switzerland**

Annual Report 2023 [extract]
5 Financial statements [extract]
Consolidated financial statements [extract]
Notes to the UBS Group AG consolidated financial statements [extract]
Additional information [extract]
Note 21 Fair value measurement [extract]
d) Valuation adjustments and other items [extract]

Deferred day-1 profit or loss reserves

For new transactions where the valuation technique used to measure fair value requires significant inputs that are not based on observable market data, the financial instrument is initially recognized at the transaction price. The transaction price may differ from the fair value obtained using a valuation technique, where any such difference is deferred and not initially recognized in the income statement.

Deferred day-1 profit or loss is generally released into *Other net income from financial instruments measured at fair value through profit or loss* when pricing of equivalent products or the underlying parameters becomes observable or when the transaction is closed out.

The table below summarizes the changes in deferred day-1 profit or loss reserves during the respective period. In accordance with IFRS, no day-1 profit or loss reserves were recognized on positions acquired with the Credit Suisse Group and no significant new positions were originated between the acquisition date and 31 December 2023.

Deferred day-1 profit or loss reserves

USD m	2023	2022	2021
Reserve balance at the beginning of the year	422	418	269
Profit / (loss) deferred on new transactions	260	299	459
(Profit) / loss recognized in the income statement	(278)	(295)	(308)
Foreign currency translation	0	0	(2)
Reserve balance at the end of the year	404	422	418

4.6 Business combinations

IFRS 3 *Business Combinations* requires an acquirer to disclose additional information about financial instruments arising from business combinations that occur during the reporting period. These requirements are discussed below.

4.6.1 Acquired receivables

Some constituents were concerned that prohibiting the use of an allowance account when accounting for acquired receivables at fair value (see Chapter 45 at section 3.3.4) could make it impossible to determine the contractual cash flows due on those assets and the amount of those cash flows not expected to be collected. They asked for additional disclosure to help in assessing considerations of credit quality used in estimating those fair values, including expectations about receivables that will be uncollectible. *[IFRS 3.BC258]*. Consequently, the IASB decided to require the following disclosures to be made about such assets acquired in a business combination:

- Fair value of the receivables
- Gross contractual amounts receivable

  And
- The best estimate at the acquisition date of the contractual cash flows not expected to be collected

This information should be provided by major class of receivable, such as loans, direct finance leases and any other class of receivables. *[IFRS 3.B64(h)]*.

Although these requirements will produce some of the information users need to evaluate the credit quality of receivables acquired, the IASB acknowledged that it may not provide all such information. This was seen as an interim measure and the IASB said it would monitor a related FASB project with a view to improving the disclosure requirements in the future. *[IFRS 3.BC260]*. The FASB project was completed in July 2010, but IFRS 3 was not subsequently changed, although the disclosure requirements in IFRS 7 about credit risk were expanded significantly by IFRS 9 (see section 5.3 below).

4.6.2 Contingent consideration and indemnification assets

The following information about contingent consideration arrangements and indemnification assets (see Chapter 41 at sections 2.7.1 and 2.12, respectively) should be given: *[IFRS 3.B64(g)]*

- The amount recognised as at the acquisition date
- A description of the arrangement and the basis for determining the amount of the payment

  And
- An estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated

  If the maximum amount of the payment is unlimited, that fact must be disclosed

These are requirements of IFRS 3 and apply irrespective of whether such items meet the definition of a financial instrument (which they normally will).

5 Nature and extent of risks arising from financial instruments

IFRS 7 establishes a second key principle, namely: *[IFRS 7.31]*

Extract from IFRS 7

31 An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.

Again, this is supported by related disclosure requirements which focus on qualitative and quantitative aspects of the risks arising from financial instruments and how those risks have been managed. *[IFRS 7.32]*.

Providing qualitative disclosures in the context of quantitative disclosures enables users to link related disclosures and hence form an overall picture of the nature and extent of risks arising from financial instruments. The interaction between qualitative and quantitative disclosures contributes to disclosure of information in a way that better enables users to evaluate an entity's exposure to risks. *[IFRS 7.32A]*.

These risks typically include, but are not limited to, credit risk, liquidity risk and market risk, which are defined as follows: *[IFRS 7 Appendix A]*

(a) *Credit risk*, the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

(b) *Liquidity risk*, the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.

(c) *Market risk*, the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. It comprises three separate types of risk:

(i) *Currency risk*, the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

Currency risk (or foreign exchange risk) arises on financial instruments that are denominated in a foreign currency, i.e., in a currency other than the functional currency in which they are measured. For the purpose of IFRS 7, currency risk does not arise from financial instruments that are non-monetary items or from financial instruments denominated in an entity's functional currency. *[IFRS 7.B23]*. Therefore, if a parent with the euro as its functional and presentation currency owns a subsidiary with the pound sterling as its functional currency, monetary items held by the subsidiary that are denominated in sterling do not give rise to any currency risk in the consolidated financial statements of the parent.

(ii) *Interest rate risk*, the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

It is explained that interest rate risk arises on interest-bearing financial instruments recognised in the statement of financial position (e.g., debt instruments acquired or issued) and on some financial instruments not recognised in the statement of financial position (e.g., some loan commitments). *[IFRS 7.B22]*.

(iii) *Other price risk*, the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

Other price risk arises on financial instruments because of changes in, for example, commodity prices, equity prices, prepayment risk (i.e., the risk that one party to a financial asset will incur a financial loss because the other party repays earlier or later than expected), and residual value risk (e.g., a lessor of motor cars that writes residual value guarantees is exposed to residual value risk). *[IFRS 7.B25, IFRS 7.IG32]*.

Two examples of financial instruments that give rise to equity price risk are a holding of equities in another entity, and an investment in a trust, which in turn holds investments in equity instruments. Other examples include certain forward contracts and options to buy or sell specified quantities of an equity instrument and swaps that are indexed to equity prices. The fair values of such financial instruments are affected by changes in the market price of the underlying equity instruments. *[IFRS 7.B26]*.

The specified disclosures can be provided either in the financial statements or may be incorporated by cross-reference from the financial statements to some other statement that is available to users of the financial statements on the same terms and at the same time, such as a management commentary or risk report (preparation of which might be required by a regulatory authority). Without the information incorporated by cross-reference, the financial statements are incomplete. *[IFRS 7.B6, IFRS 7.BC46]*.

Consistent with the approach outlined in section 3 above, it is emphasised that the extent of these disclosures will depend on the extent of an entity's exposure to risks arising from financial instruments. *[IFRS 7.BC41]*. Therefore, entities with many financial instruments and related risks should provide more disclosure and those with few financial instruments and related risks may provide less extensive disclosure. *[IFRS 7.BC40(b)]*.

The IASB recognised that entities view and manage risk in different ways and that some entities undertake limited management of risks. Therefore, disclosures based on how risk is managed are unlikely to be comparable between entities and, for some entities, would convey little or no information about the risks assumed. Accordingly, whilst at a high level the disclosures are approached from the perspective of information provided to management (see section 5.2 below), certain minimum disclosures about risk exposures are specified to provide a common, and relatively easy to implement, benchmark across different entities. Obviously, those entities with more developed risk management systems would provide more detailed information. *[IFRS 7.BC42]*.

It is explained in the Basis for Conclusions that the implementation guidance, which illustrates how an entity might apply IFRS 7, is consistent with the disclosure requirements for banks developed by the Basel Committee (known as Pillar 3), so that banks can prepare, and users receive, a single co-ordinated set of disclosures about financial risk. *[IFRS 7.BC41]*. The standard was originally written before the financial crisis and there have been a number of subsequent initiatives to improve the reporting of risk by financial institutions, both from a regulatory and a financial reporting perspective, for example as set out in section 8 below.

In developing the standard, the IASB considered various arguments that risk disclosures should not be included within the financial statements (even by cross-reference). For example, concerns were expressed that the information would be difficult and costly to audit and that it did not meet the criteria of comparability, faithful representation and completeness because it is subjective, forward-looking and based on management's judgement. It was also suggested that the subjectivity involved in the sensitivity analyses could undermine the credibility of the fair values recognised in the financial statements. However, the IASB was not persuaded and these arguments were rejected. *[IFRS 7.BC43, IFRS 7.BC44, IFRS 7.BC45, IFRS 7.BC46]*.

5.1 Qualitative disclosures

For each type of risk arising from financial instruments, an entity is required to disclose: *[IFRS 7.33(a), IFRS 7.33(b)]*

(a) The exposures to risk and how they arise

And

(b) Its objectives, policies and processes for managing the risk and the methods used to measure the risk

Any changes in either (a) or (b) above compared to the previous period, together with the reasons for the change, must be disclosed. These changes may result from changes in exposure to risk or the way those exposures are managed. *[IFRS 7.33(c), IFRS 7.IG17]*.

The type of information that might be disclosed to meet these requirements includes, but is not limited to, a narrative description of: *[IFRS 7.IG15]*

Extract from IFRS 7

IG15 The type of qualitative information an entity might disclose to meet the requirements in paragraph 33 includes, but is not limited to, a narrative description of:

- (a) the entity's exposures to risk and how they arose. Information about risk exposures might describe exposures both gross and net of risk transfer and other risk-mitigating transactions.
- (b) the entity's policies and processes for accepting, measuring, monitoring and controlling risk, which might include:
  - (i) the structure and organisation of the entity's risk management function(s), including a discussion of independence and accountability;
  - (ii) the scope and nature of the entity's risk reporting or measurement systems;
  - (iii) the entity's policies for hedging or mitigating risk, including its policies and procedures for taking collateral; and
  - (iv) the entity's processes for monitoring the continuing effectiveness of such hedges or mitigating devices.
- (c) the entity's policies and procedures for avoiding excessive concentrations of risk.

It is noted that information about the nature and extent of risks arising from financial instruments is more useful if it highlights any relationship between financial instruments that can affect the amount, timing or uncertainty of an entity's future cash flows. The extent to which a risk exposure is altered by such relationships might be apparent from other required disclosures, but in some cases further disclosures might be useful. *[IFRS 7.IG16]*.

The following extract from the financial statements of Hunting PLC shows the type of disclosure that can be seen in practice.

Practical example 5-1: Hunting PLC (2023) United Kingdom

Annual Report and Accounts 2023 [extract]

Financial statements [extract]

Notes to the Consolidated Financial Statements [extract]

30. Financial Risk Management [extract]

The Group's activities expose it to certain financial risks, namely market risk (including foreign exchange risk and interest rate risk), as well as credit risk and liquidity risk. The Group's risk management strategy seeks to mitigate potential adverse effects on its financial performance. As part of its strategy, both primary and derivative financial instruments are used to hedge certain risk exposures.

There are clearly defined objectives and principles for managing financial risks established by the Board of Directors, with policies, parameters and procedures covering the specific areas of funding, banking relationships, foreign exchange and interest rate exposures and cash management, together with the investment of surplus cash. The Group's treasury function is responsible for implementing the policies and for providing a centralised service to the Group for funding, foreign exchange and interest rate management and counterparty risk management. It is also responsible for identifying, evaluating and hedging financial risks in close cooperation with the Group's operating companies.

(a) Market Risk: Foreign Exchange Risk

The Group's international base is exposed to foreign exchange risk from its investing, financing and operating activities, particularly in respect of Sterling, Chinese Renminbi, Saudi Arabia Riyal and Canadian Dollars. Foreign exchange risks arise from future commercial transactions and cash flows, and from recognised monetary assets and liabilities that are not denominated in the functional currency of the Group's local operations.

...

(i) Transactional Risk

The exposure to exchange rate movements in significant future commercial transactions and cash flows is hedged by using forward foreign exchange contracts. Certain forward foreign exchange contracts have been designated as hedging instruments of highly probable forecast transactions. Treasury engages with business units to help identify transactional exposures. External hedging activity is then performed by Treasury on behalf of the business units to ensure that transactional risk is managed appropriately and in accordance with Treasury policy. Exposures are also identified and hedged, if necessary, on an ad-hoc basis, such as when a purchase order in a foreign currency is placed. Currency exposures arise where the cash flows are not in the functional currency of the entity. Exposures arising from committed long-term projects beyond a 12-month period are also identified.

...

(ii) Translational Risk

Foreign exchange risk also arises from financial assets and liabilities not denominated in the functional currency of an entity's operations. Forward foreign exchange contracts are used to manage the exposure to changes in foreign exchange rates. Where appropriate, hedge accounting is applied to the forward foreign exchange contracts and the hedged item to remove any accounting mismatch.

Foreign exchange risk also arises from the Group's investments in foreign operations. This has previously been hedged using foreign exchange swaps that have been designated in a net investment hedge to hedge the foreign currency translation risk. The foreign exchange exposure arising from the translation of its net investments in foreign operations into the Group's presentation currency of US Dollars has also previously been managed by designating any borrowings that are not US Dollar denominated as a hedge of the net investment in foreign operations. The foreign exchange exposure primarily arises from Sterling and Canadian Dollar denominated net investments. The accumulated foreign exchange net post-tax gains included in the currency translation reserve in respect of net investment hedges at the beginning and end of the year is $25.0m.

(b) Market Risk: Interest Rate Risk

Variable interest rates on cash at bank, short-term deposits, overdrafts and borrowings expose the Group to cash flow interest rate risk, and fixed interest rates on loans and short-term deposits expose the Group to fair value interest rate risk. The Group's treasury function manages the Group's exposure to interest rate risk and uses interest rate swaps and caps, when considered appropriate.

(c) Credit Risk

The Group's credit risk arises from its cash at bank and in hand, investments, derivative financial instruments, accrued revenue, outstanding trade receivables, other receivables and contract assets.

At the year-end, the Group had credit risk exposure to a wide range of counterparties. Credit risk exposure is continually monitored and no individual exposure is considered to be significant in the context of the ordinary course of the Group's activities whether through exposure to individual customers, specific industry sectors and/or regions.

(i) Credit Risk: Total Cash and Bank

Hunting PLC's Board approves the treasury policies that determine which counterparties can be used. Due diligence is carried out prior to the authorisation of a bank or financial institution as an approved counterparty. For banks and financial institutions, exposure limits are set for each approved counterparty, as well as the types of transactions that may be entered into. Approved institutions that the Group's treasury function can invest surplus cash with must all have a minimum A2, P2 or F2 short-term rating from Standard & Poor's, Moody's or Fitch rating agencies, respectively.

At the year-end, cash at bank and in hand totalled $45.5m (2022 – $29.4m), with $31.2m (2022 – $19.7m) deposited with banks with Fitch short-term ratings of F1 to F1+. Of the remaining $14.3m (2022 – $9.7m), $11.6m (2022 – $6.2m) was held with two financial institutions within mainland China which, given the Group's operations in this jurisdiction, were deemed necessary. Despite not having formal credit ratings from any of the ratings agencies mentioned above, an internal assessment determined that the banks' credit profiles were appropriate for the amounts held on deposit. There are no formal restrictions on this cash as such; however, prior approval would be required from various state authorities in China before any cash could be paid offshore. This cash balance could be used by the Group to service intercompany loans, which total $1.7m at the year-end. In order for the Group to access the balance of $9.9m, a dividend would need to be declared.

During the year, the treasury function invested surplus cash in-line with its cash management and investment policies in short-term deposits. The use of these deposits enables the treasury function to diversify its counterparty concentration risk by depositing funds with various financial institutions and improve the yields on a portion of its surplus cash.

...

The credit risk of foreign exchange contracts is calculated before the contract is acquired and compared to the credit risk limit set for each counterparty. Credit risk is calculated as a fixed percentage of the nominal value of the instrument.

(ii) Credit Risk: Receivables

The Group makes sales to a large number of different customers; however a significant proportion of sales are made to service companies in the oil and gas sector. The majority of the Group's customers are based in North America. On a quarterly basis, the Group's entities submit information to the head office on individual receivables balances greater than $0.2m, on individual receivable balances that are both greater than $32,500 and 60 days overdue, and on quarterly average receivables balances. At the year-end, trade receivables of $179.4m (2022 – $158.9m) comprised individual balances greater than $0.2m, with no individual customer balance representing more than 9% (2022 – 7%) of the year-end receivables balance of $204.7m (2022 – $183.1m).

The risk of customer default for outstanding trade receivables, accrued revenue and contract assets is continuously monitored. Credit account limits are set locally by management and are primarily based on the credit quality of the customer taking into account past experience through trading relationships and the customer's financial position. The probability that a customer would default has remained broadly flat in 2023. The Group used Credit Benchmark software to monitor the creditworthiness and changing credit profiles of its customers. Credit Benchmark uses a similar ratings framework to the main credit ratings agencies for classifying the credit quality of a business. However, Credit Benchmark ratings are based on contributed risk views from leading global financial institutions, including 15 Global Systemically Important Banks domiciled in the US, Continental Europe, Switzerland, the UK, Japan, Canada, Australia and South Africa. The contributions are anonymised, aggregated and published twice monthly in the form of Credit Consensus Ratings and Aggregate Analytics.

Although in most cases the Credit Benchmark consensus rating of a business is based on a number of contributing views, there are instances where there is only a single source on which the rating is based. During 2023, 38% of sales, which is more than $347m (2022 – 37%/$263m) of the Group's revenue, were made to customers with a Credit Benchmark investment-grade rating of bbb or higher, as shown in the table below. This includes customers with a single-source rating, whereby the rating is based on only a single source rather than a consensus rating which has been derived from a number of contributing views.

...

To reduce credit risk exposure from outstanding receivables, the Group has taken out credit insurance with an external insurer, subject to certain conditions. Details of the impairment of trade and other receivables can be found in note 18.

5.2 Quantitative disclosures

For each type of risk arising from financial instruments (see section 5 above), entities are required to disclose summary quantitative data about their exposure to that risk at the reporting date. It should be based on the information provided internally to key management personnel of the entity as defined in IAS 24 *Related Party Disclosures* (see Chapter 35 at section 3.1.1.D), for example, the board of directors or chief executive officer, and should include the matters set out in section 5.3 to section 5.5 below. *[IFRS 7.34(a), IFRS 7.34(b)]*.

This 'management view' approach was adopted by the IASB because it was considered to: *[IFRS 7.BC47]*

- Provide a useful insight into how the entity views and manages risk
- Result in information that has more predictive value than information based on assumptions and methods that management does not use, for instance, in considering the entity's ability to react to adverse situations
- Be more effective in adapting to changes in risk measurement and management techniques and developments in the external environment
- Have practical advantages for preparers of financial statements because it allows them to use the data they use in managing risk

  And
- Be consistent with the approach used in segment reporting (see Chapter 32)

When several methods are used to manage a risk exposure, the information disclosed should use the method(s) that provide the most relevant and reliable information. It is noted, in this context, that IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* discusses relevance and reliability (see Chapter 3 at section 4.3). *[IFRS 7.B7]*.

Where the quantitative data disclosed as at the reporting date are unrepresentative of an entity's exposure to risk during the period, further information that is representative should be provided. *[IFRS 7.35]*. For example, if an entity typically has a large exposure to a particular currency, but at year-end unwinds the position, the entity might disclose a graph that shows the exposure at various times during the period, or it might disclose the highest, lowest, and average exposures. *[IFRS 7.IG20]*.

In developing IFRS 7, the IASB considered whether quantitative information about average risk exposures during the period should be given in all cases. However, they considered that such information is more informative only if the risk exposure at the reporting date is not representative of the exposure during the period. They also considered it would be onerous to prepare. Consequently, they decided that IFRS 7 would only require disclosure by exception, i.e., when the position at the reporting date was unrepresentative of the exposure during the reporting period. *[IFRS 7.BC48]*.

5.3 Credit risk

There are extensive disclosure requirements for financial instruments that are subject to the IFRS 9 impairment requirements (e.g., debt instruments measured at amortised cost or fair value through other comprehensive income). Those requirements are also supplemented by some detailed implementation guidance. The requirements of IFRS 9 relating to the measurement of impairments are dealt with in Chapter 47.

5.3.1 Scope and objectives

The objective of these disclosures is to enable users to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows. To achieve this objective, the disclosures should provide: *[IFRS 7.35B]*

- Information about the entity's credit risk management practices and how they relate to the recognition and measurement of expected credit losses, including the methods, assumptions and information used to measure those losses (see section 5.3.2 below)
- Quantitative and qualitative information that allows users of financial statements to evaluate the amounts in the financial statements arising from expected credit losses, including changes in the amount of those losses and the reasons for those changes (see section 5.3.3 below)

  And
- Information about the entity's credit risk exposure, i.e., the credit risk inherent in its financial assets and commitments to extend credit, including significant credit risk concentrations (see section 5.3.4 below)

An entity will need to determine how much detail to disclose, how much emphasis to place on different aspects of the disclosure requirements, the appropriate level of aggregation or disaggregation and whether additional explanations are necessary to evaluate the quantitative information disclosed. *[IFRS 7.35D]*. If the disclosures provided are insufficient to meet the objectives above, additional information that is necessary to meet those objectives must be disclosed. *[IFRS 7.35E]*.

To avoid duplication, IFRS 7 allows this information to be incorporated by cross-reference from the financial statements to some other statement that is available to users of the financial statements on the same terms and at the same time, such as a management commentary or risk report. Without the information incorporated by cross-reference, the financial statements are incomplete. *[IFRS 7.35C]*.

A number of the disclosures about credit risk are required to be given by class (see section 3.3 above). In determining these classes, financial instruments in the same class should reflect shared economic characteristics with respect to credit risk. A lender, for example, might determine that residential mortgages, unsecured consumer loans and commercial loans each have different economic characteristics. *[IFRS 7.IG21]*.

Unless otherwise stated, the disclosure requirements set out in section 5.3.2 to section 5.3.4 below are applicable only to financial instruments to which the impairment requirements in IFRS 9 are applied. *[IFRS 7.35A]*.

5.3.2 Credit risk management practices

An entity should explain its credit risk management practices and how they relate to the recognition and measurement of expected credit losses. To meet this objective, it should disclose information that enables users to understand and evaluate: *[IFRS 7.35F]*

- How it has determined whether the credit risk of financial instruments has increased significantly since initial recognition, including if and how:
  - Financial instruments are considered to have low credit risk, including the classes of financial instruments to which it applies

    And
  - The presumption that there have been significant increases in credit risk since initial recognition when financial assets are more than 30 days past due has been rebutted
- Its definitions of default, including the reasons for selecting those definitions. This may include: *[IFRS 7.B8A]*
  - The qualitative and quantitative factors considered in defining default
  - Whether different definitions have been applied to different types of financial instruments

    And
  - Assumptions about the cure rate, i.e., the number of financial assets that return to a performing status, after a default has occurred on the financial asset
- How the instruments were grouped if expected credit losses were measured on a collective basis
- How it has determined that financial assets are credit-impaired
- Its write-off policy, including the indicators that there is no reasonable expectation of recovery and information about the policy for financial assets that are written off but are still subject to enforcement activity

  An asset (or portion thereof) should be written off only if there is no reasonable expectation of recovery *[IFRS 9.5.4.4]*

  And
- How the requirements for the modification of contractual cash flows of financial instruments have been applied, including how the entity:
  - Determines whether the credit risk on a financial asset that has been modified while the loss allowance was measured at an amount equal to lifetime expected credit losses has improved to the extent that the loss allowance reverts to being measured at an amount equal to 12-month expected credit losses

    And
  - Monitors the extent to which the loss allowance on financial assets meeting the criteria in the previous bullet is subsequently remeasured at an amount equal to lifetime expected credit losses

    Quantitative information that will assist users in understanding the subsequent increase in credit risk of modified financial assets may include information about modified financial assets meeting the criteria above for which the loss allowance has reverted to being measured at an amount equal to lifetime expected credit losses, i.e., a deterioration rate. *[IFRS 7.B8B]*. Including qualitative information can also be a useful way of meeting this disclosure requirement.

An entity should also explain the inputs, assumptions and estimation techniques used to apply the impairment requirements of IFRS 9. For this purpose, it should disclose: *[IFRS 7.35G]*

- The basis of inputs and assumptions and the estimation techniques used to:
  - Measure 12-month and lifetime expected credit losses
  - Determine whether the credit risk of financial instruments has increased significantly since initial recognition

    And
  - Determine whether a financial asset is credit impaired

  This may include information obtained from internal historical information or rating reports and assumptions about the expected life of financial instruments and the timing of the sale of collateral *[IFRS 7.B8C]* or information about the estimated maximum period considered when determining estimated credit losses in respect of revolving credit facilities.[8]
- How forward-looking information has been incorporated into the determination of expected credit losses, including the use of macroeconomic information

  Where relevant, this will include information about the use of multiple economic scenarios in determining those expected credit losses (see Chapter 47, particularly Chapter 47 at section 5.6).

  In rare circumstances, there may be relevant forward-looking information that cannot be incorporated into the determination of significant increases in credit risk or the measurement of expected credit losses because of a lack of reasonable and supportable information. In such cases, disclosures should be made that are consistent with the objective in IFRS 7, i.e., to enable users of the financial statements to understand the credit risk to which the entity is exposed.[9]

  And
- Changes in estimation techniques or significant assumptions made during the reporting period and the reasons for those changes

5.3.2.A Application of overlays and post-model adjustments

Banks calculate expected credit losses under IFRS 9 using models which rely on the use of data and the application of judgement. Overlays or post-model adjustments are terms often used to refer to adjustments made to the model output to address shortcomings in the models or limitations on the data. Determining such adjustments requires additional use of judgement.

As a result of macroeconomic events such as the global coronavirus pandemic, many banks have applied such adjustments in calculating expected credit loss due to, for example, models not being calibrated for the severe economic conditions and market uncertainty the banks were facing. These adjustments have often been material and most regulators are keen for banks to provide clear and transparent disclosures about them.

Although neither IAS 1 (or, when applied, IFRS 18) nor IFRS 7 explicitly mention model adjustments as part of the disclosure requirements, this does not mean that disclosures in relation to model adjustments should be omitted. As noted in section 5.3.2 above, IFRS 7.35G contains various disclosure requirements in relation to the significant assumptions and estimates used to calculate the expected credit loss which are just as relevant to post-model adjustments as they are to the underlying models, whether made in response to the coronavirus pandemic or to other situations. In addition, as discussed in Chapter 3 at section 5.2.1, IAS 1.125 (or, when IFRS 18 is applied, IAS 8(2027).31A) requires the disclosure of information about certain assumptions concerning the future and other major sources of estimation uncertainty at the end of the reporting period. *[IAS 1.125, IAS 8(2027).31A].*

8 Transition Resource Group for Impairment of Financial Instruments, *Meeting Summary*: 11 December 2015, IASB, para. 46. Available on the IFRS Foundation's website

9 Transition Resource Group for Impairment of Financial Instruments, *Meeting Summary*: 16 September 2015, IASB, para. 48. Available on the IFRS Foundation's website.

The following extract from the financial statements of Lloyds Banking Group plc shows how an entity might present some of this information.

Practical example 5-2: Lloyds Banking Group plc (2023) **United Kingdom**

Annual Report and Accounts 2023 [extract]

Financial statements [extract]

Notes to the consolidated financial statements [extract]

Note 24: Allowance for expected credit losses [extract]

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Individual assessments and application of judgement in adjustments to modelled ECL

The table below analyses total ECL allowances by portfolio, separately identifying the amounts that have been modelled, those that have been individually assessed and those arising through the application of judgemental adjustments.

			Judgements due to:		
	Modelled ECL £m	Individually assessed £m	Inflationary and interest rate risk £m	Other[1] £m	Total ECL £m
At 31 December 2023					
UK mortgages	**991**	**–**	**61**	**63**	**1,115**
Credit cards	**703**	**–**	**92**	**15**	**810**
Other Retail	**866**	**–**	**33**	**46**	**945**
Commercial Banking	**1,124**	**340**	**–**	**(282)**	**1,182**
Other	**32**	**–**	**–**	**–**	**32**
Total	**3,716**	**340**	**186**	**(158)**	**4,084**
At 31 December 2022					
UK mortgages	946	–	49	214	1,209
Credit cards	698	–	93	(28)	763
Other Retail	903	–	53	60	1,016
Commercial Banking	972	1,008	–	(111)	1,869
Other	46	–	–	–	46
Total	3,565	1,008	195	135	4,903

1 2022 includes £1 million which was previously reported within judgements due to COVID-19.

Individual assessed ECL

Stage 3 ECL in Commercial Banking is largely assessed on an individual basis by the Business Support Unit using bespoke assessment of loss for each specific client based on potential recovery strategies. While these assessments are based on the Group's latest economic view, the use of Group-wide multiple economic scenarios and weightings is not considered appropriate for these cases due to their individual characteristics. In place of this, a range of case-specific outcomes are considered with any alternative better or worse outcomes that carry a 25 per cent likelihood taken into account in establishing a probability-weighted ECL. At 31 December 2023, individually assessed provisions for Commercial Banking were £340 million (2022: £1,008 million) which reflected a range of £291 million to £413 million (2022: £908 million to £1,140 million), based on the range of alternative outcomes considered.

Application of judgement in adjustments to modelled ECL

Impairment models fall within the Group's model risk framework with model monitoring, periodic validation and back testing performed on model components, such as probability of default. Limitations in the Group's impairment models or data inputs may be identified through the ongoing assessment and validation of the output of the models. In these circumstances, management applies appropriate judgemental adjustments to the ECL to ensure that the overall provision adequately reflects all material risks. These adjustments are determined by considering the particular attributes of exposures which have not been adequately captured by the impairment models and range from changes to model inputs and parameters, at account level, through to more qualitative post-model adjustments. Post-model adjustments are not typically calculated under each distinct economic scenario used to generate ECL, but on final modelled ECL. All adjustments are reviewed quarterly and are subject to internal review and challenge, including by the Audit Committee, to ensure that amounts are appropriately calculated and specific release criteria is identified.

During 2022 the intensifying inflationary pressures, alongside rising interest rates within the Group's outlook created further risks not deemed to be fully captured by ECL models. These pressures played out in 2023 with households experiencing increased interest rates and living costs. These risks, whilst still present, are beginning to subside with inflation now reducing and interest rates now believed to have peaked. As a result, the judgements held in respect of inflationary and interest rate risks are at a slightly reduced level of £186 million (2022: £195 million). Other judgements continue to be applied for broader data and model limitations, both increasing and decreasing ECL. These include incremental risks associated with a material devaluation in commercial real estate prices present since 2022. Given ECL models only capture future price movements, and not the suppressed level, there is a risk that further losses are yet to emerge as well as greater risk on specific sector valuations. At 31 December 2023 judgemental adjustments resulted in net additional ECL allowances totalling £28 million (2022: £330 million).

Judgements due to inflationary and interest rate risk

UK mortgages: £61 million (2022: £49 million)

There has been only modest evidence of credit deterioration in the UK mortgages portfolio through 2023 despite the high levels of inflation and the rising interest rate environment. Increases in new to arrears and defaults that have emerged are mainly driven by variable rate customers, who have experienced material increases in their monthly payment. Mortgage ECL models use UK Bank Rate as a driver of predicted defaults largely capturing the stretch on customers due to increased payments, and that has contributed materially to the elevated levels of ECL at 31 December 2023. The impact is also partly mitigated by stressed affordability assessments applied at loan origination which means most customers have demonstrated the ability to absorb payment shocks.

However, there remains a potential risk to affordability from continued inflationary pressures combined with higher interest rates, and that this may not be fully captured by the Group's ECL models. The risk remains for customers maturing from low fixed rate deals, the accumulated impact on variable rate product holders, lower levels of real household income and rental cover value. Therefore a judgemental uplift in ECL has been taken in these segments of the mortgages portfolio, either where inflation is expected to present a more material risk, or where segments within the model do not recognise UK Bank Rate as a material driver of predicted defaults.

Credit cards: £92 million (2022: £93 million) and Other Retail: £33 million (2022: £53 million)

The Group's ECL models for credit cards and personal loan portfolios use predictions of wage growth to account for future affordability stress. As elevated inflation erodes nominal wage growth, adjustments have been made to the econometric models to account for real, rather than nominal, income to produce adjusted predicted defaults. These adjustments also include the specific risk to affordability from increased housing costs, not captured by CPI. As these adjustments are made within predicted default models, they are calculated under each economic scenario and impact the staging of assets through increased PDs.

Alongside these portfolio-wide adjustments management has also made an additional uplift to ECL for customers with lower income levels and higher indebtedness deemed most vulnerable to inflationary pressures and interest rate rises. Although this segment of customers has not exhibited any greater deterioration to date, uplifts continue to be applied to recognise that continued inflation and interest rates risks remain.

Other judgements

UK mortgages: £63 million (2022: £214 million)

These adjustments principally comprise:

Increase in time to repossession: £106 million (2022: £118 million)

Due to the Group suspending mortgage litigation activity between late-2014 and mid-2018 due to policy changes for the treatment of arrears, and as collections strategy normalises post COVID-19 pandemic, the Group's experience of possessions data on which our models rely is limited. This reflects an adjustment made to allow for an increase in the time assumed between default and repossession. A number of defaulted accounts, equivalent in scale to the estimated shortfall in possessions experienced, have had their provision coverage judgementally increased to the level of those accounts already in repossession. A further adjustment is made to accounts which have been in default for more than 24 months, with an arrears balance increase in the last six months. These accounts have their probability of possession judgmentally set to an increased level based on observed historical losses incurred on accounts that were of an equivalent status.

Asset recovery values: £nil (2022: £69 million)

The low level of repossession volumes throughout 2020 to 2022 restricted the calibration of Forced Sale Discount (FSD) model parameters which uses the achieved sales price experience over the last 12 months. Over this period management partly incorporated an increasing trend in FSD rates through judgementally extending the observation period. At December 2023 the level of sales volumes observed over the past 12 months has subsequently returned to an adequate level for model calibrations to again be performed removing the need for judgemental adjustment.

Adjustment for specific segments: £23 million (2022: £25 million)

The Group monitors risks across specific segments of its portfolios which may not be fully captured through wider collective models. The judgement for fire safety and cladding uncertainty has been maintained. Though experience remains limited the risk is considered sufficiently material to address through judgement, given that there is evidence of assessed cases having defective cladding, or other fire safety issues.

Adjustment for Stage 2 oversensitivity: £(68) million (2022: £nil)

Management has observed an increasing degree of oversensitivity in the number of recently originated low risk accounts moving to Stage 2 through the PD trigger mechanism. This arises from a blend of factors currently present, with the combination of the Group's current MES assumptions and the uplift approach applied, disproportionately applying greater forward-looking uplifts to recent vintages. Given these accounts have shown no significant movement in observed credit scores and were originated under a similar or more adverse economic outlook, an adjustment has been made pending a model rebuild. Management has judgementally increased the threshold applied to these accounts by one further grade (to what is set out on **page 277**) which results in £6 billion of assets being moved back to Stage 1 which results in a lower 12-month ECL.

Credit cards: £15 million (2022: £(28) million) and Other Retail: £46 million (2022: £60 million)

These adjustments principally comprise:

Lifetime extension on revolving products: Credit cards: £67 million (2022: £82 million) and Other Retail: £10 million (2022: £14 million)

An adjustment is required to extend the lifetime used for Stage 2 exposures on Retail revolving products from a three-year modelled lifetime, which reflected the outcome data available when the ECL models were developed. Incremental defaults beyond year three are calculated through the extrapolation of the default trajectory observed throughout the three years and beyond. The judgement has reduced slightly in the period following refinement to the discounting methodology applied.

Adjustments to loss given defaults (LGDs): Credit cards: £(50) million (2022: £(96) million) and Other Retail: £37 million (2022: £13 million)

A number of adjustments have been made to the loss given default assumptions used within unsecured and motor credit models. For unsecured portfolios, the adjustments reflect the impact of changes in collection debt sale strategy on the Group's LGD models, incorporating up to date customer performance and forward flow debt sale pricing. For motor, the adjustment captures a decline in used car prices.

Commercial Banking: £(282) million (2022: £(111) million)

These adjustments principally comprise:

Corporate insolvency rates: £(292) million (2022: £(35) million)

During 2023, the volume of UK corporate insolvencies continued to exhibit an increasing trend beyond December 2019 levels, revealing a marked misalignment between observed UK corporate insolvencies and the Group's credit performance. This dislocation gives rise to uncertainty over the drivers of observed trends and the appropriateness of the Group's Commercial Banking model response which uses observed UK corporate insolvencies data to anchor future loss estimates to. Given the Group's asset quality remains strong with low new defaults, a negative adjustment is applied by using the long-term average rate. The larger negative adjustment in the period reflects the widening gap between the increasing industry level and the long-term average rate used.

Adjustments to loss given defaults (LGDs): £(105) million (2022: £(105) million)

Following a review on the loss given default approach for commercial exposures, management deems that ECL should be adjusted to mitigate limitations identified in the approach which are causing loss given defaults to be inflated. These include the benefit from amortisation of exposures relative to collateral values at default and a move to an exposure-weighted approach being adopted. These temporary adjustments will be addressed through future model development.

Commercial Real Estate (CRE) price reduction: £67 million (2022: £nil)

Rolling the forecast model forwards into the period has resulted in the material fall in CRE prices seen in late 2022 moving out of the model assumptions used to assess ECL. Given the model uses future changes in the metric as a driver of defaults and loss rates there is a risk that the model benefit that arises does not reflect the residual risk caused by the sustained low level of prices. Management therefore considers it appropriate to judgementally reinstate the CRE price drop within the ECL model assumptions given the materially reduced level in CRE prices could still trigger additional defaults Within this adjustment management has refined the potential impact on loss rates through capturing updated valuations as well as stressing valuations on specific sectors where evidence suggests valuations may lag achievable levels, notably in cases of stressed sale.

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5.3.3 Quantitative and qualitative information about amounts arising from expected credit losses

An entity should explain the changes in the loss allowance and reasons for those changes by presenting a reconciliation of the opening balance to the closing balance. This should be given in a table for each relevant class of financial instruments, showing separately the changes during the period for: *[IFRS 7.35H]*

- The loss allowance measured at an amount equal to 12-month expected credit losses
- The loss allowance measured at an amount equal to lifetime expected credit losses for:
  - Financial instruments for which credit risk has increased significantly since initial recognition but that are not credit-impaired financial assets
  - Financial assets that are credit-impaired at the reporting date (but were not credit-impaired when purchased or originated)

    And
  - Trade receivables, contract assets or lease receivables for which the loss allowance is measured using a simplified approach based on lifetime expected credit losses

  And
- Financial assets (or, potentially, loan commitments or financial guarantee contracts - see Chapter 47 at section 11) that were credit-impaired when purchased or originated

  Additionally, the total amount of undiscounted expected credit losses on initial recognition of any such assets during the reporting period should also be disclosed.

In addition, it may be necessary to provide a narrative explanation of the changes in the loss allowance during the period. This narrative explanation may include an analysis of the reasons for changes in the loss allowance during the period, including: *[IFRS 7.B8D]*

- The portfolio composition
- The volume of financial instruments purchased or originated

  And
- The severity of the expected credit losses

For loan commitments and financial guarantee contracts the loss allowance is recognised as a provision. Information about changes in the loss allowance for financial assets should be shown separately from those for loan commitments and financial guarantee contracts. However, if a financial instrument includes both a loan (i.e., financial asset) and an undrawn loan commitment (i.e., loan commitment) component and the expected credit losses on the loan commitment component cannot be separately identified from those on the financial asset component, the expected credit losses on the loan commitment should be recognised together with the loss allowance for the financial asset. To the extent that the combined expected credit losses exceed the gross carrying amount of the financial asset, the expected credit losses should be recognised as a provision. *[IFRS 7.B8E]*.

An explanation should also be provided of how significant changes in the gross carrying amount of financial instruments during the period contributed to changes in the loss allowance. This information should be provided separately for each class of financial instruments for which loss allowances are analysed (see above). It should also include relevant qualitative and quantitative information. Examples of changes in the gross carrying amount of financial instruments that contribute to changes in the loss allowance may include: *[IFRS 7.35I]*

- Changes because of financial instruments originated or acquired during the reporting period
- The modification of contractual cash flows on financial assets that do not result in a derecognition of those financial assets
- Changes because of financial instruments that were derecognised, including those that were written off during the reporting period

  And
- Changes arising from the measurement of the loss allowance moving from 12-month expected credit losses to lifetime losses (or *vice versa*)

The information disclosed should provide an understanding of the nature and effect of modifications of contractual cash flows on financial assets that have not resulted in derecognition as well as the effect of such modifications on the measurement of expected credit losses. The following information should, therefore, be given: *[IFRS 7.35J]*

- The amortised cost before the modification and the net modification gain or loss recognised for financial assets for which the contractual cash flows have been modified during the reporting period while they had a loss allowance based on lifetime expected credit losses

  And
- The gross carrying amount at the reporting period of financial assets that have been modified since initial recognition at a time when the loss allowance was based on lifetime expected credit losses and for which the loss allowance has changed during the reporting period to an amount equal to 12-month expected credit losses

These requirements apply to all modifications whether they are as a result of credit related or other commercial reasons. However, if an entity has the ability to separately identify different types of modifications and considers that the separate disclosure of these items is relevant to achieving the overall objective of the disclosures in this section, the entity could provide this additional detail as part of the disclosure.[10]

10 Transition Resource Group for Impairment of Financial Instruments, *Meeting Summary*: 22 April 2015, IASB, para. 57(b). Available on the IFRS Foundation's website.

The following Illustration shows how this information might be presented. *[IFRS 7.IG20B]*.

Illustration 5-1: Information about changes in the loss allowance

Mortgage loans - loss allowance	12-month expected credit losses	Lifetime expected credit losses (collectively assessed)	Lifetime expected credit losses (individually assessed)	Credit-impaired financial assets (lifetime expected credit losses)
CU'000				
Loss allowance as at 1 January	**X**	**X**	**X**	**X**
Changes due to financial instruments recognised as at 1 January:				
- Transfer to lifetime expected credit losses	(X)	X	X	-
- Transfer to credit-impaired financial assets	(X)	-	(X)	X
- Transfer to 12-month expected credit losses	X	(X)	(X)	-
- Financial assets that have been derecognised during the period	(X)	(X)	(X)	(X)
New financial assets originated or purchased	X	-	-	-
Write-offs	-	-	(X)	(X)
Changes in models/risk parameters	X	X	X	X
Foreign exchange and other movements	X	X	X	X
Loss allowance as at 31 December	**X**	**X**	**X**	**X**

Significant changes in the gross carrying amount of mortgage loans that contributed to changes in the loss allowance were:

- The acquisition of the ABC prime mortgage portfolio increased the residential mortgage book by x%, with a corresponding increase in the loss allowance measured on a 12-month basis.
- The write off of the CUXX DEF portfolio following the collapse of the local market reduced the loss allowance for financial assets with objective evidence of impairment by CUX.
- The expected increase in unemployment in Region X caused a net increase in financial assets whose loss allowance is equal to lifetime expected credit losses and caused a net increase of CUX in the lifetime expected credit losses allowance.

The significant changes in the gross carrying amount of mortgage loans are further explained below:

Mortgage loans - gross carrying amount	12-month expected credit losses	Lifetime expected credit losses (collectively assessed)	Lifetime expected credit losses (individually assessed)	Credit impaired financial assets (lifetime expected credit losses)
CU'000				
Gross carrying amount as at 1 January	**X**	**X**	**X**	**X**
Individual financial assets transferred to lifetime expected credit losses	(X)	-	X	-
Individual financial assets transferred to credit-impaired financial assets	(X)	-	(X)	X
Individual financial assets transferred from credit-impaired financial assets	X	-	X	(X)
Financial assets assessed on collective basis	(X)	X	-	-
New financial assets originated or purchased	X	-	-	-
Write-offs	-	-	(X)	(X)
Financial assets that have been derecognised	(X)	(X)	(X)	(X)
Changes due to modifications that did not result in derecognition	(X)	-	(X)	(X)
Other changes	X	X	X	X
Gross carrying amount as at 31 December	**X**	**X**	**X**	**X**

Where the loss allowance for trade receivables or lease receivables is measured using a simplified approach based on lifetime expected credit losses, the information about modifications need be given only if those financial assets are modified while more than 30 days past due. *[IFRS 7.35A(a)]*.

To provide an understanding of the effect of collateral and other credit enhancements on the amounts arising from expected credit losses, the following must be disclosed by class of financial instrument: *[IFRS 7.35K]*

- The amount that best represents the maximum exposure to credit risk at the end of the reporting period without taking account of any collateral held or other credit enhancements (e.g., netting agreements that do not qualify for offset in accordance with IAS 32)
- A narrative description of collateral held as security and other credit enhancements, including:
  - A description of the nature and quality of the collateral held
  - An explanation of any significant changes in the quality of that collateral or credit enhancements as a result of deterioration or changes in the entity's collateral policies during the reporting period

    And
  - Information about financial instruments for which a loss allowance has not been recognised because of the collateral

  This might include information about: *[IFRS 7.B8G]*
  - The main types of collateral held as security and other credit enhancements, examples of the latter being guarantees, credit derivatives and netting agreements that do not qualify for offset in accordance with IAS 32
  - The volume of collateral held and other credit enhancements and its significance in terms of the loss allowance
  - The policies and processes for valuing and managing collateral and other credit enhancements
  - The main types of counterparties to collateral and other credit enhancements and their creditworthiness

    And
  - Information about risk concentrations within the collateral and other credit enhancements

  And
- Quantitative information about the collateral held as security and other credit enhancements, e.g., quantification of the extent to which collateral and other credit enhancements mitigate credit risk, on financial assets that are credit-impaired at the reporting date

Disclosure of information about the fair value of collateral and other credit enhancements is not required, nor is a quantification of the exact value of the collateral included in the calculation of expected credit losses (i.e., the loss given default). *[IFRS 7.B8F]*. Furthermore, these requirements do not apply to lease receivables. *[IFRS 7.35A(b)]*.

For a financial asset, the maximum exposure to credit risk is typically the gross carrying amount, net of any amounts offset in accordance with IAS 32 and any impairment losses recognised in accordance with IFRS 9. *[IFRS 7.B9]*. Activities that give rise to credit risk and the associated maximum exposure to credit risk include but are not limited to: *[IFRS 7.B10]*

- Granting loans to customers and placing deposits with other entities

  In these cases, the maximum exposure to credit risk is the carrying amount of the related financial assets.
- Entering into derivative contracts, e.g., foreign exchange contracts, interest rate swaps and purchased credit derivatives

  When the resulting asset is measured at fair value, the maximum exposure to credit risk at the reporting date will equal the carrying amount.
- Granting financial guarantees

  In this case, the maximum exposure to credit risk is the maximum amount the entity could have to pay if the guarantee is called on, which may be significantly greater than the amount recognised as a liability.

  And
- Making a loan commitment that is irrevocable over the life of the facility or is revocable only in response to a material adverse change

  If the issuer cannot settle the loan commitment net in cash or another financial instrument, the maximum credit exposure is the full amount of the commitment. This is because it is uncertain whether the amount of any undrawn portion may be drawn upon in the future. This may be significantly greater than the amount recognised as a liability.

The contractual amount outstanding on financial assets that were written off during the reporting period and which are still subject to enforcement activity must be disclosed. *[IFRS 7.35L]*.

5.3.4 Credit risk exposure

Users should be able to assess an entity's credit risk exposure and understand its significant credit risk concentrations. Therefore, an entity should disclose, by 'credit risk rating grades' (see below), the gross carrying amount of financial assets and the exposure to credit risk on loan commitments and financial guarantee contracts. This information should be provided separately for financial instruments: *[IFRS 7.35M]*

- For which the loss allowance is measured at an amount equal to 12-month expected credit losses
- For which the loss allowance is measured at an amount equal to lifetime expected credit losses and that are:
  - Financial instruments for which credit risk has increased significantly since initial recognition but are not credit-impaired financial assets
  - Financial assets that are credit-impaired at the reporting date (but were not credit-impaired when purchased or originated).

    And
  - Trade receivables, contract assets or lease receivables for which the loss allowances are measured using a simplified approach based on lifetime expected credit losses

    Information for these assets may be based on a provision matrix. *[IFRS 7.35N]*.

  And
- That are financial assets (or, potentially, loan commitments or financial guarantee contracts - see Chapter 47 at section 11) that were credit-impaired when purchased or originated

These disclosures should distinguish between financial instruments for which the loss allowance is equal to 12-month or lifetime expected credit losses even where the maturity of a financial instrument is twelve months or less in spite of the fact that the loss allowance should be the same under either approach.[11]

11 Transition Resource Group for Impairment of Financial Instruments, *Meeting Summary*: 11 December 2015, IASB, para. 64. Available on the IFRS Foundation's website.

The following Illustrations show how this information might be presented. *[IFRS 7.IG20C, IFRS 7.IG20D]*.

Illustration 5-2: Information about credit risk exposures and significant credit risk concentrations

Consumer loan credit risk exposure by internal rating grades

20X1	Consumer-credit card		Consumer-automotive	
CU'000	Gross carrying amount		Gross carrying amount	
	Lifetime	12-month	Lifetime	12-month
Internal Grade 1-2	X	X	X	X
Internal Grade 3-4	X	X	X	X
Internal Grade 5-6	X	X	X	X
Internal Grade 7	X	X	X	X
Total	**X**	**X**	**X**	**X**

Corporate loan credit risk profile by external rating grades

20X1	Corporate-equipment		Corporate-construction	
CU'000	Gross carrying amount		Gross carrying amount	
	Lifetime	12-month	Lifetime	12-month
AAA-AA	X	X	X	X
A	X	X	X	X
BBB-BB	X	X	X	X
B	X	X	X	X
CCC-CC	X	X	X	X
C	X	X	X	X
D	X	X	X	X
Total	**X**	**X**	**X**	**X**

Corporate loan risk profile by probability of default

20X1	Corporate-unsecured		Corporate-secured	
CU'000	Gross carrying amount		Gross carrying amount	
	Lifetime	12-month	Lifetime	12-month
0.00-0.10	X	X	X	X
0.11-0.40	X	X	X	X
0.41-1.00	X	X	X	X
1.01-3.00	X	X	X	X
3.01-6.00	X	X	X	X
6.01-11.00	X	X	X	X
11.01-17.00	X	X	X	X
17.01-25.00	X	X	X	X
25.01-50.00	X	X	X	X
50.00+	X	X	X	X
Total	**X**	**X**	**X**	**X**

Illustration 5-3: Information about credit risk exposures using a provision matrix

The reporting entity manufactures cars and provides financing to both dealers and end customers. It discloses its dealer financing and customer financing as separate classes of financial instruments and applies the simplified approach to its trade receivables so that the loss allowance is always measured at an amount equal to lifetime expected credit losses. The following table illustrates the use of a provision matrix as a risk profile disclosure under the simplified approach: *[IFRS 7.IG20D]*

20X1	Trade receivables days past due				
CU'000	Current	More than 30 days	More than 60 days	More than 90 days	Total
Dealer financing					
Expected credit loss rate	0.10%	2%	5%	13%	
Estimated total gross carrying amount at default	CU20,777	CU1,416	CU673	CU235	CU23,101
Lifetime expected credit losses - dealer financing	CU21	CU28	CU34	CU31	CU114
Customer financing					
Expected credit loss rate	0.20%	3%	8%	15%	
Estimated total gross carrying amount at default	CU19,222	CU2,010	CU301	CU154	CU21,687
Lifetime expected credit losses - customer financing	CU38	CU60	CU24	CU23	CU145

Credit risk rating grades are defined as ratings of credit risk based on the risk of a default occurring on the financial instrument. *[IFRS 7 Appendix A]*. The number of credit risk rating grades used to disclose the information above should be consistent with the number that the entity reports to key management personnel for credit risk management purposes. If past due information is the only borrower-specific information available and past due information is used to assess whether credit risk has increased significantly since initial recognition, an analysis by past due status should be provided for that class of financial assets. *[IFRS 7.B8I]*.

When expected credit losses are measured on a collective basis, it may not be possible to allocate the gross carrying amount of individual financial assets or the exposure to credit risk on loan commitments and financial guarantee contracts to the credit risk rating grades for which lifetime expected credit losses are recognised. In that case, the disclosure requirement above should be applied to those financial instruments that can be directly allocated to a credit risk rating grade and separate disclosure should be given of the gross carrying amount of financial instruments for which lifetime expected credit losses have been measured on a collective basis. *[IFRS 7.B8J]*.

A concentration of credit risk exists when a number of counterparties are located in a geographical region or are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. Information should be provided to enable users to understand whether there are groups or portfolios of financial instruments with particular features that could affect a large portion of that group of financial instruments, such as concentration to particular risks. This could include, for example, loan-to-value groupings, geographical, industry or issuer-type concentrations. *[IFRS 7.B8H]*.

For financial instruments within the scope of IFRS 7 to which the impairment requirements in IFRS 9 are *not* applied, disclosure should be given by class of instrument of the amount that best represents the entity's maximum exposure to credit risk at the reporting date (see section 5.3.3 above). The amount disclosed should not take account of any collateral held or other credit enhancements (e.g., netting agreements that do not qualify for offset in accordance with IAS 32). This disclosure is not required for financial instruments whose carrying amount best represents this amount, *[IFRS 7.36(a)]*, but will be required, for example, for written credit default swaps measured at fair value through profit or loss.

Entities should also provide, by class of financial instrument to which the impairment requirements in IFRS 9 are not applied, a description of collateral held as security and of other credit enhancements, and their financial effect (e.g., a quantification of the extent to which collateral and other credit enhancements mitigate credit risk) in respect of the amount that best represents the maximum exposure to credit risk. This applies irrespective of whether the maximum exposure to credit risk is disclosed separately or is represented by the carrying amount of a financial instrument. *[IFRS 7.36(b)]*. The requirement may be met by disclosing: *[IFRS 7.IG22]*

- The policies and processes for valuing and managing collateral and other credit enhancements obtained
- A description of the main types of collateral and other credit enhancements (examples of the latter being guarantees and credit derivatives, as well as netting agreements that do not qualify for offset in accordance with IAS 32)
- The main types of counterparties to collateral and other credit enhancements and their creditworthiness

  And
- Information about risk concentrations within the collateral or other credit enhancements

Whilst the standard suggests this information should, or at least could, involve disclosure of quantitative information, the implementation guidance implies more discursive disclosures might suffice in some cases. Therefore, entities will need to make a judgement based on their own specific circumstances.

5.3.5 Collateral and other credit enhancements obtained

When an entity obtains financial or non-financial assets during the period by taking possession of collateral it holds as security, or calling on other credit enhancements such as guarantees, and these assets meet the recognition criteria in other standards, it should disclose for such assets held at the reporting date: *[IFRS 7.38]*

- The nature and carrying amount of the assets

  And
- When the assets are not readily convertible into cash, its policies for disposing of such assets or for using them in its operations

This disclosure is intended to provide information about the frequency of such activities and the entity's ability to obtain and realise the value of the collateral. *[IFRS 7.BC56]*.

5.3.6 Credit risk: illustrative disclosures

The following Illustration shows what some of the disclosures about credit risk and loss allowances for one class of a bank's lending might look like. In preparing this Illustration the following approach has been taken:

- Although not explicitly required by IFRS 7, in order to provide relevant qualitative and quantitative information (see section 5.3.3 above) and in line with the examples to the standard:
  - A reconciliation of movements in the gross carrying amounts in a tabular format has been provided

    And
  - Loans that are assessed on a specific basis and those assessed collectively have been shown separately
- IFRS 7 does not require disclosure of the proportion of stage 2 loans that are 30 days past due, but this is regarded as useful information by users and has therefore been included
- In order to avoid excessive detail only the net effect of using multiple scenarios has been provided rather than providing details of the scenarios and their weightings

  And
- In practice the various parameters used are unlikely to be independent and, in line with the EDTF's recommendations (see section 8.1 below), sensitivity to only one parameter has been disclosed

Illustration 5-4: Certain disclosures of impairment allowances by a bank for one class of lending

Small business lending

The table below shows the credit quality and the maximum exposure to credit risk based on the Bank's internal credit rating system and year-end stage classification. Except for Purchased or Originated Credit Impaired (POCI) loans, the amounts presented are gross of impairment allowances. The table analyses separately those loans which are assessed and measured individually and those which are assessed and measured on a collective basis:

In CU million							20X1	20X0
Internal rating grade	**Stage 1 Individual**	**Stage 1 Collective**	**Stage 2 Individual**	**Stage 2 Collective**	**Stage 3**	**POCI**	**Total**	**Total**
Performing								
High grade	1,168	832	-	-	-	-	2,000	2,358
Standard grade	728	340	299	358	-	-	1,725	1,886
Sub-standard grade	-	-	213	321	-	23	557	180
Low grade	-	-	75	194	-	-	269	120
Non-performing								
Individually impaired	-	-	-	-	205	31	236	208
Total	**1,896**	**1,172**	**587**	**873**	**205**	**54**	**4,787**	**4,752**

The following is a reconciliation of the gross carrying amounts at the beginning and end of year:

In CU million	Stage 1 Individual	Stage 1 Collective	Stage 2 Individual	Stage 2 Collective	Stage 3	POCI	Total
Gross carrying amount as at 1/1/20X1	**1,871**	**1,129**	**626**	**938**	**188**	**-**	**4,752**
Assets originated/purchased	167	163	-	-	-	56	386
Assets de-recognised or repaid	(137)	(125)	(59)	(81)	(35)	(4)	(441)
Transfers to Stage 1	16	8	(16)	(8)	-	-	-
Transfers to Stage 2	(48)	(19)	62	19	(14)	-	-
Transfers to Stage 3	(5)	(4)	(36)	(12)	57	-	-
Modifications to contractual cash flows	-	-	-	-	(9)	-	(9)
Change in interest charged but not received	21	12	4	13	27	-	77
Amounts written off	-	-	-	-	(12)	-	(12)
Foreign exchange revaluation	11	8	6	4	3	2	34
At 31/12/20X1	**1,896**	**1,172**	**587**	**873**	**205**	**54**	**4,787**

The following is a reconciliation of the ECL allowances as at the beginning and end of the year. The effect on ECLs of transfers between stages has been calculated based on the allowances recorded at the date of transfer:

In CU million	Stage 1 Individual	Stage 1 Collective	Stage 2 Individual	Stage 2 Collective	Stage 3	POCI	Total
ECL allowances as at 1/1/20X1	**48**	**41**	**36**	**47**	**79**	**-**	**251**
Assets originated/purchased	5	15	-	-	-	-	20
Assets de-recognised or repaid	(4)	(12)	(5)	(3)	(4)	-	(28)
Transfers to Stage 1	1	-	(2)	(1)	-	-	(2)
Transfers to Stage 2	(4)	(1)	21	5	-	-	21
Transfers to Stage 3	(1)	(1)	(10)	(4)	20	-	4
Unwind of discount	9	10	5	6	13	-	43
Modifications to contractual cash flows	-	-	-	-	(6)	-	(6)
Changes to models and inputs used for ECL calculations	7	10	6	5	18	3	49
Amounts written off	-	-	-	-	(12)	-	(12)
Foreign exchange	2	2	1	1	1	-	7
At 31/12/20X1	**63**	**64**	**52**	**56**	**109**	**3**	**347**

Of the CU587m of loans classified as stage 2 on an individual basis, CU37m (1 January: CU33m) of loans and CU17m (1 January: CU16m) of ECLs are more than 30 days past due.

The credit risk for the bank's small business customers is mostly affected by factors specific to individual borrowers, but, given the available information, the ECLs for the majority of the loans are measured on a collective basis. The key inputs in the ECL model, apart from the bank's own credit risk appraisal process, are assumptions about changes in Gross Domestic Product (GDP) and future interest rates. As at 1 January 20X1, the base scenario assumed that GDP will increase by 2.6% in 20X1 and 2.0% in 20X2, with the rate of increase declining over the next four years to 1.5%. GDP grew during 20X1 by only 2.0% and is now forecast to grow by only 1.3% in 20X2, increasing to 1.5% over the next four years. The base rate of interest assumed in the base scenario as at 1 January 20X1 was 1.2% for 20X1 and 1.4% for 20X2, increasing to 2.2% over the next four years. The average rate for 20X1 was 1.4% and the forecast for 20X2 is now 1.5%, increasing to 2.3% over the next four years.

The allowance was calculated using, in addition to the base scenario, an upside scenario and two downside scenarios, all weighted to reflect their likelihood of occurrence. The allowance as at 31 December 20X1, based upon the bank's base case scenario, is CU312.5m. The effect of applying multiple economic scenarios is to increase the allowance by CU34.5m (11%). (As at 1 January the equivalents were: CU230m, CU40m and 14.8%).

Based upon past experience, reducing the growth in GDP over the next three years by 1% (keeping interest rates constant) would increase the ECLs by approximately CU14m (1 January: CU18m).

The largest contribution to the increase in ECLs of the portfolio during the year was the update to inputs to models to reflect the deterioration in economic conditions. However, the result of changes in the base scenario has been partly offset by a small reduction in the effect of using multiple economic scenarios.

The following extract from the financial statements of VOLKSWAGEN AKTIENGESELLSCHAFT shows the type of disclosure addressing credit risk that can be seen in practice.

Practical example 5-3: VOLKSWAGEN AKTIENGESELLSCHAFT (2023) Germany

Annual Report 2023 [extract]
5 Consolidated Financial Statements [extract]
Notes [extract]
Other disclosures [extract]
36. Financial risk management and financial instruments [extract]

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Loss allowance

The Volkswagen Group consistently uses the expected credit loss model of IFRS 9 for all financial assets and other risk exposures.

The expected credit loss model under IFRS 9 takes in both loss allowances for financial assets for which there are no objective indications of impairment and loss allowances for financial assets that are already impaired. For the calculation of impairment losses, IFRS 9 distinguishes between the general approach and the simplified approach.

Under the general approach, financial assets are allocated to one of three stages, plus an additional stage for financial assets that are already impaired when acquired (stage 4). Stage 1 comprises financial assets that are recognized for the first time or for which the probability of default has not increased significantly. The expected credit losses for the next twelve months are calculated at this stage. Stage 2 comprises financial assets with a significantly increased probability of default, while financial assets with objective indications of default are allocated to stage 3. The lifetime expected credit losses are calculated at these stages. Stage 4 financial assets, which are already impaired when acquired, are subsequently measured by recognizing a loss allowance on the basis of the accumulated lifetime expected losses. Financial assets classified as impaired on acquisition remain in this category until they are derecognized.

The Volkswagen Group applies the simplified approach to trade receivables and contract assets with a significant financing component in accordance with IFRS 15. The same applies to receivables under operating or finance leases accounted for under IFRS 16. Under the simplified approach, the expected losses are consistently determined for the entire life of the asset.

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CHANGES IN LOSS ALLOWANCE FOR FINANCIAL ASSETS MEASURED AT AMORTIZED COST

€ million	Stage 1	Stage 2	Stage 3	Simplified approach	Stage 4	Total
Carrying amount at Jan. 1, 2023	**904**	**740**	**1,134**	**519**	**26**	**3,323**
Foreign exchange differences	–15	–2	12	–1	2	–5
Changes in consolidated group	0	–	–	22	–	22
Newly extended/purchased financial assets (additions)	688	–	–	242	6	936
Other changes within a stage	–189	–174	153	8	11	–191
Transfers to						
Stage 1	34	–99	–19	–	–	–85
Stage 2	–118	336	–36	–	–	183
Stage 3	–225	–71	607	–	–	311
Financial instruments derecognized during the period (disposals)	–217	–117	–160	–159	–11	–664
Utilization	–	–	–315	–21	–12	–348
Changes to models or risk parameters	28	41	4	18	4	96
Classified as held for sale	–	–	–	0	–	0
Carrying amount at Dec. 31, 2023	**890**	**654**	**1,380**	**628**	**25**	**3,578**

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CHANGES IN LOSS ALLOWANCE FOR FINANCIAL GUARANTEES AND CREDIT COMMITMENTS

€ million	Stage 1	Stage 2	Stage 3	Stage 4	Total
Carrying amount at Jan. 1, 2023	**34**	**19**	**23**	**32**	**108**
Foreign exchange differences	0	0	0	0	0
Changes in consolidated group	0	–	–	–	0
Newly extended/purchased financial assets (additions)	10	–	–	0	10
Other changes within a stage	-4	-8	18	-21	-15
Transfers to					
Stage 1	1	-1	–	–	0
Stage 2	-1	1	–	–	0
Stage 3	-3	0	6	–	3
Financial instruments derecognized during the period (disposals)	-10	-1	0	-2	-14
Utilization	–	–	-3	–	-3
Changes to models or risk parameters	–	–	0	–	0
Carrying amount at Dec. 31, 2023	**27**	**10**	**44**	**10**	**90**

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CHANGES IN LOSS ALLOWANCE FOR LEASE RECEIVABLES AND CONTRACT ASSETS

	SIMPLIFIED APPROACH	
€ million	2023	2022
Carrying amount at Jan. 1	**1,713**	**1,297**
Foreign exchange differences	17	-4
Changes in consolidated group	-162	5
Newly extended/purchased financial assets (additions)	510	611
Other changes	-224	307
Financial instruments derecognized during the period (disposals)	-400	-297
Utilization	-82	-71
Changes to models or risk parameters	-32	14
Classified as held for sale	–	-149
Carrying amount at Dec. 31	**1,341**	**1,713**

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The loss allowance on assets measured at fair value in Stage 1 rose by €6 million (previous year: €0 million) in fiscal year 2023 and those in Stage 2 declined by €2 million (previous year: increase of €1 million), resulting in a closing balance of €12 million (previous year: €8 million). Of this amount, €10 million is attributable to Stage 1 (previous year: €4 million) and €3 million to Stage 2 (previous year €4 million).

The amount contractually outstanding for financial assets that have been derecognized in the current fiscal year and are still subject to enforcement proceedings is €270 million (previous year: €304 million).

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5.4 Liquidity risk

5.4.1 Information provided to key management

As set out in section 5.2 above, an entity should disclose summary quantitative data about its exposure to risk on the basis of the information provided internally to key management personnel and IFRS 7 emphasises that this requirement applies to liquidity risk too. *[IFRS 7.B10A, IFRS 7.BC58A(b)]*.

Entities should provide an explanation of how the data disclosed are determined. If the outflows of cash (or other financial assets) included in the data could occur significantly earlier than indicated, that fact should be stated and quantitative information should be provided to enable users of the financial statements to evaluate the extent of this risk, unless that information is included in the contractual maturity analyses (see section 5.4.2 below). Similar information should be given if the outflows of cash (or other financial assets) could be for significantly different amounts than those indicated in the data. This might be required, for example, if a derivative is included in the data on a net settlement basis, but the counterparty has the option of requiring gross settlement. *[IFRS 7.B10A]*.

5.4.2 Maturity analyses

To illustrate liquidity risk, the principal minimum numerical disclosures required are: *[IFRS 7.39(a), IFRS 7.39(b)]*

- A maturity analysis for non-derivative financial liabilities (including issued financial guarantee contracts) that shows their remaining contractual maturities

  And

- A maturity analysis for derivative financial liabilities

  Where contractual maturities of derivative financial liabilities are essential for an understanding of the timing of the cash flows the maturity analysis shall be based on remaining contractual maturities, otherwise a maturity analysis provided on some other basis is acceptable.

  The contractual maturities of the following would be essential for an understanding of the timing of the cash flows: *[IFRS 7.B11B]*

  - An interest rate swap with a remaining maturity of five years in a cash flow hedge of a variable rate financial asset or liability

    And

  - All loan commitments

  Derivatives entered into for trading purposes that are typically settled before their contractual maturity (e.g., in response to fair value movements) are an example of the type of instrument that might not need to be included in the maturity analysis.[12]

These requirements are discussed further in the remainder of this sub-section.

Although these minimum disclosures address only financial liabilities, other aspects of IFRS 7 mean that most financial institutions will be required to disclose a maturity analysis of financial assets also (see section 5.4.3 below).

5.4.2.A Time bands

The time bands to be used in the maturity analyses are not specified. Rather, entities should use their judgement to determine what is appropriate. For example, an entity might determine that the following are appropriate: *[IFRS 7.B11]*

- Not later than one month
- Later than one month and not later than three months
- Later than three months and not later than one year

  And

- Later than one year and not later than five years

12 INFORMATION FOR OBSERVERS, Board Meeting: 22 January 2009, London, Project: *Improving Disclosures about Financial Instruments (proposed amendments to IFRS 7)*, Subject: *Proposed amendments on liquidity risk disclosures (Agenda paper 14B)*, IASB, para. 32. Available on the IFRS Foundation's website.

In practice, it is rare for entities outside of the financial services sector to present more than one time band covering amounts payable within one year. However, it is quite common for more than one time band to be given covering amounts payable later than one year and within five years, as Unilever and Nestlé have done (see Practical example 5-4 and Practical example 5-5 respectively in section 5.4.2.G below). For banks and similar institutions, an 'on demand' category could also be relevant.

IFRS 16 requires lessees to disclose a maturity analysis of lease liabilities applying IFRS 7.39(a) and IFRS 7.B11 separately from the maturity analyses of other financial liabilities. *[IFRS 16.58]*. Guidance in IFRS 7 illustrates a number of different approaches, each of which takes into account the maturity of the financial liabilities being presented. Two of these examples simply show lease liabilities as a separate line within a table. A third example illustrates an entity with all financial liabilities due within three years except lease liabilities which extend for 25 years. For this entity, two tables are presented, one including all financial liabilities using the following time bands:

- Less than 1 month
- 1-6 months
- 6 months - 1 year
- 1-2 years
- 2-3 years

  And
- More than 3 years

And a second analysing only the lease liabilities but using the following time bands:

- Less than 1 year
- 1-5 years
- 5-10 years
- 10-15 years
- 15-20 years

  And
- 20-25 years *[IFRS 7.IG31A]*.

When a counterparty has a choice of when an amount is paid, the liability should be included on the basis of the earliest date on which the entity can be required to pay. For example, financial liabilities such as demand deposits that an entity can be required to repay on demand should be included in the earliest time band. *[IFRS 7.B11C(a)]*. This means that the disclosure shows a worst-case scenario, even if there is only a remote possibility that the entity could be required to pay its liabilities earlier than expected, *[IFRS 7.BC57]*, (although the disclosures in section 5.4.3 below may be relevant in these circumstances, i.e., those which are based on the information used by management to manage liquidity risk).

No guidance is given on how to deal with instruments where the issuer has a choice of when an amount is paid. For example, borrowings containing embedded issuer call or issuer prepayment options might be included in the analysis for non-derivative financial liabilities based on the earliest, latest or expected contractual payment dates. Where an entity has a material amount of such instruments, it would be appropriate to explain the basis of the analyses presented.

When an entity is committed to make amounts available in instalments, each instalment should be allocated to the earliest period in which the entity can be required to pay. For example, an undrawn loan commitment would be included in the time band containing the earliest date it could be drawn down. *[IFRS 7.B11C(b)]*.

For issued financial guarantee contracts, amounts included in the maturity analysis should be allocated to the earliest period in which the guarantee could be called. *[IFRS 7.B11C(c)]*.

5.4.2.B Cash flows: general requirements

The amounts that must be disclosed in the maturity analyses are the contractual undiscounted cash flows, for example:

- Gross finance lease obligations (before deducting finance charges)
- Prices specified in forward agreements to purchase financial assets for cash
- Net amounts for pay-floating/receive-fixed interest rate swaps for which net cash flows are exchanged
- Contractual amounts to be exchanged in a derivative financial instrument (e.g., a currency swap) for which gross cash flows are exchanged

  And
- Gross loan commitments

These undiscounted cash flows will differ from the amount included in the statement of financial position because the latter amount is based on discounted cash flows. *[IFRS 7.B11D]*.

When the amount payable is not fixed, the amount disclosed should be determined by reference to the conditions existing at the reporting date. For example, if the amount payable varies with changes in an index, the amount disclosed may be based on the level of the index at the reporting date. *[IFRS 7.B11D]*. The standard does not explain whether the amount should be based on the spot or forward price of the index and, in practice, both approaches are used. Where a material difference between the two approaches could arise, it would be appropriate to explain the basis on which the information is prepared.

The definition of liquidity risk includes only financial liabilities that will result in the outflow of cash or another financial asset (see section 5 above), which means that financial liabilities that will be settled in the entity's own equity instruments and liabilities within the scope of IFRS 7 that are settled with non-financial assets will not be included in the maturity analysis. *[IFRS 7.BC58A(a)]*.

5.4.2.C Cash flows: borrowings

It follows from the requirements in section 5.4.2.B above that the cash flows included in the analysis of non-derivative financial liabilities in respect of interest-bearing borrowings should reflect coupon, as well as principal, payments (although the standard does not say this explicitly). Quite how perpetual debt obligations should be dealt with in this analysis is not clear because the amount the standard requires to be included in the latest maturity category is infinity.

A number of companies show coupon payments separately from payments of principal, for example, Unilever (see Practical example 5-4 in section 5.4.2.G below). However, separate disclosure is not required, and coupon payments are commonly aggregated with principal payments, as Nestlé and Volkswagen have (see Practical example 5-5 and Practical example 5-6 respectively in section 5.4.2.G below).

The following Illustration shows the cash flows that should be included in the maturity analysis for non-derivative financial liabilities for a simple floating rate borrowing.

Illustration 5-5: Maturity analysis: floating rate borrowing

On 1 January 20X1, Company P borrowed CU100 million from a bank on the following terms: coupons are payable on the entire principal on 30 June and 31 December each year at the annual rate of SONIA plus 1% as determined on the previous 1 January and 1 July; the principal is repayable on 31 December 20X4.

At the end of 20X1, P's reporting period, SONIA is 5% and there is no difference between spot and forward interest rates (i.e., the yield curve is flat). Accordingly, P would include the following cash flows in its maturity analysis:

	CU million
30 June 20X2	3
31 December 20X2	3
30 June 20X3	3
31 December 20X3	3
30 June 20X4	3
31 December 20X4	103
Total	**118**

5.4.2.D Cash flows: derivatives

In the case of derivatives that are settled by a gross exchange of cash flows, it is not entirely clear whether entities should disclose the related cash inflow as well as the cash outflow, although such information might be considered useful. Furthermore, because the analysis is of financial liabilities, it seems clear that, strictly, cash outflows from a derivative asset that is settled by a gross exchange of cash should not be included. However, the contractual cash flows on these instruments would appear to be no less relevant than on those that have a negative fair value and must be disclosed where relevant.

A number of approaches to these issues were seen in practice, as illustrated in Practical example 5-4 to Practical example 5-7 in section 5.4.2.G below. Unilever and Nestlé both included cash inflows as well as outflows whereas Volkswagen showed only the cash outflows; Unilever included only derivative liabilities whereas Nestlé and Volkswagen included gross-settled derivative assets too. The gross contractual cash outflows disclosed by entities with gross-settled derivatives can be staggering, as illustrated in the Volkswagen practical example 5-6.

The IASB staff has been clear that disclosure of only the outflow on derivatives that were in a liability position was explicitly required. However, IFRS 7 emphasises the need to provide a maturity analysis of assets where such information is necessary to enable users of financial statements to evaluate the nature and extent of the entity's liquidity risk (see section 5.4.3 below). This is likely to bring derivative assets within the scope of the maturity analyses[13] and, by analogy, related gross cash inflows. Similar issues can arise on commodity contracts that are accounted for under IFRS 9, which will often be settled by exchanging the commodity for cash. An additional complication with these is that one leg of the contract may not involve a cash flow.

Further issues can arise in the case of a derivative liability settled by exchanging net cash flows in a number of future periods. For example, the relevant index for a long-term interest rate swap might predict that in some periods the entity could have cash inflows. Although this issue was identified by the IASB staff,[14] it has not been addressed and it remains unclear whether, and how, these inflows should be included within the analyses.

5.4.2.E Cash flows: embedded derivatives

The application guidance to IFRS 7 explains that where an embedded derivative is separated from a hybrid (combined) financial instrument (see Chapter 42 at section 3), the entire instrument should be dealt with in the maturity analysis for non-derivative instruments. *[IFRS 7.B11A]*.

No guidance is given for dealing with embedded derivatives separated from non-financial contracts. However, applying a similar approach to those separated from financial instruments would result in them being excluded from the maturity analyses altogether. This is because the hypothecated cash flows of the embedded derivative would be treated as cash flows of the non-financial contract, and such contracts are not within the scope of IFRS 7. This is consistent with the IASB staff analysis when developing the above requirement: they planned to exclude from the maturity analysis all separated embedded derivatives except those for which the hybrid contract was a financial liability because including them was unhelpful in understanding the liquidity information provided.[15]

5.4.2.F Cash flows: financial guarantee contracts and written options

For issued financial guarantee contracts, IFRS 7 requires the maximum amount of the guarantee to be included in the maturity analysis, *[IFRS 7.B11C(c)]*, but credit default swaps and written options are not directly addressed.

How we see it

The IASB staff have noted that the question of what to include in the maturity analysis is the same for credit default swaps and written options and, in our view, the maximum amount that could be payable under such instruments must be included in the analysis.[16]

13 INFORMATION FOR OBSERVERS, Board Meeting: 16 September 2008, London, Project: *Disclosures*, Subject: *IFRS 7* Financial Instruments: Disclosures, *Liquidity risk (Agenda paper 2A)*, IASB, para. 34(b); and INFORMATION FOR OBSERVERS, Board Meeting: 22 January 2009, London, Project: *Improving Disclosures about Financial Instruments (proposed amendments to IFRS 7)*, Subject: *Proposed amendments on liquidity risk disclosures (Agenda paper 14B)*, IASB, para. 35(a). Available on the IFRS Foundation's website.

14 INFORMATION FOR OBSERVERS, Board Meeting: 16 September 2008, London, Project: *Disclosures*, Subject: *IFRS 7* Financial Instruments: Disclosures, *Liquidity risk (Agenda paper 2A)*, IASB, para. 34(c). Available on the IFRS Foundation's website.

15 INFORMATION FOR OBSERVERS, Board Meeting: 16 September 2008, London, Project: *Disclosures*, Subject: *IFRS 7* Financial Instruments: Disclosures, *Liquidity risk (Agenda paper 2A)*, IASB, paras. 40 and 41. Available on the IFRS Foundation's website.

16 INFORMATION FOR OBSERVERS, Board Meeting: 16 September 2008, London, Project: *Disclosures*, Subject: *IFRS 7* Financial Instruments: Disclosures, *Liquidity risk (Agenda paper 2A)*, IASB, para. 34(d). Available on the IFRS Foundation's website.

5.4.2.G Examples of disclosures in practice

The following extracts from the financial statements of Unilever PLC, Nestlé S.A., VOLKSWAGEN AKTIENGESELLSCHAFT and NatWest Group plc show a variety of ways that companies applied the requirements of IFRS 7 in practice.

Practical example 5-4: Unilever PLC (2023) **United Kingdom**

Unilever Annual Report on Form 20-F 2023 [extract]

Financial Statements [extract]

Notes to the Consolidated Financial Statements Unilever Group [extract]

16. Treasury risk management [extract]

16A. Management of liquidity risk [extract]

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The following table shows Unilever's contractually agreed undiscounted cash flows, including expected interest payments, which are payable under financial liabilities at the balance sheet date:

Undiscounted cash flows	€ million Due within 1 year	€ million Due between 1 and 2 years	€ million Due between 2 and 3 years	€ million Due between 3 and 4 years	€ million Due between 4 and 5 years	€ million Due after 5 years	€ million Total	€ million Net carrying amount as shown in balance sheet
2023								
Non-derivative financial liabilities:								
Bank loans and overdrafts	(524)	(1)	(1)	(1)	(1)	(3)	(531)	(506)
Bonds and other loans	(4,650)	(3,599)	(2,480)	(2,643)	(4,092)	(14,028)	(31,492)	(26,692)
Lease liabilities	(407)	(316)	(260)	(193)	(153)	(362)	(1,691)	(1,395)
Other financial liabilities	(138)	(352)	(50)	–	–	(2)	(542)	(535)
Trade payables, accruals and other liabilities	(16,113)	(63)	(23)	(16)	(4)	(26)	(16,245)	(16,245)
Deferred consideration	(168)	(5)	–	–	–	–	(173)	(172)
	(22,000)	(4,336)	(2,814)	(2,853)	(4,250)	(14,421)	(50,674)	(45,545)
Derivative financial liabilities:								
Interest rate derivatives:								(452)
Derivative contracts – receipts	542	84	84	971	54	192	1,927	
Derivative contracts – payments	(648)	(150)	(125)	(1,020)	(95)	(326)	(2,364)	
Foreign exchange derivatives:								(85)
Derivative contracts – receipts	7,704	–	–	–	–	–	7,704	
Derivative contracts – payments	(7,806)	–	–	–	–	–	(7,806)	
Commodity derivatives:								(22)
Derivative contracts – receipts	–	–	–	–	–	–	–	
Derivative contracts – payments	(22)	–	–	–	–	–	(22)	
	(230)	(66)	(41)	(49)	(41)	(134)	(561)	(559)
Total	(22,230)	(4,402)	(2,855)	(2,902)	(4,291)	(14,555)	(51,235)	(46,104)

...

Practical example 5-5: Nestlé S.A. (2023) **Switzerland**

Financial Statements 2023 [extract]

Consolidated Financial Statements of the Nestlé Group 2023 [extract]

Notes [extract]

12. Financial instruments [extract]

12.2 Financial risks [extract]

12.2b Liquidity risk [extract]

Contractual maturities of financial liabilities and derivatives (including interest)

In millions of CHF

	In the first year	In the second year	In the third to the fifth years	After the fifth year	Contractual amount	Carrying amount
2023						
Trade and other payables	**(19 204)**	**(71)**	**(21)**	**(16)**	**(19 312)**	**(19 312)**
Commercial paper [a]	(2 224)	—	—	—	(2 224)	(2 213)
Bonds [a]	(5 248)	(4 737)	(16 850)	(30 992)	(57 827)	(47 618)
Lease liabilities	(875)	(540)	(1 092)	(893)	(3 400)	(2 909)
Other financial debt	(2 425)	(83)	(107)	(60)	(2 675)	(2 501)
Total financial debt	**(10 772)**	**(5 360)**	**(18 049)**	**(31 945)**	**(66 126)**	**(55 241)**
Financial liabilities (excluding derivatives)	**(29 976)**	**(5 431)**	**(18 070)**	**(31 961)**	**(85 438)**	**(74 553)**
Non-currency derivative assets	130	2	9	—	141	141
Non-currency derivative liabilities	(51)	(1)	—	—	(52)	(52)
Gross amount receivable from currency derivatives	18 850	1 566	1 558	3 122	25 096	24 092
Gross amount payable from currency derivatives	(18 983)	(1 705)	(1 541)	(3 278)	(25 507)	(24 329)
Net derivatives	**(54)**	**(138)**	**26**	**(156)**	**(322)**	**(148)**
of which derivatives under cash flow hedges [b]	90	1	—	—	91	91

...

(a) Commercial paper of CHF 1980 million (2022: CHF 3829 million) and bonds of CHF 1774 million (2022: CHF 864 million) have maturities of less than three months.

(b) The periods when the cash flow hedges affect the income statement do not differ significantly from the maturities disclosed above.

Practical example 5-6: VOLKSWAGEN AKTIENGESELLSCHAFT (2023) Germany

Annual Report 2023 [extract]
5 Consolidated Financial Statements [extract]
Notes [extract]
Other disclosures [extract]
36. Financial risk management and financial instruments [extract]

3. Liquidity risk

The solvency and liquidity of the Volkswagen Group are secured by rolling liquidity planning, a liquidity reserve, confirmed credit lines and the issuance of securities on the international money and capital markets. The volume of confirmed bilateral and syndicated credit lines stood at €31.3 billion as of December 31, 2023 (previous year: €27.3 billion), of which €0.4 billion (previous year: €1.0 billion) was drawn down.

Local cash funds in certain countries (e.g. China, Brazil, Argentina, South Africa and India) are only available to the Group for cross-border transactions subject to exchange controls. There are no significant restrictions over and above these. The liquidity risk in Argentina rose considerably as a result of the progressive depreciation of the Argentinian peso, especially in December 2023. It cannot be ruled out that the currency will depreciate further in fiscal year 2024.

The following overview shows the contractual undiscounted cash flows from financial instruments:

MATURITY ANALYSIS OF UNDISCOUNTED CASH FLOWS FROM FINANCIAL INSTRUMENTS

	REMAINING CONTRACTUAL MATURITIES				REMAINING CONTRACTUAL MATURITIES			
€ million	up to one year	within one to five years	more than five years	2023	up to one year[1]	within one to five years	more than five years	2022[1]
Financial liabilities	116,805	111,952	23,572	252,328	86,834	108,078	24,942	219,854
Trade payables	30,890	11	1	30,901	28,721	16	0	28,738
Other financial liabilities	11,374	2,135	107	13,616	17,532	2,479	125	20,136
Derivatives	81,487	88,276	10,295	180,058	79,591	87,649	10,916	178,155
Liabilities associated with assets held for sale	18	0	-	19	114	25	-	139
	240,575	**202,373**	**33,974**	**476,922**	**212,792**	**198,247**	**35,983**	**447,023**

1 Prior-year figures adjusted (see disclosures on IFRS 17 in the "Effects of new and amended IFRSs" section).

The cash outflows on other financial liabilities include outflows on liabilities for tax allocations amounting to €18 million (previous year: €17 million).

Derivatives comprise both cash flows from derivative financial instruments with negative fair values and cash flows from derivatives with positive fair values for which a gross settlement has been agreed. Derivatives entered into through offsetting transactions are also accounted for as cash outflows. The cash outflows from derivatives for which a gross settlement has been agreed are matched in part by cash inflows. These cash inflows are not reported in the maturity analysis. If these cash inflows were also recognized, the cash outflows presented would be substantially lower. This also particularly applies if hedges have been closed with offsetting transactions.

The cash outflows from obligations from loan commitments and irrevocable credit commitments are presented in the section entitled "Other financial obligations", classified by contractual maturities.

As of December 31, 2023, the maximum potential liability under financial guarantees amounted to €910 million (previous year: €1,185 million). Financial guarantees are assumed to be due immediately in all cases.

Practical example 5-7: NatWest Group plc (2023) **United Kingdom**

2023 Annual Report and Accounts [extract]

Financial statements [extract]

Notes to the consolidated financial statements [extract]

12. Financial instruments - maturity analysis [extract]

Assets and liabilities by contractual cash flows up to 20 years

The tables on the following page show the contractual undiscounted cash flows receivable and payable, up to a period of 20 years, including future receipts and payments of interest of financial assets and liabilities by contractual maturity. The balances in the following tables do not agree directly with the consolidated balance sheet, as the tables include all cash flows relating to principal and future coupon payments, presented on an undiscounted basis. The tables have been prepared on the following basis:

Financial assets have been reflected in the time band of the latest date on which they could be repaid, unless earlier repayment can be demanded by NatWest Group. Financial liabilities are included at the earliest date on which the counterparty can require repayment, regardless of whether or not such early repayment results in a penalty. If the repayment of a financial instrument is triggered by, or is subject to, specific criteria such as market price hurdles being reached, the asset is included in the time band that contains the latest date on which it can be repaid, regardless of early repayment. The liability is included in the time band that contains the earliest possible date on which the conditions could be fulfilled, without considering the probability of the conditions being met.

For example, if a structured note is automatically prepaid when an equity index exceeds a certain level, the cash outflow will be included in the less than three months period, whatever the level of the index at the year end. The settlement date of debt securities in issue, issued by certain securitisation vehicles consolidated by NatWest Group, depends on when cash flows are received from the securitised assets. Where these assets are prepayable, the timing of the cash outflow relating to securities assumes that each asset will be prepaid at the earliest possible date. As the repayments of assets and liabilities are linked, the repayment of assets in securitisations is shown on the earliest date that the asset can be prepaid, as this is the basis used for liabilities.

The principal amounts of financial assets and liabilities that are repayable after 20 years or where the counterparty has no right to repayment of the principal are excluded from the table, as are interest payments after 20 years.

The maturity of guarantees and commitments is based on the earliest possible date they would be drawn in order to evaluate NatWest Group's liquidity position.

MFVTPL assets of £125.1 billion (2022 - £145.8 billion) and HFT liabilities of £125.8 billion (2022 - £146.7 billion) have been excluded from the following tables.

2023	0-3 months £m	3-12 months £m	1-3 years £m	3-5 years £m	5-10 years £m	10-20 years £m
Assets by contractual maturity up to 20 years						
Cash and balances at central banks	104,262	-	-	-	-	-
Derivatives held for hedging	31	29	128	104	49	49
Settlement balances	7,231	-	-	-	-	-
Loans to banks - amortised cost	5,234	1,437	23	302	-	-
Loans to customers - amortised cost	52,175	46,894	81,445	61,465	96,577	114,806
Other financial assets (1)	4,897	6,756	12,304	11,183	10,019	8,063
Finance lease	61	242	735	401	656	359
	173,891	55,358	94,635	73,455	107,301	123,277
Liabilities by contractual maturity up to 20 years						
Bank deposits	8,334	1,279	6,069	8,307	-	-
Customer deposits	393,363	31,900	6,464	11	14	19
Settlement balances	6,645	-	-	-	-	-
Derivatives held for hedging	71	175	366	192	92	8
Other financial liabilities	9,094	12,319	18,843	13,818	4,769	346
Subordinated liabilities	72	1,167	2,301	1,512	1,406	342
Other liabilities - Notes in circulation	3,237	-	-	-	-	-
Lease liabilities	30	79	172	111	175	132
	420,846	46,919	34,215	23,951	6,456	847
Guarantees and commitments - notional amount						
Guarantees (2)	2,820	-	-	-	-	-
Commitments (3)	112,807	-	-	-	-	-
	115,627	-	-	-	-	-

...

(1) Other financial assets exclude equity shares.
(2) NatWest Group is only called upon to satisfy a guarantee when the guaranteed party fails to meet its obligations. NatWest Group expects most guarantees it provides to expire unused.
(3) NatWest Group has given commitments to provide funds to customers under undrawn formal facilities, credit lines and other commitments to lend subject to certain conditions being met by the counterparty. NatWest Group does not expect all facilities to be drawn, and some may lapse before drawdown.

5.4.3 Management of associated liquidity risk

In addition to the maturity analyses for financial liabilities, the entity should provide a description of how it manages the liquidity risk inherent in those analyses. *[IFRS 7.39(c)]*. These disclosures are, in effect, intended to 'reconcile' the maturity analyses which are prepared on a worst-case scenario notion (see section 5.4.2 above) with how an entity actually manages liquidity risk (see section 5.4.1 above).[17]

It is emphasised that a maturity analysis of financial assets held for managing liquidity risk (e.g., financial assets that are readily saleable or expected to generate cash inflows to meet cash outflows on financial liabilities) is required if that information is necessary to enable users of financial statements to evaluate the nature and extent of the entity's liquidity risk. *[IFRS 7.B11E, IFRS 7.BC58D]*. IFRS 7 does not specify the basis on which such an analysis should be provided and, in practice, they are often prepared on the basis of expected, rather than contractual, maturities as this is considered more relevant information.

Other factors that might be considered when making this disclosure include, but are not limited to, whether the entity: *[IFRS 7.B11F]*

- Has committed borrowing facilities (e.g., commercial paper facilities) or other lines of credit (e.g., stand-by credit facilities) that it can access to meet liquidity needs
- Holds deposits at central banks to meet liquidity needs
- Has very diverse funding sources
- Has significant concentrations of liquidity risk in either its assets or its funding sources
- Has internal control processes and contingency plans for managing liquidity risk
- Has instruments that include accelerated repayment terms (e.g., on the downgrade of the entity's credit rating)
- Has instruments that could require the posting of collateral (e.g., margin calls for derivatives)
- Has instruments that allow the entity to choose whether it settles its financial liabilities by delivering cash (or another financial asset) or by delivering its own shares
- Has instruments that are subject to master netting agreements

  Or
- Has accessed, or has access to, facilities under supplier finance arrangements (see section 7.4.3 below and Chapter 36 section 11.4) that provide the entity with extended payment terms or the entity's suppliers with early payment terms

The final item above was added to IFRS 7 in May 2023 by amendments that are effective for periods commencing on or after 1 January 2024 (see section 7.4.3.F).

5.4.4 Puttable financial instruments classified as equity

Certain puttable financial instruments that meet the definition of financial liabilities are classified as equity instruments (see Chapter 43 at section 4.6). Despite this classification, the IASB recognises that these instruments give rise to liquidity risk and consequently requires the following disclosures about them: *[IAS 1.136A, IFRS 7(2027).19A]*

- Summary quantitative data about the amount classified as equity
- The entity's objectives, policies and processes for managing its obligation to repurchase or redeem the instruments when required to do so by the instrument holders, including any changes from the previous period
- The expected cash outflow on redemption or repurchase of that class of financial instruments

  And
- Information about how the expected cash outflow on redemption or repurchase was determined

17 INFORMATION FOR OBSERVERS, Board Meeting: 16 September 2008, London, Project: *Disclosures*, Subject: *IFRS 7* Financial Instruments: Disclosures, *Liquidity risk (Agenda paper 2A)*, IASB, para. 25. Available on the IFRS Foundation's website.

5.5 Market risk

IFRS 7 requires entities to provide disclosure of their sensitivity to market risk in one of two ways which are set out in section 5.5.1 and section 5.5.2 below. The sensitivity analyses should cover the whole of an entity's business, but different types of sensitivity analysis may be provided for different classes of financial instruments. *[IFRS 7.B21]*. This is considered by the IASB to be simpler and more suitable than the disclosure of terms and conditions of financial instruments previously required by IAS 32 and for which there is no direct equivalent within IFRS 7. *[IFRS 7.BC59]*. No sensitivity analysis is required for financial instruments that an entity classifies as equity instruments. Such instruments are not remeasured so that neither profit or loss nor equity will be affected by the equity price risk of those instruments. *[IFRS 7.B28]*.

5.5.1 'Basic' sensitivity analysis

Except where the disclosures set out in section 5.5.2 below are provided, entities should disclose: *[IFRS 7.40]*

- A sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date

  The sensitivity of profit or loss (which arises, for example, from instruments measured at fair value through profit or loss) must be disclosed separately from the sensitivity of equity (which arises, for example, from investments in equity instruments whose changes in fair value are presented in other comprehensive income). *[IFRS 7.B27]*.

  This requirement focuses exclusively on accounting sensitivity and does not include market risk sensitivities that do not directly impact profit and loss or equity, e.g., interest rate risk arising on fixed-rate financial assets held at amortised cost. In December 2008, the IASB considered encouraging entities to discuss the effect of changes in the relevant risk variable on economic value that does not manifest in profit and loss or equity but decided not to.[18]

  The term 'profit or loss' is used in IAS 1 to mean profit after tax. Therefore, it might well be argued that the amounts disclosed should take account of any related tax effects, a view corroborated by the illustrative disclosures in the implementation guidance to IFRS 7 (see Illustration 5-6 below). However, as noted below, the application guidance suggests this requirement should (and the implementation guidance might suggest it could) be met by disclosing the impact on interest expense, a pre-tax measure of profit. *[IFRS 7.B18(a), IFRS 7.IG34]*. Given this conflicting guidance, it is difficult to say that a pre-tax approach fails to comply with the standard and, in practice, both approaches are seen.

  Where a post-tax figure is disclosed, it will not always be straightforward to determine the related tax effects, especially for a multinational group, and it may be appropriate to use the guidance in Chapter 29 at section 10, which deals with the allocation of income tax between profit or loss, other comprehensive income and equity.

  How we see it

  The disclosure of market risk sensitivity may be made on either a pre-tax or a post-tax basis. This is a policy choice to be made and applied consistently and disclosed in the financial statements.

- The methods and assumptions used in preparing the sensitivity analysis

  And

- Changes from the previous period in the methods and assumptions used, and the reasons for such changes

The standard contains a reminder of the general guidance in section 3.1 above and explains that an entity should decide how it aggregates information to display the overall picture without combining information with different characteristics about exposures to risks from significantly different economic environments. For example, an entity that trades financial instruments might disclose this information separately for financial instruments held for trading and those not held for trading. Similarly, an entity would not aggregate its exposure to market risks from areas of hyperinflation with its exposure to the same market risks from areas of very low inflation. However, an entity that has exposure to only one type of market risk in only one economic environment, would not show disaggregated information. *[IFRS 7.B17]*.

18 INFORMATION FOR OBSERVERS, Board Meeting: December 2008, London, Project: *IFRS 7* Financial Instruments: Disclosures, Subject: *Minor Amendments (Agenda paper 14)*, IASB, paras. 71 to 79; and *IASB Update*, December 2008. Available on the IFRS Foundation's website.

Risk variables that are relevant to disclosing market risk include but are not limited to: *[IFRS 7.IG32]*

- The yield curve of market interest rates

  It may be necessary to consider both parallel and non-parallel shifts in the yield curve
- Foreign exchange rates

  The standard requires a sensitivity analysis to be disclosed for each currency to which an entity has significant exposure. *[IFRS 7.B24]*.
- Prices of equity instruments

  And
- Market prices of commodities

When disclosing how profit or loss and equity would have been affected by changes in the relevant risk variable, there is no requirement to determine what the profit or loss for the period would have been if the relevant risk variables had been different during the reporting period. The requirement is subtly different because the effect that is disclosed assumes that a reasonably possible change in the relevant risk variable had occurred at the reporting date and had been applied to the risk exposures in existence at that date. For example, if an entity has a floating rate liability at the reporting date, the entity would disclose the effect on profit or loss (i.e., interest expense) for the current year if interest rates had varied by reasonably possible amounts. Furthermore, this disclosure is not required for each change within a range of reasonably possible changes, only at the limits of the reasonably possible range. *[IFRS 7.B18]*.

The following Illustration shows how the amounts to be included in these disclosures in respect of a number of different instruments might be determined - for simplicity, tax effects are ignored.

Illustration 5-6: Illustration of how sensitivity disclosures can be determined

Company X, which has the euro as its functional currency, is party to the following instruments at 31 December 20X1, X's reporting date:

- A €100m floating rate borrowing
- A forward contract to sell US$10m in July 20X2 that is designated in an effective hedge of a highly probable forecast sale that is denominated in US dollars
- A short-term loan of £10m made to a related party
- An interest rate swap that is not designated as a hedge
- Investments in fixed rate debt securities that are classified as financial assets measured at amortised cost
- Investments in similar securities that are classified as debt instruments measured at fair value through other comprehensive income

  And
- Investments in a portfolio of US equities with a fair value of US$50m

Floating rate borrowing

Changes in interest rates will result in this instrument impacting on X's profit or loss. If X concludes that a reasonably possible change in interest rates is 50 basis points (0.5%), €0.5m [€100m × 0.5%] would be included in the amount disclosed as the impact on profit or loss of this reasonably possible change.

Forward contract

Changes in exchange rates will have an impact on the fair value (and carrying value) of this instrument, but this would be recognised in other comprehensive income, not profit or loss (assuming ineffectiveness is insignificant). If a reasonably possibly change in exchange rates would change the value of the contract by €0.3m, this would be included in the amount disclosed as the impact on equity of this reasonably possible change.

Foreign currency loan

Changes in spot exchange rates will have an impact on the carrying amount of this asset with changes recognised in profit or loss as a result of the application of IAS 21 *The Effects of Changes in Foreign Exchange Rates*. If a reasonably possible change in the exchange rate would alter the carrying value of the contract by €1.0m, this would be included in the amount disclosed as the impact on profit or loss of this reasonably possible change.

If the loan were made to a subsidiary of X that had sterling as its functional currency, the loan itself would eliminate on consolidation but the impact of retranslating it into euros in X's own financial statements would remain in consolidated profit or loss. Therefore, in these circumstances, the loan would still be included in the sensitivity analysis for X's consolidated financial statements.

Interest rate swap

Changes in interest rates will have an impact on the fair value (and carrying value) of this instrument and such changes would be recognised in profit or loss. If a reasonably possible change of 50 basis points in interest rates would change the value of the contract by €0.4m, this would be included in the amount disclosed as the impact on profit or loss of this reasonably possible change.

Fixed rate debt securities

Changes in interest rates will have an impact on the fair value of all these instruments. However, because those classified as measured at amortised cost are not measured at fair value, the carrying amount only of those that are classified as debt instruments measured at fair value through other comprehensive income will change as interest rates move and such change will normally be recognised in other comprehensive income. Therefore, if a reasonably possible 50 basis point change in interest rates would change the fair value of each group of instruments by €0.5m, only the amount in respect of the debt instruments measured at fair value through other comprehensive income would be included in the sensitivity disclosure as an impact on equity. Of course, there would be nothing to preclude disclosure, as additional information (if considered relevant), of the sensitivity of the fair value of those classified as measured at amortised cost to changes in interest rates.

US equity securities

The impact of a reasonably possible change in the market prices of these securities should be included in the amount disclosed as X's sensitivity to equity price risk. Changes in exchange rates might be considered to impact the fair value of these investments. However, as noted at (c)(i) in section 5 above, financial instruments that are non-monetary items do not give rise to foreign currency risk for the purposes of IFRS 7; essentially, the foreign currency risk is seen as part of the market price risk associated with such instruments. Therefore, X should take no account of these investments when disclosing its sensitivity to changes in the euro/US dollar exchange rate. Nevertheless, this information may be provided as additional disclosure where it is considered relevant.

Relevant risk variables for the purpose of this disclosure might include: *[IFRS 7.IG33]*

- Prevailing market interest rates, for interest-sensitive financial instruments such as a variable-rate loan

  Or
- Currency rates and interest rates, for foreign currency financial instruments such as foreign currency bonds

For interest rate risk, the sensitivity analysis might show separately the effect of a change in market interest rates on:

- Interest income and expense
- Other line items of profit or loss (such as trading gains and losses)

  And
- When applicable, equity

An entity might disclose a sensitivity analysis for interest rate risk for each currency in which the entity has material exposures to interest rate risk. *[IFRS 7.IG34]*.

In determining what a reasonably possible change in the relevant risk variable is, the economic environment(s) in which the entity operates, and the time frame over which it is making the assessment, should be considered. A reasonably possible change should not include "remote or 'worst case' scenarios or 'stress tests'". Moreover, if the rate of change in the underlying risk variable is stable, the chosen reasonably possible change in the risk variable need not be altered.

For example, assume that interest rates are 5% and an entity determines that a fluctuation in interest rates of ±50 basis points is reasonably possible. It would disclose the effect on profit or loss and equity if interest rates were to change to 4.5% or 5.5%. In the next period, interest rates have increased to 5.5%. The entity continues to believe that interest rates may fluctuate by ±50 basis points (i.e., that the rate of change in interest rates is stable). The entity would disclose the effect on profit or loss and equity if interest rates were to change to 5% or 6%. The entity would not be required to revise its assessment that interest rates might reasonably fluctuate by ±50 basis points, unless there is evidence that interest rates have become significantly more volatile. *[IFRS 7.B19(a)]*.

However, in circumstances when market conditions change significantly, for example as occurred in many markets in the second half of 2008[19] or more recently during 2022 where we have observed rapidly changing interest rates, we would expect an entity to reconsider its assessment of what constitutes a reasonably possible change in a market risk variable. If the entity changes its assessment of what is considered to be a reasonably possible change, ordinarily there would be no need to update the prior year disclosures. For example, where an entity assessed a reasonable possible change in interest rates in the prior year as 100 basis points, but due to changes to interest rates as a result of changing market conditions in the current year the entity believes that a 200 basis points increase is now considered to be a reasonably possible change, the prior year disclosure is not updated. However, we have observed instances where an entity has chosen to present additional sensitivity information for the comparative period based on the current years revised reasonably possible change in a market risk variable.

The time frame over which a reasonably possible change should be assessed is defined by the period until these disclosures will next be presented. This will normally coincide with the next annual reporting period, *[IFRS 7.B19(b)]*, although in some jurisdictions such information may be included in interim reports.

Because the factors affecting market risk will vary according to the specific circumstances of each entity, the appropriate range to be considered in providing a sensitivity analysis of market risk will also vary for each entity and for each type of market risk. *[IFRS 7.IG35]*.

Where an entity has exposure to other price risk, it might disclose the effect of a decrease in a specified stock market index, commodity price, or other risk variable. For example, if residual value guarantees that are financial instruments are given, the disclosure could include an increase or decrease in the value of the assets to which the guarantee applies. *[IFRS 7.B25]*.

The following Illustration from the implementation guidance shows the type of disclosure that might be provided.

Illustration 5-7: Illustrative disclosure of sensitivity analyses

Interest rate risk

At 31 December 20X1, if interest rates at that date had been 10 basis points lower with all other variables held constant, post-tax profit for the year would have been CU1.7 million (20X0: CU2.4 million) higher, arising mainly as a result of lower interest expense on variable borrowings.

If interest rates had been 10 basis points higher, with all other variables held constant, post-tax profit would have been CU1.5 million (20X0: CU2.1 million) lower, arising mainly as a result of higher interest expense on variable borrowings.

Profit is more sensitive to interest rate decreases than increases because of borrowings with capped interest rates. The sensitivity is lower in 20X1 than in 20X0 because of a reduction in outstanding borrowings that has occurred as the entity's debt has matured (see note X).

Foreign currency exchange rate risk

At 31 December 20X1, if the currency unit had weakened 10% against the US dollar with all other variables held constant, post-tax profit for the year would have been CU2.8 million (20X0: CU6.4 million) lower, and other comprehensive income would have been CU1.2 million (20X0: CU1.1 million) higher.

Conversely, if the currency unit had strengthened 10% against the US dollar with all other variables held constant, post-tax profit would have been CU2.8 million (20X0: CU6.4 million) higher, and other comprehensive income would have been CU1.2 million (20X0: CU1.1 million) lower.

The lower foreign currency exchange rate sensitivity in profit in 20X1 compared with 20X0 is attributable to a reduction in foreign currency denominated debt. Equity is more sensitive in 20X1 than in 20X0 because of the increased use of hedges of foreign currency purchases, offset by the reduction in foreign currency debt. *[IFRS 7.IG36]*.

19 INFORMATION FOR OBSERVERS, Board Meeting: December 2008, London, Project: *IFRS 7* Financial Instruments: Disclosures, Subject: *Minor Amendments (Agenda paper 14)*, IASB, para. 86. Available on the IFRS Foundation's website.

The following extracts from the financial statements of Hunting Plc illustrates how one company has addressed this disclosure requirement in respect of certain of its interest rate and foreign currency exposures.

Practical example 5-8: Hunting Plc (2023) **United Kingdom**

Annual Report and Accounts 2023 [extract]
Financial statements [extract]
Notes to the Consolidated Financial Statements [extract]
31. Financial Instruments: Sensitivity Analysis [extract]

The following sensitivity analysis is intended to illustrate the sensitivity to changes in market variables on the Group's financial instruments and show the impact on profit or loss and shareholders' equity. Financial instruments affected by market risk include cash at bank and in hand, trade and other receivables, trade and other payables, lease liabilities, borrowings and derivative financial instruments. The sensitivity analysis relates to the position as at 31 December 2023. The analysis excludes the impact of movements in market variables on the carrying value of pension and other post-retirement obligations, provisions and non-financial assets and liabilities of foreign operations.

The following assumptions have been made in calculating the sensitivity analysis:

- Foreign exchange rate and interest rate sensitivities have an asymmetric impact on the Group's results, that is an increase in rates does not result in the same amount of movement as a decrease in rates;
- For floating rate assets and liabilities, the amount of asset or liability outstanding at the balance sheet date is assumed to be outstanding for the whole year;
- Fixed-rate financial instruments that are carried at amortised cost are not subject to interest rate risk for the purpose of this analysis; and
- The carrying values of financial assets and liabilities carried at amortised cost do not change as interest rates change.

Positive figures represent an increase in profit or equity.

(a) Interest Rate Sensitivity
(i) US Interest Rates
The sensitivity rate of 2.0% (2022 – 1.0%) for US interest rates represents management's assessment of a reasonably possible change, based on historical volatility and a review of analysts' research and banks' expectations of future interest rates.

The impact on the consolidated income statement, with all other variables held constant, in applying the sensitivity above results in a $0.6m (2022 – $0.1m) increase or decrease in post-tax profit for an increase or decrease in US interest rates. There is no impact on other comprehensive income ("OCI") for a change in US interest rates.

(ii) Other Interest Rates
For all other interest rates, there is an immaterial impact on post-tax profit or loss for any reasonably possible changes in other interest rates, based on historical volatility and a review of analysts' research and banks' expectations of future interest rates. There is no impact on OCI for a change in other interest rates.

(b) Foreign Exchange Rate Sensitivity
Management has considered the impact of changes to the various foreign exchange rates on the exposed financial assets and liabilities disclosed in note 30(a)(i). The sensitivity rates selected range between 3-5% and represent management's assessment of a reasonably possible change, based on historical volatility and a review of analysts' research and banks' expectations of future foreign exchange rates. There is an immaterial impact on post-tax profit or loss and on OCI for any reasonably possible changes in the foreign exchange rates.

5.5.2 Value-at-risk and similar analyses

Where an entity prepares a sensitivity analysis, such as value-at-risk, that reflects interdependencies between risk variables (e.g., interest rates and exchange rates) and uses it to manage financial risks, it may disclose that analysis in place of the information specified in section 5.5.1 above. *[IFRS 7.41]*. If this disclosure is given, the effects on profit or loss and equity in section 5.5.1 above need not be given. *[IFRS 7.BC61]*.

In these cases, the following should also be disclosed: *[IFRS 7.41]*

- An explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided

  And

- An explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved

This applies even if such a methodology measures only the potential for loss and does not measure the potential for gain. Such an entity might comply with the disclosure requirements above by detailing the type of value-at-risk model used (e.g., whether the model relies on Monte Carlo simulations), an explanation about how the model works and the main assumptions (e.g., the holding period and confidence level). Entities might also disclose the historical observation period and weightings applied to observations within that period, an explanation of how options are dealt with in the calculations, and which volatilities and correlations (or, alternatively, Monte Carlo probability distribution simulations) are used. *[IFRS 7.B20]*.

The basic sensitivity analysis considered in section 5.5.1 above incorporates only the effects of financial instruments and other contracts within the scope of IFRS 7. In contrast, value-at-risk and similar analyses can incorporate the effects of items outside the scope of IFRS 7, for example trading inventories, own use contracts and insurance contracts. This is because the standard requires entities to disclose the analysis actually used in the management of the business, which will often include such items.

It has been suggested that disclosure of potential losses due to stress conditions would be of greater use than the disclosure requirements for value-at-risk and similar methodologies that do not contemplate extraordinary market movements. However, in December 2008, the IASB noted this would be inconsistent with the 'basic' sensitivity analysis (see section 5.5.1 above) and decided not to add such a requirement to IFRS 7.[20]

20 INFORMATION FOR OBSERVERS, Board Meeting: December 2008, London, Project: *IFRS 7* Financial Instruments: Disclosures, Subject: *Minor Amendments (Agenda paper 14)*, IASB, paras. 80 to 88; and *IASB Update*, December 2008. Available on the IFRS Foundation's website.

BP p.l.c. provides the following market risk disclosures which includes the value-at-risk limit it uses to manage that risk.

Practical example 5-9: BP p.l.c. (2023) **United Kingdom**

BP Annual Report and Form 20-F 2023 [extract]
Financial statements [extract]
Notes on the financial statements [extract]
29. Financial instruments and financial risk factors [extract]
Financial risk factors [extract]

...

(a) Market risk

Market risk is the risk or uncertainty arising from possible market price movements and their impact on the future performance of a business. The primary commodity price risks that the group is exposed to include oil, natural gas and power prices that could adversely affect the value of the group's financial assets, liabilities or expected future cash flows. The group has developed a control framework aimed at managing the volatility inherent in certain of its ordinary business exposures. In accordance with the control framework the group enters into various transactions using derivatives for risk management purposes.

The major components of market risk are commodity price risk, foreign currency exchange risk and interest rate risk, each of which is discussed below.

(i) Commodity price risk

The group's trading and shipping business is responsible for delivering value across the overall crude, oil products, gas, LNG and power supply chains. As such, it routinely enters into spot and term physical commodity contracts in addition to optimising physical storage, pipeline and transportation capacity. These activities expose the group to commodity price risk which is managed by entering into oil, natural gas and power swaps, options and futures.

The group measures market risk exposure arising from its trading positions in liquid periods using value-at-risk techniques based on Monte Carlo simulation models. These techniques make a statistical assessment of the market risk arising from possible future changes in market prices over a one-day holding period within a 95% confidence level. Trading activity occurring in liquid periods is subject to value-at-risk and other limits for each trading activity and the aggregate of all trading activity. The calculation of potential changes in value within the liquid period considers positions, historical price movements and the correlation of these price movements. Models are regularly reviewed against actual fair value movements to ensure integrity is maintained. The value-at-risk measure is supplemented by stress testing and scenario analysis through simulating the financial impact of certain physical, economic and geo-political scenarios. The value-at-risk measure in respect of the aggregated trading positions in liquid periods at 31 December 2023 was $26 million (2022 $63 million) whereas the average value-at-risk measure for the period was $49 million (2022 $89 million). This measure incorporates the effect of diversification reflecting the offsetting risks across the trading portfolio. Alternative measures are used to monitor exposures which are outside of liquid periods and for which value-at-risk techniques are not appropriate.

...

5.5.3 Other market risk disclosures

When the sensitivity analyses discussed in section 5.5.1 and section 5.5.2 above are unrepresentative of a risk inherent in a financial instrument, that fact must be disclosed together with the reason for believing the sensitivity analyses are unrepresentative. *[IFRS 7.42]*.

This can occur when the year-end exposure does not reflect the exposure during the year, *[IFRS 7.42]*, or a financial instrument contains terms and conditions whose effects are not apparent from the sensitivity analysis, e.g., options that remain out of (or in) the money for the chosen change in the risk variable. *[IFRS 7.IG37(a)]*. Additional disclosures in this second case might include:

- The terms and conditions of the financial instrument (e.g., the options)
- The effect on profit or loss if the term or condition were met (i.e., if the options were exercised)

  And
- A description of how the risk is hedged

For example, an entity may acquire a zero-cost interest rate collar that includes an out-of-the-money leveraged written option (e.g., the entity pays ten times the amount of the difference between a specified interest rate floor and the current market interest rate if that current rate is below the floor). The entity may regard the collar as an inexpensive economic hedge against a reasonably possible increase in interest rates. However, an unexpectedly large decrease in interest rates might trigger payments under the written option that, because of the leverage, might be significantly larger than the benefit of lower interest rates. Neither the fair value of the collar nor a sensitivity analysis based on reasonably possible changes in market variables would indicate this exposure. In this case, the entity might provide the additional information described above. *[IFRS 7.IG38]*.

Where financial assets are illiquid, e.g., when there is a low volume of transactions in similar assets and it is difficult to find a counterparty, additional disclosures might be required, *[IFRS 7.IG37(b)]*, for example, the reasons for the lack of liquidity and how the risk is hedged. *[IFRS 7.IG39]*.

A large holding of a financial asset that, if sold in its entirety, would be sold at a discount or premium to the quoted market price for a smaller holding could also require additional disclosure. *[IFRS 7.IG37(c)]*. This might include: *[IFRS 7.IG40]*

- The nature of the security (e.g., entity name)
- The extent of holding (e.g., 15% of the issued shares)
- The effect on profit or loss

  And
- How the entity hedges the risk

5.6 Quantitative disclosures: other matters

5.6.1 Concentrations of risk

Concentrations of risk must be disclosed if not otherwise apparent from the disclosures made to comply with the requirements set out in section 5.2 to section 5.5 above. *[IFRS 7.34(c)]*. This should include:

- A description of how management determines concentrations
- A description of the shared characteristic that identifies each concentration (for example, counterparty, geographical area, currency or market)

  For example, the shared characteristic may refer to geographical distribution of counterparties by groups of countries, individual countries or regions within countries *[IFRS 7.IG19]*

  And
- The amount of the risk exposure associated with all financial instruments sharing that characteristic

Concentrations of risk arise from financial instruments that have similar characteristics and are affected similarly by changes in economic or other conditions. It is emphasised that the identification of concentrations of risk requires judgement taking into account the circumstances of the entity. *[IFRS 7.B8]*. For example, they may arise from:

- ***Industry sectors***

  If an entity's counterparties are concentrated in one or more industry sectors (such as retail or wholesale), it would disclose separately exposure to risks arising from each concentration of counterparties.
- ***Credit rating or other measure of credit quality***

  If an entity's counterparties are concentrated in one or more credit qualities (such as secured loans or unsecured loans) or in one or more credit ratings (such as investment grade or speculative grade), it would disclose separately exposure to risks arising from each concentration of counterparties.
- ***Geographical distribution***

  If an entity's counterparties are concentrated in one or more geographical markets (such as Asia or Europe), it would disclose separately exposure to risks arising from each concentration of counterparties.

  And
- ***Concentrated counterparties***

  A limited number of individual counterparties or groups of closely related counterparties

Similar principles apply to identifying concentrations of other risks, including liquidity risk and market risk. For example, concentrations of liquidity risk may arise from the repayment terms of financial liabilities, sources of borrowing facilities, reliance on a particular market in which to realise liquid assets or certain supplier financing arrangements where finance provider(s) pay the original suppliers and the entity pays at a later date, where such arrangements result in a concentration of financial liabilities with the finance provider(s). Concentrations of foreign exchange risk may arise if an entity has a significant net open position in a single foreign currency, or aggregate net open positions in several currencies that tend to move together. *[IFRS 7.IG18A]*.

5.6.2 Operational risk

In developing IFRS 7, the IASB considered whether disclosure of information about operational risk should be required by the standard. However, the definition and measurement of operational risk were considered to be in their infancy and were not necessarily related to financial instruments. Also, such disclosures were believed to be more appropriately located outside the financial statements. Consequently, this issue was deferred for consideration in the management commentary project. *[IFRS 7.BC65]*.

5.6.3 Capital disclosures

The IASB considers that the level of an entity's capital and how it is managed are important factors for users of financial statements to consider in assessing the risk profile of an entity and its ability to withstand unexpected adverse events. It might also affect an entity's ability to pay dividends. Consequently, ED 7 contained proposed disclosures about capital. *[IAS 1.BC86]*.

However, some commentators questioned the relevance of the capital disclosures in a standard dealing with disclosures relating to financial instruments and the IASB noted that an entity's capital does not relate solely to financial instruments and, thus, they have more general relevance. Accordingly, whilst these disclosures were retained, they were included in IAS 1, rather than IFRS 7. *[IAS 1.BC88]*. Those disclosures required by IAS 1 are dealt with in Chapter 3 at section 5.4.

5.7 Interest rate benchmark (or IBOR) reform

Replacing interbank offered rates (IBOR) with alternative rates was one of the recommendations following the financial crisis. IBOR reform gives rise to several financial reporting issues which the IASB approached in two phases. In August 2020, the IASB issued a second set of amendments to IFRS 9 addressing changes made to contractual cash flows, including modifications of financial assets and financial liabilities, and to hedging relationships that occur when interest rate benchmarks are replaced with alternative benchmarks. These amendments, which were effective for periods commencing on or after 1 January 2021 and were available for earlier adoption, are discussed in the Supplement: IBOR Reform. Consequential amendments were made to IFRS 7 to enable users of financial statements to understand the effect of interest rate benchmark reform on an entity's financial instruments and risk management strategy. *[IFRS 7.24I]*. The disclosures that entities should provide are discussed in the Supplement: IBOR Reform at section 6.2.

Disclosures introduced by the first phase of the IASB's project to address IBOR reform are considered in section 4.3.5 above and the Supplement: IBOR Reform at section 6.1.

At the time of writing, IBOR Reform is substantially complete as the most significant IBORs, including all the LIBORs, have now been replaced. However, there remain some local IBORs for which the work to replace them is still in progress or has only very recently been completed, hence the guidance in this chapter remains relevant.

6 Transfers of financial assets

The objective of these requirements, which were introduced into IFRS 7 in October 2010, is that entities must disclose information that enables users of its financial statements: *[IFRS 7.42B]*

(a) To understand the relationship between transferred financial assets that are not derecognised in their entirety and the associated liabilities

And

(b) To evaluate the nature of, and risks associated with, the entity's continuing involvement in derecognised financial assets

The standard specifies detailed disclosure requirements to support objectives (a) and (b) which are discussed below in section 6.2 and section 6.3 respectively. However, these may not be sufficient to meet these objectives, in which case an entity should disclose any additional information, over and above that specified by IFRS 7, that it considers necessary. The entity should decide, in the light of its circumstances, how much additional information it needs to provide to satisfy the information needs of users and how much emphasis it places on different aspects of the additional information. It is necessary to strike a balance between burdening financial statements with excessive detail that may not assist users of financial statements and obscuring information as a result of too much aggregation. *[IFRS 7.42H, IFRS 7.B39]*.

Rather unusually, the standard specifies that these disclosures should be presented in a single note to the financial statements. *[IFRS 7.42A]*. Presumably this is to prevent entities 'hiding' these disclosures by having the detailed information scattered across a number of notes.

These requirements supplement the other requirements of IFRS 7 and apply when an entity transfers financial assets. They apply for all transferred financial assets that are not derecognised, and for any continuing involvement in a transferred asset, that exist at the reporting date, irrespective of when the related transfer occurred. *[IFRS 7.42A]*.

6.1 The meaning of 'transfer'

For the purposes of applying the disclosure requirements in this section, an entity transfers all or a part of a financial asset (the transferred financial asset) if, and only if, it either: *[IFRS 7.42A]*

(a) Transfers the contractual rights to receive the cash flows of that financial asset

Or

(b) Retains the contractual rights to receive the cash flows of that financial asset but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement

The transactions encompassed by (a) should be the same ones that would be regarded as transfers under the derecognition requirements of IFRS 9 (see Chapter 48 at section 3.6.1).

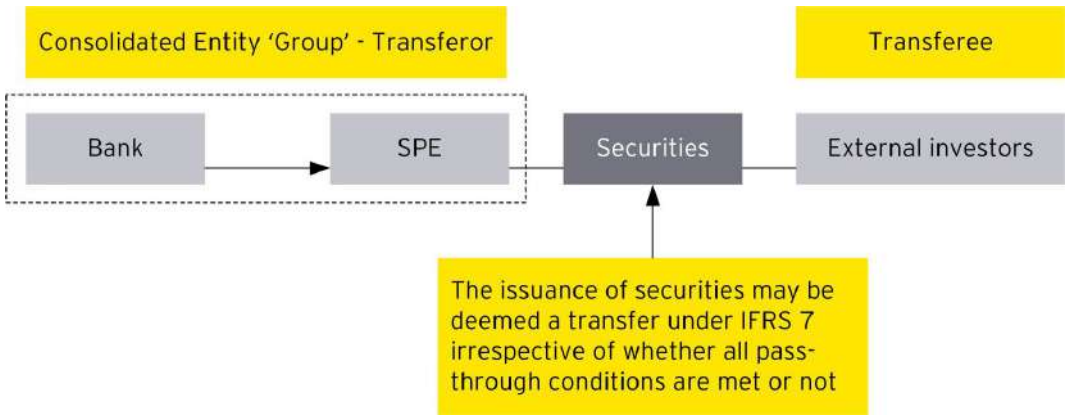
However, the transactions falling within (b) represent a larger group than those which would be regarded as 'pass-through arrangements' under IFRS 9 (see Chapter 48 at section 3.6.2). For instance, an arrangement that does not meet the 'pass-through arrangements' requirements of IFRS 9 could still be considered a transfer under IFRS 7 and therefore be subject to the IFRS 7 disclosure requirements.

6.1.1 Pass-through type arrangements

The following Illustration shows how IFRS 7.42A(b) might be applied to a securitisation of financial assets. *[IFRS 7.42A(b)]*.

Illustration 6-1: Pass-through type transfers

A bank transfers a portfolio of loans to a consolidated special purpose entity (SPE) in exchange for cash and the most junior securities issued by the SPE. The securities issued by the SPE are collateralised by the loan portfolio and the payments due under the securities are contractually linked and dependent on the cash flows from the loan portfolio. The investors do not have recourse to any other assets of the bank and the transfer by the consolidated group to the external investors does not qualify for derecognition. The transferred loans have a carrying amount of CU100 and the securities issued to third parties have a carrying amount of CU80 (net of the junior securities held by the bank of CU20). This raises the question - does the transfer of the portfolio of loans fall within the scope of IFRS 7.42A(b) even though the consolidated group does not pass on all of the cash flows collected from the transferred assets?



A strict reading of IFRS 7.42A(b) may lead to the conclusion that a transfer (for these purposes) has not taken place unless the consolidated group is required to pass through all the cash flows collected from the financial assets. In contrast, an examination of IFRS 9, which contains identical wording to IFRS 7.42A(b) and its Application Guidance and Basis for Conclusions, could be read to indicate that the IASB intended that even an obligation to pay a disproportionate share of the financial assets' cash flows may qualify as a transfer for these purposes. *[IFRS 9.3.2.4(b), IFRS 9.B3.2.7, IFRS 9.BCZ3.21, IFRS 9.BCZ3.22]*.

How we see it

We believe, as a general rule, that when the securities issued have no recourse to the consolidated group beyond the transferred assets, it is more likely that the cash flows would qualify as a transfer for disclosure purposes. In contrast, when the securities issued have recourse to other assets of the consolidated group, it would be reasonable to conclude that the assets represent collateral pledged against the issued securities rather than being considered transferred.

In determining whether a transfer under IFRS 7.42A(b) has taken place in similar circumstances to those set out above, an assessment needs to be made of the degree of contractual linkage between the cash flows due under the securities and the cash flows collected from the assets subject to the transfer. Such an assessment may require significant judgement, considering all the facts and circumstances.

In practice, the facts could be considerably far more complex than Illustration 6-1 above. For example, it is common for SPEs to enter into interest rate/foreign currency swaps with the transferor and/or other external counterparties. Because a swap is a bi-directional derivative (i.e., the cash flows could flow in either direction and therefore, over its life, could be an asset or a liability), the assessment of 'transfer' becomes complicated. In particular, one immediate question arises: what cash flows should be considered for the transfer assessment? Is it only the cash flows coming from the assets that were originally transferred to the SPE? Or is it the collective cash flows of the originally transferred assets and those of the swaps? The answer to this question is particularly relevant for the contractual linkage assessment. If only the cash flows of the original assets transferred to the SPE (i.e., excluding cash flows on the swap(s)) are considered, then the follow up question is whether the existence of the swaps alters the structure of the cash flows such that the cash flows passed on to the note holders could be considered adjusted cash flows (hence, the contractual linkage is deemed modified). In contrast, if the collective cash flows (i.e., those of the originally transferred assets and the swaps) are considered, then the immediate follow up question is what happens when the SPE becomes a net payer of cash on the swaps (i.e., when the swaps flip into a liability)?

If a transaction is not considered to be within the scope of these requirements, the disclosures about collateral discussed in section 4.4.6 above are likely to be applicable.

How we see it

The answers to all of these questions are not straightforward and depend on the specific facts and circumstances. Entities will need to apply significant judgement in these situations.

Reporting entities should disclose the factors considered in making such judgements. In cases where the contractual linkage assessment is not conclusive, reporting entities may find it appropriate to disclose the transaction, for example, in the note disclosure on transfers of financial assets and include a cross-reference to that in the note disclosure on pledged collateral.

Notwithstanding the above, entities could apply a literal reading of the text of IFRS 7.42A(b). In which case, the disclosure requirements of IFRS 7.42D, discussed in section 6.2 below, would not be required. But, since the assets would still be held as collateral against the related liabilities, the requirements in IFRS 7.14 (see in section 4.4.6 above), concerning financial assets pledged as collateral against liabilities, would still apply.

How we see it

We believe, given the over-arching purpose of disclosures about transferred financial assets, taking such a literal view is acceptable only if the nature and carrying amount of the associated liabilities are disclosed and it can be demonstrated that the disclosures in IFRS 7.42D that are not provided are not material to the reader of the financial statements.

6.2 Transferred financial assets that are not derecognised in their entirety

Financial assets may have been transferred in such a way that part or all of the financial assets do not qualify for derecognition. This might occur if:

- The contractual rights to the cash flows have been transferred but substantially all risks and rewards are retained, e.g., a sale and repurchase agreement, so that the assets are not derecognised.
- The rights to the cash flows have been transferred, the risks and rewards partially transferred and control of the assets has been retained so that the assets continue to be recognised to the extent of the entity's continuing involvement.

  Or
- An obligation has been assumed to pay the cash flows from the asset to other parties but in a way that does not meet the 'pass-through' requirements (see Chapter 48 at section 3.6.2).

The following disclosures should be given for each class of transferred financial assets that are not derecognised in their entirety: *[IFRS 7.42D]*

Extract from IFRS 7

Transferred financial assets that are not derecognised in their entirety

42D An entity may have transferred financial assets in such a way that part or all of the transferred financial assets do not qualify for derecognition. To meet the objectives set out in paragraph 42B(a), the entity shall disclose at each reporting date for each class of transferred financial assets that are not derecognised in their entirety:

(a) the nature of the transferred assets.

(b) the nature of the risks and rewards of ownership to which the entity is exposed.

(c) a description of the nature of the relationship between the transferred assets and the associated liabilities, including restrictions arising from the transfer on the reporting entity's use of the transferred assets.

(d) when the counterparty (counterparties) to the associated liabilities has (have) recourse only to the transferred assets, a schedule that sets out the fair value of the transferred assets, the fair value of the associated liabilities and the net position (the difference between the fair value of the transferred assets and the associated liabilities).

(e) when the entity continues to recognise all of the transferred assets, the carrying amounts of the transferred assets and the associated liabilities.

(f) when the entity continues to recognise the assets to the extent of its continuing involvement (see paragraphs 3.2.6(c)(ii) and 3.2.16 of IFRS 9), the total carrying amount of the original assets before the transfer, the carrying amount of the assets that the entity continues to recognise, and the carrying amount of the associated liabilities.

These disclosures should be given at each reporting date at which the entity continues to recognise the transferred financial assets, regardless of when the transfers occurred. *[IFRS 7.B32]*.

The above requirements clearly apply to transfers of entire financial assets where the transferred assets continue to be recognised in their entirety. They also apply to transfers of entire assets where the transferred assets are recognised to the extent of the transferor's continuing involvement.

However, the derecognition criteria in IFRS 9 are sometimes applied to specified parts of a financial asset (or group of similar financial assets). For example, an entity might transfer a proportion of an entire financial asset, such as 50% of all cash flows on a bond. Similarly, it may transfer specified cash flows from a financial asset, such as all the coupon payments or only the principal payment on a bond, commonly known as an interest strip and principal strip respectively. Furthermore, if the derecognition criteria are met, it is possible for the specified parts of the financial asset to be derecognised whilst the remainder of the asset remains on the statement of financial position (see Chapter 48, particularly Chapter 48 at section 3.4). This begs the question of whether the disclosure requirements in this section should be applied to such transfers.

Whilst the financial asset has not been derecognised in its entirety, it will normally be the case that the asset has not been transferred in its entirety either. Therefore, it might seem more appropriate for the disclosure requirements to follow the way in which the derecognition requirements of IFRS 9 have been applied, i.e., they should focus on the specified part of the asset that has been transferred. In this case, the entity will consider that the transaction results in partial derecognition only and will, therefore, disclose the information for the amounts derecognised as required by IFRS 7.42D. *[IFRS 7.42D]*.

Nevertheless, in the absence of specific guidance, we believe the alternative view could be supported where the disclosures would address the entire asset (i.e., inclusive of the portion not transferred). In this case, the entity will conclude that the transfer results in full derecognition and IFRS 7.42E (rather than IFRS 7.42D) will therefore apply. In the absence of specific guidance, an entity should establish an accounting policy that it applies consistently to all transactions. *[IFRS 7.42D, IFRS 7.42E]*.

Illustration 6-2: Calculating the carrying amount of assets transferred in pass through type arrangements

Taking the scenario described in Illustration 6-1 in section 6.1.1 above, if the consolidated group considers that a transfer has taken place and therefore applies the disclosure requirements of IFRS 7.42D, it should disclose the carrying amount of assets transferred as being CU80 with total associated liabilities of CU80, and explain that the associated liabilities have recourse to assets totalling CU100 (i.e., show the effect of the credit enhancement provided by the junior notes). This would be the case if the entity interpreted IFRS 7.42A(b) to mean that a transfer of a portion may qualify as a pass-through transfer, and if the degree of contractual linkage between the securities and the underlying cash flows is deemed to be sufficiently strong.

If, however, the consolidated group concludes that no transfer has taken place and, therefore, it applies the requirements in IFRS 7.14, together with the supplemental information (i.e., the nature and carrying amount of the associated liabilities, as noted earlier) it should disclose the carrying amount of assets pledged as collateral as being CU100 with total associated liabilities of CU80.

How we see it

In our view, these disclosure requirements do not apply where an entity provides non-cash financial assets as collateral to a third party and the transferee's right to control the asset (normally evidenced by its ability to resell or repledge those assets) is conditional on default of the transferor. Instead, the disclosures about collateral set out in section 4.4.6 above would apply.

The following Illustration shows how an entity might meet the quantitative disclosure requirements in IFRS 7.42D(d) and IFRS 7.42D(e) above. *[IFRS 7.IG40B]*.

Illustration 6-3: Quantitative disclosures for transferred assets not fully derecognised

	Financial assets at fair value through profit or loss		Financial assets at amortised cost		Equity investments designated at fair value through OCI
	CU million		CU million		CU million
	Trading assets	Derivatives	Mortgages	Consumer loans	Equity investments
Carrying amount of assets	X	X	X	X	X
Carrying amount of associated liabilities	(X)	(X)	(X)	(X)	(X)
For those liabilities that have recourse only to the transferred assets:					
Fair value of assets	X	X	X	X	X
Fair value of associated liabilities	(X)	(X)	(X)	(X)	(X)
Net position	**X**	**X**	**X**	**X**	**X**

6.3 Transferred financial assets that are derecognised in their entirety

An entity may have transferred financial assets in such a way that they are derecognised in their entirety, but the entity has 'continuing involvement' in those assets. Where this is the case, the additional disclosures set out in section 6.3.4 below should be given. In this context, the term continuing involvement has a different meaning to that used in the derecognition requirements of IFRS 9 (see Chapter 48 at section 5.3), which is discussed in section 6.3.1 below.

In practice, the application of these requirements might be limited given that few transfers with any form of continuing involvement (as that term is used here) will qualify for full derecognition. One example is a transfer of a readily obtainable financial asset subject to a call option that is neither deeply in the money nor deeply out of the money (see Chapter 48 at section 4.2.3), but others could certainly be encountered in practice.

6.3.1 Meaning of continuing involvement

In this context, continuing involvement arises if, as part of the transfer, the entity retains any of the contractual rights or obligations inherent in the transferred financial asset or obtains any new contractual rights or obligations relating to it. *[IFRS 7.42C]*.

For example, a financial asset transferred subject only to either (a) a deeply out of the money put option granted to the transferee, or (b) a deeply out of the money call option retained by the transferor would be derecognised. This is because substantially all the risks and rewards of ownership have been transferred. *[IFRS 9.B3.2.16(g)]*. However, the put or call option would constitute continuing involvement in the asset.

Similarly, a readily obtainable asset transferred subject to a call option that is neither deeply in the money nor deeply out of the money would also be derecognised. This is because the entity has neither transferred nor retained substantially all of the risks and rewards of ownership and has not retained control. *[IFRS 9.B3.2.16(h)]*. However, the call option would constitute continuing involvement in the asset.

The following do not constitute continuing involvement for these purposes: *[IFRS 7.42C]*

(a) Normal representations and warranties relating to fraudulent transfer and concepts of reasonableness, good faith and fair dealings that could invalidate a transfer as a result of legal action

(b) Forward, option and other contracts to reacquire the transferred financial asset for which the contract price (or exercise price) is the fair value of the transferred financial asset

Or

(c) An arrangement whereby an entity retains the contractual rights to receive the cash flows of a financial asset but assumes a contractual obligation to pay the cash flows to one or more entities in a 'pass-through arrangement' (see Chapter 48 at section 3.6.2)

An entity does not have a continuing involvement in a transferred financial asset if, as part of the transfer, it neither retains any of the contractual rights or obligations inherent in the transferred financial asset nor acquires any new contractual rights or obligations relating to the transferred financial asset. Also, an entity does not have continuing involvement in a transferred financial asset if it has neither an interest in the future performance of the transferred financial asset nor a responsibility under any circumstances to make payments in respect of the transferred financial asset in the future. The term 'payment' in this context does not include cash flows of the transferred financial asset that an entity collects and is required to remit to the transferee. *[IFRS 7.B30]*.

When an entity transfers a financial asset, it may retain the right to service that financial asset for a fee, e.g., by entering into a servicing contract. Such a contract should be assessed in accordance with the guidance above to determine whether it gives rise to continuing involvement for the purposes of these disclosures. For example, a servicer will have continuing involvement in the transferred financial asset if the servicing fee is dependent on the amount or timing of the cash flows collected from the transferred financial asset. Similarly, the right to a fixed fee that would not be paid in full as a result of non-performance of the transferred financial asset would also represent continuing involvement. This is because the servicer has an interest in the future performance of the transferred financial asset. Any such assessment is independent of whether the fee to be received is expected to compensate the entity adequately for performing the servicing. *[IFRS 7.B30A]*.

Continuing involvement in a transferred financial asset may result from contractual provisions in the transfer agreement or in a separate agreement with the transferee or a third party entered into in connection with the transfer. *[IFRS 7.B31]*.

An entity might transfer a fixed rate financial asset and, at the same time, enter into an interest rate swap with the transferee that has the same notional amount as the transferred asset. If payments on the swap are not conditional on payments being made on the transferred financial asset and the notional of the swap is not linked to the notional amount of the loan this would not preclude derecognition. *[IFRS 9.B3.2.16(p)]*.

How we see it

In our view, for the purposes of these disclosures, the interest rate swap would not represent continuing involvement in the transferred assets.

6.3.2 Changes to continuing involvement after time of transfer

The following Illustration shows the analysis that an entity would need to follow where subsequent transactions change the extent of continuing involvement.

Illustration 6-4: Changes in continuing involvement

In 20X1, Entity H transfers financial assets into an SPE in exchange for cash and 100 of the total notes issued by the SPE. Repayment of the notes issued by the SPE is dependent on, and linked to, the payments on the underlying assets. Assume the 100 notes acquired are considered sufficiently small compared to the total notes issued by the SPE such that H is considered to have transferred substantially all the risks and rewards, and so the transfer qualifies for full derecognition. Assume also that the SPE is not controlled by entity H or any of its subsidiaries. The notes acquired by H as part of the transfer are disclosed as a form of continuing involvement.

In 20X2, one of H's subsidiaries (Subsidiary A) had bought 300 notes issued by the SPE in an independent transaction of the transfer and entity H later sold the 100 notes it held. This raises the question does the sale of the 100 notes by entity H result in the consolidated group ceasing to have continuing involvement in the transferred assets?

A reporting entity will be considered to have ceased continuing involvement only if the subsequent purchases and sales of notes were not made in contemplation of each other and were independent from the original transfer of financial assets. Whether subsequent sales and purchases are linked to each other, and whether such purchases are independent of the original transfer, is a matter of judgement that needs to be considered taking into account all facts and circumstances.

Now, let's suppose that entity H makes a subsequent purchase of the 300 notes issued by the SPE instead of Subsidiary A, does the answer change?

Additional analysis is required when the subsequent purchases and sales of notes are made by the same legal entity (e.g., entity H in the above Illustration). In such a case, however, an additional question arises as to how the reporting entity would need to account for its continuing involvement. More specifically, does the reporting entity need to be able to track the sold notes to the specific notes that were acquired as part of the original transfer of financial assets before it concludes that its continuing involvement has ceased? (This assumes the entity first concluded that the subsequent purchases and sales of notes were not made in contemplation of each other and were independent from the original transfer of financial assets).

One view is that a reporting entity needs to have a tracking mechanism, enabling it to associate the transferred notes to the specific notes that were acquired as part of the original transfer of financial assets. If tracking is an issue and it cannot be proven that the notes sold subsequently are the same as those originally purchased as part of the transfer, then it cannot be assumed that the continuing involvement has ceased or reduced.

An alternative view is that a reporting entity may adopt a reasonable basis such as first-in, first-out to account for its continuing involvement.

How we see it

In our view, arrangements that are entered into some time after the financial asset was transferred, which were not contemplated at the time of the transfer would not form a part of these disclosure requirements as such a transaction would be considered to be independent. However, if the subsequent transaction was contingent upon or entered into in contemplation of the initial arrangement and, therefore, considered to be linked to the initial transfer, whether the disclosure requirements may apply or not is a matter of judgement that needs to be considered in light of all facts and circumstances. We believe, in the absence of further guidance, an entity must establish an accounting policy that it applies consistently to similar transactions. The accounting policy adopted must be disclosed.

6.3.3 Continuing involvement from a consolidated perspective

The assessment of continuing involvement in a transferred financial asset should be made at the level of the reporting entity. For example, a subsidiary may transfer to an unrelated third party a financial asset in which the parent of the subsidiary has continuing involvement. In the subsidiary's stand-alone financial statements, the parent's involvement should not be included in the assessment of whether the reporting entity (the subsidiary) has continuing involvement in the transferred asset. However, in the parent's consolidated financial statements, its continuing involvement (or that of another member of the group) in a financial asset transferred by its subsidiary would be included in determining whether the group has continuing involvement in the transferred asset. *[IFRS 7.B29]*.

6.3.4 Disclosure requirements

When an entity derecognises transferred financial assets in their entirety but has continuing involvement in those assets, it should disclose, as a minimum, the following for each type of continuing involvement at each reporting date: *[IFRS 7.42E]*

(a) The carrying amount of the assets and liabilities that are recognised in the entity's statement of financial position and represent the entity's continuing involvement in the derecognised financial assets, and the line items in which the carrying amount of those assets and liabilities are recognised

(b) The fair value of the assets and liabilities that represent the entity's continuing involvement in the derecognised financial assets

(c) The amount that best represents the entity's maximum exposure to loss from its continuing involvement in the derecognised financial assets, and information showing how the maximum exposure to loss is determined

(d) The undiscounted cash outflows that would or may be required to repurchase derecognised financial assets (e.g., the strike price in an option agreement) or other amounts payable to the transferee in respect of the transferred assets

If the cash outflow is variable, then the amount disclosed should be based on the conditions that exist at each reporting date.

(e) A maturity analysis of the undiscounted cash outflows that would or may be required to repurchase the derecognised financial assets or other amounts payable to the transferee in respect of the transferred assets, showing the remaining contractual maturities of the entity's continuing involvement

This analysis should distinguish between cash flows that are required to be paid (e.g., forward contracts), cash flows the entity may be required to pay (e.g., written put options) and cash flows the entity might choose to pay (e.g., purchased call options). *[IFRS 7.B34]*.

Entities should use judgement to determine an appropriate number of time bands in preparing the maturity analysis. For example, it might be determined that the following maturity time bands are appropriate: *[IFRS 7.B35]*

(i) Not later than one month

(ii) Later than one month and not later than three months

(iii) Later than three months and not later than six months

(iv) Later than six months and not later than one year

(v) Later than one year and not later than three years

(vi) Later than three years and not later than five years

And

(vii) More than five years

If there is a range of possible maturities, the cash flows should be included on the basis of the earliest date on which the entity can be required or is permitted to pay. *[IFRS 7.B36]*.

And

(f) Qualitative information that explains and supports the quantitative disclosures set out in (a) to (e) above

This should include a description of the derecognised financial assets and the nature and purpose of the continuing involvement retained after transferring those assets. It should also include a description of the risks to which an entity is exposed, including: *[IFRS 7.B37]*

(i) A description of how the entity manages the risk inherent in its continuing involvement in the derecognised financial assets

(ii) Whether the entity is required to bear losses before other parties, and the ranking and amounts of losses borne by parties whose interests rank lower than the entity's interest in the asset (i.e., its continuing involvement in the asset)

And

(iii) A description of any triggers associated with obligations to provide financial support or to repurchase a transferred financial asset

The types of continuing involvement into which these disclosures and those referred to below are analysed should be representative of the entity's exposure to risks. For example, the analysis may be given by type of financial instrument (e.g., guarantees or call options) or by type of transfer (e.g., factoring of receivables, securitisations and securities lending). *[IFRS 7.B33]*.

If an entity has more than one type of continuing involvement in respect of a particular derecognised financial asset the information above may be aggregated and reported under one type of continuing involvement. *[IFRS 7.42F]*.

The following Illustration shows how an entity might meet the quantitative disclosure requirements in (a) to (e) above. *[IFRS 7.IG40B]*.

Illustration 6-5: Quantitative disclosures for transferred assets fully derecognised

	Cash outflows to repurchase transferred (derecognised) assets	**Carrying amount of continuing involvement in statement of financial position**			**Fair value of continuing involvement**		**Maximum exposure to loss**
	CU million	CU million			CU million		CU million
Type of continuing involvement		**Financial assets at fair value through profit or loss**	**Financial assets at fair value through OCI**	**Financial liabilities at fair value through profit or loss**	**Assets**	**Liabilities**	
Written put options	(X)			(X)		(X)	X
Purchased call options	(X)	X			X		X
Securities lending	(X)		X	(X)	X	(X)	X
		X	X	(X)	X	(X)	X

Undiscounted cash flows to repurchase transferred assets

	Maturity of continuing involvement							
	CU million							
Type of continuing involvement	**Total**	**Less than 1 month**	**1-3 Months**	**3-6 Months**	**6 Months to 1 year**	**1-3 Years**	**3-5 Years**	**More than 5 years**
Written put options	X		X	X	X	X		
Purchased call options	X			X	X	X		X
Securities lending	X	X	X					

In addition to the information above, the following must be disclosed for each type of continuing involvement: *[IFRS 7.42G]*

(a) The gain or loss recognised at the date of transfer of the assets

Disclosure should also be given if a gain or loss on derecognition arose because the fair values of the components of the previously recognised asset (i.e., the interest in the asset derecognised and the interest retained by the entity) were different from the fair value of the previously recognised asset as a whole. In that situation, disclosure should be made of whether the fair value measurements included significant inputs that were not based on observable market data. *[IFRS 7.B38]*.

(b) Income and expenses recognised, both in the reporting period and cumulatively, from the entity's continuing involvement in the derecognised financial assets (e.g., fair value changes in derivative instruments)

And

(c) If the total amount of proceeds from transfer activity (that qualifies for derecognition) in a reporting period is not evenly distributed throughout the reporting period (e.g., if a substantial proportion of the total amount of transfer activity takes place in the closing days of a reporting period):

(i) When the greatest transfer activity took place within that reporting period (e.g., the last five days before the end of the reporting period)

(ii) The amount (e.g., related gains or losses) recognised from transfer activity in that part of the reporting period

And

(iii) The total amount of proceeds from transfer activity in that part of the reporting period

This information should be provided for each period for which a statement of comprehensive income is presented. *[IFRS 7.42G]*.

Paragraph 42E(c) of IFRS 7 requires disclosure of the amount that best represents the entity's maximum exposure to loss from its continuing involvement in the derecognised financial assets, together with information showing how the maximum exposure to loss is determined as discussed in (c) above. *[IFRS 7.42E(c)]*. This has led some to question whether an entity can consider its maximum exposure to loss of a written credit derivative to be equal to its gross carrying amount by analogy to IFRS 7.B9 discussed in section 5.3.3 above. The accounting approach to be applied is shown using the Illustration below.

Illustration 6-6: Maximum exposure to loss - written CDSs

An entity transfers a pool of readily obtainable long-term prepayable mortgage-backed securities with significant prepayment risk to a third party. Concurrently, the entity writes a credit default swap referenced to the derecognised assets for the benefit of the transferee. The transfer qualifies for full derecognition on the basis that the entity has not retained substantially all the risks and rewards (i.e., the entity retained credit risk but transferred prepayment risk) and has surrendered control over the transferred assets.

At the end of the current reporting period, the credit derivative has a positive fair value from the perspective of the entity (as the net present value of future premiums is greater than the fair values of the possible credit losses).

The entity cannot consider the maximum exposure to credit loss from the written credit derivative to be equal to the gross carrying amount because, whilst the credit derivative has a positive value at the end of the current period, its value could switch to a significant negative exposure in future. Therefore, in order to meet the disclosure requirement, an entity should disclose the notional amount. Furthermore, the entity needs to disclose, among other things, the events that would trigger the payment under the credit derivative to satisfy the supplemental qualitative information that explain and support the quantitative disclosures, as required by IFRS 7.42E(f).[21]

21 See also IFRS 7.B37 and IFRS 7.BC65L.

7 Presentation on the face of the financial statements and related disclosures

Although it requires certain minimum disclosures, IFRS 7 provides little guidance as to where financial instruments and related gains and losses should be presented on the face of the financial statements nor how such items should be disaggregated. Furthermore, the disclosures required need not always reflect how items are presented on the face of the statements. Therefore, for the time being at least, management must use its judgement in deciding how best to present much of the information relating to financial instruments, taking account of the minimum requirements of IFRS 7 and other related standards such as IAS 1.

7.1 Gains and losses recognised in profit or loss

7.1.1 Presentation on the face of the statement of comprehensive income (or income statement)

The effects of an entity's various activities, transactions and other events (including those relating to financial instruments) differ in frequency, potential for gain or loss and predictability. Accordingly, IAS 1 explains, disclosing the components of financial performance assists in providing an understanding of the financial performance achieved and in making projections of future results. *[IAS 1.86]*.

IAS 1, or, when applied, IFRS 18, prescribes requirements for line items to be included on the face of the statement of comprehensive income (or income statement) which include:

- Revenue, presenting separately interest revenue calculated using the effective interest method *[IAS 1.82(a), IFRS 18.75(a)(i)]*

  The IFRS IC clarified in March 2018 that only interest on financial assets measured at amortised cost or on debt instruments measured at fair value through other comprehensive income should be included in the amount of interest revenue presented separately (subject to the effects of qualifying hedging relationships under IFRS 9 which are discussed in section 4.2.2). In particular, it should not include, for example, interest revenue from financial assets measured at fair value through profit or loss.[22]

  In March 2019, the IFRS IC issued an agenda decision addressing the measurement of revenue arising from the physical settlement of a contract to sell a non-financial asset when that contract is in the scope of IFRS 9 and accounted for at fair value through profit or loss. The IFRS IC concluded that any such revenue should be measured at an amount reflecting the cash price received adjusted by the fair value of the contract at the settlement date - this should equal, or at least approximate, the fair value of the non-financial item delivered at the date of delivery.[23] This is illustrated in Illustration 7-1 below.
- Gains and losses arising from the derecognition of financial assets measured at amortised cost *[IAS 1.82(aa), IFRS 18.75(b)(iii)]*

  In order to determine the amount of this gain or loss, the carrying amount of the financial asset should, in principle, be updated to the date of derecognition. It should, therefore, include a revised estimate of expected credit losses determined as at the date of derecognition. However, as noted in section 3.2 above, considerations of materiality would also need to be taken into account.[24]

  There is no equivalent requirement to present separately gains and losses arising from derecognition of debt instruments measured at fair value through other comprehensive income. However, the amount of such gains and losses should be determined in the same way as for financial assets measured at amortised cost, i.e., by updating expected credit losses to the date of derecognition. *[IFRS 9.5.7.11]*.
- Impairment losses (including reversals of impairment losses or impairment gains) determined in accordance with IFRS 9 *[IAS 1.82(ba), IFRS 18.75(b)(ii)]*

  This will include losses in respect of loan commitments and financial guarantee contracts as well as financial assets.

22 *IFRIC Update*, March 2018, available on the IFRS Foundation's website.

23 *IFRIC Update*, March 2019, available on the IFRS Foundation's website.

24 Transition Resource Group for Impairment of Financial Instruments, *Meeting Summary*: 22 April 2015, IASB, paras. 24 and 25. Available on the IFRS Foundation's website.

Some might argue this line item should also include modification gains or losses, particularly if the reason for the modification was credit related. However, a summary of the April 2015 meeting of the Transition Resource Group for Impairment of Financial Instruments, published on the IASB's website, suggests this would not be appropriate. Instead, it says that if disclosing gains and losses from impairments and modifications on a net basis would provide relevant information (for example, if the reason for the modification was credit-related), this could be dealt with through additional disclosure in the notes.[25]

The summary also says that modification gains and losses should be presented separately if considered appropriate.[26] Consequently, another way in which a net figure could be presented on the face of the income statement involves presenting modification gains and losses (or at least those arising from credit-related events) in a separate line item that is adjacent to the one showing impairment losses and gains, together with a subtotal that includes these two amounts.

Another view is that because modification gains and losses are determined consistently with the effective interest method, they could be presented as a component of interest revenue. However, if the amounts included were material, we would expect separate disclosure of the amounts involved.

It was further noted that the impact of a partial write off would reduce the gross carrying value of the financial asset and, therefore, would change the calculation of the modification gain or loss. For an example of accounting for a partial write-off see Chapter 47 at section 14.1.1, Illustration 14-1.

- Where a financial asset previously measured at amortised cost is reclassified so that it is measured at fair value through profit or loss, any gain or loss arising from a difference between the previous carrying amount and its fair value at the reclassification date *[IAS 1.82(ca), IFRS 18.75(b)(iv)]*
- Where a financial asset previously classified at fair value through other comprehensive income is reclassified as measured at fair value through profit or loss, any cumulative gain or loss previously recognised in other comprehensive income that is reclassified to profit or loss *[IAS 1.82(cb), IFRS 18.75(b)(v)]*

And

- Finance costs *[IAS 1.82(b)]*[27]

The implementation guidance to IFRS 7 explains that this caption includes total interest expense (see section 4.2.2 above) but may also include amounts associated with non-financial liabilities, for example the unwinding of the discount on long-term provisions (see Chapter 27 at section 4.3.5). *[IFRS 7.IG13]*.

The IFRS IC concluded that it is not permissible to present a line item 'net finance costs' (or a similar term) on the face of the statement without showing the finance costs and finance revenue composing it. However, the presentation of finance revenue followed immediately by finance costs and a subtotal, e.g., 'net finance costs', is allowed.[28]

The demand for safe investments can sometimes result in a negative yield on very high-quality financial assets (e.g., certain government bonds or reserve bank deposits). The IFRS IC has considered this phenomenon and, in January 2015, noted that interest resulting from a negative effective interest rate on a financial asset does not meet the definition of interest revenue because it reflects a gross outflow, not a gross inflow, of economic benefits. Consequently, such expenses should not be presented as interest revenue, but in an appropriate expense classification.[29] This might be a separate line item titled, for example, 'financial expenses on liquid short-term assets' or 'other financial expenses' or using another appropriate description. Alternatively, it could be appropriate to include within another expense line, for example, 'other expenses'.

25 Transition Resource Group for Impairment of Financial Instruments, *Meeting Summary*: 22 April 2015, IASB, para. 57(a). Available on the IFRS Foundation's website.

26 Transition Resource Group for Impairment of Financial Instruments, *Meeting Summary*: 22 April 2015, IASB, para. 57(a). Available on the IFRS Foundation's website.

27 IFRS 18 which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted) was issued by the IASB in April 2024. On adoption of IFRS 18 these aspects of IAS 1 are replaced by more specific requirements in paragraphs 59 to 66 of IFRS 18. See Chapter 4 for further details on the requirements of IFRS 18.

28 *IFRIC Update*, October 2004; and *IFRIC Update*, November 2006, available on the IFRS Foundation's website.

29 *IFRIC Update*, January 2015, available on the IFRS Foundation's website.

How we see it

In our view, negative interest expense on financial liabilities measured at amortised cost meets the definition of income. Where it arises in the ordinary course of business, it would be presented as interest revenue calculated using the effective interest method. If it does not arise in the course of an entity's ordinary activities, it should be presented in another income line item.

Illustration 7-1: Physical settlement of sales contract that is accounted for as a derivative financial instrument

On 1 December 20X1, Entity A enters into a contract to sell a commodity for a fixed price of CU100 on 5 January 20X2. The contract is not considered to be for the entity's normal sale requirements and is therefore accounted for as a derivative in accordance with IFRS 9. At inception, the contract is at the money and its fair value is nil.

Entity A's reporting period ends on 31 December 20X1. On that date, the forward price of the commodity has decreased and, as a result, the fair value of the contract has increased by CU10. Entity A presents gains and losses on commodity contracts accounted for as derivatives within other operating income/expense. Therefore, the following journal is recorded for the year ended 31 December 20X1:

Dr	Derivative asset		CU10	
	Cr	Other operating income/expense		CU10

On 5 January 20X2, Entity A settles the contract by delivering the commodity and receiving CU100 in cash. The fair value of the contract has not changed between 31 December 20X1 and 5 January 20X2 and Entity A presents revenue on delivery of the commodity. The carrying value of the commodity delivered, measured at the lower of cost and net realisable value, is CU85. Therefore, Entity A records the following to reflect the settlement:

Dr	Cash		CU100	
	Cr	Derivative asset		CU10
	Cr	Revenue		CU90
Dr	Cost of sales		CU85	
	Cr	Inventory		CU85

Prior to the IFRS IC finalising the agenda decision in March 2019, referred to above, many entities measured revenue recognised in these circumstances at the cash price receivable (CU100 in this Illustration). They would also have reversed the previously recognised gains or losses on the commodity contract, typically in the line item in which those gains or losses were originally recognised (resulting in other operating expenses of CU10 in this Illustration).

The IFRS IC did not address whether this revenue is within the scope of IFRS 15 *Revenue from Contracts with Customers* and hence whether it should be included in the disclosures required by that standard. In practice, many entities do consider this revenue to be within the scope of IFRS 15 and consequently their financial statements do not necessarily distinguish it from other revenue from contracts with customers that is clearly within scope of IFRS 15.

Another matter the agenda decision does not address is when, or in what circumstances, revenue should be recognised when an entity settles such a sales contract by physical delivery. Some entities do not (or do not in all circumstances) recognise revenue but instead present the settlement of the contract on a net basis. If, in this Illustration, Entity A followed such an approach it would not present revenue of CU90 and cost of sales of CU85, but instead show a net gain on settlement of CU5. In practice, many entities (or components of an entity) that do not present revenue on physical settlement of such contracts are broker-traders that measure their inventory at fair value less costs to sell in accordance with IAS 2 *Inventories* in which case there should be no net gain or loss on settlement.

Additional line items, headings and subtotals should be presented on the face of the statement of comprehensive income (or income statement) when such presentation is relevant to an understanding of the elements of an entity's financial performance. Factors that should be considered include materiality and the nature and function of the components of income and expenses. For example, a financial institution may amend the descriptions to provide information that is relevant to the operations of a financial institution. *[IAS 1.85, IAS 1.86]*. This may also be relevant where an entity recognises negative interest on financial assets or financial liabilities.[30]

30 *IFRIC Update*, January 2015, available on the IFRS Foundation's website.

Any additional subtotals presented should: *[IAS 1.85A, IFRS 18.24]*

- Comprise line items made up of amounts recognised and measured in accordance with IFRS
- Be presented and labelled in a manner that makes the line items that constitute the subtotal clear and understandable
- Be consistent from period to period, as required by IAS 1 (see Chapter 3 at section 4.1.4)

  And
- Not be displayed with more prominence than the subtotals and totals required in IFRS for the statement(s) presenting profit or loss and other comprehensive income

The following items should also be disclosed on the face of the statement of comprehensive income (or income statement) as allocations of profit or loss for the period: *[IAS 1.81B(a), IFRS 18.76]*

- Profit or loss attributable to non-controlling interests

  And
- Profit or loss attributable to owners of the parent

7.1.2 Further analysis of gains and losses recognised in profit or loss

As noted in section 4.2.2 above, entities are required to disclose total interest income and total interest expense, calculated using the effective interest method, for financial assets and financial liabilities that are not measured at fair value through profit or loss. Whilst leases are included within the scope of IFRS 7, strictly they are not accounted for using the effective interest method (although for many leases the method prescribed in IFRS 16 results in a very similar treatment). Accordingly, where material, it appears that finance income (charges) arising on leases must be disclosed separately from the interest income (expense) disclosed above. In fact, it will sometimes be appropriate to include such items within the same caption on the face of the statement of comprehensive income (or income statement) and include a sub-analysis in the notes, albeit having regard to the restrictions on what may be presented within the separate line item containing interest revenue calculated using the effective interest method - see section 7.1.1 above.

Dividends classified as an expense (for example, those payable to holders of redeemable preference shares) may be presented either with interest on other liabilities or as a separate item. Such items are subject to the requirements of IAS 1. In some circumstances, because of the differences between interest and dividends with respect to matters such as tax deductibility, it is desirable to disclose them separately in the statement of comprehensive income (or income statement). *[IAS 32.40]*.

The following gains and losses reported in profit or loss should also be disclosed:

- The amount of dividends recognised from equity investments designated at fair value through other comprehensive income, showing separately the amounts arising on investments derecognised during the reporting period and those related to investments held at the end of the reporting period *[IFRS 7.11A(d)]*
- Changes in fair value that relate to instruments measured at fair value through profit or loss (see section 4.2.1 above)

  Little guidance is given on disaggregating gains and losses from instruments classified as at fair value through profit or loss. For example, the components of the change in fair value of a debt instrument can include:

  - Interest accruals
  - Foreign currency retranslation
  - Movements arising from changes in the issuer's credit risk

    And
  - Changes in market interest rates

  An entity is neither required to disaggregate, nor prohibited from disaggregating, these components on the face of the statement of comprehensive income (or income statement) provided the minimum disclosure requirements are met (e.g., see section 4.2 above) and the restrictions on what may be presented within the separate line item containing interest revenue calculated using the effective interest method are followed (see section 7.1.1 above).

How we see it

Given the above, in our view the interest accrual component, say, of a financial liability may be included separately within an interest expense caption or it may be included within the same caption as other components of the gain or loss such as dealing profit. As noted in section 4.1 above, whatever the entity's approach, it must be explained in its accounting policies.

And

- The amount of exchange differences recognised in profit or loss under IAS 21 except for those arising on financial instruments measured at fair value through profit or loss *[IAS 21.52(a)]*

In IAS 1 or, when applied, IFRS 18, it is explained that when items of income and expense are material, their nature and amount are required to be disclosed separately. *[IAS 1.97, IFRS 18.42]*. Circumstances that can give rise to separate disclosure include the disposal of investments *[IAS 1.98(d)]* and the early settlement of liabilities. However, gains and losses must not be reported as extraordinary items, either on the face of the statement of comprehensive income (or income statement) or in the notes. *[IAS 1.87]*.

7.1.3 Offsetting and hedges

IAS 1 or, when applied, IFRS 18, explains that income and expenses must not be offset unless required or permitted by another standard. *[IAS 1.32, IFRS 18.44]*. This is because offsetting detracts from the ability of users to understand fully the transactions, other events and conditions that have occurred and to assess the entity's future cash flows (except where it reflects the substance of the transaction or other event). *[IAS 1.33, IFRS 18.45]*. It goes on to explain that gains and losses on the disposal of non-current investments (such as many debt instruments measured at fair value through other comprehensive income) are reported by deducting the carrying amount of the asset and related selling expenses from the proceeds on disposal rather than showing gross proceeds as revenue. *[IAS 1.34, IFRS 18.B27]*. In the case of debt instruments measured at fair value through other comprehensive income, the profit or loss on disposal will also include any gains and losses that are reclassified from equity. It also explains that gains and losses arising from groups of similar transactions should be reported on a net basis, for example gains and losses arising on financial instruments held for trading or foreign exchange differences. The individual transactions should, however, be reported separately if they are material. *[IAS 1.35, IFRS 18.B28]*.

Whilst IAS 32 prescribes when financial assets and liabilities should be offset in the statement of financial position (see section 7.4.1 below), it contains no guidance on when related income and expenses should be offset. However, IFRS 9 is more prescriptive, specifying the following:

- If a group of hedged items in a cash flow hedge contains no offsetting risk positions and will affect different line items in profit or loss, the gains or losses on the hedging instrument should be apportioned to the line items affected by the hedged items when reclassified to profit or loss.

  This might be the case, for example, if a group of foreign currency expense transactions are hedged for foreign currency risk and those expenses will affect, say, both distribution costs and administrative expenses.

  The basis of apportionment between line items should be systematic and rational and not result in the grossing up of net gains or losses arising from a single hedging instrument. *[IFRS 9.B6.6.13, IFRS 9.B6.6.14]*.
- If a group of hedged items contains offsetting risk positions, i.e., a net position is hedged and the hedged risk affects different line items in profit or loss, the gains or losses on the hedging instrument should be presented in a line separate from those affected by the hedged items. Consequently, the line item relating to the hedged item will remain unaffected by the hedge accounting. *[IFRS 9.6.6.4, IFRS 9.B6.6.13]*.

  This would apply, for example, to a cash flow hedge of a group of foreign currency denominated sales and expenses. The hedging gains or losses would be presented in a line item that is separate from both revenue and the relevant expense line item(s). *[IFRS 9.B6.6.15]*.

  Another example would be a fair value hedge of a net position involving a fixed-rate asset and a fixed-rate liability. Hedge accounting would normally involve recognising the net interest accrual on the interest rate swap in profit or loss. In this case, the net interest accrual should be presented in a line item separate from gross interest revenue and gross interest expense.

  This is to avoid the grossing up of net gains or losses on a single instrument into offsetting gross amounts and recognising them in different line items. *[IFRS 9.B6.6.16]*.

These requirements imply that gains and losses from hedging instruments in other hedging relationships would be presented in the same line item that is affected by the hedged item (at least to the extent the hedge is effective) rather than being shown separately, although this is not explicitly stated in IFRS 9.

7.1.4 Embedded derivatives

IFRS 9 explicitly states that it does not address whether embedded derivatives should be presented separately in the statement of financial position. *[IFRS 9.4.3.4]*. However, the standard is silent about the presentation in profit or loss. In practice, it will depend on the nature of both the hybrid and the host whether related gains and losses are included in the same or separate captions within profit or loss.

For example, a borrowing with commodity-linked coupons that is accounted for as a simple debt host and an embedded commodity derivative might give rise to interest expense and other finance income (or expense), respectively, that would often be reported in separate captions within profit or loss. Alternatively, changes in the fair value of an embedded prepayment option in a host borrowing that is accounted for separately may be included in the same caption within profit or loss as interest expense on the host debt instrument if the value of the option varies largely as a result of change in interest rates.

7.1.5 Entities whose share capital is not equity

Gains and losses related to changes in the carrying amount of a financial liability are recognised as income or expense in profit or loss even when they relate to an instrument that includes a right to the residual interest in the assets of the entity in exchange for cash or another financial asset, such as shares in mutual funds and co-operatives (see Chapter 43 at section 4.6.1). Any gain or loss arising from the remeasurement of such an instrument (including the impact of dividends paid, where appropriate) must be presented separately on the face of the statement of comprehensive income (or income statement) when it is relevant in explaining the entity's performance. *[IAS 32.41]*.

The following Illustration shows a format for a statement of comprehensive income (or income statement) that may be used by entities such as mutual funds that do not have equity as defined in IAS 32, although other formats may be acceptable.

Illustration 7-2: Statement of comprehensive income (or income statement) format for a mutual fund

Statement of comprehensive income (income statement) for the year ended 31 December 20X1 *[IAS 32.IE32]*

	20X1	20X0
	CU	CU
Revenue	2,956	1,718
Expenses (classified by nature or function)	(644)	(614)
Profit from operating activities	2,312	1,104
Finance costs		
- other finance costs	(47)	(47)
- distributions to members	(50)	(50)
Change in net assets attributable to unit holders	2,215	1,007

Although it may not be immediately clear, the final line item in this format is an expense. Therefore, the entity's 'profit or loss' (as that term is used in IAS 1for 20X1 is CU2,312 - CU47 - CU50 - CU2,215 = CUnil.

The next Illustration shows a format for a statement of comprehensive income (or income statement) that may be used by entities whose share capital is not equity as defined in IAS 32 because the entity has an obligation to repay the share capital on demand, for example co-operatives, but which do have some equity (such as other reserves). Again, other formats may be acceptable.

Illustration 7-3: Statement of comprehensive income (income statement) format for a co-operative

Statement of comprehensive income (income statement) for the year ended 31 December 20X1 *[IAS 32.IE33]*

	20X1	20X0
	CU	CU
Revenue	472	498
Expenses (classified by nature or function)	(367)	(396)
Profit from operating activities	105	102
Finance costs		
- other finance costs	(4)	(4)
- distributions to members	(50)	(50)
Change in net assets attributable to members	51	48

In this Illustration, the line item 'Finance costs - distributions to members' is an expense and the final line item appears to be equivalent to 'profit or loss'.

Corresponding statement of financial position formats for both Illustrations are shown in section 7.4.6 below.

7.2 Gains and losses recognised in other comprehensive income

IAS 1 or, when applied, IFRS 18, requires income and expense not recognised within profit or loss to be included in a statement of comprehensive income. *[IAS 1.82A, IFRS 18.88-89]*. Material items of income and expense and gains and losses that result from financial assets and financial liabilities which are included in other comprehensive income are required to be disclosed separately and must include at least the following:

- The amount of gain or loss attributable to changes in a liability's credit risk for those financial liabilities designated as at fair value through profit or loss *[IFRS 7.20(a)(i)]*
- The revaluation gain or loss arising on equity investments designated at fair value through other comprehensive income *[IFRS 7.20(a)(vii)]*

  And
- Revaluation gains or losses arising on debt instruments measured at fair value through other comprehensive income, showing separately: *[IFRS 7.20(a)(viii)]*
  - The amount of gain or loss recognised in other comprehensive income during the period

    And
  - The amount reclassified upon derecognition from accumulated other comprehensive income to profit or loss for the period

The application of hedge accounting can also result in the recognition in other comprehensive income of gains and losses arising on hedging instruments and the reclassification thereof. However, when an entity removes such a gain or loss that was recognised in other comprehensive income and includes it in the initial cost or other carrying amount of a non-financial asset or liability, that should not be regarded as a reclassification adjustment and hence should not affect, or be included within, other comprehensive income. *[IAS 1.96, IFRS 9.BC6.380]*. The following items must also be disclosed on the face of the statement of comprehensive income as allocations of total comprehensive income for the period: *[IAS 1.81B(b), IFRS 18.87]*

- Total comprehensive income attributable to non-controlling interests

  And
- Total comprehensive income attributable to owners of the parent

7.3 Statement of changes in equity

The following information must be included in the statement of changes in equity: *[IAS 1.106(a), IFRS 18.107(a)]*

- Total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent and to non-controlling interests

  And

- For each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing changes resulting from:
  - Profit or loss
  - Other comprehensive income

    And
  - Transactions with owners acting in their capacity as owners, showing separately:
    - Contributions by and distributions to owners

      And
    - Changes in ownership interests in subsidiaries that do not result in a loss of control

An analysis of other comprehensive income by item must be presented for each component of equity, either in the statement or in the notes. *[IAS 1.106A, IFRS 18.109]*.

Where hedge accounting is applied, IFRS 7 specifies additional information that must be presented within the reconciliation and analysis noted above or the notes thereto. This is covered in more detail in section 4.3.3 above.

As noted in section 7.2 above, when an entity applying IFRS 9 removes a gain or loss on a cash flow hedge that was recognised in other comprehensive income in order to include it in the initial cost or other carrying amount of a non-financial asset or liability, that adjustment must not be included within other comprehensive income. *[IFRS 9.BC6.380]*. Such an entry must instead be presented within the statement of changes of equity (because it affects an entity's net assets and hence its equity), albeit separately from other comprehensive income.

The amount of dividends recognised as distributions to owners during the period must be disclosed on the face of the statement of changes in equity or in the notes. *[IAS 1.107, IFRS 18.110]*.

In addition, IAS 32 notes that IAS 1 requires the amount of transaction costs accounted for as a deduction from equity in the period to be disclosed separately.[31] *[IAS 32.39]*.

If an entity reacquires its own equity instruments from related parties, disclosure must be provided in accordance with IAS 24 (see Chapter 33). *[IAS 32.34]*.

If an entity, such as a mutual fund or a co-operative, has no issued equity instruments, it may still need to present a statement of changes in equity. For example, such an entity may have gains or losses arising on debt instruments measured at fair value through other comprehensive income that are recognised in equity; also, co-operatives, for example, may have a balance on equity.

7.4 Statement of financial position

7.4.1 Offsetting financial assets and financial liabilities

It is common for reporting entities to enter into offsetting arrangements with their counterparties. Offsetting arrangements allow market participants to manage counterparty credit risks and manage liquidity risk. In particular, netting arrangements generally reduce the credit risk exposures of market participants to counterparties relative to their gross exposures. Such mechanisms also permit the management of existing market risk exposures by taking on offsetting contracts with the same counterparty rather than assuming additional counterparty risk by entering into an offsetting position with a new counterparty. Furthermore, for a regulated financial institution, position netting may also have regulatory capital implications.

31 IFRS 18 which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted) was issued by the IASB in April 2024. These aspects of IAS 1 are required to be disclosed in line with IFRS 18 and the cross-reference in IAS 32.39 is amended accordingly.

IAS 1 or, when applied, IFRS 18, sets out a general principle that assets and liabilities must not be offset except where such offset is permitted or required by an accounting standard or interpretation (see Chapter 3 at section 4.1.6). *[IAS 1.32, IFRS 18.44]*. This general prohibition on offset is due to the fact that net presentation of assets and liabilities generally does not provide a complete depiction of the assets and liabilities of an entity. In particular, offsetting obscures the existence of some assets and liabilities in the statement of financial position and it impacts key financial ratios such as gearing, and measures such as total assets or liabilities.

IAS 32 provides some exceptions to this general rule in the case of financial assets and liabilities. IAS 32 requires a financial asset and a financial liability to be offset if both criteria under IAS 32 paragraph 42 are met.

Extract from IAS 32

Offsetting a financial asset and a financial liability (see also paragraphs AG38A-AG38F and AG39)

42 A financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position when, and only when, an entity:

(a) currently has a legally enforceable right to set off the recognised amounts; and

(b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

...

These two conditions are often called the IAS 32 Offsetting Criteria. There is, however, one exception to the offsetting requirement. This exception arises when a transferred financial asset does not qualify for derecognition. In such a circumstance, the transferred asset and the associated liability must not be offset, *[IAS 32.42]*, even if they otherwise satisfy the offsetting criteria (see Chapter 48 at section 5.5.1).

IAS 32 argues that offset is appropriate in the circumstances set out in (a) and (b) above because the entity has, in effect, a right to, or an obligation for, only a single net future cash flow and, hence, a single net financial asset or financial liability. In other circumstances, financial assets and financial liabilities are presented separately from each other, consistently with their characteristics as resources or obligations of the entity. *[IAS 32.43]*. Furthermore, the amount resulting from offsetting must also reflect the reporting entity's expected future cash flows from settling two or more separate financial instruments. *[IAS 32.BC94]*.

Offset is not equivalent to derecognition, since offsetting does not result in the financial asset or the financial liability being removed from the statement of financial position, but in net presentation of a net financial asset or a net financial liability. Moreover, no gain or loss can ever arise on offset, but may arise on derecognition. *[IAS 32.44]*.

IAS 32 acknowledges that an enforceable right to set off a financial asset and a financial liability affects the rights and obligations associated with that asset and liability and may affect an entity's exposure to credit and liquidity risk. However, such a right is not, in itself, a sufficient basis for offsetting. The entity may still realise the asset and settle the liability separately and, in the absence of an intention to exercise the right or to settle simultaneously, the amount and timing of an entity's future cash flows are not affected. Similarly, an intention by one or both parties to settle on a net basis without the legal right to do so is not sufficient to justify offsetting because the rights and obligations associated with the individual financial asset and financial liability remain unaltered. *[IAS 32.46, IAS 32.AG38E]*.

IAS 32 elaborates further on the detail of the offsetting criteria as set out in the following subsections.

7.4.1.A Criterion (a): Enforceable legal right of set-off

IAS 32 describes a right of set-off as a debtor's legal right, by contract or otherwise (for example, it may arise as a result of a provision in law or a regulation), to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor. The enforceability of the right of set-off is thus essentially a legal matter, so that the specific conditions supporting the right may vary from one legal jurisdiction to another. *[IAS 32.45]*. Care must, therefore, be taken to establish which laws apply to the relationships between the parties.

In unusual circumstances, a debtor (A) may have a legal right to apply an amount due from a third party (B) against an amount due to a creditor (C), provided that there is an agreement among A, B and C that clearly establishes A's right to set off amounts due from B against those due to C. *[IAS 32.45]*. For example, a foreign branch of a US bank makes a loan to a foreign subsidiary of a US parent with the parent required to deposit an amount equal to the loan in the US bank for the same term. The terms of the transactions may give the bank a legal right to set off the amount due to the parent against the amount owed by the foreign subsidiary. Another example is bank accounts maintained for a group of companies where each member of the group agrees that its credit balance may be the subject of set-off in respect of debit balances of other members of the group. In our experience, not all jurisdictions recognise this type of contractual multilateral set-off arrangement, particularly in bankruptcy scenarios.

A right of set-off may currently be available or it may be contingent on a future event (e.g., the right may be triggered or exercisable only on the occurrence of some future event, such as the default, insolvency or bankruptcy of one of the counterparties). Even if the right of set-off is not contingent on a future event, it may only be legally enforceable in the normal course of business, or in the event of default, or in the event of insolvency or bankruptcy, of one or all of the counterparties. *[IAS 32.AG38A]*.

The revised application guidance makes it clear that, in order for an entity to currently have a legally enforceable right of set-off, the right: *[IAS 32.AG38B]*

- Must not be contingent on a future event

  And

- Must be legally enforceable in all of the following circumstances:
  - The normal course of business
  - The event of default

    And
  - The event of insolvency or bankruptcy of the entity and all of the counterparties

The nature and extent of the right of set-off, including any conditions attached to its exercise and whether it would remain in the event of default or insolvency or bankruptcy, may vary from one legal jurisdiction to another. Consequently, it cannot be assumed that the right of set-off is automatically available outside of the normal course of business. For example, the bankruptcy or insolvency laws of a jurisdiction may prohibit, or restrict, the right of set-off in the event of bankruptcy or insolvency in some circumstances. *[IAS 32.AG38C]*. Therefore, contractual provisions, the laws governing the contract, or the default, insolvency or bankruptcy laws applicable to the parties need to be considered to ascertain whether the right of set-off is enforceable in the circumstances set out above. *[IAS 32.AG38D]*. In assessing whether an agreement meets these conditions, entities will need to make a legal determination, which may involve obtaining legal advice.

The Basis for Conclusions suggests that to meet the criteria for offsetting, these rights must exist for all counterparties. Thus, if one party, including the reporting entity, will not or cannot perform under the contract, the other counterparties will be able to enforce that right to set-off against the party that has defaulted or become insolvent or bankrupt. *[IAS 32.BC80]*. However, the revised application guidance above appears to focus only on whether the rights of the reporting entity are legally enforceable. It is also clear that the above reference to 'all of the counterparties' pertains to the legal enforceability in the circumstances listed (i.e., the normal course of business, the events of default, insolvency or bankruptcy), and not who holds the set-off right.

How we see it

Normally the standard and its application guidance would prevail over the basis for conclusions, and we consider that the IASB's most likely intention, consistent with the wording in the body and application guidance of the standard, was to require only the reporting entity to have a legal right to set off in the circumstances noted above - including, in the event of the reporting entity's own default, insolvency or bankruptcy.

The requirement that a reporting entity must be able to legally enforce a right of set-off in the event of its own bankruptcy means that the counterparty (or counterparties) to a netting agreement must not have the ability to force gross settlement in the event of the reporting entity's default, insolvency or bankruptcy. It also means that the reporting entity may need to obtain legal advice as to whether its legal right to net settle will survive the bankruptcy laws of the jurisdiction in which it is located.

Many contracts give only the non-defaulting party the right to enforce the netting provisions in case of default, insolvency or bankruptcy of any of the parties to the agreement. Unless the insolvency laws in the relevant jurisdiction would force net settlement, such contracts would fail the IAS 32 criteria because the reporting entity cannot enforce such rights of set-off in the event of its own bankruptcy, regardless of the fact that, in practice, it is highly unlikely that the non-defaulting party would insist on gross settlement. In practice, most of these contracts would not achieve offsetting under IAS 32 anyway, because the legal right of set-off available under such contracts is usually not enforceable in the normal course of business. Generally speaking, these contracts are structured this way because entities do not intend to settle net other than in situations of default. In other circumstances, entities need to determine whether the right to enforce net settlement would survive their own bankruptcy.

A right of set-off that can be exercised only upon the occurrence of a future event is often referred to as a 'conditional' right of set-off. For example, an entity may have a right of set-off that is exercisable on changes to particular legislation or change in control of the counterparties. Conditional rights of set-off such as these do not meet the offsetting criteria and, hence, the financial asset and financial liability subject to such rights of set-off would not qualify to be offset.

As the description of a right of set-off itself envisages an amount being due to each party either now or in the future, the passage of time and uncertainties relating to amounts to be paid do not preclude an entity from currently having a legally enforceable right of set-off. The fact that payments subject to a right of set-off will only arise at a future date is not in itself a condition or form of contingency that prevents offsetting. *[IAS 32.BC83]*.

However, if the right of set-off is not exercisable during a period when amounts are due and payable, then the entity does not meet the offsetting criterion as it has no right to set off those payments. Similarly, a right of set-off that could disappear or that would no longer be enforceable after a future event that could take place in the normal course of business or in the event of default, or in the event of insolvency or bankruptcy, such as a ratings downgrade, would not meet the currently (legally enforceable) criterion. *[IAS 32.BC84]*.

Some contracts include representation clauses under which the right to set-off is automatically invalidated if any undertakings or representations in the contract turns out to be incorrect in a material respect.

How we see it

We believe such clauses, as mentioned above, would generally not render the right of set-off a conditional right of set-off.

In certain circumstances, an entity may, in order to exercise its right of set-off, need to unilaterally take a procedural action within its control. For example, an entity may be required to notify the counterparty, in the form of a letter in advance, in order to effect net settlement under the terms of the contract. In some cases, an entity may need to apply to a court to effect set-off when a counterparty becomes bankrupt (as a matter of process), although that right is assured and is upheld in the event of default of a counterparty in that jurisdiction.

How we see it

In our view, the mere fact that such actions, as mentioned above, are needed before an entity can exercise the right of set-off would not make the exercisability of that right contingent on a future event. However, in the latter example above, the probability of favourable or unfavourable judgement from the court would have to be assessed separately as part of the 'legal enforceability' requirement to conclude whether the right of set-off meets the offsetting criteria in IAS 32.

Unlike US GAAP, IAS 32 does not specify a particular level of assurance required to meet the 'legally enforceable' criterion. Instead, it leaves such determination to judgement and consideration of the relevant facts and circumstances. In practice, entities are expected, in their day-to-day business, to obtain reasonable assurance on enforceability of contractual rights as part of prudent risk management regardless of the accounting requirements.

7.4.1.B Master netting agreements

It is common practice for an entity that undertakes a number of financial instrument transactions with a single counterparty to enter into a 'master netting arrangement' with that counterparty. These arrangements are typically used by financial institutions to restrict their exposure to loss in the event of bankruptcy or other events that result in a counterparty being unable to meet its obligations. Such an agreement commonly creates a conditional right of set-off that becomes enforceable, and affects the realisation or settlement of individual financial assets and financial liabilities, only following a specified event of default or in other circumstances not expected to arise in the normal course of business. Entities who enter into such master netting agreements, other than not meeting the legal right of set-off requirement, also typically do not intend to settle net in the normal course of business.

Where an entity has entered into such an agreement, the agreement does not provide the basis for the offset of assets and liabilities unless both offsetting criteria are satisfied. *[IAS 32.50]*. For enforceable master netting arrangements that create a conditional right of set off, this will typically be the case only if the default (or other event specified in the contract) has actually occurred. When financial assets and financial liabilities subject to a master netting arrangement are not offset, the effect of the arrangement falls within the scope of the disclosure requirements of IFRS 7 (see section 7.4.2 below).

7.4.1.C Criterion (b): Intention to settle net or realise the gross amount simultaneously ('the net settlement criterion')

An entity's intention to settle net or settle simultaneously may be demonstrated through its past experience of executing set-off or simultaneous settlement in similar situations, its usual operating practices or by reference to its documented risk policies. Thus, incidental net or simultaneous settlement of a financial asset or financial liability does not meet the criterion above.

The requirement for an intention to settle net or to settle simultaneously is, however, considered only from the reporting entity's perspective.

IAS 32 notes that an entity's intentions with respect to settlement of particular assets and liabilities may be influenced by its normal business practices, the requirements of the financial markets and other circumstances that may limit the ability to settle net or simultaneously. *[IAS 32.47]*. In practice, even though a reporting entity has the right to settle net, it may settle gross either because of lack of appropriate arrangements or systems to effect net settlement or to facilitate operations, which would likely preclude offsetting.

Simultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an organised financial market or a face-to-face exchange. *[IAS 32.48]*. The procedures of the clearing house or exchange may provide that the amount to be paid or received for different products be settled gross. However, such payments may be made simultaneously. Hence, even though the parties may make payment or receive payment separately for different product types, settlement occurs at the same moment and there is exposure only to the net amount.

The standard states that the reference to 'simultaneous' settlement in the conditions for offset above is to be interpreted literally, as applying only to the realisation of a financial asset and settlement of a financial liability at the same moment. *[IAS 32.48]*. For example, the settlement of a financial asset and a financial liability at the same nominal time but in different time zones is not considered to be simultaneous.

Nevertheless, it became apparent to the IASB that there was diversity in practice related to the interpretation of 'simultaneous' settlement in IAS 32. In practice, due to processing constraints, settlement of gross amounts rarely occurs at exactly the same moment, even when using a clearing house or settlement system. Rather, actual settlement takes place over a period of time (e.g., clearing repos and reverse repos in batches during the day). Arguably, therefore, 'simultaneous' is not operational and ignores settlement systems that are established to achieve what is economically equivalent to net settlement. Consequently, IAS 32 has often been interpreted to mean that settlement through a clearing house does meet the simultaneous settlement criterion, even if not occurring at the same moment. The IASB agreed that some, but not all, settlement systems should be seen as equivalent to net settlement and, in order to reduce diversity of accounting treatment, introduced guidance into IAS 32 in December 2011 to clarify how criterion (b) should be assessed in these circumstances. *[IAS 32.BC94-BC100]*.

The amendments explain that if an entity can settle amounts in a manner such that the outcome is, in effect, equivalent to net settlement, the entity will meet the net settlement criterion. This will occur if, and only if, the gross settlement mechanism has features that: (i) eliminate or result in insignificant credit and liquidity risk, and (ii) will process receivables and payables in a single settlement process or cycle. For example, a gross settlement system that has all of the following characteristics would meet the net settlement criterion: *[IAS 32.AG38F]*

Extract from IAS 32

AG38F If an entity can settle amounts in a manner such that the outcome is, in effect, equivalent to net settlement, the entity will meet the net settlement criterion in paragraph 42(b). This will occur if, and only if, the gross settlement mechanism has features that eliminate or result in insignificant credit and liquidity risk, and that will process receivables and payables in a single settlement process or cycle. For example, a gross settlement system that has all of the following characteristics would meet the net settlement criterion in paragraph 42(b):

(a) financial assets and financial liabilities eligible for set-off are submitted at the same point in time for processing;

(b) once the financial assets and financial liabilities are submitted for processing, the parties are committed to fulfil the settlement obligation;

(c) there is no potential for the cash flows arising from the assets and liabilities to change once they have been submitted for processing (unless the processing fails-see (d) below);

(d) assets and liabilities that are collateralised with securities will be settled on a securities transfer or similar system (for example, delivery versus payment), so that if the transfer of securities fails, the processing of the related receivable or payable for which the securities are collateral will also fail (and *vice versa*);

(e) any transactions that fail, as outlined in (d), will be re-entered for processing until they are settled;

(f) settlement is carried out through the same settlement institution (for example, a settlement bank, a central bank or a central securities depository); and

(g) an intraday credit facility is in place that will provide sufficient overdraft amounts to enable the processing of payments at the settlement date for each of the parties, and it is virtually certain that the intraday credit facility will be honoured if called upon.

The IASB deliberately chose the language above so that it was clear that settlement systems established by clearing houses or other central counterparties should not automatically be assumed to meet the net settlement criterion. Conversely, irrespective of the names used in a particular jurisdiction, other settlement systems may meet the net settlement criterion if that system eliminates or results in insignificant credit and liquidity risk and processes receivables and payables in the same settlement process or cycle. *[IAS 32.BC101]*.

7.4.1.D Situations where offset is not normally appropriate

An entity may enter into a number of different financial instruments designed to replicate, as a group, the features of a single financial instrument (such a replication is sometimes referred to as creating a 'synthetic instrument'). For example, if an entity issues floating rate debt and then enters into a 'pay fixed/receive floating' interest rate swap, the combined economic effect is that the entity has issued fixed rate debt.

IAS 32 argues that each of the individual financial instruments that together constitute a 'synthetic instrument':

- Represents a contractual right or obligation with its own terms and conditions
- May be transferred or settled separately

  And
- Is exposed to risks that may differ from those to which the other financial instruments in the 'synthetic instrument' are exposed

Accordingly, when one financial instrument in a 'synthetic instrument' is an asset and another is a liability, they are not offset and presented on an entity's statement of financial position on a net basis unless they meet the offsetting criteria. *[IAS 32.49(a), IAS 32.AG39]*.

Other circumstances where the offsetting criteria are generally not met, and therefore offsetting is usually inappropriate, include: *[IAS 32.49(b), IAS 32.49(c), IAS 32.49(d), IAS 32.49(e)]*

(a) Financial assets and financial liabilities which arise from financial instruments having the same primary risk exposure (e.g., assets and liabilities within a portfolio of forward contracts or other derivative instruments) but involving different counterparties

(b) Financial or other assets that are pledged as collateral for non-recourse financial liabilities (see section 7.4.1.F below)

(c) Financial assets which are set aside in trust by a debtor for the purpose of discharging an obligation without those assets having been accepted by the creditor in settlement of the obligation (e.g., a sinking fund arrangement)

Or

(d) Obligations incurred as a result of events giving rise to losses that are expected to be recovered from a third party by virtue of a claim made under an insurance policy

Derivative assets and liabilities that are not transacted through central clearing systems are very unlikely to qualify for offsetting. For example, it is rare that they will be settled net in the normal course of business and even where associated offsetting agreements exist, they are usually conditional on the default of one of the counterparties.

7.4.1.E Cash pooling arrangements

Groups often use what are commonly known as cash pooling arrangements. Typically, these will involve a number of subsidiaries within a group each having a legally separate bank account with the same bank that may have positive or negative (overdrawn) balances. In many respects, these accounts will be managed on an aggregated basis, for example interest will normally be determined on a notional basis using the net balance of all accounts; similarly, any overdraft limit will normally apply to the net balance.

These arrangements may or may not give the group a legally enforceable right to set off the balances in these accounts. Clearly, if there is no such right the balances must not be offset in the group financial statements. However, where such a right exists and meets criterion (a) (see section 7.4.1.A), the entity should assess whether there is an intention to settle the balances net or simultaneously, i.e., to what extent criterion (b) is met (see section 7.4.1.C).

The IFRS IC considered criterion (b) for a particular cash pooling arrangement where:

- The group instigated regular physical transfers of balances into a single netting account
- Such transfers were not required under the terms of the cash-pooling arrangement and were not performed at the reporting date

And

- At the reporting date, the group expected that its subsidiaries would use their bank accounts before the next net settlement date by placing further cash on deposit or by withdrawing cash to settle other obligations

The IFRS IC observed that the group expects cash movements to take place on individual bank accounts before the next net settlement date because the group expects its subsidiaries to use those bank accounts in their normal course of business. Consequently, to the extent the group did not expect to settle its subsidiaries' period-end account balances on a net basis, it would not be appropriate for the group to assert it had the intention to settle the entire period-end balances on a net basis at the reporting date. Therefore, presenting these balances net would not appropriately reflect the amounts and timings of the expected future cash flows, taking into account the entity's normal business practices.

In other cash-pooling arrangements, a group's expectations regarding how subsidiaries will use their bank accounts before the next net settlement date may be different. Consequently, in those circumstances, the group would be required to apply judgement in determining whether there was an intention to settle on a net basis at the reporting date. The IFRS IC also noted that many different cash pooling arrangements exist in practice and the determination of what constitutes an intention to settle on a net basis would depend on the individual facts and circumstances of each case. The related disclosure requirements (see section 7.4.2 below) should also be considered.[32]

32 *IFRIC Update*, March 2016, available on the IFRS Foundation's website.

7.4.1.F Offsetting collateral amounts

Many central counterparty clearing houses require cash collateral in the form of variation margin to cover the fluctuations in the market value of 'over-the-counter' and exchange-traded derivatives. In 2011, the IASB clarified that the offsetting criteria do not give special consideration to items referred to as 'collateral'. Accordingly, a recognised financial instrument designated as collateral must be set off against the related financial asset or financial liability if, and only if, it meets the offsetting criteria in IAS 32. This might be the case, for instance, if variation margin is used to settle cash flows on derivative contracts. However, the IASB also noted that, if an entity can be required to return or receive back collateral, the entity would not currently have a legally enforceable right of set-off in all relevant circumstances and, therefore, offsetting would not be appropriate. *[IAS 32.BC103]*.

In practice, to set off collateral against related financial assets and liabilities, a reporting entity would also need to assess, among other factors:

(i) Whether the amounts paid or received (however they might be described) actually represent a partial settlement of the amounts due under the derivative contracts (see below)

(ii) Whether the right of offset is legally enforceable in the event of default, insolvency or bankruptcy of either party as well as in the normal course of business

(iii) Whether the right to offset the collateral and the open position is conditional on a future event

(iv) whether the collateral will form part of the actual net settlement of the underlying contracts

And

(v) Whether there is a single process for both the settlement of the underlying contracts and the transfer of the collateral

The analysis of whether payments or receipts, whether described as margin payments or otherwise, are in fact partial settlements of an open derivative position, can require the application of significant judgement, including particularly an assessment of the legal relationship between the clearing member and the clearing house.

Centrally-cleared derivatives can generally be structured and documented as either collateralised-to-market (CTM) or as settled-to-market (STM). The difference between the two types of derivatives is based on the commercial terms used in relation to how counterparty risk arising from movements in the mark to market value of a derivative is managed or settled. The economic cash flows exchanged by counterparties in CTM and STM derivatives would usually be identical (i.e., they include both an initial margin and variation margin amount), however, the difference is the treatment of the variation margin. For a CTM contract, the variation margin transferred is treated as collateral with an equal receivable or payable for a return of the collateral, as the variation margin may be used to settle the derivative contract on close out. For a STM contract, the daily payment or receipt of variation margin is used to settle the daily mark to market movement.

For a STM contract, when the mark to market exposure is settled, this might indicate it is appropriate to regard the variable margin payment as a partial settlement of the derivative resulting in the partial derecognition of the derivative. This situation sometimes occurs with exchange traded futures for which gains and losses on the open position are realised over time as opposed to being accumulated until the final settlement date.

For CTM contracts, the IAS 32 offsetting requirements explained in Section 7.4.1 above would need to be considered to determine whether the cumulative mark to market exposure may be offset against the collateral posted, however, as STM contracts are treated as a partial settlement, there will be nothing to offset.

The accounting outcome for a payment mechanism considered to represent a partial settlement is unlikely to be significantly different from one that is considered to give rise to collateral if the collateral qualifies for offset. However, the regulatory capital consequences can be very different (and the disclosure requirements are different too, see section 7.4.2 below). Consequently, many clearing houses provide their members with a choice of payment mechanisms, one of which is designed to achieve partial settlement and the other the provision of collateral.

7.4.1.G Unit of account

IAS 32 does not specify the 'unit of account' to which the offsetting requirements should be applied. For example, they could be applied to individual financial instruments, such as entire derivative assets or liabilities, or they could be applied to identifiable cash flows arising on those financial instruments. In practice, both approaches are seen with the former being more commonly applied by financial institutions and the latter by energy producers and traders. This diversity became apparent to the IASB during its project that amended IAS 32 in December 2011. Nevertheless, whilst the IASB considered imposing an approach based on individual cash flows (which, on a conceptual level, it favoured), it concluded that the different interpretations applied today do not result in inappropriate application of the offsetting criteria. The Board also concluded that the benefits of amending IAS 32 would not outweigh the costs for preparers. *[IAS 32.BC105-BC111]*. Accordingly, IAS 32 was not amended, thereby allowing this diversity to continue. Reporting entities must establish an accounting policy and apply that policy consistently.

7.4.2 Offsetting financial assets and financial liabilities: disclosure

This section discusses the requirements of IFRS 7 introduced by the IASB in December 2011. These requirements are similar to requirements introduced into US GAAP by the FASB at around the same time and are intended to assist users in identifying major differences between the effects of the IFRS and US GAAP offsetting requirements (without requiring a full reconciliation). *[IAS 32.BC77]*.

7.4.2.A Objective

The objective of these requirements is to disclose information to enable users of financial statements to evaluate the effect or potential effect of netting arrangements, including rights of set-off associated with recognised financial assets and liabilities, on the reporting entity's financial position. *[IFRS 7.13B]*.

To meet this objective, the minimum quantitative disclosure requirements considered in section 7.4.2.C below may need to be supplemented with additional (qualitative) disclosures. Whether such disclosures are necessary will depend on the terms of an entity's enforceable master netting arrangements and related agreements, including the nature of the rights of set-off, and their effect or potential effect on the entity's financial position. *[IFRS 7.B53]*.

7.4.2.B Scope

The disclosure requirements considered in section 7.4.2.C below are applicable not only to all recognised financial instruments that are set off in accordance with IAS 32 (see section 7.4.1 above), but also to recognised financial instruments that are subject to an enforceable master netting arrangement or 'similar agreement' that covers similar financial instruments and transactions, irrespective of whether they are set off in accordance with IAS 32. *[IFRS 7.13A, IFRS 7.B40]*.

In this context, enforceability has two elements: first, enforceability as a matter of law under the governing laws of the contract; and second, consistency with the bankruptcy laws of the jurisdictions where the reporting entity and counterparty are located. The latter is critical since, regardless of the jurisdiction selected to govern the contract, local insolvency laws in an insolvent counterparty's jurisdiction can override contractual terms in the event of insolvency. Determining whether an agreement is enforceable for the purposes of these disclosures may require judgement based on a legal analysis that is sometimes, but not necessarily, based on legal advice.

These 'similar agreements' include, but are not limited to, derivative clearing agreements, global master repurchase agreements, global master securities lending agreements, and any related rights to financial collateral. The 'similar financial instruments and transactions' include, but are not restricted to, derivatives, sale and repurchase agreements, reverse repurchase agreements, securities borrowing and securities lending agreements. However, loans and customer deposits with the same financial institution would not be within the scope of these disclosure requirements, unless they are set off in the statement of financial position; nor would financial instruments that are subject only to a collateral agreement. *[IFRS 7.B41]*.

The scope of equivalent disclosures in US GAAP is restricted to derivatives, repurchase agreements accounted for as collateralised borrowings and reverse repurchase agreements and securities lending and borrowing arrangements. In November 2012, the IASB considered this and effectively confirmed that the scope of IFRS 7 is broader than US GAAP. As a result, trade or other receivables and payables, such as balances with brokers, that are subject to an umbrella netting arrangement (normally where an entity's customer is also a supplier, and *vice versa*), are likely to fall within the scope of these disclosure requirements. Practical example 7-1 (BP p.l.c.) in section 7.4.2.D below illustrates one company's disclosures about receivables and payables in addition to derivatives.

7.4.2.C Disclosure requirements

To meet the objective in section 7.4.2.A above, the standard requires entities to disclose, at the end of the reporting period, in a tabular format unless another format is more appropriate, the following information separately for recognised financial assets and for recognised financial liabilities: *[IFRS 7.13C]*

- The gross amounts of those recognised financial assets and recognised financial liabilities within the scope of the disclosures (see section 7.4.2.B above) [Amount (a)]

  This excludes any amounts recognised as a result of collateral agreements that do not meet the offsetting criteria in IAS 32. Instead, these will be disclosed in Amount (d) (see below). *[IFRS 7.B43]*.
- The amounts that are set off in accordance with the criteria in IAS 32 when determining the net amounts presented in the statement of financial position [Amount (b)]

  These amounts will be disclosed in both the financial asset and financial liability disclosures. However, the amounts disclosed (in, for example, a table) should be limited to the amounts subject to set-off. For example, an entity may have a recognised derivative asset and a recognised derivative liability that meet the offsetting criteria. If the gross amount of the asset is larger than the gross amount of the liability, the financial asset disclosure table will include the entire amount of the derivative asset in Amount (a) and the entire amount of the derivative liability in Amount (b). However, while the financial liability disclosure table will include the entire amount of the derivative liability in Amount (a), it will only include the amount of the derivative asset that is equal to the amount of the derivative liability in Amount (b). *[IFRS 7.B44]*.
- The net amounts presented in the statement of financial position [Amount (c) = Amount (a) - Amount (b)]

  For instruments that are within the scope of these disclosure requirements, but which do not meet the offsetting criteria in IAS 32, the amounts included in Amount (c) would equal the amounts included in Amount (a). *[IFRS 7.B45]*.

  Amount (c) should be reconciled to the individual line-item amounts presented in the statement of financial position. For example, if an entity determines that the aggregation or disaggregation of individual line-item amounts provides more relevant information, it should reconcile the aggregated or disaggregated amounts included in Amount (c) back to the individual line-item amounts presented in the statement of financial position. *[IFRS 7.B46]* IFRS 18, when applied, contains additional guidance for determining when to aggregate or disaggregate information within the financial statements (see Chapter 4 at section 2.2).
- The amounts subject to an enforceable master netting arrangement or similar agreement that are not included in the amounts subject to set-off above [Amount (d)], including:
  - Amounts related to recognised financial instruments that do not meet some or all of the offsetting criteria in IAS 32 [Amount (d)(i)]

    This might include, for example, current rights of set-off where there is no intention to settle the open positions subject to these rights net or simultaneously, or conditional rights of set-off that are enforceable and exercisable only in the event of the default, insolvency or bankruptcy of any of the counterparties. *[IFRS 7.B47]*.

    And
  - Amounts related to financial collateral (including cash collateral) [Amount (d)(ii)]

    The fair value of those financial instruments that have been pledged or received as collateral must be disclosed. To ensure that the disclosures reflect the maximum net exposure to credit risk, the amendments require the amounts disclosed for financial collateral not offset to include actual collateral received, whether recognised or not as well as actual collateral pledged. The amounts disclosed must not relate to any payables or receivables recognised to return or receive back such collateral. *[IFRS 7.B48]*. The amounts disclosed for collateral would exclude non-financial collateral, for instance, land and buildings.

  References to Amounts (a), (b), *et seq.* can be traced through to Illustration 7-4 in section 7.4.2.D below.

  The total amount included in Amount (d) for any instrument is limited to the amount included in Amount (c) for that instrument. *[IFRS 7.13D]*. In other words, an entity takes into account the effects of over-collateralisation by financial instrument, so that, for example, an over-collateralisation on one asset does not make up for an under-collateralisation on another. To do so, it first deducts the amounts included in Amount (d)(i) from the amount included in Amount (c). It then limits the amounts included in Amount (d)(ii) to the remaining amount in Amount (c) for the related financial instrument.

However, if rights to collateral are available to cover multiple contracts with the same counterparty, for example through a cross collateralisation agreement, such rights can be taken into account in arriving at Amount (d)(ii). *[IFRS 7.B49]*.

Entities must provide a description of the rights of set-off associated with the entity's financial instruments included in Amount (d), including the nature and type of those rights. For example, conditional rights would need to be described. For instruments subject to rights of set-off that are not contingent on a future event but that do not meet the remaining criteria in IAS 32, the description should include the reasons why the criteria are not met. For any financial collateral received or pledged, it would be appropriate to disclose the terms of the collateral (such as why the collateral is restricted). *[IFRS 7.13E, IFRS 7.B50]*.

And

- The net amount after deducting Amount (d) from Amount (c) [Amount (e)]

The financial instruments disclosed in accordance with the requirements of paragraph IFRS 7.13C above may be subject to different measurement requirements, for example a payable related to a repurchase agreement may be measured at amortised cost, while a derivative will be measured at fair value. Instruments must be included at their recognised amounts and any resulting measurement differences must be described in the related disclosures. *[IFRS 7.B42]*.

The disclosures may be grouped by type of financial instrument or transaction (e.g., derivatives, repurchase and reverse repurchase agreements or securities borrowing and securities lending agreements). *[IFRS 7.B51]*.

Alternatively, disclosure of Amounts (a) to (c) may be grouped by type of financial instrument with disclosure of Amounts (c) to (e) by counterparty. Amounts that are individually significant in terms of total counterparty amounts must be separately disclosed with the remaining individually insignificant counterparty amounts aggregated into one line item. Names of the counterparties need not be given, although designation of counterparties (Counterparty P, Counterparty Q, Counterparty R, etc.) must remain consistent from year to year for the periods presented to maintain comparability. Qualitative disclosures should be considered so that further information can be given about the types of counterparties. *[IFRS 7.B52]*.

If the above quantitative and qualitative disclosures are included in more than one note to the financial statements, the amendments require the information in the individual notes to be cross-referenced to each other. This is intended to increase the transparency of the disclosures and enhance the value of information. *[IFRS 7.13F]*.

7.4.2.D Offsetting disclosures - illustrative examples

The amendment that introduced the disclosures related to offsetting financial instruments provides the following Illustration showing ways in which an entity might provide the required quantitative disclosures described above. However, these Illustrations do not address all possible ways of applying the disclosure requirements. *[IFRS 7.IG40D]*.

Illustration 7-4: Illustration of offsetting disclosures

Background

An entity has entered into transactions subject to an enforceable master netting arrangement or similar agreement with the following counterparties. The entity has the following recognised financial assets and financial liabilities resulting from those transactions that meet the scope of the disclosure requirements.

Counterparty A:

The entity has a derivative asset (fair value of CU100 million) and a derivative liability (fair value of CU80 million) with Counterparty A that meet the IAS 32 offsetting criteria. Consequently, the gross derivative liability is set off against the gross derivative asset, resulting in the presentation of a net derivative asset of CU20 million in the entity's statement of financial position. Cash collateral has also been received from Counterparty A for a portion of the net derivative asset (CU10 million). The cash collateral of CU10 million does not meet the IAS 32 offsetting criteria, but it can be set off against the net amount of the derivative asset and derivative liability in the case of default and insolvency or bankruptcy, in accordance with an associated collateral arrangement.

Counterparty B:

The entity has a derivative asset (fair value of CU100 million) and a derivative liability (fair value of CU80 million) with Counterparty B that do not meet the IAS 32 offsetting criteria, but which the entity has the right to set off in the case of default and insolvency or bankruptcy. Consequently, the gross amount of the derivative asset (CU100 million) and the gross amount of the derivative liability (CU80 million) are presented separately in the entity's statement of financial position.

Cash collateral has also been received from Counterparty B for the net amount of the derivative asset and derivative liability (CU20 million). The cash collateral of CU20 million does not meet the IAS 32 offsetting criteria, but it can be set off against the net amount of the derivative asset and derivative liability in the case of default and insolvency or bankruptcy, in accordance with an associated collateral arrangement.

Counterparty C:

The entity has entered into a sale and repurchase agreement with Counterparty C that is accounted for as a collateralised borrowing. The carrying amount of the financial assets (bonds) used as collateral and posted by the entity for the transaction is CU79 million and their fair value is CU85 million. The carrying amount of the collateralised borrowing (repo payable) is CU80 million.

The entity has also entered into a reverse sale and repurchase agreement with Counterparty C that is accounted for as a collateralised lending. The fair value of the financial assets (bonds) received as collateral (and not recognised in the entity's statement of financial position) is CU105 million. The carrying amount of the collateralised lending (reverse repo receivable) is CU90 million.

The transactions are subject to a global master repurchase agreement with a right of set-off only in default and insolvency or bankruptcy and, therefore, do not meet the IAS 32 offsetting criteria. Consequently, the related repo payable and repo receivable are presented separately in the entity's statement of financial position.

Illustration of the disclosures by type of financial instrument:

Financial assets subject to offsetting, enforceable master netting arrangements and similar agreements

CU million

As at 31 December 20X1	(a)	(b)	(c)=(a)-(b)	(d)		(e)=(c)-(d)
				Related amounts not set off in the statement of financial position		
	Gross amounts of recognised financial assets	Gross amounts of recognised financial liabilities set off in the statement of financial position	Net amounts of financial assets presented in the statement of financial position	(d)(i), (d)(ii) Financial instruments	(d)(ii) Cash collateral received	Net amount
Description						
Derivatives	200	(80)	120	(80)	(30)	10
Reverse repurchase, securities borrowing and similar agreements	90	-	90	(90)	-	-
Other financial instruments	-	-	-	-	-	-
Total	**290**	**(80)**	**210**	**(170)**	**(30)**	**10**

Financial liabilities subject to offsetting, enforceable master netting arrangements and similar agreements

CU million

As at 31 December 20X1	(a)	(b)	(c)=(a)-(b)	(d)		(e)=(c)-(d)
				Related amounts not set off in the statement of financial position		
	Gross amounts of recognised financial liabilities	Gross amounts of recognised financial assets set off in the statement of financial position	Net amounts of financial liabilities presented in the statement of financial position	(d)(i), (d)(ii) Financial instruments	(d)(ii) Cash collateral pledged	Net amount
Description						
Derivatives	160	(80)	80	(80)	-	-
Repurchase, securities lending and similar agreements	80	-	80	(80)	-	-
Other financial instruments	-	-	-	-	-	-
Total	**240**	**(80)**	**160**	**(160)**	**-**	**-**

Illustration of amounts offset disclosed by type of financial instrument and amounts not offset by counterparty:

Financial assets subject to offsetting, enforceable master netting arrangements and similar agreements

CU million

As at 31 December 20X1	(a)	(b)	(c)=(a)-(b)
	Gross amounts of recognised financial assets	Gross amounts of recognised financial liabilities set off in the statement of financial position	Net amounts of financial assets presented in the statement of financial position
Description			
Derivatives	200	(80)	120
Reverse repurchase, securities borrowing and similar agreements	90	-	90
Other financial instruments	-	-	-
Total	**290**	**(80)**	**210**

Illustration of amounts offset disclosed by type of financial instrument and amounts not offset by counterparty:

Financial assets subject to offsetting, enforceable master netting arrangements and similar agreements

CU million

As at 31 December 20X1	(a)	(b)	(c)=(a)-(b)
	Gross amounts of recognised financial assets	Gross amounts of recognised financial liabilities set off in the statement of financial position	Net amounts of financial assets presented in the statement of financial position
Description			
Derivatives	200	(80)	120
Reverse repurchase, securities borrowing and similar agreements	90	-	90
Other financial instruments	-	-	-
Total	**290**	**(80)**	**210**

Net financial assets subject to enforceable master netting arrangements and similar agreements, by counterparty

CU million

As at 31 December 20X1	(c)	(d)		(e)=(c)-(d)
		Related amounts not set off in the statement of financial position		
	Net amounts of financial assets presented in the statement of financial position	(d)(i), (d)(ii) Financial instruments	(d)(ii) Cash collateral received	Net amount
Counterparty A	20	-	(10)	10
Counterparty B	100	(80)	(20)	-
Counterparty C	90	(90)	-	-
Other	-	-	-	-
Total	**210**	**(170)**	**(30)**	**10**

Financial liabilities subject to offsetting, enforceable master netting arrangements and similar agreements

CU million

As at 31 December 20X1	(a)	(b)	(c)=(a)-(b)
	Gross amounts of recognised financial liabilities	Gross amounts of recognised financial assets set off in the statement of financial position	Net amounts of financial liabilities presented in the statement of financial position
Description			
Derivatives	160	(80)	80
Repurchase, securities lending and similar agreements	80	-	80
Other financial instruments	-	-	-
Total	**240**	**(80)**	**160**

Net financial liabilities subject to enforceable master netting arrangements and similar agreements, by counterparty

CU million

As at 31 December 20X1	(c)	(d)		(e)=(c)-(d)
		Related amounts not set off in the statement of financial position		
	Net amounts of financial liabilities presented in the statement of financial position	(d)(i), (d)(ii) Financial instruments	(d)(ii) Cash collateral pledged	Net amount
Counterparty A	-	-	-	-
Counterparty B	80	(80)	-	-
Counterparty C	80	(80)	-	-
Other	-	-	-	-
Total	**160**	**(160)**	**-**	**-**

BP p.l.c. provides the following disclosures about the extent of its offsetting.

Practical example 7-1: BP p.l.c. (2023) **United Kingdom**

BP Annual Report and Form 20-F 2023 [extract]

Financial statements [extract]

Notes on the financial statements [extract]

29. Financial instruments and financial risk factors [extract]

(b) Credit risk [extract]

...

Financial instruments subject to offsetting, enforceable master netting arrangements and similar agreements

The following table shows the amounts recognized for financial assets and liabilities which are subject to offsetting arrangements on a gross basis, and the amounts offset in the balance sheet.

Amounts which cannot be offset under IFRS, but which could be settled net under the terms of master netting agreements if certain conditions arise, and collateral received or pledged, are also presented in the table to show the total net exposure of the group.

$ million

At 31 December 2023	Gross amounts of recognized financial assets (liabilities)	Amounts set off	Net amounts presented on the balance sheet	Related amounts not set off in the balance sheet: Master netting arrangements	Related amounts not set off in the balance sheet: Cash collateral (received) pledged	Net amount
Derivative assets	**25,188**	**(2,625)**	**22,563**	**(3,436)**	**(1,245)**	**17,882**
Derivative liabilities	**(18,277)**	**2,625**	**(15,652)**	**3,436**	**263**	**(11,953)**
Trade and other receivables	**17,867**	**(7,789)**	**10,078**	**(1,141)**	**(633)**	**8,304**
Trade and other payables	**(16,284)**	**7,789**	**(8,495)**	**1,141**	**44**	**(7,310)**
At 31 December 2022						
Derivative assets	33,199	(8,804)	24,395	(3,988)	(918)	19,489
Derivative liabilities	(34,918)	8,804	(26,114)	3,988	436	(21,690)
Trade and other receivables	17,947	(8,381)	9,566	(1,325)	(224)	8,017
Trade and other payables	(20,671)	8,381	(12,290)	1,325	61	(10,904)

7.4.3 Assets and liabilities

IAS 1 or, when applied, IFRS 18, does not prescribe the order or format in which items are to be presented on the face of the statement of financial position, but states that the following items relating to financial instruments, are sufficiently different in nature or function to warrant separate presentation: *[IAS 1.54, IAS 1.57, IFRS 18.103-104, IFRS 18.106]*

- Trade and other receivables
- Cash and cash equivalents
- Other financial assets
- Trade and other payables
- Provisions

  And
- Other financial liabilities

IAS 1 or, when applied, IFRS 18, does not list the loss allowance in respect of financial assets measured at amortised cost as an amount to be separately presented on the face of the statement;[33] rather, it is an integral part of the amortised cost measurement. *[IAS 1.33, IFRS 18.45]*. However, additional line items, headings and subtotals must be presented on the face of the statement of financial position when the size, nature or function of an item or aggregation of similar items is such that separate presentation is relevant to an understanding of the entity's financial position. Additional line items may also be presented by disaggregating the line items noted above. *[IAS 1.55, IAS 1.57(a), IFRS 18.106]*.

Any additional subtotals presented should: *[IAS 1.55A, IFRS 18.24]*

- Comprise line items made up of amounts recognised and measured in accordance with IFRS
- Be presented and labelled in a manner that makes the line items that constitute the subtotal clear and understandable
- Be consistent from period to period (see Chapter 3 at section 4.1.4)

  And
- Not be displayed with more prominence than the subtotals and totals required in IFRS for the statement of financial position

The judgement on whether additional items are presented separately should be based on an assessment of: *[IAS 1.58, IFRS 18.B109]*

- The nature and liquidity of assets
- The function of assets within the entity

  And
- The amounts, nature and timing of liabilities

The descriptions used and the ordering of items or aggregation of similar items may be amended according to the nature of the entity and its transactions, to provide information that is relevant to an understanding of the entity's financial position. For example, a financial institution may amend the descriptions to provide information that is relevant to the operations of a financial institution. *[IAS 1.57(b), IFRS 18.106]*. Consequently, entities need not necessarily use categorisations that are the same as the measurement categories in IFRS 9, something that was stated explicitly in IAS 39. *[IAS 39(2017).45]*.

However, the use of different measurement bases for different classes of assets suggests that their nature or function differs and, therefore, that they must be presented as separate line items. *[IAS 1.59, IFRS 18.B109]*. For example, financial assets measured at amortised cost would normally be presented separately from debt instruments measured at fair value through other comprehensive income, particularly by a financial institution.

As noted in section 7.1.4 above, IFRS 9 explicitly states that it does not address whether embedded derivatives should be presented separately in the statement of financial position. *[IFRS 9.4.3.4]*. Although the guidance in the previous paragraph suggests that embedded derivatives will often be presented separately on the face of the statement of financial position, this will not always be the case, e.g., for the 'puttable instruments' shown in Illustration 7-6 in section 7.4.6 below, which is based on IAS 32.

33 Transition Resource Group for Impairment of Financial Instruments, *Meeting Summary*: 11 December 2015, IASB, para. 77. Available on the IFRS Foundation's website.

Further sub-classifications of the line items presented must be disclosed, either on the face of the statement of financial position or in the notes, classified in a manner appropriate to the entity's operations. *[IAS 1.77, IFRS 18.42]*. The detail provided in sub-classifications will depend on the size, nature and function of the amounts involved and will vary for each item. For example, receivables could be disaggregated into amounts receivable from trade customers, receivables from related parties and other amounts. Assets included within receivables that are not financial instruments, such as many prepayments, must also be shown separately. *[IAS 1.78(b), IFRS 18.B111(b)]*.

7.4.3.A Supply chain financing and reverse factoring arrangements - introduction

An increasingly common type of arrangement involves the provision of finance linked to the supply of goods or services which can be referred to by a variety of names including 'supply-chain finance', 'supplier finance', and 'structured payable transactions' which, to some extent, reflects the wide variety of such arrangements. One of the more common types of arrangement, often referred to as 'reverse factoring', will typically contain a number of the following features:

- The arrangement involves a purchaser of goods and/or services, a group of its suppliers and a financial intermediary which enter into tri-partite or a series of bilateral agreements.
- The purchaser is often a large, creditworthy entity that uses a number of suppliers, many of which will have a higher credit risk than the purchaser.
- The arrangement is nearly always initiated by the purchaser rather than the supplier.
- The arrangements operate continuously for all future purchases until the arrangement is cancelled.
- They are often put in place in connection with the purchaser attempting to secure extended payment terms from its suppliers.
- The intermediary/service provider is often a financial institution who will normally make available IT systems to facilitate the arrangement (or secure another party to do this).
- The intermediary makes available to suppliers an optional invoice discounting or factoring facility for invoices accepted or agreed by the purchaser, often on terms that enable the supplier to derecognise the receivable.
- The purchaser will commit to pay the invoice on the due date, sometimes by using a payment facility operated by the intermediary which may be called an irrevocable payment undertaking.
- Interest and cross-default terms are included in the supply agreement to protect the intermediary in the event of the purchaser defaulting or missing the payment date.
- Those interest terms will be similar to ones included in most supply agreements, although they are rarely enforced by suppliers.
- The credit risk the intermediary is taking on is that of the purchaser, but it may be able to charge a higher financing cost to the supplier (in the form of the discount) than it would if lending to the supplier directly.

  And
- It can be difficult to determine the overall financing costs of the arrangement, and who bears those costs, especially if the supply involves items for which the pricing is subjective/unobservable.

The primary accounting concern with these types of arrangement is whether the purchaser should present the resulting financial liability as a trade or similar payable or as a debt-like liability. This determination could have a significant impact on the purchaser's financial position, particularly its leverage or gearing ratios. However, as can be seen from the guidance in section 7.4.3 above, and as acknowledged by the IASB, debt is neither defined in, nor required to be disclosed by, IFRS accounting standards. *[IAS 7.BC11]*. In fact, the need for clear disclosure of complex supplier arrangements under IFRS accounting standards is something that has been emphasised by a number of European and US regulators.[34]

34 For example, Press Release 74/14, *FRC urges clarity in the reporting of complex supplier arrangements by retailers and other businesses*, Financial Reporting Council, December 2014. Available on the Financial Reporting Council's website.

More recently, in early 2020, Moody's Investors Service wrote to the IFRS IC highlighting their concerns about the classification and disclosure of liabilities and liquidity risks arising from supply chain financing arrangements such as reverse-factoring and asked the IFRS IC to consider providing guidance.[35] The IFRS IC issued in December 2020 an agenda decision setting out its analysis of:

- How an entity presents liabilities to which reverse factoring arrangements relate (i.e., how it presents liabilities to pay for goods or services received when the related invoices are part of a reverse factoring arrangement)

  And

- What information about reverse factoring arrangements an entity should disclose in its financial statements

The IFRS IC described reverse factoring arrangements simply as ones in which a financial institution agrees to pay amounts an entity owes to the entity's suppliers and the entity agrees to pay the financial institution at a date later than suppliers are paid. It addressed four separate matters, as follows:

(i) Presentation in the statement of financial position

(ii) Derecognition of a financial liability

(iii) Presentation in the statement of cash flows

(iv) Notes to the financial statements

These matters are covered in turn in the sections below.[36]

7.4.3.B Supply chain financing and reverse factoring arrangements - presentation in the statement of financial position

The IFRS IC noted that an entity must present trade and other payables separately from other financial liabilities. *[IAS 1.54, IFRS 18.103-104]*. This is because they are sufficiently different in nature or function from each other to warrant separate presentation. *[IAS 1.57, IFRS 18.106]*. Trade payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier. *[IAS 37.11(a)]*. Some current liabilities, such as trade payables, are part of the working capital used in the entity's normal operating cycle. *[IAS 1.70, IFRS 18.B96]*. Therefore, an entity must present a financial liability as a trade payable only when it:

- Represents a liability to pay for goods or services
- Is invoiced or formally agreed with the supplier

  And

- Is part of the working capital used in the entity's normal operating cycle

An entity must present separately items of a dissimilar nature or function unless they are immaterial. *[IAS 1.29, IFRS 18.42]*. Also, line items must be included in the statement of financial position when the size, nature or function of an item (or aggregation of similar items) is such that separate presentation is relevant to an understanding of the entity's financial position. *[IAS 1.57(a), IFRS 18.106]*. Accordingly, an entity must present:

- Other payables together with trade payables only when those other payables have a similar nature and function to trade payables, for example, when other payables are part of the working capital used in the entity's normal operating cycle

  And

- Liabilities that are part of a reverse factoring arrangement separately when the size, nature or function of those liabilities makes separate presentation relevant to an understanding of the entity's financial position

  In assessing whether to present such liabilities separately (including whether to disaggregate trade and other payables) an entity should consider the amounts, nature and timing of those liabilities. *[IAS 1.55, IAS 1.58(c), IFRS 18.B109]*.

35 Classification and Disclosure of Liabilities and Liquidity Risks Arising from Supply Chain Financing Arrangements, Moody's Investors Service, January 2020.

36 *IFRIC Update*, December 2020, available on the IFRS Foundation's website.

When assessing whether to present liabilities that are part of a reverse factoring arrangement separately an entity might consider factors including, for example:

- Whether additional security is provided as part of the arrangement that would not be provided without the arrangement

  And

- Whether the terms of liabilities that are part of the arrangement are substantially different from the terms of the entity's trade payables that are not part of the arrangement[37]

7.4.3.C Supply chain financing and reverse factoring arrangements - derecognition of a financial liability

The agenda decision explains that an entity should assess whether and when to derecognise a liability that is (or becomes) part of a reverse factoring arrangement by applying the derecognition requirements in IFRS 9 (see Chapter 48 at sections 6.2 and 6.5). If a trade payable to a supplier is derecognised and a new financial liability to a financial institution recognised, the entity should determine how to present that new liability in its statement of financial position by applying IAS 1 as set out in section 7.4.3.B above.[38]

7.4.3.D Supply chain financing and reverse factoring arrangements - presentation in the statement of cash flows

The agenda decision explains that cash flows from a reverse factoring arrangement should be classified as operating or financing. However, this omits the possibility of the cost of goods or services forming part of the cost of an item of property, plant or equipment, or maybe an intangible asset, in which case the cash flow would be classified as either investing or financing.

The IFRS IC observed that the nature of the liabilities that are part of the arrangement may help in determining the nature of the related cash flows as arising from operating or financing activities. For example, if the related liability is considered to be a trade or other payable that is part of the working capital used in the entity's principal revenue-producing activities, payments to settle the liability would be classified as operating (or possibly investing). In contrast, if the related liability is not a trade or other payable because the liability represents borrowings, payments to settle the liability would be classified as financing.

Investing and financing transactions that do not require the use of cash or cash equivalents must be excluded from the statement of cash flows. Consequently, if a cash inflow and cash outflow occur when an invoice is factored as part of a reverse factoring arrangement, those cash flows are presented in the statement of cash flows. If no cash flows are involved the transaction must be disclosed elsewhere in the financial statements in a way that provides all the relevant information about the financing activity (see section 7.4.3.E below). *[IAS 7.43]*.[39]

The treatment of reverse factoring arrangements in the statement of cash flows is discussed further in Chapter 36 at section 4.4.6.

7.4.3.E Supply chain financing and reverse factoring arrangements - notes to the financial statements

The IFRS IC highlighted a number of disclosure requirements that could be relevant for reverse factoring arrangements. Firstly, IAS 7 *Statement of Cash Flows* requires disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes. *[IAS 7.44A]*. This will be relevant if the cash flows for liabilities that are part of a reverse factoring arrangement were, or future cash flows will be, classified as financing.

37 *IFRIC Update*, December 2020, available on the IFRS Foundation's website.

38 *IFRIC Update*, December 2020, available on the IFRS Foundation's website.

39 *IFRIC Update*, December 2020, available on the IFRS Foundation's website.

Next, reverse factoring arrangements will often give rise to liquidity risk because:

- The entity will have concentrated a portion of its liabilities with one financial institution rather than a diverse group of suppliers.

  The entity may also obtain other sources of funding from the financial institution which could increase the risk of the entity having to pay a significant amount, at one time, to one counterparty, especially if it were to encounter any difficulty in meeting its obligations.

  Or

- Some suppliers may have become accustomed to, or reliant on, earlier payment of their trade receivables under the reverse factoring arrangement.

  If the financial institution were to withdraw the reverse factoring arrangement, those suppliers could demand shorter credit terms which could affect the entity's ability to settle liabilities, particularly if the entity were already in financial distress.

In this context, the IFRS IC drew attention to the requirements in IFRS 7, addressed in more detail in section 5.4 above, for an entity to disclose how exposures to risk arising from financial instruments (including liquidity risk) arise, what the entity's objectives, policies and processes are for managing the risk, summary quantitative data about the entity's exposure to liquidity risk at the end of the reporting period (including further information if this data is unrepresentative of the entity's exposure to liquidity risk during the period) and concentrations of risk.

The IFRS IC also observed that an entity must:

- Disclose the judgements that management has made in assessing how to present liabilities and cash flows related to reverse factoring arrangements if those judgements are among the ones that have the most significant effect on the amounts recognised in the financial statements. *[IAS 1.122, IAS 8(2027).27G]*.

  And

- Provide information about reverse factoring arrangements to the extent they have a material effect on an entity's financial statements and such information is relevant to an understanding of those financial statements. *[IAS 1.112, IFRS 18.113]*.

Finally, in this context, the IFRS IC noted that making materiality judgements involves both quantitative and qualitative considerations.[40]

7.4.3.F Supply chain financing and reverse factoring arrangements - amendments to IAS 7 and IFRS 7

In May 2023, the IASB published *Supplier Finance Arrangements - Amendments to IAS 7 and IFRS 7* that will require an entity to provide additional disclosures about its supplier finance arrangements. As explained in section 7.4.3.E above, supplier financing arrangements may give rise to additional liquidity risk by concentrating liabilities with one or a small number of financial institutions rather than a large number of suppliers. Therefore, supplier finance arrangements have been added as an example of other factors that might be relevant to disclose when explaining how an entity manages its liquidity risk, see section 5.4.3, *[IFRS 7.39(c), IFRS 7.B11F]*, and when explaining concentrations of liquidity risk. *[IFRS 7.34(c), IFRS 7.IG18A(a)(iv)]*. The amendments to IAS 7 also require the disclosure of information about an entity's use of supplier finance arrangements and these are discussed at Chapter 36 at section 11.4.

The amendments were effective for annual reporting periods commencing on or after 1 January 2024, albeit with certain transitional relief, and early adoption is permitted. Additional information in relation to scope, disclosures and implementation is set out in Chapter 36 at section 11.4.

40 *IFRIC Update*, June 2020, available on the IFRS Foundation's website.

7.4.4 The distinction between current and non-current assets and liabilities

For entities presenting a statement of financial position that distinguishes between current and non-current assets and liabilities, the requirements of IAS 1 for determining whether items are classified as current or non-current are dealt with in Chapter 3 at sections 3.1.1 to 3.1.4. This section deals with five interpretive issues that have arisen in applying those requirements to financial instruments, some of which have resulted in amendments being made to IAS 1. *[IAS 1.66, IAS 1.69, IFRS 18.99, IFRS 18.100, IFRS 18.101, IFRS 18.102]*.

Extract from IAS 1

66 An entity shall classify an asset as current when:

(a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;

(b) it holds the asset primarily for the purpose of trading;

(c) it expects to realise the asset within twelve months after the reporting period; or

(d) the asset is cash or a cash equivalent (as defined in IAS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

An entity shall classify all other assets as non-current.

69 An entity shall classify a liability as current when:

(a) it expects to settle the liability in its normal operating cycle;

(b) it holds the liability primarily for the purpose of trading;

(c) the liability is due to be settled within twelve months after the reporting period; or

(d) it does not have the right at the end of the reporting period to defer settlement of the liability for at least twelve months after the reporting period.

An entity shall classify all other liabilities as non-current.

Extract from Appendix A of IFRS 9

Held for trading A financial asset or financial liability that:

(a) is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;

(b) on initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or

(c) is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

7.4.4.A Derivatives

IAS 1 or, when applied, IFRS 18, requires assets and liabilities held 'primarily for the purpose of trading' to be classified as current. *[IAS 1.66(b), IAS 1.69(b), IFRS 18.99(b), IFRS 18.101(b)]*. A derivative that is entered into by an entity in order make a gain from short term price fluctuations is an example of an asset or liability held primarily for the purpose of trading.

Where a derivative is not designated as a hedging instrument in an effective hedge, it is classified for measurement purposes by IFRS 9 as held for trading irrespective of the purpose for which it is held (see Chapter 44 at section 3). *[IFRS 9 Appendix A]*. This does not mean that any derivative not designated as a hedging instrument in an effective hedge must always be classified as current because the IFRS 9 classification is for measurement purposes only. *[IAS 1.BC38I]*. Whilst a derivative held primarily for trading purposes must be presented as current regardless of its maturity date, other derivatives must be classified as current or non-current on the basis of their cash flow settlement date(s). Accordingly, derivatives that have cash flow settlements due to occur less than 12 months from the end of the reporting period, or derivatives that have maturities of more than 12 months from the end of the reporting period, but which are expected to be settled within 12 months must be presented as a current asset or liability. Conversely, derivatives that have a maturity of more than twelve months and are expected to be held for more than twelve months after the reporting period and are not held for trading must be presented as non-current assets or liabilities. *[IAS 1.BC38J]*. Settled-to-market derivatives are likely to be presented as current due to their daily settlement mechanism (if they have any fair value to present on the Statement of Financial Position at all).

Derivatives may involve a series of cash flows throughout the duration of the instrument (e.g., interest rate swaps), some may give rise to an exchange of cash flows only at maturity of the instrument (e.g., foreign currency swaps and futures), and others may give rise to daily settlement (e.g., settled-to-market derivatives).

IAS 1 explains that current assets and liabilities include the current portion of non-current financial assets and liabilities suggesting derivatives with staggered payment dates that are not held primarily for the purposes of trading should be split into current and non-current portions. *[IAS 1.68, IAS 1.71, IFRS 18.B95, IFRS 18.B97]*. The IFRS IC and the IASB have considered how to split into current and non-current components the carrying amount of such derivatives, however, have decided not to address this issue. Consequently, entities will need to apply judgement in determining an appropriate split. Entities would apply the same judgement consistently to similar types of derivatives. In most cases an entity might reasonably determine the split based on how a derivative asset will be realised or a derivative liability will be settled. For example, the current component of a five-year interest rate swap with interest payments exchanged quarterly could be determined as the present value of the expected net interest cash flows of the swap for the forthcoming twelve months after the reporting date.[41]

This is illustrated in the example below:

Illustration 7-5: Classification of non-trading derivatives: current vs. non-current

Entity A enters into a loan with quarterly interest payments based on a fixed interest rate, a term of 5 years and annual repayments of principal. To hedge the interest rate risk created by this loan, Entity A also enters into a fixed-floating interest rate swap with the same life, the same notional amount and same timing of cash flows as the loan, however, hedge accounting has not been applied.

The interest rate swap would be classified as held for trading based on the definition in IFRS 9 Appendix A, however, it would be presented as current and non-current based on the requirements of IAS 1.66 and IAS 1.69.

Therefore, the portion of the interest rate swap which is expected to be realised or settled within 12 months would be classified as current with the remainder being classified as non-current.

If the entity had applied hedge accounting, the derivative would be presented in the same way.

If the derivative is an embedded derivative (see Chapter 42 at section 3), the approach to classification as current or non-current may not be the same for each of the following scenarios:

- The host is a non-derivative financial liability but the embedded derivative is presented as a component of the hybrid instrument.
- The host is a non-financial contract or a non-derivative financial liability and the embedded derivative is presented separately to the host

We discuss the approach of each in turn below.

If the derivative is an embedded derivative that is (i) closely related to the host financial liability and is not accounted for separately; (ii) not considered closely related to the host contract but the whole hybrid contract is a financial liability measured at fair value; or (iii) not considered closely related to the host contract, separated for the purposes of measuring the hybrid financial liability, but presented as a measurement adjustment to the host financial liability, the financial liability would be presented as current or non-current based on the requirements of IAS 1.66 and IAS 1.69. The host contract and any cash flows related to the embedded derivative, would be presented as current or non-current based on an assessment of the combined instrument's cash flows and management's intention for entering into the combined instrument.

41 INFORMATION FOR OBSERVERS IFRIC meeting: March 2007, London, Project: *Current or non-current presentation of derivatives that are not designated as hedging instruments in effective hedges (Agenda Paper 9(ii))*, IASB, paras. 14 and 17; and INFORMATION FOR OBSERVERS Board Meeting: 11 March 2008, London, Project: *ED Annual improvements process-Comment analysis,* Subject: *IAS 1 Current/non-current classification of derivatives (Q6) (Agenda paper 8E)*, IASB, para. 12. Available on the IFRS Foundation's website.

If the embedded derivative is not closely related to a host contract and is accounted for separately at fair value, it would be presented as current or non-current based on the requirements of IAS 1.66 and IAS 1.69. The derivative, having been separated from the host contract, is classified and measured separately from the host. However, in most cases, it is not possible to settle or realise an embedded derivative separately from the host contract. In such cases, settlement or realisation will need to be considered in the context of the embedded derivative's link to the host contract, including the identified contractual terms of the embedded derivative and its (imputed) cash flows (see Chapter 42 at Section 5).

There may be situations where a derivative that is not held primarily for the purpose of trading is expected to give rise to net cash inflows within the next 12 months and net cash outflows thereafter (or vice versa). Applying the above approach mechanically could result in a positive current portion and a negative non-current portion, which is difficult to reconcile with the fact that a derivative is normally seen as a single asset or liability and therefore it would not be appropriate to be grossed up in this way.

Notwithstanding the above, some consider that paragraph IAS 1.BC38J supports a basis for classifying a derivative financial instrument that is not held primarily for the purposes of trading wholly as current or non-current on the basis of its ultimate maturity and final expected settlement date. In particular, it says "… a financial liability that is not held [primarily] for trading purposes… should be presented as current or non-current on the basis of its settlement date. For example, derivatives that have a maturity of more than twelve months and are expected to be held for more than twelve months after the reporting period should be presented as non-current assets or liabilities." *[IAS 1.BC38J]*. This approach would also avoid some of the complications mentioned above and, in practice, a degree of diversity is seen, with some entities applying this alternative approach.

7.4.4.B Convertible loans

Where an entity issues convertible bonds that are accounted for as an equity component (i.e., the holders' rights to convert the bonds into a fixed number of the issuer's equity instruments) and a liability component (i.e., the entity's obligation to deliver cash to holders at the maturity date), the issue arises whether the liability component should be classified as current or non-current if the conversion option may be exercised at any time before maturity. The previous version of IAS 1 explained that any terms of a liability which could, at the option of the counterparty, result in its settlement by the issue of equity instruments would not affect its classification. *[IAS 1.69(d)]*. In other words, provided the entity could not be required to settle the liability component in cash within one year, it would be classified as non-current even if the holder could exercise the conversion option (thereby requiring the liability component to be derecognised) within one year.

It has not been clear whether a similar approach could be applied to convertible bonds and similar instruments for which the conversion option is classified as a liability. However, in January 2020, the IASB amended IAS 1 to clarify that the potential settlement of a liability by the issue of equity instruments would affect its classification unless it arises from a counterparty conversion option recognised separately from the liability as an equity component of a compound financial instrument. *[IAS 1.76A, IAS 1.76B, IFRS 18.B107, IFRS 18.B108]*. This amendment, adoption of which was required for periods beginning on or after 1 January 2024, is likely to change some entities' presentation of, for example, convertible bonds that are denominated in a currency other than their functional currency and for which the conversion option is accounted for as an embedded derivative.

7.4.4.C Long-term loans with repayment on demand terms

IAS 1 or, when applied, IFRS 18 requires liabilities for which the entity does not have the right to defer settlement for at least twelve months after the reporting date to be classified as current. *[IAS 1.69(d), IFRS 18.101(d)]*. Some long-term loan agreements, particularly in Hong Kong, contain clauses allowing the lender an absolute right to demand repayment at any time before maturity. Historically, borrowers often approached these clauses in the same way as more conventional covenants because the risk of exercise was considered very low (except in situations that might adversely affect the borrower's ability to repay). Consequently, the clause would result in classification of a loan as current only if such adverse matters relating to the borrower existed at the end of the reporting period.[42]

However, in 2010, the IFRS IC addressed this situation, noting that the requirements of IAS 1 are clear, i.e., such terms always result in the loan being classified as current.[43]

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42 IASB Staff Paper 16, Project: *IAS 1* Presentation of Financial Statements, Topic: *Current/non-current classification of callable term loan*, IFRS IC Meeting, September 2010. Available on the IFRS Foundation's website.

43 *IFRIC Update*, September 2010, available on the IFRS Foundation's website.

7.4.4.D Debt with refinancing or roll over agreements

The previous version of IAS 1 stated that if an entity expects, and has the discretion, to refinance or roll over an obligation for at least twelve months after the reporting period under an existing loan facility, the obligation should be classified as non-current even if it would otherwise be due within a shorter period *[IAS 1.73]* and the IFRS IC and IASB had been considering the circumstances in which this guidance should apply for some time.

One particular area of concern had been the classification of liabilities arising from a short-term commercial paper programme that is backed by a long-term loan facility. In these arrangements: the commercial paper is typically issued for a term of 90 or 180 days; the issuer will normally attempt to issue new instruments to replace those maturing; and a bank (often the sponsor or manager of the scheme) will have provided the entity with a longer-term loan facility that may be drawn down if any issue of commercial paper is under-subscribed. In this situation, *prima facie* the entity has in place an agreement (the loan facility) that can be used to refinance the short-term liability (from the commercial paper) on a long-term basis and might consider classifying the liability arising from commercial paper as non-current.

However, in January 2011 after analysing outreach requests, the IFRS IC noted that there was no charted diversity in practice where an agreement is reached to refinance an existing borrowing with a different lender - here IAS 1.73 is not considered applicable, whatever the terms of the new facility, and the existing borrowing would be classified as current. Therefore, the commercial paper liabilities must be classified as current.[44] In January 2020, the IASB amended IAS 1 to remove the reference in paragraph 73 to 'refinance' and bring the wording of the standard into line with the IFRS IC's view on how it should be (and is being) applied.

7.4.4.E Loan covenants

If an entity does not have the right to defer settlement of the liability for at least twelve months after the reporting period, the liability is reported as current. *[IAS 1.69(d), IFRS 18.101(d)]*. Furthermore, when an entity breaches a provision of a long-term loan arrangement (commonly called a covenant) on or before the end of the reporting period with the effect that the liability becomes payable on demand, the liability is classified as current because, at the end of the reporting period, it does not have the right to defer settlement for at least twelve months after that date. *[IAS 1.74, IFRS 18.B102]*.

The application of these requirements, including in some commonly occurring situations, has sometimes proved challenging. Consequently, the IASB in January 2020 issued amendments to IAS 1, that were intended to clarify when loans with covenants should be classified as current or non-current. However, constituents and, subsequently, the IFRS IC identified potential concerns with these amendments. As a result, in October 2022 the IASB published a further amendment to IAS 1 *Non-current Liabilities with Covenants*, which also deferred the effective date to periods beginning on or after 1 January 2024. These requirements are discussed in more detail in Chapter 3 at section 3.1.4.

7.4.5 Equity

IAS 1 or, when applied, IFRS 18, explains that the face of the statement of financial position must include line items that present the following amounts within equity: *[IAS 1.54(q), IAS 1.54(r), IFRS 18.104]*

- Non-controlling interests, presented within equity

  And

- Issued capital and reserves attributable to owners of the parent

As for assets and liabilities, additional line items, headings and subtotals must be presented on the face of the statement of financial position when such presentation is relevant to an understanding of the entity's financial position and additional line items may also be presented by disaggregating the line items noted above. *[IAS 1.55]*. Further sub-classifications of the line items presented must be disclosed, either on the face of the statement of financial position or in the notes, classified in a manner appropriate to the entity's operations. *[IAS 1.77, IFRS 18.42]*. The detail provided in the sub-classifications will depend on the size, nature and function of the amounts involved and will vary for each item. For example, equity capital and reserves should be disaggregated into various classes, such as paid-in capital, share premium and reserves. *[IAS 1.78(e), IFRS 18.B111(f)]*. A description of the nature and purpose of each reserve within equity must also be provided. *[IAS 1.79(b), IFRS 18.130(b)]*.

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44 *IFRIC Update*, January 2011; and IASB Staff Paper 8, Project: *Work in progress*, Topic: *IAS 1* Presentation of Financial Statements - *current/non-current classification of debt (rollover agreements) - outreach results*, IFRS IC Meeting, January 2011. Available on the IFRS Foundation's website.

For each class of share capital, the following information must be disclosed, either on the face of the statement of financial position or in the notes: *[IAS 1.79(a), IFRS 18.130(a)]*

- The number of shares authorised
- The number of shares issued and fully paid, and issued but not fully paid
- Par value per share, or that the shares have no par value
- A reconciliation of the number of shares outstanding at the beginning and at the end of the period
- The rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital
- Shares in the entity held by the entity or by its subsidiaries (treasury shares *[IAS 32.34]*) or associates

  And
- Shares reserved for issue under options and contracts for the sale of shares, including the terms and amounts

An entity without share capital, such as a partnership or trust, should disclose equivalent information, showing changes during the period in each category of equity interest, and the rights, preferences and restrictions attaching to each category of equity interest, *[IAS 1.80, IFRS 18.131]*, (assuming, of course, it has actually issued instruments that meet the definition of equity).

Where puttable financial instruments and obligations arising on liquidation (see Chapter 43 at section 4.6) are reclassified between financial liabilities and equity, entities are required to disclose the amount reclassified into and out of each category and the timing and reason for that reclassification. *[IAS 1.80A, IFRS 7(2027).19B]*. This requirement was introduced by the amendments to IAS 32 and IAS 1 dealing with the classification of puttable financial instruments and obligations arising on liquidation.

7.4.6 Entities whose share capital is not equity

Continuing Illustration 7-2 and Illustration 7-3 in section 7.1.5 above, the following Illustrations show corresponding statement of financial position formats that may be used by entities such as mutual funds that do not have equity as defined in IAS 32, or entities such as co-operatives whose share capital is not equity as defined in IAS 32 because the entity has an obligation to repay the share capital on demand.

Illustration 7-6: Statement of financial position format for a mutual fund

Statement of financial position at 31 December 20X1 *[IAS 32.IE32]*

	20X1		20X0	
	CU	CU	CU	CU
Non-current assets (classified in accordance with IAS 1)	91,374		78,484	
Total non-current assets		91,374		78,484
Current assets (classified in accordance with IAS 1)	1,422		1,769	
Total current assets		1,422		1,769
Total assets		92,796		80,253
LIABILITIES				
Current liabilities (classified in accordance with IAS 1)	647		66	
Total current liabilities		(647)		(66)
Non-current liabilities excluding net assets attributable to unit holders (classified in accordance with IAS 1)	280		136	
		(280)		(136)
Net assets attributable to unit holders		**91,869**		**80,051**

As for the equivalent income statement format, it may not be immediately clear what the final line item in this format represents. It is, in fact, a liability and, therefore, the entity's 'equity' (as that term is used in IAS 1) at the end of 20X1 is CU92,796 - CU647 - CU280 - CU91,869 = CUnil.

Illustration 7-7: Statement of financial position format for a co-operative

Statement of financial position at 31 December 20X1 *[IAS 32.IE33]*

	20X1		20X0	
	CU	CU	CU	CU
ASSETS				
Non-current assets (classified in accordance with IAS 1)	908		830	
Total non-current assets		908		830
Current assets (classified in accordance with IAS 1)	383		350	
Total current assets		383		350
Total assets		**1,291**		**1,180**
LIABILITIES				
Current liabilities (classified in accordance with IAS 1)	372		338	
Share capital repayable on demand	202		161	
Total current liabilities		(574)		(499)
Total assets less current liabilities		**717**		**681**
Non-current liabilities (classified in accordance with IAS 1)	187		196	
		(187)		(196)
RESERVES*				
Reserves, e.g., revaluation reserve, retained earnings	530		485	
		530		485
		717		**681**
MEMORANDUM NOTE TOTAL MEMBERS' INTERESTS				
Share capital repayable on demand		202		161
Reserves		530		485
		732		**646**

* In this Illustration, the entity has no obligation to deliver a share of its reserves to its members.

The line item 'Share capital repayable on demand' is part of the entity's liabilities and the items within 'Reserves' represent its equity.

Although not required by IAS 1 an entity adopting this type of format for its statement of financial position may choose to present an analysis of movements in (or reconciliation of) total members' interests (often defined as equity plus share capital repayable on demand, perhaps adjusted for other balances with members) if this is considered to provide useful information; this would not remove the need to present a statement of changes in equity.

7.5 Statement of cash flows

The implementation guidance to IFRS 9 acknowledges that the terminology in IAS 7 was not updated to reflect publication of the standard but does explain that the classification of cash flows arising from hedging instruments within the statement of cash flows should be consistent with the classification of these instruments as hedging instruments. In other words, such cash flows are classified as operating, investing or financing activities, on the basis of the classification of the cash flows arising from the hedged item. *[IFRS 9.IG G.2]*.

The classification of cash flows arising from supply chain financing and reverse factoring arrangements has been considered by the IFRS IC. This is discussed in section 7.4.3.D above, alongside other presentation and disclosure aspects of such arrangements.

8 Regulatory considerations

Regulators continue to emphasise the importance of clear and transparent disclosures, particularly in respect of entities' exposure to credit risk and the determination of expected credit loss provisions. For example, the Task Force on Disclosures about Expected Credit Losses sponsored by UK regulators published their third Disclosures on Expected Credit Loss (DECL) report[45] in September 2022, which includes enhancements to recommendations made in their previous report along with illustrative best practice examples to further aid the quality and comparability of disclosures between large UK banks. In addition, ESMA published a report in December 2021 on the application of IFRS 7 and IFRS 9 to banks' expected credit loss disclosures citing room for improvement in the level of compliance, comparability and transparency in disclosures. We expect regulator focus to continue in this area.

Initiatives by other bodies, such as reports and surveys of the Enhanced Disclosure Task Force of the Financial Stability Board (see section 8.1 below) and the Basel Committee on Banking Supervision, may also influence the disclosures provided, particularly by financial institutions, as could other regulatory actions and initiatives.

8.1 Enhanced Disclosure Task Force

The Enhanced Disclosure Task Force ('EDTF') was a private sector group comprising representatives from financial institutions, investors and analysts, credit rating agencies and external auditors. It was formed by the Financial Stability Forum in May 2012 and its objectives included the development of principles for enhanced disclosures about market conditions and risks, including ways to enhance the comparability of those disclosures and identifying those disclosures seen as leading practice.

In October 2012, the EDTF issued its first report - *Enhancing the Risk Disclosures of Banks* - in which seven fundamental principles for achieving enhanced risk disclosures were identified, namely that disclosures should:

- Be clear, balanced and understandable
- Be comprehensive and include all of the bank's key activities and risks
- Present relevant information
- Reflect how the bank manages its risks
- Be consistent over time
- Be comparable among banks

  And
- Be provided on a timely basis

The report also identified 32 detailed recommendations for enhancing risk disclosures, grouped under the following subjects (as well as addressing more general matters):

- Risk governance and risk management strategies/business model
- Capital adequacy and risk-weighted assets
- Liquidity
- Funding
- Market risk
- Credit risk

  And
- Other risks

These were accompanied by illustrative examples as well as observations on, and extracts from, recent reports issued by banks and were followed by three further reports charting the progress of a number of banks in applying the principles and recommendations set out in the first report. The latest of these reports noted that banks should continue to improve their credit risk disclosures. In November 2015, a few months before the EDTF was disbanded having completed its work, it published another report - *Impact of Expected Credit Loss Approaches on Bank Risk Disclosures* - containing guidance for banks in this area.

45 *Recommendations on a comprehensive set of IFRS 9 Expected Credit Loss disclosures*, The Taskforce on Disclosures about Expected Credit Losses, 9 September 2022. Available on the Financial Reporting Council's website.

The aims of the November 2015 guidance were to enhance banks' disclosures, help the market understand the then upcoming change in provisioning based on expected credit losses (whether under IFRS accounting standards or US GAAP) and promote consistency and comparability of disclosures across internationally active banks. It built on the existing fundamental principles and recommendations noted above and addressed the following key areas of user focus:

- Concepts, interpretations, and policies developed to implement the new expected credit loss approaches, including the significant credit deterioration assessment required by IFRS 9
- The specific methodologies and estimation techniques developed
- The impact of moving from an incurred to an expected credit loss approach
- Understanding the dynamics of changes in impairment allowances and their sensitivity to significant assumptions, including those as a result of the application of macro-economic assumptions
- Any changes made to the governance over financial reporting, and how they link with existing governance over other areas including credit risk management and regulatory reporting

  And
- Understanding the differences between the expected credit losses applied in the financial statements and those used in determining regulatory capital

In particular, it contained additional considerations regarding the application of certain of the existing 32 recommendations. Some of these were temporary, addressing the transition to an expected credit loss framework, and some are more permanent which continue to apply following the adoption of the new accounting standards.

Whilst the EDTF is not a standard setter and its recommendations are not mandatory, regulators in a number of countries have strongly encouraged their implementation, and analysts, investors and other stakeholders continue to show an interest in them. Whilst some of the recommended disclosures overlap with those required by IFRS 7, many of them are not included in any other framework or authoritative guidance. Also, although the recommendations are designed for large international banks, they should be equally relevant for other banks that actively access the major public equity or debt markets. Therefore, all major banks should assess the availability and quality of data that are necessary to provide these disclosures and, more generally, the full range of the EDTF disclosures.

9 Effective dates and transitional provisions

IAS 1 was amended by the IASB in January 2020 and October 2022 to clarify the requirements for classifying financial liabilities as current or non-current (see section 7.4.4.B, section 7.4.4.D and section 7.4.4.E above). The amendments are effective for periods commencing on or after 1 January 2024 and must be applied retrospectively in accordance with IAS 8. Earlier application was permitted, although an entity would be required to disclose it had done so. Both sets of amendments should be adopted at the same time. *[IAS 1.139U, IAS 1.139W]*.[46]

In May 2023, the IASB issued amendments to IAS 7 and IFRS 7, that require an entity to provide additional disclosures about its supplier finance arrangements. The amendments are effective for annual reporting periods beginning on or after 1 January 2024. These amendments to IFRS 7 are discussed above in section 5.4.3 and section 7.4.3.F. The amendments to IAS 7 and to IFRS 7 should be applied at the same time.

In April 2024, the IASB issued IFRS 18, the new IFRS accounting standard is a result of the IASB's Primary Financial Statements project, which was aimed at improving comparability and transparency of communication in financial statements. It will replace IAS 1. While several sections will be brought forward from IAS 1, with limited wording changes, IFRS 18 introduces new requirements on presentation within the statement of profit or loss, including specified totals and subtotals. It also requires disclosure of management-defined performance measures and includes new requirements for aggregation and disaggregation of financial information based on the identified 'roles' of the primary financial statements and the notes. These new requirements are expected to impact all reporting entities. Narrow scope amendments have been made to IAS 7 and some requirements previously included within IAS 1 have been moved to IAS 8, which will also be renamed IAS 8 *Basis of Preparation of Financial Statements*. IAS 34 will be amended to require disclosure of management-defined performance measures. Minor consequential amendments to other standards have also been made. IFRS 18, and the amendments to the other standards, is effective for reporting periods beginning on or after 1 January 2027, but earlier application is permitted and must be disclosed. IFRS 18 will apply retrospectively. See Chapter 4 for further details on the transitional provisions and impact on disclosures because of implementing IFRS 18. This chapter addresses a number of requirements of IAS 1 that are relevant to financial instruments. Where those requirements are brought forward into IFRS 18 (or IAS 8)[47] without substantive change, references to IFRS 18 (or IAS 8) have been added. Where those matters have changed, this is footnoted and a cross-reference to Chapter 4 added.

In May 2024, the IASB issued *Amendments to IFRS 9 and IFRS 7, Amendments to the Classification and Measurement of Financial Instruments*. The amendments to IFRS 7 require additional disclosures for financial assets and liabilities with contractual terms that reference a contingent event (including those that are ESG-linked) as discussed in section 4.2.3 above, and equity instruments classified at fair value through other comprehensive income, as discussed in section 4.4.4 above. The amendments to IFRS 9 are addressed in Chapter 44 at section 10. The amendments are effective for periods beginning on or after 1 January 2026, however entities can either early adopt all the amendments at the same time or early adopt only the amendments relating to the classification of financial assets and their related disclosures and apply the other amendments from the effective date. The amendments apply retrospectively with an adjustment to the opening balance of financial assets and financial liabilities, with the cumulative effect as an adjustment to the retained earnings opening balance. Prior periods are not required to be restated and can only be restated without using hindsight.

IFRS 19 *Subsidiaries without Public Accountability: Disclosures* was issued by the IASB in May 2024 to simplify the preparation of financial statements by eligible subsidiaries. Eligible subsidiaries that elect to apply IFRS 19 are allowed to provide reduced disclosures while still applying the recognition, measurement and presentation requirements in other IFRS accounting standards. IFRS 19 contains certain disclosure requirements that are similar to that of IFRS 7 but these have been scaled down in order to achieve the objective of reduced disclosure requirements for eligible subsidiaries. For example, all entities will be required to disclose the inputs, assumptions and estimation techniques used to calculate the loss allowance and explain the changes in the loss allowance and the reason for such change. *[IFRS 19.65-67]*. However, only entities that provide financing to customers as a main business activity as defined by IFRS 18 will need to provide disclosures in relation how significant increase in credit risk is determined and entity's definition of default. *[IFRS 19.68-71]*. IFRS 19 is effective for annual reporting periods beginning on or after 1 January 2027, with earlier application permitted (subject to jurisdictional endorsement). See Chapter 4 at section 7 for further details on IFRS 19, including the relevant eligibility criteria.

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46 IFRS 18 *Presentation and Disclosure in Financial Statements* issued in April 2024 will supersede IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted).

47 IAS 8 '*Basis of Preparation of Financial Statements*' effective for reporting periods beginning on or after 1 January 2027 (with earlier application permitted).

10 Future developments

The IASB has no active project to comprehensively address the presentation and disclosure of financial instruments. However, we can expect to see a gradual evolution of disclosure requirements in the light of practical experience. For example, the IASB performs post-implementation reviews and issues amendments to clarify requirements or add disclosures requirements.

10.1 Post-implementation Review of IFRS 9 Financial Instruments - Impairment

The IASB has now completed its *Post-implementation Review of IFRS 9 Financial Instruments - Impairment*.[48] As part of this review, the IASB requested information on the application of the credit risk disclosures of IFRS 7. The summary report published in July 2024 concluded that the standard works as intended and provides useful information to users of financial instruments and the requirements can be applied consistently. However, further clarification and application guidance is needed in some areas to support greater consistency in application. As a result, the IASB has added to its research pipeline targeted improvements to the disclosure requirements about credit risk which may result in amendments to IFRS 7 in due course. Additionally, the IASB will consider as part of the Amortised Cost Measurement project, potential clarifications and application guidance about assessing whether changes in expected cash flow of a financial asset should be accounted for as a modification or a derecognition and the intersection of the modification requirements with the requirements for purchased or originated credit impaired financial assets. This outcome of this project may result in amendments to IFRS 7.

10.2 Climate-related and Other Uncertainties

In July 2024, the IASB published the Exposure draft *Climate-related and Other Uncertainties in the Financial Statements-Proposed illustrative examples*[49] with comments to be received by 28 November 2024. The IASB proposes to add eight examples to IFRS accounting standards that illustrate how an entity applies the requirements in those standards to report the effects of climate-related and other uncertainties in its financial statements. The proposed examples mostly focus on climate-related uncertainties, but the principles and requirements illustrated apply equally to other types of uncertainties.

One of these proposed examples explains how the requirements in paragraphs 35A to 38 of IFRS 7, discussed in more detail in section 5.3 above, can be approached. In this proposed example, an entity is a financial institution that provides a range of products to various types of customers. As part of its credit risk management practices, the entity considers the effects of climate-related risks on its credit risk exposures (specifically in this example, drought risk for agricultural customers and risk of flooding for loans secured on real estate). Consequently, the entity considers what information to disclose about the effects of climate-related risks on its exposure to credit risk. For example, an entity might disclose the following:

- An explanation of the entity's credit risk management practices related to climate-related risks and how those practices relate to expected credit losses. In particular, how climate-related risks affect:
  - Determination of whether the credit risk on these financial instruments has increased significantly since initial recognition

    And
  - The grouping of instruments if expected credit losses are measured on a collective basis.
- An explanation of how climate-related risks were incorporated in the inputs, assumptions and estimation techniques used to measure the expected credit loss in Section 5.5 of IFRS 9. For example, an entity may disclose:
  - How climate-related risks were incorporated in the inputs for determining expected credit losses such as the probabilities of default and loss given at default
  - How forward-looking information about climate-related risks was incorporated into the determination of expected credit losses

    And
  - Any changes made to its estimation techniques or significant assumptions to reflect climate-related risks and the reasons for those changes.

48 Post Implementation Review IFRS 9 Financial Instruments Impairment July 2024. Available on the IFRS Foundation's website.

49 Exposure draft climate-related and other uncertainties in the Financial Statements

- Information about collateral held as security and other credit enhancements, including information about properties held as collateral that are subject to flood risk and whether that risk is insured.
- Information about concentrations of climate-related risk.

No effective date or transition requirements are proposed as materials accompanying IFRS accounting standards, including illustrative examples, are not an integral part of those standards.

10.3 Financial Instruments with Characteristics of Equity

In November 2023, the IASB published an Exposure Draft *Financial Instruments with Characteristics of Equity* - proposed amendments to IAS 32 *Financial Instruments: Presentation*, IFRS 7: *Financial Instruments: Disclosures* and IAS 1 *Presentation of Financial Statements*. The comment period ended on 29 March 2024. The exposure draft proposes enhanced presentation and disclosure requirements for financial liabilities and equity instruments and aims to improve the information provided about features of financial liabilities and equity instruments that would not otherwise be apparent from their classification. The exposure draft therefore proposes to expand the objectives of IFRS 7 to also provide information on how the entity is financed, its capital resources and its ownership structure, including potential dilution of the ownership structure from financial instruments issued at the reporting date. The proposed amendments include significant additions to the existing IFRS 7 disclosure requirements. At the time of writing, the IASB is in the process of discussing the detailed feedback gathered from comment letters and outreach meetings with users of financial statements on the exposure draft. It is currently planned that the final amendments will be issued in 2026. See Chapter 43 at section 12.9 for further details and the tentative decisions reached by the IASB.

10.4 Contracts for Renewable Electricity

In May 2024, the IASB published *Contracts for Renewable Electricity*, an exposure draft proposing amendments to IFRS 9 and IFRS 7.[50] The proposals primarily address when such contracts are accounted for as executory contracts or as financial instruments within the scope of IFRS 9 and would make it easier for any such contracts that are within the scope of IFRS 9 to be designated as hedging instruments. In addition, the proposals would at the same time introduce a number of disclosure requirements into IFRS 7 designed to enable investors to understand the effects of these contracts on an entity's financial performance and the timing and uncertainty of the entity's future cash flows. Specifically, an entity would disclose:

- The terms and conditions of the contracts. Examples of terms and conditions include the remaining contract duration and the type of pricing
- For contracts for renewable electricity that are not measured at fair value through profit or loss, either:
  - The fair value of the contracts at the reporting date

    Or
  - The volume of renewable electricity a seller expects to sell, or a purchaser expects to purchase, over the remaining duration of the contracts. An entity is permitted to provide this information as a range for each of the following periods: not later than one year; later than one year and not later than five years; and later than five years.

For sellers and purchasers of renewable electricity, the proposals include a specific requirement to disclose the proportion of renewable electricity covered by the contracts to the total electricity sold or purchased during the period.

At the time of writing, the IASB were hoping to finalise any amendments by the end of 2024, with the new requirements to be available for companies to apply as soon as possible thereafter.

More detailed information about the proposals can be found in Chapter 41 at section 3.3.7 including scoping criteria and amendments to the own use exception. Furthermore, Chapter 49 at section 3.2.6.A contains details on applying hedge accounting to power purchase agreements and virtual power purchase agreements. The IFRS 7 disclosure amendments must be applied when the IFRS 9 amendments are applied.

50 IFRS - IASB proposes amendments for renewable electricity contracts

10.5 Dynamic Risk Management Project

The IASB has for many years had on its agenda a project in relation to Dynamic Risk Management, that aims to comprehensively address the application of hedge accounting to macro hedges (also known as portfolio hedging), and this is discussed in more detail in Chapter 49 at section 10. At the time of writing, the IASB plans to issue an exposure draft by the middle of 2025 and we expect the exposure draft to propose adding a number of related disclosure requirements to IFRS 7.

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Appendix B - Defined terms

Extract from IFRS standards - Definitions	
12-month expected credit losses	The portion of **lifetime expected credit losses** that represent the **expected credit losses** that result from default events on a financial instrument that are possible within the 12 months after the reporting date. *[IFRS 9 Appendix A]*.
amortised cost of a financial asset or financial liability	The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any **loss allowance**. *[IFRS 9 Appendix A]*.
contract assets	Those rights that IFRS 15 *Revenue from Contracts with Customers* specifies are accounted for in accordance with this Standard for the purposes of recognising and measuring impairment gains or losses. *[IFRS 9 Appendix A]*.
credit-adjusted effective interest rate	The rate that exactly discounts the estimated future cash payments or receipts through the expected life of the financial asset to the **amortised cost of a financial asset** that is a **purchased or originated credit-impaired financial asset**. When calculating the credit-adjusted effective interest rate, an entity shall estimate the expected cash flows by considering all contractual terms of the financial asset (for example, prepayment, extension, call and similar options) and **expected credit losses**. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1-B5.4.3), **transaction costs**, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the remaining life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments). *[IFRS 9 Appendix A]*.
credit-impaired financial asset	A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired include observable data about the following events: (a) significant financial difficulty of the issuer or the borrower; (b) a breach of contract, such as a default or **past due** event; (c) the lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider; (d) it is becoming probable that the borrower will enter bankruptcy or other financial reorganisation; (e) the disappearance of an active market for that financial asset because of financial difficulties; or (f) the purchase or origination of a financial asset at a deep discount that reflects the incurred **credit losses**. It may not be possible to identify a single discrete event- instead, the combined effect of several events may have caused financial assets to become credit-impaired. *[IFRS 9 Appendix A]*.

credit loss	The difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e. all cash shortfalls), discounted at the original **effective interest rate** (or **credit-adjusted effective interest rate** for **purchased or originated credit-impaired financial assets**). An entity shall estimate cash flows by considering all contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) through the expected life of that financial instrument. The cash flows that are considered shall include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms. There is a presumption that the expected life of a financial instrument can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the expected life of a financial instrument, the entity shall use the remaining contractual term of the financial instrument. *[IFRS 9 Appendix A]*.
credit risk	The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. *[IFRS 7 Appendix A]*.
credit risk rating grades	Rating of credit risk based on the risk of a default occurring on the financial instrument. *[IFRS 7 Appendix A]*.
currency risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. *[IFRS 7 Appendix A]*.
derecognition	The removal of a previously recognised financial asset or financial liability from an entity's statement of financial position. *[IFRS 9 Appendix A]*.
derivative	A financial instrument or other contract within the scope of this Standard with all three of the following characteristics. (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying'). (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. (c) it is settled at a future date. *[IFRS 9 Appendix A]*.
dividends	Distributions of profits to holders of equity instruments in proportion to their holdings of a particular class of capital. *[IFRS 9 Appendix A]*.
effective interest method	The method that is used in the calculation of the **amortised cost of a financial asset or a financial liability** and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period. *[IFRS 9 Appendix A]*.

effective interest rate	The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the **gross carrying amount of a financial asset** or to the **amortised cost of a financial liability**. When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the **expected credit losses**. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1-B5.4.3), **transaction costs**, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments). *[IFRS 9 Appendix A]*.
equity instrument	**An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.** *[IAS 32.11]*.
expected credit losses	The weighted average of **credit losses** with the respective risks of a default occurring as the weights. *[IFRS 9 Appendix A]*.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. *[IFRS 13 Appendix A]*.
financial asset	**A *financial asset* is any asset that is:** **(a) cash;** **(b) an equity instrument of another entity;** **(c) a contractual right:** **(i) to receive cash or another financial asset from another entity; or** **(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or** **(d) a contract that will or may be settled in the entity's own equity instruments and is:** **(i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or** **(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.** **For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.** *[IAS 32.11]*.

financial guarantee contract	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. *[IFRS 9 Appendix A]*.
financial instrument	**A *financial instrument* is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.** *[IAS 32.11]*.
financial liability	**A *financial liability* is any liability that is:** **(a) a contractual obligation:** **(i) to deliver cash or another financial asset to another entity; or** **(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or** **(b) a contract that will or may be settled in the entity's own equity instruments and is:** **(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or** **(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.** **As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D.** *[IAS 32.11]*.
financial liability at fair value through profit or loss	A financial liability that meets one of the following conditions: (a) it meets the definition of **held for trading**. (b) upon initial recognition it is designated by the entity as at fair value through profit or loss in accordance with paragraph 4.2.2 or 4.3.5. (c) it is designated either upon initial recognition or subsequently as at fair value through profit or loss in accordance with paragraph 6.7.1. *[IFRS 9 Appendix A]*.
firm commitment	A binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates. *[IFRS 9 Appendix A]*.
forecast transaction	An uncommitted but anticipated future transaction. *[IFRS 9 Appendix A]*.
gross carrying amount of a financial asset	The **amortised cost of a financial asset**, before adjusting for any **loss allowance**. *[IFRS 9 Appendix A]*.

hedge ratio	The relationship between the quantity of the hedging instrument and the quantity of the hedged item in terms of their relative weighting. *[IFRS 9 Appendix A]*.
held for trading	A financial asset or financial liability that: (a) is acquired or incurred principally for the purpose of selling or repurchasing it in the near term; (b) on initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or (c) is a **derivative** (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument). *[IFRS 9 Appendix A]*.
impairment gain or loss	Gains or losses that are recognised in profit or loss in accordance with paragraph 5.5.8 and that arise from applying the impairment requirements in Section 5.5. *[IFRS 9 Appendix A]*.
interest rate risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. *[IFRS 7 Appendix A]*.
interim financial report	***Interim financial report* means a financial report containing either a complete set of financial statements (as described in IAS 1 *Presentation of Financial Statements* (as revised in 2007)) or, when applied, IFRS 18 *Presentation and Disclosure in Financial Statements* or a set of condensed financial statements (as described in this Standard) for an interim period.** *[IAS 34.4]*.
lessee	An entity that obtains the right to use an **underlying asset** for a period of time in exchange for consideration. *[IFRS 16 Appendix A]*.
lifetime expected credit losses	The **expected credit losses** that result from all possible default events over the expected life of a financial instrument. *[IFRS 9 Appendix A]*.
liquidity risk	The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset. *[IFRS 7 Appendix A]*.
loans payable	Loans payable are financial liabilities, other than short-term trade payables on normal credit terms. *[IFRS 7 Appendix A]*.
loss allowance	The allowance for **expected credit losses** on financial assets measured in accordance with paragraph 4.1.2, lease receivables and **contract assets**, the accumulated impairment amount for financial assets measured in accordance with paragraph 4.1.2A and the provision for expected credit losses on loan commitments and **financial guarantee contracts**. *[IFRS 9 Appendix A]*.
market risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: **currency risk, interest rate risk** and **other price risk**. *[IFRS 7 Appendix A]*.

market risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: **currency risk, interest rate risk** and **other price risk**. *[IFRS 7 Appendix A]*.
modification gain or loss	The amount arising from adjusting the **gross carrying amount of a financial asset** to reflect the renegotiated or modified contractual cash flows. The entity recalculates the gross carrying amount of a financial asset as the present value of the estimated future cash payments or receipts through the expected life of the renegotiated or modified financial asset that are discounted at the financial asset's original **effective interest rate** (or the original **credit-adjusted effective interest rate** for **purchased or originated credit-impaired financial assets**) or, when applicable, the revised **effective interest rate** calculated in accordance with paragraph 6.5.10. When estimating the expected cash flows of a financial asset, an entity shall consider all contractual terms of the financial asset (for example, prepayment, call and similar options) but shall not consider the **expected credit losses**, unless the financial asset is a **purchased or originated credit-impaired financial asset**, in which case an entity shall also consider the initial expected credit losses that were considered when calculating the original **credit-adjusted effective interest rate**. *[IFRS 9 Appendix A]*.
other price risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from **interest rate risk** or **currency risk**), whether those changes are caused by factors specific to the individual financial instrument or its issuer or by factors affecting all similar financial instruments traded in the market. *[IFRS 7 Appendix A]*.
past due	A financial asset is past due when a counterparty has failed to make a payment when that payment was contractually due. *[IFRS 9 Appendix A]*.
purchased or originated credit-impaired financial asset	Purchased or originated financial asset(s) that are **credit-impaired** on initial recognition. *[IFRS 9 Appendix A]*.
puttable instrument	**A *puttable instrument* is a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.** *[IAS 32.11]*.
reclassification date	The first day of the first reporting period following the change in business model that results in an entity reclassifying financial assets. *[IFRS 9 Appendix A]*.
regular way purchase or sale	A purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned. *[IFRS 9 Appendix A]*.
transaction costs	Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see paragraph B5.4.8). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument. *[IFRS 9 Appendix A]*.

Chapter 51 Insurance contracts

Contents

Overview **4336**

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Overview

This chapter deals with IFRS 17 *Insurance Contracts* (IFRS 17 or the standard) which was issued in May 2017 and amended in June 2020 and December 2021. IFRS 17 addresses the recognition, measurement, presentation and disclosure of insurance contracts issued, reinsurance contracts held and investment contracts with discretionary participation features issued.

IFRS 17 is effective for accounting periods beginning on or after 1 January 2023 and supersedes IFRS 4 *Insurance Contracts*. IFRS 4 did not prescribe detailed measurement and recognition requirements for insurance contracts but, instead, largely permitted insurers to continue to use their accounting practices (local GAAP) prior to adoption of IFRS accounting standards. IFRS 17, therefore, represents a fundamental change for insurers which requires the same recognition and measurement model instead of diverse local GAAPs.

The general model in IFRS 17 requires insurance contract liabilities to be measured using discounted probability-weighted current estimates of future cash flows, a risk adjustment for non-financial risk and a contractual service margin representing the profit expected from fulfilling the contracts. Insurance revenue is recognised as services are provided. IFRS 17 also has specific modifications to the general model including a simplified measurement approach, the premium allocation approach, intended for short-term contracts, and an adaptation of the general model, the variable fee approach, for contracts with direct participation features. There are also modifications to the basic measurement rules for reinsurance contracts held, which must be accounted for separately from the underlying insurance contracts issued.

IFRS 17 is a complex standard that covers the accounting for a wide range of contracts that insurers and non-insurers issue globally and provides detailed guidance on many areas (such as contract boundaries, contract aggregation for measurement purposes, modifications of contracts and business combination accounting) on which IFRS 4 was silent. The transition requirements must be applied retrospectively unless impractical and in which case IFRS 17 addresses how insurers deal with impracticability by requiring two alternative approaches to fully retrospective application, a modified retrospective approach and a fair value approach.

The degree of change compared to previous practice under IFRS 4 varies based on existing accounting policies and the types of business insurers write. However, the change is significant for nearly all types of insurance contracts.

What you need to know

- IFRS 17 applies to all entities that issue insurance contracts, not just entities regulated as an insurer. Therefore, non-insurers may be affected by IFRS 17, if they issue contracts that meet the definition of an insurance contract, as they are no longer permitted to use previous accounting practices, such as IFRS 15 *Revenue from Contracts with Customers* or IFRS 9 *Financial Instruments*, unless there is a specific exemption from applying IFRS 17 to those contracts.
- IFRS 17 is effective for annual reporting periods beginning on or after 1 January 2023. The basic principle in the standard is that it must be adopted retrospectively with restatement of the comparative period(s) presented. However, if fully retrospective application is impracticable, two alternative measurement approaches are available.
- IFRS 17 is a complex standard with an accounting model that combines a current balance sheet measurement of insurance contracts with recognition of profit over the period that services are provided.
- IFRS 17 is a significant change for many entities issuing insurance contracts as their previous accounting policies under IFRS 4 differ considerably from those under IFRS 17. The costs involved in implementing IFRS 17 are generally substantial because of the need for significant system changes.

1 Introduction

The International Accounting Standards Board (IASB) issued IFRS 17 in May 2017. In June 2020, IFRS 17 was amended by *Amendments to IFRS 17* (the June 2020 amendments) and in December 2021, IFRS 17 was amended by *Initial Application of IFRS 17 and IFRS 9 - Comparative Information* (the December 2021 amendments). Following these amendments, IFRS 17 became effective for annual periods beginning on or after 1 January 2023, with early application permitted, provided an entity also applied IFRS 9 at the same time.

IFRS 17 superseded IFRS 4, an interim standard that allowed entities to use a wide variety of accounting practices for insurance contracts, that reflected national accounting requirements and variations of those requirements. The IASB had always intended to replace IFRS 4; the differences in accounting treatment across jurisdictions and practices made it difficult for investors and analysts to understand and compare insurers' results. Most stakeholders agreed on the need for a common global insurance accounting standard even though opinions varied as to what it should contain. Long-term and complex insurance risks are difficult to reflect in the measurement of insurance contracts. In addition, insurance contracts are subject to several measurement challenges. Some previous accounting practices under IFRS 4 did not adequately reflect the true underlying financial position or the financial performances of these insurance contracts. *[IFRS 17.BC1, IFRS 17.BC4]*.

More than 20 years in development, IFRS 17 represents a complete overhaul of accounting for insurance contracts. The standard is intended to increase the transparency of insurers' financial positions and performance and make their financial statements more comparable with both other insurers and other industries.

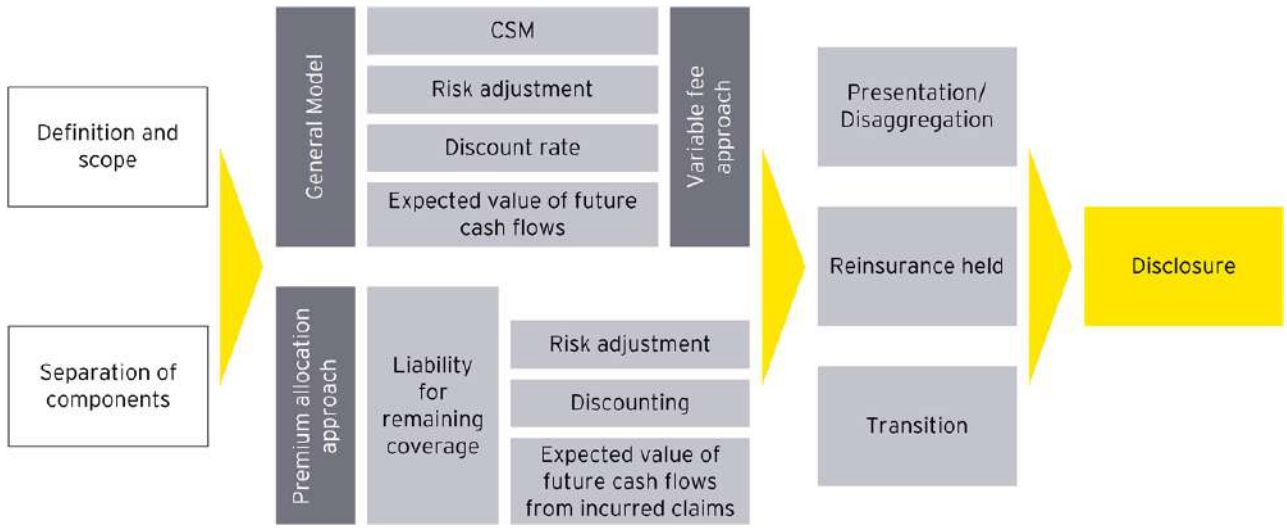
IFRS 17 applies a current value approach to measuring insurance contracts and recognises profit as insurers provide services to policyholders. The profit or loss earned from underwriting activities are reported separately from financing activities. Detailed note disclosures explain how items like new business issued, experience in the year, cash receipts and payments, and changes in assumptions affected the performance and the carrying amount of insurance contracts.

The changes in financial reporting that come with IFRS 17 affects both preparers of financial statements and users. Users of financial statements will now receive more and different information about an entity's insurance contracts in the IFRS financial statements than in the past, which may change the way they assess and compare insurers. Preparers will need to help analysts and other users of their financial statements to interpret IFRS 17 information and understand how it relates to what they received previously when IFRS 4 was applied.

1.1 Overview of IFRS 17

IFRS 17 establishes principles for the recognition, measurement, presentation and disclosure of insurance contracts issued, reinsurance contracts held and investment contracts with discretionary participation features that an entity issues.

The following diagram visually presents the key features of the standard:



IFRS 17 reflects the Board's view that an insurance contract combines features of both a financial instrument and a service contract. In addition, many insurance contracts generate cash flows with substantial variability over a long period. To provide useful information about these features, the Board developed an approach that:

- Combines current measurement of the future cash flows with the recognition of profit over the period that services are provided under the contract
- Presents insurance service results (including presentation of insurance revenue) separately from insurance finance income or expenses
- Requires an entity to make an accounting policy choice on a portfolio basis whether to recognise all insurance finance income or expense for the reporting period in profit or loss or to recognise some of that income or expense in other comprehensive income *[IFRS 17.BC16]*

Overall, IFRS 17 results in: *[IFRS 17.BC26]*

- The measurement of the liability for remaining coverage and the resulting profit and revenue recognition for a group of insurance contracts being broadly consistent with IFRS 15 - except that:
  - For insurance contracts without direct participation features, the measurement is updated for changes in financial assumptions
  - For insurance contracts with direct participation features, the measurement is also updated for changes in financial assumptions which include changes in the fair value of the items in which the entity and the policyholder participate ('underlying items')
- The liability for a group of insurance contracts relating to incurred claims being measured is broadly consistent with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

An entity may apply a simplified measurement approach (the premium allocation approach) to some insurance contracts. This simplified measurement approach allows an entity to measure the amount relating to remaining service by allocating the premium as insurance revenue over the coverage period.

The transition provisions under IFRS 17 require a full retrospective application of the standard unless it is impracticable, in which case, entities must apply either a modified retrospective approach or a fair value approach (see section 17.2 below).

Following the issuance of IFRS 17, the IASB created a Transition Resource Group (TRG). The members of the TRG include financial statement preparers and auditors with both practical and direct knowledge of implementing IFRS 17. The TRG members work in different countries and regions. The TRG's purpose is to:

- Provide a public forum for stakeholders to follow the discussion of questions raised on implementation.
- Inform the IASB in order to help it determine what, if any, action will be needed to address those questions. Possible actions include providing supporting materials such as webinars, case studies and/or referral to the Board or Interpretations Committee.

The TRG met three times in 2018 and once in 2019. As of the date of the last TRG meeting, in April 2019, a total of 127 issues had been submitted by constituents of which the TRG discussed 22 in detail. The rest are questions that:

- Were answered by IASB staff applying only the requirements in IFRS 17
- Did not meet the submission criteria

  Or
- Were considered through a process other than a TRG discussion (e.g., annual improvements or outreach)

Views expressed by the TRG have been incorporated in this chapter, as appropriate. While TRG members' views are non-authoritative, entities should consider these as they implement the standard. Since IFRS 17 became effective on 1 January 2023, the work of the TRG for IFRS 17 is complete, and any support for the implementation and application of IFRS 17 will be dealt with through the activities of the IASB and the Interpretations Committee.

The views expressed in this chapter may evolve as implementation continues and additional issues are identified. Conclusions in seemingly similar situations may differ from those reached in the Illustrations contained in this chapter due to differences in the underlying facts and circumstances.

2 The objective, definitions and scope of IFRS 17

2.1 The objective of IFRS 17

The objective of IFRS 17 is to ensure that an entity provides relevant information that faithfully represents the recognition, measurement, presentation and disclosure principles for insurance contracts within its scope. This information gives a basis for users of financial statements to assess the effect that insurance contracts have on the entity's financial position, financial performance and cash flows. *[IFRS 17.1]*.

2.2 Definitions

The definitions that are relevant to the application of IFRS 17 and included within Appendix A of the standard are likewise included in Appendix C of this chapter. A list of these terms is produced below, in alphabetical order.

- Contractual service margin
- Coverage period
- Experience adjustment
- Financial risk
- Fulfilment cash flows
- Group of insurance contracts
- Insurance acquisition cash flows
- Insurance contract
- Insurance contract services
- Insurance contract with direct participation features
- Insurance contract without direct participation features
- Insurance risk
- Insured event
- Investment component
- Investment contract with discretionary participation features
- Liability for incurred claims
- Liability for remaining coverage
- Policyholder
- Portfolio of insurance contracts
- Reinsurance contract
- Risk adjustment for non-financial risk
- Underlying items

2.3 Scope

An entity must apply IFRS 17 to: *[IFRS 17.3]*

- Insurance contracts, including reinsurance contracts, that it issues
- Reinsurance contracts it holds

  And
- Investment contracts with discretionary participation features that it issues, provided the entity also issues insurance contracts

How we see it

IFRS 17 does not mention a *'de minimis'* limit on the number of insurance contracts that an entity must issue to ensure that its investment contracts with discretionary participation features are within the scope of IFRS 17.

The IASB's decision, in line with IFRS 4, to retain investment contracts with discretionary participation features within the scope of the insurance contracts standard means that entities account for these contracts under IFRS 17. However, in many cases, the measurement model under IFRS 17 represents a major change from existing accounting practices applied to investment contracts with discretionary participation features under IFRS 4.

IFRS 17 specifies that all references to insurance contracts throughout the standard also apply to: *[IFRS 17.4]*

- Reinsurance contracts held, except:
  - For references to insurance contracts issued
  - The specific requirements for reinsurance contracts held discussed in section 11 below
- Investment contracts with a discretionary participation feature as set out above except for the reference to insurance contracts and as described in section 12.4 below

In addition, all references to insurance contracts also apply to insurance contracts acquired by an entity in a transfer of insurance contracts or a business combination other than reinsurance contracts held. *[IFRS 17.5]*.

It can be seen from this that IFRS 17 applies to all insurance contracts (as defined in IFRS 17) throughout the duration of those contracts, regardless of the type of entity issuing the contracts. *[IFRS 17.BC64]*. Consistent with other IFRS accounting standards, it is a transaction-based standard. Consequently, non-insurance entities are within its scope if they issue contracts that meet the definition of an insurance contract.

The Board decided to base its approach on the type of activity rather than on the type of the entity because: *[IFRS 17.BC63]*

- A robust definition of an insurer that could be applied consistently from country to country would be difficult to create.
- Entities that might meet the definition frequently have major activities in other areas as well as in insurance, and would need to determine how and to what extent these non-insurance activities would be accounted for in a manner similar to insurance activities or in a manner similar to how other entities account for their non-insurance activities.
- If an entity that issues insurance contracts accounted for a transaction in one way and an entity that does not issue insurance contracts accounted for the same transaction in a different way, comparability across entities would be reduced.

Conversely, contracts that fail to meet the definition of an insurance contract are not within the scope of IFRS 17 (unless they are investment contracts with discretionary participation features and the entity also issues insurance contracts). This will be the case even if such contracts are regulated as insurance contracts under local legislation. If a contract is not within the scope of IFRS 17, then it will need to be accounted for under other appropriate IFRS accounting standards such as IFRS 9 or IFRS 15.

An entity must consider its substantive rights and obligations, whether they arise from a contract, law or regulation, when applying IFRS 17. A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. Contractual terms include all terms in a contract, explicit or implied, but an entity disregards terms that have no commercial substance (i.e., no discernible effect on the economics of the contract). Implied terms in a contract include those imposed by law or regulation. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). *[IFRS 17.2]*. The Basis for Conclusions observes that these considerations are consistent with IFRS 15 and apply when an entity classifies a contract and when it assesses the substantive rights and obligations for determining the boundary of a contract. *[IFRS 17.BC69]*.

The assessment of whether a contract is an insurance contract will include an assessment of whether the contract contains significant insurance risk (discussed in section 3.5 below). In addition, even if the contract contains significant insurance risk, an entity needs to assess whether the contract also contains embedded derivatives (discussed in section 5.1 below), distinct investment components (discussed in section 5.2 below), or a promise to provide distinct goods or services other than insurance contract services (discussed in section 5.3 below) that need to be separated and accounted for under other IFRS accounting standards.

Contracts within the scope of IFRS 17 are excluded from the scope of the following IFRS accounting standards (except for specific exceptions which are discussed separately elsewhere in this chapter):

- IFRS 7 *Financial Instruments: Disclosures*
- IFRS 9
- IFRS 15
- IAS 32 *Financial Instruments: Presentation*
- IAS 36 *Impairment of Assets*
- IAS 37
- IAS 38 *Intangible Assets*

Any assets for insurance acquisition cash flows (see section 7.3 below) are also excluded from the scope of IAS 38.

Contracts within the scope of IFRS 17 are excluded from the measurement provisions of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

Contracts within the scope of IFRS 17 are not excluded from the scope of IFRS 13 *Fair Value Measurement* which means that any reference to fair value in IFRS 17 is fair value as defined and measured under IFRS 13. However, IFRS 17 does not generally require that insurance liabilities are measured at fair value except on transition in certain circumstances and, in those circumstances, IFRS 13's measurement requirements are modified to exclude the demand deposit floor (see section 17.5 below).

How we see it

IFRS 4 allowed entities to use their previous accounting policies for contracts that met the definition of an insurance contract. Hence, many non-insurance entities, such as banks and service companies, applied similar measurement guidance to that for their non-insurance contracts (e.g., IFRS 9 or IFRS 15), to account for their insurance contracts. Many contracts issued by non-insurers that were previously within the scope of IFRS 4 are also within the scope of IFRS 17. Since IFRS 17 has specific recognition, measurement and presentation requirements for insurance contracts, non-insurers that issue contracts within the scope of IFRS 17 will no longer be able to apply previous accounting practices to these contracts but will have to apply the requirements of IFRS 17 instead. The effect of applying IFRS 17 to such contracts could be significant for some non-insurance entities.

The scope of IFRS 17 excludes various items that may meet the definition of insurance contracts. These are discussed in section 2.3.1 below. IFRS 17 also allows an entity a choice of applying IFRS 17 or another IFRS accounting standard to some contracts as discussed in sections 2.3.2 and 2.3.3 below.

2.3.1 Transactions not within the scope of IFRS 17

IFRS 17 excludes the following transactions that may meet the definition of insurance contracts: *[IFRS 17.7]*

- Warranties provided by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer (see section 2.3.1.A below).
- Employers' assets and liabilities that arise from employee benefit plans, and retirement benefit obligations reported by defined benefit retirement plans (these are accounted for under IAS 19 *Employee Benefits*, IFRS 2 *Share-based Payment* and IAS 26 *Accounting and Reporting by Retirement Benefit Plans*).
- Contractual rights or contractual obligations contingent on the future use of, or right to use, a non-financial item (for example, some licence fees, royalties, variable and other contingent lease payments and similar items (these are accounted for under IFRS 15, IFRS 16 *Leases* and IAS 38).
- Residual value guarantees provided by the manufacturer, dealer or retailer and lessees' residual value guarantees embedded in a lease (they are accounted for under IFRS 15 and IFRS 16). However, stand-alone residual value guarantees that transfer insurance risk are not addressed by other IFRS accounting standards and are within the scope of IFRS 17. *[IFRS 17.BC87(d)]*.
- Financial guarantee contracts, unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts (see section 2.3.1.B below).
- Contingent consideration payable or receivable in a business combination. Contingent consideration in a business combination is required to be recognised at fair value at the acquisition date with subsequent remeasurements of non-equity consideration included in profit or loss. *[IFRS 3.58]*.
- Insurance contracts in which the entity is the policyholder, unless those contracts are reinsurance contracts held (see section 2.3.1.C below).
- Credit card contracts (or similar contracts) that provide insurance coverage (see section 2.3.1.D below).

The main scope exclusions are discussed below.

How we see it

IFRS 17 excludes residual value guarantees provided by a manufacturer, dealer or retailer, from its scope, whereas they had not been excluded from the scope of IFRS 4. This change brings residual value guarantees into line with product warranties by enabling manufacturers, dealers and retailers to apply IFRS 15 and IAS 37 and to avoid some of the complexities of the IFRS 17 general model, such as the accounting for the contractual service margin.

2.3.1.A Product warranties

Warranties provided by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer are outside the scope of IFRS 17. *[IFRS 17.7(a)]*. Such warranties might provide a customer with assurance that the related product will function as the parties intended because it complies with agreed-upon specifications (called 'assurance-type warranties'), or they might provide the customer with a service in addition to the assurance that the product complies with agreed-upon specifications (called 'service-type warranties'). *[IFRS 17.BC89, IFRS 15.B28]*.

IFRS 15.B28-B33 sets out the accounting treatment for these two types of warranties. For some entities the assessment as to whether the warranty is outside the scope of IFRS 17 will be straightforward. For other entities, we believe judgement might be needed to determine whether the scope exception applies as discussed in Chapter 28 at section 9.1.

Without this exception, many product warranties would have been covered by IFRS 17 as they would normally meet the definition of an insurance contract. The Basis for Conclusions observes that the IASB excluded them from the scope of IFRS 17 because if the standard were to apply, entities would generally apply the premium allocation approach to such contracts, which would result in accounting similar to that which would result from applying IFRS 15. Further, in the Board's view, accounting for such contracts in the same way as other contracts with customers would provide comparable information for the users of financial statements for the entities that issue such contracts. Hence, the Board concluded that changing the existing accounting for these contracts would impose costs and disruption for no significant benefit. *[IFRS 17.BC90]*.

Conversely, a product warranty is within the scope of IFRS 17 if it is not issued by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer. See section 3.7.1 below.

Other types of warranty are not specifically excluded from the scope of IFRS 17. A warranty issued by a vendor to the purchaser of a business as part of the sale agreement (e.g., an indemnity clause for contingent liabilities related to tax computations of the acquired entity) is an example of a warranty that would not fall within the scope of IFRS 17 as such a warranty does not result in the transfer of a pre-existing risk (see section 3.4 below).

Accounting judgement as to whether warranties are within the scope of IFRS 17 is illustrated in Practical example 2-1 below.

Practical example 2-1: Rolls-Royce Holdings plc (2023) — United Kingdom

2023 Annual Report [extract]
FINANCIAL STATEMENTS [extract]
CONSOLIDATED FINANCIAL STATEMENTS AND NOTES [extract]
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]
1 Accounting policies [extract]
Revisions to IFRS applicable in 2023 [extract]
IFRS 17 Insurance Contracts [extract]

...

The Group has reviewed whether its arrangements meet the accounting definition of an insurance contract. While some contracts, including Civil Aerospace LTSAs, may transfer an element of insurance risk, they relate to warranty and service type agreements that are issued in connection with the Group's sales of its goods or services and therefore will remain accounted for under the existing revenue and provisions standards. The Directors have judged that such arrangements entered into after the original equipment sale remain sufficiently related to the sale of the Group's goods and services to allow the contracts to continue to be measured under IFRS 15 *Revenue from Contracts with Customers* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

...

How we see it

An extended warranty offered to a customer by a manufacturer, dealer or retailer concurrent with the sale of goods (e.g., a three-year extended warranty offered in addition to a one-year manufacturer's guarantee) would be a service-type warranty and outside the scope of IFRS 17. However, if the service-type warranty was issued by a subsidiary separate from the subsidiary selling the goods, the warranty would be outside the scope of IFRS 17 in the consolidated financial statements of the group but within the scope of IFRS 17 in the separate financial statements of the subsidiary (unless the fixed fee service exemption is applied in the financial statements of the subsidiary - see section 2.3.2 below).

2.3.1.B Financial guarantee contracts

A financial guarantee contract as defined by IFRS 9 is as follows: *[IFRS 9 Appendix A]*

Extract from IFRS 9

Appendix A
Defined terms

financial guarantee contract	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

These contracts transfer credit risk and may have various legal forms, such as a guarantee, some types of letters of credit, a credit default contract or an insurance contract. *[IFRS 17.BC91]*.

Financial guarantee contracts are excluded from the scope of IFRS 17 unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts. If so, the issuer may elect to apply either IFRS 17 or IAS 32, IFRS 7 and IFRS 9 to such financial guarantee contracts. The issuer may make that on a choice contract by contract basis, but the choice for each contract is irrevocable. *[IFRS 17.7(e)]*.

This accounting policy election is the same as was previously available in IFRS 4. The Board decided to carry forward to IFRS 17 the option to account for a financial guarantee contract as if it were an insurance contract, without any substantive changes, because the option has worked in practice and results in consistent accounting for economically similar contracts issued by the same entity. The Board did not view it as a high priority to address the inconsistency that results from accounting for financial guarantee contracts differently depending on the issuer. *[IFRS 17.BC93]*.

The IASB was concerned that entities other than credit insurers could elect to apply IFRS 4 to financial guarantee contracts and consequently (if their accounting policies permitted) recognise no liability on inception. Therefore, it imposed the restrictions outlined above. *[IFRS 9.BCZ2.12]*. The application guidance to IFRS 9 contains further information on these restrictions where it is explained that assertions that an issuer regards contracts as insurance contracts are typically found throughout the issuer's communications with customers and regulators, contracts, business documentation as well as in their financial statements. Furthermore, insurance contracts are often subject to accounting requirements that are distinct from the requirements for other types of transaction, such as contracts issued by banks or commercial companies. In such cases, an issuer's financial statements would typically include a statement that the issuer had used those accounting requirements, i.e., ones normally applied to insurance contracts. *[IFRS 9.B2.6]*. Nevertheless, other companies did consider it appropriate to apply IFRS 4 rather than IFRS 9 to these contracts.

It is observed in the Basis for Conclusions that some credit-related contracts lack the precondition for payment that the holder has suffered a loss. One example of such a contract is one that requires payments in response to changes in a specified credit rating or credit index. The Board concluded that those contracts are derivatives and do not meet the definition of an insurance contract. Therefore, such contracts will continue to be accounted for as derivatives under IFRS 9. The Board noted that these contracts were outside the scope of the policy choice in IFRS 4 carried forward into IFRS 17, so continuing to account for them as derivatives would not create further diversity. *[IFRS 17.BC94]*.

Accounting for financial guarantee contracts by issuers that have not elected to use IFRS 17 is discussed in Chapter 41 at section 2.4.2.

Accounting for the revenue associated with financial guarantee contracts issued in connection with the sale of goods is dealt with under IFRS 15. *[IFRS 9.B2.5(c)]*.

How we see it

In our view, on transition to IFRS 17, an entity that has previously asserted explicitly that it regards financial guarantee contracts as insurance contracts and has used accounting applicable to insurance contracts may reconsider its previous election regarding accounting for financial guarantee contracts made under IFRS 4 and decide whether it would prefer to account for those contracts under IFRS 17 or IFRS 9. This is because there are no specific transition provisions either within IFRS 17 or IFRS 9 as to whether previous elections made under a different IFRS accounting standard, i.e., IFRS 4, should be continued. Hence, IFRS 17 would not prevent an entity from making new elections on application of IFRS 17. However, an entity which had not previously asserted explicitly that it regards such contracts as insurance contracts or which had not previously used accounting applicable to insurance contracts (i.e., IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 accounting was applied under IFRS 4) may not reconsider its previous election (either implicitly or explicitly made).

It is likely that insurers that have previously issued financial guarantee contracts and accounted for them under an insurance accounting and regulatory framework will meet the requirement to have asserted explicitly that these contracts are regarded as insurance contracts and hence will be able to reconsider its previous election. It is unlikely that an entity not subject to an insurance accounting and regulatory framework would meet this requirement because it would not have previously made the necessary assertions.

2.3.1.C Direct insurance contracts in which the entity is the policyholder

Accounting by policyholders of direct insurance contracts (i.e., those that are not reinsurance contracts) is excluded from the scope of IFRS 17. However, holders of reinsurance contracts (cedants) are required to apply IFRS 17. *[IFRS 17.7(g)]*.

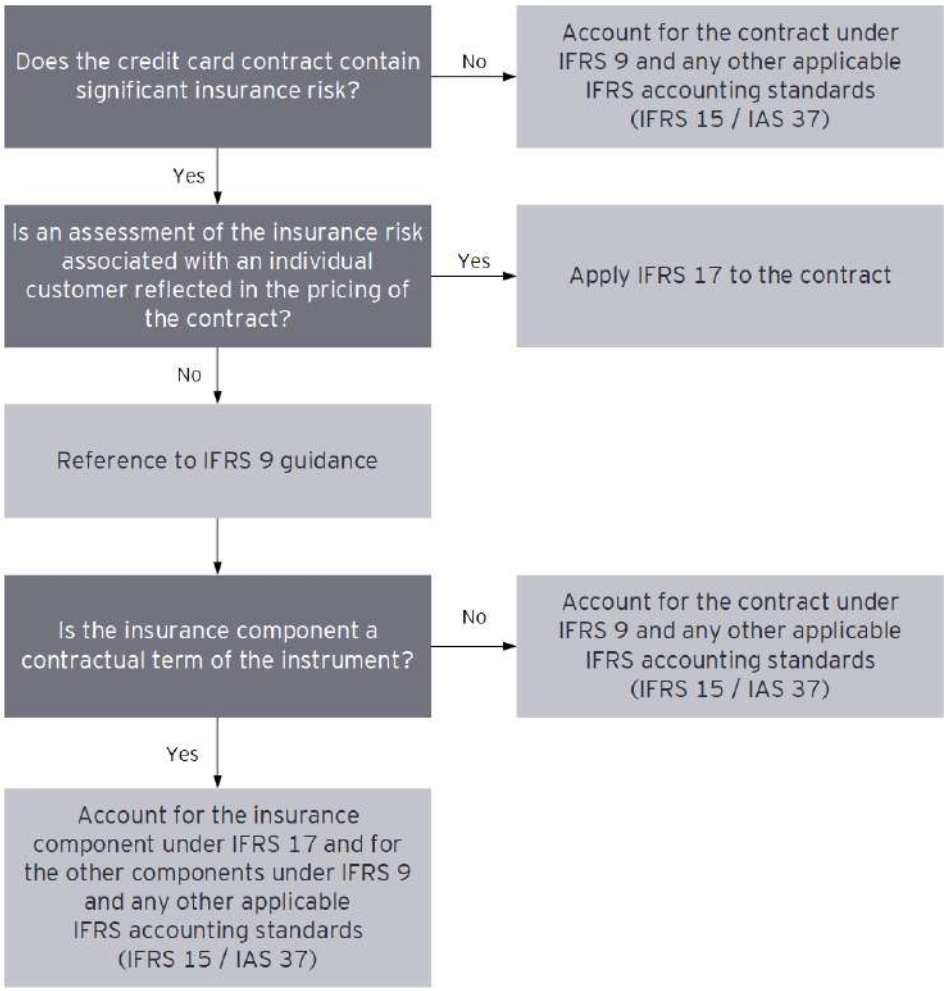
The IASB originally intended to address accounting by policyholders of direct insurance contracts in IFRS 17. The Basis for Conclusions observes that other IFRS accounting standards include requirements that may apply to some aspects of contracts in which the entity is the policyholder. For example, IAS 37 sets out the requirements for reimbursements from insurance contracts held that provide cover for expenditure required to settle a provision and IAS 16 *Property, Plant and Equipment* sets out the requirements for some aspects of reimbursement under an insurance contract held that provides coverage for the impairment or loss of property, plant and equipment. Furthermore, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*[1] specifies a hierarchy that an entity must use when developing an accounting policy if no IFRS accounting standard applies specifically to an item. Accordingly, the Board did not view work on policyholder accounting as a high priority. *[IFRS 17.BC66]*.

2.3.1.D Credit card contracts (or similar contracts) that provide insurance coverage

Credit card contracts (or similar contracts that provide credit or payment arrangements) that provide services that meet the definition of an insurance contract are excluded from the scope of IFRS 17 if, and only if, the entity does not reflect an assessment of the insurance risk associated with an individual customer in setting the price of the contract with that customer. If excluded from IFRS 17, these contracts would be within the scope of IFRS 9 and other applicable IFRS accounting standards. However, if, and only if, the insurance component is a contractual term of such a financial instrument (rather than, say, required by local legislation), IFRS 9 requires an entity to separate and apply IFRS 17 to that insurance component. *[IFRS 17.7(h), IFRS 9.2.1(e)(iv)]*.

1 The consequential amendments resulting from IFRS 18 Presentation and Disclosure in Financial Statements, once effective, changes the title of IAS 8 to 'Basis of Preparation of Financial Statements' to better reflect the amended content of IAS 8. See Chapter 4 for further details on the requirements of IFRS 18.

This can be illustrated by the diagram below:



An example of a credit card contract (or similar contract) that provides insurance coverage is one in which the regulation of the jurisdiction where the entity issuing the credit card operates requires the entity to provide coverage for some purchases made by the customer using the credit card. Under this coverage the entity:

- Must refund the customer for some claims against a supplier in respect of a misrepresentation or breach of the purchase agreement (for example, if the goods are defective or if the supplier fails to deliver the goods) if the supplier does not rectify

  And

- Is entitled to be indemnified by the supplier for any loss suffered in satisfying its liability with its customer

As a result, according to the regulation, the entity and the supplier are jointly and severally liable to the customer, i.e., the customer can choose whether to claim from the entity or from the supplier. In addition, subject to a maximum amount, the customer can claim from the entity or from the supplier an amount in excess of the amount paid using the specific credit card (for example, the entire purchase price, even if only part of the purchase price was paid using the credit card, and any additional costs reasonably incurred as a result of the supplier failure). Normally, the entity does not charge any fee to the customer or charges an annual fee to the customer that does not reflect an assessment of the insurance risk associated with that individual customer.

This insurance coverage is not subject to the product warranty exemption (see section 2.3.1.A above) because the credit card issuer is required to compensate the customer for a loss unrelated to the performance of the credit card.

The insurance coverage described above differs from:

- The insurance coverage that an entity issuing a credit card contract sells to its customers as an agent, such as travel insurance or roadside assistance provided by another party (the principal). A credit card contract that includes this insurance coverage is not within the scope of IFRS 17.
- The insurance coverage that an entity issuing a credit card contract sells to its customers as a principal and meets the specified conditions for a fixed-fee service contract (see section 2.3.2 below).

- The insurance coverage that an entity issuing a credit card provides for the settlement of the customer's obligation created by the contract, such as a waiver of the loan balance if the customer dies (see section 2.3.3 below).[2]

In adding this scope exclusion to IFRS 17, the Board noted that IFRS 9 and IFRS 17 both have requirements that address credit risk and insurance risk, which are the prominent features of such contracts. Furthermore, the Board was aware that in applying IFRS 4, which had different criteria for separating components of an insurance contract compared to IFRS 17, most entities separated the components of such contracts. For example, an entity applying IFRS 4 might account for the credit card component applying IFRS 9, the insurance component applying IFRS 4, and any other service components applying IFRS 15. Acknowledging that entities had already identified methods to separate the components of such contracts, the Board concluded that changing the existing accounting for these contracts would impose costs and disruption to entities that typically do not issue contracts in the scope of IFRS 17, other than some credit card contracts and similar contracts that meet the definition of an insurance contract, for no significant benefit. *[IFRS 17.BC94B]*.

Under IFRS 9, an entity is required to separate and apply IFRS 17 to an insurance coverage component, if and only if, that component is a contractual term of that financial instrument (rather than required by regulation). In the Board's view, applying IFRS 17 to the insurance coverage components in credit card (or similar) contracts that include insurance coverage as part of the contractual terms will result in the most useful information for users of financial statements. In addition, it will increase comparability between insurance coverage provided as part of the contractual terms of a credit card contract and insurance coverage provided as a separate stand-alone contract. Other IFRS accounting standards, such as IFRS 15 or IAS 37, might apply to other components of the contract, such as service components or insurance components required by law or regulation. *[IFRS 17.BC94C]*.

2.3.2 Fixed-fee service contracts

A fixed-fee service contract is one in which the level of service depends on an uncertain event but the fee does not. Examples include roadside assistance programmes and maintenance contracts in which the service provider agrees to repair specified equipment after a malfunction. Such contracts can meet the definition of an insurance contract because: *[IFRS 17.BC95]*

- It is uncertain whether, or when, assistance or a repair will be needed
- The owner is adversely affected by the occurrence

  And
- The service provider compensates the owner if assistance or repair is needed

Although these contracts may meet the definition of insurance contracts, their primary purpose is to provide services for a fixed fee. IFRS 17 permits entities a choice of applying IFRS 15 instead of IFRS 17 to such contracts that it issues if, and only if, they meet specified conditions. The entity may make that choice contract by contract, but the choice for each contract is irrevocable. The conditions are: *[IFRS 17.8]*

- The entity does not reflect an assessment of the risk associated with an individual customer in setting the price of the contract with that customer.
- The contract compensates the customer by providing services, rather than by making cash payments to the customer.

  And
- Insurance risk transferred by the contract arises primarily from the customer's use of services, rather than from uncertainty over the cost of those services.

The Board had proposed originally to exclude fixed fee service contracts whose primary purpose is the provision of services from the scope of IFRS 17. However, some stakeholders noted that some entities issue both fixed-fee service contracts and other insurance contracts. For example, some entities issue both roadside assistance contracts and insurance contracts for damage arising from accidents. Therefore, the Board decided to allow entities a choice of whether to apply IFRS 15 or IFRS 17 to fixed-fee service contracts to enable such entities to account for both types of contract in the same way. In the view of the Board, if IFRS 17 is applied to fixed-fee service contracts, entities would generally apply the premium allocation approach (see section 10 below) to such contracts which would result in accounting similar to that resulting from applying IFRS 15. *[IFRS 17.BC96, IFRS 17.BC97]*.

2 IASB Staff paper 2D: Project: *Amendments to IFRS 17* Insurance Contracts, Paper topic: *Credit Cards that provide Insurance coverage*, IASB meeting, March 2019, paragraphs 5-7. Available on the IFRS Foundation's website.

The accounting policy choice between applying IFRS 17 or IFRS 15 applies only to fixed-fee service contracts. When an entity charges a fee which varies with the level of service provided (e.g., an elevator service contract that levies a fee per breakdown according to the work required), then the contract is unlikely to transfer significant insurance risk and it would be a service contract within the scope of IFRS 15.

How we see it

The Basis for Conclusions mentions that the choice of whether to apply IFRS 15 or IFRS 17 was introduced to assist entities that issue both roadside assistance contracts and insurance contracts in being able to apply IFRS 17 to all contracts issued. However, it is possible that other types of fixed-fee service contracts are now within the scope of IFRS 17 as the choice between IFRS 15 and IFRS 17 is only available where the specified conditions are met.

Whether an individual risk assessment is present or not may require the exercise of judgement. In many cases, service agreements are priced to reflect some form of risk assessment. If an entity charges each policyholder the same fee to service the same asset ('community priced'), then the risk assessment is performed at a portfolio level rather than the individual customer level. However, if the fixed fee for servicing is based on the specific condition of the asset (for example, the age of motor vehicle) and/or the policyholder (for example, claims history), this would be indicators of an individual risk assessment that reflects the nature of an insurance contract rather than a service contract.

2.3.3 Loan contracts that transfer significant insurance risk only on settlement of the policyholder's obligation created by the contract

Some contracts meet the definition of an insurance contract but limit the compensation for the insured event to the amount otherwise required to settle the policyholder's obligation created by the contract (for example, loans with death waivers). An entity must choose to apply either IFRS 17 or IFRS 9 to such contracts that it issues unless such contracts are excluded from the scope of IFRS 17.7 (see section 2.3.1 above). The entity must make that choice for each portfolio of insurance contracts (see section 6.1 below), and the choice for each portfolio is irrevocable. *[IFRS 17.8A]*.

Examples of such contracts are:

- Mortgages when the outstanding balance of the mortgage is waived if the borrower dies and the consideration for the life assurance coverage is part of the overall interest rate charged on the mortgage.
- Lifetime mortgages (sometimes called equity release mortgages) where the entity's recourse is limited to the mortgaged property. If the property is sold for less than the mortgage balance (when the customer dies or moves into long-term care) then the loss is borne by the entity.
- Student loan contracts where repayments are income and/or life contingent and may not be made at all if the borrower's income never exceeds the repayment threshold or the borrower dies.
- A loan provided to a customer to buy a non-financial asset which is repaid through low instalments over the period of the loan with a final, higher 'balloon' payment at maturity. At maturity the customer can choose to return the non-financial asset to the entity instead of making the 'balloon' payment and the supplier is exposed to a loss if the value of the non-financial asset received is less than the 'balloon' amount.

This accounting policy choice was added to IFRS 17 because of stakeholder concerns that such contracts are typically issued by non-insurers. Such entities might be expected to be in a less advanced stage of IFRS 17 implementation and might not have fully assessed the implications of IFRS 17 on their business. In addition, these contracts do not usually have the legal form of insurance contracts. It is observed in the Basis for Conclusions that applying either IFRS 17 or IFRS 9 would provide useful information about such contracts. Hence, the Board concluded that requiring an entity to apply IFRS 17 to those contracts, when the entity had previously been applying an accounting policy consistent with IFRS 9 or IAS 39 to those contracts (or *vice versa*), could impose costs and disruption with no significant benefit. *[IFRS 17.BC94E]*.

It is further observed in the Basis for Conclusions that the accounting policy choice for each portfolio was made irrevocable in order to mitigate the lack of comparability that might otherwise arise between similar contracts issued by the same entity, and between similar contracts issued by different entities. *[IFRS 17.BC94F]*.

2.3.4 Other accounting standards which affect insurers

IFRS 17 does not address other aspects of accounting by insurers, such as accounting for financial assets held by insurers and financial liabilities issued by insurers which are within the scope of IFRS 7, IFRS 9 and IAS 32. However, some other IFRS accounting standards provide optional measurement exceptions for investments included within investment funds that provide investors with benefits determined by units in that fund including, but not limited to, the underlying items related to insurance contracts with direct participation features and investment contracts with discretionary participation features (see sections 12.3 and 12.4 below) as follows:

- IFRS 9 requires that if an issued financial liability is part reacquired, such a purchase must result in derecognition of that part of the financial liability that is reacquired. However, some entities operate, either internally or externally, an investment fund that provides investors with benefits determined by units in the fund and recognise financial liabilities for the amounts to be paid to those investors. Similarly, some entities issue groups of insurance contracts with direct participation features and those entities hold the underlying items. Some such funds or underlying items include the entity's own financial liabilities (for example, a corporate bond issued). Despite the usual requirements in IFRS 9 for the derecognition of financial liabilities re-acquired, an entity may elect not to derecognise its financial liability that is acquired by such a fund or is an underlying item when, and only when, the entity repurchases its financial liability for that specific purpose (i.e., to be held by such a fund or held as an underlying item). Instead, the entity may elect to continue to account for that instrument as a financial liability and to account for the repurchased instrument as if the instrument were a financial asset and measure it at fair value through profit or loss. That election is irrevocable and is made on an instrument-by-instrument basis. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features in the scope of IFRS 17. *[IFRS 9.3.3.4, IFRS 9.3.3.5]*. See Chapter 48 at section 6.1.
- IAS 16 requires each class of owner-occupied property to be measured either under the cost model or a revaluation model with revaluation gains recognised in other comprehensive income. Some entities operate, either internally or externally, an investment fund that provides investors with benefits determined by units in the fund. Similarly, some entities issue groups of insurance contracts with direct participation features and hold the underlying items. Some such funds or underlying items include owner-occupied property. Despite the normal requirements of IAS 16, the entity may elect to measure such owner-occupied properties using the fair value model in accordance with IAS 40 *Investment Property* (i.e., at fair value through profit or loss). For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. An entity treats owner-occupied property measured using the IAS 40 fair value model as a separate class of property, plant and equipment. *[IAS 16.29, IAS 16.29A, IAS 16.29B]*. See Chapter 19 at section 6.6. IAS 28 *Investments in Associates and Joint Ventures* permits a separate election, at initial recognition of the associate or joint venture, to measure an associate or joint venture at fair value through profit or loss in accordance with IFRS 9 if it is held by, or held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust or similar entity including investment-linked insurance funds. An example of an investment-linked insurance fund is a fund held by an entity as the underlying items for a group of insurance contracts with direct participation features. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. *[IAS 28.18]*. See Chapter 12 at section 3.3.
- IAS 32 requires that if an entity reacquires its own equity instruments, those shares ('treasury shares') are deducted from equity and no gain or loss is recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. Some entities operate, either internally or externally, an investment fund that provides investors with benefits determined by units in the fund and recognise financial liabilities for the amounts to be paid to those investors. Similarly, some entities issue groups of insurance contracts with direct participation features and those entities hold the underlying items. Some such funds or underlying items include the entity's treasury shares. Despite the normal requirements of IAS 32, an entity may elect not to deduct from equity a treasury share that is included in such a fund or is an underlying item when, and only when, an entity reacquires its own equity instrument for such purposes. Instead, the entity may elect to continue to account for that reacquired treasury share as equity and to account for the reacquired instrument as if the instrument were a financial asset and measure it at fair value through profit or loss in accordance with IFRS 9 (this means that the entity's shares are recognised both as equity and as a financial instrument). That election is irrevocable and made on an instrument-by-instrument basis. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. *[IAS 32.33, IAS 32.33A]*. See Chapter 43 at section 9.2.
- IAS 40 permits an entity to separately elect between the fair value model or the cost model for all investment property backing liabilities that pay a return linked directly to the fair value of, or returns from, specified assets including that investment property (e.g., insurance contracts with direct participation features). *[IAS 40.32A]*. The choice to use either the fair value model or the cost model for all other investment property is a separate election. *[IAS 40.30]*. See Chapter 20 at section 5.1.

3 The definition of an insurance contract

3.1 The definition

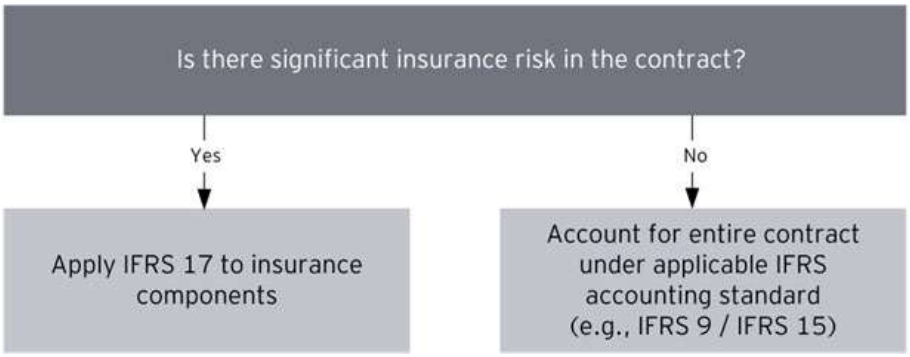
The term defined by IFRS 17 is as follows: *[IFRS 17 Appendix A]*

Extract from IFRS 17

Appendix A
Defined terms

insurance contract	A contract under which one party (the issuer) accepts significant **insurance risk** from another party (the **policyholder**) by agreeing to compensate the **policyholder** if a specified uncertain future event (the **insured event**) adversely affects the **policyholder**.

This definition determines which contracts are within the scope of IFRS 17 as opposed to other IFRS accounting standards.



The definition of an insurance contract is the same as the definition in IFRS 4 except for two clarifications. *[IFRS 17.BC67].* Therefore, most contracts that were insurance contracts under IFRS 4 are expected to be insurance contracts under IFRS 17, although IFRS 17 does not contain transitional provisions that 'grandfather' conclusions on the classification as insurance contract made under IFRS 4 (except for the consequential amendments to IFRS 3 *Business Combinations* - see section 14 below).

The two clarifications made by IFRS 17 to the application guidance explaining the definition of an insurance contract require that: *[IFRS 17.BC67]*

- An insurer should consider the time value of money in assessing whether the additional benefits payable in any scenario are significant (see section 3.5 below)
- A contract does not transfer significant insurance risk if there is no scenario with commercial substance in which the insurer can suffer a loss on a present value basis (see section 3.5 below)

Both of the two clarifications referred to above are intended to ensure that the determination of insurance risk is made on a present value basis as it was considered that IFRS 4 was unclear on the matter. Additionally, the definition of significant insurance risk (see section 3.5 below) uses the word 'amounts' instead of 'benefits' in order to capture payments that may not necessarily be payable to policyholders (for example claim handling expenses).

The definition of an insurance contract is discussed in more detail, as follows: *[IFRS 17.B2]*

- Uncertain future events (see section 3.2 below)
- Payments in kind (see section 3.3 below)
- The distinction between insurance risk and financial risks (see section 3.4 below)
- Significant insurance risk (see section 3.5 below)
- Changes in the level of insurance risk (see section 3.6 below)
- Examples of insurance and non-insurance contracts (see section 3.7 below)

Frequently asked questions

Question 3-1: Would IFRS 17 apply to, among others, service contracts including a form of EBITDA guarantee?

(TRG meeting September 2018 - Agenda paper no. 11, Log S33)

The submission described a specific fact pattern of an entity that provides hotel management services. The service fee that the entity charges is determined as a percentage of gross hotel revenue. The entity also guarantees the hotel owner a specified level of EBITDA. To the extent that the actual hotel EBITDA is below the specified level, the entity is obligated to make payments to the hotel owner. The amount payable under the guarantee may exceed the amount of the service fee receivable. The submission asks whether the guarantee provided by the entity is within the scope of IFRS 17.

The IASB Staff noted a contract is assessed against the definition of an insurance contract and the scope requirements of IFRS 17. The definition of an insurance contract in IFRS 17 is the same as the definition of an insurance contract in IFRS 4, with clarifications to the related guidance in Appendix B of IFRS 4. When assessing whether the contract meets the definition of an insurance contract, an assessment is made as to whether the contract transfers significant insurance risk. When assessing whether an insurance contract is within the scope of IFRS 17, an assessment is made as to whether any of the scope exclusions of IFRS 17 are applicable. IFRS 17 includes a scope exclusion for warranties provided by a manufacturer, dealer or retailer in connection with the sale of its services to a customer and also excludes contractual obligations contingent on the future use of a non-financial item (for example, contingent payments), as stated in IFRS 17.7 (see section 2.3.1 above).

How we see it

A service provider, such as a hotel operator, can be a 'retailer' under the product warranty scope exclusion (see section 2.3.1.A above). However, to qualify for the scope exclusion, the hotel operator must be providing a warranty in connection with the sale of its own services to the customer rather than providing income protection for the customer. Hence the entity would need to determine the nature of its services provided to the customer based on the terms and conditions of the contractual arrangement.

As discussed in sections 2.3.1.D and 2.3.3 above, IFRS 17 has a scope exclusion for certain credit card contracts (or similar contracts) that provide insurance coverage and an accounting policy choice to apply either IFRS 9 or IFRS 17 to loan contracts that transfer significant insurance risk only on settlement of the policyholder's obligation created by the contract.

3.2 Uncertain future events

Uncertainty (or risk) is the essence of an insurance contract. Accordingly, IFRS 17 requires at least one of the following to be uncertain at the inception of an insurance contract: *[IFRS 17.B3]*

(a) The probability of an insured event occurring

(b) When the insured event will occur

Or

(c) How much the entity will need to pay if the insured event occurs

An insured event will be one of the following:

- The discovery of a loss during the term of the contract, even if the loss arises from an event that occurred before the inception of the contract
- A loss that occurs during the term of the contract, even if the resulting loss is discovered after the end of the contract term *[IFRS 17.B4]*

  Or
- The determination of the ultimate cost of a claim which has already occurred but whose financial effect is uncertain *[IFRS 17.B5]*

This last type of insured event above arises from 'retroactive' contracts, i.e., those providing insurance coverage against an adverse development of an event which has occurred prior to the policy inception date. An example is a reinsurance contract that covers an insurer against adverse development of claims that are already reported by its policyholders but still need to be settled. In those contracts, the insured event is the determination of the ultimate cost of those claims. The implications of this on measurement is discussed in section 11.5.2.A below.

3.3 Payments in kind

Some insurance contracts require or permit payments to be made in kind. In such cases, the entity provides goods or services to the policyholder to settle the entity's obligation to compensate the policyholder for insured events. Such contracts are insurance contracts, even though the claims are settled in kind, and are treated the same way as insurance contracts when payment is made directly to the policyholder. For example, some insurers replace a stolen article directly rather than compensating the policyholder for the amount of its loss. Another example is when an entity uses its own hospitals and medical staff to provide medical services covered by the insurance contract. *[IFRS 17.B6]*.

Although these are insurance contracts, if they meet the conditions for fixed-fee service contracts (see section 2.3.2 above) entities can elect to apply either IFRS 15 or IFRS 17.

3.4 The distinction between insurance risk and financial risk

The definition of an insurance contract refers to 'insurance risk' which is defined as "risk, other than financial risk, transferred from the holder of a contract to the issuer". *[IFRS 17 Appendix A]*.

A contract that exposes the reporting entity to financial risk without significant insurance risk is not an insurance contract. *[IFRS 17.B7]*. 'Financial risk' as defined by IFRS 17 is as follows: *[IFRS 17 Appendix A]*

Extract from IFRS 17

Appendix A
Defined terms

financial risk	The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, currency exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

It is important to make a distinction between non-financial risk and financial risk because this affects the measurement and presentation of insurance contracts. Under the general model (see section 9 below) and the premium allocation approach (see section 10 below), the effect of, and changes in, financial risk are treated differently to the effect of, and changes in non-financial risks (e.g., insurance risk). For contracts with direct participation features, a distinction between non-financial risk and financial risk is also made but this distinction has different consequences in terms of the measurement model (see section 12 below). An example of a question concerning the distinction between non-financial risk and financial risk was a submission to the TRG that asked whether changes in fulfilment cash flows as a result of changes in inflation assumptions should be treated as changes in non-financial risk (and adjust the contractual service margin) or changes in financial risk for contracts measured under the general model (see Question 15-3 in section 15.3 below).

An example of a non-financial variable that is not specific to a party to the contract is an index of earthquake losses in a particular region or an index of temperatures in a particular city. An example of a non-financial variable that is specific to a party to the contract is the occurrence or non-occurrence of a fire that damages or destroys an asset of that party. Furthermore, the risk of changes in the fair value of a non-financial asset is not a financial risk if the fair value reflects changes in the market prices for such assets (i.e., a financial variable) and the condition of a specific non-financial asset held by a party to the contract (i.e., a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in that car's condition, that risk is insurance risk, not financial risk. *[IFRS 17.B8]*. This is illustrated in Illustration 3-1 below.

Contracts that expose the issuer to both financial risk and significant insurance risk can be insurance contracts. For example, many life insurance contracts guarantee a minimum rate of return to policyholders, creating financial risk, and at the same time promise death benefits that may significantly exceed the policyholder's account balance, creating insurance risk in the form of mortality risk. Such contracts are insurance contracts. *[IFRS 17.B9]*.

Under some contracts, an insured event triggers the payment of an amount linked to a price index. Such contracts are insurance contracts provided that the payment contingent on the insured event could be significant. *[IFRS 17.B10]*. This is illustrated in Illustration 3-2 below.

The definition of an insurance contract requires risk to be transferred from the policyholder to the insurer. This means that the insurer must accept, from the policyholder, a risk to which the policyholder was already exposed. Any new risk created by the contract for the entity or the policyholder is not insurance risk. *[IFRS 17.B11]*. For example, a construction contract may contain a clause requiring a builder to pay the customer a penalty (sometimes referred to as 'liquidated damages') if the builder fails to perform under the contract. The quantum of the damages could result in the builder suffering a loss under the contract. This is not an insurance contract for the builder because the risk of paying the penalty has been created by the construction contract itself rather than being a pre-existing risk to which the customer was already exposed.

Illustration 3-1: Residual value insurance

Entity A issues a contract to Entity B that provides a guarantee of the fair value at a future date of an aircraft (a non-financial asset) held by Entity B. Entity A is not the manufacturer, dealer or retailer of the aircraft and also is not the lessee of the aircraft (residual value guarantees given by a lessee under a lease are within the scope of IFRS 16).

This is an insurance contract (unless changes in the condition of the asset have an insignificant effect on its value). The risk of changes in the fair value of the aircraft is not a financial risk because the fair value reflects not only changes in market prices for similar aircraft but also the condition of the specific asset held.

However, if the contract compensated Entity B only for changes in market prices and not for changes in the condition of Entity B's asset, the contract would be a derivative and within the scope of IFRS 9.

Illustration 3-2: Contract with life contingent annuity linked to price index

Entity A issues a life-contingent annuity the value of which is linked to a cost of living index.

The contract is an insurance contract because the payment is triggered by an uncertain future event - the survival of the person who receives the annuity. The link to the price index is a derivative, but it also transfers insurance risk because the number of payments to which the index applies depends on the survival of the annuitant. If the resulting transfer of insurance risk is significant, the derivative meets the definition of an insurance contract in which case it should not be separated from the host contract (see section 5.1 below).

3.4.1 Insurable interest

For a contract to be an insurance contract, the insured event must have an adverse effect on the policyholder. *[IFRS 17.B12]*. In other words, there must be an 'insurable interest'. *[IFRS 17.BC73]*.

The IASB considered whether it should eliminate the notion of insurable interest and replace it with the notion that insurance involves assembling risks into a pool in which they can be managed together. *[IFRS 17.BC74]*. However, the IASB decided to retain the notion of insurable interest contained in IFRS 4, because without the reference to 'adverse effect', the definition might have captured any prepaid contract to provide services with uncertain costs. In addition, the notion of insurable interest is needed to avoid including gambling in the definition of insurance. Furthermore, the definition of an insurance contract is a principle-based distinction, particularly between insurance contracts and those used for hedging. *[IFRS 17.BC75]*.

The adverse effect on the policyholder is not limited to an amount equal to the financial impact of the adverse event. So, for example, the definition includes 'new for old' insurance coverage that pays the policyholder an amount that permits the replacement of a used or damaged asset with a new asset. Similarly, the definition does not limit payment under a life insurance contract to the financial loss suffered by a deceased's dependents, nor does it preclude the payment of predetermined amounts to quantify the loss caused by a death or accident. *[IFRS 17.B12]*.

A contract that requires a payment if a specified uncertain event occurs which does not require an adverse effect on the policyholder as a precondition for payment, is not an insurance contract. Such contracts are not insurance contracts even if the holder of the contract uses the contract to mitigate an underlying risk exposure. For example, if the holder of the contract uses a derivative to hedge an underlying financial or non-financial variable correlated with the cash flows from an asset of the entity, the derivative is not conditional on whether the holder is adversely affected by a reduction in the cash flows from the asset. Conversely, the definition of an insurance contract refers to an uncertain future event for which an adverse effect on the policyholder is a contractual precondition for payment. A contractual precondition does not require the insurer to investigate whether the uncertain event actually caused an adverse effect, but it does permit the insurer to deny payment if it is not satisfied that the event caused an adverse effect. *[IFRS 17.B13]*.

Illustration 3-3: Reinsurance contract with 'original loss warranty' clause

Entity A agrees to issue a contract to Entity B to provide reinsurance cover for CU5m against losses suffered. The insurance losses suffered by Entity B, which are recoverable under the contract, are limited to those arising from events where the industry-wide insured loss exceeds a threshold of CU100m (sometimes described as an 'original loss warranty'). This means that only losses suffered by Entity B up to CU5m from events exceeding an industry-wide insured loss of CU100m can be recovered under the contract.

Assuming insurance risk is significant, this is an insurance contract as Entity B can only recover its own insurance claims arising from those events.

If the contract allowed Entity B to claim up to CU5m every time there was an event with an industry-wide loss exceeding a threshold of CU100m, regardless of whether Entity B had suffered insurance claims from that event, then this would not be an insurance contract because there would be no insurable interest in the arrangement.

3.4.2 Lapse, persistency and expense risk

Lapse or persistency risk (the risk that the policyholder will cancel the contract earlier or later than the issuer had expected in pricing the contract) is not insurance risk. This is because the resulting variability in the payment to the policyholder is not contingent on an uncertain future event that adversely affects the policyholder. *[IFRS 17.B14]*.

Similarly, expense risk (the risk of unexpected increases in the administrative costs incurred by the issuer associated with the servicing of a contract, rather than in the costs associated with insured events) is not insurance risk because an unexpected increase in expenses does not adversely affect the policyholder. *[IFRS 17.B14]*.

Therefore, a contract that exposes an entity to lapse risk, persistency risk or expense risk is not an insurance contract unless it also exposes the entity to significant insurance risk. *[IFRS 17.B15]*.

3.4.3 Insurance of non-insurance risks

If the issuer of a contract which does not contain significant insurance risk mitigates the risk of that contract by using a second contract to transfer part of that first contract's risk to another party, this second contract exposes that other party to insurance risk. This is because the policyholder of the second contract (the issuer of the first contract) is subject to an uncertain event that adversely affects it and thus it meets the definition of an insurance contract. *[IFRS 17.B15]*.

Illustration 3-4: Insurance of non-insurance risks

Entity A agrees to compensate Entity B for losses on one or more contracts issued by Entity B that do not transfer significant insurance risk. The contract issued by Entity A to compensate Entity B is a direct insurance if it transfers significant insurance risk from Entity B to Entity A, and so Entity B is a policyholder of an insurance contract issued by Entity A and not the holder of a reinsurance contract. IFRS 17 does not apply if the entity is the holder of an insurance contract that is not a reinsurance contract (see section 2.3.1.C above).

3.5 Significant insurance risk

A contract is an insurance contract only if it transfers 'significant insurance risk'. *[IFRS 17.B17]*. Insurance risk is further discussed by IFRS 17 as follows: *[IFRS 17.B18, IFRS 17.B19]*

Extract from IFRS 17	
B18	Insurance risk is significant if, and only if, an insured event could cause the issuer to pay additional amounts that are significant in any single scenario, excluding scenarios that have no commercial substance (ie no discernible effect on the economics of the transaction). If an insured event could mean significant additional amounts would be payable in any scenario that has commercial substance, the condition in the previous sentence can be met even if the insured event is extremely unlikely, or even if the expected (ie probability-weighted) present value of the contingent cash flows is a small proportion of the expected present value of the remaining cash flows from the insurance contract.
B19	In addition, a contract transfers significant insurance risk only if there is a scenario that has commercial substance in which the issuer has a possibility of a loss on a present value basis. However, even if a reinsurance contract does not expose the issuer to the possibility of a significant loss, that contract is deemed to transfer significant insurance risk if it transfers to the reinsurer substantially all the insurance risk relating to the reinsured portions of the underlying insurance contracts.

The additional amounts described above are determined on a present value basis. If an insurance contract requires payment when an event with uncertain timing occurs and if the payment is not adjusted for the time value of money, there may be scenarios in which the present value of the payment increases, even if its nominal value is fixed. An example is insurance that provides a fixed death benefit when the policyholder dies, with no expiry date for the cover (often referred to as whole-life insurance for a fixed amount). It is certain that the policyholder will die, but the date of death is uncertain. Payments may be made when an individual policyholder dies earlier than expected. Because those payments are not adjusted for the time value of money, significant insurance risk could exist even if there is no overall loss on the portfolio of contracts. Similarly, contractual terms that delay timely reimbursement to the policyholder can eliminate significant insurance risk. An entity must use the discount rates required as discussed in section 9.3 below to determine the present value of the additional amounts. *[IFRS 17.B20]*.

IFRS 17 does not prohibit a contract from being an insurance contract if there are restrictions on the timing of payments or receipts. However, the existence of restrictions on the timing of payments may mean that the policy does not transfer significant insurance risk if it results in the lack of a scenario that has commercial substance in which the issuer has a possibility of a loss on a present value basis.

3.5.1 Quantity of insurance risk

No quantitative guidance supports the determination of 'significant' in IFRS 17. This was a deliberate decision because the IASB considered that if quantitative guidance was provided, it would create an arbitrary dividing line that would result in different accounting treatments for similar transactions that fall marginally on different sides of that line and would, therefore, create opportunities for accounting arbitrage. *[IFRS 17.BC78]*.

The IASB also rejected defining the significance of insurance risk by reference to the definition of materiality within the *Conceptual Framework for Financial Reporting* because, in its opinion, a single contract, or even a single book of similar contracts, would rarely generate a loss that would be material to the financial statements as a whole. Consequently, IFRS 17 defines the significance of insurance risk in relation to individual contracts (see section 3.5.2 below). *[IFRS 17.BC79]*.

The IASB also rejected the notion of defining the significance of insurance risk by expressing the expected (probability weighted) average of the present values of the adverse outcomes as a proportion of the expected present value of all outcomes, or as a proportion of the premium. This definition would mean that a contract could start as a financial liability and become an insurance contract as time passes or probabilities are reassessed. This idea would have required the constant monitoring of contracts over their life to see whether they continued to transfer insurance risk. The IASB considered that it would be too burdensome to require an entity to continuously monitor whether a contract meets the definition of an insurance contract over its duration. Consequently, as discussed in section 3.6 below, an assessment of whether significant insurance risk has been transferred is normally required only at the inception of a contract. *[IFRS 17.BC80]*.

IFRS 4 contained an illustrative example which implied that insured benefits must be greater than 101% of the benefits payable if the insured event did not occur for there to be insurance risk in an insurance contract. *[IFRS 4.IG2 Example 1.3]*. However, no equivalent example has been included in IFRS 17.

Some jurisdictions have their own guidance as to what constitutes significant insurance risk. However, other jurisdictions offer no quantitative guidance. The Board observed that some US GAAP practitioners apply a guideline that a reasonable possibility of a significant loss is at least a 10% probability of a loss of at least 10% of premium. *[IFRS 17.BC77]*. It is not disputed in the Basis for Conclusions that a 10% probability of a loss of at least a 10% of premium results in a transfer of significant insurance risk. Indeed, the words 'extremely unlikely' and 'a small proportion' (see section 3.5 above) suggests that the IASB envisages that significant insurance risk could exist at a lower threshold than a 10% probability of a loss of at least 10% of premium.

How we see it

The lack of a quantitative definition of significant insurance risk means that insurers must apply their own judgement as to what constitutes significant insurance risk. Although the IASB did not want to create an 'arbitrary dividing line', the practical impact of this lack of guidance is that insurers have to apply their own criteria to determine what constitutes significant insurance risk and there will probably be diversity in practice as to what these dividing lines are, at least at the margins.

There is no specific requirement under IFRS 17 for insurers to disclose any thresholds used in determining whether a contract contains significant insurance risk. However, IFRS 17 requires an entity to disclose the significant judgements made in applying IFRS 17 (see section 16.3 below) whilst IAS 1 *Presentation of Financial Statements*[3] requires an entity to disclose the judgements that management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements (see Chapter 3 at section 5.1.1.A).

3.5.2 The level at which significant insurance risk is assessed

Significant insurance risk must be assessed by individual contract, rather than by portfolios or groups of contracts or by reference to materiality to the financial statements. Thus, insurance risk may be significant even if there is a minimal probability of significant losses for a portfolio or group of contracts. *[IFRS 17.B22]*. There is no exception to the requirement for assessment at an individual contract level, unlike IFRS 4 which permitted an insurer to make an assessment based on a small book of contracts if those contracts were relatively homogeneous.

The IASB decided to define significant insurance risk in relation to a single contract rather than at a higher level of aggregation because, although contracts are usually managed on a portfolio basis, the contractual rights and obligations arise from individual contracts. Materiality by reference to the financial statements was considered an inappropriate basis to define significant insurance risk because a single contract, or even a single book of similar contracts, would rarely generate a material loss in relation to the financial statements as a whole. See section 3.5.1 above.

See section 4 below on when it may be necessary to combine a set or series of contracts as a whole to report the substance.

If an insurance contract is separated into non-insurance components and insurance components (see section 5 below), IFRS 17 is applied only to the remaining components of the host insurance contract. *[IFRS 17.13]*.

A contract which has insignificant insurance risk as a whole is likely to be accounted for under either IFRS 9 or IFRS 15. IFRS 15 contains guidance for separating contracts that are partially within the scope of IFRS 15 and partially within the scope of another IFRS accounting standard which implies that it might be possible, subject to materiality considerations, for the part of a service contract that contains insurance risk to be accounted for under IFRS 17. *[IFRS 15.7(b)]*.

3.5.2.A Self insurance

An insurer can accept significant insurance risk from a policyholder only if it issues an insurance contract to an entity separate from itself. Therefore, 'self-insurance' (i.e., retaining a risk that could have been covered by insurance) such as a self-insured deductible where the policyholder cannot claim for losses below the excess limit of an insurance policy, is not insurance because there is no insurance contract with a third party. *[IFRS 17.B27(c)]*.

3 IFRS 18 *Presentation and Disclosure in Financial* Statements, which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted) was issued by the IASB in April 2024. See Chapter 4 for further details on the new concepts and requirements of IFRS 18.

Accounting for self-insurance and related provisions is covered by IAS 37 which requires that a provision is recognised only if there is a present obligation as a result of a past event, if it is probable that an outflow of resources will occur and a reliable estimate can be determined. *[IAS 37.14]*.

3.5.2.B Mutual insurers

A mutual insurer accepts risk from each policyholder and pools that risk. Although policyholders bear the pooled risk collectively in their capacity as owners, the mutual has still accepted the risk that is the essence of an insurance contract and therefore IFRS 17 applies to those contracts. *[IFRS 17.B16]*. Accounting for insurance contracts issued by mutual entities is discussed in section 9.11 below.

3.5.2.C Intragroup insurance contracts

Where there are insurance contracts between entities in the same group, these are eliminated in the consolidated financial statements as required by IFRS 10 *Consolidated Financial Statements*. However, for the individual or separate financial statements of the issuer or holder, there is an insurance contract. *[IFRS 17.B27(c)]*. If any intragroup insurance contract is reinsured with a third party that is not part of the group, this third-party reinsurance contract must be accounted for as a direct insurance contract in the consolidated financial statements of a non-insurer because the intragroup contract will be eliminated on consolidation. This residual direct insurance contract (i.e., the policy with the third party) is outside the scope of IFRS 17 from the viewpoint of the consolidated financial statements of a non-insurer because policyholder accounting is excluded from IFRS 17 as discussed in section 2.3.1.C above.

Illustration 3-5: Insurance provided by group company

Parent A pays an insurance premium to Subsidiary B in exchange for an insurance contract within the scope of IFRS 17. Subsidiary B invests the premiums received and pays claims incurred under the insurance contract to Parent A.

In the consolidated financial statements of Group A, IFRS 17 does not apply since the group has not issued an insurance contract. The transactions between Parent A and Subsidiary B are eliminated on consolidation in accordance with IFRS 10.B86 (see Chapter 8 at section 2.4). Claims from third parties against Parent A which are covered by the intra-group insurance contract are accounted for under IAS 37 (see section 3.5.2.A above).

In the separate financial statements of Parent A, IFRS 17 does not apply as Parent A is the holder of an insurance contract. IFRS 17 would also not apply if Parent A was the holder of an insurance contract issued by a third-party insurer (i.e., an insurer outside Group A). See section 2.3.1.C above.

In the separate, individual, or consolidated financial statements of Subsidiary B, IFRS 17 applies as Subsidiary B has issued an insurance contract.

How we see it

Reporting entities should carefully consider the consequences of intragroup contracts in financial statements prepared under IFRS accounting standards, other than the consolidated financial statements, e.g., separate financial statements or individual financial statements of subsidiaries. For example, as shown in Illustration 3-5 above, a subsidiary may have to recognise and measure its insurance liabilities under IFRS 17 for the purpose of its own IFRS financial statements even if those insurance liabilities have been eliminated on consolidation.

3.5.3 Significant additional amounts

The 'additional amounts that are significant in any single scenario' described in section 3.5 above refer to the present value of amounts that exceed those that would be payable if no insured event occurred (excluding scenarios that lack commercial substance). These additional amounts include claims handling and claims assessment costs but exclude: *[IFRS 17.B21]*

- The loss of the ability to charge the policyholder for future service. For example, in an investment-linked life contract, the death of the policyholder means that the entity can no longer perform investment management services and collect a fee for doing so. However, the economic loss for the entity does not result from insurance risk. Consequently, the potential loss or future investment management fees are not relevant when assessing how much insurance risk is transferred by a contract.
- The waiver on death of charges that would be made on cancellation or surrender of the contract. Because the contract brought these charges into existence, their waiver does not compensate the policyholder for a pre-existing risk. Hence, they are not relevant in determining how much insurance risk is transferred by a contract.

- A payment conditional on an event that does not cause a significant loss to the holder of the contract. For example, where the issuer must pay CU1m if an asset suffers physical damage causing an insignificant economic loss of CU1 to the holder. The holder, in this case, has transferred to the insurer the insignificant insurance risk of losing CU1. At the same time, the contract creates non-insurance risk that the issuer will need to pay an additional CU999,999 if the specified event occurs. Because there is no scenario in which an insured event causes a significant loss to the holder of the contract, the issuer does not accept significant insurance risk from the holder and this contract is not an insurance contract.
- Possible reinsurance recoveries - the insurer must account for these separately.

It follows from this that if a contract pays a death benefit exceeding the amount payable on survival (excluding any waiver or surrender charges mentioned above), the contract is an insurance contract unless the additional death benefit is insignificant (judged by reference to the contract rather than to an entire portfolio of contracts). Similarly, an annuity contract that pays out regular sums for the rest of a policyholder's life is an insurance contract, unless the aggregate life-contingent payments are insignificant because the insurer could suffer a significant loss on an individual contract if the annuitant survives longer than expected. *[IFRS 17.B23]*.

Frequently asked questions

Question 3-2: Is the risk related to a premium waiver provision a pre-existing risk of the policyholder transferred to the entity by the contract and therefore an insurance risk, or a new risk created by the contract?

(TRG meeting September 2018 - Agenda paper no. 07, Log S78)

The TRG members considered a submission which discussed whether a contract that contains a provision that waives the payment of a premium under certain circumstances is an insurance contract. In such cases, the main insured event in the contract differs from the event triggering a premium waiver. For example, the primary coverage may be a term life contract covering mortality risk and premiums are waived if the policyholder has been disabled for six consecutive months, although the policyholder continues to receive the benefits originally promised under the insurance contract despite the waiver of premiums. The TRG members agreed with the IASB staff analysis and observed that:

- There is an insurance risk when an entity provides a waiver of premiums if a specified event occurs
- The waiver of premiums differs from the situations discussed above (i.e., the economic loss of the ability to charge the policyholder for future service and the waiver, on death, of contract surrender or cancellation charges)

This is because the risk of the events giving rise to the waiver exists before the contract is issued. It is not a risk created by the contract and the contract does not increase the potential adverse effects. In addition, the events that trigger a waiver are contractual pre-conditions without which the entity can deny the waiver.

The TRG members observed that the consequences of such a waiver of premiums are:

- The inclusion of a clause in an investment contract in which premiums are waived by contractual pre-conditions makes the investment contract an insurance contract.

  And
- The inclusion of such a waiver in a contract that would also be an insurance contract without the waiver, would impact the quantity of benefits provided by the contract and therefore the coverage period, affecting the recognition of the contractual service margin in profit or loss.

Question 3-3: Should an entity exclude from insurance revenue, premiums waived as a result of an insured event or should it account for them as part of insurance service expense (i.e., an incurred claim)?

(TRG meeting April 2019 - Agenda paper no. 02, Log S117)

The IASB staff clarified, and the TRG agreed that, to the extent that a premium waiver results from an insured event, it is a claim and, therefore, recognised as an insurance service expense.

3.6 Changes in the level of insurance risk

IFRS 17 requires the assessment of whether a contract transfers significant insurance risk to be made only once. The Basis for Conclusions states that this assessment is made 'at inception'. *[IFRS 17.BC80]*. We interpret this phrase to mean that the assessment is made when the contract is issued rather than the start of the coverage period since a contract can be recognised at an earlier date than the start of the coverage period (see section 7 below).

As the assessment of significant insurance risk is made only once, a contract that qualifies as an insurance contract remains an insurance contract until all rights and obligations are extinguished, i.e., discharged, cancelled or expired, unless the contract is derecognised because of a modification (see section 13 below). *[IFRS 17.B25]*. This applies even if circumstances have changed such that insurance contingent rights and obligations have expired. The IASB considered that requiring insurers to set up systems to continually assess whether contracts continue to transfer significant insurance risk imposed a cost that far outweighed the benefit that would be gained from going through the exercise. *[IFRS 17.BC80]*. For a contract acquired in a business combination or transfer, the assessment of whether the contract transfers significant insurance risk is made at the date of acquisition or transfer (see section 14 below).

For some contracts, the transfer of insurance risk to the issuer occurs after a period of time. *[IFRS 17.B24]*. Once such a contract becomes an insurance contract, it remains an insurance contract until extinguishment as discussed above.

Frequently asked questions

Question 3-4: How should the exercise of an option to convert a contract to a different type of contract be treated?

(TRG meeting April 2019 - Agenda paper no. 02, Log S107)

The submission asked how a contract which transfers insurance risk after a period of time, as discussed in IFRS 17.B24, should be classified. The Staff analysis explained that for a contract to meet the definition of an insurance contract, there needs to be a transfer of significant insurance risk. IFRS 17.B24 explains that contracts that transfer insurance risk only after an option is exercised do not meet the definition of insurance contracts at inception. An entity should consider the requirements of other IFRS accounting standards in order to account for such contracts until they become insurance contracts. A contract which only transfers insurance risk after a period of time is different from an insurance contract that provides an option to add further insurance coverage, discussed in Agenda Paper 3 of the May 2018 TRG meeting.

Some stakeholders suggested to the IASB that a contract should not be accounted for as an insurance contract if the insurance-contingent rights and obligations expire after a very short time. IFRS 17 addresses aspects of this by requiring that scenarios that lack commercial substance are ignored in the assessment of significant insurance risk and stating that there is no significant transfer of insurance risk in some contracts that waive surrender penalties on death (see sections 3.5.3 above and 12.4.1 below). *[IFRS 17.BC81]*.

The following Illustration is based on the example in IFRS 17, of a contract where the transfer of insurance risk only occurs after a period of time. *[IFRS 17.B24]*.

Illustration 3-6: Deferred annuity with policyholder election

Entity A issues a deferred annuity contract which provides a specified investment return to the policyholder and includes an option for the policyholder to use the proceeds of the investment on maturity to buy a life-contingent annuity at the same rates that Entity A charges other new annuitants at the time the policyholder exercises that option.

This is not an insurance contract at inception because it does not contain significant insurance risk. Entity A remains free to price the annuity on a basis that reflects the insurance risk that will be transferred to it at that time. Such a contract transfers insurance risk to the issuer only after the option is exercised. Consequently, the cash flows that would occur on the exercise of the option fall outside the boundary of the contract and before exercise there are no insurance cash flows within the boundary of the contract. Consequently, on inception, the contract is a financial instrument within the scope of IFRS 9.

However, if the contract specifies the annuity rates (or a basis other than market rates for setting the annuity rates), the contract transfers insurance risk to Entity A (the issuer) on issuance because Entity A is exposed to the risk that the annuity rates will be unfavourable when the policyholder exercises the option. In that case, the cash flows that would occur when the option is exercised are within the boundary of the contract.

3.7 Examples of insurance and non-insurance contracts

This section contains examples given in IFRS 17 of insurance and non-insurance contracts.

3.7.1 Examples of insurance contracts

The following are examples of contracts that are insurance contracts, if the transfer of insurance risk is significant: *[IFRS 17.B26]*

- Insurance against theft or damage.
- Insurance against product liability, professional liability, civil liability or legal expenses.
- Life insurance and prepaid funeral plans (although death is certain, it is uncertain when death will occur or, for some types of life insurance, whether death will occur within the period covered by the insurance). Although prepaid funeral plans that provide benefits in kind might be fixed fee service contracts, they may not meet the conditions required by IFRS 17 to use IFRS 15 accounting (see section 2.3.2 above) because insurance risk arises primarily from the uncertainty over the cost of the service.
- Life-contingent annuities and pensions (contracts that provide compensation for the uncertain future event - the survival of the annuitant or pensioner - to assist the annuitant or pensioner in maintaining a given standard of living, which would otherwise be adversely affected by his or her survival).
- Insurance against disability and medical costs.
- Surety bonds, fidelity bonds, performance bonds and bid bonds (i.e., contracts that provide compensation if another party fails to perform a contractual obligation, for example an obligation to construct a building). Accounting for these contracts and consideration as to whether they are insurance contracts or loan commitments under IFRS 9 is contained in Chapter 41 at section 2.5.1. These types of bonds differ from financial guarantee contracts in that the latter are based on underlying financial obligations, rather than non-financial ones (see section 2.3.1.B above).
- Product warranties issued by another party for goods sold by a manufacturer, dealer or retailer are within the scope of IFRS 17. However, as discussed in section 2.3.1.A above, product warranties issued directly by a manufacturer, dealer or retailer are outside the scope of IFRS 17 and are instead within the scope of IFRS 15 or IAS 37.
- Title insurance (insurance against the discovery of defects in title to land that were not apparent when the insurance contract was issued). In this case, the insured event is the discovery of a defect in the title, not the defect itself.
- Travel assistance (compensation in cash or in kind to policyholders for losses suffered in advance of, or during travel).
- Catastrophe bonds that provide for reduced payments of principal, interest or both if a specified event adversely affects the issuer of the bond (unless the specified event does not create significant insurance risk, for example if the event is a change in an interest rate or a foreign exchange rate).
- Insurance swaps and other contracts that require a payment based on changes in climatic, geological and other physical variables that are specific to a party to the contract.

These examples are not intended to be an exhaustive list.

The following illustrative examples, based on examples contained previously in IFRS 4, provide further guidance on situations where there is significant insurance risk.

Illustration 3-7: Guarantee fund established by contract

A guarantee fund is established by contract. The contract requires all participants to pay contributions to the fund so that it can meet obligations incurred by participants (and, perhaps, others). Participants would typically be from a single industry, e.g., insurance, banking or travel.

The contract that establishes the guarantee fund is an insurance contract.

This example contrasts with Illustration 3-11 in section 3.7.2 below, where a guarantee fund has been established by law and not by contract.

Illustration 3-8: No market value adjustment (MVA) for maturity benefits

A contract permits the issuer to deduct an MVA, a charge which varies depending on a market index, from surrender values or death benefits. The contract does not permit the issuer to deduct an MVA for maturity benefits.

The policyholder obtains an additional survival benefit because no MVA is applied at maturity. That benefit is a pure endowment because the insured person receives a payment on survival to a specified date, but beneficiaries receive nothing if the insured person dies before then. If the risk transferred by that benefit is significant, the contract is an insurance contract.

Illustration 3-9: No market value adjustment (MVA) for death benefits

A contract permits the issuer to deduct an MVA from surrender values or maturity payments. The contract does not permit the issuer to deduct an MVA for death benefits.

The policyholder obtains an additional death benefit because no MVA is applied on death. If the risk transferred by that death benefit is significant, the contract is an insurance contract.

3.7.2 Examples of transactions that are not insurance contracts

The following are examples of transactions that are not insurance contracts: *[IFRS 17.B27]*

- Investment contracts that have the legal form of an insurance contract but do not transfer significant insurance risk to the issuer. For example, life insurance contracts in which the insurer bears no significant mortality or morbidity risk are not insurance contracts. Investment contracts with discretionary participation features do not meet the definition of an insurance contract. However, they are within the scope of IFRS 17 provided they are issued by an entity that also issues insurance contracts (see section 12.4 below).
- Contracts that have the legal form of insurance but return all significant risk back to the policyholder through non-cancellable and enforceable mechanisms that adjust future payments by the policyholder as a direct result of insured losses, for example, some financial reinsurance contracts or some group contracts. Such contracts are normally financial instruments or service contracts.
- Self-insurance, in other words retaining a risk that could have been covered by insurance. See section 3.5.2.A above.
- Contracts (such as gambling contracts) that require a payment if an unspecified uncertain future event occurs, but do not require, as a contractual precondition for payment, that the event adversely affects the policyholder. However, this does not preclude the specification of a predetermined payout to quantify the loss caused by a specified event such as a death or an accident. See section 3.4.1 above.
- Derivatives that expose one party to financial risk but not insurance risk, because the derivatives require that party to make payment based solely on the changes in one or more of a specified interest rate, a financial instrument price, a commodity price, a foreign exchange rate, an index of prices or rates, a credit rating or a credit index or other variable, provided that, in the case of a non-financial variable, the variable is not specific to a party to the contract.
- Credit-related guarantees that require payments even if the holder has not incurred a loss on the failure of a debtor to make payments when due.
- Contracts that require a payment that depends on a climatic, geological or any other physical variable not specific to a party to the contract (commonly described as weather derivatives).
- Contracts that provide for reduced payments of principal, interest or both, that depend on a climatic, geological or any other physical variable that is not specific to a party to the contract (commonly referred to as catastrophe bonds).

An entity must apply other IFRS accounting standards, such as IFRS 9 and IFRS 15, to the contracts described above. *[IFRS 17.B28]*.

The credit-related guarantees and credit insurance contracts referred to above can have various legal forms, such as that of a guarantee, some types of letters of credit, a credit default contract or an insurance contract. As discussed in section 2.3.1.B above, those contracts are insurance contracts) if they require the issuer to make specified payments to reimburse the holder for a loss that the holder incurs because a specified debtor fails to make payment when due to the policyholder applying the original or modified terms of a debt instrument. However, such insurance contracts are excluded from the scope of IFRS 17 unless the issuer has previously asserted explicitly that it regards the contracts as insurance contracts and has used accounting applicable to insurance contracts. *[IFRS 17.B29]*.

Credit-related guarantees and credit insurance contracts that require payment, even if the policyholder has not incurred a loss on the failure of the debtor to make payments when due, are outside the scope of IFRS 17 because they do not transfer significant insurance risk. Such contracts include those that require payment: *[IFRS 17.B30]*

- Regardless of whether the counterparty holds the underlying debt instrument

  Or

- On a change in the credit rating or the credit index, rather than on the failure of a specified debtor to make payments when due

The following Illustrations, based on examples contained previously in IFRS 4, illustrate further situations where IFRS 17 is not applicable.

Illustration 3-10: Investment contract linked to asset pool

Entity A issues an investment contract in which payments are contractually linked (with no discretion) to returns on a pool of assets held by the issuer (Entity A).

This contract is within the scope of IFRS 9 because the payments are based on asset returns and there is no transfer of significant insurance risk.

Illustration 3-11: Guarantee fund established by law

Guarantee funds established by law exist in many jurisdictions. Typically, they require insurers to contribute funds into a pool in order to pay policyholder claims in the event of insurer insolvencies. They may be funded by periodic (usually annual) levies or by levies only when an insolvency arises. The basis of the funding requirement varies although typically most are based on an insurer's premium income.

The commitment of participants to contribute to the fund is not established by contract so there is no insurance contract. Obligations to guarantee funds are within the scope of IAS 37.

Illustration 3-12: Right to recover future premiums

Entity A issues an insurance contract which gives it an enforceable and non-cancellable contractual right to recover all claims paid out of future premiums, with appropriate compensation for the time value of money.

Insurance risk is insignificant because all claims can be recovered from future premiums. Consequently, the insurer cannot suffer a significant loss and the contract is a financial instrument within the scope of IFRS 9.

Illustration 3-13: Market value adjustment (MVA) without death or maturity benefits

A contract permits the issuer to deduct an MVA from surrender payments. The contract does not permit an MVA for death and maturity benefits. The amount payable on death or maturity is the amount originally invested plus interest.

The policyholder obtains an additional benefit because no MVA is applied on death or maturity. However, that benefit does not transfer insurance risk from the policyholder because it is certain that the policyholder will live or die and the amount payable on death or maturity is adjusted for the time value of money. Therefore, the contract is an investment contract because there is no significant insurance risk. This contract combines the two features discussed in section 3.7.1 above. When considered separately, these two features transfer insurance risk. However, when combined, they do not transfer insurance risk. Therefore, it is not appropriate to separate this contract into two insurance components. *[IFRS 17.9]*.

If the amount payable on death were not adjusted in full for the time value of money, or were adjusted in some other way, the contract might transfer significant insurance risk.

4 Combining insurance contracts

Extract from IFRS 17

Combination of insurance contracts

9 A set or series of insurance contracts with the same or a related counterparty may achieve, or be designed to achieve, an overall commercial effect. In order to report the substance of such contracts, it may be necessary to treat the set or series of contracts as a whole. For example, if the rights or obligations in one contract do nothing other than entirely negate the rights or obligations in another contract entered into at the same time with the same counterparty, the combined effect is that no rights or obligations exist.

[IFRS 17.9].

This requirement is intended to prevent entities entering into contracts that individually transfer significant insurance risk, but collectively do not, and accounting for part(s) of what is effectively a single arrangement as separate insurance contracts.

Parties are considered to be related for the purpose of combining contracts when they meet the definition of related parties in IAS 24 *Related Party Disclosures*.

Frequently asked questions

Question 4-1: When may it be necessary to treat a set or series of insurance contracts as a whole, applying IFRS 17.9?

(TRG meeting May 2018 - Agenda paper no. 01, Log S47)

The TRG members discussed the analysis of an IASB staff paper and observed that:

- A contract with the legal form of a single contract would generally be considered on its own to be a single contract in substance. However, there may be circumstances where a set or series of insurance contracts with the same or a related counterparty reflect a single contract in substance.
- The fact that a set or series of insurance contracts with the same counterparty are entered into at the same time is not, in itself, sufficient to conclude that they achieve, or are designed to achieve, an overall commercial effect. Determining whether it is necessary to treat a set or series of insurance contracts as a single contract involves significant judgement and careful consideration of all relevant facts and circumstances. No single factor is determinative in applying this assessment.
- The following considerations might be relevant in assessing whether a set or series of insurance contracts achieve, or are designed to achieve, an overall commercial effect:
  - The rights and obligations are different when looked at together compared to individually, for example, if the rights and obligations of one contract negate the rights and obligations of another contract.
  - The entity is unable to measure one contract without considering the other. This may be the case where there is interdependency between the different risks covered in each contract and the contracts lapse together. When cash flows are interdependent, separating them can be arbitrary.
- The existence of a discount, in itself, does not mean that a set or series of contracts achieve an overall commercial effect.
- The TRG members also observed that the principles for combining insurance contracts in IFRS 17.9 are consistent with the principles for separating insurance components from a single contract, as discussed at the February 2018 meeting of the TRG (see section 5 below).

How we see it

The TRG discussion clarifies that in order for an entity to combine a set or series of insurance contracts, those contracts need firstly to be entered into with the same or a related counterparty. If this requirement is not met, the set or series of insurance contracts cannot be combined under this specific guidance in IFRS 17. If this requirement is met, this fact, in and of itself, is not sufficient to conclude that the set or series of insurance contracts should be combined.

Determining whether it is necessary to combine a set or series of insurance contracts into a single contract involves significant judgement and careful consideration of all relevant facts and circumstances. Examples of facts and circumstance to consider in determining whether the contracts were designed to achieve an overall commercial effect are:

- Are the two contracts each priced based upon a single risk; or priced in contemplation of the entire transaction?
- Does the lapse of one contract change the rights and obligations of the other contract(s)?
- Does measuring the contracts separately result in one/some of the contract(s) being onerous whereas when measured as a whole the contract is profitable?
- Do both the direct and ceded policies cover the same underlying insurance risks, and would they be impacted similarly by the underlying insured events?
- Are the rights and obligations different when looked at together, compared to when looked at individually, for example through a guarantee or indemnification provided to the insurer?

Illustration 4-1: Combination of insurance contracts

Insurance Company A enters into an insurance policy with Insured B. Company A simultaneously enters into a fronting agreement with Captive Insurer C, a related party of Insured B. The purpose of the fronting agreement is to reinsure 100% of the insurance risk from A's insurance policy with B. However, A would be legally required to honour the obligations imposed by the insurance policy with B if C failed to indemnify A.

Insurance Company A should consider whether it should combine the insurance policy with Insured B and the reinsurance contract with Captive Insurer C, taking into consideration the factors identified by the TRG (see Question 4-1 above).

How we see it

The guidance on the combination of insurance contracts may impact the accounting for fronting arrangements with related parties as follows:

- In Illustration 4-1 above, if the insurance contract is not combined with the reinsurance contract, the two contracts will be accounted for on a gross basis. The liabilities under the insurance policy may consequently not exactly offset the reinsurance asset due to, for example, different measurement models (the insurance contract might be eligible for the premium allocation approach but the reinsurance contract might not, or *vice versa*), contract boundary, coverage period and allowing for the risk of non-performance within the measurement of the reinsurance contract.
- In Illustration 4-1 above, if the insurance contract is combined with the reinsurance contract, the single arrangement will be accounted for on a net basis under IFRS 17. However, if the combined arrangement does not meet the criteria for significant insurance risk transfer, it would not be within the scope of IFRS 17.

In addition to the specific guidance on combining contracts in IFRS 17, it may be necessary to consider whether the reporting entity is acting as an agent or principal in relation to the insurance contract services being provided. Where the entity merely acts as an agent on behalf of the other parties of an arrangement through, for example, a tripartite arrangement or a series of agreements, it would be necessary to account for the contracts on that basis in order to reflect the economic substance of a set or series of insurance contracts, even if a related party situation is not present. Concluding that an insurance company is acting as an agent is not expected to be common because the entity that holds a reinsurance contract does not normally have a right to reduce the amounts it owes to the underlying policyholder by amounts it expects to receive from the reinsurer, i.e., the entity commonly retains the primary responsibility for fulfilling the insurance contract services to its policyholders. While IFRS 17 does not include specific guidance on how to determine whether an entity is acting as an agent or a principal, guidance in IFRS 15.B34-B38 might be relevant under the IAS 8.11 hierarchy. When an entity acts as an agent in respect of an insurance contract, the accounting for that insurance contract by the entity would be outside of the scope of IFRS 17.

5 Separating components from an insurance contract

Insurance contracts may contain one or more components that would be within the scope of another IFRS accounting standard if they were separate contracts. Such components may be embedded derivatives, an investment component or a component for services other than insurance contract services.

IFRS 17 requires an insurer to identify and separate components in certain circumstances. When separated, those components must be accounted for under the relevant IFRS accounting standard instead of under IFRS 17. *[IFRS 17.10]*. The IASB considers that accounting for such components separately using other applicable IFRS accounting standards makes them more comparable to similar contracts that are issued as separate contracts and allows users of financial statements to better compare the risks undertaken by entities in different businesses or industries. *[IFRS 17.BC99]*.

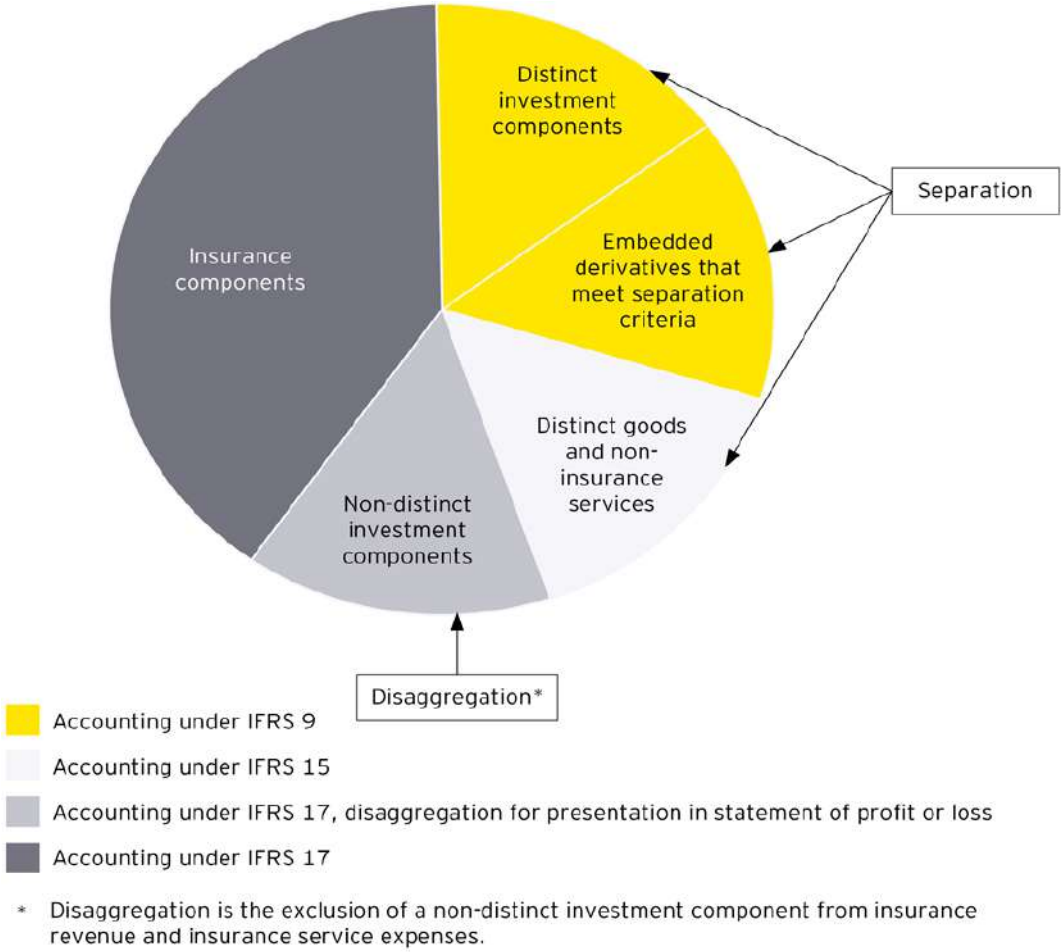
Therefore, an insurer must:

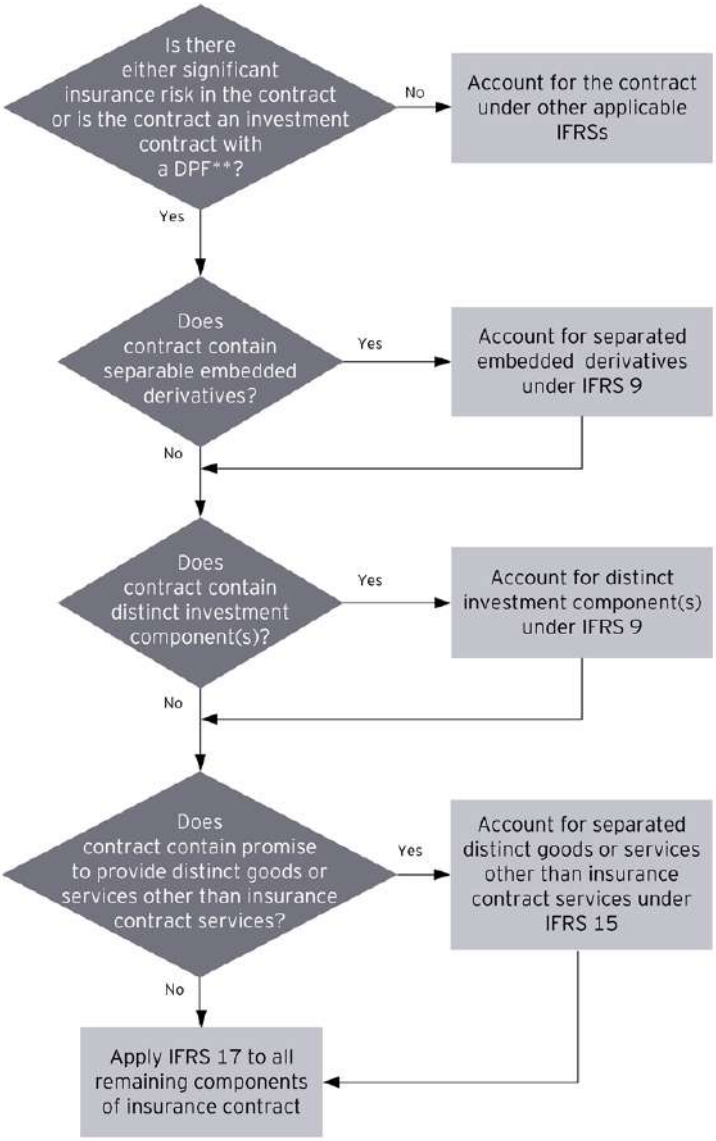
- Apply IFRS 9 to determine whether there is an embedded derivative to be separated and, if there is, account for that separate derivative (see section 5.1 below)
- Separate from a host insurance contract, an investment component if, and only if, that investment component is distinct and apply IFRS 9 to account for the separated component, unless it is an investment contract with discretionary participation features (see section 5.2 below), *[IFRS 17.11]*,

  And then
- Separate from the host insurance contract, any promise to transfer to a policyholder distinct goods or services other than insurance contract services applying IFRS 15.7 (see section 5.3 below) *[IFRS 17.12]*

After separating the components described above (i.e., distinct non-insurance components), an entity applies IFRS 17 to all remaining components of the host insurance contract. *[IFRS 17.13]*. The recognition and measurement criteria of IFRS 17 are discussed in sections 7 and 8 below. Non-distinct investment components are accounted for under IFRS 17. However, they are disaggregated (i.e., excluded) from insurance revenue and insurance service expenses (see section 5.2.3 below).

The diagrams below illustrates the approach to separating non-insurance components:





** Investment contracts with Discretionary Participation Features (DPF) are within the scope of IFRS 17 if the entity that issues them also issues insurance contracts. See sections 2.3 and 12.4.

5.1 Separating embedded derivatives from an insurance contract

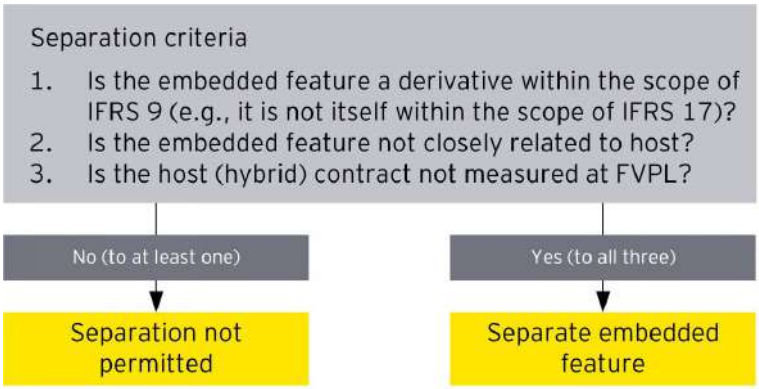
An entity applies IFRS 9 to determine whether to separate an embedded derivative from a host insurance contract. An embedded derivative is a component of a hybrid contract that also includes a non-derivative host, meaning that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified. This is determined according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, price or rate index, credit rating or index, or other variable, provided that, in the case of a non-financial variable, the variable is not specific to a party to the contract. *[IFRS 9.4.3.1]*.

IFRS 9 requires separation of an embedded derivative from its host if, and only if: *[IFRS 9.4.3.3]*

- A separate instrument with the same terms as the embedded feature meets the definition of a derivative within the scope of IFRS 9 (this would not be the case if the embedded derivative is itself an insurance contract within the scope of IFRS 17).
- The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host insurance contract. According to IFRS 9, a derivative embedded in an insurance contract relates closely to the host insurance contract if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (without considering the host contract). *[IFRS 9.B4.3.8(h)]*.

  And
- The hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss (i.e., a derivative that is embedded in a financial liability at fair value through profit or loss is not separated).

The diagram below illustrates the embedded derivative decision tree:



The Board believes that accounting separately for some embedded derivatives in insurance contracts: *[IFRS 17.BC104]*

- Ensures that contractual rights and obligations that create similar risk exposures are treated alike whether or not they are embedded in a non-derivative host contract
- Counters the possibility that entities might seek to avoid the requirement to measure derivatives at fair value by embedding a derivative in a non-derivative host contract

IFRS 4 had previously required IFRS 9 or IAS 39 to be applied to derivatives embedded in a host insurance contract unless the embedded derivative was itself an insurance contract. *[IFRS 4.7]*. IFRS 17 does not contain a statement that such embedded derivatives (i.e., derivatives that are insurance contracts themselves) are excluded from IFRS 9. However, any derivative that itself is an insurance contract is scoped out by IFRS 9 and, therefore, would not be subject to the embedded derivative separation guidance of IFRS 9 but accounted for under IFRS 17. *[IFRS 9.2.1(e)(i)]*.

A derivative is a financial instrument within the scope of IFRS 9 with all three of the following characteristics: *[IFRS 9 Appendix A]*

- Its value changes in response to a change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to the underlying of the contract
- It requires no initial net investment or an initial net investment that would be smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors
- It is settled at a future date

The following are examples of embedded derivatives that may be found in insurance contracts:

- Benefits, such as death benefits, linked to equity prices or an equity index
- Options to take life-contingent annuities at guaranteed rates
- Guarantees of minimum interest rates in determining surrender or maturity values
- Guarantees of minimum annuity payments where the annuity payments are linked to investment returns or asset prices
- A put option for the policyholder to surrender a contract. These can be specified in a schedule, based on the fair value of a pool of interest-bearing securities or based on an equity or commodity price index
- An option to receive a persistency bonus (an enhancement to policyholder benefits for policies that remain in-force for a certain period)
- An industry loss warranty where the loss trigger is an industry loss as opposed to an entity specific loss
- A catastrophe trigger where a trigger is defined as a financial variable such as a drop in a designated stock market
- An inflation index affecting policy deductibles
- Contracts where the currency of claims settlement differs from the currency of loss
- Contracts with fixed foreign currency rates

The following Illustration shows an embedded derivative in an insurance contract that is not required to be separated and accounted for under IFRS 9.

Illustration 5-1: Death or annuity benefit linked to equity prices or index

A contract has a death benefit linked to equity prices or an equity index 'that is payable only on death or when annuity payments begin, and not on surrender or maturity'.

The equity-index feature meets the definition of an insurance contract (unless the life-contingent payments are insignificant) because the policyholder benefits only when the insured event occurs. Therefore, the derivative and the host insurance contract are interdependent and the derivative is closely related to the insurance contract. The embedded derivative is not required to be separated and accounted for under IFRS 9 but remains within the scope of IFRS 17. *[IFRS 9.B4.3.8(h)]*.

The following Illustration shows an embedded derivative in an insurance contract that is required to be separated and accounted for under IFRS 9.

Illustration 5-2: Policyholder option to surrender contract for value based on a market index

An insurance contract gives the policyholder the option to surrender the contract for a surrender value based on an equity or commodity price or index (i.e., the surrender amount is indexed to the value of equity instruments or the price of a commodity).

The option is not closely related to the host insurance contract because the surrender value is derived from an index and is not interdependent with the insurance contract. Therefore, the surrender option is required to be accounted for under IFRS 9. *[IFRS 9.B4.3.5(c), IFRS 9.B4.3.5(d)]*.

The meaning of 'closely related' is discussed more generally in Chapter 42 at section 4.

IFRS 17 removed the exception in IFRS 4 that allowed an insurer not to separate and measure at fair value, a policyholder's option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate), even if the exercise price differed from the carrying amount of the host insurance liability. *[IFRS 4.8]*. Instead, the requirements of IFRS 9 are used to determine whether an entity needs to separate a surrender option. *[IFRS 17.BC105(b)]*.

How we see it

Although IFRS 17 did not carry forward the exception from separating and measuring at fair value, a policyholder's option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate), the value of a typical surrender option and the host insurance contract are likely to be interdependent because one component cannot be measured or exist without the other. Therefore, in practice, this change may not result in separation of the surrender option from the host insurance contract.

5.2 Separating investment components from an insurance contract

IFRS 17 introduces the concept of an investment component, which is defined differently compared to the notion of a deposit component included in IFRS 4. *[IFRS 4.10]*.

An investment component is the amount an insurance contract requires the entity to repay to a policyholder in all circumstances, regardless of whether an insured event occurs. *[IFRS 17 Appendix A]*.

IFRS 17 requires distinct investment components to be separated from the host insurance contract and accounted for under IFRS 9. Investment components that are not distinct are accounted for under IFRS 17. However, investment components accounted for under IFRS 17 are excluded from the insurance service result (i.e., they are not accounted for as either insurance revenue or insurance service expenses). See section 5.2.3 below. *[IFRS 17.85]*.

5.2.1 The definition of an investment component

Frequently asked questions

Question 5-1: How to determine whether an insurance contract includes an investment component.

(TRG meeting April 2019 - Agenda paper no. 01, Log S85, S90 and S112)

The submissions ask how to:

- Determine whether an insurance contract includes an investment component
- Assess whether an investment component is distinct (see section 5.2.2 below)
- Determine the amount of an investment component (see section 5.2.3 below)

In determining whether the contract requires the entity to make a payment in all circumstances, the Staff observed that:

- IFRS 17 requires an entity to assess at inception whether an investment component is separated from an insurance contract. To make that assessment, the entity determines whether the contract includes an investment component at inception.
- Different events can trigger a payment to a policyholder under an insurance contract. For example, a payment could be due because the policyholder terminates the contract, an insured event occurs, or the contract reaches its maturity. The insurance contract includes an investment component only if a payment would occur in all circumstances. For example, a non-cancellable contract that requires an entity to pay an amount when the policyholder dies, includes an investment component because the entity is required to pay the amount in all circumstances. The amount to be paid in this case is a claim for a future event that is the death of the policyholder (although the timing is uncertain). However, a non-cancellable contract that requires an entity to pay an amount only if the policyholder survives to a specified age but does not require the entity to pay any amount if the policyholder dies before that, does not include an investment component. The amount to be paid in this case is a claim for an insured event, i.e., the survival of the policyholder.
- IFRS 17 states that an entity needs to assess the insurance risk excluding scenarios that have no commercial substance (i.e., no discernible effect on the economics of the transaction). Hence, for the purpose of determining whether an insurance contract includes an investment component, the entity needs to assess whether scenarios in which no payments are made have commercial substance. The entity does not consider a scenario for which no payment is made if that scenario has no commercial substance.
- In some scenarios, the amount of the payment could be zero. However, this does not necessarily mean that no investment component exists. For example, an entity would need to consider whether a scenario in which the amount of payment is zero arises from:
  - A payment that an entity makes to the policyholder early in the coverage period that might reduce the investment component to zero later in the coverage period.
  - The policyholder's decision to use a payment due from the entity to settle amounts due to the entity. This might be the case when the policyholder decides to terminate a contract early in the coverage period and uses a surrender amount to pay surrender charges that are equal to or higher than the surrender amount, or when the policyholder has the option to use a surrender amount to buy insurance coverage, such as an annuity. In the staff's view, the fact that the policyholder chooses to use a payment it is due to fund payments to the entity does not mean the entity is not required to make payments in all circumstances. This is because settling amounts due on a net or gross basis does not affect the outcome of the assessment of whether an investment component exists.
  - A payment amount may be made to a policyholder upon cancellation of a contract that is calibrated to reflect outstanding future periods in which a service is provided. Such a payment may indicate that the policyholder is entitled to a premium refund reflecting its consumption of service over the life of the contract. In this case, the payments may represent a refund of premiums for unused coverage rather than an investment component.

Any payments on cancellation that represent premium refunds for unused coverage rather than an investment component are not required to be disclosed separately from the investment component. See section 16.1.1 below. *[IFRS 17.103(c)]*.

The following Illustrations are based on examples of insurance contracts from the April 2019 TRG meeting that further illustrate whether an insurance contract includes an investment component.

Illustration 5-3: Investment component in a life cover contract

In exchange for a single premium of CU1,000 paid by a 60 year-old policyholder, the life cover contract promises to pay an amount of CU2,000 when the policyholder reaches 80 years old or when the policyholder dies before reaching 80 years old. The policyholder cannot terminate the contract.

The life cover contract includes an investment component because the contract requires the insurer to make a payment to the policyholder in all circumstances, i.e., whether the policyholder reaches 80 years old or dies before reaching 80 years old.

Illustration 5-4: Investment component in immediate annuity contract

In exchange for premiums, the immediate annuity contract with a guarantee payment period promises to make regular payments to the policyholder for the remainder of the policyholder's life, or the estate of the policyholder for a remaining guaranteed period if the policyholder dies before the end of the guaranteed period (for example, if the guaranteed period is three years and the policyholder dies at the end of Year 1, the estate will continue to receive regular payments for two years). This example assumes that the policyholder cannot terminate the contract.

The immediate annuity contract with a guaranteed payment period includes an investment component. The staff observe that the contract requires the entity to make a payment in all circumstances i.e., regular payments to the policyholder or to the estate of the policyholder for the guaranteed period.

Illustration 5-5: Investment component in deferred annuity contract

The deferred annuity contract promises to pay a surrender amount to the policyholder if the policyholder dies or terminates the contract before reaching 60 years old or, if the policyholder reaches 60 years old, to make regular payments to the policyholder for the remainder of the policyholder's life. In addition, if the policyholder dies before reaching 80 years old, the contract requires the entity to pay an amount at least equal to the amount accumulated to the policyholder through deposits less payments already made. It is assumed that if the policyholder reaches 80 years old, the regular payments received between the ages of 60 years old and 80 years old at least equal the amount accumulated through deposits and the amount accumulated through deposits does not accrue interest after the policyholder reaches 60 years old. The policyholder cannot terminate the contract after reaching 60 years old.

The deferred annuity contract includes an investment component because the contract requires the entity to pay a fixed amount in all circumstances, either a surrender amount if the policyholder dies or terminates the contract before reaching 60 years old or an amount that is equal to the amount accumulated by the policyholder through deposits, if the policyholder dies between the ages of 60 and 80 or reaches 80 years old.

Illustration 5-6: Pure protection contract

In exchange for premiums, the pure protection contract promises to pay a fixed amount of CU1,000 to the policyholder on the death of the policyholder, if the policyholder dies within a 5-year coverage period or a variable surrender amount to the policyholder if the policyholder opts to surrender the contract before the end of Year 4. No amount is paid to the policyholder if the policyholder keeps the contract to Year 5 and survives.

The pure protection contract does not contain an investment component because there are circumstances with commercial substance in which no amount is paid.

A contract which does not require a payment to a policyholder if it continues to the end of the coverage period without a claim being made, does not contain an investment component. There may be a payment upon surrender but this payment is regardless of whether the insured event occurs. However, because there is no payment on maturity, there is a scenario where no payment to the policyholder is made (provided this scenario has commercial substance). Therefore, a pure protection contract does not contain an investment component because there are circumstances with commercial substance in which no amount is paid. The same would apply to a contract where there is no payment upon death before maturity (i.e., a pure endowment contract).

5.2.2 Separable investment components

Many insurance contracts have an implicit or explicit investment component that would, if it were a separable financial instrument, be within the scope of IFRS 9. However, the Board decided that it would be difficult to routinely separate such investment components from insurance contracts. *[IFRS 17.BC108]*.

Accordingly, IFRS 17 requires an entity to separate from a host insurance contract an investment component if, and only if, that investment component is distinct from the host insurance contract. *[IFRS 17.11(b)]*. The Board concluded that, in all cases, entities would be able to measure the stand-alone value for a separated investment component by applying IFRS 9. *[IFRS 17.BC109]*.

The words 'if, and only if' mean that voluntary separation of investment components which are not distinct is prohibited. This is a change from IFRS 4, which permitted voluntary unbundling of deposit components if the deposit component could be measured separately. The Board considered whether to permit an entity to separate a non-insurance component when not required to do so by IFRS 17; for example, some investment components with interrelated cash flows, such as policy loans. Such components may have been separated when applying previous accounting practices. However, the Board concluded that it would not be possible to separate in a non-arbitrary way, a component that is not distinct from the insurance contract nor would such a result be desirable. The Board also noted that when separation ignores interdependencies between insurance and non-insurance components, the sum of the values of the components may not always equal the value of the contract as a whole, even on initial recognition. That would reduce the comparability of the financial statements across entities. *[IFRS 17.BC114]*.

An investment component is distinct if, and only if, both of the following conditions are met: *[IFRS 17.B31]*

- The investment component and the insurance component are not highly interrelated.
- A contract with equivalent terms is sold, or could be sold, separately in the same market or the same jurisdiction, either by entities that issue insurance contracts or by other parties. The entity must take into account all information reasonably available in making this determination. However, the entity is not required to undertake an exhaustive search to identify whether an investment component is sold separately.

An investment component and an insurance component are highly interrelated if, and only if: *[IFRS 17.B32]*

- The entity is unable to measure one component without considering the other. For example, if the value of one component varies according to the value of the other, an entity must apply IFRS 17 to account for the combined investment and insurance components.

  Or

- The policyholder is unable to benefit from one component unless the other is also present. For example, if the lapse or maturity of one component in a contract causes the lapse or maturity of the other, the entity must apply IFRS 17 to account for the combined investment and insurance components.

Frequently asked questions

Question 5-2: How to assess whether an investment component is distinct.

(TRG meeting April 2019 - Agenda paper no. 01, Log S85, S90 and S112)

The submissions ask how to:

- Determine whether an insurance contract includes an investment component (see section 5.2.1 above)
- Assess whether an investment component is distinct
- Determine the amount of an investment component (see section 5.2.3 below)

Assessing whether an investment component is distinct, the Staff considered the two criteria in IFRS 17.B31.

TRG members discussed the analysis on assessing whether an investment component is distinct and observed that an investment component within an insurance contract is not distinct if the investment component and the insurance component are highly interrelated, i.e., when:

- It is not possible to measure one component without considering the other. This could be the case when the contract requires the entity to make payments for which either the amount or the timing depend on the insured event. IFRS 17.BC10(a) explains that ignoring interdependencies between components of an insurance contract would have the result that the sum of the values of the components may not always equal the value of the contract as a whole, even on initial recognition. Thus, if the value of one component varies according to the value of the other component the resulting measurement might not be meaningful for one of (or for both) the components.
- The policyholder cannot benefit from one component if the other is not present. The lapse or maturity of one component causing the lapse or maturity of the other component is sufficient to conclude that the two components are highly interrelated. For example, the lapse of the insurance component causing the lapse of the investment component is sufficient to conclude that the two components are highly interrelated, even if the lapse of the investment component does not cause the lapse of the insurance component. A contractual term preventing the policyholder from cancelling the investment component or the insurance component or both may indicate that the policyholder cannot benefit from one component without the other.

TRG members also observed that the hurdle for separation of investment components from an insurance contract is high.

The following Illustrations are based on examples of insurance contracts from the April 2019 TRG meeting that further illustrate whether an investment component within an insurance contract is distinct.

Illustration 5-7: Investment component in a life cover contract

In exchange for a single premium of CU1,000 paid by a 60 year-old policyholder, the life cover contract promises to pay an amount of CU2,000 when the policyholder reaches 80 years old or when the policyholder dies before reaching 80 years old. The policyholder cannot terminate the contract.

The value of the insurance component varies according to the value of the investment component because the insured event in this example is the timing of death. Although the payment of CU2,000 is certain, it is uncertain when the policyholder will die and, therefore whether the entity will pay the amount of CU2,000 before the policyholder reaches 80 years old and how soon that may be after the inception of the contract. Therefore, the entity cannot measure the insurance component without considering the investment component and, as a result, the investment component is not distinct and the entity cannot separate it from the insurance contract.

The IASB staff further observed that the policyholder cannot benefit from one component when the other component is not present because both components lapse together.

Illustration 5-8: Investment component in deferred annuity contract

The deferred annuity contract promises to pay a surrender amount to the policyholder if the policyholder dies or terminates the contract before reaching 60 years old or, if the policyholder reaches 60 years old, to make regular payments to the policyholder for the remainder of the policyholder's life. In addition, if the policyholder dies before reaching 80 years old, the contract requires the entity to pay an amount at least equal to the amount accumulated to the policyholder through deposits less payments already made. It is assumed that if the policyholder reaches 80 years old, the regular payments received between the ages of 60 years old and 80 years old at least equal the amount accumulated through deposits and the amount accumulated through

deposits does not accrue interest after the policyholder reaches 60 years old. The policyholder cannot terminate the contract after reaching 60 years old.

In this contract the investment component is: (i) a surrender amount if the policyholder dies or terminates the contract before reaching 60 years old; or (ii) an amount that is equal to the amount accumulated by the policyholder through deposits, if the policyholder reaches 60 years old. The insurance component is possible payments exceeding the amount accumulated by the policyholder through deposits.

If the policyholder dies after reaching 60 years old and before reaching 80 years old, the entity makes a payment reflecting the amount accumulated by the policyholder through deposits. The timing of that payment depends on the death of the policyholder. Therefore, the entity cannot measure the investment contract without considering the insurance component. As a result, the investment component is not distinct and the entity cannot separate it from the insurance contract.

The IASB staff also observed that the death of the policyholder causes the maturity of both the insurance component in the contract and the investment component in the contract.

The following Illustration is based on Example 4 in the Illustrative Examples to IFRS 17: *[IFRS 17.IE43-50]*

Illustration 5-9: Insurance contract with an account balance and a minimum death benefit

An entity issues a whole life insurance contract with an account balance. The contract does not have a fixed term. The entity receives a premium of CU1,000 when the contract is issued. The account balance is increased annually by voluntary amounts paid by the policyholder, increased or decreased by amounts calculated using the returns from specified assets and decreased by fees charged by the entity (e.g., asset management fees).

The contract promises to pay the following:

- A death benefit of CU5,000 plus the amount of the account balance if the insured person dies during the coverage period

  And

- The account balance, if the contract is cancelled (i.e., there are no surrender charges)

The entity has a claims processing department to process the claims received and an asset management department to manage investments. An investment product that has equivalent terms to the account balance, but without the insurance coverage, is sold by another financial institution.

The contract contains an investment component because an amount is paid to the policyholder in all circumstances (i.e., either the account balance if the contract is cancelled or the death benefit plus the account balance if the insured person dies during the coverage period).

The existence of an investment product with equivalent terms indicates that the components may be distinct. However, if the right to provide death benefits provided by the insurance coverage either lapses or matures at the same time as the account balance, the insurance and investment components are highly interrelated and are therefore not distinct. Consequently, the account balance would not be separated from the insurance contract and would be accounted for by applying IFRS 17.

Claims processing activities are part of the activities the entity must undertake to fulfil the contract and the entity does not transfer a good or service to the policyholder because the entity performs those activities. Thus, the entity would not separate the claims processing component from the insurance contract.

Asset management activities, similar to claims processing activities, are part of the activities the entity must undertake to fulfil the contract and the entity does not transfer a good or service other than insurance contract services to the policyholder because the entity performs those activities. Thus, the entity would not separate the asset management component from the insurance contract.

How we see it

An account balance in a savings-type insurance contract is a clear example of a repayable contract feature that would typically be an investment component. There are various other repayable amounts that may also meet the definition of an investment component depending on the applicable circumstances, for example guaranteed annuity payments and no-claim bonuses.

The requirements in IFRS 17 for separating investment components do not specifically address the issue of contracts artificially separated through the use of side letters, the separate components of which should be considered together. However, IFRS 17 does state that it may be necessary to treat a set or series of contracts as a whole in order to report the substance of such contracts. For example, if the rights or obligations in one contract do nothing other than entirely negate the rights or obligations of another contract entered into at the same time with the same counterparty, the combined effect is that no rights or obligations exist (see section 4 above).

5.2.3 Measurement of the non-distinct investment component

A distinct investment component is accounted for under IFRS 9. See section 5.2 above. A non-distinct investment component is accounted for under IFRS 17.

Although an entity applies IFRS 17 to account for both the combined investment and insurance components of an insurance contract if those components are highly interrelated (i.e., non-distinct), insurance revenue and insurance service expenses presented in profit or loss must exclude any non-distinct investment component. *[IFRS 17.85, IFRS 17.BC108(b)]*.

IFRS 17 does not explain how to determine the amount of non-distinct investment components that an entity is required to exclude from insurance revenue and insurance service expense. This issue was discussed at the April 2019 meeting of the TRG.

Frequently asked questions

Question 5-3: How to determine the amount of an investment component.

(TRG meeting April 2019 - Agenda paper no. 01, Log S85, S90 and S112)

The submissions ask how to:

- Determine whether an insurance contract includes an investment component (see section 5.2.1 above)
- Assess whether an investment component is distinct (see section 5.2.2 above)
- Determine the amount of an investment component

The Staff observed that there could be circumstances in which the investment component is not explicitly identified by the contractual terms or where the amount of the investment component varies over time. The Staff observed that, in these circumstances, an approach for determining the investment component that is based on a present value basis as at the time of making this determination would be consistent with the requirements of IFRS 17.B21, which refers to the present value of significant additional amounts that result in a contract being defined as an insurance contract (see section 3.5.3 above). The staff consider that if the amounts that would be payable if no insurance event had occurred are determined on a present value basis, it would be consistent to determine the investment component on a present value basis too.

The TRG members observed that:

- In some cases, it may be reasonable to determine the amount of the investment component that an entity is required to exclude from insurance revenue and insurance service expenses using the explicit amount identified by contractual terms. For example, the amounts of a non-distinct investment component can be identified as an explicit surrender amount or explicit guaranteed payments.
- In other cases, it may be appropriate to determine the amount of the investment component that an entity is required to exclude from insurance revenue and insurance service expenses on a present value basis at the time of making the determination. For example, in an uncancellable contract that requires an entity to pay the policyholder an amount when the policyholder dies or reaches the age of 80 (see Illustrations 5-3 in section 5.2.1 and Illustration 5-7 in section 5.2.2 above), using the present value of the payments the contract requires the entity to make at the age of 80 as the amount of the investment component would result in a reasonable outcome because death in the early periods of coverage would reflect a higher insurance claim than in later periods.

The TRG members also observed that if an entity uses an explicit surrender amount for determining the amounts to be excluded from insurance revenue and insurance service expense, it should not be required to determine whether a part of that amount reflects a premium refund. The TRG members noted that both an investment component and a premium refund will be excluded from revenue and expenses recognised from a contract in these circumstances. In addition, there is no requirement to separately disclose any premium refund from the non-distinct investment component.

IFRS 17 requires an entity to determine the amount of a non-distinct investment component only at the time insurance revenue and incurred claims are recognised and to exclude the amounts so identified from insurance revenue and insurance service expenses. *[IFRS 17.BC34]*. Accordingly, when a claim is incurred, IFRS 17 requires an entity to determine how much of that claim is an investment component. An entity should also determine whether it was expected to become payable in that period. The contractual service margin for a group of insurance contracts without direct participation features is adjusted for differences between any investment component expected to become payable in the period (adjusted for the effect of the time value of money and financial risk) and the actual investment component that becomes payable in

the period (see section 9.6 below). The result is that the net effect on the contractual margin is the effect of the change in timing of the repayment of the investment component. This means the entity would have to be able to determine the differences between any investment component expected to become payable in the period and the actual investment component that becomes payable. *[IFRS 17.B96, IFRS 17.BC235]*.

How we see it

Although it is observed in the Basis for Conclusions that non-distinct investment components need be identified only at the time insurance revenue and incurred claims are recognised, so as to exclude the amount of the investment components so identified, an entity may also need to identify any non-distinct investment component before an incurred claim is recognised in order to determine whether it was expected to become payable in a period.

5.3 Goods or services other than insurance contract services

After applying IFRS 9 to embedded derivatives and separating a distinct investment component from a host insurance contract, an entity is required to separate from the host insurance contract any promise to transfer to a policyholder distinct goods or services other than insurance contract services (i.e., non-insurance services) by applying the requirements of IFRS 15 for a contract that is partially within the scope of IFRS 15 and partially within the scope of other IFRS accounting standards. *[IFRS 17.12]*.

This means that, on initial recognition, an entity must: *[IFRS 17.12]*

- Apply IFRS 15 to attribute the cash inflows between the insurance component and any promises to provide distinct goods or services other than insurance contract services

  And

- Attribute the cash outflows between the insurance component and any promised goods or services other than insurance contract services accounted for applying IFRS 15 so that:
  - Cash outflows that relate directly to each component are attributed to that component
  - Any remaining cash outflows are attributed on a systematic and rational basis, reflecting the cash outflows the entity would expect to arise if that component were a separate contract

The allocation of the cash inflows between the host insurance contract and the distinct good or service other than an insurance contract service should be based on the stand-alone selling price of the components. The Board believes that, in most cases, entities would be able to determine an observable stand-alone selling price for the bundled goods or services if those components meet the separation criteria. *[IFRS 17.BC111]*. If the stand-alone selling price is not directly observable, an entity would need to estimate the stand-alone selling price of each component to allocate the transaction price. This stand-alone selling price might not be directly observable if the entity does not sell the insurance and the goods or components separately, or if the consideration charged for the two components together differs from the stand-alone selling prices for each component. In this case, applying IFRS 15 results in any discounts and cross-subsidies being allocated to components proportionately or on the basis of observable evidence. *[IFRS 17.BC112]*. IFRS 17 requires that cash outflows should be allocated to their related component, and that cash outflows not clearly related to one of the components should be systematically and rationally allocated between components. Insurance acquisition cash flows and some fulfilment cash flows relating to overhead costs do not clearly relate to one of the components. A systematic and rational allocation of such cash flows is consistent with the requirements in IFRS 17 for allocating acquisition and fulfilment cash flows that cover more than one group of insurance contracts to the individual groups of contracts, and is also consistent with the requirements in other IFRS accounting standards for allocating the costs of production, e.g., the requirements in IFRS 15 and IAS 2 *Inventories*. *[IFRS 17.BC113]*.

For the purpose of separation, an entity does not consider activities that it must undertake to fulfil a contract unless the entity transfers a good or service other than insurance contract services to the policyholder as those activities occur. For example, an entity may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the policyholder as the tasks are performed. *[IFRS 17.B33]*.

A good or service other than an insurance contract service promised to a policyholder is distinct if the policyholder can benefit from the good or service either on its own or together with other resources readily available to the policyholder. Readily available resources are goods or services that are sold separately (by the entity or by another entity), or resources that the policyholder has already got (from the entity or from other transactions or events). *[IFRS 17.B34]*.

A good or service other than insurance contract service that is promised to the policyholder is not distinct if: *[IFRS 17.B35]*

- The cash flows and risks associated with the goods or services are highly interrelated with the cash flows and risks associated with the insurance components in the contract
- The entity provides a significant service in integrating the goods or non-insurance services with the insurance components

The Board considered, but rejected, the possibility to separate non-insurance components that are not distinct because it would not be possible to separate, in a non-arbitrary way, a component that is not distinct from the insurance contract nor would such a result be desirable. *[IFRS 17.BC114]*.

The following Illustration is based on Example 5 in the Illustrative Examples to IFRS 17: *[IFRS 17.IE51-55]*

Illustration 5-10: Separating components from a stop-loss contract with claims processing services

An entity issues a stop loss contract to a policyholder (which is an employer). The contract provides health coverage for the policyholder's employees, with these features:

- Insurance coverage of 100% for the aggregate claims from employees exceeding CU25m (the 'stop loss' threshold). The employer will self-insure claims from employees up to CU25m.
- Claims processing services for employees' claims during the next year, regardless of whether these have exceeded the stop-loss threshold of CU25m. The entity is responsible for processing the health insurance claims of employees on behalf of the employer.

Analysis

The entity considers whether to separate the claims processing services from the insurance contract. Similar services to process claims on behalf of customers are available in the market.

The criteria for identifying distinct non-insurance services are met in this example because:

- Claims processing services, similar to those for employers' claims on behalf of the employer, are sold as a stand-alone service without any insurance coverage.
- These services benefit the policyholder independently of the insurance coverage. Had the entity not agreed to provide those services, the policyholder would have to process its employees' medical claims itself or engage other service providers.
- Cash flows associated with claims processing services are not highly interrelated with the cash flows of the insurance coverage, and the entity does not provide for a significant service of integrating claims processing services with the insurance components.

Accordingly, the entity separates the claims processing services (for all claims) from the insurance contract and accounts for them by applying IFRS 15.

The following Illustration is Based on Example 4 in the Illustrative Examples to IFRS 17: *[IFRS 17.IE43-50]*

Illustration 5-11: Separating components from a life insurance contract with an account balance

An entity issues a life insurance contract with an account balance and receives a premium of CU1,000 when the contract is issued. The account balance increases annually by voluntary amounts paid by the policyholder and is credited with returns from specified assets and decreased by fees charged by the entity (e.g., asset management fees).

The contract promises to pay:

- A death benefit of CU5,000 plus the amount of the account balance, if the insured person dies during the coverage period

  And

- The account balance, if the contract is cancelled (i.e., there are no surrender charges)

The entity uses a claims processing department to process the claims received and an asset management department to manage investments. Other financial institutions offer investment products whose terms are equivalent to the account balance, but without the insurance coverage.

Analysis

The existence of an investment product with equivalent terms indicates that the components may be distinct. However, if the right to provide death benefits provided by the insurance coverage either lapses or matures at the same time as the account balance is returned, the insurance and investment components are highly interrelated and therefore not distinct. Consequently, there would be no separation of an account balance and insurance contract, and the account balance would be accounted for by applying IFRS 17. Amounts related to the investment component would not be presented as insurance revenue or insurance service expenses.

An entity must undertake claims processing and asset management activities to fulfil the contract and does not transfer distinct goods or services to the policyholder simply because the entity performs these. Thus, the entity would not separate these components from the insurance contract.

6 Level of aggregation

IFRS 17 defines the level of aggregation to be used for measuring insurance contracts and their related profitability. This is a key issue in identifying onerous contracts and in determining the recognition of profit or loss and presentation in the financial statements.

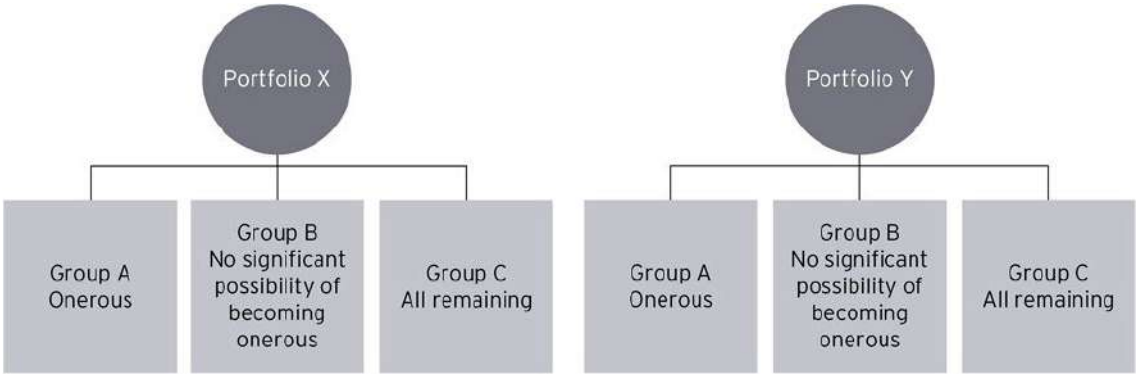
The starting point for aggregating contracts is to identify portfolios of insurance contracts. A portfolio comprises contracts that are subject to similar risks and managed together. *[IFRS 17.14]*.

IFRS 17 then requires an entity to divide the contracts in each portfolio on initial recognition into the following groups: *[IFRS 17.16]*

- Those contracts that are onerous at initial recognition (except for those contracts subject to the premium allocation approach where an entity can assume no contracts are onerous at initial recognition unless facts and circumstances indicate otherwise - see section 9.8 below)
- Those contracts that have no significant possibility of becoming onerous subsequently

  And
- All remaining contracts in the portfolio

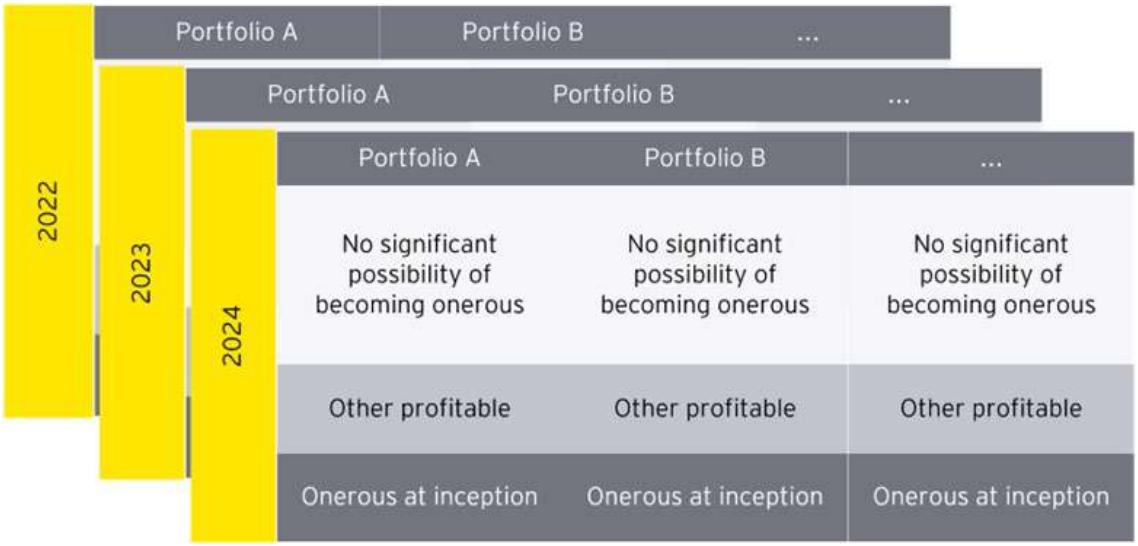
This can be illustrated as follows:



An entity is permitted, but not required, to divide the portfolio into more groups based on profitability if its internal reporting provides information of profitability at a more detailed level. See section 6.2.1 below. *[IFRS 17.21]*.

Groups of contracts are established at initial recognition and are not reassessed. *[IFRS 17.24]*.

An entity is prohibited from grouping contracts issued more than one year apart (except in certain circumstances when applying IFRS 17 for the first time, see sections 17.4 and 17.5 below). *[IFRS 17.22]*. This is commonly referred to as the 'annual cohort' requirement (see section 6.2.2 below). This means that separate groups for each portfolio are created at least annually.



Entities implementing IFRS 17 raised concerns relating to the level of aggregation requirements. The Board, therefore, considered whether to amend the requirements, and if so, how. Having considered a number of possible amendments, the Board reaffirmed its view that the benefits of the level of aggregation requirements significantly outweigh the costs. The Board decided to retain the requirements unchanged. *[IFRS 17.BC139A, IFRS 17.BC139B]*. See section 6.2.2 below.

To measure a group of contracts, an entity may estimate the fulfilment cash flows (see section 8 below) at a higher level of aggregation than the group or portfolio. This assumes the entity is able to include the appropriate fulfilment cash flows in the measurement of the group by allocating such estimates to groups of contracts.

How we see it

The level of aggregation is important because it determines the extent to which expected gains or losses arising from individual contracts may be offset with expected gains and losses of other contracts. It also determines the pattern of profit recognition over time.

Separating contracts issued more than one year apart is a new concept compared to many existing insurance accounting practices. In addition to operational challenges, maintaining separate 'cohorts' limit an entity's ability to offset profits and losses (or spread different levels of profitability) arising from different generations of contracts in a portfolio. The application of the aggregation level under IFRS 17 will, therefore, strongly affect requirements for process, systems and data when implementing the standard.

6.1 Identifying portfolios

A portfolio comprises contracts that are subject to similar risks and managed together. Contracts have similar risks if the entity expects their cash flows will respond similarly in amount and timing to changes in key assumptions. Contracts within a product line would be expected to have similar risks and, thus, would be in the same portfolio if they were managed together. Contracts in different product lines (for example, single premium-fixed annuities as opposed to regular-term life insurance) would not be expected to have similar risks and would be in different portfolios. *[IFRS 17.14]*.

Deciding which contracts have similar risks is a matter of judgement. Many insurance products provide a basic level of insurance cover with optional add-ons (or riders) at the discretion of the policyholder. For example, a homeowner insurance policy may provide legal cost protection or additional accidental damage cover at the policyholder's discretion in return for additional premiums. The question arises as to the point at which policies of a similar basic type have been tailored to the level at which the risks have become dissimilar. Rider benefits issued and priced separately from the host insurance contract may need to be accounted for as separate contracts because they, in substance, represent new contracts (see section 6.1.1 below).

IFRS 17 defines financial risks and insurance risk (a non-financial risk). Financial risk is defined to include "The risk of a possible change in... [a] currency exchange rate". *[IFRS 17 Appendix A]*. In September 2022, the IFRS IC observed that when IFRS 17 requires an entity to consider or reflect only particular risks (for example, only non-financial risk), it explicitly refers to the risks to be considered or reflected. Consequently, the IFRS IC concluded that, because IFRS 17.14 refers to 'similar risks' without specifying any particular types of risk, an entity is required to consider all risks - including currency exchange rate risk - when identifying portfolios of insurance contracts. However, 'similar risks' do not mean 'identical risks'. An entity could therefore identify portfolios of contracts that include contracts subject to different currency exchange rate risk. The IFRS IC observed that what an entity considers to be 'similar risks' will depend on the nature and extent of the risks in the entity's insurance contracts. See Question 8-1 in section 8.3 below for further detail on this agenda decision.

For presentation purposes only, insurance contracts are aggregated in the statement of financial position at portfolio level (see section 15 below).

How we see it

The definition of portfolio may differ from how this term is defined under IFRS 4. An entity's practice under IFRS 4 for identifying portfolios may not be consistent with the IFRS 17 requirement that contracts with different risks will be in different portfolios. Practices applied under IFRS 4 for recognising losses from onerous contracts were based on wider groupings of contracts than those in IFRS 17. For example, liability adequacy tests were often applied at product or legal entity level. We believe the level of aggregation requirements under IFRS 17 will lead to a more granular grouping and, as such, the requirements under IFRS 17 are likely to result in earlier identification of losses compared to the reporting under IFRS 4.

6.1.1 Separation of insurance components within an insurance contract

Insurers may combine different types of products or coverages with different risks into one insurance contract. Examples include a contract for both life and disability insurance and one for both pet and home insurance. In some situations, separating a single insurance contract into separate risk components may be required for regulatory reporting purposes. Although IFRS 17 provides guidance on separating non-insurance components within an insurance contract (see section 5 above), the standard is silent as to whether an insurance contract can be separated into different insurance components (i.e., allocated to different portfolios for aggregation purposes) and, if so, the basis for such a separation.[4]

Frequently asked questions

Question 6-1: Is it permitted to separate different insurance components from the host insurance contract and measure the components separately?

(TRG meeting February 2018 - Agenda paper no. 01, Log S02)

Some entities may combine, for example, home and motor insurance in a single contract for certain policyholders and also issue these products separately in the market to other policyholders. IFRS 17 seems to imply that, in these circumstances, the entity would have three portfolios (home, motor, and home & motor insurance) because the contracts contain three different types of risk. However, IFRS 17 refers to groups of insurance contracts and is silent as to whether an insurance contract may be separated into different 'sub-insurance components' voluntarily. The TRG members discussed the analysis of an IASB staff paper and observed that:

- The lowest unit of account that is used in IFRS 17 is the contract that includes all insurance components.
- Entities would usually design contracts in a way that reflects their substance. Therefore, a contract with the legal form of a single contract would generally be considered a single contract in substance.

However:

- There may be circumstances where the legal form of a single contract would not reflect the substance of its contractual rights and obligations.
- Overriding the contract unit of account presumption by separating insurance components of a single insurance contract involves significant judgement and careful consideration of all relevant facts and circumstances. It is not an accounting policy choice.
- Combining different types of products or coverages that have different risks into one legal insurance contract is not, in itself, sufficient to conclude that the legal form of the contract does not reflect the substance of its contractual rights and obligations. Similarly, the availability of information to separate cash flows for different risks is not sufficient to conclude that the contract does not reflect the substance of its contractual rights and obligations.
- The fact that a reinsurance contract held provides cover for underlying contracts that are included in different groups is not, in itself, sufficient to conclude that accounting for the reinsurance contract held as a single contract does not reflect the substance of its contractual rights and obligations.

The TRG members also observed that considerations that might be relevant in the assessment of whether the legal form of a single contract reflects the substance of its contractual rights and contractual obligations include:

- Interdependency between the different risks covered
- Whether components lapse together
- Whether components can be priced and sold separately

The TRG members observed that an example of when it may be appropriate to override the presumption that a single legal contract is the lowest unit of account is when more than one type of insurance cover is included in one legal contract solely for the administrative convenience of the policyholder and the price is simply the aggregate of the standalone prices for the different insurance covers.

The TRG submission provided a specific fact pattern of a contract containing a long term life coverage with annual renewable health riders. At each annual renewal date, the entity can reassess the risks and

4 IASB Staff paper 2C: Project: I*nsurance Contracts*, Paper topic: *Responding to the external editorial review*, IASB meeting, February 2017, Issue A8. Available on the IFRS Foundation's website.

can set a price that fully reflects those risks with respect to renewable health riders but cannot reprice or cancel the life coverage of the contract. The following factors indicate its substance as a single contract:

- The renewable health riders are not sold separately
- If the life coverage is cancelled by the policyholder, the renewable riders are cancelled at the same time

  And
- The renewable riders are rarely cancelled and most of them remain until the end of the coverage period of the life contract.

Therefore, in relation to this example:

- The contract is included in its entirety in a single portfolio and in a single group and is not split to reflect the ways its components would be allocated to portfolios and groups if they were issued as separate contracts
- The cash flows within the boundary of the contract would be assessed for the contract in its entirety. The assessment of when a substantive obligation to provide the policyholder with services ends will be performed for the contract in its entirety. Therefore, in this example, cash flows related to the premiums within the contract boundaries include cash flows related to the renewable health riders beyond the annual re-pricing date

  And
- The contract would be evaluated against the criteria for applying the premium allocation approach in its entirety.

How we see it

We expect that, in some cases, an insurer that issues combined contracts would choose not to separate them because of the practical difficulties in separating cash flows between components and the loss of the potential for offsetting adverse changes in assumptions on some risks with favourable changes in other risks. However, in other situations, for example, for some types of group business and reinsurance contracts, the combination of different coverages into a single contract may be for the purpose of administrative convenience. In these cases, it may be a better reflection of the substance of the arrangement to record premiums and claims and manage for different risks included in one legal contract separately. Separation into sub-insurance components is an important aspect of the application of the level of aggregation under IFRS 17 and requires closer analysis to see whether and to what extent such separation should be applied.

Some regulatory frameworks require entities to report some, or all, risks of a combined risk insurance contract separately. If accounted for as a single contract under IFRS 17, then the regulatory separation would give rise to a difference between accounting and regulatory reporting.

6.2 Groups of insurance contracts

A group of insurance contracts is the main unit of account for determining measurement. Measurement of insurance contracts occurs at the group level within each portfolio (see section 8 below) and each portfolio, to the extent relevant, will consist usually of a minimum of three separate types of groups.

An entity will typically enter into transactions for individual contracts, not groups of contracts. Therefore, IFRS 17 includes requirements that specify how to recognise groups that include contracts issued in more than one reporting period (see section 6.2.2 below) and how to derecognise contracts from within a group (see section 13.3 below). *[IFRS 17.BC139]*.

Once groups are established at initial recognition an entity must not reassess the composition of the groups subsequently. Additional contracts are added to the group after initial recognition of the group following the criteria discussed in section 7 below. *[IFRS 17.24]*. A group of contracts must comprise a single contract if that is the result of applying the requirements. *[IFRS 17.23]*.

To measure a group of contracts, an entity may estimate the fulfilment cash flows (see section 9.2 below) at a higher level of aggregation than the group or portfolio, provided that the entity is able to include the appropriate fulfilment cash flows in the measurement of the group by allocating such estimates to groups of contracts. *[IFRS 17.24]*.

An entity need not determine the grouping of each contract individually. If an entity has reasonable and supportable information to conclude that all contracts in a set of contracts will be in the same group, it may perform the classification based on measuring this set of contracts ('top-down'). If the entity does not have such reasonable and supportable information, it must determine the group to which contracts belong by evaluating individual contracts ('bottom-up'). *[IFRS 17.17]*.

The Board concluded that groups should be established on the basis of profitability in order to avoid offsetting of profitable and unprofitable contracts because information about onerous contracts provided useful information about an entity's pricing decisions. *[IFRS 17.BC119]*.

In making this requirement to separate groups based on profitability, the Board: *[IFRS 17.BC123]*.

- Did not want entities to depict one type of contract as cross-subsidised by a different type of contract, but also did not want to recognise losses for claims developing as expected within a group of similar contracts.
- Did not want the contractual service margin of an expired contract to exist as part of the average contractual service margin of a group long after coverage provided by the contract ended, but also did not want to recognise a disproportionate amount of contractual service margin of contracts lapsing as expected within a group of similar contracts.

Hence, the Board concluded that a balance could be achieved in principle by: *[IFRS 17.BC124]*.

- Requiring contracts in a group to have future cash flows the entity expects will respond similarly in amount and timing to changes in key assumptions meaning that losses on insurance contracts for one type of insurance risk would not be offset by gains on insurance contracts for a different type of insurance risk and would provide useful information about the performance of contracts insuring different types of risk.
- Requiring contracts in a group to have similar expected profitability meaning that loss-making contracts could not be grouped with profitable contracts, whether at initial recognition or if changes in conditions make a previously profitable group loss-making. Such a requirement would provide information about loss-making groups of insurance contracts. See section 6.2.1 below.
- Requiring groups not to be reassessed after initial recognition.

6.2.1 Identifying groups based on profitability

To divide a portfolio into the three minimum groups on inception based on an assessment of profitability will require judgement, using quantitative factors, qualitative factors or a combination of such factors. For example, identifying (sets of) contracts that can be grouped together could require some form of expected probability-weighted basis of assessment as insurance contracts are measured on this basis (see section 9 below). Alternatively, it may be possible to do this assessment based on the characteristics of the types of policyholders that are more or less prone to make claims than other types of policyholders (e.g., based on age, gender, geographical location or occupation). Therefore, this assessment is likely to represent a significant effort for insurers and is likely to differ from any form of aggregation used previously under IFRS 4, when many entities would not have performed aggregation at a level lower than portfolio.

For contracts issued to which an entity does not apply the premium allocation approach, an entity must assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous: *[IFRS 17.19]*

- Based on the likelihood of changes in assumptions which, if they occurred, would result in the contract becoming onerous
- Using information about estimates prepared by the entity's internal reporting. Hence, in assessing whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous:
  - An entity must not disregard information provided by its internal reporting about the effect of changes in assumptions on different contracts on the possibility of their becoming onerous
  - However, an entity is not required to gather additional information beyond that provided by the entity's internal reporting about the effect of changes in assumptions on different contracts

The objective of the requirement to identify contracts that are onerous at initial recognition is to identify contracts that are onerous measured as individual contracts. An entity typically issues individual contracts and it is the characteristics of the individual contracts that determine how they should be grouped. However, the Board concluded this does not mean that the contracts must be measured individually. If an entity can determine, using reasonable and supportable information, that a set of contracts will all be in the same group, the entity can measure that set to determine whether the contracts are onerous or not, because there will be no offsetting effects in the measurement of the set. The same principle applies to the identification of contracts that are not onerous at initial recognition and that have no significant possibility of becoming onerous subsequently. The objective is to identify such contracts at an individual contract level, but this objective can be achieved by assessing a set of contracts if the entity can conclude using reasonable and supportable information that the contracts in the set will all be in the same group. *[IFRS 17.BC129]*.

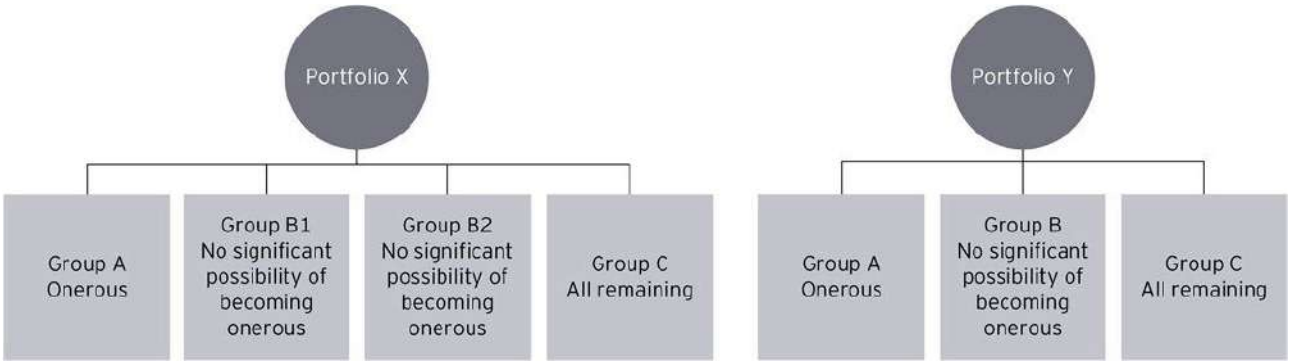
An entity is permitted, but not required, to subdivide the groups into further groups. For example, an entity may choose to divide portfolios into: *[IFRS 17.21]*

- More groups that are not onerous at initial recognition if the entity's internal reporting provides information that distinguishes:
  - Different levels of profitability

    Or
  - Different possibilities of contracts becoming onerous after initial recognition

  And
- More than one group of contracts that are onerous at initial recognition if the entity's internal reporting provides information at a more detailed level about the extent to which the contracts are onerous

This can be illustrated, as follows:



If contracts within a portfolio fall into different groups only because law or regulation specifically constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics, the entity may include these contracts in the same group. *[IFRS 17.20]*. This expedient has been provided because the Board concluded that it would not provide useful information to group separately contracts that an entity is required by law or regulation to group together for determining the pricing or level of benefits. In the Board's opinion, all market participants will be constrained in the same way, particularly if such entities are unable to provide insurance coverage solely on the basis of differences in that characteristic. *[IFRS 17.BC132]*.

This expedient must not be applied by analogy to other items. *[IFRS 17.20]*. For example, an entity might set the price for contracts without considering differences in a specific characteristic because it believes using that characteristic in pricing may result in a law or regulation prohibiting its use in the future or because doing so is likely to fulfil a public policy objective. These practices, sometimes referred to as 'self-regulatory practices', do not qualify for grouping exception caused by regulatory constraints. *[IFRS 17.BC133]*.

Each group (or sub-group) of insurance contracts is measured separately (whether under the general model discussed in section 9 below, the premium allocation approach discussed in section 10 below, reinsurance contracts held discussed in section 11 below or the variable fee approach discussed in section 12.3 below).

Frequently asked questions

Question 6-2: How should 'no significant possibility' be interpreted, as set out in IFRS 17.16(b)?

(TRG meeting May 2018 - Agenda paper no. 07, Log S35)

The IASB staff observed that the term 'no significant possibility' (of becoming onerous) should be interpreted in the context of the objective of the unit of account requirement. The objective is to identify contracts with no significant possibility of becoming onerous at initial recognition in order to group such contracts separately from contracts that are onerous at initial recognition and any remaining contracts in the portfolio that are not onerous at initial recognition. 'No significant possibility of becoming onerous' is different from 'significant insurance risk' and the concept of significant insurance risk should not be used by analogy.

Illustration 6-1: Identifying groups when profitability constrained by law

An insurer is not permitted by law to price car insurance based on gender. Assume that the premium/risk relationship for motor contracts differs materially depending on gender. Without the relief provided by IFRS 17.20, the insurer would be required to split the motor contracts into separate groups based on gender as profitability varies by gender. However, IFRS 17.20 allows the insurer to combine them in one group as the law constrains the entity's ability to set a different price based on gender and, hence, equalise profitability.

How we see it

The issuance of contracts that an entity expects to be onerous will be more visible under IFRS 17 due to the requirement to include these contracts in a separate group and disclose losses arising from onerous contracts issued in the reporting period as well as the movement in the loss component of all such contracts. Insurers may issue contracts that are priced below the amount needed to recover the expected fulfilment costs and acquisition expenses for several reasons, for example:

- The entity may place an implicit value on expected profits from policy renewals that are outside the contract boundary (see section 7.1 below) but, from which, the insurer expects to make an appropriate level of profit in the longer term.
- An individual contract may be priced to make an expected loss in the context of other contracts with the same policyholder or related parties, e.g., other family members, such that the insurer expects to make an appropriate level of profit from the package of policies.
- An entity may price contracts at a loss for commercial reasons, such as securing a targeted market position.

Pricing information is important in identifying contracts or sets of contracts that an entity expects to be onerous at initial recognition. This may pose some challenges as, historically, insurers have separated pricing and reserving processes. The identification of contracts expected to be onerous when issued may require system and process changes and greater coordination between front and back office.

IFRS 17 is clear that contracts can be grouped together if regulatory restraints on pricing or benefits are the sole reason that those contracts (or sets of contracts) would be in separate groups. Therefore, if an entity applies this expedient and groups underlying contracts together, it should be able to prove that no other factor exists that would have resulted in different groupings.

6.2.2 'Annual cohorts'

An entity is prohibited from grouping contracts *issued* (emphasis added) more than one year apart (except in certain circumstances when grouping insurance contracts on transition using either the modified retrospective approach or the fair value approach - see sections 17.4 and 17.5 below, respectively). To achieve this, the entity must, if necessary, further divide the groups described in section 6.2.1 above. *[IFRS 17.22]*.

The prohibition on grouping together contracts that have been issued more than one year apart is one of the more contentious requirements of IFRS 17. It was included because the Board was concerned that, without it, entities could have perpetually open portfolios and this could: lead to a loss of information about the development of profitability over time; result in the contractual service margin persisting beyond the duration of contracts in the group; and consequently, result in profits not being recognised in the correct periods. *[IFRS 17.BC136]*. The Board acknowledges in the Basis for Conclusions that using a one-year issuing period was an operational simplification given for cost-benefit reasons. *[IFRS 17.BC137]*.

The Board considered whether prohibiting groups from including contracts issued more than one year apart would create an artificial divide for contracts with cash flows that affect or are affected by cash flows to policyholders of contracts in another group (sometimes referred to as 'mutualisation'). Some stakeholders asserted that such a division would distort the reported result of those contracts and would be operationally burdensome. However, the Board concluded that applying the requirements of IFRS 17 to determine the fulfilment cash flows for groups of such contracts provides an appropriate depiction of the results of such contracts. The Board acknowledged that, for contracts that fully share risks, the groups together will give the same results as a single combined risk-sharing portfolio. Therefore, it considered whether IFRS 17 should give an exception to the requirement to restrict groups to include only contracts issued within one year. However, the Board concluded that setting the boundary for such an exception would add complexity to IFRS 17 and create the risk that the boundary would not be robust or appropriate in all circumstances. Hence, IFRS 17 does not include such an exception. Nonetheless, the Board noted that the requirements specify the amounts to be reported, but not the methodology to be used to arrive at those amounts. Therefore, it may not be necessary for an entity to restrict groups in this way to achieve the same accounting outcome in some circumstances. *[IFRS 17.BC138]*.

There is no requirement in IFRS 17 that an entity must use the same issue period for each group. The period for a cohort could also be shorter than twelve months. As the cohort period is one of the factors that determines the composition of a group of contracts, the prohibition to subsequently reassess the composition of a group also applies to the cohort period. *[IFRS 17.24]*.

The IASB considered, but rejected, a suggestion to amend the annual cohort requirement to base it on the date contracts are 'recognised', instead of the date they are 'issued'. In doing so, the Board confirmed that it intended annual cohorts to be determined based on the date of issue of the contract and not the date of initial recognition. This is because the objective of the annual cohort requirement is to facilitate timely recognition of profits, losses and trends in profitability. The profitability of a contract is initially set when the contract is issued, based on facts and circumstances at that date, for example interest rates, underwriting expectations and pricing. Hence, the Board concluded that determining annual cohorts based on the date that contracts are issued is necessary to provide useful information about trends in profitability. *[IFRS 17.BC139T]*.

This means, for example, that a profitable contract issued on 1 January 2022 which has a coverage period beginning 1 January 2022 will be in the same annual cohort (i.e., group) as a profitable contract issued on 1 January 2022 which has a coverage period beginning on 1 January 2025 (assuming both contracts are part of the same portfolio). However, a profitable contract issued on 1 January 2023 (within the same portfolio) with a coverage period beginning 1 January 2023 will be in a different group from the other contracts as it was issued more than one year apart from the issue date of the other two contracts. As a result, if an entity issues profitable contracts for coverage that does not start for several years and premiums are not due until the coverage starts, the date of initial recognition will be several years after the date of issue.

The IASB staff acknowledge that the use of the term 'issued' has consequences for the practical relief available for determining the discount rate at the date of initial recognition of the group, since the weighted average discount rates used only cover the period that the contracts were issued which cannot exceed one year (see section 9.3 below). The IASB staff observed that these effects are a consequence of the unit of account being the group of insurance contracts rather than the individual contract, and an entity could choose to further divide the annual cohort and thereby avoid these effects.

How we see it

IFRS 17 requires that groups of contracts do not include any contracts that are issued more than one year apart. This could cause practical challenges with tracking the issue date of contracts because the date of issuance is not necessarily the same as the date of initial recognition of a contract. An example would be contracts that are expected to be profitable and which are issued in advance of the beginning of the coverage period and before the date when the first premium is due. This could give rise to practical issues, for example, if a contract is issued in one annual period, but is initially recognised in another.

One way to divide the groups is to use an annual period that coincides with an entity's financial reporting period (e.g., contracts issued between 1 January and 31 December comprise a group for an entity with an annual reporting period ending 31 December). However, IFRS 17 does not require any particular approach for setting the annual period and entities may also use a period less than twelve months when grouping insurance contracts. In addition, an entity that produces interim financial statements is not required to restrict the grouping of contracts issued to those contracts which were issued in that interim period since the restriction on grouping contracts is based on a maximum of one year (see section 6 above).

6.2.2.A Contracts with intergenerational sharing of risks

Some stakeholders have expressed the view that the level of aggregation requirements artificially segregate portfolios and will not properly depict business performance, particularly when applying the annual cohort requirement to insurance contracts with risk sharing between different generations of policyholders. As a result, the IASB reconsidered the IFRS 17 aggregation requirements during its deliberations on the June 2020 amendments to IFRS 17 but decided that the requirements should be unchanged.

In the Board's view, intergenerational sharing of risk between policyholders is reflected in the fulfilment cash flows and therefore, also reflected in the contractual service margin of each generation of mutualised contracts, as discussed in section 12.1 below. However, each generation of contracts may be more or less profitable for an entity than other generations. Even if the policyholders across all annual cohorts share equally in the returns, the amount of the entity's share in those returns created by each generation may differ, reflecting the contractual terms of each annual cohort and the economic conditions during the coverage period of each annual cohort. For example, an entity's share of 20% of the returns of underlying items is a higher amount for annual cohorts for which the coverage period includes periods in which the returns are 5% than it is for annual cohorts for which the coverage period includes only periods in which the fair value returns are 1%. Accordingly, removing the requirement for annual cohorts for those groups of contracts with intergenerational sharing of risks between policyholders would average higher or lower profits across generations, resulting in a loss of information about changes in profitability over time. *[IFRS 17.BC139J]*.

The Basis for Conclusions notes that two aspects of applying the annual cohort requirement to some contracts with intergenerational sharing of risks between policyholders that could increase the costs of applying the requirement and reduce the benefits of the resulting information were identified. These are: *[IFRS 17.BC139K]*

- Distinguishing between the effect of sharing of risks and the effect of discretion
- Allocating changes in the amount of the entity's share of the fair value of underlying items across annual cohorts that share in the same pool of underlying items

The aspect of the annual cohort requirement in respect of the first bullet point above relates to circumstances in which an entity has discretion over the portion of the fair value returns on underlying items that is paid to policyholders and the portion that is retained by the entity. For example, an entity may be required under the terms of the insurance contracts to pay policyholders a minimum of 90% of the total fair value returns on a specified pool of underlying items with discretion to pay more to policyholders. The Board acknowledged that an entity that has such discretion is required to apply additional judgement to allocate changes in fulfilment cash flows between groups in a way that appropriately reflects the effect of sharing of risks and the effect of the discretion. However, an entity would be required to make that judgement to measure new contracts recognised in the period even if the entity was not required to apply the annual cohort requirement. *[IFRS 17.BC139L]*.

The concern set out in the second bullet point above relates to insurance contracts with direct participation features. For those contracts an entity adjusts the contractual service margin for changes in the amount of the entity's share of the fair value of underlying items. IFRS 17 does not include requirements on how to allocate those changes across annual cohorts that share in the same pool of underlying items. The Board observed that an entity needs to exercise judgement to identify an allocation approach that provides useful information about the participation of each annual cohort in the underlying items and to avoid allocation approaches that do not provide useful information. *[IFRS 17.BC139M]*.

In the Board's view, the information that results from the judgements an entity makes in determining the allocation approaches discussed above will provide useful insights about how management expects businesses to develop and could assist users of financial statements to hold management to account based on those expectations. *[IFRS 17.BC139N]*.

The Board also considered that the benefits of the information provided by the annual cohort requirement are particularly high for some specific insurance contracts with intergenerational sharing of risks. Those specific contracts: *[IFRS 17.BC139O]*

- Include features such as financial guarantees on the returns from underlying items and/or other cash flows that do not vary with returns on underlying items (for example, insurance claims)
- Do not share the effect of changes in those features between the entity and policyholders or share the effect between the entity and policyholders in a way that does not result in the entity's share being small

The Board observed that information about the effect of financial guarantees is particularly important in low interest rate environments. The Board acknowledged that for some insurance contracts with substantial intergenerational sharing of risks, it is likely to be rare for the effect of financial guarantees and other cash flows that do not vary with returns on underlying items to cause an annual cohort to become onerous. However, it is exactly that rarity that makes the information particularly useful to users of financial statements when such an event occurs and information about the effect of financial guarantees is particularly important when interest rates are low. *[IFRS 17.BC139P]*.

How we see it

The IASB decided not to create any specific exceptions to the annual cohorts for contracts with inter-generational mutualisation (i.e., mutualised contracts). As specific practical issues may arise when applying the annual cohort requirement to these types of products, entities would need to find practical ways to apply the annual cohorts in a suitable manner considering the available guidance and the specific circumstances of their jurisdiction. However, an exemption exists in EU-adopted IFRS accounting standards (see Chapter 1 at section 4.2.1.A).

6.3 Identifying groups for contracts applying the premium allocation approach

For a group of insurance contracts to which the premium allocation approach applies (see section 10 below), an entity assesses aggregation of insurance contracts as discussed in sections 6.1 and 6.2 above except that the entity must assume that no contracts in the portfolio are onerous at initial recognition unless facts and circumstances indicate otherwise. *[IFRS 17.18]*.

An entity assesses whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous subsequently by assessing the likelihood of changes in applicable facts and circumstances.

7 Initial recognition

7.1 Initial recognition of insurance and reinsurance contracts issued

Extract from IFRS 17

25 An entity shall recognise a group of insurance contracts it issues from the earliest of the following:

(a) the beginning of the coverage period of the group of contracts;

(b) the date when the first payment from a policyholder in the group becomes due; and

(c) for a group of onerous contracts, when the group becomes onerous.

[IFRS 17.25].

If there is no contractual due date, the first payment from the policyholder is deemed to be due when it is received. *[IFRS 17.26]*.

An entity is required to determine whether any contracts form a group of onerous contracts before the earlier of the first two dates above (i.e., before the earlier of the beginning of the coverage period and the date when the first payment from a policyholder in the group is due) if facts and circumstances indicate there is such a group. *[IFRS 17.26]*.

In recognising a group of insurance contracts in a reporting period, an entity must include only contracts that individually meet one of the above-mentioned recognition criteria. *[IFRS 17.28]*. This clarifies that an individual contract has to be recognised initially and measured at a time which is specific to the contract. This means that the date of initial recognition of an individual contract added to a group of insurance contracts has to be determined for that individual insurance contract using the measurement assumptions at that date, rather than determined by the date of initial recognition of the group to which individual contracts will be added.

In addition, an entity must make estimates for the discount rates at the date of initial recognition (see section 9.3 below) and for the coverage units provided in the reporting period (see section 9.7 below). *[IFRS 17.28]*.

An entity may include more contracts in the group after the end of a reporting period (subject to the constraint that contracts within a group cannot be issued more than a year apart (see section 6.2.2 above). An entity must add contracts to the group in the reporting period in which the contracts meet the recognition criteria set out above, applied to each contract individually. *[IFRS 17.28]*.

When new contracts are added to a group, this may result in a change to the determination of the weighted average discount rates at the date of initial recognition (see section 9.3 below). An entity must apply any revised discount rates from the start of the reporting period in which the new contracts are added to the group. *[IFRS 17.28]*. There is no retrospective 'catch-up' adjustment for previous reporting periods, the effect of any change in average discount rates is therefore recognised prospectively.

For reinsurance contracts held, the group consists of the reinsurance contracts, not the underlying direct contracts which are subject to the reinsurance.

Illustration 7-1: Determining the date of recognition of a group of insurance contracts

Example 1

An entity issues a group of insurance contracts to policyholders beginning on 25 December 20X3. The coverage period of the group begins on 1 January 20X4 and the first premium from a policyholder in the group is due on 5 January 20X4 The group of insurance contracts is not onerous.

The group of insurance contracts is recognised on 1 January 20X4 (i.e., the start of the coverage period of the group) which is earlier than the date that the first premium is due.

Example 2

An entity issues a group of insurance contracts to policyholders beginning on 25 December 20X3. The coverage period of the group begins on 1 January 20X4 and the first premium from a policyholder in the group is due on 30 December 20X3. The group of insurance contracts is not onerous.

The group of insurance contracts is recognised on 30 December 20X3 (i.e., the date that the first premium is due) which is earlier than the date of the beginning of the coverage period. However, if the entity has a reporting date of 31 December 20X3, only those contracts within the group issued as at the reporting date will be recognised in the financial statements for the period ending 31 December 20X3.

Example 3

An entity issues a group of insurance contracts to policyholders beginning on 25 December 20X3. On 25 December 20X3, the entity determines that the group of insurance contracts is onerous. The coverage period of the group begins on 1 January 20X4 and the first premium from a policyholder in the group is due on 5 January 20X4.

The group of insurance contracts is recognised on 25 December 20X3, which is when the group of insurance contracts is determined to be onerous. However, if the entity has a reporting date of 31 December 20X3, only those contracts within the group that are issued as at the reporting date will be recognised in the financial statements for the period ending 31 December 20X3.

How we see it

The issue date of a contract is when an entity is bound by the terms of the contract and, as such, has a contractual obligation to accept risk. The issue date is typically before the beginning of the coverage period and due date for the initial premium. However, IFRS 17 only requires recognition of issued insurance contracts before the coverage period or premium due date if facts and circumstances indicate that the contracts in the group are onerous. Allowing entities to recognise insurance contracts after the entity has accepted risk represents a practical expedient introduced by the Board to allow entities to continue their existing recognition practices. However, an entity is required to consider whether facts and circumstances indicate that insurance contracts it has issued are onerous at issue date or any other time before they would otherwise be recognised.

Assessing expected profitability is performed on initial recognition of contracts as they are assigned to a group of contracts. The contracts all then stay within that same group until they are derecognised. This means that contracts assigned to a particular group on initial recognition are not reallocated to another group if their profitability characteristics change subsequently (e.g., from profitable to loss-making).

7.2 Initial recognition of reinsurance contracts held

IFRS 17 states that for a group of reinsurance contracts held the requirements discussed in section 7.1 above do not apply. *[IFRS 17.62, IFRS 17.62A]*.

Extract from IFRS 17

Recognition

62 Instead of applying paragraph 25, an entity shall recognise a group of reinsurance contracts held from the earlier of the following:

(a) the beginning of the coverage period of the group of reinsurance contracts held; and

(b) the date the entity recognises an onerous group of underlying insurance contracts applying paragraph 25(c), if the entity entered into the related reinsurance contract held in the group of reinsurance contracts held at or before that date.

62A Notwithstanding paragraph 62(a), an entity shall delay the recognition of a group of reinsurance contracts held that provide proportionate coverage until the date that any underlying insurance contract is initially recognised, if that date is later than the beginning of the coverage period of the group of reinsurance contracts held.

A group of reinsurance contracts itself cannot be onerous (see section 11.4 below).

IFRS 17 does not include guidance on when a contract provides proportionate coverage. In the Basis for Conclusions, it is observed that many reinsurance arrangements are designed to cover the claims incurred under underlying insurance contracts written during a specified period. In some cases, the reinsurance contract held covers the losses of separate contracts on a proportionate basis. In other cases, the reinsurance contract held covers aggregate losses from a group of underlying contracts that exceed a specified amount. *[IFRS 17.BC304]*.

When a reinsurance contract held provides proportionate coverage, the initial recognition of the (group of) reinsurance contract(s) will, as a simplification, be later than the beginning of the coverage period if no underlying contracts have been recognised as at that date. *[IFRS 17.BC305(a)]*.

However, when the group of reinsurance contracts held covers aggregate losses arising from a group of insurance contracts over a specified amount, the group of reinsurance contracts held is recognised when the coverage period of the group of reinsurance contracts begins. In these contracts, the entity benefits from coverage - in case the underlying losses exceed the threshold - from the beginning of the group of reinsurance contracts held because such losses accumulate throughout the coverage period. In the Board's view, the coverage benefits the entity from the beginning of the coverage period of the group of reinsurance contracts held because such losses accumulate throughout the coverage period. *[IFRS 17.BC305(b)]*.

Illustration 7-2: Recognition of reinsurance contract held providing proportionate coverage

An entity holds a reinsurance contract in respect of a term life insurance portfolio on a quota share basis whereby 20% of all premiums and all claims from the underlying insurance contracts are ceded to the reinsurer. The reinsurance contract is considered to be a group for the purpose of aggregation and incepts on 1 January 20X4. The first underlying insurance contract is recognised on 1 February 20X4.

As the reinsurance contract held provides proportionate coverage, initial recognition of the contract is delayed until the later of the beginning of the coverage period of the contract and the initial recognition of any underlying contract, i.e.,1 February 20X4.

Illustration 7-3: Recognition of reinsurance contract held which does not provide proportionate coverage

An entity holds a reinsurance contract which provides excess of loss protection for a motor insurance portfolio. In exchange for a fixed premium of CU100, the reinsurance contract provides cover for claims arising from individual events in the portfolio in excess of CU500 up to a limit of CU200. The reinsurance contract is considered to be a group for the purpose of aggregation and incepts on 1 January 20X4. The first underlying motor insurance contract is recognised on 1 February 20X4.

As the reinsurance contract held does not provide proportionate coverage (because neither the premiums nor the claims are a proportion of the premiums and claims from the underlying insurance contracts) the contract is recognised at the beginning of the coverage period of the contract, i.e., 1 January 20X4.

Illustration 7-4: Recognition of reinsurance contract held when the underlying insurance contracts are onerous

An entity holds a reinsurance contract in respect of a term life insurance portfolio on a quota share basis, whereby 20% of all premiums and all claims from the underlying insurance contracts are ceded to the reinsurer. The reinsurance contract is considered to be a group for the purpose of aggregation. The reinsurance contract was entered into on 1 December 20X3 and incepts on 1 January 20X4. The first underlying insurance contract was entered into on 1 December 20X3 and incepted on 1 January 20X4. On 15 December 20X3, the group of underlying insurance contracts are determined to be onerous.

As the group of underlying insurance contracts are onerous and the reinsurance held was entered into at the same time as the underlying insurance contracts, the date of initial recognition of the reinsurance contract held is 15 December 20X3.

How we see it

The recognition requirements for reinsurance contracts held that provide proportionate coverage are meant to simplify recognition and measurement for these contracts. Circumstances in which the first underlying ceded contract is recognised shortly after the reinsurance contract is written will result in similar timing of recognition for proportionate and 'other-than-proportionate' reinsurance contracts. In other cases, there may be a greater difference in the timing of recognition.

As mentioned above, IFRS 17 does not include guidance on when a contract provides proportionate coverage. Entities would, therefore, need to consider how it will determine whether a contract provides proportionate coverage or not. The guidance as per IFRS 17.BC304 referenced above, could provide a useful input to this consideration.

7.3 Initial recognition of insurance acquisition cash flows

Insurance acquisition cash flows are defined by IFRS 17 as follows: *[IFRS 17 Appendix A]*

Extract from IFRS 17

Appendix A

Defined terms

insurance acquisition cash flows	Cash flows arising from the costs of selling, underwriting and starting a **group of insurance contracts** (issued or expected to be issued) that are directly attributable to the **portfolio of insurance contracts** to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or **groups of insurance contracts** within the portfolio.

Any insurance acquisition cash flows paid at the date of initial recognition of the group of insurance contracts are recognised as part of the contractual service margin of the group of insurance contracts (see section 9.5 below).

Any insurance acquisition cash flows an entity expects to pay after the related group of insurance contracts is recognised are part of the fulfilment cash flows of the group of insurance contracts (see section 9.2 below).

However, an entity must recognise an asset for insurance acquisition cash flows paid (or insurance acquisition cash flows for which a liability has been recognised under another IFRS accounting standard) before the related group of insurance contracts is recognised, unless it elects to expense those acquisition cash flows as incurred for premium allocation approach contracts (see section 10 below). The entity must recognise such an asset for each related group of insurance contracts. *[IFRS 17.28B]*. The entity needs to allocate insurance acquisition cash flows to an existing or future group of insurance contracts using a systematic and rational method. *[IFRS 17.28A]*.

If an entity recognises in a reporting period only some of the insurance contracts expected to be included in the group (see section 6.2 above), it must determine the related portion of an asset for insurance acquisition cash flows for the group on a systematic and rational basis considering the expected timing of recognition of contracts in the group. *[IFRS 17.28D]*.

The systematic and rational method of allocating insurance acquisition cash flows to groups referred to above must be used to allocate: *[IFRS 17.B35A]*

- Insurance acquisition cash flows that are directly attributable to a group of insurance contracts:
  - To that group

    And
  - To groups that will include insurance contracts that are expected to arise from renewals of the insurance contracts in that group
- Insurance acquisition cash flows directly attributable to a portfolio of insurance contracts, other than those allocated above, to groups in the portfolio

The last bullet point above means that insurance acquisition cash flows directly attributable to a portfolio of insurance contracts, but not directly attributable to a group of insurance contracts are systematically and rationally allocated to existing or future groups of insurance contracts in the portfolio. *[IFRS 17.BC184B]*.

The Basis for Conclusions notes that, in some situations, an entity issues an insurance contract with a short coverage period, such as one year, but might incur high up-front costs, such as commissions to sales agents, relative to the premium the entity will charge for that short coverage contract. The entity agrees to those costs because it anticipates that some policyholders will renew their contracts. Often, the costs are fully directly attributable to the initial insurance contract issued because they are non-refundable and are not contingent on the policyholder renewing the contracts. In some circumstances, such commissions are higher than the premium charged and the application of the Board considered that recognising a loss in those circumstances would provide useful information to policyholders as it reflects that the entity does not have the right to charge policyholders to renew the contracts or to reclaim the commission from the sales agents if policyholders choose not to renew their contracts. *[IFRS 17.BC184C, IFRS 17.BC184D]*.

This requirement also provides useful information to users of financial statements about insurance acquisition cash flows. This approach depicts the payment of up-front costs such as commission as an asset that an entity expects to recover through expected renewals of contracts. The asset reflects the right of an entity to not pay again, costs it has already paid to obtain renewals. The information resulting from the requirement is comparable to the information provided by IFRS 15 for the incremental costs of obtaining a contract. *[IFRS 17.BC184E]*.

The Board considered whether it should develop requirements to specify how to allocate insurance acquisition cash flows to expected renewals of contracts. However, it concluded that requiring an allocation applying a systematic and rational method, consistent with the requirements for allocating fixed and variable overheads (see section 9.2.3.L below), was sufficient. *[IFRS 17.BC184F]*.

An entity might add insurance contracts to a group of insurance contracts across more than one reporting period. In such circumstances, the entity must derecognise the portion of an asset for insurance acquisition cash flows that relates to insurance contracts added to the group in that period and continue to recognise an asset for insurance acquisition cash flows to the extent that the asset relates to insurance contracts expected to be added to the group in a future reporting period. *[IFRS 17.B35C]*.

Impairment and derecognition of insurance acquisition cash flow assets are discussed in sections 9.10 and 13.4 below, respectively.

7.4 Initial recognition of investment contracts with discretionary participation features

The date of initial recognition of an investment contract with discretionary participation features (see section 12.3 below) is the date that the entity becomes party to the contract. This is consistent with the requirements for recognition of a financial instrument in IFRS 9 and is likely to be earlier than the date of initial recognition for an insurance contract. *[IFRS 17.71]*.

8 Measurement - overview

IFRS 17 has a default approach to measuring groups of insurance contracts (which is the unit of account for measurement as discussed in section 6.2 above) described in this chapter as the 'general model'. The general model does not distinguish between so-called short duration and long duration (or life and non-life) insurance contracts. It also does not distinguish between insurance products.

IFRS 17 also includes modifications and a simplification to the general model that are applicable in specific circumstances (see section 8.2 below).

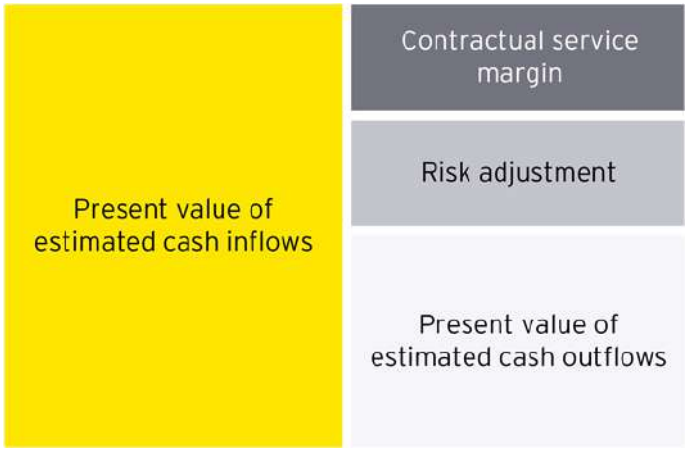
The basic revenue recognition principle under IFRS 17 is that no profit is recognised on initial recognition of a group of insurance contracts, but that a loss must be recognised if the group of contracts is onerous (see section 7 above for the timing of initial recognition). Subsequently, profit and revenue are recognised as services are provided under the contract.

8.1 Overview of the general model

The general model measures a group of insurance contracts as the sum of the following components, or 'building blocks', for each group of insurance contracts: *[IFRS 17.32]*

- Fulfilment cash flows, which comprise:
  - Estimates of expected future cash flows over the life of the contract (see section 9.2 below)
  - An adjustment to reflect the time value of money and the financial risks related to the future cash flows to the extent that the financial risks are not included in the estimates of the future cash flows (see section 9.3 below)
  - A risk adjustment for non-financial risk (see section 9.4 below)
- A contractual service margin representing unearned profit an entity will recognise as it provides service under the insurance contracts in the group (see section 9.5 below)

This is illustrated in the diagram below:

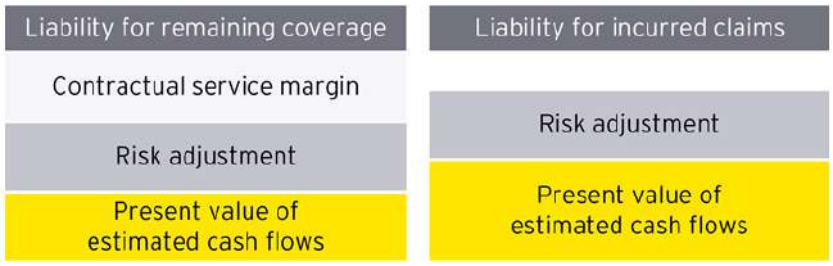


After initial recognition of a group of insurance contracts, the carrying amount of the group at each reporting date is the sum of:

- The liability for remaining coverage, comprising:
  - The fulfilment cash flows related to future service allocated to the group at that date
  - The contractual service margin of the group at that date

  And
- The liability for incurred claims comprising the fulfilment cash flows related to past service allocated to the group at that date

The components of the liability for remaining coverage and the liability for incurred claims are, as follows:



The general model is discussed further in section 9 below.

8.2 Modifications to the general model

An entity must apply the general model to all groups of insurance contracts except as follows: *[IFRS 17.29]*

- A simplified or premium allocation approach may be applied for groups of insurance contracts meeting either of the specified criteria for that approach (see section 10 below)
- For groups of reinsurance contracts held, an entity must apply either the general model or the premium allocation approach as modified by separate measurement requirements (see section 11 below)
- An adaptation of the general model, the 'variable fee approach' is applied to insurance contracts with direct participation features (see section 12 below)
- For groups of investment contracts with discretionary participation features, an entity applies the general model (as modified) because of the lack of insurance risk in the contracts (see section 12.4 below)

8.3 Insurance contracts in a foreign currency

Extract from IFRS 17	
30	When applying IAS 21 *The Effects of Changes in Foreign Exchange Rates* to a group of insurance contracts that generate cash flows in a foreign currency, an entity shall treat the group of contracts, including the *contractual service margin*, as a monetary item.

[IFRS 17.30].

The Basis for Conclusions observes that, without this requirement, the contractual service margin (see section 9.5 below) might otherwise be classified as a non-monetary item, because it is similar to a prepayment for goods and services. However, in the Board's view, it was simpler to treat all components of the measurement of an insurance contract in the same way. Since the measurement in IFRS 17 is largely based on cash flow estimates, the Board concluded that it was more appropriate to view the insurance contract as a whole as a monetary item. *[IFRS 17.BC277]*. The Board's conclusion that the insurance contract is a monetary item does not change if an entity measures a group of insurance contracts using the simplified approach (i.e., the premium allocation approach) for the measurement of the liability for remaining coverage. *[IFRS 17.BC278]*.

Treating insurance contracts as monetary items means that groups of insurance contracts in a foreign currency are retranslated to the entity's functional currency using the exchange rate applying at each reporting date. Exchange differences arising on retranslation are accounted for in profit or loss. IFRS 4 contained no similar assertion and, therefore, many insurers, following the guidance on monetary and non-monetary items in IAS 21 *The Effects of Change in Foreign Exchange Rates*, treated unearned premium provisions (i.e., deferred revenue) and deferred acquisition costs in a foreign currency as non-monetary items and did not retranslate these balances subsequent to initial recognition.

Exchange differences arising applying IAS 21 on changes in the carrying amount of groups of insurance contracts are included in profit or loss, unless they relate to changes in the carrying amount of groups of insurance contracts that have been included in other comprehensive income (when disaggregation of insurance finance income and expenses is applied - see section 15.3 below), in which case they are included in other comprehensive income. *[IFRS 17.92]*.

Frequently asked questions

Question 8-1: Should an entity consider currency exchange risks when applying IFRS 17 to identify portfolios of insurance contracts?

In September 2022, the IFRS IC discussed a request which asked whether an entity considers currency exchange risks when applying IFRS 17 to identify portfolios of insurance contracts.

The IFRS IC noted that IFRS 17 requires an entity to recognise and measure groups of insurance contracts. The first step in establishing groups of insurance contracts is to identify portfolios of insurance contracts. Paragraph 14 of IFRS 17 states that "a portfolio comprises contracts subject to similar risks and managed together". The request asks whether currency exchange rate risks are among the risks an entity considers when assessing whether insurance contracts are 'subject to similar risks'.

IFRS 17 defines financial risks and insurance risk (a non-financial risk). Financial risk is defined to include "The risk of a possible change in... [a] currency exchange rate". When IFRS 17 requires an entity to consider or reflect only particular types of risks (for example, only non-financial risk), it explicitly refers to the risks to be considered or reflected. Therefore, the IFRS IC concluded that, because paragraph 14 of IFRS 17 refers to 'similar risks' without specifying any particular types of risk, an entity is required to consider all risks - including currency exchange risks - when identifying portfolios of insurance contracts. However, 'similar risks' does not mean 'identical risks'. Therefore, an entity could identify portfolios of contracts that include contracts subject to different currency exchange rate risks. The IFRS IC observed that what an entity considers to be 'similar risks' will depend on the nature and extent of the risks in the entity's insurance contracts.

Question 8-2: How should an entity apply IAS 21 in conjunction with IFRS 17 in measuring a group of insurance contracts that generate cash flows in more than one currency?

In September 2022, the IFRS IC discussed a request which asked how to account for insurance contracts with cash flows in more than one currency.

Measuring a multi-currency group of insurance contracts

An entity measures a group of insurance contracts at the total of the fulfilment cash flows and the contractual service margin. Paragraph 30 of IFRS 17 states that "when applying IAS 21...to a group of insurance contracts that generate cash flows in a foreign currency, an entity shall treat the group of contracts, including the contractual service margin, as a monetary item".

Paragraph 8 of IAS 21 defines monetary items as "units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency" and paragraph 20 describes a foreign currency transaction as "a transaction that is denominated or requires settlement in a foreign currency". Paragraphs 21-24 of IAS 21 require an entity to:

- Recognise on initial recognition a foreign currency transaction in the functional currency at the spot exchange rate at the date of the transaction
- Determine the carrying amount of a monetary item in conjunction with other relevant IFRS accounting standards

  And
- Translate at the end of the reporting period foreign currency monetary items into the functional currency using the closing rate

The requirements in both IFRS 17 and IAS 21 refer to transactions or items that are denominated or require settlement in a single currency. IFRS accounting standards include no explicit requirements on how to determine the currency denomination of transactions or items with cash flows in more than one currency.

Therefore, the IFRS IC observed that, in measuring a multi-currency group of insurance contracts, an entity:

- Applies all the measurement requirements in IFRS 17 to the group of insurance contracts, including the requirement in paragraph 30 to treat the group - including the contractual service margin - as a monetary item.
- Applies IAS 21 to translate at the end of the reporting period the carrying amount of the group - including the contractual service margin - at the closing rate (or rates).
- Uses its judgement to develop and apply an accounting policy that determines on initial recognition the currency or currencies in which the group - including the contractual service margin - is denominated (currency denomination). The entity could determine that the group - including the contractual service margin - is denominated in a single currency or in the multiple currencies of the cash flows in the group.

The entity develops an accounting policy on currency denomination that results in information that is relevant and reliable (as described in paragraph 10 of IAS 8) and is applied consistently for similar transactions, other events and conditions (paragraph 13 of IAS 8). The accounting policy is based on the entity's specific circumstances and the terms of the contracts in the group. The entity cannot simply presume that the contractual service margin for the group is denominated in the functional currency. Such a presumption would, in effect, fail to treat the contractual service margin as a monetary item as required by paragraph 30 of IFRS 17.

Single-currency denomination versus multi-currency denomination

The entity's accounting policy on currency denomination determines which effects of changes in exchange rates are changes in financial risk accounted for applying IFRS 17 and which of these effects are exchange differences accounted for applying IAS 21.

A single-currency denomination treats:

- Changes in exchange rates between the currency of the cash flows and the currency of the group of contracts as changes in financial risk that an entity accounts for applying IFRS 17.

  And

- Changes in exchange rates between the currency of the group of contracts and the functional currency as exchange differences that an entity accounts for applying IAS 21.

A multi-currency denomination treats all changes in exchange rates as exchange differences that an entity accounts for applying IAS 21.

In applying IFRS 17, there is a single contractual service margin for the group of insurance contracts. Appendix A to IFRS 17 defines the contractual service margin as representing "the unearned profit the entity will recognise as it provides insurance contract services under the insurance contracts in the group." Accordingly, under a multi-currency denomination, the entity would:

- Assess whether the group of contracts is onerous considering the contractual service margin as a single amount.
- Prevent the carrying amount of the contractual service margin being negative by, when necessary to do so, recognising a loss.

  And

- Determine the amount of the contractual service margin to recognise in profit or loss by applying a single method of determining the coverage units provided in the current period and expected to be provided in the future to the amounts denominated in the multiple currencies. This would result in the entity allocating each of the currency amounts of the contractual service margin translated into the functional currency equally to each coverage unit.

Conclusion

In the light of its analysis, the IFRS IC considered whether to add to the work plan a standard-setting project on how to account for the foreign currency aspects of insurance contracts. The IFRS IC observed that it has not obtained evidence that such a project would be sufficiently narrow in scope that the IASB or the IFRS IC could address it in an efficient manner. Consequently, the IFRS IC decided not to add a standard-setting project to the work plan. In accordance with paragraph 8.7 of the Due Process Handbook, at its October 2022 meeting, the IASB discussed, and did not object to, this agenda decision.[5]

5 *IFRIC Update*, September 2022, *Addendum to IFRIC Update-Committee's agenda decisions*. Available on the IFRS Foundation's website.

The following Illustration is based on an Illustrative Example in an IASB staff paper.

Illustration 8-1: Multi-currency groups of insurance contracts

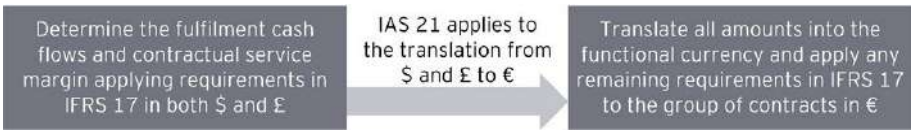
These are the two approaches identified by the Interpretations Committee[6] which could be applied to multi-currency groups of insurance contracts.

Single-currency denomination

A group of insurance contracts (including the contractual service margin) with cash flows in more than one currency, is denominated in a single currency, such as the currency of the premiums or the predominant cash flows ('single-currency denomination' approach).

Multi-currency denomination

A group of insurance contracts (including the contractual service margin) is denominated in multiple currencies, reflecting the currencies of the fulfilment cash flows ('multi-currency denomination' approach).



How we see it

In the absence of specific guidance in IAS 21 and IFRS 17 on how to apply IAS 21 to a group of insurance contracts that are impacted by cash flows of multiple currencies, the IFRS IC concluded that the entity must use judgement in developing and applying an accounting policy that results in information that is relevant and reliable based on the two currency denomination approaches identified by the Committee. The two approaches considered identified by the IFRS IC are:

- Denominate a group of insurance contracts (including the contractual service margin) with cash flows in more than one currency, in a single currency, such as the currency of the premiums or the predominant cash flows ('single-currency denomination').
- Denominate a group of insurance contracts (including the contractual service margin) in multiple currencies, reflecting the currencies of the fulfilment cash flows ('multi-currency denomination').

The IFRS IC focused on addressing the main features of these approaches. However, the IFRS IC felt it should not address the more detailed mechanical issues. Therefore, entities will need to determine in more detail how to implement these currency accounting policies following the principles set out in the agenda decision.

The accounting policy selected by an entity will impact how it treats the effect of changes in exchange rates, including, where applicable, the disaggregation in the statement of comprehensive income between profit or loss and other comprehensive income. Where changes in exchange rates are accounted for applying IFRS 17, the effect of these changes are treated as insurance finance income or expenses following the requirements of IFRS 17. Where changes in exchange rates are treated as exchange differences accounted for applying IAS 21, the effects of changes in exchange rates are included in the statement of profit or loss, unless they relate to changes in the carrying amount of groups of insurance contracts in other comprehensive income, in which case these effects are also included in other comprehensive income.

Entities should apply judgement to determine the appropriate line item(s) in which exchange differences are recorded as neither IAS 21 nor IFRS 17 specify where exchange differences on insurance contract liabilities accounted for under IAS 21 should be presented in the statement of financial performance (see also Chapter 16 at section 11.1). This policy should be applied consistently. However, foreign currency risk is considered to be financial risk by IFRS 17 and so presenting exchange differences arising from insurance contracts in insurance service expenses would not be appropriate.

The Committee's observations about measuring a multi-currency group of insurance contracts appear to also apply to contracts measured under the variable fee approach, although the difference between the two currency denomination approaches means that the outcome for dealing with exchange differences under the variable fee approach is likely to be different compared to the general model. As such, for an insurance contract with direct participation features, additional considerations will be necessary in determining how to deal with the effects of exchange differences for each of the currency denomination policies.

6 IASB Staff paper 2: Project: *Multi-currency Groups of Insurance Contracts (IFRS 17 and IAS 21)*, Paper topic: *Comments on tentative agenda decision*, IFRS IC meeting, September 2022. Available on the IFRS Foundation's website.

9 Measurement - General Model

As explained in section 8.1 above, the general model is based on the following building blocks for each group of insurance contracts: *[IFRS 17.32]*

- Fulfilment cash flows, which comprise:
  - Estimates of expected future cash flows over the life of the contract (see section 9.2 below)
  - An adjustment to reflect the time value of money and the financial risks related to the future cash flows to the extent that the financial risks are not included in the estimates of the future cash flows (see section 9.3 below)

    And
  - A risk adjustment for non-financial risk (see section 9.4 below)
- A contractual service margin, representing the unearned profit on the group of contracts (see section 9.5 below)

The contractual service margin is released to profit or loss over the period that services are provided to the policyholder. Therefore, at initial recognition, no profit should normally be recognised. However, a loss is recognised if the group of contracts is onerous at the date that the group is determined to be onerous (see section 6 above). Measurement of onerous contracts is discussed in section 9.8 below. The contractual service margin for insurance contracts with direct participation features is adjusted over the service period in a different way from the contractual service margin for insurance contracts without direct participation features. Contracts with direct participation features are discussed in section 12.3 below. Once the contractual service margin is utilised, the group of insurance contracts will be measured using only the fulfilment cash flows.

9.1 The contract boundary

This section deals with the general requirements of IFRS 17 to establish the contract boundary. Identifying the contract boundary under IFRS 17 is fundamental to the measurement of the fulfilment cash flows of a group of contracts. Contract boundary issues specifically related to reinsurance contracts issued are discussed in section 9.9.1 below. Contracts boundary issues related to reinsurance contracts held are discussed in section 11.2 below.

Extract from IFRS 17

BC159 The measurement of a group of insurance contracts includes all the cash flows expected to result from the contracts in the group, reflecting estimates of policyholder behaviour. Thus, to identify the future cash flows that will arise as the entity fulfils its obligations, it is necessary to draw a contract boundary that distinguishes whether future premiums, and the resulting benefits and claims, arise from:

(a) existing insurance contracts. If so, those future premiums, and the resulting benefits and claims, are included in the measurement of the group of insurance contracts; or

(b) future insurance contracts. If so, those future premiums, and the resulting benefits and claims, are not included in the measurement of the group of existing insurance contracts.

[IFRS 17.BC159].

A liability or asset relating to expected premiums or expected claims outside the boundary of the existing insurance contract must not be recognised. Such amounts relate to future insurance contracts. *[IFRS 17.35]*. However, an asset must be recognised for acquisition cash flows paid before the related group of insurance contracts is recognised (see section 7.3 above and section 9.1.3 below).

Estimates of cash flows in a scenario must include all cash flows within the boundary of an existing contract and no other cash flows. In determining the boundary of a contract, an entity must consider its substantive rights and obligations and whether they arise from a contract, law or regulation (see section 2.3 above). *[IFRS 17.B61]*.

When an issuer of an insurance contract is required by the contract to renew or otherwise continue the contract, it must assess whether premiums and related cash flows that arise from the renewed contract are within the boundary of the original contract. *[IFRS 17.B63]*.

The principle of a contract is that it binds one or both of the parties. If both parties are bound equally, the boundary of the contract is generally clear. Similarly, if neither party is bound, it is clear that no genuine contract exists. Therefore: *[IFRS 17.BC160]*

- The outer limit of the existing contract is the point at which the entity is no longer required to provide coverage and the policyholder has no right of renewal. Beyond that outer limit, neither party is bound.
- The entity is no longer bound by the existing contract at the point at which the contract confers on the entity the practical ability to reassess the risk presented by a policyholder and, as a result, the right to set a price that fully reflects that risk.

An entity has the practical ability to set a price at a future date (a renewal date) that fully reflects the risk in the contract from that date in the absence of constraints that prevent the entity from setting the same price it would for a new contract with the same characteristics as the existing contract issued on that date, or if it can amend the benefits to be consistent with the price it will charge. Similarly, an entity has the practical ability to set a price when it can reprice an existing contract so that the price reflects overall changes in the risks in a portfolio of insurance contracts, even if the price set for each individual policyholder does not reflect the change in risk for that specific policyholder. When assessing whether the entity has the practical ability to set a price that fully reflects the risks in the contract or portfolio, it must consider all the risks that it would consider when underwriting equivalent contracts on the renewal date for the remaining service. In determining the estimates of future cash flows at the end of a reporting period, an entity must reassess the boundary of an insurance contract to include the effect of changes in circumstances on the entity's substantive rights and obligations. *[IFRS 17.B64]*.

However, if an entity has the practical ability to reassess the risk presented by a policyholder but does not have the right to set a price that fully reflects the reassessed risk, the contract still binds the entity. Thus, that point of reassessment would lie within the boundary of the existing contract, unless the restriction on the entity's ability to reprice the contract is so minimal that it is expected to have no commercial substance (i.e., the restriction has no discernible effect on the economics of the transaction). In the Board's view, a restriction with no commercial substance does not bind the entity. *[IFRS 17.BC161]*.

It may be more difficult to decide the contract boundary if the contract binds one party more tightly than the other. Examples of circumstances in which it is more difficult include: *[IFRS 17.BC162]*

- An entity may price a contract so that the premiums charged in early periods subsidise the premiums charged in later periods, even if the contract states that each premium relates to an equivalent period of coverage. This would be the case if the contract charges level premiums and the risks covered by the contract increase with time. The Board concluded that the premiums charged in later periods would be within the boundary of the contract because, after the first period of coverage, the policyholder has obtained something of value, namely the ability to continue coverage at a level price despite increasing risk.
- An insurance contract might bind the entity, but not the policyholder, by requiring the entity to continue to accept premiums and provide coverage (without the ability to reprice the contract) but permitting the policyholder to stop paying premiums, although possibly incurring a penalty. In the Board's view, the premiums the entity is required to accept and the resulting coverage it is required to provide fall within the boundary of the contract.
- An insurance contract may permit an entity to reprice the contract on the basis of general market experience (for example, mortality experience), without permitting the entity to reassess the individual policyholder's risk profile (for example, the policyholder's health). In this case, the insurance contract binds the entity by requiring it to provide the policyholder with something of value - continuing insurance coverage without the need to undergo underwriting again. Although the terms of the contract are such that the policyholder has a benefit in renewing the contract, and the entity expects that renewals will occur, the contract does not require the policyholder to renew the contract.

Even if an entity is prevented from repricing an existing contract using an individual policyholder's risk assessment, where it is able to reprice to fully reflect the risks of the portfolio as a whole, the repriced cash flows are outside the contract boundary provided both criteria for repricing at a portfolio level mentioned above are met. *[IFRS 17.BC163]*.

As a result of the above context, IFRS 17 specifies that cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with insurance contract services.

Extract from IFRS 17

34 Cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with insurance contract services (see paragraphs B61-B71). A substantive obligation to provide insurance contract services ends when:

(a) the entity has the practical ability to reassess the risks of the particular policyholder and, as a result, can set a price or level of benefits that fully reflects those risks; or

(b) both of the following criteria are satisfied:

(i) The entity has the practical ability to reassess the risks of the portfolio of insurance contracts that contain the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio; and

(ii) The pricing of the premiums up to the date when the risks are reassessed does not take into account the risks that relate to periods after the reassessment date.

[IFRS 17.34].

The assessment of the contract boundary is made in each reporting period. This is because an entity updates the measurement of the group of insurance contracts to which the individual contract belongs and, hence, the portfolio of contracts in each reporting period. For example, in one reporting period an entity may decide that a renewal premium for a portfolio of contracts is outside the contract boundary because the restriction on the entity's ability to reprice the contract has no commercial substance. However, if circumstances change so that the same restrictions on the entity's ability to reprice the portfolio take on commercial substance, the entity may conclude that future renewal premiums for that portfolio of contracts are within the boundary of the contract. *[IFRS 17.BC164]*.

Frequently asked questions

Question 9-1: How to interpret the term 'contract boundary' described in IFRS 17.34 in the context of contracts with annual repricing mechanisms.

(TRG meeting February 2018 - Agenda paper no. 02, Log S22)

The submission describes specified fact patterns of two insurance contracts. In these fact patterns, the insurance fees are repriced annually at a portfolio level using step-rated fee tables. Hence, risk is assessed at a portfolio of insurance contracts level rather than an individual contract level, and therefore IFRS 17.34(a) is not applicable. The contract boundary is instead determined based on the assessment of risk applying IFRS 17.34(b).

TRG members discussed the analysis in the staff paper and noted that:

- IFRS 17.34(a) refers to the practical ability to reassess the risks of the policyholder (i.e., policyholder risk). IFRS 17.34(b) should be read as an extension of the risk assessment in IFRS 17.34(a) from the individual to portfolio level, without extending policyholder risks to all types of risks and considerations applied by an entity when pricing a contract. The staff noted that policyholder risk includes both the insurance risk and the financial risk transferred from the policyholder to the entity and, therefore, excludes lapse risk and expense risk.
- For the specified fact patterns of the two contracts described in the submission, the conclusion in the paper is that an entity can reset annually the premiums of the portfolios to which both of the example contracts belong to reflect the reassessed risk of those portfolios. The entity has the practical ability to reassess the risks of the specific portfolio of insurance contracts that contains the contract and, as a result, can set a price that fully reflects the risk of that portfolio and meets the requirements of IFRS 17.34(b)(i). In the fact pattern presented, premiums increase in line with age each year based on a step-rated table, i.e., the contract does not charge level premiums. Consequently, the staff analysis assumes that the requirements in IFRS 17.34(b)(ii) are also met. Accordingly, for those two contracts, the cash flows resulting from the renewal terms should not be included within the boundary of the existing insurance contract.
- If, conversely, the fact patterns of the two contracts described in the submission was varied such that the entity instead has a practical ability to reassess risks only at a general level (e.g., for a general community) and, as a result, can set a price for the portfolio of insurance contracts that contains the contract (e.g., using a generic step-rate table), then this would provide the individual

policyholders within the portfolios with a substantive right and consequently, the cash flows resulting from these renewal terms should be included within the boundary of the existing contract.

TRG members observed that, in practice, some entities use a step-rated premium table for pricing that averages out the pricing between the different levels on the table (i.e., between the different steps). All relevant facts and circumstances would need to be considered in assessing whether the requirements in IFRS 17.34(b)(ii) are met.

TRG members also observed that the two examples described are for specific fact patterns. In practice, the features of contracts and their repricing might be different from those examples. The facts and circumstance of each contract should be assessed to reach an appropriate conclusion applying the requirements of IFRS 17.

Question 9-2: Whether the reference to a 'portfolio of insurance contracts' in IFRS 17.34(b) is a 'portfolio of insurance contracts' as defined in Appendix A of IFRS 17?

(TRG meeting April 2019 - Agenda paper no. 02, Log S86)

The submission asked whether the reference to a 'portfolio of insurance contracts' in IFRS 17.34(b) is a 'portfolio of insurance contracts' as defined in Appendix A of IFRS 17. The submission noted the discussion of Agenda Paper 2 at the February 2018 TRG meeting (see Question 9-1 above) and stated that some stakeholders think that a 'portfolio of insurance contracts' should be interpreted at a more granular level than is defined in Appendix A of IFRS 17 for the purpose of applying IFRS 17.34(b) (for example, at a group of insurance contracts level). The TRG agreed with the Staff's analysis that a 'portfolio of insurance contracts' is a defined term in Appendix A of IFRS 17. There is no difference between the use of that defined term in IFRS 17.14 and IFRS 17.34.

Question 9-3: What is the interrelation between the requirements in IFRS 17.35 (cash flows that are outside the boundary of an insurance contract) and the requirements in IFRS 17.B64 (reassessment of the boundary of an insurance contract at each reporting date)?

(TRG meeting September 2018 - Agenda paper no. 05, Log S66)

The submission considered how to account for cash flows of an insurance contract issued that, at initial recognition, are outside the boundary of the contract when facts or circumstances change over time. In particular, the staff paper considered the interaction between the statement in IFRS 17.35 that cash flows outside the boundary of a contract at initial recognition are cash flows of a new contract and the final sentence of IFRS 17.B64 which permits an entity to re-assess the boundary of an insurance contract to include the effect of changes in circumstances. The IASB staff observed that:

- The requirements in the two paragraphs are different because they address two different circumstances.
- When IFRS 17.35 applies, additional cash flows will be recognised as a new contract when the recognition criteria of a new group of contracts are met.
- IFRS 17.B64 discusses the assessment of the practical ability of an entity to reprice a contract considering constraints that might limit that ability and, therefore, applies to the reassessment of the contract boundary in this context. For example, a contract boundary reassessment may occur when, in one reporting period, repricing restrictions that have no commercial substance but in the next reporting period, facts and circumstances come to light that would have led to a different conclusion at inception (if known then). When IFRS 17.B64 applies, the fulfilment cash flows are updated to reflect changes in cash flows that are within the (revised) contract boundary. When such changes relate to future service, they are recognised by adjusting the carrying amount of the contractual service margin of the group of contracts to which the contract belongs.

The TRG members agreed with the IASB staff observations but noted the apparent conflict between the two paragraphs which stems from a lack of clarity of the meaning of IFRS 17.B64. IASB staff observed that the meaning of the last sentence in IFRS 17.B64 should be considered in the context of the preceding sentences in IFRS 17.B64, B61 to B63 and the Basis for Conclusions. The TRG members also expressed different views as to the applicability of the distinction between IFRS 17.35 and B64 in circumstances where cash flows that are outside the contract boundary at initial recognition relate to an additional type of coverage that may be provided over the coverage period of the contract.

Question 9-4: Are cash flows related to free additional coverage within the boundary of the insurance contracts purchased by policyholders?

(TRG meeting September 2018 - Agenda paper no. 11, Log S62)

The IASB staff discussed a question submitted to the TRG regarding a type of entity in which parties become members by purchasing an insurance contract. Members of the entity are also provided with free additional insurance coverage. The entity can cancel the free additional insurance coverage at any

time and the question arises as to whether cash flows related to the free additional coverage are within the boundary of the insurance contracts purchased by policyholders. The IASB staff concluded that the right of an entity to cancel coverage at any time means that the entity does not have a substantive obligation to provide future service related to the free additional insurance coverage. The expected cash flows related to future free additional insurance coverage are, therefore, not included in the boundary of the insurance contract and are not included in the liability for remaining coverage. If the entity has a substantive obligation for the free additional insurance coverage that has already been provided, such as unpaid claims, the cash flows related to that coverage are within the boundary of the contract and are included in the liability for incurred claims.

Question 9-5: Are cash flows within the boundary of a group insurance contract, if those cash flows relate to periods after the entity can cancel the group insurance policy?

(TRG meeting September 2018 - Agenda paper no. 08, Log S61)

The TRG members considered an IASB staff paper which discussed a submission about the boundary of a contract for an agreement between an entity and an association or bank (referred to as a group insurance policy), under which the entity provides insurance coverage to members of an association or to customers of a bank (referred to as 'certificate holders').

In the case of group association policies, the insurance entity has a policy with an association or bank to sell insurance coverage to individual members or customers. Although the legal contract is between the entity and the association or bank, the insurance coverage for each certificate holder is priced as if it were an individual contract. In the case of group creditor policies with a bank, the entity can sell insurance coverage to individual customers of the bank. These policies have the same facts and circumstances as the group association policy, other than insurance cover being linked to the remaining outstanding balance of the loan or mortgage issued by the bank to the certificate holder. The entity pays the remaining outstanding loan balance to the bank when an insured event occurs (rather than the certificate holder or their beneficiaries who are liable for paying the outstanding balances). In the fact pattern submitted, the entity can terminate the policy with a 90-day notice period. In such arrangements, the question arises as to whether the cash flows related to periods after the notice period of 90 days are within the boundary of an insurance contract and whether the policyholder is the bank (or association) or the individual certificate holders.

The TRG members agreed with the analysis and conclusion of the staff paper including the steps that an entity should perform in its analysis and observed that:

- For group insurance policies an entity should consider whether the policyholder is the association or bank, or the certificate holders. This is the case regardless of whether that compensation is received directly or indirectly by paying amounts on the policyholder's behalf.
- For group insurance policies, an entity should consider whether the arrangement reflects a single insurance contract or multiple insurance contracts (i.e., with each certificate holder). Rebutting the presumption that the contract is a single contract by separating components requires judgement and careful consideration of all facts and circumstances (see section 6.1.1 above).
- For the group insurance policies described in the submission, the following facts and circumstances are indicative that the arrangement reflects multiple insurance contracts (i.e., an insurance contract with each certificate holder) for the purpose of applying IFRS 17:
  - The insurance coverage is priced and sold separately
  - Other than being members of the association or customers of the bank the individuals are not related to one another
  - Purchase of the insurance coverage is an option for each individual
- An entity should assess the boundary of each insurance contract. For the group insurance policies described in the submission, the entity's substantive obligation to provide services under the contract ends at the point the entity can terminate the contract. This means that, in these examples, the substantive obligation ends after 90 days and cash flows within the boundary are those related to the obligation to provide services over the period of 90 days. The certificate holder's expectation that the group insurance policy will not be terminated earlier than the contract term is not relevant to the assessment of the contract boundary.

The TRG members also observed that, in practice, there are many group insurance contracts with different terms and the assessment of whether a group insurance policy arrangement reflects a single insurance contract or multiple insurance contracts should be applied to group insurance policies considering all relevant facts and circumstances.

Illustration 9-1: Contract boundary of a stepped premium life insurance contract

An entity issues a group of annual insurance contracts which provide cover for death, and total and permanent disablement. The cover is guaranteed renewable every year (i.e., the entity must accept renewal) for twenty years regardless as to changes in health of the insured. However, the premiums increase annually with the age of the policyholder and the insurer may increase premium rates annually provided that the increase is applied to the entire portfolio of contracts (premium rates for an individual policyholder cannot be increased after the policy is underwritten).

Analysis

The contract boundary is one year.

The guaranteed renewable basis means that the entity has a substantive obligation to provide the policyholder with services. However, the substantive obligation ends at the end of each year. This is because the entity has the practical ability to reassess the risks of the portfolio that contains the contract. Therefore, the entity can set a price that reflects the risk of that portfolio and the pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account the risks that relate to premiums after the reassessment date (as premiums are adjusted annually for age). Therefore, both criteria mentioned above are satisfied.

Illustration 9-2: Contract boundary of a level premium life insurance contract

An entity issues a group of insurance contracts which provide cover for death, and total and permanent disablement. The cover is guaranteed renewable (i.e., the entity must accept renewal) for twenty years regardless as to changes in health of the insured. The premium rates are level for the life of the policy irrespective of policyholder age. Therefore, the insurer will generally 'overcharge' younger policyholders and 'undercharge' older policyholders. In addition, the insurer may increase premium rates annually provided that the increase is applied to the entire portfolio of contracts (premium rates for an individual policyholder cannot be increased after the policy is underwritten).

Analysis

The contract boundary is twenty years.

The guaranteed renewable basis means that the entity has a substantive obligation to provide the policyholder with services. The substantive obligation does not end until the period of the guaranteed renewable basis expires. Although the entity has the practical ability to reassess the risks of the portfolio that contains the contract and, therefore, can set a price that reflects the risk of that portfolio, the pricing of the premiums does take into account the risks that relate to premiums after the reassessment date. The entity charges premiums in the early years to recover the expected cost of death claims in later years. Therefore, the second criterion in IFRS 17.34(b)(ii) for drawing a shortened contract boundary when an entity can reassess the premiums or benefits for a portfolio of insurance contracts is not satisfied.

How we see it

Establishing the boundary of a contract is crucial as it determines the cash flows that will be included in its measurement. Drawing a contract boundary at the point where the entity has the practical ability to reprice (or amend the benefits under the contract) to fully reflect the risks of the policyholder may not reflect the entity's expectations about future cash flows from renewals. This could result in contracts being reported as onerous even when an insurer expects to recover all costs from future renewals.

An entity's ability to reprice an individual insurance contract (and a policyholder's option not to renew the contract) creates a contract boundary. This means that, if premiums are received from the policyholder after the contract boundary date (i.e., the contract continues beyond the boundary period) this will be treated as the recognition of a new contract - even if the rights and obligations of the entity and the policyholder are included within the single original policy document. The result would be that payments and related future cash flows will be recognised as new separate contracts. This is likely to result in a change from how entities dealt with future premiums under IFRS 4.

9.1.1 Options to add insurance coverage

As discussed in section 3.6 above, for some contracts, the transfer of insurance risk to the issuer occurs after a period of time. Consider the example of a contract that provides a specified investment return and includes an option for the policyholder to use the proceeds of the investment on maturity to buy a life-contingent annuity at the same rates the entity charges other new annuitants at the time the policyholder exercises that option. Such a contract transfers insurance risk to the issuer only after the option is exercised, because the entity remains free to price the annuity on a basis that reflects the insurance risk that will be transferred to the entity at that time. Consequently, the cash flows that would occur on the exercise of the option fall outside the boundary of the contract, and before exercise, there are no insurance cash flows within the boundary of the contract. However, if the contract specifies the annuity rates (or a basis other than market rates for setting the annuity rates), the contract transfers insurance risk to the issuer because the issuer is exposed to the risk that the annuity rates will be unfavourable to the issuer when the policyholder exercises the option. In that case, the cash flows that would occur when the option is exercised are within the boundary of the contract. *[IFRS 17.B24]*.

Frequently asked questions

Question 9-6: How should an option to add coverage to an existing coverage on terms that are not guaranteed be accounted for?

(TRG meeting May 2018 - Agenda paper no. 03, Log S36)

The TRG discussed an IASB staff paper that analysed how to determine the contract boundary of insurance contracts that include an option to add insurance coverage at a later date. The TRG members observed that:

- An option to add insurance coverage at a future date is a feature of the insurance contract.
- An entity should focus on substantive rights and obligations arising from that option to determine whether the cash flows related to the option are within or outside the contract boundary.
- Unless the entity considers that an option to add coverage at a future date is a separate contract, the option is an insurance component that is not measured separately from the remainder of the insurance contract.
- If an option to add insurance coverage is not a separate contract and the terms are guaranteed by the entity, the cash flows arising from the option would be within the boundary of the contract because the entity cannot reprice the contract to reflect the reassessed risks when it has guaranteed the price for one of the risks included in the contract.
- If an option to add insurance coverage is not a separate contract and the terms are not guaranteed by the entity, the cash flows arising from the option might be either within or outside of the contract boundary, depending on whether the entity has the practical ability to set a price that fully reflects the reassessed risks of the entire contract. The analysis in the IASB staff paper: (i) assumed that the option to add insurance coverage at a future date created substantive rights and obligations; and (ii) noted that, if an entity does not have the practical ability to reprice the whole contract when the policyholder exercises the option to add coverage, the cash flows arising from the premiums after the option exercise date would be within the contract boundary. The TRG members expressed different views about whether an option with terms that are not guaranteed by the entity would create substantive rights and obligations.
- If the cash flows arising from an option to add coverage at a future date are within the contract boundary, the measurement of a group of insurance contracts is required to reflect, on an expected value basis, the entity's current estimates of how the policyholders in the group will exercise the option.

Question 9-7: Which are the cash flows within the boundary of each of two specific fact patterns of health insurance contracts for which the policyholder has a right to terminate a contract, which results in its lapse, and a right to reinstate the contract?

(TRG meeting April 2019 - Agenda paper no. 02, Log S126)

The submission describes two specific fact patterns of health insurance contracts for which the policyholder has a right to terminate a contract, which results in its lapse, and a right to reinstate the contract. The policyholder's right to reinstate the contract is either exercised by paying the premiums that were not paid since the contract has lapsed until the reinstatement date or by exercising an option that the policyholder acquired after the contract has lapsed. In the latter case, the option is repriced annually based on the latest mortality table. In both cases, when the insurance contract is reinstated, it is reinstated without further underwriting or repricing of the premiums.

The IASB staff declined to provide further analysis of the specific transaction, but observed that an entity should assess whether its substantive obligation to provide services ends when a contract with such features lapses applying the criteria set out in section 9.1 above (and discussed further above) and that cash flows related to the unexpired portion of the coverage period, such as the expected reinstatement of contracts, are part of the liability for remaining coverage.

9.1.2 Constraints or limitations relevant in assessing repricing

As discussed in section 9.1 above, when assessing whether an entity has the practical ability to set a price that fully reflects the risks in the contract or portfolio, it must consider all the risks that it would consider when underwriting equivalent contracts on the renewal date for the remaining service. In determining the estimates of future cash flows at the end of a reporting period, an entity must reassess the boundary of an insurance contract to include the effect of changes in circumstances on the entity's substantive rights and obligations. *[IFRS 17.B64]*.

Frequently asked questions

Question 9-8: What constraints or limitations, other than those arising from the terms of an insurance contract, would be relevant in assessing the practical ability of an entity to reassess the risks of the particular policyholder (or of the portfolio of insurance contracts that contains the contract) and set a price or level of benefits that fully reflects those risks?

(TRG meeting May 2018 - Agenda paper no. 03, Log S43 and S49)

The TRG members observed that:

- A constraint that equally applies to new contracts and existing contracts would not limit an entity's practical ability to reprice existing contracts to reflect their reassessed risks.
- When determining whether it has the practical ability to set a price at a future date that fully reflects the reassessed risks of a contract or portfolio, an entity must (i) consider contractual, legal and regulatory restrictions; and (ii) disregard restrictions that have no commercial substance.
- IFRS 17 does not limit pricing constraints to contractual, legal and regulatory constraints. Market competitiveness and commercial considerations are factors that an entity typically considers when pricing new contracts and repricing existing contracts. As such, sources of constraints may also include market competitiveness and commercial considerations, but constraints are irrelevant to the contract boundary if they apply equally to new and existing policyholders in the same market.
- A constraint that limits an entity's practical ability to price or reprice contracts differs from choices that an entity makes (pricing decisions) which may not limit the entity's practical ability to reprice existing contracts in the way envisaged by IFRS 17.B64.

The TRG members also observed that an entity should apply judgement to decide whether commercial considerations are relevant when considering the contract boundary requirements of IFRS 17.

9.1.3 Contract boundary matters related to insurance acquisition cash flows

As discussed in section 7.3 above, in some circumstances, an insurer may pay insurance acquisition cash flows on insurance contracts which are expected to last for many years but where the contract boundary is much shorter. For example, an insurer may pay significant up-front insurance acquisition cash flows in the first year of a contract on the basis that the contract will last for a number of years, but the contract boundary may be only one year (e.g., because of the reasons explained in Illustration 9-1 above). In some cases, part of the commission is refundable from the agent if the future renewals do not occur as expected. In other circumstances, the commission is not refundable.

IFRS 17 requires an entity to allocate insurance acquisition cash flows to groups of insurance contracts using a systematic and rational method (see section 7.3 above) unless, as permitted under the premium allocation approach (see section 10.1 below), it chooses to recognise them as an expense. *[IFRS 17.28A]*.

At the end of each reporting period, an entity must revise amounts allocated to each group using the systematic and rational method specified above to reflect any changes in assumptions that determine the inputs to the method of allocation used. The entity must not change amounts allocated to a group of insurance contracts after all contracts have been added to the group. *[IFRS 17.B35B]*.

How we see it

As discussed in section 7.3 above, IFRS 17 does not contain specific requirements explaining how to allocate parts of the acquisition cash flows to anticipated contract renewals of different groups of insurance contracts on a systematic and rational basis. Therefore, the determination of such an allocation is a matter of judgement.

A distinction can be made when an insurer has paid an intermediary separately for exclusivity or future services as these costs are not attributable to an insurance contract and these payments would be outside the scope of IFRS 17 and may be within the scope of another IFRS accounting standard.

See sections 9.9.1 and 11.2 below for a discussion on matters related to the assessment of contract boundary, specifically as they relate to reinsurance contracts issued and held, respectively.

9.2 Estimates of expected future cash flows

The first element of the building blocks in the general model discussed in section 8 above is an estimate of the future cash flows over the life of each contract.

Extract from IFRS 17

B37 The objective of estimating future cash flows is to determine the expected value, or probability-weighted mean, of the full range of possible outcomes, considering all reasonable and supportable information available at the reporting date without undue cost or effort. Reasonable and supportable information available at the reporting date without undue cost or effort includes information about past events and current conditions, and forecasts of future conditions (see paragraph B41). Information available from an entity's own information systems is considered to be available without undue cost or effort.

[IFRS 17.B37].

All the future cash flows within the boundary of each contract in a group are included within the measurement estimate (see section 9.1 above). *[IFRS 17.33]*. However, the fulfilment cash flows must not reflect the non-performance risk (i.e., own credit) of the entity. *[IFRS 17.31]*. As discussed in section 6 above, an entity is permitted to estimate the future cash flows at a higher level of aggregation than a group and then allocate the resulting fulfilment cash flows to individual groups of contracts.

The estimates of future cash flows must: *[IFRS 17.33]*

- Incorporate, in an unbiased way, all reasonable and supportable information available without undue cost or effort about the amount, timing and uncertainty of those future cash flows. To do this, an entity estimates the expected value (i.e., the probability-weighted mean) of the full range of possible outcomes.
- Reflect the perspective of the entity, provided that the estimates of any relevant market variables are consistent with observable market prices for those variables (see section 9.2.1 below).
- Be current - the estimates must reflect conditions existing at the measurement date, including assumptions at that date about the future (see section 9.2.2 below).
- Be explicit - the entity must estimate the adjustment for non-financial risk separately from the other estimates. The entity must also estimate the cash flows separately from the adjustment for the time value of money and financial risk, unless the most appropriate measurement technique combines these estimates (see section 9.4 below).

The starting point for an estimate of future cash flows is a range of scenarios that reflects the full range of possible outcomes. Each scenario specifies the amount and timing of the cash flows for a particular outcome, and the estimated probability of that outcome. The cash flows from each scenario are discounted and weighted by the estimated probability of that outcome to derive an expected present value. Consequently, the objective is not to develop a most likely outcome, or a more-likely-than-not outcome, for future cash flows. *[IFRS 17.B38]*.

When considering the full range of possible outcomes, the objective is to incorporate all reasonable and supportable information available without undue cost or effort in an unbiased way, rather than to identify every possible scenario. In practice, developing explicit scenarios is unnecessary if the resulting estimate is consistent with the measurement objective of considering all reasonable and supportable information available without undue cost or effort when determining the mean. For example, if an entity estimates that the probability distribution of outcomes is broadly consistent with a probability distribution that can be described completely with a small number of parameters, it will be sufficient to estimate the smaller number of parameters. Similarly, in some cases, relatively simple modelling may give an answer within an acceptable range of precision, without the need for many detailed simulations. However, in some cases, the cash flows may be driven by complex underlying factors and may respond in a non-linear fashion to changes in economic conditions. This may happen if, for example, the cash flows reflect a series of interrelated options that are implicit or explicit. In such cases, more sophisticated stochastic modelling is likely to be necessary to satisfy the measurement objective. *[IFRS 17.B39]*.

The scenarios developed must include unbiased estimates of the probability of catastrophic losses under existing contracts. Those scenarios exclude possible claims under possible future contracts. *[IFRS 17.B40]*.

An entity must estimate the probabilities and amounts of future payments under existing contracts on the basis of information obtained including: *[IFRS 17.B41]*

- Information about claims already reported by policyholders.
- Other information about the known or estimated characteristics of the insurance contracts.
- Historical data about the entity's own experience, supplemented when necessary with historical data from other sources. Historical data is adjusted to reflect current conditions, for example, if:
  - The characteristics of the insured population differ (or will differ, for example, because of adverse selection) from those of the population that has been used as a basis for the historical data
  - There are indications that historical trends will not continue, that new trends will emerge, or that economic, demographic and other changes may affect the cash flows that arise from the existing insurance contracts

    Or
  - There have been changes in items such as underwriting procedures and claims management procedures that may affect the relevance of historical data to the insurance contracts
- Current price information, if available, for reinsurance contracts and other financial instruments (if any) covering similar risks, such as catastrophe bonds and weather derivatives, and recent market prices for transfers of insurance contracts. This information must be adjusted to reflect the differences between the cash flows that arise from those reinsurance contracts or other financial instruments, and the cash flows that would arise as the entity fulfils the underlying contracts with the policyholder.

As a change to many accounting practices under IFRS 4, IFRS 17 does not contain an explicit deferred acquisition cost asset, for costs which relate to contracts that have already been recognised. Instead, paid insurance acquisition cash flows are included as a 'negative liability' within the measurement of the contractual service margin on initial recognition (see section 9.2.3.E below). Because the contractual service margin can never be negative for insurance contracts issued, there is no longer a need to perform any separate recoverability assessments for acquisition costs deferred once they have been included in the measurement of the group of insurance contracts. A recoverability assessment is necessary for the asset held for insurance acquisition cash flows paid before the related group of insurance contracts is recognised (see section 7.3 above and section 9.10 below).

Consistent with IFRS 4, catastrophe provisions and equalisation provisions (provisions generally build up over years following a prescribed regulatory formula which are permitted to be released in years when claims experience is high or abnormal) are not permitted to the extent that they relate to contracts that are not in-force at the reporting date (i.e., future claims would be outside the boundary of the existing contract). Although IFRS 17 prohibits the recognition of these provisions as a liability, it does not prohibit their segregation as a component of equity. Consequently, insurers are free to designate a proportion of their equity as an equalisation or catastrophe reserve. When a catastrophe or equalisation provision has a tax base, but is not recognised in the IFRS financial statements, then a taxable temporary difference will arise that should be accounted for under IAS 12 *Income Taxes*.

How we see it

The estimates of future cash flows must be on an expected value basis and, therefore, should be unbiased. This means that they should not include any additional estimates above the probability-weighted mean for 'uncertainty', 'prudence' or an implicit or explicit management loading for risk. A risk adjustment for non-financial risk (see section 9.4 below) is determined separately to reflect the compensation for bearing the non-financial risk resulting from the uncertain amount and the timing of the cash flows.

Techniques such as stochastic modelling may be more robust or easier to implement if there are significant interdependencies between cash flows that vary based on returns on assets and other cash flows. Judgement is required to determine the technique that best meets the objective of consistency with observable market variables in specific circumstances.

9.2.1 Market variables and non-market variables

IFRS 17 identifies two types of variables that can affect estimates of cash flow: *[IFRS 17.B42]*

- Market variables (i.e., those that can be observed in, or derived directly from, markets (for example, prices of publicly traded securities and interest rates))
- Non-market variables (i.e., all other variables, such as the frequency and severity of insurance claims and mortality)

Market variables will generally give rise to financial risk (e.g., observable interest rates) and non-market variables will generally give rise to non-financial risk (e.g., mortality rates). However, this will not always be the case, there may be assumptions that relate to financial risks for which variables cannot be observed in, or derived directly from, markets (e.g., interest rates that cannot be observed in, or derived directly from, markets). *[IFRS 17.B43]*.

9.2.1.A Market variables

Market variables are variables that can be observed in, or derived directly from markets (e.g., prices of publicly traded securities and interest rates).

Estimates of market variables must be consistent with observable market prices at the measurement date. An entity must maximise the use of observable inputs and must not substitute its own estimates for observable market data except in the limited circumstances as permitted by IFRS 13. *[IFRS 13.79]*.

Consistent with IFRS 13, if variables need to be derived (e.g., because no observable market variables exist) they must be as consistent as possible with observable market variables. *[IFRS 17.B44]*.

Market prices blend a range of views about possible future outcomes and also reflect the risk preferences of market participants. Consequently, they are not a single-point forecast of the future outcome. If the actual outcome differs from the previous market price, this does not mean that the market price was 'wrong'. *[IFRS 17.B45]*.

An important application of market variables is the notion of a replicating asset or a replicating portfolio of assets. A replicating asset is one whose cash flows exactly match, in all scenarios, the contractual cash flows of a group of insurance contracts in amount, timing and uncertainty. In some cases, a replicating asset may exist for some of the cash flows that arise from a group of insurance contracts. The fair value of that asset reflects both the expected present value of the cash flows from the asset and the risk associated with those cash flows. If a replicating portfolio of assets exists for some of the cash flows that arise from a group of insurance contracts, the entity can use the fair value of those assets to measure the relevant fulfilment cash flows instead of explicitly estimating the cash flows and discount rate. *[IFRS 17.B46]*. IFRS 17 does not require an entity to use a replicating portfolio technique. However, if a replicating asset or portfolio does exist for some of the cash flows that arise from insurance contracts and an entity chooses to use a different technique, the entity must satisfy itself that a replicating portfolio technique would be unlikely to lead to a materially different measurement of those cash flows. *[IFRS 17.B47]*.

Techniques other than a replicating portfolio technique, such as stochastic modelling techniques, may be more robust or easier to implement if there are significant interdependencies between cash flows that vary based on returns on assets and other cash flows. Judgement is required to determine the technique that best meets the objective of consistency with observable market variables in specific circumstances. In particular, the technique used must result in the measurement of any options and guarantees included in the insurance contracts being consistent with observable market prices (if any) for such options and guarantees. *[IFRS 17.B48]*.

Frequently asked questions

Question 9-9: Should 'risk neutral' or 'real world' scenarios be used for stochastic modelling techniques to project future returns on assets, applying IFRS 17.B48?

(TRG meeting May 2018 - Agenda paper no. 07, Log S14)

The IASB staff responded to a submission to the TRG which asked whether 'real world' or 'risk neutral' scenarios should be used in stochastic modelling when, for example, measuring options and guarantees. Real world scenarios are those based on an assumed distribution that is intended to reflect realistic assumptions about actual future asset returns. Risk neutral scenarios are those based on an underlying assumption that, on average, all assets earn the same risk-free return. A risk neutral approach uses a range of scenarios reflecting the assumed volatility of returns for an asset price consistent with volatility implied by option prices.

The IASB staff clarified that IFRS 17 does not require an entity to divide estimated cash flows into those that vary based on the returns on underlying items and those that do not (see section 9.3 below) and, if not divided, the discount rate should be appropriate for the cash flows as a whole. The IASB staff observed that any consideration beyond this is actuarial (i.e., operational measurement implementation) in nature and, therefore, does not fall within the remit of the TRG. The TRG members did not disagree with the IASB staff's observations.

How we see it

The application guidance is clear that although market variables will generally provide a measurement basis for financial risks (e.g., observable interest rates) this will not always be the case. The same is true for non-financial risks and non-market variables. For example, some non-financial risks could be observable in markets, whereas not all financial risks will be observable.

In practice, we believe that the use of a replicating portfolio approach is likely to be rare as IFRS 17 refers to the need to consider the approach only when an asset exists whose cash flows exactly match those of the liability (or a portion thereof).

9.2.1.B Non-market variables

Non-market variables are all other variables (other than market variables) such as the frequency and severity of insurance claims and mortality.

Estimates of non-market variables must reflect all reasonable and supportable evidence available without undue cost or effort, both external and internal. *[IFRS 17.B49]*. Non-market external data (e.g., national mortality statistics) may have more or less relevance than internal data (e.g., internally developed mortality statistics), depending on the circumstances. *[IFRS 17.B50]*.

Estimated probabilities for non-market variables must not contradict observable market variables. For example, estimated probabilities for future inflation rate scenarios must be as consistent as possible with probabilities implied by market interest rates. *[IFRS 17.B51]*.

In some cases, an entity may conclude that market variables vary independently of non-market variables. If so, the entity must consider scenarios that reflect the range of outcomes for the non-market variables, with each scenario using the same observed value of the market variable. *[IFRS 17.B52]*.

In other cases, market variables and non-market variables may be correlated. For example, there may be evidence that lapse rates (a non-market variable) are correlated with interest rates (a market variable). Similarly, there may be evidence that claim levels for house or car insurance are correlated with economic cycles and, therefore, with interest rates and expense amounts. The entity must ensure that the probabilities for the scenarios and the risk adjustments for the non-financial risk that relate to the market variables are consistent with the observed market prices that depend on those market variables. *[IFRS 17.B53]*.

Illustration 9-3: Persuasiveness of internal and national mortality statistics

An entity that issues life insurance contracts does not rely solely on national mortality statistics. It considers all other reasonable and supportable internal and external information available without undue cost or effort when developing unbiased estimates of probabilities for mortality scenarios for its insurance contracts. For example:

- Internal mortality statistics may be more persuasive than national mortality data if national data is derived from a large population that is not representative of the insured population. This could be because the demographic characteristics of the insured population could significantly differ from those of the national population, meaning that an entity would need to place more weight on the internal data and less weight on the national statistics.
- Conversely, if the internal statistics are derived from a small population with characteristics that are believed to be close to those of the national population, and the national statistics are current, an entity must place more weight on the national statistics. *[IFRS 17.B50]*.

9.2.2 Using current estimates

In estimating each cash flow scenario and its probability, an entity must use all reasonable and supportable information available without undue cost or effort. *[IFRS 17.B54]*. Undue cost and effort is discussed in section 17.4 below.

An entity must review the estimates that it made at the end of the previous reporting period and update them. In doing so, an entity considers whether: *[IFRS 17.B54]*

- The updated estimates faithfully represent the conditions at the end of the reporting period

  Or
- The changes in estimates faithfully represent the changes in conditions during the period. For example, suppose that estimates were at one end of a reasonable range at the beginning of the period. If the conditions have not changed, shifting the estimates to the other end of the range at the end of the period would not faithfully represent what happened during the period. If an entity's most recent estimates are

different from its previous estimates, but conditions have not changed, it must assess whether the new probabilities assigned to each scenario are justified. In updating its estimates of those probabilities, the entity must consider both the evidence that supported its previous estimates and all newly available evidence, giving more weight to the more persuasive evidence.

The probability assigned to each scenario must reflect the conditions at the end of the reporting period. Consequently, applying IAS 10 *Events after the Reporting Period*, an event occurring after the end of the reporting period that resolves an uncertainty that existed at the end of the reporting period does not provide evidence of the conditions that existed at that date. *[IFRS 17.B55]*.

Current estimates of expected cash flows are not necessarily identical to the most recent actual experience. For example, suppose that mortality experience in the reporting period was 20% worse than the previous mortality experience and previous expectations of mortality experience. Several factors could have caused the sudden change in experience, including: *[IFRS 17.B56]*

- Lasting changes in mortality
- Changes in the characteristics of the insured population (for example, changes in underwriting or distribution, or selective lapses by policyholders in unusually good health)
- Random fluctuations
- Identifiable non-recurring causes

An entity must investigate the reasons for the change in experience and develop new estimates of cash flows and probabilities in the light of the most recent experience, the earlier experience and other information. The result for the example above, when mortality experience worsened by 20% in the reporting period, would typically be that the expected present value of death benefits changes, but not by as much as 20%. However, if mortality rates continue to be significantly higher than the previous estimates for reasons that are expected to continue, the estimated probability assigned to the high-mortality scenarios will increase. *[IFRS 17.B57]*.

Estimates of non-market variables must include information about the current level of insured events and information about trends. For example, mortality rates have consistently declined over long periods in many countries. The determination of the fulfilment cash flows reflects the probabilities that would be assigned to each possible trend scenario, taking account of all reasonable and supportable information available without undue cost or effort. *[IFRS 17.B58]*.

In a similar manner, if cash flows allocated to a group of insurance contracts are sensitive to inflation, the determination of the fulfilment cash flows must reflect current estimates of possible future inflation rates. Because inflation rates are likely to be correlated with interest rates, the measurement of fulfilment cash flows must reflect the probabilities for each inflation scenario in a way that is consistent with the probabilities implied by the market interest rates used in estimating the discount rate (see section 9.2.1.A above). *[IFRS 17.B59]*.

When estimating the cash flows, an entity must take into account current expectations of future events that might affect those cash flows. The entity must develop cash flow scenarios that reflect those future events, as well as unbiased estimates of the probability of each scenario. However, an entity must not take into account current expectations of future changes in legislation that would change or discharge the present obligation or create new obligations under the existing insurance contract until the change in legislation is substantively enacted. *[IFRS 17.B60]*.

Illustration 9-4: Faithful representation of conditions at the reporting date and changes in the period

If conditions have not changed in a period, shifting a point estimate from one end of a reasonable range at the beginning of the period to the other end of the range at the end of the period would not faithfully represent what has happened during the period.

If the most recent estimates are different from previous estimates, but conditions have not changed, an entity must assess whether the new probabilities assigned to each scenario are justified. In updating its estimates of those probabilities, the entity considers both the evidence that supported its previous estimates and all newly available evidence, giving more weight to the more persuasive evidence.

An entity must not update probabilities for claim events to reflect actual claims that took place after the reporting date but before the financial statements are finalised. For example, there may be a 20% probability at the end of the reporting period that a major storm will strike during the remaining six months of an insurance contract. After the end of the reporting period, but before the financial statements are authorised for issue, a major storm strikes. The fulfilment cash flows under that contract must not reflect hindsight (i.e., the storm that occurred in the next period). Instead, the cash flows included in the measurement includes the 20% probability apparent at the end of the reporting period (with disclosure, applying IAS 10, that a non-adjusting event occurred after the end of the reporting period). *[IFRS 17.B55, IAS 10.10, IAS 10.11]*.

9.2.3 Cash flows within the contract boundary

As discussed in section 9.1 above, estimates of cash flows include all cash flows within the boundary of an insurance contract and in determining the contract boundary, an entity must consider its substantive rights and obligations and whether those rights and obligations arise from contract, law or regulation.

Many insurance contracts have features that enable policyholders to take actions that change the amount, timing, nature or uncertainty of the amounts they will receive. Such features include renewal options, surrender options, conversion options and options to stop paying premiums while still receiving benefits under the contracts. The measurement of a group of insurance contracts must reflect, on an expected value basis, the entity's current estimates of how the policyholders in the group will exercise the options available, and the risk adjustment for non-financial risk (see section 9.4 below) must reflect the entity's current estimates of how the actual behaviour of the policyholders may differ from the expected behaviour. This requirement to determine the expected value applies regardless of the number of contracts in a group; for example it applies even if the group comprises a single contract. Therefore, the measurement of a group of insurance contracts must not assume a 100% probability that policyholders will: *[IFRS 17.B62]*

- Surrender their contracts, if there is some probability that some of the policyholders will not

  Or

- Continue their contracts, if there is some probability that some of the policyholders will not

The Basis for Conclusions states that IFRS 17 does not require or allow the application of a deposit floor when measuring insurance contracts. If a deposit floor were to be applied, the resulting measurement would ignore all scenarios other than those involving the exercise of policyholder options in the way that is least favourable to the entity. This would contradict the principle that an entity should incorporate in the measurement of an insurance contract future cash flows on a probability-weighted basis. *[IFRS 17.BC166]*. The expected cash outflows include outflows over which the entity has discretion. *[IFRS 17.BC168]*. The Board considered whether payments that are subject to the entity's discretion meet the definition of a liability in the *Conceptual Framework for Financial Reporting* (the Conceptual Framework). The contract, when considered as a whole, clearly meets the Conceptual Framework's definition of a liability. Some components, if viewed in isolation, may not meet the definition of a liability. However, in the Board's view, including such components in the measurement of insurance contracts would generate more useful information for users of financial statements. *[IFRS 17.BC169]*.

Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract, including cash flows for which the entity has discretion over the amount or timing. IFRS 17 provides the following examples of such cash flows: *[IFRS 17.B65]*

- Premiums - see section 9.2.3.A below
- Payments, including claims and non-distinct investment components, to a policyholder - see section 9.2.3.B below
- Payments to a policyholder that vary based on underlying items (including non-distinct investment components) - see section 9.2.3.C below
- Payments to a policyholder resulting from derivatives - see section 9.2.3.D below
- Insurance acquisition cash flows - see section 9.2.3.E below
- Claims handling costs - see section 9.2.3.F below
- Costs incurred in providing contractual benefits in kind - see section 9.2.3.G below
- Policy administration and maintenance costs - see section 9.2.3.H below
- Transaction-based taxes and levies - see section 9.2.3.I below
- Payments by the insurer of tax in a fiduciary capacity - see section 9.2.3.J below
- Potential cash inflows from recoveries - see section 9.2.3.K below
- An allocation of fixed and variable overheads - see section 9.2.3.L below
- Costs the entity will incur in providing an investment activity, an investment-return service or an investment-related service - see section 9.2.3.M below
- Any other costs specifically chargeable to the policyholder - see section 9.2.3.N below

The Board decided not to include only insurance cash flows that are incremental at a contract level as that would mean that entities would recognise different contractual service margins and expenses depending on the way they structure their acquisition activities. *[IFRS 17.BC182(a)]*. For example, different liabilities would be reported if the entity had an internal sales department rather than outsourcing sales to external agents as the costs of an internal sales department, such as fixed salaries, are less likely to be incremental than amounts paid to an agent.

At initial recognition of an insurance contract, the fulfilment cash flows will include estimates for these cash flows. Subsequently, as services are provided under the contract, the liability for remaining coverage is reduced and insurance revenue is recognised except for those changes that do not relate to services provided in the period (premiums received, investment component changes, changes related to transaction-based taxes, insurance finance income or expenses, and insurance acquisition cash flows). See section 15.2.1 below.

Frequently asked questions

Question 9-10: Are cash flows still within the boundary of the contract if those cash flows relate to periods when insurance coverage is no longer provided and where the policyholder bears all the risks related to the investment services?

(TRG meeting September 2018 - Agenda paper no. 11, Log S79)

The submission considered, in particular, whether cash flows should be considered to be within the boundary of the contract if those cash flows arise in periods in which the investment component exists but no insurance coverage is provided. The IASB staff observed that cash flows within the boundary of a contract may relate to periods in which coverage is no longer provided, such as when claims are expected to be settled in the future that relate to premiums that were within the boundary of the contract. Periods of coverage may also be outside the boundary of a contract if, for example, an entity can fully reprice premiums.

How we see it

The list of cash flows within the boundary of an insurance contract is more extensive than permitted under many local GAAPs (and, hence, applied previously under IFRS 4). For example, some local GAAPs permit only incremental costs to be included. Some local GAAPs also permit an accounting policy choice whether or not to expense as incurred or defer over the policy period certain costs such as insurance acquisition cash flows. IFRS 17 does not allow a choice as to whether or not to include these cash flows when they are within the boundary of the insurance contract.

9.2.3.A Premium cash flows

Premium cash flows include premium adjustments, instalment premiums from a policyholder and any additional cash flows that result from those premiums. *[IFRS 17.B65(a)]*.

How we see it

Some insurance contracts charge a higher premium to policyholders who pay by (say) monthly instalments compared to those who pay a single amount on policy inception. The increased amount billed to those paying by instalments may include an implicit interest charge. Under IFRS 4, accounting practices for the higher premium charged to those who pay by instalments have been diverse. Under IFRS 17, the fulfilment cash flows arising from any incremental premium chargeable to policyholders is insurance revenue as it does not meet the definition of insurance finance income or expenses (see section 15.3 below) nor is it a distinct non-insurance service as the insurance and financing are not usually sold separately (see section 5.3 above).

9.2.3.B Payments to (or on behalf of) a policyholder

These payments include claims that have already been reported but have not yet been paid (i.e., reported claims), claims for events that have occurred but for which claims have not been reported (i.e., incurred but not reported (IBNR) claims) and all future claims for which an entity has a substantive obligation. *[IFRS 17.B65(b)]*. These claim payments also include any non-distinct investment components, although the non-distinct investment components are excluded from insurance revenue and insurance service expenses (see section 5.2 above).

9.2.3.C Payments to (or on behalf of) a policyholder that vary depending on returns on underlying items

Some insurance contracts give policyholders the right to share in the returns on specified underlying items. *[IFRS 17.B65(c)]*. Underlying items are items that determine some of the amounts payable to a policyholder. Underlying items can comprise any items, e.g., a reference portfolio of assets, the net assets of the entity, or a specified subset of the net assets of the entity. *[IFRS 17 Appendix A]*.

Payments to policyholders that vary depending on returns from underlying items are found most frequently in contracts with participation features. These are discussed in section 12 below. These payments also include any non-distinct investment components, although the non-distinct investment components are excluded from insurance revenue and insurance service expenses (see section 5.2 above)

9.2.3.D Payments to (or on behalf of) a policyholder resulting from derivatives

Examples of such derivatives include options and guarantees embedded into the contract, to the extent that those options and guarantees are not separated from the contract (see section 5.1 above). *[IFRS 17.B65(d)]*.

9.2.3.E Insurance acquisition cash flows

These cash flows comprise an allocation of insurance acquisition cash flows attributable to the portfolio to which the contract belongs. *[IFRS 17.B65(e)]*.

There is no restriction on insurance acquisition cash flows to those resulting from successful efforts. So, for example, the directly attributable costs of an underwriter of a portfolio of motor insurance contracts do not need to be apportioned between those costs relating to efforts that result in the issuance of a contract and those relating to unsuccessful efforts. The Basis for Conclusions observes that the Board considered whether to restrict insurance acquisition cash flows included in the measurement of a group of insurance contracts to those cash flows directly related to the successful acquisition of new or renewed insurance contracts. However, it was concluded that this was not consistent with an approach that measured profitability of a group of contracts over the duration of the group and, in addition, the Board wanted to avoid measuring liabilities and expenses at different amounts depending on how an entity structures its insurance activities. *[IFRS 17.BC183]*.

Changes in estimates of insurance acquisition cash flows are adjusted against the liability for remaining coverage, but do not adjust insurance revenue as they do not relate to services provided by the entity. *[IFRS 17.B123(a)(v)]*. Separately, insurance revenue related to insurance acquisition cash flows is determined by allocating (or amortising) the portion of the premiums that relates to recovering these cash flows to each reporting period in a systematic way on the basis of passage of time, with a corresponding entry to insurance service expenses (i.e., DR insurance service expense, CR insurance revenue). *[IFRS 17.B125]*. See section 15.2.1 below.

9.2.3.F Claims handling costs

These are costs that an entity will incur in investigating, processing and resolving claims under existing insurance contracts (as opposed to claim payments to policyholders - see section 9.2.3.B above). Claims handling costs include legal and loss adjusters' fees and the internal costs of investigating claims and processing claims payments. *[IFRS 17.B65(f)]*.

9.2.3.G Costs incurred in providing contractual benefits in kind

These costs are those related to the type of payments in kind discussed in section 3.3 above. *[IFRS 17.B65(g)]*.

9.2.3.H Policy administration and maintenance costs

These costs include the costs of billing premiums and handling policy changes (for example, conversions and reinstatements). Such costs also include recurring commissions that are expected to be paid to intermediaries if a particular policyholder continues to pay the premiums within the boundary of the insurance contract. *[IFRS 17.B65(h)]*.

9.2.3.I Transaction-based taxes

These include such taxes as premium tax, value added taxes and goods and service taxes and levies (such as fire service levies and guarantee fund assessments) that arise directly from existing insurance contracts, or that can be attributed to them on a reasonable and consistent basis. *[IFRS 17.B65(i)]*. See also section 9.2.3.J below.

Premium or sales taxes are typically billed to the policyholder and then passed onto the tax authorities with the insurer usually acting as an agent for the tax authorities. The cash flows within the contract boundary would, therefore, include both the tax inflow and the tax outflow. Guarantee fund or similar assessments are usually billed to the insurer directly based on a calculation made by the tax authority often derived from the insurer's market share of particular types of insurance business. There is usually only a cash outflow for these assessments.

Changes in cash flows that relate to transaction-based taxes collected on behalf of third parties (such as premium taxes, value added taxes and goods and services taxes) adjust the liability for remaining coverage (i.e., are included within the balance of portfolios of insurance contracts included in the statement of financial position), but do not adjust insurance revenue as these do not relate to services expected to be covered by the consideration received by the entity. *[IFRS 17.B123(a)(iii)]*.

9.2.3.J Payments by the insurer in a fiduciary capacity

These are payments (and related receipts) made by the insurer to meet tax obligations of the policyholder. *[IFRS 17.B65(j)]*. In some jurisdictions, the insurer is required to make these payments (e.g., to pay the policyholder's tax on gains made on underlying items). Income tax obligations which are not paid in a fiduciary capacity (e.g., the insurer's own income tax obligations) are not cash flows within the boundary of an insurance contracts. See section 9.2.4 below.

9.2.3.K Potential inflows from recoveries

Some insurance contracts permit the insurer to sell, usually damaged, property acquired in settling the claim (salvage). The insurer may also have the right to pursue third parties for payment of some or all costs (subrogation). Potential cash inflows from recoveries (i.e., both salvage and subrogation) on future claims covered by existing insurance contracts are included in the cash flows within the boundary of an insurance contract. The same applies to potential cash inflows from recoveries on past claims, to the extent that they do not qualify for recognition as separate assets under the criteria of another IFRS accounting standard. *[IFRS 17.B65(k)]*.

9.2.3.L An allocation of fixed and variable overheads

Fixed and variable overheads included in the cash flows within the boundary of an insurance contract include the directly attributable costs of: *[IFRS 17.B65(l)]*

- Accounting
- Human resources
- Information technology and support
- Building depreciation
- Rent
- Maintenance and utilities

These overheads must be allocated to groups of contracts using methods that are systematic and rational and are consistently applied to all costs that have similar characteristics.

Other IFRS accounting standards govern the accounting treatment of some of the fixed or variable overheads, for example:

Fixed and variable overheads	Applicable IFRS
Human resources	IAS 19
Information technology	IAS 16/IAS 38
Depreciation	IAS 16/IFRS 16/IAS 38
Other allocated overhead amounts	IFRS 9 or another IFRS accounting standard

IFRS 17 will therefore interact with the recognition and measurement principles of other IFRS accounting standards. For example, an entity might include building depreciation costs in the fulfilment cash flows and will treat these as insurance service expenses under IFRS 17, recognising an incurred insurance service expense and corresponding revenue. See section 15.2.1 below for a discussion on the interaction between IFRS 17 and other IFRS accounting standards.

9.2.3.M Costs incurred in providing investment activity, investment-return and investment-related services

These are costs the entity will incur: *[IFRS 17.B65(ka)]*

- Performing investment activities, to the extent the entity performs these activities to enhance benefits from insurance coverage for policyholders. Investment activities enhance benefits from insurance coverage if the entity performs those activities expecting to generate an investment return from which policyholders will benefit if an insured event occurs.
- Providing investment-return services to policyholders of insurance contracts without direct participation features (see section 9.7.1 below).
- Providing investment-related services to policyholders of insurance contracts with direct participation features (see section 12.3.4 below).

Investment activity costs that an entity incurs are included in the fulfilment cash flows to the extent that the entity incurs those costs to provide investment-return services or investment-related services. It is acknowledged in the Basis for Conclusions that an entity may also incur investment activity costs to enhance benefits from insurance coverage from customers. Therefore, IFRS 17 specifies that an entity is required to include investment activity costs in the fulfilment cash flows to the extent that the entity performs those activities to enhance benefits from insurance coverage for policyholders. In determining whether investment activity costs enhance benefits from insurance coverage for policyholders, an entity needs to apply judgement in a similar manner to when it determines whether an investment-return service exists (see section 9.7.1 below). *[IFRS 17.BC283I]*.

Costs resulting from investment activity performed for the benefit of shareholders, rather than policyholders, are excluded from the list above. Therefore, it can be inferred by omission that the IASB does not consider shareholder-related investment costs to be fulfilment cash flows directly related to insurance contracts.

How we see it

When applying judgement as to whether investment activities enhance benefits from insurance coverage for policyholders, an entity would have to determine whether performing the investment activities enhances insurance benefits payable to policyholders and should be included in the fulfilment cash flows, or that it does not enhance insurance benefits payable to policyholders and should not be included in the fulfilment cash flows. Considerations in applying this judgement might include whether there is an implicit or explicit enhancement of benefits when pricing the product reflecting the likely investment return achieved, the level of investment activities undertaken, whether and how future benefits to policyholder are affected by investment returns and the time period between receipt of premiums and payment of benefits.

9.2.3.N Any other costs

These are any other costs specifically chargeable to the policyholder under the insurance contract. *[IFRS 17.B65(m)]*.

In some cases, income tax paid by an entity, even though not paid in a fiduciary capacity, is specifically chargeable to the policyholder under the terms of the contract. Such a tax, which can be described as a 'policyholder tax', arises for example, when an entity pays income tax on assets that are underlying items to insurance contracts, and charges the policyholder for its share of that income tax.

'Other costs' include income tax payments and receipts that are specifically chargeable to the policyholder under the terms of an insurance contract (see section 9.2.4 below for tax not specifically chargeable to the policyholder under the terms of an insurance contract). The consequence of this is that:

- An entity will continue to apply IAS 12 to those income tax payments to measure the amounts of such income tax payments to be included in the fulfilment cash flows.
- An entity will recognise insurance revenue for the consideration paid by the policyholder for these tax payments and receipts consistent with the recognition of insurance revenue for other incurred expenses. The IASB staff's view is that for income tax payments specifically chargeable to the policyholder under the contract terms, when the tax expense is incurred applying IAS 12, the entity will treat it as an incurred expense applying IFRS 17[7] (see also section 15.2.1 below). Although the amount

7 IASB Staff paper 2F: Project: *Amendments to IFRS 17*, Paper topic: *Other topics raised by respondents to the Exposure Draft* Amendments to IFRS 17, IASB meeting, February 2020, paragraph 15. Available on the IFRS Foundation's website.

charged to the policyholder is part of insurance revenue, the related income tax charge incurred in the period will be included within income tax (not insurance service expenses) and will be income tax payable and not part of the liability for incurred claims.

How we see it

IFRS 17.B121 distinguishes between (a)(i) 'insurance service expenses' and (a)(ia) income tax. This was needed as income tax cannot be presented as insurance services expenses as, under IAS 1, income tax needs to be presented separately in profit or loss. Therefore, incurred income tax expenses should be presented in the income tax expense line item on the face of the statement of profit or loss and not within the insurance service expenses.

9.2.4 Cash flows excluded from the contract boundary

Having provided a list of cash flows that are within the boundary of an insurance contract, IFRS 17 then provides a list of cash flows that must not be included when estimating the cash flows that will arise as an entity fulfils an existing insurance contract. These are as follows: *[IFRS 17.B66]*

- Investment returns. Investments are recognised, measured and presented separately
- Cash flows (payments or receipts) that arise under reinsurance contracts held. Reinsurance contracts held are recognised, measured and presented separately (see section 11 below)
- Cash flows that may arise from future insurance contracts, i.e., cash flows outside the boundary of existing contracts (see section 9.2.3 above)
- Cash flows relating to costs that cannot be directly attributed to the portfolio of insurance contracts that contain the contract, such as some product development and training costs. Such costs are recognised in profit or loss when incurred
- Cash flows that arise from abnormal amounts of wasted labour or other resources that are used to fulfil the contract. Such costs are recognised in profit or loss when incurred
- Income tax payments and receipts the insurer does not pay or receive in a fiduciary capacity or that are not specifically chargeable to the policyholder under the terms of the contract (see section 9.2.3.N above for tax specifically chargeable to the policyholder under the terms of the contract)
- Cash flows between different components of the reporting entity, such as policyholder funds and shareholder funds, if those cash flows do not change the amount that will be paid to the policyholders
- Cash flows arising from components separated from the insurance contract and accounted for using other applicable IFRS accounting standards (see section 5 above)

How we see it

Investment returns are not part of the fulfilment cash flows of a contract because measurement of the contract does not depend on the assets that the entity holds. However, where a contract includes direct participation features or other types of contracts where payments to a policyholder vary depending on returns on underlying items, the measurement of the fulfilment cash flows includes the effect of returns from underlying items on those cash flows.

9.3 Discount rates

The second element of measuring fulfilment cash flows under the general model (discussed in section 9 above) is an adjustment (i.e., a discount) to the estimates of future cash flows to reflect the time value of money and financial risks related to those cash flows (to the extent that they are not included in the cash flow estimates). The adjustment is made by discounting estimated future cash flows. Discount rates must: *[IFRS 17.36]*

- Reflect the time value of money, characteristics of the cash flows and liquidity characteristics of the insurance contract
- Be consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts (e.g., timing, currency and liquidity)
- Exclude the effect of factors that influence such observable market prices, but do not affect the future cash flows of the insurance contracts

The discount rates calculated according to the requirements above must be determined, as follows:
[IFRS 17.B72, IFRS 17.B73]

Insurance liability measurement component	Discount rate for liability
Fulfilment cash flows	Current rate at reporting date
Changes in the fulfilment cash flows for contracts without direct participation features that relate to future service and affect the contractual service margin (including insurance and reinsurance contracts issued and reinsurance contracts held)	Rate at date of initial recognition of group
Contractual service margin interest accretion for contracts without direct participation features (including insurance and reinsurance contracts issued and reinsurance contracts held)	Rate at date of initial recognition of group
Changes in the fulfilment cash flows for contracts with direct participation features that relate to future service and affect the contractual service margin	Current rate at reporting date
Liability for remaining coverage under the premium allocation approach for groups of insurance contracts with a significant financing component	Rate at date of initial recognition of group
Loss component for onerous contracts (see section 9.8 below)	IFRS 17 does not specify. For contracts accounted for under the general model, the entity has an accounting policy choice between current rates and the rate at date of initial recognition of the group. This choice should be applied to all contracts under the general model. For contracts with direct participation features, current rate at the reporting date must be used.
Insurance finance income or expenses	**Discount rate used for profit and loss amount when disaggregating between profit or loss and other comprehensive income**
Insurance finance income or expenses for which disaggregation between profit or loss and other comprehensive income is optional, and for which changes in financial risk do not have a substantial effect on amounts paid to policyholders (see section 15.3.1 below)	Rate at date of initial recognition of group
Insurance finance income or expenses for which disaggregation between profit or loss and other comprehensive income is optional, and for which changes in financial risk assumptions have a significant effect on amounts paid to policyholders (see section 15.3.1 below)	Rate that allocates the remaining revised finance income or expense over the duration of the group at a constant rate ('effective yield approach') or, for contracts that use a crediting rate, uses an allocation based on the amounts credited in the period and expected to be credited in future periods ('projected crediting approach').
Insurance finance income or expenses for which disaggregation between profit or loss and other comprehensive income is optional for incurred claims of groups of contracts applying the premium allocation approach (see section 15.3.3 below)	Rate at date of incurred claim
Insurance finance income or expenses for which disaggregation between profit or loss and other comprehensive income is optional for groups of insurance contracts with direct participation features for which the entity holds the underlying items (see section 15.3.4 below)	Amount that eliminates accounting mismatches with income or expenses on the underlying items, i.e., the net of the two should be nil ('current period book yield approach').

IFRS 17 does not specify requirements for accretion of interest on assets for insurance acquisition cash flows. The Board decided against specifying such requirements because doing so would be inconsistent with IFRS 15. *[IFRS 17.BC184H]*. Consequently, entities have an accounting policy choice as to whether to accrete interest on such assets and the rate to use for such accretion.

For insurance contracts without direct participation features, the Board concluded that changes in the effects of the time value of money and financial risk do not affect the amount of unearned profit. This is the case even if the payments to policyholders vary with returns on underlying items through a participation mechanism. Accordingly, the entity does not adjust the contractual service margin to reflect the effects of changes in these assumptions and hence a discount rate at initial recognition is used. *[IFRS 17.BC228]*.

Discount rates must reflect the rate at initial recognition of the group, considering that contracts may be added to the group after its initial recognition. This can be achieved by applying rates that correspond to the initial recognition date over the period that the contracts in the group are issued, or a weighted average rate that reflects these rates which apply over the period that contracts in the group are issued, which cannot exceed one year. *[IFRS 17.B73]*. As explained in section 7 above, this can result in a change in the discount rates during the period of the contracts as newly recognised contracts are added to the group. When contracts are added to a group in a subsequent reporting period (because the period of the group spans across two reporting periods) and weighted average discount rates are revised, an entity must apply the revised discount rates from the start of the reporting period in which the new contracts are added to the group. *[IFRS 17.28]*. This means that there is no retrospective catch-up adjustment for previous reporting periods (see section 15.4 below).

In some jurisdictions, a liquid risk-free yield curve (or interest rate) might be negative. An entity uses the current market rates even if those are negative and this results in the present value of future payments exceeding, rather than being lower than the value of the undiscounted fulfilment cash flows.

Frequently asked questions

Question 9-11: How to account for the difference that may arise between the current discount rate of each contract when it joins the group and the weighted average discount rates used at initial recognition?

(TRG meeting April 2019 - Agenda paper no. 02, Log S93)

The IASB staff observed that entities which apply the other comprehensive income disaggregation option use the discount rates determined at the date of initial recognition of a group of insurance contracts to determine the amounts recognised in profit or loss using a systematic allocation. An entity is permitted to use weighted average discount rates over the period that contracts in a group are issued to determine the discount rate at the date of initial recognition of a group of contracts. The weighted average discount rate used should achieve the outcome that the amounts recognised in other comprehensive income over the duration of the group of contracts total zero.

Question 9-12: Should an entity use an effective yield rate or a yield curve, specifically, in terms of IFRS 17.B72(e)(i) for a group of insurance contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to policyholders?

(TRG meeting May 2018 - Agenda paper no. 07, Log S29)

IFRS 17 does not state whether the discount rate should be a yield curve or a single discount rate. The IASB staff confirmed that, in applying the discount rate determined at the date of initial recognition to nominal cash flows that do not vary based on returns from underlying items, IFRS 17 does not mandate the use of an effective yield rate or a yield curve. In response to the IASB staff, a few TRG members commented that using an effective yield rate compared to using a yield curve could result in a significant difference to insurance finance income or expense to be included in profit or loss over the reporting periods subsequent to initial recognition.

How we see it

As mentioned above, there is no retrospective catch-up adjustment from the weighted average discount rates at initial recognition for previous reporting periods. As discussed in section 15.4 below, the frequency of an entity's reporting period and the accounting policy choice available under IFRS 17.B137, would determine what is the 'previous reporting period' in this respect. When an entity chooses a Period-To-Date (PTD) approach, the previous reporting period would be the interim reporting period, so no catch-up is applied regarding any previous interim or annual reporting period. Conversely, if an entity chooses a Year-To-Date (YTD) approach, the previous reporting period would be determined by reference to the annual reporting period. Both approaches will however, ultimately result in the same weighted average discount rate at initial recognition.

IFRS 17 requires that the discount rates applied reflect the characteristics of the liability. One such relevant characteristic is timing and duration of the cash flows, which would be particularly prominent for long-term liabilities. Typically, the characteristics of timing and duration may be reflected through the use of a yield curve. Possible practical considerations of this might be:

- Whether a different method could be applied to some types of (cash flows of) participating contracts.
- Whether an entity could use an approach to convert a curve into a single rate as a practical simplification for some types of products. However, this requires careful consideration as an entity would still have to substantiate in every reporting period, whether the IFRS 17 discount rate principles are satisfied. As such, there will be a number of challenges to such an approach.
- Whether to use a flat rate for short-term liabilities as for such liabilities, the impact of the timing may not be significant. However, it would be a practical expedient that requires a definition of 'short' for these purposes. In addition, materiality aspects may have to be considered.

Discount rates used for regulatory purposes may be a starting point to determine the discount rate curve (or components of that curve) for use under IFRS 17. However, an entity would have to decide if, or to what extent, such an estimate would be consistent with the requirements in IFRS 17 and make any adjustments necessary. In going through this process, entities should be aware of the reference in IFRS 17 to the requirements in IFRS 13 on the consideration of observable market prices and the use of estimation techniques.

9.3.1 Discount rates consistent with characteristics of cash flows

Estimates of discount rates must be consistent with other estimates used to measure insurance contracts to avoid double counting or omissions; for example: *[IFRS 17.B74]*

- Cash flows that do not vary based on the returns on any underlying items must be discounted at rates that do not reflect any such variability
- Cash flows that vary based on the returns on any financial underlying items must be:
  - Discounted using rates that reflect that variability

    Or
  - Adjusted for the effect of that variability and discounted at a rate that reflects the adjustment made
- Nominal cash flows (i.e., those that include the effect of inflation) must be discounted at rates that include the effect of inflation
- Real cash flows (i.e., those that exclude the effect of inflation) must be discounted at rates that exclude the effect of inflation

However, discount rates must not reflect the non-performance (i.e., own credit) risk of the entity. *[IFRS 17.31]*. The requirement for discount rates to be consistent with the characteristics of the cash flows of insurance contracts is from the perspective of the entity. IFRS 17 requires an entity to disregard its own credit risk when measuring the fulfilment cash flows. *[IFRS 17.31, IFRS 17.BC197]*.

Cash flows that vary based on the returns on underlying items must be discounted using rates that reflect that variability, or adjusted for the effect of that variability and discounted at a rate that reflects the adjustment made. The variability is a relevant factor regardless of whether it arises because of contractual terms or because the entity exercises discretion, and regardless of whether the entity holds the underlying items. *[IFRS 17.B75]*.

Cash flows that vary with returns on underlying items with variable returns, but that are subject to a guarantee of a minimum return, do not vary solely based on the returns on the underlying items, even when the guaranteed amount is lower than the expected return on the underlying items. Hence, an entity must adjust the rate that reflects the variability of the returns on the underlying items for the effect of the guarantee, even when the guaranteed amount is lower than the expected return on the underlying items. *[IFRS 17.B76]*.

IFRS 17 does not require an entity to divide estimated cash flows into those that vary based on the returns on underlying items and those that do not. If an entity does not divide the estimated cash flows in this way, the entity must apply discount rates appropriate for the estimated cash flows as a whole, e.g., using stochastic modelling techniques or risk-neutral measurement techniques. *[IFRS 17.B77]*.

For cash flows of insurance contracts that do not vary based on the returns on underlying items, the discount rate reflects the yield curve in the appropriate currency for instruments that expose the holder to no or negligible credit risk, adjusted to reflect the liquidity characteristics of the group of insurance contracts. That adjustment must reflect the difference between the liquidity characteristics of the group of insurance contracts and the liquidity characteristics of the assets used to determine the yield curve. Yield curves reflect assets traded in active markets that the holder can typically sell readily at any time without incurring significant costs. In contrast, under some insurance contracts the entity cannot be forced to make payments earlier than the occurrence of insured events, or dates specified in the contracts. *[IFRS 17.B79]*.

Frequently asked questions

Question 9-13: Should the liability for any minimum interest rate guarantees made to policyholders be measured through adjusting the discount rate (rather than through adjustments to the cash flows)?

(TRG meeting May 2018 - Agenda paper no. 07, Log S38)

The IASB staff stated that although IFRS 17 requires the time value of a guarantee to be reflected in the measurement of fulfilment cash flows, it does not require the use of a specific approach to achieve this objective. Financial risk is included in the estimates of future cash flows or in the discount rate used to adjust the cash flows. Judgement is required to determine the technique for measuring market variables and the technique must result in the measurement of any options and guarantees being consistent with observable market prices. Any consideration beyond this is actuarial (i.e., operational measurement implementation) in nature. The TRG members did not disagree with the IASB staff's observations.

How we see it

IFRS 17 does not require an entity to divide estimated cash flows into those that vary based on the returns on underlying items and those that do not. By not dividing the cash flows, an entity avoids the complexity of having to disentangle cash flows that may be interrelated. However, if an entity does not divide the estimated cash flows in this way, it should apply discount rates for the estimated cash flows as a whole in a way that is consistent with the principles of the standard; for example, using stochastic modelling or risk-neutral measurement techniques. Both approaches, dividing or not dividing cash flows, have their own conceptual and practical implications, so entities should carefully assess what methods will be most suited to their particular circumstances.

Entities should be aware that, even for participating contracts, at least some of the cash flows to policyholders are independent of returns on underlying items; for example, payments for fixed death benefit or expenses of the entity that do not vary with the underlying items.

9.3.2 Current discount rates consistent with observable market prices

Discount rates must include only relevant factors, i.e., factors that arise from the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts. Such discount rates may not be directly observable in the market. Hence, when observable market rates for an instrument with the same characteristics are not available, or observable market rates for similar instruments are available but do not separately identify the factors that distinguish the instrument from the insurance contracts, an entity must estimate the appropriate rates. IFRS 17 does not require a particular estimation technique for determining discount rates. In applying an estimation technique, an entity must: *[IFRS 17.B78]*

- Maximise the use of observable inputs and reflect all reasonable and supportable information on non-market variables available without undue cost or effort, both external and internal. In particular, the discount rates used must not contradict any available and relevant market data, and any non-market variables used must not contradict observable market variables.
- Reflect current market conditions from the perspective of a market participant
- Exercise judgement to assess the degree of similarity between the features of the insurance contracts being measured and the features of the instrument for which observable market prices are available and adjust those prices to reflect the differences between them

How we see it

It is unlikely that there will be an observable market price for a financial instrument with the same characteristics as an insurance contract in terms of the timing and nature of the estimated cash flows. An entity will need to exercise judgement to assess the degree of similarity between the features of the insurance contracts measured and those of the instruments for which observable market prices are available and adjust those prices to reflect the differences. This will require establishing a robust estimation process for discount rates, including related controls for determining the inputs to discount rates based on the conditions at the reporting date.

Some insurance contracts will have a contract boundary which extends beyond the period for which observable market data is available. In these situations, the entity will have to determine an extrapolation of the discount rate yield curve beyond that period. IFRS 17 provides no specific guidance on estimation techniques to extrapolate the discount rate curve. In practice, multiple techniques exist. IFRS 17 indicates that applying an appropriate estimation technique requires judgement, weighing the principle to use the best information available and adjusting for information about market participant assumptions that is reasonably available. In these situations, the entity will have to extrapolate the discount rate yield curve beyond the observable period, taking care to consider the reference in IFRS 17 to the fair value methodology included in IFRS 13.

9.3.3 'Bottom-up' or 'top-down' approach

IFRS 17 proposes two basic methods for determining discount rates for cash flows of insurance contracts that do not vary based on the returns on underlying items, as follows:

A 'bottom-up' approach

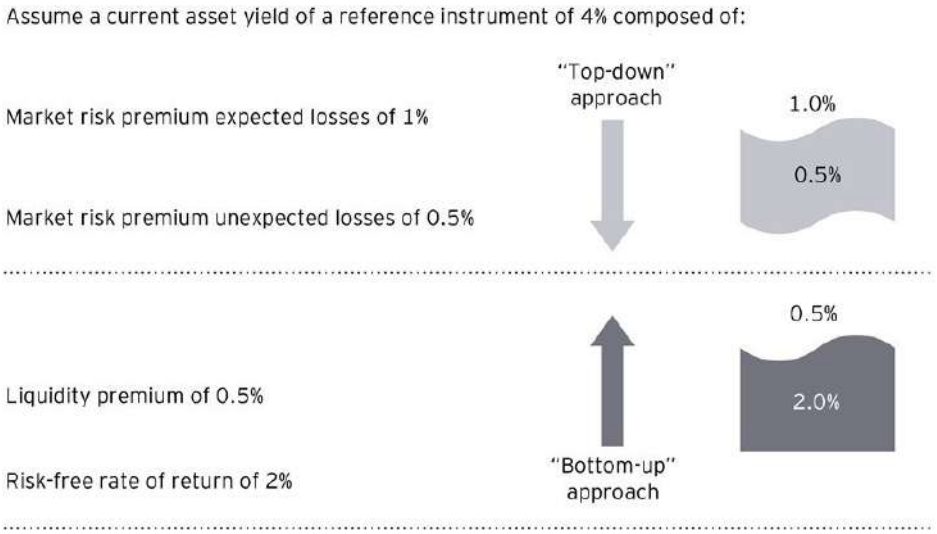
The 'bottom-up' approach determines discount rates by adjusting a liquid risk-free yield curve to reflect the differences between the liquidity characteristics of the financial instruments that underlie the rates observed in the market and the liquidity characteristics of the insurance contracts. *[IFRS 17.B80]*.

A 'top-down' approach

The 'top-down' approach determines the appropriate discount rates for insurance contracts based on a yield curve that reflects the current market rates of return implicit in a fair value measurement of a reference portfolio of assets. An entity must adjust that yield curve to eliminate any factors that are not relevant to the insurance contracts, but is not required to adjust the yield curve for differences in liquidity characteristics of the insurance contracts and the reference portfolio. *[IFRS 17.B81]*.

In theory, when considering all required adjustments, both the 'top-down' and 'bottom-up' approaches should give the same result although in practice this is not necessarily the case.

An example of the approaches giving the same result is illustrated below, where the overall liability discount rate is 2.5% in each case. The example assumes that there are no differences between the liquidity characteristics of the liability and the reference portfolio of assets. The 'top down' approach starts with a current asset yielding 4% and this rate is reduced by 1.5% for expected and unexpected losses while the 'bottom up' approach starts with a risk-free rate of 2% which is increased by a liquidity premium of 0.5%.



In estimating the yield curve on a 'top down' basis, an entity uses measurement bases consistent with IFRS 13, as follows: *[IFRS 17.B82]*

- If there are observable market prices in active markets for assets in the reference portfolio, an entity must use those prices
- If a market is not active, an entity must adjust observable market prices for similar assets to make them comparable to market prices for the assets being measured
- If there is no market for assets in the reference portfolio, an entity must apply an estimation technique. For such assets an entity must:
  - Develop unobservable inputs using the best information available in the circumstances. Such inputs might include the entity's own data and, in the context of IFRS 17, the entity might place more weight on long-term estimates than on short-term fluctuations

    And
  - Adjust the data to reflect all information about market participant assumptions that is reasonably available

In adjusting the yield curve, an entity must adjust market rates observed in recent transactions in instruments with similar characteristics for movements in market factors since the transaction date, and must adjust observed market rates to reflect the degree of dissimilarity between the instrument being measured and the instrument for which transaction prices are observable. For cash flows of insurance contracts that do not vary based on the returns on the assets in the reference portfolio, such adjustments include: *[IFRS 17.B83]*

- Adjusting for differences between the amount, timing and uncertainty of the cash flows of the assets in the portfolio and the amount, timing and uncertainty of the cash flows of the insurance contracts

  And
- Excluding market risk premiums for credit risk, which are relevant only to the assets included in the reference portfolio

In principle, for cash flows of insurance contracts that do not vary based on the returns of the assets in the reference portfolio, there must be a single illiquid risk-free yield curve that eliminates all uncertainty about the amount and timing of cash flows. However, in practice, the top-down approach and the bottom-up approach may result in different yield curves, even in the same currency. This is because of the inherent limitations in estimating the adjustments made under each approach, and the possible lack of an adjustment for different liquidity characteristics in the top-down approach. An entity is not required to reconcile the discount rate determined under its chosen approach with the discount rate that would have been determined under the other approach. *[IFRS 17.B84]*.

No restrictions are specified on the reference portfolio of assets used in the top-down approach. However, fewer adjustments would be required to eliminate factors that are not relevant to the insurance contracts when the reference portfolio of assets has similar characteristics. For example, if the cash flows from the insurance contracts do not vary based on the returns on underlying items, fewer adjustments would be required if an entity used debt instruments as a starting point rather than equity instruments. For debt instruments, the objective would be to eliminate from the total bond yield the effect of credit risk and other factors that are not relevant to the insurance contracts. One way to estimate the effect of credit risk is to use the market price of a credit derivative as a reference point. *[IFRS 17.B85]*.

When the Board considered feedback from entities implementing IFRS 17 as part of the June 2020 amendments, it also considered feedback from users of financial statements that the principle-based requirements for determining discount rates could limit comparability between entities. The Board made no amendments to IFRS 17 in response to that feedback. In the Board's view, requiring an entity to determine discount rates using a rules-based approach would result in outcomes that are appropriate only in some circumstances. IFRS 17 requires entities to apply judgement when determining the inputs most applicable in the circumstances. To enable users of financial statements to understand the discount rates used, and to facilitate comparability between entities, IFRS 17 requires entities to disclose information about the methods used and judgements applied. *[IFRS 17.BC205A, IFRS 17.BC205B]*.

Frequently asked questions

Question 9-14: When using a top-down approach to determine discount rates, should the reference portfolio of assets reflect the liquidity characteristics of the insurance contracts? If using an own portfolio of assets as the reference portfolio, should the effect of purchasing and selling assets during the reporting period be reflected in the discount rates used for insurance contracts?

(TRG meeting September 2018 - Agenda paper no. 02, Log S65, S72)

The TRG members discussed an IASB staff paper which responded to a submission that asked whether, in applying a top-down approach to determine the discount rates for insurance contracts with cash flows that do not vary based on the returns of underlying items:

- An entity could use the assets it holds as a reference portfolio of assets
- An entity could ignore the liquidity characteristics of insurance contracts
- Changes in the assets the entity holds could result in changes in the discount rates used to measure insurance contracts under specific circumstances

The TRG members agreed with the IASB staff analysis and conclusion in this paper that an entity can use the assets it holds as a reference portfolio when determining a top-down discount rate to measure its insurance liabilities. The TRG members observed that:

- IFRS 17 does not specify restrictions on the reference portfolio of assets used in applying a top-down approach to determine discount rates and also does not define 'a reference portfolio of assets'. Consequently, a portfolio of assets an entity holds can be used as a reference portfolio to determine the discount rates provided that the discount rates achieve the objectives of reflecting the characteristics of the insurance contracts and are consistent with observable current market prices.
- IFRS 17 requires that discount rates reflect, among other factors, the liquidity characteristics of the insurance contracts. However, when using the top-down approach, as a simplification, IFRS 17 permits an entity not to adjust the yield curve derived from a reference portfolio of assets for differences between the liquidity characteristics of the insurance contracts and those of the reference portfolio. The IASB expected a reference portfolio of assets typically to have liquidity characteristics that more closely match the liquidity characteristics of a group of insurance contracts than would be the case for highly-liquid, high-quality bonds.
- In determining the appropriate discount rates for cash flows that do not vary based on underlying items, an entity ensures that at each reporting date, those discount rates reflect the characteristics of the insurance contracts, even when the entity chooses to use a portfolio of assets that it holds to determine the discount rates.
- An entity needs to make adjustments to the yield curve of the reference portfolio of assets at each reporting date to eliminate any effect on discount rates of credit risk and differences in liquidity characteristics of the insurance contracts and the reference portfolio. However, if the entity uses the simplification and does not make any adjustments to the reference portfolio curve to reflect differences in liquidity characteristics between the reference portfolio and the insurance contracts, then fluctuations in the liquidity of the reference portfolio will be mirrored in changes in discount rates used to measure the group of insurance contracts.
- The TRG members also observed that, when an entity uses the simplification related to liquidity (i.e., the top-down approach discussed above), small changes in discount rates that result from changes in the composition of the reference portfolio could result in significant changes to the insurance contract liabilities measured using those rates, particularly with respect to long-term insurance contracts.

Both the IASB staff and the TRG members note that IFRS 17 contains disclosure requirements for qualitative and quantitative information about the significant judgements and changes in those

judgements (see section 16.3 below) and consider that, if the effect of illiquidity were to be significant, entities would be expected to disclose such information in their financial statements.

Question 9-15: Would it be appropriate, if applying the top-down discount rate approach, to determine discount rates at initial recognition of each group using a target asset mix that the entity plans to invest in for that group as the reference portfolio of assets, and subsequently, using the actual asset mix covering all underwriting years as the reference portfolio of assets?

(TRG meeting April 2019 - Agenda paper no. 02, Log S91)

The IASB staff observed that identifying a reference portfolio that will enable an entity to meet the objectives required for setting a discount rate is dependent on specific facts and circumstances and providing specific application guidance is not within the remit of the TRG.

How we see it

In the bottom-up approach, entities will need to determine an appropriate method to adjust the observable market information in a way that reflects the difference in liquidity characteristics of the insurance contracts compared to those of the observable instrument. The liquidity characteristics will depend on the specific nature of a contract. For example, annuities in payment are generally viewed as very illiquid as they cannot be surrendered and only expire on the annuitant's death. Different methods to estimate an illiquidity premium may be available in practice.

9.4 Risk adjustment for non-financial risk

The third element of measuring fulfilment cash flows in the general model (see section 9 above) is a risk adjustment for non-financial risk.

The risk adjustment for non-financial risk is the compensation that the entity requires for bearing the uncertainty about the amount and timing of cash flows that arise from non-financial risk. *[IFRS 17.37]*. Non-financial risk is risk arising from insurance contracts other than financial risk, which is included in the estimates of future cash flows or the discount rate used to adjust the cash flows. The risks covered by the risk adjustment for non-financial risk are insurance risk and other non-financial risks such as lapse risk and expense risk. *[IFRS 17.B86]*.

In theory, the risk adjustment for non-financial risk for insurance contracts measures the compensation that the entity would require to make it indifferent between: *[IFRS 17.B87]*

- Fulfilling a liability that has a range of possible outcomes arising from non-financial risk

  And

- Fulfilling a liability that will generate fixed cash flows with the same expected present value as the insurance contracts

In developing the objective of the risk adjustment for non-financial risk, the Board concluded that a risk adjustment for non-financial risk must not represent: *[IFRS 17.BC209]*

- The compensation that a market participant would require for bearing the non-financial risk that is associated with the contract. This is because the measurement model is not intended to measure the current exit value or fair value, which reflects the transfer of the liability to a market participant. Consequently, the risk adjustment for non-financial risk must be determined as the amount of compensation that the entity, not a market participant, would require.
- An amount that would provide a high degree of certainty that the entity would be able to fulfil the contract. Although such an amount might be appropriate for some regulatory purposes, it is not compatible with the Board's objective of providing information that will help users of financial statements make decisions about providing resources to the entity.

The risk adjustment for non-financial risk reflects the entity's perception of the economic burden of its non-financial risks; it is not a current exit value or fair value, which reflects the transfer to a market participant. *[IFRS 17.BC209]*. Therefore, the risk adjustment for non-financial risk reflects the compensation the entity would require for bearing the non-financial risk arising from the uncertain amount and timing of the cash flows, the risk adjustment for non-financial risk also reflects: *[IFRS 17.B88]*

- The degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk
- Both favourable and unfavourable outcomes, in a way that reflects the entity's degree of risk aversion

The purpose of the risk adjustment for non-financial risk is to measure the effect of uncertainty in the cash flows that arise from insurance contracts, other than uncertainty arising from financial risk. Consequently, the risk adjustment for non-financial risk must reflect all non-financial risks associated with the insurance contracts. It must not reflect the risks that do not arise from the insurance contracts, such as general operational risk. *[IFRS 17.B89]*.

The risk adjustment for non-financial risk must be included in the measurement in an explicit way. The risk adjustment for non-financial risk is conceptually separate from the estimates of future cash flows and the discount rates that adjust those cash flows. The entity must not double-count the risk adjustment for non-financial risk by, for example, also including the risk adjustment for non-financial risk implicitly when determining the estimates of future cash flows or the discount rates. The yield curve (or range of yield curves) used to discount cash flows that do not vary based on the returns on underlying items which are required to be disclosed (see section 16.3 below) must not include any implicit adjustments for non-financial risk. *[IFRS 17.B90]*.

Frequently asked questions

Question 9-16: Does the risk adjustment for non-financial risk take into account uncertainty related to how management will apply discretion?

(TRG meeting April 2019 - Agenda paper no. 02, Log S110)

The IASB staff observed that the risk adjustment for non-financial risk does not reflect risks that do not arise from insurance contracts such as general operational risk. Paragraphs B98 and B99 of IFRS 17 distinguish between a change in the discretionary cash flows, that is regarded as relating to future service, and changes in assumptions that relate to financial risk on an entity's commitment. Therefore, uncertainty related to how management applies discretion for a group of insurance contracts, if not considered a general operational risk, should be captured in the risk adjustment for non-financial risk (e.g., to the extent management discretion reduces the amount it would charge for uncertainty, the discretion would reduce the risk adjustment for non-financial risk). The risk adjustment for non-financial risk should reflect both favourable and unfavourable outcomes in a way that reflects the entity's degree of risk aversion.

Illustration 9-5: Risk adjustment for non-financial risk

Compensation an entity requires to be indifferent between fixed and variable outcomes

The risk adjustment for non-financial risk would measure the compensation the entity would require to make it indifferent between fulfilling a liability that, because of non-financial risk, has a 50% probability of being CU90 and a 50% probability of being CU110, and fulfilling a liability that is fixed at CU100. As a result, the risk adjustment for non-financial risk conveys information to users of financial statements about the amount charged by the entity for the uncertainty arising from non-financial risk about the amount and timing of cash flows. *[IFRS 17.B87]*.

9.4.1 Techniques used to estimate the risk adjustment for non-financial risk

IFRS 17 does not specify the estimation technique(s) used to determine the risk adjustment for non-financial risk. This is because the Board decided that a principle-based approach, rather than identifying specific techniques, would be consistent with its approach on how to determine a similar risk adjustment for non-financial risk in IFRS 13. Furthermore, the Board concluded that limiting the number of risk-adjustment techniques would conflict with its desire to set principles-based IFRS accounting standards and, given that the objective of the risk adjustment is to reflect an entity-specific perception of non-financial risk, specifying a level of aggregation that was inconsistent with the entity's view would also conflict with that requirement. *[IFRS 17.BC213]*.

Therefore, the risk adjustment under IFRS 17 must be determined based on the principle of the compensation that the entity requires for bearing the uncertainty arising from non-financial risk inherent in the cash flows that arise as the entity fulfils the group of insurance contracts. According to this principle, the risk adjustment for non-financial risk reflects any diversification benefit the entity considers when determining the amount of compensation that it requires for bearing that uncertainty. *[IFRS 17.BC214]*.

IFRS 17 states that risk adjustment for non-financial risk has the following characteristics: *[IFRS 17.B91]*

- Risks with low frequency and high severity will result in higher risk adjustments for non-financial risk than risks with high frequency and low severity

- For similar risks, contracts with a longer duration will result in higher risk adjustments for non-financial risk than contracts with a shorter duration
- Risks with a wider probability distribution will result in higher risk adjustments for non-financial risk than risks with a narrower distribution
- The less that is known about the current estimate and its trend, the higher the risk adjustment will be for non-financial risk
- To the extent that emerging experience reduces uncertainty about the amount and timing of cash flows, risk adjustments for non-financial risk will decrease and *vice versa*

Extract from IFRS 17

B92 An entity shall apply judgement when determining an appropriate estimation technique for the risk adjustment for non-financial risk. When applying that judgement, an entity shall also consider whether the technique provides concise and informative disclosure so that users of financial statements can benchmark the entity's performance against the performance of other entities. Paragraph 119 requires an entity that uses a technique other than the confidence level technique for determining the risk adjustment for non-financial risk to disclose the technique used and the confidence level corresponding to the results of that technique.

[IFRS 17.B92].

It is likely that some entities will want to apply a cost of capital approach technique to estimate the risk adjustment for non-financial risk because this will be the basis of local regulatory capital requirements. It is observed in the Basis for Conclusions that although the usefulness of a confidence level technique diminishes when the probability distribution is not statistically normal, as is often the case for insurance contracts, the cost of capital approach would be more complicated to calculate than a confidence level disclosure. However, the Board expects that many entities will have the information necessary to apply the cost of capital technique. *[IFRS 17.BC217]*. This implies that the Board is anticipating that some, or perhaps many, entities will use a cost of capital technique to measure the risk adjustment for non-financial risk.

When the Board considered feedback from entities implementing IFRS 17, it also considered feedback from users of financial statements that the principles-based requirements for determining the risk adjustment for non-financial risk could limit comparability between entities. The Board made no amendments to IFRS 17 in response to that feedback, for the same reason it made no amendments in response to similar feedback on discount rates (see section 9.3 above). *[IFRS 17.BC214A]*.

How we see it

IFRS 17 does not prescribe particular techniques for estimating the risk adjustment of a group of contracts. The standard incorporates guidance with the aim of aiding entities in selecting an appropriate method. Selecting an appropriate technique will be a matter of judgement. In making this judgement, the entity should consider the specific risk characteristics of the group of insurance contracts under consideration.

Changes in the risk adjustment will reflect several factors, for example: release from risk as time passes, changes in an entity's risk appetite (the amount of compensation it requires for bearing uncertainty), changes in expected variability in future cash flows, and diversification between risks. Entities will need to distinguish between changes in the risk adjustment relating to current and past service (reflected immediately in profit or loss) and those relating to future service (which adjust the contractual service margin - see section 9.5 below).

Different entities may determine different risk adjustments for similar groups of insurance contracts because the risk adjustment for non-financial risk is an entity specific perception, rather than a market participant's perception, based on the compensation that a particular entity requires for bearing the uncertainty about the amount and timing of the cash flows that arise from non-financial risks. Accordingly, to allow users of financial statements to understand how entity-specific assessments of risk aversion might differ from entity to entity, disclosure is required of the confidence level used to determine the risk adjustment for non-financial risk or, if a technique other than confidence level is used, the technique used and the confidence level corresponding to the technique (see section 16.3 below).

Frequently asked questions

Question 9-17: Which level is the risk adjustment for non-financial risk required to be determined: in (a) the individual financial statements of entities that are part of a consolidated group (i.e., parent and subsidiary entities that issue insurance contracts), and (b) the consolidated financial statements of the group of entities?

(TRG meeting May 2018 - Agenda paper no. 02, Log S46)

IFRS 17 does not specify the level within an insurance group at which to determine the risk adjustment for non-financial risk. Therefore, the question arises as to whether, in the individual financial statements of a subsidiary, the risk adjustment for non-financial risk should reflect the degree of risk diversification available to the entity or to the consolidated group as a whole and whether, in the consolidated financial statements of a group of entities, the risk adjustment for non-financial risk issued by entities in the group should reflect the degree of risk diversification available only to the consolidated group as a whole. This issue was discussed by the TRG and the results of the discussion were as follows:

- In respect of individual financial statements, the degree of risk diversification that occurs at a level higher than the issuing entity level is required to be considered if, and only if, it is considered when determining the compensation the issuing entity would require for bearing non-financial risk related to the insurance contracts it issues. Equally, risk diversification that occurs at a level higher than the issuing entity level must not be considered when determining the risk adjustment for non-financial risk if it is not considered when determining the compensation the issuing entity would require for bearing non-financial risk related to the insurance contracts it issues.
- In respect of consolidated financial statements, the IASB staff opinion is that the risk adjustment for non-financial risk should be the same as the risk adjustment for non-financial risk at the individual entity level because determining the compensation that the entity would require for bearing non-financial risk related to insurance contracts issued by the entity is a single decision that is made by the entity that is party to the contract (i.e., the issuer of the insurance contract). However, differing views were expressed by TRG members. Some TRG members agreed with the IASB staff but other TRG members read the requirements as requiring different measurement of the risk adjustment for non-financial risk for a group of insurance contracts at different reporting levels if the issuing entity would require different compensation for bearing non-financial risk than the consolidated group would require. The TRG members also observed that, in some cases, the compensation an entity requires for bearing non-financial risk could be evidenced by capital allocation in a group of entities.

Subsequently, the Board considered whether it should clarify its intention in respect of determining the risk adjustment for non-financial risk in the consolidated financial statements of a group of entities in response to those different views. The Board concluded that doing so would address only some differences that could arise in the application of the requirements for determining the risk adjustment for non-financial risk, given the high degree of judgement required to apply those requirements. The Board concluded that practice needs to develop in this area. If necessary, the Board will seek to understand how the requirements are being applied as part of the Post-implementation Review of IFRS 17. *[IFRS 17.BC214C]*.

Question 9-18: For insurance contracts issued by an industry pool, should the risk adjustment for non-financial risk be determined at the association (pool) level or at the individual member entity level and could the risk adjustment for non-financial risk be measured differently in the financial statements of the members when compared to the financial statements of the pool?

(TRG meeting September 2018 - Agenda paper no. 09, Log S52)

In the fact pattern an association manages two industry pools:

- Pool 1 - in which some members are appointed to issue contracts on behalf of all members
- Pool 2 - to which members can choose to transfer some insurance contracts they have issued

The IASB staff considered that there should be only one risk adjustment for each insurance contract and that the risk adjustment is either at an individual member level or at an association level, depending on who has issued the contract. Consistent with the discussion in Question 9-17 above, some TRG members disagreed with the IASB staff's view that there is one single risk adjustment for a group of insurance contracts that reflects the degree of diversification that the issuer of the contract considers in determining the compensation required for bearing non-financial risk. Those TRG members expressed the view that each entity would consider the compensation it would require for non-financial risk, rather than the compensation required by the association. This would mean that the risk adjustment would not necessarily be determined by the entity that issued the contract (e.g., the pool or individual member of

the association that priced the risk). As noted above, the IASB did not amend or clarify IFRS 17 on this matter.

Question 9-19: Should the effect of reinsurance held be considered in calculating the risk adjustment for non-financial risk for contracts that have been reinsured?

(TRG meeting April 2019 - Agenda paper no. 02, Log S118)

The IASB staff observed that the risk adjustment for non-financial risk reflects the degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk. Therefore, if an entity considers reinsurance when determining the compensation it requires for bearing non-financial risk related to underlying insurance contracts, the effect of reinsurance (both cost and benefit) would be reflected in the risk adjustment for non-financial risk of the underlying insurance contracts.

The IASB staff further observed that IFRS 17 requires that the risk adjustment for non-financial risk for reinsurance contracts held represents the amount of risk being transferred by the holder of the group of reinsurance contracts to the issuer of those contracts. Therefore, the risk adjustment for non-financial risk of the reinsurance contract held could not be nil, unless:

- The entity considers reinsurance when determining the compensation it requires for bearing non-financial risk related to underlying insurance contracts

  And

- The cost of acquiring the reinsurance is equal or less than the expected recoveries

The TRG members agreed with the IASB staff observations that if an entity considers reinsurance when determining the compensation it requires for non-financial risk, the effect of the reinsurance would be included in the risk adjustment and that the measurement of the risk adjustment for non-financial risk of a reinsurance contract held is the amount of risk transferred to the reinsurer.

How we see it

The risk adjustment reflects diversification benefits the entity considers when determining the amount of compensation it requires for bearing that uncertainty. This approach implies that diversification benefits could reflect effects across groups of contracts, or diversification benefits at an even higher level of aggregation. However, when determining the risk adjustment at a level more aggregated than a group of contracts, an entity must establish an appropriate method for allocating the risk adjustment to the underlying groups. This will form part of the requirements for systems and processes that an entity will need to develop when implementing the standard.

In addition, since IFRS 17 does not specify the level of aggregation at which to determine the risk adjustment for non-financial risk, the question arises as to whether the risk adjustment for non-financial risk could be negative for a group of insurance contracts. This situation could, in theory, arise where a diversification benefit is allocated between two or more groups of insurance contracts and the additional diversification risk for one group may be negative as the insurer would accept a lower price for taking on these liabilities given that it reduces the risk for the entity in total. IFRS 17 is silent as to whether a risk adjustment could be negative. However, a negative risk adjustment would normally be inappropriate as it would not reflect the purpose of the risk adjustment for non-financial risk which is to measure the effect of uncertainty in the cash flows (see section 9.4 above). So, for example, a risk adjustment should not reduce fulfilment cash flows below the best estimate of the expected future cash flows.

9.4.2 Presentation of the risk adjustment for non-financial risk in the statement of comprehensive income

The change in risk adjustment for non-financial risk is not required to be disaggregated between the insurance service result and the insurance finance income or expenses. When an entity decides not to disaggregate the change in the risk adjustment for non-financial risk, the entire change must be included as part of the insurance service result. Changes in the risk adjustment for non-financial risk that relate to future service adjust the contractual service margin. *[IFRS 17.81, IFRS 17.B96(d), IFRS 17.B97(a)(ii)]*.

When the risk adjustment for non-financial risk is disaggregated between profit or loss and other comprehensive income, the method of disaggregation is determined by the disaggregation policy applied to that portfolio (see section 15.3.1 below). If disaggregation is applied, any adjustments to the contractual service margin are determined using the rate at initial recognition.

9.5 Contractual service margin

The fourth element of the building blocks in the general model (see section 9 above) is the contractual service margin. The contractual service margin is a new concept to IFRS accounting standards, introduced in IFRS 17 to identify the expected profitability of a group of contracts and recognise this profitability over time in an explicit manner, based on the pattern of services provided under the contract.

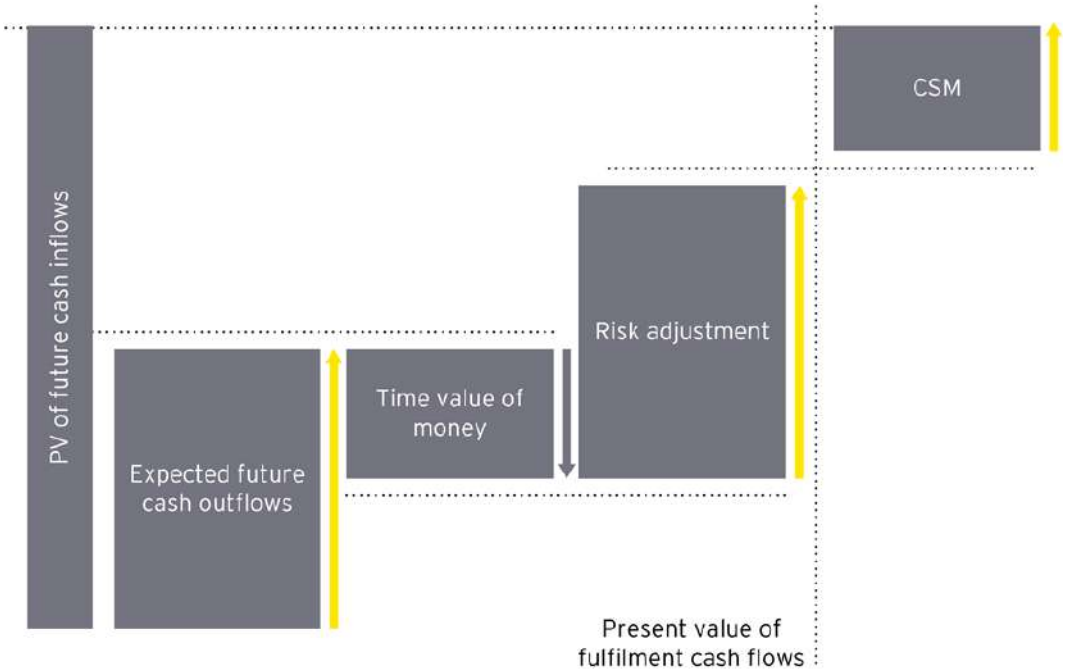
The contractual service margin is a component of the asset or liability for the group of insurance contracts that represents the unearned profit the entity will recognise as it provides insurance contract services in the future. Hence, the contractual service margin would usually be calculated at the level of a group of insurance contracts rather than at an individual insurance contract level.

9.5.1 Initial recognition

An entity must measure the contractual service margin on initial recognition of a group of insurance contracts at an amount that, unless the group of contracts is onerous (see section 9.8 below) or where there is insurance revenue and expenses recognised from the derecognition of an asset for other cash flows (see section 15.2.1.A below), results in no income or expenses arising from: *[IFRS 17.38]*

- Initial recognition of an amount for the fulfilment cash flows (see section 9.2 above)
- Any cash flows arising from the contracts in the group at that date
- The derecognition at the date of initial recognition of:
  - Any asset recognised for insurance acquisition cash flows (see section 7.3 above)

    And
  - Any other asset or liability previously recognised for cash flows related to the group of contracts



The approach above on initial recognition applies to contracts with and without participation features, including investment contracts with discretionary participation features. A contractual margin is not specifically identified for contracts subject to the premium allocation approach although the same principle of profit recognition applies (i.e., no day 1 gain and recognition over the coverage period as insurance contract services are provided) (see section 10 below).

For groups of reinsurance contracts held, the calculation of the contractual service margin at initial recognition is modified to take into account the fact such groups are usually assets rather than liabilities and that a margin payable to the reinsurer, rather than making profits, is an implicit part of the premium (see section 11 below).

For insurance contracts acquired in a transfer of insurance contracts or in a business combination within the scope of IFRS 3, an entity must apply the above in accordance with the requirements for acquisitions of insurance contracts. *[IFRS 17.39]*. The contractual service margin at initial recognition is calculated as the difference between the consideration and the fulfilment cash flows at the date of the acquisition (see section 14 below).

Before the recognition of a group of insurance contracts, an entity might be required to recognise an asset or liability for cash flows related to the group of insurance contracts other than insurance acquisition cash flows either because of the occurrence of the cash flows or because of the requirements of another IFRS accounting standard. Cash flows are related to the group of insurance contracts if those cash flows would have been included in the fulfilment cash flows at the date of initial recognition of the group had they been paid or received after that date. To apply the requirement in the last bullet point above, an entity must derecognise such an asset or liability to the extent that the asset or liability would not be recognised separately from the group of insurance contracts if the cash flow or the application of the IFRS accounting standard occurred at the date of initial recognition of the group of insurance contracts. *[IFRS 17.B66A]*. For example, an entity that recognised a liability for premiums received in advance of the recognition of a group of insurance contracts would derecognise that liability when the entity recognises a group of insurance contracts to the extent the premiums relate to the contracts in the group. The performance obligation that was depicted by the liability would not be recognised separately from the group of insurance contracts had the premium been received on the date of initial recognition of the group. No insurance revenue arises on the derecognition of the liability.

How we see it

As a result of the measurement requirements, the contractual service margin on initial recognition is the balancing number needed to avoid a day 1 profit. The contractual service margin cannot depict unearned losses. Instead, IFRS 17 requires an entity to recognise a loss in profit or loss for onerous groups of contracts (see section 9.8 below).

Contracts accounted for under IFRS 17 will be the only type of contracts under IFRS accounting standards that will explicitly disclose the expected remaining profitability. The notion of the contractual service margin is a unique feature of the standard. The way users will evaluate and appreciate the contractual service margin is expected to be a key aspect of the decision-usefulness of the IFRS 17 accounting model.

9.6 Subsequent measurement

The carrying amount of a group of insurance contracts at the end of each reporting period must be the sum of: *[IFRS 17.40]*

- The liability for remaining coverage comprising:
  - The fulfilment cash flows related to future service allocated to the group at that date, measured applying the requirements discussed in section 9.2 above - see section 9.6.1 below
  - The contractual service margin of the group at that date, measured applying the requirements discussed in section 9.6.3 below
- The liability for incurred claims, comprising the fulfilment cash flows related to past service allocated to the group at that date, measured applying the requirements discussed in section 9.2 above - see section 9.6.2 below

Hence, after initial recognition, the fulfilment cash flows comprise two components:

- Those relating to future service (the liability for remaining coverage)
- Those relating to past service (the liability for incurred claims)

Frequently asked questions

Question 9-20: Should an entity's obligation to pay amounts subject to insurance risk after an incurred claim be treated as a liability for remaining coverage or a liability for incurred claims?

(TRG meeting September 2018 - Agenda paper no. 01, Log S63)

In some circumstances an incurred claim can create insurance risk for an entity that would not exist if no claim was made. Two examples cited of this situation are:

- Insurance coverage for disability that provides an annuity for the period when a policyholder is disabled
- Insurance coverage for fire that provides compensation for the cost of rebuilding a house after a fire

The question, therefore, arises whether the entity's obligation to pay these amounts, that are subject to insurance risk, should be treated as a liability for incurred claims or a liability for remaining coverage.

One view is that the insured event is the uncertain event that the policyholder becomes disabled or the uncertain occurrence of a fire. Consequently, the liability for incurred claims is the entity's obligation to pay for a policyholder's claim on becoming disabled or for a fire. The amount of the claim (i.e., the total payments under the annuity or the cost of rebuilding the house) is uncertain but such features are clearly envisaged under IFRS 17 by the inclusion of a risk adjustment for non-financial risk in the liability for incurred claims. In contrast, the liability for remaining coverage is the entity's obligation to pay valid claims relating to accident/illness that have not yet occurred causing disability or the entity's obligation to pay claims relating to fire events that have not yet occurred.

The alternative view is that the insured events are the uncertain event of the policyholder becoming disabled following an accident/illness in the period and the uncertain event of the policyholder remaining disabled and eligible to claim or the uncertain event of a claim for the uncertain amount of the cost of rebuilding a house damaged by fire, Consequently, the liability for incurred claims is the entity's obligation to settle a claim already made by a policyholder for the period of disability or to pay for a policyholder's cost of rebuilding the house. The amount to settle the claims as they are made is relatively certain and not subject to insurance risk (and in the case of annuities expected to be small assuming annuities are paid monthly). In contrast, the liability for remaining coverage is the entity's obligation to pay claims for future periods of disability both for policyholders that are already disabled or those yet to become disabled or to pay claims relating to fires that have not yet occurred and to pay claims for the cost of building a house for buildings already damaged by fire events. This treatment would be consistent with the treatment of such contracts acquired after the policyholder becomes disabled or after a fire event (i.e., cover for events that have already occurred but which financial effect is still uncertain).

The TRG members discussed an IASB staff paper which argued that both approaches represent valid interpretations of IFRS 17 and are a matter of judgement for the entity as to which interpretation provides the most useful information about the service provided to the policyholder.

The TRG members observed that:

- The classification of an obligation as a liability for incurred claims or a liability for remaining coverage does not affect the determination of fulfilment cash flows. However, the classification does affect the determination of the coverage period. Consequently, the classification affects whether some changes in fulfilment cash flows adjust the contractual service margin, as well as the allocation of the contractual service margin.
- The definitions in IFRS 17 allow an entity to use judgement when determining whether the obligation to pay an annuity after a disability event and the obligation to pay the costs of rebuilding a house after a fire event are part of the liability for remaining coverage or liability for incurred claims.
- It is a matter of judgement for an entity to develop an accounting policy that reflects the insurance service provided by the entity to the policyholder under the contract in accordance with IFRS 17. The requirements of IAS 8 apply and hence the entity should apply an approach consistently for similar transactions and over time.
- Whatever approach an entity applies, IFRS 17 requires disclosure of significant judgements made in applying the standard and requires disclosures relating to the contractual service margin, which will enable users to understand the effects of the approach required.
- These observations are also relevant when law or regulation impose a requirement for an entity to settle a claim by life-contingent annuity.

Although leaving the decision open to the entity allows preparers to determine which approach provides more useful information given the facts and circumstances around their products, the accounting policy choice may result in identical contracts being accounted for differently in the financial statements of different insurers.

How we see it

It is likely that life insurers would often prefer to elect that the liability for remaining coverage is the entity's obligation to pay claims for future periods of disability both for policyholders that are already disabled or those yet to become disabled consistent with the long-term nature of many of their contracts. In contrast, it is likely that non-life insurers would often prefer to elect that the liability for remaining coverage is the entity's obligation to pay claims relating to events that have not yet occurred as this is similar to most existing non-life practices under IFRS 4. This will have important consequences for property and casualty insurers when they acquire contracts that have liabilities in their settlement period.

9.6.1 The liability for remaining coverage

The liability for remaining coverage is defined by IFRS 17 as follows: *[IFRS 17 Appendix A]*

Extract from IFRS 17

Appendix A
Defined terms

liability for remaining coverage

An entity's obligation to:

(a) investigate and pay valid claims under existing **insurance contracts** for **insured events** that have not yet occurred (ie the obligation that relates to the unexpired portion of the insurance coverage); and

(b) pay amounts under existing **insurance contracts** that are not included in (a) and that relate to:

(i) **insurance contract services** not yet provided (ie the obligations that relate to future provision of **insurance contract services**); or

(ii) any **investment components** or other amounts that are not related to the provision of **insurance contract services** and that have not been transferred to the **liability for incurred claims.**

At initial recognition, the liability for remaining coverage includes all remaining cash inflows and outflows under an insurance contract. Subsequently, at each reporting date, the liability for remaining coverage, excluding the contractual service margin, is re-measured using the fulfilment cash flow requirements discussed in section 9.2 above. That is, it comprises the present value of the best estimate of the cash flows required to settle the obligation together with an adjustment for non-financial risk. The fulfilment cash flows for the liability for remaining coverage for contracts without direct participation features are discounted at the date of initial recognition of the group (under both the general model and the premium allocation approach where applicable) (see section 9.3 above).

An entity must recognise income and expenses for the following changes in the carrying amount of the liability for remaining coverage: *[IFRS 17.41]*

- Insurance revenue - for the reduction in the liability for remaining coverage because of services provided in the period (see section 15.2.1 below for measurement)
- Insurance service expenses - for losses on groups of onerous contracts, and reversals of such losses (see section 9.8 below)
- Insurance finance income or expenses - for the effect of the time value of money and the effect of financial risk (see section 15.3 below)

How we see it

Usually, the fulfilment cash flows should reduce over the contract period as the insurance contract services still to be provided decline. When future insurance contract services can no longer occur, then the fulfilment cash flows of the liability for remaining coverage should be nil. An exception to this may occur where premiums for past service remain outstanding at a reporting date. In this case, even though all insurance contract services have been provided, the liability for remaining coverage could still contain an amount for the premiums receivable.

9.6.2 The liability for incurred claims

The liability for incurred claims is defined by IFRS 17 as follows: *[IFRS 17 Appendix A]*

Extract from IFRS 17

Appendix A
Defined terms

liability for incurred claims An entity's obligation to:

(a) investigate and pay valid claims for **insured events** that have already occurred, including events that have occurred but for which claims have not been reported, and other incurred insurance expenses; and

(b) pay amounts that are not included in (a) and that relate to:

(i) **insurance contract services** that have already been provided; or

(ii) any **investment components** or other amounts that are not related to the provision of **insurance contract services** and that are not in the **liability for remaining coverage**.

At initial recognition of a group of contracts, the liability for incurred claims is usually nil as no insured events covered under the contracts have occurred. Subsequently, at each reporting date, the liability for incurred claims is measured using the fulfilment cash flow requirements discussed in sections 9.2 and 9.4 above. That is, it comprises the present value of the expected cash flows required to settle the obligation together with an adjustment for non-financial risk. This includes future cash flows relating to past events allocated to the group of contracts (including expenses) as discussed in section 9.2.3 above.

The liability for incurred claims under the general model, including claims arising from contracts with direct participation features, is discounted at a current rate (i.e., the rate applying as at the reporting date). The liability for incurred claims under the premium allocation approach need not be discounted if certain conditions are met (see section 10.5 below). Otherwise, the liability for incurred claims under the premium allocation approach is also discounted at a current rate.

There is no direct relationship between the liability for incurred claims and the liability for remaining coverage. That is, the creation of a liability for incurred claims (or a reduction in the value of incurred claims) does not necessarily result in an equal and opposite reduction to the liability for remaining coverage. There is no contractual service margin attributable to the liability for incurred claims as the contractual service margin relates to remaining (i.e., future) service provided over the coverage period and incurred claims relate to past service.

Consequently, the establishment of a liability for incurred claims should give rise to the following accounting entry:

		CU	CU
Dr	Insurance service expense - profit or loss	X	
	Cr Liability for incurred claims		X

Subsequent to initial recognition, an entity must recognise income and expenses for the following changes in the carrying amount of the liability for incurred claims: *[IFRS 17.42]*

- Insurance service expenses - for the increase in the liability because of claims and expenses incurred in the period, excluding any investment components (see section 15.2.2 below)
- Insurance service expenses - for any subsequent changes in fulfilment cash flows relating to incurred claims and incurred expenses (see section 15.2.2 below)
- Insurance finance income or expenses - for the effect of the time value of money and the effect of financial risk (see section 15.3 below)

Disclosure of the liability for incurred claims is required showing the development of actual claims compared with previous estimates of the liability for incurred claims, except for those claims for which uncertainty about the amount and timing of payments is typically resolved within one year (see section 16.5.3 below).

How we see it

IFRS 17 does not distinguish between or require separate disclosure of the components of the liability for incurred claims which represent claims notified to the insurer (sometimes described as 'outstanding claims') and claims incurred but not reported (sometimes described as 'IBNR claims'). IFRS 17 also does not distinguish between, or require, separate disclosure of those components of the liability for incurred claims that represent the entity's liability for expected payments to the policyholder and those that represent an allocation of expenses.

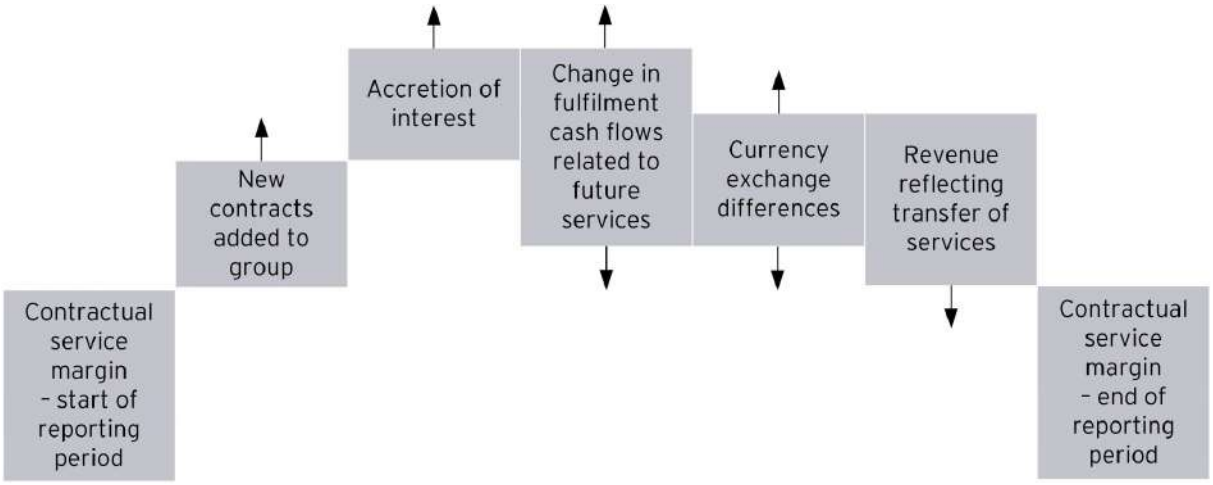
9.6.3 Subsequent measurement of the contractual service margin (for insurance contracts without direct participation features)

The contractual service margin at the end of the reporting period represents the profit in the group of insurance contracts that has not yet been recognised in profit or loss because it relates to the future service to be provided under the contracts in the group. *[IFRS 17.43]*.

At the end of each reporting period, the carrying amount of the contractual service margin of a group of insurance contracts without direct participation features comprises the carrying amount at the start of the reporting period adjusted for: *[IFRS 17.44]*

- The effect of any new contracts added to the group (see section 7 above)
- Interest accreted on the carrying amount of the contractual service margin during the reporting period, measured at the discount rates at initial recognition (see section 9.3 above)
- The changes in fulfilment cash flows relating to future service (see below), except to the extent that:
  - Such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to a loss (see section 9.8 below)

    Or
  - Such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage (see section 9.8 below)
- The effect of any currency exchange differences (see section 8.3 above) on the contractual service margin
- The amount recognised as insurance revenue because of the transfer of insurance contract services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period (see section 9.7 below)



IFRS 17 does not specify the order in which the calculations above need to be performed. This means that the choice as to which order to perform calculations can have an impact on the statement of comprehensive income, for example, there will be more interest accretion if an entity performs interest accretion after adding new contracts rather than before. However, IFRS 17.44(e) states that the amount recognised as insurance revenue because of the transfer of insurance services in the period is determined by the allocation of the contractual margin remaining at the end of the period. The use of the word 'end' implies that this should be the last step.

The changes in fulfilment cash flows that relate to future events which adjust the contractual service margin for a group of insurance contracts without direct participation features are, as follows: *[IFRS 17.B96]*

- Experience adjustments arising from premiums received in the period that relate to future service, and related cash flows such as insurance acquisition cash flows and premium-based taxes, measured at the discount rates applying at the date of initial recognition.
- Changes in estimates of the present value of the future cash flows in the liability for remaining coverage (except those changes described in IFRS 17.B97(a), discussed below) measured at the discount rates applying at the date of initial recognition.
- Differences between any investment component expected to become payable in the period and the actual investment component or loan to a policyholder that becomes payable in the period. Those differences are determined by comparing (i) the actual investment component that becomes payable in the period with (ii) the payment in the period that was expected at the start of the period plus any insurance finance income or expenses related to that expected payment before it becomes payable. Hence, the contractual service margin is not adjusted for insurance finance income or expenses that depict the effect on the investment component of the time value of money and financial risk between the beginning of the period and the unexpected payment or non-payment of the investment component. *[IFRS 17.BC235fn28]*.
- Differences between any loan to a policyholder expected to become repayable in the period and the actual loan to a policyholder that becomes repayable in the period. Those differences are determined by comparing (i) the actual loan to a policyholder that becomes repayable in a period with (ii) the repayment in the period that was expected at the start of the period plus any insurance finance income or expenses related to that expected repayment before it becomes repayable.
- Changes in the risk adjustment for non-financial risk that relate to future service. An entity is not required to disaggregate the change in the risk adjustment for non-financial risk between (i) a change related to non-financial risk and (ii) the effect of the time value of money and changes in the time value of money (see section 9.4.2 above). If an entity does make such a disaggregation, it must adjust the contractual service margin for the change related to non-financial risk, measured at the discount rates applying at the date of initial recognition. This means that in case of disaggregation the contractual service margin is not adjusted for changes in the risk adjustment for non-financial risk that result from the effect of the time value of money and changes in the time value of money. *[IFRS 17.BC224fn27]*.

In respect of investment components, the Board did not regard as useful information, for example, the recognition of a gain for a delay in repaying an investment component accompanied by a loss that adjusts the contractual service margin for the expected later repayment. Acceleration or delay in repayments of investment components only gives rise to a gain or loss for the entity to the extent that the amount of the repayment is affected by its timing. As IFRS 17 does not require an entity to determine the amount of an investment component until a claim is incurred, accordingly, when a claim is incurred, IFRS 17 requires an entity to determine how much of that claim is an investment component, and whether it was expected to become payable in that period. IFRS 17 requires any unexpected repayment of an investment component to adjust the contractual service margin. The contractual service margin will also be adjusted for changes in future estimates of cash flows which will include (but not separately identify) the reduction in future repayments of investment components. This achieves the desired result of the net effect on the contractual service margin being the effect of the change in timing of the repayment of the investment component. *[IFRS 17.BC235]*.

The contractual service margin for contracts without direct participation features must not be adjusted for the following changes in fulfilment cash flows because they do not relate to future service: *[IFRS 17.B97]*

- The effect of the time value of money and changes in the time value of money, and the effect of financial risk and changes in financial risk. These effects comprise:
  - The effect, if any, on estimated future cash flows
  - The effect, if disaggregated, on the risk adjustment for non-financial risk
  - The effect of a change in discount rate
- Changes in estimates of fulfilment cash flows in the liability for incurred claims
- Experience adjustments, except those described above that relate to future service

IFRS 17 notes that some changes in the contractual service margin offset changes in the fulfilment cash flows for the liability for remaining coverage, resulting in no change in the total carrying amount of the liability for remaining coverage. To the extent that changes in the contractual service margin do not offset changes in the fulfilment cash flows for the liability for remaining coverage, an entity must recognise income and expenses for the changes, applying the requirements in section 9.6.1 above. *[IFRS 17.46]*.

The terms of some insurance contracts without direct participation features give an entity discretion over the cash flows to be paid to policyholders. A change in the discretionary cash flows is regarded as relating to future service, and accordingly adjusts the contractual service margin. To determine how to identify a change in discretionary cash flows, an entity must specify at inception of the contract the basis on which it expects to determine its commitment under the contract; for example, based on a fixed interest rate, or on returns that vary based on specified asset returns. *[IFRS 17.B98]*.

An entity must use that specification to distinguish between the effect of changes in assumptions that relate to financial risk on that commitment (which do not adjust the contractual service margin) and the effect of discretionary changes to that commitment (which adjust the contractual service margin). *[IFRS 17.B99]*.

If an entity cannot specify at inception of the contract what it regards as its commitment under the contract and what it regards as discretionary, it must regard its commitment to be the return implicit in the estimate of the fulfilment cash flows at inception of the contract, updated to reflect current assumptions that relate to financial risk. *[IFRS 17.B100]*.

Frequently asked questions

Question 9-21: For insurance contracts without direct participation features, is a difference between the expected and the actual crediting rate applied to a policyholder's account balance included in insurance finance income or expenses, or does it adjust the contractual service margin applying IFRS 17.B96(c)?

(TRG meeting September 2018 - Agenda paper no. 11, Log S57)

The submission was focused on insurance contracts without direct participation features for which the account balance is expected to be payable in the future and ignores the effect of any discretion. The IASB staff observed that IFRS 17.B96 is applicable for differences between any investment component expected to become payable in the period and the actual investment component that becomes payable in the period. However, in the fact pattern provided, the account balance is not expected to become payable in the period and does not become payable in the period and, therefore, the requirement to adjust the contractual service margin does not apply in that period.

Question 9-22: Do all premium experience adjustments relate to future service and therefore adjust the contractual service margin, or is an entity required to identify whether the experience adjustment relates to current, past, or future service?

(TRG meeting September 2018 - Agenda paper no. 04, Log S77)

The submission asked how differences between expected premiums and actual premiums (i.e., premium experience adjustments) which relate to current or past service should be accounted for (i.e., should these adjust the contractual service margin or be recognised in the statement of profit or loss immediately as part of either insurance revenue or insurance service expenses?).

The TRG members agreed with the analysis in the IASB staff paper and observed that:

- Applying the general model, experience adjustments arising from premiums received in the period that relate to future services adjust the contractual service margin. Premium adjustments related to current or past service should be recognised immediately in the statement of profit or loss as part of insurance revenue.
- Although premium experience adjustments are not specifically referenced in IFRS 17.B124, the purpose of that paragraph is to demonstrate an alternative analysis of insurance revenue as determined by IFRS 17.B123 (see section 15.2.1.A below). Hence, applying the requirements in IFRS 17 should result in premium experience adjustments relating to current and past service being included in insurance revenue despite the lack of a specific reference in IFRS 17.B124.
- For the premium allocation approach, the requirements for allocating premium adjustments above, apply to expected premium receipts, including premium experience adjustments (see section 15.2.1.B below).

The TRG members also observed that:

- Given that an entity is required to disclose an analysis of insurance revenue recognised in the period, an additional line item may be necessary in the reconciliation to reflect the effect of premium experience adjustments on the revenue recognised in the period (see section 16.1.1 below).
- In some circumstances, judgement may be required to determine whether premium experience adjustments relate to future service and therefore adjust the contractual service margin rather than are recognised in the statement of profit or loss.

The June 2020 amendments to IFRS 17 added a specific reference to experience adjustments for premium receipts consistent with the TRG comments. See section 15.2.1.A below.

How we see it

The requirement to accrete interest on the contractual service margin at historic rates for groups of contracts without direct participation features creates a data challenge for entities because they need to store and accurately apply a potentially large number of discount rates at initial recognition. The number of historic discount rates that need to be tracked may be greater for participating contracts without direct participation features. The reason is that the rate applied to adjust the contractual service margin for changes in fulfilment cash flows is more likely to differ from the rate to accrete interest on the contractual service margin as the former should reflect the characteristics of the specific liabilities rather than a risk-free rate.

Deciding whether a premium experience adjustment relates to future service, or is part of the coverage provided in past (or current) periods, may not always be clear and may require judgement. For example, attributing expected premium receipts that are overdue to past or future coverage might not be obvious in all situations.

IFRS 17 contains the principle that changes in fulfilment cash flows relating to past service should not adjust the contractual service margin but be recorded in profit or loss for the period. However, in our view, the definitions in Appendix A of the liability for remaining coverage and the liability for incurred claims are not prescriptive as to whether they include premiums related to past service. If changes in expected future premiums included in the liability for remaining coverage relate to past service (see section 9.6.1 above) these changes could be recognised as insurance revenue in the period. This result in a treatment consistent with that of premium experience adjustments. Similarly, experience adjustments from non-distinct investment components that relate to past service could also be reported in profit or loss.

Alternatively, if premiums related to past service are recorded in the liability for incurred claims (see section 9.6.2 above), then the effects of these adjustments are not recorded in insurance revenue but in insurance service expenses.

IFRS 17 requires that changes in financial assumptions should not adjust the contractual service margin under the general model. However, when financial assumptions have changed since initial recognition, the question arises, how to measure the impact on cash flows resulting from changes in non-financial assumptions when adjusting the contractual service margin. In our view, in situations where the effects of changes in financial risk have an effect on estimated future cash flows, determining the changes in fulfilment cash flows resulting from changes in non-financial assumptions when adjusting the contractual service margin for changes related to future services could either be performed using (i) financial assumptions at inception or (ii) using financial assumptions at initial recognition prospectively with actual financial experience used up to the measurement date (i.e., 'prospective lock-in'). This should be applied consistently to all financial risks that affect future cash flows under the general model, as an accounting policy choice at the reporting entity level. It should also be disclosed, if applicable, as material accounting policy information.

9.7 Allocation of the contractual service margin to profit or loss

Determining how to release the contractual service margin to profit or loss is a key aspect of IFRS 17 and one of the key challenges implementing the standard.

The basic principle is that an amount of the contractual service margin for a group of insurance contracts is recognised in profit or loss in each period to reflect the insurance contract services provided under the group of insurance contracts in that period.

The amount recognised in profit or loss is determined by: *[IFRS 17.B119]*

- Identifying the coverage units in the group. The number of coverage units in a group is the quantity of insurance contract services provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage period
- Allocating the contractual service margin at the end of the period (before recognising any amounts in profit or loss to reflect the insurance contract services provided in the period) equally to each coverage unit provided in the current period and expected to be provided in the future

  And
- Recognising in profit or loss the amount allocated to coverage units provided in the period

It is observed in the Basis for Conclusions that the Board views the contractual service margin as depicting the unearned profit for coverage and other services provided over the coverage period. Insurance coverage is the defining service provided by insurance contracts and an entity provides this service over the whole of the coverage period, and not just when it incurs a claim. Consequently, the contractual service margin is recognised over the coverage period in a pattern that reflects the provision of coverage as required by the contract. To achieve this, the contractual service margin for a group of insurance contracts remaining (before any allocation) at the end of the reporting period is allocated over the coverage provided in the current period and expected remaining future coverage, on the basis of coverage units, reflecting the expected duration and quantity of benefits provided by contracts in the group. The Board considered whether: *[IFRS 17.BC279]*

- The contractual service margin must be allocated based on the pattern of expected cash flows or on the change in the risk adjustment for non-financial risk caused by the release of risk. However, the Board decided the pattern of expected cash flows and the release of the risk adjustment for non-financial risk are not relevant factors in determining the satisfaction of the performance obligation of the entity. They are already included in the measurement of the fulfilment cash flows and do not need to be considered in the allocation of the contractual service margin. Hence, the Board concluded that coverage units better reflect the provision of insurance coverage.

  And

- The contractual service margin must be allocated before any adjustments made because of changes in fulfilment cash flows that relate to future service. However, the Board concluded that allocating the amount of the contractual service margin adjusted for the most up-to-date assumptions provides the most relevant information about the profit earned from service provided in the period and the profit to be earned in the future from future service.

The Board also considered whether the allocation of the contractual service margin based on coverage units would result in profit being recognised too early for insurance contracts with fees determined based on the returns on underlying items. For such contracts, IFRS 17 requires the contractual service margin to be determined based on the total expected fee over the duration of the contracts, including expectations of an increase in the fee because of an increase in underlying items arising from investment returns and additional policyholder contributions over time. The Board rejected the view that the allocation based on coverage units results in premature profit recognition. The Board noted that the investment component of such contracts is accounted for as part of the insurance contract only when the cash flows from the investment component and from insurance and other services are highly interrelated and hence cannot be accounted for as distinct components. In such circumstances, the entity provides multiple services in return for an expected fee based on the expected duration of contracts, and the Board concluded the entity should recognise that fee over the coverage period as the insurance services are provided, not when the returns on the underlying items occur. *[IFRS 17.BC280]*.

IFRS 17 requires the contractual service margin remaining at the end of the reporting period to be allocated equally to the coverage units provided in the period and the expected remaining coverage units. IFRS 17 does not specify whether an entity should consider the time value of money in determining that equal allocation and consequently does not specify whether that equal allocation should reflect the timing of the expected provision of the coverage units. The Board concluded that should be a matter of judgement by an entity. *[IFRS 17.BC282]*.

Consistent with the requirements in IFRS 15, the settlement of a liability is not considered to be a service provided by the entity. Thus, the recognition period for the contractual service margin is the coverage period over which the entity provides the coverage promised in the insurance contract, rather than the period over which the liability is expected to be settled. The risk margin the entity recognises for bearing risk is recognised in profit or loss as the entity is released from risk in both the coverage period and the settlement period. *[IFRS 17.BC283]*. For contracts with a coverage period of one year, this means that the contractual service margin will be released over that one-year period (possibly, a single reporting period). For longer-term contracts, with a coverage period lasting many years, an entity will have to use judgement in order to determine an appropriate allocation of the contractual service margin to each reporting period.

Frequently asked questions

Question 9-23: How should the contractual service margin be allocated to coverage units provided in the current period and expected to be provided in the future applying IFRS 17.B119(b).

(TRG meeting February 2018 - Agenda paper no. 07, Log S09)

The IASB staff observed that the contractual service margin is allocated equally to each coverage unit provided in the current period and expected to be provided in the future. Therefore, the allocation is performed at the end of the period, identifying coverage units that were actually provided in the current period and coverage units that are expected at this date to be provided in the future.

Question 9-24: What is the definition of 'quantity of benefits' in IFRS 17.B119(a) for use in determining the amortisation pattern of the contractual service margin?

(TRG meeting February 2018 and May 2018 - Agenda papers no. 05, Log S01)

In May 2018, the TRG analysed an IASB staff paper that contained the IASB staff's views on sixteen examples of different types of insurance contracts. The TRG members observed that:

- IFRS 17 established an objective for coverage units which was to reflect the services provided in a period under a group of insurance contracts. However, it does not establish detailed requirements, and it would not be possible to develop detailed requirements that would apply appropriately to the wide variety of insurance products existing globally.
- The determination of coverage units is not an accounting policy choice but involves judgement and estimates to best achieve the principle of reflecting the services provided in each period. Those judgements and estimates should be applied systematically and rationally.
- The analysis of the examples in the IASB Staff paper depends on the fact patterns in that paper and would not necessarily apply to other fact patterns. The method that best reflects the services provided in each period would be a matter of judgement based on facts and circumstances.
- In considering how to achieve the principle, the TRG members observed:
  - The period in which an entity bears insurance risk is not necessarily the same as the insurance coverage period.
  - Expectations of lapses of contracts are included in the determination of coverage units because they affect the expected duration of the coverage. Consistently, coverage units reflect the likelihood of insured events occurring to the extent that they affect the expected duration of coverage for contracts in the group.
  - Because the objective is to reflect the insurance services provided in each period, different levels of service across periods should be reflected in the determination of coverage units.
  - Determining the quantity of benefits provided under a contract requires an entity to consider the benefits expected to be received by the policyholder, not the costs of providing those benefits expected to be incurred by the entity.
  - A policyholder benefits from the entity standing ready to meet valid claims, not just from making a claim if an insured event occurs. The quantity of benefits provided therefore relates to the amounts that can be claimed by the policyholder.
  - Different probabilities of an insured event occurring in different periods do not affect the benefit provided in those periods of the entity standing ready to meet valid claims for that insured event. Different probabilities of different types of insured events occurring might affect the benefit provided by the entity standing ready to meet valid claims for the different types of insured events.
  - IFRS 17 does not specify a particular method or methods to determine the quantity of benefits. Different methods may achieve the objective of reflecting the services provided in each period, depending on facts and circumstances.

The TRG members considered that the following methods might achieve the objective if they are reasonable proxies for the services provided under the groups of insurance contracts in each period:

- A straight-line allocation over the passage of time, but reflecting the number of contracts in a group
- A method based on the maximum contractual cover in each period
- A method based on the amount the entity expects the policyholder to be able to validly claim in each period if an insured event occurs
- Methods based on premiums. However, premiums will not be reasonable proxies when comparing services across periods if they are receivable in different periods to those in which insurance services are provided, or if they reflect different probabilities of claims for the same type of insured event in different periods rather than different levels of service of standing ready to meet claims. Additionally, premiums will not be reasonable proxies when comparing contracts in a group if they reflect different levels of profitability in contracts. The level of profitability in a contract does not affect the services provided by the contract.
- Methods based on expected cash flows. However, methods that result in no allocation of the contractual service margin to periods in which the entity is standing ready to meet valid claims do not meet the objective.

Question 9-25: How does an entity determine the amount of the contractual service margin (i.e., the quantity of benefits) to recognise in profit or loss in a period because of the transfer of insurance coverage for survival in that period?

(IFRS IC final agenda decision June 2022)

In 2022, the IFRS IC was asked to consider a fact pattern of a group of annuity contracts under which the policyholder of each contract:

(a) Pays the premium upfront and has no right to cancel the contract or seek a refund

(b) Receives a periodic payment from the start of the annuity period for as long as the policyholder survives (for example a fixed amount of CU100 for each year that the policyholder survives)

And

(c) Receives no other services under the contract (for example, no other types of insurance coverage or investment-return service)

The fact pattern referred to groups of contracts for which the annuity period starts immediately after contract inception ('immediate annuity') and also those for which the annuity period starts on a specified date after contract inception ('deferred annuity'). For example, a contract entered into in 2022 for which the annuity period starts in 2042.

Applicable requirements in IFRS 17

Paragraph 44(e) of IFRS 17 requires an entity to adjust the carrying amount of the contractual service margin for the amount recognised as insurance revenue because of the transfer of insurance contract services in the period. The entity determines this amount by allocating the contractual service margin over the current and remaining coverage period applying paragraph B119 of IFRS 17.

Paragraph B119 of IFRS 17 states that an entity recognises in profit or loss in each period an amount of the contractual service margin to reflect the insurance contract services provided under the group of insurance contracts in that period. The amount is determined by:

(a) Identifying the coverage units in the group. The number of coverage units in a group is the quantity of insurance contract services provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage period.

(b) Allocating the contractual service margin at the end of the period equally to each coverage unit provided in the current period and expected to be provided in the future.

(c) Recognising in profit or loss the amount allocated to coverage units provided in the period.

The definition of insurance contract services in Appendix A to IFRS 17 describes insurance coverage as 'coverage for an insured event'. An insured event is defined as 'an uncertain future event covered by an insurance contract that creates insurance risk'.

Methods for applying the requirements to the fact pattern

The request sets out two methods of determining, for each contract in the group, the quantity of benefits of insurance provided in the current period and expected to be provided in the future.

Method 1

Current period - determined based on the annuity payment the policyholder is able to validly claim in the current period.

Expected to be provided in the future - determined based on the present value of the annuity payments the policyholder is expected to be able to validly claim in the future until the end of the coverage period (the balance of expected future annuity payments as at the end of the current period).

Method 2

Current period - determined based on the total of: (i) the annuity payment the policyholder is able to validly claim in the current period, and (ii) the present value of the annuity payments the policyholder is expected to be able to validly claim in the future until the end of the coverage period (the balance of the expected future annuity payments as at the end of the current period).

Expected to be provided in the future - determined based on the present value of the balances of the expected future annuity payments at the beginning of each future period, until the end of the coverage period.

Applying paragraph B119(a) of IFRS 17, an entity:

(a) Identifies the insurance contract services to be provided under the group of contracts. In the fact pattern described in the request, insurance coverage for survival is the only insurance contract service provided under the group of contracts.

(b) Considers the expected coverage period for each contract in the group. In the fact pattern described in the request, the expected coverage period would reflect the entity's expectations of how long the policyholder will survive.

(c) Considers the quantity of the benefits provided under each contract in the group.

IFRS 17 does not prescribe a method for determining the quantity of the benefits provided under a contract. Instead, an entity is required to use a method that meets the principle in paragraph B119 of reflecting the insurance contract services provided in each period. In selecting a method that meets that principle, an entity considers (a) the benefits provided to the policyholder under a contract with respect to the insurance contract services provided, and (b) when those benefits are provided. Different methods may achieve the principle depending on the facts and circumstances.

In the fact pattern described in the request, the terms of the annuity contract provide the policyholder with the right to claim a periodic amount (CU100 in the example) from the start of the annuity period for as long as the policyholder survives. Consequently, the IFRS IC observed that:

(a) The benefits provided to the policyholder under the contract with respect to the insurance coverage for survival are the policyholder's right to claim a periodic amount for as long as they survive. The policyholder also benefits from transferring to the entity the risk related to the uncertainty about how long they will survive. However, IFRS 17 requires an entity to account for that insurance risk in the risk adjustment for non-financial risk, separately from the contractual service margin.

(b) The benefits of being able to claim a periodic amount are provided to the policyholder in each year of the policyholder's survival from the start of the annuity period:

  (i) The policyholder has no right to claim an amount for surviving in periods before the start of the annuity period. The entity accepts insurance risk from inception of the contract but provides no benefits to the policyholder in the form of amounts that can be claimed until the annuity period starts. Paragraphs BC140-BC141 of the Basis for Conclusions on IFRS 17 explain that an entity can accept insurance risk before it is obliged to perform an insurance coverage service.

  (ii) Survival in one year does not provide the policyholder with the right to claim amounts that compensate the policyholder for surviving in future years; that is, the policyholder's right to claim amounts in future years is contingent on the policyholder surviving in those future years.

The IFRS IC's conclusion

The IFRS IC concluded that, in applying IFRS 17 to determine the quantity of the benefits of insurance coverage for survival provided under each annuity contract, a method based on the amount of the annuity payment the policyholder is able to validly claim (Method 1) meets the principle in paragraph B119 of IFRS 17 of reflecting the insurance coverage provided in each period by:

- Assigning a quantity of the benefits only to periods for which the entity has an obligation to investigate and pay valid claims for the insured event (survival of the policyholder).

  And

- Aligning the quantity of the benefits provided in a period with the amount the policyholder is able to validly claim in each period.

A method based on the present value of expected future annuity payments (Method 2) does not meet the principle in paragraph B119 of IFRS 17 of reflecting the insurance coverage provided in each period because it would:

- Assign a quantity of the benefits to periods for which the entity has no obligation to investigate and pay valid claims for the insured event (for example, to the deferral period of a deferred annuity contract).

  And

- Misrepresent the quantity of the benefits provided in a period by considering amounts the policyholder is able to claim and benefit from only in future periods.

The request asked only about the recognition of the contractual service margin in profit or loss. For the annuity contracts described in the request, the entity accepts insurance risk related to the uncertainty about how long the policyholder will survive. The IFRS IC noted that the entity would apply other requirements in IFRS 17 to recognise in profit or loss-separately from the contractual service margin-the risk adjustment for non-financial risk, representing the entity's compensation for bearing insurance risk and other non-financial risks. The IFRS IC did not discuss these other requirements.

Under a group of annuity contracts, an entity could provide other insurance contract services to policyholders in addition to insurance coverage for survival-for example, insurance coverage for death in a deferral period or an investment-return service. The conclusion in this agenda decision applies to insurance coverage for survival, regardless of other services provided. If the contracts provide other insurance contract services, the entity would also need to consider the pattern of transfer of those services to the policyholder.

The IFRS IC concluded that the principles and requirements in IFRS accounting standards provide an adequate basis for an issuer of a group of annuity contracts as described in the request to determine the amount of the contractual service margin to recognise in profit or loss in a period because of the transfer of insurance coverage for survival in that period. Consequently, the IFRS IC decided not to add a standard-setting project to the work plan.

In accordance with paragraph 8.7 of the Due Process Handbook, at its July 2022 meeting, the IASB discussed, and did not object to, this agenda decision.[8]

The examples below, discussed by the TRG in the May 2018 meeting, apply the principles above to specific fact patterns for insurance contracts issued without direct participation features. Examples for reinsurance contracts issued, reinsurance contracts held and insurance contracts with direct participation features are discussed in sections 9.9.4, 11.5.2 and 12.3.4 below respectively.

Illustration 9-6: Credit life loan insurance

A life insurance policy pays a death benefit equal to the principal and interest outstanding on a loan at the time of death. The balance of the loan will decline because of contractually scheduled payments and cannot be increased.

Applying the principles above, the method suggested for determining the quantity of benefits is the cover for the contractual balance outstanding because it is both the maximum contractual cover and the amount the entity expects the policyholder to be able to make a valid claim for if the insured event occurs.

Illustration 9-7: Credit life product with variable amount of cover

A credit life insurance policy where the amount payable on an insured event varies (for example, claims might relate to an outstanding credit card balance). In these cases, the sum assured will vary over time, rather than simply reducing. In addition, the sum assured may be limited based on the lender's credit limits.

Applying the principles above, the methods suggested for determining the quantity of benefits are either the constant cover of the contractual maximum amount of the credit limit or cover based on the expected credit card balances (i.e., the amount the entity expects the policyholder to be able to make a valid claim for if the insured event occurs).

Illustration 9-8: Mortgage loss cover

An insurance contract provides cover for five years for default losses on a mortgage, after recovering the value of the property on which the mortgage is secured. The balance of the mortgage will decline because of contractually scheduled payments and cannot be increased.

Applying the principles above, the methods suggested for determining the quantity of benefits are either the maximum contractual cover (the contractual balance of mortgage) or the amount the entity expects the policyholder to be able to make a valid claim for if the insured event occurs (the contractual balance of the mortgage less the expected value of the property).

Illustration 9-9: Product warranty

A five-year warranty coverage insurance contract provides for replacement of a purchased item if it fails to work properly within five years of the date of purchase. Claims are typically skewed toward the end of the coverage period as the purchased item ages.

Applying the principles above, the quantity of benefits is constant over the five year coverage period if the price of replacement product is expected to remain constant. However, if the cost of the replacement product rises over the coverage period (e.g., inflation costs) then the coverage units should include expectations about the cost of replacing the item.

8 *IFRIC Update*, June 2022, available on the IFRS Foundation's website.

Illustration 9-10: Extended product warranty

Extended warranty policies cover the policyholders after the manufacturer's original warranty has expired. The policies provide new for old cover in the event of a major defect to the covered asset.

Applying the principles above, the expected coverage duration does not start until the manufacturer's original warranty has expired. The policyholder cannot make a valid claim to the entity until then.

Illustration 9-11: Health cover

An insurance contract provides health cover for 10 years for specified types of medical costs up to CU1m over the life of the contract, with the expected amount and expected number of claims increasing with age.

Applying the principles above, the expected coverage duration is the 10 year period during which cover is provided, adjusted for any expectations of the limit being reached during the ten years and lapses. For determining the quantity of benefits the following two methods are suggested:

- Comparing the contractual maximum amount that could have been claimed in the period with the remaining contractual maximum amount that can be claimed as a constant amount for each future coverage period. So, if a claim of CU100,000 were made in the first year, at the end of the year the entity would compare CU1m coverage provided in the year with coverage of CU900,000 for the following nine years, resulting in an allocation of 1/9.1 of the contractual service margin for the first year.

  Or

- Comparing the maximum amount that could be claimed in the period with the expected maximum amounts that could be claimed in each of the future coverage periods, reflecting the expected reduction in cover because of claims made. This approach involves looking at the probabilities of claims in different periods to determine the expected maximum amounts in future periods. However, in this fact pattern, the probability of claims in one period affects the amount of cover for future periods, thereby affecting the level of service provided in those periods.

Illustration 9-12: Transaction liability

A transaction liability policy will pay claims for financial losses arising as a result of breaches of representations and warranties made in a specified and executed acquisition transaction. The policy period (contract term) is for 10 years from the policy start date. The insurer will pay claims for financial losses reported during the 10-year policy period up to the maximum sum insured.

Applying the principles above, the insured event is the discovery of breaches of representations and warranties (consistent with the definition of title insurance - see section 3.7 above). Coverage starts at the moment the contract is signed and lasts for 10 years. The IASB staff rejected the view that the coverage period is just one day (i.e., the transaction closing date, which is the date on which the representations and warranties were made).

Illustration 9-13: Combination of different types of cover

This example assumes there are five different contracts (A-E) in a single group of insurance contracts. Each contract has a different combination of four coverages (accidental death, cancer diagnosis, surgery and inpatient treatment). Each contract has a different coverage period. Coverages have a high level of interdependency in the same insurance contract; if a coverage of an insurance contract in the group of insurance contracts lapses, other coverages of the same insurance contract lapse simultaneously. Presented in the table below is the summary of the contracts:

Contract	Coverage				Coverage period
	Accidental death	Cancer diagnosis	Surgery	Inpatient treatment	
A	Cover of 2000	Cover of 1000	Cover of 500	Cover of 50	2 years
B	N/A	Cover of 1000	Cover of 500	N/A	5 years
C	N/A	N/A	Cover of 500	Cover of 50	2 years
D	N/A	N/A	Cover of 500	Cover of 50	5 years
E	Cover of 2000	N/A	N/A	N/A	10 years

The entity charges the same annual premium amount for each type of cover, and the total annual premium amount for a contract is the sum of the premiums for each type of cover included in the contract.

Applying the principles above, the expected coverage duration is the period in which cover is provided, adjusted for expectations of lapses. The quantity of benefits for each contract is the sum of all the levels of cover provided. So, based on the cover set out in the table, the total coverage units for contract A for each year would be CU3,550 (i.e., 2,000 + 1,000 + 500 + 50) and for contract B 1,500 (i.e., 1,000 + 500). Methods which do not reflect the different amounts of cover provided by each contract would not appear to be valid. A method based on annual premiums may be valid depending on the factors mentioned in the TRG analysis above.

In this example, in all scenarios the coverage period is the same for all coverage components so the probability of the insured event does not affect the coverage period and can be ignored. If the coverage period for the various covers is different, then the probability of the insured event becomes relevant as some coverage components will expire before other coverage components.

Illustration 9-14: Life contingent annuity

A life contingent pay out annuity pays a fixed monthly amount of CU10 each period until the annuitant dies.

Applying the principles above, the expected coverage duration is the probability weighted average expected duration of the contract. The expected coverage duration is reassessed in each period. The quantity of benefits is the fixed monthly amount of CU10. An approach that does not reassess the expected coverage period would appear to be inconsistent with the current measurement principle of IFRS 17.

The IASB staff rejected the view that there is a constant level of benefits provided over the life of the annuitant and that the contractual service margin should be amortised straight line over the remaining expected life of the annuitant (i.e., the quantity of benefits is CU10 per year and the coverage period is the length of time until there will no longer be any payments made to the policyholder which is estimated at 40 years) because it does not reflect the expected duration of the contract. The IASB staff also rejected the view that the contract is a series of individual promises to pay a fixed amount at a future point in time if the annuitant is still alive at that point in time because it requires an entity to split a contract into multiple individual contracts and also does not appear to require reassessment of the expected coverage duration.

Illustration 9-15: Forward purchase of fixed rate annuity

A forward contract to buy an annuity in the future at a fixed rate. The premium is payable when the annuity is bought. If the policyholder dies, or cancels the contract, before the date the annuity can be purchased, the policyholder receives no benefit.

Applying the principles above, the entity bears insurance risk from the date the forward contract is issued, but the coverage period does not start until the date the annuity starts (as a claim cannot be made before that date). The insured event is that the policyholder lives long enough (i.e., survives) to receive payments under the annuity.

How we see it

IFRS 17 is silent on whether an entity should allocate the contractual service margin to profit or loss using coverage units that reflect the time value of money. In our view, both methods (i.e., considering time value of money and not considering it) are acceptable, but an entity must apply the method consistently as an accounting policy choice.

Following the TRG discussion referred to above, we expect entities will have to apply judgement based on the specific product characteristics in determining the quantity of benefits underlying coverage units in a way that best depicts the provision of insurance contract services over the coverage period of the group of contracts.

9.7.1 Allocating the contractual service margin on the basis of coverage units determined by considering both insurance coverage and any investment return service

IFRS 17 defines insurance contract services as the following services that an entity provides to the policyholder of an insurance contract: *[IFRS 17 Appendix A]*

- Coverage for an insured event (insurance coverage)
- For insurance contracts without direct participation features, the generation of an investment return for the policyholder, if applicable (investment-return service)

  And
- For insurance contracts with direct participation features, the management of underlying items on behalf of the policyholder (investment-related service)

As the contractual service margin is recognised in profit or loss to reflect the provision of insurance contract services, this means that the period over which the contractual service margin is amortised includes both the period in which the entity provides insurance contract services and the period over which it provides an investment-return service (for insurance contracts without direct participation features) or an investment-related service (for insurance contracts with direct participation features). The coverage period of insurance contracts with direct participation features is discussed in section 12.3.4 below.

Extract from IFRS 17

B119B Insurance contracts without direct participation features may provide an investment-return service if, and only if:

(a) an investment component exists, or the policyholder has a right to withdraw an amount;

(b) the entity expects the investment component or amount the policyholder has a right to withdraw to include an investment return (an investment return could be below zero, for example in a negative interest rate environment); and

(c) the entity expects to perform investment activity to generate that investment return.

[IFRS 17.B119B].

In this regard, a right to withdraw an amount from the entity includes a policyholder's right to:

- Receive a surrender value or refund of premiums on cancellation of a policy

  Or
- Transfer an amount to another insurance provider *[IFRS 17.BC283C]*

In IFRS 17, as issued in 2017, the coverage period of an insurance contract without direct participation features included only the period in which an entity provided insurance contract services and did not include the period in which an entity provided investment return-services. In May 2018, most TRG members disagreed that insurance contracts under the general model should be treated as providing only insurance services. Stakeholders also expressed concerns that contracts which provide insurance coverage that ends significantly before the investment-return service ended would result in 'front-end' revenue recognition and deferred annuity contracts with an account balance accumulating in the period before the annuity payments start could result in 'back-end' revenue recognition if insurance coverage is provided only during the annuity periods. As a result, the Board was persuaded that some insurance contracts outside the scope of the variable fee approach (i.e., those that do not contain direct participation features) provide an investment-return service and that recognising the contractual service margin considering both insurance coverage and an investment-return service will provide useful information to users of the financial statements. *[IFRS 17.BC283B]*.

The Board admits that specifying conditions for an investment-return service creates the risk that an appropriate outcome may not be achieved in all scenarios (for example, entities might also conclude that an investment-return service exists in circumstances in which the Board would conclude otherwise such as when an entity provides only custodial services relating to an investment component). Balancing those potential risks, the Board decided to specify conditions that are necessary to identify, but not determinative of, the existence of an investment-return service. An entity is required to apply judgement, considering the facts and circumstances, to determine whether an insurance contract meets the conditions to provide an investment-return service. *[IFRS 17.BC283D, IFRS 17.BC283E]*.

For the purpose of amortising the contractual service margin, the period of investment-return service ends at or before the date that all amounts due to current policyholders relating to those services have been paid, without considering payments to future policyholders included in the fulfilment cash flows as a result of mutualisation (see section 12.1 below). *[IFRS 17.B119A]*.

Illustration 9-16: Forward purchase of fixed rate annuity

An insurance contract matures in year 10 and pays the customer the account value at maturity. The contract also includes a death benefit that varies depending on which year in the 10-year period the death occurs. Specifically, if the customer dies in years 1-5, the customer's beneficiary would receive a death benefit that is the higher of 110% of the premium paid or the accumulated account value (assume that the death benefit for years 1-5 results in significant insurance risk). However, if the customer dies in years 6-10 the customer's beneficiary receives only the account value. There is no surrender penalty.

Does the insurer only have to consider years 1-5 for determining the coverage units to determine the amortisation of the contractual service margin? Or does the insurer need to consider all 10 years for determining coverage units and amortisation of the contractual service margin?

IFRS 17 states that coverage units should be determined reflecting the benefits to the policyholder during the period of both the insurance coverage and the investment return services (i.e., 10 years). Under IFRS 17 as issued in 2017, the insurer would have only considered years 1-5 for determining the coverage units since that reflected the period of the insurance benefits and IFRS 17 was amended in June 2020 as shown in the diagram below.

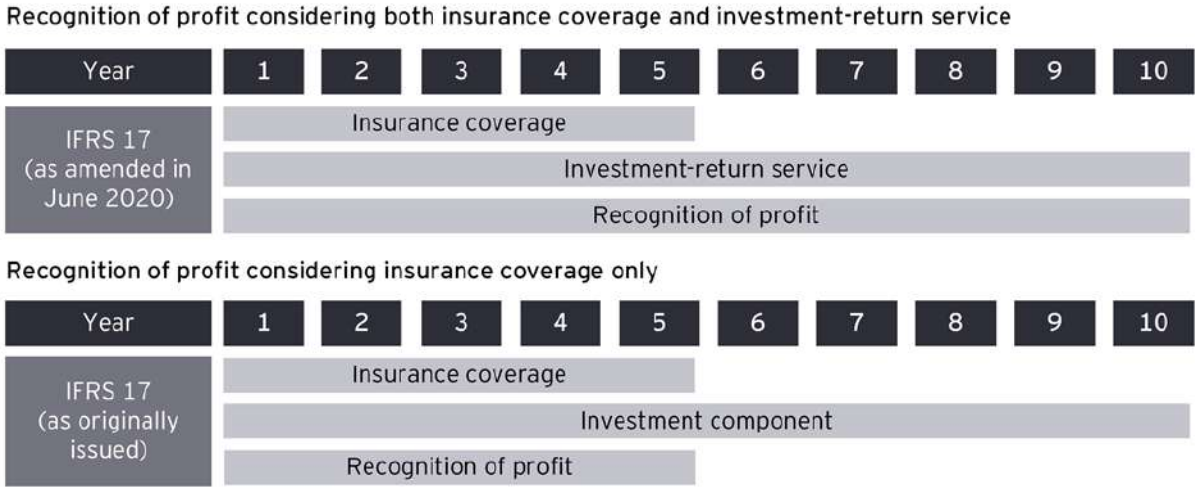


Illustration 9-17: Deferred annuity contract without an investment component which provides an investment-return service

A deferred annuity contract is a contract under which premiums are paid up-front. The premiums earn a return during the accumulation phase and the accumulated amount can be converted into an annuity at a fixed conversion rate at a future date. The accumulation phase could be a substantial number of years. During the accumulation phase the policyholder has the right to transfer the accumulated amount to another annuity provider or to receive the accumulated amount if (s)he dies. After conversion into an annuity, there is no period of guaranteed payments, i.e., if the policyholder dies after conversion, but before the first annuity payment the policyholder receives nothing. Hence, the contract does not have an investment component. However, although there is no investment component, the policyholder has the right during the accumulation phase to withdraw an amount from the entity that includes an investment return. (An investment-return service can only exist if the contract includes an investment component or if the policyholder has a right to withdraw an amount from the entity).

How we see it

IFRS 17 does not contain specific guidance on how to determine the coverage units for investment-return or investment-related services and how these services are weighted with services from insurance coverage. The TRG did also not discuss this matter in detail. Therefore, entities will have to apply judgement in determining coverage units in a way that reflects the investment services provided to the policyholders and how these services are combined with insurance coverage services if a contract includes both types of services.

9.8 Onerous contracts

An insurance contract is onerous at the date of initial recognition if the fulfilment cash flows allocated to the contract, including any previously recognised insurance acquisition cash flows and any cash flows arising from the contract at the date of initial recognition in total are a net outflow.

As discussed in section 7 above, a loss must be recognised on initial recognition of a group of insurance contracts if that group is onerous. As discussed in section 6.2 above, an entity should group such contracts in a portfolio separately from contracts that are not onerous.

When a group of insurance contracts is onerous, an entity should recognise a loss component and book the corresponding loss in profit or loss for the net outflow for the group of onerous contracts, resulting in the carrying amount of the liability for remaining coverage of the group being equal to the fulfilment cash flows and the contractual service margin of the group being zero. *[IFRS 17.47]*.

Subsequent to initial recognition, a group of insurance contracts becomes onerous (or more onerous) if the following amounts exceed the carrying amount of the contractual service margin: *[IFRS 17.48]*

- Unfavourable changes relating to future service in the fulfilment cash flows allocated to the group arising from changes in estimates of future cash flows and the risk adjustment for non-financial risk
- For a group of insurance contracts with direct participation features, the decrease in the amount of the entity's share of the fair value of the underlying items

An entity must recognise a loss in profit or loss to the extent of that excess.

For losses under onerous groups of insurance contracts recognised either on initial recognition or subsequently, an entity must establish (or increase) a loss component of the liability for remaining coverage for an onerous group depicting the losses recognised. A 'loss component' means a notional record of the losses attributable to each group of onerous insurance contracts. The liability for the expected loss is contained within the liability for remaining coverage for the onerous group (as it is within the fulfilment cash flows). Keeping a record of the loss component of the liability for remaining coverage is necessary in order to account for subsequent reversals, if any, of the onerous group and any loss component is required to be separately disclosed (see section 16.1.1 below). The loss component determines the amounts that are presented in profit or loss as reversals of losses on onerous groups and are consequently excluded from the determination of insurance revenue and, instead, credited to insurance service expenses. *[IFRS 17.49]*.

After an entity has recognised a loss on an onerous group of insurance contracts, it must allocate: *[IFRS 17.50]*

- The subsequent changes in fulfilment cash flows of the liability for remaining coverage on a systematic basis between:
  - The loss component of the liability for remaining coverage
  - The liability for remaining coverage, excluding the loss component
- Solely to the loss component until that component is reduced to zero:
  - Any subsequent decrease relating to future service in fulfilment cash flows allocated to the group arising from changes in estimates of future cash flows and the risk adjustment for non-financial risk
  - Any subsequent increases in the amount of the entity's share of the fair value of the underlying items

IFRS 17 does not specify the order in which an entity allocates the fulfilment cash flows in the bullet points above (i.e., whether IFRS 17.50(a) or 50(b) is applied first). *[IFRS 17.IE95(c)]*.

An entity must adjust the contractual service margin only for the excess of the decrease over the amount allocated to the loss component.

The subsequent changes in the fulfilment cash flows of the liability for remaining coverage to be allocated are: *[IFRS 17.51]*

- Estimates of the present value of future cash flows for claims and expenses released from the liability for remaining coverage because of incurred insurance service expenses
- Changes in the risk adjustment for non-financial risk recognised in profit or loss because of the release from risk
- Insurance finance income or expenses

The systematic allocation required above must result in the total amounts allocated to the loss component being equal to zero by the end of the coverage period of a group of contracts (since the loss component will have been realised in the form of incurred claims). *[IFRS 17.52]*.

IFRS 17 does not prescribe specific methods to track the loss component. The IASB considered whether to require specific methods but concluded that any such methods would be inherently arbitrary. The IASB, therefore, decided to require an entity to make a systematic allocation of changes in the fulfilment cash flows for the liability for remaining coverage that could be regarded as affecting either the loss component or the rest of the liability. *[IFRS 17.BC287]*.

How we see it

Tracking the loss component of the liability for remaining coverage for each group of onerous contracts will be a new and complex task, particularly for many life insurers. Most non-life insurers will be familiar with the concept of releasing provisions for unearned premiums and unexpired risks, and we expect that tracking a loss component should be easier for short duration contracts. Maintaining the loss component is not equivalent to maintaining a negative contractual service margin because the purpose of the loss component is to separately account for and present the shortfall in the insurance liability and, in contrast to the contractual service margin, is not directly driven by the performance of services under the group of contracts.

Changes in the liability for remaining coverage due to insurance finance income or expenses, release from risk, and incurred claims and other insurance service expenses, need to be allocated between the loss component and the remainder of the liability for remaining coverage on a systematic basis. An entity could allocate the effect of these changes to the loss component in proportion to the total liability, although other bases could be appropriate. Whichever approach is adopted, it should be applied consistently. This also implies that insurance finance income or expenses must be allocated to the loss component to reflect the accretion of interest.

Changes in the liability for incurred claims are not allocated to the liability for remaining coverage.

Illustration 9-18: Application of the loss component for a group of onerous contracts

An entity determines that a group of insurance contracts without direct participation features is onerous at initial recognition. On initial recognition, the fulfilment cash flows (disregarding discounting and other adjustments) are a net cash outflow of CU50. Therefore, this is recognised as a loss in profit or loss. There is no contractual service margin. The loss component of the liability for remaining coverage is CU50.

At the entity's next reporting date, it calculates that the fulfilment cash flows for the liability for remaining coverage have decreased by CU60. Applying IFRS 17.50, the entity decides that it will first allocate the subsequent changes in fulfilment cash flows of the liability for remaining coverage in a systematic way between the loss component and the liability for remaining coverage excluding the loss component. The entity then decides to allocate any subsequent decrease relating to future service in the fulfilment cash flows solely to the loss component. As a result of the systematic allocation, CU40 adjusts the loss component of the liability for remaining coverage by a release (i.e., a credit) to profit or loss. The remaining CU20 reduction does not adjust the loss component of the liability for remaining coverage. Consequently, at the reporting date, the loss component of the liability for remaining coverage is CU10 (i.e., CU50 less CU40).

How we see it

IFRS 17 clearly implies that insurance finance income or expenses should be allocated to the loss component to reflect the accretion of interest. Even though the total liability for remaining coverage is measured using current rate, the standard is not explicit on what discount rate - a current rate or a rate at inception - should be used for allocating insurance finance income or expenses to the loss component. An entity should therefore make an accounting policy choice on this matter that is applied consistently for contracts accounted for under the general model.

When the entity applies a current rate for allocating insurance finance income or expenses to the loss component, it should also determine an accounting policy on whether it records the remeasurement of the loss component in profit or loss at the current rate, or whether it disaggregates this effect between insurance service result and insurance finance income or expense using the rate determined at inception. It should apply this accounting policy consistently to contracts accounted for under the general model (see section 15.2.1.A below).

However, for contracts with direct participation features, the loss component should be determined at the current rate, consistent with the measurement model, with the resulting effects included in insurance service result (see sections 12.3.3 and 15.3 below).

9.9 Reinsurance contracts issued

A reinsurance contract is a contract issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more insurance contracts issued by that other entity (underlying contracts). *[IFRS 17 Appendix A]*.

The requirements for recognition and measurement of reinsurance contracts issued are the same as for insurance contracts. This means that the issuer should make an estimate of the fulfilment cash flows including estimates of expected future cash flows. At initial recognition (and at each reporting date) this will include estimates of future cash flows arising from underlying insurance contracts expected to be issued by the reinsured entity (and covered by the issued reinsurance contract) that are within the contract boundary of the reinsurance contract. This is because the issuer of the reinsurance contract has a substantive obligation to provide insurance cover (i.e., services) for those unissued policies. However, the unit of account for measurement is the reinsurance contract rather than the underlying individual direct contracts.

9.9.1 The contract boundary of a reinsurance contract issued

The terms and conditions of reinsurance contracts create specific application questions as to the contract boundary. This section discusses the application to reinsurance contracts issued; for the general principles see section 9.1 above. For the matters that relate more specifically to reinsurance contracts held, see section 11.2 below.

Frequently asked questions

Question 9-26: What is the contract boundary of a reinsurance contract that contains a break clause?

(TRG meeting February 2018 - Agenda paper no. 03, Log S15)

Some reinsurance contracts issued may contain break clauses which allow either party to cancel the contract at any time following a specified notice period. TRG members observed that, in an example of a reinsurance contract where the reinsurer can terminate coverage at any time with a three-month notice period, the initial contract boundary for the issuer of the reinsurance contract would exclude cash flows related to underlying insurance premiums outside of that three-month notice period.

Question 9-27: From the perspective of the cedant, is there is an expectation of a symmetrical treatment of the contract boundary between the reinsurer and the cedant for the examples discussed at the May 2018 meeting for reinsurance held?

(TRG meeting September 2018 - Agenda paper no. 11, Log S75)

This example is similar to the example discussed at the May 2018 TRG meeting. See Questions 11-3 and Question 11-4 in section 11.2 below. The May 2018 example was from the perspective of the cedant. The September 2018 example is from the perspective of the reinsurer. The contract boundary is the same from each perspective because:

- When the cedant has a right to receive services, the reinsurer has an obligation to provide services
- When the cedant has an obligation to pay premiums, the reinsurer has a right to compel premiums

The submission to the IASB staff in September 2018 included an additional fact pattern in which there is (or there is not) a unilateral right for the reinsurer to amend the rate of the ceding commission it pays, in addition to unilateral termination rights. The IASB staff observed that in this fact pattern, the existence of the right to terminate the contract with a three month notice period determines the cash flows within the contract boundary regardless of the existence of a right to amend the rate of the ceding commission if the contract is not terminated. Therefore, the same accounting would apply to the additional fact pattern provided.

9.9.2 Issued adverse loss development covers

For reinsurance contracts which cover events that have already occurred, but for which the financial effect is uncertain, IFRS 17 states that the insured event is the determination of the ultimate costs of the claim. *[IFRS 17.B5]*.

Frequently asked questions

Question 9-28: How should insurance revenue and insurance service expenses be presented for insurance contracts acquired in conjunction with a business combination or similar acquisition in their settlement period. More specifically, should revenue reflect the entire expected claims or not?

(TRG meeting February 2018 - Agenda paper no. 07, Log S04)

The IASB staff stated that for insurance contracts that cover events that have already occurred but the financial effect of which is uncertain, the claims are incurred when the financial effect is certain. This is not when an entity has a reliable estimate if there is still uncertainty involved. Conversely this is not necessarily when the claims are paid if certainty has been achieved prior to settlement. Accordingly, insurance revenue would reflect the entire expected claims as the liability for remaining coverage reduces because of services provided. If some cash flows meet the definition of an investment component, those cash flows will not be reflected in insurance revenue or insurance service expenses.

This results in entities accounting differently for similar contracts, depending on whether those contracts are issued originally by the entity or whether the entity acquired those contracts in their settlement period. Assuming a long settlement period, the potential consequences of this distinction include:

- An entity applies the general model for contracts acquired in their settlement period because the period over which claims would develop is much longer than one year, whilst entities expect to apply the premium allocation approach for similar contracts that they issue.
- An entity recognises revenue for the contracts acquired in their settlement period over the period the claims are expected to develop, while revenue is not recognised over this period for similar contracts issued.

The TRG members observed that, although the requirements in IFRS 17 are clear, applying the requirements reflects a significant change from existing practice and this change results in implementation complexities and costs.

In May 2018, the IASB staff prepared an outreach report which included implementation concerns regarding the subsequent treatment of insurance contracts issued and acquired in their settlement period. Subsequently, the IASB decided not to change IFRS 17 for this issue but has amended IFRS 17 to provide transitional relief for these contracts when the modified retrospective approach (see section 17.4 below) or the fair value approach (see section 17.5 below) is applied.

This issue is not specific to reinsurance contracts issued, it is also relevant to direct adverse development covers issued.

How we see it

Some reinsurance contracts issued (as well as direct insurance contracts issued) may contain a mixture of both retrospective and prospective coverage. In these circumstances an entity would need to apply judgement as to: (i) the portfolio of contracts to which a contract with such a mixture should be allocated; and (ii) whether the legal contract containing both types of cover must be split into separate retrospective and prospective components, with each component allocated to different portfolios, applying the guidance discussed in section 6.1.1 above.

9.9.3 Accounting for ceding commissions and reinstatement premiums

Reinsurance contracts include common types of commissions due from a reinsurer to a cedant. These include both:

- Commissions that are not contingent on claims
- Commissions that are contingent on claims

Questions have arisen as to how these commissions should be accounted for in the financial statements of the reinsurer.

Frequently asked questions

Question 9-29: How should ceding commissions paid by the reinsurer to the cedant be treated in the reinsurer's statement of financial performance?

The submission considers whether the treatment is different for fixed commissions and commissions that are not fixed

(TRG meeting September 2018 - Agenda paper no. 03, Log S55)

The submission asked how the following should be accounted for in the financial statements of the reinsurer:

- Common types of commission due to the cedant
- Reinstatement premiums charged to the cedant in order to continue coverage following the occurrence of an insured event

The TRG members discussed the analysis in an IASB staff paper and observed that:

- The requirements in IFRS 17.86 for the presentation of income and expenses from reinsurance contracts held are based on the economic effects of exchanges between the reinsurer and the cedant and it would be appropriate to apply an assessment of the economic effect of such exchanges to reinsurance contracts issued as well.
- The economic effect of amounts exchanged between a reinsurer and a cedant that are not contingent on claims is equivalent to the effect of charging a different premium. Therefore, these amounts would be recognised as part of insurance revenue.
- The economic effect of amounts exchanged between a reinsurer and a cedant that are contingent on claims is equivalent to reimbursing a different amount of claims than expected. Therefore, these amounts would be recognised as part of insurance service expenses.
- Unless a cedant provides a distinct service to the reinsurer that results in a cost to the reinsurer for selling, underwriting and starting a group of reinsurance contracts that it issues, a ceding commission is not an insurance acquisition cash flow of the insurer. The IASB staff observed that, unlike insurance acquisition costs that are paid to a third-party intermediary, ceding commissions are paid by the reinsurer to the cedant who is the policyholder of the contract.
- Amounts exchanged between the reinsurer and the cedant that are not contingent on claims may meet the definition of an investment component if they are repaid to the cedant in all circumstances. However, an amount deducted from the initial premium up-front is not an investment component (although the impact on insurance revenue is the same).

The TRG members observed that applying the requirements in IFRS 17 for amounts exchanged between a reinsurer and a cedant has practical implications because the requirements are different from existing practice. The TRG members also observed that applying the requirements of IFRS 17 may affect key performance measures currently used to assess the performance of reinsurers.

- Applying the guidance above in practice to the reinsurer:
  - A ceding commission charged as a fixed amount or as a percentage of premiums on the underlying insurance contracts is a reduction in insurance revenue. If paid after the premium is received, the ceding commission may meet the definition of an investment component, provided the amounts are repaid to the policyholder in all circumstances.
  - A commission contingent on claims (i.e., excluding any minimum amounts that are, in effect, non-contingent, see Illustration 9-19 below) is part of claims and recognised as part of insurance service expenses.
  - A mandatory reinstatement premium contingent on a claim amount and settled net with the claims paid to the cedant is equivalent to reimbursing a different amount of claims to the cedant and should be recognised as part of insurance service expenses when incurred.
  - A voluntary reinstatement premium which is not contingent on claims (i.e., the cedant can decide not to pay the additional premium and the contract terminates) is equivalent to the effect of charging a higher premium to extend the contract coverage to an additional period, or higher level of exposure, and is recognised as insurance revenue. The IASB staff observed that when the reinsurer has no right to exit or reprice the contract (the reinstatement premium is at predetermined rates), the expected cash flows related to the reinstatement premium are within the boundary of the initial reinsurance contract and voluntary reinstatement premiums cannot be considered cash flows related to a future contract.

The following flow chart may assist in the assessment of how to account for exchanges between a reinsurer and a cedant.

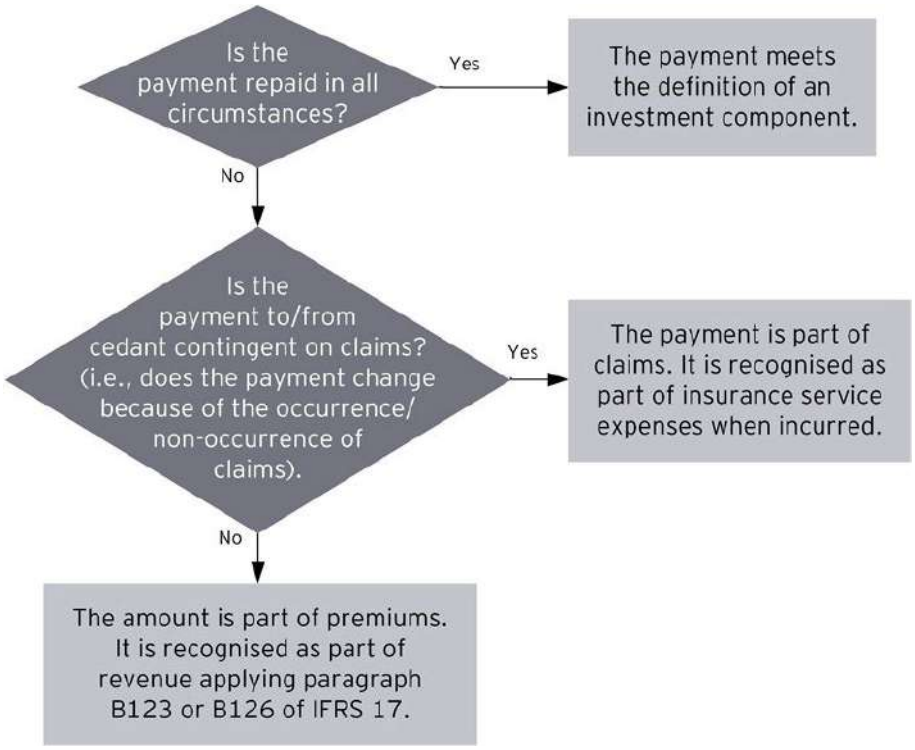


Illustration 9-19: Accounting for reinsurance commissions

Example 1

A reinsurer receives reinsurance premiums of CU6,000. The reinsurer is obligated to pay a ceding commission of 30% of the reinsurance premium (CU1,800). The premium is paid net of the ceding commission at initial recognition. No further ceding commission is payable.

As the ceding commission is charged as a fixed amount and not dependent on claims it is a reduction in insurance revenue. Insurance revenue is therefore CU4,200 (i.e., CU6,000 less CU1,800). The ceding commission is not an investment component because it is settled net of the premium at initial recognition.

Example 2

A reinsurer receives reinsurance premiums of CU6,000 at initial recognition. The reinsurer is obligated to pay a sliding scale ceding commission of between 20% and 40% of the reinsurance premium, contingent on the loss ratio of the contract. If the loss ratio is above 75% then there is a minimum commission of 20% (CU1,200) and if the loss ratio is below 55% there is a maximum commission of 40% (CU2,400). A provisional commission of CU1,800 is deducted from the premium of CU6,000 at initial recognition.

The maximum amount of the sliding scale commission of CU2,400 is not contingent on claims as it will always be received by the cedant as either a claim payment or a commission payment. Hence, insurance revenue is CU3,600 for this contract (i.e., CU6,000 less CU2,400). As in Example 1, the provisional commission of CU1,800 is not an investment component because it is settled net of the premium. The remaining commission amount of CU600 is treated as an investment component as it is repaid to the cedant at a future date after the premium has been paid.

Example 3

A reinsurer receives reinsurance premiums of CU1,000. The reinsurer is obligated to pay a profit commission of 25% (profit = reinsurance premium minus claims incurred by the reinsurer under the contract). Any profit commission amounts are paid at the end of the coverage period.

The maximum amount of the profit commission of CU250 (i.e., 25% of CU1,000) is not contingent on claims as it will always be received by the cedant either as a claim payment or a commission payment. Hence, insurance revenue is CU750 for this contract (i.e., CU1,000 less CU250). The maximum commission amount of CU250 is treated as an investment component as it is repaid to the cedant at a future date after the premium has been paid.

How we see it

During the TRG discussions, the IASB staff observed that the requirements for the presentation of income or expenses from reinsurance contracts held are based on the economic effect of exchanges between the reinsurer and the cedant. Therefore, the assessment of the economic effect of such exchanges included in the Illustration above would apply to both reinsurance contracts issued and reinsurance contracts held.

9.9.4 Determining the quantity of benefits for identifying coverage units

As discussed in section 9.7.1 above, the question of how to determine the quantity of benefits for coverage units was discussed by the TRG in both February 2018 and May 2018. In May 2018, the TRG analysed an IASB staff paper that contained the IASB staff's views on sixteen examples of different types of insurance contracts.

The following Illustrations apply the principles discussed in section 9.7.1 above to specific fact patterns for reinsurance contracts issued.

Illustration 9-20: Proportional reinsurance issued

A reinsurance contract issued provides proportional cover for underlying contracts issued during the contract period. The reinsurance contract issued is for a period of one year. Underlying contracts are written uniformly throughout the year and are annual policies that are reasonably homogenous and provide relatively even cover over their one-year coverage periods.

Applying the principles in section 9.7.1 above, the expected coverage duration of the reinsurance contract issued is two years. This is because the reinsurer has a substantive obligation to provide services under the contract for a period of two years as the risks attaching over a single policy year will cover two years of exposure to risk. A valid method for determining the quantity of benefits (over which to amortise the contractual service margin) is the amount for which the policyholder has the ability to make a valid claim. This is because the pattern of coverage should reflect the expected pattern of underwriting of the underlying contracts because the level of service provided depends on the number of underlying contracts in-force. Therefore, the more contracts in-force, the higher the level of service.

Illustration 9-21: Reinsurance adverse development of claims with claim limit

A reinsurance adverse development cover contract will pay claims in excess of a stated aggregate amount on a group of underlying property and casualty contracts where the claim event has already occurred. There is a total aggregate limit to the amount payable under the contract. Because there is uncertainty in the ultimate amount and timing of the final settlements of the underlying claims, the insured event is the determination of the ultimate cost of settling those claims.

Applying the principles in section 9.7.1 above, the expected coverage duration would be the period from inception of the contract to the time at which the limit of cover is expected to be reached, adjusted for expected lapses, if any. Valid methods for determining the quantity of benefits (for amortising the contractual service margin) are:

- Comparing the contractual maximum amount that could have been claimed in the period with the remaining contractual maximum amount that can be claimed as a constant amount for each future coverage period

  Or

- Comparing the expected amount of underlying claims covered in the period with the expected amount of underlying claims remaining to be covered in future periods

A straight-line method over the expected coverage duration might not be valid because it would not reflect the different levels of cover provided across periods.

Illustration 9-22: Reinsurance adverse development of claims without claim limit

A reinsurance adverse development cover contract will pay claims in excess of a stated aggregate amount on a group of underlying property and casualty contracts where the claim event has already occurred. There is no total aggregate limit to the amount payable under the contract. Because there is uncertainty in the ultimate amount and timing of the final settlements of the underlying claims, the insured event is the determination of the ultimate cost of settling those claims.

Applying the principles in section 9.7.1 above, the expected coverage duration would be the period to when the financial effect of the claims becomes certain. This may be before the claims are paid if certainty has been achieved prior to the actual payment. An entity will need to estimate the expected duration of the period in which claims will be made and payments will be made to estimate the fulfilment cash flows. Valid methods for determining the quantity of benefits are:

- Equal benefits in each coverage period, which would end at the date of the last expected settlement payment

  Or

- Compare the expected amount of underlying claims covered in the period with the expected amount of underlying claims remaining to be covered in future periods

  Or

- If the underlying claims were of equal size, comparing the number of underlying claims covered in the period with the number of underlying claims remaining to be covered in future periods

9.10 Impairment of assets recognised for insurance acquisition cash flows

As discussed in section 7.3 above, an entity must recognise as an asset insurance acquisition cash flows paid (or insurance acquisition cash flows for which a liability has been recognised under another IFRS accounting standard) before the related group of insurance contracts is recognised.

As a result, IFRS 17 requires an entity to assess the recoverability of any insurance acquisition cash flow asset recognised before the related group of insurance contracts is recognised at the end of each reporting period, if facts and circumstances indicate the asset may be impaired. If an entity identifies an impairment loss, the entity must adjust the carrying amount of the asset and recognise any impairment loss identified in profit or loss. If an impairment loss is reversed, an entity must adjust the carrying amount of the asset and recognise the reversal of any such loss in profit or loss. *[IFRS 17.28E, IFRS 17.28F]*.

In assessing the recoverability: *[IFRS 17.B35D]*

- An entity must recognise that impairment loss in profit or loss and reduce the carrying amount of an asset for insurance acquisition cash flows so that the carrying amount of each asset does not exceed the expected net fulfilment cash inflows (see section 9.2 above) for the related group of insurance contracts.
- When an entity allocates insurance acquisition cash flows to groups of insurance contracts that will include insurance contracts that are expected to arise from renewals of the insurance contracts in that group, the entity must recognise an impairment loss in profit or loss and reduce the carrying amount of the related assets for insurance acquisition cash flows to the extent that:
  - The entity expects those insurance acquisition cash flows to exceed the net fulfilment cash inflows for the expected renewals
  - The excess determined in the preceding bullet point has not already been recognised as an impairment loss applying the requirements above for assets directly attributable to a group

An entity must recognise in profit or loss a reversal of some or all of an impairment loss previously recognised applying the requirements above and increase the carrying amount of the asset, to the extent that the impairment conditions no longer exist or have improved. *[IFRS 17.28F]*.

It is observed in the Basis for Conclusions that the impairment test is intended to be consistent with the impairment test for capitalised contract costs in IFRS 15 (see Chapter 28 at section 9.3.4) and therefore an entity recognises an impairment loss in profit or loss and reduces the carrying amount of an asset for insurance acquisition cash flows so that it does not exceed the expected net cash inflow for the related group. *[IFRS 17.BC184J]*.

The Basis for Conclusions also observes that an asset for insurance acquisition cash flows is measured at a group level. An impairment test at a group level compares the carrying amount of an asset for insurance acquisition cash flows allocated to a group with the expected net cash inflow of the group. That net cash inflow includes cash flows for contracts unrelated to any expected renewals but expected to be in that group. The Board, therefore, decided to require an additional impairment test specific to cash flows for expected renewals. The additional impairment test results in the recognition of any impairment losses when the entity no longer expects the renewals supporting the asset to occur or expects the net cash inflows to be lower than the amount of the asset. Without the additional impairment test, cash flows unrelated to any expected renewals might prevent the recognition of such an impairment loss. *[IFRS 17.BC184K]*.

Illustration 9-23: Applying the two impairment tests for an insurance acquisition cash flow asset

At the beginning of Year 1 an entity pays commissions of CU38 relating to a group of contracts yet to be issued. Those commissions meet the definition of insurance acquisition cash flows.

The commissions are directly attributable to insurance contracts the entity expects to issue later in Year 1 (Group 1). The entity expects that some policyholders of those insurance contracts that will be issued in Year 1 will renew those contracts in Year 2 (Group 2), Year 3 (Group 3) and Year 4 (Group 4). Accordingly, at the beginning of Year 1, the entity allocates the commissions of CU38 on a systematic and rational basis to the expected future groups of insurance contracts as follows:

- Group 1 - CU25
- Group 2 - CU5
- Group 3 - CU5
- Group 4 - CU3

The entity recognises an asset for insurance acquisition cash flows of CU38 at the beginning of Year 1.

At the end of Year 1, the entity derecognises the asset of CU25 allocated to Group 1 and includes the insurance acquisition cash flows in the measurement of Group 1. At the end of Year 1, there are no facts and circumstances indicating that the assets for insurance acquisition cash flows allocated to each of Groups 2 to 4 may be impaired. Therefore, at the end of Year 1, the carrying amount of the asset for insurance acquisition cash flows is CU13 (i.e., CU5 + CU5 + CU3 as per above).

At the end of Year 2, the entity derecognises the asset of CU5 allocated to Group 2 and includes the insurance acquisition cash flows in the measurement of Group 2. At the end of Year 2, facts and circumstances indicate that the asset for insurance acquisition cash flows for Groups 3 and 4 may be impaired. The carrying amount of the asset for insurance acquisition cash flows subject to impairment testing is CU8 (i.e., CU5 + CU3 as per above).

To perform the impairment tests the entity estimates the following amounts:

	Year 3 (Group 3)	Year 4 (Group 4)
	CU	CU
Expected net fulfilment cash inflows		
Expected renewals	3	1
Other than renewals (new contracts to be issued)	6	1
Total expected net cash inflows	9	2
Asset for insurance acquisition cash flows	5	3
Impairment	-	**(1)**

Applying the additional impairment test specific to insurance acquisition cash flows allocated to expected contract renewals, the entity compares the amount of insurance acquisition cash flows allocated to expected renewals to the total expected net cash inflows for those expected renewals, as follows:

	Year 3 (Group 3)	Year 4 (Group 4)	Total
	CU	CU	CU
Expected net fulfilment cash inflows			
Amount of insurance acquisition cash flows allocated to expected renewals	5	3	8
Expected net cash inflows for expected renewals	3	1	4
Impairment			**(4)**

Accordingly, the entity recognises an expense in profit or loss an impairment of CU4 comprising of: *[IFRS 17.B35D]*

- CU1 identified applying IFRS 17.B35D(a)

  And

- CU4 identified applying IFRS 17.B35D(b)(i) less CU1 already identified above applying IFRS 17.B35D(ii)

After recognising the total impairment loss of CU4, the entity will allocate the total amount of insurance acquisition cash flows remaining in assets of CU4 to groups of contracts still to be recognised (Group 3 and Group 4) on a systematic and rational basis.

How we see it

As discussed in sections 7.3 and 9.1.3 above, IFRS 17 does not contain specific requirements for how to allocate the acquisition cash flows to different (future) groups of insurance contracts on a systematic and rational basis. Therefore, determining such an allocation will be a matter of judgement based on facts and circumstances.

The standard requires that an entity revises the amounts of the asset for insurance acquisition cash flows allocated to each (future) group of insurance contract according to the applied systematic and rational method. The impairment test for the insurance acquisition cash flows allocated to a (future) group would be applied after carrying through any revised allocation. Such revised allocation may reduce the risk of an impairment of the amount of insurance acquisition cash flows allocated to a particular (future) group, although the entity would have to perform any revisions consistent with the systematic and rational basis for allocation.

9.11 Insurance contracts issued by mutual entities

A mutual entity accepts risks from each policyholder and pools those risks. However, a defining feature of a mutual entity is that the most residual interest of the entity is due to a policyholder and not to a shareholder. Thus, the fulfilment cash flows of an insurer that is a mutual entity generally include the rights of policyholders to the whole of any surplus of assets over liabilities. This means that, for an insurer that is a mutual entity, there must, in principle, normally be no equity remaining and no net comprehensive income reported in any accounting period. *[IFRS 17.BC265]*. In addition, the Basis for Conclusions clarifies that not all entities that may be described as mutual entities have the feature that the most residual interest of the entity is due to a policyholder. *[IFRS 17.BC265fn33]*.

Payments to policyholders with a residual interest in a mutual entity vary depending on the returns on underlying items - the net asset of the mutual entity. These cash flows (i.e., the payments that vary with the underlying items) are within the boundary of an insurance contract. *[IFRS 17.B65(c)]*. Although policyholders with a residual interest in the entity bear the pooled risk collectively, the mutual, as a separate entity has accepted risk from each individual policyholder and therefore the risk adjustment for non-financial risk for these contracts reflects the compensation the mutual entity requires for bearing the uncertainty from non-financial risk in those contracts. However, because the net cash flows of the mutual entity are returned to policyholders, applying IFRS 17 to contracts with policyholders with a residual interest in the mutual entity will result in no contractual service margin for those contracts.

Mutual entities may also issue insurance contracts that do not provide the policyholder with a residual interest in the mutual entity. Consequently, groups of such contracts are expected to have a contractual service margin. Determining whether a contract provides the policyholder with a residual interest in the mutual entity requires consideration of all substantive rights and obligations.

The IASB also suggested that to provide useful information about its financial position a mutual can distinguish between: *[IFRS 17.BC269]*

- Liabilities attributable to policyholders in their capacity as policyholders
- Liabilities attributable to policyholders with the most residual interest in the entity

The statement of financial performance could include a line item "income or expenses attributable to policyholders in their capacity as policyholders before determination of the amounts attributable to policyholders with the most residual interest in the entity".

The IASB decided not to develop specific guidance for, or defining mutual entities because: *[IFRS 17.BC269B]*

- A core principle of IFRS 17 is the requirement to include in the fulfilment cash flows all the expected future cash flows that arise within the boundary of insurance contracts, including discretionary cash flows and those due to future policyholders
- If entities were required to account for the same insurance contract differently depending on the type of entity issuing the contract, comparability among entities would be reduced
- A robust definition of a mutual entity to which different requirements would apply would be difficult to create

9.12 Amounts receivable from an intermediary

Most insurers use intermediaries as a link between them and a policyholder to arrange an insurance contract. In many of these arrangements, the policyholder pays the cash premiums to the intermediary but the contract between the insurer and the intermediary allows the intermediary to pay the premiums to the insurer at a later date. In some situations, when the policyholder has paid the premiums to the intermediary, the policyholder has not discharged its obligation to the insurer. In other situations, when the policyholder has paid the premiums to the intermediary, the policyholder has discharged its obligation under the insurance contract and the insurer is obliged to provide insurance contract services to the policyholder. Normally, if the policyholder has discharged its obligation under the insurance contract and the intermediary fails to pay the premiums to the insurer, the insurer does not have the right to recover the premiums from the policyholder, or to cancel the insurance contract. IFRS 17 is silent on whether future cash flows within the boundary of an insurance contract are removed from the measurement of a group of insurance contracts only when these cash flows are recovered or settled in cash.

Frequently asked questions

Question 9-30: Are premiums receivable from an intermediary when a policyholder has discharged its obligation to an insurer within the scope of IFRS 9 or IFRS 17?

In September 2023, the IFRS IC discussed two submissions that asked how an entity that issues insurance contracts (insurer) applies the requirements in IFRS 17 and IFRS 9 to premiums receivable from an intermediary.

In the fact pattern described in the requests, an intermediary acts as a link between an insurer and a policyholder to arrange an insurance contract between them. The policyholder has paid in cash the premiums to the intermediary, but the insurer has not yet received in cash the premiums from the intermediary. The agreement between the insurer and the intermediary allows the intermediary to pay the premiums to the insurer at a later date.

When the policyholder paid the premiums to the intermediary, the policyholder discharged its obligation under the insurance contract and the insurer is obliged to provide insurance contract services to the policyholder. If the intermediary fails to pay the premiums to the insurer, the insurer does not have the right to recover the premiums from the policyholder, or to cancel the insurance contract.

The requests asked whether, in the submitted fact patterns, the premiums receivable from the intermediary are future cash flows within the boundary of an insurance contract and included in the measurement of the group of insurance contracts applying IFRS 17 or are a separate financial asset applying IFRS 9. The requests set out two views.

Under the first view (View 1), the insurer determines that the premiums receivable from the intermediary are future cash flows within the boundary of an insurance contract. Applying View 1, when the policyholder pays the premiums to the intermediary:

- For a group of contracts to which the premium allocation approach does not apply, the insurer continues to treat the premiums receivable from the intermediary as future cash flows within the boundary of an insurance contract and, applying IFRS 17, include them in the measurement of the group of insurance contracts until recovered in cash.

  And

- For a group of contracts to which the premium allocation approach applies, the insurer does not increase the liability for remaining coverage-it does so only when it recovers the premiums in cash from the intermediary.

Under the second view (View 2), because the payment by the policyholder discharges its obligation under the insurance contract, the insurer considers the right to receive premiums from the policyholder to be settled by the right to receive premiums from the intermediary. The insurer therefore determines that the premiums receivable from the intermediary are not future cash flows within the boundary of an insurance contract but, instead, a separate financial asset. Applying View 2, when the policyholder pays the premiums to the intermediary:

- For a group of contracts to which the premium allocation approach does not apply, the insurer removes the premiums from the measurement of the group of insurance contracts and, applying IFRS 9, recognises a separate financial asset.

  And

- For a group of contracts to which the premium allocation approach applies, the insurer increases the liability for remaining coverage and, applying IFRS 9, recognises a separate financial asset.

Applying the requirements in IFRS accounting standards

The Committee observed that IFRS 17 is the starting point for an insurer to consider how to account for its right to receive premiums under an insurance contract.

Paragraph 33 of IFRS 17 requires an insurer to include in the measurement of a group of insurance contracts an estimate of all the future cash flows within the boundary of each contract in the group. Paragraph B65 explains that cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract, including premiums from a policyholder.

The Committee observed that paragraph B65 of IFRS 17 does not distinguish between premiums to be collected directly from a policyholder and premiums to be collected through an intermediary. In applying IFRS 17, premiums from a policyholder collected through an intermediary are therefore included in the measurement of a group of insurance contracts.

Paragraph 34 of IFRS 17 specifies that cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with insurance contract services.

In the fact pattern described in the requests, the insurer has not recovered the premiums in cash, but the policyholder has discharged its obligation under the insurance contract. The Committee observed that IFRS 17 is silent on whether future cash flows within the boundary of an insurance contract are removed from the measurement of a group of insurance contracts only when these cash flows are recovered or settled in cash.

Therefore, the Committee observed that, in accounting for premiums receivable from an intermediary when payment by the policyholder discharges the policyholder's obligation under the insurance contract, an insurer develops and applies an accounting policy in accordance with IAS 8 to determine that:

- Cash flows are removed when the cash flows are recovered or settled in cash (View 1)

  Or

- When the policyholder's obligation under the insurance contract is discharged (View 2)

IFRS 17 and IFRS 9 deal differently with the measurement, presentation and disclosure of expected credit losses from premiums receivable from an intermediary. The Committee considered that, depending on which view (View 1 or View 2) an insurer applies, it is required to apply all the measurement and disclosure requirements in the applicable IFRS accounting standards. Therefore, an insurer applies either IFRS 17 (including paragraph 131 that requires disclosure of information about the credit risk that arises from contracts within the scope of IFRS 17) or IFRS 9 (and the requirements in IFRS 7) to the premiums receivable from an intermediary.

Conclusion

In light of its analysis, the Committee considered whether to recommend that the IASB considers adding a standard-setting project on when cash flows are removed from the measurement of a group of insurance contracts to the work plan. The Committee noted that any such project would involve assessing whether changes to the Standards would have unintended consequences. This assessment may take considerable time and effort to complete because it would involve, among other steps, analysing a broad range of contracts (not only those set out in the fact pattern described in the requests). The Committee observed that the application of either View 1 or View 2 when accounting for premiums paid by a policyholder and receivable from an intermediary would provide users of financial statements with useful information based on the requirements in IFRS 17 or IFRS 9.

Consequently, the Committee concluded that a project would not be sufficiently narrow in scope that the IASB or the Committee can address it in an efficient manner. The Committee therefore decided not to recommend that the IASB considers adding a standard-setting project to the work plan.[9] At its October 2023 meeting, the IASB discussed and did not object to, the agenda decision.

9 *IFRIC Update*, September 2023, *Addendum to IFRIC Update-Committee's agenda decisions*. Available on the IFRS Foundation's website.

How we see it

When a policyholder has paid premiums to an intermediary but has not discharged its obligation to an insurer until the intermediary has remitted the premiums to the insurer, the premium receivables remain in the scope of IFRS 17. This is because, the right to receive premiums from the policyholder has not been settled by the right to receive premiums from the intermediary and the conditions underlying View 2 above have therefore not been satisfied.

Other receivables due from intermediaries, such as amounts withheld to pay future claims or loans made by the insurer to the intermediary are within the scope of IFRS 9 since no obligation to the policyholder has been settled.

9.13 Other matters

9.13.1 Impairment of insurance receivables

IFRS 17 does not refer to impairment of insurance receivables (e.g., amounts due from policyholders or agents in respect of insurance premiums).

A premium receivable (including premium adjustments and instalment premiums) is a right arising from an insurance (or reinsurance) contract. Rights and obligations under contracts within the scope of IFRS 17 are excluded from the scope of IFRS 9 (see section 2.3 above). As a premium receivable is a cash flow it is measured on an expected present value basis (see section 9.2 above) which must include an assessment of credit risk. This cash flow is remeasured at each reporting date. Receivables from insurance contracts are not required to be disclosed separately on the statement of financial position but are subsumed within the overall insurance contract balances (see section 15 below).

9.13.2 Policyholder loans

Some insurance contracts permit the policyholder to obtain a loan from the insurer with the insurance contract acting as collateral for the loan. Under IFRS 4, policyholder loans may have been separated from insurance contract balances and shown as separate assets. IFRS 17 regards a policyholder loan as an example of an investment component with interrelated cash flows which is not separated from the host insurance contract. *[IFRS 17.BC114]*. Consequently, a policyholder loan is included within the overall insurance contract balance and is part of the fulfilment cash flows (and is not within the scope of IFRS 9).

The repayment or receipt of amounts lent to and repaid by policyholders does not give rise to insurance revenue (see section 15.1 below). However, the contractual service margin is adjusted for any difference between a loan to a policyholder expected to become payable or repayable in a period and the actual loan that becomes payable or repayable in a period, after adjusting for insurance finance income or expense related to that expected payment or repayment before it becomes payable or repayable (see section 9.6.3 above).

A waiver of a loan to a policyholder would be treated the same way as any other claim.

There may be situations when an insurance policy is collateral for a stand-alone loan, not stemming from the contractual terms of an insurance contract and not highly interrelated with an insurance contract. Such a loan would be within the scope of IFRS 9.

10 Premium allocation approach

The premium allocation approach is an optional simplified form of measuring an eligible group of insurance contracts issued, reinsurance contracts issued or reinsurance contracts held. The eligibility is assessed for each group of insurance contracts and the election is made for each eligible group. However, the ability to use the premium allocation approach for reinsurance contracts held must be assessed separately from the use of the premium allocation approach for the related underlying insurance contracts covered by reinsurance (see section 11.6 below).

The IASB considers the premium allocation approach similar to the customer consideration approach in IFRS 15. *[IFRS 17.BC289]*. Therefore, compared to the general model, using the premium allocation approach results in a simpler accounting method is:

- The premium allocation approach does not require separate identification of the elements (i.e., the four building blocks, see section 8.1 above) of the general model until a claim is incurred. Only a total amount for a liability for remaining coverage on initial recognition is determined (see section 10.3 below).
- After initial recognition, the liability for remaining coverage is recognised over the coverage period on the basis of the passage of time unless the expected pattern of release from risk differs significantly from the passage of time, in which case, it must be recognised based on the expected timing of incurred claims and benefits (see section 10.4 below).
- An entity need only assess whether a group of insurance contracts is onerous if facts and circumstances indicate that the group is onerous. In contrast, the general model requires an assessment of whether a group of contracts is onerous at each reporting date after the initial recognition of a group (see section 9.8 above). The carrying amount of the liability for remaining coverage under the premium allocation approach will be the same as under the general model for groups of contracts that are onerous.
- An entity also has certain accounting elections available once an entity decides to use the premium allocation approach for a group of insurance contracts (see section 10.2 below).

How we see it

The premium allocation approach is intended to produce an accounting outcome similar to that of the unearned premium approach used by many non-life or short-duration insurers under IFRS 4. The results from this approach are therefore likely to be more readily understood within the context of many short-duration contracts. However, there are some important differences:

- The liability for remaining coverage is measured using premiums received minus any insurance acquisition cash flows at the measurement date. The word 'received' is interpreted literally, rather than interpreted to mean amounts due (see section 10.3 below). Under IFRS 4, the unearned premium provision would have often been set up based on premiums receivable, with a separate asset recorded for the premium receivable.
- No separate asset is recognised for deferred acquisition costs, except for those assets in respect of insurance acquisition cash flows paid before the related group of insurance contracts is recognised (see section 7.3 above). Instead, any acquisition cash flows are subsumed within the liability for remaining coverage, unless the entity elects to expense insurance acquisition cash flows (see section 10.1 below).
- Most non-life or short-duration insurers would not have discounted their insurance liabilities under IFRS 4.
- The fulfilment cash flows model required for incurred claims, which is the same as the general model except for a simplification in respect of the time value of money (see section 10.5 below), is likely to be different than the incurred claim model used under IFRS 4.

10.1 Criteria for use of the premium allocation approach

The premium allocation approach is permitted if, and only if, at the inception of the group of contracts, one of the following conditions are met: *[IFRS 17.53]*

- The entity reasonably expects that such simplification would produce a measurement of the liability for remaining coverage for the group that would not differ materially from the measurement that would be produced applying the requirements for the general model discussed in section 7 above (i.e., the fulfilment cash flows related to future service plus the contractual service margin).

  OR

- The coverage period of each contract in the group (including insurance contract services arising from all premiums within the contract boundary determined at that date applying the requirements discussed in section 9.1 above) is one year or less.

The second condition means that all contracts with a coverage period of one year or less qualify for the premium allocation approach, regardless of whether the first condition is met. However, for insurance contracts with a coverage period greater than one year (e.g., long-term construction insurance contracts, long-term disability insurance contracts or extended warranty-type contracts), entities will need to apply judgement in interpreting the meaning of 'that would not differ materially' (see section 10.1.2 below).

The first criterion above is not met if, at the inception of the group of contracts, an entity expects significant variability in the fulfilment cash flows that would affect the measurement of the liability for the remaining coverage during the period before a claim is incurred. Variability in the fulfilment cash flows increases with, for example: *[IFRS 17.54]*

- The extent of future cash flows related to any derivatives embedded in the contracts
- The length of the coverage period of the group of contracts

A discussion identifying the main sources of variability between the premium allocation approach and the general model is included in section 10.1.1 below. A discussion of the meaning of 'differ materially in these circumstances' is included in section 10.1.2 below.

Frequently asked questions

Question 10-1: Is an entity required or permitted to reassess a contract's eligibility for the premium allocation approach and as a result to revoke its election to apply the approach?

(TRG meeting April 2019 - Agenda paper no. 2, Log S123)

No. An entity may apply the premium allocation approach to some insurance contracts provided that certain criteria are met at inception. As required by IFRS 17.53, the criteria are assessed for each group and the election is made for each group meeting the criteria. Given the eligibility criteria are assessed *at inception*, the standard does not require or permit reassessment of the eligibility criteria or the election to apply the approach subsequent to initial recognition.

If an entity applied the premium allocation approach to a contract that is subsequently modified to such an extent that the contract no longer meets the eligibility criteria, the entity must derecognise the original contract and recognise the modified contract as a new contract, applying IFRS 17 or other applicable standards. *[IFRS 17.72(c)]*.

How we see it

The eligibility criteria required for use of the premium allocation approach under IFRS 17 means that not all contracts regulated as 'non-life' or 'short-duration' by local regulators will qualify for that approach.

Contracts with a coverage period of one year or less are always eligible for the premium allocation approach. Those with a coverage period of more than a year may also be eligible. However, an entity must determine, at inception of a group of contracts, that the measurement of the liability for remaining coverage at each reporting date measured under the premium allocation approach will not be materially different from the outcome under the general model.

IFRS 17 does, in principle, not prohibit an entity from applying the premium allocation approach to eligible groups of contracts that would otherwise be required to apply the variable fee approach. However, the situations where such variable fee contracts would be eligible is likely to be limited to groups of contracts with a coverage period of one year or less. For groups of contracts with a coverage period of more than a year it will be very difficult to demonstrate that the outcome under the premium allocation approach will not be materially different from that under the variable fee model given the specific nature of contracts with direct participation features.

10.1.1 Main sources of difference between the premium allocation approach and the general approach

The first criterion for use of the premium allocation approach discussed in section 10.1 above involves a comparison of the liability for remaining coverage under the general model and the premium allocation approach over the expected period of the liability for remaining coverage. This assessment is made at inception and is not reassessed subsequently.

Under all situations the liability for incurred claims is the same between the premium allocation approach and general model. This means that after the coverage period has expired there will be no difference between the two approaches, unless the election not to discount incurred claims, discussed in section 10.2 below, is used. However, several situations exist under which the premium allocation approach and the general model could produce different measurements for the liability for remaining coverage during the coverage period, and therefore could impact the eligibility of the premium allocation approach. These must be considered when designing the approach used for assessing the applicability of the premium allocation approach. Three examples of potential sources of differences are, as follows:

- Changing expectations of profitability for the period of remaining coverage - see section 10.1.1.A below
- Changing interest rates - see section 10.1.1.B below
- Uneven revenue recognition - see section 10.1.1.C below

10.1.1.A Changing expectations of profitability for the period of remaining coverage

When the expectation of the remaining profitability changes during the coverage period of a group of insurance contacts, so that it is still profitable, the results can differ under the premium allocation approach and general model. In this situation, the premium allocation approach will not recognise this improvement or deterioration in profitability in an explicit way until the exposure is earned, whereas the general model will recognise a portion of this change in expectations now through the unwinding of the contractual service margin even though the exposure has not yet been earned.

The significance of this difference will vary depending on how likely it is that the expected profitability of the remaining coverage might change and how much it may vary by. However, if the change in expectation of future profitability is to such an extent that the contract becomes onerous under the general model, then both approaches will give the same results.

10.1.1.B Changing interest rates

Under the premium allocation approach, if there is a significant financing component, an amount should be included for accretion of interest although this is based on the interest rate at the date of initial recognition of the group (see section 9.3 above). As a result, the premium allocation approach never considers the current interest rates for the liability for remaining coverage, unlike the general model. So, if the discount rate changes significantly from the initial recognition of the contract this will result in a difference in the liability for remaining coverage between the premium allocation approach and the general model. The impact of this difference and its significance will depend on various factors including how large the discounting impact was originally, how large a change might reasonably be expected in the currency of the liabilities during the coverage period and the length of term of the liabilities. Longer-tailed contracts are more likely to be affected by discounting than shorter-tailed contracts.

10.1.1.C Uneven revenue recognition patterns

Under the premium allocation approach, revenue is based on the passage of time or expected pattern of release of risk (see section 10.4 below). However, under the general model, the contractual service margin is allocated based on coverage units reflecting the expected quantity of benefits and duration of each group of insurance contracts (see section 9.7 above).

One example of where differences in revenue recognition between the two approaches could occur is for contracts in which the claims vary due to seasonality, and therefore the timing of claims occurring would not be evenly spread over coverage period based on the passage of time. This could arise if the release of risk is 'significantly different from the passage of time'. For example, property insurance contracts exposed to catastrophes tend to have uneven earnings patterns.

Illustration 10-1: Comparison of the liability for remaining coverage under the general model and the premium allocation approach when there are changes in expected cash flows

Consider a group of contracts measured in accordance with the general model. A premium of CU2,000 is received at the beginning of a two-year coverage period. The entity estimates fulfilment cash flows in years 1 and 2 will be CU900 each year. The opening contractual service margin is CU200 [CU2,000 - CU900 - CU900 = CU200] (for illustration purposes, discount and risk adjustment are ignored).

The entity incurs claims in year one, as expected, of CU900. At the end of year one, the entity assumes that cash flows in the following year of coverage will increase from the previous estimate of CU900 to CU950. In terms of IFRS 17.44(c), this change in the fulfilment cash flows relates to future services and consequently reduces the contractual service margin from CU200 to CU150. The amount recognised as insurance revenue because of the transfer of services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period applying IFRS 17.B119 amounts to CU75 (CU150 ÷ 2).

	Contractual service margin
	CU
At beginning of year 1	200
Adjustment for future service	(50)
Allocation to profit or loss	(75)
At the end of year 1	**75**

The liability for remaining coverage at the end of year 1, in accordance with the general model, would be CU950 + CU75 = CU1,025.

Revenue in year 1 would be CU975 [expected insurance service expense of CU900 + release of the contractual service margin of CU75]. Revenue in year 2 would be CU1,025 [expected insurance service expense of CU950 + release of the contractual service margin of CU75].

If the entity had applied the premium allocation approach, it would have allocated CU1,000 to profit or loss in year 1 (assuming that the expected release of risk would still not be differing significantly from the release of risk at the end of year 1) as revenue and the liability for remaining coverage at the end of year 1 would be CU1,000, i.e., a different amount compared with the general model.

This example illustrates that requirement in the general model to allocate an amount of the contractual service margin in profit or loss after making adjustments for changes in expected cash flows relating to future service can cause the liability for remaining coverage (in accordance with the general model) to differ from the liability for remaining coverage (in accordance with the premium allocation approach).

10.1.2 Applying materiality for the premium allocation approach eligibility assessment

In order to qualify for the premium allocation approach under the first criterion in section 10.1 above, the measurement for the liability for remaining coverage must not 'differ materially' from that produced applying the general model. Materiality is defined in IAS 1 and IAS 8 (by cross reference to IAS 1) as follows: *[IAS 1.7, IAS 8.5]*

Extract from IAS 1

7 The following terms are used in this Standard with the meanings specified:

...

Material:

Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.

...

In addition to the general requirements of IAS 1 and IAS 8, there are specific materiality requirements in IFRS 17. Eligibility for the application of the premium allocation approach must be assessed for each group of insurance contracts, *[IFRS 17.53],* and therefore materiality is considered at the group of contracts level. If the measurement of the liability for remaining coverage is not materially different for a group of insurance contracts measured using the premium allocation approach compared to that calculated using the general model in a range of scenarios that have a reasonable possibility of occurring, then the premium allocation approach can be adopted for that particular group.

How we see it

As IFRS 17 does not contain any further specific guidance on how to determine whether outcomes are materially different, judgement will need to be applied in setting the thresholds and determining how these thresholds are applied.

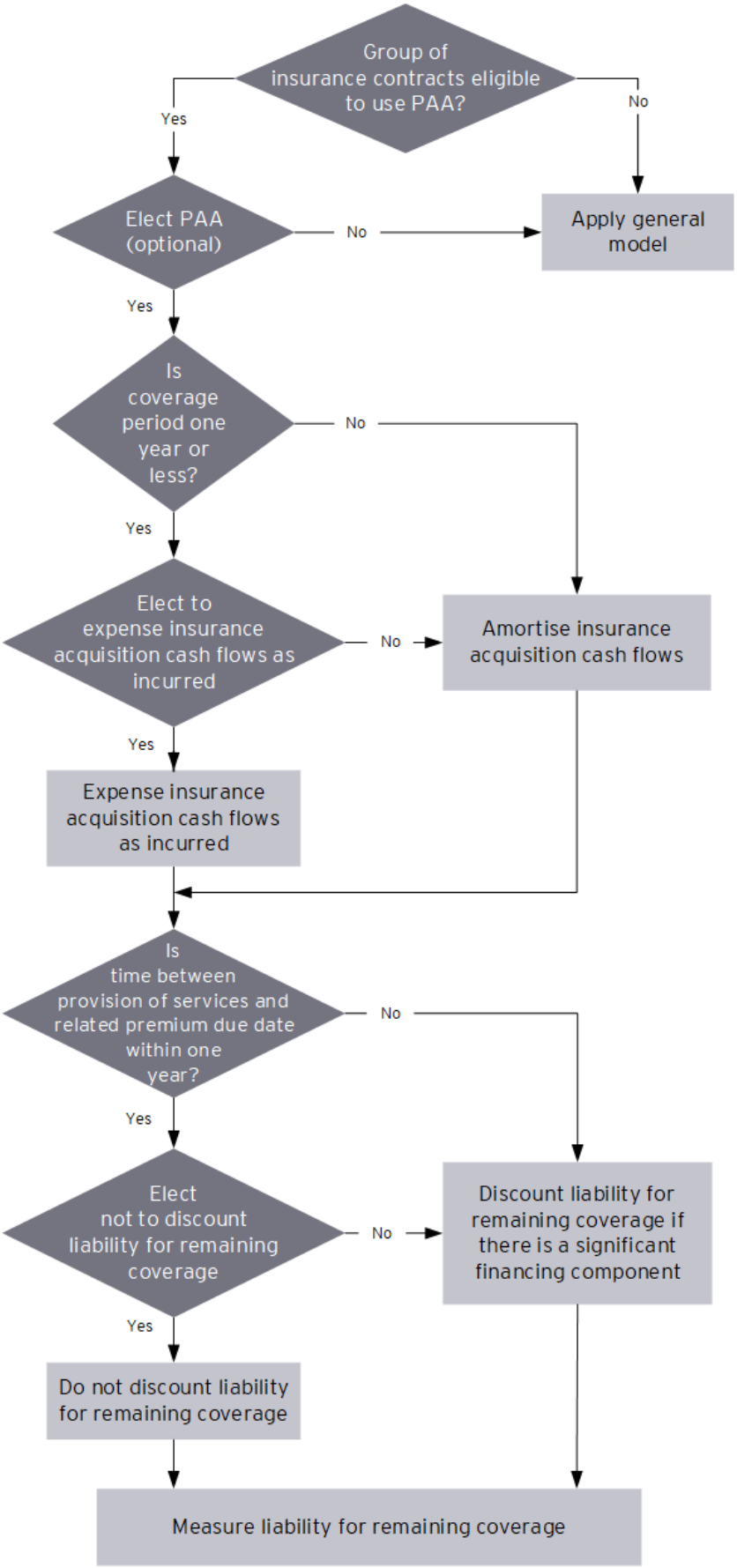
IFRS 17 also does not contain any specific guidance on what 'reasonably expects' entails. Therefore, an entity needs to apply judgement in identifying the range of relevant scenarios within the context of the specific features and circumstances of the group (e.g., duration of the contracts, expected profitability, volatility of profitability, earnings pattern, payment pattern, currency, etc.). The future scenarios should reflect the variability in the fulfilment cash flows the entity expects that would affect the measurement of the liability for remaining coverage during the period before a claim is incurred.

10.2 Elections under the premium allocation approach

Once an entity decides to use the premium allocation approach for a group of contracts, the following elections are available for the group, in certain circumstances:

- Whether to recognise insurance acquisition cash flows as an expense when it incurs those costs or to include those cash flows within the liability for remaining coverage (and hence amortise those cash flows over the coverage period). An entity is able to recognise insurance acquisition cash flows as an expense when it incurs those costs, provided that the coverage period of each contract in the group on initial recognition is no more than one year. Otherwise, acquisition cash flows must be included within the liability for remaining coverage. *[IFRS 17.59(a)]*.
- Whether or not to adjust the liability for remaining coverage to reflect the time value of money and the effect of financial risk. An entity is not required to adjust the liability for remaining coverage to reflect the time value of money and the effect of financial risk if, at initial recognition, the entity expects that the time between providing each part of the services and the related premium due date is no more than one year. Otherwise, the liability for remaining coverage must be adjusted to reflect the time value of money and the effect of financial risk using the discount rates as determined on initial recognition if the insurance contracts in the group have a significant financing component. *[IFRS 17.56]*.
- Whether or not adjust the liability for incurred claims for the time value of money and the effect of financial risk if those cash flows are expected to be paid or received within one year or less from the date that the claims are incurred (see section 10.5 below).

The diagram below shows the elections that are available for the liability for remaining coverage for groups of contracts measured in accordance with the premium allocation approach.


Group of insurance contracts eligible to use PAA?
Yes
No
Elect PAA (optional)
No
Apply general model
Yes
Is coverage period one year or less?
No
Yes
Elect to expense insurance acquisition cash flows as incurred
No
Amortise insurance acquisition cash flows
Yes
Expense insurance acquisition cash flows as incurred
Is time between provision of services and related premium due date within one year?
No
Yes
Elect not to discount liability for remaining coverage
No
Discount liability for remaining coverage if there is a significant financing component
Yes
Do not discount liability for remaining coverage
Measure liability for remaining coverage

10.3 Measurement of the liability for remaining coverage on initial recognition

An entity measures the liability for remaining coverage on initial recognition of a group of insurance contracts eligible for the PAA that are not onerous, as follows: *[IFRS 17.55(a)]*

- The premium, if any, received at initial recognition

  Minus

- Any insurance acquisition cash flows at that date, unless the entity is eligible and chooses to recognise the payments as an expense (provided coverage period is a year or less)

  Plus or minus

- Any amount arising from the derecognition at that date of:
  - Any asset for insurance acquisition cash flows that the entity paid before the related group of insurance contracts is recognised (see section 7.3 above)

    And

  - Any other asset or liability previously recognised for cash flows related to the group of contracts (see section 9.5.1 above)

Premium received means 'received' rather than receivable or due (see FAQ 10-2 below).

The carrying amount of the liability for remaining coverage must be adjusted to reflect the time value of money and the effect of financial risk when the insurance contracts in the group have a significant financing component. The discount rate is the rate at the date of initial recognition of the group determined using the requirements discussed in section 9.3 above. An entity is permitted to adjust the liability for remaining coverage to reflect the time value of money and the effect of financial risk irrespective of whether the contracts in the group have a significant financing component. However, an entity is not required to adjust the carrying amount of the liability for remaining coverage to reflect the time value of money and the effect of financial risk if, at initial recognition, the entity expects that the time between providing each part of the service and the related premium due date is no more than one year. *[IFRS 17.56]*.

If the entity is not able, or chooses not, to recognise insurance acquisition cash flows as an expense when incurred (see section 10.2 above) the insurance acquisition cash flows are included in the measurement of the liability for remaining coverage. The effect of recognising insurance acquisition cash flows as an expense when incurred, increases the liability for remaining coverage. There would be an increased profit or loss expense at the date the expense is incurred (which may be before the initial recognition of the contract) followed by an increase in profit released from the liability for remaining coverage over the coverage period.

An entity applying the premium allocation approach must assume that no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise. An entity must assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous subsequently by assessing the likelihood of changes in applicable facts and circumstances. *[IFRS 17.18]*.

If at initial recognition and at any time during the coverage period, facts and circumstances indicate that a group of insurance contracts is onerous, an entity must calculate the difference between: *[IFRS 17.57]*

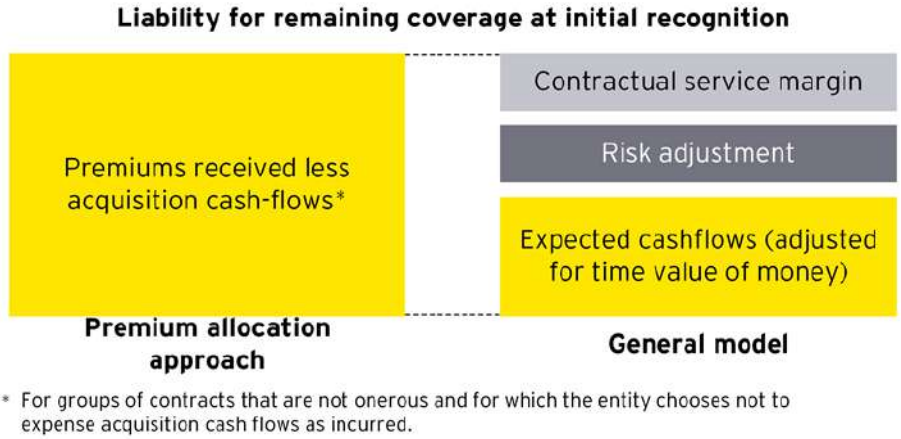
- The carrying amount of the liability for the remaining coverage as determined above

  And

- The fulfilment cash flows (see sections 9.2 to 9.4 above) that relate to the remaining coverage of the group of contacts

Any difference arising is recognised as a loss in profit or loss and increases the liability for remaining coverage. *[IFRS 17.58]*. In performing the fulfilment cash flows calculation, above, if an entity does not adjust the liability for incurred claims to reflect the time value of money and the effect of financial risk, it must also not include any such adjustment in the fulfilment cash flows. *[IFRS 17.57(b)]*.

The following diagram provides an overview of the premium allocation approach on initial recognition compared to the general model, assuming the entity does not expense insurance acquisition cash flows as incurred:



Frequently asked questions

Question 10-2: Do paragraphs 55(a)(i) and 55(b)(i) of IFRS 17 preclude the recognition of future premiums already invoiced but not yet paid and future premiums not yet invoiced in the measurement of the liability for remaining coverage applying the premium allocation approach?

(TRG meeting February 2018 - Agenda paper no. 7, Log S23 and May 2018 - Agenda paper no. 6, Appendix A, Topic 2 S27)

Yes. The TRG members agreed with the IASB staff view that the words 'premiums, if any, received' in IFRS 17.55(a)(i) and 55(b)(i) means premiums actually received at the reporting date. It does not include premiums due or premiums expected. However, the TRG members noted that applying these requirements reflects a significant change from existing practice and this change will result in implementation complexities and costs. However, the IASB concluded not to amend the standard.

Illustration 10-2: Measurement at initial recognition of a group of insurance contracts using the premium allocation approach

An entity issues a group of insurance contracts on 1 July 20X1. The insurance contracts have a coverage period of 10 months that ends on 30 April 20X2. The entity's annual reporting period ends on 31 December each year and the entity prepares interim financial statements as of 30 June each year.

The entity expects to receive premiums of CU1,220 and to pay directly attributable acquisition cash flows of CU20. It is anticipated that no contracts will lapse during the coverage period and that facts and circumstances do not indicate that the group of contracts is onerous.

The group of insurance contracts qualifies for the premium allocation approach. As the time between providing each part of the coverage and the related premium due is no more than a year, the entity chooses not to adjust the carrying amount of the liability for remaining coverage to reflect the time value of money and the effect of financial risk (therefore no discounting or interest accretion is applied). Further, the entity chooses to recognise the insurance acquisition cash flows as an expense when it incurs the relevant costs. All other amounts, including the investment component, are ignored for simplicity.

On initial recognition, assuming the premiums were received and the acquisition cash flows paid, the liability for remaining coverage is CU1,220 (i.e., the premium received). The acquisition cash flows of CU20 are expensed as incurred. If the premiums were not received on initial recognition (i.e., they are receivable at a later date) then the liability for remaining coverage is CU0.

How we see it

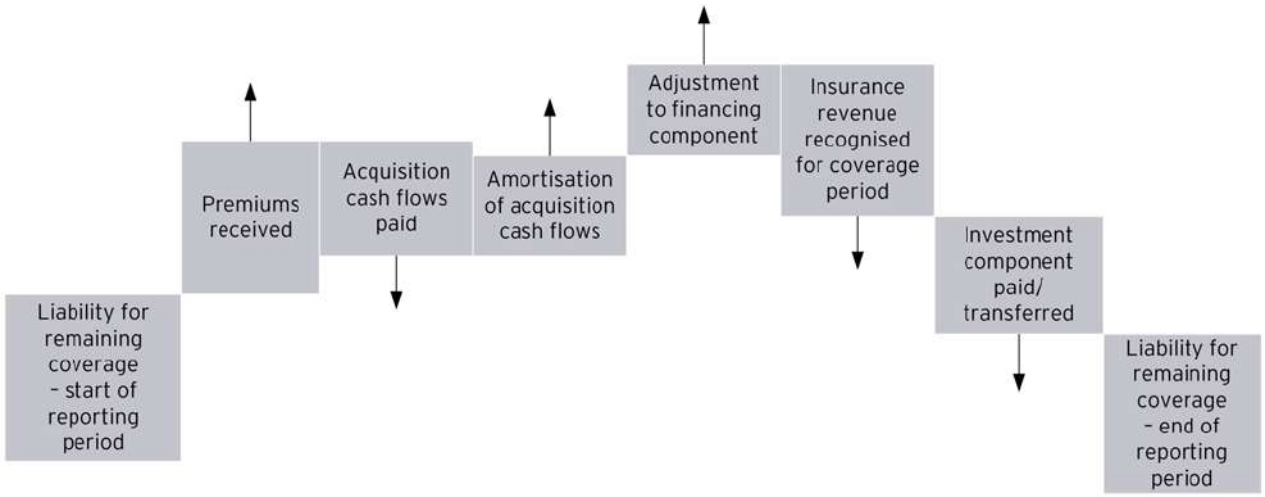
If the entity does not expense insurance acquisition cash flows as incurred, these cash flows will reduce the liability for remaining coverage. Therefore, the effect of recognising insurance acquisition cash flows as an expense when incurred results in a higher liability for remaining coverage. This will reduce the likelihood of any subsequent onerous contract loss. There would be an increased profit or loss expense at the date the cost is incurred followed by an increase in profit released from the liability for remaining coverage over the coverage period.

10.4 Subsequent measurement - liability for remaining coverage

At the end of each subsequent reporting period, assuming the group of insurance contracts is not onerous, the carrying amount of the liability is the carrying amount at the start of the reporting period: *[IFRS 17.55(b)]*

- Plus the premiums received in the period
- Minus insurance acquisition cash flows, unless the entity is eligible and chooses to recognise the payments as an expense (see section 10.2 above)
- Plus any amounts relating to amortising insurance acquisition cash flows recognised as an expense in the reporting period, unless the entity is eligible and chooses to recognise the payments as an expense when incurred
- Plus any adjustment to a financing component, if any (see below)
- Minus the amount recognised as insurance revenue for services provided in that period
- Minus any investment component paid or transferred to the liability for incurred claims

This can be illustrated by the following diagram:



If a group of insurance contracts was onerous at initial recognition, then an entity would continue to compare the carrying amount of the liability for remaining coverage as calculated above with the fulfilment cash flows and recognise any further deficits or surpluses (to the extent that the fulfilment cash flows still exceed the liability for remaining coverage on a cumulative basis) in profit or loss.

Under the premium allocation approach, insurance revenue for the period is the amount of expected premium receipts (excluding any investment component and after adjustment to reflect the time value of money and the effect of financial risk, if applicable) allocated to the period for services provided. An entity must allocate the expected premium receipts to each period of insurance contract services: *[IFRS 17.B126]*

- On the basis of the passage of time

  But

- If the expected pattern of release of risk during the coverage period differs significantly from the passage of time (which might be the case, for example, if risk of claims were skewed towards a particular time of year such as the 'hurricane season'), on the basis of the expected timing of incurred insurance service expenses

An entity must change the basis of allocation between the two methods (passage of time and incurred insurance service expenses) as necessary if facts and circumstances change. *[IFRS 17.B127]*.

How we see it

The liability for remaining coverage may be an asset balance if premiums are received after the recognition of revenue. This is because revenue is determined by the provision of services, independent of the receipt of cash.

An entity needs to apply judgement in interpreting 'differs significantly from the passage of time' when determining the appropriate basis for allocating insurance revenue to the period for services provided.

A change in the basis of allocating insurance between the two methods (passage of time and expected timing of incurred insurance service expenses) results from new information and accordingly is not a correction of an error and will be accounted for prospectively as a change in accounting estimate (see section 15.2.1.B below).

The following Illustration shows the subsequent measurement of a group of insurance contracts using the premium allocation approach assuming the same fact pattern as Illustration 10-2 in section 10.3 above.

Illustration 10-3: Measurement subsequent to initial recognition of a group of insurance contracts using the premium allocation approach

Assuming the same fact pattern as Illustration 10-2 in section 10.3 above.

On initial recognition, the entity receives all premiums and pays all acquisition cash flows. The entity expects to be released from risk evenly over the 10-month contract period. At the reporting date (31 December 2023), the contract is still not expected to be onerous.

For the six-month reporting period ending on 31 December 20X3, the entity recognises insurance revenue of CU732 (i.e., 60% of CU1,220). The insurance acquisition cash flows of CU20 are recognised as insurance service expense (as per Illustration 10-2 above, the entity has chosen to recognise the acquisition cash flows as incurred and not over the passage of time).

At 31 December 20X3, the liability for remaining coverage is CU488 (i.e., CU1,220 - CU732 or 40% of CU1,220). Note that, alternatively, if premiums were not received/paid until 1 January 20X4, the liability for remaining coverage would be an asset of CU732 at 31 December 20X3.

For the six-month reporting period ending 30 June 20X4, the entity recognises the remaining CU488 as insurance revenue and there is no liability for remaining coverage at 30 June 20X4.

Frequently asked questions

Question 10-3: How should differences between expected premiums and actual premiums which relate to current or past service be accounted for applying the premium allocation approach?

(TRG meeting September 2018 - Agenda paper no. 4, Log S53)

The TRG agreed with an IASB staff paper which stated that any premium experience adjustments under the premium allocation approach are part of expected premium receipts. Therefore, in applying paragraph B126 of IFRS 17, these are allocated to insurance revenue on the basis of either the passage of time or the expected release from risk (see above). If the expected pattern of release of risk differs significantly from the passage of time, the expected premium receipts are allocated over the coverage period on the basis of the expected timing of the incurred insurance service expense.

How we see it

The approach to allocate premium experience adjustments (i.e., the difference between the premium receipt expected and the actual premium cash flows received in the period) to insurance revenue on the basis of either the passage of time or the expected release from risk does not appear to preclude an entity from allocating any premium experience adjustment to both past and future services and, hence, recognise the resulting revenue relating to past services in the current period. Splitting the premium experience adjustment between past and future periods adds complexity.

IFRS 17, for the general model, contains the principle that changes in fulfilment cash flows relating to past service should not adjust the contractual service margin but be recorded in profit or loss for the period (see section 9.6.3 above). Considering this principle, when applying the premium allocation approach, it would be appropriate to also record changes in expected future premiums of the liability for remaining coverage that relate to past service in profit or loss as an adjustment to insurance revenue for the period. This would result in a treatment consistent with that of premium experience adjustments under the general model.

10.5 Subsequent measurement - liability for incurred claims

The liability for incurred claims for a group of insurance contracts subject to the premium allocation approach (which should usually be nil on initial recognition) is measured in the same way as the liability for incurred claims using the general model (i.e., a discounted estimate of future cash flows with a risk adjustment for non-financial risk). See section 9.6.2 above.

However, an entity is not required to adjust the future cash flows for the time value of money and the effect of financial risk if those cash flows (for that group of insurance contracts) are expected to be paid or received in one year or less from the date the claims are incurred. *[IFRS 17.59(b)]*. This is a separate election from the choice not to adjust the carrying amount of the liability for remaining coverage to reflect the time value of money and the effect of financial risk at initial recognition (see section 10.2 above).

When insurance finance income or expenses is included entirely in profit or loss, incurred claims are discounted at current rates (i.e., the rate at the reporting date). When insurance finance income or expenses is disaggregated between profit or loss and other comprehensive income (see section 15.3 below) the amount of insurance finance income or expenses included in profit or loss is determined using the discount rate at the date of the incurred claim (see section 9.3 above).

Frequently asked questions

Question 10-4: Why is the option in IFRS 17.59(b) where an entity is not required to adjust future cash flows in the liability for incurred claims for the time value of money and the effect of financial risk if those cash flows are expected to be paid or received in one year or less from the date the claims are incurred, limited to groups of contracts applying the premium allocation approach?

(TRG meeting September 2018 - Agenda paper no. 11, Log S64)

This practical expedient is a simplification that applies only to groups of insurance contracts accounted for applying the premium allocation approach which is a simplified approach. Applying the requirements of IFRS 17 to contracts applying the general model, subject to materiality considerations, an entity is required to adjust the estimates of future cash flows to reflect the time value of money and the effect of financial risk.

Illustration 10-4: Subsequent measurement of the liability for incurred claims using the premium allocation approach

Assuming the same fact pattern as Illustration 10-2 above.

For the six-month reporting period ending on 31 December 20X3, there were claims of CU636 incurred, including a risk adjustment for non-financial risk related to those claims of CU36. None of the claims have been paid at the reporting date. The claims will be paid within one year after the claims are incurred. Therefore, the entity chooses not to adjust the liability for incurred claims for the time value of money and the effect of financial risk.

At 31 December 20X3, the liability for incurred claims is CU636, which is also the amount for incurred claims recorded in profit or loss as insurance service expenses.

For the six-month reporting period ending on 30 June 20X4, there were claims incurred of CU424, including a risk adjustment for non-financial risk related to those claims of CU24. During the period claims of CU800 were paid.

At 30 June 20X4 the total liability for incurred claims and the risk adjustment for non-financial risk is CU260 (i.e., CU636 + CU400 + CU24 - CU800). The total incurred claims recognised in profit or loss as insurance service expenses for the six-month reporting period ending on 30 June 20X4 is CU424 (i.e., CU400 + CU24).

How we see it

It is possible that a group of insurance contracts may exist for which the entity would be eligible not to adjust the liability for remaining coverage for time value of money (because the contract does not contain a significant financing component or it does contain a significant financing component but each part of the coverage and the related premium due date are within one year) but for which it may have to discount the liability for incurred claims (because the claims are not expected to settle within one year or less from the date in which they are incurred). This would likely be the case for products with short coverage periods and long-tail claim settlement periods.

IFRS 17 does not state whether the discounting election above relating to the liability for incurred claims is irrevocable or not. There may be circumstances in which groups of claims that were expected originally to be settled within one year (and, hence, not discounted) subsequently turn out to take much longer to settle. In those circumstances, an entity should start discounting the claims in the period in which it identifies such change and account for the impact of the change prospectively (as this is a change in estimate).

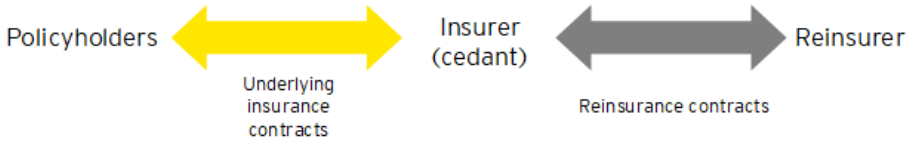
11 Reinsurance contracts held

IFRS 17 defines a reinsurance contract as follows: *[IFRS 17 Appendix A]*.

Extract from IFRS 17

Appendix A
Defined terms

reinsurance contract	An **insurance contract** issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more **insurance contracts** issued by that other entity (underlying contracts).



IFRS 17 requires a reinsurance contract held to be accounted for separately from the underlying insurance contracts to which it relates. This is because an entity that holds a reinsurance contract (a cedant) does not normally have a right to reduce the amounts it owes to the underlying policyholder by amounts it expects to receive from the reinsurer. It is acknowledged in the Basis for Conclusions that separate accounting for the reinsurance contracts and their underlying insurance contracts might create mismatches that some regard as purely accounting, for example, on the timing of recognition, the measurement of the reinsurance contracts and the recognition of profit. However, the Board concluded that accounting for a reinsurance contract held separately from the underlying insurance contracts gives a faithful representation of the entity's rights and obligations and the related income and expenses from both contracts. *[IFRS 17.BC298]*. Examples of potential accounting mismatches are:

- Contract boundaries for reinsurance held may differ from those of the underlying direct insurance contracts. As a result, accounting for reinsurance held requires the cedant (insurer) to estimate cash flows for underlying direct contracts that have not been issued yet but are within the boundary of the reinsurance contract held (see section 11.2 below).
- Underlying insurance contracts may meet one of the criteria to apply the premium allocation approach, but the related reinsurance contracts do not, possibly because the contract boundary of the reinsurance contract held differs from that of the underlying insurance contracts (see section 11.6 below).
- Reinsurance contracts held cannot be accounted for under the variable fee approach even if the underlying direct insurance contracts are accounted for under the variable fee approach (see section 11.7 below).

A modified version of the general model is applied by cedants for reinsurance contracts held. This is to reflect that: *[IFRS 17.BC302]*

- Groups of reinsurance contracts held are usually assets rather than liabilities
- Entities holding reinsurance contracts generally pay a margin to the reinsurer as an implicit part of the premium rather than making profits from the reinsurance contracts

Most reinsurance contracts held will be 'loss making' if the underlying insurance contracts to which they relate are profitable. Given that IFRS 17 does not permit gains on initial recognition of insurance contracts issued, it would seem inappropriate to require anticipated losses on related reinsurance contracts held to be expensed on initial recognition. This would create an accounting mismatch.

The following table includes a comparison between the general model for insurance contracts issued and modifications of the general model for reinsurance contracts held:

General model for insurance contracts issued	Modifications of general model for reinsurance contracts held
Recognition	
A group of insurance contracts issued is recognised from the earlier of: (see section 7 above) ▸ The beginning of the coverage period of the group of contracts Or ▸ The date when the first payment from a policyholder in the group becomes due Or ▸ For a group of onerous contracts, when the group becomes onerous	A group of reinsurance contracts held is recognised from the earlier of: ▸ The beginning of the coverage period of the group of reinsurance contracts held Or ▸ The date the entity recognises an onerous group of underlying insurance contracts, if the entity entered into the related reinsurance contract held in the group of reinsurance contracts entered into at or before that date (A simplification exists for proportionate reinsurance (see section 11.3 below))
Measurement	
The contract boundary requirements under the general model also apply to reinsurance contracts held (see section 11.2 below). However, due to different terms and conditions of the reinsurance contracts held, contract boundaries for reinsurance held may differ from those of the underlying direct insurance contracts.	
Assumptions used for measurement must be consistent with the assumptions used for measurement of the underlying insurance contracts issued (see section 11.4.1 below)	
The risk adjustment for non-financial risk reflects the compensation that the insurer requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk (see section 9.4 above).	The risk adjustment for non-financial risk reflects the amount of the risk transferred from the insurer to the reinsurer. *[IFRS 17.64]*.
The non-performance risk of the insurer must not be reflected in the fulfilment cash flows of the insurance contracts issued (see section 9.2 above). However, an assessment of credit risk of amounts due from policyholders or agents must be reflected in the fulfilment cash flows (see section 9.13.1 above).	Non-performance risk of the reinsurer must be included in the measurement of the fulfilment cash flows of the reinsurance contracts held (see section 11.4.4 below).
Day 1 gains are initially recognised in the statement of financial position as a contractual service margin and recognised in profit or loss as the insurer renders services. In contrast, all day 1 losses are recognised in profit or loss immediately.	All day 1 differences are initially recognised in the statement of financial position as a contractual service margin and recognised in profit or loss as the reinsurer renders services, except for: ▸ Any portion of a day 1 difference (i.e., the net cost of purchasing reinsurance cover) that relates to events before initial recognition of the reinsurance contract held Or ▸ Any day 1 gain on initial recognition of the reinsurance contract held which is expected to recover the losses at initial recognition of onerous underlying insurance contracts. (See section 11.4 below)
Changes in the fulfilment cash flows adjust the contractual service margin if they relate to future coverage and other future services (see section 9.7 above).	Changes in the fulfilment cash flows adjust the contractual service margin if they relate to future coverage and other future services. However, changes in fulfilment cash flows are recognised in profit or loss if the related changes in the underlying contracts are also recognised in profit or loss when the underlying contracts are onerous (see section 11.5 below).

How we see it

Key considerations arising for insurers will be the extent of any accounting mismatches arising from the different treatment of reinsurance contracts held compared to the underlying insurance contracts.

Accounting mismatches may arise from the requirement to account for reinsurance contracts held separately from the underlying insurance contracts. One example of this is that a different measurement model (general model, variable fee approach or premium allocation approach) could be applied to the underlying insurance contracts, than the one applied to the reinsurance held contract (general model or premium allocation approach).

11.1 Level of aggregation

An entity must divide portfolios of reinsurance contracts held by applying the same criteria as for insurance contracts issued discussed in section 6 above, with the provision that references to onerous contracts (see section 9.8 above) must be replaced with a reference to contracts on which there is a net gain on initial recognition. *[IFRS 17.61]*. This appears to mean that a portfolio of reinsurance contracts held must be divided at least into:

- A group of contracts on which there is a net gain on initial recognition (i.e., a net inflow), if any
- A group of contracts that have no significant possibility of a net gain arising subsequent to initial recognition, if any
- A group of the remaining contracts in the portfolio

An entity is not allowed to group contracts purchased more than a year apart. A group of contracts is not reassessed after initial recognition. It is acknowledged by IFRS 17 that, for some reinsurance contracts held, applying the general model, as modified, will result in a group that comprises a single contract. *[IFRS 17.61]*.

A reinsurance contract held cannot be onerous. Therefore, the requirements for onerous contracts in the general model (see section 9.8 above) do not apply. *[IFRS 17.68]*.

Frequently asked questions

Question 11-1: Should a reinsurance contract held be separated into components for measurement purposes to reflect the underlying contracts covered? For example, should a reinsurance contract held that provides coverage to underlying contracts that are included in different groups of insurance contracts be separated?

(TRG meeting February 2018 - Agenda paper no. 1, Log S19)

In the context of considering separation of insurance components within a single insurance contract (see section 6.1.1 above), the TRG observed that the fact that a reinsurance contract held provides cover for underlying contracts that are included in different groups is not in itself, sufficient to conclude that accounting for the reinsurance contract held as a single contract does not reflect the substance of its contractual rights and obligations.

11.2 The boundary of a reinsurance contract held

The contract boundary requirements of IFRS 17 (see section 9.1 above) also apply to reinsurance contracts held.

Frequently asked questions

Question 11-2: Should the boundary of a reinsurance contract held include anticipated cash flows from unissued underlying contracts?

(TRG meeting February 2018 - Agenda paper no. 3, Log S18)

Yes. In some cases, reinsurance contracts held offer protection for underlying contracts that an entity has not yet issued. The question arises as to whether the boundary of a reinsurance contract held should include those anticipated cash flows from unissued underlying contracts (which will not have been recognised as underlying insurance contracts by the entity).

In February 2018, this issue was discussed by the TRG who agreed with the IASB staff's conclusion that the application of the contract boundary requirements to reinsurance contracts held means that cash flows within the boundary of a reinsurance contract held arise from substantive rights and obligations of the entity, i.e., the holder of the contract. Therefore:

- A substantive right to receive services from the reinsurer ends when the reinsurer has the practical ability to reassess the risks transferred to the reinsurer and can set a price or level of benefits for the contract to fully reflect the reassessed risk, or when the reinsurer has a substantive right to terminate the contract.
- Accordingly, the boundary of a reinsurance contract held could include cash flows from underlying contracts covered by the reinsurance contract that are expected to be issued by the cedant in the future.

This means that an entity will need to estimate the fulfilment cash flows of contracts it expects to issue that will give rise to cash flows within the boundary of the reinsurance contracts that it holds. Some stakeholders argued that this will result in an accounting mismatch between the direct insurance contracts issued and the reinsurance contracts held. However, the Basis for Conclusions states that the IASB disagreed that differences between the carrying amount of the reinsurance contract held and the underlying insurance contracts are accounting mismatches. The carrying amount of a reinsurance contract held is nil before any cash flows occur or any service is received. Thereafter any difference that arise between the carrying amount of the reinsurance contract held and the underlying insurance contracts are not accounting mismatches, but differences caused by: *[IFRS 17.BC309E]*

- The provision of coverage, for example because the reinsurer provides coverage for less than 100% of the risks the entity covers
- The timing of cash flows
- Interest accreted on the contractual service margin of the reinsurance contract held from an earlier period than, and at a different discount rate from, the interest accreted on the contractual service margin of the underlying insurance contracts, reflecting the different effects of the time value of money on the contractual service margin and fulfilment cash flows

The TRG members observed that applying this requirement is likely to result in operational complexity because it is a change from existing practice under IFRS 4. This increase in cost and complexity resulting from a change in existing practice is acknowledged in the Basis for Conclusions, but the IASB concluded that the benefits of appropriately reflecting an entity's rights and obligations as the holder of a reinsurance contract outweigh those costs. *[IFRS 17.BC309F]*.

Question 11-3: What is the boundary of a reinsurance contract held with a break clause that allows either party to cancel the contract at any time following a specified notice period?

(TRG meeting February 2018 - Agenda paper no. 3, Log S15; TRG meeting September 2018 - Agenda paper no. 5)

Some reinsurance contracts held may contain break clauses which allow either party to cancel the contract at any time following a specified notice period. In February 2018, the TRG members observed that, in an example of a reinsurance contract which:

- Is issued and recognised on 1 January
- Covers a proportion of all risks arising from underlying insurance contracts issued in a 24-month period

- Provides the unilateral right to both the cedant and the reinsurer to terminate the contract with a three-month notice period to the other party with respect to only new business ceded

The initial contract boundary would exclude cash flows related to premiums outside of that three-month notice period.

In September 2018, the IASB staff clarified to TRG members that if, at the end of the three months, neither the entity nor the reinsurer had given notice to terminate the reinsurance contract with respect to new business ceded, this would not cause a reassessment of the contract boundary. This is because the contract boundary determination at initial recognition (i.e., three months) was not based on an assessment of the practical ability to set a price that fully reflected the risk in the contract. (In other words, a contract boundary is only reassessed if there has been a change in circumstances which affect the assessment of whether an entity's substantive rights and obligations have commercial substance). The cash flows related to underlying contracts that are expected to be issued and ceded in the next three-month period are cash flows outside the existing contract boundary. In response to a concern that this may result in daily reinsurance contracts being recognised for every day that passes in which either party does not exercise its termination right, the IASB staff observed that reinsurance contracts held are recognised only when the recognition criteria are met (i.e., when the coverage period begins). The contract boundary is determined at initial recognition and, in this example, that will result in a new reinsurance contract held being recognised after the end of the first three-month period with a contract boundary of cash flows arising from contracts expected to be issued in the following three months. Both of these contracts held could belong to a single annual group of contracts applying the level of aggregation criteria.

The submission to the IASB staff in September 2018 included a fact pattern in which there is a unilateral right for the reinsurer to amend the rate of the ceding commission it pays, in addition to unilateral termination rights. The IASB staff observe that in this fact pattern, the existence of the right to terminate the contract with a three-month notice period determines the cash flows within the contract boundary regardless of the existence of a right to amend the rate of the ceding commission if the contract is not terminated. Therefore, the same accounting would apply to this additional fact pattern.

Question 11-4: How should the boundary of a reinsurance contract held be determined when the reinsurer has the right to reprice remaining coverage prospectively?

(TRG meeting May 2018 - Agenda paper no. 4, Log S39)

The TRG discussed an IASB staff paper concerning the determination of the boundary of a reinsurance contract held when the reinsurer has the right to reprice remaining coverage prospectively. In the fact pattern provided, the reinsurer can adjust premium rates at any time, subject to a minimum three-month notice period and could choose either: (i) not to exercise the right to reprice, in which case, the holder of the reinsurance contract is committed to continue paying premiums to the reinsurer; or (ii) to exercise the right to reprice, in which case, the holder has the right to terminate coverage.

The TRG members observed that:

- For reinsurance contracts held, cash flows are within the contract boundary if they arise from substantive rights and obligations that exist during the reporting period in which the entity (i.e., the holder) is compelled to pay amounts to the reinsurer or in which the entity has a substantive right to receive services from the reinsurer.
- A right to terminate coverage that is triggered by the reinsurer's decision to reprice the reinsurance contract is not relevant when considering whether a substantive obligation to pay premiums exists. Such a right is not within the entity's control and therefore the entity would continue to be compelled to pay premiums for the entire contractual term.
- The entity's expectations about the amount and timing of future cash flows, including with respect to the probability of the reinsurer repricing the contract, would be reflected in the fulfilment cash flows.

The TRG members also observed that, although the fact pattern in this example was limited in scope, it demonstrates the principle that both rights and obligations need to be considered when assessing the boundary of a contract. This means, for the current fact pattern, the boundary of the reinsurance contract held would reflect the expected contract boundary of the underlying contracts and should not end at the first point at which the reinsurer has the right to increase premium rates.

Illustration 11-1: The contract boundary of reinsurance contracts held

On 1 January, the insurer enters into a 100% proportionate reinsurance cover for a group of underlying insurance contracts it expects to issue over the next two years. The reinsurance contract includes a unilateral right to both the cedant and the reinsurer to terminate the contract with a six-month notice period to the other party with respect only to new business ceded.

An insurer expects to issue three one-year insurance contracts all within year one of the two-year period covered by the reinsurance contract. These contracts were issued on 1 January, 30 June and 31 December in year one respectively with their coverage period starting at the same date. 1 January in year one is the beginning of the coverage period of the group of underlying insurance contracts (IFRS 17.25(a)). The coverage period for the group of underlying insurance contracts is from 1 January in year one to 30 December in year two. Assume the group of underlying insurance contracts is measured using the general model.

The reinsurance contract held is recognised on 1 January in year one. In this example the reinsurance contract held, as a single contract, is identified as a group of insurance contracts.

The contract boundary of the reinsurance contract held recognised on 1 January in year one includes cash flows related to premiums inside the six-month notice period. In applying the measurement requirements of IFRS 17.32-36 to the reinsurance contract held, the insurer uses consistent assumptions to measure the estimates of the present value of the future cash flows for the reinsurance contracts held and the estimates of the present value of the future cash flows for the first two contracts, issued on 1 January and 30 June in year one, included in the group of underlying insurance contracts. The present value of the future cash flows of the reinsurance contract held would exclude cash flows related to premiums for the third contract, issued on 31 December.

The coverage period for the reinsurance contract held recognised on 1 January in year one is equal to the coverage period for the group of underlying insurance contracts, from 1 January in year one to 29 June in year two. However, the reinsurance contract held recognised on 1 January excludes the underlying contract issued on 31 December of year one.

The contract boundary and coverage period of the reinsurance contract held, recognised on 1 January in year one, is illustrated by the grey block in the Illustration below:

Illustration 11-2: Coverage period for proportional reinsurance treaty that protects an insurer for contracts it issues in a year

An insurer holds a proportional reinsurance treaty that protects it for claims arising from underlying insurance contracts it issues in a year. Each of the underlying insurance contracts has a coverage period of one year. However, the reinsurance treaty provides coverage for claim events that can occur in a period of up to two years. Consequently, the coverage period for the reinsurance contract held is the two-year period.

How we see it

In some cases, reinsurance contracts held will offer protection for underlying contracts that an entity has not yet issued. If the reinsurance cash flows arising from the anticipated underlying contracts are within the boundary of a reinsurance contract, the measurement of the reinsurance contract will reflect those cash flows - as the standard requires that future cash flows within the boundary be taken into account. An entity will need to estimate the fulfilment cash flows of contracts it expects to issue that will give rise to cash flows within the boundary of the reinsurance contracts that it holds. The estimates must be adjusted as time passes and the underlying direct contracts that are subject to reinsurance are actually issued. Reinsurance fulfilment cash flows for future underlying contracts expected to be issued include an estimate of the amount of risk adjustment an entity expects will be transferred to the reinsurer when underlying contracts are recognised, as well as future fulfilment cash flows such as estimated reinsurance premiums and claim recovery cash flows.

11.3 Recognition

The recognition requirements for an insurance contract issued are modified for the purposes of the recognition of reinsurance contracts held. *[IFRS 17.62]*. See section 7.2 above. In short, an entity must recognise a group of reinsurance contracts held from the earlier of the following:

- The beginning of the coverage period of the group of reinsurance contracts held, or if the reinsurance contracts provide proportionate coverage at the later of the beginning of the coverage period of the group, or the initial recognition of any underlying contract

  And

- The date the entity recognises an onerous group of underlying insurance contracts applying IFRS 17.25(c), if the entity entered into the related reinsurance contract held in the group of reinsurance contracts held at or before that date and, in all other cases, from the beginning of the coverage period of the group

Regarding the first criterion, for groups of reinsurance contracts held that provide proportionate coverage, the entity must not recognise the group of reinsurance contracts until it has recognised at least one of the underlying contracts. *[IFRS 17.62A]*.

In contrast, for contracts which do not provide proportionate coverage, the recognition date is usually the start of the coverage period except if the underlying group of contracts is onerous. In these contracts the entity benefits from coverage from the beginning of the group of reinsurance contracts held because such losses accumulate throughout the coverage period. *[IFRS 17.BC305(b)]*. An example of such a contract is one that provides cover for aggregate losses from a single event, in excess of a predetermined limit and with a fixed payable premium.

11.4 Measurement - initial recognition

11.4.1 Initial measurement - fulfilment cash flows

A reinsurance contract held must be measured using the same criteria for fulfilment cash flows and contractual service margin as an insurance contract issued to the extent that the underlying contracts are also measured using this approach. However, the entity must use consistent assumptions to measure the estimates of the present value of future cash flows for the group of both the reinsurance contracts held and the underlying insurance contracts. *[IFRS 17.63]*.

Frequently asked questions

Question 11-5: Paragraph 63 of IFRS 17 requires the use of assumptions for the measurement of the estimates of the present value of the future cash flows for a group of reinsurance contracts held that are consistent with those used to measure the underlying insurance contracts. Does this mean that the use of an identical discount rate is required?

(TRG meeting February 2018 - Agenda paper no. 7, Log S17)

No. The TRG agreed with the IASB staff, that 'consistent' in this context does not necessarily mean 'identical' (i.e., the use of an identical discount rate for measurement of the group of underlying insurance contracts and the related group of reinsurance contracts held was not mandated). The extent of dependency between the cash flows of the reinsurance contract held and the underlying contracts should be evaluated in applying the requirements of IFRS 17.63.

Question 11-6: What discount rate should be used to measure the present value of future cash flows of a reinsurance contract held if the liquidity characteristics of the underlying contracts are different from those of the reinsurance contract held?

(TRG meeting May 2018 - Agenda paper no. 7, Log S40)

The TRG agreed with the IASB staff when they noted that consistency is required to the extent that the same assumptions apply to both the underlying contracts and the reinsurance contracts held. In the IASB staff's view, this requirement does not require or permit the entity to use the same assumptions used (e.g., the same discount rates) for measuring the underlying contracts when measuring the reinsurance contracts held if those assumptions are not valid for the term of the reinsurance contracts held. If different assumptions apply for reinsurance contracts held, the entity uses those different assumptions when measuring the contract.

11.4.2 Measurement at initial recognition - contractual service margin

In determining the contractual service margin on initial recognition, the requirements of the general model are modified to reflect the fact that there is no unearned profit but, instead, a net gain or net cost on purchasing the reinsurance.

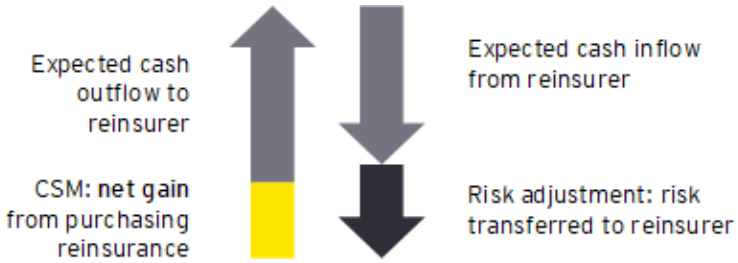
Hence, on initial recognition, unless the net cost of purchasing reinsurance coverage relates to events that occurred before the purchase of the group of reinsurance contracts, the entity must recognise any net cost or net gain on purchasing the group of reinsurance contracts held as a contractual service margin measured at an amount equal to the sum of: *[IFRS 17.65]*

- The fulfilment cash flows
- The amount derecognised at that date of any asset or liability previously recognised for cash flows related to the group of reinsurance contracts held
- Any cash flows arising at that date

  And
- Any income recognised in profit or loss when an entity recognises a loss on initial recognition of an onerous group of underlying contracts (see section 11.4.3 below)

If expected cash outflows to a reinsurer exceed the sum of expected inflows and the risk adjustment, the contractual service margin represents a net cost of purchasing reinsurance.

If expected cash inflows from the reinsurer plus the risk adjustment exceed expected outflows, the contractual service margin represents a net gain of purchasing reinsurance.



If the net cost of purchasing reinsurance coverage relates to events that occurred before the purchase of the group of reinsurance contracts held, an entity must recognise such a cost immediately in profit or loss as an expense. *[IFRS 17.65A]*.

It is stated in the Basis for Conclusions that the IASB decided that the net expense of purchasing reinsurance should be recognised over the coverage period as services are received unless the reinsurance covers events that have already occurred. For reinsurance contracts held which cover events that have already occurred, the Board concluded that entities should recognise the whole of the net expense at initial recognition, to be consistent with the treatment of the net expense of purchasing reinsurance before an insured event has occurred. The Board acknowledged that this approach does not treat the coverage period of the reinsurance contract consistently with the view that for some insurance contracts the insured event is the discovery of a loss during the term of the contract, if that loss arises from an event that had occurred before the inception of the contract. However, the Board concluded that consistency of the treatment of the net expense across all reinsurance contracts held would result in more relevant information. *[IFRS 17.BC312]*.

These accounting requirements above can be summarised as follows:

Fact pattern on initial recognition	Accounting for net gain or cost
Expected cash inflows exceed expected cash outflows	Contractual service margin recognised for net gain (i.e., credit balance)
Expected cash outflows exceed expected cash inflows	Contractual service margin recognised for net cost (i.e., debit balance)
Expected cash outflows exceed expected cash inflows and coverage relates to events that occurred before the purchase of the group of reinsurance contracts held	Net cost immediately recognised in profit or loss as an expense

How we see it

IFRS 17 provides no guidance as to how a cedant should account for the net cost of a reinsurance contract held, which provides both prospective and retroactive coverage. In these circumstances, an entity would need to apply judgement as to the portfolio to which a contract providing both prospective and retrospective coverage should be allocated and whether the legal contract could be split into separate retrospective and prospective insurance components, with each component allocated to different portfolios as an in-substance separate contract for accounting purposes, applying the guidance discussed in section 6.1.1 above.

Measurement of a reinsurance contract held on initial recognition is shown by the following Illustration. The initial recognition of reinsurance contracts in situations where a group of underlying insurance contracts is onerous at initial recognition as discussed in section 11.4.3 below.

The following Illustration is based on Example 11 in the Illustrative Examples to IFRS 17: *[IFRS 17.IE124-129]*

Illustration 11-3: Measurement on initial recognition of groups of reinsurance contracts held

An entity enters into a reinsurance contract that, in return for a premium of CU300m, covers 30% of each claim from the underlying insurance contracts. The underlying insurance contracts are issued at the same time as the entity enters into the reinsurance contract. Applying the relevant criteria, the entity considers that the group comprises a single contract held. For simplicity, this example disregards the risk of non-performance of the reinsurer and all other amounts.

The entity measures the estimates of the present value of future cash flows for the group of reinsurance contracts held using assumptions consistent with those used to measure the estimates of the present value of the future cash flows for the group of the underlying insurance contracts, as shown in the table below:

	Underlying contracts	Reinsurance contracts
	CU million	CU million
Estimates of the present value of future cash inflows	1,000	270
Estimates of the present value of future cash outflows/premium paid	(900)	(300)
Risk adjustment for non-financial risk	(60)	18
Contractual service margin (liability)/asset	(40)	12
Insurance contract asset/(liability) on initial recognition	-	-

The entity measures the present value of the future cash inflows consistent with the assumptions of the cash outflows of the underlying insurance contracts. Consequently, the estimate of cash inflows is CU270m (i.e., 30% of CU900m). The risk adjustment is determined to represent the amount of risk being transferred by the holder of the reinsurance contract to the issuer of the contract. Consequently, the risk adjustment, which is treated as an inflow rather than an outflow, is CU18m (i.e., estimated to be 30% of 60).

The contractual service margin is an amount equal to the sum of the fulfilment cash flows and any cash flows arising at that date. In this example, there is a net loss on purchasing the reinsurance and the contractual service margin is in an asset position.

Alternatively, If the premium was only CU260m, there would be a net gain of CU28m on purchasing the reinsurance and the contractual service margin would represent a liability of CU28m to eliminate the net gain on inception.

	Underlying contracts	Reinsurance contracts
	CU million	CU million
Estimates of the present value of future cash inflows	1,000	270
Estimates of the present value of future cash outflows/premium paid	(900)	(260)
Risk adjustment for non-financial risk	(60)	18
Contractual service margin liability	(40)	(28)
Insurance contract asset/(liability) on initial recognition	-	-

11.4.3 Initial measurement of reinsurance held of underlying insurance contracts that are onerous at initial recognition

An entity must adjust the contractual service margin of a group of reinsurance contracts held and, as a result, it must recognise income when the entity recognises a loss at initial recognition of an onerous group of underlying contracts or on addition of onerous underlying insurance contracts to that group. *[IFRS 17.66A]*. This requirement applies to all reinsurance contracts held and is irrespective of the measurement model used by the underlying contracts.

It is clarified in the Basis for Conclusions that, for this accounting to apply, an entity must enter into the reinsurance contract held before or at the same time as it recognises the onerous underlying insurance contracts. The Board concluded that it would not be appropriate for an entity to recognise a recovery of loss when the entity does not hold a reinsurance contract. *[IFRS 17.BC315C]*. This does not preclude the entity from recognising a gain for contracts that are added to the onerous underlying group subsequently, as these underlying contracts are initially recognised after the entity entered into the reinsurance contract held.

The amount of the adjustment to the contractual service margin of a group of reinsurance contracts held and resulting income is determined by multiplying: *[IFRS 17.B119D]*

- The loss recognised on the underlying contracts

  And
- The percentage of claims on underlying insurance contracts the entity expects to recover from the group of reinsurance contracts held

How we see it

The calculation of the gain from loss recovery on initial recognition makes no distinction between cash flows of the underlying group of insurance contracts that are covered by the reinsurance contract and those cash flows that are not covered. Presumably, this is because at initial recognition it would be difficult to identify what proportion of a loss on a group of underlying contracts results from covered cash flows and what proportion arises from uncovered cash flows. However, for subsequent measurement, the treatment of those cash flows that are covered by the reinsurance agreement and those that are not differs (see section 11.5.1.B below).

An entity must also establish (or adjust) a loss-recovery component of the asset for remaining coverage for a group of reinsurance contracts held depicting the recovery of losses recognised applying the requirements above. The loss-recovery component determines the amounts that are presented in profit or loss as reversals of recoveries of losses from reinsurance contracts held and are, consequently, excluded from the allocation of premiums paid to the reinsurer. *[IFRS 17.66B]*.

An entity might include in an onerous group of insurance contracts, both onerous insurance contracts covered by a group of reinsurance contracts held and onerous insurance contracts not covered by the group of reinsurance contracts held. In such cases, the entity must apply a systematic and rational method of allocation to determine the portion of losses recognised on the group of insurance contracts that relates to insurance contracts covered by the group of reinsurance contracts held. *[IFRS 17.B119E]*.

Similarly, reinsurance contracts held may provide cover across different groups of underlying insurance contracts. For example, a motor reinsurance contract held may provide protection for underlying insurance contracts within a portfolio comprising both onerous contracts and those not expected to become onerous. Some reinsurance contracts are written on a 'whole account' basis and cover all of an insurer's underlying groups of insurance contracts. IFRS 17 does not provide guidance as to how to measure the reinsurance contract in these circumstances. Consequently, an insurer will have to use judgement in weighting the underlying cash flows from different insurance groups to the reinsurance contract.

IFRS 17 does not require an entity to track insurance contracts at a lower level than the level of the group of insurance contracts. Accordingly, the Board specified that, in these circumstances, an entity applies a systematic and rational method of allocation to determine the portion of losses on a group of insurance contracts that relates to underlying insurance contracts covered by a reinsurance contract held. Requiring a systematic and rational method of allocation is consistent with other requirements in IFRS 17. *[IFRS 17.BC315H]*.

The loss recovery requirements add complexity to IFRS 17 because it requires an entity to track a loss-recovery component. However, the Board concluded that the added complexity was justified given the strong stakeholder support for the information that entities will provide to users of financial statements. In addition, the Board noted that the loss-recovery component of a reinsurance contract held is treated similarly to the loss component on insurance contracts issued. *[IFRS 17.BC315G]*.

The following Illustration, based on Example 12C in the Illustrative Examples on IFRS 17, shows the application of these requirements at initial measurement. *[IFRS 17.IE138A-138K]*.

Illustration 11-4: Initial measurement of a group of reinsurance contracts held that provides coverage for groups of underlying insurance contracts, including an onerous group

At the beginning of Year 1, an entity enters into a reinsurance contract that in return for a fixed premium covers 30% of each claim from the groups of underlying insurance contracts. The reinsurance held is the only contract in the group. The underlying insurance contracts are issued at the same time as the entity enters into the reinsurance contract held. For simplicity it is assumed that no contracts will lapse before the end of the coverage period, there are no changes in estimates and all other amounts, including the effect of discounting, the risk adjustment for non-financial risk and the risk of non-performance of the reinsurer are ignored.

Some of the underlying insurance contracts are onerous at initial recognition. Thus, the entity establishes a group comprising the onerous contracts. The remainder of the underlying insurance contracts are expected to be profitable and, in this example, the entity establishes a single group comprising the profitable contracts. The coverage period of the underlying insurance contracts and the reinsurance contract held is three years from the beginning of Year one. Service is provided evenly over the coverage periods.

The entity expects to receive CU1,110 on the underlying insurance contracts immediately after initial recognition. Claims on the underlying insurance contracts are expected to be incurred evenly across the coverage period and are paid immediately after claims are incurred.

The entity measures the group of underlying insurance contracts on initial recognition, as follows:

	Profitable group of insurance contracts	Onerous group of insurance contracts	Total
	CU	CU	CU
Estimates of the present value of future cash inflows	900	210	1,110
Estimates of the present value of future cash outflows	(600)	(300)	(900)
Fulfilment cash flows	300	(90)	210
Contractual service margin	(300)	-	(300)
Insurance contract asset/(liability) on initial recognition	**-**	**(90)**	**(90)**
Loss on initial recognition	**-**	**90**	**90**

The entity establishes a group comprising a single reinsurance contract held that provides proportionate coverage. The entity pays a premium of CU315 to the reinsurer immediately after initial recognition. The entity expects to receive recoveries of claims from the reinsurer on the same day that the entity pays claims on the underlying insurance contracts.

Applying IFRS 17, the entity measures the estimates of the present value of the future cash flows for the group of reinsurance contracts held using assumptions consistent with those used to measure the estimates of the present value of the future cash flows for the groups of underlying insurance contracts. Consequently, the estimate of the present value of the future cash inflows is CU270 (recovery of 30% of the estimates of the present value of the future cash outflows for the groups of underlying insurance contracts of CU900).

The entity measures the group of reinsurance contracts held on initial recognition as follows:

	Initial recognition	
	CU	
Estimates of present value of future cash inflows (recoveries) being 900 × 30%	270	
Estimates of present value of future cash outflows (premiums)	(315)	
Fulfilment cash flows	**(45)**	
Contractual service margin of the reinsurance contract held (before the loss recovery adjustment)	45	
Loss-recovery component (being 90 × 30%)	27	(a)
Contractual service margin of the reinsurance contract held (after the loss-recovery adjustment)	**72**	(b)
Reinsurance contract asset on initial recognition	**27**	(c)
Income on initial recognition	**(27)**	(a)

(a) Applying IFRS 17, the entity adjusts the contractual service margin of the reinsurance contract held and recognises income to reflect the loss recovery. The entity determines the adjustment to the contractual service margin and the income recognised as CU27 (the loss of CU90 recognised for the onerous group of underlying insurance contracts multiplied by 30%, the fixed percentage of claims the entity expects to recover).

(b) The contractual service margin of CU45 is adjusted by CU27, resulting in a contractual service margin (after adjustment) of CU72, reflecting a net cost on the reinsurance contract held.

(c) The reinsurance contract asset of CU27 comprises the fulfilment cash flows of CU45 (net outflows) and a contractual service margin reflecting a net cost of CU72. The entity establishes a loss-recovery component of the asset for remaining coverage of CU27 depicting the recovery of losses recognised.

How we see it

Under the loss recovery requirements of IFRS 17, insurers will need to identify the extent to which changes in fulfilment cash flows of a group reinsurance contracts held relate to corresponding changes of underlying groups of contracts that have been recognised in profit or loss. Where an onerous group of insurance contracts includes both onerous contracts covered by the reinsurance contracts held and onerous contracts not covered by the reinsurance contracts held, this will require a means of allocating the changes in fulfilment cash flows of an onerous group of underlying contracts between them. This could give rise to significant operational complexity. An entity could consider subdividing groups of insurance contracts issued or reinsurance contracts held into further groups of contracts in order to facilitate such allocations.

11.4.4 Initial measurement of the effect of the risk of non-performance

In addition to using consistent assumptions, an entity must make the following modifications in calculating the fulfilment cash flows:

- Estimates of the present value of the future cash flows for the group of reinsurance contracts held must reflect the effect of any risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes. *[IFRS 17.63]*. This is because an entity holding a reinsurance contract faces the risk that the reinsurer may default or may dispute whether a valid claim exists for an insured event. *[IFRS 17.BC308]*. The estimates of expected losses from non-performance risk are based on expected values over the lifetime of the reinsurance asset.
- The estimate of the risk adjustment for non-financial risk must be determined so that it represents the amount of risk being transferred by the cedant to the reinsurer. *[IFRS 17.64]*.

The requirement to reflect the non-performance risk on an expected value basis is similar to the requirement in IFRS 9 to provide for expected credit losses on certain financial instruments. However, IFRS 9 does not apply to rights under a contract within the scope of IFRS 17, such as a receivable due under a reinsurance contract held (see section 2 above). Consequently, the IFRS 9 credit loss model does not apply. Instead, non-performance risk is reflected on an expected value basis over the estimated lifetime of the insurance contract using the guidance for expected values as part of the fulfilment cash flows (see section 9.13.1 above).

Frequently asked questions

Question 11-7: For reinsurance contracts held, is the risk of non-performance of the reinsurer considered within the estimates of the present value of future cash flows or the risk adjustment for non-financial risk?

(TRG meeting May 2018 - Agenda paper no. 7, Log S42)

The TRG agreed with the IASB staff that the risk of non-performance must be contained within the estimates of the present value of future cash flows. The risk adjustment does not include an adjustment for the risk of non-performance.

Question 11-8: Should non-performance risks of a reinsurer such as insolvency and dispute risk be identified as financial or non-financial risks and what impact does this determination have on the measurement of the risk adjustment for reinsurance contracts held?

(TRG meeting April 2019 - Agenda paper no. 2, Log S119)

IFRS 17.63 discusses the estimates of the present value of the future cash flows of a reinsurance contract held and specifically requires that those estimates should include the effect of any risk of non-performance by the issuer of the reinsurance contract including the effects of collateral and losses from disputes. Applying IFRS 17.64, he risk adjustment for non-financial risk of a reinsurance contract held reflects only the risks that the cedant transfers to the reinsurer. The risk of non-performance by the reinsurer is not a risk transferred to the reinsurer, nor does it reduce the risk transferred to the reinsurer. It is only reflected in the present value of the future cash flows of the reinsurance contract held, similar to the treatment of financial risks.

IFRS 17.63 does not provide specific requirements on how to determine the effect of any risk of non-performance. IFRS 17.67 requires that changes in the fulfilment cash flows related to the risk of non-performance do not adjust the contractual service margin, therefore an entity recognises them in profit or loss. This treatment is consistent with the accounting treatment for financial risks.

How we see it

According to IFRS 13, the risk of non-performance is the risk that an entity will not fulfil its obligation. This risk includes, but is not limited to, the entity's own credit risk. IFRS 17.63 requires that an entity must include in the estimates of the present value of the future cash flows for the group of reinsurance contracts held, the effect of any risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes. As such, the risks of an entity not fulfilling its obligation could be influenced by different factors (including both the ability to pay and dispute over the amount contractually due). Evaluating what gives rise to the risk of non-performance involves the application of judgement because it depends on the specific circumstances of the reinsurance arrangement.

Even though the risk of non-performance should not be incorporated in the risk adjustment, changes in fulfilment cash flows that relate to the risk of non-performance will affect the measurement of the risk adjustment for non-financial risk to the extent that the underlying expected cash flows have reduced (e.g., because of insolvency of a reinsurer). This is because the risk inherent in those revised cash flows may have changed. As a result, we would expect the risk adjustment for non-financial risk to be calculated on the expected fulfilment cash flows after the fulfilment cash flows have been adjusted for the effect of non-performance.

11.5 Subsequent measurement of reinsurance contracts held

Instead of applying the subsequent measurement requirements of the general model, an entity must measure the contractual service margin at the end of the reporting period for a group of reinsurance contracts held as follows: *[IFRS 17.66]*

Change in the carrying amount of the contractual service margin of a group of reinsurance contracts held in a period	
The carrying amount determined at the start of the reporting period.	X/(X)
The effect of new contracts added to the group.	X/(X)
Interest accreted on the carrying amount of the contractual service margin, measured at discount rates determined at the date of initial recognition of a group of contracts using the discount rates as determined by the general model (see section 9.3 above).	X/(X)
Income recognised in profit or loss when an entity offsets a loss on an onerous group of underlying contracts (see section 11.4.3 above).	(X)
Reversals of a loss-recovery component recognised (see section 11.4.3 above) to the extent those reversals are not changes in the fulfilment cash flows of the group of reinsurance contracts held.	X
Change in fulfilment cash flows measured at the discount rates applied on initial recognition (see section 9.3 above) to the extent that the change relates to future service, unless (see section 11.5.1 below): ▸ The change results from a change in fulfilment cash flows allocated to a group of underlying insurance contracts that does not adjust the contractual service margin for the group of underlying insurance contracts. Or ▸ The change results from applying the onerous contract requirements to the measurement of a group of underlying insurance contracts using the premium allocation approach.	X/(X)
The effect of any currency exchange differences arising on the contractual service margin.	X/(X)
The amount recognised in profit or loss because of services received in the period determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period of the group of reinsurance contracts held (see section 11.5.2 below).	(X)/X
The carrying amount determined at the end of the reporting period.	X/(X)

Consistent with the requirements for insurance contracts issued (see section 9.6.3 above) IFRS 17 does not specify the order in which the calculations above need to be performed. This means that the choice as to which order to perform the calculations can have an impact on the statement of comprehensive income, for example, there will be more interest accretion if an entity performs interest accretion after adding new contracts rather than before. However, IFRS 17.66(e) states that the amount recognised in profit or loss because of services received in the period is determined by the allocation of the contractual margin remaining at the end of the period after all other steps. The use of the word 'end' implies that this must be the last step.

11.5.1 Changes to the contractual service margin that result from changes in estimates of cash flows

The contractual service margin of a group of insurance contracts issued can never be negative. In contrast, IFRS 17 does not include a limit on the amount by which the contractual service margin of a group of reinsurance contracts held could be adjusted as a result of changes in estimates of cash flows. In the Board's view, the contractual service margin for a group of reinsurance contracts held is different from that for a group of insurance contracts issued. The contractual service margin for the group of reinsurance contracts held depicts the expense the entity incurs when purchasing reinsurance coverage rather than the profit it will make by providing services under the insurance contract. Accordingly, the Board placed no limit on the amount of the adjustment to the contractual service margin for the group of reinsurance contracts held, subject to the amount of premium paid to the reinsurer. *[IFRS 17.BC314]*.

It is stated in the Basis for Conclusions that the Board considered the situation that arises when the underlying group of insurance contracts becomes onerous after initial recognition because of adverse changes in estimates of fulfilment cash flows relating to future service. In such a situation, the entity recognises a loss on the group of underlying insurance contracts (this situation would also apply to the subsequent accounting of underlying direct contracts that were already onerous at their initial recognition). The Board concluded that corresponding changes in cash inflows from a group of reinsurance contracts held should not adjust the contractual service margin of the group of reinsurance contracts held, with the result that the entity recognises no net effect of the loss and gain in the profit or loss for the period. This means that, to the extent that the change in the fulfilment cash flows of the group of underlying contracts is matched with a change in fulfilment cash flows on the group of reinsurance contracts held, there is no net effect on profit or loss. *[IFRS 17.BC315]*.

These requirements are shown by the following Illustration, based on Examples 12A and 12B in IFRS 17. *[IFRS 17.IE130-138]*.

Illustration 11-5: Measurement subsequent to initial recognition of groups of reinsurance contracts held

An entity enters into a reinsurance contract that, in return for a fixed premium, covers 30% of each claim from the underlying insurance contracts (the entity assumes that it could transfer 30% of non-financial risk from the underlying contracts to the reinsurer). In this example, the effect of discounting, the risk of the reinsurer's non-performance, and other amounts are disregarded for simplicity. Applying the relevant criteria, the entity considers that the group comprises a single contract held.

Immediately before the end of year one, the entity measures the group of underlying insurance contracts and the reinsurance contract held, as follows:

	Insurance contract liability	Reinsurance contract asset
	CU million	CU million
Fulfilment cash flows (before the effect of any change in estimates)	300	(90)
Contractual service margin	100	(25)
Insurance contract liability/(reinsurance contract asset) immediately before the end of year one	**400**	**(115)**

In this example, the difference between the contractual service margin for the reinsurance contract held of CU25m and 30% of the underlying group of insurance contracts of CU30m (30% × CU100) arises because of a different pricing policy between the underlying group of insurance contracts and the reinsurance contract held.

Example A

At the end of year one, the entity revises its estimates of the fulfilment cash flows of the underlying group of contracts. The entity estimates there is an increase in the fulfilment cash flows of the underlying contracts of CU50m and a decrease in the contractual service margin by the same amount (the group of underlying insurance contracts is not onerous).

The entity increases the fulfilment cash flows of the reinsurance contract held by 30% of the change in fulfilment cash flows of the underlying group of insurance contracts (CU15m = 30% of CU50m).

Applying IFRS 17.66, the entity adjusts the contractual service margin of the reinsurance contract held by the whole amount of the change in the fulfilment cash flows of this reinsurance contract held of CU15m from CU(25)m to CU(10)m. This is because the whole change in the fulfilment cash flows allocated to the group of underlying insurance contracts adjusts the contractual service margin of those underlying insurance contracts.

Therefore, at the end of year one, the entity measures the insurance contract liability and the reinsurance contract asset, as follows:

	Insurance contract liability	Reinsurance contract asset
	CU million	CU million
Fulfilment cash flows (including the effect of any change in estimates)	350	(105)
Contractual service margin	50	(10)
Insurance contract liability/(reinsurance contract asset) immediately before the end of year one	**400**	**(115)**

These changes do not affect estimates of profit or loss as all changes in the fulfilment cash flows go to the contractual service margin.

Example B

At the end of year one, the entity revises its estimates of the fulfilment cash flows of the underlying group of contracts. The entity estimates that there is an increase in the fulfilment cash flows of the underlying group of insurance contracts of CU160m. This change makes the underlying group of insurance contracts onerous and the entity decreases the contractual service margin by CU100m to zero and recognises the remaining CU60m as a loss in profit or loss.

The entity increases the fulfilment cash flows of the reinsurance contract held by CU48m which equals 30% of the fulfilment cash flows of the underlying group of insurance contracts (CU48m=30% of CU160m).

Applying IFRS 17.66, the entity adjusts the contractual service margin of the reinsurance contract held for the change in fulfilment cash flows that relate to future services to the extent this change results from a change in the fulfilment cash flows of the group of underlying insurance contracts that adjusts the contractual service margin for that group.

Consequently, the change in the fulfilment cash flows of the reinsurance contract held of CU48m is recognised as follows, by:

- Adjusting the contractual service margin of the reinsurance contract held for CU30m of the change in the fulfilment cash flows. The CU30m is equivalent to the change in the fulfilment cash flows that adjusts the contractual service margin of the underlying contracts of CU100m (CU30m = 30% × CU100m). Consequently, the contractual service margin of the reinsurance contract held of CU5m equals the contractual service margin on initial recognition of CU25m adjusted for the part of the change in the fulfilment cash flows of CU30m (CU5m = CU(25)m + CU30m). This represents a contractual service margin 'asset'.
- Recognising the remaining change in the fulfilment cash flows of the reinsurance contract held, CU18m (i.e., CU48m - CU30m) immediately in profit or loss.

Therefore, at the end of year one, using these alternative estimates, the entity measures the insurance contract liability and the reinsurance contract asset, as follows:

	Insurance contract liability	Reinsurance contract asset
	CU million	CU million
Fulfilment cash flows (including the effect of any change in estimates)	460	(138)
Contractual service margin	-	5
Insurance contract liability/(reinsurance contract asset) at the end of year one	**460**	**(133)**
The effect on profit or loss will be:		
Profit/(loss) at the end of year one	**(60)**	**18**

11.5.1.A Subsequent measurement of non-performance risk

Any changes in expected credit losses are economic events that must be reflected as gains and losses in profit or loss when they occur. To this end, IFRS 17 prohibits changes in fulfilment cash flows that relate to the risk of non-performance adjusting the contractual service margin. In the Board's view, differences in expected credit losses do not relate to future service. *[IFRS 17.67]*. Accordingly, this results in consistent accounting for expected credit losses between reinsurance contracts held and purchased and originated credit-impaired financial assets accounted for in accordance with IFRS 9 (which does not apply to rights and obligations arising under a contract within the scope of IFRS 17 such as a receivable due under a reinsurance contract held - see section 2.3 above and also section 16.1.1 below). *[IFRS 17.BC309]*.

As noted in section 11.4.4 above, the risk adjustment for non-financial risk does not include an adjustment for the risk of non-performance (which is already contained within the estimates of the present value of future cash flows). However, changes in fulfilment cash flows that relate to the risk of non-performance will affect the risk adjustment for non-financial risk to the extent that the underlying expected cash flows have reduced because the risk inherent in those revised cash flows has changed.

Illustration 11-6: Changes in reinsurance contract held balances caused by non-performance

An insurer (i.e., the cedant) holds a 100% quota share reinsurance contract. Assume the group of reinsurance contracts held consists of this single contract. Further assume that the present value of future cash inflows of the reinsurance contract held amounts to CU73, that consists of CU75, less CU2 as an estimate of non-performance. The risk adjustment for non-financial risk of the reinsurance contract held amounts to CU10. As a result, the reinsurance contract asset amounts to CU83.

As a result of a credit event, the reinsurer becomes insolvent. The insurer is an ordinary creditor of the reinsurer and the insurer's best estimate is that it will receive only 20% in any CU of the 'gross' claim of CU75. Assume that under the entity's method for estimating the risk adjustment, an expected cash flow of CU15 (consisting of CU75, less CU60 (80%) as an estimate of non-performance) would result in a risk adjustment for non-financial risk of 2.

The risk adjustment for non-financial risk following the credit event amounts to CU2 as the insurer should calculate the risk adjustment for non-financial risk using the fulfilment cash flows it expects, which in this case would be the net cash flows of CU15. As a result, the reinsurance contract asset now amounts to CU17. Therefore, there is an overall loss of CU66 (CU83 less CU17) to be recorded in the statement of comprehensive income (see section 16.1.1 below for further detail).

11.5.1.B Subsequent measurement of a loss-recovery component

As discussed in section 11.4.3 above, at initial recognition, an entity must establish (or adjust) a loss-recovery component of the asset for remaining coverage for a group of reinsurance contracts held depicting the recovery of losses recognised. This loss-recovery component must be accounted for in a manner consistent with the loss component of the group of underlying insurance contracts issued. As such, after the entity has established a loss component, it must adjust the loss-recovery component to reflect changes in the loss component of an onerous group of underlying insurance contracts.

The carrying amount of the loss-recovery component must not exceed the portion of the carrying amount of the loss component of the onerous group of underlying insurance contracts that the entity expects to recover from the group of reinsurance contracts held. *[IFRS 17.B119F]*.

A loss-recovery component reverses, consistent with reversal of the loss component of underlying groups of contracts issued, even when those reversals are not changes in the fulfilment cash flows of the group of reinsurance contracts held. Such reversals adjust the contractual service margin. *[IFRS 17.66(bb)]*. For example, a loss-recovery component might be reversed by a change in fulfilment cash flows in the underlying group of insurance contracts that has no corresponding change in fulfilment cash flows in the reinsurance contract held (e.g., because of a favourable change in expense assumptions not covered under the reinsurance agreement).

How we see it

IFRS 17.66(bb) states that reversals of a loss-recovery component of a group of reinsurance contracts held that arise from non-covered cash flows should adjust the contractual service margin of the group of reinsurance contracts held. However, IFRS 17 does not, within this context, refer to increases in the loss-recovery component that arise from cash flows that are not covered by the reinsurance contract. This appears to indicate that, after initial recognition, a loss-recovery component of a group of reinsurance contracts held is adjusted only for changes in non-covered cash flows when those changes result in a decrease in the loss component on the underlying group of contracts. For subsequent measurement, the loss recovery guidance of IFRS 17 can only result in decreases of the loss component for changes in non-covered cash flows, but not increases. The loss-recovery component can subsequently only be increased for changes in cash flows that are covered under the terms of the reinsurance contract held. This subsequent treatment of the loss-recovery component therefore differs from the way that a loss-recovery component is set up on initial recognition (see section 11.4.3 above).

The following Illustration based on Example 12C in the Illustrative Examples on IFRS 17 shows how this operates in practice. *[IFRS 17.IE138L, IFRS 17.IE138M]*.

Illustration 11-7: Measurement subsequent to initial recognition of groups of reinsurance contracts held

Assuming the same fact pattern as Illustration 11-5 above.

At the end of Year one, the entity measures the insurance contract liability and the reinsurance contract asset, as follows:

	Insurance contract liability		Reinsurance contract asset
	Profitable group of insurance contracts	Onerous group of insurance contracts	
	CU million	CU million	CU million
Estimates of future cash inflows (recoveries)	-	-	(180)
Estimates of present value of future cash outflows (claims)	400	200	-
Fulfilment cash flows	400	200	(180)
Contractual service margin	200	-	(48)
Insurance contract liability/ (reinsurance contract asset) immediately before the end of year one	**600**	**200**	**(228)**

Applying IFRS 17.66(e) and B119, the entity determines the amount of the contractual service margin recognised in profit or loss for the service received in Year one as CU24m, which is calculated by dividing the contractual service margin on initial recognition of CU72m by the coverage period of three years. Consequently, the contractual service margin of the reinsurance contract held at the end of Year one of CU48m equals the contractual service margin on initial recognition of CU72m minus CU24m.

At the end of Year two, the entity revises its estimates of the remaining fulfilment cash outflows of the groups of underlying insurance contracts. The entity estimates that the fulfilment cash flows of the groups of underlying insurance contracts increase by 10%, from future cash outflows of CU300m (see Illustration 11-5 in section 11.5.1 above) to future cash outflows of CU330m. Consequently, the entity estimates the fulfilment cash flows of the reinsurance contract held also increase from future cash inflows of CU9 m to future cash inflows of CU99m.

At the end of Year two, the entity measures the insurance contract liability and the reinsurance contract asset, as follows:

	Insurance contract liability		Reinsurance contract asset
	Profitable group of insurance contracts	Onerous group of insurance contracts	
	CU million	CU million	CU million
Estimates of future cash inflows (recoveries)	-	-	(99)
Estimates of present value of future cash outflows (claims)	220	110	-
Fulfilment cash flows	220	110	(99)
Contractual service margin	90	-	(21)
Insurance contract liability/ (reinsurance contract asset)	**310**	**110**	**(120)**
Recognition of loss and recovery of loss		**(10)**	**3**

As a result of the changes in the estimates of the remaining fulfilment cash flows:

- The entity increases the expected remaining cash outflows of the groups of underlying insurance contracts by 10% for each group (CU30m in total) and increases the expected remaining cash inflows of the reinsurance contract held by 10% of the expected recoveries of CU90m (CU9m).
- Applying IFRS 17.44(c), the entity adjusts the carrying amount of the contractual service margin of the profitable group of underlying insurance contracts of CU200m by CU20m for the changes in fulfilment cash flows relating to future service. Applying IFRS 17.44(e), the entity also adjusts the carrying amount of the contractual service margin by CU90m for the amount recognised as insurance revenue ((CU200m - CU20m = CU180m) ÷ 2). The resulting contractual service margin at the end of Year two is CU90m (CU200m - CU20m - CU90m).
- Applying IFRS 17.48, the entity recognises in profit or loss an amount of CU10m for the changes in the fulfilment cash flows relating to future services of the onerous group of underlying insurance contracts.
- Applying IFRS 17.66(c)(i), the entity adjusts the contractual service margin of the reinsurance contract held for the change in fulfilment cash flows that relate to future service unless the change results from a change in fulfilment cash flows allocated to a group of underlying insurance contracts that does not adjust the contractual service margin for that group. Consequently, the entity recognises the change in the fulfilment cash flows of the reinsurance contract held of CU9m by:
  - Recognising immediately in profit or loss CU3m of the change in the fulfilment cash flows of the reinsurance contract held (30% of the CU10m change in the fulfilment cash flows of the onerous group of underlying insurance contracts that does not adjust the contractual service margin of those contracts).

    And
  - Adjusting the contractual service margin of the reinsurance contract held by CU6m of the change in the fulfilment cash flows (CU9m - CU3m).

  Consequently, the contractual service margin of the reinsurance contract held of CU(21m) equals the contractual service margin at the end of Year one of CU(48m) adjusted for CU6m and for CU21m of the contractual service margin recognised for the service received in Year two (CU(21)m = (CU(48)m + CU6m) ÷ 2).

As discussed in section 11.4.3 above, an entity might include in an onerous group of insurance contracts both onerous insurance contracts covered by a group of reinsurance contracts held and onerous insurance contracts not covered by the group of reinsurance contracts held. To adjust the contractual service margin for changes in fulfilment cash flows allocated to a group of underlying insurance contracts that do not adjust the contractual service margin for that group of underlying insurance contracts, an entity must apply a systematic and rational method of allocation to determine the portion of losses recognised on the group of insurance contracts that relate to insurance contracts covered by the group of reinsurance contracts held. *[IFRS 17.B119E]*.

11.5.2 Allocation of the contractual service margin to profit or loss

The principles for release of the contractual service margin for reinsurance contracts held follows the same principles as for insurance and reinsurance contracts issued, i.e., the contractual service margin is released to profit or loss as the reinsurer renders service. For a reinsurance contract held, the period that the reinsurer renders service is the coverage period of the reinsurance contract which includes both the period of insurance coverage as well as the period of any investment return service.

The line item in profit or loss to which the contractual service margin is released will depend upon the policy choice for the presentation of income and expenses from a group of reinsurance contracts held - see section 15.2.1.C below.

Frequently asked questions

Question 11-9: For reinsurance contracts held, are coverage units determined based on the services provided by the reinsurer, or the coverage units of the underlying insurance contracts?

(TRG meeting, May 2018 - Agenda paper no. 7, Log S41)

Applying IFRS 17.B119, the coverage units of a group of insurance contracts are determined based on the quantity of coverage provided by the contracts in that group. For a group of reinsurance contracts held, this is the coverage received by the insurer from the reinsurer under those reinsurance contracts held, and not the coverage provided by the insurer to its policyholders through the underlying insurance contracts. When determining the quantity of benefits received from a reinsurance contract held, an entity may consider relevant facts and circumstances related to the underlying insurance contracts.

See section 9.9.4 above for an example of determining the quantity of benefits for identifying coverage units in proportional reinsurance issued.

11.5.2.A Retroactive reinsurance

For retroactive reinsurance contracts held, the coverage period of the underlying insurance contracts may have expired prior to the inception of the reinsurance contract held. In respect of these contracts, the coverage is provided against an adverse development of an event that has already occurred. *[IFRS 17.B5]*. This means that the contractual service margin must be released over the expected settlement period of the claims of the underlying insurance contracts (since that is, in effect, the coverage period for the reinsurance contract).

Since incurred claims are treated as a liability for incurred claims on the underlying direct/assumed side, but as part of the liability for remaining coverage on the reinsurance held side, the question arises as to whether this creates an asymmetry in the recognition of changes in claims between the direct contract issued (relating to past service) and the reinsurance contract held. There should be no asymmetry because IFRS 17.66 (see section 11.5.1 above) indicates that the contractual service of reinsurance contracts held is not adjusted by the change that results from a change in fulfilment cash flows allocated to a group of underlying insurance contracts that does not adjust the contractual service margin for the group of underlying insurance contracts. These fulfilment cash flows include the liability for incurred claims, as changes in the liability for incurred claims do not adjust the contractual service margin for the underlying contracts as there is no contractual service margin on the liability for incurred claims. Accordingly, any change in the fulfilment cashflows of the reinsurance contract held due to the changes of the liability for incurred claims of the underlying contracts will impact profit or loss and not the contractual service margin of the reinsurance contract held. This is shown by the following Illustration:

Illustration 11-8: Treatment of changes in reinsurance recoveries arising from past events

Company A (the cedant) has a liability for incurred claims of CU100. It decides to enter into a reinsurance contract under which it cedes 50% of the liability for incurred claims.

The cedant pays a reinsurance premium of CU55 to the reinsurer at inception and cedes an amount of CU50 (i.e., 50%) of its liability for incurred claims. This results in a net cost of reinsurance of CU5 at initial recognition. The net cost of CU5 goes immediately through profit or loss following IFRS 17.65A (net cost of purchasing reinsurance coverage recognised as an expense).

In Year one, the liability for incurred claims of the underlying direct contracts increases from CU100 to CU115. As a consequence, the share of liability for incurred claims ceded to the reinsurer increases by CU7.5 (50% of CU15) and implies a favourable change (increase) in the asset for remaining coverage of the reinsurance contract held of CU7.5.

The favourable change in the asset for remaining coverage of CU7.5 should be credited directly to profit or loss to match the treatment for the change of the underlying liability for incurred claims and not to the contractual service margin. This accounting (i.e., direct to profit or loss) should be the same if the deviation was unfavourable.

11.6 Premium allocation approach for reinsurance contracts held

An entity may use the premium allocation approach (see section 10 above), adapted to reflect the features of reinsurance contracts held that differ from insurance contracts issued, for example, the generation of expenses or a reduction in expenses rather than revenue, to simplify the measurement of a group of reinsurance contracts held if, at the inception of the group: *[IFRS 17.69]*

- The entity reasonably expects that the resulting measurement would not differ materially from the result of applying the requirements in the general model for reinsurance contracts held, as discussed above
  Or
- The coverage period of each contract in the group of reinsurance contracts held (including coverage from all premiums within the contract boundary determined at that date applying the definition in the general model) is one year or less

Assessment of the eligibility for groups of reinsurance contracts held to be able to use the premium allocation approach is independent on whether the entity applies the premium allocation approach to the underlying groups of insurance contracts issued by an entity. Therefore, for example, reinsurance contracts which are written on a twelve month risks attaching basis (i.e., the underlying insurance contracts subject to the reinsurance contract incept over a twelve month period) will have a contract boundary of up to two years if each of the underlying insurance contracts have a coverage period of one year (see Illustration 11-2 in section 11.2 above). The two year contract boundary means that those reinsurance contracts held will not meet the twelve month criterion for use of the premium allocation approach and would have to qualify for the premium allocation approach on the basis that the resulting measurement would not differ materially from the result of applying the requirements of the general model. As a consequence, a mismatch in measurement models may arise if the underlying contracts are accounted for under the premium allocation approach while the reinsurance contract needs to be accounted for under the general model.

IFRS 17 confirms that an entity cannot meet the first condition above if, at the inception of the group, an entity expects significant variability in the fulfilment cash flows that would affect the measurement of the asset for remaining coverage during the period before a claim is incurred. Variability in the fulfilment cash flows increases with, for example: *[IFRS 17.70]*

- The extent of future cash flows relating to any derivatives embedded in the contracts
  And
- The length of the coverage period of the group of reinsurance contracts held

When a group of reinsurance contracts held is accounted for applying the premium allocation approach and an entity has a group of underlying insurance contracts that are onerous on initial recognition (see section 11.4.3 above), the carrying amount of the asset for remaining coverage is adjusted instead of the contractual service margin. *[IFRS 17.70A]*.

How we see it

IFRS 17 provides for the recognition of a reinsurance loss-recovery component at initial recognition of a group of onerous underlying insurance contracts when the group of reinsurance contracts held is accounted for under the premium allocation approach. However, the standard does not include guidance on the *subsequent* treatment of a loss-recovery component when the group of reinsurance contracts held is accounted for under the premium allocation approach. Following the requirements for the loss-recovery component under the general model, the carrying amount of the loss-recovery component must not exceed the portion of the carrying amount of the loss component of the onerous group of underlying insurance contracts that an entity expects to recover from the group of reinsurance contracts held. Therefore, the loss-recovery component should be nil if the loss component of the onerous group of underlying insurance contracts is nil. On this basis, the loss-recovery component recognised at initial recognition should be reduced to nil in line with reductions in the onerous group of underlying insurance contracts.

Furthermore, analogising from the requirements for the loss-recovery component under the general model, an entity would not be precluded from subsequently recording or increasing a loss-recovery component for changes in the loss component of an onerous group of underlying contracts when a group of reinsurance contracts held is accounted for under the premium allocation approach. In doing so, an entity would need to determine the loss-recovery component in way that is adapted to the specific mechanics of the premium allocation approach but consistent with the principles of the loss-recovery component under the general model.

11.7 Reinsurance contracts held and the variable fee approach

An entity is not permitted to use the variable fee approach for reinsurance contracts held. The variable fee approach also cannot be applied to reinsurance contracts issued. *[IFRS 17.B109]*. Therefore, this will cause an accounting mismatch when an entity has reinsured contracts subject to the variable fee approach discussed in section 12.3 below. It is stated in the Basis for Conclusions that the IASB considers that the entity and the reinsurer do not share in the returns on underlying items and, as such, the criteria for the variable fee approach are not met, even if the underlying insurance contracts issued are insurance contracts with direct participation features. The IASB decided not to modify the scope of the variable fee approach to include reinsurance contracts held as it was considered that such an approach would be inconsistent with the Board's view that a reinsurance contract held should be accounted for separately from the underlying contracts issued. *[IFRS 17.BC248]*.

12 Measurement of contracts with participation features

Many entities issue participating contracts (referred to in IFRS 17 as contracts with participation features), in which both the policyholder and the entity benefit from the financial return on the premiums paid by sharing the performance of the underlying items over the contract period. Participating contracts can include cash flows with different characteristics, for example:

- Cash flows that do not vary with returns from underlying items, such as death benefits and financial guarantees
- Cash flows that vary with returns from underlying items - either via a contractual link to the returns on underlying items or through an entity's right to exercise discretion in determining payments to policyholders

Insurance entities in many countries have issued contracts with participation features. An example of an insurance contract with a participation feature is a contract with a death cover in which the policyholder pays annual premiums into an account held by the insurer and receives the higher of a specified death benefit or the account balance (less fees), the return on which is based on the return generated by specified investments. Participating contracts may also contain discretionary participation features. In some countries, insurance companies must return to the policyholders at least a specified proportion of the investment profits on certain contracts but may give more. In other countries, bonuses are added to the policyholder account at the discretion of the insurer. In a third example, insurance companies distribute realised investment gains to the policyholder, but have discretion over the timing of realising the gains. These gains are normally based on the investment return generated by the underlying assets, and sometimes include an allowance for profits made on other contracts.

For measurement and presentation purposes, IFRS 17 does not distinguish between those participating insurance contracts that have discretionary features and those insurance contracts which do not have discretionary features. This is a change from IFRS 4, which had separate requirements for insurance contracts with discretionary participating features.

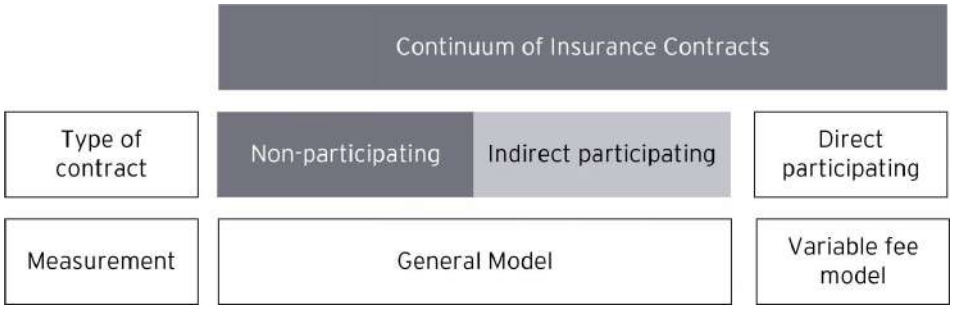
IFRS 17 includes:

- A mandatory adaptation to the general model (the variable fee approach) for insurance contracts that include direct participation features (see section 12.3 below).
- As part of the variable fee approach, a different method for determining the insurance finance income or expenses recorded in profit or loss when insurance finance income or expenses is disaggregated between profit or loss and other comprehensive income and when the underlying items are held (see section 15.3 below).
- Specific requirements within the general model for investment contracts with discretionary participation features (see section 12.4 below)

Insurance contracts without direct participation features are not permitted to be accounted for under the variable fee approach, even if such contracts contain participation features (sometimes referred to as indirect participating contracts). For example, an insurance contract where the profit sharing is not based on a share of a clearly identified pool of underlying items. Consequently, there will be a difference between the recognition of insurance revenue for insurance contracts without direct participation features but that have some asset dependent cash flows, and for insurance contracts with direct participation features accounted for using the variable fee approach. Different discount rates must also be used for re-measuring the contractual service margin (see section 9.3 above).

Contracts with participation features, including those contracts that meet the criteria for the variable fee approach, are not excluded from applying the premium allocation approach, but IFRS 17 appears to assume that they will typically not meet the eligibility criteria (as the coverage period may be significantly in excess of one year).

The following diagram compares accounting for direct participating contracts to other insurance contracts (assuming the premium allocation approach is not applied).



Reinsurance contracts issued and held cannot be insurance contracts with direct participation features for the purposes of IFRS 17 (see section 11.7 above). *[IFRS 17.B109]*.

Many participating contracts also contain an element of discretion, which means that the entity can choose whether to pay additional benefits to policyholders. However, contracts without participation features may also contain an element of discretion. As discussed in section 9.2 above, the expected cash outflows of an insurance contract includes outflows over which the entity has discretion. IFRS 4 permitted the discretionary component of an insurance contract with participation features to be classified in its entirety as either a liability or as equity. *[IFRS 4.34(b)]*. As a result, under IFRS 4, many insurers classified the entire contract (including amounts potentially due to shareholders) as a liability. This treatment is not available under IFRS 17 as insurers are required to split the liability and equity components. Under IFRS 17, entities must make a best estimate of the liability due to policyholders (both current and future) under the contracts and amounts attributable to shareholders are part of shareholders' equity.

The following are two examples of contracts with a participation feature:

Illustration 12-1: Unitised with-profits policy

Premiums paid by the policyholder are used to purchase units in a 'with-profits' fund at the current unit price. The insurer guarantees that each unit added to the fund will have a minimum value which is the bid price of the unit. This is the guaranteed amount. In addition, the insurer may add two types of bonuses to the with-profits units. These are a regular bonus, which may be added daily as a permanent increase to the guaranteed amount, and a final bonus that may be added on top of those guaranteed amounts when the with-profits units are cashed in. Levels of regular and final bonuses are adjusted twice per year. Both regular and final bonuses are discretionary amounts and are generally set based on expected future returns generated by the funds.

Illustration 12-2: Participation policy with minimum interest rates

An insurance contract provides that the insurer must annually credit each policyholder's 'account' with a minimum interest rate (3%). This is the guaranteed amount. The insurer then has discretion regarding whether and what amount of the remaining undistributed realised investment returns from the assets backing the participating policies are distributed to policyholders in addition to the minimum. The contract states that the insurer's shareholders are only entitled to share up to 10% in the underlying investment results associated with the participating policies. As that entitlement is up to 10%, the insurer can decide to credit the policyholders with more than the minimum sharing rate of 90%. Once any additional interest above the minimum interest rate of 3% is credited to the policyholder it becomes a guaranteed liability.

How we see it

Determining how to faithfully represent the complex features of some participating contracts was one of the greatest challenges the IASB faced in finalising IFRS 17.

It is important to note that the differences between the variable fee approach for direct participation contracts and the general model applied to all other contracts exist for subsequent measurement only. As the requirements for initial measurement are the same for both models, any differences in measurement on initial recognition between contracts would be the result of differences in the terms and conditions of those contracts, but not the application of the two different measurement models.

12.1 Contracts with cash flows that affect or are affected by cash flows to policyholders of other contracts (mutualisation)

Entities should consider whether the cash flows of insurance contracts in one group affect the cash flows to policyholders of contracts in another group. In practice, this effect is often referred to as 'mutualisation', even though this term is not defined in IFRS 17. The standard uses the term 'risk sharing'. The economic effect of risk sharing is that a large population of policyholders effectively act together as a loss-absorbing 'buffer' when an adverse event occurs. The insurer itself incurs a loss only if the loss-absorbing capacity of the large population of policyholders is exhausted (i.e., the insurer, and ultimately its shareholders, act as risk-taker of last resort). As such, mutualised contracts result in policyholders subordinating their claims or cash flows to those of other policyholders, thereby reducing the direct exposure of the entity to a collective risk.

IFRS 17 observes that some insurance contracts affect the cash flows to policyholders of other contracts by requiring: *[IFRS 17.B67]*

- The policyholder to share the returns on some specified pool of underlying items

  And

- Either:
  - The policyholder to bear a reduction in their share of the returns on the underlying items because of payments to policyholders of other contracts that share in that pool, including payments arising under guarantees made to policyholders of those other contracts

    Or

  - Policyholders of other contracts bear a reduction in their share of returns on the underlying items because of payments to the policyholder, including payments arising from guarantees made to the policyholder

Sometimes, such contracts will affect the cash flows to policyholders of contracts in other groups. The fulfilment cash flows of each group reflect the extent to which the contracts in the group cause the entity to be affected by expected cash flows, whether to policyholders in that group or to policyholders in another group. Hence, the fulfilment cash flows for a group: *[IFRS 17.B68]*

- Include payments arising from the terms of existing contracts to policyholders of contracts in other groups, regardless of whether those payments are expected to be made to current or future policyholders

  And

- Exclude payments to policyholders in the group that have been included in the fulfilment cash flows of another group

For example, to the extent that payments to policyholders in one group ('first group') are reduced from a share in the returns on underlying items of CU350 to CU250 because of payments of a guaranteed amount to policyholders in another group ('second group'), the fulfilment cash flows of the first group would include the payments of CU100 (i.e., would be CU350) and the fulfilment cash flows of the second group would exclude CU100 of the guaranteed amount. *[IFRS 17.B69]*.

The reference to future policyholders is necessary because sometimes the terms of an existing contract are such that the entity is obliged to pay to policyholders amounts based on underlying items, but with discretion over the timing of the payments. That means that some of the amounts based on underlying items may be paid to policyholders of contracts that will be issued in the future that share in the returns on the same underlying items, rather than to existing policyholders. From the entity's perspective, the terms of the existing contract require it to pay the amounts, even though it does not yet know when or to whom it will make the payments. *[IFRS 17.BC172]*.

Illustration 12-3: Risk sharing and guarantees

An insurer has issued participating contracts to two policyholders, A and B, that share in the same pool of underlying assets. The insurer has discretion as to how to share the returns of the underlying assets, but is bound by the minimum return guarantee in each individual contract. The terms of the contracts are the same, except that A's minimum return guarantee is 10% and B's is 5%. The pay-out of the returns to policyholder A and B are interdependent as both policyholders share in the same pool of underlying assets.

Assume the actual return from the underlying items is 8%. For A, the 8% of actual return from the underlying items is less than the minimum return guarantee of 10%. The opposite is true for B. Based on the contractual terms for both policyholders, A receives 10% (minimum return guarantee), and B receives the residual return of 6% (8% less 2% additional return paid to A). Thus, the amount paid to B is reduced in order to satisfy the minimum return promised to A, i.e., there is interdependency between the two pay-outs.

In this example, the insurer does not have to pay the difference between the actual returns and the minimum return guarantee to A. Instead, policyholder B absorbs a loss (or rather, misses out on an opportunity gain) to the benefit of the shareholders of the insurer. However, the insurer would need to pay the shortfall if the return from the underlying assets is insufficient to pay the minimum return guarantee of both policyholders. In this example, if the return is less than 7.5%, the minimum guarantees of both A and B could not be paid from this return in full and therefore the insurer would need to step in to pay the shortfall.

Different practical approaches can be used to determine the fulfilment cash flows of groups of contracts that affect or are affected by cash flows to policyholders of contracts in other groups. In some cases, an entity might be able to identify the change in the underlying items and resulting change in the cash flows only at a higher level of aggregation than the groups. In such cases, the entity must allocate the effect of the change in the underlying items to each group on a systematic and rational basis. *[IFRS 17.B70]*.

After all insurance contract services have been provided to the contracts in a group, the fulfilment cash flows may still include payments expected to be made to current policyholders in other groups or future policyholders. An entity is not required to continue to allocate such fulfilment cash flows to specific groups, but can, instead, recognise and measure a liability for such fulfilment cash flows arising from all groups. *[IFRS 17.B71]*.

The Board considered whether to provide specific guidance on amounts that have accumulated over many decades in participating funds and whose 'ownership' may not be attributable definitively between shareholders and policyholders. It concluded that it was not necessary. In principle, IFRS 17 requires an entity to estimate the cash flows in each scenario. If that requires difficult judgements or involves unusual levels of uncertainty, an entity would consider those matters in deciding what disclosures it must provide to satisfy the disclosure objective in IFRS 17 (see section 16 below). *[IFRS 17.BC170]*.

The Board also considered whether prohibiting groups from including contracts issued more than one year apart would create an artificial divide for contracts with cash flows that affect, or are affected by, cash flows to policyholders in another group. The Board acknowledged that, for contracts that fully share risks, the groups together will give the same results as a single combined risk-sharing portfolio and therefore considered whether IFRS 17 should give an exception to the requirement to restrict groups to include only contracts issued within one year. However, the Board concluded that setting the boundary for such an exception would add complexity to IFRS 17 and create the risk that the boundary would not be robust or appropriate in all circumstances. Nonetheless, the Board noted that the requirements specify the amounts to be reported, not the methodology to be used to arrive at those amounts. Therefore, it may not be necessary for an entity to restrict groups in this way to achieve the same accounting outcome in some circumstances. *[IFRS 17.BC138]*. Details about IFRS 17's requirements for annual cohorts and inter-generational sharing of risk is contained in section 6.2.2.A above.

Frequently asked questions

Question 12-1: For annual groups of contracts that all share in the return of a specified pool of underlying items, with some of the return contractually passing from one group of policyholders to another, in what circumstances would measuring the contractual service margin at a higher level than an annual cohort level, such as a portfolio level, achieve the same accounting outcome as measuring the contractual service margin at an annual cohort level applying IFRS 17.22?

(TRG meeting September 2018 - Agenda paper no. 10, Log S74)

The TRG members discussed the IASB staff paper and observed that:

- When a specified pool of underlying items consists of insurance contracts issued to the policyholders that share in the returns of that pool, the criteria for mutualisation are met regardless of whether the policyholders' share is 100% of the return of the pool of underlying items or only part of the pool of underlying items.
- The criteria for mutualisation are also met when a specified pool of underlying items do not include the insurance contracts issued to those policyholders (for example, where underlying items are financial assets), if the contracts require policyholders to bear a reduction in their share of the returns on the underlying items because of payments to policyholders of other contracts that share in that pool.
- For contracts that share in 100% of the return of a pool of underlying items consisting of insurance contracts issued to those policyholders, the contractual service margin will be nil. Therefore, measuring the contractual service margin at a higher level than the annual cohort level, such as a portfolio level, would achieve the same accounting outcome as measuring the contractual service margin at an annual cohort level.
- Conversely when contracts share to a lesser extent in the return on a pool of underlying items consisting of insurance contracts issued to those policyholders, an entity could be affected by the expected cash flows of each contract issued. Therefore, the contractual service margin of the groups of contracts (at annual cohort level) may differ from the contractual service margin measured at a higher level, such as a portfolio level. To assess whether measuring the contractual service margin at a higher level would achieve the same accounting outcome as measuring the contractual service margin at an annual cohort level, an entity would need to determine what the effect would be (i.e., the accounting outcome would need to be the same in all circumstances, regardless of how assumptions and experience develop over the life of the contract).

In addition, TRG members expressed concern that, in practice, cash flows would be determined at a higher level of measurement than in the examples provided in the IASB staff paper and then the entity would have to allocate the effect of the change in the underlying items to each group on a systematic and rational basis.

How we see it

Mutualisation applies only in the specific circumstances where policyholders are contractually required to share with policyholders of other contracts the returns on the same specified pool of underlying items. Cash flows to policyholders of contracts without participation features will typically be independent of amounts paid to other contracts. For example, holders of motor insurance contracts are generally not affected by amounts paid to holders of other motor insurance contracts issued by the same entity.

The standard does not limit the application of mutualisation to contracts with direct participation features, so, in principle, it could apply to other types of participating contracts too. However, meeting the criteria of mutualisation will arguably be more challenging the more the contract features are dissimilar to those of a contract with direct participation features.

To the extent mutualisation applies across groups of contracts written in different reporting periods, an entity will be able to offset losses on some groups with profits from other groups when measuring the affected groups. The question arises as to whether an entity will achieve the same outcome by measuring the affected groups together based on the combined risk sharing of those groups. Although the standard does not prohibit the use of practical expedients that would achieve the same outcome, an entity would have to substantiate the measurement outcome in the same way, considering all relevant aspects of the measurement. For example, an entity must not only consider the effect of loss recognition, but also the release pattern of the contractual service margin over the coverage period.

12.2 Participating insurance contracts without direct participation features

Insurance contracts without direct participation features must apply the general model without adaptation, even though such contracts may have participation features (also referred to as indirect participating contracts).

The terms of some insurance contracts without direct participation features give an entity discretion over the cash flows to be paid to policyholders. A change in discretionary cash flows is regarded as relating to future service, and, accordingly, adjusts the contractual service margin. To determine how to identify a change in discretionary cash flows, an entity must specify at inception of the contract, the basis on which it expects to determine its commitment under the contract, for example, the commitment could be based on a fixed interest rate, or returns that vary based on specified asset returns. *[IFRS 17.B98]*.

An entity must use that specification to distinguish between the effect of changes in assumptions that relate to financial risk on that commitment (which do not adjust the contractual service margin) and the effect of discretionary changes to that commitment (which adjust the contractual service margin). *[IFRS 17.B99]*.

If an entity cannot specify at inception of the contract, what it regards as its commitment under the contract and what it regards as discretionary, it must consider its commitment to be the return implicit in the estimate of the fulfilment cash flows at inception of the contract, updated to reflect current assumptions for financial risk. *[IFRS 17.B100]*.

Illustration 12-4: Adjusting the contractual service margin for the effects of a change in discretionary cash flows

Entities A and B issue identical groups of insurance contracts without direct participation features one day before a reporting period ends. The contracts have a coverage period of five years. The policyholder receives the higher of a fixed death benefit or an account balance if he or she dies during the coverage period or an account balance at the end of the coverage period if he or she survives the coverage period. The contracts transfer significant insurance risk, although for the purposes of illustrating the effect of discretion over amounts credited to policyholder account balances, we disregard the death benefit cost.

At contract inception, the entities:

- Receive premiums of CU1,000
- Specify that their commitment under the contract is to credit interest to the account balances at a rate equal to the return on an internally specified pool of assets, minus a 2% spread
- Expect investment returns from the specified pool of assets to be 10% a year
- Expect to pay benefits at maturity of the contracts of CU1,469 (i.e., to credit interest at the rate of 8% a year for five years (CU1,000 × 1.08^5 = CU1,469)
- Recognise fulfilment cash flows of CU912 (CU1,469 ÷ 1.1^5)
- Recognise a contractual service margin of CU88 (CU1,000 - CU912)

At the first subsequent reporting date (one day later), both entities revise their expectations of returns from the specified pool of assets downward from 10% to 9% a year.

Entity A's stated policy is that it will maintain its 2% spread. Therefore, Entity A:

- Expects to credit interest to the account balances of its policyholders at the rate of 7% a year
- Expects to pay benefits at maturity of CU1,403 (CU1,000 × 1.07^5 = CU1,403)
- Measures fulfilment cash flows at the reporting date of CU912 (CU1,403 ÷ 1.09^5 = CU912)
- Maintains the contractual service margin of the group of contracts at CU88 because the measurement of fulfilment cash flows has not changed (assume accretion of interest and release of contractual service margin to profit or loss in one day is insignificant)

Entity B decides to apply its discretion and reduce the spread that it deducts from the return on the specified pool of assets from 2% to 1% a year. Therefore, Entity B:

- Expects to credit interest to the account balances of its policyholders at the rate of 8% a year (9% expected annual return, minus 1% spread)
- Expects to pay benefits at maturity of CU1,469 (CU1,000 × 1.08^5 = CU1,469)
- Measures fulfilment cash flows at the reporting date of CU956 (CU1,469 ÷ 1.09^5 = CU955)
- Adjusts the contractual service margin for the group of contracts from CU88 to CU44 to reflect the adjustment to fulfilment cash flows resulting from an increase in fulfilment cash flows caused by its discretion to change the basis of policyholder payments (CU912 - CU956 = -CU44, contractual service margin of CU88 - CU44 = CU44)

12.3 Contracts with direct participation features

IFRS 17 identifies a separate set of insurance contracts with participation features described as insurance contracts with direct participation features. These contracts apply an adapted version of the general model, commonly referred to as the 'variable fee' approach.

For contracts using the variable fee approach, the changes in the contractual service margin are mostly driven by the movements in the assets 'backing' the contracts or other profit-sharing items (referred to as 'underlying items') rather than by the fulfilment cash flows of the insurance contract liability. Use of the variable fee approach instead of the general model is mandatory for those insurance contracts that meet the criteria of the variable fee approach (see section 12.3.1 below). The assessment of eligibility for the variable fee approach should be performed at individual contract level although in practice this could be applied to 'clusters' of contracts as long as the outcome would not be different. The Board observed that one assessment should be sufficient for an entity to determine whether the criteria are met for each contract in a set of homogenous contracts issued in the same market conditions and priced on the same basis. *[IFRS 17.BC249D]*.

The variable fee approach applies to insurance contracts that meet its criteria; the fact that participation features are discretionary does not necessarily preclude contracts from meeting the criteria. However, contracts with participation features are significantly different across jurisdictions. Not all contracts with participation features will meet the criteria to be accounted for as direct participation contracts.

Conceptually, insurance contracts with direct participation features are contracts under which an entity's obligation to the policyholder is the net of: *[IFRS 17.B104]*

- The obligation to pay the policyholder an amount equal to the fair value of the underlying items

  And

- A variable fee that the entity will deduct from the obligation in exchange for the future service provided by the insurance contract comprising:
  - The amount of the entity's share of the fair value of the underlying items, less
  - Fulfilment cash flows that do not vary based on the returns on underlying items

Under this approach: *[IFRS 17.BC243]*

- Changes in the estimates of the obligation to pay the policyholder an amount equal to the fair value of the underlying items are recognised in profit or loss or other comprehensive income, just as would changes in the fair value of most underlying items.
- Changes in the estimates of the variable fee for future service and changes in estimates of cash flows relating to future service would be accounted for constantly. Accordingly, changes in the entity's share of underlying items adjust the contractual service margin so that the changes are recognised in profit or loss over the coverage period.
- The financial statements of the entity report a net investment return only to the extent that the return on the assets the entity holds (if measured at fair value thought profit or loss) do not match the returns on the promised underlying items.

The Board concluded that returns to the entity from underlying items should be viewed as part of the compensation the entity charges the policyholder for service provided under the insurance contract, rather than as a share of returns from an unrelated investment, in a narrow set of circumstances in which the policyholders directly participate in a share of the returns on the underlying items. In such cases, the fact that the fee for the contract is determined by reference to a share of the returns on the underlying items is incidental to its nature as a fee. The Board concluded that depicting the gains and losses on the entity's share of the underlying items as part of a variable fee for service faithfully represents the nature of the contractual arrangement. *[IFRS 17.BC244]*.

IFRS 17 requires the contractual service margin for insurance contracts with direct participation features to be updated for more changes than those affecting the contractual service margin for other insurance contracts. In addition to the adjustments made for other insurance contracts, the contractual service margin for insurance contracts with direct participation features is also adjusted for the effect of changes in: *[IFRS 17.BC240]*

- The entity's share of the underlying items

  And

- Financial risks other than those arising from the underlying items, for example, the effect of financial guarantees

The Board decided that these differences are necessary to give a faithful representation of the different nature of the fee in these contracts. The Board concluded that, for many insurance contracts, it is appropriate to depict the gains and losses on any investment portfolio related to the contracts in the same way as gains and losses on an investment portfolio unrelated to insurance contracts. *[IFRS 17.BC241]*.

Illustration 12-5: The 'variable fee approach' compared to the general model

A group of contracts with participating features was written at the beginning of the year, in which the entity received premiums in total of CU1,000, which was used to purchase financial assets. The policyholder participates in 90% and the entity in 10% of the assets' return.

At initial recognition, the expected present value of the cash outflows is CU900 and the contractual service margin is CU100. Assume the CU900 represents a non-distinct investment component.

Over the contract term of three years, the change in the fair value of the underlying financial assets amount to a net gain of CU30, of which the policyholders received CU27 (90% × CU30) and the entity CU3 (10% × CU30).

In addition, the entity incurred, cumulatively over the three-year period, cash flows that do not vary based on the returns on underlying items of CU2.

Assuming the impact of all other variables over the three-year period to be negligible, the cumulative results reported in the entity's statement of profit or loss can be illustrated, as follows:

	Cumulative results over the three-year term	
	General model	Variable fee approach
	CU	CU
Insurance revenue*	100	103
Insurance service expenses*	(2)	(2)
Insurance service result	98	101
Investment income (IFRS 9)	30	30
Insurance finance and expense	(27)	(30)
Net financial result	3	-

* The insurance revenue and insurance services expenses exclude the non-distinct investment component of CU900.

Under the general model, the subsequent change in the entity's share of the underlying items would not form part of the contractual service margin and would have emerged as part of the net finance result as incurred. In terms of the 'variable fee approach', a change in the entity's share of the underlying items forms part of the contractual service margin and subsequently released to insurance revenue over the coverage period.

12.3.1 Definition of an insurance contract with direct participation features

An entity must assess whether a contract has direct participation features using its expectations at inception of the contract and must not reassess the conditions, unless the contract is modified (see section 13.1 below for modifications). *[IFRS 17.B102]*. As noted in section 12.3 above, the assessment is made at individual contract level.

Insurance contracts with direct participation features are insurance contracts that are substantially investment-related service contracts under which an entity promises an investment return based on underlying items (i.e., items that determine some of the amounts payable to a policyholder). Hence, these contracts are defined as insurance contracts for which: *[IFRS 17.B101]*

- The contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items (see section 12.3.1.A below).
- The entity expects to pay the policyholder an amount equal to a substantial share of the fair value returns from the underlying items (see section 12.3.1.B below).
- The entity expects a substantial proportion of any change in the amounts paid to the policyholder to vary with the change in fair value of the underlying items (see section 12.3.1.C below).

When an insurance contract is acquired in a business combination or transfer, the criteria as to whether the contract applies the variable fee approach is assessed at the business combination or transfer date (see section 14 below).

Situations where cash flows of insurance contracts in a group affect the cash flows of contracts in other groups are discussed in section 12.1 above.

How we see it

Participating contracts differ significantly between jurisdictions. Not all participating contracts will meet the criteria to be accounted for under the variable fee approach. An entity will need to exercise judgement when determining whether a contract contains direct participation features and, therefore, will be accounted for applying the variable fee approach based on the specific facts and circumstances. However, while the degree to which a contract may meet or fail the eligibility criteria will vary, the outcome is binary. Examples of products that are generally expected to be in scope are UK-style with-profits contracts, unit-linked contracts and Continental European contracts with 90% participation.

12.3.1.A A share of a clearly defined pool of underlying items

The pool of underlying items can comprise any items, for example, a reference portfolio of assets, the net assets of the entity, or a specified subset of the net assets of the entity, as long as they are clearly identified by the contract. An entity need not hold the identified pool of underlying items (although there are accounting consequences of this - see section 15.3.1 below). However, a clearly identified pool of underlying items does not exist when: *[IFRS 17.B106]*

- An entity can change the underlying items that determine the amount of the entity's obligation with retrospective effect

  Or

- There are no underlying items identified, even if the policyholder could be provided with a return that generally reflects the entity's overall performance and expectations, or the performance and expectations of a subset of assets the entity holds. An example of such a return is a crediting rate or dividend payment set by the entity at the end of the period to which it relates. In this case, the obligation to the policyholder reflects the crediting rate or dividend amounts the entity has set and does not reflect identified underlying items.

The word 'share' referred to in the section heading above does not preclude the existence of the entity's discretion to vary amounts paid to the policyholder. However, the link to the underlying items must be enforceable. *[IFRS 17.B105]*.

For the variable fee approach to be applied, the contract must specify a determinable fee and because of this a clearly identified pool of underlying items must exist. Without a determinable fee, which can be expressed as a percentage of portfolio returns or portfolio asset values rather than only as a monetary amount, the share of the return on the underlying items the entity retains would be entirely at the discretion of the entity and, in the IASB's view, this would not be consistent with being equivalent to a fee. *[IFRS 17.BC245(a)]*. However, IFRS 17 does not mention a stated minimum determinable fee.

The standard does not require that an entity measures the underlying items at fair value in the statement of financial position. There is also no restriction on the type of asset which can be an underlying item. This means that underlying items can be, for example, a subsidiary of the group, assets such as financial assets measured at amortised cost or non-participating insurance contracts measured in accordance with the general model in IFRS 17. In February 2020, the IASB confirmed that non-participating insurance contracts held as underlying items are measured in accordance with IFRS 17 rather than at fair value on the grounds that creating an exception for these assets would add significant complexity to IFRS 17.[10] However, as discussed in section 12.3.1.B below, a substantial portion of the fair value returns of underlying items, regardless of how they are measured for accounting purposes, must be payable to the policyholder.

12.3.1.B A substantial share of the fair value returns on the underlying items

The entity should expect to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items. The Basis for Conclusions further clarifies that it would not be a faithful representation to depict an obligation to pay an amount equal to the fair value of the underlying items if the policyholder does not expect to receive a substantial part of the fair value returns on the underlying items. *[IFRS 17.BC245(b)(i)]*.

10 IASB Staff paper 2F: Project: *Amendments to IFRS 17*, Paper topic: *Other topics raised by respondents to the Exposure Draft* Amendments to IFRS 17, IASB meeting, February 2020, Appendix A, paragraph 1. Available on the IFRS Foundation's website.

IFRS 17 provides no specific quantitative threshold for 'substantial'. However, an entity must interpret the word 'substantial' as in both 'substantial share' and 'substantial proportion' (see section 12.3.1.C below): *[IFRS 17.B107]*

- In the context of the objective of insurance contracts with direct participation features being contracts under which the entity provides investment-related services and is compensated for the services by a fee that is determined by reference to the underlying items

  And

- Assess the variability in the amounts:
  - Over the duration of the insurance contract
  - On a present value probability-weighted average basis, not a best or worst outcome basis

IFRS 17 further explains that if, for example, the entity expects to pay a substantial share of the fair value returns on underlying items, subject to a guarantee of a minimum return, there will be scenarios in which: *[IFRS 17.B108]*

- The cash flows that the entity expects to pay to the policyholder vary with the changes in the fair value of the underlying items because the guaranteed return and other cash flows that do not vary based on the returns on underlying items do not exceed the fair value return on the underlying items
- The cash flows that the entity expects to pay to the policyholder do not vary with the changes in the fair value of the underlying items because the guaranteed return and other cash flows that do not vary based on the returns on underlying items exceed the fair value return on the underlying items

The entity's assessment of the variability will reflect a present value probability-weighted average of all these scenarios.

As many participating contracts contain guarantees, the question as to whether a contract is one with direct participation features or not depends on the effect of the guarantee on the expected value of the cash flows at inception. It does not mean that there can be no scenarios in which the guarantee 'kicks in'. Instead, it does mean that the effect of those scenarios on a probability-weighted basis should be such that a substantial share of the expected returns payable to the policyholder is still based on the fair value of the underlying items. Considering the impact of options and guarantees on the eligibility criteria will have to be based on the specific facts and circumstances and requires the use of judgement.

When the cash flows of insurance contracts in a group affect the cash flows to policyholders of contracts in other groups (see section 12.1 above), an entity must assess whether the conditions for meeting the classification of the contracts as insurance contracts with direct participation features are met by considering the cash flows that the entity expects to pay to the policyholders. *[IFRS 17.B103]*.

How we see it

If underlying items are not measured on a fair value basis in an entity's financial statements, this does not preclude them from qualifying for the variable fee approach. The eligibility depends on the expectation of payments of a substantial share of the fair value returns to the policyholder rather than the accounting measurement of the underlying items.

Frequently asked questions

Question 12-2: Would contracts where the return is based on an amortised cost measurement of the underlying items fail the definition of insurance contract with direct participation features?

(TRG meeting February 2018 - Agenda paper no. 7, Log S26)

The IASB staff observed that contracts which provide a return that is based on an amortised cost measurement of the underlying items would not automatically fail the definition of an insurance contract with direct participation features. Entities' expectations of returns would be assessed over the duration of the contract and, therefore, returns based on an amortised cost measurement might equal returns based on the fair value of the underlying items over the contract duration.

The TRG members agreed with the IASB staff's conclusion that the variable fee approach could be met when the return is based on amortised cost measurement of the underlying items.

Question 12-3: For a unit-linked insurance contract for which the entity charges an asset management fee, determined as a percentage of the fair value of the underlying items at the end of each period, and a premium for mortality cover, by reducing the underlying items at the beginning of each period, how does the entity determine what is a substantial share of the fair value returns?

(TRG meeting April 2019 - Agenda paper no. 2, Log S115)

The submission asked, firstly, how to determine the share of the fair value returns on the underlying items ignoring the fixed premium charge for mortality cover and, secondly, whether and how the premium for mortality cover deducted from the underlying items impacts the calculation of the fair value returns. IFRS 17.B101(b) requires that the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items as a condition for meeting the definition of an insurance contract with direct participation features.

The IASB staff stated that, in this example, the fixed annual charge for mortality cover is, in effect, an amount paid out of the policyholder's share and, therefore, the policyholder's share includes that charge.

However, to determine whether the definition of an insurance contract with direct participation features is met, an entity also needs to consider whether it expects a substantial proportion of any change in the amounts paid to the policyholder to vary with the change in the fair value of the underlying items (see section 12.3.1.C below). For the purposes of this condition, an entity considers changes in any amounts to be paid to the policyholder regardless of whether they have been paid from the underlying items or not. The TRG members observed that a distinguishing feature in this example is that the premium for mortality is fixed rather than varying with the fair value of the underlying items. The IASB staff confirmed that the analysis might differ had the charge varied with the fair value of the underlying items. The TRG members also observed that when determining whether an insurance contract is in the scope of the variable fee approach, in some circumstances it may be necessary to consider the way a charge is determined, rather than the way it is labelled in the contract, to identify what the charge represents. The IASB staff also noted that one of the other conditions of assessing eligibility for the variable fee approach is that a substantial proportion of the changes in amounts paid to policyholders should vary with the changes in the fair value of the underlying items, regardless of whether they have been paid from the underlying items or not.

Illustration 12-6: Calculation of the expected fair value returns with and without mortality charge

This Illustration shows how an entity calculates the expected fair value returns on the underlying items applying IFRS 17.B101(b).

Without mortality charge

An insurance contract gives the policyholder the returns on underlying items, after paying an annual management fee of 0.75% of the fair value of the underlying items. The expected duration of the contract is five years and the expected annual returns on underlying items are 5%. The expected account balance is calculated in the following table:

Year	1	2	3	4	5	Total
	CU	CU	CU	CU	CU	CU
Opening balance	15,000	15,632	16,290	16,977	17,692	
Returns on underlying items	750	782	815	849	885	4,081
Annual management fee	(118)	(123)	(128)	(134)	(139)	(642)
Closing balance	**15,632**	**16,290**	**16,977**	**17,692**	**18,437**	

To apply IFRS 17.B101(b), the expected fair value returns are CU4,081, of which the entity expects to pay to the policyholder CU3,437 (CU18,437 - CU15,000).

With mortality charge

An insurance contract gives the policyholder the returns on underlying items, after paying an annual management fee of 0.75% of the fair value of the underlying items. The expected duration of the contract is 5 years and the expected annual returns on underlying items are 5%. An annual charge for mortality cover of CU100 reduces the underlying items at the start of each year. The expected account balance is calculated in the following table:

Year	1	2	3	4	5	Total
	CU	CU	CU	CU	CU	CU
Opening balance	15,000	15,527	16,076	16,648	17,245	
Mortality charge	(100)	(100)	(100)	(100)	(100)	(500)
Returns on underlying items	745	771	799	827	857	3,999
Annual management fee	(118)	(122)	(127)	(131)	(136)	(634)
Closing balance	**15,527**	**16,067**	**16,648**	**17,245**	**17,866**	

To apply IFRS 17.B101(b) the expected fair value returns are CU3,999. The entity expects to pay to the policyholders CU2,866 (CU17,866 - CU15,000) having deducted the mortality charge. Hence, in total, the share of the fair value returns the entity expects to pay to the policyholder is CU3,366 (CU2,866 + CU500).

How we see it

Many participating contracts contain options and guarantees. An option may, for example, include a policyholder's right to change a particular financial benefit to another type of financial benefit under potentially favourable terms. A guarantee could entitle the policyholder to a specified minimum annual return. An entity would need to apply IFRS 9 to determine whether, and if so, how an embedded derivative is required to be separated.

The impact that non-distinct options and guarantees have on the eligibility criteria for the variable fee approach will require the use of judgement. The question as to whether a contract includes direct participation features can depend on the effect of these guarantees and options on the expected value of the cash flows at inception. In order to qualify for the variable fee approach, the effect of scenarios that result in the guarantee being payable, on a probability-weighted basis, should be such that a substantial share of the expected returns payable to the policyholder are still based on the fair value of the underlying items.

12.3.1.C A substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items

The entity should expect that a substantial proportion of any change in the amounts to be paid to the policyholder will vary with the change in fair value of the underlying items. It would not be a faithful representation to depict an obligation to pay an amount equal to the fair value of the underlying items if the entity were not to expect changes in the amount to be paid to vary with the change in fair value of the underlying items. *[IFRS 17.BC245(bXii)]*.

The discussion in section 12.3.1.B above applies here, including how to apply the words 'substantial proportion'.

12.3.2 Measurement of the risk adjustment for non-financial risk using the variable fee approach

IFRS 17's guidance for the measurement of the risk adjustment for non-financial risk (see section 9.4 above) does not prescribe how the risk adjustment should be calculated for contracts where the entity shares in the results from underlying items with policyholders. The risk adjustment for non-financial risk is the compensation that the entity requires for bearing the uncertainty about the amount and timing of cash flows that arise from non-financial risk as the entity fulfils the insurance contract. Consequently, the risk adjustment for non-financial risk should reflect only the risk of the entity and not also the additional risk of the policyholder. However, the entity's risk is not limited to the shareholder's share in the underlying items but would also include the risk of any returns which do not vary with underlying items (e.g., the effect of guarantees).

12.3.3 Measurement of the contractual service margin using the variable fee approach

At initial recognition, the contractual service margin for a group of insurance contracts with direct participation features is measured in the same way as a group of insurance contracts without direct participation features (i.e., as a balancing figure intended to eliminate any day 1 profits unless the contract is onerous - see section 9.5 above). The contractual service margin is also adjusted based on changes in the fair value of underlying items, which includes the impact of discount rate changes rather than discount rates at the measurement date of the group (see section 9.3 above). *[IFRS 17.B113(a)]*.

At the end of a reporting period, for insurance contracts with direct participation features, the carrying amount of the contractual service margin of a group of contracts equals the carrying amount at the start of the reporting period adjusted, as follows: *[IFRS 17.45]*

Change in the carrying amount of the contractual service margin in a period under the variable fee approach	
Contractual service margin at the beginning of the period	X
Effect of new contracts added to the group (see section 7 above)	X/(X)
Change in the amount of the entity's share of the change in the fair value of the underlying items (see section 12.3.1 above), except to the extent that: ▸ The entity elects to and applies risk mitigation (see section 12.3.5 below) ▸ The decrease in the amount of the entity's share of the fair value of the underlying items exceeds the carrying amount of the contractual service margin, giving rise to an onerous contract loss (see section 9.8 above) Or ▸ The increase in the amount of the entity's share of the fair value of the underlying items reverses any onerous contract loss above	X/(X)
Change in fulfilment cash flows relating to future service, except to the extent that: ▸ Risk mitigation is applied (see section 12.3.5 below) ▸ Such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to an onerous contract loss (see section 9.8 above) Or ▸ Such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage	X/(X)
Effect of currency exchange differences (see section 8.3 above)	X/(X)

Change in the carrying amount of the contractual service margin in a period under the variable fee approach	
The amount recognised as insurance revenue because of the transfer of insurance contract services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period	(X)
Contractual service margin at the end of the period	X

As discussed in section 9.6.3 above, IFRS 17 does not specify the order in which the calculations above need to be performed. However, IFRS 17.44(e) states that the amount recognised as insurance revenue because of the transfer of insurance services in the period is determined by the allocation of the contractual margin remaining at the end of the period. The use of the word 'end' implies that this should be the last step.

IFRS 17 further states that:

- Changes in the obligation to pay the policyholder an amount equal to the fair value of the underlying items do not relate to future service and do not adjust the contractual service margin *[IFRS 17.B111]*
- Changes in the amount of the entity's share of the fair value of the underlying items relate to future service and adjust the contractual service margin *[IFRS 17.B112]*

Changes in fulfilment cash flows that do not vary based on returns on underlying items comprise: *[IFRS 17.B113]*

- The change in the effect of the time value of money and financial risks not arising from the underlying items. An example of this would be the effect of financial guarantees. These relate to future service and adjust the contractual service margin except to the extent that the entity applies risk mitigation.
- Other changes in estimates of fulfilment cash flows. An entity applies the same requirements consistent with insurance contracts without direct participation features to determine what extent they relate to future service and therefore adjust the contractual service margin (see section 9.6.3 above).

An entity is not required to identify the separate components of the adjustments to the contractual service margin resulting from changes in the entity's share of the fair value of underlying items that relate to future service and changes in the fulfilment cash flows relating to future service. Instead, a combined amount may be determined for some or all of the adjustments. *[IFRS 17.B114]*.

Except in situations when a group of contracts is onerous, or to the extent the entity applies the risk mitigation exception (see section 12.3.5 below), the effect of the general model and the variable fee approach may be compared, as follows:

Comparison of	General model	Variable fee approach
Insurance finance income or expenses (total) recognised in statement of financial performance	▸ Change in the carrying amount of fulfilment cash flows arising from the time value of money and financial risk ▸ Accretion of interest on the contractual service margin at rate at initial recognition ▸ Any difference between the present value of a change in fulfilment cash flows measured at current rates and rates at initial recognition that adjust the contractual service margin	Change in the fair value of underlying items
Changes in the carrying amount of fulfilment cash flows arising from the time value of money and financial risk	Recognised immediately in the statement of financial performance *[IFRS 17.87, IFRS 17.88, IFRS 17.89]*	Adjusts the contractual service margin unless risk mitigation applies (in which case it adjusts profit or loss or other comprehensive income) *[IFRS 17.87(c), IFRS 17.B113(b)]*
Discount rates for accretion of, and adjustment to, the contractual service margin	Rates determined at initial recognition	Rate included in the balance sheet measurement (i.e., current rates) *[IFRS 17.B113(a)]*

How we see it

Under the variable fee approach, an entity is not required to identify the separate components of the adjustments to the contractual service margin resulting from changes in the entity's share of the fair value of underlying items that relate to future service and changes in the fulfilment cash flows relating to future service. Not making this split might be easier administratively. However, disaggregating this change might provide useful information, better reflect the sources of measurement changes, and result in greater consistency with the insurance contract roll-forward analyses for contracts accounted for under the general model.

An entity that does not separate the changes in its share of the fair value of underlying items from changes in the policyholder's share is likely to need to disclose the roll-forward of the carrying amount of insurance contracts with direct participation features separately from the roll-forward for other insurance contracts, because the gross amounts of insurance finance income or expenses and changes in fulfilment cash flows relating to future services (including the policyholders' share of the change in the fair value of underlying items), may be significantly different in size and nature from corresponding amounts for contracts subject to the general model.

12.3.4 Allocation of the contractual service margin to profit or loss

The contractual service margin for an insurance contract with direct participation features is allocated to profit or loss using the same methodology discussed in section 9.7 above for the general model. That is, by identifying the coverage units in the group and releasing the contractual service margin in profit or loss to reflect the insurance contract services in the period.

IFRS 17 defines insurance contract services in respect of contracts with direct participation features as: *[IFRS 17 Appendix A]*

- Coverage for an insured event (insurance coverage)
- The management of underlying items on behalf of the policyholder (investment-related service)

This means that the period over which the contractual service margin is amortised for contracts with direct participation features includes both the period in which the entity provides coverage and the period over which it provides an investment-related service.

For the purpose of amortising the contractual service margin, the period of investment-related service ends at or before the date that all amounts due to current policyholders relating to those services have been paid, without considering payments to future policyholders included in the fulfilment cash flows as a result of mutualisation (see section 12.1 above). *[IFRS 17.B119A]*.

Illustration 12-7: Insurance services and investment component with different durations

An insurance contract with direct participation features matures in year 10 and pays the customer the account value at maturity. The contract also includes a death benefit that varies depending on which year in the 10-year period the death occurs. Specifically, if the customer dies in years 1 to 5, the customer's beneficiary would receive a death benefit that is the higher of 110% of the premium paid or the accumulated account value (assume that the death benefit for years 1 to 5 results in significant insurance risk). However, if the customer dies in years 6 to 10, the customer's beneficiary receives only the account value. There is no surrender penalty.

The insurer needs to consider all 10 years for determining coverage units and amortisation of the contractual service margin as over that period insurance contract services are provided rather than only during years 1-5.

See also section 12.2 above for discussion of insurance contracts without direct participation features.

12.3.5 Risk mitigation

For contracts with direct participation features, IFRS 17 requires changes in the shareholder's share of underlying items and cash flows that do not vary with underlying items (together part of the variable fee of a such contract) to adjust the contractual service margin (see section 12.3.3 above). However, amounts payable to policyholders that do not vary with underlying items create risks for an entity, particularly if the amounts payable are independent of the amounts that the entity receives from investments, for example, if the insurance contract includes guarantees. An entity is also at risk from possible changes in its share of the fair value returns on underlying items and may purchase derivatives to mitigate such risks. When applying IFRS 9, such derivatives are measured at fair value through profit or loss. Consequently, an accounting mismatch arises because the change in the carrying amount of the insurance liability (i.e., the hedged item) does not go through profit or loss. A similar accounting mismatch arises if the entity uses instruments other than derivatives to mitigate risk such as reinsurance contracts held because the variable fee approach cannot be used for reinsurance contracts held. *[IFRS 17.BC250, IFRS 17.BC251, IFRS 17.BC252, IFRS 17.BC253]*.

To address these mismatches, IFRS 17 permits entities relief from the requirements of the variable fee approach. This relief allows an entity to choose not to recognise a change in the contractual service margin to reflect some or all of the changes in the time value of money or the effect of financial risk on: *[IFRS 17.B115]*

- The amount of the entity's share of the underlying items if the entity mitigates the effect of financial risk on that amount using derivatives or reinsurance contracts held
- The changes in fulfilment cash flows that do not vary based on the returns on underlying items arising from a change in the effect of the time value of money and financial risk, for example, the effect of financial guarantees, if the entity mitigates the effect of financial risk on those fulfilment cash flows using derivatives, non-derivative financial instruments measured at fair value through profit or loss, or reinsurance contracts held

See Illustration 12-5 in section 12.3 above for a comparison between the general model and the variable fee approach.

An entity that elects to use this approach must determine the eligible fulfilment cash flows in a group of contracts in a consistent manner in each reporting period. *[IFRS 17.B117]*.

When risk mitigation is applied using derivatives or non-derivative financial instruments, any insurance finance income or expenses arising must be included in profit or loss. If an entity mitigates the effect of financial risk using reinsurance contracts held, it must apply the same accounting policy for the presentation of insurance finance income or expenses as the entity applies to the reinsurance contracts held (i.e., profit or loss if disaggregation is not applied or split between profit or loss and other comprehensive income if disaggregation is applied - see section 15.3 below). *[IFRS 17.B117A]*.

Use of this relief is conditional on the entity having a previously documented risk management objective and strategy for mitigating the financial risk described above. In applying that objective and strategy: *[IFRS 17.B116]*

- An economic offset exists between the insurance contracts and the derivative, non-derivative financial instrument measured at fair value, or reinsurance contract held (i.e., the values of the insurance contracts and the risk mitigating items generally move in opposite directions because they respond in a similar way to the changes in the risk being mitigated). An entity must not consider accounting measurement differences in assessing the economic offset.
- Credit risk does not dominate the economic offset.

If, and only if, any of the conditions above cease to be met, an entity must cease to apply the risk mitigation accounting prospectively from that date. An entity must not make any adjustment for changes previously recognised in profit or loss. *[IFRS 17.B118]*. This means that an entity can discontinue the use of risk mitigation option only if any of the eligibility criteria cease to apply and not on a voluntary basis. Therefore, the entity would apply risk mitigation consistently until the criteria for risk mitigation are no longer met. This is intended to be aligned with the hedge accounting discontinuation requirements in IFRS 9 as IFRS 9 does not allow an entity to discontinue hedge accounting unless the hedging relationship ceases to meet the qualifying criteria.[11]

11 IASB Staff paper 2D: Project: *Amendments to IFRS 17* Insurance Contracts, Paper topic: *Annual improvements*, IASB meeting, April 2019, paragraph 10. Available on the IFRS Foundation's website.

The Board considered but rejected feedback that an entity should be permitted to apply the risk mitigation option when it uses non-derivative financial instruments measured at fair value through other comprehensive income. The Board noted that, in most circumstances, the risk mitigation option would not resolve perceived mismatches between amounts recognised in profit or loss for insurance contracts with direct participation features using the other comprehensive income option in IFRS 17 and assets measured at fair value through other comprehensive income. In addition, the proposal would have resulted in the ineffectiveness of the risk mitigation strategy being recognised in other comprehensive income. That would be inconsistent with the hedge accounting requirements in IFRS 9. The Board observed that an entity could avoid mismatches by applying both the fair value option in IFRS 9 (to designate financial assets at fair value through profit or loss) and the risk mitigation option in IFRS 17. The Board was also not persuaded by the view that an entity should be permitted to apply the risk mitigation option when it uses non-derivative financial instruments to mitigate the effect of financial risk on the entity's share of the fair value of the underlying items. For instance, when the entity mitigates such financial risk by investing premiums in assets other than the underlying items, e.g., through an investment in fixed rate bonds. In the Board's view, permitting an entity to apply the risk mitigation option in that circumstance would contradict the principle that an entity need not hold the underlying items for the variable fee approach to apply. *[IFRS 17.BC256D, IFRS 17.BC256E, IFRS 17.BC256F]*.

How we see it

The exemption, in the case of risk mitigation, from the requirement of the variable fee approach to adjust the contractual service margin for changes in financial assumptions relating to future service is an important feature. It was introduced to reduce accounting mismatches that would otherwise arise from economic risk mitigation where movements in the fair value of derivatives, reinsurance contracts held, or non-derivative financial instruments are reported in profit or loss. However, there is little guidance about the practical application of this approach. For example, how to interpret and apply the provision for 'some or all' changes in the time value of money or financial risk to be excluded from the contractual service margin when an entity mitigates financial risk using the eligible instruments.

12.3.6 Disaggregation of insurance finance income or expenses between profit or loss and other comprehensive income

As discussed in section 15.3 below, entities have an accounting policy choice, per portfolio of insurance contracts, between:

- Including insurance finance income or expenses in profit or loss

  Or

- Disaggregating insurance finance income or expenses between profit or loss and other comprehensive income

For insurance contracts with direct participation features, when disaggregation is selected, allocation of the insurance finance income or expenses between profit or loss and other comprehensive income is different depending on whether or not the underlying items are held, as follows:

- If the underlying items are not held, then the insurance finance income or expenses included in profit or loss is calculated using a systematic allocation arising from the estimates of future cash flows that that can be determined in one of two ways (known as the 'effective yield approach' and the 'projected crediting approach'). See section 15.3.2 below.
- If the underlying items are held, then the insurance finance income or expenses included in profit or loss is an amount that eliminates accounting mismatches with income and expenses on the underlying items held. This means that the expenses or income from the movement of the insurance liability should exactly match the income or expenses included in profit or loss for the underlying items, resulting in the net of the two separately presented items being nil. This approach is sometimes referred to as the 'current period book yield approach'. (See section 15.3.4. below).

Frequently asked questions

Question 12-4: For a direct participating contract that shares returns with policyholders by paying dividends, on what basis should the adjustment to the CSM reflect changes related to non-economic experience on underlying items be measured and in applying the current period book yield approach to disaggregate insurance finance income or expense, is the adjustment limited to financial income or expenses on the underlying items held?

(TRG meeting April 2019 - Agenda paper no. 2, Log S114)

The submission described a specific fact pattern for a contract applying the variable fee approach where the entity shares returns on underlying items with policyholders by paying dividends. The dividend scale varies based on the market value returns with respect to economic experience of the investments, and on a statutory basis for the non-economic experience (such as from expenses and reinsurance contracts held). Two questions were asked. Firstly, in determining the adjustment to be made to the contractual service margin under the variable fee approach for the shareholder's share in underlying items, should the change in the non-economic experience on the underlying items be determined on an IFRS, statutory or fair value basis? Secondly, when an entity applies the current period book yield approach under IFRS 17.89 to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income, is this limited to financial income or expense on underlying items held or should it include all income or expense arising from underlying items?

The IASB staff observed that under the variable fee approach an entity adjusts the contractual service margin of a group of contracts based on changes in the fair value of underlying items. Therefore, a statutory basis or an IFRS measure (which are not fair value measurements) cannot be used to determine the adjustment to the contractual service margin.

The IASB staff also observed that, when disaggregation is applied under IFRS 17.89 and B134, the amount of income or expense included in profit or loss should exactly match the income or expense included in profit or loss for the underlying items, resulting in the net of the two separately presented items being nil. Therefore, income or expense on underlying items is not limited to financial income or expense.

12.4 Investment contracts with discretionary participation features

An investment contract with discretionary participation features does not contain significant insurance risk and is, therefore, a financial instrument. Nevertheless, these contracts are within the scope of IFRS 17, provided the entity also issues insurance contracts. *[IFRS 17.3(c)]*.

There is no *de minimis* limit on the number of insurance contracts that an entity must issue in order to ensure that its investment contracts with discretionary participation features are within the scope of IFRS 17. In theory, an entity need only issue one insurance contract.

An investment contract with discretionary participation features is defined by IFRS 17 as follows: *[IFRS 17 Appendix A]*

Extract from IFRS 17

Appendix A
Defined terms

investment contract with discretionary participation features	A financial instrument that provides a particular investor with the contractual right to receive, as a supplement to an amount not subject to the discretion of the issuer, additional amounts: (a) that are expected to be a significant portion of the total contractual benefits; (b) the timing or amount of which are contractually at the discretion of the issuer; and (c) that are contractually based on: (i) the returns on a specified pool of contracts or a specified type of contract; (ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or (iii) the profit or loss of the entity or fund that issues the contract.

Although investment contracts with discretionary participation features do not meet the definition of insurance contracts, the advantages of treating them the same as insurance contracts rather than as financial instruments when they are issued by entities that issue insurance contracts include: *[IFRS 17.BC83]*

- Investment contracts with discretionary participation features and insurance contracts that specify a link to returns on underlying items are sometimes linked to the same underlying pool of assets. Sometimes investment contracts with discretionary participation features share in the performance of insurance contracts. Using the same accounting for both types of contracts will produce more useful information for users of financial statements because it enhances comparability within an entity. It also simplifies the accounting for those contracts. For example, some cash flow distributions to participating policyholders are made in aggregate both for insurance contracts that specify a link to returns on underlying items and for investment contracts with discretionary participation features. This makes it challenging to apply different accounting models to different parts of that aggregate participation.
- Both of these types of contract often have characteristics, such as long maturities, recurring premiums and high acquisition cash flows, that are more commonly found in insurance contracts than in most other financial instruments. The Board developed the model for insurance contracts specifically to generate useful information about contracts containing such features.
- If investment contracts with discretionary participation features were not accounted for by applying IFRS 17, some of the discretionary participation features might be separated into an equity component in accordance with the Board's existing requirements for financial instruments. Splitting these contracts into components with different accounting treatments would cause the same problems that would arise if insurance contracts were separated. Also, in the Board's view, the accounting model it has developed for insurance contracts, including the treatment of discretionary cash flows is more appropriate than using any other model for these types of contracts.

Investment contracts with discretionary participation features are accounted for in the same way as other insurance contracts. This means that the general model is applied (as discussed in section 9 above) and, at initial recognition, an entity should assess whether the contracts contain direct participation features and hence should apply the variable fee approach (discussed in section 12.3 above).

However, as investment contracts with discretionary participation features do not transfer insurance risk, IFRS 17 requires certain modifications: *[IFRS 17.71]*

- The date of initial recognition is the date the entity becomes party to the contract (see section 7 above).
- The contract boundary (see section 9.1 above) is modified so that cash flows are within the contract boundary if they result from a substantive obligation of the entity to deliver cash at a present or future date. The entity has no substantive obligation to deliver cash if it has the practical ability to set a price for the promise to deliver the cash that fully reflects the amount of cash promised and related risks.

- The allocation of the contractual service margin is modified so that the entity recognises the contractual service margin over the duration of a group of contracts in a systematic way that reflects the transfer of investment services under the contract.

Frequently asked questions

Question 12-5: Does an investment contract that contains a crediting rate meet the third criteria of the definition of an investment contract with discretionary participation features in IFRS 17?

(TRG meeting April 2019 - Agenda paper no. 2, Log S94 & S95)

The Basis for Conclusions of IFRS 4 states that: *[IFRS 4.BC162]*

Extract from IFRS 4

BC162 The definition of a discretionary participation feature does not capture an unconstrained contractual discretion to set a 'crediting rate' that is used to credit interest or other returns to policyholders (as found in the contracts described in some countries as 'universal life' contracts). Some view these features as similar to discretionary participation features because crediting rates are constrained by market forces and the insurer's resources. ...

The submission asked whether, in the light of IFRS4.BC162, an example contract in a specific jurisdiction with a crediting rate met the third requirement in IFRS 17 to qualify as an investment contract with discretionary participation features relating to the contractual basis for the discretionary returns. The crediting rate in the example was based on returns of assets held as well as the weighted average rates on local treasury bonds. The crediting rate could be adjusted by the entity to some extent, based on future expected revenue and returns (the discretionary feature). The submissions assumed that the contract meets the first and second criteria of the definition of an investment contract with discretionary participation features in IFRS 17.

The IASB staff observed that the definition of an investment contract with discretionary participation features in IFRS 17 is consistent with the definition in IFRS 4. Both require that the additional discretionary amounts are contractually based on specified pools of contracts, specified pools of assets, or the profit or loss of the entity or fund that issues the contract. Any discretionary features in each investment contract need to be assessed against these criteria considering all relevant facts and circumstances. It appears that the IASB staff were sceptical that the investment contract in the example met the criteria of an investment contract with discretionary participation features.

How we see it

The release of the contractual service margin for investment contracts with discretionary participation features is not based on coverage units (see section 9.7 above), rather it is based on the investment services provided over the life of the contracts. It appears that this requirement is similar to the revenue recognition guidance contained in IFRS 15. Given that IFRS 15 would apply to fees from investment contracts without discretionary participation features, this would be consistent with other investment management contracts.

12.4.1 Contracts with switching features

Some contracts may contain options for the policyholder to switch between funds over the lifetime of the contract and therefore change from holding an investment contract measured under IFRS 9 to holding an investment contract with discretionary participation features measured under IFRS 17 (or *vice versa*) provided the entity also issues insurance contracts. Where the assessment at contract inception has concluded that the contract is not an investment contract with discretionary participation features the question arises as to whether the existence of the option means that the contract is accounted for under IFRS 17 (as an investment contract with discretionary participation features). If the option contains features (for example in terms of pricing) that require it to be considered within the boundary of the contract (see section 9.1 above) the option may already scope the contract within IFRS 17 from inception as an investment contract with discretionary participation features.

IFRS 17 states that once a contract is within its scope then it is not subsequently reassessed even if, at a later date, it is no longer a contract within its scope if the contract would have been reassessed at that date. *[IFRS 17.B25]*. Therefore, investment contracts with discretionary participation features, issued by an entity that also issues insurance contracts, that subsequently lose their 'discretionary feature' as the result of the exercise of a policyholder option will remain within the scope of IFRS 17.

13 Contract modification and derecognition

A contract that qualifies as an insurance contract remains so until all rights and obligations are extinguished (i.e., discharged, cancelled or expired), unless the contract is derecognised because of a contract modification. *[IFRS 17.B25]*.

IFRS 4 contained no guidance on when or whether a modification of an insurance contract might cause derecognition of that contract. Therefore, prior to IFRS 17, most insurers would have applied the requirements, if any, contained in local GAAP.

IFRS 17 does not contain guidance for modifications of non-insurance contracts that could result in those contracts becoming contracts within the scope of IFRS 17. Modifications of non-insurance contracts are accounted for under the relevant IFRS and a contract within the scope of another IFRS could only become (wholly or partly) within the scope of IFRS 17 once the contract was derecognised under the original standard. For example, IFRS 15.20-21 explains how an entity accounts for a modification of a contract to sell goods and services within its scope (i.e., whether the original contract is derecognised or not) and IFRS 9.3.3.2 explains when an exchange between an existing borrower and lender of debt instruments with substantially different terms is accounted for as a modification or an extinguishment of the original financial liability.

13.1 Modifications of insurance contracts

An insurance contract may be modified, either by agreement between the parties or as a result of a change in regulation. If the terms are modified, an entity must derecognise the original insurance contract and recognise the modified contract as a new contract if and only if, any of the conditions listed below are satisfied. *[IFRS 17.72]*.

- If the modified terms were included at contract inception:
  - The modified contract would have been excluded from the scope of IFRS 17.
  - An entity would have separated different components from the host insurance contract (see section 5 above) resulting in a different insurance contract to which IFRS 17 would have applied.
  - The modified contract would have had a substantially different contract boundary (see section 9.1 above).
  - The modified contract would have been included in a different group of contracts at initial recognition (e.g., the contracts would have been onerous at initial recognition rather than having no significant possibility of becoming onerous subsequently) (see section 6 above).
- The original contract met the definition of an insurance contract with direct participation features, but the modified contract no longer meets that definition or *vice versa*.
- The entity applied the premium allocation approach (see section 10 above) to the original contract, but the modifications mean that the contract no longer meets the eligibility criteria for that approach.

In summary, any contract modification that changes the accounting model or the applicable standard for measuring the components of the insurance contract, is likely to result in derecognition.

If a contract modification meets none of the conditions above for derecognition, the entity must treat any changes in cash flows caused by the modification as changes in the estimates of the fulfilment cash flows. *[IFRS 17.73]*.

In practical terms, this means that an entity will need to determine whether the change in the estimate of the fulfilment cash flows arising from the modification is a past service event (which affects profit or loss in the current period) or a future service event (which affects the contractual service margin). For contracts applying the premium allocation approach, any adjustments to premium receipts or insurance acquisition cash flows arising from a modification, adjust the liability for remaining coverage and insurance revenue is allocated to the period for services provided (which would also require judgement in determining the period to which the modification applies). See sections 9.6, 10.4 and 12.3.3 above for the accounting for changes in the fulfilment cash flows.

The exercise of a right included in the terms of a contract is not a modification. *[IFRS 17.72]*. This includes the exercise of a right that could change the nature of the insurance contract. In February 2020, the IASB discussed a staff paper prepared on this issue as a result of feedback from respondents who stated that an accounting mismatch could arise from a contract that changes in nature over time. Such a contract could change its nature due to the policyholder exercising an option. An example of such a contract noted in the staff paper is a contract with a savings phase with profit sharing that provides the policyholder with an option to subsequently convert the account balance into an annuity at a guaranteed rate. At inception, that

contract might meet the requirements to be accounted for under the variable fee approach. Subsequently, when the policyholder exercises the annuity option, the entity will still be required to continue applying the variable fee approach. In contrast, at inception of an annuity contract without a savings phase the entity would normally apply the general model. The IASB staff observed that different respondents favoured different suggested ways of amending IFRS 17 to address this matter such as to exclude cash flows generated from exercising some options from the contract boundary, providing an accounting election to separate some components of an insurance contract or other changes. In conclusion, the IASB agreed with the IASB staff recommendation not to amend IFRS 17 as the suggested changes touched on key aspects of IFRS 17 and the IASB staff believed these were likely to result in unintended consequences and some of the options suggested would significantly reduce comparability across entities and would increase the complexity of IFRS 17. In addition, the IASB agreed with the IASB staff's decision to decline to provide further application guidance or educational material on the matter, as suggested by some respondents, on the grounds that such guidance could be disruptive to the IFRS 17 implementation stage.[12]

Accounting for derecognition of a modified contract is discussed in section 13.3 below.

How we see it

The guidance on contract modification and derecognition under IFRS 17 is likely to result in differences from practices applied previously under IFRS 4. In particular, derecognition of a contract can only happen from a modification or extinguishment and not from the exercise of an option in a contract. This can lead to different accounting practices from those adopted previously under IFRS 4, for example for contracts that change their nature over time. A contract that is accounted for under the variable fee approach may have an accumulation phase, where the policyholder receives the returns from a pool of underlying items, and a pay-out phase, where the accumulated contract value is exchanged for a life contingent payout annuity at guaranteed rates. Because the option to take out the annuity was included in the original contract, the exercise of that option by the policyholder is not a modification. Therefore, when the contract moves into the payout annuity phase, it would not result in a derecognition of the accumulation contract and recognition of a new payout annuity contract. The contract would therefore continue to be accounted for under the variable fee approach. This is the case even though a contract that only contained a life contingent payout annuity would not meet the definition of a direct participating contract and would, therefore, be accounted for under the general model if it was issued as a separate contract.

13.2 Derecognition of insurance contracts

An insurance contract is derecognised when, and only when: *[IFRS 17.74]*

- It is extinguished, i.e., when the obligation specified in the insurance contract expires or is discharged or cancelled

  Or

- Any of the conditions for modifications, which result in derecognition, are met (see section 13.1 above)

The treatment of contract derecognition differs depending on which of the two scenarios above applies (see section 13.3 below).

When an insurance contract is extinguished, the entity is no longer at risk and is not required to transfer economic resources to satisfy the contract. Therefore, the settlement of the last claim outstanding on a contract does not necessarily result in derecognition of the contract *per se*, although it may result in the remaining fulfilment cash flows under a contract being immaterial. For derecognition to occur, all obligations must be discharged or cancelled. When an entity purchases reinsurance, it must derecognise the underlying insurance contracts only when those underlying insurance contracts are extinguished. *[IFRS 17.75]*.

13.3 Accounting for derecognition

IFRS 17 contains three different ways to treat the derecognition of a contract, depending on the circumstances. These three different ways are extinguishment, transfer and modification.

12 IASB Staff paper 2F: Project: *Amendments to IFRS 17*, Paper topic: *Other topics raised by respondents to the Exposure Draft* Amendments to IFRS 17, IASB meeting, February 2020, paragraphs 20-25. Available on the IFRS Foundation's website.

The effect of derecognition on amounts previously recognised in other comprehensive income is discussed in section 13.3.4 below.

13.3.1 Derecognition resulting from extinguishment

An entity derecognises an insurance contract from within a group of insurance contracts by applying the following requirements: *[IFRS 17.76]*

- The fulfilment cash flows allocated to the group for both the liability for remaining coverage and the liability for incurred claims are adjusted to eliminate the present value of the future cash flows and risk adjustment for non-financial risk relating to the rights and obligations that have been derecognised from the group
- The contractual service margin of the group is adjusted for the change in fulfilment cash flows described above, to the extent required by the general model, as discussed in section 9.6 above (for contracts without direct participation features) and section 12.3 above (for contracts with direct participation features)
- The number of coverage units for expected remaining insurance contract services is adjusted to reflect the coverage units derecognised from the group, and the amount of the contractual service margin recognised in profit or loss in the period is based on that adjusted number to reflect services provided in the period (see section 9.7 above)

An entity might not know whether a liability has been extinguished because claims are sometimes reported years after the end of the coverage period. As a result, an entity might be unable to derecognise those liabilities. Ignoring contractual obligations that remain in existence and may generate valid claims would not give a faithful representation of an entity's financial position. However, it is expected that when the entity has no information to suggest there are unasserted claims on a contract with an expired coverage period, the entity would measure the insurance contract liability at a very low amount. Accordingly, there may be little practical difference between recognising an insurance liability measured at a very low amount and derecognising the liability. *[IFRS 17.BC322]*.

13.3.2 Derecognition resulting from transfer

When an entity derecognises an insurance contract because it transfers the contract to a third party, the entity must: *[IFRS 17.77]*

- Adjust the fulfilment cash flows allocated to the group for the rights and obligations that have been derecognised, as discussed in section 13.3.1 above
- Adjust the contractual service margin of the group from which the contract has been derecognised for the difference between the change in the contractual cash flows resulting from derecognition and the premium charged by the third party (unless the decrease in fulfilment cash flows is allocated to the loss component of the liability for remaining coverage)

If there is no contractual service margin to be adjusted, then the difference between the fulfilment cash flows derecognised and the premium charged by the third party is recognised in profit or loss.

13.3.3 Derecognition resulting from modification

When an entity derecognises an insurance contract and recognises a new insurance contract as a result of a modification described in section 13.1 above, the entity must: *[IFRS 17.77]*

- Adjust the fulfilment cash flows allocated to the group relating to the rights and obligations that have been derecognised, as discussed in section 13.3.1 above
- Adjust the contractual service margin of the group, from which the contract has been derecognised for the difference between the change in the contractual cash flows resulting from derecognition and the hypothetical premium the entity would have charged, had it entered into a contract with terms equivalent to the new contract at the date of the contract modification, less any additional premium charged for the modification (unless the decrease in fulfilment cash flows is allocated to the loss component of the liability for remaining coverage)

  And

- Measure the new contract recognised assuming the entity received the hypothetical premium that it would have charged, had it entered into the modified contract at the date of the contract modification

Illustration 13-1: Contract derecognition resulting from modification

An entity modifies an insurance contract issued such that the modified contract would have been included in a different group of contracts and, applying the guidance in IFRS 17, determines that the contract should be derecognised and replaced by a new contract. The original contract was part of a group of insurance contracts that was not onerous. The group of contracts that the modified contract joins is also not onerous.

At the date of modification, the fulfilment cash flows of the contract were CU100 and the additional premium received at that date for the contract modification is CU20. The entity estimates that a hypothetical premium that it would have charged had it entered into the modified contract at that date was CU112. The fulfilment cash flows of the newly recognised contract were CU105.

This gives rise to the following accounting entries:

			CU	CU
Dr	Cash		20	
Dr	Derecognition of fulfilment cash flows in the group from which the contract is derecognised		100	
	Cr	Adjustment to contractual service margin of the group from which the modified contract is derecognised (20 + 100 - 112)		8
	Cr	Recognition of fulfilment cash flows of modified contract		105
	Cr	Addition to the contractual service margin of the group that the modified contract joins (112 - 105)		7

Frequently asked questions

Question 13-1: Is a new contract recognised as a result of a modification accounted for similarly to contracts acquired in their settlement period applying IFRS 17.B5 and how are the coverage units identified?

(TRG meeting April 2019 - Agenda paper no. 2, Log S82)

The IASB staff clarified that when an entity recognises new contracts that are in their settlement period, as a result of a modification that results in a derecognition of an existing contract, and which, therefore, cover events that have already occurred but the financial effect of which is uncertain, the insured event is the determination of the ultimate cost of the claims. This means that an entity recognises a liability for remaining coverage rather than a liability for incurred claims. See section 14.2 below.

How we see it

Determining any hypothetical premium will require the exercise of judgement by the reporting entity. This judgement may require input from an entity's pricing information and may place higher demands on data and systems. The estimate of the hypothetical premium is also a key input in determining the derecognition effect that will be adjusted against the contractual service margin of the original group of contracts and the contractual service margin that the newly recognised contract will add to the group of contracts of which it becomes a part.

13.3.4 Reclassification adjustments arising from derecognition

When an entity transfers a group of insurance contracts, or derecognises an insurance contract because it either transfers that contract to a third party (see section 13.3.2 above), or derecognises the insurance contract and recognises a new insurance contract (see section 13.3.3 above), it must: *[IFRS 17.91]*

- For insurance contracts without direct participation features or contracts with direct participation features where the entity does not hold the underlying items, reclassify to profit or loss as a reclassification adjustment any remaining amounts for the group (or contract) that were previously recognised in other comprehensive income as a result of its accounting policy choice, if any, to disaggregate the finance income or expenses of a group of insurance contracts (see section 15.3.2 below).

  Or

- For insurance contracts with direct participation features contracts where the entity holds the underlying item (i.e., it applies the current book yield approach), not reclassify to profit or loss, as a reclassification adjustment, any remaining amounts for the group (or contract) that were previously recognised in other comprehensive income as a result of its accounting policy choice, if any, to disaggregate the finance income or expenses of a group of insurance contracts (see section 15.3.4 below).

13.3.5 Contracts applying the premium allocation approach that are derecognised

IFRS 17 does not contain guidance on how contracts accounted for under the premium allocation approach (see section 10 above) must apply the requirements in sections 13.3.1 to 13.3.3 above in circumstances in which the derecognised contracts are part of a group which has a liability for remaining coverage but no separate contractual service margin (as a contractual service margin is not recognised separately under the premium allocation approach).

13.4 Derecognition of assets for insurance acquisition cash flows paid before the related group of insurance contracts is recognised as an asset

An entity must derecognise an asset recognised for insurance acquisition cash flows paid before the related group of insurance contracts is recognised as an asset when the insurance acquisition cash flows allocated to the group of insurance contracts are included in the measurement of the group. The derecognition must be allocated against the contractual margin and not taken to profit or loss unless the contract is onerous (see section 9.8 above). *[IFRS 17.28C]*.

If an entity recognises in a reporting period only some of the insurance contracts expected to be included in the group, the entity must determine the related portion of an asset for insurance acquisition cash flows for the group on a systematic and rational basis considering the expected timing of recognition of contracts in the group. The entity must derecognise that portion of the asset and include it in the measurement of a group of insurance contracts as above. *[IFRS 17.28C]*. In this situation it would also be necessary to perform an impairment test on any remaining asset for acquisition cash flows that relates to the group (see section 9.10 above).

14 Acquisition of insurance contracts

Insurance contracts may be acquired in a transfer (often referred to as a portfolio transfer) or in a business combination, as defined in IFRS 3.

IFRS 3 requires a group of insurance contracts acquired in a business combination to be measured at the acquisition date under IFRS 17 rather than at fair value. *[IFRS 3.31A]*. This means that insurance contracts acquired in a transfer or a business combination are classified and measured in the same way as those issued by the entity at the date of the combination or transfer, except that the fulfilment cash flows are recognised at the date of the combination or transfer.

This results in the following key differences for insurance contracts acquired in a business combination within the scope of IFRS 3 compared with the accounting used previously under IFRS 4:

- Contracts acquired in a business combination within the scope of IFRS 3 after the date of initial application of IFRS 17 (i.e., accounting periods beginning on or after 1 January 2023) are classified as insurance contracts based on the contractual terms, economic conditions, operating or accounting policies and other pertinent factors and conditions as they exist at the acquisition date. *[IFRS 3.15, IFRS 3.64N]*. Other assessments like the eligibility for the premium allocation approach or variable fee approach for direct participation contracts must also be based on the contractual terms and conditions at the date of acquisition. Previously, when IFRS 4 applied, IFRS 3 contained an exception from this requirement for insurance contracts and stated that insurance contracts acquired in a business combination within its scope must be classified on the basis of the contractual terms and other factors at the inception of the contract rather than at the date of acquisition.
- Contracts acquired in a transfer that is not a business combination are classified as insurance contracts based on the contractual terms, economic conditions, operating or accounting policies and other pertinent factors and conditions as they exist at the acquisition date (i.e., there is no transitional relief - see section 17.2 below).
- Contracts are measured under the IFRS 17 requirements, rather than at fair value. Consequently, no option is available to split the value of the acquired insurance contracts into two components, as was permitted under IFRS 4 (i.e., between a liability in accordance with the insurer's accounting policies and an intangible asset representing the difference between fair value and the value of that liability under the IFRS 17 measurement model).

In a business combination, an entity is required to classify contracts (i.e., assess whether a contract transfers significant insurance risk or is an investment contract with discretionary participation features) based on the contractual terms and other factors at the date of acquisition rather than the original inception date of the contract.[13]

When considering feedback from entities implementing IFRS 17, the Board considered but rejected a suggestion to reinstate the previous IFRS 4 exception in IFRS 3. In the Board's view, by removing the exception, IFRS 17 makes the accounting for the acquisition of insurance contracts consistent with the accounting for acquisitions of other contracts acquired in a business combination. The Board was not persuaded by the argument that applying the requirement will result in differences in accounting between an acquirer's consolidated financial statements and an acquiree's financial statements. In the Board's view, differences in accounting between an acquirer's financial statements and an acquiree's financial statements depict differences arising from the economics of the acquisition, they are not unique to insurance contracts and are not unusual when applying IFRS accounting standards. Those differences reflect changes in facts and circumstances at the acquisition date compared to facts and circumstances at the date the acquiree recognised the contracts. In addition, differences between an acquirer's financial statements and an acquiree's financial statements can arise for other reasons, for example, because of the elimination of intragroup transactions. *[IFRS 17.BC327B, IFRS 17.BC327C, IFRS 17.BC327D]*.

13 IASB Staff paper 2C: Project: I*nsurance Contracts*, Paper topic: *Responding to the external editorial review*, IASB meeting, February 2017, Issue A12. Available on the IFRS Foundation's website.

IFRS 17 requires an entity to treat the consideration received or paid for insurance contracts acquired in a transfer of business or a business combination within the scope of IFRS 3, including contracts in their settlement period, as a proxy for the premiums received. This means that the entity determines the contractual service margin in accordance with all other requirements of IFRS 17 in a way that reflects the premium paid for the contracts. In a business combination within the scope of IFRS 3, the consideration received or paid is the fair value of the contracts at that date. However, IFRS 17 states that the entity does not apply the requirement in IFRS 13 that the fair value of a financial liability with a demand feature cannot be less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. *[IFRS 17.B94]*.

The consideration received or paid for the contracts excludes the consideration received or paid for any other assets or liabilities acquired in the same transaction. Therefore, an acquirer will have to allocate the consideration received or paid between contracts within the scope of IFRS 17, other assets and liabilities outside the scope of IFRS 17 and goodwill, if any. *[IFRS 17.B94]*.

For insurance contracts measured using the general model, including the variable fee approach, on initial recognition (i.e., acquisition) the contractual service margin is calculated: *[IFRS 17.B95]*

- For acquired insurance contracts issued based on the requirements of the general model (see section 9 above)
- For acquired reinsurance contracts held based on the requirements of the general model as modified (see section 11 above) using the consideration received or paid for the contracts as a proxy for the premiums received or paid at the date of initial recognition

If the premium allocation approach applies to insurance contracts acquired in a transfer or business combination, the premium received is the initial carrying amount of the liability for remaining coverage and the liability for incurred claims. *[IFRS 17.B94]*. If facts and circumstances indicate that the contract is onerous, the difference between the carrying amount of the liability for remaining coverage and the fulfilment cash flows that relate to the remaining coverage must be treated the same way as a contract under the general model (i.e., recognised within goodwill or the gain on bargain purchase in a business combination or recognised as a loss in profit or loss on a transfer).

If the acquired insurance contracts issued are onerous: *[IFRS 17.B95A]*

- For contracts acquired in a business combination within the scope of IFRS 3, the excess of the fulfilment cash flows over the consideration paid or received must be recognised as part of goodwill or the gain on a bargain purchase.

  Or

- For contracts acquired in a transfer, the excess of the fulfilment cash flows over the consideration paid or received is recognised as a loss in profit or loss. The entity must establish a loss component of the liability for remaining coverage for that excess (i.e., the onerous group) and apply the guidance discussed in section 9.8 above to allocate subsequent changes in fulfilment cash flows to that loss component.

For a group of reinsurance contracts held when the underlying insurance contracts issued are onerous and a loss-recovery component has been recognised, an entity must determine the loss-recovery component of the asset for remaining coverage at the date of transaction by multiplying: *[IFRS 17.B95B]*

- The loss component of the liability for remaining coverage of the group of underlying insurance contracts at the date of transaction

  And

- The percentage of claims on the underlying insurance contracts the entity expects at the date of transaction to recover from the group of reinsurance contracts held

Any loss-recovery component determined above is part of goodwill or the gain on a bargain purchase for reinsurance contracts held acquired in a business combination within the scope of IFRS 3, or as income in profit or loss for contracts acquired in a transfer. *[IFRS 17.B95C]*.

At the date of the transaction, onerous underlying insurance contracts might be included in a group of insurance contracts with other onerous contracts not covered by the group of reinsurance contracts held. In that situation, for the purposes of applying the requirements above, the entity must use a systematic and rational allocation basis to determine the portion of the loss component of the group of insurance contracts that relates to insurance contracts covered by the group of reinsurance contracts held. *[IFRS 17.B95D]*.

Investment contracts within the scope of IFRS 9 are required to be measured at fair value when acquired in a business combination.

The two following Illustrations, based on Illustrative Examples 13 and 14 of IFRS 17, demonstrate the measurement on initial recognition for insurance contracts acquired: *[IFRS 17.IE139-145, IFRS 17.IE146-151]*

Illustration 14-1: Measurement on initial recognition of insurance contracts acquired in a transfer that is not a business combination

An entity acquires insurance contracts in a portfolio transfer from another entity. The seller pays CU30 to the entity to take on those insurance contracts. The entity determines that the acquired contracts form a group, as if it had entered into the contracts on the date of the transaction. The entity applies the general model to the measurement of the insurance contracts.

On initial recognition, the entity determines that the consideration received (i.e., the deemed premium) of the group of insurance contracts is CU30 and the fulfilment cash flows are, as follows:

- Example A - outflow (or liability) of CU20
- Example B - outflow (or liability) of CU45

For simplicity, this example ignores all other amounts.

On initial recognition, the entity measures the liability for the group of contracts, as follows:

	Example A	Example B
	CU	CU
Fulfilment cash flows	20	45
Contractual service margin	10	-
Insurance contract liability on initial recognition	**30**	**45**
The effect on profit or loss will be:		
Profit/(loss) on initial recognition	**-**	**(15)**
Carrying amount of the insurance contract liability:		
Deemed premium received for the group of insurance contracts	30	30
Loss on acquired onerous insurance contracts	-	15
Total	**30**	**45**

For contracts that are not onerous, the contractual service margin is the difference between the premium received by the entity (CU30) and the fulfilment cash flows (CU20) (i.e., CU30 less CU20 resulting in a contractual service margin of CU10 in Example A). Consequently, in Example A, the total insurance contract liability is equal to the premium received.

In Example B, the premium received (CU30) is less than the fulfilment cash flows (CU45). Therefore, the entity concludes that the contract is onerous. Consequently, the difference between CU30 and (CU45) of (CU15) is an expense in profit or loss and the insurance contract liability is equal to the fulfilment cash flows. The entity also establishes a loss component of CU15 for the liability for remaining coverage. The insurance contract liability of CU45 is the sum of the fulfilment cash flows of CU45, including the loss component of CU15.

Illustration 14-2: Measurement on initial recognition of insurance contracts acquired in a business combination

An entity acquires insurance contracts as part of a business combination within the scope of IFRS 3 and estimates that the transaction results in goodwill when it applies IFRS 3. The entity determines that the acquired contracts form a group, as if it had entered into the contracts on the date of the transaction. The entity applies the general model to the measurement of the insurance contracts.

On initial recognition, the entity determines that the consideration received (i.e., fair value of the acquired contracts, reflecting the deemed premium) of the group of insurance contracts is CU30 and the fulfilment cash flows are, as follows:

- Example A - outflow (or liability) of CU20
- Example B - outflow (or liability) of CU45

For simplicity, this example ignores all other amounts.

On initial recognition, the entity measures the liability for the group of contracts, as follows:

	Example A	Example B
	CU	CU
Fulfilment cash flows	20	45
Contractual service margin	10	-
Insurance contract liability on initial recognition	**30**	**45**
The effect on profit or loss will be:		
Profit/(loss) on initial recognition	-	-
Carrying amount of the insurance contract liability:		
Deemed premium received for the group of insurance contracts	30	30
Recognised as part of goodwill (or gain on a bargain purchase)	-	15
Total	**30**	**45**

In Example A, the entity measures the contractual service margin as the difference between the deemed premium (CU30) and the fulfilment cash flows (CU20). Consequently, in Example A the contractual service margin is CU10; and the total insurance contract liability of CU30 is the sum of the fulfilment cash flows of CU20 and the contractual service margin of CU10 (i.e., equal to the deemed premium).

In Example B, the fulfilment cash flows exceed the deemed premium. Consequently, the contractual service margin is zero (as the difference between the deemed premium (CU30) and the fulfilment cash flows (CU45) reflects an expected net outflow of CU15); and the excess of CU15 of the fulfilment cash flows (CU45) over the deemed premium (CU30) is part of the goodwill on the business combination. The entity also establishes a loss component of CU15 for the liability for remaining coverage. The insurance contract liability of CU45 is the sum of the fulfilment cash flows of CU45, including the loss component of CU15.

How we see it

When insurance contracts issued or reinsurance contracts held are acquired in a transfer of insurance contracts that does not form a business, or in a business combination within the scope of IFRS 3, an entity should also apply the aggregation requirements for the identification of portfolios of insurance contracts and divide those into groupings, as explained in section 5 above, as if it had entered into the contracts on the date of transaction. This implies that contract classifications and eligibility assessments relevant to such acquired contracts (i.e., significant insurance risk, direct participation features, eligibility for the premium allocation approach) are based on the terms and conditions at the acquisition date.

As IFRS 3 also refers to 'groupings' and 'operating and accounting policies', this implies that other assessments like the eligibility for the premium allocation approach or variable fee approach for direct participation contracts (see sections 10.1 and 12.3.1 above) should be based on the contractual terms and conditions at the date of acquisition rather than at the date of the original inception of the contract. This approach may result in, for example, contracts that are insurance contracts from the perspective of the acquiree but investment contracts from the perspective of the acquirer. Consequently, there will be a different accounting treatment for the same contracts between the consolidated financial statements that includes the acquiree and the separate financial statements of the acquiree in such a situation. However, this would reflect the substance that the acquirer has purchased investment contracts rather than insurance contracts.

14.1 Assets for insurance acquisition cash flows acquired in a business combination within the scope of IFRS 3 or a transfer of insurance contracts that do not form a business

Extract from IFRS 17

Asset for insurance acquisition cash flows

B95E When an entity acquires insurance contracts issued in a transfer of insurance contracts that do not form a business or in a business combination within the scope of IFRS 3, the entity shall recognise an asset for insurance acquisition cash flows at fair value at the date of the transaction for the rights to obtain:

(a) future insurance contracts that are renewals of insurance contracts recognised at the date of the transaction; and

(b) future insurance contracts, other than those in (a), after the date of the transaction without paying again insurance acquisition cash flows the acquiree has already paid that are directly attributable to the related portfolio of insurance contracts.

[IFRS 17.B95E].

The asset for insurance acquisition cash flows must be excluded from the measurement of insurance contracts acquired in a business combination within the scope of IFRS 3 or in a transfer of insurance contracts that do not form a business. *[IFRS 17.B95F]*.

These insurance acquisition cash flow assets recognised for the rights to obtain future insurance contracts are excluded from the scope of IAS 38. *[IAS 38.3(g)]*. IAS 38 excludes from its scope contracts within the scope of IFRS 17 and any assets for insurance acquisition cash flows as defined in IFRS 17. However, rights to obtain future insurance contracts such as customer relationships or customer lists which are unconnected to any previously paid insurance acquisition cash flows and relate to contracts which do not meet the recognition criteria of IFRS 17 would fall within the scope of IAS 38. *[IFRS 17.BC327H]*.

The IASB concluded that requiring an entity to recognise assets for insurance acquisition cash flows for rights to obtain future insurance contracts and future renewals at the acquisition date ensures that the contractual service margin of groups of insurance contracts the entity recognises subsequent to the acquisition appropriately reflect the rights the entity paid for relating to those future groups as part of the consideration for the acquisition. Requiring an entity to recognise any such assets at the acquisition date is consistent with the other requirements in IFRS 17 for recognising an asset for insurance acquisition cash flows (see section 7.3 above). The Board decided that to achieve that consistency, it is necessary to determine the rights described in the first bullet point above by reference to insurance acquisition cash flows the acquiree has already paid. Otherwise, broader rights to obtain future contracts from intangible assets such as customer relationships, unconnected to any previously paid insurance acquisition cash flows, could be included in the insurance acquisition cash flow assets. In contrast, the Board decided that such reference is not needed to determine the rights described in the subsequent bullet point above. The fact that these rights relate only to renewals means they are sufficiently constrained. *[IFRS 17.BC327I]*.

14.2 Subsequent treatment of contracts acquired in their settlement period

For retroactive insurance contracts that cover events that have already occurred, but for which, the financial effect is uncertain, IFRS 17 states that the insured event is the determination of the ultimate costs of the claim. *[IFRS 17.B5]*. As the claim has occurred already, the question arises as to how insurance revenue and insurance service expense must be presented for these insurance contracts when they are acquired in a business combination or similar acquisition in their settlement period. More specifically, whether insurance revenue must reflect the entire expected claims or not.

Frequently asked questions

Question 14-1: How should insurance revenue and insurance service expenses be presented for insurance contracts acquired in conjunction with a business combination or similar acquisition in their settlement period. More specifically, should revenue reflect the entire expected claims or not?

(TRG meeting February 2018 - Agenda paper no. 7, Log S04)

The IASB staff observed that IFRS 17.B5 states that for those contracts which cover events that have already occurred but the financial effect of which is uncertain the insured event is the determination of the ultimate cost of the claim. Therefore, acquiring contracts in their settlement period is essentially providing coverage for the adverse development of claims.

The subsequent treatment for the liability for remaining coverage is set out in IFRS 17.41, Accordingly, revenue would reflect the entire expected claims.

If some cash flows meet the definition of an investment component, those cash flows will not be reflected in revenue or expenses.

Frequently asked questions

Question 14-2: For issued adverse loss cover and contracts acquired in their settlement period when are claims incurred for these contracts and, what subsequent treatment should be applied if the liability for remaining coverage is determined to have nil contractual service margin at initial recognition and estimates of future cash outflows decrease subsequently?

(TRG meeting May 2018 - Agenda paper no. 7, Log S32)

The IASB staff stated that, for contracts acquired in their settlement period, claims are incurred (and, hence, the liability for remaining coverage is reduced) when the financial effect becomes certain. This is not when the entity has a reliable estimate if there is still uncertainty involved. Conversely, this is not necessarily when the claims are paid if certainty has been achieved prior to the actual payment.

The IASB staff also stated that subsequent measurement of insurance contracts acquired, including changes in estimates that adjust the contractual service margin is the same as for insurance contracts issued applying IFRS 17.40-52. Therefore, in a scenario where the liability for remaining coverage is determined to have nil contractual service margin at initial recognition for contracts acquired in their settlement period (i.e., insurance contracts are measured at zero with nil contractual service margin) and estimates of net future cash outflows decrease subsequently (i.e., favourable change in fulfilment cash flows), the IASB staff stated that a contractual service margin larger than zero may be recognised post acquisition.

The TRG members had no specific comments on the IASB staff observations, although the TRG members had previously observed that the requirements reflect a significant change from existing practice and this change results in implementation complexities and costs. However, the IASB declined to create an exception to the general classification and measurement requirements in IFRS 17 for contracts acquired in their settlement period. The Board concluded that an entity that acquires a contract should, at the acquisition date, apply the requirements for identifying whether a contract has an insured event and meets the definition of an insurance contract, just as an entity that issues a contract applies the requirement at the issue date. *[IFRS 17.BC327E]*.

This results in different accounting for similar contracts, depending on whether the contracts are issued by the entity or whether the entity acquired those contracts in their settlement period. The most notable outcomes of this distinction include:

- An entity applies the general model for contracts acquired in their settlement period, because the period over which claims could develop (i.e., the coverage period for the determination of the ultimate cost of the claims) is longer than one year, whilst the entity would expect to apply the premium allocation approach for similar contracts that it issues
- An entity recognises revenue for the contracts acquired in their settlement period over the period the claims can develop, while revenue is no longer recognised over this period for similar contracts issued

Some contracts acquired in their settlement period will not meet the definition of an insurance contract at the acquisition date. This is because, in some circumstances, all claim amounts are known at the acquisition date but remain unpaid. In such circumstances, the acquirer is not providing insurance coverage, the contract does not meet the definition of an insurance contract and the acquirer would account for the contract as a financial liability applying IFRS 3 and subsequently IFRS 9. The Board also observed that for contracts that meet the definition of an insurance contract at the acquisition date, an entity would need to consider whether any amounts payable to the policyholder meet the definition of an investment component (and are therefore excluded from insurance revenue). *[IFRS 17.BC327G]*.

The following illustrates an accounting policy for contracts acquired in their settlement period in a business combination:

Practical example 14-1: AXA SA (2023) France

UNIVERSAL REGISTRATION DOCUMENT - ANNUAL REPORT 2023 [extract]

6 CONSOLIDATED FINANCIAL STATEMENTS [extract]

6.6 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]

Note 1 Accounting principles [extract]

1.3 PRINCIPLES AND METHODS OF CONSOLIDATION [extract]

1.3.2 Business combinations and subsequent changes in the Group ownership interest [extract]

1.3.2.2 VALUATION OF ASSETS ACQUIRED, AND LIABILITIES ASSUMED IN A BUSINESS COMBINATION [extract]

Insurance and investment contracts [extract]

...

Groups of insurance contracts acquired in their settlement period are, if material, valuated as if they were new insurance contracts issued by the acquirer as at the acquisition date: the LRC are recognized for such insurance contracts using the General Measurement Model described in paragraph 1.14.5, with the consideration received used as a proxy for the premiums received. Subsequently, the whole amount of the LRC recognized for the acquired claim settlement liabilities is recycled in the insurance revenue over the coverage period applying the mechanism described in paragraph 1.19.1.

...

IFRS 17 includes transition relief for the settlement of claims incurred before an insurance contract is acquired when the modified retrospective approach or the fair value approach is used (see sections 17.4 and 17.5 below). Furthermore, IFRS accounting standards includes transition relief that allows entities to continue to apply their previous IFRS 4 classification as insurance contracts of contracts acquired in a business combination before the date of initial application of IFRS 17 (see section 17.2.1.C below).

14.3 Business combinations under common control

IFRS 3 does not apply to a combination of entities or businesses under common control (i.e., a common control business combination). *[IFRS 3.2(c)]*.

Similarly, IFRS 17 limits the accounting requirements in respect of business combinations (discussed in section 14 above) to 'a business combination within the scope of IFRS 3'. This requirement excludes business combinations outside the scope of IFRS 3, such as business combinations under common control, from the specific measurement requirements of IFRS 17 applying to those combinations with the scope of IFRS accounting standards. *[IFRS 17.BC327A]*.

How we see it

Business combinations under common control are outside the scope of IFRS 17. Consequently, an entity will need to develop an appropriate accounting policy for business combinations under common control. Currently, there is no guidance in IFRS accounting standards for business combinations under common control, i.e., transactions in which the combining businesses are ultimately controlled by the same party both before and after the combination. Accounting for business combinations under common control is discussed in Chapter 11 at section 3 and the application and use of the pooling of interests method is discussed in Chapter 11 at section 3.3

14.4 Portfolio transfers - practical issues

14.4.1 The difference between a business combination and a transfer of insurance contracts that do not form a business

When an entity acquires a portfolio of insurance contracts, the main accounting consideration is to determine whether that acquisition meets the definition of a business. IFRS 3 defines a business as: *[IFRS 3 Appendix A]*

Extract from IFRS 3

Appendix A
Defined terms

business	An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities.

The application guidance to IFRS 3 notes that a business consists of inputs and processes applied to those inputs that have the ability to contribute to the creation of outputs. Although businesses usually have outputs they are not required for an integrated set of assets and activities to be a business. *[IFRS 3.B7, IFRS 3.B8]*. Where it is considered that a business is acquired, goodwill may need to be recognised, as may deferred tax liabilities, in respect of any acquired intangibles. For a transfer which does not constitute a business, neither goodwill nor deferred tax are recognised.

Rights to issue or renew contracts in the future (as opposed to existing insurance contracts) are separate intangible assets and the accounting for the acquisition of such rights is discussed in section 14.4.3 below.

An entity recognises an asset at fair value for insurance acquisition cash flows that relate to future insurance contracts and future renewals acquired in a transfer that is not a business as discussed in section 14.1 above.

How we see it

The determination of whether a portfolio of contracts or a business has been acquired will be a matter of judgement based on the facts and circumstances. Acquisitions of contracts that also include the acquisition of underwriting systems and/or the related organised workforce are more likely to meet the definition of a business than merely the acquisition of individual or multiple contracts.

14.4.2 Deferred taxation

For transactions that meet the definition of a business combination, IAS 12 requires deferred tax to be recognised in respect of temporary differences arising in business combinations, for example if the tax base of the asset or liability remains at cost when the carrying amount is fair value. IFRS 17 contains no exemption from these requirements. Therefore, deferred tax will often arise on temporary differences created by the recognition of insurance contracts at a value different from that applied previously by the acquiree (e.g., because the fulfilment cash flows at the date of acquisition for the insurance contracts acquired, calculated on the basis of the contractual terms at the date of the acquisition, is likely to be different from the carrying value of the fulfilment cash flows calculated by the acquiree on the basis of contractual terms on initial recognition of the insurance contract). The deferred tax adjusts the amount of goodwill recognised. For transactions that do not meet the definition of a business combination, the initial recognition exemption applies and no deferred tax is recognised on initial recognition (as discussed in section 14.4.1 above).

14.4.3 Customer lists and relationships not connected to insurance contracts

The requirements discussed in section 14 above apply only to insurance contracts that exist at the date of a business combination or transfer and the requirements discussed in section 14.1 above apply to insurance acquisition cash flows related to the rights to obtain future insurance contracts.

Therefore, they do not apply to customer lists and customer relationships reflecting the expectation of future insurance contracts and related insurance acquisition cash flows that do not meet the IFRS 17 recognition criteria. IAS 36 and IAS 38 apply to such transactions as they apply to other intangible assets.

The following Illustration deals with customer relationships acquired together with a portfolio of one-year motor insurance contracts.

Illustration 14-3: Purchase of portfolio of one-year motor insurance contracts

Parent A obtained control of insurer B in a business combination on 31 December 20X3. B has a portfolio of one-year motor insurance contracts that policyholders may cancel annually.

Because Insurer B establishes its relationships with policyholders through insurance contracts, the customer relationship with the policyholders meets the contractual-legal criterion for recognition as an intangible asset. IAS 36 and IAS 38 apply to the customer relationship intangible asset. *[IFRS 3.IE30(d)]*.

15 Presentation

IFRS 17 specifies line items of amounts that need to be presented on the face of the statement of financial position and statement of financial performance. These are supplemented by disclosures in the notes to explain the amounts recognised on the face of the primary financial statements (see section 16 below).

IFRS 17 requires separate presentation of amounts relating to insurance contracts issued and reinsurance contracts held in the primary statements. There is nothing to prevent an entity from providing further sub-analysis of the required line items (which may make the relationship of the reconciliations to the face of the statement of financial position more understandable). Indeed, IAS 1 requires presentation of additional line items (including the disaggregation of line items specifically required), headings and subtotals on the face of the statements of financial position and financial performance when such presentation is relevant to an understanding of the entity's financial position or financial performance. *[IAS 1.54, IAS 1.55, IAS 1.56, IAS 1.82-86]*.

15.1 Statement of financial position

For presentation in the statement of financial position, IFRS 17 and IAS 1 require insurance contracts to be aggregated by portfolios and presented separately, as follows: *[IFRS 17.78, IAS 1.54(da), IAS 1.54(ma)]*

- Insurance contracts issued that are assets
- Insurance contracts issued that are liabilities
- Reinsurance contracts held that are assets
- Reinsurance contracts held that are liabilities

A portfolio is a group of insurance contracts that are subject to similar risks and managed together (see section 6.1 above). *[IFRS 17.14]*.

The requirement to present insurance contracts assets and liabilities at a portfolio level provides significant operational relief and does not significantly diminish the usefulness of information compared to a requirement to present assets and liabilities at a group of insurance contract level. *[IFRS 17.BC330B]*.

Any assets or liabilities for insurance acquisition cash flows paid before the related group of insurance contracts is recognised (see section 7.3 above) must be included in the carrying amount of the related portfolios of insurance contracts issued and any assets or liabilities for cash flows related to portfolios of reinsurance contracts held are included in the carrying amount of the portfolios of reinsurance contracts held. *[IFRS 17.79]*.

There is no requirement for disclosure of portfolio balances in respect of the general model, premium allocation approach, or variable fee approach to be shown separately on the face of the statement of financial position. There is also no requirement for the components of the portfolio balances (such as the contractual service margin or the risk adjustment for non-financial risk) to be presented separately on the face of the statement of financial position.

However, an entity must disclose reconciliations in the notes to the financial statements that show how the amounts disclosed on the face of the statement of financial position (i.e., the net carrying amount of contracts within the scope of IFRS 17) changed during the reporting period because of cash flows and income and expenses recognised in the statement of financial performance. Separate reconciliations are required for insurance contracts issued and reinsurance contracts held. *[IFRS 17.98]*. The detailed requirements of these reconciliations are discussed in section 16.1 below. In summary, separate reconciliations are required for contracts subject to the general model and the premium allocation approach together with reconciliations for the individual components of the contract balances. An entity is required to consider the level of aggregation of these reconciliations necessary to meet the overall disclosure objectives of IFRS 17. *[IFRS 17.95]*.

Under IFRS 4, some entities presented separately in the statement of financial position different amounts arising from an insurance contract, as if those different amounts were separate assets or liabilities. For example, some entities presented line items labelled as premiums receivable, claims payable and deferred acquisition costs separately from the insurance contract liability. Different entities presented different line items and had different definitions of what those line items were (for example, some entities presented as premiums receivable amounts that were not yet billed while other entities presented only billed amounts that remain outstanding). Some stakeholders expressed the view that they would like to continue that practice of further disaggregation because they view such disaggregated line items as providing meaningful information to users of financial statements. However, the Board disagreed with this approach to presentation because it could result in the presentation of amounts that are not separable assets or liabilities. For example, premiums receivable for future coverage is not a gross asset separable from the related liability for the future coverage. *[IFRS 17.BC330D]*. IAS 1 permits the presentation of additional line items (including by disaggregation of required line items), headings and subtotals in the statement of financial position, when such presentation is relevant to an understanding of the entity's financial position. *[IAS 1.55]*.

The Board also considered some stakeholders' suggestions that entities should be permitted to present one insurance contract asset or liability for all insurance contracts issued by the entity (that is, present insurance contracts at an entity level). The Board rejected that suggestion because that would risk an unacceptable loss of useful information for users of financial statements. *[IFRS 17.BC330C]*.

In addition, the statement of financial position must include, among others, line items that present the following amounts, including those that back policyholder liabilities (see Chapter 3 at section 3.1.5): *[IAS 1.54]*

- Investment property
- Intangible assets
- Financial assets, with separate presentation of trade and other receivables and cash and cash equivalents
- Financial liabilities, with separate presentation of trade and other payables
- Liabilities and assets for current tax, as defined in IAS 12
- Deferred tax liabilities and deferred tax assets, as defined in IAS 12

How we see it

The presentation requirements are significantly different from those required by IAS 32 for financial instruments. These are also likely to differ significantly from the presentation applied previously by an insurer under IFRS 4. For example, individual positive and negative contract balances with different counterparties within one portfolio are aggregated (netted) on the statement of financial position.

All rights and obligations arising from an insurance contract are included in the presentation of the portfolio on a net basis, unless the components of the contract are separated and accounted for under a different IFRS (see section 6.1.1 above). The rights and obligations presented net include all related non-distinct elements, for example, policyholder loans, insurance premiums receivable, liabilities for incurred claims and insurance acquisition cash flows that have been included in the measurement of the contractual service margin.

The fulfilment cash flows of an insurer that is a mutual entity generally include the rights of policyholders to the whole of any surplus of assets over liabilities. This means that, for an insurer that is a mutual entity, there should, in principle, be no equity and no net comprehensive income reported in any accounting period. Mutual insurers may choose to present additional line items and sub totals on the face of their statement of financial position. This would distinguish amounts due to or from policyholders, in their capacity as policyholders, from amounts due to, or from, qualifying mutual policyholders (including future policyholders) in their capacity as holders of the most residual interest in the entity.

15.2 Statement of financial performance

An entity is required to disaggregate the amounts recognised in the statement of profit or loss and the statement of other comprehensive income (collectively, referred to in the standard as the statement of financial performance) into: *[IFRS 17.80, [IAS 1.82(a)(ii), IAS 1.82(ab)]*

- Insurance service result comprised of:
  - Insurance revenue

    And
  - Insurance service expenses
- Insurance finance income or expenses

Income or expenses from reinsurance contracts held are presented separately from the expenses or income from insurance contracts issued. *[IFRS 17.82, IAS 1.82(ac)]*.

An entity may present the income or expense from a group of reinsurance contracts held, other than insurance finance income or expenses, as either: *[IFRS 17.86]*

- A single amount (net presentation)

  Or
- Separately (gross presentation):
  - The amounts recovered from the reinsurer
  - An allocation of the premium paid

When the gross presentation for reinsurance held is used, an entity is not allowed to present the allocation of the reinsurance premiums paid as a reduction in revenue. *[IFRS 17.86(c)]*.

Insurance finance income or expenses must be presented separately for insurance contracts issued and reinsurance contracts held on the face of the statement of profit or loss. *[IAS 1.82(bb), IAS 1.82(bc)]*. When insurance finance income or expenses is disaggregated it must also be shown separately for insurance contracts issued and reinsurance contracts held in other comprehensive income, within items of other comprehensive income that will be reclassified subsequently to profit or loss when specific conditions are met. *[IAS 1.7(i), IAS 1.7(j)]*.

In addition, the profit or loss section or the statement of profit or loss must include, among others, line items that present the following amounts for the period: *[IAS 1.82]*

- Revenue, presenting separately
  - Interest revenue calculated using the effective interest method
  - Insurance revenue
- Gains and losses arising from the derecognition of financial assets measured at amortised cost
- Finance costs
- Impairment losses (including reversals of impairment losses or impairment gains) determined in accordance with IFRS 9.5.5.
- Share of the profit or loss of associates and joint ventures using the equity method
- Tax expense, being the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax

The following table illustrates a summary statement of financial performance under IFRS 17 using the net presentation for reinsurance held.

Illustration 15-1: Illustrative statement of financial performance

Statement of profit or loss and other comprehensive income	**20X2**	**20X1**
	CU m	**CU m**
Insurance revenue	10,304	8,894
Insurance service expenses	(9,069)	(8,489)
Insurance service result before reinsurance contracts held	**1,235**	**405**
Income/(expenses) from reinsurance contracts held	(448)	(327)
Insurance service result	**787**	**78**
Insurance finance income or expenses from contracts issued within the scope of IFRS 17	(394)	(353)
Finance income or expenses from reinsurance contracts held	200	300
Net financial result	**(194)**	**(53)**
Profit before tax	**593**	**25**
Other comprehensive income		
Items that may be reclassified subsequently to profit or loss		
Insurance finance income or expenses from contracts issued within the scope of IFRS 17	50	(25)
Finance income or expenses from reinsurance contracts held	(25)	50
Other comprehensive income for the year net of tax	**25**	**25**
Total comprehensive income for the year	**618**	**50**

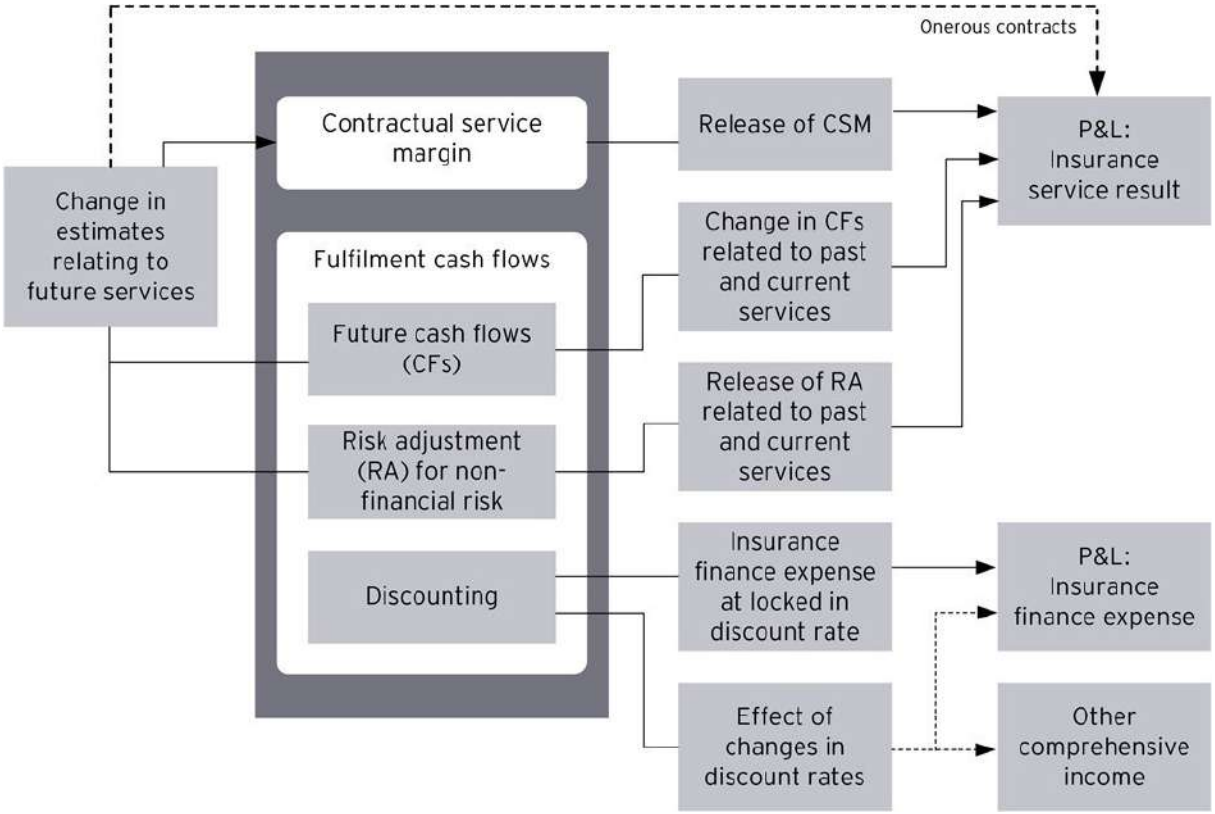
The following Illustration shows the presentation of the insurance service result if the result from reinsurance contracts held is shown on a gross basis.

Illustration 15-2: Insurance service result if the result from reinsurance contracts held is shown on a gross basis

Statement of profit or loss and other comprehensive income	**20X2**	**20X1**
	CU m	**CU m**
Insurance revenue	10,304	8,894
Insurance service expenses	(9,069)	(8,489)
Insurance service result before reinsurance contracts held	**1,235**	**405**
Income/(expenses) from reinsurance contracts held		
Amounts recovered from the reinsurer	300	200
Allocation of reinsurance premiums paid	(748)	(527)
Reinsurance held subtotal	**(448)**	**(327)**
Insurance service result	**787**	**78**

There is nothing to prevent an entity from providing further sub-analysis of the components of the insurance service result (which may make the relationship of the reconciliations discussed in section 16.1 below to the face of the statement of financial performance more understandable). Indeed, IAS 1 states that an entity must present additional line items (including by disaggregating line items specified by the standard), headings and subtotals in the statement(s) presenting profit or loss and other comprehensive income when such presentation is relevant to an understanding of the entity's financial performance. *[IAS 1.85]*.

The following diagram illustrates the high-level relationship of the movements in the building blocks of the general model (discussed in section 8 above) and their relationship with the presentation in the statement of financial performance.



Each of the amounts required to be reported in the statement of financial performance are discussed in sections 15.2.1 to 15.3 below.

15.2.1 Insurance revenue

Insurance revenue depicts the provision of services arising from a group of insurance contracts at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. *[IFRS 17.83]*.

Insurance revenue from a group of insurance contracts is therefore the consideration for the contracts, i.e., the amount of premiums paid to the entity: *[IFRS 17.B120]*

- Adjusted for financing effect (the time value of money)
- Excluding any investment components

Investment components are accounted for separately and are not part of the insurance service result.

The amount of insurance revenue recognised in a period depicts the transfer of promised services at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. The total consideration for a group of contracts covers the following: *[IFRS 17.B121]*

- Amounts related to the provision of services, comprising:
  - Insurance service expenses, excluding any amounts related to the risk adjustment for non-financial risk included per bullet point below and any amounts allocated to the loss component of the liability for remaining coverage
  - Amounts related to income tax that are specifically chargeable to the policyholder
  - The risk adjustment for non-financial risk, excluding any amounts allocated to the loss component of the liability for remaining coverage
  - The contractual service margin.
- Amounts related to insurance acquisition cash flows

Expected allocated expenses for insurance service expenses will be included in the fulfilment cash flows. For example, an entity might include building costs in the fulfilment cash flows (see section 9.2.3 above). The entity will determine depreciation costs over the period of the useful life of the building applying the requirements of IAS 16. When these allocated depreciation expenses are incurred under IFRS 17 they are treated initially as part of the liability for incurred claims. The entity will reduce the liability for remaining coverage and recognise insurance revenue. When such depreciation expenses are incurred applying IAS 16 (or another standard), the amount included in the liability for incurred claims is deemed to be settled and a corresponding credit to the asset is recorded under IAS 16 (or a corresponding liability under another standard). Another example is the treatment of expected defined benefit pension costs allocated and included in the measurement of a group of insurance contracts applying B65(l) of IFRS 17. An estimate of such expected cash flows will be included in the measurement from the initial recognition of the group of insurance contracts. When the employee service that gives rise to the pension cost occurs, a pension cost and liability will be recognised applying IAS 19. At that point, the relevant expected cash flows will be removed from the measurement of the group of insurance contracts. Continuing to include the cash flows expected to settle the pension liability in the measurement of a group of insurance contracts would result in double-counting the liability for those cash flows, and the insurance liability will continue to exist long after the insurer has fulfilled its other obligations under the insurance contract. Accordingly, an insurer removes expected cash flows from the measurement of a group of contracts under IFRS 17 when the cash flows are recovered or settled, or when the cash flows are recognised as an asset or liability under another IFRS.[14]

An entity accounts for income tax applying IAS 12. When income tax expenses that are specifically chargeable to the policyholder under the terms of an insurance contract are recognised applying IAS 12, an entity recognises insurance revenue for the consideration paid by the policyholder for such income tax amounts when the entity recognises the income tax amounts in profit or loss. This means that when an entity incurs income tax expenses that are specifically chargeable to the policyholder under the terms of an insurance contract, the entity will need to reduce the liability for remaining coverage and recognise insurance revenue accordingly.[15] As IAS 1 requires a separate presentation of the tax expense, the related income tax amount incurred in the period is reported as part of the tax expense line item. *[IAS 1.82(d)]*.

14 IASB Staff paper AP04: Project: *Premiums Receivable from an Intermediary (IFRS 17 and IFRS 9)*, Paper topic: I*nitial consideration*, IFRS Interpretations Committee meeting, March 2023, pages 12-13. Available on the IFRS Foundation's website.

15 IASB Staff paper 2: Project: *Amendments to IFRS 17*, Paper topic: *Sweep issues*, IASB meeting, May 2020, page 6. Available on the IFRS Foundation's website.

Illustration 15-3: Interaction between IFRS 17 and other IFRS accounting standards

At 31 December 20X4 (Q4/H2), Entity A recognised a liability for a group of insurance contracts on the face of its statement of financial position.

Note: All other amounts, apart from those mentioned below, are ignored for simplicity.

The fulfilment cash flows of the liability for remaining coverage at 31 December 20X4 includes the following:

	CU
Allocated depreciation on right-of-use asset expected to be incurred during 20X5[1]	218
Expected income tax payment for 20X5, chargeable to the policyholder	120

[1] At 31 December Entity A has recognised a right-of-use asset (CU436) and a corresponding lease liability (CU446) related to the current lease contract as required by IFRS 16.

The actual expenses incurred during 20X5 amount to:

	CU
Income tax expense recognised and measured in terms of IAS 12 Current tax	120
Amortisation of right-of-use asset	218

The journal entries to account for the consequences of the actual expenses incurred within 20X5 may be presented (assuming no differences between actual and expected expenses), as follows:

			CU	CU
Dr	Amortisation expense		218	
	Cr	Right-of-use asset - accumulated amortisation		218
Application of IFRS 16				
Dr	Liability for remaining coverage		218	
	Cr	Insurance revenue		218
Application of IFRS 17.41(a)				
Dr	Insurance service expenses		218	
	Cr	Liability for incurred claims		218
Application of IFRS 17.42(a)				
Dr	Liability for incurred claims		218	
	Cr	Amortisation expense		218

Deemed settlement of liability for incurred claims when expense is incurred under IFRS 16

Income tax

			CU	CU
Dr	Liability for remaining coverage		120	
	Cr	Insurance revenue		120
Application of IFRS 17.41(a) and B121(a)(ia)				
Dr	Income tax expense		120	
	Cr	Current tax liability		120

Application of IAS 12

The above journal entries may result in the following line items in the statement of profit or loss for the period ended 31 December 20X5:

	IAS 1 ref	CU
Insurance revenue (120 + 218)	82(a)(ii)	338
Insurance service expenses	82(ab)	(218)
Insurance service result		120
Tax expense	82(d)	(120)

15.2.1.A Insurance revenue related to the provision of services in a period

When an entity provides services in a period, it reduces the liability for remaining coverage for the services provided and recognises revenue. This is consistent with revenue recognition under IFRS 15 in which an entity recognises revenue and derecognises the performance obligation for services that it provides. *[IFRS 17.B123]*.

The reduction in the liability for remaining coverage that gives rise to insurance revenue excludes changes in the liability that do not relate to services expected to be covered by the consideration received by the entity. These are changes that: *[IFRS 17.B123]*

- Do not relate to services provided in the period, for example, include:
  - Changes resulting from cash inflows from premiums received
  - Changes that relate to investment components in that period
  - Changes resulting from cash flows from loans to policyholders
  - Changes that relate to transaction-based taxes collected on behalf of third parties (such as premium taxes, value added taxes and goods and services taxes)
  - Insurance finance income or expenses
  - Insurance acquisition cash flows
  - Derecognition of liabilities transferred to a third party
- Relate to services, but for which the entity does not expect consideration, i.e., increases and decreases in the loss component of the liability for remaining coverage

Additionally, any insurance revenue presented in profit or loss must exclude any investment components as well as amounts not arising from the provision of insurance services. *[IFRS 17.85]*.

To the extent that an entity derecognises an asset for cash flows other than insurance acquisition cash flows at the date of initial recognition of a group of insurance contracts (see section 9.5.1 above), it must recognise insurance revenue and expenses for the amount derecognised at that date. *[IFRS 17.B123A]*.

After having explained what insurance revenue is not, IFRS 17 then explains which changes in the liability for remaining coverage in the period relates to services for which the entity expects to receive compensation. Those changes are: *[IFRS 17.B124]*

- Insurance service expenses incurred in the period (measured at the amounts expected at the beginning of the period), excluding:
  - Amounts allocated to the loss component of the liability for remaining coverage
  - Repayments of investment components
  - Amounts related to transaction-based taxes collected on behalf of third parties (such as premium taxes, value added taxes and goods and services taxes)
  - Insurance acquisition expenses
  - The amount related to the risk adjustment for non-financial risk
- The change in risk adjustment for non-financial risk, excluding:
  - Changes included in insurance finance income or expenses
  - Changes that adjust the contractual service margin because they relate to future service
  - Amounts allocated to the loss component of the liability for remaining coverage
- The amount of the contractual service margin recognised in profit or loss in the period
- Other amounts, if any, for example, experience adjustments for premium receipts other than those that relate to future service

Insurance revenue related to insurance acquisition cash flows must be determined by allocating the portion of the premiums that relate to recovering those cash flows to each reporting period in a systematic way on the basis of passage of time. An entity must recognise the same amount as insurance service expenses. *[IFRS 17.B125]*. The purpose of this is to separately identify and recognise the recovery of the insurance acquisition cash flows through insurance revenue over the coverage period.

Frequently asked questions

Question 15-1: Can experience adjustments relate to insurance acquisition cash flows and how do they align with the definition of insurance acquisition cash flows?

(TRG meeting September 2018 - Agenda paper no. 6, Log S80)

The IASB staff paper noted that insurance acquisition cash flows are included in the determination of the contractual service margin or loss component for a group of insurance contracts on initial recognition. They are treated the same way as other cash flows incurred in fulfilling insurance contracts. An entity is, therefore, not required to identify whether it will recover the acquisition cash flows at each reporting date since the measurement model captures any lack of recoverability automatically. It does this by limiting the contractual service margin from becoming negative. When expected cash inflows are less than the total of expected cash outflows (including acquisition cash flows) and the risk adjustment for non-financial risk, a loss component is recognised along with a charge to profit or loss.

The TRG members observed that:

- An entity is not required separately to identify whether it will recover insurance acquisition cash flows at each reporting date.
- IFRS 17 assumes that the portion of premiums relating to the recovery of insurance acquisition cash flows is equal to the current estimate of total expected insurance acquisition cash flows at each reporting period.

The TRG members also noted that experience adjustments arising from premiums received in the period that relate to future service, and the related cash flows such as insurance acquisition cash flows, adjust the contractual service margin.

This means that, for example, if initial estimates of acquisition cash flows, payable at the end of a one-year coverage period, were CU100 and, at six months into the coverage period, the entity now expects to pay CU120 for acquisition cash flows at the end of the coverage period compared to the initial expectation of CU100; then the amount of insurance service expenses related to the amortisation of acquisition cash flows (and insurance revenue recognised) at six months is CU60 (CU120 × 6/12).

Question 15-2: Does IFRS 17 require or permit an entity to accrete interest on the amount of acquisition cash flows paid for determining the insurance revenue and insurance services expenses applying IFRS 17.B125?

(TRG meeting April 2019 - Agenda paper no. 2, Log S121)

The IASB staff observed that an entity is required to determine insurance revenue related to insurance acquisition cash flows by allocating the portion of premiums that relate to recovering those cash flows to each reporting period in a systematic way on the basis of passage of time. Such a systematic way does not preclude consideration of interest accretion.

The following Illustration shows how insurance acquisition cash flows are allocated to revenue.

Illustration 15-4: Allocating a portion of premiums to recovery of insurance acquisition cash flows

An entity issues a group of insurance contracts with a coverage period of four years. The entity pays initial acquisition cash flows of CU200 and expects to pay trail commission of CU50 at the end of year 4. The group of contracts is not determined to be onerous. The entity estimates, at the time of initial recognition of the group of contracts, that the discount rate that applies to nominal cash flows that do not vary based on the returns on any underlying items is 3% per year.

The present value of expected insurance acquisition cash flows at initial recognition is CU244 [CU200 + (CU50 ÷ 1.03^4)] which is part of the initial liability for remaining coverage. This is reduced as the cash flows related to the acquired insurance contracts occur. The entity elects to accrete interest on the insurance acquisition cash flows (see section 9.3 above) and estimates the portion of premiums that relates to the recovery of insurance acquisition cash flows in each of the four years of coverage after accreting interest on the opening balance to be CU63, CU65, CU67 and CU68. The entity recognises the same amounts as insurance service expenses in each year (i.e., insurance revenue and insurance service expenses are grossed up for the same amount of CU263).

		Year 1	Year 2	Year 3	Year 4
		CU	CU	CU	CU
A.	Memorandum balance at the beginning of the year of coverage	244	188	129	66
B.	Accretion of interest at 3% per year	7	6	4	2
C.	Amount allocated for the year (A+B)/the number of remaining years of coverage	(63)	(65)	(67)	(68)
D.	Memorandum balance at the end of the year	188	129	66	0

How we see it

Revenue recognition will be different from practice under IFRS 4, particularly for life contracts where the accounting practice in many jurisdictions is to recognise premiums due in a period as equivalent to revenue. Revenue in IFRS 17 excludes investment components and recognises revenue as service is provided, instead of when premiums are due to be received. Maintaining records of the liability for remaining coverage for each group of insurance contracts, including any loss component, over the course of the coverage period, and adjusting the amount recognised in profit or loss in each period as revenue for investment components will call for new systems and processes. This new measurement of insurance revenue is also likely to change reported metrics and even impact on the perceived size of entities where this is based on the amount of revenue reported.

Insurance revenue should also incorporate a financing effect (i.e., the adjustment for the effect of time value of money, see section 15.2.1 above), with a corresponding effect reflected in insurance service expenses (see section 15.2.2 below). IFRS 17 is clear that for contracts with direct participation features, this effect is determined using a current discount rate. IFRS 17 is also clear that for contracts accounted for under the premium allocation approach, the financing effect (if any) for the liability for remaining coverage should be determined using the discount rate at initial recognition of the group of contracts. However, IFRS 17 is not clear on whether the financing effect for contracts accounted for under the general model should be based on the current rate or the rate at initial recognition. An entity would therefore have to make an accounting policy choice between a current rate and a rate at initial recognition for determining the financing effect under the general model and apply this choice consistently to contracts accounted for under the general model.

An entity must allocate the portion of the premium that relates to recovering the insurance acquisition cash flows in a systematic way on the basis of time over the coverage period. Such a pattern does not necessarily have to be purely time-proportionate but could also be another systematic basis that appropriately considers the passage of time, like coverage units. Further, as observed by the IASB staff and the TRG in Question 15-2 above, IFRS 17 does not preclude determining this basis in a way that considers the accretion of interest. This means an entity will have to determine its accounting policy on accreting interest to the memorandum balance of insurance acquisition cash flows.

15.2.1.B Revenue under the premium allocation approach

When an entity applies the premium allocation approach, insurance revenue for the period is the amount of expected premium receipts (excluding any investment component and adjusted to reflect the time value of money and the effect of financial risk, if applicable) allocated to the period. The entity must allocate the expected premium receipts to each period of insurance contract services: *[IFRS 17.B126]*

- On the basis of the passage of time

  But

- If the expected pattern of release of risk during the coverage period differs significantly from the passage of time, then on the basis of the expected timing of incurred insurance service expenses

An entity must change the basis of allocation between the two methods above, as necessary, if facts and circumstances change. *[IFRS 17.B127]*. Any change must be reflected in the basis of allocation as a change in accounting estimate and applied prospectively (see section 10.3 above).

If an entity using the premium allocation approach does not expense insurance acquisition cash flows as incurred (see section 10.2 above), the same guidance applies for allocating these to revenue as discussed in section 15.2.1 above for the general approach.

How we see it

The premium allocation approach has many similarities with current practice for non-life insurance based on the unearned premium reserve (UPR) method. However, entities should determine whether the allocation guidance in IFRS 17 requires a change in the revenue recognition pattern. This would be the case if, for example, the expected pattern of release of risk during the coverage period differs significantly from the passage of time, but the entity currently recognises revenue based on the passage of time.

IFRS 17 is silent on how to apply the systematic way on the basis of passage of time for allocating the insurance acquisition cash flows over the coverage period. The standard, therefore, does not appear to preclude applying this allocation pattern in a way that is consistent with the pattern for recognising insurance revenue under the premium allocation approach. This could be administratively easier for entities as they can then determine revenue on a 'net' basis (i.e., the premium amount less insurance acquisition cash flows) and then 'gross up' insurance revenue and insurance service expenses for the amount of insurance acquisition cash flows allocated to the period for presentation in the statement of financial performance.

As discussed in section 15.2.1.A above, IFRS 17 is clear that for contracts accounted for under the premium allocation approach, the financing effect (if any) should be determined using the discount rate at initial recognition of the group of contracts.

15.2.1.C Income or expense from reinsurance contracts held

IFRS 17 permits an entity to present income or expenses from a group of reinsurance contracts held, other than insurance finance income or expenses, either: *[IFRS 17.86]*

- As a single amount

  Or

- Separately, the amounts recovered from the reinsurer and an allocation of the premiums paid that, together, give a net amount equal to that single amount

If an entity presents separately the amounts recovered from the reinsurer and an allocation of the premiums paid, it must: *[IFRS 17.86]*

- Treat reinsurance cash flows that are contingent on claims on the underlying contracts (which would include profit commission payable or receivable) as part of the claims that are expected to be reimbursed under the reinsurance contract held
- Treat amounts from the reinsurer that it expects to receive that are not contingent on the claims of the underlying contracts (for example, some types of commissions, see Illustration 9-19 in section 9.9.3 above) as a reduction in the premiums to be paid to the reinsurer
- Treat amounts recognised relating to recovery of losses when an entity has a group of reinsurance contracts held providing coverage for an onerous group of underlying insurance contracts as amounts recovered from the reinsurer (see section 11.4.2 above)
- Not present the allocation of premiums paid as a reduction in revenue

15.2.2 Insurance service expense

Insurance service expense comprises the following: *[IFRS 17.84, IFRS 17.103(b)]*

- Incurred claims (excluding repayments of investment components) and other incurred service expenses
- Amortisation of insurance acquisition cash flows
- Changes in fulfilment cash flows that relate to past services, i.e., relating to the liability for incurred claims
- Changes in fulfilment cash flows that relate to future service, but which do not adjust the contractual service margin, i.e., losses on onerous groups of contracts and reversals of such losses

An entity needs to disaggregate this information (for example, to show insurance acquisition cash flows separately from other insurance service expenses) when it is relevant to understanding the entity's financial performance (see section 15.2 above).

With respect to the change in risk adjustment for non-financial risk, the entire change is included as part of insurance service result, unless the entity has decided to disaggregate this change between the insurance service result and the insurance finance income or expense. *[IFRS 17.81]*.

How we see it

As with insurance revenue, insurance service expense also incorporates a financing effect (i.e., the adjustment for the effect of time value of money, see section 15.2.1 above). IFRS 17 is clear that for contracts with direct participation features, this effect is determined using a current discount rate. However, IFRS 17 is not clear on whether the financing effect for contracts accounted for under the general model should be based on the current rate or the rate at initial recognition. For contracts accounted for under the premium allocation approach, IFRS 17 is also silent on whether the financing effect of the liability for incurred claims should be based on the current rate or the rate at the date the claim is incurred.

An entity would therefore have to make an accounting policy choice as to which rates to use and apply its policy consistently for similar transactions, other events and conditions as required by IAS 8.

15.3 Insurance finance income or expenses

Insurance finance income or expenses comprise the change in the carrying amount of the group of insurance contracts arising from: *[IFRS 17.87]*

- The effect of the time value of money and changes in the time value of money

  And

- The effect of financial risk and changes in financial risk

  But

- Exclude any such changes for groups of insurance contracts with direct participation features that would adjust the contractual service margin, but do not do so in certain circumstances and are included in insurance service expenses instead. These circumstances occur when:
  - The entity's share of a decrease in the fair value of the underlying items exceeds the carrying amount of the contractual margin and gives rise to a loss, or an increase in the amount of the entity's share of the fair value that causes a reversal of that loss
  - Increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin and give rise to a loss, or decreases in fulfilment cash flows are allocated to the loss component of the liability for remaining coverage

Insurance finance income or expenses do not include income or expenses related to financial assets or liabilities within the scope of IFRS 9, such as investment finance income on underlying items. This is disclosed separately under IAS 1 (see section 15.2 above).

An entity is required to include in insurance finance income or expenses the effect of the time value of money and financial risk and changes therein. For this purpose: *[IFRS 17.B128]*

- Assumptions about inflation based on an index of prices or rates or on prices of assets with inflation-linked returns are assumptions that relate to financial risk
- Assumptions about inflation based on an entity's expectation of specific price changes are not assumptions that relate to financial risk
- Changes in the measurement of a group of insurance contracts caused by changes in the value of underlying items (excluding additions and withdrawals) are changes arising from the effect of the time value of money and financial risk and changes therein

The words in the last bullet point above mean that changes in the measurement of insurance contracts arising from changes in underlying items, including changes in the value of underlying items not caused by the time value of money or the effect of financial risks, for example, where the underlying items include non-financial assets, should be treated as insurance finance income or expenses. This is because the underlying items are regarded as investments that determine the amount of some payments to policyholders. The underlying items referred to are those that affect measurement of all insurance contracts and not only underlying items in respect of contracts with direct participation features. The Basis for Conclusions observes that, without this requirement, changes in underlying items could adjust the contractual service margin of insurance contracts without direct participation features. The Board considered a view that, although it would be complex, the effects of changes in cash flows from participating in underlying items that are not financial in nature (for example, insurance contracts) should be presented within the insurance service result, rather than within insurance finance income or expenses. The Board disagreed with this view because the requirement to reflect changes from participation in underlying items in insurance finance income or expenses appropriately depicts the nature of the participation, as an investment. In the Board's view, policyholder participation in underlying items that are not solely financial in nature, such as insurance contracts, should not change the underlying insurance service result. Further, splitting the effect of changes in cash flows resulting from the participation in underlying items that are not solely financial in nature into an amount that should be included in the insurance service result and an amount that should be included in insurance finance income or expense would be complex and could disrupt implementation for some entities. *[IFRS 17.BC342A]*.

An entity's accounting policy on currency denomination determines which effects of changes in exchange rates are changes in financial risk accounted for applying IFRS 17 and which of these effects are exchange differences accounted for applying IAS 21. Neither IAS 21 nor IFRS 17 specify where, in profit or loss, exchange differences under IAS 21 are presented. See section 8.3 above.

Frequently asked questions

Question 15-3: Are changes in fulfilment cash flows as a result of changes in inflation assumptions treated as changes in non-financial risk (which may adjust the contractual service margin) or changes in financial risk for contracts measured under the general model?

(TRG meeting April 2019 - Agenda paper no. 2, Log S122)

The submission provided examples of cash flows, such as claims contractually linked to a specified consumer price inflation index and cash flows that are not contractually linked to an index, but which are expected to increase with inflation. The IASB staff observed that cash flows that an entity expects to increase with an index are an assumption that relates to financial risks, even if the cash flows are not contractually linked to a specific index. The TRG members did not disagree with the IASB staff's observation.

15.3.1 Presentation of insurance finance income or expenses in the statement of comprehensive income

Except for insurance finance income or expenses arising from insurance contracts under the variable fee approach when risk mitigation is applied, entities have an accounting policy choice between presenting insurance finance income or expenses in profit or loss, or disaggregated between profit or loss and other comprehensive income. *[IFRS 17.88, IFRS 17.89]*.

If an entity mitigates the effect of financial risk under the variable fee approach (see section 12.3.5 above) using derivatives and non-derivative financial assets measured at fair value through profit or loss, it must include insurance finance income or expenses for the period in profit or loss. If an entity mitigates the effect of financial risk using reinsurance contracts held, insurance finance income or expenses must be allocated between profit or loss and other comprehensive income on the basis of the allocation used by the reinsurance contract. *[IFRS 17.B117A]*.

An entity must apply its choice of accounting policy to portfolios of insurance contracts. The choice is then applied to all groups of contracts within that portfolio. In assessing the appropriate accounting policy for a portfolio of insurance contracts, applying the requirements of IAS 8, the entity must consider for each portfolio the assets that the entity holds and how it accounts for those assets. *[IFRS 17.B129]*.

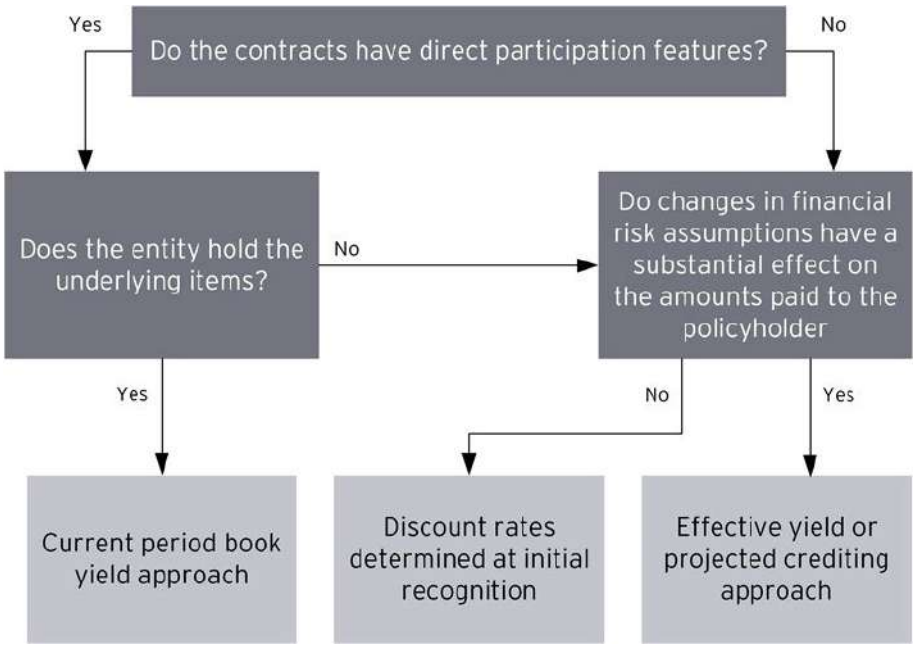
A summary of the policy choices that apply when allocating insurance finance income or expenses in the statement of comprehensive income between profit or loss and other comprehensive income are, as follows:

Type of contract	Accounting	Unit of account
General model		
Present value of future cash flows	All in profit or loss unless disaggregated between profit or loss and other comprehensive income	Disaggregation choice per portfolio
Risk adjustment for non-financial risk	If the entity has elected to disaggregate the risk adjustment between insurance service result and insurance finance income or expenses (see section 9.4.2 above): insurance finance income and expenses allocation follows the present value of future cash flows per above (i.e., all in profit or loss or disaggregated)	Disaggregation choice per portfolio
Contractual service margin	All in profit or loss at the rate at initial recognition as not revalued at current interest rates	N/A
Premium allocation approach		
Liability for remaining coverage	All in profit or loss as not revalued at current interest rates	N/A
Liability for incurred claims	All in profit or loss unless disaggregated between profit or loss and other comprehensive income	Disaggregation choice per portfolio
Variable fee approach		
Present value of future cash flows	All in profit or loss unless disaggregated between profit or loss and other comprehensive income	Disaggregation choice per portfolio
Risk adjustment for non-financial risk	If the entity has elected to disaggregate the risk adjustment between insurance service result and insurance finance income or expenses (see section 9.4.2 above): insurance finance income and expenses allocation follows the present value of future cash flows per above (i.e., all in profit or loss or disaggregated)	Disaggregation choice per portfolio
Contractual service margin	The contractual service margin is measured at current interest rates which this leads to an offset between fulfilment cash flows and contractual service margin rather than being presented in insurance finance income or expenses	N/A

When disaggregation is selected, the methodology required for allocating insurance finance income or expenses between profit or loss and other comprehensive income is different depending on the entity's accounting policy choices based on the nature of the insurance contract liabilities in the portfolio.

The disaggregation approaches for each type of insurance contract are discussed in sections 15.3.2 to 15.3.4 below.

In summary, the approach to determining what portion of insurance finance income or expenses is attributed to profit or loss for portfolios of contracts, except those to which risk mitigation is applied, under the variable fee approach is, as follows:



This can be further illustrated, as follows:

Contract type	Amount recognised in profit or loss	Remaining OCI element reclassified to profit or loss upon derecognition or transfer
Groups of insurance contracts without direct participating features where the effect of financial risk assumptions does not have a substantial effect on the policyholder	Using discount rates determined on initial recognition	Yes
Groups of insurance contracts without direct participating features where the effect of financial risk assumptions has a substantial effect on the policyholder	Choice of (a) effective yield or (b) projected crediting approach	Yes
Contracts accounted for under the premium allocation approach (incurred claims)	Using discount rates determined at date of incurred claim	Yes
Groups of insurance contracts with direct participating features where the underlying items are not held but the effect of financial risk assumptions has a substantial effect on the policyholder	Choice of (a) effective yield or (b) projected crediting approach	Yes
Groups of insurance contracts with direct participating features where the underlying items are held	Current period book yield approach (i.e., net profit or loss impact in the period should be nil)	No

Frequently asked questions

Question 15-4: In a situation in which portfolios of insurance contracts change due to the manner in which the entity manages its contracts, what is the impact of such a change on the group unit of account or the application of the option to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income?

(TRG meeting April 2019 - Agenda paper no. 2, Log S106)

The IASB staff observed that IFRS 17.24 requires that an entity establishes groups of contracts at initial recognition and does not reassess the composition of the groups subsequently. IFRS 17.B129 states that the option to disaggregate insurance finance income or expense between profit or loss and other comprehensive income is a policy choice applied to portfolios of insurance contracts. The requirements of IAS 8 are applicable for changes in accounting policies. Applying IAS 8.13 means that an entity selects and applies its accounting policy consistently for similar portfolios of insurance contracts.

This implies that when an entity decides to choose a policy of disaggregation (or decides to cease a policy of disaggregation) that policy change or choice should be applied to all similar portfolios.

How we see it

Allowing entities a choice between recognising insurance finance income or expenses wholly in profit or loss, or disaggregating it between profit or loss and other comprehensive income, significantly reduces the comparability of profits between entities that apply IFRS 17. There is a trade-off between ensuring comparability between entities and allowing entities to choose how to present insurance finance income or expenses in the accounting in a way that, together with the accounting for their assets backing the insurance liabilities, best fits with how they manage financial risk.

Entities would typically try to minimise accounting mismatches between assets and liabilities. For example, entities that have financial assets held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets and, therefore, record the effect of fair value fluctuations on those debt securities in other comprehensive income under IFRS 9, would be expected to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income on related insurance contract liabilities to minimise accounting mismatches. Conversely, an entity would be less inclined to disaggregate insurance finance income or expenses for portfolios of insurance contracts where the assets backing those liabilities include a substantial proportion of financial instruments which are held at fair value with changes in fair value through profit or loss under IFRS 9.

In presenting insurance finance income or expense, an entity is permitted, but not required, to disaggregate the change in risk adjustment for non-financial risk between the insurance service result and insurance finance income or expenses. The risk adjustment reflects the uncertainty of the present value of cash flows. Consequently, its measurement reflects the time value of money. Permitting entities, as an accounting policy choice, to disaggregate a financing element of changes in the risk adjustment for non-financial risks allows an entity to select its preferred way of reporting the effects of changes in the risk adjustment as part of how the entity manages, and presents, the effects of changes in financial risks. If an entity chooses not to disaggregate the time value of money effect of changes in the carrying amount of the risk adjustment for non-financial risk, the entity should include the entire change in the risk adjustment for non-financial risk as part of the insurance service result (see section 9.4.2 above).

15.3.2 Allocating insurance finance income or expenses for contracts except those with direct participation features for which the entity holds the underlying items

For insurance contracts without direct participation features and contracts with direct participation features where the entity does not hold the underlying items (i.e., all insurance contracts except those with direct participation features for which the entity holds the underlying items), an entity must make an accounting policy choice between: *[IFRS 17.88]*

- Including insurance finance income or expenses for the period in profit or loss

  Or

- Disaggregating insurance finance income or expenses for the period to include in profit in loss, an amount determined by a systematic allocation of the expected total insurance finance income or expenses over the duration of the group of contracts

When an entity chooses a disaggregation policy for a portfolio, the amount included in other comprehensive income is the difference between the insurance finance income or expenses included in profit or loss measured on a systematic allocation basis (see section 15.3.1 above) and the total insurance finance income or expenses in the period, i.e., the amount included in other comprehensive income is the balancing figure. *[IFRS 17.90]*.

This approach applies to both the liability for remaining coverage and the liability for incurred claims under the general model. Under the premium allocation approach, it applies only to the liability for incurred claims. It does not apply to the liability for remaining coverage under the premium allocation approach unless the group of contracts becomes onerous as the liability for remaining coverage is discounted using the rates at initial recognition of the group and not at current rates. Disaggregating discount rates for the liability for incurred claims under the premium allocation approach is discussed in section 15.3.3 below.

A systematic allocation means an allocation of the total expected insurance finance income or expenses of a group of insurance contracts over the duration of the group that: *[IFRS 17.B130]*

- Is based on characteristics of the contracts, without reference to factors that do not affect the cash flows expected to arise under the contracts. For example, the allocation of the insurance finance income or expenses must not be based on expected recognised returns on assets if those expected recognised returns do not affect the cash flows of the contracts in the group.
- Results in the amounts recognised in other comprehensive income over the duration of the group of contracts totalling zero. The cumulative amount recognised in other comprehensive income at any date is the difference between the carrying amount of the group of contracts and the amount that the group would be measured at when applying the systematic allocation.

When an entity that has disaggregated insurance finance income or expenses of a group of insurance contracts transfers that group of insurance contracts or derecognises an insurance contract as a result of a modification or transfer (see section 13.3.4 above), it must reclassify to profit or loss as a reclassification adjustment any remaining amounts for the group (or contract) that were previously recognised in other comprehensive income as a result of its accounting policy choice. *[IFRS 17.91(a)]*.

15.3.2.A Allocating insurance finance income or expenses for contracts for which changes that relate to financial risk do not have a substantial effect on the amounts paid to the policyholder

For groups of insurance contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to the policyholder, the systematic allocation (i.e., the amount presented in profit or loss) is determined using the discount rates at the date of initial recognition of the group of contracts. *[IFRS 17.B131]*.

For contracts applying the general model, as the contractual service margin is not remeasured using current rates, all insurance finance income or expenses arising from the accretion of interest of the contractual service margin is recorded in profit or loss.

Frequently asked questions

Question 15-5: For contracts measured applying the general model, when an entity makes an accounting policy choice to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income (OCI), should accumulated OCI on insurance contracts be reclassified to profit or loss when experience does not unfold as expected, and if so, how?

(TRG meeting April 2019 - Agenda paper no. 2, Log S102)

Under IFRS 17, the amount of insurance finance income or expenses allocated to profit or loss is determined by a systematic allocation of the expected total finance income or expenses over the duration of the group. This results in the amounts recognised in other comprehensive income over the duration of the group of contracts totalling zero. The IASB staff observed that the cumulative amount recognised in other comprehensive income at any date is the difference between the carrying amount of the group of contracts and the amount that the group would be measured at when applying the systematic allocation of the expected total insurance finance or expenses over the duration of the group. That is, when the insurance liability is increased or decreased as a result of experience adjustments, the discount rate used for the systematic allocation of the expected total insurance finance income or expenses continues to be calculated as before (e.g., based on the discount rates determined at initial recognition for a group of insurance contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to the policyholder) and a reclassification adjustment occurs only on derecognition.

Illustration 15-5: Allocating insurance finance income or expenses for contracts where the impact of financial risk on the amounts paid to policyholders is not substantial

On initial recognition of a group of insurance contracts an entity expects to pay policyholders CU1,890 at the end of Year 3. The impact of financial risk on the amounts paid to the policyholders is not substantial and is not affected by changes in discount rates. The interest rate at initial recognition of the group of contracts is 10% and there are no changes to this applying a weighted average discount rate. For simplicity it is assumed that all premiums (cash inflows) are received at the date of initial recognition and all other amounts, including the risk adjustment for non-financial risk, are ignored. Applying IFRS 17.B131, the entity disaggregates insurance finance income or expense using the discount rates determined on initial recognition of the group.

At initial recognition, the present value of expected future cash flows is CU1,420 (i.e., CU1,890 discounted for 3 years at 10% being CU1,562 after one year, CU1,718 after 2 years and CU1,890 after 3 years).

At the end of year 1, the present value of expected future cash flows is CU1,562 (i.e., CU1,890 discounted for 2 years at 10%). The insurance finance income or expenses of CU142 (i.e., CU1,562 less CU1,420) is debited to profit or loss as there is no difference between current discount rates and the discount rate at initial recognition.

At the end of year 2, market interest rates have reduced to 5%. As a result, the present value of expected future cash flows at the end of year 2 is CU1,800. The insurance finance income or expenses of CU238 (i.e., CU1,800 less CU1,562) is allocated, as follows:

- CU156 is debited to profit or loss being the difference between CU1,800 and CU1,562 at the discount rate at initial recognition of 10%.
- CU82 is debited to other comprehensive income being the difference being total insurance finance income or expenses of CU238 and the amount allocated to profit or loss of CU156.

At the end of year 3, market interest rates are still 5%. As a result, the insurance finance income or expenses of CU90 (i.e., CU1,890 less CU1,800) is allocated, as follows:

- CU172 is debited to profit or loss being the difference between CU1,718 and CU1,890 using the discount rate and cash flows at initial recognition of 10%.
- CU82 is credited to other comprehensive income being the difference being total insurance finance income or expenses of CU90 and the amount allocated to profit or loss of CU172.

The net cumulative amount in other comprehensive income at the end of year 3 is CU nil.

15.3.2.B Allocating insurance finance income or expense for contracts for which changes in assumptions that relate to financial risk have a substantial effect on amounts paid to policyholders

For groups of insurance contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to the policyholders, which will include contracts with direct participation features for which the underlying items are not held, a systematic allocation for the finance income or expenses arising from the estimates of future cash flows can be determined in one of the following ways: *[IFRS 17.B132(a)]*

- Using a rate that allocates the remaining revised expected finance income or expenses over the remaining duration of the group of contracts at a constant rate ('effective yield approach')

  Or

- For contracts that use a crediting rate to determine amounts due to the policyholders, using an allocation that is based on the amounts credited in the period and expected to be credited in future periods to the policyholder ('projected crediting approach')

IFRS 17 does not provide guidance on how to determine 'substantial effect' although it is presumably intended to be interpreted similarly to the words 'substantial share' and 'substantial proportion' discussed in the context of insurance contracts with direct participation features in section 12.3.1 above. A group of insurance contracts with direct participation features will usually be a group for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to the policyholders. In addition, a group of insurance contracts that have failed to meet the criteria for applying the variable fee approach because of, for example, a lack of a clearly identified pool of underlying items (see section 12.3.1 above) might also be groups of contracts for which changes in assumptions that relate to financial risk (e.g., a change in the crediting rate or dividend amount) have a substantial effect on the amounts paid to policyholders.

The decision to elect either an effective yield approach or a projected crediting approach is an accounting policy choice and is applied to eligible groups according to the criteria in IAS 8.

A systematic allocation for the finance income or expenses arising from the risk adjustment for non-financial risk, if separately disaggregated from other changes in the risk adjustment for non-financial risk, is determined using an allocation consistent with that used for the allocation for the finance income or expenses arising from the future cash flows. *[IFRS 17.B132(b)]*.

A systematic allocation for the finance income or expenses arising from the contractual service margin is determined: *[IFRS 17.B132(c)]*

- For insurance contracts without direct participation features, using the discount rates determined at the date of initial recognition of the group of contracts (which results in the entire insurance finance income or expenses allocated to profit or loss since the contractual service margin is not remeasured at current rates)
- For insurance contracts with direct participation features, using an allocation consistent with that used for the allocation for the interest income or expenses arising from future cash flows

The following Illustrations are based on Example 15A and 15B in the Illustrative Examples to IFRS 17: *[IFRS 17.IE155-164, IFRS 17.IE165-172]*

Illustration 15-6: Allocating insurance finance income or expenses for contracts where the impact of financial risk on the amounts paid to policyholders is substantial - effective yield approach

On initial recognition of a group of insurance contracts an entity expects to pay policyholders CU1,890 at the end of Year 3. The interest rate at initial recognition of the group of contracts is 10% and there are no changes to this applying a weighted average discount rate. For simplicity it is assumed that all premiums (cash inflows) are received at the date of initial recognition and all other amounts, including the risk adjustment for non-financial risk, are ignored. The entity choses to disaggregate insurance finance income or expenses using a systematic allocation of the total expected insurance finance income or expenses over the remaining duration of the group.

At initial recognition, the present value of expected future cash flows is CU1,420 (i.e., €1,890 discounted for 3 years at 10%, being CU1,562 after one year, CU1,718 after 2 years and CU1,890 after 3 years).

At the end of year 1, market interest rates have reduced to 5%. Consequently, the entity revises its expectations as to the future cash flows it will pay its policyholders and now expects to pay only CU1,802 at the end of year 3. The revised constant interest rate is calculated at 7.42% a year (i.e., the rate required to accrete CU1,562 up to CU1,802). As a result, the revised present value of future cash flows at the end of year 1 is CU1,635.

Applying IFRS 17.B132(a)(i), the entity recognises in profit or loss the insurance finance income or expenses calculated as the change in estimates of the present value of the future cash flows at the constant rate of return. In year 1, the finance expenses of CU142 in profit or loss is the difference between the estimates of the present value of future cash flows at the original constant rate of 10% at the end of the year 1 of CU1,562 and the corresponding amount at the beginning of the period of CU1,420. Applying IFRS 17.B130(b), the entity recognises in other comprehensive income the difference between the total insurance finance expense of CU215 (i.e., the difference between opening fulfilment cash flows of CU1,420 and the current fulfilment cash flows of CU1,635) and the amount included in profit or loss of CU142, i.e., CU73.

At the end of year 2, market interest rates are still 5%. The present value of expected future cash flows discounted at current rates is CU1,716. The insurance finance income or expenses of CU81 (i.e., the difference between CU1,716 and the opening revised cash flows of CU1,635) is allocated, as follows:

- CU116 is debited to profit or loss being the difference between the estimates of future cash flows of CU1,562 and CU1,678 using the constant rate of return of 7.42%
- CU35 is credited to other comprehensive income being the difference being total insurance finance income or expenses of CU81 and the amount allocated to profit or loss of CU116

At the end of year 3, market interest rates are still 5%. As a result, the insurance finance income or expenses of CU86 (i.e., CU1,802 less CU1,716) is allocated, as follows:

- CU124 is debited to profit or loss being the difference between the final cash flows of CU1,802 and the previous discounted figure of CU1,678 using the constant rate of return of 7.42%
- CU38 is credited to other comprehensive income being the difference being total insurance finance income or expenses of CU86 and the amount allocated to profit or loss of CU124

The net cumulative amount in other comprehensive income at the end of year 3 is nil.

Illustration 15-7: Allocating insurance finance income or expenses for contracts where the impact of financial risk on the amounts paid to policyholders is substantial - projected crediting rate approach

On initial recognition of a group of insurance contracts, an entity receives a single premium of CU15 for 100 insurance contracts with a coverage period of three years. The total premium for the group of contracts is CU1,500. On initial recognition, the entity expects to achieve rate of return on underlying items of 10% each year and to credit the policyholder account balances by 8% each year (the expected crediting rate). Consequently, the entity expects to pay policyholders CU1,890 at the end of Year 3 (CU1,500 × 1.08 × 1.08 × 1.08). At initial recognition, the present value of the expected cash flow at the end of Year 3 amounts to CU1,420 (CU1,890 ÷ ((1 + 0.10)^3)).

In Year 1, the entity credits the policyholder account balances with a return of 8% a year, as expected at the date of initial recognition.

At the end of Year 1, the market interest rate falls from 10% per year to 5% per year. Consequently, the entity revises its expectations about cash flows as follows:

- It will achieve a return of 5% in Year 3 after reinvesting the maturity proceeds of the bonds that mature at the end of Year 2
- It will credit the policyholder account balances 8% in Year 2 and 3% in Year 3
- It will pay policyholders CU1,802 at the end of Year 3 (CU1,500 × 1.08 × 1.08 × 1.03)

The entity elects to disaggregate insurance finance income or expenses using an allocation to profit or loss based on amounts credited in the period and expected to be credited in future periods (a 'projected crediting rate approach').

Therefore, the entity allocates the remaining expected insurance finance income or expenses over the remaining life of the contracts using the series of discount rates calculated as the projected crediting rates multiplied by the constant factor. The constant factor and the series of discount rates based on crediting rates at the end of Year 1 are, as follows:

- The product of the actual crediting rate in Year 1 and the expected crediting rates in Years 2 and 3 equals 1.20 (1.08 × 1.08 × 1.03)
- The carrying amount of the liability increases by a factor of 1.269 over three years because of the interest accretion (CU1,802 ÷ CU1,420)
- Consequently, each crediting rate needs to be adjusted by a constant factor (K), as follows 1.08K × 1.08K × 1.08K = 1.269
- The constant K equals 1.0184 calculated as $(1.269 \div 1.20)^{1/3}$
- The resulting interest accretion rate for Year 1 is 10% (calculated as 1.08 × 1.0184)

The carrying amount of the liability at the end of Year 1 for the purposes of allocating insurance finance income or expenses to profit or loss is CU1,562 (CU1,420 × 1.08 × 1.0184).

The actual crediting rate for Years 2 and 3 are as expected at the end of Year 1. The resulting accretion rate for Year 2 is 10% (calculated as (1.08 × 1.0184) - 1) and for Year 3 is 4.9% (calculated as (1.03 × 1.0184) - 1).

	Initial recognition	Year 1	Year 2	Year 3
	CU	CU	CU	CU
Estimates of future cash flows at the end of Year 3	1,890	1,802	1,802	1,802
Estimates of the present value of future cash flows at current discount rates (A)	1,420	1,635	1,716	1,802
Estimates of future cash flows at discount rates based on projected crediting (B)	1,420	1,562	1,718	1,802
Amount accumulated in other comprehensive income (A-B)	-	73	(2)	-

In the table above, CU1,716 equals the estimate of the future cash flows at the end of Year 3 of CU1,802 discounted at the current market rate of 5% per year, i.e., CU1,802 ÷ 1.05 = CU1,716.

CU1,718 equals the estimates of future cash flows at the end of Year 3 of CU1,802 discounted at the projected crediting rate of 4.9% per year, i.e., CU1,802 ÷ 1049 = CU1,718.

There is an amount of CU2 accumulated in other comprehensive income at the end of Year 2 because the discount rate based on projected crediting rate of 4.9% per year (1.03 × K) is different from the current discount rate of 5% per year.

The insurance finance income or expenses included in profit or loss and other comprehensive income are, as follows:

	Year 1	Year 2	Year 3
Insurance income and expensed arising from fulfilment cash flows			
	CU	CU	CU
Profit or loss	(142)	(156)	(84)
Other comprehensive income	(73)	75	(2)
Total comprehensive income	**(215)**	**(81)**	**(86)**

The entity recognises in profit or loss the insurance finance expenses calculated as the change in the estimates of the present value of the future cash flows at the projected crediting rate. In Year 1, insurance finance expenses of CU142 is the difference between the estimates of the present value of the future cash flows at the original crediting rate of 10% at the end of Year 1 of CU1,562 and the corresponding amount at the beginning of the period of CU1,420.

The entity includes in other comprehensive income, the difference between the amount recognised in total comprehensive income and the amount recognised in profit or loss. In Year 1, for example, the amount included in other comprehensive income of CU(73) is CU(215) minus CU(142). In Years 1-3, the total other comprehensive income equals zero (CU0 = CU(73) + CU75 + CU(2)).

The entity recognises, in total comprehensive income, the change in estimates of the present value of the future cash flows at the current discount rate. In Year 1, the total insurance finance expenses of CU(215) is the difference between the estimates of the present value of the future cash flows at the current discount rate at the beginning of Year 1 of CU1,420 and the corresponding amount at the end of Year 1 of CU1,635.

15.3.3 Allocating insurance finance income or expenses for incurred claims when applying the premium allocation approach

When the premium allocation approach is applied (see section 10 above), an entity may be required, or may choose to discount the liability for incurred claims (see section 10.5 above). In such cases, it may also choose to disaggregate the insurance finance income or expenses as discussed in section 15.3.1 above. If the entity makes this choice, it must determine the insurance finance income or expenses in profit or loss using the discount rate determined at the date of the incurred claim. *[IFRS 17.B133]*.

15.3.4 Allocating finance income or expenses for insurance contracts with direct participation features for which the entity holds the underlying items

For insurance contracts with direct participation features, for which the entity holds the underlying items, an entity must make an accounting policy choice between: *[IFRS 17.89]*

- Including insurance finance income or expenses for the period in profit or loss

  Or

- Disaggregating insurance finance income or expenses for the period to include in profit or loss an amount that eliminates accounting mismatches, with income or expenses included in profit or loss on the underlying items held

This means that, when disaggregation is applied, the amount included in profit or loss for insurance finance income or expenses for insurance contracts with direct participation features exactly matches the insurance finance income or expenses included in profit or loss for the underlying items, resulting in the net of the separately presented items being nil. *[IFRS 17.B134]*. This is sometimes referred to as the current period book yield approach.

An entity may qualify for the current period book-yield approach in some periods but not in others, because of a change in whether it holds the underlying items. If such a change occurs, the accounting policy choice available to the entity changes from that set out above to that set out in section 15.3.1 above or *vice versa*.

Hence, an entity might change its accounting policy between that set out above and that set out in section 15.3.1 above. In making such a change, an entity must: *[IFRS 17.B135]*

- Include the accumulated amount previously included in other comprehensive income at the date of the change as a reclassification adjustment in profit or loss in the period of change and in future periods, as follows:
  - If the entity had previously applied the requirements described in section 15.3.1 above, it must include in profit or loss the accumulated amount included in other comprehensive income before the change as if it were continuing the approach described in section 15.3.1 above based on the assumptions that applied immediately before the change.

    And
  - If the entity had previously applied the requirements above, it must include in profit or loss the accumulated amount included in other comprehensive income before the change as if it were continuing the approach above based on the assumptions that applied immediately before the change.
- Not restate prior period comparative information

An entity must not recalculate the accumulated amount previously included in other comprehensive income as if the new disaggregation had always applied; nor update the assumptions used for the reclassification in future periods after the date of the change. *[IFRS 17.B136]*.

When an entity that has disaggregated the insurance finance income or expenses of a group of insurance contracts with direct participation features using the current book yield approach and transfers that group of insurance contracts or derecognises an insurance contract due to a modification (see section 13.3.4 above), it must not reclassify to profit or loss as a reclassification adjustment any remaining amounts for the group (or contract) that were previously recognised in other comprehensive income as a result of its accounting policy choice. *[IFRS 17.91(b)]*. This is a different accounting treatment than for contracts which do not apply the current book yield approach (see section 15.3.2 above).

The following Illustration is based on Example 16 in the Illustrative Examples to IFRS 17: *[IFRS 17.IE173-185]*

Illustration 15-8: Allocating insurance finance income or expense for contracts using the current book yield approach

An entity issues 100 insurance contracts with a coverage period of three years. The coverage period starts when the insurance contracts are issued. The contracts meet the criteria for insurance contracts with direct participation features.

The entity receives a single premium of CU15 for each contract at the beginning of the coverage period (total future cash inflows of CU1,500). The entity promises to pay policyholders on maturity of the contract, an accumulated amount of returns on a specified pool of bonds minus a charge equal to 5% of the premium and accumulated returns calculated at that date. Thus, policyholders that survive to maturity of the contract receive 95% of the premium and accumulated returns. In this example, all other amounts, including the risk adjustment for non-financial risk are ignored for simplicity.

The entity invests premiums received of CU1,500 in zero coupon fixed income bonds with a duration of three years (the same as the returns promised to policyholders). The bonds return a market interest rate of 10% per year. At the end of Year 1, market interest rates fall from 10% a year to 5% per year. The entity measures the bonds at fair value through other comprehensive income applying IFRS 9. The effective interest rate of the bonds acquired is 10% per year, and that rate is used to calculate investment income in profit or loss. For simplicity, this example excludes the effect of accounting for expected credit losses on financial assets. The value of the bonds held by the entity is illustrated in the table below:

	Initial recognition	Year 1	Year 2	Year 3
	CU	CU	CU	CU
Fair value	1,500	1,811	1,902	1,997
Amortised cost	1,500	1,650	1,815	1,997
Cumulative amounts recognised in other comprehensive income	-	161	87	-
Change in other comprehensive income		161	(74)	(87)
Investment income recognised in profit or loss (effective interest rate)		150	165	182

The entity elects to disaggregate insurance finance income or expenses for each period to include in profit or loss an amount that eliminates accounting mismatches with income or expense included in profit or loss on underlying items held. Therefore, the entity needs to analyse the changes in fulfilment cash flows to decide whether each change adjusts the contractual service margin. The source of the fulfilment cash flows is, as follows:

	Year 1	Year 2	Year 3
Fulfilment cash flows	**CU**	**CU**	**CU**
Opening balance	**-**	**1,720**	**1,806**
Change related to future service: new contracts	(75)	-	-
Change in the policyholders' share in the fair value of the underlying items	295	86	90
Cash flows	1,500	-	(1,896)
Closing balance	**1,720**	**1,806**	**-**

Fulfilment cash flows are the estimate of the present value of the future cash inflows and the estimate of the present value of the future cash outflows (in this example, all cash outflows vary based on the returns on underlying items). For example, at initial recognition the fulfilment cash flows of CU(75) are the sum of the estimates of the present value of the future cash inflows of CU(1,500) and the estimates of the present value of the future cash outflows of CU1,425 (the policyholders' share of 95% of the fair value of the underlying items at initial recognition of CU1,500).

The change in the policyholders' share in the fair value of the underlying items is 95% of the change in fair value of the underlying items. For example, in Year 1, the change in the policyholders' share in the underlying items of CU295 is 95% of the change in fair value in Year 1 of CU311 (CU1,811 - CU1,500). The entity does not adjust the contractual service margin for the change in the obligation to pay policyholders an amount equal to the fair value of the underlying items because it does not relate to future service.

The entity determines the carrying amount of the contractual service margin at the end of each reporting period, as follows:

	Year 1	Year 2	Year 3
Contractual service margin	**CU**	**CU**	**CU**
Opening balance	**-**	**61**	**33**
Change related to future service: new contracts	75	-	-
Change in the entity's share in the fair value of the underlying items	16	5	5
Change relating to current service: recognition in profit or loss for the service provided	(30)	(33)	(38)
Closing balance	**61**	**33**	**-**

The entity adjusts the contractual service margin for the change in the amount of the entity's share of the fair value of the underlying items because those changes relate to future service. For example, in Year 1 the change in the amount of the entity's share of the fair value of the underlying items of CU16 is 5% of the change in fair value of the underlying items of CU311 (CU1,811 - CU1,500). This example does not include cash flows that do not vary based on the returns on underlying items.

The entity determines the amount of contractual service margin recognised in profit or loss by allocating the contractual service margin at the end of the period (before recognising any amounts in profit or loss) equally to each coverage unit provided in the current period and expected to be provided in the future. In this example, the coverage provided in each period is assumed to be the same. Hence, the contractual service margin recognised in profit or loss for Year 1 of CU30 is the contractual service margin before allocation of CU91 (CU75 + CU16), divided by three years of coverage.

The amounts recognised in the statement(s) of financial performance for the periods are, as follows:

	Year 1	Year 2	Year 3
Statement(s) of financial performance	**CU**	**CU**	**CU**
Profit or loss			
Contractual service margin recognised in profit or loss for the service provided	30	33	38
Insurance service result	**30**	**33**	**38**
Investment income	150	165	182
Insurance finance expense	(150)	(165)	(182)
Profit	**30**	**33**	**38**
Other comprehensive income			
Gain/(loss) on financial assets measured at fair value through other comprehensive income	161	(74)	(87)
Gain/(loss) on insurance contracts	(161)	74	87
Total other comprehensive income	**-**	**-**	**-**

The entity does not adjust the contractual service margin for the changes in the obligation to pay the policyholders an amount equal to the fair value of the underlying items because those changes do not relate to future service. Consequently, the entity recognises those changes as insurance finance income or expenses in the statement(s) of financial performance. For example, in Year 1, the change in fair value of the underlying items is CU311 (CU1,811 - CU1,500).

Furthermore, the entity disaggregates the insurance finance income or expenses for the period between profit or loss and other comprehensive income to include in profit or loss an amount that eliminates accounting mismatches with the income or expenses included in profit or loss on the underlying items held. This amount exactly matches the income or expenses included in profit or loss for the underlying items, resulting in the net of the two separately presented items being zero. For example, in Year 1, the total amount of the insurance finance income or expenses of CU311 is disaggregated and the entity presents in profit or loss the amount of CU150 that equals the amount of finance income for the underlying items. The remaining amount of insurance finance income or expenses of CU161 is recognised in other comprehensive income.

15.4 Reporting the contractual service margin in interim financial statements

Extract from IFRS 17

The effect of accounting estimates made in interim financial statements

B137 If an entity prepares interim financial statements applying IAS 34 *Interim Financial Reporting*, the entity shall make an accounting policy choice as to whether to change the treatment of accounting estimates made in previous interim financial statements when applying IFRS 17 in subsequent interim financial statements and in the annual reporting period. The entity shall apply its choice of accounting policy to all groups of insurance contracts it issues and groups of reinsurance contracts it holds.

[IFRS 17.B137].

An entity which elects not to change the treatment of estimates made in previous interim financial statements is likely to have a different accounting result than an entity which elects to change estimates made in previous interim reporting periods. This is because adjusting the contractual service margin for changes in estimates of the fulfilment cash flows but not for experience adjustments has the consequence that the accounting depends on the timing of a reporting date. *[IFRS 17.BC236]*.

When an entity elects not to change estimates made in previous interim financial statements, the amounts presented in any annual report should equal the values as of the end of the last interim period and the cumulative profit or loss for the year should be the sum of the profit or loss amounts for each interim period. Each interim period is determined separately as if it were a discrete period and the annual period is simply the total of the profit or loss of the discrete interim periods.

When an entity does restate estimates made in previous interim periods, each interim report includes information which, in aggregate, results in the year-to-date figures in that interim report being equal to the value which would have resulted if IFRS 17 had been applied to the full year to date period without any interim periods. The cumulative profit or loss to date of the interim period would equal the cumulative amount on an annual basis to date.

The Board concluded that permitting an accounting policy choice would ease IFRS 17 implementation by enabling an entity to assess which accounting policy is less burdensome. To avoid a significant loss of useful information for users of financial statements, the Board concluded that the entity is required to apply consistently its choice of accounting policy to all groups of insurance contracts it issues and groups of reinsurance contracts it holds (i.e., accounting policy choice at reporting entity level). *[IFRS 17.BC236B, IFRS 17.BC236C]*.

There is also related transitional relief available upon applying IFRS 17 for entities applying the modified retrospective approach that elect an accounting policy not to change the treatment of estimates made in previous interim reporting periods. See section 17.4 below.

Frequently asked questions

Question 15-6: Can the requirements in IFRS 17.B137 be extended to apply to monthly reporting that is prepared for internal management reporting and external regulatory reporting?

(TRG meeting September 2018 - Agenda paper no. 11, Log S56)

The IASB staff confirmed that the requirements of IFRS 17.B137 described above apply only to interim reports prepared applying IAS 34. This can cause a particular issue for groups where the parent does, but the subsidiary does not, prepare IAS 34 interim financial statements. If the parent prepares IAS 34 interim financial statements, but the subsidiary does not, (e.g., the subsidiary prepares interim internal management reports that do not comply with IAS 34) then the choice of changing the treatment of previous estimates in subsequent interim financial statements is available only to the parent and not applicable to the subsidiary. The TRG members agreed with the IASB staff's interpretation but highlighted the significant operational challenges of applying it in practice.

Illustration 15-9: The contractual service margin and interim reporting

This example focuses on the impact of the release of the contractual service margin on insurance revenue and not on the impact on profit or loss of other components of an insurance contract liability. The example also assumes there are no other changes in expectations and ignores accretion of interest for simplicity.

An entity with an annual reporting period ending on 31 December publishes half-yearly interim financial statements.

At 31 December 20X3, the entity has issued a group of insurance contracts with a contractual service margin of CU1,200 and an expected coverage period of two years. The entity expects to provide coverage evenly over the coverage period and expects to incur claims in H2 20X3 of CU300.

At the end of H1 20X4, the entity increases its estimate of claims to be incurred in H2 of 20X4 by CU200 to CU500. The entity adjusts (reduces) the related contractual service margin by CU200 and reduces the contractual service margin by CU250 for services provided in H1 (CU1,200 - CU200) ÷ 4. At the end of H1 20X4, the entity carries forward a contractual service margin of CU750.

The entity incurs claims in H2 20X4 of CU300 (as originally expected).

Option A - the entity elects not to change the treatment of its previous estimates in subsequent interim financial statements and in the annual financial report

As a result of incurring claims in H2 20X4 of CU300, the entity recognises a favourable experience adjustment in profit or loss (i.e., a credit to insurance service expenses) of CU200 in H2.

The entity releases CU250 from the contractual service margin to profit or loss (insurance revenue) in H2 and carries forward a contractual service margin of CU500 (CU750 - CU250) at 31 December 20X4 in the H2 20X4 interim as well as annual 2024 financial statements.

In summary, in 20X4, the entity recognises CU500 as part of insurance revenue, a positive experience adjustment in insurance service expenses of CU200 and carries forward a contractual service margin of CU500 in both its interim financial statements for H2 20X4, as well as its annual financial statements for that year.

Option B - the entity elects to change the treatment of its previous estimates in subsequent interim financial statements and in the annual financial report

If the entity does change its previous estimates, then the position at the end of the H2 20X4 interims and the 20X4 financial report is the cumulative result for the calendar year. Therefore, the impact on the annual financial statements is as follows:

- There is no experience adjustment in the year - claims in 20X4 are as expected at 31 December 20X3.
- The entity would release CU600 from the contractual service margin to profit or loss in the calendar year 20X4 and would carry forward a contractual service margin of CU600 (CU1,200 brought forward - CU600 release to P&L = CU600).

In summary, in 20X4 the entity recognises CU600 as part of insurance revenue in 20X4 and carries forward a contractual service margin of CU600 at 31 December 20X4 instead of recognising insurance revenue of CU500 and a positive experience adjustment in insurance service expenses of CU200 and carrying forward a contractual service margin of CU500 under option A above.

How we see it

The policy choice in IFRS 17.B137 applies only to interim financial statements that are prepared applying IAS 34 and have gone through the full internal governance procedures with management able to provide a statement of compliance with IAS 34. IFRS 17.B137 cannot be applied to interim reports that do not meet these conditions. However, an entity does not need to publish a set of interim financial statements in order to qualify as IAS 34 interim financial statements within the context of IFRS 17.B137. For example, an entity could prepare IAS 34 interim reports on a quarterly basis, but only publish its interim reports for the second quarter and fourth quarter. In this case, the entity could still choose to apply a period-to-period accounting policy under IFRS 17.B137 on a quarterly basis. In this example, the entity should disclose relevant information in the notes of second quarter and fourth quarter financial statements to explain how it prepares its published financial statements under the period-to-period approach. More specifically, the entity would need to explain that the year-to-date result is the sum of the discrete first and second quarters and would also have to consider whether additional disclosure on the effects of changes in estimates would be necessary based on the requirements of IAS 34.16A(d). The same approach would apply to the fourth quarter interim report.

Practical example 15-1: Prudential plc (2023) **United Kingdom**

Annual Report 2023 [extract]
Financial statements [extract]
Notes to the consolidated financial statements [extract]
A Basis of preparation and accounting policies [extract]
A3 Accounting policies [extract]
A3.1 Critical accounting policies, estimates and judgements [extract]
(a) Critical accounting policies with associated critical estimates and judgements - Measurement of insurance and reinsurance contracts under IFRS 17 [extract]

...

The effect of accounting estimates made in interim financial statements

Effect of estimates made in interim financial statements	IFRS 17 allows an accounting policy choice as to whether to change the treatment of accounting estimates made in previous interim financial statements when applying IFRS 17 in the annual reporting period. The Group has elected to allow updates to accounting estimates made in interim financial statements when applying IFRS 17 in the annual reporting period.

Practical example 15-2: Sun Life Financial Inc. (2023) **Canada**

ANNUAL REPORT 2023 [extract]
CONSOLIDATED FINANCIAL STATEMENTS AND NOTES [extract]
Notes to the Consolidated Financial Statements [extract]
1. Material Accounting Policies [extract]
Insurance Contracts [extract]
Level of Aggregation [extract]
Subsequent Measurement [extract]

...

We have not changed the accounting estimates made in previous interim financial statements in the preparation of these Consolidated Financial Statements. In particular, the CSM at the end of each reporting period is the CSM at the beginning of the reporting period adjusted as described above, rather than the CSM at the beginning of the calendar year adjusted as described above.

16 Disclosure

One of the main objectives of IFRS 17 is to establish principles for the disclosure of insurance contracts which gives a basis for users of the financial statements to assess the effect that insurance contracts have on an entity's financial position, financial performance and cash flows. *[IFRS 17.1]*.

Hence, the objective of the disclosure requirements is for an entity to disclose information in the notes that, together with the information provided in the statement of financial position, statement(s) of financial performance and statement of cash flows, gives a basis for users of financial statements to assess the effect of contracts within the scope of IFRS 17. To achieve that objective, an entity must disclose qualitative and quantitative information about: *[IFRS 17.93]*

- The amounts recognised in its financial statements for contracts within the scope of IFRS 17 (see section 16.1 below)
- Disclosures showing the effect of transition (see section 16.2 below)
- The significant judgements, and changes in those judgements, when applying IFRS 17 (see section 16.3 below)
- The nature and extent of risks arising from contracts within the scope of IFRS 17 (see section 16.5 below)

The disclosure objective is supplemented with some specific disclosure requirements designed to help the entity satisfy this objective. By specifying the objective of the disclosures, the Board aims to ensure that entities provide the information that is most relevant for their circumstances and to emphasise the importance of communication to users of financial statements rather than compliance with detailed and prescriptive disclosure requirements. In situations in which the information provided to meet the specific disclosure requirements is not sufficient to meet the disclosure objective, the entity is required to disclose additional information necessary to achieve that objective. *[IFRS 17.BC347]*.

The Board used the disclosure requirements in IFRS 4, including the disclosure requirements in IFRS 7 that are incorporated in IFRS 4 by cross-reference, as a basis for the requirements in IFRS 17. This is because stakeholders have indicated that such disclosures provide useful information to users of financial statements for understanding the amount, timing and uncertainty of future cash flows from insurance contracts. The disclosure requirements brought forward from IFRS 4 include information about significant judgements in applying the standard as well as most of the disclosures about the nature and extent of risks that arise from insurance contracts. *[IFRS 17.BC348]*. In addition, when developing IFRS 17, the Board identified key items it views as critical to understanding the financial statements of entities issuing insurance contracts, in the light of the requirement to update the measurement of insurance contracts at each reporting date. Consequently, additional disclosures have been added requiring: *[IFRS 17.BC349]*

- Reconciliations of opening to closing balances of the various components of the liability for remaining coverage and the liability for incurred claims
- An analysis of insurance revenue
- Information about initial recognition of insurance contracts in the statement of financial position
- An explanation of when an entity expects to recognise the contractual service margin remaining at the end of the reporting period in profit or loss
- An explanation of the total amount of insurance finance income or expenses in profit or loss and the composition and fair value of underlying items for contracts with direct participation features
- Information about the entity's approach to determining various inputs into the fulfilment cash flows
- The confidence level used to determine the risk adjustment for non-financial risk
- Information about yield curves used to discount cash flows that do not vary based on returns from underlying items
- Information about the effect of the regulatory framework in which the entity operates.

IFRS 17 requires a reporting entity to consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. Preparers are informed that if the mandatory disclosures required are not enough to meet the disclosure objective, additional information must be disclosed as necessary to meet that objective. *[IFRS 17.94]*.

An entity must aggregate or disaggregate information so that useful information is not obscured either by the inclusion of a large amount of insignificant detail or by the aggregation of items that have different characteristics. *[IFRS 17.95]*.

Preparers are also reminded of the requirements in IAS 1 relating to materiality and aggregation of information. IFRS 17 states that examples of aggregation bases that might be appropriate for information disclosed about insurance contracts include: *[IFRS 17.96]*

- Type of contract (e.g., major product lines)
- Geographical area (e.g., country or region)
- Reportable segment, as defined in IFRS 8 *Operating Segments*

IAS 1 requires comparative information to be presented in respect of the preceding period for all amounts reported in the current period's financial statements unless IFRS accounting standards permit or require otherwise. An entity must also include comparative information for narrative and descriptive information if it is relevant to understanding the current period's financial statements. *[IAS 1.38]*

How we see it

The disclosure requirements of IFRS 17 are more extensive compared with those in IFRS 4. They comprise 40 paragraphs of the standard. Insurance entities have not had to provide many of these disclosures in the past, so complying with the disclosure requirements will be a challenge for data, systems and processes. Entities will need to apply judgement in how they break down the required disclosures into separate lines of business, reportable segments, or geographical areas. Entities will need to determine this based on the objective of providing decision useful information to the users of the financial statements in accordance with the disclosure principles of IFRS 17.

The provision of additional disclosures should be considered when compliance with the specific requirements in IFRS is insufficient to enable users of financial statements to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance. This point is made explicitly in IFRS 17.94.

Applying the concept of materiality, a specific disclosure otherwise required by an IFRS accounting standard in the financial statements, need not be provided if the information resulting from that requirement is not material. This is the case even if the IFRS accounting standard contains a list of specific requirements or describes them as minimum requirements. The IASB has issued *IFRS Practice Statement 2: Making Materiality Judgements*. This is a non-mandatory statement that entities may apply to assist in making materiality judgements (see Chapter 3 at section 4.1.8).

16.1 Explanation of recognised amounts

The first part of the disclosure objective established by the standard is that an entity must disclose qualitative and quantitative information about the amounts recognised in its financial statements for contracts within its scope. *[IFRS 17.93]*.

The principal method by which the disclosure objective is achieved is by the disclosure of reconciliations that show how the net carrying amounts of contracts within the scope of IFRS 17 changed during the period because of cash flows and income and expenses recognised in the statement(s) of financial performance. Separate reconciliations must be disclosed for insurance contracts issued and reinsurance contracts held. An entity must adapt the requirements of the reconciliations described below to reflect the features of reinsurance contracts held that differ from insurance contracts issued; for example, the generation of expenses or reduction in expenses rather than revenue. *[IFRS 17.98]*.

Enough information must be provided in the reconciliations to enable users of financial statements to identify changes from cash flows and amounts that are recognised in the statement(s) of financial performance. To comply with this requirement, an entity must: *[IFRS 17.99]*

- Disclose, in a table, the reconciliations set out in sections 16.1.1 to 16.1.2 below
- For each reconciliation, present the net carrying amounts at the beginning and at the end of the period, disaggregated into a total for portfolios of contracts that are assets and a total for portfolios of contracts that are liabilities, that equal the amounts presented in the statement of financial position as set out in section 15.1 above

The objective of the reconciliations detailed in sections 16.1.1 to 16.1.2 below is to provide different types of information about the insurance service result. *[IFRS 17.102]*.

16.1.1 Reconciliations required for contracts applying the general model

These reconciliations are required for all contracts other than those to which the premium allocation approach is applied including contracts with direct participation features. Firstly, an entity must provide overall reconciliations from the opening to the closing balances separately for each of the following: *[IFRS 17.100]*

- The net liabilities (or assets) for the remaining coverage component, excluding any loss component
- Any loss component (see section 9.8 above)
- The liabilities for incurred claims

Within the overall reconciliations above, an entity must separately disclose each of the following amounts related to insurance contract services, if applicable: *[IFRS 17.103]*

- Insurance revenue
- Insurance service expenses, showing separately:
  - Incurred claims (excluding investment components) and other incurred insurance service expenses
  - Amortisation of insurance acquisition cash flows
  - Changes that relate to past service, i.e., changes in fulfilment cash flows relating to the liability for incurred claims
  - Changes that relate to future service, i.e., losses on onerous groups of contracts and reversals of such losses
- Investment components excluded from insurance revenue and insurance service expenses (combined with refunds of premiums unless refunds of premiums are presented as part of the cash flows in the period)

Below is an example of this overall reconciliation, based on an illustrative disclosure in the IASB's *IFRS 17 Effects Analysis*.

	Liability for remaining coverage			
	Excluding onerous contracts component	**Onerous contracts component**	**Liabilities for incurred claims**	**Total**
	CU	**CU**	**CU**	**CU**
Insurance contract liabilities 20X4	**161,938**	**15,859**	**1,021**	**178,818**
Insurance revenue	**(9,856)**			**(9,856)**
Insurance services expenses	**1,259**	**(623)**	**7,985**	**8,621**
Incurred claims and other expenses		(840)	7,945	7,105
Acquisition expenses	1,259			1,259
Changes that relate to future service: loss on onerous contracts and reversals of those losses		217		217
Changes that relate to past service: changes to liability for incurred claims			40	40
Investment components	**(6,465)**		**6,465**	**0**
Insurance service result	**(15,062)**	**(623)**	**14,450**	**(1,235)**
Insurance finance expenses	**8,393**	**860**	**55**	**9,308**
Total changes in the statement of comprehensive income	**(6,669)**	**237**	**14,505**	**8,073**
Cash flows				
Premiums received	33,570			33,570
Claims, benefits and other expenses paid			(14,336)	(14,336)
Acquisition cash flows paid	(401)			(401)
Total cash flows	**33,169**	**-**	**(14,336)**	**18,833**
Insurance contract liabilities 20X5	**188,438**	**16,096**	**1,190**	**205,724**

Secondly, an entity must also disclose reconciliations from the opening to the closing balances separately for each of the following: *[IFRS 17.101]*

- The estimates of the present value of the future cash flows
- The risk adjustment for non-financial risk
- The contractual service margin

Within these reconciliations, an entity must disclose the following amounts related to services, if applicable: *[IFRS 17.104]*

- Changes that relate to future service, showing separately:
  - Changes in estimates that adjust the contractual service margin
  - Changes in estimates that do not adjust the contractual service margin, i.e., losses on groups of onerous contracts and reversals of such losses
  - The effects of contracts initially recognised in the period
- Changes that relate to current service, which include:
  - The amount of the contractual service margin recognised in profit or loss to reflect the transfer of services
  - The change in the risk adjustment for non-financial risk that does not relate to future service or past service
  - Experience adjustments, excluding amounts relating to the risk adjustment for non-financial risk included above
- Changes that relate to past service, i.e., changes in fulfilment cash flows relating to incurred claims

Below is an example of these reconciliations, based on an illustrative disclosure in the IASB's *IFRS 17 Effects Analysis*:

	Estimates of the present value of future cash flows	Risk adjustment	Contractual service margin	Total
	CU	CU	CU	CU
Insurance contact liabilities 20X4	**163,962**	**5,998**	**8,858**	**178,818**
Changes that relate to current service	**35**	**(604)**	**(923)**	**(1,492)**
Contractual service margin recognised for service period			(923)	(923)
Risk adjustment recognised for the risk expired		(604)		(604)
Experience adjustments	35			35
Changes that relate to future service	**(784)**	**1,117**	**(116)**	**217**
Contracts initially recognised in the period	(2,329)	1,077	1,375	123
Changes in estimates reflected in the contractual service margin	1,452	39	(1,491)	-
Changes in estimates that result in onerous contact losses	93	1		94
Changes that relate to past service	**47**	**(7)**		**40**
Adjustments to liabilities for incurred claims	47	(7)		40
Insurance service result	**(702)**	**506**	**(1,039)**	**(1,235)**
Insurance finance expenses	**9,087**	**-**	**221**	**9,308**
Total changes in the statement of comprehensive income	**8,385**	**506**	**(818)**	**8,073**
Cash flows	**18,833**			**18,833**
Insurance contract liabilities 20X5	**191,180**	**6,504**	**8,040**	**205,724**

In addition, to complete the reconciliations above, an entity must also disclose separately each of the following amounts not related to services provided in the period, if applicable: *[IFRS 17.105]*

- Cash flows in the period, including:
  - Premiums received for insurance contracts issued (or paid for reinsurance contracts held)
  - Insurance acquisition cash flows
  - Incurred claims paid and other insurance service expenses paid for insurance contracts issued (or recovered under reinsurance contracts held), excluding insurance acquisition cash flows
- The effect of changes in the risk of non-performance by the issuer of reinsurance contracts held
- Insurance finance income or expenses
- Any additional line items that may be necessary to understand the change in the net carrying amount of the insurance contracts

How we see it

As discussed in section 11.4.4. above, the risk of non-performance includes both credit and dispute risk. IFRS 17.105 requires insurers to disclose the effect of changes in the risk of non-performance by issuers of reinsurance contracts held. IFRS 17 also states that changes in the fulfilment cash flows that result from changes in the risk of non-performance by the issuer of a reinsurance contract held do not relate to future service and shall not adjust the contractual service margin. Hence, these changes should be recognised in the statement of comprehensive income in the period in which these effects occur. However, IFRS 17 does not state whether the effect of change in the risk of non-performance is part of insurance service expenses or part of insurance finance income or expenses. Where an entity makes the judgement that the risk of non-performance is a non-financial risk, it will present the effects of non-performance risk for reinsurance held as insurance service expenses. Where an entity makes the judgement that the risk of non-performance is a financial risk, per Appendix A of IFRS 17, it will present the effects of non-performance risk for reinsurance held as insurance finance income or expenses in the statement of comprehensive income. If an entity treats non-performance risk as a financial risk also applies the option to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income, then it follows from the disaggregation requirements in IFRS 17 that subsequent changes arising in non-performance risk should also be disaggregated between profit and loss and other comprehensive income according to IFRS 17.88 and IFRS 17.89 (see section 15.3.1 above).

When an entity recognises an asset for insurance acquisition cash flows paid for existing or future groups of insurance contracts before those insurance contracts are recognised (see section 7.3 above), it must disclose a reconciliation from the opening to the closing balance of assets recognised for those insurance acquisition cash flows. The information must be aggregated at a level which is consistent with that for the other reconciliations of insurance contracts discussed above. *[IFRS 17.105A]*.

The reconciliation of the insurance acquisition cash flows above must disclose separately any recognition of impairment losses and reversals of impairment losses of the insurance acquisition cash flow assets. *[IFRS 17.105B]*.

In respect of insurance revenue recognised in the period, entities must provide the following analysis: *[IFRS 17.106]*

- The amounts relating to the changes in the liability for remaining coverage as discussed in section 15.2.1 above, separately disclosing:
  - The insurance service expenses incurred during the period
  - The change in the risk adjustment for non-financial risk
  - The amount of the contractual service margin recognised in profit or loss because of the transfer of insurance contract services in the period
  - Other amounts, if any, for example, experience adjustments for premium receipts other than those that relate to future service
- The allocation of the portion of the premiums that relate to the recovery of insurance acquisition cash flow

Below is an example of this insurance revenue analysis, based on an illustrative disclosure in the IASB's *IFRS 17 Effects Analysis*.

	20X5
	CU
Amounts related to liabilities for remaining coverage	**8,597**
Expected incurred claims and other expenses	7,070
Contractual service margin for the service provided	923
Risk adjustment for the risk expired	604
Recovery of acquisition cash flows	**1,259**
Insurance revenue	**9,856**

The effect on the statement of financial position for insurance contracts issued and reinsurance contracts held that are initially recognised in the period, must be shown separately, disclosing the effect at initial recognition on: *[IFRS 17.107]*

- The estimates of the present value of future cash outflows, showing separately the amount of the insurance acquisition cash flows
- The estimates of the present value of future cash inflows
- The risk adjustment for non-financial risk

  And
- The contractual service margin

In the reconciliation showing the effect of insurance contracts issued and reinsurance contracts held, there must be separate disclosure of the following: *[IFRS 17.108]*

- Contracts acquired from other entities in transfers of insurance contracts or business combinations
- Groups of contracts that are onerous

Below is an example of this analysis, based on an illustrative disclosure in the IASB's *IFRS 17 Effects Analysis*. The example shows insurance contracts issued only for an entity which has not acquired contracts in the period via transfers or business combinations.

	Total	Of which contracts acquired	Of which onerous contracts
	CU	CU	CU
Contracts initially recognised in 20X5			
Estimates of the present value of futures cash inflows	(33,570)	(19,155)	(1,716)
Estimates of the present value of future cash outflows			
Insurance acquisition cash flows	401	122	27
Claims payable and other expenses	30,840	17,501	1,704
Risk adjustment	1,077	658	108
Contractual service margin	1,375	896	-
Total	**123**	**22**	**123**

Additionally, an entity must disclose *quantitatively* (emphasis added) when it expects to recognise the contractual service margin remaining at the end of the reporting period in profit or loss, in appropriate time bands. Such information should be provided separately for insurance contracts issued and reinsurance contracts held. *[IFRS 17.109]*. The total contractual service margin amount should be reconciled to the contractual service margin shown in the reconciliations above.

An entity is also required to disclose quantitatively, in appropriate time bands, when it expects to derecognise an asset for insurance acquisition cash flows. *[IFRS 17.109A]*.

Frequently asked questions

Question 16-1: What is the sequence to be applied to adjusting a loss component in a financial period when one experience adjustment that relates to future service would increase a loss component, while another would decrease it; and should a gross disclosure be provided applying paragraphs 103(b) and 104(a) of IFRS 17?

(TRG meeting April 2019 - Agenda paper no. 02, Log S125)

In the example submitted, there was a premium experience adjustment related to future service that would increase a loss component and a change in fulfilment cash flows related to future service that would decrease a loss component. The IASB staff observed that IFRS 17 requires an entity to provide disclosure of changes that relate to future service separately from those related to current or past service and in the example submitted, all changes relate to future service. That is, no sub-analysis of the changes that relate to future service was required for the example included in the submission.

Question 16-2: How should the reconciliation of estimates of the present value of future cash flows applying paragraphs 101 and 104 of IFRS 17 for the annual reporting period be disclosed, considering the requirements in IFRS 17.B137 relating to interim financial statements?

(TRG meeting April 2019 - Agenda paper no. 02, Log S83)

The submission asks, for example, whether changes disclosed as relating to past service in an interim reporting period should be disclosed as changes relating to current service in the annual reporting. The IASB staff stated the amounts disclosed in the reconciliations in IFRS 17.101 and 104 reflected the amounts included in the measurement of insurance contracts and that the description of the amount as relating to past or current service does not affect the measurement as both are treated in the same way when determining the fulfilment cash flows and any effect of changes in fulfilment cash flows on the contractual service margin.

How we see it

The roll forward reconciliations are detailed analyses of movements in the carrying amounts of insurance contracts issued and reinsurance contracts held. They will provide more information and transparency to users than they currently receive from IFRS financial statements. An entity is required to provide analyses of the change in the carrying amount that view insurance contracts in two ways:

- The building blocks view (present value of expected future cash flows, risk adjustment for non-financial risk, and the contractual service margin)
- By type of insurance obligation (the liability for incurred claims and the liability for remaining coverage split between the loss component and the non-loss component)

The reconciliations are two views of the same events in a reporting period. Entities need to decide to what extent they build the reconciliations from low-level detailed data on changes in the carrying amounts of insurance contracts maintained in a general ledger (and/or data warehouse) versus maintaining high-level data in the general ledger and taking a top-down approach to analysing movements and obtaining the required movements data from other sources. On one hand, a bottom-up approach to maintaining movement data in the general ledger/data warehouse represents a significant data and process challenge. On the other hand, a top-down approach risks an entity being unable to provide the analyses in a robust and timely way.

16.1.2 Information about contracts to which the entity applies the premium allocation approach

16.1.2.A Accounting policies adopted for contracts applying the premium allocation approach

When an entity uses the premium allocation approach, it must disclose the following: *[IFRS 17.97]*

- Which of the criteria for the use of the premium allocation approach for insurance contracts issued and reinsurance contracts held it has satisfied
- Whether it makes an adjustment for the time value of money and the effect of financial risk for the liability for remaining coverage and the liability for incurred claims
- Whether it recognises insurance acquisition cash flows as expenses when it incurs those costs or amortises insurance acquisition cash flows over the coverage period

These choices are discussed in sections 10.1, 10.4 and 10.5 above.

16.1.2.B Reconciliations required for contracts applying the premium allocation approach

The reconciliations described below apply to contracts using the premium allocation approach. Most also apply for contracts using the general model (see section 16.1.1 above). As with the general model, for each reconciliation, an entity should present the net carrying amounts at the beginning and at the end of the period, disaggregated into a total for portfolios of contracts that are assets and a total for portfolios of contracts that are liabilities, that equal the amounts presented in the statement of financial position as set out in section 15.1 above. *[IFRS 17.99]*.

Overall reconciliations from the opening to the closing balances are required separately for each of: *[IFRS 17.100]*

- The net liabilities (or assets) for the remaining coverage component, excluding any loss component
- Any loss component (see section 9.8 above)
- The liabilities for incurred claims with separate reconciliations for:
  - The estimates of the present value of the future cash flows
  - The risk adjustment for non-financial risk

Within the overall reconciliations above, separate disclosure of each of the following amounts related to services, if applicable: *[IFRS 17.103]*

- Insurance revenue
- Insurance service expenses, showing separately:
  - Incurred claims (excluding investment components) and other incurred insurance service expenses
  - Amortisation of insurance acquisition cash flows
  - Changes that relate to past service, i.e., changes in fulfilment cash flows relating to the liability for incurred claims
  - Changes that relate to future service, i.e., losses on onerous groups of contracts and reversals of such losses
- Investment components excluded from insurance revenue and insurance service expenses (combined with refunds of premiums unless refunds of premiums are presented as part of the cash flows in the period)

Disclosure is also required of each of the following amounts that are not related to services provided in the period, if applicable: *[IFRS 17.105]*

- Cash flows in the period, including:
  - Premiums received for insurance contracts issued (or paid for reinsurance contracts held)
  - Insurance acquisition cash flows
  - Incurred claims paid and other insurance service expenses paid for insurance contracts issued (or recovered under reinsurance contracts held), excluding insurance acquisition cash flows
- The effect of changes in the risk of non-performance by the issuer of reinsurance contracts held
- Insurance finance income or expenses
- Any additional line items that may be necessary to understand the change in the net carrying amount of the insurance contracts

The disclosures required when an entity recognises an asset for acquisition cash flows paid for existing or future groups of insurance contracts before those insurance contracts are recognised insurance acquisition cash flow assets also apply to contracts accounted for under the premium allocation approach (see section 16.1.1 above).

16.1.3 Explanation of the total amount of insurance finance income or expenses in each reporting period

The total amount of insurance finance income or expenses in the reporting period must be disclosed and explained. In particular, an entity must explain the relationship between insurance finance income or expenses and the investment return on its assets, to enable users of its financial statements to evaluate the sources of finance income or expenses recognised in profit or loss and other comprehensive income. *[IFRS 17.110]*.

Specifically, for contracts with direct participation features, an entity must: *[IFRS 17.111, IFRS 17.112, IFRS 17.113]*

- Describe the composition of the underlying items and disclose their fair value.
- Disclose the effect of any adjustment to the contractual service margin in the current period as a result of the application of risk mitigation whereby a choice not to adjust the contractual service margin to reflect some or all of the changes in the effect of financial risk on the entity's share of underlying items for the effect of the time value of money and financial risks not arising from the underlying items (see section 12.3.6 above).
- Disclose, in the period when the entity changes the basis of disaggregation of insurance finance income or expense between profit or loss and other comprehensive income because of a change in whether it holds the underlying items (see section 15.3.4 above):
  - The reason why the entity was required to change the basis of disaggregation
  - The amount of any adjustment for each financial statement line item affected
  - The carrying amount of the group of insurance contracts to which the change applied at the date of the change

16.2 Transition amounts

An entity must provide disclosures that enable users of financial statements to identify the effect of groups of insurance contracts measured at the transition date when applying the modified retrospective approach (see section 17.4 below) or the fair value approach (see section 17.5 below) on the contractual service margin and insurance revenue in subsequent periods. To achieve this, IFRS 17 requires various disclosures to be made in each reporting period until the contracts which exist at transition have expired or been extinguished. These disclosures are necessary because the Board expects that there will be some differences in the measurement of insurance contracts when applying the different transition approaches permitted in IFRS 17. *[IFRS 17.BC399]*

Hence, an entity must disclose the reconciliation of the contractual service margin and the amount of insurance revenue in section 16.1.1 above, separately for: *[IFRS 17.114]*

- Insurance contracts that existed at the transition date to which the entity has applied the modified retrospective approach
- Insurance contracts that existed at the transition date to which the entity has applied the fair value approach

All other insurance contracts (i.e., including those which the entity has accounted for fully retrospectively)

Practical example 16-1: Zurich Insurance Group Ltd (2023) **Switzerland**

Annual Report 2023 [extract]
Financial Review [extract]
Consolidated financial statements [extract]
7 Insurance and reinsurance contracts [extract]

...

The following tables provide a summary of the movement in the CSM by transition approach for the years ended December 31, 2023 and 2022, respectively:

Table 7.15a

CSM by transition approach for groups of insurance contracts issued – current period

in USD millions	Modified retrospective	Fair value	All other insurance contracts	Total
Contractual service margin as of January 1, 2023	7,734	1,969	5,413	15,117
Changes that relate to future services				
Changes in estimates that adjust the CSM	135	602	323	1,059
Contracts initially recognized in the period	–	–	1,643	1,643
Changes that relate to current services				
CSM recognized for services provided in P&L	(697)	(254)	(945)	(1,895)
Changes related to provision of insurance services	(562)	348	1,021	807
Foreign currency translation effects	474	35	160	669
Insurance finance (income)/expense	9	22	84	115
Other changes	(94)	(11)	134	29
Total other changes	389	46	378	813
Contractual service margin as of December 31, 2023	**7,561**	**2,363**	**6,813**	**16,737**

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Practical example 16-2: Zurich Insurance Group Ltd (2023) **Switzerland**

Annual Report 2023 [extract]
Financial Review [extract]
Consolidated financial statements [extract]
9 Insurance revenue [extract]

...

Table 9.2

Insurance revenue by transition approach measured under BBA and VFA

In USD millions for the years ended December 31	2023		2022	
	Contracts measured under BBA	Contracts measured under VFA	Contracts measured under BBA	Contracts measured under VFA
Contracts measured under the modified retrospective approach	482	2,620	511	2,777
Contracts measured under the fair value approach	1,406	440	1,339	161
All other contracts	4,472	729	4,133	529
Insurance revenue measured under BBA and VFA	**6,360**	**3,788**	**5,983**	**3,466**

In addition, for all periods in which disclosures are made for contracts that, on transition, were accounted for using either the modified retrospective approach or the fair value approach, an entity must explain how it determined the measurement of insurance contracts at the transition date. The purpose of this is to enable users of financial statements to understand the nature and significance of the methods used and judgements applied in determining the transition amounts. *[IFRS 17.115]*.

An entity that chooses to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income applies the requirements discussed in section 17.4.4 below (for the modified retrospective approach) or in section 17.5.1 below (for the fair value approach). This is to determine the cumulative difference between the insurance finance income or expenses that would have been recognised in profit or loss and the total insurance finance income or expenses at the transition date for the groups of insurance contracts to which the disaggregation applies. For all periods in which amounts determined applying these alternative transitional approaches exist, the entity must disclose a reconciliation of the opening to the closing balance of the cumulative amounts included in other comprehensive income for financial assets measured at fair value through other comprehensive income related to the groups of insurance contracts. The reconciliation must include, for example, gains or losses recognised in other comprehensive income in the period and gains or losses previously recognised in other comprehensive income in previous periods reclassified in the period to profit or loss. *[IFRS 17.116]*.

How we see it

Transition disclosures will require considerable effort. Entities need to think about their solutions for identifying and tracking these amounts carefully. They will need to continue separately disclosing the contractual service margin for contracts in-force at transition in the years after transition and must consider this requirement when building their financial reporting processes and systems. The effort of tracking the contractual service margins for groups of contracts present at transition that are not determined on a full retrospective basis must be considered together with the effort of applying a full retrospective approach at transition.

16.3 Significant judgements made in applying IFRS 17

IAS 1 requires that an entity should disclose, along with material accounting policy information, the judgements, apart from those involving estimations which are required separately, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. *[IAS 1.122]*.

Consistent with IAS 1, the second part of the disclosure objective established by IFRS 17 is that an entity should disclose the significant judgements and changes in judgements made by an entity in applying the standard. *[IFRS 17.93(b)]*.

Specifically, an entity must disclose the inputs, assumptions and estimation techniques it has used, including: *[IFRS 17.117]*

- The methods used to measure insurance contracts within the scope of IFRS 17 and processes to estimate the inputs to those methods. Unless impracticable, an entity must also provide quantitative information about those inputs.
- Any changes in methods and processes for estimating inputs used to measure contracts, the reason for each change, and the type of contracts affected.
- To the extent not covered above, the approach used:
  - To distinguish changes in estimates of future cash flows arising from exercising discretion from other changes in estimates of future cash flows for contracts without direct participation features
  - To determine the risk adjustment for non-financial risk, including whether changes in the risk adjustment for non-financial risk are disaggregated into an insurance service component and an insurance finance component, or are presented in full in the insurance service result
  - To determine discount rates
  - To determine investment components
  - To determine the relative weighting of the benefits provided by insurance coverage and investment-return service (for insurance contracts without direct participation features) or insurance coverage and investment-related service (for insurance contracts with direct participation features)

If an entity chooses to disaggregate insurance finance income or expenses into amounts presented in profit or loss and in other comprehensive income (see sections 15.3.1 to 15.3.4 above), it must disclose an explanation of the methods used to determine the insurance finance income or expenses recognised in profit or loss. *[IFRS 17.118]*.

An entity must also disclose the confidence level used to determine the risk adjustment for non-financial risk. If the entity uses a technique other than the confidence level technique, it must disclose: *[IFRS 17.119]*

- The technique used
- The confidence level corresponding to the results of that technique

The following example illustrates disclosure of critical accounting judgements relating to separation of insurance contract components (see section 5.3 and section 6.1.1).

Practical example 16-3: Admiral Group plc (2023) **United Kingdom**

Annual Report and Accounts 2023 [extract]

Financial Statements [extract]

Notes to the Consolidated Financial Statements [extract]

2. Critical accounting judgements and estimates [extract]

2.1 Critical accounting judgements [extract]

Unit of account: combination of insurance contracts and separation of distinct components [extract]

...

In addition, any cashflows related to promises to transfer distinct goods or services, other than insurance contract services, that are within the host insurance contract are separated and recognised by applying IFRS 15. In determining whether there are such distinct components, the following is considered:

- whether the policyholder can benefit from the good or service on its own or together with other resources available to the policyholder
- whether the cashflows and risks associated with the good or service are highly interrelated with the cashflows and risks associated with the insurance components in the contract
- whether the Group provides a significant service in integrating the good or service with the insurance components.

After separating any such distinct components, IFRS 17 is applied to all remaining components of the (host) insurance contract.

The Group has determined that, in applying these requirements to its insurance contracts:

- The individual insurance policies contained in a 'multi-cover policy' are treated as separate contracts, given that the components can be priced and sold separately, there is little interdependency between the risks covered, and the components can lapse separately
- The cashflows associated with administration fees (for changes to the underlying insurance policy), and instalment income (being the additional fees payable by a policyholder associated with paying for an insurance contract over 12 months, rather than in one up-front payment), are non-distinct given that the policyholder cannot benefit from these services separately and the services are highly interrelated with the core insurance policy. These cashflows are therefore treated as insurance revenue under IFRS 17. However, for the component of the insurance policy that is underwritten outside the Group by a third party insurer, the Group is performing an agency service on behalf of the third party insurer, and therefore this component is treated as a separate component of revenue and accounted for under IFRS 15
- The cashflows associated with ancillary or 'add on' products (which are sold within the same set of contracts as the core product), are separated from the core product in cases where the policyholder can benefit from the product on its own, and where the cashflows are not highly interrelated with the insurance components in the contract or the Group does not provide a significant service in integrating the products.

...

The following example illustrates disclosure of the confidence level used to determine the risk adjustment for non-financial risk and also includes risk adjustment sensitivity analysis.

Practical example 16-4: Aviva plc (2023) **United Kingdom**

Annual Report and Accounts 2023 [extract]
IFRS Financial Statements [extract]
Notes to the consolidated financial statements [extract]
40 - Insurance and reinsurance contracts [extract]
(g) Significant judgements, estimates and assumptions [extract]
(i) Fulfilment cash flows [extract]
Risk adjustments for non-financial risk [extract]

...

The Group estimates the Risk Adjustment's corresponding confidence level by comparing the combined value of best estimate cash flows and Risk Adjustment with a distribution of possible outcomes on an ultimate horizon. For life and participating contracts the confidence interval, net of reinsurance corresponds to the 68th percentile (2022: 70th percentile), for non-life contracts it corresponds to the 77th percentile (2022: 74th percentile). The percentiles disclosed benefit from the diverse profile of entities within the Group, but not from diversification between the Group's Life and non-Life segments and are uncertain estimates made as of 31 December, which could reasonably change within 12 months. Factors which could cause them to change include variations in the Company's risk profile or quantification thereof, for example as might arise from economic factors such as changes in risk-free discount rates or changes in the composition of insurance liabilities. the movements in the value of the net risk adjustment required to move the confidence level by 2.5 percentage points can be seen in the table below. The figures assume that there are no changes in estimate of future cashflows when in reality a lot of factors which influence the risk adjustment calibration will also impact the estimate of future cashflows.

	2023 £m	2022 £m
Life and participating business		
Movement in net risk adjustment required for 2.5pp confidence level increase	**65**	75
Movement in net risk adjustment required for 2.5pp confidence level reduction	**(65)**	(75)
Non-Life business		
Movement in net risk adjustment required for 2.5pp confidence level increase	**45**	48
Movement in net risk adjustment required for 2.5pp confidence level reduction	**(41)**	(46)

For Life risk and Participating contracts, this is the confidence level that the liabilities recognised and associated reinsurance balances, excluding CSM, are sufficient to cover the ultimate cost of in-force insurance liabilities applying period end assumptions. For non-Life contracts, this represents the confidence level that net claims liabilities recognised are sufficient to cover the ultimate cost of claims. Net non-Life claims liabilities include the liability for incurred claims, asset for incurred claims and the asset for remaining coverage on reinsurance contracts held that reinsure against adverse development on incurred claims.

An entity must disclose the yield curve (or range of yield curves) used to discount cash flows that do not vary based on the returns on underlying items. When an entity provides this disclosure in aggregate for a number of groups of insurance contracts, it must provide such disclosures in the form of weighted averages, or relatively narrow ranges. *[IFRS 17.120]*.

The following example illustrates disclosure of ranges of yield curves.

Practical example 16-5: Manulife Financial Corporation (2023) — Canada

2023 Annual Report [extract]
Consolidated Financial Statements [extract]
Notes to Consolidated Financial Statements [extract]
Note 7 Insurance and Reinsurance Contract Assets and Liabilities [extract]
(g) Significant judgements and estimates [extract]
(iii) Discount Rates [extract]

Insurance contract cash flows for non-participating business are discounted using risk-free yield curves adjusted by an illiquidity premium to reflect the liquidity characteristics of the liabilities. Cash flows that vary based on returns of underlying items are adjusted to reflect their variability under these adjusted yield curves. Each yield curve is interpolated between the spot rate at the last observable market data point and an ultimate spot rate which reflects the long-term real interest rate plus inflation expectations.

For participating business, insurance contract cash flows that vary based on the return of underlying items are discounted at rates reflecting that variability.

For insurance contracts with cash flows that vary with the return of underlying items and where the present value is measured by stochastic modelling, cash flows are both projected and discounted at scenario specific rates, calibrated on average to be the risk-free yield curves adjusted for liquidity.

The spot rates used for discounting liability cash flows are presented in the following table and include illiquidity premiums determined with reference to net asset spreads indicative of the liquidity characteristics of the liabilities by geography.

					December 31, 2023					
	Currency	Liquidity category	Observable years	Ultimate year	1 year	5 years	10 years	20 years	30 years	Ultimate
Canada	CAD	Illiquid	30	70	**5.17%**	**4.33%**	**4.92%**	**4.86%**	**4.80%**	**4.40%**
		More liquid	30	70	**5.14%**	**4.22%**	**4.69%**	**4.72%**	**4.69%**	**4.40%**
U.S.	USD	Illiquid	30	70	**5.38%**	**4.54%**	**5.37%**	**5.65%**	**5.27%**	**5.00%**
		More liquid	30	70	**5.32%**	**4.57%**	**5.25%**	**5.56%**	**5.18%**	**4.88%**
Japan	JPY	Mixed	30	70	**0.53%**	**0.77%**	**1.08%**	**1.75%**	**2.24%**	**1.60%**
Hong Kong	HKD	Illiquid	15	55	**4.20%**	**4.01%**	**4.98%**	**4.61%**	**4.19%**	**3.80%**

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16.4 Disclosure of accounting policy information

Unlike IFRS 4, IFRS 17 does not contain an explicit requirement to disclose material accounting policy information for insurance contracts and related liabilities, income and expense. However, IAS 1 requires an entity to disclose material accounting policy information. *[IAS 1.117]*

Accounting policy information is likely to be material to an entity's financial statements if that information relates to material transactions, other events or conditions and: *[IAS 1.117B]*

- The entity changed its accounting policy during the reporting period and this change resulted in a material change to the information in the financial statements
- The entity chose the accounting policy from one or more options permitted by IFRSs, for example a choice between historical cost and fair value
- The accounting policy was developed in accordance with IAS 8 in the absence of an IFRS that specifically applies
- The accounting policy relates to an area for which the entity is required to make significant judgements or assumptions in applying an accounting policy and the entity discloses those judgements or assumptions in accordance with IAS 1
- The accounting required is complex and users of the entity's financial statements would otherwise not understand those material transactions, other events or conditions.

In addition, certain specific disclosures concerning accounting policy choices in respect of discounting and insurance acquisition cash flows are required by IFRS 17 when the premium allocation approach is used (see section 16.1.2.A above).

IFRS 17 contains a number of specific accounting policy elections, the exercise of which (or not) may be material to the financial statements. Some of these are summarised in the table below. Accounting policy elections applicable only on transition are discussed in section 17 below.

Accounting policy choice	Unit of Account	Revocable choice?
Election to apply IFRS 17 or IAS 32/IFRS 9 to financial guarantee contracts if previously asserted to be insurance contracts (see section 2.3.1.B above)	Individual contract	No
Election to apply either IFRS 15 or IFRS 17 to certain fixed-fee service contracts (see section 2.3.2 above)	Individual contract	No
Election to apply either IFRS 17 or IFRS 9 to certain loan contracts that transfer insurance risk only on settlement (see section 2.3.3 above)	Accounting policy at level of portfolio of contracts	No
Multi-currency groups of insurance contracts - election to apply a 'single-currency denomination' approach or a 'multi-currency denomination' approach (see section 8.3 above)	IAS 8 applies	IAS 8 applies
Accretion of interest on insurance acquisition cash flows - voluntary election (see section 9.3 above)	IAS 8 applies	IAS 8 applies
Discount rate used for loss component, insurance revenue and insurance service expenses - election between current rate and rate at date of initial recognition of the group, applies to all contracts under the general model (see sections 15.2.1 and 15.2.2 above)	IAS 8 applies	IAS 8 applies
Election to apply either IFRS 17 or IFRS 9 to amounts receivable from an intermediary when a policyholder has discharged its obligation to an insurer (see section 9.12 above)	IAS 8 applies	IAS 8 applies
Use of the premium allocation approach (see section 10 above)	Group of contracts	No - unless contract modified (see section 13.1 above).
Premium allocation approach - election to expense insurance acquisition cash flows as incurred for contracts where coverage period of each contract in group is no more than one year as opposed to including within the liability for remaining coverage (see section 10.2 above)	Group of contracts	No
Premium allocation approach - election to not adjust the liability for remaining coverage to reflect the time value of money and effect of financial risk if, on initial recognition, the time between providing services and premium due date is no more than one year (see section 10.2 above).	Group of contracts	No
Premium allocation approach - election not to adjust the liability for incurred claims to reflect the time value of money and effect of financial risk if the cash flows are expected to be paid or received in one year or less from the date the claims are incurred (see section 10.5 above).	Group of contracts	Yes - if eligibility criteria failed in subsequent periods
Use of risk mitigation for eligible contracts applying the variable fee approach (see section 12.3.5 above)	Group of contracts	If, and only if, conditions cease to apply (see section 12.3.5 above).

Accounting policy choice	Unit of Account	Revocable choice?
Present changes in the risk adjustment for non-financial risk in insurance service expenses or disaggregate between insurance service expenses and insurance finance income or expenses (see section 15.2.2 above)	IAS 8 applies	IAS 8 applies
Present insurance finance income or expenses in profit or loss or disaggregate between profit or loss and other comprehensive income (see section 15.3.1 above)	Portfolio of contracts	Yes - provided change satisfies IAS 8 criteria. For variable fee contracts, if underlying items now held or no longer held change is mandatory (see section 12.3.6 above)
Election as to whether to change the treatment of accounting estimates made in previous interim financial statements when applying IFRS 17 in subsequent interim financial statements and in the annual reporting period (see section 15.4 above)	Reporting entity	IAS 8 applies
Net or gross presentation of reinsurance held in profit or loss (see section 15.2 above)	Reporting entity	IAS 8 applies

16.5 Disclosure about the nature and extent of risks

The third part of the disclosure objective established by IFRS 17 is that an entity is required to disclose the nature and extent of the risks from contracts within the scope of the standard. *[IFRS 17.93]*.

To comply with this objective, an entity must disclose information that enables users of its financial statements to evaluate the nature, amount, timing and uncertainty of future cash flows that arise from contracts within the scope of IFRS 17. *[IFRS 17.121]*.

The disclosures detailed below are considered to be those that would normally be necessary to meet this requirement. These disclosures focus on the insurance and financial risks that arise from insurance contracts and how they have been managed. Financial risks typically include, but are not limited to, credit risk, liquidity risk and market risk. *[IFRS 17.122]*. Many similar disclosures were contained in IFRS 4, often phrased to the effect that an insurer should make disclosures about insurance contracts assuming that insurance contracts were within the scope of IFRS 7. The disclosures required by IFRS 17 are tailored to the recognition and measurement of the standard and do not cross-refer to IFRS 7.

For each type of risk arising from contracts within the scope of IFRS 17, an entity must disclose: *[IFRS 17.124]*

- The exposures to risks and how they arise
- The entity's objectives, policies and processes for managing the risks and methods used to measure them
- Any changes in the above from the previous period

An entity must also disclose, for each type of risk: *[IFRS 17.125]*

- Summary quantitative information about its exposure to that risk at the end of the reporting period, with disclosure based on information provided internally to the entity's key management personnel
- The disclosures detailed in sections 16.5.1 to 16.5.5 below, to the extent not provided by the summary quantitative information required above

If the information disclosed about an entity's exposure to risk at the end of the reporting period is not representative of its exposure to risk during the period, the entity must disclose that fact, the reason why the period-end exposure is not representative, and further information that is representative of its risk exposure during the period. *[IFRS 17.123]*.

Disclosure of an entity's objectives, policies and processes for managing risks and the methods used to manage the risk provides an additional perspective that complements information about contracts outstanding at a particular time and might include information about:

- The structure and organisation of the entity's risk management function(s), including a discussion of independence and accountability
- The scope and nature of its risk reporting or measurement systems, such as internal risk measurement models, sensitivity analyses, scenario analysis, and stress testing, and how these are integrated into the entity's operating activities. Useful disclosures might include a summary description of the approach used, associated assumptions and parameters (including confidence intervals, computation frequencies and historical observation periods) and strengths and limitations of the approach.
- The processes for accepting, measuring, monitoring and controlling insurance risks and the entity's underwriting strategy to ensure that there are appropriate risk classification and premium levels
- The extent to which insurance risks are assessed and managed on an entity-wide basis
- The methods employed to limit or transfer insurance risk exposures and avoid undue concentrations of risk, such as retention limits, inclusion of options in contracts, and reinsurance
- Asset and liability management techniques
- The processes for managing, monitoring and controlling commitments received (or given) to accept (or contribute) additional debt or equity capital when specified events occur

Additionally, it might be useful to provide disclosures both for individual types of risks insured and overall. These disclosures might include a combination of narrative descriptions and specific quantified data, as appropriate to the nature of the contracts and their relative significance to the insurer.

Quantitative information about exposure to insurance risk might include:

- Information about the nature of the risk covered, with a brief summary description of the class (such as annuities, pensions, other life insurance, motor, property and liability).
- Information about the general nature of participation features whereby policyholders share in the performance (and related risks) of individual contracts or pools of contracts or entities. This might include the general nature of any formula for the participation and the extent of any discretion held by the insurer.
- Information about the terms of any obligation or contingent obligation for the insurer to contribute to government or other guarantee funds established by law which are within the scope of IAS 37.

16.5.1 Concentrations of risk

An entity must disclose information about concentrations of risk arising from contracts within the scope of IFRS 17, including a description of how the entity determines the concentrations, and a description of the shared characteristic that identifies each concentration (for example, the type of insured event, industry, geographical area, or currency). *[IFRS 17.127]*.

IFRS 17 explains that concentrations of financial risk might arise, for example, from interest-rate guarantees that come into effect at the same level for a large number of contracts. Concentrations of financial risk might also arise from concentrations of non-financial risk, e.g., if an entity provides product liability protection to pharmaceutical companies and also holds investments in those companies (i.e., a sectoral concentration). *[IFRS 17.127]*.

Other concentrations could arise from, for example:

- A single insurance contract, or a small number of related contracts. For example, when an insurance contract covers low-frequency, high-severity risks such as earthquakes
- Single incidents that expose an insurer to risk under several different types of insurance contract. For example, a major terrorist incident could create exposure under life insurance contracts, property insurance contracts, business interruption and civil liability.
- Exposure to unexpected changes in trends. For example, unexpected changes in human mortality or in policyholder behaviour
- Exposure to possible major changes in financial market conditions that could cause options held by policyholders to come into the money. For example, when interest rates decline significantly, interest rate and annuity guarantees may result in significant losses
- Significant litigation or legislative risks that could cause a large single loss, or have a pervasive effect on many contracts
- Correlations and interdependencies between different risks
- Significant non-linearities, such as stop-loss or excess of loss features, especially if a key variable is close to a level that triggers a material change in future cash flows
- Geographical concentrations

Disclosure of concentrations of insurance risk might include a description of the shared characteristic that identifies each concentration and an indication of the possible exposure, both before and after reinsurance held, associated with all insurance liabilities sharing that characteristic.

Disclosure of the historical performance of low-frequency, high-severity risks might be one way to help users assess cash flow uncertainty associated with those risks. For example, an insurance contract may cover an earthquake that is expected to happen, on average, once every 50 years. If the earthquake occurs during the current reporting period, the insurer will report a large loss. If the earthquake does not occur during the current reporting period, the insurer will report a profit. Without adequate disclosure of long-term historical performance, it could be misleading to report 49 years of large profits, followed by one large loss, because users may misinterpret the insurer's long-term ability to generate cash flows over the complete cycle of 50 years. Therefore, describing the extent of the exposure to risks of this kind and the estimated frequency of losses might be useful. If circumstances have not changed significantly, disclosure of the insurer's experience with this exposure may be one way to convey information about estimated frequencies. However, there is no specific requirement to disclose a probable maximum loss (PML) in the event of a catastrophe.

16.5.2 Insurance and market risks - sensitivity analysis

Extract from IFRS 17

Insurance and market risks-sensitivity analysis

128 An entity shall disclose information about sensitivities to changes in risk variables arising from contracts within the scope of IFRS 17. To comply with this requirement, an entity shall disclose:

(a) a sensitivity analysis that shows how profit or loss and equity would have been affected by changes in risk variables that were reasonably possible at the end of the reporting period:

(i) for insurance risk-showing the effect for insurance contracts issued, before and after risk mitigation by reinsurance contracts held; and

(ii) for each type of market risk-in a way that explains the relationship between the sensitivities to changes in risk variables arising from insurance contracts and those arising from financial assets held by the entity.

(b) the methods and assumptions used in preparing the sensitivity analysis; and

(c) changes from the previous period in the methods and assumptions used in preparing the sensitivity analysis, and the reasons for such changes.

[IFRS 17.128].

Market risk comprises three types of risk: currency risk, interest rate risk and other price risk. *[IFRS 7 Appendix A]*.

If an entity prepares a sensitivity analysis (e.g., an embedded value analysis) that shows how amounts different from those above are affected by changes in risk variables and uses that sensitivity analysis to manage risks arising from contracts within the scope of IFRS 17, it may use that sensitivity analysis in place of the analysis specified above. In this case, the entity must also disclose: *[IFRS 17.129]*

- An explanation of the method used in preparing such a sensitivity analysis and of the main parameters and assumptions underlying the information provided
- An explanation of the objective of the method used and of any limitations that may result in the information provided

16.5.3 Insurance risk - claims development

An entity must disclose actual claims compared with previous estimates of the undiscounted amount of the claims (i.e., claims development). The disclosure regarding claims development must start with the period when the earliest material claim(s) arose and for which there is still uncertainty about the amount and timing of the claims payments at the end of the reporting period. However, the disclosure is not required to start more than 10 years before the end of the reporting period (although there is transitional relief for first-time adopters - see section 17.2.1.A below). An entity is not required to disclose information about the development of claims for which uncertainty about the amount and timing of the claims payments is typically resolved within one year. *[IFRS 17.130]*.

An entity must reconcile the disclosure about claims development with the aggregate carrying amount of the liabilities for incurred claims disclosed in the reconciliation required by IFRS 17.100(c) and discussed in sections 16.1.1 and 16.1.2.B above. *[IFRS 17.130]*. Hence, only incurred claims are required to be compared with previous estimates and not amounts within the liability for remaining coverage. In this context, incurred claims also means incurred claim recoveries included in the equivalent IFRS 17.100(c) reconciliation for reinsurance contracts held as well as those arising from insurance and reinsurance contracts issued. *[IFRS 17.100]*.

These requirements apply to the liability for incurred claims arising from all models (i.e., general model, premium allocation approach and variable fee approach). However, because insurers need not disclose the information about claims for which uncertainty about the amount and timing of payments is typically resolved within a year, it is unlikely that many life insurers will need to give the disclosure.

The claims development information is required to be shown on an undiscounted basis. Hence, any discounting adjustment will be a reconciling item between the claims development table and the carrying amount of the liability for incurred claims. In addition, given the long tail nature of many non-life insurance claims liabilities, it is likely that many non-life insurers will have claims outstanding at the reporting date that are more than ten years old and which will also need to be included in a reconciliation of the claims development table to the carrying amount of the liability for incurred claims.

IFRS 17 does not contain an illustrative example of disclosure of claims development information (or, indeed, specifically require disclosure in a tabular format). The example below is based on an Illustrative Example contained in the Implementation Guidance to IFRS 4. This example, as a simplification for illustration purposes, presents five years of claims development information by underwriting year, although the standard itself requires ten (subject to the transitional relief upon first-time adoption) and assumes no reinsurance held. The figures in the table comprise all liabilities for incurred claims including the risk adjustment for non-financial risk, claims handling expenses and other incurred insurance expenses outstanding at the reporting date. Other formats are permitted, including, for example, presenting information by accident year or reporting period rather than underwriting year.

Illustration 16-1: Disclosure of claims development

The top half of the claims development information shows how the insurer's estimates of incurred claims for each underwriting year develop over time. For example, at the end of 20X1, the insurer's estimate of the undiscounted liability for incurred claims that it would pay for insured events relating to insurance contracts underwritten in 20X1 was CU680. By the end of 20X2, the insurer had revised the estimate of incurred claims (both those paid and those still to be paid) to CU673.

The lower half of the table reconciles the cumulative incurred claims to the amount appearing in the statement of financial position. First, the cumulative payments are deducted to give the cumulative unpaid claims for each year on an undiscounted basis. Second, the effect of discounting is deducted to give the carrying amount in the statement of financial position.

Incurred claim year	20X1	20X2	20X3	20X4	20X5	Total
	CU	CU	CU	CU	CU	CU
Estimate of incurred claims:						
At end of underwriting year	680	790	823	920	968	
One year later	673	785	840	903		
Two years later	692	776	845			
Three years later	697	771				
Four years later	702					
Estimate of incurred claims	702	771	845	903	968	
Cumulative payments	(702)	(689)	(570)	(350)	(217)	
	-	82	275	553	751	1,661
Effect of discounting	-	(14)	(68)	(175)	(265)	(562)
Liabilities net of discounting for which uncertainty is expected to be settled within one year						20
Liabilities for incurred claims	-	68	207	378	486	1,119

How we see it

IFRS 17 does not address the claims development presentation of:

- Exchange differences associated with insurance liabilities arising on retranslation (e.g., whether previous years' incurred claims should be retranslated using exchange rates as at the current reporting period date)
- Claims liabilities acquired in a business combination or transfer (as discussed in section 14.2 above, for contracts acquired in their settlement period, claims are incurred only when the financial effect becomes certain)
- Claims liabilities disposed of in a business disposal or transfer
- Whether claims should include claims handling or other allocated expenses or could be defined as comprising claims payment amounts only (with - attributable expenses included as a reconciling item)
- Whether claims development should be provided on both a gross and net of reinsurance basis (although it must be reconciled to the IFRS 17.100(c) reconciliations)
- Whether claims development information includes or exclude the risk adjustment for non-financial risk. If excluded, the risk adjustment for non-financial risk is reflected as a reconciling item.

As IFRS 17 is silent on these matters, a variety of treatments would appear to be permissible, provided these are adequately explained to the users of the financial statements, consistently applied in each reporting period and the information reconciles with the carrying amount of the liability for incurred claims included in the statement of financial position.

16.5.4 Credit risk - other information

Extract from IFRS 7

Appendix A
Defined terms

credit risk	The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

[IFRS 7 Appendix A].

For credit risk that arises from contracts within the scope of IFRS 17, an entity must disclose: *[IFRS 17.131]*

- The amount that best represents its maximum exposure to credit risk at the end of the reporting period, separately for insurance contracts issued and reinsurance contracts held
- Information about the credit quality of reinsurance contracts held that are assets

IFRS 17 provides no further detail about what is considered to be the maximum exposure to credit risk for an insurance contract or reinsurance contract held at the end of the reporting period (such as whether it is the maximum possible loss, the maximum probable loss or the fulfilment cash flows). The equivalent IFRS 7 requirement for financial instruments requires disclosure of credit risk gross of collateral or other credit enhancements. *[IFRS 7.35K(a)]*. However, IFRS 17 does not specify that the maximum credit risk should be disclosed gross of collateral or other credit enhancements.

Information about the credit quality of reinsurance could be provided by an analysis based on credit risk rating grades.

16.5.5 Liquidity risk - other information

Extract from IFRS 7

Appendix A
Defined terms

liquidity risk	The risk that an entity will encounter financial difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.

[IFRS 7 Appendix A].

For liquidity risk arising from contracts within the scope of IFRS 17, an entity must disclose: *[IFRS 17.132]*

- A description of how it manages the liquidity risk
- Separate maturity analyses for portfolios of insurance contracts issued that are liabilities and portfolios of reinsurance contracts held that are liabilities that show, as a minimum, net cash flows of the portfolios for each of the first five years after the reporting date and in aggregate beyond the first five years. An entity is not required to include in these analyses liabilities for remaining coverage measured applying the premium allocation approach. The analyses may take the form of:
  - An analysis by the estimated timing of the remaining contractual undiscounted net cash flows

    Or
  - An analysis by the estimated timing of the estimates of the present value of the future cash flows
- The amounts that are payable on demand, explaining the relationship between such amounts and the carrying amount of the related portfolios of contracts, if not disclosed in the maturity analysis above.

As the requirement is to disclose 'net cash flows' rather than 'fulfilment cash flows', the liabilities analysis excludes the risk adjustment for non-financial risk. The analysis also excludes the contractual service margin. An analysis of the expected recognition of the contractual service margin is required separately (see section 16.1.1 above).

Practical example 16-6: Aviva plc (2023) **United Kingdom**

Annual Report and Accounts 2023 [extract]
IFRS Financial Statements [extract]
Notes to the consolidated financial statements [extract]
54 - Risk management [extract]
(d) Liquidity risk [extract]
Maturity analysis [extract]
(i) Analysis of maturity of insurance and investment contract liabilities [extract]

For insurance and participating investment contract liabilities, including reinsurance contract liabilities, the following table shows the estimates of the present value of future cash flows at 31 December 2023 and 2022 analysed by estimated timing.

For non-participating investment contracts, almost all may be surrendered or transferred on demand. The earliest contractual maturity date is therefore 2023 statement of financial position date, for a surrender amount approximately equal to the current statement of financial position liability.

However, we expect surrenders, transfers and maturities to occur over many years, and therefore the table below reflects the expected cash flows for these contracts, rather than their contractual maturity date.

2023	Within 1 year £m	One to Two years £m	Two to Three years £m	Three to Four years £m	Four to Five Years £m	Five to 15 years £m	Over 15 years £m	Total £m
Life risk	3,751	2,302	2,230	2,226	2,252	20,623	26,009	59,393
Participating	3,650	2,087	1,998	1,923	2,006	15,612	11,163	38,439
Non-life	4,803	2,748	1,747	1,206	828	2,048	469	13,849
Insurance contract and participating investment contract liabilities	12,204	7,137	5,975	5,355	5,086	38,283	37,641	111,681
Non-participating investment contract liabilities	1,543	1,259	2,908	4,109	4,833	52,385	91,551	158,588
Total contract liabilities	13,747	8,396	8,883	9,464	9,919	90,668	129,192	270,269

Restated[1] 2022	Within 1 year £m	One to Two years £m	Two to Three years £m	Three to Four years £m	Four to Five Years £m	Five to 15 years £m	Over 15 years £m	Total £m
Life risk	3,677	2,458	2,383	2,328	2,324	21,247	21,849	56,266
Participating	3,539	2,151	2,136	2,036	1,945	16,953	11,200	39,960
Non-life	5,137	2,329	1,489	1,034	687	1,607	410	12,693
Insurance contract and participating investment contract liabilities	12,353	6,938	6,008	5,398	4,956	39,807	33,459	108,919
Non-participating investment contract liabilities	1,401	1,053	2,559	3,622	4,275	46,859	81,419	141,188
Total contract liabilities	13,754	7,991	8,567	9,020	9,231	86,666	114,878	250,107

1. The 2022 comparative amounts have been restated following the adoption of IFRS 17 and for a correction in respect of historic accounting for with-profits funds (see note 1).

The amounts from insurance and investment contract liabilities that are payable on demand are set out below.

	2023		2022	
	Amount payable on demand £m	Carrying value £m	Amount payable on demand £m	Carrying value £m
Insurance contracts - Life risk	11,378	11,324	9,559	9,549
Insurance contracts - Participating	38,246	38,131	39,213	39,626
Non-participating investment contract liabilities	158,514	158,588	140,952	141,188
	208,138	208,043	189,724	190,363

IFRS 7 does not contain an equivalent requirement to disclose 'amounts that are payable on demand'. As such, the nature of this requirement in IFRS 17 is not entirely clear since many insurance liabilities are theoretically payable on demand even though they may not settle for many years or may not have been notified at the reporting date. It is also not clear =whether the disclosure is intended to be net of cash inflows in respect of portfolios of insurance contracts and reinsurance assets held that are liabilities.

16.5.6 Regulatory disclosures

Most insurance entities are exposed to externally imposed capital requirements. Therefore, IAS 1 disclosures in respect of these requirements are likely to be applicable.

Where an entity is subject to externally imposed capital requirements, disclosure must be made of the nature of these requirements and how these requirements are incorporated into the management of capital. Whether or not these requirements have been complied with in the reporting period and, where they have not been complied with, the consequences of such non-compliance must also be disclosed. *[IAS 1.135]*.

Many insurance entities operate in several jurisdictions. Where an aggregate disclosure of capital requirements and how capital is managed would not provide useful information or distorts a financial statement user's understanding of an entity's capital resources, separate information must be disclosed for each capital requirement to which an entity is subject. *[IAS 1.136]*.

In addition to the requirements of IAS 1, an entity must disclose information about the effect of the regulatory frameworks in which it operates, for example, minimum capital requirements or required interest-rate guarantees. *[IFRS 17.126]*. These extra disclosures do not contain an explicit requirement for an insurer to quantify its regulatory capital requirements. The IASB considered whether to add a requirement for insurers to quantify regulatory capital on the grounds that such disclosures might be useful for all entities operating in a regulated environment. However, the Board was concerned about developing such disclosures in isolation in a project on accounting for insurance contracts that would go beyond the existing requirements in IAS 1. Accordingly, the Board decided to limit the disclosures about regulation to those set out above. *[IFRS 17.BC369, IFRS 17.BC370, IFRS 17.BC371]*.

Additionally, if an entity includes contracts within the same group which would have been in different groups only because law or regulation specifically constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics (see section 6.2.1 above), it discloses that fact. *[IFRS 17.126]*.

16.5.7 Disclosures required by IFRS 7 and IFRS 13

Contracts within the scope of IFRS 17 are not excluded from the scope of IFRS 13. Therefore, any insurance contracts measured at fair value are also subject to the disclosures required by IFRS 13. IFRS 17s measurement approach is not a fair value measurement. In addition, all contracts within the scope of IFRS 17 are excluded from the scope of IFRS 7. *[IFRS 7.3(d)]*. Under IFRS 4, investment contracts with discretionary participation features were within the scope of IFRS 7.

However, IFRS 7 applies to: *[IFRS 7.3(d)]*

- Derivatives that are embedded in contracts within the scope of IFRS 17, if IFRS 9 requires the entity to account for them separately

Investment components that are separated from contracts within the scope of IFRS 17, following the separation requirements of IFRS 17 set out in section 5.2 above.

- if IFRS 17 requires such separation
- An issuer's rights and obligations arising under insurance contracts that meet the definition of financial guarantee contracts, if the issuer applies IFRS 9 in recognising and measuring these contracts (see section 2.3.1.B above)
- An entity's rights and obligations that are financial instruments arising under credit card contracts, or similar contracts that provide credit or payment arrangements that an entity issues that meet the definition of an insurance contract, if the entity applies IFRS 9 to those rights and obligations (see section 2.3.1.D above)
- An entity's rights and obligations that are financial instruments arising under insurance contracts that an entity issues that limit the compensation for insured events to the amount otherwise required to settle the policyholder's obligation created by the contract, if the entity elects to apply IFRS 9 to such contracts (see section 2.3.3 above)

16.5.8 Key performance indicators and management performance measures

IFRS 17 does not require disclosure of key performance indicators or management performance measures (management performance measures apply when IFRS 18 *Presentation and Disclosure in Financial Statements* - see Chapter 4 - is adopted). However, such disclosures might be a useful way for an insurer to explain its financial performance during the period and to give an insight into the risks arising from insurance contracts.

17 Effective date and transition

17.1 Effective date

An entity must apply IFRS 17 for annual reporting periods beginning on or after 1 January 2023. *[IFRS 17.C1]*. When IFRS 17 is applied, IFRS 4 is withdrawn. *[IFRS 17.C34]*. Local regulators may impose a later effective date with a consequential impact on the transition date.

If an entity applies IFRS 17 earlier than reporting periods beginning on or after 1 January 2023 it must disclose that fact. However, early application is permitted only for entities that also apply IFRS 9 on or before the date of initial application of IFRS 17. *[IFRS 17.C1]*.

For the purposes of the transition requirements discussed in section 17.2 below: *[IFRS 17.C2]*

- The date of initial application is the beginning of the annual reporting period in which an entity first applies IFRS 17 (i.e., 1 January 2023 for an entity first applying the standard with an annual reporting period ending 31 December 2023)
- The transition date is the beginning of the annual reporting period immediately preceding the date of initial application (i.e., 1 January 2022 for an entity first applying the standard with an annual reporting period ending 31 December 2023 which reports only one comparative period)

17.2 Transition - general requirements

An entity must apply IFRS 17 retrospectively from the transition date unless: *[IFRS 17.C3]*

- It is impracticable

  Or
- The entity chooses to apply the fair value approach for a group of insurance contracts with direct participation features (to which it could apply IFRS 17 retrospectively) when risk mitigation has been applied prospectively to the group from the transition date and the entity has used derivatives, non-derivative financial instruments measured at fair value through profit or loss, or reinsurance contracts held or to mitigate financial risk arising from that group of contracts before transition date *[IFRS 17.C5A]*

Notwithstanding the requirement for retrospective application, if it is impracticable (as defined in IAS 8), to apply IFRS 17 retrospectively for a group of insurance contracts, an entity must apply one of the following two approaches instead: *[IFRS 17.C5]*

- A modified retrospective approach (see section 17.4 below)

  Or
- A fair value approach (see section 17.5 below)

An entity must also apply either the modified retrospective approach or the fair value approach to measure an asset for insurance acquisition cash flows if, and only if, it is impracticable to identify, recognise and measure any assets for insurance acquisition cash flows retrospectively. *[IFRS 17.C5B]*.

IAS 8 states that applying a requirement is 'impracticable' when an entity cannot apply it after making every reasonable effort to do so. *[IAS 8.5]*. Guidance on what impracticable means in the context of restatement of prior periods following a change in accounting policy is discussed at Illustration 17-1 below.

The Board permitted these alternative options to the full retrospective approach on the grounds that measuring the remaining amount of the contractual service margin for contracts acquired in prior periods, as well as the information needed in the statement of financial performance in subsequent periods, was likely to be challenging for preparers. This is because these amounts reflect a revision of estimates for all periods after the initial recognition of a group of contracts. *[IFRS 17.BC377]*. In the Board's opinion, measuring the following amounts needed for retrospective application would often be impracticable: *[IFRS 17.BC378]*

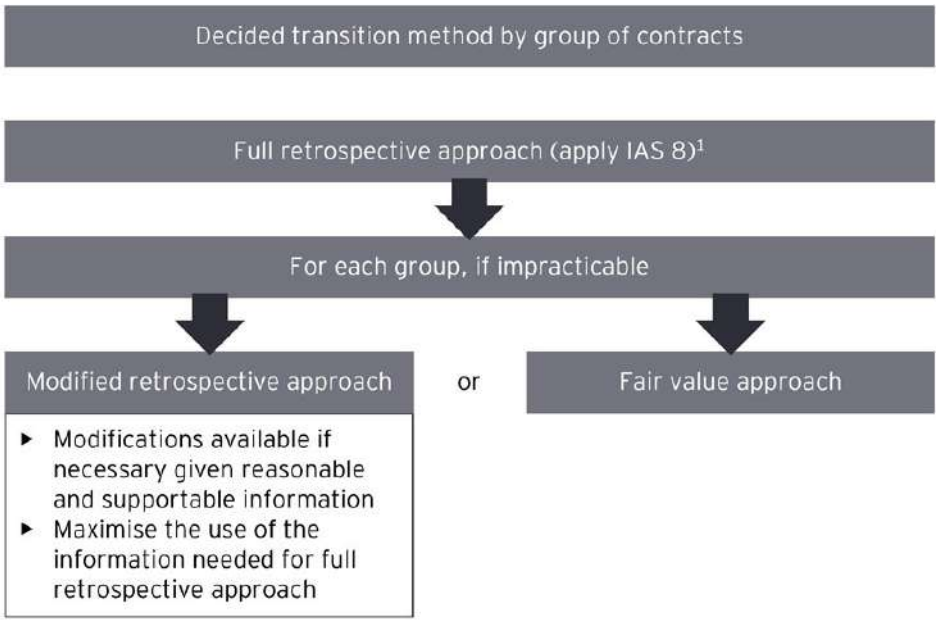
- The estimates of cash flows at the date of initial recognition
- The risk adjustment for non-financial risk at the date of initial recognition
- The changes in estimates that would have been recognised in profit or loss for each accounting period because they did not relate to future service, and the extent to which changes in the fulfilment cash flows would have been allocated to the loss component
- The discount rates at the date of initial recognition
- The effect of changes in discount rates on estimates of future cash flows for contracts for which changes in financial assumptions have a substantial effect on the amounts paid to policyholders

The choice of applying either a modified retrospective approach or a fair value approach exists separately for each group of insurance contracts when it is impracticable to apply IFRS 17 retrospectively to that group. An entity is permitted to use either of these two methods, although use of the modified retrospective approach is conditional on the availability of reasonable and supportable information. *[IFRS 17.C6(a)]*.

Within the two permitted methods there are also measurement choices available depending on the level of prior year information. Consequently, there is likely to be considerable diversity in practice across entities in calculating the contractual service margin at transition date. In turn, this will result in potentially different releases of the contractual service margin (i.e., different profit) for similar types of contracts in subsequent accounting periods. The Board acknowledged that the choice of transition methods results in a lack of comparability of transition amounts. *[IFRS 17.BC373]*.This explains why the Board included a requirement for disclosures that track the effects of the modified retrospective approach and the fair value approach on the contractual service margin and insurance revenue in future periods (see section 16.2 above).

It is observed in the Basis for Conclusions that no simplification is provided for contracts that have been derecognised before transition. This is because the Board considers that reflecting the effect of contracts derecognised before the transition date on the remaining contractual service margin was necessary to provide a faithful representation of the remaining profit of the group of insurance contracts. *[IFRS 17.BC390]*.

An overview of the transition methods is illustrated below:



1 An entity eligible to apply the full retrospective approach can also elect to use the fair value approach for a group of insurance contracts with direct participation features when risk mitigation is applied prospectively to the group from the transition date.

Illustration 17-1: Guidance on meaning of 'impracticable'

IAS 8 does not require the restatement of prior periods following a change in accounting policy or the correction of material errors if such a restatement is impracticable.

The standard devotes a considerable amount of guidance to discussing what 'impracticable' means for these purposes.

IAS 8 states that applying a requirement is impracticable when an entity cannot apply it after making every reasonable effort to do so. It goes on to note that, for a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:

- The effects of the retrospective application or retrospective restatement are not determinable
- The retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period

  Or
- The retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:
  - Provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed
  - Would have been available when the financial statements for that prior period were authorised for issue from other information

An example of a scenario covered by the first bullet above is that, in some circumstances, it may impracticable to adjust comparative information for one or more prior periods to achieve comparability with the current period because data may not have been collected in the prior period(s) in a way that allows either retrospective application of a new accounting policy (or its prospective application to prior periods) or retrospective restatement to correct a prior period error, and it may be impracticable to recreate the information.

IAS 8 observes that it is frequently necessary to make estimates in applying an accounting policy and that estimation is inherently subjective, and that estimates may be developed after the reporting period. Developing estimates is potentially more difficult when retrospectively applying an accounting policy or making a retrospective restatement to correct a prior period error, because of the longer period of time that might have passed since the affected transaction, other event or condition occurred.

However, the objective of estimates related to prior periods remains the same as for estimates made in the current period, namely, for the estimate to reflect the circumstances that existed when the transaction, other event or condition occurred. Hindsight should not be used when applying a new accounting policy to, or correcting amounts for, a prior period, either in making assumptions about what management's intentions would have been in a prior period or estimating the amounts recognised, measured or disclosed in a prior period. However, the fact that significant estimates are frequently required when amending comparative information presented for prior periods does not prevent reliable adjustment or correction of the comparative information.

Therefore, retrospectively applying a new accounting policy or correcting a prior period error requires distinguishing information that:

- Provides evidence of circumstances that existed on the date(s) as at which the transaction, other event or condition occurred

  And
- Would have been available when the financial statements for that prior period were authorised for issue, from other information. The standard states that for some types of estimates, it is impracticable to distinguish these types of information. When retrospective application or retrospective restatement would require making a significant estimate for which it is impossible to distinguish these two types of information, it is impracticable to apply the new accounting policy or correct the prior period error retrospectively.

17.2.1 Transitional relief and prohibition - all entities

IFRS 17 provides disclosure exemptions for all entities, a prohibition from applying risk mitigation retrospectively prior to the transition date and measurement exemptions or modifications on transition. Consequential amendments to IFRS 3 provide transitional relief for business combinations within the scope of IFRS 3 prior to the date of initial application of IFRS 17.

17.2.1.A Disclosure relief

IFRS 17 contains the following disclosure relief on transition:

- An entity is exempt from the IAS 8 requirement to present the amount of the adjustment resulting from applying IFRS 17 affecting each financial line item to either the current period or each prior period presented and the impact of applying IFRS 17 in those periods on earnings per share. *[IFRS 17.C3(a)]*. In the Board's view, the cost of providing this disclosure, which would include the running of parallel systems, would exceed the benefits. *[IFRS 17.BC400]*.
- An entity need not disclose previously unpublished information about claims development that occurred earlier than five years before the end of the annual reporting period in which it first applies IFRS 17 (i.e., information about claims that occurred prior to 1 January 2019 for an entity first applying the standard with an annual reporting period ending 31 December 2023). An entity that elects to take advantage of this disclosure relief should disclose that fact. *[IFRS 17.C28]*.

17.2.1.B Prohibition from applying the risk mitigation prior to the transition date

An entity must not apply the risk mitigation option available for insurance contracts with direct participation features (see section 12.3.5 above) before the transition date of IFRS 17. An entity may apply the risk mitigation option prospectively on or after the transition date if, and only if, the entity designates risk mitigation relationships at or before the date it applies the option. *[IFRS 17.C3(b)]*.

The Board was aware that some stakeholders would have preferred that the Board amend IFRS 17 to permit retrospective application of the risk mitigation option. In the view of those stakeholders, permitting retrospective application of the option would be the optimal approach to achieve comparability between the information provided about risk mitigation activities that took place before and after the transition date. Acknowledging that view, the Board considered whether it should amend IFRS 17 to permit retrospective application of the risk mitigation option. However, the Board noted that if an entity was permitted to apply the option retrospectively, it could freely decide the extent to which to reflect risk mitigation activities in the contractual service margin based on a known accounting outcome. The entity could do this in a way that would not reflect how the entity would have applied the option in previous periods, without hindsight, had it always applied IFRS 17. Such a risk would affect the credibility of information presented on transition to IFRS 17 and in subsequent periods in which those groups of insurance contracts continue to exist. In the Board's view, these costs would outweigh the benefits of permitting retrospective application of the option. Therefore, the Board reaffirmed its decision to prohibit retrospective application of the option because of the risk of the use of hindsight. *[IFRS 17.BC393C]*. Some stakeholders suggested alternative approaches that would avoid the risk of the use of hindsight. However, the Board also rejected these approaches as unworkable. *[IFRS 17.BC393D, IFRS 17.BC393E]*.

17.2.1.C Business combinations within the scope of IFRS 3 before initial application of IFRS 17

For contracts acquired in business combinations within the scope of IFRS 3 before the date of initial application of IFRS 17, an entity classifies those contracts as insurance contracts based on the contractual terms, economic conditions, operating or accounting policies or other factors as they existed at the date of initial recognition of those contracts rather than at the acquisition date of the business combination. *[IFRS 3.64N]*. This relief allows entities to continue to apply their previous IFRS 4 classification as insurance contracts of contracts acquired in a business combination before the date of initial application of IFRS 17 but does not apply to other assessments made under IFRS 17.

This relief also does not apply to transfers of contracts (e.g., portfolio transfers) that are not business combinations.

17.2.2 Disclosures about the effect of transition

At transition to IFRS 17, entities should provide the disclosures required by IAS 8 applicable to changes in accounting policies apart from the exemption discussed above (i.e., there is no requirement to present the amount of the adjustment resulting from applying IFRS 17 affecting each financial line item to either the current period or each prior period presented and the impact of applying IFRS 17 in those periods on earnings per share).

IAS 8 requires the following disclosures upon initial application of an IFRS: *[IAS 8.28]*

- The title of the IFRS accounting standard (i.e., IFRS 17)
- A statement that the change in accounting policy is made in accordance with the transitional provisions
- The nature of the change in accounting policy
- Where applicable, a description of the transitional provisions (which means that an entity would need to explain whether and how it had applied the retrospective, modified retrospective and fair value approaches)
- When applicable, the transitional provisions that might have an effect on future periods
- The amount of any adjustment relating to periods prior to the accounting periods presented in the financial statements, to the extent practicable
- If retrospective application is impracticable, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy is consistently applied

In addition, as discussed in section 16.2 above, entities are required to provide disclosures to enable users of the financial statements to identify the effects of groups of insurance contracts measured at transition date applying the modified retrospective approach or the fair value approach on the contractual service margin in subsequent periods. This information is provided in the form of reconciliations. In all periods for which disclosures are made for those contracts which used the modified retrospective or fair value approach on transition, an entity should continue to explain how it determined the measurement requirements at transition date.

17.3 Retrospective application of transition

When applying IFRS 17 retrospectively, an entity must: *[IFRS 17.C4]*

- Identify, recognise and measure each group of insurance contracts as if IFRS 17 had always applied
- Identify, recognise and measure any assets for insurance acquisition cash flows as if IFRS 17 had always applied (except that an entity is not required to apply the recoverability assessment test discussed in section 9.10 above before the transition date)
- Derecognise any existing balances that would not exist had IFRS 17 always applied
- Recognise any resulting net difference in equity

The balances derecognised upon application of IFRS 17 would include balances recognised previously under IFRS 4, as well as items such as deferred acquisition costs, deferred origination costs (for investment contracts with discretionary participation features) and some intangible assets that relate solely to existing contracts. The requirement to recognise any net difference in equity means that no adjustment is made to the carrying amounts of goodwill from any previous business combination. *[IFRS 17.BC374]*. However, the value of contracts within the scope of IFRS 17 that were acquired in prior period business combinations or transfers would have to be adjusted by the acquiring entity from the date of acquisition (i.e., initial recognition of the contracts) together with any intangible related to those in-force contracts (see section 14 above).

Any intangible asset derecognised would include an intangible asset that represented the difference between the fair value of insurance contracts acquired in a business combination or transfer. It would also include a liability measured in accordance with an insurer's previous accounting practices for insurance contracts where an insurer previously chose the option in IFRS 4 to use an expanded presentation that split the fair value of acquired insurance contracts into two components. *[IFRS 4.31]*.

Applying the standard retrospectively means that the comparative period (i.e., the annual reporting period immediately preceding the date of initial application) must be restated and comparative disclosures made in full in the first year of application subject to the exemptions noted below. An entity may also present adjusted comparative information applying IFRS 17 for any earlier periods (i.e., earlier than the annual reporting period immediately preceding the date of initial application) but is not required to do so. If an entity does present adjusted comparative information for any prior periods, the reference to 'the beginning of the annual reporting period immediately preceding the date of initial application' (see section 17.1 above) must be read as 'the beginning of the earliest adjusted comparative period presented'. *[IFRS 17.C25]*. However, an entity is not required to provide the disclosures specified in section 16 above for any period presented before the beginning of the annual accounting period immediately preceding the date of initial application. *[IFRS 17.C26]*. This relief is intended for entities that are required to present more than one comparative period in their annual financial statements.

If an entity presents unadjusted comparative information and disclosures for any earlier periods, it must clearly identify the information that has not been adjusted, disclose that it has been prepared on a different basis, and explain that basis. *[IFRS 17.C27]*.

The requirement to apply IFRS 17 retrospectively as if it had always applied, means that an entity that elects not to change estimates made in previous interim financial statements (see section 15.4 above) must estimate the contractual service margin for all individual interim periods previously presented, in order to get to a number for the contractual service margin that reflects that as if IFRS 17 had always been applied. *[IFRS 17.B137]*. This is based on the fact that only a fully retrospective interim contractual service margin roll-forward would provide the outcome that corresponds to a situation as if IFRS 17 had always been applied. Retrospective application of the standard by an entity that issues interim financial statements may present significant additional operational challenges for insurers upon transition. This is because the contractual service margin for each interim reporting period subsequent to initial recognition of a group of contracts would need to be tracked and estimated in accordance with the requirements in IFRS 17 to determine the contractual service margin on transition date. Therefore, for entities applying the modified retrospective approach, transitional relief is available from this requirement (see section 17.4 below).

The IASB considered that some stakeholders implementing IFRS 17 thought that the inclusion of specified modifications in IFRS 17 implies that an entity cannot make estimates in applying IFRS 17 retrospectively. The Board noted that IAS 8.51, which states that "...the objective of estimates related to prior periods remains the same as estimates related to the current period, namely, for the estimates to reflect the circumstances that existed when the transaction, other event or condition occurred" specifically acknowledges the need for estimates in retrospective application and that this paragraph applies to entities that apply IFRS 17 for the first time, just as it does to entities that apply other IFRS accounting standards for the first time. *[IFRS 17.BC380C]*.

In addition, some stakeholders suggested that the Board could reduce the burden of applying the transition requirements by specifying methods that can be used, for example, methods using information from embedded value reporting or information prepared for regulatory reporting purposes. However, the Board rejected this suggestion and concluded that specifying methods would conflict with the approach in IFRS 17 of establishing measurement objectives that can be satisfied using different approaches. In particular situations, some methods may be more applicable, or may be easier to implement, and it would not be practicable for an IFRS accounting standard to specify in detail every situation in which particular methods would be appropriate. The appropriateness of any method depends on the particular facts and circumstances. Furthermore, specifying methods could risk incorrectly implying other methods that would satisfy the requirements of IFRS 17, cannot be used. *[IFRS 17.BC380D]*.

How we see it

IFRS 17 does not include, unlike some other IFRS accounting standards, a simplification for contracts that have been derecognised before transition date. This is due to the inherent reliance of the model on the contractual service margin at initial recognition of a group of contracts, combined with the long-term nature of many insurance contracts. The consequence is that full retrospective application will be impracticable in more situations because entities will not have sufficient historic information for contracts that were derecognised in the past.

There is likely to be considerable diversity of practice across entities in calculating the contractual service margin at transition date. This will result in potentially different releases of the contractual service margin (i.e., different profit) for similar types of contracts in subsequent accounting periods. This explains why the Board included a requirement for disclosures that track the effects of the modified retrospective approach and the fair value approach on the contractual service margin and insurance revenue in future periods (see section 16.2 above).

Full retrospective application is based on a revision of estimates for all periods after the initial recognition of a group of contracts, requiring the use of historical data. Particularly for long-duration contracts, full retrospective application is likely to be impracticable in many cases, because an entity would have to use hindsight if some of the historical data is lacking.

17.4 Modified retrospective approach

This approach contains a series of permitted modifications to (full) retrospective application, as follows: *[IFRS 17.C7]*

- Assessment of insurance contracts or groups of insurance contracts that would have been made at the date of inception or initial recognition (see section 17.4.1 below)
- Amounts related to the contractual service margin or loss component for insurance contracts without direct participation features (see section 17.4.2 below)
- Amounts related to the contractual service margin or loss component for insurance contracts with direct participation features (see section 17.4.3 below)
- Insurance finance income or expenses (see section 17.4.4 below)

An entity is permitted to use each modification listed above only to the extent that it does not have reasonable and supportable information to apply a full retrospective approach. *[IFRS 17.C8]*.

The objective of the modified retrospective approach is to achieve the closest outcome to retrospective application possible using reasonable and supportable information available without undue cost or effort. Accordingly, in applying this approach, an entity must: *[IFRS 17.C6]*

- Use reasonable and supportable information. If the entity cannot obtain reasonable and supportable information necessary to apply the modified retrospective approach, it should apply the fair value approach.
- Maximise the use of information that would have been used to apply a fully retrospective approach, but only use information available without undue cost or effort.

'Undue cost and effort' is not defined in IFRS accounting standards. However, *IFRS for Small and Medium-sized Entities* (IFRS for SMEs) states that considering whether obtaining or determining the information necessary to comply with a requirement would involve undue cost or effort depends on the entity's specific circumstances and on management's judgement of the costs and benefits from applying that requirement. This judgement requires consideration of how the economic decisions of those that are expected to use the financial statements could be affected by not having that information. Applying a requirement would involve undue cost or effort by a small and medium sized entity (SME) if the incremental cost (for example, valuers' fees) or additional effort (for example, endeavours by employees) substantially exceed the benefits those that are expected to use the SME's financial statements would receive from having the information. The Basis for Conclusions to the IFRS for SMEs further observes that:

- The undue cost or effort exemption is not intended to be a low hurdle. This is because an entity is required to carefully weigh the expected effects of applying the exemption on the users of the financial statements against the cost or effort of complying with the related requirement. In particular, the IASB observed that it would expect that if an entity already had, or could easily and inexpensively acquire, the information necessary to comply with a requirement, any related undue cost or effort exemption would not be applicable. This is because, in that case, the benefits to the users of the financial statements of having the information would be expected to exceed any further cost or effort by the entity.

  And

- An entity must make a new assessment of whether a requirement will involve undue cost or effort at each reporting date.

The IASB's Conceptual Framework also notes that although cost is a pervasive constraint on the information provided by financial reporting and that the cost of producing information must be justified by the benefits that it provides, the cost is ultimately borne by the users (not the preparers) and implies that any cost constraint should be seen from a user's viewpoint. If needed information is not provided, users incur additional costs to obtain that information elsewhere or to estimate it. *[CF 2.39, CF 2.40]*.

To use each modification, an entity must have the reasonable and supportable information necessary to apply that modification. If not, the entity is required to apply the fair value approach to the group of insurance contracts. The Basis for Conclusions observes that the Board expects that estimates will often be needed when applying a specified modification in the modified retrospective approach. *[IFRS 17.BC380A, IFRS 17.BC380C]*.

The Board considered feedback from entities implementing IFRS 17 that said the requirement to use reasonable and supportable information significantly increases the costs of applying the modified retrospective approach. The Board acknowledged that removing the requirements relating to the use of reasonable and supportable information might provide significant cost relief for those entities. However, the Board disagreed with suggestions to amend IFRS 17 in that regard because, in its view, entities should use information that is reasonable and supportable. Permitting an entity to use information that is not reasonable and supportable would undermine the credibility of the information that results from applying IFRS 17. In addition, permitting an entity to ignore reasonable and supportable information available without undue cost or effort that the entity would have used to apply a retrospective approach would be contrary to the objective of the modified retrospective approach and would reduce comparability between contracts issued before and after the transition date. *[IFRS 17.BC380B]*.

How we see it

Basis for Conclusions articulates the IASB's intent that an entity is allowed to make estimates when applying a specified modification in the modified retrospective approach. This clarification of what the IASB intended will assist entities in applying the modified retrospective approach.

17.4.1 Assessments at inception or initial recognition

When it is impracticable for an entity to apply the retrospective approach to a group of contracts at initial recognition, it must determine the following by using information available at the transition date: *[IFRS 17.C9]*

- How to identify groups of contracts (see section 6 above)
- Whether an insurance contract meets the definition of an insurance contract with direct participation features (see section 12.3.1 above)
- How to identify discretionary cash flows for insurance contracts without direct participation features (see section 12.2 above)
- Whether an investment contract meets the definition of an investment contract with discretionary participation features (see section 12.4 above)

To apply IFRS 17 retrospectively, an entity needs to determine the group of insurance contracts to which individual contracts would have belonged on initial recognition. IFRS 17 requires entities to group only contracts written within one year. *[IFRS 17.BC391]*.The IASB considered that it may not always be practicable for entities to group contracts written in the same one year period retrospectively. *[IFRS 17.BC392]*. Consequently, in aggregating contracts when it is impracticable to apply a retrospective approach, an entity is permitted (to the extent that reasonable and supportable information does not exist) to aggregate contracts in a portfolio issued more than one year apart into a single group. *[IFRS 17.C10]*. This may mean that a single group of, say, term life contracts, could span many years to the extent that reasonable and supportable information would not be available to aggregate the contracts into groups that only contain contracts issued within one year.

To the extent there is no reasonable and supportable information, as discussed above, an entity must classify as a liability for incurred claims, a liability for settlement of claims incurred before an insurance contract was acquired in a transfer of business contracts that do not form a business or in a business combination within the scope of IFRS 3 (see section 14.2 above). *[IFRS 17.C9A]*. This relief was added in response to feedback that suggested that it would often be impracticable for an entity to apply IFRS 17 retrospectively to contracts acquired before the transition date (that is, to classify and measure those contracts as a liability for remaining coverage). *[IFRS 17.BC382A]*.

17.4.2 Determining the contractual service margin or loss component for groups of insurance contracts without direct participation features

When it is impracticable for an entity to apply the full retrospective approach at initial recognition to determine the contractual service margin or the loss component of the liability for remaining coverage, it is permitted to determine these at transition date using a modified approach to determine the components of the liability for remaining coverage. *[IFRS 17.C11]*.

The modified retrospective approach requires that reasonable and supportable information exists for the cash flows prior to transition up until the date of initial recognition (i.e., the date past which reasonable and supportable information is no longer available). This means all of the cash flows within the boundary of the insurance contract, as discussed in section 9.1 above, including, for example, internally allocated directly attributable insurance acquisition cash flows, claims handling costs, policy maintenance and administration costs and an allocation of fixed and variable overheads.

The modified retrospective approach allows considerable judgement as it permits an entity to go back as far as it is able in order to determine reliable accounting estimates for the fulfilment cash flows. Inevitably, this will result in diversity in practice by first time adopters and some lack of comparability in the release of the contractual margin in future periods between entities with longer-term contracts.

The process applied is as follows:

- The future cash flows at the date of initial recognition of a group of insurance contracts must be estimated as the amount of the future cash flows at the transition date (or earlier, if the future cash flows at the earlier date can be determined retrospectively), adjusted by the cash flows that have occurred between the date of initial recognition of a group of insurance contracts and the transition date (or earlier date). The cash flows known to have occurred include those resulting from contracts that were derecognised before the transition date. *[IFRS 17.C12]*.
- The discount rates that applied at the date of initial recognition of a group of insurance contracts (or subsequently) must be determined: *[IFRS 17.C13]*
  - Using an observable yield curve that, for at least three years immediately before the transition date, approximates the yield curve estimated applying a basis comparable with the general approach to calculating discount rates (see section 9.3 above), if such an observable yield curve exists.

    Or
  - If the observable yield curve described above does not exist, the discount rates that applied at the date of initial recognition, or subsequently, should be estimated by determining an average spread between an observable yield curve and the yield curve estimated applying the general approach, and applying that spread to that observable yield curve. That spread should be an average over at least three years immediately before the transition date.
- The risk adjustment for non-financial risk at the date of initial recognition of a group of insurance contracts, or subsequently, must be determined by adjusting the risk adjustment for non-financial risk at the transition date by the expected release of risk before the transition date. The expected release of risk must be determined by reference to the release of risk for similar insurance contracts that the entity issues at the transition date. *[IFRS 17.C14]*.

An entity must use the same systematic and rational method that it expects to use after the transition date to allocate any insurance acquisition cash flows paid (or for which a liability has been recognised applying another IFRS accounting standard) before the transition date (excluding any amount relating to insurance contracts that ceased to exist before the transition date) to: *[IFRS 17.C14B]*

- Groups of insurance contracts recognised at the transition date
- Groups of insurance contracts that are expected to be recognised after the transition date

Insurance acquisition cash flows paid before the transition date that are allocated to a group of insurance contracts that is recognised at the transition date adjust the contractual service margin of that group, to the extent insurance contracts expected to be in the group have been recognised at that date. Other insurance acquisition cash flows paid before the transition date, including those that are allocated to a group of insurance contracts that is expected to be recognised after the transition date, are also recognised as an asset (see section 7.3 above). *[IFRS 17.C14C]*.

This systematic and rational method mentioned above must be the same systematic and rational method as the entity expects to apply after the transition date (see section 7.3 above). To the extent that the entity does not have reasonable and supportable information to use a systematic and rational method, the following amounts must be determined to be nil at the transition date: *[IFRS 17.C14D]*

- The adjustment to the contractual service margin of groups of insurance contracts that are recognised at the transition date and any asset for insurance acquisition costs relating to that group
- The asset for insurance acquisition cash flows for groups of insurance contracts that are expected to be recognised after the transition date

The purpose of this modification is to avoid an entity not being allowed to use the modified retrospective approach and having to use the fair value approach solely because of a lack of information about insurance acquisition cash flows before transition date.

An entity that makes an accounting policy choice not to change the treatment of accounting estimates made in previous interim financial statements (see section 15.4 above) must determine the contractual service margin or loss component at the transition date as if it had not prepared interim financial statements before the transition date, if there is no reasonable and supportable information to apply a retrospective approach. *[IFRS 17.C14A]*. This means that entities without reasonable and supportable retrospective information do not have to recalculate insurance contract liabilities prior to transition date on a more frequent basis than annual.

If applying the modified requirements above results in a contractual service margin at initial recognition, the entity must determine the contractual service margin at transition date, as follows: *[IFRS 17.C15]*

- Use the modified discount rates calculated above to accrete interest on the contractual service margin
- Determine the amount of the contractual service margin recognised in profit or loss because of the transfer of services before the transition date, by comparing the remaining coverage units at that date with the coverage units provided under the group of contracts before the transition date (see section 9.7 above)

If applying the modified requirements above results in a loss component of that liability for remaining coverage at the date of initial recognition, an entity must determine any amounts allocated to that loss component before the transition date applying the modified requirements above and using a systematic basis of allocation. *[IFRS 17.C16]*.

For a group of reinsurance contracts held that provides coverage for an onerous group of insurance contracts and was acquired before or at the same time that the insurance contracts were issued, an entity should establish a loss-recovery component of the asset for remaining coverage at the transition date (see section 11.4.3 above). To the extent that there is no reasonable and supportable information to apply a retrospective approach, the entity must determine the loss-recovery component by multiplying: *[IFRS 17.C16A]*

- The loss component of the liability for remaining coverage for the underlying insurance contracts at the transition date

  And

- The percentage of claims for the group of underlying insurance contracts the entity expects to recover from the group of reinsurance contracts held

However, if an entity does not have reasonable and supportable information to determine the loss recovery, it is not permitted to identify a loss-recovery component for the group of reinsurance contracts held. *[IFRS 17.C16C]*.

At the transition date, onerous underlying insurance contracts might include in an onerous group of insurance contracts both onerous insurance contracts covered by the group of reinsurance contracts held and onerous insurance contracts not covered by a group of reinsurance contracts held. In that case, for the purpose of determining the loss-recovery component, the entity must use a systematic and rational basis of allocation to determine the portion of the loss component of the group of insurance contracts that relates to insurance contracts covered by the group of reinsurance contracts held. *[IFRS 17.C16B]*.

The following Illustration, based on Example 17 in the Illustrative Examples to IFRS 17, shows the measurement of contracts without direct participation features at the transition date using the modified retrospective approach: *[IFRS 17.IE186-191]*

Illustration 17-2: Measurement of groups of insurance contracts without direct participation features applying the modified retrospective approach

An entity issues insurance contracts without direct participation features and aggregates those contracts into groups. The entity estimates the fulfilment cash flows at the transition date applying the general model as the sum of:

- An estimate of the present value of future cash flows of CU620 (including the effect of discounting of CU(150))

  And

- A risk adjustment for non-financial risk of CU100

The entity concludes that it is impracticable to apply IFRS 17 retrospectively. As a result, the entity chooses to apply the modified retrospective approach to measure the contractual service margin at the transition date. The entity uses reasonable and supportable information to achieve the closest outcome to retrospective application.

Analysis

The entity determines the contractual service margin at the transition date by estimating the fulfilment cash flows on initial recognition, as follows:

Future cash flows at the date of initial recognition of the group of insurance contracts are estimated to be the sum of future cash flows of CU770 at the transition date and cash flows of CU800 that are known to have occurred between the date of initial recognition of the group of insurance contracts and transition date. This includes premiums paid on initial recognition of CU1,000 and cash outflows of CU200 paid during the period. This amount includes cash flows resulting from contracts that ceased to exist before the transition date.

- The entity determines the effect of discounting at the date of initial recognition of the group of insurance contracts to equal CU(200), calculated as the discounting effect on estimates of future cash flows at the date of initial recognition determined above. The entity determines the effect of discounting by using a yield curve that, for at least three years immediately before the transition date, approximates the yield curve estimated applying the methodology described (see section 9.3 above). The entity estimates this amount to equal CU50, reflecting that the premium received on initial recognition; thus, the discounting effect relates only to future cash outflows.
- The entity determines the risk adjustment for non-financial risk on initial recognition of CU120, as the risk adjustment for the non-financial risk at the transition date of CU100 adjusted by CU20 to reflect the expected release of risk before the transition date. The entity determines the expected release of risk by reference to the release of risk for similar insurance contracts that the entity issues at the transition date.
- The contractual service margin on initial recognition is CU110, the amount that would result in no profit or loss on initial recognition of the fulfilment cash flows of CU110. The subsequent movement in the contractual service margin uses the discount rates derived above to accrete interest and recognises the amount in profit or loss because of the transfer of services. Comparing the remaining coverage units at the transition date with the coverage units provided by the group before the transition date results in CU90. Consequently, the contractual service margin on the transition date is CU20.

This is illustrated, as follows:

	Transition date	Adjustment to initial recognition	Initial recognition
	CU	CU	CU
Estimates of future cash flows	770	(800)	(30)
Effect of discounting	(150)	(50)	(200)
Risk adjustment for non-financial risk	100	20	120
Fulfilment cash flows	**720**	**(830)**	**(110)**
Contractual service margin	20	90	110
Liability for remaining coverage	**740**		-

How we see it

The modified retrospective approach allows considerable judgement, as it permits an entity to use historical data to determine reliable accounting estimates for the fulfilment cash flows. Inevitably, this will likely result in diversity in practice that reduces the comparability in the release of the contractual service margin in future periods between entities with longer-term contracts.

17.4.3 Determining the contractual service margin or loss component for groups of insurance contracts with direct participation features

When it is impracticable for an entity to apply the full retrospective approach, at initial recognition, to determine the contractual service margin or the loss component of the liability for remaining coverage for groups of contracts with direct participation features, these should be determined, as: *[IFRS 17.C17]*

- The total fair value of the underlying items at the transition date (A in the table in Illustration 17-3 below)

  Minus

- The fulfilment cash flows at the transition date (B)

  Plus or minus

- An adjustment for (C):
  - Amounts charged by the entity to policyholders (including amounts deducted from the underlying items) before that date.
  - Amounts paid before that date that would not have varied based on the underlying items.
  - The change in the risk adjustment for non-financial risk caused by the release from risk before that date. An entity should estimate this amount by reference to the release of risk for similar insurance contracts that the entity issues at the transition date.
  - Insurance acquisition cash flows paid (for which a liability has been recognised under another IFRS accounting standard) before the transition date that are allocated to the group.
- If the sum of (A) - (C) above results in a contractual service margin - minus the amount of the contractual service margin that relates to services provided before that date. The sum of (A)-(C) is a proxy for the total contractual service margin for all services to be provided under the group of contracts, i.e., before any amounts that would have been recognised in profit or loss for services provided. An entity should estimate the amounts that would have been recognised in profit or loss for services provided by comparing the remaining coverage units at the transition date with the coverage units provided under the group of contracts before the transition date.

  Or

- If the sum of (A) - (C) results in a loss component, adjust the loss component to nil and increase the liability for remaining coverage excluding the loss component by the same amount.

The following Illustration, based on Example 18 in the Illustrative Examples to IFRS 17, shows how to apply the modified retrospective approach to contracts with direct participation features at the transition: *[IFRS 17.IE192-199]*

Illustration 17-3: Measurement of groups of insurance contracts with direct participation features applying the modified retrospective approach

An entity issues 100 insurance contracts with direct participation features five years before the transition date and aggregates these contracts into a group. Under the terms of the contracts:

- A single premium is paid at the beginning of the coverage period of 10 years.
- The entity maintains account balances for policyholders and deducts charges from those account balances at the end of each year.
- A policyholder will receive an amount equal to the higher of the account balance and the minimum death benefit, if an insured person dies during the coverage period.
- If an insured person survives the coverage period, the policyholder receives the value of the account balance.

The following events occurred in the five-year period prior to the transition date:

- The entity paid death benefits and other expenses of CU239 comprising:
- CU216 of cash flows that vary based on returns from underlying items
- CU23 of cash flows that do not vary based on the returns from underlying items

  And

- The entity deducted charges from the underlying items of CU55

The entity estimates the fulfilment cash flows at the transition date to be CU922, comprising the estimates of the present value of the future cash flows of CU910 and a risk adjustment for non-financial risk of CU12. The fair value of the underlying items at that date is CU948.

The entity makes the following estimates:

- Based on an analysis of similar contracts that the entity issues at transition date, the estimated change in the risk adjustment for non-financial risk caused by the release from risk in the five-year period before transition date is CU14.

  And

- The units of coverage provided before the transition date is approximately 60% of the total coverage units of the group of contracts.

Analysis

The entity applies a modified retrospective approach to determine the contractual service margin at transition date. It determines that the contractual service margin for services provided before the transition date of CU26 is the percentage of the coverage units provided before the transition date, and the total coverage units of 60% multiplied by the contractual service margin before recognition in profit or loss is CU44. This is illustrated, as follows:

	CU
Fair value of the underlying items at transition date (A)	948
Fulfilment cash flows at the transition date (B)	(922)
Adjustments (C):	
Charges deducted from underlying items before the transition date	55
Amounts paid before transition date that would not have varied based on the returns on underlying items	(23)
Estimated change in the risk adjustment for non-financial risk caused by the release from risk before transition date	(14)
Contractual service margin of the group of contracts before recognition in profit or loss	**44**
Estimated amount of the contractual service margin that relates to services provided before the transition date	(26)
Estimated contractual service margin at the transition date	**18**

The total insurance contract liability at the transition date is CU940, which is the sum of the fulfilment cash flows of CU922 and the contractual service margin of CU18.

In addition, an entity must apply the same methodology described in section 17.4.2 above to recognise an asset for insurance acquisition cash flows, and any adjustment to the contractual service margin of a group of insurance contracts with direct participation features for insurance acquisition cash flows. *[IFRS 17.C17A]*.

How we see it

For the variable fee approach, the modified retrospective approach focuses on the contractual service margin for the open contracts at transition. However, historical information and estimates of certain effects, for example fees charged to policyholders or death benefits paid before the transition date, are still required for all contracts, including contracts derecognised before the transition date, in order to estimate the contractual service margin at transition.

Another important feature of the variable fee approach is that no loss component will exist at transition when the modified retrospective approach is applied. As a result, the possibility of an entity being able to establish a contractual service margin in case of favourable changes in circumstances after transition increases.

17.4.4 Insurance finance income or expenses

The modified requirements for insurance finance income or expenses differ depending on whether, as a result of applying the modified retrospective approach, groups of insurance contracts include those issued more than one year apart (see section 17.4.1 above).

17.4.4.A Groups of insurance contracts that include contracts issued more than one year apart

When an entity has aggregated a group of insurance contracts on a basis that includes contracts issued more than one year apart in the same group: *[IFRS 17.C18]*

- The entity is permitted to determine the discount rates at the date of initial recognition for the contractual service margin, the liability for remaining coverage and for incurred claims for contracts applying the premium allocation approach, as at the transition date instead of at the date of initial recognition or incurred claim date.
- If an entity chooses to disaggregate insurance finance income or expenses between amounts included in profit or loss and amounts included in other comprehensive income (see sections 15.3.1 to 15.3.4 above), the entity needs to determine the cumulative amount of insurance finance income or expenses recognised in other comprehensive income at the transition date in order to be able to reclassify any remaining amounts from other comprehensive income to profit or loss upon subsequent transfer or derecognition. The entity is permitted to determine the cumulative difference on transition either by:
  - Applying the requirements for groups of contracts that do not include contracts issued more than one year apart - see section 17.4.4.B below

    Or
  - As nil, except for:

    Insurance contracts with direct participation features where the entity holds the underlying items when the cumulative difference is equal to the cumulative amount recognised in other comprehensive income on the underlying items

The table below provides a summary of the requirements:

	Groups at transition date	
	Include contracts issued more than one year apart (see section 17.4.4.A)	**Do not include contracts issued more than one year apart (see section 17.4.4.B)**
1. Discount rates to determine insurance finance income or expenses subsequent to transition	Permitted to determine the discount rate at initial recognition and at the date of incurred claims, at the transition date instead of at the date of initial recognition or incurred claims	If an entity is applying the permitted modification in determining the discount rate at initial recognition (or subsequently), it must determine other discount rates in the same way
2. Cumulative other comprehensive income at transition date for: A) Groups of direct participating contracts for which entity holds underlying items	Equal to the cumulative amount recognised in other comprehensive income on the underlying items	
B) Groups of other contracts for which changes in financial assumptions have a substantial effect on the amounts paid to policyholders	Set to nil	Set to nil
C) Other groups of contracts subject to general model	Set to nil; or apply fully retrospective or modified retrospective approach to estimating discount rates at initial recognition	Determine cumulative difference by applying fully retrospective or modified retrospective approach to estimating discount rates at initial recognition
D) Groups of contracts subject to premium allocation approach- entity disaggregates interest expense on incurred claims	Set to nil; or apply fully retrospective approach or modified retrospective approach to estimating discount rates at initial recognition	Determine cumulative difference by applying fully retrospective or modified retrospective approach to estimating discount rates when claims incurred

How we see it

For groups of insurance contracts with direct participation features where disaggregation is applied and for which the entity holds the underlying items (i.e., application of the current period book yield approach), the modification for disaggregating insurance finance income or expenses at transition allows an entity to determine the cumulative amount of insurance finance income or expenses recognised in OCI at the transition date equal to the cumulative amount recognised in OCI on the underlying items at that date. In certain circumstances, the interaction of this provision with the initial application of IFRS 9 could result in mismatches between amounts accumulated in OCI for the underlying items and the amounts accumulated in OCI for insurance contracts on the date of initial application. This is because the modification is applied at the date of transition to IFRS 17 (1 January 2022) whereas the date of initial application of IFRS 9 is 1 January 2023. To the extent the amount recognised in OCI under the modification exceeds the amount recognised in OCI for the underlying items at the date of initial application, an entity could elect to transfer amounts recognised in OCI for the insurance liabilities to another part of equity. This is because this mismatch would reflect amounts that would not be reclassified to profit or loss in a future period and IFRS 17 or another IFRS accounting standard would not prohibit transferring such an amount from OCI to other parts of equity. Entities would have to consider any specific capital requirements that apply under local law and regulations.

17.4.4.B Groups of insurance contracts that do not include contracts issued more than one year apart

When an entity has aggregated a group of insurance contracts on a basis that does not include contracts issued more than one year apart in the same group: *[IFRS 17.C19]*

- If an entity applies the requirements in section 17.4.2 above for groups of insurance contracts without direct participation features to estimate the discount rates that applied at initial recognition (or subsequently), it must also determine the discount rates specified for accreting the interest on the contractual service margin, measuring the changes in the contractual service margin, discounting the liability for remaining coverage under the premium allocation approach and for disaggregated insurance finance income or expenses in the same way.
- If an entity chooses to disaggregate insurance finance income or expenses between amounts included in profit or loss and amounts included in other comprehensive income (see sections 15.3.1 to 15.3.4 above), the entity needs to determine the cumulative amount of insurance finance income or expenses recognised in other comprehensive income at the transition date in order to be able to reclassify any remaining amounts from other comprehensive income to profit or loss upon subsequent transfer or derecognition in future periods. The entity must determine the cumulative difference:
  - For insurance contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to policyholders - if it applies the requirements in section 17.4.2 above to estimate the discount rates at initial recognition - using the discount rates that applied at the date of initial recognition, also applying the requirements in section 17.4.2 above
  - For groups of insurance contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to policyholders, on the basis that the assumptions that relate to financial risk that applied at the date of initial recognition are those that apply on the transition date, i.e., as nil
  - For insurance contracts for which an entity will apply the premium allocation approach to discount the liability for incurred claims - if the entity applies the requirements in section 17.4.2 above to estimate the discount rates at initial recognition (or subsequently) - using the discount rates that applied at the date of the incurred claim, also applying the requirements in section 17.4.2 above
  - For insurance contracts with direct participation features where the entity holds the underlying items - as equal to the cumulative amount recognised in other comprehensive income on the underlying items

Although entities are permitted to set the cumulative balance in other comprehensive income for disaggregated insurance finance income or expenses at nil on transition in certain circumstances, the same option is not permitted under IFRS 9 for any related financial assets. Therefore, an accounting mismatch will arise. It is observed in the Basis for Conclusions that the Board considered feedback from some stakeholders that preferred alternative modifications to those modifications set out above for determining the amount of insurance finance income or expenses accumulated in other comprehensive income at the transition date in order to resolve the accounting mismatch. The Board disagreed with these suggestions on various grounds and declined to amend either IFRS 9 or IFRS 17. *[IFRS 17.BC384A, IFRS 17.BC384B]*.

In addition, to the extent that an entity has made an accounting policy choice not to change the treatment of accounting estimates made in previous interim financial statements and is unable to apply this treatment retrospectively (see section 17.4.1 above) it should determine amounts related to insurance finance income or expenses at the transition date as if it had not prepared interim financial statements before the transition date.

How we see it

The possibility and, in some cases, the requirement, to set OCI related to insurance liabilities on transition to nil, sometimes referred to as the 'fresh start' approach may be viewed as an important aspect to managing the transition effects of IFRS 17. In particular, this will be the case in jurisdictions where interest rates guaranteed in the past are relatively high compared with the existing low interest rate environment that may still apply at transition. This approach would immediately affect shareholder's equity at transition, but more favourably impact profit or loss in the years after transition due to a lower interest accretion on the insurance liabilities. If setting OCI balances to nil, entities should carefully consider what rate at initial recognition will be used for disaggregating insurance finance income or expenses after transition. Under the modified retrospective approach, the standard allows entities to set the rate at the transition date rather than at the inception date. Using the rate at transition would, in our view, best align with an OCI balance of nil as the rate at the transition date would be consistent with a transition OCI balance of nil under the IFRS 17 model.

For contracts with direct participation features applying the current period book-yield approach, the simplification to set the OCI balance for the insurance liabilities at the amount of the underlying items at transition seems logical. Where the interaction of this provision with the initial application of IFRS 9 results in mismatches between amounts accumulated in OCI for the underlying items and the amounts accumulated in OCI for insurance contracts on the date of initial application, an entity could elect to transfer amounts recognised in OCI for the insurance liabilities to another part of equity (see our comment under section 17.4.4.A above).

17.5 Fair value approach

The fair value approach is:

- Permitted as an alternative to the modified retrospective approach for a group of contracts when full retrospective application of that group of contracts is impracticable (see section 17.2 above)

  Or

- Required when full retrospective application of a group of contracts is impracticable and an entity cannot obtain reasonable and supportable information for that group of contracts to use the modified retrospective approach (see section 17.3 above)

  Or

- Permitted for a group of insurance contracts with direct participation features when risk mitigation has been applied prospectively to the group from the transition date and the entity has used derivatives, reinsurance contracts held or non-derivative financial instruments at fair value through profit or loss to mitigate financial risk arising from that group of contracts before transition date (see section 12.3.5 above)

To apply the fair value approach, an entity must determine the contractual service margin or loss component of the liability for remaining coverage at the transition date as the difference between the fair value of a group of insurance contracts and the fulfilment cash flows measured at that date. In determining fair value, an entity must apply the requirements of IFRS 13. This excludes the requirement that the fair value of a financial liability with a demand feature (e.g., a demand deposit floor) cannot be less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. *[IFRS 17.C20]*. This means that insurance contract liabilities can be measured at an amount lower than the discounted amount repayable on demand.

For a group of reinsurance contracts held to which the underlying insurance contracts are onerous at the transition date, an entity determines the loss-recovery component of the asset for remaining coverage by multiplying: *[IFRS 17.C20A]*

- The loss component for the liability for remaining coverage for the underlying insurance contracts at the transition date

  And

- The percentage of claims for the group of underlying insurance contracts the entity expects to recover from the group of reinsurance contracts held

At the transition date, onerous underlying insurance contracts might be included in a group of insurance contracts with other onerous insurance contracts that are not covered by the group of reinsurance contracts held. In that case, for the purpose of applying the calculation above, an entity must use a systematic and rational basis of allocation to determine the portion of the loss component of the group of insurance contracts that relates to insurance contracts covered by the group of reinsurance contracts held. *[IFRS 17.C20B]*.

How we see it

When applying the fair value approach at transition to a group of insurance contracts that contains both liabilities for remaining coverage and incurred claims, the question arises whether the difference between the fulfilment cash flows and the fair value of that group should include liabilities for remaining coverage as well as the liabilities for incurred claims (as the liability for incurred claims does not contain a contractual service margin). In our view, because IFRS 17.C20 requires the fair value approach to be applied at the level of a group of insurance contracts, the fulfilment cash flows of the group and its fair value should consider both liabilities for remaining coverage and liabilities for incurred claims in that situation.

In applying the fair value approach, an entity may use reasonable and supportable information for what the entity would have determined, given the terms of the contract and market conditions at the date of inception or initial recognition, as appropriate or, alternatively, reasonable and supportable information at the transition date in determining the following: *[IFRS 17.C21, IFRS 17.C22]*

- How to identify groups of insurance contracts
- Whether an insurance contract meets the definition of an insurance contract with direct participation features
- How to identify discretionary cash flows for insurance contracts without direct participation features
- Whether an investment contract meets the definition of an investment contract with discretionary participation features (see section 12.4 above)

In addition, the general requirements of IFRS 17 are modified when the fair value approach is used as follows: *[IFRS 17.C23]*

- An entity may choose to classify as a liability for incurred claims, a liability for settlement of claims incurred before an insurance contract was acquired in a transfer of insurance contracts that do not form a business or in a business combination within the scope of IFRS 3. *[IFRS 17.C22A]*.
- When determining groups of insurance contracts, an entity may include those issued more than one year apart. An entity is only allowed to divide groups into those that include contracts issued within a year or less if it has reasonable and supportable information to make the decision. This reflects the Board's expectation that grouping of contracts issued within a year (or less) will be challenging in situations where the fair value approach is applied. *[IFRS 17.C23]*.
- An entity determines the discount rate at the date of initial recognition of a group of contracts and discount rates of incurred claims under the premium allocation approach (when discounting has been elected - see section 10.5 above) at the transition date instead of the date of the initial recognition or incurred claim. *[IFRS 17.C23]*.

Frequently asked questions

Question 17-1: In applying the fair value approach on transition, should the fair value reflect the non-performance risk of the entity?

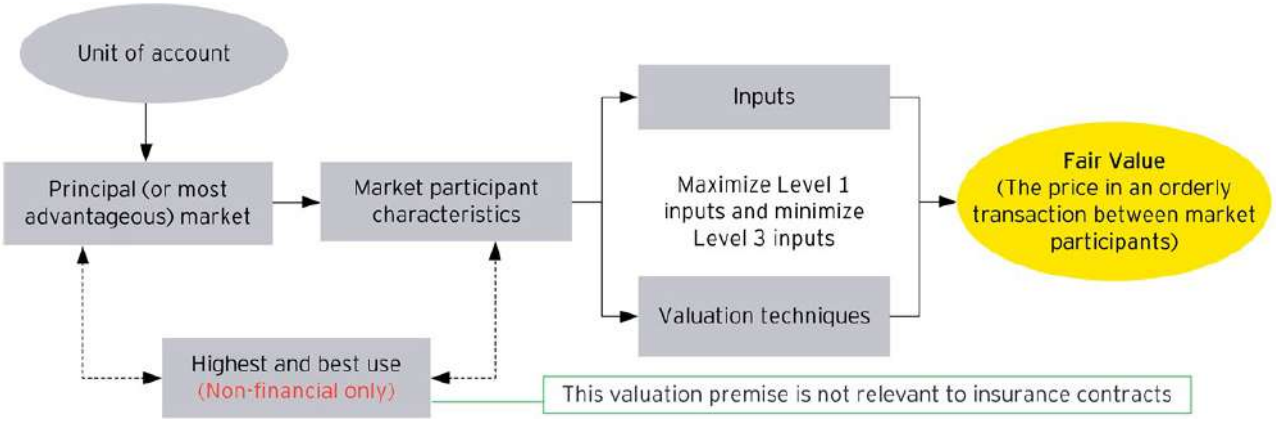
(TRG meeting April 2019 - Agenda paper no. 02, Log S127)

The IASB staff confirmed that when, applying the fair value approach, an entity determines the contractual service margin by comparing the fulfilment cash flows and the fair value of a group of insurance contracts. The fair value measurement in this situation reflects the effect of non-performance risk as required by IFRS 13 (but not the requirements relating to demand features). However, the fulfilment cash flows of an entity do not reflect the non-performance risk of the entity and this applies also to the fulfilment cash flows of an entity using the fair value approach on transition. Therefore, the fulfilment cash flows of an entity that applies the fair value approach on transition exclude non-performance risk, but non-performance risk is considered when determining the fair value of a group of contracts at transition date for the purpose of the calculation of the contractual service margin as the difference between the fulfilment cash flows and fair value.

Illustration 17-4: The fair value framework

The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions. *[IFRS 13.BC55-BC59]*.

This diagram below illustrates the interdependence of the various components of the fair value measurement principles in IFRS 13. All of these interdependent components need to be considered. A decision on one will impact another and, thus, conclusions will require refinement as each component is considered.



The unit of account determines the level at which an asset or liability is aggregated or disaggregated for financial reporting purposes. IFRS 17 determines the unit of account to determine the fair value of a group of insurance contracts for both business combinations (see section 14 above) and transition purposes.

The reference market determines the possible source of market data (whether observable or estimated using a valuation technique) that can be used within the fair value calculation as well as the characteristics of a hypothetical market participant. If there is a principal market for the asset or liability being measured, fair value should be determined using the price in that market, even if a price in a different market is more advantageous at the measurement date. Only in situations where there is no principal market for the asset or liability being measured, can an entity consider the most advantageous market. The most advantageous market is the one that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability. The entity must have access to the market at the measurement date.

Market participants are other entities with whom the entity would enter into a transaction in the reference market. Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics: *[IFRS 13.BC55-BC59]*

- Independent of each other
- Knowledgeable, having a reasonable understanding about the asset or liability
- Willing to enter into a transaction for the asset or liability
- Able to enter into a transaction

Three widely used valuation techniques are the market approach, the cost approach and the income approach. An entity must use valuation techniques consistent with one or more of those approaches to measure fair value. *[IFRS 13.62]*.

Some of the key differences between the measurement model under IFRS 17 fulfilment cash flows and the fair value measurement approach under IFRS 13 are:

	IFRS 17 fulfilment cash flows	IFRS 13 fair value
Overall objective	Fulfilment of insurance contract, but considering consistency with market information where necessary	View of a (hypothetical) market participant
Entity's own risk of non-performance	Excludes own risk of non-performance	Includes own risk of non-performance
Adjustment for risk	Reflecting the entity's perception of non-financial risk	Reflecting a market participant's perception of risk
Service margin	N/A	Service margin required by a market participant

How we see it

Determining fair value will pose many challenges and require significant judgement. An important area is the level of aggregation and its impact on diversification. The fair value of a single group of insurance contracts may not take into account any benefits of diversification which would likely be considered by entities when determining the fulfilment cash flows.

IFRS 13 includes a requirement on demand deposits, which means that the fair value of a financial liability with a demand feature can never be less than present value of the amount payable on demand. This requirement does not have to be applied when calculating the fair value of insurance contracts at transition. However, all other IFRS 13 requirements must be applied in determining fair value, including the requirement to consider the entity's own non-performance risk.

17.5.1 Disaggregated insurance finance income or expenses using the fair value approach

If an entity chooses to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income, it is permitted to determine the cumulative amount of insurance finance income or expenses recognised in other comprehensive income at the transition date: *[IFRS 17.C24]*

- Retrospectively, but only if it has reasonable and supportable information to do so

  Or
- As nil, unless the below applies
- For insurance contracts with direct participation features where the entity holds the underlying items, as equal to the cumulative amount recognised in other comprehensive income from the underlying items

How we see it

Although the above-mentioned option allows for other comprehensive income to be set at nil on transition, no equivalent option exists under transition to IFRS 9 for financial assets held at fair value through other comprehensive income. Entities should, therefore, carefully evaluate the combined transition impact of IFRS 17 and IFRS 9 and determine a transition approach that results in a useful depiction of this relationship in the years after transition.

17.5.2 Asset for insurance acquisition cash flows using the fair value approach

In applying the fair value approach for an asset for insurance acquisition cash flows, an entity determines an asset for insurance acquisition cash flows at the transition date at an amount equal to the amount of insurance acquisition cash flows the entity would incur at the transition date for the rights to obtain: *[IFRS 17.C24A]*

- Recoveries of insurance acquisition cash flows from premiums of insurance contracts issued before the transition date but not yet recognised at the transition date (a)
- Future insurance contracts that are renewals of insurance contracts recognised at the date of transition and insurance contracts described in (a) above, (b)
- Future insurance contracts, other than those in (b) above, after the date of transition without paying again insurance acquisition cash flows the entity has already paid that are directly attributable to the related portfolio of insurance contracts

The amount of any asset for insurance acquisition cash flows is excluded from the measurement of any groups of insurance contracts recognised at the transition date. *[IFRS 17.C24B]*.

Frequently asked questions

Question 17-2: When the fair value approach to transition is applied, are insurance acquisition cash flows that occurred prior to the transition date recognised as revenue and expenses in the statement of financial performance applying paragraphs B121(b) and B125 of IFRS 17 for reporting periods subsequent to the transition date?

(TRG meeting February 2018 - Agenda paper no. 06, Log S05)

The TRG members noted that:

- Applying the fair value transition approach means that the amount of insurance acquisition cash flows included in the measurement of the contractual service margin will be only amounts occurring after the transition date that are also included in the fulfilment cash flows. When this approach to transition is applied, an entity is not permitted to include in the measurement of the contractual service margin any insurance acquisition cash flows occurring prior to the date of transition.
- The fair value approach is intended to provide an entity with a 'fresh start' approach to transition.
- Since insurance acquisition cash flows that occurred prior to the transition date are not included in the measurement of the contractual service margin at the transition date, they are not included in the presentation of insurance revenue and expenses for reporting periods subsequent to the transition date.

The IASB staff noted that this analysis applies in all situations that the fair value transition approach is taken, irrespective of whether the entity can identify and measure the insurance acquisition cash flows that applied prior to the transition date.

How we see it

Even though the fair value transition approach of IFRS 17 allows for the recognition of an asset for insurance acquisition cash flows for contracts to be recognised *after the transition date* (see section 7.3 above), no insurance acquisition cash flows should be included in the measurement of any contracts included in the measurement of the groups of contracts recognised at the transition date.

17.6 Redesignation of financial assets and financial liabilities - when IFRS 9 has been applied previously

IFRS 17 allows a generous degree of dispensation for entities to redesignate their financial assets within the scope of IFRS 9 when IFRS 17 is applied. In addition, a consequential change to IFRS 9 allows redesignation of financial liabilities in certain circumstances.

17.6.1 Redesignation of financial assets

At the date of initial application of IFRS 17, an entity that had applied IFRS 9 to annual reporting periods before the initial application of IFRS 17: *[IFRS 17.C29]*

- May reassess whether an eligible financial asset meets the condition to be held within a business model whose objective is to hold financial assets in order to collect contractual cash flows, or is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. A financial asset is eligible only if the financial asset is held for an activity that is connected with contracts within the scope of IFRS 17. Examples of financial assets that would not be eligible for reassessment are financial assets held for banking activities or financial assets held for investment contracts that are outside the scope of IFRS 17
- Must revoke its designation of a financial asset measured at fair value through profit or loss if the original designation was made to avoid or reduce an accounting mismatch and that accounting mismatch no longer exists because of the application of IFRS 17
- May designate a financial asset as measured at fair value through profit or loss if, in doing so, it eliminates or significantly reduces an accounting mismatch that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on different bases
- May irrevocably elect to designate an investment in an equity instrument at fair value through other comprehensive income, provided that equity instrument is neither held for trading nor contingent consideration recognised by an acquirer in a business combination to which IFRS 3 applies
- May revoke its previous designation of an investment in an equity instrument at fair value through other comprehensive income

An entity must apply the above based on the facts and circumstances that exist at the date of initial application of IFRS 17. An entity must apply these designations and classifications retrospectively. In doing so, it must apply the relevant requirements in IFRS 9. The date of initial application for that purpose is deemed to be the date of initial application of IFRS 17 (i.e., accounting periods beginning on or after 1 January 2023). *[IFRS 17.C30]*.

However, for a financial asset derecognised between the transition date and date of initial application of IFRS 17 an entity may apply the classification overlay (see section 17.7 below) for the purpose of presenting comparative information as if IFRS 17.C29 (i.e., the requirements set out immediately above) had been applied to that asset. Such an entity adapts the requirements of the classification overlay so that it is based on how the entity expects the financial asset would be designated applying the bullet points above at the date of initial application of IFRS 17. *[IFRS 17.C33A]*. The classification overlay, therefore, permits an entity to redesignate financial instruments derecognised in the comparative periods to avoid accounting mismatches in those comparative periods.

Any changes resulting from applying the above do not require the restatement of prior periods. However, the entity may restate prior periods only if it is possible without the use of hindsight. This may result in a situation whereby the comparative period is restated for IFRS 17 (which may include changes that affect financial instruments within the scope of IFRS 9). For example, accounting for investment components that are separated, but not for consequential changes resulting in the classification of financial assets (this situation will also potentially arise when an entity has not previously applied IFRS 9 (see section 17.7 below). If an entity restates prior periods, the restated financial statements must reflect all IFRS 9 requirements for those affected financial assets. If an entity does not restate prior periods, the entity must recognise, in the opening restated earnings (or other component of equity, as appropriate) at the date of initial application, any difference between:

- The previous carrying amount of those financial assets

  And
- The carrying amount of those financial assets at the date of initial application *[IFRS 17.C31]*

Other disclosure requirements when redesignation of financial assets is applied are, as follows:

- The basis for determining financial assets eligible for redesignation
- The measurement category and carrying amount of the affected financial assets determined immediately before the date of initial application of IFRS 17
- The new measurement category and carrying amount of the affected financial assets determined after redesignation
- The carrying amount of financial assets in the statement of financial position that were previously designated as measured at fair value through profit or loss in order to significantly reduce or avoid an accounting mismatch that no longer exists *[IFRS 17.C32]*
- Qualitative information that would enable financial statement users to understand: *[IFRS 17.C33]*
  - How the entity applied the various options available for reassessment, revocation and designation described above
  - Reasons for any designation or de-designation of financial assets measured at fair value through profit or loss in order to significantly reduce or avoid an accounting mismatch
  - Why the entity reached a different conclusion in the new assessments, applying the requirements of the business model test

A simplified summary of the IFRS 9 redesignations above when initially applying IFRS 17 is, as follows:

IFRS 9 asset class	Re-designate?	New category
Amortised cost	Yes - may reassess classification and change if business model has changed and assets are held in respect of an activity that is connected with contracts within the scope of IFRS 17	Fair value through other comprehensive income or fair value through profit or loss depending on the business model
	Yes - may designate on an instrument-by-instrument basis if this eliminates or significantly reduces an accounting mismatch	Fair value through profit or loss
Fair value through other comprehensive income (debt securities)	Yes - may reassess classification and change if business model has changed and assets are held in respect of an activity that is connected with contracts are within the scope of IFRS 17	Amortised cost or fair value though profit or loss depending on the business model
	Yes - may designate on an instrument-by-instrument basis if this eliminates or significantly reduces an accounting mismatch	Fair value through profit or loss
Fair value through profit or loss (debt securities)	Yes - fair value through profit or loss designation must be revoked if designation on grounds of accounting mismatch and accounting mismatch no longer applies due to IFRS 17	Amortised cost or fair value through other comprehensive income depending on business model
Fair value through profit or loss (equity securities not held for trading)	Yes - free election instrument by instrument	Fair value through other comprehensive income
Fair value through other comprehensive income (equity securities)	Yes - free election instrument by instrument	Fair value through profit or loss

17.6.2 Redesignation of financial liabilities

When IFRS 17 is applied, IFRS 9 states that:

- A previous designation of a financial liability measured at fair value through profit or loss should be revoked if that designation was previously made in order to eliminate or reduce an accounting mismatch, but the condition which caused the mismatch is no longer satisfied as a result of the application of IFRS 17.
- A financial liability may be designated as measured at fair value through profit or loss if that designation would not have previously been permitted because it did not satisfy the condition (i.e., because there was no accounting mismatch) and that condition is now satisfied as a result of the application of these amendments.

Such a designation and revocation must be made on the basis of the facts and circumstances that exist at the date of initial application of the amendments to IFRS 9, and the classification must be applied retrospectively. *[IFRS 9.7.2.39]*. However, prior periods may only be restated if it is possible to do so without the use of hindsight. *[IFRS 9.7.2.40]*.

17.7 Entities that have not previously applied IFRS 9

An entity that adopts IFRS 9 at the same time that it adopts IFRS 17 may assess financial asset classifications, elections and designations while, at the same time, assessing the implications of the requirements of IFRS 17. An entity adopting IFRS 9 at the same time that it adopts IFRS 17 applies the transitional provisions of IFRS 9, which include a number of elections and (de)designations.

IFRS 17 requires any net differences resulting from its application to be recorded in net equity at the date of transition (i.e., 1 January 2022 for an entity applying IFRS 17 for the first time in its annual reporting period ending 31 December 2023). In contrast, IFRS 9's starting point records net differences resulting from its application in net equity at the date of initial application (i.e., 1 January 2023 for an entity applying IFRS 17 for the first time in its annual reporting period ending 31 December 2023). Comparative periods may be restated if it is possible to do so without the use of hindsight. *[IFRS 9.7.2.15]*.

How we see it

The IFRS 17 and IFRS 9 transition requirements do not address how to treat an IAS 39 cash flow hedge reserve in accumulated OCI for cash flow hedge relationships that are discontinued upon initial application of IFRS 9 and IFRS 17 (even though the future hedged transactions are still expected to occur). For example, an entity may have designated a cash flow hedge to fix the interest rate variability of forecasted reinvestments of debt instruments backing long-term insurance liabilities. An entity may decide to discontinue such a relationship because it now applies an accounting model for both insurance liabilities and related financial assets where the effects of interest rate changes (and any other relevant financial risks) are recognised in profit or loss. Such a change in accounting model would result in recognising the interest rate effect of financial assets and insurance liabilities on transition in opening retained earnings. In this case, we believe an entity has an accounting policy choice following IAS 8. It could transfer the cash flow hedge reserve to retained earnings on transition. This is because an entity may assess that there is no longer an appropriate recycling mechanism from OCI to profit or loss for prior hedging gains or losses (see Chapter 49 at section 2.6.2). Alternatively, it could recycle the hedge reserve from other comprehensive income to profit and loss over time as the hedged forecasted transactions impact profit or loss (based on the accrual of interest on the hedged forecast financial assets).

However, even if comparative periods are restated, IFRS 9 cannot be applied to items already derecognised at the date of initial application (i.e., 1 January 2023 if IFRS 9 is first applied in a calendar year ending 31 December 2023). *[IFRS 9.7.2.1]*. Therefore, IAS 39 accounting, for example, available-for-sale accounting, would remain in the comparative statement of comprehensive income for financial assets derecognised in that comparative period.

The Board received information that, for some entities, these differing transition requirements of IFRS 17 and IFRS 9 could lead to significant accounting mismatches between financial assets and insurance contract liabilities in the comparative information presented on initial application of the two Standards. Consequently, the Board concluded that IFRS 17 should be amended to enable entities to reduce those accounting mismatches. As a result, the IASB issued the December 2021 amendments. *[IFRS 17.BC398G]*.

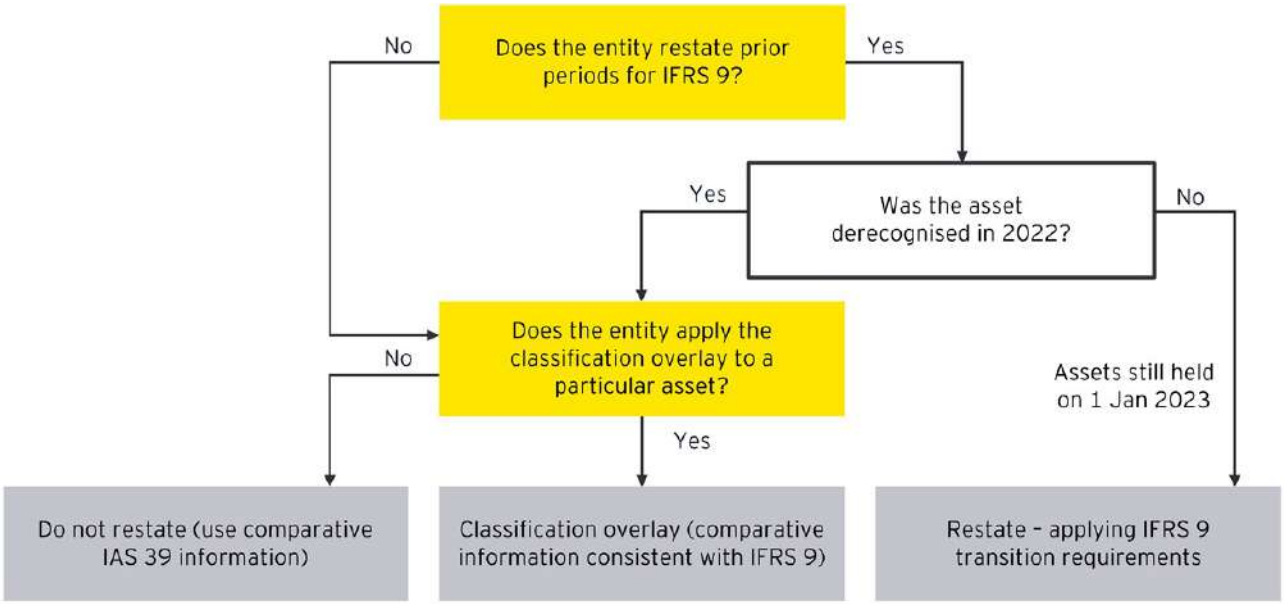
The December 2021 amendments introduce an optional classification overlay for financial assets in the comparative period. The classification overlay may be applied by: *[IFRS 17.C28A, IFRS 17.BC398H]*

- Entities that adopt IFRS 17 and IFRS 9 at the same time and choose to restate comparative information applying IFRS 9. These entities can apply the classification overlay to financial assets derecognised in the comparative period (to which IFRS 9 cannot be applied).
- Entities that adopt IFRS 17 and IFRS 9 at the same time and do not restate comparative information applying IFRS 9. For these entities, the classification overlay can be applied to any financial asset in the comparative period.
- Entities that applied IFRS 9 before they apply IFRS 17 for the first time. These entities can apply the classification overlay to assets that would have been redesignated in accordance with paragraph C29 of IFRS 17 if they had not been derecognised in the comparative period. See section 17.6 above.

The application of the classification overlay is optional on an instrument-by-instrument basis. This is to allow an entity to assess whether, for a particular financial asset, the benefits of applying the classification overlay outweigh the costs. However, this option does not prevent an entity from applying it at a high level of aggregation, for example, by considering the level at which an entity would assess its business model when applying IFRS 9. *[IFRS 17.BC398R]*.

If an entity elects to apply the classification overlay, it can only do so for comparative periods to which it applies IFRS 17 (i.e., between the transition date to IFRS 17 and the date of initial application of IFRS 17). *[IFRS 17.C28E(c)]*.

A decision tree on the classification overlay and presentation of comparative information about financial assets on initial application of IFRS 9 and IFRS 17 is shown below:



Based on October 2021 IASB staff paper Agenda Ref 2

17.7.1 Classification and measurement under the classification overlay

An entity that applies the classification overlay to a financial asset must: *[IFRS 17.C28B]*.

- Use reasonable and supportable information available at the transition date to determine how the entity expects that financial asset would be classified and measured on initial application of IFRS 9 (for example, using preliminary assessments performed to prepare for initial application of IFRS 9)
- Present comparative information as if the classification and measurement requirements of IFRS 9 had been applied to that financial asset

The IASB noted that an entity could, for example, use preliminary assessments of the business model and cash flow characteristics performed to prepare for the initial application of IFRS 9 as reasonable and supportable information for the classification overlay. Applying the classification overlay, the carrying amount of a financial asset would be determined consistently with how the entity expects it to be measured on initial application of IFRS 9. For example, for a financial asset previously measured at amortised cost, that is presented at fair value through profit or loss when applying the classification overlay, the carrying amount at the transition date to IFRS 17 would be its fair value at that date. *[IFRS 17.BC398J]*.

Any difference between the previous carrying amount of a financial asset and the carrying amount at the transition date that results from applying the classification overlay is recognised in opening retained earnings (or other component of equity, as appropriate) at the transition date (i.e., 1 January 2022 for most entities). *[IFRS 17.C28D]*.

The amendment does not change any of the transition requirements of IFRS 9. Entities that choose to apply the classification overlay to some or all of their financial assets will therefore still need to apply the requirements of IFRS 9 to any financial assets that continue to be recognised at the date of initial application of IFRS 9. This means that at the date of initial application of IFRS 9, entities that apply the classification overlay will be required to assess whether the classification of financial assets that continue to be recognised at that date is in accordance with IFRS 9. If the classification determined applying the classification overlay does not meet the requirements of IFRS 9 on the date of initial application of IFRS 9, the entity would be required to update the classification of a financial asset on that date and apply the updated classification retrospectively as per the transition requirements of IFRS 9. *[IFRS 17.BC398K]*.

17.7.2 Impairment of financial assets under the classification overlay

In applying the classification overlay, an entity is permitted but not required to apply the impairment requirements of IFRS 9 (i.e., the expected credit loss model). If a financial asset would be subject to the impairment requirements of IFRS 9 following the classification under the classification overlay but the entity does not apply those impairment requirements, it must continue to present any impairment amount recognised in the prior reporting period in accordance with IAS 39. Otherwise, any impairment amount previously recognised for that financial asset should be reversed. *[IFRS 17.C28C]*.

The Board allowed this choice of impairment model observing that some entities may not yet be prepared to apply the impairment requirements of IFRS 9, and that comparative information would still be improved by applying the classification overlay, even without applying the impairment requirements of IFRS 9. *[IFRS 17.BC398M]*.

How we see it

The classification overlay requires an entity to present impairments recognised in the prior period under IAS 39 if it chooses not to apply the expected credit loss model of IFRS 9 when applying the classification overlay to the 2022 comparatives. However, it does not specify what an entity should do if the financial asset did not recognise any prior period impairments previously under IAS 39, for example if the classification of a debt security is fair value through other comprehensive income under IFRS 9 but was fair value through profit or loss under IAS 39. In our view, as IFRS 17 is silent on this matter, an entity has an accounting policy choice as to whether it records incurred losses in accordance with the IAS 39 impairment model, or not, in the 2022 comparatives for those financial assets.

17.7.3 Disclosure of the use of the classification overlay

An entity that applies the classification overlay must disclose qualitative information that enables users of financial statements to understand: *[IFRS 17.C28E(a)]*.

- The extent to which the classification overlay has been applied (such as whether it has been applied to all financial assets derecognised in the comparative period).
- Whether and to what extent the impairment requirements in IFRS 9 have been applied under the classification overlay.

The Board rejected respondents' suggestions to disclose the quantitative effects of the classification overlay at the transition date to IFRS 17. As applying the classification overlay would improve consistency of comparative information, the Board considered that the costs of such quantitative disclosure requirements would likely outweigh the benefits. *[IFRS 17.BC398N]*. Also, the Bord observed that other IFRS accounting standards, such as IAS 1, might require further disclosure about the impact of the classification overlay. *[IFRS 17.BC398O]*.

18 Future developments

18.1 IFRS 18

IFRS 18 *Presentation and disclosure in financial statements*, which supersedes IAS 1 for reporting periods on or after 1 January 2027 (with earlier application permitted) was issued by the IASB in April 2024. See Chapter 4 for further information of the new concepts and requirements of IFRS 18.

18.2 IFRS 19

IFRS 19 *Subsidiaries without Public Accountability*, was issued by the IASB in May 2024 to simplify the preparation of financial statements by eligible subsidiaries. Eligible subsidiaries that elect to apply IFRS 19 are allowed to provide reduced disclosures while still applying the recognition, measurement and presentation requirements in other IFRS accounting standards. IFRS 19 is effective for accounting periods beginning on or after 1 January 2027, with earlier application permitted (subject to jurisdictional endorsement), However, IFRS 19 does not contain any reduced disclosures in respect of IFRS 17. See Chapter 4 at section 7 for further details on the requirements of IFRS 19.

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Appendix C - Defined terms

Extract from IFRS 17

Appendix A
Defined terms

This appendix is an integral part of IFRS 17 Insurance Contracts.

contractual service margin	A component of the carrying amount of the asset or liability for a **group of insurance contracts** representing the unearned profit the entity will recognise as it provides **insurance contract services** under the **insurance contract**s in the group.
coverage period	The period during which the entity provides **insurance contract services**. This period includes the **insurance contract services** that relate to all premiums within the boundary of the **insurance contract**.
experience adjustment	A difference between: (a) for premium receipts (and any related cash flows such as **insurance acquisition cash flows** and insurance premium taxes) - the estimate at the beginning of the period of the amounts expected in the period and the actual cash flows in the period; or (b) for insurance service expenses (excluding insurance acquisition expenses) - the estimate at the beginning of the period of the amounts expected to be incurred in the period and the actual amounts incurred in the period.
financial risk	The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, currency exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.
fulfilment cash flows	An explicit, unbiased and probability-weighted estimate (ie expected value) of the present value of the future cash outflows minus the present value of the future cash inflows that will arise as the entity fulfils **insurance contracts**, including a **risk adjustment for non-financial risk**.
group of insurance contracts	A set of **insurance contracts** resulting from the division of a **portfolio of insurance contracts** into, at a minimum, contracts issued within a period of no longer than one year and that, at initial recognition: (a) are onerous, if any; (b) have no significant possibility of becoming onerous subsequently, if any; or (c) do not fall into either (a) or (b), if any.
insurance acquisition cash flows	Cash flows arising from the costs of selling, underwriting and starting a **group of insurance contracts** (issued or expected to be issued) that are directly attributable to the **portfolio of insurance contracts** to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or **groups of insurance contracts** within the portfolio.
insurance contract	A contract under which one party (the issuer) accepts significant **insurance risk** from another party (the **policyholder**) by agreeing to compensate the **policyholder** if a specified uncertain future event (the **insured event**) adversely affects the **policyholder**.

insurance contract services	The following services that an entity provides to a **policyholder** of an **insurance contract**: (a) coverage for an **insured event** (insurance coverage); (b) for **insurance contracts without direct participation features**, the generation of an investment return for the policyholder, if applicable (investment-return service); and (c) for **insurance contracts with direct participation features**, the management of underlying items on behalf of the **policyholder** (investment-related service).
insurance contract with direct participation features	An **insurance contract** for which, at inception: (a) the contractual terms specify that the **policyholder** participates in a share of a clearly identified pool of **underlying items;** (b) the entity expects to pay to the **policyholder** an amount equal to a substantial share of the fair value returns on the **underlying items**; and (c) the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items.
insurance contract without direct participation features	An **insurance contract** that is not an **insurance contract with direct participation features**.
insurance risk	Risk, other than **financial risk**, transferred from the holder of a contract to the issuer.
insured event	An uncertain future event covered by an **insurance contract** that creates **insurance risk**.
investment component	The amounts that an **insurance contract** requires the entity to repay to a **policyholder** in all circumstances, regardless of whether an **insured event** occurs.
investment contract with discretionary participation features	A financial instrument that provides a particular investor with the contractual right to receive, as a supplement to an amount not subject to the discretion of the issuer, additional amounts: (a) that are expected to be a significant portion of the total contractual benefits; (b) the timing or amount of which are contractually at the discretion of the issuer; and (c) that are contractually based on: (i) the returns on a specified pool of contracts or a specified type of contract; (ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or (iii) the profit or loss of the entity or fund that issues the contract.
liability for incurred claims	An entity's obligation to: (a) investigate and pay valid claims for **insured events** that have already occurred, including events that have occurred but for which claims have not been reported, and other incurred insurance expenses; and (b) pay amounts that are not included in (a) and that relate to: (i) **insurance contract services** that have already been provided; or (ii) any **investment components** or other amounts that are not related to the provision of **insurance contract services** and that are not in the **liability for remaining coverage**.

liability for remaining coverage	An entity's obligation to: (a) investigate and pay valid claims under existing **insurance contracts** for **insured events** that have not yet occurred (ie the obligation that relates to the unexpired portion of the insurance coverage); and (b) pay amounts under existing **insurance contracts** that are not included in (a) and that relate to: (i) **insurance contract services** not yet provided (ie the obligations that relate to future provision of **insurance contract services**); or (ii) any **investment components** or other amounts that are not related to the provision of **insurance contract services** and that have not been transferred to the **liability for incurred claims**.
policyholder	A party that has a right to compensation under an **insurance contract** if an **insured event occurs**.
portfolio of insurance contracts	**Insurance contracts** subject to similar risks and managed together.
reinsurance contract	An **insurance contract** issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more **insurance contracts** issued by that other entity (underlying contracts).
risk adjustment for non-financial risk	The compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils **insurance contracts**.
underlying items	Items that determine some of the amounts payable to a **policyholder**. **Underlying items** can comprise any items; for example, a reference portfolio of assets, the net assets of the entity, or a specified subset of the net assets of the entity.

Chapter 52 General Requirements for Disclosure of Sustainability-related Financial Information (IFRS S1)

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Overview

Current landscape

Sustainability reporting has attracted increasing interest from various stakeholders in recent years. A holistic approach to corporate reporting, with key components that include sustainability reporting, financial reporting and assurance has emerged. In response to both the demand for information from the investment community and broader public expectations of the role of businesses in society, a plethora of frameworks, methodologies and metrics for sustainability reporting have been developed.

Currently, there are a number of sustainability-related reporting frameworks, standards and metrics. Some focus on non-financial information and sustainability-related matters, while others focus specifically on climate-related disclosures. The target audience for those frameworks, standards and metrics varies, e.g., investors and wider society. Although information may overlap in certain respects, differences in subject matter and audience give rise to diverging approaches to materiality with either an emphasis on the impact of sustainability matters on an entity, or an entity's impact on the external environment, or both. This diversity in objectives and approaches underlines the urgent need for a global framework to provide greater comparability and reduce the complexity in sustainability reporting.

Background

The IFRS Foundation was encouraged by stakeholders participate in the work towards a coherent and comprehensive corporate-reporting system and the development of a converged, global framework on sustainability-related reporting. This led the Trustees of the IFRS Foundation, through a consultation process, to assess the demand for sustainability reporting at a global level and explore the IFRS Foundation's role in the development of global sustainability standards.[1] The IFRS Foundation received feedback from multiple stakeholder consultations on both the need for it to play a role in sustainability standard setting and on the changes to its constitution gave a clear message - there is a growing demand to improve the global consistency and comparability of sustainability reporting and an urgent need for action.

The IFRS Foundation, which had been responsible for setting global accounting standards for several years, started to deliberate and plan for the establishment of the International Sustainability Standards Board (or the ISSB). In April 2021, in response to demands from global capital markets for the development of standards to provide a comprehensive global baseline of sustainability disclosures, the Trustees of the IFRS Foundation published a proposal to amend the IFRS Foundation's Constitution to accommodate the formation and operation of the ISSB. The establishment of the ISSB was announced by the Trustees of the IFRS Foundation on 3 November 2021, during the Finance Day of the COP26 climate change conference.

To lay the groundwork for the new board, prior to the establishment of the ISSB, the IFRS Foundation set up a Technical Readiness Working Group (TRWG) with the objectives of accelerating convergence in global sustainability reporting standards and the technical preparation for the ISSB under the governance of the IFRS Foundation. The TRWG was comprised of representatives from the Taskforce for Climate-related Financial Disclosures (TCFD), the Value Reporting Framework (VRF), the Climate Disclosure Standards Board (CDSB), the World Economic Forum (WEF) and the International Accounting Standards Board (IASB), supported by the International Organization of Securities Commissions (IOSCO) and its Technical Expert Group of securities regulators.[2] The TRWG's work on general requirements for the disclosure of sustainability-related financial information and the climate-related disclosure resulted in prototype standards titled *General Requirements for Disclosure of Sustainability-related Financial Information Prototype* and *Climate-related Disclosures Prototype* respectively, published on the IFRS Foundation's website in November 2021. The prototype standards were not subject to the IFRS Foundation's formal due process or that of any TRWG member.

In an effort to address the calls from users of general purpose financial reports for more consistent, complete, comparable and verifiable sustainability-related financial information, in March 2022, the ISSB published its first two Exposure Drafts on IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* and IFRS S2 *Climate-related Disclosures* for public comment that ended in July 2022. The Exposure Drafts were built on the TRWG's prototype standards, as well as the work of standard-setters and framework-providers, which had been subject to extensive public consultation and redeliberation. The Exposure Drafts attracted significant interest in the market, with the ISSB receiving

1 *Consultation Paper on Sustainability Reporting*, September 2020, available on the IFRS Foundation's website.

2 The VRF (which houses the Integrated Reporting Framework and the SASB Standards) and the CDSB have now been consolidated into the ISSB.

over 700 comment letters and survey responses as feedback on each of the Exposure Drafts from respondents representing a range of stakeholder groups and geographies.

Issuance of IFRS S1 and IFRS S2

On 26 June 2023, after a year of deliberations on the feedback on the two Exposure Drafts, the ISSB issued its first two IFRS sustainability disclosure standards (ISSB standards). The standards are aimed to enable users of general purpose financial reports to assess an entity's exposure to, and management of, sustainability-related risks and opportunities over the short, medium and long term, and inform their decisions relating to providing resources to an entity. Moreover, the sustainability-related financial information publication is intended to complement the information in the entity's general purpose financial statements. Under the governance of the IFRS Foundation, the ISSB works closely with the International Accounting Standards Board (the IASB) to ensure connectivity and compatibility between IFRS accounting standards and ISSB standards.

The ISSB standards are comprised of:

- The full text of IFRS S1 plus with five appendices and the full text of IFRS S2 plus with three appendices. The appendices are integral parts of IFRS S1 and IFRS S2 and have the same authority as the main text
- *Illustrative Guidance* and *Illustrative Examples* which accompany ISSB standards but are not part of them, nor are they intended to provide interpretative guidance. However, the examples illustrate aspects of the requirements in ISSB standards and help in their implementation
- The *Basis for Conclusions* which accompanies ISSB standards, but it is not part of them, nor is it intended to provide interpretative guidance. The Basis for Conclusions summarises the considerations of the ISSB in developing ISSB standards
- IFRS S2 is accompanied by Industry-based Guidance on Implementing IFRS S2, which is not intended to create additional requirements. IFRS S2 requires an entity to refer to and consider the applicability of the industry-based disclosure topics defined in the Industry-based Guidance on Implementing IFRS S2, when identifying the climate-related risks and opportunities. Even if an entity concludes not to use the Industry-based Guidance on Implementing IFRS S2, industry specific disclosures are still required by ISSB standards. The disclosure topics identified and defined in the industry-based guidance include climate-related risks and opportunities that are typically associated with particular business models, activities or other common features that characterise participation in an industry. The industry-based guidance also suggests possible ways to measure and disclose information about climate-related risks and opportunities, including metrics and targets.

Interoperability

ISSB standards can be used on a standalone basis or integrated into jurisdictional requirements to serve broader stakeholder or other public policy needs. The ISSB, with fourteen board members from various parts of the world, is committed to formal engagement with jurisdictions that develop their own sustainability reporting requirements. Within the context of interoperability with other jurisdictions, several initiatives have been taken so far, including:

- Forming the Jurisdictional Working Group (JWG) to discuss important strategic matters relating to IFRS S1 and IFRS S2 and jurisdictional initiatives on sustainability reporting
- Establishing the Sustainability Standards Advisory Forum (SSAF) as a formal technical advisory body to the ISSB which is represented by jurisdictional and regional bodies that contribute their technical input and expertise to inform the ISSB's standard-setting work
- Collaborating with Global Reporting Initiative standards (GRI standards)
- Working closely with the European Commission and EFRAG (formerly the European Financial Reporting Advisory Group) to facilitate interoperability. On 2 May 2024, the IFRS Foundation and EFRAG published interoperability guidance on the alignment between ISSB standards and ESRS[3]
- Developing guidance for jurisdictions on how to adopt ISSB standards into the various jurisdictions[4]

In addition to the ongoing actions of the ISSB to achieve interoperability of ISSB standards with other jurisdictional requirements, IFRS S1 already includes requirements to support this goal. For example, sustainability-related financial information in accordance with ISSB standards is:

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3 *IFRS Foundation and EFRAG publish interoperability guidance,* May 2024, available on the IFRS Foundation's website.

4 *Inaugural Jurisdictional Guide for the adoption or other use of ISSB Standards,* May 2024, available on the IFRS Foundation's website.

- Aimed at meeting the information needs of primary users, i.e., current and potential investors, creditors and other lenders
- Based on a materiality assessment consistent with that used in the application of IFRS accounting standards
- Presented with information disclosed to meet other requirements, such as specific jurisdictional requirements, but must not be obscured by such additional information
- Aligned with TCFD Recommendations on governance, strategy, risk management, and metrics and targets
- Required for short, medium and long-term time horizons without defining those horizons as this would be an entity- or industry-specific determination

The role of IFRS S1 in ISSB standards

IFRS S1 sets out the general requirements for a complete set of sustainability-related financial disclosures and requires an entity to disclose information about all sustainability-related risks and opportunities that could reasonably be expected to affect the entity's prospects. The effect on the entity's prospects refers to the effect on the entity's cash flows and its access to finance or cost of capital over the short, medium or long term.

The information required by IFRS S1 relates to general aspects of how an entity operates, in particular, its governance, strategy, risk management, and metrics and targets associated with sustainability-related risks and opportunities. IFRS S1 refers to these four aspects as the 'core content', meaning information that is essential to users' understanding of how an entity identifies, assesses, prioritises, monitors and manages sustainability-related risks and opportunities. The focus on core content builds on the widely accepted recommendations of the TCFD. IFRS S1 also deals with some general matters such as the requirement for fair presentation of those sustainability-related risks and opportunities and the requirement to provide comparative information.

An entity is required to apply IFRS S1 in conjunction with all the other ISSB standards before it can assert compliance with ISSB standards. The other ISSB standards are intended to set out specific requirements for the sustainability-related topics with which they deal. The purpose of IFRS S1 is to establish the basis of application of all topic-based ISSB standards that will be developed by the ISSB in the future, in addition to IFRS S2 which is the first topic-based standard and covers disclosure requirements that are specific to climate. This purpose, in the context of sustainability-related financial disclosures is similar, in some respects, to that of the IASB's *Conceptual Framework*, IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, which are applicable to general purpose financial statements prepared in accordance with IFRS accounting standards.[5]

Relationship between IFRS S1 and IFRS S2

IFRS S2 is the first topic-based standard issued by the ISSB and is to be applied in conjunction with IFRS S1. Although in this first phase of their development, IFRS S2 is the ISSB's only topic-based standard, IFRS S1 requires entities to disclose material sustainability-related financial information about all sustainability-related risks and opportunities that could reasonably be expected to affect the entity's prospects. This requirement effectively covers sustainability-related topics beyond climate (subject to the 'climate first' transition relief which allows an entity to provide only climate-related disclosures in its first year of applying IFRS S1 and IFRS S2). IFRS S1 also provides a list of other sources of guidance to help entities identify the relevant sustainability-related risks and opportunities and the material information about them, which includes references to pronouncements of other standard-setting bodies.

This chapter deals with the requirements of IFRS S1 and Chapter 53 deals with the requirements of IFRS S2.

Effective date of IFRS S1 and IFRS S2

Both IFRS S1 and IFRS S2 are effective for annual reporting periods beginning on or after 1 January 2024. However, the mandatory application of ISSB standards depends on each jurisdiction's endorsement or regulatory processes and is not linked to the application of IFRS accounting standards. Therefore, an entity applying IFRS accounting standards for financial reporting purposes is not required to also apply ISSB standards, and vice versa.

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5 IFRS 18 *Presentation and Disclosure in Financial Statements*, which supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted) was issued by the IASB in April 2024. See Chapter 4 for further details on the new concepts and requirements of IFRS 18.

ISSB's support in implementing IFRS S1 and IFRS S2

The ISSB is committed to supporting the implementation of ISSB standards. The related initiatives include:

- Creating the Transition Implementation Group (TIG) to analyse and publicly discuss any questions that arise during the implementation phase of ISSB standards. The TIG is expected to support implementation in the initial phase of application of ISSB standards and will inform the ISSB to determine if any follow up actions are needed. The members of the TIG include sustainability reporting and financial statement preparers, auditors and other users from a variety of industries and countries, as well as public and private entities. The International Organization of Securities Commissions (IOSCO), the International Auditing and Assurance Standards Board (IAASB) and the International Public Sector Accounting Standards Board (IPSASB) have been assigned as official observers of the TIG. The TIG does not issue authoritative guidance and, therefore, the use of its materials and related discussions are not mandatory for an entity to assert compliance with ISSB standards. Throughout this chapter, there are summaries of the discussions that the TIG had up to September 2024.
- Developing educational material to explain and illustrate how an entity might apply some of the requirements in IFRS S1 and IFRS S2. The educational material is not intended to provide interpretative guidance. The ISSB's educational material is not part of ISSB standards and cannot add or change their requirements. The examples included in the educational material focus on particular requirements and therefore are not intended to explain or illustrate how the entity would apply all of the core content requirements in IFRS S1 and IFRS S2.

Use of 'Practical examples'

Extracts from reports presented in this chapter as 'Practical examples' are reproduced for illustrative purposes. These extracts illustrate practices that entities have so far developed in sustainability reporting (e.g., reporting under TCFD framework). However, they have not been subject to any review on compliance with ISSB standards, other sustainability-related frameworks or local capital market rules and they are not intended to represent the 'best practice'. Due to the early stage of the implementation phase of ISSB standards, no extracts of reports prepared under the ISSB standards have been reproduced, but suitable extracts may be included in future updates of this chapter. The extracts presented as a starting point for an entity to determine what needs to be disclosed under the ISSB standards, but should also be read in conjunction with the rest of the information provided in the reports from which these extracts were extracted to understand their intended purpose.

What you need to know

- The Trustees of the IFRS Foundation established the ISSB in November 2021.
- The ISSB issued its first two standards, namely IFRS S1 and IFRS S2 in June 2023.
- The ISSB decided to add to its work plan two sustainability-related research projects on: a) biodiversity, ecosystems and ecosystem services, and b) human capital.
- The ISSB standards can be used on a standalone basis or integrated into jurisdictional requirements.
- In applying ISSB standards, IFRS S1 must be applied in conjunction with the other ISSB standards that provide requirements for specific sustainability-related topics (e.g., IFRS S2 for climate-related matters).
- IFRS S1 and IFRS S2 are effective for annual reporting periods beginning on or after 1 January 2024 and include various transition reliefs that are available in the first year of application. Mandatory application of ISSB standards will depend on each jurisdiction's endorsement or regulatory processes.
- The application of IFRS S1 and IFRS S2 is not linked to the application of IFRS accounting standards. Therefore, entities that apply IFRS accounting standards for financial reporting purposes are not required to also apply ISSB standards.
- This chapter deals with the requirements of IFRS S1 and Chapter 53 deals with the requirements of IFRS S2.

1 Introduction to IFRS S1

1.1 The objective of IFRS S1

IFRS S1 sets out the general requirements for the content and presentation of information that an entity needs to provide about sustainability-related risks and opportunities. *[IFRS S1.4].* The objective of providing such information is to support users of general purpose financial reports in their decision-making process that relates to providing resources to the entity which prepares the general purpose financial report. *[IFRS S1.1].* That is, this information is intended to enable those users to assess the entity's exposure to sustainability-related risks and opportunities over the short, medium and long term, as well as to assess how the entity manages those risks and opportunities in order to inform their decisions in providing resources to that entity.

General purpose financial reports are defined by IFRS S1 as those that provide financial information about an entity that is useful for the users of those reports in making decisions related to providing resources to the entity, and include, but are not restricted to, an entity's general purpose financial statements (or financial statements) and sustainability-related financial disclosures. *[IFRS S1 Appendix A].* Information about an entity's sustainability-related risks and opportunities is incorporated in disclosures, referred to as sustainability-related financial disclosures, that constitute a particular form of general purpose financial report and which supplements and complements the information provided in the entity's financial statements.

To further clarify the objective of IFRS S1, there are certain components embedded in the standard as further discussed in the next sections:

- Who does IFRS S1 consider to be the users of general purpose financial statements (see section 1.1.1 below)
- How does IFRS S1 describe the sustainability-related risks and opportunities addressed by ISSB standards (see section 1.1.2 below)

1.1.1 Primary users

IFRS S1 defines primary users of general purpose financial reports (primary users) as the "existing and potential investors, lenders and other creditors".[6] *[IFRS S1 Appendix A].* This definition was built on what is stated in paragraph 1.7 of the Conceptual Framework: "General purpose financial reports are not designed to show the value of a reporting entity; instead, they provide information to help existing and potential investors, lenders and other creditors estimate the value of the reporting entity".

According to this definition, ISSB standards focus on the information needs of primary users in making their decisions about providing resources to an entity, rather than the needs of a broader group of stakeholders. The Basis for Conclusions to IFRS S1 states that "Disclosures made in accordance with IFRS Sustainability Disclosure Standards are conceptually and practically complementary to - but not a replacement for - reporting on an entity's significant impacts on people, the environment and the economy". This clearly distinguishes sustainability-related financial information provided in accordance with ISSB standards from the broader, multi-stakeholder perspective adopted by other sustainability-related frameworks that focus on how an entity contributes to sustainable development. *[IFRS S1.BC49].* For further discussion on the perspective adopted by other sustainability frameworks, see section 3.2.7 below.

Although focusing on the information needs of primary users is widely accepted by the market, identifying and assessing the information that would be useful to primary users may not always be straightforward. Primary users need sufficient and relevant information to make their decisions about where and when to provide resources to the entity that prepares the general purpose financial reports, as well as what type of resources to provide. Also, primary users are a diverse group with potentially differing objectives and types of risk exposure and the range of their interests on sustainability matters is rather wide and varies across industries, locations as well as business models and business activities. For further discussion on the identification of information that is useful to primary users, see section 3.2.2 below.

6 The terms users of general-purpose financial reports, or primary users, or users are used within the IFRS sustainability disclosure standards to describe the same population.

1.1.2 Description of sustainability-related risks and opportunities

1.1.2.A Sustainability is a broad term

The term sustainability is a broad term and applies widely across environmental, social and governance matters and encompasses a wide range of notions. Sustainability is frequently linked to 'sustainable development', defined by the United Nations in 1987 as: "development that meets the needs of the present without compromising the ability of future generations to meet their own needs".[7] IFRS S1 focuses on requiring disclosures about sustainability-related financial information related to an entity's governance, strategy, risk management and metrics, and targets in relation to those risks and opportunities. Therefore, the relationship of sustainability-related risks and opportunities with the established notions of sustainability and sustainable development, is fundamental to an understanding of the scope of IFRS S1 and ISSB standards in general. *[IFRS S1.BC42, IFRS S1.BC43].*

1.1.2.B The concept of value

In line with its commitment to leverage from the existing material available from other frameworks and standard-setters, the ISSB based the description of sustainability-related risks and opportunities on the concepts of the Integrated Reporting Framework.[8] One of the fundamental concepts in the Integrated Reporting Framework is that an entity's ability to create, preserve and erode value for itself over time (and thus to generate returns for the entity's investors, lenders and other creditors) is inextricably linked to value that the entity creates, preserves or erodes for others. *[IFRS S1.BC46].* In particular, the Integrated Reporting Framework contains the following key points:

Extract from the Integrated Reporting Framework

2.2 An integrated report explains how an organization creates, preserves or erodes value over time. Value is not created, preserved or eroded by or within an organization alone. It is:

- Influenced by the external environment
- Created through relationships with stakeholders
- Dependent on various resources.

...

2.6 The ability of an organization to create value for itself is linked to the value it creates for others.

...

This concept is also broadly consistent with the IASB's Exposure Draft on Management Commentary.[9] *[IFRS S1.BC47].*

The broader concept of value reflects that primary users are interested not just in the value the entity creates for itself, but also in the value that the entity creates for others since that value may ultimately affect, for example, the cash flows generated by the entity, its cost of capital, or the availability of funding. The value concept also clarifies how important longer time horizons are. This is because, although the sources of value may not affect the entity's financial performance in the near term, they may impact its performance, and ultimately its value, as assessed by primary users over time.

1.1.2.C The concept of value in the description of sustainability in IFRS S1

IFRS S1 explains how an entity's ability to create, preserve or erode value is influenced by its interactions within the interdependent system in which it operates. In particular, an entity interacts, directly or indirectly, with its stakeholders, society, the economy and the natural environment throughout its value chain. Such interactions result from an entity's own actions in operating its business model to achieve its strategic purposes, as well as from the influences it receives from the external environment in which it operates. In the context of IFRS S1, these interactions take place within an interdependent system and have a dual meaning. That is, an entity both: a) depends on resources and relationships throughout its value chain to generate cash flows; and b) affects those resources and relationships through its activities and outputs by contributing to the preservation, regeneration and development of those resources and relationships or to their degradation and depletion. *[IFRS S1.2, IFRS S1.B2].*

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7 *Sustainability | United Nations*, available on the United Nations' website (accessed in September 2024).

8 *Integrated Reporting Framework | Integrated Reporting*, January 2021, available on the IFRS Foundation's website.

9 *Exposure Draft: Management Commentary (ifrs.org)*, IASB, May 2021, available on the IFRS Foundation's website.

IFRS S1 provides the following example of the close relationship between the value the entity creates, preserves or erodes for others and the entity's own ability to succeed and achieve its goals: *[IFRS S1.B3]*.

Extract from IFRS S1

B3 For example, if an entity's business model depends on a natural resource-such as water-the entity could both affect and be affected by the quality, availability and affordability of that resource. Specifically, degradation or depletion of that resource-including resulting from the entity's own activities and from other factors-could create a risk of disruption to the entity's operations and affect the entity's business model or strategy and could ultimately negatively affect the entity's financial performance and financial position. In contrast, regeneration and preservation of that resource-including resulting from the entity's own activities and from other factors-could positively affect the entity. Similarly, if an entity operates in a highly competitive market and requires a highly specialised workforce to achieve its strategic purposes, the entity's future success will likely depend on the entity's ability to attract and retain that resource. At the same time, that ability will depend, in part, on the entity's employment practices-such as whether the entity invests in employee training and wellbeing-and the levels of employee satisfaction, engagement and retention. These examples illustrate the close relationship between the value the entity creates, preserves or erodes for others and the entity's own ability to succeed and achieve its goals.

1.1.2.D Requirement to identify sustainability-related risks and opportunities based on the description of sustainability in IFRS S1

As described in section 1.1.2.C above, an entity's interactions (i.e., its dependence on resources and relationships and its impact on those resources and relationships by its activities and outputs) may give rise to sustainability-related risks and opportunities. IFRS S1 requires an entity to provide information about those sustainability-related risks and opportunities. However, according to IFRS S1, the sustainability-related risks and opportunities about which an entity is expected to provide information are limited to those that "could reasonably be expected to affect the entity's cash flows, its access to finance or cost of capital over the short, medium or long term". For the purposes of IFRS S1, these sustainability-related risks and opportunities are referred to as "sustainability-related risks and opportunities that could reasonably be expected to affect the entity's prospects". *[IFRS S1.3].* The enhanced description of concepts that underlie sustainability-related risks and opportunities in IFRS S1 is intended to assist entities in identifying them.

How we see it

IFRS S1 provides a description of the concepts underlying sustainability-related risks and opportunities, rather than a definition for sustainability. This broad description does not set exact boundaries for the universe of topics covered by sustainability-related financial disclosures so as to reflect the evolving nature of these topics. It follows that the identification of sustainability-related risks and opportunities by an entity may change over time and reassessment of that identification may become necessary (see relevant discussion on reassessing the scope of sustainability-related risks and opportunities in section 1.2.3 below).

1.2 Identifying sustainability-related risks and opportunities

1.2.1 The identification process

To meet the objective of IFRS S1, an entity is required to identify the sustainability-related risks and opportunities that could reasonably be expected to affect its prospects and then to make a materiality assessment to identify and disclose the material information about the identified risks and opportunities. In both identifying sustainability-related risks and opportunities and the material information to be disclosed about them, an entity focuses on the objective of IFRS S1 (see section 1.1 above). As further discussed in section 1.1.1 above, ISSB standards focus on the information needs of primary users (e.g., investors), which distinguishes them from other sustainability-related frameworks that may adopt different perspectives, e.g., a broader or multi-stakeholder perspective or more focus on how an entity contributes to sustainable development.

For the purposes of identifying sustainability-related risks and opportunities, materiality is not an attribute of a risk or opportunity, rather it is an attribute of information about that risk and/or opportunity. This distinction is similar to the concepts applied in the IASB's *Conceptual Framework* (for further

information, see Chapter 2 at section 5.1.1).[10] Also, the IASB's Exposure Draft on Management Commentary has proposed requirements for an entity to focus on key matters and to provide material information about those key matters.

IFRS S1 does not explicitly require the two steps of: a) identifying the sustainability-related risks and opportunities that could reasonably be expected to affect an entity's prospects; and b) identifying material information about those risks and opportunities, to be performed sequentially. In practice, the assessment performed under these two steps is likely to be iterative.

An entity needs to disclose information about the judgements it has made to prepare its sustainability-related financial disclosures that most significantly affect those disclosures. IFRS S1 refers to the process of identifying sustainability-related risks and opportunities that could be reasonably expected to affect the entity's prospects as an example of where judgement is expected to be needed. (see further discussion on judgements in section 6.1 below). *[IFRS S1.74]*.

How we see it

Along with the description of concepts that underlie sustainability-related risks and opportunities (discussed in section 1.1.2 above), all relevant facts and circumstances need to be considered when identifying such risks and opportunities. Those facts and circumstances include both:

- External evidence

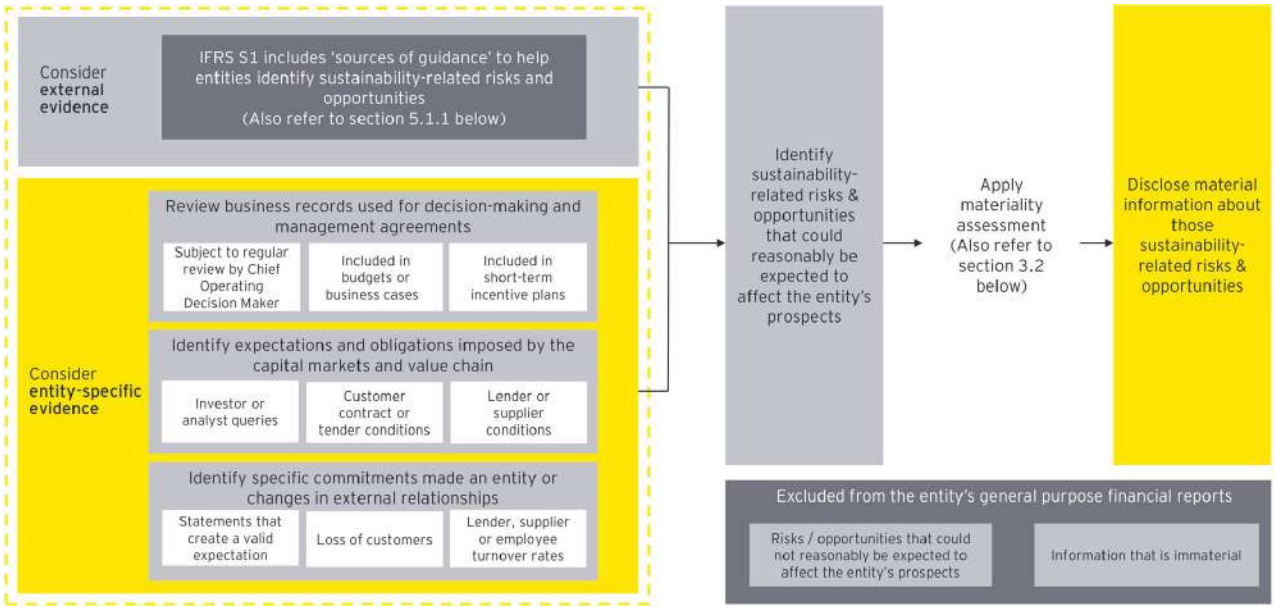
  And

- Entity-specific evidence

These sources of evidence are described below.

Figure 1-1 summarises the steps for identifying sustainability-related risks and opportunities and indicates when materiality is assessed.

Figure 1-1: Process for identifying sustainability-related risks and opportunities



External evidence

The sources of external evidence that provide insight into potential sustainability-related risks and opportunities may vary depending on the sector and jurisdiction in which the entity operates. IFRS S1 provides additional guidance in the section of 'sources of guidance' to help entities identify sustainability-related risks and opportunities that could reasonably be expected to affect an entity's prospects, including those across a range of sustainability-related issues and those that are specific to industries. For further discussion on those sources of guidance, see discussion in section 5.1.1 below.

Entity-specific evidence

10 Paragraph 2.21 of the IASB's Conceptual Framework states: "The most efficient and effective process for applying the fundamental qualitative characteristics would usually be…First, identify an economic phenomenon, information about which is capable of being useful to users of the reporting entity's financial information. Second, identify the type of information about that phenomenon that would be most relevant. Third, determine whether that information is available and whether it can provide a faithful representation of the economic phenomenon".

An entity should also review evidence that is specific to it to identity potential sustainability-related risks and opportunities. Figure 1-2 below outlines some common sources of entity-specific evidence.

Figure 1-2: Common sources of entity-specific evidence

Sources of entity-specific evidence	Description
Contents of business records used for decision-making and management agreements	Evidence of the existence of a sustainability-related risk or opportunity may be found in various types of business records maintained by an entity. Sustainability-related risks or opportunities may arise from documents used for decision making or agreements such as: ▸ Reports that are regularly reviewed by the Chief Operating Decision Maker of an entity ▸ Budgets or business cases for new investments or reorganisations ▸ Short-term incentive plans or other remuneration or performance management arrangements These sources may be evidence that the risk or opportunity could reasonably be expected to affect the entity's prospects. This is based on the presumption that a sustainability-related risk or opportunity that could not reasonably be expected to affect the entity's prospects would not be expected to be mentioned in agreements and business records used for decision-making.
Expectations and obligations imposed by the capital markets and value chain	Sustainability-related questions from investors and analysts and sustainability-related conditions set by customers, suppliers and lenders may provide insight into the sustainability-related risks and opportunities faced by an entity.

By considering both external evidence and entity-specific evidence, an entity will have identified a pool of potential sustainability-related risks and opportunities. A filter is applied to assess which of those sustainability-related risks and opportunities could reasonably be expected to affect an entity's prospects. This filter requires assessing whether there is a linkage between the sustainability-related risks and opportunities and the entity's future cash flows, access to finance or cost of capital over the short, medium or long term.

Frequently asked questions

Question 1-1: Would it be sufficient for entities to rely on their prior or existing sustainability reporting practices when identifying sustainability-related risks and opportunities?

In identifying sustainability-related risks and opportunities that could reasonably be expected to affect their prospects as required by ISSB standards, entities have different perspectives and different existing data sets to refer to. There are entities that have not previously prepared disclosures to comply with any sustainability-reporting framework, nor do they have a mature risk management function for the identification of key risk areas. There are also entities that have well-established prior or existing practices on sustainability reporting that may, or may not, have the same objective as ISSB standards (e.g., focusing on how an entity contributes to sustainable development, rather than the information needs of primary users).

It is expected that entities will use different starting points in identifying sustainability-related risks and opportunities. However, solely basing this process on prior or existing practices applied by the entity is not enough to ensure that an entity has considered all relevant factors in identifying those sustainability-related risks and opportunities to meet the objective of ISSB standards (see discussion about the objective in section 1.1 above). That is, in adopting ISSB standards, an entity needs to conduct a holistic and thorough analysis.

How we see it

Regardless of the starting point of an entity in the identification process of sustainability-related risks and opportunities that could reasonably be expected to affect its prospects, the assessment needs to be based on a fresh holistic analysis of the entity. This is because prior or existing practices applied by the entity in identifying sustainability-related risks and opportunities will not be sufficient to meet the requirements of ISSB standards.

Question 1-2: Can sustainability-related risks result to an entity losing its ability to operate as a 'going concern'?

In identifying the sustainability-related risks and opportunities that could reasonably be expected to affect its prospects, there may be cases that an entity identifies risks that could lead to situations affecting its ability to operate as a 'going concern'. For example, an entity may accidentally cause damage to nature or human beings while conducting its operations which could result to significant reputational damage or put on risk its licence to conduct business and therefore, affect the entity's prospects.

How we see it

It is possible that an entity's operations may accidentally cause damage to nature or people which could result in the entity being exposed to significant reputational damage or put on risk its licence to conduct business. When an entity exercises judgement in identifying sustainability-related risks, the entity should consider the likelihood and magnitude of the risk occurring. In cases such as this, an entity may conclude that the risk represents a sustainability-related risk that could reasonably be expected to affect its prospects because of the magnitude of the consequence of the risk, even though the likelihood of occurrence is low.

Question 1-3: Does an entity need to consider any mitigation activities, in place or planned, when identifying sustainability-related risks that could reasonably be expected to affect its prospects and when disclosing material information about them?

(TIG meeting 19 September 2024 - Agenda paper no. 2, ISSB meeting 20 November 2024 - Agenda paper no. 9C)

In September 2024, the TIG discussed whether an entity needs to consider any mitigation activities, either those that are already in place or those that have been planned, when identifying sustainability-related risks that could reasonably be expected to affect its prospects. The TIG also discussed whether the information about those identified sustainability-related risks needs to be disclosed separately from any relevant mitigation activities (i.e., on a gross basis) or after considering them (i.e., on a net basis).

The TIG noted that an entity's process to identify sustainability-related risks that could reasonably be expected to affect its prospects is a fundamental step to identify the information about those risks that is material to the users and, ultimately, meet the objective of IFRS S1 (see section 1.2 above). Such information is intended to help primary users in making decisions about providing resources to the entity and therefore, the entity needs to consider an external perspective in addition to its own. With that in mind, the TIG acknowledged that the ISSB standards are not explicit on whether or how an entity needs to consider any mitigation activities when identifying sustainability-related risks that could reasonably be expected to affect its prospects. However, the TIG noted that, judgement is expected to be applied when identifying sustainability-related risks which, depending on specific facts and circumstances, may include determining whether and how risk mitigation activities would be a factor for an entity to consider while identifying such risks. Moreover, the TIG emphasised that caution needs to be exercised when identifying sustainability-related risks 'net' of the effect of risk mitigation activities. In applying judgement, there are several considerations with respect to the mitigation activities for an entity to carefully think through, for example:

- The 'control' an entity has over a mitigation activity which indicates the entity's ability to manage the risk and how much visibility an entity has on how the mitigation activity progresses
- The effectiveness of a mitigation activity, how an entity assesses the effectiveness
- How much effort the entity puts in place to mitigate the risk or how prominent its mitigation activities are
- The phase of implementation of the mitigation activity (e.g., already put in place and implemented, initial stages of implementing, planning to put in place for a future period)

- Whether the mitigation activity relates to a risk that is evolving. Depending on the nature of the risk that is being addressed, the entity's mitigation activities may need to be reassessed over-time to ensure that they are fit for purpose

Depending on its analysis of the various considerations about the risk mitigation activities (such as the ones listed above), an entity needs to determine whether these mitigants could affect the extent to which it is exposed to a risk and whether and how it expects its prospects to be affected. That is, depending on the specific circumstances, an entity may determine that, due to its mitigation activities, it may, or it may not be exposed to a sustainability-related risk that could reasonably be expected to affect its prospects.

The ISSB standards include various requirements that are either explicit or not explicit in terms of how information about an entity's risk mitigation activities should be disclosed. The TIG emphasised that, ultimately, an entity needs to ensure that primary users have a complete understanding of its thought process, with respect to identification of sustainability-related risks and how these are mitigated, to make their decisions. That is, entities need to identify what information would be useful to its primary users and what disclosures are to be provided based on its materiality assessment by considering whether omitting, misstating or obscuring information about its risk mitigation activities could reasonably be expected to influence the decisions of primary users. Such disclosures need to include information that primary users need to make their own assessment about the effect of mitigation activities.

In its agenda paper, the ISSB staff used some examples that illustrate the issue as well as the considerations involved in the thought process while applying the principles of the ISSB standards. The TIG noted that these examples have been primarily used for illustration purposes, rather than to provide an answer for all scenarios, and emphasised the judgement needed based on the specific facts in each situation. Consider the following illustrations from the TIG agenda paper:

Illustration 1-1: Sustainability-related risk is identified despite of in place or planned risk mitigation activities

Scenario A

An entity operates in an industry that is known for its supply chain activities being concentrated in jurisdictions with high incidences of human rights violations. Its supply chain activities are concentrated in jurisdictions with high incidences of human rights violations. Therefore, it is reasonably expected that entities in this industry are exposed to sustainability-related risks related to human rights violations. However, the entity has implemented risk mitigation activities, to ensure its suppliers operate entirely in one jurisdiction that is known for its effective policies to prevent human rights violations. Thus, due to its mitigation activities the entity determines this risk is not expected to affect its prospects. However, when considering whether it could reasonably be expected to affect its prospects, the entity notes that despite its risk mitigation activities, this risk is so pervasive in its industry, it is a risk that could be reasonably be expected to affect the entity's prospects. The entity therefore identifies this as a sustainability-related risk that could reasonably be expected to affect its prospects, effectively identifying the risk 'before' or despite the effect of its mitigation activities.

Scenario B

An entity's assets are at risk of damage due to increasing severe weather events that it considers to be attributable to climate-related risks, and therefore identifies a sustainability-related risk. The entity plans to mitigate this risk by selling these assets. However, as this risk mitigation activity is only planned and the entity still owns these assets, the entity remains exposed to this sustainability-related risk. The entity therefore identifies this as a sustainability-related risk that could reasonably be expected to affect its prospects. That is, despite planned mitigation activities, the entity identifies a sustainability-related risk.

Illustration 1-2: Sustainability-related risk is not identified due to risk mitigation activities

Scenario A

An entity operates in an industry that is subject to stringent regulations regarding its wastewater treatment. Ten years ago, the entity implemented risk mitigation activities including the introduction of 'best-in-class' equipment to facilitate wastewater treatment. This equipment undergoes mandatory routine maintenance, and the entity conducts daily random tests of water quality. The entity has never experienced any challenges associated with its water quality, and never failed to meet its regulatory obligations related to water quality. The entity considers whether exposure to a risk associated with its wastewater treatment would be one that is reasonably expected to affect its prospects, given the entity has effectively managed this risk for ten years, and that its primary users are aware of the stringent regulatory requirements for wastewater treatment and its approach to mitigate this risk. The entity does not identify this as a sustainability-related risk that could reasonably be expected to affect its prospects due to the effect of the risk mitigation.

Scenario B

An entity operates in the automobile industry and in 2024 20% of its manufactured vehicles were gasoline-powered. The entity operates in only one jurisdiction which has introduced a regulation that will tax the production of gasoline-powered vehicles produced after 2028. Therefore, the entity is, in 2024, exposed to a sustainability-related transition risk. However, by 2025, as part of its risk mitigation strategy, the entity has ended production of gasoline-powered vehicles. Therefore, when considering the sustainability-related risks that the entity is exposed to in 2025, the entity does not identify this as a sustainability-related risk that could reasonably be expected to affect its prospects.

How we see it

We believe that when identifying the sustainability-related risks that could reasonably be expected to affect its prospects, an entity would generally not consider mitigation activities that are in place or are planned to address those risks. However, identifying sustainability-related risks requires judgement to be applied and, in some cases, risk mitigation activities could affect this identification process. When identifying what information is material about sustainability-related risks, mitigation activities are part of the assessment, as such information could affect the decisions that primary users make about providing resources to the entity. In determining what information is material, the entity needs to consider the primary users' perspective in addition to its own.

1.2.2 Use of reasonable and supportable information

1.2.2.A The concept of reasonable and supportable information

Many stakeholders, during the consultation process for the Exposure Draft of IFRS S1, shared their concerns with the ISSB about the range of capabilities and preparedness of entities around the world to apply the requirements of ISSB standards. The cost of investing in and operating the systems and processes necessary to prepare the disclosures required by ISSB standards can be relatively high for some entities. Also, the availability of high-quality external data can be limited in some markets, industries and parts of the value chain, and some entities can struggle to access the skills or expertise needed to prepare the disclosures. *[IFRS S1.BC8].* For example, despite the guidance provided in IFRS S1 to assist in the identification of sustainability-related risks and opportunities that could reasonably be expected to affect an entity's prospects (discussed in section 1.2.1 above), entities may still find it challenging to make such an assessment and understand how far they should go within their value chain.

These concerns led the ISSB to make decisions about proportionality in the application of ISSB standards to ease the burden of disclosure and assist entities in this application process. One of these decisions was to introduce in IFRS S1 the concept of "all reasonable and supportable information that is available to the entity at the reporting date without undue cost or effort". This concept is not unique to sustainability-related financial disclosures. There are amounts recognised and measured according to IFRS accounting standards by also referring to this concept, but its use is limited to specific circumstances to guide an entity in applying requirements that involve a high level of measurement uncertainty, rather than being used as a broad principle. *[IFRS S1.BC9, IFRS S1.BC10, IFRS S1.BC11].*

Similarly, this concept only applies to specific requirements of IFRS S1 where judgement is involved. The ISSB believes that the use of this concept is beneficial where entities apply requirements that involve a high level of judgement or uncertainty because it establishes parameters for the type of information to consider, and for the effort required to obtain such information. *[IFRS S1.BC15].*

1.2.2.B Application of the concept of reasonable and supportable information in IFRS S1

IFRS S1 requires the concept of "all reasonable and supportable information that is available to the entity at the reporting date without undue cost or effort" to be applied: a) in the identification process of sustainability-related risks and opportunities that could reasonably be expected to affect an entity's prospects and b) in the determination of the scope of an entity's value chain (including its breadth and composition) in relation to each of those sustainability-related risks and opportunities. *[IFRS S1.B6, IFRS S1.B7].*

For further discussion about the determination of the scope of the value chain, see section 3.3.3 below. The ISSB's intention is to avoid situations where entities overstate or understate their reported sustainability-related risks and/or opportunities. *[IFRS S1.BC51].* IFRS S1 also requires this concept to be used with respect to the preparation of disclosures about the anticipated financial effects of a sustainability-related risk or opportunity (see discussion in section 4.3.4 below).

IFRS S1 goes on to determine what qualifies as reasonable and supportable information as follows: *[IFRS S1.B8, IFRS S1.B9, IFRS S1.B10]*

Extract from IFRS S1

Reasonable and supportable information

B8 Reasonable and supportable information used by an entity in preparing its sustainability-related financial disclosures shall cover factors that are specific to the entity as well as general conditions in the external environment. In some cases-such as in identifying sustainability-related risks and opportunities that could reasonably be expected to affect an entity's prospects-reasonable and supportable information includes information about past events, current conditions and forecasts of future conditions. Other IFRS Sustainability Disclosure Standards may specify what is reasonable and supportable information in specific cases.

B9 An entity may use various sources of data that may be both internal and external. Possible data sources include the entity's risk management processes; industry and peer group experience; and external ratings, reports and statistics. Information that is used by the entity in preparing its financial statements, operating its business model, setting its strategy and managing its risks and opportunities is considered to be available to the entity without undue cost or effort.

B10 An entity need not undertake an exhaustive search for information to identify sustainability-related risks and opportunities that could reasonably be expected to affect the entity's prospects. The assessment of what constitutes undue cost or effort depends on the entity's specific circumstances and requires a balanced consideration of the costs and efforts for the entity and the benefits of the resulting information for primary users. That assessment can change over time as circumstances change.

This concept, in itself, does not introduce additional disclosure requirements, nor does it intend to exempt an entity from providing a disclosure. Rather, it is intended to emphasise that relevant and appropriate information is required. Also, it is intended to assist those entities that find it challenging to apply the requirements in ISSB standards and would otherwise be unable to comply fully with them. Entities need to provide only information that is supportable and reasonable and use all information that is available to them at the reporting date, without carrying out an exhaustive search that would represent 'undue cost or effort'. This is determined based on an entity's circumstances (e.g., a less exhaustive search for information is permitted if the cost of obtaining particular information is proportionately higher for the entity than for other entities with more resources). This does not mean that no effort is necessary, especially given the fact that such information relates to a risk or opportunity that could reasonably be expected to affect the entity's prospects. *[IFRS S1.BC16, IFRS S1.BC17].*

How we see it

In identifying sustainability-related risks and opportunities, an entity needs to consider its specific circumstances when searching for reasonable and supportable information without undue cost or effort. However, we expect that searching for such information will only infrequently involve undue cost or effort. Although an entity is not required to carry out exhaustive search for information, the effort an entity makes in this identification process needs to be commensurate with the processes set up for identifying its sustainability-related risks and opportunities, as discussed in section 1.2.1 above.

1.2.3 Reassessing the scope of sustainability-related risks and opportunities

An entity's sustainability-related risks and opportunities, along with their effects and expectations of those effects on an entity, change over time and in relation to the interdependent system in which an entity operates. The ISSB initially considered requiring entities to reassess the scope of each sustainability-related risk and opportunity throughout their value chain at each reporting date. However, the ISSB decided that primary users would typically benefit from a reassessment only if a significant event or a significant change in circumstances occurs and that doing so at each reporting date was not necessary. However, an entity may choose to reassess the scope of any sustainability-related risk or opportunity throughout its value chain more frequently (e.g., annually). *[IFRS S1.B12, IFRS S1.BC45, IFRS S1.BC59, IFRS S1.BC60, IFRS S1.BC61, IFRS S1.BC62].*

According to IFRS S1 "a significant event or significant change in circumstances can occur without the entity being involved in that event or change in circumstances, or as a result of a change in what the entity assesses to be important to users of general purpose financial reports". *[IFRS S1.B11].* Generally, assessing whether an event or change in circumstances is significant and, therefore, reassessment of the scope of all affected sustainability-related risks and opportunities is required throughout the entity's value chain, is a matter of judgement. *[IFRS S1.75(d)].* For further discussion on judgements, see section 6.1 below.

IFRS S1 provides examples of the types of events or changes in circumstances that would be considered significant. They also illustrate that a significant event or significant change in circumstances can occur without the entity being involved in that event or change in circumstances, or as a result of a change in what the entity assesses to be important to primary users. *[IFRS S1.B11].*

Extract from IFRS S1

B11 On the occurrence of a significant event or significant change in circumstances, an entity shall reassess the scope of all affected sustainability-related risks and opportunities throughout its value chain. A significant event or significant change in circumstances can occur without the entity being involved in that event or change in circumstances or as a result of a change in what the entity assesses to be important to users of general purpose financial reports. For example, such significant events or significant changes in circumstances might include:

(a) a significant change in the entity's value chain (for example, a supplier in the entity's value chain makes a change that significantly alters the supplier's greenhouse gas emissions);

(b) a significant change in the entity's business model, activities or corporate structure (for example, a merger or acquisition that expands the entity's value chain); and

(c) a significant change in an entity's exposure to sustainability-related risks and opportunities (for example, a supplier in the entity's value chain is affected by the introduction of a new regulation that the entity had not anticipated).

While an entity is required to reassess the scope of all affected sustainability-related risks and opportunities arising throughout its value chain when such a significant event or significant change in circumstances occurs, not all sustainability-related risks and opportunities will necessarily be affected. This is further explained by the example provided in the Basis for Conclusions to IFRS S1. *[IFRS S1.BC61].*

Illustration 1-3: Reassessing the scope of sustainability-related risks and opportunities

A regulation is introduced for greenhouse gas emissions associated with employee travel that an entity had not anticipated. Because of this regulation, the entity may be required to reassess which categories to include in the measurement of its Scope 3 greenhouse gas emissions. However, this regulation does not affect the entity's other sustainability-related risks and opportunities in its value chain (e.g., the entity's identified risk of water scarcity). Therefore, the entity is not required to reassess the scope of those other sustainability-related risks and opportunities.

It is not necessary to have a change in the entity's value chain to conclude that a significant event or significant change in circumstances has occurred. That is, the scope of a sustainability-related risk or opportunity may change even though the entity's value chain has not changed. *[IFRS S1.BC61].*

2 Scope

2.1 The scope of IFRS S1

Entities apply IFRS S1 when preparing and reporting sustainability-related financial disclosures in accordance with ISSB standards. The scope of IFRS S1 covers sustainability-related risks and opportunities that could reasonably be expected to affect an entity's prospects (as discussed in section 1.1.2 above). Therefore, any sustainability-related risks and opportunities that could not reasonably be expected to affect an entity's prospects are outside the scope of IFRS S1. *[IFRS S1.5, IFRS S1.6].*

IFRS S1 sets out the general requirements for providing primary users with a complete set of sustainability-related financial disclosures (as discussed in section 1.1 above). This means that IFRS S1 focuses on the overall sustainability-related financial disclosures, while other ISSB standards specify information an entity is required to disclose about specific sustainability-related risks and opportunities (e.g., IFRS S2). *[IFRS S1.7].* In order to comply with the specific requirements set out by other ISSB standards for sustainability-related risks and opportunities related to specific topics that could reasonably be expected to affect an entity's prospects, it is also necessary to take into account the relevant requirements of IFRS S1.

The sustainability-related financial disclosures provided in accordance with the requirements of ISSB standards are part of an entity's general purpose financial reports (as discussed in section 1.1 above). Such disclosures can be applied regardless of which generally accepted accounting principles or practices (GAAP) the entity uses in preparing the related financial statements. *[IFRS S1.8].* IFRS S1 uses definitions and requirements that are consistent, if applicable, with the IASB's Conceptual Framework, IAS 1 and IAS 8. However, its rationale is to introduce a base for decision-useful and comparable reporting of sustainability-related financial information by requiring the application of some established practices from financial reporting, rather than mandating the use of IFRS accounting standards used for the preparation of financial statements. *[IFRS S1.BC5].*

2.2 Application by public sector or entities other than profit-oriented entities

The terminology used in ISSB standards is suitable for profit-oriented entities, including public-sector business entities. However, the ISSB identified interest in ISSB standards from, among others, the public sector, entities other than profit-oriented entities, as well as regulators and other organisations that oversee financial market stability. Considering this interest, the ISSB decided not to preclude not-for-profit activities in the private sector or public sector from applying ISSB standards, but if they do so, IFRS S1 specifies that they may need to amend the descriptions used for particular items of information. *[IFRS S1.9, IFRS S1.BC4].*

3 Conceptual foundations

3.1 Fair presentation of sustainability-related risks and opportunities

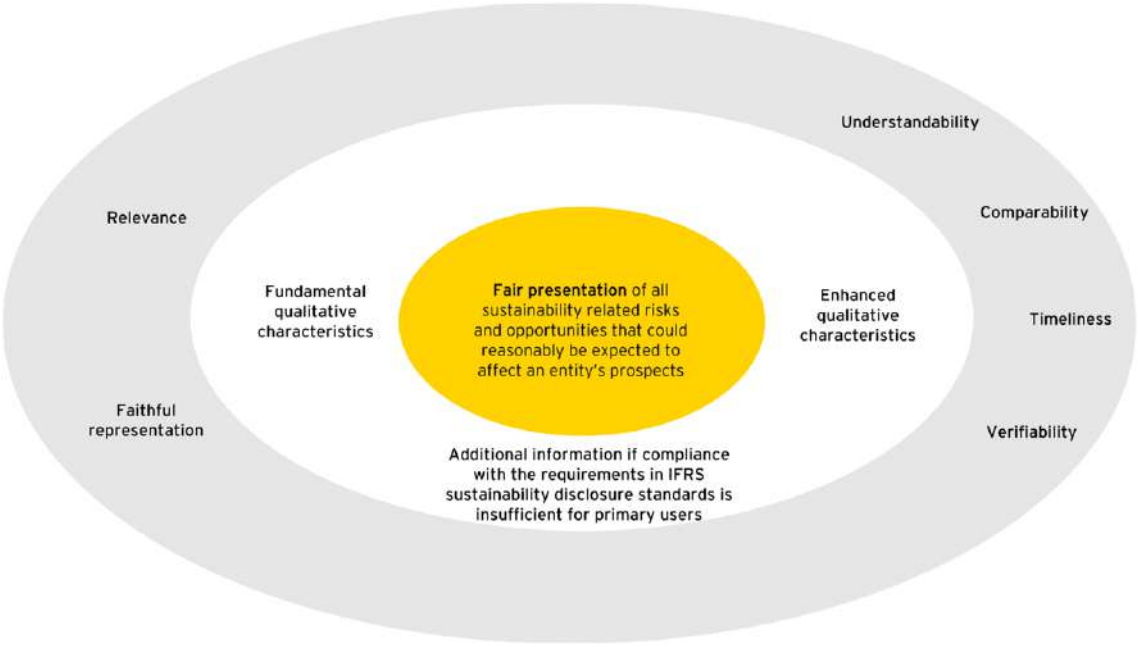
The concept of fair presentation is well-understood in IFRS accounting standards (as described in the IASB's Conceptual Framework and IAS 1) and in other GAAP. IFRS S1 adapted this concept in the context of sustainability-related financial disclosures.

IFRS S1 requires an entity to provide a complete set of sustainability-related financial disclosures that presents fairly all sustainability-related risks and opportunities that could reasonably be expected to affect an entity's prospects. *[IFRS S1.11].* Moreover, to meet the objective of IFRS S1, sustainability-related financial disclosures need to include information that is useful to primary users to enable their decision-making relating to providing resources to the entity (see section 1.1 above).

To achieve fair presentation of sustainability-related risks and opportunities and ensure that the information about them is useful, sustainability-related financial information needs to meet the fundamental qualitative characteristics of being relevant and faithfully representing what it purports to represent in accordance with the principles set out in IFRS S1. Along with the fundamental qualitative characteristics, IFRS S1 includes a list of additional qualitative characteristics that enhance the usefulness of sustainability-related financial information. These enhancing qualitative characteristics are: comparability; verifiability; timeliness; and understandability of the sustainability-related financial information. *[IFRS S1.10, IFRS S1.13].* The qualitive characteristics are further discussed in section 3.1.1 below.

In addition to meeting the qualitative characteristics mentioned above, to achieve fair presentation, IFRS S1 also requires an entity to disclose additional information if compliance with the specifically applicable requirements in ISSB standards is insufficient to enable primary users to understand the effects of sustainability-related risks and opportunities on the entity's cash flows, its access to finance and cost of capital over the short, medium and long term. *[IFRS S1.15, IFRS S1.BC63].* For further discussion on the additional information, see section 3.2.4.A below.

Figure 3-1: Fair presentation



3.1.1 Qualitative characteristics of sustainability-related financial information

While the nature of some of the information required to meet the objective of IFRS S1 differs in some respects from the information provided in financial statements (see further discussion in section 3.2.1 below), the qualitative characteristics have been adapted from the IASB's Conceptual Framework. The IASB's Conceptual Framework describes the objective of, and the concepts that apply to, general purpose financial reports and one of its purposes is to assist the IASB to develop IFRS accounting standards for preparing financial statements based on consistent concepts. Since the sustainability-related financial information is part of the general purpose financial reports, the qualitative characteristics of the IASB's Conceptual Framework also apply to sustainability-related financial disclosures. *[IFRS S1.D1, IFRS S1.D2].*

Given that there is no separate conceptual framework directly applicable to ISSB standards, IFRS S1 includes guidance on the qualitative characteristics (both the fundamental and the enhancing ones) of sustainability-related financial information. These qualitative characteristics are intended to assist entities in preparing their sustainability-related financial disclosures by explaining their applicability to sustainability-related financial information (e.g., the fact that information in the form of explanations or forward-looking statements is still verifiable). It is also intended to ensure that information in general purpose financial reports (both in sustainability-related financial disclosures and in financial statements) is useful to users of those reports. *[IFRS S1.BC64, IFRS S1.BC65].*

A description for each qualitative characteristic of sustainability-related financial information is included in section 3.1.1.A and 3.1.1.B below, which is based on Appendix D of IFRS S1. *[IFRS S1 Appendix D].*

3.1.1.A Fundamental qualitative characteristics

Relevance

Relevant sustainability-related financial information can make a difference to the decisions made by primary users. Information can make a difference in a decision even if some users choose not to take advantage of it or are already aware of it from other sources. This occurs when the information has predictive value, confirmatory value or both. In particular:

- Sustainability-related financial information with predictive value exists if the information can be used as an input to processes employed by primary users to predict future outcomes. This information does not need to be a prediction or forecast, rather it is employed by primary users in making their own predictions. For example, information about water quality, which can include information about the water being polluted, could inform the expectations of primary users about the ability of an entity to meet local water quality requirements.
- Sustainability-related financial information has confirmatory value if it provides feedback (confirms or changes) about previous evaluations.

These values (predictive and confirmatory) are interrelated; information that has predictive value often also has confirmatory value. For example, information for the current year about greenhouse gas (GHG) emissions, which can be used as the basis for predicting GHG emissions in future years, can also be compared with predictions about GHG emissions for the current year that were made in previous years. The results of those comparisons can help a primary user to correct and improve the processes that were used to make those predictions in previous years.

Moreover, sustainability-related financial information is relevant when it is material to the primary users of a specific reporting entity (materiality is further discussed in section 3.2 below). Because of the specificity of materiality to a particular reporting entity, Appendix D of IFRS S1 considers materiality to be an entity-specific aspect of relevance. This is because materiality is based on the nature or magnitude, or both, of the sustainability-related financial information for a specific entity. *[IFRS S1.D4-D8].*

Faithful representation

Sustainability-related financial information represents phenomena in words and numbers. To be useful, other than representing relevant phenomena, the information must also faithfully represent the substance of the phenomena that it purports to represent. Such faithful representation is achieved when the depiction of a sustainability-related risk or opportunity is complete, neutral and accurate. The objective of general purpose financial reports is to maximise those qualities to the extent possible. In particular: *[IFRS S1.D9-D15]*

- A complete depiction of a sustainability-related risk or opportunity includes all material information necessary for primary users to understand that risk or opportunity.
- A neutral depiction is one without bias in the selection or disclosure of information. The information is neutral if it is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to make it more likely that primary users will receive that information favourably or unfavourably. Neutral information is relevant (which, by definition, is capable of making a difference in primary users' decisions), rather than without purpose or without influence on behaviour. Some sustainability-related financial information (e.g., targets or plans) is aspirational. A neutral discussion of such matters covers both aspirations and the factors that could prevent an entity from achieving these aspirations. Neutrality is supported by the exercise of prudence, which is the exercise of caution when making judgements under conditions of uncertainty (i.e., that opportunities are not overstated and risks are not understated and vice versa).
- Information can be accurate without being perfectly precise in all respects. The required attainable precision and the factors that make information accurate, depend on the nature of the information and the nature of the matters to which it relates. For example, accuracy requires that:

- Factual information is free from material error
- Descriptions are precise
- Estimates, approximations and forecasts are clearly identified as such
- No material errors are made in selecting and applying an appropriate process for developing an estimate, approximation or forecast
- Assertions and inputs used in developing estimates are reasonable and based on information of sufficient quality and quantity
- Information on judgements about the future faithfully reflects both those judgements and the information on which they are based

The ISSB noted that, according to the IASB's Conceptual Framework, to be a perfectly faithful representation, a depiction would have three characteristics: it would be complete, neutral and free from error. However, considering that entities may not be familiar with the term 'free from error' in the context of sustainability-related financial disclosures, the ISSB decided to use the term 'accurate', instead of 'free from error', to describe a 'complete depiction' of an entity's sustainability-related financial information. *[IFRS S1.BC66].*

3.1.1.B Enhancing qualitative characteristics

Comparability

The decisions made by the primary users involve choosing between alternatives (e.g., selling or holding an investment, or investing in one reporting entity or another). Comparability is the characteristic that enables primary users to identify and understand similarities and differences in items. Unlike the other qualitative characteristics, comparability requires at least two items.

Information is more useful if it can also be compared with information provided by the entity in previous periods, as well as information provided by other entities, in particular, those with similar activities or operating within the same industry. Comparability should not be confused with uniformity. Appendix D of IFRS S1 notes that while consistency and comparability are related, the former refers to the use of the same approaches or methods for providing disclosures about the same sustainability-related risks and opportunities from period to period, both by a reporting entity and other entities. That is, consistency helps in achieving comparability, which is the goal. *[IFRS S1.D17-D20].*

Verifiability

Verifiability helps to give primary users confidence that information is complete, neutral and accurate (see also description for faithful representation above). Information is verifiable if it is possible to corroborate either the information itself or the inputs used to derive it.

Verifiability means that various knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Quantified information need not be a single point estimate to be verifiable, rather a range of possible amounts and the related probabilities that can also be verified.

Verifiable information is more useful to primary users than information that is not verifiable. It can be enhanced by providing, for example:

- Information that can be corroborated by comparing it with other information available to primary users about: an entity's business, other businesses or the external environment in which the entity operates
- Information that can be supported by assurance providers
- Information about inputs and methods of calculation used to produce estimates or approximations
- Information that has been reviewed and agreed by the entity's board, board committees or equivalent bodies

Some sustainability-related financial information will be presented as explanations or forward-looking information. That information can be supportable, for example, by faithfully representing fact-based strategies, plans and risk analyses. To help primary users decide whether to use such information, a description of the underlying assumptions and methods of producing the information, as well as other factors that provide evidence that the information reflects the actual plans or decisions made by the entity would be necessary. *[IFRS S1.D21-D24].*

Timeliness

Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Although older information may be less useful, some may continue to be timely long after the end of a reporting period (e.g., when primary users need to identify and assess trends). *[IFRS S1.D25].*

Understandability

Information is understandable when it is clear and concise. In particular: *[IFRS S1.D26-D33]*

- The level of clarity in disclosures depends on the nature of the information. In some cases, in addition to narrative text, an entity may need to add tables, graphs or diagrams (or even additional text or tables for those additions to avoid obscuring material detail). Clarity can be enhanced by distinguishing information about developments in the reporting period from 'standing' information that remains unchanged, or changes little, from one period to the next (e.g., by separately describing features of an entity's sustainability-related governance and risk management processes that have changed since the previous reporting period). In some cases, information about sustainability-related risks and opportunities may be inherently complex and difficult to present in a manner that is easy to understand. Such information needs to be presented as clearly as possible, rather than being excluded. Excluding such information would render those reports incomplete and potentially misleading.
- Disclosures are concise if they include only material information. Any immaterial information included needs to be provided in a way that avoids obscuring material information (see also section 3.2.4.B below).

Having clear and concise information can be achieved when an entity:

- Avoids generic (i.e., 'boilerplate') information, that is not specific to the entity;
- Avoids duplication of information in its general purpose financial reports, including unnecessary duplication of information also provided in the related financial statements; and
- Uses clear language and clearly structured sentences and paragraphs

The completeness, clarity and comparability of sustainability-related financial information all rely on information being presented as a coherent whole. Coherence is also important in meeting the requirements of IFRS S1 about connected information (see relevant discussion in section 3.4 below). For the information to be coherent, an entity needs to:

- Present it in a way that explains the context and the connections between the related items of information. That is, if sustainability-related risks and opportunities located in one part of an entity's general purpose financial reports have implications for information disclosed in other parts, the entity needs to include the information necessary for primary users to assess those implications.
- Provide it in a way that allows primary users to relate information about its sustainability-related risks and opportunities to information in the entity's financial statements.

3.2 Materiality

3.2.1 Definition of materiality

In meeting the objective of IFRS S1, an entity is required to disclose information about its sustainability-related risks and opportunities that could reasonably be expected to affect the entity's prospects (see section 1.2 above). *[IFRS S1.17, IFRS S1.B13].* Such information needs to be useful to primary users so that they make their decisions relating to providing resources to the entity (see section 1.1 above), and this occurs when the information disclosed is material.

IFRS S1 defines materiality as follows: *[IFRS S1.18]*

Extract from IFRS S1	
18	In the context of sustainability-related financial disclosures, information is material if omitting, misstating or obscuring that information could reasonably be expected to influence decisions that primary users of general purpose financial reports make on the basis of those reports, which include financial statements and sustainability-related financial disclosures and which provide information about a specific reporting entity.

The definition of materiality was developed based on the definitions of 'material information' and 'material' in the IASB's Conceptual Framework and IAS 1, respectively. This definition is used in IAS 1 with a specific reference to the financial statements. The materiality assessment in the IASB's Conceptual Framework is not constrained to what is financially material in the financial statements but focuses on the identification of information that is useful to primary users. These primary users are consistent with those of the sustainability-related financial disclosures prepared in accordance with ISSB standards (see section 1.1.1 above). Such a consistency emphasises that the purpose of the materiality assessment is to ensure that the primary users have the information that is relevant to their decision-making and that users do not make

their decisions on the basis of just one form of general purpose financial reports published by the entity. *[IFRS S1.BC68].*

The alignment in the concept and definition of materiality, applicable to both sustainability-related financial information and information in the financial statements, facilitates the connectivity between them (for further discussion on connected information, see section 3.4 below) and it supports the application of ISSB standards, given the broad use of IFRS accounting standards. However, the materiality judgements for sustainability-related financial disclosures will inevitably differ from those for financial statements since they serve their specific objectives and provide different types of information about an entity. In fact, information about sustainability-related risks and opportunities is intended to capture a broader set of information that is not constrained by the definitions of assets, liabilities, equity, income and expenses under IFRS accounting standards, nor the criteria for recognising them. Compared with information included in financial statements, sustainability-related financial information may have different measurement bases and considers financial implications over longer time periods, including interactions throughout an entity's value chain. It follows that the material information about sustainability-related risks and opportunities that could reasonably be expected to affect the entity's prospects, aim to complement the information provided in the financial statements about the entity's assets, liabilities, equity, income and expenses. *[IFRS S1.BC1, IFRS S1.BC69].*

Including a specific definition of materiality in IFRS S1 (applicable to all ISSB standards) was a deliberate decision by the ISSB given that ISSB standards are not designed to be applied only with IFRS accounting standards, but any GAAP (see section 2.1 above) that may not share the same definition of materiality. Also, given the variation in how the concept of materiality is interpreted, applied and enforced in various jurisdictions in the context of sustainability-related financial information, a definition of materiality in IFRS S1 was a key decision to make it clear to entities how the materiality concept needs to be applied and assessed under ISSB standards. *[IFRS S1.BC71, IFRS S1.BC72].*

How we see it

Applying the materiality concept in the context of sustainability-related financial disclosures is relatively new and this is expected to evolve over time. Although this application can be informed by the assessment of materiality in financial statements, more judgement may be needed by an entity given the more qualitative nature of sustainability-related financial disclosures. Therefore, an entity needs to establish the appropriate processes to make materiality judgements based on its specific circumstances.

3.2.2 Identifying material information

As mentioned in section 3.2.1 above, an entity needs to disclose material information about its sustainability-related risks and opportunities such that the information is useful to primary users in making their decisions about providing resources to the entity. However, the identification of such material information requires judgement. IFRS S1 requires an entity to disclose information about the judgements it has made to prepare its sustainability-related financial disclosures that have the most significant effect on those disclosures. An example of making such a judgement is when an entity identifies material information to be included in the sustainability-related financial disclosures. For further discussion on judgements, see section 6.1 below. *[IFRS S1.74].*

Similar to the process of identifying the sustainability-related risks and opportunities that could reasonably be expected to affect an entity's prospects (discussed in section 1.2 above), the ISSB indicated in IFRS S1, various ways to assist in the identification of material information about those risks and opportunities. In particular, apart from the definition of materiality discussed in section 3.2.1 above, the following sections include:

- Guidance relating to identifying and meeting primary users' information needs (see section 3.2.2.A below)
- Requirements to be applied while identifying material information by considering:
  - The sources of guidance an entity uses in this identification process (see section 3.2.2.B below)
  - Possible future events with uncertain outcomes (see section 3.2.2.C below)
  - Other characteristics of material information (i.e., additional information disclosed by an entity, aggregation and disaggregation of information, interaction with law or regulation, commercially sensitive information) (see section 3.2.4 and 3.2.5 below)

3.2.2.A Information needs of primary users

In identifying the material information to be disclosed, apart from understanding the definition of materiality underpinned in the application of standards (see section 3.2.1 above), an entity needs to understand the types of decisions made by primary users and what it can do to meet those information needs. IFRS S1 gives an overview of what is involved in the primary users' decisions that relate to providing resources to the entity. These are decisions about: *[IFRS S1.B14]*.

- Buying, selling or holding equity and debt instruments
- Providing or selling loans and other forms of credit
- Exercising rights to vote on, or otherwise influence, the actions of the entity's management that affect the use of the entity's economic resources

These types of decisions depend on primary users' expectations of their returns (e.g., dividends, principal and interest payments or market price increases). Such expectations depend on primary users' assessment of the amount, timing and uncertainty of future net cash inflows to the entity. Also, those expectations depend on the primary users' assessment of the stewardship that the entity's management and its governing body(s) or individual(s) exercises on the entity's economic resources. *[IFRS S1.B15]*.

Having considered the types of decisions that primary users make and the expectations on which their decisions depend, an entity needs to consider the characteristics of primary users and its own circumstances to determine what could reasonably be expected to influence their decisions made for a specific entity. IFRS S1 describes primary users as those "who have reasonable knowledge of business and economic activities and who review and analyse information diligently. At times, even well-informed and diligent users may need to seek the aid of an adviser to understand sustainability-related financial information". *[IFRS S1.B16, IFRS S1.B17]*.

The information needs and desires of the primary users may differ among them, may be conflicting and could evolve over time. However, it is acknowledged that sustainability-related financial disclosures do not, and cannot, provide all the information that primary users need, such as specialised information needs that are unique to particular users. Instead, sustainability-related financial disclosures aim to meet the common information needs of an entity's primary users. *[IFRS S1.B18]*.

The *Implementation Guidance* to IFRS S1 goes on to explain the approach an entity follows to meet the common information needs of its primary users. In particular, an entity identifies the information needs of one of the three types of primary users e.g., investors (existing and potential), and then those of the two remaining types i.e., lenders and other creditors (existing and potential). The combination of those information needs forms the set of common information needs that the entity aims to meet. There may be information needs shared by all types of primary users or specific to only one or two types. However, using this approach, an entity identifies the common information needs of primary users, without having to identify the information needs that are shared by all types of primary users (i.e., the information needs that the primary users have in common), as this would exclude potential information that meets the needs of only one type of primary users. *[IFRS S1.IG5, IFRS S1.IG6]*.

Apart from the general purpose financial reports, primary users also consider other sources to meet their information needs (e.g., the industry in which an entity operates, the entity's competitors and the state of the economy, the entity's press releases as well as other documents the entity has published). However, the fact that information needed by primary users is publicly available does not relieve an entity from disclosing material information about the sustainability-related risks and opportunities that could reasonably be expected to affect the entity's prospects to comply with ISSB standards. *[IFRS S1.IG7]*.

How we see it

In some cases, significant judgement may be required in determining what meets the primary users' information needs, especially because such needs may evolve over time.

3.2.2.B Sources applied in assessing materiality

The starting point for an entity in identifying material information about a sustainability-related risk or opportunity is to apply the requirements of the ISSB standard that specifically applies to that sustainability-related risk or opportunity (e.g., the requirements in IFRS S2 for climate-related disclosures as discussed in Chapter 53). However, in the absence of such an ISSB topical standard, the entity applies the requirements specified in the section of IFRS S1 related to the sources of guidance, which is further discussed in section 5.1.2 below. *[IFRS S1.B20].*

3.2.2.C Possible future events with uncertain outcomes

A materiality assessment is also required for information about possible future events with uncertain outcomes and IFRS S1 includes specific considerations for this assessment. In particular, IFRS S1 states: *[IFRS S1.B22]*

Extract from IFRS S1

B22 In some cases, IFRS Sustainability Disclosure Standards require the disclosure of information about possible future events with uncertain outcomes. In judging whether information about such possible future events is material, an entity shall consider:

(a) the potential effects of the events on the amount, timing and uncertainty of the entity's future cash flows over the short, medium and long term (referred to as 'the possible outcome'); and

(b) the range of possible outcomes and the likelihood of the possible outcomes within that range.

If the potential effects of a possible future event are significant and the event is likely to occur, the information about that event is more likely to be material. However, information about low-probability and high-impact outcomes still needs to be considered as these may be material either individually or in combination with information about other low-probability and high-impact outcomes. For example, an entity is exposed to several sustainability-related risks that could individually cause the same type of disruption to the entity (e.g., disruption to its supply chain). Information about an individual source of risk is not material because disruption caused from that source is highly unlikely to occur. However, information about the aggregate risk (i.e., the risk of supply chain disruption from all sources) may be material. *[IFRS S1.B23].*

Moreover, if a possible future event is expected to affect an entity's cash flows, but only many years in the future, information about that event is usually less likely to be considered material than information about a possible future event with similar effects that are expected to occur sooner. However, in some circumstances, primary users' decisions could reasonably be expected to be influenced by information, regardless of the magnitude of the potential effects of the future event or the timing of that event (e.g., if information about a particular sustainability-related risk or opportunity is highly scrutinised by primary users of an entity's general purpose financial reports). *[IFRS S1.B24].*

Frequently asked questions

Question 3-1: Do the ISSB standards require an entity to consider the time value of money (e.g., using a discounted cashflow model) when making judgements about whether information is material?

IFRS S1 does not explicitly require an entity to use discounting techniques or cash flow models to quantify amounts when identifying which information about sustainability-related risks and opportunities is material to disclose. Entities are also not prohibited from using a mechanism to distinguish between the financial effect that is expected to occur in the short term compared to the long term. However, there is no specific requirement in the ISSB standards to do so.

However, the time value of money is relevant to the entity's materiality assessment. This is acknowledged in IFRS S1 by contrasting the expected effects on cash flows "many years in the future" with similar effects that are expected to "occur sooner". That is, the likelihood of the event occurring in both scenarios is comparable, but it is the timing of the occurrence of the event that is different. IFRS S1 goes on to explain that information about the former scenario is, usually, less likely to be considered material than the latter scenario (see discussion in this section above).

As explained in IFRS S1, in its materiality assessment, an entity needs to consider both quantitative and qualitative factors. Information could be material "regardless of the magnitude of the of the potential effects of the future event or the timing of that event" (see discussion at this section above and at section 3.2.3 below). Although the timing of cashflows is an important consideration, along with other quantitative factors, qualitative factors are equally important. Therefore, omitting such information, purely due to considering the time value of money, may lead to primary users missing material information.

3.2.3 Quantitative and qualitative factors in materiality judgements

Identifying material information about an entity's sustainability-related risks and opportunities that could reasonably be expected to affect its prospects requires judgement (see discussion in 3.2.2 above). An entity's materiality judgements focus on the objective of IFRS S1, which is to provide information that meets the needs of primary users (discussed in section 1.1 above). Therefore, there are various factors to consider when making these judgements, such as:

- The nature of the sustainability-related risk or opportunity.
- The nature of the entity's operations, assets, and liabilities (e.g., whether the majority of the entity's assets and liabilities are long-lived or short-lived).
- The growth prospects for the entity, the growth prospects of the industry in which the entity operates (e.g., high growth, stable, in decline) and the relationship between those two and the extent of the entity's exposure to the sustainability-related risk or opportunity. For example, whether an entity's exposure to a sustainability-related risk increases, remains constant or reduces relative to the prospects of the entity.

As further discussed in section 3.2.1 above, information is material if "omitting, misstating or obscuring that information could reasonably be expected to influence decisions that the primary users of general purpose financial reports make on the basis of those reports, which provide information about a specific reporting entity". Appendix D of IFRS S1 describes materiality as an entity-specific aspect of relevance which is assessed in the context of an entity's sustainability-related financial disclosures and is based on the nature or magnitude of the item to which the information relates, or both. Materiality judgements are specific to an entity and IFRS S1 does not specify any thresholds for materiality or predetermine what would be material in a particular situation. In identifying such information, an entity needs to assess whether this information, individually or in combination with other information, is material in the context of the entity's sustainability-related financial disclosures taken as a whole. This assessment requires the consideration of both quantitative and qualitative factors (e.g., the magnitude and the nature of the effect of a sustainability-related risk or opportunity on the entity). *[IFRS S1.B19, IFRS S1.B21, IFRS S1.D8].*

Making quantitative assessments

Making materiality judgements by using quantitative factors is a relative concept and, generally, can be readily understood and applied when preparing financial statements. For example, an asset with a cost (and fair value) of CU100 may be material to an entity that has total net assets of CU500. However, the same asset may be immaterial to a different entity that has total net assets of CU10,000 (assuming that any loss on the asset would have an immaterial impact on the entity's profit or loss and/or equity). The amounts considered for this assessment (i.e., the entity's total net assets or profit or loss) must relate to the same reporting period.

However, when preparing sustainability-related disclosures, such an assessment may not be straightforward, for example:

- When the sustainability-related risk or opportunity arises, the items subject to that risk or opportunity considered in the assessment (e.g., the asset) may not yet exist or their value (e.g., the value of the asset or the total net assets or profit or loss) when exposed to that risk or opportunity may be different from their current value/carrying amount.
- The level of uncertainty about the occurrence of a sustainability-related risk or opportunity and the magnitude of its impact on the entity's prospects is likely to increase as the time horizon extends (see further discussion in section 3.2.2.C above).
- When considering the components of the assessment, these may be considered in their 'current state' or their 'expected future state'. In particular:
  - 'Current state' refers to the components based on the entity's measurement in the current reporting period, even though their exposure to the sustainability-related risk or opportunity is expected in the future.
  - 'Expected future state' refers to the components based on the entity's forecasted measurements at the time of the expected exposure to the sustainability-related risk or opportunity.

Figure 3-2: Current versus expected future state

Current state	Expected future state
Materiality judgements based on the 'current state' use more observable or objective measures. This could reduce the degree of judgement and the significant estimation uncertainty (that would otherwise be required for forecasted measurements), especially if the risk exposure extends over a prolonged period of time and there is a likelihood that the entity's measurements change over that time period. Using the 'current state' may make the materiality judgements: a) easier to apply, and b) more useful, in case of concerns of the primary users that the forecasted measurements may not present fairly the sustainability-risks or opportunities that could reasonably be expected to affect the entity's prospects. For example, an entity assesses that an asset is exposed to a climate-related risk which, if it eventuates, could result in the asset being fully impaired. To determine whether information about that risk is quantitatively material, the entity bases its assessment on its financial statements for the current reporting period.	Materiality judgements based on the 'expected future state' places the judgement in the context of the entity's expected situation at the time the entity is expected to be exposed to the sustainability-related risk or opportunity. Using the 'expected future state' may be more appropriate when an entity has no assets or operations exposed to sustainability-related risks or opportunities in the current period, but it expects to have such assets or operations in the future. In that case, the entity may conclude that its exposure to the future sustainability-related risk or opportunity is material information, even though the sustainability-related risk or opportunity does not materially affect the entity in the current reporting period. However, the perceived relevance of this information needs to be balanced against any concerns about the reliability and verifiability of that information. For example, an entity is constructing a new production facility that is expected to be fully operational in 3 years. Once the facility is operational, the entity expects its revenues to increase significantly. The entity considers that the new production facility will be exposed to a climate-related risk. In determining whether information about that risk is quantitatively material, the entity considers what the value of that facility may be when the risk may arise.

Making qualitative assessments

The IASB's Practice Statement 2 *Making Materiality Judgements* explains that qualitative factors are "characteristics of an entity's transactions, other events or conditions, or of their context, that, if present, make information more likely to influence the decisions of the primary users of the entity's financial statements". Qualitative factors can include entity-specific factors (such as the involvement of a related party of the entity) and external factors (such as the geography, industry sector and markets in which the entity operates). Typically, in the context of financial statements, qualitative factors are considered if an item is not assessed to be quantitatively material. The same reasoning applies in the context of sustainability-related financial disclosures that represent or relate to amounts. Other sustainability-related financial disclosures will typically be narrative information about the entity's governance arrangements, its strategy and decision making, and its risk management processes. Materiality assessments relating to narrative disclosures should be similar to the judgements made about narrative disclosures in the preparation of the financial statements and notes.

How we see it

An entity needs to exercise judgement to identify the material information to be included in its sustainability-related financial disclosures. In many cases, entities make this judgement based on the 'current state' of the item to which the assessed information relates. We do not believe that making this judgement based on the 'expected future state' of such an item would be appropriate when the respective information about that item in its 'current state' would be material. In meeting the requirements of IFRS S1 with respect to the disclosure of such judgements (see further discussion in section 6.1. below), the context and assumptions used in the entity's assessment need to be disclosed. This includes disclosures about an entity's assessment on:

- Whether the entity uses the 'current state' of items being assessed and qualitative information about how its strategy and business model are expected to evolve over the time in relation to the exposure to the sustainability-related risk or opportunity.
- Whether the entity uses the 'expected future state' of items and an explanation about how the future state assumptions reconcile with the entity's measurements in the current period.

3.2.4 Additional information disclosed by an entity

3.2.4.A Additional information provided when the requirements of ISSB standards are not sufficient

Under certain circumstances, an entity may need to provide information that is additional to the information provided to comply with the specifically applicable requirements in an ISSB standard. In particular, when compliance with the requirements of an ISSB standard that specifically applies to an entity's circumstances is not sufficient for primary users to understand the effects of sustainability-related risks and opportunities on the entity's cash flows, its access to finance and cost of capital over the short, medium and long term, the entity needs to disclose additional information. *[IFRS S1.B26].*

How we see it

Sometimes compliance with the specific requirements of ISSB standards is not sufficient and, therefore, additional information would be needed to support primary users in making their decisions about providing resources to an entity. Such additional information would constitute material information and be required by IFRS S1 (see discussion about the definition of materiality in section 3.2.1 above).

3.2.4.B Requirements for not obscuring material information

Generally, if information is not material, there is no need to disclose such information that is otherwise required by an ISSB standard, even if the specific ISSB standard contains a list of specific requirements or describes them as minimum requirements. *[IFRS S1.B25].* Moreover, sustainability-related financial information required by ISSB standards needs to be clearly identified and distinguished from other information provided by the entity that is additional to what is required by ISSB standards (see relevant discussion about location of information in section 5.2 below). However, when such information is included, an entity needs to ensure that material information is not obscured.

Because IFRS S1 uses a definition of material information that is consistent with IAS 1, the ISSB also decided to include guidance in IFRS S1 with respect to the concept of obscuring material information building on similar requirements in IAS 1. That is, information may be obscured when it is communicated in a way that would have a similar effect for primary users to omitting or misstating that information. *[IFRS S1.B27, IFRS S1.BC73].*

IFRS S1 provides examples of circumstances that may result in material information being obscured: *[IFRS S1.B27]*

Extract from IFRS S1

B27 An entity shall identify its sustainability-related financial disclosures clearly and distinguish them from other information provided by the entity (see paragraph 62). An entity shall not obscure material information. Information is obscured if it is communicated in a way that would have a similar effect for primary users to omitting or misstating that information. Examples of circumstances that might result in material information being obscured include:

(a) material information is not clearly distinguished from additional information that is not material;

(b) material information is disclosed in the sustainability-related financial disclosures, but the language used is vague or unclear;

(c) material information about a sustainability-related risk or opportunity is scattered throughout the sustainability-related financial disclosures;

(d) items of information that are dissimilar are inappropriately aggregated;

(e) items of information that are similar are inappropriately disaggregated; and

(f) the understandability of the sustainability-related financial disclosures is reduced as a result of material information being hidden by immaterial information to the extent that a primary user is unable to determine what information is material.

Material information required by ISSB standards must be presented prominently and be distinguishable from immaterial information (e.g., provided to comply with law, regulation or other requirements), to avoid being obscuring. Potential ways for achieving this distinction could be, for example, when the information required by ISSB standards is: *[IFRS S1.BC74]*

- Extracted by primary users by using digital tagging
- Presented together with immaterial information in a single report but is distinguished from it by using appropriate formatting (e.g., using boxes or shading to emphasise or make the distinction clear)
- Presented separately so that it is clearly distinguished from immaterial information (e.g., splitting the report into parts)

How we see it

An entity may assess that a sustainability-related risk or opportunity is not reasonably expected to affect its prospects. We generally believe that information about such a sustainability-related risk or opportunity is not expected to be material and therefore, would not need to be disclosed in the entity's sustainability-related financial disclosures. However, while making this assessment, an entity may consider that comparable peer entities (such as entities operating in the same industry) have identified that same sustainability-related risk or opportunity as one that could reasonably be expected to affect their prospects. In such case, the entity needs to assess whether the information that this sustainability-related risk or opportunity has been assessed as not reasonably be expected to affect its prospects may be, in itself, material information to its primary users. If that information is assessed as material, the entity needs disclose it. We believe this logic is also aligned with Example K of IFRS Practice Statement 2 *Making Materiality Judgements* which could be applied by analogy to the ISSB standards.

3.2.4.C Interaction with law or regulation

Frequently, entities may need to comply with law or regulation enforced in the jurisdictions they operate that specifies disclosure requirements on sustainability-related information. In such circumstances, the entity is permitted to include in its sustainability-related financial disclosures, information to meet legal or regulatory requirements, even if that information is not considered material under ISSB standards. Information to meet legal or regulatory requirements may be included in the same location as information required by ISSB standards, as discussed in section 5.2.1 below. However, the entity needs to ensure that such information does not obscure material information, as discussed in section 3.2.4.B above. *[IFRS S1.B31].*

Material sustainability-related financial information is disclosed, even if law or regulation permits the entity not to disclose such information. However, an entity need not disclose information otherwise required by an ISSB standard if law or regulation prohibits the entity from disclosing that information. However, if such material information is omitted for that reason, an entity needs to identify the type of information not disclosed and explain the source of the restriction. *[IFRS S1.B32, IFRS S1.B33].*

3.2.5 Other characteristics of material information

3.2.5.A Aggregation and disaggregation

Building on the principles of aggregation and disaggregation in IAS 1, IFRS S1 requires an entity to consider all facts and circumstances to determine how to aggregate and disaggregate information in its sustainability-related financial disclosures. *[IFRS S1.B29].* The ISSB considered that the concepts of aggregation and disaggregation embedded in IAS 1 in relation to the information provided in the financial statements are equally important for sustainability-related financial disclosures. This is to ensure that primary users are provided with information at appropriately aggregated and disaggregated levels.

To avoid reducing the understandability of sustainability-related financial disclosures, an entity needs to ensure that material information is not obscured by immaterial information or material items of information that are dissimilar to each other are not aggregated. *[IFRS S1.B29].* In general, information cannot be aggregated if doing so would obscure information that is material. Items of information that are eligible for being aggregated have shared characteristics, rather than those that do not have shared characteristics. For example, disaggregating information by geographical location or in consideration of the geopolitical environment may be necessary to ensure that material information is not obscured when reporting about the use of water drawn from abundant sources and water drawn from water-stressed areas. *[IFRS S1.B30].*

The following example is based on the ISSB's *Educational material: Nature and social aspects of climate-related risks and opportunities* that was published in December 2023.[11]

Extract from Educational material: Nature and social aspects of climate-related risks and opportunities

Example 1- Disclosing disaggregated information about a climate-related risk (nature aspect)

Example 1 illustrates how an entity might apply paragraph 13(b) of IFRS S2 and the principles of aggregation and disaggregation in paragraphs B29-B30 of IFRS S1 to disclose information about where in its business model and value chain a climate-related risk is concentrated. The example is not intended to illustrate all of the information the entity might need to disclose when it applies these paragraphs.

...

Fact pattern

The entity operates in the agricultural products industry. It grows wheat itself in two regions: Region 1 and Region 2. The entity also buys wheat from a supplier who grows the crop in Region 1. The entity mills the wheat and sells it to customers.

The entity's business model depends on water because growing wheat relies on rainfall and on irrigation from other water sources. Region 1 currently has high baseline water stress and the entity expects the water stress to become worse over the medium term.

The entity identifies water scarcity as a climate-related risk to which it is exposed. Climate change drives water scarcity in Region 1 through increasing temperatures and changing precipitation patterns. As a result, there is likely to be a significant reduction in the water available in this region. Water scarcity can affect the entity's prospects because, for example, reduced water availability can disrupt its own wheat production and can increase the price it pays to purchase the crop from its supplier.

Application of IFRS S2

In accordance with paragraph 10 of IFRS S2, the entity discloses information that enables users of general purpose financial reports to understand water scarcity in Region 1 as a climate-related risk that the entity has determined could reasonably be expected to affect its prospects.

Water scarcity is a location-specific risk. Therefore, the entity decides that disclosing information about the amount of wheat exposed to this risk by region will provide material information to users of general purpose financial reports. Accordingly, applying paragraph 13(b) of IFRS S2 and the principles of aggregation and disaggregation in paragraphs B29-B30 of IFRS S1, the entity disaggregates its total amount of wheat (grown and purchased, in metric tonnes) between the region that has high baseline water stress (Region 1) and the region that does not (Region 2). Table 1 illustrates this disaggregation.

Table 1: Disaggregation of crop by region (in metric tonnes)

	Region with high baseline water stress (Region 1)			Other region (Region 2)		
Total	*grown*	*purchased*	***total***	*grown*	*purchased*	***total***
E = C + D	A	B	**C = A + B**	D	—	**D**

...

11 *Educational material: Nature and social aspects of climate-related risks and opportunities*, ISSB, December 2023, available on the IFRS Foundation's website.

3.2.5.B Commercially sensitive information

While IFRS S1 was being developed, stakeholders were concerned about disclosing information that could be considered commercially sensitive. The concerns related to the potential impact on an entity's competitive advantage by revealing details about its strategy and planned actions through the disclosures required by ISSB standards. The concerns were mainly focused on disclosing commercially sensitive information about opportunities, rather than risks, as these could affect an entity's competitiveness in the market or otherwise be commercially harmful. *[IFRS S1.BC76, IFRS S1.BC77].*

Considering these concerns, the ISSB introduced in IFRS S1 a targeted exemption by permitting an entity, in limited circumstances, to omit from its sustainability-related financial disclosures information about a sustainability-related opportunity. Such an omission is permitted even if information is otherwise required by an ISSB standard, and the information is material. *[IFRS S1.B34].*

The exemption is intentionally narrow and applies only to the disclosure of information about opportunities, and it is not permitted to be applied for non-disclosure of information about risks. Also, the exemption is not intended to permit broad non-disclosure of information about opportunities. *[IFRS S1.BC79, IFRS S1.B37].* Rather, an entity qualifies for the exemption if, and only if: *[IFRS S1.B35, IFRS S1.BC80, IFRS S1.BC81, IFRS S1.BC83]*

- Information about the sustainability-related opportunity is not already publicly available. That is, the exemption does not apply to information that is already publicly available (e.g., continuous disclosure notices, investor presentations, briefings to analysts, or other publicly available documents) as it is unlikely that such disclosure will harm an entity's advantage in pursuing the opportunity.
- Disclosure of the information could reasonably be expected to prejudice seriously the economic benefits the entity would otherwise be able to realise in pursuing the opportunity.
- The entity has determined that it is impossible to disclose that information in a manner that would enable the entity to meet the objectives of the disclosure requirements without seriously prejudicing the economic benefits the entity would otherwise be able to realise in pursuing the opportunity. For example, an entity needs to first consider whether it is possible to disclose the information about the opportunity at a sufficiently aggregated level to resolve its concerns about commercial sensitivity, before applying the exemption. However, if it does so, an entity needs to ensure that aggregation does not obscure material information (as discussed in section 3.2.5.A above).

IFRS S1 requires additional disclosures when this exemption is applied. In particular, if an entity elects to use the exemption for each item of information omitted, the entity needs to: *[IFRS S1.B36]*

- Disclose the fact that it has used the exemption to make users aware that information has been excluded for reasons of commercial sensitivity

  And

- Reassess, at each reporting date, whether the information qualifies for the exemption and, if the entity is no longer eligible for the exemption, disclose that information at that reporting date

3.2.6 Reassessment of material information

The individual circumstances of an entity and/or the external environment may change and, therefore, the sustainability-related risks and opportunities that users reflect to make their decisions can also change over time. Accordingly, the material sustainability-related financial information disclosed by an entity may change from one reporting period to another due to changes in circumstances and assumptions to reflect the evolving information needs of primary users (see section 3.2.2.A above). This means that some types of information included in an entity's sustainability-related financial disclosures for prior periods may no longer be material. Conversely, some types of information not previously disclosed may become material. This dynamic nature of materiality led the ISSB to the decision of requiring entities to reassess their materiality judgements at each reporting date to take account of changes in circumstances and assumptions. *[IFRS S1.B28].*

3.2.7 Interoperability considerations

Overall, the ISSB's intention is to establish a comprehensive global baseline of sustainability-related financial disclosures that meet the information needs of primary users in relation to sustainability-related risks and opportunities. This global baseline is intended to serve as a comprehensive foundation of disclosure requirements, for which jurisdictions will be able to add any necessary incremental disclosure requirements to this common baseline. To achieve this, interoperability with jurisdictional requirements is imperative. The more compatible ISSB standards are with the law or regulation in the jurisdictions in which entities operate (including law or regulation that specifies the documents, formats and structures for

disclosing information), the more likely it is to achieve comparable, cost-effective and decision-useful sustainability-related financial disclosures that are designed to meet the needs of primary users. *[IFRS S1.BC27, IFRS S1.BC28].*

However, applying ISSB standards as global baseline along with other jurisdictional sustainability-related frameworks could be challenging. Not all sustainability-related frameworks share the same definition of materiality that is used in ISSB standards (discussed in section 3.2.1 above). There are similarities in the language used when referring to assessing material information in the context of the short, medium and long-term effects of sustainability issues. However, in practice, determining what is 'material' depends on the issue, the context, the time frame and the stakeholder. For example, the key difference between the GRI standards, the European Sustainability Reporting Standards (ESRS) and ISSB standards is the audience (i.e., ISSB standards focus on primary users, whereas GRI and ESRS have a broader set of 'users' of the information).

Lack of interoperability could be costly for entities and risks undermining the provision of clear and consistent information to primary users. Primary users need to be able to clearly identify which information is relevant to them and which information is relevant to a broader set of stakeholders, so that material information for primary users is not obscured. *[IFRS S1.BC31].* Also, understanding the similarities and differences between ISSB standards and the requirements of other sustainability frameworks will avoid duplication of information in entity's general purpose financial report, consistent with what IFRS S1 requires (see relevant discussion in section 3.4.3 below).

In supporting the interoperability among ISSB standards and the other frameworks, the ISSB:

- Included in IFRS S1 clarifications on concepts and terminologies (e.g., an extensive description of sustainability and its connection with the value of an entity as discussed in section 1.1.2 above), as well as specific definitions (e.g., materiality as discussed in section 3.2.1 above), to explain their use by ISSB standards compared with other jurisdictional initiatives and sustainability reporting frameworks
- Included a list of sources of guidance as part of the identification process of sustainability-related risks and opportunities that could reasonably be expected to affect an entity's prospects and the identification of material information about those risks and opportunities (as discussed in section 3.2.2.B above) contributes to the interoperability with other sustainability-related frameworks and the reduction of the burden for entities already using or are mandated to comply with those other frameworks
- Permits entities to include information disclosed to meet other requirements (e.g., specific jurisdictional requirements) as long as it does not obscure the material information provided in complying with ISSB standards (as discussed in section 3.2.4.B above)

Moreover, the IFRS Foundation proceeded with the following:

- Published in May 2024, the Inaugural Jurisdictional Guide for the adoption or other use of the ISSB Standards. As a growing number of jurisdictions are moving forward with their plans to adopt or otherwise use ISSB standards, this guide aims to set the basis for the development of jurisdictional profiles that describe jurisdictional approaches. Also, the guide aims to enable market participants and regulators to understand jurisdictional progress towards delivering globally consistent and comparable sustainability-related information for capital markets[12]
- Collaborated with EFRAG and together published *interoperability guidance* on the alignment between ISSB standards and the ESRS, in May 2024. The guidance material focuses on climate-related disclosures, so it mainly covers the requirements in IFRS S2 and, where relevant, the requirements of IFRS S1. For further information, refer to our publication, *IFRS Sustainability Developments: Interoperability guidance published on ESRS and ISSB standards*[13]
- Published in September 2024 'Voluntarily applying ISSB Standards - A guide for preparers'.[14] This guide aims to support preparers as they start to apply ISSB standards voluntarily and help them communicate their progress to primary users. The guide highlights the two elements of ISSB standards that are designed to support implementation for preparers. These are: a) transition reliefs so that preparers can use a phased-in approach to the requirements (see discussion at section 9 and Chapter 53 at section 7) and b) proportionality mechanisms that provide measures to address the range of capabilities and circumstances of entities (see discussion at section 1.2.2 and section 4.3.4.E Chapter 53 at sections 4.3.1.C, 4.3.3.C and 5.6.1).

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12 *Inaugural Jurisdictional Guide for the adoption or other use of ISSB Standards*, May 2024, available on the IFRS Foundation's website.

13 *IFRS Sustainability Developments: Interoperability guidance published on ESRS and ISSB standards*, May 2024, available on the IFRS Foundation's website.

14 Voluntarily applying ISSB Standards-A guide for preparers, September 2024, available on the IFRS Foundation's website.

How we see it

The interoperability guidance published by the IFRS Foundation and EFRAG will be useful for entities that want to claim compliance with both ISSB standards and ESRS. In particular, multi-national entities that may need to comply with both sets of standards if they have both reporting entities in jurisdictions that require compliance with ESRS, and reporting entities in jurisdictions that require compliance with ISSB standards. Entities starting with either set of standards should be aware of key differences between them and reflect these in their disclosures accordingly, to the extent they are applicable and material to the entity. However, entities should ensure that information required to be disclosed under ISSB standards is clearly identifiable alongside information required to be disclosed under ESRS. Entities should keep in mind that the guidance must be read in conjunction with the relevant standards in order to meet the requirements of either set of standards.

3.3 Reporting entity

3.3.1 Definition of a reporting entity

IFRS S1 defines reporting entity as an entity that is required, or chooses, to prepare general purpose financial statements. *[IFRS S1 Appendix A].* The entity that is required to disclose sustainability-related financial information is the same as the one that prepares the related financial statements. *[IFRS S1.20].* For example, when the entity applies IFRS accounting standards, the consolidated financial statements provide information about the parent and its subsidiaries as a single reporting entity. The reporting entity's sustainability-related financial disclosures focus on the sustainability-related risks and opportunities that enable primary users to assess the effects of those risks and opportunities on the entity's prospects (i.e., the effects on the prospects of the parent and its subsidiaries, in the case of information presented in consolidated financial statements). *[IFRS S1.B38].*

Requiring the same reporting entity for both financial statements and sustainability-related financial disclosures is one of the decisions the ISSB made for the purposes of enabling information disclosed in the financial statements to be connected with sustainability-related financial information (as discussed in section 3.4 below). *[IFRS S1.BC85].*

3.3.2 Breadth of reporting

The reporting entity is required to disclose information about sustainability-related risks and opportunities throughout its value chain (see section 1.2 above). This means that the reporting entity is required to identify the sustainability-related risks and opportunities that could reasonably be expected to affect its prospects and determine the scope of its value chain, including its breadth and composition, in relation to each of those sustainability-related risks and opportunities.

The value chain is also mentioned in the section of IFRS S1 on the 'core content' of information under the strategy pillar; an entity is required to disclose the current and anticipated effects of sustainability-related risks and opportunities that could reasonably be expected to affect its prospects throughout its business model and value chain and describe where these risks and opportunities are concentrated (see section 4.3.4 below).

IFRS S1 defines the value chain as follows: *[IFRS S1 Appendix A]*

Extract from IFRS S1

Appendix A
Defined terms

value chain	The full range of interactions, resources and relationships related to a reporting entity's business model and the external environment in which it operates. A value chain encompasses the interactions, resources and relationships an entity uses and depends on to create its products or services from conception to delivery, consumption and end-of-life, including interactions, resources and relationships in the entity's operations, such as human resources; those along its supply, marketing and distribution channels, such as materials and service sourcing, and product and service sale and delivery; and the financing, geographical, geopolitical and regulatory environments in which the entity operates.

Resources and relationships can vary for a number of reasons. For example, they may take various forms (e.g., natural, manufactured, intellectual, human, social, financial), they can be internal (e.g., workforce, know-how, organisational processes) or external (e.g., accessing materials and services or relationships with suppliers, distributors and customers), they can be recognised as assets in the entity's financial statements or not.

Moreover, resources and relationships can be direct or extend throughout the entity's value chain (e.g., the entity's supply and distribution channels, the effects of the consumption and disposal of the entity's products, the entity's sources of finance and its investments, including investments in associates and joint ventures). That is, if the entity's business partners throughout its value chain face sustainability-related risks and opportunities, the entity could be exposed to related consequences of its own. *[IFRS S1.B4, IFRS S1.B5].*

Therefore, even though the reporting entity that prepares sustainability-related financial disclosures is the same as the one that prepares the related financial statements, the breadth of reporting is not the same. That is, the sustainability-related financial disclosures are not constrained to what is recognised in the financial statements, but goes beyond that to capture information about the value chain.

3.3.3 Determining the scope of value chain

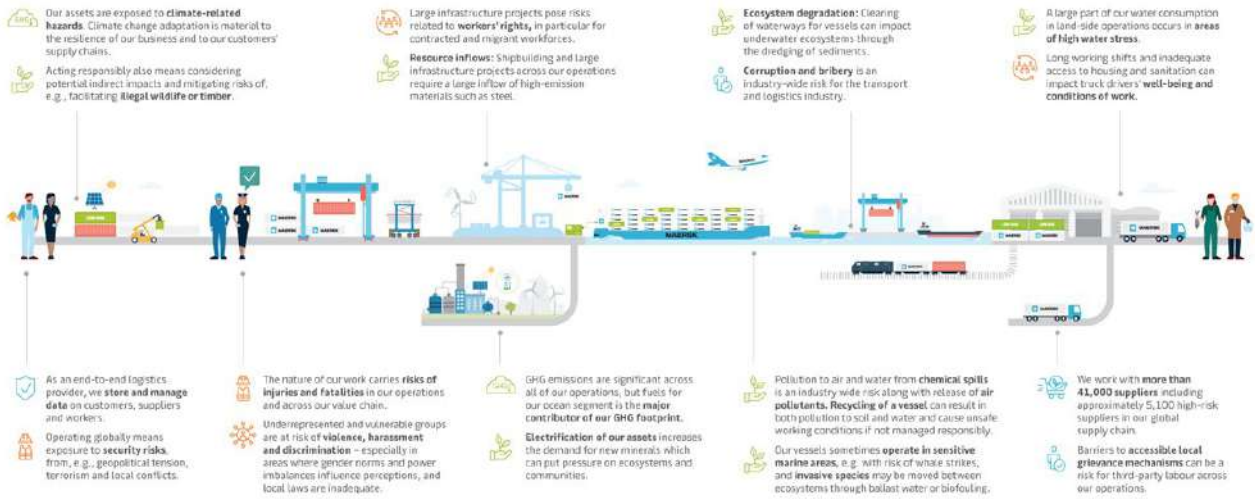
Determining the scope of an entity's value chain could be challenging due to the possible scope of the value chain, as well as potential complexities in obtaining information to prepare the required disclosures. This is because obtaining information about the value chain may require a reporting entity to collect information from parties that the entity does not control or in which it has no ownership interest. For example, the ultimate consumers of an entity's products may be the most important contributors to the entity's Scope 3 GHG emissions. Also, the employment practices of a supplier in an entity's supply chain could have a reputational effect on the entity, even if the supplier has no direct relationship with the reporting entity. *[IFRS S1.BC56, IFRS S1.BC57].* Joint ventures, associates and investments are not considered to be part of the reporting entity that is presenting consolidated financial statements. However, the reporting entity recognises these items in its financial statements and reports aspects of their performance. Likewise, sustainability-related financial information related to those investments is relevant to primary users in assessing the effects of sustainability-related risks and opportunities on the entity's prospects. *[IFRS S1.BC54].*

Although assessing the scope of the value chain may be challenging, it is not new or unique to the field of sustainability reporting. As part of their general purpose financial reports, entities frequently produce management commentary that provides insights into factors that have affected the entity's financial performance and financial position and factors that could affect its ability to create value and generate cash flows in the future. These factors also capture aspects of the value chain including the activities of diverse investments and dependencies. Therefore, since entities also assess activities within their value chain for general planning and risk management purposes, the requirements in IFRS S1 are effectively following this approach in the analysis of risk management or strategic business model.

In its Sustainability Report 2023, A.P. Moller-Maersk A/S included a figure showing the considerations made across its operations and value chain when identifying potential sustainability-related risks and opportunities that could reasonably be expected to affect its prospects.

Practical example 3-1: A.P. Møller - Mærsk A/S (2023) Denmark

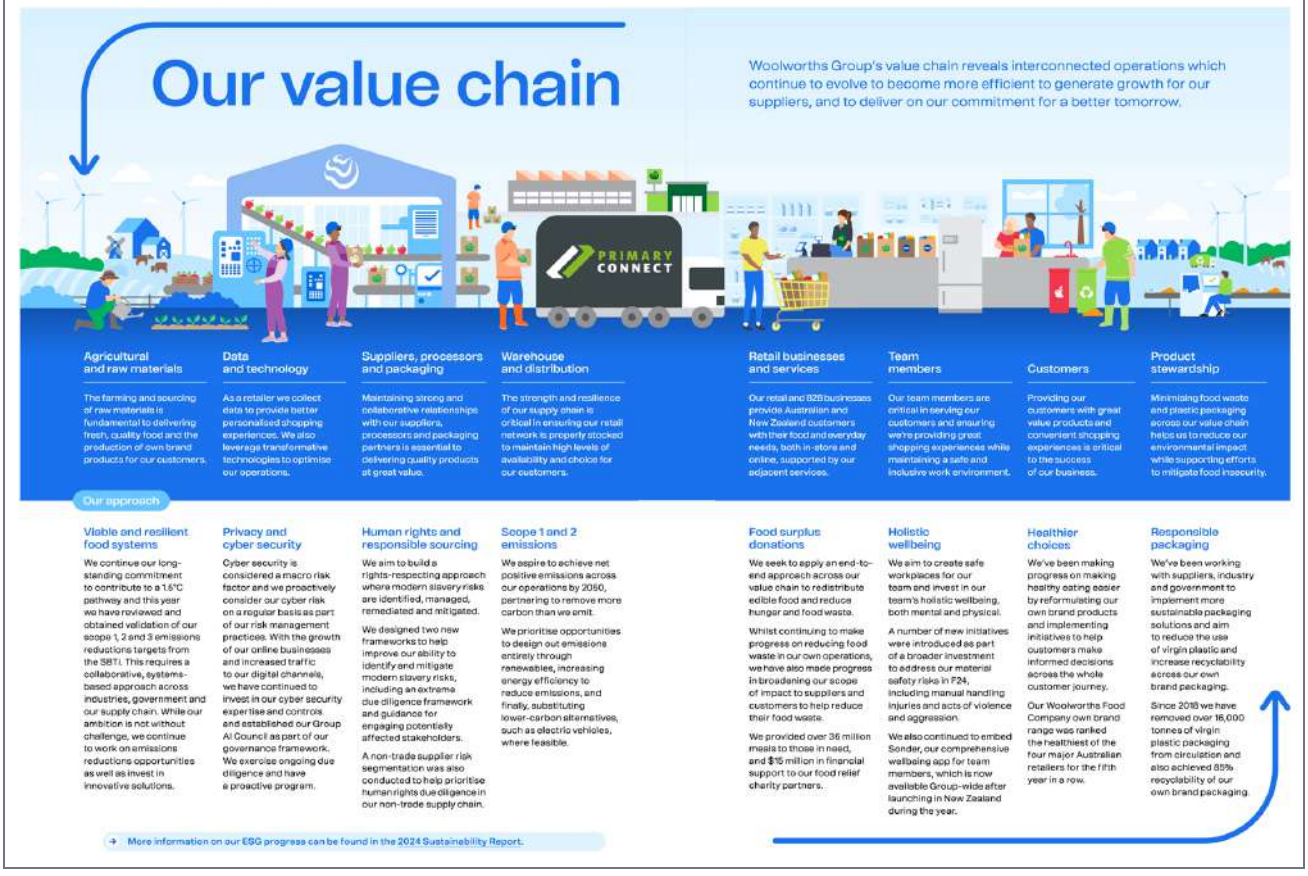
Sustainability Report 2023 [extract]
Strategy and governance [extract]
Our material ESG topics [extract]
How we impact people and the environment across our operations and value chain [extract]



In its Annual Report 2024, Woolworths Group Limited disclosed how it has expanded its focus to consider food waste across its value chain:

Practical example 3-2: Woolworths Group Limited (2024) Australia

Annual Report 2024 [extract]
SECTION 1 [extract]
Performance Highlights [extract]



The ISSB noted that determining the value chain and clarifying the breadth of reporting is a process that is unique for each entity and is difficult to specifically prescribe through principles or standards, as it is unlikely to apply in the same way to all types of entities. The ISSB also referred to the existing market guidance and practice around reporting on a broad range of activities in the value chain and across subsidiaries (e.g., the SASB standards contain disclosure topics and metrics that demonstrate how an entity could report on value chain activities, and which of those activities may be relevant for a given industry).

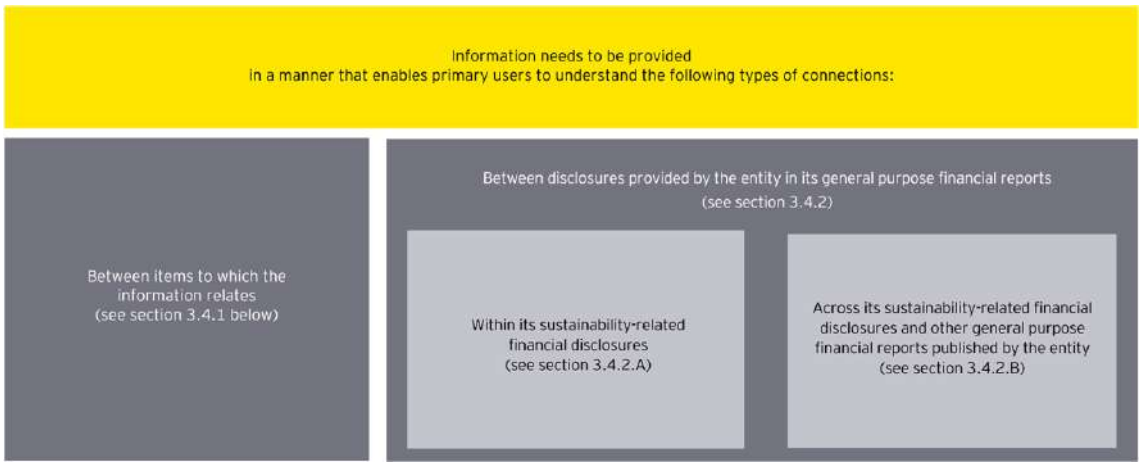
In determining the scope of its value chain, an entity is required to use "all reasonable and supportable information that is available to the entity at the reporting date without undue cost or effort", in relation to each sustainability-related risk and opportunity identified that could reasonably be expected to affect the entity's prospects. This concept assists entities by establishing parameters for the type of information they consider when preparing disclosures regarding the value chain, and the effort required to obtain such information. For further information about this concept, see section 1.2.2 above.

3.4 Connected information

Entities are required to provide information in a manner that enables primary users to understand connections between various disclosures in an entity's general purpose financial reports, as well as insight into the connections between the items to which the information relates. *[IFRS S1.B39]*.

The following Figure 3-3 illustrates the types of connections for which information needs to be provided according to IFRS S1: *[IFRS S1.21]*

Figure 3-3: Types of connections for which information is required



3.4.1 Connections between items to which the information relates

IFRS S1 provides examples relating to information about connections between items to which the information relates: *[IFRS S1.B40]*

- An entity pursued a particular sustainability-related opportunity that resulted in revenue increase. The connected information will depict the relationship between the entity's strategy and its financial performance.
- An entity identified a trade-off between two sustainability-related risks it is exposed to and took action on the basis of its assessment of that trade-off. The connected information will depict the relationship between those risks and the entity's strategy.
- An entity committed to a particular sustainability-related target, but that commitment has not yet affected the entity's financial position or financial performance because the applicable recognition criteria have not been met. The connected information will depict that relationship.

3.4.2 Connections between disclosures provided in general purpose financial reports

With respect to the connections between various disclosures in an entity's general purpose financial reports, IFRS S1 distinguishes two categories: a) connections between disclosures provided by an entity within its sustainability-related financial disclosures; and b) connections between disclosures provided across an entity's sustainability-related financial disclosures and other general purpose financial reports published by the entity.

3.4.2.A Connections between disclosures provided within an entity's sustainability-related financial disclosures

IFRS S1 explains the nature of information about connections between disclosures provided by an entity within its sustainability-related financial disclosures, as follows: *[IFRS S1.B41]*

- Information about a particular sustainability-related risk or opportunity explaining the connections between disclosures on governance, strategy and risk management (i.e., relating to the four content pillars as further discussed in section 4 below).
- Information between disclosures about various sustainability-related risks and opportunities provided within an entity's sustainability-related financial disclosures. For example, when an entity integrates its oversight of sustainability-related risks and opportunities and, therefore, needs to integrate the disclosures on governance instead of providing separate disclosures on governance for each sustainability-related risk and opportunity.

3.4.2.B Connections between disclosures provided across sustainability-related financial disclosures and other general purpose financial reports published by the entity

Connected information also needs to be provided to explain the connections between disclosures provided across an entity's sustainability-related financial disclosures and other general purpose financial reports published by the entity. For example, an entity needs to explain how information provided in its sustainability-related financial disclosures is connected with the information provided in its related financial statements. However, this type of connections is not restricted to connections with the related financial statements, but it also relates to all other reports that constitute the general purpose financial report (e.g., the management commentary).

IFRS S1 requires information about the current and anticipated effects of sustainability-related risks and opportunities on an entity's financial position, financial performance and cash flows (see relevant discussion on the core content information about the strategy pilar in section 4.3.4 below). This requirement represents a specific application of connected information between sustainability-related financial disclosures and the related financial statements of an entity.

To promote this connectivity, IFRS S1 requires an entity to: *[IFRS S1.22, IFRS S1.23, IFRS S1.24]*

- Identify the financial statements to which the sustainability-related financial disclosures relate
- Use consistent data and assumptions in preparing the sustainability-related financial disclosures with the related financial statements (to the extent possible considering the requirements of IFRS accounting standards or other applicable GAAP)
- Use the presentation currency of its related financial statements, when currency is specified as the unit of measure in the sustainability-related financial disclosures

An entity is required to align data and assumptions to the extent possible by taking into consideration the requirements in IFRS accounting standards (or other GAAP) instead of mandating full alignment. This is because there could be legitimate reasons for data and assumptions to vary between an entity's sustainability-related financial disclosures and its financial statements. For example:

- An entity's net-zero commitment may not give rise to a provision, based on the requirements in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. That is, simply making a commitment to offset future GHG emissions does not in itself give rise to a present obligation for an entity and, therefore a provision would not be recognised until the entity has emitted the gas it has promised to offset. This was also discussed by the IFRS Interpretations Committee in its agenda decision in April 2024.[15]
- While testing specific assets for impairment according to the requirements in IAS 36 *Impairment of Assets,* an entity may only use a subset of the data and assumptions needed when preparing disclosures about climate resilience reflecting various climate scenarios according to IFRS S2 (see Chapter 53 at section 4.3.3). For example, IAS 36 requires cash flow projections in the determination of value in use to be based on the most recent budgets or forecasts for a maximum of five years, unless management is confident that its projections are reliable and it can demonstrate its ability, based on past experience, to forecast cash flows accurately over a longer period.

15 *IFRIC Update*, April 2024, available on the IFRS Foundation's website.

The following examples are based on the Basis for Conclusions to IFRS S1: *[IFRS S1.BC88]*

Illustration 3-1: Examples of the types of connections

Entity W, a pharmaceutical company, has been exposed to claims of unethical testing. Therefore, it may need to explain how its strategic response has, or has not, led to the recognition of provisions and associated operating costs in its financial statements.

Entity X, an electronics manufacturer, has publicly announced a target of net zero for its corporate greenhouse gas emissions, which are primarily created during its manufacturing process. Entity X adopts a new strategy that involves shifting its procurement of energy to renewable sources and investing in more energy-efficient machinery. Therefore, Entity X may need to explain how this strategy to achieve the target led to an increase in capital expenditure and possibly an impairment review of non-energy-efficient machinery, as well as lower (and less volatile) energy prices, increased revenue due to a related increased demand from its customers, and an increase in margins on sales.

Entity Y, a supplier, finds that demand for its goods has risen due to its treatment of workers and its record on respecting workers' rights, especially because its approach in this area was better than many of its peers. Entity Y may need to explain how its strategy and performance in relation to the treatment of its workers has positioned it favourably and has led to increases in revenue.

Entity Z has a net zero greenhouse gas emissions plan that relies on replacing its fleet of diesel-powered vehicles with electric vehicles. Shifting to electric vehicles will require much more capital investment than was necessary for diesel vehicles. The transition plan is that each vehicle will be replaced when it reaches the end of its useful economic life. Entity Z concludes that the vehicles are not impaired and no changes to depreciation rates or useful life estimates are required to be reflected in the financial statements. Entity Z may need to explain that the transition plan will have consequences for its future cash flows and that its accounting, as reflected in the financial statements, is consistent with its transition plan.

3.4.3 Characteristics of connections

Drawing connections between disclosures involves, but is not limited to, disclosing necessary explanations and cross-references and using consistent data, assumptions, and units of measure. In doing so, IFRS S1 requires: *[IFRS S1.B42]*

- Explanation of the connections between disclosures in a clear and concise manner
- Avoiding unnecessary duplication if an ISSB standard requires the disclosure of common items of information (see also discussion on the enhancing qualitative characteristic of understandability of information in section 3.1.1.B above)
- Disclosing information about significant differences between the data and assumptions used in preparing the entity's sustainability-related financial disclosures and the data and assumptions used in preparing the related financial statements, as explained in section 3.4.2.B above.

When disclosing sustainability-related financial information, there is a possibility that this information could result in duplication of information within the general purpose financial report. This is because other frameworks (such as IFRS accounting standards or other GAAP) may require similar information. Therefore, in identifying and explaining the connections both between the items to which the information relates and between disclosures provided by the entity in its general purpose financial reports (discussed in sections 3.4.1 and 3.4.2 above), an entity needs to avoid unnecessary duplication. To achieve this, one approach an entity may consider is to use cross references from sustainability-related financial disclosures to the other general purpose financial reports published by the entity, subject to the specified requirements being met. The requirements about information included in sustainability-related financial disclosures by cross-reference are further discussed in section 5.2.2 below.

The following examples are included in IFRS S1 to describe the nature of disclosures that could explain the various types of connections. For example, in providing connected information, an entity may: *[IFRS S1.B43, IFRS S1.B44]*

- Explain the effect or likely effect of its strategy on its financial statements and financial planning, or explain how that strategy relates to the metrics the entity uses to measure progress against targets.
- Explain how its use of natural resources or changes within its supply chain could amplify or, alternatively, reduce its sustainability-related risks and opportunities. The information about the use of natural resources or changes within its supply chain may need to be linked to information about current or anticipated financial effects on the entity's production costs, its strategic response to mitigate those risks and its related investment in new assets. Also, the narrative information about the related metrics and targets may need to be linked to information in the related financial statements.

- Explain the combined effects of its sustainability-related risks and opportunities and its strategy on its financial position, financial performance and cash flows over the short, medium and long term. For example, when the entity faces decreasing demand for its products because of consumer preferences for lower-carbon alternatives, it may need to explain how its strategic response (e.g., closing a major factory) could affect its workforce and local communities, and the effect of that response on the related financial statements (e.g., the effect of closing a major factory on the useful lives of its assets and on impairment assessments).
- Describe the alternatives it considered in setting its strategy in response to its sustainability-related risks and opportunities, including a description of the trade-offs between those risks and opportunities. For example, an entity may need to explain the potential effects of its decision to restructure its operations (e.g., developing new products) in response to a sustainability-related risk (e.g., how environmental risks affect its reputation or ability to operate) on the future size and composition of the entity's workforce, or financial performance reported in the entity's financial statements.

4 Core content

4.1 Overview of TCFD

IFRS S1 requires an entity to disclose information about its governance, strategy, risk management and metrics and targets in relation to its sustainability-related risks and opportunities. These disclosure requirements represent the 'core content' that provides information about the way the entity manages those risks and opportunities. Information disclosed in relation to this 'core content' is necessary for primary users to assess the effects of sustainability-related risks and opportunities on an entity's cash flows, its access to finance and cost of capital over the short, medium and long term.

The core content disclosure requirements are derived from, and build on, the four pillars of the TCFD Recommendations, as summarised in Figure 4-1 below.

Figure 4-1: Core content builds on the four TCFD pillars

In 2024, the IFRS Foundation took over the monitoring of the progress on climate-related disclosures from the TCFD. The TCFD recommendations are a good starting point for entities as they begin implementing ISSB standards. The TCFD recommendations have been fully incorporated into ISSB standards, therefore, entities applying IFRS S1 and IFRS S2 will meet the TCFD recommendations. Although the requirements in IFRS S2 are consistent with the four core TCFD recommendations and eleven recommended disclosures, IFRS S2 includes additional requirements, which means that if an entity meets the TCFD requirements, it does not automatically meet the requirements of IFRS S2. Examples of these additional requirements include disclosing industry-based metrics, information about planned use of carbon credits to achieve their net emissions targets, and additional information about financed emissions.[16] The IFRS Foundation has published a comparison of the requirements in IFRS S2 and the TCFD recommendations.[17]

An entity may have overarching processes, controls and procedures that are used to monitor and manage various sustainability-related risks and opportunities in an integrated manner. IFRS S1 does not require an entity to repeat disclosures relating to the core content for each type of sustainability-related risk and opportunity. Instead, an entity discloses that its approach to monitoring and managing a specific sustainability-related risk and opportunity is integrated into its overall process, controls and procedures and, if material, explain any adaptations made to those processes to address any unique characteristics of that specific risk and opportunity. *[IFRS S1.B41(b), IFRS S1.B42(b), IFRS S1.BC94].*

How we see it

The purpose of the core content disclosure requirements in IFRS S1 is to require an entity to explain its actual sustainability-related activities, instead of prescribing how it should govern, manage risks and opportunities, and set strategy in managing its business. If, for example, an entity has limited governance arrangements or strategies in place to monitor and manage its sustainability-related risks and opportunities, the entity is required to disclose that fact if that would be material information to primary users. Entities need to consider whether to introduce process improvements to strengthen their arrangements and processes for managing and monitoring sustainability-related risks and opportunities.

16 *Making the transition from TCFD to ISSB*, ISSB, available on the IFRS Foundation's website.

17 *Comparison of IFRS S2 with the TCFD Recommendations*, ISSB, November 2024, available on the IFRS Foundation's website.

4.2 Governance

In defining 'governance', the TCFD includes a reference to the *G20/OECD Principles of Corporate Governance*, which states "Governance involves a set of relationships between an organization's management, its board, its shareholders, and other stakeholders. Governance provides the structure and processes through which the objectives of the organization are set, progress against performance is monitored, and results are evaluated."[18]

The objective of the governance disclosures in IFRS S1 is to enable primary users to understand the governance processes, controls and procedures an entity uses to monitor, manage and oversee sustainability-related risks and opportunities. *[IFRS S1.26]*.

To help primary users evaluate whether and how much attention is given to sustainability-related risks and opportunities, IFRS S1 requires disclosure of: *[IFRS S1.27]*

- The governance body(s) or individual(s) with oversight of an entity's sustainability-related risks and opportunities (see section 4.2.1 below)
- The management's role in the governance processes, controls and procedures used to monitor, manage and oversee sustainability-related risks and opportunities (see section 4.2.2 below)

4.2.1 Information about the oversight role

'Governance body(s)' that may have oversight of sustainability-related risks and opportunities include boards, committees or equivalent bodies charged with governance. IFRS S1 acknowledges that, for some entities, the responsibility for the oversight of sustainability-related risks and opportunities may be held by an individual(s) rather than a governance body(s). An individual may be charged with the overall oversight of sustainability-related risks and opportunities because of their specific expertise and experience. *[IFRS S1.BC96]*.

IFRS S1 requires an entity to disclose information about oversight arrangements, as set out in Figure 4-2 below: *[IFRS S1.27(a)]*

Figure 4-2: Disclosures about oversight role

Theme	Disclosure required
Responsibility	Identify the governance body(s) or individual(s) responsible for oversight of sustainability-related risks and opportunities. This requirement includes information about how responsibilities for sustainability-related risks and opportunities is reflected in the terms of reference, mandates, role descriptions and other related policies applicable to that body(s) or individual(s). *[IFRS S1.27(a)(i)]*.
Competency	Describe how the governance body(s) or individual(s) determines whether they have, or will need to develop, the appropriate skills and competencies to oversee strategies that respond to sustainability-related risks and opportunities. *[IFRS S1.27(a)(ii)]*.
Inform	Explain how, and how often, they are informed about sustainability-related risks and opportunities. *[IFRS S1.27(a)(iii)]*.
Address	Explain how they take sustainability-related risks and opportunities into account when overseeing strategy and risk management and assessing transactions. As part of this disclosure, explain whether the governance body(s) or individual(s) has considered trade-offs associated with those risks and opportunities. *[IFRS S1.27(a)(iv)]*.
Monitor	Describe their oversight of the setting of targets and tracking progress against those targets. As part of this disclosure, explain whether and how related performance metrics are included in remuneration policies. *[IFRS S1.27(a)(v)]*.

18 *Recommendations of the TCFD*, Appendix 5: Glossary and Abbreviations, page 62, TCFD, June 2017. Available on the TCFD's website.

4.2.2 Information about management's role

The governance disclosure requirements distinguish between oversight by a governance body or individual and the responsibilities of management-level positions or committees to enable primary users to understand how responsibilities are delegated within the entity in relation to sustainability-related matters. To illustrate this, the board of directors of an entity may provide oversight on broader sustainability-related matters, whereas executives within management may make operational decisions about how specific sustainability-related risks and opportunities are assessed and managed.

IFRS S1 requires an entity to make disclosures about management's role in the governance processes, controls and procedures used to monitor, manage and oversee sustainability-related risks and opportunities. These disclosures are summarised in Figure 4-3 below: *[IFRS S1.27(b)]*

Figure 4-3: Disclosures about management's role

Theme	Disclosure required
Delegation	Information about whether the role is delegated to a specific management-level position or committee and how oversight over that position or committee is exercised. *[IFRS S1.27(b)(i)]*. As such, this disclosure enables primary users to understand how responsibilities are delegated and how the individual(s) or the governance body(s) maintains oversight over those delegated responsibilities. *[IFRS S1.BC99]*.
Processes	Information about whether management uses controls and procedures to support the oversight of sustainability-related risks and opportunities and, if so, how these controls and procedures are integrated with other internal functions. *[IFRS S1.27(b)(ii)]*.

Given the nature of the disclosure requirements about the role of the governance body and the role of management, it is likely that entities will use narrative disclosures to meet those requirements.

Depending on the nature of the information, clarity of the disclosure may be enhanced through the use of tables, graphs or diagrams in addition to narrative text.

Practical examples 4-1, 4-2 and 4-3 below show how some entities, in applying the TCFD Recommendations, have identified and described the role and mandate of the governance bodies that have oversight of its sustainability-related risks and opportunities and management's delegated roles in the governance. These entities provide a visual representation of the role of each body which is explained further in the accompanying narrative disclosure included in the relevant reports, which also details the processes, controls and procedures used to monitor, manage and oversee their sustainability-related risks and opportunities.

Practical example 4-1: Flutter Entertainment plc (2023) **Ireland**

Annual Report & Accounts 2023 [extract]
Strategic report [extract]
Sustainability [extract]
GOVERNANCE AND ACCOUNTABILITY [extract]

Telstra Group Limited has included in its Annual Report a flow chart where is explains its approach to climate risk governance:

Practical example 4-2: Telstra Group Limited (2024) Australia

Telstra Annual Report 2024 [extract]

Acting on climate and nature [extract]

Governance of climate and nature-related matters [extract]

...

	Description		Key climate and nature responsibilities
Oversight	**Board**	Oversees Telstra Group's approach to Environment, Social and Governance issues including approving key external environmental targets and selected environmental disclosures. Comprised of nine members with a diverse range of skills[50] and experience including environment, social and governance and risk management.	Approves key external environment targets and selected environment disclosures, including IRFS 2 and TNFD reporting.
	Audit and Risk Committee (ARC)	Oversees the design and implementation of Telstra's risk management framework. Reviews and monitors the Group's ESG performance and considers significant issues relating to ESG including reviewing reports from management on the Group's climate and nature-related risks and risk management plans to deal with those risks. Makes recommendations to the Board on key environmental targets and selected environmental disclosures, including IFRS S2 and TNFD disclosures.	Provide recommendations to the Board, for its approval on key external environment targets and selected environment disclosures, including IFRS S2 and TNFD reporting, and on changes to risk appetite set by the Board. In FY24, climate and nature-related topics presented included: greenwashing, nature and biodiversity, carbon credits and external positioning of our climate activities, and emerging mandatory reporting standards for climate.
Strategy and Management	**CEO Leadership Team**	The CEO and their senior leadership team including the CFO make up the CEOLT and hold ultimate accountability over the effectiveness of risk management in the company.	Review quarterly updates on climate and nature-related risks from the Sustainability Executive and Environment Executives Group (EEG). Deliver management decisions and oversight in relation to Telstra Group's sustainability strategy to effectively manage climate and sustainability risk within risk appetite.
	Sustainability Executive	Provides day-to-day management of nature and climate-related activities, risks, opportunities, dependencies and impacts.	Chairs the monthly Environment Executives Group and reports key progress and recommended actions to the CEOLT and ARC.
	Environment Executives Group (EEG)	Meeting monthly, the EEG is attended by functional leads from across the business to discuss environment, nature and climate-related matters.	Determine climate and nature ambition and key priorities. Oversee execution of management decisions on climate and nature-related matters within function areas, identify resourcing and capability requirements and provide function specific climate and nature-related recommendations to the CEOLT.
	Sustainability Centre of Expertise (CoE)	Reporting to the Sustainability Executive, the Sustainability CoE is a team of subject matter experts (including climate and nature) who liaise with internal and external stakeholders.	Accountable for the design and delivery of the sustainability strategy. Provide cross function support, education and capacity building on climate and nature-related matters. Monitor and prepare disclosures and mandatory sustainability reporting. Input into consultations with external bodies and agencies.
	Other governance forums	Governance forums to bring together delivery leads, risk owners, subject matter experts and other stakeholders to lead specific components of the sustainability strategy.	Provide leadership, recommendations and guidance for the management of individual climate and nature-related targets such as scope 1+2 emissions reduction, network waste recycling or forums that manage biodiversity risks including pollution, invasive species and other risks. Oversee execution risk specific management actions and policies.
	Working Groups	Specialist project groups which bring together cross function representatives and subject matter experts to progress actions towards our nature and climate targets, manage nature and climate-related risks, and develop internal capability and expertise.	Deliver project specific aims and objective, report on progress and provide recommendations to the EEG, including resourcing and training requirements. In FY24, a Nature and Biodiversity working group was formed, tasked with identifying and assessing existing and emerging nature and biodiversity issues to form our first nature and biodiversity register of risks and opportunities.

...

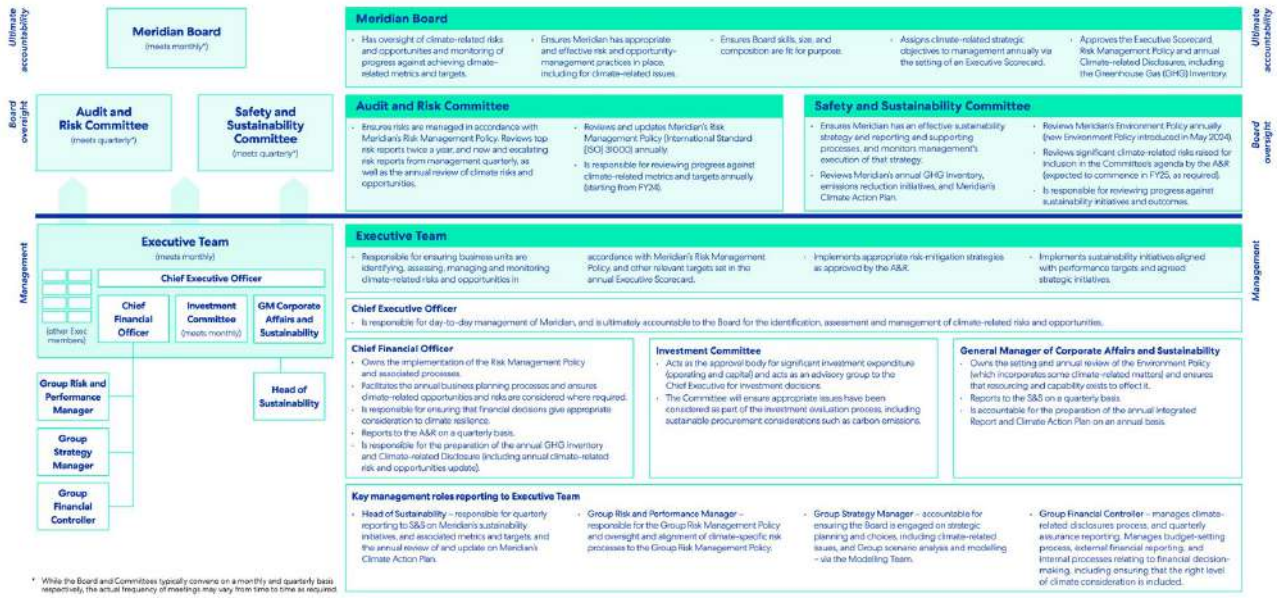
In its Climate-related Disclosure, Meridian Energy Limited discloses how its governance is structured for climate-related matters:

Practical example 4-3: Meridian Energy Limited (2024) — New Zealand

Climate-related Disclosure 2024 [extract]

Governance [extract]

Governance and Management Hierarchy Overview [extract]



4.3 Strategy

The TCFD defines 'strategy' as referring to "an organization's desired future state. An organization's strategy establishes a foundation against which it can monitor and measure its progress in reaching that desired state. Strategy formulation generally involves establishing the purpose and scope of the organization's activities and the nature of its businesses, taking into account the risks and opportunities it faces and the environment in which it operates."[19]

The objective of the strategy disclosures in IFRS S1 is to enable primary users to understand an entity's strategy for managing sustainability-related risks and opportunities. *[IFRS S1.28].* These disclosures can be used to inform primary users' expectations about the future performance of an entity.

19 *Recommendations of the TCFD*, Appendix 5: Glossary and Abbreviations, pages 63-64, TCFD, June 2017. Available on the TCFD's website.

In Note 16 of its 2024 financial statements, BHP Group Limited disclosed the focus of its climate-related strategy:

Practical example 4-4: BHP Group Limited (2024) Australia

Annual Report 2024 [extract]

Financial Statements [extract]

1 Consolidated Financial Statements [extract]

1.6 Notes to the Financial Statements [extract]

16 Climate change [extract]

The Group recognises that warming of the climate is unequivocal, the human influence is clear and physical impacts are unavoidable. Identifying, monitoring and assessing the actual and potential impacts of climate change is complex and the Group continues to develop its assessment of the actual and potential financial impacts of climate-related risks (threats and opportunities), including the transition to a net zero economy and physical risk impacts.

The Group's current climate change strategy focuses on:

- building a portfolio to support the megatrends shaping our world, including future-facing commodities (copper, nickel and potash) and steelmaking materials (iron ore and steelmaking coal)
- reducing operational (Scopes 1 and 2 from operated assets) greenhouse gas (GHG) emissions
- investing in low to zero GHG emissions technologies
- supporting Scope 3 GHG emissions reductions in the Group's value chain and promoting product stewardship
- managing climate-related risks
- working with others to enhance the global policy and market response

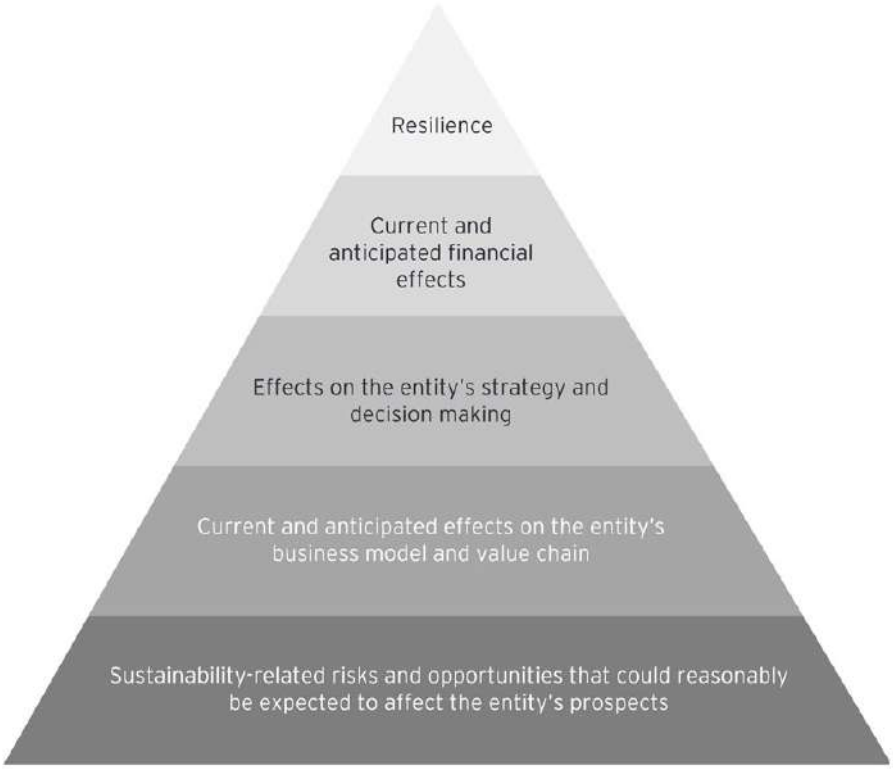
...

The foundation of the strategy disclosures is information about the sustainability-related risks and opportunities that could reasonably be expected to affect the entity's prospects (see section 4.3.1 below). The other strategy disclosures build on that initial disclosure by providing information about: *[IFRS S1.29]*

- The current and anticipated effects of those sustainability-related risks and opportunities on the entity's business model and value chain (see section 4.3.2 below)
- The effects of those risks and opportunities on the entity's strategy and decision-making (see section 4.3.3 below)
- The current and anticipated effects of those risks and opportunities on the entity's financial position, financial performance and cash flows (see section 4.3.4 below)
- The resilience of the entity's strategy and its business model to those sustainability-related risks (see section 4.3.5 below)

These strategy disclosure sub-topics are summarised in Figure 4-4 below.

Figure 4-4: Strategy disclosure sub-topics



4.3.1 Disclosures about sustainability-related risks and opportunities that could reasonably be expected to affect the entity's prospects

As discussed in section 1.2 above, an entity is required to identify the sustainability-related risks and opportunities that could reasonably be expected to affect its prospects. IFRS S1 requires an entity to disclose a description of each of those sustainability-related risks and opportunities. *[IFRS S1.30]*.

To provide primary users with further context in relation to each of those sustainability-related risks and opportunities, IFRS S1 requires an entity to specify the time horizons over which the effects of each of those sustainability-related risks and opportunities could reasonably be expected to occur. IFRS S1 identifies the time horizons as being the short, medium or long term. *[IFRS S1.30(b)]*.

The ISSB decided to not prescribe specific time frames that represent 'short term', 'medium term' and 'long term' because the ISSB considered that relevant information about an entity's sustainability-related risks and opportunities is best understood in the context of entity-specific assessments of short, medium and long term. For that reason, IFRS S1 requires an entity to also disclose an explanation of how the entity defines the 'short term', 'medium term' and 'long term' time horizons and how those definitions are linked to the planning horizons used by the entity for strategic decision-making. *[IFRS S1.30(c), IFRS S1.BC102]*.

In defining these time horizons, an entity needs to take into account a number of factors that can vary between entities and the industries in which they operate. Also, time horizons often become management processes, e.g., rolling forecast horizons, budget periods and strategic planning cycles. IFRS S1 includes the following examples as entity-specific or industry-specific factors: *[IFRS S1.31, IFRS S1.BC102]*

- Cash flow, investment and business cycles
- Planning horizons typically used in an entity's industry for strategic decision-making and capital allocation plans
- The time horizons over which primary users conduct their assessments of entities in that industry

Meridian Energy Limited disclosed in its Climate-related Disclosure 2024 how it defines the time horizons across which it assesses its climate-related risks:

Practical example 4-5:	**Meridian Energy Limited (2024)**	**Australia**

Climate-related Disclosure 2024 [extract]
Risk Management [extract]
Identifying and assessing climate-related risks and opportunities - methodology [extract]

Time horizons and risk scoring

Meridian's annual climate risk and opportunity assessment considers scenarios across three time horizons. Longer time horizons are helpful in considering the useful lives of assets (beyond a typical business case horizons). These horizons will continue to be reviewed based on emerging and relevant contexts, including climate science. The time horizons are as follows:

- Short term: from today through to 2030.
- Medium term: from 2030 to 2050.
- Long term: from 2050 to 2100.

4.3.2 Disclosures about the effects of sustainability-related risks and opportunities on the entity's business model and value chain

IFRS S1 requires an entity to describe the current and anticipated effects of sustainability-related risks and opportunities on the entity's business model and value chain and where in that business model and value chain those sustainability-related risks and opportunities are concentrated. For example, the sustainability-related risks and opportunities may be concentrated across geographical areas, facilities or types of assets. *[IFRS S1.32].*

The examples below are based on the Basis for Conclusions to IFRS S1 and illustrate the type of information an entity may provide to disclose where in its business model and value chain sustainability-related risks and opportunities are concentrated: *[IFRS S1.BC52]*

Illustration 4-1: Examples showing where in the entity's business model and value chain sustainability-related risks and opportunities are concentrated

Entity A operates in the beverage industry and has identified that it needs to disclose risks associated with water use, especially in areas where water is scarce. Entity A may describe how its use of water affects the supply available to meet its operational needs. It may explain how its water consumption affects communities close to the entity's operations that rely on the same source of water. It may also explain how over-consumption of water in those locations could lead to risks of reputational damage and loss of customers, or to the imposition of taxes or limits on the use of the resource. It may also describe how these risks have been assessed throughout its supply chain.

Entity B is a clothing brand and has identified that it needs to describe the opportunity associated with changing to use less resource-intensive materials in its products and packaging. The potential effects may be driven by Entity B's commitments to sustainable business practices, or consumer preferences for more sustainable or recycled alternatives. Entity B may also disclose the areas of its value chain and operations that are potentially most affected by this opportunity, and the processes in place to assess and monitor the opportunity.

Entity C is an electronics manufacturer and has identified that it needs to describe the risks of human rights issues in its supply chain, including reputational damage and supply chain disruptions. In doing so, Entity C may describe the effects on its policies, actions it has taken to assess and monitor the risks, and how it manages any identified abuses.

4.3.3 Disclosures about the effects of sustainability-related risks and opportunities on the entity's strategy and decision-making

To enable primary users to understand the effects of sustainability-related risks and opportunities on an entity's strategy and decision-making, IFRS S1 requires an entity to disclose information about: *[IFRS S1.33]*

- How the entity has responded to, and plans to respond to, sustainability-related risks and opportunities in its strategy and decision-making
- The entity's progress in respect of plans it has disclosed in previous reporting periods, including quantitative and qualitative information
- Trade-offs between sustainability-related risks and opportunities that the entity considered

The example below illustrates disclosures about trade-off between sustainability-related risks and opportunities:

Illustration 4-2: Example on trade-offs between sustainability-related risks and opportunities

During the reporting period, Entity A decided where to locate its new manufacturing facility that would replace the existing facility that was approaching the end of its useful life. Entity A had considered two alternative sites for its new manufacturing facility:

Site X is located in the same region as the existing facility. However, the site is prone to flash flooding during heavy rains due to the poor drainage systems at the site and its surrounding area.

Site Y is located in a different region, which is not prone to flood risk. A consequence of relocating to Site Y is that Entity A is currently the main employer in the community that surrounds Site X. A decision by Entity A to relocate to Site Y is that it would have an adverse effect on its local workforce and indirectly on the economic prospects for the entire community.

Entity A performed impact assessments to investigate the extent of flood risk of Site X and the social risk of moving to Site Y and identified options for mitigating those risks. Entity A decided, on cost/benefit grounds, to build its new manufacturing facility at Site X and as part of the development works, install new drainage systems that can divert flood waters away from the site and the community. In reaching this decision, Entity A also considered the benefit of continued access to the locally trained and engaged workforce to operate the facility.

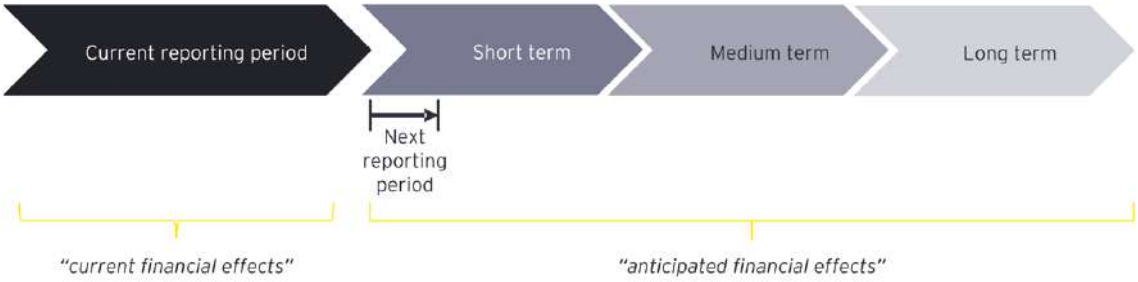
4.3.4 Disclosures about current and anticipated financial effects of sustainability-related risks and opportunities

IFRS S1 requires an entity to disclose quantitative and qualitative information about: *[IFRS S1.34]*

- The effects of the entity's sustainability-related risks and opportunities on its financial position, financial performance and cash flows for the reporting period, which is referred to as 'current financial effects'
- The anticipated effects of those sustainability-related risks and opportunities on its financial position, financial performance and cash flows over the short, medium and long term, taking into consideration how the entity includes those sustainability-related risks and opportunities in its financial planning. These are referred to as 'anticipated financial effects'

The timescales contemplated by the meaning of 'current financial effects' and 'anticipated financial effects' are illustrated in Figure 4-5 below.

Figure 4-5: Timeline for current and anticipated financial effects



Disclosures of current and anticipated financial effects are intended to supplement or expand upon information provided in the related financial statements. This includes identifying and explaining the connections between sustainability-related risks and opportunities and the information reported in the financial statements (see discussion on connected information in section 3.4.2.B above). Connections between items of information may be able to be explained without duplicating information by using cross-references. For example, a cross reference to information disclosed in the notes to the financial statements may satisfy the requirement in IFRS S1 to disclose how sustainability-related risks and opportunities have affected an entity's current and anticipated financial position, financial performance and cash flows. The use of cross-references is subject to the requirements in IFRS S1 (see further discussion in section 5.2.2 below).

In Note 16 of its 2024 financial statements, BHP Group Limited disclosed the areas of the financial statements that could be affected by its strategy and decision-making related to climate-related risks and opportunities.

Practical example 4-6: BHP Group Limited (2024) Australia

Annual Report 2024 [extract]
Financial Statements [extract]
1 Consolidated Financial Statements [extract]
1.6 Notes to the Financial Statements [extract]
16 Climate change [extract]

...

Areas of these Financial Statements that may be impacted in connection with this strategy throughout the value creation and delivery cycle of the Group's operations, include:

Phase	Areas of potential Financial Statement impact
Exploration and acquisition	– Financial impact of portfolio decisions
Development and mining / Process and logistics	– Impact of transition risks on asset carrying values – Physical climate-related risks and asset carrying values – Application of carbon pricing assumptions and acquisition of carbon credits – Useful economic lives of property, plant and equipment – Expenditure on operational (Scopes 1 and 2 from operated assets) decarbonisation
Sales, marketing and procurement	– Expenditure to support value chain (Scope 3) decarbonisation
Closure and rehabilitation	– Timing, scope and expected cost of closure and rehabilitation activities

At the date of issue of these Financial Statements, indicators show the appropriate measures are not in place globally to drive decarbonisation at the pace or scale required to achieve the aim of the Paris Agreement to limit the global average temperature increase to 1.5°C above pre-industrial levels. The significant judgements and key estimates used in the preparation of these Financial Statements reflect the Group's current planning range (which implies a projected global average temperature increase of approximately 2°C by CY2100), as described below.

While not the basis of preparation of these Financial Statements, the Group continues to perform sensitivity analysis under the Group's 1.5°C scenario to consider potential Financial Statement impacts of commodity and carbon prices in a rapidly decarbonising world. The Group's 1.5°C scenario is not a forecast of what is likely to occur.

Future changes to the Group's climate change strategy or global decarbonisation trends may impact the Group's significant judgements and key estimates, and result in material changes to financial results, cash flows and the carrying values of certain assets and liabilities in future reporting periods.

The Group has developed three unique planning cases which comprise the Group's planning range: a 'most likely' base case, used as the basis for judgements and assumptions in these Financial Statements, and an upside case and downside case that provide the range's boundaries. The three cases reflect proprietary forecasts for the global economy and associated sub-sectors (i.e. energy, transport, agriculture and steel) and the resulting market outlook for the Group's core commodities.

Given the complexity and inherent uncertainty of long run forecasting, these pathways are reviewed periodically to reflect new information, with a process in place to assess the need to update internal long-term price

...

4.3.4.A Disclosures about current financial effects

IFRS S1 requires an entity to disclose quantitative and qualitative information about how sustainability-related risks and opportunities have affected its financial position, financial performance and cash flows for the reporting period. *[IFRS S1.35(a)]*.

An entity may also be required to disclose these current financial effects in the notes to its financial statements when applying IFRS accounting standards or other GAAP. As discussed in section 4.3.4 above, an entity should consider whether it can include a cross reference to this information to avoid unnecessary duplication of disclosures. There may be cases where sustainability-related risks and opportunities have affected an entity's financial position, financial performance and cash flows for the reporting period. This is illustrated in the Illustration 4-3 below:

Illustration 4-3: Sustainability-related risks and opportunities with effects in the current reporting period

Entity A is an energy provider operating in country Z where the government imposed a regulation that includes certain targets to entities for reducing carbon dioxide emissions. The regulation was enacted a few years ago and is applicable in the next reporting period. Entity A identified climate-related risks due to that regulation.

Entity A applies IFRS accounting standards. This regulation is considered by Entity A to be a triggering event for an impairment assessment, which has led to partial impairment of certain power production facilities and the reduction of their useful life.

Entity A would need to disclose in its sustainability-related financial disclosures how these climate-related risks have affected its financial position, financial performance and cash flows for the reporting period. To avoid duplicating this information, Entity A may cross-reference to the notes to its financial statements such as the notes discussing about property, plant and equipment, impairment, and provisions.

There may be cases where sustainability-related risks and opportunities have not affected an entity's financial position, financial performance and cash flows for the reporting period. However, explaining that fact may still be material information for primary users. This is reflected in the Illustration 4-4 below:

Illustration 4-4: Sustainability-related risks and opportunities with no effects in the current reporting period

Entity B operates in the leasing industry of diesel-powered cars which have negligible value. Cars are leased for a minimum of five years. Entity B identified climate-related risks and opportunities relating to the significant contribution of Scope 1 GHG emissions by diesel-powered cars. Therefore, Entity B included in its business plan a target to gradually replace those cars with electric-powered ones. The replacement of cars will be conducted gradually based on when current lease term of each car ends. There is no capital commitment during the lease term in the current reporting period. Entity B assessed the effects of those risks and opportunities on its financial position, financial performance and cash flows for the current period and concluded that there are no implications.

Entity B would need to disclose in its sustainability-related financial disclosures how these climate-related risks and opportunities have affected its financial position, financial performance and cash flows for the reporting period. Although Entity B assessed that there are no implications in the current reporting period, it may conclude that disclosing the fact that there are no current financial implications could still be a material information for primary users.

Even though there is no effect in the current reporting period from these sustainability-related risks and opportunities, anticipated financial effects arising may exist (see Illustration 4-5 below).

In Note 16 of its 2024 financial statements, BHP Group Limited specifically disclosed the potential effect of climate-related risks and opportunities on the carrying values of assets recognised in its financial statements.

Practical example 4-7: BHP Group Limited (2024) Australia

Annual Report 2024 [extract]

Financial Statements [extract]

1 Consolidated Financial Statements [extract]

1.6 Notes to the Financial Statements [extract]

16 Climate change [extract]

Impact of transition risks on asset carrying values

Significant judgements and key estimates in relation to the preparation of these Financial Statements, including asset carrying values and impairment assessments, are impacted by the Group's current assessment of the range of economic and climate-related conditions that could exist in the world's transition to a net zero economy, considering the current trajectory of society and the global economy as a whole.

For example, demand for the Group's commodities may decrease due to policy, regulatory (including carbon pricing mechanisms), legal, technological, market or societal responses to climate change, resulting in a proportion of a cash generating unit's (CGU) reserves becoming incapable of extraction in an economically viable fashion. Alternatively, technological or market developments increasing demand for commodities in the portfolio that help enable decarbonisation may have a positive impact on prices for those commodities.

The Group has developed three unique planning cases which comprise the Group's planning range: a 'most likely' base case, used as the basis for judgements and assumptions in these Financial Statements, and an upside case and downside case that provide the range's boundaries. The three cases reflect proprietary forecasts for the global economy and associated sub-sectors (i.e. energy, transport, agriculture and steel) and the resulting market outlook for the Group's core commodities.

Given the complexity and inherent uncertainty of long run forecasting, these pathways are reviewed periodically to reflect new information, with a process in place to assess the need to update internal long-term price outlooks for developments in the periods between pathway updates.

The Group reflects the planning range and associated price outlooks in the internal valuations used as the basis for the Group's impairment assessments.

The discount rate used in the internal valuations reflects a real post-tax weighted average cost of capital (WACC), including country and state risk premia where appropriate, and ranges from 7.0 per cent to 9.5 per cent across the Group (2023: 7.0 per cent to 9.5 per cent). Cash flow forecasts used as the basis for impairment testing include asset specific risks, including climate-related risks such as operational interruptions as a result of physical climate-related risks, and therefore the Group does not include a separate climate-related risk adjustment in the Group's WACC.

Further detail on the Group's significant judgements and estimates that inform the planning range and FY2024 impairment assessments, is included in note 13 'Impairment of non-current assets'.

In addition to the planning range, and as described below in 'Paris Agreement and 1.5°C scenarios', the Group uses its 1.5°C scenario, which implies a global average temperature increase of 1.5°C by CY2100, to test resilience of the Group's portfolio in a rapidly decarbonising world.

Physical climate-related risks and asset carrying values

The Group's operations are exposed to physical climate-related risks. In FY2024, the Group continued to progress studies of physical climate-related risks to better understand the potential impacts on safety, productivity and cost, with the work to continue in FY2025.

The studies consider potential impacts of acute and chronic risks from material climate hazards, which differ based on an operated asset's geographic region, asset infrastructure and operational processes. The studies are ongoing and therefore the Group's consideration of physical climate-related risks, including factors such as potential operational interruptions caused by extreme weather events, therefore includes only the Group's current best estimates of related potential financial impacts.

Given the complexity of physical climate-related risk modelling and the status of the Group's ongoing physical risk assessment process, the identification of additional risks and/or the detailed development of the Group's response may result in material changes to financial results and the carrying values of assets and liabilities in future reporting periods.

Useful economic lives of property, plant and equipment

The determination of useful lives of the Group's PP&E requires judgement, including consideration of the Group's climate change strategy, targets and goals, decarbonisation plans and the possible impact of transition risks on demand for the Group's commodities.

Useful lives are reviewed each reporting period, including to ensure they do not exceed the remaining expected operating life of the operation in which they are utilised. The remaining lives of the Group's operations reflect the Group's planning range and its underlying climate-related assumptions.

A key component of the Group's operational decarbonisation strategy is the displacement of diesel within the Group's operations, particularly the haul truck fleet. The Group is supporting the development of new equipment by original equipment manufacturers, including entering into partnerships focused on the development and trialling of electric locomotives and haul trucks.

While technical and commercial development of the technology needed is progressing, the Group's operational plans generally assume replacement of haul trucks, and other diesel powered equipment, at the end of their useful lives in line with the Group's regular fleet renewal programs. For example, a significant proportion of the Group's existing WAIO mining fleet is due for replacement prior to the expected availability of battery electric vehicle solutions. As such, the Group's decarbonisation plans have not had a material impact on the estimated remaining useful lives of the Group's existing fleet of assets in FY2024.

Woolworths Group Limited in Note 3.6 (Property, plant and equipment) and Note 3.9 (Impairment of non-financial assets) of its Annual Report, disclosed that there is no effect in the current reporting period from sustainability-related matters but indicates that there may be an effect in future reporting periods.

Practical example 4-8: Woolworths Group Limited (2024) Australia

Annual Report 2024 [extract]
SECTION 4 Financial Report
Consolidated Financial Statements [extract]
Notes to the Consolidated Financial Statements [extract]
3 Assets and liabilities [extract]
3.6 Property, plant and equipment [extract]

Financial reporting impacts of sustainability-related matters

The Group has identified climate-related physical risks to its assets and is currently working through actions to address these risks, including improving the resilience of its assets through the implementation of generators for areas exposed to a high risk of power outages, flood barriers, rainwater harvesting, and roof strengthening.

Useful lives

During the period, there were no changes to the useful lives of property, plant and equipment as a result of climate-related risks. If in future reporting periods there are changes to the proposed useful lives and/or residual values due to climate-related risks, these changes will be accounted for on a prospective basis.

3.9 Impairment of non-financial assets [extract]

Financial reporting impacts of sustainability-related matters

Notwithstanding that the Group continues to assess the potential impacts of climate change on its impairment testing, the Group has identified climate-related physical risks to its assets and is currently working through actions to address these risks. These actions include the replacement of its existing assets with more environmentally-friendly alternatives, such as refrigeration, solar and LED lighting, and converting the Group's home delivery fleet to electric vehicles, as well as increasing the resilience of the Group's store and supply chain assets through the implementation of generators for areas exposed to a high risk of power outages. Furthermore, the Group incorporates the potential increase of future flood risk into its existing site selection and design procedures.

Given that the average remaining useful life of the Group's significant non-financial tangible assets is approximately eight years, the potential impacts of climate change are not considered to present a risk of impairment of the carrying value of non-financial assets in the near term.

4.3.4.B Disclosures about anticipated financial effects: Next annual reporting period

Anticipated financial effects refer to those financial effects anticipated in the next annual reporting period and to those financial effects anticipated over the short, medium and long term.

IFRS S1 requires disclosure of information that connects the current financial effects with the anticipated financial effects in the next annual reporting period. In accordance with this disclosure requirement in IFRS S1, an entity is required to disclose quantitative and qualitative information about those sustainability-related risks and opportunities that have both of the following characteristics: *[IFRS S1.35(b)]*

- The sustainability-related risks or opportunities were identified as having current financial effects (see also section 4.3.4.A above).
- Within the next annual reporting period, there is a significant risk of a material adjustment to the carrying amounts of assets and liabilities reported in the related financial statements.

Similar to the disclosure of current financial effects, the information required by this disclosure may also be disclosed in the notes to the entity's financial statements due to requirements in IAS 1 for the disclosure of sources of estimation uncertainty. Therefore, an entity may need to consider whether to include a cross reference to this information to avoid unnecessary duplication of disclosures.

How we see it

In our view, when an entity prepares sustainability-related financial disclosures about current financial effects and about anticipated effects for the next annual reporting period, it needs to base its materiality assessment for these disclosures on assumptions and data used for the information included in the financial statements and vice versa. This is consistent with the requirements of IFRS S1 to use 'consistent data and assumptions' in both the preparation of financial statements and in disclosing sustainability-related financial information (discussed in section 3.4.2.B).

4.3.4.C Disclosures about anticipated financial effects: Short, medium and long term

IFRS S1 requires an entity to disclose quantitative and qualitative information about how the entity expects its financial position to change over the short, medium and long term, given its strategy to manage sustainability-related risks and opportunities, taking into consideration the entity's:

[IFRS S1.35(c)]

- Investment and disposal plans, including plans for which the entity is not contractually committed
- Planned sources of funding to implement its strategy

An entity's investment and disposal plans may include plans for capital expenditure, major acquisitions and divestments, joint ventures, business transformation, innovation, new business areas, and asset retirements.

Similarly, IFRS S1 also requires an entity to disclose quantitative and qualitative information about how the entity expects its financial performance and cash flows to change over the short, medium and long term, given its strategy to manage sustainability-related risks and opportunities. *[IFRS S1.35(d)]*.

Illustration 4-5: Sustainability-related risks and opportunities with anticipated financial effects

Consider the same facts as in Illustration 4-4 above.

Although the climate-related risks identified in Illustration 4-4 do not affect Entity B's financial position, financial performance, and cash flows in the current reporting period, there are anticipated financial effects. Entity B needs to disclose those anticipated effects. For example, shifting the fleet to electric-powered cars will require Entity B to make an additional capital investment of approximately CU1million for the replacement of the petrol-powered cars with electric-powered ones and the installation of charging points where needed. It is expected that 30% of the total fleet will be replaced each year with the aim of replacing the total feel within the next three years. The shift to electric-powered cars aims to reduce Entity B's Scope 1 GHG emissions produced by petrol-powered cars by approximately 20,000 tons each year.

4.3.4.D Measurement of current and anticipated financial effects

IFRS S1 does not provide guidance on how to measure current and anticipated financial effects other than to indicate that quantitative information may be disclosed as a single amount or a range. The ISSB acknowledged that, in some cases, ranges of possible outcomes could be more useful than single estimates. *[IFRS S1.36, IFRS S1.BC89].*

How we see it

Given the variety of factors that may need to be considered in quantifying the anticipated financial effects of a sustainability-related risk or opportunity, an entity may need to use judgement to determine how to measure those effects. Such judgement relates to selecting the method that an entity expects that it will best reflect the anticipated effect on its financial position, financial performance and cash flows. In exercising judgement to select a relevant measurement method, an entity may consider whether the measurement methods used in IFRS accounting standards or other GAAP (such as expected value or the most likely amount) could be relevant to apply by analogy to quantify the anticipated financial effects.

4.3.4.E Preparing disclosures about anticipated financial effects

Stakeholders raised concerns about the difficulties that some entities may face in disclosing information about anticipated financial effects. To address these concerns, specifically for the preparation of disclosures about the anticipated financial effects of a sustainability-related risk or opportunity, IFRS S1 allows an entity to: *[IFRS S1.37, IFRS S1.BC106, IFRS S1.BC107]*

- Use all reasonable and supportable information that is available to the entity at the reporting date without undue cost or effort (for further information see discussion in section 1.2.2 above). The ISSB further clarified this requirement in the context of anticipated effects as summarised in Figure 4-6 below.
- Use an approach that is commensurate with the skills, capabilities and resources that are available to the entity for preparing those disclosures. However, the ISSB clarified that an entity cannot avoid providing quantitative information for anticipated financial effects because it does not have the skills or capabilities to do so if it has the resources available to obtain or develop those skills or capabilities.

Figure 4-6: The concept of reasonable and supportable information in the context of disclosures for anticipated effects

Phrase	Meaning
"use all reasonable and supportable information"	An entity is prohibited from overstating or understating the anticipated financial effects of opportunities or risks premised on information that is unsupportable or unreasonable.
"use… information that is available to the entity at the reporting date"	An entity is permitted to use only the information that is available to the entity at the reporting date (including information about past events, current conditions and forecasts of future conditions).
"use… information that is available to the entity… without undue cost or effort"	An entity is not required to carry out an exhaustive search for information to determine or measure the anticipated financial effects of risks and opportunities. Instead, an entity is permitted to carry out an information search that is proportional to the cost and effort involved in obtaining that information.

4.3.4.F Criteria and disclosures when quantitative information about current and anticipated financial effects is not required

The ISSB has established criteria for when an entity is not required to disclose quantitative information about the financial effects of a sustainability-related risk or opportunity. In particular: *[IFRS S1.38, IFRS S1.39, IFRS S1.BC109]*

- For either current or anticipated financial effects of a sustainability-related risk or opportunity, IFRS S1 states that an entity is not required to provide quantitative information if:
  - Those current or anticipated financial effects are not separately identifiable. That is, the financial effects may arise from many risks or opportunities and affect many items in the financial statements. As such, it may be difficult to attribute financial effects to an individual sustainability-related risk or opportunity.
    Or
  - The level of measurement uncertainty involved in estimating those effects is so high that the resulting quantitative information would not be useful. See section 6.2 below for a further discussion on measurement uncertainty.
- Specifically for anticipated financial effects of a sustainability-related risk or opportunity, IFRS S1 does not require an entity to provide quantitative information on those anticipated financial effects if the entity lacks the skills, capabilities or resources to do so.

For current or anticipated financial effects of a particular sustainability-related risk or opportunity, the ISSB clarified that, even if an entity is not in a position to disclose quantitative information, it is still required to provide other quantitative and qualitative information that would be useful to primary users. For that reason, if an entity concludes that it is unable to provide quantitative information, IFRS S1 requires to: *[IFRS S1.40]*

- Explain why the entity has not provided quantitative information.
- Provide qualitative information about those financial effects-this is to include identifying line items, totals and subtotals within the related financial statements that are likely to be affected, or have been affected, by that sustainability-related risk or opportunity.
- Provide quantitative information about the combined financial effects of that sustainability-related risk or opportunity with other sustainability-related risks or opportunities and other factors. However, disclosing quantitative information about the combined financial effects is not required if the entity determines that this information would not be useful.

4.3.5 Disclosures about the resilience of the entity's strategy and business model to sustainability-related risks

IFRS S1 requires a resilience assessment of an entity's strategy and business model. The purpose of the resilience assessment is to inform primary users about the entity's ability to cope with and withstand the effects of sustainability-related risks and related uncertainties in different scenarios.

In particular, IFRS S1 requires an entity to disclose an assessment of the resilience of the entity's strategy and business model in relation to its sustainability-related risks, including information about how the assessment was carried out and its time horizon. The assessment is to be a qualitative and, if applicable, quantitative assessment. When providing quantitative information, IFRS S1 permits an entity to disclose a single amount or a range. *[IFRS S1.41].*

IFRS S1 acknowledges that other ISSB standards may specify the type of information an entity is required to disclose about its resilience to specific sustainability-related risks and how to prepare those disclosures, including whether a scenario analysis is required. *[IFRS S1.42].* For example, IFRS S2 includes specific requirements for resilience assessments for an entity's climate-related risks (see Chapter 53 at section 4.3).

The requirements to disclose information about the resilience of an entity's strategy and business models and to disclose information about the current and anticipated financial effects of an entity's sustainability-related risks and opportunities are designed to meet different information needs. The requirements for a resilience assessment relate to an entity's capacity to adjust to the uncertainties arising from sustainability-related risks, whereas the requirements on the current and anticipated financial effects of sustainability-related risks and opportunities relate to the effects of risks and opportunities on an entity's financial performance, financial position and cash flows. Therefore, these requirements can be applied independently. However, while an entity is not required to carry out a resilience assessment to determine the anticipated financial effects of sustainability-related risks and opportunities, the ISSB also acknowledged that an entity may find the resilience assessment useful and relevant in determining the anticipated financial effects of sustainability-related risks and opportunities. *[IFRS S1.BC113].*

4.4 Risk management

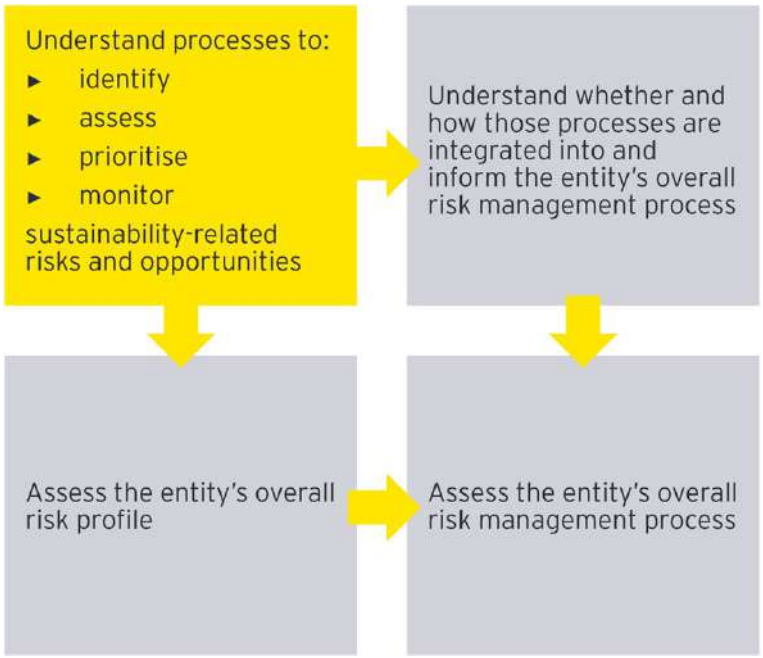
The TCFD defines 'risk management' as referring to "a set of processes that are carried out by an organization's board and management to support the achievement of the organization's objectives by addressing its risks and managing the combined potential impact of those risks".[20]

The objective of risk management disclosures in IFRS S1 is to enable primary users to: *[IFRS S1.43]*

- Understand an entity's processes to identify, assess, prioritise and monitor sustainability-related risks and opportunities (see discussion in section 4.4.1 and 4.4.2 below)
- Understand whether and how those processes are integrated into and inform the entity's overall risk management process (see discussion in section 4.4.3 below)
- Assess the entity's overall risk profile and its overall risk management process

This objective is summarised in Figure 4-7 below:

Figure 4-7: Risk management processes



The TCFD noted that in assessing an entity's financial and operating results, many investors want insight into the governance and risk management context in which such results are achieved.[21] This focus helps to draw a distinction between the purpose of the risk management disclosures and the strategy disclosures. The ISSB explained that disclosures about risk management processes relate to the risk management framework that the entity has put in place. In contrast, disclosures about strategy are focused on providing information about an entity's strategy for managing sustainability-related risks and opportunities. *[IFRS S1.BC116].*

20 *Recommendations of the TCFD*, Appendix 5: Glossary and Abbreviations, page 63, TCFD, June 2017. Available on the TCFD's website.

21 *Recommendations of the TCFD*, C Recommendations and Guidance, page 17, TCFD, June 2017. Available on the TCFD's website.

In its ESG Report 2023, The Hong Kong and China Gas Company Limited (Towngas) disclosed the way it conducts its climate risk assessment by giving a summarised description of its risk management processes which is further analysed in a separate report it published.

Practical example 4-9: The Hong Kong and China Gas Company Limited (Towngas) (2023) **Hong Kong**

Environmental, Social and Governance Report 2023 [extract]

NEUTRALISING OUR FOOTPRINT [extract]

Climate Change Management [extract]

Identifying, Assessing, and Managing Climate-related Risks

To evaluate the potential impacts of climate change on our assets, businesses and value chain, we conduct comprehensive climate risk assessments using various climate models and scenarios analyses. This helps us account for a wide range of potential impacts and uncertainties and prepare for future climate-related risks. To ensure comprehensive strategic planning and informed decision-making for the future, we regularly review and update our assessments, strategies and scenario analysis to address emerging climate-related risks and opportunities in different time horizons. We also maintain open communication with stakeholders and explore strategies for strengthening our resilience against transition and physical climate-related risks. For more details, please refer to *the Guide* and sections below.

Physical Risks

Physical risks associated with climate change impacts can be broadly classified as acute (e.g., floods, droughts) and chronic (e.g., sea-level rise, temperature increases). In order to evaluate the impacts of physical risks present in our assets, three Representative Concentration Pathways (RCP) scenarios (RCP 2.6, RCP 4.5, RCP 8.5) were used. These scenarios ranged from limiting the global average temperature of 1.5°C to align with The Paris Agreement (RCP 2.6) to managing the challenges of a drastic increase in average temperature of 4°C (RCP 8.5).

In 2021 we conducted a deep asset physical risk assessment for our Tai Po Gas Production Plant and an asset level assessment of 100 major assets on the Chinese mainland. To extend the assessment coverage across the Chinese mainland, we included new projects and conducted asset level assessments of over 300 assets in 2023. Focusing on chronic risks, we used a climate model to identify climate-sensitive/vulnerable assets, i.e. assets most exposed to extreme impacts such as extreme temperature, rainfall and water stress.

Visits to over 10 selected assets were conducted in 2023 to understand their vulnerability and capacity to adapt to key hazards. We ensure that effective systems are in place to withstand different climate stressors. We also held ESG and climate change training for managerial employees on site to show them the climate impact projections for the assets, as well as to equip them with the knowledge required to tackle climate hazards in the future.

Risk	Time Horizon[1]	Potential Financial Implications	Mitigation Plan/Response
Acute Heavy rainfall and increased frequency and intensity of river floods	Medium to Long Term	↑ Costs and ↓ revenue from asset damage ↑ Resilience upgrade expenses ↑ Insurance costs and claims	· Review plan for adapting our infrastructure to climate change · Strengthen crisis management plans
Chronic Increased temperatures	Long Term	↓ Revenue from gas-related services ↑ Operating costs due to energy use	· Diversify businesses to transform into a multi-energy provider

Transition Risks and Opportunities

In 2020, we analysed various assumptions under four self-developed scenarios based on the International Energy Agency's (IEA) *World Energy Outlook 2019*, which consider technological advancements and policy implementations. This enabled us to identify potential transition risks that could impact the Group under different time horizons. To ensure our analysis aligns with the latest trends, we updated these scenarios using the Network for Greening the Financial System (NGFS) scenarios and developed the Net Zero 2050 Scenario to align with the goal of limiting a global temperature rise to 1.5°C. We then prioritised top transition risks under the Net Zero 2050 Scenario and Below 2°C Scenario specifically for gas-related businesses.

Risk	Time Horizon[1]	Potential Financial Implications	Mitigation Plan/ Response Measure
Policy and Legal Mandates on/regulation of products and services	Short to Medium Term	↓ Revenue from gas-related services ↑ Compliance and insurance costs ↑ Income from low-carbon offerings	· Align with government policies for low-carbon development · Reduce GHG emissions via low-carbon energy and efficiency improvements
Technology Technological improvements or innovations to support the transition to a lower-carbon economy	Medium to Long Term	↑ Investment in new technologies ↑ R&D spending ↓ Operational costs due to energy efficiency	· Reduce operational GHG emissions · Support R&D with proprietary technologies
Market Shifting consumer behaviour	Medium to Long Term	↓ Revenue from gas-related services ↑ Operating costs due to raw material price changes ↑ Income from low-carbon products	· Diversify businesses to transform into a multi-energy provider
Reputation Shareholders are likely to divest from fossil fuels and invest in low-carbon businesses	Long Term	· Change in capital availability ↑ Communication costs	· Enhance open disclosure for increased capital availability

[1]Short term runs to 2025, aligned with our near-term targets that cover carbon reduction, energy efficiency, etc.; medium term runs to 2035, aligned with the Group's plan to replace fossil fuels in phases by introducing and using zero-carbon fuels in our HK operations; long term runs to 2050, aligned with the Hong Kong's Climate Action Plan 2050 to achieve carbon neutral before 2050

4.4.1 Risk management processes for identifying sustainability-related risks

IFRS S1 requires an entity to disclose information about the processes and related policies that it uses to identify, assess, prioritise and monitor sustainability-related risks. The information to be disclosed includes information about: *[IFRS S1.44(a)]*

- The inputs and parameters used by the entity in the processes and policies that identify, assess, prioritise and monitor sustainability-related risks (e.g., information about data sources and the scope of operations covered in those processes)
- Whether and how scenario analysis is used to inform the entity's identification of sustainability-related risks
- How the nature, likelihood and magnitude of the effects of those risks is assessed by the entity (e.g., whether qualitative factors, quantitative thresholds or other criteria are considered)
- Whether and how sustainability-related risks are prioritised by the entity relative to other types of risk
- How sustainability-related risks are monitored by the entity
- Whether and how the entity has changed the processes it uses compared with the previous reporting period

4.4.2 Risk management processes for identifying sustainability-related opportunities

IFRS S1 also requires an entity to disclose information about the processes that it uses to identify, assess, prioritise and monitor sustainability-related opportunities. *[IFRS S1.44(b)]*.

Unlike the disclosures for risk management processes for sustainability-related risks, IFRS S1 does not detail specific information that needs to be disclosed about the entity's risk management processes that apply to its opportunities. The ISSB explained that the disclosure requirements for sustainability-related risks are more detailed than those for opportunities, because of the relative maturity of risk management processes and to meet the primary users' needs for information about an entity's processes for identifying, assessing, prioritising and monitoring risks. *[IFRS S1.BC119]*.

How we see it

Disclosures relating to risk management may also enable primary users to understand an entity's processes for managing its sustainability-related opportunities. Therefore, some of those disclosures could also inform the disclosures relating to sustainability-related opportunities.

4.4.3 Integrating disclosures about risk management processes

IFRS S1 requires an entity to also disclose the extent to which, and how, an entity's processes for identifying, assessing, prioritising and monitoring sustainability-related risks and opportunities are integrated into and inform the entity's overall risk management process. *[IFRS S1.44(c)]*. This information assists primary users in evaluating the entity's overall risk profile and risk management activities.

When an entity uses the same risk management process to identify, assess, prioritise or monitor different sustainability-related risks and opportunities, the entity needs to integrate those disclosures instead of providing separate risk management disclosures for each sustainability-related risk and opportunity. To illustrate this, the ISSB provided the following example: An entity discloses that its climate-related risks and opportunities are integrated into its overall process for managing risks and opportunities. However, other (non-climate) sustainability-related risks and opportunities are identified, assessed, prioritised and monitored separately due to being subject to specific risk management processes that are not part of its overall risk management process. *[IFRS S1.BC118]*.

4.5 Metrics and targets

4.5.1 Metrics

The objective of disclosures on metrics and targets is to enable primary users to understand an entity's performance in relation to its sustainability-related risks and opportunities. *[IFRS S1.45]*.

For each sustainability-related risk and opportunity that could reasonably be expected to affect the entity's prospects, IFRS S1 requires an entity to disclose: *[IFRS S1.46]*

- The metrics required by an applicable ISSB standard
- The metrics the entity uses to measure and monitor:
  - That sustainability-related risk and opportunity (even if those metrics are not required by ISSB standards)

    And
  - The entity's performance in relation to that risk and opportunity, including the entity's progress towards any targets it has set and any targets it is required to meet by law or regulation

When disclosing the metrics as specified above, IFRS S1 requires an entity to include industry-based metrics in relation to its sustainability-related risks and opportunities. That is, an entity needs to include metrics that are associated with particular business models, activities or other common features that characterise participation in an industry. *[IFRS S1.48, IFRS S1.BC125]*.

4.5.1.A Metrics required by ISSB standards

For metrics that apply to climate-related risks and opportunities, IFRS S1 requires an entity to apply the requirements of IFRS S2. IFRS S2 requires an entity to refer to and consider the applicability of the industry-based disclosure topics defined in the *Industry-based Guidance on Implementing IFRS S2*, when identifying the climate-related risks and opportunities that could reasonably be expected to affect an

entity's prospects. These are typically associated with particular business models, activities or other common features that characterise participation in an industry. Moreover, the industry-based guidance also suggests possible ways to measure and disclose information about climate-related risks and opportunities. (See Chapter 53 at section 4.5). Even if an entity concludes not to use the *Industry-based Guidance on Implementing IFRS S2*, industry specific disclosures are still required by ISSB standards.

For metrics that apply to sustainability-related risks and opportunities other than climate, the ISSB is yet to issue other topic-based ISSB standards that may otherwise specifically apply to that sustainability-related risk or opportunity. Accordingly, in the absence of an ISSB standard that specifically applies to a sustainability-related risk or opportunity, IFRS S1 requires an entity to apply the sources of guidance requirements to identify applicable metrics. An entity is also required to identify the source (the specific standards, pronouncements, industry practice and other sources of guidance) and the metric when the metric is taken from a source other than an ISSB standard. *[IFRS S1.47, IFRS S1.49].* For further discussion on sources of guidance, see section 5.1.2 below.

4.5.1.B Metrics developed by the entity

For metrics developed by an entity, IFRS S1 requires an entity to disclose the following information: *[IFRS S1.50]*

Figure 4-8: Disclosures for metrics developed by an entity

Theme	Disclosure required
Definition	How the metric is defined, including: ▸ Whether the metric is derived by adjusting a metric taken from a source other than ISSB standards ▸ If so, which source and how the metric disclosed by the entity differs from the metric specified in that source
Nature	Whether the metric is an absolute measure, a measure expressed in relation to another metric or a qualitative measure. The ISSB gives an example of a qualitative measure as indicating status by using the red, amber, green 'traffic light' colours
Validation	Whether the metric is validated by a third party and, if so, which party
Calculation	The method used to calculate the metric and the inputs to the calculation, including: ▸ The limitations of the method used ▸ The significant assumptions made

4.5.2 Targets

An entity's targets will include any targets it has set to monitor progress towards achieving its strategic goals as well as any targets it is required to meet by law or regulation. *[IFRS S1.51].*

For each target, IFRS S1 requires an entity to disclose: *[IFRS S1.51]*

- The metric used to set the target and to monitor progress towards reaching the target
- The specific quantitative or qualitative target the entity has set or is required to meet
- The period over which the target applies
- The base period from which progress is measured
- Any milestones and interim targets
- Performance against each target and an analysis of trends or changes in the entity's performance
- Any revisions to the target and an explanation for those revisions

An entity is required to consistently define and calculate metrics for each reporting period, including those metrics used to set the entity's targets and monitor progress towards reaching them. In the event a metric is redefined or replaced in a reporting period, an entity is required to: *[IFRS S1.52, IFRS S1.B52]*

- Disclose a revised comparative amount, unless it is impracticable to do so
- Explain the changes to the metric
- Explain the reasons for those changes, including why the metric that has been redefined or replaced provides more useful information

The metrics and targets disclosed by entity have to be labelled and defined using names and descriptions that are meaningful, clear and precise. *[IFRS S1.53].*

5 General requirements

5.1 Sources of guidance

As discussed in sections 1.2 and 3.2.2 above, IFRS S1 requires an entity to identify sustainability-related risks and opportunities that could reasonably be expected to affect the entity's prospects, as well as material information that apply to those risks and opportunities. Both identification processes are informed by the sources of guidance included in IFRS S1.

In these identification processes, an entity is required to first apply ISSB standards that specifically apply to that sustainability-related risk or opportunity. *[IFRS S1.54, IFRS S1.56].* IFRS S1 also includes other sources of guidance which are intended to give direction to entities, especially in situations where there are no directly applicable requirements in ISSB standards. Such guidance effectively provides entities with a roadmap for the appropriate use of other standards and frameworks to produce decision-useful disclosures for primary users about sustainability-related risks and opportunities. The sources of guidance included in IFRS S1 are those that, if selected, would likely result in the provision of information that would enable entities to meet the objective of IFRS S1. The ISSB believes that this can contribute to reducing diversity in practice and improving comparability between information provided by peer entities. *[IFRS S1.BC128].*

Up to the date of issuance of this chapter the ISSB has so far issued specific requirements for disclosing information about sustainability-related risks and opportunities in relation to climate (i.e., IFRS S2). The use of other sources of guidance is particularly useful in these early days of the ISSB's standard setting activities, until more ISSB standards, beyond climate, are developed and issued. The ISSB believes that, as additional ISSB standards will be developed, the reliance of entities on those other sources of guidance will gradually decrease. This is because the range of the future ISSB standards will assist in identifying sustainability-related risks and opportunities, as well as in setting out disclosures designed to meet the needs of primary users and, therefore, there will be fewer gaps to fill. *[IFRS S1.BC128].*

Despite the importance of other sources of guidance during the period of development of the full range of ISSB standards as described above, the ISSB expects that these other sources will continue to be useful to entities to meet the objective of IFRS S1 even after that period. *[IFRS S1.BC128].*The rationale behind the requirements of IFRS S1 in respect of other sources of guidance is similar to that of IAS 8 applied under IFRS accounting standards. That is, there will be circumstances where a particular event, transaction or other condition is not specifically addressed by any ISSB standard. Also, the range of sustainability topics and the information needs of primary users are continuously evolving and it is likely that ISSB standards may not provide specific guidance for all possible circumstances. Moreover, the ISSB considered that this guidance can be particularly useful for entities that have not previously reported sustainability-related financial disclosures that focus on meeting the needs of primary users.

5.1.1 Use of sources of guidance when identifying sustainability-related risks and opportunities

As discussed in section 5.1 above, in identifying the sustainability-related risks and opportunities that could reasonably be expected to affect an entity's prospects, an entity needs to apply ISSB standards. That is, an entity needs to consider the sustainability-related topics and the respective sustainability-related risks and opportunities associated with those topics included in ISSB standards. *[IFRS S1.54].*

In addition to ISSB standards, IFRS S1 provides a list of other sources of guidance to assist in the judgement involved in this identification process. The ISSB decided to distinguish the sources of guidance between those that an entity is required to refer to and consider the applicability of and sources that an entity is permitted, but not required, to refer to and consider the applicability of. The ISSB clarified that the use of "refer to and consider the applicability of" a source of guidance is intended to require or permit an entity to refer to that source of guidance and consider whether it is applicable. If it is, then an entity is required or permitted to apply that source of guidance. *[IFRS S1.BC131, IFRS S1.BC132].*

The list of sources of guidance that an entity is required to refer to and consider the applicability of is limited to the Sustainability Accounting Standards Board standards (the SASB standards). This was decided by the ISSB to make the application of the requirements less burdensome rather than an entity being required to refer to and consider the applicability of a long list of sources. The ISSB considered that using the SASB standards could reduce application costs for entities and produce useful and comparable disclosures for primary users. This is because the SASB standards were developed with a similar objective to IFRS S1 and their overall design with respect to disclosure topics and associated metrics generally follows the structure of the requirements in IFRS S1. In fact, the industry-based guidance provided by the SASB standards is complementary to the general requirements of IFRS S1, and includes disclosure topics

that are focused on sustainability-related risks and opportunities that arise in an industry throughout the value chain. *[IFRS S1.55(a), IFRS S1.BC129, IFRS S1.BC130, IFRS S1.BC134]*.

In February 2024, the ISSB issued educational material *Using the SASB Standards to meet the requirements in IFRS S1* which points out the usefulness of SASB standards as source of guidance. [22] In particular, the educational material emphasised that using the SASB standards can be beneficial because they are designed to provide primary users with decision-useful information that is comparable with peers. SASB standards are tailored to specific industries which enables entities to access guidance relevant to their business activities on sustainability-related topics beyond climate. Moreover, the ISSB's educational material outlines how to use the SASB standards in order to meet the requirements in IFRS S1.

Each SASB standard contains: *[IFRS S1.IG12]*

- *Industry descriptions:* Intended to support entities in identifying applicable industry guidance by describing the business models, activities and other common features that characterise participation in the industry (see section 5.1.1.A below)
- *Disclosure topics:* Describe specific sustainability-related risks or opportunities associated with the activities conducted by entities within a particular industry (see section 5.1.1.A below)
- *Metrics:* Accompany disclosure topics and are designed to provide useful information regarding an entity's performance for a specific disclosure topic (either individually or as part of a set) (see section 5.1.2.A below)
- *Technical protocols:* Provide guidance on definitions, scope, implementation and presentation of associated metrics (see section 5.1.2.A below)
- *Activity metrics:* Quantify the scale of specific activities or operations of an entity and they are intended to be used in conjunction with metrics accompanying the disclosure topics to normalise data and facilitate comparisons (see section 5.1.2.A below)

5.1.1.A Considerations when referring to the SASB standards to identify sustainability-related risks and opportunities

SASB industry descriptions

Entities can start identifying the relevant sustainability-related risks and opportunities by searching for the applicable SASB standards. In considering the applicability of SASB standards, an entity first needs to understand the activities that a particular SASB standard relates to. The SASB standards have descriptive names (e.g., Oil & Gas - Exploration & Production) and are organised by sector (e.g., Extractives & Minerals Processing). In addition, each industry SASB standard includes an 'industry description' section which summarises the typical business activities to which the SASB standard applies. The industry descriptions summarise the business that each SASB standard covers so that an entity understands the activities addressed and determines if a SASB standard is likely to be applicable to its business model and associated activities. The industry names and descriptions may not precisely align with the industry an entity considers itself to be a part of because industries can be classified and defined according to varying conventions. In performing that assessment, an entity may determine that: *[IFRS S1.IG14, IFRS S1.IG15, IFRS S1.IG16]*

- Its business model and activities closely align with the description of a single SASB standard, in which case, the entity may need to refer only to that particular applicable SASB standard.
- Its business model and activities closely align with the description of more than one SASB standard (e.g., when the entity constitutes a hybrid or complex business model with activities spanning a wider array of activities than those reflected in any single SASB standard) and, therefore, needs to refer to and consider the applicability of those SASB standards.
- Its industry does not precisely align with the industry name of the SASB standard to which it considers itself to be part of, or its activities may not be specifically addressed by a SASB standard(s) for a particular industry. However, other SASB standards are likely to address those activities or similar activities.

SASB disclosure topics

The disclosure topics in the SASB standards are useful in helping entities understand the range of sustainability-related risks and opportunities that are within the scope of IFRS S1, which is particularly important in the identification of the sustainability-related risks and opportunities. This is because the disclosure topics have been informed by market input and empirical research, and they focus on sustainability-related risks and opportunities that are likely to affect an entity's prospects in a particular

22 *Using the SASB Standards to meet the requirements in IFRS S1*, ISSB, February 2024, available on the IFRS Foundation's website.

industry. Furthermore, the metrics that accompany disclosure topics in the SASB standards are commonly tailored to the activities of entities within a particular industry (see discussion on metrics in section 5.1.2.A below). Many entities may find they are already managing activities and disclosing information related to the disclosure topics in the SASB Standards. *[IFRS S1.BC134]*.

Having identified the SASB standard(s) that closely align(s) with its activities, an entity needs to determine which disclosure topic(s) within that SASB standard(s) align(s) with its activities in order to identify the sustainability-related risks and opportunities based on its business model and activities. *[IFRS S1.IG17]*. Consider the following Illustration, based on an example provided in the *Implementation Guidance* to IFRS S1, about using disclosure topics of the SASB standards to enable entities to consistently identify sustainability-related risks and opportunities based on their business model and activities: *[IFRS S1.IG18, IFRS S1.IG19]*

Illustration 5-1: Identifying sustainability-related risks and opportunities by referring to and considering the applicability of SASB standards

Entity B conducts meat, poultry and dairy operations and, therefore, refers to and considers the applicability of the Meat, Poultry & Dairy SASB standard. Entity B concludes that the disclosure topics in that SASB standard that are applicable in its circumstances include disclosure topics such as the food safety and the workforce health & safety. Effectively, Entity B's process of identification of sustainability-related risks and opportunities is informed by the using the disclosure topics in this SASB standard.

In applying those disclosure topics, Entity B explains that a failure to maintain the quality and safety of its product may result in costly recalls, harm the reputation of its brand, lead to fines, reduce its revenues and increase regulatory scrutiny, including the imposition of trade restrictions.

Moreover, Entity B uses the disclosure topics to meet the requirements of IFRS S1 about how it manages the identified risks. In particular, Entity B provides information about its robust workforce safety practices to avoid reputational impairment, costly turnover, low worker morale and productivity, risks associated with potential liability for injuries, associated healthcare and workers' compensation costs.

The approach described in Illustration 5-1 above can be repeated for each of the applicable disclosure topics of the entity. However, the disclosure topics of the SASB standards are meant to inform the identification of sustainability-related risks and opportunities of a typical entity within a given industry, rather than every entity within a given industry. That is, SASB standards may include disclosure topics that would not result in useful information for primary users for every entity within a given industry. For example, an entity operating in a particular industry may not engage in activities that are covered by a disclosure topic of that industry in the SASB standards. Therefore, information resulting from that disclosure topic would not be useful to its primary users. Also, the disclosure topics in SASB standards are not exhaustive and, as such, they are not meant to include every disclosure topic that would result in useful information and be applicable to all entities in a given industry. *[IFRS S1.IG13, IFRS S1.IG20]*.

Therefore, when an entity considers the applicability of the disclosure topics of SASB standards, it may, for the reasons explained above, conclude that those disclosure topics are not sufficient to inform the identification of all sustainability-related risks and opportunities that could reasonably be expected to affect its prospects.

The ISSB's educational material includes five key questions an entity may consider when identifying which industry SASB standard and disclosure topics are applicable:

- What are the principal business activities of the entity?
- What are the business activities of peers or competitors of the entity?
- Does the SASB standard reviewed by the entity contain disclosure topics that accurately describe sustainability-related risks and opportunities relevant to the entity?
- Which sustainability-related risks and opportunities do investors most often ask the entity to discuss or disclose?
- Do the disclosure topics align with any risks or opportunities identified by the entity's enterprise risk management processes?

The following examples from the *Implementation Guidance* to IFRS S1 illustrate the identification of sustainability-related risks and opportunities by referring to and considering the applicability of the SASB standards: *[IFRS S1.IE Example 1, IFRS S1.IE3, IFRS S1.IE4, IFRS S1.IE Example 2, IFRS S1.IE9, IFRS S1.IE10, IFRS S1.IE11]*

Extract from IFRS S1

Example 1–An entity with a single line of business

Entity Y is a regional passenger airline company. In identifying sustainability-related risks and opportunities that could reasonably be expected to affect its prospects, Entity Y is required to apply IFRS Sustainability Disclosure Standards in accordance with paragraph 54 of IFRS S1. In addition to applying IFRS Sustainability Disclosure Standards, Entity Y is required to refer to and consider the applicability of the disclosure topics in the SASB Standards. Entity Y concludes that its business model and activities most closely align with the *Airlines* SASB Standard.

Entity Y applies IFRS S2 *Climate-related Disclosures* and identifies climate-related risks or opportunities that could reasonably be expected to affect its prospects. In addition, Entity Y refers to and considers the applicability of the disclosure topics in the *Airlines* SASB Standard in accordance with paragraph 55(a) of IFRS S1. Entity Y concludes that all four disclosure topics in the *Airlines* SASB Standard are applicable to its activities and uses those disclosure topics to inform its identification of sustainability-related risks and opportunities that could reasonably be expected to affect its prospects.

…

Example 2–A large conglomerate with diverse activities

Entity A is a large conglomerate with diverse activities. Entity A produces electrical and industrial equipment for use in a range of industries. In addition to IFRS Sustainability Disclosure Standards, Entity A is required to refer to and consider the applicability of the disclosure topics in the SASB Standards in identifying its sustainability-related risks and opportunities. Because of the wide-ranging nature of its activities, Entity A begins its consideration of the applicability of the SASB Standards by considering the various sectors into which the SASB Standards are grouped. Entity A conducts activities in industries in the Health Care, Resource Transformation and Infrastructure sectors, and in some cases owns particular parts of its production process rather than relying on suppliers. It also has some activities in the Transportation and Consumer Goods sectors.

Entity A refers to and considers the applicability of the disclosure topics in the SASB Standards. Entity A concludes that eight SASB Standards are applicable to its business model and activities. Entity A considers the disclosure topics in the eight standards. Although Entity A observes that it engages in activities related to all of those disclosure topics, Entity A concludes that some of those disclosure topics are not applicable in the entity's circumstances. For example, Entity A concludes that the sustainability-related risk or opportunity characterised by a particular disclosure topic could not reasonably be expected to affect its prospects over the short, medium or long term because the disclosure topic relates to activities that are insignificant for the entity.

Entity A concludes that most of the disclosure topics in the SASB Standards it has considered are applicable to its significant activities. In some cases where it has less significant activities, it finds that only particular disclosure topics in those related industries are applicable. For example, Entity A concludes that most of the disclosure topics that it considered for its transportation and retail businesses are not applicable, due to the relatively small size of these businesses. However, Entity A concludes that incidents related to safety and labour practices in these businesses, although unlikely to have a large effect on its cash flows in the short term, could have a major effect on its reputation over the medium and long term. This reputational risk could affect the performance of its larger businesses, including its ability to attract and retain talent, over a medium- and long-term time horizon, which could be reasonably expected to affect its medium- and long-term cash flows, access to finance and cost of capital. Thus, Entity A considers these topics in identifying sustainability-related risks and opportunities that could reasonably be expected to affect its prospects.

5.1.1.B Considerations when referring to other sources of guidance to identify sustainability-related risks and opportunities

The entity may also need to consider additional sources of guidance specified in IFRS S1 to identify its sustainability-related risks or opportunities. *[IFRS S1.IG13, IFRS S1.IG20].* In particular, an entity may refer to and consider the applicability of the CDSB Framework Application Guidance for Water-related Disclosures and the CDSB Framework Application Guidance for Biodiversity-related Disclosures (collectively referred to as 'CDSB Framework Application Guidance'). In addition, an entity is permitted to refer to and consider the applicability of the most recent pronouncements of other standard-setting bodies whose requirements are designed to meet the needs of primary users, and to refer to the sustainability-related risks and opportunities identified by entities that operate in the same industries or geographical regions. *[IFRS S1.55(b)].*

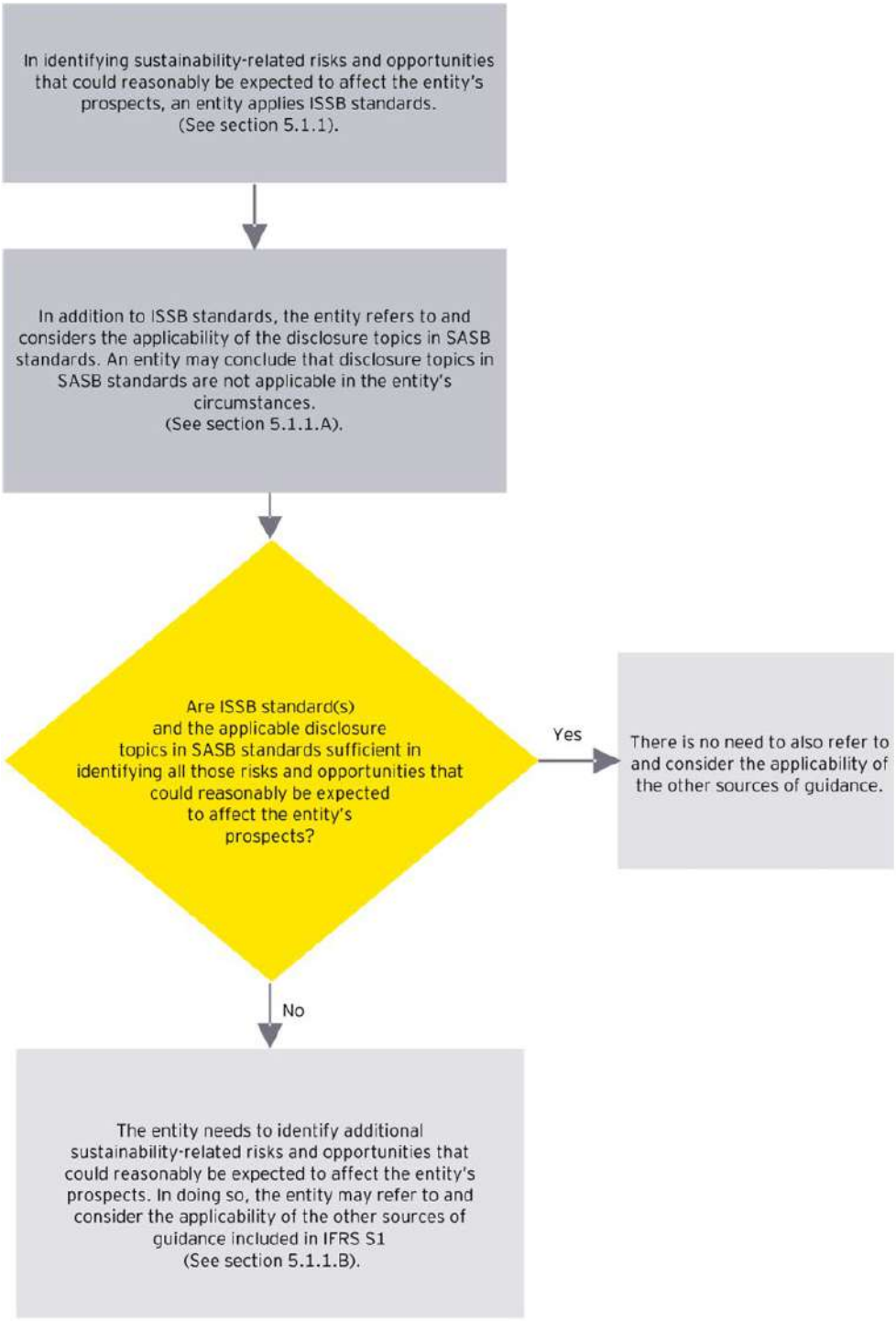
For example, the CDSB Framework Application Guidance can support entities in identifying biodiversity-related risks (e.g., reduction in soil fertility, reduction in pollination for crop production, reduced availability of fish stocks) or water-related opportunities (e.g., improved water efficiency, development of new products and services, conservation and restoration of ecosystems through engagement and collaboration with stakeholders). However, that does not preclude an entity from having identified water- or biodiversity-related risks and opportunities in accordance with the SASB standards or other sources of guidance. *[IFRS S1.IG26, IFRS S1.IG27].*

Moreover, the CDSB Framework Application Guidance explains how water- and biodiversity-related risks may be connected to other sustainability-related risks and opportunities that could reasonably be expected to affect an entity's prospects (e.g., water-related risks such as more frequent flooding are often inherently linked to climate-related risks). This information is necessary for an entity in meeting the requirements of IFRS S1 about connected information, as discussed in section 3.4 above).

Sustainability-related risks and opportunities identified by entities that operate in the same industries or geographical regions or share similar characteristics can also be a useful reference for an entity in identifying its own sustainability-related risks and opportunities. Also, in practice, some regulators may focus on specific areas in relation to their oversight of sustainability reporting. These focus areas may include references to sustainability-related risks and opportunities that could be common in a specific geographic region or industry operating within that region. However, when referring to peer disclosures prepared in accordance with sustainability-related frameworks other than ISSB standards, an entity needs to understand how relevant these sources are for the preparation of disclosures in accordance with ISSB standards. That is, an entity needs to ensure that the process of identifying sustainability-related risks and opportunities meets the information needs of primary users.

The main reasons that the ISSB decided to permit and not require entities to consider these sources were: a) to prevent entities from having to consider an extensive list of open-ended sources of guidance that would lead to an increased burden for entities; and b) to facilitate the transition to ISSB standards by enabling entities to use sources that they may already be familiar with. The application of those sources of guidance is intended to support the application of ISSB standards and, therefore, an entity is still required to comply with all the requirements in ISSB standards to assert compliance with them. *[IFRS S1.BC135].*

Figure 5-1: Use of sources of guidance to identify sustainability-related risks and opportunities



How we see it

An entity applies ISSB standards as a starting point and refers to and considers the applicability of the SASB standards to identify its sustainability-related risks and opportunities. However, an entity needs to use its judgement to determine whether these two sources are sufficient to identify all those sustainability-related risks and opportunities that could reasonably be expected to affect its prospects. If they do not, the entity needs to identify additional sustainability-related risks and opportunities that could reasonably be expected to affect its prospects. In doing so, an entity may refer to and consider the applicability of the other sources of guidance discussed in this section. Although the other sources of guidance listed in IFRS S1 constitute an extensive list of open-ended sources, if an entity does refer to any of those, its goal remains that it must meet the information needs of primary users, rather than a broader remit of users.

5.1.2 Sources of guidance when identifying material sustainability-related financial information

As discussed in section 5.1 above, in determining whether information about sustainability-related risks and opportunities that could reasonably be expected to affect an entity's prospects is material, an entity needs to apply the requirements of ISSB standard that specifically applies to that sustainability-related risk or opportunity. For example, if an entity identifies climate-related risks and opportunities that could reasonably be expected to affect its prospects, the requirements in IFRS S2 (that are discussed in Chapter 53) are those that the entity needs to apply since IFRS S2 is ISSB standard that specifically applies to climate-related risk and opportunities. *[IFRS S1.56].*

However, as mentioned in section 5.1 above, ISSB has, thus far, only issued specific requirements for disclosing information about sustainability-related risks and opportunities in relation to climate (i.e., IFRS S2). Moreover, the information needs of primary users is continuously evolving and it is possible that ISSB standards may not provide specific guidance for all circumstances. Therefore, in the absence of an ISSB standard that specifically applies to a sustainability-related risk or opportunity, an entity needs to apply the requirements to sources of guidance specified in IFRS S1. Those requirements emphasise the judgement that is expected to occur when identifying information to ensure that the sustainability-related risks and opportunities are presented fairly in an entity's disclosures (see also discussion on fair presentation in section 3.1.1.A above). That is, while developing disclosures in the absence of an ISSB standard, an entity is required to identify information from sources of guidance that: *[IFRS S1.57, IFRS S1.C1]*

- Is relevant to the decision-making needs of primary users
- Faithfully represents the entity's risks and opportunities in relation to the specific sustainability-related risk or opportunity

The list of sources of guidance included in IFRS S1 is intended to assist in making this judgement by including metrics that may be relevant to a particular sustainability-related risk or opportunity for a particular industry or in specified circumstances.

IFRS S1 requires an entity to provide information that fairly presents the sustainability-related risks and opportunities that could reasonably be expected to affect an entity's prospects (see section 3.1 above). Therefore, when an entity needs to refer to and consider the applicability of other sources of guidance to identify material information, it needs to ensure that the disclosures developed are relevant to the decision-making of primary users, and faithfully represent the entity's sustainability-related risks and opportunities.

5.1.2.A Considerations when referring to the SASB standards to identify material information about sustainability-related risks and opportunities

SASB metrics, technical protocols and activity metrics

As discussed in section 5.1.2 above, in the absence of an ISSB standard that specifically applies to a sustainability-related risk or opportunity, an entity needs to apply judgement to identify information that is relevant and faithfully represents that sustainability-related risk or opportunity. In making this judgement, IFRS S1 requires an entity to refer to and consider the applicability of the metrics associated with the disclosure topics included in the SASB standards. For each disclosure topic that an entity identifies as reasonably likely to affect its prospects (as discussed in section 5.1.1.A above), the entity would refer to and consider the applicability of metrics related to that disclosure topic. Those metrics accompany the disclosure topics and are designed to, either individually or as part of a set, provide useful and comparable information regarding an entity's performance for a specific disclosure topic (i.e., an entity's performance in responding to a specific sustainability-related risk or opportunity). Each of these metrics is supported by technical protocols that provide guidance on definitions, scope, implementation and presentation. The technical protocols may also serve as criteria against which the disclosed information can be verified (which is one of the enhancing qualitative characteristics of the provided information as discussed in section 3.1.1.B above). In conjunction to those metrics, there are activity metrics that quantify the scale of specific activities or operations by an entity and are used to normalise data and facilitate comparison. *[IFRS S1.58(a), IFRS S1.IG12, IFRS S1.IG23].*

By considering the applicability of the metrics associated with each relevant topic, and any relevant activity metrics, an entity is able to identify applicable disclosures. The ISSB's educational material suggests reviewing the list of metrics associated with each relevant disclosure topic and reviewing the list of activity metrics together with the metrics to normalise data and facilitate comparison. Moreover, the educational material includes seven key questions that an entity may consider when identifying which industry SASB standard and disclosure topics are applicable:

- Would a metric in the SASB standard help investors understand the entity's performance in relation to sustainability-related risks and opportunities to which it may be exposed?
- Do the entity's peers or competitors report metrics specified by SASB standards?
- Have investors asked the entity to discuss or disclose information consistent with metrics in the SASB standards?
- Has the entity reviewed the underlying technical protocols in the SASB standard that accompany each metric to help ensure that metrics are compiled consistently?
- Does the metric in the SASB standards align with information that is already managed or disclosed by the entity?
- If the entity already collects information similar to that required by the metric, how could the information be better aligned?
- Does the entity employ methodologies for data collection that are similar to those specified in the SASB standards' technical protocols?

Consider the following Illustration, based on an example provided in the *Implementation Guidance* to IFRS S1, which is a continuation of the example provided in Illustration 5-1 in section 5.1.1.A above. The example relates to requirement in IFRS S1 to refer to and consider the applicability of the metrics associated with the disclosure topics included in SASB standards: *[IFRS S1.IG18, IFRS S1.IG22, IFRS S1.IG23, IFRS S1.IG24]*

Illustration 5-2: Identifying material information about sustainability-related risks and opportunities by referring to and considering the applicability of SASB standards

Entity B conducts meat, poultry and dairy operations and therefore, refers to and considers the applicability of the Meat, Poultry & Dairy SASB standard. Entity B concludes that the disclosure topics in that SASB standard that are applicable in its circumstances include disclosure topics such as the food safety and the workforce health & safety. In identifying material information about the sustainability-related risks and opportunities it has identified based on those disclosure topics, Entity B refers to and consider the applicability of the following metrics included in the Meat, Poultry & Dairy SASB Standard:

(a) food safety:
  (i) FB-MP-250a.1-Global Food Safety Initiative (GFSI) audit (1) non conformance rate and (2) associated corrective action rate for (a) major and (b) minor non-conformances
  (ii) FB-MP-250a.2-Percentage of supplier facilities certified to a Global Food Safety Initiative (GFSI) food safety certification program
  (iii) FB-MP-250a.3-(1) Number of recalls issued and (2) total weight of products recalled

  And

  (iv) FB-MP-250a.4-Discussion of markets that ban imports of the entity's products

(b) workforce health & safety:
  (i) FB-MP-320a.1-(1) Total recordable incident rate (TRIR) and (2) fatality rate

  And

  (ii) FB-MP-320a.2-Description of efforts to assess, monitor, and mitigate acute and chronic respiratory health conditions

In applying the accompanying technical protocols of the SASB standards, Entity B discloses information related to workforce health and safety for all of its workers, regardless of their location and type of employment (e.g., full-time, part-time, direct, contract, executive, labour, salary, hourly or seasonal). Entity B applies the accompanying technical protocols as a guide in supplementing its metrics with appropriate context (e.g., a discussion of notable recalls, including information related to the cause, amount, remediation cost, nature (voluntary or involuntary), associated corrective actions and other significant outcomes related to the recall, such as legal proceedings or consumer illness).

The importance of providing industry-specific disclosures to primary users is also explicit in the section of IFRS S1 that relates to the core content of disclosures about metrics (see discussion in section 4.5 above), which requires an entity to disclose industry-based metrics in relation to its sustainability-related risks and opportunities (i.e., metrics associated with particular business models, activities or other common features that characterise participation in an industry). The associated metrics are likely to be applicable in assessing the effects of sustainability-related risks and opportunities on the entity's cash flows, its access to finance and cost of capital over the short, medium and long term. Entity-specific judgement is needed for

the metrics chosen in the information about sustainability-related risks and opportunities to be material. *[IFRS S1.BC125, IFRS S1.BC133].*

The following examples are a continuation of the Illustrative Example 1 and Example 2 included in the *Implementation Guidance* to IFRS S1 provided in the respective extract in section 5.1.1 above and relate to the identification of information about sustainability-related risks and opportunities that could reasonably be expected to affect an entity's prospects by referring to and considering the applicability of the SASB standards: *[IFRS S1.IE Example 1, IFRS S1.IE Example 2, IFRS S1.IE5-9, IFRS S1.IE12-15]*

Extract from IFRS S1

Example 1-An entity with a single line of business

Entity Y is a regional passenger airline company. In identifying sustainability-related risks and opportunities that could reasonably be expected to affect its prospects, Entity Y is required to apply IFRS Sustainability Disclosure Standards in accordance with paragraph 54 of IFRS S1. In addition to applying IFRS Sustainability Disclosure Standards, Entity Y is required to refer to and consider the applicability of the disclosure topics in the SASB Standards. Entity Y concludes that its business model and activities most closely align with the *Airlines* SASB Standard.

...

In disclosing information about its sustainability-related risks and opportunities, Entity Y applies IFRS Sustainability Disclosure Standards that specifically apply to its identified sustainability-related risks and opportunities. For example, Entity Y applies IFRS S2 to disclose information about its greenhouse gas emissions. In the absence of an IFRS Sustainability Disclosure Standard that specifically applies to the sustainability-related risks and opportunities which Entity Y has identified, Entity Y refers to and considers the applicability of the metrics associated with the applicable disclosure topics in the *Airlines* SASB Standard. Entity Y concludes that applying these metrics will provide information that is relevant to the decision-making of users of general purpose financial reports and faithfully represents the sustainability-related risks and opportunities that it has identified. For example, the metrics associated with the 'Accident & Safety Management' disclosure topic include:

(a) TR-AL-540a.1-Description of implementation and outcomes of a Safety Management System;

(b) TR-AL-540a.2-Number of aviation accidents; and

(c) TR-AL-540a.3-Number of governmental enforcement actions of aviation safety regulations.

In identifying information to provide, Entity Y considers the applicability of the technical protocols accompanying the metrics. For example, while disclosing a description of the implementation and outcomes of a Safety Management System, Entity Y might describe any actions or measures it has implemented to mitigate any safety risks and hazardous situations that it has identified. These actions or measures include, for example, particular changes in controls, operations, management, processes, products, business partners, training or technology.

Entity Y is required to apply the requirements relating to 'core content' in IFRS S1. Entity Y considers the disclosure topics, metrics and associated technical protocols in the *Airlines* SASB Standard when providing information required by IFRS S1, including information relating to strategy and metrics and targets.

Entity Y discloses that it applied the disclosure topics and metrics in the *Airlines* SASB Standard in preparing its sustainability-related financial disclosures, in accordance with paragraphs 49 and 59 of IFRS S1.

Example 2 - A large conglomerate with diverse activities

Entity A is a large conglomerate with diverse activities. Entity A produces electrical and industrial equipment for use in a range of industries. In addition to IFRS Sustainability Disclosure Standards, Entity A is required to refer to and consider the applicability of the disclosure topics in the SASB Standards in identifying its sustainability-related risks and opportunities. Because of the wide-ranging nature of its activities, Entity A begins its consideration of the applicability of the SASB Standards by considering the various sectors into which the SASB Standards are grouped. Entity A conducts activities in industries in the Health Care, Resource Transformation and Infrastructure sectors, and in some cases owns particular parts of its production process rather than relying on suppliers. It also has some activities in the Transportation and Consumer Goods sectors.

...

In the absence of an IFRS Sustainability Disclosure Standard that specifically applies to the sustainability-related risks and opportunities that Entity A has identified, Entity A refers to and considers the applicability of the metrics associated with applicable disclosure topics. In identifying applicable metrics,

Entity A considers whether the metric will provide information that is relevant to the decision-making of users of general purpose financial reports and that faithfully represents the sustainability-related risks and opportunities that it has identified.

In preparing its sustainability-related financial disclosures, Entity A concludes that some information should be aggregated to avoid obscuring material information with immaterial information. For example, it concludes that information about its strategy for sourcing critical materials for devices produced by its various activities should be aggregated because the entity manages the supplier relationships for those critical materials centrally.

In contrast, for other types of information, Entity A concludes aggregation would result in obscuring material information. For example, it concludes that information about the number of recalls related to its equipment in the Health Care sector should not be aggregated with information about the number of recalls related to its equipment in the Consumer Goods sector because the technologies, production processes and markets for each sector differ. Therefore, there are also varied reasons for the occurrence of product recalls in these sectors.

Entity A discloses information about the SASB Standards it has applied in preparing its sustainability-related financial disclosures, in accordance with paragraphs 49 and 59 of IFRS S1, including identifying the specific SASB Standards, disclosure topics and metrics it applied. Entity A also provides information to enable users of general purpose financial reports to understand the judgements that it has made in the process of preparing its sustainability- related financial disclosures and that have the most significant effect on the information included in those disclosures in accordance with paragraph 74 of IFRS S1.

The ISSB expects (as in the case of disclosure topics discussed in section 5.1.1 above) the associated metrics in the SASB standards to be typically applicable for an entity with the given business model and associated activities. Also, those metrics are not exhaustive. In situations where an entity concludes that metrics specified in the SASB standards are not applicable in its circumstances or are not sufficient to identify information that would fairly present all sustainability-related risks and opportunities that could reasonably be expected to affect its prospects (as discussed in 5.1.2 above), an entity needs to exercise judgement to refer to and consider other sources of guidance in accordance with IFRS S1 in this identification process. *[IFRS S1.57, IFRS S1.C1, IFRS S1.IG13, IFRS S1.BC133].*

5.1.2.B Considerations when referring to other sources of guidance to identify material information about sustainability-related risks and opportunities

To the extent that there is no conflict with ISSB standards, an entity is permitted to refer to and consider the applicability of: a) the CDSB Framework Application Guidance; b) the most recent pronouncements of other standard-setting bodies whose requirements are designed to meet the needs of primary users; and c) the information, including metrics, disclosed by entities that operate in the same industry(s) or geographical region(s). *[IFRS S1.58(b)]*.

For example, an entity refers to and considers the applicability of the CDSB Framework Application Guidance in identifying information, including metrics, about the water- or biodiversity-related risks or opportunities that could reasonably be expected to affect an entity's prospects. An entity may consider the CDSB Framework Application Guidance in applying the core content requirements that are discussed in section 4 above).

The Illustrative example below is based on the *Implementation Guidance* to IFRS S1: *[IFRS S1.IG27]*

Illustration 5-3: Identifying material information to disclose about the sustainability-related risks and opportunities by referring to and considering the applicability of CDSB Framework Application Guidance

(a) Governance-in providing disclosures on governance relating to water- related risks and opportunities, the CDSB Framework Application Guidance on Water-related Disclosures suggests an entity may provide information about how water policies, strategy and information are delegated to management. In relation to collaboration with stakeholders to achieve effective water management, the guidance also suggests an entity may provide information about whether there are specific bodies, individuals or mechanisms located in areas that are affected by significant water loss whose function is to ensure compliance with water-related regulation and engagement with stakeholders.

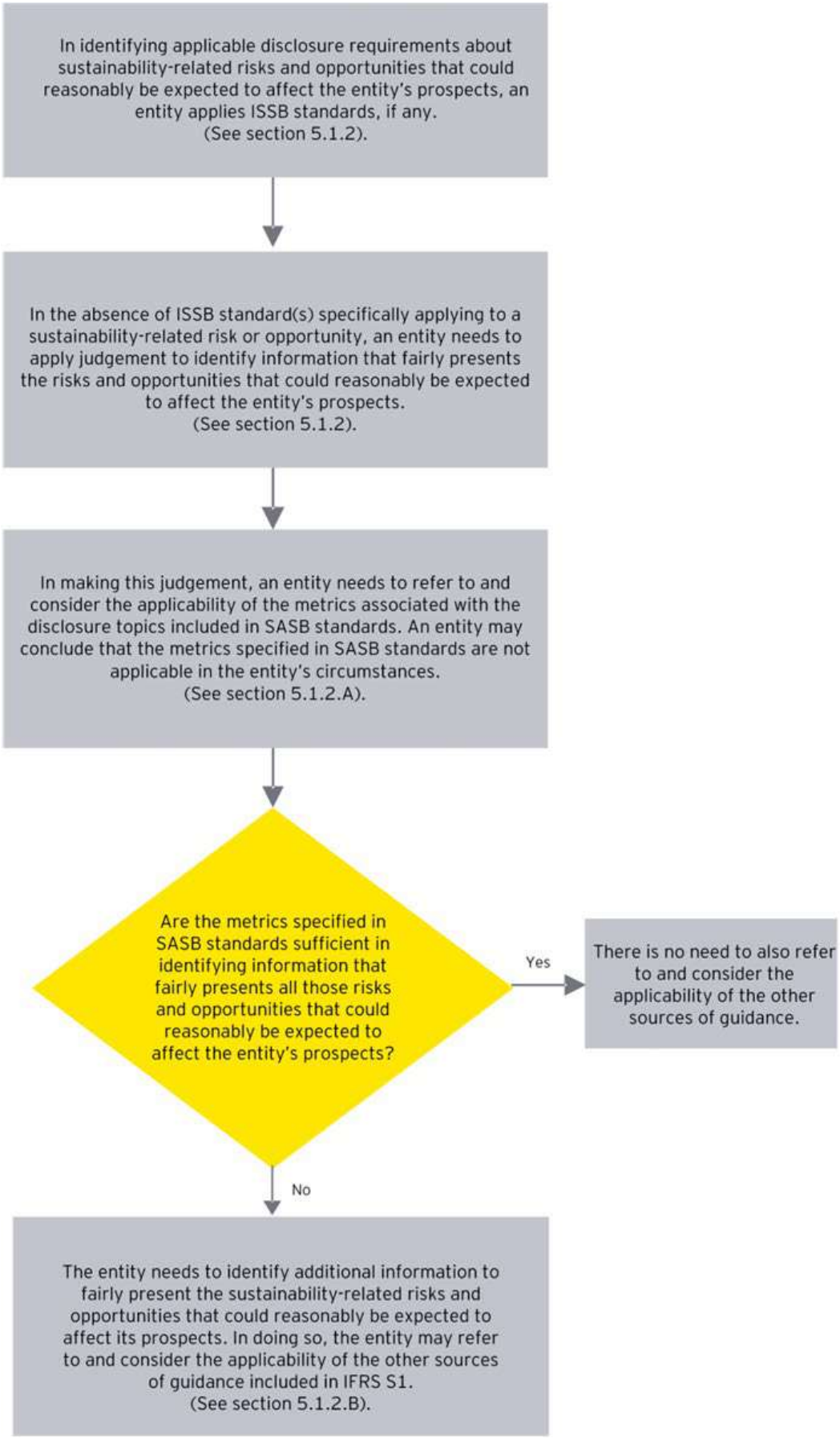
(b) Strategy-in providing disclosures on strategy relating to biodiversity- related risks and opportunities, the CDSB Framework Application Guidance on Biodiversity-related Disclosures suggests an entity may provide, for example, information about the geographic-specificity of biodiversity-related risks and opportunities and how those risks and opportunities may vary over the short, medium and long term. The guidance also suggests the type of quantitative and qualitative information an entity may consider providing in accordance with paragraphs 34-40 of IFRS S1, for example, the operational expenses, cost savings and revenue associated with biodiversity management, such as information about remediation costs or provisions in the case of accidents such as polluting spills, costs of staff training and revenue from biodiversity-efficient products and services.

(c) Metrics and targets-the CDSB Framework Application Guidance on Biodiversity-related Disclosures provides examples of common biodiversity metrics such as concentrations of key pollutants in wastewater, the volume of timber and non-timber forest products harvested and areas of forest, grassland or wetland converted due to urbanisation. Due to changes in biodiversity over time, the guidance suggests an entity provides information about the time frames it has set for targets. The guidance also discusses targets tailored to specific locations due to geographical variation in biodiversity priorities, as well as differing legal and regulatory requirements.

Moreover, an entity may refer to and consider the applicability of the sources specified in Appendix C to IFRS S1, namely the GRI standards and the European Sustainability Reporting Standards (ESRS). Unlike the SASB standards and the CDSB Framework Application Guidance, the GRI standards and ESRS are intended to meet the information needs of a different audience than only primary users. Therefore, IFRS S1 states that, if an entity refers to and considers the applicability of the GRI standards and ESRS, this is only allowed to the extent that these sources assist the entity in meeting the objective of IFRS S1 (see section 1.1 above) and do not conflict with ISSB standards. Allowing an entity to refer to and consider the applicability of those sources in identifying material information about sustainability-related risks or opportunities, but not in identifying the sustainability-related risks or opportunities themselves, is intended to ensure that any information disclosed by entities relates to a topic that has been identified as being of interest to primary users. *[IFRS S1.58(c), IFRS S1.C2, IFRS S1.BC137, IFRS S1.BC138]*.

Although a subset of disclosures provided in accordance with GRI standards or ESRS could produce information that is useful to primary users, an entity still needs to consider the requirements in ISSB standards and not just repurpose a report prepared in accordance with those standards to automatically consider it as meeting the requirements in ISSB standards. In addition, an entity needs to comply with the requirement of IFRS S1 not to obscure material information required by ISSB standards (discussed in section 3.2.4.B above). Otherwise, if an entity applies these standards without applying the requirements in ISSB standards, it will not be able to make an explicit and unreserved statement of compliance with ISSB standards (see discussion about compliance also in section 7 below). *[IFRS S1.58(c), IFRS S1.C3, IFRS S1.BC138, IFRS S1.BC139]*.

Figure 5-2: Use of sources of guidance to identify material information about sustainability-related risks and opportunities



5.1.3 Disclosure of information about sources of guidance

To enable primary users to understand how sustainability-related financial disclosures have been prepared, an entity is required to identify and disclose:

- The sources of guidance (e.g., specific standards, pronouncements, industry practice or other sources, including, if applicable, the disclosure topics in the SASB standards) it applied in preparing its sustainability-related financial disclosures. *[IFRS S1.59(a)]*.
- The industry or industries specified in ISSB standards, the SASB standards or other sources of guidance relating to a particular industry or industries that the entity has applied to the disclosures it has provided, including in identifying applicable metrics. This is intended to help primary users to understand the materiality judgements made by an entity in applying the industry-based disclosure requirements (e.g., if an SASB standards were used to prepare disclosures). By disclosing the industry as required above, primary users will be able to understand if a metric applicable for an entity in that industry has been omitted. *[IFRS S1.59(b), IFRS S1.BC140]*.
- Information about the judgements an entity has made in the process of preparing its sustainability-related financial disclosures that have the most significant effect on the information included in those disclosures (see section 6.1 below) that include the sources of guidance applied. As part of this disclosure, it may be necessary for an entity to also disclose that it considered other sources of guidance but did not apply them. *[IFRS S1.74, IFRS S1.75, IFRS S1.BC141]*.

5.2 Location of disclosures

The disclosures required by ISSB standards need to be part of an entity's general purpose financial reports. As explained in section 1.1 above, general purpose financial reports are those that provide financial information about a reporting entity that is useful to primary users in making decisions relating to providing resources to the entity. Therefore, requiring sustainability-related financial disclosures to be part of an entity's general purpose financial report, is intended to ensure that the primary users of those reports are provided with a comprehensive and connected package of reports. *[IFRS S1.60, IFRS S1.BC142]*.

5.2.1 Flexibility in location of disclosures

Apart from requiring the sustainability-related financial disclosures to be part of an entity's general purpose financial report, IFRS S1 does not prescribe the exact location of those disclosures within general purpose financial reports. There are various possible locations in which the sustainability-related financial information can be disclosed, but this may be subject to regulations or other requirements that apply in the jurisdiction in which an entity operates. That is, there may be regulations or other requirements that specify the exact location in which an entity is required to provide its sustainability-related financial disclosures. For example, in some jurisdictions, entities prepare management commentary (also known as the 'management report', 'management's discussion and analysis', 'operating and financial review', 'integrated report' or 'strategic report') or a similar report. When such a report forms part of an entity's general purpose financial reports, this can be considered a possible location for sustainability-related financial disclosures. *[IFRS S1.61, IFRS S1.BC143]*.

Moreover, the information required by ISSB standards can be included in the same location as the information disclosed to meet other requirements, such as information required by regulators (as discussed in section 3.2.4.C above). However, in such cases, the entity needs to ensure that the sustainability-related financial disclosures are clearly identifiable and not obscured by the additional information provided to meet those other requirements. See also section 3.2.4.B above for the requirements for not obscuring material information. *[IFRS S1.62]*.

5.2.2 Information included by cross-reference

There are cases where information required by ISSB standards may be available in another report published by the entity. For example, the required information could be disclosed in the related financial statements. As discussed in section 3.4.3 above, IFRS S1 specifies that when ISSB standards require the disclosure of common items of information, an entity is required to avoid unnecessary duplication. In such cases, IFRS S1 permits an entity to include cross-reference in another report published by the entity to provide sustainability-related financial disclosures. *[IFRS S1.63, IFRS S1.B45]*.

Despite the benefit of cost-effectiveness when including information by cross-reference, IFRS S1 includes specific conditions in which cross-referencing is permitted. In particular, if material information is included in an entity's sustainability-related financial disclosures by cross-reference (cross-referenced information),

that information is required to be available whenever an entity's sustainability-related financial disclosures are available. That is, the cross-referenced information needs to be available on the same terms and at the same time as all other sustainability-related financial disclosures. *[IFRS S1.B45, IFRS S1.BC144].*

When the cross-referenced information is not part of the same report as the entity's sustainability-related financial disclosures, an entity needs to explain how primary users can access that information. In doing so, an entity needs to clearly identify in its sustainability-related financial disclosures, the report within which the cross-referenced information is located, and explain how to access that report. Also, the cross-reference needs to indicate a precisely specified part of that report. *[IFRS S1.B47, IFRS S1.BC144].*

The cross-referenced information, effectively, becomes part of the complete set of sustainability-related financial disclosures and, therefore, it needs to comply with the requirements of ISSB standards (e.g., it needs to meet the qualitative characteristics discussed in section 3.1.1 above). An entity needs to ensure that this complete set of sustainability-related financial disclosures is not made less understandable because of including information by cross-reference. Moreover, the responsibility of the governance body(ies) or individual(s) authorising general purpose financial reports is the same for information included by cross-reference as for the information included directly. *[IFRS S1.B45, IFRS S1.B46].*

In its Annual Report 2024, Telstra Group Limited listed the documents that comprise its reporting suite for 2024, as follows:

Practical example 5-1: Telstra Group Limited (2024) Australia

Telstra Annual Report 2024 [extract]

Our reporting suite

Our FY24 reporting suite includes:

Our 2024 Telstra Annual Report (this report) which describes our strategy, financial performance and remuneration practices for FY24. It also includes climate and nature related disclosures guided by ISSB (International Sustainability Standards Board) IFRS (International Financial Reporting Standards) S2 and the recommendations of the TNFD (Taskforce on Nature-related Financial Disclosures).

Our 2024 Corporate Governance Statement which provides information about governance at Telstra.

Our 2024 Bigger Picture Sustainability Report which provides an in-depth look at our approach and performance in relation to our most material sustainability impacts.

Our 2024 Modern Slavery Act Statement which explains how we identify, manage and mitigate the specific risks of modern slavery in our operations and supply chains.

All reports are available at telstra.com/governance.

The sections of our Annual Report titled FY24 financial performance, FY24 highlights, Chair's message, CEO's message, Strategy and performance, Our material risks, Outlook, and Full year results and operations review comprise our operating and financial review (OFR) and form part of the Directors' report. Our OFR, Directors' report and Financial report were released to the ASX on 15 August 2024 in the document titled 'Financial results for the year ended 30 June 2024' which is available at telstra.com/investor.

Moreover, in its Bigger Picture Sustainability Report 2024, Telstra Group Limited included various cross-references to its Annual Report 2024, where the sustainability-related information can be found without duplicating it:

Practical example 5-2: Telstra Group Limited (2024) Australia

Telstra Annual Report 2024 [extract]

Sustainability at Telstra [extract]

Governance

Our governance arrangements and practices are essential for the long-term performance and sustainability of our company. They provide the structure through which our strategy and business objectives are set, our performance is monitored and the risks we face are managed.

For more information, see our **2024 Corporate Governance Statement** available on our reports page.

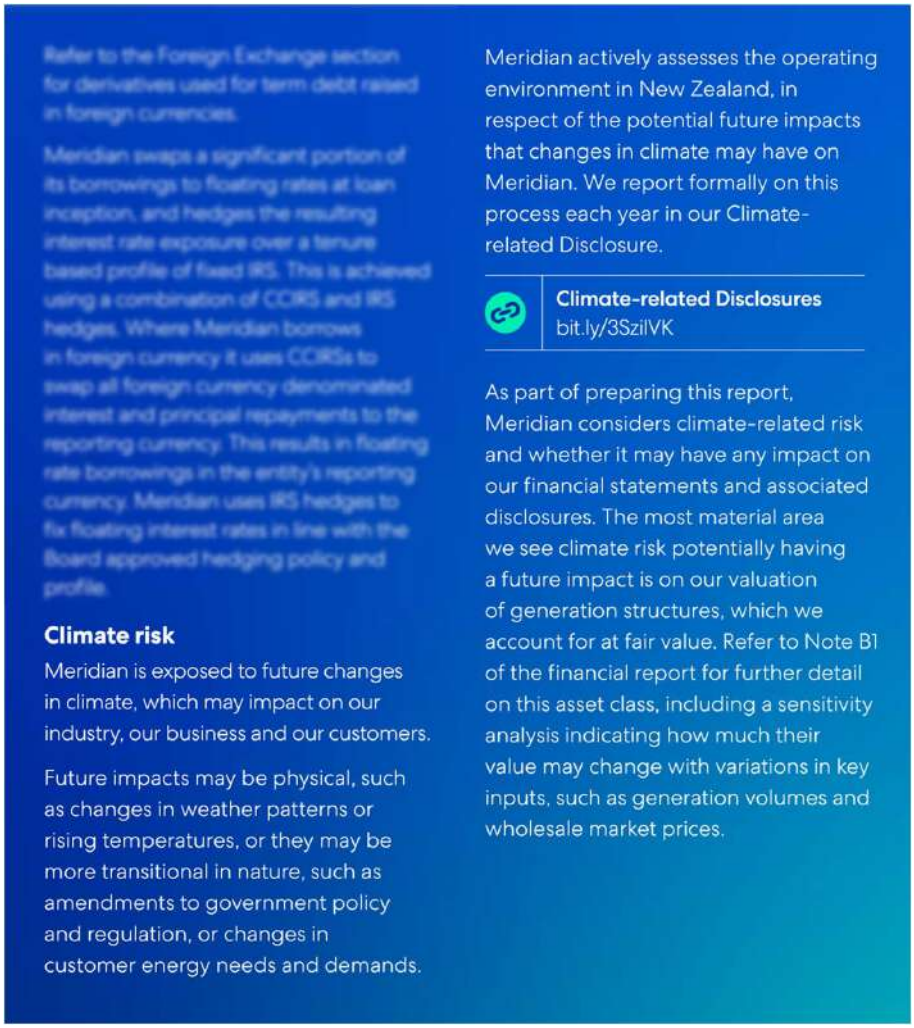
For an overview of sustainability governance at Telstra, see our ***In focus: Sustainability at Telstra*** paper available on our reports page.

For specific information on governance in relation to climate and nature, see the 'Acting on climate and nature' section in our **2024 Annual Report** available on our reports page.

Note D1 of the financial statements 2024 of Meridian Energy Limited includes cross-references to its Climate-related Disclosures 2024 as well as other notes within the financial statements where the effect from climate risks has been disclosed:

Practical example 5-3: Meridian Energy Limited (2024) **New Zealand**

INTEGRATED REPORT 2024 [extract]
Financial performance [extract]
Notes to the Group financial statements: [extract]
D: Financial instruments used to manage risk [extract]
D1: Financial risk management [extract]



Refer to the Foreign Exchange section for derivatives used for term debt raised in foreign currencies.

Meridian swaps a significant portion of its borrowings to floating rates at loan inception, and hedges the resulting interest rate exposure over a tenure based profile of fixed IRS. This is achieved using a combination of CCIRS and IRS hedges. Where Meridian borrows in foreign currency it uses CCIRSs to swap all foreign currency denominated interest and principal repayments to the reporting currency. This results in floating rate borrowings in the entity's reporting currency. Meridian uses IRS hedges to fix floating interest rates in line with the Board approved hedging policy and profile.

Climate risk

Meridian is exposed to future changes in climate, which may impact on our industry, our business and our customers.

Future impacts may be physical, such as changes in weather patterns or rising temperatures, or they may be more transitional in nature, such as amendments to government policy and regulation, or changes in customer energy needs and demands.

Meridian actively assesses the operating environment in New Zealand, in respect of the potential future impacts that changes in climate may have on Meridian. We report formally on this process each year in our Climate-related Disclosure.

Climate-related Disclosures
bit.ly/3SzilVK

As part of preparing this report, Meridian considers climate-related risk and whether it may have any impact on our financial statements and associated disclosures. The most material area we see climate risk potentially having a future impact is on our valuation of generation structures, which we account for at fair value. Refer to Note B1 of the financial report for further detail on this asset class, including a sensitivity analysis indicating how much their value may change with variations in key inputs, such as generation volumes and wholesale market prices.

How we see it

IFRS S1 permits an entity to cross-reference to another report published by that entity if that other report includes information required by ISSB standards (as discussed in this section).

We believe that IFRS S1 does not explicitly require 'another report published by the entity' to be part of the entity's general purpose financial reports. However, local laws and regulations may have more specific requirements than ISSB standards indicating to which other reports an entity can cross-reference. Therefore, the extent of cross-reference may differ according to each jurisdiction.

Moreover, IFRS S1 does not define which reports constitute an entity's general purpose financial reports. The definition of 'general purpose financial reports' in Appendix A of IFRS S1 states that "general purpose financial reports include-but are not restricted to-an entity's general purpose financial statements and sustainability-related financial disclosures". Therefore, it is at the entity's discretion to define which other reports (apart from the general purpose financial statements and sustainability-related financial disclosures) it considers to be 'general purpose financial reports' based on the definition provided in Appendix A of IFRS S1 "Reports that provide financial information about a reporting entity that is useful to primary users in making decisions relating to providing resources to the entity…".

For example, Entity A publishes a climate-related transition plan in 2024. The climate-related transition plan includes information that meets specific requirements in ISSB standards and is issued on the same terms and at the same time as Entity A's sustainability-related financial disclosures. Entity A intends to cross-reference to the specific information included in the transition plan to avoid duplicating this information in its 2024 sustainability-related financial disclosures. Entity A's conclusion would differ depending on: a) how it determines what its general purpose financial reports are comprised of, and b) the jurisdiction in which it operates. For example:

- Entity A does not consider its climate-related transition plan to be part of its general purpose financial reports. Entity A operates in country Y where cross-references both within general purpose financial reports and to other reports published by the entity are allowed. Entity A decides to cross-refer to information included in the 2024 climate-related transition plan.
- Entity A does not consider its climate-related transition plan to be part of its general purpose financial reports. Entity A operates in country X where cross-references are only allowed as part of the information provided in an entity's general purpose financial reports. Entity A concludes that it cannot cross-refer to information included in its climate-related transition plan, but needs to repeat it in its sustainability-related financial disclosures.
- Entity A considers its climate-related transition plan to be part of its general purpose financial reports. Depending on whether the jurisdiction in which Entity A operates allows cross-references within its general purpose financial reports, it can cross-refer to information included in the 2024 climate-related transition plan to avoid repeating the same information in its sustainability-related financial disclosures.

5.3 Timing of reporting

5.3.1 Simultaneous reporting of sustainability-related financial disclosures and financial statements

IFRS S1 requires an entity to provide its sustainability-related financial disclosures at the same time as it issues its related financial statements. This is also a natural consequence of the requirement in IFRS S1 that information included in an entity's sustainability-related financial disclosures by cross-reference needs to be available on the same terms and at the same time as all other sustainability-related financial disclosures. This simultaneous issuance is intended to provide primary users with a coherent, holistic and connected picture of an entity's financial position and performance, and to provide users with a comprehensive set of sustainability- related financial disclosures to enable more informed decisions. *[IFRS S1.64, IFRS S1.BC142, IFRS S1.BC145].*

5.3.2 Reporting period of sustainability-related financial disclosures

An entity normally prepares sustainability-related financial disclosures for a 12-month period (unless, for practical reasons, an entity prefers to report, for example, a 52-week period which is not precluded by IFRS S1). Regardless of this determination, an entity's sustainability-related financial disclosures need to cover the same reporting period as the related financial statements. *[IFRS S1.64, IFRS S1.65].*

IFRS S1 requires an entity to provide specific disclosures when it changes the end of its reporting period and provides sustainability-related financial disclosures for a period longer or shorter than 12 months. In particular, it needs to disclose the period covered by the sustainability-related financial disclosures, the reason for using a longer or shorter period, and the fact that the amounts disclosed in the sustainability-related financial disclosures are not entirely comparable. *[IFRS S1.64, IFRS S1.66].*

Sometimes entities receive information after the end of the reporting period about conditions that existed at the end of that reporting period. If such information is received before the date on which the sustainability-related financial disclosures are authorised for issue, the entity needs to update disclosures that relate to those conditions in the light of the new information. *[IFRS S1.67].*

Moreover, there may be transactions, other events and conditions that occur after the end of the reporting period, but before the date on which the sustainability-related financial disclosures are authorised for issue. In such cases, an entity needs to disclose information about those transactions, other events and conditions if non-disclosure of that information could reasonably be expected to influence decisions that primary users make on the basis of those reports. *[IFRS S1.68].*

How we see it

IFRS S1 requires the reporting period covered by the sustainability-related financial disclosures to be the same as the related financial statements. However, the reporting period of an entity may be different from the reporting periods used by some or all entities in a group (when the reporting entity is a parent of a group and prepares consolidated financial statements) and/or in its value chain. Although all entities in a group need to have the same reporting period, there may be situations where the applicable GAAP allows a mismatch if certain criteria are met. We believe that, if such an exception applies in the related financial statements, this exception will also apply for the sustainability-related financial disclosures of that reporting entity. This is consistent with the requirements of IFRS S1 for connectivity between financial statements and sustainability-related financial information (discussed in section 3.4.2.B above). Moreover, IFRS S2 acknowledges a potential mismatch in the reporting period of entities in the value chain with respect to GHG emissions, that may result in information not being readily available for the reporting entity to use when it prepares its own disclosures for its reporting period (see Chapter 53 at section 5.3.3).

5.3.3 Interim reporting

IFRS S1 does not mandate which entities are required to provide interim sustainability-related financial disclosures, or the frequency, or timing of such disclosures after the end of an interim period. However, entities may be required to publish interim general purpose financial reports by governments, securities regulators, stock exchanges and accountancy bodies, when their debt or equity securities are publicly traded.

Unlike IFRS accounting standards, ISSB standards do not include a standard that is specific to interim reporting. Instead, there are requirements within IFRS S1 that relate to interim reporting. In particular, entities that are required, or elect, to publish interim sustainability-related financial disclosures may be required, or choose, to provide less information than is provided in that of their annual sustainability-related financial disclosures. This is due to timeliness and cost considerations, and to avoid repetition of information previously reported. In general, interim sustainability-related financial disclosures are intended to provide an update on the latest complete set of the respective annual disclosures and therefore, focus on new information, events and circumstances without duplicating information previously reported. However, although more condensed sustainability-related financial disclosures may be provided, IFRS S1 does not prohibit or discourage an entity from publishing a complete set of sustainability-related financial disclosures (according to the requirements in IFRS S1) as part of its interim general purpose financial report. *[IFRS S1.69, IFRS S1.B48].*

5.4 Comparative information

IFRS S1 requires an entity to disclose comparative information in respect of the preceding period for all amounts disclosed in the reporting period, unless another ISSB standard permits or requires otherwise. Moreover, IFRS S1 requires an entity to disclose comparative information for narrative and descriptive sustainability-related financial disclosures if that information is useful to primary users to understand the reporting period's disclosures. *[IFRS S1.70, IFRS S1.B49].*

The IASB decided to not limit this requirement to metrics, but to expand it to 'all amounts' as this would be more useful to primary users. Amounts reported in sustainability-related financial disclosures may relate,

e.g., to the current and anticipated financial effects of sustainability-related risks and opportunities or to metrics and targets. *[IFRS S1.71, IFRS S1.BC147].*

For specific disclosure requirements about comparative information when changes occur in amounts that are estimates, see discussion in section 6.2.3 below.

Frequently asked questions

Question 5-1: How do the requirements in IFRS S1.70 on providing comparative information apply in the case of acquiring or disposing of a subsidiary of the reporting entity?

(TIG meeting 13 June 2024 - Agenda paper no. 2, ISSB meeting 24 July 2024 - Agenda paper no. 9)

In June 2024, the TIG discussed a question about the application of the requirements in IFRS S1.70 to disclose comparative information. The question related to the provision of comparative information where there is a change in the composition of the reporting entity as a result of acquiring or disposing of a subsidiary. In particular, there are situations where a reporting entity discloses in the current reporting period amounts that relate to a newly acquired subsidiary in which it previously did not hold an interest. Also, there are situations where a reporting entity disposes of its entire interest in a subsidiary at the start of the current reporting period and therefore, there are not any amounts to be disclosed relating to that disposed subsidiary in the current reporting period.

In discussing a situation similar to the one described above, the TIG agreed that, unless another ISSB standard permits or requires otherwise, IFRS S1.70 requires an entity to disclose comparative information for all amounts disclosed in the current period but does not further prescribe what the entity should include or exclude from the amounts presented in the preceding reporting period. To determine the amounts required to be presented as comparative information, IFRS S1.70 is applied together with the other requirements in IFRS S1, such as the requirements in IFRS S1.20 on 'reporting entity' and IFRS S1.21-24 on 'connected information'.

Therefore, if during the current reporting period the reporting entity acquires a subsidiary in which it previously did not hold an interest (i.e., the subsidiary is only part of the group in the current reporting period from the date of acquisition, based on applicable GAAP), for amounts disclosed in the current reporting period, the comparative information will not include amounts related to the newly acquired subsidiary. Similarly, if during the current reporting period the reporting entity disposes of its entire interest in a subsidiary (i.e., the subsidiary is only part of the group up until the date of its disposal, based on applicable GAAP), for amounts disclosed in the current reporting period, the comparative information will include amounts relating to that subsidiary. In particular, the TIG used the following examples:

- An entity had a subsidiary throughout the entire preceding period but disposed of that subsidiary three months after the beginning of the current reporting period. The subsidiary is part of the group for the purposes of consolidated financial statements based on the applicable GAAP up until the date of disposal (three months into the reporting period). The comparative information will include amounts related to the subsidiary as part of the reporting entity for the entire preceding period (i.e., twelve months)
- An entity had a subsidiary throughout the entire preceding period and that subsidiary solely represented its operations in a specific industry. The entity disposed of that subsidiary on the first day of the current reporting period. In the comparative period, some industry-specific metrics that were disclosed related only to the industry represented by that subsidiary. As the entity no longer undertakes any activities in this specific industry, those industry-specific metrics are not disclosed in the current reporting period. Therefore, the entity is not required to provide comparative information for those industry metrics, because the metrics are not disclosed in its current reporting period. However, the TIG described such a situation as an 'extreme scenario' and further clarified that, if metrics are still disclosed in the current reporting period and the disposed subsidiary contributed to the corresponding comparative information for those metrics (e.g., amounts relating to Scope 2 GHG emissions), the comparative information would not be adjusted as a result of the disposal of the subsidiary in the current reporting period.

With respect to the application of IFRS S1.70 in combination with the other requirements in IFRS S1, the TIG specifically emphasised the following:

- An entity's sustainability-related financial disclosures need to be for the same reporting entity as the related financial statements (discussed in section 3.3 above). The requirements related to comparative information in IFRS S1.70 are bound by the composition of that reporting entity in the related financial statements in the comparative period. Therefore, when there has been a change to the composition of the reporting entity (such as an acquisition or disposal), in applying IFRS S1.70, the comparative information provided about the reporting entity needs to reflect the composition of the reporting entity in the related financial statements in the comparative period. That is, for information accompanying the consolidated financial statements, what information is given will depend on the composition of the group at that time, in accordance with applicable GAAP.
- IFRS S1 requires information explaining the connections between disclosures across an entity's sustainability-related financial disclosures and its related financial statements. Also, data and assumptions used when preparing sustainability-related financial disclosures need to be consistent with the corresponding ones used in the preparation of the related financial statements (discussed in section 3.4.2.B above). Therefore, to the extent information is provided about the effects of an acquisition or disposal in the sustainability-related financial disclosures, the entity needs to be led by the respective information that was provided in the related financial statements. Such a consideration would establish the connection between the information provided in the disclosures and enable primary users to understand the connections between those disclosures. For example, where the decision about an acquisition or disposal of a subsidiary is part of an entity's strategy, this may lead to the identification of a new sustainability risk and therefore, the recognition of a liability in the related financial statements, in relation to that sustainability risk.
- In practice, more complex scenarios may arise in which the composition of the reporting entity may not be the only relevant factor in explaining changes in comparative information between periods. Such scenarios could be step acquisitions, step disposals or scenarios in which the reporting entity had a business relationship with the acquired entity prior to acquisition and therefore, was part of its value chain, or where the entity is still part of the value chain by virtue of a business relationship after disposal. In such scenarios, relevant information about sustainability-related risks and opportunities related to that entity that arises from the reporting entity's value chain, would still be included in current and comparative information.

In its Sustainability Report 2023, A.P. Moller-Maersk A/S clarified that any data from divestments and acquisitions relating to ESG performance have been included until the day of the transaction or from the reporting year following the transaction respectively.

Practical example 5-4: A.P. Møller - Mærsk A/S (2023) Denmark

Sustainability Report 2023 [extract]
Data and assurance [extract]
ESG performance data accounting policies [extract]
Basis of reporting [extract]
Scope and consolidation [extract]

Data from divestments are included until the day of transaction, while data from acquisitions are included from the reporting year following the transaction. In 2023, data from Pilot Freight Services (Pilot), Senator International (Senator) and LF Logistics, which were acquired in 2022, has been included in the ESG performance data.During 2023, the acquisitions of Martin Bencher Group and Grindrod Logistics was completed. Data from these companies will be included in the Annual Report 2024. Data from Maersk Supply Services is included up until the divestment date of 15 May 2023.

Along with the above mentioned question, the TIG discussed the application of the requirements in IFRS S1.70 when applying IFRS S2 where there is a change in the composition of the reporting entity, such as an acquisition or a disposal of a subsidiary. Please refer to the relevant discussion in Question 4-3 in Chapter 53.

6 Judgements, uncertainties and errors

6.1 Judgements

In preparing and presenting sustainability-related financial disclosures, an entity will need to apply various judgements. IFRS S1 requires an entity to disclose information about the judgements (apart from those involving estimations of amounts discussed in section 6.2 below) an entity has made in the process of preparing its sustainability-related financial disclosures. This requirement specifically relates to judgements that have the most significant effect on the information included in the sustainability-related financial disclosures. Providing such information to primary users enables them to understand how sustainability-related financial disclosures have been prepared. *[IFRS S1.74, IFRS S1.BC158].*

IFRS S1 provides some examples where judgement is required by an entity in preparing its sustainability-related financial disclosures. These are when an entity is: *[IFRS S1.75]*

- Identifying sustainability-related risks and opportunities that could be reasonably expected to affect the entity's prospects (see section 1.2 above)
- Determining which sources of guidance to apply (see section 5.1 above)
- Identifying material information to include in the sustainability- related financial disclosures (see section 3.2.2 above)
- Assessing whether an event or change in circumstances is significant and requires reassessment of the scope of all affected sustainability-related risks and opportunities throughout the entity's value chain (see section 1.2.3 above)

This requirement builds on the principle of IAS 1 relating to judgements made by an entity in applying its accounting policies that have the most significant effects on the amounts recognised in an entity's financial statements. The ISSB decided to include this overarching requirement for judgements made by an entity in the absence of a specifically applicable disclosure requirement about judgements in other ISSB standards. Other ISSB standards may require disclosure of judgements and estimates. In such cases, the requirements in IFRS S1 would complement those more specific requirements. However, other ISSB standards may also require disclosure of some of the information that an entity would otherwise be required to disclose in accordance with this overarching requirement in IFRS S1. *[IFRS S1.76, IFRS S1.BC159, IFRS S1.BC160, IFRS S1.BC162].*

6.2 Measurement uncertainty

6.2.1 Estimated amounts give rise to measurement uncertainty

Measurement uncertainty arises when amounts included in sustainability-related financial disclosures cannot be measured directly and can only be estimated. Such measurement uncertainty not only arises when estimating metrics, but also in other cases, such as when providing information about the effects of sustainability-related risks and opportunities on an entity's financial position, financial performance and cash flows for the reporting period, and the anticipated financial effects over the short, medium and long term (see further discussion in section 4.3.4 above). *[IFRS S1.BC163].*

The following example is based on the Basis for Conclusions to IFRS S1: *[IFRS S1.BC163].*

Illustration 6-1: Example of measurement uncertainty
Entity N's assets are increasingly at risk from climate-related forest fire events. This risk is considered as part of the impairment analysis and measurement of those assets. The frequency and severity of these fires are highly uncertain. Therefore, primary users need information about this uncertainty, including the fact that there is a significant risk of a material adjustment within the next annual reporting period to the carrying amounts of these assets.

6.2.2 IFRS S1 requirements for measurement uncertainties

IFRS S1 requires an entity to disclose information to enable primary users to understand the most significant uncertainties affecting the amounts reported in the sustainability-related financial disclosures. In doing so, an entity identifies the amounts it has disclosed that are subject to a high level of measurement uncertainty and, for each of those amounts, it needs to disclose: (i) the sources of measurement uncertainty (e.g., the dependence of the amount on the outcome of a future event, on a measurement technique or on the availability and quality of data from the entity's value chain), and (ii) the assumptions, approximations and judgements the entity has made in measuring the amount. *[IFRS S1.77, IFRS S1.78, IFRS S1.82, IFRS S1.BC163].*

These disclosure requirements relate to estimates used in preparing sustainability-related financial disclosures and are the entity's most difficult, subjective or complex judgements. In some cases, estimates involve assumptions about possible future events with uncertain outcomes. The greater the number of variables and assumptions, the more subjective and complex those judgements become. Accordingly, the uncertainty affecting the amounts reported in the sustainability-related financial disclosures increases. *[IFRS S1.79, IFRS S1.80].*

The use of reasonable estimates is essential in preparing sustainability-related financial disclosures. However, estimates need to be accurately described and explained to avoid undermining the usefulness of the information that includes those estimates. IFRS S1 is explicit that even a high level of measurement uncertainty would not necessarily prevent such an estimate from providing useful information. *[IFRS S1.79].*

The type and extent of the information an entity may need to disclose will vary according to the nature of the amount reported in the sustainability-related financial disclosures, i.e., the sources of and the factors contributing to the uncertainty and other circumstances.

IFRS S1 provides examples of the type of information an entity may need to disclose: *[IFRS S1.81]*

Extract from IFRS S1

81 The type and extent of the information an entity might need to disclose vary according to the nature of the amount reported in the sustainability-related financial disclosures-the sources of and the factors contributing to the uncertainty and other circumstances. Examples of the type of information an entity might need to disclose are:

(a) the nature of the assumption or other source of measurement uncertainty;

(b) the sensitivity of the disclosed amount to the methods, assumptions and estimates underlying its calculation, including the reasons for the sensitivity;

(c) the expected resolution of an uncertainty and the range of reasonably possible outcomes for the disclosed amount; and

(d) an explanation of changes made to past assumptions concerning the disclosed amount, if the uncertainty remains unresolved.

How we see it

There may be cases where specific sustainability-related information about conditions that existed at the end of that reporting period is not available before the date on which the sustainability-related financial disclosures are authorised for issue (see discussion in section 5.3.2 above). In such cases, the use of reasonable estimates may be essential in preparing sustainability-related financial disclosures relating to the information that is not yet available. IFRS S1 is explicit that even a high level of measurement uncertainty would not necessarily prevent such an estimate from providing useful information. Therefore, estimating such information is required unless estimates are not reasonable considering the concept of 'reasonable and supportable information' discussed in section 1.2.2 above.

6.2.3 Revised comparative information for estimated metrics

6.2.3.A New information for estimated metrics disclosed in the preceding period

As explained in section 5.4 above, an entity is required to provide comparative information in respect of the preceding period for all amounts disclosed in the reporting period (unless another ISSB standard permits or requires otherwise). Sometimes, the amount disclosed for a metric is an estimate (as discussed in section 6.2.1 above), and there may be cases where an entity identifies new information in relation to the estimated metric that was disclosed in the preceding period. If this new information provides evidence of circumstances that existed in that preceding period, IFRS S1 requires an entity to: *[IFRS S1.B50]*

- Disclose a revised comparative amount that reflects that new information
- Disclose the difference between the amount disclosed in the preceding period and the revised comparative amount
- Explain the reasons for revising the comparative amount

Although the feedback that the ISSB received for the principle of providing comparative information was widely accepted, there were concerns over its application specifically to comparative information of amounts that are estimates. One of the main concerns related to the fact that the requirement to revise comparative information differs from the approach to changes in estimates in financial statements prepared under IFRS accounting standards. That is, according to the requirements in IFRS accounting standards, changes in estimates are recognised in the current and future periods affected by the change and, therefore, the comparative information is not changed. Instead, the change in estimate is reflected in the profit or loss of the reporting period that the change occurs and in equity because they are part of a double-entry model. However, in sustainability-related financial disclosures, estimates cannot affect equity (e.g., a change in a Scope 3 GHG emissions estimate affects only the estimate itself). Therefore, revised comparatives that reflect updated estimates are useful information for primary users to understand trends. Consequently, the ISSB decided that an entity would provide more useful information if the entity revised comparatives to reflect changes in estimates that relate to the preceding period rather than changing reporting period information. *[IFRS S1.BC149, IFRS S1.BC150, IFRS S1.BC151]*.

IFRS S1 acknowledges that sometimes it may be impracticable to revise a comparative amount to achieve comparability with the reporting period (e.g., data may not have been collected in the preceding period in a way that allows retrospective application of a new definition of a metric which may make it impracticable to recreate the data). Therefore, a revised comparative amount for the preceding period does not need to be disclosed if it is impracticable to do so, but an entity needs to disclose that fact. *[IFRS S1.B51, IFRS S1.B54]*.

However, if a metric is forward-looking and relates to possible future transactions, events and other conditions, the entity is permitted, but not required, to revise a comparative amount for that forward-looking metric (e.g., when disclosing expected expenditure on new equipment for a future year and the price of that equipment subsequently increases). If the entity chooses to provide comparative information for a forward-looking metric, it needs to ensure that this does not involve the use of hindsight. *[IFRS S1.B51]*.

How we see it

As more reliable information becomes available in the current reporting period that supports sustainability-related metrics that are based on estimates, it may be appropriate to revise previously reported estimates to improve comparability of the information provided to primary users. For example, in the case of assessing progress towards net zero targets, improved or more granular GHG emissions data may become available in future periods. Therefore, an entity needs to set up appropriate processes and controls to collect the necessary data to provide revised estimates retrospectively and disclose what has changed compared to the preceding period.

Please refer to Question 4-4 of Chapter 53 for the discussion that the TIG had on specific question about providing estimates in the current period by using information disclosed in the prior period and whether these estimates need to be revised in the following year when these become comparative information.

Frequently asked questions

Question 6-1: Does the requirement in IFRS S1.B50 to revise estimated amounts disclosed in a preceding period relate only to estimated amounts disclosed for metrics or all estimated amounts disclosed, including those disclosed for metrics?

(TIG meeting 15 March 2024 - Agenda paper no. 2, ISSB meeting 16 May 2024 - Agenda paper no. 9)

The TIG agreed with the ISSB staff analysis that revision of estimated amounts disclosed in the preceding period (as long as the relevant circumstances outlined in IFRS S1.B50 exist) is required when those amounts are metrics, rather than requiring revision of all estimated amounts. However, this requirement does not apply to errors as IFRS S1 has specific requirements for errors.

The TIG agenda paper noted that, the first sentence of IFRS S1.B50 states that "in some cases, the amount disclosed for a metric is an estimate". This is immediately followed by the sentence referring to "the estimated amount disclosed in the preceding period" to imply that the specific 'amount disclosed' refers to that which is indicated in the first sentence i.e., 'amount disclosed for a metric'. Therefore, by no means is the use of word 'amounts' intended to expand the requirement in IFRS S1.B50 to all amounts.

Moreover, the TIG agenda paper noted that, although the Basis for Conclusions of IFRS S1 is not part of IFRS S1 and does not establish requirements, it does provide useful context. In this respect, the TIG agenda paper refers to IFRS S1.BC147-BC155 where the ISSB's considerations have been included in relation to the requirements in IFRS S1 on comparative information. However, the fact that the requirement in IFRS S1.B50 is not explained in the Basis for Conclusions of IFRS S1 should not be interpreted as applying to all estimated preceding period amounts disclosed.

During its discussion, the TIG pointed out the following:

- IFRS S1 does not define 'amounts', nor does it define 'metrics'. However, there are examples of 'amounts' provided in IFRS S1.71 that include metrics and targets as well as current and anticipated financial effects of sustainability-related risks and opportunities. Also, IFRS S1.46, IFRS S1.48 and IFRS S2.28 set out requirements for disclosing metrics, including cross-industry metrics and industry-specific metrics. The TIG suggested that entities to consider listing clearly and consistently what their metrics are to allow them to better scope the implications of the requirements to revise preceding period estimated amounts. Also, data quality scoring may be useful when assessing the level of estimation within metrics.
- Although the requirements in ISSB standards do not change the requirements in the accounting standards applied by an entity (e.g., IFRS accounting standards), the connection with the related financial statements is still necessary. That is, explaining the relationship between prior period amounts that are adjusted in accordance with ISSB standards and the respective unadjusted information in the related financial statements may be necessary.
- In certain cases, narrative or descriptive disclosures may be necessary to explain the consequential effects from revising preceding period estimated amounts that are metrics as this may be material information for the primary users. Therefore, although IFRS S1.BC152 explains that such narrative or descriptive disclosures are not required, entities need to apply judgement to determine whether these additional explanations would be useful to primary users.

Question 6-2: When an entity estimates Scope 3 GHG emissions in the current period by using information disclosed in the prior period, in applying the requirements of IFRS S1.B50, does that entity need to revise those estimated amounts in the following year when these become comparative information?

See response to Question 4-4 in Chapter 53 at section 4.5.

6.2.3.B Revised comparatives for redefined, replaced and new metrics

If an entity redefines, replaces or introduces a new metric in the reporting period, it needs to disclose a revised comparative amount for that metric, unless it is impracticable to do so. IFRS S1 includes a definition for the term 'impracticable' in Appendix A, clarifying that "applying a requirement is impracticable when an entity cannot apply it after making every reasonable effort to do so". This definition is based on IAS 1 for consistent use with IFRS accounting standards. Accordingly, IFRS S1 also sets a high threshold for how an entity determines whether it is impracticable to meet the requirements and this threshold is higher than a cost-benefit threshold. In addition, an entity needs to explain the changes in the metric and the reasons for those changes, including why the redefined or replacement metric provides more useful information than the previous metric. *[IFRS S1.B52, IFRS S1.B53, IFRS S1.BC152, IFRS S1.BC155]*.

6.3 Errors

IFRS S1 describes prior period errors as omissions from and misstatements in the entity's sustainability-related financial disclosures for one or more prior periods. These errors can be the effects of mathematical mistakes, mistakes in applying the definitions for metrics or targets, oversights or misinterpretations of facts, or fraud. Such errors arise from a failure to use, or the misuse of, reliable information that was available when the sustainability-related financial disclosures for that period(s) were authorised for issue. Also, errors arise when such reliable information is not used or misused, while it could reasonably be expected to have been obtained and considered in the preparation of those disclosures. *[IFRS S1.84, IFRS S1.B56].*

Potential reporting period errors are corrected before the sustainability-related financial disclosures are authorised for issue, if these are discovered in the reporting period to which they relate. However, material errors are sometimes not discovered until a subsequent period. If an entity identifies a material error in its prior period sustainability-related financial disclosures, this needs to be corrected by restating the comparative amounts for the prior period(s) disclosed, unless it is impracticable to do so. *[IFRS S1.83, IFRS S1.86, IFRS S1.B57].*

Moreover, if a material error is identified in the sustainability-related financial disclosures for its prior periods, an entity needs to disclose the nature of that error, and the correction (to the extent practicable) for each prior period disclosed. Also, if correction of that error is impracticable, an entity needs to disclose the circumstances that led to the existence of that condition and a description of how and from when the error has been corrected. When it is impracticable to determine the effect of an error on all prior periods presented, the comparative information is restated to correct the error from the earliest date practicable. *[IFRS S1.B58, IFRS S1.B59].*

Corrections of errors are distinguished from changes in estimates. This is because estimates are approximations that an entity may need to revise due to additional information that becomes known (see also discussion in section 6.2 above), rather than omissions or misstatements. Therefore, IFRS S1 distinguishes the requirements for an entity that revises a comparative amount (e.g., to update an estimate for a metric or redefine a metric), as discussed in section 6.2.3 above, and the requirements for restating an amount due to an error. *[IFRS S1.85, IFRS S1.BC165].*

7 Statement of compliance

An explicit and unreserved statement of compliance can be included only if an entity's sustainability-related financial disclosures comply with all the requirements of ISSB standards. Qualified statements of compliance with ISSB standards are not allowed. Including a statement of compliance is important information to communicate to primary users about the entity having applied all the requirements of ISSB standards, rather than having been selective in its approach to reporting sustainability-related financial information. *[IFRS S1.72, IFRS S1.BC156].*

However, there are situations where IFRS S1 relieves an entity from disclosing information that is specifically required by an ISSB standard, without preventing that entity from asserting compliance with them. These situations relate to where: *[IFRS S1.73]*

- Law or regulation may prohibit an entity from disclosing information that is specifically required by an ISSB standard (see discussion on interaction with law or regulation in section 3.2.4.C above)
- The information about a sustainability-related opportunity is commercially sensitive (see discussion on commercially sensitive information in section 3.2.5.B above)

To assert compliance with ISSB standards, an entity does not necessarily need to implement strategic goals. For example, an entity does not need to follow a particular transition plan to a lower-carbon economy, but it is required to disclose information about the targets it has set or is required to set by law or regulation. That is, an entity that does not manage some of its sustainability-related risks and opportunities, or that has not established its own metrics and targets for them, could still assert compliance with ISSB standards by disclosing that fact, as this is often material for primary users to know. Similarly, an entity may not have governance processes, controls or procedures in place to monitor and manage specific sustainability-related risks and opportunities, but that fact, in itself, is often material for primary users to know through a disclosure. *[IFRS S1.BC157].*

As discussed in section 3.2.7 above, the aim of the Inaugural Jurisdictional Guide issued in May 2024 is to set the basis for the development of jurisdictional profiles and enable market participants and regulators to understand the progress that each jurisdiction makes towards developing sustainability-related information. This jurisdictional guide also discusses the assertion of compliance with ISSB standards by confirming the fact that such compliance is only possible if an entity complies with all requirements in ISSB standards (subject to the exemptions mentioned above relating to situations where law or regulation prohibits specific disclosures or situations of information that is commercially sensitive). Additionally, the jurisdictional guide emphasises that the ISSB has provided transition reliefs from specific requirements in ISSB standards to facilitate their initial application (see discussion in section 9 below). The reliefs are available to all entities in the first year they apply ISSB standards and entities using those reliefs will be able to assert compliance with ISSB standards. For example, using the 'climate-first' relief (discussed in section 9.3 below), an entity can limit its disclosures to information that relates only to climate-related risks and opportunities in the first annual reporting period in which it applies ISSB standards, and still be able to assert compliance.

However, in the jurisdictional guide it is acknowledged that the pace of progress in adopting ISSB standards will vary by jurisdiction. Therefore, to facilitate primary users understanding of the application of the climate-relevant requirements in ISSB standards, after the first year of using the 'climate-first' transition relief, entities that comply with all the requirements in IFRS S2 and with the climate-relevant provisions in IFRS S1 (including those in jurisdictions described as 'adopting climate requirements in ISSB Standards') can state that they comply with the climate-related requirements in ISSB standards.

Moreover, some jurisdictions may consider extending the transition reliefs for periods beyond those included in ISSB standards. This is further explained in the additional guide for preparers 'Voluntarily applying ISSB Standards - A guide for preparers' issued in September 2024 (see also discussion in section 3.2.7 above). In particular, an entity would not be able to state compliance if those reliefs are extended beyond the first year. In such case, an entity would state that it partially applied ISSB standards and needs to identify the requirements that were not met. An entity would need to state this 'partial application' by describing how its disclosures only partially comply with the requirements of ISSB standards and how it is progressing. The reasons for phasing its disclosures beyond the first year of application that is allowed for by the transition reliefs could also be useful information for an entity to disclose.

8 Effective date

Several stakeholders stressed the fact that, due to the urgency of creating a global baseline of sustainability-related financial disclosures, the effective dates for IFRS S1 and IFRS S2 should not be more than 12 months after their issuance. The ISSB decided that setting an effective date for annual reporting periods beginning on or after 1 January 2024 is consistent with its current pace in meeting primary users' urgent need for sustainability-related and climate-related financial disclosures. *[IFRS S1.BC167, IFRS S1.BC171].*

In particular, an entity needs to apply IFRS S1 for annual reporting periods beginning on or after 1 January 2024. Earlier application is permitted, however, if doing so, an entity needs to disclose that fact and apply IFRS S2 at the same time. *[IFRS S1.E1].* The actual effective date for entities will depend on when ISSB standards become mandatory in the jurisdictions in which they operate, unless those entities voluntarily apply ISSB standards before they become mandatory in their jurisdictions.

9 Transition reliefs

How well prepared an entity is to apply ISSB standards will depend on various factors such as an entity's current reporting approach for sustainability-related risks and opportunities, its size and the jurisdiction in which it operates, etc. Taking into consideration the level of preparedness, the ISSB acknowledged that entities may need time to create or adjust internal systems, processes and controls to prepare the disclosures required by ISSB standards. Therefore, the ISSB decided to introduce transition reliefs. *[IFRS S1.BC170].*

IFRS S1 includes transition reliefs available in the first annual reporting period in which an entity applies ISSB standards that are discussed in section 9.1, 9.2 and 9.3 below. *[IFRS S1.E3].*

9.1 Transition relief for simultaneous reporting

The ISSB considered the feedback received from stakeholders expressing a number of concerns about data availability and preparer readiness to meet the requirement of simultaneous reporting of sustainability-related financial disclosures and financial statements, especially in the first year of application of ISSB standards. For example, challenges due to the potential reporting burden and higher costs, time-consuming collection and aggregation of data due to underdeveloped systems, delayed calculation of metrics due to later finalisation of financial statements.

In response to these concerns, the ISSB decided to provide transition relief to give entities more time to prepare and align reporting of sustainability-related financial disclosures and financial statements. The transition relief is available in the first annual reporting period in which an entity applies IFRS S1 and allows an entity to not report its sustainability-related financial disclosures at the same time as its related financial statements. *[IFRS S1.BC145, IFRS S1.BC146, IFRS S1.BC172].* In particular, Appendix E states: *[IFRS S1.E4]*

Extract from IFRS S1

E4 In the first annual reporting period in which an entity applies this Standard, the entity is permitted to report its sustainability-related financial disclosures after it publishes its related financial statements. In applying this transition relief, an entity shall report its sustainability-related financial disclosures:

(a) at the same time as its next second-quarter or half-year interim general purpose financial report, if the entity is required to provide such an interim report;

(b) at the same time as its next second-quarter or half-year interim general purpose financial report, but within nine months of the end of the annual reporting period in which the entity first applies this Standard, if the entity voluntarily provides such an interim report; or

(c) within nine months of the end of the annual reporting period in which the entity first applies this Standard, if the entity is not required to and does not voluntarily provide an interim general purpose financial report.

As indicated above, the relief permits the annual sustainability-related financial disclosures to be provided with the following second-quarter or half-year interim general purpose financial report. The ISSB decided to specify the timing of delay to enable primary users to know when the information would be provided. However, this relief is not suggesting that an entity is required to provide quarterly or half-yearly reporting (see also discussion about interim reporting in section 5.3.3 above). *[IFRS S1.BC172, IFRS S1.BC173].*

9.2 Transition relief for comparative information

Considering that entities may be able to apply the requirements in IFRS S1 sooner if comparative information is not required in the first annual reporting period in which they apply IFRS S1, the ISSB decided to provide a relief from the requirement to disclose comparative information. This relief allows an entity to report on only that first annual reporting period without being required to provide disclosures specified in IFRS S1 for any period before the date of initial application. That is, an entity is not required to disclose comparative information in the first annual reporting period in which it applies IFRS S1. *[IFRS S1.E3, IFRS S1.BC174].*

9.3 'Climate-first' transition relief

Limiting an entity's disclosures to information that relates only to climate-related risks and opportunities in the first annual reporting period in which an entity applies IFRS S1, is another relief that the ISSB decided to provide to entities. Therefore, the entity would apply the requirements in IFRS S1 only to the extent that they relate to the disclosure of information about climate-related risks and opportunities. *[IFRS S1.E5, IFRS S1.BC175]*.

In particular, if an entity applies this relief: *[IFRS S1.E5, IFRS S1.E6, IFRS S1.BC176]*

- It applies IFRS S2 (that is discussed in Chapter 53) to identify climate-related risks and opportunities and discloses information about them.
- It is required to disclose that fact.
- The relief from providing comparative information would be extended. Specifically, in the first annual reporting period in which it applies IFRS S1, the entity is not required to disclose comparative information about its climate-related risks and opportunities. Also, in the second annual reporting period in which the entity applies IFRS S1, the entity is not required to disclose comparative information about its sustainability-related risks and opportunities, other than its climate-related risks and opportunities. Therefore, comparative information in relation to climate-related risks and opportunities is required in the second annual reporting period.

Some entities that decide to take advantage of this relief in the first year of application of IFRS S1, may also wish to disclose information about sustainability-related risks and opportunities, beyond those relating to climate. The ISSB clarified that this relief is not intended to restrict an entity from providing incremental information to primary users. Instead, the relief is still available to entities that want to also provide information for sustainability-related risks and opportunities, in addition to those relating to climate, to the extent that this additional information does not reflect information about all sustainability-related risks and opportunities that could be reasonably expected to affect the entity's prospects. Therefore, the ISSB emphasised the importance of ensuring in those cases where the relief is used, that the information about climate-related risks and opportunities provided in accordance with IFRS S1 and IFRS S2 is not obscured by the incremental information. *[IFRS S1.BC177]*.

How we see it

Entities may already have been disclosing information about sustainability-related topics, other than climate, in their general purpose financial reports. In the first annual reporting period that these entities apply ISSB standards, they may continue providing information in their sustainability-related financial disclosures about the other sustainability-related topics for consistency and comparability purposes with their prior year reporting. However, they need to be explicit that the 'climate-first' transition relief is applied and that the additional information is not provided for the purposes of complying with the full requirements of ISSB standards had the 'climate-first' relief not been applied. They also need to ensure that material information provided in accordance with ISSB standards is not obscured by this additional information.

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Appendix C - Defined terms

Extract from IFRS standards - Definitions	
business model	An entity's system of transforming inputs through its activities into outputs and outcomes that aims to fulfil the entity's strategic purposes and create value for the entity and hence generate cash flows over the short, medium and long term.
disclosure topic	A specific sustainability-related risk or opportunity based on the activities conducted by entities within a particular industry as set out in an **IFRS Sustainability Disclosure Standard** or a SASB Standard.
general purpose financial reports	Reports that provide financial information about a **reporting entity** that is useful to **primary users** in making decisions relating to providing resources to the entity. Those decisions involve decisions about: (a) buying, selling or holding equity and debt instruments; (b) providing or selling loans and other forms of credit; or (c) exercising rights to vote on, or otherwise influence, the entity's management's actions that affect the use of the entity's economic resources. General purpose financial reports include-but are not restricted to-an entity's general purpose financial statements and **sustainability-related financial disclosures**.
IFRS Sustainability Disclosure Standards	Standards of that name issued by the International Sustainability Standards Board.
impracticable	Applying a requirement is impracticable when an entity cannot apply it after making every reasonable effort to do so.
material information	In the context of **sustainability-related financial disclosures**, information is material if omitting, misstating or obscuring that information could reasonably be expected to influence decisions that **primary users of general purpose financial reports** make on the basis of those reports, which include financial statements and sustainability-related financial disclosures and which provide information about a specific **reporting entity**.
primary users of general purpose financial reports (primary users)	Existing and potential investors, lenders and other creditors.
reporting entity	An entity that is required, or chooses, to prepare general purpose financial statements.
scenario analysis	A process for identifying and assessing a potential range of outcomes of future events under conditions of uncertainty.
sustainability-related financial disclosures	A particular form of **general purpose financial reports** that provide information about the **reporting entity's** sustainability-related risks and opportunities that could reasonably be expected to affect the entity's cash flows, its access to finance or cost of capital over the short, medium or long term, including information about the entity's governance, strategy and risk management in relation to those risks and opportunities, and related metrics and targets.
users of general purpose financial reports (users)	See **primary users of general purpose financial reports (primary users)**. These definitions describe the same population.

value chain	The full range of interactions, resources and relationships related to a **reporting entity's business model** and the external environment in which it operates. A value chain encompasses the interactions, resources and relationships an entity uses and depends on to create its products or services from conception to delivery, consumption and end-of-life, including interactions, resources and relationships in the entity's operations, such as human resources; those along its supply, marketing and distribution channels, such as materials and service sourcing, and product and service sale and delivery; and the financing, geographical, geopolitical and regulatory environments in which the entity operates.

Chapter 53 Climate-related Disclosures (IFRS S2)

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Overview

IFRS S2 *Climate-related Disclosures* is the first topic-based standard issued by the International Sustainability Standards Board (ISSB). IFRS S2 cannot be applied by an entity in isolation of other requirements. The ISSB standards are designed such that IFRS S2 needs to be applied in conjunction with IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information*, even if an entity elects to apply the 'climate first' transition relief in its first year of applying ISSB standards.

In supporting the initial application of ISSB standards, the ISSB created the Transition Implementation Group (TIG) to analyse and publicly discuss any questions that arise during the implementation phase of ISSB standards. The TIG does not issue authoritative guidance and, therefore, the use of its materials and related discussions are not mandatory for an entity to assert compliance with ISSB standards. Throughout this chapter, there are summaries of the discussions that the TIG had up to September 2024.

For more explanation on the relationship between IFRS S1 and IFRS S2 and the development of these standards as well as the formation of the TIG, refer to Chapter 52 at the Overview section.

1 Introduction to IFRS S2

1.1 The objective and scope of IFRS S2

IFRS S2 requires an entity "to disclose information about its climate-related risks and opportunities that is useful to primary users of general purpose financial reports in making decisions relating to providing resources to the entity's To meet this objective, an entity is required to disclose information about the climate-related risks and opportunities that could reasonably be expected to affect the entity's prospects. Consistent with the requirements in IFRS S1, risks and opportunities that could reasonably be expected to affect the entity's prospects are those that could reasonably be expected to affect its cash flows, its access to finance or cost of capital over the short, medium, and long term. *[IFRS S2.1, IFRS S2.2]*.

Those climate-related risks and opportunities that are not reasonably expected to affect an entity's prospects are outside the scope of IFRS S2. *[IFRS S2.4]*.

An entity's climate-related risks and opportunities are a subset of its sustainability-related risks and opportunities that are required to be disclosed in accordance with IFRS S1. For further information on the identification of sustainability-related risks and opportunities, refer to Chapter 52 at section 1.2.

In developing IFRS S2, the ISSB acknowledged that climate change is likely to present risks for nearly all entities and economic sectors. The ISSB also acknowledged that climate change opportunities might be available to entities, such as opportunities arising from an entity's actions to mitigate climate change or adapt to the effects of climate change. *[IFRS S2.BC2]*.

An entity's exposure to climate-related risks and opportunities might be direct (i.e., the impact is on the entity's own resources) or indirect through its value chain and relationships with, for example, suppliers and customers. The concept of a 'value chain' is explained in Chapter 52 at section 3.3.2. Furthermore, the extent of an entity's exposure to climate-related risks and opportunities will depend on factors such as the sector, industry, location (geographical and geopolitical) in which the entity operates and other specific circumstances including its business model. The nature and extent of an entity's exposure to climate-related risks and opportunities will affect how primary users assess an entity's overall risk profile and, therefore, influence users' decisions about whether they will provide resources to the entity. *[IFRS S2.BC2]*.

When an entity prepares the climate-related financial disclosures required by IFRS S2 (such as the cross-industry metric disclosures about the amount and percentage of assets or business activities vulnerable to climate-related transition risks and physical risks - see section 4.5.1 below), the entity needs to consider the linkages between the amounts disclosed in its climate-related financial disclosures and the amounts recognised and disclosed in its corresponding financial statements. Connections between these disclosures may be able to be explained by cross referring to information already reflected in the entity's financial statements. To assist an entity in assessing and disclosing the extent to which climate change affects its financial statements prepared in accordance with IFRS accounting standards, refer to *Applying IFRS: Connected Financial Reporting: Accounting for Climate Change (Updated May 2024)*.[1] *[IFRS S2.BC133]*.

1 *Applying IFRS Connected Financial Reporting: Accounting for Climate Change May 2024*, EY Global, May 2024, available on ey.com/ifrs.

2 Climate-related risks and opportunities

IFRS S2 applies to the climate-related risks to which an entity is exposed and the climate-related opportunities that are available to the entity. *[IFRS S2.3].*

2.1 Climate-related risks

Consistent with the Taskforce for Climate-related Financial Disclosures (TCFD) Recommendations, climate-related risks to which IFRS S2 applies are either: *[IFRS S2.BC18]*

- Physical risks from climate change ('climate-related physical risks')

  Or

- Transition risks associated with the transition to a lower-carbon economy ('climate-related transition risks')

IFRS S2 defines the 'climate-related physical risks' and 'climate-related transition risks', as follows: *[IFRS S2 Appendix A]*

Extract from IFRS S2

Appendix A
Defined terms

climate-related physical risks	Risks resulting from climate change that can be event-driven (acute physical risk) or from longer-term shifts in climatic patterns (chronic physical risk). Acute physical risks arise from weather-related events such as storms, floods, drought or heatwaves, which are increasing in severity and frequency. Chronic physical risks arise from longer-term shifts in climatic patterns including changes in precipitation and temperature which could lead to sea level rise, reduced water availability, biodiversity loss and changes in soil productivity. These risks could carry financial implications for an entity, such as costs resulting from direct damage to assets or indirect effects of supply-chain disruption. The entity's financial performance could also be affected by changes in water availability, sourcing and quality; and extreme temperature changes affecting the entity's premises, operations, supply chains, transportation needs and employee health and safety.
climate-related transition risks	Risks that arise from efforts to transition to a lower-carbon economy. Transition risks include policy, legal, technological, market and reputational risks. These risks could carry financial implications for an entity, such as increased operating costs or asset impairment due to new or amended climate-related regulations. The entity's financial performance could also be affected by shifting consumer demands and the development and deployment of new technology.

An entity may seek to manage the physical and transition risks related to climate change by developing mitigation and adaptation responses: *[IFRS S2.BC21]*

- Mitigation efforts relate primarily to an entity's responses to transition risks (e.g., adopting new technologies or changing business models to reduce greenhouse gas (GHG) emissions).
- Adaptation responses primarily involve an entity preparing for both the current and anticipated effects of physical risks (e.g., infrastructure investments to improve resilience to physical risks).

The ISSB explained that an entity's climate-related risks and opportunities will not necessarily be mutually exclusive. This is because, for example, a customer preference for low-carbon products might simultaneously represent both a risk to the demand for an entity's existing product line and an opportunity for the entity to produce an alternative low-carbon product or gain market share. *[IFRS S2.BC23].*

2.2 Climate-related opportunities

In the same way that climate-related risks refer to the potential negative effects that climate change may have on an entity, climate-related opportunities refer to the potential positive effects arising from climate change for an entity. IFRS S2 also clarifies that climate-related opportunities may arise from an entity's efforts to mitigate and adapt to climate change. *[IFRS S2 Appendix A].*

2.3 Nature and social aspects of climate-related risks and opportunities

IFRS S2 does not define the scope of the term 'climate-related'. The ISSB explained that this is because climate change impacts are wide ranging and interrelated and their effects on an entity will vary depending on the region, market and industry in which an entity operates, which means it is not possible to precisely define the full scope of climate-related risks and opportunities that might affect an entity. *[IFRS S2.BC25].*

Extract from the Basis for Conclusions to IFRS S2

BC25 Although the requirements in IFRS S2 do not explicitly reference some climate-related matters such as reduced access to fresh water, biodiversity loss, deforestation and climate-related social impacts, disclosures about these and other such matters are required if an entity determines that the information is material for users of general purpose financial reports. For example, if a beverage manufacturer determines it is exposed to short-, medium- or long-term effects of climate change on water availability-especially in water-stressed regions-the entity might determine that information about the implications of reduced water availability for its strategy, operations, capital planning and asset values is material. Therefore, this information would be required by IFRS S2.

In some cases, a risk or opportunity identified by an entity may have attributes that are related to climate as well as nature or socioeconomic factors. The impact that the risk or opportunity may have on an entity is unaffected by how it is classified or viewed. However, the timing of when information about that risk or opportunity is disclosed could be affected by its classification if the entity applies the 'climate first' transition relief (as discussed in Chapter 52 at section 9.3).

In December 2023, the IFRS Foundation published *Education material: Nature and social aspects of climate-related risks and opportunities* to explain whether and how entities should consider the nature and social aspects of climate-related risks and opportunities when applying IFRS S2. The education material includes three examples of climate-related risks and opportunities with a nature or social aspect. While the educational material is not part of the standard and does not add or change requirements in IFRS S2, these examples indicate that climate-related risks and opportunities can be broad in scope.

Extract from Educational material: Nature and social aspects of climate-related risks and opportunities

Example 3–Disclosing information about a company's response to a climate-related risk (social aspect)

…

Fact pattern

An entity operates in the electric utilities and power generators industry. It generates electricity from both renewable and fossil fuel sources and sells that electricity to customers in its jurisdiction.

The entity operates in a jurisdiction with a nationally determined contribution (NDC) arising from the latest international agreement on climate change (as defined in Appendix A of IFRS S2). To align with that NDC, the entity has set a greenhouse gas (GHG) emissions reduction target for 20XY.

To achieve its GHG emissions reduction target, the entity plans to phase out its coal-based plants by 20X0 and increase its renewable energy production by X%. The entity currently has X00 employees working in its coal-based plants. Those plants operate next to the only remaining coal mining site in the jurisdiction, which currently employs more than X,000 people.

Considering the NDC in the entity's jurisdiction, the entity is pursuing a 'just transition' to a lower-carbon economy. That is, the entity is transitioning to a lower-carbon economy in a way that is as fair and inclusive as possible to everyone concerned and maximises opportunities for decent work among all communities, workers and social groups. The entity anticipates that its jurisdiction will introduce regulation requiring entities to undertake their transition to a lower-carbon economy in this manner.

Consequently, the entity identifies regulatory risk associated with the NDC in its jurisdiction as a climate-related risk to which it is exposed. The latest international agreement on climate change, and the NDC arising from it, were developed to combat climate change. If the entity is not able to comply with the 'just transition' requirements associated with the NDC, there can be regulatory, reputational and legal consequences, which can affect the entity's prospects.

Application of IFRS S2

In accordance with paragraph 10 of IFRS S2, the entity discloses information that enables users of general purpose financial reports to understand the regulatory risk associated with how the entity manages its workforce as it transitions to a lower-carbon economy as a climate-related risk that it has determined could reasonably be expected to affect its prospects.

…

How we see it

Climate-related social impacts, nature and biodiversity loss, water, and deforestation could represent climate-related risks and opportunities that are within the scope of IFRS S2. Therefore, an entity that elects to use the 'climate first' transition relief in their first year of applying ISSB standards will still need to disclose information about those risks and opportunities if the entity judges that:

- The risks and opportunities are climate-related

  And

- The risks and opportunities could reasonably be expected to affect the entity's prospects

3 Identifying climate-related risks and opportunities

Similar to sustainability-related risks and opportunities (as discussed in Chapter 52 at section 1.2), climate-related risks and opportunities arise from an entity's impacts and dependencies on natural resources and its relationships with stakeholders and society, the economy and its interaction with the natural environment. *[IFRS S2.BC26].*

The importance of understanding the role of impacts and dependencies in the identification of climate-related risks and opportunities is explained further in Figure 3-1 below.

Figure 3-1: Impacts and dependencies

Topic	Explanation	Example
Dependencies	A climate-related risk may arise from changes in the availability, quality or cost-stability of essential inputs that an entity depends on.	A sports drink company depends on the availability and quality of water to manufacture its products. Supplies of fresh water become limited during times of drought, which could result in water supply disruptions and higher water costs. This could affect production volumes and costs and, therefore, affect the amount of future cash flows that the sports drink company can expect to generate from its operations. *[IFRS S2.BC27].*
Impacts	A climate-related risk or opportunity may arise if an entity's impacts on climate change affect the resources and relationships on which the entity depends.	A manufacturing company expects a carbon tax to be introduced in a key jurisdiction in which it has emissions-intensive operations. The introduction of a carbon tax will increase the company's costs of production which it will pass onto consumers through higher product prices. Higher prices will affect the demand of the company's products and thus the amount of its future cash flows and the useful life of its manufacturing plant. *[IFRS S2.BC28].*

The TCFD provided categories for climate-related risks and opportunities, which may help an entity to identify its climate-related risks and opportunities under IFRS S2. A list of these categories is provided in Figure 3-2 below. Furthermore, the ISSB noted that the *Industry-based Guidance on Implementing IFRS S2*, which is based on the SASB standards but is not intended to be comprehensive or interpreted as such, provides some parameters for identifying climate-related risks and opportunities. This is discussed further in section 4.3.1.B below. *[IFRS S2.BC24].*

Figure 3-2: Categories of climate-related risks and opportunities

Physical risks	Transition risks	Opportunities
▸ Acute risk ▸ Chronic risk	▸ Policy and legal risks ▸ Market risk ▸ Technology risk ▸ Reputation risk	▸ Resource efficiency ▸ Energy source ▸ Products and services ▸ Markets ▸ Resilience

4 Core content

4.1 Overview

The core content disclosures in IFRS S2 are structured around four thematic areas that address how an entity oversees and manages its climate-related risks and opportunities. The core content areas require an entity to disclose information about its governance, strategy, risk management, and metrics and targets. This disclosure is intended to provide primary users with a complete set of information that enables them to understand the entity's exposure to and management of its climate-related risks and opportunities. *[IFRS S2.BC30].*

These disclosure requirements in IFRS S2 for climate-related risks and opportunities are structured around the same core content disclosure requirements in IFRS S1 for general sustainability-related risks and opportunities. The purpose of the core content disclosures and guidance on avoiding duplication in disclosures are discussed in Chapter 52 at section 4.1.

4.1.1 Comparison with TCFD Recommendations

In July 2023, the ISSB published *Comparison IFRS S2 Climate-related Disclosures with the TCFD Recommendations*, which notes that the requirements of IFRS S2 integrate and are consistent with the 11 recommended disclosures of the TCFD.[2] In analysing the core content requirements in IFRS S2 and the associated core recommendations, recommended disclosures and guidance in the TCFD, the ISSB categorised the differences between IFRS S2 and TCFD Recommendations into three types, which are summarised in Figure 4-1 below:

Figure 4-1: Comparing TCFD Recommendations and IFRS S2

Type of difference	What IFRS S2 requires
Different wording	In some cases, IFRS S2 uses different wording to capture the same information as the TCFD Recommendations. In those cases, the requirements in IFRS S2 are considered to be broadly consistent with the TCFD Recommendations.
More detailed information	In some cases, IFRS S2 requires the disclosure of more detailed information, noting that the IFRS S2 disclosure requirements remain in line with the corresponding TCFD Recommendations.
Different guidance	In some cases, IFRS S2 requirements differ from the TCFD Recommendations, but mainly as a result of providing additional requirements and guidance. However, there is no intended difference between IFRS S2 and the TCFD's overall recommendations.

The specific differences between the IFRS S2 requirements and the TCFD Recommendations for each of the core content areas are identified and explained in the sections below.

How we see it

Entities that are currently preparing climate-related disclosures in accordance with the TCFD Recommendations cannot assume that their existing disclosures will be sufficient to comply with ISSB standards. As noted in the table above, IFRS S2 includes additional requirements and guidance. IFRS S1 also specifies additional disclosure considerations. All of these requirements need to be met in order to provide a complete set of sustainability-related financial disclosures in accordance with ISSB standards.

2 Further guidance provided by the ISSB on the TCFD can be found at *Making the transition from TCFD to ISSB*, available on the IFRS Foundation's website.

4.2 Governance

The governance disclosure requirements in IFRS S2 for climate-related risks and opportunities correspond with the governance disclosure requirements for sustainability-related risks and opportunities in IFRS S1. As such, the commentary in Chapter 52 at section 4.2 on governance disclosure requirements in IFRS S1 is also applicable to the preparation of governance disclosures relating to climate-related risks and opportunities.

An entity is not required to provide separate governance disclosures for each sustainability-related risk and opportunity if oversight of the entity's sustainability-related risks and opportunities is managed on an integrated basis. In such cases, an entity needs to avoid unnecessary duplication by providing an integrated governance disclosure that meets the requirements set out in both IFRS S2 and IFRS S1. *[IFRS S2.7].*

TCFD comparison

The ISSB indicates that IFRS S2 disclosure requirements for an entity's governance on climate-related risks and opportunities is broadly consistent with the TCFD recommended disclosures.

However, in its TCFD comparison document, the ISSB noted that IFRS S2 requires disclosure of more detailed information about the description of the board's oversight of climate-related risks and opportunities. For example, how responsibilities for climate-related risks and opportunities are reflected in the terms of reference, mandates, role descriptions and other related policies applicable to the governance body(ies) or individual(s) who have oversight of those risks and opportunities.

4.3 Strategy

The strategy requirements in IFRS S2 for climate-related risks and opportunities correspond with the strategy disclosure requirements for sustainability-related risks and opportunities in IFRS S1, except that IFRS S2 has additional requirements and provides additional guidance in relation to:

- Identifying and classifying climate-related risks and opportunities that could reasonably be expected to affect the entity's prospects
- The effects of an entity's climate-related risks and opportunities on its strategy and decision-making, including information about its climate-related transition plan (if it exists)
- The resilience of the entity's strategy and business model to climate-related changes, developments and uncertainties

The following sections discuss each of these additional requirements and guidance.

For the remainder of the strategy disclosure requirements in IFRS S2, the commentary in Chapter 52 at section 4.3 on strategy disclosure requirements in IFRS S1 is also applicable to the preparation of strategy disclosures relating to climate-related risks and opportunities.

4.3.1 Disclosures about climate-related risks and opportunities

4.3.1.A Classifying climate-related risks

IFRS S2 requires an entity to classify each climate-related risk identified as either a climate-related physical risk or climate-related transition risk. *[IFRS S2.10(b), IFRS S2.B5].* The differences between physical risks and transition risks are discussed in sections 2 and 3 above.

In its Integrated Report and Financial Statements 2023, Mondi plc discloses its physical risks, transition risks and its climate-change related opportunities. It describes one of physical risks, as follows:

Practical example 4-1: Mondi plc (2023) United Kingdom

Integrated report and financial statements 2023 [extract]
Strategic report [extract]
Mondi Action Plan 2030 (including our TCFD disclosure) [extract]
Taking Action on Climate: TCFD [extract]
Climate change-related risks: Physical risks [extract]

Risk	Risk description	How we manage and mitigate this risk	Estimated financial impact (€m)
1. Higher wood procurement costs **Timeframe:** Long term	Temperature increase, changes in rainfall patterns and windstorms can result in large-scale forest damage. In Europe, at lower altitudes, fibre losses from pests (e.g. bark beetles) and diseases are expected to continue unless precipitation increases. A reduction in the cutting capacity of the sawmilling industry due to a lack of spruce saw logs could lead to a change in the mix of available pulpwood and sawmill chips. Increasing competition for wood is being driven by demand for renewable raw materials and timber for green energy generation to achieve EU GHG reduction and Net-Zero targets. At the same time, there is a call to increase forest areas set aside for conservation, which is reflected in the 2030 EU Forest Strategy.	In mountainous regions, we expect an increase in yearly forest growth due to rising temperatures. At lower altitudes, spruce will be mainly replaced with other softwood species. We are investigating alternatives to support flexibility in species mix for our future pulp production. We invest in research and development projects and are building strategic partnerships with forest owners and industries, NGOs and scientific institutions to foster sustainable forest management. This is supported by the sustainable working forest model and fit-for-purpose certification concepts, which we developed and promote with our partners. We have started to explore approaches to climate-fit forestry to enhance forest ecosystems' resilience. We also promote the cascading use of wood nationally and via Cepi on a European level.	90–180

4.3.1.B Using industry-based guidance to identify climate- related risks and opportunities

In identifying the climate-related risks and opportunities that could reasonably be expected to affect an entity's prospects, IFRS S2 requires an entity to refer to and consider the applicability of the industry-based disclosure topics defined in the *Industry-based Guidance on Implementing IFRS S2*, which was issued by the ISSB at the same time as IFRS S1 and IFRS S2.[3] *[IFRS S2.12].*

In the Exposure Draft of IFRS S2, the ISSB proposed industry-based requirements that were derived from SASB standards (with enhancements made to the international applicability of some requirements) to enable comparable disclosures among industry peer entities. Feedback on the proposed industry-based requirements was mixed, in part because of concerns about the ability and relevance of applying some of the proposals internationally given the SASB standards were primarily developed for the US market. In response to that feedback, the ISSB decided to retain the industry-based guidance with some enhancements to its international applicability but issued it as non-authoritative guidance that "suggests possible ways to apply some of the disclosure requirements in IFRS S2 but does not create additional requirements".

The disclosure topics identified and defined in the industry-based guidance list climate-related risks and opportunities that are typically associated with particular business models, activities or other common features that characterise participation in an industry. For example, in the real estate industry, the industry-based guidance identifies energy management, water management, management of tenant sustainability impacts and climate change adaption as disclosure topics. *[IFRS S2.BC135, IFRS S2.BC136].*

The industry-based guidance also suggests possible ways to measure and disclose information about climate-related risks and opportunities. This is discussed further in relation to metrics and targets in section 4.5 below.

IFRS S2 requires an entity to "refer to and consider the applicability of" the disclosure topics defined in the *Industry-based Guidance on Implementing IFRS S2*. The same requirements are included in IFRS S1 in relation to the sources of guidance. As discussed in Chapter 52 at section 5.1, this requirement means that, after referring to the industry-based guidance, an entity is not required to apply that guidance if the entity considers that it is not applicable. However, even if an entity concludes not to use the Industry-based Guidance on Implementing IFRS S2, industry specific disclosures are still required by ISSB standards. If an entity concludes that the industry-based guidance does not apply, reference is to be made to the sources of guidance specified in IFRS S1. *[IFRS S2.12].*

3 *Industry-based Guidance on implementing Climate-related Disclosures*, ISSB, June 2023, available at the IFRS Foundation's website.

The ISSB included this requirement to refer to the industry-based guidance because it considers the guidance to be a helpful starting point for identifying climate-related risks and opportunities about which an entity might need to prepare disclosures. The ISSB also noted that the disclosure topics and associated metrics set out in the guidance are not intended to be exhaustive and therefore, it should not be interpreted as being comprehensive. Consequently, an entity will also need to disclose climate-related financial information about other topics that are common to an industry but that are not included in the industry-based guidance if those topics relate to climate-related risks and opportunities that could reasonably be expected to affect the entity's prospects. *[IFRS S2.BC137, IFRS S2.BC24].*

4.3.1.C Using reasonable and supportable information to identify climate-related risks and opportunities

In identifying the climate-related risks and opportunities that could reasonably be expected to affect an entity's prospects, IFRS S2 requires an entity to use all reasonable and supportable information that is available to the entity at the reporting date without undue cost or effort. This information includes information about past events, current conditions and forecasts of future conditions. *[IFRS S2.11].*

The requirement that an entity "use all reasonable and supportable information that is available to the entity at the reporting date without undue cost or effort" is a concept that is employed in both IFRS S1 and IFRS S2 so that the ISSB could clarify its expectations about the level of effort needed to comply with a specific disclosure requirement.

More information about the application of the "use all reasonable and supportable information that is available to the entity at the reporting date without undue cost or effort" concept is provided in Chapter 52 at section 1.2.2.

Frequently asked questions

Question 4-1: Can an entity use scenario analysis to assist in identifying climate-related risks and opportunities?

Many entities that have been previously reporting in accordance with the TCFD may have used scenario analysis to assist in the identification of their climate-related risks and opportunities. Under ISSB standards, an entity can, but is not required to, use scenario analysis to assist in identifying its climate-related risks and opportunities. This is acknowledged in the Basis for Conclusions on IFRS S2, which states that "climate-related scenario analysis can be used to inform a variety of other disclosures required by IFRS S2, including the identification and assessment of risks and opportunities". Furthermore, IFRS S2 requires an entity to disclose in its risk management disclosures whether and how scenario analysis is used to inform the entity's identification of climate-related risks. *[IFRS S2.25(a)(ii), IFRS S2.BC69].*

Although an entity is not required to use scenario analysis in the identification of climate-related risks and opportunities, IFRS S2 requires scenario analysis to be used for the purposes of assessing the resilience of the entity's strategy and business model to climate-related changes. This is discussed further in section 4.3.3 below.

How we see it

Scenario analysis is an analytical tool that can be used for different purposes. An entity may, but is not required under IFRS S2 to, perform such an analysis to inform the identification of climate-related risks and opportunities that an entity considers could reasonably be expected to affect its prospects. However, under IFRS S2, an entity is required to use scenario analysis in order to assess the resilience of its business model and strategy based on a range of outcomes that may be plausible but uncertain.

If an entity discloses that it uses scenario analysis to inform its identification of climate-related risks and opportunities, it needs to make it apparent to primary users that the risks and opportunities identified are those could be reasonably expected to affect its prospects rather than just being presented as outputs of the scenario analysis. Identifying a valid and complete set of climate-related risks and opportunities is important as they form the foundation of other disclosures that seek to provide information to primary users about the entity's exposure to climate-related risks and opportunities and the entity's planned response to that exposure. This includes disclosures about:

- The current and anticipated effects of the risks and opportunities on the entity's business model and value chain
- How the entity is responding/plans to respond to those risks and opportunities in its strategy and decision-making

- The current and anticipated effects of the risks and opportunities on the entity's financial position, financial performance and cash flows
- The resilience of the entity's strategy and business model to those risks and opportunities

4.3.2 Disclosures about the effects of climate-related risks and opportunities on the entity's strategy and decision-making

Consistent with IFRS S1, IFRS S2 requires an entity to disclose information to enable primary users to understand the effects of climate-related risks and opportunities, including how it has responded, and plans to respond, to such risks and opportunities in its strategy and decision-making. However, IFRS S2 is more prescriptive by also requiring the disclosure of: *[IFRS S2.14(a)]*

- How the entity plans to achieve any climate-related targets it has set,

  And
- Any targets it is required to meet by law or regulation

Figure 4-2 below outlines the specific disclosures that IFRS S2 requires an entity to provide about its responses or planned responses to climate-related risks and opportunities.

Figure 4-2: An entity's responses to climate-related risks and opportunities

Required disclosure	Remarks
Information about current and anticipated changes to the entity's business model, including its resource allocation, to address climate-related risks and opportunities. *[IFRS S2.14(a)(i)]*.	Examples include: ▸ Plans to manage or decommission operations that are carbon, energy or water-intensive ▸ Reallocation of resources due to demand or supply-chain changes ▸ Reallocation of resources due to new business development resulting in capital expenditure or additional expenditure on research and development ▸ Acquisitions or divestments
Information about current and anticipated *direct* mitigation and adaptation efforts. *[IFRS S2.14(a)(ii)]*.	Examples include: ▸ Changes in production processes ▸ Equipment changes ▸ Relocation of facilities ▸ Workforce adjustments ▸ Product specification changes
Information about current and anticipated *indirect* mitigation and adaptation efforts. *[IFRS S2.14(a)(iii)]*.	Examples include: ▸ Working with customers ▸ Working with supply chains
Information about an entity's climate-related transition plan (if it has one). *[IFRS S2.14(a)(iv)]*.	Information to be disclosed about an entity's transition plan includes: ▸ Key assumptions used in developing the transition plan ▸ Dependencies on which the transition plan relies upon
Information about how the entity plans to achieve any climate-related targets, including any GHG emission targets. *[IFRS S2.14(a)(v)]*.	This includes targets that the entity has set and targets that the entity is required to meet by law or regulation. The targets are discussed further in section 4.5 below.

With respect to the entity's plans, IFRS S2 also requires an entity to disclose:

- Information about how the entity is resourcing, and intends to resource, those plans *[IFRS S2.14(b)]*
- Information (both quantitative and qualitative) about the progress of those plans compared to previous reporting periods *[IFRS S2.14(c)]*

4.3.2.A Climate-related transition plans

IFRS S2 defines the 'climate-related transition plan' as follows: *[IFRS S2 Appendix A]*

Extract from IFRS S2

Appendix A
Defined terms

climate-related transition plan	An aspect of an entity's overall strategy that lays out the entity's targets, actions or resources for its transition towards a lower-carbon economy, including actions such as reducing its **greenhouse gas** emissions.

The ISSB considers that disclosure of an entity's transition plan, or set of plans, to respond to the expected transition to a lower-carbon economy (if it has such plans) will help primary users assess the effects of climate-related risks and opportunities on the entity's cash flows, its access to finance and cost of capital. *[IFRS S2.BC46].*

IFRS S2 does not specify what is included in a transition plan. The ISSB notes that a transition plan will reflect an entity's individual circumstances, therefore, its focus is to enhance the comparability and consistency of disclosures about transition plans. *[IFRS S2.BC52].* Transition plans can vary; for some entities, their transition plans form part of their overall business strategy as the plan is being used to adjust the entity's business model in response to its climate-related risks and opportunities. Whereas for some other entities, the plan does not form part of the overall business strategy and instead applies only to a particular product line, business unit or set of activities. *[IFRS S2.BC47].*

To assess the credibility of an entity's transition plan and to be able to make comparisons between entities' transition plans, primary users need to understand the assumptions and dependencies that underpin an entity's transition plan. For that reason, IFRS S2 requires an entity to disclose:

- The assumptions it made in developing its climate-related transition plan
- The dependencies on which the plan's achievement relies

The ISSB explains the difference between assumptions and dependencies in the context of transition plans in Figure 4-3 below: *[IFRS S2.BC52]*

Figure 4-3: Differences between assumptions and dependencies in transition plans

	Meaning	Examples
Assumption	A belief, expectation, hypothesis or premise that the entity expects will occur and, therefore, builds into its climate-related transition plan. Assumptions are uncertain.	▸ Expectations about regulatory requirements ▸ Expectations about the ability of an entity to implement planned changes within its value chain
Dependencies	Critical factors and conditions that are required for an entity's transition plan to be realised.	▸ An emission removal technology that an entity will rely upon to meet its GHG emission targets ▸ The minimum level of resource availability needed so that the entity can implement its transition plan

In preparing its climate-related financial disclosures, an entity needs to consider how to make connections between information disclosed in its transition plan and the disclosure of other information such as its GHG emissions, its emission targets and climate resilience. *[IFRS S2.BC49].*

How we see it

IFRS S2 does not require an entity to develop a transition plan. The standard only requires the disclosure of particular information about transition plans if an entity has such a plan. In our view, given the importance that primary users place on information about an entity's transition plan, an entity that does not have a transition plan needs to consider disclosing that fact.

Some organisations that are external to the ISSB have also been working on guidance on the preparation of transition plans. One such initiative is the Transition Plan Taskforce (TPT) which was launched by the UK Government with the intention to set out good practices for robust and credible transition plan disclosures as part of an entity's annual reporting on forward business strategy. The TPT published its *Disclosure Framework* in October 2023, which sets out five key elements of a good practice transition plan, which are expanded upon through 19 sub-elements and a series of disclosure recommendations for each sub-element.[4]

TPT's five key elements of a good practice transition plan are summarised in Figure 4-4 below.

Figure 4-4: Key elements of a transition plan

Key element	Details
Foundations	"An entity shall disclose the Strategic Ambition of its plan. This shall comprise the entity's objectives and priorities for responding and contributing to the transition towards a low GHG emissions, climate-resilient economy, and set out whether and how the entity is pursuing these objectives and priorities in a manner that captures opportunities, avoids adverse impacts for stakeholders and society, and safeguards the natural environment. Under this element, an entity should also disclose the high-level implications that this transition plan will have on its business model and value chain, as well as the key assumptions and external factors on which the plan depends."
Implementation Strategy	"An entity shall disclose the actions it is taking within its business operations, products and services, and policies and conditions to achieve its Strategic Ambition, as well as the resulting implications for its financial position, financial performance, and cash flows."
Engagement Strategy	"An entity shall disclose how it is engaging with its value chain, industry peers, government, public sector, communities, and civil society in order to achieve its Strategic Ambition."
Metrics & Targets	"An entity shall disclose the metrics and targets that it is using to drive and monitor progress towards its Strategic Ambition."
Governance	"An entity shall disclose how it is embedding its transition plan within its governance structures and organisational arrangements in order to achieve the Strategic Ambition of its transition plan."

The ISSB's Vice-Chair, Sue Lloyd, stated in a foreword included in the TPT Disclosure Framework that the TPT Disclosure Framework, "provides a practical and useful complement to [the ISSB] Standards. It will be a useful tool for companies in developing transition plans and informing the disclosure requirements in IFRS S2".

How we see it

External initiatives such as the TPT Disclosure Framework may provide a useful source of insight and guidance that entities may choose to refer to when preparing their transition plan disclosures in accordance with IFRS S2. In our view, these initiatives may help to improve good disclosure practices and, as such, an entity may wish to consider the relevance of those initiatives to its own disclosures. However, entities need to be mindful that ISSB standards do not require an entity to comply with the guidance or recommendations in the TPT Disclosure Framework or other external initiatives and that, similarly, compliance with the TPT Disclosure Framework or other external initiatives will not necessarily mean that the entity's disclosures comply with ISSB standards.

All requirements in IFRS S1 and IFRS S2 need to be met in order to provide a complete set of sustainability-related financial disclosures in accordance with ISSB standards.

4 *TPT Disclosure Framework*, TPT, October 2023, available in the TPT's website.

4.3.3 Disclosures about the resilience of the entity's strategy and business model

Because the likelihood, magnitude and timing of climate-related risks and opportunities affecting an entity are uncertain and often complex, primary users have indicated that they need to understand the resilience of the entity's strategy and business model to climate change. *[IFRS S2.BC57].*

IFRS S2 defines 'climate resilience' as follows: *[IFRS S2 Appendix A]*

Extract from IFRS S2

Appendix A
Defined terms

climate resilience	The capacity of an entity to adjust to climate-related changes, developments or uncertainties. Climate resilience involves the capacity to manage **climate-related risks** and benefit from **climate-related opportunities**, including the ability to respond and adapt to **climate-related transition risks** and **climate-related physical risks**. An entity's climate resilience includes both its strategic resilience and its operational resilience to climate-related changes, developments and uncertainties.

Compared to IFRS S1, the climate resilience disclosure requirements in IFRS S2 are more extensive and prescriptive and require a scenario analysis to be completed. In providing quantitative information, IFRS S2 permits an entity to disclose a single amount or a range. *[IFRS S2.22].*

IFRS S2 requires disclosure of:

- An entity's assessment of its climate resilience as at the reporting date. *[IFRS S2.22(a)].*
- How and when the entity carried out climate-related scenario analysis, which is used to inform the resilience assessment. *[IFRS S2.22(b)].*

The relationship between a resilience assessment and scenario analysis is explained in Figure 4-5 below.

Figure 4-5: Difference between a resilience assessment and scenario analysis

Topic	Explanation
Resilience assessment	Using a range of plausible but uncertain climate outcomes (i.e., scenarios), management assesses the implications for the entity's business model and strategy and its capacity to adapt or respond. *[IFRS S2.BC59].* Information about an entity's assessment of its climate resilience has to be disclosed as at each reporting date. *[IFRS S2.BC68].*
Scenario analysis	An analytical exercise used to inform that resilience assessment. An entity is not required to disclose the specific results of its scenario analysis. Instead, an entity is required to disclose information about its interpretation of those results. *[IFRS S2.BC59].* A scenario analysis does not need to be performed every year. *[IFRS S2.BC68].*

4.3.3.A Resilience assessment

Within the context of an entity's identified climate-related risks and opportunities, paragraph 22(a) requires disclosure of information about the resilience of the entity's strategy and business model to the following factors described in Figure 4-6 below: *[IFRS S2.BC58]*

Figure 4-6: Assessing resilience

Factor	Explanation	Example
Climate-related changes	Such as events or changes resulting from climate change	▸ Pervasive wildfires ▸ Rising sea levels
Climate-related developments	Such as evolving macroeconomic factors, e.g., regulatory responses and demographic shifts	▸ Regulatory limits on the use of particular fossil fuels
Climate-related uncertainties	Such as different confidence intervals associated with climate-related changes and climate-related developments	▸ Assumptions about the pervasiveness of wildfires ▸ Assumptions about the stringency of regulation

A resilience assessment involves interpreting the results of the scenario analysis. In particular, IFRS S2 requires that an entity's disclosure of the assessment of its climate resilience as at the reporting date enables primary users to understand: *[IFRS S2.BC59, IFRS S2.22(a)]*

- The implications (if any) for its strategy and business model, including how the entity would need to respond to the effects identified in the scenario analysis
- The significant areas of uncertainty considered in the entity's assessment of its climate resilience
- The entity's capacity to adjust or adapt its strategy and business model to climate change over the short, medium and long term, including:
  - The availability of, and flexibility in, the entity's existing financial resources to respond to the effects identified in the climate-related scenario analysis, including to address climate-related risks and to take advantage of climate-related opportunities
  - The entity's ability to redeploy, repurpose, upgrade or decommission existing assets
  - The effect of the entity's current and planned investments in climate-related mitigation, adaptation and opportunities for climate resilience

The following Illustration is based on the example used in the Basis for Conclusions to IFRS S2 to explain the type of information that an entity might disclose about the significant areas of uncertainty considered in its climate resilience assessment: *[IFRS S2.BC60]*

Illustration 4-1: Example showing disclosure of significant areas of uncertainty

In performing scenario analysis, Entity A identifies that future climate-driven migration could have implications in the long term for some of the assets and operations of Entity A and its major suppliers that are located near Region X which might become uninhabitable due to rising sea levels. Depending upon where those affected local communities relocate, the ability for Entity A and its suppliers to continue to run their operations at full capacity could be adversely impacted. It is not known whether, where or when the local communities may relocate and the consequential impact on Entity A's operations and its supply chain is also uncertain.

In accordance with paragraph 22(a)(ii) of IFRS S2, Entity A discloses that its resilience assessment is subject to significant uncertainty arising from the effects of future climate-driven migration from Region X, which, in turn, has implications for the stability of Entity A's supply chain and the resilience of its own assets and operations that are located near Region X. Given the time horizon that applies to this risk in the long term, Entity A also discloses that the degree of judgement required to interpret the results of this scenario analysis also increases.

In its 2024 Climate Report, Commonwealth Bank of Australia discloses its assessment of the resilience of its portfolio, as follows:

Practical example 4-2: Commonwealth Bank of Australia (2024) — Australia

Climate Report 2024 [extract]

Risk [extract]

Our approach to climate risk [extract]

Identifying and assessing [extract]

Assessing the resilience of our portfolio

Our assessment of the Bank's resilience to climate risks through the CRMA considers the extent to which industries or regions we lend to are exposed to *physical* or *transition risks*. The table below identifies sub sectors, primarily based on ANZSIC classifications within our portfolio which are exposed to elevated climate-related *physical* or *transition risk*. This year, we have tested the resilience of 48% and 89% of our lending portfolios to potential climate-related *physical* and *transition risks*, respectively.

	Jun 24		Jun 23[1]			
Sectors[2]	**Total sector** TCE $bn	TCE % of total	**Total sector** TCE $bn	TCE % of total	Physical risk[3]	Transition risk[4]
Consumer	**793.0**	**57.5%**	**776.8**	**55.5%**		
Australian home loans exposed to high physical risk[5]	30.3	2.2%	30.1	2.2%	●	
Australian home loans exposed to high cyclone risk	11.0	0.8%	11.0	0.8%	●	
Australian home loans exposed to high flood risk	16.9	1.2%	16.7	1.2%	●	
Australian home loans exposed to high fire risk	1.8	0.1%	1.8	0.1%	●	
Australian home loans exposed to sea level rise	1.6	0.1%	1.6	0.1%	●	
Australian home loans exposed to high transition risk[5]	16.5	1.2%	16.0	1.1%		●
Agriculture & forestry	**32.5**	**2.4%**	**30.0**	**2.1%**		
Dairy	7.2	0.5%	7.4	0.5%	●	●
Livestock	13.5	1.0%	11.9	0.8%	●	●
Transport & storage	**27.9**	**2.0%**	**24.8**	**1.8%**		
Coal terminals[6]	0.3	0.0%	0.4	0.0%		●
LNG terminals[7]	0.2	0.0%	0.2	0.0%		●
Air transport[8]	6.1	0.4%	3.7	0.3%		●
Oil and gas shipping (including FPSO)[9]	0.1	0.0%	0.4	0.0%		●
Rail transport	1.9	0.1%	1.8	0.1%		●
Road transport	4.9	0.4%	4.1	0.3%		●
Pipeline transport	0.8	0.1%	0.9	0.1%		●
Manufacturing	**19.5**	**1.4%**	**19.3**	**1.4%**		
Petroleum refining	0.0	0.0%	0.0	0.0%		●
Heavy industry (steel, alumina, aluminium and cement)[10]	0.9	0.1%	1.0	0.1%		●
Chemicals manufacturing	0.8	0.1%	1.0	0.1%		●
Auto manufacturing	1.3	0.1%	1.2	0.1%		●
Retail trade	**15.7**	**1.1%**	**15.4**	**1.1%**		
Automotive fuel retailing	1.3	0.1%	1.6	0.1%		●
Wholesale trade	**16.8**	**1.2%**	**15.9**	**1.1%**		
Petroleum product wholesaling and marketing	1.9	0.1%	1.8	0.1%		●
Electricity, gas & water	**15.9**	**1.2%**	**13.7**	**1.0%**		
Non-renewable power generation[10,11]	1.5	0.1%	1.9	0.1%		●
Gas supply	0.5	0.0%	0.6	0.0%		●
Mining, oil & gas	**6.9**	**0.5%**	**7.3**	**0.5%**		
Upstream oil and gas exploration and production	1.7	0.1%	2.4	0.2%		●
Thermal coal mining[10]	1.0	0.1%	0.9	0.1%		●
Metallurgical coal mining	0.1	0.0%	0.1	0.0%		●
Total elevated risk	**90.7**	**6.6%**	**87.4**	**6.2%**		
Total TCE	**1,378.1**		**1,400.1**			

...

4.3.3.B Scenario analysis

As noted above, IFRS S2 does not require an entity to disclose the results of its scenario analysis. Instead, IFRS S2 requires disclosure of information about the approach the entity used to carry out its scenario analysis.

In relation to how the scenario analysis was carried out, IFRS S2 requires disclosure of: *[IFRS S2.22(b)]*

- Information about the inputs used in the analysis
- Key assumptions made in the analysis

Disclosures about inputs and assumptions used in the analysis are discussed in Figure 4-7 below (noting these lists are not exhaustive).

Figure 4-7: Scenario analysis inputs and assumptions

Disclosures about inputs	Disclosures about assumptions
▸ Which climate-related scenarios were used for the analysis and the sources of those scenarios ▸ Whether the analysis included a diverse range of climate-related scenarios ▸ Whether the scenarios used are associated with climate-related transition risks or climate-related physical risks ▸ Whether a climate-related scenario aligned with the 'latest international agreement on climate change' was used ▸ Why the entity decided that its chosen scenarios are relevant to assessing its resilience to climate-related changes, developments or uncertainties ▸ The time horizons used in the analysis ▸ What scope of operations (e.g., the operating locations and business units) was used in the analysis	▸ Climate-related policies in the jurisdictions in which the entity operates ▸ Macroeconomic trends ▸ National- or regional-level variables (e.g., local weather patterns, demographics, land use, infrastructure and availability of natural resources) ▸ Energy usage and mix ▸ Developments in technology

The 'latest international agreement on climate change' is defined by IFRS S2 to mean "An agreement by states, as members of the United Nations Framework Convention on Climate Change, to combat climate change. The agreements set norms and targets for a reduction in greenhouse gases.". *[IFRS S2 Appendix A]*.

When the ISSB issued IFRS S2, the Paris Agreement of April 2016 was the latest international agreement on climate change. Signatories to the Paris Agreement agreed to: *[IFRS S2.BC145]*

- Limit the increase in the global average temperature to well below 2 degrees Celsius above pre-industrial levels
- Pursue efforts to limit the temperature increase to 1.5 degrees Celsius above pre-industrial levels

However, the ISSB decided against requiring the use of scenarios consistent with the latest international agreement on climate change or particular science-based scenarios for the following reasons: *[IFRS S2.BC67]*

- It would not be practical to specify which scenarios an entity should be required to use.
- Any scenarios specified in the standards might quickly become out of date and could lead to an entity disclosing information that does not reflect its circumstances or the views of management on what might be plausible.

IFRS S2 requires disclosure of the reporting period in which the climate-related scenario analysis was carried out. This is because the ISSB decided that, for the purposes of IFRS S2, an entity could carry out scenario analysis as part of its multi-year strategic planning cycle (e.g., every 3-5 years) rather than be required to update its scenario analysis at each reporting date.

Although an entity is not required to update its scenario analysis at each reporting date, IFRS S2 requires the entity to: *[IFRS S2.B18, IFRS S2.BC68]*

- At a minimum, update its climate-related scenario analysis in line with its strategic planning cycle
- Assess its climate resilience on an annual basis to reflect updated insight into the implications of climate uncertainty for the entity's business model
- Disclose the information required in section 4.3.3 above at each reporting date, including the information about how and when the scenario analysis was carried out, even if the scenario analysis had not been updated during the reporting period

IFRS S2 only requires scenario analysis to be used in assessing an entity's climate resilience. However, an entity may choose to use scenario analysis to inform a variety of other disclosures that are required by IFRS S2, including: *[IFRS S2.BC69]*

- Identifying and assessing climate-related risks and opportunities (see section 3 above)
- Assessing the anticipated financial effects associated with those risks and opportunities (see section 4.3.3.C below)
- Developing transition plans (see section 4.3.2.A above)

In its 2024 Climate Report, Commonwealth Bank of Australia discloses information about the scenarios used in its scenario analysis. This includes the following information:

Practical example 4-3: Commonwealth Bank of Australia (2024) — Australia

Climate Report 2024 [extract]

Appendix [extract]

4. Approach to climate scenario analysis [extract]

Climate scenario analysis is a rapidly evolving field, with global scenarios regularly produced and updated. We use assumptions and inputs drawing from credible, global climate scenarios produced by parties such as the *Network for Greening the Financial System (NGFS)*.

We review our choice of scenarios to check that, in our view, they present plausible and appropriately severe outcomes; are consistent with market practices (including use by regulators and peer banks); and that they have detailed sector and geographic data readily available.

Depending on the nature of changes in the scenarios, in some cases, we may look to re-run previous analyses using updated information.

Climate scenario analysis considers the effects of climate risk over the long term (~30 years), medium term (~10 years) and short term (~3 years) time horizons. In some cases we may focus on specific time horizons. This approach helps us to consider the changing impacts on the Bank's risk profile over time, due to longer term *chronic physical risks*; increasingly frequent and severe *acute physical risks*; and evolving *transition risks* arising from regulatory change, technological advancements and evolving stakeholder expectations.

Climate scenarios used in the Group Climate Risk Materiality Assessment

Our CRMA was based on the following two severe, but plausible, climate scenarios:

Severe physical risk scenario	Severe transition risk scenario
Source: based on the *NGFS* 'Current Policies' scenario which assumes that only current global and local climate policies are maintained.	**Source:** based on the *NGFS 'Sudden Wake-up Call'* short-term scenario, and the *NGFS 'Delayed Transition'* mid- and long-term scenario.
Scenario description: • Global emissions continue to rise until 2080 and the world warms to >3°C above pre-industrial levels by 2100. • This leads to irreversible changes such as sea level rises and increasing severity and frequency of weather events. For example: – Increasing number of severe cyclones which may track further south. – Fire activity is larger and more intense. – Increased intensity of rainfall events drives moderate increases in flooding in coastal catchments. • Agricultural productivity in certain geographies and commodities decreases significantly by 2050. • Government action and demand for finance shifts towards climate resilience and adaptation measures.	**Scenario description:** • Globally coordinated government policies are rapidly introduced to further reduce greenhouse gas emissions. This is followed by a disruptive transition that ultimately limits global warming to well below 2°C above pre-industrial levels by 2100. • Climate policy leads to a fossil fuel market crash, including asset stranding, abrupt devaluation of polluting firms, and a general tightening of financial conditions. • Stakeholder expectations for corporate action on climate change continue to increase. • Severe weather events continue to increase in intensity to 2030, before stagnating at those levels.

In its 2023 Global Sustainability Report, Nutrien Ltd discloses information about the scenarios used in its scenario analysis. This includes the following information:

Practical example 4-4: Nutrien Ltd (2023) — Canada

Global Sustainability Report 2023 [extract]

Governance [extract]

Nutrien Climate-related Disclosures [extract]

Scenarios

We continue to evaluate, refine and consider various climate scenarios to help identify risks and opportunities and assess the resiliency of our business model. These scenarios are hypothetical and are not intended to be used as forecasts or predictions.

	Transition scenarios	Physical scenarios
Scenario models	International Energy Agency ("IEA") Scenarios: • Announced Pledges Scenario ("APS") • Sustainable Development Scenario ("SDS") • Net Zero Emissions ("NZE") by 2050	The Intergovernmental Panel on Climate Change ("IPCC") Sixth Assessment Report (AR6): • SSP 1-2.6 • SSP 5-8.5 • SSP 2-4.5 A combination of IPCC AR6 scenarios may be best suited for identifying and assessing a potential range of outcomes of future events under conditions of uncertainty
Time horizons	Impact models cover the time horizon over the next 30 years to 2050	Scenario models are focused primarily between the 2030 and the 2050 time horizons as these relate to key milestones for global emissions reductions
Potential key inputs	• Key internal inputs include production estimates, emissions factors and discount rates • External inputs include carbon prices and CO_2 emissions assumptions based on the IEA's World Energy Outlook for the relevant period	• Key internal inputs include our global operational footprint, grower regional locations, historical sales, acreage and yield data • External inputs include historical and projected acres data, inflation rates and the latest IPCC climate datasets covering flood depth, extreme wind, extreme rainfall, wildfire, drought, hail and thunderstorm, heat and cold hazards
Key areas of our organization to be considered	• Nitrogen, Potash and Phosphate operating segments, which account for most of our Scope 1 and 2 GHG emissions profile • Retail growers as nitrogen fertilizer application accounts for a significant portion of our Scope 3 GHG emissions	• Retail with its direct connection to grower customers • Wholesale production operations and key transportation, storage and distribution sites
Potential climate-related risks and opportunities	• Carbon pricing mechanisms • Growers expected to reduce emissions • New technologies or products risk • New strategies and technologies to reduce GHG emissions • New markets for ammonia • Helping growers reduce emissions from agriculture • Reputational risks associated with climate change including our stakeholder's perception of our role in the transition to a lower-carbon economy	• Physical risk to growers • Physical risks to our supply chain and our transportation, distribution and logistics networks • Helping growers deal with chronic impacts of climate change

4.3.3.C Application guidance on preparing climate-related scenario analysis

During the development of IFRS S2, the ISSB received feedback that scenario analysis might be challenging, and especially so for entities that lack the skills, capabilities and resources to carry out that analysis. In response to that feedback, the ISSB confirmed that an entity is required to use climate-related scenario analysis to assess its climate resilience and also: *[IFRS S2.BC62, IFRS S2.BC63]*

- Included application guidance in IFRS S2 for preparing climate-related scenario analysis, noting that scenario analysis encompasses a range of practices, from qualitative scenario narratives to sophisticated quantitative modelling.
- Clarified that the approach an entity uses for scenario analysis needs to be 'commensurate with its circumstances'.

The application guidance in IFRS S2 was developed to support an entity to select an approach to scenario analysis that is commensurate with its circumstances. This application guidance is based on the range of practices outlined in documents published by the TCFD, including, *Technical Supplement: The Use of Scenario Analysis in Disclosure of Climate-related Risks* and *Opportunities* and *TCFD: Guidance on Scenario Analysis for Non-Financial Companies*. [5,6] *[IFRS S2.BC64]*.

This application guidance requires an entity to use an approach to scenario analysis that enables it to consider all reasonable and supportable information available to the entity at the reporting date without undue cost or effort. In making judgements on the selection of an approach to scenario analysis, the application guidance specifies: *[IFRS S2.B1]*

- The factors to consider when assessing an entity's circumstances (see (i) in this section below)
- The factors to consider when determining an entity's appropriate approach to climate-related scenario analysis (see (ii) in this section below)
- Additional factors to consider when determining an entity's approach to climate-related scenario analysis over time (see (iii) in this section below)

5 *Technical Supplement: The Use of Scenario Analysis in Disclosure of Climate-Related Risks and Opportunities,* TCFD, June 2017, available in the TCFD's website.

6 *TCFD: Guidance on Scenario Analysis for Non-Financial Companies,* TCFD, October 2020, available in the TCFD's website.

(i) Assessing an entity's circumstances

Assessing an entity's circumstances requires consideration of: *[IFRS S2.B2]*

- The entity's exposure to climate-related risks and opportunities
- The skills, capabilities and resources available to the entity for the climate-related scenario analysis

An entity's approach to climate-related scenario analysis needs to be commensurate with the entity's circumstances at the time the climate-related scenario analysis is carried out. For example, an entity with a relatively low climate risk exposure and limited resources might develop a scenario narrative that is focused on a key product, business unit or operating location. In contrast, a large entity that is highly exposed to climate risks and has strong analytical expertise might perform sophisticated quantitative modelling that uses a range of scenarios to capture multiple risk transmission channels across the entity's own operations and value chain. *[IFRS S2.BC65].*

Figure 4-8: Assessing an entity's circumstances

Factors to consider	Explanation
Exposure to climate-related risks and opportunities	An entity's exposure to climate-related risks and opportunities will inform the entity's assessment of: ▸ Its circumstances ▸ The approach to use for its climate-related scenario analysis Generally speaking, the greater the entity's exposure to climate-related risks or opportunities, the more likely it is the entity would determine that a more technically sophisticated form of climate-related scenario analysis is required. *[IFRS S2.B4].*
Skills, capabilities and resources available	An entity considers both internal and external skills, capabilities and resources when determining an appropriate approach to use for its climate-related scenario analysis. Context is necessary when assessing an entity's skills and capabilities, noting also that the ISSB expects entities to develop their skills and capabilities and strengthen their disclosures over time through a process of learning and iteration. For instance, an entity that is only just starting to explore scenario analysis in assessing climate resilience or that participates in an industry where scenario analysis is not commonly used might need more time to develop its skills and capabilities. Consequently, such entities might be unable to use a quantitative or technically sophisticated approach to scenario analysis without undue cost or effort. In contrast, an entity that participates in an industry whereby scenario analysis is an established practice (such as the extractive industries) would be expected to have had experience to develop its skills and capabilities. However, if an entity's climate-related risk exposure warrants a sophisticated approach to scenario analysis, IFRS S2 states that the entity cannot use a lack of skills or capabilities to justify using a less sophisticated approach if it has the resources available to invest in obtaining or developing the necessary skills and capabilities. *[IFRS S2.B6, IFRS S2.B7, IFRS S2.BC65].*

Each time an entity carries out scenario analysis, it is required to assess its circumstances. The following Illustration is based on the example used in IFRS S2 to explain when an entity reassesses its circumstances: *[IFRS S2.B3]*

Illustration 4-2: Reassessing an entity's circumstances

Entity A carries out its climate-related scenario analysis every three years to align with its strategic planning cycle. In accordance with paragraph B3 of IFRS S2, Entity A would be required to assess its circumstances every three years when it carries out its scenario analysis. Each time Entity A assesses its circumstances, it needs to reconsider its exposure to climate-related risks and opportunities and the skills, capabilities and resources available at that time.

(ii) Determining the appropriate approach to climate-related scenario analysis

Determining an approach to climate-related scenario analysis that considers all reasonable and supportable information available to the entity at the reporting date without undue cost or effort involves: *[IFRS S2.B8]*

- Selecting inputs to the climate-related scenario analysis
- Making analytical choices about how to carry out the climate-related scenario analysis

According to IFRS S2, reasonable and supportable information includes information that is obtained from an external source or owned or developed internally and is about: *[IFRS S2.B9]*

- Past events
- Current conditions
- Forecasts of future conditions
- Quantitative or qualitative information

Judgement is needed to determine the mix of inputs and analytical choices that enables an entity to consider all reasonable and supportable information that is available to it at the reporting date without undue cost or effort. The degree of judgement required depends on the availability of detailed information and the time horizon (i.e., the degree of judgement required increases as the time horizon increases and the availability of detailed information decreases). *[IFRS S2.B10].*

Selecting inputs

An entity also needs to consider all reasonable and supportable information available to it at the reporting date without undue cost or effort when selecting the scenarios, variable and other inputs to use in its climate-related scenario analysis. *[IFRS S2.B11]*

The ISSB clarified that publicly available climate-related scenarios from authoritative sources that describe future trends and a range of pathways to plausible outcomes are inputs that are available to the entity without undue cost or effort. *[IFRS S2.B11].*

Having a reasonable and supportable basis for selecting a particular scenario or set of scenarios means that the inputs to an entity's climate-related scenario analysis need to be relevant to the entity's circumstances. Therefore, when selecting a scenario or set of scenarios, the entity considers factors such as: *[IFRS S2.B12, IFRS S2.13, IFRS S2.BC66]*

- The type and nature of activities undertaken by the entity
- The geographical location of those activities
- The physical and transition risks to which it is exposed

IFRS S2 does not specify the scenarios that an entity is required to use because the ISSB decided that it would not be practical, the scenarios specified might become outdated and it could lead to information being disclosed that fails to reflect the entity's specific circumstances and management's view of what is plausible. *[IFRS S2.BC67].*

The below Illustration is based on an example used in IFRS S2: *[IFRS S2.B12]*

Illustration 4-3: Selecting relevant scenarios

Entity A's assets and operations are concentrated in Jurisdiction X where emissions are likely to be regulated in the near future. To carry out scenario analysis, Entity A selects a scenario that is consistent with Jurisdiction X's commitments to the latest international agreement on climate change.

IFRS S2 also requires an entity to disclose information such as the number of scenarios used and whether the scenarios cover different outcomes or pathways (such as, orderly and disorderly transition scenarios). This forms part of the requirement to disclose whether the analysis included a diverse range of scenarios. *[IFRS S2.22(b)(i)(2), IFRS S2.BC66].*

How we see it

In our view, IFRS S2 requires an entity to perform scenario analysis using at least two scenarios. Some entities may identify a scenario as their 'base case' for the purposes of identifying the climate-related risks and opportunities that can reasonably be expected to affect their prospects. When this occurs, and depending on facts and circumstances, it may be possible for an entity to meet the disclosure objectives of IFRS S2 by assessing the resilience of the entity's strategy and business model using only one other scenario. However, in our view, good practice is for an entity to assess resilience using at least two other scenarios that are different from the 'base case'. This may include using different scenarios for transition risks and physical risks when assessing resilience of an entity's strategy and business model.

Making analytical choices

Analytical choices include whether an entity uses qualitative analysis or quantitative modelling in carrying out climate-related scenario analysis.

IFRS S2 requires an entity to prioritise the analytical choices that will enable it to consider all reasonable and supportable information that is available to it at the reporting date without undue cost or effort. For example, an entity's resilience assessment needs to incorporate multiple carbon price pathways associated with a given outcome (e.g., a 1.5 degree Celsius outcome) if information about those pathways is available without undue cost or effort and this approach is warranted by the entity's risk exposure. *[IFRS S2.B14].*

In making those analytical choices, the ISSB noted that: *[IFRS S2.B15]*

- The use of quantitative information will often enable a more robust assessment of an entity's climate resilience.
- The use of qualitative information including scenario narratives, which might or might not be combined with quantitative data, can also provide a reasonable and supportable basis for an entity's resilience assessment.

(iii) Additional considerations when determining an entity's approach to climate-related scenario analysis over time

IFRS S2 states that an entity's approach to climate-related scenario analysis may not be the same from one reporting period or strategic planning cycle to the next. *[IFRS S2.B16].* This is because:

- Climate-related scenario analysis is an evolving practice.
- The approach to scenario analysis that an entity uses is based on its particular circumstances (i.e., its exposure to climate-related risks and opportunities and the skills, capabilities and resources available to the entity). Therefore, as those circumstances change over time, the entity's approach to climate-related scenario analysis will change too.

For example, an entity that is highly exposed to climate-related risks might initially carry out scenario analysis by using qualitative scenario narratives because it does not currently have the skills, capabilities or resources to carry out quantitative climate-related scenario analysis. However, as the entity builds its capabilities through experience over time, the entity would begin to apply a more advanced quantitative approach to climate-related scenario analysis. In contrast, an entity that is highly exposed to climate-related risks which does have access to the necessary skills, capabilities or resources, is required to apply a more advanced quantitative approach to climate-related scenario analysis. *[IFRS S2.B17].*

TCFD comparison

The ISSB indicates that IFRS S2 disclosure requirements for an entity's strategy for managing climate-related risks and opportunities is broadly consistent with the TCFD recommended disclosures. However, in its TCFD comparison document, the ISSB noted that there are some differences, including those outlined below.

For disclosures related to an entity's climate-related risks and opportunities, IFRS S2:

- Includes an additional requirement for an entity to refer to and consider the applicability of industry-based disclosure topics in the *Industry-based Guidance on Implementing IFRS S2*, when identifying climate-related risks and opportunities
- Requires more detailed information to be disclosed about where climate-related risks and opportunities are concentrated within an entity's business model and value chain

For disclosures related to the impact of an entity's climate-related risks and opportunities on its business strategy and financial planning, IFRS S2:

- Requires more detailed information about the entity's response to the identified risks and opportunities, including any transition plans that the entity has and how the entity plans to achieve its climate-related targets
- Sets out criteria for when quantitative and qualitative information is required when disclosing the current and anticipated effects of the risks and opportunities on an entity's financial position, financial performance and cash flows
- Sets out the parameters for the information and approach to be used in disclosing the anticipated financial effects (i.e., to use all reasonable and supportable information that is available at the reporting date without undue cost or effort and to use an approach that is commensurate with the entity's circumstances)

For disclosures related to the resilience of the entity's strategy, IFRS S2:

- Does not specify specific scenarios that an entity must use in its climate-related scenario analysis
- Requires more detailed information to be disclosed about the resilience assessment, including significant areas of uncertainty in the assessment, the entity's capacity to adjust and adapt its strategy and business model, and how and when the scenario analysis was carried out
- Sets out the parameters for the information and approach to be used in climate-related scenario analysis (i.e., to consider all reasonable and supportable information that is available at the reporting date without undue cost or effort and to use an approach that is commensurate with the entity's circumstances)

4.4 Risk management

The risk management requirements in IFRS S2 for climate-related risks and opportunities correspond with the risk management disclosure requirements for sustainability-related risks and opportunities in IFRS S1, except that IFRS S2 requires an entity to provide information about the use of climate-related scenario analysis in its risk management processes.

Specifically, IFRS S2 requires an entity to explain whether and how the entity uses climate-related scenario analysis to inform its identification of climate-related opportunities when disclosing information about the processes it uses to identify, assess, prioritise and monitor climate-related opportunities. *[IFRS S2.25(b)]*.

In respect of the remainder of the risk management disclosure requirements in IFRS S2, the commentary in Chapter 52 at section 4.4 on risk management disclosure requirements also applies to the preparation of risk management disclosures relating to climate-related risks and opportunities.

An entity is not required to provide separate risk management disclosures for each sustainability-related risk and opportunity if oversight of the entity's sustainability-related risks and opportunities is managed on an integrated basis. In such cases, an entity is required to avoid unnecessary duplication by providing an integrated risk management disclosure that meets the requirements set out in IFRS S2 and IFRS S1. *[IFRS S2.26]*.

TCFD comparison

The ISSB indicates that IFRS S2 disclosure requirements about risk management for climate-related risks and opportunities is broadly consistent with the TCFD recommended disclosures, which focus more on risks.

For disclosures that describe an entity's processes for identifying, assessing, and managing climate-related risks, the ISSB noted in its TCFD comparison document that IFRS S2:

- Requires more detailed information about: the input parameters that an entity uses to identify risks; if and how the entity uses scenario analysis to identify risks; and whether the entity's processes for identifying, assessing, prioritising and monitoring risks have changed since the last reporting period
- Includes additional disclosures of the entity's processes for identifying, assessing, prioritising and monitoring opportunities

For disclosures related to describing how an entity's processes for identifying, assessing, and managing climate-related risks are integrated into the entity's overall risk management, the ISSB noted that IFRS S2 includes additional disclosures on the extent to which, and how, the processes used to identify, assess, prioritise and monitor opportunities are integrated into and inform the entity's overall risk management process.

4.5 Metrics and targets

The disclosure requirements in IFRS S2 for metrics and targets are much more detailed than the general disclosure requirements for metrics and targets in IFRS S1 because IFRS S2 specifically addresses the metrics and targets that are relevant to climate-related risks and opportunities.

To enable primary users to understand an entity's performance in relation to its climate-related risks and opportunities, including progress towards any of the climate-related targets it has set, and any targets it is required to meet by law or regulation, IFRS S2 requires an entity to disclose:

- Information related to seven cross-industry metric categories (i.e., metrics that are industry agnostic) (see section 4.5.1 below)

- Industry-based metrics associated with the entity's business model and economic activities (i.e., metrics that are relevant to the industry that the entity participates in) (see section 4.5.2 below)
- Climate-related targets, which may be set either by the entity or required by laws or regulations that apply to the entity, to mitigate or adapt to climate-related risks or take advantage of climate-related opportunities, including metrics used by the government body or management to measure progress towards these targets (see section 4.5.3 below) *[IFRS S2.27, IFRS S2.28]*

IFRS S2 requires an entity to disclose information about metrics even if the entity does not have governance arrangements, strategies or risk management processes that address climate-related risks and opportunities. The ISSB clarified that the objective of the disclosures on metrics is to require an entity to disclose information about its performance against: *[IFRS S2.BC73]*

- The metrics it uses for measuring and monitoring climate-related risks and opportunities (which may include metrics that are not specified by IFRS S2)
- The metrics specified by IFRS S2 (even in cases where the entity does not use those metrics to measure and monitor its climate-related risks and opportunities)

4.5.1 Cross-industry metrics

IFRS S2 requires entities to disclose information about seven cross-industry metric categories that the ISSB derived from the TCFD's *Guidance on Metrics, Targets and Transition Plans*[7], which was published in October 2021.

The seven cross-industry metric categories are summarised in Figure 4-9 below. *[IFRS S2.29].*

Figure 4-9: Cross-industry metrics

#	Category	Information to be disclosed
1	GHG emissions	Absolute gross GHG emissions generated during the reporting period (in metric tonnes of CO_2 equivalent), classified as: ▸ Scope 1 GHG emissions ▸ Scope 2 GHG emissions ▸ Scope 3 GHG emissions This disclosure and other GHG-related disclosures are discussed further in sections 4.5.1.A and 5 below.
2	Climate-related transition risks	The amount and percentage of assets or business activities vulnerable to climate-related transition risks (see section 4.5.1.B below)
3	Climate-related physical risks	The amount and percentage of assets or business activities vulnerable to climate-related physical risks (see section 4.5.1.B below).
4	Climate-related opportunities	The amount and percentage of assets or business activities aligned with climate-related opportunities (see section 4.5.1.B below)
5	Capital deployment	The amount of capital expenditure, financing or investment deployed towards climate-related risks and opportunities (see section 4.5.1.C below)
6	Internal carbon pricing	▸ An explanation of whether and how the entity is applying a carbon price in decision-making ▸ The price of GHG emissions (per metric tonne) that the entity uses to assess the costs of its GHG emissions See section 4.5.1.D below.
7	Remuneration	▸ A description of whether and how climate-related considerations are factored into executive remuneration ▸ The percentage of executive management remuneration recognised in the current reporting period that is linked to climate-related considerations See section 4.5.1.E below.

7 *TCFD: Guidance on Metrics, Targets and Transition Plans,* TCFD, October 2021, available in the TCFD's website.

By requiring entities to provide common information to primary users regardless of the industries to which they belong, the cross-industry metrics are intended to allow users to: *[IFRS S2.BC75]*

- Assess an entity's exposure to, and management of, its climate-related risks and opportunities
- Gain an understanding of key aspects and drivers of climate-related risks and opportunities
- Gain insight into the potential effects of climate change on the entity

4.5.1.A GHG emissions disclosures

An entity is required to disclose its absolute gross GHG emissions generated during the reporting period. An entity's gross GHG emissions are classified as: *[IFRS S2.29(a)(i)]*

- Scope 1 GHG emissions
- Scope 2 GHG emissions
- Scope 3 GHG emissions

An entity's disclosure of its GHG emissions is expressed as metric tonnes of CO_2 equivalent. This means that the entity needs to aggregate the seven constituent GHG gases into CO_2 equivalent value. Refer to section 5.3.2 for further discussion.

In its 2023 Annual Report, Standard Chartered plc discloses its total GHG emissions for Scope 1, Scope 2 and Scope 3 (by category) in tonnes of CO_2 equivalent. The footnotes indicate where restatements have been made.

Practical example 4-5: Standard Chartered PLC (2023) **United Kingdom**

Annual Report 2023 [extract]
Sustainability Review [extract]
Sustainability Strategic Pillars [extract]
Pillar 3: Deliver on our annual milestones set forth in our net zero roadmap [extract]
Our emission sources [extract]

Scopes of GHG emissions	2023[4] (tCO_2e)	2022 (tCO_2e)	2021 (tCO_2e)
Scope 1 emissions[1]	**8,488**	2,071	2,902
Scope 2 emissions[2]	**26,246**	47,363	82,761
Total Scope 1 and 2 emissions[3]	**34,734**	49,434	85,663
Scope 3 emissions:			
Category 1: Purchased goods and services (other)	**286,304**	380,732	330,224
Category 1: Purchased goods and services (data centres)[5]	**4,431**	7,060	43,132
Category 2: Capital goods	**42,707**	34,496	47,217
Category 4: Upstream transportation and distribution	**24,125**	20,300	20,949
Category 5: Waste generated in operations[6]	**520**	747	
Category 6: Business travel (air travel)	**60,279**	39,107	3,654
Category 6: Business travel (miscellaneous other than air travel)	**8,918**	2,654	4,994
Category 7: Employee commuting	**71,228**	61,917	
Category 13: Downstream leased assets (real estate)	**7,898**	8,594	
Category 15: Investments[7,8]	**41,944,000**	49,512,000	45,200,000
Total Scope 3 emissions	**42,450,410**	50,067,607	45,650,190
Total emissions	**42,485,144**	50,117,041	45,735,853

1 As we aim to improve our emissions measurement and reporting year-on-year, we have included fugitive emissions in our Scope 1 figures for the first time in 2023: 5,266 tCO_2e. Prior year data was not available for fugitive emissions. For more information on the methodology and assumptions used to calculate GHG emissions, please refer to the Environmental Reporting Criteria at sc.com/sustainabilityhub.

2 Scope 2 indirect emissions include indirect emissions from purchased electricity measured under the market-based approach as set out in the GHG protocol.

3 Our Scope 1 and 2 emissions calculations for the most recent reporting year were independently assured by Global Documentation Ltd., the assurance scope excluded fugitive emissions. Market-based emissions have decreased from 2022 to 2023 due to footprint reduction, efficiency gains and the purchase of additional energy attribution certificates by the Group.

4 The reporting period for GHG emissions is 1 October to 30 September. This only differs for Category 1: Purchased Goods (other); Category 2: Capital goods; Category 4: Upstream transportation and distribution; Category 6: Business travel (miscellaneous other than air travel) and Category 15: Investments where a period of 1 January to 31 December is used. Emissions data for these categories is also on a one-year lag with emissions reported in 2023 based on 2022 emissions data.

5 Purchased goods and services (data centres) have been restated from 706tCO_2e to 7,060tCO_2e due to an error in converting the unit of emissions.

6 Waste emissions have been restated from 498tCO_2e to 747tCO_2e due to an out of date emissions factor being used in prior year.

7 Category 15: Investments only includes financed emissions and are measured on a one-year lag, with emissions reported in 2023 being based on 2022 emissions and financial data. Financed emissions are included on page 110. A facilitated emissions baseline was measured for the first time during the year. Refer to page 112 for more details.

8 2022 absolute emissions have been restated from 58.5$MtCO_2e$ to 49.5$MtCO_2e$. This is due to (i) reduction in shipping absolute emissions as improved data has resulted in individual ship-level fair values being obtained; (ii) pausing of aviation emissions reporting due to the sale of the Group's aviation leasing and lending business; (iii) decreases in Automotive Manufacturers' emissions due to changes in the industry emissions reporting methodology referenced earlier on page 95; (iv) decreases in emissions from the 'Others' sector where improved data has been obtained to calculate emissions; and (v) the sectoral baselining of emissions reporting for Cement and Commercial Real Estate as separate high-emitting sectors.

In its 2023 Annual Report, Magna International Inc. discloses information about its GHG intensity metrics.

Practical example 4-6: Magna International Inc. (2023) — Canada

FY 2023 Sustainability Report [extract]

Sustainability Metrics [extract]

5.1 Energy Management and Emissions [extract]

5.1.2 Emissions

Energy consumed can be converted to CO_2 emissions based on regional conversion factors. In order to help us and our stakeholders better assess trends related to the emissions we generate, we track emissions "intensity" on the basis of total sales, employee headcount and aggregate square footage of our facilities and offices. These intensity metrics assist us in determining whether we are becoming more efficient by normalizing emissions on a per dollar of sales, per employee and per square footage basis. The raw data for Scope 1 & 2 emissions, together with intensity metrics are set out below. Magna adheres to the GHG Protocol Corporate Accounting and Reporting Standard ("GHG Protocol") for its Scope 1 and 2 reporting. Magna adheres to the GHG Protocol Corporate Value Chain (Scope 3) Standard and guidance from the SBTi for its Scope 3 reporting. We use commonly accepted emission factors such as those available from the GHG Protocol, International Energy Association (IEA), United States EPA, including its eGrid database, United Kingdom Department for Energy Security and Net Zero, ecoinvent and CEDA (Comprehensive Environmental Data Archive), as well as other local or regional references. Our Scope 1 and 2 emissions data is verified annually by an independent third party verification firm.

ISSB S2, 29(a)(i)	2023	2022	2021[1]
Scope 1 Emissions (metric tons)	424,561	433,636	436,267
Scope 2 Emissions (metric tons)[1]	1,150,656	1,168,803	1,089,730
Scope 1 & 2 Emissions (metric tons)[2]	1,575,217	1,602,439	1,525,997
Sales (USD, millions)	42,797	37,840	36,242
Sales Intensity (CO_2 metric tons/$ Sales)	0.0000368	0.0000424	0.0000421
Employees	179,000	168,000	158,000
Employee Intensity (metric tons/employee)	8.8	9.5	9.7
Square Footage (million sq. ft)	83.8	84.4	83.5
Square Footage Intensity (metric tons/sq. ft.)	0.0186	0.0189	0.0183

Notes:
(1) Market-based emissions calculation method.
(2) Sales Intensity, Employee Intensity and Square Footage Intensity are calculated based on combined Scope 1 and 2 Emissions.

In connection with our net-zero commitment and submission of near-term and net-zero targets to SBTi for validation, we submitted our Scope 1, 2 and 3 baseline emissions for 2021 as per the table below:

Emission Type	2021 Baseline Year
Scope 1 (tCO_2e)	436,267
Scope 2 (tCO_2e)	1,089,730
Scope 3 (tCO_2e)	58,655,441
Total	60,181,438

IFRS S2 requires the *Greenhouse Gas Protocol: A Corporate Accounting and Reporting Standard* (2004) to be used to measure an entity's GHG emissions unless a jurisdictional authority or a securities exchange on which the entity is listed requires a different method to be used to measure the entity's GHG emissions. *[IFRS S2.29(a)(ii)]*. The *Greenhouse Gas Protocol: A Corporate Accounting and Reporting Standard* (2004) is one of the publications that are collectively referred to as the GHG Protocol. Refer to section 5 below for more details on the GHG Protocol and the use of other methods.

An entity is required to disclose the approach that it uses to measure GHG emissions, including: *[IFRS S2.29(a)(iii)]*

- The measurement approach, inputs and assumptions used to measure its GHG emissions
- The reason why the entity has chosen the measurement approach, inputs and assumptions used to measure its GHG emissions
- Any changes the entity made to the measurement approach, inputs and assumptions during the reporting period and the reasons for those changes (see section 5.3.1 below for further discussion)

In its 2023 Climate-Related Disclosures Report, Scales Corporation Limited discloses information about measurement approach, inputs and assumptions the entity uses to measure its GHG emissions:

Practical example 4-7: Scales Corporation Limited (2023) **New Zealand**

Climate-Related Disclosures Report - 2023 [extract]

5. Metrics and Targets [extract]

5.2.3 Inclusions [extract]

Table 6: Inclusions, methodologies and uncertainties

Scope	Emission Category	Activity	Data Source	Gwp Source	Methodology, Data Quality, Uncertainty (Qualitative)
Scope 1	Stationary combustion	Fossil fuels used by plant equipment	Invoices	MFE guidelines 2023	Fuel based method. Low uncertainty
	Mobile combustion	Fossil fuels used by fleet/pool vehicles and forklifts	Fuel purchase transaction history	MFE guidelines 2023	Fuel based method. Low uncertainty
	Fugitive emissions	Refrigerant used by refrigeration equipment	Maintenance reports and invoices	MFE guidelines 2023	Top up method. Applicable to Scales' owned refrigeration equipment. Low uncertainty
Scope 2	Purchased energy	Electricity consumption	Invoices	Selection of electricity grid factors by operating location	Location based method. High data quality and low uncertainty due to complete invoice sets
Scope 3	Business travel	Air travel	Travel itineraries, reimbursements, credit card purchase history	MFE guidelines 2023, Consumption emissions modelling report	Hybrid method. Distance based where data is available, otherwise dollars spent. Variable data quality, medium uncertainty overall
		Rental car/taxis	Travel itineraries, reimbursements, credit card purchase history	MFE guidelines 2023, Consumption emissions modelling report	Hybrid method. Distance/fuel based for rental cars where data is available, otherwise dollars spent. Dollars spent for taxis. Variable data quality, medium uncertainty overall
		Hotels and accommodation	Travel itineraries, reimbursements, credit card purchase history	MFE guidelines 2023, Consumption emissions modelling report	Nights stayed method. Country selected based on itineraries, and conservatively approximated where unspecified. High uncertainty overall
	Employee commuting	Employee commuting and working from home	Internal reports/ staff survey	MFE guidelines 2023	Distance based method to determine commuting, days working from home approximated. Data quality is low due to difficulty in validating survey results. High uncertainty
	Upstream transportation and distribution	Movement of product from suppliers	Logistics shipping and freight reports	UK GHG conversion factors 2023	Tonnes km (tkm) based method. Distances and weight determined between supplier and plant. Only includes emissions from upstream freight we are responsible for. Variable data quality, medium uncertainty
	Downstream transportation and distribution	Movement of product to customers	Logistics shipping and freight reports	MFE guidelines 2023, UK GHG conversion factors 2023	tkm based method. Distances and weight determined between plant and customer. Only includes emissions from downstream freight we are responsible for. Variable data quality, medium uncertainty
	Purchased goods and services	Coldstores/toll processing provided by a third party (toll processing relates specifically to Shelby)	Third-party supplier warehouse volume reports/invoices	Selection of electricity grid factors by operating location	Hybrid method. Used data from owned facilities to extrapolate out to third-party coldstorage and toll processing sites. For coldstorage we used m3 to kWh conversion factor. High uncertainty
	Fuel and energy related activities	Transmission and distribution (T&D) losses		Selection of electricity T&D loss factors by operating location	Electricity consumption approach. Methodology as per MFE guidelines. Grid-average transmission losses-estimation based on national generator and consumption totals. High data quality, low level of uncertainty.
		Well-to-tank emissions		UK GHG conversion factors 2023	Fuel consumption approach, methodology based on UK GHG conversion factors. High data quality, medium uncertainty.
	Waste generated in operations	Waste	Supplier invoices and waste reports	MFE guidelines 2023	Hybrid method. Weight based where data is available, otherwise weight is estimated by bin volumes and number of collections. Landfills use gas capture technology. Variable data quality, medium uncertainty
		Water supply and wastewater	Council invoices and meter data	MFE guidelines 2023	Hybrid method. Volume based where council data is available for processing sites. Per capita basis for office spaces. Domestic wastewater treatment factors used as industrial factors are unavailable. Variable data quality, medium uncertainty
	Upstream leased assets	Short-term leased space	Property measurements and invoices	MFE guidelines 2023	Estimate based on energy intensity (square meter energy consumption) of existing sites for offices. Used site footprints and m3 to kWh conversion factor for coldstore consumption. High uncertainty

Additional disclosure requirements relating to an entity's absolute gross Scope 1, Scope 2 and Scope 3 GHG emissions are outlined in Figure 4-10 below. *[IFRS S2.29(a)(iv)]*.

Figure 4-10: GHG emissions disclosures

GHG emissions	Specific disclosures
Scope 1 and Scope 2	An entity is required to disaggregate Scope 1 and Scope 2 GHG emissions between: ▸ The consolidated accounting group (e.g., the parent and its consolidated subsidiaries); and ▸ Other investees excluded from the consolidated accounting group (e.g., investees include associates, joint ventures and unconsolidated subsidiaries) An Illustration of this disaggregation is provided in Illustration 4-4 below.
Scope 2	For Scope 2 GHG emissions, an entity discloses: ▸ Its location-based Scope 2 GHG emissions ▸ Information about any contractual instruments that will inform users' understanding of the entity's Scope 2 GHG emissions (i.e., IFRS S2 does not require an entity to also disclose its market-based Scope 2 GHG emissions) The meaning of 'location-based' and 'market-based' Scope 2 GHG emissions is discussed further in section 5.2.3 below.
Scope 3	For Scope 3 GHG emissions, an entity is required to disclose the categories included within the entity's measure of Scope 3 GHG emissions, in accordance with the Scope 3 categories described in the *Greenhouse Gas Protocol Corporate Value Chain (Scope 3) Accounting and Reporting Standard (2011)*. These categories are: ▸ Category 1. Purchased goods and services ▸ Category 2. Capital goods ▸ Category 3. Fuel- and energy-related activities (not included in Scope 1 or Scope 2) ▸ Category 4. Upstream transportation and distribution ▸ Category 5. Waste generated in operations ▸ Category 6. Business travel ▸ Category 7. Employee commuting ▸ Category 8. Upstream leased assets ▸ Category 9. Downstream transportation and distribution ▸ Category 10. Processing of sold products ▸ Category 11. Use of sold products ▸ Category 12. End-of-life treatment of sold products ▸ Category 13. Downstream leased assets ▸ Category 14. Franchises ▸ Category 15. Investments Additional disclosures are required for Scope 3 'financed emissions' if an entity is engaged in asset management, commercial banking or insurance activities. Financed emissions are discussed further in section 5.7 below.

The following Illustration is based on Illustrative Example 1 in *Accompanying Guidance on Climate-related Disclosures*: *[IFRS S2.IE3, IFRS S2.IE4, IFRS S2.IE5]*

Illustration 4-4: Disaggregating Scope 1 and Scope 2 GHG emissions

Entity A has an 80% interest in SubCo and a 40% interest in an incorporated joint venture, JVCo. Entity A and the other parties to the joint venture jointly control JVCo. Entity A has been appointed as the operator of JVCo, which means that Entity A is responsible for managing and conducting the activities and operations approved by the joint venturers.

Entity A prepares financial statements in accordance with IFRS accounting standards. In accordance with IFRS accounting standards, Entity A prepares consolidated financial statements which present the assets, liabilities, equity, income, expenses and cash flows of Entity A and the entities it controls as single economic entity. Entity A determines that it controls SubCo. The reporting entity of Entity A's consolidated financial statements, therefore, consists of Entity A and SubCo. The assets, liabilities, equity, income, expenses and cash flows of JVCo are not included in the Entity A consolidated group because Entity A does not control JVCo. Instead, Entity A recognises its interest in JVCo as an equity accounted investment.

Entity A's consolidated group is also the reporting entity for the preparation of Entity A's sustainability-related financial disclosures, including its disclosure of GHG emissions. Entity A has selected the operational control approach[8] to measure its GHG emissions. Because Entity A has operational control over JVCo, all of JVCo's GHG emissions are included in Entity A's GHG emissions (as the reporting entity).

The Scope 1 and Scope 2 GHG emissions for each individual entity is:

	GHG emissions (metric tonnes CO_2e)		
	Scope 1	**Scope 2**	**Total**
Entity A (parent)	1,000	350	1,350
SubCo	3,000	800	3,800
JVCo	6,000	1,400	7,400

The Scope 1 and Scope 2 GHG emissions for the Entity A reporting entity in accordance with operational control is measured as follows (noting that by having operational control, Entity A would include 100% of the GHG emissions into the measurement of its GHG emissions):

	GHG emissions (metric tonnes CO_2e)		
	Scope 1	**Scope 2**	**Total**
Entity A (parent)	1,000	350	1,350
SubCo	3,000	800	3,800
JVCo	6,000	1,400	7,400
Total	10,000	2,550	12,550

In accordance with paragraph 29(a)(iii) of IFRS S2, Entity A discloses the disaggregation of its Scope 1 and Scope 2 GHG emissions between the consolidated group and its other investee as follows:

	GHG emissions (metric tonnes CO_2e)		
	Scope 1	**Scope 2**	**Total**
Entity A consolidated group	4,000	1,150	5,150
Investment in JVCo	6,000	1,400	7,400
Total Scope 1 and Scope 2 GHG emissions (operational control basis)	10,000	2,550	12,550

8 The operational control approach is discussed is section 5.2.2.B (ii) below.

Frequently asked questions

Question 4-2: Does Category 15: Investments apply only to financial institutions?

Category 15 is relevant for any entity with investments that are not included in the entity's Scope 1 and Scope 2 GHG emissions. Financial institutions such as commercial banks often have a large number of investments in this category.

Question 4-3: How do the requirements in IFRS S1 for comparative information apply to the disclosure of GHG emissions when a subsidiary in a group has been acquired or disposed of?

(TIG meeting 13 June 2024 - Agenda paper no. 2, ISSB meeting 24 July 2024 - Agenda paper no. 9)

Having considered its issue in Question 5-1 of Chapter 52, the TIG further discussed the application of the requirements in IFRS S1.70 about comparative information when applying IFRS S2 when there has been a change in the composition of the reporting entity (such as the acquisition or disposal of a subsidiary) and whether IFRS S2 would require a different approach than IFRS S1.

The TIG noted that IFRS S1.70 applies to all information disclosed using ISSB standards, unless another ISSB standard requires or allows otherwise. Considering this requirement, the TIG agreed that since IFRS S2 does not include any additional specific requirements related to the disclosure of comparative information, the principles of IFRS S1 need to be applied in the application of IFRS S2. Therefore, consistent with the outcome for Question 5-1 in Chapter 52, the TIG agreed that when there has been a change in the composition of the reporting entity as a result of acquiring or disposing of a subsidiary, comparative climate-related information reflects the composition of the reporting entity in the related financial statements in the comparative period. That is, for information accompanying the consolidated financial statements, what information is given will depend on the composition of the group at that time, in accordance with applicable GAAP.

In its discussion, the TIG considered the requirement in IFRS S2 to measure GHG emissions in accordance with the GHG Protocol. IFRS S2.29a(ii) requires an entity to measure its GHG emissions in accordance with the GHG Protocol only to the extent that the requirements in the GHG Protocol do not conflict with the requirements in IFRS S2. Apart from requirements associated with the measurement of GHG emissions, the GHG Protocol also includes requirements associated with other aspects of GHG emissions reporting. However, the TIG referred to IFRS S2.B23 and agreed that an entity is only required to use the GHG Protocol to measure the GHG emissions of the reporting entity using the relevant measurement approach selected in applying the GHG protocol. That is, the GHG Protocol is only used to measure what is required to be disclosed by ISSB standards and any other requirements in the GHG Protocol (including those relating to comparative information) would not affect the application of IFRS S1 requirements. Therefore, the information provided for the current reporting period and the comparative period relating to GHG emissions needs to reflect the composition of the reporting entity at each of those points in time based on the applicable GAAP, in accordance with IFRS S1.

The TIG also pointed out the fact that while information about GHG emissions is required to be provided for the consolidated group (according to the applicable GAAP), the composition of the group does not limit the choice of approach about how the emissions are measured. Any of the alternative GHG emissions measurement approaches included in the GHG Protocol is available to the entity and permitted by IFRS S2 (see further discussion at section 5.2.2). The difference between the boundaries of a reporting entity and the approach to measurement may not necessarily lead to a direct relationship between changes in the reporting entity and changes in the measurement of GHG emissions. The TIG used the following example: An entity acquires a subsidiary in the current period but had operational control over that subsidiary's operations in the comparative period. The change in the reporting entity in the current period does not lead to any change in the measurement of the GHG emissions for the reporting entity with respect to the comparative period because the entity already had operational control over the subsidiary for the comparative period.

Question 4-4: : When an entity estimates Scope 3 GHG emissions in the current period by using information disclosed in the prior period, in applying the requirements of IFRS S1.B50, does that entity need to revise those estimated amounts in the following year when these become comparative information?

(TIG meeting 13 June 2024 - Agenda paper no. 1, ISSB meeting 24 July 2024 - Agenda paper no. 9)

The TIG discussed a situation where a reporting entity has the same reporting period as an entity in its value chain but the information about Scope 3 GHG emissions included in Category 15 Investments of that entity in its value chain is not available in time for the reporting entity's year-end reporting. Therefore, to estimate its GHG emissions for the current reporting period, the reporting entity uses, as a reasonable estimate, the information disclosed by the entity in its value chain from the prior period.

Illustration 4-5: Estimated information for the comparative period

Entity A is the reporting entity and Entity B is an entity that is included in Entity A's value chain. Both entities have a 12-month reporting period that ends on 31 December. Entity A reports two years of information, the current reporting period (ended 31 December 20X2) and comparative period (ended 31 December 20X1) by estimating and disclosing GHG emissions information as follows:

- In its prior period report (20X1), Entity A used GHG emissions data from Entity B's 20X0 report as an estimate for 20X1.
- For its current period (20X2), Entity A used GHG emissions data from Entity B's 20X1 report as a reasonable estimate for 20X2.
- For its comparative period in the 20X2 report (i.e., 20X1 information included as comparative information in the 20X2 report), Entity A updated the comparative period's estimated amounts based on the new information as it now has the actual data of Entity B's 20X1 report.

As a result, Entity A uses for both 20X2 (Entity B's 20X1 published GHG emissions data as an estimate) and 20X1 (actual Entity B's 20X1 published GHG emissions data) the same 20X1 GHG emissions data set.

The TIG considered the concerns raised in the situation described above with respect to the comparability of information reported when applying IFRS S1.B50(a) and whether changes as a result of decarbonisation, in Entity B's GHG emissions would be reflected appropriately over time. However, the TIG agreed that even in such situations, it is still necessary to apply the requirements of IFRS S1.B50 to revise preceding period estimates (assuming these have been considered by the entity as a reasonable estimate) when presenting comparative information to reflect new information that provides evidence of circumstances that existed in that preceding period. In doing so, the entity will provide primary users with information about what was changed, how much it changed by and why it was changed.

During its discussion, the TIG pointed out the following:

- IFRS S1.B50 requires an entity to revise an estimated amount disclosed in the preceding period if new information is identified and the new information provides evidence of circumstances that existed in the preceding period. However, purely revising the estimates to comply with this requirement would not be sufficient. An entity is also required to disclose the difference between the amount disclosed in the preceding period and the revised comparative amount, as well as to explain the reasons for revising the comparative amount. Such information, which complements the revised estimates, enhances the primary users' understandability of the disclosed information (see discussion in Chapter 52 at section 3.1.1.B). Moreover, current period disclosure about the likelihood of revising estimates in future periods (e.g., in anticipation of receiving updated information for an estimated amount that is currently being disclosed) could be material to users (see also Chapter 52 at section 6.2.2 for further discussion on disclosure requirements about measurement uncertainties).
- In preparing disclosures to meet the requirements in IFRS S1.B50, an entity is required to apply materiality. Whether information is material is a matter of judgement and depends on the facts involved and the circumstances of a specific entity. An entity needs to determine whether revising preceding period estimated amounts when providing comparative information as well as providing information about the difference between a preceding period amount and a current period revised amount is material. An entity may assess, based on both qualitative and quantitative factors, that such information would influence decisions that primary users make or may determine that this is not material information and therefore, not apply the requirements IFRS S1.B50. See discussion on the application of materiality in Chapter 52 at section 3.2.
- The TIG noted that, although the question was discussed in the context of Scope 3 Category 15 GHG emissions for an entity operating in the financial services industry, the outcome and the points

emphasised above would be equally applicable to all other metrics that are estimates (in specific circumstances) and to entities across different industries. However, the TIG made some additional points that specifically apply to the measurement of Scope 3 GHG emissions:

- The approach of using prior period information from an entity in the value chain as the basis to estimate current period information is appropriate in the circumstances of an entity to measure GHG emissions according to the requirements in IFRS S2. This includes the use of a measurement approach, inputs and assumptions that result in a faithful representation of this measurement as well as the use all reasonable and supportable information that is available to the entity at the reporting date without undue cost or effort (for further discussion, see section 5.6.1 above).
- IFRS S1 and IFRS S2 are applied together. Requirements in IFRS S1 are applied in the context of the overall disclosure objective and specific disclosure objectives in IFRS S2. Therefore, the TIG emphasised the requirements of IFRS S2 with respect to providing information that: a) enables primary users to understand the most significant uncertainties affecting amounts reported in an entity's sustainability-related financial disclosures (see Chapter 52 at section 6.2.2), b) is a complete, neutral and accurate depiction of an entity's sustainability-related risks and opportunities (see Chapter 52 at section 3.1), c) is of sufficient quality and quantity and includes estimates for which reasonable assertions and inputs are used (see Chapter 52 at section 3.1.1.B) and, d) is clear and concise (see Chapter 52 at section 3.1.1.B).

4.5.1.B Assets or business activities vulnerable to climate-related risks or aligned to climate-related opportunities

An entity is required to disclose the amount and percentage of assets or business activities that are:

- Vulnerable to climate-related transition risks
- Vulnerable to climate-related physical risks
- Aligned with climate-related opportunities

These disclosures are required separately for transition risks, physical risks and opportunities.

Figure 4-11 below lists some example metrics, which are provided in *Accompanying Guidance on IFRS S2 Climate-related Disclosures*.

Figure 4-11: Cross-industry metrics relating to risks and opportunities

Metric category	Example metrics (expressed in amount and percentage)
Climate-related transition risks	▸ volume of real estate collaterals highly exposed to transition risk ▸ concentration of credit exposure to carbon-related assets ▸ percentage of revenue from coal mining ▸ percentage of revenue passenger kilometres not covered by the Carbon Offsetting and Reduction Scheme for International Aviation
Climate-related physical risks	▸ proportion of property, infrastructure or other alternative asset portfolios in areas subject to flooding, heat stress or water stress ▸ proportion of real assets exposed to climate-related hazards ▸ number and value of mortgage loans in 100-year flood zones ▸ wastewater treatment capacity located in 100-year flood zones ▸ revenue associated with water withdrawn and consumed in regions of high or extremely high baseline water stress
Climate-related opportunities	▸ revenues from products or services that support the transition to a lower-carbon economy ▸ net premiums written related to energy efficiency and lower-carbon technology ▸ number of (1) zero-emissions vehicles, (2) hybrid vehicles and (3) plug-in hybrid vehicles sold ▸ proportion of homes delivered certified to a third-party, multi-attribute, green-building standard

In preparing these disclosures, IFRS S2 states that an entity must use all reasonable and supportable information that is available to the entity at the reporting date without undue cost or effort. *[IFRS S2.30].* The application of this requirement is discussed further in sections 4.3.1.C above as well as Chapter 52 at section 1.2.2.B.

Frequently asked questions

Question 4-5: What do the terms 'business activities' and 'vulnerable' mean in the absence of definitions in IFRS S2?

(TIG meeting 15 March 2024 - Agenda paper no. 1, ISSB meeting 16 May 2024 - Agenda paper no. 9)

The TIG agreed with the ISSB staff analysis that the nature of an entity's assets and business activities and associated vulnerabilities could vary greatly, depending on the entity. The ISSB staff explained that this is why specific metrics are not prescribed in paragraph 29 of IFRS S2. Instead, decisions about the disclosure of those metrics should be made in the context of the disclosure objectives of IFRS S2. The disclosure objectives provide an entity with an 'anchor' to apply judgement to determine the information to be disclosed and the level of granularity at which that information is disclosed. The information that is required to be disclosed is that which is reasonably expected to influence an investor decision, which also means that materiality judgements are critical in determining the information to provide.

The TIG observed that factors that could be considered when identifying 'business activities' include:

- Activities that are exposed to climate-related risks which may impact the entity's operations and future performance. This is based on the specific disclosure objectives on metrics and targets to enable primary users to understand 'an entity's performance' in relation to such risks.
- The types of activities involved in revenue generation or that result in costs incurred.
- Activities based on the various types of operations within the business.

This determination will require an entity to exercise judgement including considering the disclosure that would provide the most decision-useful information to primary users.

Given IFRS S2 requires an entity to disclose separately the business activities vulnerable to physical risks and transition risks because those types of risks might materialise over different time horizons, the TIG also observed that this fact should be considered when determining the types of business activities impacted by physical or transition risks.

The TIG also made the following observations on the term 'vulnerable':

- An entity's 'exposure' to a risk is a helpful guide for determining 'vulnerability' to a risk.
- An assessment of the breadth and composition an entity's value chain is relevant in identifying potential vulnerabilities across the business as a result of climate-related risks.
- The *Industry-based Guidance on implementing IFRS S2* might assist in the identification of relevant types of vulnerabilities based on the entity's business.
- Scenario analysis can provide insights into the entity's exposure to climate-related risks and, therefore, the resulting vulnerabilities.
- An entity might consider the inputs for an asset impairment test for financial statement preparation purposes, as part of an assessment of vulnerabilities across assets for sustainability-related financial disclosures.

In its 2023 Annual Report, NZX Limited discloses information about cross-industry metrics:

Practical example 4-8: NZX Limited (2023) **New Zealand**

2023 Annual Report [extract]

NZX 2023 CLIMATE STATEMENT [extract]

5. Metrics & Targets [extract]

5.2 Other metrics [extract]

Cross-industry metric category	
Transition risks: Assets or business activities vulnerable	72.1% of total operating revenue (Capital Markets Origination, Secondary Markets and Funds Management revenue streams)
Physical risks: Assets or business activities vulnerable	9.7% of total assets (Property, plant & equipment and right-of-use lease assets)
Climate-related opportunities: revenue, assets or business activities	No assets linked to climate-related opportunities
Capital deployment: capital expenditure, financing or investment	No capital is currently deployed in low-emissions products and services
Internal emissions price:	$143 per tCO_2e (Price of carbon credit offsets that we purchase from Toitū)
Remuneration	Air travel-linked KPIs (Air travel is NZX's largest emission source)

4.5.1.C Capital deployment

An entity is required to disclose the amount of capital expenditure, financing or investment deployed towards climate-related risks and opportunities. *[IFRS S2.29(e)]*.

IFRS S2 does not provide application guidance that is specific to this disclosure requirement, but it does provide some general guidance, which is outlined in section 4.5.1.F below. In addition, the Accompanying Guidance on IFRS S2 lists the following as example metrics:

- Percentage of annual revenue invested in research and development of lower-carbon products/services
- Percentage of investment in climate adaptation measures (for example, soil health, irrigation and technology)

The following Practical Examples illustrate the disclosure of information about capital deployment:

Practical example 4-9: Z Energy Limited (2023) New Zealand

Climate Statements [extract]
Metrics and Targets [extract]
Exposure to transition and physical risks [extract]

Capital deployment

Expenditure against future energy solutions commitments under Overseas Investment Act

In 2022, a commitment was made as part of Ampol's application for consent under the Overseas Investment Act 2005 to acquire Z to spend at least $50 million toward low carbon investments by 30 April 2029 to support future energy solutions in New Zealand. At the end of 2023, $47.8 million (which includes $17.5m for taking the Group's holding in Flick Energy to 100 per cent) has been spent aligned with this commitment.

2023 total capital expenditure on climate-related risks and opportunities

Total capital expenditure, financing and investment deployed towards climate-related risks and opportunities in 2023 was $32.6 million, and included investment in the following climate-related risks and opportunities:

Description	Associated risk/opportunity	Approach and assumptions
EV charging rollout	Reputation Market and technology changes Investment in low carbon Optimise asset base	Installation of additional 82 EV charging bays at Z retail sites
Additional capital investment in Flick	Reputation Market and technology changes Invest in low carbon	Additional capital investment in Flick Electric to bring Z's ownership up to 100%
Investment in Red Phase	Reputation Market and technology changes Investment in low carbon Optimise asset base	Investment in Red Phase
Forest Partners	Emissions Trading Scheme (ETS) Obligations	Investment in the Forest Partners forestry joint venture to help meet Z's future carbon credit obligations

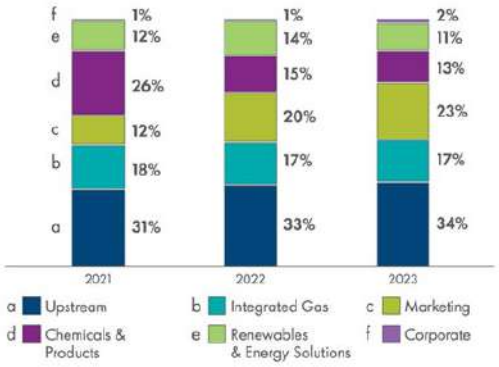
Practical example 4-10: Shell plc (2023) **United Kingdom**

Annual Report and Accounts [extract]

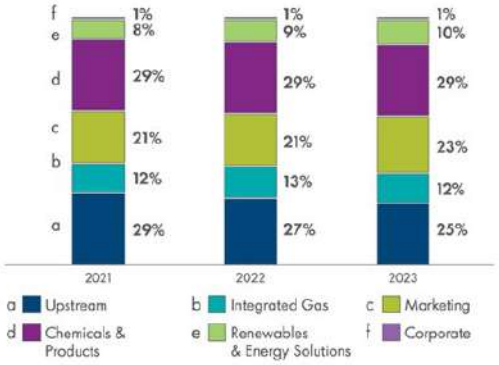
Our journey to net zero [extract]

Energy transition strategy [extract]

Cash capital expenditure evolution by segment



Operational expenditure evolution by segment



Cash capital expenditure by segment for 2024 is expected to be approximately $8 billion for Upstream, $5 billion for Integrated Gas, $3 billion for Marketing, $3-4 billion for Chemicals and Products, and $4-5 billion for Renewables and Energy Solutions.

Investing in the energy transition

Total cash capital expenditure* of $24.4 billion in 2023

Non-energy products [A]	Low-carbon energy solutions [B]
$2.3 billion	$5.6 billion
LNG, gas and power marketing and trading [C]	**Oil, oil products and other [D]**
$4.0 billion	$12.5 billion

[A] Products for which usage does not cause Scope 3, Category 11 emissions: Lubricants, Chemicals, Convenience Retailing, Agriculture & Forestry, Construction & Road.
[B] E-Mobility and Electric Vehicle Charging Services, Low-Carbon Fuels, Renewable Power Generation, Environmental Solutions, Hydrogen, CCS. We define low-carbon energy products as those that have an average carbon intensity that is lower than conventional hydrocarbon products, assessed on a life-cycle basis.
[C] LNG Production & Trading, Gas & Power Trading, and Energy Marketing.
[D] Upstream segment, GTL, Refining & Trading, Marketing fuel and hydrocarbon sales, Shell Ventures, Corporate segment.

Movements in cash capital expenditure in 2023 versus 2022 were driven by:

- Non-energy products: 41% lower in 2023 than in 2022 due to the completion of Shell Polymers Monaca in 2022 and greater inorganic expansion in Lubricants and Convenience Retailing in 2022.
- Low-carbon energy solutions: increased by 30% mainly due to the acquisition of Nature Energy (nearly $2 billion) and the roll-out of electric vehicle charging.
- LNG, gas and power marketing and trading: comparable year on year.
- Oil, oil products and other: remained at a similar level to 2022.

Energy transition: Total cash capital expenditure* by segment

$ billion

Classification	Segment	2023		2022	
Non-energy products [A]	Marketing	0.9	2.3	1.5	3.9
	Chemicals and Products	1.4		2.4	
Low-carbon energy solutions [B]	Marketing	3.3	5.6	1.4	4.3
	Renewables & Energy Solutions	2.3		2.9	
LNG, gas and power marketing and trading [C]	Integrated Gas	3.7	4.0	3.8	4.2
	Renewables & Energy Solutions	0.3		0.4	
Oil, oil products and other [D]	Integrated Gas	0.5	12.5	0.5	12.5
	Upstream	8.3		8.1	
	Marketing	1.4		2.0	
	Chemicals and Products	1.8		1.4	
	Renewables & Energy Solutions	0.1		0.2	
	Corporate	0.4		0.3	
Total		24.4	24.4	24.8	24.8

[A] Products for which usage does not cause Scope 3, Category 11 emissions: Lubricants, Chemicals, Convenience Retailing, Agriculture & Forestry, Construction & Road.
[B] E-Mobility and Electric Vehicle Charging Services, Low-Carbon Fuels, Renewable Power Generation, Environmental Solutions, Hydrogen, CCS. We define low-carbon energy products as those that have an average carbon intensity that is lower than conventional hydrocarbon products, assessed on a life-cycle basis.
[C] LNG Production & Trading, Gas & Power Trading, and Energy Marketing.
[D] Upstream segment, GTL, Refining & Trading, Marketing fuel and hydrocarbon sales, Shell Ventures, Corporate segment.
* Non-GAAP measure (see page 365).

4.5.1.D Internal carbon prices

An entity is required to disclose: *[IFRS S2.29(f), IFRS S2.BC130]*

- An explanation of whether and how the entity is applying a carbon price in decision-making (e.g., investment decisions, transfer pricing and scenario analysis)-this is referred to as an 'internal carbon price'
- The price of GHG emissions (per metric tonne) that the entity uses, if any, to assess the costs of its GHG emissions

Extract from IFRS S2

Appendix A
Defined terms

Internal carbon price	Price used by an entity to assess the financial implications of changes to investment, production and consumption patterns, and of potential technological progress and future emissions-abatement costs. An entity can use internal carbon prices for a range of business applications. Two types of internal carbon prices that an entity commonly uses are: (a) a shadow price, which is a theoretical cost or notional amount that the entity does not charge but that can be used to understand the economic implications or trade-offs for such things as risk impacts, new investments, the net present value of projects, and the cost and benefit of various initiatives; and (b) an internal tax or fee, which is a carbon price charged to a business activity, product line, or other business unit based on its **greenhouse gas** emissions (these internal taxes or fees are similar to intracompany transfer pricing).

[IFRS S2 Appendix A].

In explaining how the internal carbon price is used in decision-making, an entity is expected to explain whether it is using a current price, shadow price or another price to represent the price for each metric tonne of carbon. However, if the entity does not have an internal carbon price, the entity needs to consider disclosing that fact. *[IFRS S2.BC130]*.

In its 2023 TCFD Report, Cemex, S.A.B. de C.V. discloses information about its use of internal carbon pricing:

Practical example 4-11: Cemex, S.A.B. de C.V. (2023) **Mexico**

Report 2023 [extract]
Task Force on Climate-Related Financial Disclosure Response (TCFD) [extract]
Strategy [extract]

Internal Carbon Pricing

Since 2020, Cemex designed a methodology to implement an internal carbon price as a shadow price with the primary objective of driving low-carbon investments and changing internal behaviors, reflecting a cost for CO_2 emissions that simulates a scenario in which all our sites in the world operate under an emission trading system (ETS). Every year, we update the price of carbon according to the latest EU ETS average price forecast from a ten analysts' report (83.5 EUR/t for 2023 and 142 EUR/t for 2030; UKA 2023: 53.6 GBP/ton), which also includes UK ETS price forecast. California market price increased based on Analyst's Best Estimate used for California operation (33 USD/t in 2023, 28 USD/t in 2022 and 48 USD/t in 2030). A carbon floor price is used for non-regulated countries outside EU and California (22 USD/ton in 2023, 20 USD/ton in 2022 and 36 USD/t in 2030). These forecasts are used in all our business units, allowing managers to make operational and investment decisions taking into consideration the impact of CO_2 emissions on their present and future financial performance.

4.5.1.E Executive remuneration

An entity is required to disclose: *[IFRS S2.29(g)]*

- A description of whether and how climate-related considerations are factored into executive remuneration
- The percentage of executive management remuneration recognised in the current period that is linked to climate-related considerations

How we see it

IFRS S2 does not define 'executive management'. As such, entities will need to exercise judgement in determining which management roles will represent 'executive management' and are, therefore, within the scope of this disclosure requirement.

In our view, this disclosure would allow primary users to understand whether, and to what extent, the managers of an entity that have the authority and responsibility for managing the activities of the entity are incentivised through remuneration for their performance in managing the entity's climate-related risks and opportunities. In that context, to identify the management roles that represent 'executive management', an entity could consider the definition of 'key management personnel' in IAS 24 *Related Party Disclosures*, which states that "Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity".

IFRS S2 also does not define 'remuneration'. In our view, the ordinary meaning of 'remuneration' would be sufficient to apply this disclosure requirement. In determining what constitutes 'remuneration', an entity could also consider referring to the definition of 'compensation' in IAS 24, which includes short-term employee benefits (e.g., wages), post-employment benefits (e.g., pensions), other long-term employee benefits (e.g., long-service leave), termination benefits and share-based payment.

4.5.1.F Preparation guidance

In preparing the cross-industry metric disclosures other than GHG emissions mentioned above, IFRS S2 states that an entity is required to consider: *[IFRS S2.B65]*

- The time horizons over which the effects of climate-related risks and opportunities could reasonably be expected to occur (refer to Chapter 52 at section 4.3.1)
- Where in the entity's business model and value chain climate-related risks and opportunities are concentrated (e.g., geographical areas, facilities or types of assets) (refer to Chapter 52 at section 4.3.2)
- The information disclosed in relation to the effects of climate-related risks and opportunities on the entity's financial position, financial performance and cash flows for the reporting period (refer to Chapter 52 at section 4.3.4)
- Whether industry-based metrics partially or completely provide the information required by the cross-industry metric disclosures
- Connectivity between the cross-industry metric disclosures and the amounts recognised and disclosed in the related financial statements. Connectivity also includes consistency in the data and assumptions used (to the extent possible) in the disclosures and in the preparation of the financial statements

4.5.2 Industry based metrics

In addition to cross-industry metrics, IFRS S2 requires an entity to disclose industry-based metrics that are associated with one or more particular business models, activities or other common features that characterise participation in an industry. Disclosure of industry-based metrics is required to enable primary users to understand an entity's exposure to and management of climate-related risks and opportunities that are common to the entity's industry. *[IFRS S2.BC134].*

IFRS S2 requires an entity to refer to the *Industry-based Guidance on Implementing IFRS S2* and consider the applicability of the industry-based metrics corresponding to the disclosure topics identified for the relevant industry. *[IFRS S2.32].* As discussed in section 4.3.1.B above, this requirement means that, after referring to the industry-based guidance, an entity is not required to apply that guidance if the entity considers that it is not applicable. However, even if an entity concludes that the industry-based guidance does not apply, IFRS S2 still requires the entity to disclose industry-based metrics. As the ISSB has explained, the disclosure topics and metrics included in the industry-based guidance is not intended to be

exhaustive. Therefore, information about other topics not included in the industry-based guidance will need to be disclosed if the entity determines that the information is material. *[IFRS S2.BC37]*.

4.5.3 Climate-related targets

IFRS S2 requires an entity to disclose:

- Its climate-related targets (see section 4.5.3.A below)
- Information about its approach to setting, reviewing and monitoring progress against each target (see section 4.5.3.B below)
- Information about its performance against each target (see section 4.5.3.C below)
- Specific information for each GHG emission target the entity has (if any) (see section 4.5.3.D below)

4.5.3.A Disclosures about an entity's climate-related targets

IFRS S2 requires an entity to disclose its quantitative and qualitative climate-related targets. These may be either: *[IFRS S2.33]*

- Targets that the entity has set to monitor progress towards achieving its strategic goals

  Or
- Targets that the entity is required to meet by law or regulation (if any)

These targets include any GHG emissions targets.

For each target, IFRS S2 requires an entity to disclose the following:

Figure 4-12: Climate-related target disclosures

Information to disclose	Further information
The metric used to set the target *[IFRS S2.33(a)]*	IFRS S2 also requires an entity to consider cross-industry metrics and industry-based metrics when identifying and disclosing metrics used to set climate-related targets and to measure progress. *[IFRS S2.B67]*. For metrics that were developed by an entity to measure progress towards a target, IFRS S1 specifies additional disclosures that the entity is required to make (see Chapter 52 at section 4.5.2).
The objective of the target *[IFRS S2.33(b)]*	An entity might refer to, for example, mitigation, adaptation or conformance with science-based initiatives.
The part of the entity to which the target applies *[IFRS S2.33(c)]*	An entity might refer to, for example, whether the target applies to the entity in its entirety or only a part of the entity (e.g., a specific business unit or specific geographical region).
Target measurement considerations	Specifically, an entity is required to disclose: ▸ The period over which the target applies *[IFRS S2.33(d)]* ▸ The base period from which progress is measured *[IFRS S2.33(e)]* ▸ Any milestones and interim targets. *[IFRS S2.33(f)]*.
If the target is quantitative, whether it is an absolute target or an intensity target *[IFRS S2.33(g)]*	IFRS S2 describes: ▸ An *absolute target* as "a total amount of a measure or a change in the total amount of a measure" ▸ An *intensity target* as "a ratio of a measure, or a change in the ratio of a measure, to a business metric" *[IFRS S2.B66]*
How the latest international agreement on climate change has informed the target *[IFRS S2.33(h)]*	This disclosure includes any jurisdictional commitments that arise from the latest international agreement.

4.5.3.B Approach to set, review and monitor progress against targets

An entity is required to disclose information about the entity's approach to: *[IFRS S2.34]*

- Setting and reviewing each target
- Monitoring its progress against each target

The information to be disclosed includes: *[IFRS S2.34]*

- Whether a third party has validated the target and the methodology for setting the target
- The entity's processes for reviewing the target
- The metrics used by the entity to monitor its progress towards reaching the target
- Any revisions that have been made to the target and an explanation for those revisions

4.5.3.C Reporting performance against each target

An entity is required to disclose information about its performance against each climate-related target. The information disclosed also needs to include an analysis of trends or changes in the entity's performance. *[IFRS S2.35]*.

In identifying and disclosing the metrics used to set and monitor progress towards reaching a target, IFRS S2 requires that an entity refers to and considers the applicability of cross-industry metrics and industry-based metrics. The metrics include those described in an applicable ISSB standard and metrics that otherwise satisfy the IFRS S1 requirements. *[IFRS S2.37]*.

4.5.3.D GHG emission targets

In addition to the requirements outlined above, IFRS S2 also requires information to be disclosed in relation to any GHG emissions target(s) that an entity has set (or is required to meet by law or regulation) which is summarised in Figure 4-13 below. *[IFRS S2.36]*.

Figure 4-13: GHG emission target disclosures

Information to disclose	Further information
The scope of the GHG emissions target	Specifically, an entity is required to disclose: ▸ Which GHG emissions are covered by the target (noting that the various constituent gases are described in section 5.2 below) *[IFRS S2.36(a)]* ▸ Whether the target covers Scope 1, Scope 2 or Scope 3 GHG emissions *[IFRS S2.36(b)]*
Whether the target is a gross GHG emissions target or net GHG emissions target *[IFRS S2.36(c)]*	IFRS S2 describes: ▸ Gross GHG emissions targets as "reflect[ing] the total changes in greenhouse gas emissions planned within the entity's value chain". ▸ Net GHG emissions targets as "the entity's targeted gross greenhouse gas emissions minus any planned offsetting efforts (for example, the entity's planned use of carbon credits to offset its greenhouse gas emissions)". For net GHG emissions targets, the entity is also required to separately disclose its associated gross GHG emissions target. IFRS S2 also clarifies that the net GHG emissions target disclosure cannot obscure information about the entity's gross GHG emissions target. *[IFRS S2.B68, IFRS S2.B69]*.

Information to disclose	Further information
Whether the target was derived using a sectoral decarbonisation approach *[IFRS S2.36(d)]*	In the Basis for Conclusions to IFRS S2 the ISSB explains that a sectoral decarbonisation approach sets GHG emissions targets on a sector-by-sector basis by translating GHG gas emissions targets made at the international level (e.g., established through the latest international agreement on climate change) into sector-based benchmarks, against which the performance of individual entities can be compared. A sectoral decarbonisation approach acknowledges that entities operating in different sectors will have specific challenges associated with the transition to a lower-carbon economy (because, for example, the location of where in an entity's value chain that GHG emissions are concentrated will vary by sector). The Science Based Targets Initiative (SBTi) uses a sectoral decarbonisation approach. *[IFRS S2.BC150].*
The entity's planned use of carbon credits to offset GHG emissions to achieve any net GHG emissions target *[IFRS S2.36(e)]*	IFRS S2 defines a carbon credit as "An emissions unit that is issued by a carbon crediting programme and represents an emission reduction or removal of greenhouse gases. Carbon credits are uniquely serialised, issued, tracked and cancelled by means of an electronic registry". *[IFRS S2 Appendix A].* Information to be disclosed about an entity's planned use of carbon credits includes: *[IFRS S2.36(e)]* ▸ The extent of the entity's use of carbon credits to achieve its net GHG emissions targets (if any) ▸ The identity of the third-party scheme(s) that will verify or certify the carbon credits ▸ The type of carbon credit - this includes whether the underlying offset will be nature-based or based on technological carbon removals (see further discussion below) ▸ Any other factors that primary users might need to understand the credibility and integrity of the scheme from which the entity obtains carbon credits (e.g., assumptions regarding the permanence of the carbon offset) An entity might also disclose information about carbon credits it has already acquired and which the entity is planning to use to meet its GHG emissions targets. *[IFRS S2.B71].*

Carbon credits

Carbon credits may be nature-based (i.e., aim to enhance natural carbon sinks, such as through afforestation, soil-based carbon sequestration and the use of other biomass stores) or based on technological carbon removals. The ISSB noted that disclosure about the type of carbon credit helps primary users to assess an entity's risk profile. For example, if an entity plans to use carbon credits based on technological carbon removals, a user will want to understand whether the technological solution is currently economical at commercial scales or whether it will likely require substantial investment to be economically viable in the future. In contrast, nature-based approaches are often more cost-effective than technological solutions. However, nature-based approaches may be subject to concerns about:

- Quality of the carbon offset scheme based on 'permanence' (i.e., how long the GHG emissions will be safely removed from the atmosphere) and 'additionality' (i.e., whether any new climate benefits have been brought about by a particular investment that would not have occurred anyway)

  And
- Their secondary effects on other social and environmental issues, such as food production

Consequently, disclosures about an entity's reliance on carbon credits, how credits are generated, and the credibility and integrity of the scheme from which the entity obtains the credits provide important information to users because additional climate-related risks and opportunities may arise from uncertainty about the suitability of some schemes, the available technology and future prices of carbon credits. The ISSB notes that this may happen because, for example: *[IFRS S2.BC154, IFRS S2.BC155, IFRS S2.BC156]*.

- Carbon capture and storage technology solutions might prove to be ineffective.

  Or

- Regulations might be introduced or revised to discourage or ban the use of specified carbon credit schemes due to climate activism efforts, policy changes or concerns about food shortage issues that might arise as a consequence of decisions made.

TCFD comparison

The ISSB indicates that some of the IFRS S2 disclosure requirements for metrics and targets relating to climate-related risks and opportunities are broadly consistent with the TCFD recommended disclosures.

For disclosures related to the metrics used by an entity to manage and assess its climate-related risks, the ISSB noted in its TCFD comparison document that IFRS S2 requires the disclosure of industry-based metrics in addition to the categories of cross-industry metrics which are also included in TCFD guidance.

For disclosures related to GHG emissions, the ISSB noted that IFRS S2 includes additional requirements to:

- Separately disclose Scope 1 and Scope 2 GHG emissions for the consolidated group and for investees that are not part of the consolidated group (e.g., equity accounted investments)
- Disclose Scope 2 GHG emissions according to the location-based approach and to disclose information about any contractual instruments relating to Scope 2 GHG emissions
- Disclose 'financed emissions' if the entity has activities in asset management, commercial banking or insurance
- Disclose the measurement approach, inputs and assumptions used to measure Scope 3 GHG emissions

IFRS S2 also specifies a Scope 3 measurement framework for preparing disclosures on Scope 3 GHG emissions. The general 'disaggregation' principle in IFRS S1 would also require an entity to disaggregate its GHG emissions disclosure by constituent gases if that disaggregation provides material information to users of the entity's general purpose financial reports.

For disclosures related to targets used by the entity to manage its climate-related risks and opportunities and its performance against those targets, the ISSB noted that IFRS S2:

- Differs from the TCFD Recommendations by requiring an entity to disclose how the latest international agreement on climate change has informed its target and whether the target has been validated by a third party
- Requires more detailed information to be disclosed about the entity's GHG emissions targets and additional requirements about the planned use of carbon credits to achieve the entity's net GHG emissions targets
- Includes additional requirements to disclose information about the entity's approach to setting and reviewing targets, monitoring progress against those targets, including whether a sectoral decarbonisation approach was used in setting the targets

5 Greenhouse gas emissions

5.1 Measurement of GHG emissions

IFRS S2 requires an entity's disclosure of its GHG emissions to be measured in accordance with the *Greenhouse Gas Protocol: A Corporate Accounting and Reporting Standard (2004)*. The ISSB clarified that an entity applies the requirements in the GHG Protocol only to the extent that those requirements do not conflict with IFRS S2. In other words, an entity uses the GHG Protocol to measure what is required to be disclosed by IFRS S1 and IFRS S2. Therefore, as an example, an entity is required to disclose its Scope 3 emissions because that it is a requirement in IFRS S2 even though the GHG Protocol does not require the disclosure of Scope 3 GHG emissions. *[IFRS S2.29(a)(ii), IFRS S2.B23].*

An exception to the general requirement in IFRS S2 to use the GHG Protocol to measure GHG emissions applies if an entity is required by a jurisdictional authority, or a securities exchange on which it is listed, to use a different method for measuring its GHG emissions. This exception applies for as long as the jurisdiction's, or securities exchange's, requirement to use a different method applies to the entity. Furthermore, in some cases, the jurisdiction's, or securities exchange's, specific requirements might apply only to one part of the reporting entity (e.g., its operations in a specific jurisdiction) or for only some categories of GHG emissions (e.g., Scope 1 and Scope 2 GHG emissions). In such cases, the exception that IFRS S2 allows does not exempt the entity from being required to disclose its Scope 1, Scope 2 and Scope 3 GHG emissions for the whole of the entity. *[IFRS S2.B24, IFRS S2.B25].*

5.2 Overview of GHG Protocol

The GHG Protocol provides standards and guidance for accounting for, measuring and reporting emissions of the following seven GHGs identified by the United Nations Framework Convention on Climate Change (UNFCCC):

- Carbon dioxide (CO_2)
- Methane (CH_4)
- Nitrous oxide (N_2O)
- Hydrofluorocarbons (HFCs)
- Perfluorocarbons (PFCs)
- Sulphur hexafluoride (SF_6)
- Nitrogen trifluoride (NF_3)

These gases are classified as GHGs because they trap heat in the atmosphere.

The following publications are collectively known as the GHG Protocol:

- *Corporate Accounting and Reporting Standard* (Corporate Standard)[9]
- *Scope 2 Guidance*[10]
- *Corporate Value Chain (Scope 3) Accounting and Reporting Standard* (Scope 3 Standard)[11]
- *Technical Guidance for Calculating Scope 3 Emissions* (Scope 3 Guidance)[12]

The following sections provide a brief introduction to some of the key concepts in the GHG Protocol that may be relevant for measuring an entity's GHG emissions. Detailed guidance on the application of the GHG Protocol can be found in the EY publication, *Sustainability reporting developments - A comprehensive guide - Greenhouse Gas Protocol Interpretative guidance*.[13]

5.2.1 Accounting for, measuring and reporting GHG emissions

Accounting for, measuring and reporting GHG emissions in accordance with the GHG Protocol is based on the following process:

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9 Refer Corporate Standard, available in the GHG Protocol website.

10 Refer Scope 2 Guidance, available in the GHG Protocol website.

11 Refer *Corporate Value Chain (Scope 3) Standard,* available in the GHG Protocol website.

12 Refer *Scope 3 Calculation Guidance,* available in the GHG Protocol website.

13 Sustainability reporting developments: A comprehensive guide, Greenhouse Gas Protocol, Interpretative guidance, September 2024, available at www.ey.com.

Figure 5-1: Process under the GHG Protocol

A reporting entity defines its organisational boundary	The organisational boundary, which determines the entities (or portions of entities) that are included by the reporting entity for purposes of GHG emissions reporting. A reporting entity identifies its organisational boundary using either the equity share or control approach. This is discussed further in section 5.2.2 below.
⬇	
The reporting entity establishes its operational boundary	Determining a reporting entity's operational boundaries is the process of: ▸ Identifying the emissions that relate to the reporting entity (which is established by the organisational boundary) ▸ Determining if these emissions are direct (Scope 1) or indirect (Scope 2 or Scope 3) ▸ Determining the extent of accounting for and reporting indirect emissions (i.e., which Scope 3 emissions, if any, are included in the GHG inventory and reported). In accordance with IFRS S2, a reporting entity will be required to include Scope 3 emissions in its GHG inventory
⬇	
The reporting entity calculates GHG emissions	Once the boundaries are set, the reporting entity calculates GHG emissions for each reported scope (i.e., Scope 1, Scope 2 and Scope 3). These emissions are typically measured in metric tonnes of individual GHGs and metric tonnes of carbon dioxide equivalent (CO_2e) units, a standard metric used to compare the impact of GHGs on the environment.

The GHG Protocol is designed to enable reporting entities to track and report consistent and comparable GHG emissions data over time. Therefore, it requires a reporting entity to establish a base year (a specific year or an average of multiple years) against which subsequent emissions can be compared. The GHG Protocol requires the base year emissions to be retrospectively recalculated in certain circumstances to maintain comparability over time.

5.2.2 Organisational boundary

A reporting entity may have many different entities in its legal and organisational structure, which may include wholly owned subsidiaries, partially owned subsidiaries and equity method investments. The GHG Protocol provides guidance on whether a reporting entity must include emissions from these various entities when measuring its GHG emissions. The GHG Protocol refers to the process of identifying which entities to include as "setting organisational boundaries".

The GHG Protocol allows a reporting entity to select one of two methods of setting organisational boundaries:

- The equity share approach

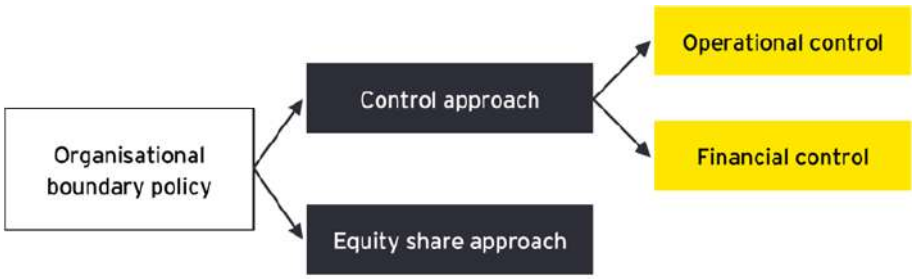
  Or

- The control approach

The GHG Protocol calls these methods consolidation approaches. For entities that wholly own and control all their operations, either approach will result in the same organisational boundary. However, for entities that have partially owned operations (or for entities that only have an economic interest in the operations without control), the organisational boundary identified, and therefore, the GHG emissions included in their inventory, can differ depending on the consolidation approach used.

Because control can be defined from an operational or financial perspective, the GHG Protocol further divides the control approach into the operational control approach and financial control approach. The decision tree below shows the options available to a reporting entity for determining its organisational boundary:

Figure 5-2: Determining the organisational boundary



5.2.2.A Equity share approach

Under the equity share approach, a reporting entity sets its organisational boundary based on its share of the equity of an owned, or partially owned, entity (i.e., the reporting entity includes the same proportionate share of emissions of the owned entity as its share of equity of the entity). The equity share percentage used by the reporting entity should reflect the extent of the rights the reporting entity has to both the risks and rewards generated by an owned entity. This percentage is often the same as the legal ownership share of the owned entity, but it may not be in all cases. For example, the equity share and ownership share will differ when the ownership share does not faithfully represent the economic interest in the owned entity.

5.2.2.B Control approach

Under the control approach, a reporting entity includes within its organisational boundaries 100% of the emissions of operations over which it has control, regardless of the equity share or legal ownership share held by the reporting entity. For example, a reporting entity that has an equity share of 65% and control over a subsidiary would account for and report 100% of the subsidiary's emissions using the control approach. Conversely, if the reporting entity has an equity share of 35% in an entity that it does not control, none of the emissions of the uncontrolled entity would be included in the reporting entity's GHG inventory.

The GHG Protocol provides two methods of determining control:

- Financial control (see (i) of this section below)
- Operational control (see (ii) of this section below)

The selected control approach must be used consistently throughout the entire organisation and over time.

(i) Financial control

A reporting entity has financial control over another entity if it can control the entity to gain economic benefits from the entity's activities. Financial control is often obtained if the reporting entity has the right to the majority of the economic benefits of the operation. Similar to the concept of equity share above, the determination of financial control depends on the economic substance of the relationship rather than the legal ownership. That is, financial control is not determined by legal ownership but by whether the reporting entity holds the rights to the majority of the economic benefits of the operation (e.g., the risks and rewards of ownership of the entity's assets). For example, a reporting entity may have financial control over another entity that is a variable interest entity, even though it owns less than 50% of the other entity.

When financial control is shared jointly by two or more parties (e.g., a joint venture under IFRS 11 *Joint Arrangements*), emissions are accounted for using the equity share approach even when the financial control approach is applied throughout the remainder of the reporting entity.

How we see it

We believe that the determination of financial control will often be consistent with the determination of control for financial reporting purposes under IFRS accounting standards (i.e., if an entity is consolidated for financial reporting purposes, it will likely be included in the organisational boundaries under the financial control approach).

However, the financial accounting guidance on the assessment of control under IFRS accounting standards has changed since the Corporate Standard was first issued. Therefore, there may be differences between the consolidation conclusion under the GHG Protocol's financial control approach and the conclusion for financial accounting.

(ii) Operational control

The GHG Protocol specifies that a reporting entity that applies the operational control approach needs to include any facility over which it has operational control in the organisational boundary, even if it is not the owner of the facility. This is particularly relevant for leased assets and other assets that are operated under a contractual arrangement. Determining the organisational boundary for these assets and contractual arrangements is outside the scope of this chapter.

A reporting entity that elects to use the operational control approach determines control by whether it has the authority to introduce and implement operating policies at an operation or facility. Operational control does not mean that the reporting entity can make **all** decisions concerning the operation or facility. For example, operational control may include decisions about how the day-to-day functions are performed but may not include certain other significant decisions (e.g., financing decisions, buying/selling significant assets) otherwise relevant to the financial control conclusions.

Certain facilities or operations may be under joint control (e.g., joint ventures). Under the operational control approach, a reporting entity needs to determine whether it can introduce and implement operating policies for each facility or operation to determine whether the facilities or operations under joint control are included in its reporting boundary. A reporting entity that has operational control over an operation will include 100% of the operation's emissions in its reporting boundary even though it only owns 50% of the investee.

The following Practical Example explains how SAP SE has determined its organisational boundary:

Practical example 5-1: SAP SE (2022) Germany

SAP Integrated Report 2022 [extract]

Non-Financial Notes: Environmental Performance [extract]

Carbon Emissions [extract]

Organizational Boundaries

SAP defines its organizational boundaries by applying the operational control approach as set out in the GHG Protocol.

Operational control is established when SAP has the full authority to introduce and implement its operating policies. The emissions of all operations over which the company has operational control and all owned, leased facilities, co-location data centers, and vehicles that the company occupies or operates are accounted for in the carbon emissions. They are based either on measurements or, where no measured data is available, on estimations and extrapolations.

A portion of SAP's leased facilities operates under full-service or multitenant leases, where SAP does not have access to actual energy consumption information. SAP includes these facilities in our definition of operational control and accounts for them by estimating related energy consumption.

To support the growing demand for SAP's cloud offerings, we subcontract computation power in local third-party data centers. Carbon emissions are approximated and included based on the consumed or extrapolated computation power.

In most instances, however, SAP has 100% ownership of its subsidiaries. Accordingly, the difference between applying the control versus the equity approach is about 0.98% based on SAP revenue. If investments in associates were included, the difference would be even smaller, about 0.71%.

Frequently asked questions

Question 5-1: What is the difference between the reporting entity concept in IFRS S1 and the organisational boundary for GHG emissions disclosures?

IFRS S1 specifies that sustainability-related financial disclosures are prepared for the same reporting entity as the related financial statements. A reporting entity would prepare consolidated financial statements if the reporting entity was a consolidated group comprised of a parent entity and its subsidiaries. The sustainability-related financial disclosures would be similarly prepared for the consolidated group. Therefore, the sustainability-related financial information disclosed would be the sustainability-related risks and opportunities that either affect the consolidated group directly or affect the consolidated group's value chain.

The organisational boundary determined for GHG emissions is only relevant for the purposes of preparing the reporting entity's GHG emissions disclosures. The organisational boundary is not relevant for determining whether other sustainability-related financial information needs to be disclosed in the reporting entity's sustainability-related financial disclosures.

Consolidated financial statements and organisational boundaries are different concepts and determined based on different criteria. Therefore, the composition of a consolidated group and an organisational boundary will align only if the specific facts and circumstances of an entity's operations and structure are such that they happen to align. In many cases, they will not align which may explain why paragraph 29(a)(iv) requires an entity to disaggregate emissions between the consolidated accounting group and other investees that are not part of the consolidated accounting group.

Question 5-2: What are examples of entities (or assets) that would be included in the organisational boundary for GHG emissions disclosure purposes that would not form part of the consolidated group?

As stated in the previous question, paragraph 29(a)(iv) of IFRS S2 requires an entity to disaggregate emissions between the consolidated accounting group and other investees that are not part of the consolidated accounting group. The types of entities (or assets) that would not be part of a consolidated group depends on the applicable accounting policies as well as measurement approach that is adopted for GHG emissions reporting purposes.

Equity share approach

The equity share approach (which is explained above in Section 5.2.2.A) typically includes the following entities in the organisational boundary to the extent they are outside of the consolidated accounting group:

- Associates
- Joint ventures
- Unconsolidated subsidiaries
- Any other entity not being a subsidiary, associated or joint venture subject to GHG emission disclosure requirements under the equity share approach.

The equity share approach will include those entities in the organisational boundary, but only include emissions attributable to that entity to the extent of the entity's share of equity in that entity. Similarly, for subsidiaries of a consolidated group that are not wholly-owned subsidiaries, the equity share approach will include those subsidiaries in the organisational boundary and only include emissions attributable to those subsidiaries to the extent of the entity's share of equity in them.

Operational control approach

The operational control approach (which is explained above in Section 5.2.2.B) typically includes the following in the organisational boundary to the extent they are outside of the consolidated accounting group:

- Unconsolidated entities (including subsidiaries, associates, joint ventures and other entities) where the entity has operational control (e.g., an organisational boundary based on operational control would include GHG emissions attributable to interests of other joint venture partners in a joint venture that is classified as a joint operation in accordance with IFRS 11)
- Facilities that are not recognised as assets in the consolidated group's financial statements but the entity has operational control

In each of these cases, all of the emissions attributable to the entity or assets that within the entity's operational control (i.e., 100% of the GHG emissions) will form part of the entity's Scope 1 and Scope 2 GHG emissions.

Financial control approach

The financial control approach (which is explained above in Section 5.2.2.B) typically includes the following in the organisational boundary to the extent they are outside of the consolidated accounting group:

- Unconsolidated subsidiaries (e.g., when the investment entity exception is used in IFRS accounting standards)
- Joint ventures accounted for in accordance with the equity method of accounting. As noted in this section above, emissions are accounted for using the equity share approach when financial control is shared jointly by two or more parties.

5.2.3 Scope 2 GHG emissions calculation methods

Scope 2 GHG emissions measurement methods are:

- Location-based method (see section 5.2.3.A below)
- Market-based method (see section 5.2.3.B below)

5.2.3.A Location-based method

The location-based method reflects the average emissions factors of the electricity grids on which a reporting entity consumes electricity. The location-based method is required to be used by all reporting entities. A reporting entity's electricity procurement decisions (e.g., a decision to purchase electricity generated from renewable sources) are not factored into the location-based method calculation of Scope 2 emissions. Therefore, this method can be applied in all locations and provides information on emissions from the overall mix of generation sources used in the grid. The location-based method results in Scope 2 emissions from a reporting entity's activities in the respective regions that are consistent with the Scope 2 emissions from other entities' activities in the same region. This provides better comparability of entities based on the location of their activities.

Under the location-based method, a reporting entity uses an emissions factor that represents the average emissions from energy generation within a defined geographical area (e.g., local, subnational or national level) during a defined time period, which is often 12 months (i.e., the grid average emissions factor). Supplier-specific emissions factors should not be used under this method. Additionally, these emissions factors do not reflect the impact of contractual instruments.

5.2.3.B Market-based method

The market-based method represents the emissions associated with the choices a reporting entity makes when acquiring electricity. Scope 2 emissions under the market-based method are derived from a reporting entity's contractual relationships or instruments. For example, if a reporting entity chooses a specific energy generation supplier or enters into a supply agreement for electricity from a regional wind farm, it would use the emissions factors resulting from these contracts in its Scope 2 emissions calculation under the market-based method. Unlike the location-based method, the market-based method provides information about the decisions a reporting entity has made to reduce emissions from its consumption of electricity.

Contractual instruments include direct contracts with a supplier (e.g., power purchase arrangements, virtual power purchase arrangements) and bundled or unbundled attribute claims (e.g., renewable energy certificates, energy attribute certificates, guarantees of origin, supplier-specific emission rates, residual mix factors).

While the GHG Protocol requires the disclosure of Scope 2 GHG emissions on both location-based as well as the market-based method, IFRS S2 only requires the disclosure of the location-based method. In addition to this, entities are required to provide information about any contractual instruments that is necessary to inform users' understanding of the entity's Scope 2 GHG emissions. *[IFRS S2.29(a)(v)]*.

5.3 Categories of GHG emissions

Appendix A to IFRS S2 includes definitions of:

- Direct GHG emissions, specifically Scope 1 GHG emissions
- Indirect GHG emissions, which refer to Scope 2 and Scope 3 GHG emissions

These definitions from IFRS S2 are reproduced below:

Extract from IFRS S2

Appendix A
Defined terms

indirect greenhouse gas emissions	Emissions that are a consequence of the activities of an entity, but occur at sources owned or controlled by another entity.
Scope 1 greenhouse gas emissions	Direct **greenhouse gas** emissions that occur from sources that are owned or controlled by an entity.
Scope 2 greenhouse gas emissions	**Indirect greenhouse gas emissions** from the generation of purchased or acquired electricity, steam, heating or cooling consumed by an entity. Purchased and acquired electricity is electricity that is purchased or otherwise brought into an entity's boundary. Scope 2 greenhouse gas emissions physically occur at the facility where electricity is generated.
Scope 3 greenhouse gas emissions	**Indirect greenhouse gas emissions** (not included in **Scope 2 greenhouse gas emissions**) that occur in the **value chain** of an entity, including both upstream and downstream emissions. **Scope 3 greenhouse gas** emissions include the Scope 3 categories in the Greenhouse Gas Protocol Corporate Value Chain (Scope 3) Accounting and Reporting Standard (2011):

5.3.1 Measurement approach, inputs and assumptions

As noted in section 4.5.1.A above, IFRS S2 requires an entity to disclose the measurement approach, inputs and assumptions used to measure its GHG emissions. This disclosure required includes information about: *[IFRS S2.B26]*

- The measurement approach the entity uses in accordance with the GHG Protocol (see section 5.3.1.A below)
- The applicable method if the entity is not using the GHG Protocol and the measurement approach the entity uses (see section 5.3.1.B below)
- The emission factors the entity uses (see section 5.3.1.C below)

5.3.1.A GHG Protocol measurement approaches

Because the GHG Protocol includes different measurement approaches for measuring its GHG emissions, IFRS S2 requires an entity to disclose: *[IFRS S2.B27]*

- The approach it uses to determine its GHG emissions (e.g., the equity share or control approach)
- The reason(s) for the entity's choice of measurement approach and how that approach enables users of the entity's general purpose financial reports to understand the entity's performance in relation to its climate-related risks and opportunities, including progress towards its climate-related targets (if any)

5.3.1.B Other methods and measurement approaches

If an entity discloses its GHG emissions measured in accordance with another method (as outlined in section 5.1), IFRS S2 requires the entity to disclose: *[IFRS S2.B28]*

- The applicable method and measurement approach the entity uses to determine its GHG emissions
- The reason(s) for the entity's choice of method and measurement approach and how that approach enables users of the entity's general purpose financial reports to understand the entity's performance in relation to its climate-related risks and opportunities, including progress towards its climate-related targets (if any)

Frequently asked questions

Question 5-3: Is an entity permitted to use the relief that allows for the use of a method other than the GHG Protocol Corporate Standard to measure the entity's GHG emissions in a circumstance in which only part of the entity is required by a jurisdictional authority to use another method to measure its GHG emissions?

(TIG meeting 19 September 2024 - Agenda paper no. 3, ISSB meeting 20 November 2024 - Agenda paper no. 9C)

The ISSB staff's analysis of this question noted that an entity applying IFRS S2 would be:

- Permitted to measure part of its GHG emissions using a measurement method that is different from the GHG Protocol Corporate Standard, but only to the extent that part of the entity is required by a jurisdictional authority or an exchange on which it is listed to use that different method for measuring those GHG emissions
- Required to measure the remainder of its GHG emissions in accordance with the GHG Protocol Corporate Standard

The part of an entity's GHG emissions that is measured using a method that is different from the GHG Protocol Corporate Standard could refer, for example, to a subsidiary of the entity or to specific assets or operations of the entity.

If and when an entity applies this relief based on the ISSB staff's analysis, the entity's GHG emissions disclosures would be comprised of amounts measured using different methods (i.e., some measured using the GHG Protocol Corporate Standard, and others measured using a different method). To ensure that an entity's GHG emissions disclosures are understood by users of the general purpose financial reports, the ISSB staff's analysis noted that the entity would need to:

- Disclose the applicable method the entity has used to measure its GHG emissions if the entity is not using the GHG Protocol Corporate Standard, including the measurement approach the entity uses
- If material, disaggregate total GHG emissions by
  - GHG emissions measured using the GHG Protocol Corporate Standard
  - GHG emissions measured using a method(s) that is different from the GHG Protocol Corporate Standard
- Consider the qualitative characteristics of sustainability-related financial information, such as the understandability and comparability of the GHG emissions information.

There were mixed views among TIG members on this question. While many TIG members agreed with the ISSB staff's analysis, some other TIG members acknowledged a tension between that analysis and the requirement in IFRS accounting standards (specifically IFRS 10 *Consolidated Financial Statements*) that a reporting entity applies uniform accounting policies in the preparation of its consolidated financial statements. As a result, this question is expected to be raised with the ISSB in a future meeting.

An entity is not required to apply this relief. If the relief is not applied, the entity would be required to measure all of its GHG emissions in accordance with the GHG Protocol Corporate Standard. This may mean that an entity would need to recalculate some of its GHG emissions that were measured in accordance with the requirements of the jurisdictional authority or exchange for the purposes of preparing its sustainability-related financial disclosures in accordance with ISSB Standards.

An example of how an entity might apply the jurisdictional relief based on the ISSB staff analysis (refer Question 5-3 above) is outlined in the following Illustration:

Illustration 5-1: Disclosure considerations when applying jurisdictional relief to part of an entity

Entity P is incorporated in Country X and prepares sustainability-related financial disclosures for its consolidated group, which includes a subsidiary Entity S which is incorporated in Country Y. Entity S is required by the regulations in Country Y to separately report its Scope 1 and Scope 2 GHG emissions using a measurement method that is different from the GHG Protocol Corporate Standard. Entity S's GHG emissions are material to Entity P's consolidated group.

In preparing the sustainability-related financial disclosures for the consolidated group, Entity P elects to use the jurisdictional relief permitted by paragraph 29(a)(ii) of IFRS S2. Accordingly, Entity P discloses its absolute gross GHG emissions generated during the reporting period in accordance with paragraph 29(a)(i) of IFRS S2 as follows:

	GHG emissions (metric tonnes CO_2e)			
	Scope 1	**Scope 2**	**Scope 3**	**Total**
GHG emissions measured using GHG Protocol Corporate Standard	8,000	2,700	32,000	42,700
Entity S's GHG emissions measured according to local regulations	3,000	1,100	-	4,100
Total GHG emissions for the consolidated group	11,000	3,800	32,000	46,800

In accordance with paragraph 29(a)(iii), Entity P would disclose the measurement approaches, inputs and assumptions it used to measure its GHG emissions. This would include disclosing that a method that is different from the GHG Protocol Corporate Standard was used to measure the Scope 1 and Scope 2 GHG emissions attributable to Entity S.

5.3.1.C Emissions factors

If an entity estimates the GHGs emitted using activity data and emissions factors as its basis for measuring its GHG emissions, IFRS S2 requires the entity to use the emissions factors that best represent the entity's activity. IFRS S2 does not specify the emissions factors that an entity is required to use. *[IFRS S2.B29]*. These estimates require:

- 'Activity data', which refers to the number of times that a specific activity occurs for which an emissions factor is available and can be applied. For Scope 1 emissions, activity data is often denominated in fuel consumed (e.g., litres of petrol, cubic feet of natural gas) or units of product produced
- An 'emissions factor', which refers to a value that represents the quantity of a specific GHG (or CO_2e) emitted for a specific unit of activity. For example, CO_2e emissions by fuel type for specific vehicles are common emissions factors used for calculating Scope 1 mobile emissions

Consequently, IFRS S2 requires an entity to disclose information so that primary users can understand the emission factors that the entity has used to measure its GHG emissions. *[IFRS S2.B29]*.

5.3.2 Aggregation of GHGs into CO_2 equivalents

Although there are seven constituent GHGs, IFRS S2 requires an entity's disclosure of its absolute gross GHG emissions generated during the reporting period to be expressed in metric tonnes of CO_2 equivalent (CO_2e). *[IFRS S2.29(a)(i)]*.

If an entity uses direct measurement (also known as 'direct monitoring') to measure its GHG emissions by measuring the concentration of GHGs and the rate of emissions from operations and processes, this means that the entity will be directly, and separately, measuring the specific constituent GHG emitted (e.g., the units of methane (CH_4) emitted). To convert the constituent GHGs into a CO_2 equivalent value, IFRS S2 requires an entity to use global warming potential (GWP) values based on a 100-year time horizon, from the latest Intergovernmental Panel on Climate Change assessment available at the reporting date. *[IFRS S2.B21]*.

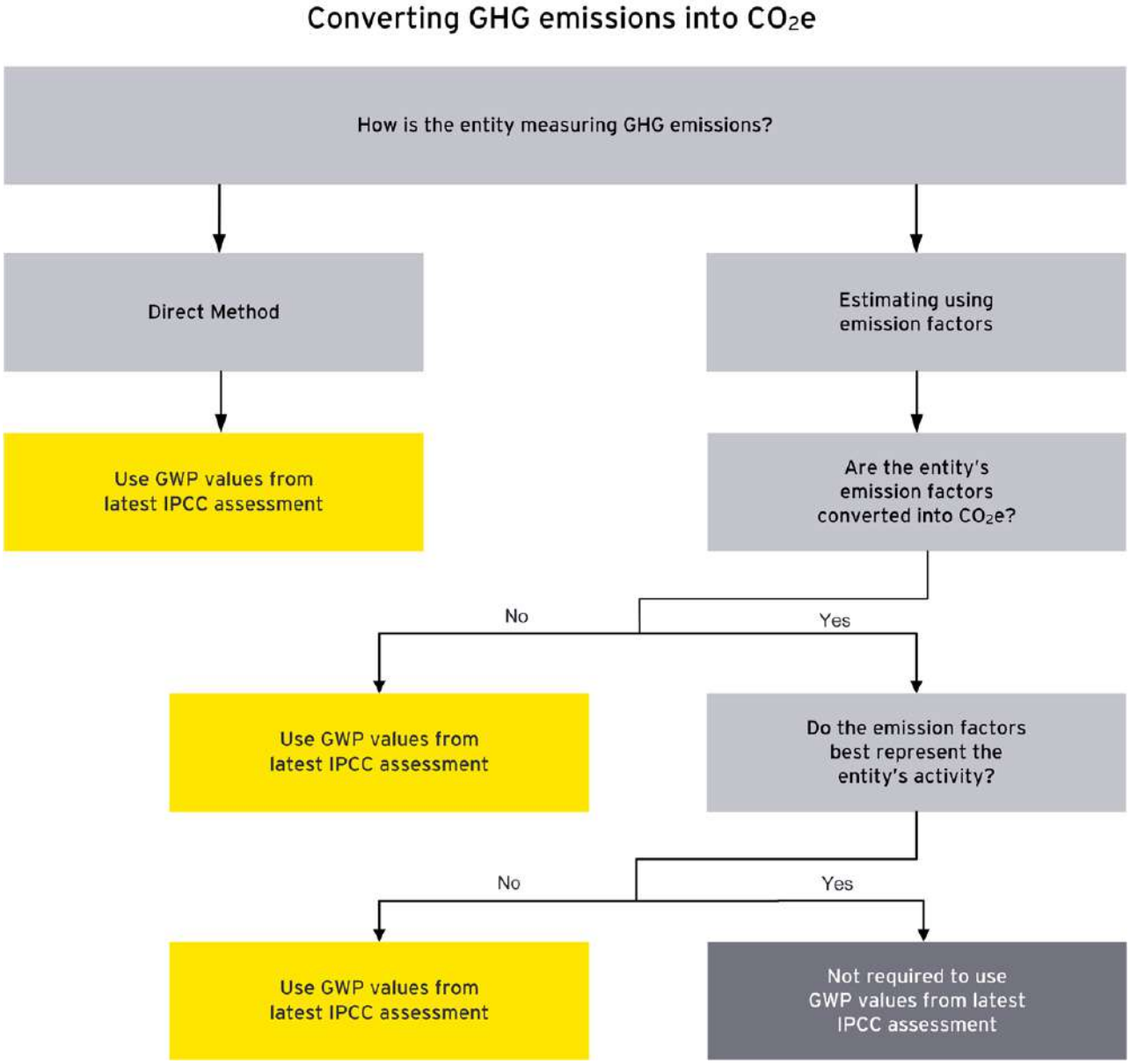
Each of the seven constituent GHGs have a different GWP. The GWP of a given GHG indicates how much energy one unit of the GHG absorbs (i.e., the ability of that gas to trap heat in the atmosphere) compared to one unit of carbon dioxide, generally over a 100-year period. The larger the GWP, the more that the GHG warms the earth compared to carbon dioxide over the stated time period. For example, PFCs and HFCs

often absorb thousands of times more energy than carbon dioxide. The GWP of each GHG is used to convert GHGs, other than carbon dioxide, into carbon dioxide equivalent (CO_2e) units. Therefore, the CO_2e unit of measurement is used to evaluate releasing (or avoiding releasing) different GHGs against a common basis. *[IFRS S2 Appendix A].*

If an emission factor used by an entity has already converted the constituent gases into CO_2e values, IFRS S2 does not require the entity to recalculate the emission factors using GWP values based on a 100-year time horizon from the latest Intergovernmental Panel on Climate Change assessment available at the reporting date. However, if the emission factors are not converted into CO_2e values, then the entity is required to use the GWP values based on a 100-year time horizon from the latest Intergovernmental Panel on Climate Change assessment available at the reporting date. *[IFRS S2.B22].*

Figure 5-3 below, which is based on a flowchart from TIG meeting 19 September 2024 - Agenda paper no. 5, illustrates factors that an entity needs to consider when converting GHG emissions into a CO_2 equivalent value:

Figure 5-3: Decisions in converting GHG emissions into CO_2e



At its September 2024 meeting, the TIG discussed whether the jurisdictional relief in IFRS S2 can be applied to relieve an entity from the requirement to use GWP values from the latest IPCC assessment in circumstances where the entity is required by a jurisdictional authority to use different GWP values. Based on the feedback provided by TIG members, this issue is expected to be considered further by the ISSB in a forthcoming meeting.

5.3.3 Using information from reporting periods that are different from the entity's reporting period

An entity's reporting period may be different from the reporting periods used by some or all the entities in its value chain. A consequence of mismatched reporting periods is that GHG emissions information that relates to the entity's value chain may not be readily available for the entity to use when it prepares its own disclosures for its reporting period. The ISSB acknowledged that different reporting periods can cause challenges in preparing disclosures that rely on value chain information. For that reason, where an entity's reporting period is different from the reporting periods of entities in its value chain, IFRS S2 permits an entity to measure its GHG emissions using information for reporting periods that are different from its own reporting period if all of the following conditions are met: *[IFRS S2.B19]*

- The entity uses the most recent data available from those entities in its value chain without undue cost or effort to measure and disclose its GHG emissions.
- The length of the reporting periods is the same.
- The entity discloses the effects of significant events and changes in circumstances (relevant to its GHG emissions) that occur between the reporting dates of the entities in its value chain and the date of the entity's general purpose financial reports.

5.4 Scope 1 GHG emissions

Scope 1 emissions are emissions from sources owned or controlled by a reporting entity. For example, emissions from equipment, a vehicle or production processes that are owned or controlled by the reporting entity are considered Scope 1 emissions. These emissions include all direct emissions within the entity's inventory boundary. The combination of organisational and operational boundaries make up a reporting entity's inventory boundary, which is also called the reporting boundary.

Two or more reporting entities should never account for the same emissions as Scope 1 emissions. For example, emissions from the generation of heat, electricity or steam that is sold to another entity are not subtracted from Scope 1 emissions but are reported as Scope 2 emissions by the entity that purchases the related energy. Theoretically, if every entity and individual throughout the world reported their GHG emissions using the same organisational boundary (e.g., equity share, financial control or operational control approach), the total of all Scope 1 emissions would equal the total GHGs emitted throughout the world.

5.5 Scope 2 GHG emissions

According to the GHG Protocol, an entity's Scope 2 GHG emissions need to be measured using either a location-based approach or a markets-based approach. This is described further in section 5.2.3 above on the application of the GHG Protocol.

As noted in section 5.2.3 above, IFRS S2 requires an entity to: *[IFRS S2.29(a)(v), IFRS S2.B30]*

- Disclose its location-based Scope 2 GHG emissions
- Provide information about any 'contractual instruments' the entity has entered into if it has entered into those instruments and information about those instruments would inform users' understanding of the entity's Scope 2 GHG emissions

The meaning of a 'contractual instrument' is explained in IFRS S2: *[IFRS S2.B31]*

Extract from IFRS S2	
B31	Contractual instruments are any type of contract between an entity and another party for the sale and purchase of energy bundled with attributes about the energy generation or for unbundled energy attribute claims (unbundled energy attribute claims relate to the sale and purchase of energy that is separate and distinct from the greenhouse gas attribute contractual instruments). Various types of contractual instruments are available in different markets and the entity might disclose information about its market-based Scope 2 greenhouse gas emissions as part of its disclosure.

5.6 Scope 3 GHG emissions

IFRS S2 requires an entity to disclose information about its Scope 3 GHG emissions according to the 15 categories of Scope 3 GHG emissions as described in the GHG Protocol. The purpose of this disclosure is to enable primary users to understand the source of the entity's Scope 3 emissions. *[IFRS S2.29(a)(vi), IFRS S2.B32].*

As such, when an entity prepares its Scope 3 GHG emissions disclosures, IFRS S2 requires the entity to: *[IFRS S2.B32, IFRS S2.B34]*

- Consider its entire value chain (upstream and downstream)
- Reassess which Scope 3 categories and entities throughout its value chain to include in the measurement of its Scope 3 GHG emissions if a significant event or a significant change in circumstances has occurred. This reassessment is consistent with the requirements in IFRS S1 about reassessing the scope of sustainability-related risks and opportunities (see Chapter 52 at section 1.2.3)

Frequently asked questions

Question 5-4: What is the relationship between the GHG Corporate Value Chain Standard and IFRS S2 in measuring an entity's Scope 3 GHG emissions?

(TIG meeting 13 June 2024 - Agenda paper no. 1, ISSB meeting 24 July 2024 - Agenda paper no. 9, TIG meeting 19 September 2024 - Agenda paper no. 1, ISSB meeting 20 November 2024 - Agenda paper no. 9C)

The *Greenhouse Gas Protocol Corporate Value Chain (Scope 3) Accounting and Reporting Standard* (2011) (GHG Corporate Value Chain Standard) is referenced by IFRS S2 in the:

- Definition of Scope 3 GHG emissions *[IFRS S2, Appendix A]*
- Requirements about the disclosure of Scope 3 GHG emissions categories *[IFRS S2.29(a)(vi)(1)]*

However, the GHG Protocol Corporate Value Chain Standard is not referenced by IFRS S2 in relation to the measurement of Scope 3 GHG emissions. Consequently, an entity is required to use the Scope 3 measurement framework in paragraphs B38-B57 of IFRS S2 to measure its Scope 3 GHG emissions. This means that the entity measures its Scope 3 GHG emissions using:

- A measurement approach, inputs and assumptions that result in a faithful representation of this measurement *[IFRS S2.B38]*
- All reasonable and supportable information that is available to the entity at the reporting date without undue cost or effort *[IFRS S2.B39]*
- Given the GHG Protocol Corporate Value Chain Standard includes optionality about the boundary of GHG emissions within categories to be included in an entity's measure of its Scope 3 GHG emissions as well as in relation to aspects of measurement of Scope 3 GHG emissions (e.g., when information could be excluded from measurement), the TIG was asked in its September 2024 meeting about how an entity needs to consider those 'optional' requirements when applying IFRS S2. Based on the discussion at the TIG meeting, this question is expected to be raised with the ISSB in a future meeting.

5.6.1 Scope 3 measurement framework

Scope 3 GHG emissions can be quantified by either direct measurement (i.e., the direct monitoring of GHG emissions) or estimation (which involves approximate calculations of data based on assumptions and appropriate inputs). The ISSB considers that, in theory, direct measurement provides the most accurate evidence of an entity's Scope 3 GHG emissions. However, the ISSB also acknowledges that, due to the challenges of directly measuring Scope 3 GHG emissions, an entity's measurement of Scope 3 GHG emissions is likely to include the use of estimation rather than solely comprising direct measurement. *[IFRS S2.B38, IFRS S2.B43, IFRS S2.B44, IFRS S2.B45].*

IFRS S2 requires an entity to use a measurement approach, inputs and assumptions that result in a faithful representation of its measurement of Scope 3 GHG emissions. Although IFRS S2 does not specify the inputs an entity is required to use to measure its Scope 3 GHG emissions, the standard does require the entity to prioritise inputs and assumptions using the following identifying characteristics:

- Data based on direct measurement (see section 5.6.1.A below)
- Data from specific activities within the entity's value chain (see section 5.6.1.B below)
- Timely data that faithfully represents the jurisdiction of, and the technology used for, the value chain activity and its GHG emissions (see section 5.6.1.C below)
- Data that has been verified (see section 5.6.1.D below)

Each of these characteristics are explained further in the sections below, noting that these characteristics are not listed in a particular order and, as such, an entity's prioritisation of the measurement approach, inputs and assumptions may require management to use judgement to make trade-offs between data. *[IFRS S2.B40, IFRS S2.B42].*

An example of a trade-off that management may need to make is between the timeliness of the data and specificity of the data. Recent data may provide less detail about the specific value chain activity (such as technology used, location and jurisdiction of the activity) whereas data that is older and published infrequently might be more representative of the value chain activity and its GHG emissions. *[IFRS S2.B42].*

When an entity selects the measurement approach, inputs and assumptions to measure its Scope 3 GHG emissions, IFRS S2 specifies that the entity is required to use all reasonable and supportable information that is available to the entity at the reporting date without undue cost or effort. *[IFRS S2.B39].*

IFRS S2 states that an entity is required to apply the Scope 3 measurement framework to prioritise inputs and assumptions even if: *[IFRS S2.B41]*

- The entity is required by a jurisdictional authority or securities exchange to use a method other than the GHG Protocol to measure its GHG emissions
- The entity has elected to use the transition relief that allows the entity to measure its GHG emissions using a method other than the GHG Protocol for its first annual reporting period when its applies IFRS S2

5.6.1.A Data based on direct measurement

IFRS S2 requires an entity to prioritise direct measurement of Scope 3 GHG emissions, but acknowledges that it expects that Scope 3 GHG emissions data will include estimation. *[IFRS S2.B43, IFRS S2.B44].*

IFRS S2 outlines that estimates of Scope 3 GHG emissions are likely to use two types of inputs: *[IFRS S2.B45]*

- Data that represents the entity's activity that results in GHG emissions (activity data). For example, the entity might use distance travelled as activity data to represent the transport of goods within its value chain.
- Emission factors that convert activity data into GHG emissions. For example, the entity will convert the distance travelled (activity data) into GHG emissions data using emission factors.

5.6.1.B Data from specific activities within the entity's value chain

Measurement of an entity's Scope 3 GHG emissions will be based on: *[IFRS S2.B46]*

- Primary data - data obtained directly from specific activities within the entity's value chain (e.g., data provided by suppliers)
- Secondary data - data not obtained directly from activities within the entity's value chain (e.g., data from third party data providers and industry-average data)
- A combination of both primary and secondary data

IFRS S2 requires an entity to prioritise primary data when estimating the entity's Scope 3 GHG emissions. This is because the ISSB considers that data from specific activities within an entity's value chain provides a more accurate representation of the entity's specific value chain activities and, thus, primary data provides a better basis to measure an entity's Scope 3 GHG emissions. However, if an entity uses secondary data to measure its Scope 3 GHG emissions, IFRS S2 requires the entity to consider the extent to which the secondary data faithfully represents the entity's activities. *[IFRS S2.B47, IFRS S2.B48, IFRS S2.B49].*

Examples of primary and secondary data are provided in Figure 5-4 below:

Figure 5-4: Primary and secondary data

Type of data	Examples
Primary data	▸ Data sources include meter readings, utility bills and other methods that represent specific activities in the entity's value chain. ▸ Data sources may be from internal sources such as from the entity's own records or from external sources such as from suppliers and other value chain partners (e.g., supplier-specific emission factors for purchased goods or services). *[IFRS S2.B48].*

Secondary data	▸ Data sources include third-party data providers and industry-average data (e.g., from published databases, government statistics, literature studies and industry associations).
	▸ Secondary data includes both: *[IFRS S2.B49]*
	  ▸ Data used to approximate the activity or emission factors
	  ▸ Primary data from a specific activity (proxy data) that is used to estimate GHG emissions for another activity

5.6.1.C Timely data that faithfully represents the jurisdiction of, and the technology used for, the value chain activity and its GHG emissions

If an entity uses secondary data to measure its Scope 3 GHG emissions, IFRS S2 requires the entity to prioritise the use of activity or emissions data that is: *[IFRS S2.B50, IFRS S2.B51, IFRS S2.B52]*

- Based on, or represents, the technology used in the value chain activity the data is intended to represent (see Illustration 5-2 below)
- Based on, or represents, the jurisdiction in which the activity happened (e.g., where the entity operates or where the activity took place)
- Timely and representative of the entity's value chain activity during the reporting period (e.g., considering whether the secondary data sources relied on information collected in the entity's current reporting period or in a reporting period that is different from the entity's current reporting period)

The Illustration below is based on an example used in IFRS S2: *[IFRS S2.B50]*

Illustration 5-2: Use of secondary data

In measuring its Scope 3 GHG emissions from business travel, Entity A obtains primary data from its business travel activities including data about:

- The specific aircraft model used for each flight
- Distance travelled for each flight
- Travel-class used by the travelling employees

Entity A would then estimate its GHG emissions from business travel by applying this primary data with secondary data on the GHG emissions relating to each of those activities.

5.6.1.D Verified data

IFRS S2 requires an entity to prioritise Scope 3 GHG emissions data that is verified. Data can be subject to internal or external verification and may involve on-site checking, reviewing calculations, or cross-checking of data against other sources. *[IFRS S2.B53].*

The ISSB acknowledges that an entity might need to use unverified data if it is unable to verify its Scope 3 GHG emissions without undue cost or effort. *[IFRS S2.B54].*

5.6.1.E Disclosure of inputs to Scope 3 GHG emissions

As part of an entity's disclosure of information about the measurement approach, inputs and assumptions that the entity uses to measure its Scope 3 GHG emissions in accordance with IFRS S2 (as discussed in section 5.3.1 above), the entity is required to disclose information about: *[IFRS S2.B55, IFRS S2.B56]*

- The characteristics of the data inputs referred to in section 5.6.1 on Scope 3 measurement framework that are used in the measurement of Scope 3 GHG emissions
- How the entity has prioritised the highest quality data available, which faithfully represents the value chain activity and its Scope 3 GHG emissions
- The extent to which the entity's Scope 3 GHG emissions are measured using:
- Inputs from specific activities within the entity's value chain
- Inputs that are verified

IFRS S2 includes a specifically stated presumption that Scope 3 GHG emissions can be estimated reliably using secondary data and industry averages. However, if an entity determines it is impracticable to estimate its Scope 3 GHG emissions (i.e., the entity cannot apply the requirement after making every reasonable effort to do so), IFRS S2 requires the entity to disclose how it is managing its Scope 3 GHG emissions. The ISSB expects that cases when measuring Scope 3 GHG emissions is impracticable will be rare. *[IFRS S2.B57]*.

5.7 Financed emissions

IFRS S2 requires an entity participating in financial activities, including commercial and investment banks, asset managers and insurance entities to provide additional and specific disclosures about its Category 15 Scope 3 GHG emissions or those emissions associated with its investments, specifically its 'financed emissions' in: *[IFRS S2.B59]*

- Asset management (see section 5.7.1 below)
- Commercial banking (see section 5.7.2 below)
- Insurance (see section 5.7.3 below)

Extract from IFRS S2

Appendix A
Defined terms

financed emissions	The portion of gross greenhouse gas emissions of an investee or counterparty attributed to the loans and investments made by an entity to the investee or counterparty. These emissions are part of Scope 3 Category 15 (investments) as defined in the Greenhouse Gas Protocol Corporate Value Chain (Scope 3) Accounting and Reporting Standard (2011).

[IFRS S2 Appendix A].

The amount of financed emissions of an entity participating in financial activities is a key focus area for primary users because it is an indicator of an entity's exposure to climate-related risks and opportunities and how the entity might need to adapt its financial activities over time. This is because: *[IFRS S2.B58]*

- Investees, borrowers and counterparties with high GHG emissions could be more susceptible to risks associated with technological changes, shifts in supply and demand and policy changes.
- As a consequence, those risks could increase the exposure of entities providing financial services to counterparties, borrowers and investees to credit risk, market risk, reputational risk and other financial and operational risks (such as credit risk associated with financing borrowers affected by carbon taxes or reputational risks from financing fossil fuel projects).

The application guidance in IFRS S2 supports the use of different measurement approaches to calculate an entity's financed emissions. In developing this application guidance, the ISSB's intention was to allow for measurement methodologies for different asset classes to emerge and be accepted by the market, such as the measurement methodologies developed by the Partnership for Carbon Accounting Financials. *[IFRS S2.BC125]*.

Frequently asked questions

Question 5-5: Does the scope of the requirement to disclose 'financed emissions' also determine what is included or excluded from an entity's Scope 3 Category 15 GHG emissions disclosures?

(TIG meeting 19 September 2024 - Agenda paper no. 4, ISSB meeting 20 November 2024 - Agenda paper no. 9C)

No. The TIG noted that the 'financed emissions' disclosure requirements in paragraph 29(a)(vi)(2) of IFRS S2 is directed at requiring entities engaged in specific activities (i.e., asset management, commercial banking or insurance) to disclose additional information about the GHG emissions included in Scope 3 Category 15 beyond the general requirement for all entities to disclose Scope 3 GHG emissions.

As such, many TIG members noted that the inclusion or exclusion of activities or asset classes in these financed emissions requirements has no bearing on the general requirement for all entities to disclose Scope 3 GHG emissions in accordance with paragraph 29(a)(i)(3) of IFRS S2.

5.7.1 Asset management

IFRS S2 requires an entity that participates in asset management activities to disclose the information set out in Figure 5-5 below:

Figure 5-5: Asset management disclosures

Information to disclose	Further considerations
The entity's absolute gross financed emissions, disaggregated by Scope 1, Scope 2 and Scope 3 GHG emissions *[IFRS S2.B61(a)]*	-
For each of the disaggregated Scope 1, Scope 2 and Scope 3 GHG emissions disclosures, the total amount of assets under management (AUM) included in the entity's financed emissions disclosures, expressed in the presentation currency of the entity's financial statements *[IFRS S2.B61(b)]*	-
The percentage of the entity's total AUM included in the financed emissions calculation *[IFRS S2.B61(c)]*	Explain the exclusions, including the type of assets excluded and associated amount of AUM, if the percentage of the entity's total AUM included in the financed emissions calculation is less than 100%.
The methodology used by the entity to calculate its financed emissions *[IFRS S2.B61(d)]*	Describe the allocation method used by the entity to attribute its share of emissions in relation to the size of its investments.

5.7.2 Commercial banking

IFRS S2 requires an entity that participates in commercial banking activities to disclose the information set out in Figure 5-6 below:

Figure 5-6: Commercial banking disclosures

Information to disclose	Further considerations	
The entity's absolute gross financed emissions, disaggregated by Scope 1, Scope 2 and Scope 3 GHG emissions for each industry by asset class. *[IFRS S2.B62(a)].*	For disaggregation by industry	The Global Industry Classification Standard (GICS) 6-digit industry-level code is required to classify counterparties (using the latest version of the classification system available at the reporting date).
	For disaggregation by asset class	Asset classes include: ▸ Loans ▸ Project finance ▸ Bonds ▸ Equity investments ▸ Undrawn loan commitments If financed emissions are calculated and disclosed for other asset classes, the entity is required to explain why including those additional asset classes provides relevant information to primary users.
The entity's gross exposure to each industry by asset class, expressed in the presentation currency of the entity's financial statements. *[IFRS S2.B62(b)].*	For funded amounts	Gross exposure is to be calculated as the funded carrying amounts (before subtracting any loss allowance), whether prepared in accordance with IFRS accounting standards or other GAAP.
	For undrawn loan commitments	The full amount of the commitment is disclosed separately from the drawn portion of loan commitments.
The percentage of the entity's gross exposure included in the financed emissions calculation. *[IFRS S2.B62(c)].*	For exclusions	Explain the exclusions, including the type of assets excluded, if the percentage of the entity's gross exposure included in the financed emissions calculation is less than 100%.
	For funded amounts	Exclude all impacts of risk mitigants (if applicable) from gross exposure.
	For undrawn loan commitments	Separately disclose the percentage of the entity's undrawn loan commitments included in the financed emissions calculation.
The methodology used by the entity to calculate its financed emissions. *[IFRS S2.B62(d)].*	Describe the allocation method used by the entity to attribute its share of emissions in relation to the size of its gross exposure.	

5.7.3 Insurance

IFRS S2 requires an entity that participates in insurance activities to disclose the information set out in Figure 5-7 below:

Figure 5-7: Insurance disclosures

Information to disclose	Further considerations	
The entity's absolute gross financed emissions, disaggregated by Scope 1, Scope 2 and Scope 3 GHG emissions for each industry by asset class. *[IFRS S2.B63(a)]*.	For disaggregation by industry	The GICS 6-digit industry-level code is required to classify counterparties (using latest version of the classification system available at the reporting date).
	For disaggregation by asset class	Asset classes include: ▸ Loans ▸ Bonds ▸ Equity investments ▸ Undrawn loan commitments If financed emissions are calculated and disclosed for other asset classes, the entity is required to explain why including those additional asset classes provides relevant information to primary users.
The entity's gross exposure for each industry by asset class, expressed in the presentation currency of the entity's financial statements. *[IFRS S2.B63(b)]*.	For funded amounts	Gross exposure is to be calculated as the funded carrying amounts (before subtracting any loss allowance), whether prepared in accordance with IFRS accounting standards or other GAAP.
	For undrawn loan commitments	The full amount of the commitment is disclosed separately from the drawn portion of loan commitments.
The percentage of the entity's gross exposure included in the financed emissions calculation. *[IFRS S2.B63(c)]*.	For exclusions	Explain the exclusions, including the type of assets excluded, if the percentage of the entity's gross exposure included in the financed emissions calculation is less than 100%.
	For undrawn loan commitments	Separately disclose the percentage of the entity's undrawn loan commitments included in the financed emissions calculation.
The methodology used by the entity to calculate its financed emissions. *[IFRS S2.B63(d)]*.	Describe the allocation method used by the entity to attribute its share of emissions in relation to the size of its gross exposure.	

5.8 Facilitated and associated emissions

Although not specifically addressed in IFRS S2, the Basis for Conclusions on IFRS S2 indicates that, due to the lack of an established methodology, the ISSB decided that the calculation of financed emissions is not required to include: *[IFRS S2.BC127, IFRS S2.BC129]*

- Derivatives
- 'Associated emissions' of underwriting portfolios in the insurance and reinsurance industries
- 'Facilitated emissions' relating to financial activities associated with investment banking

At its September 2024 meeting, the TIG discussed whether an entity with facilitated or associated emissions (i.e., asset class: derivatives, underwriting activities in the insurance and reinsurance industries and investment bank activities in the investment banking industry) would be required to include those emissions within its measurement of Scope 3 GHG emissions. Based on the feedback provided by TIG members, this issue is expected to be considered further by the ISSB in a forthcoming meeting.

6 Effective date

IFRS S2 is effective for annual reporting periods beginning on or after 1 January 2024. An entity is permitted to apply IFRS S2 earlier than 1 January 2024, but to do so, the entity is required to disclose that fact and it is also required to apply IFRS S1 at the same time. *[IFRS S2.C1].*

The actual effective date for entities will depend on when ISSB standards become mandatory in the jurisdictions in which they operate, unless those entities voluntarily apply the standards before they become mandatory in their jurisdictions. See also relevant discussion in Chapter 52 at section 8.

7 Transition reliefs to IFRS S2

In developing IFRS S2, the ISSB decided to provide some relief to ease an entity's transition to the new requirements in the entity's first year of applying those requirements.

The transition reliefs set out in Table 7-1 below are available for an entity to use in the first annual reporting period in which the entity applies IFRS S2. The entity can choose to use all, some, or none of those reliefs in its first annual reporting period. *[IFRS S2.C4, IFRS S2.BC174].*

Figure 7-1: Transition reliefs for IFRS S2

Relief topic	Nature of relief that applies to the first annual reporting period in which the entity applies IFRS S2
Comparative information	An entity is not required to disclose comparative information. *[IFRS S2.C3].*
GHG Protocol	An entity is permitted to continue to use a method other than the GHG Protocol to measure its GHG emissions if the entity used that method to measure its GHG emissions in the annual reporting period immediately preceding the date of initial application of IFRS S2. *[IFRS S2.C4(a)].* The date of initial application is the start of the reporting period in which an entity first applies IFRS S2.
Scope 3 GHG emissions	An entity is not required to disclose its Scope 3 GHG emissions, including the additional information about financed emissions (if applicable). *[IFRS S2.C4(b)].*

If an entity uses either of the abovementioned reliefs relating to the GHG Protocol or Scope 3 GHG emissions, IFRS S2 allows the entity to continue to use that relief so that it is not required to present that information as comparative information in subsequent reporting periods. *[IFRS S2.C5].* This is explained further in Illustration 7-1 below:

Illustration 7-1: Comparative information transition relief

Entity A applies ISSB standards for the first time for the annual reporting period ending 31 December 2024.

In its first set of sustainability-related financial disclosures, Entity A elects to not disclose its Scope 3 GHG emissions in accordance with the transition relief options available in IFRS S2.

In its second set of sustainability-related financial disclosures, which is for the annual reporting period ending 31 December 2025, Entity A is required to disclose its Scope 3 GHG emissions for the 2025 reporting period. However, in accordance with the transition relief in IFRS S2, Entity A elects to not disclose its Scope 3 GHG emissions for the 2024 comparative period.

In its third set of sustainability-related financial disclosures, which is for the annual reporting period ending 31 December 2026, Entity A is required to disclose its Scope 3 GHG emissions for the 2026 reporting period and its Scope 3 GHG emissions for the 2025 comparative period. This is because the transition relief for Scope 3 GHG emissions only applies to the Scope 3 GHG emissions that relate to the first annual reporting period.

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Appendix C - Defined terms

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carbon credit	An emissions unit that is issued by a carbon crediting programme and represents an emission reduction or removal of **greenhouse gases**. Carbon credits are uniquely serialised, issued, tracked and cancelled by means of an electronic registry.
climate resilience	The capacity of an entity to adjust to climate-related changes, developments or uncertainties. Climate resilience involves the capacity to manage **climate-related risks** and benefit from **climate-related opportunities**, including the ability to respond and adapt to **climate-related transition risks** and **climate-related physical risks**. An entity's climate resilience includes both its strategic resilience and its operational resilience to climate-related changes, developments and uncertainties.
climate-related physical risks	Risks resulting from climate change that can be event-driven (acute physical risk) or from longer-term shifts in climatic patterns (chronic physical risk). Acute physical risks arise from weather-related events such as storms, floods, drought or heatwaves, which are increasing in severity and frequency. Chronic physical risks arise from longer-term shifts in climatic patterns including changes in precipitation and temperature which could lead to sea level rise, reduced water availability, biodiversity loss and changes in soil productivity. These risks could carry financial implications for an entity, such as costs resulting from direct damage to assets or indirect effects of supply-chain disruption. The entity's financial performance could also be affected by changes in water availability, sourcing and quality; and extreme temperature changes affecting the entity's premises, operations, supply chains, transportation needs and employee health and safety.
climate-related risks and opportunities	Climate-related risks refers to the potential negative effects of climate change on an entity. These risks are categorised as **climate-related physical risks and climate-related transition risks**. Climate-related opportunities refers to the potential positive effects arising from climate change for an entity. Efforts to mitigate and adapt to climate change can produce climate-related opportunities for an entity.
climate-related transition plan	An aspect of an entity's overall strategy that lays out the entity's targets, actions or resources for its transition towards a lower-carbon economy, including actions such as reducing its **greenhouse gas** emissions.
climate-related transition risks	Risks that arise from efforts to transition to a lower-carbon economy. Transition risks include policy, legal, technological, market and reputational risks. These risks could carry financial implications for an entity, such as increased operating costs or asset impairment due to new or amended climate-related regulations. The entity's financial performance could also be affected by shifting consumer demands and the development and deployment of new technology.
CO2 equivalent	The universal unit of measurement to indicate the **global warming potential** of each **greenhouse gas**, expressed in terms of the **global warming potential** of one unit of carbon dioxide. This unit is used to evaluate releasing (or avoiding releasing) different **greenhouse gases** against a common basis.

financed emissions	The portion of gross greenhouse gas emissions of an investee or counterparty attributed to the loans and investments made by an entity to the investee or counterparty. These emissions are part of Scope 3 Category 15 (investments) as defined in the Greenhouse Gas Protocol Corporate Value Chain (Scope 3) Accounting and Reporting Standard (2011).
global warming potential	A factor describing the radiative forcing impact (degree of harm to the atmosphere) of one unit of a given **greenhouse gas** relative to one unit of CO2.
greenhouse gases	The seven greenhouse gases listed in the Kyoto Protocol-carbon dioxide (CO2); methane (CH4); nitrous oxide (N2O); hydrofluorocarbons (HFCs); nitrogen trifluoride (NF3); perfluorocarbons (PFCs) and sulphur hexafluoride (SF6).
indirect greenhouse gas emissions	Emissions that are a consequence of the activities of an entity, but occur at sources owned or controlled by another entity
internal carbon price	Price used by an entity to assess the financial implications of changes to investment, production and consumption patterns, and of potential technological progress and future emissions abatement costs. An entity can use internal carbon prices for a range of business applications. Two types of internal carbon prices that an entity commonly uses are: (a) a shadow price, which is a theoretical cost or notional amount that the entity does not charge but that can be used to understand the economic implications or tradeoffs for such things as risk impacts, new investments, the net present value of projects, and the cost and benefit of various initiatives; and (b) an internal tax or fee, which is a carbon price charged to a business activity, product line, or other business unit based on its greenhouse gas emissions (these internal taxes or fees are similar to intracompany transfer pricing).
latest international agreement on climate change	An agreement by states, as members of the United Nations Framework Convention on Climate Change, to combat climate change. The agreements set norms and targets for a reduction in **greenhouse gases**.
Scope 1 greenhouse gas emissions	Direct **greenhouse gas** emissions that occur from sources that are owned or controlled by an entity.
Scope 2 greenhouse gas emissions	**Indirect greenhouse gas emissions** from the generation of purchased or acquired electricity, steam, heating or cooling consumed by an entity. Purchased and acquired electricity is electricity that is purchased or otherwise brought into an entity's boundary. Scope 2 greenhouse gas emissions physically occur at the facility where electricity is generated.
Scope 3 greenhouse gas emissions	**Indirect greenhouse gas emissions** (not included in **Scope 2 greenhouse gas emissions**) that occur in the **value chain** of an entity, including both upstream and downstream emissions. Scope 3 greenhouse gas emissions include the **Scope 3 categories** in the Greenhouse Gas Protocol Corporate Value Chain (Scope 3) Accounting and Reporting Standard (2011).

Scope 3 categories	Scope 3 greenhouse gas emissions are categorised into these 15 categories-as described in the Greenhouse Gas Protocol Corporate Value Chain (Scope 3) Accounting and Reporting Standard (2011): (1) purchased goods and services; (2) capital goods; (3) fuel- and energy-related activities not included in **Scope 1 greenhouse gas emissions or Scope 2 greenhouse gas emissions;** (4) upstream transportation and distribution; (5) waste generated in operations; (6) business travel; (7) employee commuting; (8) upstream leased assets; (9) downstream transportation and distribution; (10) processing of sold products; (11) use of sold products; (12) end-of-life treatment of sold products; (13) downstream leased assets; (14) franchises; and (15) investments.

Supplement IBOR Reform

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Overview

One of the reforms mandated by the Financial Stability Board following the financial crisis was to push for benchmark Interbank Offered Rates (IBORs), such as LIBOR, to be replaced by new 'official' benchmark rates, known as alternative Risk Free Rates (RFRs), a process hereinafter referred to as 'IBOR Reform' or 'the Reform'.

The IASB responded with two separate amendments to IFRS: the Phase 1 Amendments were published in September 2019 (effective for years beginning on or after 1 January 2020, but with early application permitted); and the Phase 2 Amendments were published in August 2020 (effective for years beginning on or after 1 January 2021, but again with early application permitted). Once IBOR Reform is complete and the RFRs have become established in the market, the Phase 1 and Phase 2 amendments will cease to be required.

The Phase 1 Amendments address the accounting consequences that arise during the period before financial instruments transition from referencing IBORs to referencing replacement benchmark interest rates. They primarily permit the continuation of hedge accounting for hedge relationships that reference IBORs that are expected to be replaced by IBOR Reform. This supplement describes how the reliefs to allow hedging relationships to continue are applied and the additional disclosures that are required.

The Phase 2 Amendments address the accounting consequences that arise once financial instruments and leases transition from referencing IBORs to referencing replacement benchmark interest rates. This supplement describes how the reliefs are applied to financial instruments when they transition to replacement benchmark interest rates, including the effect on hedging relationships and, again, the disclosures entities are required to provide.

Differences between the IFRS accounting standards and US GAAP guidance on this topic are not addressed in this supplement as the standards are not converged. Therefore, differences between IFRS accounting standards and US GAAP could exist that are not discussed in this supplement.

At the time of writing, IBOR Reform is substantially complete as the most significant IBORs, including all the LIBORs, have now ceased and been replaced. However, there remain some local IBORs for which the work to replace them is still in progress or has only very recently been completed, hence the guidance in this chapter remains relevant.

What you need to know

- The end of IBORs present various accounting challenges, for which the amendments to IFRS accounting standards provide relief. The IASB achieved this with the Phase 1 and Phase 2 Amendments to IFRS accounting standards.
- The Phase 1 Amendments primarily permit the continuation of hedge accounting for hedge relationships that reference IBORs that are expected to be replaced by IBOR Reform. They provide relief from the uncertainty caused by IBOR Reform which could otherwise affect hedging relationships.
- The main elements of the Phase 2 Amendments provide that for modifications to financial instruments that are necessary to implement IBOR Reform, and for which the new basis for calculating cash flows is 'economically equivalent' to the previous basis:
  - (i) The effective interest rate (EIR) on floating-rate financial instruments is adjusted.
  - (ii) The formal designation of hedge relationships is amended and hedge accounting will continue.
- To the extent that any additional modifications are made to financial instruments, it will be necessary to assess whether they would lead to the instruments' derecognition.
  If not:
  - (i) For floating rate instruments not recorded at fair value through profit or loss, the net present value of the additional modification (discounted at the adjusted EIR noted in (i) above) is recorded in profit or loss.
  - (ii) Hedge accounting will only continue as long as the hedge is not required to be discontinued, applying the normal hedge accounting rules. If the hedge continues, the formal designation is amended, but there could, in future, be additional hedge ineffectiveness.
- Both the Phase 1 and Phase 2 Amendments contain some significant additional disclosure requirements.
- IFRS 16 *Leases* was amended to provide relief for the accounting by lessees for leases which refer to IBORs.

1 Introduction

1.1 Background

IBOR Reform is ongoing since, whilst the most significant IBORs have now completed the transition to RFRs, some local IBORs are still to transition. Examples of RFRs that have replaced or are in the process of replacing IBORs include the following:

- Hong Kong dollar Overnight Index Average (HONIA) that has replaced Hong Kong Dollar LIBOR.
- Swiss Average Rate Overnight (SARON) that has replaced Swiss LIBOR.
- Secured Overnight Financing Rate (SOFR) that has replaced US dollar LIBOR.
- Sterling Overnight Indexed Average (SONIA) that has replaced sterling LIBOR.
- Tokyo Overnight Average (TONA) that has replaced Japanese Yen LIBOR.
- Canadian Overnight Repo Rate Average (CORRA) that has replaced Canadian Dollar Offered Rate (CDOR), which ceased on 28 June 2024.[1]
- The Singapore Overnight Rate Average (SORA) that has replaced Singapore Dollar Swap Offer Rate (SOR), which ceased in 2023 and is in the process of replacing Singapore Interbank Offered Rate (SIBOR, which will cease after December 2024.[2]

In March 2021, the Intercontinental Exchange (ICE) Benchmark Administration (the administrator of LIBOR), in conjunction with the UK's Financial Conduct Authority (FCA) announced that it would stop publishing the following LIBOR settings based on submissions from panel banks, after 31 December 2021: all GBP, EUR, CHF and JPY LIBOR settings and the one-week and two-month US dollar LIBOR settings. All remaining US dollar LIBOR settings (i.e., the overnight and the one-, three-, six- and twelve-month settings) ceased to be published based on panel bank submissions after 30 June 2023.

The FCA, which regulates LIBOR, confirmed on 29 September 2021 that 'synthetic' LIBOR would continue to be published for one-month, three-month and six-month sterling and yen LIBOR until 31 December 2022. The FCA indicated that it would not compel publication of yen LIBOR thereafter. The synthetic LIBOR is based on forward looking term versions of the relevant RFR plus the ISDA fallback spread adjustment (see below). However, the FCA stressed that these synthetic LIBORs do not meet the conditions of the Benchmark Regulation, are not for use in new contracts and are intended to help reduce disruption for certain contracts that are particularly difficult to amend (often referred to as 'tough legacy') to help ensure an orderly wind-down.[3]

In September 2022, the FCA confirmed that publication of one and six-month synthetic sterling LIBOR would be required until the end of March 2023, after which these settings would permanently cease.[4] In April 2023, the FCA confirmed that three-month synthetic sterling LIBOR would continue until the end of March 2024 and then permanently cease, and that one-month, three-month and six-month US dollar LIBOR settings would continue in synthetic form until 30 September 2024 and then permanently cease.[5] See below in section 6.2.1 for further detail on the availability of synthetic LIBORs.

Meanwhile, the Euro Overnight interest Average (EONIA) was, in effect, replaced by the Euro Short Term-Rate (€STR) and publication of EONIA ceased on 3 January 2022.[6] Reforms to the Euro Interbank Offered Rate (EURIBOR) methodology were completed in 2019 with the process by which it was set changing from a quotes-based to a transactions-based methodology. Since then, the organisation which overseas EURIBOR, the European Money Markets Institute (EMMI), has continued to improve the methodology by which it is set and the most recent changes were proposed in October 2023[7] and started to be implemented in May 2024 (with a phased implementation due to complete in October 2024).[8] These changes ensure that EURIBOR continues to satisfy the requirements of the Benchmark Regulation and does not need to be replaced with a RFR.

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1 RIP CDOR 1986 - 2024: A Recap of CDOR's Final Days, available on Mondaq website.

2 SIBOR Transition to SORA, FAQs for consumers, The Association of Banks in Singapore, available on the ABS website.

3 Further arrangements for the orderly wind-down of LIBOR at end-2021, FCA, 29 September 2021.

4 FCA announces decision on cessation of 1- and 6-month synthetic sterling LIBOR at end-March 2023, Financial Conduct Authority, 29 September 2022.

5 FCA announces decision on synthetic US dollar LIBOR, FCA, 3 April 2023

6 EONIA was defined as €STR +8.5bp since October 2019 and publication permanently ceased on 3 January 2022.

7 EMMI Consultation Paper: Proposed changes to Euribor Methodology, October 2023, available on EMMI website.

8 EURIBOR Transparency Indicators, See page 5, June 2024, available on EMMI website and see page Euribor® Reform on the EMMI website.

The RFRs that were originally introduced are overnight rates based on actual transactions and reflect the average of the interest rates that certain financial institutions pay to borrow overnight either on an unsecured basis (such as SONIA) or on secured overnight repurchase transactions (such as SOFR). The interest paid on an overnight RFR-based loan is calculated in arrears over a period, usually by compounding the daily rate. Term RFRs, based on the forward market for overnight RFRs are available for use in certain circumstances and allow borrowers to know in advance the interest they will pay for a period, in a similar manner to IBOR-based loans. On 29 July 2021, the U.S. Alternative Reference Rates Committee (ARRC) formally endorsed the use of the 1-month, 3-month and 6-month SOFR Term Rates administered by the Chicago Mercantile Exchange (CME) Group.[9] In addition, the 12-month SOFR Term Rate was endorsed in May 2022.[10] However, given concerns about the potential financial stability risks that could result from the widespread use of Term SOFR, the ARRC recommended that the use of Term SOFR be limited to the following specific purposes:[11]

- As a fallback rate for legacy LIBOR cash products
- For new use in business loans, and also certain securitisations that hold Term SOFR assets
- For use in derivatives only if issued to end-users to hedge cash products that reference the Term SOFR rate

Whilst the ARRC recognised the use of Term SOFR in the above cases, it continued to recommend the use of overnight SOFR and SOFR averages for all products.

One-month, three-month, six-month and twelve-month forward looking term SONIA Reference Rates also became available from the beginning of 2021. References in this supplement to SOFR and SONIA are to overnight rates unless indicated otherwise.

On 23 October 2020, the International Swaps and Derivatives Association (ISDA) published its IBOR fallback protocol and supplements, which were designed to address transition for those derivative contracts still outstanding on the permanent cessation of an IBOR. However, derivative market participants were encouraged to amend or close out existing IBOR contracts before then, without waiting to use the fallback mechanism.[12]

IBORs, fixed in advance for a period (such as 3-months or 6-months), include a bank's credit risk premium for that period. However, the RFRs are designed to exclude all but overnight credit risk and SOFR is based on secured lending rates. Hence, applying the ISDA Fallbacks, the transition includes a spread adjustment to the previous derivative floating rate, which takes effect from when the period for the current LIBOR (or synthetic LIBOR) fixing comes to an end. The same approach is used for derivatives that transition with the central clearing houses. The ISDA fallback spread adjustments, sometimes referred to as Credit Adjustment Spreads ('CAS') are based on the average historical spread between the relevant IBOR and the compounded RFR over the previous five years (see section 2.1.3 below). The ISDA spread adjustments for LIBOR became fixed on 5 March 2021.[13] These included:

- US dollar 3-months 26.161bp
- Sterling 3-months 11.93bp
- Sterling 6-months 27.66bp
- Japanese Yen 3-months 0.835bp

ISDA also published spread adjustments for other IBORs including CDOR and HIBOR.[14] Also, during 2020, derivative clearing houses such as the CME and the London Clearing House (LCH) adopted RFRs as discount rates to value LIBOR derivatives. Amending the reference rate for derivatives does not affect their credit risk. Consequently, a spread may be required to be added to the RFR discount rate to reflect the appropriate credit risk. For example, for uncollateralised derivatives, unless compensating changes are also made to the calculation of the Credit Valuation Adjustment (CVA), it does not follow that an overall reduction in the discount rates used to value them would be appropriate.

The Reform also affects future cash flows on non-derivative floating rate financial instruments such as bonds and loans, referenced to IBORs. These need to be bilaterally renegotiated, as with other transactions that reference IBORs, such as some leases. In each country, working groups have been formed to issue recommendations and assist market participants in the transition from IBORs, including fallback language, possible replacement rates and the related spread adjustment methodologies for different types of loans.

9 ARRC Formally Recommends Term SOFR, ARRC press release 29 July 2021.

10 ARRC Provides Update Endorsing CME 12-Month SOFR Term Rate, 19 May 2022.

11 Summary and Update of the ARRC's Term SOFR Scope of Use Best Practice Recommendations, 21 April 2023

12 Understanding IBOR Benchmark Fallbacks, ISDA, June 2020.

13 IBOR Fallbacks - Technical Notice - Spread Fixing Event for LIBOR, Bloomberg, 5 March 2021.

14 CAD CDOR Fallbacks, Bloomberg, 17 May 2022, HIBOR fallbacks, Bloomberg, 2 November 2022.

How we see it

Entities need to update their assessment of the accounting implications of the scenarios they expect to encounter as they continue to transition from IBORs to RFRs and complete their programmes to implement the new requirements before the remaining IBORs cease and local IBORs that are still to transition. The work required to negotiate the new terms for loans (especially where there are multiple parties to the contract such as syndicated loans) and to amend derivative valuation models could be substantial.

1.2 IFRS Amendments

In 2018, the IASB added a project to its agenda to consider the financial reporting implications of the Reform. It identified two groups of accounting issues that could have financial reporting implications. These were:

- *Phase 1:*

  Pre-replacement issues - issues affecting financial reporting in the period before the replacement of an existing interest rate benchmark with an alternative RFR.
- *Phase 2:*

  Replacement issues - issues that might affect financial reporting when an existing interest rate benchmark is replaced with an alternative RFR.

The IASB gave priority to the Phase 1 issues because they were more urgent at that time and in September 2019, the Board issued *Interest Rate Benchmark Reform, Amendments to IFRS 9, IAS 39 and IFRS 7* (the Phase 1 Amendments) to address them. The Phase 1 Amendments provided a number of temporary exceptions from applying specific hedge accounting requirements of both IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement* (see section 4.1 below). They primarily permit the continuation of hedge accounting for hedge relationships that reference IBORs that are expected to be replaced by IBOR Reform. The Phase 1 Amendments also added some additional disclosure requirements to IFRS 7 *Financial Instruments: Disclosures* (see section 6.1 below).

The Phase 1 Amendments were effective for accounting periods beginning on or after 1 January 2020 and early application was permitted.

In August 2020, the IASB issued *Interest Rate Benchmark Reform Phase 2, Amendments to* IFRS 9, IAS 39, IFRS 7, IFRS 4 *and* IFRS 16 (the Phase 2 Amendments). The Phase 2 Amendments provided the following changes in respect of financial instruments that are directly affected by the Reform:

- A practical expedient when accounting for changes in the basis for determining the contractual cash flows of financial assets and liabilities, to require the effective interest rate to be adjusted (see section 2 below).
- Reliefs from discontinuing hedge relationships (see sections 4.2 and 4.3 below).
- Temporary relief from having to meet the separately identifiable requirement when an RFR instrument is designated as a hedge of a risk component (see sections 4.2.4 and 5 below).
- Additional IFRS 7 disclosures (see section 6.2 below).

How we see it

The Phase 2 Amendments introduced additional areas of judgement, for which entities need to ensure they have appropriate accounting policies and governance in place. For the additional disclosures, entities must ensure they can gather and present compliant information.

The Phase 2 Amendments also affected IFRS 16 *Leases* (see section 7 below) and IFRS 4 *Insurance Liabilities* (see section 8 below). The amendments to IFRS 4 were designed to allow insurers who are still applying IAS 39 to obtain the same reliefs as those provided by the amendments made to IFRS 9. Given the limited scope of the IFRS 4 amendments, this supplement only provides references to IAS 39 in respect of hedge accounting, which is still applied by many entities.

The Phase 2 Amendments were effective for annual periods beginning on or after 1 January 2021 and early application was permitted (see section 5 below).

While all LIBORs had fully transitioned by the end of 2024, other IBORs (such as the Johannesburg InterBank Average Rate (JIBAR)) were still progressing their transition and other IBORs may transition at some further date in the future which has not yet been set.[15] The Phase 1 and Phase 2 Amendments to IFRS accounting standards apply on an instrument-by-instrument basis, and it is possible that, for some IBORs, application of Phase 2 will not happen until an as yet unknown number of years in the future.

In this EY Global IFRS video from September 2020 Tony Clifford and David Bradbery provide a summary of the IASB's IBOR Reform Phase 2 Amendments.

15 Update on the Johannesburg Interbank Average Rate (Jibar) transition plan (resbank.co.za), May 2024

2 Changes in the basis for determining the contractual cash flows

In its Phase 2 Amendments the IASB identified four ways that changes in the basis for determining the contractual cash flows of a financial instrument might be made in order to achieve IBOR Reform: *[IFRS 9.5.4.6, IFRS 9.6.9.2, IFRS 9.BC6.620(a)]*

- By amending the contractual terms (for instance, to replace a reference to an IBOR with a reference to an RFR)
- Through activation of an existing fallback clause in the contract
- Without amending the contractual terms, but by changing the way that an interest rate benchmark is calculated
- A hedging instrument could alternatively be changed as required by the Reform by closing out an existing IBOR-related derivative and replacing it with a new derivative with the same counterparty, on similar terms except referencing an RFR, or by combining the existing IBOR-related derivative with a new basis swap that swaps the existing referenced IBOR for the RFR

The first two approaches are relatively self-explanatory. The third corresponds, for example, to the decision made in Europe in 2019 to redefine EONIA as ESTR plus 8.5bp and also to the changes made in 2019 to how EURIBOR is calculated. The IASB believes that changes in methods for calculating the interest rate could, in effect, represent a modification of the contractual cash flows. *[IFRS 9.BC5.297, IFRS 9.BC5.298, IFRS 9.BC5.299]*. However, the Phase 2 Amendments use the phrase, 'changes in the basis for determining contractual cash flows' instead of 'modification of the contractual cash flows', so as not to imply that the Phase 2 Amendments provide guidance on the treatment of those modifications that occur outside the scope of the Reform. The IASB identified the general model of modifications to contractual cash flows as a topic to be addressed as part of the Post Implementation Review of IFRS 9. In September 2024, they commenced the Amortised Cost Measurement Project and included modification of contractual cash flows in the project plan.[16] This is also discussed in Chapter 46 at section 3.8.4.[17]

The fourth method of making changes to the basis for determining contractual cash flows of an instrument, by replacing a hedging instrument, as described above, was added following responses to the Phase 2 ED. Many derivatives, especially those cleared through central clearing counterparties, will potentially never be adjusted to achieve the Reform but, instead, be replaced by a new derivative on similar terms. (This is discussed in more detail in section 2.3 below).

For all four changes, an entity needs to assess whether they are a 'direct consequence of the Reform' (as discussed in section 2.1.1 below) and result in new contractual cash flows that are 'economically equivalent' (as discussed in section 2.1.2 below).

If yes, then the reliefs applicable for the adjustment of the EIR (as described in section 2.1 below) and for the continuation of hedging relationships (as described in section 4.2.2 below) must be applied.

If the changes are not a direct consequence of the reform or do not result in economically equivalent contractual cash flows, it is first necessary to assess if the changes require the derecognition of the original instrument, as described in section 2.2 below.

If derecognition is required, then the reliefs applicable to the EIR and the continuation of hedging relationships are not available.

If derecognition is not required by the changes, then the reliefs could be partially applicable:

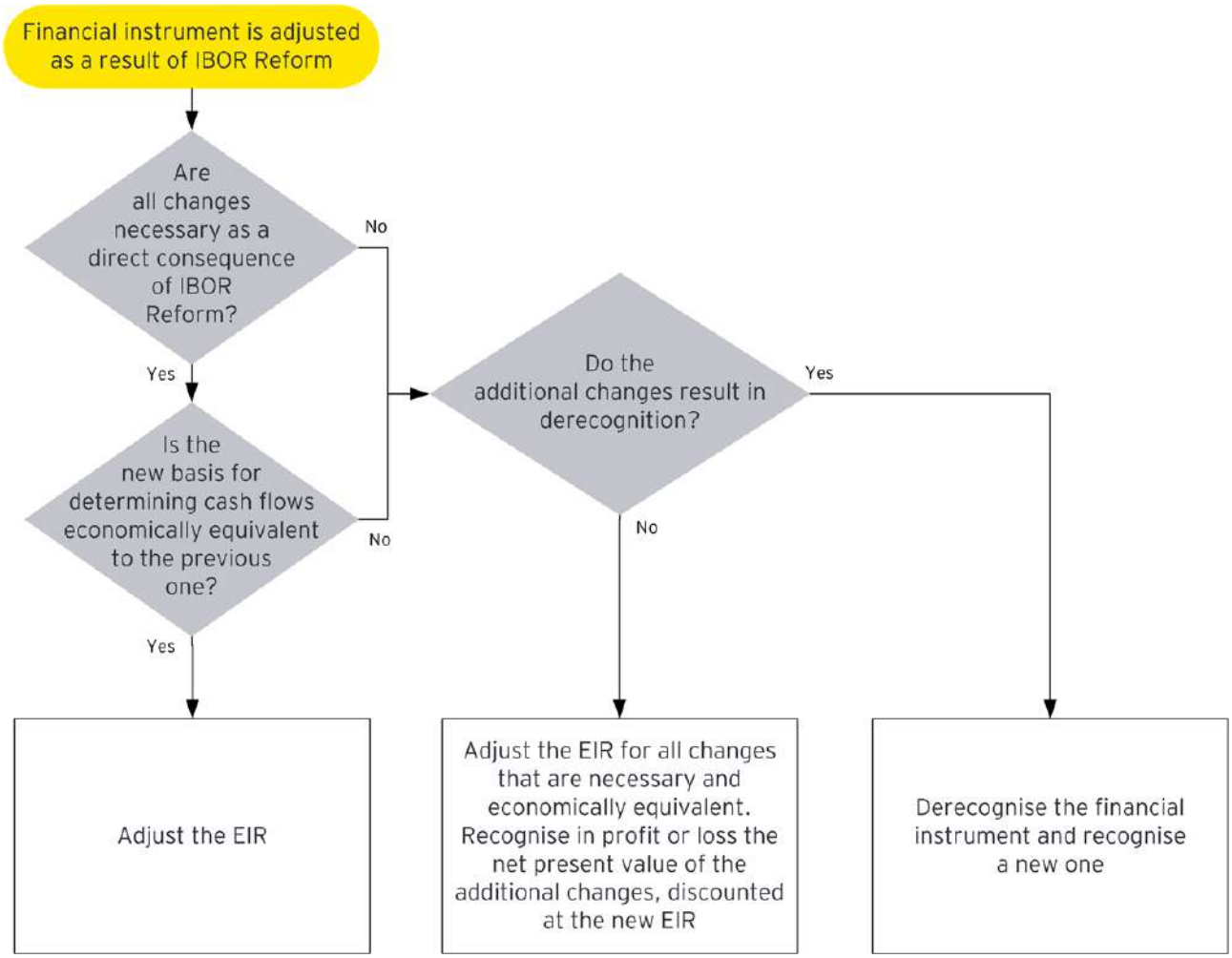
- A modification gain or loss will potentially need to be recognised after revising the EIR for instruments involving an EIR, as described in section 2.1 below.
- A hedging relationship can potentially still continue, as described in section 4.2.2 below.

16 IASB Staff Paper AP11, Amortised Cost Measurement, Project commencement, September 2024, See Appendix A - Initial list of project, page 13, topics 2 and 3. Available on the IFRS Foundation's website.

17 IASB Staff Paper 3A, Project: *Post-implementation review of IFRS 9 - Classification and Measurement*, Paper topic: *Modifications of financial assets and financial liabilities*, IASB meeting, July 2022. Available on the IFRS Foundation's website.

2.1 Changes in the rate of interest

The requirements are summarised in the following flow chart:



This section covers the application of the relief applicable to instruments with an EIR. However, because the two conditions required to apply this relief (i.e., the changes are a direct consequence of the Reform and the changes result in economically equivalent contractual cash flows) are the same as for the relief allowing the continuation of hedging relationships, the clarifications provided in this section on these two conditions are also applicable for the purpose of assessing the continuation of hedging relationships (as further discussed in section 4.2.2 below).

If an IBOR is amended to refer to an RFR, without the benefit of the Phase 2 Amendments:

- First, the entity would have to assess whether the changes made to a financial instrument to achieve the Reform would lead to its derecognition.
- Second, if the instrument is not derecognised and is recorded at amortised cost or at fair value through other comprehensive income, the entity would apply the requirements in IFRS 9.5.4.3 and recalculate the carrying amount of the financial instrument using the original effective interest rate (EIR), i.e., based on the IBOR before transition to the RFR.

The second of these would mean that interest revenue or expense would continue to be recognised using an IBOR-based EIR over the remaining life of the instrument, even if the IBOR is no longer available. The Board considered that, in this context, this outcome would not necessarily provide useful information to users of the financial statements, as the interest recognised would not reflect the economic effects of changes made to a financial instrument as a result of the Reform. *[IFRS 9.BC5.306]*.

Therefore, the Phase 2 Amendments require, as a practical expedient, for changes to cash flows that relate directly to the Reform to be treated as changes to a floating interest rate, i.e., the EIR is updated to reflect the change in an interest rate benchmark from IBOR to an RFR without adjusting the carrying amount. In effect, the change is treated as akin to a movement in the market rate of interest. *[IFRS 9.5.4.7]*.

The use of the practical expedient is subject to two conditions: *[IFRS 9.5.4.7]*

- First, the change in the basis for determining contractual cash flows must be 'necessary as a direct consequence of interest rate benchmark reform'.
- Second, the new basis for determining the contractual cash flows must be 'economically equivalent to the previous basis', immediately preceding the change.

Each of these conditions is discussed, in turn, below.

It must be noted that the addition of a fallback provision and the activation of a fallback provision are both treated in the Phase 2 Amendments as changes to the basis for determining contractual cash flows. This implies that if a financial instrument is, first, amended to add a fallback provision and, second, this provision is activated, then the Phase 2 practical expedient will be applied twice. However, applying the expedient, the accounting effects arise only on activation. Some 'hardwired' fallbacks specify two transitions, first to an overnight RFR and second, to a term RFR when it becomes available. Presumably, Phase 2 reliefs will be available for each transition.

How we see it

Because of the practical expedient, transition to RFRs will generally result in a change in the EIR for floating-rate financial instruments recorded at amortised cost or at fair value through OCI. However, many financial instruments such as loans will need to be renegotiated bilaterally and entities will need to establish policies and procedures to avoid, or else identify, any modifications over and above those required by the Reform and to ensure that they are accounted for appropriately (see section 2.2.1 below).

2.1.1 Direct consequences of the Reform

There is limited guidance in the Phase 2 Amendments as to what changes for determining contractual cash flows would be a direct consequence of the Reform. In Phase 1, the IASB defined IBOR Reform as "the market-wide reform of an interest rate benchmark, including the replacement of an interest rate benchmark with an alternative benchmark rate such as that resulting from the recommendations of the Financial Stability Board's July 2014 report, '*Reforming Major interest Rate Benchmark*'." *[IFRS 9.6.8.2, IAS 39.102B]*. IBOR Reform can, therefore, be read to encompass any replacement of references to an IBOR with a rate considered acceptable by local regulators, such as an RFR, and any related amendments necessary to implement the Reform, including those needed to achieve economic equivalence (see section 2.1.2 below).

Some respondents to the Phase 2 ED asked the question as to whether the reliefs are only available if, in the particular jurisdiction, IBOR Reform is mandated by laws or regulations. Consequently, they would not be available if, for example, financial instruments were modified only because of a concern that the IBOR could, in future, be discontinued due to reduced liquidity or to align with global market developments. In the Phase 2 Amendments' Basis for Conclusions, the IASB has clarified that, while the changes must be a direct consequence of the Reform, they do not, in themselves, have to be mandatory. *[IFRS 9.BC5.313]*.

2.1.2 Economically equivalent

The Phase 2 Amendments provide examples of where changes would be 'economically equivalent': *[IFRS 9.5.4.8]*

Extract from IFRS 9

5.4.8 Examples of changes that give rise to a new basis for determining the contractual cash flows that is economically equivalent to the previous basis (ie the basis immediately preceding the change) are:

(a) the replacement of an existing interest rate benchmark used to determine the contractual cash flows of a financial asset or financial liability with an alternative benchmark rate - or the implementation of such a reform of an interest rate benchmark by altering the method used to calculate the interest rate benchmark - with the addition of a fixed spread necessary to compensate for the basis difference between the existing interest rate benchmark and the alternative benchmark rate;

(b) changes to the reset period, reset dates, or the number of days between coupon payment dates in order to implement the reform of an interest rate benchmark; and

(c) the addition of a fallback provision to the contractual terms of a financial asset or financial liability to enable any change described in (a) and (b) above to be implemented.

It will be clear from the list above that 'economically equivalent' does not mean 'economically identical'. The IASB also makes it clear that it regards 'economic equivalence' to be principle-based and the above list is not intended to be exhaustive. *[IFRS 9.BC5.315, IFRS 9.BC5.317]*. For instance, it would be consistent with these examples to include amendments to caps and floors so as to maintain their economic effect (see Illustration 2-1 in section 2.1.4 below). It would also be consistent with the examples for transition to a synthetic LIBOR such as those defined by the FCA (see section 1.1 above), to be considered as economically equivalent.

The Basis for Conclusions also clarifies that, while the notion of economic equivalence means that the interest rate will be substantially the same before and after the replacement, as long as the changes are consistent with the above examples, there is no requirement to demonstrate this is the case through a quantitative analysis ("the entity would not be required to analyse whether the discounted present value of the cash flows of that financial instrument are substantially similar before and after the replacement"). *[IFRS 9.BC5.315, IFRS 9.BC5.316]*. Accordingly, the IASB set no 'bright lines' and an entity is required to apply judgement to assess whether circumstances meet the economic equivalence condition.

How we see it

The term 'economically equivalent' is not defined in the Phase 2 Amendments. Whilst the IASB's intention is that the assessment is predominantly qualitative in nature, entities need to develop an accounting policy and processes to ensure that the assessment can be carried out consistently in a suitably controlled manner. Associated with this, entities are advised to review how their existing accounting policy for modifications of financial instruments is determined and applied in practice.

For many financial instruments, the changes needed to transition to an RFR will require negotiation between the two parties to the contract and it is possible that the agreed modifications could go further than those needed just to implement the Reform. After an entity applies the practical expedient to modifications to the financial instrument required by the Reform, it then separately assesses any further modifications that are not required by the Reform to determine whether they result in derecognition of the financial instrument (see section 2.2 below). If they do not result in derecognition, an entity uses the updated EIR to adjust the carrying amount of an instrument not recorded at fair value through profit or loss, and immediately recognises a modification gain or loss in profit or loss within interest income or expense. *[IFRS 9.5.4.9]*.

Extract from IFRS 9

5.4.9 If changes are made to a financial asset or financial liability in addition to changes to the basis for determining the contractual cash flows required by interest rate benchmark reform, an entity shall first apply the practical expedient in paragraph 5.4.7 to the changes required by interest rate benchmark reform. The entity shall then apply the applicable requirements in this Standard to any additional changes to which the practical expedient does not apply. If the additional change does not result in the derecognition of the financial asset or financial liability, the entity shall apply paragraph 5.4.3 or paragraph B5.4.6, as applicable, to account for that additional change. If the additional change results in the derecognition of the financial asset or financial liability, the entity shall apply the derecognition requirements.

Application of these requirements means an entity first applies the practical expedient to a change that is required by IBOR Reform (i.e., a change that meets both the conditions in IFRS 9.5.4.7, as discussed in this section and then applies the normal requirements in IFRS 9 to those changes to which the practical expedient does not apply.

Examples of possible changes that would most likely not be viewed as economically equivalent, include:

- Changes to the principal or notional value
- Changes in maturity and methods of repayment (such as a move from a bullet repayment to by instalment)
- Changes in credit spread to reflect changes in the credit quality of the obligor
- The addition or removal of caps and floors, prepayment and extension options

In many cases, an instrument will transition on a date that is different to the fixing date when the contractual cash flows are scheduled to periodically reset to the current floating rate. At the time of transition an instrument will often therefore, in effect, be a combination of a fixed rate instrument until the end of the previous fixing period and a floating rate instrument for all future fixings. IBOR Reform affects only the future fixings, which following transition will reference the new RFR. For the instrument to transition on an economically equivalent basis, any cash flows remaining from the final IBOR fixing before transition, will normally continue until the next scheduled fixing takes place, which will reference the RFR.

How we see it

In general, any transition that is economically equivalent is likely to share three main characteristics:

- The new basis for determining contractual cash flows is qualitatively similar to the previous one.
- The amendment is designed to help ensure an equitable transition to an RFR for both parties to the contract. This will, in theory, most easily be demonstrated if the amendment is in accordance with an industry-accepted protocol designed with this objective.
- An economically equivalent transition involves no significant change in a financial instrument's fair value. Therefore, any adjustment to the spread other than to reflect the difference between RFRs and IBORs on transition, or a payment by one party to the other, to compensate for a change in terms, which is not small when compared to the original contractual cash flows, could indicate that the terms are not economically equivalent and will require careful analysis.

2.1.3 ISDA fallback spread

The challenges associated with determining an appropriate method for calculating the basis spread between RFRs and IBORs on transition are illustrated well by the process through which ISDA arrived at its derivative fallback protocol for the cessation of LIBOR. ISDA set out the following criteria:

(i) Minimising value transfer at the time the fallback is applied

(ii) Minimising any potential for manipulation

(iii) Eliminating or mitigating against the impact of market disruption at the time the fallback is applied

ISDA consulted on three possible approaches to set the spread, noting that they each satisfied these criteria to varying degrees:[18]

(1) Arguably the most 'economically equivalent' approach, in that it would be present value neutral, would be to base the spread on the forward market view of the spread between the IBORs (for each tenor, such as 3-months or 6-months) and the RFR at the date of calibration. However, this approach would be complicated, and the necessary data is unlikely to be readily available. The forward approach would require a forward IBOR curve and a forward RFR curve for the term of all financial instruments and so potentially out to 40 or 50 years. This would require both an established RFR market as well as extensive market data, which does not currently exist.

(2) The simplest approach would be what is termed the 'spot' method. This bases the spread adjustment on the spot spread between the relevant IBOR and the adjusted RFR on the day before the fallback provisions are triggered. This approach is likely to ensure that the current rate of interest is 'substantially the same'. Its disadvantages are not only that it does not reflect the market expectations on forward rates (and so will not be present value neutral on the date of calibration), but it is likely to be more volatile than a forward spread.

(3) The majority of respondents to ISDA's consultation preferred what became the adopted approach, using the median historical spread between the relevant IBOR and the compounded RFR over the previous five years. It was recognised that this "is unlikely to be present value neutral on the calibration date because spot rates are unlikely to be consistent with forward rates and because the average historical market conditions may not match market expectations for future market conditions". However, it has two major advantages: first, it is less volatile than spot rates and captures the tendency of interest rates to fluctuate around a long-term mean and, hence, is likely to be a better approximation to the forward spread; and, second, it is based on readily available information.

The ISDA methodology for determining the spread can be applied by entities more broadly to the transition of many non-derivatives to RFRs, e.g., it can provide a starting point in bilateral negotiations to amend a contract. As has already been mentioned in section 1 above, the ISDA fallback spreads were 'fixed' on 5 March 2021.

18 *Interbank Offered Rate (IBOR) Fallbacks for 2006 ISDA definitions, Consultation on Certain Aspects of Fallbacks for Derivatives Referencing GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW*, ISDA, July 2018.

How we see it

Any approach to adjust the spread on transition to an RFR must be practical to apply and make use of data that is reliable and readily available. Because of limitations on the availability of data, there will be more than one acceptable method for determining the spread between IBOR and an RFR. The types of approaches explored by ISDA can, in theory, all result in transitions which are economically equivalent.

When using approaches such as that developed by ISDA that are based on rigorous quantitative analysis, it will likely not be necessary to make a quantitative evaluation of the economic equivalence on an instrument-by-instrument basis.

2.1.4 Addition of and adjustment to floors and caps

One particular area that could cause challenges is the introduction of, or adjustment of interest rate floors and caps to financial instruments on transition to RFRs. For floors, this was particularly relevant whilst risk free interest rates were close to zero or even negative, as was the case in many jurisdictions in 2020 and 2021. In a rising interest rate environment, such as that experienced since 2022, interest rate caps become increasingly relevant. A simple example, where an interest rate floor is modified so as to give the same economic effect as before transition, is shown in Illustration 2-1 below.

For more complex fact patterns, which might involve introducing a floor or cap where none was present before, or resetting the floor so that, for example, for a floor the RFR cannot go below zero or for a cap the RFR cannot go above 5%, and which could also involve an amendment to the spread or a cash compensation paid to the lender, the assessment will be more difficult. The analysis will depend on whether the modification is considered to be required by the Reform and whether the effect is economically equivalent (see further discussion in section 2.1.1 and section 2.1.2 above). The addition of a floor or cap is unlikely to be viewed as economically equivalent unless the likelihood of the floor or cap being activated is insignificant. The Amendments provide only limited guidance, and this is an area where judgement is required.

These requirements as applied to an interest rate floor are shown in Illustration 2-1 below and also in Illustrations 4-2 to 4-4 in section 4.3 below.

Illustration 2-1: Application of the Phase 2 relief for amendment of a floor

An existing short-term loan pays 3-month US dollar LIBOR + 100 bp, with a floor of LIBOR = zero. It is restructured to pay SOFR + 126bp, when 26bp is determined to be the market basis difference between 3-month LIBOR and SOFR. (26bp is based on the ISDA fallback spread although rounded to simplify the example). The floor is amended to SOFR + 26bp = zero. Both before and after transition, including the credit spread, the loan has an effective floor of 100bp.[19]

The amendment of the instrument, including the floor, is a direct consequence of IBOR Reform and the new terms are assessed to be economically equivalent to the old ones, as the only adjustment is to replace 3-month LIBOR with SOFR plus the market basis difference, with an equivalent adjustment to the floor and the difference in volatility between the two floors is considered negligible. Therefore, Phase 2 IFRS 9.5.4.7 relief is applied, the EIR is amended to SOFR + 126bp and there is no need to consider any other accounting consequences.

2.1.5 Cash settlement

Another challenging issue is whether any cash settlement between the parties to a contract on transition, to compensate for the difference in fair value of a financial instrument, would automatically imply that the change is not economically equivalent. As already noted, 'economic equivalence' does not mean 'economically identical', and the guidance states that interest rates must be 'substantially similar', implying that there is a level of tolerance as to what changes would meet the criterion (see section 2.1.2 above). As described in more detail in section 2.3 below, in the context of modification or replacement of derivatives, an example is included in the Basis for Conclusions, where replacing a derivative with a new one on current market terms, with cash settlement for the difference in fair value, would not be regarded as economically equivalent. However, in this example, the contractual terms of the new at-market derivative are described as 'substantially different'.

19 In practice, there might also be a further minor adjustment to the spread to reflect the difference in volatility of an RFR based floor compared to an IBOR based floor, but this is ignored for the purpose of this example.

In contrast, another example regarded as economically equivalent involves no cash settlement and the replacement of the original derivative with an off-market derivative with identical terms other than the replacement RFR. A situation involving some cash settlement could fall between these two extremes. Therefore, a transition involving some cash settlement could still be viewed as economically equivalent provided it is relatively small when considered against the contractual cash flows of the original instrument.

This is an area where judgement is required.

2.2 Derecognition

It is possible that amendments made to financial instruments on transition to RFRs could lead to their derecognition and the recognition of new instruments. Assessing whether derecognition is required could have a significant consequence for their accounting treatment. For a financial instrument that is not measured at fair value through profit or loss, the possible outcomes of this assessment include a profit or loss on derecognition, the classification of the new instrument, the measurement of the EIR, and its staging if subject to the expected credit loss impairment requirements. Meanwhile, for all financial instruments, including derivatives, the derecognition assessment could be critical for the continuation or discontinuance of hedge accounting (see section 2.2.1 below).

2.2.1 Modification of financial instruments

The issue as to when a modification of a financial instrument might lead to its derecognition is specifically addressed in IFRS 9 only for financial liabilities and not for financial assets. The key requirement for financial liabilities is that a modification that results in a 'substantial change' in the expected cash flows will lead to the derecognition of the original liability and the recognition of a new one. *[IFRS 9.3.3.2]*. There is no equivalent guidance in IFRS 9 for modifications of financial assets, although, in 2012, the IFRS Interpretations Committee, in discussing the restructuring of Greek Government Bonds, considered that it would be appropriate to analogise, at least to some extent, to those requirements in IFRS 9 applying to modifications and exchanges of financial liabilities (see Chapter 48 at section 3.4.2 for further details).[20] This is an area which requires judgement, and many entities will have already developed an appropriate accounting policy. In September 2024, the IASB commenced the Amortised Cost Measurement Project, which once complete should result in additional guidance for modifications.[21]

The Phase 2 Amendments only require an assessment of whether the derecognition criteria apply if changes are made to the financial instrument beyond those that qualify for the practical expedient (see section 2.1 above). Changes qualify for the practical expedient if:

- The change in the basis for determining contractual cash flows is a direct consequence of the Reform.
- The new basis for determining the contractual cash flows is economically equivalent to the previous basis immediately preceding the change.

It follows that changes that qualify for the practical expedient are not required to be assessed for whether they are sufficiently substantial that the instrument would be derecognised. *[IFRS 9.5.4.9]*.

For any changes that are made to a financial instrument that go beyond what is necessary to implement IBOR Reform, entities will need to assess whether the instrument must be derecognised and a new one recognised instead.

How we see it

The Amendments provide no further guidance on what level of modification would be viewed as sufficiently substantial as to lead to derecognition and this assessment will require judgement and possibly the refinement of existing policies and processes to implement the assessment. While IFRS 9 states that a 10% change in the net present value of contractual cash flows of a liability would be considered substantial, it is recognised that the assessment ought also to have regard to qualitative factors, such as the introduction of new contractual features.

20 IFRIC Update, September 2012, *IAS 39* Financial Instruments: Recognition and Measurement-*Derecognition of financial instruments upon modification*. Available on the IFRS Foundation's website.

21 IASB Staff Paper AP11, Amortised Cost Measurement, Project commencement, September 2024, See Appendix A - Initial list of project, page 13, topics 2 and 3 relate to the modifications of contractual cash flows. Available on the IFRS Foundation's website.

2.3 Modification or replacement of derivative contracts

The fourth method of changing the basis for determining contractual cash flows has already been introduced in section 2 above: the close-out and replacement of a derivative with the same counterparty and on the same terms, or the addition of a basis swap. As set out in the Basis for Conclusions, the IASB was concerned that it is the substance of an arrangement that determines the accounting treatment, rather than its form and examined four scenarios. *[IFRS 9.BC6.619]*.

2.3.1 Two new derivatives, one equal and offsetting the original derivative

The first scenario involves the counterparties to an IBOR derivative entering into two new derivatives, one derivative equal and offsetting the original IBOR-based derivative so as to close it out with no gain or loss and a second derivative that references the RFR, but otherwise with the same terms as the original derivative so that it has an equivalent fair value. *[IFRS 9.BC6.620(a)]*. According to the IASB's analysis, the counterparty to the new derivatives is the same as to the original derivative, the original derivative has not been derecognised and the terms of the alternative benchmark rate derivative are not substantially different from that of the original derivative. The Board, therefore, concluded that such an approach could be regarded as consistent with the changes required by the Reform and since the new derivative is economically equivalent to the original derivative, the Phase 2 hedge accounting reliefs will apply (see section 4.2 below).

If the original derivative is not legally extinguished, this implies that all three derivatives - the original IBOR derivative and the two new ones - would need to be designated together as the hedging instrument. However, in practice, it is likely that the counterparties to the original derivative and the second one which closes it out, will choose to legally extinguish the two derivatives. The process for extinguishing derivatives cleared by a central clearing counterparty is known as 'compression'. In that case, applying the derecognition guidance for financial liabilities, *[IFRS 9.3.3.2]*, the original derivative could be treated as modified rather than as derecognised, since it is an exchange with the same counterparty and does not constitute a 'substantial modification' of the original terms. The relief criterion in IFRS 9.6.9.2(b), that the original hedging instrument is not derecognised, would, therefore, be considered to be met. This approach would also be consistent with the IASB's focus on the substance rather than the legal form, given that it will make no difference to the subsequent net cash flows, whether or not the derivative is legally extinguished.

2.3.2 Derivative replaced with a new derivative

It would give the same result as that described above, if on transition an existing swap is legally terminated and at the same time, a new interest rate swap is entered into, in which all terms and conditions remain unchanged, apart from the new RFR which replaces the IBOR. Notably, we would expect the terms of the new instrument to contain a fixed spread adjustment (similar to the CAS referred to in section 1.1 above) to reflect the absence of credit risk in the RFR which is inherent in the IBOR. If this fixed spread adjustment is not included, it would therefore contribute to the new derivative not being economically equivalent. Derecognition of the original derivative would not be required if, similar to the scenario described in section 2.3.1 above, the conditions to derecognise a financial liability have not been met as the terms are not substantially different.

By contrast, in the second scenario examined by the IASB, the original IBOR derivative is terminated and the unrealised gain or loss settled in cash, and a new RFR derivative is entered into on substantially different terms reflecting the current market rate. Because the IBOR derivative has been extinguished and replaced with a new one on substantially different terms, the IASB considered that this is not consistent with the changes required by the Reform and so the Phase 2 hedge accounting reliefs from discontinuing hedge relationships, discussed in section 4.2.2 above, will not apply. This analysis implies that the first derivative would be derecognised and the second one recognised in its place. *[IFRS 9.BC6.620(b)]*.

2.3.3 New basis swap linked to the derivative

In the third scenario, the entity enters into a new basis swap, specific to a particular derivative instrument, which swaps the existing interest rate benchmark for that instrument to the RFR. This is viewed by the IASB as economically equivalent to modifying the contractual terms of the original instrument, as long as the basis swap is linked or coupled with the original derivative rather than being entered into at a portfolio level. *[IFRS 9.BC6.620(c)]*. The scenario does not specify whether the basis swap needs to be with the same counterparty as the original derivative and it is unclear whether this is expected to be assumed or whether the omission is deliberate.

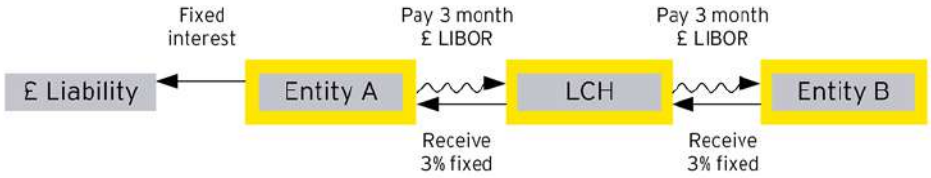
2.3.4 Novation to a new counterparty and amendment of the derivative

In a fourth scenario considered by the IASB, it clarified that novating an IBOR-based derivative to a new counterparty and subsequently amending the derivative with that counterparty to refer to an RFR, would result in extinguishment of the original derivative. *[IFRS 9.BC6.620(d)]*. This is because novation of a derivative would result in the derecognition of the original derivative. The Phase 2 hedge accounting reliefs will, therefore, not apply.

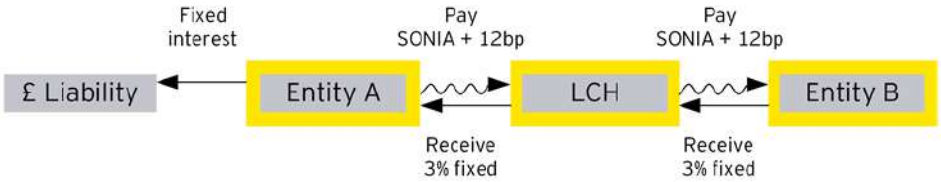
The process of modifying a derivative is shown in Illustration 2-2. Whilst sterling LIBOR, as used in the example, ceased on 31 December 2021, the principles of the example apply equally to IBOR linked derivatives that are still to transition.

Illustration 2-2: Modification of a derivative

Entity A is a party to a swap (swap 1) with a notional value of £10 million and a remaining five-year maturity on which, quarterly, it pays sterling 3-month LIBOR (fixed in advance at the beginning of the quarter) and receives 3% fixed. When first traded with Entity B, the swap was novated to the London Clearing House (LCH), which thereby serves as the swap counterparty to both A and B. A designates the swap as the hedging instrument in a fair value hedge of a fixed rate sterling liability.



In October 2021, Entities A and B choose to amend swap 1 in order to transition it to SONIA, at a time when the basis difference between 3-month LIBOR and overnight SONIA for this instrument is determined to be 12 basis points (based on the ISDA fallback protocol, although rounded to simplify the example) (see section 2.1.3 above). A and B enter into two new swaps, swap 2 with terms equal and opposite to those of swap 1, plus a new SONIA swap, swap 3. Swap 3 has the same notional value and remaining term to maturity as swap 1 and continues to pay 3% fixed, but starting from the next quarterly fixing date, A makes a quarterly payment of SONIA + 12bp (compounded daily).



Swaps 2 and 3 are novated to the LCH and A and B elect to compress the two offsetting LIBOR swaps (i.e., swaps 1 and 2). This gives rise to no profit or loss or net cash flow but legally extinguishes the two swaps. Because the net effect of the transaction is to exchange swap 1 with swap 3, with the LCH being the counterparty to both swaps, swap 1 is treated as modified by the exchange rather than derecognised. Consequently, the replacement qualifies to be assessed as to whether hedge accounting can continue, as described in section 4.2.2 below. See Chapter 49 at section 8.3.5 for a discussion of when novating derivatives to a central clearing party does not require the hedging relationship to be discontinued.

How we see it

The first two scenarios for the replacement of swaps discussed in the Basis for Conclusions are intended to represent two ends of a spectrum. The first illustrates where the terms of the new RFR derivative are the same as the old IBOR one, except that it now references the RFR with the addition of an appropriate spread. In the second scenario, the terms are substantially different. It follows that there could be intermediate fact patterns, where the derivative is amended more than is strictly necessary to transition to the RFR, without the terms being substantially different. Hence, the derivative will still not be derecognised. Assessing whether the terms are substantially different will require the development of policies and processes to make the assessment and the application of judgement.

2.3.5 Transition by central clearing houses

A further complexity can arise when entities agree that instruments will reference IBOR until the cessation date, but for operational reasons, convert the instruments prior to cessation date. The LCH operationally converted all bookings for LIBOR swaps to RFRs prior to cessation date.

For example, the LCH changed all CHF LIBOR swap bookings to SARON on 4 December 2021 but the swaps continued to reference CHF LIBOR until 31 December 2021. This meant that, for CHF LIBOR swaps with a fixing date from 4 December to 31 December, the final LIBOR fixing between the date of conversion and the date of transition was retained. Retaining this final LIBOR fixing helped ensure that the transition was economically equivalent. To help make this operational, the LCH replaced each LIBOR swap with three separate 'bookings', which, in combination, achieved this result as shown in the Illustration below. Following the transitions that took place in December 2021, LCH applied a similar approach to transition derivatives that reference US dollar LIBOR, which ceased on 30 June 2023.[22]

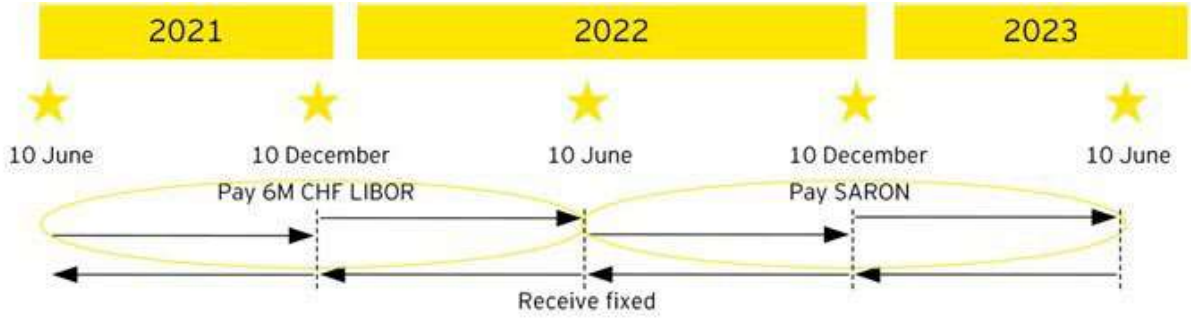
Illustration 2-3: LCH transition of LIBOR swaps

Consider a swap with a two-year term pay 6-month CHF LIBOR, receive fixed

- First transacted on 10 June 2021 and maturing on 10 June 2023
- Fixing dates on 10 December and 10 June annually

Upon conversion on 4 December 2021, three bookings are made:

The overall effect from the combination of the three bookings is as reflected in the diagram below:



How we see it

Consistent with the guidance set out in the Phase 2 Amendments, the three new bookings would be viewed together as a continuation of the original LIBOR swap, which is treated as modified rather than derecognised. The LCH received legal advice that the three new bookings have no contractual effect and do not alter or amend the legal rights and obligations under the original derivative, which helps support them being considered together as a continuation of the original swap.

22 Article: *US dollar Libor transition: A new countdown in motion, Philip Whitehurst, LCH,* Risk.net February 2022, available on LCH group's website.

3 Classification

3.1 Classification of financial assets

Any new financial assets, or any that have been derecognised and a new one recognised because they have been subject to substantial modification (see section 2.2 above), will need to be classified to determine their accounting treatment. A financial asset can only be accounted for at amortised cost or at fair value through other comprehensive income (FVOCI) if, at initial recognition, the cash flows represent Solely Payment of Principal and Interest (SPPI). *[IFRS 9.B4.1.7-26]*. See Chapter 44 at section 5 for further guidance on the SPPI assessment.

As part of the IBOR Reform project, in October 2019,[23] the IASB considered whether, if IBORs are replaced with backward-looking term rates (such as a rate for the next six months based on the average overnight rate for the previous six months), this would cause instruments to fail the SPPI assessment. The IASB noted that there are no specific conditions or exceptions that would automatically disqualify contractual cash flows to be SPPI. Any assessment of interest must focus on what the entity is being compensated for (i.e., whether the entity is receiving consideration for basic lending risks, costs and a profit margin). The IASB concluded that the current guidance in IFRS 9 provides an adequate basis to determine whether alternative benchmark rates are SPPI and that, provided the interest rate continues to reflect the time value of money and does not reflect other risks and features, the new instrument will pass the SPPI assessment.

Entities will, therefore, need to apply judgement in assessing whether there are any modifications to the time value of money element in replacement RFRs and, if there are, whether these modifications will cause a financial asset to fail the SPPI test.

This principle is illustrated by two examples, for SONIA (Illustration 3-1) and Adjustable Rate Mortgages (Illustration 3-2).

Illustration 3-1: SPPI evaluation for SONIA

SONIA is replacing sterling LIBOR as the risk-free rate for sterling loans. Whilst LIBOR is forward-looking, SONIA is backward-looking. SONIA is a daily rate which is compounded to determine the rate for an interest payment period such as three months. The interest to be paid is, therefore, only known at the end of the interest period. To facilitate timely payment of interest, it is useful for borrowers to know in advance what amount of interest is required to be paid. As such, the interest is determined five working days prior to the interest payment date, based on the compounded rate over a period starting and finishing five business days before the interest period begins and ends. In this instance, an entity will be able to assess from a qualitative perspective that there is no significant modification to the time value of money and, hence, the financial asset meets the SPPI criterion.

Illustration 3-2: SPPI Evaluation for Adjustable Rate Mortgages (ARMs)

ARMs are US dollar floating rate mortgages, that have historically been reset once a year, 45 days in advance of the period, and often based on LIBOR. After transition, it was recommended by the Alternative Reference Rates Committee (ARRC) that rates would be reset 45 days in advance, every six months, based on a 30-day compounded SOFR average plus a spread adjustment. The recommended spread adjustment was similar to that introduced by ISDA in its fallback for derivatives (see section 2.1.3 above).

It was not the intent of the ARRC to introduce features that deviate from the time value of money. Rather, it has sought to achieve the optimal lending terms, considering the needs of both issuers and investors. The market is familiar with a rate that is fixed in advance once a year and the frequency of reset has been amended to once every six months in order to continue to provide certainty as to the next interest payment, and also to make the rate more responsive to changes in market rates. The rate is calculated 45 days in advance, consistent with previous practice, and given that term SOFR rates were not available when the ARRC issued their recommendations, the rate was based on overnight SOFR plus a spread adjustment. The 30-day average was chosen to smooth out day-to-day SOFR volatility. Meanwhile, the spread adjustment was designed to reconcile SOFR (collateralised) to LIBOR (uncollateralised) and to capture the theoretical forward interest rate curve out to 6 months.

23 IASB Update, October 2019; and IASB Staff Paper 14B, Project: *IBOR Reform and its Effects on Financial Reporting - Phase 2*, Paper topic: *Accounting implications from derecognition of a modified financial instrument*, IASB meeting, October 2019, paragraphs 30 to 50. Available on the IFRS Foundation's website.

Although term SOFR rates are now available, we understand that 30-day average SOFR is still used as the index for many ARMs. On the basis that the lender is being compensated only for credit risk and the time value of money with a profit margin, and based on the quantitative analysis performed by the ARRC and published together with their recommendations to document their thought process,[24] it can be assessed qualitatively that an ARM would still satisfy the SPPI criterion and can be recorded by the lender at amortised cost or at fair value through OCI, depending on the IFRS 9 business model.

3.2 Separation of embedded derivatives

In October 2019, the IASB also considered in the context of its IBOR project, whether any amendment to IFRS 9 was required to clarify if fallback provisions added as a result of the Reform must be separated from a host financial liability as an embedded derivative.

In the context of the Reform, fallbacks arise where the contractual terms of financial instruments contemplate the replacement of an established interest rate benchmark with an alternative interest rate benchmark. Such a contractual term could involve basing the new rate of interest on the overnight RFR plus a spread or, as with US Adjustable Rate Mortgages, could be based on an average of the RFR determined over a period, and set in advance (see Illustration 3-2 in section 3.1 above).

Given that the separation of embedded derivatives is only assessed when a financial liability is first recognised, the issue is only relevant for new financial liabilities and those that have been significantly modified. If the economic terms of the financial instrument are affected by the fallback, there is a risk that it will not be closely related to the economic characteristics and risks of the host contract. Where this is the case, the fallback will need to be separated and accounted for as an embedded derivative.

In finalising the Phase 2 amendments, the IASB concluded that existing IFRS accounting standards provides an adequate basis to determine the accounting for fallbacks that could arise in the context of interest rate benchmark reform. Applying the guidance in IFRS 9.B4.3.8(a), when a new financial liability is recognised, entities must assess whether the fallback could at least double the initial return and result in a rate of return that is at least twice what would be expected for a similar contract at the time the fallback takes effect. This assessment is often referred to as the 'double-double test'.

How we see it

The vast majority of fallbacks added to financial liabilities in the context of the Reform do not require separation as an embedded derivative. This is because such fallbacks are normally consistent with the financial instrument transitioning to an alternative RFR on an economically equivalent basis. When the fallback is triggered, application of the practical expedient results in the transition being reflected as a change to a market rate of interest. The fallback is, therefore, clearly and closely related to the debt host contract and does not require separation as an embedded derivative.

24 *Options for using SOFR in Adjustable Rate Mortgages*, The Alternative Reference Rates Committee, July 2019.

4 Hedge accounting

4.1 Phase 1 reliefs

Extract from IFRS 9

6.8.1 An entity shall apply paragraphs 6.8.4-6.8.12 and paragraphs 7.1.8 and 7.2.26(d) to all hedging relationships directly affected by interest rate benchmark reform. These paragraphs apply only to such hedging relationships. A hedging relationship is directly affected by interest rate benchmark reform only if the reform gives rise to uncertainties about:

(a) the interest rate benchmark (contractually or non-contractually specified) designated as a hedged risk; and/or

(b) the timing or the amount of interest rate benchmark-based cash flows of the hedged item or of the hedging instrument.

The Phase 1 reliefs apply to all hedging relationships that are directly affected by uncertainties due to the Reform, regarding the timing or amount of interest rate benchmark-based cash flows of the hedged item or hedging instrument (i.e., uncertainty about what the new benchmark will be and when it will take effect). *[IFRS 9.6.8.1]*. However, if the hedged item or hedging instrument is designated for risks other than just interest rate risk, the exceptions only apply to the interest rate benchmark-based cash flows. The relief does not, therefore, apply to net investment hedges, as the hedged item must have interest-based cash flows to be eligible.

In this section, we first describe the reliefs for hedge accounting in accordance with IFRS 9. In section 4.1.3 below, we set out the differences for entities still applying IAS 39 for hedge accounting.

4.1.1 The Phase 1 reliefs for IFRS 9

Application of the reliefs is mandatory. *[IFRS 9.7.1.8]*. The first three reliefs for IFRS 9 provide for:

(1) The assessment of whether a forecast transaction (or component thereof) is highly probable *[IFRS 9.6.8.4]*.

(2) Assessing when to reclassify the amount in the cash flow hedge reserve to profit and loss *[IFRS 9.6.8.5]*.

(3) The assessment of the economic relationship between the hedged item and the hedging instrument *[IFRS 9.6.8.6]*.

On application of each of these reliefs, it must be assumed that the benchmark on which the hedged cash flows are based (whether or not contractually specified) and/or, for relief three, the benchmark on which the cash flows of the hedging instrument are based, are not altered as a result of the Reform.

It is possible that the designated hedged item is an IBOR risk component of a financial instrument. To be an eligible risk component, it would have to be 'separately identifiable' and 'reliably measurable', as discussed in Chapter 49 at section 2.2. *[IFRS 9.6.3.7(a)]*. The fourth relief provides that, where a benchmark component of interest rate risk has been designated as the hedged item and it is affected by the Reform, the requirement that the risk component is separately identifiable need be met only at the inception of the hedging relationship. *[IFRS 9.6.8.7]*. Hence, as long as the IBOR was considered to be separately identifiable when the hedge relationship was first established, the IBOR will continue to qualify as a risk component even if the IBOR ceases to be separately identifiable. (The issue of whether a benchmark rate is separately identifiable is considered further in sections 4.2.4 and 5 below).

The Basis for Conclusions also clarifies that if IBOR cash flows have been designated as the hedged item in a cash flow hedge, the entity should continue to measure ineffectiveness based on the IBOR-based cash flows. However, the Basis for Conclusions also states that if the entity has chosen to measure changes in fair value of the IBOR cash flows using a 'hypothetical derivative', the hypothetical derivative should be measured using a market-based discount rate that reflects market participants' assumptions about the uncertainty arising from the Reform. *[IFRS 9.BC6.570]*. This would be consistent with the rate which market participants would apply to actual IBOR derivatives used as hedging instruments. Therefore, the use of the market-based discount rate will not, in itself, increase hedge ineffectiveness.

Illustration 4-1: Application of Phase 1 relief

Entity A is hedging an eight-year floating rate borrowing referenced to a 3-month local IBOR that is due to cease in the foreseeable future. It is known that any interest coupons payable after the loan has been amended to implement the Reform, will not be determined with reference to the local IBOR, but according to the new RFR. The borrowing was previously designated in a cash flow hedge of the 3-month local IBOR interest rate risk. It is not yet known how the amendment will be achieved or when it will occur. Therefore, there is still uncertainty due to the Reform about the timing or amount of interest rate benchmark-based cash flows of the loan and the associated hedging instrument. While the uncertainty exists, the Phase 1 Amendment requires Entity A to ignore that fact and assume the hedged interest coupons on the borrowing and associated hedging instrument will remain local IBOR-based cash flows for the purposes of assessing and measuring effectiveness.

For 'dynamic' or 'macro' hedging strategies (i.e., where hedging instruments and hedged items are added to or removed from an open portfolio in a continuous hedging strategy, resulting in frequent de-designations and re-designations) the entity need only satisfy the separately identifiable requirement when hedged items are initially designated within the hedging relationship. The entity does not subsequently need to reassess this requirement for any hedged items that have been re-designated. *[IFRS 9.6.8.8]*.

However, the Phase 1 Amendments do not provide any relief from the requirement that changes in the fair value or cash flows of the risk component must be reliably measurable. *[IFRS 9.BC6.575]*.

The reliefs are intended to be narrow in their effect, such that other than the specific reliefs provided, the usual requirements within the IFRS 9 hedge accounting guidance must be applied. The Basis for Conclusions contains an example of where relief will not be available: benchmark-based cash flows cannot be assumed to still be highly probable if an entity decides not to issue forecast debt due to the uncertainties arising from the Reform. *[IFRS 9.BC6.560]*. Also, to the extent that a hedging instrument is altered so that its cash flows are based on an RFR, but the hedged item is still based on IBOR (*or* vice versa), there is no relief from measuring and recording any ineffectiveness that arises due to differences in their changes in fair value. *[IFRS 9.BC6.567, IFRS 9.BC6.568]*.

4.1.2 End of Phase 1 reliefs for IFRS 9

Reliefs one and two above cease to apply prospectively at the earlier of when the uncertainty arising from the Reform is no longer present with respect to the timing and amount of the IBOR-based cash flows of the hedged item, and:

- For relief one, when the hedging relationship that the hedged item is part of is discontinued
- For relief two, when the entire amount accumulated in the cash flow hedge reserve has been reclassified to profit and loss *[IFRS 9.6.8.9, IFRS 9.6.8.10]*

Relief three ceases prospectively, as follows:

- For a hedged item, when the uncertainty arising from the Reform is no longer present with respect to the timing and amount of IBOR-based cash flows of the hedged item
- For a hedging instrument, when the uncertainty arising from the Reform is no longer present with respect to the timing and amount of IBOR-based cash flows of the hedging instrument
- If the hedging relationship is discontinued before either of the two above events occur, at the date of discontinuation *[IFRS 9.6.8.11]*

When an entity designates a group of items as the hedged item, the end of relief requirements would be applied prospectively to each individual item within the designated group of items. *[IFRS 9.6.8.12]*.

Relief four ceases either when the formal designation of the hedge relationship is amended, applying the Phase 2 relief (see section 4.2 below) or when the hedging relationship is discontinued, applying the normal IFRS 9 discontinuation guidance. This means that until either of these occur, the risk component will continue to be designated, even if it is no longer separately identifiable. This is particularly relevant for fair value hedges as the hedged items will generally not need to be amended for the Reform. *[IFRS 9.6.8.13]*.

The reliefs will continue indefinitely in the absence of any of the events described above. The Basis for Conclusions sets out a number of different fact patterns, which could arise as contracts are amended in anticipation of the replacement of an interest rate benchmark, to illustrate when uncertainties due to the Reform will end. *[IFRS 9.BC6.587-593]*. The key message is that, in most cases, relief will only end when a contract is amended to specify both what the new benchmark will be and when it will take effect, and the spread adjustment that will be applied. As the relief is applied on a contract-by-contract basis, for some IBORs, the uncertainty could continue for a number of years as discussed in section 1.2 above.

Because the Phase 1 reliefs only cease to apply once there is no longer uncertainty over the benchmark that will apply, when it will be applied, and the change to the spread, it follows that agreement of a fallback arrangement will not in itself end the uncertainty and so does not bring an end to the Phase 1 relief, unless it specifies both the method and date of transition.

The FCA announced in March 2021, that most LIBOR settings would cease at the end of 2021 and ISDA fixed the basis spreads that applied to the RFR on transition under the fallback protocol (see section 1 above). This raised the question whether there remained any uncertainty with respect to the amount or timing of IBOR Reform, and, hence, whether Phase 1 had ended. As decisions are taken for other IBORs on how and when they will transition to RFRs, a similar question will arise. As noted in IFRS 7.24H(d), deciding whether there remains uncertainty is a judgement that entities need to make and disclose if the effect is material. In making this judgement the following factors are relevant:

- If the hedged item is floating rate but is not subject to the ISDA transition protocol and will require bilateral negotiation, there is still uncertainty as to amount and timing. Similarly, entities could decide to bilaterally negotiate the terms of transition so as to override the terms of the fallback.
- As mentioned in section 1.1 above, the FCA still required the ICE Benchmark Administration to continue publishing certain LIBOR settings (i.e., one-, three- and six- months settings for GBP and JPY) on a non-representative, 'synthetic' basis for 12-months beyond December 2021 to help deal with 'tough legacy' contracts.
- In September 2022, the FCA confirmed that they would require publication of one and six-month synthetic sterling LIBOR until the end of March 2023, after which these settings permanently ceased. In April 2023, the FCA confirmed that publication of three-month synthetic sterling LIBOR would continue until the end of March 2024, after which it permanently ceased. Following the end of US dollar LIBOR on 30 June 2023, one-month, three-month and six-month US dollar LIBOR settings continued in synthetic form until they permanently ceased on 30 September 2024.[25]
- Entities could also have chosen to transition earlier than the date of cessation and the London Clearing House (LCH), in its circular of 18 March 2021, reiterated its recommendation that its members' transition cleared derivatives ahead of the fallback date, in which case, they are not obliged to use the ISDA fallback spread.

  And
- Although it could be known when derivatives will transition and the RFR and spread adjustment that will be applied, there could be an additional adjustment at the transition date, to reflect any further differences in market fair value.

Whether or not it is judged that Phase 1 has ended, it is possible that estimates of the fixed spread that will be applied on transition to RFRs will already be reflected in the market's valuation of IBOR-based instruments. Prior to the LIBORs' cessation, market valuations converged, to a significant extent, on the ISDA fallback spreads.

There could be situations in which the uncertainty for particular elements of a single hedging relationship could end at different times. For example, assume an entity is required to apply the relevant exceptions to both the hedged item and the hedging instrument, as will typically be the case for a cash flow hedge. If the hedging instrument in that hedging relationship is amended to be based on an RFR earlier than the hedged item, such that the uncertainty about the timing and the amount of RFR-based cash flows of the hedging instrument is eliminated, the relevant exceptions would no longer apply to the hedging instrument even though they would continue to apply to the hedged item. *[IFRS 9.BC6.594]*. The hedged item will, therefore, by default, continue to be measured by reference to changes in IBOR, even though it is expected that it will be amended in the near term. The consequence of this is that any delay between the modification of the hedging instrument and the hedged item in a cash flow hedge will potentially introduce a new source of hedge ineffectiveness, specifically, any changes in the basis risk between the RFR interest on the hedging instrument and the IBOR interest on the hedged item. However, as the ISDA fallback spreads have now been fixed, the effect of this could be small. ISDA fallback spreads have also been fixed for other IBORs such as the Kuala Lumpur Interbank Offered Rate (KLIBOR) and Tel Aviv Inter-Bank Offered Rate (TELBOR), which are still to transition.[26]

This problem does not arise for fair value hedges, since the hedged instrument will not be amended as a result of the Reform and Phase 2 allows the designated hedged risk to be revised when the hedging instrument is amended (see section 4.2 below).

25 The end of LIBOR, FCA, 1 October 2024

26 IBOR Fallbacks Technical Note (IBOR Fallbacks Technical Note (Republication of HIBOR fallbacks), Bloomberg, 8 September 2023. IBOR Fallbacks Technical Note (New Fallbacks), 31 January 2023

4.1.3 Phase 1 reliefs for IAS 39

As many entities remain under the hedge accounting requirements of IAS 39, Phase 1 Amendments were also made to IAS 39. *[IAS 39.102A-102O, IAS 39.108G]*. These are consistent with those for IFRS 9, as described in sections 4.1.1 and 4.1.2 above, but with the following differences:

- For the prospective assessment that a hedge is expected to be highly effective, it is assumed that the benchmark on which the hedged cash flows are based (whether or not it is contractually specified) and/or the benchmark on which the cash flows of the hedging instrument are based, are not altered as a result of the Reform. *[IAS 39.102F]*. This relief ends under the same conditions as the IFRS 9 relief for the assessment of the economic relationship between the hedged item and the hedging instrument (see section 4.1.2 above).
- For the retrospective assessment of effectiveness, an entity could continue to apply hedge accounting to a hedging relationship for which effectiveness is outside of the 80-125% range during the period of uncertainty arising from the Reform. This applies to any hedge relationship affected by the uncertainties due to the Reform and is not restricted to the amount of ineffectiveness that can be directly attributed to the Reform. *[IAS 39.BC250]*.

  The relief is, however, subject to satisfying the other conditions in IAS 39.88, including the prospective assessment that the hedge is expected to be highly effective (as amended above). The relief ceases at the earlier of when there is no longer uncertainty with respect to the cash flows of both the hedged item and the hedging instrument, and when the hedging relationship is discontinued *[IAS 39.102M]*.

  This relief could be particularly important if there is a delay between when a hedging instrument is amended for the Reform and the amendment of the hedged item (or vice versa). Any actual ineffectiveness would still need to be measured and recognised in the financial statements. This should be calculated based on how market participants would value the hedged items and hedging instruments and would include the effect of any increase in discount rates that the market requires due to the uncertainties arising from the Reform. *[IAS 39.102G]*. However, as the ISDA fallback spreads have now been fixed, the effect of this could be small.
- For a hedge of 'a benchmark portion' (similar to 'a risk component' under IFRS 9) of interest rate risk that is affected by the Reform, the requirement that the portion is separately identifiable need be met only at the inception of the hedge. *[IAS 39.102H]*.

4.2 Phase 2 hedge accounting amendments

As noted above, the Phase 1 Amendments only cover pre-replacement issues. The issues that affect financial reporting when an existing interest rate benchmark is replaced with an RFR, are addressed by Phase 2. Hedge relationships within the scope of Phase 2 are the same as those within the scope of Phase 1 (see section 4.1 above). As with section 4.1 above, we first describe the reliefs for hedge accounting under IFRS 9 and then, in sections 4.2.7 and 4.2.8, below set out any differences for entities still applying IAS 39 for hedge accounting.

4.2.1 Phase 2 reliefs for IFRS 9

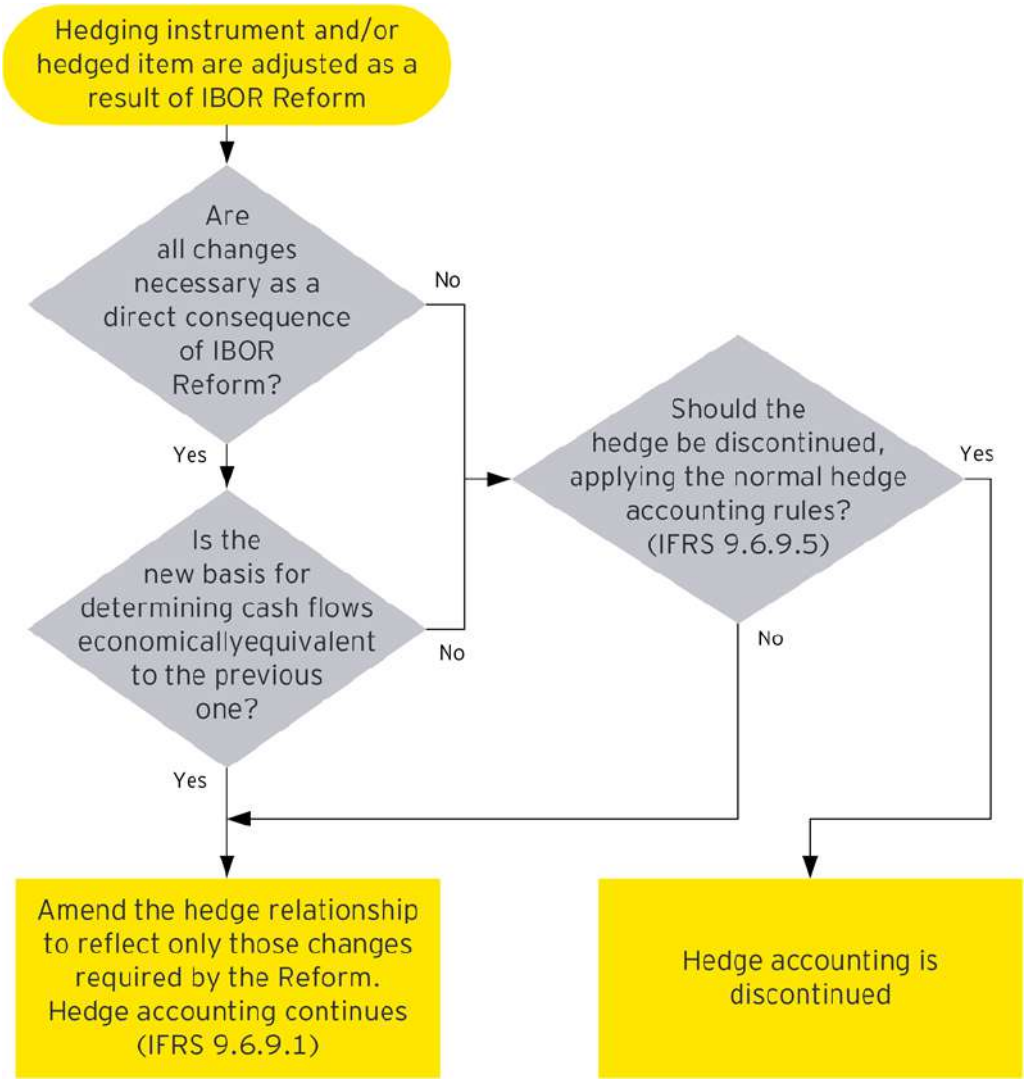
The Phase 2 Amendments for IFRS 9 provide the following reliefs (the 'Phase 2 reliefs'):

(1) Relief from discontinuing hedge relationships because of changes to hedge documentation required by the Reform (see section 4.2.2 below)

(2) Temporary relief from having to meet the 'separately identifiable' requirement (see sections 4.2.4 and 4.2.5 below)

4.2.2 Phase 2 reliefs from discontinuing hedge relationships

The application of the Phase 2 reliefs is summarised in the following flow chart:



The Phase 2 Amendments require that as and when an entity ceases to apply the Phase 1 reliefs to a hedging relationship (see section 4.1.2 above), the entity must amend the formal designation of that hedging relationship to reflect the changes that are required by the Reform. However, the hedge designation need not be amended immediately. It must be amended by the end of the reporting period during which a change required by the Reform is made to the hedged risk, hedged item or hedging instrument. Such an amendment does not constitute a discontinuation of the hedge relationship. *[IFRS 9.6.9.1, IFRS 9.6.9.4]*.

For this purpose, 'the end of the reporting period' should be given its normal interpretation as the end of an interim reporting period if an entity or group of which the entity is a member, publishes interim financial statements in accordance with IAS 34 *Interim Financial Reporting*.

These amendments to the hedge designation covered by the Phase 2 relief are restricted to one or more of the following:

- Designating an RFR as the hedged risk
- Amending the description of the hedged item, including any designated portion of the cash flows or fair value of the hedged item
- Amending the description of the hedging instrument *[IFRS 9.6.9.1]*

The changes must be directly required by the Reform, which means that both of the following conditions must be met:

- The changes must be necessary as a direct consequence of interest rate benchmark reform.
- The new basis for determining the contractual cash flows is 'economically equivalent' to the previous basis (i.e., the basis immediately preceding the change) *[IFRS 9.6.9.1, IFRS 9.5.4.5, IFRS 9.5.4.6, IFRS 9.5.4.7]*.

As already discussed in section 2.1.2 above, the Amendments include examples of the type of changes required by interest rate reform that are considered to be economically equivalent to the previous basis, as follows:

- The replacement of an existing interest rate with an RFR or effecting such a reform of an interest rate benchmark by changing the method used to calculate the interest rate benchmark, with the addition of a fixed spread to compensate for a basis difference between the existing interest rate benchmark and the RFR
- Changes to the reset period, reset dates, or the number of days between coupon payment dates that are necessary to effect the reform of an interest rate benchmark
- The addition of a fallback provision to the contractual terms of a financial asset or liability to enable any of the changes described above to be made *[IFRS 9.5.4.8]*

The above guidance is reasonably straight forward to apply if the changes made to hedged items or hedging instruments are only those necessary to achieve IBOR Reform and so are made on an economically equivalent basis. If changes are made to a financial asset or liability (including a derivative) designated in a hedging relationship, or to the designation of the hedging relationship, beyond those required by the Reform, the Amendments require that an entity must first apply the normal requirements in IFRS 9 to determine if those additional changes would result in the discontinuation of the hedge relationship. If the additional changes do not result in the discontinuation of hedge accounting, an entity must amend the formal designation of the hedging relationship, as described above, without discontinuing the hedge relationship. *[IFRS 9.6.9.5]*.

As already set out in section 2.1.2 above, examples of possible changes that would most likely not be viewed as economically equivalent, and hence not required by the Reform, would include:

- Changes to the principal or notional value
- Changes in maturity and methods of repayment (such as a move from a bullet repayment to instalments)
- Changes in credit spread to reflect changes in the credit quality of the obligor
- The addition or removal of caps and floors, prepayment and extension options.

Such additional changes must, therefore, be assessed to determine if, applying the normal IFRS 9 requirements, they would lead to the discontinuation of the hedge, as discussed in Chapter 49 at section 8.3. According to IFRS 9, apart from when there is a change in the risk management objective, hedges are discontinued only when the qualifying criteria are no longer met, i.e., if:

- The hedging instrument or hedged item are no longer eligible for hedge accounting.
- There is no longer an economic relationship between the hedged item and the hedging instrument.
- The effect of credit risk dominates the value changes that result from the economic relationship.

  Or

- The hedged item or hedging instrument is derecognised *[IFRS 9.6.5.6, IFRS 9.6.4.1]*.

It is likely that the most challenging of these criteria in the context of IBOR Reform is the last: determining whether the hedged item or hedging instrument is derecognised (see section 2 above).

If the hedge relationship is not discontinued, the hedge relationship is amended to: i) designate an RFR as the hedged risk; ii) amend the description of the hedged item, including any designated portion of the cash flows or fair value of the hedged item; and/or iii) amend the description of the hedging instrument *[IFRS 9.6.9.5, IFRS 9.6.9.1]*, in each case, to the extent required by the Reform. This means that any changes that are made to the hedging instrument or hedged item beyond those required by IBOR Reform will need to be included in the ongoing measurement of hedge ineffectiveness. This is shown in Illustration 4-4 in section 4.3.2 below.

As discussed in section 2.2 above, in the context of derecognition, it is possible that a hedging instrument will be changed by entering into two new derivatives with the same counterparty, one that is equal and offsetting to the original derivative and another one on similar terms except referencing an RFR. This is most likely to arise for derivatives cleared by a central clearing counterparty.

Phase 2 hedge accounting relief is obtained in this situation as long as two criteria are met:

(i) The original derivative is not derecognised, as outlined earlier in section 2.3 above.

(ii) The change is made on an economically equivalent basis.

The examples contained in the Basis for Conclusions have already been introduced in section 2.3 above in the context of derecognition. Although they provide guidance on whether or not an approach would be regarded as consistent with the changes required by the Reform, they do not specify whether the conclusion is driven primarily by the assessment of derecognition, or of economic equivalence, or both. In scenario (a), replacement of an original IBOR-based derivative by an RFR-based derivative on 'similar terms' is considered to meet both these criteria, whereas it is implied that in scenario (b) the replacement on 'substantially different terms' causes neither criterion to be met. It is, therefore, unclear whether there could be fact patterns that avoid derecognition, but still fail economic equivalence.

Also, as already discussed in the context of derecognition, the examples are intended to represent two ends of a spectrum. It would, therefore, be possible to apply the Phase 2 reliefs to fact patterns that involve a less substantial difference in terms. However, no guidance is provided as to how much change would be permitted before the derivative would be derecognised or the terms would no longer be regarded as economically equivalent. As a result, this is an area where judgement needs to be applied.

In another scenario examined by the IASB, the entity enters into a new basis swap, specific to a particular derivative instrument, which swaps the existing interest rate benchmark for that instrument to the RFR. This is viewed by the IASB as economically equivalent to modifying the contractual terms of the original instrument, as long as the basis swap is linked or coupled with the original derivative rather than being entered into at a portfolio level. *[IFRS 9.BC6.620(c)]*. The scenario does not specify whether the basis swap needs to be with the same counterparty as the original derivative, but this is probably assumed.

In contrast, in a further example discussed in the Basis for Conclusions, an entity enters into a basis swap in order to mitigate ineffectiveness arising between different methods of compounding of RFRs for cash products and derivatives. (A possible scenario is if the cash products and derivatives transition to RFRs on a slightly different basis, thus introducing a new source of potential hedge ineffectiveness). The implication is that an amendment of the hedge relationship to encompass the addition of this basis swap would result in the discontinuation of the hedge relationship. *[IFRS 9.BC6.617]*. The reason is not clearly articulated, but it is possibly because the addition of the basis swap is not strictly necessary to achieve IBOR Reform, rather it is a subsequent addition to improve hedge effectiveness.

Changes to hedge designations and hedge documentation required by the Reform may need to be made at different times for different hedge relationships, and more than once for individual hedge relationships. For instance, for a cash flow hedge, it is possible that the hedge designation and documentation will need to be amended twice: once when the derivative is modified to refer to an RFR; and again when the hedged item is renegotiated to refer to an RFR. An entity must apply the relief from discontinuing hedge relationships on each occasion the criteria are met. *[IFRS 9.6.9.3]*.

The usual IFRS 9 requirements are applied for accounting for changes in the fair value of the hedging instrument and the hedged item. Therefore, they are measured at fair value as RFR-based or IBOR-based, depending on whether they have each been amended or not, except that, for cash flow hedges, the cash flow hedge reserve is remeasured to the lower of the cumulative gain or loss on the hedging instrument and the cumulative change in fair value of the hedged item, as discussed in Chapter 49 at section 7.2. *[IFRS 9.6.9.3]*. When redesignating the hedge of a fixed-rate debt instrument, in order to be consistent with the continuation of the hedge, the component of the fixed cash flows designated as the hedged component should be adjusted to reflect the spread between RFR and IBOR. This is shown in Illustration 4-2 in section 4.3.1 below.

Meanwhile, if the change in fair value of the designated cash flows in a cash flow hedge is measured using a hypothetical derivative, after transition of the hedged financial instrument the hypothetical derivative will be adjusted to reflect the RFR (see Illustration 4-4 in section 4.3.2 below).

Any hedge ineffectiveness is recognised in profit and loss, as normal. The IASB does not expect that there would be a significant change in fair value on transition since that would imply that the amendments had not been made on an economically equivalent basis. *[IFRS 9.BC6.626]*. However, if there is a mismatch in timing in the amendment of the hedging instrument or hedged item, this could give rise to some ineffectiveness for cash flow hedges (see Illustration 4-4 in section 4.3.2 below).

When the hedged item is amended, amounts accumulated in the cash flow hedge reserve are deemed to be based on the RFR. The same applies for a hedge that has previously been discontinued, when the contractual cash flows of the previously designated item are modified. This results in the release of the cash flow hedge reserve to profit or loss in the same period or periods in which the hedged cash flows that are now based on the RFR affect profit or loss. *[IFRS 9.6.9.7, IFRS 9.6.9.8]*.

Extract from IFRS 9

Cash flow hedges

6.9.7 For the purpose of applying paragraph 6.5.11, at the point when an entity amends the description of a hedged item as required in paragraph 6.9.1(b), the amount accumulated in the cash flow hedge reserve shall be deemed to be based on the alternative benchmark rate on which the hedged future cash flows are determined.

6.9.8 For a discontinued hedging relationship, when the interest rate benchmark on which the hedged future cash flows had been based is changed as required by interest rate benchmark reform, for the purpose of applying paragraph 6.5.12 in order to determine whether the hedged future cash flows are expected to occur, the amount accumulated in the cash flow hedge reserve for that hedging relationship shall be deemed to be based on the alternative benchmark rate on which the hedged future cash flows will be based.

4.2.3 Phase 2 relief for groups of items

The Phase 2 Amendments also provide reliefs for items within a designated group of items (such as those forming part of a macro cash flow hedging strategy, see Chapter 49 at section 10.2) that are amended for modifications directly required by the Reform. The reliefs allow the hedging strategy to remain and not be discontinued. As items within the hedged group transition at different times from IBORs to RFRs, they will be transferred to sub-groups of instruments that reference RFRs as the hedged risk. The existing IBOR would remain designated as the hedged risk for the other sub-group of hedged items, until they too are updated to reference the new RFR. *[IFRS 9.6.9.9]*.

Although the Amendments do not provide detailed guidance on how the relief for groups of items will work, we currently assume that:

(i) If the hedged item was originally established as an 'open' portfolio, new hedging instruments and hedged items, whether they reference IBOR or RFRs, may be added to the groups as they are entered into.

And

(ii) At each transition, the hypothetical derivative for the sub-group will require updating.

The entity must ensure that each sub-group continues to meet the normal requirements of IFRS 9 to be an eligible hedged item. If any sub-group fails to meet the requirement to be designated as a hedged item, the entity must discontinue hedge accounting for the hedge relationship in its entirety. Meanwhile, hedge ineffectiveness must be measured and recorded as normal for the hedge relationship in its entirety. *[IFRS 9.6.9.10]*.

4.2.4 Phase 2 temporary relief for designation of risk components

IFRS 9 requires that a risk component designated in a hedge relationship is both 'reliably measurable' and 'separately identifiable' to be eligible for hedge accounting, as discussed in Chapter 49 at section 2.2. *[IFRS 9.6.3.7(a)]*. The Phase 2 Amendments provide temporary relief to entities from having to meet the separately identifiable requirement when an RFR instrument is designated as a hedge of a risk component, both upon designation of a new hedge relationship and for existing hedge relationships when changes required by the Reform are made to hedge designations and hedge documentation (see section 4.2.1 above and section 4.2.7 below). The relief allows entities to assume that the separately identifiable requirement is met, provided the entity reasonably expects the RFR risk component to become separately identifiable within the next 24 months. The 24-month period applies to each RFR separately (i.e., it applies on a rate-by-rate basis) and starts from the date an entity designates the RFR as a risk component for the first time.

If an entity reasonably expects that an RFR will not be separately identifiable within 24 months after initial designation, the relief will end for that RFR. Hedge accounting should be discontinued prospectively from the date of that reassessment for all hedging relationships in which the RFR was designated as a risk component. *[IFRS 9.6.9.11, IFRS 9.6.9.12]*.

The assessment of whether a risk component is separately identifiable is discussed further in section 4.2.5 below. Meanwhile, it must be stressed that no relief is provided from the requirement for the risk component to be 'reliably measurable' throughout the life of the hedging relationship (see section 4.2.6 below).

The relief from the need to assess whether an RFR risk component is separately identifiable only applies for uncertainties arising directly from the Reform. The relief is not available for hedging relationships where there is uncertainty over whether the risk component is separately identifiable, but the uncertainty is not as a direct result of the Reform.

How we see it

The relief from having to satisfy the separately identifiable requirement should significantly ease the transition to RFRs by allowing hedging relationships to be designated and to continue, even before the new RFRs are fully established as market benchmarks. However, entities must ensure they are comfortable to make the appropriate judgements at the time of transition and over the subsequent 24 months, while introducing suitable processes and governance to update their assessment.

This judgement is discussed in more detail in the next section.

4.2.5 Determination of whether an RFR is a separately identifiable risk component

Although the Phase 1 and 2 Amendments provide reliefs for the assessment of whether a non-contractually specified risk component is separately identifiable, and so can be designated as a hedged risk, they do not provide guidance on what is meant by 'separately identifiable'. Therefore, there should generally be no difference to how this criterion is interpreted in situations unrelated to IBOR reform. There are, however, a couple of points made in the Phase 2 Amendments that could be relevant, first, for fair value hedges and, second, for cash flow hedges.

(i) Fair value hedges

The first point is that the relief is provided only for 'separately identifiable' and not for 'reliably measurable', and so, the two criteria are clearly different. It is to be expected that an RFR might become sufficiently liquid that it is reliably measurable, but without yet being separately identifiable within the hedged item such as a fixed-rate debt instrument. *[IFRS 9.B6.3.9]*.

Whilst much of the pre-existing guidance in IFRS 9 on how to determine whether or not a risk component is separately identifiable, was written primarily to permit hedging of components of non-financial items, one example appears particularly relevant for interest rate hedges, as in the extract below: *[IFRS 9.B6.3.10(d)]*

Extract from IFRS 9

B6.3.10 ...

(d) Entity D holds a fixed-rate debt instrument. This instrument is issued in an environment with a market in which a large variety of similar debt instruments are compared by their spreads to a benchmark rate (for example, LIBOR) and variable rate instruments in that environment are typically indexed to that benchmark rate. Interest rate swaps are frequently used to manage interest rate risk on the basis of that benchmark rate, irrespective of the spread of debt instruments to that benchmark rate. The price of fixed-rate debt instruments varies directly in response to changes in the benchmark rate as they happen. Entity D concludes that the benchmark rate is a component that can be separately identified and reliably measured. Consequently, Entity D may designate hedging relationships for the fixed rate debt instrument on a risk component basis for the benchmark interest rate risk.

This paragraph is cited only as an example, so this should not be read as a list of criteria for a rate to qualify as separately identifiable. Nevertheless, this example could be read to imply that, for a benchmark interest rate to qualify as a risk component, it has to be the basis on which fixed rate debt instruments are frequently priced and floating rate debt instruments frequently vary in rate, and that it would be insufficient for the rate to be used only in the swap market. Not only did SONIA swaps already make up more than half the sterling swaps market by volume in 2021, but in November 2019, it was claimed that "SONIA is now the norm in issuance of floating rate sterling bonds and securitisations".[27] An entity might therefore have concluded in 2021 that SONIA was already separately identifiable and, if not yet, it would be within 24 months.

27 Speech delivered at the Risk.net LIBOR Summit 2019 by Edwin Shooling Latter, Director of Markets and Wholesale Policy at the UK's Financial Conduct Authority.

Prior to 2022, the percentage of the total US dollar swaps traded that referenced SOFR continued to be significantly lower than LIBOR-based swaps. In addition, there was slower progress in the growth of the issuance of SOFR-based cash instruments. However, based on the recommendations of the US Alternative Reference Rates Committee, there was an expectation that by 2022, SOFR (the chosen US dollar RFR) would eventually become the primary US dollar benchmark interest rate. On this basis, prior to 2022, we would have expected that most entities applying IFRS 9 for hedge accounting purposes would have concluded that SOFR would be separately identifiable within 24 months. By the end of Q1 2022, the volume and liquidity of SOFR swaps had surpassed that of US dollar LIBOR swaps, providing strong evidence that SOFR had superseded LIBOR as the primary US dollar derivative benchmark rate. Therefore, from 2022, we would expect entities for the purpose of applying hedge accounting under IFRS 9 (and IAS 39), to have considered SOFR to be a separately identifiable risk component of US dollar cash instruments.[28]

Although the guidance in IFRS 9 as to the criterion for a risk component to be separately identifiable is very similar to that in IAS 39 for a risk portion, the wording is not exactly the same. IAS 39 mentions that, "for a fixed rate financial instrument hedged for changes in fair value attributable to changes in a risk-free or benchmark rate, the risk-free or benchmark rate is normally regarded as both a separately identifiable component of the financial instrument and reliably measurable" (see section 4.2.8 below). The IASB has never said that it had intended the application of 'separately identifiable' to interest rates to change on the application of IFRS 9, which could imply that if a benchmark risk portion is considered identifiable under IAS 39, then it would also be a separately identifiable risk component under IFRS 9. However, the example in IFRS 9.B6.3.10(d) arguably provides a more detailed interpretation of what constitutes a 'benchmark'.

Meanwhile, the question also arises as to whether it is still possible to designate an IBOR as a separately identifiable risk component. The answer is clearly 'yes' until the RFR becomes established and it is likely that after that, for a short while, the IBOR and the RFR will both be separately identifiable, as the market transitions from one benchmark rate to another.

(ii) Cash flow hedges

The second point made in the Phase 2 Amendments is that it is clear that the exception for identifying risk components applies to cash flow hedges as well as fair value hedges. *[IFRS 9.BC6.649]*. This leads to the question of whether it is possible to designate an RFR as a risk component of an IBOR floating rate debt instrument. The relevance of this question arises mainly where there is a mismatch in the timing of the amendment of a hedging derivative and the floating rate instrument that is the hedged item, so that the derivative is amended to refer to an RFR before the hedged item. The issue here is not whether, for instance, the RFR will form the basis of floating rate instruments within 24 months, but whether it will ever be regarded as a separately identifiable component of an *IBOR-based* floating rate.

In the deliberations regarding timing mismatches in the Phase 2 Amendments, it was suggested in a Staff Paper that hedge ineffectiveness could be minimised in the period before the hedged item is amended, by adjusting the hedged risk to the RFR rather than the contractual interest rate.[29] This might be read to endorse the possibility of designating an RFR component of IBOR. However, there is no specific guidance on this issue within the Phase 2 Amendments. Unlike fair value hedges, in the past there has been much less practice of designation of risk components in floating rate instruments, unless the risk was already contractually specified (e.g., LIBOR risk in a loan that was indexed to LIBOR). Also, the examples in both IFRS 9 and IAS 39 only address fair value hedges. Therefore, it is more difficult to draw on past precedent or practice to support designating an RFR as a component of LIBOR.

The case for SONIA as a component of sterling LIBOR is perhaps easier to make, since it was first introduced in 1997 and SONIA can be thought of as 'overnight sterling LIBOR' and so a 'building block' of term LIBOR.[30] SOFR, however, which is based on overnight borrowing in the US Treasury repo market, is somewhat different in nature from US dollar LIBOR. Overnight SOFR is also quite volatile and can, on occasion, exceed 3-month US dollar LIBOR.

However, since, 'tough legacy' financial instruments were dealt with by creating for a limited time 'synthetic' IBORs, by redefining some GBP, JPY and US dollar LIBORs to be based on the term version of the RFRs plus the ISDA fallback spreads, then it follows that the RFR will have become a benchmark component of the corresponding synthetic LIBOR.

28 Bloomberg Article: *SOFR liquidity eclipses LIBOR*, Blomberg, 9 February 2022, available on Bloomberg's website.

29 IASB Staff Paper 14A, Project: *IBOR Reform and its Effects on Financial Reporting - Phase 2*, Paper topic: *End of application - Phase 1 exceptions*, IASB meeting, January 2020, paragraph 28. Available on the IFRS Foundation's website.

30 When SONIA was reformed in 2018, so it could qualify as an RFR, the main changes were only to base it on a wider range of participants' transactions and to amend the volume weighting methodology.

For the purpose of Illustration 4-4 in section 4.3.2 below, it has been assumed that SOFR cannot be designated as a component of US dollar LIBOR.

(iii) Term structure of separately identifiable risk components

The question also arises as to whether the separately identifiable criterion needs to be assessed separately depending on the maturity of the hedging instrument and the hedged item. For instance, would a hedge of a 30-year fixed rate bond be assessed separately from a hedge of a one-year bond, bearing in mind that there is likely to be far more activity in the market for shorter term instruments?

To use the IFRS 9 terminology, the separately identifiable assessment must be performed in the context of the market structure, and the structure of the interest rate market will always include a term structure. The topic of market structure is discussed in Chapter 49 at section 2.2. If it is determined that (for instance) SOFR is, or will be, separately identifiable, it follows that this is likely to be the case equally, whether SOFR is being used to hedge loans with (for example) six months, five years or ten years maturity. If bond prices are not aligned with SOFR swap rates, then there will always be an opportunity for arbitrage, to help bring the market in line.

Synthetic LIBORs are set by reference to the term version of the corresponding RFR plus a CAS. It should, therefore, follow that the RFR has become a separately identifiable risk component of the synthetic LIBOR. This is relevant where an RFR derivative is designated as a hedge of a synthetic LIBOR exposure.

How we see it

Once an RFR is separately identifiable, it is likely to be so for any maturity. If another benchmark becomes established for certain maturities, the assessment of whether the RFR is separately identifiable is made for any maturity for which it is the benchmark. Should the market fragment in future, such that more than one benchmark emerges, serving different segments of the market, the continuing assessment required by IFRS 9.6.9.12 of the Amendments would be made separately for each segment of the market.

4.2.6 Determination of whether an RFR is a reliably measurable risk component

'Reliably measurable' is not defined further in IFRS 9 or in the IAS 39 hedge accounting guidance, but IAS 39 required that unquoted equity instruments that were not quoted in active markets to be recorded at cost if not 'reliably measurable'. *[IAS 39.46(c)]*. The guidance stated that the fair value would be reliably measurable if the range of variability of fair value measurements is not significant or the probabilities of the various estimates can be reasonably assessed and used when measuring fair value. *[IAS 39.AG80]*. The standard went on to say that there are many situations where the range of variability for unquoted equity investments is likely not to be significant and that it is normally possible to measure reliably a financial asset acquired from a third party. *[IAS 39.AG81]*. Given this guidance, 'reliably measurable' does not appear to be an especially high hurdle and it is likely that most derivatives referencing the RFRs will be considered reliably measurable once a market begins to develop.

4.2.7 Phase 2 amendments for IAS 39

As is the case for the Phase 1 amendments (see section 4.1.3 above), the Phase 2 Amendments also include changes to IAS 39. The corresponding amendments to IAS 39 are consistent with those for IFRS 9, but with the following differences:

- IAS 39 is amended so that for the assessment of retrospective hedge effectiveness for fair value hedges, the cumulative fair value changes can be reset to zero when the exception to the retrospective assessment ends. This election is made separately for each hedging relationship (i.e., on a hedge-by-hedge basis). However, actual hedge ineffectiveness will continue to be measured and recognised in full in profit or loss. *[IAS 39.102V]*.
- The Phase 2 amendments also clarify that changes to the method for assessing hedge effectiveness due to modifications required by IBOR Reform, will not result in the discontinuation of hedge accounting. *[IAS 39.102P(d)]*.

One of the changes to the method for assessing hedge effectiveness that could be required is where the approach has previously been based on regression analysis and there are insufficient data points to enable this approach to be applied for the RFR. While the Amendment is not explicit on this issue, presumably regression could be replaced by another approach until sufficient data becomes available, at which point, the use of regression would resume, as long as this is documented as the strategy at the time the hedge relationship is adjusted.

As discussed in section 4.2.2 above in the context of IFRS 9, if a hedged item, or hedging instrument is amended to transition from IBOR to an RFR, but changes are made in addition to those required by IBOR Reform to obtain the Phase 2 hedge accounting reliefs, it is necessary to assess, first, whether the additional changes result in the discontinuation of hedge accounting, applying the normal hedge accounting requirements. Under IAS 39, one of the criteria for continuing hedge accounting is that the hedge is expected to be highly effective. As a consequence, it will be necessary to assess whether any additional changes made on transition to an RFR mean that the hedge is no longer expected to be highly effective. If this is the case, hedge accounting must be discontinued and Phase 2 hedge accounting relief is not available.

4.2.8 Determination of whether an RFR is a separately identifiable risk component under IAS 39

Similar to the Phase 1 and 2 Amendments for IFRS 9 (see sections 4.1.1, 4.2.4 and 4.2.5 above), the amendments to IAS 39 provide reliefs for the assessment of whether a non-contractually specified risk component is separately identifiable, and so can be designated as a hedged risk. However, again, the Amendments provide no new guidance on what is meant by 'separately identifiable'. As mentioned in section 4.2.5 above, whilst the guidance in IFRS 9 for a risk component to be separately identifiable is very similar to that in IAS 39 for a risk portion, the wording is not exactly the same. In particular, IAS 39 contains a simpler statement compared to the considerations included in IFRS 9, as follows: "... for a fixed rate financial instrument hedged for changes in fair value attributable to changes in a risk-free or benchmark rate, the risk-free or benchmark rate is normally regarded as both a separately identifiable component of the financial instrument and reliably measurable." *[IAS 39.AG99F(a)]*.

How we see it

Given the IAS 39 reference to 'risk-free or benchmark' as a separately identifiable component, it has been established practice to designate other benchmarks, such as the overnight interest rate swap rate (OIS). It is possible that those entities still applying IAS 39 will have considered RFRs such as SONIA and SOFR as separately identifiable components of the change in fair value of fixed rate debt, by the time they respectively replaced sterling LIBOR and US dollar LIBOR, on the basis that they were already viewed by regulators as benchmarks and SOFR is also (nearly) risk-free. Similarly, entities may identify other RFRs as separately identifiable components of a change in the fair value of fixed rate date that has historically been valued by reference to other IBORs, as the date approaches for when they are due to be replaced.

4.3 Application of Phase 2 reliefs

4.3.1 Fair value hedges

Since the hedged item will have a fixed rate, it will not need to be amended as part of IBOR Reform. Hence, Phase 1 ends when there is no longer uncertainty as to the timing and amount of the hedging instrument. This is expected to occur when the hedging instrument is amended as required by the Reform. This would include when the hedging derivative transitions to referencing an RFR, either through a centrally managed conversion process such as that run by the LCH, or the completion of bilateral negotiations to amend the derivative. At that time, Phase 2 will apply and it will also be necessary to amend the designated hedged risk.

A hedging derivative could be amended in one of two main ways: the transition basis spread could be added either to the floating leg of the derivative or subtracted from the fixed leg. For instance, if a hedging swap had been pay 3% fixed, receive 3-month US dollar LIBOR, when the transition basis difference is considered to be 26bp, it would be acceptable for the amended derivative to be pay 3%, receive SOFR + 26bp or, alternatively, pay 2.74%, receive SOFR (where 2.74% is 3.0% - 26bp). In the examples below, for the hedging derivative the transition basis adjustment has been made to the floating leg, as the LCH have applied this approach for interest rate swaps they transition.[31]

Whether or not the transition basis spread is added to the floating leg or deducted from the fixed leg, the amendment would take effect from the date of the first reset of the floating leg to SOFR (or other RFR as appropriate). For the purposes of hedge accounting, the hedge is likely to need to be redesignated earlier,

31 *Managing the Transition to RFRs, SwapClear's Approach to the Conversion Process*. London Clearing House, 4 November 2021.

since once the contractual terms of the hedging instrument are amended, there will no longer be any uncertainty as to the timing and amount of IBOR-based cash flows.

As already mentioned in section 1 above, changing the derivative's reference should not require a change in the discount rate used to measure it. The discount rate should reflect the credit risk of the counterparty and this will not have changed just because of IBOR Reform. IBOR-based derivatives that are fully collateralised are already discounted at overnight rates, such as the RFRs. In contrast, it would be inappropriate to move to a risk-free discount rate for uncollateralised trades (i.e., if they have previously been discounted at IBOR, then it would follow that they should now be discounted at the RFR plus the transition spread) unless compensating changes are also made to the way that Credit Valuation Adjustments (CVAs) are calculated, such that there is no net impact on their valuation.

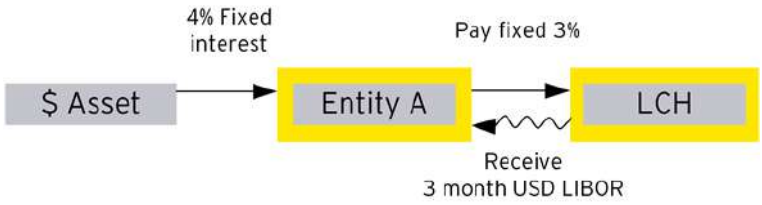
Whether the derivative is amended to pay 3%, receive SOFR + 26bp, or to pay 2.74%, receive SOFR, the designated hedged risk would most likely be revised to be a fair value hedge of a 2.74% component of the hedged item for changes in SOFR. (The advantage of designating the 2.74% component for changes in SOFR rather than a 3% component for changes in SOFR + 26bp, is that the former is much easier to calculate and apply, especially subsequent to transition when all new hedges will be designated for changes in SOFR-flat, i.e., with no spread adjustment).

Meanwhile, the discount rate used to measure the hedged risk would change from LIBOR to SOFR See Chapter 49 at section 7.4.5, for further discussion on discount rates in this context. On transition, the cumulative change in fair value of a 2.74% component of a fixed rate debt for changes in SOFR (discounted using SOFR) should be more or less the same value as the previously recorded change in fair value of a 3% component for changes in 3-month US dollar LIBOR (discounted using LIBOR), so there should be only a small change in value, if any, to be recorded in profit or loss.

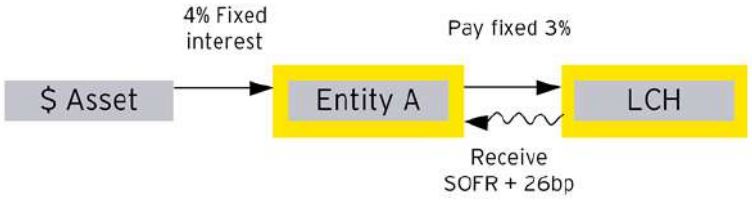
The following two examples illustrate the key features of the Phase 2 Amendments for fair value hedges, the first where the derivative is amended on an economically equivalent basis and the second where it is determined that it is not.

Illustration 4-2: Application of Phase 2 relief to a fair value hedge

Company A has previously entered into an interest rate swap paying fixed 3% and receiving 3-month US dollar LIBOR (fixed in advance at the beginning of the quarter). It had been designated in a hedge of the exposure to changes in fair value attributable to US dollar LIBOR, of cash flows equivalent to a 3% coupon plus principal of a 4% fixed US dollar asset.



On 1 November 2022, the basis difference between SOFR and LIBOR is determined to be 26 basis points (based on the ISDA fallback, rounded to simplify the example). The swap is accordingly amended to pay fixed 3%, receive SOFR+26bps, effective from the first time the floating leg resets to SOFR.



The new swap is considered 'economically equivalent' to the old swap, since the only change has been to refer to SOFR instead of LIBOR and to adjust the floating spread based on the current market rates (see section 2.1 above). As a result, the formal designation of the hedging instrument is amended without discontinuing the hedge.

SOFR is expected to be a separately identifiable component of US dollar interest rates within 24 months and, therefore, can now be designated as the hedged risk component (see section 4.2.5 above). Consequently, the description of the hedged item is also amended when the derivative transitions to a hedge of changes in fair value attributable to SOFR, of the component of the 4% asset equivalent to a 2.74% coupon plus principal, where 2.74% is the previous 3% less the 26 basis points spread. (An entity applying IAS 39 for hedge accounting must also update how hedge effectiveness will be assessed in future (see section 4.2.7 above)).

At the next period end, the swap is remeasured to its new fair value, based on SOFR, consistent with the normal hedge accounting requirements. This remeasurement will include any difference in fair value of the swap immediately before and after its modification, but as the derivative has been modified on an 'economically equivalent basis', the effect should be small. The asset is also adjusted for the difference in its fair value with respect to the designated hedged risk. This will include the difference in fair value between the 3% coupon plus principal discounted at 3-month US dollar LIBOR and the 2.74% coupon plus principal discounted at SOFR. This difference should also be small. Any net change of fair value on the amendment of the swap and of the designated hedged component, is recorded in profit or loss as part of the recorded hedge ineffectiveness for the period (see section 4.2.2 above).

Illustration 4-3: Application of Phase 2 relief to a fair value hedge where the swap is amended to reflect the current market rate of interest

Entity A is a party to a swap with a notional value of £10 million and a remaining five-year maturity on which, quarterly, it pays sterling 3-month LIBOR (fixed in advance at the beginning of the quarter) and receives 3% fixed. The swap has been designated as a fair value hedge of a 3% component of a 4% fixed liability for changes in LIBOR.

On 1 November 2021, when the market rate for a five-year SONIA swap is 2.7%, the swap is amended to refer to SONIA at a time when the basis difference between 3-month LIBOR and SONIA is considered to be 12bp. However, rather than amend the swap to receive 3% and pay SONIA+12bp, which would be economically equivalent, the swap is amended to reflect the current market rate of interest, so that Entity A receives 2.7% and pays SONIA, effective from the first time the floating leg resets to SOFR. The present value of the net 18bp difference between the fixed and floating rates on the old and new swaps (3% - 2.7% - 12bp) is settled in cash. The entity determines that:

(i) The new swap is not economically equivalent to the old one, due to the combined 18bp change in the interest payments (12bp added to the floating pay leg and 30bp subtracted from the fixed receive leg).

(ii) However, the revised contractual cash flows are not substantially different, so do not give rise to the swap's derecognition.

(iii) Hence, applying IFRS 9.6.9.5, as all the other IFRS 9 hedge accounting criteria are considered to still be met, the hedge relationship is not discontinued.

As a consequence, the entity amends the hedge relationship to reflect the changes, that is, to be a fair value hedge of the SONIA risk of a net 2.88% (3% - 12bp) fixed rate component of the 4% fixed rate liability, but using a receive 2.7%, pay SONIA swap. It is not possible to amend the hedged item to be a 2.7% fixed rate component, because the hedged item can only be amended to reflect changes required by the Reform. However, the cumulative change in fair value of a 2.88% component of a fixed rate debt for changes in SONIA should be more or less the same value as the previously recorded change in fair value of a 3% component for changes in 3-month sterling LIBOR, so there should be only a small change in value, if any, to be recorded in profit or loss on transition.

The 2.88% component and the 2.7% swap will have fair values with different sensitivities to changes in SONIA, which will be an additional source of ongoing hedge ineffectiveness. Meanwhile, the reduction in the swap's fixed rate will, over time, be compensated, in profit or loss, by fair value changes as the swap reverts to a nil fair value at maturity.

4.3.2 Cash flow hedges

For a cash flow hedge, both the hedging instrument and the hedged item are likely to be required to be amended as required by the Reform. It is possible that they will be amended at different times and it is also possible that they will be amended on different bases, so that, for instance, the hedging instrument transitions using the ISDA protocol, whereas the basis of transition for the hedged item depends on bilateral negotiation. Phase 1 will end for each of the hedging instrument and the hedged item when there is no uncertainty of timing or amount, which could be at different times, while Phase 2 will potentially need to be applied more than once, when each of the hedging instrument and hedged item are amended.

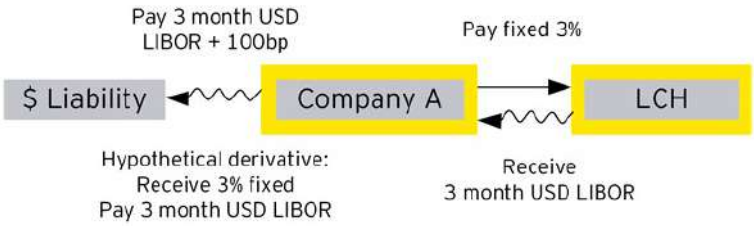
In general, the method of designating the hedged risk and, hence, a hypothetical derivative should not change just because of IBOR Reform beyond what is strictly required by the Reform. Accordingly, if prior to transition, the designated hedged risk was the variability of IBOR cash flows, the new designated risk would be the variability of RFR plus the transition spread cash flows, as this would be economically equivalent. This is also likely to result in no gain or loss to be recorded on revising the hypothetical derivative and should not lead to any increase in future hedge ineffectiveness if the spread is calculated using the ISDA fallback protocol and the hedging instrument is amended in the same manner.

Alternatively, if the previously designated hedged risk was the variability of all the cash flows of the hedged item, then going forward, any hypothetical derivative would need to reflect the actual transition spread on the hedged item as negotiated between the parties. If this results in a change in the fair value of the hedged item, this could give rise to a profit or loss when the hypothetical derivative is amended. Also, if the transition spread on the hedged item differs from that on the hedging instrument, this difference in spread could also introduce a new ongoing source of hedge ineffectiveness.

The following Illustration shows the application of Phase 2 to a cash flow hedge.

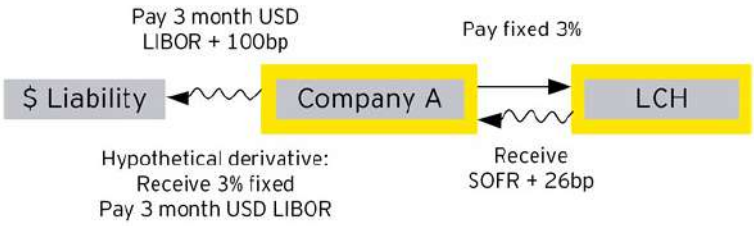
Illustration 4-4: Application of Phase 2 relief to a cash flow hedge relationship

The initial fact pattern is the same as that in Illustration 4-2 above, except that it is a cash flow hedge of the US dollar LIBOR risk of a US dollar LIBOR plus 100bp liability. Ineffectiveness has been assessed and measured using a hypothetical derivative on which Company A receives 3% fixed and pays 3-month US dollar LIBOR (fixed in advance at the beginning of the quarter).



As in Illustration 4-2, on 1 November 2022, the derivative is amended to pay fixed 3%, receive SOFR+26bp, effective from the first SOFR fixing date. The main difference in this example is that the US dollar LIBOR borrowing will also need to be amended as part of IBOR Reform, through bilateral negotiation, but at the time the derivative is amended, it is assumed that this will not happen for some time, potentially several months.

At this point the hedge documentation will need to be amended to describe the amended swap as the hedging instrument in a cash flow hedge of the US dollar LIBOR liability (see section 4.2.1 above). SOFR is expected to be a separately identifiable component of US dollar interest rates within 24 months. However, Company A does not consider SOFR will ever be a separately identifiable component of US dollar LIBOR (see section 4.2.5 above). As a result, the hypothetical derivative is not amended at this time and continues to be based on LIBOR.



The original hedge relationship continues (see section 4.2.1 above), and the amount recorded in the cash flow hedge reserve continues to be based on LIBOR as required by the Phase 1 Amendments.

Because the swap is valued based on SOFR+26bp and the liability based on LIBOR, this remeasurement will give rise to a degree of ineffectiveness which will need to be recorded in profit or loss. However, given that the ISDA protocol transition spread has been fixed, this is likely to be relatively small. The entity considers that there is still an 'economic relationship' between SOFR and US dollar LIBOR, such that hedge accounting continues to be permitted. (An entity applying IAS 39 would be relieved from the 80-125% retrospective effectiveness assessment but would need to meet the prospective effectiveness assessment (see section 4.2.7 above)).

At the end of each accounting period from when the swap is amended until the liability is also renegotiated, the cash flow hedge reserve is remeasured to the lower of:

- The cumulative gain or loss in fair value of the SOFR swap (which will include gains or losses accumulated prior to the swap's transition)

  And

- The cumulative gain or loss in fair value of the US dollar LIBOR hypothetical derivative

One month after the derivative is amended, the liability is renegotiated on 1 December 2022, when the basis difference between 3-month US dollar LIBOR and SOFR is agreed to be 25 basis points, based on observable US LIBOR and SOFR swap quotations at that date. However, as part of the bilateral negotiation to amend the liability, the credit spread is also reduced by 20bp, due to an improvement in the borrower's credit quality. The liability is accordingly amended to pay SOFR + 105bp (where 105bp is the previous 100bp plus the current 3-

month US dollar LIBOR-SOFR basis of 25bp, less the change in credit spread of 20bp), with effect from the first time that the floating leg resets to SOFR.

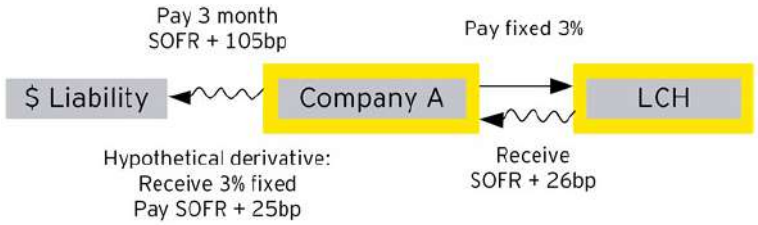
Apart from the 20bp change in credit spread, the amendment is considered to be required as a direct consequence of the Reform and the new basis for determining the contractual cash flows is considered to be economically equivalent to the old basis (see section 2.1 above).

The 20bp change in credit spread is not considered to be a substantial modification of the liability, since quantitatively, the change in net present value discounted at the revised EIR of SOFR +125bp is less than 10% and the change is also judged to be not substantial from a qualitative perspective. Hence, the liability is not derecognised.

Applying the Phase 2 relief on modification of a financial instrument (see section 2.2.1 above), the effective interest rate (EIR) on the liability is amended to SOFR + 125bp (where 125bp is the previous 100bp plus the current 3-month LIBOR-SOFR basis of 25bp).

The 20bp change in credit spread is not, however, covered by the Phase 2 relief and the net present value of the 20bp reduction, discounted at the revised EIR of SOFR plus 125bp, is recorded as an immediate credit to profit or loss.

The hedge documentation is now amended for a second time (see section 4.2.1 above). The Phase 1 relief requiring the hedged risk to continue to be based on LIBOR comes to an end and the hedge is now documented as a cash flow hedge of the SOFR risk in the SOFR + 105bp liability. (An entity applying IAS 39 for hedge accounting will also need to update the hedge documentation for any change in how hedge effectiveness will be assessed (see section 4.2.7 above)). Again, the amendment of the hedge documentation, to refer to the modified hedged item and the new designated risk component, does not constitute a discontinuation of the original hedging relationship (see section 4.2.1 above). Hence, the fixed leg of the hypothetical derivative is not updated to reflect current market conditions. Instead, it is amended to be a receive 3%, pay SOFR + 25bp swap.



The amount accumulated in the cash flow hedge reserve is now deemed to be based on SOFR (see section 4.2.1 above).

Note that because of the timing mismatch, the derivative (pay 3%, receive SOFR+26bp) and the hypothetical derivative (receive 3.0%, pay SOFR + 25bp) have a 1bp different net cash flow. A small degree of hedge ineffectiveness will, therefore, arise in the future, as changes in the fair values of the derivative and the hypothetical derivative will not be the same.

However, applying IFRS 9, the entity considers that there is still an 'economic relationship' (see Chapter 49 at section 6.4.1) between the derivative and the hypothetical derivative going forward. For entities applying IAS 39, the hedge must be assessed prospectively to be highly effective and the level of retrospective hedge ineffectiveness will need to be monitored to ensure that the hedge continues to qualify for accounting purposes as there is no longer any relief from the 80/125% effectiveness requirements (see section 4.2.7 above).

The cash flow hedge reserve is remeasured at the next period end, to the lower of:

- The cumulative gain or loss in fair value of the amended swap

  And

- The cumulative gain or loss in fair value of the revised hypothetical derivative

Hence, the amount of ineffectiveness actually recorded will depend on whether the change in the fair value of the derivative is greater than that on the hypothetical derivative.

How we see it

Entities are recommended to ensure that there are as few mismatches as possible in the timing of the amendment of hedging instruments and hedged items, to minimise the level of recorded hedge ineffectiveness. For the US dollar LIBORs that ceased at the end of June 2023, since the ISDA fallback spreads had been fixed, this was no longer a major concern. This is because market spreads had largely converged on the ISDA fallbacks. But for those IBORs that are still to cease, such as JIBAR and other local IBORs, there could still be some variability in the market spread between the IBOR and the replacement RFR during the period until the IBOR ceases. Hedging relationships where the hedged item transitions to synthetic LIBOR may subsequently transition to an RFR, which would require the hedging relationship to be updated for each transition.

Ensuring that the hedged item and hedging instrument transition at a similar time could be especially challenging if an entity's swap traders do not know if a particular derivative is designated in a hedging relationship, as is more likely to be the case where a dynamic strategy is used or if derivatives are designated in 'proxy' hedges under IAS 39 and IFRS 9 (see Chapter 49 section 6.2.1 for a general discussion on designating proxy hedges). Procedures would need to be established to help ensure that derivatives are not modified without first considering the accounting consequences.

An EY Global IFRS video from November 2020 is available in which Tony Clifford, Jane Hurworth and David Bradbery discuss some practical issues in applying the IFRS IBOR Reform amendments. In the video, the Phase 2 Amendments are applied to illustrative examples of a fair value hedge and a cash flow hedge.

Access the EY video here

5 Transition

5.1 Phase 1

The effective date of the Phase 1 Amendments was for annual periods beginning on or after 1 January 2020, although earlier application was permitted. The requirements had to be applied retrospectively. However, the reliefs only applied to hedging relationships that existed at the beginning of the reporting period in which an entity first applies those requirements or were designated thereafter, and to the amount accumulated in the cash flow hedge reserve that existed at the beginning of the reporting period in which an entity first applies those requirements. It follows that it was not possible to apply the reliefs retrospectively to hedge relationships that were not previously designated as such. *[IFRS 9.7.2.26(d)]*.

Extract from IFRS 9

7.2.26 As an exception to prospective application of the hedge accounting requirements of this Standard, an entity:

(a) …

(d) shall apply the requirements in Section 6.8 retrospectively. This retrospective application applies only to those hedging relationships that existed at the beginning of the reporting period in which an entity first applies those requirements or were designated thereafter, and to the amount accumulated in the cash flow hedge reserve that existed at the beginning of the reporting period in which an entity first applies those requirements.

5.2 Phase 2

The Phase 2 Amendments became effective for annual periods beginning on or after 1 January 2021, with earlier application permitted. *[IFRS 9.7.1.10, IAS 39.108H]*. Application of the Phase 2 Amendments is mandatory, to ensure comparability.

Application was retrospective although, as is normal under IFRS accounting standards, hedge relationships could not be designated retrospectively. However, discontinued hedging relationships had to be reinstated in certain circumstances as described below. *[IFRS 9.7.2.43, IFRS 9.7.2.44, IFRS 9.7.2.45, IAS 39.108I, IAS 39.108J]*.

Extract from IFRS 9

7.2.43 An entity shall apply *Interest Rate Benchmark Reform-Phase 2* retrospectively in accordance with IAS 8, except as specified in paragraphs 7.2.44-7.2.46.

7.2.44 An entity shall designate a new hedging relationship (for example, as described in paragraph6.9.13) only prospectively (ie an entity is prohibited from designating a new hedge accounting relationship in prior periods). However, an entity shall reinstate a discontinued hedging relationship if, and only if, these conditions are met:

(a) the entity had discontinued that hedging relationship solely due to changes required by interest rate benchmark reform and the entity would not have been required to discontinue that hedging relationship if these amendments had been applied at that time; and

(b) at the beginning of the reporting period in which an entity first applies these amendments (date of initial application of these amendments), that discontinued hedging relationship meets the qualifying criteria for hedge accounting (after taking into account these amendments).

7.2.45 If, in applying paragraph 7.2.44, an entity reinstates a discontinued hedging relationship, the entity shall read references in paragraphs 6.9.11 and 6.9.12 to the date the alternative benchmark rate is designated as a non-contractually specified risk component for the first time as referring to the date of initial application of these amendments (ie the 24-month period for that alternative benchmark rate designated as a non-contractually specified risk component begins from the date of initial application of these amendments).

It should be noted that while discontinued hedges had to be reinstated if they met the criteria, there was no equivalent requirement or ability to account retrospectively for hedge relationships that never qualified for hedge accounting in the first place.

In practice, this meant, for instance, that an entity could not reinstate a hedging relationship that did not previously exist or was voluntarily de-designated, even if it could have met the conditions for hedge accounting and then failed as a direct consequence of IBOR Reform.

Continuing to meet all the qualifying criteria included the need for the risk management objective, as discussed in Chapter 49 at section 6.2, of the discontinued hedge relationship to remain unchanged. This was unlikely to have been the case if either the hedged item or the hedging instrument was subsequently designated in a new hedge relationship, such that the hedging instrument was no longer designated as a hedge of the same hedged item.

To the extent that application of the practical expedient would have resulted in a different accounting treatment to that applied by the entity for changes made prior to application of the Phase 2 Amendments to the basis for determining contractual cash flows, this formed part of the transition adjustment.

If hedges for which RFR instruments were designated as a hedge of a risk component were previously discontinued and reinstated upon first application of the Phase 2 Amendments, the 24-month period to which the separately identifiable relief applies (see sections 4.2.4 and 4.2.5 above), began from the date of initial application of the Phase 2 Amendments.

An entity was not required to restate prior periods on application of the Phase 2 Amendments. It could do so, but only if it were possible without the benefit of hindsight. If it did not restate prior periods, the entity had to recognise any difference in carrying values as an adjustment to retained earnings (or other component of equity, if appropriate) at the beginning of the annual reporting period that included the initial date of application. *[IFRS 9.7.2.46, IAS 39.108K]*.

6 Disclosures

6.1 Phase 1

Consequential amendments were made by the Phase 1 Amendments to IFRS 7, as shown below. *[IFRS 7.24H]*.

Extract from IFRS 7

Uncertainty arising from interest rate benchmark reform

24H For hedging relationships to which an entity applies the exceptions set out in paragraphs 6.8.4-6.8.12 of IFRS 9 or paragraphs 102D-102N of IAS 39, an entity shall disclose:

(a) the significant interest rate benchmarks to which the entity's hedging relationships are exposed;

(b) the extent of the risk exposure the entity manages that is directly affected by the interest rate benchmark reform;

(c) how the entity is managing the process to transition to alternative benchmark rates;

(d) a description of significant assumptions or judgements the entity made in applying these paragraphs (for example, assumptions or judgements about when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows); and

(e) the nominal amount of the hedging instruments in those hedging relationships.

These requirements are illustrated in Practical example 6-1 below:

Practical example 6-1: Standard Chartered PLC (2023) **United Kingdom**

Annual Report 2023 [extract]
Financial statements [extract]
Notes to the financial statements [extract]
Note 13. Financial instruments [extract]

Interest rate benchmark reform

During 2023, significant progress was made in support of LIBOR transition.

New LIBOR-referencing business had ceased and a full suite of Risk Free Rate-referencing derivative and cash products were standard offerings across the Group.

Having completed the remediation of all non-USD LIBOR exposures at the end of 2021 with no reliance on synthetic rates, the Programme focused on remediating legacy USD LIBOR stock ahead of the USD LIBOR cessation date (30 June 2023).

The Group made significant progress towards completing its remediation of legacy exposures over the course of 2023. Clients with legacy USD LIBOR loans were engaged to remediate their contracts via active conversion to alternative rates, or other suitable transition mechanisms such as the inclusion of robust fallbacks. For derivatives, the Group adhered to the International Swaps and Derivatives Association (ISDA) 2020 IBOR Fallbacks Protocol for all its trading entities and continued to engage clients to do the same or to negotiate remediation bilaterally. The Group also successfully participated in CCP conversion events, including both tranches of the London Clearing House (LCH) conversions for USD LIBOR and also the SGD/THB conversion, as well as the CME Eurodollar futures and the Hong Kong Exchanges and Clearing (HKEX) USD LIBOR events. This significantly reduced our overall notional exposure to USD LIBOR, as centrally cleared derivatives and bilateral derivatives with fallbacks represented a substantial portion of the Group's overall USD LIBOR notional exposure.

At 31 December 2023, a number of contracts remain subject to remediation but these are considered immaterial for the Group. The largest population of remaining exposures are syndicated loans, either on a standalone basis, or where the loans have been hedged with derivatives. These contracts currently operate under a synthetic USD LIBOR rate.

Risks which the Group is exposed to due to LIBOR transition

The Group has largely mitigated all material adverse outcomes associated with the cessation of IBOR benchmarks, and these have not required a change to the Group's risk management strategy.

However, the Group will continue to focus on the un-remediated contracts, and manage the risks of the transition until fully complete.

Particular attention will continue to be paid to: legal risk of any contracts that may remain outstanding after the end of synthetic LIBOR (currently scheduled for end of September 2024); conduct risk arising from continued remediation; financial and accounting risk in terms of the financial impact of IBOR transition for the outstanding contracts, and also financial instruments that may be affected by accounting issues such as accounting for contractual changes due to IBOR reform, fair value measurement and hedge accounting, as well as other risks inherent in the reform.

As at 31 December 2022 the Group had the following notional principal exposures to interest rate benchmarks that were subject to interest rate benchmark reform.

IBOR exposures by benchmark at 31 December 2022	USD LIBOR $million	GBP LIBOR $million	SGD SOR $million	THB FIX $million	Other IBOR $million	Total IBOR $million
Assets						
Loans and advances to banks	145	–	–	–	–	145
Loans and advances to customers	21,395	–	420	–	–	21,815
Debt securities, AT1 and other eligible bills	2,843	–	15	–	–	2,858
	24,383	–	435	–	–	24,818
Liabilities						
Deposits by banks	332	–	–	–	–	332
Customer accounts	3,066	–	–	34	–	3,100
Repurchase agreements and other secured borrowing	671	–	–	–	–	671
Debt securities in issue	1,211	–	–	–	–	1,211
Subordinated liabilities and other borrowed funds	–	–	–	–	–	–
	5,280	–	–	34	–	5,314
Derivatives – Foreign exchange contracts						
Currency swaps and options	135,145	–	2,273	959	–	138,377
Derivatives – Interest rate contracts						
Swaps	671,534	–	7,512	10,998	–	690,044
Forward rate agreements and options	22,067	–	–	9	–	22,076
Exchange traded futures and options	31,922	–	–	–	–	31,922
Equity and stock index options	49	–	–	–	–	49
Credit derivative contracts	3,974	–	46	129	–	4,149
Total IBOR derivative exposure	864,691	–	9,831	12,095	–	886,617
Total IBOR exposure	894,354	–	10,266	12,129	–	916,749
Loan commitments off-balance sheet	2,798	–	14	–	–	2,812

Note 14. Derivative financial instruments: Mat

Interest rate benchmark reform

As at 31 December 2023, there are no derivative instruments designated in fair value or cash flow hedge accounting relationships that were linked to IBOR reference rates (31 December 2022: $65,769 million).

The Phase 1 disclosures do not cease to be required once the Phase 2 Amendments begin to be applied, although the population of instruments to be disclosed will decline over time as they transition to RFRs. The Phase 1 disclosures provide information on the hedging relationships that are still subject to the Phase 1 reliefs.

6.2 Phase 2

Consequential amendments were made by the Phase 2 Amendments to IFRS 7, to enable users of financial statements to understand the effect of interest rate benchmark reform on an entity's financial instruments and risk management strategy. *[IFRS 7.24I, IFRS 7.24J]*.

Extract from IFRS 7

Additional disclosures related to interest rate benchmark reform

24I To enable users of financial statements to understand the effect of interest rate benchmark reform on an entity's financial instruments and risk management strategy, an entity shall disclose information about:

(a) the nature and extent of risks to which the entity is exposed arising from financial instruments subject to interest rate benchmark reform, and how the entity manages these risks; and

(b) the entity's progress in completing the transition to alternative benchmark rates, and how the entity is managing the transition.

24J To meet the objectives in paragraph 24I, an entity shall disclose:

(a) how the entity is managing the transition to alternative benchmark rates, its progress at the reporting date and the risks to which it is exposed arising from financial instruments because of the transition;

(b) disaggregated by significant interest rate benchmark subject to interest rate benchmark reform, quantitative information about financial instruments that have yet to transition to an alternative benchmark rate as at the end of the reporting period, showing separately:

(i) non-derivative financial assets;

(ii) non-derivative financial liabilities; and

(iii) derivatives; and

(c) if the risks identified in paragraph 24J(a) have resulted in changes to an entity's risk management strategy (see paragraph 22A), a description of these changes.

The quantitative disclosures provided by entities could exclude those exposures that are expected to expire or mature before the IBOR ceases. This is because for these instruments, the entity would not consider itself to be exposed to the risks relating to IBOR Reform. This disclosure would, therefore, relate only to a subset of the total population of instruments referencing a significant interest rate benchmark subject to the Reform. However, if an entity wished to include these exposures, it could be justified as they could still be affected by IBOR Reform related risk, such as reduced liquidity in the IBOR before it expires or matures. *[IFRS 7.BC35LLL]*.

The proposal in the Phase 2 ED to disclose the carrying value of non-derivative financial assets and financial liabilities and the nominal value of derivatives, was replaced in the Phase 2 amendments with a more flexible approach. Entities can select the basis for the quantitative information they provide about financial instruments that have yet to transition to an alternative benchmark rate. Examples of approaches that may be followed, as set out in the Basis for Conclusions to the amendments to IFRS 7, include:

- The carrying amounts of non-derivative financial assets, the carrying amount of non-derivative financial liabilities and the nominal amount of derivatives
- The amounts related to recognised financial instruments (for example, the contractual par amount of non-derivative financial assets and non-derivative financial liabilities, and nominal amounts of derivatives)

  Or
- The amounts provided internally regarding these financial instruments to key management personnel of the entity (as defined in IAS 24 *Related Party Disclosures*), for example, the entity's board of directors or chief executive officer

This approach is intended to reduce the incremental effort needed to provide the additional disclosure required by the Phase 2 Amendments, whilst still meeting the objective of the disclosure to provide relevant information on the entity's progress in implementing the Reform. *[IFRS 7.BC35KKK]*. Entities must provide the Phase 2 IFRS 7 disclosures when they apply the Phase 2 Amendments to IFRS 9 and IAS 39 (or IFRS 4). The Basis for Conclusions clarifies that, on initial application, the new disclosures need not be provided for prior reporting periods unless the entity also restates prior periods for the effects of the Phase 2 Amendments to IFRS 9 and IAS 39 (or IFRS 4). *[IFRS 7.BC35OOO]*.

One of the concerns that some entities, in particular banks, identified when preparing to provide these quantitative disclosures was that, while reports on the instruments still subject to the Reform may be prepared for key management personnel and regulators, the information is not of the quality (in terms of completeness and accuracy) normally expected for disclosure in the audited financial statements. This is because, like any temporary reporting used to monitor a transition project, the information is built on a 'best effort basis' and was not intended to achieve the level of accuracy of the usual accounting disclosures.

A parallel can perhaps be drawn with the disclosure requirement in IAS 8.30 for new IFRSs that have been issued but are not yet effective, as both disclosures are temporary and deal with current known information about a future change. IAS 8.30 requires that an entity disclose "known or reasonably estimable information relevant to assessing the possible impact that application of the new IFRS will have on the entity's financial statements in the period of initial application", as discussed further in Chapter 3 at section 5.2.1. The objective of the Phase 2 disclosures is to reflect how the entity is implementing the Reform, which for some entities may still be a reasonably complex project.

It is also relevant that the amendments to the IFRS Taxonomy 2021, which incorporate the Phase 2 Amendments' disclosures, included a 'text block' element (to allow text as opposed to numerical input), in the table to address the IFRS 9.24J(b) requirements. This was to address the fact that the information can be disclosed in various ways. The Taxonomy reflects that the Board permits the use of text block elements for the disclosure of quantitative information because the disclosure requirements are not prescriptive about how the quantitative information should be provided. The Phase 2 Amendments, therefore, permit an entity to choose the way in which it provides this quantitative information, for example an entity can provide such information as an amount or a percentage accompanied by qualitative information to explain the context of the quantitative information.

A variety of approaches have been used to provide the quantitative disclosures. For derivatives, the information presented has included notional values, fair values and both in combination. For non-derivatives, book values or nominal values were used.

6.2.1 Disclosure for instruments which have not transitioned

The Phase 2 Amendments require disclosure at the end of the reporting period of exposures which are still to transition from IBOR to RFR. *[IFRS 7.24J(b)]*. The FCA in its announcement on 5 March 2021[32] confirmed that twenty-six of the thirty-five LIBOR settings 'will cease immediately after'

- 31 December 2021 for twenty-four of the LIBORs (all seven euro and Swiss franc LIBORs, the overnight, one-week, two- and twelve-month yen LIBORs, the overnight, one-week, two-month and twelve-month sterling LIBORs, and the one-week and two-month US dollar LIBORs

  And

- 30 June 2023 for two US dollar LIBORs (overnight and twelve month)

For the nine remaining LIBORs the FCA confirmed on 29 September 2021 that:

- Publication for six of the LIBORs (one-, three- and six-month sterling and Japanese yen LIBOR) would continue for twelve months on a synthetic basis from 1 January 2022 using a new methodology to help ensure an orderly wind-down for legacy contracts only, with no new use of these LIBORs permitted.

  And

- The FCA would consult on whether the three other US dollar LIBOR settings (one-, three- and six-month) would also continue on a synthetic basis after 30 June 2023.[33]

32 *FCA announcement on future cessation and loss of representativeness of the LIBOR benchmarks*, 5 March 2021.

33 FCA announce *further arrangements for the orderly wind-down of LIBOR at end-2021*, 29 September 2021.

In September 2022[34] they confirmed that:

- One and six-month synthetic sterling LIBOR would be required until the end of March 2023 after which they would permanently cease.
- A conclusion was not reached on whether three-month synthetic sterling LIBOR would continue beyond March 2023.
- Synthetic yen LIBOR (one-, three- and six-month) would permanently cease at the end of 2022.
  And
- They will provide an update later whether synthetic US dollar LIBORs will be required.

In April 2023 the FCA confirmed[35] that:

- Three-month synthetic sterling LIBOR would continue until the end of March 2024, after which it would permanently cease.
- One-month, three-month and six-month US dollar LIBOR settings would continue in synthetic form until 30 September 2024, after which they will permanently cease. The use of these synthetic LIBORs for any new contracts was prohibited, but its use was permitted for all legacy contracts except cleared derivatives. Section 6.2.4 below describes the disclosure requirements for instruments that reference synthetic LIBOR, for which further transition is expected.

'Transition' is not defined by the Phase 1 or Phase 2 amendments, therefore, determining which exposures should be included in the disclosure is a matter of judgement. In making this judgement, entities should consider the Phase 2 Amendments' disclosure objective, which requires entities to disclose the nature and extent of risks arising from financial instruments subject to IBOR reform. *[IFRS 7.24I]*.

Instruments could be changed from IBOR to RFR in a series of steps, each of which could represent a 'transition' and be eligible for the reliefs which the Phase 2 amendments provide, depending on the specific facts and circumstances. Transition dates for the application of the relief for resetting the effective interest rate are also likely to differ from the transition dates for applying the hedge accounting reliefs. These steps could potentially include: when a fall-back is added; when an entity decides to use the fallback or when bilateral negotiation is completed; when exposures are automatically converted by a central clearing house such as the LCH; when an IBOR ceases to be published; when a fallback is activated; or the first time the floating rate of an instrument resets to an RFR. Entities should determine at the reporting date the stage their exposures have reached in the transition from IBOR to RFR and include in the disclosure those exposures which they consider still present a risk arising from IBOR Reform.

Entities should disclose any significant judgements made in the determination, in order to meet the objectives of IFRS 7.24I (see section 6.4 below). For example, if an entity includes in its disclosure, IBOR exposures with fall-back provisions which will convert to an RFR immediately after the reporting date, we would generally expect adequate disclosure of this circumstance, including if no further changes are expected to these exposures/contracts due to IBOR Reform. For example, this would have applied for entities reporting as at 31 December 2021, which was immediately prior to the cessation of the majority of LIBORs and may have applied for entities reporting at 30 June 2023, which was immediately prior to the cessation of the remaining US dollar LIBORs. This could have included a quantification of those exposures separately from others for which either such fall-backs have not yet been agreed or else will not take effect immediately after the reporting date, e.g., the fallbacks relate to IBORs that will not cease for some time, such as those US dollar LIBORs that ceased after 30 June 2023 or other local IBORs for which a timetable for their replacement has not yet been set. This would provide more meaningful information to users about the nature and extent of the risks arising from these financial instruments.

6.2.2 Application to loan commitments

The Phase 2 Amendments describe that the quantitative disclosures should show separately non-derivative financial assets, non-derivative financial liabilities and derivatives. *[IFRS 7.24J(b)]*. However, the disclosures do not relate just to these items since the amendments to IFRS 7 are not restricted to just those financial instruments within the scope of IFRS 9. *[IFRS 7.24I, IFRS 7.24J]*. Rather, the Phase 2 disclosures apply to all financial instruments within the scope of IFRS 7, which includes recognised and unrecognised financial instruments, some of which are outside the scope of IFRS 9. *[IFRS 7.4]*. Certain loan commitments, for example, are excluded from the scope of IFRS 9 (other than for the calculation of the expected credit loss) but are within the scope of IFRS 7 since they are still considered to be derivatives in nature. *[IFRS 9.BCZ2.2]*. As a result, loan commitments outside the scope of IFRS 9, should be included in the quantitative disclosures, where their relevance for the IBOR Reform programme is material.

34 *FCA announces decision on cessation of 1- and 6-month synthetic sterling LIBOR at end-March 2023*, Financial Conduct Authority, 29 September 2022

35 FCA announces decision on synthetic US dollar LIBOR, FCA, 3 April 2023

6.2.3 Level of detail for different categories

In terms of the level of granularity that should be provided in the quantitative information, there is no requirement to split the amounts into individual balance sheet line items. It would, however, be permissible to include this additional level of detail if it provided useful information on the entity's exposure to the risks posed by IBOR Reform, consistent with the disclosure objective of IFRS 7. *[IFRS 7.1]*.

Similarly, there is no requirement to analyse the quantitative information by product type. Nor is there a requirement to include within the disclosure those exposures indirectly affected by IBOR Reform, for example, where a discount rate used by the entity in a valuation technique to calculate fair value is expected to change from IBOR to RFR.

How we see it

If the entity considers that different product types, or some other subdivision of the information, represent materially different risks in relation to IBOR Reform, then the provision of a further level of disaggregation would be consistent with the broader principles of IFRS 7 and the intention for this disclosure.

6.2.4 Exposures that reference a new rate but for which further transition could occur

As IBOR Reform has progressed, some IBORs were fully or partially reformed rather than being replaced. EURIBOR and the Canadian Overnight Repo Rate Average (CORRA) could be considered examples of such interest rates.

Some LIBORs were made available on a synthetic basis to help deal with tough legacy exposures by allowing them more time to run off. The synthetic LIBORs could not be used for new transactions. The FCA state that whilst the synthetic LIBORs are calculated using a new methodology, they do not meet the requirements of the Benchmarks Regulation.[36] Since exposures referencing synthetic IBORs do not reference a reformed benchmark interest rate, it would appear reasonable for them to still be included in the Phase 2 disclosures. If an entity's exposure to synthetic IBORs is material, they could require separate disclosure to distinguish between synthetic IBOR exposures that:

- The entity expects will transition to RFRs
- Are expected to mature whilst the synthetic IBOR remains available

  And
- Are not expected to transition to RFRs

The Phase 2 quantitative disclosure requirements are shown in Illustration 6-1. While this shows one way to comply with IFRS 7.24J(b), other approaches are possible.

How we see it

Judgement is required to define the best measures to reflect the entity's progress towards completing the Reform, considering that the Basis for Conclusions indicates that entities should make use of information that is already available to reduce the cost of providing the information. Entities should also consider whether the disclosure is sufficient to meet the objective of IFRS 7.24I(a), to provide information about the nature and the extent of risks to which the entity is exposed arising from financial instruments subject to IBOR Reform.

36 *Further arrangements for the orderly wind-down of LIBOR at end-2021*, Financial Conduct Authority, 29 September 2021.

6.2.5 Phase 2 disclosure: Illustrations and examples

Illustration 6-1: Phase 2 Quantitative Disclosures, our publication Good Bank (International) Limited 2022

Extract from Note 48 *Risk Management* in EY's *Good Bank 2023*:[37]

48.4.3.1 IBOR reform

...

The tables below show the Bank's exposure to significant IBORs subject to reform that have yet to transition to RFRs as at the current year end and the prior year end. The tables exclude exposures to IBORs that will expire before transition is required.

In $ million 31 December 2023	Non derivative financial assets - carrying value	Non-derivative financial liabilities - carrying value	Derivatives Nominal amount[1]
Goodland[38] IBOR $ (1 month)	1,247	1,610	1,474
Goodland IBOR $ (2 months)	1,459	1,545	1,800
Goodland IBOR $ (3 months)	1,181	1,266	1,340
Synthetic LIBOR GBP (3 months)	162	984	1,275
Synthetic LIBOR USD (3 months)	453	887	906
Synthetic LIBOR USD (6 months)	306	430	822
Other	1,318	967	1,247
	6,126	**7,689**	**8,864**
Cross currency swaps			
LIBOR GBP (3 months) to Goodland IBOR $ (3 months)			460
	6,126	**7,689**	**9,324**

1 *The IBOR exposures for derivative nominal amounts include loan commitments.*

48.4.3.2

Instruments referenced to synthetic LIBOR GBP (3 months) will transition no later than 31 March 2024 after which this synthetic LIBOR ceases. Instruments referenced to synthetic LIBOR USD (3 months) and synthetic LIBOR USD (6 months) will transition no later than 30 September 2024 after which these synthetic USD LIBORs cease. The transition date for Goodland IBORs has been determined as 30 June 2024.

In $ million 31 December 2022	Non derivative financial assets - carrying value	Non-derivative financial liabilities - carrying value	Derivatives Nominal amount[1]
Goodland IBOR $ (1 month)	2,366	2,610	3,374
Goodland IBOR $ (2 months)	1,459	2,945	3,800
Goodland IBOR $ (3 months)	1,185	2,066	2,340
Synthetic LIBOR GBP (3 months)	1,272	1,984	1,975
LIBOR USD (3 months)	1,453	1,787	2,206
LIBOR USD (12 months)	1,306	1,430	2,221
Other	464	541	562
	9,505	**13,363**	**16,478**
Cross currency swaps			
LIBOR GBP (3 months) to Goodland IBOR $ (3 months)			960
	9,505	**13,363**	**17,438**

The table of disclosures above presents the significant IBOR, disaggregated by tenor. Whilst this is not a specific requirement of the Phase 2 Amendments, it arguably provides the most useful information on significant IBOR exposures. Practical examples from Toronto-Dominium Bank and Shell plc, showing their IBOR exposures, are included below.

37 Good Bank (International) Limited: *Illustrative consolidated financial statements for the year ended 31 December 2023*, EY Global, 31 December 2023. Available on ey.com/IFRS.

38 Goodland is a fictional country created for EY publication, Good Bank (International) Limited.

Practical example 6-2: The Toronto-Dominion Bank (2023) — Canada

2023 Annual Report

FINANCIAL RESULTS [extract]

CONSOLIDATED FINANCIAL STATEMENTS [extract]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS [extract]

NOTE 11 DERIVATIVES [extract]

Interest Rate Benchmark Reform

The Bank's hedging relationships no longer have exposure to USD LIBOR, but continue to have exposure to CDOR benchmark rates. As a result of IBOR reform, CDOR benchmark rates are subject to discontinuance, or may become illiquid after the adoption of ARRs as established benchmark rates. Judgment may be required in determining whether certain hedging relationships that involve hedging changes in fair value or variability of cash flows attributable to interest rate or foreign exchange risk continue to qualify for hedge accounting.

Impacted hedging relationships will continue to be monitored for all remaining benchmark rates still subject to ARR transition. As the new ARRs will differ from the prior benchmark rates, new or revised hedging strategies may be required to better align derivative hedging instruments with hedged items. Given ongoing market developments, the assessment of the impact on the Bank's hedging strategies and its mitigation plans is progressing.

As at October 31, 2023, the Bank has transitioned all derivative instruments designated in qualifying hedge accounting relationships referencing USD LIBOR to an ARR and it no longer has exposure to any residual USD LIBOR derivative notional amounts (October 31, 2022 – $148 billion).

The following table discloses the notional amount of derivative instruments designated in qualifying hedge accounting relationships referencing CDOR that have yet to transition to an ARR and mature after June 28, 2024.

Derivative Instruments Designated in Qualifying Hedge Accounting Relationships[1]

(millions of Canadian dollars)

	As at	
	October 31, 2023	October 31, 2022
Notional	**Hedging derivatives maturing after June 28, 2024 (for CDOR)**	
Interest rate risk		
Interest rate swaps	**$ 137,624**	$ 135,732
Foreign exchange risk		
Interest rate swaps	**70,929**	54,810
Cross-currency swaps[2]	**75,127**	56,335
Total	**$ 283,680**	$ 246,877

[1] CDOR transitioning to Canadian Overnight Repo Rate Average.

[2] Cross-currency swaps may be used to hedge foreign exchange risk or a combination of interest rate risk and foreign exchange risk in a single hedge relationship. Both these types of hedges are disclosed under the Foreign exchange risk as the risk category.

Credit Risk

Credit risk on derivatives, also known as counterparty credit risk, is the risk of a financial loss occurring as a result of the failure of a counterparty to meet its obligation to the Bank.

Derivative-related credit risks are subject to the same credit approval, limit and monitoring standards that are used for managing other transactions that create credit exposure. This includes evaluating the creditworthiness of counterparties, and managing the size, diversification and maturity structure of the portfolios. The Bank actively engages in risk mitigation strategies through the use of multi-product derivative master netting agreements, collateral and other risk mitigation techniques. Master netting agreements reduce risk to the Bank by allowing the Bank to close out and net transactions with counterparties subject to such agreements upon the occurrence of certain events. The current replacement cost and credit equivalent amount shown in the following table are based on the standardized approach for counterparty credit risk. According to this approach, the current replacement cost accounts for the fair value

Practical example 6-3: Shell plc (2022) — United Kingdom

Shell Annual Report and Accounts 2022 [extract]

CONSOLIDATED FINANCIAL STATEMENTS [extract]

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS [extract]

20 - FINANCIAL INSTRUMENTS [extract]

Interbank Offered Rate (IBOR) reform

USD London Interbank Offered Rate (LIBOR) is the most significant IBOR for Shell. USD LIBOR will transition immediately after June 30, 2023. Significant IBOR exposures, disaggregated by tenure at December 31, 2021, are as follows:

	$ million December 31, 2021		
	Non-derivative financial assets – carrying value	Non-derivative financial liabilities – carrying value	Derivatives – Nominal amount
USD LIBOR (1 month)	62	–	
USD LIBOR (3 months)	1,155	1,200	5,828
USD LIBOR (6 months)	75		
Cross-currency interest rate swaps:			
EUR Fixed to USD LIBOR (3 months)			8,311
GBP Fixed to USD LIBOR (3 months)			1,227
CHF Fixed to USD LIBOR (3 months)			1,359
MYR LIBOR (3 months) to USD LIBOR (3 months)			360
Total	1,292	1,200	17,085

6.3 Sources of hedge ineffectiveness

As discussed in section 4.1.3 above, the Phase 1 Amendments provide relief under IAS 39 from the retrospective assessment of hedge effectiveness where effectiveness is outside the 80-125% range for any hedge relationships affected by IBOR Reform. Also, section 4.2.7 above discusses how the Phase 2 Amendments allow entities, for the purpose of the IAS 39 assessment of retrospective hedge effectiveness, to reset the cumulative fair value changes to zero. However, any actual hedge ineffectiveness continues to be recognised in full, which is the case under both IFRS 9 and IAS 39. As a result of the Reform, it could be necessary for entities to revise or expand the disclosures they provide in relation to hedge ineffectiveness.

For example, entities are required to disclose, by risk category, a description of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term. *[IFRS 7.23E]*. Also, when other sources of hedge ineffectiveness emerge in a hedging relationship, an entity is required to disclose those sources by risk category and explain the resulting hedge ineffectiveness, as discussed in Chapter 50 at section 4.3.3. Although there are no new specific disclosure requirements on this within the Phase 1 or Phase 2 Amendments, as a consequence of IBOR Reform and application of the Amendments, entities may need to enhance these disclosures to include the additional interest rate risk related hedge ineffectiveness that could reasonably be expected to arise as financial instruments designated in hedging relationships are affected by the Reform.

6.4 Significant judgements

Entities when applying the Phase 1 and Phase 2 amendments, could be required to make various judgements in order to apply the reliefs and produce the disclosures. Separate disclosure should be provided of any significant judgements in line with the requirements of IAS 1 *Presentation of Financial Statements*, paragraph 122, which is discussed further in Chapter 3 at section 5.1.1.A. Since this disclosure requirement is already established in IFRS accounting standards, the IASB, did not specify additional disclosure for significant judgements when finalising the IBOR Reform amendments. *[IFRS 7.BC35MMM]*.

Significant judgements which could arise for which entities would be required to provide disclosure could include (but are not limited to) the following:

- How entities assess whether transition has taken place on an 'economically equivalent' basis. This is discussed further in section 2 above.
- To determine when the Phase 1 reliefs should end, entities will need to assess whether there remains any uncertainty with respect to the amount or timing of IBOR Reform. This is discussed further in section 4.1.2 above.
- The assessment of whether an RFR is expected to be separately identifiable, as described in sections 4.2.4 and 4.2.5 above.
- To determine which exposures should be included in the Phase 2 Amendments quantitative disclosures, entities will need to identify those exposures which have not transitioned and continue to present a risk arising from IBOR Reform, as discussed in section 6.2.1 above.

How we see it

Although the IASB responded to preparers' concerns by making the Phase 2 quantitative disclosure requirements less onerous, by allowing entities to choose the basis for the quantitative information provided, production of these disclosures is still a significant element of any IBOR Reform financial reporting project.

6.5 Transition disclosures

The Phase 2 Amendments provided relief from having to meet some of the IAS 8 *Accounting Policies, Changes in Accounting estimates and Errors* disclosure requirements upon initial adoption. *[IFRS 7.44HH]*. On first adopting the Phase 2 Amendments, entities did not have to provide information for the current and prior period of the amount of the transitional adjustment for each financial statement line item affected and the impact on basic and diluted earnings per share. *[IAS 8.28(f)]*.

Whilst relief was provided from one of the IAS 8 transition disclosures, the other disclosures were still required. This included the amount of any adjustment arising on transition relating to periods before the period of adoption (as an adjustment to opening retained earnings), along with a description of the transitional provisions. These requirements are discussed in Chapter 3 at section 5.1.2.A. *[IAS 8.28(a)-IAS 8.28(e), IAS 8.28(g), IAS 8.28(h)]*.

7 Amendments to IFRS 16 *Leases*

IFRS 16 has been amended to address situations where lease agreements specifically refer to an IBOR and will need to be amended to refer to an RFR.

To the extent that:

- The modification is necessary as a direct consequence of the Reform (see section 2.1.1 above)
- The new basis for determining lease payments is 'economically equivalent' to the previous basis (see section 2.1 above)
- There are no further modifications other than those required by the Reform

Lessees are required to remeasure their lease liabilities in similar fashion to any other change in future lease payments resulting from a change in an index or a rate used to determine those payments in accordance with IFRS 16.42, rather than as a lease modification. *[IFRS 16.104, IFRS 16.105]*.

Applying IFRS 16, modifying a lease contract to change the basis for determining the variable lease payments meets the definition of a lease modification, because a change in the calculation of the lease payments would change the original terms and conditions determining the consideration for the lease. Without the relief, IFRS 16 would require an entity to account for a lease modification by remeasuring the lease liability by discounting the revised lease payments using a revised discount rate (with an offsetting adjustment to the right-of-use asset). Further guidance on accounting for lease modifications is discussed in Chapter 24 at section 5.5. In the Board's view, reassessing the lessee's entire incremental borrowing rate when the modification is limited to what is required by the Reform would not reflect the economic effects of the modified lease. The practical expedient requires remeasurement of the lease liability using a discount rate that only reflects the change to the basis for determining the variable lease payments as required by the Reform.

If, in contrast, other changes to the lease are made at the same time, the normal modification rules in IFRS 16 apply, even to those modifications required by the Reform. *[IFRS 16.106]*. In contrast to the amendments for financial assets and financial liabilities in IFRS 9, the Board decided not to specify the order of accounting for lease modifications required by the Reform and other lease modifications. This is because the accounting outcome would not differ regardless of the order in which an entity accounts for lease modifications required by the Reform and other lease modifications.

For finance leases, a lessor is required to apply the requirements in IFRS 9 to a lease modification, so the amendments in paragraphs 5.4.5-5.4.9 of IFRS 9 would apply when those modifications are required by the Reform.

The effective date was for annual reporting periods beginning on or after 1 January 2021. Early application was permitted. An entity is not required to restate comparative periods and may have done so only if it was possible without the use of hindsight. *[IFRS 16.C1B, IFRS 16.C20C, IFRS 16.C20D]*.

8 Amendments to IFRS 4 *Insurance Contracts*

At the time the amendments became effective, IFRS 4 *Insurance Contracts* provided insurers an election to defer the implementation of IFRS 9. These entities had to adopt IFRS 9 when *IFRS 17 Insurance Contracts* took effect from 1 January 2023. *[IFRS 4.20R]*. IFRS 4 was therefore amended so that insurers who were still using IAS 39 *Financial Instruments: Recognition and Measurement* could obtain the same reliefs as other entities. The amendments to IFRS 4 clarified that prior to these entities adopting IFRS 9, references in the amendments to IFRS 9.B5.4.5 should have been read as referring to IAS 39.AG7 and references to IFRS 9.5.4.3 and IFRS 9.B5.4.6 should have been read as referring to IAS 39.AG8. *[IFRS 4.20S]*. This means that those insurers that were still applying IAS 39 obtained the same reliefs for assessing derecognition and resetting the EIR as other entities.

The effective date was for annual reporting periods beginning on or after 1 January 2021. Early application was permitted. *[IFRS 4.50]*. An entity was not required to restate comparative periods and could do so only if it was possible without the use of hindsight. *[IFRS 4.51]*.

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Appendix B - Defined terms

Extract from IFRS standards - Definitions	
derecognition	The removal of a previously recognised financial asset or financial liability from an entity's statement of financial position. *[IFRS 9 Appendix A]*.
derivative	A financial instrument or other contract within the scope of this Standard with all three of the following characteristics. (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying'). (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. (c) it is settled at a future date. *[IFRS 9 Appendix A]*.
effective interest rate	The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the **gross carrying amount of a financial asset** or to the **amortised cost of a financial liability**. When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the **expected credit losses**. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1-B5.4.3), **transaction costs**, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments). *[IFRS 9 Appendix A]*.

financial asset	A *financial asset* is any asset that is: (a) cash; (b) an equity instrument of another entity; (c) a contractual right: (i) to receive cash or another financial asset from another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or (d) a contract that will or may be settled in the entity's own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments. *[IAS 32.11]*.
insurer	The party that has an obligation under an **insurance contract** to compensate a **policyholder** if an **insured event** occurs. *[IFRS 4 Appendix A]*.
modification gain or loss	The amount arising from adjusting the **gross carrying amount of a financial asset** to reflect the renegotiated or modified contractual cash flows. The entity recalculates the gross carrying amount of a financial asset as the present value of the estimated future cash payments or receipts through the expected life of the renegotiated or modified financial asset that are discounted at the financial asset's original **effective interest rate** (or the original **credit-adjusted effective interest rate** for **purchased or originated credit-impaired financial assets**) or, when applicable, the revised **effective interest rate** calculated in accordance with paragraph 6.5.10. When estimating the expected cash flows of a financial asset, an entity shall consider all contractual terms of the financial asset (for example, prepayment, call and similar options) but shall not consider the **expected credit losses**, unless the financial asset is a **purchased or originated credit-impaired financial asset**, in which case an entity shall also consider the initial expected credit losses that were considered when calculating the original **credit-adjusted effective interest rate**. *[IFRS 9 Appendix A]*.

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Introductory note

This index uses chapter number followed by section number for locators. A section number includes all its sub-sections. For example the locator Ch.33, 2.7 will include subsections 2.7.1 and 2.7.2 in Chapter 33. The locator Ch.22, 5.3.1 will include subsections 5.3.1.A and 5.3.1.B. Where a range is indicated, for example, Ch.03, 2–3, this means the topic starts from the beginning of section 2 to the end of section 3.

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IAS 1.58 CH50, 7.4.3
IAS 1.58(c) CH50, 7.4.3.B
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IAS 1.59 CH50, 7.4.3
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IAS 1.63 CH03, 3.1.1
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IAS 1.65 CH03, 3.1.1
IAS 1.66 CH03, 3.1.3
IAS 1.66 CH03, 3.1.1
IAS 1.66 CH23, 2.3.1.B
IAS 1.66 CH38, 5.1.1.A
IAS 1.66 CH50, 7.4.4
IAS 1.66(b) CH50, 7.4.4.A
IAS 1.66(d) CH36, 3.4
IAS 1.67 CH03, 3.1.1
IAS 1.67 CH18, 10.2
IAS 1.68 CH03, 3.1.3
IAS 1.68 CH03, 3.1.1
IAS 1.68 CH18, 2.2.2
IAS 1.68 CH28, 10.1.2
IAS 1.68 CH23, 2.3.1.B
IAS 1.68 CH50, 7.4.4.A
IAS 1.69 CH03, 3.1.4
IAS 1.69 CH03, 3.1.1
IAS 1.69 CH28, 10.1.2
IAS 1.69 CH50, 7.4.4
IAS 1.69(b) CH50, 7.4.4.A
IAS 1.69(d) CH03, 3.1.4
IAS 1.69(d) CH50, 7.4.4.B
IAS 1.69(d) CH50, 7.4.4.C
IAS 1.69(d) CH50, 7.4.4.E
IAS 1.70 CH03, 3.1.1
IAS 1.70 CH28, 10.1.2
IAS 1.70 CH50, 7.4.3.B
IAS 1.71 CH50, 7.4.4.A
IAS 1.72A CH03, 3.1.4
IAS 1.72B CH03, 3.1.4
IAS 1.73 CH03, 3.1.4
IAS 1.73 CH50, 7.4.4.D
IAS 1.74 CH03, 3.1.4
IAS 1.74 CH34, 2.3.2
IAS 1.74 CH50, 7.4.4.E
IAS 1.75 CH03, 3.1.4
IAS 1.75A CH03, 3.1.4
IAS 1.75A CH34, 2.1.3
IAS 1.76 CH03, 3.1.4
IAS 1.76 CH03, 5.6
IAS 1.76 CH34, 2.3.2
IAS 1.76 CH34, 2.1.3
IAS 1.76(b) CH34, 2.1.3
IAS 1.76(d) CH34, 2.1.3
IAS 1.76A CH03, 3.1.4
IAS 1.76A CH50, 7.4.4.B
IAS 1.76B CH03, 3.1.4
IAS 1.76B CH50, 7.4.4.B

IAS 1.76ZA CH03, 3.1.4
IAS 1.76ZA CH03, 3.1.4
IAS 1.76ZA CH03, 5.5
IAS 1.77 CH03, 3.1.6
IAS 1.77 CH35, 5.2
IAS 1.77 CH50, 7.4.3
IAS 1.77 CH50, 7.4.5
IAS 1.78 CH03, 3.1.6
IAS 1.78(b) CH50, 7.4.3
IAS 1.78(e) CH50, 7.4.5
IAS 1.79 CH03, 3.1.6
IAS 1.79(a) CH50, 7.4.5
IAS 1.79(a)(vi) CH43, 9
IAS 1.79(b) CH50, 7.4.5
IAS 1.80 CH03, 3.1.6
IAS 1.80 CH50, 7.4.5
IAS 1.80A CH03, 3.1.6
IAS 1.80A CH50, 7.4.5
IAS 1.81A CH03, 3.2.1
IAS 1.81A CH03, 3.2.2
IAS 1.81A CH03, 3.2.4.A
IAS 1.81B CH03, 3.2.2
IAS 1.81B CH03, 3.2.4.A
IAS 1.81B CH08, 5.5
IAS 1.81B CH14, 4.2
IAS 1.81B(a) CH50, 7.1.1
IAS 1.81B(b) CH50, 7.2
IAS 1.82 CH03, 3.2.2
IAS 1.82 CH14, 5
IAS 1.82 CH37, 3.2
IAS 1.82 CH51, 15.2
IAS 1.82(a) CH49, 9
IAS 1.82(a) CH50, 7.1.1
IAS 1.82(a)(ii) CH51, 15.2
IAS 1.82(aa) CH50, 4.2.1
IAS 1.82(aa) CH50, 7.1.1
IAS 1.82(ab) CH51, 15.2
IAS 1.82(ac) CH51, 15.2
IAS 1.82(b) CH50, 7.1.1
IAS 1.82(ba) CH47, 14.1
IAS 1.82(ba) CH47, 14.1.1
IAS 1.82(ba) CH50, 7.1.1
IAS 1.82(ba) CH47, 14
IAS 1.82(bb) CH51, 15.2
IAS 1.82(bc) CH51, 15.2
IAS 1.82(c) CH12, 12.1.2
IAS 1.82(ca) CH50, 7.1.1
IAS 1.82(ca) CH44, 8.1
IAS 1.82(cb) CH50, 7.1.1
IAS 1.82(cb) CH44, 8.1
IAS 1.82(d) CH51, 15.2.1
IAS 1.82-86 CH51, 15
IAS 1.82A CH03, 3.2.4.A
IAS 1.82A CH12, 12.1.3
IAS 1.82A CH14, 5
IAS 1.82A CH50, 7.2
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IAS 1.85 CH21, 11.1
IAS 1.85 CH38, 3.2.1.B
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IAS 1.85A CH50, 7.1.1
IAS 1.85B CH03, 3.2.1
IAS 1.86 CH03, 3.2.1
IAS 1.86 CH50, 7.1.1
IAS 1.87 CH03, 3.2.6.B
IAS 1.87 CH50, 7.1.2
IAS 1.88 CH03, 3.2.1
IAS 1.88 CH03, 4.1.7
IAS 1.88 CH09, 2.1.1.C
IAS 1.88 CH09, 2.1.1.D
IAS 1.88 CH31, 11
IAS 1.89 CH03, 4.1.7
IAS 1.90 CH03, 3.2.4.C
IAS 1.90 CH29, 13.2
IAS 1.90 CH29, 14.2
IAS 1.91 CH03, 3.2.4.C
IAS 1.91 CH03, 3.2.4.A
IAS 1.91 CH29, 13.2
IAS 1.92 CH03, 3.2.4.B
IAS 1.92 CH49, 9.1
IAS 1.92 CH49, 7.2.1
IAS 1.92 CH49, 7.2.2
IAS 1.93 CH03, 3.2.4.B
IAS 1.94 CH03, 3.2.4.A
IAS 1.94 CH03, 3.2.4.B
IAS 1.95 CH03, 3.2.4.B
IAS 1.96 CH03, 3.2.4.B
IAS 1.96 CH49, 7.2.2
IAS 1.96 CH50, 7.2
IAS 1.97 CH03, 2.4.1
IAS 1.97 CH03, 3.2.6.A
IAS 1.97 CH20, 12.4
IAS 1.97 CH22, 7.2
IAS 1.97 CH36, 5.1
IAS 1.97 CH50, 7.1.2
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IAS 1.98(d) CH50, 7.1.2
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IAS 1.99 CH03, 3.2.2
IAS 1.99 CH38, 3.2.1.B
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IAS 1.102 CH28, 10.3
IAS 1.103 CH03, 3.2.3.B
IAS 1.103 CH28, 10.3
IAS 1.104 CH03, 3.2.3.B
IAS 1.104 CH28, 10.3
IAS 1.105 CH03, 3.2.3
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IAS 1.106 CH14, 4.2
IAS 1.106 CH43, 8.1
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IAS 1.106(b) CH03, 5.3
IAS 1.106(d) CH14, 4.5.1
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IAS 1.106A CH50, 7.3
IAS 1.107 CH03, 3.3
IAS 1.107 CH50, 7.3
IAS 1.108 CH03, 3.3

IAS 1.109 CH03, 3.3
IAS 1.109 CH08, 4.4
IAS 1.109 CH43, 8.1
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IAS 1.110 CH03, 5.3
IAS 1.111 CH03, 3
IAS 1.112 CH03, 3.4
IAS 1.112 CH36, 4.4
IAS 1.112 CH36, 4.4.6
IAS 1.112 CH36, 11
IAS 1.112 CH36, 11.1.4
IAS 1.112 CH36, 11.5
IAS 1.112 CH50, 7.4.3.E
IAS 1.112(c) CH14, 2.1
IAS 1.113 CH03, 3.4
IAS 1.114 CH03, 3.4
IAS 1.116 CH03, 3.4
IAS 1.117 CH03, 5.1.1
IAS 1.117 CH18, 11.2.2
IAS 1.117 CH22, 7.2
IAS 1.117 CH24, 5.8.4
IAS 1.117 CH28, 10
IAS 1.117 CH39, 15.5.6
IAS 1.117 CH31, 15
IAS 1.117 CH51, 16.4
IAS 1.117-124 CH09, 2.1.1.C
IAS 1.117-124 CH38, 3.2.1.B
IAS 1.117-121 CH16, 11.4
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IAS 1.117B CH03, 5.1.1
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IAS 1.117B-117C CH28, 10
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IAS 1.117D CH03, 5.1.1
IAS 1.117E CH03, 5.1.1
IAS 1.122 CH03, 5.1.1.A
IAS 1.122 CH05, 2.1.2.A
IAS 1.122 CH14, 3
IAS 1.122 CH16, 11.4
IAS 1.122 CH17, 5
IAS 1.122 CH11, 3.3.2
IAS 1.122 CH22, 7.2
IAS 1.122 CH24, 5.8.4
IAS 1.122 CH27, 2.2.2
IAS 1.122 CH27, 6.17
IAS 1.122 CH31, 3.1
IAS 1.122 CH36, 4.4
IAS 1.122 CH36, 4.4.6
IAS 1.122 CH36, 11
IAS 1.122 CH39, 4.1
IAS 1.122 CH39, 11.5.2
IAS 1.122 CH31, 15
IAS 1.122 CH50, 4.1
IAS 1.122 CH51, 16.3
IAS 1.122 CH50, 7.4.3.E
IAS 1.122-133 CH28, 10.5.2
IAS 1.123 CH03, 5.1.1.A
IAS 1.124 CH03, 5.1.1.A
IAS 1.125 CH03, 5.2.1
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IAS 1.125 CH24, 5.8.4
IAS 1.125 CH27, 7.1
IAS 1.125 CH29, 5.1.2
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IAS 1.125 CH39, 15.5.6
IAS 1.125 CH38, 3.2.6.A
IAS 1.125 CH39, 11.5.2
IAS 1.125 CH31, 15
IAS 1.125 CH50, 5.3.2.A
IAS 1.125 CH41, 2.11
IAS 1.125-133 CH16, 11.4
IAS 1.126 CH03, 5.2.1
IAS 1.127 CH03, 5.2.1
IAS 1.128 CH03, 5.2.1
IAS 1.129 CH03, 5.2.1
IAS 1.129 CH29, 5.1.2
IAS 1.129 CH29, 8.1.1.A
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IAS 1.131 CH03, 5.2.1
IAS 1.132 CH03, 5.2.1
IAS 1.133 CH03, 5.2.1
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IAS 1.135 CH03, 5.4.1
IAS 1.135 CH51, 16.5.6
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IAS 1.136 CH51, 16.5.6
IAS 1.136A CH03, 5.4.2
IAS 1.136A CH50, 5.4.4
IAS 1.137 CH03, 5.6
IAS 1.137 CH09, 2.4.1
IAS 1.137 CH34, 2.1.3.A
IAS 1.138 CH03, 5.6
IAS 1.138(b) CH14, 4.1
IAS 1.138(c) CH35, 4
IAS 1.139U CH03, 3.1.4
IAS 1.139U CH50, 9
IAS 1.139W CH50, 9
IAS 1.IG3 CH03, 3.1.7
IAS 1.IG6 CH29, 13.2
IAS 1.IG Part I CH03, 3.1.7
IAS 1.IG Part I CH03, 3.2.3.A
IAS 1.IG Part I CH03, 3.2.4.A
IAS 1.IG Part I CH03, 3.2.4.B
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IAS 1.IG Part I CH03, 3.3
IAS 1.IG10 CH03, 5.4.1
IAS 1.IG11 CH03, 5.4.1
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IAS 1.BC13Q CH03, 4.1.5
IAS 1.BC30F CH03, 4.1.8
IAS 1.BC32C CH03, 2.4.1
IAS 1.BC33 CH37, 5.1.4
IAS 1.BC38G CH03, 3.1.5
IAS 1.BC38I CH50, 7.4.4.A
IAS 1.BC38J CH50, 7.4.4.A
IAS 1.BC48A CH03, 3.1.4
IAS 1.BC48EA CH03, 3.1.4
IAS 1.BC48ED CH03, 3.1.4
IAS 1.BC48EE CH03, 3.1.4
IAS 1.BC48F CH03, 3.1.4
IAS 1.BC55 CH03, 3.2.2.A
IAS 1.BC56 CH03, 3.2.2.A
IAS 1.BC56 CH20, 12.2.1
IAS 1.BC64 CH03, 3.2.6.B
IAS 1.BC76D CH03, 3.4

IAS 1.BC84 CH03, 5.2.1
IAS 1.BC86 CH03, 5.4.1
IAS 1.BC86 CH50, 5.6.3
IAS 1.BC88 CH50, 5.6.3
IAS 1.BC100B CH03, 5.4.2
IAS 1.BC103 CH33, 5.5.1

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IAS 2.3(a) CH39, 14.4
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IAS 2.3(a) CH39, 3.1.1
IAS 2.3(b) CH23, 3.1.3.E
IAS 2.3(b) CH23, 3.4.2
IAS 2.3(b) CH39, 14
IAS 2.3(b) CH39, 14.4
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IAS 2.4 CH39, 1.1
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IAS 2.5 CH23, 2.3
IAS 2.6 CH18, 2.2.2
IAS 2.6 CH18, 11.2.8
IAS 2.6 CH23, 2.2
IAS 2.6 CH23, 2.3.1.B
IAS 2.6 CH23, 3
IAS 2.6 CH23, 3.3
IAS 2.6 CH28, 10.2
IAS 2.7 CH23, 3
IAS 2.8 CH23, 2.3
IAS 2.8 CH39, 14.1
IAS 2.9 CH18, 9.2.1.B
IAS 2.9 CH23, 3
IAS 2.9 CH23, 3.3
IAS 2.9 CH28, 5.7.3
IAS 2.9 CH39, 12.4.2
IAS 2.9 CH39, 14.5
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IAS 2.16 CH23, 3.1.3
IAS 2.16 CH23, 3.4.1
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IAS 2.16(c) CH23, 3.1.3.B
IAS 2.16(c) CH27, 6.2
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IAS 2.18 CH23, 3.1.3.C
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IAS 2.22 CH23, 3.2.1.B
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IAS 2.24 CH23, 3.2.2
IAS 2.25 CH23, 3.2.2
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IAS 2.27 CH23, 3.2.2.B
IAS 2.28 CH23, 3.3
IAS 2.28 CH23, 3.3.1.B
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IAS 2.30 CH23, 3.3.1
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IAS 2.32 CH23, 3.3.1.A
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IAS 2.33 CH23, 3.3.1.C
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IAS 2.36 CH23, 6.1
IAS 2.37 CH23, 6.1
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IAS 2.39 CH23, 6.1
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IAS 7.8 CH36, 3.2.4
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IAS 7.9 CH36, 3.2

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IAS 7.14(g) CH36, 4.4.12
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IAS 27.BC27 CH09, 2.1.1.E

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IAS 28.3 CH07, App. B
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IAS 28.3 CH14, 2.2.2.C
IAS 28.3 CH30, 12.9.2
IAS 28.3 CH35, 3.1.1.C
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IAS 28.18 CH12, 3.3.2.A
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IAS 28.21 CH13, 8.2.7

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IAS 28.30 CH08, 3.3.2.B
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IAS 28.30 CH12, 7.5.1
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IAS 28.31 CH12, 7.5
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IAS 28.31A CH12, 6.2.2
IAS 28.31B CH08, 3.3.2.B
IAS 28.31B CH12, 6.2.2
IAS 28.32 CH08, 3.3.2.G
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IAS 28.32 CH12, 6.2.2.A
IAS 28.32 CH12, 7.5.2
IAS 28.32 CH21, 12.4.6
IAS 28.33 CH12, 8.1
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IAS 28.35 CH12, 8.2
IAS 28.36 CH06, 5.22.8.F
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IAS 28.42 CH12, 10.2
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IAS 28.42 CH21, 12.4.5
IAS 28.42 CH21, 12.4.6
IAS 28.43 CH12, 10.2
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IAS 28.43 CH21, 12.4.6
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IAS 28.BC16 CH12, 2.4
IAS 28.BCZ18 CH12, 2.6
IAS 28.BCZ19 CH12, 8.1
IAS 28.BC22 CH12, 3.4
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IAS 28.BC30 CH13, 8.2.4
IAS 28.BC37I CH08, 3.3.2
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IAS 28.BC37J CH08, 3.3.2
IAS 28.BC37J CH08, 7.1
IAS 28.BCZ40 CH12, 8.3

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IAS 29.34 CH17, 8
IAS 29.35 CH17, 4.3.2
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IAS 29.39 CH17, 14

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IAS 32.4(f)(ii) CH41, 2.9
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IAS 32.9(c) CH39, 12.7
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IAS 32.11 CH41, App. C
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IAS 32.11 CH43, 5.2.3.A
IAS 32.11 CH43, App. B
IAS 32.11 CH44, App. C
IAS 32.11 CH45, App. C
IAS 32.11 CH47, 11.1
IAS 32.11 CH48, 2.1
IAS 32.11 CH48, App. B
IAS 32.11 CH49, App. B
IAS 32.11 CH50, App. B
IAS 32.11 S: IBOR, App. B
IAS 32.11(b)(i) CH43, 6.6.4.A
IAS 32.11(b)(i) CH43, 6.6.4.B
IAS 32.11(b)(ii) CH43, 5.1.2
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IAS 32.16(b)(ii) CH43, 6.6.8
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IAS 32.16B CH08, 5.6
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IAS 32.49(c) CH50, 7.4.1.D
IAS 32.49(d) CH50, 7.4.1.D
IAS 32.49(e) CH50, 7.4.1.D
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IAS 32.AG14D CH43, 4.6.4.B
IAS 32.AG14E CH43, 4.6.2
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IAS 32.AG14G CH43, 4.6.4.F
IAS 32.AG14H CH43, 4.6.4.F
IAS 32.AG14I CH43, 4.6.4.F
IAS 32.AG14J CH43, 4.6.4.E
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IAS 32.AG38C CH50, 7.4.1.A
IAS 32.AG38D CH50, 7.4.1.A
IAS 32.AG38E CH50, 7.4.1
IAS 32.AG38F CH50, 7.4.1.C
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IAS 32.BC94-BC100 CH50, 7.4.1.C
IAS 32.BC101 CH50, 7.4.1.C
IAS 32.BC103 CH50, 7.4.1.F
IAS 32.BC105-BC111 CH50, 7.4.1.G

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IAS 33.52 CH33, 6.4.6
IAS 33.52 CH33, 7.2
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IAS 33.58 CH33, 6.2.2
IAS 33.59 CH33, 6.2.2
IAS 33.59 CH33, 6.4.2.A
IAS 33.60 CH33, 6.2.2
IAS 33.60 CH33, 6.4.2.A
IAS 33.61 CH33, 6.2.2
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IAS 33.66 CH33, 5.4
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IAS 33.67A CH03, 3.2.4.A
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IAS 33.73A CH33, 5.5.1
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IAS 33.A2 CH33, 4.3.3
IAS 33.A3 CH33, 6.3.1
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IAS 33.IE2 CH33, 3.2
IAS 33.IE2 CH33, 4.1
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IAS 33.IE4 CH33, 4.3.3
IAS 33.IE5 CH33, 6.4.2.B
IAS 33.IE5A CH33, 6.4.5
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IAS 33(2027).73C CH33, 5.5.2
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IAS 34.4 CH37, 5.2
IAS 34.4 CH37, 11.1.1
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IAS 34.15 CH14, 2.1.1
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IAS 34.15A CH37, 11.1.1
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IAS 34.15A CH50, 2.3
IAS 34.15B CH28, 10.6
IAS 34.15B CH37, 4.1
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IAS 34.15B(a) CH37, 4.3.1
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IAS 34.16A CH14, 2.1.1
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IAS 34.16A(b) CH37, 4.3.12
IAS 34.16A(b) CH37, 8.2.1
IAS 34.16A(c) CH37, 4.3.13
IAS 34.16A(d) CH37, 11.1.1
IAS 34.16A(d) CH37, 9.5.2.B
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IAS 34.29 CH37, 8.1
IAS 34.29 CH37, 8.1.1
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IAS 34.30(c) CH37, 9.5.2.B
IAS 34.30(c) CH37, 9.5.1
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IAS 36.126-132 CH21, 13.2
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IAS 36.130 CH21, 13.2.2
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